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ANZ Australian Property Outlook

December 2006

Inside:

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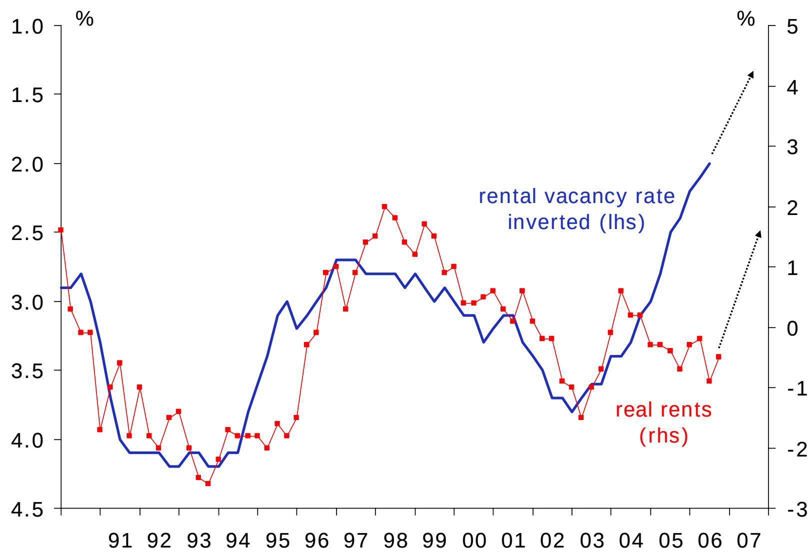
Economic Overview

The RBA has lifted interest rates on three occasions this year – 25bp in May, August and November. The cash rate stands at 6.25%, the same level as the previous peak in interest rates in late-2000. It is likely that no further rate rises will be needed in this cycle.

Residential Property

Housing markets have tightened further in 2006. Rental vacancy rates are already *well* below trend and are likely to fall *significantly* further in the year ahead as new dwelling supply slips further below underlying housing demand. A critical shortage of rental accommodation will take several years to turnaround, placing significant upward pressure on dwelling rents and will eventually be the catalyst for the next upturn in dwelling construction.

Chronic rental shortage to drive next upturn



Sources: Economics@ANZ; ABS, REIA

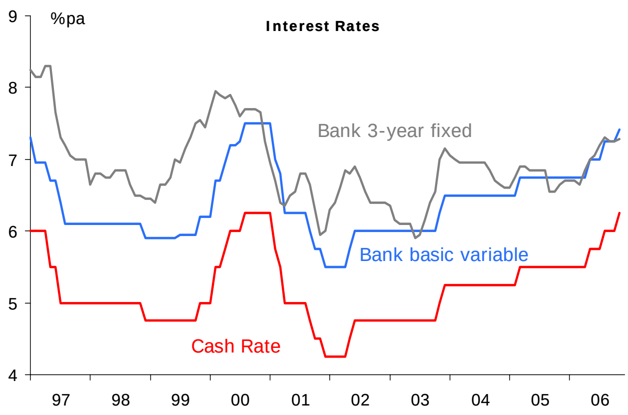
Commercial Property

Major capital city **CBD office** markets continue to tighten with vacancy rates now having fallen continuously since 2004. Continued tightening and associated rental adjustments will underpin further strong growth in capital values. **Retail** sales growth has slowed, but low unemployment, solid wages growth and tax cuts will provide support. The **tourist accommodation** sector continues to record healthy gains in terms of occupancy rates and room rates. The outlook for 2007 remains positive. **Industrial property** markets are strengthening. Strong growth in investable funds will continue in the year ahead, buoyed by the recent changes to superannuation and robust household income gains.

