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"The significant problems that we have created cannot be solved at the level of thinking we were at when we created them." – Albert Einstein

A Macro Perspective

Since January, multiple events within the capital markets seem to have come and gone virtually unnoticed if one were simply to contrast the trading levels of equity markets then and now. Despite a recent partial recovery, there has been a rapid decline in commodity and energy prices - which, after FX and interest rate hedges, represent the largest notional derivative market. Yet, market participants aren't asking the seemingly natural questions to identify those counterparties that may be exposed to what collectively might be massive losses on the other side of large out-of-the-money commodity/energy-linked derivative trades. If we learned anything from the 2008 liquidity crisis, it is that the derivatives market is rarely perfectly hedged and that the dislocation created when markets shift quickly tend to be more concentrated and correlated than what a financial model suggests. Where has the conversation been on where substantial energy/commodity derivative counterparty losses reside?

More specific to the commercial real estate markets, many of Wall Street's eyes remain fixed on Texas in the wake of the global energy sell-off. Some have been quick to compare today's conditions to the boom-and-bust the Lone Star State witnessed in the 1980's. On the one hand, optimists suggest a much less energy-dependent Texan economy today versus then. True, there have been dozens of Fortune 1000 company relocations to both Dallas and Houston over the years and Austin has diversified into a hub of tech and media-related enterprises. On the other hand, what many may not appreciate is the fact that Texas represents today 40% of total US oil production – up from 25% just five years prior (and up from the 25-28% proportion that had been constant for over the prior three decades). On that measure alone, Texas stands to take a disproportionate hit relative to other energy-rich states like Oklahoma, Louisiana, Pennsylvania, and Colorado.

JPMorgan's global economic research team compiled some interesting data points for comparative purposes:

*"In the first half of 1986, crude oil prices fell just over 50%. At the end of 1985, the unemployment rate in Texas was equal to that of the nation as a whole; at the end of 1986 it was 260 basis points higher than the national rate; and

*Following the hit to the labor market, the real estate market suffered a longer, slower burn and by the end of 1988 Texas house prices were down over 14% from their peak in early 1986 (over the same period, national house prices were <u>up</u> over 14%)."

A review of national employment data reveals that the domestic economy as a whole has only recently recovered the jobs lost in the 2008-2009 liquidity crisis, which implies that there is a "lost" period of six years with effectively zero job growth to the pre-crisis high-water mark. With the boom in energy during that same period, Texas reabsorbed all of its post-crisis lost jobs by 2011 – effectively, a rate that was three years prior to the rest of the nation.

Sam Rines, contributing to *The National Interest,* observed that "from its peak in January 2008 through today, the United States has created only 750,000 jobs. Texas created over a million jobs during that same period – meaning that the rest of the country is still short 300,000 jobs. During the recovery, job creation has been all Texas – or at the very least – disproportionately Texas."

If Texas is to thank for the employment recovery, consider the implications in light of the following recent observations:

*Challenger, Gray & Christmas releases data that shows circa 53,000 jobs were lost in January 2015 – 40% of which are directly related to the energy sector; reports suggest that energy sector job losses for all of 2014 were about 14,000; therefore, the energy sector job losses witnessed in January alone represent 150% of the losses for the entire preceding year;

*Houston/Paris-based Shlumberger, which is the world's largest oilfield services conglomerate, announces in April 2015 that it will cut 11,000 jobs in addition to the 9,000 jobs that the firm cut January 2015, bringing the total reduction to 15% of its workforce;

**The New York Times* reports that Sasol (South African-based) is delaying indefinitely a $14 billion diesel/natural gas project in Louisiana, Total (French-based) announces a 10% immediate cut in capex, Hess (American-based) announces that it will halve the number of its active rigs in North Dakota's Bakken Formation, Cenovus (Canadian-based) immediately cuts its 2015 capex budget by 15%; the International Energy Association estimates that 2015 capex worldwide is to be immediately cut by at least $100 billion.

