Thinktank

Thinktank Property Finance

Quarterly Market Update
January – March 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 final quarter of 2019 domestically saw interest rates cut once by the Reserve Bank of Australia (RBA) Board in October to make it three cuts for the year. Internationally the Federal Reserve Bank's Open Market Committee (FOMC) cut official interest rates in the United States at their October meeting but then held rates steady for the rest of the quarter. This was not totally unexpected but the statements by Fed Chairman Jerome Powell that further cuts were unlikely were. In the UK Prime Minister Boris Johnson was resoundingly re-elected in the mid-December general election. The resulting economic outcome for the UK and the EU has the potential to allow for a more sensible Brexit and increasingly this is being factored into various economic forecasts as is the seemingly short-term resolution of the US – China trade dispute.

IMF World Economic Outlook, January 2020 " Tentative Stabilization, Sluggish Recovery?"

As expected economic performance from most the major international agencies has turned down as reflected during the past quarter such as by the OECD Interim Economic Outlook. The OECD forecasted GDP growth falling to 3.2% in 2019 and rising to 3.4% in 2020. In its latest World Economic Update just released in January, the IMF reduced its projected global growth to 2.9% for 2019, down 0.1% compared to its October forecast and by the same 0.1% for 2020 and 0.2% for 2021 while recovering to 3.4%. It said; *"The downward revision primarily reflects negative surprises to economic activity in a few emerging market economies, notably India, which led to a reassessment of growth prospects over the next two years. ....On the positive side, market sentiment has been boosted by tentative signs that manufacturing activity and global trade are bottoming out, a broad-based shift toward accommodative monetary policy, intermittent favourable news on US-China trade negotiations, and diminished fears of a no-deal Brexit."* Forecasts for the United States economy call for continued growth to 2.0% in 2020 but 1.7% in 2021. China is forecast to grow at 6.0% in 2020 and 5.8% in 2021 while India is forecast to slowing to 4.8% for 2019 but pick-up again to 5.8% for 2020 and 6.5% for 2021 once again ahead of China.

3rd quarter GDP up 0.4%, 1.7% yoy. Westpac and AiG surveys are falling but "illion" Expectations rise.

Third quarter national accounts released by the ABS on 4 December 2019 recorded quarterly growth of 0.4% (1.7% annual) compared to 0.6% growth in the second quarter of this calendar year. This was below the RBA projected growth to June 2019 of 1.75% and 2.25% at Dec 2019 (down from 2.50%) and 2.75% in 2020; all above the OECD and IMF figures. Unemployment which had risen slightly has now fallen to 5.1% and moved below the RBA's 2020 forecast of 5.25% and is a key to future rate moves. The CPI for the third quarter continued at 0.5% and the annualised core rate ticked up to 1.7%. The RBA is forecasting it rising to 1.75% by December 2019 (to be released on 29 January) and 2.0% by June 2020.

Three Westpac economic surveys were released in December; 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 sharply by 8.6 points to 52.9. The monthly Leading Index also fell to -0.56% in Sept. The Consumer Sentiment Survey fell by 1.7% in December and then again in January by a further 1.8% no doubt impacted by the bushfires; it now stands at 93.4 well into negative territory below 100. The three monthly *Australian Industry Group (AiG) Performance Indices* were all in negative territory at the end of December. Manufacturing rose for the month up slightly by 0.2 but still ended below 50 at 48.3. Services was down substantially, falling 5.0 points ending just below the 50 mark at 48.7. Construction fell for the month by 1.1 and stayed in contraction at 42.9. The illion Business Expectations Index in contrast reached an all-time high of 26 points for the March 2020 quarter and the Actual Index was also up but down on a year ago. We discuss all of the surveys in more detail later in this report.

2. Capital Markets and Interest Rates

ASX 200 flat for the 4th 1/4 but up 20% for 2019. A-REITs up 15% for the year but down 2% for the 1/4; Banks recovery stalled on more breaches and squeezed margins.

