Economics

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The double squeeze play: US regional banks and office real estate

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There's a double squeeze play underway across the US, one involving selected regional banks, with a spillover into a troubled market for office real estate. Both sides of the squeeze are at least partly due to the fallout of an unusually rapid pace to Fed rate hikes. But even those not directly invested in either of these asset classes need to consider the degree to which their fallout could impact Fed policy and the broader economic climate.

While many of the country's largest banks have thrived thus far in 2023, the regional banks that have failed this year had assets greater than the totality of banks that went under in 2008. That financial crisis, however, also featured runaway household mortgage defaults, took down a major insurer and a large investment bank, and led to fire sale rescues of two other investment banks. So thus far, the scale of what's hit the headlines this year is still much less dramatic in terms of its impact on overall credit conditions.

Despite a trend towards consolidation, the US still has thousands of commercial banks, and that alone increases the odds that a handful can run into trouble when monetary policy tightens aggressively. But that also means that the economy can weather the storm clouds of a string of defaults as long as these aren't the few giants of the industry. While both banking and commercial real estate are feeling the sting of higher interest rates, our analysis suggests that thus far, the impact of their squeeze might be offset by the Fed opting to pause on rates, cancelling the additional tightening that we would have otherwise seen.

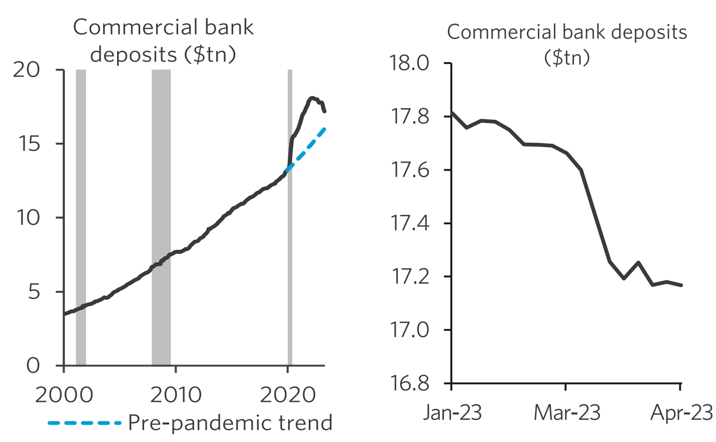
Not as scary as it sounds, so far at least

Banks have felt a pinch from the Fed's tightening, cutting mark-to-market valuations for Treasuries and fixed rate loans, and increasing competition for deposits from higher yielding short-term assets. But in the same months that have swept some banks away, others have still reported strong earnings. And some of what we're seeing is more a reversion to more normal conditions after ballooning liquidity during the pandemic.

Take, for example, the screaming headlines seen of late about deposit flight, or the parallel decline in monetary aggregates that are, for the most part, made up of deposits. It's true that the outright decline we've seen in the M2 measure of money supply is without precedent since the Great Depression. Deposits rarely see outright declines. But the scary year-to-date trend (Chart 1, right) it looks like an entirely different and less scary story when put into a longer perspective (Chart 1, left).

Instead of a crushing drop, the latest dip looks like only a partial retreat back to the normal trend after outsized growth. Of course, these aggregates mask changes among banks, with large money center banks benefiting from inflows seeking greater safety, and the regional banks that were judged to be in trouble seeing outflows. But for the macro economy, the aggregates still matter.

Chart 1: Deposits have fallen (R), but still above trend (L)



Source: US Federal Reserve, CIBC

Moreover, money leaving deposits doesn't equate to money leaving the economy, or funds no longer available to creditors. Many cite the magnetic attraction of higher yielding money market funds, which indeed have grown in recent months. But where does that money end up? Some rushed to Fed facility that the central bank is now restricting access to. But much of it also ends up in commercial paper issued by either banks, or by corporate clients that might have otherwise relied on loans. For banks, however, the cost of those funds from wholesale sources of financing will be higher than what was paid on deposits, and retaining deposits will also entail boosting yields for others. That still has the equivalent impact of further Fed rate hikes in terms of what they have to charge for loans.

How's that lifeblood of the economy?

