Economics@ANZ

ANZ Australian Property Outlook

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Inside:

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For Economics@ANZ to be the most respected, sought-after and commercially valued source of economics research and information on Australia, New Zealand, the Pacific and Asia.

Inside

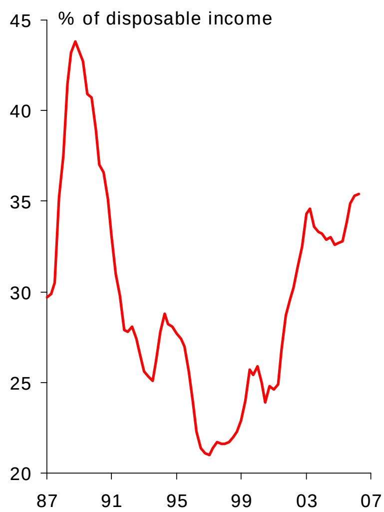
Economic Overview

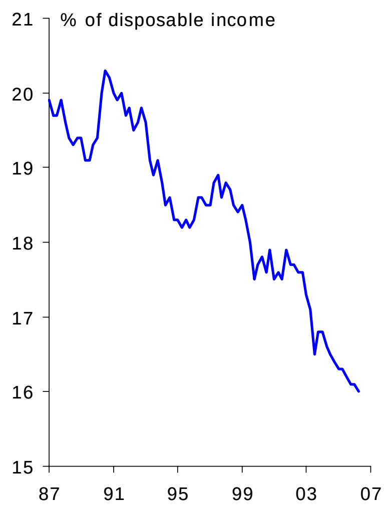
The Australian economy has accelerated in 2007. Buoyant labour and equity markets have supported household income growth and strong global growth and a breaking of the drought will provide further impetus in 2007-08. Rising inflationary pressures drove the August interest rate hike and still suggest the next move will be upward.

Residential Property

The housing market is reaching crisis point. Prices are reaccelerating, rental growth is up strongly and vacancy rates are plunging towards record lows. However, despite strong housing demand and a robust economy, building has stayed worryingly low. Affordability for both renters and would-be owners is set to worsen over the medium-term. Indeed, a chronic shortage of housing will intensify pressure on rents and established house prices going forward. While these factors present strong signals to build, monetary policy and tight builder margins on greenfield development will continue to delay a much needed recovery.

Purchase affordability has deteriorated but rental has improved





Source: ABS, Economics@ANZ

Commercial Property

CBD office markets continue to tighten with vacancy rates now having fallen continuously since 2004. Rental adjustments and further yield compression will underpin strong growth in capital values. Despite the risk of higher interest rates and petrol prices over the coming year, retail sales growth is likely to remain above-trend, bolstered by increases in disposable income and low unemployment. The tourist accommodation sector continues to record healthy gains in terms of occupancy rates and room rates and the outlook remains positive.

Economic Overview

Economy remains very supportive…

Booming property markets have been bolstered by solid growth in the domestic economy. Australia has enjoyed a 'golden' decade and a half without recession and the strength of current conditions in the household, business and public sectors (and the notable absence of any serious imbalances) suggest this record breaking run will continue. Following a modest slowdown in 2006, the economy has rebounded this year and appears set to strengthen further, driven by booming global growth, expanding resource investment/production, strong infrastructure spending and the breaking of the drought. After moderating to just 2.7% in 2006, GDP is expected to accelerate and register growth of 4.2% in 2007 and 4.1% in 2008. Sizeable employment and wages gains combined with generous tax cuts and buoyant equity markets have boosted household income which in turn has underpinned strong household spending and home sales. Solid labour demand and increased workforce participation lifted employment growth to 2.8% over the year to June and lowered the unemployment rate to a thirty three year low of just 4.3%.

While dwelling starts and approvals have fallen, dwelling investment has actually risen significantly (+9.5% over the year to March) supported by a huge backlog of work yet to be done. Extremely tight home rental markets are already forcing rents and rental yields higher and with new supply currently running well below underlying demand, these pressures will intensify. The looming housing crisis will eventually attract investors and developers back into the market and the coming housing upturn will be both vigorous and sustained.

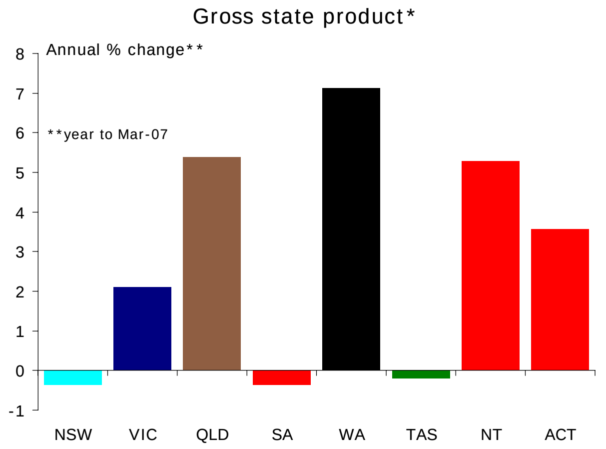
Business investment has also buttressed growth in recent years buoyed by the resources boom, record levels of engineering construction activity and solid demand for new retail, office and industrial space. The near-term outlook remains positive led by the massive lift in infrastructure spending announced in the recent round of state budgets. Moreover, the escalation in commercial property returns is leading a new wave of pre-committed and speculative building activity. While the high exchange rate is hurting competitiveness (particularly in the manufacturing sector), exports are forecast to contribute significantly to growth in the years ahead, supported by voracious Chinese demand for commodities and a sharp rise in productive capacity following the boom in resource investment experienced in recent years.

Tightening labour markets and skilled labour constraints have boosted international migration which combined with a 'mini baby boom' lifted population growth to 1.4% in 2006 and we expect further gains in net international migration and population in the years ahead.

…but state growth remains uneven

The phrase 'two speed economy' has been coined in recent years to describe the out-performance of those states benefiting most from the commodity boom (Western Australia, Queensland and the Northern Territory) while activity in other states has been more subdued. New South Wales has been firmly stuck in reverse for the past five quarters, and both South Australia and Tasmania experienced mild recessions in the past year. Divergent economic outcomes have been a major driver of property markets with the New South Wales housing sector weakening sharply, while most other markets have enjoyed solid house price gains.

