Featured Manager News Private Credit

More funds shorting CMBS credit stress as long investors return

David Graubard • April 16, 2020 3 minutes read

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Investors that heeded the Canyon Partners Joshua Friedman's suggestion to short commercial real estate (CRE) and hold cash last March on Bloomberg TV feel like they won the lottery today.

The world's largest credit fund, Canyon, took a $1 billion area position against the CRE sector using the CMBX BBB, a CDS index which tracks the values of bonds backed by various commercial properties. The trade has been the 'Big Short 2' for its negative outlook on U.S. retailers and malls.

While investors often short the heavy retail exposed CMBX.6 and CMBX.7 BBBs, Canyon bet against the CMBX.11 which has more recent vintage deals. Canyon declined to comment for this article.

“The short trade worked out well for those investors who stuck with it long enough,” said one hedge fund manager. “But it was also not an easy trade. A lot of people lost money on the short trade that gave up too early, and for other people it worked out. Timing is everything.”

Illustrating the highs to lows since COVID-19 crisis began, consider this – the CMBX.6 BBB went from a high of $95 in mid-January to a low of $68 in early April and is now at $72 and CMBX 6 BB went from a high of $89 in mid-January to a low of $51 in early April and is now $54, the manager added.

Investors are coming back into the commercial mortgage-backed securities (CMBS) market gingerly. “Recently there has been some demand from both real money investors adding to longs and short covering,” he added.

April and May remittance reports from borrowers should give some clarity on how the commercial property collateral has performed in the pandemic, although the full impact may not be clear until the third quarter, when second quarter financials are available.

According to structured products data provider Trepp, billionaire Carl Icahn was fortunate he was late to the game for the short CMBX party in not putting on his trade until the second half of 2019. Not only did he not carry meaningful insurance costs in 2017 and 2018, once concerns over retailers started closing stores over COVID-19, the trade – on paper – became enormously profitable very quickly.

The CMBX trade involves buying credit default swaps against subordinate bonds in CMBX derivative indices that are each tied to a basket of 25 CMBS deals issued in a particular year.

On the other side of the CMBX short trade, most visibly, has been mutual fund giant Alliance Bernstein, which has suffered massive losses on its long CMBS strategy, amid soaring fears of the pandemic finally crippling U.S. shopping malls whose debt is expected to experience skyrocketing defaults.

According to the Financial Times, more than two dozen funds managed by AllianceBernstein have sold over $4 billion worth of CMBX protection to the likes of Icahn. One among them is AllianceBernstein’s $29 billion American Income Portfolio, which is down 15% since the beginning of March, having written $1.9 billion of protection on CMBX 6, while some of the group’s smaller funds have higher concentrations.

The mutual fund published a paper in October, “The Real Story Behind the CMBX. 6: Debunking the Next ‘Big Short.'”

Multiple credit funds these days are shorting CMBX indices on the information of rising real-estate defaults, especially hotels and travel industries.

An indication of stress in the CMBS market is that $53 billion in bids wanted in competition (BWICs) was put out for bid in the first quarter with 10% on average failing to trade, according to Empirasign, a securitization data provider. Mid-March saw $10 billion in CMBS offers on separate days that cleared.

With so much market drama, Bank of America recently issued its insights on CMBS shorts. BofA’s CMBS analyst Alan Todd focused on lower-rated CMBX tranches.

“Since pre-SFIG, BB-rated tranches from CMBX 10-13 fell by approximately 40-45 points, which is a larger drop in price than that experienced by the CMBX.6 tranche over the same period of time,” he wrote. “While some of this price action could be due to increased hedging by investors that own the corresponding 2016-2019 cash bonds, we think the price drop is also reflective of investors’ view that a greater amount of the weaker collateral in more recently issued deals will encounter difficulty.”

He added that one looming, but incredibly important question we have is that although we know master servicers are responsible for remitting 100% of each loan's principal and interest to the extent it's deemed recoverable, will they be able to offer borrowers 60- or 90-day forbearance periods similar to what the government-sponsored enterprises (GSEs) offered to its borrowers?

"With distress in CRE rising across the board and delinquencies expected to increase significantly over the next two months, we think it is necessary that CMBS servicers and borrowers negotiate forbearance programs to help mitigate the risks of broad-based defaults," he said.

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