Capital Debt Markets Update

Summer 2022

Quick Stats

GOC 5-Year Bond

3.161

▲ 1.552

03/01/2022 - 07/14/2022

GOC 10-Year Bond

3.165

▲ 1.346

03/01/2022 - 07/14/2022

S&P/TSX Composite Index

18,359

▼ 2,645

03/01/2022 - 07/14/2022

Prime Rate

4.70%

+2.00% as of 07/14/2022

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From Pandemic to Interest Rate Panic

Over two years ago, an unprecedented COVID-19 pandemic had significantly impacted the global economy, with mandatory lockdown and work-from home arrangements sending the Bank of Canada overnight rate plummeting from 1.75% on March 1st, 2020, to 0.25% by March 29th. Today, with the economy rebounding, a war ongoing in Ukraine, lockdowns continuing in China and ever-rising prices in food and energy due to rising labor costs and supply chain issues, the world could not look more different than in 2020, causing major inflation issues in an economy rebounding from the pandemic.

On June 1st, 2022, the Bank of Canada hiked its overnight rate by 50 basis points. They are taking an aggressive approach to curbing soaring inflation, which hit 6.8% in April 2022 - the highest since January of 1991. In addition, the United States Federal Reserve announced a rate hike of their own, raising by 75 basis points to a benchmark funds range of 1.5-1.75%. After the previous American Federal funds rate increase on March 16, we saw a 60bps increase after three weeks for the 5-year Canada bond yield and a 35bps increase for 10-year bonds. It is likely the Government of Canada will hike the overnight rate on both July 13th and in September to further combat rampant inflation.

Since January 2021, the 5-Year Government of Canada Bond Yield has been steadily increasing, where on June 8, 2022, the yield surged past 3% and hit the 3.60% threshold on June 13, a level that had not been seen since 2008. The rise is over 100 basis points in less than two weeks, a stark contrast to the 0.3% yield we saw back in mid-2020. Back in January, the 5-year GOC was trading at approximately 125bps and the 10-year was trading at approximately 145bps. Since the high point on June 13, the bond yields for both 5 and 10-year have been stabilizing, being at 3.106 for 5-year bonds and 3.211 for 10-year bonds as of June 29. Spreads have remained tight, being between 10 bps.

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Pre-COVID 5-year mortgages could be obtained within the 3's and spreads were not that different compared to today. Presently, pricing remains in the high 4's to low 5's for all but AAA-grade properties. The result is that based on required Debt Coverage Ratios, less debt capital is available, or acquisition prices may have to be renegotiated to allow purchasers to meet their investment criteria. This has yet to be firmly recognized by the transactions that are closing. To mitigate the impact of inflationary pressures on interest rates, we have been working with lenders to fix favorable rates for our clients to ensure they are not overly impacted by the recent federal rate increases. With the costs of lending becoming increasingly more expensive, we can see a negative impact on the value of real estate in the future due to buyers holding off from completing transactions until interest rates stabilize, adjusting a real estate market rebounding from a long pandemic. Thus, many are rushing to complete deals now while locking in rates to mitigate any impacts.

The debt renewal market will represent the largest risk to borrowers over the next year. Anticipating an uncertain market well ahead of time by engaging a debt professional to analyze the asset and prepare a submission can result in executing a debt opportunity at the low point in the trend.

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Bond Rate Review

Back in 2019, both 5- and 10-year bond values had been steadily decreasing, with the 5-year trading at 178bps and 10-year at 188bps at the start of the new year for a tight spread of 9bps. Spreads became increasingly volatile as the year progressed, with inverted bond yields being commonplace throughout the third and fourth quarters of 2019 and into the new year, however both traded around the 150bps mark for much of the year.

As 2020 progressed and the global pandemic made major impacts in terms of borrowing, the Canadian Government lowered its overnight rate target by 50bps to 0.75% to stimulate a COVID stricken economy. At the time, GOC bond yields were in freefall – with the 10-year nearly dropping over 50 bps in five days (between March 3 and 8) as borrowers held back from acquiring additional debt and mortgage holders suspending debt service until assets were stabilized. The GOC 5- and 10-year bonds stayed below 2.00, with widened spreads often in the range of 25-40 bps until March 2022, when we saw great increases in both yields as spending generally increased post-pandemic, creating inflation and resulting interest rate hikes. Despite the inflation and interest rate concerns, we do not expect high inflation and interest rates to last long-term as the economy is already starting to slow prior to the anticipated July 13th announcement, and likely will continue to slow upon further overnight rate increases.

In addition, our team has compared bond rates in the weeks prior and following notable federal rate increases and decreases. From our analysis, while Canadian bond rates are heavily affected by changes in overnight rates, they have not significantly changed thus far in response to the recent American federal rate increase. However, after the next Bank of Canada meeting, we likely will see another rate increase to match the American federal funds rate increase, so there is a possibility that the Canadian bond rate will be affected by this change instead.

Charts and Information courtesy of Investing.com

Red/green line represents 5-Year Bond Yields, while purple line represents 10-Year Bond Yields. A 2.00 baseline is shown to show the difference between pricing pre-and-post pandemic.

The series of "black swan" events that have occurred from early 2020 to the present date bears consideration. The latter part of 2018 was a period where the 5-year bond was trading close to 200+ bps which provide the opportunity to secure corresponding mortgage rates in the low 4% range. The anomaly of 2020 through to early 2022 is shown by using the baseline of 2% and reflecting the occurrence of volatility and direction resulting from the BoC approach of "quantitative easing" and "quantitative tightening".

The red/green line represents 5-Year Bond Yields, while the purple line represents 10-Year Bond Yields through that period demonstrating the variance in pricing for both. One would hope that the actions of the BoC will allow for the interest rate environment to adjust to more normal levels.

