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Capital markets appear to be balancing softening global economic growth rates against a strong U.S. consumer and a return to accommodative monetary policy by global central banks. Equity markets did not provide much direction and spent the quarter trading within well-defined ranges. Bond yields continued to fall over the quarter as markets priced in lower interest rates for longer.

It’s a familiar story for those following the global economy over the last decade. Experience would suggest that a strong U.S. consumer combined with easing central bank policies and lower rates is enough to keep the global economy afloat and drive equities higher. While this is our base case, all economies, including the U.S., are hovering near stall speeds with earnings declining in Europe. We are also weary of central banks’ limited ability to further stimulate economies through policy tools available at current interest rates. In aggregate, we are left to believe that global economies and markets are more exposed to unforeseen external shocks than they have been in recent years.

Private commercial mortgages remain a high conviction investment for us. Many investors integrating these mortgages into fixed income portfolios have benefitted from both yield enhancement and value add that is uncorrelated to equity market movements.

Real assets are long-term stable investments by their nature; however, we have observed shifting dynamics over recent years that create tremendous opportunities. These shifts also heighten the importance of diligence and strategic planning.

The need for developed economies to update aging infrastructure is not a new story, but it is one that becomes more important with every passing year. As central banks become increasingly constrained with their policy tools, we believe the appetite for deficit spending will continue to expand and that infrastructure will be at the forefront. As environmental considerations become increasingly important to corporate stakeholders, we also believe that demand for renewable infrastructure will increase.

In real estate, the transformation of retail into the world of e-commerce has implications for the future of shopping and even the importance of logistics in the industrial space. Office vacancies in Toronto and Vancouver are at historic lows1 at a time where the dynamics of office leasing is also shifting. We have observed strong demand from new tenants such as WeWork, which represents an opportunity but also increases the importance of managing tenant risk.

We still see a strong pipeline of opportunities in real assets that can maintain attractive risk-adjusted returns compared to equities and bonds.

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1 CBRE Limited. As at Sep 30, 2019.
**Canadian Mortgage Market**

Commercial mortgage spreads slightly tightened over the third quarter, however remain above 2018 levels.

**Chart 1 - Commercial Mortgage Spreads**

Source: RBC 5-Year Commercial Mortgage Spreads. As at Sep 30, 2019.
Following volatility in late 2018 and early 2019, the commercial mortgage spread premium over corporate bonds has stabilized near long-term averages and remains attractive.

**Chart 2 - Commercial Mortgage Spread Premium**

<table>
<thead>
<tr>
<th>Jan-18</th>
<th>May-18</th>
<th>Sep-18</th>
<th>Jan-19</th>
<th>May-19</th>
<th>Sep-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage Spread - BBB Corporate Spread</td>
<td>0.90</td>
<td>0.80</td>
<td>0.70</td>
<td>0.60</td>
<td>0.50</td>
</tr>
<tr>
<td>Long Term Average</td>
<td>0.40</td>
<td>0.30</td>
<td>0.20</td>
<td>0.10</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Source: RBC 5-Year Commercial Mortgage Spreads less FTSE BBB Corporate Bond Spreads. As at Sep 30, 2019.

Long-term Government of Canada (“GoC”) yields fell further in the third quarter and have caused the term premium, or the additional yield for extending maturity on mortgages, to continue to dissipate.

**Chart 3 - Government of Canada Yield Curve**

Source: Bloomberg Financial LP. As at Sep 30, 2019.

Conversely, prime interest rates relative to GoC yields are near a 25-year low.

**Chart 4 - Prime Rate is Comparatively High**

Source: Bloomberg Financial LP. As at Sep 30, 2019.

As a result, prime rate floating mortgages, which are used on real estate at earlier stages of the real estate life cycle (i.e. land, construction, interim/bridge financing), have become increasingly attractive versus term GoC based mortgages.

**Chart 5 - Floating Prime Rate Based Mortgage less 5-Year Term Mortgage All-In Rate**

Source: Canada’s prime interest rate plus 1% spread less the RBC 5-year Term Mortgage all-in rate. Oct 31, 2019.

Higher yields can also be achieved by moving out the risk spectrum within term loans. By taking the five-year GoC yield and adding the respective spread for each mortgage category, Chart 6 depicts all-in yields incrementally increasing.
Although investors can increase yields by moving out the risk spectrum within the term-based lending landscape, this may not be the most efficient tactic from a risk-return perspective.

Instead, from a total commercial mortgage portfolio perspective, pairing floating prime rate loans with high-quality term loans can provide attractive aggregate risk and return metrics.
Canadian Commercial Real Estate Market

Office

At the end of the third quarter, the office vacancy rate was 11.0%, representing a 20 basis points (“bps”) decline over the quarter.² The decline in vacancy rates is largely a result of growing demand from the technology sector in downtown Toronto, Vancouver and Montreal.

