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JULY 2022

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Commercial Mortgage Commentary

Market Trends

Inflation, Rates Challenge CRE Development

Inflation, inflation, inflation. In today's world there is no avoiding the issue of the rising cost of living – or the rising cost of everything for that matter. The word itself as a search term on Google has never attracted more attention in its entire history than it did in Q2 (the data has been tracked since 2004). It is no surprise then that the subject has also become a major point of concern in the commercial real estate (CRE) space. For a quick take on current market conditions, Canadian CPI inflation was 7.7% at the time of writing and CPI trim came in at 5.4%. Such elevated and widespread price pressures have ushered an aggressive monetary policy response by the Bank of Canada (BoC) that has pushed interest rates higher across credit markets. Mortgage rates have surged to decade-long highs as a result. Many economists are now concerned that such combative monetary policy could trigger a recession in the coming quarters.

Rising construction costs paired with a greater likelihood of a recession are challenging the economic viability of development projects. The former is displayed in the widely followed building construction indices compiled by Statistics Canada. The most recent report indicates residential and non-residential construction costs were up 22.6% and 12.8% year-over-year (YoY), with major drivers attributed to higher costs for fuel, transportation, materials and labour. Rising input costs have challenged the cost-value equation of CRE developments to such an extent that the value of some projects at completion are now lower than the costs incurred to develop them. This is not to say that these developments should – or are – being scrapped entirely. Many developers are dealing with the challenge by factoring in longer hold periods post-completion, while others are electing to delay construction starts and opting for a wait-and-see approach. Policy rate hikes are used to combat higher prices by restricting economic activity. In the development sector, it appears they are doing just that.

For lenders, it is in their best interest to keep a close eye on the market for any signs of shifting sentiment caused by the surge in prices. Financiers are seeing demand for new projects begin to taper off and some have even reported previously approved (pre-construction) deals being pulled out of the pipeline – a move initiated by borrowers themselves. Although this is only happening to a small minority of deals at this time, it is a noteworthy observation to remind us of the sensitivity that rising rates can have on the viability of projects. Certain lenders have since decided to step back from land and development deals entirely, while those who still have some appetite have raised pricing and will only lend to borrowers with superior balance sheets able to withstand development delays and an economic downturn.

For borrowers, reports of cost overruns and sub-trades demanding higher than agreed upon charges for services rendered have become more frequent as of late. Some multi-family rental projects are being put on hold as economic viability becomes more challenging, with high double-digit rent increases cited as a requirement to offset the rising costs of construction and financing. Concerns about refinancing debt at project completion are also increasingly front-of-mind given the upward trajectory of rates. In contrast, condominium developers are facing an entirely different set of dynamics and are most concerned with the impact that higher rates will have on buyer demand. A slowdown in sales would directly impact the ability to start and complete projects. There does not seem to be a clear consensus within the CRE community on which type of residential project will be most resilient over the coming quarters; however, a narrow majority appear to believe it is preferrable to be on the condo side of development.

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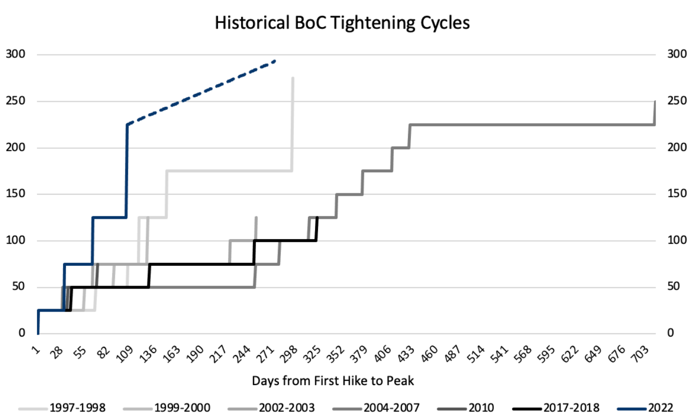
Base Rates

Canadian borrowing costs reached decade-long highs in Q2 with the impact of recent BoC rate increases and expectations for future hikes most visible in Government of Canada (GoC) and Canada Mortgage Bond (CMB) yields. These yields have surged as much as 150% year-to-date (YTD) and pushed mortgage rates to levels unseen since the early 2010s and the aftermath of the global financial crisis.

