

Will Canada's Big Cities Shine Again?

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The pandemic has devastated economic activity in Canada's major urban centres, with many businesses shuttered, employers shifting to remote work, and an exodus of households searching for more space. After more than a decade of intensification and economic leadership, this shift in the opposite direction has been sudden, and raises questions about the future of the largest urban centres. That said, it appears that much of the current shock is temporary, while some movement reflects a near-term magnification of already-existing trends. So, while they might look and feel a bit different after COVID, Canada's big cities should remain engines of economic activity.

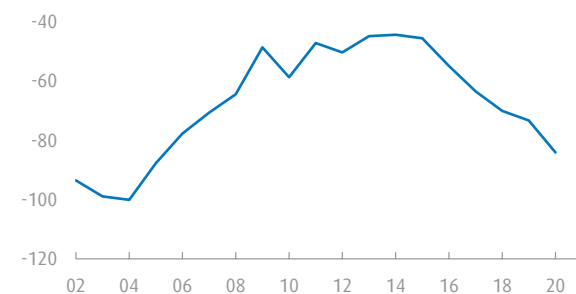
The Exodus in Perspective

In the twelve months through July 2020, more than 80,000 people migrated out of Toronto, Montreal and Vancouver, on net, to other areas of the respective province. That marked the largest outflow in 15 years, and by all accounts accelerated sharply in the post-COVID segment of that period (Chart 1). Combined with a steep falloff in international non-permanent residents, this slowed combined population growth in these centres by 0.7 pts over the course of 2020. It remains to be seen how much of the shift is permanent.

Consider that even before the pandemic, there were persistent net outward migration flows from the biggest cities to other parts of the province. And, those outflows have been steadily increasing since 2014. There is a fundamental (i.e., non-pandemic) demographic story here involving the Baby Boom Echo. Indeed, the biggest driver of net outflows is consistently the 25-to-45 age group (Chart 2), which is typical of growing families (and, contrary to what you might have been told, families don't usually want to raise kids in dense condo developments). While we're on it, Chart 2 also dispels the myth that retirees are flocking downtown en masse. In raw numbers, net outflows in the 25-to-45 group have accelerated in recent years, partly because the size of the cohort continues to grow. So, the pandemic has prodded some temporary movement out of the major cities; while it also likely pulled forward some movement that was

Chart 1
Moving Out

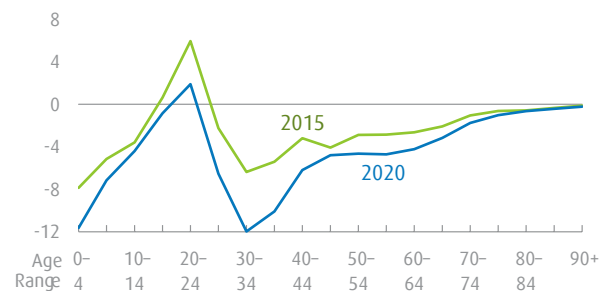
Canada (000s of people: 12-mnth total through July of each year)
Net Intraprovincial Flows — Toronto, Montreal, Vancouver



Sources: BMO Economics, Statistics Canada

Chart 2
Demographics Matter Too

Canada (000s of people: 12-mnth total through July of each year)
Net Intraprovincial Migration — Toronto, Montreal, Vancouver



Sources: BMO Economics, Statistics Canada

eventually going to take place anyway in the years ahead. As such, the observed 'exodus' from the cities might be somewhat exaggerated at the moment.

The Hunt for Space

The forceful rebound in housing markets across Canada has been one feature of the pandemic, and it has been characterized by a relative shift in strength from big urban markets (i.e., Toronto, Montreal, Vancouver) to perimeter

markets. For example, Toronto prices are up 'only' 11.9% y/y, but Barrie (+27%) and London (+26%) are running magnitudes stronger. Meantime, condo price growth has slowed to just 3.1% y/y, or a record 14.3 ppts below the growth in single-detached homes (Chart 3). That's by far the widest gap in 20 years of data, and reflects a combination of temporary, semi-permanent and permanent factors:

Temporary: The acute impact of the pandemic has significantly disturbed the economics of the major downtown condo markets. For example, many investors leading up to COVID were purchasing properties that would be cash-flow negative with a 20% down payment. They were relying on some combination of strong rent growth, the short-term rental market, and price appreciation. But, during the pandemic, downtown rents have fallen as office buildings have shut; travel flows have all but ceased, weighing heavily on short term demand; and prices have stagnated as a result. To compound the issue, the vast majority of new supply in Canada's major cities in recent years has been in the form of condos, so rental vacancy rates are on the rise (Chart 4). This market will continue to struggle this year, but the temporary nature of these shocks should ultimately allow it to regain its balance in relatively short order.

