WCM July Newsletter

DID YOU KNOW

Raymond James Summer edition of WorthWhile magazine is out and available on our website.

In this edition you can read about ChatGPT, 'step up" in basis, and IRA charitable contributions.

MONTHLY COMMENTARY

It never rains, but it pours.

The impact of the current market conditions on Commercial Real Estate.

By: Rees Petersen, CFA®

DOING GOOD TOGETHER

Look to our Newsletters over the next couple of months for opportunities to join us in making a difference.

Integrity, diligence
& unwavering commitment

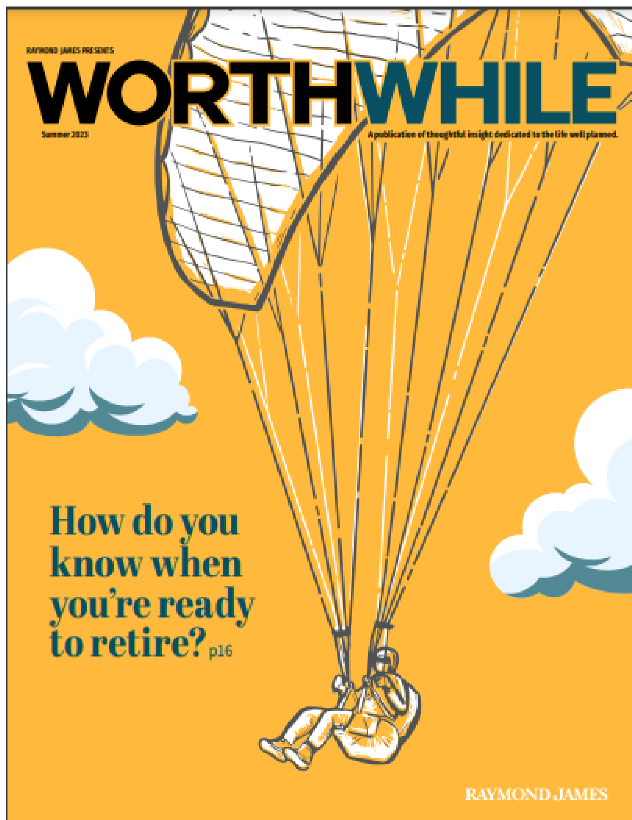
Thank you for the continued trust you place in us and our office. Our practice continues to grow because of you. Your referrals are the best compliment that you can give.

DID YOU KNOW ?

WorthWhile magazine:

You can see Raymond James WorthWhile magazine on our WCM Website. This Raymond James publication offers thoughtful insight to timely subjects. This summer printing will discuss the below contents including ChatGPT, Cost Basis Step Up, and Charitable contributions through your IRA.

You can access this publication on the Wasatch Capital Management website. You can also get pickup printed copies of this publication from our office in Cottonwood Heights.



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Cover

Pulling the retirement rip cord

Retiring – intentionally – before age 65 might be within your grasp. But no matter what age you are, how do you know if you're truly ready to retire? From staying connected and finding a sense of purpose to planning your financial goals, we answer your questions and help you explore your options around retirement readiness. p16

Investing

Riding the waves

Recessions, market volatility, economic turbulence – it's all been in the headlines lately. But we've seen it before. For investors with a long-term focus, we explore what past downturns and their subsequent recoveries have historically looked like, to help you take advantage of the opportunities. p22

Email us

WorthWhile wants to hear your thoughts. Please email worthwhile@raymondjames.com. Your email address will not be shared.

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It never rains, But it pours.

By Rees Petersen, CFA®

Bad times can indeed escalate and become worse. Unfortunate events, or circumstances, often compound and intensify, much like a torrential downpour following rain.

The next recession was supposed to be different. While we appeared to be heading into a mild recession in 2019, there were ample reasons to be optimistic the next recession would be kinder to commercial real estate (**CRE**):

- Construction levels were restrained compared with other recent expansions, so supply was generally balanced with demand;
- Most property types were enjoying either record- or cycle-high occupancy and rents, as tenant demand remained healthy, but not wildly strong;
- Leverage was moderate relative to asset values (low Loan-to-Value Ratios) and revenues (low Debt Service Coverage Ratios);
- Underwriting standards were generally sensible, particularly given the long (10-year) expansion that typically gives rise to risky lending as returns fall; and,
- Capital markets were highly liquid, as both equity and debt capital were ample.

