Putin's War: Impact on Canada

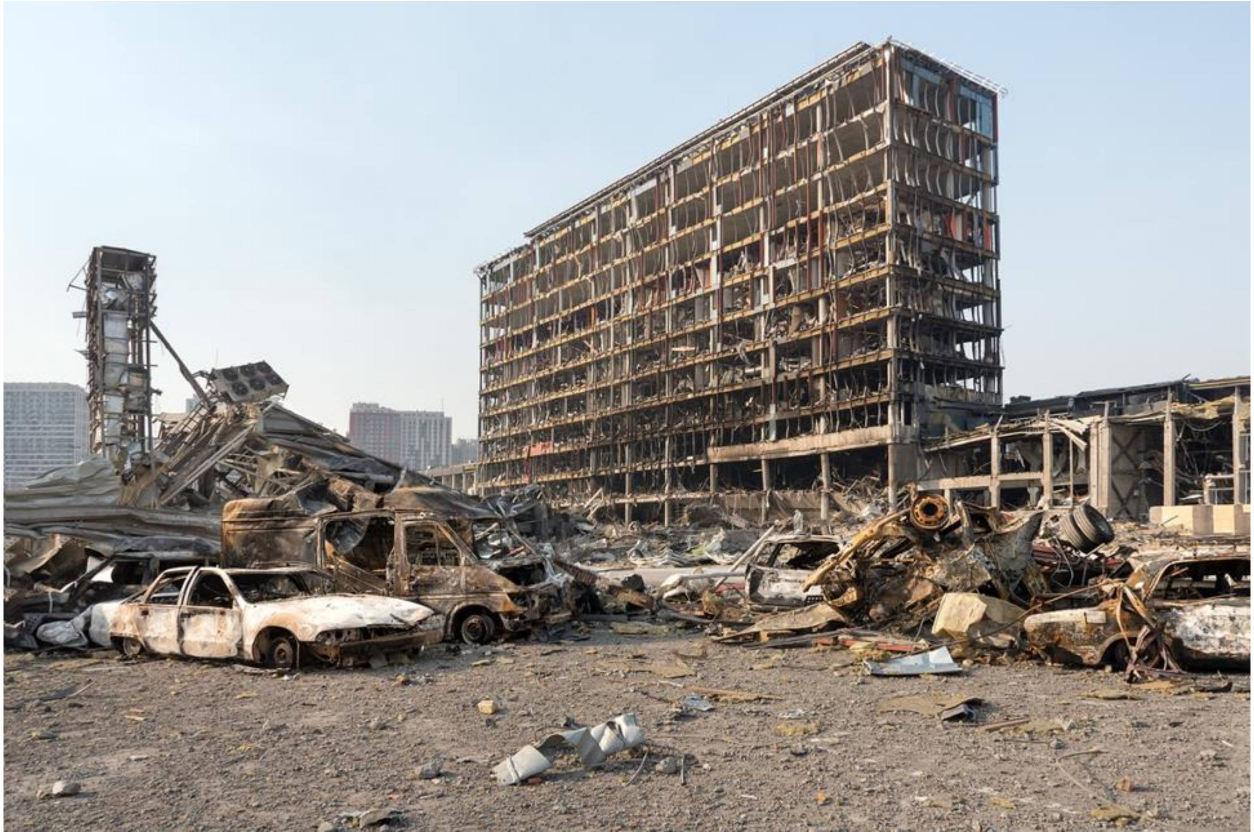
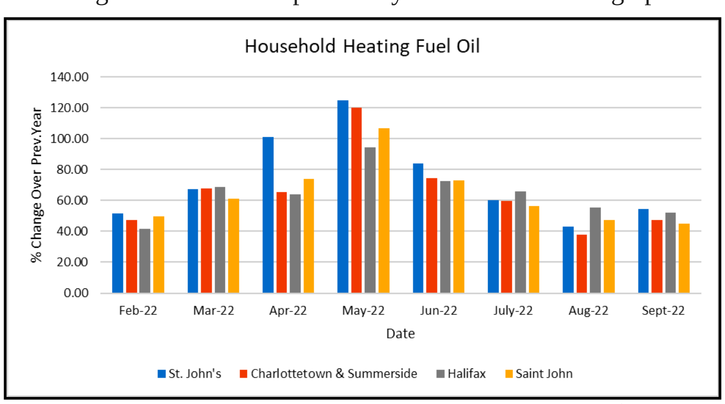


