Thinktank

Thinktank Property Finance

Quarterly Market Update
April – June 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 first quarter of 2020 saw a dramatic shift of policy focus from a variety of global and domestic issues in mid-January when we last published our Quarterly Update to the single attention grabbing coronavirus pandemic declared by the WHO on 11 March 2020. Domestically we saw interest rates cuts twice by the Reserve Bank of Australia (RBA) Board in March bringing rates to an all time low. Internationally the Federal Reserve Bank's Open Market Committee (FOMC) also cut official interest rates in the United States. In the UK Prime Minister Boris Johnson faced his own personal battle with COVID-19 after his resoundingly re-election in the mid-December general election which seemed a distant memory.

IMF World Economic Outlook, April 2020 - " The Great Lockdown". Global output -3.0% in 2020 but +5.8% rebound in 2021.

In its latest World Economic Update just released the IMF estimated that global gross domestic product (GDP) will shrink by 3.0% (previously forecast: +3.3%) this year followed by an above trend recovery of 5.8% in 2021 (previously forecast: +3.4%). The IMF projects Australia real GDP to contract sharply by 6.7% in 2020 followed by an expansion of 6.1% in 2021. In its Update, the IMF had this to say; *"As a result of the pandemic, the global economy is projected to contract sharply by –3% in 2020, much worse than during the 2008–09 financial crisis. In a baseline scenario, which assumes that the pandemic fades in the second half of 2020 and containment efforts can be gradually unwound, the global economy is projected to grow by 5.8% in 2021 as economic activity normalizes, helped by policy support. There is however extreme uncertainty around the global growth forecast."* Forecasts for the United States economy call for negative growth -5.9% in 2020 but rebounding to 4.7% in 2021. China is forecast to still grow at 1.2% in 2020 and surge 9.2% in 2021 while India is also forecast for a positive 1.9% for 2020 and pick-up strongly to 7.4% for 2021. The overall outlook for Emerging & Developing Asia is much more positive than elsewhere with the IMF forecasting overall growth as a group of 1.0% for 2020 rising to 8.5% in 2021.

4th quarter GDP up 0.5%, 2.2% yoy. Westpac and AiG surveys are falling sharply but PMI lifts! COVID-19 impact still to come in the months ahead.

Fourth quarter national accounts released by the ABS on 4 March 2020 recorded quarterly growth of 0.5% (2.2% annual) compared to 0.4% growth in the third quarter of the last calendar year. Unemployment stayed steady at 5.2% in March and like all other statistics expectations are drastically changed but it remains a key to future rate moves post COVID-19. Forecasts vary but are most recently in the area of a peak of 10% in June and gradually reducing to 7% by the end of the calendar year 2020. The CPI for the first quarter was up just 0.3% and the annualised core rate rose to 2.2%. Forecasts are for a slowdown in inflation with commodities like oil dropping with Transport costs down -1.9% in the first quarter ABS results. Unemployment will doubtless be the key factor in keeping interest rates at their record low for a very long time to come.

Three Westpac economic surveys were recently released. The quarterly Westpac – ACCI Survey of Industrial Trends index fell sharply to 45.0 from 56.1. The monthly Westpac– MI Leading Index also fell to -2.47% in April. Not surprisingly the Westpac – MI Consumer Sentiment Survey fell by a record 17.5% in April as a result of COVID-19; it now stands at 75.6 deeply into negative territory below 100 and its lowest level since the recession of the ealy 1990s. The three monthly *Australian Industry Group (AiG) Performance Indices* were surprisingly not all in negative territory at the end of March. Manufacturing rose for the month up by a strong 9.4 points ending above 50 at 53.7. Services was down substantially, falling 8.3 points ending well below the 50 mark at 38.7. Construction fell for the month by 4.8 and stayed in contraction at 37.9. We will talk about these survey results rather more than usual in the rest of our Update given the more useful role to be played by gauging Consumer and Business sentiment than simply historical data on which we typically rely for our analysis.

2. Capital Markets and Interest Rates

We continue to look at capital markets as part of our regular summary of economic and financial conditions in Australia as the first quarter of 2020 saw world and domestic markets gyrate wildly as a result of COVID-19. Along with listed equity markets we look at listed Australian Real Estate Investment Trusts (A-REITs) and unlisted property indices. The ASX and equity markets globally have featured daily volatility well beyond what might have been expected even once markets became aware of the coronavirus. The decline in the major banks share prices had levelled out early in the first quarter but in addition to new breach revelations and action by regulators the concern about dividends and future bad debt provisioning has seen the ASX Bank Index fall by 32.6% in the year to date.

ASX 200 flat down 29% in 1st 1/4 after being up 20% for 2019. A-REITs up 15% for 2019 but down 35% for the 1/4; Banks down heavily with doubt on dividends. COVID-19 changes everything.

