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January 8, 2025

The CRE Outlook: Key Insights and Strategies for Banking Leaders

CBA 2025 Bank Presidents Seminar

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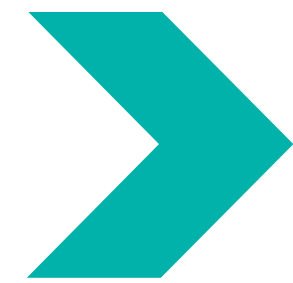
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Robert S. McWhorter – Shareholder | Buchalter

➤ **Agenda: The CRE Outlook**

- 1. Welcome and Introduction**
- 2. Overview of Commercial Real Estate Market in 2024**
- 3. Banking Strategies for CRE: How are banks navigating and managing CRE Portfolio**
- 4. FDIC Regulatory Insights: Review of Banks for CRE Compliance**
- 5. Legal Considerations for CRE**
- 6. Questions and Answers**



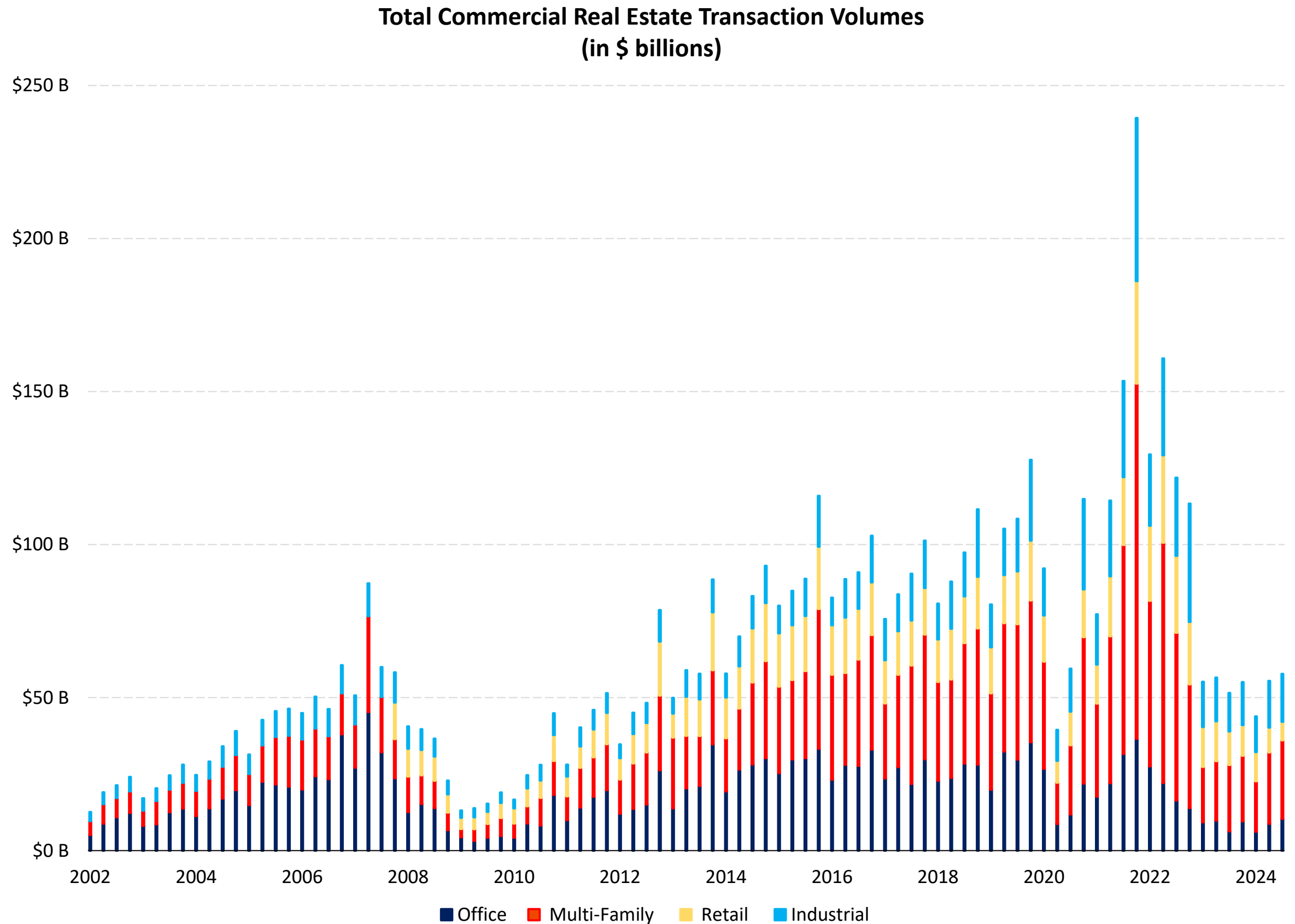


Overview of the Commercial Real Estate Market

CRE Transaction Volumes Have Yet to Recover



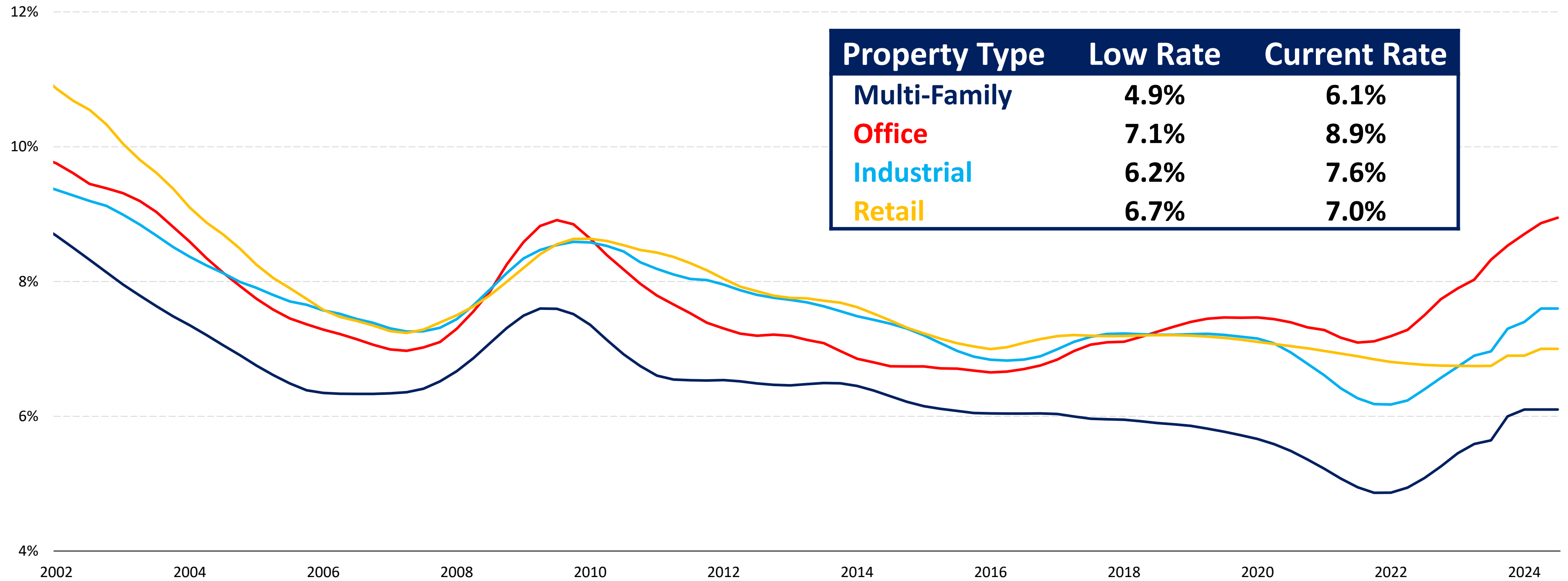
- After peaking at \$239 billion in Q4 2021, total commercial real estate transaction values have fallen to just \$43 billion in Q1 2024.
- Transaction values of Office CRE totaled only \$6 billion in Q1 2024, the lowest since the Great Financial Crisis, driven by collapsing CRE values in many urban hubs.
- As distress sales increase there is enormous amounts of investment capital that is ready to be deployed.



CRE Cap Rates Found Some Equilibrium



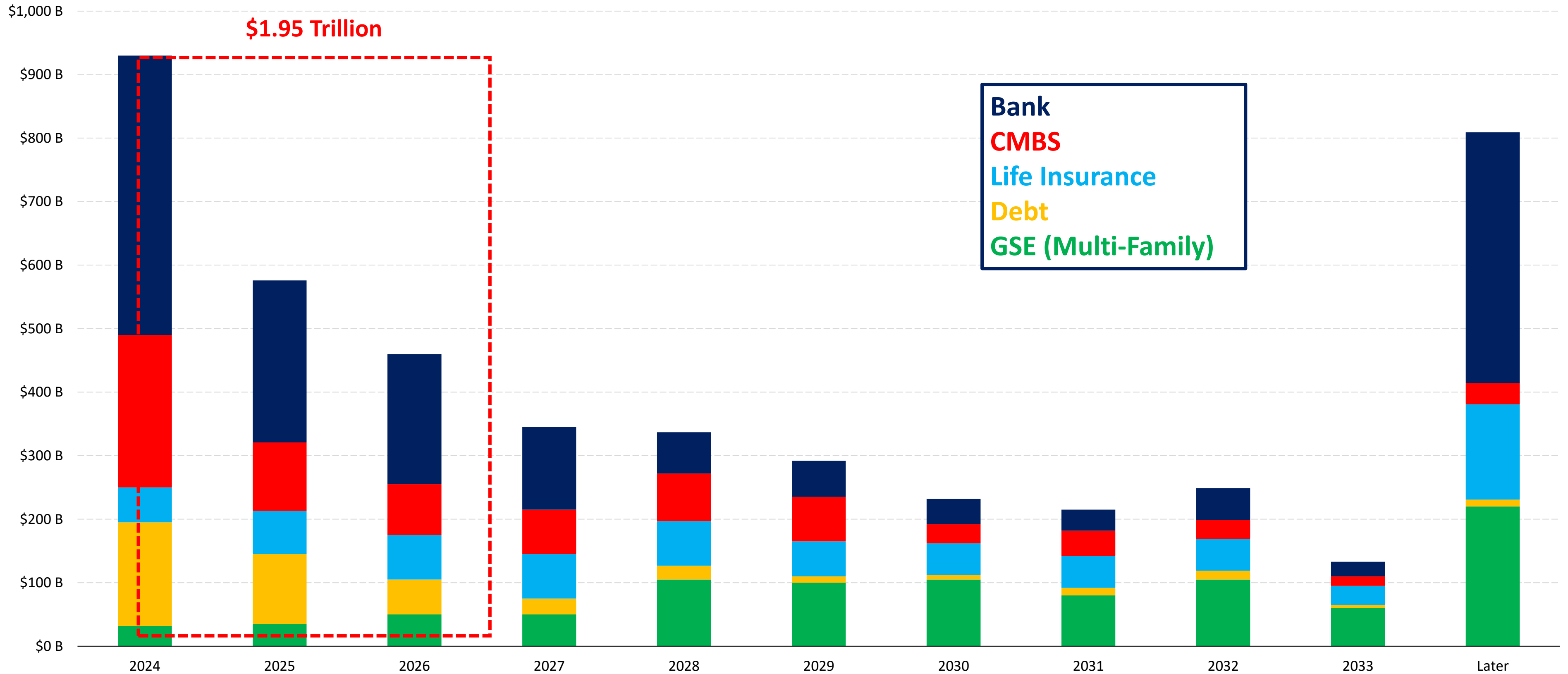
Cap Rates by Property Type (%)



Coming Commercial Maturities Will Bring More Pain



Commercial Real Estate Loan Maturities (in \$ billions)



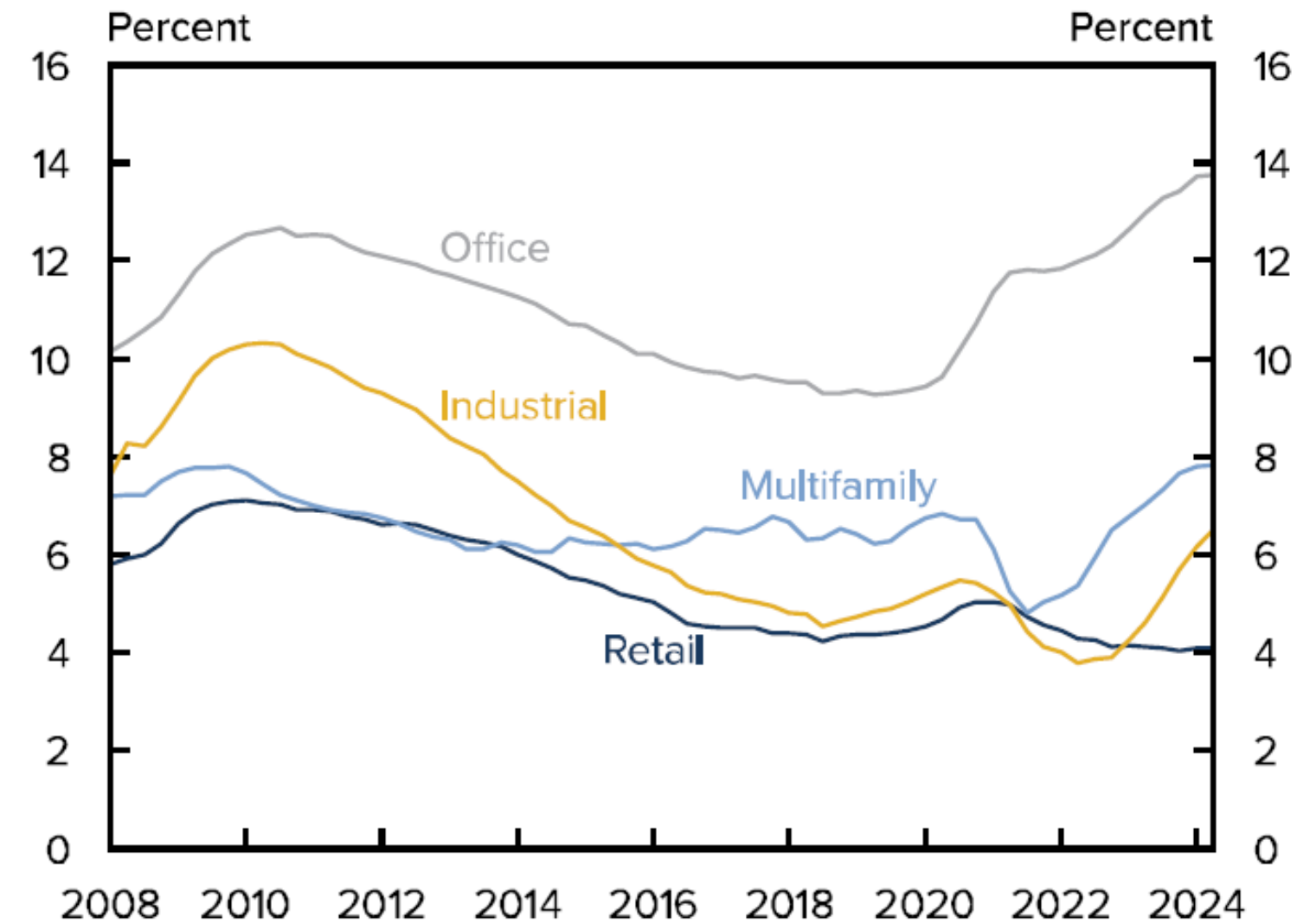
Source: Mortgage Bankers Association

➤ CRE – Office Sector Analysis

Office Vacancy Rates – U.S.

- **Overall office vacancy rate:** Increased from **13.0% (Q2 2023)** to **13.8% (Q2 2024)**
- **Vacancy rates in the 20 largest office markets:** Increased from **14.2% (Q2 2023)** to **15.1% (Q2 2024)**.
- U.S. Treasury expected office vacancy rates in 2025 to **increase** because 45% of office space leased prior to 2020 “has yet to roll over.”

3.1.1.2 Vacancy Rates by Property Type



Note: Data as of 2024:Q2.

Source: CoStar.

➤ CRE – Multifamily and Industrial Property Sector Analysis

Multifamily Properties

Market Overview

- Declining Property Values
- Rising Vacancy Rates: Increased from **7.0% (Q2 2023)** to **7.8% (Q2 2024)**.

Factors

- ❖ Certain markets experience significant increases in supply
- ❖ Vacancy rate viewed as reaching its peak with supply/demand “to become more balanced in coming quarters” in 2025

Industrial Properties

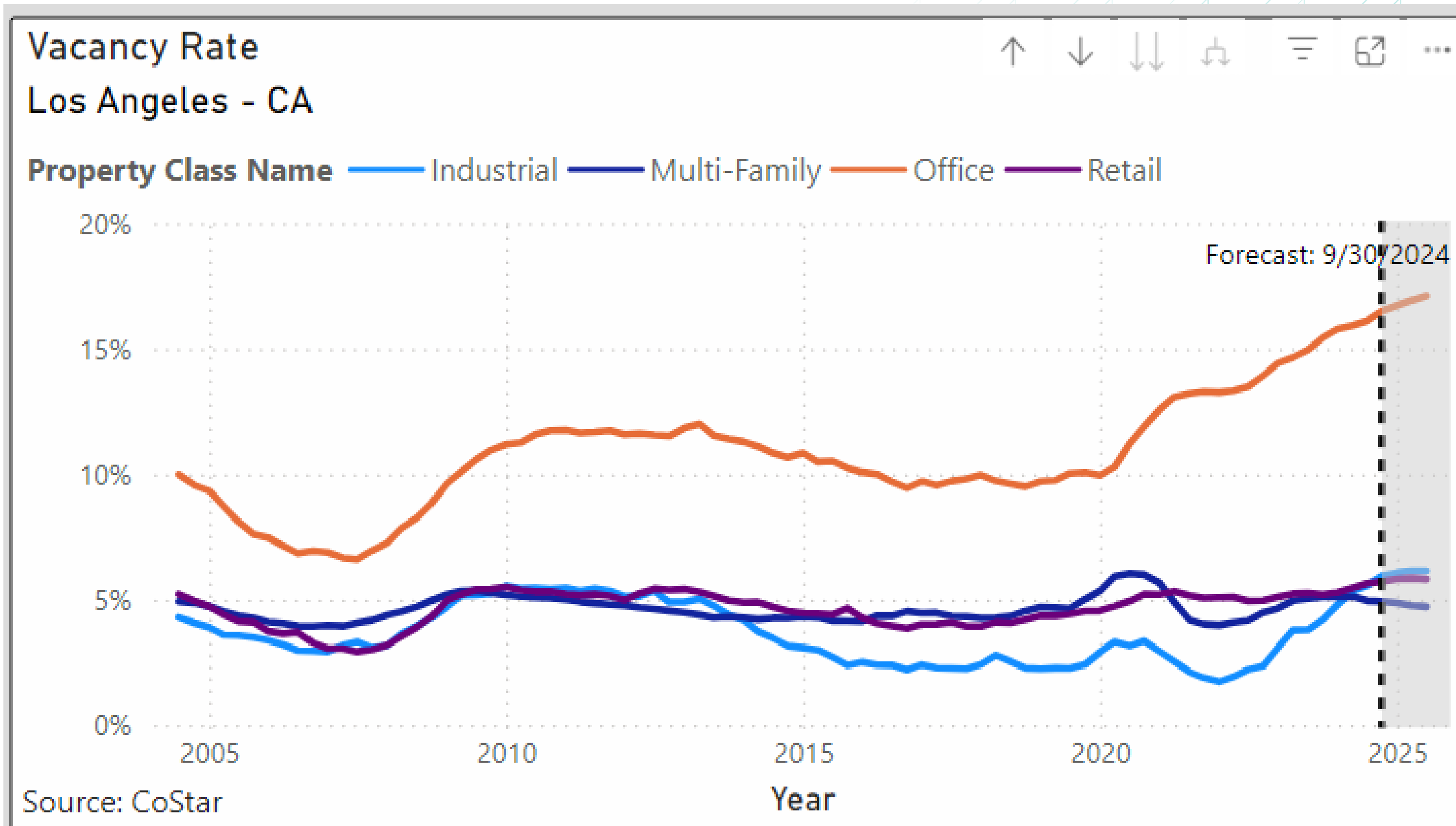
Market Overview

- Declining Property Values
- Rising Vacancy Rates: Increased from **4.6% (Q2 2023)** to **6.5% (Q2 2024)**.

