RESEARCH BRIEF
CANADA CENTRAL BANK POLICY

IPA INSTITUTIONAL PROPERTY ADVISORS

THIRD QUARTER 2021

CBC Action Signals Recovery Progress; Investors May Notice Rippling Impact

Asset purchase taper may put upward pressure on interest rates. Starting in July the Central Bank of Canada (CBC) will reduce weekly asset purchases from $3 billion to $2 billion. Additional moderations could take place in the coming quarters and the program may be phased out completely by year end. Scaling back quantitative easing indicates confidence in the economic recovery from the pandemic. At the same time, lower weekly asset purchases could apply upward pressure to interest rates with less liquidity being injected into the money supply. Nonetheless, the CBC stood firm on its plan to hold the key policy rate at 0.25 percent during the July meeting, though unexpectedly severe inflation could force the hand of the central bank.

Inflationary concerns mounting. Headline inflation is now expected to be at 3 percent in 2021 and remain above the 2 percent target through 2023. Despite higher expectations for inflation, the CBC believes it is transitory and plans to hold the key policy rate firm until the economic slack is absorbed. The bank anticipates that this will not occur until at least the second half of 2022. Many commercial real estate investors are aware that higher interest rates could arrive sooner. Buyers may be inclined to lock in deals while lending rates are low in the near term, fueling competition for properties and putting downward pressure on cap rates. On the tenant demand side, however, inflation and higher interest rates would drive up costs of capital, inventory expenditures and employee compensation, weighing on firms' ability to grow and absorb space.

Some properties more adaptable to inflation. In real estate segments with shorter lease terms and high turnover, such as apartments and hotels, rental rates can be more accommodating to inflation. Rents for these types of properties can be adjusted frequently, allowing operators to move rates upward alongside prices of goods. Hotels have notable ground to make up before inflation correlates with daily rate hikes, but relaxed travel restrictions are starting to generate room demand, which presents investors with a window of opportunity. Apartment rent growth has also been shy of inflation, but second half job gains should be a boon for demand and rates.

Economic Considerations

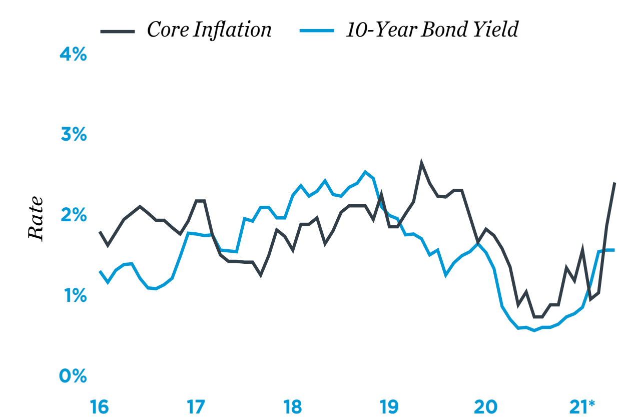
Strong GDP growth expected for several years. The first quarter improvement in GDP was slightly weaker than anticipated and greater COVID-19 restrictions in the spring likely stunted momentum in April and May. The CBC moved its 2021 forecast downward to 6.0 percent growth from 6.5 percent. Nevertheless, the bank expects pent-up savings will accelerate GDP gains in the coming years and lifted its forecasts for both 2022 and 2023. By the end of 2023 the CBC anticipates that GDP growth will be 750 basis points higher than the earlier expectation.

Service sector recovery lagging. Canada added 230,700 jobs in June, recovering approximately 84 percent of what was lost in the previous two months amid provincial lockdowns. Most of the gains were part-time roles in the service industries, a segment that has been disproportionately impacted throughout the health crisis. Hiring momentum should build as vaccination efforts allow reopening. Consumers with savings accumulated are eager to get out of their homes and shop, driving retail sales. Still, labour slack in the service sector is possible if compensation fails to attract workers to openings, burdening demand for retail space.

5.6% *Annualized 1Q Increase in GDP*

8.1% *Annual Increase in Total Employment as of 2Q*

Inflation and Interest Rate Trends



** Through May*
Sources: IPA Research Services; Bank of Canada; Capital Economics; StatCan