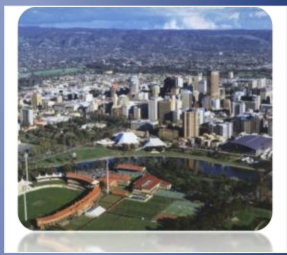

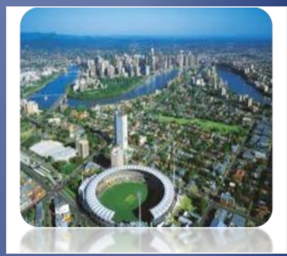

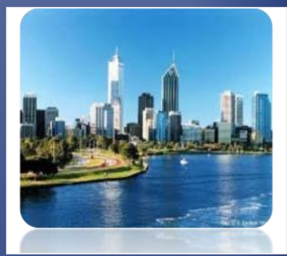

# THINKTANK COMMERCIAL PROPERTY FINANCE

## *Quarterly Market Update January - March, 2016*

Up-to-date views on the state of the Australian commercial property market seen in light of recent global economic and financial market developments. We also discuss the implications current monetary policy has for the domestic economic outlook and individual property market sectors across the country.

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## 1. The Global and Australian Economies

The final quarter of 2015 domestically saw interest rates held steady by the Reserve Bank of Australia (RBA) Board following its two 25 basis point cuts early in the year. Sub-trend growth remains the key ongoing issue for the Australian economy as confidence appears to be returning to both consumers and business, at least in small measures. International issues such as terrorism and the ongoing turmoil in Syria regularly hit the front pages and in turn impact on sentiment but the national mood generally appeared to be improving. This was mirrored or perhaps motivated by political events with a change in political leadership in early September when Malcolm Turnbull replaced Tony Abbot as leader of the Liberal Party and succeeded him as Prime Minister. The expectations for a resurgence in both consumer and business confidence were immediately matched by actual results but the hard work is yet to come and the Mid Year Economic and Financial Outlook presented by the new Treasurer in mid-December was a sobering event. Internationally we have seen some further downgrades to expected economic performance, this time mostly attributed to the substantial fall in commodity prices over the past year. The recent release by the Organisation for Economic Cooperation and Development (OECD) of its semi-annual Economic Outlook once again saw the OECD downgrading its forecast for global growth and for Australia. Its latest forecast for the advanced and emerging economies GDP of 2.9% for 2015 reflects a downgrade of 0.2% from a forecast of 3.1% made in its last update which was already a reduction from 3.5% last year. Reductions in growth are more modest in the advanced economies albeit they remain at low growth levels of 2.0%, down 0.1%. Emerging economies are forecast to grow at 4.0% in 2015 and 4.5% in 2016 with China and India the standouts at 6.8% and 7.3% respectively. Despite the steady cutback in growth estimates for 2015, the projections from the OECD for 2016 are still for World Output to be up 0.4% to 3.3% in 2016. Chinese growth is expected to edge down to 6.5% as the restructuring of the economy progresses but that forecast is unchanged as is all of Emerging and Developing Asia. A special country report on Australia highlights the transition the economy is undergoing as a result of the decline in commodity prices and has downgraded growth by 0.4% to 2.4% in 2015 and 0.3% to 2.9% in 2016 and to 3.0% in 2017. Overall the OECD foresees lower global trend growth for some time to come and the following comments sum up their view; "There are increasing signs that the anticipated path of potential output may fail to materialise in many economies, requiring a reassessment of monetary and fiscal policy strategies." Just as the New Year started, the World Bank also issued revised forecasts for global growth, lowering 2015 estimates to 2.4 % and 2016 forecasts to 2.9 % which is 0.4% less than the OECD.

