Canada | Q3 2021

Research Report

# Canada real estate outlook

As the Canadian Economy finds its legs, real estate fundamentals strengthen across all asset classes

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# Economic Outlook

## Economic activity picked up despite markets' concerns about early interest rate hikes and rising inflation

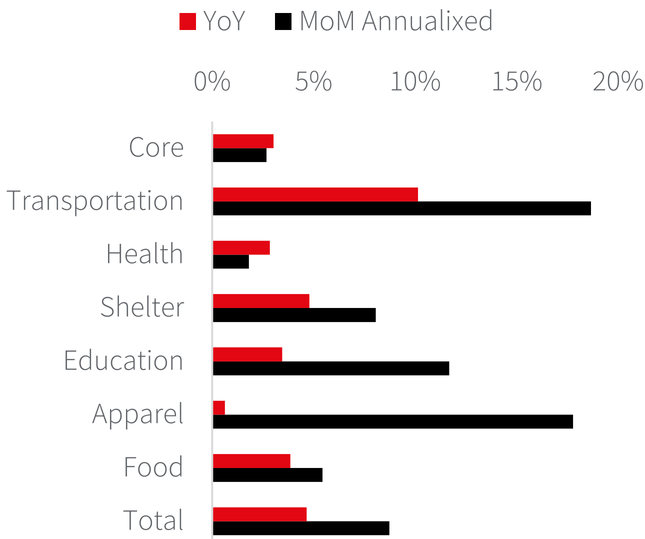
There are signs that the Canadian economy is finally beginning to find its legs after several quarters of "stop and go" dynamics caused by the pandemic and associated social gathering restrictions. However, while domestic demand is perking up, the supply-side of the economy remains beset by headwinds that have generated a sudden burst of inflation. In this complicated environment of temporarily high inflation coupled with buoyant demand, there is pressure on the Bank of Canada (BoC) to begin tightening monetary policy earlier than expected only a few months ago. Yet the outlook remains cloudy, in part because to the uncertain length of the labour, supply chain and commodity shocks, but also due to the evolving slowdown in China and growing Omicron variant worries. Consequently, markets are likely over-estimating the extent of hiking planned by the Bank of Canada over the coming year.

Statistics Canada's initial estimate suggests the economy grew 1.9% (annualized) in Q3, led by a surge in energy exports and a strong rebound in consumer spending following an actual contraction of activity in Q2 due to COVID-related lockdowns. The rebound would be even stronger were it not for supply chains snarls that are holding back production and pushing up prices. We expect the economic momentum to solidify through the rest of the year, leading to annual growth of almost 5% as supply shocks ease and energy prices stabilize. The outlook over the next two years calls for sustained, above trend real GDP growth as the economy recovers from the pandemic, thanks to effective containment efforts, widespread vaccination (almost 75% of the population is fully vaccinated) and a rebound in exports to the US. Moreover, policy stimulus remains ample and household balance sheets are healthy, owing to significant accumulated savings over the lockdown periods.

### "Shocking" inflation

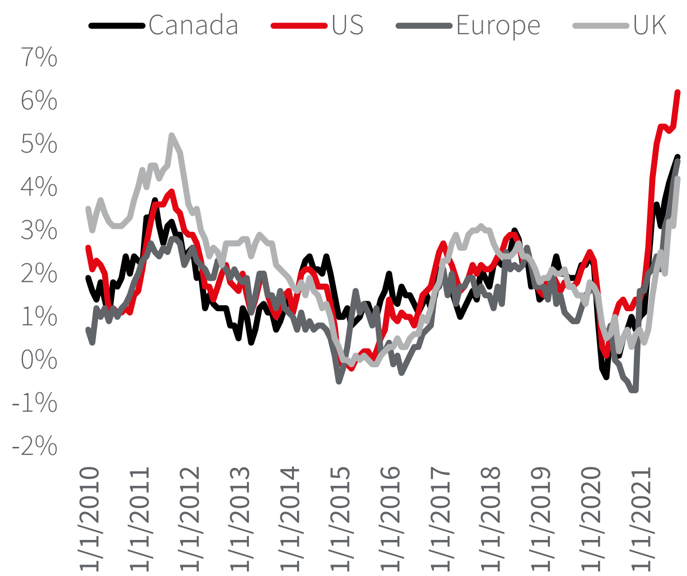
The big surprise this year is inflation. Consumer price inflation reached an annual 4.7% in October, the fastest pace since 2003. Most of the increase was due to surging energy prices, which are a burden to consumers but a boom for oil-producing provinces. Nevertheless, core inflation (ex-food and energy) stood 3.2% year-on-year, reflecting a broad-based increase in prices from rents to vehicles. We do not expect these high inflation levels to persist and are forecasting inflation rates to converge back to the Bank of Canada's 2% target next year, once the supply shocks now hitting the economy eventually fade. These shocks, which include supply chains hiccups, worker hesitancy, energy shortages and weakness in China, are all symptoms of the difficulty in getting people and resources back to work now that lockdowns have been lifted. They are not expected to persist indefinitely.

**Canada CPI Breakdown (October 2021)**
**The supply shocks driving up inflation won't last indefinitely**




Source: Statistics Canada

**Western CPI Inflation (YoY)**




Source: Bloomberg

A combination of supply shocks is hitting the Canadian economy, slowing growth and boosting prices. Supply chain problems are the most visible of the post re-opening shocks. These delays, in part caused by transportation clogs and component shortages, are fundamentally driven by low inventories and a broad shift away in consumer purchases from services to goods during the lockdowns. As bothersome as these shortages may be, workarounds will eventually be found for most obstacles. Indeed, there are already signs that supply chain tensions are starting to ease.

The second shock relates to energy shortages and rising energy prices. Mother Nature is partly to blame (for example, with increased hurricanes in the US and wind droughts in the UK and actual droughts in Northern China). Unfortunately, climate change implies ever more disruptive weather going forward, which is particularly challenging for renewable energy sources. In China, overzealous coal production restrictions to meet Net Zero targets are the cause of the energy scarcity that has forced factories to shut down across the country. All of these forces have put upwards pressure on natural gas and oil prices, which have contributed to higher commodity prices more broadly. While erratic weather may argue for higher price volatility, we are not expecting energy shortages to last indefinitely.

The third big supply shock comes from China. Several factors are at play. China's a zero-tolerance COVID policy and coal caps (see above) have combined to shut down a lot of activity. President Xi Jinping's new "Common Prosperity" agenda, which is aiming to curb the excesses of capitalism and redistribute wealth, has rattled business confidence. But perhaps most concerning is the real estate turmoil related to Evergrande and other big highly levered developers. This crisis is caused by the regulatory crackdown against excessive credit to real estate that is deemed to have made housing unaffordable for families. From the perspective of the West, these shocks can be stagflationary, because, so long as they are mild, they mostly affect us by slowing down our imports. But a more severe slowdown in China is possible if ever the Evergrande crisis gets out of hand and causes a housing market crash. With construction being a huge share of Chinese GDP and housing remaining the main savings vehicle for most people, a sizeable real estate correction could quickly transform the China supply shock into a deflationary demand contraction.

The final supply shock stems from the labour market, where certain sectors are experiencing shortages in Canada. However, the situation is far less acute than in the US, which is seeing a significant decline in participation rates due to Delta concerns, child-rearing responsibilities and early retirements. However, Canadian participation rates have rapidly rebounded, and the total employment number now sits above pre-pandemic levels. The rate of unfilled positions is rapidly increasing, now reaching 4.8%, nearly 2 percentage points above pre-COVID levels. A tighter labour market is the main reason we expect the BoC to hike ahead of the Fed next year.