Photo Credit: Synel Bigstock Photo

Title "*A clever person solves a problem. A wise person avoids it" (Albert Einstein).* When Russia invaded Ukraine in February 2014, annexed Crimea and supported pro-Russian separatists in the war in Donbas, the western world expressed its concern and little else. Faced with a corrupt administration and weak armed forces in Ukraine, NATO (North Atlantic Treaty Organisation) focused instead on training and equipping the Ukrainian military. While the United States and the United Kingdom recognised the threat, other major economies continued to facilitate the Russian strategy of eliminating Ukraine as the transit route for its natural gas into the European Union. Many in the European Union increased their reliance on Russian gas, in particular Germany, which continued to promote the new Nord Stream 2 pipe line under the Baltic Sea. They were assisted by the Biden administration in the United States, which waived the sanctions imposed on the pipe line company by the former Trump presidency. A problem deferred is rarely a problem solved. In retrospect it is easy to recognise the mistakes, a belief that trade would trump Putin's ambitions to stem the tide of former Soviet countries "defecting" to the West. A focus on short term economic goals rather than long term security. In failing to take a resolute stand with Ukraine, the West emboldened President Putin to invade the remainder of Ukraine eight years later. Although the triggering event was the Revolution of Dignity in February 2014, the desire of most Ukrainians to chose the European Union instead of closer ties with Russia is, in a very real sense, about the freedom of individuals to choose their own path. The Ukrainians are fighting our war and suffering horribly; were they not to do so, our children or grandchildren would have to… something to bear in mind as we consider the impact on our wallets of Putin's war.

Operating Expenses

The main impact on operating expenses has been the increase in heating (oil and natural gas). The percentage change in heating oil cost over the previous year is shown in the graph below:



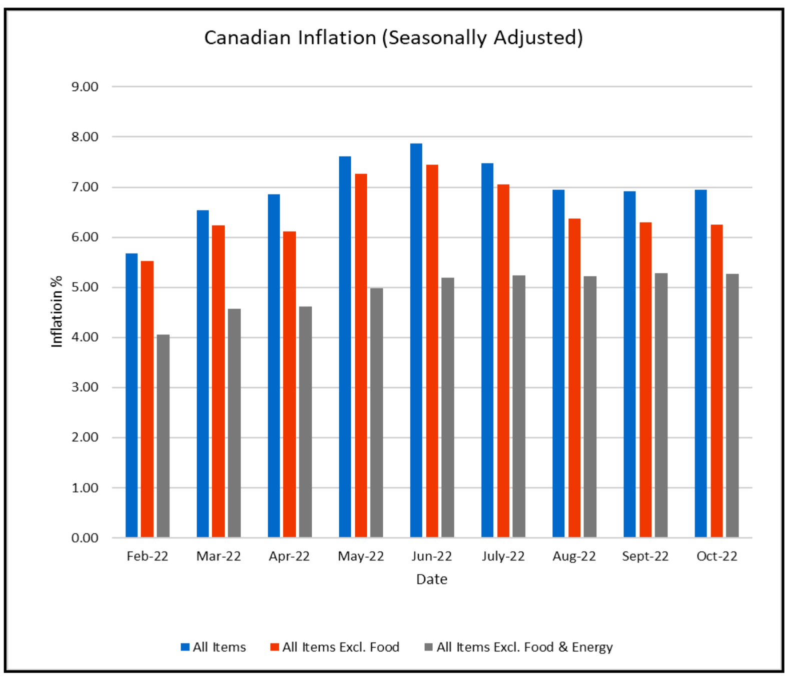
Source: Statistics Canada Table 18-10-0001-01 Monthly Average Retail Prices for Gasoline and Fuel Oil, by Geography

TURNER DRAKE & PARTNERS LTD.

By September heating oil prices appeared to have stabilised at about 50% over last year (St. John's 55%, Charlottetown 47%, Halifax 52%, Saint John 45%).