The story is unfolding quickly in Canada. Press reports reflect a circa 10% year-over-year increase in Calgary home prices for the first half of 2014. With the steep drop in energy prices, however, Calgary prices in January 2015 were shown as down 45% year-over-year and Edmonton prices were lagging by 35% year-over-year. Certainly it is too far-fetched to draw a parallel to what may play out in Texas; nonetheless, worth watching.

Macroeconomists appear divided on whether or not the drop in energy prices will be a net positive or net negative for the domestic economy. Logical arguments are made that savings at the gas pump, at a minimum, should ripple through the broader economy. Worth considering: retail sales from December 2014 through March 2015 have been lackluster and generally panning out worse than economists' monthly consensus expectations in each instance. Given that energy prices have had quite some time to trickle into consumer wallets, the data is not supporting the argument that discretionary spending should increase.

Transatlantic Rebound

Across the Atlantic the average price for leveraged loans in Europe climbed to north of 97 cents on the euro, which represents the highest trading level since August 2007. A vast majority of the price improvement has been within the past two years, with a pronounced increase over the past 6-8 months on the heels of continued easing of monetary policy by the ECB. The European high yield market trailed the recovery witnessed in the US, but has rapidly closed the gap. Issuance of European CLO's are on track to exceed pre-crisis levels in 2015 and data suggests that European high yield issuance is up nearly 90% year over year as issuers take advantage of the open window to refinance existing indebtedness. The recovery's magnitude is nothing short of remarkable given the region's persistently lackluster fundamental economic conditions and leaves little room for error in the instance of increasing corporate or sovereign defaults.

Drowning in Illiquidity

Bankers and regulators on both sides of the pond are sending signals that there may be a liquidity concern within the fixed income markets. On October 15, 2014, there was a free fall in Treasury yields, which typically fluctuate by only a few basis points in any given day. On that specific trading day, however, yields plunged by 30 basis points and radically reverted back by the close of trading. The Federal Reserve made statements upon the close of market that day and on subsequent occasions that have called into question overall liquidity fundamentals in the Treasury market.

More recently, Jamie Dimon remarked publicly that his institution senses a decline in liquidity across multiple segments of the bond market, not isolated within Treasuries. Affiliated research by JPMorgan's credit research team sheds light on how changes among issuers, investors, and dealers have affected trading activity within the general fixed income marketplace. A few of their observations include:

"Credit trading activity has been rising slowly and it is 50% greater than it was pre-crisis. Growth in trading has not kept up with the growth in new issuance. As a result, bond market turnover has been declining. US corporate bond market turnover was 15% below 2011 and 38% below 2006;

Issuers: In recent years there has been a large increase in the number of bond issuers, and these new issuers have less debt. This affects liquidity as bonds from issuers with less debt turn over less than bonds of larger issuers;

Investors: The share of corporate bonds in funds which offer daily liquidity to their clients (mutual funds and ETF's) has doubled since pre-crisis. Flows into and out of these funds are correlated. This results in many funds looking to adjust portfolios in the same way at the same time in volatile market periods, reducing liquidity;

Dealers: Dealer positions are small compared to market size and turnover. Dealers in 2014 held positions averaging just 0.25% of the market and less than 1 day's average trading volume, so dealers are not positioned to act as market shock absorbers. Regulatory changes have contributed to this;

For individual bonds, time since issuance is the key factor in liquidity. High grade bonds turn over 8x more in the first month after issuance than a year later (3x in high yield bonds). This effect is stronger now than pre-crisis;

Trading volumes are concentrated with 90% of trading occurring in the top 20% of bonds. This is less concentrated than pre-crisis; and

Larger bonds trade more than smaller bonds but not much more. 4% of high grade bonds (15% of notional balance) are larger than $2 billion. If the other 96% of bonds traded with the same turnover as the $2 billion bonds then overall bond market trading would have been just 14% more active in 2014."

