All the Credit®
Episode 18 Transcript

PGIM FIXED INCOME

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Introduction

Female Voice: You're listening to All the Credit, a monthly Podcast Series brought to you by PGIM Fixed Income an active global fixed income investment manager, and now your host senior portfolio manager, Mike Collins.

Mike Collins, CFA, Host and Senior Portfolio Manager: Hi. Welcome to episode 18 of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income, and your host of All the Credit. The global real estate markets, from shopping malls, to hotels, to office space, warehouse properties, and certainly housing, have all been greatly impacted by the global COVID pandemic, for better or for worse. Some of the impacts seem to actually just be accelerating existing trends. Like the shift away from brick and mortar shopping toward online shopping, or millennials finally moving out to the suburbs. But other effects are disrupting typically stable sectors like office space and certainly the global conference and convention businesses. In this podcast, we're going to assess the broad trends in the global real estate marketplace. Do a deep dive into each of the key commercial real estate segments. Try to summarize the current state of the crazy housing market. Explore whether or not some of the pandemic related effects we're seeing are indeed permanent or transitory. And finally, discuss some of our favorite fixed income investments that are related to or even specifically collateralized by real estate. So, for this episode of All the Credit, we've compiled an awesome panel of some of PGIM's top real estate research and portfolio management specialists. Lee Menifee is responsible for leading PGIM Real Estate's research efforts, overseeing the research teams that support all of PGIM Real Estate's investment activities in the U.S. and Latin America. Sean Beggan is a senior member of PGIM Fixed Income’s securitized products research team specializing in commercial mortgage backed securities, or CMBS. Previously, Sean worked in PGIM's own real estate finance group where he originated warehouse and securitized commercial real estate loans. And Gabe Rivera is a portfolio manager on PGIM Fixed Income’s securitized products team. Gabe manages and trades a variety of asset backed securities, commercial mortgage backed securities, and non-agency residential mortgage backed securities. Previously, Gabe was our lead residential housing analyst at PGIM Fixed Income. Lee, Sean, Gabe and I are here to give you All the Credit. Welcome, gentlemen.

Lee Menifee, Head of Americas Investment Research, PGIM Real Estate: Thank you, Michael. Glad to be here.

Sean Beggan, Vice President, Securitized Products: Thanks, Mike. Happy to be here.

Gabe Rivera, Securitized Products Portfolio Manager: Great to be here, Mike.

Mike Collins: All right guys. Lee let's start with you. Introduce yourself to our listeners. You're not part of PGIM Fixed Income directly, but are part of PGIM. Nonetheless, the big asset management umbrella within Prudential Financial. Describe how PGIM Real Estate fits into PGIM and share your background and current role.

Lee Menifee: Thank you. PGIM Real Estate does fit under the PGIM umbrella, I guess we touch most of the real estate in the broader PGIM organization. Although obviously in the Fixed Income group and other groups we also touch real estate in different ways. Where PGIM Real Estate fits in, we are one of the largest equity owners of real estate and one of the largest debt originators of real estate in the world. Our client base is primarily comprised of institutional investors, although with a rapidly growing retail investor component and high net worth component to that as well. My role here is to head up the Americas research group. I'm part of a global research group that supports the broader PGIM Real Estate organization. And our job is just to provide evidence-based research that helps us to make better investment decisions.

Mike Collins: So, let's start with the big picture, Lee. Why don't you summarize for our audience the key trends you're seeing across the global real estate markets?

