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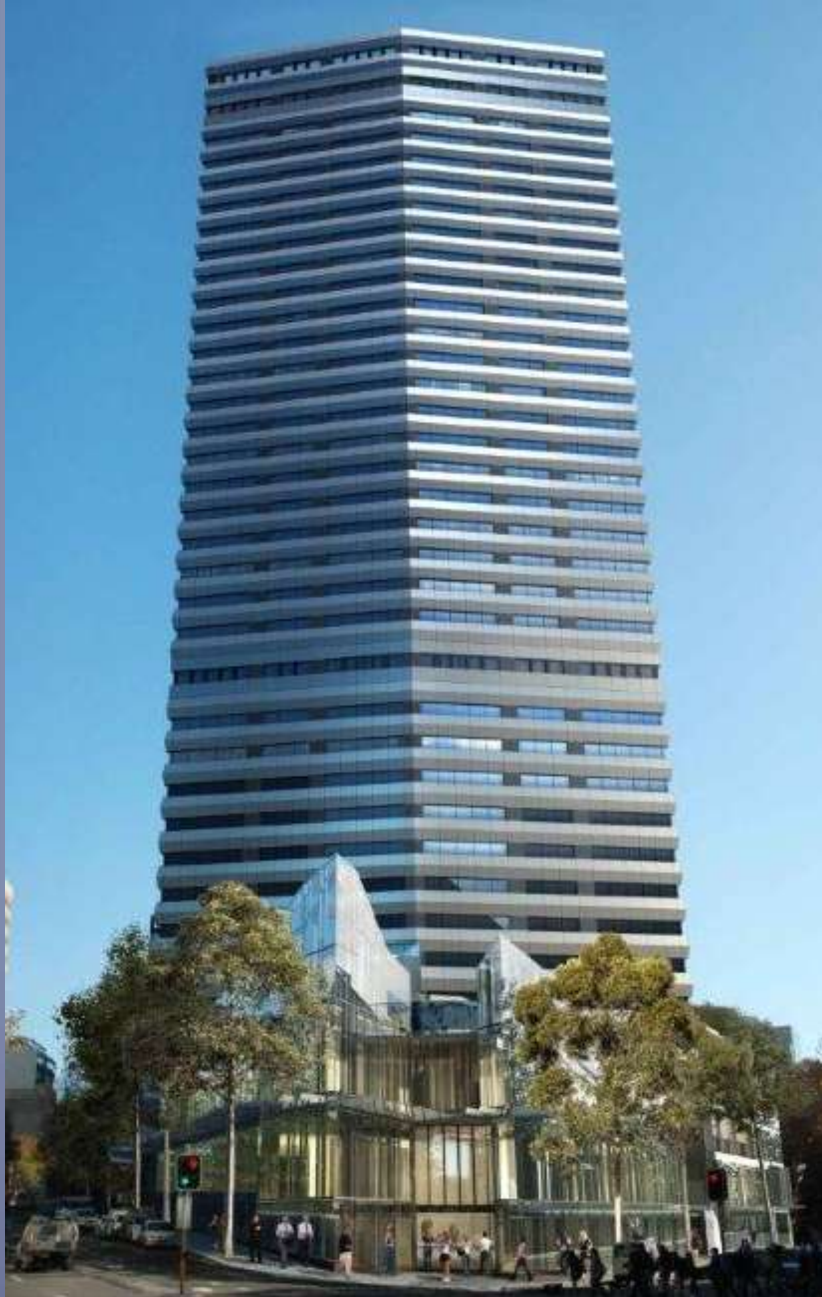

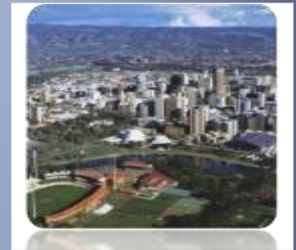

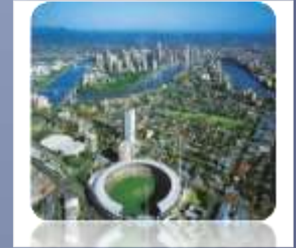

THINKTANK COMMERCIAL PROPERTY FINANCE

Quarterly Market Update July - September, 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.