Economic Overview

The future course of interest rates remains a key focus for the property industry. The RBA has lifted interest rates on three occasions this year – 25bp in May, August and November. There have now been eight increases in the tightening cycle which began in mid-2002. As at November, the cash rate stands at 6.25%, the same level as the previous peak in interest rates in late 2000. Standard and basic variable mortgage rates are also broadly back to late 2000 levels, although fixed term rates remain a little below those peaks.

Interest rates at cyclic peak



Source: Reserve Bank of Australia

The primary driver of higher interest rates has been accelerating price pressures. Headline Consumer Price Index inflation was around 4% in the year to September, well above the 2% to 3% RBA target band. Some of this reflected special factors such as cyclone-induced increases in banana prices and high petrol costs. But even the core measures of inflation have shown a worrying upward trend, rising from 2.5% at end 2005 to around 3% more recently.

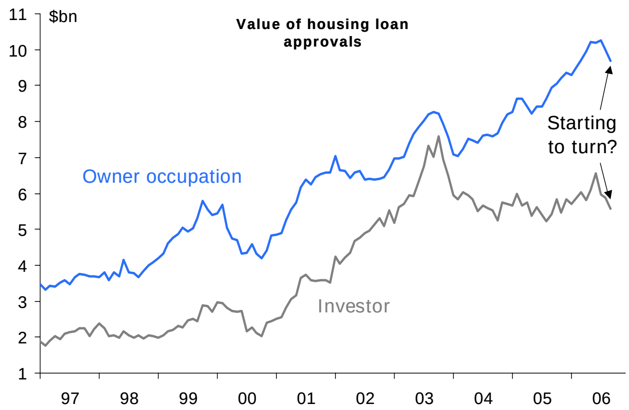
More generally, the economy remains tightly stretched after 15 years of continuous growth with the unemployment rate reaching new 30-year lows of 4.6% and business capacity utilisation at close to cyclical highs. It will require a period of sub-potential growth – say less than 3% - to ease these capacity constraints and allow core inflation to cool.

However, the RBA's own forecasts suggest economic growth will remain around potential for some time to come and that core inflation will remain around 3% for the next two years, with some slight easing towards the end of that period. Any further lift in the quarterly growth of core inflation – perhaps above 0.8% per quarter – is likely to precipitate a further rate increase.

The dilemma for the RBA is that inflation is difficult to tame once it gets away – a danger if policy is tightened too slowly – whereas economic growth can be readily kick-started through a rapid reversal of interest rates should policy be tightened too quickly. The new Governor Glenn Stevens does not want to be the Governor who let inflation loose after all the hard work of the past 15 years. This suggests the RBA will maintain a tightening bias for the foreseeable future and will continue to warn of inflationary dangers.

The RBA will now be watching closely for signs that higher interest rates are beginning to bite. There have been some tentative signs that housing finance approvals are beginning to cool. The value of finance approvals for owner-occupied housing fell by 5.4% over the 2 months to September. Finance approvals for investors have fallen even more sharply, declining by 15% over the 3 months to September. Also, the pace of monthly retail spending has been easing in trend terms since March 2006.

Demand for housing finance begins to ease



Source: Australian Bureau of Statistics

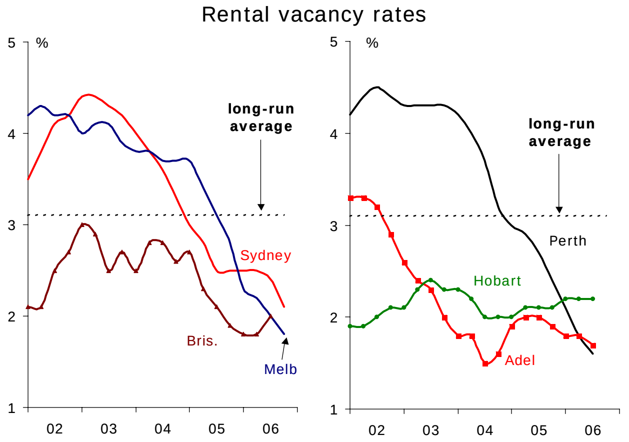
This should be sufficient for the RBA to hold policy steady at least for the next few months. Further out we believe it is most likely that no further rate rises will be needed in this cycle, and that the current level of interest rates will be the peak. Nevertheless, if interest rates were to move again, then there is still a greater chance of a rate increase rather than of a rate fall.

