TD Global Investment Solutions

Real Assets Market Report 30 Minutes

Real Assets Market Report

Fall Edition 2024

For institutional investment professionals only. Not for further distribution

Table of Contents

Investment Outlook **3**

Canadian Commercial Mortgages **4**

Private Debt **6**

Investment Grade Private Debt Market 7

Global Commercial Real Estate (Canada and International) **10**

Office 10

Retail 12

Industrial 14

Multi-unit Residential 17

Global Infrastructure **19**

Investment Outlook

In the current environment, alternative assets can benefit diversified portfolios, especially when implemented over the long term. Alternative assets have the potential to provide inflation protection and attractive absolute returns, while acting as long-term portfolio stabilizers via their diversification benefits and less correlated income streams.

Commercial mortgages have provided accretive income while insulating investor returns from the increased volatility in interest rates.

Within private debt, high credit quality and global diversification can provide an income ballast in an uncertain economic environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.

We believe a significant portion of the value adjustments in the Canadian commercial real estate space have been taken. Moving forward, we see more reason for confidence in the multi-unit residential, retail, and industrial spaces. Globally, the majority of the real estate value adjustments have occurred in the U.S., U.K. and Nordic countries, while other regions, such as Australia, are in the midst of value adjustments.

Within global infrastructure, increases in cash flow from higher-than-expected inflation are buffering valuations against rising interest rates. Investor appetite is particularly focused on essential infrastructure that can generate stable, growing cash flows, including energy generation/ transition investments and seaport enhancement projects.

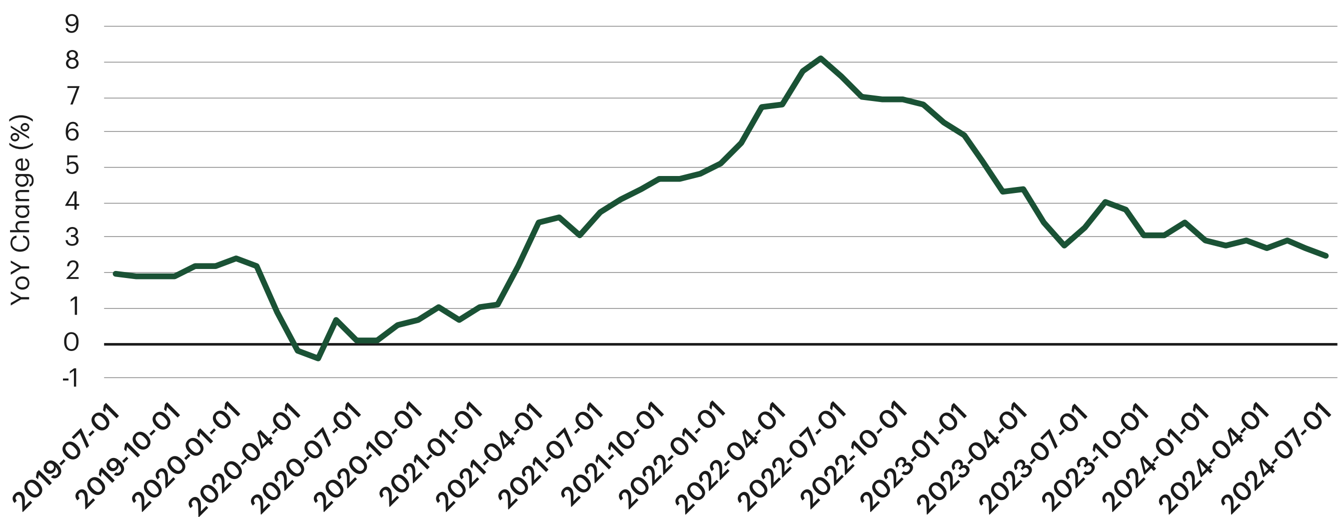
Outlook

Canadian Commercial Mortgages

Over the second quarter, the Bank of Canada ("BoC") began lowering interest rates with a 25 basis points ("bps") cut in June. This makes the BoC one of the first central banks to cut rates. The lower inflation and weaker economic growth are believed to have led their decision. Currently, the market anticipates another 1 or 2 interest rate cuts by the end of the year, and policy rate is expected to be back to a natural rate of 2.25% by 2026[1] which could provide opportunities for borrowers to access more accretive financing which likely will lead to increasing transaction volume within the real estate market.

Figure 1: Canada Consumer Price Index (year-over-year change)

Source: Bank of Canada. As at July 1, 2024.

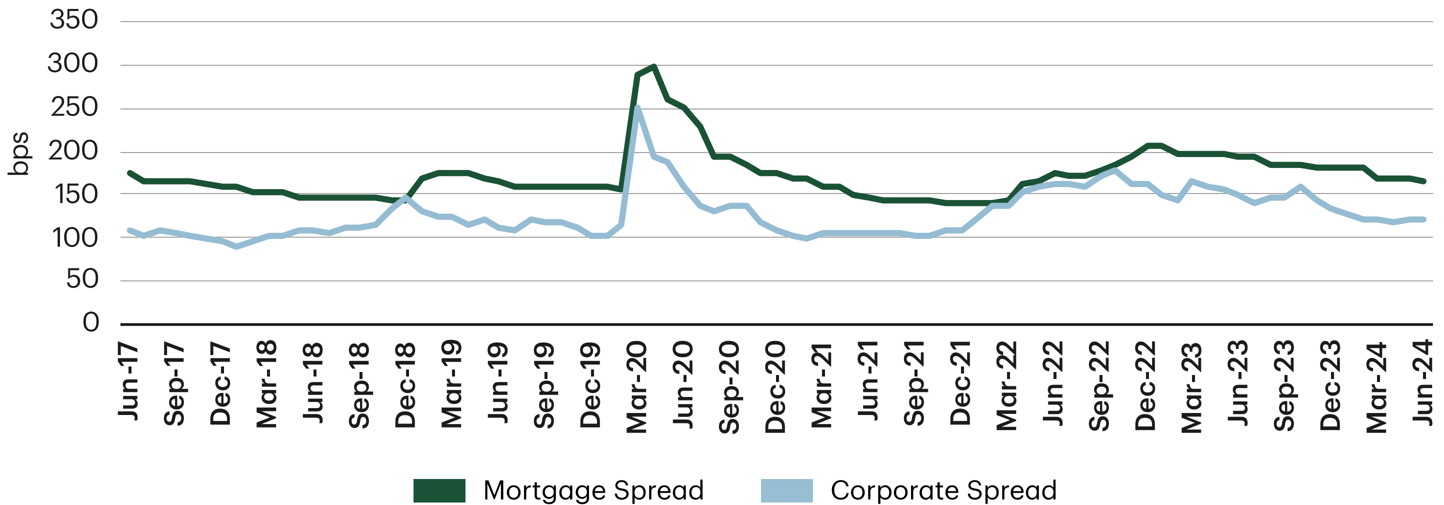


[1] TD Economics. As of Jul 1, 2024.

Commercial mortgage spreads displayed little volatility and continue to tighten. High quality commercial spreads ended the quarter at 150-160 bps, while lower quality spreads remain in the 200-230 bps range. With many major commercial mortgage lenders, including banks and insurance companies, reporting that they are behind their origination targets, competition for deals has heightened, pricing has sharpened and, as such, spreads are experiencing some pressure and are expected to continue to tighten in the short term. However, when compared with corporate bonds, high quality commercial mortgages continue to be attractive with the five-year BBB corporate spreads trading at 123 bps above GoCs.

Figure 2: Mortgage & Corporate Bond Spreads

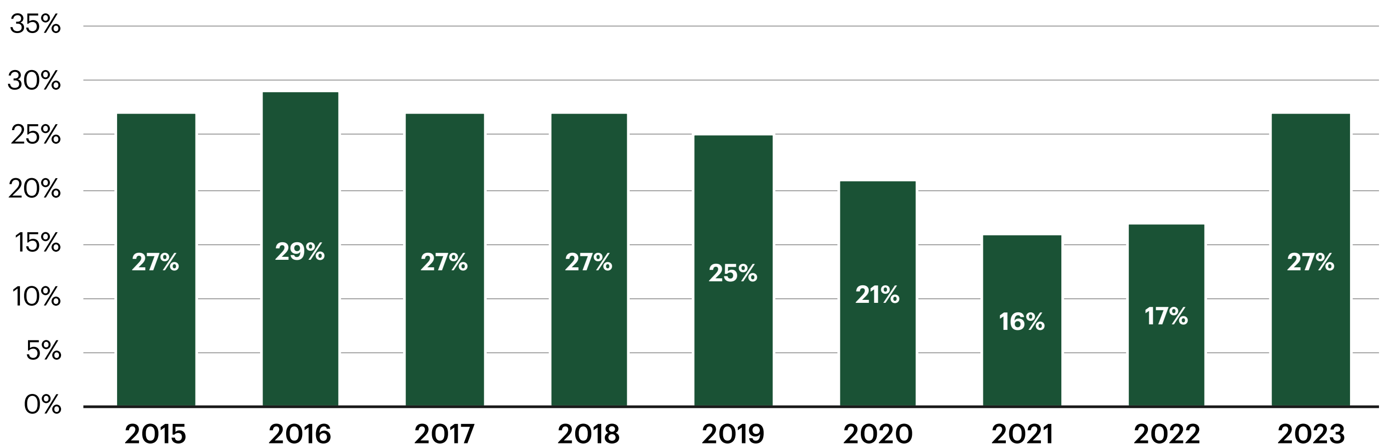
Source: TD Asset Management Inc., Intellifi, CMLS Financial Risk – average spread of category 6 and 7 maturity of 4.5 yrs to 5 yrs, Bloomberg Canada Aggregate Corporate Spread. As of June 30, 2024.



