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Scenario planning

What if China stumbles?

We focus a lot on the baseline view of the Australian economy, our view of the most likely economic future. But if recent times (especially the GFC and Brexit) have taught us anything, it's that some of the assumptions that underpin 'most likely' can and sometimes do pan out differently than expected.

There are a number of risks to the most likely view, both upside and downside. They include anything from geopolitical tensions around trade, the potential for faster than anticipated global growth, through to longer term uncertainty about the speed of automation uptake. It could also include unlikely but possible risks, such as a biosecurity outbreak, or a policy change to cut migration.

That's where scenario analysis is useful. Scenarios challenge the key assumptions that underpin our baseline view, allowing us to peer around the corner at other alternative versions of the future. It allows us not only to identify risks but also the opportunities in a range of possible futures, supporting our ability to make good decisions under uncertainty.

We have modelled 10 scenarios using Deloitte Horizon – our large scale macro-econometric model of the whole Australian economy. The framework is a powerful tool that gives us insight into 56 separate industries and the ability to deep dive into the implications for the revenues, costs, profitability and employment of industries.

The power of Horizon is that we are able to drill down even further to provide firm level insights, where the modelled impacts are tailored to your firm's specific asset allocation, weighted average lease expiry profiles and sectoral exposure. When building understanding of sectoral exposure, it is critical to know what demand will look like across different property segments, as well as debt and leasing profiles, to get a sense of the size of the risk to your business.

In the next section, we use a scenario to consider how the outlook for a dummy REIT 'Property ABC' might change under a China stumbles scenario.

What would a real estate investment trust look like in a fictitious scenario 'What if China stumbled'?

Introducing 'Property ABC'

Our dummy Australian REIT – 'Property ABC' – has a relatively even spread of exposure across segments and across geographies. In the residential segment it is more weighted toward detached housing (charts below).

We will use our 'Property ABC' to explain the forecast impacts from a China stumbles scenario.

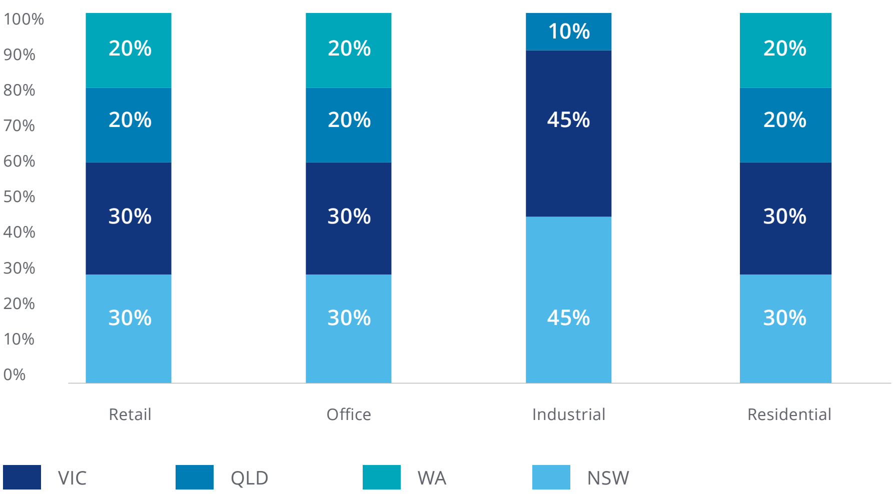
But remember this is not a crystal ball! There are a myriad of different ways any given scenario can play out – it depends a lot on what assumptions you make (such as government reactions).

China stumbles

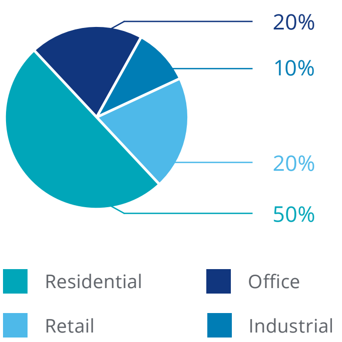
This scenario imagines China experiencing a large economic shock that halves its growth for two years and tips Australia into a short recession – the first in more than 26 years. Our defences are weaker and vulnerabilities higher than they were pre-GFC.

- Interest rates and the $A are already low, and don't have as much room to fall
- The federal budget position would mean any fiscal response would probably be less aggressive than during the GFC
- Household debt has escalated rapidly due to an extended period of ultra-low rates, increasing the vulnerability of household to economic shocks.

