Thinktank

Thinktank Property Finance

Quarterly Market Update July - September 2019

Up-to-date views on the state of the Australian commercial and residential property markets 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.

1 Global & Australian Economics

The second quarter of 2019 domestically saw interest rates cut once by the Reserve Bank of Australia (RBA) Board in June and then again in July to start the third quarter. Internationally the Federal Reserve Bank's Open Market Committee (FOMC) left official interest rates in the United States unchanged but are a chance to cut at their July meeting. This was not unexpected but what was a continuation of the turnaround by Fed Chairman Jerome Powell from last year when increases were being considered. UK Prime Minister Theresa May found herself in what appeared to be a no win situation and her resignation became inevitable. The resulting economic outcome for the UK and the EU has the potential to be dire and increasingly this is being factored into various economic forecasts. As expected economic performance from most the major international agencies has turned down as reflected during the past quarter with the OECD Economic Outlook similar to that of earlier releases from the IMF. The OECD is forecasting GDP growth falling to 3.2% in 2019 and rising to 3.4% in 2020. In its latest Global Economic Prospects released in June, the World Bank reduced its projected global growth to 2.6% for 2019, down 0.3% and by 0.1% for 2020 to 2.7% and kept 2021 at 2.8%. It said "Downside risks to growth predominate, including rising trade barriers, a build-up of government debt, and deeper-than expected slowdowns in several major economies." As trade tensions increase the OECD has revised down the growth forecasts as a result also citing a "no deal" withdrawal of the UK from the EU and a greater slowdown than envisaged in China. Forecasts for the United States economy call for continued growth to 2.8% in 2019 but 2.3% in 2020. China is forecast to grow at 6.2% in 2019 and 6.0% in 2020 while the fastest growth is still expected to come from India at 7.2% for 2019 and 7.4% for 2020. Australian growth was raised to 2.3% forecast for 2019 after having been cut in the previous report after weak fourth quarter GDP and 2.5% growth is projected for 2020.

First quarter national accounts released by the ABS on 5 June 2019 recorded quarterly growth of 0.4% (1.8% annual) compared to 0.2% (2.3% annual) growth in the final quarter of last calendar year. This was below the RBA projected growth to Mar 2019 of 2.5% which has now been adjusted to 1.75% at June 2019 and 2.75% at Dec 2019 (down from 3.0%); all above the OECD and World Bank figures. Unemployment has risen slightly to 5.2% which remains just above the RBA's forecast of 5.0% and is a key to future rate moves. The CPI for the first quarter continued to be low at 0.1% and an annualised core rate of 1.3% with the RBA forecasting 1.5% for June 2019 rising to 1.75 by December 2019 and 2.0% by June 2020.

"Trade Uncertainty dragging down global growth".

World Bank Global Economic Prospects

"Heightened tensions, subdued investment recovery"

OECD Economic Outlook

Three Westpac economic surveys were released in June; 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 still positive this quarter but was down by 0.3 points to 61.5. The monthly Leading Index also fell to -0.56% in June. The Consumer Sentiment Survey had been up and down during the quarter but finished up in June by 1.2% to temporarily just move into positive territory at 100.7 . The three monthly Australian Industry Group (AiG) Performance Indices were also weak with only one remaining in positive territory at the end of June. Manufacturing fell for the month down 3.3 and ended just below 50 at 49.4. Services was down slightly by 0.3 but stayed above the 50 mark at 52.2. Construction rose for the month by 2.6 points but stayed in contraction at 43.0. Illion (D&B) Business Expectations Index for the June Quarter was down 13.2% annually. We discuss all of the surveys in more detail later in this report.

1st quarter GDP up 0.4%, 1.8% yoy. Westpac and AiG surveys remain negative.

2 Capital Markets and Interest Rates

We continue to look at capital markets as part of our regular summary of economic and financial conditions in Australia as the second quarter of 2019 saw the Federal Election as a key focus in May and the start of an easing cycle in interest rates in June. Along with listed equity markets we pay attention to listed Australian Real Estate Investment Trusts (A-REITs) as well as various debt related investments that are often of particular interest to our reading audience that have a special interest in real property. The ASX had a negative 2018 as did most global equities markets so a strong bounce back in the first half of 2019 was welcome. The A-REIT Index was also down last year and similarly has continued to bounce back in the second three months of 2019. The decline in the major banks share prices has levelled out despite operating threats to income returns mainly as Shareholders (particularly with holdings in SMSFs) experience relief at the continuation of dividend franking credits following Labor's defeat in the Federal Election.

