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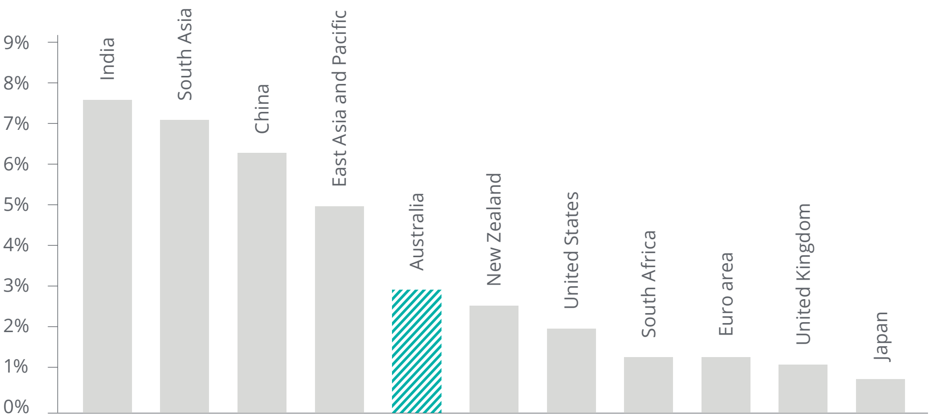
# Macroeconomic backdrop

Australia has chalked up its 26th consecutive year of economic growth, and the clouds around Australia's economy are clearing. Commodity prices have firmed up and the slowdown in mining investment growth is now mostly in the rear view mirror. Mine approvals came to a halt a while ago, but it wasn't until 2017 that the already approved projects were completed.

The good news for Australia is that global economic growth has picked up during 2017, much of that driven by Asian economies, and in recent months that has translated into much stronger employment growth in Australia. That growth should also lift demand for capital, boosting the outlook for business investment.

Australia remains at the upper end of developed economies for projected growth, supported by population growth and linkages to Asia, but constrained by high household debt.

**Chart 1 – Expected GDP growth of major economies, average annual growth across 2017 and 2018 (forecast)**

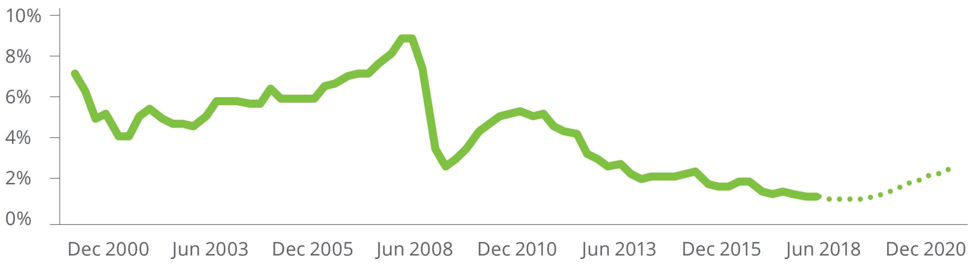


But global growth is yet to translate to inflation. While there are encouraging signs of global inflation emerging, the outlook is for official Australian interest rates to stay near record lows until late in 2018 or early in 2019, a blessing for real estate markets, especially so in NSW and Victoria and the ACT.

While the general consensus is that the next move for Australian rates will be up, we expect no upward movements in Australian interest rates until late in 2018 or early in 2019.

Household debt has escalated with house prices – Australia's household debt to income ratio is now the second highest in the world, behind only Switzerland.

**Chart 2 – Australian interest rates, 90 day bank bill**

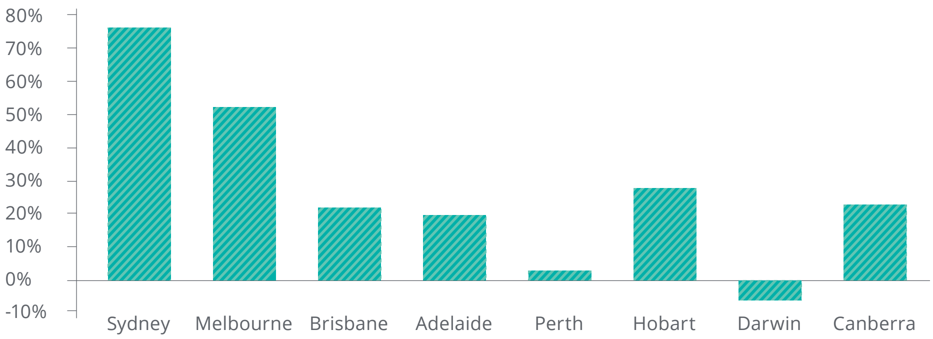



Having said that, **the Royal Commission into the banking industry** may raise the effective cost of borrowing as banks are likely to respond by continuing to limit lending to risky initiatives, including some property development and foreign borrowers.

**Outlook for the residential segment**

The current residential property upswing has seen strong price inflation, up around 47% across capital cities since December 2012 (around the beginning of the current upswing nationally). Chart 3 shows that price growth has been uneven across the states, pulled along by the Sydney and Melbourne markets.