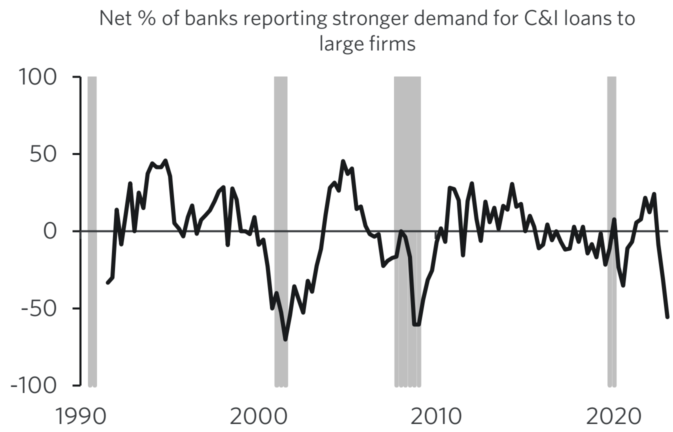
Loans, as that tired cliché goes, are the lifeblood of the economy. So the linkage between deposits and lending activity is very much in the headlines, but it's more complex than it's made out to be. The common perception is that a draining of deposits causes a drop in loans. While that's a plausible story for any one institution, in the aggregate, there's also a cause and effect in the other direction, in which a decline in loans outstanding is what actually causes a drop in aggregate deposits.

If a company flush with cash opts to pay down a loan, it takes those funds from a bank deposit. The banking system then records a reduction in its assets (loans outstanding drop) and an equal reduction in deposits. But in that scenario, it's actually the decision to pay down debt that causes the drop in deposits, not weakness in deposits that reduces lending.

The Fed's survey of lending officers suggests that cause and effect are running in both directions these days. Fewer banks are reporting that there is stronger demand for commercial and industrial (C&I) loans (Chart 2). While that could reflect strong profits and internal sources of funds that reduce the need to tap credit lines, typically it's been more an indicator of softening business confidence and weaker growth plans. That can be seen in the fact that such a weakening in loan demand is often a hallmark of recessions, although it doesn't tend to lead them, and in 2017 was a false warning sign (Chart 3).

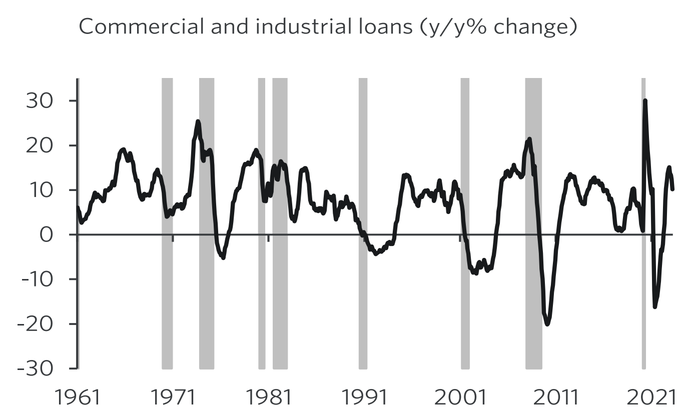
As is often the case, such recession fears also see loan supply curtailed, and of late we're also seeing banks reporting that they are indeed tightening lending standards (Chart 4). So far, the stall in C&I loans has been very short lived, and still has the pace of such lending at healthy year-on-year levels. But the Fed likely want to see a greater retreat ahead, and it looks likely to have its way. The last four times the loan officers survey seen an equivalent degree of tightening in supply and softening in loan demand have all been associated with an outright year-on-year drop in C&I loans. So whether it's due to regional bank ills, or simply the impact of much higher rates, it appears that the Fed tightening will at least entail a close brush with recession, a reason why the central bank ought to stay on hold at this point.

