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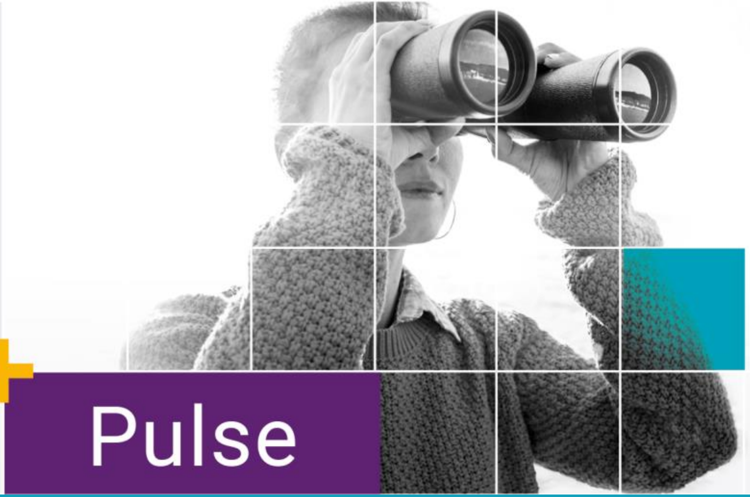


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# The US Real Estate Sector: The sword of Damocles?

The US real estate market is under scrutiny. Its importance in the economic landscape and the trauma of the 2008 crisis is driving investors exceedingly cautious, especially in the face of increasing interest rates. Are we facing an imminent market shock? Is the current US real estate market comparable to that of 2008? Two diverging paths are emerging: the residential real estate versus the commercial real estate sectors. Here, we offer insights into the dynamics of these two markets.

## Residential Real Estate: A Question of Supply

As a result of the Federal Reserve (Fed) hiking cycle, US mortgage rates have hit their highest level since 2002, reaching around 8.0% for 30-year loans. The increased rates have made homeownership challenging, especially for first-time buyers. In December 2019, the 30-year US mortgage rate stood at 3.7% with 70% of American borrowers preferring this maturity, making them highly sensitive to rate fluctuations. With the current rate nearing 8.0% and the US median existing-home sale price at $406,700, an American household would pay roughly $450,000 in interest over 30 years, up from $230,000 in late 2019. Monthly payments would increase by 34%, and the interest expense would surge from 57% to 111% of the principal.

It's worth noting that most American households now have fixed-rate mortgages[1], contrasting the 2008 financial crisis when adjustable-rate mortgages dominated. Homeowners, with significantly lower rates than current ones, have no incentive to sell and buy a new one. This reduces the available properties for sale. Currently, about 1 million existing homes are available compared to a pre-COVID average of over 2 million. Benefiting from the scarcity of older properties and witnessing a 9% annual price drop (due to normalized construction material prices), new homes sales have spiked by 31.5% YoY. This dichotomy between supply and demand is stabilising the market, which is up by almost 2% YoY (new and existing homes combined). In short, the housing market remains under pressure due to a mismatch between supply and demand that is not weakening and is even supported by a labour market that is showing little signs of weakness. The adjustment observed in prices corresponds to the end of post-Covid situation. In short, there is no need to be concerned...

## Commercial Real Estate: A House of Cards?

Unlike residential real estate, players in the commercial market usually opt for loans spanning between 5 and 7 years. These loans are annually refinanced and renegotiated based on current financial conditions. However, various negative factors are challenging this financing model.

On the structural side, the rise of remote work has drastically affected occupancy rates, leading to plunging occupancy rates[2]. In major US cities like New York, Philadelphia, and Los Angeles, this rate hovers around 50%. As a result, companies renegotiate leases for smaller spaces[3], driving up vacancy rates for landlords[4].On the supply side, landlords face headwinds on both their assets and liabilities. Rising vacancies resulting from lower demand is driving rents downward, affecting revenues and in turn assets.

The gradual debt refinance – at higher rates – will exacerbate owners' situation, even more so as rental income also slows. In addition, as banks demand stronger collateral and lower Loan-to-Value (LTV) ratios, owners will need to allocate more equity, thereby diminishing their profitability. Moreover, regional banks, which primarily fund commercial real estate, are still in the spotlight after the series of bankruptcies in March 2023 and hence are now stricter in their financing requirements. Our statistical analysis indicates that the prevailing interest rates will continue to depress prices, worsening the sector's financial health. Financial markets have not remained indifferent to these latent risks. The US REITS Index has dropped by 30% since its December 2021 peak, and non-agency Commercial Mortgage-Backed Securities indices have also fallen 10% since the end of 2021. Additionally, distressed Commercial Real Estate assets rose by over 10% in Q1.23, reaching $64 billion.

When discussing US real estate, it's crucial to differentiate between residential and commercial sectors. While residential property prices are starting to rise again – once post-Covid effects are purged, the financial health of commercial sector keeps deteriorating and therefore additional vulnerabilities are still likely to show up. The long lags and the robust US economic cycle may provide some respite, but a blend of high-interest rates, structural shifts in occupancy rates, and a weakening economic environment is set to deteriorate the commercial real estate scenario. Knock-on effects on regional banks and landlords are expected, probably by early 2024.

[1] 95% of American households have fixed-rate debt (source: MBA).
[2] Effective occupancy rates for leased offices.
[3] The usual commercial property leases are for 5 years, renewable subject to conditions. This allows the owners to match their asset and liability maturities.
[4] Rate at which available properties are not let (as opposed to the occupancy rate).