RISING DOLLAR: THREAT OR NO SWEAT?

Ontario's Industrial Market in Good Shape Despite Higher Canadian Dollar's Drag on Manufacturing

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Rising Dollar: Threat or No Sweat? is the eighth in a continuing series of research publications by GWL Realty Advisors Inc. Other published reports include:

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To obtain any of these reports, visit **www.gwlra.com** and click "Investor Info" then "Research Reports".

Data used in this report obtained from: Bank of Canada, the Conference Board of Canada, Cushman & Wakefield LePage, Industry Canada and Statistics Canada.

EXECUTIVE SUMMARY

A sharp 35% increase in the value of the Canadian dollar from \$0.63 USD in January 2002 to \$0.85 USD in October 2005 has presented significant challenges to Ontario's economy. The rising dollar has severely hampered export growth and is placing downward pressure on manufacturing output. Ontario's economy is more reliant on manufacturing than other provinces – particularly in the automotive sector – thus the threat to overall economic growth for Ontario and for Canada is significant. Fortunately, the domestic component of Ontario's economy has performed strongly, absorbing much of the slack from weakened export levels.

Despite the challenges presented by a rising dollar, the industrial real estate market has remained highly resilient. Industrial space availability has maintained a low rate of between 3.8% and 5.5% of total inventory since the late 1990s, new construction levels have been disciplined, and an increasingly diverse array of businesses has kept industrial absorption levels healthy. Although the dollar is having the strongest impact on the manufacturing sector, it is estimated that direct manufacturing only occupies 30% of Ontario's total industrial real estate inventory.

Another factor is the fact that the decline in manufacturing's prominence in Ontario – both in terms of exports and employment – is more linked to a **continuing structural shift to services** as the driver of Ontario's economy than it is to a higher exchange rate.

This is not to suggest that the rising dollar is not a threat to the industrial market in the longer term. At \$0.85 USD the dollar is at its highest level in 13 years and some forecasts suggest the dollar could continue to rise in future years. Thus it is important to understand potential impacts of any future increases.

Based on the results of an econometric model prepared by the Conference Board of Canada (CBoC), the manufacturing sectors most negatively impacted by a higher Canadian dollar are apparels, textiles, autos, primary metals and fabricated metals. If the Canadian dollar appreciates 10% above current projections (to close to \$0.90 USD), manufacturing employment in Ontario could decline by 50,000 jobs by 2007, on top of the over 66,000 manufacturing jobs lost in Ontario over the last three years.

For the manufacturing sector, a rising dollar is definitely a threat. For the industrial market in Ontario, given its relative supply/demand balance and its diversity, the dollar's rise in the short term is "no sweat."

OUTLINE OF THE REPORT

As this report will specifically address the impacts of a high dollar on Ontario's economic performance, two key themes will be addressed:

- The impacts on Ontario's industrial real estate market, comprised of the Greater Toronto Area, Ottawa, London and the greater Kitchener-Waterloo Region; and
- The results of a report prepared for GWL Realty Advisors by CBoC that through econometric modelling estimated the effects of a rising dollar on the export performance of Ontario's manufacturing sector.

EXPORT WEAKNESS AND ECONOMIC IMPACTS: THREATS

Economic Challenges

The Canadian dollar's increase from a monthly average of $0.63 USD in January 2002 to $0.85 USD in October 2005 represents an increase of roughly 35% and marks one of the strongest rallies in the dollar's history. As the manufacturing heart of Canada's economy, a rising dollar is of particular concern to Ontario for a number of reasons:

- Drastically reduced export growth;
- Increased inventory levels;
- Lower industrial capacity utilization;
- Stagnant manufacturing employment growth over the long term and declines in the short term; and
- Reduced GDP growth.

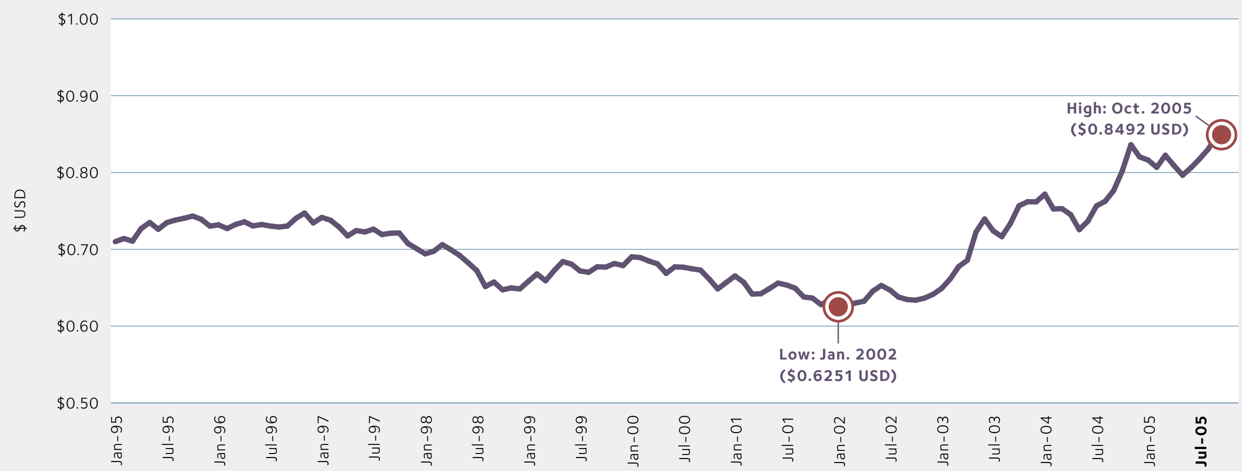
There are a number of factors behind the rapid appreciation of the Canadian dollar:

