Economics & Markets Research

ANZ Property Outlook

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Inside

Economic Overview

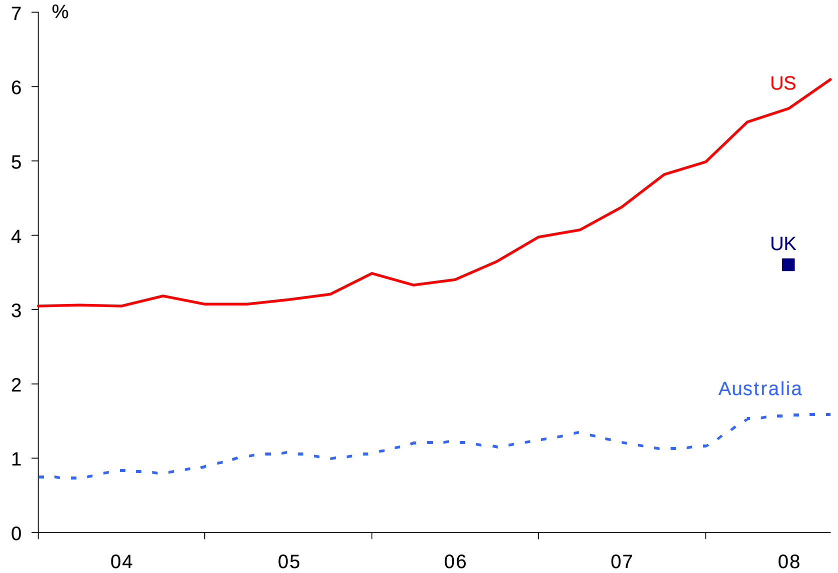
While the Australian economy held up remarkably well for most of last year, 2009 will be far more difficult. Growth will continue to slow as collapsing equity prices and rising unemployment weigh on consumer spending and businesses pare back investment plans. Nonetheless, our macro-team remains confident that the Australian economy will come through the global downturn in far better shape than our developed world counterparts.

Residential Property

Despite rising unemployment, we continue to believe that Australian house prices will remain well supported. If housing supply remains on its current trajectory, Australia will face a critical and potentially intractable shortage of housing that would force rents and house prices significantly higher.

Conservative lending will prevent a US style collapse in house prices

Mortgage delinquencies (30+ days)



Sources: MBA, S&P, ANZ Economics and Markets Research

Commercial Property

CBD office markets remain vulnerable to a weaker economic environment, tougher credit conditions and an emerging deterioration in the demand/supply balance.

Retail property vacancy rates are still low, but will rise as trading conditions deteriorate in 2009. Rent increases will be smaller and yields will rise.

Tourist accommodation saw its first falls in occupancies and takings in H2 2008. Lower international visitors and local business travel will bite in 2009.

The risks to **industrial** property market are predominantly to the downside. The historical geographic and asset grade premia that had narrowed in recent years are now re-emerging.

Economic Overview

Global recession to deepen

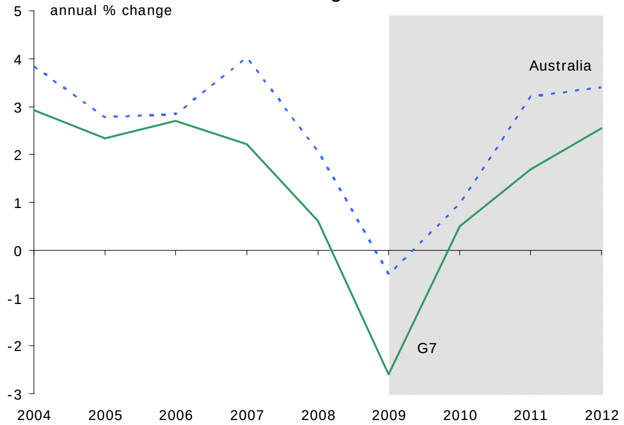
The dramatic deterioration of global financial markets in the second half of 2008 has driven much of the developed world into recession. While extraordinary monetary and fiscal policy action has seen interest rate spreads narrow and liquidity conditions improve, global economic growth will be weaker in 2009 than in any year since the Second World War. Fourth quarter activity data for the major developed economies has been universally woeful and even the developing world has slowed sharply. Global growth forecasts continue to be revised downwards and recovery relies heavily on the efficacy of official policy action in stabilising the global financial system. More recent export and industrial production data and the meltdown in Eastern Europe suggest the global financial crisis and economic downturn have considerably further to run.

Australia – a milder downturn

While the Australian economy held up remarkably well for most of last year, 2009 will clearly be far more difficult. Growth will continue to weaken throughout the year as collapsing equity prices and rising unemployment weigh on consumer spending and businesses pare back investment plans. Nonetheless, our macro-team remain confident that the Australian economy will come through the global downturn in far better shape than our developed world counterparts. The domestic economy was well positioned going into the crisis and significant, pre-emptive and *effective* policy action (and substantial capacity for more) and a sharp decline in the $A should help avert a US/Japan/UK/Europe style economic collapse. The parlous state of the banking sectors in each of these countries is limiting the positive impact of monetary policy easing. In contrast, despite a moderate tightening of lending standards, the strength of the Australian financial system (and virtual absence of a sub-prime mortgage market) will be a key support to the domestic credit creation process and economic activity.

Australia will continue to outperform

Real GDP growth



Sources: ABS, Datastream, ANZ Economics and Markets Research

Nonetheless, we are not immune and the global slump will inevitably drag domestic activity lower. Australia will experience a mild recession in 2009, the unemployment rate will rise sharply to 7.2% by the end of 2010 and weak investor sentiment will maintain downward pressure on asset prices.

Housing to remain resilient…

Despite rising unemployment, we continue to believe that Australian house prices will remain relatively well supported and will not experience anything like the spectacular falls that have occurred in the US, UK and many other developed countries.

Australian housing market conditions are a far cry from those overseas. Conservative lending practices have protected us from the ravages of the sub-prime mortgage crisis and delinquency rates and foreclosures have remained at historically low levels. Unlike the US where a clear oversupply is weighing on prices, Australian housing markets continue to tighten and sharp falls in home building approvals in the second half of last year foreshadow a further slump in housing supply in 2009. Since peaking in mid-2008, variable mortgage rates have fallen to levels not seen since the 1960s and housing affordability has improved dramatically. This combined with a doubling (a tripling for construction/new) of the first homebuyers grant has seen encouraging signs of an improvement in sales market conditions. After plummeting through much of 2008, housing finance commitments have rebounded (albeit from low levels) led by first homebuyers, auction clearance rates and private sales markets have strengthened and new home sales have risen. With global conditions deteriorating and unemployment on the rise it is still too early to call a house price recovery. However, unless the economy weakens further than is currently expected, we expect prices will reach a nadir in the second half of 2009.