Lee Menifee: Sure. I'll start with that there's more similarities than differences right now about what's going on globally. But I'll highlight first just the differences. And really the key differences are the pace of the economic recovery, which is what determines tenant demand and also, to a certain extent, investor demand. That is evolving unevenly across the world. You have Asia Pacific, which was first in and first out of the COVID-19 crisis. And of course, now we're in a situation where at least in parts of Asia Pacific are now sort of one of the first back in, possibly followed by some other regions. You have Europe, which has been a little bit more of a gradual climb out and that's reflected in the underlying real estate demand and to a certain extent investor demand. You have Latin America, which is emerging much more slowly, although it is emerging from the downturn. And we're seeing that with a pickup first in real estate that is more export based, has led the recovery in Latin America. And that we expect to be followed by more domestic. And then finally the U.S., which is, I would say, leading all the regions at the moment for a variety of reasons involving vaccines and very consequentially the massive amounts of stimulus that have been put in the economy for the last year. And that's showing up in our readings of investor demand and particularly tenant demand, which has proved to be much more resilient than we expected a year ago and is coming back faster than we expected. But those are the differences. I'll highlight some of the similarities. Maybe I'll just start with the basics, which is that we're not building a lot of real estate around the world, at least relative to previous cycles. So, supply is fairly contained in most of the markets. And it was contained really going into early last year as well. And what that means is that what was looking like more of a peak of a cycle, most markets went into that with lower vacancies and better fundamentals than in many prior downturns. A second similarity is a massive increase in investor interest in real estate. And I don't think that that's necessarily unique to real estate, I think it tracks well with the investor interest in yield assets in general. Real estate having the additional advantage of some yield assets of also providing the potential for income growth, in addition to that current yield. And then I would say that investor interest has been driven partly by that increase in tenant demand. But really it is that relative yield, and really the relative yield to risk free which is elevated. But of course, a lot of asset classes are elevated relative to risk free. But when we look at that, the similar credit, real estate still has a little bit of risk premium over some of the comparable risk corporate bonds. One other area to highlight is that investor interest, which historically has been very concentrated in the major property types, is really spilling over into niche sectors. And niche sectors, what I'm talking about are things other than office, industrial, residential, and retail. Those niche sectors, which could be things like data centers, senior housing, hospitality—all of those are attracting more investor interest, and for the most part for very good reason. Because the structural and, in some cases, cyclical outlook for them is very favorable. And they're also benefiting from that lack of supply.

Mike Collins: And that's certainly where our active management capabilities, your research capabilities, and obviously you'll hear from Sean and Gabe and the strong research capabilities we have at PGIM Fixed Income to really find those attractive, whether it's cyclical or secular niches within the real estate markets. Lee, one of the big topics on everybody's mind, certainly our clients' minds, is inflation, everybody's terrified about inflation. I mean do your investors think of real estate investments as an inflation hedge or a way to maybe benefit from rising prices or rising inflation? How do you think about that?

Lee Menifee: The interest in real assets in general has increased as inflation—I'm not going to say inflation expectations as they pick up, because inflation expectations actually remain fairly contained—but certainly, the number of headlines around inflation and the actual inflation figures make it a very valid area to concentrate on. Historically, there is evidence that real estate has provided an inflation hedge. And so, in periods when inflation expectations are rising, you see real estate risk premium go down. In other words, investors are willing to pay up for assets because they expect that to provide income protection in periods of high inflation. Now in the U.S., for instance, we've really only had one period of high inflation in institutional real estate history. So, there are very few periods when you can actually say that this actually works. But I would say that in periods of both rising inflation expectations, and in periods of disinflation, real estate actually performs very well. Deflation is a different story. And I think that the concerns about deflation are a little bit more 2020 than 2021 at this point.

Mike Collins: Sure. Thank you, Lee. Gabe, why don't we turn to you? Why don't you share your background with the audience and the recent change in your responsibilities within PGIM Fixed Income?

Gabe Rivera: Sure Mike, so I began my career 17-years ago or so at BlackRock, and I was hired into the firm's mortgage research group, where I worked as part of a team building and implementing residential repayment and credit models. I later transitioned into the portfolio management team there, where I focus on non-agency RMBS investing during the depth of the housing crisis. Wanting to explore the sell side and market making, I left BlackRock for Barclays Capital in 2010, where I was ultimately responsible for heading the CMBS trading desk. I had the pleasure of joining PGIM in 2016 as the head of PGIM residential credit research team. And given the growth in the structure products portfolio and my experience about the buy side RMBS portfolio manager and a CMBS sell side trader, I was asked to transition into a portfolio management role within the securitized products team. And together with other colleagues on the team, I'm now responsible for managing the firm's ABS, CMBS, and RMBS investments across all of PGIM Fixed Income portfolios.

Mike Collins: And you've certainly been our resident expert on residential housing. How would you characterize, Gabe, the U.S. housing market today?

