CMBS Third Quarter Market Outlook: Performance to Remain Stable Despite Signs the Market May Slow

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- Although there are some signals of a larger economic slowdown, we expect CMBS issuance to remain stable in the second half of 2019 because of strong real estate fundamentals.
- We believe the delinquency rate will remain low; however, the rates for postcrisis and multifamily loans are beginning to creep up.
- Real estate fundamentals remain strong across most property types; however, we see pockets of risk in each asset type, including multifamily and industrial properties.

Even though the market is seeing some signs of slowing, Morningstar Credit Ratings, LLC believes the performance of commercial mortgage-backed securities will hold steady for the remainder of the year, given the low-interest-rate environment and the availability of cash in the market. After nearly nine years of steady growth, the labor market is stalling somewhat. The U.S. Bureau of Labor Statistics reported that only 75,000 new jobs were added in May 2019, less than half of the 180,000 jobs anticipated by economists. Economists associate the muted job growth with lagging economic growth and employer uncertainty tied to rising trade tensions. Still, the jobless rate was stable at 3.6%, the lowest rate in half a century, so we do not anticipate any major disruption.

While there is noise surrounding the U.S.-China trade war and job market, CMBS performance will be steady for the rest of the year. The Federal Reserve has held off on interest-rate hikes and is instead considering lowering rates, which will keep the lending market strong. Although many economists agree that there may be a slight market correction by 2020, the overall sentiment is not overly bearish. Both gross domestic product growth and the inflation rate have remained within a healthy range. This slower growth is a positive sign that no bubble is forming, making a major correction unlikely. Underwriting standards for CMBS loans have also become more conservative since the Dodd-Frank risk-retention rules went into effect in December 2016, with lower-leveraged, higher-quality loans being securitized in CMBS deals. According to Trepp, LLC, conduit loans in second-quarter 2019 had an average loan-to-value ratio of 57.0%, compared with 64.0% in second-quarter 2015.

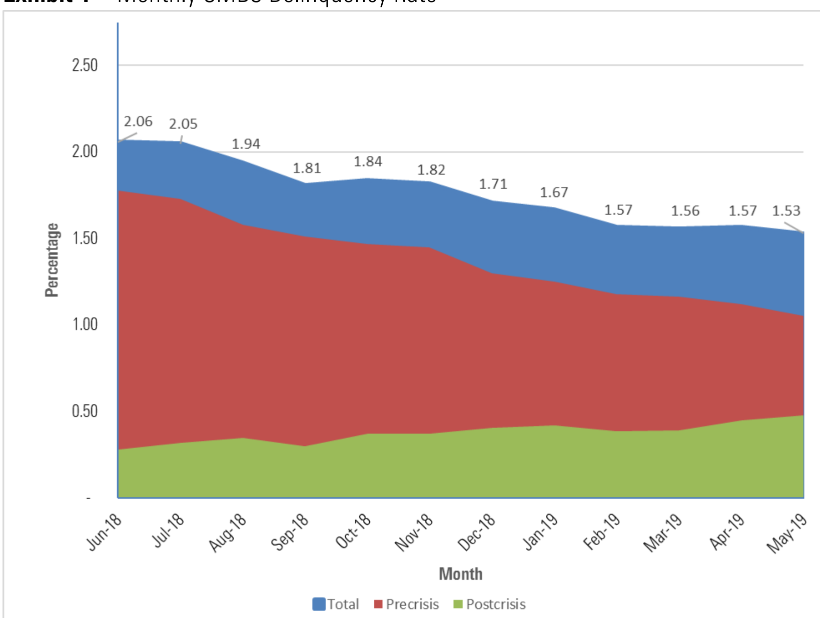
Issuance Picked up in the Second Quarter

U.S. CMBS issuance lagged in the beginning of the year, with first-quarter 2019 issuance down 14.7% from the year prior. However, issuance outpaced 2018 levels in the second quarter, with second-quarter issuance at $22.6 billion as of June 28, above $21.1 billion the year prior. This brings the year-to-date number up to $39.1 billion, only 3.4% below issuance for the same period in 2018, according to industry newsletter *Commercial Mortgage Alert*. Although we anticipate issuance will keep pace with 2018, it's highly unlikely that it will hit the levels of 2014 and 2015, before the risk-retention rules went into effect. One major reason is the popularity of other lending sources, such as life insurance companies and banks, which are often seen as more favorable to investors than CMBS financing. Still, low interest rates and availability of capital in the market should keep issuance strong through the next quarter.