**Chart 3 – Change in nominal house values, Dec 2011 – Sept 2017 (per cent)**



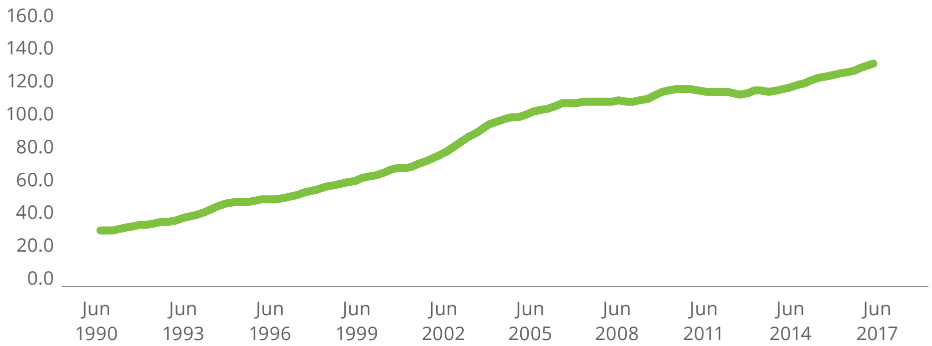

*Source: ABS Cat.6416*

In 2017, house prices fell in Perth and Darwin, linked to population movements and employment opportunities. Slower price growth in the Brisbane market also likely reflects low employment growth as well as the risks of oversupply in the apartment segment, but this may have bottomed out now.

Household debt has escalated with house prices – Australia's household debt to income ratio is now the second highest in the world, behind only the Swiss. And while growth in debt has been most pronounced for higher income households, higher debt adds to the economy's vulnerability in the face of a shock, and could also lead to lower future growth (IMF 2017).[1]

1. IMF, 2017, Global Financial Stability Report, October.

**Chart 4: Housing debt to income**

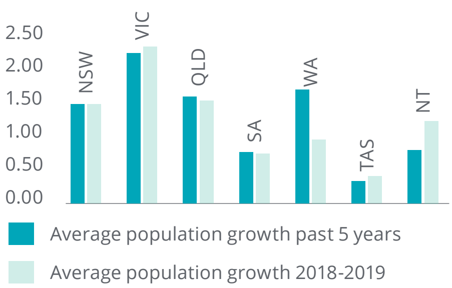



*Source: Reserve Bank of Australia*

Regulators aiming to restrain increasing property debt amid concerns of an overheating market have targeted investor lending. Tighter lending standards and restrictions on the volume of 'interest only' loans to total new residential mortgages, have pushed up rates for investors. Market activity has begun cooling with house price growth slowing in the latter half of 2017.

Despite the vulnerabilities, the residential market generally continues to be buoyed by other fundamentals. Underlying demand remains solid with strong (albeit uneven) population growth expected to continue into 2020, and jobs growth has been strong, especially in Victoria.

**Chart 5: Average population growth, past five years and across 2017-18 and 2018-19**




And the outlook for construction activity in the near term varies across the states:

- For both NSW and Victoria, growth in housing construction has slowed from its peaks but remains at high levels and is underpinned by strong underlying demand. In Victoria, population growth is containing risks of oversupply.
- Housing construction fell in QLD over 2017, having reached its peak in mid-2016. Despite population growth edging higher, housing construction is likely to remain relatively flat in the near term. Similarly for SA, the housing construction outlook is also relatively flat, because while approvals have picked up in late 2017, population growth projections remain weak.
- WA's housing construction has seen a large downturn in recent years (including a large fall in 2017), but looks to be stabilising, with building approvals and loan approvals steadying.

Taken together with the outlook for interest rates, slowing house price growth (moderating the prospect of further capital gains), restrictions on lending (such as on interest only loans and loans to investors, as well as lending to foreign investors); we expect the current upswing to peter out and enter a period of moderation rather than an abrupt adjustment.

## Outlook for the commercial segment

Demand for new office space is largely determined by white-collar employment growth. The standout performers in 2017 were the Melbourne and Sydney CBD markets. Melbourne has seen particularly strong growth, while Brisbane is gradually catching up to its east coast competitors after an extended period of weakness. Overall office vacancy rates have continued to fall, due to positive net demand in CBD markets and withdrawals in non-CBD markets.

The outlook for white collar employment over the next few years is a positive news story – job growth is increasingly being driven by service-based sectors, with health care by far the front runner, and with professional services and education also expected to generate jobs.

Commercial construction has been a relatively disappointing part of the Australian economic story over the past few years – it was initially hoped that construction could fill some of the hole left by the mining construction 'cliff' (after the first phase of the China boom), but it didn't pan out that way.

That looks set to change in 2018, with commercial construction set to grow over the year. Building approvals have picked up since mid-2016, supported by strength in the office, and education sectors.

In total, there are $20 billion worth of office projects under construction across Australia in late 2017, the largest of which is the $6 billion Barangaroo development. There are a further $8 billion worth of projects yet to kick off.

