



SPRING 2023

# DEBT MARKET OUTLOOK



# Our Commitment to Keeping You Informed.

Here's to growth and new beginnings! To kick off 2023, albeit a couple months late, we've been working hard on some major changes at Impact Commercial, starting off with our branding and communications. You may have noticed Impact has been a little noisier on social media, with more frequent communication on weekly CRE tips and guidance, recent creative fundings, and team building activities, which embodies our biggest priority: **Adding Value for Our Clients**. We take our responsibility to educate our clients and industry partners very seriously and this initiative is simply an extension of our ongoing commitment.

In the spirit of this commitment, we are also excited to be circulating this first of a much more comprehensive Debt Market Outlook that we'll be releasing each Spring and Fall. This will not replace our monthly Interest Rate Commentary, so you can still expect a brief market snapshot in your inbox each month keeping you right up to speed on interest rates, inflation, and other trends we are continuously on top of. In our 100+ years of combined experience, we hope we've picked up some useful insights and can't wait to continue to share them with you!

Despite most economist forecasts last year airing heavily on the conservative side, Canada's Overnight Rate has climbed steadily to 4.50%; a level not seen since November 2007. With short-term rates having been rapidly and artificially propped up, Canada's yield curve has become inverted over the past several quarters, indicating a very likely upcoming policy-induced recession.

Even so, the goal of this Market Outlook is not to worry you about the past, but to excite you about the future. We project that the light at the end of the tunnel is closer than you think, with Bank of Canada rates expected to drop as early as Q1 2024, and fixed mortgage rates already on their way lower.

We hope you enjoy this new content and please never hold back from giving us your two cents!



**01**

REFOCUS ON THE  
LONG-TERM





**02**

WHAT'S NEXT?

# Look to the Past for **Guidance**

Our understanding of what's next relies on two items which always seem to repeat throughout history: **Human Behavior**, and **Economic Growth**.

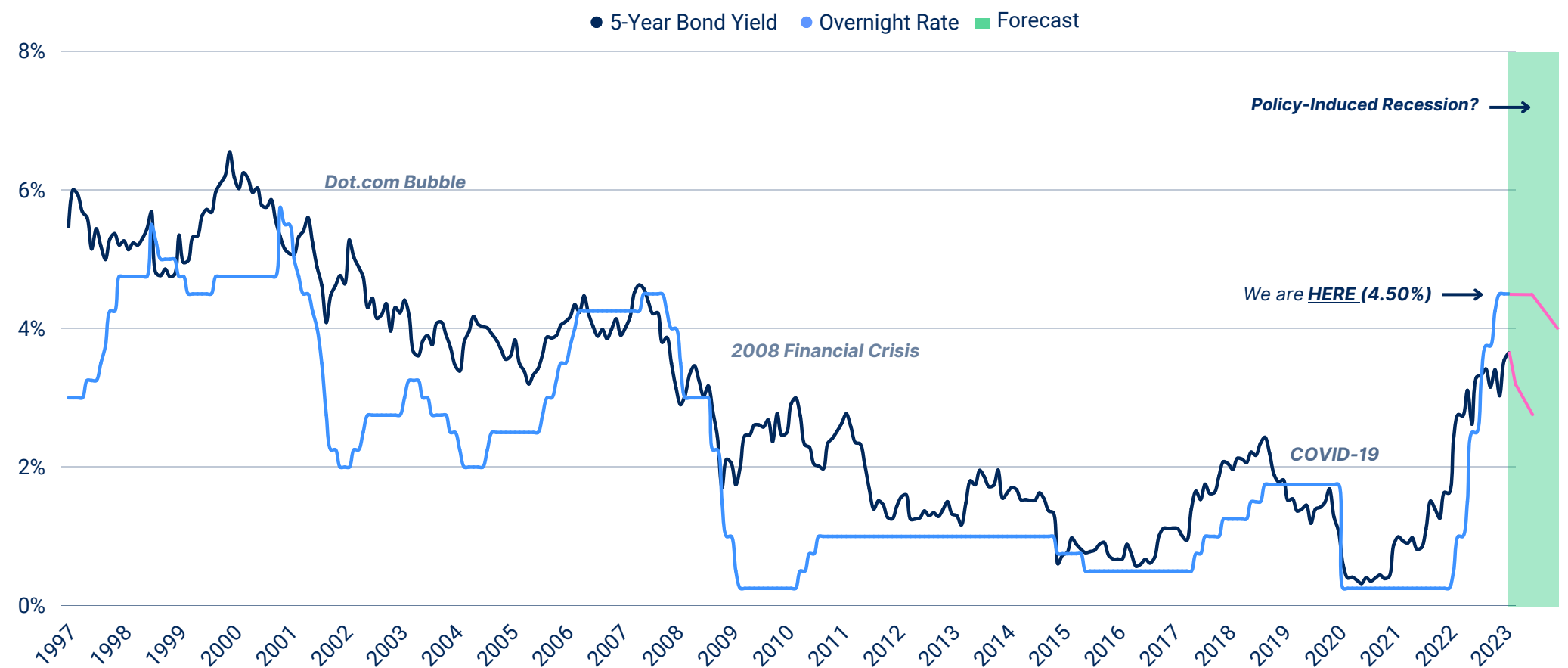
**Human Behavior** is largely emotional and follows elongated cycles of risk-on/risk-off, boom/bust, and fear/euphoria based decision making. Only the most experienced and capable of firms/individuals understand that things are never as good or as bad as they seem.

