# CANADIAN ECONOMIC OUTLOOK & MARKET FUNDAMENTALS

FOURTH QUARTER UPDATE 2018

20TH ANNUAL EDITION

Morguard

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FOURTH QUARTER UPDATE 2018

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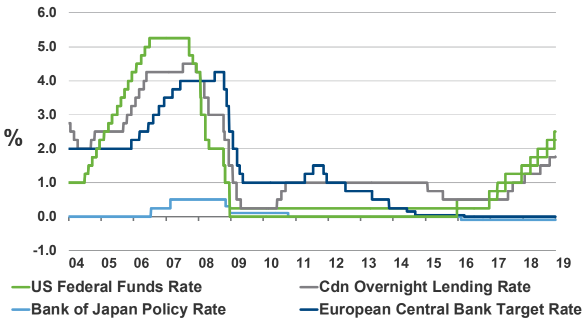


Source: Bank Of Canada, Federal Reserve Board, European Central Bank, Bank of Japan

**National Inflation**
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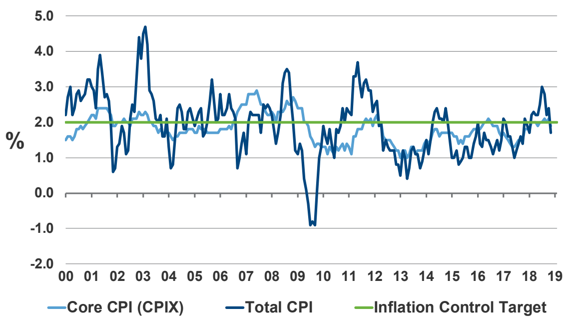


Source: Bank Of Canada, Statistics

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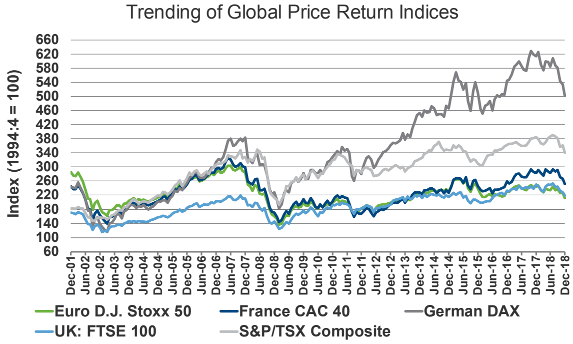


Source: RBC Capital Markets

**Mortgage Spreads**
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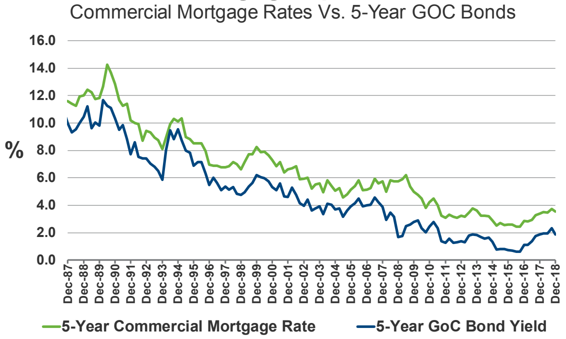



Source: RBC Capital Markets, Bank of Canada

## BANK OF CANADA HELD OFF ON RATE HIKE

The Bank of Canada (BofC) maintained its target overnight rate in the fourth quarter. On December 5th, the BofC announced it would hold its overnight target rate at 1.75%, which the bank reiterated on January 9, 2019. A major determining factor for the bank's decision was the ongoing uncertainty surrounding tariffs and a potential trade war between China and the U.S. While the recent G20 meetings indicated there was a measure of global economic upside, downside risks had increased. The global economic growth trend had already begun to soften in the second half of 2018, despite above-average U.S. expansion. Domestic considerations were also a factor in the bank's decision to hold off on hiking the overnight rate. A sharp drop in oil prices carried through much of the fourth quarter, resulting in reduced energy sector activity. Geopolitical events were also a cause for concern. Additionally, increased U.S. shale oil production had the potential to drive oil prices and energy sector output lower. A number of other factors also influenced the bank's decision to hold off on further rate hikes. Non-energy business investment, the impact of rising interest rates on household credit, federal business tax changes, and capacity constraints were also taken into consideration. The consensus projection indicated the bank would likely increase rates at a relatively modest pace barring a significant improvement in the economic outlook.

