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Economics Group

Special Commentary

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Does CRE Pose a Risk to the Financial System?

Executive Summary

There appears to be an incredible amount of commercial construction taking place in many American cities today. With memories of the housing market implosion of the last decade still fresh in many minds, it is natural to wonder if a bubble is developing in the commercial property market. If so, could the financial system be brought to its knees as it nearly was a decade ago?

We are not overly concerned about commercial real estate (CRE) at this time. For starters, fundamentals in the CRE market appear to be fairly solid at present. Moreover, the nation's banking system does not appear to be overly exposed to commercial mortgages. There are a number of factors that could trigger the next U.S. recession, but we do not believe that a sharp downturn in the nation's CRE market will be the catalyst.

We do not believe that a sharp downturn in the nation's CRE market will be the catalyst for the next recession.

Is Commercial Real Estate Overbuilt?

Anyone who has spent time recently in America's cities, even smaller ones, will note the incredible amount of construction activity that appears to be underway. Construction cranes seem to permeate the skyline. And this anecdotal evidence of strong activity in CRE is generally supported by hard data. Private nonresidential construction spending has grown at a solid rate through much of this expansion (Figure 1). There are currently about 300,000 open jobs—a record number—in the construction industry, which has led to a 3% rise in construction wages over the past year. This acceleration in wages in conjunction with rising costs of materials have put upward pressure on the overall cost of construction.

Figure 1

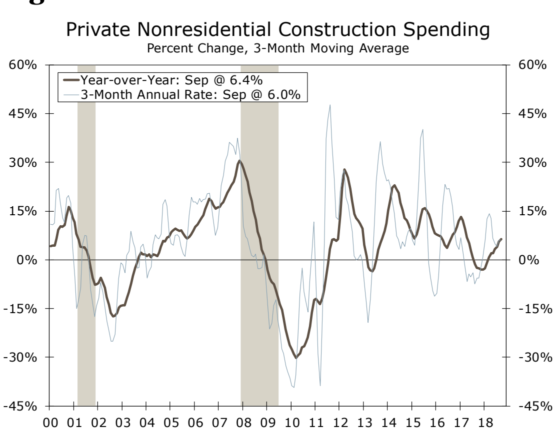
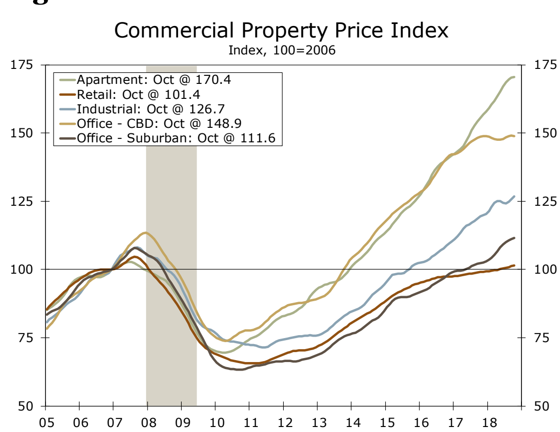


Figure 2



Source: U.S. Department of Commerce, Real Capital Analytics and Wells Fargo Securities

Rising costs and strong demand have led to significant increases in CRE prices.

The rise in costs and strong demand have led to a significant increase in CRE prices, at least in some segments of the market. As shown in Figure 2, apartment property prices have shot up about 130% since 2010 while prices of office buildings in central business districts have doubled over that period. Prices of industrial buildings, which includes warehouses, are up about 70% over the past seven years, although retail and suburban offices have registered more muted price gains.

An observer may feel some disquiet about these developments. After all, it was overbuilding in the nation's housing market that nearly imploded the financial system a decade ago. Older readers will remember the overbuilding in CRE in the 1980s that led to the demise of multiple savings and loan institutions and contributed to the recession of 1990-91. Is trouble brewing again in the CRE market?

Do Banks Have Excessive Exposure to CRE?

Let's start with some perspective about the financing of commercial real estate. The value of commercial mortgages outstanding currently stands at an all-time high of $2.8 trillion. However, that sizeable value is well short of the $10.7 trillion worth of residential mortgages outstanding at present, not to mention the record high of $11.3 trillion that was reached in early 2008. But the macro economy could still be negatively impacted by a downturn in the commercial property market, should one occur, if certain segments of the financial sector are overly exposed to commercial mortgages.

Depository institutions in the United States presently own $1.7 trillion worth of commercial mortgages, which accounts for about 60% of the total amount of commercial mortgages outstanding (Figure 3). [1] As a point of reference, American banks directly owned only 30% of the $11.3 trillion worth of residential mortgages outstanding in Q1-2008 (the record high for residential mortgages). At first blush, it appears that banks could be overly exposed to commercial mortgages today.