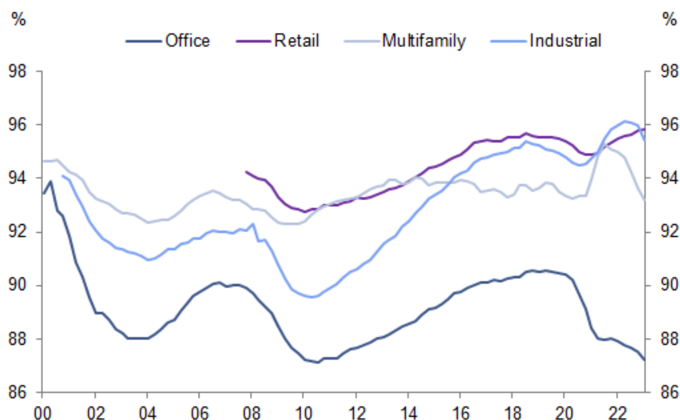
STORMS DON'T LAST FOREVER.

Item	YTD Change
Dow Jones Ind Avg	3.8%
S&P 500 Index	15.9%
EAFE Foreign Index	9.66%
Emerging Market Index	5.71%
Barclays Agg Bond Index	2.09%
10-Year Inflation Forecast	2.25%
Unemployment Rate	3.7%

**Market index data as of 6/30/2023*

Commercial real estate seemed positioned to weather the next economic storm, widely anticipated to be mild, especially compared with the last recession. Financial regulations put into place in the aftermath of the Global Financial Crisis were designed to protect the CRE sector - and its financial enablers - from its worst instincts.

With the conspicuous exception of the office sector, the Covid-19 recession did not fundamentally alter CRE's outlook. The economy recovered surprisingly quickly, and property fundamentals for occupancy of most real estate types, in most markets, followed suit.



Source: CoStar, Goldman Sachs Global Investment Research

Indeed, as shown in the chart above, property occupancy rates remained at historically high levels overall in both the public (REIT) and private real estate markets.

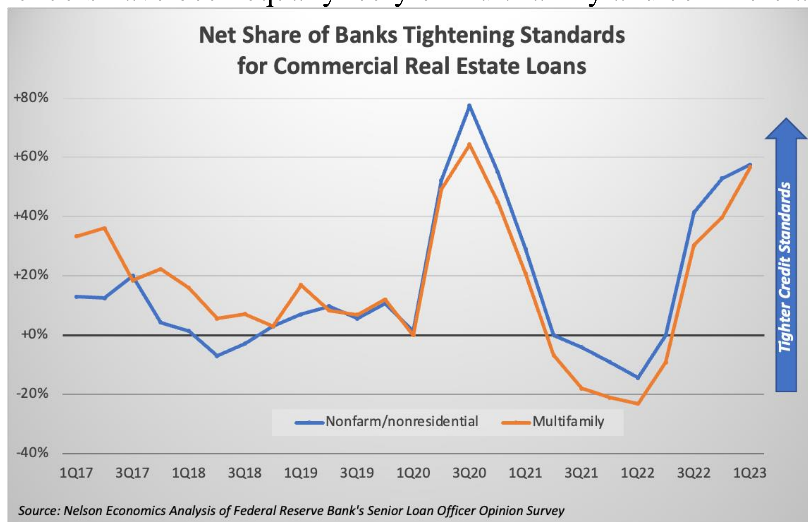
Yet, there is growing cause for concern. The work from home bill is coming due. Commercial real estate — spanning offices, apartment complexes, warehouses and malls — has come under substantial pressure in recent months. Prior to the pandemic, 95% of US offices were occupied. Today, that number is closer to 47%. The drop wiped out $453 billion of commercial real-estate value, according to the US National Bureau of Economic Research (NBER). The Green Street Commercial Property Price Index® tracks the pricing of institutional-quality commercial real estate. This index is down 15% from its March 2022 peak.

