Allianz Research | 24 May 2024

What to watch: US commercial real estate and the Fed, oil price roller coaster and corporate optimism returns after Q1 earnings

Ludovic Subran
Chief Economist
ludovic.subran@allianz.com

Jordi Basco Carrera
Lead Investment Strategist
jordi.basco_carrera@allianz.com

Pablo Espinosa Uriel
Investment Strategist
pablo.espinosa-uriel@allianz.com

Ano Kuhanathan
Head of Corporate Research
ano.kuhanathan@allianz-trade.com

Yao Lu
Sector Advisor
yao.lu@allianz-trade.com

Executive summary

This week we look at three critical issues:

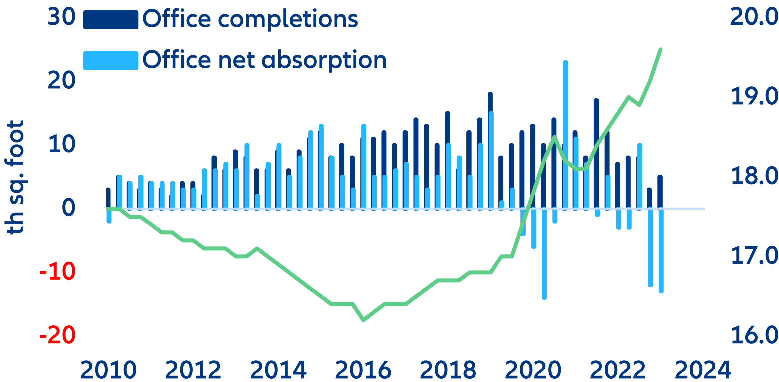
- **Delayed Fed pivot deepens US commercial real estate crisis.** While commercial real estate has a few bright spots – notably logistics and data centers – the office segment shows no signs of recovery, especially in the US (down -24% in nominal terms from mid-2022 peak), hit by the double whammy of structurally lower occupancy and the increase in interest rates. In principle, the delay in Fed cuts has a minor effect on valuations as long as terminal rates are not adjusted upwards. But in practice, early cuts would alleviate the dire situation of the sector, boosting investor confidence and allowing the return of leverage, besides reducing the risks of potential cross-effects from other downbeat assets. The big concern is the looming CRE debt maturity wall: 2024 is a critical year, with USD1trn of CRE debt to be refinanced. According to CBRE estimates, the office segment will face the highest debt-funding gap, with refinancing needs amounting to USD112.8bn between 2023 and 2026. We expect the fall in prices to continue at a slower pace and bottom out (-30% peak-to-trough) in the second half of the year in the case of a "benign delay" but it could be much deeper (beyond -40%) if terminal rates increase or if the delayed pivot causes further economic damage.
- **Oil markets: Supply, geopolitics and the Fed are taking turns in the driving seat.** The upcoming OPEC+ meeting on 01 June is unlikely to deliver a major surprise as we expect current supply curbs to be maintained. Oil prices have been on a roller coaster lately, breaching the 90 USD/bbl threshold in early April due to rising geopolitical tensions in the Middle East before falling back to around 82 USD/bbl recently on the back of concerns over demand and Fed policy rates. Looking ahead, we forecast oil prices to average 84 USD/bbl in 2024 before consolidating slightly to an average of 81 USD/bbl in 2025.
- **Q1 earnings: the return of corporate optimism.** S&P 500 companies have continued to outperform expectations, leading to the second highest year-over-year earnings growth since Q2 2022. Despite mixed guidance for the next quarter, analysts still project +11% earnings growth for 2024. In Europe, results are less optimistic but show signs of improvement, with positive momentum suggesting +5% earnings growth for 2024 will be feasible. Despite these encouraging signs, the current market reactivity and earnings concentration indicate elevated risks centered around a few companies and high valuations, potentially leading to asymmetric negative reactions to bad news.

Delayed Fed pivot deepens US commercial real estate crisis

The lights are still off in the US office sector. While commercial real estate has a few bright spots – notably logistics and data centers – that are benefiting from the boom in e-commerce and artificial intelligence, the office segment shows no signs of recovery[1]. Since the pandemic lockdowns, the shift to remote work has eaten into demand for office space, sending the vacancy rate soaring to 20% (Figure 1), and this trend looks set to continue. The US office price index[2] is already down -24% so far in 2024 and we expect the slump to continue through the year (by further 8pps), with a stabilization only expected in 2025.

