TD Global Investment Solutions

Real Assets Market Report 30 Minutes

Real Assets Market Report

2023 Year in Review and Outlook

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Investment Outlook

2023 was a challenging year, with a rollercoaster ride of market sentiment to match. Economic indicators and forecasts were often mixed, markets saw significant volatility, and the year both started and ended under the shadow of a potential economic slowdown. That said, many broad market indices showed positive returns and we still saw plenty of opportunities for active investment management.

We believe that an allocation to alternative assets can benefit diversified portfolios, especially when implemented over the long term. Commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates. Investor appetite within infrastructure remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows. Within the private debt space, high credit quality and global diversification provides safety in a potentially recessionary environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.

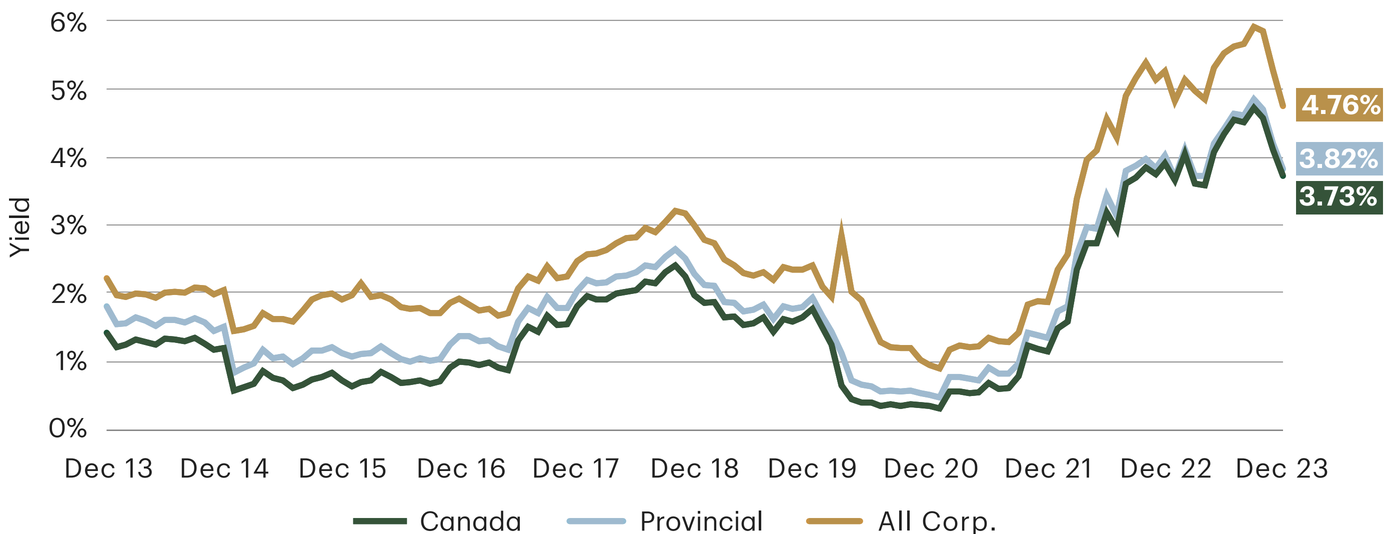
In real estate, Canada's growing demographic profile continues to be supportive of domestic real estate, particularly multi-unit residential. Office properties continue to experience leasing and valuation headwinds and a flight to quality, while fundamentals remain sound across the other property types. Globally, we believe that high-quality assets with low leverage and portfolios that are globally diversified may be able outperform in the current environment.

Outlook

Canadian Commercial Mortgages

The headwind of rising interest rates on performance became a tailwind for commercial mortgages in the fourth quarter as interest rates fell significantly across the yield curve. Notably, the five-year Government of Canada ("GoC") bond yield fell by 66 basis points ("bps"), while the 10-year GoC bond yield witnessed a fall of 93 bps over the quarter. Despite rising for the first three quarters of 2023, the drop in rates caused yields to be slightly lower than where they began 2023, as shown in **Figure 1**. This unrealized appreciation of mortgage holdings augmented commercial mortgage strategies with accretive coupons to deliver very strong returns in 2023.

Figure 1: Short-term Index Yield Decreased Over the Fourth Quarter



Source: Bloomberg L.P. As of Dec 29, 2023.

Most lenders entered 2023 cautiously, with uncertainty looming over the economic outlook and reduced appetite for commercial real estate as an asset class. Many lenders returned from the sidelines following the U.S. State and regional bank flareup in March and high-quality commercial mortgage liquidity continued to improve throughout the remainder of the year. Improving lender sentiment, broad-based lender appetite for high-quality commercial mortgages, and a soft-landing narrative which continued to gain traction were all factors contributing to tightening commercial mortgage spreads in 2023.

Figure 2: Commercial Real Estate Spreads

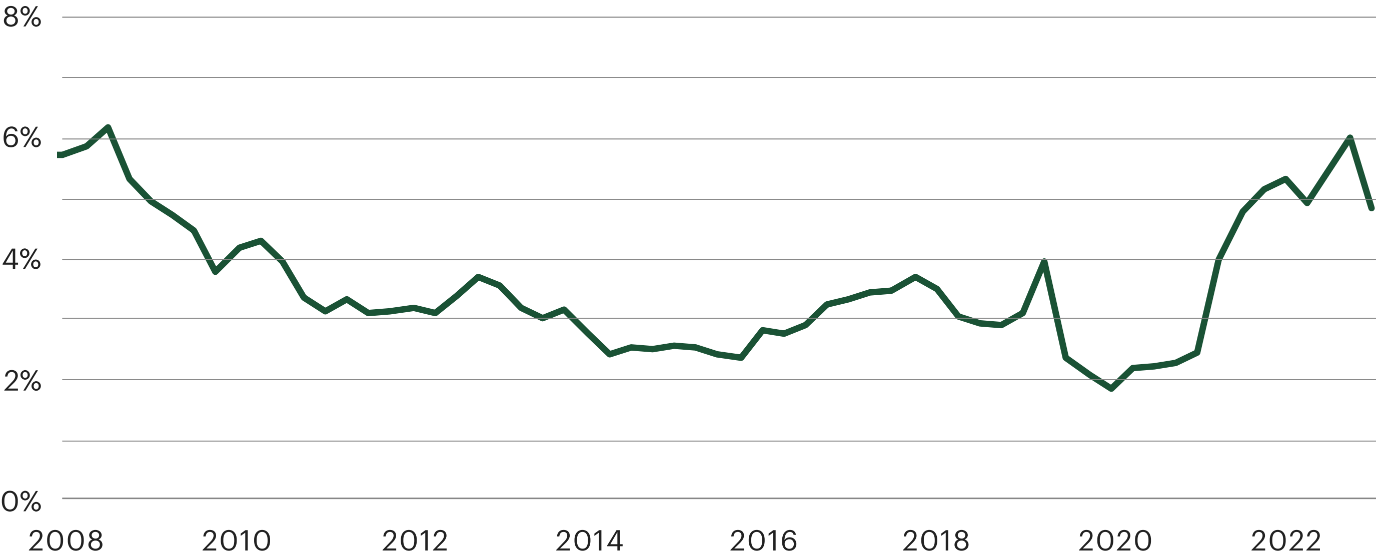
Source: Bloomberg L.P., CMLS Financial. As of Dec 31, 2023.