**OECD Economic Outlook - "Moving forward in difficult times"**

The RBA in its November quarterly Statement on Monetary Policy (SoMP) kept its forecast growth by Australia's Major Trading Partners (MTP) to be a little below the long-run average pace at 4% through 2015 and growing slightly in 2016. China's growth for 2015 was assumed to be a little below the Chinese Government's target of 7% and falling slightly further in 2016. The report was issued some weeks before the release of the third quarter national accounts by the Australian Bureau of Statistics (ABS) on 2 December 2015 with growth of 0.9% and annual GDP growth lift from last quarter to a still below trend rate of 2.5%. Unemployment has fallen to 5.8% which is well below the RBA's earlier forecast high of 6.5% in this cycle and if the currently projected lift in GDP actually eventuates it would seem that the peak has already passed but the RBA is still forecasting a range of 6.0% to 6.25% for the coming year.

**RBA November SoMP maintained expected Australian GDP at 2.5% to Dec'15 but reduced it to 3.0% for Dec'16**

The other key economic indicator for our domestic economy each quarter is the Consumer Price Index which rose 0.5% in the third quarter of 2015 to be up 1.5% year over year. The increase in CPI for the quarter was in line with most forecasts and the underlying annualised rate of inflation (trimmed mean) of 2.1% remains well within the RBA target band of 2% - 3%. The longer range forecasts remain quite wide at those same levels for 2016 and beyond and 2.0% for 2015; still very much within a range that the RBA is comfortable with. The next quarterly release is on 27 January 2016 the Wednesday before the RBA Board meeting on 2 February 2016 which is the first of the New Year.

The three Westpac survey results we follow that were released during the month of December included the Westpac – MI Consumer Sentiment Survey, the Westpac – ACCI Survey of Industrial Trends and the Westpac–MI Leading Index. The quarterly Industrial Trends reading was positive for a fifth straight quarter but down by 3.2 points to 53.5. The monthly Leading Index remained in negative territory at-0.21% and the Consumer Sentiment Survey fell by 0.9 points but remained just positive at 100.8 Of the three monthly Australian Industry Group (AiG) performance indices however only one remained in positive territory at the end of the quarter and all fell during the month of December. Manufacturing ended the quarter at 51.9 down 0.6 points but expanding for a sixth month in a row. Exports benefitting from a lower AUD continue to be cited for the improvement. Services and Construction are both now contracting at levels of 46.3 and 46.8 respectively. As usual we discuss all of the surveys in more detail later in this report but it would appear that the more widespread pick-up across the economy we wrote about last quarter may be stalling in part impacted by international issues. It seems that the glow that accompanied the change in political leadership that took place in early September has in part abandoned both consumer and business sentiment. A weak start to the year is not exactly what most of us expected.

**Three Westpac and three AiG surveys were released during the end of the quarter and all declined – only two of the six are now positive**

## 2. Interest Rates

The RBA left rates on hold during the Quarter as expected with the Cash Rate at a record low level of 2.00% following its last cut in May. There remains uncertainty as to whether a further reduction will be required with some forecasters still expecting cuts in early 2016 but both Westpac and CBA are holding to their predictions of no change. RBA Board minutes and the November quarterly SoMP have not provided any strong guidance in that regard other than to reinforce a degree of satisfaction with current policy settings but repeating that if circumstances changed there remained scope for further easing in Monetary Policy.

Futures markets have moved a bit since the December RBA Board meeting when interest and foreign exchange rates had stabilised somewhat. The markets have now priced in a cut towards the end of 2016 and forward swap rates are again inverted up to three years and at the longer end, ten year swaps have once again dropped slightly below 3%. International events could change this but the more likely pressure from foreign central bank moves is seen to be the policy stance of the US Federal Reserve Bank. After more than a year of holding rates steady the US Federal Reserve FOMC finally increased the Fed Rate by ¼% to ½% at its December meeting to finally start the rate increase cycle in the United States. Described by many as one of the most signaled moves by a Central Bank in history there was little in the way of immediate market reaction. The real interest now is in how quickly the next increases will come with many forecasting three more moves of 25 basis points in 2016 making for a full 1% increase before pausing at the end of the year. The big move at the end of the year was in the currency with the AUD/USD moving from just below 0.73 between Christmas and New Year to just below 0.70 in the first weeks after New Year.

