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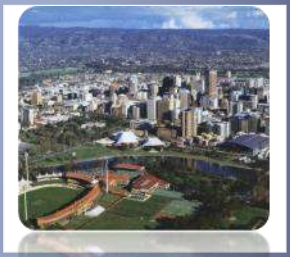

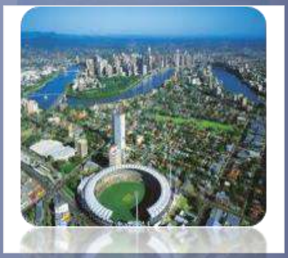

THINKTANK PROPERTY FINANCE

Quarterly Market Update January - March, 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.

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1. The Global and Australian Economies

The final 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 fourth time this year at their December meeting. This was not unexpected but there are some signs that the number of increases that occur in 2019 may be less than previously forecast. President Donald Trump continues to occupy world headlines and newspaper editorials and not just for his economic policies but the "shutdown" now. More recently international developments relating to trade tariffs and events such as in the Middle East and the Korean Peninsula, all of which continue to have a significant potential impact on the Australian economy. There are now however, signs that various international agencies are slightly softening their forecasts of global growth for 2019 with concerns on the trade front as the US pursues tougher policies. Expected economic performance from most the major international agencies has turned down slightly 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 3.7% GDP growth this past year but falling to 3.5% in 2019 and 2020. In its latest World Economic Outlook, the IMF kept its projected global growth at 3.7% for 2018 but reduced it by 0.2 for 2019 to 3.5% and by 0.1 in 2020 to 3.6%. It said *"Risks to global growth tilt 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 2.5% in 2019. China is forecast to grow at 6.6% in 2018 and 6.2% in 2019 while the fastest growth is still expected to come from India at 7.3% for 2018 and 7.5% for 2019. The major downside is noted in the area of trade which could be significant.

OECD Economic Outlook "Growth has peaked: Challenges in engineering a soft landing"
IMF World Economic Outlook " A Weakening Global Expansion"

Third quarter national accounts released by the ABS on 9 December 2018 recorded quarterly growth of 0.3% (2.8% annual) compared to 0.9% (3.4% annual) growth in the second quarter of this calendar year. 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 risen very slightly, most recently to 5.1% which remains below the RBA's forecast. The CPI for the third quarter continued to be low at 0.4% which produced an unchanged annualised core rate of 1.9%.

Three Westpac economic surveys 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 still positive this quarter but was down by 3.1 points to 63.1. The monthly Leading Index also fell to -0.27% in December. The Consumer Sentiment Survey was up slightly in December by 0.1 to move a little further into positive territory at 104.4 but fell strongly below 100 into negative territory early in the New Year as it did in the United States. The three monthly *Australian Industry Group (AiG) Performance Indices* were all down with only one remaining in positive territory at the end of December. Manufacturing fell slightly for the month down 1.8 but enough to bring it below 50 to 49.5. Services was down 3.0 but stayed above the 50 mark at 52.1. Construction fell further into contraction at 42.6 after falling 1.9 points. We discuss all of the surveys in more detail later in this report. Illion (D&B) Business Expectations Index for the 1st Quarter is down 12.9% to 20.9 points and the Actual Index down 15.5% to 15.2. The expectations were described in the report as "bleak" and Economic Adviser Stephen Koukoulas wrote "There were sharp declines in expectations across all categories."

3rd quarter GDP up 0.3%, 2.8% yoy - Unemployment and inflation are stable. Westpac and AiG surveys turn negative as does illion (D&B) Expectations Index

2. Capital Markets and Interest Rates

In the final quarter of 2018 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 with the All Ordinaries Index down 7.4%. The A-REIT Index was down a lot less at 2.1% for the year. We have shown Oct–Dec performance to the right. A-REITs have done well to be down less than the others while Banks and other Financials fell back 14.8% for the year as they suffered from the Royal Commission.