The MSCI All Property Index report for the first three months of 2019 was released in May and we will feature the results for the first half in the News and Views section of our September Monthly Market Focus. Direct Real Estate recorded total annualised returns of 9.3% for the first quarter compared to 10.2% for 2018. Listed Real Estate as shown above by the ASX A-REIT 200 Index had a spectaculart return of 21.1% for the 12 months to 31 March 2019. This was a continuation of the recognition of unit prices trading at below net asset values which has pushed prices up as investors have returned to the sector having avoided much of the last year's downturn.

The RBA in its May quarterly Statement on Monetary Policy (SoMP) has its forecast growth by Australia's Major Trading Partners (MTP) reducing slightly and falling just below the long-run average pace of 4% to 3¾% for the next two years noting that global growth has moderated and trade tensions remain high. Growth forecasts have been downgraded by ¾% to 1¾% for the year ending June 2019 but back up to 2¾% by December 2019. The underlying quarterly CPI rate was 0.5% and the annualised rate of inflation (trimmed mean) of 1.8% remains just below the RBA target band of 2%-3% and slightly below the previous forecast in the SoMP of 2.0%. The RBA's forecast has increased to 1.75% to June 2019 and 2.00% to December 2019 and then staying at 2.0%. The SoMP was preceded in early April by the half-yearly Financial Stability Review (FSR) which featured plenty of comment on Property, both Residential and Commercial and including observations on high-rise unit development and non-ADI funding including LRBAs.

ASX 200 up 6.4% for the 2nd quarter & A-REITs 3.2%; Banks recover up 10.1% but margins squeezed

ASX 200 Indices (ex income)

The RBA brought rates down during the second quarter of 2019 and then started the third quarter with a further cut in July. The key drivers continue to be low CPI, sub-trend growth and low but steady employment. The May quarterly SoMP did not provide any strong guidance in regard to policy but the July minutes did with a continued focus on employment. The AUD/USD exchange rate has drifted up and down a bit but seems destined to remain around USD 0.70 for the time being. Opinion on future interest rate movements has shifted to further easing as noted above with the question being how much and for how long. Forward swap rates have now fallen considerably ranging from just about 1.05% at three years and 1.25% for five years. At the longer end, 10 year Commonwealth Bonds are down to 1.45%. International events and foreign central bank moves have not had much impact recently on the RBA's monetary policy but that appears to have changed and a decision of the US Federal Reserve Bank's FOMC to cut rates in July could be significant. Movements in the US yield curve have also been watched closely with 10 year US Treasuries falling below 3.00% at the end of last year and now at 2.10% with 2 year bond rates at 1.85%.

RBA May SoMP easing slightly. Cash Rate down and the US FOMC set to cut in 2019; AUD/USD stays around 0.70.

3 Residential

Residential markets were very closely followed during the second quarter of 2019 as prices for housing levelled out somewhat. Overall the Capital Cities fell by 1.1% and were also down in the regionals by 0.9%. For the month of June, both Melbourne and Sydney were up 0.2% and 0.1% respectively. The annual housing price statistics through the past twelve months have shown substantial corrections in Sydney of 10.9% and 9.8% in Melbourne markets. The easing of the latest monthly price falls is welcome. The ABS reported lending was down 2.4% in May and down 20.9% for the year. Investor loans remain down 27.8% from a year ago while residential building approvals were down 19.6% year over year.

Houses: Houses in Sydney were down -10.8% for the year and In Melbourne they were down -11.8%. For the nation as a whole the decline was less at -7.4%. In six of eight capital cities houses down in price for the year and Perth fell by -9.0% to rank fourth just behind Darwin. Notably Adelaide was only down modestly at -0.5% while Brisbane was down -2.5% for the year. Regional prices were down -3.2%.

Units: Unit prices as reported by Core Logic are down by less than houses in both Sydney and Melbourne for the last 12 months being -8.0% and -3.3%. Perth is down -9.8% and the combined capitals -5.9%. The AIG/HIA PCI Apartment Index for June was up by 1.2 points but remained deeply into contraction below 50 at 37.9 . As stated previously, our concern for unit prices lies in the large supply of settlements of newly completed apartments over the next two years and how these will be funded. As noted below, this has also attracted the attention of the RBA and their comments on rental yields are interesting with CoreLogic reporting gross rental yields of 3.2% in both Melbourne and Sydney.