Gabe Rivera: Well, as pretty much everyone has experienced one way or another, the U.S. housing market is very hot right now. You've probably heard the horror stories of people walking into an open house, and by the time they're out there are already 10 plus offers over ask on the table. So, what's going on? And the answer is that a confluence of factors, including favorable demographics, tight inventories, historically low mortgage rates, and a global pandemic have fueled home prices higher by 6% year-to-date, and 14.6% over the past year, as measured by the Case-Shiller National Home Price Index. It is worth noting that the year-over-year rate is the fastest ever on record since the index started back in 1988. And notably that includes a year just prior to the housing bust. It is worth noting that the housing market fundamentals even well before the pandemic hit, were in great shape. Housing formations by the millennial cohort looking to move out of rental units or from mom and dad's basement was robust. And housing inventories are very tight. So, then the pandemic hit. And overnight the home became the place where you work, the place where your kids went to school and the place where you spend pretty much the entire day. Mortgage rates hit all-time lows and millennials living in tight quarters and perhaps planning on buying a home the next three to five years decided to accelerate their home purchases all at the same time. And those who have fled cities, density metros. So the pandemic was this perfect storm for housing and home buying turned euphoric, and prices, specifically those for suburban homes, rose rapidly, as demand overtook supply.

Mike Collins: So, you mentioned the housing bubble and the housing bust in 2005, '06, '07 and '08. And how we've seen this huge home price appreciation. And my sense is affordability is starting to become an issue. I know a lot of people are just walking away and saying I just can't do it. I'm just going to wait for house prices to come down. I mean what's your opinion on whether or not there's the risk of a housing bubble, and whether or not home price appreciation is going to continue to go up, or if we're going to have a pullback?

Gabe Rivera: That's a great question, Mike. And it's one we've been getting a lot lately. Is there a bubble in housing? And listen, we don't believe there is a bubble in housing. And that doesn't mean there couldn't be one of the future. But the factors that define a bubble are just not there at the moment. The housing market fundamentals, as we see them, are very strong. Unlike the prior housing prices, we weren't seeing rampant speculative activity of the kind where one borrower would buy various properties with the sole aim of selling it to someone else at a higher price. The lending environment is also very different now. It used to be that pretty much anyone would walk into a bank and walk out with a mortgage. Income verification was extremely lax with many of the loans having little to no documentation at all. No money down financing was widespread and a low credit score was not really a gating issue. The picture today is very different. The government sponsored enterprises which guarantee the bulk of the mortgages being originated in the U.S. pretty much dominate the current housing finance system. And that is provided for the streamlining of technology and standardization in the underwriting process. A borrower taking out a mortgage nowadays is fully vetted to ensure that he or she has the financial wherewithal to repay that mortgage. On the demand side of things, we have this huge wave of millennials about to reach peak home buying age. So, housing formations are expected to remain robust for the foreseeable future as demographic moves from rental unit's to homeownership. And on the supply front, as we all know, the picture is pretty grim. We've underbuilt for the past decade, and there's just not enough inventory to meet the demand. The current inventory of homes available for sale continues to fall and setting at new all-time lows for May at 1.2 million units. So no, Mike, we're not back in 2006. We're not in another housing bubble. The financing apparatus is lending to borrowers that have the means to make their mortgage payments. Inventories are tight, and the demand is real and not speculative.

Mike Collins: I think the financing part of that is a really important element. People were buying multiple houses because they could get the mortgage, and now it's brutal still to get a mortgage these days and go through the process. So, what would your forecast be for home values going forward? Is the level at least, or the rate of home price appreciation going to moderate?

Gabe Rivera: That's a great question, Mike. I mean as we enter the post-pandemic world and workers return back to the office and kids go back to school and restaurants and gyms and cities reopen, something which is already starting to happen. The utility of a big home in the suburbs, perhaps with a longer commute to work, will subside. So as life normalizes, the long-term drivers of the housing market should also begin to normalize. And already we're starting to see this in the data. Mortgage purchase applications are down 22% from the 2020 peak and back in line with the 2019 levels. And to be clear, this doesn't mean we expect home price depreciation. But we do expect home price gains to decelerate to a more moderate analyzed long-term rate over the coming years. And we think that's a good thing for the housing market.

Mike Collins: Do people view housing as affordable right now?