ASX down 9.7% for the 4th quarter – Financials ex REITs continue to suffer from the Hayne Royal Commission down 9.2%, A-REITs down 3.6%

ASX Indices (ex income)

The decline in the major banks share prices comes despite good income returns to Shareholders (particularly those with holdings in SMSFs) through fully franked dividends which are now under threat as is the case with AMP. The effect of negative publicity from the Royal Commission has not impacted on A-REITs who also share in high income returns and distributions. The recognition of unit prices trading at below net asset values pushed prices up earlier in the year as investors have warmed once again to the sector with A-REITs avoiding the recent downturn. We look forward to the MSCI Investor Returns Report for the 12 months to December 2018 which we intend to feature in the News and Views section of our March Monthly Market Focus when we can again make some comparisons both with respect to recent performance and longer term trends.

The RBA in its November quarterly Statement on Monetary Policy (SoMP) has its forecast growth by Australia's Major Trading Partners (MTP) reducing slightly but staying above the long-run average pace of 4% for the next year and at just below that rate for the following year 2019 then falling slightly noting that trade tensions have escalated and represent a downside risk. The underlying quarterly CPI 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 has increased to 2.25% through to December 2019 and then staying at that level. With the release of recent continued falls in housing prices there have been some economists talking of a possible cut in official interest rates. This remains very much a minority view.

RBA November SoMP shows little change. Cash Rate steady but the US Fed Rate is up again; AUD/USD now below 0.72

The RBA held rates steady again during the final quarter of 2018. The key drivers continue to be low CPI, sub-trend growth and low but steady employment. The November quarterly SoMP did not provide any strong guidance in regard to policy but public statements did. The AUD/USD exchange rate has drifted down further to briefly dip below USD 0.70 but has since recovered to just under USD 0.72. Opinion on future interest rate movements has firmed to no change as noted above with the question being for how long. Forward swap rates are now slightly more positive up to five years ranging from just about 2.10% at three years and 2.40% for five years. At the longer end, ten year Commonwealth Bonds are down further at 2.32%. International events and foreign central bank moves are not having much impact on the RBA's monetary policy but recent decisions of the US Federal Reserve Bank's FOMC to increase rates may be 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 the quarter and now at 2.79% with 2 year bond rates at 2.62%. The RBA Board met on 4 December 2018 and as expected there was no change in the Cash Rate as they are expected to do once again on 5 February 2019 following the annual January break.

3. Residential

National dwelling values fell again by 2.3% in the Dec. qtr. The largest in ten years; Sydney down 3.9% and Melbourne down 3.2%.

CoreLogic RP Data

Not surprisingly, commentators continued to pay close attention to Residential markets during the final quarter of 2018 as prices for housing fell again in five of the capital cities With the impact of a 3.9% decline in Sydney, overall the Capital Cities fell by 2.8% and were also down in the regionals by 0.5%. For the month of December, both Melbourne and Sydney had slipped to falls of 1.5% and 1.8% respectively. The annual housing price statistics through the past twelve months have shown substantial corrections in Sydney of 8.9% and 7.0% in Melbourne markets and while originally a welcome pause for regulators, there is now concern. The ABS reported lending was down 2.5% in November and loans to owner occupiers fell by a small 1.4%. Investor loans fell by a solid 4.5% putting lending to investors down around 30% from its peak in early 2017. Dwellings approvals were down sharply in November falling 9.1% in the month following a fall of 1.4% in October. Approvals are now 32.8% below the level of this time last year. Encouragingly, ANZ Research describes the housing market downturn as likely a “textbook adjustment.”

Houses: Houses in Sydney were down 10.0% for the year and In Melbourne houses were down 9.1%. For the nation as a whole the decline was less at 5.2%. In only one other capital were houses down in price for the year and that was Perth which fell by 4.3%. Notably Adelaide and Brisbane were up albeit modestly. Regional prices were hardly down at all at -0.2% but nationally the fall was 6.7% for 2018.