Residential Property

Housing markets continue to tighten

Soft developer sentiment combined with strengthening underlying housing demand has seen housing markets tighten further in 2006. Rental vacancy rates are already *well* below trend in all state capitals and are likely to fall *significantly* further in the year ahead as weakened affordability forces potential buyers into rental markets and new dwelling supply slips even further below underlying housing demand. A critical shortage of rental accommodation will take several years to turnaround and will place significant upward pressure on dwelling rents and consumer price inflation.

Critical shortage of rental housing developing



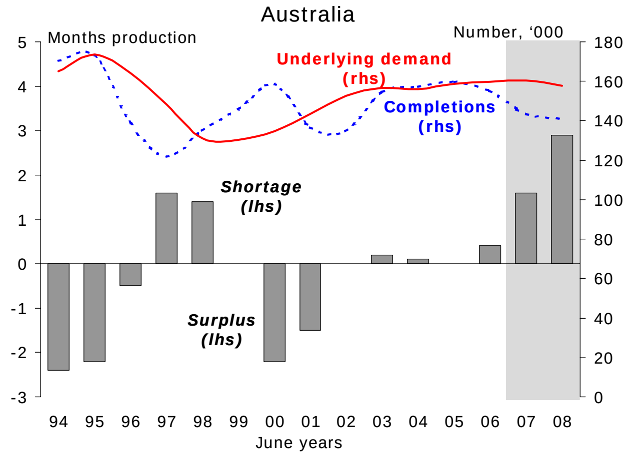
Sources: REIA; Economics@ANZ

Fundamentals to trigger next upturn

This dramatic tightening of housing market fundamentals will eventually be the catalyst for the next upturn in dwelling construction. After being roughly in balance over the past 5 years, new housing supply will fall *significantly* below underlying demand in the next 2 years. Strengthened by increased international migration, underlying housing demand has risen to 160,000 per annum, while dwelling commencements are expected to fall to just 145,000 in 2006-07. With rental vacancies already reaching critically low levels in some areas, a further tightening of the housing demand/supply balance in the year ahead will place increasing upward pressure on rents (and yields) attracting developers and buyers back into the market.

Dwelling approvals appeared to have passed their nadir in early 2006 however a series of interest rate rises over this period are once again testing this bottom and weighing against recovery. Renewed weakness in approvals will intensify pent-up demand. We expect a strong rebound in home building activity from the second half of 2007 that will lift starts towards record highs in 2008-09.

Housing market set to tighten even further

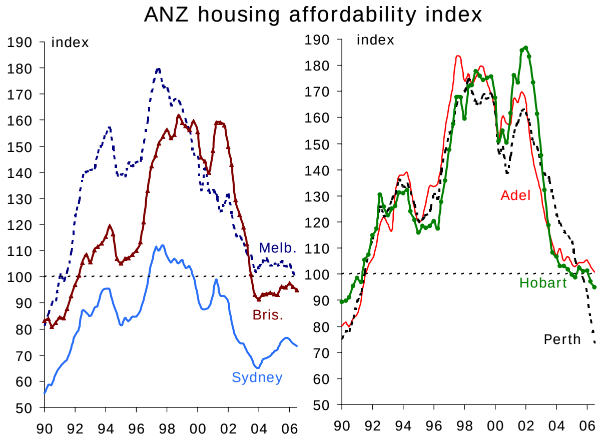


Source: ABS Cat. No. 8750.0, 3222.0, 3101.0, Economics@ANZ

Housing affordability squeezed…

While household income growth has been strong, housing affordability[1] has been squeezed by a combination of rising house prices and more recently higher interest rates. In most state capitals, housing affordability has plummeted to lows not seen since the late 1980s when mortgage interest rates reached 17%!

