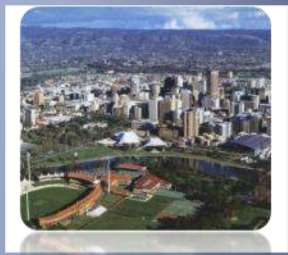

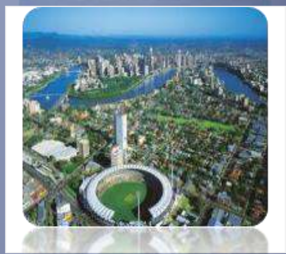

THINKTANK COMMERCIAL PROPERTY FINANCE

Quarterly Market Update October - December, 2018

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.

1. The Global and Australian Economies

The third quarter of 2018 domestically saw interest rates held unchanged by the Reserve Bank of Australia (RBA) Board while internationally the Federal Reserve Bank's Open Market Committee (FOMC) increased official interest rates in the United States for a third time this year at their September meeting. This was not unexpected but there are clear signs of a fourth increase emerging in their meeting in December. President Donald Trump continues to occupy world headlines and newspaper editorials and not just for its economic policies which have been reinforced by the passage of corporate tax cuts by both houses of congress. More recently international developments relating to trade tariffs have overshadowed other events such as in the Middle East and the Korean Peninsula, all of which continue to have a significant potential impact on the Australian economy. There are now however, signs that despite these factors various international agencies are slightly softening their forecasts of global growth for 2019 with concerns on the trade front as the US pursues tougher policies. Expected economic performance from most the major international agencies has turned down slightly as reflected during the past quarter with the OECD Interim Economic Outlook similar to that of the more recent research from the IMF. The OECD is forecasting 3.7% GDP growth in 2018 and the same in 2019, down 0.2% from June. In its latest World Economic Outlook, the IMF reduced its projected global growth by 0.2% to 3.7% for 2018 and 2019, and said *"the risk of worse outcomes has increased, even for the near term."* Trade tensions are a definite risk and the IMF has revised down the growth forecasts as a result. These latest reports include stable prospects for the United States economy with the implementation by the US Administration of policies that will stimulate growth to 2.9% in 2018 and 2.7% in 2019. China is forecast to grow at 6.6% in 2018 and 6.2% in 2019 while the fastest growth is still expected to come from India at 7.3% for 2018 and 7.4% for 2019.

OECD Interim Outlook "High uncertanty weighing on global growth"
IMF World Economic Outlook "Challenges to Steady Growth

Second quarter national accounts released by the Australian Bureau of Statistics (ABS) on 9 September 2018 recorded quarterly growth of 0.9% (3.4% annual) compared to 0.4% growth in the first quarter of this calendar year. This compared to an expectation by the RBA that growth to June 2018 would be 2.75% and then rising by 0.50% through to Dec 2018 and another 0.25% to June 2019 before dropping off slightly to 3.0% in June 2020. Unemployment has fallen further, most recently to 5.0% which is below the RBA's forecast. The CPI for the second quarter continued to be low at 0.4% which produced an annualised core rate of 1.9%, unchanged from the previous quarter.

2nd quarter GDP up 0.9%, 3.4% yoy - Unemployment and inflation are stable
Westpac and AiG surveys mostly positive as is D&B Expectations Index

Three Westpac economic surveys were recently released; 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 again this quarter and was up by 2.1 points to 66.5. The monthly Leading Index rose to +0.21% in September from a slightly negative -0.02 in August. The Consumer Sentiment Survey was up slightly in October by 1.0 to move a little further into positive territory at 101.5. The three monthly *Australian Industry Group (AiG) Performance Indices* were mixed with two remaining in positive territory and one falling into contraction at the end of September. Manufacturing rose strongly for the month up 2.3 to 59.0 while Services was up slightly by 0.3 to stay above the 50 mark at 52.5. Construction fell into contraction at 49.3 after falling 2.5 points. We discuss all of the surveys in more detail later in this report. D&B Business Expectations Index for the 4th Quarter is up 2.3% to 22.2 points and 29.4% over last year.