Units: Unit prices as reported by Core Logic are down by less than houses in both Sydney and Melbourne for last year being -6.3% and -2.3%. Perth is down the most at -6.5% and the combined capitals -4.5% Multi-unit ‘high rise’ approvals were down 17.9% yoy and the AIG/HIA PCI Apartment Index for December was down 2.3 points slipping even further deeply into contraction below 50 at 26.3 . 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.

The RBA had this to say in its November SoMP; “Credit conditions tightened, particularly for investors, as regulators implemented a range of measures from late 2014 onwards to mitigate the risks associated with certain forms of housing lending. Over the same period, financing conditions tightened for foreign investors leading to a reduction in demand for housing from this source. Banks may have become less willing to extend credit due to heightened public scrutiny, partly as a result of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.” And; “Liaison contacts continue to report that demand for new, off-the-plan apartments in Sydney and Melbourne has declined significantly since mid 2017, driven by a pull-back in demand from domestic investors and foreign buyers. Off-the-plan sales typically precede the issuance of a building approval, suggesting that higher-density residential approvals are likely to moderate further.”

HTW in their most recent Capital City Property Market research continue to 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 starting to decline and also declining in Sydney and the same for units. Brisbane and Adelaide houses are both seen as being in rising markets. 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 re-rated their trend as Deteriorating which continues. Their ratings remain Fair on the basis of recent value shifts even though absolute prices remain high in both markets. A few ratings and trends have changed with the split of houses and units leaving six of ten Trends as Deteriorating.

4. Office

CBRE Research has recently produced a summary of transaction activity in the Commercial real estate sector for 2018 that is highlighted to the right and as reported in the AFR. They recorded 818 deals valued at more than $5 million over the year totalling $32.8 billion compared to 908 deals in 2017 and 1055 deals in 2016. Most were in the Office sector at $15.8 billion and Sydney was the preferred destination with $12.5 billion. They have also provided a good summary of the past quarter's key statistics of all capital city CBD and fringe markets. Its A-grade averages show a further slight tightening of yields in all markets and forecasts for the same in 2019. Not surprisingly Sydney led the way at 4.75% down 18 bps with net effective rents rising by 14.9% for the year. Melbourne was reported a fall of 17 bps to yields of 4.86% with net effective rents (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 quarter while rents in Perth and Adelaide were up 5.5% and 3.5% respectively with Perth's average yields are unchanged at 6.96% and Adelaide's fell 6 bps to 6.84%.

Commercial property deals down 9% for 2018.
Market activity to enter downturn with a slump in Chinese activity
CBRE / AFR

In regards to vacancy, JLL is also quoted in the AFR as reporting Sydney to have reached 4.1%, its lowest level since the 2000 Sydney Olympics while Melbourne was even lower at 3.7%, the lowest since the late 1980s. By contrast vacancy rates remain high circa 13% in Adelaide and Brisbane but have improved slightly however secondary markets are still weak. Perth has also improved slightly but still over 20% with vacancy rates in secondary properties even higher as tenants take advantage of favourable lease conditions to upgrade premises. The Property Council of Australia's upcoming Office Market Report is due to be released on 6 February 2019 and we expect the highlights of that research will continue to show the stark difference between Melbourne & Sydney and the rest of the Capital Cities remaining in place and likely remain so for some time to come. Our February News and Views will contain a full analysis of the OMR and will include forecasts for each of the markets we cover.

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. 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 but have rerated Brisbane and Adelaide from Weak to Fair and Improving and we continue to keep the trend for all three of these capitals as Stable.