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 fourth quarter of 2019 saw a continuation of the easing cycle in interest rates which started in June and July. Along with listed equity markets we look at 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 and equity markets globally bounced back strongly in 2019 after a negative 2018. In the fourth quarter however they were down from third quarter highs. The decline in the major banks share prices had levelled out but new breach revelations and action by regulators has seen the ASX Financials Index (ex REITS) fall by 7.8% in the last quarter despite being up 7.4% for the year.

The MSCI All Property Index report for the second half of 2019 won't be released until late February and we will feature the results in the News and Views section of our March Monthly Market Focus. Direct Real Estate continues to perform well but we are expecting total returns to come in below double digits and less than 2018. Listed Real Estate as shown above by the ASX A-REIT 200 Index had a slightly negative third quarter but a return of 14.6% for the 12 months to 31 December 2019. This was a continuation of the ongoing recognition of unit prices trading at below net asset values. Those in the Retail sector may struggle as earnings continue to be squeezed but as noted in section 5 prices have proven to be very resilient as capitalisation rates enjoy further compression .

The RBA in its November 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 3¾% for the next two years. Growth forecasts have been downgraded slightly by ¼% to 2¼% for the year ending December 2019 but back up to 2¾% by December 2020. The underlying quarterly CPI rate was 0.5% and the annualised rate of inflation (trimmed mean) of 1.7% remains below the RBA target band of 2%-3% and slightly below the previous forecast in the SoMP of 1¾%. The RBA's forecast has increased to 2.0% to June 2020 and then falling slightly for the next year to 1¾% before hitting 2.0% again in December 2021 bringing it back to the lower end of its target range.

RBA November SoMP easing slightly. Cash Rate steady for now and the US FOMC also on hold; AUD/USD around 0.68

The RBA brought rates down during the final quarter of 2019 with a cut in October and holding steady since then ahead of their Christmas/New Year break. The key drivers continue to be low CPI, sub-trend growth and low but steady employment growth which saw the unemployment rate rise to 5.4% in August but then fall to 5.1% in its latest release. The November quarterly SoMP appeared to provide an expectation by many economists of a February rate cut but this changed with the positive December employment data. The AUD/USD exchange rate which had drifted down and seemed destined to remain below USD 0.68 and then rose slightly above that level. Opinion on future interest rate movements had shifted to further easing but the IMF noted the following; "The room for monetary policy to combat further growth declines is limited. Countries with fiscal space can rely more on fiscal stimulus to support demand if the need arises." Forward swap rates however have fallen ranging from just about 0.79% at three years and 0.83% for five years. At the longer end, 10 year Commonwealth Bonds range from 0.94% to 1.01%. International events and foreign central bank moves which had not had much impact in the past year on the RBA's monetary policy appear to be more relevant and the decisions of the US Federal Reserve Bank's FOMC have been significant. Movements in the US yield curve have also been watched closely with 10 year US Treasuries now at 1.57% to 1.65% with 2 year bond rates at 1.40% to 1.46%. Fears of the inverted yield-curve appear to have subsided if not disappeared completely for the moment at least.

3. Residential

Residential markets continued their strong recovery during the final quarter of 2019 as prices for housing increased nationally and rose sharply in Sydney and Melbourne. Overall the Capital Cities were up 4.7% and also up in the regionals by 0.5%. For the month of December, Melbourne and Sydney were up 1.4% and 1.7% respectively. The annual housing price statistics through the past twelve months have shown substantial corrections in Sydney of 5.3% and the same in Melbourne. The lift in the latest monthly prices continues to be welcome in the face of some other disappointing indicators. The ABS reported lending was up 3.1% in November for the year. Investor loans remain down 0.2% from a year ago while owner occupied were up 10.0%. Residential building approvals were down 11.8% year over year.