- The recent strength of the Chinese and Indian economies combined with a strong U.S. recovery has led to a sharp increase in the price of commodities that are important exports for Canada;
- Massive budget and current account deficits in the U.S. that are a source of concern for investors, resulting in a selling of the U.S. dollar in world financial markets and placing upward pressure on the Canadian dollar; and
- The Canadian economy has run solid fiscal budget surpluses and large current account surpluses.

To illustrate, the Canadian dollar's movement since 2000 can be seen in Figure 1 below, with the most recent month (October 2005) representing a 10-year high of $0.8492 USD.

Figure 1: Canada-U.S. Dollar Exchange Rate, Monthly Average

January 2000–October 2005



Source: Bank of Canada, GWL Realty Advisors Inc.

Other challenges facing Ontario manufacturers, some of which are beyond their control, include:

- A steady rise in unfilled orders for the past six months;
- Difficulties manufacturers have been having in delivering products due to supply chain bottlenecks, traffic congestion and delays at border crossings;
- Production slowdowns due to years of under-investment and skilled labour shortages;
- Soaring cost of inputs;
- Increased foreign competition;
- Higher energy prices; and
- Further labour cost disadvantages relative to the U.S.

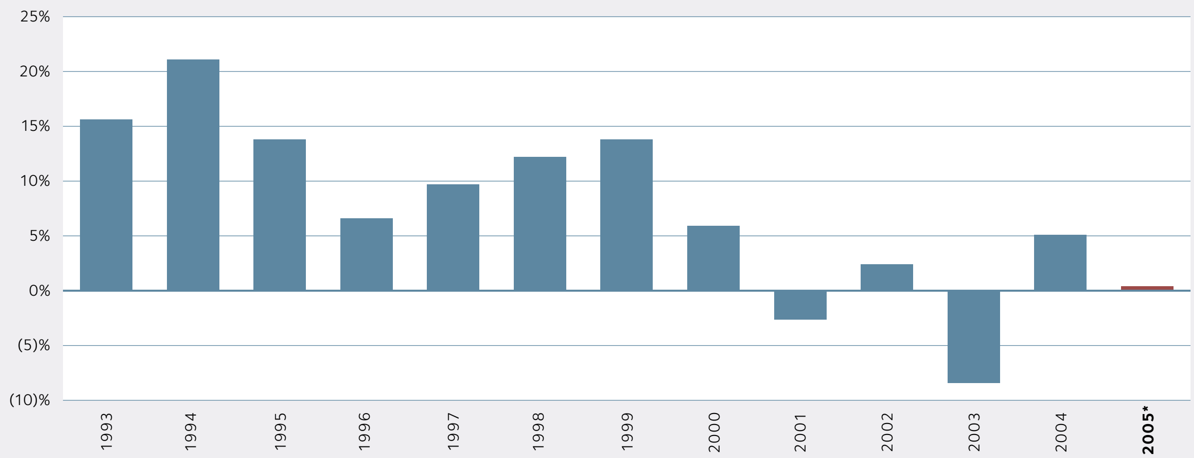
Canada is at a disadvantage when unit labour costs compared to the U.S. are adjusted by the exchange rate. The 8.6% appreciation of the Canadian dollar in relation to the U.S. dollar in the second quarter of 2005 compared to the same quarter in 2004, resulted in a sharp gain of 11.5% in unit labour costs measured in U.S. dollars. This was more than twice the gain of 4.3% in the United States.

Export Growth Curtailed

The most significant impact of a rising dollar on Ontario is reduced export growth. Though Ontario's global exports reached an historical high of $207.1 billion in 2000, the high dollar has clearly limited export growth in recent years (Figure 2, below). In 2003 exports dropped more than 8.0% to $189.1 billion, but rebounded in 2004 to $198.9 billion. However, Ontario's exports are at $149.3 billion year-to-date September 2005 and on pace to finish the year at $199.0 billion, which represents virtually no growth over the previous year.