The uncertain timing of the long-awaited monetary policy pivot is not helping, but it will not fundamentally affect capital values – as long as the terminal rate does not change. Market expectations for the first Fed rate cut have been postponed repeatedly, given the still-strong economy, which is supporting overall demand, and stubborn inflation[3]. A sign of prices trending towards the Fed's 2% target will be key to any potential pivot. Meanwhile, the delay is posing additional problems for the office segment, keeping away the leveraged buyers that would have helped to shore up liquidity, besides depressing investor sentiment (2023 marked a record low for investment activity[4] and it has continued to sink in Q1 2024 according to preliminary reports) and raising the risks of potential cross-effects from other downbeat assets. At the macro level, high-for-longer interest rates suggest that transacted prices[5] will continue to decline, but it could get worse if inflation remains sticky, preventing the Fed from cutting at all even as the economy decelerates. However, the variable to watch is the terminal rate. If the Fed's terminal rate increases by 50bps, and the 10Y yield stabilizes above 4% for the next couple of years, prices could face an extended and more severe decline through 2025 (a further 15pps in the next two years, more than 40% compounded, peak-to-trough).

Figure 1: US office vacancy rate



Sources: LSEG Datastream, Allianz Research

[1] 1.5 days higher than in France, for example, contributing to the trans-Atlantic difference in office markets.

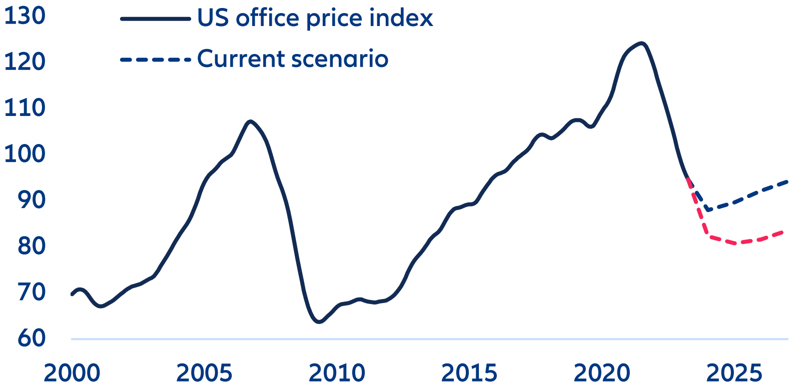
[2] Based on Real Capital Analytics numbers. Especially in the case of commercial real estate prices, the use of one or other index can lead to very heterogeneous outcomes.

[3] You can find our analysis of the delay in other asset classes in our previous pieces: sovereign and EM or cross-asset correlations.

[4] In nominal terms. Data taken from CBRE global investment activity report.

[5] Transacted prices reflect actual sales, while capital values are appraised estimates; in periods of low liquidity and high interest rates uncertainty, discrepancies between both are wider and take longer to fade.

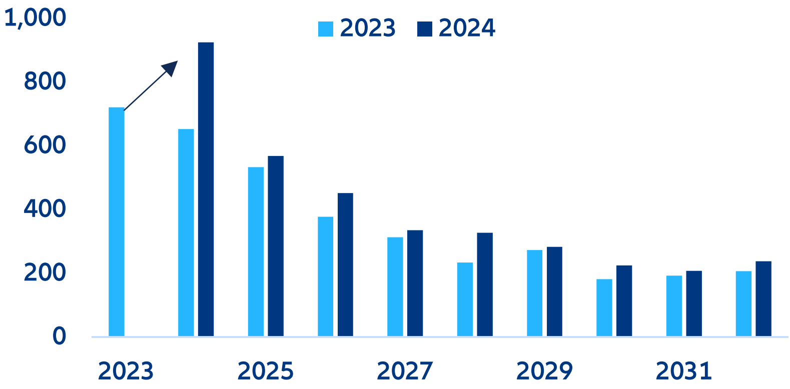
Figure 2: US CRE office price indexes – different scenarios



Sources: Real Capital Analytics, LSEG Datastream, Allianz Research

The bigger concern is the looming CRE debt maturity wall: USD1trn of CRE debt will need to be refinanced in 2024. The Fed delay will cause problems in a fundamental year for CRE debt maturities (Figure 3), with appetite for such debt already low. According to CBRE estimates, the office segment will face the highest debt-funding gap, with refinancing needs amounting to USD112.8bn between 2023 and 2026. Although it is not in the interest of any lender to set excessively high interest rates on loans[6], as doing so would make repayments or refinancing unlikely, the room to escape adjusting mortgage loan terms to current financial conditions is narrower and narrower. Maturity extensions, which was one of the preferred ways to avoid this in 2023[7], only work when market participants expect interest rates to fall in the near future. In many cases, however, refinancing at higher rates is simply not feasible, and we expect to see more debt restructurings and partial write-offs going forward.

