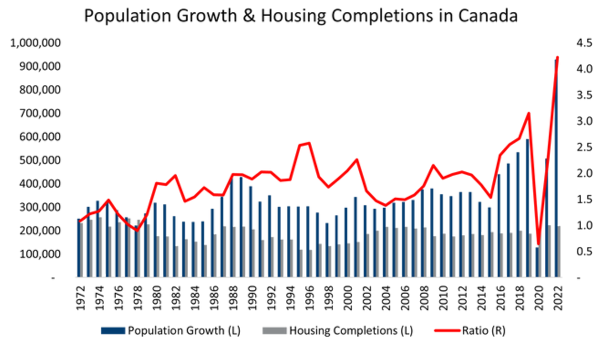
Commercial Mortgage Commentary

Market News

More Incentives for Apartment Construction

Housing affordability has become a central feature of the cultural and political landscape in Canada in recent years. Home prices soared during the pandemic to put home ownership out of reach for many Canadians. More recently, rents from small towns to large urban centers have seen double-digit percentage increases year-over-year. Interest rates, constructions costs, and behavioral changes have had much influence on home prices and rents but at the root of the issue is a fundamental imbalance between housing supply and demand, which has widened to its most acute levels on record.

A recent analysis by the Fraser Institute highlighted the key factors driving the housing supply/demand imbalance by analyzing annual population growth (a proxy for housing demand) and housing completions (a proxy for housing supply) between 1972 and 2022. Two items that were particularly alarming. First, Canada has never constructed as many homes in a single year as it did back in 1974 when 257,243 units were completed. Over the past five decades the country has seen about 190,000 units completed annually on average. Second, in 2016 Canada's population growth eclipsed



Source: Statistics Canada

the 400,000 mark for the first time since 1988-89 and has been accelerating ever since, reaching around a million in 2022. This combination of stagnant housing completions and a rapidly rising population have been working in tandem to challenge housing affordability. The ratio of new people per new unit of housing reached a record high of 4.2 in 2022.

Decades of underbuilding and a severe misalignment in housing and immigration policies have culminated in the acute housing affordability challenges of today. The Canada Mortgage Housing Corporation (CMHC) estimates that, at the current trajectory, Canada will be short about 3.5 million housing units by 2030. That is equivalent to about 16 years worth of housing construction based on average completions of 213,791 between 2020-2022.

To try and alleviate some of those pressures and spur housing development, the federal government responded with a flurry of announcements in the fall of 2023. Among them was an additional $15 billion in funding for the Apartment Construction Loan Program, previously called the Rental Construction Financing Initiative. The program is administered by CMHC and offers low-cost financing and favorable loan terms for the development of purpose-built rental housing. The announcement brings total funding for the program to $40 billion and, since its inception in 2017, $17 billion has been committed to facilitate the construction of 46,000 new rental units.

The benefits of the program are numerous and address many of the issues being faced by developers in this higher interest rate environment. Most notably, borrowers are able to secure a low interest fixed rate loan for 10 years – inclusive of the construction, lease up and operational phases of the building – at up to 100% loan to cost. The loan is subject to interest [Continues on Next Page]

only payments for the construction period through to lease up, while principal and interest payments are due 12 months after the property has been stabilized.

CMHC also offers financing for the construction and operation of purpose-built rental housing through the popular MLI Select program. MLI Select offers reduced insurance premiums, higher leverage and extended amortization periods for properties that commit to affordable, sustainable and accessible rental housing. Recent announcements by the federal government to increase the annual limit on Canada Mortgage Bonds (CMB) issuances should improve funding and accessibility for all CMHC multi-unit insurance products, including MLI Select mortgages.

The high interest rate environment has challenged housing development at a time when new supply has never been in greater need. CMHC insurance products like the Apartment Loan Construction Program and MLI Select offer attractive terms to reduce financing costs and incentivize housing development. As one of the country's largest suppliers of CMHC insured mortgages, CMLS Financial is equipped to offer you tailored financing solutions and to help navigate the range of CMHC insured mortgage options. Contact your regional representative for more information.

Fixed Income Markets

Bank of Canada

In its final interest rate decision of 2023, the Bank of Canada (BoC) maintained its key policy rate at 5.0%. The bank initiated a total of three 25bps hikes throughout the year, a significant deceleration from a 400bps increase in 2022. Regardless, the policy rate continues to sit at its highest level since 2001 and has translated into a large and abrupt rise in borrowing costs.