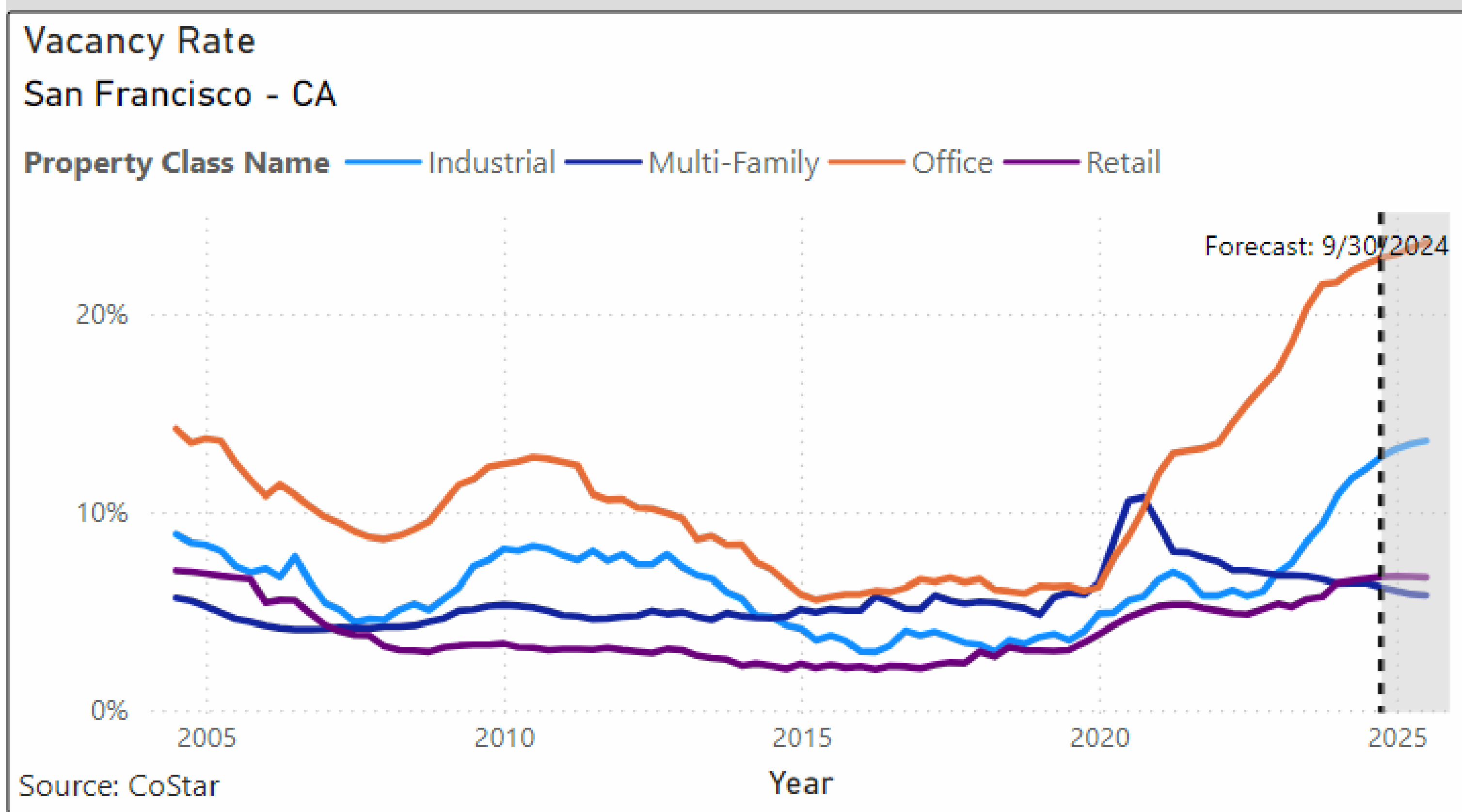
Factors

- ❖ Supply outstripping modest demand
- ❖ New construction has slowed, which may correct situation

Vacancy Rate – L.A.

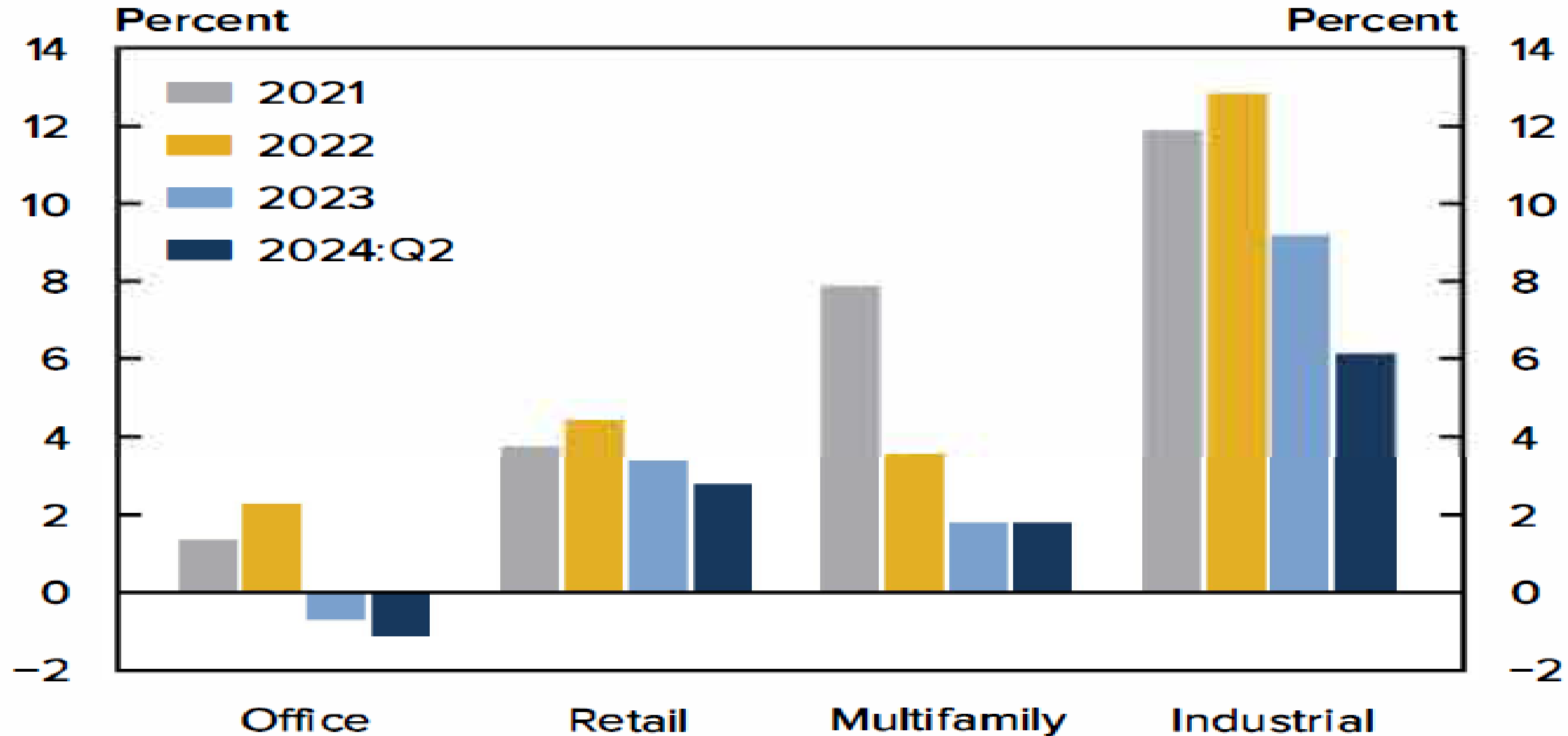


Vacancy Rate – S.F.



Net Operating Income for CRE Properties

3.1.1.3 Year-Over-Year Change in Net Operating Income by Property Type



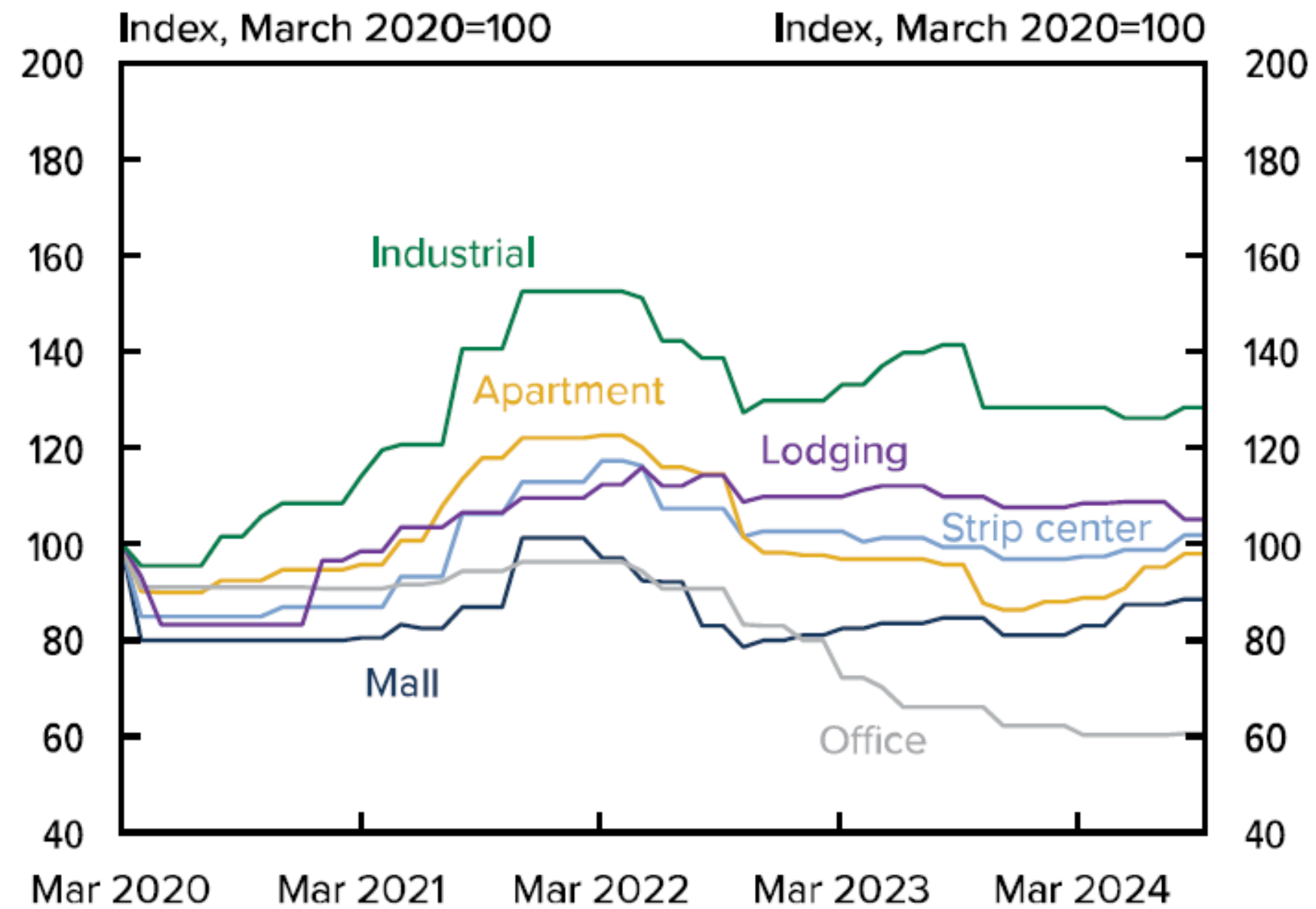
Net Operating income for office space has been negative since 2023

Note: Data as of 2024:Q2.

Source: CoStar.

➤ CRE Property Values

3.1.1.4 Commercial Property Price Indexes by Property Type

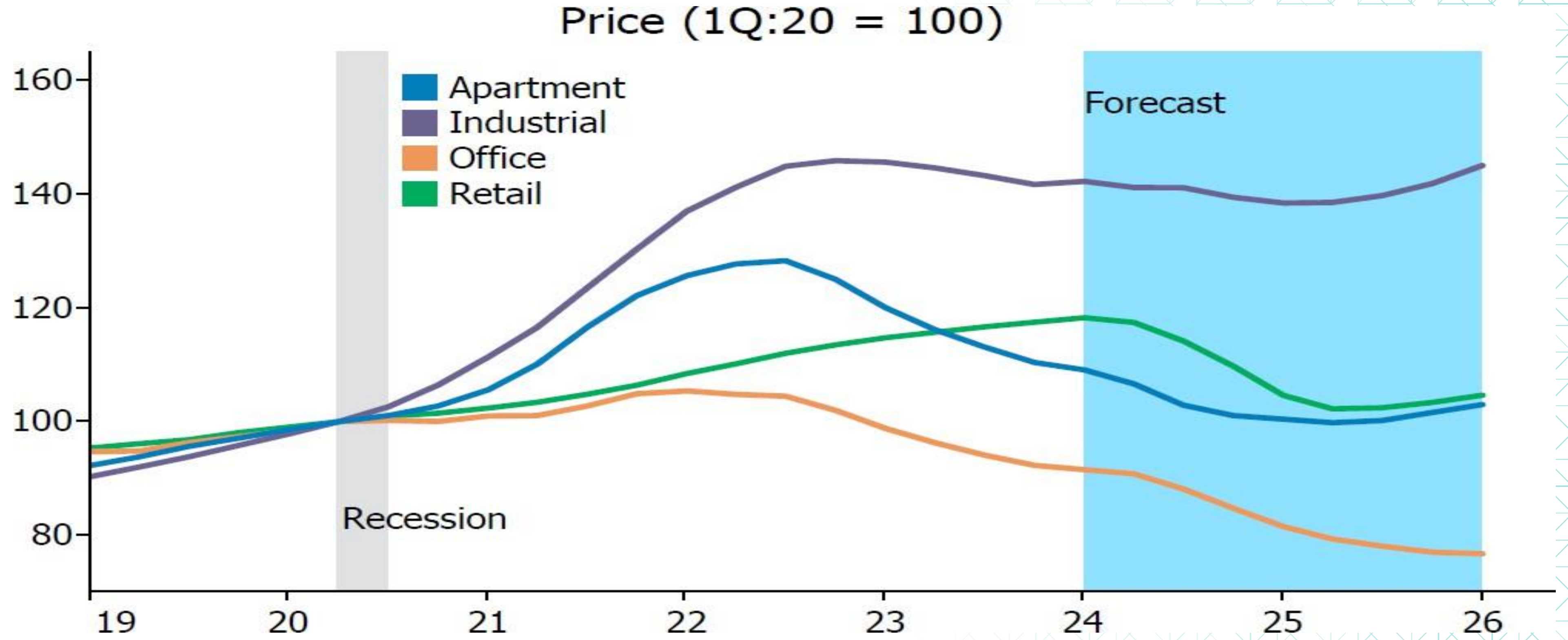


Note: Data as of September 2024.

Source: Green Street's Commercial Property Price Index.

- **Commercial Office Property Values Have Declined by about 40% from Pre-Pandemic Levels**

CRE Property Prices Forecast

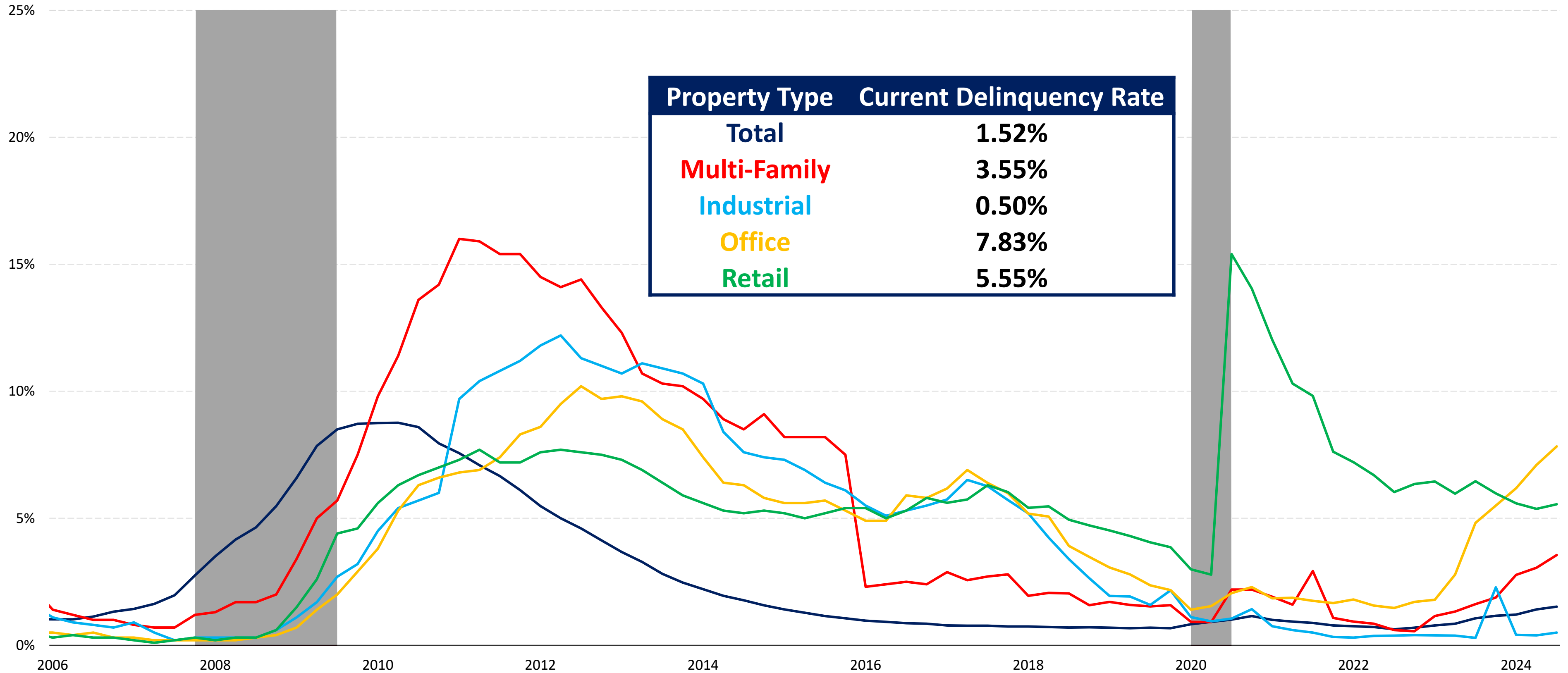


Source: CoStar Portfolio Strategy (historical data through 4Q:23, baseline forecast updated February 2024).
Note: CoStar's baseline forecast assumes no recession, but below-trend growth in 2024 and 2025.