It was a quiet finish to 2023 with no new major developments on the commercial mortgage front. Top-tier spreads remain anchored narrowly around the 170 bps mark with non-top tier spreads showing wider dispersion between 190-250 bps. Bifurcation of quality was a theme all throughout 2023 and lender preferences continue to be skewed sharply towards industrial, multi- unit residential, and grocery-anchored retail assets. More borrowers are amenable to 10-year terms now that interest rates have fallen from peaks but deal flow is still strongly skewed towards 5-year and shorter terms.

High Quality

Looking forward, commercial mortgage strategies with shorter-term maturities and strong relationships are advantageously positioned in today's market. Shorter-term mortgages allow for expedited repayment and the ability to redeploy lending capital at coupon levels near 15-year highs. The 5-year fixed commercial mortgage rate illustrates this in **Figure 3**.

Figure 3: 5-year Fixed Rate Commercial Mortgage Rates



Source: TD Asset Management Inc. Intellifi. CMLS Financial Risk – average spread of category 6 and 7 maturity of 4.5 years to 5 years. Bloomberg Canada Aggregated Corporate Spread (OAS). As of Dec 31, 2023.

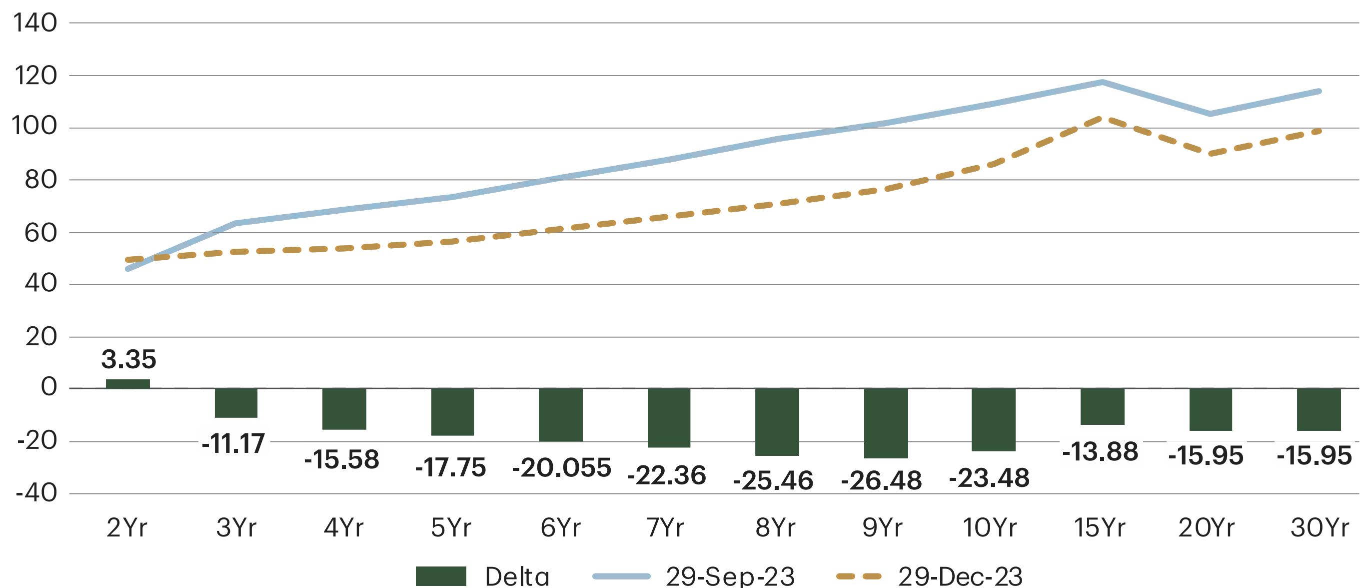
That said, the ability to capitalize on the elevated interest rate market will further come down to the lender's ability to transact with well-capitalized borrowers with excellent properties securing the mortgages. Defensive property types, such as multi-unit residential and grocery-anchored retail paired with high-quality office and well-located industrial should further help bolster income collection from an overall portfolio perspective.

Fixed Rate

Private Debt

After early 2023 was characterized by upward moves in interest rates and stubborn cost inflation, the fourth quarter of 2023 saw a significant reversal of multiple metrics. As inflation eased, central bank rhetoric became more benign and recession fears subsided, rates reversed downward, and credit spreads narrowed to reflect the more stable projected environment. Lower rates and solidified financial markets in Q4 brought private issuers back to the market in short- and mid-term tenors, allowing for strong issuance at stable or lower coupon levels. Longer-term issuance was still very sparce. Private debt yield levels ended 2023 in the 5.0 - 5.5% range, higher than 2022 year-end but lower than the peaks of 2023. The volatile rates environment gave way to a prosperous forward view but should not change private lender's commitment to only deploying client capital when incremental income over comparable public bonds is sufficient to meet our investor objectives.

Figure 4: U.S. Corporate A Spread

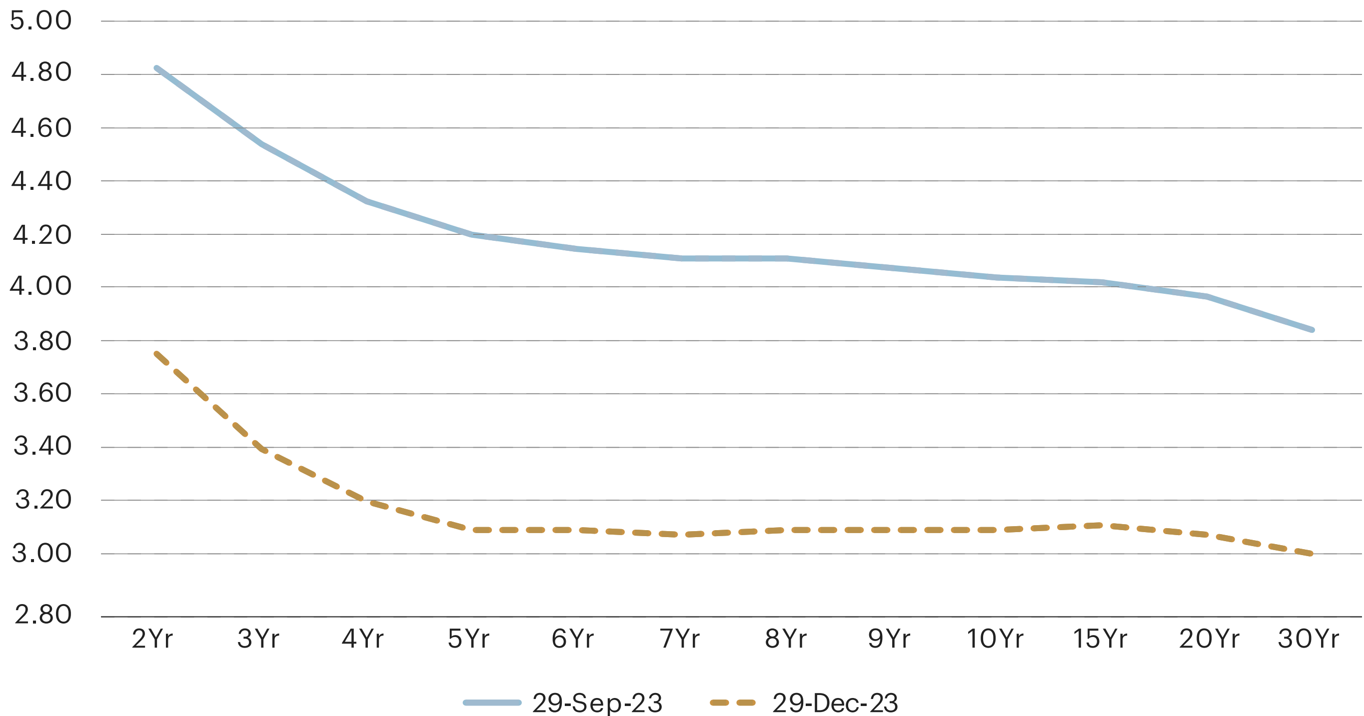


Source: Bloomberg L.P. As of Dec 31, 2023.