…but commercial property vulnerable

The commercial property market remains at an impasse and a dearth of transactional evidence raises serious questions over the extent of true price discovery. Nonetheless, reported property yields appear to have risen by between 50 and 150 basis points across the sector and valuations remain susceptible both to further capitalisation rate expansion and a weakening of rental expectations as fundamentals deteriorate. After tightening substantially in recent years, additional capacity and softening tenant demand are already driving an increase in sub-lease vacancy and a renewed rise in incentives. While the supply pipeline has been cut dramatically by the global financial crisis, office markets in both Brisbane and Perth (where rents soared in recent years) appear particularly vulnerable.

Paul Braddick

Residential Property

Australian house prices resilient

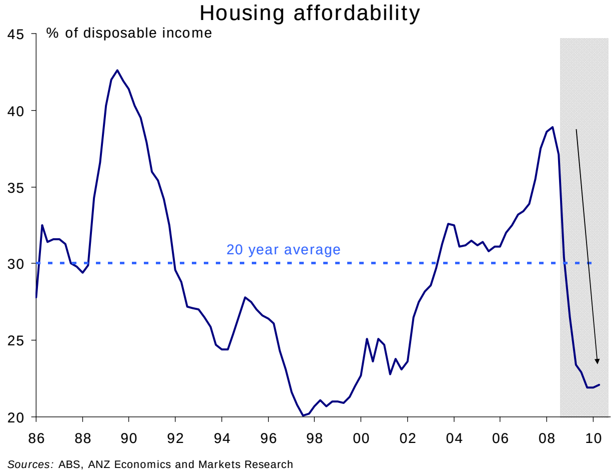
Since peaking in early 2008, the national median house price has fallen by 3.9% and weak sentiment, a deteriorating economic environment and rising unemployment present further downside risks.

However, there remain strong reasons to expect that we will avoid a US-style house price collapse. Principal among these is the significant, pre-emptive and *effective* policy action taken to date, plus the fact that unlike our developed world counterparts, Australian policy authorities have ample ammunition in store should further stimulus be required. Since August last year, the Reserve Bank has cut the official cash rate by a massive 400 basis points. Of this, 375 basis points have been passed through to the standard variable mortgage rate for new and existing mortgage holders.

In contrast, over the period to December, US authorities cut official rates by 500 basis points with only a meagre 15 basis points flowing through to existing borrowers. The relative potency of monetary policy in Australia and the resultant dramatic improvement in Australian housing affordability will be key factors supporting house prices in the year ahead.

Housing affordability improves dramatically

Housing affordability



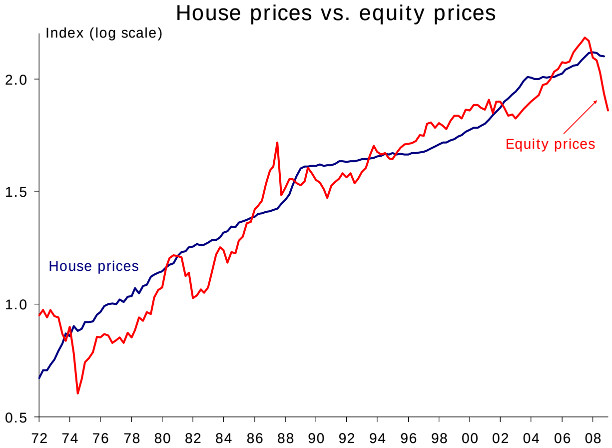
Sources: ABS, ANZ Economics and Markets Research

Far stronger regulatory oversight and the conservative lending practices of most Australian financial institutions mean we do not face the sub-prime mortgage crisis and associated forced selling that has driven house prices sharply lower in the US. Boosted by non-recourse lending policies and collapsing house prices, anecdotes suggest up to 80% of home sales in some US cities have been forced sellers! In contrast, with sub-prime mortgages representing just over 1% of the Australian market (cf. a peak of over 15% in the US) and full recourse lending, mortgage delinquencies and foreclosures remain at historically low levels and a lack of forced sales provides considerable downside protection to house prices.

In stark contrast with the oversupplied US housing market, the ongoing tightening of the Australian housing demand/supply balance will also provide substantial support to prices and (eventually) building activity. The extension to the first homebuyer grant has boosted demand at the lower end of the market and tight rental conditions, rising rents and improved yields will increasingly encourage new homebuyers and investors back into the market. With further official rate cuts expected, home borrowers should be able to access mortgage interest rates of less than 5% by the middle of the year (a far cry from the standard variable rate of 9.6% in August last year). Combined with rising property yields, this will see positive gearing opportunities emerge for residential investors. Moreover, ongoing volatility and uncertainty in global equity and other asset markets will further highlight the relative security of the Australian housing sector.

House prices ease but equities collapse!

House prices vs. equity prices



Sources: ABS, Datastream, ANZ Economics and Markets Research

Nonetheless, after peaking in early 2008, the national median house price has fallen by 3.9% - the largest decrease since the 1940s. Perth (-6.7%) and Sydney (-4.1%) experienced the biggest declines last year and further falls are expected in the first half of 2009, particularly in Perth. Market sentiment weakened sharply last year on the back of declining affordability and job security and fears that Australian house prices would follow those in the US/UK etc. Price falls have been most significant at the upper end of the market, while lower priced homes have generally been more resilient. More recently the extensions to the first homebuyer's grant and sharply improved housing affordability have boosted demand, particularly at the lower end of the market.

On balance, though risks remain to the downside, we still believe Australian house prices will experience a *relatively* soft landing. Peak to trough we expect the median national house price to fall by around 6%, which while significant, pales next to the 50%+ (and counting) collapse in equities.

Housing supply – shortage or excess?

