SPECIAL REPORT
FOREIGN EXCHANGE RATE

IPA INSTITUTIONAL PROPERTY ADVISORS
A DIVISION OF MARCUS & MILLICHAP, BROKERAGE

JANUARY 2023

Current Foreign Exchange Dynamic has Key Implications for Canada's CRE Market

Weak Canadian dollar aids property performance and sales. The Canadian dollar is facing a confluence of forces that have weakened it relative to the United States currency, with important implications on Canadian commercial properties. A weaker Loonie relative to the American greenback supports Canada's near-term tourism outlook, a tailwind for the hospitality and retail sectors. A weaker CAD and expected lower interest rates in Canada also appeal to investors from the U.S., who make up the largest share of foreign buyers in the marketplace. This foreign exchange dynamic and its effects on properties are set to continue, due to three key factors: lower interest rates relative to the U.S., currency risk perceptions and international oil prices.

Key Takeaways

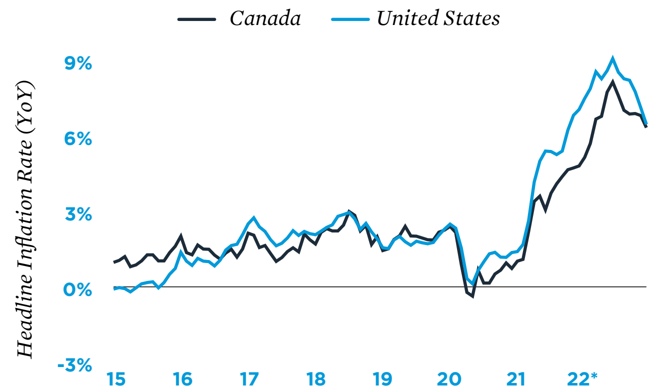
- Widening Canada-U.S. interest rate differential, a strong U.S. dollar and potentially subdued oil prices will likely keep the Canadian dollar weak in 2023.
- Hospitality and retail markets in metros with high exposure to the tourism sector may benefit from the weakening Loonie.
- Lower interest rates and a relatively cheap Canadian dollar could act as a tailwind for investment activity into Canada by lowering debt-servicing costs for cross-border investors.

Inflation and Interest Rate Factors

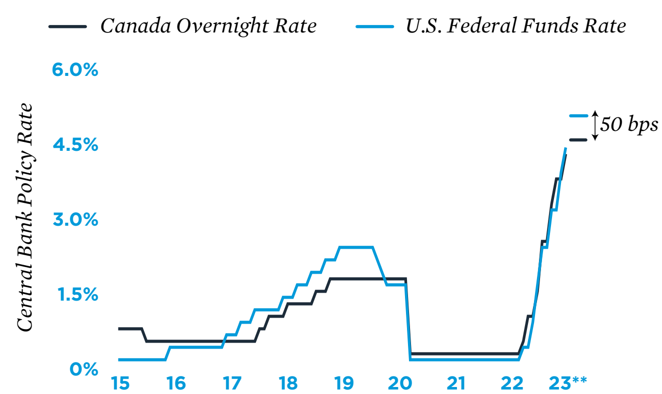
Inflation slightly lower in Canada compared to the U.S. While multi-decade high inflation in both Canada and the U.S. has persisted since the beginning of 2021, price growth over the past two years was relatively less dramatic in Canada. Between March 2021 and December 2022, on average, Canada's headline inflation rate was 130 basis points below that of the U.S., which is well-above the long-term average spread of 10 basis points. This gap was partly driven by softer increases in energy prices within Canada. Despite these differences in the price movement, the Bank of Canada and the Federal Reserve have taken a similar approach in their monetary policy in order to curb broad-based price acceleration.