Figure 3: US CRE maturity wall, showing the effect from maturity extensions (USD bn).



Sources: Mortgage Bankers Association, Allianz Research.

Delinquent CRE mortgage loans in large banks have doubled since 2022 – as with other riskier lenders – but office mortgage loans unlikely to trigger a systemic crisis. The uptick in mortgage delinquency rates is set to continue, especially in the lower quality spectrum. In terms of loans in bank portfolios, the increase in delinquencies should be less pronounced, with a disproportionate effect on smaller (more concentrated) banks. Our initial analysis shows that, in aggregated terms, and on its own, even the deepest shock to office real estate, would not be large enough to create a systemic crisis. But it would create serious problems for some banks and erase a significant share

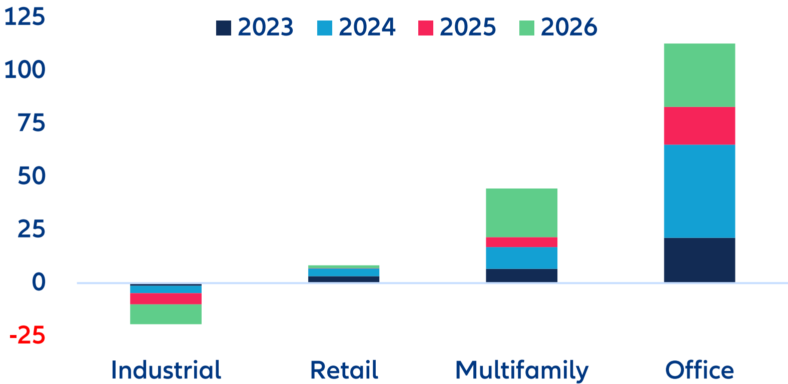
[6] From the point of view of a debt investor, an increase in interest rates skews the possible outcomes: they can benefit from them if the borrower continues to pay, but there is an increased likelihood of default. The fewer parties involved in a contract, the more flexibility to agree on terms that are mutually satisfactory.

[7] For more details on the US case, see the real estate section of our private assets outlook: Private(r) for longer?. Estimations are than at least one-fifth of the 2024 maturities came from one-year extensions to loans supposed to mature in 2023.

of their profits as they would need to set aside more money as loss allowance[8]. The key in this case is the shock occurring on its own. Risks could rise if the 'high for longer' environment adds further strain by creating troubles in sectors that were not as severely impacted as the office segment. While the system can handle absorbing losses in one sector at a time, managing simultaneous losses across multiple sectors would be much more challenging. However, there are CRE debt exposures outside banks' balance sheets, in many cases in less safe products, which are at higher risk. Data from Trepp reports the delinquency rate in office commercial mortgage-backed securities at 7% in April, in comparison to 1.5% on big banks for CRE. Reports of CRE collateralized loan obligations[9], an even riskier area on the market, show similarly concerning figures.

In this context, it is worth mentioning that the office segment is not the only risky spot: The multifamily segment is also under pressure because of the structural population shift triggered by the pandemic. The structural shifts triggered by the pandemic also resulted in more people moving away from large, expensive cities to the more affordable and warmer Sunbelt region. Between April 2020 and July 2023, 13 of the 15 fastest-growing cities were located in this area. The South saw its population grow by 3.9mn, with 63.2% of this increase attributed to domestic migration. In contrast, the Northwest, Mideast and West have all experienced out-migration. The massive relocation from urban to suburban areas resulted in a surge in investment volume in 2021. However, elevated interest rates also pose refinancing challenges for developers in the multifamily segment, which ranks second after the office segment with refinancing needs amounting to USD44.5bn between 2023 and 2026, according to CBRE estimates.

Figure 4: Debt-funding gap of CRE by sector in the US (USD bn)



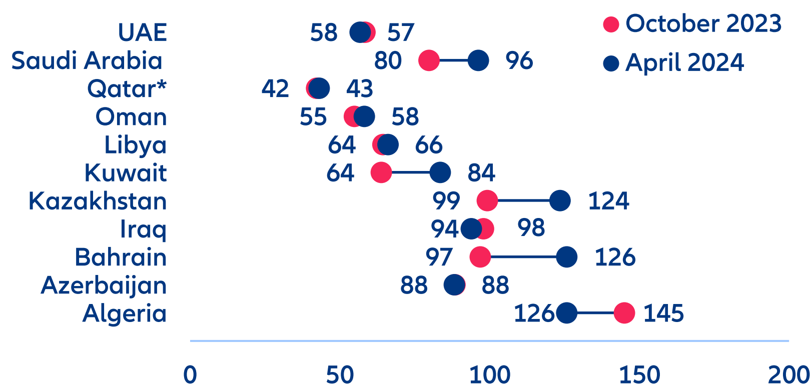
Sources: CBRE, Allianz Research. Notes: The debt-funding gap is estimated based on five-year loans originated in 2018, 2019, 2020 and 2021.

