CMLS Financial®

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Customer Forward Thinking.™

Commercial Mortgage Commentary

Market Trends

Commercial Mortgage Activity Adjusts to Elevated Borrowing Costs

Global economic headwinds continue to put upward pressure on interest rates and tighten credit conditions. At the time of writing, Canada's Consumer Price Index (CPI) was up 7.0% year-over-year (YoY), down marginally from a 39-year high of 8.1% in June, but about 3.5 times greater than the Bank of Canada's (BoC) 2% target. Such elevated levels of inflation have forced the BoC to tighten monetary policy at a pace unrivalled by historical tightening cycles. As a result, Government of Canada (GoC) bonds yields and other key base rates for commercial mortgages have climbed to levels unseen since 2010.

The consequence of this historic monetary policy pivot has been an equally historic acceleration in commercial mortgage rates. Institutional quality conventional mortgages are now garnering all-in rates above 5%, while the typical CMHC-insured mortgage has pushed above 4%. Just 12 months ago, identical mortgages might have secured rates less than half that. Evidently, such abrupt and significant increases in borrowing costs have cooled activity rather quickly. Observed mortgage transactions were down some 15-30% YoY in Q3. A sizable portion of lenders report that deal flow, especially in the conventional and development spaces, has declined for two consecutive quarters. Similarly, about 40% of lenders asked in a recent survey reported that origination in Q3 was down by 5-15% YoY, while a further 15% reported that origination was down greater than 15% YoY. Deal volume is especially suppressed in the acquisition space as market uncertainty has led many investors to pause on new purchases.

While several indicators point to a continued decline in mortgage activity in Q3, there was also some evidence that the market may be stabilizing. For starters, all-in rates relatively stabilized through Q3 as coupons increased at a decreasing rate, offering some reprieve for borrowers after a volatile pricing cycle in late Q1 and Q2 (see Commercial Mortgage Rates section for a more comprehensive discussion of spreads). A number of lenders reported that loan pipelines are starting to strengthen and that they are expecting a busier Q4 following a quiet summer. Is this an indication that market activity may have found the floor? Perhaps. Several significant economic risks remain, but for now it appears that market participants, at least some of them, are getting accustomed to operating in this new high-rate environment.

So, what can borrowers expect moving forward? For starters, the cheap money seen through the pandemic is well behind us. Base rates have reached a new altitude causing all-in mortgage rates to more than double across risk buckets. And mortgage spreads, particularly in the conventional space, have ascended from the ultra-sharp pricing that pervaded the market through late 2021 and early 2022. Lenders are also more conservative with loan structure and underwriting. Tighter leverage and stronger recourse are the new norm after a highly competitive market several months ago forced lenders to stretch terms to win deals. Some lenders have even backed away from entire asset classes until they have more confidence in where the market and wider economy are headed. But despite these headwinds, many lenders remain well capitalized, and borrowers should find comfort in the fact that there remains plenty of liquidity available for strong deals.

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Base Rates

Key commercial mortgage base rates closed Q3 at or above the previous quarter. Consequently, all-in commercial mortgage rates remain significantly elevated relative to this time last year and much of the past decade. The yield curve pushed sharply into inverted territory in the quarter with 2yr GoC bond yields exceeding 10yr yields by about 65bps.

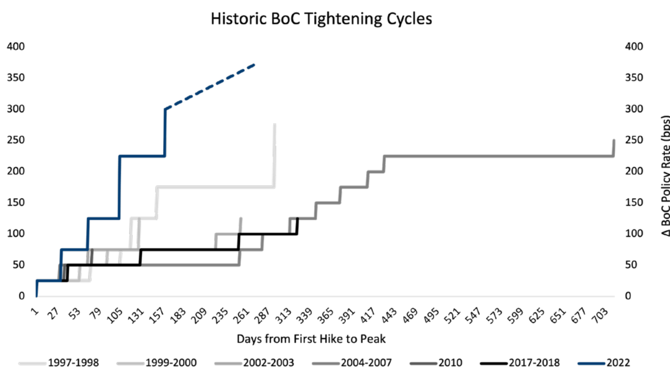
Bank of Canada Rate

In an attempt to bring down soaring inflation, the BoC hiked its key policy rate by 75bps to 3.25% on September 7th. The Bank has hiked rates five times since March for a total of 300bps. The chart below shows that this has been the most aggressive tightening cycle in the past 25 years. And with inflation still well above its 1-3% target range and trending near its highest level in four decades, the Bank made it clear in its latest statement that it expects more rate hikes in the coming months. Several major Canadian banks are now forecasting the policy rate to reach 4% by year-end, with a risk of further hikes if inflation remains stubbornly high.

