

Canadian Real Estate Market Update

Q4 2023



Canadian Economic Overview¹



In the third quarter of 2023, Canada's Real Gross Domestic Product ("GDP") declined by 0.3%, or 1.1% in annualized terms

- > This is the first contraction since the second quarter of 2021, and contrasts significantly from market expectations of a slight expansion



On the employment front, employment levels remained stable with no significant changes in December 2023

- > The unemployment rate remained constant from last month's 5.8%
- > Job gains were seen in sectors like professional services and healthcare, but there were declines in retail and manufacturing



In December, the Consumer Price Index ("CPI") in Canada increased by 3.4% year-over-year ("Y/Y"), up from a 3.1% rise in November

- > Excluding gasoline, Y/Y CPI growth slowed from 3.6% in November to 3.5% in December
- > Food prices from stores remained consistent with a 4.7% Y/Y increase in December, mirroring the November rate
- > Overall, even though the headline inflation number accelerated, the price trends for core goods is showing signs of becoming more stable and benign



With a softening economy, stable labour market, and inflation measures looking quite tame, the Bank of Canada ("BOC") may feel better about the restrictiveness of their policy and could in fact begin to ease off if further softening persists



A material risk to a rate cutting cycle beginning in 2024 is an "Inflation Revival" scenario that Fiera Capital forecasts with a 45% probability, over the next 12 months – if this does not occur (55% probability), other scenarios involve less restrictive interest rates



For the first time in two years, the negative effects from down-cycles in economic growth and liquidity that have formed a headwind for real estate may be changing and setting the asset class up for an asymmetric recovery

Canadian Real Estate Outlook

Industrial²

- > In Q4 2023, Canada's industrial sector's availability rate experienced a significant increase, reaching 3.2% with a 0.7% quarter-over-quarter ("Q/Q") uptick - the highest quarterly rise since 2009
- > This increase was driven by a surge in new supply deliveries, which hit a record high in Q4 2023, outpacing the net absorption rate
- > The small bay segment continues to capitalize on the benefits of undersupply - only 53 out of 209 construction projects currently underway fall into this category, representing only 1.5 million square feet ("sf")
- > Net absorption throughout the year was relatively muted, leading to the lowest annual total since 2009 at 10.4 million sf
- > Total space under construction dropped by 22.6% Q/Q to 34.7 million sf, its lowest level since Q3 2021
- > Despite these trends, the average net asking lease rate remained relatively stable (+6.1% Y/Y), with a minor decline in Q4 2023
- > Regionally, different markets across Canada exhibited varying trends
 - For instance, London remained the tightest industrial market with an exceptionally low availability rate
 - In contrast, cities like Toronto and Montreal saw negative net absorption in the quarter
- > Pre-leasing activity also slowed down in 2023 compared to the robust levels seen in previous years

Multi-Residential³

- > CMHC's 2023 Rental Market Report highlights an ongoing trend of declining vacancy rates across Canada's major cities, with Vancouver remaining notably low at 0.9%
- > Nationally, the vacancy rate for purpose-built rental apartments fell to its lowest since 1988, at 1.5%, alongside a notable rent increase due to a widening gap between supply and demand
- > Despite additional deliveries, supply has not kept pace with demand spurred by immigration, young Canadians entering the rental market, and older households downsizing
- > This has led to an 8% increase in the average rent for a two-bedroom apartment, reaching over \$1,350
- > The secondary rental market also saw tightened conditions, with rental condo vacancy rates dropping to 0.9% and rent for these units rising
- > Challenges such as financing delays and labour shortages in construction are expected to continue, exacerbating the supply-demand imbalance



Summary

Overall, the Canadian industrial market in Q4 2023 was marked by rising availability rates due to a wave of new supply (still well below its average availability of 4.8% since 2000), slower pre-leasing, and a modest decline in rental rates. Despite the recent softening, the industrial sector continues to benefit from a long-term structural supply/demand imbalance and is likely to exhibit relative sector strength in the long-term.



Summary

Canada's housing affordability crisis is underscored by its ranking in the 2023 Demographia International Housing Affordability Survey, with three Canadian cities among the 15 least affordable globally. The country's median affordability score of 5.3 classifies it as "Severely Unaffordable." In response, the Federal Government has enacted policies to encourage the development of new purpose-built rental housing, including removing the GST on new rental housing construction⁴ and, in Ontario, eliminating the provincial 8% HST portion on such developments.⁵ These measures mark significant steps toward addressing the housing crisis. Looking forward, the sector is expected to see exceptionally strong rental growth rates continue into the future.