Figure 2: Export Growth, Ontario

Annually, 1993–Year-to-Date September 2005



*2005 year-to-date monthly rate annualized
Source: Industry Canada, GWL Realty Advisors Inc.

There are other factors besides the exchange rate that can be blamed for weaker export growth: a post-9/11 decline in new aircraft orders and capacity constraints in some manufacturing sectors.

Despite Export Weakness, Some Positives

The news is not all negative, as there is some evidence to suggest manufacturers are remaining competitive despite the higher dollar.

- The value of Ontario's manufacturing shipments rose 5.7% in August 2005 compared to the previous month, to almost $27.0 billion, representing the highest level in 12 months.
- Over the first eight months of 2005, shipments were 1.3% higher than during the same period in 2004.

As evidence, and as shown in Figure 3 below, manufacturing shipments actually rose from nearly $24.0 million in 2004 to over $27.0 million during 2005 – during a period when the dollar was climbing strongly.

Figure 3: Ontario Manufacturing Shipments, Seasonally Adjusted

January 2002–September 2005

Source: Statistics Canada, GWL Realty Advisors Inc.

Certainly, much of the movement in manufacturing shipments is related to demand for autos, as approximately 85% of the 2.7 million vehicles made in Ontario in 2004 were exported – primarily to the United States. Also, while the specific amount is not known, there is certainly some component of manufacturing shipments that are not for export but destined for the domestic market.

Similarly, it is has been healthy domestic demand in Ontario's economy – fuelled by strong consumer spending, low interest rates and services sector employment growth – that has largely reduced the slack from the weakened manufacturing sector and the reduced export growth.

So what does all this mean for manufacturing employment, which is a key driver of real estate demand?

EMPLOYMENT TRENDS AND ONTARIO INDUSTRIAL REAL ESTATE MARKET IMPACTS: "NO SWEAT"

It is logical to assume that any downward pressure on manufacturing in Ontario caused by a high dollar would at some point reduce demand for industrial space, halt new supply and even lead to negative absorption. Overall this has not been the case in Ontario in recent years, and the reasons are related primarily to:

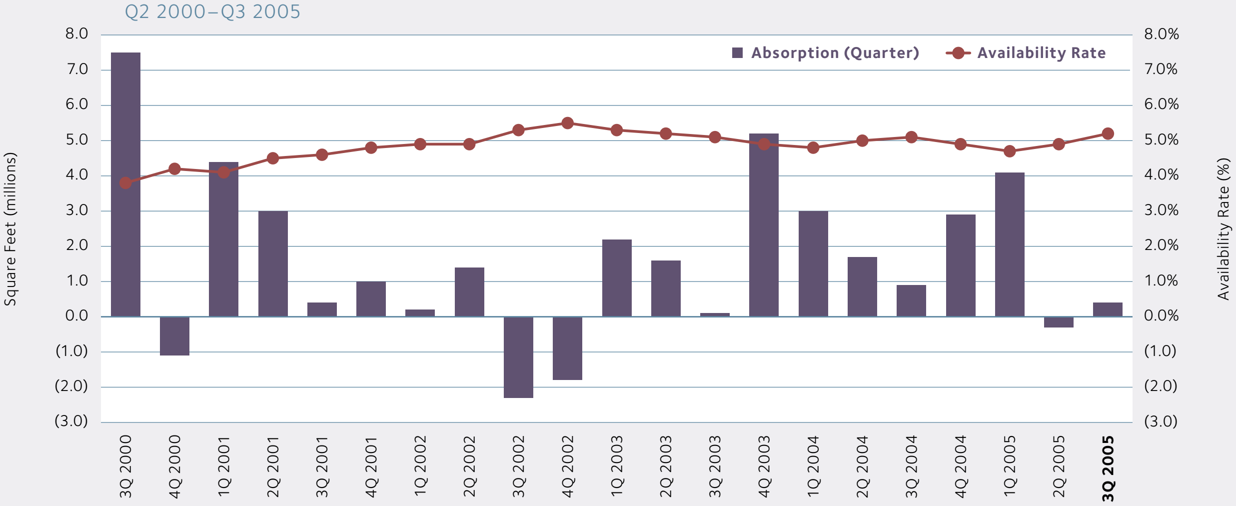
- The overall health of the industrial market in Ontario;
- The manner in which employment, which is rightly used as a proxy for industrial space demand, is classified;
- The increasing use of industrial real estate by firms that do not fall into the commonly accepted definition of "industrial-type" employment; and
- A wider variety of industrial properties in the marketplace, appealing to a wider array of tenancies. For example, modern warehousing and distribution users are demanding newer, larger and higher industrial buildings located close to major transportation routes, while smaller, older industrial properties in central areas are increasingly attracting retail and office users as tenants. This represents a shift away from the traditional notion that industrial buildings are only suitable for manufacturers and warehousing firms.