The RBA as usual has had a good deal to say about housing. In the SoMP, "While the pace of decline in some large cities appears to have moderated somewhat, housing price declines have become more widespread geographically since the start of 2019; prices have contracted a little in most other capital cities and in a larger number of regional areas. Capital city housing prices have now retraced to mid 2016 levels but remain 15% higher than five years ago." And in the FSR, "The capacity of geared investors to maintain their loan repayments can partly depend on attracting tenants and earning rental income.

Residential continued

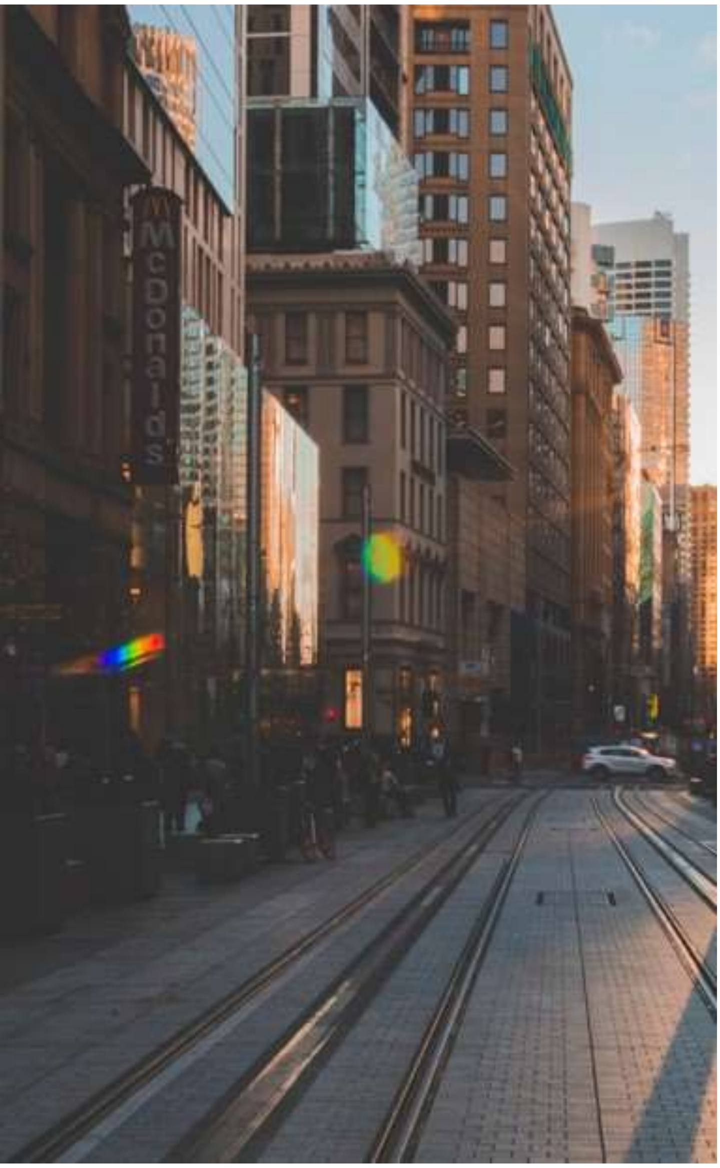
Weaker apartment market conditions may encourage selling by investors struggling to meet their mortgage payments or those who want to limit potential capital losses in an environment of falling prices. These dynamics would generate further price declines. Investors in other existing residential property are also affected by declining rents and increased vacancies associated with the large increase in supply of new apartments, particularly in Sydney." We took a close look at the new supply issue when we reviewed the RLB Crane Index in our News and Views section of May's Monthly Market Focus and continue to hold a cautious view despite upgrading our ratings and trends for both Houses and Units in Melbourne and Sydney.

HTW in their most recent Capital City Property Market research continue to reflect the views in our ratings with both Sydney and Melbourne shown as approaching the bottom or at the bottom for both houses and units. Demand is shown as being soft for units but fair for houses. Brisbane houses are seen as being at the bottom of the market and Adelaide are is seen as being in a rising market. Perth appears to be at the bottom of its market cycle for houses and declining for units. The Adelaide unit market is now seen as at the start of recovery and houses are rising off the bottom of its market. This quarter we recognised a partial recovery in the cases of Sydney and Melbourne and raised their ratings and trends to Fair and Stable. Other ratings and trends have had minor changes leaving seven of ten trends as Fair and only Perth ratings as Weak. All eight other ratings are Fair.

