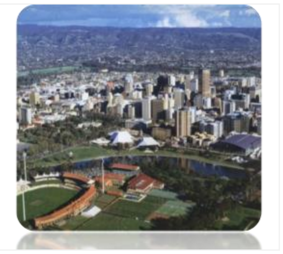
Australian Commercial Real Estate Market Focus





The following represents a monthly snapshot of how we see the commercial property markets across the country along with the near term outlook. For a more detailed commentary, please visit our website thinktank.net.au for our Quarterly Market Update.

Following its sharp decline in June, the Westpac - Melbourne Institute Consumer Sentiment Index fell by a further 3.1% to 92.2 well below the 100 level indicating neutral optimism. In somewhat contradictory signals, the AiG-PMI recovered in July, after contracting in June by rising 6.2 points to 50.4, indicating conditions across the sector were broadly stable. The detailed survey results showed manufacturing exports expanding for a third month in a row and for the sixth month this year, reflecting the lower Australian dollar. Negatives continue to be found in the progressive closure of local automotive assembly and further declines in mining and other business investment in machinery and equipment. The Dun & Bradstreet Business Expectations Survey shows sales expectations surging to its highest level since the fourth quarter of 2003. Retail sales lifted 0.7% in June to be up 4.9% for the year with household goods sales rising 11.2%.

The Reserve Bank of Australia (RBA) Board continues to leave the Cash Rate unchanged since its May cut to 2.00% and a recent speech by RBA Governor Glenn Stevens gives us some greater insight as to why the RBA's view of Australian Economic Capacity may be changing. We take a closer look at this issue in our News and Views section and what longer term implications this might have on economic decision making. We won't have to wait long to see if any conclusions we reach are accurate with the RBA releasing its quarterly Statement on Monetary Policy on Friday 6 August. Futures markets continue to forecast only a mid-range probability of any further decreases this year and the latest Federal Reserve comments, both official from the FOMC minutes and unofficial from mistakenly released Fed staffers memos, indicate an increase in US rates later in 2015.

While not much has changed on the basis of the latest reports on the Residential sector; the big news continues to come from the Banks' shift on lending to investors for residential property prompted by pressure from APRA. Portfolio growth limitations and interest rate increases will certainly have an impact and in some cases a formal halt to lending to some segments of the sector will reduce borrowing for residential investment property. Our own view however is that much of the impact will be felt in the demand for units not houses and that is not where the biggest price increases have been; 11.6% compared to 7.2%.

We have lifted the trend for Melbourne Commercial and Industrial and eight markets are now Improving but five are still Deteriorating. There are five markets that are Strong or Good and five are still weak. Emphasising the two or three speed economy we currently have, Sydney and Melbourne have nine of sixteen ratings as either Strong and/or Improving while Perth and Adelaide have eight either Weak and/or Deteriorating.

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

Sources: ABS, ACCI, AiG, ABS, ANZ Research, ATO, CBA, CBRE, Colliers International, CoreLogic RP Data, HTW, IMF, IPD, JLL, Knight Frank, Melbourne Institute, OECD, PCA, RBA, , Savills Research, Westpac Economics

News and Views

- In a recent major speech, the RBA Governor, Glenn Stevens suggested that Australia's potential growth rate may be lower than what has previously been assumed. In the address he spoke of the present vexing economic disparity in Australia that is below trend growth but an unchanged unemployment rate over the past year. The Governor put forward a few possible explanations, namely data issues, slower wages growth and a lower level of trend growth to explain the conundrum. While it sounds like an overly academic debate the issues are very relevant to business and property as we outline below.

- Trend or average growth for the Australian economy has been considered by the RBA to be around 3.00% – 3.25% and has been used as the measure of the potential growth that would be the highest that an economy could expand at over the long run without a lift in inflation. It is important because the assumed level of trend growth will influence what actions with respect to monetary policy the RBA takes to have the economy achieve its optimum level of growth. The charts opposite are taken from a research article by Michael Blythe, Chief Economist of the CBA; the first one shows how GDP growth has tracked over the past twenty-five years. The implications are that lower potential growth means less need for additional policy stimulus and higher risks in overstimulating the economy.

- With respect to the same issue, Bill Evans, Chief Economist at Westpac wrote in a separate article; "This average concept always appeared to be somewhat curious given that it covered both pre and post GFC periods. It has generally been accepted that due to the sharp build up in debt in the developed economies, the headwinds associated with that debt have constrained growth. Adopting averages over longer periods seemed to overlook that particular observation." The fact that for the past five years GDP growth has been below the 3.25% level as shown in Chart 1 emphasises that point.

- In his speech the Governor said the following; "…perhaps trend output growth is lower than the 3.00% - 3.25% that we have assumed for many years." He then added; "To the extent that our assumptions about trend growth may need to be revisited, that will be worth some discussion…If there are assumptions about absolute growth rates embedded in business or fiscal strategies, or retirement income plans, they would need to be re-examined."

- The CBA research notes that the emerging debate about a step down in potential growth rates throws up some interesting implications for interest rates. Some simple calculations as shown in Chart 2 highlight the point. If trend growth is still 3.25% p.a. then the economy is running about 5% below that potential at present. But if trend growth is actually more like 2.75% p.a. that spare capacity shrinks to less than 2%. Michael Blythe writes; "A lower potential growth rate is consistent with our calculations that the neutral cash rate is now 3.50% (previously 5.50%). Longer-term interest rates should also be lower, on average."

