

## Understanding the Credit Spread Effect on CRE Valuations

### Forget inverted yield curves, the bond market has much more insight to offer.

By Erik Sherman

Standard advice the public hears about bonds is that when the Treasury yield curve inverts, there's a good chance a recession is on its way. At some point. Eventually.

A new Green Street report by managing director Daniel Ismail and analyst Harsh Hemnani notes that bond markets have much more information to offer about asset valuations, if you know where to look. Bonds can offer terrific tools that play well to the realities of commercial real estate that are different from many other markets, such as equities, forex, and commodities trading.

Transactional data in these markets can be useful to spot trends as they develop in real time with constant mark-to-market feedback. CRE markets, however, tend to operate privately. Much of the information is delayed or available only through commercial feeds, all of which still have to wait for sales to process and all information to be available.

For CRE, watching bond spreads can offer insights otherwise unavailable. In some ways, the information is far more extensive. Global equity market issuance in 2022 was \$1 trillion, compared to the \$26.8 trillion for fixed-income issuance, according to the Securities Industry and Financial Markets Association. The difference in volumes indicates that available bond-type data is vaster.

One good place is in credit spreads. The differences between yields of various Treasuries and corporate bonds show the general sentiments of investors. When spreads widen, investors are becoming more cautious and need additional compensation for perceived risk. That means in general values of all assets should be falling. In many types of assets, that might be obvious because they're being repriced in markets, "although the greatest decline will occur where cash flows are sensitive to changes in the economy." Or spreads could tighten, meaning that investors perceive less risk, typically resulting in higher asset prices because less risk-related discount could be argued.

New economic data does cause investors to change their topline forecasts. However, shifts in credit spreads "serve as a more immediate canary in the coal mine," the authors say. It's faster to react to news, so looking at credit spreads in addition to macroeconomic fundamentals is important "when understanding the forces that are driving prices in both listed and private real estate deals."

Typically, spreads don't have an outsized effect on returns because changes tend to be limited. That isn't the case when stress is unusually high, like during the pandemic when rising spreads coexisted with poor REIT performance.

Investors should be aware that rising spreads have different effects in CRE, depending on the

property category. Hotels, malls, and offices feel a bigger impact, while less economically-sensitive sectors as manufactured homes, towers, and data centers are less sensitive.

Also, sometimes factors other than spreads will have a larger impact, such as the runup of interest rates last year.