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1. The Global and Australian Economies

The second 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 second time this year at their June meeting. This was not unexpected but there are clear indications from Fed members that further increases in 2018 are on their way. 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 Penninsula; all of which continue to have a significant potential impact on the Australian economy. There are now clearer signs that despite these factors various international agencies have firmed up their forecasts of global growth for the current year and 2019 with further stimulus likely from the United States. Expected economic performance from almost all the major international agencies is positive as reflected during the past quarter with the latest OECD Global Outlook similar to that of the IMF. The OECD is forecasting 3.8% GDP growth in 2018 and growing to 3.9% in 2019. In its latest World Economic Update, the IMF continued to project global growth of 3.9% for 2018 and 2019, but said *"the risk of worse outcomes has increased, even for the near term."* Trade tensions are a definite risk but the IMF have not revised down the growth forecasts for any of the countries involved in the various trade disputes. These latest reports include upgraded prospects for the United States economy and to some extent rely on 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 6.4% in 2019 while the fastest growth is expected to come from India at 7.3% for 2018 and 7.5% for 2019.

OECD Outlook - Stronger growth but risks loom large IMF Update – Less even expansion, rising trade tensions

First quarter national accounts released by the Australian Bureau of Statistics (ABS) on 6 June 2018 recorded quarterly growth of 1.0% (3.1% annual) compared to 0.4% growth in the fourth quarter of 2017. 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 slightly in the quarter to 5.4% for June and remains below the RBA's earlier forecasts; it is now looking at a forecast of 5.25% June 2019 to June 2020. The CPI for the first quarter continued to be low at 0.4% for the quarter which produced an annualised core rate of 1.9%, unchanged from the previous quarter.

1st quarter GDP up 1.1%, 2.5% yoy - Unemployment and inflation are stable Westpac and AiG surveys remain positive but D&B slightly negative

Three Westpac surveys covering June 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 for a fourteenth straight quarter and was up by 4.4 points to 63.8. The monthly Leading Index fell to +0.11% in June but was still positive. The Consumer Sentiment Survey was up slightly in June by 0.3 points to stay in positive territory at 102.1. The three monthly *Australian Industry Group (AiG) Performance Indices* all remained in positive territory at the end of June but just. Services rose strongly for the month rising 4.0 to a high 63.0 while Manufacturing fell slightly by 0.1 to stay well above the 50 mark at 57.4. Construction also stayed in expansion, but just, at 50.6 after falling 3.4 points. We discuss all of the surveys in more detail later in this report. D&B Business Expectations Index for the 3rd Quarter is down 8.3% to 21.7 points but still up 29.6% over last year. "Trade risks have intensified over the past few months and business leaders, particularly those with a heavy focus on export markets, are watching these developments closely." The analysis also showed the retail sector reported significant declines across all indices.

2. Capital Markets and Interest Rates

This quarter we will begin 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 will play attention to listed Australian Real Estate Investment Trusts (A-REITs) as well as various debt related investments and 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 has continued the trend passing a 10 year high in early July. A-REITs did very well climbing back from trading at a discount to book values while Banks fell back by 7% as they faced head-winds from the Royal Commission.

ASX up 8.6% for the fiscal year – Banks suffer from the Royal Commission down 7.0%. A-REITs strong winners up 9.6%

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 counter-effect of negative publicity from the Hayne Royal Commission has not of course impacted on A-REITs who also share in high income returns and distributions. The recognition of unit prices trading at below net asset values has also pushed prices up as investors have warmed once again to the sector. The MSCI Investor Returns Report which we featured in the News and Views section of our June Monthly Market Focus made some interesting comparisons both with respect to recent performance and longer term trends. Returns on Bonds were reported at 5.8% and equities at 13.1% total return split 1/3 income and 2/3 capital growth. Direct Real Estate was slightly less than Equities at 11.9% and split evenly between income and capital growth.

The RBA in its May 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. The underlying quarterly 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%. The more recent semi-annual Financial Stability Review was also little changed from that of six months earlier and particularly focussed on the potential impact of low interest rates on financial risk-taking. Separately the RBA also discussed the risk to the Australian Financial System of interest rates rising quickly globally with resulting flattening of yield curves and the indirect impact of the potential dampening of demand for financial services by their customer base. All sorts of questions are being asked by market participants and commentators as to the future of variable rate benchmarks such as BBSW locally and LIBOR in international markets.

The RBA held rates steady again during the second quarter of 2018. The key drivers continue to be low CPI, sub-trend growth and low but steady employment. The May quarterly SoMP did not provide any strong guidance in regard to policy but public statements did. The AUD/USD exchange rate has stayed below USD 0.75 and by most forecasts is likely to stay there and fall further. 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 2.40% at three years and 2.60% for five years. At the longer end, ten year Commonwealth Bonds are near 2.80%. International events and foreign central bank moves have in the past been key to the RBA's monetary policy but the expected decision of the US Federal Reserve Bank's FOMC to again increase rates in June has had little impact. Movements in the US yield curve have also been watched closely with 10 year US Treasuries at 2.83% by the end of the quarter but with 2 year bond rates rising to 2.60% and flattening the yield curve prompting speculation of an inverted curve by the end of 2018. The RBA Board met again on the 3 July 2018 and as expected there was no change in the Cash Rate.