Gabe Rivera: I think on the affordability point, and that's a great sort of point, prices are rising very rapidly. Let's not conflate that. And if you look at some of the polls, specifically from the University of Michigan, there's a percentage who think it's a good time to buy. It's lower now than at any point during the great financial crisis. It has not been this low since the early 1980's. So, the attitude towards housing is definitely beginning to change. Payments are also higher. The monthly mortgage payments of the medium price is up roughly $200 since January. And that is a 19% increase in just four months. I mean at the same time, if you look at standard metrics of affordability, some of the indices having a 3% mortgage is a really powerful thing. And on a long-term basis, housing sort of still remains affordable, and in our mind, even though there are sort of obviously pockets where it's starting to look very hot.

Mike Collins: Thank you, Gabe. Sean let's turn to you. You actually worked in what is now part of Lee's group specializing in effectively underwriting commercial real estate loans. Tell us what you did for them and how the transition from the private side to the public side has been?

Sean Beggan: I started my career 34-years ago. And I started basically at a life insurance company in asset management. It well before CMBS even existed. And then worked through a developer and then ended up on the street with the advent of the CMBS market. And then I came over to Prudential when it was Prudential Mortgage Capital on the lending side in 1998. So, I've been around for quite a while in real estate. I retired from my position in 2017. But I still wanted to get back into commercial real estate since it was a long-term part of my career. So I was fortunate enough to start with PGIM Fixed Income’s structured product group, where Gabe also works. I'm responsible for taking a look at CMBS research and credit, looking at all the SASB deals. So Single Asset Single Borrower transactions, which are large pieces of real estate. And looking at conduit transactions, which are just an amalgamation of a number of smaller real estate loans that are securitized. Working on this side, on the buy side, is a little bit more interesting. You get to ask more questions, which I think is great. I mean you have to answer the questions when you're on the sell side, but you get to ask more questions. And you can dig a little bit deeper and be a little bit more thoughtful. So, it's been a great ride so far.

Mike Collins: So, let's drill into some of the key segments of real estate. I would say office is probably right at the top of the list of people's curiosity or concerns. Are we going to go back to the office? It felt like recently, this pandemic was really moderating and now we're seeing what may be a fifth wave of COVID cases in the U.S., and certainly globally. Even if people go back to work three or four days a week, does that mean we're going to have a glut of office supply forever? What's your view on office space?

Sean Beggan: Well it's interesting, because when the pandemic started and everyone was asked to go home and work from home, first people didn't understand if it would actually work. It was a lot of companies that were reluctant to let people have the flexibility. They were starting to, but they were reluctant to let it happen. And then it's been pretty much a good success. Productivity has been very good. And will we need as much office space in the future? I think that's an unanswered question yet. People are going to go back. The need for training younger workers, the need for collaboration, all of that and corporate culture is something that really is better manifested in the office environment. So, we are going to go back. It's been starts and stops with people going back so far. There's been some companies that very early on in the pandemic asked people to come back to work and didn't have much success at it and sent people home again. But I think in the fall we are expecting, or at least we were expecting up until the most recent news, that many companies would be returning to work at that point. What are they going to be faced with? It's going to be different. Flexibility is here. I think that the number of days we spend in the office will probably change. There may be one day or maybe as many as two or three days a week that people will be working from home. But generally, people will return to the office place. They'll have the commute again, and they'll have to live with that. And what will change in the office? Offices themselves will be different in a way. I mean video conference rooms will be more prevalent. People will still want their space. I mean you would say that, if this has taught us anything, people need to have a little bit more space. But people also like to have their own workspace. So, I don't think we're going to move to a co-working environment where everyone's just hoteling a desk, and sharing a desk per se. Some industries maybe are capable of doing that. But I don't think that's going to be the case. What's going to happen with overall office and future construction? The pipeline for new office buildings has slowed dramatically. And it should. The only thing that's getting built right now would be built to suits for companies that are growing and expanding and need the space. I think the class A office buildings are probably going to do okay here. They've got better HVAC systems. They have better light, better access through their lobbies, they might have no touch lobbies which I think is good for employees. And class B and C will struggle a bit more. Fortunately for office, lease terms tend to be longer, five years, ten years is normal. So, there's a lot of office space that doesn't have to be resolved right now for landlords. They still have tenants on the hook, those tenants may or may not use that space, they generally are paying, which we're seeing I think in the multifamily side and the residential side as well, people have been paying through the pandemic. And the decision will be made by the corporate executives in the corporate real estate side of whether they need as much space in the future. And I think looking at some studies and study by CBRE, large companies have said that they probably will be downsizing some of their office space going forward. Not a lot 10-20% maybe. And the reality is they probably had an oversupply to begin with. And productivity and other technological means have resulted in them not needing as much space. Medium sized companies, it's a mixed bag. I mean some of them are saying they'll have the same amount of space. Some of them are actually saying they'll expand. Small companies that are growing, they will continue to increase their footprint in the office industry. So, I think while the jury is out on what's going to happen, office is not going away, I think class A office space is going to do very well. And we're going to return to the office at some point. When? I'm not sure.

