Australian real estate market focus

June 2022

Thinktank..

The following represents a monthly snapshot of how we see the property markets across the country along with the near-term outlook. For more in depth commentary, please visit our website thinktank.net.au for our latest Quarterly Market Update. This month in News and Views we take a look at some of the latest research on long term interest rates and their impact on commercial property capitalisation rates across various sectors.

The Westpac-MI Consumer Sentiment Index fell sharply in May by 5.6% from 95.8 to 90.4 remaining well below the 100 level impacted by the interest rate increases. The Westpac Melbourne Institute Leading Index fell to 0.88% in April from 1.69% in March. May's result for the AiG Manufacturing Index was also negative breaking 3 months of gains falling by 6.1 points to 52.4 but staying in positive territory above 50. Both of the other AiG indices fell with the PCI construction index down in May by 5.5 points to 50.4, just in expansion but the PSI covering services and retail was down by a significant 8.6 points to 49.2, slipping into contraction below 50.

At its closely watched June meeting the RBA Board raised the Cash Rate as expected and choosing to do so by 0.50% from 0.35% to 0.85%, in only its second increase since November 2010. Further increases are expected this year over the next few months. This was a surprisingly large increase and Governor Lowe's remarks after the Board meeting specifically mentioned high inflation particularly as a key factor. The 1st quarter GDP results at 0.8% for the quarter and 5.3% yoy; were good but on the back of a high quarterly CPI for March of 5.1%, the strongest rise since 2001. Retail sales for March were also positive being up 1.6% for the month and 9.4% yoy. The unemployment rate of 3.9% in April after two months of 4.0% was also said to evidence the resilience of the Australian economy. Rates continue to rise by similar amounts in the US with the second of two forecast 50 bps increases by the FOMC expected this month. Last week the Bank of Canada increased its Cash Rate by 50 bps to 1.50%.10 year US Treasury Yields traded up at 3.00% at the start of the month while AUS 10 year Gov't bonds were back up to 3.5%. The AUD is once again up a bit at USD 0.72.

CoreLogic dwelling prices for May began the long expected start of a decline. National Housing values posted a 0.1% fall for the month, its first since September 2020 but was still up 1.1% for the quarter despite falls in Sydney and Melbourne. In Sydney, House prices were down 1.1% for the month with units down 0.7% resulting in a 1.0% decline in overall dwelling prices. The results were similar in Melbourne for houses being down for the month 0.8% and 0.7% for dwellings while units were down by 0.3%. Brisbane and Adelaide continued to perform well again this month with dwellings up 0.8% and 1.8% respectively while Regional outperformed Capitals by 0.5% to negative -0.3% for May and 3.8% to 0.4% for the quarter. Our ratings have been updated and we will be keeping a close watch on trends as interest rate increases continue to hit the market.

We have reflected the initial decline of Residential in some capitals and have slightly modified our ratings and trends for some but with many remaining stable for the near term. Sydney and Melbourne houses have both been re-rated as Fair and Declining. Retail continues to be showing the expected signs of volatility as sales improve.as noted above. Office continues its slow but steady recovery from the pandemic lockdowns while Industrial remains very strong and we are maintaining our Ratings and Trends which are either Strong or Good with an Improving Trend in each of the capitals. It remains to be seen how interest rate increases will impact on commercial capitalisation rates but a relatively flat yield curve appears to be encouraging and we look more closely at this topic in our News and Views section inside.

	SYDNEY		MELBOURNE		ADELAIDE		BRISBANE (SEQ)		PERTH	
Resi- Homes	Fair	Declining	Fair	Declining	Good	Stable	Good	Stable	Good	Stable
Resi- Units	Fair	Declining	Fair	Declining	Good	Stable	Good	Stable	Good	Stable
Office	Fair	Stable	Fair	Stable	Strong	Stable	Fair	Stable	Fair	Stable
Retail	Weak	Stable	Weak	Stable	Good	Stable	Good	Stable	Good	Stable
Industrial	Strong	Improving	Strong	Improving	Strong	Improving	Good	Improving	Good	Improving

