Manulife Investment Management

CANADIAN COMMERCIAL
REAL ESTATE OUTLOOK

Growth to decelerate in 2019, but fundamentals support recovery next year

Real estate team
Manulife Investment Management Private Markets
June 2019

Growth to decelerate in 2019, but fundamentals support recovery next year

The Canadian economy is likely to further decelerate this year, growing by just 1.4%, after growth of 1.8% in 2018 and 3.0% in 2017.[1] This slowdown reflects weakening in some key areas—consumer spending, the housing market, and energy sector investments, which are being dampened by higher interest rates, government measures to restrain housing markets, and limited capacity to transport oil. Fortunately, the current downward trend may be transitory, with an expected 2020 growth rebound to 2.0%.[1]

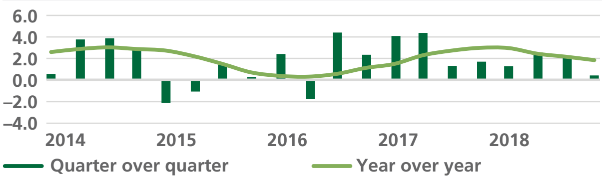
The housing market is under pressure, but a sharp correction isn't likely: Rising interest rates, and the federal government's mortgage stress test that reduces the maximum mortgage amount home buyers can qualify for, have taken a toll on housing investments, which declined by 2.3% in 2018.[2] Lower sales volume and weakening market sentiment, however, don't seem to have affected housing prices, which remained generally stable, growing by an average of 2.3% in 2018.[3] Another positive factor is that the stress test appears to be achieving its goal of improving the overall credit quality of borrowers—the share of mortgages with a loan-to-income ratio of over 450% has fallen from a peak of 20.8% prior to the stress test, to 6.2% as of mid-2018.[4] So, with market price stability and improved borrower credit quality, coupled with strong labor markets and continued immigration, a sharp correction in housing markets appears unlikely.

Consumers are challenged by debt burden and slower wealth growth, but wage increases could offset the impact: Consumer spending in the second half of 2018 was challenged by rising household debt, sluggish household wealth growth, and weaker wage growth, resulting in overall economic GDP growth falling to its lowest level since the 2017/2018 financial crisis.[1] A softer housing market is likely to remain a limiting factor because of the wealth effect, but wage growth is expected to trend up this year,[3] which should help the recent downward curve.

Business investment in the non-energy sector is positioned to contribute more to growth: Global growth is showing signs of slowing down, but in Canada it's predicted business investment will experience a turnaround this year. One of the main drivers of this increased growth will be the accelerated investment incentive, announced in last year's government of Canada economic statement, which allows companies to write off the full cost of machinery and equipment.[5] The ratification of the United States-Mexico-Canada (USMCA), expected this year, should further reduce uncertainty over trade with the United States and encourage businesses to make long overdue investments in production capacity.

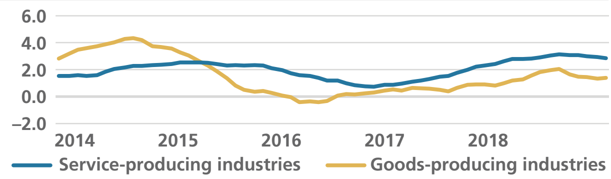
Weakness in global economic growth remains a headwind: Trade tensions, higher tariffs, and geopolitical uncertainties (e.g., Brexit) all continue to weigh down global economic growth, which appears to have peaked at 3.0% in 2018, and is forecast to fall to 2.9% this year.[6] Although Canada's biggest trading partner, the United States, continues to enjoy above-trend growth, the slowdown worldwide could weigh on the Canadian economy.

Real GDP growth (%)



Source: Statistics Canada, December 2018.

Average weekly wage, annual growth, 12-month average (%)



Source: Statistics Canada, October 2018.

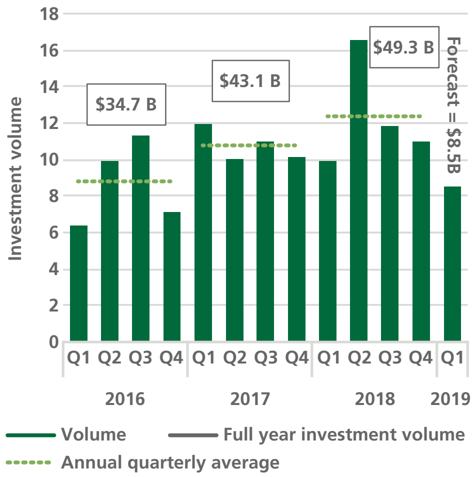
1 "Canadian Outlook Executive Summary: Spring 2019," Conference Board of Canada, 2019. **2** Statistics Canada, as of March 1, 2019. **3** RBC Economic Research, as of March 2019. **4** "The Impact of Recent Policy Changes on the Canadian Mortgage Market," Bank of Canada, November 2018. **5** "2018 Fall Economic Statement: Investing in Middle Class jobs," Government of Canada, November 2018. **6** The World Bank, January 2019.