Housing affordability falling again



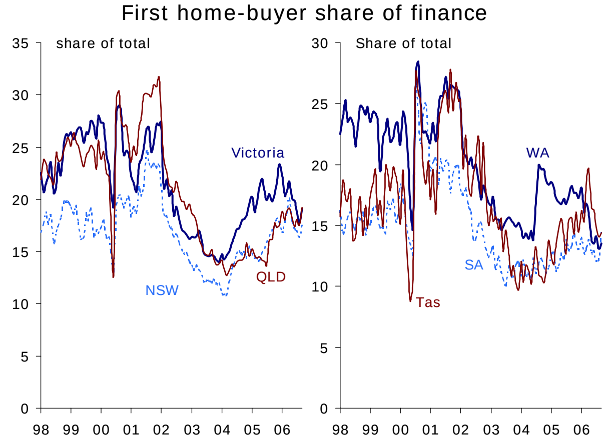
Sources: Economics@ANZ; ABS

A moderation of house price growth since early 2004 in some capitals saw affordability improve in line with household income growth, but the recent reacceleration in house prices has lowered affordability once more. The deterioration in affordability has been particularly marked in Perth where house prices continue to boom (up 46% in the year to September 2006).

[1] The ANZ housing affordability index compares the debt serving cost of the median priced home, with average household disposable income. An index value of 100 means the average household can service a loan on the median priced dwelling (assuming a loan to valuation ratio of 80%.)

First homebuyer activity provides a good barometer for assessing affordability conditions. Clearly the flattening in prices growth over 2004 and 2005 alleviated barriers to entry for first-home buyers, with their share of total owner-occupier finance lifting in all states. However, renewed prices growth in most capitals and a series of interest rate rises since then, first-home buyers are once again being priced out the market. The more recent deterioration in affordability, being policy-induced rather than demand driven is likely to pose a significant constraint on further acceleration in house price growth.

First homebuyers priced out of market

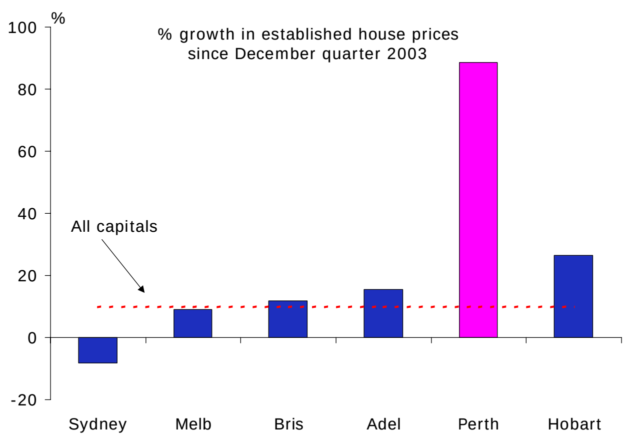


Sources: ABS, Economics@ANZ

House prices strengthening

After moderating since early 2004, house prices have reaccelerated up to September 2006. Sydney and Perth remain the outliers with Sydney house prices registering a gain of just 1.4% over the year to September, while Perth house prices rose by a remarkable 46% over the same period. Other capitals have enjoyed healthy (if less spectacular) gains, averaging 7.4%.

House prices reflating



Source: ABS

This reflation in house prices is symptomatic of solid housing market fundamentals and a generally accommodating economy and labour market. With good employment growth expected through 2007 and the housing market set to tighten further, house prices will remain well supported.

