ECONOMICS & MARKETS RESEARCH

AUSTRALIAN PROPERTY OUTLOOK

Property market finds it feet

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INSIDE:

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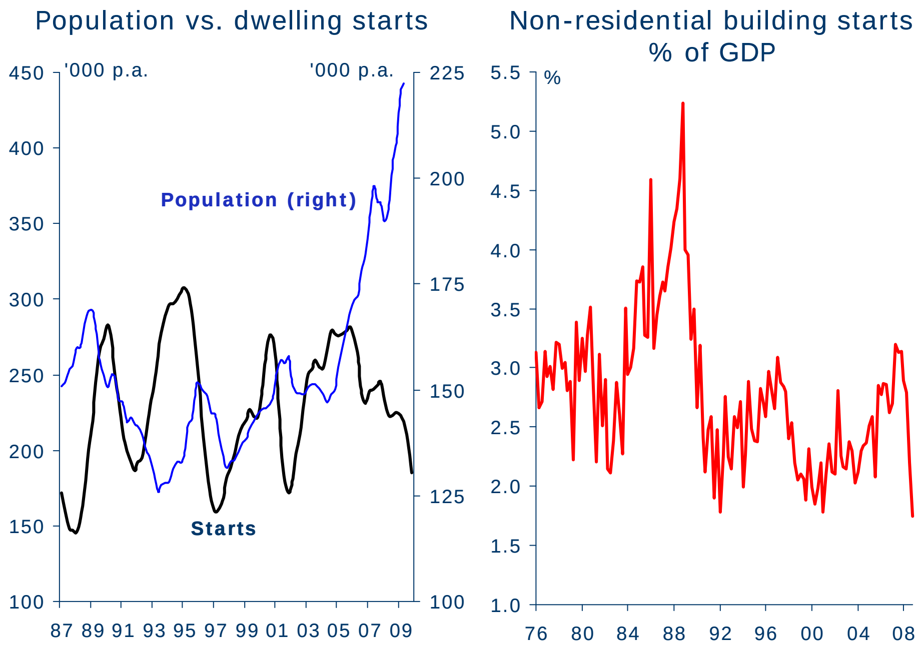
Economic overview

Australia has come through the GFC in very good shape due largely to significant, pre-emptive and effective policy action from the Government and the Reserve Bank. Despite rising interest rates, economic growth is expected to return to 'trend' by the second half of 2010 buoyed by record population growth, a lift in dwelling construction and strong mining and infrastructure investment.

Residential Property

The remarkable rise in Australian house prices in 2009 has finally silenced the doomsayers. The phased removal of the FHOB and ongoing increases in interest rates will test the market's resilience. However, while prices are expected to decelerate in 2010, a growing physical shortage of housing and improved investor sentiment should drive ongoing price gains.

Market values protected by under-building



Source: ANZ Economics and Markets Research, ABS

Commercial Property

Investors will look through weakening short-term office market fundamentals and focus on resetting valuation benchmarks for what has quickly turned from a scenario of severe recession to a relatively soft landing.

For the retail sector, interest rate headwinds will pale into less significance against healthy forces building quietly out of a crisis that did not impact severely on the real economy, yet has done so on investment parameters.

Strong A$ has weighed on international tourist arrivals which combined with the GFC's impact on domestic travel has seen hotel occupancy and takings weaken. Prospects should improve along with the broader economy in 2010.

The falls in industrial capital values over the past 2 years are expected to come to an end as we have likely seen the end of yield decompression, especially for prime assets.

ECONOMIC OVERVIEW

Australia 'decouples' from the developed world

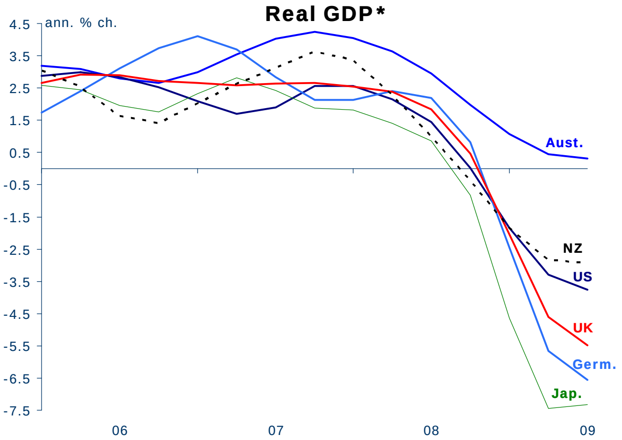
Global economy remains fragile

An unprecedented monetary and fiscal policy response to the global financial crisis (GFC) appears to have successfully arrested the savage decline in global economic activity and the outlook for 2010 now appears far brighter. Credit spreads have narrowed to 'pre-Lehman' levels and equity markets have rallied and are priced for a 'V'-shaped recovery.

However, growth remains largely stimulus driven and is not yet self-sustaining. Real economic impacts of the global financial crisis are still being felt throughout the developed world. Employment in the US and Europe continues to decline (albeit at a reducing rate) and activity will be constrained for some time by difficult financing conditions and the need to rebuild household and banking sector balance sheets. A turn in the inventory cycle may see measured growth in the developed world bounce in the quarters ahead, but underlying activity is expected to remain subdued. Key structural impediments to growth remain and the cyclical upturn in *the developed world* is expected to be unusually restrained.

But importantly for Australia, the Chinese economy has responded well to the massive policy stimulus which lifted growth in the year to September to a robust 8.9%. Solid export demand for our bulk commodities and ongoing investment in coal, iron ore and LNG capacity will be key drivers of Australian growth in the years ahead.

Australia outperforms the developed world



Sources: ABS, Datastream, ANZ Economics and Markets Research

Australia – the worst is behind us

Australia has come through the GFC in very good shape due largely to significant, pre-emptive and effective policy action from the Government and the Reserve Bank. It is one of very few developed economies to avoid a (deep) technical recession and the labour market and house prices have been remarkably resilient. Forecasts for an unemployment peak above 8% have been slashed and many believe the current 6½% outlook will prove overly pessimistic. *Economic growth is now expected to return to 'trend' by H2 2010* buoyed by record population growth, a lift in dwelling construction and strong mining and infrastructure investment.

