WEEKLY COMMENTARY

Slow-Motion Office Wreck?

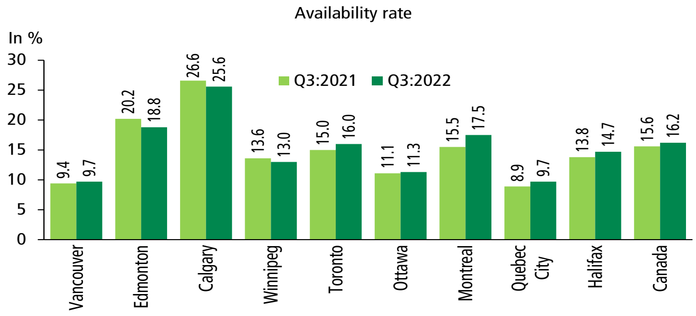
By Jimmy Jean, Vice-President, Chief Economist and Strategist

As we look back on the wild year that was 2022, office workers returning to in-person work (mostly in a hybrid format) marks a key milestone in the transition to a post-pandemic world. Days in the office might feel a lot like the old normal, but the fact that many of us are in only a few days a week means that this is still very much a new normal. Research on working arrangements in the US suggests the share of paid full days worked from home has settled around the 30% mark in 2022. That is about half of where it was in the spring of 2020 but well above the estimated 5% pre-pandemic.

This means that the situation is far from settled for the commercial real estate market, and by extension, for the stock of capital that corporate offices represent. Nothing surprising given commercial real estate's reputation for being a "long game," with leases lasting a decade not being uncommon in the industry. In principle, this gives most corporations some time to assess what the hybrid world entails for their office space needs. That said, cost pressures from inflation, wages and interest rates are leading some companies to look at redundancies, and one obvious solution jumps at executives any time they roam those deserted offices floors.

Since 2000, the availability rate for offices has never been as high at the national level. Calgary, Edmonton and Montreal had the highest availability rates as of the third quarter (graph). Across North America, the tech sector is among those that have been reducing office use most aggressively. The sector has been more prone to adopt full-time telework arrangements—notably recent startups pulling together talent spread out globally—but has also seen layoffs this year. In a recession scenario where more sectors experience layoffs, we may see further pressure on office space availability, especially as some of those leases will gradually be up for renewal.

GRAPH
The availability rate of office space has increased in most markets



Sources : Altus Group and Desjardins, Economic Studies

From the lens of an economist, it raises a number of issues. Effectively, the pandemic and its lockdowns have ushered in another case of technological disruption. True, the ability to remote work has existed for well over two decades. In some sectors like business consulting, hybrid work was common well before the pandemic hit. With some significant investment in connectivity capacity during the initial lockdowns, businesses were able to broaden this capability across their office workers in a matter of weeks.

But as with any case of technological disruption, old capital is made obsolete and loses its value. One example is how ride-share services have upended the traditional taxi industry across the world. In New York City, the value of a taxi medallion—the certificate required to operate a yellow cab—went from above US$1M in 2014 to just over US$100K this year, leaving many drivers mired in debt. In the case of offices, some significant square footage is now unnecessary in a paradigm where people show up only part of the week. A survey by Colliers suggests that

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60% of businesses will require between 50% and 70% of their current office space within three years.

Just like honking yellow cabs continue to roam the streets of New York, the emptied physical space will not be going anywhere soon. However, compared to yellow cab medallions, the question of how much those assets will be worth is more complicated. Office real estate is segmented into classes depending on their quality. Currently, demand for Class A (e.g., newer offices, well-ventilated, equipped with modern amenities and optimized for collaborative work) remains strong across markets. The more dated Class C buildings in less desirable locations are the ones that may experience increased vacancies as well as downward pressures on rent and property values. The markdowns could be significant. Recent empirical research for New York suggests that offices may end up losing 39% of their pre-pandemic value on a permanent basis.