From a property type perspective, multi-unit residential continues to be favored by lenders given the stable fundamentals. Demand for older and lower quality industrial assets have softened. Office remains a concern for lenders and the asset class is seeing very little financing activity. On the other hand, retail assets are seeing increased interest, as both lending and transactions in this sector have grown significantly since the pandemic. In 2023, retail loan origination increased by 36% compared to 2022, which was comparable to pre-pandemic levels. This demonstrates lenders confidence in retail assets and its forward-looking fundamentals, especially for grocery-anchored and necessity-based retail spaces.

Figure 3: Retail Loan Origination (as a % of Total Origination)

Source: TD Asset Management Inc., Intellifi. As of December 31, 2023.



Private Debt

The long-awaited interest rate easing that started during Q2 2024, and continued through the summer months, heavily drove the fixed income and investment grade private debt markets across the G7 countries where most private placement (investment grade private debt) lending happens. Due to long-dated rates stabilization, there has been significant recovery in the long-dated financing program activities compared to previous muted quarters as borrowers that had postponed going to the market have started returning to the market.

As G7 key economic indicators started showing signs of an economic slowdown and progress towards inflation target ranges, central banks have initiated or are expected to start rate cut programs and continue them into H2 2024. This dynamic translated into the normalization of medium and long tenor rates, where key investment grade ("IG") financing happens. It's noticeable that due to strong demand from yield seeking investors, the IG credit spreads are staying close to multi year lows, while overall rates still make the IG private placement space attractive with yields being in the range of 5.0-5.5%.

Despite the positive estimated impact of rates compression in the upcoming months, we remain cautious in our H2 2024 outlook. This is mostly driven by:

- the potential credit spread expansions from current historical lows driven by signs of a slowing economy and slight credit weakening, and
- potential rate volatility coming from the U.S. Presidential election and both candidates' economic plans, including tax, tariffs and its impact on job creation, inflation and national debt.

The sovereign rate curve in Canada has compressed in Q2. On the international side, rates initially rose before compressing over the remaining summer months. Slightly lower all-in interest costs mean issuers started returning to the capital markets in Q2 and later in Q3 – as activity was strong in mid-term tenors. In addition, we saw a strong transaction pipeline with expected closings over H2 2024 as deals materialize and issuers benefit from the stabilizing long rates environment. Private debt yield levels ended Q2 in the 5.0 - 5.5% range, still offering multi-year highs.

Investment Grade Private Debt Market

Over Q2 2024, IG credit spreads in Canada and the U.S. were mixed. In Canada there was spread compression across the curve among A and BBB credit ratings while the U.S. and U.K. corporate spreads expanded somewhat from historical lows.

Figure 4: Canadian Sovereign Curve change in Q2 2024

Source: Bloomberg Finance L.P. As of June 30, 2024.

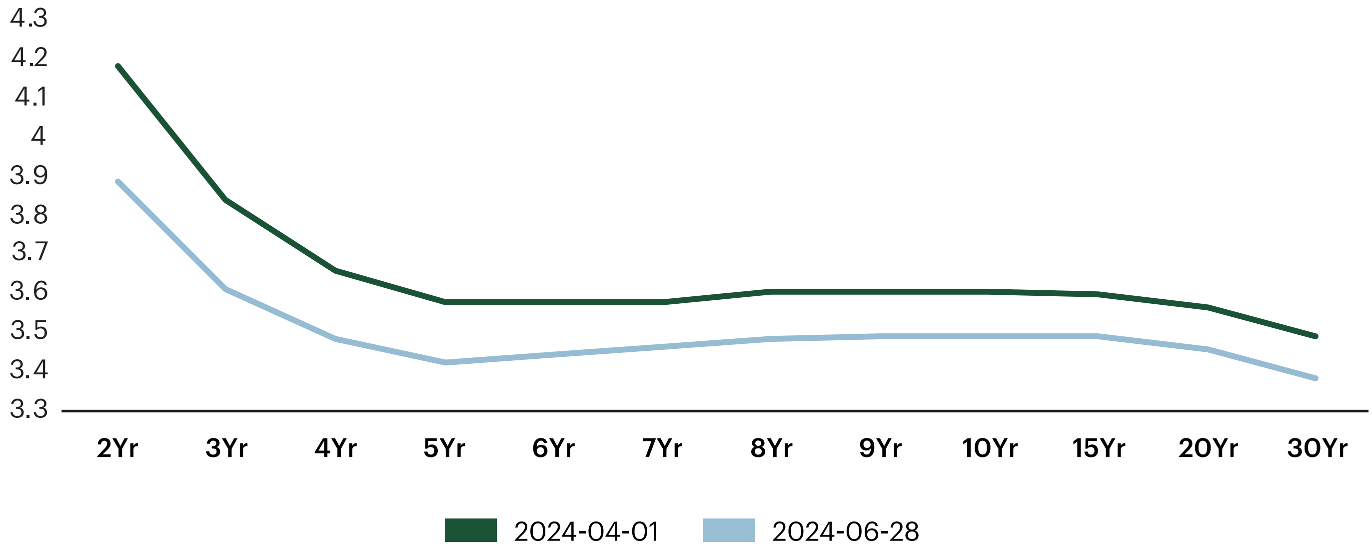


Figure 5: Canada, U.S. and U.K. Investment Grade Corporate Spreads Long-term View, %

Source: Bloomberg Finance L.P. As of June 30, 2024.