## FALLING GASOLINE PRICES TOOK THE WIND OUT OF INFLATION SAIL

Upward pressure on consumer pricing eased during the fourth quarter, due in large part to falling gasoline prices. In November, the Consumer Price Index (CPI) rose to 1.7% from 2.4% in the previous month. The November figure was the lowest year-over-year gain year-to-date for 2018, according to Statistics Canada. The price of gasoline fell 9.4% in November. In the same month, CPI excluding gasoline rose 1.9% year-over-year. Moreover, all eight major components of CPI increased, led by the shelter index at 2.4%. However, in six of the eight components tracked price growth slowed. According to a recent TD Economics report, the softer headline inflation rate recorded in November was largely in line with expectations. The downdraft in energy prices recorded recently was expected to continue over the near term, which will have a negative impact on economic growth and buffer against a significant run up in consumer prices.

## FOUR QUARTER EQUITY MARKET PERFORMANCE WAS DECIDEDLY BEARISH

Fourth quarter Canadian equity market performance was generally bearish. The S&P/TSX Composite Index finished 2018 down approximately 12.0%, marking the worst annual performance since 2008. Much of the decline in the benchmark took place in early December, before a modest rally unfolded as 2018 came to a close. The December slide coincided with declines in the broader global equity market. The fourth quarter slide capped off a 21.0% year-to-date decline for the Canadian energy component of the S&P/TSX. Falling oil prices and pipeline delays have both taken their toll on the sector. The consumer discretionary segment of the index fell 18.0% in 2018, while Cannabis stocks finished the year in negative territory. As 2018 came to a close, it was clear investor pessimism was on the rise. However looking to 2019, industry consensus pointed to a more positive performance outlook. Upside potential was generally linked to the overall health of Canadian corporate balance sheets. Downside risks included the impact of rising interest rates on consumer spending and debt servicing costs, and the ongoing threat of a global trade war. On balance however, the outlook optimism contrasted the bearish fourth-quarter Canadian equity market performance.

## POSITIVE INVESTOR SENTIMENT LASTED THROUGH TO YEAR END

Canadian commercial real estate sector investor sentiment remained positive through to the end of 2018. This was a factor in fourth quarter market characteristics. Investment demand was generally stable and healthy with most major asset classes commanding strong interest. Purchasers continued to exercise discipline, against a backdrop of increased macro risk. The strength of the demand cycle resulted in mild cap rate compression in asset classes with growth potential. The industrial and multi-suite residential asset classes offered this type of upside rental growth potential. In the office sector, cap rates have largely stabilized, with prime assets commanding strong investor interest. In the retail sector, values have edged lower, particularly for older assets or those requiring re-positioning. Power centre yields edged slightly higher, while prime street front rates compressed. Overall, the retail sector value trend softened, given heightened sector risk. The Canadian commercial real estate sector's generally healthy investment demand cycle continued to support healthy sales activity during the fourth quarter. In continuing the record pace of 2018, fourth quarter activity was expected to push annual transaction volume to a record high for a third consecutive year. Looking ahead over the near term, investor sentiment was expected to remain generally stable and healthy barring an unforeseen change in sector or economic fundamentals.