**Economic Growth.** Policy makers have a really hard time balancing inflation and interest rates. It's easy for us to criticize their decisions (and yes, we believe Central Banks have gone too far), but we're optimistic now that BoC Governor Macklem has indicated a pause on further rate increases.

Our belief on what's next is that we're in a "mushy middle" transitional period for the next six to nine months. Once this period ends, a return to a bull market will occur. Personal income, employment, and immigration largely remain strong, but the huge cost of borrowing is only just starting to bite into the economy.

At Impact, we don't see a situation where economic growth beyond a stagnant rate of 0% to 1.0% can be sustained in the face of these interest rate levels. If this holds true (as you can see above, the bond market is already pricing this in), the next key event will be when the Bank of Canada begins cutting the Overnight Rate. As soon as this happens, the risk-on/off switch will be flipped and a new wave of capital deployment will begin.

<b>GoC 5-Year Bond</b>	3.02%	<b>5-Year CMB</b>	3.33%	<b>Bank Prime Rate</b>	6.70%	<b>CA Inflation YoY Feb</b>	5.20%
<b>GoC 10-Year Bond</b>	2.87%	<b>10-Year CMB</b>	3.38%	<b>BoC Overnight Rate</b>	4.50%	<b>US Inflation YoY Mar</b>	5.00%