Terminal rate likely to differ across countries. Last year, the BoC increased its policy rate at a similar pace compared to its American counterpart. Yet, the broadening divergence in price growth has translated into a lower expected terminal rate in Canada. Current market consensus points to the BoC's overnight rate peaking between 4.25 and 4.75 per cent, while the U.S. federal funds rate is anticipated to stabilize around 4.75 to 5.25 per cent. While this outcome is not guaranteed, earlier last year, the fixed income market had already priced in this rate differential, as Canada's two-year government bond yield started to dip below the U.S. two-year treasury yield. By the end of 2022, this spread had widened to roughly 50 basis points. Lower interest rates in Canada, as a result, shifted demand away from the Loonie toward the USD, which led to an 8 per cent depreciation in the Canadian dollar relative to its American counterpart by the end of 2022. This year, as the interest rate differential persists between the two economies, the CAD will likely continue to remain weak.

Inflation Less Severe in Canada Since 2021



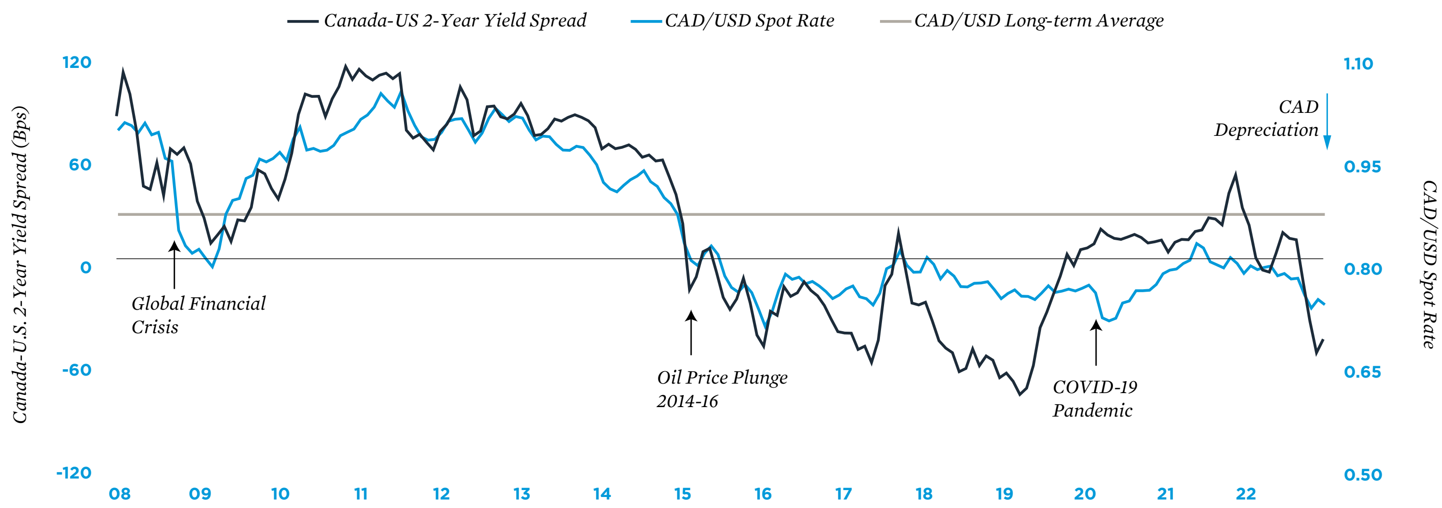
Lower Terminal Rate Expected in Canada



** Headline inflation rate through December; ** Market consensus for 2Q 2023*
Sources: IPA Research Services; Bank of Canada; BMO; Bureau of Labor Statistics; CIBC; CME FedWatch Tool; Federal Reserve; RBC; Statistics Canada; TD Bank

