Commercial Mortgage Commentary

Market News

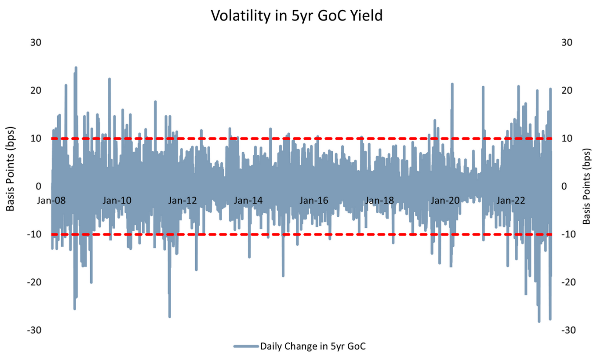
U.S. Banking Crisis Roils Financial Markets

Friday March 10th marked a major setback for the global economy after a run on deposits forced Silicon Valley Bank (SVB), the 16th largest U.S. bank by assets, to become insolvent. Its closure at the hands of federal regulators marked the second largest bank failure in American history. Liquidity concerns quickly spread to other regional banks with lower capital requirements and less diverse deposit bases. Just two days later, Signature Bank of New York would fall, becoming the third largest bank failure in U.S. history. The contagion spread as far as Switzerland with the country's central bank forcing the takeover of struggling Credit Suisse by rival UBS after the former came under immense liquidity pressures. Both banks are considered global systemically important banks and are among the largest in the world. Back in America, the federal government sought to bring stability to the market by making the swift decision to guarantee all uninsured deposits at SVB and Signature. Meanwhile, the Federal Reserve addressed liquidity pressures across the banking sector by making hundreds of billions of dollars available through the newly created Bank Term Funding Program and other programs.

The factors that led to SVB's ultimate demise have been well documented, but in summary, a sharp rise in interest rates over the past year put pressure on the bank's depositors while simultaneously hammering the value of its assets. SVB, as a result of the heavy tech company exposure in its clientele, saw a massive influx of deposits during the pandemic as easy monetary policy allowed tech companies to earn massive valuations and raise mountains of cash. Between December 2019 and December 2021, SVB saw its deposits rise 204% from $62 billion to $189 billion. The challenge for SVB was that much of these deposits were invested in longer-term government bonds and mortgage-backed securities – about $125 billion worth at the end of 2021 – and as interest rates rose rapidly to quell inflation, the value of these bonds plummeted. At the same time, tech valuations fell sharply, crimping these companies' ability to raise capital and forcing them to draw on the mountain of deposits on hand at the bank. With clients eager to access their cash, SVB was forced to sell large portions of its securities portfolio to meet withdrawals and in the process realized large losses on those investments. On March 8th, the bank sought to raise several billion in equity to shore up its balance sheet, a decision that ultimately spooked depositors and caused a run on the bank. In the following days, clients attempted to withdrawal amounts equivalent to about 80% of the bank's total deposits, rendering it insolvent.

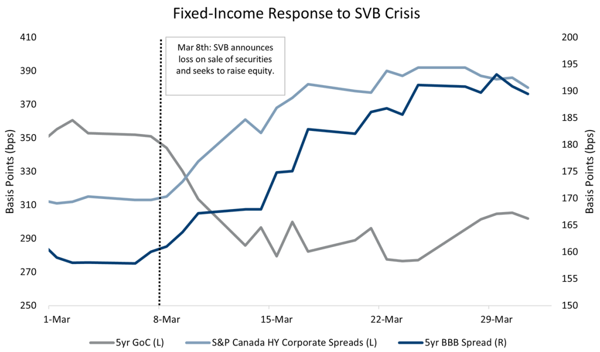
The repercussions in Canada were primarily felt in bond markets. Government bond yields plummeted some 60-80 basis points (bps) in the weeks following as capital fled toward lower risk assets. Fixed-income volatility climbed to levels unseen since the Global Financial Crisis. The graph on page 2 illustrates this rise in volatility by tracking day-over-day changes in the yield on 5yr Government of Canada (GoC) bonds going back to 2008. While the frequency of days where yields moved by more than +/- 10bps had increased since central banks moved aggressively to fight inflation at the start of 2022, no month over the entire timeframe saw more of these large swings than March 2023 with 9. Volatility in commercial mortgage rates has become more acute as volatility in key base rates has accelerated.

Credit spreads across fixed-income markets were also volatile. In Canada, the spread over GoC on 5yr BBB corporate bonds spiked as much as 30bps in the latter weeks of March. Five-year corporate BBB spreads had been declining consistently over the previous 4 months after reaching a 52-week high of 202bps at the end of October. The recent spike saw spreads close March within a few basis points of this high at 190bps.