Investment Grade Private Debt Market

Over the fall of 2023, investment grade credit spreads in Canada tightened considerably. This combined with a downward shift in the Organisation for Economic Co-operation and Development (OECD) sovereign interest rates to boost fixed-income returns and lower yield levels across the mid and longer-duration part yield curves. As is illustrated in **Figure 4**, credit spreads where lending strategies typically have exposure (US, UK, EUR, AUD) saw material tightening. The same dynamic is shown in the Canadian sovereign rate curve in **Figure 5**.

Figure 5: Canadian Sovereign Curve



Source: Bloomberg L.P. As of Dec 31, 2023.

Private Debt

Global Commercial Real Estate (Canada and International)

Office

In 2023, investors and tenants favored higher-quality spaces and an increase in renovation initiatives in older product to compete with new. In the U.S. market, 6% of office space, which is the equivalent of 330 million square feet within the 5.6 billion tracked by Cushman & Wakefield, is considered obsolete due to misalignment with the escalating demand for hybrid workspaces and evolving efficiency/ESG priorities.[1,2] This narrative extends into the Canadian market, where Downtown Toronto all-office sublease availability plateaued at 4.4 million square feet in Q3 2023, with a notable 2.9% decrease in Downtown Class A sublease availability. This was driven by stronger demand for quality sublet space in newer buildings and the increased flexibility in disposition and termination options offered by landlords.[3]

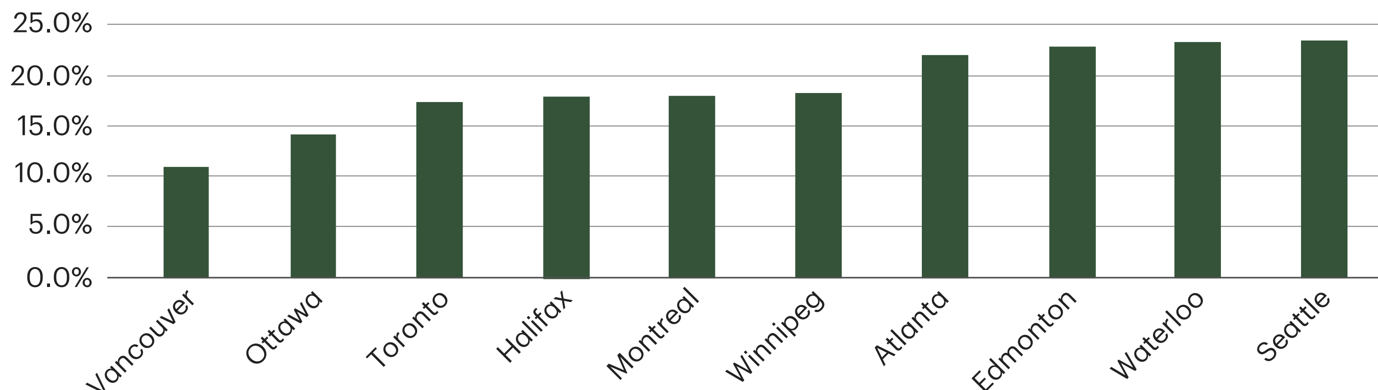
The recovery story unfolds unevenly, with top-tier office products leading in both markets. This highly sought category, representing the top 10 -15% tier of any market, exhibits resilience, recording 100 million square feet of positive net absorption in the U.S. market since 2020.[4] From a supply side, lending constraints and heightened borrowing costs, influenced by high interest rates, are expected to recalibrate the supply pipeline for new constructions in both markets, which should help keep supply in line with the lowered overall demand.[5] In addition, for older stock to remain competitive, there is a shift towards renovating outdated space, with 11.4 million square feet of office stock currently undergoing significant investment.[6]

[1] "2024 US Macro Outlook" - Cushman & Wakefield. As of December 2023.
[2] "Obsolescence Equals Opportunity" - Cushman & Wakefield. As of February 2023.
[3] "JLL Reports Upswing in Toronto Office Leasing in Q3" - ConstructConnect Canada. As of November 2023.
[4] "2024 US Macro Outlook" - Cushman & Wakefield. As of December 2023.
[5] Ibid.
[6] Ibid.

Vacancy rates remain elevated in certain regions globally. In the Canadian market: downtown Toronto's vacancy peaked at 15.8% and Vancouver is at 11.0%, demonstrating their strength against other U.S. counterparts such as Los Angeles and Houston at 25.1% and 29.5%, respectively (see **Figure 6**).[7] Calgary has the highest vacancy rate of 30.9% and is leading policy changes in Canada towards office-to-residential conversions, however the effect of this initiative on their supply issue is expected to be minimal given that conversions tend to only be feasible with smaller sized office buildings.[8]

European vacancy rates increased to 8.3%, with stabilization in some capitals but spikes in Dublin and others.[9] Paris Central Business District, Cologne, and Hamburg maintain lower vacancy rates, indicating a supply shortage for quality office spaces.[10]

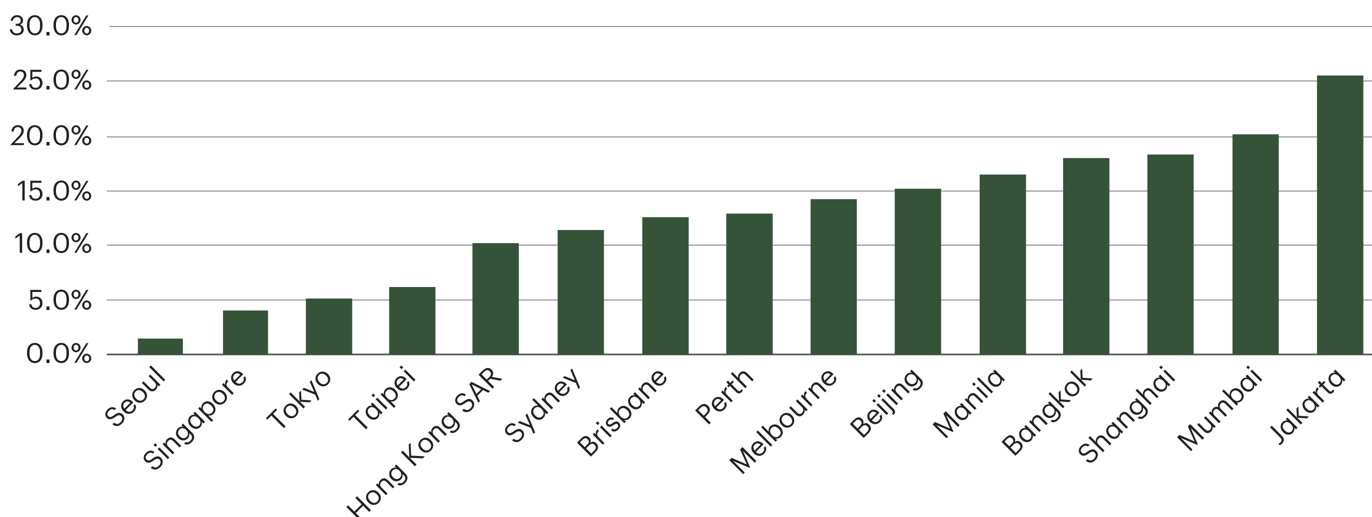
Figure 6: North American Downtown Vacancy Rates



Source: CBRE. As of Dec 31, 2023.

