

# écOtéra

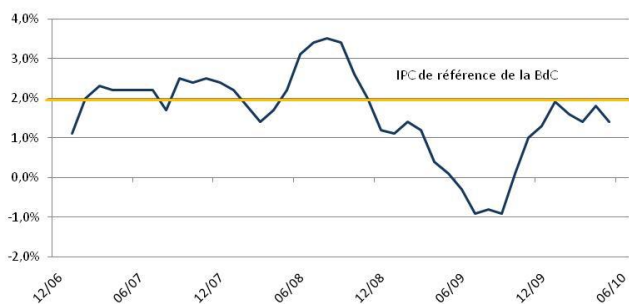
Weekly  
review



## Financial news

In May, the Consumer Price Index (CPI) rose 0.3%. This increase can essentially be explained by rising prices for electricity (4.2%), fresh produce (3.2%) and lodging for travellers (4.4%). The inflation rate decreased from 1.8% in April to 1.4% in May on an annualized basis. However, in a context where industrial capacity utilization rates are nearing their full potential (see previous issue of *écOtéra*), there are fears of a resurgence of inflationary pressures. One could therefore expect the Bank of Canada to raise its key interest rate (for a second time in a row) by 25 basis points the next time its directors meet, which will be in mid-July.

**Indice des prix à la consommation**  
variation annuelle en %



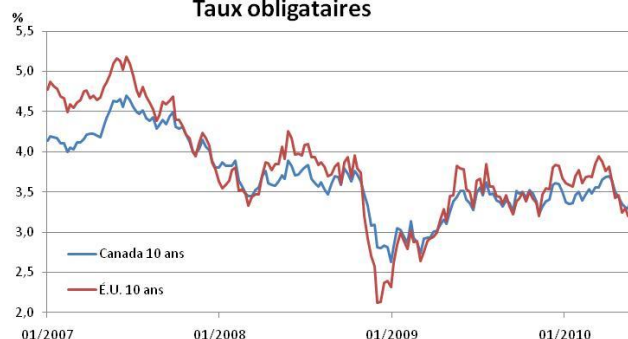
Source: Statistique Canada, Otéra

In the U.S., the financial news was so-so last week. Construction starts went from 659,000 in April to 593,000 in May, a 10% drop. Moreover, construction permit requests dropped 5.9% in May. According to the U.S. Conference Board, the Composite Leading Indicator grew 0.4% after remaining level through April. Finally, there is still no inflationary pressure in the U.S. In fact, their own CPI went down 0.2% in May after dropping 0.1% in April. The lack of upward pressure on consumer prices combined with an upturn in financial risks will most likely incite the Federal Reserve to keep its guide rate unchanged for the rest of 2010.

## The bond market

The latest round of disappointing statistics in the U.S. combined with weak inflationary growth kept long-term bond rates trending downwards. This inflationary languor is in fact compelling the Federal Reserve to keep its key interest rate low through 2010. The ten-year bond rate in Canada posted a drop of 7 basis points to settle at 3.32%, while its U.S. counterpart dropped a single basis point to end the week at 3.23%.

**Taux obligataires**



Source: Bloomberg

## The Canadian corporate debt market

Two weeks ago, corporate bonds were issued to the tune of \$3.1 B in the primary market, including a surprise issue by the Royal Bank of Canada consisting of \$1.5 B of subordinated Class 2b debt (Aa1/A+/AALow) in accordance with OSFI, as opposed to the initially planned amount of \$500 M. The securities were issued at a fixed rate of 171 basis points above GoC 2.5/15, and RBC has the option of converting the interest rate to a floating rate 141 basis points above the CDOR any time as of June 15, 2015. This new type of convertible bond could serve as a precedent for other Canadian banks seeking to issue debt complying with OSFI requirements in terms of the Basel II capital standards.

Last week, 1.5 billion dollars' worth of corporate bonds were issued, including a \$350-M issue of 10-year bonds by Loblaw's (BBB/BBB). The demand for these securities was strong (54 investors), and traded at 178 basis points above GoC 3.5%/20.

## The debt market

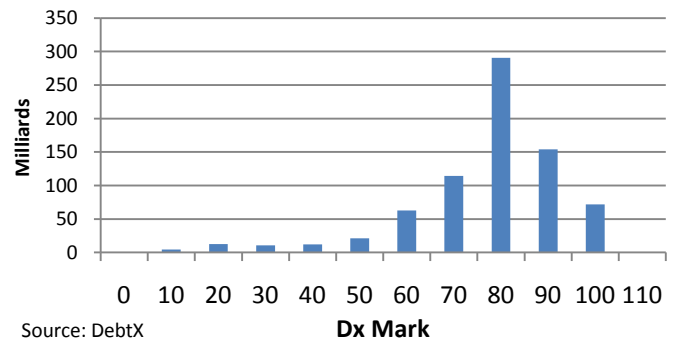
The annual general meeting of the CMSA, now known by the name of the CRE Finance Council, took place last week in New York. Here are the broad strokes of the topics discussed:

