Canada's Economic and Commercial Real Estate Predictions for 2024

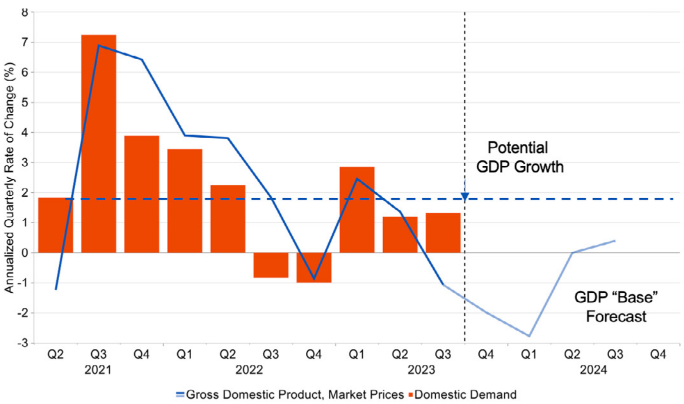
Carl Gomez, CoStar's Chief Economist and Head of Market Analytics

1 Canada's economy slips into recession.

Canada's economy has slowed down appreciably. In Q3 2023, growth fell by an annualized rate of 1%. With a slight upward revision to Q2 growth (which was initially estimated as a modest decline), the country narrowly avoided a technical recession. Facing materially higher borrowing costs, highly indebted consumers in Canada were barely able to contribute to domestic growth during Q3 while non-residential business spending contracted by nearly 10%. As a result, government spending was the only component keeping Canadian domestic demand afloat, even after accounting for the strongest population growth in recent Canadian history. All told, the likelihood that Canada is or will be entering into recession by 2024, is high. This is especially true given that per capita GDP growth in Canada has already contracted for five consecutive quarters – the weakest pace in the developed world.

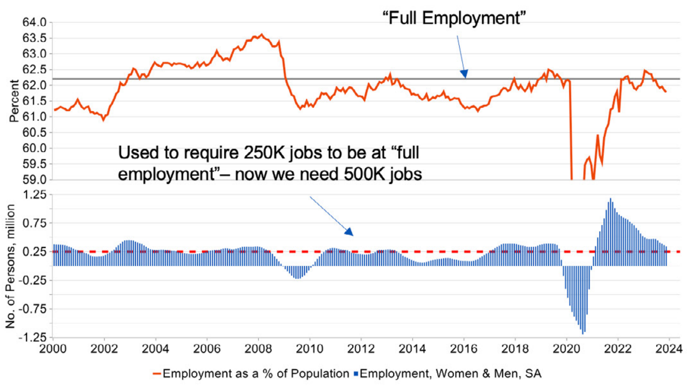
While policymakers such as the Bank of Canada continue to point to a historically low unemployment rate as a reflection of continued excessive demand and inflationary pressure in the Canadian economy, it is important to also note that the labour market may not be as tight as the unemployment rate implies. Although population growth is surging, the unemployment rate has been distorted by unusually low labour force participation rates. Meanwhile, the employment rate – or the percentage of the overall population with a job – has been steadily eroding and is now below what could be considered a "full employment" level. Given rapid population growth, Canada will need to produce even more jobs than it has in the past, just to prevent a further slackening of labour market conditions.

Real GDP & Domestic Demand Off the Boil



Source: CoStar, Macrobond; December 2023

Employement Rate & Job Growth



Source: CoStar, Macrobond; December 2023

2 The Bank of Canada will need to cut rates due to a policy mistake.

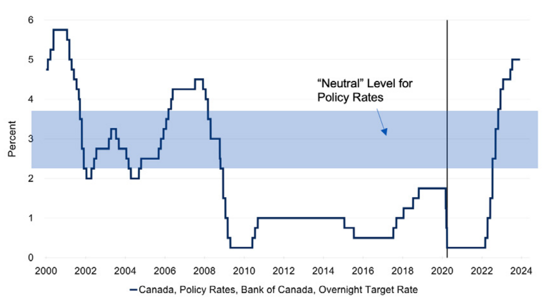
Like other central banks around the world, the Bank of Canada has forcefully lifted policy interest rates to combat a global surge in inflation. Although the Bank remains concerned about sticky domestic inflation given that its core measure remains above its 2% target, underlying inflationary pressures have largely receded in Canada. In fact, the only major components of inflation that have heated up over the past year are mortgage interest costs and residential rental prices. Ironically, the Bank of Canada's sharp interest rate increases have largely been responsible for the flare ups in both segments. If these two components were excluded from the Bank of Canada's core inflation estimate, inflation would actually be running slightly below the Bank of Canada's target rate of 2%, reflecting the underlying disinflationary pressures building up in Canada.