Mike Collins: That's a great summary. I would say if there's another segment of commercial real estate that's in question, it's retail. And this has been more of a secular decline, I think in brick and mortar retails. I mentioned but there are some malls and people are out about shopping again. What's your take on the retail sector?

Sean Beggan: Well retail had issues before the pandemic. With the growth of ecommerce year-over-year leading all through the 2000's, we knew that there was a lot of dead soldiers, if you will, of retailers that were going to fall by the wayside. I think the pandemic has just basically sped up all those retailers. They've either filed BK already, or they've been dissolved in some way, or they've got themselves down to so few locations throughout the country, that it will be a nonevent when they go away. So, I think that that's been the crux of what's happened with retail. When people think about retail, they generally think about malls. And we have our decision that we think that malls are going to survive, but it's going to be the higher end malls that make it. At one point, there were almost 2,000 malls in this country, 2,000 enclosed malls. And that was I think the heyday peaked in 1986. And since then it's actually been declining. Now, if you look at Greene Street Analytics which has a database of all the malls in the country, we're down to about 943 malls. So, under 1,000 at this point. And out that 1,000, the highest rankings, which they conclude to be A++ and A+ malls total only about 88. So, you're talking about less than 9% of all the malls. Those are sort of the fortress malls from the nomenclature, and they're going to make it and they're going to do fine. And that's kind of where we focus our research on. I don't think the rest of the 943 are going away. I think there are probably a third that goes away over time. The pandemic has sped it up because they can't backfill their stores. There's no need for them. But malls are evolving, just like retail is evolving. I mean at one-point Woolworths proliferated in the United States and it's no longer around. We all remember Blockbuster Video, or at least some of us remember a Blockbuster Video. They've gone and there's been new concepts that come out. I mean we're now seeing fewer internet companies, such as Warby Parker, decide they need to have a bricks and mortar presence as well. So, I think we're going to see more of that. I think the department store story is over now. Sears is basically gone. JC Penney is a much smaller footprint. Macy's, I think is going to survive, they're going to be fine. Neiman Marcus, Nordstrom should work as well too. They had fewer stores, and they're involved with more of those higher end walls. So, I think we'll be okay there on that side. So now it's just going to be the rest of the in line and the mall shop space, as it figures out what size footprint they need to have. A lot of stores have decided that malls are a good location for fulfillment centers. And so, it's been sort of in tandem with their website presence, they like to have a local presence. And it's proved that sales are better in markets where the retailer actually has a bricks and mortar presence as well. So, I think retail is going to continue to suffer here. Ecommerce has grown. I think one thing that came out of the pandemic is that many people that did not want to even try buying stuff on the internet have done it. And once they've done it, they're going to stay there. For a while people thought the clothing industry was not going to be something that went directly to the internet. And clearly people are buying a lot of their clothes on the internet at this point. So, I think that you will continue to see that. I do think ecommerce growth is kind of slow, mostly because it's been enormous up to date. And I think going forward retail will survive; it's going to be a little bit different. Fortunately, there is not a lot of growth in terms of new stores development and new center development. You're not seeing new malls getting built at all. You are seeing some larger centers, grocery anchored centers, which we needed during the pandemic. You are seeing some neighborhood centers, which will have your drugstores and your local services. And retail has also embraced the concepts of entertainment. And we're seeing more entertainment. And if you've gone to your local grocery store recently, you've probably noticed that the bakeries and some other stores have been replaced with physical therapy. There might be a yoga center as well too. So I think it's always a transition for real estate, it always adapts and it's going to be fine. But it's still going to continue to struggle with ecommerce.