2. Capital Markets and Interest Rates

This quarter we continue taking a look at capital markets as part of our regular summary of economic and financial conditions in Australia. 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 good fiscal 2018 and continued the trend passing a 10 year high in early July but has since reversed that trend and suffered a correction taking its lead from Wall Street. We have shown June–Sept performance to the right. A-REITs have done well to buck the trend to be up slightly while Banks fell back as well as they suffered from the Hayne Royal Commission and have fallen a further 8% since the end of the quarter.

ASX down 2.6% for the 3rd quarter – Banks suffer from the Royal Commission down 2.4%. A-REITs up slightly

ASX Indices (ex income)

The decline in the major banks share prices comes despite strong income returns which benefit Shareholders (particularly those with holdings in SMSFs) through fully franked dividends. The effect of negative publicity from the Royal Commission has not impacted on A-REITs who also share in high income returns and distributions. The recognition of unit prices trading at below net asset values pushed prices up earlier in the year as investors have warmed once again to the sector with A-REITs avoiding the recent downturn. The MSCI Investor Returns Report for the 12 months to June 2018 which we featured in the News and Views section of our September Monthly Market Focus made some comparisons both with respect to recent performance and longer term trends. Returns on Bonds were reported as being down to 4.0% and equities at 13.1% total return split 1/3 income and 2/3 capital growth. Direct Real Estate remained slightly less than Equities at 11.7% and split evenly between income and capital growth. Listed Real Estate was only 9.7% with income of 5.9% but capital growth of only 3.8.

The RBA in its August quarterly Statement on Monetary Policy (SoMP) again revised a bit higher its forecast growth by Australia's Major Trading Partners (MTP) at slightly above the long-run average pace of 4% for the next year and at just below that rate for the following year 2019 then falling slightly in line with other forecasts. The underlying quarterly CPI rate was 0.5% and the annualised rate of inflation (trimmed mean) of 1.9% remains just below the RBA target band of 2%-3% and slightly below the forecast in the SoMP of 2.0%. The RBA's forecast remains at 2.0% through to December 2019 and then rising slightly by 0.25%. Separately the RBA also discussed the risk to the Australian Financial System of interest rates rising quickly globally. While not mentioned in the SoMP, the Bank of Canada has just recently raised rates again after a number of previous increases and the Bank of Canada Rate is now above our Cash Rate by a quarter of one percent at 1.75%.

RBA August SoMP shows little change. Cash Rate steady but the US Fed Rate is up again; AUD/USD now down well below 0.72

The RBA held rates steady again during the third quarter of 2018. The key drivers continue to be low CPI, sub-trend growth and low but steady employment. The August quarterly SoMP did not provide any strong guidance in regard to policy but public statements did. The AUD/USD exchange rate has drifted down further to below USD 0.72 and by many forecasts may fall further and test USD 70 cents. Opinion on future interest rate movements has firmed to no change with the question simply being for how long. Forward swap rates are now slightly more positive up to five years ranging from just about 2.10% at three years and 2.40% for five years. At the longer end, ten year Commonwealth Bonds are down slightly at 2.60%. International events and foreign central bank moves have in the past been key to the RBA's monetary policy but recent decisions of the US Federal Reserve Bank's FOMC to increase rates have had little impact. Movements in the US yield curve have also been watched closely with 10 year US Treasuries staying over 3.00% at the end of the quarter and with 2 year bond rates rising to 2.80%. The RBA Board met on 2 October and as expected there was no change in the Cash Rate as they are expected to do once again on 6 November.