The impacts may be greater than might have been expected even a few months ago. A recent survey by Land & Buildings, of 495 medical lab / life science buildings showed this sector of real estate was surprisingly mired in the same work from home trends as office buildings. Most analysts have been insistent that the medical labs sector of CRE would be the most insulated from work from home trends. Land & Buildings used cell phone data showing the number of employees in the buildings, for more than 60 minutes, was down 50% in the period from March 2022-Feburary 2023, compared March 2019 to February 2020.

The rapid increase in interest rates over the past year has been painful, since purchases of commercial buildings are typically financed with large loans. Office properties have been getting hammered the hardest. Hybrid work remains popular, affecting the rents many building owners can charge. “You have fundamentals under pressure from work from home at a time when lending is less available than [it has been] over the last decade,” said Rich Hill, Head of Real Estate Strategy & Research at Cohen & Steers. “Those two factors will lead to a pretty significant decline in valuations.” Trouble may build as the economy slows. Hill predicted that commercial property values could plummet by as much as 30% this year, making refinancing much more difficult for property owners who will likely be asked by banks to put up more equity.

What has changed? Commercial real estate markets are being starved of the credit they need to function. CRE is a debt-driven business. During a credit crunch, monetary supply is limited, and conditions are more challenging for taking risks, making banks and other financial institutions less willing to extend credit. Commercial mortgages function differently from 30-year fixed rate loans that form the bedrock of the US housing market. Investors borrow for shorter periods, typically less than 10 years, and structure loans with large balloon payments at the end. These loans are designed to be refinanced. If they are not, the owner FedExes the keys back to the lender. Landlords rely on debt to finance building and tenant space improvements needed to attract or retain new tenants. Since the Global Financial Crisis, instead of foreclosing on properties whose value was plummeting, banks and insurance companies lengthened loan terms and ignored short-term valuations. When Covid-19 brought the economy to a standstill in March 2020, banks and insurance companies turned to this "extend and pretend" play once again. "A rolling loan", they said, "gathers no loss." Now the air has been sucked out of inflated valuations. Banks and insurers are under increased scrutiny from regulators and ratings companies over their real estate lending.

Banks started tightening lending standards in early 2022, when the Federal Reserve Bank began to slow the economy by hiking rates. The Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices shows lenders have been equally leery of multifamily and commercial assets like offices and retail.



My sense is one of the biggest issues facing commercial real estate today is the strain on banks. In the current environment, banks have less capacity to stomach financial blows. Anxiety about bank lending to commercial real estate is beginning to spiral, prompting customers to pull their deposits. Regulators, embarrassed about the second and third largest bank failures in US history happening this year, are in no mood to be accommodative. Asked about the danger posed by commercial real estate, Federal Reserve Chair Jerome Powell said, in May, that banks remained "strong" and "resilient." However, attention is increasingly being focused on the links between US lenders and the property sector.

Smaller financial institutions are grappling with outflows of deposits to larger peers and money-market funds offering better returns. Plus, bank investments in government bonds, once considered low-risk, are notching up losses as interest rates climb. The worst outcome, according to Neil Shearing, Group Chief Economist at Capital Economics, is that a "doom loop" develops:

1. Questions about the health of banks with sizable exposures to commercial real estate loans cause customers to pull deposits.
2. This forces lenders to demand repayment — exacerbating the sector's downturn and further damaging the banks' financial position.
3. This triggers more deposit outflows in a vicious cycle.

“You have fundamentals under pressure from work from home at a time when lending is less available than [it has been] over the last decade,” Rich Hill, head of real estate strategy at Cohen & Steers, told CNN. “Those two factors will lead to a pretty significant decline in valuations.”

“I’m more concerned than I’ve been in a long time,” said Matt Anderson, Managing Director Applied Data & Research at Trepp, which provides data on commercial real estate. Signs of strain are increasing. The proportion of commercial office mortgages where borrowers are behind with payments is rising, according to Trepp.

High-profile defaults are making headlines. Earlier this year, a landlord owned by asset manager PIMCO defaulted on nearly $2 billion in debt for seven office buildings in San Francisco, New York City, Boston, and Jersey City. On 6 June 2023, Park Hotels & Resorts, owners of the 1,921-room Hilton San Francisco Union Square and the 1,024-room Parc 55 San Francisco, announced the company will default on its $725 million nonrecourse, commercial mortgage-backed security loan, which is scheduled to mature in November.

