AVISON YOUNG

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Debt Market Monitor

Debt Capital Markets Services

Is complacency really over in the bond market?

Bonds have an inverted relationship between price and yield. With interest rates and bond yields poised to increase, bond prices will take a hit. The longer the maturity of the bond, the larger the hit. A 10-year bond that is subjected to a 2% increase in yield will suffer a 20% loss in value – not an investment for the faint of heart in the current environment. Imagine if you were the manager of a major bond fund like Pacific Investment Management Co. – arguably the world's largest actively managed bond fund at nearly $80 billion in value with more than $1.4 trillion in managed assets. What would your reaction be to the current market conditions and the forecast of rising rates?

Inflation and interest rates are closely linked. The higher the inflation rate, the more likely interest rates are to rise. The U.S. Federal Reserve Bank ("the Fed") has strongly signaled that further multiple rate increases will be delivered this year and in 2019. Notwithstanding this clear sign and the fact that some rate increases have already been implemented, 10-year U.S. treasury bonds have been volatile – falling to levels well off their February 2018 peak only to oscillate higher in April. This situation represents volatility at its finest. The Fed and bond investors give the impression that they are at odds with their respective views of the near term – but someone appears to be wrong. It looks as though relatively lower yields in the bond market are projecting bond investors' sentiment that inflation and a strong U.S. economy are not quite as worrisome as the Fed might have us believe. The bond market is more than just an economic indicator, and it has been known to be dreadfully wrong.

Check the 2007 to 2008 records.

Investors' views and economic reality do not seem to be aligned at present. Long-term treasury yields are slightly in excess of 3% and are nowhere near the Fed's inflation target of 2% plus the real economic growth of 2% to 3%. Historically, long term interest rates tend to fluctuate around the rate of nominal GDP growth. This rule of thumb implies that 30-year rates should be in the 4-5% range – if inflation were actually 2%. Sooner or later, the disconnect will align and the gap between bond yields and GDP growth will close.

Either growth will weaken dramatically or interest rates will rise significantly. Place your bets.

Fiscal Snapshot

Bank of Canada

	Bank Rate	Bank Prime Lending
April 2018	1.50	3.45
One month ago	1.50	3.45
One year ago	0.75	2.70

Government of Canada Benchmark Bond Yields

	5-Year	10-Year	Long
April 2018	2.11	2.30	2.40
One month ago	2.04	2.23	2.37
One year ago	1.12	1.63	2.31

Indicative Commercial Mortgage Spreads* Over Government of Canada Bond Yields

Conventional	5-Year	10-Year
April 2018	1.50 - 2.00	1.65 - 2.00
One year ago	1.70 - 2.10	1.85 - 2.35
Insured	**5-Year**	**10-Year**
April 2018	0.80 - 1.10	0.80 - 1.10
One year ago	0.90 - 1.10	0.90 - 1.20

*Spreads are indicative of high quality real estate in major Canadian markets.

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Highlighted Transaction

Asset Type	Multi-tenanted flex office development
Location	Major Canadian city
Facility Details	A $20M non-recourse, committed non-revolver loan to assist with future development of additional density. The term of the facility is for 36 months with an extension feature for an additional 24 months. The structure includes a floating rate and provided for an interest rate swap to a fixed rate, at our client's option.

Intelligent Debt Financing Solutions

The Avison Young Debt Capital Markets dedicated team is focused on providing innovative North American-wide debt and equity solutions to accomplish goals. We originate debt and equity for all types of real estate and all types of clients. Debt origination includes fixed and floating rate structures, permanent and construction financing, structured finance, bridge and mezzanine debt and insured agency financing - CMHC and Fannie Mae / Freddie Mac.

Our years of combined debt/equity capital markets experience has created meaningful relationships that we can put to work for you.

Please contact our Debt Capital Markets team for more details related to debt financings or real estate transactions.

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