A vastly improved growth outlook means the earlier 'emergency' monetary policy settings are no longer appropriate and the RBA has commenced the task of lifting official interest rates back towards 'neutral'. While interest rates remain at relatively low levels, a subdued recovery in employment combined with slowing wages growth and rising house prices suggest debt servicing will be an increasingly heavy burden on many households in the years ahead.

Housing will pass 2010 resilience test

The remarkable rise in Australian house prices in 2009 has finally silenced the doomsayers. The national median house price has risen by an impressive 10% over the first ten months of the year buoyed by low interest rates, the First Home Owner Boost (FHOB) and tightening underlying fundamentals. The phased removal of the FHOB and ongoing increases in interest rates will test the market's resilience. However, while house prices are expected to decelerate in 2010, a growing physical shortage of housing and improved investor sentiment should drive ongoing price gains.

Inadequate supply remains the single greatest issue facing the Australian housing sector. Unless significant action is taken to remove the structural impediments to home building, Australia will face an intractable shortage of housing that will drive a deterioration in affordability (both purchase and rental) beyond anything we have ever seen.

Commercial property close to nadir

Commercial property valuations have fallen sharply in the past two years. However, prices (particularly for higher grade assets) appear to be approaching a nadir. Capital raisings have driven reduced gearing levels and diminished the risk of a fire sale of distressed assets. As a consequence, capitalisation rates are showing tentative signs of improvement. An unusually subdued supply response (outside of Brisbane and Perth office markets) means that the commercial property sector will begin the next cyclical upturn with a vacancy rate peak well below that experienced in the early 1990s.

However, despite reduced gearing, a considerable refinancing challenge (exacerbated by the Senate defeat of ABIP) remains that will test the resilience of both the listed and unlisted sectors in 2010.

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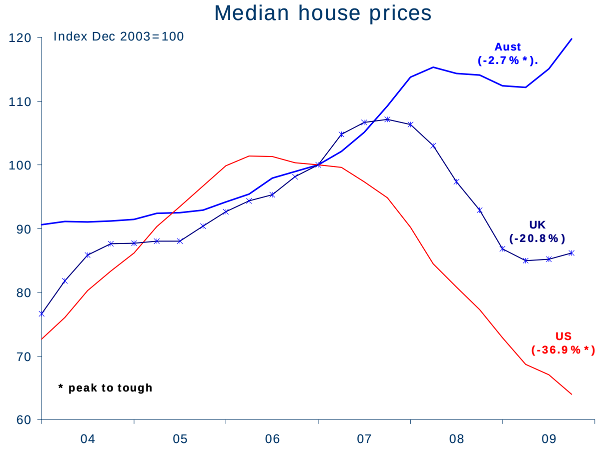
Australian housing defies the doomsayers

Australian house prices resilient

Few can now doubt the underlying strength of the Australian housing market. While house prices fell precipitously across the developed world (US -37%, UK -21%) Australian house prices barely moved (falling by just 2.7% peak to trough) and have subsequently risen sharply.

Australian house prices outperform

Median house prices



Sources: Residex, Datastream, ANZ Economics and Markets Research

Widespread forecasts of a looming collapse in Australian house prices ignored the stark fundamental differences between Australia and most of the rest of the developed world. The global financial crisis had its genesis in the wholesale collapse of US home lending standards. Skewed incentives, predatory lending, fraud and ineffective prudential supervision drove the US sub-prime mortgage share to over 15% (from just 3% in 2000) and the total mortgage delinquency rate to 8.5%! In contrast, strong prudential regulation and conservative lending practices kept sub-prime lending to less than 1% of the Australian mortgage market.

Equally important was the relative strength of the Australian economy, particularly the labour market. A high level of forced selling is a prerequisite for significant house price declines and a relatively modest rise in unemployment combined with the virtual absence of sub-prime mortgages in Australia ensured that forced selling remained at very low levels.

Other key factors that supported Australian house prices include sharply lower interest rates, high proportions of variable rate mortgages (which heightened the effectiveness of monetary policy) and on balance sheet lending (which increases incentives for responsible lending), a robust financial sector (that allowed pass through of rate cuts), full recourse loans and a *severe physical shortage of housing*.

Positive outlook

National median home prices rose by 10% in the first 10 months of 2009 buoyed by low interest rates, the first home owners boost (FHOB), tightening underlying fundamentals and more recently a sharply improved economic outlook and vastly improved market sentiment. The relaxation of foreign investment rules earlier this year rules has seen a marked rise home purchase by wealthy overseas investors which has added to price gains.

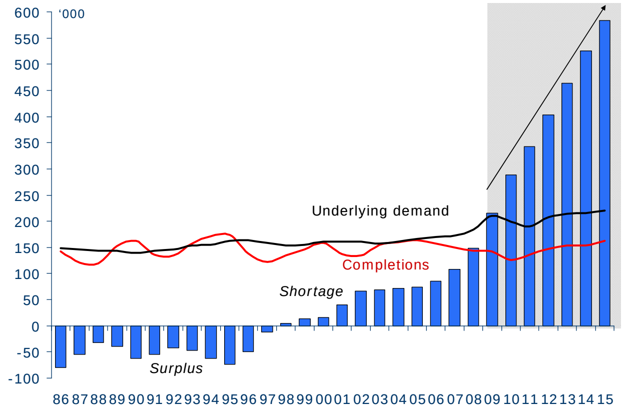
While we still expect a deceleration of prices in 2010 as the FHOB is removed and interest rates are lifted towards 'neutral', recent momentum suggests price gains could be stronger than anticipated. Despite a marked rise in properties for sale, auction clearance rates have remained high in recent weeks and an upgraded economic outlook and improved job security will continue to boost investor and homebuyer confidence.

Housing shortage will become intractable

Moreover, each day underlying housing demand remains above new supply, the market tightens further. We estimate that underlying housing demand is running at an annual rate of 200,000 while dwelling completions are expected to fall to under 130,000 in 2009-10. With the market already extremely tight (reflected in near record low rental vacancy rates in most state capitals), an *additional* shortfall of 70,000 dwellings will have a marked impact. The nascent recovery in dwelling approvals will partially close the gap in 2010-11, however, *it remains highly unlikely that annual completions will get anywhere near the 200,000 required to meet demand in the foreseeable future*.