Source: Impact Commercial, Trading Economics

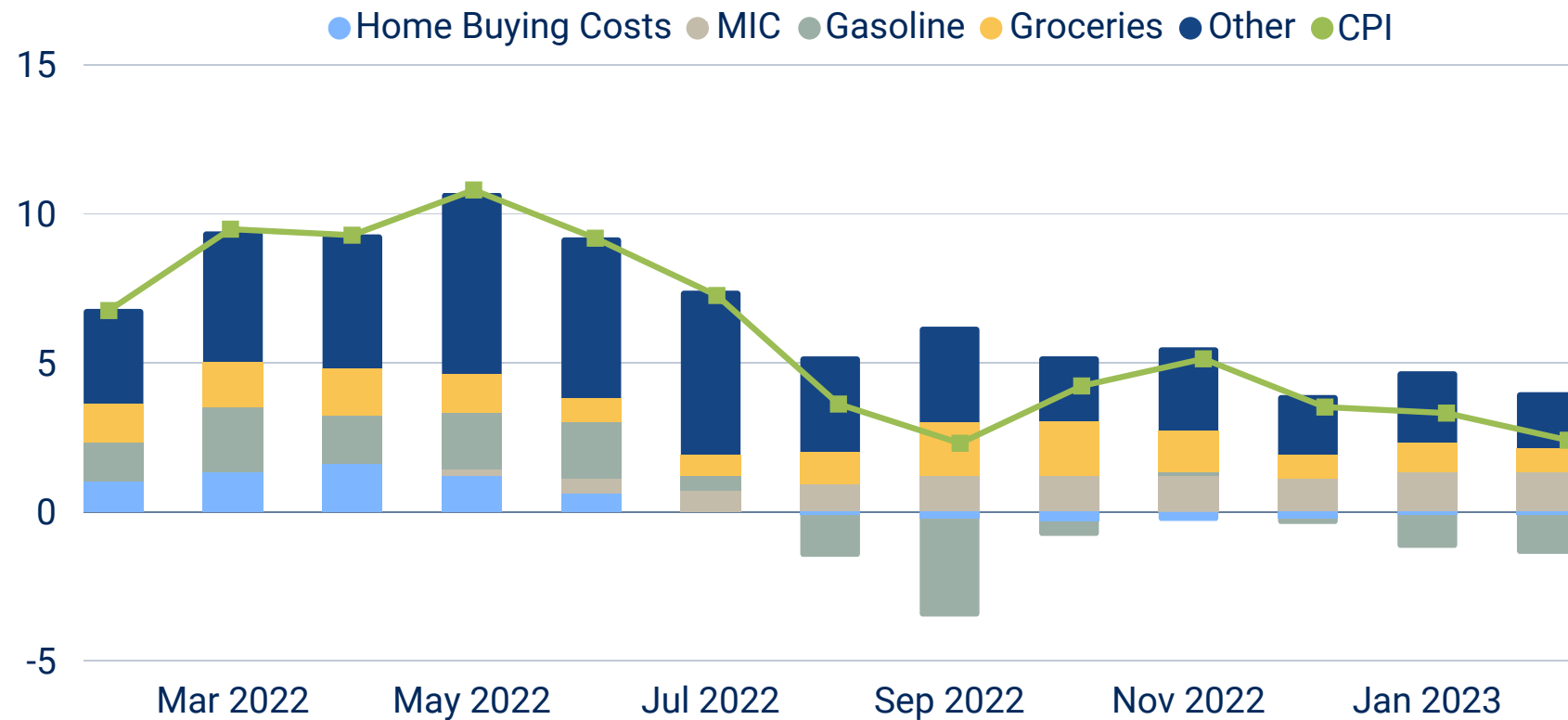
# Inflation is Yesterday's News

To a great extent, the impact of inflation has already been factored into the market. The Bank of Canada has increased its policy rate from 0.25% to 4.50% in less than a year, culminating in an Overnight Rate **17 times higher** than the start of 2022. This cannot be sustained in the long-run.

Playing out now is the fine-tuning of much smaller inflation numbers (0.1% from Feb to Mar, compared to 0.4% from Jan to Feb) and it's expected that year-over-year inflation rates will start to experience more meaningful declines. Inflation really is yesterday's news - both literally and figuratively, as yesterday morning U.S. inflation data came in at 5% YoY for March, compared to 6% YoY for February!

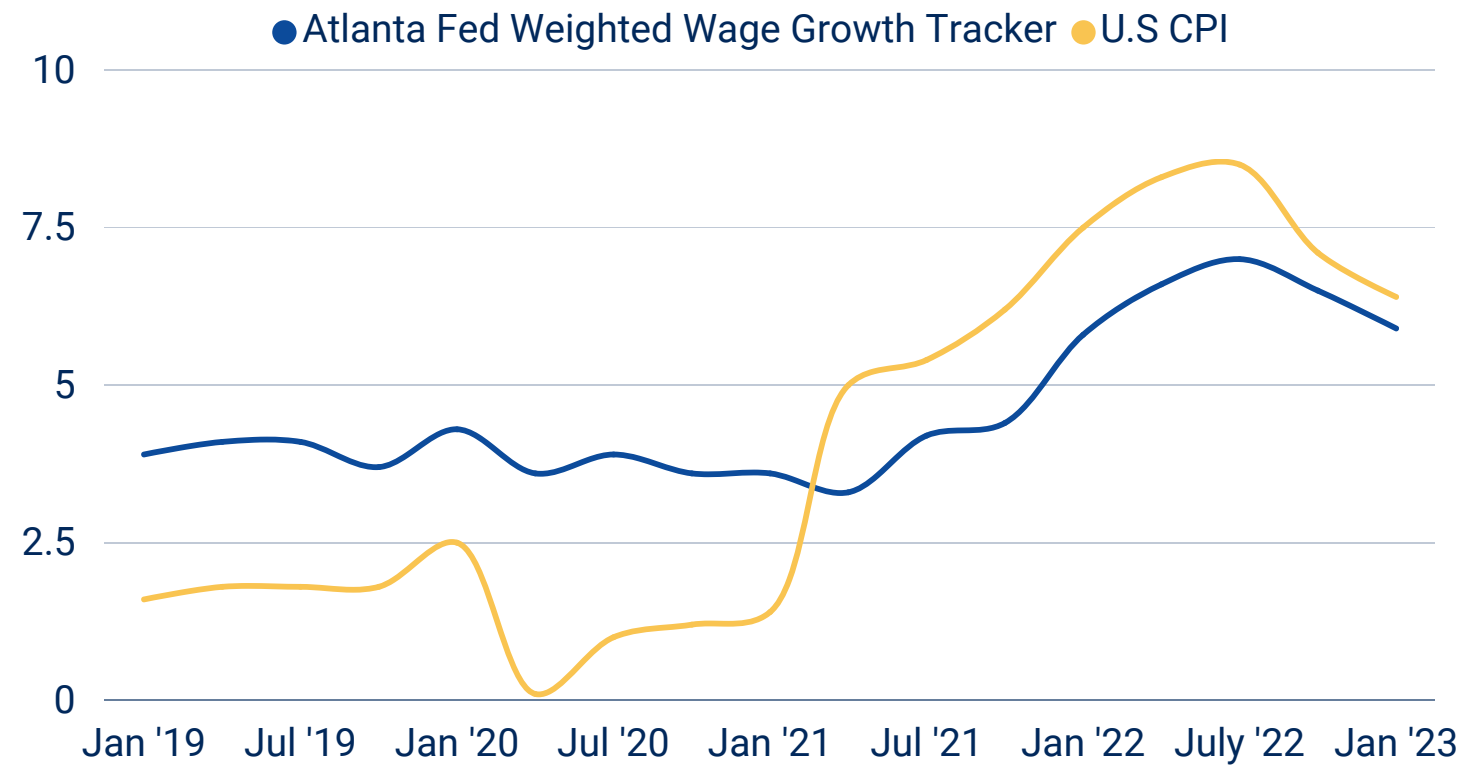
Until we see the forecasted declining economic/employment data to start being published, we'll remain in the "mushy middle" where long-term planning is most challenged.