### What does this mean for monetary policy?

Seemingly in response to the higher high inflation, the BoC recently brought forward the timing of its projected rate hikes by a quarter to the middle of 2022. There are two reasons for this shift. The first is that the Canadian labour market is doing just fine. Employment has returned to pre-COVID levels and there is probably not much slack left in the economy. While the BoC says that there are no signs of acceleration in wages, it is reasonable to begin thinking about tightening even if actual real GDP growth has been somewhat disappointing. The other reason for the Bank's hawkish tilt is that it wants to increase its optionality. In the event that inflation expectations became unanchored due to persistent or even accelerating inflation, the BoC needs to be in a position to react credibly.

Markets are expecting the BoC to hike rates upwards of six times in 2022. They seem destined to be disappointed, in part because they are probably misunderstanding monetary policy. Reacting severely to temporary supply shocks would be a policy mistake. Monetary policy can only affect aggregate demand - it can't do anything to unblock Chinese ports or convince recalcitrant workers to rejoin the labour force. Moreover, monetary policy acts with a lag of at least one year. That means that tightening at this point will only hamper demand a year from now, precisely when the supply chain constraints will have likely passed. Moreover, an abrupt tightening would likely cause financial turmoil given the amount of debt in circulation.

We remain of the view that the BoC will keep its cool, tightening gradually as inflation falls from its current heights to something closer to target towards the middle of next year. Our outlook on tightening is bimodal. If the slowdown in China remains modest, we see two hikes by the BoC in the second half of 2022, with perhaps four hikes in 2023. However, if China slows as significantly as we expect, then the central banks may stay on hold through all of next year.

# Office Outlook

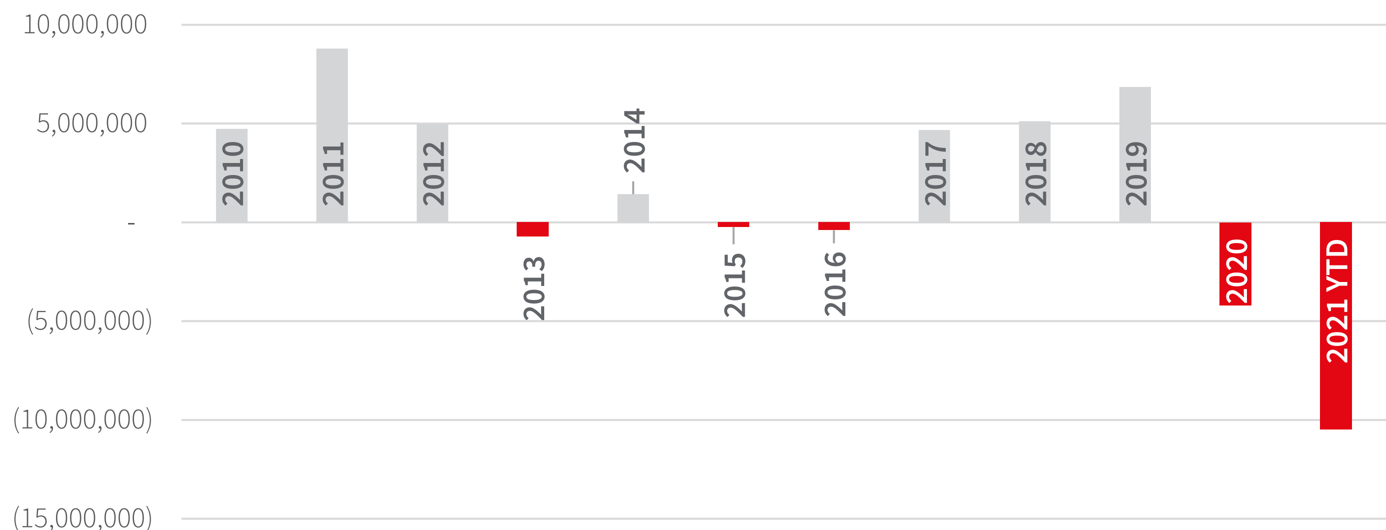
## Vacancy continues to drift upwards but demand for high quality built out space remains high

All major Canadian markets experienced an increase in vacancy this quarter with the overall Canadian vacancy rate rising to 14.1%, compared to 13.3% last quarter. Vancouver leads the way with the lowest vacancy rate in the country, sitting at just 7.1%, while Calgary continues to be at the top end of the spectrum with an overall vacancy rate of 27.6%. Despite some markets experiencing an upswing in Class A vacancy, the "flight to quality" trend continues, with many tenants wanting to be able to persuade their employees to come back to the office by offering best-in-class space and access to great amenities.

Over 89% of the over 12-year-olds have received at least 1 dose of the COVID-19 vaccine in Canada as of November 20, 2021, with those fully vaccinated at 86%. Despite these rates being substantially higher than our American neighbors, the return to the office has been hindered by the surge of Delta infections, and with the recent Omicron variant, some companies are certainly taking a "wait and see" approach before committing to going back to the office. Several large companies have also announced a mandatory vaccination policy in order to return to the office, while others have imposed COVID-19 testing for those who are not fully vaccinated.

For both Vancouver and Toronto, the CBD markets continue to hold steady, however, the Montreal, Edmonton and Calgary CBD markets are experiencing high negative absorption, creating a tenant-favourable market in those regions. Ottawa continues to be more insulated due to the number of government and crown corporations occupying the space there.

There continues to be a surge of excellent sublease opportunities on the market, as companies reevaluate their office space needs. Many of these spaces are built-out already, providing additional enticement to prospective tenants, who would otherwise face longer move-in times due to the supply chain shortages of late.