Real estate market Q1 review and outlook[7]

Investment market

After three consecutive record-setting years, Canadian investment volumes moderated slightly in Q1 2019. Acquisitions are forecast to reach $8.5 billion in the first quarter, which would be more in line with the 2016 quarterly average than the 2018. Even though investment activity showed a clear slowdown over the first quarter, the conditions for investment remain favorable. The Government of Canada 10-year benchmark bond yield has retrenched significantly since it peaked at 2.60% in early October of 2018, ending the first quarter of this year at 1.70%. Other positive factors are that the Bank of Canada seems to have put a pause on interest-rate increases for the time being, liquidity remains abundant, and debt is highly accessible, especially for transactions involving industrial or multifamily assets. All signs point to volumes rebounding toward mid-2019, with several noteworthy office transactions poised to close in the second quarter.

Canada investment volumes (Q1 2016–Q1 2019)

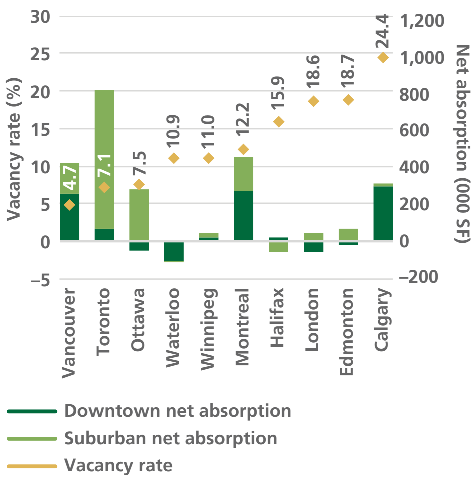


Source: CBRE Research, RealNet Canada, RealTrack, Collette Plante, JLR Land Title Solutions, Real Capital Analytics, as of Q1 2019.

Office market

The Canadian office market continued to exhibit strong fundamentals, with the vacancy rate decreasing by 40 basis points (bps) quarter over quarter, to 11.5% in Q1 2019. Downtown vacancy rates remained relatively flat, decreasing by only 20bps nationally. However, tightness persists, with four of the five largest downtown office markets at historic low vacancy rates. With downtown markets holding steady, strengthening suburban markets led activity in Q1 2019, with over 1.4 million square feet (SF) of absorption, predominantly in Toronto, followed by Ottawa, Montreal, and Vancouver. This marks the third consecutive quarter of elevated suburban leasing activity, with six of the ten major markets reporting vacancy reductions of 60bps or more. Recovery is ongoing in Alberta, with a significant increase in the amount of sublet space on the market, which is returning to pre-oil recession levels. While overall vacancy has remained stable quarter over quarter in Edmonton and Calgary, sublet space on the market in Q1 2019 decreased by 25.1% and 8.6%, respectively, indicating an improved outlook for market conditions.

Canada office fundamentals by market



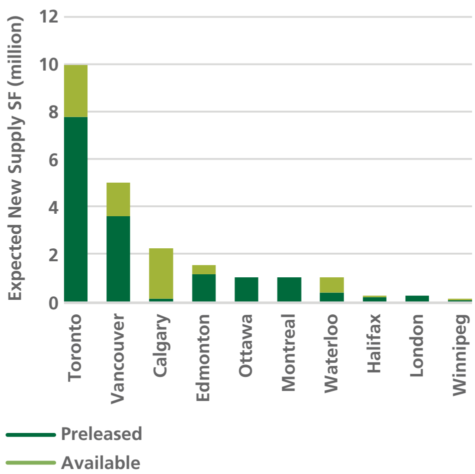
Source: CBRE Research, as of Q1 2019.