Industrial availability has remained well within normal levels in Ontario, despite the economic impacts of a high dollar and a strong reliance on manufacturing. Industrial availability has averaged between 3.8% and 5.5% since the end of 2000, as shown in Figure 4 below. By comparison, industrial availability in the U.S. industrial market has been chronically above 8.0% in most cities, and even above 11% in many others during the same period. The average vacancy rate for a normal, balanced industrial market in Canada is between 5.0% and 6.0%.

Furthermore, industrial space absorption has been positive in 17 of the last 21 quarters, including throughout all of 2004 when the dollar was making its strongest value gains.

Figure 4: Ontario Industrial Real Estate Market Trends
Toronto, Ottawa, Kitchener-Waterloo Region and London

Q2 2000–Q3 2005



Source: CB Richard Ellis Limited, GWL Realty Advisors Inc.

To reflect Ontario's industrial market in Figure 4, only the four markets for which historical data was available were examined: the Greater Toronto Area (GTA), London (including St. Thomas), Ottawa, and the greater Kitchener-Waterloo region (including Guelph, Cambridge and Brantford). These markets contain a combined 898.8 million square feet of industrial space. The GTA alone contains an estimated 740.3 million square feet of industrial space, thus the GTA carries the strongest market weighting and has the most impact on provincial and national industrial market trends.

According to data from Raymond James Equity Research, it is estimated that the industrial space market in Canada as a whole is split as follows:

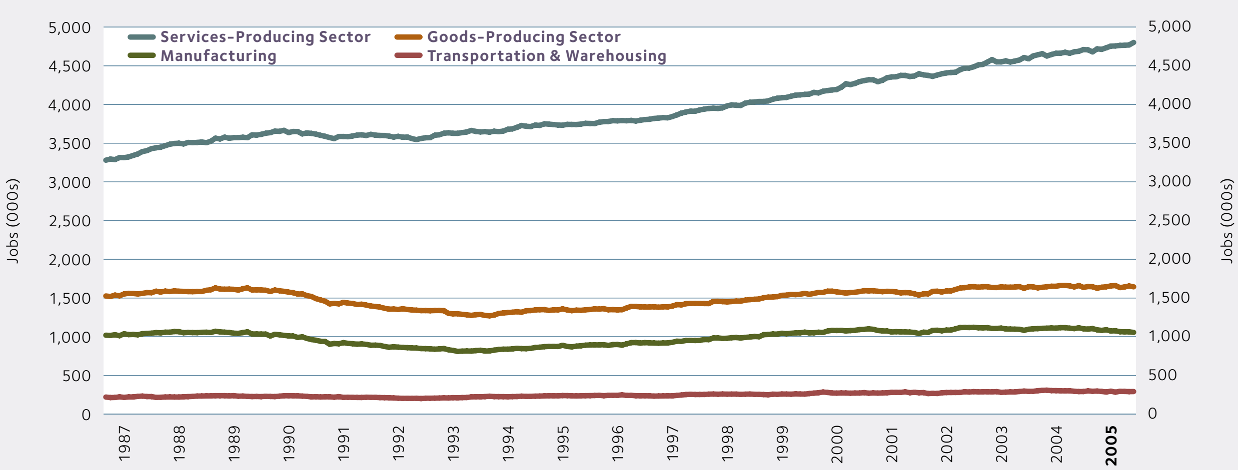
- Warehouse and distribution centres represent 40% of industrial space;
- Manufacturers represent 30% (and most manufacturing facilities are user-owned, due to the heavy investment in machinery and equipment);
- Mixed use/storage represents 20%; and
- Research/development represents 10%.

If it is assumed these proportions accurately reflect the industrial market in the GTA and southern Ontario, and it is likely they do, then the downward pressure exerted by a higher dollar will impact demand and occupancy levels for these uses differently. It will also depend, as will be seen later, on the level of exposure an industrial market has to a particularly vulnerable manufacturing sector, such as automotive or apparel, for example. Most importantly, if manufacturing represents 30% of the industrial market, this suggests only that proportion of the industrial market is at risk if the dollar continues to hamper the manufacturing sector. From a demand perspective, warehousing and distribution have become the most prominent drivers of demand for industrial space – particularly when the domestic consumer segment of the economy has been so strong – and there is little evidence to suggest these sectors have been negatively impacted by a high dollar.

On a seasonally adjusted basis, manufacturing employment in Ontario is currently at the exact same level that it was in January 2002, when the Canadian dollar began its rapid ascent. More recently, however, manufacturing employment in Ontario has fallen from its 19-year high of 1.12 million in November 2002 to 1.06 million in October 2005 – a decline of 66,200 jobs. During this time, industrial absorption in Ontario was 21.6 million square feet and availability declined from 5.5% to 5.2%. Thus it is clear that **if employment drives industrial absorption then sectors other than manufacturing have been "carrying the ball."**

Figure 5: Selected Employment Sectors, Ontario, Seasonally Adjusted

January 1987–October 2005



Source: Statistics Canada, GWL Realty Advisors Inc.

