Thinktank

Thinktank Property Finance

Quarterly Market Update
July – September 2020

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. The Global and Australian Economies

The second quarter of 2020 saw a continuation of the dramatic shift of policy focus from a variety of global and domestic issues to the coronavirus pandemic declared by the WHO on 11 March 2020. Domestically we have seen interest rates kept at all-time record lows and as discussed in more detail later in this update they are expected to stay at these ultra-low levels for a very long time. After a period of positive developments in Australia the very recent resurgence of reported COVID-19 cases in Victoria has led to the re-implementation of various restrictions including lockdowns of a number of Local Government Areas and the closure of State borders. These will all have negative consequences for the local Victorian economy and flow-on impact nationally.

IMF World Economic Outlook, June 2020 - " A Crisis Like No Other, An Uncertain Recovery". Global output -4.9% in 2020 but +5.4% rebound in 2021.

In its latest World Economic Update just released the IMF estimated that global gross domestic product (GDP) will shrink by 4.9% (previously forecast: -3.0%) this year followed by an above trend recovery of 5.4% in 2021 (previously forecast: +5.8%). In its update, the IMF had this to say: *"The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast. As with the April 2020 WEO projections, there is a higher-than-usual degree of uncertainty around this forecast. The baseline projection rests on key assumptions about the fallout from the pandemic……Where lockdowns are required, economic policy should continue to cushion household income losses with sizable, well-targeted measures as well as provide support to firms suffering the consequences of mandated restrictions on activity."* Forecasts for the United States economy now call for negative growth -8.0% in 2020 and rebounding to 4.5% in 2021. China is now forecast to still grow at 1.0% in 2020 and surge 8.2% in 2021 while India is now forecast for a negative 4.5% for 2020 and pick-up strongly to 6.0% for 2021.

1st quarter GDP - 0.3%, +1.4% yoy. Westpac and AiG surveys are falling sharply but PMI lifts! COVID-19 impact still to come in the months ahead.

First quarter national accounts released by the ABS on 3 June 2020 recorded quarterly negative growth of 0.3% (1.4% annual) compared to 0.5% growth in the fourth quarter of the last calendar year. Unemployment rose sharply to 7.1% in May and like all other statistics expectations are drastically changed but it remains a key to future rate moves post COVID-19. Forecasts had varied but many had been in the area of a peak of 10% in June and these have since been pulled back. The CPI for the first quarter was up just 0.3% and the annualised core rate rose to 2.2%. The popular Trimmed Mean was 0.5% for the quarter but only 1.8% for the year. Forecasts are for a continued slowdown in inflation with commodities like oil dropping with Transport costs down -1.9% in the first quarter ABS results. Unemployment will doubtless remain the key factor in keeping interest rates at their record low for a very long time to come.

Three Westpac economic surveys were recently released. The quarterly Westpac – ACCI Survey of Industrial Trends index continued to fall sharply to 24.0 from 45.0. The monthly Westpac – MI Leading Index also fell to minus 4.79% in May. Remarkably the Westpac – MI Consumer Sentiment Survey rose again in June to 93.7 to get back to pre COVID-19 levels after suffering a 20% fall. The resurgence of cases in Victoria will likely see a return of negative volatility. The three monthly *Australian Industry Group (AiG) Performance Indices* saw two improve and one move into expansion at the end of June. Manufacturing rose for the month up by a strong 9.9 points ending above 50 at 51.5. Services was down marginally, falling just 0.1 points but still ending well below the 50 mark at 31.5. Construction was up for the month by 10.6 and stayed in contraction at 35.5. We will talk about these survey results in the rest of our update given the high level of volatility we are seeing which reflects Consumer and Business sentiment better than just the historical data on which we typically rely for our analysis.

2. Capital Markets and Interest Rates

ASX 200 down 12% in 2020 ytd after being up 20% for 2019. A-REITs down 24.3% ytd; Banks down heavily with doubt on dividends and arrears. COVID-19 has changed everything.