Some are even speculating that office space might turn out to be a stranded asset. This seems rather pessimistic, as owners will be looking into adaptive reuse of the space to mitigate the blow. This process has happened time and again in the history of most cities' industrial neighbourhoods, although it can span over many decades. In the current context, the repurposing of abandoned offices invariably brings up housing, given its short supply. If somehow the excess stock of office space could be converted into housing, it would be a win-win. As Canada is looking to step up the pace of immigration to soon reach 500k per year, there's little doubt that all ideas to unlock desperately needed housing supply must be considered. And repurposing idle offices into housing would bring the added benefit of limiting urban sprawl and reducing carbon emissions.

Unfortunately, these common sense arguments bump into the complexities of office real estate. First, these structures have been designed and configured for the specific needs of corporate offices, not residential units. The location of elevators, plumbing architecture, heating and cooling fixtures, exposure to natural light, balconies—these are just a few of the amenities that are designed differently in a residential building. Second, and especially in the case of older office buildings, they may also need deeper retrofits to adhere to modern norms pertaining to ventilation, energy efficiency or fire safety, entailing significant costs. Third, it may be that such conversions require specialized expertise within the construction industry, and it's safe to assume that this expertise is in short supply currently.

Given the costs (including those of materials and labour) and the risks, new residential units sold in freshly converted office buildings would need to be able to fetch a high enough price to make conversions a profitable endeavour. It's not unreasonable to expect that only the most affluent might be able to afford the minimum asking price (or the rent) on these units. That would hardly improve housing affordability for middle- and low-income households. If the goal is to specifically convert offices into affordable housing, it might not be attainable absent significant government involvement.

Even if the converted units were affordable, there is the question of whether central business districts are attractive for typical households. This means making sure they are equipped with schools, daycares, hospitals, public facilities and retail spaces. These public investments would be needed precisely when the depreciation of properties is likely to put pressure on municipalities' tax receipts, meaning that federal and provincial involvement would be heavily solicited.

Bottom line: We are back in the office, but office real estate will no longer be the same. This has major impacts. The investors who have piled into the asset class when interest rates were low know that very well. And it might get worse before it gets better.

What to Watch For

By Randall Bartlett, Senior Director of Canadian Economics, Tiago Figueiredo, Associate – Macro Strategy, Marc Desormeaux, Principal Economist, and Francis Généreux, Principal Economist

UNITED STATES

TUESDAY December 13 - 8:30	
November	**m/m**
Consensus	0.3%
Desjardins	0.3%
October	**0.4%**

Consumer price index (November) – Inflation continued to slow in October, with the consumer price index coming in at 7.7% compared to its June peak of 9.1%. The trend should hold true in November. We expect to see a slight fall in energy prices, with gasoline pump prices down 2.9%. Growth in food prices should come in close to October's 0.6%. Stripping out food and gas, we also expect a repeat of October's 0.3% core price growth due to lower goods prices (particularly used cars and trucks) and a more sustained trend on the services side. Overall, the month-over-month change in the all items index should come in at 0.3% as well. The year-over-year change in the all items index should fall from 7.7% to 7.3%, with core inflation edging down from 6.3% to 6.1%.

WEDNESDAY December 14 - 14:00	
December	
Consensus	4.50%
Desjardins	4.50%
November 2	**4.00%**

Federal Reserve meeting (December) – The Fed isn't done tightening monetary policy just yet. Inflation is still too high and the labour market too tight. That said, recent Fed messaging suggests we'll see the pace of rate hikes start to slow with this meeting, moving from 75 bps increases to a 50 bps rise. It'll be interesting to see where the Fed's latest dot plot puts the estimated terminal rate.

THURSDAY December 15 - 8:30	
November	**m/m**
Consensus	-0.1%
Desjardins	-0.3%
October	**1.3%**

Retail sales (November) – Retail sales outperformed expectations in October, posting a monthly gain of 1.3%, the biggest since February. Expect some pullback in November, mostly due to a dip in motor vehicle sales, which are catching their breath after a busy October. We should also see a drop in gasoline station receipts. Outside these two components, we're getting mixed signals from the data released so far. Anecdotal reports of strong post-Thanksgiving sales contradict card transaction data suggesting declines in several sectors, particularly durable goods stores and department stores. All in all, we expect total retail sales to be down 0.3%, while sales excluding food and gas likely rose 0.2%.