3. Residential

Once again, commentators continued to pay close attention to Residential markets during the third quarter, prices for homes and units fell slightly in four of the capital cities and with the impact of a 1.5% decline in Sydney, overall the Capital Cities fell by the same 1.5% and were also down in the regionals by 0.9%. For the month of September, both Melbourne and Sydney had slipped to falls of 0.9% and 0.6% respectively. The monthly housing price statistics through the past three months have shown further corrections in the Sydney and Melbourne markets (more so in Sydney) which was welcome news to many observers particularly at the RBA. There is now not much difference to be found between houses and units. Houses in Sydney were down 4.9% for the year to date and units were down 2.2%. In Melbourne YTD houses were down 5.1% and units were 1.5% lower. The ABS reported investor loans were down 1.1% for the month of Aug after a 1.4% decrease the previous month; the total of housing finance was down 2.1% for the month. For the year that figure is down 10.1% and down 20.5% for investors which confirms that the APRA macro-prudential tightening has had the desired impact after having announced last quarter the removal of the restrictions on ADI lending to investors. Dwelling approvals appear to tell the same story with figures for all residential dwellings up just 13.6% for the month of August from a year ago. Multi-unit 'high rise' approvals were down 18.4% yoy while houses were down 1.7%. The Australian Industry Group/Housing Industry Association Performance of Construction Index for September was down 2.5 points slipping into contraction below 50 at 49.3. By sector, house building activity fell in September with the sub-index lower by 7.8 points at 42.0 and surprisingly the apartment sub-index rose by 11.4 points but remained in contraction at 44.2.

Capital city dwelling values fell by 1.5% in the Sept. qtr. with Sydney down 1.5% and Melbourne down 2.4%.
CoreLogic RP Data

The RBA had this to say in its August SoMP; "The decline in housing credit growth since mid 2017 partly reflected a reduction in interest-only (IO) lending (which is more prevalent among investors than owner-occupiers). Banks raised interest rates and tightened some lending standards on these loans following APRA's measures to reinforce sound residential mortgage lending practices, particularly the requirement that authorised deposit-taking institutions (ADIs, such as banks) limit new IO lending to 30 per cent of total new residential mortgage lending. There may have been some further tightening in lending standards by banks during 2018 due to additional public scrutiny. The construction of higher-density housing in the eastern states has driven much of this upswing in activity, while the pick-up in the construction of detached houses has been more modest. Liaison with developers in the major east coast cities indicate that sales of off-the-plan apartments have declined over the past year. Construction activity is nevertheless expected to remain at a high level for some time yet as a result of the large pipeline of work yet to be done, especially in New South Wales and Victoria."

Our own anecdotal evidence from discussions with Melbourne developers is that conditions are indeed tough. The construction pipeline is however very large and we will look at this more closely in our November News and Views article on the RLB Crane Report.

HTW in their most recent Capital City Property Market research continue to reflect the views in our ratings with Sydney and Melbourne still the clear leaders but having reached the peak of the market for houses in Melbourne and starting to decline and also declining in Sydney and the same for units. Brisbane and Adelaide houses are both seen as being in rising markets. Perth appears to be at the bottom of its market cycle for houses and declining for units. The Perth unit market is also declining and Adelaide is at the bottom of its market. We have recognised a correction beyond "softening" in the case of Sydney and Melbourne and have re-rated their trend as Deteriorating. Their ratings remain Fair on the basis of recent value shifts even though absolute prices remain high in both markets. Other ratings and trends have been kept unchanged.

4. Office

Recent trends in the sector continued during the second quarter of 2018 with Sydney and Melbourne staying well ahead of the other capital cities with improving rental markets and falling incentives. This half, Melbourne has moved ahead of Sydney as white collar jobs growth drives the take up of Commercial space. By contrast vacancy rates remain high in Adelaide and Brisbane as these cities continue to grapple with weaker demand for office space; despite a slight increase, Brisbane is expected to continue to show steady improvement. Perth on the other hand has improved slightly but with vacancy rates in secondary properties very high as tenants take advantage of favourable lease conditions to upgrade premises. The Property Council of Australia's Office Market Report was released on 2 August 2018 and the highlights of that research are shown in the panel to the right with the stark difference between Melbourne & Sydney and the rest of the Capital Cities remaining in place and expected to remain so for some time to come. Our August News and Views contains a full analysis of the OMR and includes forecasts which show a continued fall in Sydney vacancy rates to record levels.