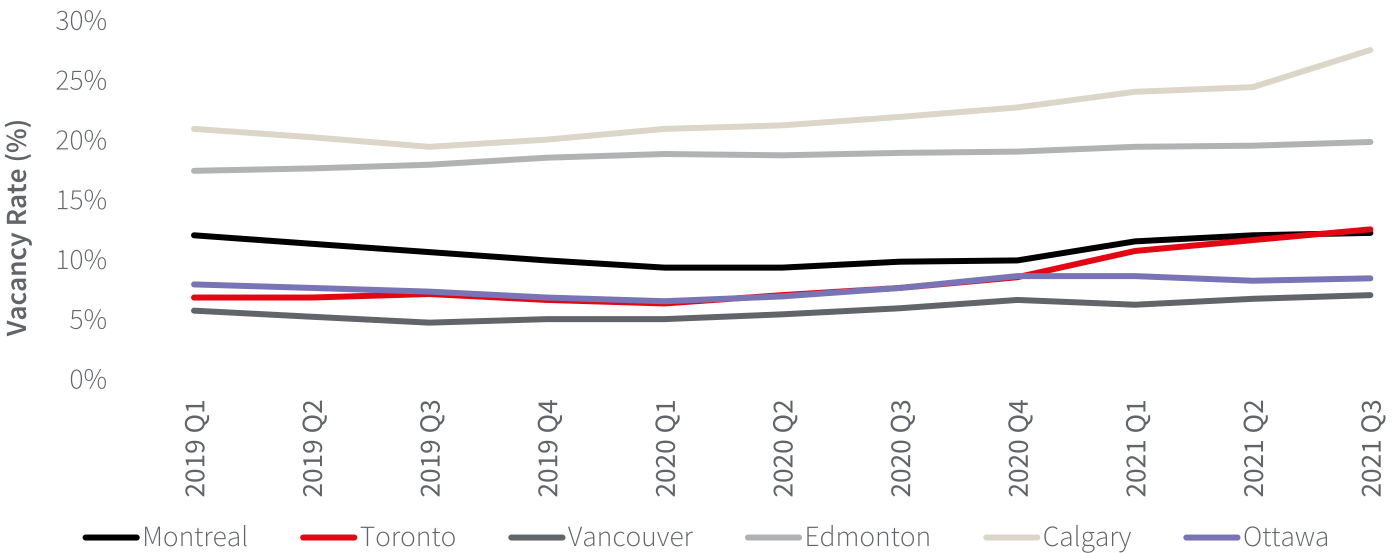

Source: JLL Research , CoStar, Altus Insite

Indeed, many supplies are reportedly taking at least double the amount of time to be delivered compared to pre-pandemic times, due to staffing challenges, steel shortages and major delays of cargo shipments. These holdups have also led to higher construction costs (see Canada Construction Outlook), so many tenants have opted to have their landlords complete their build-outs, making already improved space more sought after.

The recent catastrophic floods in British Columbia have destroyed critical transportation infrastructure, creating a further challenge for supply chains in not only BC, but Alberta as well. The upcoming winter season will make it more difficult to rebuild the roads and further complicate recovery efforts. A province-wide state of emergency was declared, and it is estimated it will be well into 2022 and beyond before the highways are repaired. There is also the possibility of additional storms threatening the region which would postpone that timeline further.

Most Canadian markets have new construction projects in the pipeline with over 18.8 million square feet currently under construction in the six major markets, but many of these projects are behind schedule due to the supply chain delays. The majority of the new projects are in the Toronto and Vancouver markets with 8.6 million square feet and 6.4 million square feet respectively under construction. With pent-up demand for quality space in these markets, the new supply is a welcome addition, however, two-thirds of the space is pre-leased in Toronto, and half the space is already pre-leased in the Vancouver market.

**Vacancy continues to creep upward across the country**
**Historic vacancy by market Q1 2019 – Q3 2021 (%)**




Source: JLL Research , CoStar, Altus Insite

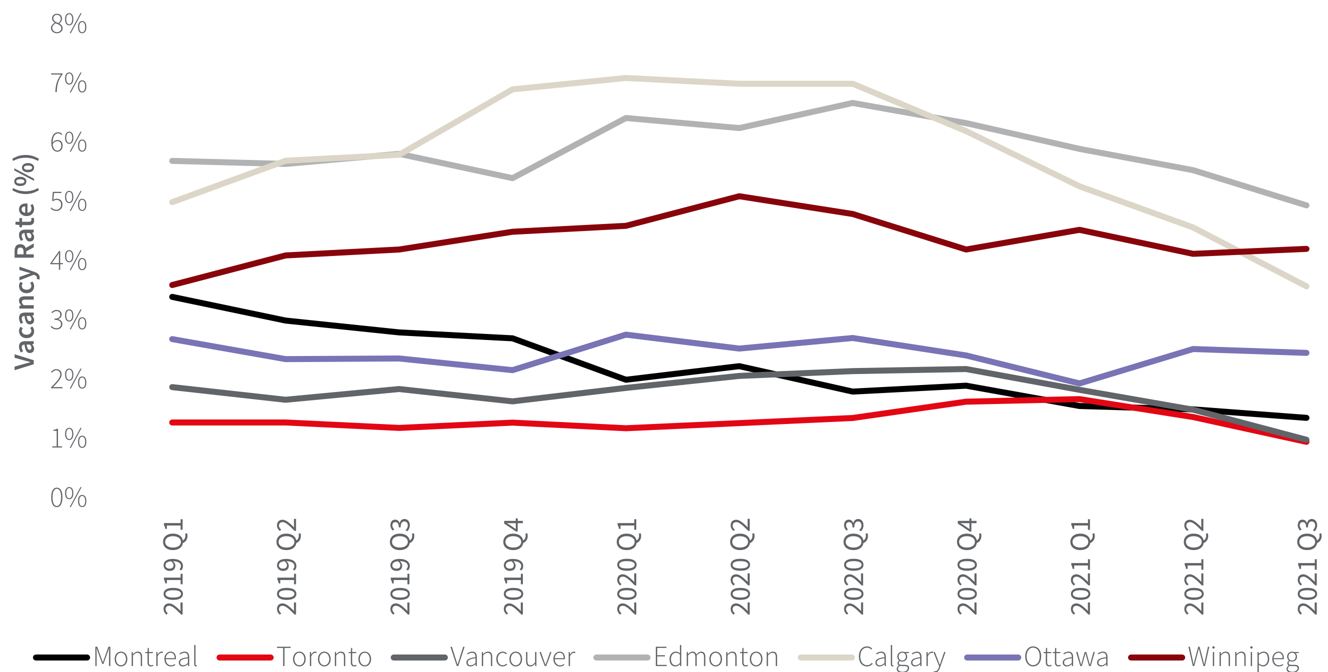
# Industrial Outlook

## Vacancy again hits a new historic low and new supply can’t keep up

The Canadian Industrial market continues to be red hot. Vacancy compressed another 40 basis points on the quarter and 90 basis points year to date to hit another historic low of only 1.8%. Toronto, Vancouver, and Montreal witnessed their already low vacancy rates decrease even further and remain the tightest markets in the country with vacancy ranging from 1.0% to 1.3%. Meanwhile the most dramatic change in market dynamics is in Alberta, particularly Calgary. In a single quarter Calgary’s vacancy dropped 100 basis points and 260 basis points since the beginning of the year. Extremely low vacancy and rapidly rising occupancy costs in Toronto and Vancouver have made user expansion very difficult in these markets. As such the Calgary market was one of the few major Canadian markets with significant available space which has been quickly taken up over the past 3 quarters.

