Will Canada's Big Cities Shine Again?

Reprinted with permission from Robert Kavcic, Senior Economist, BMO Capital Markets, February 26, 2021.

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 ppts 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

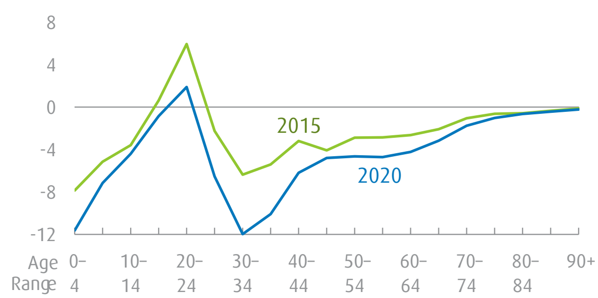
Chart 1
Moving Out

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 incented 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.

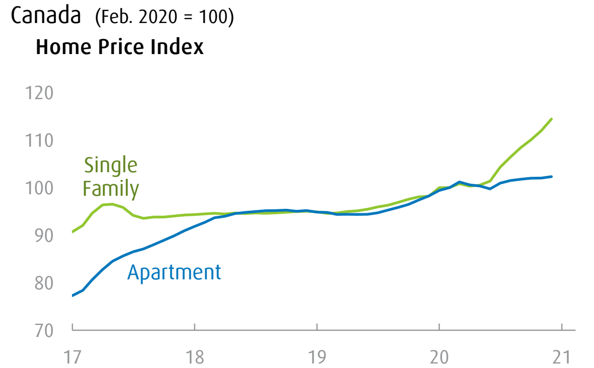
Permanent: Demographic trends, along with constrained supply (either through geography or policy), have long been creating an environment of strength for single detached home prices in and around the major cities—we've been arguing as much for almost a decade. The extent that the pandemic has pulled 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 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.

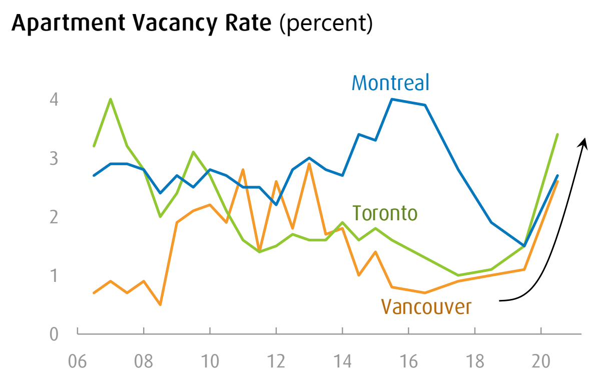
In fact, it is the industry composition of employment in the biggest cities that leaves us most optimistic about a strong recovery. While we often think of the big cities as centres for culture, recreation, restaurants and tourism, the reality is that relative employment is driven more by professional, 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.

Chart 3
The Hunt for Space



Sources: BMO Economics, Haver Analytics

Chart 4
For Rent



Sources: BMO Economics, Canada Mortgage and Housing Corporation

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

Canada (Feb. 2020 = 100)
Employment

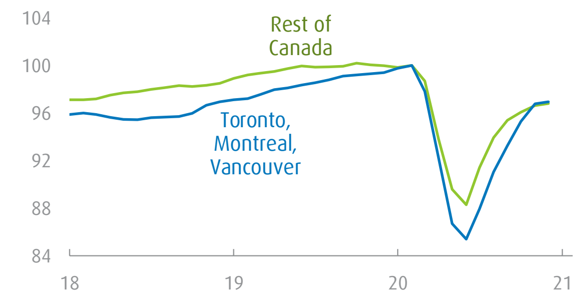


Chart 6
Relative Employent Concentration

Toronto, Montreal, Vancouver — 2019 (vs. rest of Canada: ppts)