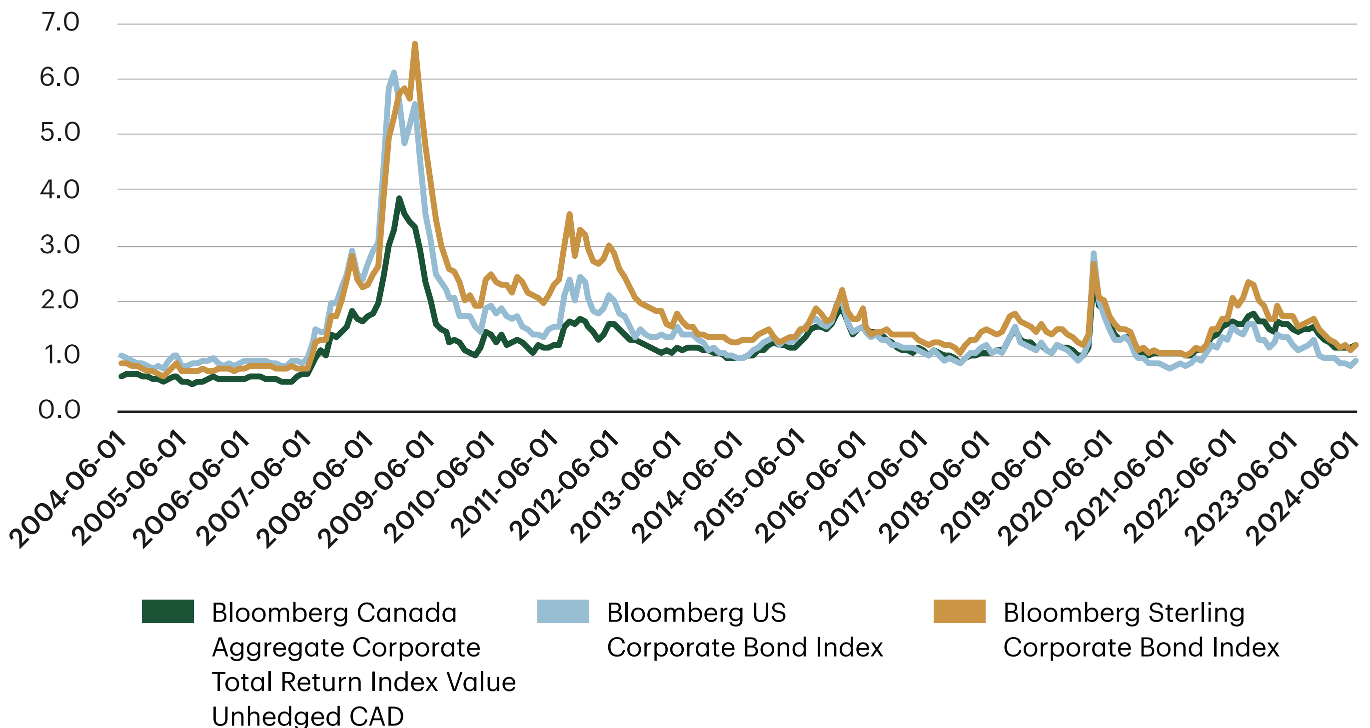
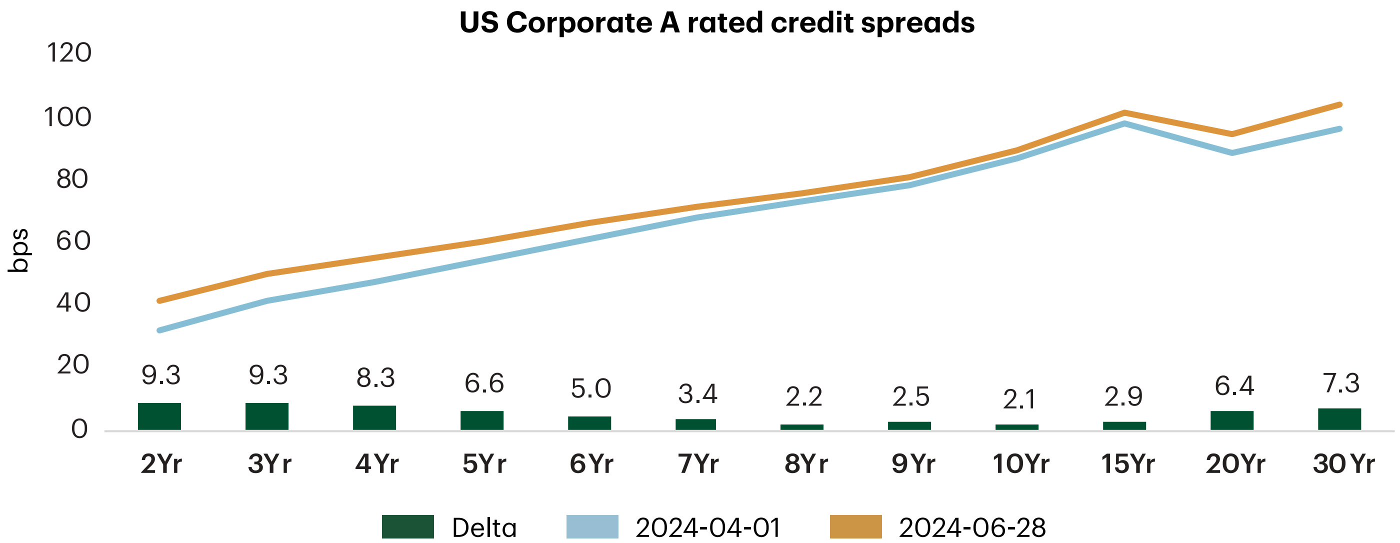
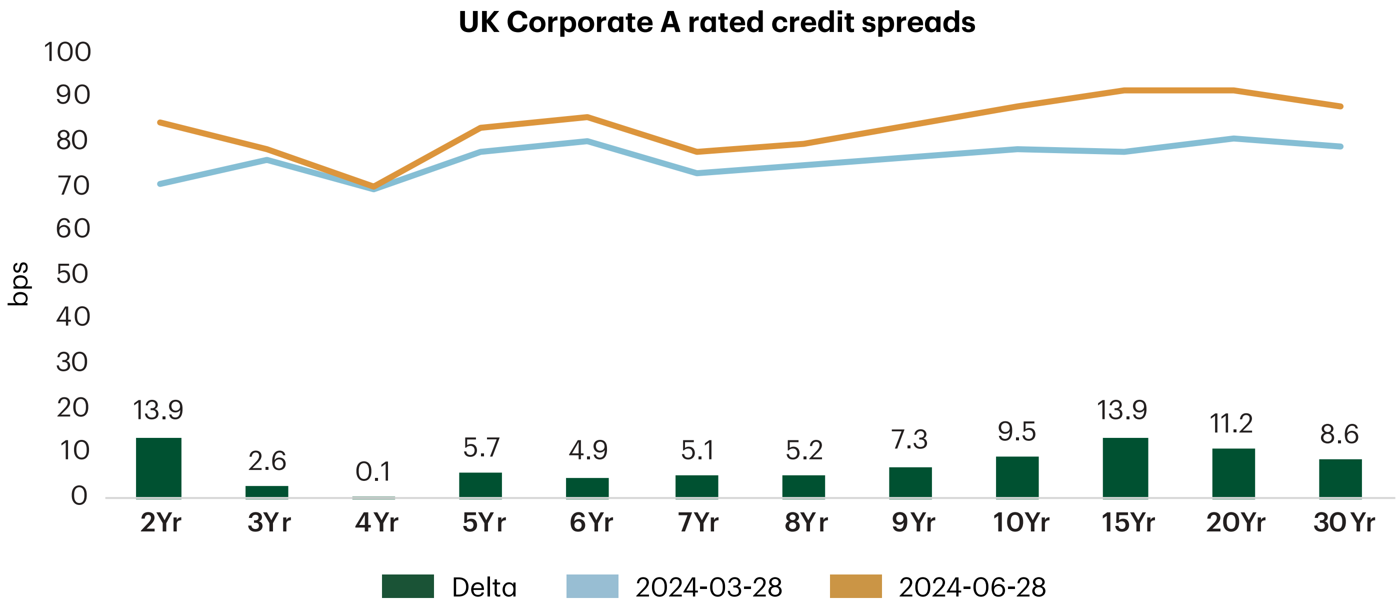


Figure 6: U.S. and U.K. Corporate Credit Spreads Expanding Single Digits, bps

Source: Bloomberg Finance L.P. As of June 30, 2024.





Private Debt

Key Sector Trends

Power & Energy (Renewables)

In Canadian power sectors, new awards for power purchase agreements in BC, Alberta, Ontario and Quebec offer contracted financing opportunities going forward as well as a revival of transaction activity on the already commissioned renewables generation and energy storage projects.

In the U.S., Inflation Reduction Act Tax Credits are fueling new renewables development by project sponsors with the U.S. becoming the second largest market globally for renewable investments after China and seeing first half investment levels rise 63% in H1 2024.

Another big driver of transactions activity is the corporate PPA market, with contracting by big tech companies for clean energy supply to power data centers allowing for the growth of AI solutions.

In other power and energy areas, without structural tailwinds, cumulative interest rate increases over the last couple years continue to mute transaction activity as participants incorporate valuation and leverage cost realities. Lenders should take a vigilant view when taking construction risk in an environment of continued inflationary pressures.

Infrastructure

A promising future pipeline of Canadian social infrastructure projects exists from mid-2024 onwards, assuming governments can achieve budgeted affordability levels. There are attractive opportunities in smaller, niche projects where direct relationships can allow for a swifter adjustment to project cost increases. Strong appetite for infrastructure debt from life insurance companies continues to cap value creation opportunities, particularly on longer-term projects. Again, lenders should remain vigilant when taking construction risk in an inflationary environment.

Private Corporate

Borrowers are accessing the market aggressively as recent stability in medium term rates drive strong issuance. Strong demand from fixed income investors drives corporate spread tightening and, hence, is reducing value creation opportunities with deals closing where buyers' oversubscription on plain vanilla corporate structures pushes spread compressions.

Real Estate

After interest rate increases slowed transaction opportunities, buyers and sellers have continued their adjustment to valuation differentials, coming to market supported by improved and very high-quality tenants or projects. There is value in focusing on multi-unit residential and industrial opportunities given the uncertain backdrop of re-leasing dynamics in select office and retail markets. The transaction bucket is expected to remain muted until commercial real estate valuation levels stabilize and the cap rates expansion cycle is over.

Private Securitization

Attractive transactions with an investment-grade profile are not common outside of the Collateralized Loan Obligation ("CLO") market.

Global Commercial Real Estate (Canada and International)

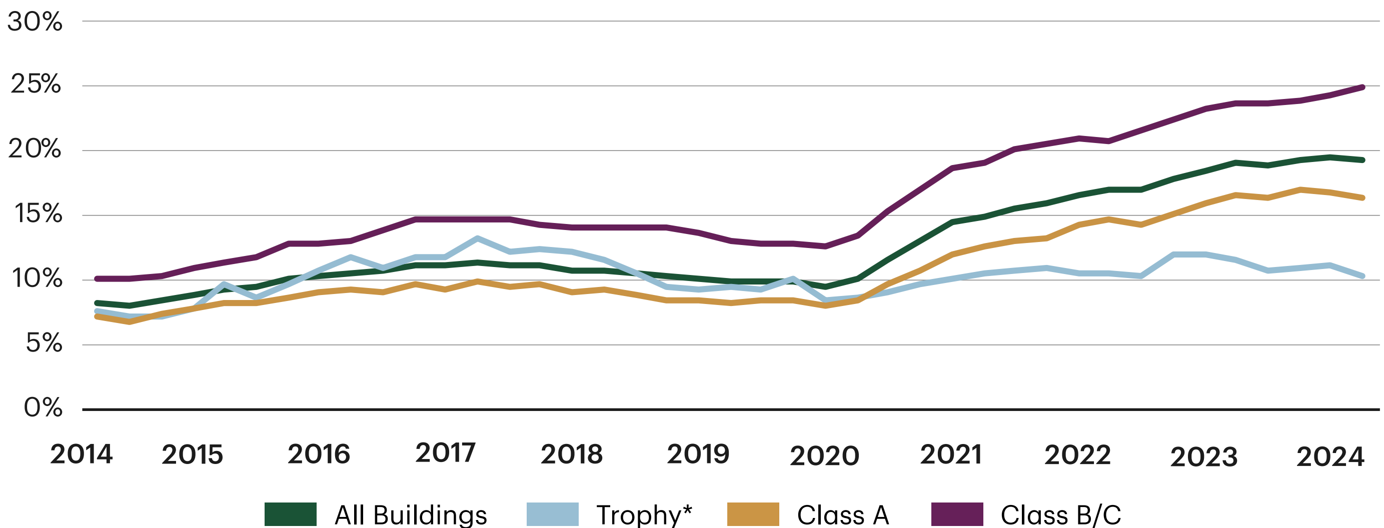
Office

The global commercial office sector is navigating a complex landscape marked by varying regional dynamics. Asian cities have generally shown signs of stability with a notable increase in office utilization rates as more people return to the workplace, which is generally back to pre-pandemic levels.[2] This trend underscores the region's resilience and adaptability, driven partially by cultural factors that prioritize in-office work. Office markets in Canada and the U.S. are lagging but are seeing a slow recovery throughout 2024.