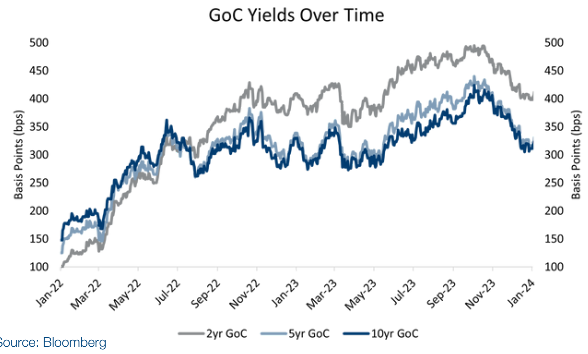
Economic contraction, flat consumption and business investment, and steadily rising unemployment are evidence that inflationary pressures are indeed easing from the weight of higher interest rates. GDP declined 1.1% on an annualized basis in Q3, and the unemployment rate has been inching upward since the spring of last year as record population growth outpaces modest growth in employment. Inflation has fallen considerably from around 6.3% at the beginning of 2023 to 3.4% as of December and is nearing the BoC's 1-3% target range. Nevertheless, the BoC has indicated that it will maintain the current policy rate until it is confident that less volatile measures of inflation have shown more consistent signs of easing. CPI median and CPI trim remain in the mid-to-high-3% range.

The combination of declining inflation and weakening economic data have shifted the discussion on central bank policy rates from how much higher rates will rise to how soon banks will begin to cut – a stark contrast from sentiment in the autumn of last year. The general consensus among economists points to 100-150bps in rate cuts at the BoC by the end of 2024, with cuts commencing sometime mid-year. South of the border, forecasts from central bankers at the U.S. Federal Reserve following the most recent interest rate announcement implied three 25bps cuts to the federal funds rate by the end of 2024.

Government Bonds

Irrespective of the debate around if, when and by how much the BoC might cut interest rates in 2024, a significant decline in Government of Canada (GoC) bond yields in the final months of last year has already brought about significant rate relief for borrowers – at least relative to the highs seen back in October. After reaching their highest levels in 16 years, 2-year, 5-year and 10-year GoC yields shed between 100-120bps in the final two months of the year to close at 3.98%, 3.15% and 3.11%, respectively. Fueling the descent in bond yields was growing evidence of easing inflationary pressures and dovish messaging from central banks increasing the probability of rate cuts in 2024.

While the drop in yields in November and December was quite substantial, it is important to consider the declines in a broader context. GoC bond yields finished the year relatively in line with where they stood in January 2023, masking a volatile year for interest rates. At current levels, yields are still considerably higher than levels seen over the past decade.



Source: Bloomberg

Canada Mortgage Bonds

Following several months of industry consultations, the federal government scrapped plans to consolidate the CMB program into its regular GoC borrowing program. The CMB program will remain as is and will see the limit on annual issuances lifted from $40 billion to $60 billion, with the additional $20 billion dedicated exclusively toward the funding of multi-unit residential mortgages. The government expects that this will help build up to 30,000 more rental units per year.

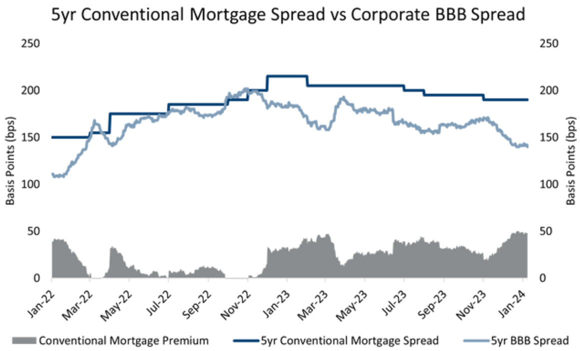
Additionally, the government announced its intention to start purchasing as much as $30 billion in CMB annually on the open market starting in 2024. The idea here is that the government would earn a higher rate of interest on the CMB it owns than the interest it pays on the GoC bonds borrowed to finance those CMB purchases. The difference in interest would [Continues on Next Page]

be revenue to the government that could then be allocated toward affordable housing initiatives. A detailed summary of the CMB program, its role in financing multi-unit residential housing in Canada, and the government's initial consideration to consolidate the program can be found in the Q2 2023 CMLS Commentary.