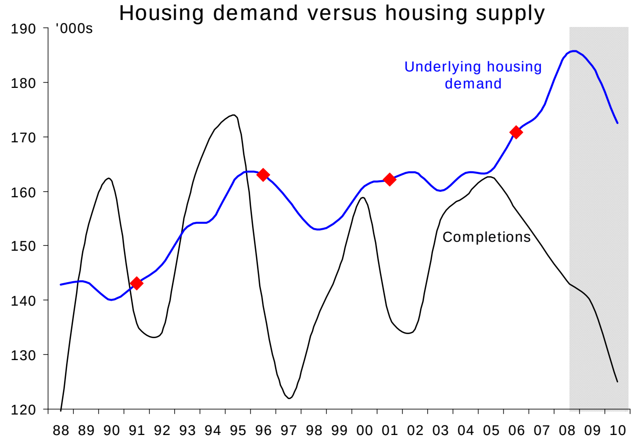
For some time we have highlighted the widening gap between underlying housing demand and housing supply and the critical and potentially chronic undersupply of housing Australia faces in the years ahead.

However, recent analysis has asserted that the rising level of *unoccupied housing* in Australia reflects an *excess* of housing stock. The 2006 Census showed 822,000 unoccupied dwellings (just under 10% of the existing housing stock). This includes vacant rental properties, holiday homes, homes under major renovation and 'frictional' vacancies (properties vacated prior to settlement/demolition, deceased estates etc). While the proportion of unoccupied dwellings rose slightly in the five years to 2006, it has remained around 9.4% of the total dwelling stock on average for the past 30 years. Hence other than vacant rental properties (which are at or near record lows), the level of unoccupied dwellings appears to be a *structural* phenomenon. While suggested shifts in land tax would increase property holding costs and at the margin release some of this stock for occupation, this is unlikely to be sufficient to make significant inroads into the massive undersupply of housing that we will face in the decade ahead.

Underlying housing demand is running at just over 180,000 per annum, while new housing supply is shrinking rapidly. Building approvals have collapsed in the past year and completions in 2009-10 could fall below 120,000. Australia currently has one of the (if not the) strongest population growth rates in the developed world and even if skilled migration targets were cut to zero in the years ahead in response to fears of rising unemployment, underlying housing demand would still be 150,000 in 2010.

We currently estimate that by mid-2010 that Australia will have an *unprecedented* underlying housing shortage of 250,000 dwellings!

Inadequate supply driving a critical shortage

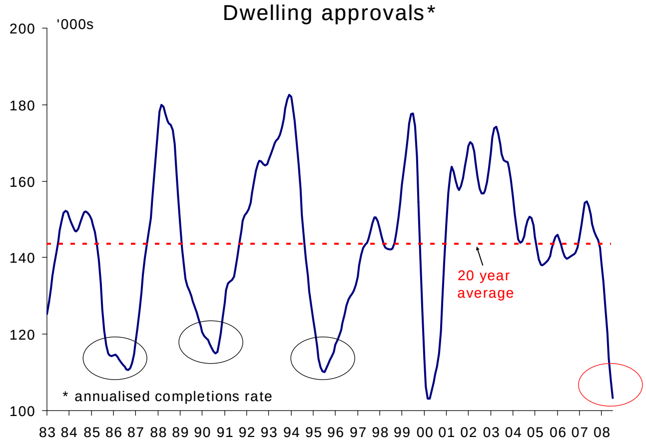


Sources: Australian Bureau of Statistics; Economics@ANZ

Government incentives encouraging the provision of affordable rental housing and announced public housing initiatives will only partially redress this imbalance.

The immediate policy focus needs to be shifted to arresting the savage declines in private building approvals experienced in the past year. Total dwelling approvals in January slumped to a 26 year low (excluding the post-GST dislocation), with detached house approvals down 23% and other dwelling approvals down a massive 53% in the past year. The number of dwelling approvals in January represents an annualised completions rate of just 103,000 and without a marked near-term recovery, housing starts in 2009 will be the lowest on the 25 year data record, at a time when we already face an unprecedented housing shortage and underlying housing demand is running at a record high!

Dwelling approvals have collapsed



Sources: ABS, ANZ Economics and Markets Research

Many issues are weighing on the developer market including difficult market sentiment, inadequate land release, government charges, rising costs as building regulations tighten and declining profit margins as house prices soften. However, a major concern at present appears to be access to finance. Lending criteria have been tightened across the finance sector in response to a radically changed risk environment and difficult wholesale funding conditions with institutions generally requiring higher pre-sales and lower loan to valuation ratios. With funding conditions likely to remain challenging for some time and risk appetites expected to be constrained by the weakening economic environment, the Government may need to look at extending the Australian Business Investment Partnership to the residential development sector with a particular focus on 'affordable' housing projects.

If housing supply remains on its current trajectory, Australia will face a critical and potentially intractable shortage of housing throughout the decade ahead that would force rents and house prices significantly higher and drive both rental and house purchase affordability/availability to extremely difficult levels.

Paul Braddick

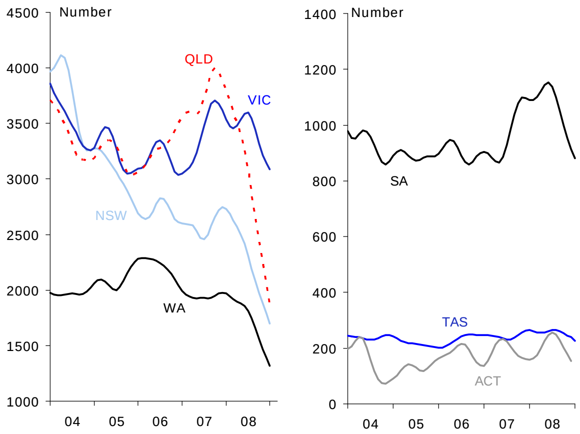
New South Wales

The NSW economy is set to contract over the next two years with joblessness rising significantly and sentiment remaining vulnerable to any further global financial developments. This backdrop will weigh heavily on housing market outcomes despite monumental impetus from policy makers. Surprisingly, home building approvals have continued to languish, reaching record lows in early 2009. Owner-occupier finance to *non*-first-home buyers however does appear to have bottomed, suggesting the traditional interest rate trigger for recovery may be starting to engage.

Sydney median house prices have been flat-lining for around 5 years. While this has helped restore affordability conditions vis-à-vis other capital cities, it has, in the face of prohibitive developer charges (despite recent alleviations), seriously undermined the economics of home production. Margins remain tight and when combined with heightened uncertainty about future returns (i.e. fears that house prices might fall more substantially) it is not surprising we have seen a significant retreat by the development sector. A subsequent tightening in credit conditions and in pre-sale criteria introduce additional barriers to deal flow. The upshot is an inadequate supply of housing to the state. Given limited broad-acre development opportunities, resolution of Sydney's supply issues will challenge the development sector to provide an affordable medium- and high-density product that also offers an adequate return to builders.

