Thinktank

March 2020

Australian Real Estate Market Focus

The following represents a monthly snapshot of how we see the 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.

The Westpac-MI Consumer Sentiment Index rose by 2.3% in February to 95.5 but remains well below 100. The AiG PMI for February was down by 1.1 points to 44.3 and staying in contraction below 50. The Westpac-MI Leading Index lifted slightly in January from -0.62 to -0.32 but still materially below trend. 4th quarter GDP was as expected at 0.5%, 2.2% annual but the major factor influencing future performance is the COVID-19 outbreak and the potential damaging short-term impact on Australia's economy.

At its March meeting the RBA Board cut the Cash Rate to a new record low of 0.50%. Governor Lowe spoke of the possibility of further easing almost solely on the basis of the coronavirus. The Q4 CPI came in at a slightly improved 0.7% with the annualised rate rising to 1.8% but the prospect of a negative GDP figure for the current quarter is very real and a negative second quarter would signal a technical recession. The Unemployment Rate for January had risen to 5.3% and will now likely go higher. The US Fed which was expected to cut rates at its March meeting went early and cut by 50bps. The AUD has now fallen to USD 0.65 with many senior economists now looking to another cut within a month or two bringing the Cash Rate to only slightly above zero at 0.25%. This prospect appears to already be reflected in the AUD/USD exchange rate.

CoreLogic housing prices for February showed further strong gains in Sydney and Melbourne with houses up 1.8% and 1.3% respectively. Units were up as well, 1.5% for the month in Sydney and 1.0% in Melbourne but we remain concerned about the ongoing supply of newly completed apartments. The month-on-month lift of 1.1% in national housing values was also good and brought the annual recovery to 6.1%.

There have been few changes in our ratings and trends this month except for Retail which continues to weaken. Melbourne and Sydney Residential remain at Good for Houses and with an Improving trend with Sydney reporting an over 80% clearance rate on the last day of February. Units are Fair and Stable in both cities. Industrial ratings in both cities also remain Strong matching the Office sectors there making four markets rated as Strong and Improving with all in Sydney and Melbourne. Perth's Resi-Homes rating moved to Fair back in December and Adelaide has three Improving trends and Brisbane has two. Retail is Fair and Deteriorating in Sydney and Melbourne and Weak and Deteriorating elsewhere. Retail trends remain a growing concern and already weak consumer sentiment will only suffer further with negative coverage of COVID-19 and associated declining tourism and ultimately increased unemployment. Our News and Views section covers the MSCI Property Index report to 31 December 2019 with further comments on the Retail sector.

	Sydney	Melbourne	Adelaide	Brisbane (SEO)	Perth
Resi- Homes	Good Improving	Good Improving	Fair Improving	Fair Stable	Fair Stable
Resi- Units	Fair Stable	Fair Stable	Fair Improving	Fair Stable	Weak Deteriorating
Office	Strong Improving	Strong Improving	Fair Improving	Fair Improving	Fair Stable
Retail	Fair Deteriorating	Fair Deteriorating	Weak Deteriorating	Weak Deteriorating	Weak Deteriorating
Industrial	Strong Improving	Strong Improving	Weak Stable	Fair Improving	Weak Stable

Sources: ABS, ACCI, AiG, ABS, AFR, ANZ Research, ATO, CBA, CBRE, Colliers International, CoreLogic, Cushman & Wakefield, HTW, IMF, MSCI, JLL, Knight Frank, Melbourne Institute, OECD, PCA, Preston Rowe Patterson, RBA, RLB, Savills Research, Westpac Economics, World Bank

News and Views

- Our usual follow-up to the semi-annual Property Council of Australia (PCA) Office Market Report (OMR) is the MSCI All Property Index. The recent release of the Index shows a further fall below the 5 year and 10 year average rates of return down to 7.5% compared to 10.5% last year and 8.3% six months ago. The Total Return is less evenly split between Capital Growth of 2.1% and Income Return of 5.3% with yield compression less of a factor and Retail continuing to falter. As reported in the AFR by Nick Lenaghan at the report's release recently: "It is not surprising we have seen a slowdown in property growth across the board given where returns were at in 2019," MSCI executive director Mitchell McCallum said. The Total Return of 7.5% was the lowest since September 2010 when it was 8.0%.

