The Razor’s Edge

It feels like asset markets around the world are trending along a razor’s edge. On one side lies a return to normalcy and a resumption of the great secular bull market. On the other, there’s an abyss, where lies a litany of rather painful potential outcomes: mild recession, a financial crisis, deflation, hyperinflation, depression.... Who knows!

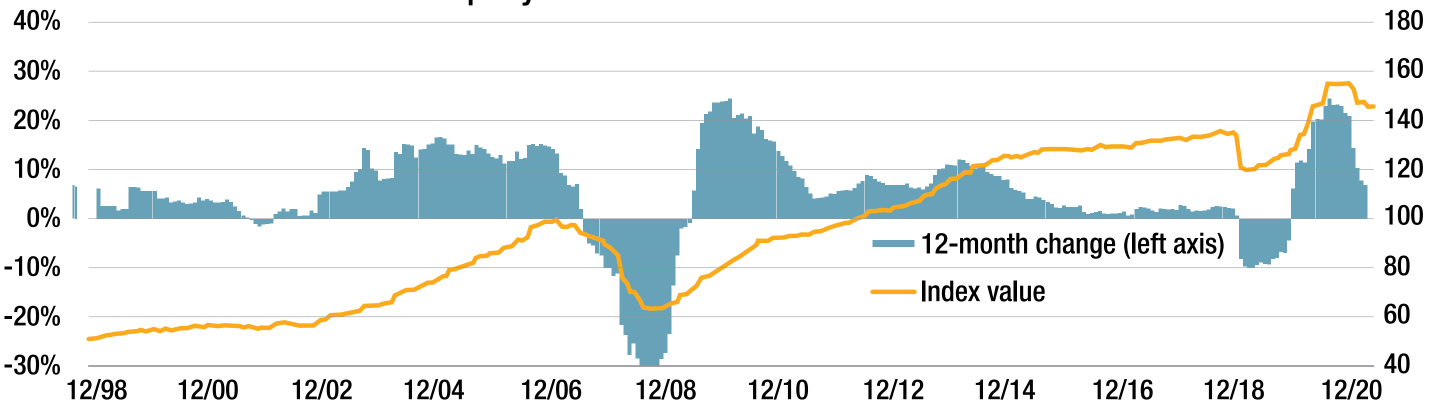
Unfortunately for all of us, at this point, it’s just very unclear what happens next. Let’s survey some trends in important asset classes and see if that will shed some light.

Real Estate

The real estate market is moving in slow-motion. The market cannot decide whether what we are seeing is a slow-moving trainwreck or something else. Financial conditions have tightened so dramatically and so fast there’s a sense in which the market is either confused about the truth or scared to acknowledge it. A kind of shellshock has settled in on the minds of property owners and fund managers and the only thing they can manage to utter is something like “I guess we’ll just wait and see.”