Rentals to pose a RBA policy dilemma

Rental markets are already tight and on our current reading, the development of a chronic rental shortage over the next 12 to 18 months is likely. The combined effect of increasingly disgruntled new households having to rent (instead of becoming owner-occupiers), a reluctant developer market and a lack of new supply generally will be to bid up rentals. However, given a segmented investor market and that lease arrangements typically last up to 12 months before enabling rental adjustments, there are considerable lags in the system. Some rental markets are already showing an up-tick in rentals but chronic shortages should bring more sizeable adjustments.

This is likely to pose a dilemma for the RBA in attempting to keep a lid on inflation. With dwelling rentals feeding directly into the CPI, a 15% increase in rentals (for instance) would add 0.8% to the annual increase in the CPI, enough to blow core inflation well out of the 2%-3% target range.

The most *direct* policy tool for neutralising this sizeable boost to underlying inflation is a reduction in interest rates[2]. But this policy action runs counter to the objective of reducing general inflationary pressures. To ignore the physical housing demand/supply imbalance that is developing risks intensifying rental inflation and thereby potentially undermining the broader inflationary strategy.

Dwelling starts forecasts

June years: ('000)	**2005**	***2006 (est.)***	***2007 (f)***	***2008 (f)***
Australia	**157.4**	***150.8***	***145.4***	***153.9***
NSW	37.6	*32.3*	*29.6*	*36.0*
Victoria	41.0	*39.1*	*37.1*	*37.6*
Queensland	38.9	*37.3*	*35.6*	*38.2*
South Australia	10.6	*10.7*	*9.2*	*7.6*
Western Australia	22.8	*25.6*	*27.8*	*28.6*
Tasmania	2.8	*2.6*	*2.4*	*2.4*
NT	1.3	*1.3*	*1.1*	*0.9*
ACT	2.4	*1.9*	*2.6*	*2.5*

Source: ABS, Economics@ANZ. *States may not add due to rounding*

[2]An interest rate reduction will divert householder demand back to owner-occupation and generate a direct supply response from the speculative sector and through the owner-occupier sector.

New South Wales

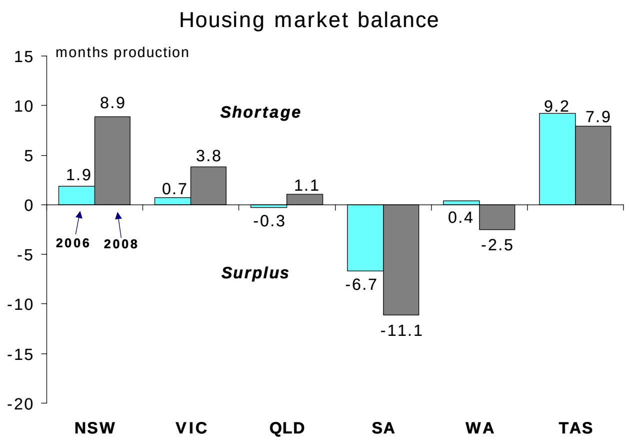
The NSW economy has been in technical recession and has under-performed all other states by a significant margin in recent years. However, there are encouraging signs. Employment growth is picking up and the unemployment rate has fallen in recent months. Residential building approvals too bottomed earlier this year, clawing back from very low levels and house prices have stopped falling.

Housing market fundamentals are in great shape with NSW already in pent-up demand at June 2006. This shortage is set to get considerably bigger over the next couple of years with building approvals expected to remain well below underlying requirements. By June 2008, the NSW housing market will have pent-up demand equivalent to around 9 months production.

Housing market tightness is also evident in rental markets with vacancies approaching record lows in the past few months. While part of this rental market tightness reflects a diversion of buyer demand towards rental stock in the face of difficult affordability conditions, it also reflects broader demand/supply imbalances, a consequence of not building enough homes.

Three interest rate rises this year and an already sluggish economy are going to lean heavily against recovery in dwelling construction. As a consequence, market tightness will intensify over 2007 with rental vacancies most probably breaching record lows and rental growth spiking in response over 2007/08. Such market signals will be a necessary precursor to a rebound in construction levels, restoration in investor sentiment and a solid underpinning for prices growth.