APAC's preference for fully-on site work outpaces the preference for hybrid work, which is more prevalent in North America and Europe. The U.S. leads in hybrid work with 51% of Grade A office tenants adopting this model, while Asian markets like South Korea show 90% of tenants preferring fully in-office arrangements.[11] However, some differences exist within this region which is reflected in regional vacancy rates, with developing APAC cities experiencing the highest vacancies globally in Q3 2023 (see **Figure 7**). Such variances between APAC's developing and developed markets underscore the regional nuances in the adoption of work models post-pandemic and their impact on office space demand.

Figure 7: Asia Pacific Vacancy Rates by City



Source: Knight Frank. As of Sep 30, 2023.

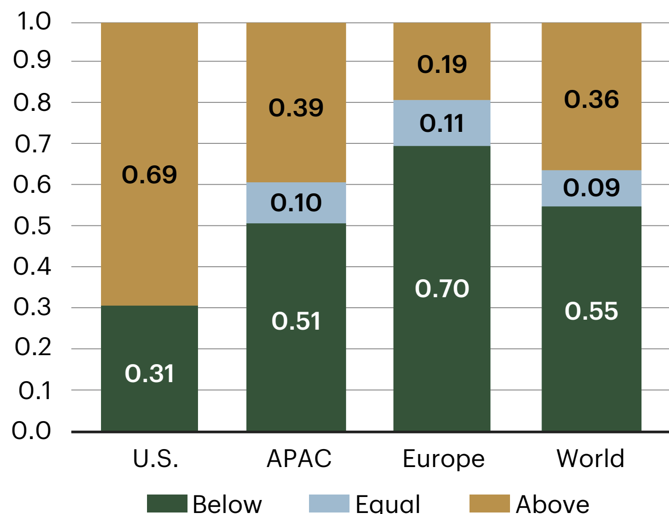
[7] "Canada Office Figures Q3 2023" - CBRE Canada. As of Q3 2023.
[8] "Calgary Office Conversion & Upcoming Developments" - Calgary Herald. As of November 2023.
[9] "Occupational Markets Research Article" - Savills. As of Q3 2023.
[10] Ibid.
[11] "AP Office Spotlight July 2023" - Savills Asia-Pacific. As of July 2023.

Overall, global office markets are transitioning towards high-quality, ESG-compliant spaces and spaces that can allow for better hybrid work environments. This shift is leading to the obsolescence of older office stocks and a surge in renovations. Resilience remains strong for top-tier office spaces, and the limited forecasted new supply in certain cities presents an opportunity to recalibrate demand-supply dynamics. European markets show varied vacancy trends, and the APAC region predominantly favors traditional in-office work, underscoring global regional differences in post-pandemic office space demand.

Retail

Post-pandemic retail rent recovery has varied by region (see **Figure 8**). Select prime retail destinations in Europe and the APAC regions are still grappling with the aftermath of the pandemic with most rental rates still below pre-pandemic levels, while the U.S. demonstrates the opposite. However, this is not broad-based in the U.S., but rather more nuanced, as some cities like Seattle Central Business District experienced strong rental declines, while other high-street locations, such as Oak Street in Chicago, recorded growth of over 9% year-over-year.[12]

Figure 8: Proportion of Markets Above, Equal or Below Pre-Pandemic Retail Rental Rates



Source: Cushman & Wakefield, Main Streets Across the World. September 2023.

North America has also experienced varying degrees of retail foot traffic. Within the U.S., challenges in the form of lower foot traffic within certain downtown central business districts had a noticeable correlation with lower return-to-office rates. This has had a negative impact on retail fundamentals within central business districts. According to a report by CBRE, for the first time in more than 15 years, U.S. availability rates in downtown central business districts have surpassed that of suburban retail.[13] With higher levels of remote work in the U.S., workers' preferences have gravitated towards shopping in places closer to home (i.e. suburbs) and retailers have taken note of these emerging shopping habits.

In Canada, downtown retail in major cities like Montreal have seen improving levels of foot traffic.[14] One of the main contributors to this would be the return in tourism levels, but also Montreal's opening of the Réseau express métropolitain, a new automated light metro network between the South Shore and the city centre which has allowed for better and efficient access to its downtown core. Vancouver's high street retail node, Robson Street, also saw upward momentum in leasing rates thanks to strengthening international and domestic travel and increasing returns to office, which has added additional foot traffic to the node.

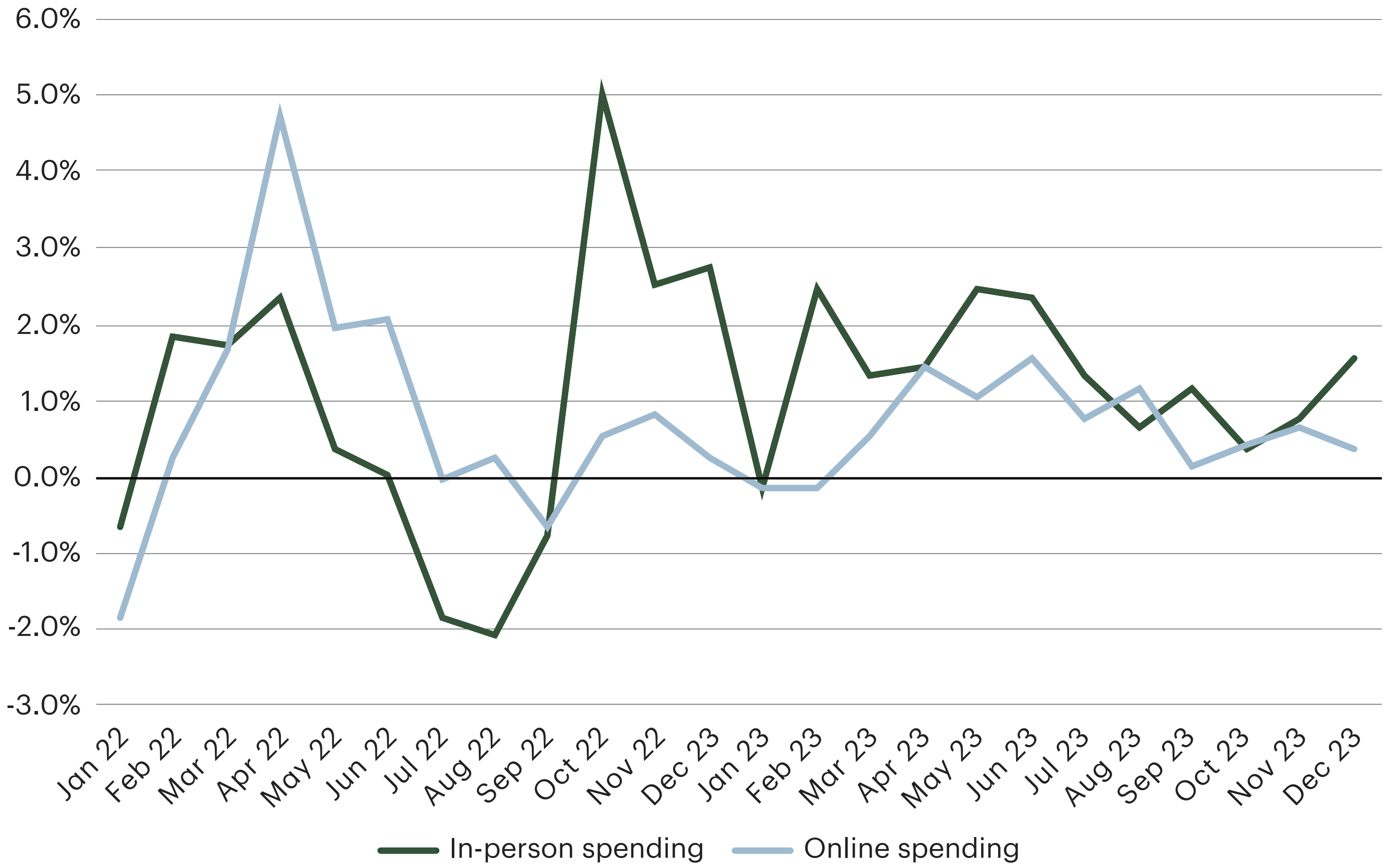
[12] Cushman & Wakefield, Main Streets Across the world. September 2023.