THURSDAY December 15 - 9:15	
November	**m/m**
Consensus	0.1%
Desjardins	-0.2%
October	**-0.1%**

Industrial production (November) – We haven't seen two consecutive months of gains in industrial production since April. After picking up 0.1% in September, it was back down 0.1% in October. We expect another decline in November. Strong growth in hours worked suggests that the automotive sector probably grew at a brisk pace, but it will be more than offset by other manufacturing losses. We're forecasting a 0.3% decline in overall manufacturing output. The rest of industrial production—energy production and mining—should see no change, leading us to forecast a decrease of 0.2% for total industrial production.

CANADA

WEDNESDAY December 14 - 8:30	
October	**m/m**
Consensus	1.9%
Desjardins	1.9%
September	**0.0%**

Manufacturing sales (October 2022) – Manufacturing sales are expected to have taken a substantial leap forward in October, likely rising by 1.9% in the month. This is in line with Statistics Canada's 2.0% flash estimate. October's advance is anticipated to be largely a price story, as import prices rose in the month on the back of a weaker Canadian dollar and as oil prices edged higher. Meanwhile, manufacturing volumes likely eked out a more modest advance as indicated by rising manufacturing employment and imported inputs to the manufacturing process, albeit offset somewhat by weakness in auto production.

THURSDAY December 15 - 8:15	
November	**ann. rate**
Consensus	255,000
Desjardins	259,000
October	**267,100**

Housing starts (November 2022) – Housing starts are expected to have settled in at a still respectable 259,000 in November. The decline in the value of building permits in the month as well as October likely weighed on the headline along with lower construction employment. However, the recent persistence of housing starts in the face of falling existing home sales and building permits suggests it may be stickier than some typical inputs to the forecast would suggest.

THURSDAY December 15 - 9:00	
November	**m/m**
Consensus	n/a
Desjardins	-3.7%
October	**1.3%**

Existing home sales (November 2022) – After posting the first advance in seven months in October, existing home sales are expected to have declined in November. This is on the back of falling sales in major centres like Toronto and Vancouver as well as the province of Quebec. Within Ontario, smaller cities like Ottawa, Mississauga, Durham, London, Windsor and St. Catharines are all expected to have seen sales take a step back in the month. The western cities of Edmonton and Saskatoon look to have moved in the same direction. One of the few pieces of good news is that Calgary may have seen an increase in existing home sales in November.

FRIDAY December 16 - 8:30	
October	**m/m**
Consensus	1.3%
Desjardins	0.9%
September	**0.1%**

Wholesale sales (October 2022) – Wholesale trade likely moved higher in October on the back of gains in both sales volumes and prices. This is modestly lower than Statistics Canada's early indicator of a 1.3% increase in the month. Higher import and CPI goods prices combined with a depreciating Canadian dollar likely boosted wholesale prices in October. Meanwhile, rising wholesale employment and motor vehicle sales are expected to have provided a fillip to wholesale sales volumes in the month.

OVERSEAS

MONDAY December 12 - 2:00	
October	**m/m**
Consensus	0.4%
September	**-0.6%**

United Kingdom: Monthly GDP (October) – UK real GDP declined in three of the four months between June and September. That puts the British economy in recession territory, with quarterly real GDP falling an annualized 0.7% over the summer. We expect the year to end with another quarterly decline. It remains to be seen if monthly GDP fell again in October, however. Since September's 0.6% decline was largely due to economic disruption from the national mourning period for Queen Elizabeth II, we may see a rebound in October. This is supported by retail sales data, which was up 0.6% after falling 1.5% in September. In any event, we expect further declines in monthly GDP thereafter.

WEDNESDAY December 14 - 21:00
November

China: Retail sales and industrial production (November) – Economic indicators for China have been fairly volatile for some time, due in part to the government's zero-COVID policy. October data showed a 0.5% year-over-year decline in retail sales but a 5.0% gain in industrial production. The latter may have slowed in November, with exports seeing a sharp year-over-year decline during the month, falling from 7.0% to just 0.9%. Furthermore, last month's lockdowns in several Chinese cities are likely to have again impacted retail sales, which could be down even further.