Housing shortages to grow sharply



Sources: ABS; Economics@ANZ

Victoria

Economic growth in Victoria has been moderate with Gross State Product lifting 2.7% in 2005/06, just short of the national growth in GDP. That said, labour market conditions remain favourable with trend employment growth running at almost 3% over the year to October 2006 and the unemployment rate trending down to its lowest level since early 1990. House prices have rallied up to the September quarter 2006 and are now up 7.5% on year earlier levels, an indication that broader household sector conditions and housing market fundamentals remain sound.

Building approvals too have been on a moderate upward trend since February this year. In October, building approvals were trending at an annualised completions rate of 36,300. This is below the annual average underlying dwelling requirement of around 41,500. Technically, the Victorian housing market is broad supply/demand balance but will, on our current track for dwelling construction, move gradually into a position of moderate pent-up demand over the next couple of years.

Melbourne's rental markets too are very tight and as is the case in NSW, will play a key role in the stock adjustment to emerging shortages. Inner-Melbourne, where rental vacancies are at a new low of 1.8% in September, has experienced the greatest tightening in the past few years, amidst persistent agitation in some quarters warning of chronic oversupply. Given this and with relatively little new supply in inner Melbourne in prospect, there is every likelihood this market will remain well supported.

Melbourne house prices have reflated in recent quarters, lifting 7.5% in the year to September 2006. Combined with interest rate rises, renewed prices growth has impacted on affordability conditions, although not as severely as in other capitals. The first home-buyer market had started to reclaim its share of the owner-occupier market over the 2004 and 2005, but this trend has reversed once again this year, an indication that price may be imposing a stronger barrier to entry.

Queensland

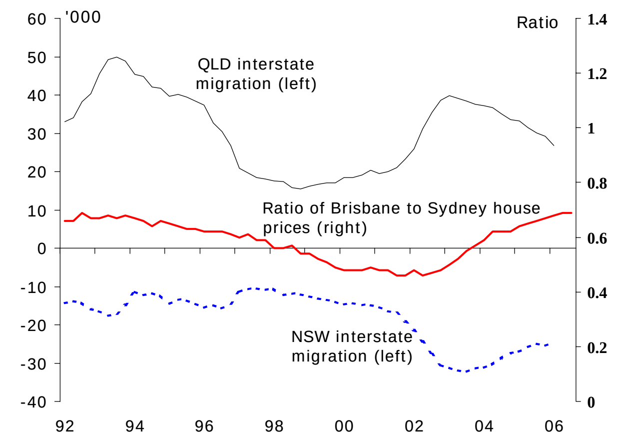
The Queensland economy is growing strongly, riding the commodity price and resource investment waves. This strength is boosting employment and incomes growth. Jobs growth has risen to 4.2% over the year to October 2006 and the unemployment rate has fallen sharply to 4%. We have seen renewed strength in house prices and the commencement of a recovery in building approvals. The Queensland economy is expected to slow a little but will maintain a clear premium above the national average.

Building approvals are already trending at an annualised completions rate of 36,250, not much below underlying requirements (37,000). With dwelling completions forecast to track underlying demand closely over the next couple of years, the Queensland market is projected to remain in broad demand/supply balance.

Brisbane's rental market had tightened along with most other capitals until the beginning of this year, although a bottom appears to have formed more recently, suggesting a potential easing in market conditions is occurring. A slowing in population growth, reflecting a reversal in NSW/QLD interstate movement may be also playing its part in transferring rental market pressures from Brisbane to Sydney.

Brisbane house prices have risen 6.5% over the year to September 2006 and first-home buyers are still clawing back share of total finance. Recent interest rate rises will test affordability and the sustainability of renewed momentum in house prices.