USD Reserve Status and Declining Oil Prices Also Weakening CAD

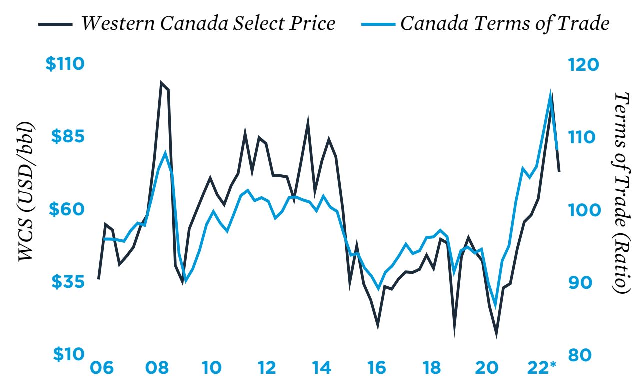
CAD/USD Closely Tracks Countries' Yield Gap



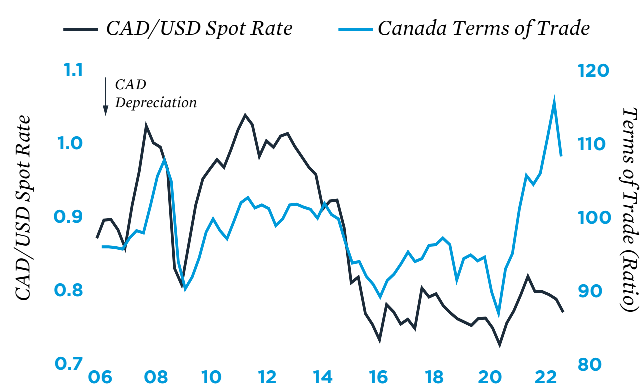
U.S. dollar a safe-haven asset during economic downturns. Global investors have long favoured assets in USD, the world's dominant reserve currency, to hedge against market volatility, which often leads to periods of a strong greenback. This was evident in the last three economic events — the COVID-19 pandemic, the oil price plunge of 2014-16 and the Global Financial Crisis — during which the USD strengthened against the CAD by an average of 23 per cent. In 2023, as the global economy is expected to slow with recessionary fears looming, investors may again flock to the greenback to shelter against near-term uncertainties. The USD, as a result, will likely maintain its strength for an extended period of time. This perceived safety in USD will likely be another factor that keeps the CAD weak, suppressing the CAD/USD rate well-below its long-term average throughout 2023.

Terms of trade deteriorated in Canada as oil prices fell. Canada's heavy reliance on oil exports imposes a close connection between oil prices and its export prices. In the third quarter of 2022, as the price of Western Canada Select declined from the peak witnessed in June 2022, Canada's overall export prices fell by more than 4 per cent. This reduction in export prices resulted in a deterioration in the nation's terms of trade, or the ratio of export prices to import prices, which measure the health of a country's international trade. Worsening terms of trade indicate that foreign importers needed fewer Canadian dollars for goods and services exported from Canada. This series of events helped drag down the value of the Canadian dollar, relative to the American counterpart. In 2023, a potentially slowing global economy may further weigh on oil prices, which could lead to little improvement in Canada's terms of trade. The CAD, as a result, will likely remain weak relative to the USD.