Canadian inflation pressures continued to ease in February



\*Source: Impact Commercial, RBC Economics, Statistics Canada.

U.S. wage growth is playing catch up with inflation



\*Source: Impact Commercial, RBC Economics, Atlanta Federal Reserve, Bureau of Labour Statistics.

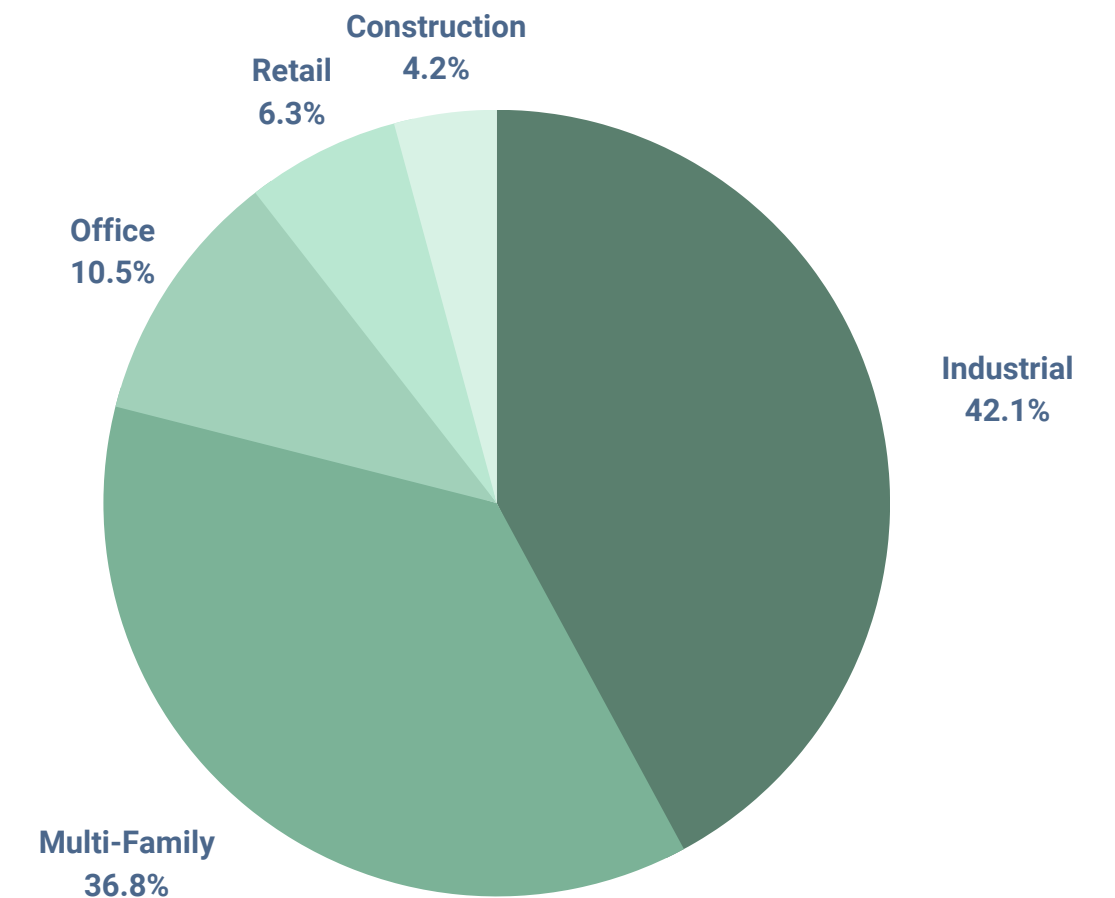
# Lenders' Appetite

One area Canada is truly a "World Champion" at is our banking system. While we at Impact specialize in commercial and construction mortgages (we're not economists or regulators), we have an in-depth understanding of how secure, strong, reputable and liquid Canada's lending community is.