**Canada’s 5 largest markets saw a notable decline in vacancy with Calgary experiencing the most dramatic decline**

**Historic vacancy by market Q1 2019 – Q3 2021 (%)**



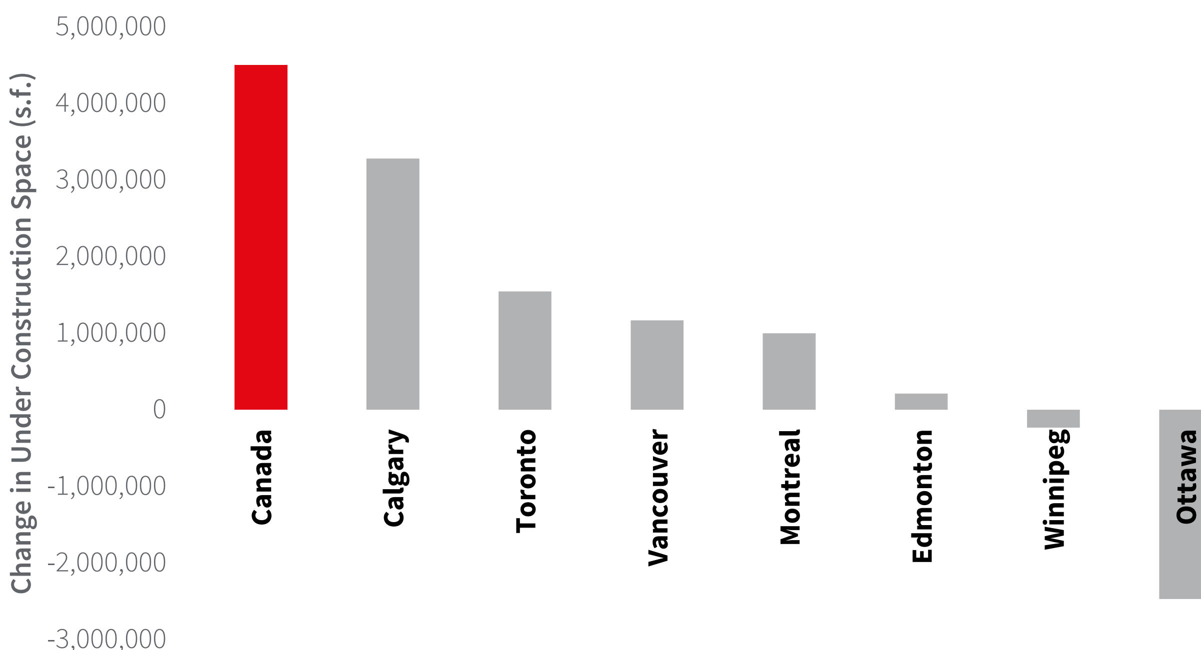

Source: JLL Research , CoStar

The past 3 quarters have also seen a strong increase in under construction space hitting 36.8 million s.f. this quarter amid historically tight market conditions. Calgary again saw the most notable increase with under construction space more than doubling since last quarter. This is largely due to two built to suit e-commerce facilities totaling 3.4 million s.f. Fringe markets just outside of major metropolitan areas are also seeing a major uptick in activity as users and developers search out extremely scarce industrial land. Hamilton and Durham Region, in Greater Toronto's West and East fringe, have experienced huge upticks in activity after years of being considered secondary markets for modern logistics facilities. Meanwhile, Ford's new 540,000 s.f. facility, which is expected to be complete in Q1 2023, is 30km east of Ottawa and well outside of any established industrial areas. Despite the increase in construction starts, new supply is unlikely to satisfy user demand. Prelease rates currently sit at 65.2% for current under construction product while very little product makes it to delivery without an end user. Furthermore, lead times for steel along with other key materials such as precast paneling and lighting is 12 months due to continued supply chain disruptions. This will delay many new construction starts through 2022 and may also lengthen the construction timeline for current projects as an unexpected delay in any one material could delay completion for the entire project.

Nationally, average net rental rates stand at $10.39, a 2.0% increase from last quarter and a 3.9% increase year over year. While the annual rate of increase is relatively modest, rate increases are accelerating in Canada's largest markets which is expected to push the annual rate of increase much higher in the coming quarters. Montreal is the standout market this quarter with rates rising 7.0% since just last quarter and 27.2% year over year. Meanwhile the rate of increase is accelerating in Vancouver and Toronto. The quarterly rate of increase hit 3.4% and 2.6% respectively. This is the highest quarterly rate of increase since early in 2020 for both markets as these markets navigate historically low vacancy. Looking into 2022, strong upward pressure on rates is expected to continue as vacancy is expected to remain at or near historic lows.

**Calgary led the way with new ground breakings while Ottawa saw construction space diminish due to a 2.7M s.f. completion**

**Quarter over quarter change in under construction space (s.f.)**




Source: JLL Research , CoStar, Altus Insite

# Retail Outlook

## Canada retail fundamentals strengthen entering the holiday season

The outlook for Canada retail this holiday season and in 2022 remains strong. Consumer confidence has recovered since reopening, retailers are optimistic about the future, and Canadian households built up unprecedented demand when physical stores were shut down. Canada retail sits in a favourable spot.

As retail sales increased by double digits from last year, overall spending should remain elevated. Canadians who have saved during the pandemic will gradually redirect a significant share of those savings to retail and food services in 2022.

A wide range of retailers have expanded, including the sectors most affected by the pandemic. Interest in the home, grocery, mass merchandise, fitness & wellness, QSR, and pet shop categories surged during the pandemic.

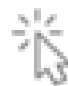
Additionally, retailers that invested in e-commerce have benefited from heightened online sales, backfilling strategic physical spaces left by those who downsized or went bankrupt.

Troubled by tightening health restrictions and recurring bans during the pandemic, the Canada retail leasing market should see continued improvement in activity.

With no significant volatility in sight, the overall leasing volume in 2022 should reach or exceed 2019 levels. Out of caution, retailers will continue to look at foot traffic and exterior entrances to lease spaces, with a greater emphasis outside CBDs because shoppers remain more local.

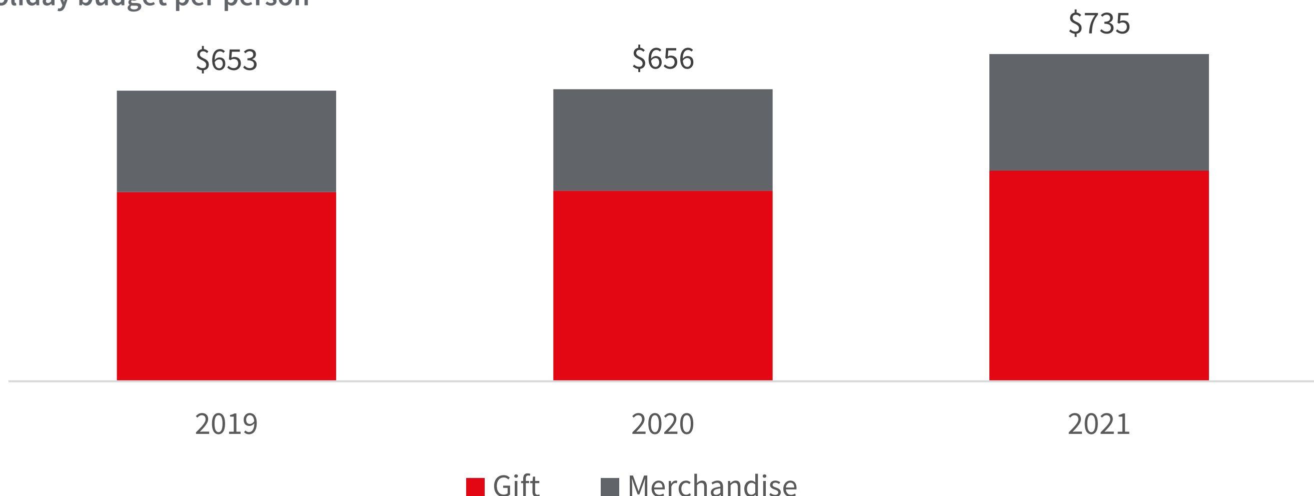
The trend to move in remains stronger than the trend to move out. After a peak in 2020, available space should continue to decrease now that developers have readjusted to lower demand and significantly reduced new supply.

Following a brief weakening, rents are likely to pick up again – all major markets now show positive annual growth. Rent-collection rates have converged to pre-pandemic norms, with more tenants shifting from a vulnerable to stable position.



Click to check
2021 Retail Holiday Survey

**Canadian shoppers plan to spend 12 percent more this holiday season**
**Holiday budget per person**




Source: JLL Research, Holiday Survey 2021

The ramp-up to the recovery of food services, specifically full-service restaurants, will be gradual. With patios closed during the winter, the number of diners will level off until it picks up again in the spring. By the summer of 2022, with less hesitancy from diners, foot traffic should increase again to be in line with or above pre-pandemic levels.