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

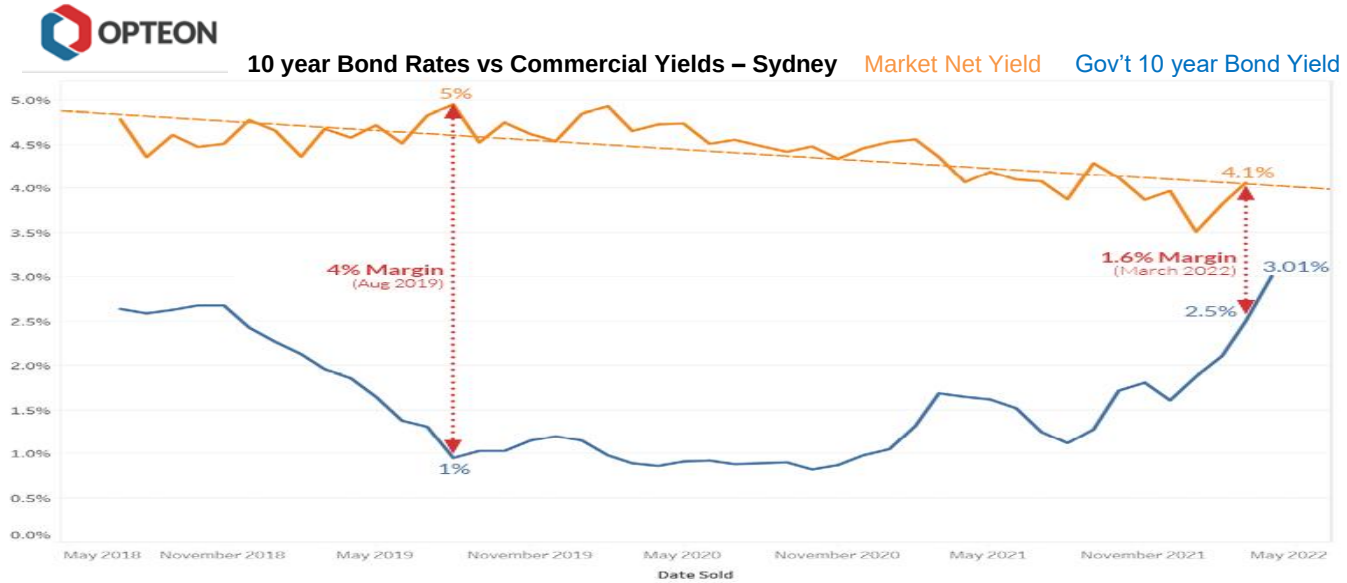
News and Views

o The beginning of the cycle of rising interest rates with the increase in the Cash Rate by the Reserve Bank of Australia over the past two months has generated plenty of discussion and research in the finance industry around long-term interest rates and the impact they have on the values of Commercial Property. We have chosen two very interesting and well prepared papers that come from somewhat different approaches in addressing the same topic. J. P. Morgan Research's paper focusses mainly on the impact on listed A-REITs but draws on the same historical relationship that capitalisation rates for that sector have with 10 year Government Bond Rates. The properties in this sector tend to be larger than privately held properties and often with major tenants on long-term leases. The other research is from the well known Australian valuation firm, Opteon who have taken much of their data from their own direct experience in sub-$50 million commercial transactions in the greater Sydney market area.

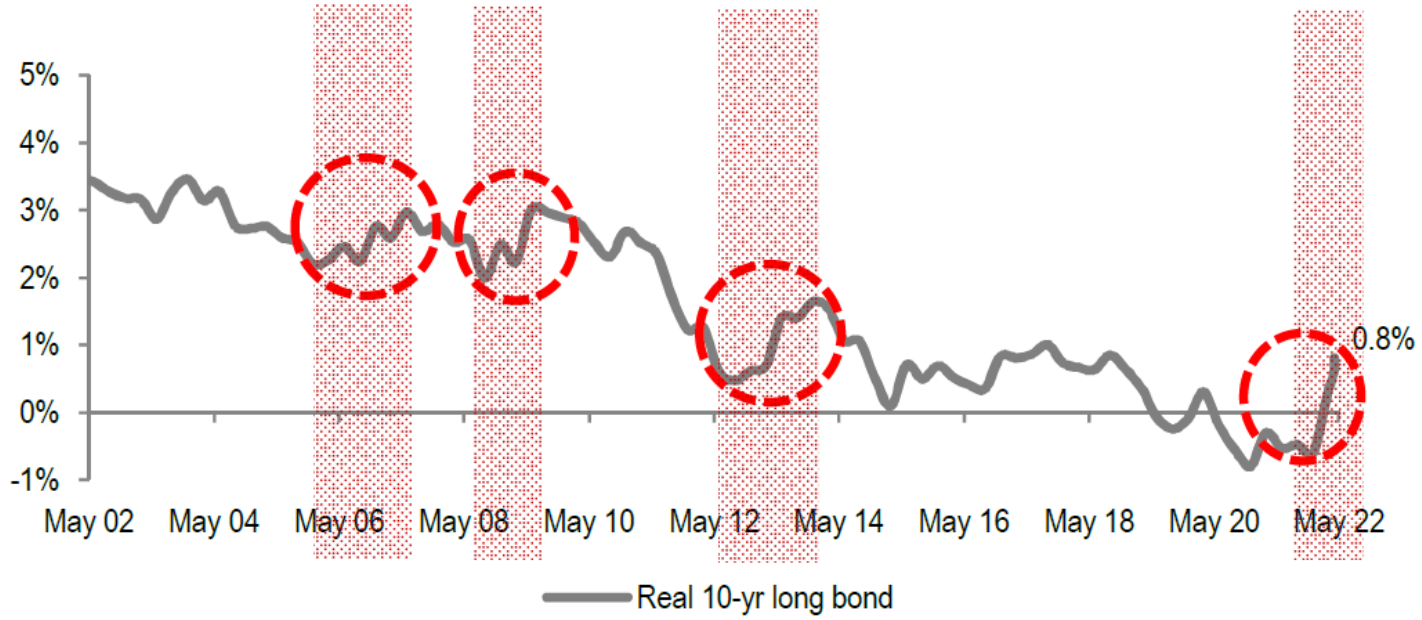
o The Opteon research entitled "Shrinking Risk Margins Challenge sub-$50 million Commercial Assets" points out Commercial property prices have been rising over the last 2 years faster than net income growth, resulting in contracting property yields. As the growth in value has not been driven by income growth, headwinds are emerging, due to rising interest rates, and trimmed mean inflation at its highest rate since 2013. Added to those factors is the rising value of government bond rates, increasing the attractiveness of this investment class. These market factors have seen the risk margin between bonds and commercial property drop since 2019, particularly impacting key markets like Sydney. This is resulting in commercial property yield margins struggling to stay above the government bond rate. For example, as shown in the graph below, net yields on properties within the sub $50 million space in Sydney have been falling, which means that the risk margin is expected to drop below 1%. The orange dotted line is based on Opteon's own sales data.