State growth varies widely



Source: ABS, Economics@ANZ * Real state final demand plus net international exports

Reserve Bank policy dilemma

Accelerating economic activity has renewed upward pressure on inflation and interest rates. A sharp jump in core inflation in the June quarter drove an official interest rate hike in August and both inflationary and policy risks still remain skewed to the upside.

However, the Reserve Bank will face an increasingly stark policy dilemma in coming years; rising interest rates are directly eroding housing affordability by lifting required repayments, but more importantly they are also restraining new home building activity and intensifying the issues surrounding a critical shortage of affordable housing. New dwelling supply is running *well below* underlying demand, and interest rate hikes will further delay any recovery home building, driving rents and prices higher. Nonetheless, robust economic growth and rising inflationary pressures are likely to force the Reserve Bank's hand yet again next year, suggesting both home purchase and rental affordability *will continue to deteriorate sharply* in the years ahead.

Paul Braddick

Residential Property

Difficult affordability – get used to it.

Much attention has been given to housing affordability in recent years. Most measures show unequivocally the percentage of income required to service a loan on a typical dwelling has increased sharply over the past decade. On Economics@ANZ's measure of house purchase affordability, the repayment burden has increased from 22.3% of disposable income in 1997 to 35.2% of income in 2007, its highest level since 1991. Despite widespread debate, there is considerable misinterpretation of affordability measures and a general misunderstanding about the drivers and nature of the affordability 'problem'. As a consequence, many suggested policy solutions (land release, tax incentives - to savers, renters, and investors, first-home grant extensions, shared equity schemes etc) are likely to miss the mark, potentially fuelling the 'problem'. Essentially, proposals that directly or indirectly promote demand for housing are likely to manifest in higher prices. Supply proposals such as accelerated land release or developer incentives to produce low cost accommodation are also no panacea for dealing with the general affordability 'problem' but could be effective within a social policy framework to combat extreme affordability circumstances.

Affordability decline is market induced

A distinction needs to be made between a 'deterioration in measured affordability' that is driven by price rises and one that is driven by rising in interest rates. The former is generated from 'within the market' whilst the latter is policy-induced. The former generally occurs when confidence is high (demand) while the latter is imposed to alter market behaviour (policy). In the late 1980s, a booming economy drove house prices higher; mortgage rates followed, propelling the typical repayment burden up to 44% of income in 1989 – the highest on record. It had fallen back to 38.9% a year later. This time around, the rise in the burden so far over the decade to 2007 attributable to interest rates is less than 1% of income with the bulk (12.1% of the total 12.9%) attributable to higher house prices.[1]

As with any market, house price outcomes reflect the combined effects of shifts in supply and demand for dwellings. In this context, it is not the supply of *new* dwellings *built* per se that matters but the demand for and supply of both new *and* established stock *that presents to the marketplace*. The flow of *new* dwellings is critical to maintaining fundamental balance (i.e. "bums on seats" irrespective of whether tenure is ownership or tenancy) but the flow of new dwellings also comes into play in the broader context of maintaining a balance between those wishing to buy and sell dwellings (investors and occupiers). The only reliable barometer or market-clearing mechanism here is the house price. Importantly, variations in prices growth across localities play an important role in signalling to the market how the balance between demand and supply is playing out and to investors/builders specifically where new investment should be located.

While pent-up demand for dwellings could be helping to underpin prices growth at present, such a condition did not exist between 1997 and 2003 (when the market was balanced), a period which saw prices more than double. 'Fundamentals' can be discounted as a key driver of the rise in house prices over this period. We must therefore look to other developments. The structural decline in interest rates over the first half of the 1990s is often cited as a key driver. While this made a significant contribution, it does not explain the full extent of prices growth.[2] The fact that affordability has moved well beyond long-term average levels suggests there have been other forces at work. A halving of the capital gains tax in 1999 is one worthy of mention. This measure increased potential after-tax return and by definition boosted threshold values for a significant proportion of the market.

Probably the most important development has been the direct and indirect effects of an extended period of economic stability. This experience has engendered a high level of household confidence. Stemming from a perceived lower risk of joblessness, householders are now prepared to borrow more to achieve home-ownership. Together with ongoing tax advantages, owner householders have generally been attracted to investing in bigger and better homes. On the other side of the same coin, the suite of available lending products and funding sources has broadened considerably. Traditional rules on lending have made way for a diverse set of criteria, effectively raising potential borrowing limits and enabling households to borrow more funds per dollar of income. The chart below highlights the potential increase in average borrowing limits from a hypothetical shift in eligibility criteria.[3] The gradual evolution of the mortgage market in a deregulated environment, a history of low default rates and more recently, relative stability in interest rate and economic cycles

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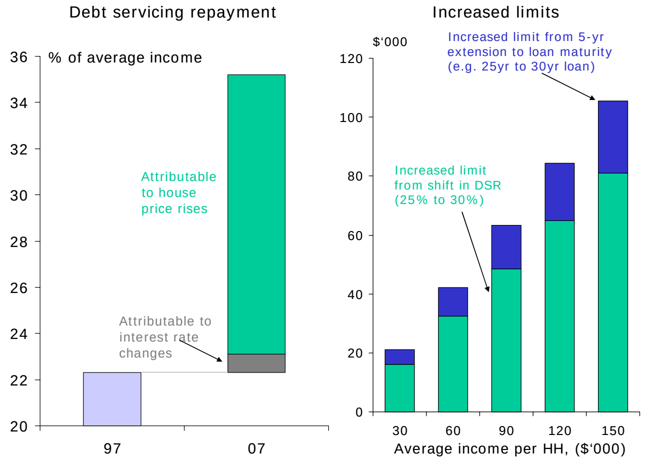
[1] This assumes the standard variable rate. A greater incidence of discounting is likely to have reduced the interest rate impact to something below 1% of income, possible even to below zero over this period.

[2] If it did, the interest burden for a typical dwelling will have reverted to somewhere around its long-term average and not beyond it.