The absolute exposure of American banks to CRE is not nearly as high as their exposure was to residential mortgages a decade ago.

But the absolute exposure of American banks to commercial mortgages at present is not nearly as high as their exposure was to residential mortgages a decade ago. In absolute terms, banks directly held $3.4 trillion worth of residential mortgages in early 2008. Furthermore, they had indirect exposure through their ownership of residential mortgage-backed securities, which amounted to more than $1 trillion a decade ago. Thus, bank exposure to the residential real estate market totaled nearly $4.5 trillion in 2008, far more than their $1.7 trillion worth of exposure to CRE today.

Figure 3

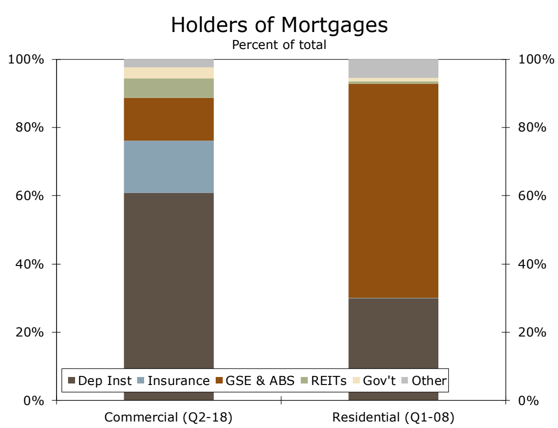
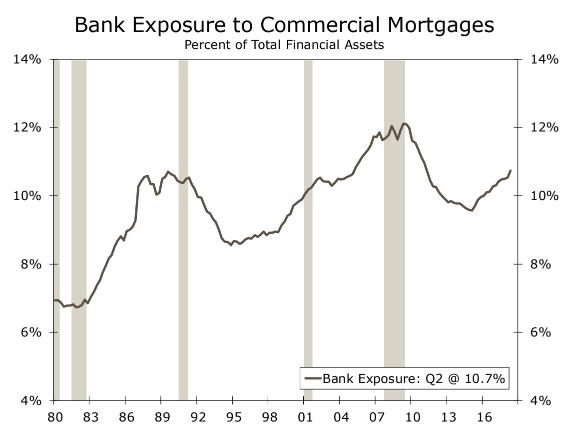


Figure 4



Source: Federal Reserve Board and Wells Fargo Securities

[1] Depository institutions include commercial banks as well as credit unions, but the former account for the vast majority of commercial mortgages held by depository institutions. For simplicity, we will refer to depository institutions as "banks" hereafter.

How does the exposure of American banks to commercial mortgages today compare with the past? Figure 4 shows that banks ramped up their holdings of commercial mortgages sharply from about 7% of all their financial assets in the early 1980s to more than 10% by the end of that decade. Their relative exposure receded throughout most of the 1990s before trending up to 12% before the financial crisis. Today, commercial mortgages account for nearly 11% of the total financial assets of the American banking system.

It does not appear that American banks are overly exposed to commercial property.

In short, it does not appear that American banks are overly exposed to commercial property, either absolutely or relatively. They own $1.7 trillion worth of commercial mortgages, which is less than one-half of the amount of residential mortgages they held, both directly and indirectly, prior to the financial crisis. In addition, the exposure of American banks to CRE is not out of line in a historical context. But American banks could still suffer significant losses if the commercial property market were to experience a significant downturn. How strong are the fundamentals in the CRE market at present?

Fundamentals of CRE Market Appear to be Fairly Solid

A common concern among real estate investors is the potential adverse impact rising interest rates may have on property values, as higher rates tend to lead to higher cap rates. However, despite small upward movements recently, cap rates remain below the lows seen prior to this cycle (Figure 5). Rising interest rates also come amidst an increasingly solid economic backdrop that is driving demand for commercial real estate. We anticipate the rise in cap rates should be minimal and largely offset by rising occupancy and higher rents. Meanwhile, commercial property prices continue to climb higher, a fact that does not appear to be dissuading investors. Transaction volumes have reversed course and expanded modestly recently. According to Real Capital Analytics, volumes reached $152.7 billion in the third quarter of 2018, a magnitude not reached since 2015 and the second strongest quarter of the expansion.