CBD Office Vacancies
Sydney - 4.6% and Melbourne - 3.6%
Brisbane 14.6%, Adelaide 14.7% and Perth 19.4% trends unchanged
PCA Office Market Report July 2018

Savills Research – Quarter Time, National Office Report once again provides an excellent statistical summary of all capital city CBD and fringe markets. Its A-grade averages show a further tightening of yields in some markets with others flat. Not surprisingly Sydney led the way at 4.75% down 15 bps% with net effective rents rising by 7.6% for the year. Melbourne was reported flat yields of 5.20% with N.E. rents also flat up 8.9% yoy. Brisbane had flat rentals and lower yields at 6.00%, down 15 bps over the past quarter while rents in Perth and Adelaide fell but Perth's average yields are unchanged at 7.0% as markets look to an economic recovery in WA to boost office demand. Other research continues to reconfirm the capital cities of Brisbane, Perth and Adelaide, are seeing generous incentives and good availability of space in their CBD markets which means many tenants are upgrading their office space and as a result secondary suburban/metro vacancy is still rising.

The Sydney CBD Office sector remains Strong and is still Improving with withdrawals continuing to play a big role while in Melbourne higher levels of net absorption as noted above continue to keep the market at a Strong rating and also with an Improving trend. Both reported low vacancy rates and as with most other markets some modest tightening of yields continues to be reported with the exception of Adelaide. Even in weaker leasing markets such as Brisbane with high vacancy rates and incentives, yields for prime properties have fallen. Perth has also fallen slightly despite falling rents and sky-high incentives. HTW describes Sydney as still rising with Melbourne approaching the peak. Adelaide as flat and approaching the bottom of the market and Perth is at the bottom and both in economic contraction. Brisbane is also at the bottom but with tightening vacancy and steady economic growth. Yields are still tightening slightly in most locations, even those with weak fundamentals; with rising interest rates, rental growth may take over from yield compression in terms of total return. 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 together with Brisbane and Adelaide and we continue to keep the trend for all three of these capitals as Stable.

5. Retail

Retail sales statistics reported by the ABS for August 2018 were up modestly at 0.3% following several months of similar numbers. Annual growth was 3.8% up from 2.9% in July but is partly affected by a soft patch for sales in Q3 2017. Looking at the annual growth by State, they remain quite uneven with WA flat and SA up a strong 0.8%.

Victoria and NSW were up 0.2% and 0.5% respectively while QLD was up 0.1%. A surprise was Department Stores which recorded an upswing of 0.9 for the month; Electrical Goods were down 0.5%. The Westpac-MI Index of Consumer Sentiment stayed in optimistic territory rising slightly in October to 101.5 from September's 100.5 just above pessimism. The AiG Performance of Services Index rose slightly in September by 0.3 points and stayed in expansion at 52.5 points but remained below the 12 month average of 55.0. However, the retail trade sub-sector was up 2.0 points to 59.2 the highest result for this sub-sector since June 2016.

The ongoing weakness of department stores remains the ongoing news for the sector and the outcomes of negotiations with major landlords will be followed closely as the expected downsizing continues. Various owners have expressed confidence they can cope with these developments but there are still a lot more changes to take place in the retail sector and investors need to be remain alert. The semi-annual JLL Retail Centre Managers survey conducted in August reported modest vacancy of 3.4% but with particular weakness in the fashion sector in terms of leasing demand.

Moving Annual Turnover recorded modest growth with Neighbourhood +0.6% and Sub-regional +0.3% and Specialty stores down in both -