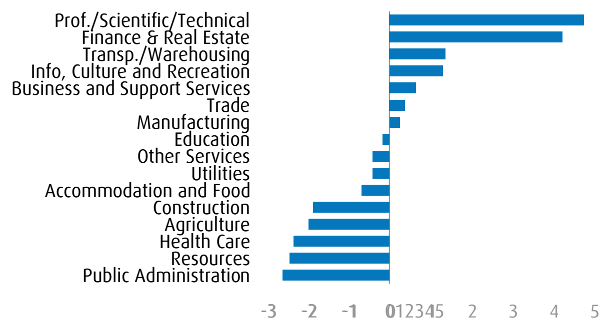
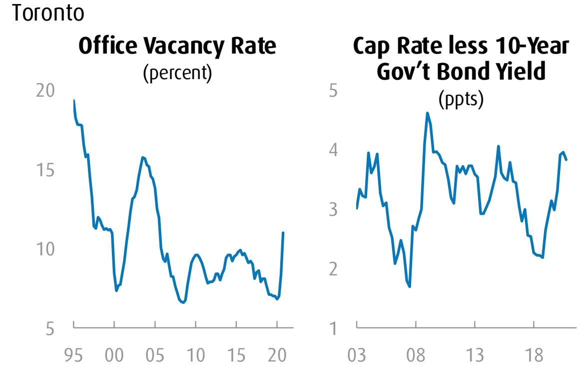


Chart 7
Repricing Looms

Toronto



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.

To PRC Residents: This material does not constitute an offer to sell or the solicitation of an offer to buy any financial products in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC"). BMO and its affiliates do not represent that this material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any applicable registration or other requirements in the PRC, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. This material may not be distributed or published in the PRC, except under circumstances that will result in compliance with any applicable laws and regulations.

Singapore Residents: This document has not been registered as a prospectus with the Monetary Authority of Singapore and the material does not constitute an offer or sale, solicitation or invitation for subscription or purchase of any shares or financial products in Singapore. Accordingly, BMO and its affiliates do not represent that this document and any other materials produced in connection therewith may lawfully be circulated or distributed, whether directly or indirectly, to persons in Singapore. This document and the material do not and are not intended to constitute the provision of financial advisory services, whether directly or indirectly, to persons in Singapore. This document and any information contained in this report shall not be disclosed to any other person. If you are not an accredited investor, please disregard this report. BMO Singapore Branch does not accept legal responsibility for the contents of the report. In Asia, Bank of Montreal is licensed to conduct banking and financial services in Hong Kong and Singapore. Certain products and services referred in this document are designed specifically for certain categories of investors in a number of different countries and regions. Such products and services would only be offered to these investors in those countries and regions in accordance with applicable laws and regulations. The Information is directed only at persons in jurisdictions where access to and use of such information is lawful.

To Thai Residents: The contents hereof are intended solely for the use of persons qualified as Institutional Investors according to Notification of the Securities and Exchange Commission No. GorKor. 11/2547 Re: Characteristics of Advice which are not deemed as Conducting Derivatives Advisory Services dated 23 January 2004 (as amended). BMO and its affiliates do not represent that the material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any regulatory requirements in Thailand, or pursuant to an exemption available under any applicable laws and regulations.

To U.S. Residents: BMO Capital Markets Corp. furnishes this report to U.S. residents and accepts responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal.

These documents are provided to you on the express understanding that they must be held in complete confidence and not republished, retransmitted, distributed, disclosed, or otherwise made available, in whole or in part, directly or indirectly, in hard or soft copy, through any means, to any person, except with the prior written consent of BMO Capital Markets.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., (Member FDIC). Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets.

BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A. (member FDIC), Bank of Montreal Europe p.l.c, and Bank of Montreal (China) Co. Ltd, the institutional broker dealer business of BMO Capital Markets Corp. (Member FINRA and SIPC) and the agency broker dealer business of Clearpool Execution Services, LLC (Member FINRA and SIPC) in the U.S., and the institutional broker dealer businesses of BMO Nesbitt Burns Inc. (Member Investment Industry Regulatory Organization of Canada and Member Canadian Investor Protection Fund) in Canada and Asia, Bank of Montreal Europe p.l.c. (authorised and regulated by the Central Bank of Ireland) in Europe and BMO Capital Markets Limited (authorised and regulated by the Financial Conduct Authority) in the UK and Australia.

A member of BMO Financial Group.