ASX 200 Indices (ex income)

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 2020 saw world and domestic markets continue to gyrate as a result of COVID-19. Along with listed equity markets we look at listed Australian Real Estate Investment Trusts (A-REITs). The ASX and equity markets globally have featured daily volatility well beyond what might have been expected even once markets became aware of the coronavirus. The ASX 200 recovered 17.4% in the second quarter but was still down 12% for 2020. The decline in the major banks share prices had levelled out early in the first quarter but in addition to new breach revelations and action by regulators the concern about dividends and future bad debt provisioning has seen the ASX Bank Index fall by 21.1% in the year to date after recovering 10.6% in the second quarter. The impact of COVID-19 loan repayment deferrals remains uncertain as four additional months has just been added to the initial six months made available to Bank borrowers. The question of course is how many will become long-term arrears.

Direct Real Estate's performance is somewhat uncertain and one of our preferred measures from MSCI has signalled that while they expect to release their quarterly indices as usual valuations may contain a "material uncertainty" disclaimer. Listed Real Estate as shown above by the ASX A-REIT 200 Index had a very negative first half but recovered 18.3% in the second quarter. Those in the Retail sector were already struggling as earnings continue to be squeezed and write downs as a result of revaluations of major regional shopping centres have had a significant impact. We discuss this further in section 5 Retail of this Quarterly Update.

RBA May SoMP and April FSR poles apart. Cash Rate at 0.25% on hold as is US FOMC; AUD/USD recovers to 0.69 on USD weakness

The RBA in its May quarterly Statement on Monetary Policy (SoMP) had its usual set of forecasts for economic indicators which were much changed from the February edition but in line with the April Financial Stability Review (FSR) which addressed the coronavirus pandemic which was largely ignored in the February SoMP. By the time of the FSR release in early April the RBA had this to say about it; "The shock to global financial markets from the COVID-19 pandemic has been very large…. The Australian financial system enters this challenging period in a strong starting position. Financial markets in Australia have been dysfunctional at times but banks are well placed to navigate difficulties in funding markets." The FSR also spoke of the non-Bank sector of which Think Tank is a participant and the role of the Australian Office of Financial Management; "The initial transactions from the Australian Government's $15 billion fund for investing in asset-backed securities and warehouse facilities has already resulted in a significant easing in funding conditions for these lenders." The May SoMP went on to say; "The AOFM invested in its first deal in late March and expressed support for upcoming deals with a particular focus on mezzanine tranches. In addition, the AOFM noted that unfavourable market conditions have resulted in distorted pricing in the secondary market for ABS. As a result, it will also purchase existing securities from investors who commit to supporting activity in the primary market." This has continued in the period since those remarks were made and the AOFM has contributed greatly to the liquidity of securitised mortgage markets.

The RBA brought rates down during the first half of 2020 with two 25 basis points cuts in March solely as a result of COVID-19. The AUD/USD exchange rate which had drifted down fell more sharply to just below USD 0.55 and then rose just as suddenly as the impact of the coronavirus on the US economy became clearer. Speeches from Governor Lowe and other RBA figures confirmed the RBA would keep three-year Treasuries at the same 25 basis points as the Cash Rate and market rates have seen shorter term rates like BBSW fall below that. Five and ten year treasuries remain below 1% and the Cash Rate is expected to remain unchanged at 0.25% until 2023.

3. Residential

Residential markets fell during the second quarter of 2020 as prices for housing softened nationally and more so in Sydney and Melbourne. The long-term impact of COVID-19 on property prices is not known but we have moved from a Watch trend to Softening as further declines are expected. Overall the Capital Cities were down 1.1% for the quarter and also down nationally by 0.8%%. For the month of June, Melbourne and Sydney were down 0.8% and 1.1% respectively.