As we continue to monitor the impact that pending announcements have on movement of interest rates both before and after, being prepared to set a mortgage rate can yield positive results.

TIMEFRAME	EVENT	GOC 5-YEAR BOND YIELD	GOC 10-YEAR BOND YIELD	SPREAD (+/-)
AUG 20, 2019	INVERSION	1.303	1.225	-0.078
MAR 2, 2020	Two Weeks Prior	0.895	0.965	0.070
MAR 9, 2020	One Week Prior	0.633	0.663	0.030
MAR 16, 2020	Federal Fund Rate Drop Announcement	0.809	0.961	0.152
MAR 23, 2020	Following Week	0.752	0.871	0.119
MAR 30, 2020	Two Weeks Later	0.586	0.690	0.104
JAN 1, 2021		0.387	0.673	0.286
MAY 18, 2022	Two Weeks Prior	2.767	2.877	0.110
MAY 25, 2022	One Week Prior	2.640	2.790	0.150
JUNE 1, 2022	Overnight Rate Increase Announced	2.873	3.008	0.135
JUNE 8, 2022	Following Week (Week Prior to US Hike)	3.161	3.239	0.078
JUNE 15, 2022	US Federal Rate Hike (Two Weeks after Canadian Hike)	3.305	3.382	0.077
JUNE 22, 2022	Following Week (US)	3.214	3.330	0.116

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Lender Update

As we enter another month of post COVID-19 market rebounding alongside rising inflation and interest rates, the underwriting process is being done with higher interest rates than previously - with lenders being more cautious in terms of debt given the uncertainty of the Canadian real estate market and the Canadian and Global financial sectors. This is causing the amount of debt being available for lending to decrease. COVID-19 also continues to be a lingering concern - especially if another lockdown may occur at some point, further complicating matters.

CMHC financing remains strong during 2022, with MLI Select proving to be a positive alternative for affordable multi-family refinancing during this time and bridge lending also being an attractive option for investors. Released in March, the program offers up to 95% LTV and up to 50-year amortization for both new construction and existing product depending on how well your property fits CMHC affordability and sustainability parameters, all with just a 1.1 minimum DCR. As expected, the program is proving popular with borrowers committed to providing affordable, accessible and sustainable housing.

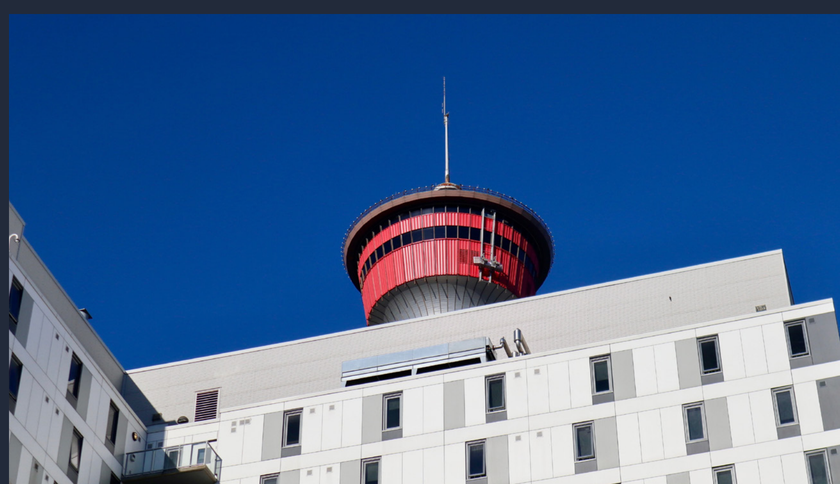
As of June 10, 2022, we are seeing 5-5.50% fixed interest rates for conventional commercial mortgages with a 75% LTV. For high-leverage mortgages, we are seeing interest rates of 6-6.75% with LTVs in the 85-95% range. Unfortunately, due to the trend of rising interest rates, these estimations are expected to increase further in the coming weeks. However, our team has been working to fix interest rates for our clients to ensure we can lock in favorable mortgage terms.

In the first quarter of 2022, there have been some notable trades of both owner-user and investment properties:

Case Study

Case Study 1

The Avison Young team arranged first mortgage financing to facilitate the refinance of a fully leased industrial property located in Calgary, Alberta. The property is a single tenant 41,000 square foot heavy-duty truck maintenance facility with a strong borrower and we were able to negotiate fixing the interest rate over 2 months in advance. Without the work of the AY team to fix the rate, the client would have paid a rate approximately 100bps higher than expected, thereby saving substantial costs over the mortgage term.



Case Study 2

In Q1 2022, The AY team funded a 61% land loan to facilitate the acquisition of MLI Select-funded development of a 41-unit rental apartment building located in Calgary, Alberta, in which the borrowers of this loan were experienced developers with strong net worths. The $13.3MM MLI Select construction loan will be funded in July, and equates to 94% loan to cost at an interest rate below Prime. Within just a 3.5-week time frame, the AY team was able to secure funding for the project.

Postscript

Though we have not updated the data quoted in the preceding commentary, the pending announcement by the Bank of Canada on July 13th was an occurrence that would provide some context in viewing future risks and benefits. A full point increase in the overnight rate has filtered into the cost of Bank Prime.

On July 14th there have been what would be considered modest increases in the 5- and 10-year bond rates which are trading close to par. On the other hand, the 2-year bond rate is trading close to 15bps higher than the 10, though many economists use the 2-month (trading at 2.49bps) bond as a reference point in making decisions on the health of the economy. The high-water mark for the 5-year bond was in June of this year, in the 3.50bps to 3.60bps, with today's 5- and 10-year bond being around 3.18.

Rather than wait for the next quarter to provide information on trends and possible strategies, we will look to sending out comments as key changes occur.

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