BRITISH COLUMBIA REAL ESTATE ASSOCIATION

Commercial Leading Indicator

BC Commercial Leading Indicator Points to Strong Growth Ahead

The BCREA Commercial Leading Indicator (CLI) continued to signal strength in the BC commercial market, rising 0.8 points to 112.6 from a revised level of 111.8 in the first quarter. On a year-over-year basis, the CLI is now 3.7 per cent above its level in the second quarter of 2011.

The trend in the CLI has continued a steep rise from early 2011, reflecting a pick-up in employment numbers, particularly in the manufacturing sector, as well as calmer financial market conditions. A rising trend in the CLI has in the past been consistent with an acceleration in commercial real estate activity in the subsequent two to four quarters.

This quarter's increase in the CLI was driven entirely by the employment and financial components of the index while some economic activity measure, such as retail sales, have trended lower. Indeed, after making a significant contribution to gains in the CLI for the past five quarters, the economic activity component of the CLI has been flat for two consecutive quarters. For certain industries, particularly those important to the industrial sector like manufacturing, storage, and transportation, elevated global economic uncertainty through the summer months likely produced a slight drag on activity. As those global economic fears quiet down and the BC economy continues to produce stronger job growth, we expect to see improvements in economic activity.

About the CLI

The BCREA Commercial Leading Indicator was designed to forecast changes in broad commercial real estate activity. Our research shows that the variables that compose the CLI reliably forecast BC commercial real estate activity at a lag of two to four quarters. The index is revised each quarter due to revisions in the underlying data.

Commercial Leading Indicator

Economic Environment

The BC economy posted solid growth through the first half of 2012, sustaining momentum gained in the closing months of 2011. Consumer spending has rebounded on the back of much stronger employment growth and new home construction remains strong in spite of a cooling re-sale market.

BC international export growth was impacted by slowing economic growth in emerging markets and the ripple effects from ramped-up uncertainty in the Euro zone. After increasing 14 per cent in 2011, BC international exports rose just 2.2 per cent year-to-date in 2012. Much of the drag in export performance was due to a stark reversal of international exports to Asia. Exports to all major Asian markets but China and Japan have suffered significant declines in 2012. Moreover, economic growth in the US has been disappointing through the first half of the year, posting sub-2 per cent growth in real GDP for two consecutive quarters. This means demand from the US continues to be modest, producing only 3.2 per cent growth in BC goods shipped south of the border.

Photo by: Thom Quine

However, we expect stronger consumer demand, improved employment, and solid construction investment will help to offset much of the drag on growth from softer international export sales this year. We forecast economic growth of 2.5 per cent in 2012, followed by a modest increase in economic growth to 2.6 per cent in 2013. These forecasts are contingent on stabilization of the Euro-crisis as well as policymakers in the US avoiding the so-called "fiscal-cliff" that, if unaddressed, will lead to significant government spending cuts and tax increases that will take a significant bite out of US economic growth in 2013.

Employment

Strong economic growth in 2011 and a solid start to 2012 has started to produce improved employment prospects in the province. Employment growth in 2012 has been a steady 2 per cent compared to less than 1 per cent last year. Much of the rebound in employment growth has been in full-time jobs, an important indicator of business confidence and future income growth.

Isolating employment in sectors that tend to lead commercial real estate activity, office employment continues to struggle, falling slightly for the second consecutive quarter. Conversely, manufacturing payrolls continue to rise in 2012. Average employment in manufacturing grew 5.1 per cent in the second quarter of the year on the heels of over 8 per cent growth in the first quarter. Average manufacturing employment in 2012 is up by close to 20,000 jobs compared to the first half of 2011.

Manufacturing and Trade

The BC manufacturing sector may be starting to feel the weight of a slowing global economy as total sales through the first six months of the year are just 0.5 per cent higher than 2011. Looking below the headline numbers shows a continued divergence in demand for durable goods (such as wood products and machinery) and non-durable goods like food products and pulp and paper.

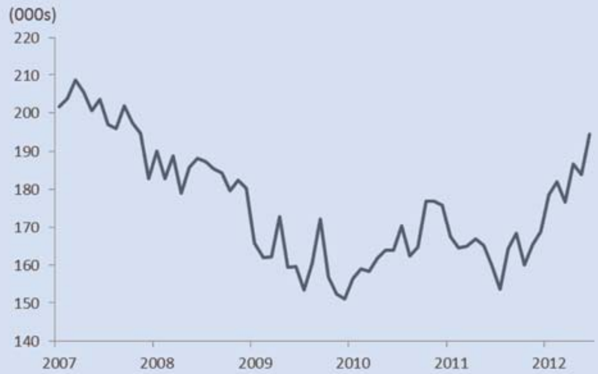
Manufacturing Employment Recovery

The BC manufacturing sector shed over 50,000 jobs from the end of 2007 to the depths of the global financial crisis and ensuing recession in 2009.

Since then, manufacturing employment has been volatile. On a number of occasions, the sector has shown encouraging signs of recovery that unfortunately turned out to be false starts.