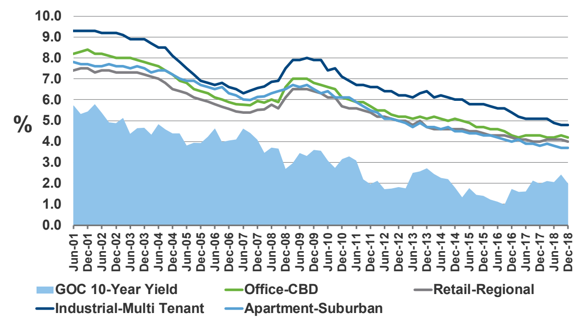
## SOLID PERFORMANCE PATTERN FORECAST

The Canadian commercial property asset class was expected to cap off another year of solid investment performance in the fourth quarter. Barring a sharp fourth-quarter dip, sector returns for the calendar year were expected to remain in the mid-to-high single digits. The industrial and multi-suite residential sectors have outperformed during the first three quarters of 2018, a trend that was likely to continue in the final quarter of 2018. By the three-quarter mark of the year, the industrial sector had already banked a year-to-date return of 12.1%. The multi-suite residential rental sector posted a similar result for the same time period. The office sector posted a more than respectable 7.1% total return, with retail at 5.6%. A similar performance breakdown was anticipated for the fourth quarter. For 2018, the office and retail sectors were tracking calendar year returns of below the long-term average. Weakness in Alberta was the primary drag on office sector performance in 2018. Moderately positive retail performance has been a byproduct on ongoing structural changes in the sector that have had a negative impact for the past few years. Ongoing headwinds in the retail industry had a negative impact on performance. The industrial and multi-suite residential sectors were on track to outperform, as a result of strong income growth and modest capital appreciation. On balance, a solid finish to the year with regard to Canadian real estate sector investment performance was forecast, in keeping with the broader 2018 trend.

## MINOR VARIATION IN SECTOR PERFORMANCE FORECAST

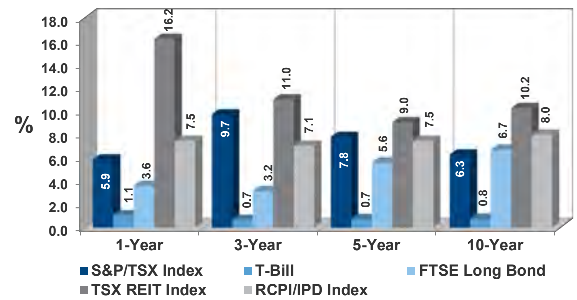
The probability of material change in Canadian commercial real estate investment market characteristics over the near term is quite low. The economic growth outlook is indicative of generally healthy rental market performance patterns and resulting income stability and growth overall. At the same time, the continued maturing of the capital cycle will unfold. Investment demand will continue to outdistance the supply of prime assets offered for sale. The industrial and multi-suite residential sectors will outperform, as was the case in 2018, while retail headwinds persist. The energy sector driver malaise will continue to have a somewhat negative impact on performance in Alberta's office market. Solid results will be generated through the balance of the country's major office markets. In short, while there will be areas of weakness, the broader outlook is largely stable and healthy in keeping with the recent sector performance pattern.

**Yield Spreads**
Cap Rates vs. 10-Year GOC Bonds



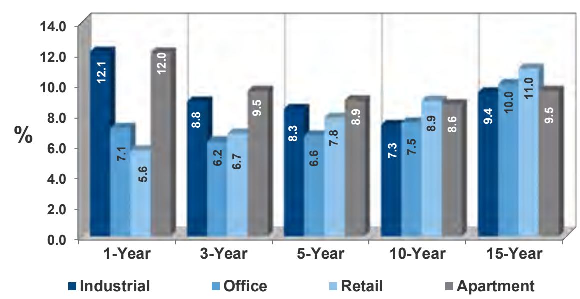

Source: AltusInSite (Dec 2018) , Bank of Canada (Dec 2018)