Canada's Terms of Trade Worsen as Oil Prices Fall



CAD Loses Value as Terms of Trade Deteriorate



** Through 3Q.*
Sources: IPA Research Services; Alberta Energy; Statistics Canada

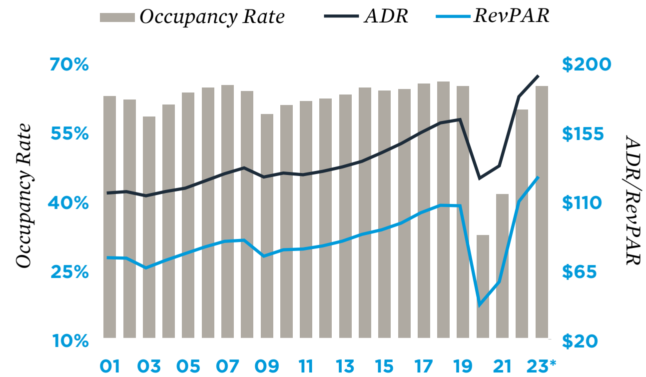
Impact on Commercial Real Estate

Less expensive Canadian dollar benefits hotel performance. As pandemic concerns faded and travel restrictions were lifted, Canada's hospitality sector experienced a swift rebound over the past two years. This was primarily driven by an increase in domestic and international leisure travelers. Major airports across the country saw a substantial uptick in passenger traffic. Montreal's airport, for example, recorded an over tenfold year-over-year increase in transborder arrivals during the summer months in 2022. This brisk rebound caused the average daily rate and revenue per available room to eclipse their pre-pandemic levels by roughly 16 per cent each. Looking forward, with the Canadian dollar expected to remain cheap relative to the USD, inbound transborder travel will likely be further supported. Western metros will continue to see a healthy influx of vacationers from the U.S. looking to enjoy Canada's mountains and outdoor activities. Meanwhile, Eastern metros may see more corporate visitors, due to the presence of Canada's major business hubs.

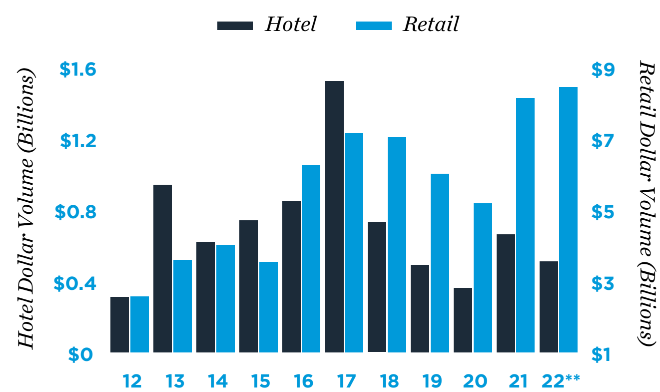
Weaker CAD likely to keep Canadians travelling domestically. In addition to a likely uptick in inbound international travel, the persistent strength of the USD may also weigh on outbound transborder trips, encouraging Canadians to travel domestically. This will lend further support for hotel room demand within Canada, which will contribute to continuing growth opportunities within the nation's hospitality sector. This uptick in demand will be additionally aided by limited supply growth of only 0.6 per cent expected this year. Underlying performance metrics, as a result, are likely to continue to improve. The national average occupancy rate for 2023 is expected to reach the pre-pandemic level of 65 per cent, with the annual average daily rate and revenue per available room rising 7.7 per cent and 14.8 per cent, respectively. Positive investor sentiment, as a result, will likely continue to prevail within Canada's hospitality sector.

Uptick in travel to benefit retail demand. After peaking in June 2022, Canada's retail sales began leveling off as consumers started to grapple with declining disposable income and tightening budgets, due to rapidly rising inflation and borrowing costs. This pullback in consumer demand caused retail leasing activity to slow notably. Looking forward, although elevated interest rates will continue to weigh on the sector's fundamentals, metros like Vancouver and Montreal will likely see consumer demand moderate at a slower pace, thanks to foot traffic generated from the tourism industry. Consequently, these metros' retail markets may remain more stable compared to markets that are not as reliant on tourism. Furthermore, a relatively weak CAD will encourage more spending by American visitors. Leasing activity in these metros, and in turn the transaction market, will likely be better protected against near-term economic headwinds.

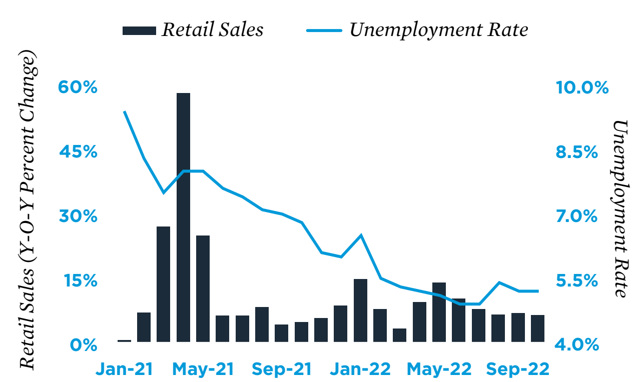
Hospitality Sector Poised for Further Recovery



