RESEARCH BRIEF
CANADA INFLATION

IPA INSTITUTIONAL PROPERTY ADVISORS
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Inflation Returns to Target Range; Too Soon for Bank of Canada to Declare Victory

Inflation falls sharper than expected. In June, Canada's inflation hit 2.8 per cent, down from the 3.4 per cent seen in May. Like previous months, the largest contributor to price increases was mortgage interest costs; if removed, this would have pushed inflation to the 2.0 per cent target. While the 2.8 per cent reading in June was still a promising outcome, as it is within the Bank of Canada's target range of 1.0 to 3.0 per cent, it mainly reflects a fall in energy inflation. This was largely driven by strong base-year effects, given the Russian-Ukraine war elevating prices early last year. With the subsequent fall in energy costs driving most of this price deceleration, there is a possibility for inflation to rise above the Bank's target range again in the near future as these yearly effects will be largely eliminated over the coming months. Still, when removing volatile CPI categories like food and energy, prices rose 3.6 per cent in June, down from the 4.0 per cent seen in May, which continues to indicate broad-based easing in inflationary pressures.

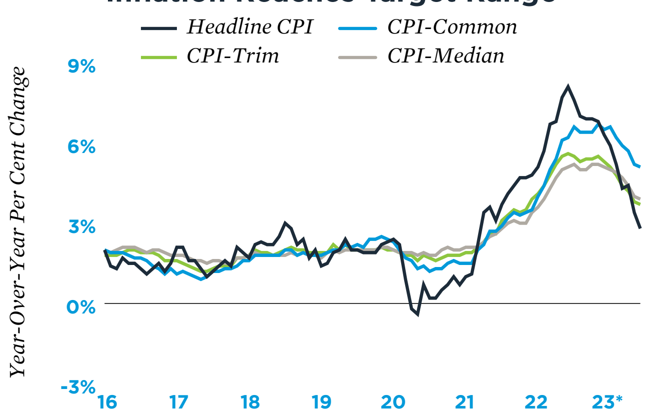
Risks of another rate hike linger. The consensus among economists and the money market is that this inflation reading, coupled with an easing labour market, will be enough to push the Central Bank back to the sidelines at its next policy meeting. However, sticky core inflation provides some risk that a further rate hike may be necessary. The monthly change in CPI-Trim and CPI-Median accelerated to 0.3 per cent in June, up from the 0.2 per cent in seen May, keeping their annual rates elevated at an average of 3.8 per cent. As a result, it may be more challenging than expected to get inflation back to the 2.0 per cent target on a sustained basis.

Commercial Real Estate Outlook

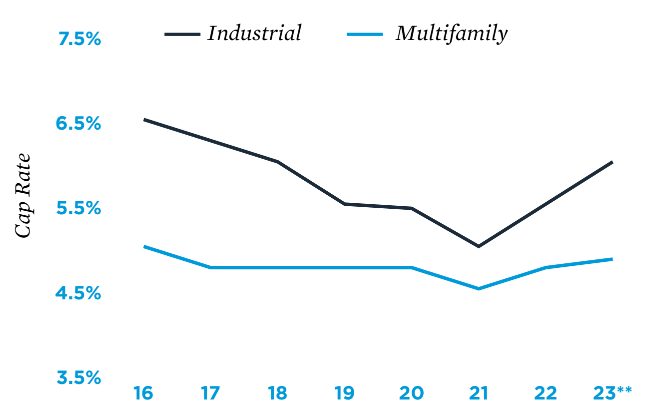
Investor confidence may begin to build. Despite mixed results from June's inflation reading, it is still likely the Bank of Canada holds its overnight rate at 5.0 per cent for the remainder of the year, as money markets are pricing in an 80 per cent chance of a rate pause. Due to this, commercial real estate transaction activity may gain momentum over the upcoming months as borrowing costs begin to show signs of stabilization. With interest rate uncertainty expected to abate, clearer underwriting conditions will allow for prices to recalibrate. This should cause price expectation gaps to mitigate between buyers and sellers. Additionally, there still-healthy underlying fundamentals across the property spectrum that will likely support an uptick in transaction activity as large volumes of deployable capital wait on the sidelines. This comes after the BoC increased its overnight rate 475 basis points over a 16-month period, causing transaction activity to stall. As of the first quarter, total dollar volume transacted was down roughly 70 per cent year-over-year, while sales prices began to stagnate and in some cases drop.

Fundamentals healthy for many major property types. With national vacancy rates and annual rent growth reaching record levels last year for industrial and multifamily properties, coupled with robust performance throughout the first half of this year, investment activity could see an uptick once borrowing costs stabilize later this year. As cap rates inched up slightly over the first quarter, more buyers will likely be able to find ways to make deals pencil despite elevated interest rates eating into returns. Consequently, investment volumes may be at or nearing their troughs.

Inflation Reaches Target Range



Cap Rates Inch Up as Interest Rates Rise



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** Through June; ** Through 1Q*
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada; Canada Mortgage and Housing Corporation; Capital Economics; CoStar Group, Inc.; Statistics Canada