Since the cost of fuel to generate electricity is increasing, so will the cost of electricity generated by oil and gas. Nova Scotia Power has applied to the regulator for a 11.6% increase during the period 2022 to 2024 but this is expected to be reduced because the Province has offered to provide relief from greenhouse gas expenses. They are close lipped as to how it will be applied but we estimate that it should decrease the proposed average increase to 8.79%. New Brunswick Power applied for an "across the board" increase (excluding six pulp and paper mills) of 8.9% for April 2023. Prince Edward Island's Maritime Electric has applied for a one-year increase equating to about 2% for residential and small business customers, and up to 4.3% for large industrial users, for 2022-2023 to cover the cost of replacement power necessitated by repeated repair shutdowns at the Point Lepreau Nuclear Power Plant in 2021. In June they applied to increase rates for the next three years by about 3% annually for small users but since then have had to cope with the cost of widespread devastation inflicted by Hurricane Fiona. They are expected to apply for an additional 0.8% to increase resiliency of their power distribution system. Newfoundland Power's rates actually decreased slightly in July 2022.

It would be easy to blame all of our inflation on the war in Ukraine and it obviously has had an impact: increased oil, mineral, metal and food costs fuel some of it. Both can, in large measure, be attributed to Putin's war. However, the Covid-19 pandemic, its continued disruption of supply chains especially for goods sourced in China, the reduction in the work force, together with the Bank of Canada's fiscal stimulus, were also factors, albeit amplified by the war. That fed inflation, first in goods, then services, according to the Bank. They report that by August 2022 almost 80% of the goods and services that make up the Consumer Price Index (CPI) were rising by more than 3% per annum, 60% were rising by over 5% per year, and about 43% by more than 7% annually.



Source: Statistics Canada Table 18-10-0006-01 Consumer Price Index, Monthly, Seasonally Adjusted.

By September, Canadian inflation, as measured by the All-items Consumer Price Index had fallen from its June 2022 peak of 8.13% (7.87% seasonally adjusted) to 6.90% (6.92% seasonally adjusted). The Bank of Canada started to raise its Overnight Rate in March to combat inflation before it became "baked in" by wage increase expectations. Until March 2022 the Overnight Rate had been steady at 0.25%. It then increased seven times during the remainder of 2022 and as of December 7th stood at 4.25% and was expected to remain close to that level for 2023 in the hope of avoiding a recession. However, the Bank's target rate for inflation of 2% is a long way from our present 7.0%. South of the border the United States Federal Reserve raised their benchmark interest rate by another 0.75% on November 2nd (though it did indicate that its rate hikes may be coming to an end). The Bank of Canada's chief concern appears to be the labour shortage which they attribute to pent up demand for goods and services resulting from the Covid-19 lockdown. They view this as a temporary problem and their monetary policy is therefore designed to reduce demand until it is in equilibrium with labour supply again. However, it appears to us to be a little bit of a stretch to attribute this labour shortage solely to excess demand; it is too widespread geographically and across too many sectors. Whilst the backlog of demand is a factor, a more likely explanation is that the Baby Boomers, those born between 1946 and 1966, are now retiring in greater numbers, and the cohort that follows is too small to replace them. We took a look at the problems this would cause in our Newsletters in 1995, 2007, and 2013 (were you paying attention?). This retirement wave started in 2011, will peak between 2022 to 2026, before ending in 2031. The impact has been surcharged by Covid-19 which has disrupted work patterns and caused a re-assessment of the value of work itself. This is amplified by a generation that is less focused on the long term and more on the "here and now" … perhaps due to the fact that climate change increasingly threatens their future, or in some cases to a family and school upbringing that prioritized self-esteem over self-reliance. This is resulting in staff churn, and attendant training issues, at most companies as new hires "try out the job" and then move on after a year or so to something new. There is also a mental health crisis, triggered by the Covid-19 lockdowns, which became visible once people started to return to work. This has increased sick time and decreased productivity. The anticipated "productivity bounce" that was expected in 2022 following the vaccination program and the "return to normal" has not occurred: global productivity continues to fall. Part of this is due to supply chain issues and China's dogged insistence on fighting Covid-19 with lock-downs (recently relaxed), but The Economist magazine's "The World Ahead 2023" posits that the new work pattern of working from home may also be an issue. Whilst "wfh" promises individual productivity gains for "deep work" away from the noisy and busy office environment this may be outweighed by the lack of "water-cooler chat", those chance interactions that facilitate communication and spur new ideas. The Economist suggests too that communication between departments has suffered, resulting in lower productivity. Many companies would agree, on-line video meetings are no substitute for the real thing, they lack the informality of personal contact so important for team building and idea generation. The Covid-19 lockdowns and the increased propensity to work from home have also substantially reduced training opportunities for new entrants to the work force and those changing jobs. Life now is often a frustrating experience of missed appointments with contractors due to impaired communications and the reality that a problem, usually rectified in a single on-site visit, may now be the subject of multiple attempts as inadequately trained personnel struggle to learn on the job. Then there is the public sector, unburdened by productivity requirements and unhindered by cost constraints, they continue to squeeze out the private sector as they mop up the shrinking labour pool. Government at all levels, happily oblivious to the commercial pressures that drive the private sector, appear reluctant to restore work practices and patterns that existed pre-Covid… resulting in time and cost burdens that now have to be borne by the users of their services. Add Putin's war to this toxic mix and it appears optimistic to assume that inflation will quickly return to its pre-Covid 2% annual growth. A base annual rate of 4% may be the least we can hope for during this decade with temporary respite if the economy goes into recession. Add 1% to 2% for the impact of fuel, food, metal and mineral price increases resulting from the war in Ukraine, the cost of assisting them during the conflict, and later the reconstruction that will be required, and the impact will linger well after the war is over.