Office

JLL has reported a slight increase in vacancy rates in both Sydney and Melbourne with the former up from 3.7% to 4.1% while the latter ticked up by one basis point to 3.8%. The Property Council of Australia (PCA) Office Market Report (OMR) for July 2019 will be released in early August and will be featured in the News and Views section of that month's Monthly Market Focus. While resource centred markets in Brisbane and Perth have improved vacancy rates still remain high and Adelaide are reported as inching out slightly. Colliers CBD Office Snapshot also reported further yield compression in these markets ranging from 4.7% in Melbourne and 4.8% in Sydney up to 6.3% in Adelaide. Secondary property have higher vacancy rates in all of the Capitals than for Prime and in some locations such as Perth this is very significant. Non-CBD metropolitan markets were reported on by JLL with yields only slightly higher than shown in CBD premium sectors.

Amongst numerous research notes on the strength of Melbourne and Sydney office markets one by BIS Oxford Economics on Melbourne stood out, reporting that the Melbourne office market boom will roll on until at least 2024. The report said "We're looking at six years with a sub-5% vacancy rate. Under those conditions the market should generate another 30-40% growth in rents with values escalating by about 25%." It noted that the uplift has also made its way into the suburbs where the estimated metro vacancy rate has fallen to 4.6%.



Vacancy rates ease in Melbourne and Sydney; Brisbane and Perth improve while Adelaide softens.

JLL - July 2019

HTW continues to describe Sydney as approaching the peak with Melbourne already at the peak of the market. Adelaide is at the start of recovery with steady economic growth and Perth is at the bottom of the market but economic conditions are viewed as flat. Brisbane is experiencing steady vacancy and steady economic growth. Yields are still tightening slightly in most locations, even those with weak fundamentals, so for those experiencing rental growth and cap rate compression gains in total return will be very strong. As a result we have made no changes to our Ratings and Trends with Sydney remaining Strong as does Melbourne with both enjoying an Improving trend. We continue to see the Perth market as remaining Weak with Brisbane and Adelaide as Fair and Improving but we continue to keep the trend for Perth as Stable.

Retail

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Retail sales rose by only 0.1% in May but that was after having fallen by that same amount in April. With continued weak private sector business surveys suggesting conditions had remained difficult in June as well, we can expect weak totals for the full second quarter. The weak sales data trend has taken annual sales growth back down to 2.4% the slowest pace since January 2018. Making predictions about trends in this sector is extremely difficult, with sales for the year up only 0.5% in New South Wales after falling 0.1% in May while Queensland has soared by 4.7% for the year. Compounding the difficulty for investors is the performance of the differing retail sectors, with Department Stores up 0.3% for the month but only 1.4% for the year. Household Goods Retailing was down again in May by 0.4% for the month after falling 0.9% in April and down 0.1% for the year. By size, small retailers are struggling down 0.6% in May and up only 0.5% for the year. Other indicators reflecting the volatility of this sector were the Westpac-MI Index of Consumer Sentiment just falling back into "pessimistic" territory in early June at 99.8. Surprisingly however sentiment regarding "time to buy a house or major household item" improved. The AiG Services Index was down slightly at 52.2 but the Retail component lifted by 2.7 points although it remained below the 50 point level of expansion at 47.1. Consumers obviously continue to remain unsure of the future.

Retail continued

The ongoing weakness of Department Stores continues to be major news for the sector and the outcomes of negotiations with major landlords are followed closely as downsizing continues. The announcements of various closures of continues quite regularly and while various operators have expressed confidence they can cope with these developments, there are still a lot more changes to take place in the retail sector and investors need to be remain alert. Colliers recently produced their Retail Research and Forecast Report which was featured in a recent Robert Harley AFR article quoted to the right. It details amongst other things the rationalisation taking place in A-REIT portfolios as unlisted funds continued to dominate acquisitions with the expectation that more retail assets will transfer from listed to unlisted ownership as A-REITs continue to refine their portfolios in 2019.