Chart 2: Demand for loans is also dropping



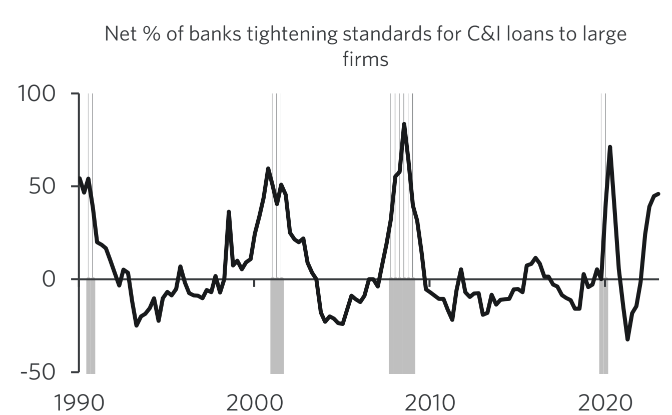
Source: US Federal Reserve, CIBC

Chart 3: Loan declines a not-perfect recession sign



Source: US Federal Reserve, CIBC

Chart 4: Banks are tightening lending standards



Source: US Federal Reserve, CIBC

The Offset

How problematic this will end up being for the economy will in part depend on whether the “whack a bank” game continues, with new troubled names cropping up from week to week. That’s difficult to assess, going back to the fact that the sharp rise in interest rates has imposed mark-to-mark losses across the sector, and the sheer number of banks in the US.

But it will also depend on the degree to which the Fed and other regulators cushion the blow. Had a banking crisis emerged when inflation was subdued, the Fed’s response would be to slash the risk-free rate aggressively, so that wider spreads, on top of softer government yields, reset monetary conditions at an appropriate level. With inflation elevated, the Fed is still doing this adjustment, not by cutting rates, but assuming May was the last hike, but by eschewing about 50 bps in hikes that we would have otherwise seen.

What’s not clear yet is whether that’s a sufficient offset, but all in yields on 10-year BBB corporate bonds are actually lower than they were in early March. Of course, borrowing costs are up sharply from where they were in 2021, but that’s exactly what the Fed needs to see in its fight against inflation. It wants a slowdown in credit, so it has no intention of easing rates until the economy sees more pain.

That, however, isn’t the only offset in play. By allowing banks to get credit from the Fed against the full face value of Treasuries that have declined in value, the central bank is letting banks cover deposit outflows without having to sell assets at a loss, thereby helping them to preserve their capital, while still however, seeing their bank shrink. The FDIC, for its part, seized failed banks, and absorbed enough of their losses to allow them to be sold, thereby keeping the depositors whole. Shareholders aren’t getting a bailout, but these actions are preventing a steeper slide in aggregate deposits.

Out of office messages

A tightening in credit conditions, whether linked to higher costs for banks to retain deposits, or simply due to greater concerns over recession risks ahead, could add to the stress on the US commercial real estate sector. At well under 1%, delinquencies on commerical real estate loans were hovering only a hair above multi-decade lows according to Fed data. But the underlying economics has been impacted by higher interest rates.The Green Street Advisors index of commercial property prices has fallen 15% from its year ago peak, although it’s down only marginally from pre-pandemic levels.

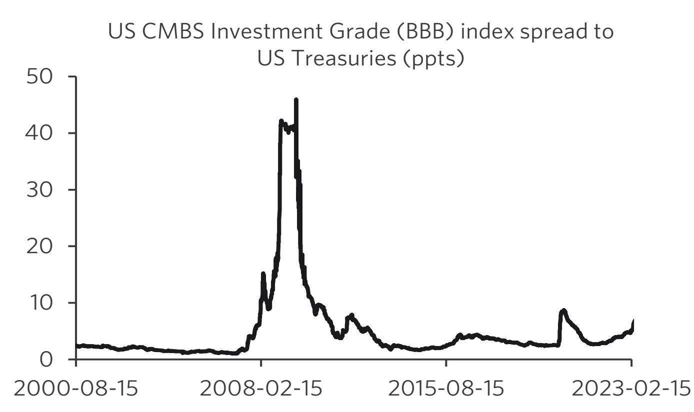
Real estate tends to be a leveraged investment, is therefore sensitive to rising interest rates, and is also a cyclical sector that is impacted by economic slowdowns. The greatest total exposure to banks and other investors lies in the nearly $12 trilion that households owe on their home mortgages. Better underwriting standards in that sector should protect the economy from a repeat of the 2008 crisis. As of Q4 2022, deliquencies on household mortgages were still below 2019 levels, athough a climb is likely once the unemployment rate heads higher as the economy slows.