CRE Delinquencies Show Increasing Stress



Delinquency Rates by Commercial Real Estate Type (%)



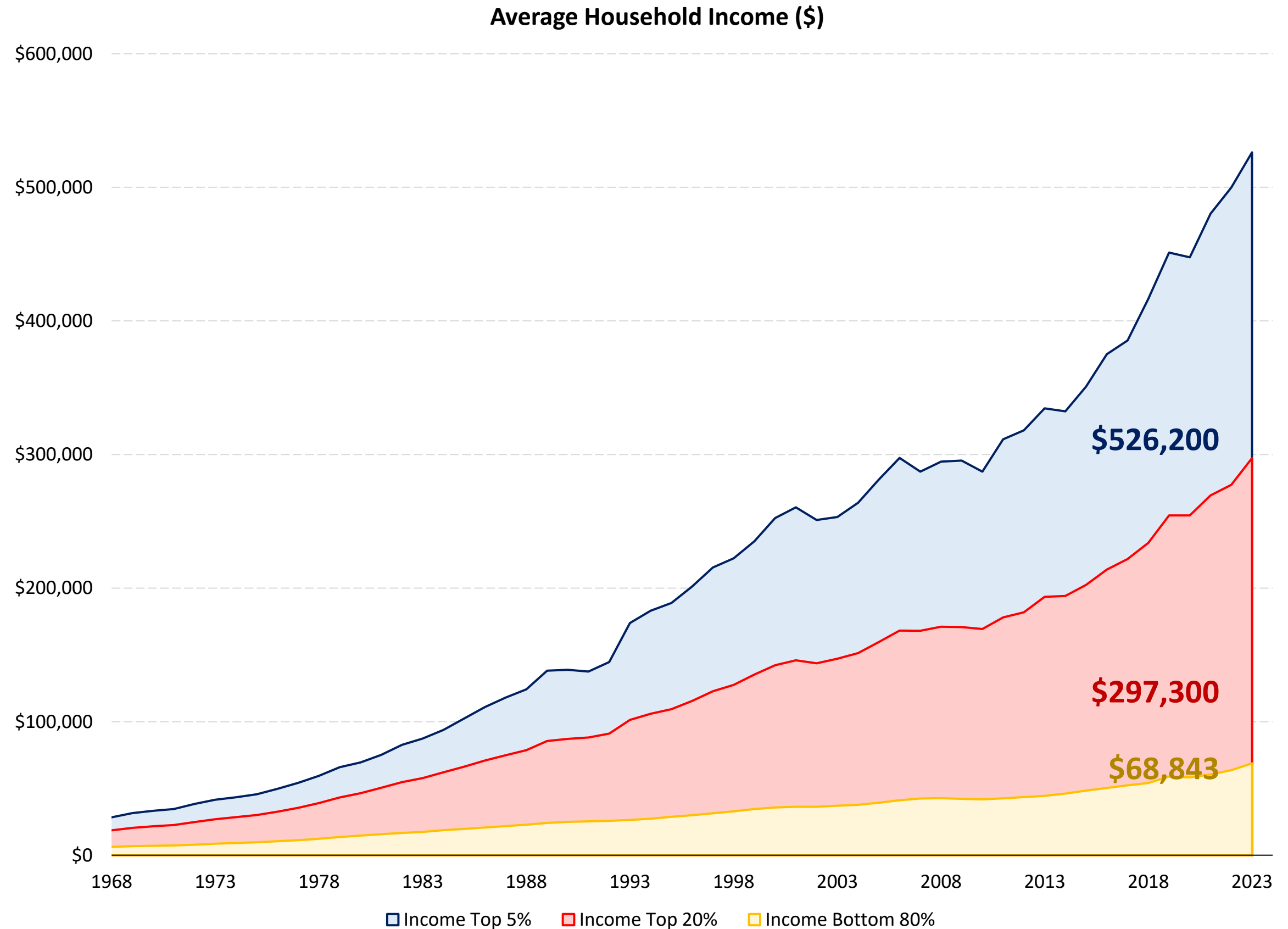
Grey Bars Indicate Recession

Source: S&P Global

The Top 20% Continue to Separate From the Bottom 80%



- Unsurprisingly, mean household income has continued to expand among the different wealth classes. In 2023, the mean household income for the top 5% of earners in the U.S. was \$526,200 compared to \$297,300 for the top 20% and just \$68,843 for the bottom 80% of earners.
- A large part of this income disparity is due to the fact that the bottom 50% of earners in the United States own just 1% of all stocks and mutual funds.
- The top 10% of earners in the U.S. own roughly 67% of total wealth while the bottom 50% own just 2.5%.



Source: U.S. Census Bureau

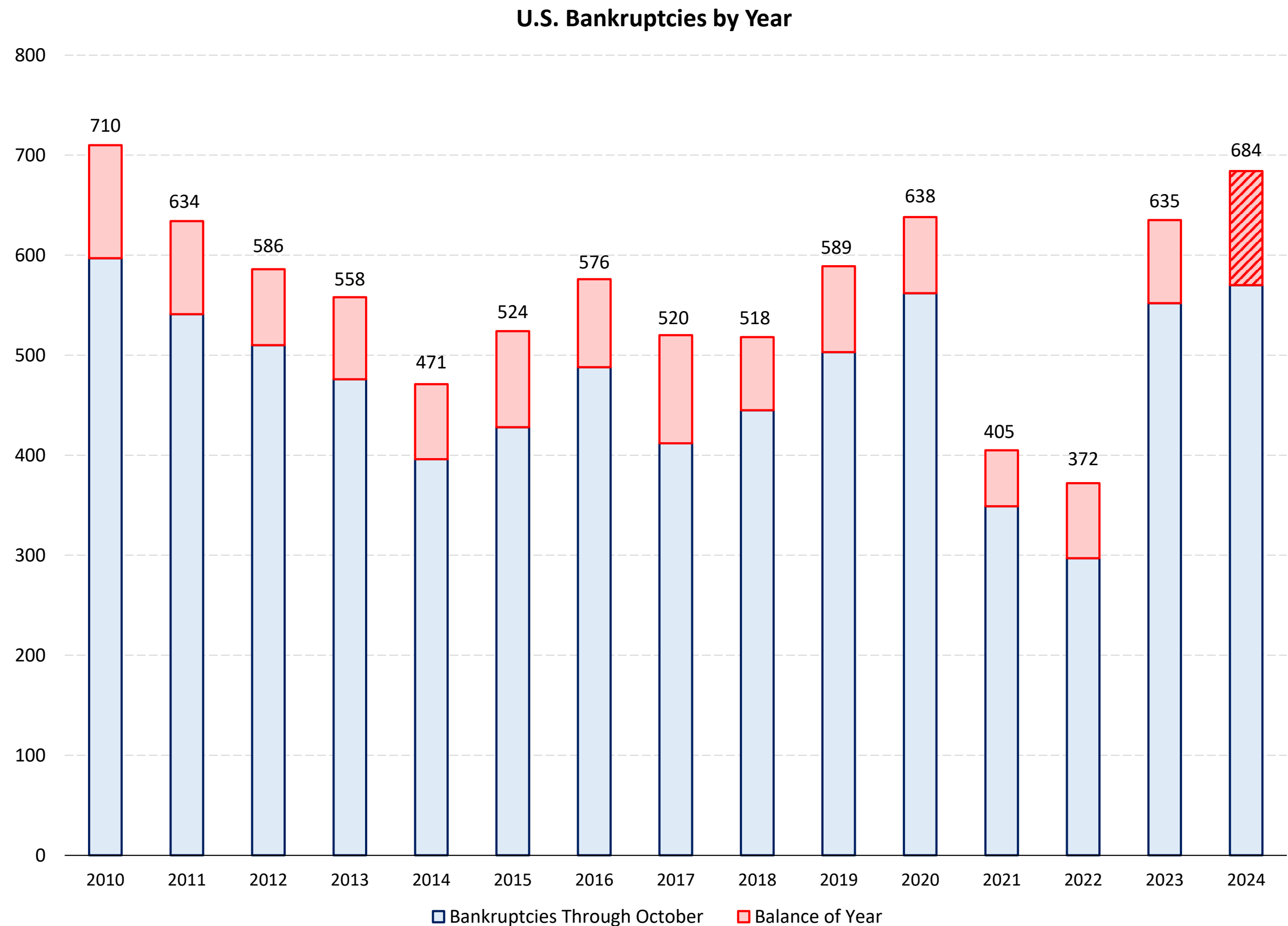
Corporations Across Industries Continue to Struggle



- Through October, **570** companies have filed for bankruptcy. Annualized, this amounts to 684 total bankruptcies.

- Notable bankruptcies in 2024 include:

- Spirit Airlines
- Red Lobster
- Big Lots
- Wheel Pros
- Tupperware Brands
- JOANN Inc.
- American Tire Distributors
- TGI Fridays



➤ Bankruptcy Issues

Commercial Chapter 11 Bankruptcies

Key Statistics:

- **Commercial chapter 11 filings: 20%** increase from calendar 2023 to calendar 2024 (6,583 to 7,879 filings)
- **Overall Commercial Filings: 11% year-over-year increase** (Dec. 2023–Dec. 2024).
- **Commercial Chapter 11 Filings: 8% increase** during the same period

Bankruptcy Drivers (ABI/Reuters):

- Rising interest rates
- Inflation and higher labor costs
- Geopolitical tensions
- Post-pandemic consumer spending shifts

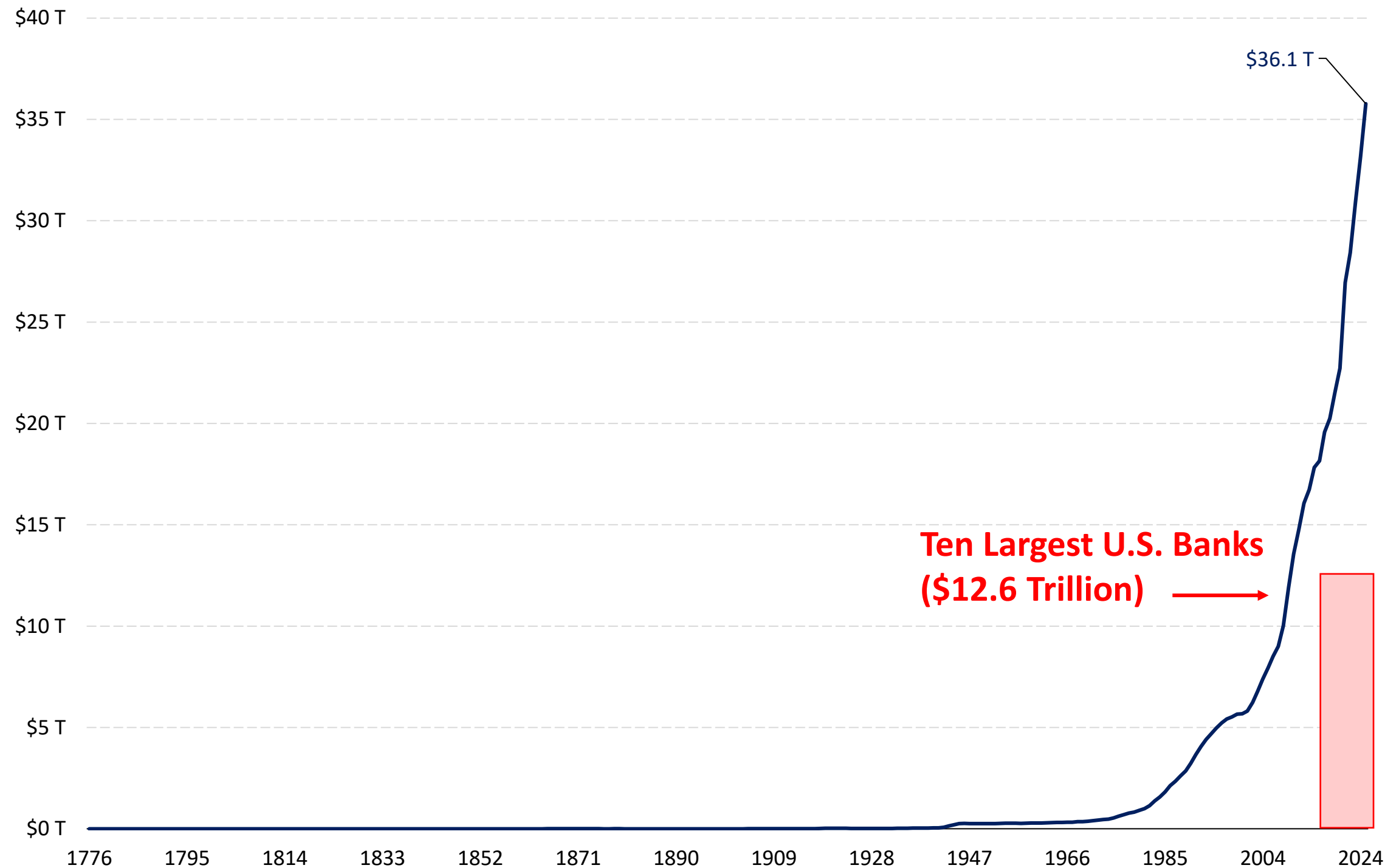


Government Debt Soared to a Colossal Level



U.S. Gross National Debt (in \$ trillions)

- Since FY 2021, the start of the Biden Administration, the U.S. has added more than \$13 trillion in debt. It previously took the country 234 years, until FY 2010, to reach \$13 trillion in debt.
- The United States has increased the national debt more than **\$30 trillion** since the start of the 21st century.
- On average, the United States has increased its debt by \$1 trillion every **142 days** since the start of COVID-19.



Source: U.S. Treasury Department



FDIC Regulatory Insights: Review of Banks for CRE Compliance



CRE Trends



Agency Reports

Financial Stability Oversight
Council (FSOC) Annual Report
FDIC – Quarterly Banking Profile
OCC – Annual Report



California

CRE Regulatory Guidance

CRE – Regulatory Guidance

Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

2006

FIL-64-2023 Advisory: Managing Commercial Real Estate Concentrations in a Challenging Economic Environment

2023

2023

FIL-34-2023 Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts

Applicable Rules and Regulations



- Part 364, Appendix A, Part II



- Section 365.2 Real Estate Lending Standards



- Part 365, Appendix A



- Part 323 Appraisals

Part 364

Applicable Rules and Regulations

Part 364, Appendix A (II) (c)

An institution should establish and maintain loan documentation practices that:

- Enable informed lending decisions
- Assess risk on an ongoing basis
- Identify the purpose, source of repayment, and ability to repay in a timely manner for each loan
- Ensure any claim against a borrower is legally enforceable
- Demonstrate appropriate administration and monitoring of a loan
- Take into account the size and complexity of a loan



Part 365

Applicable Rules and Regulations

Section 365.2(b)(2)

Each bank shall adopt and maintain written real estate lending policies that must address:

- Loan portfolio diversification
- Prudent underwriting
- Loan administration procedures
- Documentation, approval, and reporting requirements to monitor compliance with lending policies



Part 365

Applicable Rules and Regulations

Section 365.2(c)

Banks must monitor the conditions in the real estate market in its lending area to ensure that real estate lending policies continue to be appropriate

Part 365 Appendix A

Loan administration procedures should address documentation, including the type and frequency of collateral evaluations

Credit underwriting and administration procedures should reflect Part 323 requirements



CRE Accommodations and Workouts

- **FIL-34-2023, Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts**
- The Policy Statement contains supervisory expectations for an institution's risk management process for loan workout programs, loan workout arrangements, classification of loans, and regulatory reporting and accounting considerations.
- The update includes:
 - 1) The addition of a new section on short-term loan accommodations;
 - 2) information about changes in accounting principles since 2009; and
 - 3) revisions and additions to examples of CRE loan workouts.

CRE Loan Review

Forward-Looking Aspects of Credit Risk Evaluation



Thinking about how current debt is structured and the potential impact of existing terms relative to changes in market conditions.



Evaluating repayment capacity under amortizing payment terms.



Understanding the potential impacts of market changes, such as interest rate changes or changes in real estate market conditions.



Layering of risks.

Repricing Risk

- The Guidance on Concentrations in CRE Lending, **Sound Risk Management Practices, FIL-104-2006**, notes: “Consistent with the Agencies’ real estate lending guidelines, CRE lending policies should address:
...Requirements for feasibility studies and sensitivity analysis or stress testing.”
- Both fixed-rate and variable-rate loans can present repricing risk.
- Bank management should consider repricing risk as part of underwriting and credit administration practices.

Global Cash Flow Analysis



Global cash flow analysis is used to assess credit risk by determining the repayment capacity from multiple, interrelated sources

Financial metrics are often complex, requiring judgement to calculate and evaluate



Effective global cash flow analysis is about understanding the sources and sustainability of cash flow, and any other demands on cash flow from related entities

Liquidity Evaluation and Verification



Liquid assets of the borrower or a guarantor, sponsor, or affiliated entity may be another source of repayment when cash flows are insufficient to meet debt obligations.



When repayment of collateral is reliant on liquid assets, examiners will assess reasonableness and bank's efforts to verify and secure such assets.

Guarantor Ability and Willingness

Assess each guarantor's *ability* **and** *willingness* to provide financial support:

Assessment of financial **ability**:

- Review credit history
- Evaluate global cash flows
- Determine unencumbered assets and liquidity
- Identify contingent liabilities

Assessment of **willingness**:

- Consider demonstrated performance
- Determine economic incentives
- Review actions to enforce prior guarantees

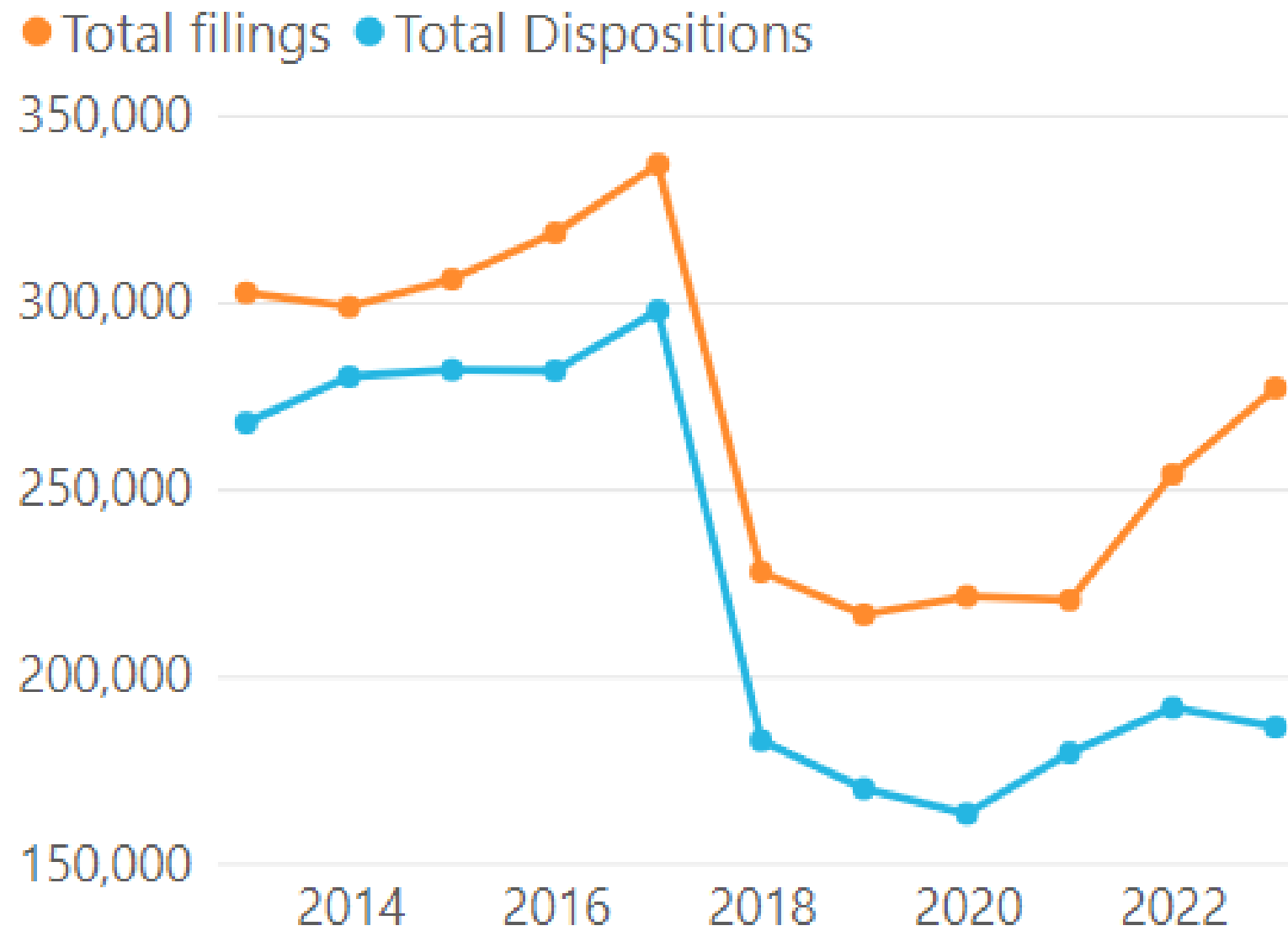


**Legal Consideration for Commercial Real
Estate Matters for 2025**

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➤ The Court – Increase in Civil Filings

Filings and dispositions for Unlimited Civil



For 2023:

- **Total Filings: 277,080**
- **Dispositions: 186,343**
- **Case Clearance Rate: 89%**

Clearance Rate: Measure of how efficiently courts by comparing number of case disposed of to the number of cases filed.

When clearance rates are consistently below 100%, caseloads will grow.

