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écOtéra

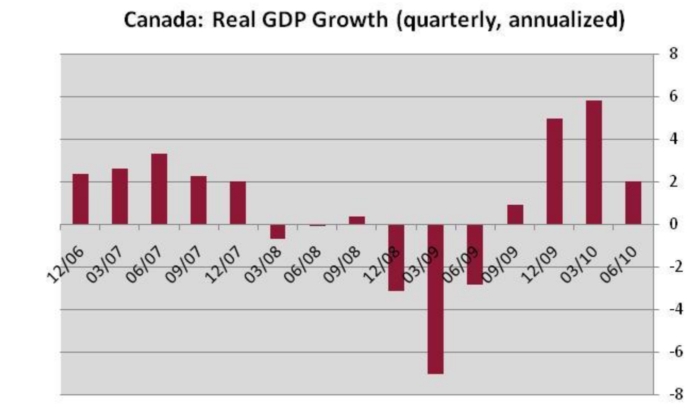
Weekly review

Otéra
Caisse de dépôt et placement du Québec

Financial news

According to Statistics Canada figures released on August 24th, retail sales climbed 0.1% in June, after three consecutive monthly decreases (-0.2% in May). This increase is essentially due to the automotive sector, which posted a gain of 2.1%. Bracketing this sector would turn the 0.1% increase into a 0.5% drop. The fact that retail sales are back in positive territory is good news. Combined with the 0.8% expansion in discretionary spending during the month, they pushed real GDP up to 0.2% for June, a noticeable improvement over April and May.

According to this week's figures from Statistics Canada, the GDP progressed 2.0% on an annualized basis during the second quarter of 2010. Although this figure was slightly less than the 2.5% expected, the overall picture of the Canadian economy pretty closely reflects the expectations of most economists. The output gap (i.e. the spread between the actual and potential levels of the GDP) continues to close, which should theoretically prompt the BoC to decree another increase in its key interest rates in early September in order to counter renewed inflationary pressures. On the other hand, the growth of the American economy, unsteady though it may be, could induce monetary authorities to opt for a few months' break in the monetary tightening cycle.

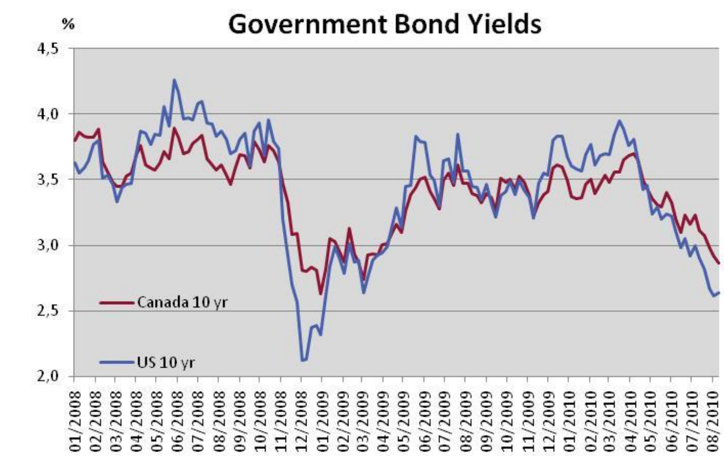


Source: Bloomberg

In the U.S., despite the revised slight drop of the real GDP growth (from 2.4% to 1.6%), the economic news for the past week was more encouraging. New orders for durable goods increased 0.3% in July after a 0.1% decrease in June. Household consumption resumed its upward climb, posting 0.4% on an annualized basis in July after levelling off in June. Personal income increased 0.2% in July after also languishing in June. The U.S. Department of Labor logged 473,000 new applications for unemployment insurance in the week ended August 21st, i.e. 6.2% fewer than the week before (and its lowest level since July 24th). Finally, according to a U.S. Conference Board survey, consumer confidence is up again in August, after two downward-trending months. Its index went from 51.0 to 53.5, but despite the good news, the variability in the indicators over the last few months suggests that economic recovery remains a slog south of the border.

The bond market

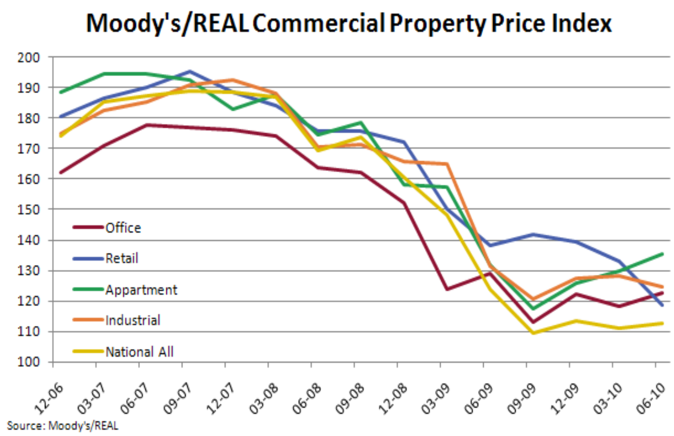
Despite the concerns over economic recovery in the U.S., the long-term bond market was somewhat bolstered by the latest North American statistics about the economy and inflation, as well as the recent speech by Fed president Ben Bernanke, who reiterated his agency's resolve to apply whatever measures are necessary in support of his country's economy. The result was that the ten-year bond rate in Canada dropped 5 basis points to 2.84%, while its U.S. equivalent climbed slightly (2 b.p.) to close the week at 2.58%.