[3] The chart assumes the current standard variable rate. The lower the rate, the greater the potential lift in borrowing limits from any constant shift in eligibility criteria.

suggest this credit environment has developed as a rational response to a reassessment of risk. In a strong economic environment, this is likely to manifest in higher house prices. The affordability 'problem' is created and solved in the same stroke.

It's the market

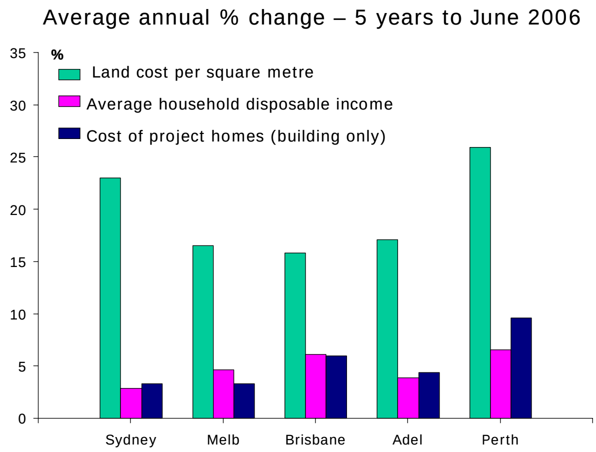


Source: ABS, RBA, Economics@ANZ

What about the cost side?

Claims are often made that the heightened cost of residential building has been a key contributor to the deterioration in affordability. This is not supported by data. The 'all capitals' cost of project homes (materials, labour and builder margins) over the past decade has escalated at roughly the same rate as average incomes, suggesting at worst a small additional burden from the cost side[4]. Indeed, in the Eastern seaboard capitals, the cost of project homes has risen at a *slower* rate than average incomes over the past decade.

Building costs *not* driving affordability down



Sources: ABS, UDIA, Economics@ANZ

Higher infrastructure costs associated with new land development are now seriously challenging the economics of fringe development. The burden of such imposts has shifted upwards by varying degrees across the capitals. The incidence of this additional cost burden is difficult to pin down but should reflect to some extent in average land prices[5]. Vacant lot prices *have* surged (by between 15% and 25% per annum over the past 5 years), reflecting an imbalance between lot supply and lot demand from developers. The implied land value on capital-improved lots too (established market) has in all likelihood been the main component driving "house price" growth over the past decade but in sought after localities is more likely reflect demand strength than higher costs.

The combined cost-push and investor-demand-pull impact on land prices in greenfield localities has coincided with a flattening in house prices, with fringe areas doing relatively poorly. Rising fuel costs, a shift to user-pays system for infrastructure and the ongoing shift in socially-driven preferences for inner-city location have altered the economics of fringe development. As a consequence and if such a trend continues, the solution to the general affordability 'problem' is less likely to be seeded in fringe development. Prices momentum in inner-city locations remains strong. The case for building more well-located, medium-density and "highish" rise developments remains compelling.

Rental affordability – worse to come

Using Census data, Economics@ANZ has estimated the percentage of incomes paid to landlords was effectively flat in the five years to 2006 (20.2% to 20.4%). This average rental burden masks variation across the spectrum, with the bottom decile paying upwards of 60% of income and the top decile paying less than 10%. There has also been a *slight* rise in the share of renters that pay greater than 30% of their income in rent (from 30% to 33%). The bulk of these households is in the lower income ranges. There has been solid growth in the number of renter households in the middle income ranges over the past five years. Stemming primarily from more difficult purchase affordability conditions, this compositional shift has placed a significant downward influence on the *average* rental burden even though the burden within each income range has generally risen.

From a broader perspective, rentals are at their most affordable level in a 23-year record[6]. Vacancy rates are at historically low levels and the economy and the jobs market are strong. The scene is set for a medium-term re-calibration of rentals that will serve as a key signal to restore balance to the rental and broader market. The 'stress' being experienced by low income (tenant and owner-households) is unlikely to be redressed via broad housing market developments but more sensibly by carefully targeted income support or incentives to provide low cost rental accommodation.

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[4] This does not account for the alleviation in burden from the first home owners grant.

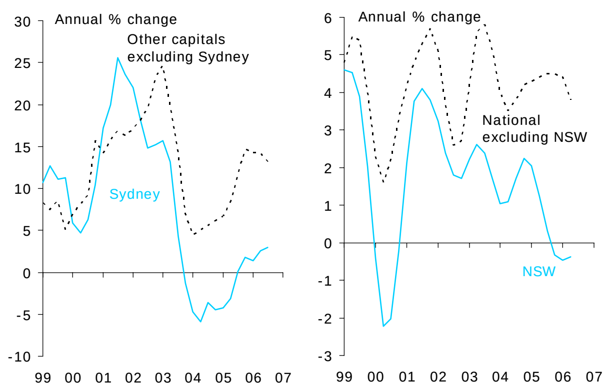
[5] Depending upon market conditions at the time, none, some or all will be passed on through the various stages of production to the ultimate dwelling owner.

[6] Here, we include the incomes of *all* households, not just those in the rental market already.

New South Wales

While impaired housing affordability and the ill-timed introduction of the vendor tax played their parts, the stark underperformance of the New South Wales housing market in recent years is largely attributable to a sustained slump in the state economy. New South Wales has been in 'technical recession[7]' over the five quarters since the end of 2005.

NSW 'recession' weighs on house prices



Sources: ABS, Economics@ANZ

Sydney's median house price fell by 7.3% between December 2003 and March 2007 and home sales have plummeted, particularly in the investor market. Market weakness is concentrated in the western and outer suburbs where price falls have been even more dramatic. In contrast, the top end of the market has remained well supported with double digit price gains experienced in Vaucluse, Queens Park, Palm Beach, Longueville and Darling Point over the year to March. Moreover, Sydney's median price jumped encouragingly in the June quarter

Developer sentiment has been hammered by a nasty combination of reduced house prices, weakened sales and sharply higher infrastructure costs. Tentative signs of recovery in building approvals in early 2006 were quickly snuffed out by three interest rate hikes and new dwelling approvals in May this year were a full 50% below their peak in September 2003. New supply is now falling well short of underlying housing demand and looks likely to do so for a number of years.