Nevertheless, the increase in demand for goods and services faces limitations. Retailers have difficulty staffing, and shopping centres hold weekly job fairs to recruit salespeople. One sector with particular challenges is food services, which lacks food-counter attendants and kitchen helpers. Food service job vacancy sits above 10 percent, while the average national rate has now risen to 4 percent.

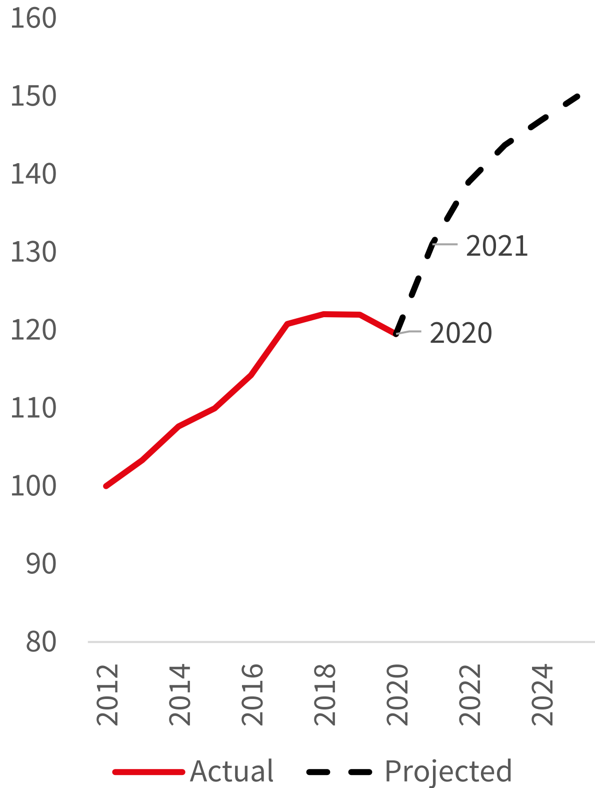
In addition, retailers are concerned that they won't be able to restock shelves during the holiday season. The price of shipping containers from South Asia to North America has quadrupled from last year. Also, shoppers prioritized the purchase of certain items, reconfiguring and slowing supply chains.

Despite foot traffic being far from ideal, retailers in downtown areas have reported improvement and many are encouraged by the gradual ramp-up. Office workers, responsible for most downtown traffic, continue to trickle back. Visits to workplaces stepped up another notch in late September. Early studies suggest that the adoption of hybrid work will directly reduce urban consumer spending by at least 5 to 10 percent.

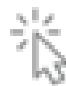
The trade areas of shopping centres will gradually re-expand as shoppers again venture further afield from their homes. Shopping centres will also extend their opening hours to pre-pandemic times. Shopper hesitancy will decline and shopping centres will receive more visitors from beyond their local neighbourhood. This will spur increased innovation and creativity as the buzz and excitement around malls returns.

**Canada retail sales should increase by 10 percent in 2021**

**Retail Sales, Volume Index (2012=100)**




Source: Statistics Canada, Oxford Economics

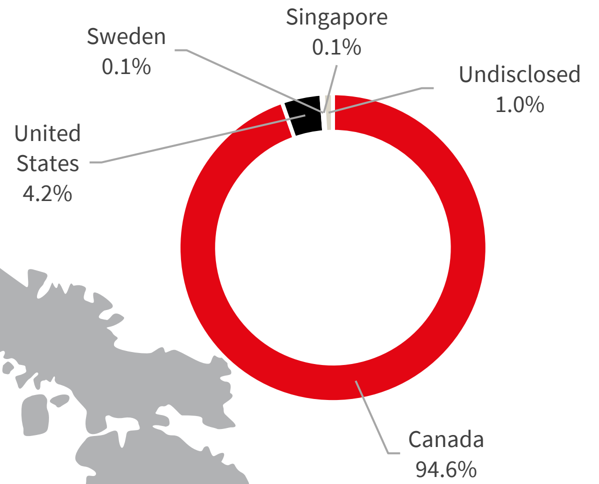


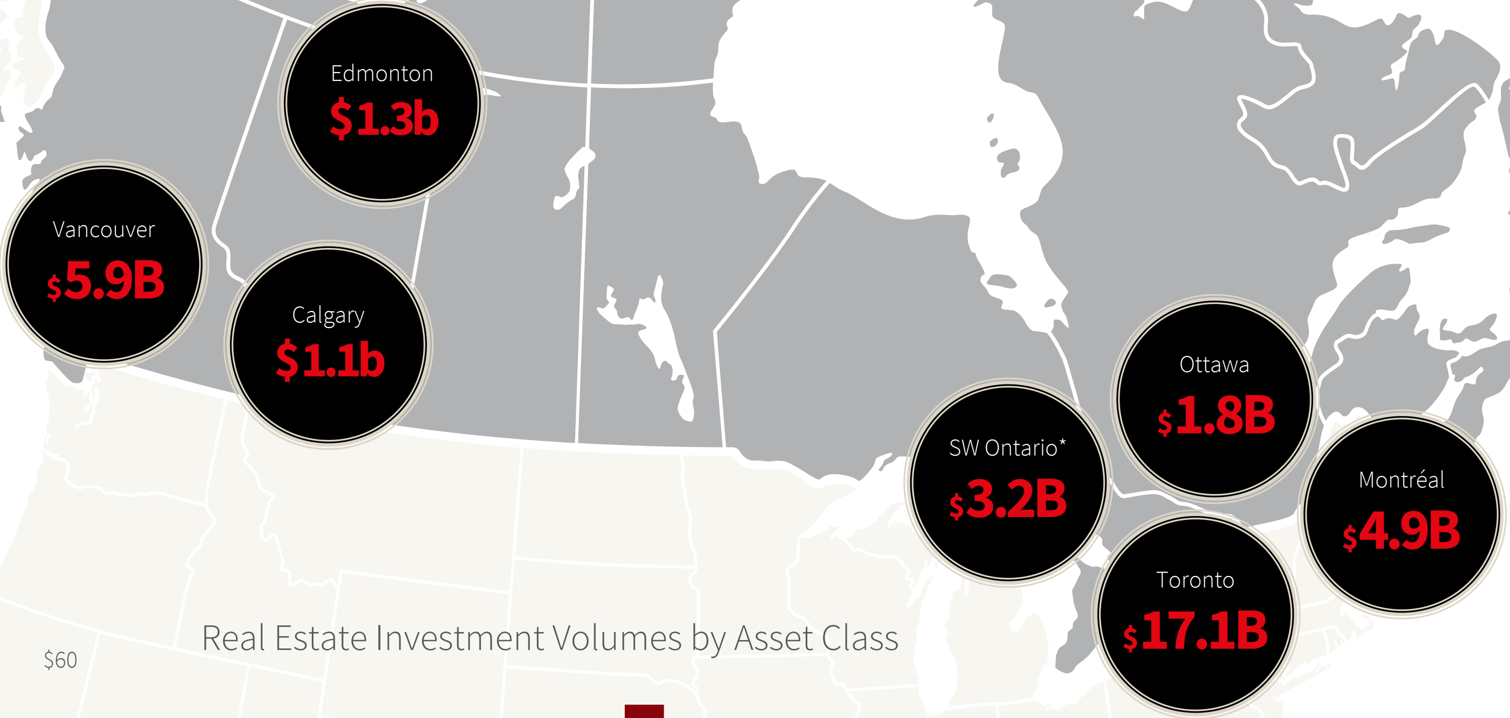
[Click to check Canada Retail Outlook Fall 2021]