[8] Data from Trepp's anonymized loan level repository indicate that loss-allowance ratios for office loans are, on average, at almost 6%, up from 1.2% in early 2020.
[9] Real Estate Pain Is Showing Up in Collateralized Loan Obligations (CLOs) - Bloomberg

Oil markets: Supply, geopolitics and the Fed are taking turns in the driving seat

The next OPEC+ meeting on 01 June is unlikely to be a game-changer… Markets will be closely watching the outcome of next week's meeting of the Organization of Petroleum Exporting Countries (OPEC) and its partners, known as the OPEC+. The group is likely to extend its production cuts of 2.2mn barrels per day (bpd), aiming to keep prices above the 80 USD/bbl mark. However, non-OPEC production has been compensating for the OPEC+ cuts, with US output at a record high despite some decreases recently due to weather-related shutdowns, keeping the price increase in check. Saudi Arabia, which has been making the largest cuts, needs oil prices close to 96 USD/bbl (up from the previous estimate of 80 USD/bbl) to finance its ambitious transformation plans (Figure 5). However, if the country returns to its previous production (close to 10mn bpd) by next year, its breakeven price could fall back to about 85 USD/bbl.

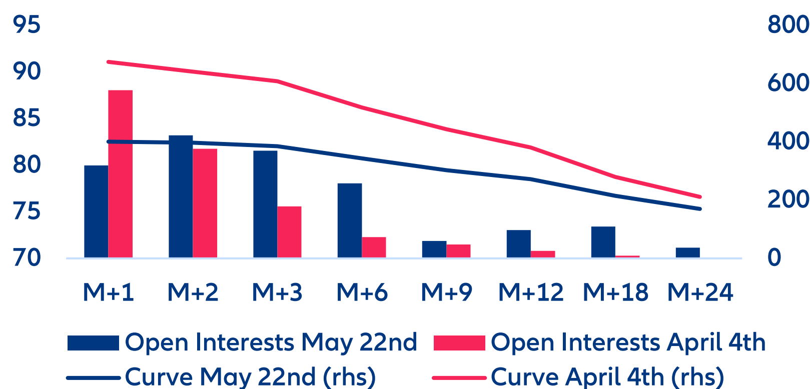
Figure 5: Fiscal breakeven estimates (USD/bbl)



**Not an OPEC+ member*
Sources: IMF, Allianz Research

…But the group could start to relax its supply curbs if it decides to bet on the "geopolitical premium" that has been driving up oil prices recently. Crude Brent was trading at over 90 USD/bbl in early April on the back of rising tensions between Iran and Israel. Such geopolitical risks often disrupt supply chains and create uncertainty about future supplies. However, their impact on oil prices can be short-lived. In early April, traders were mostly worried about short-term supply and the forward curve was in strong backwardation mode (i.e. oil was expected to be much cheaper in the following months – see Figure 6). Indeed, that price spike was followed by a stabilization once the immediate threats were assessed and managed.

Figure 6: Brent forward price curves (USD/bbl) and open interests (1000s of contracts)