- In terms of new CMBS issues, many participants pointed out how difficult it was to assemble a critical volume of loans to structure a new issue. The main reasons cited were weak borrower demand for conduit-type loans, a relatively small number of properties with low debt, and the difficulty of selling securities in the absence of additional guarantees and/or of very conservative origination.
- As far as commercial mortgage loans are concerned, the insurance companies have been providing some strong alternatives to the CMBS sector, mainly for trophy properties by offering very low pricing.
- In terms of regulatory concerns, there has been a lot of uncertainty surrounding the possibility of compelling originators of new issues to actually hold some of the new securities issued.
- Investors have been demanding greater transparency from special servicers regarding information released about accounts in default.
- Most participants are anticipating delinquency to reach 11% or even 12% by the end of the year and a slow return of financing availability.
- Because it is mostly driven by demographic factors, the multi-family residential sector is assumed to be the first to rebound. On the other hand, the office sector will see its delinquency rate increase on the short term due to long-term leases expiring and tenants who may not be in a position to renew their rental contracts.

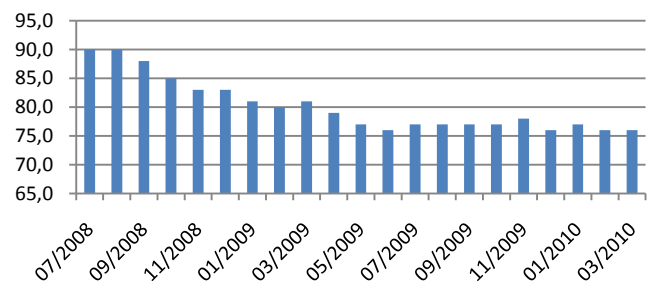
S&P has just completed its review of 217 fusion- and conduit-type CMBS issues in light of the new rating criteria it introduced last June. At the time, S&P rated 3,570 of the 4,467 bonds in the 217 issues as "credit watch negative." The upshot of the review, which ended on May 27, 2010, was that 3,057 bonds were downgraded, 511 remained the same, and only 7 improved. As anticipated, the downgrading was concentrated in the 2005 to 2007 cohorts. 33% involved 2007 issues, 27% involved 2006 issues and 23% involved 2005 issues. Among the 217 transactions examined, 34.1% of AAA-rated bonds were downgraded. Of the 164 AM classes and 183 AJ classes downgraded, 31 and 84 respectively lost their "investment grade" status.

The total value of the loans that collateralize American CMBS, as assessed by DebtX, increased to 76.4% at the end of April from 75.9% (price/balance) at the end of March. According to Kingsley Greenland, CEO of DebtX, "The increase in U.S. CMBS collateral prices was the result of tightening credit spreads and a flattening of the Treasury yield curve."

### Valeur totale des prêts US \$



### Prix (moyenne pondérée) en % du solde



For its part, Morgan Stanley is raising US\$4.7 B for its Real Estate Fund VIII, whereas it initially targeted US\$10 B. Many clients evidently decided not to invest with Morgan Stanley any longer after incurring heavy losses with them during the economic crisis. The bank incidentally mentioned that it is expecting to lose \$US5.4 B on an \$8.8-B fund launched in 2007. As an example, the Washington State Investment Board had invested US\$880 M in two previous vehicles, but decided against investing in the new MS fund.

The secondary U.S. CMBS market started climbing last week, and spreads tightened by about 15 to 25 basis points in the Super Senior tranches. In lockstep with the recovery of stock markets, CMBS investors seemed to have regained some confidence after the CREFC assembly. Although still performing below the average over the last six months, the demand was also picking up, with US\$300 to 400 M every day on the bid lists

| Fixed Rate (Conduit) | Avg. Life | Spread (bp) |              |            |
|----------------------|-----------|-------------|--------------|------------|
|                      |           | 6/16        | Week Earlier | 52-wk Avg. |
| AAA                  | 5.0       | S+182       | S+199        | +264       |
|                      | 10.0      | S+373       | S+384        | +486       |
| AA                   | 10.0      | S+2,665     | S+2,615      | +3,002     |
| A                    | 10.0      | S+3,205     | S+3,136      | +3,681     |
| BBB                  | 10.0      | T+4,468     | T+4,414      | +5,294     |

### ASKING SPREADS OVER TREASURYS

10-year loans with 50-59% LTV

|              | 6/11 | Month Earlier |
|--------------|------|---------------|
| Office       | 235  | 247           |
| Retail       | 225  | 236           |
| Multi-family | 209  | 225           |
| Industrial   | 223  | 235           |

Source: Trepp

Source: CMA, June 18, 2010