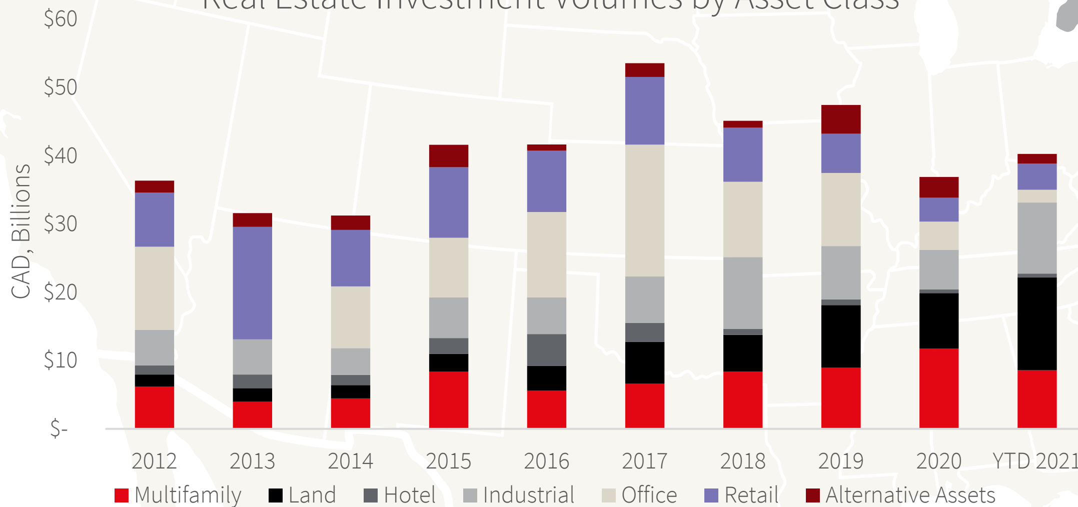
# Local Markets Key Statistics & Trends

## National investment volume, YTD 2021

# $40B



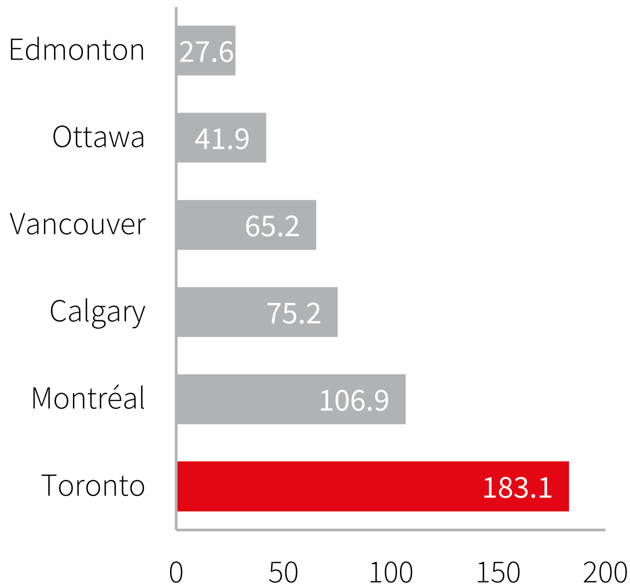




Source: RCA, RealNet , Gettel Network, Commercial Edge, CoStar, JLL Valuations Advisory.
All transactions > $5m, Direct and Entity Level | Excludes residential lots and residential occupier purchases | Market data as of latest available
*Southwest Ontario includes Hamilton, Kitchener, Waterloo, Cambridge, Guelph, Stratford, London, Woodstock, and Brantford