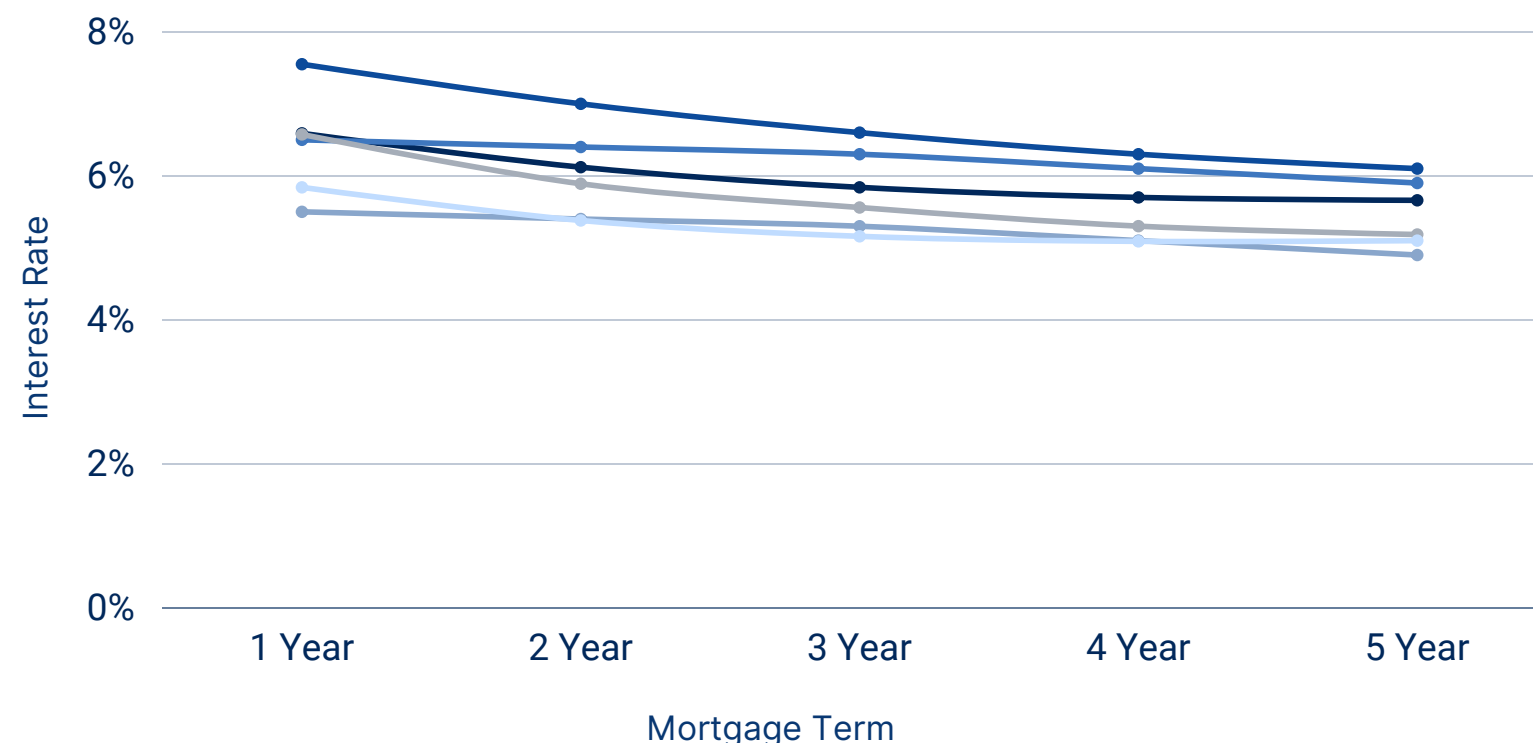
Yes, many can be frustrating to deal with due to their perceived lack of flexibility, timeliness, and constant desire for maximum security, but we rarely worry about their survival. They're incredibly well-managed and diversified, so we can all put aside fears of contagion from the recent collapses of Silicon Valley Bank, Signature Bank and a number of their peers in the U.S. and Europe.