Semi-permanent: A year of lockdowns and travel restrictions have incited an explosion in demand for recreational property and real estate typically outside normal commuting distance. As travel restrictions ease, so should the extraordinary demand for such properties. However, the ability to work remotely has made the economics of such ownership more appealing. That is, even if we return to an environment where time is split between home and office, ownership of a second property is no longer just a Friday evening-to-Sunday afternoon proposition. As a result, some of the increase in prices will likely stick.

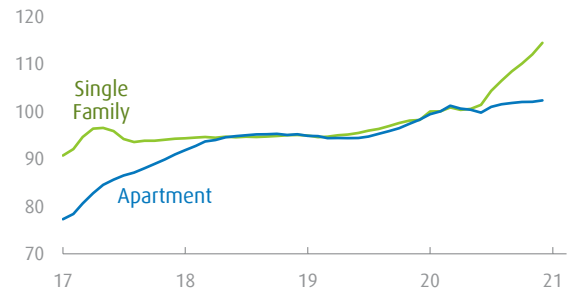
Permanent: Demographic trends, along with constrained supply (either through geography or policy), have long been creating an environment of strength for single detached home prices in and around the major cities—we've been arguing as much for almost a decade. The extent that the pandemic has pulled forward some of the inevitable shift into this segment of the housing market suggests that a good portion of the gains will stick, major changes in interest rates aside.

The Future (of Work) is Wide Open

Employment in the biggest cities has been hit hard by the pandemic, as evidenced by the quiet streets and pathways. Since February 2020, Toronto, Montreal and Vancouver have lost 271k jobs, or just over 40% of the total decline

Chart 3
The Hunt for Space

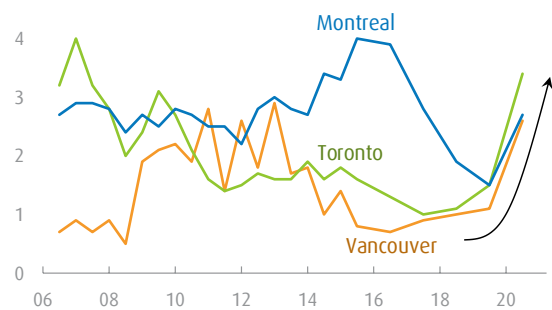
Canada (Feb. 2020 = 100)
Home Price Index



Sources: BMO Economics, Haver Analytics

Chart 4
For Rent

Apartment Vacancy Rate (percent)



Sources: BMO Economics, Canada Mortgage and Housing Corporation

reported for Canada overall (Chart 5). While this sounds dramatic, keep in mind that these cities accounted for almost 38% of employment before the pandemic broke out. They were hit harder because of their industry makeup, as well as stricter lockdowns in Toronto and Montreal, but the hit hasn't been way out of proportion and the recovery has been swift.

In fact, it is the industry composition of employment in the biggest cities that leaves us most optimistic about a strong recovery. While we often think of the big cities as centres for culture, recreation, restaurants and tourism, the reality is that relative employment is driven more by professional, scientific and technical services, finance, logistics and businesses support (Chart 6). These are all sectors that should remain consistent drivers of Canadian job growth. At the same time, there should be significant pent-up demand in the culture and recreation space, while accommodation and food does not actually carry a relatively high weight in the big three cities.

Commercial Question Marks

The biggest question is not how employment in these key sectors will perform, but how much will be performed in a traditional office. And for this, there is no answer yet. Various surveys make two things clear: there's little appetite to stay fully remote for good; but, there's also little expectation of going all the way back to a 40-to-60 hour at-your-desk approach either. The truth is somewhere in between, and might come with offices that look and feel a bit different. Few argue that this flexibility is a bad thing, and it will vary by job type.

In the near term, office vacancies are on the rise. Toronto's downtown vacancy rate jumped to 7.2% in 2020Q4 (or 11% city-wide), according to CBRE; Montreal rose to 10.2%; and Vancouver to 5.8%. These markets were extremely tight before the pandemic (unlike Calgary, which sits at almost 30%). Plus, massive federal fiscal support has kept some tenants in place, though their future is uncertain as those measures eventually wind down.