Retail sector is under pressure and buyers are holding back

AFR – Robert Harley

Colliers in their latest Retail Snapshot update reported slightly lower yields in most locations. For Sydney Regional Centres as low as 4.0% and just a bit lower in Melbourne at 3.80%. Smaller Neighbourhood Centres are at 5.0% and 5.5% in Brisbane and Sydney. Perth is not much higher at 6.2% and Adelaide at 6.5%. HTW continues to describe Sydney as approaching the peak of market with the same ultra low yields as Colliers of 4.0% but Melbourne as starting to decline. They see local economic conditions as still showing steady growth in Sydney but contracting in Melbourne. Brisbane is described as at the peak of the market while Adelaide and Perth both remain at the bottom of the market with steady/increasing vacancies and stable/declining rents. There are no changes to our ratings this quarter and all are rated as Fair except Adelaide which is Weak. Trends are considered Stable by us in all of the capitals we cover. It still remains to be seen when the weakness in retail businesses will be reflected in retail property prices and most analysts appear to agree.

Industrial

The ACCI – Westpac Survey of Industrial Trends for the June quarter fell by 0.3 points 61.8 to be at 61.5 but continued its above average trend since June 2016 when the index was at 54.8 at the time of the previous Federal election. As noted earlier in our update this is consistent with other surveys we follow with the AiG PMI falling by 3.3 points in June and just into Contraction at 49.4. Manufacturing continues to lose the benefit from local apartment and infrastructure projects which are slowing amidst falling demand. The Westpac MI Leading Index recovered slightly but remained in negative territory in May at -0.45% and Senior Economist Matt Hassan commented that GDP growth is expected to fall to 2.2% in calendar 2019 well below the forecast of 2.75% by the RBA in the May SoMP. The illion (D&B) Business Actuals Index was also down 13.2% for the June quarter pointing to a slowing economy.

"Industrial property's run as one of the hottest real estate sectors in Australia (and globally) will go on for at least a further three years, with both rents and capital values set to rise over this period."

BIS Oxford Economics

BIS Oxford Economics recent "Sydney Industrial Property Prospects" took a very positive view on rising rents and further yield compression as a result of strong demand for logistics space and declining global bond rates. Prime Sydney and Melbourne are now ranging from 5.00% and 6.00%. Brisbane has come down from 6.35% to 6.07% while the same tightening of 28 basis points but with yields up to 7.75% in Adelaide. Secondary properties, have also seen a contraction of spreads from Prime. Rents are stable in Perth and yields for Prime properties have softened by 18 bps and are reported as tightening from 7.38% to 7.20%. HTW in their latest monthly review sees Perth remaining in oversupply and is rated in contraction but at the bottom of the market. We have upgraded our ratings for both Melbourne and Sydney to Strong from last quarter's update but have made no other changes to our ratings or trends.

Thinktank Market Focus

The second quarter of the year saw Australian interest rates cut in June and then start the third quarter with a second cut in July. In the United States the FOMC looks to have formally changed course with interest cuts likely in the third quarter as well. Economically we have remained in a period of extended below trend growth both domestically and internationally but by comparison Australia has been better off than most. The likelihood is that international growth will weaken further and interest rates will fall in the US and elsewhere. Lower housing prices domestically had provided greater flexibility for our domestic policy makers and employment growth seems the key to any further change in Monetary Policy at the RBA . Risks however may be levelling out with the Federal Election out of the way and reduced interest rates suggesting the third quarter of 2019 may be a flat one with the prospect of some improvement by the end of the year with annual GDP not in decline.

The global media's attention continues to be focussed on the Trump administration's steady front page headlines but have frequently been interrupted by Brexit negotiations and the resulting resignation of UK Prime Minister May. The prospect of Boris Johnson as her replacement only adds to further uncertainty.

The decision of the Federal Reserve FOMC to hold the Fed Funds Rate at their March meeting was not unexpected but Fed Chairman Jerome Powell's announcement that there would be no further rate increases this year was and a cut in US rates now looks more likely at the end of July. The impact this has had on the AUD/USD exchange rate was for a brief rise and then back to trade aroun 0.70 with Westpac forecasting 0.68.