Most of our lenders are sitting on ample funds to lend on all asset classes outside of land. Per a recent lender survey we conducted, lenders are full throttle with Industrial and Multifamily rental properties.

## Lender-Preferred Commercial Asset Classes\*



## Survey of Conventional Commercial Mortgage Interest Rates\*



Another key takeaway from our lender survey was the inversion of short and long term interest rates. As of today, Canada's yield curve has been inverted for several quarters. Higher rates at the short end of the curve (1-2 years) have taken their toll on real estate and other asset prices. Future economic weakness would force the Bank of Canada to eventually cut interest rates meaningfully, which will likely mark the bottom of the real estate correction. We expect that would coincide with a fantastic entry point into the Commercial Real Estate sector.

\*Source: Anonymous responses from lenders surveyed in Q1 2023.



# What's Going on with Interest Rates?

Okay, on to the fun part with some forecasts (DISCLAIMER: interest rate forecasting is a full contact sport and everyone's best guess)!

We've mentioned many times that almost every single economist vastly misjudged the speed and scale of interest rate increases in 2022, so take any predictions you hear with a grain of salt.

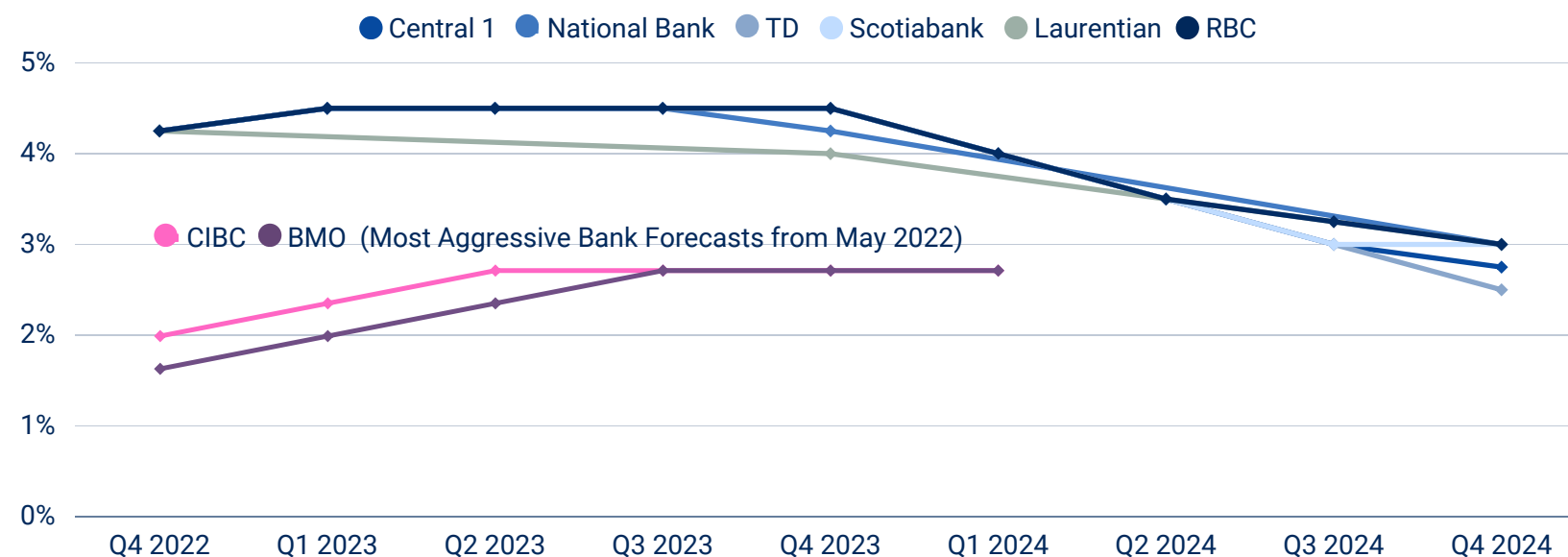
What we're confident of is interest rates won't go much higher from here in the next 1-2 years. Our expectation, along with many others', is that the Bank of Canada holds their rate ( $\pm 0.25\%$ ) for the rest of the year. So far, so good as the rate was held steady at 4.50% at yesterday's meeting.

We've been looking for (okay, waiting for) some negative news to accelerate the inevitable cycle that needs to play out, but it simply hasn't come. Employment growth (another forecast-beating 35,000 new jobs in March) and GDP are still holding up strong.