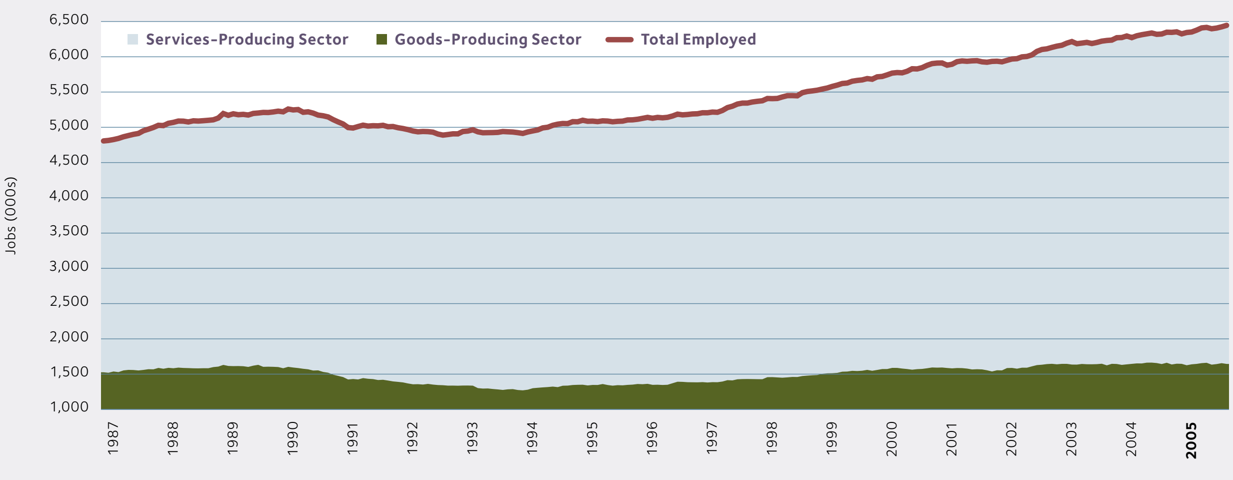
As Figure 5 illustrates, while services-producing employment has grown by approximately 1.5 million since 1987, employment growth in the goods-producing sector (which includes manufacturing) has been virtually flat. **Thus it is clear from an employment perspective that it is increasingly the services-producing sector that is driving demand for industrial space.** Although transportation & warehousing employment growth, which by definition falls under the services-producing sector, has also been flat, this particular sub-sector is a major user and driver of demand for industrial space in Ontario. However, this sub-sector also has an extremely high floor space per employee ratio, thus changes in transportation & warehousing employment levels will be virtually impossible to detect through industrial space absorption.

Though recent job losses in Ontario's manufacturing sector can be attributed in part to the rise of the Canadian dollar, other sectors have been picking up the slack. Furthermore, the relationship between the rise in the Canadian dollar and manufacturing job losses is not direct but *indirect*.

- Although Ontario has lost 59,600 manufacturing jobs in the 12 months ended October 2005, the services-producing sector added 114,100 jobs during the same period.
- Manufacturing accounts for only 16.4% of overall employment in Ontario at October 2005. This is the lowest proportion in the recorded data (since 1987) and is likely the lowest proportion in recent decades.
- Ontario's unemployment rate is a low 6.4%, compared to 6.6% for Canada as a whole.
- **Most tellingly, the loss of manufacturing jobs and that sector's decline as a share of overall employment is due to a structural shift away from manufacturing to services as the engine of Ontario's economy.**

Figure 6: Goods-Producing vs. Services-Producing Employment, Ontario, Seasonally Adjusted

January 1987–October 2005



Source: Statistics Canada, GWL Realty Advisors Inc.

It is also clear from Figure 6 above that the growth in employment in Ontario since 1987, and likely before then, has been almost entirely within the services-producing sector. Though both services- and goods-producing employment dipped in the mid-1990s due to the fallout from a recession, services-producing employment has grown the most rapidly.

Blurring of “Industrial-Type” Employment

Clearly, the lines are blurred when it comes to classifying “industrial-type” employment (traditionally defined as manufacturing, utilities, and transportation & warehousing) versus “office-type” employment. A vast number of industrial properties in Ontario or anywhere else contain tenants that fall outside of the “industrial-type” definition, including wholesale trade, retail (distribution), research & development and technology – businesses that might also be found in office properties. It is these sectors and other “office-type” employment sectors that have been driving demand for industrial space in Ontario. Intuitively, a loss of manufacturing jobs should at some point be reflected in higher industrial space availability, but this has not been the case in Ontario.