Source: Bloomberg

Further up the risk curve, spreads on the S&P Canada High Yield Corporate Bond Index climbed some 77bps within a matter of days following SVB's failure and closed the month at 380bps. As for commercial mortgage markets, some lenders have reported upward pressure on mortgage spreads in response to the banking crisis and fixed-income market volatility, but for now, it seems that spreads have remained in line with where they were prior to the crisis (see Commercial Mortgage Rates section for more details).



Source: Bloomberg, S&P

While U.S. government intervention appears to have stemmed the panic in global financial markets for now, the factors that led to SVB's failure in the first place have not entirely disappeared. Interest rates still stand at levels unseen in over a decade, meaning that asset values at banks remain severely depressed. In the U.S., the Federal Deposit Insurance Corporation (FDIC) estimates that banks in that country held $620 billion in unrealized losses at the end of 2022. An estimate by professors at New York University put that number higher at $1.7 trillion – equivalent to about 80% of total bank equity capital in America.

Looking ahead, concerns are growing about the commercial mortgage portfolios at these already struggling U.S. regional banks. It is estimated that regional banks account for somewhere between 65-80% of the $5.5 trillion in outstanding multi-family and commercial mortgages in Amrica. Concerns stem from these banks ability to refinance maturing mortgages at higher rates at the same time that underwriting standards have tightened, especially for those on lower quality office buildings dealing with elevated vacancy rates, lower occupancy and declining rents. Time will tell if unrealized losses and maturing commercial mortgages result in further banking turmoil, or if actions to date have been enough to stave off further crises.

Base Rates

The Bank of Canada (BoC) held its key policy rate flat for the first time in over a year and concerns of a global banking crisis brought about heightened volatility in bond markets. Additionally, an announcement by the federal government on the future of the Canada Mortgage Bond (CMB) program led to limited CMB bond market liquidity through the final week of March. This had the effect of upending the origination process for CMHC insured mortgages, although the market has somewhat stabilized since.

Bank of Canada Rate

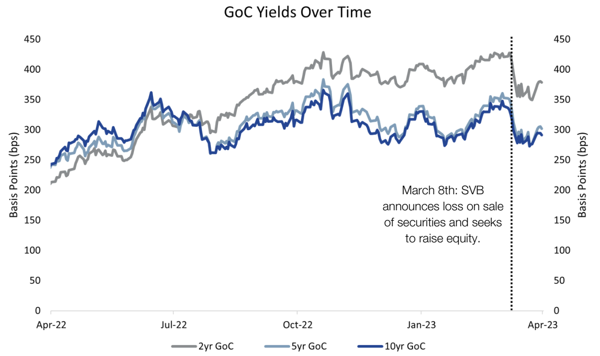
At its March 8th interest rate decision, the BoC became one of the first central banks among developed economies to pause its aggressive rate tightening cycle, holding its key policy rate at 4.50%. Since March 2022, the bank raised rates 8 times for a cumulative total of 425bps, marking one of its sharpest tightening campaigns in history. The pause, restated by the BoC on April 12th, will give the bank time to assess how rate hikes to date are impacting inflation and the economy.

Headline inflation has continued to fall month-to-month since reaching a 4-decade high of 8.1% in July 2022, with the Consumer Price Index (CPI) declining to 5.2% in February. That said, less volatile measures of core inflation continue to hover around the 5% mark, drawing concerns that more work may be needed to drive inflation back down to its 1-3% target range.

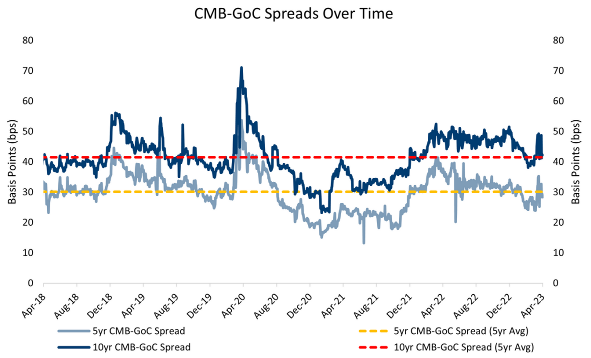
On the economic front, Canada's economy stalled in Q4 2022 with growth flat over the 3-month period. However, it has proven quite resilient through the first 2 months of 2023 with growth of 0.5% MoM in January and 0.3% MoM in February. Meanwhile, Canada's labour market continues to remain historically tight and wage growth elevated. The country added 35,000 jobs in March on top 22,000 in February and 150,000 in January, holding the unemployment rate firmly at 5.0%. Average hourly wages were up 5.3% YoY in March.