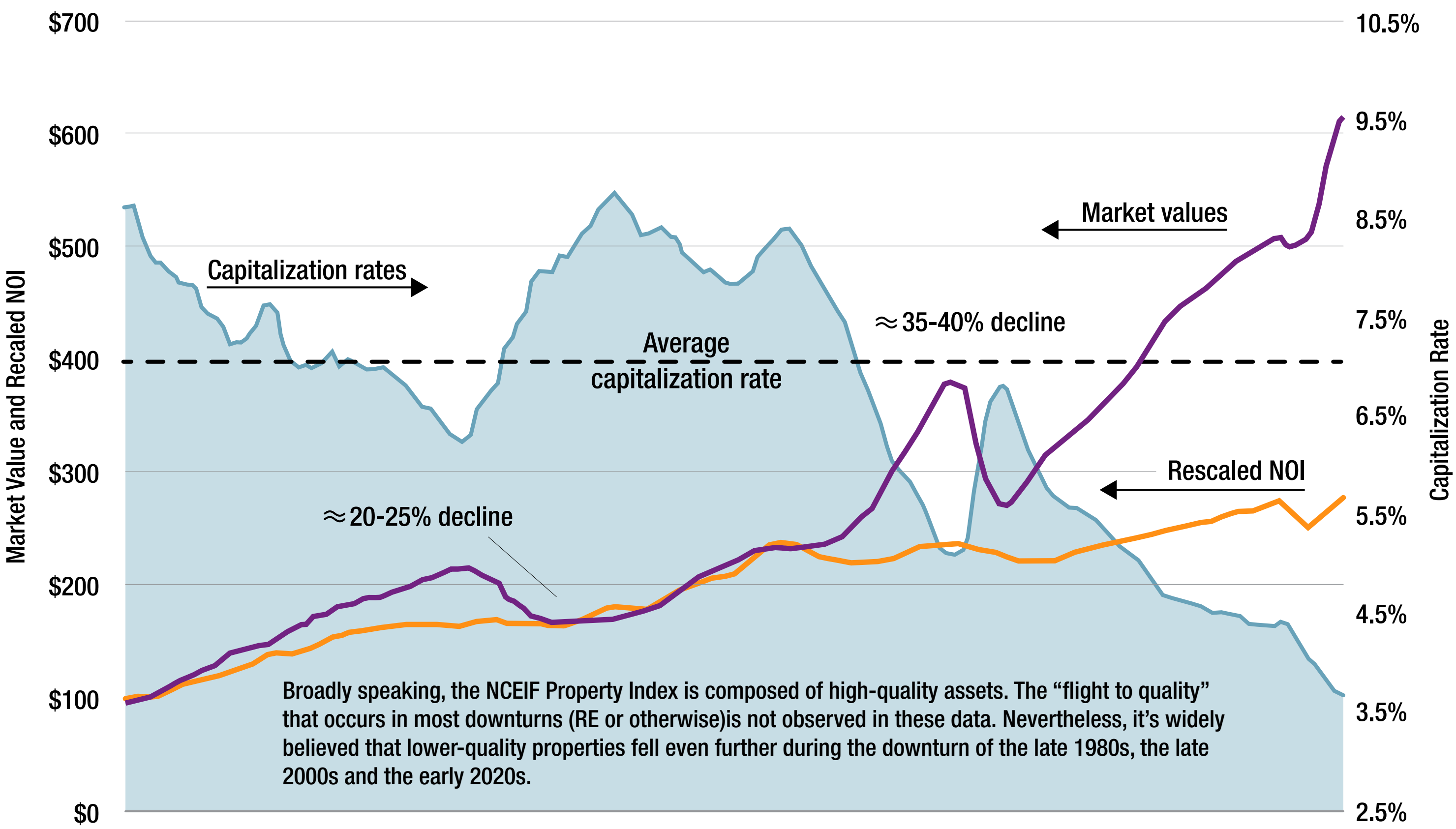
The truth is that with rates where they are just about every property in the world is due for a mark down. For over a decade, real estate valuations were supported by an intoxicating tailwind of low and ever lower rates.

Green Street Commercial Property Price Index®



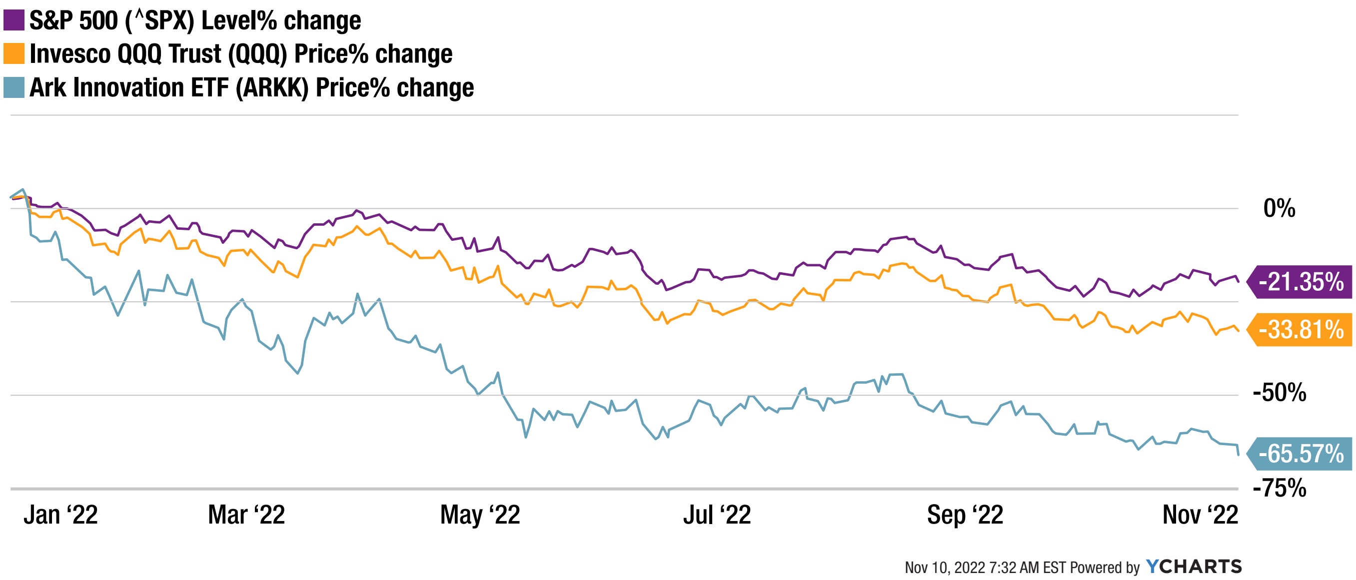
Now the party is over and the market just doesn't want to accept that a serious decline is possible and maybe even likely. Everyone seems to be just holding out and hoping for a quick reversal in interest rates. Look, as we discussed last month, there's a decent chance that this will happen but it might not. And if it doesn't the downside is considerable.