National dwelling values rose by 4.0% in the Dec qtr and 1.1% in the last month. Sydney up 6.2% & Melbourne up 6.1% for the qtr - CoreLogic RP Data

Houses: Houses in Sydney were up 6.2% for the year and In Melbourne they were up 4.6%. For the nation as a whole the increase was less at 2.1%. Only three of eight capital cities houses were down in price for the year and Perth fell by -6.7% to rank seventh just ahead of Darwin. Notably Adelaide was only down modestly at -0.3% while Brisbane was up 0.4% for the year. Regional prices were down -0.4%.

Units: Unit prices as reported by Core Logic are up by less than houses in Sydney but more in Melbourne for the last 12 months being up 6.5%. Perth is down -7.2% and the combined capitals -3.4%. The AIG/HIA PCI Index for December was down by 1.1 points and remains deeply into contraction below 50 at 38.9 . As stated previously, our concern for unit prices lies in the large supply of settlements of newly completed apartments over the next two years. CoreLogic reports gross rental yields of 4.1% in Melbourne and 3.6% in Sydney.

The RBA had a number of comments about housing in their November SoMP; “The fall in housing prices over 2017 and 2018 was an important reason behind weakness in consumption and dwelling investment. After stabilising midyear, housing price growth has picked up in Sydney and Melbourne, although conditions vary considerably across the country. Conditions in established markets appear to be firming in Brisbane and to have troughed in Adelaide. The pace of housing price growth has picked up in regional Australia in recent months. However, housing prices in Perth and Darwin declined further over the last quarter to be around their 2006 levels.” And, “Residential building approvals declined further in the September quarter, to be around 35% below their peak in 2017. To date, the decline in dwelling investment has been much smaller than the decline in building approvals because a large volume of dwellings is still under construction. Completions of existing projects are expected to outpace approvals of new dwellings for some time. The turnaround in the established housing market in some regions has not yet translated into a pick-up in pre-sales of new houses and apartments for most developers, according to information from the Bank’s business liaison program.” We will take a close look at the new supply issue for units when we review the RLB Crane Index next quarter but continue to hold a cautious view despite upgrading our ratings and trends for both Houses and Units in Melbourne and Sydney.

HTW in their most recent Capital City Property Market research continue to reflect the views in our ratings with Sydney shown at the bottom for units but at the start of recovery for houses and Melbourne at the start of recovery for both houses and units. Demand is still shown as being soft for units but fair for houses in Sydney while in Melbourne it is fair for units and strong for houses. Brisbane houses are also seen as being at the start of recovery while Adelaide houses are seen as being at the bottom of the market as are both Brisbane and Adelaide units. Perth still appears to be at the bottom of its market cycle for houses and declining for units. Other ratings and trends have had minor changes leaving nine of ten trends as Fair and only Perth’s is Deteriorating. Both of Perth’s ratings are Weak with all eight other ratings being Fair.

4. Office

Vacancy rates ease slightly in Melbourne but down in Sydney; Brisbane and Adelaide improve while Perth remains high.
JLL - January 2020

JLL released its Office Vacancy update recently in advance of the Property Council of Australia (PCA) Office Market Report (OMR) which is published in early February. We will be featuring the latter in the News and Views section of that month's Monthly Market Focus and expect similar results. While resource centred markets in Brisbane and Perth have improved vacancy rates still remain high and Adelaide are reported as inching out slightly. CBD Office vacancies were reported as slightly higher in Melbourne from 6 months ago at 3.3% but still the lowest of the capital cities while Sydney was down to 3.7%. Brisbane was down to 11.9% and in Adelaide vacancy rates also fell to 12.8%. Perth remained high at 18.4% just marginally down from January's level. Secondary property have higher vacancy rates in all of the Capitals than for Prime and in some locations such as Perth this is very significant.