## 3. Residential

As almost always seems to be the case in Australia, residential housing remains a key focus of markets and financial commentators. The heat has certainly come out of the Sydney and Melbourne markets during the last quarter of the year responding in part to the impact of APRA's action in limiting ADIs' growth in investor loans for residential property. This appears to have had the desired policy impact with all Banks responding with changes to their lending standards for residential investments and their pricing. The impact on lending statistics continues be felt with the latest Australian dwelling finance approvals for October 2015 showing a monthly fall of 2.0% in the value of all housing related finance and an annual reduction of 8.4%. These figures are very different for owner-occupiers as compared to investors with the latter down 9.2% for the past year and the former still a buoyant 21.1% higher during the same period. The contrast is quite dramatic and looks very likely to continue. Dwelling approvals have also fallen back with November figures for all residential buildings down 12.7% for the month and 8.4% for a year ago. Multi-unit approvals crashed by 24.0% while houses were only 0.6% lower. The Australian Industry Group / Housing Industry Association Performance of Construction Index for December tells a similar story for Houses and Apartments with the sub-indices for those sectors showing Houses up 4.6 points to 52.6 and Apartments down a whopping 1 4.7 points to 54.3. This last figure compares to a 12 month average of 56.6 while Houses is now above its 12 month average of 50.2.

**The fourth quarter of 2015 saw values fall 1.4% for combined Capital Cities with the year over year increase now down to 7.8%**
**CoreLogic RP Data**

The CoreLogic RP Data housing value figures at the end of the fourth quarter showed a quarterly decline across the capital cities nationally of 1.4 % but on a year over year basis the gain was 7.8 %. The divergence between the individual capitals has narrowed somewhat from previous quarters with a pull-back in Sydney of 2.3 % and Melbourne of 1.9 %. This reduced yoy gains to 11.5 % in Sydney and 11.2 % in Melbourne while Brisbane was a long way back at 4.1 %. Perth is recording losses of 3.7 % for the year and Adelaide is just negative at 0.1 %.

We continue to watch the Residential sector closely because of the impact it has on shaping other markets as well as Government and Regulatory attitudes to monetary and fiscal policy. We have moved to reduce Sydney and Melbourne to Good and Stable in line with indications of both markets coming off the boil. Our view is that while the exceptional strength of most of the past year has now passed we are unlikely to see significant reductions from the prior period. As noted earlier we do think that the measures taken to slow residential investment growth that have taken hold were well advised and as noted last quarter we had expected a return to Good and Stable ratings for both of the market leaders. Unfortunately Adelaide and Perth are also likely to remain Fair and Weak but should also return to a level of stability while Brisbane is in the middle. Views certainly remain divided as to prospects for the coming year with the ANZ still expecting the decline in housing activity to drive the need for further stimulus by way of a reduction in interest rates. Others have also taken a more negative view with a prediction of a fall of up to 10% in residential property prices over the next year but it is worth noting that much of the oversupply in stock that is being forecast is in the unit sector and we are not convinced that the same observations apply to houses.

# 4. Office

During the quarter we had the release of the semi-annual PCA /IPD Australia Property Index which showed overall commercial property returns for the year reaching 12%. These were the best returns since the GFC and Office returns were slightly above the average at 12.5%. Sydney and Melbourne were the stars of the sector with total returns for the year of 14.7% helped by strong capital growth. In Perth, where values are falling in the wake of the resources decline, the return was just 4.5%. In commenting on the report, MSCI said that the aggressive tightening of cap rates is being seen more broadly across the property market, spurred on by the lower cost of debt capital and an unprecedented level of investment activity. Despite the tightening in cap rates, the spread between commercial real estate cap rates and the bond rates was still high and would continue to be favourable as long as interest rates remain low in the short run. The report was highlighted in our December Monthly Market Focus.