THURSDAY December 15 - 7:00	
December	
Consensus	3.50%
Desjardins	3.50%
November 3	**3.00%**

United Kingdom: Bank of England meeting (December) – One year ago, the Bank of England (BoE) was the first major central bank to start tightening monetary policy. It started with a gradual approach, but then embarked on a series of larger rate hikes after failing to make a dent in inflation. November 2022 saw the BoE announce its first 75 bps raise, although the decision was not unanimous, with two members of the Monetary Policy Committee in favour of something smaller. For the December 15 meeting, we expect the BoE to announce a 50 bps increase and to continue sending clear signals of further rate hikes in 2023.

THURSDAY December 15 - 8:15	
December	
Consensus	2.50%
Desjardins	2.75%
October 27	**2.00%**

Eurozone: European Central Bank meeting (December) – While inflation appears to have recently peaked in the eurozone, it remains extremely high at close to 10%. Compared to the United States, not only is inflation higher but the European Central Bank (ECB) was also later than the Fed to start raising rates. With that in mind, it's safe to expect another 75 bps rate hike, although 50 bps is also a possibility. We'll be looking to see what signals the bank sends about its upcoming monetary policy decisions. We predict the ECB will continue to indicate that further rate hikes will be needed in 2023. We'll also be interested in the ECB's new economic growth and inflation outlook.

Economic Indicators

Week of December 12 to 16, 2022

Day	Hour	Indicator	Period	Consensus	Desjardins forecast	Previous data
UNITED STATES						
MONDAY 12	14:00	Federal budget (US$B)	Nov.	n/a	-248.0	-87.8
TUESDAY 13	8:30	Consumer price index				
		Total (m/m)	Nov.	0.3%	0.3%	0.4%
		Excluding food and energy (m/m)	Nov.	0.3%	0.3%	0.3%
		Total (y/y)	Nov.	7.3%	7.3%	7.7%
		Excluding food and energy (y/y)	Nov.	6.1%	6.1%	6.3%
WEDNESDAY 14	8:30	Export prices (m/m)	Nov.	-0.6%	-0.8%	-0.3%
	8:30	Import prices (m/m)	Nov.	-0.5%	-0.6%	-0.2%
	14:00	Federal Reserve meeting	Dec.	4.50%	4.50%	4.00%
	14:30	Speech of the Federal Reserve Chair, J. Powell				
THURSDAY 15	8:30	Initial unemployment claims	Dec. 5-9	234,000	234,000	230,000
	8:30	Philadelphia Fed index	Dec.	-10.0	-10.0	-19.4
	8:30	Empire manufacturing index	Dec.	-1.0	-2.5	4.5
	8:30	Retail sales				
		Total (m/m)	Nov.	-0.1%	-0.3%	1.3%
		Excluding automobiles (m/m)	Nov.	0.2%	0.1%	1.3%
	9:15	Industrial production (m/m)	Nov.	0.1%	-0.2%	-0.1%
	9:15	Production capacity utilization rates	Nov.	79.8%	79.7%	79.9%
	10:00	Business inventories (m/m)	Oct.	0.4%	0.3%	0.4%
	16:00	Net foreign security purchases (US$B)	Oct.	n/a	n/a	118.0
FRIDAY 16	---	---				
CANADA						
MONDAY 12	8:30	National balance sheet	Q3			
	15:25	Speech of the Bank of Canada Governor, T. Macklem				
TUESDAY 13	---	---				
WEDNESDAY 14	8:30	Manufacturing sales (m/m)	Oct.	1.9%	1.9%	0.0%
THURSDAY 15	8:15	Housing starts (ann. rate)	Nov.	255,000	259,000	267,100
	9:00	Existing home sales (m/m)	Nov.	n/a	-3.7%	1.3%
FRIDAY 16	8:30	International transactions in securities ($B)	Oct.	n/a	n/a	-22.27
	8:30	Wholesale sales (m/m)	Oct.	1.3%	0.9%	0.1%

NOTE: Desjardins, Economic Studies are involved every week in the Bloomberg survey for Canada and the United States. Approximately 15 economists are consulted for the Canadian survey and a hundred or so for the United States. The abbreviations m/m, q/q and y/y correspond to monthly, quarterly and yearly variation respectively. Following the quarter, the abbreviations f, s and t correspond to first estimate, second estimate and third estimate respectively. The times shown are Eastern Standard Time (GMT - 5 hours). Forecast of Desjardins, Economic Studies of the Desjardins Group.