o Graph 1 opposite is taken from the J.P. Morgan paper entitled "How Long Bond Yield Movements Impact Cap Rates." It states in our view, movements in long duration interest rates are the most relevant for real estate valuations and real rates are more important than nominal rates as real estate provides a good inflation hedge. We have reviewed 20-years of data and our key takeaway is that real estate cap rates are strongly correlated with real bond yields over the medium term, with cap rate spreads to real bonds largely holding within a 4-6% range (the implied risk premium). This indicates that, all else being equal, real estate cap rates will rise (and capital values of real estate come under pressure) when real bond yields rise significantly as they have done.

o As shown in Graph 2, real estate cap rates have also followed a downward trend for the past 20 years (outside the GFC period), albeit have been far less volatile than real bond yields. However, when examining the spread between cap rates and real bond yields, this has been remarkably consistent over the past 20 years and largely within a 4-6% band. Given the recent spike in real bonds, this spread has touched the lower end of the band for office and retail, whilst the spread is now below 4% for industrial. This suggests to us that cap rates may come under upward pressure or that rent growth will run well ahead of inflation – which is likely for industrial.

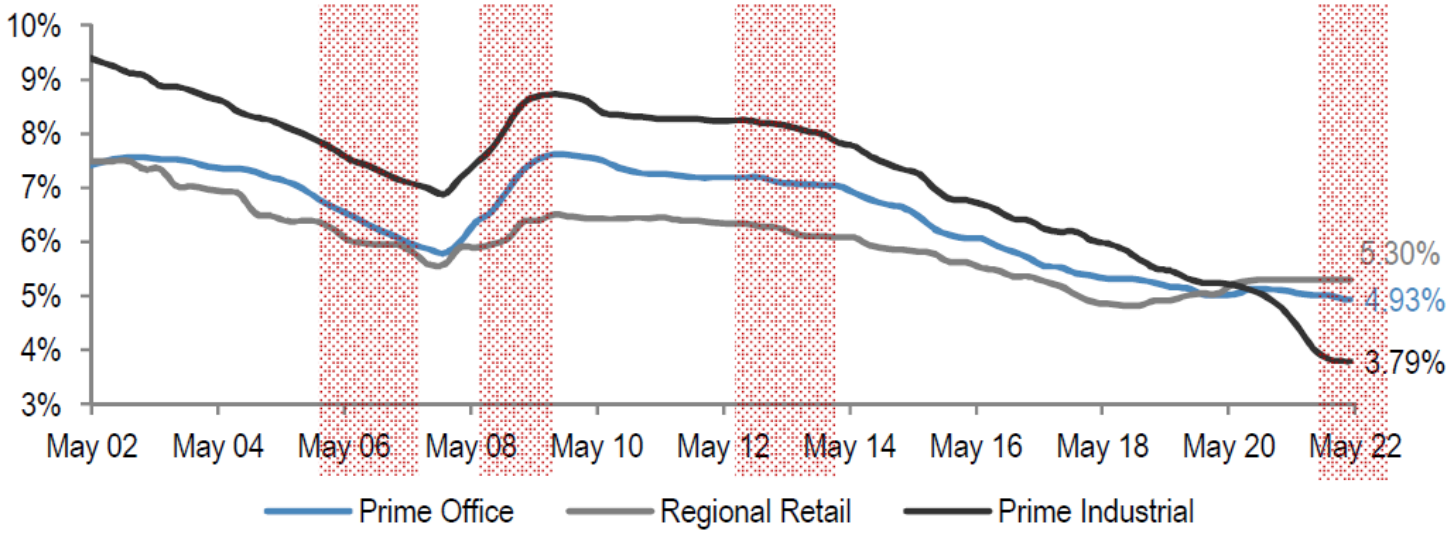


Graph 1 – Real 10 year Commonwealth Government Bond Yields



Source: J.P. Morgan and Bloomberg Finance LP

Graph 2 - National Prime Office, Regional Retail and Prime Industrial Cap Rates



Source: J.P. Morgan and JLL Research

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- Self-Managed Superannuation Fund (SMSF) loans; and
- Loan serviceability options ranging from fully verified to self-certification of income.