In Canada, tenants are becoming more selective on the types of office spaces, focusing on offices that not only meet their operational needs but help them achieve their sustainability goals. As such, the flight to quality theme is gaining momentum across the board especially in Trophy and Class A office spaces that offer enhanced amenities, modern infrastructure, and better environmental performance. This segment of the office sector is exhibiting lower vacancy when compared to Class B/C office buildings (see Figure 7).

Figure 7: National Downtown Office Vacancy by Segment In Canada.

Source: CBRE Research Q2 2024.



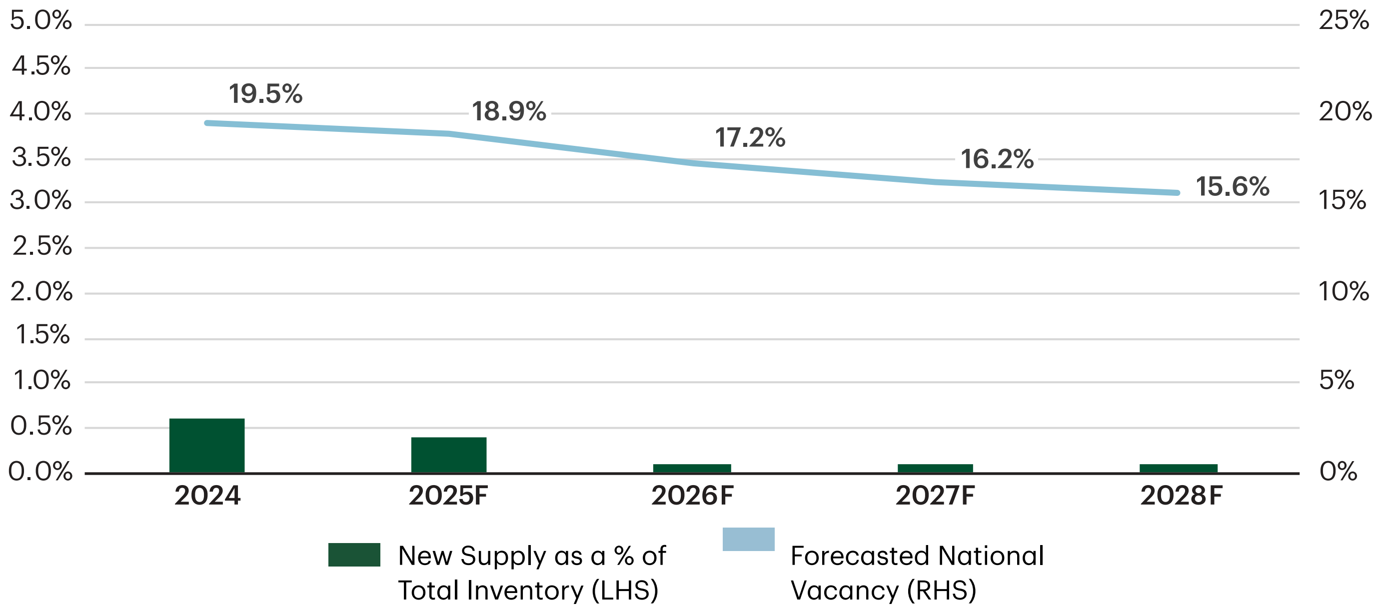
[2] JLL, Global Real Estate Sector Outlook, Q4 2024
* Trophy series includes top-tier properties in Vancouver, Calgary, Toronto and Montreal.

Another positive sign is the two consecutive quarters of notable decrease in Canada's inventory of sublease spaces and positive absorption of 3.0 million square feet.[3] Ottawa has been one of the markets that observed the largest market vacancy tightening from 13% to 11.8%[4] during Q2 2024 as tenants focused on relocating into better amenitized buildings.[5]

Canadian office construction has also fallen to 5.7 million square feet, its lowest level since 2005 and well below the 10-year average of 14.6 million square feet.[6] This restraint in new developments should give the market time to work through the current glut of vacant space. As shown in Figure 8, the significant decline in forecasted supply is expected to help recalibrate the current supply/demand imbalance.

Figure 8: Forecasted Limited Supply Expected to Stabilize Vacancy in Canada

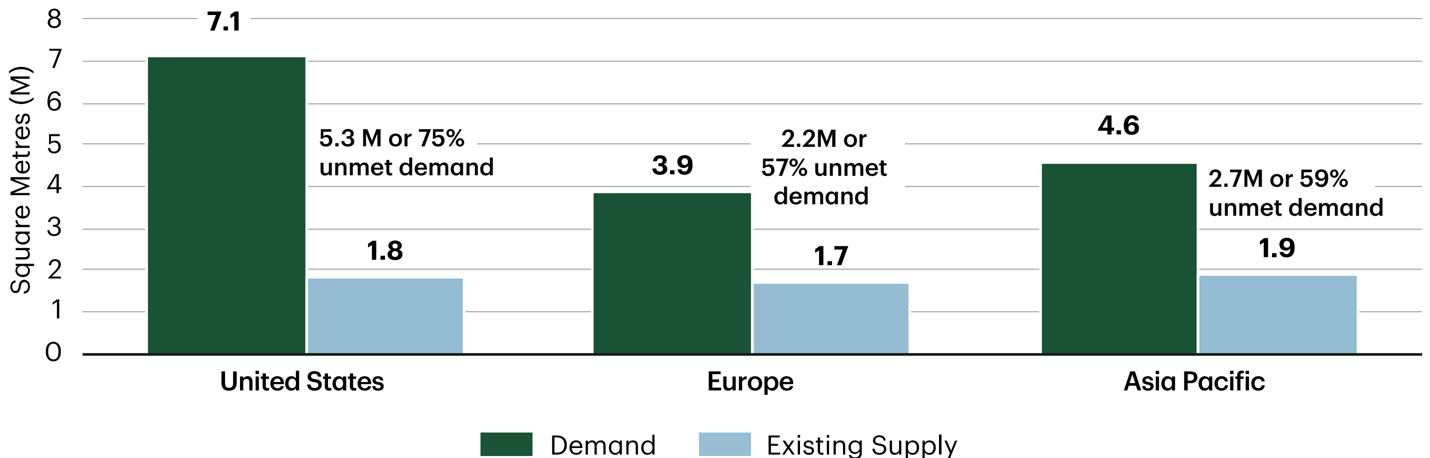
Source: CBRE Canada Office Forecast Q1 2024.



Ultimately, as you look across the globe, the increasing demand for low-carbon office space is outpacing supply, leading to an increased competition for premium spaces across various regions, as shown in Figure 9.

Figure 9: Occupational Requirements for Low-carbon Offices (2023 – 2030)

Source: JLL Global Real Estate Outlook. As at August 2024.

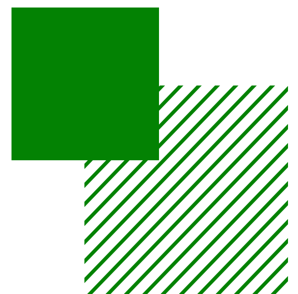


[3] CBRE, Historical Office-Industrial Q2 2024.
[4] CBRE, Historical Office-Industrial Q2 2024.
[5] CBRE Canada Office Figures Q2 2024.
[6] CBRE Canada Office Figures Q2 2024.

Retail

The global commercial retail sector continues to navigate a period of change, driven by a combination of economic recovery, rising consumer confidence, and challenges such as inflation and supply chain disruptions. Generally, North America has been seeing limited deliveries of new retail supply, which has helped improve retail fundamentals. Tourism in Europe and Asia Pacific has surged, boosting foot traffic in retail destinations, especially in key tourist hubs. While each retail market is different, JLL expects that, with the limited supply in desirable locations, prime rents are expected to increase in many markets in 2025.[7]

In the past several years, the retail market in the U.S. and Canada has seen declining availability rates driving improved absorption levels and limited supply deliveries. In the U.S., new supply over Q2 fell 43.4% from the previous quarter.[8] It is expected that it will be challenging for retailers to find high quality space in desirable locations given that retail availability sits at a low of 4.7%.[9] In the past several years, Canada has seen extremely limited deliveries of new supply, particularly super regional malls (see Figure 10). In fact, since 2017 Canada's national retail square foot per capita has declined by 6%. This decline is also driven by Canada's recent spike in population growth, which has been a significant driver to the strength in retail space leasing.[10] Most recent data from ICSC (2018) calculates that Canada's retail square foot per capita was 16.8 square feet, which is below the U.S. at 23.5 square feet, illustrating the relative health of Canada's retail market.