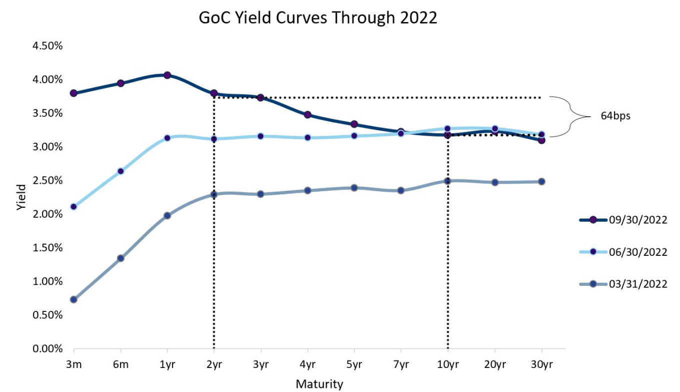
Government Bond Yields

The BoC's current tightening cycle helped send GoC bond yields soaring through the first half of 2022. By mid-June, yields across all term lengths had pushed to their highest levels in over 10 years. The third quarter commenced with an easing of yields – the 5yr and 10yr GoC each dropped around 100bps through July – before pivoting back toward their June highs on renewed inflation fears and more hawkish rhetoric from central banks.

Two-year, 5yr and 10yr GoCs closed Q3 at 3.80%, 3.32% and 3.17%, respectively. Notice the significant inversion in the yield curve as 2yr yields exceeded 10yr yields by over 60bps. The 2yr-10yr spread is typically used as a barometer for the health of the economy. An inverted yield curve – where short term yields push above longer-term yields – has been a fairly reliable predictor of economic recession over the past several decades.



Source: Bloomberg



Source: Bloomberg

Base Rates	2022-09-30	QoQ	YTD	YoY	2 Years	5 Years	10 Years
		Delta (bps)					
Bank of Canada Rate	3.25%	▲ 175	▲ 300	▲ 300	▲ 300	▲ 225	▲ 225
Canada Government 5yr	3.32%	▲ 20	▲ 207	▲ 221	▲ 297	▲ 156	▲ 203
Canada Government 10yr	3.17%	▼ -6	▲ 168	▲ 164	▲ 259	▲ 105	▲ 144
Canada Mortgage Bond 5yr	3.64%	▲ 19	▲ 208	▲ 235	▲ 305	▲ 153	▲ 205
Canada Mortgage Bond 10yr	3.62%	▼ -8	▲ 173	▲ 175	▲ 265	▲ 107	▲ 145
RBC Prime Rate	5.45%	▲ 175	▲ 300	▲ 300	▲ 300	▲ 225	▲ 245

Base Rate Changes Over Time

Source: Bloomberg

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Canada Mortgage Bond Yields

Similar to GoC yields, base rates for CMHC insured mortgages softened through July before pushing back toward earlier highs. Two-year, 5yr and 10yr CMBs closed Q3 at 3.92%, 3.64% and 3.62%, respectively. Year-to-date, yields are up 287bps, 208bps and 173bps. As is the case across credit markets, the sharper rise in shorter-term yields saw the CMB yield curve invert in Q3. Looking at the relationship between CMB and GoC yields, useful for those lenders who price insured mortgages over GoC, deltas for 5yr and 10yr terms were at or near their historical levels. The 5yr CMB-GoC spread averaged 33bps through Q3, in line with its five-year moving average of 30bps. The 10yr CMB-GoC spread averaged 47bps, up from its five-year moving average of 41bps. There were no CMB issuances this quarter in the primary market.