[13] CBRE Econometric Advisors, The Full Picture, December 20, 2023.

[14] JLL Retail Outlook, Canada, Fall 2023.

Looking at property subtypes, Canada has seen a bifurcation in the retail segment over the year. Large shopping centers and grocery-anchored retail sites are benefiting the most from the recovery and stabilization of in-person shopping (see **Figure 9**), while suburban strip malls have struggled.

Figure 9: In-person Shopping in Canada



Source: RBC Data & Analytics, RBC Economics. As of Dec 31, 2023.

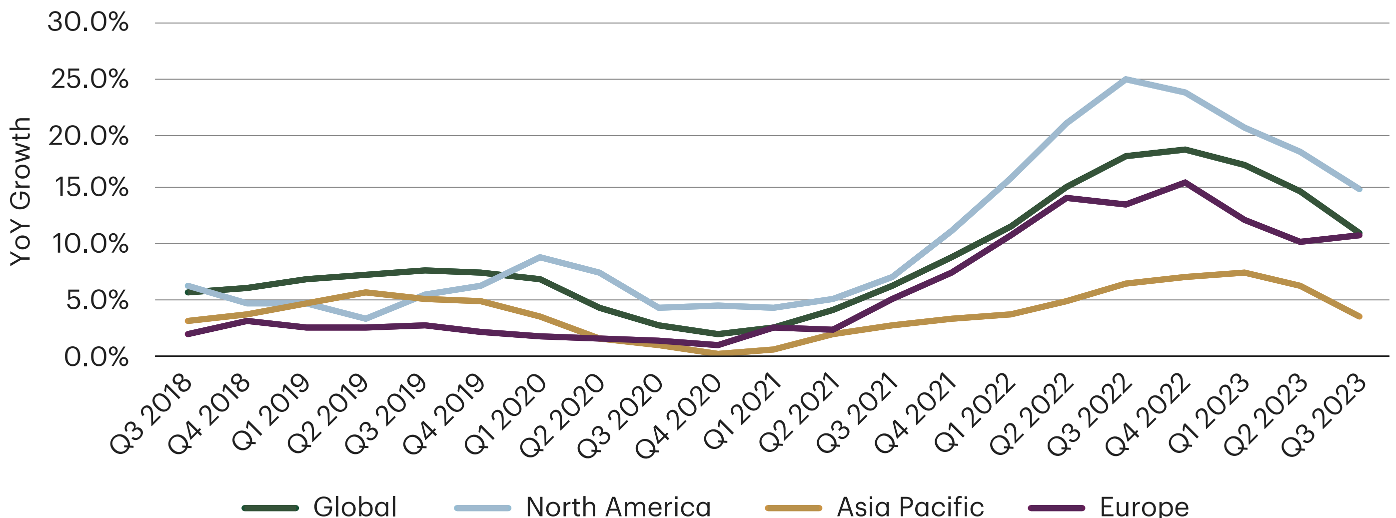
Selecting resilient retail subtypes will be crucial for real estate investors. The importance of focusing on amenities, experiences, and selecting a diversified tenant base can ensure retail centres are best positioned to cater to a wide consumer base. In addition, large retail sites with residential densification potential are becoming critical to creating a greater sense of community, while enhancing capital value.

Resilient

Industrial

Deceleration in logistics rental growth across key global markets (see **Figure 10**) illustrates a shift from the rapid ascents of previous years to more measured increases. North America's rental growth has moderated to a 15% increase, Europe is at 10.8%, and Asia Pacific has grown by 3.6%, reflecting a positive yet stabilizing trend in the industrial sector (see **Figure 11**).[15] Despite the slowdown from historic highs, the sector still maintains a favourable growth trajectory, indicative of persistent demand for logistics spaces in a post-pandemic economy adjusting to new supply chain dynamics and the continued rise of e-commerce.

Figure 10: Global Logistics Rent Growth



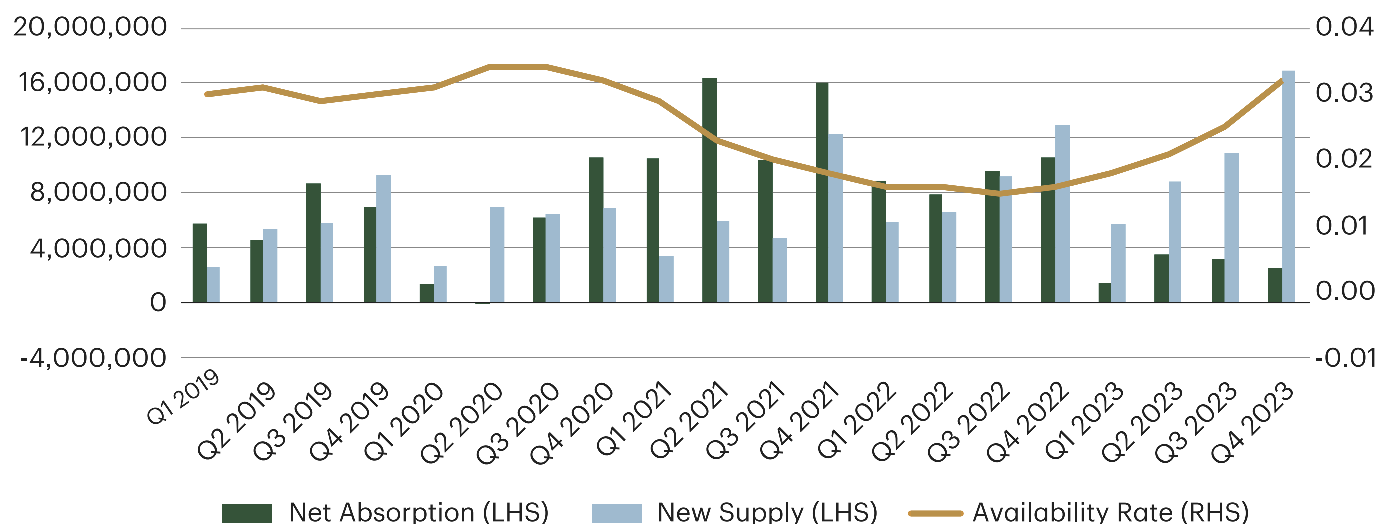
Source: JLL. As of Sep 30, 2023.

[15] "Global Market Perspective: Logistics" - JLL Canada. As of November 2023.

In the U.S., industrial net absorption has moderated from the exceptional levels seen in 2021 and 2022. Approximately half of the expected demand in these years was expedited due to the rapid expansion of online shopping facilities.[16] U.S. industrial availability rates, historically averaging 9%, contracted to a record low of 4.6% in Q2 2022, followed by a gradual rise to 7.1% to end 2023.[17] Despite this uptick, the availability rate is projected to remain below historical averages, with last-mile spaces being particularly competitive.

