RESEARCH BRIEF
CANADA CENTRAL BANK POLICY

IPA INSTITUTIONAL PROPERTY ADVISORS
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Central Bank Firm on Tightening; Inflation Resistant Assets Increasingly Favoured

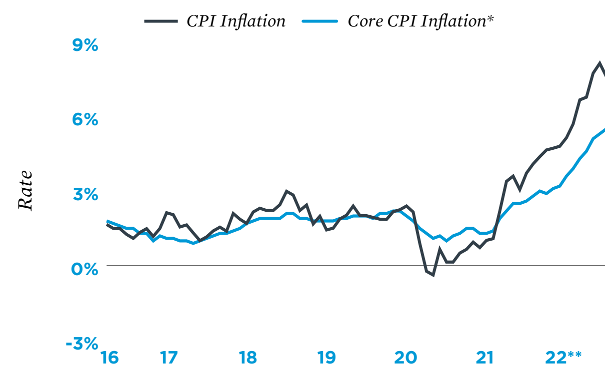
Bank remains hawkish in battle against inflation. In line with its July messaging, the Bank of Canada raised the overnight rate by another 75 basis points in September to 3.25 per cent, the fifth hike this year. This rate increase, coupled with the bank's quantitative tightening program, has pushed interest rates to a 14-year high. The central bank's decision was guided by a still elevated core inflation rate, high short-term inflation expectations, strong wage growth and the continued excess demand in the economy. The bank states that it expects to increase interest rates further, given the inflation outlook, but offered little forward guidance on the magnitude of these future rate hikes. However, the most recent trends of declining oil prices and improving global supply chains suggest reduced inflationary pressure in the latter part of the year. Meanwhile, the drop in Canada's import volumes in July, the lower than expected second-quarter GDP, and expectations for softer retail sales in the fall all signal a slowing economy in the second half. These developments suggest that the BoC's next move may not be as aggressive as the last two, and the hawkish monetary policy has likely already reached its peak.

Investors continue to recalibrate their CRE portfolios. The current rising interest rate environment is causing investors to re-evaluate their CRE strategies. As sellers adjust to this new higher interest rate norm, buyers are increasingly prioritizing assets perceived as lower risk over upside opportunities. Although the expectation gap remains wide, buyers and sellers are increasingly attentive to re-aligning their price expectations with the market.

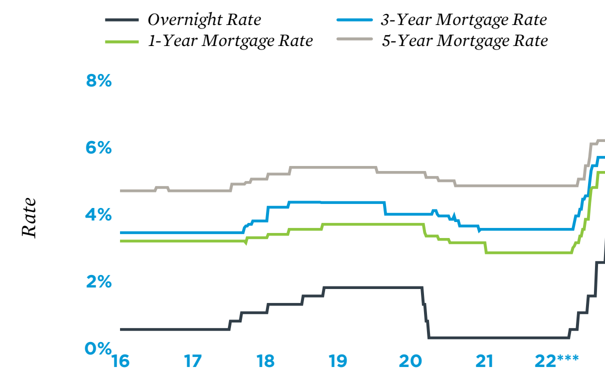
Rate hikes create a further demand and supply imbalance. Home mortgage rates have reached new highs, which has dampened affordability in the housing market. Home sales in July 2022 recorded a 29 per cent year-over-year fall, and mortgage rates will likely face continued upward pressure for the remainder of the year. The slowdown in home sales will aid the multifamily segment, as higher debt servicing costs will redirect potential homeowners to the rental market and continue to drive demand for apartments. A further tailwind for owners, multifamily assets tend to be more resistant to periods of high inflation, as the ability to readjust rents on a yearly basis allows them to keep better pace with the macroeconomic environment. On the supply side, higher interest rates will raise borrowing costs for developers, further hindering availability nationwide. This imbalance between supply and demand bodes well for investors' perception of apartments.

Hospitality sector offers inflation resistance, but not without risks. Over the summer months, pent-up travel demand generated strong hotel revenues. Both the average daily rate and revenue per available room in July 2022 were over 16 per cent above their July 2019 levels. As travel restrictions continue to be lifted, tourism should recover further, which will continue to support the hospitality sector. However, the central bank's hawkish stance poses downside risks. Higher costs and rising interest rates are weighing on consumer budgets, especially in the non-essential category, which is already evident in late summer spending habits. As a result, the hospitality sector may see a demand slowdown as consumers tighten their spending. Still, the asset's ability to adjust rates on a daily basis creates a potential hedge against inflation, providing a potential backstop for investors.

Core Inflation Remains Stubbornly High



Conventional Mortgage Rates Set to Rise Further



* Core inflation rate is the CPI-Common rate; ** Through July; *** Through September 7
Sources: IPA Research Services; Bank of Canada; Capital Economics; Royal Bank of Canada; Statistics Canada; STR; The Canadian Real Estate Association

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