Canada has increasingly become an attractive destination for existing and new technology companies due to a young and highly educated labour force. While technology workers only represent approximately 5% of the Canadian workforce,³ technology tenants are having an increasingly disproportionate impact on office demand, as displayed in Chart 7, which has historically been driven by finance and professional service tenants.

Chart 7 - Percentage of Leasing Activity in Toronto, Montreal and Vancouver


Demand for flexible offices (i.e. co-working space) has also seen accelerated growth in the past several years. From year-end 2017, square footage of flexible offices has grown by 80% as major operators like Regus and WeWork expand their footprint. Currently, flexible offices only occupy 1.4% of office inventory and are expected to grow. We believe co-working tenancy can provide an opportunity to improve office space offerings, but we also recognize the importance of managing portfolio risk (i.e. tenant diversification).

The pipeline of office construction remains active, notably in downtown Vancouver and Toronto (see Chart 9). Despite new supply, expectations are for vacancy rates to remain low given strong pre-leasing activity in Toronto and Vancouver, where 71% and 43% of new supply has been pre-leased, respectively.

**Chart 8 - Historical Canadian Flexible Office Market**

![Chart 8 - Historical Canadian Flexible Office Market](image)


**Chart 9 - Office Construction**

![Chart 9 - Office Construction](image)


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Retail

The total national vacancy rate decreased by 42 bps from the end of 2018 to 5.8% in the first half of 2019. Regional shopping centres are seeing positive leasing momentum subsequent to the departure of Sears. Included in the vacancy figures are approximately 17% of the 14.7 million square feet of former Target space and 71% of the 15.5 million square feet of Sears that have potential to be repositioned.6

**Chart 10 - National Vacancy Rate**

The announcement of Forever 21 store closures across Canada reaffirms the evolving consumer preference for unique experiential offerings beyond apparel-focused retailers. Landlords continue to incorporate fitness, and food & beverage centres (i.e. food halls) to their retail sites to attract a diversified tenant mix while also driving foot traffic and sales productivity. This departure from the traditional apparel-focused format, and repositioning towards experiential and destination type format, is a trend that is expected to persist.

**Chart 11 - Share of Shopping Centre Gross Leasable Area ("GLA") Leased by Tenant Type**

Supply forecasted for delivery in 2019 is expected to reach a 13-year low of 3.4 million square feet (see Chart 12). Mixed use developments in desirable urban centres remain the dominant retail format under construction.

**Chart 12 - Historic New Supply**

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**Industrial**

The national industrial availability rate declined to 2.9% to end the third quarter, which marked a historic low. Robust market fundamentals in Toronto, Vancouver and Montreal have led these major cities to achieve some of the lowest vacancy rates in North America.\(^7\)

**Chart 13 - Availability Rates by City**

<table>
<thead>
<tr>
<th>City</th>
<th>Availability Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vancouver</td>
<td>2.0%</td>
</tr>
<tr>
<td>Calgary</td>
<td>4.0%</td>
</tr>
<tr>
<td>Edmonton</td>
<td>6.5%</td>
</tr>
<tr>
<td>Winnipeg</td>
<td>8.0%</td>
</tr>
<tr>
<td>Toronto</td>
<td>9.0%</td>
</tr>
<tr>
<td>Ottawa</td>
<td>10.5%</td>
</tr>
<tr>
<td>Montreal</td>
<td>12.5%</td>
</tr>
<tr>
<td>Halifax</td>
<td>14.0%</td>
</tr>
<tr>
<td>National</td>
<td>9.2%</td>
</tr>
</tbody>
</table>


Demand for industrial space is largely driven by the e-commerce industry’s desire for logistic, distribution and warehousing facilities. When compared to a global scale, the e-commerce industry in Canada is underpenetrated (see Chart 14) and well positioned for growth. In fact, over a five-year period, Canada is anticipated to grow e-commerce sales by 102%, above USA’s growth of 88% over the same period.

**Chart 14 - Global E-commerce Sales**


As e-commerce grows, return rates of products are expected to increase. Studies have shown that on average, 30% of products purchased online are returned versus only 10% for in-store purchases.\(^8\)

Product returns further increase the demand for industrial space as return activity typically requires 15-20% more space than standard distribution activities.\(^9\)

Year over year, absorption (i.e. demand) continues to surpass the pace of new supply (see Chart 15). We expect this trend to be more pronounced in supply constrained markets like Toronto and Vancouver where there is a lack of developable land (i.e. Ontario Greenbelt, Agricultural Land Reserve), lengthy development approval processes and lack of political will.

**Chart 15 - Supply and Demand**


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\(^7\) CBRE Limited. September 2019.