Another reason the classifications for industrial-type employment versus office-type employment cannot be relied upon definitively to reflect an upward or downward movement in absorption is the simple observation that up to half of the employees “industrial-type” firms, such as manufacturers, are involved in services-type jobs such as administration, management, planning and design.

To synthesize this point, a recent article in *The Economist* (”Industrial Metamorphosis” – Oct. 1, 2005) had a relevant observation:

> **“Before long no one will much care whether firms are classified under manufacturing or services. Future prosperity will depend not on how economic activity is labelled, but on economies’ ability to innovate and their capacity to adjust.”**

Automotive Sector: “Big Three” Challenged, Toyota Breaks New Ground

The weakness in Ontario’s auto sector has been compounded in part by a rise in oil prices, which in turn has curtailed demand for larger autos and sport utility vehicles, combined with an overall cooling of demand from the United States. This is putting Ontario’s manufacturing sector at increased risk as the province is heavily reliant on the auto sector. The recent announcement by General Motors of the potential future closing of an auto assembly plant in Oshawa, combined with reduced demand from the other two “Big Three” automakers in Ontario, will no doubt be a challenge that will likely be felt in industrial real estate markets in the long run. However, other auto manufacturers in Ontario such as Honda and Toyota have been picking up the slack. For example, the recent ground-breaking for Ontario’s second Toyota assembly plant in Woodstock will be completed in 2008 and will create an estimated 1,300 direct new jobs. This plant will also trigger demand for new and existing industrial space in the immediate area and throughout southwestern Ontario, as Toyota typically prefers parts suppliers to be located close to the assembly plant to minimize disruptions in the supply chain and ensure fewer delays in their just-in-time inventory system.

CONFERENCE BOARD OF CANADA: STUDY RESULTS

It has been shown that throughout the challenging economic environment of recent years the industrial real estate sector in Ontario has maintained its stability. Of concern to the industrial market should be the prospect that over the long term a stubbornly high dollar may eventually lead to real negative impacts on the sector.

- The domestic wing of Ontario's economy (e.g., consumer spending, machinery & equipment investment) has been "carrying the ball" in the face of export challenges, but if the domestic wing of the economy begins to falter and the dollar remains high, growth prospects for future years will undoubtedly be reduced. This is because a trickle-down effect will take place, where due to Ontario's over-reliance on manufacturing, the domestic wing of the economy will eventually be impacted if export growth cannot recover.
- The high dollar has sharply reduced economic growth in the Canadian economy. This year, real GDP growth of 2.3% is anticipated in the wake of a 2.8% gain in 2004. In the 2000 to 2002 period, real GDP growth averaged 3.5%. The slowdown in export growth resulting from the higher dollar has been a major contributor. Slower export growth has cut into production and employment, and as a result, the CBoC recently reduced the forecast of growth in the Ontario economy to 2.3% in 2005 from 3.4% last fall.

To assess the potential impacts of a high dollar, an econometric model was prepared by CBoC for GWL Realty Advisors that simulates the Ontario economy and the economic impacts that may occur if the Canadian dollar were to continue rising through 2007.

The model estimates the impact of a rising Canadian dollar on Ontario's economy by year, from 2005 to 2007. It was simulated under the assumption that the Canadian dollar appreciates 10% higher than the base case (i.e., actual dollar trading level) beginning in the first quarter of 2005. This implies a Canadian dollar worth $0.881 USD in 2005, $0.867 USD in 2006 and $0.87 USD in 2007. The impact of the higher dollar was compared with the CBoC's base case projections, which assume a dollar trading at or close to $0.80 USD between 2005 and 2007. The effect of the higher dollar on manufacturing output and employment in the Ontario economy was then estimated.

The equations in the econometric model are estimated using a lagged structure to account for the fact that a change in a key economic variable such as the exchange rate may not be fully felt immediately in the economy. It often takes several quarters for businesses affected by the exchange rate to adjust their production to the new economic realities.

Table 1 below shows the results of the model, by manufacturing sector in Ontario, if the US dollar price of the Canadian dollar were to rise by 10.0% starting in the first quarter of 2005, causing the (average) foreign currency price of Canadian exports to rise. The appreciation also means that the local (i.e., Canadian dollar) price of imports declines on average.

- The rise in the price of Canadian goods in international markets (relative to other similar goods in these markets) represents a deterioration in Canada's international price competitiveness, and exports begin to decline.
- As manufacturing firms cut back production the demand for workers in the sector shrinks. Manufacturing employment therefore contracts in a pattern similar to output, shrinking 4.0% below the base case in the first year of the shock and an additional 4.9% in 2006.
- The most trade-dependent industries – such as textiles, apparel, autos and parts, and printing – experience the most significant output decline as a result of the stronger dollar.
- Compared to other trade-dependent industries, the food, beverages and tobacco industry experiences a relatively smaller decline in output, as this sector produces a substantial proportion of its product for the domestic market.