Eventually, the market should prove to be an efficient clearing mechanism. That is, the downtown office market could see a downward adjustment in rent and/or upward adjustment in cap rates, which themselves could ultimately draw demand back in. To this point, cap rates outside much harder-hit markets like Calgary have held relatively steady, but they have become more attractive relative to long-term government bond yields (though the latter are rising quickly) (Chart 7). As we get further removed from the pandemic, it's likely that prime downtown office space will continue to demand a premium, and more availability should be absorbed – perhaps with some repricing, and some negative ripple effects on suburban office markets.

Transit Still Critical

Assuming the largest urban centres do in fact come back relatively strong, quality transit should remain a key priority. Interestingly, one of the most sought-after policy answers pre-pandemic was how to improve affordability. Faster transit further outside the major cities was one answer, albeit a very long-term one. The pandemic's introduction of widespread work-from-home has, in a round-about way, shown how allowing people to live further beyond what are currently acceptable commuting lines can serve as a very effective affordability valve. Downtown rents, which were under intense upward pressure, are now falling; and while households are aggressively bidding up home prices in locations further outside the major cities, many are doing so with an eye on better affordability.

Chart 5
Job Recovery Underway

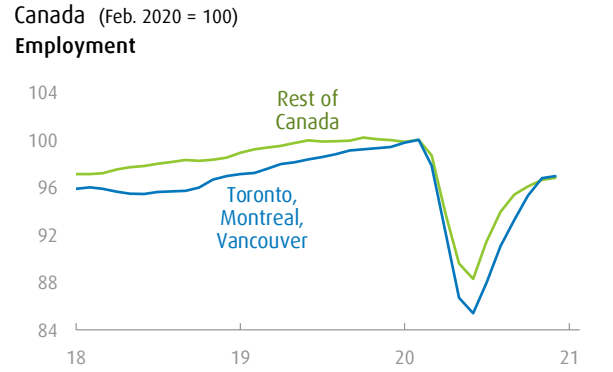


Chart 6
Relative Employment Concentration

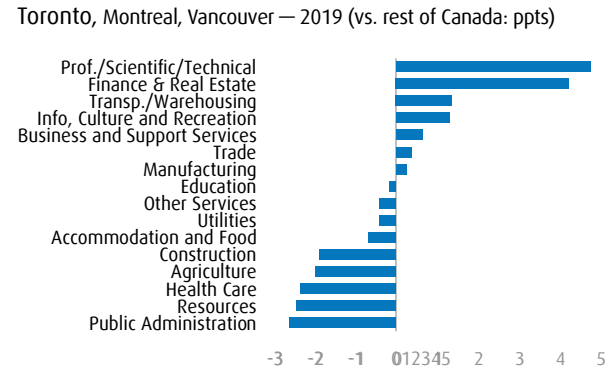
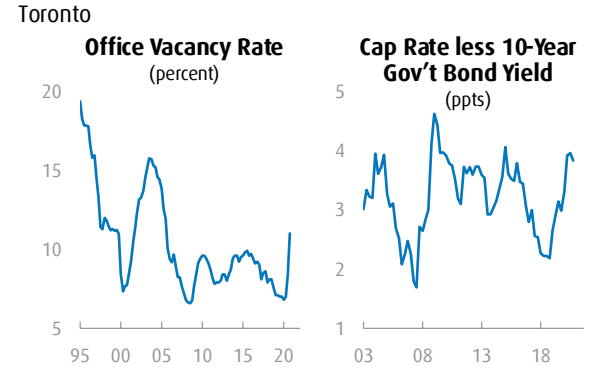


Chart 7
Repricing Looms



Sources: BMO Economics, Haver Analytics, CBRE, Bank of Canada

With that in mind, Ottawa's recently-announced eight-year, \$14.9 billion, program to support public transit infrastructure is encouraging. The current lull in demand is not permanent, and policymakers have a chance to make up some much-needed

ground on this front. In fact, consideration could even be given to redirecting some of the massive ongoing fiscal support to an area like transit, that will have longer term productivity-and affordability-enhancing benefits.

The Bottom Line: Canada's major cities are in the midst of a generational challenge, but they are likely to come back steadily as immunity broadens. Some of what we've seen through the

pandemic represents the pulling forward of shifts that were going to happen anyway, like the demand for single-detached homes. Some of it, like remote work, hints at long-term adjustments that will reshape, but not completely alter, the work environment. And, some is temporary, leaving hearty pent-up demand in areas like entertainment and recreation. The big cities will ultimately remain engines of the Canadian economy.

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