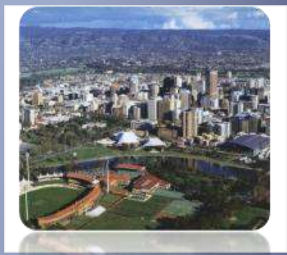

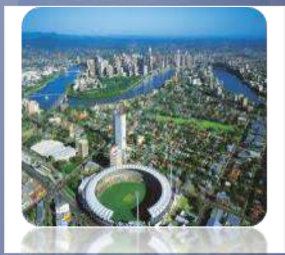

THINKTANK PROPERTY FINANCE

Quarterly Market Update April - June, 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. The Global and Australian Economies

The first quarter of 2019 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) left official interest rates in the United States unchanged at their March meeting. This was not unexpected but what was surprising was the announcement by Fed Chairman Jerome Powell that there would be no increases in 2019 contrary to what had been previously forecast. President Donald Trump continues to occupy a lot of world headlines and newspaper editorials but Brexit which has come to a head in terms of timing and is now centre stage. UK Prime Minister Theresa May finds herself in what appears to be a no win situation as does the whole country. The resulting economic outcome for the UK and the EU promises 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 the more recent research from the IMF. The OECD is forecasting 3.6% GDP growth this past year but falling to 3.3% in 2019 and 3.4% in 2020 with Australia at 2.7% for 2019 and 2.5% for 2020. In its latest World Economic Outlook just released, the IMF reduced its projected global growth to 3.6% for 2018 and by 0.2 for 2019 to 3.3% and kept 2020 at 3.6%. It said *"Global growth is set to moderate in the near tern, then pick up modestly. Risks are tilted to the downside."* Trade tensions are increasing and the IMF 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 2.9% in 2018 but 2.3% in 2019. China is forecast to grow at 6.6% in 2018 and 6.3% in 2019 while the fastest growth is still expected to come from India at 7.1% for 2018 and 7.3% for 2019. Australian growth was cut to 2.1% forecast for 2019 after 2.8% in 2018 which is significant and reflects weak fourth quarter GDP growth as noted below.

OECD Economic Outlook "Global growth is weakening as some risks materialise". IMF World Economic Outlook "Growth slowdown, precarious recovery"

Fourth quarter national accounts released by the ABS on 9 March 2019 recorded quarterly growth of 0.2% (2.3% annual) compared to 0.3% (2.8% annual) growth in the third quarter of last calendar year. This was below the RBA projected growth to Dec 2018 of 3.5% which has now been adjusted to 2.5% at June 2019 and 3.0% at Dec 2019; well above the OECD and IMF figures. Unemployment has fallen slightly to 4.9% which remains just below the RBA's forecast and is a key to future rate moves. The CPI for the fourth quarter continued to be low at 0.5% and an annualised core rate of 1.8%.

Three Westpac economic surveys were released in March; 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 1.3 points to 61.7. The monthly Leading Index also fell to -0.56% in February. The Consumer Sentiment Survey was down strongly in March by 4.8% to move a into negative territory at 98.8 but more recently bounced slightly in early April above 100 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 March. Manufacturing fell slightly for the month down 3.0 but stayed above 50 at 51.0. Services was up slightly by 0.3 but stayed below the 50 mark at 44.8. Construction rose for the month but stayed in contraction at 45.6. We discuss all of the surveys in more detail later in this report. Illion (D&B) Business Expectations Index for the 1st Quarter were down 7.1% annually and were labelled "bleak" by Economic Adviser Stephen Koukoulas. Surprisingly though the June interim results were positive based largely on an expectation of stronger selling prices which were described as "difficult to reconcile".

4th quarter GDP up 0.2%, 2.3% yoy. Westpac and AiG surveys remain negative.

2. Capital Markets and Interest Rates

The first quarter of 2019 got the year off to a good start as we continue to 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 negative 2018 as did most global equities markets so a strong bounce back was welcome. The A-REIT Index was down a lot less at 2.1% for the year and similarly bounced back in the first three months of 2019. Banks and other Financials weren't as fortunate and only picked up 2.0% after dropping 14.8% for the year as they suffered from the Royal Commission which released its final report on 4 February 2019. The further decline in the major banks share prices comes despite good income returns to Shareholders (particularly with holdings in SMSFs) through fully franked dividends which are now under threat as a major part of Labor Party policy in the current Federal election campaign.