Source: 2424 Court Statistics Report, Statewide Caseload Trends, 2013-2014 through 2022-2023

➤ The Courts

Court Budget Constraints

- **\$97 million reduction to superior courts** - fiscal year 2024-25 budget
- A **7.95% reduction to the state-level judiciary**, including the Supreme Court, Courts of Appeal, Habeas Corpus Resource Center, and the Judicial Council.
- In 2024, courts froze hiring, adopted furloughs, and reduced hours at their clerks' offices and public counters



Blaine Corren, 2024 Year in Review: Judicial Council of California (December 17, 2024)
<https://newsroom.courts.ca.gov/news/2024-year-review-judicial-council-california>



Banking Strategies for CRE: How are banks navigating and managing CRE Portfolio

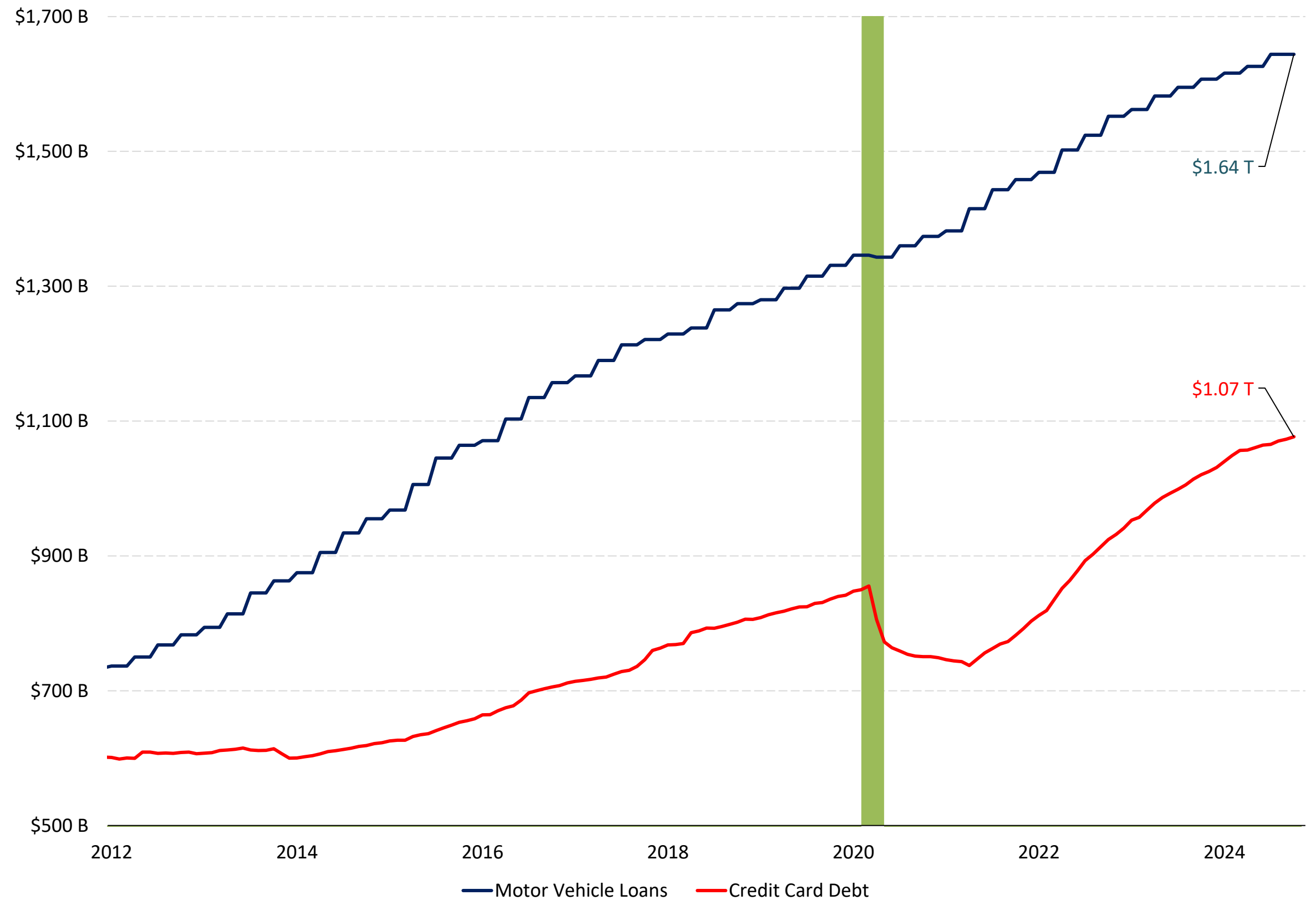


Consumer Debt Kept Setting New Highs



Auto Loans and Credit Card Debt (in \$ billions)

- Americans continue to spend at an unsustainable pace as consumer credit card debt has exploded to \$1.07 trillion. Consumer credit card debt has increased for 43 consecutive months, and a new record high has been reached in each of the last 30 months.
- In addition to credit card debt, total auto loans have increased 17 consecutive quarters and are now at a record high of \$1.64 trillion.
- The percentage of Americans who used a Buy Now Pay Later program grew to 13.6% in 2023.



Grey Bars Indicate Recession
Source: St. Louis Federal Reserve, New York Fed Consumer Credit Panel/Equifax

Housing Sales Activity Collapsed but for New Homes



Existing Home Sales (in thousands)



New Home Sales (in thousands)

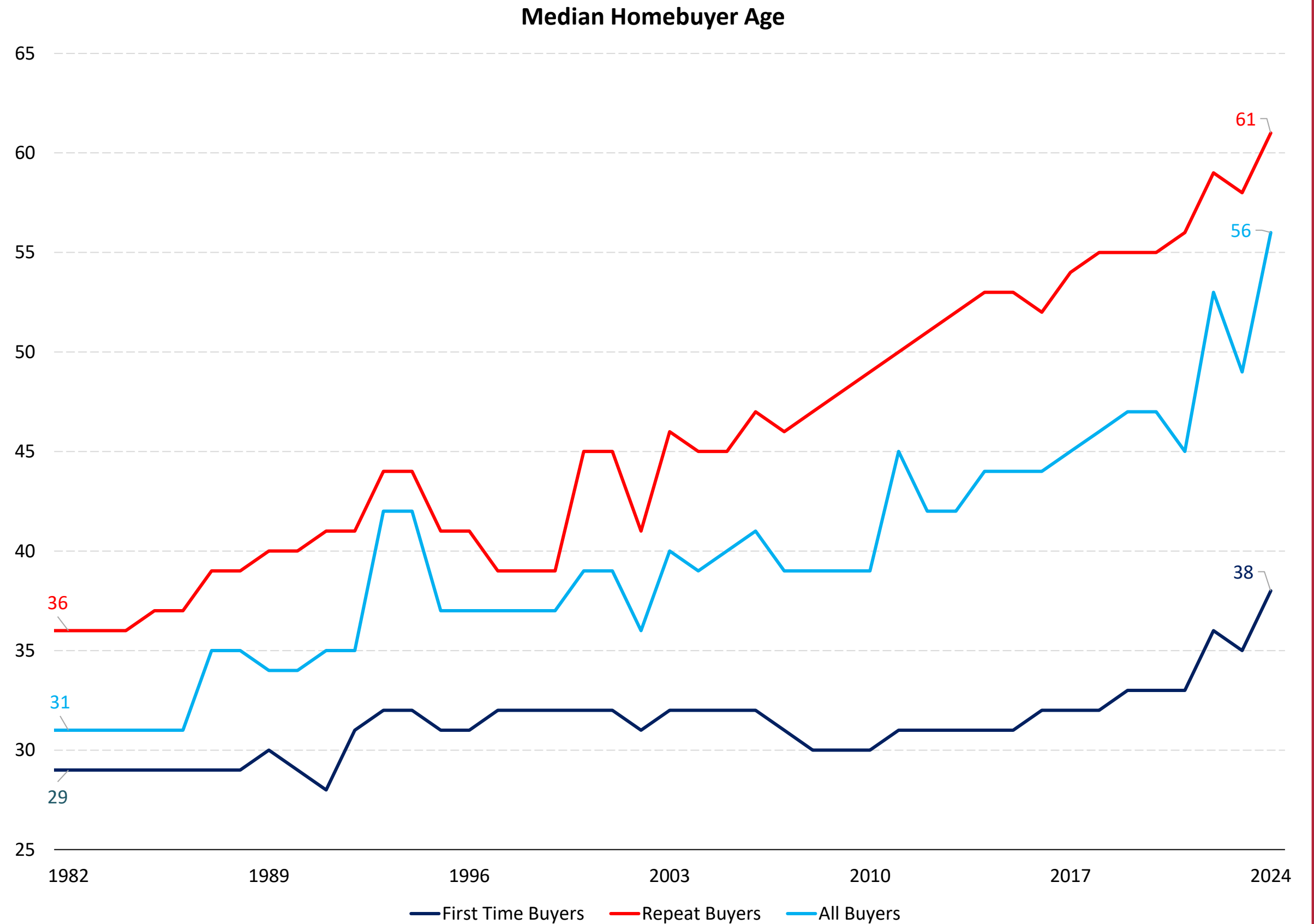


Source: National Association of Realtors

Younger People Are Being Priced Out of the Market



- For the year ending July 2024, the median age of first-time home buyers rose from 35 to 38, while the share of first-timers dropped from 32% to 24% of all buyers.
- An 18% down payment, the median percentage buyers put down, on a \$435,000 home comes to \$78,300. For context, the U.S. median household income in 2023 was \$80,610.



Source: National Association of Realtors



Questions?



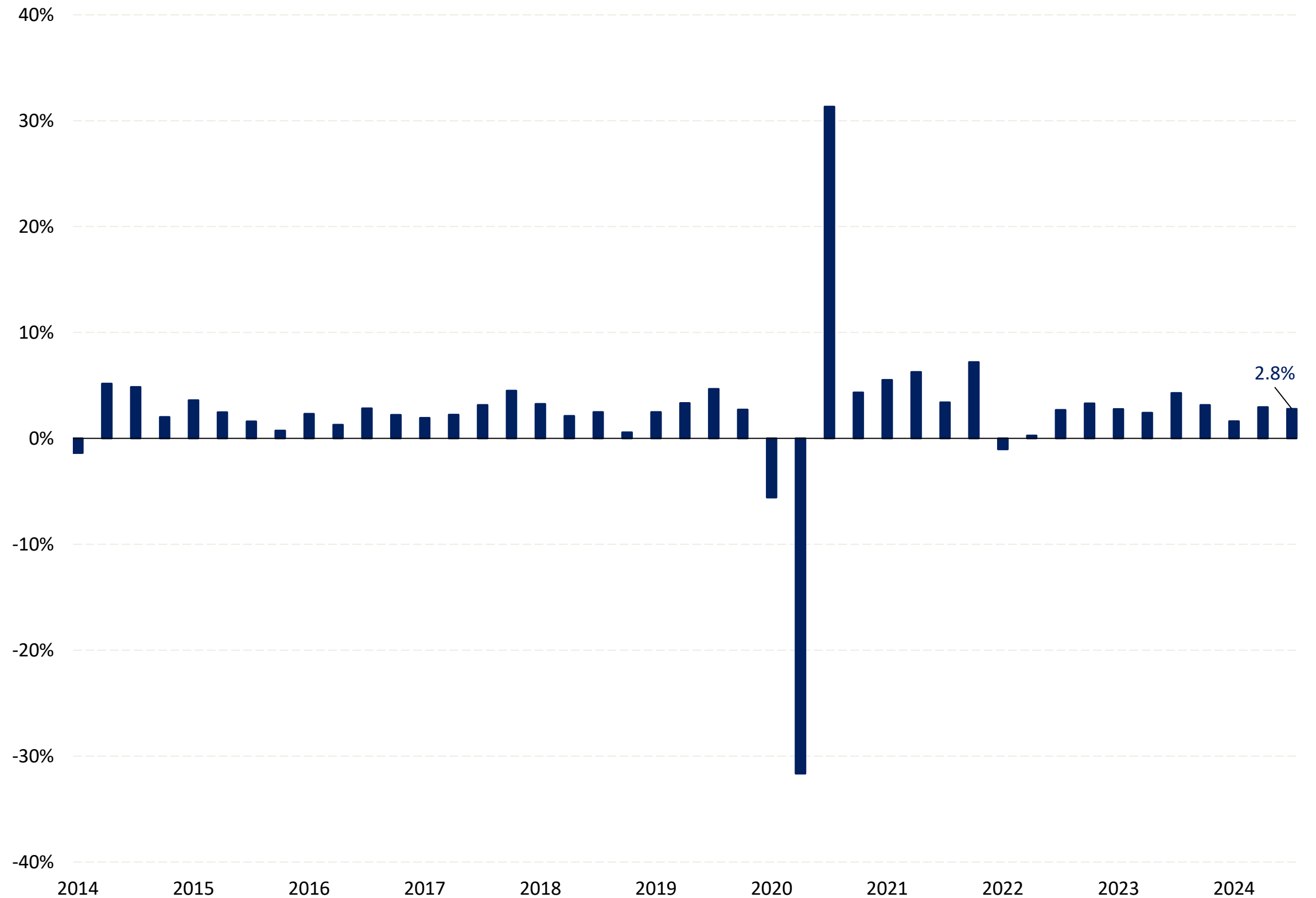
Appendix

Government Deficit Spending Kept the Economy Afloat



U.S. Real Gross Domestic Product QoQ Change (%)

- Real GDP remained resilient in 2024, growing at an average annualized rate of 2.5% through three quarters (+1.6% in Q1, +3.0% in Q2, and +2.8% in Q3).
- Government spending has largely kept the economy afloat as federal outlays totaled \$6.7 trillion in FY 2024, a 10% increase from FY 2023 and \$71 billion short of being the most expensive fiscal year on record (FY 2021).
- Consumer spending has also remained resilient as personal consumption expenditures (PCE) have grown at an average rate of 2.5% in 2024.



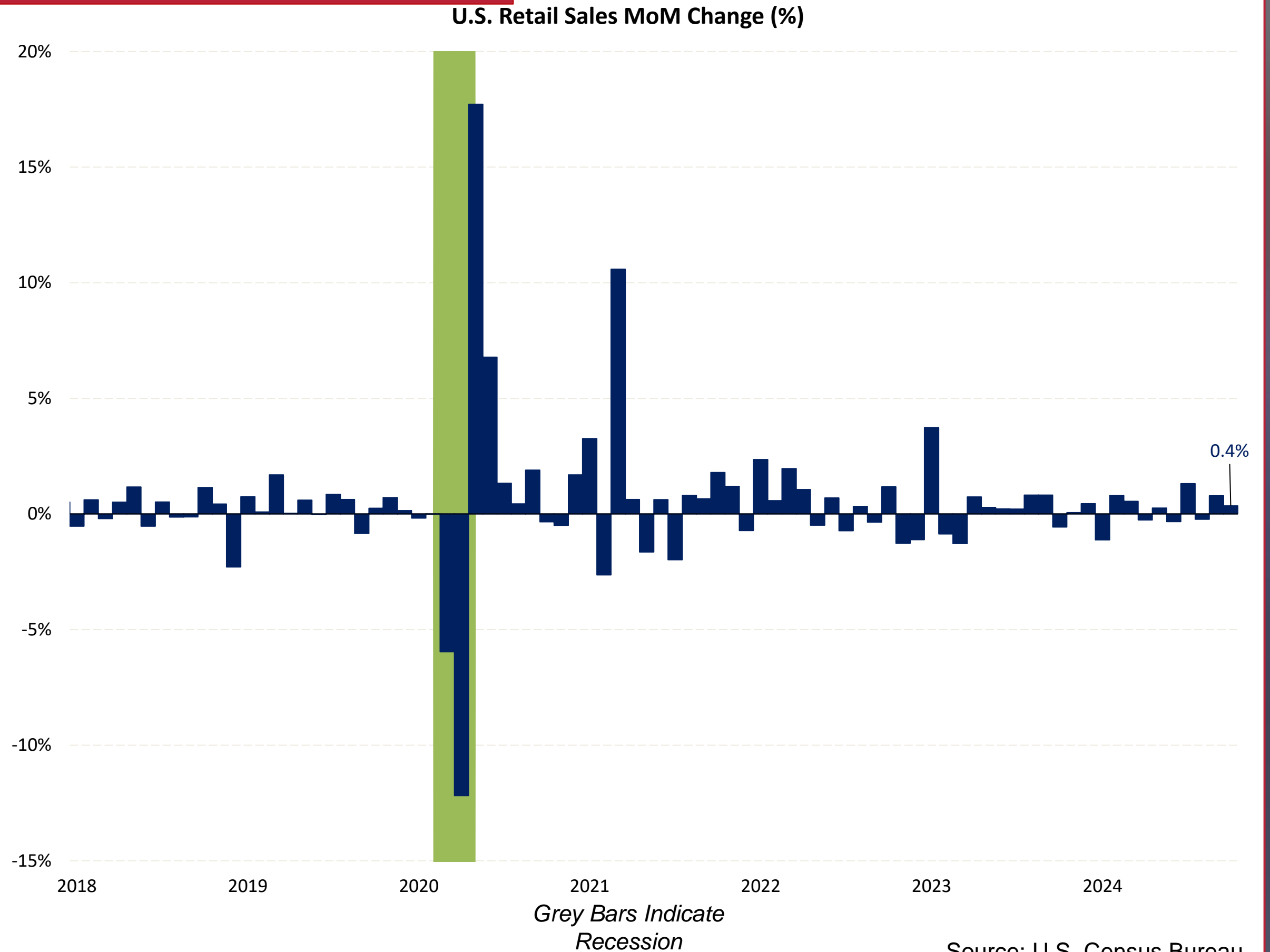
Source: Bureau of Economic Analysis

Consumer Spending Tempered but Steady



- Total consumer spending has increased 2.1% YTD through October. This represents the lowest YTD increase through October since 2015.

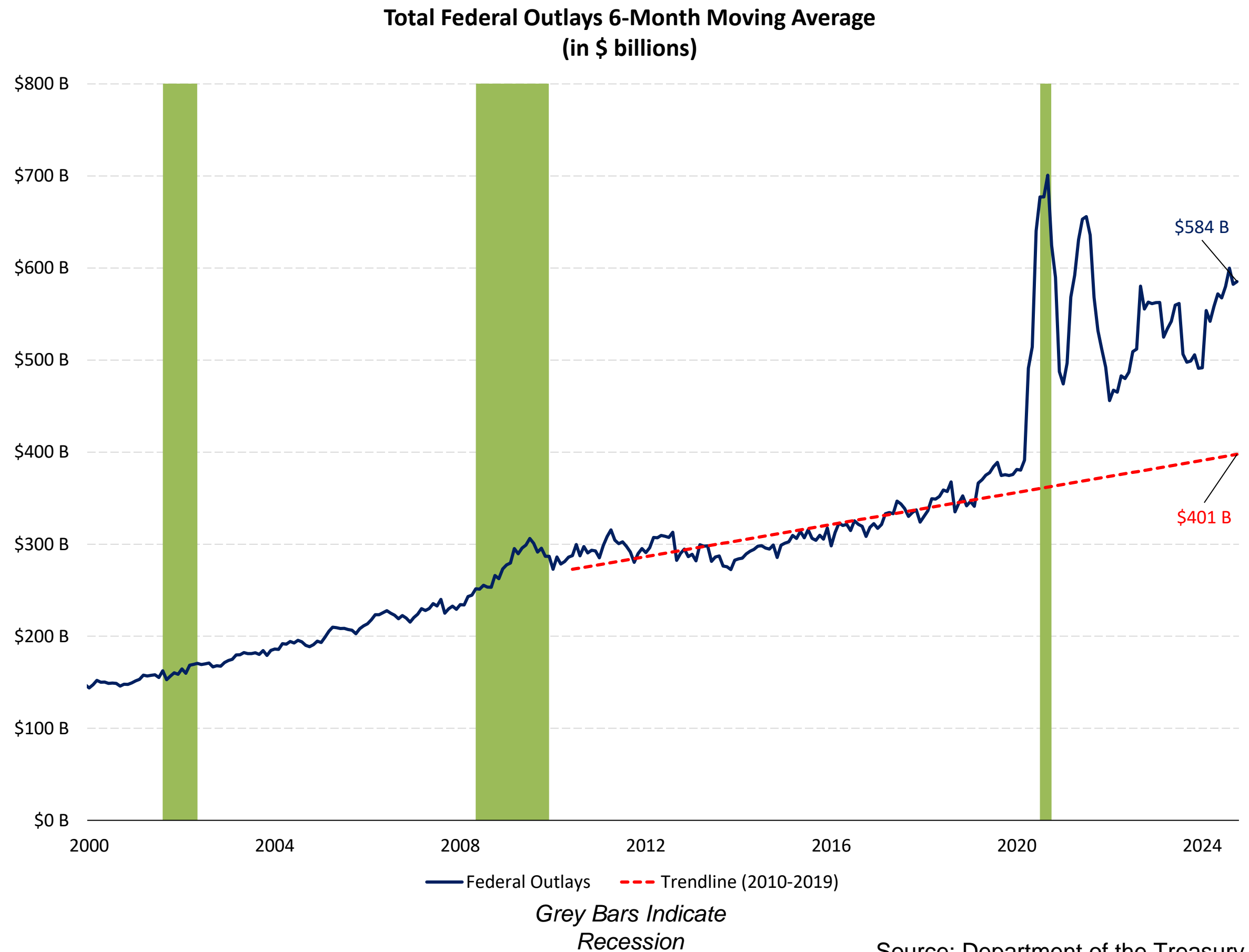
Kind of Business	Adjusted YoY (%)
Non-Store Retailers	7.0%
Food Services Places	4.3%
Motor Vehicle and Parts Dealers	3.4%
Retail and Food Services	2.8%
Food & Beverage Stores	2.7%
Health & Personal Care Stores	1.6%
Furniture Stores	1.5%
Electronics & Appliance Stores	-2.3%
Gas Stations	-7.0%



Federal Government Outlays Continued to Break Records



- In FY 2024 the federal deficit was \$1.8 trillion. This accounted for **6.2%** of Real GDP output.
- In October 2024, the first month of the 2025 Fiscal Year, total federal outlays were \$584 billion. This represents the highest start to a fiscal year in our country's history.
- The last 12 months have seen federal outlays of **\$6.9 trillion** compared to receipts of just \$4.8 trillion.
- Based on the trendline from 2010 through 2019, the United States has overspent on federal outlays in total by approximately **\$10 trillion** since 2020.



