

MBA

Welcome to the Global Capital Markets

When the U.S. stock market plunged on Feb. 27, investors were reminded of just how interdependent international markets have become. **By Jamie Woodwell**

Commercial/multifamily delinquency rates did not jump on Tuesday, Feb. 27. There were no reports of falling rents or increasing vacancy rates. No new signs of over-construction or increased balloon risk. A world away, rumors of a capital gains tax on Chinese investments set about a string of events that in a matter of hours led to slightly higher borrowing costs for U.S. commercial real estate borrowers.

'Flight to quality' comes quickly

For years, U.S. real estate markets have been the beneficiary of an abundance of capital. The result continues to be low borrowing costs at competitive terms, high property valuations, strong commercial/multifamily mortgage origination volumes and record levels of mortgage debt outstanding. On occasions such as the crisis of Long-Term Capital Management in 1998 and the events of September 11, 2001, flows reversed. Feb. 27 marked another, albeit much slighter, such reversal.

While commercial real estate fundamentals did not change, the broad appetite for risks among fixed-income investors did. As the Chinese stock market jitters affected the carry trade and prices

in other markets, some investors looked for security in Treasuries and other risk-free instruments. A similar "flight to quality" occurred three weeks later when the Mortgage Bankers Association (MBA) reported a jump in delinquency rates on non-prime, single-family mortgages.

The resulting flight to quality, and drop in demand for other fixed-income securities such as commercial mortgage-backed securities (CMBS) and other securitized instruments, meant a drop in prices. And since a drop in a bond price means a rise in its yield, borrowing costs for commercial/multifamily real estate rose slightly.

When Long-Term Capital Management failed in 1998, the spread between AAA CMBS and swaps widened 84 basis points, from 27 basis points to 111 basis points, in just six weeks. In the six weeks following the Sept. 11, 2001 attacks, spreads widened 17 basis points, from 45 basis points to 62 basis points. In the four weeks after the Chinese stock market dip, spreads widened 6 basis points from 23 basis points to 29 basis points.

Mounting pressures heighten risks

While the timing and cause of this jump in rates may not have been foreseen, the coming of such a jump has been. In

its August 2006 report, titled "Outlook for the Real Estate Finance Industry," the Council to Shape Change, an independent group of 19 real estate finance industry leaders created by the MBA, noted: "Due to the ever tighter linkages within the capital markets, the real estate finance system could be more susceptible to shocks to the financial system." The council concluded that the industry could be hit by a sizable financial market shock over the next several years.

In a January article in *Mortgage Banking*, I noted, "Participants throughout the industry are [rightly] scanning the horizon for signs of inclement weather that may be heading our way. And while no thunderheads are imminent, it's worth raising a couple of the likely suspects that could start moving in." The likely suspects included new construction, balloon risk and financial market shocks. Even with careful risk management, there's little the industry can do to prevent such events.

Historically, the location of a property has been very important. To a large extent, the performance of a property — and the loans that back it — depends on local market conditions. Increasingly, global capital flows make the difference between a marginal uptick or downtick in values. The added capital, liquidity and transparency that stem from these global markets will continue to benefit the commercial/multifamily real estate market as a whole.

These same forces mean that real estate investors need to be just as aware of the effect of shocks to the global financial market as they are of risks linked to increased local development activity or a loan maturity date. Welcome to the global capital markets.



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REAL ESTATE FINANCING TIED TO GLOBAL EVENTS

The Feb. 27 Chinese stock market drop caused spreads to widen but only slightly compared with past events.

10-YEAR AAA CMBS SPREADS OVER SWAPS



*Long-Term Capital Management Crisis

Source: Morgan Stanley