CMLS Financial®

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Commercial Mortgage Commentary

In The News

Office Market Resuscitation on the Horizon

Office buildings around the world continue to face challenges following the seismic shift in how and where employees are choosing to work - creating an increased risk for office investors on both the debt and equity side.

In Q1 2024 there have been 3 noteworthy Canadian office transactions in the news, signaling a potential shift in appetite among investors that may speed up as the year goes on, subject to the BoC (Bank of Canada) reining in inflation and taking steps to cut rates. The 3 transactions in Q1 totaled ~$460MM, with Vancouver leading the way with 2 transactions that include a multi-property deal valued at $300MM and a $130.5MM debt to equity conversion wherein the lender took majority ownership. The Toronto transaction was the smallest at $28.1MM.

The above may indicate rising investor demand for well-priced assets in core markets, but the demand from the Lender side remains to be seen. As of Q4 2023, the Intellifi's Commercial Lender Sentiment Survey indicated that interest in office lending remains quite muted even in the more resilient city center locations such as downtown Toronto and Vancouver. In the survey, 70% of lender respondents indicated they have low interest in city center office and 30% said they are not interested in lending on these assets. In each of the last 3 years, sentiment has waned further as the office market faces more scrutiny. The number of respondents with interest in suburban office was lower than city center, as expected. This is likely to stem from the bid-ask spread on office valuations coupled with high interest rates (inability to get enough leverage to pay out existing debt) and the uncertainty surrounding Return to Office (“RTO”). Despite the meek interest reported for office from Canadian lenders, Colliers National Investment Report indicated a total 601 office sale transactions in 2023 across Vancouver (165), Edmonton (29), Calgary (46), Toronto (237), Ottawa (33), and Montreal (91).

Office fundamentals continue to be stressed at the start of 2024 with Canadian office vacancy up from prior year as absorption remains negative in most areas across Canada. One major market where we are not seeing negative absorption is in Vancouver which has been among the strongest office markets in North America as per JLL’s Q4 2023 Office Insights.

One concern that investors now have is the unclear relationship between office vacancy rates and utilization rates. Many fear that while office vacancies have been holding steady - although at higher-than-normal levels – the real impacts of work-from-home are yet to be felt in full, as long-term leases have kept rent roll vacancies down. One indicator of this trend is that availability has increased more than vacancies, reflecting the increased supply in the sub-leasing market. That said, as the year came to a close sublease space had decreased to its lowest point in 2023 according to CBRE. This trend could see some reversal as major tenants across Canada continue to enforce RTO policies which might result in organizations taking back space from the sub-leasing market or committing to new and higher quality spaces as a flight-to-quality is one of the leading trends in the office leasing market.

With inflation showing signs of stabilizing, the timeline to cutting rates is inching nearer which might create opportunities for lenders and owners to come together on office transactions in the later part of the year or early 2025. Importantly, a few well-timed rate cuts could ease the pressure on office owners by allowing them to refinance existing high-interest debt, reducing the burden on cashflow. Get connected with your trusted mortgage advisor to position yourself for the next stage of this evolving market.

Fixed Income Markets

Bank of Canada (BoC)

On April 10th, the Bank of Canada (BoC) once again decided to maintain its key policy rate at 5%, which marks the sixth consecutive meeting where the rate has remained unchanged. The BoC aims to keep interest rates higher for longer to lower inflation further as they battle the unique economic challenges brought on by the pandemic.

The most recent consumer price index (CPI) figure showed a rate of 2.8%, which was a surprise to economists who had predicted a rate above January's 2.9%. This decrease was reflected in sectors such as cellular and internet services. Meanwhile, there were significant increases in mortgage interest and rent, rising by 26.3% and 8.2%, respectively, contributing to inflationary pressures.

In February, employment increased by 41,000. However, after declining in January, the unemployment rate rose by 0.1 percentage points to 5.8%. Despite this, Canada's wages are still rising at a rapid pace, although showing signs of slowing with, the average hourly wage growth decelerating from 5.3% in January down to 5%.