**PCA/IPD Australia Property Index confirms the best market for years with Sydney and Melbourne way out front**
**MSCI**

Herron Todd White featured the Office market in their year end Month in Review edition and reflected much the same situation with Sydney and Melbourne markets rising and at their peak in the cycle respectively and Adelaide and Perth at the bottom of the market. Brisbane appears to be a bit of a contradiction with oversupply and rising vacancy rates but considered to be at the peak of the market by HTW. Lower vacancies in Sydney have started to moderate incentives and net effective rents are increasing as supply tightens for a number of reasons including withdrawals for refurbishment and high levels of absorption resulting from limited new stock. The next wave of supply in the development cycle may not hit until the second half of 2018 which suggests the Sydney Office sector should continue to have an Improving trend and could easily be upgraded shortly. As with most other markets some tightening of yields continues to be reported and this will probably continue as interest rates remain at very low levels even when fundamentals may not be strengthening. By the end of the quarter, yields on prime Sydney and Melbourne towers had closed to between 5.25% and 6.5% and 6.5% to 7.5% for secondary properties. Even in weaker leasing markets with high vacancy rates yields for prime properties have fallen and range from 6.5% to 8.0% in the other capital cities as buyers continue the search for yield. One very sobering feature is the level of rental incentives reported by Knight Frank in the Perth CBD Office market as being 45% of net rent.

The changes to our ratings in the Commercial sector earlier in the year reflected the Improving trends in Sydney and Melbourne with both markets now rated as Good. As in the Property Index Report the contrast with the other capitals is quite stark where we see Weak conditions and a Deteriorating trend continuing as a result of poor business fundamentals in the resources sector and other key industries. Yields have continued to tighten in all locations but expectations are that fundamentals will now have to improve if this is to continue and as a result we have made no changes to our ratings this quarter.

# 5. Retail

Retail sales fluctuated on the basis of the ABS monthly reporting during the fourth quarter but ended up more or less the same as last quarter with November recording a 0.4% rise for the month and 4.3% for the year. This was seen by almost all commentators as being within their expectations. Once again the more interesting data is in the break-up by sector and geography cafes and restaurants leading the sector with a 1% gain closely followed by household goods at 0.9%. Department stores were actually lower for the month after a big rise in October but are still up 4.1% for the year. Rather predictably, Victoria and NSW are above average in their annual growth and the other States below average in decreasing order of Qld, SA and WA.

Colliers International featured research on Retail's new foreign entrants during the quarter which is very noticeable in almost all markets. This together with the failure late in the quarter of Dick Smith and Laura Ashley raises some concern for incumbent retailers reflected perhaps in the weak AiG PSI Services Index for December of 46.3, down 1.9 points. Low vacancy rates and stable rents with low incentives however have kept demand and yields quite stable. Ranging from 5% for Prime properties in Melbourne to 7% in weaker areas such as Perth, investors still like Retail. Once again this quarter we have compared the property fundamentals of the sector geographically over the last quarter through recent Herron Todd White monthly Market Indicators. Balanced and rising markets are reported for Melbourne and Sydney while Adelaide and Perth are both judged to be at the bottom of the market cycle with oversupply and declining rental trends. Brisbane is seen as improving which is consistent with our ratings which remain unchanged.

**November sales up 4.3% for the year but below trend of 5.2% and some segments are still struggling**

## 6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the December quarter of 2015 fell for the second quarter in a row to be down 3.2points to 53.5 compared to 56.7 in the September quarter. While the strength of the positive reading of the index remains modest, it is broadly based and almost all of the sub-indices are positive and there has been some improvement in Capacity Utilisation which is now just slightly below normal. Labour expectations are positive which seems to align with the improvement we are seeing in the unemployment data coming from the ABS. The survey also includes an Expectations Composite Index and this remains positive at 60.8, up 1.0 points from September. These results are also consistent with the Australian Industry Group PMI for December which we mentioned earlier. This index was down slightly to 51.9 and was the sixth consecutive reading in the expansionary zone above 50. While this reading of sentiment within the manufacturing industry also remains modest, it too is broadly based with five of the seven sub-indices in positive territory with only stock levels and deliveries remaining below 50, being an indication of efforts to reduce stock levels. Consistently similar comments cited by respondents to the survey were made concerning stronger local orders and exports as a result of the lower AUD balanced with the negative impact of reduced orders from local automotive assemblers and mining and heavy engineering projects. The Dun & Bradstreet Business Expectations survey appears to echo these findings with Capital Investment expectations up from the previous quarter but Business expectations slightly down.

