ISA Insights Strategy Analysis by LaSalle

Briefing

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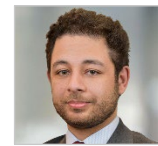
Here for the duration: Banks, rates and the impact on property

Authors:

Dominic Silman
Europe Head of Debt and Value-add Capital Research and Strategy
London



Zuhaib Butt
Director of Investment Risk Strategy & Management
London

Silicon Valley Bank (SVB) and Signature Bank failed. Regulators hastily arranged the sale of Credit Suisse to UBS. Concerns spread about numerous other small and major global banks including Deutsche Bank. Recent events have raised fears that the global economy is in for a credit crunch of unknown magnitude and duration. As we release our first *LaSalle Macro Quarterly (LMQ)*, a revamp of our long-standing "macro indicators deck," banking sector strains represent the number one macro risk we are assessing.

The proximate cause of each recent bank failure was deposit flight, a drain from the liabilities side of the bank balance sheet. This is fundamentally not a toxic assets problem of the sort that banks faced in the Global Financial Crisis (GFC). Rather, it is a liquidity issue that can be addressed by temporary emergency funding from central banks. But solvency, the greater concern for banks in the longer run is closely tied to the *duration* of the asset book.

When investors in interest rate-sensitive assets refer to duration, they typically mean the change in value associated with a change in risk-free rates. SVB failed, in large part, due to a perception that it had sustained severe losses on riskless (but long-duration) US Treasuries and near-riskless agency mortgage-backed securities as these assets had mechanically repriced in the higher interest rate environment.

Just as there was a mechanical element to the initiation of this crisis, there is a mechanical feedback loop that can help the crisis partially self-resolve. As worries around bank solvency, credit conditions and the real economy spread, expectations for policy rates fell, causing long-duration assets to once more increase in price, shoring up balance sheets.

As a result, there has been a 360-degree round trip in interest rate forward curves between the beginning of February and the end of March. At first, curves shifted upward due to spiking inflation data, before falling substantially as banking systems came under pressure, followed by a return to the status quo as resolution measures stabilized markets and inflation seized the attention of policymakers and investors

once again. As a result of this volatility in rate expectations, the MOVE index of bond option volatility[1] [LMQ slide 3] has reached the highest levels since the GFC.

There are many media, economic and financial industry sources to turn to for a deeper discussion of the underpinnings of the recent financial sector instability, or to track the daily news flow and the resulting volatility. Our focus is on the practical considerations for investors in property. We have identified four key recommendations for how real estate investors can assess risks and manage through volatility.

1

Don't miss the forest for the trees. A lot of analyses have focused on idiosyncratic aspects of individual banks. For example, Silicon Valley Bank has been highlighted for its tech sector links and an unusually large share of its deposits not covered by deposit insurance. Credit Suisse had faced multiple controversies in recent years, including a recent disclosure of reporting irregularities which triggered an equity sell-off, as well as an outsized exposure to losses in cryptocurrencies.

Fundamentally, however, the current pressures impact all banks, with the weakest links facing the greatest strain. The question is: How far beyond those weakest links will the challenges spread? This will depend on how the vagaries of sentiment and fear interact with the willingness of policymakers to take action to protect the banking system. Thus far, action taken to resolve liquidity issues seems to have had the intended stabilizing effect, with banks such as Deutsche tested, but not forced to failure.

2

Monitor the path of monetary policy and bear in mind duration. Central banks meeting at the end of March faced a dilemma between continuing their path of tightening to fight inflation, versus moderating or pausing to prioritize financial stability. In the end, the European Central Bank (ECB), Federal Reserve ('Fed') and the Bank of England (BoE) all opted to press ahead with rate rises [LMQ slide 4]. Their decisions were helped in part by data showing an unexpected re-acceleration in inflation, and perhaps also wishing not to betray significant concern about the stability of financial systems.

Volatility in rates markets has a symmetric aspect, so both the initial fall in expectations and the return to a higher implied path for rates have contributed to the MOVE index reaching decade highs. Research suggests[2] that bond volatility is

[1] The Merrill Lynch Option Volatility Estimate (MOVE) index is constructed in a similar way to the VIX. It is a yield curve weighted index of the normalized implied volatility of 1-month Treasury options
[2] Based on work by Natixis, a French corporate and investment bank

less tied to meeting-by-meeting central bank decisions, which may be well-telegraphed, and more to expectations about the 'terminal' rate—the highest level that policy rates will reach over a cycle. As we near that peak rate, bond options are more sensitive to news at the margin than they were even to 75bp rate increases when it was well understood that the terminal rate was still far higher.

Long duration—and therefore high sensitivity to interest rates—is a characteristic not just of bonds, but any long-hold assets with uncertain cashflows, including income-producing real estate. It follows that real estate values, especially in sectors and geographies which have repriced furthest and most quickly such as UK industrial, are also more tightly linked to terminal policy rates at this point than month-to-month central bank decisions.

3

Take an active approach toward real estate debt. Bank lending is likely to become more conservative as duration risk attracts both external regulatory attention and enhanced internal risk management scrutiny. Any pullback in bank lending activity should further increase the importance of private credit across the economy, including in real estate. This could be beneficial to non-bank lenders funded by sticky capital, who can be expected to originate a greater proportion of mortgage loans. On the equity side, investors should cautiously manage their debt maturity schedule in the near term and diversify their sources of debt capital over the medium term.

4

Manage risk and diversify. The failures of SVB, Signature and Credit Suisse, and the pressures on other banks, have elicited a policy response that some banking experts consider to be sufficient to prevent severe additional damage to the economy. Certainly, rate-setters have felt sufficiently confident to press ahead with policy rate increases. But as in all cases of banking sector turbulence, there is considerable uncertainty and outcomes will depend on difficult-to-predict sentiment factors. Ultimately, the systemic nature of financial market risks makes them inherently difficult to control. As real estate managers and investors, our best approach is to understand and monitor these risks and practically diversify investments to mitigate the impact on the overall portfolio.

LOOKING AHEAD

- We recommend focusing on the overall health of the financial system, rather than sector-specific concerns, such as sizing incremental negatives on tech-related real estate from the failure of SVB. Surely, the loss of a sector-focused relationship lender will have some impact on tech companies. But well before the failure of SVB, the same duration-driven hit to the value of bonds and real estate was affecting early-stage technology companies. We do not think the incremental negative for tech is as important as the broader macro uncertainties.
- Investors should bolster their monitoring of banking health generally and their banking relationships specifically. This includes careful mapping of where deposits are held and sources of debt finance, especially credit lines. These exposures should then be continuously compared to assessments of bank health and market measures of risk, such as credit default swap (CDS) spreads [LMQ slide 6] and Liquidity Coverage Ratios (LCRs). LaSalle has undertaken a comprehensive global exercise to match such exposures and compare them against a dashboard that tracks the health of close to 100 major banks globally.

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