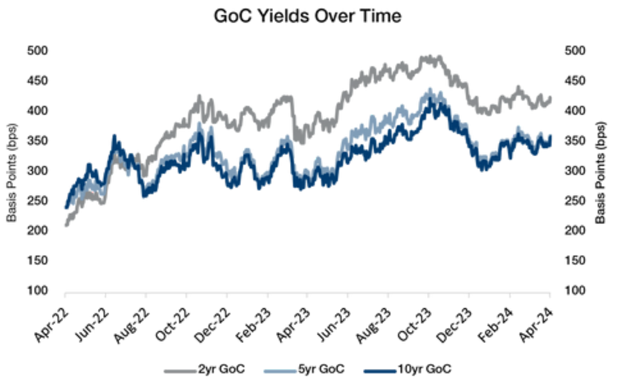
According to economists at the Big 5 Banks, the number of jobs is not increasing at the same rate as workforce growth, signaling that the unemployment rate is likely to increase. Increased unemployment and stagnant wage growth coupled with lower inflation might prompt the Bank of Canada to consider cutting rates sooner than what was expected last quarter.

The central bank is set to release new economic growth projections towards the end of April, which will provide further clarity on the battle to control inflation, including updated consumer price index data, GDP growth, and residential housing sales statistics.

Government Bond Yields

In early 2024, the financial markets predicted 4-6 rate cuts. However, due to the persistent inflation and the strong economy, which were discussed earlier, there has been an increase in bond yields. This reflects the expectation that higher interest rates will continue for a longer period than initially anticipated.

Towards the end of 2023, GoC bond yields had decreased by 100-120bps. But in the first quarter of 2024, they have risen almost halfway back to the previous level. For example, 5-year GoC yields reached a high of about 435bps towards the end of 2023, then fell to around 315bps in early January. Since then, the rate has increased by ~40bps to 3.54% as of April 1, 2024.



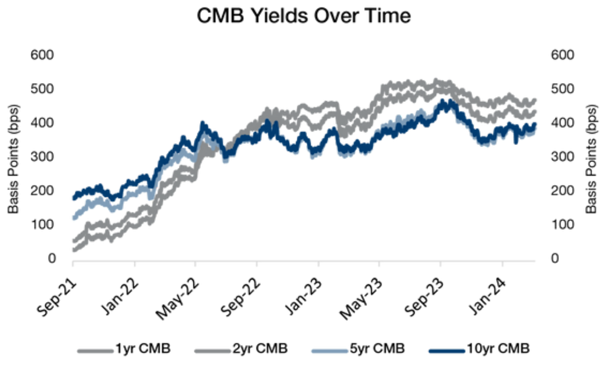
Source: Bloomberg

Canada Mortgage Bond Yields

The Canadian government has announced plans to purchase $3.75 billion worth of Canadian Mortgage Bonds. This move is part of a fiscal policy measure aimed at supporting housing finance. The government aims to buy up to half of the CMB issuance in 2024, which could total $30 billion. While this initiative is not classified as quantitative easing, it raises concerns about the potential market volatility and impact on the stability of these financial instruments.

The government's purchase of Canadian Mortgage Bonds could potentially lower the cost of financing for housing by reducing the yields on these bonds. This, in turn, could lead to lower mortgage rates, making borrowing more affordable. This could stimulate demand in the housing market. However, the long-term impacts on housing affordability and the market dynamics would depend on a range of factors, including broader economic conditions and other housing policy measures.

During the latter half of 2023, the CMB experienced an upward trend with some occasional fluctuations. Overall, it showed a continuous ascent with periodic retracements. As we transitioned into the first quarter of 2024, the activity appeared to stabilize, indicating a more cautious market sentiment. In Q1 2024, the 5-year CMB rate increased by almost 30bps and is currently sitting at around 390bps.