5. Retail

Despite retail sales growing in November by 0.4%, annual growth of 2.8% was down from 3.6% in October, we would caution investors to tread warily in this property sector. Black Friday (the day after American Thanksgiving) is important for November sales but the Christmas sales period is the key for the Retail industry and early signs are not good with Consumer Sentiment falling sharply in December according to the Westpac MI Consumer Sentiment survey. Making predictions about trends in this sector is extremely difficult, with sales flat in South Australia but up a strong 0.6 per cent in Western Australia. Victoria and NSW were up a small 0.1% and a strong 0.8%, respectively, while Queensland experienced 0.4% seasonally adjusted growth. Compounding the difficulty for investors and SMSFs is the performance of the differing retail sectors, with department stores back to relatively flat growth in November with zero trend growth and 0.4% seasonally adjusted with Household Goods Retailing was up 1.2% on that basis while Electrical Goods was up a very strong 3.3%. Other indicators reflecting the volatility of this sector were the Westpac-MI Index of Consumer Sentiment staying in optimistic territory, rising slightly in December to 104.4 but then falling by 4.7% in January to 99.6, just below the "pessimism level".

The ongoing weakness of Department Stores and DDS remains the major news for the sector and the outcomes of negotiations with major landlords will be followed closely as the expected downsizing continues. CBRE highlighted this in a recent research article asking the question "Have sub-regional shopping centres fallen out of favour with investors?" Various owners have expressed confidence they can cope with these developments but there are still a lot more changes to take place in the retail sector and investors need to be remain alert. Rather alarming was a report from the British Fidelity in a paper entitled "Retail's fall from grace" suggesting a 10-30% de-rating of the sector. Underscoring this was news that RICS (Britain's API) had told valuers in Britain to be "aware of potential for significant changes in value". Domestically, Vicinity recently devalued 48 retail centres by a total of $205 million, 26 of which were sub-regionals.

Pressure on both Dept Stores and Discount Dept Stores is being observed globally. Sub-regionals are currently perceived to be the riskest of the shopping centre sectors.
CBRE

HTW continues to describe Sydney and Melbourne as both "approaching the peak of market" with ultra low yields of 4.0%. They see local economic conditions as still showing steady growth in Sydney but flat in Melbourne. Brisbane is described as "peak of the market" while Adelaide and Perth both remain at the "the bottom of the market" with steady/increasing vacancies and declining rents. 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 HTW describes it as a property sector in a state of flux. It may take an increase in interest rates to trigger a re-evaluation although given an increase in interest rates is not expected anytime soon the sector may remain unchanged as owners and operators work to deal with changing consumer trends.

6. Industrial

The ACCI – Westpac Survey of Industrial Trends for the December quarter of 2018 fell by 3.1 points from the September result of 66.2 to be at 63.1 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 into contraction at 49.5. Manufacturing is losing the benefit from local apartment and infrastructure projects which are slowing amidst falling demand. The uptrend in exports however has continued at a moderate pace and expectations are down slightly with a net 22% of businesses expecting the general business environment to strengthen over the next six months. The Westpac MI Leading Index fell into negative territory in December to 0.27% and Chief Economist Bill Evans commented that growth will fall to 2.6% in 2019 well below that forecast by the RBA which he expects to be revised down in February. The illion (D&B) Business Actuals Index was also down this quarter as is the Expectations Index .

HTW in a recent review of the sector retained a positive view on Sydney reporting steady rents as it approaches the peak of the 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. Prime Sydney and Melbourne are ranging from 5.25% and 6.25% while Brisbane, Adelaide and Perth range from 6.92% in Brisbane to 8.03% 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 an average 7.39%. 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 final quarter of the year saw Australian interest rates remain unchanged but in the United States the FOMC, as expected, increased rates at their December meeting after three earlier increases during the year. Economically we have remained in a period of extended below trend growth both domestically and internationally but by comparison Australia remains much 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 may weaken slightly but interest rates will continue to rise modestly in the US and elsewhere. Lower housing prices domestically have provided greater flexibility for our domestic policy makers while stable growth fuels lower unemployment without any obvious need to adjust monetary policy. Risks however are to the downside.