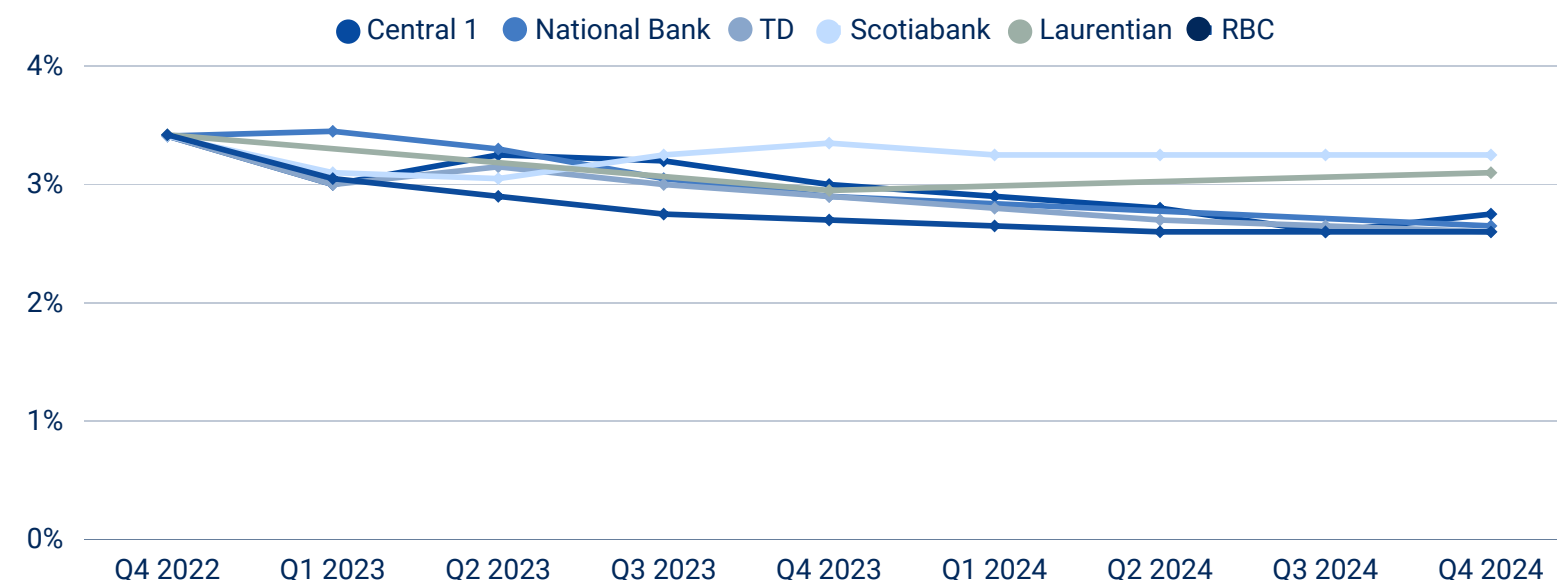
So, what effect is this going to have on interest rates?

We don't have all the answers, but what we do know is we shouldn't sit on our hands and wait for something to happen without acting on our belief in commercial real estate as an important long-term investment (you can revisit on Page 4). Despite elevated interest rates, there are still great opportunities to find value if you have the right team around you.

**BoC Overnight Rate Projections\***



**GoC 5-Year Bond Yield Projections\***



\*Source: Select lender economic updates.

# Looking Ahead for Commercial Real Estate

At Impact, we pride ourselves on being **problem solvers**, so we're always going to have a "glass half-full" mentality. If you're not surrounding yourself with people/firms with this attribute, we wish you well (but be prepared to miss out on life-changing friendships and business opportunities). So what's in store for Commercial Real Estate? In B.C. it's is a continuance of the long-term bull market we've enjoyed for the past two decades. We see nothing outside of a critical shortage of skilled trades that stands on our way. Yes, monetary policy is doing its job for now, but we see interest rate pressures subsiding in the next 8-12 months and the return of that critical *decisiveness* that's been lacking in the markets.

Taking a slight liberty, we'll bend a few of our favourite Warren Buffett quotes to commercial real estate:

- **The value of Commercial Real Estate is the income it will generate in the future.** If you buy properties that generate low levels of income, you'll be disappointed. If you buy properties that will generate increasing levels of income, you'll be richly rewarded!
- **People who hold cash equivalents feel comfortable. They shouldn't. They've opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value.** Commercial Real Estate in B.C. is extremely competitive, and we're strong believers the biggest opportunities come in times of uncertainty when the market is weaker.