Fewer Delinquencies for Now

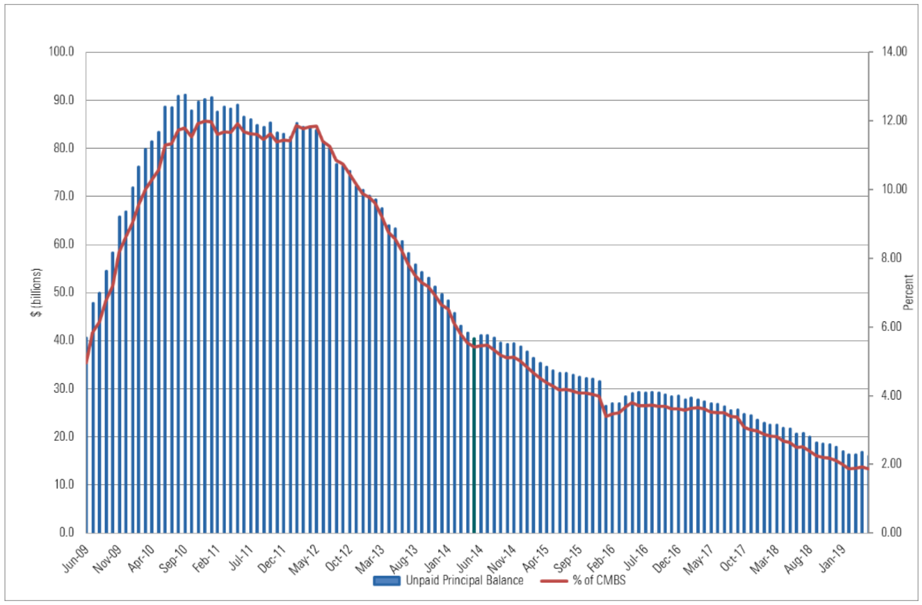
The CMBS delinquency rate continues to fall, as less risky CMBS loans are issued and the troubled CMBS 1.0 loans are slowly liquidated. The delinquency rate has steadily declined since 2012 and was down to 1.53% in May 2019, the lowest it's been since February 2009. Specially serviced loans also reached a 10-year low, making up just 1.86% of the CMBS universe in May 2019, down from 2.64% a year earlier. We expect this trend to continue through the next quarter; however, we note that the delinquency rate of postcrisis, or CMBS 2.0, loans has started to climb. In May 2018, only 0.29% of postcrisis loans were delinquent; by May 2019, the rate had risen to 0.48%. As legacy loans dwindle, their effect on falling delinquency rates will lessen, and postcrisis problem loans will take center stage. While we believe the rate could still fall as the remaining legacy loans are liquidated, we anticipate an inflection point will come in 2020, as a slowing economy and changing consumer trends could cause certain loans to falter. In the sections below, we detail some of the trends we expect to see in the coming months that will present both opportunities and challenges to multifamily, retail, and industrial properties.

Exhibit 1 – Monthly CMBS Delinquency Rate



Source: Morningstar Credit Ratings, LLC

Exhibit 2 – Special-Servicing Balance and Rate



Source: Morningstar Credit Ratings, LLC

Multifamily Delinquencies Are Climbing

We view multifamily as a stable asset class; however, the delinquency rate for multifamily properties has been inching up. As of May 2019, 0.41% of multifamily properties in the CMBS universe were delinquent, up from 0.32% the year prior. While this is still the lowest percentage of any property type, it could be the beginning of a trend. In May 2019, multifamily delinquencies accounted for 13.8% of CMBS delinquencies, whereas in the year prior, this property type only made up 7.5% of the CMBS delinquency universe.