Table 1: Conference Board of Canada Analysis Forecast Manufacturing Output from Current Levels Under Rising Dollar Scenarios
2005, 2006 and 2007

Manufacturing Sector	2005 ($0.881 USD)	2006 ($0.867 USD)	2007 ($0.87 USD)	2005–2007 Annual Average
Apparel	(5.8%)	(12.9%)	(12.5%)	(10.4%)
Autos & Parts	(9.0%)	(8.3%)	(7.3%)	(8.2%)
Chemicals	(2.1%)	(2.6%)	(2.3%)	(2.3%)
Fabricated Metal	(4.5%)	(6.8%)	(6.2%)	(5.8%)
Food, Beverages, Tobacco	(3.2%)	(3.0%)	(2.9%)	(3.0%)
Furniture	(2.8%)	(3.7%)	(3.4%)	(3.3%)
Machinery	(4.1%)	(4.1%)	(3.4%)	(3.9%)
Miscellaneous	(5.4%)	(7.2%)	(6.6%)	(6.4%)
Non-Metallic Minerals	(2.7%)	(3.7%)	(3.4%)	(3.3%)
Paper	(2.1%)	(3.2%)	(3.1%)	(2.8%)
Petroleum & Coal	(1.4%)	(1.6%)	(1.4%)	(1.5%)
Plastics & Rubber	(3.0%)	(4.8%)	(4.4%)	(4.1%)
Primary Metals	(4.8%)	(6.5%)	(5.9%)	(5.7%)
Printing	(5.5%)	(9.0%)	(8.3%)	(7.6%)
Textiles	(17.0%)	(23.7%)	(22.4%)	(21.0%)
Wood Products	(0.7%)	(0.9%)	(0.9%)	(0.8%)
ALL MANUFACTURING	**(6.0%)**	**(7.6%)**	**(6.9%)**	**(6.8%)**
Manufacturing Employment	**(4.0%)**	**(4.9%)**	**(4.4%)**	**(4.4%)**

Source: The Conference Board of Canada, GWL Realty Advisors Inc.

A 10.0% higher dollar has a negative impact on real output in Ontario's manufacturing sector. Real output is 6.0%, 7.6% and 6.9% below the base case in 2005, 2006 and 2007 respectively, as a higher-valued dollar leads to a sharp slowdown in production. Although each sub-sector is negatively impacted by a higher dollar, the results for different manufacturing sectors vary widely. Manufacturers in the petroleum & coal sector record minimal losses in output as a result of a higher dollar. As price takers in world markets, currency fluctuations do not change the demand for their products and, as a result, production and output do not change significantly due to a higher dollar. Conversely, textiles and apparel manufacturers make sharp reductions in output due to a higher valued dollar. The higher dollar results in rising prices for Canadian apparel and textile products in the U.S. market.

In 2005 and 2006 manufacturing employment is 4.0% and 4.9% respectively, below the base case level. By 2007, employment is 4.4% below the base case. It is estimated that the losses in both output and exports would cost the manufacturing sector 50,000 jobs by 2007.

A related analysis that CBoC completed pertained to potential impacts on the profit margins of Ontario's manufacturing sub-sectors (Table 2 below), by determining the percentage of net exports of each sub-sector. In terms of profit margins, the Ontario manufacturing sectors that are most vulnerable to a 10.0% appreciation of the dollar include aerospace, paper, wood products and furniture manufacturers. These sectors share a common trait: They export a high portion of output to the United States and import a relatively small share of inputs. As a result, these sectors do not benefit from the dampening effect that an appreciating currency has on the cost of imported inputs. Conversely, profit margins of food manufacturers, which import a high portion of inputs from the United States, would not be significantly affected by a higher-valued currency.

Table 2: Vulnerability of Ontario Manufacturers to Currency Appreciation, by Sector