National dwelling values fell by 0.8% in the June qtr and 0.7% in the last month. Sydney down 0.8% & Melbourne down 2.3% for the qtr - CoreLogic RP Data

Houses: Houses in Sydney were down 1.1% for the past 3 months and In Melbourne they were down 2.8%. For the nation as a whole the fall was less at 0.9%. Only one of eight capital cities houses were down in price for the year which was Perth which fell by -2.5%. Notably Adelaide was up modestly at 2.0% while Brisbane was up 4.9% for the year. Regional prices were up 3.6%.

Units: Unit prices as reported by Core Logic are down by less than houses in both Sydney and Melbourne for the last quarter being down 0.1% and 1.2% respectively. Perth is down -1.5% and the combined capitals down - 0.5%. The AIG/HIA PCI Index for June recovered by 10.6 points but still remains deeply into contraction below 50 at 35.5. AiG reported that contraction in the apartment and commercial sectors was steeper while house building indicated a more modest decline. Our concern for unit prices lies in the large supply of settlements of newly completed apartments over the next two years. CoreLogic reports lower gross rental yields of 3.9% in Melbourne and 3.4% in Sydney and is forecasting a decline as demand reduces in the face of growing unemployment and less foreign students. Recent reports cite growing vacancy rates for CBD units in both cities and discounting of rents.

The RBA had a number of comments about housing in their May SoMP with some of them modified from the April FSR and subsequent speeches by Governor Lowe; "Survey information suggests expectations for housing price growth over the next year have fallen sharply, with over half of respondents now expecting prices to decline, compared with around 10% over the first three months of the year. The deterioration in established housing market conditions is expected to prolong the decline in dwelling investment. Dwelling investment is expected to be significantly lower over most of the forecast period than forecast in the previous Statement. The trough in construction activity is now projected to occur in early 2021, half a year later than previously expected." Later in the Statement: "Residential construction firms in the AIG Performance of Construction Index indicated that new business had declined sharply over recent months. Greenfield lot sales declined a little in Sydney in the March quarter and remained flat in Melbourne; cancellation rates had also edged up in these cities. Nationally, lot sales increased a little in the March quarter, but remained relatively low and are expected to decline over the year ahead. These indicators suggest continued weakness in dwelling investment in the near term. Liaison contacts have also cited concerns about increased settlement failures."

HTW in their most recent Capital City Property Market research continue to reflect the views in our ratings with all Capital Cities shown as at the start of decline or just peaking for houses and units. Demand is still shown as being soft for units but fair for houses in Melbourne while in Sydney it is soft for both units and houses. Brisbane houses are seen as declining while Adelaide houses are seen as being at the bottom of the market. Perth still appears to be at the bottom of its market cycle for houses and declining for units. Perth's rating for units is Weak and houses are Fair. Perth's trend for Units remains Deteriorating. All other ratings are Fair and trends Softening. We shifted from an overall Watch for most of the trends in the Residential sector as the impact of COVID-19 becomes clearer. Longer term the issue of population growth and migration is central to the supply and demand equation of housing and even with a strong V shaped recovery which is looking much less likely, growth will be diminished.

4. Office

The ANZ/Property Council Survey which was conducted in June provides some interesting views of investor sentiment especially comparing them to the March results. Sentiment in the office sector was surprisingly low despite an overall improvement for other sectors with the survey having been taken in June ahead of the Melbourne second lockdown. ANZ Senior Economist Felicity Emmett commented "Property sentiment remains depressed in the wake of COVID-19 and the shutdowns put in place by the federal and state governments to contain it. The impact has been widespread across states and sectors, with residential, office, industrial, retail and tourism sectors all heavily impacted. Not surprisingly, the tourism sector has been the hardest hit, although office property expectations have deteriorated further over recent months as businesses reassess the long-term outlook for office space."

COVID-19 continues to weigh on property sentiment. "The impact of COVID-19 is immense despite the survey closing before the Melbourne shutdown was announced."

