ConnText Podcast

July 2022

TRANSCRIPT

Real Estate Insights with Tom Cloutier, Director, Portfolio Management and Trading

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Hi all, I'm Rich Sega bringing you the Conning ConnText podcast just past mid-year 2022. Our high hopes for a prosperous and productive year that we expressed at its start have been put on hold here in its 3rd quarter. Inflation is still raging, as is the war in Ukraine. Threats from the geopolitical front as well as from domestic policy have roiled markets; they've also reset risk tolerances and investment expectations.

I'll be joined today by my Hartford colleague Tom Cloutier, Director, Structured Credit Research & Trading. We'll talk a bit about commercial real estate in the current inflationary environment, the various fixed income sectors that are related to it, and some opportunities they present for insurers' portfolios.

[FADE TO MUSIC]

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS]

Will we have a global recession? The recent IMF projections show a stark weakening trend across all regions. In many ways, the current investing environment might feel even worse than 2008 or the spring of 2020. All major financial asset classes have lost money over the last six months, and that rarely happens. Bonds are having their worst year on record and stocks are seeing their roughest start in decades.

Three major disruptors have hit the investment world since early 2020: first, the severe deflationary effects of COVID-19; then, the huge negative supply shock of lockdowns followed by a big positive demand shock once they were lifted leading to reflation; and lastly, the terrible impacts of Russia's invasion in Ukraine. The implications for insurers' portfolios are several, including volatile cash flow, erratic liquidity needs, shifting risk appetite among policyholders leading to changes in demand for insurance products. But the two main concerns for managers of insurance portfolios have been the threats of persistent inflation, and rising interest rates.

Those COVID-related inflationary forces are self-regulating (that is, they will cure without policy help, though it could take a very long time). But others like war, fiscal excess, and energy shortages are created by government policy. As such, they will persist until policy changes. Sadly, the war in Ukraine drags on, and we see few signs that US spending and energy policy in the Biden Administration will change in the near future, these latter 2 being the biggest contributors to US inflation.

Some analysts think the Federal Reserve is "behind the curve." Certainly, 13 years after the end of the Financial Crisis and 2008-09 recession, there's no need for the policy rate to remain at emergency levels, near zero. So the Fed has room to move up. And even if our forecast of moderating inflation proves to be accurate, 5.5% inflation is well above the Federal Reserve's 2% - 2 ½% target for "price stability" which means it's unlikely the FOMC (i.e., Federal Open Market Committee, the group in charge of central bank policy) will change course on their strategy to raise rates beyond their "neutral" level. While we don't believe it was necessary to move 75 bps in June, they did, and we now believe, with the recent 9+% YOY inflation print in June, that the FOMC will continue to be aggressive inflation fighters even if price increases ease.

By the July meeting, the FOMC had already raised rates by 150 basis points. Based on the current "dot plots," those indications of the members rate biases from a recent meeting, it appears that an additional 150-200 basis points of interest rate increases are possible, tapering off after 2024.

[FADE TO MUSIC]

SEGMENT 3 – Q&A w/ TOM CLOUTIER

[RS]

Now let's speak with Tom Cloutier, Director of Structured Credit Research, responsible for all research, surveillance, and investing of Conning's $3.2B positions in commercial mortgage-backed securities, that's CMBS.

Tom, let's start with the obvious challenge that everyone feels these days…how is inflation affecting your markets and are RE-based assets a decent hedge against it?

[Tom Cloutier (TC)]

Hi Rich - thanks for having me on the podcast.

Real estate has long been considered an inflation hedge, based on the principle that income generated by buildings tends to keep pace with consumer prices. In other words, rising inflation results in higher cash flows and higher rents. However, there is a closer correlation between cashflow growth - and the ability to raise rents - and GDP and employment levels. Rising GDP and falling unemployment usually encourage consumer spending, hiring, and expansion, which can drive commercial real estate cashflows. Rising inflation generally leads to slower economic growth, causing corporations to pull back on hiring, expansion plans and business travel. It can also lead to job security concerns for employees, who in turn may reduce spending on retail and leisure travel.

Rapidly increasing interest rates present a challenge for certain property types. Real estate tends to perform best when prices are increasing at a moderate pace in response to healthy economic growth, as property owners can more easily raise rents when a growing economy creates demand for commercial property space. Today's inflation is more difficult to hedge b/c it is driven by increasing costs for raw materials, labor and energy, as well as dislocations in the global supply chain. These factors are beginning to hurt growth prospects. Actions the Fed takes to contain inflation may also exacerbate the situation and push the economy into recession, possibly leading to layoffs and rising unemployment, which would further limit demand for space. Rent growth is always important, but especially so during a period with higher rates b/c it's harder for valuations to keep up with inflation through capital appreciation.