Rather than on households, the current focus is on what the Mortgage Bankers Association estimates is the $4.5 trillion in mortgage debt on commercial and multifamily property. Markets are starting to take note of potential stresses ahead, as witnessed by the climb in CMBS spreads (Chart 5), although they remain nowhere near the extreme stress levels of the 2008 financial crisis, and are diversified across property types.

The largest slice of the $4.5 trillion in non-single-family commercial mortgage debt, at nearly $2 trillion, is attributable to multifamily housing. A rising unemployment rate ahead could impact credit quality in that sector, but there are no particularly large storm clouds brewing.

But office real estate is the next largest slice, accounting for $750 bn, and it’s been challenged by the legacy of the COVID-19 pandemic and its impact on working from home. A New York Times survey found that more than a quarter of working days were now taking place remotely, more than five times higher than pre-panedmic levels. Office vacancy rates are rising sharply, and there’s more to come as leases get renewed and companies respond to hybrid employment relationships by booking less space.

Chart 5: CMBS market flashing yellow, not red



Source: US Federal Reserve, CIBC

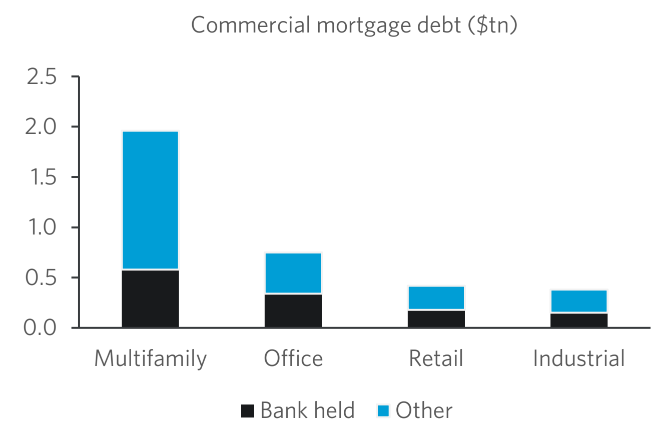
To what exent will a squeeze on bank funding add to that trouble? Commercial banks hold about 45% of the mortgage debt on office buildings (Chart 6), and of that $339 bn, almost 30% matures in 2023. But more of the debt is actually held by other institutions, including those buying securitized mortgages. Presumably, these other sources of finance could step into any gaps if those were tied solely to bank funding issues.

That leaves the underlying economics as the key. Property owners could still opt to walk away if their equity stake has been eroded away, which can be the case if at today's mortgage and occupancy rates there's no flow left for the owner. In other cases, the site might be appropriate for redevelopment if it's in an area suitable for condos or apartments, for example. Remember as well that not all the debt being refinanced was issued when rates were at rock bottom levels. Or the building might no longer be as leveraged, or is in a hotter local market, such that the economics still work at today's higher borrower rates. Location, location, location still rules in real estate, and even within a given city, a premium building can remain well occupied while others empty out.

For the economy, there is a difference between office and factory real estate. In the rust belt era, it wasn't just the factory that vanished, but the jobs for the workers that were previously inside it. The office jobs are mostly still there, just relocated, and buildings can be turned over to new owners at a low enough price that they stay viable even with a long run at a lower occupancy. So the spillovers here from the financial system to the real economy aren't as dramatic as in other cases where asset valuations tumble.

Indeed, the greatest economic fallout won't eminate from financial strains for today's office towers, but from the disincentives to build new ones. As of March, office construction was running at an $84 bn annualized pace and is up 16% from a year ago, but that reflects decisions taken before the Fed's aggressive rate hikes. Expect a sharp drop off as these projects come to completion. But remember, that's just the sort of correction in the interest sensitive side of the economy that the Fed needs to see if inflation is to be vanquished.

Chart 6: Offices mortgages a key market



Source: Mortgage Bankers Assoc., April 2023, CIBC

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