In Canada, net absorption levels fell to the lowest levels since 2009 and new supply outpaced absorption levels in 2023. One of the contributors to lower absorption levels is attributed to the material slowdown in pre-leasing when compared to a few years ago. For context, 2021 and 2022 saw preleasing activity near 90%, while only 59% of new supply in 2023 was preleased.[18] As a result, availability rates moved up 160 bps through 2023, ending at 3.2%.

Figure 11: Canadian Industrial Supply and Demand



Source: JLL. As of Sep 30, 2023.

In Europe, occupier activity in the logistics sector has also slowed, returning to pre-pandemic levels. The European market peaked in mid-2022 with 46 million square meters of space taken up, but since then total take up volume has receded by nearly a third, dropping to 31 million square meters, bringing it more in line with pre pandemic levels of 30 million square meters per year.[19] Despite these conditions, prime logistics rents in Europe have surged by 37% over the past five years, indicating a persistent demand for strategic nearshoring locations.[20]

The APAC industrial sector showed distinct trends influenced by regional factors. Japan faced a significant shortage in modern logistics warehouses, especially in its regional cities, while areas like Greater Tokyo experienced oversupply.[21] South Korea struggled with an oversupply issue in Greater Seoul, particularly in cold storage segments, resulting in vacancy rates peaking at 20%.[22] Australia's super prime industrial and logistics spaces, notably in Sydney, Melbourne, and Perth, recorded significant rent growth of 20-40% in 2022.[23] This trend continued into the first three quarters of 2023 and then declined to around 20%.[24]

From the historically high rental rate growth and record low vacancy levels the global industrial market witnessed between 2021 and 2022, the sector is stabilizing post-pandemic. Overall, the sector is transitioning from rapid to steady growth, driven by evolving supply chain needs and ongoing e-commerce expansion.

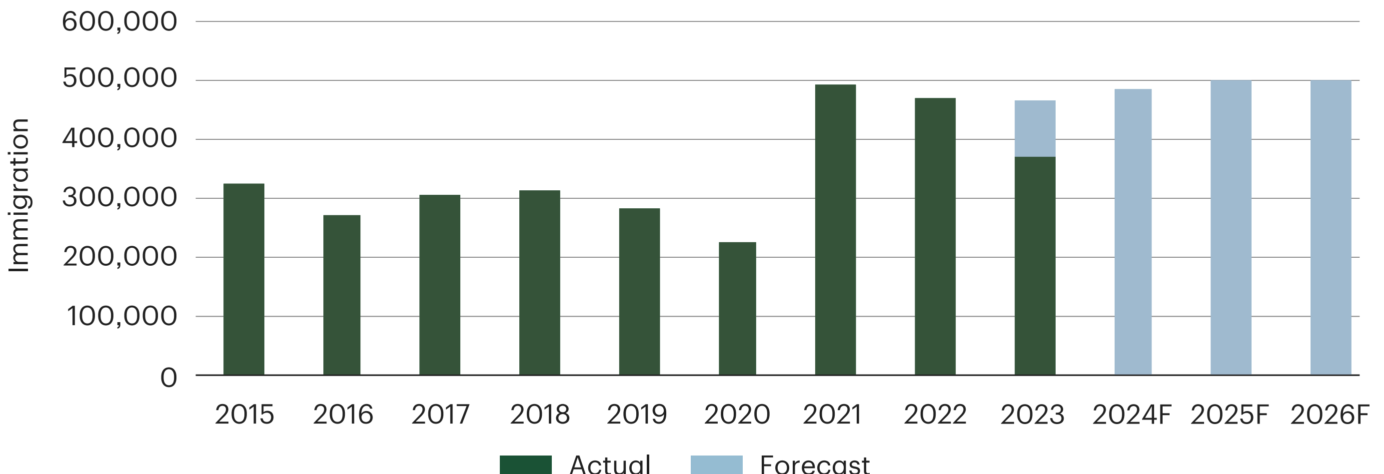
[16] "2024 US Macro Outlook" - Cushman & Wakefield. As of December 2023.
[17] CBRE EA. As of Dec 31, 2023.
[18] "Canada Industrial Figures Q4 2023" - CBRE Canada. As of Q4 2023.
[19] "European Industrial & Logistics Sector Outlook 2024" - Cushman & Wakefield. As of Q3 2023.
[20] Ibid.
[21] "Asia Pacific real estate market update" – Schroders Capital. As of May 2023.
[22] Ibid.
[23] "Australian Industrial & Logistics Figures 4Q23" – CBRE Research. As of Q4 2023.
[24] Ibid.

Multi-unit Residential

In Canada, the lack of purpose-built supply is perpetuated through rising construction costs, labor shortages, high interest rates, and scarce dry powder. The notion of interest rates being higher for longer means that developments, investment, and transaction activity is expected to remain relatively muted in the coming years, further constraining supply.

The continued lack of housing starts, including purpose-built rentals, is unable to meet Canada's growing demand for housing. For example, there is a wide gap in the relationship between housing starts and population growth. Canada grew by 553,568 people from 2018-22, and at the same time, only 205,762 homes were completed in the period.[25] In addition, Canada's immigration-fueled population growth will serve as a tailwind for demand. The federal government is projected to welcome 485,000 permanent residents in 2024 and 500,000 in 2025 and 2026.[26] (see **Figure 12**)

Figure 12: Historical and Forecasted Immigration into Canada



Source: JLL. As of Sep 30, 2023.

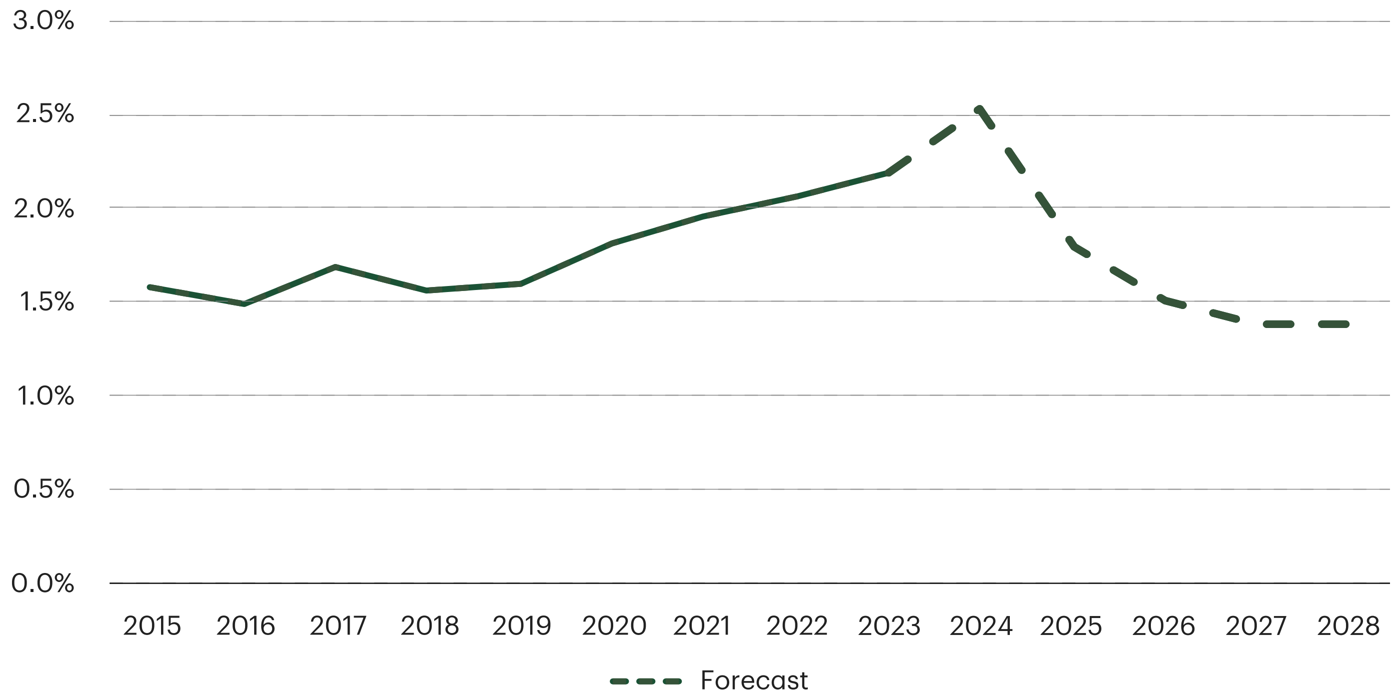
[25] Fraser Institute: Canada's Growing Housing Gap Comparing Population Growth and Housing Completions in Canada, 1972–2022. October 12, 2023.