Uncertainty

Since the war in Ukraine began in February 2022 the Bank of Canada has raised its Overnight Rate from 0.25% to 4.25%. Canada's Big Five Banks have raised their Prime Rate in step from 2.45% to 6.45%. Future increases or decreases will depend on the Bank of Canada's success in fighting inflation. The 4% increase in the Overnight and Prime Rates is now being reflected in mortgage rates. This in turn is decreasing demand for property and if sustained, will drive down commercial property values as the return required increases to reflect uncertainty. Our research has established that the most reliable predictor of commercial property values is the Overall Capitalisation Rate, the net return on an all cash purchase, this despite the fact that very few properties are purchased without debt financing. There is less variability in the Overall Capitalisation Rate (OCR), within each property type, than other measures such Internal Rate of Return (IRR), Equity Dividend (y) or Equity Yield (Y) Rates that measure cash flow after debt service and/or after-tax flow either in Year 1 or over the Investment Horizon (typically 10 years). The Overall Capitalisation Rate is based on the anticipated Year 1 Net Operating Income following the sale, divided by the Sale Price, expressed as a percentage. The OCR is the inverse of the Profits Earnings Ratio, so property values fall as the Overall Capitalisation Rate increases. OK so your eyes have now glazed over and your mind is starting to wander! Our key take-away is that increases in interest rates decrease demand, increase uncertainty and reduce property values because purchasers now require a greater return (aka Overall Capitalisation Rate). Whilst there is no measurable correlation between the return (OCR) investors require and changes in the mortgage rate because other factors influence demand, variability in the mortgage rate increases uncertainty and risk. Economic shocks due to the war in Ukraine and the Bank of Canada's wrestle with inflation, if sustained, will reduce commercial property values in this Region unless there is a counterbalancing increase in rents. The latter have increased substantially over the past five years for apartments, but that bull run may be reaching its end if only because provincial governments are starting to implement controls to curb rental increases in existing accommodation. This puts them in conflict with their goal of expanding their populations by immigration, to combat our aging population, so it remains to be seen whether it is sustainable. Industrial rents have also increased over recent years and will probably continue to do so (with a temporary pause if there is a recession). Retail rents continue to struggle with the on-line shopping habits and it is difficult to see why this trend will not continue. Office rents were a victim of overbuilding in the past decade, were then hit by Covid-19 lockdowns, faced changes in work practices as more administrative work moved on-line, and now struggle with the reluctance, especially with public employees, to escape the bosom of their homes. Net absolute office rents in many of the Region's Central Business Districts (CBDs) are substantially lower than they were in 1989 in real (and often nominal) terms. Many of the region's municipalities appear to have given up on their CBDs or continue with policies destined to facilitate their commercial demise in favour of stoking the egos of their councillors. An epiphany is overdue, and unanticipated.

Unless there is a countervailing increase in rents, each 1% increase in the Overall Capitalisation Rate will, on average, reduce the value of real estate by the following percentages: Apartments - 17%, Hotels - 10%, Industrials - 13%, Offices - 12%. A promise made more real by Putin's war in Ukraine.