ASX up 9.5% for the 1st quarter & A-REITs 11.9%; Banks continue to suffer from the Hayne Royal Commission but up 2.0%
ASX 200 Indices (ex income)

The MSCI All Property Index report for the full year 2018 was released in February and we featured the results in the News and Views section of our March Monthly Market Focus. Direct Real Estate recorded total returns of 10.3% for the year compared to a negative 2.9% for Equities after the impact of minus 7.0% capital return. Listed Real Estate had a total return of 2.7% buoyed by 5.5% income. The recognition of unit prices trading at below net asset values has pushed prices up as investors have returned to the sector having avoided much of the last year's downturn as noted above.

The RBA in its February 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 3 ¾% for the next two years noting that global growth has moderated and trade tensions remain high. Growth forecasts have been downgraded by ½% - ¾%. 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 decreased to 1.25% to June 2019 and 1.75% to December 2019 and then rising to 2.0%. The SoMP was followed up 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.

RBA February SoMP easing slightly. Cash Rate steady but the US FOMC holds for the rest of 2019; AUD/USD still near 0.71

The RBA held rates steady again during the first quarter of 2019. The key drivers continue to be low CPI, sub-trend growth and low but steady employment. The February quarterly SoMP did not provide any strong guidance in regard to policy but the April minutes did with a focus on employment. The AUD/USD exchange rate had drifted down further but has since recovered to around USD 0.71. Opinion on future interest rate movements has shifted to an easing as noted above with the question being how soon. Forward swap rates are now slightly more positive up to five years ranging from just about 1.66% at three years and 1.79% for five years. At the longer end, Apr 27 Commonwealth Bonds are down further at 1.95%. International events and foreign central bank moves have not had much impact on the RBA's monetary policy to date but recent decisions of the US Federal Reserve Bank's FOMC to increase rates have been put on hold. 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 2.59% with 2 year bond rates at 2.41%. The RBA Board met on 2 April 2019 and as expected there was no change in the Cash Rate however they appear to be heading to an easing bias and markets are building in two rate cuts of 0.25% for later in 2019.

3. Residential

As usual, commentators continued to pay close attention to Residential markets during the first quarter of 2019 as prices for housing fell again in six of the capital cities with Hobart up and Canberra flat. Overall the Capital Cities fell by 2.7% and were also down in the regionals by 1.0%. For the month of March, both Melbourne and Sydney had lower declines of 0.8% and 0.9% 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 up 2.7% in February but down 18.6% for the year. Investor loans remain down circa 30% from a year ago.

National dwelling values fell again by 2.3% in the March qtr. The largest in ten years; Sydney down 3.2% and Melbourne down 3.4%. CoreLogic RP Data

Houses: Houses in Sydney were down 11.8% for the year and In Melbourne they were down 12.4%. For the nation as a whole the decline was less at 7.4%. In five of eight capital cities houses down in price for the year and Perth fell by 7.6% to rank third. Notably Adelaide was up albeit modestly at 0.7% while Brisbane was down 1.3%. Regional prices were down 2.3%.

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 -8.9% and -3.8%. Perth is down -8.1% and the combined capitals -6.3%. The AIG/HIA PCI Apartment Index for March was up by 1.0 points but remained deeply into contraction below 50 at 31.3 . 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.

The RBA had a good deal to say in both its February SoMP and April FSR. In the SoMP, "Housing credit conditions are tighter than they have been for some time following the improvements in lending policies and practices over recent years. Over the past year, there has been ongoing work to improve lenders' assessment of potential borrowers' expenses. Lenders have also increased their focus on their responsible lending obligations. Liaison with mortgage brokers suggests that lenders are no longer making as many exceptions to their credit policies as they did in the past." And in the FSR, "The pick-up in non-bank lending to property developers has occurred as banks pulled back from this market due to concerns about increased risks. Increased risks associated with apartment markets reflect a combination of the recent easing in market conditions and further increase in supply in the next couple of years. Risks appear highest in the Sydney market, where a considerable volume of new supply is due to be completed over the next couple of years, and the recent decline in apartment prices partly reflects demand-side factors." We will be taking a look at the new supply issue when we review the RLB Crane Index in our News and Views section of May's Monthly Market Focus.