Given growing recession risks and receding non-policy induced inflation, the Bank of Canada may be forced to eventually cut its policy interest rate in 2024 to provide some accommodation. Indeed, at its current 5% level, policy rates are too restrictive for an economy that is now stumbling and developing slack across various sectors. To get back to a neutral level of interest rates, the Bank of Canada would ultimately need to cut its policy rate by a cumulative 200-250bps. Financial markets are already beginning to price in the first of these potential rate cuts in March 2024, well ahead of the US Fed.

Canadian Inflation Heat Map - Last 12 Months

Series	11/1/2022	12/1/2022	1/1/2023	2/1/2023	3/1/2023	4/1/2023	5/1/2023	6/1/2023	7/1/2023	8/1/2023	9/1/2023	10/1/2023
Mortgage Interest Cost	14.527	17.95	21.186	23.94	26.390	28.50	29.91	30.138	30.553	30.88	30.64	30.537
Alcoholic Beverages & Tobacco, Total	4.473	4.84	4.658	4.93	5.410	5.34	5.49	5.423	5.286	5.21	5.26	4.741
Clothing & Footwear, Total	0.413	1.83	0.428	1.92	2.434	2.52	0.72	0.313	0.954	1.69	1.04	-0.512
Food, Total	10.330	10.09	10.433	9.70	8.896	8.34	8.33	8.324	7.786	6.80	5.95	5.594
Health & Personal Care, Total	5.518	6.07	6.189	6.24	6.523	6.35	6.41	6.241	5.772	5.82	5.59	4.915
Household Operations, Furnishings & Equipment, Total	5.226	4.60	3.710	4.08	3.253	3.00	1.14	0.303	-0.076	0.00	-1.06	-1.204
Recreation, Education & Reading, Total	4.135	3.40	2.852	2.32	1.625	3.13	3.15	1.197	1.810	2.23	1.84	2.880
Rented Accommodation	5.923	5.90	5.784	5.35	5.318	6.06	5.65	5.716	5.380	6.35	7.08	8.082
Transport, Total	8.494	6.00	5.417	3.06	0.302	1.32	-2.38	-3.405	-0.976	2.30	3.24	-0.353
Consumer Price Index, Total	6.796	6.32	5.919	5.25	4.298	4.41	3.36	2.812	3.266	4.00	3.80	3.121

Canadian Interest Rates



Source: Bank of Canada, 12/4/2023

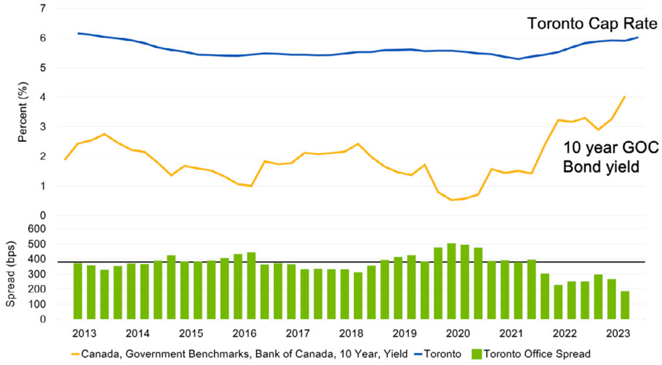
3 Canada's office valuations will see a correction.

The Canadian office market has been dealing with falling office utilization rates which are impacting underlying cash flows produced in the sector. Alongside these deteriorating fundamentals, a forceful increase in borrowing costs and tighter capital market conditions has resulted in a pullback in office trades. But due to very few comps, estimated market cap rates for office properties in Canada have remained relatively steady.

The stability of cap rate valuations in Canada's private office market appears to be at odds with both fundamentals and capital market conditions. For example, Toronto office properties were estimated to have a market cap rate of about 6% in Q3 2023, not far off from their recent lows of 5.5%. Since the risk-free interest rate proxied by the Government of Canada 10 year bond yield has moved up to around 4% in Q3, the implied "risk" spread fell to a near record low of around 200bps as of Q3, well below its historical average of 400bps. The compression of this spread, which investors often cite as the "risk premium" for real estate, implies that offices have become less risky. But this makes little sense given the deterioration in fundamentals and capital market conditions. Offices valuations should reflect a greater degree of risk such that the risk premium needs to now be higher than historical averages (ie., closer to 500 bps). This would imply that office cap rates in Toronto "should" now be closer to 8 or 9%.