[7] Ibid.
[8] Ibid.
[9] Ibid.
[10] TD Cowen: Implication from Different Population Growth Scenarios in Canada Through 2027. As of June 2024.

Figure 10: Canadian Retail Fundamentals

Source: CBRE. As of Jun 30, 2024.

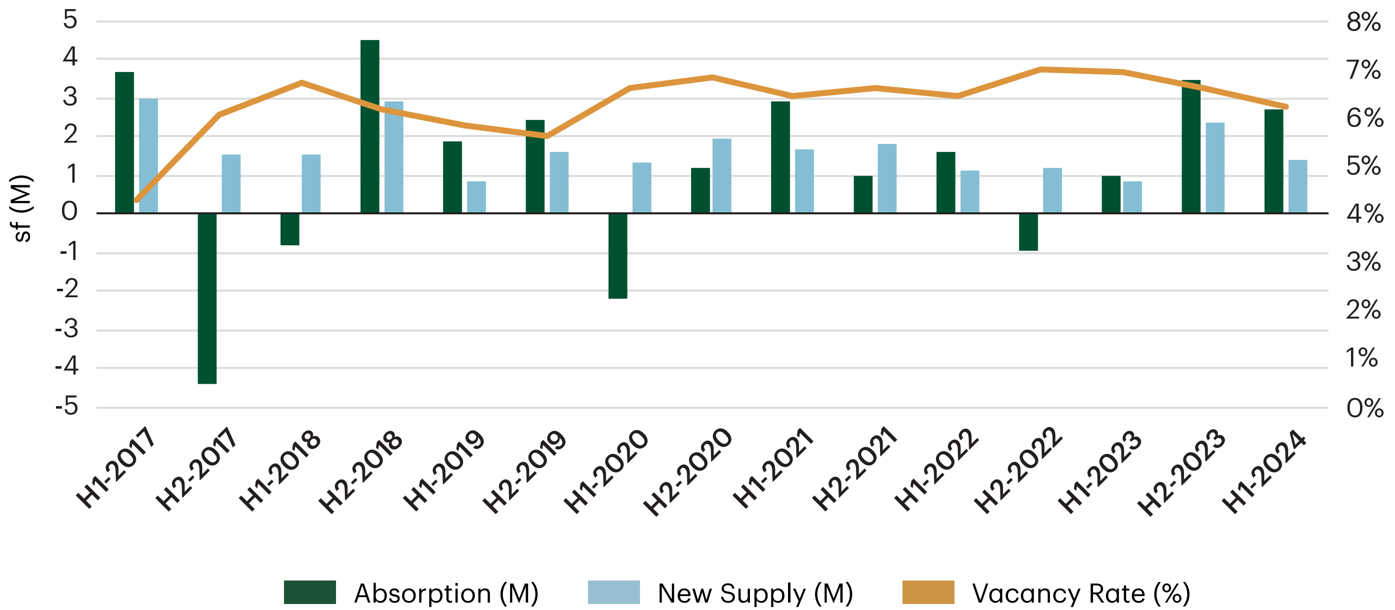
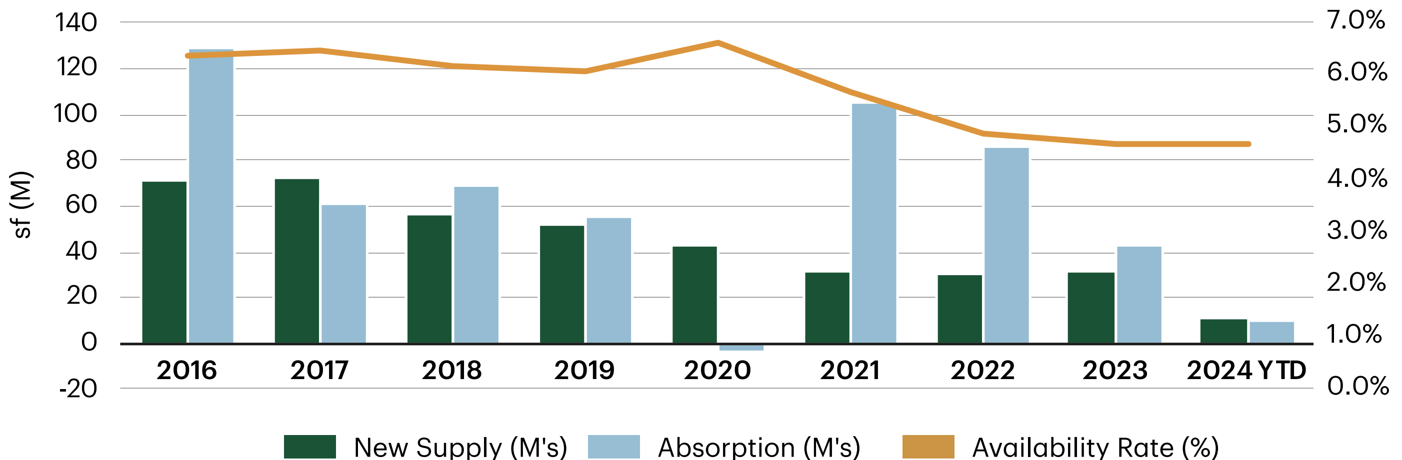


Figure 11: U.S. Retail Fundamentals

Source: CBRE. As of Jun 30, 2024



In Europe, retailers are looking beyond the current slowdown in spending, and leasing has picked up in the region's key markets. Leasing has been focused on high street and tourist corridors in large cities like London and Paris. JLL forecasts that retail rents are expected to be strong in Germany and the U.K. over a five-year basis.[11]

In the Asia Pacific, the retail sector has shown resilience. The region has benefited from a faster recovery in tourism, with international travelers contributing to strong foot traffic. Overall retail leasing activity is anticipated to remain healthy, driven by a broad base of tenants, including food & beverage, entertainment, and fashion.

[11] JLL Global Real Estate Perspective. August 2024.

Industrial

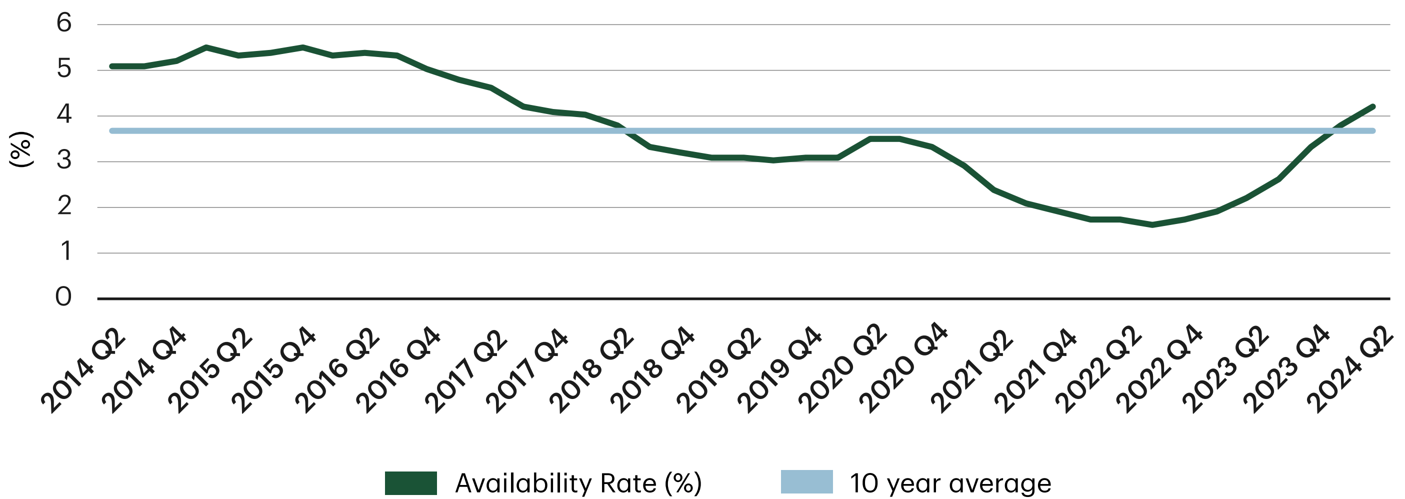
Canada experienced a continued cooling of industrial fundamentals in Q2 as national availability rates continued their upward trajectory. In Q2, availability rates rose by 40 bps quarter-over-quarter to 4.2%, the 7th consecutive quarterly increase.[12] Increasing sublease space and negative absorption are the two primary factors driving this trend. Sublease space has risen for nine consecutive quarters to a total of 13.8 million square feet, lifting the sublet availability rate to 0.7%.[13] Q2 also saw its highest negative net absorption in 15 years with -5.0 million square feet, which was mostly derived from the Toronto market.[14] Overall, rising sublet activity paired with another quarter of negative net absorption to push availability rates to their highest level since 2017.[15]

Another trend that softened Canada's industrial market in Q2 was derived from a 2.1% year-over-year decrease in national net rental rates, now at $15.95 per square foot.[16] The decline in rents ended a 12-year growth streak. This trend indicates that landlords are pulling back on their rental rate expectations to fill growing vacancies within their portfolios. Montreal and Vancouver were two of the top three cities for largest year-over-year rent decreases.[17]

[12] CBRE Data Views, Canada, Industrial, Market Trends: Forecast, as of Q2 2024.
[13] CBRE Canada Industrial Figures, Q2 2024.
[14] Ibid.
[15] Ibid.
[16] Ibid.
[17] Ibid.