Knight Frank issued a comprehensive outlook for 2020 at the start of the New Year featuring comments on Office and Industrial markets as well as their views on the Global and National economy. It noted that their view was that the current slowdown in global growth is expected to be temporary. Their Office market observation was for further yield compression to spur more development starts observing that together with increased confidence that yields will remain low given a prolonged low interest rate environment, will act to boost the value of completed assets, making development more attractive.

HTW now describes Sydney as having joined Melbourne at the peak of the market but with flat economic conditions as compared to Melbourne's steady growth. Adelaide remains at the start of recovery and with flat economic growth and Perth is the same but at the bottom of the market. Brisbane is experiencing tightening vacancy and steady economic growth. Yields are still tightening slightly in most locations, even those with weak fundamentals, so for those experiencing rental growth and cap rate compression gains in total return will be very strong. As a result we have made no changes to our Ratings and Trends with Sydney remaining Strong as does Melbourne and Brisbane and Adelaide are Fair. All four enjoy an Improving trend. The Perth market remains Weak.

5. Retail

Retail sales rose by 0.9% in November on the back of "Black Friday" following a flat previous two months and up 3.2% for the year. With continued weak private sector business surveys suggesting conditions remain difficult, we can expect weak totals for the full fourth quarter. The weak sales data trend is disappointing given the stimulus expected from the interest rate cuts we have had but consumer sentiment remains weak. Making predictions about trends in this sector remains very difficult, with sales for the month up in every state that we cover; 0.7% in New South Wales and up 1.1% in Victoria while Queensland was up 1.2%, SA 1.1% and WA 0.5%. Compounding the difficulty for investors is the performance of the differing retail sectors, with Department Stores and Clothing up 3.4% and 3.1% respectively after some very weak earlier months. Household Goods Retailing reversed recent falls in sales and was up in November by 1.2% for the month. By size, small retailers are struggling with sales at a 2.5% annual pace compared to larger retailers picking up slightly in recent months to a 4.5% to 5% for the year. Other indicators reflecting the volatility of this sector were the Westpac-MI Index of Consumer Sentiment falling further back into "pessimistic" territory in December to 95.1 and then in early January falling further to 93.4 the lowest level of the Index since July 2015. The Index has fallen by 6.2% since last year and 11.7% since January 2018. Surprisingly the AiG Services Index had been quite strong but that ended when it fell 5.0 points in December moving it just below the 50 point level to 48.7 and into Contraction.

The ongoing weakness of Department Stores continues to be major news for the sector and the outcomes of negotiations with major landlords are followed closely as downsizing continues. The announcements of various closures continues quite regularly and 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 remain alert. A major blow came after year end with new entrant Kaufland announcing it was pulling out of its planned expansion into Australia in what would have created a major competitor for Aldi, Woolies and Coles.

Department stores have delivered the slowest rate of sales growth out of the major retail categories over a ten, twenty and thirty year period.
JLL – "Departing Stores"

JLL in their recent research piece entitled "Departing Stores" reported on the challenge facing owners of regional and sub-regional shopping centres in exploring options to repurpose department store space over the next five years. Unfortunately the article featured Kaufland as a potential replacement tenant just before they announced their departure from Australia. Nonetheless, for Sydney Regional Centres yields are as low as 4.0% and just a bit lower in Melbourne at 3.80% and ranging up to 5.5%. Smaller Neighbourhood Centres are at 5.3% to 7.0% and 5.5% in Brisbane and Sydney. Perth is not much higher at 5.8% to 7.0% and Adelaide at 6.3% to 7.8%. HTW continues to describe Sydney as approaching the peak of market with Melbourne now at the peak. They see local economic conditions as flat in both capitals. Brisbane is described as also at the peak of the market while Adelaide remains at the start of recovery and Perth 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. We are still waiting for the weakness in retail businesses to be reflected in retail property prices. Eventually we would expect declining earnings must eventually overcome tighter yields.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the December quarter rose by 3.2 points from 52.9 to be at 56.1. While up for the quarter, it is well down from June when it was 61.5. As noted earlier in our update this is consistent with other surveys we follow with the AiG PMI up slightly by 0.2 points in December but remaining in Contraction at 48.3. Manufacturing continues to lose the benefit from local apartment and infrastructure projects which are slowing amidst falling demand. The Westpac MI Leading Index also fell and remained in negative territory in December at -0.92% and Chief Economist Bill Evans commented that GDP growth for 2020 is expected to fall to 2.4% well below the forecast of 2.8% by the RBA in the November SoMP although he expects that to be revised in February. The illion Business Expectations Index was up for the March quarter pointing to a stronger economy and Senior Economist Stephen Koukoulas described it as offering a counter-point to other economic indicators.