Building approvals have collapsed

Building approvals, trend



Sources: Australian Bureau of Statistics

Our estimates of demand/supply balance suggest the NSW market is already in chronic undersupply. With underlying demand at around 41,000 dwellings and approvals trending at an annualised completions rate of just over 16,000, the balance is deteriorating at a rapid rate. This development is a double-edged sword. The tight conditions which are also manifesting in historically low rental vacancy rates and rising rentals, play a significant role (along with other policy supports) in protecting the value of the established housing stock against the adverse impacts stemming from the global environment. By the same token, under-production of dwellings is placing considerable stresses on building industry viability and employment. A major turnaround in activity is not expected in 2009 and there is considerable prospect, despite the chronic imbalance, that one will not occur until the economics of building improves, confidence returns (i.e. no downside price expectations), finance returns and prohibitive government charges are unwound.

Victoria

Victoria's housing market has performed solidly in recent years with only a marginal downwards drift in the median house price and building approvals holding at relatively healthy levels compared to most other states. While slowing, the Victorian economy is expected to outperform the national economy over the next couple of years, providing a relatively benign backdrop for housing markets compared to some other states.

Victoria's underlying demand/supply balance remains tight with a shortage equivalent to around 1 year's production estimated at June 2009. Tightness is also reflected in very low vacancy rates and double-digit rentals growth over the year to December 2008. A more accommodating stance on land release, less prohibitive infrastructure charges and road-link improvements are facilitating the expansion of several growth corridors in and around metropolitan Melbourne. These corridors offer fertile territory for first home buyers looking to capitalise on government support, but will be only part of the solution to Melbourne's supply shortage with inner-suburban medium-density infill developments playing a central role as is the case in Sydney. Restoring builder confidence and access finance are prerequisites for this process to get underway.

Considerable uncertainty about labour market prospects, difficult financing conditions and a generally weak sentiment will combat the traditional interest rate trigger despite the shortage of stock. Affordability conditions have already improved and will continue to do so by years-end. Perceptions that low interest rates will persist into 2010 and that most of the state's labour market adjustments are behind us will be required before a solid trajectory in building activity re-emerges. This is unlikely until 2010.

Queensland

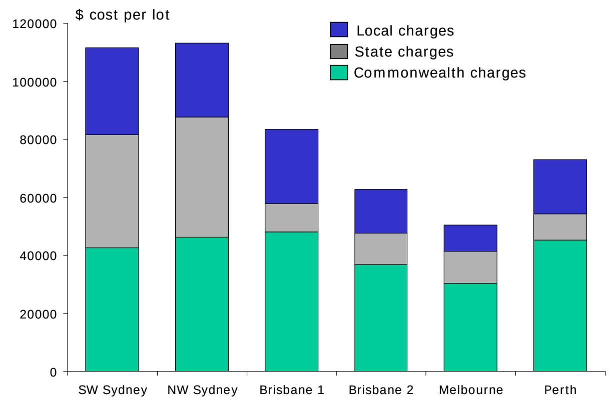
Forward indicators of Queensland building activity have collapsed with building approvals falling by 53% in just over a year to levels not seen in over two decades. The economy, a traditional out-performer has virtually stopped growing and is set to contract slightly over the next year or so. This shock to the system, largely driven by resource sector weakness and ahead, the announcement effect of a credit downgrading, is still to play out and will be a major force on the housing market. Prices are particularly vulnerable but are not expected to collapse.

With approvals trending at annualised completions rate of around 21,000 (compared to an underlying requirement of 42,000), pent-up demand will build rapidly this year. Furthermore, rental vacancies are low suggesting the demand/supply balance is already very tight.

The revised South-East Queensland Regional Plan portends a more rapid growth path than originally anticipated in the first cut of the plan in 2005. It also gives adequate consideration to what is an appropriate mix of green-field versus infill development. However, while sufficient land is being earmarked for a solid growth outlook, the cost of infrastructure still hangs as the greatest *structural* impediment to a sustained improvement in building levels. With macro policy supports in place, it is a return of confidence and finance availability that remain the key to a more immediate turnaround in building levels.

Govt. charges - a big hurdle

House and land developments as at December 2008



Source: HIA

Tasmania

The Tasmanian economy put in one of the better performances in the country in the December quarter. State final demand growth was 0.8% in the quarter (in trend terms) well above that for the eastern seaboard mainland states. Moreover, the unemployment rate remains relatively low at 4½% and compensation of employees expanded at 8½% both better than national averages. Population growth remains at solid levels. Supporting the property market is the composition of interstate migration. Arrivals are characterised by older people with greater incomes/assets creating demand. Departures are usually younger people leaving their parents home and therefore not creating undue backfill supply.

This solid backdrop has seen the Tasmanian housing market remain well supported. Housing finance approvals have grown 25% since lows in September. First home buyers have led the way accounting for just under a third of housing finance approvals in recent months. This is due to the improvements in affordability, combined with the increases in the FHOG making significant inroads into saving a deposit (especially given Tasmania's relatively low median house price). The solid demand has left house prices relatively well supported with Hobart prices easing just over 3% from late-2007 peaks.

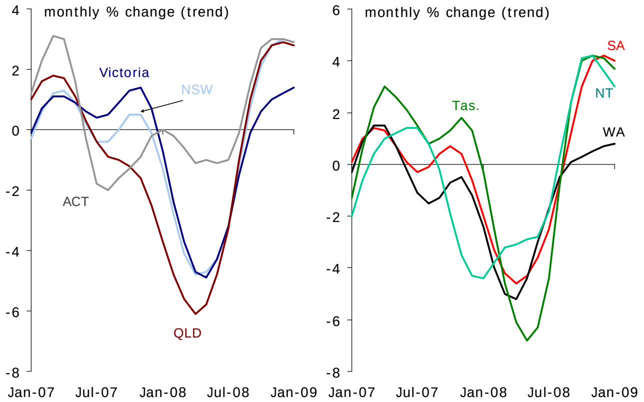
South Australia

The South Australian economy expanded at a solid 3.6% in the year to the December quarter to be the second strongest performing state. However, the news is not all good. Significant exposure to the manufacturing, mining and farming sector is weighing heavily on the unemployment rate which rose to 5.8% in February the equal highest in the country. However, annual employment growth is still positive so we have not seen a wholesale capitulation in the state labour market. We anticipate that after a solid 2007-08 in which the economy expanded 3.8%, SA will grow by ¾% this year. This slowing is in line with the rest of the country.