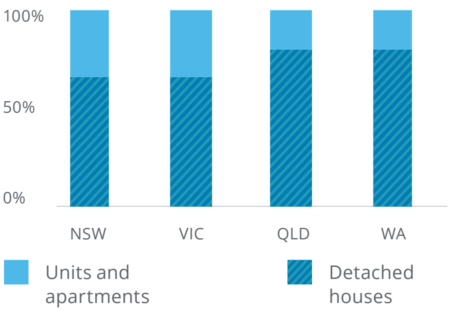
Exposure to geography by revenue



Exposure to segment by revenue



Residential – developments by type



China stumbles

Why might this scenario occur?

China's economy has been transitioning to a more sustainable growth path for a number of years; one driven by consumption reflective of household incomes. But the stimulus in 2017 has again delayed this rebalancing of the economy. The IMF increased its growth forecast for China's GDP (up from 6.6% to 6.8% for 2017 and up 0.3 percentage points to 6.3% over the next three years), but warned that the latest stimulus implies an increased risk of (and size of) a sharp adjustment should the Chinese economy face a shock to its economy.

This scenario could be triggered any time between now and 2020 (a key target year with Chinese leadership targeting a doubling of the economy over the decade). But the trigger could arrive in months, as the economy and asset prices are already stretched and overcapacity remains widespread, leaving the economy exposed to external shocks. Risks range from ongoing trade tensions between China and the US, and a risk of faster than expected interest rate normalisation in the US that could result in capital flight from China.

To be clear, this scenario is lower probability than our baseline forecasts (our view of the most probable future) - Chinese authorities still have a lot of capacity to respond to a financial crisis and they appear willing to use it.

How could this affect the Australian economy?

The most direct impact would be felt by Australian miners – lower demand for Australian exports will also see us receive lower commodity prices, and inbound capital from China would stop abruptly.

Under the scenario, the RBA would swiftly drop interest rates. The Federal Government would roll out a stimulus package in the three months following the shock, which would likely go to infrastructure spending.

By 2019, our terms of trade are more than a quarter lower compared to what would otherwise be the case. Lower national income flows through to reduced business earnings and lower wages.

The RBA works to keep interest rates as low as possible for as long as possible but the large drop in the $A sees Australia importing significant inflation growth. By 2020, the RBA is forced to raise rates to contain inflation.

Employment would be more than a quarter of a million lower – unemployment peaks just shy of 7%. Some 200,000 of the 550,000 fewer jobs in the economy would be lost in the construction sector.

Higher unemployment, lower income, the falling purchasing power of $A, together with an increased cost of borrowing hits demand for housing hard and the difficult business environment would also affect demand for non-residential property.

But the Australian economy would gradually recover, and unemployment recovers back to baseline levels (what we would have seen if the scenario didn't occur) by 2030. With China's economy well on the way to recovery and local inflation contained, interest rates start moving down from highs in 2021.

Overall impact

This scenario is generally bad news for Property ABC's revenues. But impacts differ by segments and timing.

In 2019, cap rates and rents for retail property are most affected among the segments – and by geography WA is clearly the hardest hit in this segment.

The challenging economic climate puts downward pressure on rent across segments in every state. But rents are pretty sticky; how fast this pressure translates to a revenue impact for Property ABC depends on the trust's weighted average lease expiry profile across segments.

The residential segment quickly becomes the most affected property segment – and by 2025 Property ABC's development revenue for this segment is more than 10% lower than would have been if this scenario didn't occur. At this point, retail and industrial property become the best performing segments, owing to improved profitability for retailers, and stronger performance of the manufacturing sector seeing improved demand for industrial property.

The outlook also differs by state. Activity in the WA economy is the most affected among the states because of its exposure to commodities. The NSW and Victorian economies, which are much more diversified, are more sensitive to movements in interest rates and exchange rates. QLD falls in between, being a resource state but with a relatively more diversified economy than WA.

In this scenario, Property ABC would benefit from considering reallocating its exposure across segments and states, considering its exposure to different sectors (via the mix of lessees) for its industrial property portfolio, and optimal timing around land bank investments.

Residential

Immediately following the shock in China, lower interest rates will provide some initial support to the local property market. But as the economic shock from China works its way through the economy, it becomes increasingly difficult to pre-sell new housing developments as people become concerned about the future and their job security. Demand from Chinese investors also dries up temporarily in the scenario – and will take some time to return to the Australian economy.