Two of the more challenged real estate sectors in this environment include Office and Retail because they have fewer tools to combat inflation. Leases tend to be staggered, locked in and longer-term. As leases rollover we expect downward pressure may limit the ability to respond to an ongoing massive repricing of rents. The flight to quality continues to intensify and further bifurcate office markets into "haves and "have nots". Newer properties with the best combination of location and amenities will likely have a competitive advantage. We expect supportive growth metrics for well-located central business district, trophy-type offices to perform better than the older vintage 1960's-70's offices that make up the majority of the NYC building inventory. High quality tenants will also likely be offered incentives to sign longer-term leases.

One metric we like to follow is Kastle Systems' office-usage tracking data, which for 24 months has been unable to break above the low-40% range nationally, highlighting the challenges of the work-from-home environment.

[RS]

Given the intense debate over housing demand, construction delays, meteoric price increases, what's the outlook for CMBS performance, particularly in the burgeoning multi-family market?

[TC]

Historically, properties backed by multifamily residential/commercial apartments have been considered more stable and defensive, and investments in these properties rose markedly during the pandemic. 45% of all commercial real estate investment in the last quarter of 2021, compared to 28% over the four years prior to the pandemic, according to CB Richard Ellis.

Fundamentals in the MF sector remain solid with steady rent growth and low vacancy rates. Supply has been largely in check and demand has far outpaced any potential imbalances. Homeownership levels, while off their low point, are still below the long-term averages of mid-60%. Housing affordability is constrained due to high home price appreciation (HPA), a shortage of inventory and, now, rising mortgage rates. Countering this somewhat has been rising rental inflation, creating more of a convergence of rental vs home ownership costs, and perhaps signaling an inflection point in terms of rent growth and valuations.

[RS]

Switching to the commercial side, talk for a bit about the shifting demand dynamics we've witnessed since the end of the pandemic regarding industrial properties and warehouse. We hear that CMBS is the more volatile and part of the "flexible" part of CPI. Have you seen that pattern?

[TC]

Industrial, logistics and warehouse properties were in heavy demand even prior to the pandemic. They have been viewed as a more defensive sector and have been historically under-represented in the CMBS space, but rising M&A activity and institutional sponsorship are driving greater interest in properties such as cold storage, warehouse, and logistics facilities. The exponential growth in E-Commerce has driven increasing demand for last-mile distribution facilities (think of Amazon, for example). It has been further fueled by global supply chain disruptions. The fundamental picture remains solid with industrial properties enjoying unprecedented growth in cash flows, rents and property prices, all while maintaining very low vacancy rates. I think we are seeing potential signs of a peak here as Amazon announced a pullback in development pipelines more recently; valuations have become very heated. And a shift in consumer demand into a slowing economy or recession could negatively impact the sector.

[RS]

So Tom, what do you as the best opportunities in these asset classes, and how does Conning control portfolio risks?

[TC]

Among the opportunities we are seeing, here are three leading themes.

We think there will be continuing recovery stories in the hotel sector, including destination and vacation markets, that will continue to benefit from pent-up demand for leisure travel. We also expect to see improvement in select, slow-to-recover urban/central business district hotel markets IF we see improving return-to-office numbers, commensurate with increased business/conference-related travel, over next 12-18 months.

We are watching select high-quality, newer office buildings in strong central business district locations. We expect to see more focus on urban office markets, which trailed suburban locations in terms of performance during the pandemic. We expect a large segment of the work-from-home contingent will return to offices.

We believe there are opportunities in large-loan, single-asset, single-borrower deals (SASB) that enjoy strong market liquidity across all property types. These are typically deals with well-capitalized, institutional quality sponsors that have well-defined business plans and strong track records and are willing to provide significant cash-in equity and support for the assets through the economic cycle. These are largely floating-rate, shorter-duration deals that have a built-in hedge to rising rates, can attract strong tenant profiles, and offer longer lease terms.

But regardless of the environment and opportunities, Conning's strategy is to build and manage diversified portfolios, drive relative value, generate competitive risk-adjusted returns and provide downside protection through all stages of the credit cycle. Robust risk management practices, including portfolio diversification, upfront due-diligence, stress testing, continuous surveillance and managing concentration/event risks, are all essential elements.

SEGMENT 4 – CLOSE

[RS]

Thanks Tom, for your insights into the diverse commercial property-based sectors of Fixed Income.

With inflation remaining elevated for such an extended period, some of this is becoming embedded into expectations. It's that process that leads to a steady rise in long term interest rates. We expect year-end core inflation at 5.5-5.75%. We mark real growth declining into the 2% - 2 ½% range, well below potential, due to the lack of policy progress on energy, and the threatened tax-and-spend plans of the majority party.

Despite these challenges, we can still make the case for a positive technical backdrop for U.S. assets, particularly relative to the ROW. The US has about the highest interest rates among DM, and they're poised to go higher, supporting continued strength in the dollar. And US GDP growth, while currently slowing and even declining for a quarter or two, is likely to avoid a deep recession, and could escape without one entirely if the central bank doesn't overreach.

We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

So that concludes our Conning ConnText podcast for the third quarter of 2022. Join us next time for the run up to the all-important mid-term elections, and their market impacts.

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