RESEARCH BRIEF
CANADA INFLATION

IPA INSTITUTIONAL PROPERTY ADVISORS
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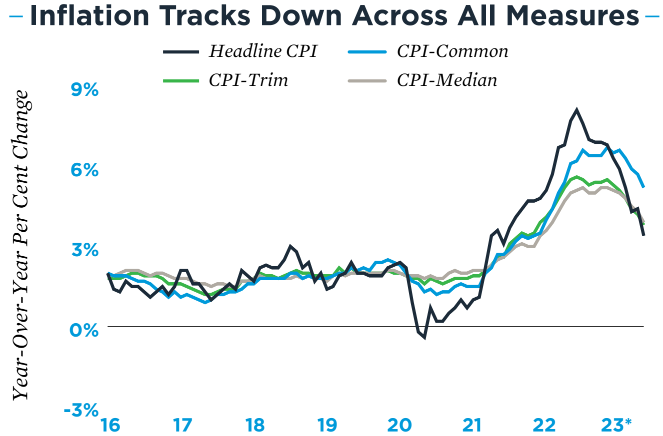
Canada Inflation Tracks Down; Positive News for Commercial Real Estate Investors

Inflation at its lowest since June 2021. Canada's consumer price index rose 3.4 per cent year-over-year in May, down from the unexpected 4.4 per cent uptick witnessed in April. This was largely driven by the lower price of gasoline, which fell 18.3 per cent annually. Favourable base effects played a large role in this gasoline price decline as the onset of the Russian-Ukraine war caused energy prices to spike substantially in the first half of last year. On the flip side, for the third consecutive month, mortgage interest costs continued to be the largest contributor to annual price gains, up roughly 30 per cent year-over-year. When excluding these costs, inflation rose 2.5 per cent, which is within the Bank of Canada's target range. While this significant slowdown in annual price growth is promising for commercial real estate investors, a further rate hike remains a possibility in July as the economy continues to remain resilient despite higher borrowing costs.

Further rate hike still probable. With annualized measures of core inflation still above 2 per cent, coupled with healthy consumer spending and a turnaround in the housing market, one additional 25 basis point hike is more likely than not. However, as the pace of inflation cools, coupled with the labour market also loosening in May, the case for another rate hike in July is not quite as strong as it seemed last month. It is becoming more likely that the Central Bank will not raise its overnight rate beyond 5.0 per cent, implying that interest rate stabilization may occur over the upcoming months. If true, this would aid investor sentiment, which may cause commercial real estate transaction activity to gain momentum.

Inflation Tracks Down Across All Measures

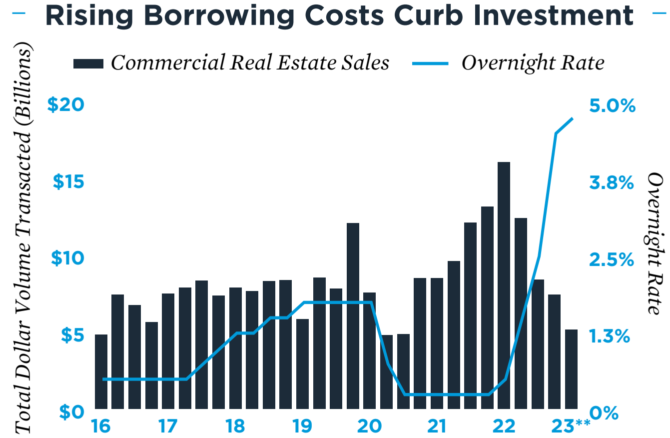


Commercial Real Estate Outlook

CRE investment may soon reach its bottom. With inflation trending down and approaching the 2 per cent target, borrowing costs may soon stabilize. Asset pricing could begin to recalibrate as uncertainty mitigates. This may cause CRE transaction activity to gain momentum over the second half of the year. Large volumes of deployable investment capital are currently on the sidelines, and with underlying fundamentals remaining healthy across the property spectrum, many investors may look to get ahead of the market. This comes after inflation rose significantly over the past year, peaking at 8.1 per cent in June 2022. Due to this, the Bank of Canada was forced to raise its overnight rate 450 basis points to 4.75 per cent. Total dollar volume transacted fell 70 per cent annually as of the first quarter of this year, with many market participants unable to make deals pencil. This was mainly due to challenging underwriting conditions, causing price expectation gaps to emerge between many buyers and sellers.

Inflation-resistant assets are a preferred investment option. Hard assets, such as real estate, tend to perform better in times of elevated inflation. Properties like multifamily and hotels typically experience yearly and daily turnover, which allows them to realign revenues with rising costs more frequently. Investor sentiment has remained relatively more positive for these select assets due to this potential inflation hedge, as well as robust demand. This is especially true for hotels, as it is the only property type to have witnessed an annual increase in total dollar volume transacted as of the end of the first quarter, rising roughly 90 per cent.

Rising Borrowing Costs Curb Investment



** Through May; ** Dollar volume through 1Q, overnight rate through 2Q*
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada; Canada Mortgage and Housing Corporation; Capital Economics; CoStar Group, Inc.; Statistics Canada