ANZ/Property Council Survey, June 2020

The impact of COVID-19 on Commercial Office markets is a question that brings varied responses with multiple comments about the impact of Working From Home (WFH) and resulting drop in demand. Colliers recently released a review of Office Middle Markets with a focus on COVID-19. While maintaining a positive view of most markets with little or no softening in capitalisation rates but noted the lack of sales volume. M3 have also issued research entitled The Valuers' View which incorporates comments on all sectors including Office. Generally they also see only moderate softening of cap rates which we talk about more in our paragraph below but with increasing vacancy particularly in the CBD this will lead to rising incentives. As evidence of confidence in the Office market we noted last quarter the announcement of GIC, Singapore's sovereign wealth fund investing to acquire 50% of Melbourne's Rialto Tower at a yield of 5%. Just recently the approval of a 42 level office tower in North Sydney above the new Victoria Cross Metro Station was also announced. We think this demonstrates the confidence in our market by major players with access to broad markets and the resources to choose wherever they wish to invest.

HTW in their most recent Month in Review focused on the Office sector and now describes Sydney as having joined Melbourne with rental oversupply and with contracting economic conditions for both. Their markets are described as being at their peak or just starting to decline while the other capital cities are further into the cycle including Perth described as being at the bottom of the market. Yields are now softening slightly in most locations, but ultra-low interest rates which are expected to last for years are offsetting lower returns. As a result we have made some changes to our Ratings and Trends with Sydney moving down to Good from Strong as does Melbourne with Brisbane Fair together with Adelaide and Perth. All five enjoy a Stable trend but subject to rapid change.

5. Retail

On the basis of recently released ABS figures for retail sales, in current prices, the seasonally adjusted estimate for Australian turnover rose 16.9% in May 2020, following a fall of 17.7% in April, and a rise of 8.5% in March 2020. As with other statistics, the volatility associated with the impact of the coronavirus pandemic make it difficult to draw The variances by category were quite wide reflecting recoveries by those that had fallen most in earlier months but all categories were up. Despite being up 5.8% for the year weak private sector business surveys suggest conditions will remain difficult. By state, Victoria and NSW lagged other states; many analysts have used pre-COVID February for comparison and on that basis Victoria was down 0.4% while WA was up 9.4%, SA up 8.5% and QLD up 7.0%. NSW was up 3.8% against February's result or about the national average.

Indicators further reflecting the volatility of this sector were the Westpac-MI Index of Consumer Sentiment rose for a second month in a row by 6.3% in June to 93.7 remarkably reversing the impact on consumers of COVID-19 in April and March which saw a 20% fall. This appears to be consumers' reaction to the early lifting of some restrictions and it is quite likely that the volatility experienced may be repeated as the current situation in Victoria plays out. The AiG had this to say as the PSI for June fell just slightly to 31.5 well into contraction below 50; "This was the second lowest result in the history of this series, following a record low in April (commencing in 2003). Reduced customer demand continued to drag down most businesses across all services sectors in June. Some respondents reported the instant asset tax write-off had a positive effect on sales as did end of financial year discounting. Consumer sales have been impacted by uncertainty, tightening income and falling employment."

Store closures are announced almost every day and the AFR quoted JLL as follows; "We remain cautious about the outlook for discretionary retail as stimulus measures roll off later in the year, which is likely to contribute to an upward trend in vacancy rates," said Andrew Quillfeldt, JLL's senior director of retail research in Australia. "The events throughout the past few months, which have led to many discretionary retailers planning to shrink their store network which will likely polarise the retail property sector even more."

Retail vacancy rate rose to 6.3% from 4.8% in the past six months. The highest in two decades.
AFR – JLL

M3 expects yields to fall by up to 50 basis points in the Retail sector with rents also falling by up to 10%. This is with the exception of Neighbourhood Centres which they expect to remain steady. HTW featured the Retail sector in June and had it in decline or at the bottom of the property cycle in all capital cities. We have all of our Retail ratings and trends at Weak and Deteriorating on the basis that eventually we would expect declining earnings must eventually overcome tighter yields and we will see lower capital values in general as reflected by listed entities recent reported valuations.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the June quarter fell to 24.0 from 45.0 in March and 56.1 in December to be around the most negative reading since the series began. This is consistent with other surveys we follow however the AiG PMI was up very surprisingly by 9.9 points in June and moving just into Expansion at 51.5. AiG commented; "Parts of Australian manufacturing expanded mildly in June for the first time since February (seasonally adjusted). This indicates an improvement from the depths of April and May, rather than a recovery to buoyant conditions." Cushman Wakefield reported it was the story of the commercial property market in a pandemic: Industrial is surging as investment in Office property slowed to a trickle amid uncertainties over longer term workplace occupancy. Likewise lockdowns have put a brake on Retail investments.