7 CBRE Research, Q4 2018.

Industrial market

Led by 11 straight quarters of demand outpacing supply, the national availability rate compressed for the fourth consecutive quarter in Q1 2019, to a record low of 3.0%. With shrinking availability, tenants are paying a premium for high-quality warehouse space, which pushed the national average net rental rate to a record high of $7.97 per SF this quarter, a 12.4% increase year over year. The growing need for distribution space has led to unprecedented industrial demand in population centers. Currently, logistics, transportation, warehousing, and e-commerce firms looking to expand their distribution networks across Canada make up 79.4% of tenants in the national market. Driven by this extraordinary demand, 22.3 million SF of new supply is projected for delivery in 2019, the highest recorded total since 2015. Despite this rise in construction activity, tight market conditions are expected to remain in force. Large space requirements have put pressure on tenants to plan for their real estate needs well in advance of their lease rollovers. As a result, 69.4% of the space forecast to be completed in 2019 has already been preleased, so until supply meets demand, these tight market conditions are expected to continue for the foreseeable future.

2019 Canada industrial new supply

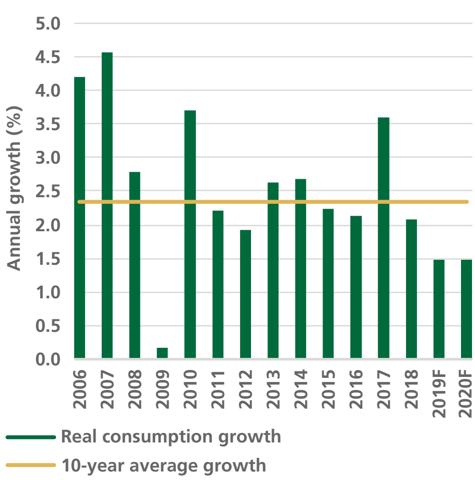


Source: CBRE Research, as of Q1 2019.

Retail market

Global economic growth is slowing, and so too is the Canadian market, although it's still strong relative to our peers. The major Canadian banks predict a slowing Canadian economy will cause growth in consumer spending to fall to its lowest level since the 2017/2018 global financial crisis by year-end 2019, driven by softening housing markets, debt financing pressures from higher interest rates, and low levels of household savings. After a year of weak retail sales growth in 2018, amounting to only 2.8%, the Conference Board of Canada forecasts growth in 2019 to rise to a minimally higher rate of 3.1%. More uncertainty for the segment will be felt in the year ahead as a result of the recent cycle of retail churn. While domestic and international brands continue to open and expand across the country, retail closures year to date have already outpaced those in 2018. As of the end of March of this year, five brands in Canada have announced they intend to close up shop, among them Gymboree, Payless ShoeSource, and Home Outfitters, which means that over 2.0 million SF of retail space will be returned to market.

Canadian real consumption annual growth

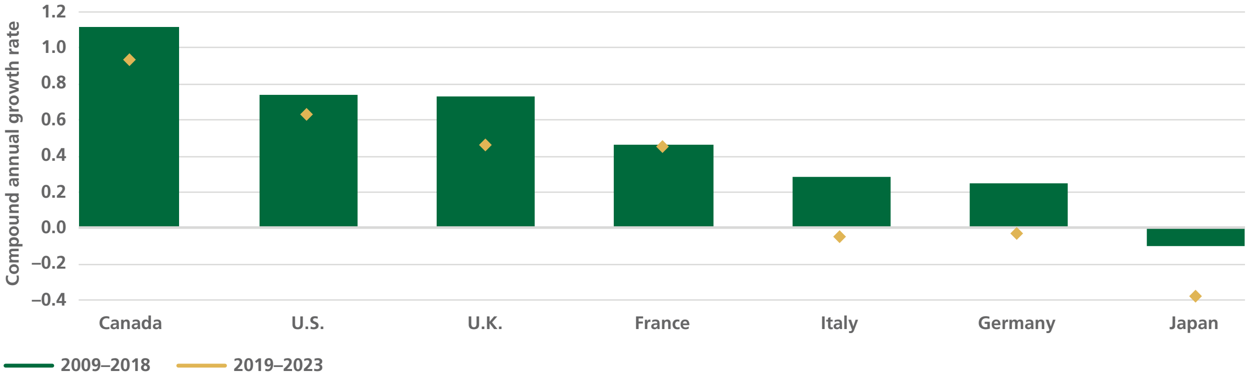


Source: Statistics Canada, various major Canadian banks, as of April 2019. F refers to forecast.