We have now re-rated Sydney and Melbourne Houses back to Fair and we have upgraded the trends of both Houses and Units from Deteriorating to Stable which reflects the general uplift in the Sydney and Melbourne Residential markets. While this applies to both Houses and Units, the latter remain on close watch as the ongoing development overhang has the potential to be a problem as large numbers of new units near settlement. Our individual sector comments for Industrial reflect the continued strength of the Melbourne and Sydney markets which we have upgraded to Strong with continued Improving trends. There has also been a return to stability in Perth Commercial reflecting that the worst may be over for WA but not quite enough for an adjustment to Ratings or Trends. We now have four markets that are Strong, all in Sydney and Melbourne, and six that are Weak, all in Adelaide and Perth. Retail remains Fair and Stable in all capitals below except Adelaide which is Weak. Brisbane and Adelaide have five Improving trends between them including the Office sector in both cities.

	SYDNEY	MELBOURNE	ADELAIDE	BRISBANE (SEQ)	PERTH
Resi - Houses	Fair **Stable**	Fair **Stable**	Fair **Improving**	Fair **Stable**	Weak **Stable**
Resi - Units	Fair **Stable**	Fair **Stable**	Fair **Improving**	Fair **Stable**	Weak **Deteriorating**
Office	Strong **Improving**	Strong **Improving**	Fair **Improving**	Fair **Improving**	Weak **Stable**
Retail	Fair **Stable**	Fair **Stable**	Weak **Stable**	Fair **Stable**	Fair **Stable**
Industrial	Strong **Improving**	Strong **Improving**	Weak **Stable**	Fair **Improving**	Weak **Stable**

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JLL
Knight Frank Research
MSCI
OECD
PCA / IPD Research
Preston Rowe Patterson
Reserve Bank of Australia
Rider Levett Bucknall
Savills Research
Westpac Economics
Westpac-Melbourne Institute

Business Relationships and Loan Inquiries

NSW, ACT

Cath Ryan
Regional Sales Executive – NSW, ACT, WA
M: 0433 862 944
E: cryan@thinktank.net.au

Paul Burns
Senior Relationship Manager - NSW/ACT
T: (02) 8669 5510
M: 0434 609 241
E: pburns@thinktank.net.au

Ranei Alam
Senior Relationship Manager – NSW
T: (02) 8669 5502
M: 0434 609 240
E: ralam@thinktank.net.au

Claire Byrne
Relationship Manager - NSW
T: (02) 8669 5522
M: 0414 235 478
E: cbyrne@thinktank.net.au

Chrissi Sutherland
Partnership & Media Manager
T: (02) 8669 5516
E: csutherland@thinktank.net.au

VIC, TAS & SA

Heather Noonan
Regional Sales Executive – VIC, TAS, SA
M: 0435 960 646
E: hnoonan@thinktank.net.au

Tony Zaccari
Senior Relationship Manager – VIC/SA
M: 0403 758 514
E: tzaccari@thinktank.net.au

Joel Harrison
Senior Relationship Manager – VIC/TAS
M: 0410 861 540
E: jharrison@thinktank.net.au

Roger Pais
Business Development Manager – VIC
M: 0466 632 212
E: rpais@thinktank.net.au

QLD & WA

Adam Hutcheson
State Sales Executive – QLD/WA
T: (07) 3117 3787
M: 0434 609 239
E: ahutcheson@thinktank.net.au

Kat Gasparovic
Relationship Manager – QLD
T: (07) 3117 3787
E: kgasparovic@thinktank.net.au

For additional information, please contact

PUBLICATIONS & MARKET UPDATE

Per Amundsen
Company Secretary
T: (02) 8669 5515
M: 0417 064 252
E: pamundsen@thinktank.net.au

STAKEHOLDERS & STRATEGY

Jonathan Street
Chief Executive Officer
T: (02) 8669 5505
M: 0438 319 432
E: jstreet@thinktank.net.au

FUNDING & FINANCE

Cullen Hughes
Chief Financial Officer & Treasurer
T: (02) 8669 5518
M: 0406 258 256
E: chughes@thinktank.net.au

CREDIT & OPERATIONS

Peter Kearns
General Manager
T: (02) 8669 5501
M: 0434 609 238
E: pkearns@thinktank.net.au

PARTNERSHIPS & DISTRIBUTION

Peter Vala
General Manager,
Partnerships & Distribution
T: (02) 8669 5512
M: 0468 989 555
E: pvala@thinktank.net.au

INVESTOR RELATIONS

Lauren Ryan
Business Development Manager – Investments
T: (02) 8669 5532
M: 0401 974 839
E: lryan@thinktank.net.au

Thinktank Property Finance

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