Despite the observations noted above, the JPMorgan team provides a caveat that it does not necessarily intend to spook the market with a view that credit markets are at risk for a large selloff.

Within the CMBS marketplace, participants share parallel observations of lapses in liquidity. With near-historic lows in current dealer MBS/CMBS inventory levels, a sell-off may become more pronounced for mark-to-market holders. Would welcome further feedback and observations from those in the market on this topic.

Four Corners of the Commercial Real Estate Capital Markets

Without a doubt, M&A activity remains robust. GE's announcement of the divesture of a majority of its real estate and commercial mortgage book is a watershed moment. Worth noting is that GE Capital's assets were estimated at $538 billion pre-crisis and have been trimmed over the years to circa $363 billion. After all of the recently announced divestitures in the unit, GE Capital appears on track to narrow its asset base to approximately $90 billion and therefore generate 10% of overall earnings versus 57% in 2007.

It is worth watching other SIFI entities whose primary source of funding for lending activity is not in the form of bank branch deposits or may view market conditions as favorable to divest of their non-core regulated lending subsidiaries.

CMBS Dashboard

Within the CMBS marketplace, 2015 securitization origination volume appears on pace with 2014's activity. A few statistics from various recent remittance activity signal that while today's lending conditions remain robust, we're not yet out of the woods:

*$1.1 billion in additional loans became delinquent in March 2015; the current tally of CMBS loans in special servicing stands at $29.4 billion (excluding loans that have matured but remain performing);

*Only 61% by count of maturing CMBS loans paid off in March, which represents the weakest payoff activity by count in over three years (stated alternatively, 40% of the billions in CMBS loans that matured in March could not refinance on time);

*March 2015 witnessed the lowest special servicer liquidation activity since 2010; $258 million in loans (of those that had loss severities) were liquidated with an outsized 74% average loss severity; the average loss severity since 2009 has consistently hovered in the 45-60% range; included in the March losses were 9 retail loans whose average loss severity was 83% (stated alternatively, with an average recovery of only 17% of par);

*In March 2015 alone, nearly $2.0 billion (112 loans in total) of CMBS 2.0/3.0 loans originated since 2010 hit the special servicer watchlists, which brings the total watchlist volume for these newly-originated loans to over $9.6 billion in balance (584 loans in total).

Evolving Retail Landscape

Seismic shifts continue within the retail space, including the following recent developments:

*Sears Holdings announces three REIT JV structures spinning off 275 stores to newly-formed JV entities with General Growth Properties, Simon Properties, and Macerich; meaningful liquidity created for the retailer; question marks evolve for landlords that own the several hundred Sears/Kmart shadow-anchored shopping centers whose namesake stores aren't placed into one of the two spin-co's; Sears Holdings shuttered another 255 stores over the trailing four quarters alone;

*Staples agrees to acquire Office Depot in a $6.3 billion merger on the heels of Office Depot's 2013 acquisition of Office Max; Staples shares sink 12% on the day of the announcement; Morgan Stanley analysis suggests that 2,000 of the 3,100 combined Staples/Office Depot stores are located within overlapping trade area footprints, which could translate into a high likelihood of hundreds of store closures on the heels of over 400 stores closed in conjunction with the 2013 Office Depot/Office Max merger;

*Walgreens announces plans to close 200 stores in the US;

*Belk, which operates nearly 300 mall-based department stores, is believed to be seeking a sale of the chain in the face of sluggish mid-market consumer spending;

*Target Corp. places its Canadian operation into bankruptcy protection and closes all 133 Canadian stores less than two years after entering the country; 17,600 employees terminated; CEO Brian Cornell quoted as conceding "simply put, we were losing money every day;" reports suggest the Canadian operation lost over $2 billion; and

*Best Buy announces that it will immediately shut 66 of the 131 of its Canadian subsidiary's big box stores.