The housing market slowed considerably through late-2008. Despite this, prices actually rose by 0.3% in the December quarter, the only state to record an increase. This was most likely driven by solid income growth combined with an acceleration of population growth rates through much of 2008. On the supply-side building approvals have been weak through much of the past 12-month increasing tightness in the property market. Along with vast improvements in affordability these factors have seemingly kicked started the property market. Housing finance approvals increased over 25% from October-Jan this year signifying that demand remains strong. We expect this upswing will be tempered by a weakening economy through 2009, especially if the unemployment rate rises sharply.

Housing finance approvals up across the board

Housing finance approvals



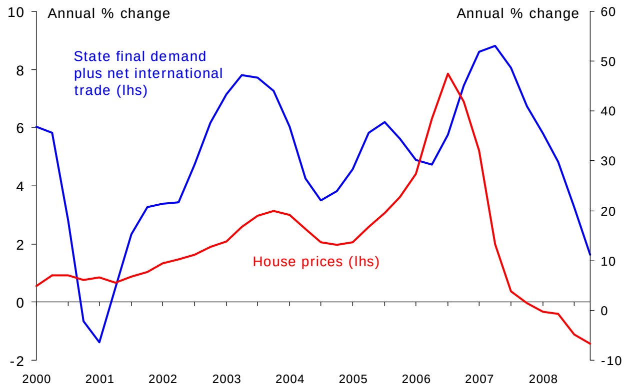
Sources: Australian Bureau of Statistics, ANZ

Western Australia

Both the Western Australian economy and property market are in a fragile state. After being at the forefront of the commodities boom in the last few years WA is now faced with the bursting of the resources bubble. After posting over 5% GSP growth in 2007-08, growth is expected to slow to less than 1% this year. The sharp falls in global commodity prices will drag on all sectors of the economy particularly state and household incomes. As the economy has slowed, the unemployment rate has risen from a low 2.8% to 3.6%. Employment levels have fallen in recent months, yet this may not be fully reflected in the labour force figures. Approximately 20,000 temporary employment arrivals had been working in WA. It is expected that unemployment will hit this segment hard and result in departures rather than adding to the unemployment rate.

Weaker WA economy poses more downside risk for house prices

Economic growth and house prices



Sources: ABS, ANZ

The weakening economy will weigh on a property market that was already in a slow decline. House prices fell 6.8% in 2008 according to the ABS, the most significant median fall in the country. That being said prices climbed over 50% in the previous 2½ years. Weak sales numbers have seen many take properties off the market and put them up for rent, seeing vacancy rates rise to over 3%. Yet the rental market remains relatively tight with annual rental growth growing at 17% in 2008, the fastest growth of all states. This has seen rental yields continue to climb, as well as support prices in the apartments market where falls have so far only been moderate.

Population growth was still running strong at over 2%p.a. through 2008 yet we would anticipate this to slow considerably as employment prospects weaken. Household income growth is also expected to slow markedly. Both of these factors should see the property market continue to moderate through 2009. Housing finance approvals have turned around in recent months but have underperformed other states. This is no surprise given affordability deteriorated so dramatically in recent years. As such, we may need to see prices in the Perth market soften further to see buyer activity pick up significantly.

Northern Territory

The NT economy contracted in the December quarter, yet 8.7% annual growth in final demand was the strongest in the country. Like WA the turnaround in the commodities cycle will hit the Territory hard, crimping export-driven growth through 2009. The unemployment rate has risen to 3.9% in February up from lows of 3.0% in 2008. The deterioration of employment prospects through the year should see the very strong rates of population growth begin to wane. This may assist in a property market that remains very tight.

Additional supply of housing has been very weak and as a consequence both prices and rents have been pushed higher. APM report weekly median rents in Darwin hitting $500, in excess of both Sydney and Melbourne and as a result residential yields are the highest in the country. Further, Darwin house prices pushed 1.8% higher in the December quarter the strongest increase in the country. Through 2008 median prices expanded 3.8% while the rest of the country went backwards at a rate of 3.3%. A slowing economy should take some of the heat out of the NT property market in 2009. Further, the government is also implementing policy to ease the housing crisis and add to the shortfall in housing supply.

Australian Capital Territory

State final demand in the ACT went backwards in the December quarter contracting by 0.7%. Household consumption and dwelling investment both dragged on growth and are expected to continue to do so through 2009. GSP growth this year is anticipated to slow to just ¼% after solid 2½% growth in 2007-08. Despite the slowdown in the economy we have not seen the unemployment rate rise, remaining at 2.4% in February, yet employment growth has stalled.

With job losses in the ACT limited so far, incomes growth has remained intact and this has supported the local property market. Demand is coming back to the market with a strong rise in housing finance approvals in recent months. This may have been prompted by softness in house prices through much of 2008 which fell more than 5% from March to June. Yet this softness was pounced upon in the December quarter and as a result price actually rose 0.7%, the second strongest rise in median prices in the country. Going forward, despite a marked slowing of the economy unemployment should remain low and income growth tick along at a reasonable pace. As such, the significant improvements in affordability should see prices well supported in the Canberra market.

Ange Montalti & Alex Joiner

Office Property

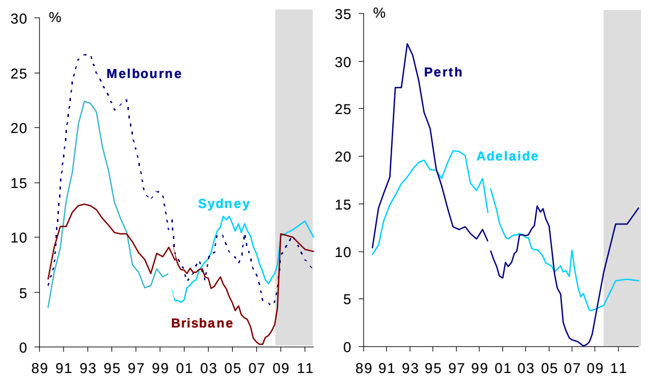
Office market – a rough ride for some

CBD office markets remain vulnerable to a weaker economic environment, tougher credit conditions and an emerging deterioration in the demand/supply balance. Centres that have benefited from the commodity wave and whose economic prospects are now looking less rosy than just a year ago face a considerable challenge over the next couple of years.