ASX 200 Indices (ex income)

The MSCI All Property Index report for the second half of 2019 was released in late February and we featured the results in the News and Views section of our March Monthly Market Focus. Direct Real Estate continued to perform well but many aspects of this have now changed and MSCI has signalled that while they expect to release their Q1 indices as usual valuations may contain a "material uncertainty" disclaimer. Listed Real Estate as shown above by the ASX A-REIT 200 Index had a very negative first quarter. Those in the Retail sector were already struggling as earnings continue to be squeezed and we discuss this further in section 5 of this Quarterly Update.

The RBA in its February quarterly Statement on Monetary Policy (SoMP) had its usual set of forecasts for economic indicators but these were quickly overshadowed and replaced by the April Financial Stability Review (FSR) and subsequent speeches by Governor Lowe which provided a whole new set of projections as well as details of monetray policy settings. The SoMP at the time still considered the economic outlook as favourable but did mention the coronavirus 47 times and clearly identified it as a major uncertainty although drought and bushfires still figured prominently. By the time of the FSR release in early April the RBA had this to say about it; "The shock to global financial markets from the COVID-19 pandemic has been very large…..The Australian financial system enters this challenging period in a strong starting position. Financial markets in Australia have been dysfunctional at times but banks are well placed to navigate difficulties in funding markets." The FSR also spoke of the non-Bank sector of which Think Tank is a participant and the role of the Australian Office of Financial Management; "A substantial rise in the cost of issuing asset backed securities has also limited the ability of non-ADI lenders to raise new funds. Some planned issues were subsequently deferred. Non-bank lenders have been able to do this because their warehouse funding facilities have been ample, having increased over recent years. However, the initial transactions from the Australian Government's $15 billion fund for investing in asset-backed securities and warehouse facilities has already resulted in a significant easing in funding conditions for these lenders."

RBA Feb SoMP and April FSR poles apart. Cash Rate at 0.25% on hold as is US FOMC; AUD/USD swings from 0.68 to 0.54, now 0.63

The RBA brought rates down during the first quarter of 2020 with two 25 basis points cuts in March soley as a result of COVID-19. The AUD/USD exchange rate which had drifted down fell more sharply to just below USD 0.55 and then rose just as suddenly as the impact of the coronavirus on the US economy became clearer. Governor Lowe's recent speech confirmed the RBA would keep three-year Treasuries at the same 25 basis points as the Cash Rate and market rates have seen shorter term rates like BBSW fall below that. Five and ten year treasuries remain below 1%. The RBA is expecting unemployment to rise to 10% and GDP for 2020 of negative 5% but with a strong recovery in 2021 as does the IMF. Some bank economists are less optimistic and as a result are forecast a Cash Rate unchanged at 0.25% until 2023.

3. Residential

Residential markets continued their recovery during the first quarter of 2020 as prices for housing increased nationally and continued to rise in Sydney and Melbourne. All of this happening ahead of the unknown impact of COVID-19 on property prices. Overall the Capital Cities were up 2.8% and also up in the regionals by 2.0%. For the month of March, Melbourne and Sydney were up 0.4% and 1.1% respectively. The annual housing price statistics through the past twelve months have shown substantial corrections in Sydney of 13.0% and 12.0%in Melbourne. The lift in the latest monthly prices was certainly welcome but reasonably can be expected to be the last for some months.

National dwelling values rose by 2.7% in the March qtr and 0.7% in the last month. Sydney up 3.9% & Melbourne up 2.9% for the qtr - CoreLogic RP Data

Houses: Houses in Sydney were up 14.5% for the past 12 months and In Melbourne they were up 12.5%. For the nation as a whole the increase was less at 7.5%. Only two of eight capital cities houses were down in price for the year and Perth fell by -3.1% to rank seventh ahead of Darwin. Notably Adelaide was up modestly at 0.9% while Brisbane was up 3.5% for the year. Regional prices were up 2.6%.

Units: Unit prices as reported by Core Logic are up by less than houses in both Sydney and Melbourne for the last 12 months being up 9.8% and 11.0% respectively. Perth is down -3.2% and the combined capitals up 8.3%. The AIG/HIA PCI Index for March was down by 4.8 points and remains deeply into contraction below 50 at 37.9 . AiG reported that contraction in the apartment and commercial sectors was steeper while house building indicated modest modest. 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 4.0% in Melbourne and 3.5% in Sydney and is forecasting a decline as demand reduces in the face of growing unemployment and less foreign students.