As a consequence the housing market has tightened significantly with the Sydney rental vacancy rate plunging to a ten year low of just 1.4% in the March quarter. Inadequate new supply suggests the market will continue to tighten and chronic rental shortages will be a seemingly intractable feature of the Sydney market for the next several years. However, rents are now beginning to accelerate and record low vacancies and improved rental returns should be the catalysts for renewed investor and developer interest in 2008. Nonetheless, any lift in house prices and building activity will rely heavily on a continuation of the recent tentative signs of improvement in the NSW economy.

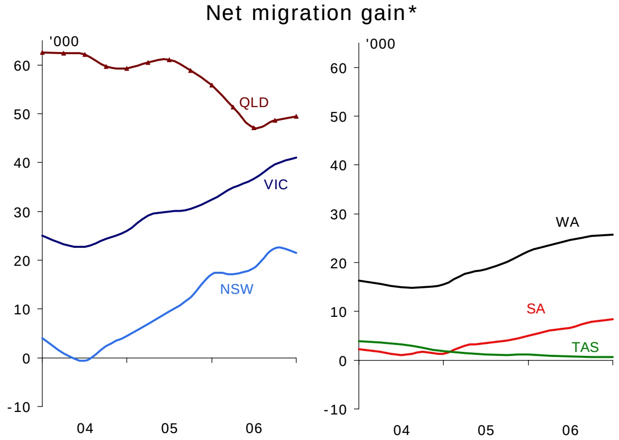
Victoria

The buoyant Victorian housing market stands in stark contrast to NSW, owing much to a far more supportive economic environment. The Victorian economy has grown at rates just below the national average.

The home sales market has improved markedly in 2007 with clearance rates, sales volumes and prices all well above year earlier levels. The median Melbourne house price was up a solid 11.5%[8] over the year to June 2007. Many suburbs are experiencing boom-time conditions with huge premiums over reserve prices becoming commonplace and several inner suburbs have seen price gains above 40% over the year to June (including Surrey Hills 45.5%, Prahran 42.7%, Port Melbourne 40.5%). The renewed strength in the sales market is also reflected in a marked rebound in housing finance with owner occupied finance commitments up 15% and investor finance up 25% over the past 5 months alone.

The Melbourne rental market has tightened substantially in recent years, with rental vacancies down to an 18 year low of just 1.2% in the March quarter. With new housing supply falling well short of demand (combined with a structural shift towards rental markets as house purchase affordability worsens) we expect the vacancy rate to reach record lows in the near future. Rents have already begun to accelerate with median house rents up 9.3% over the year to March[9] and rental affordability looks set to deteriorate dramatically.

Increased migrant intake boosting demand



Sources: ABS, Economics@ANZ *moving annual total

Solid housing demand has been bolstered by increased international migration as Victoria has gained a significantly larger share of the overall migrant intake in recent years.

However, despite a booming home sales market, building approvals continue to languish. With new

[7] As measured by two consecutive quarters of negative growth in trend state final demand plus net international exports.

[8] ABS

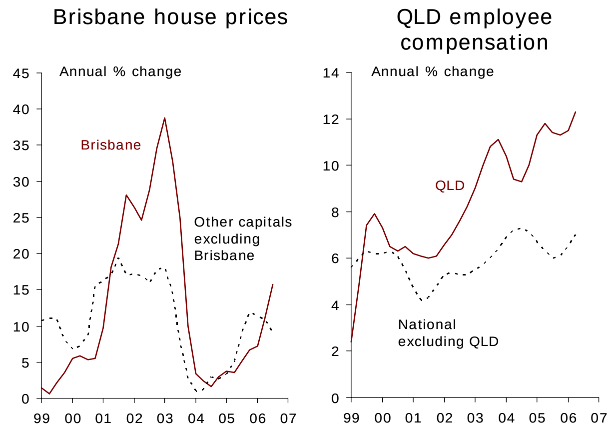
[9] Residex

building activity running well below underlying demand, the fundamental housing demand/supply balance will continue to tighten in the years ahead. Surging rents and scarce vacancies will eventually attract investors and developers back into the market; however, there will be little respite in terms of affordability for either renters or first-homebuyers in the foreseeable future.

Queensland

Along with Western Australia, Queensland continues to reap the benefits of the resources boom. Gross state product[10] has expanded at an average annual rate of 5.4% over the past three years, employment growth has averaged 4.4% and household disposable income has grown by a remarkable 10.2% per annum. Despite this very supportive economic environment, Brisbane house prices remained subdued through 2004 and 2005 but reaccelerated sharply in 2006 and grew by an impressive 15.7% over the year to June 2007. Buoyant home sales are being reflected in a surge in housing finance approvals which are up a solid 30% in trend terms over the year to May.

Strong economy is boosting house prices



Sources: ABS, Economics@ANZ

Rental markets have continued to tighten and rents are rising strongly (up 13% over the year to March).

Unlike NSW and Victoria, the rebound in building approvals in 2006 was not stymied by rising interest rates, and approvals (in trend terms) are up almost 17% over the past 18 months. House approvals have risen sharply while other residential building approvals have remained relatively static.

While the Queensland economy has outperformed, population growth has slowed in recent years as net interstate migration has declined and Queensland's share of international migration has contracted. This slowdown owes much to the earlier house price boom (2002 to 2004) which significantly narrowed Queensland's housing affordability advantage over other state markets. Nonetheless, prospects for the Queensland economy and housing markets remain bright.

South Australia

The South Australian housing market has performed strongly in recent years supported by solid household income gains and a surge in international migration that lifted annual population growth from 9,300 in 2004 to 16,150 in 2006.