Internationally, the world's media attention continues to be focussed on the Trump administration's almost constant front page headlines, only occasionally interrupted by the Brexit negotiations troubling Prime Minister May. The latter however is getting more critical and is recognised as having considerable downside to it. The decision of the Federal Reserve FOMC to increase the Fed Funds Rate at their December meeting remains important if not unexpected as Fed Chairman Jerome Powell and other voting Board members have variously expressed their views that rates may pause their cyclical upturn through the beginning of 2019. The impact this has had on the AUD/USD exchange rates continues to cause volatility and as we start the first quarter of 2019, the AUD has recovered to trade around 0.72 after having briefly dropped below the key resistance level of 0.70 .

We have added additional coverage to our Residential sector with separate Ratings and Trends for Houses and Units. We have retained the two changes to our property sector trends made last quarter which reflected the ongoing weakness in the Sydney and Melbourne Residential markets and this applies to both Houses and Units. 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. With the additional sectors we now have five markets that are Strong or Good and six that are Weak. Sydney and Melbourne Retail remain Fair and Stable. In contrast, Perth and Adelaide now have six ratings Weak but all trends are Stable. Brisbane has three Improving trends with Commercial there now Fair and Improving. Residential units remain a concern especially 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	Fair	Deteriorating	Fair	Deteriorating	Fair	Improving	Good	Improving	Weak	Stable
Residential – Units	Fair	Deteriorating	Fair	Deteriorating	Fair	Improving	Soft	Deteriorating	Weak	Deteriorating
Commercial	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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JLL
Knight Frank Research

OECD
PCA / IPD Research, MSCI
Reserve Bank of Australia
Rider Levett Bucknall
Savills Research
Westpac Economics
Westpac-Melbourne Institute

For additional information, please contacts:

Publications & Market Update

Per Amundsen
Company Secretary
T: (02) 8669 5515 M: 0417 064 252
E: pamundsen@thinktank.net.au

Sales & Distribution

Peter Vala
Head of Sales & Distribution
T: (02) 8669 5512 M: 0468 989 555
E: pvala@thinktank.net.au

Finance & Wholesale Funding

Cullen Hughes
Chief Financial Officer & Treasurer
T: (02) 8669 5518 M: 0406 258 256
E: chughes@thinktank.net.au

Credit & Operations

Peter Kearns
General Manager
T: (02) 8669 5501 M: 0434 609 238
E: pkearns@thinktank.net.au

Funding & Strategy

Jonathan Street
Chief Executive Officer
T: (02) 8669 5505 M: 0438 319 432
E: jstreet@thinktank.net.au

Funds Management & Investment

Lauren Ryan
Business Development Manager- Investments
T: (02) 8669 5532 M: 0401 974 839
E: lryan@thinktank.net.au

Business Relationships and Loan Inquiries

Heather Noonan
Regional Sales Executive
T: (02) 8669 5516 M: 0435 960 646
E: hnoonan@thinktank.net.au

Tony Zaccari
Senior Relationship Manager – VIC/SA
T: (03) 9097 1781 M: 0403 758 514
E: tzaccari@thinktank.net.au

Ranei Alam
Senior Relationship Manager – NSW
T: (02) 8669 5502 M: 0434 609 240
E: ralam@thinktank.net.au

Claire Byrne
Relationship Manager - NSW/WA
T: (02) 8669 5522 M: 0414 235 478
E: cbyrne@thinktank.net.au

Adam Hutcheson
Senior Relationship Manager – QLD
T: (07) 3117 3787 M: 0434 609 239
E: ahutcheson@thinktank.net.au

Joel Harrison
Relationship Manager – VIC/TAS
T: (03) 9097 1781 M: 0410 861 540
E: jharrison@thinktank.net.au

Paul Burns
Senior Relationship Manager NSW/ACT
T: (02) 8669 5510 M: 0434 609 241
E: pburns@thinktank.net.au

Chrissi Sutherland
Partnership & Media Officer
T: (02) 8669 5516
E: csutherland@thinktank.net.au

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