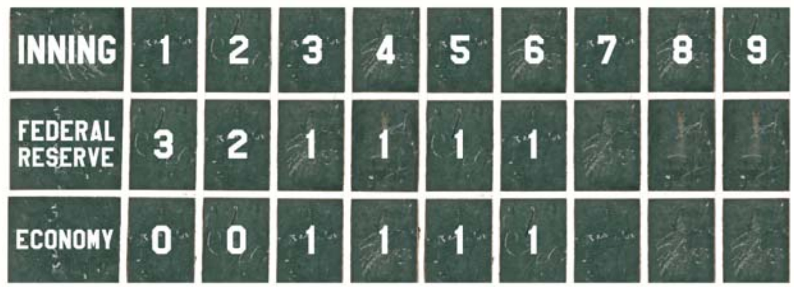
PCCP Market Commentary

Is It 2007 All Over Again?

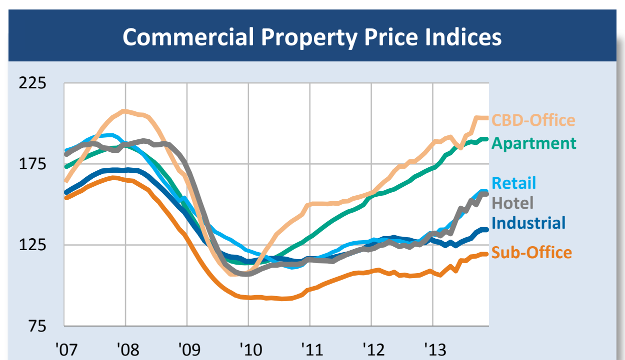
First Quarter 2014

It's year end, time for the traditional look back at the accomplishments of the year just concluded, and for a look forward at the opportunities to come. The U.S. stock markets are at record highs, despite hints that the Federal Reserve is starting to back off on its quantitative easing strategy. The Wall Street Journal reports that in numerous markets, housing prices are past prior peaks (although the numbers are uneven).[1] The U.S. Treasury is reflecting increased confidence in the economy, passing the 3.0% rate for the first time since 2011.[2] We have seen moderate GDP growth [3], a slowly declining unemployment rate[4] and increased liquidity in the capital markets since the recovery game began in 2009.



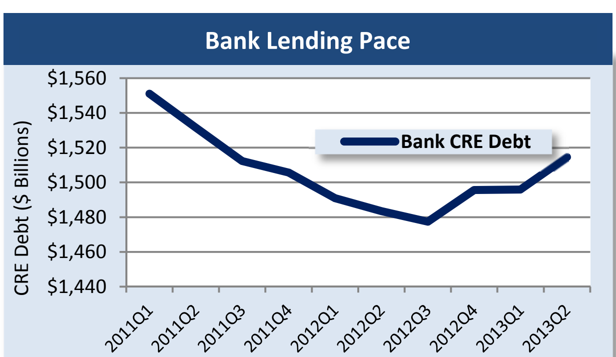
Commercial real estate was hit particularly hard during the Global Financial Crisis. We are often asked, "Where are we in the recovery?" In our baseball analogy, we are in the top of the 7th inning with the economy catching up to the Fed, but the game could go extra innings.

The availability of debt for commercial real estate in the U.S. has driven up prices and compressed cap rates, most dramatically for Class A properties in core markets. But we're not quite back to peak pricing *on average*, except for apartments and CBD office. Along with certain property types, some secondary and tertiary markets have faced rain delays and are still struggling to score back in the fifth inning.

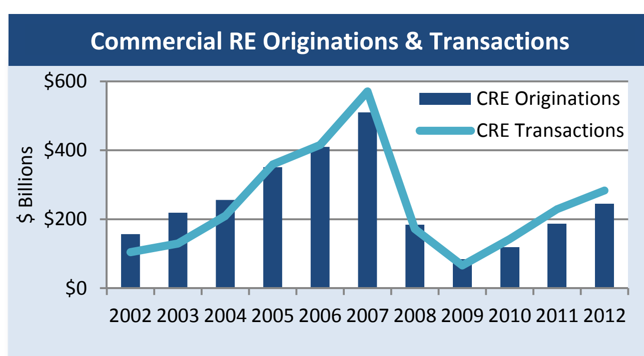


Source: Real Capital Analytics.

Liquidity is up. Loan originations are increasing across the board. Record low loan-to-deposit ratios are pushing banks back into real estate lending. Today, the total volume of commercial real estate bank loans outstanding equals mid-2007 levels.[5] This reemergence of credit will continue to drive transaction volume, and pricing, in all markets.



Source: Federal Reserve.



Sources: Real Capital Analytics, Mortgage Bankers Association.