On a recent transaction, a client of ours secured a property for \$11 million in a competitive bid situation (seven offers) that if interest rates were 3% (circa 2021), would've sold for \$15 million. Yes, we had to work out some creative financing for it (what we're built for), but the future cash flows will undoubtedly result in a significant revaluation down the road!

For others looking to add to their portfolios, we recommend focusing on the value of the property and paying a reasonable price for it based on forecasted future income. For now, The market continues to be defined by well-capitalized sellers with low mortgage debt, who understand that their properties are in short supply. These sellers can wait out the current "mushy middle" environment. While there are always exceptions, we haven't seen many duress situations and we're not expecting "forced sale" opportunities outside of zero-cash-flow land sales.

The biggest challenge right now is leverage levels are much lower than those obtainable in 2021. The higher equity required to make deals happen during the spike in interest rates has made the economic rationale for purchasing new properties much more challenging. The following table demonstrates how much of an impact interest rates have had on investor's ability to acquire commercial real estate:

	<u>Dec 2021</u>	<u>April 2023</u>	<u>2024 (Proj.)</u>
<b>Properties NOI</b>	\$100,000	\$102,000	\$104,040
<b>Interest Rate</b> (3Y Term Est.)	3.00%	6.00% ▲	4.50% ▼
<b>Debt Service Ratio</b>	1.25	1.25	1.25
<b>Mortgage Amount</b>	\$1,409,000	\$1,062,500 ▼	\$1,253,178 ▲





**03**

NEW AT IMPACT

# In the News



Larry Sit | Associate Commercial Mortgage Broker

## Most recently, we've welcomed our newest Associate Commercial Mortgage Broker, Larry!

Larry recently joined Impact Commercial as an integral part of our brokerage team. With his extensive academic experience, and previous roles as analyst and coordinator, Larry is proving to be a natural at interpreting and evaluating the necessary information to see applications through to approvals. Larry is starting off extremely strong and already nose deep in numerous applications. Larry will be off the ground building his own client list in no time!

## If you have seen us on any social media recently, then you've already been introduced to our newest Associate, Marketing & Client Services, Pauneez.

Pauneez has taken on a lead marketing role at Impact Commercial, striving to bring a fresh and innovative perspective to our marketing strategies. She spearheads company events, creates digital content and campaigns, and organizes much of our client communication. If you ever see us online, know that it is most likely Pauneez's doing!



Pauneez Tourgostar | Associate Marketing & Client Services

## In case you missed it, Impact Commercial underwent an exciting reorganization in February. It is with pleasure that we announce Jon Switzer's advancement to Managing Partner of Impact! We are excited to see what's in store with a fresh perspective and look forward to our next chapter with Jon at the wheel.

Alan will maintain a critical role as a mentor to Impact's future leaders, but will now be free to focus 100% of his energy on brokerage where he is most passionate. In case he hasn't told you, he likes doing deals!



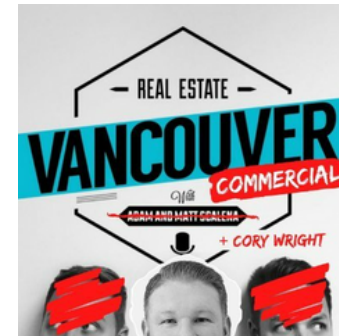
Jon Switzer | Managing Partner Commercial Mortgage Broker



Impact Commercial had the humbling pleasure of its first in-person volunteering experience at the Greater Vancouver Food Bank. On an ongoing basis, Impact will continue to support the Food Bank with meaningful donations over the holidays and regular in-person volunteering throughout each year. If you're interested in donating or joining us as a volunteer, please visit the website at <https://foodbank.bc.ca/> or contact Pauneez Tourgostar for more information.

## Other Updates to Our Client Communications Offerings

Did you know Impact Commercial is the presenting sponsor of the **Vancouver Commercial Real Estate Podcast**? We reserve the "must listen" label for a select few episodes, and the most recent episode "How Does the Collapse of Silicon Valley Bank Affect Commercial Real Estate" with Alan Haigh easily qualifies! The podcast has gained a huge following and we highly recommend tuning in if you can find the time.



Our monthly interest rate commentary is getting a makeover and you can expect the first edition in your inbox starting this May. Speaking of makeovers, we are also hard at work revamping our entire website. We don't want to spoil too much, but keep an eye out for that reveal soon.

**That's all for our new semi-annual Debt Market Outlook! If you have any questions or concerns, please don't hesitate to contact us. We are always honoured to be relied upon as a key member of your advisory team. We appreciate you joining us for the ride as we continue to grow and expand our commitment to our clients!**

# GET IN TOUCH



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