Although student housing is the problem child among multifamily properties, it's only part of the story. Student housing accounts for 45% of the delinquent multifamily properties because of oversupply and declining college enrollment. However, years of falling vacancy rates and rising rent growth have led to a construction boom in many markets, further driven by the availability of capital and the belief that multifamily properties are a less risky asset class. Rentable unit completions as a percentage of total supply have remained above 1.8% since 2016, compared with 0.9% in 2013, and will reach 2.0% by the end of 2019, according to CBRE Econometric Advisors. Although many of the markets have adequate demand, this could put push down rents on older properties while simultaneously causing vacancy rates to rise.

Even more concerning for multifamily properties is the potential rise of homeownership. In recent years, there has been a steady demand for multifamily properties, as millennials have favored amenity-rich multifamily rentals over ownership. However, low interest rates could push up homeownership, especially in markets where buying is still an affordable option. This includes the fast-growing Sun Belt markets, such as Charlotte, North Carolina, and Jacksonville, Florida, which are also in the midst of a major construction boom. A potential shift over to ownership may mean multifamily markets that have experienced the highest levels of growth could experience some weakness. In fourth-quarter 2018, homeownership rose to 64.8%, a four-year high, driven by buyers under 44, according to the U.S. Census Bureau. Although this figure dropped slightly to 64.2% in first-quarter 2019, we attribute this to seasonality and believe the percentage will continue to rise as long as the economy remains stable.

Not All Retail Is Created Equal

Although retail has long been seen as the black sheep of the property types, many retail properties are thriving, including those that are able to attract experiential tenants. Store closures in 2019 continue to set records, with more announced for 2019 by April than all of the closures in 2018, according to Coresight Research. These closures include traditional department store anchors, such as Macy's, JCPenney, and Nordstrom; stand-alone stores like Family Dollar; and in-line clothing stores, such as Charlotte Russe, Abercrombie & Fitch, and Gap. But retailers that don't have to compete with the growing e-commerce threat, including restaurant, fitness, and entertainment tenants, are expanding their brick-and-mortar presence. According to CoStar Group, Inc.'s U.S. Retail First-Quarter Market Review, Planet Fitness and AMC Theatres were among the top tenants leasing space in first-quarter 2019. The report also stated that nontraditional tenants made up more than 50% of leases signed for anchor spaces in first-quarter 2019.

Not surprisingly, investment in retail spaces that can accommodate these nontraditional tenants is up. Across all of CBRE Econometric Advisors' markets, the availability rate for neighborhood, community, and strip centers, which can easily accommodate fitness centers and restaurants, was down 20 basis points to 8.8% in the first quarter of 2019. Investment in power centers is also up, as these properties sign leases with healthcare and grocer tenants. According to Jones Lang LaSalle Inc., investment in power centers increased by 30.4% in the first quarter of 2019, the strongest first quarter since 2016. As higher-quality retail assets are securitized, the delinquency rate across all retail continues to fall. As of May 2019, retail loan delinquency was $5.40 billion, down 22.5% from the year prior.

Industrial Properties Face Uncertainty

Although the expansive growth of e-commerce will continue to provide ample demand for industrial space, many existing properties are not well-suited to the demands of the industry. Many are too small, have low ceiling heights, or lack the infrastructure for heavy wear and tear. In addition, e-commerce and rapid delivery favors locations that are in or near large metropolitan areas. Therefore, it makes sense that CoStar projects locations near major metropolitan areas, such as Sacramento, California, and the Inland Empire, to have the highest new construction in 2019, as demand continues to outpace supply. However, rent growth in these markets is keeping pace, with rent up 11.3% in Stockton, California and 9.3% in the Inland Empire in the first quarter of 2019. Conversely, industrial properties in more tertiary locations and in slow-growth Midwest markets will likely experience an uptick in vacancies, potentially placing negative performance pressure on older industrial assets secured in CMBS. This is already evidenced by the pool of delinquent loans in CMBS: whereas none of the delinquent industrial loans are in California or New York, there is a 42% exposure to Midwest states.

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