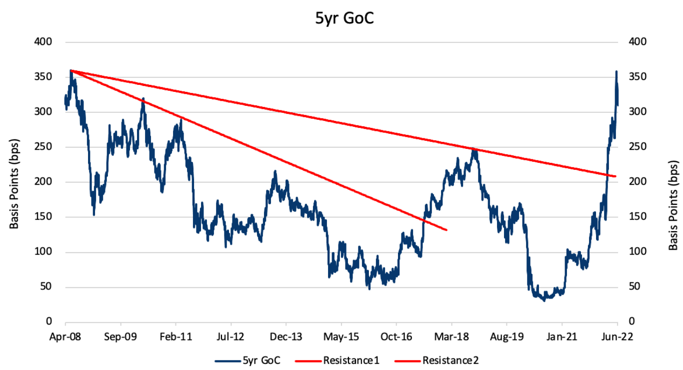
Bank of Canada Rate

The BoC hiked its key policy rate by 100bps to 2.50% at its July 13th decision, its largest move since 1998 and its third major hike since March. The Bank is currently undertaking its most aggressive tightening cycle since it began fixing its policy rate in 1996. For context, it has taken just 104 days for the Bank to hike its key rate by 225bps. During previous tightening cycles in 1997-1998 and 2004-2007 – the only other cycles where rates increased by 225bps or more – it took the Bank 295 and 430 days to make similar moves. The record pace of the Bank's tightening program shows no signs of slowing either, with 4 of Canada's largest banks forecasting the policy rate to reach somewhere between 3.00%-3.50% by year end. At an average of 3.20%, that implies about 70bps of additional tightening through the remainder of 2022. The BoC has indicated its willingness to hike the policy rate above neutral – a point that is theoretically restrictive to economic growth – if that is what is required to quell inflation. The Bank currently estimates neutral as somewhere between 2.50%-3.00%.

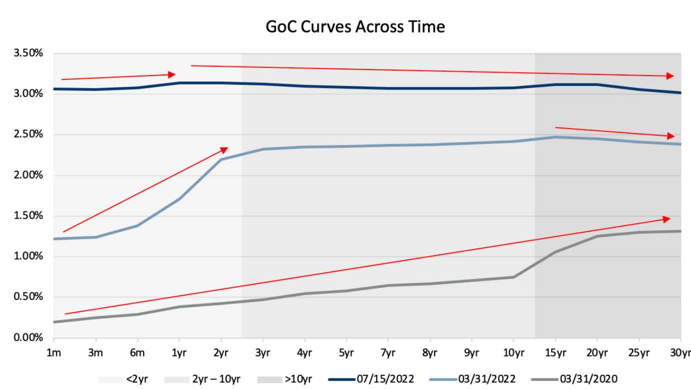


Government Bond Yields

The second quarter of 2022 saw both 5yr and 10yr government bonds rise at velocities not seen since the 90's dot-com bubble. As of July 15th, yields on the 5yr GoC were 3.09%, up 72bps relative to the end of Q1 and 183bps YTD. Yields reached as high as 3.59% in mid-June before moderating through the latter half of the month. Similarly, yields on the 10yr were 3.08%, up 67bps from Q1 and 159bps YTD. To illustrate just how quick rates have shot up, the latest 5yr GoC bond issuance fetched an average yield of 3.23% at auction. This means that the Canadian federal government, the safest borrower in the country, is now paying a comparable rate of interest to what the average institutional CRE borrower was being quoted as recently as February of this year. The elevated level of the 5yr GoC, and interest rates generally, show few signs of abating with the BoC having already hiked its policy rate well above pre-covid levels and further tightening in store. The 5yr GoC broke through a major resistance trend in Q2 to reach highs not seen in over a decade.



Elevated rates are visible across the term structure, with 2yr yields closing at 3.20% on July 15th, breaching 3.00% for the first time since July 2008. Conversely, the 10yr closed at 3.08%, a level not seen since 2011. With 1yr and 2yr yields now offering a premium to longer-dated bonds, the slope of the yield curve has tilted into inversion. The yield curve's slope is watched closely by investors as an indicator of the future health of the economy. Longer-dated yields fall below shorter-dated yields when bond investors bid up the price of longer-dated bonds, or vice versa (bond prices and yields move inversely). Greater relative demand for longer-term bonds is a sign of risk aversion and an inverted yield curve typically precedes an economic recession or, at the very least, a significant slowdown in economic activity.