Should inflation remain sticky, the labour market hold tight and GDP growth continue to outperform, the BoC may be forced to deliver additional rate hikes in the months ahead. However, instability in the global banking sector, and tightening credit conditions as a result, could make it difficult to follow through with additional tightening.

Government Bond Yields



Source: Bloomberg



Source: Bloomberg

Government bond yields slipped some 60-80bps in the wake of the SVB collapse and endured large intraday swings throughout the remainder of March. Yields began to climb again in the final days of the month with the 2yr, 5yr and 10yr GoC closing at 379bps, 302bps, and 292bps, respectively. At current levels, both 5yr and 10yr yields have slipped roughly 10-15bps below their 12-month moving average, while the 2yr GoC sits about 30bps above its 12-month average. On the short end of the yield curve, the 1yr GoC closed the quarter at 422bps, just over 25bps below where the current BoC policy rate stands at 450bps. This implies that, as at the end of Q1 2023, bond markets were forecasting the BoC to cut rates by 25bps over the following year.

Canada Mortgage Bond Yields

As with GoC yields, 2yr, 5yr and 10yr CMB yields fell some 50-70bps in the weeks following SVB's failure before retracing some of those declines to close the quarter at 393bps, 330bps and 334bps, respectively. The CMB market faced additional turmoil on March 28th when the federal government announced in its 2023 fiscal budget that it is considering whether to consolidate the CMB program with the regular government of Canada borrowing program. As indicated by the following graph, CMB bonds trade at a yield premium to GoC bonds – especially in periods of heightened market volatility – despite carrying the same credit rating and holding a full guarantee from the federal government. As per the budget, consolidation of the two programs "represents an opportunity to reduce debt charges and reinvest savings into important affordable housing programs." CMB trading ground to a near halt following the announcement, resulting in a spike in CMHC insured mortgage pricing and some challenges to hedging and rate locking activities. Activity improved in the following days and has generally returned to normal for the time being, but much uncertainty remains around the future of the CMB program. The government indicated that it intends to undertake consultations on the proposed consolidation and will provide further guidance on the matter at its fall economic and fiscal update.

Commercial Mortgage Rates

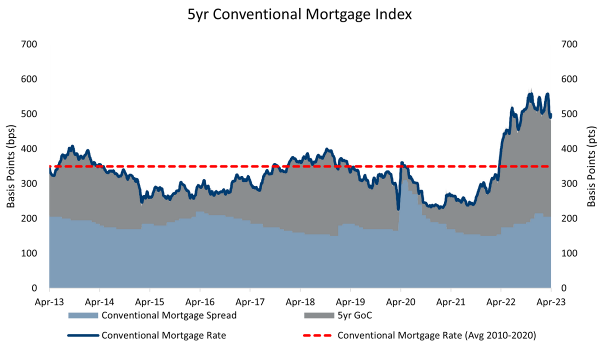
Conventional

Conventional mortgage spreads compressed in Q1 for the first time in over a year after rising considerably through 2022. As per research from Intellifi, a mortgage services firm, lenders were reporting that 5yr market leading spreads had declined through January and February to as low as 160-170bps over GoC. Supressed conventional deal flow and high capital availability saw lenders bidding competitively on the limited supply of top tier deals, driving spreads downward. That said, given limited activity in the conventional space, top tier pricing on observed transactions at Intellifi was higher in the 190-210bps range. Further up the risk curve, pricing was more difficult to gauge. Lenders generally remain cautious given heightened market volatility and economic uncertainty and, as a result, pricing for the standard conventional deal was seen anywhere from 210-260bps. Following the banking crisis of mid-March, it seems that for now most lenders have yet to report a decisive shift upward in pricing. However, many lenders have indicated the potential for a significant upward movement in spreads in the near-term given how far bond market spreads climbed and the effects that has on lender benchmarks and cost-of-funds.