JLL Retail Centre Managers' Insights

HTW continues to describe Sydney and Melbourne as both "approaching the peak of market" with ultra low yields of 4.0%. Brisbane has comparable yields of 6.0% to 7.0% for sub-regional and neighbourhood centres and HTW describes that market as "peak of the market". Adelaide and Perth both remain at the "the bottom of the market" with steady/increasing vacancies and declining rents. In Adelaide yields are reported at 5.50% to 7.75% and in Perth at 6.50% to 7.50%. There are no changes to our ratings this quarter and all are rated as Fair except Adelaide which is Weak, trends are Improving in Sydney and Melbourne and remain Stable elsewhere. It still remains to be seen when the weakness in retail businesses will be reflected in retail property prices and it may take an increase in interest rates to trigger a re-evaluation although owners remain confident in their ability to replace vacating tenants. Given an increase in interest rates is not expected anytime soon the sector may remain unchanged.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the September quarter of 2018 rose by 2.4 points from the June result of 64.1 to be at 66.5 and continued a steady uptrend since June 2016 when the index was at 54.8 at the time of the last Federal election. As noted earlier in our update this is consistent with other surveys we follow with the AiG PMI rising further into expansion at 59.0. Manufacturing continues to benefit from local apartment and infrastructure projects which are still boosting demand. The uptrend in exports has continued at a moderate pace and expectations are down slightly with a net 22% of businesses expecting the general business environment to strengthen over the next six months. The ACCI Expectations Market Composite was up at a positive 66.5 from 64.1 in June. The D&B Business Actuals Index was also up this quarter as is the Expectations Index .

HTW in a recent review of the sector retained a positive view on Sydney reporting tightening rents in a rising market. The steady economic growth cited continues as is the case for Brisbane while Melbourne and Adelaide were rated as flat. Perth has an oversupply of available property relative to demand and is rated in contraction and approaching the bottom of the market. Savills in their latest update continued to highlight stable rental levels across the country except in Perth but with yields continuing to tighten everywhere including Perth. Prime Sydney and Melbourne are ranging from 5.25% and 6.25% while Brisbane, Adelaide and Perth range from 6.92% in Brisbane to 8.03% in Adelaide South. Secondary properties, have also seen a contraction of spreads from Prime. Rents are stable in Perth and yields for Prime properties have softened by 25 bps and are reported at an average 7.39%. These remain pretty much consistent with last quarter's update and as such we have made no changes to our ratings or trends.

7. Thinktank Market Focus

The third quarter of the year saw Australian interest rates unchanged but in the United States the FOMC, as expected, increased rates at their September meeting after their earlier increase in June. Economically we have moved out of a period of extended below trend growth both domestically and internationally and by comparison Australia remains much better off than most. Despite this, domestic political upheaval is impacting on both business and consumer sentiment although more so the latter. The likelihood is that international growth will pick-up and interest rates will continue to rise modestly in the US and elsewhere. Lower housing prices domestically have provided greater flexibility for our domestic policy makers while good growth fuels lower unemployment without any obvious need to adjust monetary policy.

Internationally, the world's media attention continues to be focussed on the Trump administration's almost constant front page headlines, only occasionally interrupted by the Brexit negotiations troubling Prime Minister May. The decision of the Federal Reserve FOMC to increase the Fed Funds Rate at their September meeting remains important if not unexpected as Fed Chairman Jerome Powell and other voting Board members have variously expressed their views that rates will continue their cyclical upturn through the end of 2018 and into 2019. Talk of a flat or inverted yield curve by year-end is prevalent. The impact this has had on the AUD/USD exchange rates continues to cause volatility and as we start the fourth quarter the AUD remains below 0.72 and appears headed down closer to the next resistance level of 0.70 .

We have made just two changes to our property sector trends since last quarter which reflects the ongoing weakness in the Sydney and Melbourne Residential markets. Our individual sector comments continue to reflect the ongoing shift of the Sydney and Melbourne Residential markets to a correction after many years of strong growth. There has also been a return to stability in Perth Commercial reflecting that the worst may be over for WA but not enough for any adjustment to Ratings or Trends. We now have four markets that are Strong or Good and seven that are Weak. Sydney and Melbourne Retail remain Fair and Stable. In contrast, Perth and Adelaide still have six ratings Weak but all trends are Stable. Brisbane has one Improving trend which is Industrial while Commercial there remains Weak but Stable. Residential units are less of a concern now especially in the East Coast as the softening of those markets continues but the ongoing development overhang may be a problem.

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

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PCA / IPD Research, MSCI
Reserve Bank of Australia
Rider Levett Bucknall
Savills Research
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