Return of Cranes

It was only a matter of time until shovels and cranes came out again. And now they're increasingly evident in plain sight despite the perception that a lack of new supply is a cornerstone of the commercial real estate market's continued recovery.

Hardly newsworthy is that multifamily construction is quickly nearing pre-crisis levels, due in large part to both liquid debt capital market conditions as well as the segment's strong fundamentals.

Evidence is mounting that other property types in many markets are witnessing meaningful amounts of new supply. Lenders, take note.

For instance, Manhattan hotel construction over the past five years has resulted in a 21% increase in total room count, the result of which now appears to be playing out in RevPAR figures. New York City is virtually dead last among several national lodging forecasts for 2015 RevPAR growth and, in some estimates, looks to be flat to negative, based in large part to the presence of new room supply. On the heels of what has recently been delivered, there are an additional 27,000 new rooms (representing an incremental 25% increase in total room supply) in advanced planning/active construction, per Bloomberg estimates.

In the office segment, it remains worth keeping an eye on both the 9.5 million square feet of Manhattan office space under construction and anticipated to be delivered by 2018 and the 18 million square feet of office space under construction in Houston (yes, 18 million). Consider the following: a significant proportion of Houston office space under active development remains unleased. One specific project is the 1.1 million square foot 609 Main at Texas 48-story office tower in CBD Houston that broke ground in mid-2014 which, according to a local press article, touts "no tenants have yet been announced." Hard not to consider the effects of the continued weakness in global energy markets alongside this wave of speculative supply.

Within the industrial segment, CBRE estimates that over 140 million square feet of warehouse space is in advanced pre-development stages/under construction nationwide – a figure that appears twice the amount delivered in 2013. Within the office segment, Cassidy Turley estimates that over 79 million square feet of space broke ground in 2014 – an amount that is more than twice the rolling 10-year annual office delivery rate.

Continuing the theme of new supply, below is a snapshot of construction data points across the country. Active development appears more widespread than what some may appreciate. Thanks to the Cassidy Turley research team for providing the following excerpts:

Atlanta: "Construction on the first speculative office building this cycle has commenced; Tishman Speyer is building Three Alliance, a 500,000 s.f. development in Buckhead;"

Baltimore: "There is approximately 4.1 million s.f. (of industrial space) under construction and another 2.1 million s.f. in the immediate pipeline;"

Boston: "Some suburban submarkets are still suffering from elevated availability. On paper, markets with 25%+ availability rates would not appear to be prime locations for new construction. But they are. The growing list of suburban office/mixed-use projects includes Assembly Row (Somerville), Stations Landing (Medford), Market Street (Lynnfield), Northwest Park (Burlington), 1265 Main (Waltham), and Arsenal Street (Watertown) in addition to downtown projects Lovejoy Wharf, Seaport Square, and the pending redevelopment of the Government Center Garage;"

Charlotte: "Development activity in the uptown Charlotte office market could be making a comeback. In 2Q2014, the announcement was made that a speculative 25-story office tower totaling 634,000 s.f. would break ground by the end of 2014;"

Cincinnati: "CBD construction is booming. Since 2011, 5 new hotels have either broken ground or been delivered in the CBD. Prior to that, no new hotel had been built downtown in 27 years;"

Columbus: "Speculative development is looking like a no-brainer. There is 1.8 million s.f. of speculative industrial space underway. There is also a flurry of construction activity in the Columbus office market. There is currently 856,000 s.f. of office space under construction, 568,000 s.f. of which is speculative among 8 separate projects;"

Dallas: "Office construction is ramping up in Dallas. As of mid-year 2014, there was a total of 4.7 million s.f. under construction – more than 4 times the level of construction observed just a year prior;"

Dayton: "Over 4 million s.f. of new industrial product has delivered to the Dayton market since 2011;"

Denver: "There are currently 8 office buildings under construction that will add 950,000 s.f. to the CBD submarket. 12 multifamily buildings are under construction in the CBD that will add nearly 3,000 units to the market over the next 18 months. The average apartment asking rental rates of over $1,450 per unit are well above the Denver Metro-wide average of just over $1,100;"