Housing shortage to reach unprecedented levels

Housing market balance: Australia



Sources: ABS, ANZ Economics and Markets Research

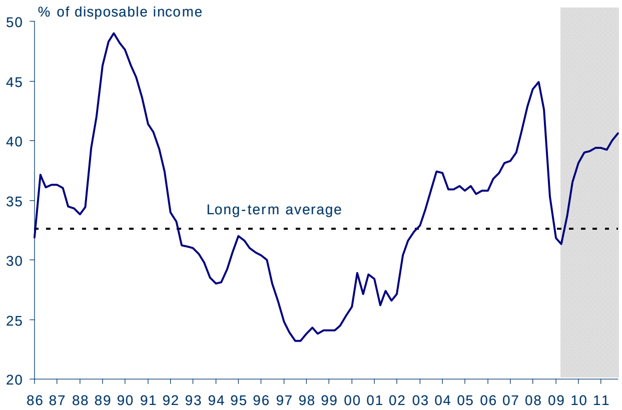
Building activity will continue to be constrained by excessive developer levies, rising regulatory costs (energy/water/fire ratings), access to finance, resistance to medium and high density infill (SOS NIMBYism), inadequate transport infrastructure, skilled labour shortages and rising interest rates.

In light of this, the Government's recent endorsement of a growth strategy that would see Australia's population expand to 35 million by 2049 is going to present considerable challenges to the housing industry, the Government and the broader society. Without a concerted public policy effort to address the issues listed above, the shortage of housing could become intractable.

The key implication is that the housing market will remain undersupplied for many years which will place further upward pressure on both rents and house prices. In combination with rising interest rates, this will drive a structural deterioration in affordability (both purchase and rental) beyond anything we have ever seen. Hence, housing *availability and affordability* look set to be major social and political issues in the decade ahead.

Housing affordability set to deteriorate

Housing *purchase* affordability



Source: RBA, ABS, ANZ

Lack of stock is *forcing* household size upwards

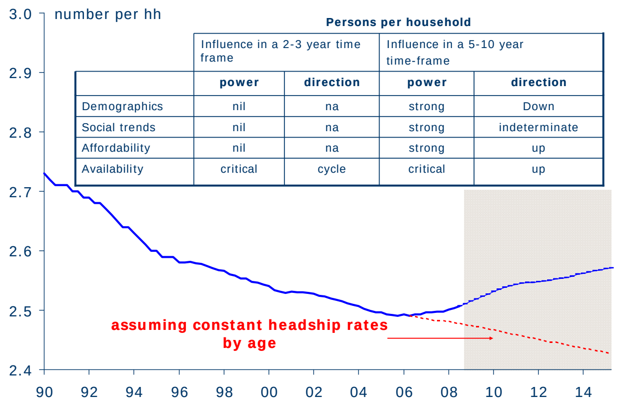
Over the past 100 years Australia experienced a marked decline in the number of persons per household led by rising divorce rates, falling birth rates, changing societal preference and an ageing of the population. Average household size fell from over 5 persons in the early 1900s to 2.5 persons in 2006. However, since then (despite ongoing *downward* demographic pressures) household size has crept *upwards*. The increase to date may seem inconsequential but as this is an average over the entire country it requires a significant change in the *marginal* household size to make an impact[1]. Moreover, our forecasts of population growth and the dwelling stock suggest that this upward trend will continue over the next 5 years.

It has been argued that rising household size in the past two years is 'solving' Australia's housing shortage. However, demographic and societal shifts such as this generally take several decades to play out and are highly unlikely to have any significant influence within a two year period. While a projected structural deterioration in housing affordability *may eventually* drive an increase in household size, it will have to work against the steady downward influence of an ageing of the population and any further shifts away from the standard family structure.

The reality is that the measured rise in persons per household has been largely *involuntary* and simply reflects inadequate housing supply. Buoyed by rapidly expanding net international migration, population growth accelerated to 2.1% in the year to March (an additional 439,000 people, the strongest increase on record). Population gains have surprised even the most optimistic forecasts in recent years and the housing industry has been unable to deliver enough new stock to satisfy demand. Consequently, the number of persons per household has been *forced* to rise as a growing population is squeezed into a limited available housing stock.

Household size *forced* to rise

Persons per occupied dwelling



Persons per household

	Influence in a 2-3 year time frame		Influence in a 5-10 year time-frame	
	power	**direction**	**power**	**direction**
Demographics	nil	na	strong	Down
Social trends	nil	na	strong	indeterminate
Affordability	nil	na	strong	up
Availability	critical	cycle	critical	up

Sources: ABS, ANZ Economics and Markets Research

The resultant gap between actual persons per household and the purely demographic projection above largely reflects 'pent up' housing demand that will eventually need to be satisfied. Outside of concerted public policy action to remove the existing impediments to home building and/or substantially lower population growth, we will endure a sustained period of rising rents and house prices. This will continue until the point when builder profit margins have risen sufficiently to encourage higher levels of residential construction. In the meantime, things are likely to become increasingly unpleasant for renters and first homebuyers.

[1] In fact the *marginal* household size last year was 4 persons (up from just 1.7 in 2004)

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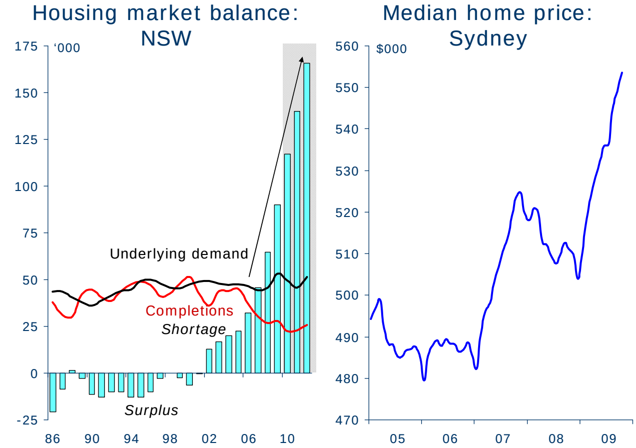
New South Wales

After a subdued 2008-09, the NSW economy is beginning to show signs of life. Population growth has jumped from a low of 0.5% in mid-2004, to a robust 1.65% over the year to June. Gains over the year were led by a net additional 85,000 international migrants (the highest on record) and a steady rise in 'natural' growth (births less deaths) of 50,000. Moreover, after falling for much of 2008-09, employment has recovered in recent months and the trend unemployment rate has fallen from 6.4% in May to 5.9% in November.