**Relative Performance**
Comparing Annualized Returns To Sept 2018



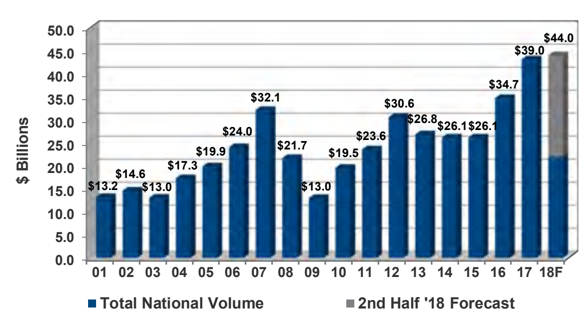

Source: © MSCI Real Estate; RBC CM; TSX Datalinx; SCM; PC Bond Analytics (Sep 2018)

**RCPI/IPD Returns**
Annualized Returns By Property Type To Sept 2018



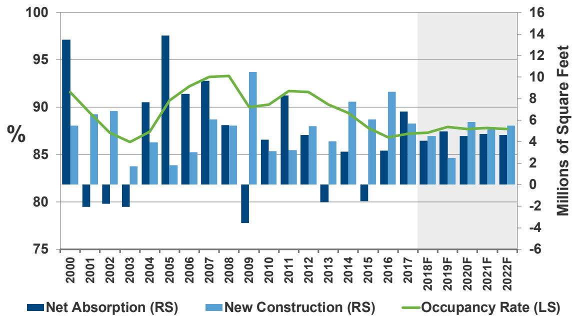

Source: RCPI; © MSCI Real Estate (Sept 2018)