Mike Collins: That is a great summary and assessment, Sean. It's really interesting. I didn't really appreciate how much the footprint of the malls had already shrunk so much. So, we're already a big chunk of the way through that. And obviously your team is really trying to focus on those top tier properties and malls. And Lee, I know your team are always looking for more niche opportunities. What are you guys looking at on the retail side, maybe away from the big malls?

Lee Menifee: Well I guess I mean to add a little bit to what Sean said about fulfillment. When we think about fulfillment and the importance of a grocery anchored center, one of the biggest uptakes of ecommerce during the pandemic was the first-time people shopped online at grocery stores. And the conventional wisdom would be that therefore those physical locations of those grocery stores are less valuable than were before. But what we figured out is that, as of now, and probably for the foreseeable future, grocers need to use those stores as fulfillment centers. So those physical locations, the same ones that were valuable before, because they had the best catchment area for consumers, are now just as valuable, maybe even more valuable, because they have to deliver things out to those consumers. And so, I think that it's another example of where in retail going into the pandemic, I think we probably thought this was going to change a lot about how we thought about retail. Coming back to Sean's comment about the malls, I'm hard pressed to think of a lot that has changed in my thinking about malls pre-pandemic and post-pandemic, because this was already so far underway. And I would say the same thing with grocery anchored centers, which had been always evolving but resilient sector before. And now you see that continuing. So, we actually think that the stability offered in a sector that has a lot of churn is still attractive for investors.

Mike Collins: And then on the other side of this Amazon effect, hurting the brick and mortar retail is exactly what you guys are talking about. The fulfillment space, the demand for warehouse space, logistics space. So, Sean, I'll start with you on the industrial, warehouse segments of the market, I mean my sense is there's actually a lot of demand. And there's a lot of transition where existing properties, whether they're retail or office or whatever, are being transitioned into warehouse and logistics types of facilities. What's our view on that space?

Sean Beggan: Well I mean through the first quarter of '21, according to CBRE, we had 44 consecutive quarters of positive absorption. So, more space has been taken and keeping up in and ahead of supply. So that's pretty good. And we've also seen asking rents rise 7% from a year ago. And they continued to rise with this entire ecommerce growth. I think that we're now starting to see a lot of building in industrial. And I think in the pipeline right now there's about 376 million square feet of industrial space. And while that might sound daunting, I don't think anyone thinks it's going to derail the industrial story. I think what might happen is asking rents will not increase as much. I think net absorption might not be quite as positive. But this should get absorbed. And industrial, like retail and like office, has many different types. The one buzzword I guess is last mile logistics. And the interesting thing with last mile logistics is that these are infill locations. In Europe, it's generally within 20 kilometers of a major metropolitan area. In the United States call it 10 or 15 miles. Because they're infill locations, because the land has alternative uses, the price is high and so it costs a lot to build. So, what's happening there is you're not seeing as much new build in those areas. It's not as easy as one would think. The place where industrial may get hurt is what they call the cornfield properties. Those large one million, two million square foot properties that are really in the middle of nowhere and really could be built anywhere for anyone. Amazon obviously has been one of the largest users of industrial and taking the most space of any retailer over the last, probably, half a decade. That's one area of industrial that may struggle a little bit. But even there I'm not so worried. I mean industrialists in some part of industrial has actually taken the place of retail in a way, because now instead of having to have something ended up in a retail store, you can have to go directly from the industrial location right to your front door. And that's happening more frequently. The pandemic introduced another concept, which I think is a strength for industrial. But this is the one area that question whether this is going to have lasting effect. And that is that we had moved to a just in time inventory. And just in time inventory means that you might not necessarily have to have as many industrial locations, much warehouse locations. But I think the idea here of having some inventory and being able to have enough toilet paper when you need it when a pandemic comes up, has been important. And I think companies are now resolved to maintain higher inventory levels. And that increases the demand for industrial properties. Whether this is going to dissipate as we get further from the pandemic is the question mark. The ecommerce side of the story though is going to basically maintain a good ground floor for industrial. So, it's definitely one of the sectors I'd say along with multifamily and self-storage that I think came into this pandemic, already in good shape, and is coming out of it maybe even in better shape.

Mike Collins: That's great. Now and part of the industrial is also manufacturing. And certainly, within the U.S., probably the manufacturing footprint is not as big as it was many years ago. Lee, anything interesting in the industrial or manufacturing space that your team is looking at?