Source: Bloomberg

The debt market

After three months on the rise, the Moody's/REAL CPPI (commercial property price index) sloped downward again, posting a 4% slide in June. This places us 0.9% lower than at the beginning of the year, but 4.2% higher than the bottom reached in 2009. Transaction volume is back on the rise as well, reaching US$2.1 B. The number of repeat sales transactions, on which the index is based, is also up: 43% in this case. According to Moody's, this might be an early indication that buyers and sellers are starting to agree on market clearing prices, which in turn would lead to even more sales and thus a more reliable, less volatile index. We will need to wait several months for confirmation, however. In Q2 2010, prices increased in the apartment and office sectors (+4% and+3.9%, respectively). On the other hand, industrial and commercial property prices posted respective decreases of 2.9% and 10.9%.



According to figures provided by the American Council of Life Insurers (ACLI), U.S. insurance companies originated US$5.9 B in commercial real estate loans in Q2 2010. This represents 20% more than in Q1 and fully 27.6% more than in the same period of 2009. Although the number of loans originated by insurance companies seems to have increased slowly over the last few quarters, it remains resolutely below pre-crisis levels. In the second quarters of 2003 to 2008, for example, insurance companies originated between $7.9 B and $12.7 B in commercial mortgage loans.

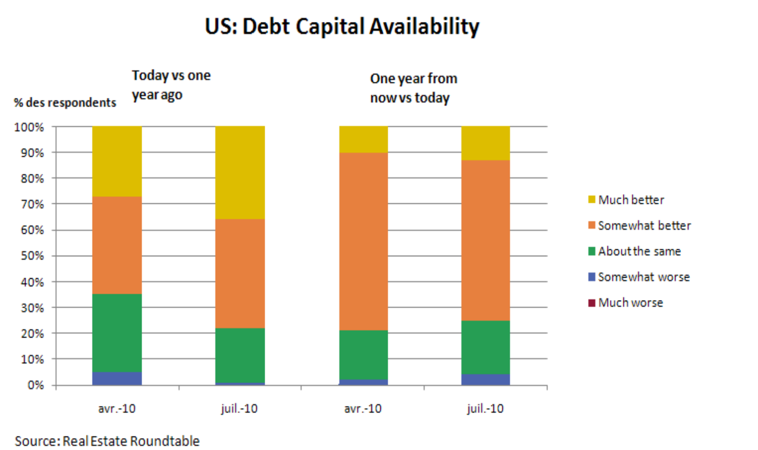
The average cap rate reported by the ACLI climbed to 7.8%, after a major decrease in Q1. Conversely, the average charged coupon rate dropped considerably to settle at 6%. The drop can be attributed to a decrease in government bond rates and to a tightening of commercial mortgage spreads. The average spread reported for Q2 2010 was 312 b.p., substantially lower than in Q2 , but nowhere near the 124 b.p. seen in Q2 2007.

Loans in the office or retail sectors were most favoured by the insurance companies and respectively accounted for 39% and 27% of the loans originated in Q2. On the credit performance side of things, the loan portfolio held by insurance companies remains very solid, with a delinquency rate of only 0.29%, i.e. 0.2% lower than the peak of the current cycle, reached last quarter.

Wells Fargo is apparently on the verge of restarting its CMBS conduit business. In fact, the bank hired over twenty bankers and support personnel to increase loan originations and to pool them into CMBS. "We believe there is going to be a resurgence of CMBS, and we are investing in anticipation of it" said Ed Blakey, head of commercial mortgage lending and servicing. "Our pipeline is growing, and we intend to be a leader of this market." In the same spirit, Barry Sternlicht, chairman and CEO of Starwood Property Trust Inc., declared on August 10th that the CMBS markets were wide open once again and that they suffered from too little supply rather than a lack of demand from buyers.

Special servicers, for their part, seem to be increasingly using principal reductions rather than liquidations as workout strategy. According to a Wells Fargo report, there were only 4 CMBS loan principal reductions in 2008, against 14 in 2009 and already 25 in 2010. In the past, loan principal write-downs were never a significant loss cause, as opposed to liquidations. Today, recent reductions reportedly accounted for $170 M in losses, most often affecting loans originated between 2005 and 2007. Office-type properties seem to be the principal source, followed by retail properties.

Although a modest improvement is anticipated for the coming year, most survey respondents are apprehensive about the fragility of the recovery. This is the basic message of the Real Estate Roundtable's Q3 2010 survey. Similar to the one conducted by FPL/REALpac in Canada, this poll queries 110 senior executives from the U.S. real estate industry to determine the pulse of the market. That industry's confidence index, called the Real Estate Roundtable Sentiment Index, dropped 2 points to 74 in Q3. According to one respondent: "The only certain thing in the world at the moment is uncertainty. Until companies begin re-hiring and the consumer regains confidence, we will remain stuck in the ditch. It would help tremendously for the government to get out of the way…It's pretty tough to play the game when they keep changing the rules". According to another, there is too much capital chasing the few good deals available. In general, some increase in valuations was expected, but survey respondents underlined the gap between class A properties and all other property types.



Despite a steady succession of discouraging economic news, prices in the secondary commercial mortgage-backed securities market have remained stable; the spreads are not increasing. The AM bonds attracted a particular amount of attention, as a few securities dating back to 2005, 2006 and even 2007 were trading above 100 ¢/$ for the first time ever(their coupons exceed the prevailing rates of newly issued bonds).