[26] Government of Canada: Supplementary Information for the 2024-2026 Immigration Levels Plan. November 1, 2023.

Rental demand is picking up beyond just the major urban centres of Toronto and Vancouver. Cities in Atlantic Canada, such as Halifax, are seeing strong growth from the large share of Canadian immigrants coupled with outmigration from the major cities.[27] In Ontario, cities outside of the Greater Toronto Area, such as Kitchener-Waterloo-Cambridge, saw record rent growth compared to the major urban centers.[28] As a result, Canada's provincial and municipal governments are working towards speeding up approval timelines for residential developments to try to facilitate new supply, especially in transit-oriented communities.

The U.S. multi-unit residential market saw demand and supply rebalance to more normal levels. The outsized deliveries of supply over 2023 caused rent growth to decelerate down from the broad-based double-digit rent growth the market experienced during the pandemic. Green Street forecasts that over the next 1 to 2 years, rent growth in certain cities will be hard to come by given the prolonged wave of new supply that will need to be digested (see **Figure 13**). In addition, it is forecasted that coastal markets will outperform due to ongoing home ownership affordability issues and low supply. It is also important to note that the recent deliveries of new supply were less focused in the coastal region. While job growth in the U.S. is softer than a year ago, long-term apartment demand is expected to be sustained by high costs of home ownership and desire for more home space, post-COVID.

Figure 13: U.S. Annual (Year-Over-Year) Multi-unit Residential Supply Growth



Source: Green Street. As of Dec 31, 2023.

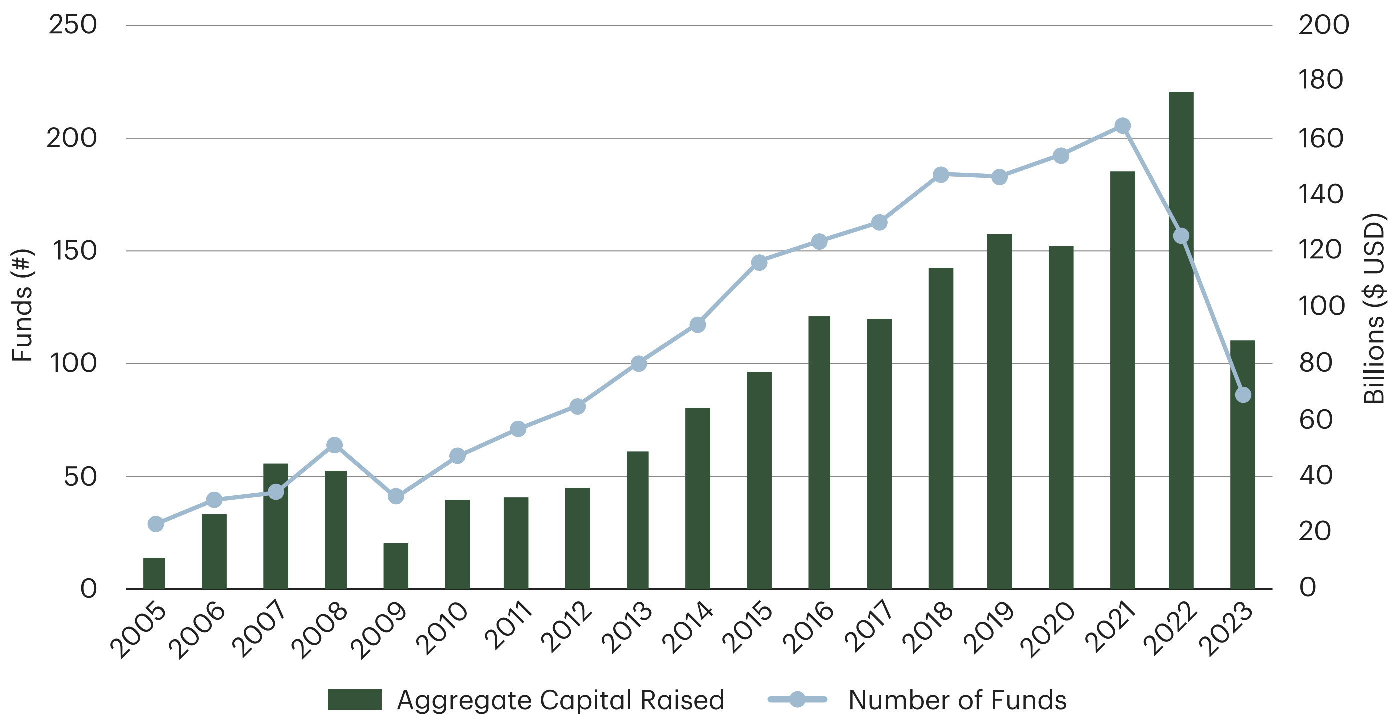
[27] Gove

[28] PWC: 2024 Emerging Trends in Real Estate. As of 2023.