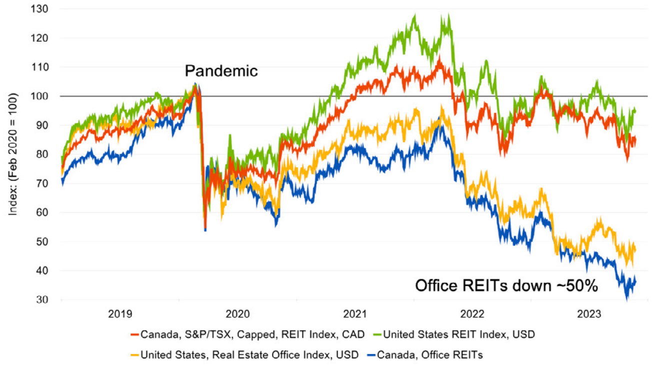
A major reason why office values have not yet adjusted in the private market is that many of the largest office properties in the country reside in the hands of well-capitalized investors such as pension funds and other institutions. However, the public REIT market has already sent implied office values down by as much as 50-60% since the pandemic due to changing market conditions. This implies that the public market believes underlying cap rate for office properties are now around 8–10%.

Office Market Cap Rate vs. 10 Yr Bond Yield



Source: CoStar, 2026 Q3

REIT Indices, Total Return



Source: CoStar, 11/23/2023

While the private market is resisting taking similar write downs due largely to a lack of comps (and in the case of well capitalized institutional owners, limited debt that needs to be marked to market) overall office property valuations cannot keep this disconnect up for much longer in Canada. As such, they are ripe for a correction such that implied market cap rates will need to rise in 2024 to reflect the reality of market conditions.

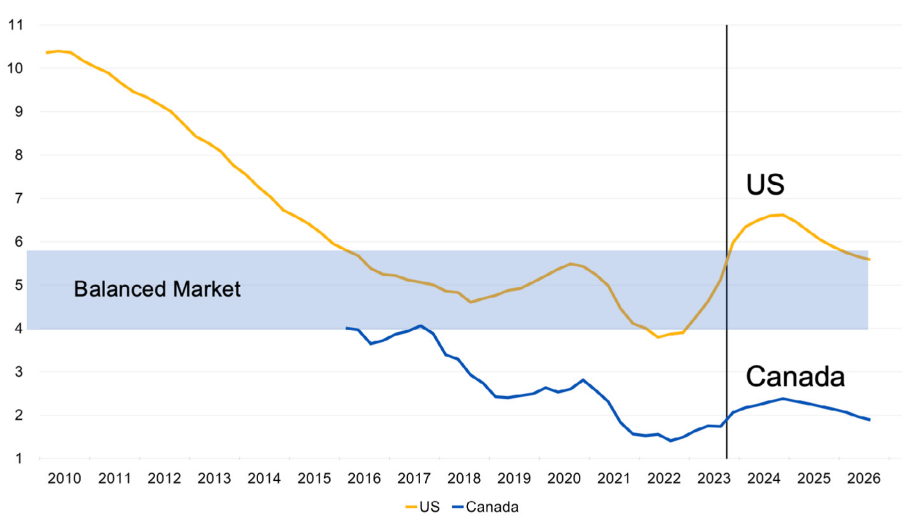
4 Canadian industrial rent growth continues to outpace the US.

Industrial rent growth in Canada and the US has increased at double digit rates. Although CoStar anticipates slower growth in industrial rents in 2024, industrial properties in Canada are expected to continue seeing stronger inflation adjusted growth than the US.

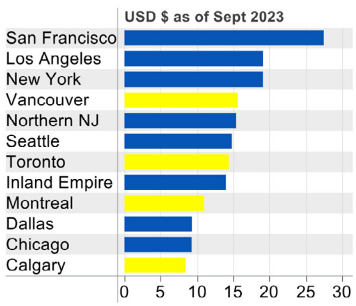
While both countries are enjoying relatively sturdy industrial demand tailwinds, Canada's outperformance is largely due to structurally constrained supply growth compared to the US. These supply constraints include the preponderance of land restrictions in various markets across Canada as well as comparatively slower entitling processes compared to many US markets. As such, industrial markets in Canada are expected to remain in the favour of landlords over the next few years with landlords on this side of the boarder continuing to have greater scope for higher rents compared to the US.