Sydney median home prices have rebounded strongly this year to be up a remarkable 9.9% year to date. Lower interest rates/improved affordability and a strong take-up of the first home buyer boost were key drivers of the rebound in home prices. This has been aided by a marked improvement in market sentiment as price outcomes belied the earlier pessimism.

House prices have rebounded sharply



Sources: ABS, RP Data-Rismark, ANZ Economics and Markets Research

Underlying these moves is a dramatic tightening of housing market conditions. Dwelling completions fell to a near-record low in 2009-10 while population gains are hitting record highs. At just 1.3%, residential vacancy rates remain near record lows and as we move beyond the temporary lift in rental supply following 2009s surge of first home buyers, vacancy rates will tighten further. Average rents rose by a solid 6.7% over the year to September and affordability (both rental and purchase) will continue to deteriorate. Dwelling approvals have recovered but a 'normal' cyclical recovery will face significant headwinds from existing market impediments and a steady upward shift in interest rates.

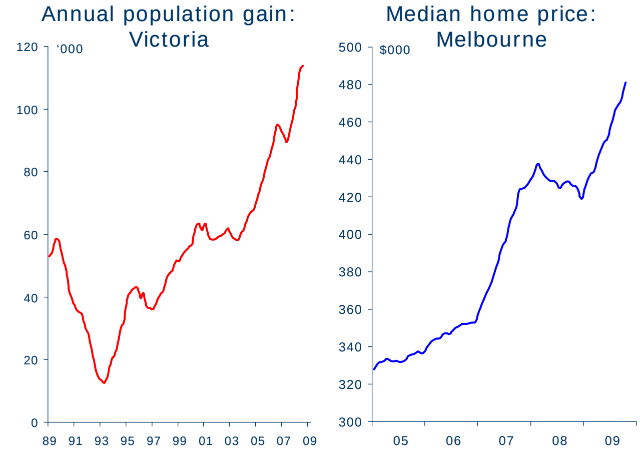
State government initiatives are beginning to address the imbalance; however, more is needed at the local, state and federal level in order to prevent a potential housing crisis in New South Wales in the years ahead.

Victoria

Melbourne's housing market has been the frontrunner in the 2009 recovery, with home prices up a stunning 14.9% in the first 10 months of the year. Market momentum remains strong with auction clearance rates resilient despite increased offerings, rising interest rates and the winding back of the FHOB.

The underlying strength of the market owes much to the dramatic increase in Victoria's population. After averaging annual gains of just 37,000 in the 1990s, Victoria's population grew by a record 114,000 in the year to June. Consequently, demand for homes (both purchase and rental) remains solid and is driving prices and rents higher.

Record population gains boost house prices



Sources: ABS, RP Data-Rismark, ANZ Economics and Markets Research

The State economy has continued to outperform, and has accounted for *all* of the dramatic rebound in national employment in the past seven months and has the second lowest unemployment rate at 5.4%. Growth has been underpinned by solid infrastructure investment and will be boosted in the year ahead by a strong rebound in dwelling investment.

Unlike NSW, new dwelling approvals remained at relatively healthy levels in Victoria during the crisis and have risen strongly in the past year. The rise has been dominated by detached houses while 'other dwellings' have remained relatively subdued – in part reflecting difficult financing conditions for multi-unit development.

New road and rail transport infrastructure projects continue to facilitate housing development along the main growth corridors and in key regional centres. In particular, the $4.3 billion Regional Rail Express project which includes the linking of Geelong, Ballarat and Bendigo with Melbourne via dedicated express train services will boost the demand for housing in these centres and relieve some of the pressure on metropolitan Melbourne. However,

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further measures to promote high and medium density infill development are required if Melbourne is to accommodate anywhere near the mooted seven million people by 2049.

Queensland

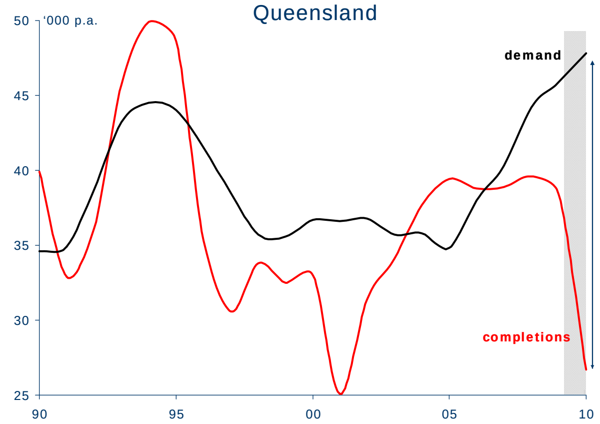
The Queensland economy slowed markedly in the past year led by a hiatus in the mining boom and a sharp decline in dwelling investment. In addition, a marked deterioration in state finances saw Queensland join Tasmania in losing its AAA credit rating.

From a peak in late 2007, new dwelling approvals fell by almost 50% by early 2009. Approvals have recovered modestly since then, but home building activity has continued to weaken. The labour market has also softened with the unemployment rate at 6.2% in November, up from just 3.8% a year earlier.

Nonetheless, house prices have recovered in 2009 (albeit less dramatically than Melbourne and Sydney) to be up 6.5% since December. Despite substantially reduced net interstate migration gains, population growth remains strong at 2.6% over the year to June and the collapse in dwelling approvals means that a huge gap has opened between underlying housing demand and new supply.

Demand rising but supply set to slump

Housing demand vs. supply: Queensland



Sources: ABS, ANZ Economics and Markets Research

This gap suggests the market will tighten considerably in the year ahead providing further support to house prices and rents despite a relatively subdued outlook for the Queensland economy.

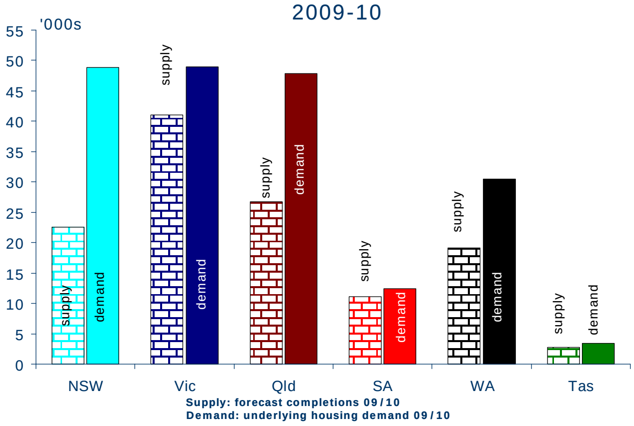
South Australia

South Australian population growth has strengthened in recent years, but at 1.2% remains the second slowest of all the states and territories. South Australia has successfully raised its international migrant intake from under 3,000 in 2002 to over 17,000 in the year to June, but still lost 4,700 in net *interstate* migration.