Base Rate Changes Over Time (Delta in bps)							
Base Rates	2023-03-31	QoQ	YoY	2 Years	5 Years	10 Years
Bank of Canada Rate	**4.50%**	▲ 25	▲400	▲425	▲ 325	▲350
Canada Government 5yr	**3.02%**	▼-37	▲ 65	▲202	▲ 105	▲172
Canada Government 10yr	**2.92%**	▼-39	▲ 51	▲134	▲ 81	▲104
Canada Mortgage Bond 5yr	**3.30%**	▼-41	▲ 56	▲206	▲ 100	▲168
Canada Mortgage Bond 10yr	**3.34%**	▼-42	▲ 44	▲138	▲ 83	▲108
RBC Prime Rate	**6.70%**	▲ 25	▲400	▲425	▲ 325	▲370

Source: Bloomberg

CMLS Financial®



Source: Bloomberg, Intellifi

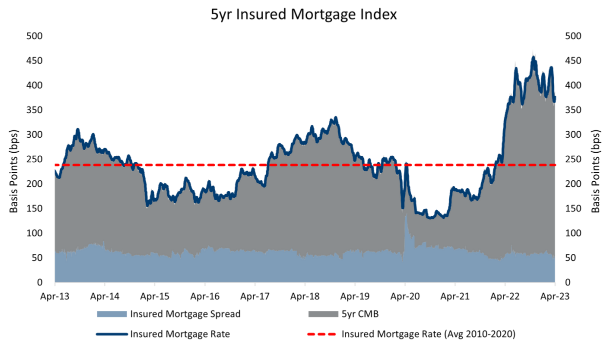
Looking at the 5yr Conventional Mortgage Index, all-in conventional rates hovered around the low-to-mid 5% mark for much of Q1 before falling to a close of 5.00% at the end of March. Declining GoC bond yields accounted for most of the decline. As for the 10yr space, activity remains quite limited given a sharply inverted yield curve and the general preference among both lenders and borrowers for shorter-term deals. That said, some lenders reported increased interest in longer duration loans in Q1 and have reduced their spread premium on 10yr deals to the 5-10bps range. Overall, Intellifi continues to see the 5-10yr term premium around 20-30bps. The 10yr Conventional Mortgage Index hovered around the mid 5% range for most of Q1 before declining to a close of 5.30% at the end of March.

Insured

CMHC insured multi-family has been one of the few bright spots in the commercial mortgage space in recent quarters with activity in Q1 remaining strong. As per Intellifi's 2022 Commercial Mortgage Survey, CMHC insured mortgages accounted for the largest share of commercial mortgage origination in Canada in 2022 with a market share of 37%, up 5 percentage points YoY. Subscribe to the Intellifi Commercial Mortgage Report here for a more in-depth summary of origination and market size trends in 2022 when it becomes available next month.

Market-leading insured spreads continued to fluctuate around the mid-40s over CMB through Q1. On a GoC equivalent basis, spreads declined through January-February in tandem with compression in CMB-GoC spreads before unwinding these declines in March. An average 5yr CMB-GoC spread of 30bps in March saw 5yr market leading spreads in the mid-70's over GoC, and an average 10yr CMB-GoC spread of 45bps put 10yr spreads around 90bps over GoC.

Looking at the 5yr Insured Mortgage Index, all-in insured rates were in the low-to-mid 4% range for much of Q1. A sharp decline in CMB yields in the latter half of March saw the index decline to around 3.75% at month end, offering some reprieve for borrowers. That said, the federal government's decision to examine whether to consolidate the CMB program with regular government of Canada borrowing significantly hampered liquidity in the CMB market. The incident put some upward pressure on spreads and challenged the origination process for certain lenders. Some lenders have since indicated that they're largely back to business as usual.



Source: Bloomberg, Intellifi

High Yield

Activity in the high yield space continued to remain quite supressed and reports from some lenders are that they are surprised more deal flow hasn't filtered down into this space given tighter underwriting in the conventional space. It appears that at current coupon rates, many borrowers are opting to either paydown debt with cash or raise equity in lieu of taking on higher yielding mortgage debt. As per Intellifi's latest lender sentiment survey, 55% of high yield respondents saw deal flow decline QoQ in Q1 from already depressed levels. Average low-high coupon responses from lenders in that same survey saw higher risk senior loans getting coupons in the 7.25-9.75% range, while subordinate debt was in the 9.50-13.00% range.

ABOUT CMLS FINANCIAL

CMLS Financial is one of Canada's largest independently owned mortgage services companies. Founded in 1974, we are proud to be Canada's Mortgage Company for over 45 years. With offices across the country, we provide a wide range of commercial lending services, residential real estate mortgages and institutional services.

For Financing Inquiries

STEVE BRYANT
Senior Vice President, Commercial
519.266.2307
steve.bryant@cmls.ca

FRANCA CERQUETI
VP & Managing Director, Western Canada
204.289.7367
franca.cerqueti@cmls.ca

ANTOINE TRONQUOY
VP & Managing Director, Quebec
514.231.1800
antoine.tronquoy@cmls.ca

CMLS Financial®