The RBA had a number of comments about housing in their February SoMP with some of them modified in the April FSR and subsequent speeches by Governor Lowe; “The signs of a trough in the early stages of residential building activity have become clearer and the recent increase in established housing prices in some markets has begun to support demand for new dwellings. Currently, dwelling investment is expected to recover more slowly than average historical relationships with interest rates and established housing prices would imply. This judgement reflects the effects of the shift in composition towards higherdensity dwellings, tight credit conditions and information from the Bank’s business liaison program.” In the FSR: “Most households now have substantial equity in their homes. The economic downturn, uncertainty and social distancing are likely to result in very little turnover in the housing market. It remains unclear how this will affect residential property prices.” We will take a close look at the new supply issue for units when we review the RLB Crane Index for Q1 in an upcoming News and Views section of our Monthly Market Focus. The highlight of the Index was that despite a drop of 37 in Residential Cranes in use nationally to 484, the number in Sydney actually increased by 3 to 236.

HTW in their most recent Capital City Property Market research continue to reflect the views in our ratings with all Capital Cities shown at the start of recovery for 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. Perth still appears to be at the bottom of its market cycle for houses and declining for units. Both of Perth’s ratings are Weak with six other ratings being Fair. Perth’s trend for Units remains Deteriorating. We have adopted an overall Watch for all other trends in the Residential sector as a result of the uncertainty that accompanies the coronavirus pandemic with even basic activities such as “open for inspections” and public auctions severely curtailed or eliminated. Longer term the issue of population growth and migration is central to the supply and demand equation of housing and even with a strong V shaped recovery growth will be diminished.

4. Office

Vacancy rates down slightly in Melbourne but up a bit in Sydney; Brisbane and Adelaide also up but Perth down. What about COVID-19?
PCA OMR - January 2020

The Property Council of Australia (PCA) Office Market Report (OMR) was published in early February and was featured in the News and Views section of that month's Monthly Market Focus. While the resource centred market of Perth improved vacancy rates somewhat to a still very high 17.6%, Adelaide and Brisbane rose slightly to 14.0% and 12.7% respectively. CBD Office vacancies were reported as slightly lower in Melbourne from 6 months ago at 3.2%, still the lowest of the capital cities while Sydney was up slightly to 3.9%. Brisbane was down to 11.9% and in Adelaide vacancy rates also fell to 12.8%. Secondary properties have higher vacancy rates in all of the Capitals than for Prime and in some locations such as Perth this remains very significant although in Adelaide it is very even.

The impact of COVID-19 on Commercial Office markets is a question that brings varied responses with multiple comments about the impact of Working From Home (WFH) and resulting drop in demand. This would have a natural impact on rents and while that may be so, the balancing factor is the extremely low interest rate environment we are experiencing and can expect to last for literally years. We had previously noted observations for further yield compression with a view to spurring 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. This may prove overly optimistic but existng quality assets are likely to enjoy low vacancy rates and benefit from record low capitalisation rates. The difference between this looming recession and its predecessors is that we do not expect a glut of property vacancies. As evidence of confidence in the Office market we would point to the announcement on 6 April of GIC, Singapore's sovereign wealth fund investing to acquire 50% of Melbourne's Rialto Tower at a yield of 5%. We think this demonstrates the confidence in our market by a global player with access to world markets and the resources to choose wherever it wishes to invest.

HTW in their April Month in Review now describes Sydney as having joined Melbourne at the peak of the market but with flat economic conditions for both. Adelaide remains at the start of recovery but faced with contraction and Perth is the same but at the bottom of the market. Brisbane is experiencing tightening vacancy and steady economic growth. Yields had been tightening slightly in most locations, even those with weak fundamentals, so the question is if ultra low interet rates which are expected to last for years to come can that offset any weakening in rental returns? As a result we have made some changes to our Ratings and Trends with Sydney moving to Good from Strong as does Melbourne with Brisbane Fair while Adelaide and Perth are rated as Weak. All five enjoy a Stable trend.

5. Retail

On the basis of preliminary ABS figues, retail sales skyrocketed by 8.2% in March and 9.9% annually on the back of stockpiling of basic goods in response to COVID-19 fears. These figures will not be confirmed until 6 May but are intended to provide more timely information on the impacts of the coronavirus. Basic food retail surged a phenomenal 23.5%. Despite being up strongly for the year as a result, the outlook is not good and significant changes are in the process of taking place for all components of the Retail sector. With very weak private sector business surveys suggesting conditions remain difficult, we are expecting very weak totals for the June and September quarters and only very optimisticly a gradual improvement through the fourth quarter. Details of the segmented reporting and State by State results will not be available for a fortnight but the data is nonetheless interesting from a behavioural view.

Indicators reflecting the volatility of this sector were the Westpac-MI Index of Consumer Sentiment falling by a record 17.7% in April to 75.6 points from 91.9 in March. The March AiG Services Index predictably fell 8.3 points to 38.7 in March moving it well below the 50 point level far into Contraction. The AiG had this to say; "This was the lowest result since March 2009 and the fourth month of contracting results. The services sector is now entering a difficult period of pandemic-related closures and adjustments from a base already weakened by summer's bushfire crisis and by longer-term factors."