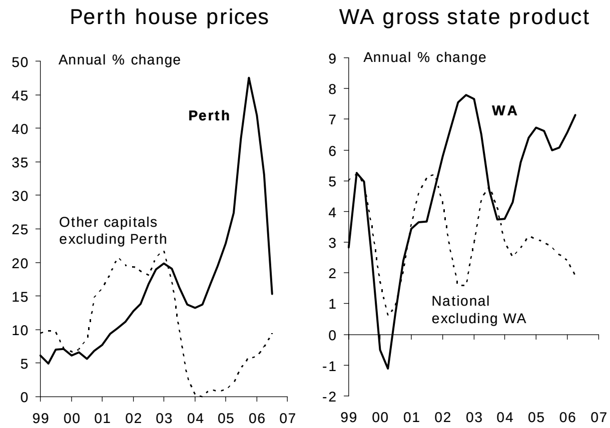
Consequently, underlying demand for housing has risen and Adelaide's median house price climbed 11.7% over the year to June 2007. Continuing momentum and buyer confidence is evidenced by a steady upward trend in housing finance, particularly in the investor segment. The Adelaide housing market remains extremely tight with the rental vacancy rate at just 0.9% in the March quarter and like other capital cities, rents are accelerating.

However, while housing fundamentals remain supportive, weakening economic activity could weigh on market outcomes in the year ahead. In recent quarters employment has stalled and economic growth has weakened sharply. The rising Australian dollar is making life increasingly difficult for the manufacturing sector, the drought has hurt farm incomes and the state is now in technical recession following two consecutive quarters of negative growth[11]. Moreover, while state government programs to attract international migrants have been very successful, South Australia is still losing significant population numbers to other states (2765 in 2006) and the trend is rising sharply. Diminished relative employment growth may exacerbate this outflow in 2007/08.

Western Australia

The Western Australian property market has cooled over the past 12 months, however, commentary foreshadowing a marked correction in Perth house prices is misguided and we continue to expect a soft landing.

Buoyant economy will support housing



Sources: ABS, Economics@ANZ

Home sales and finance approvals fell abruptly in the second half of last year, but have rebounded strongly in 2007. While house price growth has

[10] As measured by trend state final demand plus net international exports.

[11] As measured by trend state final demand plus net international exports.

clearly decelerated following three interest rate hikes last year, Perth's median house price still grew by a massive 15.3% over the year to June 2007.

Despite challenging housing affordability, our ongoing confidence reflects the fact that economic and housing market fundamentals remain *very* supportive. Trend growth in state final demand plus net international exports has accelerated and was a remarkable 7.1% over the year to March. Population growth and underlying housing demand have also risen substantially buoyed by robust growth in international and net interstate migration. Consequently, the housing market has continued to tighten with the Perth rental vacancy rate down to just 0.8% in March.

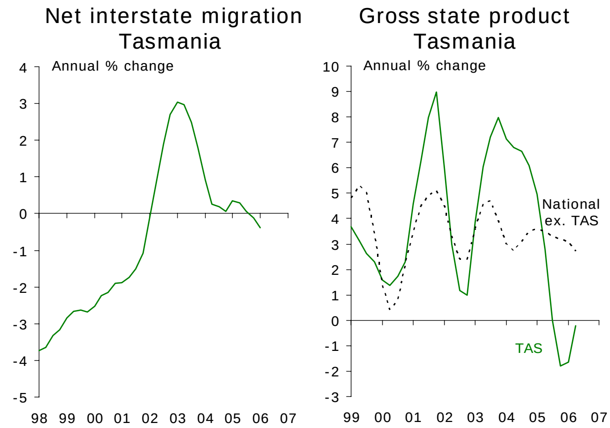
Difficult housing affordability may restrain further house price growth, however, the ongoing boom in the state economy and acute housing shortages will continue to provide support.

Tasmania

Like South Australia, the Tasmanian property market has performed well, despite a marked slowdown in economic activity. The median house price rose by a solid 9.7% over the year to June and a reacceleration of housing finance approvals in recent months suggests this positive momentum has continued.

However, Tasmanian economic activity slowed significantly last year with state final demand plus net international exports down 0.2% over the year to March. Employment growth slowed to just 0.5% over the year to June and after reaching a peak of 300 persons in 2003, net interstate migration has deteriorated sharply with a loss of 390 people recorded in 2006. Tasmanian population growth has halved from 1.25% in 2003 to 0.6% in 2006. Nonetheless, the worst of the economic downturn was in the first half of 2006 and activity has strengthened in the December and March quarters and a breaking of the drought will provide a substantial boost to farm output and income in the year ahead.

Economic fundamentals have weakened



Sources: ABS, Economics@ANZ

The Hobart home rental market has not experienced the same degree of tightening as other capital cities with the vacancy rate remarkably stable at 2.2% over the past 4 years. However, vacancies remain well below their long-term average and median rents have surged by 12% over the year to March driving a significant deterioration of rental affordability.

Northern Territory

The Darwin housing market continues to perform strongly, underpinned by robust economic growth and solid population gains. The resources boom has boosted business investment and exports substantially in recent years and job opportunities have expanded sharply. Employment was up 4.7% over the year to June, population growth has rebounded (+1.8% in 2006) and the underlying demand for housing has risen.

Darwin house prices have enjoyed a remarkable run, doubling over the previous five years and the median house price is now *higher* than both Melbourne and Brisbane). Momentum has slowed, but house prices still rose 7.4% over the year to June 2007. Household incomes have also risen substantially, but housing affordability has deteriorated sharply and may limit future growth.

Housing finance demand has decelerated in the past year, although the decline has been concentrated in the owner occupier segment while investor demand remains very strong buttressed by attractive rental yields and solid capital appreciation.

Australian Capital Territory

Canberra house prices have risen impressively, growing by 9% over the year to June supported by a buoyant ACT economy and accelerating population growth. Public sector activity and employment grew sharply in 2006 and the ACT economy expanded by 3.6% over the year to March. A healthy labour market has lowered the unemployment rate to just 3.1% in June and a solid Commonwealth Budget outlook augers well for future growth in ACT activity and employment. Household income growth in the past year outstripped all other states and territories and continues to support growth in house prices.

Rental markets have tightened further with the vacancy rate down to just 1.3% in March and rents have risen sharply, up 14.8% over the year to March. Both owner occupied and investor finance are increasing strongly with overall housing finance up a massive 35% over the year to May.