Prime Rate

Bank Prime rates climbed 175bps quarter-over-quarter (QoQ) in tandem with 175bps of hikes to the BoC policy rate in Q3. Prime closed the quarter at 5.45%, up 300bps year-to-date (YTD) from a pandemic low of 2.45%. Given that most floating rate deals are priced over Prime, the steep rise through 2022 has led to sharp and immediate increases in financing costs for floating rate borrowers – typically construction and high yield borrowers. Looking ahead to Q4, the BoC made it clear at its latest interest rate decision that it intends to continue raising its policy rate to curb inflation. It is expected that banks will continue to hike their Prime lending rates through the remainder of 2022 and into 2023 in accordance with rate hikes at the BoC.

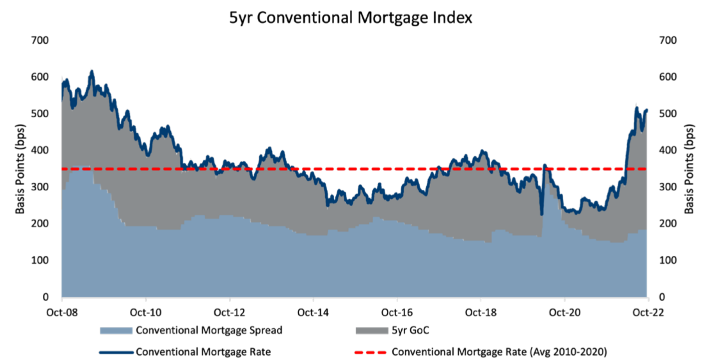
Commercial Mortgage Rates

Conventional

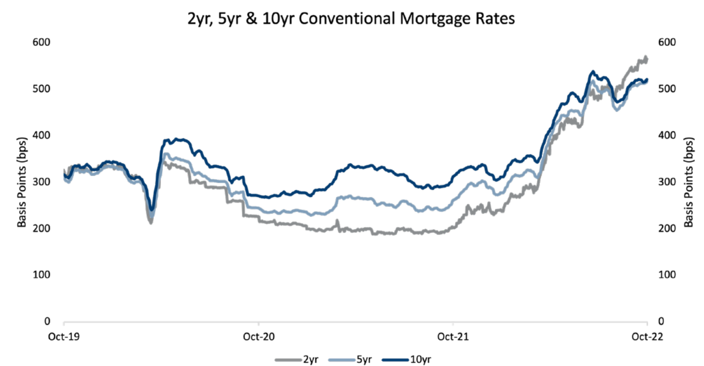
The softening of GoC bond yields through July offered some relief to conventional mortgage borrowers with 5yr mortgage rates dipping to around 4.50%. However, the resurgence of yields through the remainder of Q3 pushed mortgage rates back toward their June highs. The 5yr Conventional Mortgage Index closed the quarter near 5.20%. The last time the index eclipsed 5% was in the early 2010s. Borrowing costs at the end of Q3 were double the average conventional mortgage rate in 2021 (2.59%) and 170bps above the average through the 2010s (3.50%). The speed and magnitude at which borrowing costs have risen in recent months has brought about a significant decline in conventional mortgage activity.

Five-year conventional mortgage spreads – the other key component of conventional mortgage rates – were relatively stable through Q3. Best available pricing ticked up approximately 5-10bps QoQ to the 175-190bps range, while higher risk deals commanded spreads anywhere from 200-260bps. Year-to-date, conventional mortgage spreads have risen approximately 45bps in conjunction with rising corporate bond spreads and tightening credit conditions generally. Latest results from a survey of lenders indicate that about two thirds see spreads continuing to rise through the remainder of the year.

Interestingly, due to the inversion of the GoC yield curve, short-term mortgage rates have pushed well above longer-term rates. The 2yr all-in conventional rate was approximately 5.65% at quarter end compared to around 5.20% for both 5yr and 10yr rates. Despite the inversion, there is evidence that many borrowers continue to prefer shorter-term mortgages due to heightened market uncertainty in the near-term. From the lender perspective, few are willing to take on the added duration risk of longer-term debt when they can earn the same yield, or higher, on a shorter-term mortgage. Conventional activity in the 10yr space has been relatively muted for the past several months.