Defaults on commercial real estate loans represent a potentially serious problem for banks, given their extensive lending to the sector. Goldman Sachs estimates that 55% of US office loans sit on bank balance sheets. Regional and community banks — already under pressure after the failures of Silicon Valley Bank and Signature Bank in March — account for 23% of the total. Signature Bank had the tenth biggest portfolio of commercial real estate loans in the United States at the start of the year, according to Trepp. First Republic Bank, which received a $30 billion lifeline in May 2023 from JPMorgan Chase and other major banks, had the ninth largest. However, both had a much a greater share of their assets tied up in real estate than bigger rivals such as Wells Fargo, the leading US lender to the sector.

While the rise in commercial property prices over the past decade has provided developers and their bankers with a measure of protection, the pain could increase in the coming months. CRE owners will see a wave of investments that must be refinanced in the next two years. The Mortgage Bankers Association estimates that "of approximately $4.4 trillion of outstanding commercial and multifamily mortgages, $728 billion (16%) matures in 2023 with another $659 billion (15%) maturing in 2024."

Plummeting valuations will make refinancing tougher for property owners, who are likely to face requests from banks to put up more equity. Some owners — especially of older, less desirable office buildings — might decide it’s not worth the expense given the market climate and simply mail in the keys. While banks may prefer that option to kickstarting drawn-out, expensive foreclosure processes, it puts them in the difficult position of owning depreciating properties. “That is a scenario we will see now very often,” Christian Ulbrich, Chief Executive Officer of global commercial real estate services giant Jones Lang LaSalle, told CNN. The question, he continued, is what lenders will do in that situation, and whether banks are sitting on such sizable loan portfolios that they need to take “significant losses.”

Investors should understand conditions are likely to deteriorate further before they improve. Even a mild downturn will magnify the financing challenges as vacancies rise and rents fall, providing less support for new debt. In short, the credit crunch is sure to deepen, extending value declines and losses in commercial real estate. As recession problems deepen, commercial real estate’s debt time bomb gets worse. Property owners have already indicated they're going to walk away from loans, when neither cash flows, nor financing conditions make it worth keeping.

It's likely history won't repeat itself, but it will rhyme: While we should not expect to see the devastating losses of more recent recessions, property owners will nonetheless endure further pain. While such losses will create opportunities, savvy investors must factor in healthy discounts for continued turmoil in property capital markets, on top of declining property fundamentals. As the credit crunch continues, it will impact CRE borrowers desperate to get funding ahead of being forced into default. Banks increasingly want to walk away first, so they hopefully won't get stuck holding the bag.

Year-over-Year declines in all Bank Credit started last summer with Large Banks turning negative for the first time since 2011 - down $122B since mid-May 2023. Small and Foreign Banks are rapidly following suit.

Rees Petersen, CFA®

WCM Team This Month

Stan

Stan and his new grandson watching the NBA Finals. After 4 daughters and a granddaughter the pent-up demand for manly activities is real.

Nicola

Nicola 4th of July with her girls!

John

John went back home for dad’s 80th birthday party.

Rees

Rees & Lisa in East Millcreek at a wedding.

Matt

Matt and Sam at our office baby shower. Getting ready to welcome their first baby in a couple of weeks.

Jessica

Jessica and her family at Teton National Park

Jon

Jon and family enjoying one last American Dinner before sending Grandma back to Korea after a three month visit.

Susan

Susan and Tim

Stan Goodell, CFP®, Managing Director - Investments | 385-275-3792
Rees Petersen, CFA®, Vice President - Investments | 385-275-3607
John Clower, CFA®, Vice President - Investments | 385-275-3590
Reed Grant, Financial Advisor | 385-275-3797
John Bergerson, CFA®, MBA, Investment Portfolio Associate | 385-275-3608
Matt Brunner, Financial Advisor | 385-275-3795
Jon Metcalfe, MBA, Senior Registered Client Service Associate | 385-275-3793
Nicola Rand, Practice Business Manager | 385-275-3585
Susan Jackey, Senior Client Service Associate | 385-275-3799
Jessica Hymel, Senior Registered Client Service Associate | 385-275-3796

2750 E Cottonwood Parkway, Suite 520, Cottonwood Heights, UT 84121

1389 Center Drive, Suite 200, Park City, UT 84098

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