Indianapolis: "Over 8 million s.f. of industrial space is under construction;"

Kansas City: "Completed construction in Kansas City's office market totaled 1.1 million s.f. in 2013 – a large volume for the area and a bit puzzling since vacancy has been above 19% for five years. In 2014, an additional 728,000 s.f. is expected to be completed. From early 2013 to mid-2014, there were 5.5 million s.f. of industrial space completions. Of that, 3.1 million s.f. were speculative. Another 875,000 s.f. of industrial space is currently under construction, almost half speculative;"

Los Angeles: "The Los Angeles office market is in the midst of robust construction cycle. Over 4 million s.f. are currently underway;"

Louisville: "Developers announced plans to construct just over 6.5 million s.f. of Class A bulk warehouse space and more than 1.4 million s.f. of speculative and build-to-suit structures in 2014;"

Milwaukee: "4.7 million s.f. of industrial space was scheduled to deliver in 2014 – a 307% increase from the 1.1 million s.f. completed in 2013;"

Minneapolis: "Construction activity is heating up in the Minneapolis/St. Paul metro, particularly for multifamily and industrial space. The metro's industrial market is expanding at a pace not seen in a decade;"

Nashville: "Many new build-to-suit projects are underway and speculative construction cranes are again dotting the Nashville area skyline;"

Oakland: "The development pipeline in the East Bay warehouse market is swelling with more activity than has been seen in the last 15 years. Multifamily development is also heating up. While there were virtually no multifamily projects in the past several years, nearly 15,000 units are currently in the East bay pipeline set for delivery over the next 18 to 24 months;"

Phoenix: "New wave of development comes despite a 19.7% office space vacancy rate. During 2014, 4 new projects broke ground, three of which are speculative. In addition, 2 more speculative construction projects are expected to break ground;"

Raleigh: "The construction cycle in Raleigh/Durham is in full swing. Deliveries in 2015 will exceed the 10-year historic average for the first time since 2009;"

Sacramento: "Although construction in the Sacramento market has been fairly dormant, this trend appears to be reversing. 11 multifamily projects are currently under construction and another 17 projects are in the pipeline with half of those that broke ground by the end of 2014;"

San Diego: "San Diego experienced a surge in multifamily starts. More than 20 projects 7,200 units are currently under construction;"

San Francisco: "More than 1.2 million s.f of new office product came online during 1H2014 and 4.2 million s.f. of space is currently under development;"

San Jose/Silicon Valley: "More than 4.2 million s.f. of office space is under construction. Multifamily development is also skyrocketing. 29 major projects are under construction that will add nearly 6,600 multifamily units;"

St. Louis: "In July 2014, developers broke ground on the first new spec project in St. Louis since 2007. In addition, more than 1 million s.f. of new industrial space is scheduled to begin construction in the next 12 months;"

Washington: "Despite negative absorption in nearly half of the prior 10 quarters, there was 1.5 million s.f. of office space under construction (with half of it speculative)."

Odds and Ends

A little-publicized message out of Sacramento that could have repercussions among the money management universe is that CalPERS intends to cut the number of its private equity managers by two-thirds, which comes on the heels of its announcement last fall that it intends to exit investing in hedge funds altogether. According to Bloomberg data, CalPERS invests $31.2 billion into private equity, which represents approximately 10% of its total portfolio. In isolation, the combined announcements could likely be absorbed within the marketplace. The larger issue is that the institution is often followed by other state and local pension funds and could portend other large shifts among other plan sponsors in the near term.

A research piece was published in March by Goldman Sachs that highlights the rise of shadow banks, with particular relevance to current CRE debt financing markets. For those with access to GS research, it's worth a read.

Four domestic banks have failed since January of 2015. Included within that figure is February's failure of Doral Bank, which had $5.9 billion in total assets.