Source: LSEG Refinitiv, Allianz Research

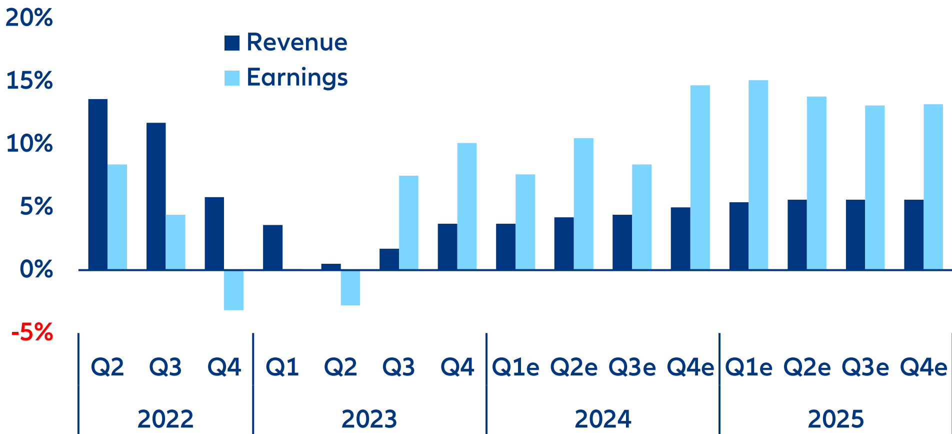
For the moment, the Fed and risks of higher-for-longer interest rates, as well as concerns over demand, have become the main drivers. Since early April, prices have fallen quite sharply to around 82 USD/bbl as of 22 May, primarily driven by global oil demand, which declined by 1.1mn bpd to 102.3mn bpd between February and March 2024. This reduction was mainly the result of lower consumption in the Middle East (-0.5mn bpd) and Europe (-0.3mn bpd). Nevertheless, resilient economic growth in other regions, especially the US and Asia, has helped sustain demand at relatively high levels. Going forward, markets are becoming increasingly bearish amid concerns over that Fed could keep US interest rates high to shake off sticky inflation, which could potentially depress US and global demand. Higher interest rates could also potentially strengthen the US dollar, which would make oil more expensive, thereby reducing global demand further.

Our oil price forecasts remain broadly the same as bearish and bullish signals seem to offset one another. Looking ahead, we expect supply to remain broadly in line with current levels and demand to continue to exhibit sluggishness, especially in Europe. On the geopolitical front, we do not rule out some episodes of tensions but we do not foresee an event with any long-lasting disruptive effects on oil supply. As a result, we forecast oil prices to average 84 USD/bbl in 2024 (slightly up from our previous forecast of 83 USD/bbl) and 81 USD/bbl in 2025 (unchanged from our previous forecast).

Q1 earnings: the return of corporate optimism

In Q1 2024, S&P 500 companies recorded the second largest year-over-year earnings growth (+7.6%) since Q2 2022 and the highest revenue growth (+3.7%) since Q4 2022, injecting markets with a renewed dose of corporate optimism. As the Q1 earnings season comes to an end, around 77% of S&P 500 companies surpassed analysts' earnings expectations, and 60% exceeded revenue estimates. Profit margins have shown positive trends as well, coming in at 11.7% higher than the previous quarter and a tad above the five-year average. This steady increase in profitability continues to highlight the strength of US companies' operational efficiencies and their capacity to navigate the current macroeconomic and geopolitical environment. Nevertheless, companies do appear less optimistic for the ongoing quarter, with more than half issuing negative EPS guidance. Analysts remain optimistic for the full year, though, projecting an earnings growth rate of ~11% (Figure 7).

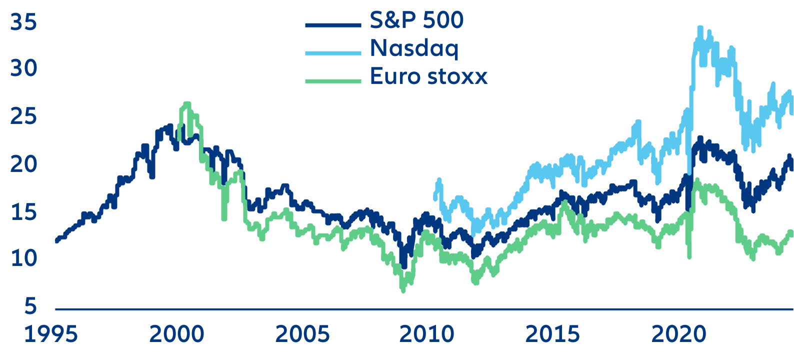
Figure 7: S&P 500 earnings and revenue growth (y/y%)



Sources: LSEG I/B/E/S, Allianz Research

Market reactions to earnings surprises have been larger than average. Companies reporting positive earnings surprises have seen an average price increase of +1%, while those reporting negative surprises have experienced an average price decrease of -3%. This differential underscores the market's sensitivity to earnings performance relative to expectations, which is being exacerbated by the stretched valuations reigning over US markets, leading to an asymmetric reaction function to positive vs negative news flow. To put this in context, the forward 12m price-to-earnings ratio for the S&P 500 currently stands at 20.8, a level close to the 2000s and 2020s equity rally (Figure 8).