While Canberra's median house price has now topped $400,000 (behind only Sydney and Perth), housing affordability remains *stronger* than all other capitals due to the fact that average ACT household income is *far* higher than any other state or territory. Standard repayments on the median home represent just 23.8% of average ACT household disposable income compared to a national average of 35.4%. Consequently, housing affordability will be less of a constraint on future house price growth in Canberra than in other capital cities and buoyant income growth should encourage ongoing gains in house prices.

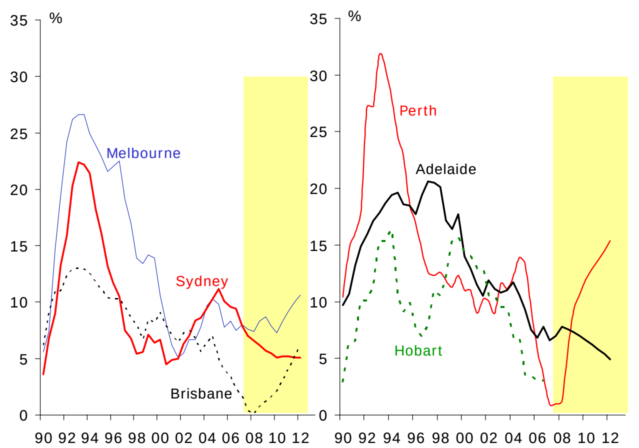
Ange Montalti & Paul Braddick

Office Property

Office markets are tightening

Fundamentals in office markets have improved markedly in the past two years. CBD vacancy rates have fallen from 10.2% in July 2004 to 6.2% in January 2007. Continued employment growth in the year ahead combined with a moderate level of new office supply points to a further tightening over 2007. Vacancies are set to break through to their lowest level since 1990 (low 5s) by the first half of 2008. From there, we expect a gradual easing in conditions as the supply response gathers momentum.

Office market has tightened



Source: Property Council of Australia, Economics@ANZ

Tighter conditions have been a key driver of office values over the year to March (+9.4%). That said, they are barely higher today than they were *prior to* the late 1980s boom. A resilient economy, a profitable business sector and reduced risk aversion are providing a favourable backdrop to market conditions. Given historically low starting point for office prices, there is considerable scope for recent price momentum to continue over the next year or two, backed by rental growth and further yield compression.

While some rise in vacancies is in prospect later in the cycle, forecasts of supply are based upon known committed and already mooted projects reported by the Property Council of Australia. A blow-out in vacancies could ensue if the supply response gathered additional momentum in response to improved investment performance. However, this is unlikely to present as a problem until 2010 at the earliest if at all, particularly with interest rate rises over the next 12 months and competition for resources from other building sectors on the cusp of a cyclical upturn.

Despite the NSW economy being in technical recession in the past year, fundamentals in the **Sydney CBD** office market have remained solid. Reflecting this, office values have lifted by over 10% in the year with *total* returns of around 17.5%.

A moderate supply pipeline (partly a reflection of weak economic growth and partly available site limitations) will avert any weakening in market fundamentals, providing support to market values over next two or three years.

Melbourne CBD office market fundamentals have remained relatively stable for the past couple of years with the vacancy rate oscillating around 8%. Absorption should recover to just below trend levels over the coming year but with an upward revision to projected supply, vacancies are expected to hold in the current range until 2010. Beyond this period, vacancies are projected yet again to breach double-digit levels. Office returns have been modest over the year to March 2007 with capital growth of just 3.4% and a total return of 11%. Any quick run-up in prices in the next couple of years leaves this market exposed to the potential for over-production. With minimal site constraint and a fertile Docklands precinct, some run-up in vacancies is expected from 2011.

The **Brisbane** office market is set to tighten sharply. Unrelenting absorption and a limited supply response will see vacancies fall to record lows. However, a strong pipeline of activity committed and/or mooted over the next few years and a surge in office building approvals in recent months will see this pattern reverse from a zero effective rate to a still 'tight' 5% by 2012. Reflecting both a strong economy *and* tight office market fundamentals, total returns in the Brisbane CBD have been outstanding in the year to March 2007, rising by over 26%. Given the prospect of a chronic shortage of office space, this strong momentum is likely to be sustained over 2007.

The **Adelaide** office market has been in a tightening phase since 1997 with vacancy rates in the "core" precinct falling from over 20% to 6.6% in January 2007. A slowing in employment will moderate absorption going forward just when supply lifts. This will stabilise vacancies over 2007 and 2008 ahead of a renewed tightening phase beyond 2008. Price growth will remain subdued over 2007/08 with stronger momentum delayed until later in the cycle.

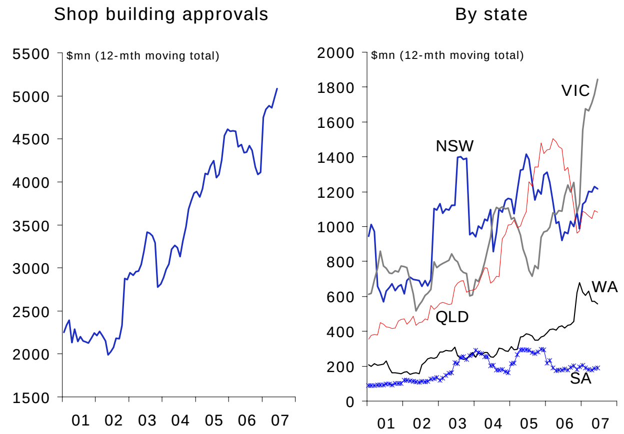
A booming economy has produced the lowest office vacancy rate on record for the **Perth CBD** market, at 0.9% in January 2007. An expected easing in employment growth and absorption over 2007 will do little to offset the impact on vacancies as new supply capacity over this period is also weak. However, a considerable development pipeline suggests vacancies are going to rise quite sharply, reaching 15% by 2012. Solid (up 20%) prices growth has been backed by strong rental growth, implying only a moderate contraction in yields over the same period. With the economy expected to remain strong, there is every chance that yields will firm further and rentals will grow strongly. This implies continued strong momentum in prices over 2007 and much of 2008.