Source: Department of the Treasury

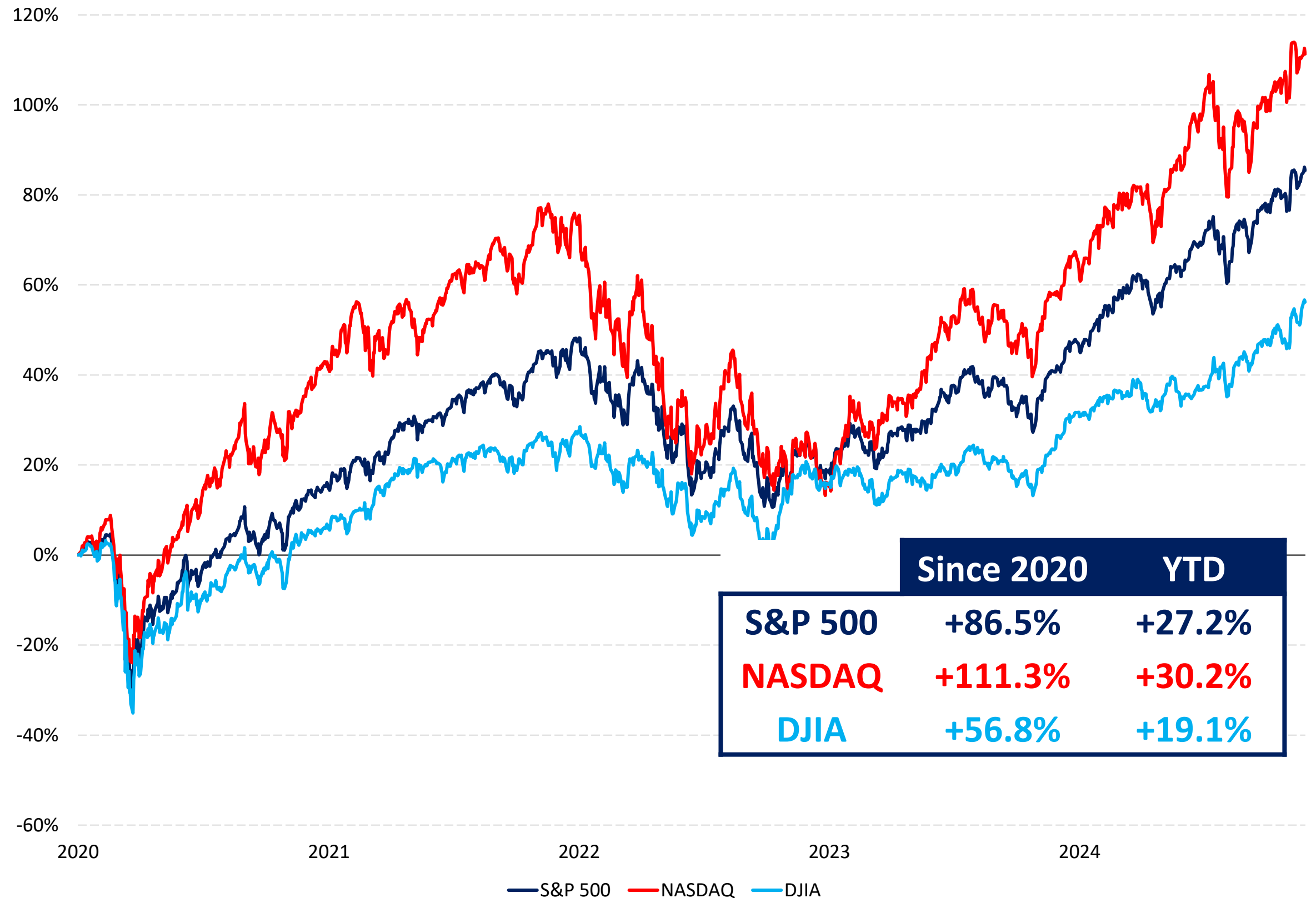
Equities Rallied in 2024 Driving High End Consumer Spend



S&P 500 Sector Performance YTD

Financials	+36.02%
Communication Services	+34.21%
Information Technology	+34.19%
Utilities	+30.07%
Consumer Discretionary	+26.19%
Industrials	+25.84%
Consumer Staples	+18.18%
Energy	+13.13%
Real Estate	+11.97%
Materials	+10.19%
Health Care	+7.76%

U.S. Equity Returns Indexed to 2020 (%)



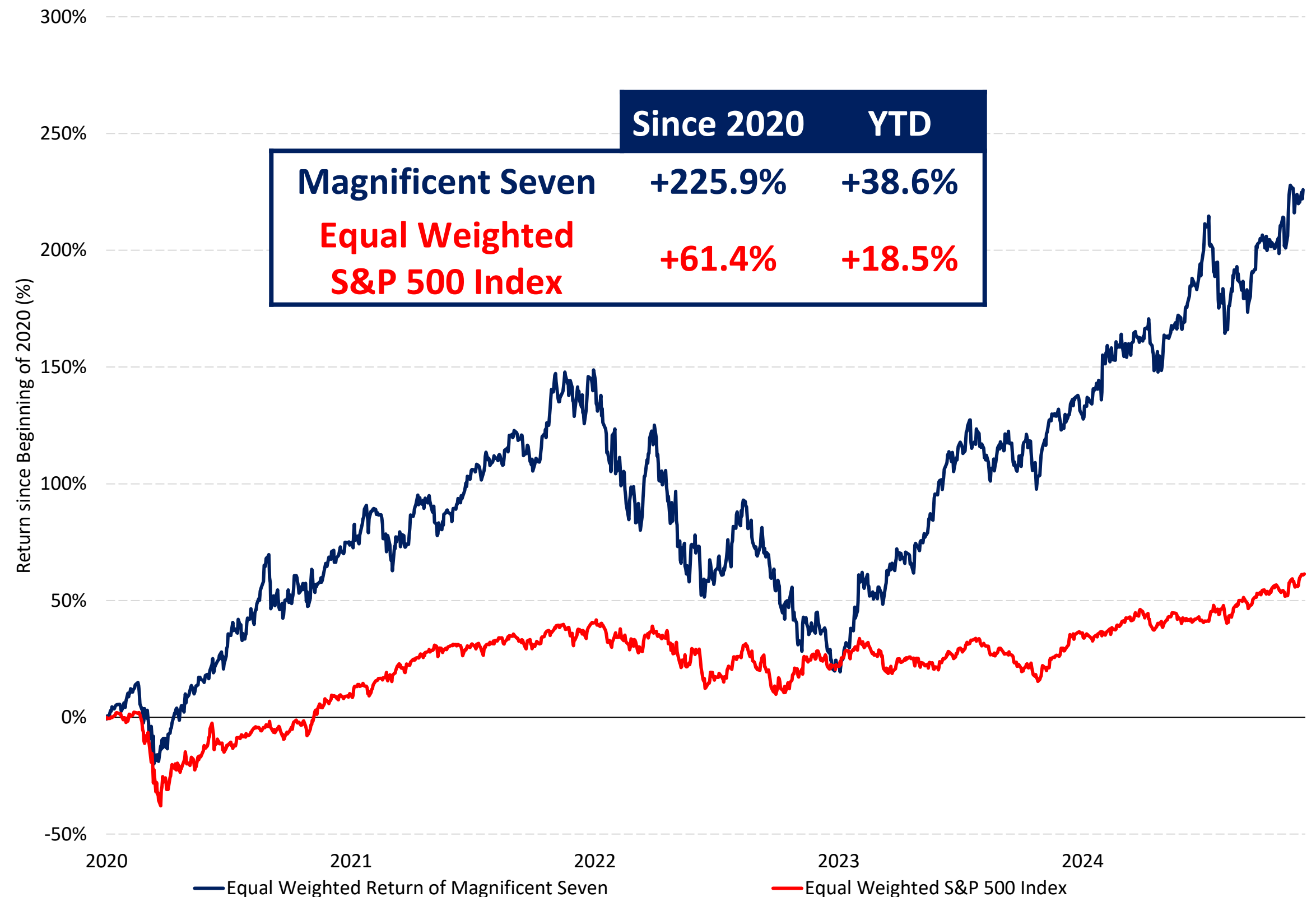
Source: Yahoo Finance, Fidelity

The Mag-7 Is Still Driving Overall Equity Returns



Company	Market Cap	P/E LTM
Apple	\$3.66 T	39.8x
Nvidia	\$3.53 T	56.9x
Microsoft	\$3.24 T	36.0x
Amazon	\$2.29 T	46.6x
Alphabet	\$2.14 T	23.1x
Meta	\$1.54 T	28.8x
Tesla	\$1.13 T	96.4x

Return from Magnificent Seven Stocks vs. S&P 500 (%)

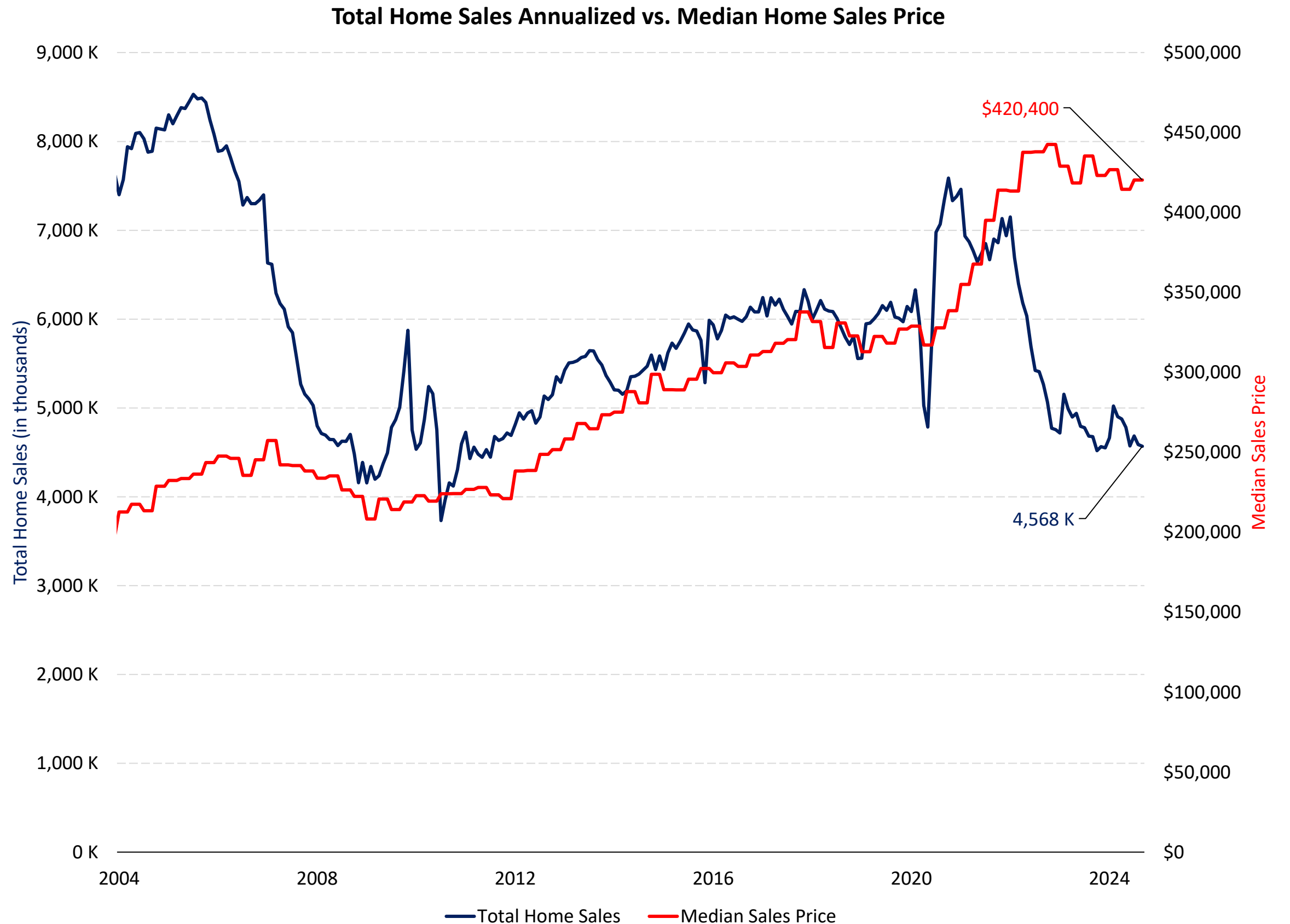


- In the first half of 2024, the Magnificent Seven generated roughly 60% of the S&P 500's overall return
- The Magnificent Seven accounted for more than half of the S&P 500's gain in 2023.

High Prices & Low Inventory Cratered Sales



- The housing market is experiencing a significant imbalance, as housing prices remain near record highs, even as sales volumes continue to plummet.
- Existing home sales have fallen to levels seen at the height of the housing crash.
- The collapse in sales in 2008 was caused by a flood of sellers with broken mortgages with very limited buyers. Today it is due to a lack of sellers with a younger generation desperately trying to own a home.



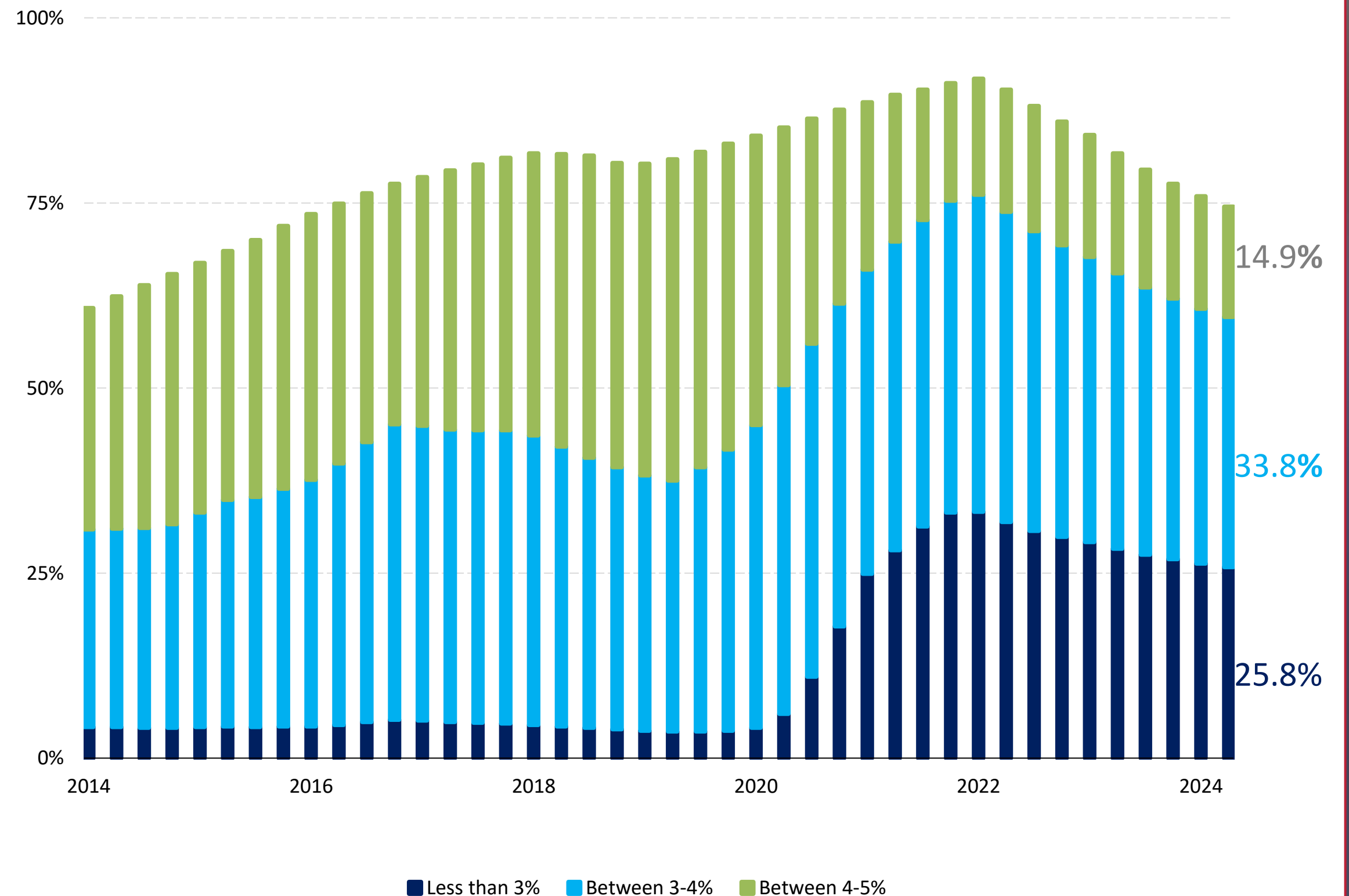
Source: National Association of Realtors, U.S. Census Bureau, U.S. Department of Housing and Urban Development

Locked-in Low Rates Suppress Inventory



Portion of Mortgages Below 5% (%)

- Nearly 14 million mortgages were refinanced between Q2 2020 and Q4 2021. The average 30-Year Fixed Rate Mortgage was 2.97% during this time.
- As of Q2 2024, approximately 73% of all outstanding mortgages are less than 5% while 60% are less than 4%.
- The 30-Year Fixed Rate Mortgage has been above 5% since April 2022. Previously, it had remained below 5% for 581 consecutive weeks (11 years) leading up to April 2022.