Multifamily market

Demand for multifamily properties is rising due to two significant national trends that are driving the sector to become one of the most sought-after commercial assets in Canada. The first is Canada's strong population growth, supported by the federal government's open immigration policies. Population growth in Canada has led that of the G7 countries by a substantial margin over the past 10 years and, according to the International Monetary Fund, will continue to do so over the next 5 years, through to 2023. The second trend is the increasing limitations on housing affordability in many urban centers across the country, pushing many Canadians the more affordable rental market. It's no surprise, then, that apartment vacancy rates in most urban centers fell below 2.0% in 2018, according to the Canadian Mortgage and Housing Corporation. Increased demand and limited vacancies also produced strong rental growth in 2018, with annual increases in average two-bedroom rents of 6.3% in Vancouver, 5.6% in Ottawa, and 4.5% in Toronto. The potential for rent growth is therefore quite real and has resulted in some multifamily transactions valued at sub-3.0% cap rates, with investors speculating on the implied future rent growth.

G7 population growth forecast (%)

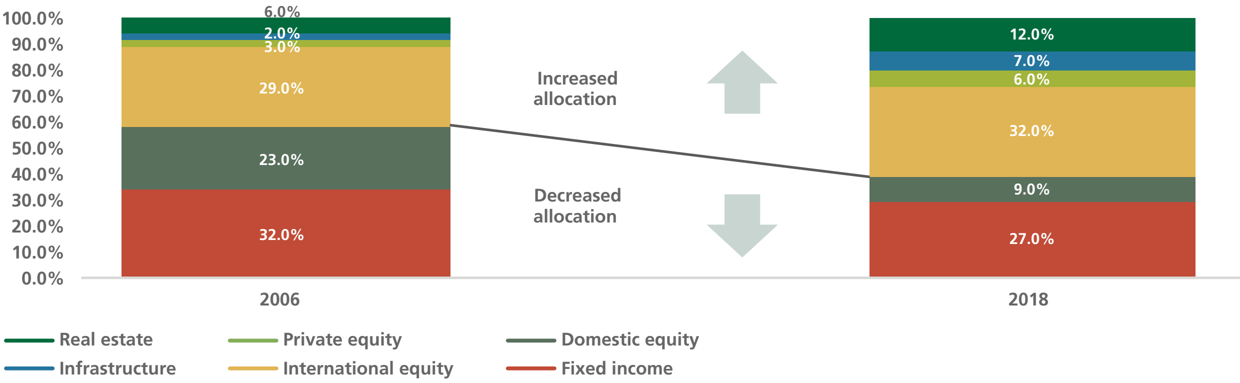


Source: International Monetary Fund, March 2019.

Canadian pension funds' allocation to real estate

Real estate was one of the few bright spots in institutional diversified portfolios in 2018, with the top five Canadian pension plans achieving an average total return of 8.5% from their real estate investments.[8] Strong real estate performance in 2018 isn't an isolated event, it's a trend that's been gathering momentum for some time. No wonder commercial real estate, and its role in a diversified portfolio, caught the attention of Canadian pension plans, and they've been steadily growing their allocation to this asset class for at least a decade now. In fact, real estate is one of the fastest-growing asset classes in the Canadian pension fund asset mix, with a 12% allocation as of 2018, double the level in 2006.[9]

Canadian institutional DB, DC, and investment pool asset mix

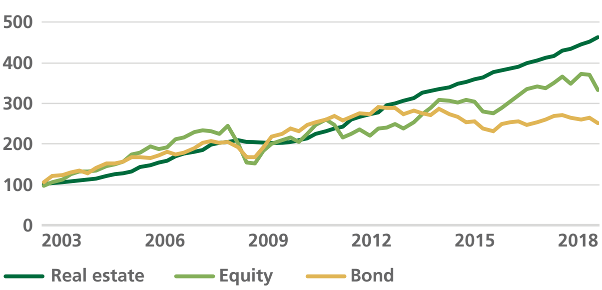


Source: Greenwich Associates, Canadian Institutional Investors, 2018.

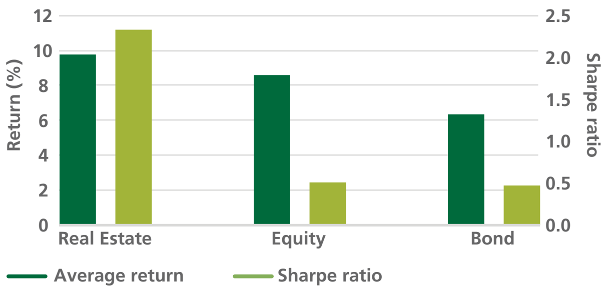
The increased real estate allocation in Canadian pension plan portfolios can be attributed to a number of factors, including the following:

Strong total return risk/return metrics: Over the past 15 years, commercial real estate has posted a higher average return rate than Canadian equities and bonds, and with less volatility, delivering superior risk-adjusted returns (Sharpe ratio).