The South Australian housing market has outperformed in recent years - home building has remained at high levels and house prices have been very resilient (aided by relatively affordable housing). Despite these gains, at $429,000 Adelaide's median house price is the second lowest of the State and Territory capital cities.

Housing supply in SA close to requirements

Housing demand vs. supply by state 2009-10



Sources: ABS, ANZ Economics and Markets Research

South Australia's manufacturing sector faces ongoing challenges with the $A remaining at high levels, but the state's prospects will increasingly be tied to mining and resource investment with several major projects likely to proceed in the years ahead.

Western Australia

The Western Australian economy has experienced a classic commodity price driven boom bust cycle in recent years and the state Budget in May predicted negative state economic growth for 2009-10 and 2010-11. However, the strong rebound in China combined with recent major project announcements suggest WA could be on the cusp of yet another resource (LNG & iron ore) led boom.

The collapse in commodity prices experienced last year led to the closure of some major mining operations and the cancellation or postponement of several major projects. Employment weakened sharply (-1.5% over the year to November) but population growth continued to accelerate (up a solid 3% over the year to June). Consequently the unemployment rate has doubled to 5.4% over the past year.

As a result, Perth home prices fell by 7.5% from late 2007 to end 2008 and appeared to face considerable further downside risks. However, renewed confidence, lower interest rates and a surge of first homebuyers saw prices recover in 2009 to be up 6.1% over the year to date. Sentiment has

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experienced a dramatic turnaround with earlier recessionary fears replaced by concerns about looming capacity constraints and skilled labour shortages.

Rising interest rates and house prices and an exodus of first home buyers will test the housing market in the year ahead as affordability deteriorates sharply once more in 2010, but a return to boom conditions underpinned by several major resource investment projects will support demand and home buyer confidence.

New dwelling approvals fell sharply last year and completions (19,000) in the current fiscal year are expected to fall well short of underlying housing demand (30,000). This will drive a renewed tightening of housing market conditions and provide support for rents and home prices.

Tasmania

The Tasmanian economy has weakened significantly with employment down a sharp 3.6% over the year to November. While population growth has strengthened in recent years buoyed by gains in Tasmania's international migrant intake, weakening labour market conditions will likely drive a deterioration in net interstate migration in the year ahead as increased numbers of Tasmanians take advantage of improved job opportunities on the mainland.

At just $365,000 Hobart's median house price is the lowest of the state capitals. Good affordability continues to attract interest from owner occupiers but investors have largely remained on the sidelines. House prices are up 5.9% over the first 9 months of 2009, however, momentum has stalled with prices flat to down in the past 4 months. New dwelling approvals remain at reasonably high levels, but are nonetheless insufficient to match demand at present. However, a likely slowing of population growth will help to close this gap in 2010.

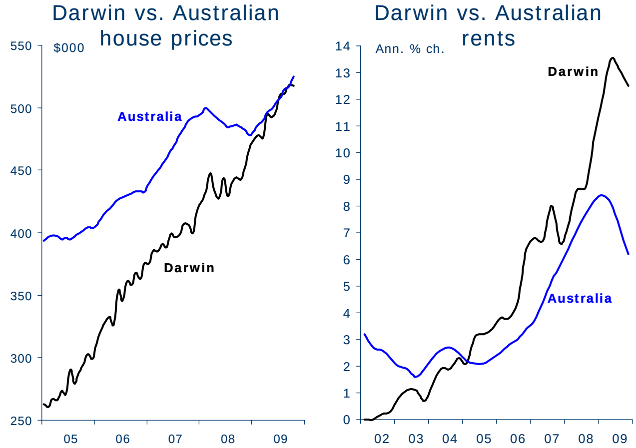
Northern Territory

Buoyant labour market conditions have seen NT employment up a remarkable 4.5% over the year to November, which has lowered the unemployment rate to just 3.5%.

Employment opportunities continue to attract new migrants and population growth remains strong. Buoyed by continued solid population gains, high average household incomes and a limited housing stock, Darwin home prices have boomed continuously since 2002 and rents have accelerated. Prices have doubled since early 2006, and at $517,000 Darwin's median house price exceeds those in Melbourne, Brisbane, Adelaide and Perth.

Rental supply is also very tight with average rents up a whopping 12.5% over the year to September.

Darwin's housing affordability deteriorates



Sources: ABS, RP Data-Rismark, ANZ Economics and Markets Research

We expect dwelling completions to fall to 1,250 in 2009-10 which will be insufficient to house expected population growth of over 5,000. Consequently, housing market conditions will continue to tighten and push prices and rents higher.

Australian Capital Territory

Despite a recent softening of labour market conditions, the ACT still boasts the lowest capital city unemployment rate at just 3.9%. A solid labour market (buoyed by growing public service employment) has enabled the ACT to considerably increase its net international migration intake which rose from just 300 in 2004 to 3,400 in the year to June boosting annual population growth to 5,600. New dwelling approvals have risen strongly in recent years and unlike most other cities appear to be sufficient to meet growing demand.

A high proportion of professional white collar workers means the average income in Canberra is well above that of any other state. This supports a remarkably high median house price of $526,000 that is second only to Sydney. Despite this, as a proportion of average household income Canberra home prices are actually the most affordable in the country.

House prices softened last year but have since rebounded to be up 11% in the first 10 months of 2009. Relatively balanced market conditions combined with rising interest rates, deteriorating affordability and fewer first homebuyers should see home prices decelerate in 2010. Outcomes will remain closely tied to public service employment prospects.