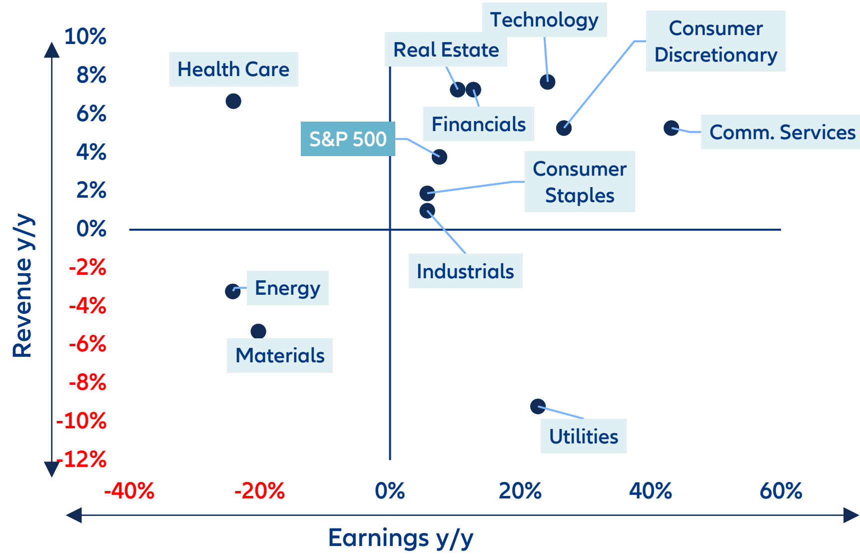
Figure 8: Cross country 12m FWD PE comparison



Sources: LSEG I/B/E/S, Allianz Research

Communication services topped the chart with the highest year-over-year earnings growth rate of +34%, but this was driven primarily by Alphabet and Meta. Excluding these two heavyweights, the sector's growth would have dropped significantly to +2%. The utilities sector saw the second-highest earnings growth rate (+33%) despite remaining squeezed on the revenue side. The consumer discretionary sector came next with +24.5%, largely due to Amazon. Without Amazon, the growth rate would have had fallen to +2.4% annually. Technology recorded a growth rate of 23.6%, with NVIDIA being a major contributor. On the red side of the earnings season, the health care and energy sectors both saw significant declines of -25.4%, followed by basic materials at -20.6% (Figure 9).

Figure 9: S&P 500 - Q1 2024 earnings growth rate estimates by sector

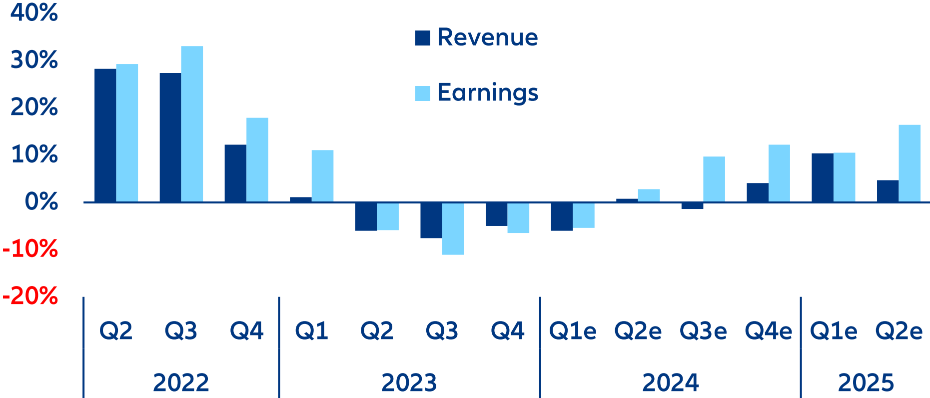


Sources: LSEG I/B/E/S, Allianz Research

The optimism is tempered on the other side of the Atlantic but there are signs of improved fundamentals. Around 90% of companies have reported so far, and approximately 60% have exceeded analyst earnings expectations and 50% have surpassed revenue estimates. Although the overall results remain negative, they indicate that the Stoxx 600 is gaining some recovery momentum after three quarters of significant negative yearly earnings and revenue growth. Companies are expected to post -2% year-over-year earnings growth and -4% revenue growth in Q1, the highest performance since Q1 2023, approaching the positive threshold for earnings and revenues. Additionally,

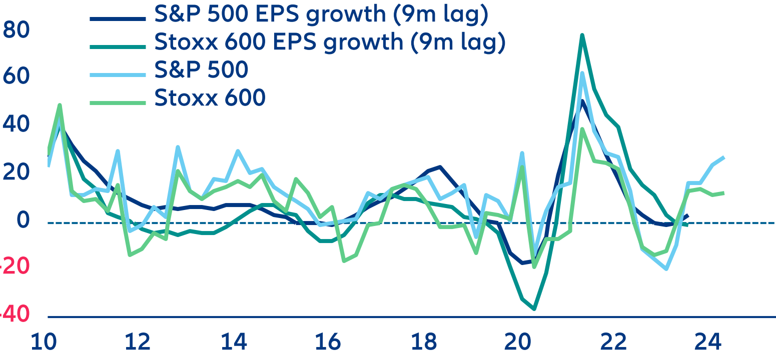
the positive quarterly earnings and revenue growth suggest that the projected ~5% earnings growth rate for 2024 might well be feasible, provided there are no exogenous factors disrupting the current trend. Ultimately, this anticipated balance sheet recovery and resilience justify the relatively narrow performance gap between US and European equities (Figure 10 & 11).