Office market vacancies bottomed in most CBD centres in the second half of 2008 but are still low. Slowing white-collar job creation has been the main contributor to this turnaround with net absorption falling sharply over this period. Further labour market weakness in 2009 points to a continuation of this trend. Fortunately, a modest development pipeline leading into this period of weaker demand is offering respite and is a clear point of difference for those attempting to draw parallels with previous cycles. The subdued supply response is largely fortuitous, reflecting the moderating impact of rising interest rates through to early 2008, more restricted access to credit and higher self-imposed hurdle rates.

Vacancy increase will be relatively moderate

CBD office vacancy rates



Source: Jones Lang LaSalle from Dec 1999, PCA from 1989 to 1999, JLL Forecasts. ANZ Economics & Markets Research

Rental yields have softened, although given little depth in sales markets, recent readings do not provide confidence that the market is achieving any meaningful degree of price discovery. Hopefully, this should weigh as a strong qualification in the context of revaluations and highlights the inadequacies of 'marking to market' when there is no market. Yield decompression for prime office space has ranged from 100bp to 170bp since December 2007. This has translated to quite substantial decline in valuations in some CBD centres but less so in those whose rental prospects remain on relatively solid ground.

The key risk to the **Sydney CBD office** market stems from ongoing economic underperformance, than any disequilibrium originating from space fundamentals. Not having had the direct economic stimulus from commodities-driven activity, Sydney office market has not had the supply pipeline that is about to severely test other centres. To the contrary, an extended period of weak economic and labour market outcomes in NSW, associated confidence effects together with credit issues have created a complementary set signals to both sides of the market that are likely to leave fundamentals only slightly weakened. Face rentals stalled in the second half of 2008 and are likely to fall slightly over 2009. A very subdued run-up in rentals in recent years will be a powerful limiter of downside risks. However, with markets expecting further generalised yield softening over this period, capital value indicators will continue to fall.

Melbourne CBD office market fundamentals are still in reasonable shape but are expected to deteriorate on lower net absorption. Solid pre-commitment level on new supply suggests managing back-fill vacancies will be the key challenge in the years ahead. Prime rentals should remain around existing levels with some downside stemming from sentiment effects. But Melbourne's relatively favourable rental affordability conditions suggest a robust outlook once the market finds it feet. In the meantime, capital values will continue to edge down further as the tail-end of the yield decompression process impacts in 2009.

Brisbane CBD office market is set for a significant adjustment. Record supply coming on in 2009 is only two-thirds pre-committed. Reflecting almost zero vacancies, spot rentals more than doubled in the past three years, but with the Queensland economy now slowing sharply, absorption levels will fall significantly just as new supply is accelerating. Brisbane CBD vacancies are set to rise to around record levels. Spot rentals are forecast to decline significantly, incentives will rise and combined with further market-wide yield softening, imply a sharp fall in values in the short-term.

Adelaide Core office market is a different story. The strength of the S.A. economy has surprised many. Record absorption and only moderate levels of new office supply have caused the office market to tighten substantially. Adelaide is the only CBD whose capital values are still rising. Rental growth in the year to December 2008 was still double digit. While we will see reversal in the demand/supply balance over 2009 and 2010, Adelaide should 'enjoy' fairly solid (albeit softer) rental growth in the years ahead. This is going to outweigh to a large extent any vulnerability to office prices that may stem from a broader market softening in yields.

We are expecting a major adjustment for the **Perth CBD** office market over 2009 and 2010. Strong demand (with deep pockets) feeding from the commodities boom and a sluggish supply response caused vacancies to tighten dramatically and rentals to almost treble in the three years to 2008. All market drivers are now in reverse: commodities prices have collapsed, the supply side is belatedly rearing its head with a record 260,000 square metres coming on over the next two years (a record) and demand for space is set to decline sharply (we expect negative net absorption). The consequences are clear - rentals and capital values will fall sharply.

Ange Montalti

Retail Property

The retail trading environment has been weighed down by poor consumer sentiment and decelerating discretionary (non-food) spending since early 2008. These conditions have led to a significant softening in retail yields, with average yields rising by 0.3 to 1.8 bps across all geographies and retail segments by the end of 2008. With rents rising by a much smaller magnitude over the same period, this indicates significant falls in capital values. Average retail property yields in December were lowest for regional and neighbourhood space (6.2% and 6.8%) and highest for CBD and bulky goods retail space (7.2% and 8.4%). This is consistent with recent anecdotal reports of strong investor demand pushing up sale prices for small to medium retail properties — no doubt as an alternative to hard-hit equity-based investments.

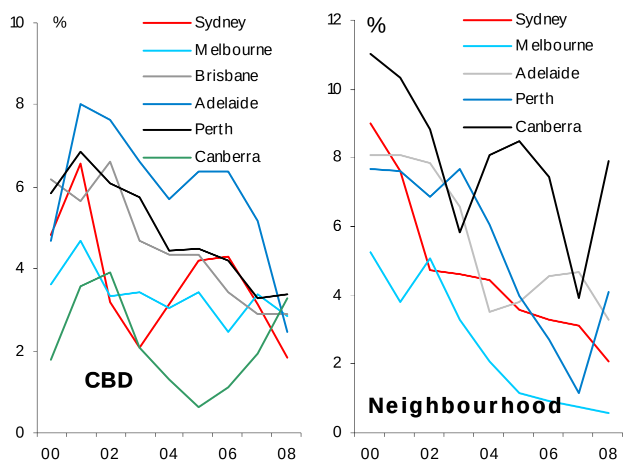
Regional shopping centre trends

	Average rent change, % p.a.		Median equivalent yield, %	
	2008	*2009f*	*2008*	*2009f*
Sydney	5.0	2.0	5.75	6.25
Melbourne	3.2	2.5	6.25	6.50
SE Qld*	3.8	3.0	6.25	6.75
Adelaide	4.8	2.5	6.25	6.75
Perth	6.4	3.0	6.25	6.50
Canberra	4.5	2.5	6.25	6.50

Source: JLL

Retail vacancies were still low by historical standards at the end of 2008, but were already rising in some locations, such as Canberra (all retail) and Perth (neighbourhood). Low vacancies were maintained despite a record 819,000 sqm of new retail floor space being added nationally in 2008, the highest annual addition in at least twenty years.