RBA May SoMP shows little change.
Cash Rate steady but the US Fed Rate is up again; AUD/USD down to 0.74

3. Residential

Once again, commentators continued to pay close attention to Residential markets during the second quarter, prices for homes and units fell slightly in four of the capital cities and with the impact of a 0.9% decline in Sydney, overall the Capital Cities fell by 0.8% but were up in the regionals by 0.6%. For the month of June, both Melbourne and Sydney had slipped to small falls of 0.4% and 0.3% respectively. The monthly housing price statistics through the past three months have shown further levelling off of 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 3.3% for the year to date and units were down 1.2%. In Melbourne YTD houses were down 2.3% and units were 0.3% lower. The ABS reported investor loans were down 0.1% for the month of May after a 0.8% decrease the previous month; the total of housing finance was up only 0.5% for the month. For the year that figure is down 3.6% and down 13.1% for investors which appears to show that the APRA macro-prudential tightening has had the desired impact so much so that the regulator has announced it is removing the restrictions on ADI lending to investors. Dwelling approvals appear to tell the same story with figures for all residential dwellings up just 3.1% for the month of May from a year ago. Multi-unit 'high rise' approvals were up 30.9% yoy while houses were up 7.0%. The Australian Industry Group/Housing Industry Association Performance of Construction Index for June was down 3.4 points but remained just in expansion above 50 at 50.6. By sector, house building activity fell in June with the sub-index lower by 8.4 points at 50.2 however the apartment sub-index remained in contraction despite rising 1.6 points to 48.4.

Capital city dwelling values fell by 0.8% in the June qtr. with Sydney down 0.9% and Melbourne down 1.4%.

CoreLogic RP Data

The RBA had this to say in its May SoMP; "The slower growth in lending to investors has reflected a decrease in IO lending, which is more prevalent among investors. This decrease followed the 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." It will now be interesting to see if a further shift to lending growth amongst non-ADI/non-Bank lenders will prompt any different action as a result of legislation aimed at allowing APRA to exercise the same regulatory constraints on this sector despite statements by APRA that they wish to use their new powers more to closely observe the non-banks as opposed to direct supervision. The following comment by the RBA suggests not. "The growth of housing credit extended by non-ADI lenders exceeds that by ADIs. Recent liaison suggests that non-ADIs have been lending to some borrowers who would typically have borrowed from ADIs in the absence of APRA's measures to tighten lending standards and limit IO mortgages. Nevertheless, lending by these institutions remains small as a share of housing credit, at less than 5%." Similarly in a recent speech APRA Chairman Wayne Byres said, "the heavy lifting on lending standards has largely been done. Any tightening from here on is expected to be at the margin as banks seek to get a better handle on borrower expenses, and better visibility of borrower debt commitments."

HTW in their most recent Capital City Property Market research 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 declining in Sydney and the same for units. Brisbane and Adelaide houses are both seen as being in rising markets. Perth is 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 continue to apply our mid-range trend either side of Stable being "softening" in the case of Sydney and Melbourne and have rated them lowered their ratings from Good to 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, particularly so in Sydney. 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. JLL has taken a closer look at Office vacancy rates in their recent research and it will be interesting to note any differences when we review the Property Council of Australia Office Market Report which is due for release on 2 August 2018. The highlights of JLL's research are shown in the panel b 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.

CBD Office Vacancies
Sydney - 4.5% and Melbourne - 4.6%
Brisbane 14.4%, Adelaide 15.1% and Perth 20.9% trends unchanged
JLL Research

Savills Research – Quarter Time, National Office Report provides an excellent statistical summary of all capital city CBD and fringe markets. Its A-grade averages show a tightening of yields over all markets except Adelaide which was steady at 7.50% while all others contracted by between 35 – 50 bps. Not surprisingly Sydney led the way at 4.90% with net effective rents rising by 13.4%. Melbourne was reported at yields of 5.20% with N.E. rents up 8.9%. Brisbane had flat rentals and yields at 6.15%, down 50 bps over the past year while rents in Perth and Adelaide fell by 1.7% and 3.8% respectively but Perth's average yields tightened by 50 bps to 7.0% as markets looked 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, suburban/metro vacancy is still rising.