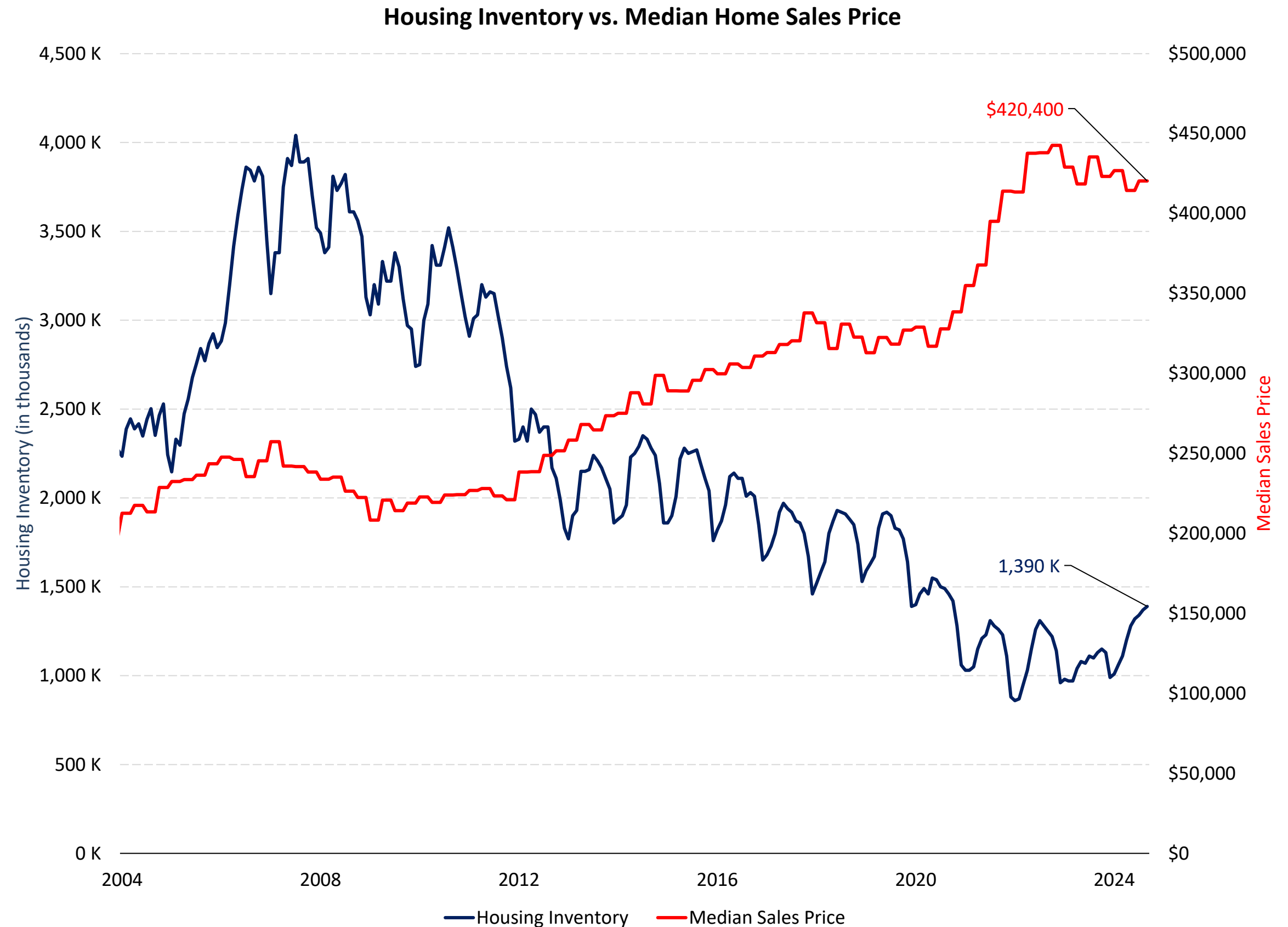


Source: Federal Housing Finance Agency

Depressed Inventory Kept Prices Elevated



- Even with the increase in interest rates, the median home sales price remains near all-time highs due to near record low housing inventory.
- A shift may be starting with housing inventories having increased in the last few months, since its low in February 2022, housing inventory has increased 520,000. Increasing supply could cause housing prices to drop.
- Housing inventory will likely increase not only for the main reasons one would sell a home (death, divorce, job loss/change) but further a rapid rise in property taxes and homeowner insurance is starting to negatively impact many.

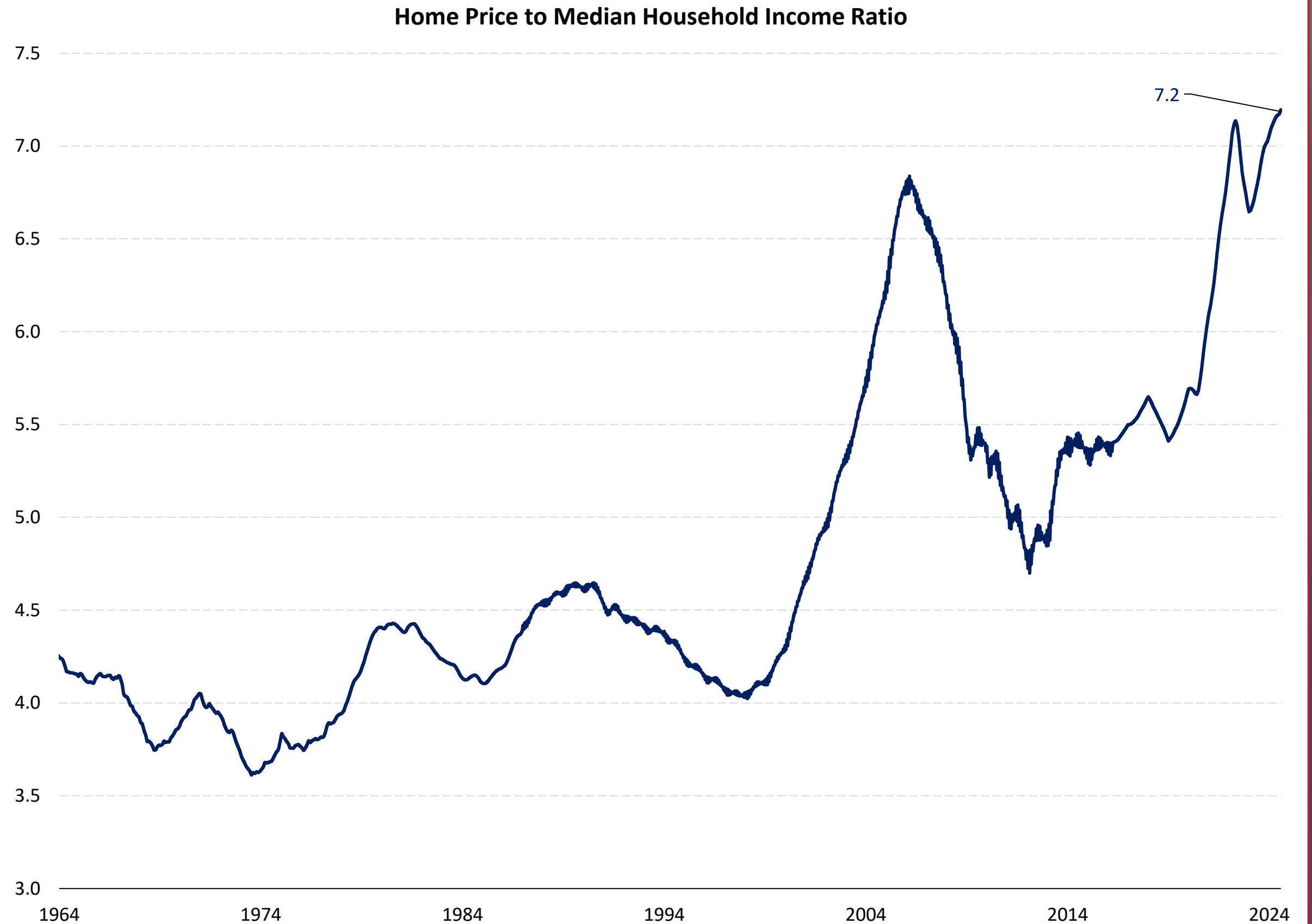


Source: National Association of Realtors, U.S. Census Bureau, U.S. Department of Housing and Urban Development

Homes Are Unaffordable and Require a Record Household Income



- Housing has become even less affordable than it was during the peak of the housing bubble in 2006. It reached 6.8 times yearly household income and today is at 7.2.
- The median sales price of a house sold in the U.S. has increased 34% since the beginning of 2019. Real median household income has decreased 1% over that same time period.
- From 1959 to 2002, the average cost of a house in the U.S. was less than 5 times the yearly household income.



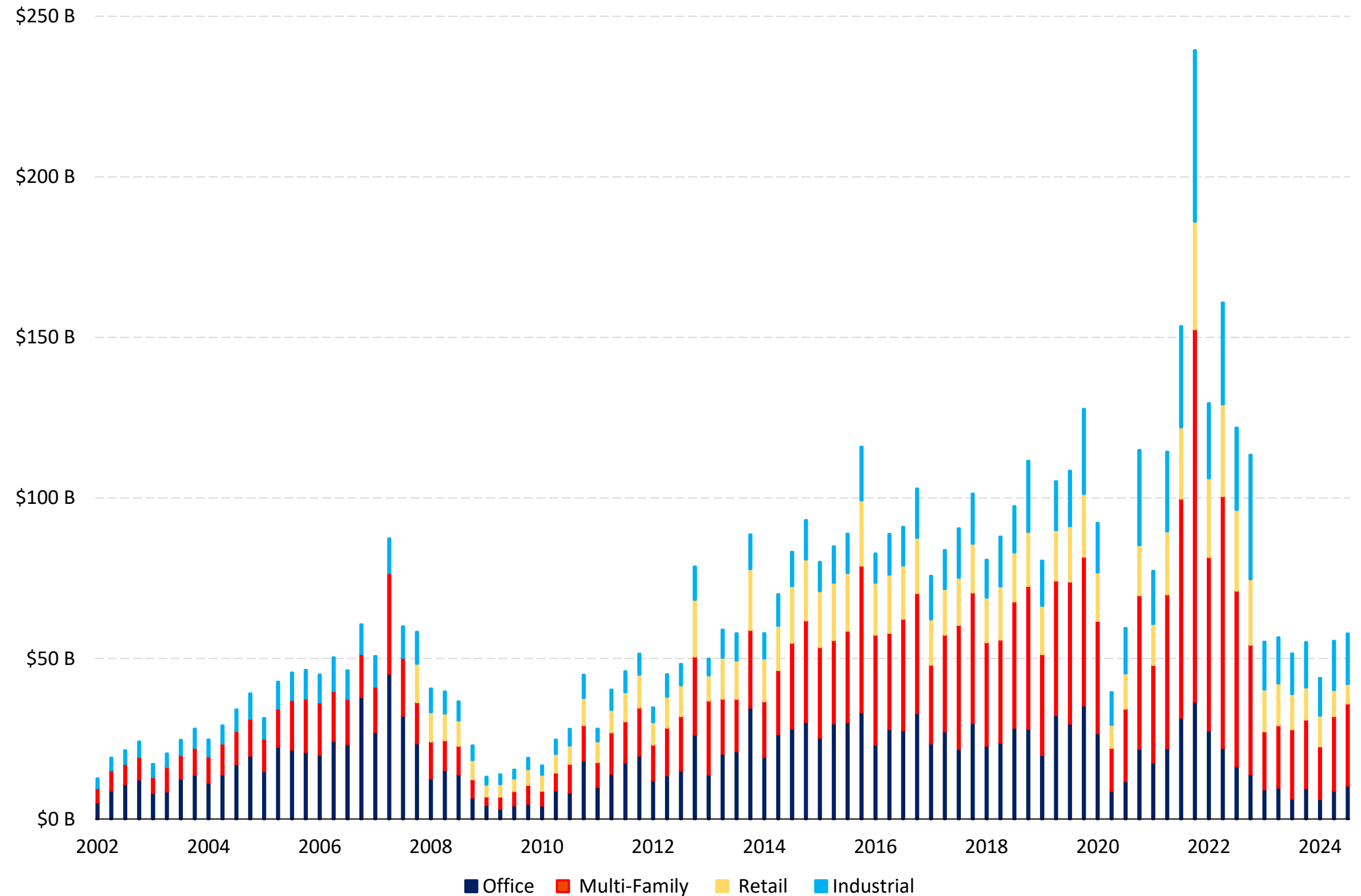
Source: St. Louis Federal Reserve, U.S. Census Bureau

CRE Transaction Volumes Have Yet to Recover



Total Commercial Real Estate Transaction Volumes
(in \$ billions)

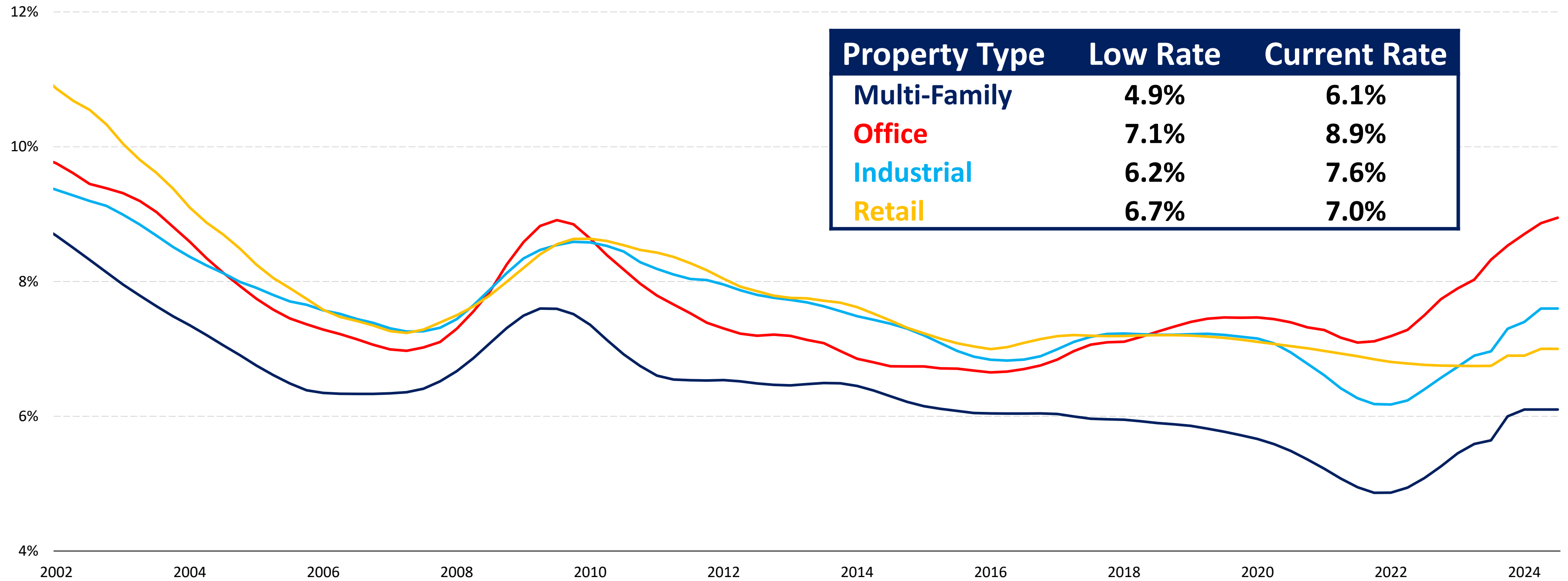
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CRE Cap Rates Found Some Equilibrium



Cap Rates by Property Type (%)

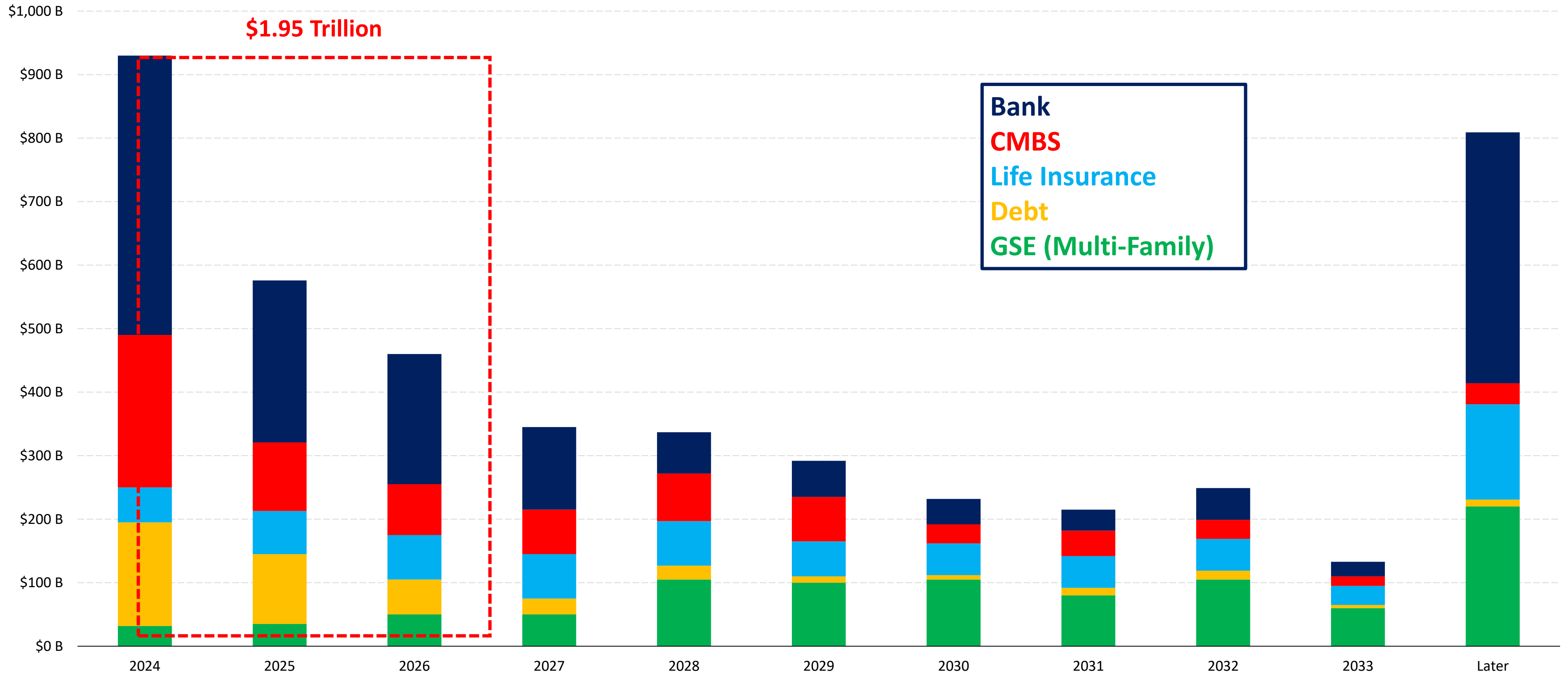


Source: CoStar

Coming Commercial Maturities Will Bring More Pain



Commercial Real Estate Loan Maturities (in \$ billions)

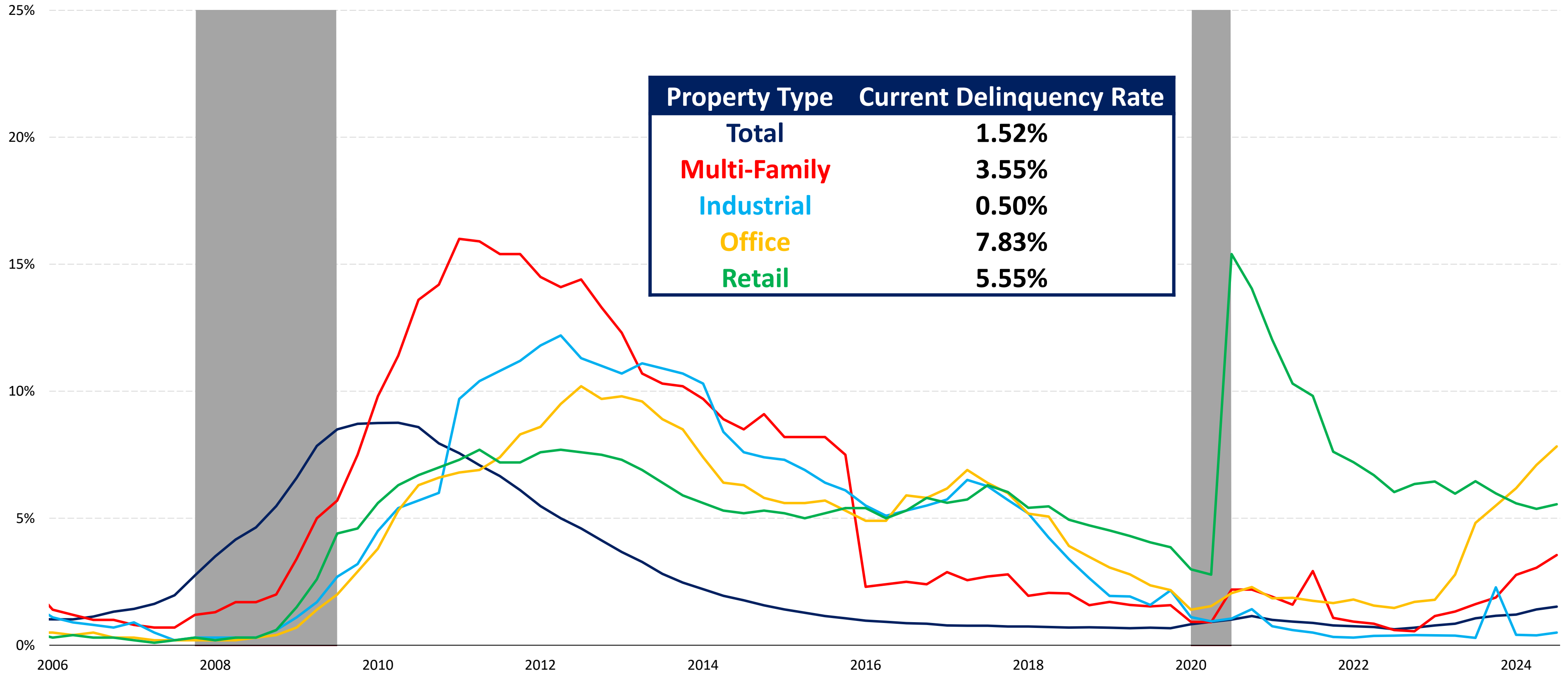


Source: Mortgage Bankers Association

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Delinquency Rates by Commercial Real Estate Type (%)