During the quarter Knight Frank again issued a number of market briefs on the sector with comments on vacancy remaining relatively unchanged in Melbourne and Sydney but with increasing availability of space in Brisbane, Perth and Adelaide especially in secondary stock with slight falls in rents as prime grade facilities are taken up. Herron Todd White continues to describe both Adelaide and Perth as being "oversupplied" and in economic "contraction" but Brisbane steady with respect to vacancy but with declining rentals and flat economic conditions. Sydney and Melbourne are both described as being in stages of rising/peak markets. Yields for prime Industrial properties with sound tenants and good WALE demonstrated some tightening across the board. Sydney and Melbourne as low as 6.75% and up to an average of 7.75% a tightening of 50 bps. Secondary properties are yielding from a low of 8.0% in Sydney all the way up to 9.25% in Melbourne. Across the country 10.0% is reported in Adelaide but somewhat firmer in Perth. Any weakness in economic fundamentals appears to continue to be offset by the demand for yield from both investors and owner-occupiers. The ratings and trends for all capitals remain unchanged.

## 7. Thinktank Market Focus

Stable interest rates during the past quarter have been no surprise but opinion continues to be split between both the markets and commentators as to whether that will last for much longer. The argument for no change is being challenged by weakening growth prospects and ongoing soft commodity prices. Economically we certainly look to be in a period of extended below trend growth both domestically and internationally and that is the challenge that keeps being repeated. Hopes that the new leadership in Canberra would present the opportunity for some fresh thinking will now have to be realised if we are to avoid further downgrades in growth prospects For some time now, every major global economic forecaster has consistently lowered growth projections with every new release such as we have most recently seen from the OECD and the World Bank. We still think that new investment in infrastructure and development schemes are more likely to succeed than just further cuts in interest rates but in their absence the RBA may have to rethink its current position.

Internationally political tensions remain focussed on the Middle East and somewhat away from economic issues. More importantly from a finance perspective there continues to be a lot of focus on the United States economy and what follow-up action the Federal Reserve FOMC will take in 2016 following its December Fed Funds Rate increase. Most observers are backing Chairman Janet Yellen to push her view that rates should continue their cyclical upturn during 2016. Despite plenty of early warnings no one can be sure of exactly what the markets' reaction will be, particularly as China's growth prospects keep being reduced.

We have made just four changes to our property sector ratings and trends since last quarter and all are in Residential. The adjustment of Sydney and Melbourne Residential to Good and Stable simply reflects the inevitable slowing of the very strong markets that both cities have enjoyed for some time. With the changes we have made, we are left with seven markets that are Good and five that remain Weak. Apart from the Residential sectors of Sydney and Melbourne which we have just adjusted, all of the rest of their sectors are Improving. This compares to Brisbane, Perth and Adelaide which have eleven ratings Weak and/or Deteriorating. Perth continues to be gloomy while Adelaide is somewhat better thanks to various State initiatives. The two or possibly three speed economy continues and it is difficult to see that changing in the near or medium term.

| | Sydney | | Melbourne | | Adelaide | | Brisbane (SEQ) | | Perth | |
|---|---|---|---|---|---|---|---|---|---|---|
| Residential | Good | Stable | Good | Stable | Fair | Stable | Good | Improving | Fair | Deteriorating |
| Commercial | Good | Improving | Good | Improving | Weak | Deteriorating | Weak | Deteriorating | Weak | Deteriorating |
| Retail | Fair | Improving | Fair | Improving | Weak | Stable | Fair | Stable | Fair | Stable |
| Industrial | Good | Improving | Good | Improving | Fair | Deteriorating | Fair | Improving | Weak | Deteriorating |

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Reserve Bank of Australia
Savills Research
Westpac Economics
Westpac-Melbourne Institute
World Bank

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