- As shown opposite in Chart 1, the 7.5% total return derived from Direct Real Estate lags substantially behind most other asset classes mainly as a result of poor capital growth. It is however worth considering that the 23.1% total return enjoyed by Listed Equities in 2019 has since been cut in half by one week of coronavirus selling here in Australia and on world-wide stock exchanges. The long-term nature of real estate investment favours steady income and slower changes in capital returns driven by smaller movements in capitalisation rates over longer periods of time.

- The AFR article referred to earlier was headlined: "Shopping mall funds turn negative" and went on to say, "The nation's six dominant unlisted shopping mall funds, controlling close to $32 billion of retail property between them, have posted negative returns over the past year, the strongest sign yet of a sector under pressure." The presentation by Will Robson of MSCI given at the report's release included comments about the reductions in Total Returns that have been seen: "With total returns slowing and capital growth diminishing, some investors are worried that the cycle may be nearing the peak. Fears about the impact of e-commerce on the sector have continued to weigh on retail asset performance and cap rate compression appears to have abated over the last quarter."

- Panellists Louise Kavanagh, Managing Director of Nuveen Real Estate and Sophie Fallman, Managing Director of Brookfield both emphasised the long term nature of investment decisions made within their funds in response to questions about current appetite for the retail sector but noting how in the short-term supply chain difficulties associated with the coronavirus would have a substantial impact on retail activity. The attractiveness of the Australian Office sector was contrasted by Brookfield noting their substantial development portfolio with a 5 – 10 year hold period with an expectation of the continuation of strong demand and low vacancy rates supporting rental growth.

- Chart 2 shows the MSCI breakdown of individual sectors for the year to December 2019 and not surprisingly shows better than average returns for Industrial and Office at 11.3% and 11.5% respectively, reversing the ranking of a year ago, while Retail has fallen sharply as noted above dropping to a 2.0% total return as a result of a negative capital return. All of the capitals still show a fairly even and steady Income Return across the various sectors. Total Returns for Perth fell to 2.2% but beat out Adelaide at 1.6%. Sydney was highest at 9.7% ahead of Melbourne which recorded 8.7% while Brisbane was at 4.1%.

- In summary the AFR article noted that the MSCI indices reveal the varying impact of future income and cap rates changes on property growth. "Looking at this we can see retail is soft across both future income growth and softening in valuers cap rate impact," Mr McCallum said. The converse is taking place in the office sector, with strong signs of future income growth while cap rates are tightening, underpinned by demand and limited supply in Sydney and Melbourne. In the industrial sector there is strong demand and cap rates are tightening. "It, however, is not reflected in expectations on future incomes and raises questions about sustained long term growth where supply doesn't have the same hurdles as office," he said.