Figure 12: Canadian National Availability Rate has Risen Above its 10-yr Average

Source: CBRE Canada. As of June 30, 2024.



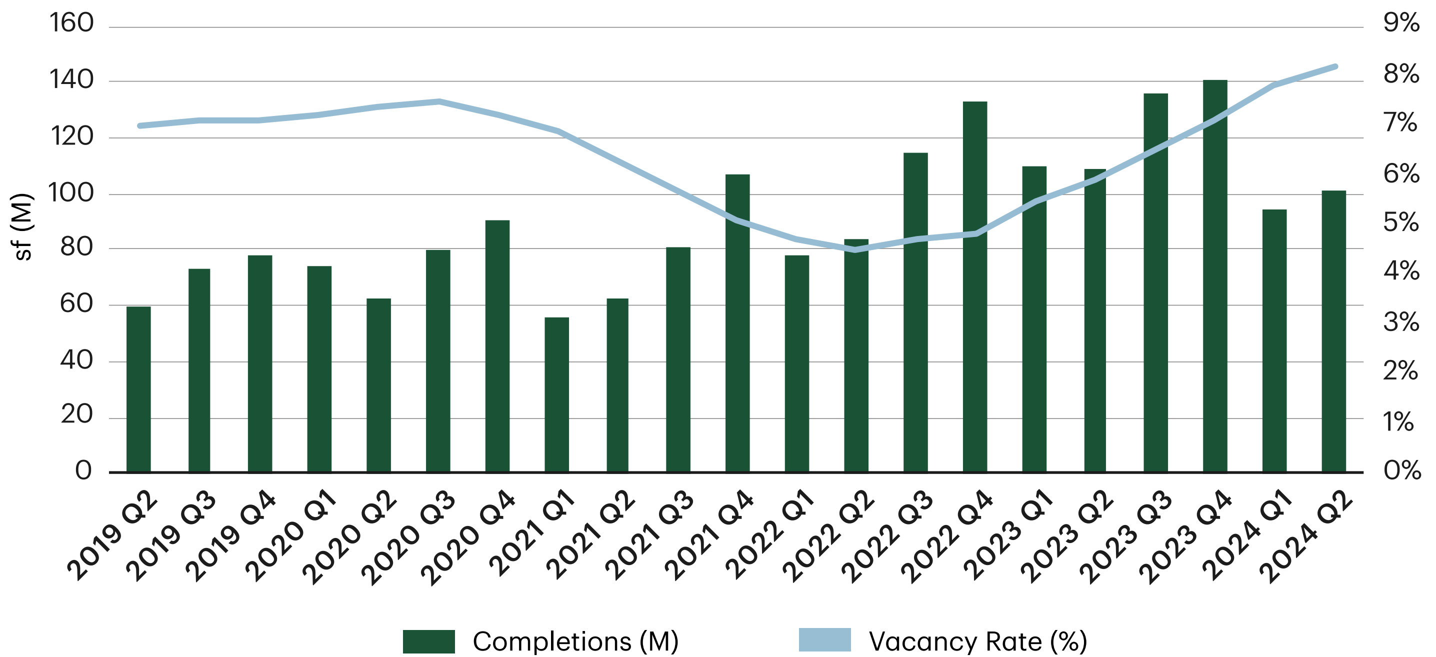
The U.S. industrial market also observed a rise in national availability rates spurred by a very challenging 2023 and first half of 2024. Despite a positive net absorption reading of 30 million square feet in Q2, excess completions are pressuring availability rates to move higher.[18] This trend can be tied back to 2023, which witnessed the most completions on record, totaling 497 million square feet that drove a 230 bps jump in availability rates compared to 2022.[19] Conversely, there was only 107 million square feet of positive net absorption in 2023, which is less than a third of the positive net absorption level averaged over the previous five years (2018-22).[20] The theme of "red-hot completions" combined with historically weak net absorption figures in 2023 have spilled over into the first half of 2024. A chronic surplus of vacant industrial space will continue driving up industrial availability, which is expected to reach 9% by the end of 2025.[21]

Industrial

[18] CBRE U.S. Industrial Availability Index, Q2 2024.
[19] CBRE Data Views, United States, Industrial, Market Trends: History, as of Q2 2024.
[20] Ibid.
[21] CBRE The Commercial Real Estate Half-time Report, July 2024.

Figure 13: Elevated New Supply Driving an Upward Climb of Availability Rates in the U.S.

Source: CBRE USA. As of June 30, 2024.



Looking beyond North America, industrial leasing markets are slowly re-emerging in Europe, rising 12% quarter-over-quarter, with the largest take-up rates seen in markets such as the U.K. and Netherlands. The most active sub-industries are manufacturers and third-party logistics ("3PL") companies. Although vacancy rates in Europe have been increasing since the second half of 2022, limited supply and regulatory obstacles are anticipated to lead to a reduction in vacancy rates beginning in 2025.[22]

Asia Pacific experienced a 20% rebound in net absorption in Q2,[23] which is a notable recovery from the slow start at the beginning of this year. The increase was driven by Tokyo and Seoul, both of which are seeing solid demand from 3PL and e-commerce companies.[24] Net absorption in the region of 2.9 million square meters is in line with its five-year average yet remains 33% below the record levels posted in 2023. Like other regions around the world, vacancy rates in Asia Pacific remain elevated due to pressures on the supply side.[25]

[22] JLL Global Real Estate Perspective, August 2024.
[23] JLL Global Real Estate Perspective, August 2024.
[24] McAuley, Matthew. Email to Author. September 3, 2024.
[25] JLL Global Real Estate Perspective, August 2024.

Multi-unit Residential

The residential sector is expected to capture a growing share of global transactions. Investment activity is projected to strengthen through the rest of 2024 and larger deal sizes are to become common moving into 2025. Larger transactions in the U.S. and a steep uptick in investment activity in Europe support a thesis for a residential market recovery.[26]

Multi-unit residential fundamentals in Canada, such as vacancy and rent growth, remain healthy when compared to the long-term trend. Stagnating delivery levels and ongoing population growth are supporting elevated fundamentals. Although the current levels of apartment construction are still not sufficient to meet the demand of Canada's recent growth in population, there are signs that developers are ramping up their focus towards constructing a larger share of purpose-built apartments. In 2023, 60.1% of the housing units delivered to the market were apartments, compared to 45.5% just 10 years earlier.[27]

In-place rents, which includes rents aggregated from new, renewed, and existing leases, rose by 6.3% year-over-year in Q2 to reach $1,521 per month.[28] This growth is smaller compared to the growth rates in the previous few quarters but is still above long-term levels. Census Metropolitan Areas ("CMA") in markets without strong rent control had the highest in-place rent growth, most notably in Calgary, Saskatoon, and Edmonton. Persistent rent growth is driving a downward trajectory in average turnover rates to 22.9% in Q2, which is a 60 bps decrease compared to the prior year. Turnover rates have steadily declined from around 28% in 2020. Low turnover and a lack of new supply are keeping a lid on low vacancy rates.[29]

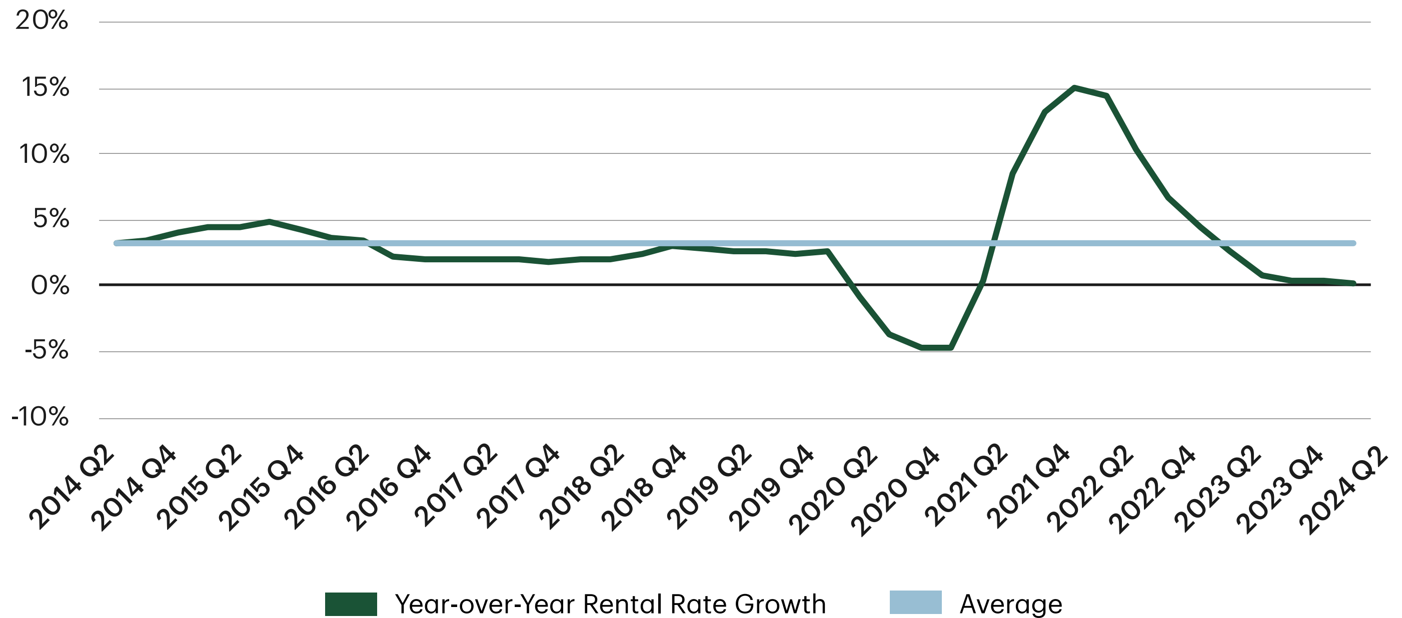
The national vacancy rate for multi-unit residential in the U.S. was 5.5% in Q2, unchanged from Q1 and 50 bps higher year-over-year. This is the highest vacancy rate since 2011 as excess supply arrives to the market. 2024 saw elevated new supply levels, but is expected to cool off in 2025, returning to the longer-term trend.[30] Meanwhile, rent growth continues to slow in Q2, rising only 0.3% year-over-year and is the 9th consecutive quarter of softening year-over-year increases.[31] 2022 and 2023 experienced back-to-back record levels of new unit completions that have