The Sydney CBD Office sector remains Strong and is still Improving with withdrawals still playing a big role while in Melbourne higher levels of net absorption 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 May 2018 were up modestly at 0.4% following several months of similar numbers. Annual growth was 2.5% down from 2.7% in April following the loss of a solid 0.6% in May 2017 which dropped off. Looking at the annual growth by State, they remain quite uneven with WA falling 0.5% and SA up a strong 1.1%. Victoria and NSW were up 0.2% and 0.5% respectively while QLD was up 0.4%. The real surprise was Department Stores which recorded an upswing of 3.9 for the month after two consecutive months of falling

sales. The Westpac-MI Index of Consumer Sentiment stayed in optimistic territory rising slightly in June to 102.1. The AiG Performance of Services Index rose strongly again in June by 4.0 points and moved further into expansion at 63.0 and remained above the 12 month average of 55.0. However, the retail trade sub-sector while up slightly in June to 48.4 this still marked over a year of contraction. The ongoing weakness of department stores remains the big news for the sector despite the May uplift and it remains to be seen how relations with major landlords are managed as the expected downsizing continues. Various owners have expressed confidence they can cope with whatever developments arise but there is still a lot to play out in the changes that are currently taking place in the retail sector and investors need to be remain alert.

Moving Annual Turnover remained soft in the second quarter at 2.8% well below the 5.1% long-term average -
Cushman & Wakefield, Retail Investment Marketbeats

Colliers Retail update for First Half 2018 shows CBD yields continuing to be stable in most capitals and staying at sub 5% levels in Sydney and Melbourne. Outside of the CBD, yields are not that much higher with regional centres now just under 5.0% and sub-regional and neighbourhood at a range of 5.25% to 7.25% with the latter being particularly strong. Sydney is described by HTW as a "rising market" while Melbourne is "approaching peak of market". 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 5.75% 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 when that arises.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the June quarter of 2018 rose strongly by 4.4 points from the March result of 59.4 to be at 63.8 and broke two quarters of moderation from 65.7 in September which was preceded by a sustained uptrend that emerged in 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 still in expansion at 57.4 after a very slight drop of 0.1 points in the June survey. Manufacturing continues to benefit from local apartment and infrastructure projects which are still boosting demand. Exports have reversed earlier signs of recovery in both surveys but expectations remain up with 37% of businesses expecting the general business environment to strengthen over the next six months. The ACCI Expectations Market Composite was up at a positive 66.8 from 61.0 in March which takes the index back above the mid–2017 peak of 64.9. The D&B Business Actuals Index has now fallen from a multi-year high as reported earlier.

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 5.63% and 6.25% while Brisbane, Adelaide and Perth range from 6.38% on Brisbane's Trade Coast to 8.63% 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 6.63% to 8.00%. 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 second quarter of the year saw Australian interest rates unchanged but in the United States the FOMC, as expected, increased rates at their June meeting after their earlier increase in March. Economically we are still in a period of extended below trend growth both domestically and internationally but by comparison Australia is better off than most especially over the long run with 25 years uninterrupted by a recession. The likelihood is that international growth will pick-up and interest rates will remain subdued for some time to come and this looks to be the bottom of the cycle domestically as interest rates rise in the USA and flatter or slightly lower housing prices domestically have provided greater flexibility for policy makers.

Internationally, the world's media attention continues to be focussed on the Trump administration's almost constant front page headlines, recently including the Europe and Russia as well as North Korea. The decision of the Federal Reserve FOMC to increase the Fed Funds Rate at their June meeting remains important if not unexpected as Fed Chairman Jerome Powell laid out his plans for Congress. Other voting Board members have variously expressed their views that rates will continue their cyclical upturn through 2018, with at least two further increases predicted in the Fed's "dot plot" survey. 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 by the start of the second quarter the AUD has moved below 0.75 after having been up to 0.79 at the start of 2018 and is headed down closer to the next resistance level of 0.70 .

We have only made two changes to our property sector trends and ratings since last quarter and these both reflect the weakening which we have applied to the Sydney and Melbourne Residential markets, moving from Good to Fair in both markets. Our individual sector comments reflect the recent shift of Sydney and Melbourne Residential market and the continuation of two intermediate trends to reflect a mid-range either side of stable. 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 six markets that are Strong or Good and seven that are Weak. Sydney and Melbourne Retail remain Fair and Stable. In contrast, Perth and Adelaide 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 much less of a concern now especially in the East Coast Capital Cities as the softening of those markets continues. Previous concerns of any sign of change in the RBA's bias on Monetary Policy seem to have abated with employment steady and inflation also steady at levels at or below 2%.

	Sydney		Melbourne		Adelaide		Brisbane (SEQ)		Perth	
Residential	Fair	Softening	Fair	Softening	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

Sources and References

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JLL
Knight Frank Research
PCA / IPD Research, MSCI
Reserve Bank of Australia
Rider Levett Bucknall
Savills Research
Westpac Economics
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