Lee Menifee: Actually, specific to the Americas, the manufacturing base in the U.S. is indeed huge. But most of it is not owned by institutional investors, most of it's owned by corporates or other providers. So, it's not really as investable of a sector. But that's not true in Mexico, where a lot of that sector is owned, or a rising share that is owned by institutional investors. Now what's the attraction of that? Well first of all, most of the leases in Mexico are in U.S. dollar denominated leases, with indexation to U.S. inflation. The tenant base in many cases are the same multinational corporates that manufacture things in other regions, including the U.S. And yet the yield spread that you can get for a building with maybe the same lease to a large multinational is 300 basis points at least higher, than it is in the U.S. And so, can you get comfortable with operating in Mexico versus the U.S., there's always going to be a little bit of a risk premium. Is the justifiable risk premium 300 or 400 basis points? In our view over the long term, no, that's not really sustainable and it should compress. So, the other thing around that sector is that it has been the manufacturing sector despite a very severe recession in Mexico, much more severe than most countries around the world. Tenant demand for industrial space first of all held up and then expanded and we've actually seen substantial rent growth over the past year. And vacancies in many markets now are the lowest they've been since we've tracked them. So, I think there's a combination of a structural story around just the growing trade within the Americas region, but also a cyclical recovery as well.

Mike Collins: That's interesting. Certainly, one of the advantages of having a global footprint, a global research capability. And, if there's less attractive opportunities in one country, you can go to the other. And obviously, global trade is always shifting, so being able to pivot is really helpful. That's really interesting. Let's shift gears guys and talk about a topic that is certainly near and dear to the hearts of many of our clients, many of the listeners on this, and it's ESG. There are very few podcasts we do where we don't touch on environmental, social, governance issues associated with our investment process and how we analyze credits. Lee, how would you characterize ESG considerations when you're looking at real estate?

Lee Menifee: For those of us who have been around for a few cycles, we've noticed that there's been a prior peak with the performance of property and interest in ESG. And we called it different things in different cycles. But generally, it would peak at the same time property markets peaked, and it would be the first thing investors would throw out the window as soon as there was trouble in the property markets. That is not true today. Investor demand for meaningful ESG measures is higher now than it was a year ago even before the pandemic. And I think that there's a lot of reasons for that. There’re some regulatory reasons, particularly driven by investors from Europe, but also increasingly around the world. And what they want to see, they want to see numbers, they don't want to hear platitudes. They want to see how you are measuring ESG, and it matters to them. The ways to measure the sort of the E, the environmental, are becoming increasingly standardized with different certifications across real estate that are sort of industry benchmarks and becoming more important to investors to meet that industry benchmark. It's also becoming important for tenants in buildings. They want to be in a building that is certified to have health benefits, clean air. We're coming full circle back to Sean's comments around office earlier, with what are tenants looking for. One of the things they're looking for is environmental sustainability in the building. There's also the governance aspect of the ESG, which I would say for an ethical fiduciary, assuming that you structured everything correctly, that should be a fairly easy hurdle for you to meet. But it's not an easy hurdle for every real estate investor. And then the social, I think that's probably the most interesting one. Because that's where I think that there haven't been a lot of good metrics historically around what exactly that meant. But now investors are looking for numbers. They want to know how many affordable housing units are you providing? What level of affordability? They want to know, does your property provide community benefit's? If your office or apartment has a retail in there? Is there a daycare or something else that serves the community? Can you quantify that for us? So, I actually think this is probably one of the most important determinants not only of how investors are looking at real estate, but it's starting to show up in performance. And when it starts to show up in performance now everybody gets interested. And it's starting to show up in the liquidity of assets, as you're seeing assets that have demonstrated ESG attributes built into them. And we're probably at the early stages where it's starting to show up in asset pricing as well. So, I would say that ESG has evolved from, I think the conversation at one point was, we have to balance ESG needs with our fiduciary obligations, and the real estate industry is coming around to ESG is a fiduciary obligation.

Mike Collins: That's a great take on it. And we're seeing certainly ESG related valuations impact all of the global asset markets. And certainly, in the corporate bond markets in the U.S., there hasn't been a big enough differentiation yet from an ESG, positive company to a negative one. But that is happening. And it's going to happen. And we are really focused on getting in front of that. So, thank you for that. Let's wrap up with positioning.