"Investment in Industrial assets accounted for 39% of all commercial property deals during the June 1/4, up 53%"
Cushman Wakefield

M3 in their Valuers' View series recently wrote that they feel Industrial property is well placed to ride out the short term uncertainty given the recent growth in demand for transport and logistics and its key role to play in keeping the basic day to day necessities of Australians in supply. According to their report yields and rents for Prime properties will show little change, while secondary properties would initially see yields tighten by 50 basis points and rents fall by only 5%. This would widen to a tightening of up to 1.0% in yields a year from now with a reduction in rents of 10-15% due to rising vacancies at that time. HTW in their most recent monthly review of the Industrial sector sees Perth remaining in oversupply and is rated as Weak and at the bottom of the market. We have kept our ratings for both Melbourne and Sydney at Good and Stable with a similar trend for the other capital cities.

7. Thinktank Market Focus

The second quarter of the year saw Australian interest rates remain at all time lows in response to the coronavirus pandemic including the Cash Rate at an all-time low of 0.25%. Economically we had remained in a period of extended below trend growth both domestically and internationally but by comparison Australia has been better off than most and the same can be said of both how we are dealing with the coronavirus and its impact on the health of Australia and its economy. The certainty is that international growth will plummet, with high unemployment and underemployment with interest rates staying low for some years to come. Housing prices domestically are now being challenged and some sectors such as CBD units may suffer. With regards to Fiscal Policy, COVID-19 has forced the Federal Budget to be moved from May to October after having destroyed the surplus and generated huge policy changes. Many of these such as JobKeeper will save us from a devastating rise in unemployment and allow SME businesses to retain contact with staff for when restrictions are lifted and gradually businesses can begin to operate productively once again.

We mentioned last quarter a positive note of our experience with landlords/investors seeking a deferral of mortgage payments during this crisis. Both State and Federal governments had announced legislation to protect tenants and that lenders had supported these moves with their own hardship relief as has Thinktank. These initiatives have worked well across all property sectors and as we said at the time, from our direct communication with our Borrowers, most businesses have sound prospects and a good percentage are already returning to normal repayment terms. Others require another period of support for a return to healthy business activity once the crisis ends and it needs to be recognised that this may require a period beyond September.

The quarterly fall of -0.8% in national housing values was not that bad but the uncertainty currently present has led us to evaluate most Residential Trends as Softening and put all Ratings as Fair other than Perth Units which remain Weak – Deteriorating having fallen by -1.3% in June according to CoreLogic. There have not been many other changes in our ratings and trends this month. Industrial ratings in both Melbourne and Sydney are Good matching the Office sectors there making four markets rated as Good and Stable with all in Sydney and Melbourne. Comment appears to be much more positive about the Industrial sector and no doubt time will tell. Retail is Weak and Deteriorating everywhere and while consumer sentiment has momentarily lifted, as noted in our comments in section 5 the outlook is not good.

	Sydney		Melbourne		Adelaide		Brisbane (SEQ)		Perth	
Residential - Houses	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Deteriorating
Residential – Units	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Softening	Weak	Deteriorating
Office	Good	Stable	Good	Stable	Fair	Stable	Fair	Stable	Fair	Stable
Retail	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating
Industrial	Good	Stable	Good	Stable	Weak	Stable	Fair	Stable	Weak	Stable

Sources and References

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Commonwealth Bank
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International Monetary Fund
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

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