Sydney house prices enticing some back



Source: ABS

South Australia

After performing strongly in recent years, the South Australian economy has slowed in 2006. Nonetheless, employment growth is picking up, having risen from around 1% annual growth in June to 2.5% in October 2006. The unemployment rate has edged down to record lows and now is slightly lower than the national average (in trend terms). A strong and unexpected lift in migration levels (particularly overseas) has been underpinning the housing market and house prices which have resumed an upward trend in recent quarters rising 6.4% over the year to September and by 15.3% since December 2003.

Contrary to the trend in other Eastern states, building approvals have started to trend down in recent months. Even at these lower levels, building approvals are still trending at an annualised completions rate (8,900) above underlying requirements (8,300). On current projections, this oversupply is estimated to increase over the next two years.

While the overall market is oversupplied, Adelaide's *rental* market is 'enjoying' relatively tight conditions with capital city vacancy rates dropping below 2%. As in most other capitals, this most probably reflects the impact of weaker buyer affordability on demand for rental stock. This pressure on rental market is unlikely to dissipate in the short-term as renewed prices growth and interest rate increases raise the barriers to entry for home buyers.

Western Australia

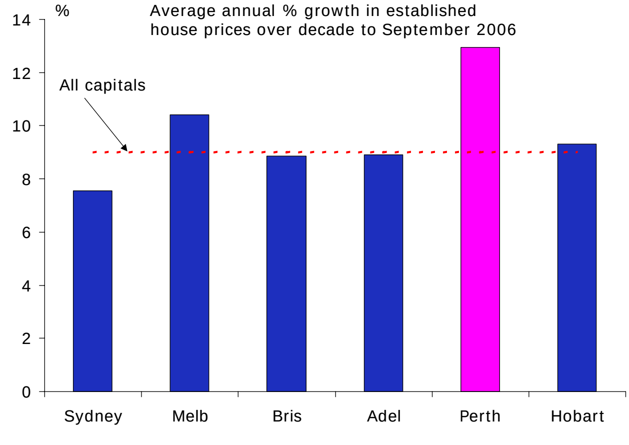
A booming Western Australian economy is pervading most sectors, not least the housing market which in the past few years has experienced remarkably strong prices growth (up 45% over the year to September 2006), healthy residential construction, sales and outstanding growth in finance for housing.

Despite a softening in commodity prices, the Western Australian economy is still booming on most fronts. The unemployment rate has stabilised at around 3.7% employment growth has slowed from 2.4% in June to 1.9% - more likely to be reflecting labour shortages than any tailing in demand for labour.

Underlying demand for housing is estimated to have risen from 16,000 dwellings annually in 2001 to around 21,000 dwellings in 2006. By and large, however, the Western Australian market has been in broad demand/supply balance in recent years. This condition will persist over 2006/07. By 2008 however, on current projections of dwelling completions, an oversupply of dwellings will emerge, equivalent to around 3 months production. This *alone* is unlikely to derail activity and prices any time in the near term but may introduce vulnerability to market conditions at some stage down the track.

While the Perth housing price upturn did not get underway until well after other major capitals, any notion that this market was in 'catch-up' mode has dissipated, with the Perth market now registering greater prices growth than any other capital city over the decade to 2006. Contrary to most other states, first-time buyers are increasingly being priced out of the market with finance to this group showing little or no growth in recent years.