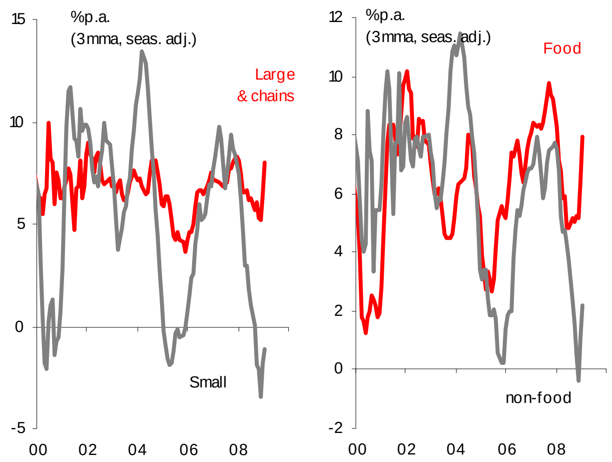
Vacancy rates* low now, but will rise in 2009



* Annual average vacancies. Source: JLL.

These low vacancy rates will provide an initial buffer for landlords, but are likely to rise through 2009. Retail turnover growth tends to be more volatile (and often weaker) for small than for large/chain retailers, and for non-food than for food retailers. This greater volatility will render small, discretionary retailers more vulnerable to the current downturn.

Retail turnover growth is more volatile – and vulnerable - for smaller and non-food retailers



Source: ABS and ANZ.

Given these headwinds, rental growth and yields will soften across the board in 2009. In **NSW,** nominal retail turnover growth has been below the national average in every month since September 2007. JLL expects Sydney's regional retail rents to grow just 2% (against 5% and 4.8% in 2008 and 2007), while average annual yields will weaken by 8.7%, from 5.75% in 2008 to 6.25% in 2009 and 2010. More positively, 2008 saw 68,000 sqm of regional retail space added, but just 11,824 sqm is due for completion in 2009. This should help to keep non-CBD retail vacancy rates relatively tight.

A similar outlook is expected for regional retail returns in **SE Qld** and **Adelaide**, with rents increasing by 3% and 2.5% respectively, and yields softening from 6.25% to 6.75%, in both states. SE Qld is expected to add 26,000 sqm of regional retail space in 2009 (after none for two years), but Adelaide has no regional space due for completion.

Victorian state final demand shrank in September 2008 (-1.7%) but limped through December (+1.2%) with above-average retail spending growth. JLL forecasts prime regional retail rents in Victoria to grow by 2.5% in 2009, while yields will soften to a lesser extent than elsewhere (by 25bps), from 6.25% to 6.50%. Melbourne will add 22,000 sqm of regional retail and 85,270 sqm of sub-regional retail space in 2009.

Western Australia has hit the end of its magical boom. As the effects of the downturn widen in 2009, average regional rent increases will halve to 3% (from 6.4% in 2008) and yields will soften by 4%. Perth will add 30,000 sqm of regional retail space in 2009, about the same as in 2008.

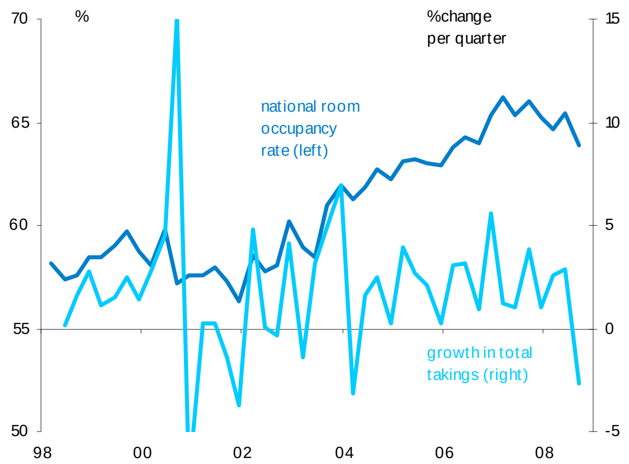
Julie Toth

Tourist accommodation

As of September 2008, there were 4,267 larger hotels, motels, serviced apartments and guest-houses (15+ rooms) in Australia, providing 634,000 beds in 220,000 rooms, up 2.5% from a year earlier. Although modest, this growth in room and bed numbers to Sep 2008 was double the pace of a year earlier and higher than the five year average growth rate of 2% p.a. Another 1,904 small operators (with 5 to 14 rooms) offered 54,000 beds in 18,000 rooms, up just 0.7% over the year. The data imply their room and bed occupancy rates are around one ppt lower than their larger counterparts.

After many years of stable occupancy rates and solid revenue growth among larger accommodation providers (15+ rooms), demand began to slide in Sep 2008, with the national room occupancy rate falling a further 2.3% to 65.3% — down 3.5% from the recent peak of 66.2% in March 2007 and the biggest national quarterly fall since Sep 2000. Total takings contracted by 2.7%, the first quarter of decline since Mar 2004. Activity in the hospitality sector more broadly (accommodation, restaurants and cafes) has been weak for some time, with the sector's real gross value added falling in every quarter of 2008.

Occupancy rates and takings begin to slide

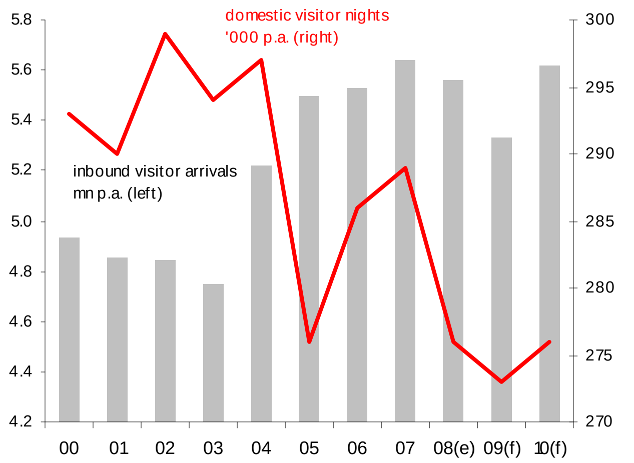


Source: ABS (seas. adj. data to Sept Qtr 2008).