Corporate Bonds

In tandem with a decline in bond yields in the final two months of 2023 was an easing in corporate credit spreads. As evidenced by an index of BBB-rated Canadian corporate bonds, spreads declined nearly 30bps from the beginning of November to a close of 140bps at year-end. The index reached an annual high of 195bps in March after the Silicon Valley Bank failure but eased as contagion risks dissipated. BBB corporate spreads hovered in the 155-170bps range for much of the remainder of the year.

The delta between conventional mortgage spreads and BBB spreads – represented by the dark grey shaded area in the below chart – has increased to slightly above its longer-run average of about 45bps. Generally a leading indicator for the direction of conventional mortgage spreads, should corporate BBB spreads continue to ease in 2024, this could be a sign of further easing for conventional mortgage spreads in the coming months. You can stay up to date on corporate bond spreads and other key financial data by subscribing to the CMLS Financial Flash Report.



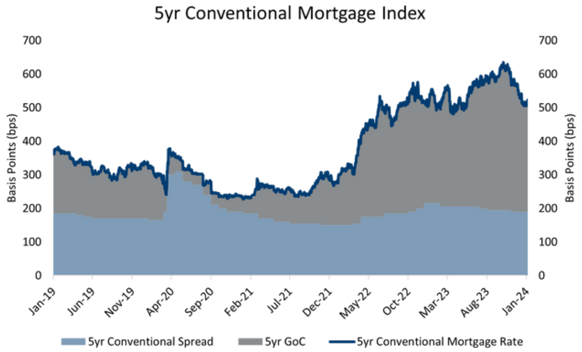
Source: Bloomberg, Intellifi

Commercial Mortgages

Conventional

Conventional mortgage spreads saw some modest declines in the final months of 2023, particularly for the highest quality mortgages. A recent poll of 30 large Canadian lenders by mortgage services firm Intellifi shows that the median lender saw spreads for the highest quality deals at 175bps over GoC, down 5bps from Q3. The survey also highlighted a continued sharp preference among lenders for higher quality deals given the amount of uncertainty in the economy. As such, the rate of spread compression for higher quality deals has been more pronounced than further up the risk curve where lenders remain more cautious. Survey results, as well as transaction data, show spreads as low as 160-170bps for 5-year deals, with 10-year deals requiring a term premium of as low as 5-10bps.

Mortgage spreads for the more typical conventional deal were seen in the 190-210bps range in Q4. The 5-Year Conventional Mortgage Index, which is a proxy for all-in conventional mortgage rates, shows that rates for the typical deal fell noticeably in Q4. This was driven predominantly by the decline in 5-year GoC yields through November and December. The index averaged ~5.20% in the final month of Q4, down ~80bps from the end of Q3. While the decline was substantial, the index has fallen back near levels seen earlier in Q1 and Q2 of 2023. From a historical context, rates are still up markedly from levels seen over the past decade.

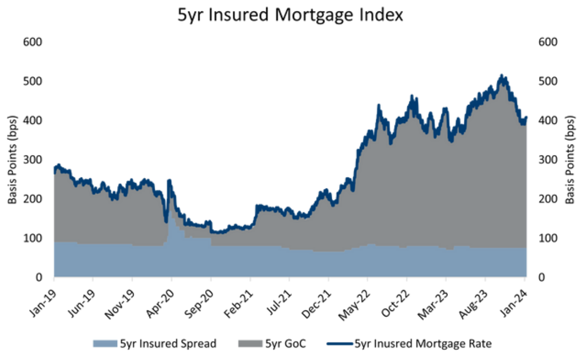


Source: Bloomberg, Intellifi

Insured

As with the conventional space, rates on 5-year insured mortgages fell considerably in Q4 thanks to declines in bond yields. The 5-Year Insured Mortgage Index averaged ~4.05% in December, down from ~4.80% in the final month of Q3, and has stabilized in recent weeks at levels seen earlier in Q1 and Q2 of 2023.

Competitive pricing for both 5-year and 10-year insured deals remains in the low-to-mid 40s over CMB for large, institutional quality deals. There remains some evidence of pricing falling below 40bps. The more typical deals sees pricing into the 50-60bps over CMB range.



Source: Bloomberg, Intellifi

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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 50 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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