"Supply constraints in the traditional markets are creating expansionary demand for new industrial product "
Knight Frank 2020 Outlook Report

Knight Frank in its recent 2020 Outlook Report was as optimistic about the Industrial sector as it was about Offices. It said "The strong performance of industrial real estate backed by record infrastructure spending suggests the sector is well positioned for further growth over the coming years." According to Colliers, Sydney and Melbourne properties are now ranging from 4.50% and 6.50%. Brisbane has come down to 5.75% to 7.00% while the same tightening is occurring but with yields from 6.75% up to 7.75% in Adelaide. HTW in their latest monthly review sees Perth remaining in oversupply and is rated as flat but at the bottom of the market. We have kept our ratings for both Melbourne and Sydney as Strong and Improving with a similar trend for Brisbane. Adelaide is at the start of recovery but still faces an oversupply of available property relative to demand according to HTW.

7. Thinktank Market Focus

The fourth quarter of the year saw Australian interest rates cut in October following on from cuts in June and July making it three for the year. This was followed by a further cut In the United States when the Fed Funds Rate was dropped by 0.25% at its October meetings with possibly more to come from the FOMC although it remains to be seen whether this happens in late January when they next meet. 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. The likelihood is that international growth will weaken further and interest rates may continue to fall in the US and elsewhere. Housing prices domestically have turned the corner but employment growth is the key to Monetary Policy at the RBA. With regards to Fiscal Policy, having a Federal Budget surplus will be a help but the bush fires have forced the Federal Government' s hand with various spending measures already announced.

The global media's attention continues to feature a lot of the Trump administration's front page headlines after having had to share the spotlight with Brexit negotiations and the new UK Prime Minister Boris Johnson's resounding December general election win. The decision of the Federal Reserve FOMC to cut the Fed Funds Rate at their October meeting was not unexpected but Fed Chairman Jerome Powell's statements since then makes it unlikely we will see further rate cuts in the near term. The impact this and the RBA cuts have had on the AUD/USD exchange rate was to continue to trade around 0.68. Current forecasts by Westpac and others is for a fall to 0.66 once the RBA cuts rates again which is though now to be unlikely until later this year.

Sydney and Melbourne Houses continue to support last quarter's re-rating to Fair and the upgrading of the trends of Houses and Units from Deteriorating to Stable. We have now moved the trend for Houses in both cities to Improving. Units however remain on close watch as the ongoing development overhang has the potential to be a problem as large numbers of new units near settlement. Our individual sector comments for Industrial reflect the continued strength of the Melbourne and Sydney markets which we were upgraded to Strong last quarter with continued Improving trends. There continues to be a return to stability in Perth Commercial reflecting that the worst is over for WA and enough for an adjustment to their Rating. We now have four markets that are Strong, all in Sydney and Melbourne, and five that are Weak, all in Adelaide and Perth. Retail remains Fair and Stable in all capitals below except Adelaide which is Weak. Brisbane and Adelaide have three Improving trends between them including the Office sector in both cities.

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

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JLL
Knight Frank Research
MSCI
OECD
PCA / IPD Research
Preston Rowe Patterson
Reserve Bank of Australia
Rider Levett Bucknall
Savills Research
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