Global Infrastructure

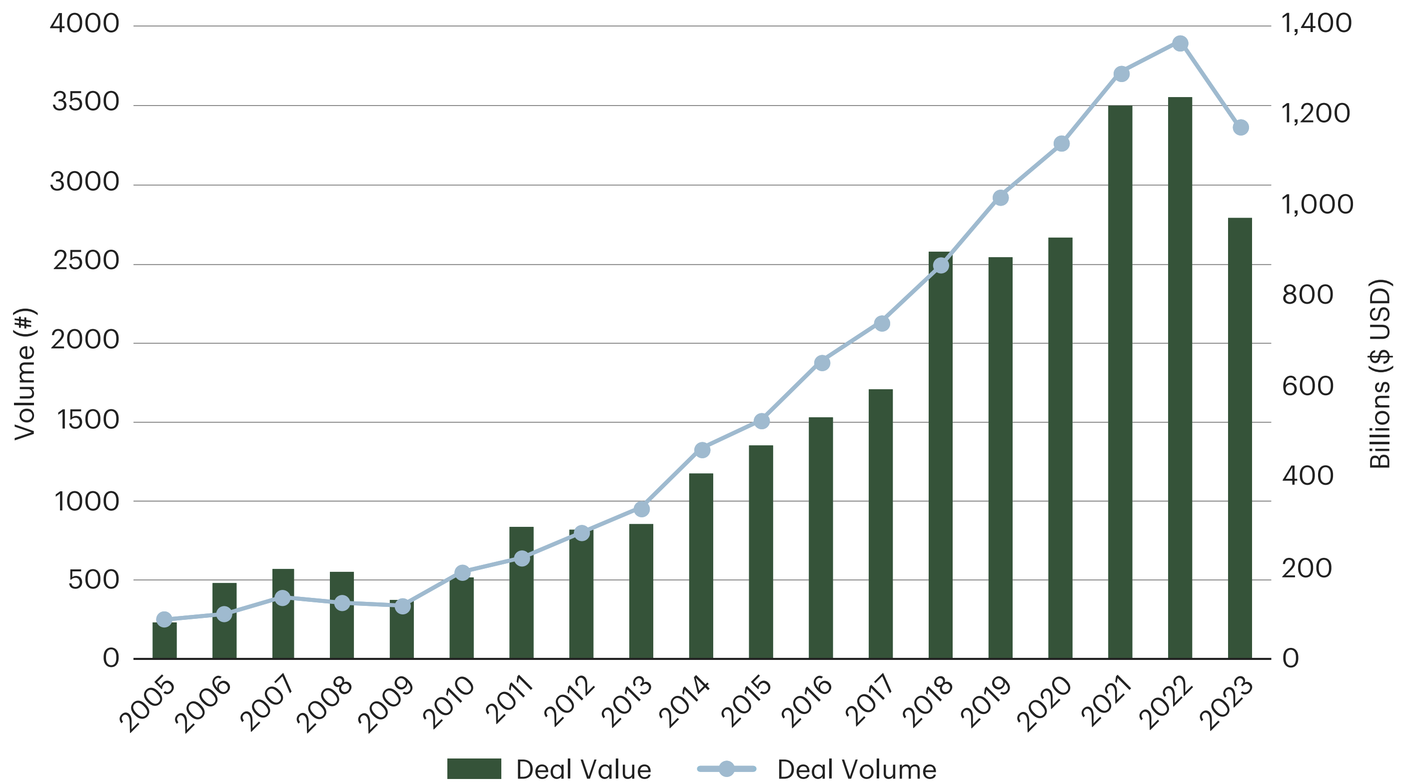
Around the world, cracks have begun to emerge in the infrastructure market with higher rates and rising market volatility. These headwinds are impacting global fundraising and deal activity, which further increases the extensive funding gap identified across the various infrastructure sectors.

Figure 14: Global Infrastructure Historical Funding



Source: Preqin, December 2023.

Figure 15: Private Infrastructure Equity Deals



Source: Infralogic, January 2024.

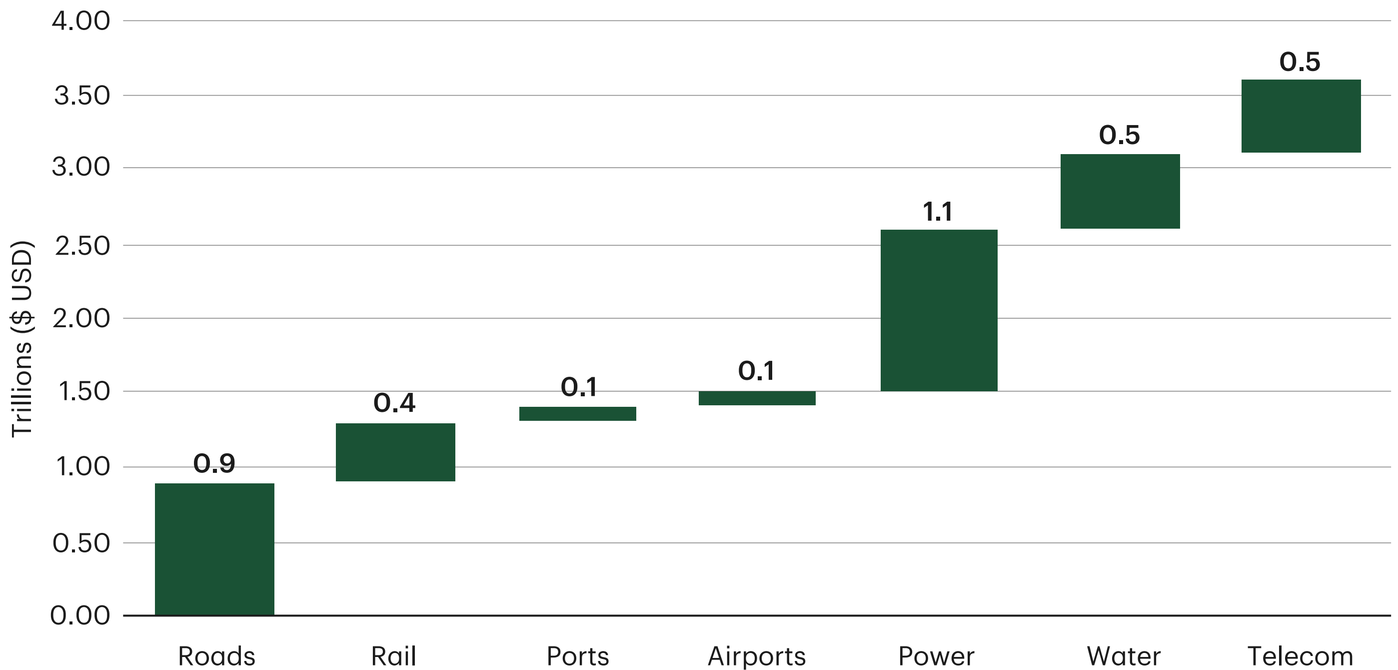
In 2022, it was a record-breaking fundraising year, with US$176.08 billion raised for infrastructure.[29] Since then, the industry has seen the weakest fundraising environment, with only US$87.75 billion raised in 2023.[30] Overall, buyers and sellers remain cautious of the macro environment, resulting in private infrastructure deal volumes falling across geographies. As such, the industry has accumulated over US$300 billion of dry powder.[31] However, buyers are looking for bargains, which sellers are unwilling to agree to, leading to wide bid-ask spreads.

Preqin's investor survey suggests that investors are heavily concerned about interest rates due to infrastructure assets being highly levered. In addition, although long-term rates have increased, the equity risk premiums for infrastructure assets have only increased 50-100 bps.[32] Discount rates are only one portion, the other is free cash flows, where the industry has shined due to strong inflation passthrough, policy support, pricing power, and infrastructure's essential service component. Overall, inflationary pressures in certain parts of the globe are slowing, and central banks will focus on cutting interest rates.

Infrastructure

[29] Preqin. January 2024.
[30] Ibid.
[31] Ibid.
[32] UBS Asset Management. Answering five tough questions from infra-skeptics. November 2023.

Figure 16: Average Global Annual Infrastructure Funding Gap



Source: McKinsey Global Institute, GWI, National Statistics, IHS Global Insight and ITF. As of August 31, 2023, in constant 2017 dollars.

Economic and population growth are the biggest drivers of infrastructure power spending, but the two emerging trends adding to it are deglobalization and decarbonization, through the onshoring of manufacturing capacity and an increased focus on energy security. As a result, renewable energy is expected to climb to 45% of the total U.S. generation mix by 2032 from the 16% it was in 2022. This includes wind, solar, geothermal, and biomass energy.[33] In the U.S., there are several policies supporting these transitions, such as the Inflation Reduction Act (IRA) and the Creasing Helpful Incentives to Produce Semiconductors (CHIPS) Act, to bridge the spending gaps in infrastructure spending.[34]

The evident infrastructure spending gap provides a tremendous opportunity for private investment, but the lack of fund raising requires regulatory bodies to intervene and provide incentives to help meet deglobalization and decarbonization goals. Platforms that have strong relationships and deal flow can take advantage of this market through energy infrastructure to earn attractive returns.

Global

[33] Morningstar. Our 10-Year Utilities Forecast: Renewable Energy to Triple by 2032. October 2023.

[34] Deloitte. State tax credits and incentives in the CHIPS Act and IRA. 2022.

Real Assets Market Report

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