Real Assets: Investment and Economic Outlook

Q4-2017

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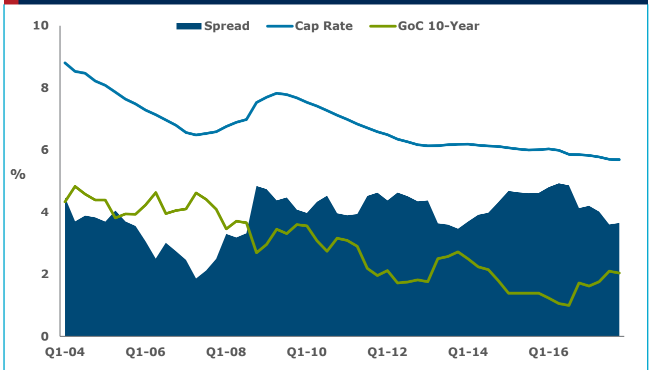
Our base case for 2018 is a continuation of the same themes from last year, although it does mark an interesting phase in the economic cycle. Most estimates of capacity utilization indicate that Canada and the U.S. have only recently reached full potential. Globally, measures of developed market unemployment also indicate that excess labour capacity has been reduced. At the same time, central bankers have taken a cautious approach to raising interest rates due to tempered inflation (CPI) levels, which remain low relative to long-term targets. In our view, CPI is a lagging indicator of the economy and markets may be underappreciating the potential for higher inflation, particularly through the latter half of 2018.

Forecasts are for Canadian commercial real estate investment activity to surpass $40 billion in 2017. This is following a record high in the previous year of $34.7 billion.[1] This is largely due to the stable political and economic environment in Canada and the demand for accretive yield opportunities that is provided by commercial real estate. The average capitalization rate (“cap rate”) in Canada is 5.69% (see Figure 1). This is a decline of 1 basis point (“bps”) from the previous quarter. The spread differential between cap rates and Government of Canada (“GoC”) bond yields narrowed to 365 bps, which is below the long-term average.

Figure 1: Capitalization Rate



Source: CBRE Limited. As at Dec 31, 2017.

In 2017, Canadian commercial mortgage spreads compressed across most sectors. However, the commercial mortgage market continues to offer compelling yield enhancement when compared to a traditional fixed income portfolio.

Within the infrastructure space, a record-breaking amount of capital was raised in 2017. Unlisted infrastructure funds raised a total of US$44.2 billion, representing a 24% increase over the 2016 record of US$35.5 billion.[2] This trend underscores continued interest from institutional

[1] CBRE Limited.
[2] InfraDeals Q3-2017 Project Finance League Table and Trend Report, Infra-News, 2017.

investors to diversify investment portfolios towards privately held infrastructure assets. Other notable trends include a new government led funding paradigm, increased confidence of European institutional investors and a surge of corporate Power Purchase Agreements with renewable generators on the basis of monetary and nonmonetary incentives.[3]

[3] 2017: The Year of Infra, Infrastructure Investors, 2017.

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