[26] Ibid.
[27] Yardi Canadian National Multifamily Report, Q2 2024.
[28] Ibid
[29] Ibid.
[30] CBRE EA Quarterly: The Full Picture, June 2024.
[31] CBRE Data Views, United States, Apartment, Market Trends: History, as of Q2 2024.

saturated the market and are the main catalyst to the slowdown to rent growth.[32] The Sun Belt region, which is where new supply has been concentrated,[33] is experiencing the largest year-over-year rent declines nationwide, with nine of the top 10 cities with the largest year-over-year rent declines in Q2 being in the Sun Belt.[34] These same nine cities also averaged an 89 bps year-over-year increase to vacancy rates, almost double the national average increase.[35] Average valuations for these nine Sun Belt cities in early 2024 were 17% lower than the previous year, compared to 13% lower nationally.[36]

Figure 14: Ninth Consecutive Quarter of Slowing Annual Rent Growth in the U.S.

Source: CBRE. As of June 30, 2024.



Overall residential investment volume in Europe, the Middle East and Africa region was €13.5 billion in Q2, which is almost double the previous quarter and 13% higher than the previous year. The largest share of investment volume was originated in the U.K. Although overall cost inflation dropped to the lowest level since 2020, average construction costs remain 26% higher than just a few years ago. Higher constructions costs are causing a drop in new development permits.[37] This will continue to put a strain on desperately needed housing in major markets.

The Asia Pacific region is experiencing the opposite investment trends of Europe, with overall investment activity in the region declining year-over-year as elevated levels of interest rates weigh on activity. JLL expects activity and fundamentals to strengthen in the short term as central banks cut rates.[38]

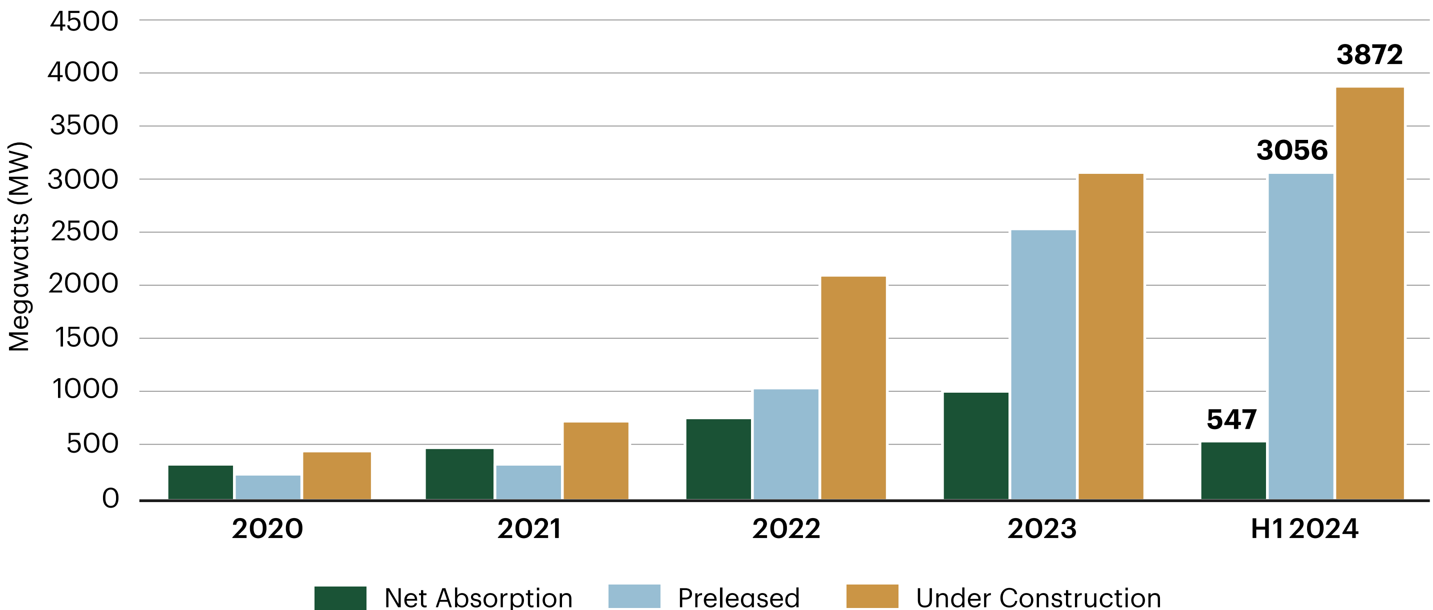
[32] Ibid.
[33] CBRE EA Quarterly: The Full Picture, June 2024.
[34] CBRE Data Views, United States, Apartment, Apartment Market Snapshot, as of Q2 2024.
[35] Ibid.
[36] CBRE Data Views, United States, Apartment, Investment Forecast Trends, as of Q1 2024.
[37] JLL Global Real Estate Perspective, August 2024
[38] Ibid.

Global Infrastructure

Artificial Intelligence ("AI") is increasingly becoming a vital part of our daily lives, with ongoing improvements in features and capabilities. This trend is driving a surge in Data Center construction, with the first half of 2024 already surpassing the total for all of 2023 (see Figure 15). The rise of Generative AI is also creating significant demand in the energy markets, encouraging investors to focus on renewable power generation to satisfy the substantial energy needs of modern technologies. Consequently, the global infrastructure market stands to gain from the growth in both the data center and power generation sectors, which are crucial for society.

Figure 15: North American Data Center Market Supply and Demand Fundamentals

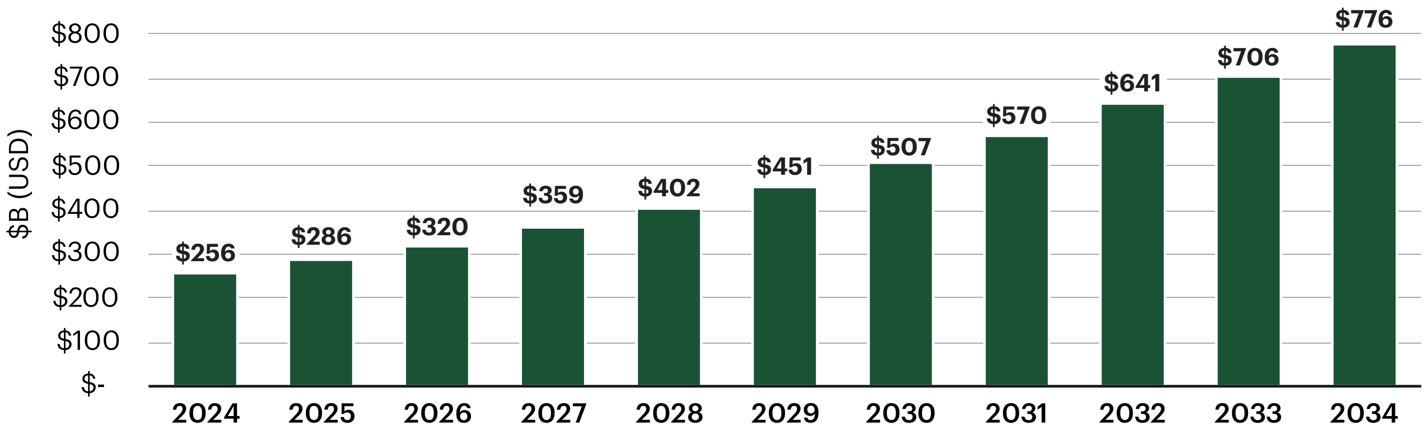
Source: CBRE, August 2024.