- Consider the importance of these deliberations for monetary policy implications writes Bill Evans in the Westpac research. "If for example, the RBA revises its assessment of trend growth to 2.75%, then it is highly unlikely that it would see a case for below trend growth in its 2016 November growth forecast, virtually eliminating the case for lower rates in November." Not surprisingly both the CBA and Westpac are forecasting stable interest rates through the rest of 2015 and 2016. Lower growth expectations and a continuation of lower longer term interest rates looks likely.

Chart 1: Australia’s Gross Domestic Product 1990 to 2015

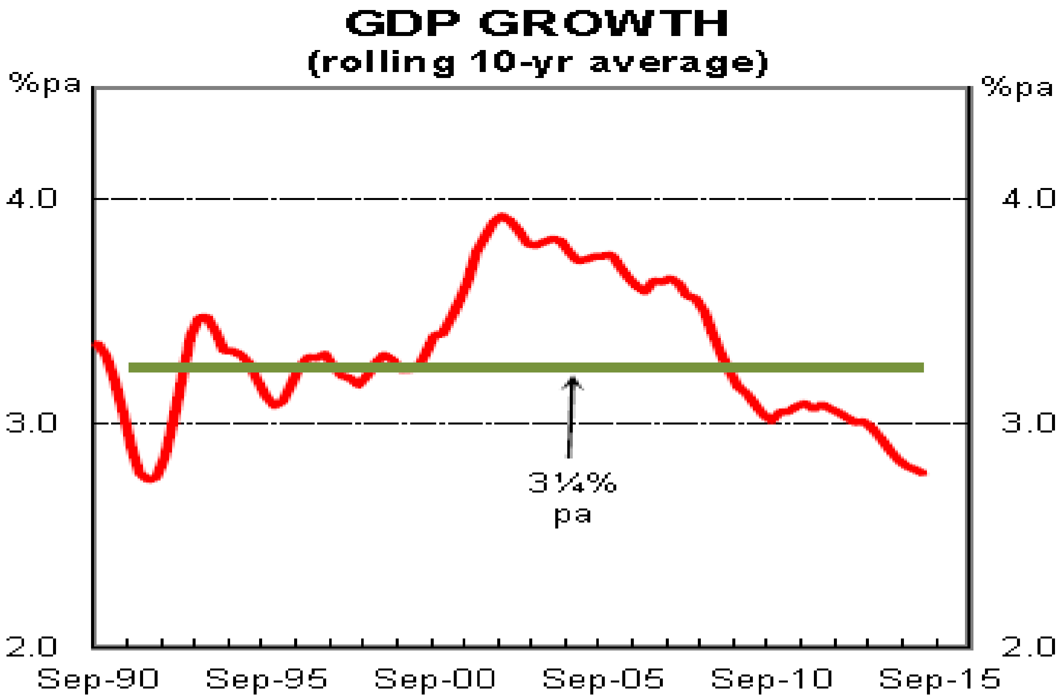
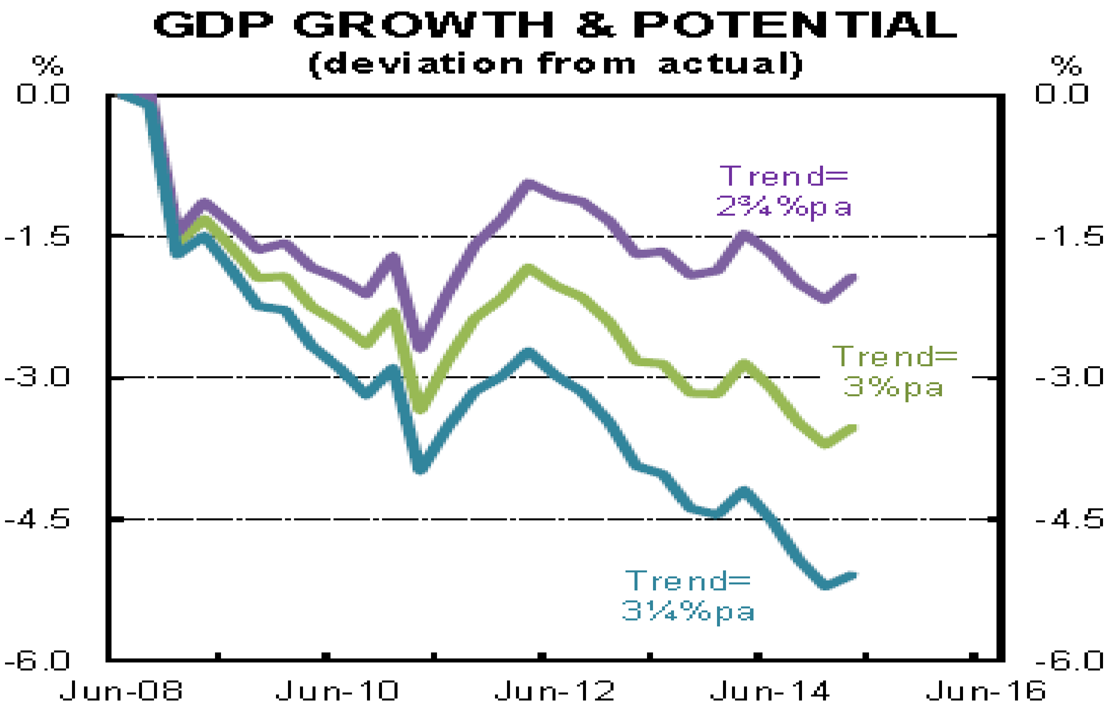


Chart 2: Australia’s Gross Domestic Product Trend Variance



Source: CBA Research

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