Paul Braddick

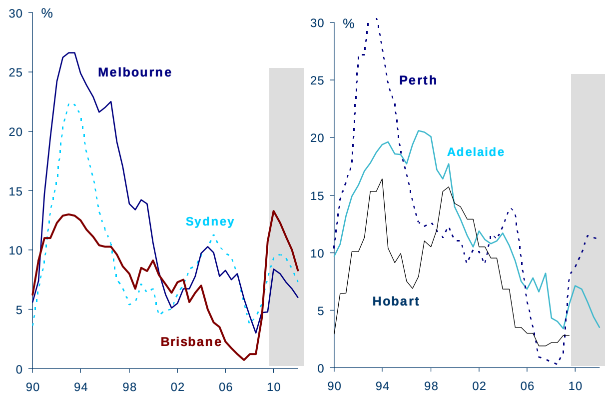
OFFICE PROPERTY

Accelerated healing

While CBD office fundamentals are likely to weaken further over 2010, the market is already looking through this period and is likely to reset valuation benchmarks for what has quickly turned from a scenario of severe recession to a relatively soft landing. The likelihood now of an early return to trend growth is providing some useful padding for investor confidence. Rentals and capital values suffered in the wake of the global financial crisis. The likelihood of recession, combined with more generalised risk aversion saw yields blow out and capital values fall by a quarter since late 2007. Australia's labour market has proven resilient in 2009 with employment trend up by year's end. This will support office space demand. Tougher credit conditions in the wake of the GFC has limited the office supply pipeline and given substantial lead times in construction, this supply line is largely set and can do little to undermine fundamental conditions in 2010.

Vacancies – no need to make a fuss

CBD office vacancy rates



Source: Property Council of Australia. ANZ Economics & Markets Research forecasts

Office market vacancies are still rising but are now unlikely to peak any higher than the peak in the last two *mini*-cycles (1999 and 2004). The CBD vacancy rate is projected to peak at around 9.5% in 2010 - less than half the peak of the early 1990s recession. With investors starting to look beyond the GFC 'chapter', 2010 should see some pre-emptive pricing on the premise that the economy returns to trend growth rate and that tighter fundamental conditions will emerge through 2011 and 2012. Rentals will stabilise over 2010 while yields will tighten. 2011 on the other hand will see both rentals and values accelerate, but yields stabilising. These developments will sow the seeds of the next construction phase which we expect to get underway in 2012.

Subdued supply had seen **Sydney's CBD** vacancy rate fall to its lowest level on record through 2008, generating a 53% increase in effective rentals over two years to 2008. However, the threat of recession saw all of these gains disappear, with rents falling back sharply. Vacancy rates are starting to lift but given a very measured supply-side response and growing economic optimism, office fundamentals, while still expected to weaken (vacancy rate peaking at 9.6%) will pose only as a moderating influence on what is likely to shape up as an improved investment environment over 2010. Incentives are expected to play the lion's share role in the adjustment period.

Melbourne's CBD office market is well placed on a number of fronts. The Victorian economy has performed relatively well and population growth is approaching its highest level in many decades. Unlike most other capitals, the Melbourne CBD office market did not experience a rental boom (effective rents are down 15% in real terms from their 2001 levels. They slipped a further 15% in the year to September, taking tenancy costs in the Melbourne CBD rents 50% below 1987 levels in real terms. Vacancies are on the rise but are expected to peak at just 8% before re-tightening. Sustained economic and employment growth combined with healthy affordability and limited supply-side places this market in premier position for solid medium term-growth in rentals and capital values.

In **Perth CBD**, net effective rentals rocketed 4-fold in the three years to 2008 to $831 per sqm, reflecting the virtual disappearance of spare capacity. With the forces of supply and demand now going into reverse, market rentals have plummeted 35% back to 2007 levels. There are tentative signs that rental falls are abating but as yet, no sign of a bottom. Renewed strength in commodities markets and confidence in the sustainability of the Chinese economic growth suggest the office demand/supply imbalance will not deteriorate as much as earlier thought (peak vacancy of 11.5% compared to 32% in the early 1990s). The **Brisbane CBD** market is similarly placed although digestion of the supply pipeline is expected to occur more quickly with the vacancy rate already jumping to over 10%. It is expected to peak at 13% by end-2009 before gradually declining through 2010. The rental adjustment, which has already been significant (effective rents have already fallen 38% since peaking in mid-2008) has most probably run a full course. We would expect rental incentives to begin easing over 2010.A relatively modest run-up in **Adelaide** rentals in the year leading up to the GFC has helped insulate the market from a more severe rental and capital value adjustment. With vacancy rates likely to lift only moderately and investment market fundamentals improving, the Adelaide office market is likely to recover sooner but expect a shallower profile.

Ange Montalti

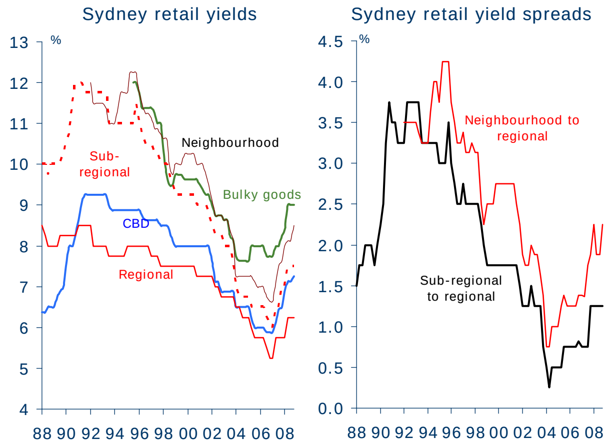
RETAIL PROPERTY

Optimism to follow relief

Despite the cloud cast by the legacy of the GFC, the retail trading environment has proven more resilient over 2009 than most were expecting. The retail sector will experience further growth over 2010 but will have to tough out rising interest rates and the absence of 'government stimulus'. For retail property however, these headwinds will pale into less significance compared to the healthy forces building quietly out of a crisis that did not impact severely on the real economy, yet has done so on investment parameters. We expect a reality check to bear upon the dynamics of rental negotiations, on to benchmarking of cap rates by valuers and naturally onto valuations themselves.

As is the case in the office market, supply of retail space is falling and the construction pipeline is contracting. The subdued supply line reflects investor caution, financing constraints, rising yields and stagnant rents. These influences, largely borne out of fear have served as fortuitous protectors of market value. Increasingly though, as economic conditions normalise and confidence returns, the impending fundamental imbalance will impose a significant positive force on market outcomes.