**Investment Activity**
Total Investment Volume



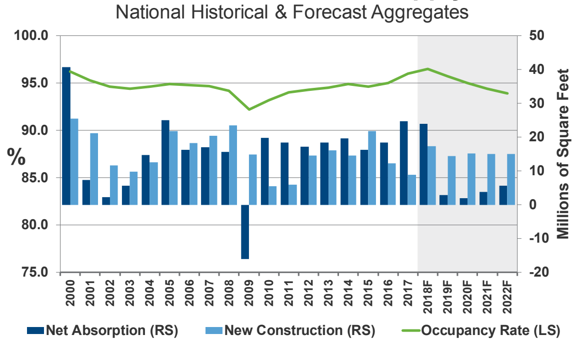

Source: CB Richard Ellis; Morguard

**Office Demand & Supply**
National Historical & Forecast Aggregates



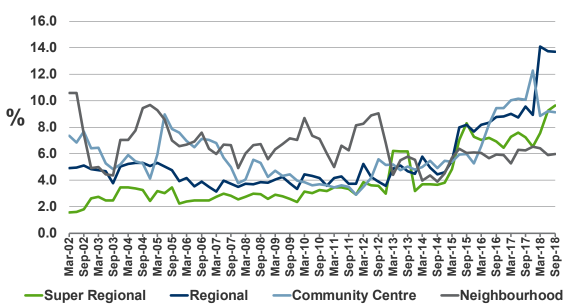

Source: CBRE Limited; CBRE Econometric Advisors

**Industrial Demand & Supply**
National Historical & Forecast Aggregates



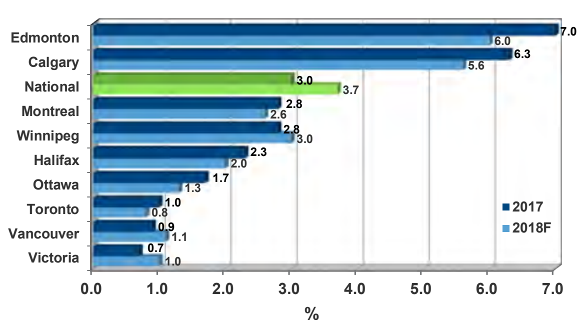

Source: CBRE Limited; CBRE Econometric Advisors

**Retail Vacancy Rates**
National Trending Across Property Types




Source: © MSCI Real Estate

**CMA's Rental Vacancy**
Rates for Structures of 3 units+




Source: CMHC, Housing Market Outlook Report

## STRONG FINISH TO THE YEAR FOR OFFICE LEASING MARKET

It was a strong finish to the year for the Canadian office leasing market. Demand characteristics were broadly positive. Technology-based companies continue to expand, while business sectors that have traditionally occupied significant volumes of space across the country also contributed to the healthy demand cycle. For the most part, demand has outpaced supply, resulting in a sharp uptick in construction activity. A total of 14.2 million square feet of new supply was under construction as of the end of the fourth quarter. The total is markedly higher than the five-year average, driven by upward pressure on rents and a robust demand backdrop. In keeping with the historic trend, Toronto accounted for the largest share of new projects underway at 53.7%. Another byproduct of the strength of the national office leasing demand cycle has been at or near cycle-low vacancy levels. At the close of the fourth quarter, average vacancy for the largest metros rested at 11.9%, down 110 bps year-over-year. The fourth-quarter rate marked a low dating back to the end of 2015. While the aggregate office leasing picture was broadly positive in the fourth quarter, Edmonton and Calgary continued to suffer the adverse effects of the ongoing energy sector malaise. Conditions were expected to have gradually stabilized by late 2019, against an otherwise stable and healthy backdrop.

## INDUSTRIAL SECTOR CONTINUED TO OUTPERFORM

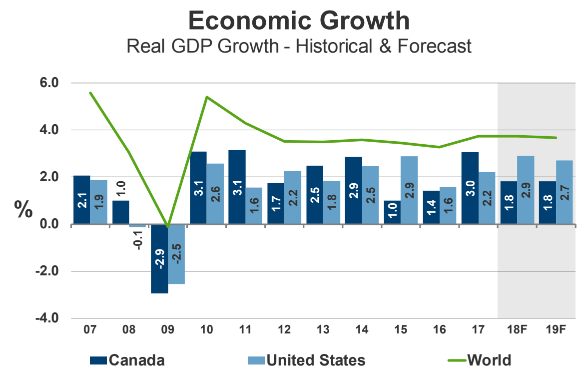
The Canadian industrial leasing market continued its impressive run of success in the fourth quarter ending the year on yet another high note. Leasing demand outdistanced supply during the final three months of 2018, with logistics, warehouse, and distribution companies continuing to absorb space in the country's larger metros. Expansion activity was supported by the healthy balance sheets of organizations across a range of business sectors including manufacturing, consumer goods, and wholesale. The strength of the demand cycle was reflected in supply fundamentals. Conditions were tight across much of the country, with new availability lows being set in a number of markets. National availability came to rest at 3.2% at year end. Toronto boasted the lowest rate of Canada's major business centres at 1.6%, with Vancouver the next lowest at 2.3% followed by Ottawa at 2.7%. Montreal registered record-low availability of 3.6% by the end of the year. With new construction completions markedly lower than the long-term national average and largely build to suit, conditions remain very tight across much of the country. The demand supply imbalance has driven rents higher, with few options available for expansion. Rent growth has been strongest for newly built space. The persistent upward pressure on rents was indicative of the overall health of the Canadian leasing market during the fourth quarter and the current phase of the cycle.

## SLIGHT SOFTENING OF STRONG MULTI-SUITE RESIDENTIAL RENTAL FUNDAMENTALS FORECAST

A slight softening of rental market fundamentals is forecast for 2019. More moderate Canadian economic growth forecast for the coming year will result in a slight moderation in the demand cycle. At the same time, an increase in new supply brought to market in some centres will elevate vacancy levels over the short term. National vacancy was forecast to edge higher in 2019, coming to rest near the 2.5% mark. Despite the upward vacancy pressure rents will continue to rise in most regions. Calgary and Edmonton will once again be the exceptions to this rule, given excess supply. Overall, conditions will be very tight in the country's largest urban centres. Prospective tenants will struggle to source options when looking to enter, upgrade, or relocate. Owners will continue to hold the upper hand in commanding higher rents. In short, multi-suite residential rental market fundamentals will soften slightly in 2019, but remain generally healthy.