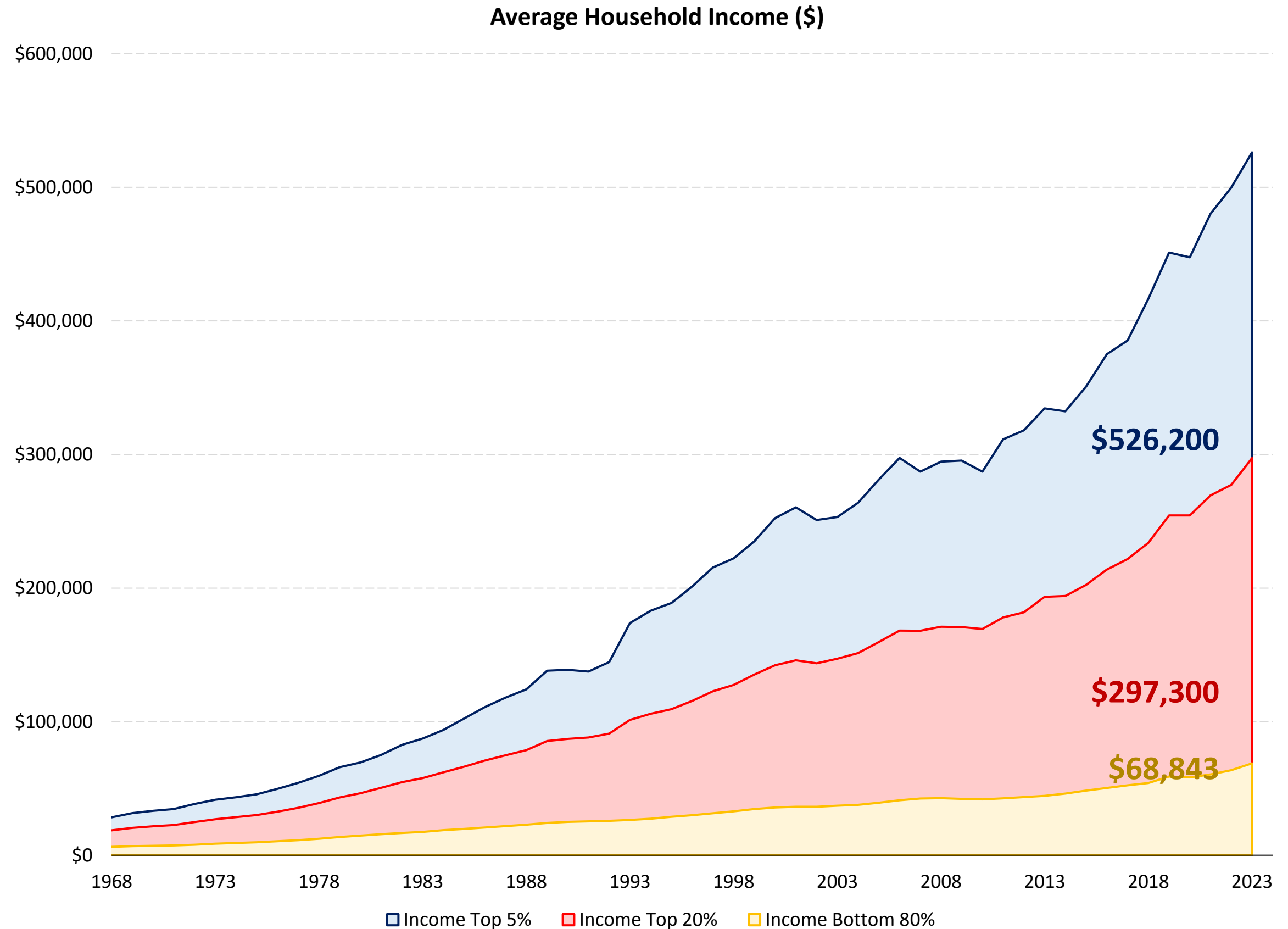
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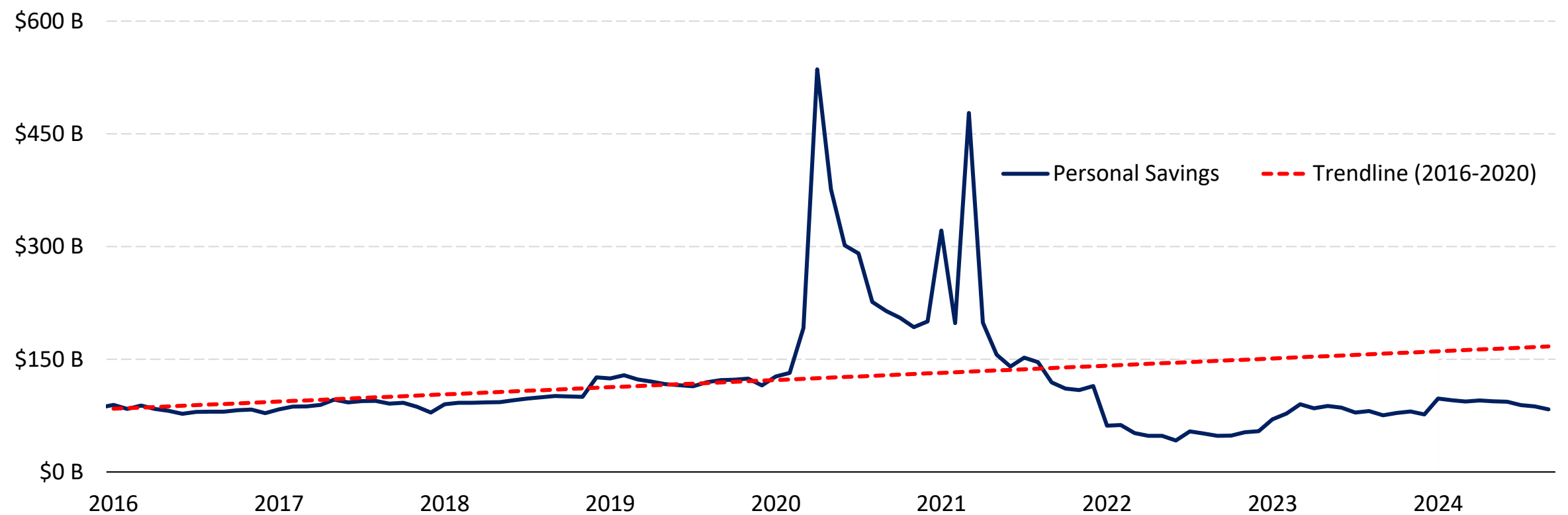
Source: U.S. Census Bureau

Consumer's COVID-19 Savings Have Now Run Dry

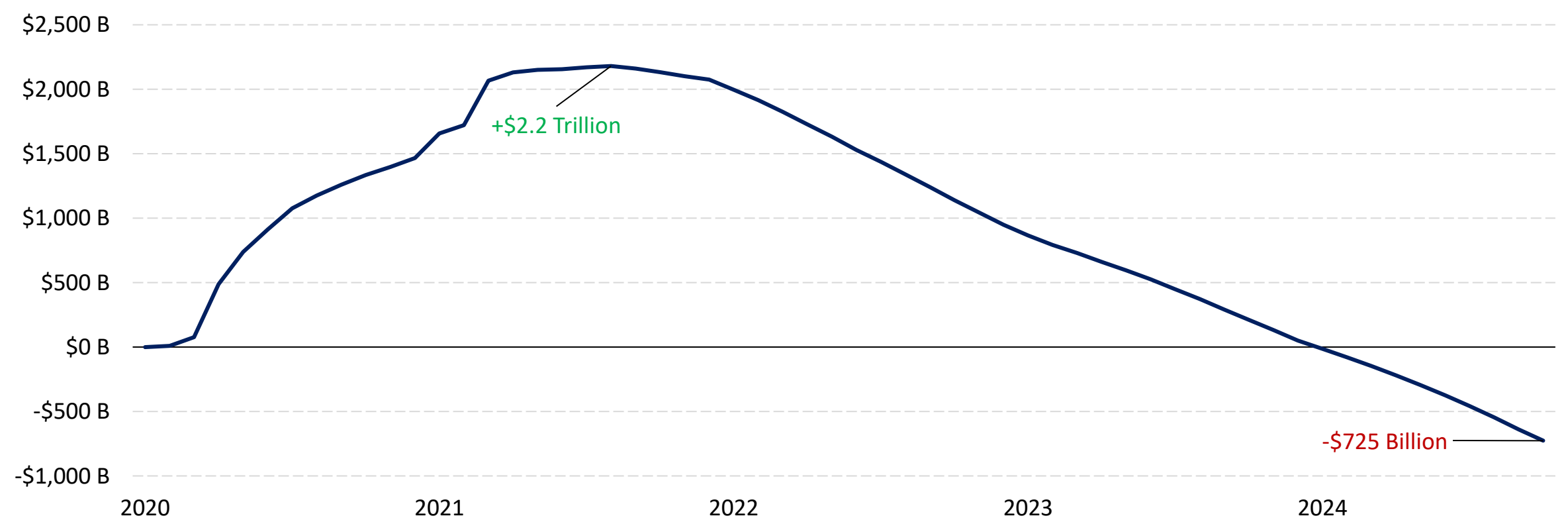


- Savings dramatically increased due to government transfer payments during COVID but consumers have now used their excess of savings and are in an even worse position than pre-COVID due to inflation.
- Currently the personal savings rate is at **4.4%**, up from a near all-time low of just 2.0% in June 2022. However, without government transfer payments the real savings rate is **-6.5%**.
- Excess Personal Savings that reached a surplus of \$2.2 trillion is now gone for the American consumer and most are struggling with little to no savings.

Aggregate Personal Savings (in \$ billions)



Aggregate Excess Personal Savings (in \$ billions)

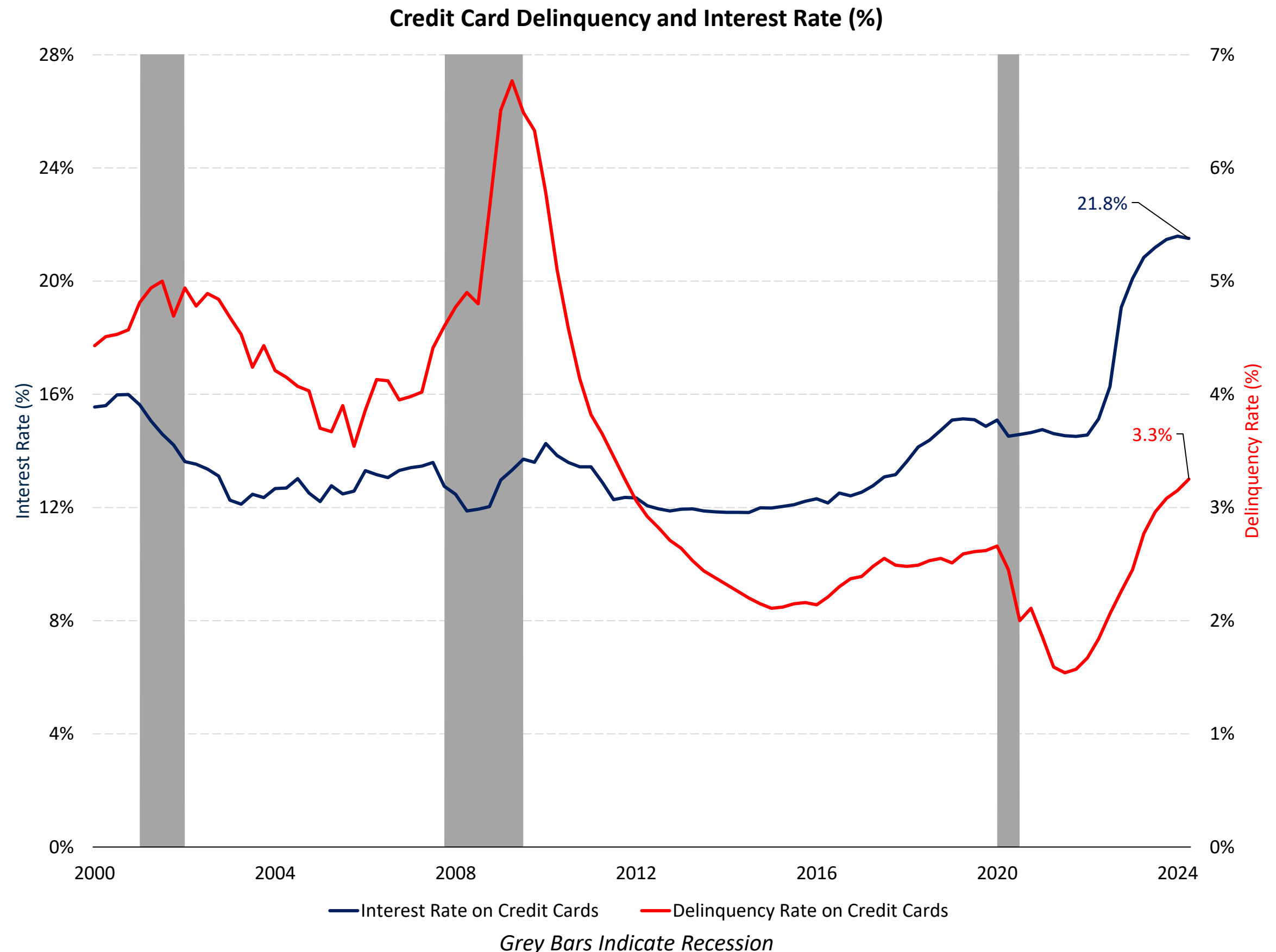


Source: Bureau of Economic Analysis

Rate Cuts Haven't Helped Struggling Consumers Yet



- In Q3, the Federal Funds rate was cut by 50 basis points, but the average interest rate on credit cards still hit an all-time high of 21.8% in the quarter, up 0.3% QoQ and 0.6% YoY.
- While credit card interest rates have reached all-time highs, credit card delinquency rates are currently the highest they've been in 13 years.
- Since reaching a low of just 1.5% in Q3 2021, the delinquency rate on credit cards has increased every quarter for 12 consecutive quarters.

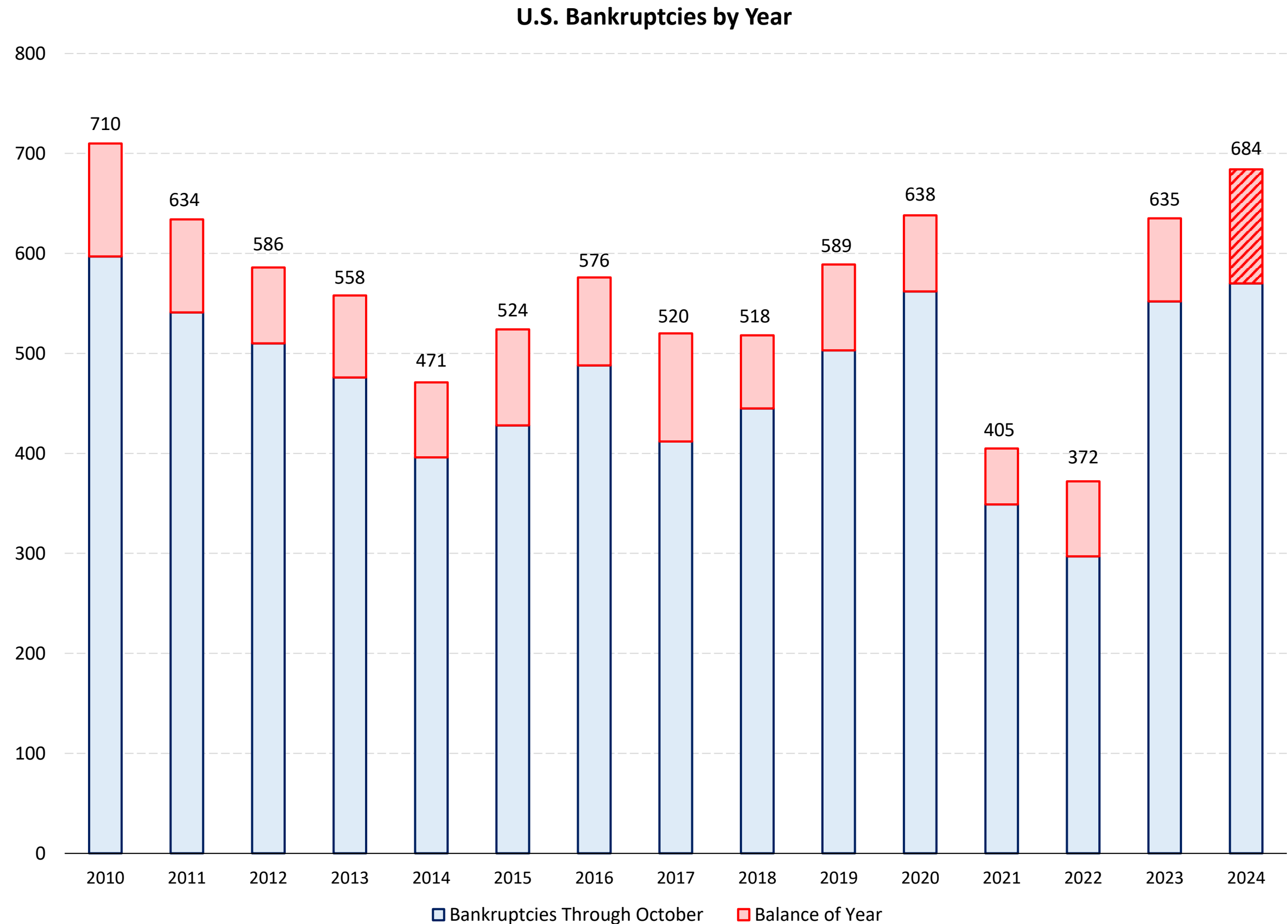


Source: St. Louis Federal Reserve

Corporations Across Industries Continue to Struggle



- U.S. bankruptcies in 2024 could reach the highest level since 2010 after filings in October continued to trend at an elevated monthly pace.
- Through October, **570** companies have filed for bankruptcy. Annualized, this amounts to 684 total bankruptcies.
- Notable bankruptcies in 2024 include:
 - Spirit Airlines
 - Red Lobster
 - Big Lots
 - Wheel Pros
 - Tupperware Brands
 - JOANN Inc.
 - American Tire Distributors
 - TGI Fridays

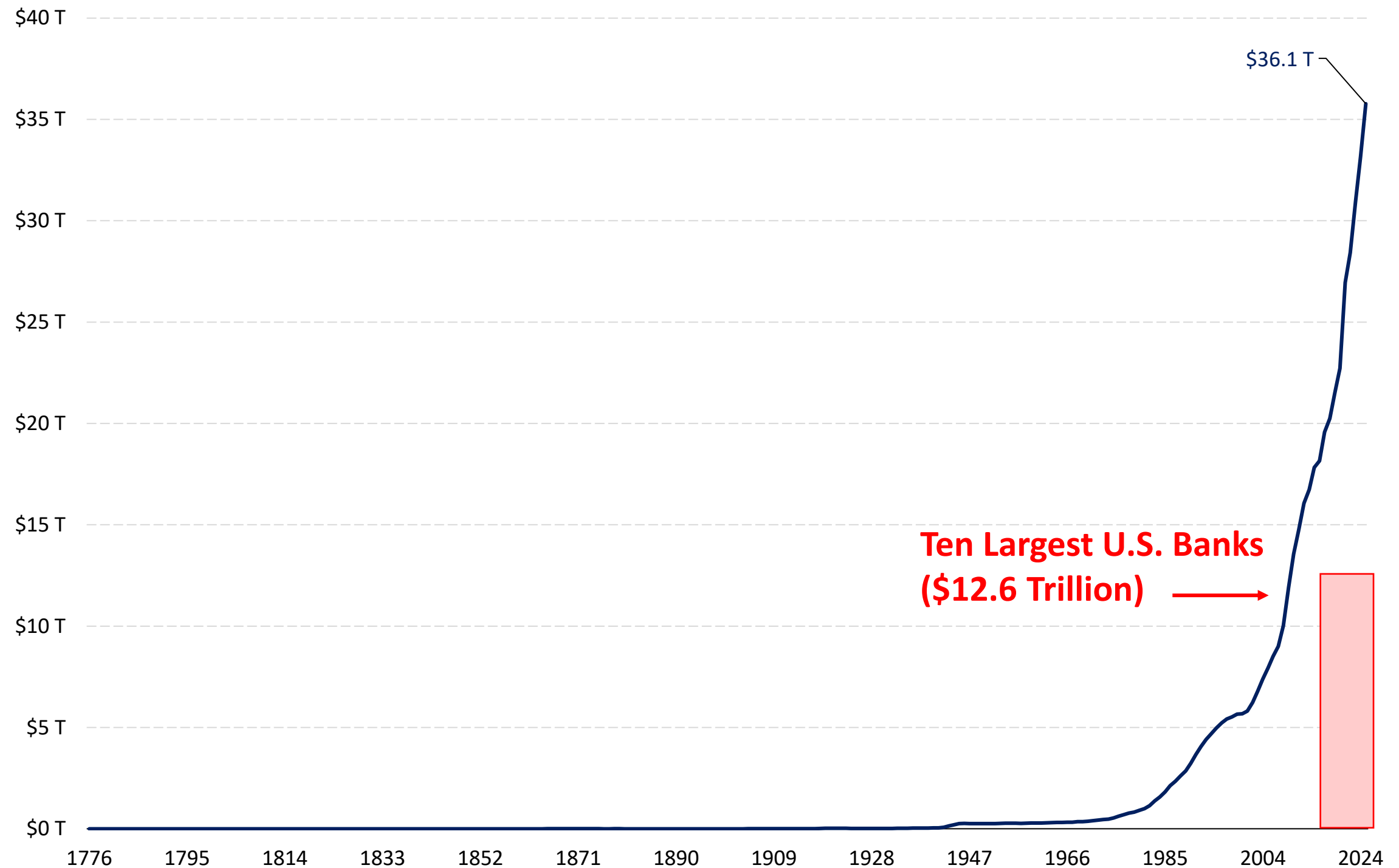


Government Debt Soared to a Colossal Level



U.S. Gross National Debt (in \$ trillions)

- Since FY 2021, the start of the Biden Administration, the U.S. has added more than \$13 trillion in debt. It previously took the country 234 years, until FY 2010, to reach \$13 trillion in debt.
- The United States has increased the national debt more than **\$30 trillion** since the start of the 21st century.
- On average, the United States has increased its debt by \$1 trillion every **142 days** since the start of COVID-19.