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 "declining markets" for houses and units. Demand is shown as being soft in Sydney but fair in Melbourne. Brisbane houses are seen as being in the start of a recovery 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 recovering and houses are rising off the bottom of its market. Last quarter we recognised a correction beyond "softening" in the case of Sydney and Melbourne and lowered their trend to Deteriorating which continues and this quarter we have lowered their ratings to Weak. A few other ratings and trends have changed leaving five of ten trends as Deteriorating and four ratings as Weak.

4. Office

The Property Council of Australia (PCA) Office Market Report (OMR) for January 2019 was released in early February and was featured in the News and Views section of that month's Monthly Market Focus. With Melbourne CBD Office vacancy rates down to 3.2% and Sydney at 4.1% these were the lowest levels in a decade. While improving over the last 6 months, vacancy rates remain high in the other major Capital Cities we cover. Perth has dipped a little further below 20% at 18.5% and Adelaide has also improved moving down further below 15% at 14.2% as the build-up of momentum in the defence and mining sectors helped office vacancy rates fall slightly. Brisbane came in slightly lower at 13.0% down from 14.7% six months ago. Overall, Australian office vacancy fell by 0.7% in the six months to January 2019 to 8.5%. Savills Quarter Time National Office update also reported further yield compression of from 35bps to 20 bps in these markets including fringe areas. Secondary property has higher vacancy rates in all of the Capitals than for Prime and in some locations such as Perth this is very significant; landlords with office buildings in city fringe locations are feeling the pinch as fringe vacancies increased from 11.0% to 12.6% in the six months to January, 2019.

Office vacancy rates continue to fall and rents rise. Melbourne and Sydney lead the way with other Capitals improving somewhat.
PCA Office Market Report January 2019

As is usually the case, Knight Frank has followed up the PCA OMR with their own detailed research on individual markets. Yields were down and rents up from a year ago in almost all markets. Not surprisingly Sydney led the way at 4.75% down 18 bps with net effective rents (NER) rising by 14.9% for the year. Melbourne was reported as softening by 17 bps to yields of 4.86% with NER up 7.2% yoy. Brisbane had a slight increase in NER of 2.7% and lower yields at 5.51%, down 32 bps over the past year while rents in Perth and Adelaide were up 5.5% and 3.5% respectively with Perth's average yields unchanged at 6.96% and Adelaide's fell 6 bps to 6.84%.

HTW describes 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 and in the midst of economic contraction. Brisbane is also at the bottom but with tightening vacancy and steady economic growth. While yields are still tightening slightly in most locations, even those with weak fundamentals, should interest rates rise at some time, 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 with Brisbane and Adelaide as Fair and Improving but we continue to keep the trend for Perth as Stable.

5. Retail

Retail sales surprised significantly to the upside in February, with a 0.8% gain coming very much against the run of play. Sales had risen just 0.1% in January after a 0.4% fall in December with very weak private sector business surveys suggesting conditions had remained difficult in February as well. The sales data instead showed a strong and relatively broad based gain, well above consensus forecasts of a 0.3% increase and taking annual sales growth back above 3% for the first time since last October. Making predictions about trends in this sector is extremely difficult, with sales up 0.7% in South Australia and a strong 0.6% in Western Australia. Victoria and NSW were also up strongly 0.8% and 0.6%, respectively, while Queensland soared by 1.4%. Compounding the difficulty for investors is the performance of the differing retail sectors, with Department Stores up 3.5% for the month but only 1.4% for the year. Household Goods Retailing was up 1.1% for the month but down 0.1% for the year. By size, small retailers are struggling down 0.6% in February 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 returning to "optimistic" territory in early April at 100.7, after falling by 4.7% in January to 99.6, just below the "pessimism" level and then bouncing back to 103.8 in February and crashing back down to 98.8 in March. Consumers are obviously unsure of the future.