Yields are set to tighten



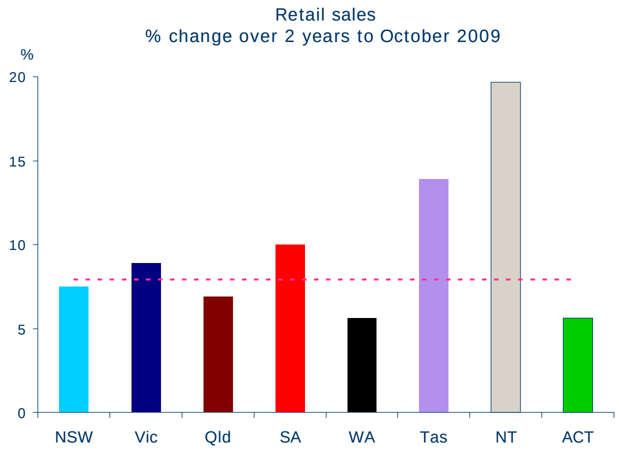
Sources: Jones Lang Lasalle

Rentals have been flattening over the past year and will in all likelihood avoid a generalised decline over 2009/10. That said, landlords will remain cautious and will be more than satisfied with protecting occupancies for the time being than securing higher rentals (given 'what could have been'). We will therefore see fairly subdued rental outcomes in 2010. However, the dynamics will shift markedly through the year as investors increasingly perceive that the economy is finding a sustainable and healthier growth path. This should improve expectations of earnings quality and lead to some diminution of the excessive risk premium that had built into *average* yields. The blow-out in spreads along the quality curve probably has further to run before settling somewhere between pre and post crisis levels. Evidence of heightened turnover of neighbourhood retail assets in the December quarter provides some confidence that price discovery is filtering down the curve. Commodity capital centre vacancy rates have jumped recently over 2009 while other capital cities remain tight. With the supply-side remaining in check, there is every prospect of fundamental conditions remaining well supported at least until the weight of new supply (not expected until at least 2012) begins to impact.

While retail turnover has been influenced by government stimulus over 2009, there is considerable uncertainty surrounding the quantum of this impact. With this influence waning, the sector is preparing itself for the more organic drivers to determine the sustainability of retail spending. Having said that, it appears all states have managed to hold activity levels well above pre-crisis levels. Given retail business creation is likely to have remained relatively subdued over the GFC, average (per business) nominal turnover is likely to have out-performed aggregate turnover.

Interestingly, all states have recorded at least reasonable growth on pre-crisis activity levels with NT (+20%) and Tasmania (+14%) being the outstanding performers with the remaining states holding activity levels around 6% to 10% higher than pre-crisis levels. Retail tenant stress levels have been ameliorated by this buoyancy in revenues. However, the impact of rising interest rates in late 2009 and into 2010 is likely to weigh on spending. With the rental burden remaining under control in 2010, there is every prospect of riding through a potentially tough trading environment without too much stress.

Retail turnover is holding up well in most states



Source: ABS

Ange Montalti

TOURIST ACCOMMODATION

Weak demand weighs on occupancy

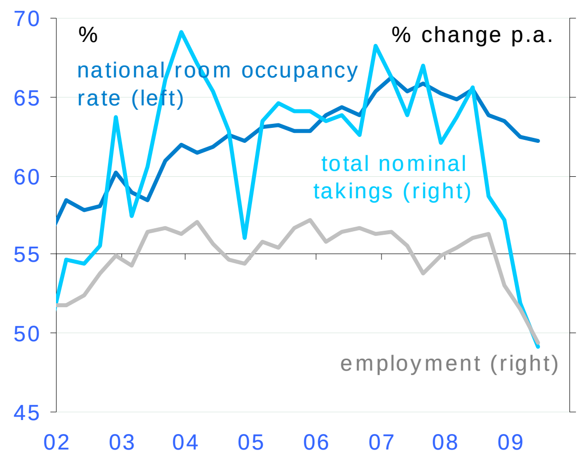
In June 2009, Australia had 4,292 accommodation providers with 15+ rooms, including hotels, motels, serviced apartments and guest-houses, up just 0.6% from a year earlier. They provided 642,000 beds in 225,000 rooms, up 1.8% from a year earlier. These growth rates were all at their slowest in 2 years, and well below their 10 year average growth rates of 1.6% p.a. (establishments) and 2.1% (guest rooms).

Another 1,866 small operators (5-14 rooms) offered 52,900 beds in 17,960 rooms, down 4.7% from a year earlier. Employment is down by 9%. This small accommodation sector has now been shrinking since at least 2005, with only a brief growth spurt in 2006.

After relatively strong occupancy rates and solid revenue growth among larger accommodation providers (15+ rooms) in 2007-08, demand, turnover and employment all fell through 2008-09. The national room occupancy rate has now fallen to 62.2%, its lowest since 2004. Total nominal takings fell in every quarter of 2008-09, to be down 5.8% from the previous year. Employment has fallen by a similar proportion (5.6% to June 2009).

This difficult period for hoteliers reflects the fortunes of the Australian hospitality industry more broadly (accommodation, restaurants and cafes), which has now been declining, in real value added terms, since mid-2007. Hospitality jobs had also been contracting, but picked up weakly in the May and August quarters of 2009 by headcount (up 2% QoQ and 3% YoY to Aug 2009) and total hours worked (+0.7% QoQ but -1.7% YoY to Aug 2009). This most recent jobs data may be signalling a welcome upturn in activity.

Occupancy, takings and employment fall

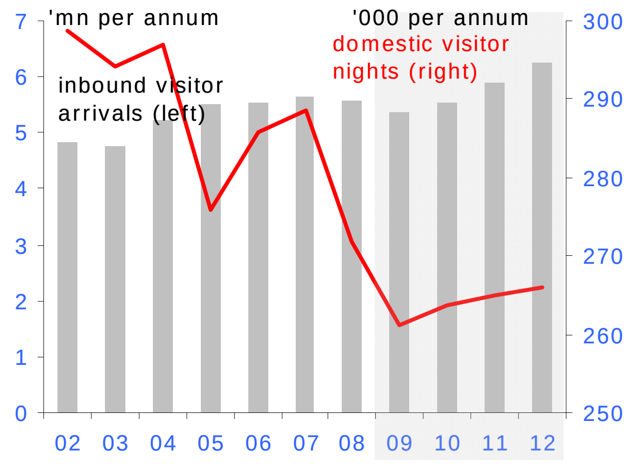


Source: ABS (seas. adj. data to Jun Qtr 2009).

