SPECIAL REPORT

Marcus & Millichap

CANADA CAPITAL MARKETS

FEBRUARY 2025

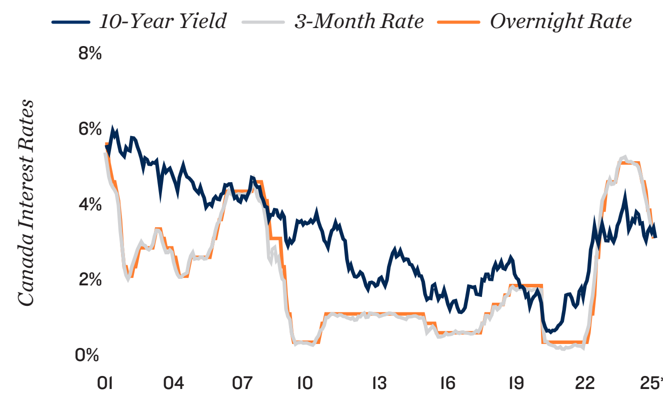
Long-Term Bond Yields Serve as Key Driver for Commercial Real Estate Market Recovery

The 10-year yield remained stubbornly high despite rate cuts. Since the Bank of Canada (BoC) began reducing interest rates in June 2024, short-term rates, such as the yield on three-month Treasury bills, have declined in line with the overnight rate. On the other hand, the 10-year Treasury yield rose notably between September 2024 and January 2025. This trend was also observed in the U.S., which led to heightened market volatility entering 2025. Canada's short-term rates are closely tied to movements in the overnight rate, but its long-term yields are influenced by a range of factors, including the government's fiscal health, long-term inflation expectations, economic growth prospects, central bank guidance and developments in the U.S. Because long-term rates often serve as a benchmark in the credit market, they have significant implications for the commercial real estate sector.

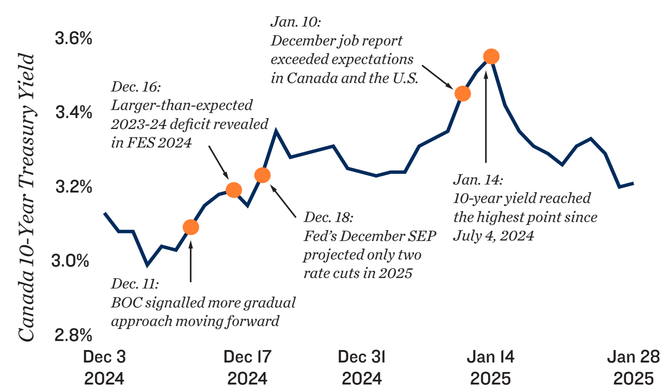
Domestic and foreign factors pushed up 10-year yield in January. While the three-month rate declined alongside the Bank of Canada's rate cuts, the 10-year yield rose due to a series of developments starting in late 2024. At its December policy meeting, the BoC decided to take a more gradual approach to monetary easing moving forward, suggesting a shift to smaller rate reductions in 2025. Subsequently, Canada's 2023-24 fiscal deficit, as outlined in the Fall Economic Statement (FES), was more than $20 billion larger than initially expected, indicating increased government debt liability. In the U.S., the Federal Reserve's latest Summary of Economic Projections (SEP) signalled just two rate cuts in 2025 – a significant scaling back from the four cuts projected back in September. Following this, the December job reports beat expectations, reinforcing a more cautious approach to future rate cuts and driving up long-term yields.

CRE market highly sensitive to long-term rates. The rise in long-term interest rates over the past three years has not only made financing more challenging for real estate buyers, but it has also narrowed the spread between government bond yields and real estate returns. This shift has decreased real estate's appeal when compared with other investment vehicles. In 2023, for example, total number of sales dropped by 22 per cent, with activity showing only a modest recovery last year. In the equity market, where high-frequency real-time data is available – such as the S&P/TSX Capped REIT Index – there have been four periods over the past 12 years where movements in the 10-year yield displayed a negative correlation with the performance of real estate returns. Most recently, the climb in the 10-year yield since September 2024 has led to a 15 per cent loss in the REIT Index.