Figure 5

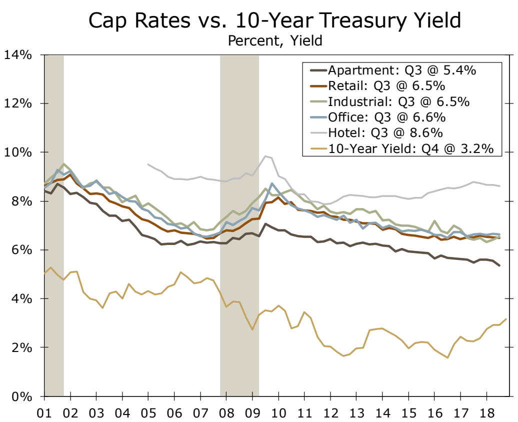
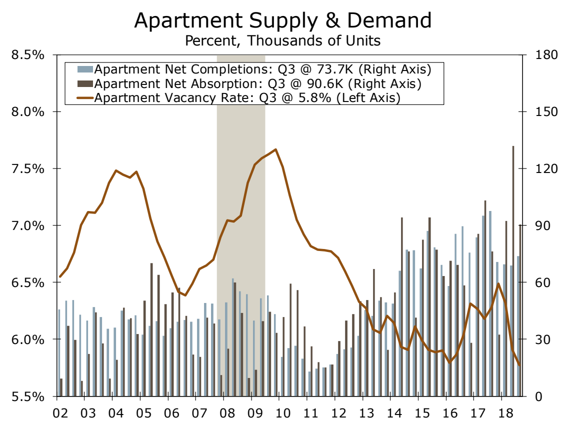


Figure 6



Source: Real Capital Analytics, CoStar, Inc. and Wells Fargo Securities

Rising interest rates come amidst an increasingly solid economic backdrop that is driving demand for CRE.

Tax reform may be playing a role in the recent pick-up in transaction volumes. Overall, the effects of tax reform should be a net positive for economic growth and be especially beneficial to the CRE industry. For property owners, tax reform will boost revenue growth via stronger economic growth and also draw more capital into the industry, as lower tax rates translate into higher risk-adjusted returns. For example, the new 20% deduction for pass-through entities should make structures a better cash-flow investment and more attractive to investors. Newly-established "opportunity zones" also provide preferential tax treatment to investment in distressed communities. In addition, 1031 like-kind exchanges, which defer capital gains tax on one property when it is exchanged for another, were preserved in the tax bill. The net effect of these provisions will likely be to attract additional capital into the industry, which will bolster property prices and apply downward pressure on cap rates.

Overall, demand for commercial real estate appears to be strong.

Overall, demand for commercial real estate appears to be strong. The apartment market is in the midst of catching a second wind. The continued tight supply of affordable single family homes combined with rising mortgage rates have caused home affordability to deteriorate further, which has dissuaded many renters from purchasing a home. Through the third quarter of 2018, demand for apartments has already eclipsed the demand registered in 2017 in its entirety, and effective rents have risen at the fastest pace since 2016. Moreover, the apartment vacancy rate recently receded to a cycle low (Figure 6). Industrial properties also continue to be a growth area, as ecommerce-inspired supply chain modernization and growing international trade volumes are keeping warehouse and distribution properties in high demand. New development over the past decade has significantly lagged demand and pushed vacancies to all-time lows and led to robust rent gains.

Meanwhile, cautious development has kept the office market in balance. The only markets that have seen significant new supply are the major gateway cities and economies driven by tech and energy, the latter of which was mostly in the first half of the decade. Despite the lack of new supply, asking rent growth has continued to moderate in 2018. Rent growth has been subdued for the past two years, slowing to a sub-3.0% pace. Demand for hotel rooms continues to be robust, as overall occupancy remains highly elevated, notably in the upscale and luxury segments. Tax reform has also boosted corporate profits and propelled business travel for company meetings and conventions. Hotel demand tends to track overall GDP growth, which bodes well for the sector's outlook as we expect the strong economic momentum seen so far this year to extend into 2019.

Conclusion

Despite the appearance of strong construction activity, we are not overly concerned about the commercial property market at this time.

Readers could be excused for feeling some disquiet when they observe seemingly ubiquitous construction cranes dotting many city skylines. With memories of the housing market implosion still fresh in many minds, it is natural to wonder if a bubble is developing in the commercial property market. Despite the appearance of strong construction activity, we are not overly concerned about the commercial property market at this time. First, the underlying fundamentals of the CRE market appear to be solid, so a precipitous plunge in commercial property prices does not appear imminent. Banks could suffer some losses if the commercial property market were to head south, which could lead to some tightening of credit conditions elsewhere. But the nation's banking system is not as exposed to commercial mortgages as it was to residential mortgages a decade ago. Although there are a number of factors that could trigger the next U.S. recession, we do not believe that a sharp downturn in the nation's CRE market will be the catalyst.

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