Gabe, I know you work closely with me and the multi-sector team that I am on within PGIM Fixed Income. We own a lot of real estate related investments. Obviously, Lee and his team own all real estate related investments, whether it's public equity, private equity, debt, they're all in on real estate. But within our portfolios at PGIM Fixed Income, particularly the multi-sector portfolios that I co-manage, we have a decent chunk of real estate. Some on the REIT side, we actually own the debt of some REITs that we really like. And to the themes you've heard today, some of them are very, niche. Like healthcare REITs that specialize in like medical office buildings and labs, or office REITs that specialize in tenants who are in the biotech or pharma industry or data storage REITs. Which is a really big growing area that we haven't talked a lot about. Or gaming REITs and the gaming sector is one that has shown tremendous resilience. Or to extent we're in office REITs, they're the top malls in the country, as Sean mentioned, that's the way to go. So Gabe, within the structure products that you specialize in, commercial mortgage backed securities, non-agency, residential mortgage backed securities, these single asset single borrower deals that Sean referenced, where we're actually underwriting or a loan on a single property in many cases, and in some cases going down the capital stack, as we say. Meaning buying is not only the senior AAA debt, but sometimes the BBB or even the BB and B rated debt. How would you summarize our positioning and our thoughts there?

Gabe Rivera: So, Mike, structured products make up a very important part of our portfolio sector allocations. And in aggregate, roughly half of the structured product securities we own are collateralized by residential or commercial real estate assets. On the residential front, we are bullish on residential credit because we are bullish on the job market and the economy and we believe the housing market fundamentals are robust. Mortgage underwriting is being done conservatively and the forward supply dynamic of the housing market are indicative of continued rising home prices. As a result, we've increased our exposure to the asset class across a variety of different instruments. In particular, one instrument we've used to express the view has been mortgage credit risk transfer securities, or CRT for short. CRT securities put simply are securities that transfer mortgage risk from one party, usually one providing mortgage insurance, to third party investors, via securitization technology. The largest issuers of CRT securities in the U.S. are Fannie Mae and Freddie Mac who use CRT to transfer risk away from the taxpayer and onto third party investors who can more adequately price the risk. One quick point that I feel that needs to be made on the ESG front. While facilitating homeownership is good ESG we feel that the GSEs could be doing a better job of taking into consideration climate change and flood risk as it relates to the pricing of mortgage risk. And now turning to the commercial real estate side of things, our exposure is primarily two-fold. We find value at the top of the capital structure in AAA CMBS conduit securities, which we deem lost remote and cheap on a relative value basis, versus investment grade corporate credit. And we take credit risk down in the capital structure within the single asset single borrower space, as you mentioned, or SASB for short. A SASB security is collateralized by a single commercial real estate asset, such as an office building. Or various properties owned by a single borrower, such as a portfolio of industrial warehouses. Unlike conduit mezzanine securities, the collateral in the SASB transaction can be fully underwritten. And we can leverage our in-house experts, such as Sean, to really dig in through each property. Some of our favorite trades in SASB space should be apparent from our conversation today. And they include exposure to industrial portfolios, multifamily properties, and top tier malls. It is worth noting that historically, we've been pretty risk averse as it relates to the hospitality sector, given the very high operating leverage, and the overnight lease structure in that space. And for the most part, we came out of the pandemic pretty unscathed by the distress in that sector.

Mike Collins: I mean I have to really give kudos to you and Sean and the whole team, even before the pandemic when we were looking at these, as you mentioned, the conduit commercial mortgage backed securities deals where we typically only play in the AAA. Because we are not, as you say, underwriting all of the loans. Somebody else is writing the loans and we're buying a pool of these loans. And so we really want to take a more conservative stance there. But your team did a great job generally avoiding these transactions that had a disproportionately high level of lodging and retail exposure. So just kind of saw the writing on the wall well before the pandemic. So thank you for that. And thank you, Lee and Sean and Gabe. I think this was a really interesting podcast. Thank you for all your thoughts. I really just want to mention to all our listeners that you can see all of our thought leadership on our website pgimfixedincome.com. We have a bond blog, aptly called The Bond Blog, as well, to get all of our latest ideas from PGIM Fixed Income. And until next time, thank you.

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