Falling occupancy and takings has also reflected significant declines in short-term (less than 12 months) visitor arrivals to Australia, which peaked in November 2007 and are currently still declining. As of September 2009, monthly visitor arrivals were below 459,000 per month (12 mma), or still 2.1% lower than a year earlier. Holiday arrivals (which make up about 45% of all short term arrivals) peaked in Jan 2006 and were still falling 4.4% p.a. in Sep 2009. Business/conference arrivals peaked in July 2008 and were still falling 15% p.a. in Sep 2009. Only short-term education arrivals and 'visiting friends/relatives' arrivals have kept growing through 2009, but neither provide much custom to accommodation providers.

Growth prospects for 2010 look marginally better, with the global and domestic economies both showing real signs of recovery as of late 2009. The Tourism Forecasting Committee (TFC) expects short-term international visitor arrivals to grow by 3.1% in 2010, after 2 years of decline. And domestic visitor nights should grow by a modest 1%, after falling substantially in 2008 and 2009. But even these weak growth projections may be threatened however, by the continuing strength of the Australian dollar, which will deter some international tourists and perhaps encourage even more Australians to holiday overseas.

Visitor numbers may begin to recover slowly



Source: Tourism Forecasting Committee, Jun 2009.

Large geographic differences remain apparent in this market. June's room occupancy rates remained highest in the ACT (69%), WA (66%) and the NT (64%). Tasmania's occupancy rate (61%) increased marginally but remained below the national average (62%). Significant falls in occupancy were evident in NSW, Vic, Qld and SA, all down from the mid-60s last year to the low 60s by June 2009. The number of accommodation establishments grew in all states and territories except NSW (-1%) and Tasmania (-0.6%) in the year to June 2009. The strongest growth was in the ACT (+3.7%) and the NT (+6.6%).

Julie Toth

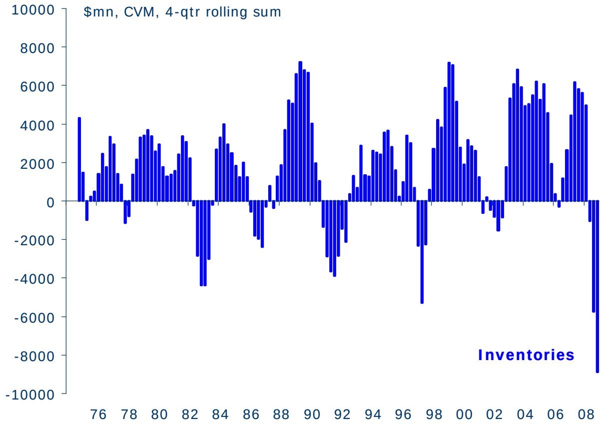
INDUSTRIAL PROPERTY

Industrial property on a slow road to recovery

The economic landscape weighed heavily on industrial property over the last 12 months. Weighing most on demand for industrial and warehousing space have been; the 13% slump in import volumes over the past three-quarters; the record 4-quarter collapse in inventories as unexpectedly solid domestic demand, supported by fiscal stimulus, ran down stocks in an environment in which business remained cautious; and following these factors the drop in business investment in new construction, down 15% in the year to June.

A sharp re-stocking phase should be expected

Inventories



Sources: ABS, ANZ Economics and Markets Research

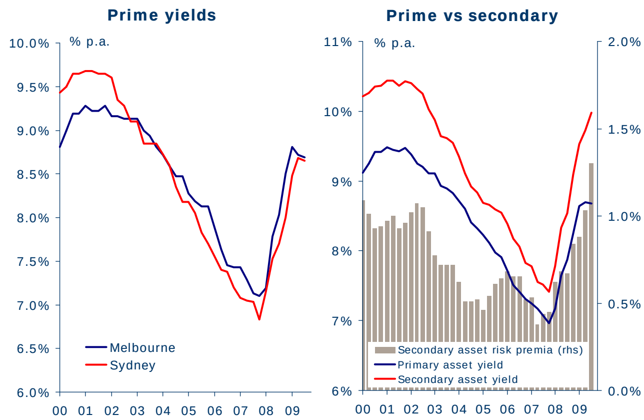
However, the worst has seemingly now past for imports and inventories. A higher Australian dollar and solid domestic economy is expected to drive a sustained recovery in imports, with 4-5% growth expected in Q3 alone. Further, it is expected that there will be a sharp rebound in inventories over the next 12-months that should support demand for warehousing space. These factors are likely to prompt a broad stabilisation of capital values and rents through much of the sector with a more sustained recovery to commence into 2010.

For now, supply of industrial space remains subdued with little new construction replacing completed projects. For 2009, additional industrial space is expected to reach just shy of 1.5 million sqm, just over half the space added in both 2007 and 2008. Of this stock around 80% is said to by pre-committed which should limit any further upside to vacancy rates. Additions to stock into 2010 are also expected to remain subdued which could result in undersupply in some sectors/areas late in the year. We anticipate demand for manufacturing and warehousing space will begin to recover in line with the economy. Demand for vacant stock has remained fairly robust and any existing excess supply should be soaked up relatively quickly given the still low levels of construction in the pipeline. As such we would anticipate any further falls in rents to be minimal. In the September quarter, average Melbourne prime rents eased around 2% with Sydney rents more resilient down only ½%.

Despite this, any return to broad rental growth of the order seen in 2006 to 2008 is unlikely to be repeated. Indeed, we anticipate rental growth to be fairly modest going forward. This is due to the foreshadowed additions to space that have been put on hold in the 2009 downturn giving potential for a sharp turn around of supply as the economy improves and/or pre-commitment levels rise. However, the speculative element of the sector is likely to continue to be deterred by relatively tight lending conditions.

Prime industrial yields are turning the corner

Industrial yields



Source: JLL, ANZ

The close to 25% falls in average capital values over the past 2 years are largely expected to come to an end this quarter or next. With both rents and capital values stabilising we have likely seen the end of any significant yield decompression, especially across prime assets with only modest weakness across select geographies.

Prime yields have already eased around 100-150 bps to around 8½-9% and secondary yields between 150-200 bps pushing towards 10%. These moves have seen yields on secondary assets trading above the premium to primary assets seen in 2000-01. This may suggest there is limited further upside to secondary yields and in a rapidly improving economic environment these assets may start to look oversold. We anticipate that industrial yields will continue to sharpen in coming years. However, we are unlikely to revisit the lows in yields seen in 2007-08 with transaction activity likely to remain relatively subdued for some time which will weigh on capital value growth. Industrial yields will likely maintain a premium over more fancied office and retail sectors with investors remaining cautious.

Alex Joiner

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