\(^8\) GWL Realty Advisors. September 2019.

Multi-unit Residential

As we enter into the later stages of the economic cycle, multi-unit residential assets can provide diversification benefits to a balanced real estate portfolio due to their consistent cash flows and defensive positioning. This is augmented by the macroeconomic fundamentals Canada is experiencing.

Canada continues to exhibit strong population growth and is, in fact, the leader in annual population growth among G7 countries (see Chart 16).

**Chart 16 - G7 Population Growth**

![Chart 16 - G7 Population Growth](image)


The majority of this growth is the result of international immigration, which accounted for 80.5% of population growth in 2018 with the greatest influx experienced in Toronto, Vancouver and Montreal. New immigrants generally rent during their first several years in Canada, which further increases the demand for rental units within these major cities.

Rising home costs are a major challenge for most Canadians. Within a 10-year period ending in the first half of 2019, the average income in Canada grew by 29.3%, while home and condominium prices grew by 66.7% and 68.4%, respectively. The high cost of housing has priced many Canadians out of home ownership and has increased the demand for multi-family housing.

**Chart 17 - Rising Canadian Home Ownership**

![Chart 17 - Rising Canadian Home Ownership](image)


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**Conference Board of Canada, CBRE. June 2019.**
Given new government policies that encourage rental construction, and as rental rates have increased, the rental market is starting to experience new supply. However, the new supply is not expected to meet current demand, particularly in Montreal, Toronto and Vancouver, where there is a rental housing deficit (see Chart 18).

**Chart 18 - Rental Deficit**

<table>
<thead>
<tr>
<th>City</th>
<th>Rental Housing Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vancouver</td>
<td>(9,500)</td>
</tr>
<tr>
<td>Calgary</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Toronto</td>
<td>(5,500)</td>
</tr>
<tr>
<td>Montreal</td>
<td>(3,500)</td>
</tr>
<tr>
<td></td>
<td>(1,500)</td>
</tr>
<tr>
<td></td>
<td>(500)</td>
</tr>
</tbody>
</table>

Global Infrastructure

Despite solid gains across all asset classes this year, the last twelve months have seen increasing volatility as central banks have swung from tightening to easing monetary policy, the world’s largest economy continues to post solid economic indicators, and we brace for a prolonged U.S.-China trade war. Against this backdrop, we believe that direct, private infrastructure investments provide stability to a portfolio, and can also benefit from an active investment approach.

By their very nature, real assets require an active investment approach to source new investments, complete detailed due diligence, and manage the asset for optimal performance. However, approaches by asset managers vary significantly. We believe that the ability to efficiently deploy capital at attractive rates of return and managing asset strategies locally are key differentiators for infrastructure investments.

Q3-2019 Infrastructure Fundraising Activity

Q3-2019 saw a slowdown in fundraising with 19 funds reaching final close and totaling US$8.4 billion, according to Preqin. This marks the slowest quarter for fundraising since Q2-2016, despite a record number of funds in the market and 241 of those funds targeting US$200 billion as of the start of Q4.

Chart 19 - Quarterly Global Unlisted Infrastructure Fundraising, Q1 2014 – Q3 2019

Source: Preqin Pro. As at Sep 30, 2019.

Q3-2019 Infrastructure Transaction Activity

The quarter saw continued strength in deal making with 593 infrastructure transactions completed for a total value of US$88 billion, according to Preqin. The number of deals this quarter versus Q3-2018 saw an increase in Asian activity from 69 to 104 transactions, while North American transactions fell from 198 to 158.

Chart 20 - Infrastructure Transaction Activity

Source: Preqin Pro. As at Sep 30, 2019.
The Core-Plus Opportunity

Strong demand for core assets within North America is putting significant pressure on pricing. Investors are potentially pulling back from transactions where the risk-adjusted returns are no longer attractive. However, the opportunity to invest in greenfield development projects can offer an attractive alternative.

According to Inframation News, 85% of greenfield transactions over the last 12 months were $500 million or less, with 66% of them being $250 million or less (see Chart 21).

Given this asymmetry in the market for greenfield projects, we believe that having an active approach with platform teams to drive growth through development can be a differentiator for a manager.

Having platform investments with on-the-ground local professionals, who are focused on specific sectors and regions, allow for a competitive advantage in deploying capital in this environment. Specifically when investing in greenfield development, where local expertise and an ability to transact on smaller deal sizes is an advantage.

A platform approach to investing in infrastructure can provide a strategy with local teams that are able to execute more efficiently on a greenfield strategy, as these projects tend to require more local knowledge and technical expertise. These projects are often smaller and may never be on the radar of larger asset managers with mandates to deploy significant capital, allowing for less competition in the acquisition and development of these assets.