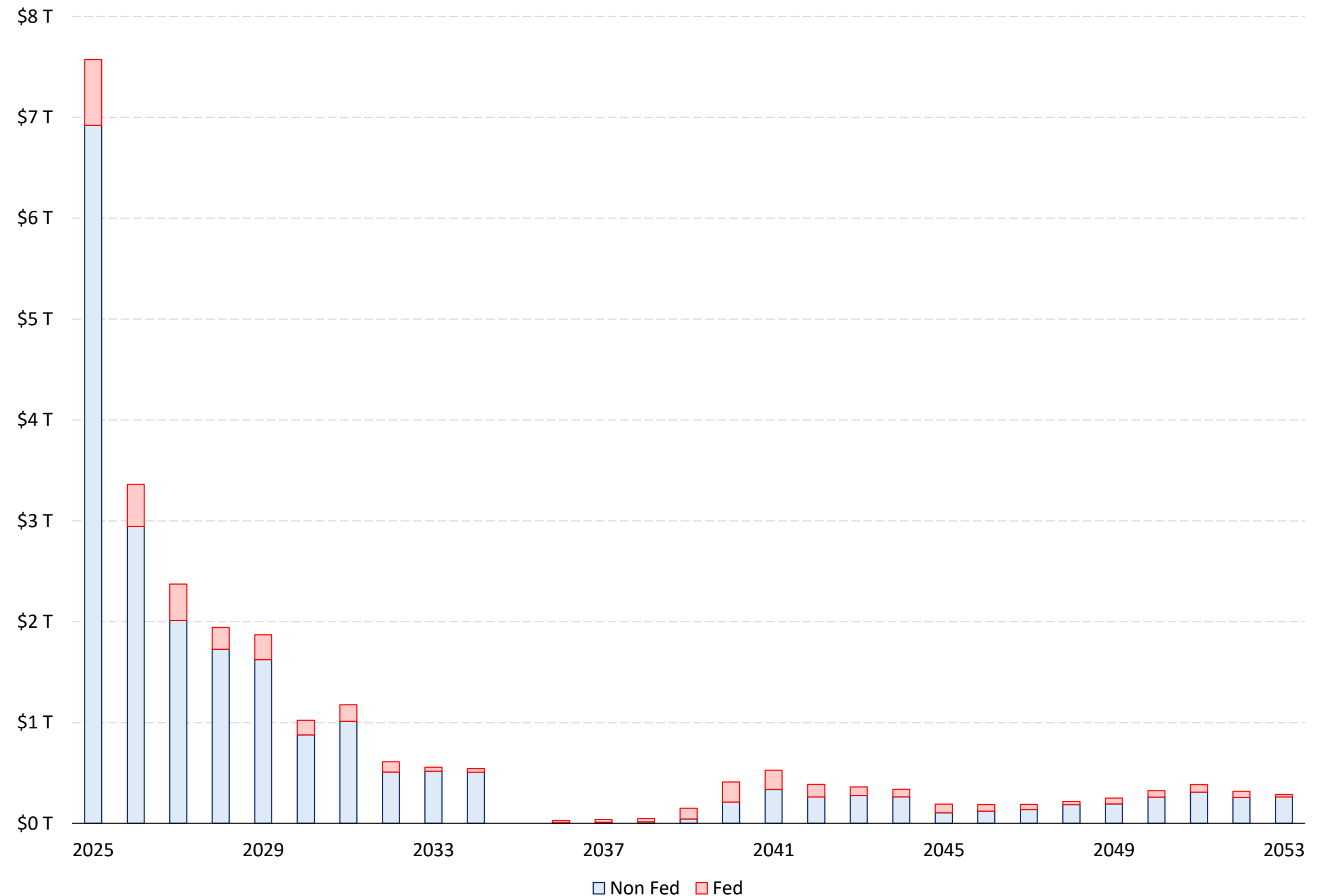


Source: U.S. Treasury Department

U.S. Treasury Maturities Are Coming Fast

U.S. Treasury Maturity Schedule (in \$ trillions)

- The U.S. Federal Government will have over **\$7.5 trillion** in Treasuries come due in 2025 representing 21% of all outstanding U.S. Government debt.
- The average yield on Treasuries due in 2025 is 4.35%. Secretary Yellen made a colossal mistake by not funding with longer duration Treasuries when rates had collapsed.
- Maturities of this magnitude will put upward pressure on rates as the U.S. Government will have to issue new debt to cover those maturities.



Crucial Items are More Expensive Than Ever



McDonald's				
Menu Item	End-of-2019 Price	Mid-2024 Price	% Increase	
Big Mac	\$1.79	\$4.19	134%	
Medium French Fries	\$1.29	\$3.89	202%	
McChicken	\$3.99	\$7.49	88%	
10 McNuggets	\$4.49	\$7.58	69%	
Cheeseburger	\$1.00	\$3.15	215%	
<i>Average price increase across these five items: 141%</i>				

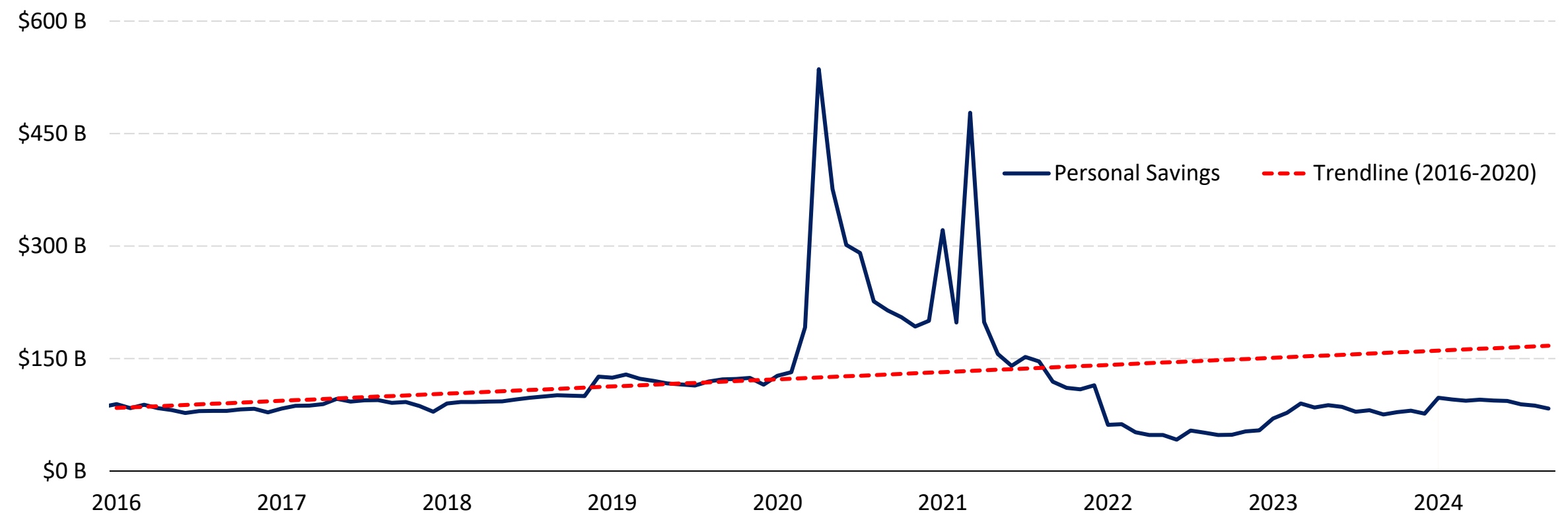
Chick-fil-A				
Menu Item	End-of-2019 Price	Mid-2024 Price	% Increase	
Deluxe Chicken Sandwich	\$3.65	\$6.55	79%	
8 Chick-fil-A Nuggets	\$3.05	\$5.99	96%	
4 Chick-n-Strips	\$4.39	\$7.85	79%	
Medium Waffle Fries	\$1.65	\$2.99	81%	
Large Milkshake	\$3.15	\$5.19	65%	
<i>Average price increase across these five items: 80%</i>				

Consumer's COVID-19 Savings Have Now Run Dry

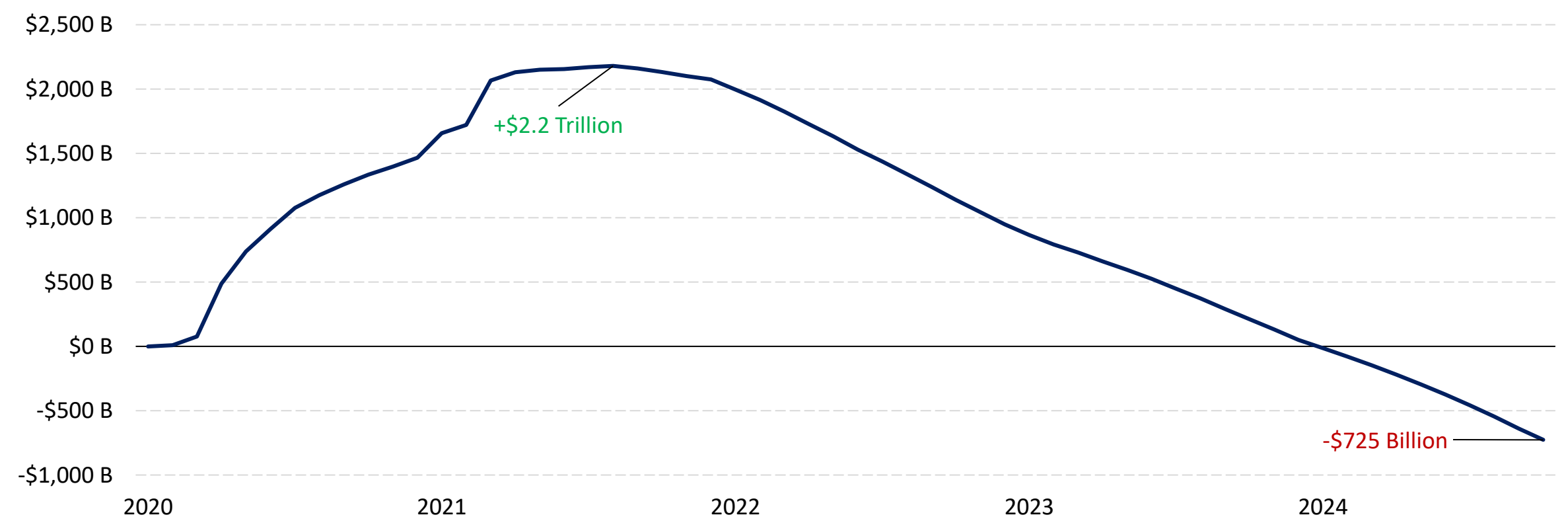


- Savings dramatically increased due to government transfer payments during COVID but consumers have now used their excess of savings and are in an even worse position than pre-COVID due to inflation.
- Currently the personal savings rate is at **4.4%**, up from a near all-time low of just 2.0% in June 2022. However, without government transfer payments the real savings rate is **-6.5%**.
- Excess Personal Savings that reached a surplus of \$2.2 trillion is now gone for the American consumer and most are struggling with little to no savings.

Aggregate Personal Savings (in \$ billions)



Aggregate Excess Personal Savings (in \$ billions)

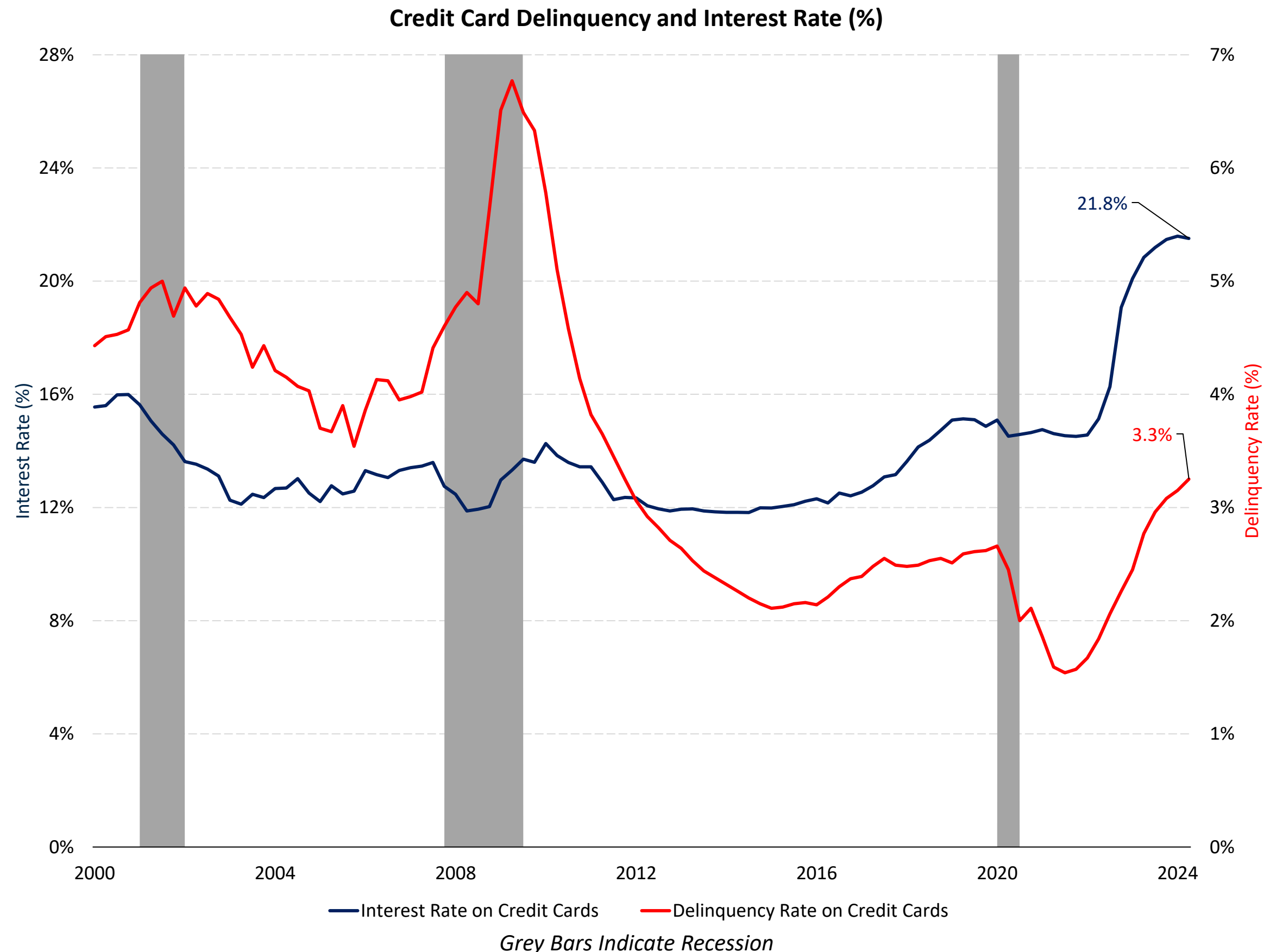


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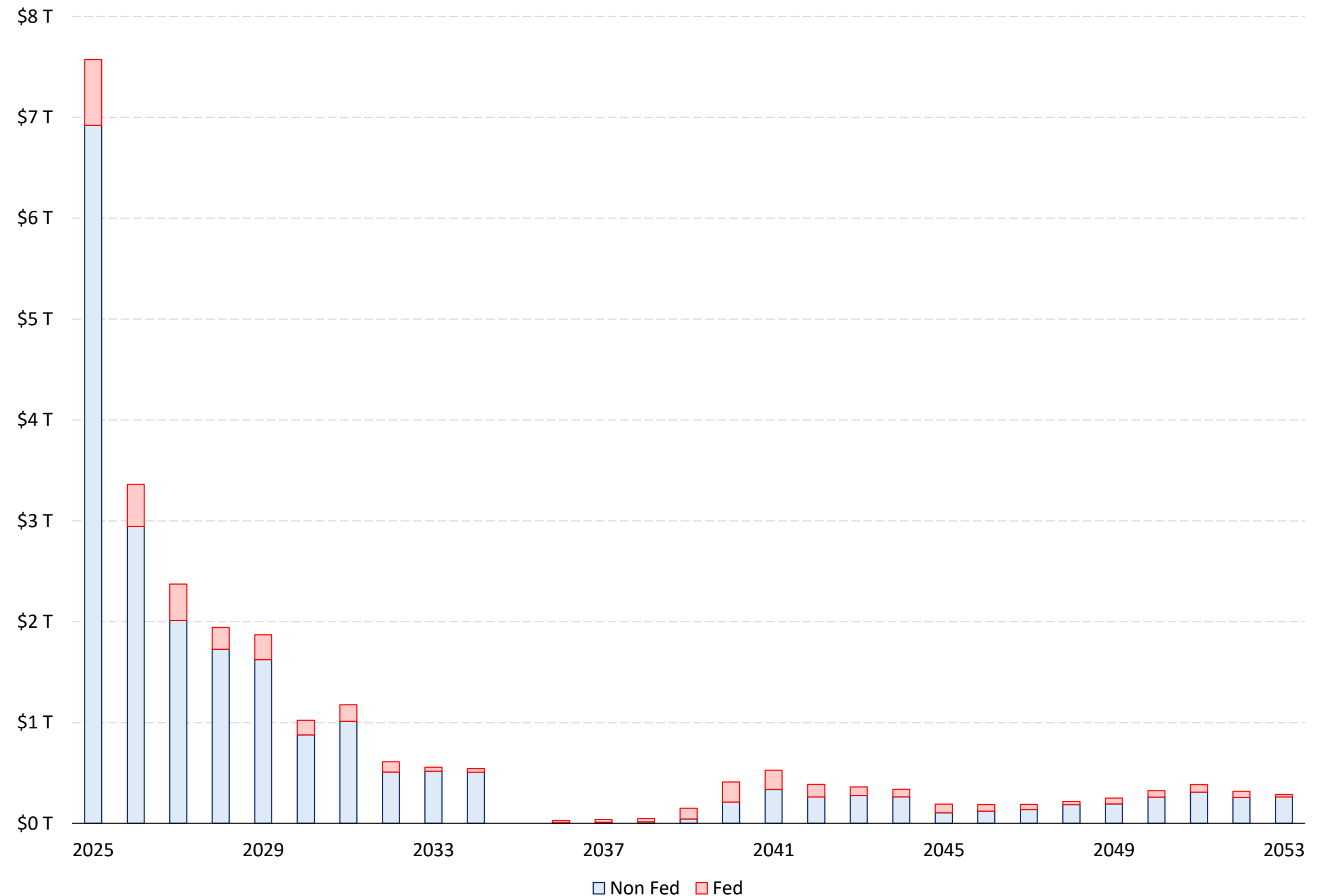


Source: St. Louis Federal Reserve

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