Prior to the invention of AI prompt engines, individuals relied on traditional search engines, which only required one-tenth of the power to perform a single query.[39] But now, with people wanting to be more efficient and using AI queries and their associated features, major companies are compelled to invest in data centers. The total data center market is currently valued at US$256 billion in 2024 and is projected to grow to US$776 billion by 2034, representing a compounded annual growth rate of 11.72% (see Figure 16).

Figure 16: Data Center Market Size 2023 to 2034

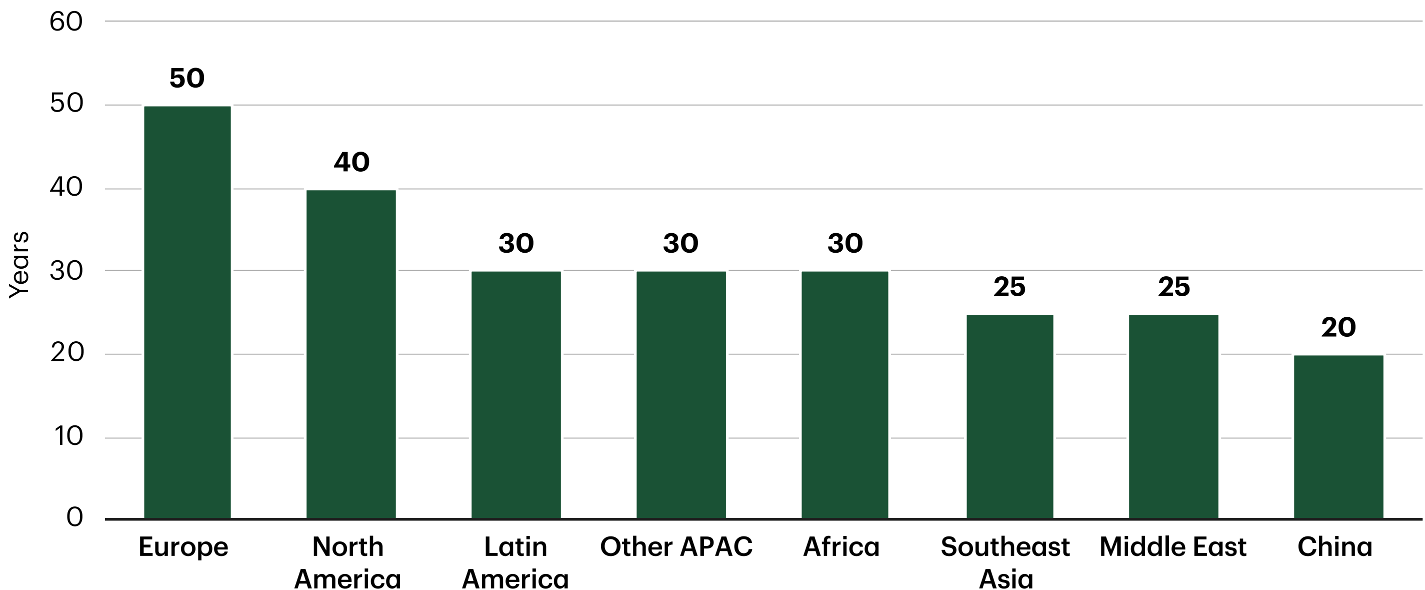
Source: Precedence Research, July 2024.



As of 2023, North America accounts for 38% of the data center market, followed closely by Europe at 30%.[40] However, these regions have aging power grids that will require significant public and private investment in the near future (see Figure 17). The average age of Europe's power grid is 50 years, and estimates suggest that over $800 billion will be needed to upgrade and modernize it for technological progress.[41]

Figure 17: The Average Age of Regional Power Grids

Source: Nexans, September 2022.

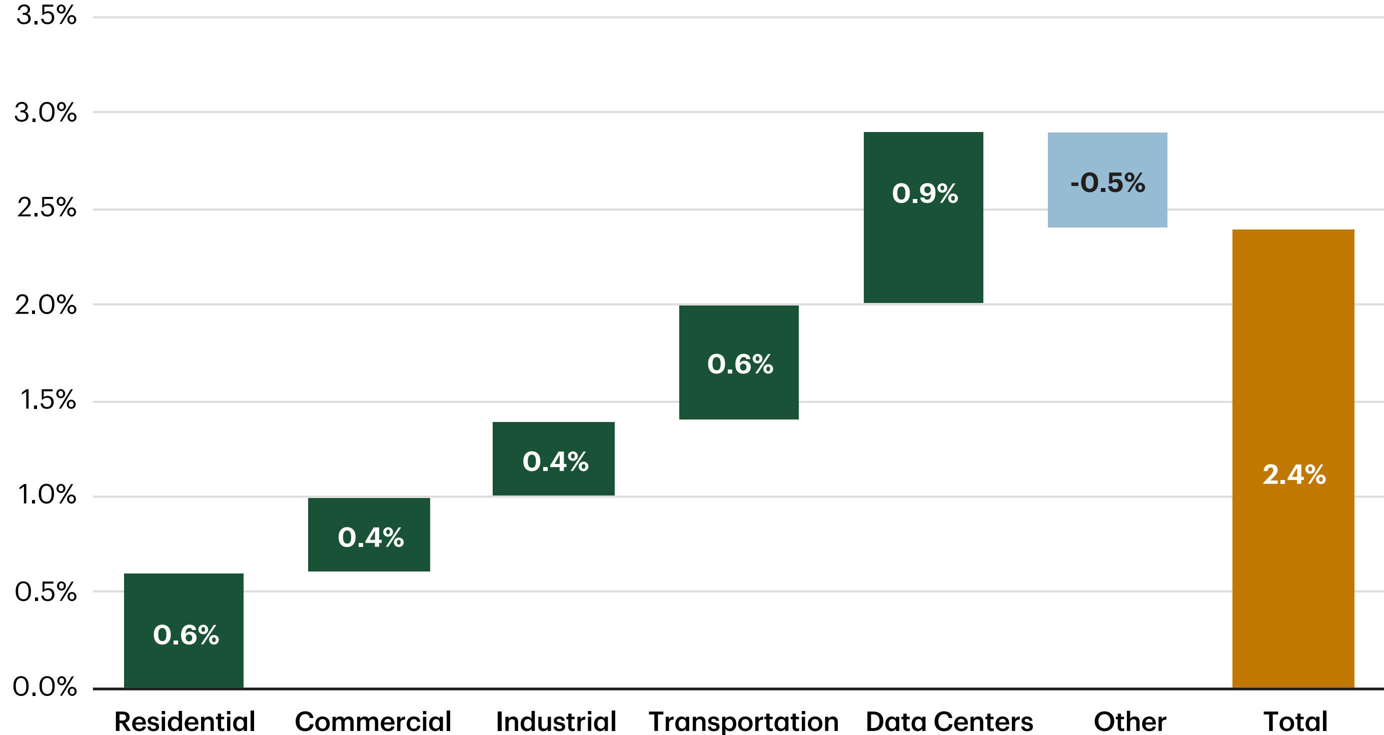


[39] International Energy Association, 2024.
[40] Precedence Research, July 2024.
[41] Goldman Sachs Research, May 2024.

In the U.S., power demand growth has been relatively stable due to technological advancements that accommodate population growth and economic activity. However, from 2024 to 2030, power demand is expected to increase at a compound annual growth rate of 2.4%, primarily driven by data centers (see Figure 18). The new generation of data centers requires substantial power for processing queries, presenting a funding opportunity for private infrastructure funds to develop data centers and supply them with renewable energy.

Figure 18: Sectoral Growth in U.S. Power Demand 2024-2030

Source: Goldman Sachs Research, May 2024.



Growth

Real Assets Market Report

For institutional investment professionals only. Not for further distribution. The information contained herein is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. This material is not an offer to any person in any jurisdiction where unlawful or unauthorized. These materials have not been reviewed by and are not registered with any securities or other regulatory authority in jurisdictions where we operate. Any general discussion or opinions contained within these materials regarding securities or market conditions represent our view or the view of the source cited. Unless otherwise indicated, such view is as of the date noted and is subject to change. Information about the portfolio holdings, asset allocation or diversification is historical and is subject to change. This document may contain forward-looking statements ("FLS"). FLS reflect current expectations and projections about future events and/or outcomes based on data currently available. Such expectations and projections may be incorrect in the future as events which were not anticipated or considered in their formulation may occur and lead to results that differ materially from those expressed or implied. FLS are not guarantees of future performance and reliance on FLS should be avoided. Any indices cited are widely accepted benchmarks for investment and represent non-managed investment portfolios. It is not possible to invest directly in an index. Information about the indices allows for the comparisons of an investment strategy's results to that of a widely recognized market index. There is no representation that such index is an appropriate benchmark for such comparison. Results for an index do not reflect trading commissions and costs. Index volatility may be materially different from a strategy's volatility and portfolio holdings may differ significantly from the securities comprising the index. Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved. TD Global Investment Solutions represents TD Asset Management Inc. ("TDAM") and Epoch Investment Partners, Inc. ("TD Epoch"). TDAM and TD Epoch are affiliates and wholly-owned subsidiaries of The Toronto Dominion Bank. ®The TD logo and other TD trademarks are the property of The Toronto-Dominion Bank or its subsidiaries.

(1124)