Figure 10: Stoxx 600 earnings and revenue growth (y/y%)



Sources: LSEG I/B/E/S, Allianz Research

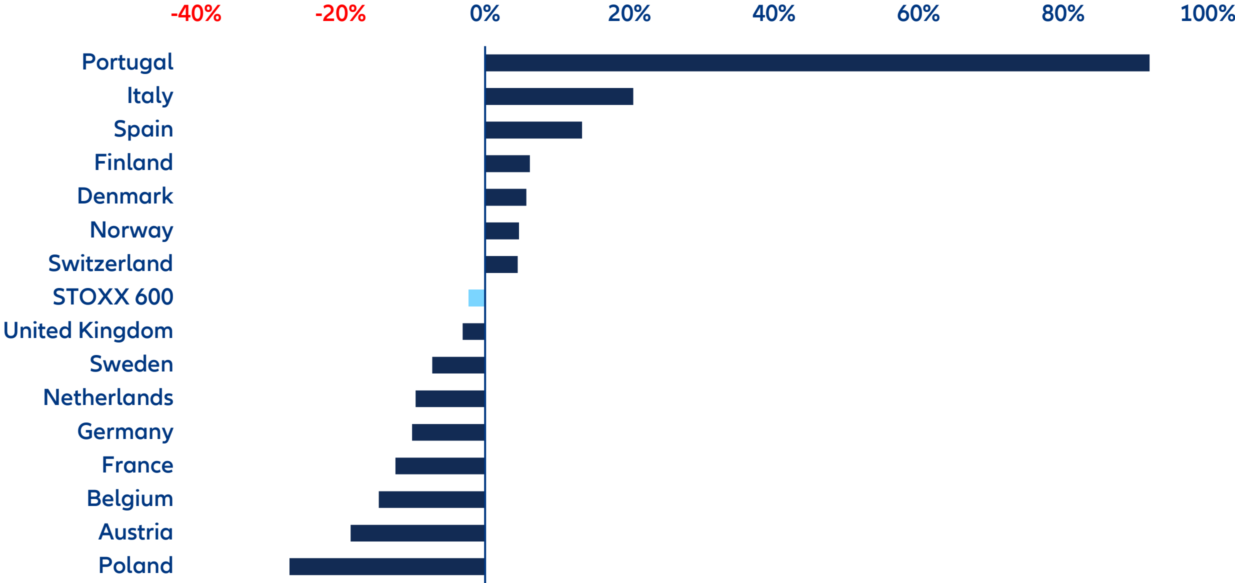
Figure 11: Price vs EPS growth comparison



Sources: LSEG I/B/E/S, Allianz Research

Despite this muted but encouraging performance, the European earnings season has been uneven across countries. Analysts expect positive Q1 earnings growth from seven of the 15 countries represented in the STOXX 600 index. Portugal (+92.0%) and Spain (+20.5%) are projected to have the highest yearly earnings growth rates, while Poland (-27.1%) and Austria (-18.6%) are expected to see the lowest growth. Looking ahead, we anticipate that the European economic recovery over the next two years will support major economies like Germany and France in achieving positive growth earnings and revenue momentum. This, in turn, should help improve the overall equity index fundamentals bringing them to more stable and comfortable levels (Figure 12).