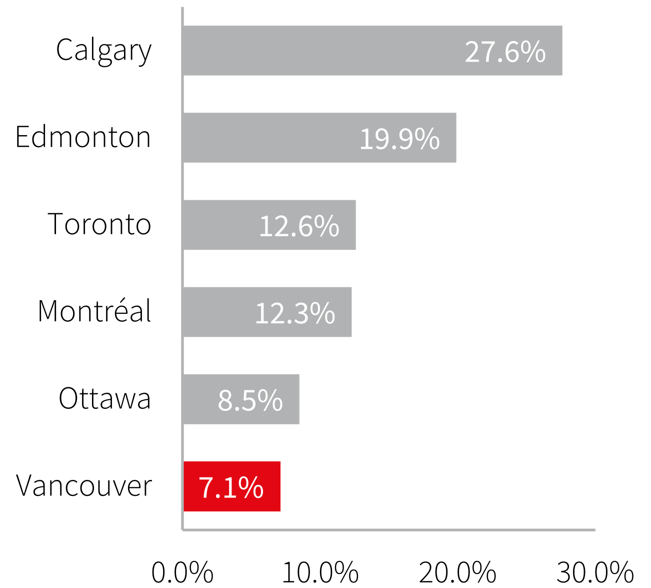
# Office Indicators

**Inventory**
Square feet (millions)



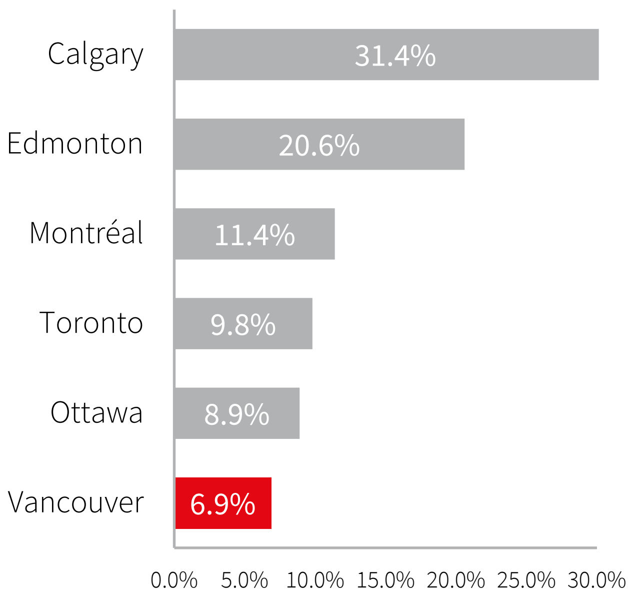

Source: JLL Research

**Total vacancy rates by market**
Vacancy rate (%)



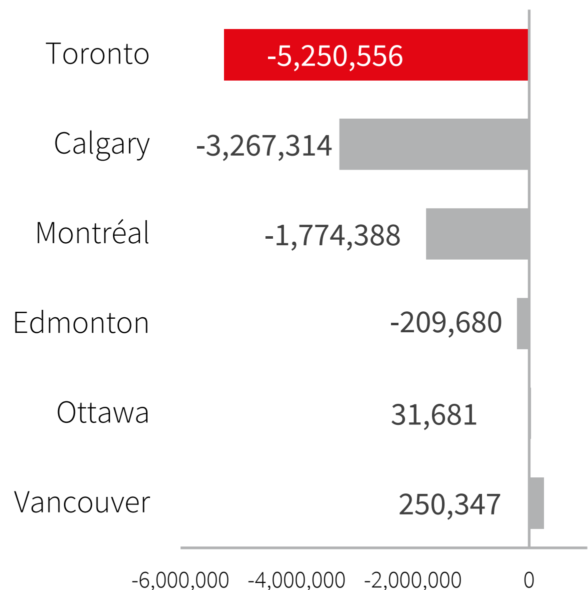

Source: JLL Research

**Total vacancy rates by market, CBD**
Vacancy rate (%)




Source: JLL Research

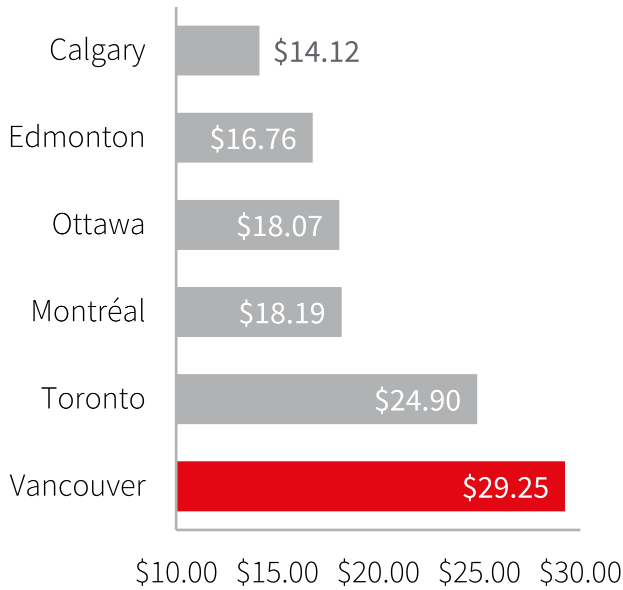
**YTD net absorption by market**
Square feet




Source: JLL Research

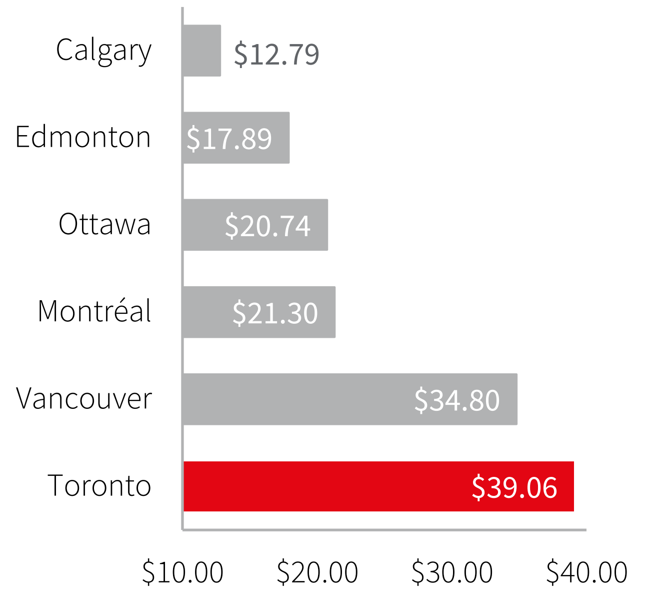
# Office Indicators

**Average net rent by market**
Dollar per square foot ($ p.s.f.)



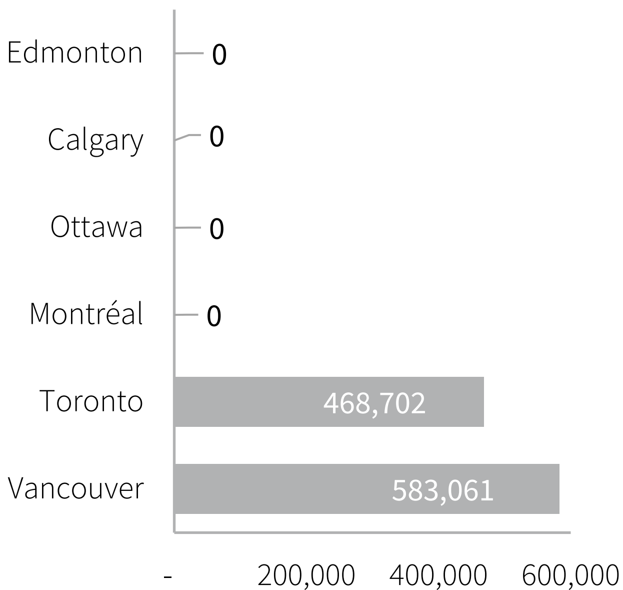

Source: JLL Research

**Average net rent by market, CBD**
Dollar per square foot ($ p.s.f.)



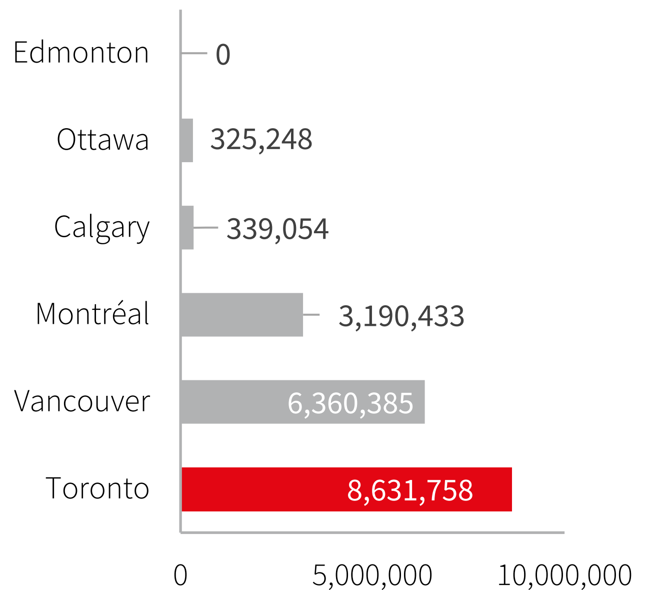

Source: JLL Research

**Quarterly completions by market**
Square feet




Source: JLL Research

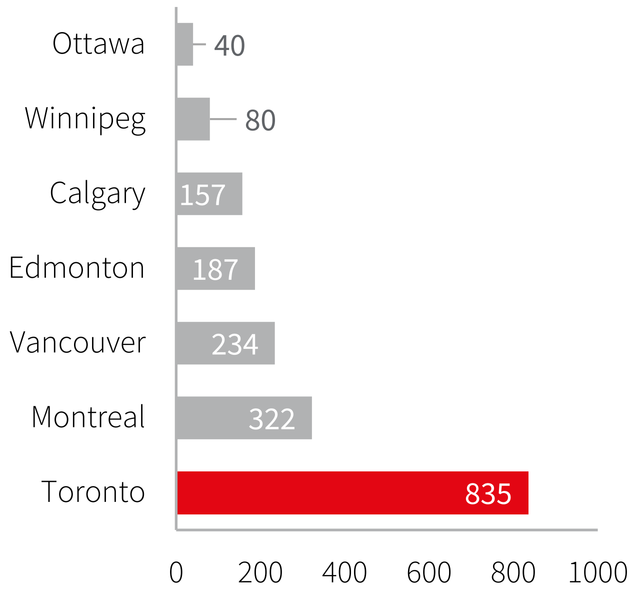
**Under construction by market**
Square feet