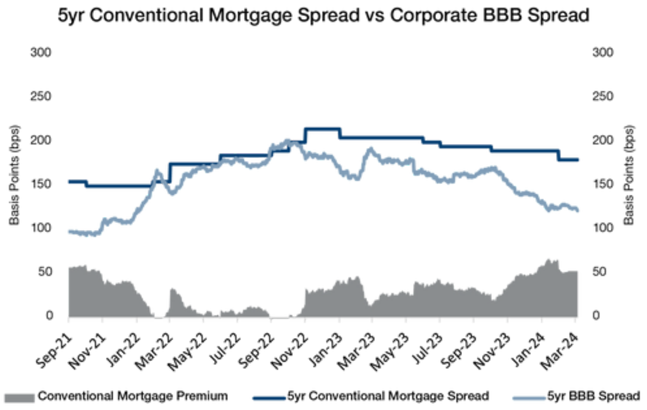
Source: Bloomberg

Corporate Bonds

Investment-grade corporate bond yields have remained stable after a major decline in Q4 of 2023, in line with government bond yields. In Q1 2024, corporate BBB spreads declined by about 10bps, resulting in an increase in the premium for commercial mortgages.

Typically, the decline in corporate BBB spreads can be a leading indicator for conventional mortgage spreads. If corporate BBB spreads continue to fall in 2024, this could put further downward pressure on conventional mortgage spreads. The fall in BBB corporate bond yields has pushed the delta between conventional mortgage spreads and corporate BBB spreads slightly above its historical average of about 45bps.

To stay up to date on corporate bond spreads and other key financial data, you can subscribe to the CMLS Financial Flash Report.



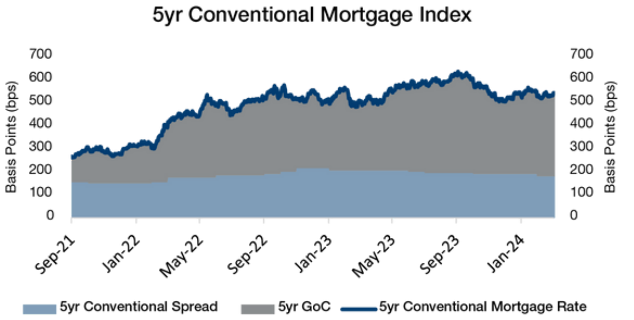
Source: Bloomberg

Commercial Mortgage Rates

Conventional

Conventional mortgage rates followed the same trend as GoC bonds and peaked in October 2023. After reaching the peak, both saw a downtrend that continued through the later parts of 2023 and into January 2024. Since then, conventional mortgage rates have retraced nearly half of their declines. The 5-Year Conventional Mortgage Index, which is a proxy for all-in conventional mortgage rates, shows that rates for the typical deal increased by 15bps in Q1 2024 and reached approximately 5.25%.

During the first quarter of 2024, conventional and conventional plus lending has remained active. Industrial and multi-family properties have accounted for more than 50% of these loans, with 5-year being the preferred term type.

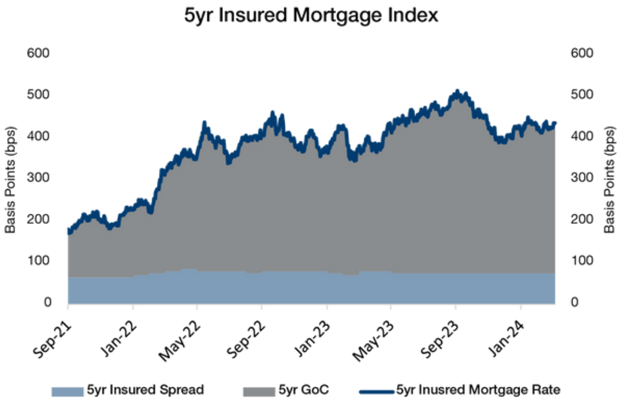


Source: Bloomberg

Insured

As with the conventional space, rates on 5-year insured mortgages rose in Q1 thanks to increases in underlying bond yields. The 5-Year Insured Mortgage Index averaged ~4.20% in March, up from ~4.05% in the final month of Q4 and has stabilized in recent weeks at levels seen earlier in Q1 and Q2 of 2023.

Competitive pricing for both 5-year and 10-year insured deals remains in the low-to-mid 40s over CMB for large, institutional-quality deals. There remains some evidence of pricing falling below 40bps for top-tier deals. The more typical deals see pricing in the 50-60bps over CMB range.



Source: Bloomberg

About CMLS Financial

CMLS Financial is one of Canada's largest independently owned mortgage services companies. Founded in 1974, we are proud to be Canada's Mortgage Company for 50 years. With offices across the country, we provide a wide range of commercial lending services, residential real estate mortgages and institutional services.

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