While mandates may be global in scope, the business of infrastructure investing is very much local. From acquiring lease-holds or concessions on land, to permitting new projects, to negotiating long-term contracts, having local “boots-on-the-ground” provides an advantage to a strategy. Not all boots are created equal, and a truly local team that is focused on a specific sector and geography allows for both local and technical expertise to add value to your portfolio. While regional investment offices are important for a strategy, having an analyst in New York, London, Sydney or Toronto likely won’t drive the same benefits as a local team within a platform.

Chart 21 - Greenfield Projects by Value (LTM)

Global Commercial Real Estate Market

Institutional investors who have real estate as part of a balanced portfolio tend to allocate domestically. As investors increasingly look to manage portfolio risk, there is now a greater demand for adding a global real estate allocation that can complement an existing domestic real estate mandate by providing additional diversification, a greater opportunity set, and the potential to enhance risk-adjusted returns. Therefore, we have added a Global Commercial Real Estate Market section to the Real Assets Report and will provide commentary on several global real estate markets.

Diversification

Diversification is a key rationale for a global real estate allocation. Performance of a property is driven by local supply and demand factors such as GDP, population growth, employment and retail sales. As a result, correlations across global markets tend to be lower than within a domestic market. For example, Canadian GDP growth tends to be less correlated with markets such as Japan, Singapore, South Korea and Spain. Thus, there is potential to further reduce the overall volatility of a diversified portfolio.

Chart 22 - Correlation: Global Real Estate Returns

<table>
<thead>
<tr>
<th></th>
<th>Asia Pacific</th>
<th>Europe</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia Pacific</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Europe</td>
<td>0.50</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td>0.63</td>
<td>0.26</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: Global Real Estate Fund Index, Sep 2009 – Jun 2019. Returns are based on local currency.
Greater Opportunity Set
Within the global real estate market, participants have the ability to access a larger opportunity set of investments. Direct commercial real estate transaction volume has averaged above $700 billion annually in the past five years, with increased investor activity in the Asia Pacific-region. This robust opportunity set allows investors to compare investment opportunities in multiple geographies, increasing the ability to strategically position a portfolio and deploy capital efficiently into high-quality, long-term assets.

Enhance Risk-Adjusted Returns
The varying return profiles that can be accessed through the global real estate markets can allow investment managers to allocate exposure to regions that are best suited to meet investor objectives. For example, managers can increase exposure to markets that are growing at a faster pace. Since national economies are not always synchronized, different markets tend to not move in tandem, as they can be influenced by local factors. Active management can take advantage of these regional differences within global markets by increasing exposure to regions that have the most attractive risk and return profiles.

Chart 23 - Quarterly Total Return by Region
![Chart showing quarterly total return by region](chart.png)

Source: Global Real Estate Fund Index, Sep 2009 – Jun 2019. Returns are based on local currency.

Ultimately, given the added diversification of global real estate and its return profile, we believe its addition to a well-balanced portfolio can equip investors with the ability to enhance risk-adjusted returns.

Chart 24 - Adding Alternative Investments
![Chart showing risk-adjusted return](chart.png)

1 Sharpe Ratio. Source: TD Asset Management. As at Sep 30, 2018. Returns are based on TD Asset Management’s assumed 7-10 year annual expected return. No assurance that expected returns will be achieved. Historical volatility is calculated using respective benchmarks between December 1998 to September 2018. Benchmarks used: Equities - S&P/TSX Composite Index; S&P 500; MSCI EAFE, Bonds - FTSE Canada Universe Bond, Mortgages - 40% FTSE TMX Mid term Index , 60% FTSE TMX Short term Index + 0.5% per annum, Canadian Real Estate: MSCI/REALPAC Canada Annual Property Index, Global Real Estate: MSCI Global Annual Property Index, Infrastructure: Median Australian Manager (Mercer MPA)

2 JLL. June 2019.
Conclusion

Within the active Canadian commercial mortgage market, there is a compelling case to participate in lending in the earlier stages of the real estate life cycle as part of a fully diversified mortgage portfolio.

Sound property fundamentals persist across all property types within the Canadian real estate market, and particularly in the industrial and multi-unit residential space. There are strong tailwinds from e-commerce that we believe will continue to fuel the demand for industrial space. Given robust population growth and demographic shifts, it is anticipated to increase the need for purpose-built rentals.

Within global infrastructure, having local teams within platforms can help drive greenfield activity in a core-plus fund that will add value to a portfolio throughout the cycle.

Finally, as institutional investors look to manage portfolio risk, we believe adding global real estate to an existing domestic real estate allocation has the potential to provide additional diversification and enhance risk-adjusted returns.
Sound property fundamentals persist across all property types within the Canadian real estate market, and particularly in the industrial and multi-unit residential space.
Contact us to find out how TDAM can bring new thinking to your most important challenges.

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