Source: JLL Research

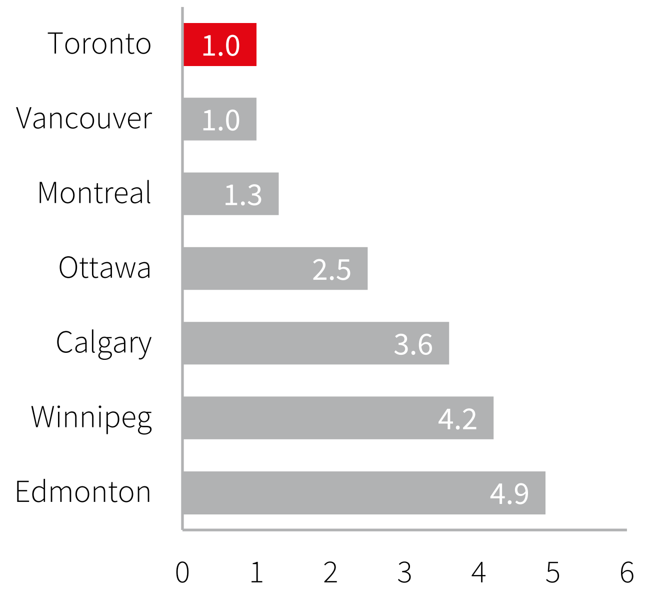
# Industrial Indicators

**Inventory**
Square feet (millions)



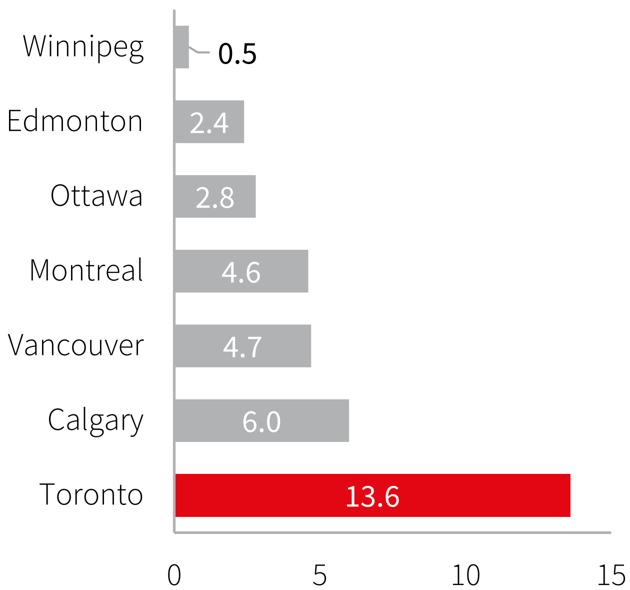

Source: JLL Research , CoStar, Altus Insite

**Total vacancy rates**
Vacancy Rate (%)



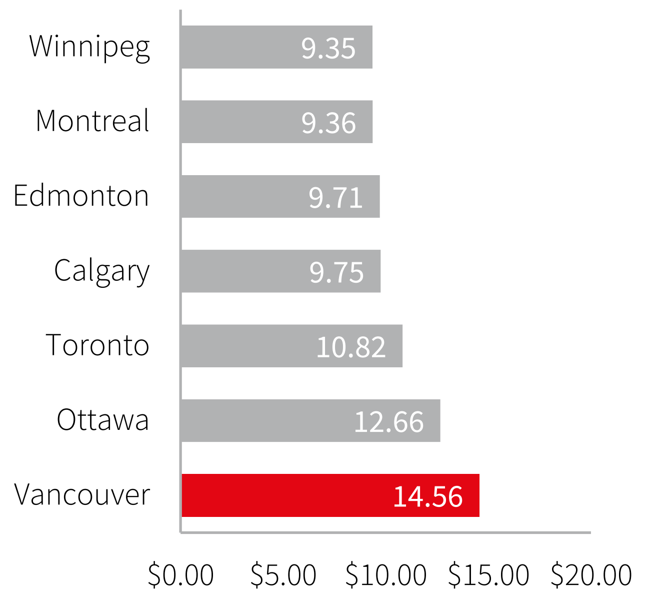

Source: JLL Research , CoStar, Altus Insite

**YTD total Net absorption**
Square feet (millions)




Source: JLL Research , CoStar, Altus Insite

**Average asking net rent**
Asking rent ($/s.f.)




Source: JLL Research , CoStar, Altus Insite

# Office Statistics

| | Inventory (s.f.) | Quarterly total net absorption (s.f.) | YTD total net absorption (s.f.) | YTD total net absorption (% of stock) | Total vacancy (%) | Direct Average asking net rent ($ p.s.f.) | Quarterly Completions (s.f.) | YTD Completions (s.f.) | Under construction (s.f.) |
|---|---|---|---|---|---|---|---|---|---|
| **Vancouver** | 65,229,890 | 364,672 | 250,347 | 0.4% | 7.1% | $29.25 | 583,061 | 786,679 | 6,360,385 |
| **Calgary** | 75,249,707 | -2,277,851 | -3,267,314 | -4.3% | 27.6% | $14.12 | 0 | 0 | 339,054 |
| **Edmonton** | 27,648,556 | -76,418 | -209,680 | -0.8% | 19.9% | $16.76 | 0 | 0 | 0 |
| **Toronto** | 183,067,963 | -1,334,192 | -5,250,556 | -2.9% | 12.6% | $24.90 | 468,702 | 2,192,834 | 8,631,758 |
| **Ottawa** | 41,895,410 | -5,517 | 31,681 | 0.2% | 8.5% | $18.07 | 0 | 134,425 | 325,248 |
| **Montreal** | 106,913,739 | -210,996 | -1,774,388 | -1.7% | 12.3% | $18.19 | 0 | 600,867 | 3,190,433 |
| **Canada Total** | **500,005,265** | **-3,540,302** | **-10,493,922** | **-2.1%** | **14.1%** | **$19.93** | **1,051,763** | **3,714,805** | **18,846,878** |

# Industrial Statistics

| | Inventory (s.f.) | Quarterly total net absorption (s.f.) | YTD total net absorption (s.f.) | YTD total net absorption (% of stock) | Total vacancy (%) | Total availability (%) | Direct Average asking net rent ($ p.s.f.) | Quarterly Completions (s.f.) | YTD Completions (s.f.) | Under construction (s.f.) |
|---|---|---|---|---|---|---|---|---|---|---|
| **Vancouver** | 234,276,877 | 1,661,653 | 4,684,989 | 2.0% | 1.0% | 1.7% | $14.56 | 526,578 | 2,105,584 | 6,572,704 |
| **Calgary** | 157,005,817 | 2,658,981 | 5,978,701 | 3.7% | 3.6% | 5.3% | $9.75 | 1,791,562 | 2,096,457 | 6,005,063 |
| **Edmonton** | 187,404,956 | 1,486,798 | 2,366,323 | 1.3% | 4.9% | 6.4% | $9.71 | 559,949 | 591,241 | 5,078,641 |
| **Winnipeg** | 79,569,547 | 258,459 | 505,717 | 0.6% | 4.2% | 4.2% | $9.35 | 290,190 | 532,190 | 217,150 |
| **Toronto** | 834,684,657 | 5,973,824 | 13,562,873 | 1.6% | 1.0% | 1.5% | $10.82 | 2,391,415 | 7,813,150 | 10,525,215 |
| **Ottawa** | 40,231,463 | 2,678,188 | 2,829,034 | 7.0% | 2.5% | 3.4% | $12.66 | 2,723,473 | 2,902,473 | 518,457 |
| **Montreal** | 321,718,548 | 1,505,236 | 4,573,405 | 1.4% | 1.3% | 2.3% | $9.36 | 960,000 | 2,890,091 | 7,870,375 |
| **Canada Total** | **1,854,891,865** | **16,223,139** | **34,501,042** | **1.9%** | **1.8%** | **2.6%** | **$10.39** | **9,243,167** | **18,931,186** | **36,787,605** |

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