Economic Indicators

Week of December 12 to 16, 2022

Country	Hour	Indicator	Period	Consensus m/m (q/q)	Consensus y/y	Previous data m/m (q/q)	Previous data y/y
OVERSEAS							
MONDAY 12							
United Kingdom	2:00	Trade balance (£M)	Oct.	-3,500		-3,135	
United Kingdom	2:00	Construction	Oct.	0.1%	6.4%	0.4%	5.7%
United Kingdom	2:00	Index of services	Oct.	0.5%		-0.8%	
United Kingdom	2:00	Monthly GDP	Oct.	0.4%		-0.6%	
United Kingdom	2:00	Industrial production	Oct.	-0.1%	-2.6%	0.2%	-3.1%
TUESDAY 13							
United Kingdom	2:00	ILO unemployment rate	Oct.	3.7%		3.6%	
Germany	2:00	Consumer price index – final	Nov.	-0.5%	10.0%	-0.5%	10.0%
Germany	2:00	ZEW survey – Current situation	Dec.	-57.0		-64.5	
Germany	2:00	ZEW survey – Expectations	Dec.	-26.7		-36.7	
Japan	18:50	Tankan large manufacturers index	Q4	7		8	
WEDNESDAY 14							
United Kingdom	2:00	Consumer price index	Nov.	0.6%	10.9%	2.0%	11.1%
Euro zone	5:00	Industrial production	Oct.	-1.5%	3.5%	0.9%	4.9%
China	21:00	Industrial production	Nov.		3.7%		5.0%
China	21:00	Retail sales	Nov.		-3.9%		-0.5%
THURSDAY 15							
France	2:45	Business confidence	Dec.	101		102	
France	2:45	Consumer price index – final	Nov.	0.4%	6.2%	0.4%	6.2%
Switzerland	3:30	Swiss National Bank meeting	Dec.	1.00%		0.50%	
United Kingdom	7:00	Bank of England meeting	Dec.	3.50%		3.00%	
Euro zone	8:15	European Central Bank meeting	Dec.	2.50%		2.00%	
Mexico	14:00	Bank of Mexico meeting	Dec.	10.50%		10.00%	
United Kingdom	19:01	Consumer confidence	Dec.	-43		-44	
FRIDAY 16							
United Kingdom	2:00	Retail sales	Nov.	0.3%	-5.6%	0.6%	-6.1%
France	3:15	PMI composite index – preliminary	Dec.	48.7		48.7	
France	3:15	PMI manufacturing index – preliminary	Dec.	48.0		48.3	
France	3:15	PMI services index – preliminary	Dec.	49.1		49.3	
Germany	3:30	PMI composite index – preliminary	Dec.	46.5		46.3	
Germany	3:30	PMI manufacturing index – preliminary	Dec.	46.5		46.2	
Germany	3:30	PMI services index – preliminary	Dec.	46.4		46.1	
Euro zone	4:00	PMI composite index – preliminary	Dec.	48.0		47.8	
Euro zone	4:00	PMI manufacturing index – preliminary	Dec.	47.1		47.1	
Euro zone	4:00	PMI services index – preliminary	Dec.	48.5		48.5	
United Kingdom	4:30	PMI composite index – preliminary	Dec.	48.0		48.2	
United Kingdom	4:30	PMI manufacturing index – preliminary	Dec.	46.5		46.5	
United Kingdom	4:30	PMI services index – preliminary	Dec.	48.5		48.8	
Euro zone	5:00	Trade balance (€B)	Oct.	n/a		-37.7	
Euro zone	5:00	Consumer price index – final	Nov.	-0.1%	10.0%	-0.1%	10.0%

Note: In contrast to the situation in Canada and the United States, disclosure of overseas economic fi gures is much more approximate. The day of publication is therefore shown for information purposes only. The abbreviations m/m, q/q and y/y correspond to monthly, quarterly and yearly variation respectively. The times shown are Eastern Standard Time (GMT - 5 hours).