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Canada Mortgage Bond Yields

Like GoC yields, benchmark rates for CMHC insured mortgages were also up substantially in Q2. As of July 15th, 5yr and 10yr CMB closed at 3.41% and 3.52% and were up 185bps and 163bps YTD, respectively. As the underlying assets of CMB carry a full guarantee by CMHC, the difference in yield between CMB over GoC reflects an asset class premium (funds borrowed for investment versus government operations). Comparing benchmarks, the 5yr CMB came in at a spread of 32bps over the 5yr GoC, slightly higher than the 60 months running average of 30bps. Similarly, the 10yr CMB-GoC spread registered at 44bps, also above its 60 months running average of 41bps. This signals that borrowing costs on assets with a crown corporation guarantee (CMHC) are also on the rise.

In the primary market, Canada Housing Trust, the special purpose trust set up by the CMHC to issue CMB, placed both a 5yr and 10yr CMB in Q2 2022. At the time of issuance, the 5yr and 10yr CMB were priced with coupons of 3.80% and 3.55%, respectively. This is particularly interesting as normally a term premium is expected for longer-dated debt. The same is true for the two bonds' yield at issuance. The 5yr came in at a yield of 3.85% while the 10yr came in at a yield of 3.56%, meaning the 10yr earned 29bps less than the 5yr (a yield curve inversion). This is a drastic change compared to the prior primary market issuances that occurred in late 2021 when the 5yr and 10yr CMB had a positive term premium of 57bps. All to say, the negative term premium upon issuance indicates uncertainty in this corner of the credit market as well. As of July 15th, the term premium in the secondary market was positive, albeit barely, at 11bps.

Prime Rate

The Bank Prime rate closed Q2 at 3.70%, up by 125bps YTD after two 50bps rate hikes in Q2 (the third hike of 25bps having occurred in Q1). Not to be outdone by itself, Prime jumped an additional 100bps in mid-July, to 4.70%, after the BoC's 100bps hike in its benchmark interest rate. The latest jump creates additional daylight between conventional lenders and their high-yield counterparts – the vast majority of whom had pivoted to originating predominately floating rate debt months ago in anticipation of rapidly rising rates.

Commercial Mortgage Rates

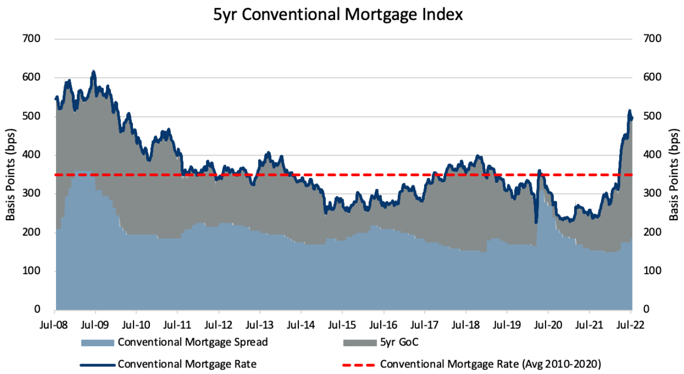
Conventional

The 5yr Conventional Mortgage Index eclipsed 5.00% in Q2, up 100bps in the quarter and 215bps YTD. Compared to the average of 2021, a period when commercial mortgage rates hovered around generational lows, the index is up a full 240bps. The rise relative to last year represents nearly a doubling in rates, about 90% of which can be attributed to the surge in GoC bond yields. The last time the index surpassed 5.00% was in May 2010 and all-in borrowing costs are now 150bps (~40%) above the average throughout the 2010s.

In 2022, lenders have thus far hiked spreads roughly 30-40bps in conjunction with rising corporate spreads and tightening credit conditions more generally. As of the end of Q2, top tier assets commanded spreads in the 160-170bps range and average assets garnered spreads anywhere from 180-220bps or higher. Premiums for more out-of-favour assets like office and retail continue to exist in the 10-20bps range and up, but are down significantly relative to earlier in the pandemic. For 10yr deals, lenders generally require a term premium over 5yr debt in the range of 10-25bps. That said, given the flatness of the GoC yield curve, the premium for a 10yr all-in conventional mortgage was around 25bps on July 15th compared to an average of 65bps through the 2010s. What little capital that seems to be available for even longer duration deals appears to require an additional 15-30bps at minimum on top of 10yr spreads.