Manufacturing Sector	International Exports (% Total Output)	International Imports (% Total Output)	Net Exports	Impact of 10% Currency Appreciation on Profits
Aerospace	78.6%	31.7%	46.9%	(4.7%)
Paper	60.8%	16.7%	44.2%	(4.4%)
Wood Products	56.4%	13.1%	43.3%	(4.3%)
Machinery	66.5%	24.1%	42.4%	(4.2%)
Furniture & Related	57.3%	16.8%	40.5%	(4.0%)
Primary Metals	56.4%	17.6%	38.8%	(3.9%)
Electronic Products	69.0%	35.4%	33.7%	(3.4%)
Motor Vehicle Parts	63.3%	30.9%	32.4%	(3.2%)
Plastics & Rubber Products	60.6%	29.8%	30.8%	(3.1%)
Transportation Equipment	79.8%	48.8%	31.0%	(3.1%)
Clothing	54.3%	24.1%	30.1%	(3.0%)
Motor Vehicles	84.9%	54.7%	30.2%	(3.0%)
Computer & Electronic Products	78.7%	49.5%	29.2%	(2.9%)
Electrical Equip., Appliances, Components	56.3%	27.7%	28.5%	(2.9%)
Fabricated Metal Products	45.5%	17.8%	27.7%	(2.8%)
Leather & Allied Products	55.8%	28.4%	27.4%	(2.7%)
Miscellaneous	56.4%	31.1%	25.3%	(2.5%)
Chemicals	49.9%	28.0%	21.9%	(2.2%)
Motor Vehicle Body & Trailer	49.1%	26.7%	22.5%	(2.2%)
Railroad Rolling Stock	59.8%	38.2%	21.6%	(2.2%)
Non-Metallic Mineral Products	37.4%	16.2%	21.2%	(2.1%)
Computer & Peripheral Equipment	96.6%	75.7%	20.9%	(2.1%)
Textiles	51.1%	32.4%	18.7%	(1.9%)
Beverage & Tobacco Products	23.7%	10.6%	13.1%	(1.3%)
Food	20.7%	15.2%	5.5%	(0.6%)
Printing & Related	20.5%	17.1%	3.5%	(0.3%)
Petroleum & Coal Products	17.1%	36.7%	(19.6%)	2.0%

Source: The Conference Board of Canada, Statistics Canada, GWL Realty Advisors Inc.

When the Canadian dollar appreciates sharply, as it did between 2002 and 2004, or even if it depreciates, manufacturing production does not necessarily change immediately. Currency fluctuations take time to feed into prices, demand and production. It also takes time for employers to expand or reduce workforces in response to changes in demand. Manufacturers are often hesitant to immediately adjust production following an exchange rate movement as they want to ensure the change represents a stable trend, as opposed to the short-term volatility exchange rates frequently exhibit.

Most importantly, changes in production or exports attributable to currency movements gradually diminish as the market adjusts to the new realities resulting from a change in the dollar.

When considering the future direction of the Canadian dollar, CBoC believes that the Bank of Canada would intervene to ensure that the dollar does not appreciate to levels that will cause even more damage to the economy. If the dollar started to rise quickly towards the $0.90 USD mark, it is likely the Bank would cut interest rates to reverse the appreciation of the currency. A dollar trading at or above $0.90 USD could push the Canadian economy into recession, something the Bank of Canada would like to avoid.

CONCLUSION: HIGH DOLLAR A THREAT TO ONTARIO'S MANUFACTURING SECTOR BUT "NO SWEAT" FOR INDUSTRIAL MARKET

While the threat posed to Ontario's economy and its manufacturing sector in particular due to a high Canadian dollar is real, **the effects on Ontario's real estate market have not been significant in the near term**.

With manufacturing uses accounting only for an estimated 30% of industrial inventory in Ontario, other uses such as warehousing & distribution and mixed use, which account for a combined 60%, have clearly not been as negatively impacted by a higher dollar. These sectors have also benefited from strength in the domestic wing of the economy and have been driving industrial space demand.

It is possible that if, as the CBoC predicts in their econometric model, there were a continued rise in the currency level over the long term, an impact would ultimately be experienced in higher industrial availability rates.

In the meantime, shrinking manufacturing employment in Ontario relative to the growing service sector is actually reflective of a wider structural shift away from goods production to higher value-added services-producing activities. This is also a sign of economic growth. Once again, *The Economist* provides a relevant quote:

> **"The division between manufacturing and services has become redundant. A more sensible split is now between low-skilled and high-skilled jobs... . The issue is not whether people work in factories or not, but whether they are creating wealth."**

How can the findings of both the CBoC's analysis and this research be used by real estate owners, managers and professionals?

- To assess risk, real estate owners and managers can compare the tenancy profile of their existing industrial portfolios with the sectors most likely to be impacted by a rising dollar, thus identifying tenants facing potential risk.
- When reviewing acquisition opportunities, real estate professionals should consider the tenants most at risk to a higher dollar, based on their sector or line of business, and conduct due diligence accordingly.

As an example, GWL Realty Advisors prepared a tenancy profile of its entire industrial portfolio in mid-2005. The results showed that the portfolio not only had a low exposure to the automotive sector, it was also not significantly exposed to the other sectors most at risk under a rising dollar scenario, as identified by the CBoC's findings.

Real estate owners can use these findings when selecting tenants to manage leasing risk. A tenant that is highly vulnerable to a rising dollar, such as a textile exporter, may require more scrutiny than a tenant from a sector that is not as at-risk. Furthermore, tenants that are highly dependent on exporting, particularly if they are a manufacturer, may present greater leasing risk than a tenant who relies predominantly on the domestic market.

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