Growth prospects for 2009 look poor. The Tourism Forecasting Committee (TFC) expects international visitor arrivals to fall by 4.1% (and real spending to decrease by 3.6%), after already falling 1.5% in 2008. Inbound business travellers will be the weakest source of demand, declining an expected 5.6% in 2009. The TFC hopes inbound visitor numbers will rebound in 2010 (up 5%), but this seems unlikely given the outlook for world growth. Australia's main tourism and business travel markets — New Zealand (the source of 20% of total short-term visitor arrivals), the UK (12%), Japan and the US — now face a protracted recession, so the inbound travel market will remain tough.

The domestic travel market also looks challenging. The TFC expects domestic visitor nights to fall by a more modest 0.9% in 2009, after a 4.5% fall in 2008. Business travel will contract as businesses seek to reduce costs and leisure travel is already being hit by tightening consumer spending. More positively, the weak A$ and newfound thrift makes local holidays more attractive than overseas ones — but this will not be enough to outweigh all these challenges. Jones Lang LaSalle suggests the weaker A$ will also attract increased counter-cyclical interest from Asian investors, in anticipation of a long-awaited pick-up in Australian hotel asset transactions, including increased distress sales and including assets at the top end of the market.

Inbound and local visitors to fall in 2009



Source: Tourism Forecasting Committee, Dec 2008.

Large geographic differences remain apparent in this market. September's room occupancy rates were highest in **WA** (68.1%) and **Canberra** (67.9%), driven by busy mining and government activity respectively. But even in these high-demand markets, occupancy rates fell in September 2008. At the other end, **Tasmania** recorded the only increase in occupancy, but continued to hold the lowest rate (60.7% seas. adj.). In the same quarter, total takings fell in all states except Tasmania and the NT. The biggest quarterly falls in total takings were in Canberra (-14.4%) and WA (-4%, seas. adj.), indicating that their high occupancy rates were maintained through some heavy price discounting. Indeed, average takings per occupied room night fell 8.6% in Canberra, 0.1% in WA and 0.2% in Tasmania (QoQ), but increased in all other markets. Little new supply is expected to come onto the market in 2009, across all geographies.

Looking ahead, reduced business and leisure travel from both domestic and inbound sources will see further falls in occupancy rates and takings across all markets, including WA. **Canberra** is likely to continue to outperform other markets (in terms of occupancy rates if not takings) due to strong government-related demand, generated from a record number of ongoing committees and inquiries.

Julie Toth

Industrial property

The economic downturn will impact heavily on the industrial property market. Although there may be some benefit for manufacturers from a lower Australian dollar, weak demand conditions both domestically and globally will continue to impact performance. The softening domestic economy is expected to significantly curb imports and lead to a run down in stocks reducing demand for warehousing and storage space. These factors were evident in the Q4 GDP figures. The manufacturing sector contracted close to 5% in the quarter and inventory levels fell sharply. Business sentiment has remained weak in recent quarters and investment is anticipated to contract throughout 2009.

The lingering global credit crisis is also impacting on industrial markets with expansion plans being postponed or cancelled with finance being both difficult to access and relatively expensive. The current environment for industrial property is poor and will continue to deteriorate through 2009. Some support may come from the Federal government stimulus package with a strong focus on infrastructure spending. Yet this spending will more likely aid in the recovery of the sector over the medium term rather than proving to be a short term saviour. Most capital city industrial sectors are now well in to the downturn. The Sydney market has weakened most, with Melbourne so far performing better due to recent quality additions to infrastructure.

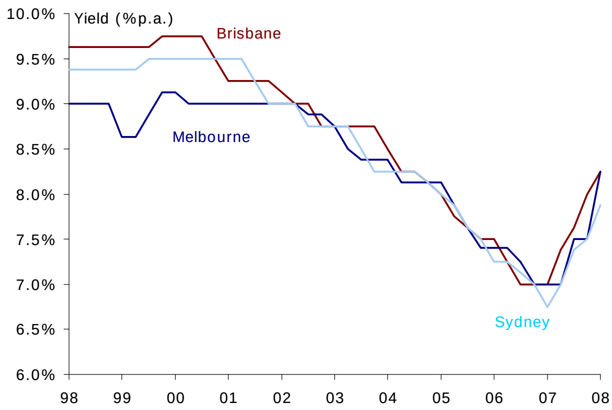
Supply conditions in the industrial market have been very strong in recent years with 2007 and 2008 both seeing in excess of 2.5mn sqm of additional space added. However, the onset of much tougher credit conditions and a slowing economy in late 2008 has seen demand fall off significantly with gross take-up weakening particularly in the eastern-seaboard capital cities. The solid pre-leasing that had seen demand remain solid in much of early 2008 dropped off late in the year foreshadowing ongoing weakness in demand for industrial property going forward.

In response to the threat of oversupply, we anticipate that a significant proportion of new supply slated for completion in 2009 will be delayed or postponed indefinitely as the market reacts to rapidly changing conditions. This will likely see completions reined into to just over 1.0mn sqm through the year. With pre-commitments now becoming rarer, speculative development has evaporated. Further, with industrial construction work in the pipeline plateauing in recent quarters and approvals falling across the sector, well below average additional space will be added to the market in 2010.

Despite this, the strong volume of additional space in recent years sees the market amply supplied. As such, as demand has softened and rental growth has slowed sharply (and in some cases contracted) across most capital cities. Pre-lease rental growth has remained solid, yet as these deals become less prevalent market rents will most likely soften further. It is anticipated that rental growth will be very weak in 2009 and 2010. Melbourne and Brisbane should on the whole record small increases, with the risk of falls in rents in the Sydney market.

Cap rates are on the way up (..and up?)

Industrial property yields – prime sector



Sources: JLL, ANZ

With thin transactions across the market there have been limited opportunities to test capital values. Despite this, uncertainty of income and rental streams has put valuations in the industrial property sector under pressure. Yet, there has been some support for valuations from the relatively low real long term bond yield. Yields in industrial property have compressed more than the more fancied sectors of office and retail over recent years. As such the historical risk premium of industrial property will now see yields soften more than other sectors.

Prime yields have already eased around 100-150 bps and secondary yields between 150-200 bps with much of these moves occurring in the fourth quarter. The historical geographic and asset grade premia that had narrowed in recent years are now re-emerging.

The risks to industrial property market are predominantly to the downside. Investors are likely to remain cautious in the current environment. Although we do not anticipate any further tightening of credit conditions a significant worsening of the economic outlook could force sales in a thin market seeing capital values continue to fall.

Alex Joiner

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