However, since the middle of 2011, manufacturing employment has been on a steady march upward. As of June 2012, manufacturing had gained back over 70 per cent of the jobs lost during the recession. If the current pace of job growth is sustained, manufacturing employment could soon eclipse levels not seen in five years.

BC Manufacturing Employment



Source: BC Stats

While growing at a much slower pace than 2011, durable goods shipments are still up 3 per cent this year while sales of non-durables have dipped close to 2 per cent.

In spite of modest sales growth, employment in manufacturing continues to recover, which may signal an uptick in demand for industrial space.

Flagging demand from Asian markets continued in the second quarter. BC exports to Korea have fallen 27 per cent year-over-year while shipments to Taiwan are 10 per cent lower this year. Demand from China remains strong, with BC exports to China rising 17 per cent year-over-year. However, exports to China of some key BC commodities have dipped. Forestry product exports, of which Chinese demand accounted for one third of in 2011, have fallen 11 per cent this year.

New Construction

Perhaps due in part to the growing recovery in manufacturing employment, construction spending in industrial space has posted notable growth. Total industrial construction spending is 50 per cent higher through the first six month of 2012 compared to the first half of 2011. Moreover, strong industrial permitting activity, particularly in Abbotsford and Vancouver, signals that this trend will continue through 2012 and 2013.

Conversely, commercial construction investment has been treading water for a number of quarters and is actually 6 per cent lower than 2011. However, both Kelowna and Metro Vancouver have been bright spots this year, registering double-digit growth in commercial building permits. Moreover, with falling office vacancy, capacity pressure on the Vancouver office market will continue until the large slate of major office projects currently in development are completed in coming years.

Retail Trade and Consumer Spending

Retail sales in BC have grown 4.8 per cent through the first half of 2012, a major improvement from an anemic 2 per cent growth at the midway point of 2011.

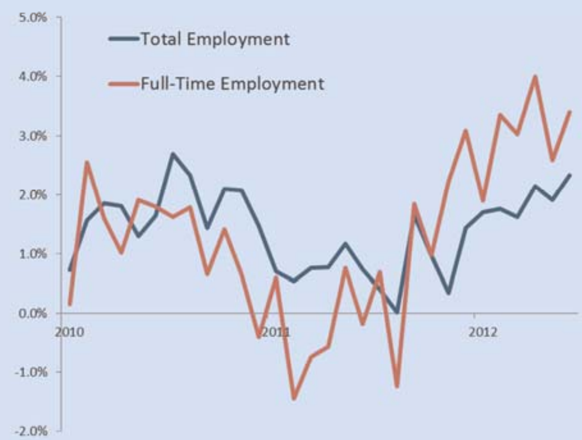
One of the major drivers of this year's improved retail performance is a recovery in BC's full-time employment, which had stagnated in the years following the 2008-2009 recession. Through July of this year, the BC economy has on average added almost 5,000 full-time jobs per month, the highest rate of full-time job creation since 2003.

Better Full-Time Employment Growth Supporting Retail Sector

Weak full-time employment growth since the 2009 recession, and the absence of higher wages that tend to be associated with full-time employment, were likely the major contributing factors to anemic 2011 retail sales.

Since the closing months of 2011, growth in full-time employment has finally started to recover, growing 3 per cent through the first six months of 2012. Consequently, retail sales growth in BC has rebounded from a disappointing 2011, expanding 4.8 per cent through the first half of the year.

Full-Time Employment Growth



Source: BC Stats

Much improved employment growth should help support retail sales for the remainder of the year, though headwinds from a slowing global economy and high household indebtedness may ultimately create a drag on sales growth. We forecast BC retail sales growth to be 4.2 per cent this year.

Interest Rates and Commercial Investment

Global economic uncertainty continues to hold benchmark Government of Canada bond yields to near historical lows. The second quarter of 2012 saw 5-year yields briefly fall to just 1.06 per cent while 10-year yields broke through 2 per cent, eventually falling as low as 1.6 per cent.

In addition to holding down bond yields, economic uncertainty may also be starting to have more of an impact on investor sentiment. The most recent REALpac/FPL sentiment survey showed that, while still broadly positive, confidence in Canadian commercial real estate is beginning to wane.

The third quarter REALpac/FPL sentiment index, which gauges industry senior executive's confidence in Canadian commercial real estate, fell to its lowest level since 2009. The most prevalent concerns among those surveyed were with regard to extremely low capitalization rates and close to peak pricing. That said, markets remain liquid with capital readily available for good quality assets.

Moreover, investment returns on commercial real estate have continued to outpace those on other assets, which should continue to spur demand from increasingly yield-hungry investors.

Diverging Residential and Non-Residential Commercial Cap Rates

As Canadian bond yields reached fresh lows in 2012, commercial real estate spreads on non-residential commercial property have widened.

Spreads on office, retail and industrial commercial real estate have jumped to 400 basis points over 5-year government bond yields due to flattening cap rates and falling bond yields.

Multi-family spreads, on the other hand, continue to undergo some compression as ongoing imbalance between supply and demand has pushed valuations higher.

Commercial Real Estate Spreads

Note: Based on Metro-Vancouver Cap Rates Spread over 5-year Government of Canada Bond Yields
Source: Colliers Canada; Bank of Canada

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