The recent weakness of Department Stores and DDS continues to be major news for the sector despite the February lift in sales and the outcomes of negotiations with major landlords are followed closely as downsizing is set to continue. The announcement of the closure of 30 Big-W outlets is just the most recent to hit the press. 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. JLL recently produced a research report entitled Australian Shopping Centre, Investment Review and Outlook 2019. It details amongst other things the rationalisation taking place in AREIT portfolios as unlisted funds continued to dominate acquisitions with the expectation that more retail assets will transfer from listed to unlisted ownership as AREITs continue to refine their portfolios in 2019.

Investors are becoming more cautious towards retail fundamentals and are increasingly pricing-in uncertainties.

JLL – Investment Review and Outlook

Savills in their latest Quarter Time update reported slightly lower yields in most locations. For Sydney Regional Centres at 4.0% and just a bit higher in Melbourne at 4.25%. Smaller Neighbourhood Centres are at 5.25% and much the same in Brisbane. A bit surprisingly Perth is not much higher but Adelaide is 75 - 125 bps more across all categories. HTW continues to describe Sydney as approaching the peak of market with the same ultra low yields as Savills 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.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the March quarter fell by 1.3 points from the December result of 63.0 to be at 61.7 but continued an above average trend 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 falling by 3.0 points in March but just staying in Expansion at 51.0. Manufacturing continues to lose the benefit from local apartment and infrastructure projects which are slowing amidst falling demand. The Westpac MI Leading Index fell further into negative territory in February to 0.56% and Chief Economist Bill Evans commented that GDP growth will fall to 2.6% in 2019 well below that forecast by the RBA which he expects to be revised down in May. The illion (D&B) Business Actuals Index was also down this quarter but as noted earlier the preliminary Expectations Index for the second quarter was unexpectedly up and may need close watching .

Knight Frank in a series of recent Market Overviews of the sector retained a positive view on Sydney and Melbourne reporting rising rents and further yield compression. Prime Sydney and Melbourne are now ranging from 5.00% and 6.00% while Brisbane and Adelaide range from 6.00% to 7.05% in Brisbane to 7.50% to 8.50% 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 29 bps and are reported at 6.83% to 7.26%.. HTW in their latest monthly review sees the steady economic growth cited in Sydney continuing 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. These remain consistent with last quarter's update and as such we have made no changes to our ratings or trends.

7. Thinktank Market Focus

The first quarter of the year saw Australian interest rates remain unchanged but in the United States the FOMC in a mild surprise announced no more increases in rates for the rest of the year. 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. 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 weaken further and interest rates will stay steady in the US and elsewhere. Lower housing prices domestically had provided greater flexibility for our domestic policy makers while stable growth fuels lower unemployment without any obvious need to adjust monetary policy just now. Risks however are to the downside and political change/uncertainty with a federal election in May suggests the second quarter of 2019 may be a flat one at best with annual GDP growth declining.

The global media's attention continues to be focussed on the Trump administration's steady front page headlines but now frequently interrupted by the increasingly ludicrous Brexit negotiations haunting UK Prime Minister May. The latter is now critical and is recognised as having a serious downside to it for the whole of the current EU. 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 the resulting inversion of the yield curve was viewed as an ominous omen. The impact this has had on the AUD/USD exchange rate was for a brief rise and then back to trade around 0.71 with Westpac forecasting 0.68.

We have finally re-rated Sydney and Melbourne Houses as Weak and we have retained the two changes made last quarter to those sector trends to Deteriorating which reflected the ongoing weakness in the Sydney and Melbourne Residential markets. This applies to both Houses and Units and while the latter remain rated as Fair, they are on close watch. 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, all in Sydney and Melbourne, and eight that are Weak. Sydney and Melbourne Retail remain Fair and Stable. In contrast, Perth and Adelaide now have six ratings Weak. Brisbane has two Improving trends with Office there now Fair and Improving. Residential units remain a concern in the East Coast as the softening of those markets continues and the ongoing development overhang is expected to be a problem as large numbers of new units near settlement.

	Sydney		Melbourne		Adelaide		Brisbane (SEQ)		Perth	
Residential - Houses	Weak	Deteriorating	Weak	Deteriorating	Fair	Improving	Fair	Stable	Weak	Stable
Residential – Units	Fair	Deteriorating	Fair	Deteriorating	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	Good	Improving	Good	Improving	Weak	Stable	Fair	Improving	Weak	Stable

Sources and References

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Reserve Bank of Australia
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