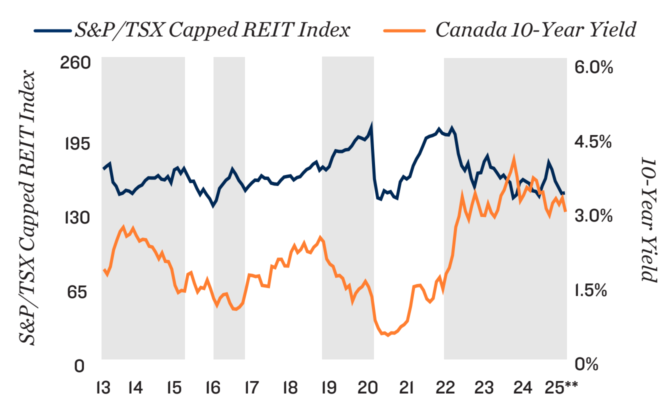
Long-Term and Short-Term Rate Trends



10-Year Reached Five-Month High in Early 2025



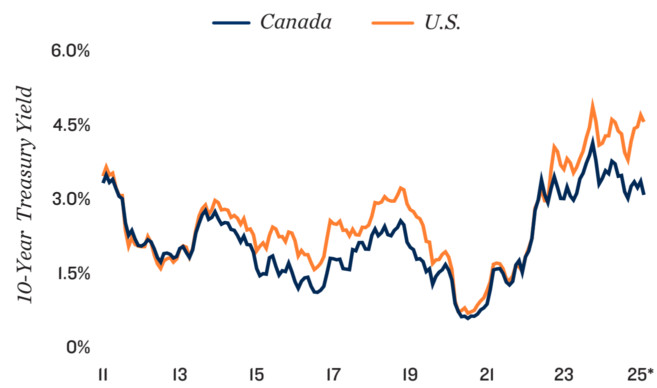
REIT Index Trend vs. 10-Year Yield



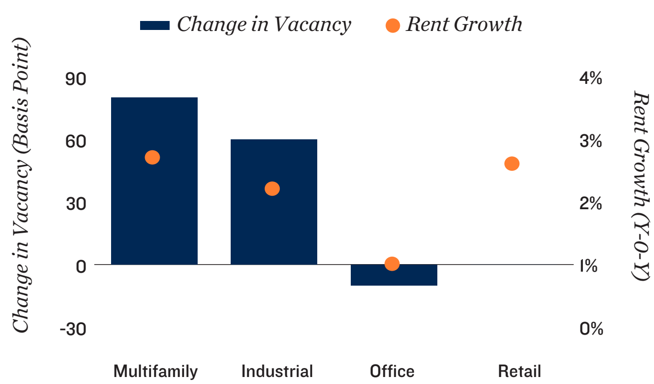
** 10-year yield through Feb. 11, three-month rate through Jan. 28; ** S&P/TSX Capped REIT Index through Feb. 11; Shaded areas show a negative correlation between REIT Index and 10-Y*

Sources: Bank of Canada; Bureau of Labor Statistics; Federal Reserve; Government of Canada, Statistics Canada; Yahoo Finance

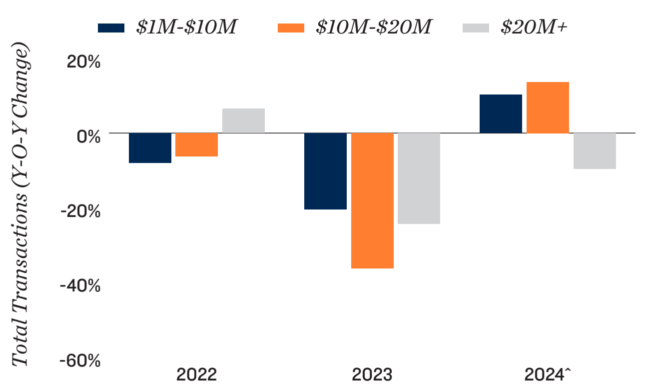
Canada and U.S. 10Y Yield Diverging



2025 Vacancy Rate and Rent Forecasts



Transaction Volumes Have Begun to Recover



Lower yields expected in Canada over 2025. Historically, Canada's 10-year yield has closely tracked its U.S. counterpart; however, this trend has diverged since late 2022, with the gap widening to nearly 150 basis points in early February 2025. This rate differential largely reflects Canada's weaker economy, which has led to a more accommodative monetary environment. The country's subdued growth outlook has been further complicated by potential U.S. tariffs heightening recession risks. These developments not only warrant additional easing from the BoC but also increase demand for government bonds – a low-risk investment – exerting downward pressure on long-term interest rates. While inflation could reaccelerate in the aftermath of a potential trade war with the U.S., the BoC is expected to maintain a dovish stance to mitigate the negative impact. As such, the recent rise in long-term rates is likely temporary and may be followed by a gradual decline over the course of 2025.

Rate movements influence CRE performance. As demand in the homeownership market is highly sensitive to interest rates, a decline in yields is set to boost single-family home sales in 2025. This could put pressure on demand for purpose-built rentals, though, which could lead to higher vacancy rates and slower rent growth amid tighter immigration policies. In the labour market, lower yields will support job creation, particularly in the tech sector and among small and medium-sized enterprises. For this reason, office demand should improve this year, helping to stabilize vacancy rates nationwide. Falling yields will also ease household debt burdens, thereby supporting consumer spending. The retail and industrial sectors will benefit as a result, with their vacancy rates holding at healthy levels throughout 2025. Trade tensions are still a material threat to these positive trends, however. Any expected recovery could be significantly disrupted if potential U.S. tariffs materialize.

Healthy fundamentals and lower rates to improve sales activity. In the wake of lower interest rates, transaction volumes for smaller deals began to recover last year; meanwhile, sales of larger properties, which typically require more financing, remained subdued. A gradual recovery in transaction activity is expected this year while long-term yields edge lower. Yet, as geopolitical and economic conditions rapidly evolve both domestically and abroad, the path to recovery is likely to be fraught with uncertainties. Investors will therefore stay cautiously optimistic this year. They will deploy sidelined capital as financial and political conditions ease, but continue to favour sectors and areas better positioned to navigate these challenges.

** U.S. 10-year yield through February 10; ^ Trailing 12-month sum through 3Q*

Sources: Marcus & Millichap Research Services; Altus Data Solutions; Bank of Canada; Bureau of Labor Statistics; Federal Reserve; Government of Canada, Statistics Canada; Yahoo Finance

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