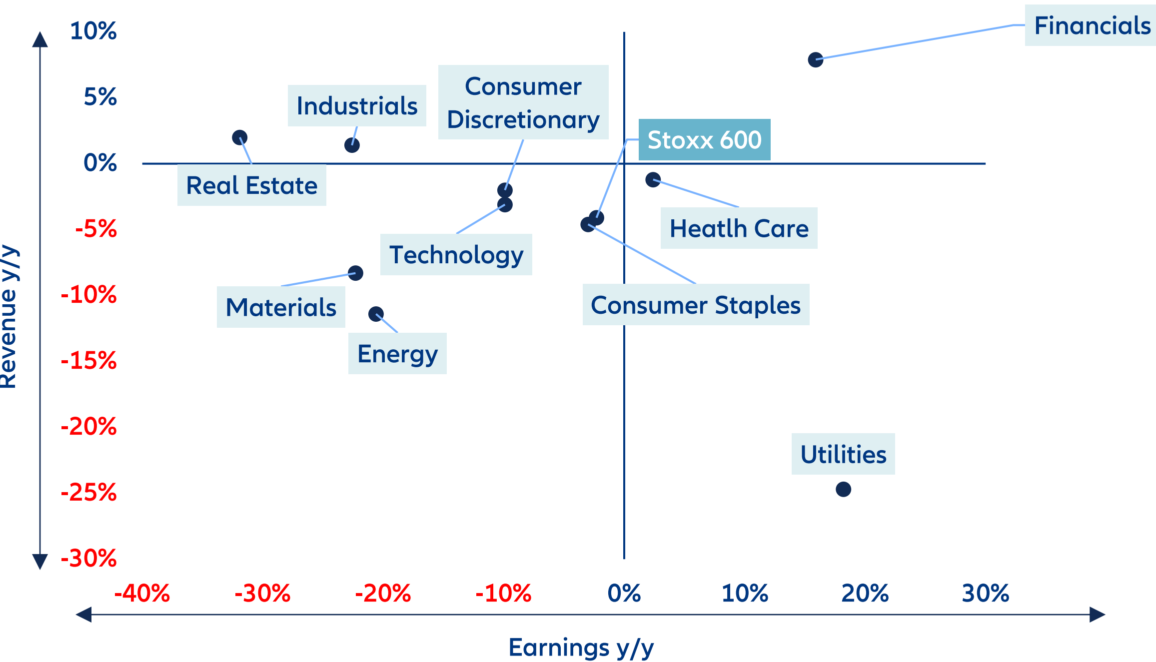
Figure 12: Stoxx 600 - Q1 2024 earnings growth rate estimates by country



Sources: LSEG I/B/E/S, Allianz Research

Financials is the only sector still posting positive year-over-year earnings and revenue growth in Europe. All other sectors have shown either the top or the bottom line in the negative. Overall, three of the ten sectors in the index are expected to show improved earnings compared to Q1 2023. Leading the charge, the utilities sector boasts the highest earnings growth rate (+18.2%), while the real estate sector is projected to have the weakest growth (-31.9%, Figure X13). Despite most sectors posting negative earnings the big European companies (i.e. GRANOLAS) are still performing well, driving broad European indices up, like in the US (Figure 13).

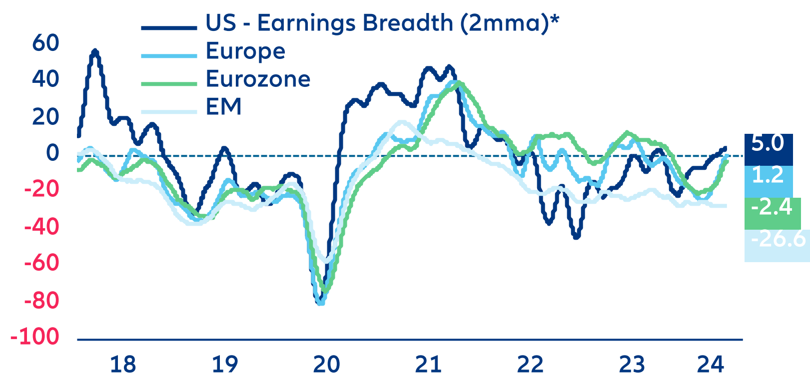
Figure 13: Stoxx 600 - Q1 2024 earnings growth rate estimates by sector



Sources: LSEG I/B/E/S, Allianz Research

Earnings revision ratios are on the rise, with analysts increasingly confident in the continuation of the earnings and revenue momentum seen in Q1. This positive outlook aligns with our macro-based earnings growth estimates and supports an expected equity performance of around +10% for both European and US markets in 2024. However, the earnings season has further highlighted the growing concentration risk within equity markets, both in terms of pricing and fundamentals, with a small subset of mega corporations driving the performance of the overall market. This underscores the asymmetric reaction of market participants to negative news, with adverse developments being traded three times more intensely than positive ones, which in turn evidences the stretched valuations and possibly overly optimistic expectations for equity market performance (Figure 14).

Figure 14: Earnings breadth (2 months moving average)



Sources: LSEG IBES, Allianz Research
Note: Earnings breadth represents the percentage of analyst expectations being revised up vs revised down

These assessments are, as always, subject to the disclaimer provided below.

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