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[1] *Wall Street Journal, Home Prices Back at Peaks in Some Areas,* December 30, 2013

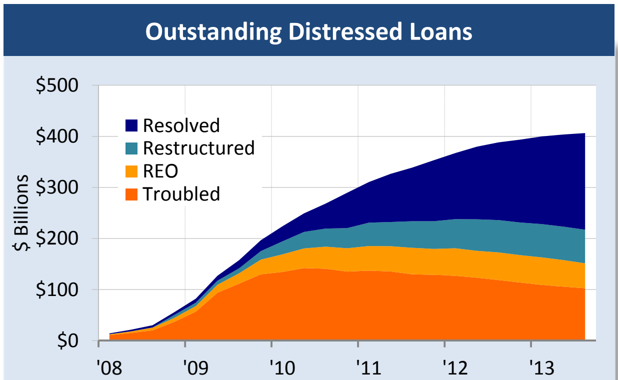
[2] *Bloomberg.com, Treasuries Advance as 10-Year Yields at Almost 3% Attract Buyers,* December 30, 2013

[3] *U.S. Department of Commerce, Bureau of Economic Analysis (2010-2012 GDP growth averaged 2.4% YoY. 3Q13 GDP growth was 3.6% QoQ)*

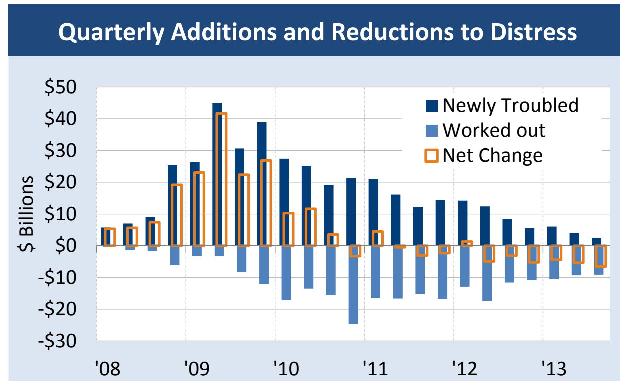
[4] *U.S. Bureau of Labor Statistics* (*unemployment as of 3Q12 was 7.3%, down from 10% three years prior)*

[5] *Federal Reserve (commercial real estate bank lending volume peaked in mid-2009 at the bottom of the market)*

In the distress arena, progress continues. CMBS delinquencies are at their lowest levels since February 2010, almost two percentage points lower than a year ago, and the proportion of mortgages in special-servicing is at a four-year low as of the end of November.[6] Low interest rates have helped counter the effects of battered property values and borrowers, lenders and special servicers have made some great plays to clean up previous errors made. Of the $406 billion of commercial mortgages that have become distressed in this cycle, approximately 63% have been worked out as of 3Q 2013.

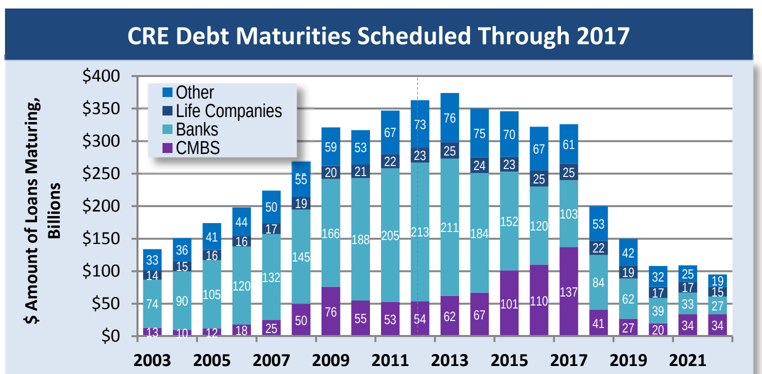


Source: Real Capital Analytics.



Source: Real Capital Analytics.

All of this is good progress. But we see some challenges ahead. The largest wave of maturities is now upon us, with approximately $1.7 trillion in loans coming due in the next three years.[7] With one-quarter of maturing CMBS loans expected to have a maturity gap of more than 30%,[8] distress may return to the market causing extra innings of play.



Source: Trepp, 2012 Q3, February 22, 2013.

Borrowers driven by fear of rising interest rates may refinance early and will be on the look-out for alternative sources for debt, particularly if rising rates eat into the profits of CMBS lenders and slow the issuance of bonds. With fixed rates for CMBS and agency lending now above 5%, a slowdown in the growth of issuance may become a harsh reality. Experienced debt investors that are able to recapitalize deals with a story have great potential to benefit from market imbalances and to earn high absolute and risk adjusted returns.

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[6] *Fitch, Commercial Mortgage Alert (delinquencies defined as the percentage of CMBS loans at least 60 days late, in foreclosure or in maturity default)*
[7] *Trepp*
[8] *PPR (maturity gap is the difference between future available refinance proceeds and balloon balances)*