Unfortunately, in the medium term the rising cost of borrowing challenges affordability in the residential market, at the same time as we see reduced demand due to higher unemployment.

- There could be a wave of fire sales by investors faced with climbing borrowing costs and stagnant rental income. Reduced competitive tension in the market, with a lower presence from both local and foreign investors, could see prices fall.
- The sector would likely see a reduced development pipeline.

From 2021, property market conditions start to improve as interest rates come back, and unemployment begins to fall. The residential sector would see a period of catch up, owing to pent up underlying demand, kicking off the next property market upswing.

Commercial

With the business cycle turning down, the outlook for business investment worsens, reducing the pipeline of future office developments. There would likely be a rising incidence in downsizing, and possibly a pickup in the number of smaller businesses folding.

The outlook for white collar employment worsens under this scenario, particularly for the professional services and the financial services sectors, although the public service wouldn't do as badly.

Vacancy rates would rise putting downward pressure on rents, but we wouldn't expect them to get as high as what we saw in the early 1990s recession. (The 1990s recession was triggered by asset bubbles, and a commercial property collapse, marked by an aggressive run up in capital values and excess stock coming on to the market).

Conditions are different now with constrained supply in the Melbourne and Sydney office markets, and while Perth and Brisbane have not performed well in recent years, these markets are close to their nadir.

White collar employment, key driver of demand for commercial property by 2020
(red means worse than baseline, through to green which means better than baseline)

	Sydney	Melbourne	Brisbane	Perth
White collar employment				

Commercial property – Indicative change compared to baseline forecasts
(red means worse than baseline, through to green which means better than baseline)

	2020	2025
Rents		
Cap values		

Retail

Reduced household income, lower wealth, higher unemployment, the lower purchasing power of $A would together see less retail spending by households, as the cost of living rises (notably through higher mortgage costs). Compared to baseline, activity would be lower across the forecast period.

Retail activity is also hit in this scenario in the short run by a fall in tourist visits to Australia – notably tourism from mainland China would slow dramatically. But over time as the $A falls, we would likely see overseas visits pick up from other countries, as the cost of visiting Australia falls notably.

With fewer customers spending less, retail businesses will be squeezed. It would likely see lower demand for retail space as some businesses would look to rationalise the space they have. This would put upward pressure on vacancies and downward pressure on rents and capital values.

The economy recovers over time, and by 2027 the impact of interest rates coming back (compared to baseline) will support a recovery in household spending.

Drivers of retail demand – Relative to baseline
(red means worse than baseline, through to green which means better than baseline)

	Wages and household wealth	Unemployment	Interest rates	Tourism
2020	No significant change			
2025			Back to baseline rate Interest rates rose and peaked in 2020, by 2025 they are back to baseline levels	Still lower but recovering to levels seen if this scenario didn't occur

Retail property – Indicative impacts compared to baseline forecasts
(red means worse than baseline, through to green which means better than baseline)

	2020	2025
Rents		
Cap values		

Industrial

- The outlook for the level of output for key sectors is an important driver of demand for industrial floor space – manufacturing, food, consumer discretionary, retail, IT, transport and logistics
- Local manufacturing (where there is local demand for outputs), includes food manufacturing, furniture, clothing and footwear etc). The manufacturing sector overall does better under this scenario due to a sizeable fall in the exchange rate. The fall in the $A makes buying locally relatively cheaper compared to what would otherwise be the case, and also improves the competitiveness of our exports. More granular analysis reveals that there is variation across the manufacturing subsectors though, with some (including metals manufacturing and machinery and equipment) being negatively affected in the short run
- The exchange rate effect is also important for small producers – and will be a positive effect for this scenario
- On the other hand, sectors reliant on transporting imports, including transport and warehousing, are relatively worse off under this scenario.

Impacts on output for key sectors for industrial land in this scenario
(red means worse than baseline, through to green which means better than baseline)

	2020	2025
Manufacturing	neutral	
Retail		
Transport and storage		
Wholesale trade		
IT		neutral

Decisions, decisions, decisions...

The rubber hits the road when this information is used to improve your strategic decisions. Essentially, the value of scenario analysis is to prepare your organisation to react faster and more effectively than your competitors to take advantage of the changing economic conditions.

If implemented successfully, scenario analysis will improve the underlying evidence on which key decisions around asset allocation, pipeline and lease management, financial structure and stakeholder management are based.

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