Likely trends for commercial property over the near term include:

- Constrained supply in the Sydney and Melbourne markets provide a positive outlook for rental growth. The Perth and Brisbane markets have likely bottomed out, with the economic and property outlook improving.
- A shift in focus to rental income growth for value appreciation given cap rates are near historical lows and further tightening potential probably limited.
- Although some firms are now discouraging remote working, in general the trend toward flexible working arrangements is becoming more mainstream and as a result there's likely to be ongoing consolidation of office space requirements by large space users.

### Outlook for the industrial segment

The outlook for industrial space demand is dependent on what is happening across a range of sectors that drive demand for industrial space. Renewed global growth and the easing of inflationary risks (and thus the delay in expected timing of interest rates) has been good news for a number of these sectors, and will likely buoy demand for Australian industrial property.

- It has reduced the risk for wholesalers and retailers that sagging housing prices could pose problems before wage growth improves to provide a rising tide for the sector.
- 2017 has seen reasonable gains in engineering activity in NSW, Victoria and Queensland, as work continues on a number of large infrastructure projects. We expect engineering construction to stop detracting from the economy's overall growth and become a more neutral contributor in the near term.
- Transport investment continues to go from strength to strength, with more than $95 billion worth of transport and storage projects underway in the latter half of 2017 and $140 billion worth of projects in planning. Much of that activity is focused in the nation's east and south.
- Conditions have improved for manufacturing supported by an increase in public sector infrastructure spending, improved global growth and an Australian dollar that, despite gaining ground in 2017, is still below the peaks of mid-2014. However, higher energy costs are weighing on profitability for manufacturers and could affect investment prospects. That said, $18 billion worth of manufacturing investment projects are in various stages of planning as at late 2017.

Likely trends for industrial property over the near term include:

- Industrial property is a tightly held market, and there are pockets of supply constraints – strong continued capital growth is expected in the near term, buoyed by the national infrastructure rollout.
- The trend of urban regeneration seen in recent years, with industrial land converted to mixed use for residential purposes, is expected to continue. This is especially true of Melbourne and Sydney where jobs growth is expected to be concentrated in the CBD.
- Further growth in foreign investor participation in the market is expected to emerge as market sophistication and maturity evolves.
- Yields will eventually be pressured by a rising global and local cost of capital, but that doesn't loom as a major risk for 2018. Yields may remain relatively stable in the coming calendar year, with some opportunity for further compression in select markets.

### Outlook for the retail segment

Retail spending is becoming more uniform across the states as retail spending growth slows in the previously robust eastern states (Deloitte Access Economics' Retail Forecasts, December 2017). While the resource states are still facing challenges, particularly in Western Australia and the Northern Territory, Queensland is less pressured. Annual retail spending growth in New South Wales and Victoria has slowed significantly in the latter half of 2017, towards the more modest growth seen in the slower population growth jurisdictions of South Australia and Tasmania. The ACT is also witnessing a significant retail slowdown after a strong period.

But forward indicators are suggesting a good basis for spending to lift in 2018, including:

- Strengthening employment outcomes
- An improving outlook for wages growth
- Low cost of borrowing
- Continued (albeit slowing) wealth gains from housing.

The value of building approvals fell slightly in the year to September 2017, ending a run of impressive gains. In terms of project activity, there are more than $5 billion worth of retail projects under construction, as well as a further $6 billion in the various planning stages (Deloitte Access Economics' Investment Monitor, December 2017).

Key risks to the sector include the effect of Amazon's recent entry and slowing growth in household wealth. We will get a better idea of the impact of Amazon's entry on bricks and mortar retailers in coming months – and therefore demand for retail floor space. But the results of a recent survey suggests that retailers are not overly alarmed by Amazon's entry to the Australian market (Deloitte's Retailer's Christmas Survey 2017). While a third of respondents believed Amazon would have a negative impact on their business, 40% believed it would benefit them. Continuing a tone of confidence, looking forward to 2018, 51% of respondents expected to grow their earnings by more than 5% next year (down from 2016 expectations, where 60% believed this would be the case).

Despite challenges and disruption in the sector, demand for retail space within the Australian market remains solid, in part due to the number of new large-scale international entrants setting up operations in Australia.

Likely trends for retail property over the near term include:

- High levels of demand for centre space are set to continue in the near term – with growth in food and hospitality uses and smaller footprints for many larger format retailers.
- There may be the potential for further yield compression in the near term, concentrated at the prime/super regional end of the spectrum. This is likely to be driven by the low frequency that these assets are offered to market and weight of capital in the sector.
- The impact of online retailing to continue to test the sector – given the relatively current low rate of penetration in Australia and Amazon opening its doors locally!

### Risks

There are risks to the outlook for Australian property: part of today's good news is also bad news. Thanks to renewed stimulus, Chinese construction activity has picked up again. But much of that money is supporting the worst performing State Owned Enterprises (SOEs), thereby increasing China's vulnerability to a sharp adjustment as the economy transitions. That's also true for Australian rates. We've used lower interest rates to ward off risks of recent years, boosting property prices, and household debt along the way.

While the most likely path for the Australian economy doesn't see a triggering of those new risks (China and/or housing), they're both plausible and relevant risks and worthwhile exploring further.

In a later chapter we present our China Stumbles scenario, and step through how scenarios can be used for strategic planning for our model REIT.

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