Ange Montalti

Retail Property

The macroeconomic outlook remains supportive of healthy retail sales growth over the next year. Nominal retail sales in the first half of this year rose at an annual rate of 6.6%, much stronger than the 5.8% recorded in 2006. The new financial year has delivered further gains in disposable income and the unemployment rate persists at multi-decade lows. Nevertheless, the risk of higher interest rates and petrol prices over the coming year could slow the pace of discretionary spending but we expect nominal retail sales to continue to expand at an above-trend rate, rising by 6½% p.a. in 2007 and 2008. In volume terms, retail turnover is forecast to expand by 4¼% in 2007 and 4½% in 2008. The performance gap between the resource-rich economies of Western Australia, Northern Territory and Queensland and the south-eastern states is narrowing. This largely reflects a recovery in private spending and investment in the south eastern states and bodes well for retail turnover.

Sales growth supports expansion in retail space



Sources: ABS, Economics@ANZ

The above-trend rate of growth in retail sales has supported renewed growth in retail floor space. We have seen a resurgence in building approvals in recent months. For the twelve months to June 2007, shop building approvals were up 17% from the same period of the previous year. These projects largely consist of extensions to suburban shopping centres and new developments along residential growth corridors.

Overall income returns on retail property have edged down slightly with the breakdown by type of retail showing a more significant decline in yields in some segments over recent years underpinned by vigorous investment demand for retail assets. However, income return on regional retail centres bucked the trend in the March quarter, edging up slightly. Rental growth will continue to be reinforced by a relatively healthy retail sales outlook and low vacancy rates, particularly in CBD areas, and this should support further capital value growth.

Building approvals for the twelve months to June show an upturn in activity ahead in **New South Wales**. Several retail projects in the pipeline include the redevelopment of Pitt Street Mall, Glenrose Shopping centre and Stocklands Merrylands Mall. Retail spending conditions are improving, supported by stronger employment gains and declining unemployment rates.

Construction activity in **Victoria** continues to be brisk with the refurbishments and extensions of a number of suburban shopping centres such as Westfield Doncaster and Westfield Bay City, Geelong as well as the retail precinct of Waterfront City Docklands and Chadstone Place. An upgrade of the Myer Melbourne store on the mall and redevelopment of the Lonsdale Street site will also underpin building activity over the coming year. Vacancy rates in Melbourne CBD remain tight and growth in specialty stores as well as the development of Docklands and in particular, the opening of the Spencer Street Direct Factory Outlet, have added to the retail experience.

Retail spending in **Queensland** continues to grow at a solid pace, outstripping the national average. For the first half of this year, nominal turnover was up 7.7% compared with the same period in 2006. Brisbane CBD yields remain firm, ranging between 6-7% for prime properties and 7-7.75% for secondary assets although smaller assets have seen yields tighten further. Growth in inner-city living and strong employment conditions (reflected in low office vacancy rates) are expected to continue to underpin tenant demand in the CBD.

Shop building approvals in **South Australia** have only ticked up marginally. For the twelve months to June, they were 8% higher than the same period of the previous year. Thus far, activity has largely featured the refurbishment of neighbourhood centres and construction of bulky goods stores to cater to new residential developments. Although retail sales have picked up encouragingly this year, new supply could limit the pace of rental growth.

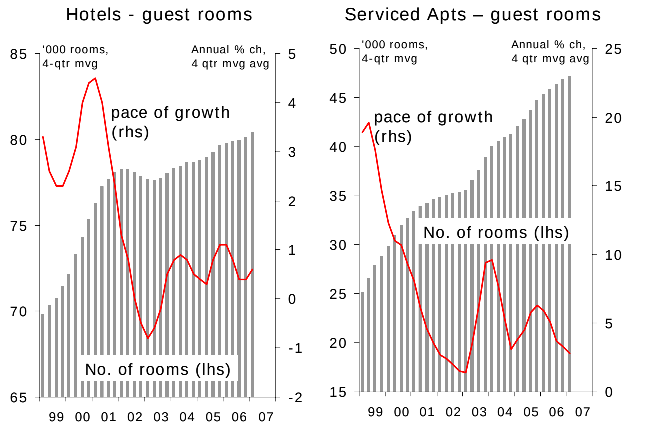
Western Australia has been recording one of the strongest rates of growth in retail turnover. Underlying economic fundamentals remain strong. The unemployment rate has stayed below 3.5% for over a year. Together with steady growth in wages and wealth gains from rising asset prices, private consumption is expected to continue to expand at a healthy pace. The outlook for CBD retail is favourable and vacancy rates are expected to remain low. CBD new supply includes a 14,000 sqm retail space at Raine Square with completion likely by the end of 2008 as well as a 15,000 sqm retail component at Century City.

Jasmine Robinson

Tourist accommodation

The tourist accommodation sector has performed solidly, with room rates reaching record highs after several years of sluggish growth, particularly in some segments such as motels & guesthouses. This reflects, in part, a slowdown in growth in room supply in recent years after robust building activity in 1998-1999 and a pick-up in 2004-2005. Demand for tourist accommodation has edged up, reflected by a stronger pick-up in international visitor arrivals. The domestic travel market has also held up well.

Growth in room supply stabilises



Sources: ABS, Economics@ANZ

Recently-released projections by the Tourism Forecasting Committee show inbound travel rising by an average rate of 5% per year over the medium term. While the strong Australian dollar is likely to put a damper on short-term visitor arrivals, our projections for a softer A$ profile over the medium term should lend some support. Domestic demand for tourist accommodation should hold steady despite the strong Australian dollar which has made overseas travel more attractive. The outlook for business travel is positive underpinned by healthy business investment and corporate profitability. Increased airline capacity with the launch of Tiger Airways later this year and the expansion by other airlines servicing the domestic market is expected to buttress growth in domestic holiday travel. However, regional tourist accommodation which relies heavily on road travel, may be adversely affected.

Overall, supply and demand conditions are now more evenly balanced, and with growth in new construction expected to be impeded by accelerating land and construction costs, this gives scope for further room rate hikes over the coming year.

The tourist accommodation market in **Victoria** remains healthy although annual growth in average takings per room night occupied has slowed in recent quarters. This largely reflects additional supply. Occupancy rates climbed to 69% in the March quarter compared with 66.4% in Q1 2006 helped by promotional rates. Building approvals have ticked up in recent quarters suggesting a steady pipeline of work ahead.