Retail⁶

- > Canada's retail fundamentals are expected to remain stable despite challenges like high inflation and labour shortages due to high construction costs and limited new supply, being primarily delivered through mixed-use projects
- > Retailers are increasingly using technology to enhance customer experience and address issues such as labour shortages, with innovations like "walk-out purchasing"
- > Mobile commerce is growing rapidly, with a significant portion of retail sales projected to be transacted through mobile devices, influencing how retailers connect with consumers and address supply chain issues
- > Open-air centres are outperforming with select cities having noted challenges with downtown areas, citing slower foot traffic from reduced office occupancy
- > According to Oxford Economics, Canada's real consumption is expected to fall by 0.3%, due to sluggish economic conditions⁷
- > Resultingly, the national retail vacancy rate was 7.1% in H1 2023, the highest since 2017

Summary

Looking ahead, even with this relative stability, the potential for a downturn in consumer retail spending presents a headwind for enclosed and larger super-regional malls, leaving the prospects for grocery or drug-anchored centres with redevelopment opportunities as most positive going forward. There is limited new supply, and reduced gross leasable area ("GLA") due to asset conversions to mixed-use. This, combined with higher replacement costs, has led to positive rent increases.



Office⁸

- > In Q4 2023, Canada's national office market reflected a mix of recovery and ongoing challenges across various regions
- > In Alberta, markets like Calgary and Edmonton displayed recovery trends with consecutive quarters of positive net absorption, a pattern also seen in Vancouver, Ottawa, and Halifax
- > The national office vacancy rate saw a slight increase, ending the year at 18.3% (+0.1% Q/Q)
- > Despite this, there was a trend towards gradual recovery, with each quarter posting progressively less negative net absorption
- > Further, there was notable leasing demand for Class 'A' properties, significantly overshadowing the Class 'B' segment and suburban markets showed signs of modest recovery, while downtown areas continued to face higher vacancy rates
- > Consequently, a large amount of Class 'B' office space, amounting to around 2.5 million sf, was repurposed, primarily for residential and other uses
- > A noteworthy observation was a decrease in sublease space, which caused it to hit the lowest level of 2023 - most markets reporting sublease levels below 3% of their total inventory
- > In terms of construction, the development pipeline reached a six-year low, with 10.9 million sf under construction nationally, representing 2.2% of national inventory
- > The slowdown in new projects aligns with the overall trend of a lightening supply pipeline

Summary

Overall, the office market continues to adjust, as tenants right-size their space needs given greater clarity on working strategies and as interest rates settle, albeit at a relatively higher level than a few years ago. Resultingly, the Manager expects continued downward repricing and limited rental growth prospects for this sector over the next several years.

Looking Ahead

The prospects for commercial real estate continue to be clouded by several factors, including the lingering effects of the Pandemic (in the office sector in particular), higher interest rates and in turn, increasing capitalization rates, along with ongoing geopolitical uncertainty. These conditions present a challenge for the industry, like other investment asset classes. However, for the first time in two years, those negative cyclical factors may be changing and setting up asymmetrically for a recovery. Additionally, the underlying fundamentals of Canadian real estate have remained especially strong in the industrial and multi-residential sectors.

As the world is entering a period of structurally higher inflation due to various converging trends, real estate is likely to outperform traditional assets like equities and especially fixed-income investments in the long-term. This trend is expected to drive the increased inclusion of "real assets," particularly in pension plan portfolios, as investors seek alternative options. As financial conditions begin to ease and the economic cycle moves closer towards recovery, real estate is poised to capture these macro-tailwinds and provide outperformance. Although a lot of uncertainty remains, Canadian real estate has traditionally outperformed other property markets during times of economic uncertainty and foreign investment is increasingly recognizing its merits.

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Endnotes

- 1 Statistics Canada – <https://www.statcan.gc.ca/en/start>
- 2 CBRE Q4 2023 MarketView – <https://www.cbre-ea.com/data/iprojects>
- 3 CMHC 2022 Rental Market Report – <https://assets.cmhc-schl.gc.ca/sites/cmhc/professional/housing-markets-data-and-research/market-reports/rental-market-report/rental-market-report-2022-en.pdf>
- 4 Government of Canada – <https://www.canada.ca/en/department-finance/news/2023/11/government-of-canada-announces-legislation-to-make-life-more-affordable-build-more-homes-and-create-good-jobs-for-canadians.html>
- 5 CBC News – <https://www.cbc.ca/news/canada/toronto/ontario-hst-cut-rentals-1.7014884>
- 6 CBRE H1 2023 MarketView – <https://www.cbre-ea.com/data/iprojects>
- 7 Oxford Economics – <https://my.oxfordeconomics.com/reportaction/A5S36D895eDA4ea19A5F47/Toc>
- 8 CBRE Q4 2023 MarketView – <https://www.cbre-ea.com/data/iprojects>