## ECONOMIC GROWTH MODERATION CONTINUED

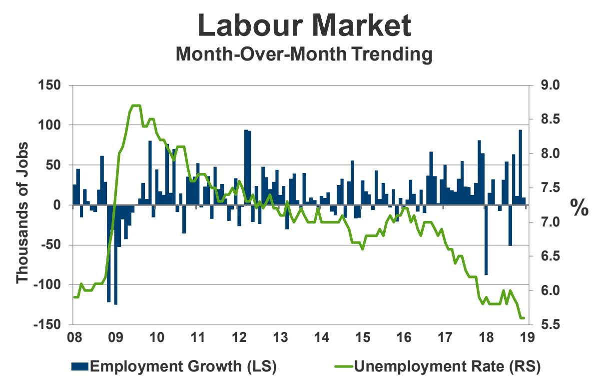
Canada's economy continued on a more modest growth track during the fourth quarter. National Gross Domestic Product (GDP) was tracking annualized growth of approximately 2.0% in the final three months of the year, similar to the pace of the preceding quarter. The weaker growth trend of the second half of 2018 was largely the result of a marked decrease in oil prices and its impact on energy sector output. The plunge in heavy oil prices forced the Alberta government to take action. The province placed a cap on production in order to reduce the potential for further reductions in pricing. As the fourth quarter progressed, prices showed signs of firming, indicating the move achieved its objective. To a large extent, however, the damage had been done as economic growth slowed in the final few months of 2018. While economic growth was expected to strengthen in 2019, a sustained oil sector recovery was not expected to emerge until well into the second half. Therefore, the national growth trend was forecast to hold at an annualized rate of 2.0% during the first half of 2019. Non-energy business investment played a larger role in the national growth trend during this period. This represented a shift away from the consumer as the most prominent economic growth driver. The combination of high levels and the higher cost of servicing household debt was expected to continue to reduce the consumer spending growth rate for the foreseeable future. At the same time, federally instituted tax changes were expected to boost business investment in the coming year. Regardless of the shift, the moderate economic growth trend of the fourth quarter was expected to continue in the coming year.



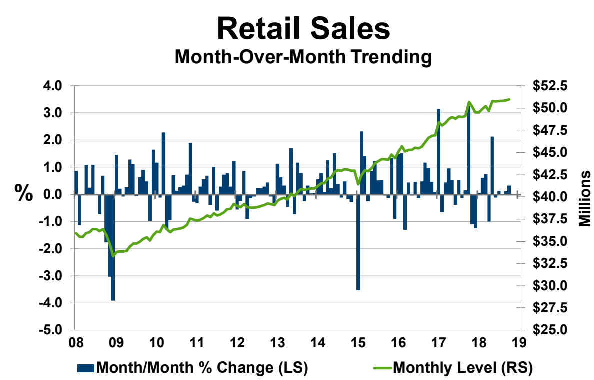

Source: Conference Board Of Canada (Dec 2018); International Monetary Fund (Oct 2018)

## WEAK WAGE GROWTH TREND WAS REPORTED

Canada's hourly wage growth trend remained relatively weak in the fourth quarter, against a backdrop of generally positive labour market fundamentals. In November, the rate at which average hourly wages increased year-over-year declined for a sixth consecutive month. A tepid 1.5% year-over-year growth rate was reported for November, markedly lower than the peak of 3.9% in May 2018 and the national inflation rate. Canadian wage growth has typically offset increases in debt servicing costs as a result of rising interest rates. The fact that wage growth has fallen below the rate of inflation has, to some extent, influenced the BofC's decision to hold off on raising its target overnight rate. The declining rate of Canadian wage growth of the recent past has taken place against a backdrop of largely positive labour market fundamentals. As of November, Canada's unemployment rate stood at a 40-year low of just 5.6%, down 20 bps quarter-over-quarter. This was a somewhat surprisingly positive result, given the addition of over 77,000 people to Canada's labour force during the same month. Total employment increased by a respectable 1.2% year-over-year. Employment growth levels stabilized in the late stages of 2018 following a summer of volatility. Despite the broad based strength of Canada's labour market however, wage growth patterns have been somewhat disappointing.