Value of $100 invested in 2003, Canada



Risk/return metrics, 2003 to 2018, Canada



Real estate is represented by the MSCI/REALPAC Canada Property Index; equity is represented by the S&P TSX Composite Total Return Index; and bond is represented by the Bloomberg Barclays Canada Aggregate Corporate Bond Index. Source: Manulife Real Estate, MSCI, S&P Market Intelligence, Bloomberg, January 2019.

8 Based on the public records of the following pension funds: Canada Pension Plan Investment Board, Ontario Municipal Employees Retirement System, Caisse de dépôt et placement du Québec, Ontario Teachers' Pension Plan Board, Healthcare of Ontario Pension Plan.
9 Canadian Institutional Investors 2018 survey, Greenwich Associates, April 25, 2019.

Healthy yield spread: The current low-yield environment has challenged pension plans that have traditionally relied heavily on bonds to meet plan liabilities. In contrast, commercial real estate continues to offer healthy spreads that could help pension plans to better meet plan liabilities.

Increased transparency and research: Enhanced performance data and analytics, coupled with robust market data and research, have inspired confidence in the asset class and the role it can play in a diversified pension plan portfolio.

Asset/liability characteristics: Real estate shares an important characteristic with fixed-income assets–the opportunity for income generation in the form of rental income. This allows plan sponsors to match their expected income to their liability stream over a specific period of time.

Inflation hedge: Real estate can provide a hedge against inflation–an important consideration for pension plans.

Optimal allocation

As of the end of 2018, the top 10 Canadian pension funds had an average allocation to real estate in excess of 14%, usually making direct investment through dedicated real estate platforms.[10] This suggests that small to medium-size plans on average maintain a much lower allocation to real estate. While the optimal allocation to real estate will vary by fund, the results of research studies are clear: Real estate can provide a real boost to portfolio performance, with a significant allocation likely improving the risk-adjusted performance of most portfolios.[11]

The case for pension funds adding/increasing an allocation to real estate is therefore quite strong. This clearly represents an opportunity for small to medium-size pension plans that are underweight in this asset class to improve portfolio performance, which can be prudently achieved through investment in core open-ended commercial pooled real estate funds. This type of fund offers many benefits for small to medium-size pension plans, including professional management and portfolio diversification by region and sector.（注）

Summary

Commercial real estate has been a rewarding investment for pension plans, benefiting from the strength and stability of its performance over the long term. In addition, the contribution real estate can make to the risk-adjusted returns of diversified portfolios has become more evident, especially in the context of recent volatility in the public space. Given the strength of commercial real estate supply/demand fundamentals in most markets in Canada, we believe real estate is well positioned to hold steady as a strong performer for pension fund portfolios going forward.

（注）カナダの年金基金における事例です。外貨建資産への投資には為替変動などのリスクが伴います。

10 Pension fund annual reports, September 2018. **11** "Optimal Allocation to Real Estate in Canada," REALpac, May 23, 2007.

ディスクレーマー

■本資料は、海外グループ会社の情報を基にマニュライフ・アセット・マネジメント株式会社（以下「当社」といいます。）が作成した情報提供資料です。■当社が特定の有価証券等の取得勧誘または売買推奨を行うものではありません。■本資料は、信頼できると判断した情報に基づいておりますが、当社がその正確性、完全性を保証するものではありません■本資料の記載内容は作成時点のものであり、将来予告なく変更される場合があります。■本資料のいかなる内容も将来の運用成果等を示唆または保証するものではありません。■本資料で使用している指数等に係る著作権等の知的財産権、その他一切の権利は、その開発元または公表元に帰属します。■本資料の一部または全部について当社の事前許可なく転用・複製その他一切の行為を行うことを禁止させていただきます。

商　　　　号：マニュライフ・アセット・マネジメント株式会社（金融商品取引業者）
登　録　番　号：関東財務局長（金商）第 433 号
加　入　協　会：一般社団法人 投資信託協会　一般社団法人 日本投資顧問業協会　一般社団法人 第二種金融商品取引業協会

※マニュライフ・インベストメント・マネジメントは、マニュライフ・ファイナンシャル・コーポレーションにおける資産運用ビジネス部門の新しいグローバル・ブランドであり、従来のブランド名であるマニュライフ・アセット・マネジメントから変更しております。また、各国拠点の社名についても順次変更を行っております。