There is also plenty of runway to do that in Canada. For example, when industrial rents in Canada are expressed in US dollars, they remain far below that of their US counterparts.

Industrial Vacancy Rates **Source:** CoStar, 2026 Q3



Industrial Rent PSF



Source: Macrobond, CoStar

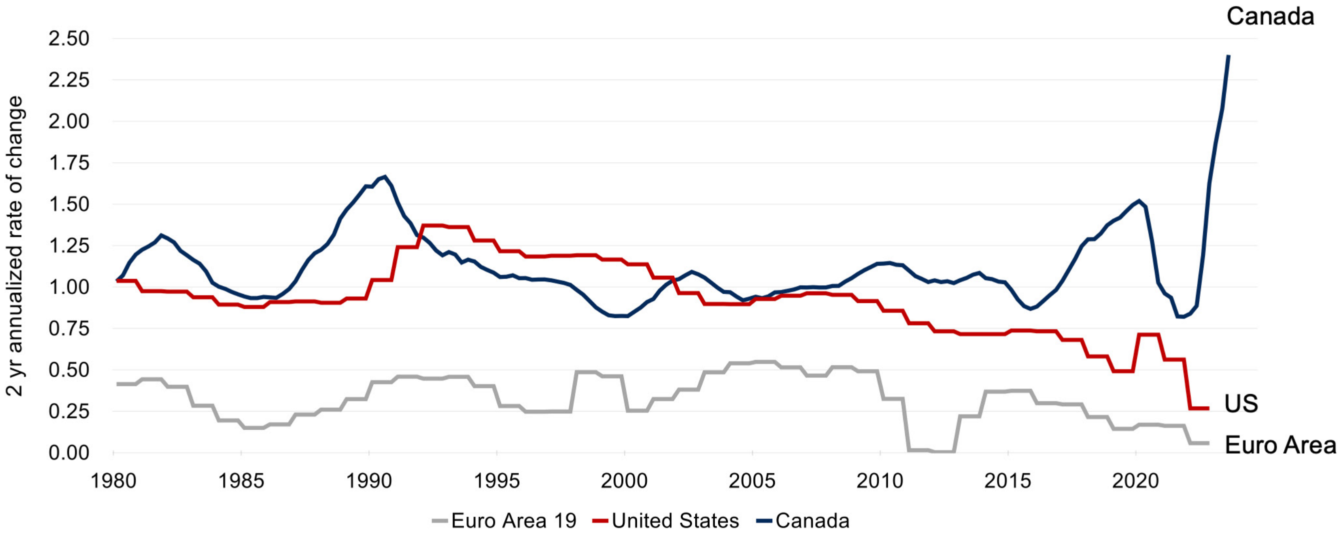
5 Surging population growth will propel residential and retail real estate even further.

Although Canada's economy is slowing abruptly while slack is developing in various sectors, the multifamily rental apartment and retail property markets will counter this trend. The main reason is due to surging population growth and persist supply constraints.

For the multifamily market, surging population growth, primarily through immigration, continues to sharply drive housing demand. This is especially the case in the rental market where nearly three decades of under-investment has resulted in persistently low apartment vacancy rates across almost every major market in the country. The net result has and will continue to be strong rent growth when landlord's have the (limited) opportunity to raise rates upon turnover of units.

While strong population growth implies strong demand for housing, it also drives solid demand for other goods and services including groceries. "Essential" retail properties such as neighbourhood centres servicing those regions where populations are growing swiftly will continue to benefit from this underlying demographic demand even as consumers pullback on more discretionary goods.

Population Growth



Source: Statistics Canada, U.S. Census Bureau, Eurostat, 2023 Q3

About the Author

Carl Gomez, CoStar's Chief Economist and Head of Market Analytics, has shared his predictions for the Canadian Economic and Commercial Real Estate market, for 2024. Carl oversees the market analytics team across Canada, that continually updates CoStar's reports with insights and clear, concise narratives on key supply and demand trends, rental rates, construction activity and economic factors that will impact the performance of your assets, or that can help you make the right business decisions.

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