Total Dollar Volume Traded Across Sectors



Consumer Spending Slowing, Job Market Robust



** Forecast; ** Trailing 12-month through 3Q*
Sources: IPA Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

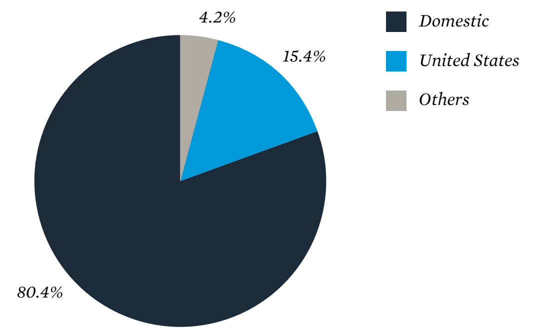
Impact on Investment Activity

U.S. the most prominent foreign buyer in Canada. Over the past 10 years, foreign buyers invested $58 billion in Canada's five main commercial real estate asset classes. These property types include multifamily, retail, office, industrial and hospitality, which constituted approximately 20 per cent of total dollar volume transacted within Canada. Among these international buyers, U.S. institutions and individual investors accounted for 79 per cent of total sales, equaling just under $46 billion. Most of these buyers are in the form of public REITs, institutional investors and private equity players. This sizable share exposes trading activity in Canada to both interest rate and foreign exchange rate fluctuations.

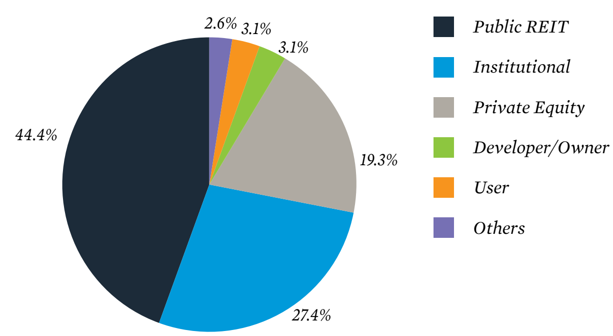
Lower financing costs for cross-border investors. In 2023, opportunities are likely to emerge, given the current macroeconomic environment and arbitrage potential within Canada relative to the U.S. As the Canadian dollar is expected to remain weak relative to the U.S. dollar, American investors will be able to secure CAD loans at favourable exchange rates. Furthermore, the relatively lower terminal rate in Canada, compared to that in the U.S., will translate into lower debt servicing costs for U.S. buyers. This will act as a tailwind to help improve investor sentiment, particularly at a time in which underwriting may soon stabilize in Canada as the BoC's overnight rate is expected to reach its peak in the first half of 2023.

Canada's ban on foreign homebuyers may shift demand to CRE. As part of the government's effort to make housing more affordable, the Prohibition on the Purchase of Residential Property by Non-Canadians Act — effective Jan. 1, 2023 — bars foreign buyers from investing in residential properties in Canada for two years. The new regulation also imposes a $10,000 fine on violators, including any entity that knowingly facilitates the transaction. Despite this fundamental change, foreign investment in CRE is not affected. Off-shore investors, who in the past benefited from Canada's profitable residential market, may now shift focus toward the CRE sector. The multifamily segment will likely attract most investor interest as it provides similar exposure to Canada's housing market. This is especially true for transborder investors, given lower interest rates in Canada and the favourable foreign exchange rate environment expected throughout 2023.

Total Dollar Volume by Investor Origin (2013-22)



U.S. Investment Dollar Volume by Type (2013-22)



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Sources: IPA Research Services; Alberta Energy; Altus Data Solutions; Bank of Canada; BMO; Bureau of Labor Statistics; CIBC; CME FedWatch Tool; CoStar Group, Inc.; Federal Reserve; RBC; Statistics Canada; TD Bank

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Price: $1,500