NCREIF Index: market values, rescaled NOI and capitalization rates based on a $100 investment for the period 1978 through the second quarter of 2022



Take a good look at the blue line here, which basically went parabolic during the COVID era, and imagine what a mean reversal might look like. The fundamental issue in the market right now is that at the old, peak valuations you have massive negative leverage already—meaning that cap rates are so low relative to borrowing costs that properties bleed money every month instead of producing cash-flow. To buy today at the old values, you'd have to believe either that rates are coming down materially and quickly or that you could dramatically improve the operating performance of the property. Both of these assumptions are hard to underwrite into our weakening, uncertain economy.

In the short-term, I think there's pain coming to the real estate world. The damage done will depend on how high rates go and how long they stay there. Some sectors are better positioned than others. I'd hate to own offices right now, that's for sure! But something like multifamily probably does ok. With for-sale housing in a serious volume recession—yes, no one can buy houses with mortgage rates at 7%—multifamily will probably continue to benefit from rising rents. Hotel, retail and industrial will be a mixed bag and ultimately will depend on how bad the economy gets.

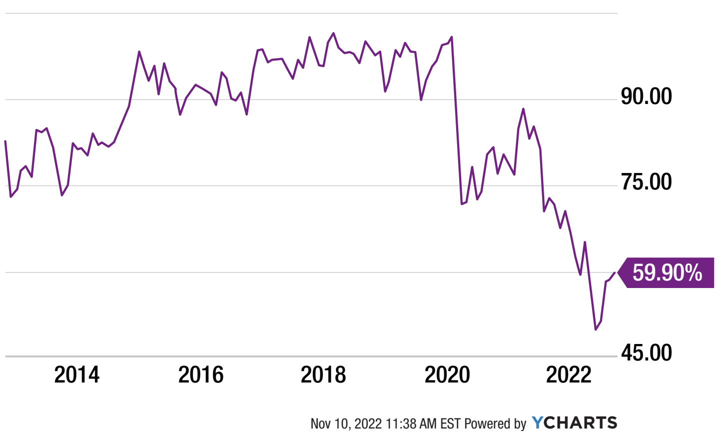


Equities

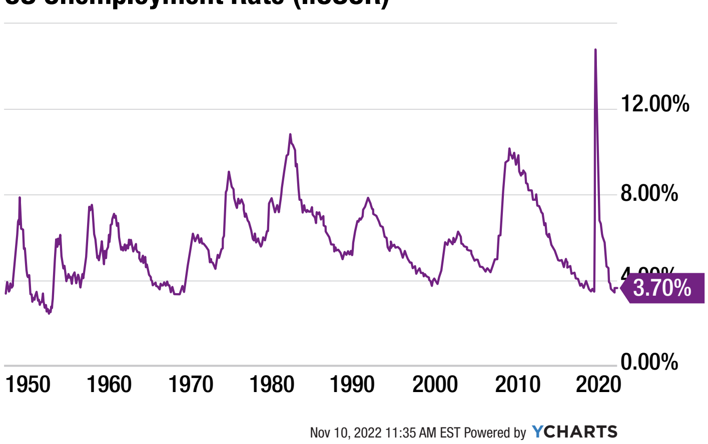
In the stock market the pain is already here, especially for the once high and mighty tech darlings (chart above).

The question now is whether more pain is coming. For equities, interest rates matter, of course, but not as much as with real estate. Here the drivers are consumers and the jobs market.

US Index of Consumer Sentiment (I:USCS)

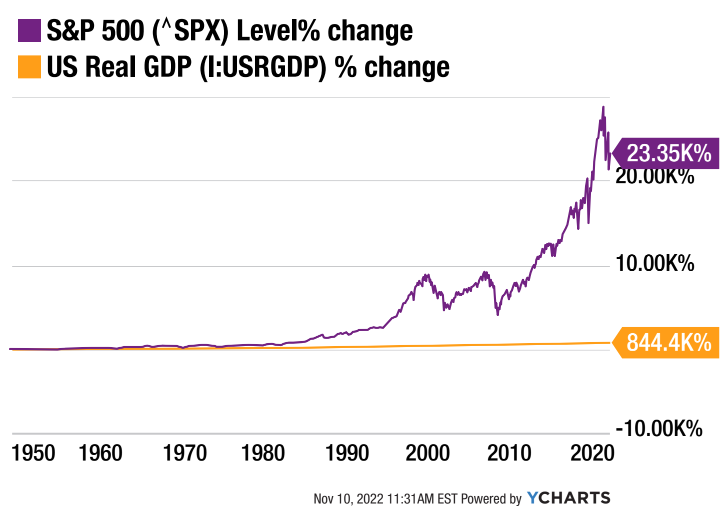


US Unemployment Rate (I:USUR)