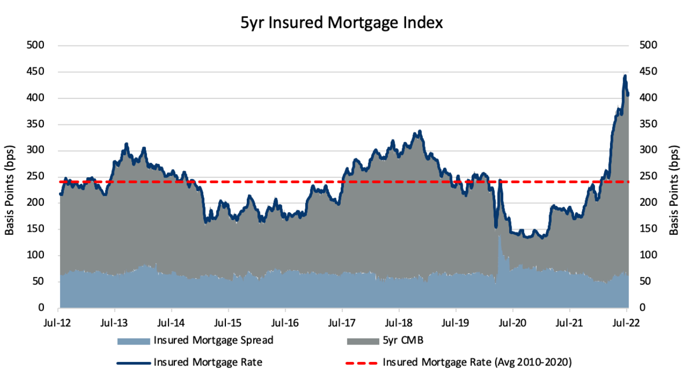
(See chart on next page)

	15-July	Delta (bps)						
		30-June	QoQ	YTD	YoY	2 Years	5 Years	10 Years
Base Rates								
Bank of Canada Rate	**2.50%**	▲ 100	▲ 200	▲ 225	▲ 225	▲ 225	▲ 200	▲ 150
Canada Government 5yr	**3.09%**	▼ -3	▲ 72	▲ 183	▲ 208	▲ 275	▲ 167	▲ 184
Canada Government 10yr	**3.08%**	▼ -14	▲ 67	▲ 159	▲ 163	▲ 255	▲ 131	▲ 134
Canada Mortgage Bond 5yr	**3.41%**	▼ -4	▲ 67	▲ 185	▲ 217	▲ 272	▲ 163	▲ 176
Canada Mortgage Bond 10yr	**3.52%**	▼ -19	▲ 63	▲ 163	▲ 165	▲ 259	▲ 128	▲ 127
RBC Prime Rate	**4.70%**	▲ 100	▲ 200	▲ 225	▲ 225	▲ 225	▲ 200	▲ 170



Insured

Average spreads on the 5yr CMHC Insured Mortgage Index closed Q2 in the 65-70bps range over CMB yields, up from 50-55bps at the end of Q1 and right around the 60 months running average of 66bps. Direct market intel suggests that sharpest pricing at the end of Q2 was in the range of 40-45bps. As CMB yields continued to surge in Q2, all-in rates followed, with the 5yr Index eclipsing 4.00% and reaching as high as 4.40% before moderating somewhat through the first 2 weeks of July. In available data back to July of 2012, April marked the first time that the index had surpassed 3.50%. The index averaged 2.40% from 2012 to 2020. For longer term loans, spreads in the 10yr space increased slightly in Q2 to 60-65bps, with all-ins climbing as high as 4.60% in the quarter.



High Yield

A rising rate environment and increased market volatility have heightened lender appetite for floating rate loans over fixed coupon deals in recent months. These floating rate deals are typically priced over Bank Prime. Given that GoC yields had risen more sharply than Prime through the first half of 2022, all-in mortgage rates for high yield deals on first-priority loans had become uncomfortably tight relative to rates in the conventional space for many lenders. However, the BoC's recent 100bps hike has pushed the premium for higher risk mortgages back toward its historical average. As of July 15th, high yield senior deals priced at Prime + 1.50%-3.00% equated to all-in mortgage rates of 6.20%-7.70% compared to conventional rates in the 5.00%-6.00% range. As the BoC continues to hike rates through 2022, these floating rate deals will continue to rise in tandem with the increases in the overnight rate. Lenders of subordinated debt have also hiked mortgage rates in recent months. Coupons in the low double digits have become more frequent and the latest lender sentiment points to subordinate yields ranging anywhere from 7.00%-14.00%.

Construction

As cited previously, activity fell markedly in the development space through Q2 as rising construction and borrowing costs stress the economic viability of projects. It has been noted that some lenders have decreased appetite for development deals while others have paused lending entirely. Those still willing to lend have raised spreads, which in tandem with rising base rates has pushed up mortgage rates for borrowers. Financing for CMHC insured construction deals continues to be the most affordable option for borrowers. Although insured spreads were relatively stable in Q2, rising base rates saw all-in coupons push borrowing costs higher to the 3.50%-4.50% range. For conventional construction loans, a combination of higher spreads and higher base rates pushed all-in coupons higher to end the quarter in the 5.00%-7.00% range. That was prior to the BoC's 100bps hike on July 13th and the coupon range for conventional construction deals has likely moved in tandem since. Like high yield mortgages, much of these deals are priced over Prime and will see further upward pressure as the BoC continues to tighten rates through 2022.

ABOUT CMLS FINANCIAL

CMLS Financial is one of Canada's largest independently owned mortgage services companies. Founded in 1974, we are proud to be Canada's Mortgage Company™ for over 40 years. With offices across the country, we provide a wide range of commercial lending services, residential real estate mortgages and institutional services.

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