How contagious is the U.S. real-estate sector?

Europe's banks and U.S. real estate – an unhealthy relationship once again questioned by markets

IN A NUTSHELL

- The renewed turbulence in European bank stocks on Friday based on concerns about their exposure to U.S. commercial real estate shows that investors are still not at ease with European banks, even after Credit Suisse's rescue.
- We're providing some perspective on European banks and how different segments of the banking sector are exposed to the CRE market.
- Historically, the first year into a rate hiking cycle creates the biggest turbulence. So far, central banks don't seem inclined to blink, but rather determined to pursue their fight against inflation.

Big losses for European banks on Friday, U.S. peers stable

Friday saw hefty selling of European banking stocks. The Stoxx Europe 600 Banks was down 5.7% at one point, ending the trading session 3.8% down. Deutsche Bank's (DB's) shares were down almost 15% during the day and ended the day with a loss of 8.5% at EUR 8.54, still above their lows of 2022. For what it's worth, the sell-off was explained with DB's exposure to the U.S. commercial real estate (CRE) market. According to 4Q22 reporting, 7% of DB's loan book (EUR 489bn) is invested in CRE, of which 51% is in the U.S., thus total exposure to U.S. CRE is EUR 17bn. DB's total assets are EUR 1.3trn. If new worries about this exposure were the reason for the sell-off, one might still wonder why it didn't spread back to the U.S., where regional banks have much higher proportionate exposure to this sector. But the KBW Bank Index even gained 0.4%, calming European worries as well somewhat. Then again, the KBW Bank Index has already lost 22.2% this year, while the Stoxx 600 Banks is only down 1%. In these terms, European banks are still far from catching up with their U.S. peers. Worries there about banking troubles weighing on economic growth have pushed 10-year Treasury yields down to 3.38% on Friday, their lowest this year.

Some perspective on European banks and CRE

Higher interest rates have so far benefited European banks but not U.S. banks because: 1. The combination of falling deposits (since April 2022 USD 600bn of deposits have been withdrawn from the U.S. banking system, by far the biggest amount in history[1]) and aggressive rate hikes in the U.S. led to pressure on U.S. banks to increase interest on deposits; 2. U.S. banks took on more interest-rate risk vs. European banks. European banks also have lower exposure to commercial real estate than U.S. banks: Median exposure to CRE for European banks is c.6% vs. U.S. regional banks at c.36%, large U.S. banks at c.16%.

[1] Source: Federal Reserve. Biggest drops so far around USD 50bn

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We still think that European banks are solidly capitalized (capital levels are at multi-decade highs) and have higher returns and liquid balance sheets. We expect that dividends in general will be paid, providing a good yield, and some banks have announced to restart share buy backs over the coming months. In contrast to the U.S. banking system, we do not observe huge deposit movements. We see that credit conditions are getting tighter but banks in Europe should be in a strong position to deal with upcoming challenges.

While it is always difficult to predict the ways of contagion, given that 15 years of loose monetary policy have surely left their mark, namely the risk of mis-valuation of assets, in certain areas of the economy, on paper, the risk of CRE to the U.S. banking system seems low. CRE represents 14% of total bank assets. Office represents maybe 3%-4% of assets. Securities, which got Silicon Valley Bank into trouble, represent 27%. The Fed stress tests in June 2022 found that all of the large banks (representing 65% of total U.S. bank assets) could safely weather an adverse economic scenario like we've seen in the Great Financial crisis of 2007/08, which involves unemployment rising to 10% and CRE prices falling 40% (across the board).

The risks of regional banks concerning CRE, however, is higher. Banks account for 50% of CRE lending. Small and regional banks account for a disproportionate share of total bank CRE lending: 70% (vs. their 35% of total bank assets). So small and regional banks account for about 35% of total CRE lending. However, the degree of contagion to small and regional banks is still unclear. Deposits at these institutions tend to be sticky, a higher share is already insured by the Federal Deposit Insurance Corporation (FDIC), and U.S. authorities have anyways unofficially guaranteed deposits above the USD 250,000 insurance threshold.

We believe that CRE prices could be hurt near-term due to the squeeze on regional bank lending, but we expect this will create a disconnect relative to the yields on U.S. Treasuries and investment grade, which we think will eventually be closed as capital comes in to fill the gap through other channels (including alternative lenders). The constraint on development and pullback of construction could set up for better fundamentals in 2024/2025. A significant tightening of regional bank lending would probably have a quality dispersion, disproportionately affecting higher-risk lending in smaller markets. As a reminder, the U.S. CRE market is split into 40% industrial (logistics), 30% residential (multifamily), 20% office, and 10% retail, with the latter two in our view bearing the highest valuation risks.

Where do we go from here?

Entering the third week of market turbulence, it is hard to still believe this could just be a storm in a teacup, given the size of deposit outflows U.S. banks are having to compensate for. For now, we would be hesitant to call the end of the crisis. U.S. regional banks seem to face a profitability issue on a larger scale, they are losing deposits, and some commentators are already drawing comparisons with the "Savings & Loan" crisis of the 1980s. Back then, more than 1,000 institutions had failed, caused by losses on real estate and commercial loans. "There needs to be clarity on the situation regarding deposits," former Treasury Secretary Larry Summers urged current Treasury Secretary Janet Yellen.

We believe investors are wrong thinking that central banks are now having to choose between fighting inflation and ensuring financial stability. Comments from both the European Central Bank (ECB) and the U.S. Federal Reserve (Fed) have made it rather clear, that fighting inflation remains top priority, even if this causes some stress in the system. This should ultimately help to tighten financial conditions and thus economic activity. Were this to lead to a bigger recession than central banks are willing to accept, they might be inclined to rethink their terminal rates for this cycle. But one should not expect central bankers to pre-commit to anything in this respect as this could imperil the very mission to tighten financial conditions. Think

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of it like being the top management of a football club that is about to fire its head coach. It would never make any hints in this direction and doubt the coach in public until the day it fires him[2].

[2] Look no further than at what happened in Munich last Friday as Bayern Munich fired their head coach in a big surprise to the German soccer community.

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Glossary

Commercial real estate (CRE) refers to properties that are used for business or commercial purposes, such as office buildings, retail spaces, warehouses etc.

The European Central Bank (ECB) is the central bank for the Eurozone.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The KBW Bank Index is a benchmark stock index of the banking sector, representing large U.S. national money center banks, regional banks, and thrift institutions.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

A share buyback involves a company buying back its own shares.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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