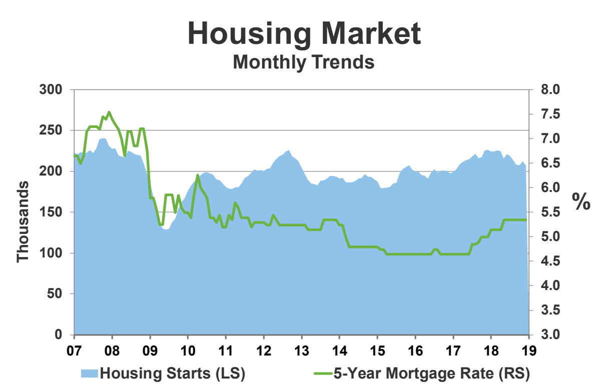

Source: Statistics Canada




Source: Statistics Canada

## RE-SALE HOME MARKET LOST MOMENTUM

Canada's existing home sales market suffered through a loss of momentum during the fourth quarter. A third consecutive decline in monthly sales was recorded in November. The downward sales trend was expected to have eroded residential investment in the final few months of 2018. The biggest losses in re-sale market momentum were tallied in markets with affordability challenges including Vancouver, Toronto, Hamilton, and Victoria. Rising interest rates and recently-introduced public sector policies have combined to slow the national re-sale market. As 2019 began, re-sale market activity continued to decline in most markets. However, as the year progresses, the expectation is that the market will gradually stabilize before a more sustained growth trajectory eventually emerges.




Source: Statistics Canada, CMHC

## OFFICE

| Property | Date | Price | SF | PSF | Purchaser | City |
|---|---|---|---|---|---|---|
| 1565, 1577 North Service Rd E | Dec-18 | $42.5 M | 110,108 | $386 | Manulife Financial | Toronto |
| Sun Life Plaza | Dec-18 | $225.0 M | 1,056,997 | $213 | Aspen Properties | Calgary |
| Oakville Corporate Ctr | Nov-18 | $54.2 M | 315,727 | $172 | Soneil Investments | Toronto |
| 140 Cremazie Blvd W | Oct-18 | $28.0 M | 222,084 | $126 | Groups Mach & Petra | Montreal |
| 1235-1275 North Service Rd W | Oct-18 | $52.1 M | 223,050 | $229 | Wafra Inc. | Toronto |
| Jean Edmonds Towers | Oct-18 | $186.0 M | 551,652 | $337 | Morguard/iA Financial | Ottawa |
| Queen's Quay Terminal | Oct-18 | $261.0 M | 494,901 | $527 | Northam/iA Financial | Toronto |

## INDUSTRIAL

| Property | Date | Price | SF | PSF | Purchaser | City |
|---|---|---|---|---|---|---|
| Congebec Inc. Portfolio | Dec-18 | $190.0 M | 1,318,752 | $144 | Skyline Comm. REIT | Various |
| 2 Bramkay St | Nov-18 | $78.0 M | 405,000 | $193 | Pure Industrial REIT | Toronto |
| 2645 Royal Windsor Dr | Oct-18 | $22.5 M | 158,829 | $142 | RFA Capital | Toronto |
| 5101 Orbitor Dr | Oct-18 | $33.5 M | 262,610 | $128 | Summit Ind. REIT | Toronto |
| 1802, 1810 Centre Ave NE | Oct-18 | $36.3 M | 214,463 | $169 | Manulife Financial | Calgary |
| 310, 330 & 334 Millway Ave | Oct-18 | $21.4 M | 102,000 | $209 | Canvas Developments | Toronto |