Chart 1 – Asset Class Return –Twelve Months to December 2019

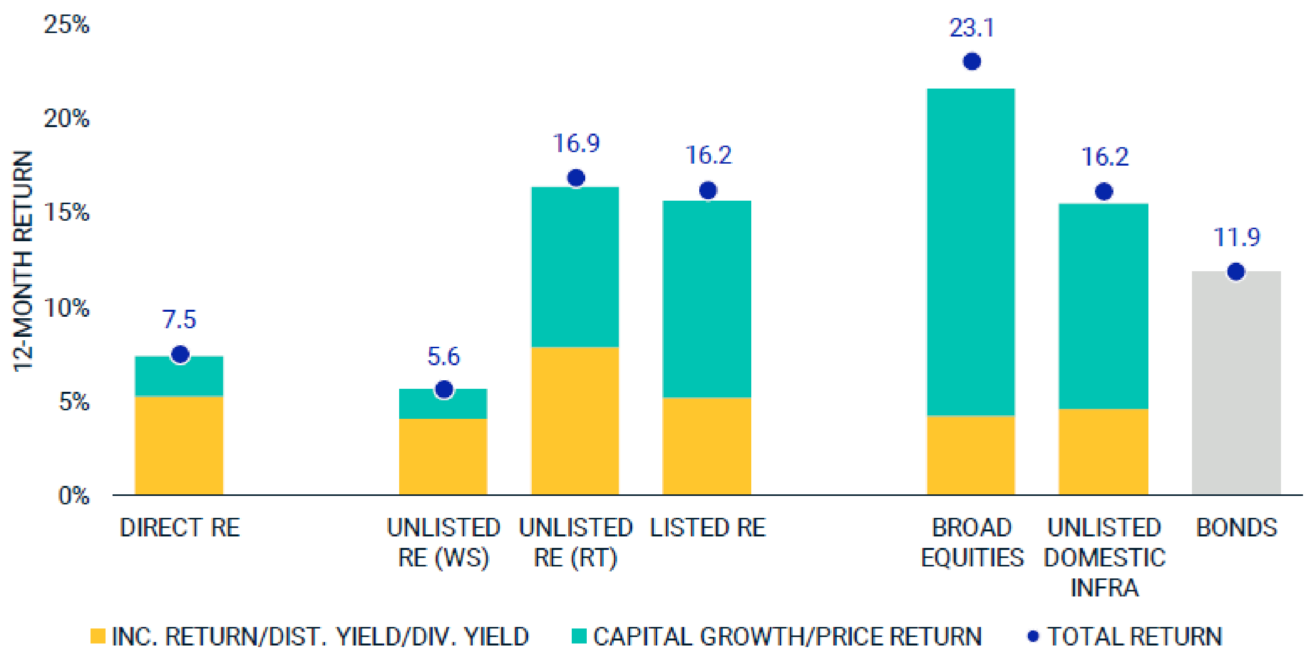
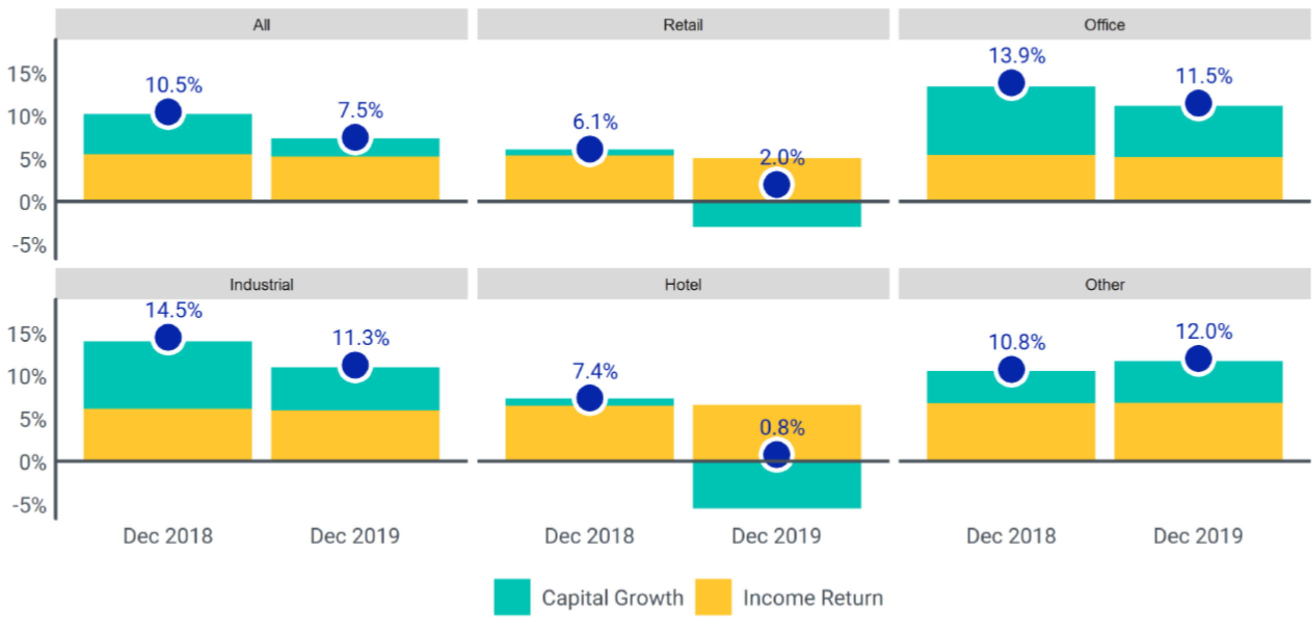


Chart 2 – Performance by Property Sector –Twelve Months to December 2019



Source: MSCI

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- Finance for the purchase, equity release and refinance of commercial and residential property;
- Set and forget loan terms up to 30 years with no ongoing fees or annual reviews;
- Self-Managed Superannuation Fund (SMSF) loans; and
- Loan serviceability options ranging from fully verified to self-certification of income.

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