Source: Bloomberg, Intellifi



Source: Bloomberg, Intellifi

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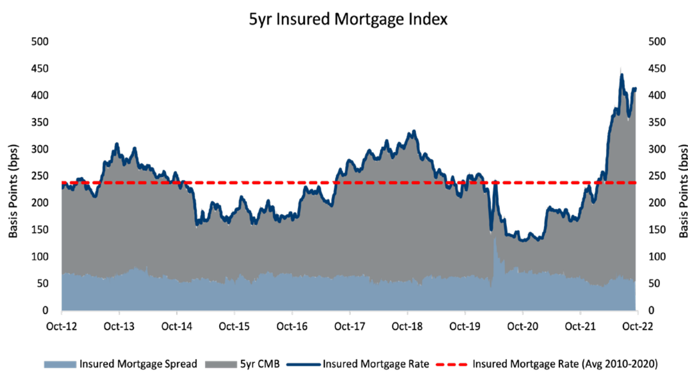
Insured

Like conventional mortgage rates, insured rates remain significantly elevated relative to earlier in the year, as well as compared to levels over the previous decade. The 5yr Insured Mortgage Index closed the quarter around 4.20%, in line with Q2 but up roughly 230bps from the average through 2021 (1.83%) and about 180bps from the average through the 2010s (2.38%). Contrary to the conventional space, however, insured mortgage spreads have remained relatively stable throughout the year. The sharpest available 5yr pricing appears to be in the mid-to-high 40s over CMB, while the typical deal commands pricing in the mid-to-high 50s over CMB. Spreads on 10yr mortgages are nearly identical and, given that the 5-and-10yr CMB yields were about equal at quarter end, 10yr all-in mortgage rates closed Q3 nearly at par with 5yr rates. The 10yr Insured Mortgage Index was 4.18% at quarter end.



Source: Bloomberg, Intellifi

High Yield

Increased market uncertainty has driven coupon ranges for riskier mortgages higher in Q3 relative to the previous quarter. Coupons for senior high yield debt ranged from 6.75-9.00% depending on deal quality. Based on observed transactions, in-favour assets like multi-family and industrial in primary markets with strong borrowers appear to be fetching coupons at the lower end of the range.

As of August, a growing number of observed transactions were fixed coupon deals, indicating that some high yield lenders are starting to find comfort in issuing fixed rate mortgages after shifting almost exclusively to floating rate loans in earlier months. A survey of lenders in Q3 showed that approximately 45% had no preference for floating rate debt. Of those lenders who indicated a preference for floating rate debt and who indicated that they require a premium for issuing fixed (only about 25% of respondents), the average premium required on a senior-ranked loan was 75bps. For subordinate debt, recent survey responses from lenders pegged coupons in the 7.50-14.00% range.

Construction

Similar to Q2, lending appetite for construction was soft through Q3. Rising base rates have pushed all-in rates for construction deals up significantly at the same time that economic confidence has deteriorated. Lenders have indicated a reduced interest for development deals as a result. Multi-family and industrial construction have proved to be somewhat resilient and continue to be the most sought-after financing opportunities. Insured construction saw competitive coupons in the range of 5.00-5.75% in Q3 (roughly equivalent to Prime minus 50bps to Prime plus 25bps), while conventional construction coupons were higher in the range 6.50-8.00% (roughly equivalent to Prime + 100-250bps). While deal flow and lending opportunities on land appear to remain strong, many lenders have stepped away from land financing or have stiff requirements for those deals that they will quote on. Lending is generally relationship based or reserved for projects nearing shovels in the ground. As of a recent lender survey in Q3, competitive coupons for land appear to be in the 7.50-9.50% (roughly equivalent to Prime + 200-400bps). Moving forward, with the BoC expected to hike rates further, all-in construction mortgages are likely to continue to face upward pressure as most construction deals are floating rate deals.

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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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