Retail rents set to fall 30pc
AFR – Jeffreies Securities

The ongoing weakness of Department Stores continues to be major news for the sector both here in Australia and abroad. News of an impending Chapter 11 filing by major US retailer JC Penny is an ominous sign for Retail trends across the globe. The MSCI Retail Index to 31 December 2019 showed a 2% total return, the lowest of the sectors we cover. The AFR reported that according to Sholto Maconochie of Jeffries Securities, retail rents could fall as much as 30% over the next two years, driving down property values, as the pandemic shutdown accelerates the decline of the once-dominant sector. The devastation across retail will expedite a wide-ranging reset of rents and assets that was already under way as the sector negotiates the challenges of e-commerce and softening sentiment.

Sydney Regional Centres yields have been 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%. Given the overwhelmingly negative consumer sentiment view, we have changed all of our Retail ratings and trends to Weak and Deteriorating on the basis that eventually we would expect declining earnings must eventually overcome tighter yields.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the March quarter fell to 45.0 from 56.1 in December to be at the most negative reading since the Global Financial Crisis. The March quarterly ACCI – Westpac Survey of Industrial Trends fell to 45.0 from 56.1 in December but covered a survey period of 10 February to 3 March so prior to the worsening recognition of the coronavirus pandemic. As noted earlier in our update this is consistent with other surveys we follow however the AiG PMI was up very surprisingly by 9.4 points in March and moving into Expansion at 53.7. AiG commented; "This somewhat surprising expansion – in the midst of the escalating COVID-19 pandemic and emerging recession – is almost entirely due to a huge surge in demand for manufactured food, groceries and personal care items, as shoppers stock up on processed food, toilet paper, cleaning products and other household essentials.

"Fundamentals within the Australian industrial and logistics market remain favourable"
COVID-19 INDUSTRIAL IMPLICATIONS
Colliers International

Colliers International, recently wrote of their view that industrial property is well placed to ride out the short term uncertainty given the recent growth in demand for transport and logistics and its key role to play in keeping the basic day to day necessities of Australians in supply. According to Colliers, Sydney and Melbourne yields for industrial properties are now ranging from 4.50% and 6.50%. Brisbane has come down to 5.75% to 7.00% while the same tightening has occurred but with yields from 6.75% up to 7.75% in Adelaide. HTW in their most recent monthly review of the Industrial sector sees Perth remaining in oversupply and is rated as Weak and at the bottom of the market. We have lowered our ratings for both Melbourne and Sydney to Good and Stable with a similar trend for the other capital cities. 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 first quarter of the year saw Australian interest rates cut twice in response to the coronavirus pandemic including an emergency mid-session 25 basis point reduction in mid-March bringing the Cash Rate to an all-time low of 0.25%. Economically we had remained in a period of extended below trend growth both domestically and internationally but by comparison Australia has been better off than most and the same can be said of both how we are dealing with the coronavirus and its impact on the health of Australia and its economy. The certainty is that international growth will plummet, with high unemployment and underemployment with interest rates staying low for some years to come. Housing prices domestically had turned the corner but will now be challenged. With regards to Fiscal Policy, COVID-19 has forced the Federal Budget to be moved from May to Otober after having destroyed the surplus and generated huge policy changes. Many of these such as JobKeeper will save us from a devastating rise in unemployment and allow SME businesses to retain contact with staff for when retrictions are lifted and gradually businesses can begin to operate productively once again.

On another positive note, our experience is that landlords/investors are seeking a deferral of mortgage payments in order to allow tenants to survive this crisis. Both State and Federal governments have announced legislation to protect tenants and lenders have supported these moves with their own hardship relief as has Thinktank. This welcome initiative is currently playing out across office, industrial and retail properties and it is our view from our direct communication with our Borrowers that most businesses have very sound prospects for a return to healthy business activity once the crisis ends.

The month-on-month lift of 0.7% in national housing values and 2.8% this past quarter was also good but the uncertainty currently present has led us to put a Watch on all our Residential Trends and put all Ratings as Fair other than Perth Units which remain Weak–Deteriorating having fallen by 0.3% in March, the only decline amongst the five we cover. There have been many other changes in our ratings and trends this month. Industrial ratings in both Melbourne and Sydney are Good matching the Office sectors there making four markets rated as Good and Stable with all in Sydney and Melbourne. Retail is Weak and Deteriorating everywhere and already poor consumer sentiment has only suffered further as noted in our comments in section 5.

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

Sources and References

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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
Westpac Economics
Westpac-Melbourne Institute

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