Average takings per available room night in **New South Wales** have grown at an annual rate of 11% in the last six months driven by strong occupancy rates which have averaged a high 78%. Limited new supply coming on stream, the strong corporate market and events calendar with the APEC Economic Leaders meeting in September 2007 and World Youth Day in July 2008 should see occupancy and revenue indicators across the board remaining solid.

Performance across **Queensland** has been mixed. Strong demand in Brisbane has driven room rates to record highs. Prospects for further increases in room rates should increase scope for new developments although construction costs remain a major drawback. Gold Coast tourist accommodation also fared well with room rates up 7.7% during the same period although new supply is likely to limit the scope for stronger rate rises. Performance in Tropical North Queensland, however, has been less favourable with demand, occupancy and revenue data slipping, possibly reflecting the impact of a weak Japanese market.

Tourist accommodation supply in **South Australia** continues to decline with the number of establishments with 5 rooms or more, falling by 3% over the year to the March quarter. Guest arrivals have, however, risen, auguring well for the tourist sector, which has seen room occupancy rates climb by 2.3 percentage points between Q1 2006 and Q1 2007 to 63.8%. Average takings per room night occupied grew by around 4% over the same period. Overall, the outlook for further increases in room rates is favourable given an expected pick-up in demand supported by an expansion in airline capacity.

The tourist accommodation sector in **Western Australia** will continue to be bolstered by the resources boom. Room rates and occupancy rates jumped by 10.9% and 5.2 percentage points respectively over the year to the March quarter. This was well above the national average. Corporate demand is expected to stay healthy and the domestic leisure market and international tourist arrivals should also pick up, lifted by the expansion of capacity by low-cost carriers. Despite the expected increase in supply over the next few years, buoyant demand is likely to support further improvements in occupancy and revenue indicators, albeit at a less robust pace.

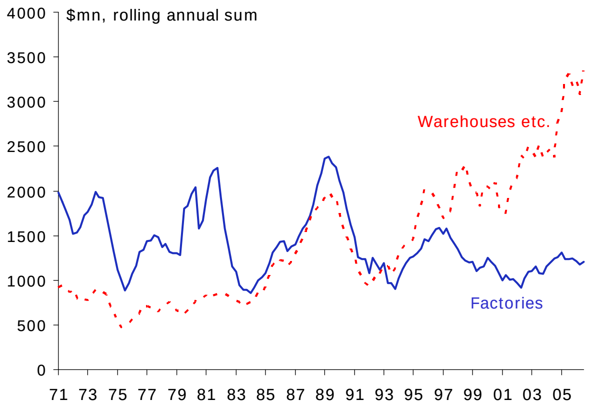
Jasmine Robinson

Industrial property

A stable economic environment, a buoyant commodities sector and strong imports growth have underpinned Australia's industrial market in recent years. This supportive backdrop is set to continue, providing a solid foundation for the sector going forward. A strong currency however, is a double-edged sword, benefiting importers/distributors whilst pressuring exporters and is compounding the long-term trend away from traditional manufacturing towards distribution-based activity. The shift has been driven by increased import penetration, the transfer of production facilities overseas and new technologies. Infrastructure improvements, including road/rail links are likely to remain a key value driver for tenants and investors.

Factories making way for distribution centres

Real value of building approvals



Source: ABS, Economics@ANZ

Growth in industrial property values is holding in a fairly pedestrian range (up 5% over the year). However, yields have continued to 'trade' at a notable premium to other commercial sectors. This implies a more favourable investment outcome on a *total* returns basis. According to CBRE[12], industrial land values have been very strong in most centres across the nation in the past year, a reflection of both strong demand and carefully managed release of industrial lots. Looking forward, rising construction costs and strength in land values, backed by a continuation of strong servicing capacity from tenants present the foundations for further strength in rentals and value.

As has been the case in most asset markets, we have seen a firming in yields in the industrial property sector in recent years. The 'capitalisation rate' on industrial property has fallen from a peak of over 11% in the depths of the early-1990s recession to 7.7% in 2006, its lowest level on a 22-year record. Industrial yields have 'traded', *on a long-term average*, at a 5.1% premium above the real risk free rate, offering the highest premium among the key property sectors. At December 2006, the premium was sitting just below its long-term average, at 4.7%. On Economics@ANZ's reading of the medium-term economic outlook and the entrenchment of lower generalised risk premia in financial markets, a lower benchmark could be supported looking forward.

Recent strength in land prices suggests tighter development conditions in the short-term. This should underpin *expectations* of rental growth, providing rationale for further yield compression which we believe will be 'validated' over the next couple of years. The compression phase should begin to cede to a stabilisation phase as the weight of the current supply in pipeline begins to come to market. However, this flattening in yield is expected to occur within a generally positive growth environment for rentals and prices.

Given the still strong total returns achieved, this tightly held sector remains on the radar for many institutional investors. Investment value in distribution centres and warehouses is more closely aligned to basic concepts such as location, access to transport links and size. Greater homogeneity in product is enhancing institutional interest, with strong savings flows into the superannuation sector ("weight of money"), offering solid structural support. Approvals for construction of industrial capacity have been very strong in recent years, reflecting strong industrial activity, (particularly in distribution sectors) and improved return prospects in related property sectors.

NSW approvals for industrial buildings have remained relatively subdued in recent years, corresponding with a generally poor economic performance. From an investment perspective, a fairly short pipeline of activity minimises the risk of any imbalance emerging in this market.

Victoria has reclaimed the prime position for planned additional warehouse capacity. The run-up in approvals commenced through 2005, coinciding with a notable upwards shift in capital growth. Approvals have stabilised at a high level through 2006. This suggests industrial construction is yet to peak in Victoria. New supply at these levels may cause some short-term indigestion, but should ride through the cycle with little dislocation, given the fairly benign outlook for the economy.

Queensland, too has had a remarkable surge in warehouse approvals through 2006, again following a pick-up in prices growth. With the Queensland economy expected to record continued above average growth over the medium- and longer terms, there is ample scope for capacity additions to hold up at these levels over 2007/08.

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[12] CBRE, "Market View" various issues.

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