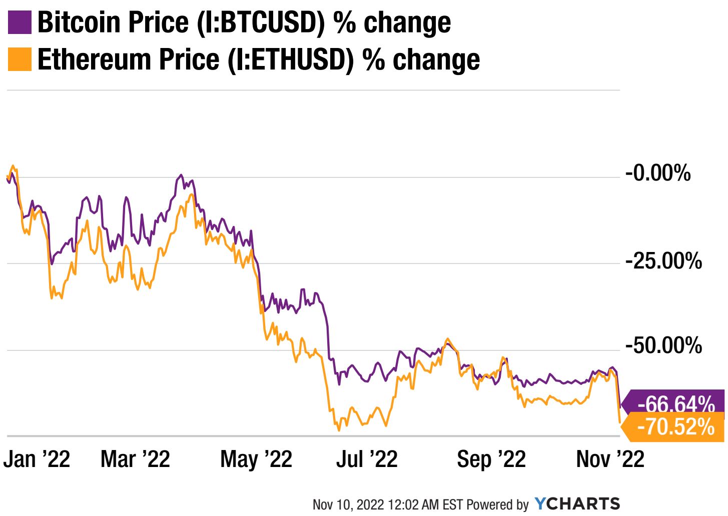
While so far, the economy has held up, consumer sentiment certainly doesn't look good and I think it's just a matter of time before things get ugly in the labor market. We've just seen way too many hiring freeze and mass layoff announcements already.

I think we've all gotten so used to high asset prices that we have forgotten what life used to be like. In the era before financialization, globalization, computers, phones and the internet, there was a much tighter relationship between GDP and the stock market. In the last 30-40 years these have completely decoupled and the great question before us is whether that's sustainable. This chart will provide some perspective and perhaps scare the hell out of you.



Crypto

Crypto is an absolute mess these days, mostly because prominent funds and venture-backed companies keep getting themselves into trouble. For a while it seemed like crypto was finding a bottom but then this FTX crisis happened and that has changed everything.



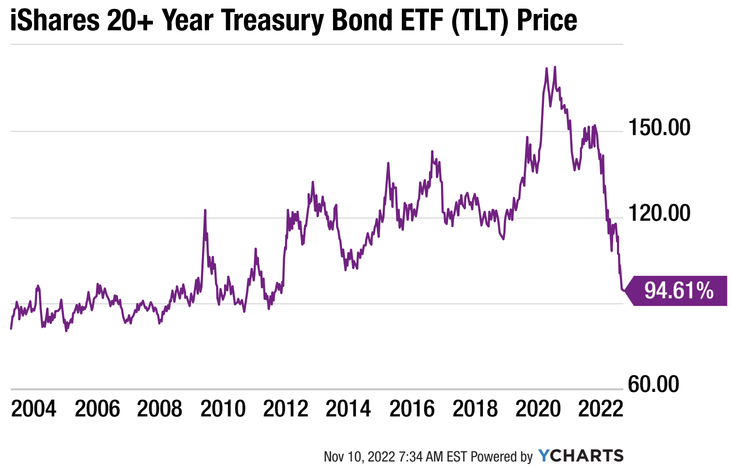
It's hard to tell what's going to happen next but I suspect it's going to be a rather long crypto winter this time around. It feels like every few weeks there's another liquidity crisis out there. While some of these companies have been rescued many have not. Fortunes have been lost. Twitter is on fire with conspiracy theories and founders are on the run or not, depending on whose story you believe. I find it hard to believe that it's a mere coincidence that many of these embattled crypto people just happen to be living in countries with, shall we say, more favorable non-extradition traditions.

Interestingly, these companies are not failing because of anything "crypto" related. No, it turns out they've been failing for a much more banal reason—i.e. classic over leverage. It turns out that applying massive leverage on the highest Beta asset class in human history is indeed not a good idea.

This downturn has been good, in my opinion, for the long-term health of the space. By driving out the speculative fever that had come to dominate the space, it has made room for the real work to continue. We shall see.

Bonds

The bond market is looking rather interesting these days. In fact, bonds might be the best risk-adjusted contrarian trade in the world right now. They are on pace to have their worst year, well…basically ever:



And as we discussed last month, there's a decent chance that the Fed will be forced to intervene again in bond markets before too long. At the first hint of a policy reversal, bonds will start to rally and they have a long way to go.

I think the takeaway from all this is that now is still a time for caution. It's definitely way too early to declare this bear market over but there's probably some decent justification for dollar cost averaging into risk assets, except for maybe real estate, simply because there's so much we don't know yet about the future rate enironment, and energy, because it's rallied so hard and oil is vulnerable for a serious pullback if the economy weakens even marginally. ▫