## RETAIL

| Property | Date | Price | SF | PSF | Purchaser | City |
|---|---|---|---|---|---|---|
| Tecumseh Mall | Nov-18 | $37.0 M | 378,932 | $98 | Europro | Windsor |
| Village Landing | Oct-18 | $51.2 M | 130,089 | $394 | Private | Edmonton |
| 410@7 Shopping Ctr | Oct-18 | $59.0 M | 238,174 | $248 | Premise Properties | Toronto |
| Hylands Ctr | Oct-18 | $48.0 M | 151,325 | $317 | Westdell Development | London |
| Burlington Shopping Ctr | Oct-18 | $26.5 M | 134,225 | $197 | Long Holdings | Toronto |
| 850 King St W | Oct-18 | $19.5 M | 82,149 | $237 | Frastell Property Mgt. | Toronto |

## MULTI-SUITE RESIDENTIAL

| Property | Date | Price | # Units | /Unit | Purchaser | City |
|---|---|---|---|---|---|---|
| Parkvue Apts./Esplanade Apts | Dec-18 | $241.0 M | 962 | $250,479 | Starlight/Homestead | Tor/Lond. |
| 20 & 40 Tuxedo Crt | Dec-18 | $75.2 M | 426 | $176,526 | Reserve Properties | Toronto |
| 11440, 11444 Ellerslie Rd SW | Dec-18 | $55.8 M | 240 | $232,500 | Skyline Apt. REIT | Edmonton |
| The Pinnacle | Nov-18 | $67.3 M | 249 | $270,080 | Timbercreek AM | Edmonton |
| 25 Cougar Crt | Nov-18 | $59.0 M | 236 | $250,000 | Starlight Investments | Toronto |
| 3545-3555 Cote Des Neiges | Oct-18 | $112.0 M | 299 | $363,344 | Akelius Canada | Montreal |
| The Treo at Sherwood | Oct-18 | $39.0 M | 158 | $246,835 | Killam Apartment REIT | Calgary |
| Elton Construction Portfolio | Oct-18 | $69.9 M | 295 | $236,834 | Realstar Group | Edmonton |
| 1 & 10 Rosemount Ave | Oct-18 | $35.0 M | 111 | $313,270 | Akelius Canada | Montreal |

* share sale

# ACKNOWLEDGEMENTS & CITED RESEARCH RESOURCES

In the course of compiling the statistical information and commenting on real estate markets, national, regionally and across Canadian metropolitan areas, we acknowledge the assistance and feedback from the following parties in completing this report:

The Altus Group, Avison Young, Bank of Canada, Bank of Japan, BMO Economics, BMO Nesbitt Burns, British Bankers' Association, Brunsdon Martin & Associates, CBRE Econometric Advisors, CBRE Limited, CIBC World Markets, Canada Newswire, Canadian Mortgage and Housing Corporation (CMHC), Canadian Mortgage Loans Services Limited, The Canadian Real Estate Association (CREA), Colliers International, Conference Board of Canada, Cushman & Wakefield, Developers and Chains e-news, Economy.com, European Central Bank, The Federal Reserve Board, Frank Russell Canada (RCPI), The Globe and Mail, ICR Commercial Real Estate, International Council of Shopping Centres (ICSC), Insite-Altus Research, International Monetary Fund, jlr Land Title Solutions, The Johnson Report (Winnipeg), Jones Lang LaSalle, Monday Report on Retailers, MSCI, The Network, Ottawa Business Journal, PC Bond Analytics, PricewaterhouseCoopers, RBC Capital Markets, RBC Economics, Real Capital Analytics, RealNet Canada Inc., RealTrack Inc., Rogers Media, Statistics Canada, Scotia Capital, TD Economics, Toronto Star, Torto Wheaton Research, Urban Land Institute, United States Department of the Treasury, York Communications

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