Perth house prices – the best over the decade



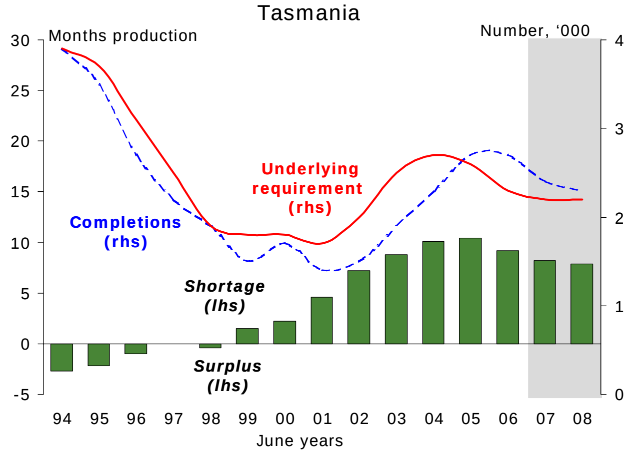
Source: ABS

Whilst a robust economy is driving prices, some of the strength can be traced to inadequate land production which has in all likelihood exacerbated the condition. While land release has responded, by increasing to record levels, bottlenecks in the production process are unlikely to relieve land market pressures over 2006/07.Some price 'correction' over the next 12 months is more than likely but the still solid outlook for the Western Australian economy suggests this adjustment will be limited and should be interpreted more as a 're-alignment' following the short and sharp momentum recorded in recent quarters and not a fundamental reassessment of where Perth house prices ought to be.

Tasmania

The Tasmanian economy has slowed sharply following a period of above-average growth. Employment growth has flattened and the unemployment rate has lifted to a 'local high'. Despite the weaker momentum in economic activity, the housing market is still relatively well positioned with rental markets remaining tight and house prices maintaining solid momentum (up 3% in the September quarter 2006 to be up 9.4% over the year). Gross state product is forecast to grow by around 2% per annum over the next couple of years - well below the rates of growth Tasmania has experienced in recent years.

Strong pent-up demand for housing remains



Source: ABS Cat. No. 8750.0, 3222.0, 3101.0, Economics@ANZ

Building approvals are trending at an annualised completions rate of 2,600 which is marginally ahead of underlying requirements. Given the considerable shortage in Tasmania, this period of "over-building" is unlikely to destabilise the housing market but bring it closer to balance.

Net interstate migration has fallen sharply from an annual peak of 3,000 in 2003 to just 300 over the year to March 2006. This turnaround, in part, reflects the relative decline in affordability conditions and softer economic and labour market outcomes.

Interest rate rises in 2006 will, in spite of pent-up demand in Tasmania, see dwelling starts edge down further over 2007 before recovering by the end of the year.

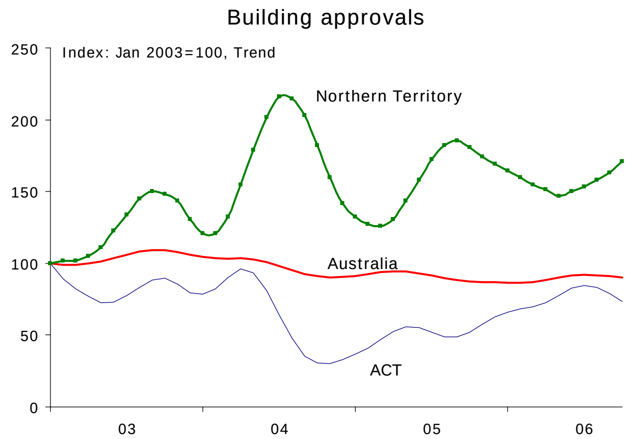
Northern Territory

Strength in commodities markets has been driving the Northern Territory economy, labour market and population growth. Annual growth in employment hit 6% in the year to October and the unemployment rate has fallen to 3%, its lowest level since 1980. This economic strength is transmitting to housing markets with house prices up 53% since December 2003 and up 17.3% over the year to September 2006. Building approvals are also recovering on the back of this strength with no sign yet of an interest rate induced slowing in activity.

With only a mild softening in commodities predicted over the next year, the Northern Territory economy should remain well supported and sentiment towards the housing market should remain positive.

Net interstate migration has turned from a negative 3400 to a small positive. While this is supporting underlying demand, a sizeable over-supply remains and will become a vulnerability should the economy slow and commodity prices fall further than expected.

ACT building approvals strengthening



Australian Capital Territory

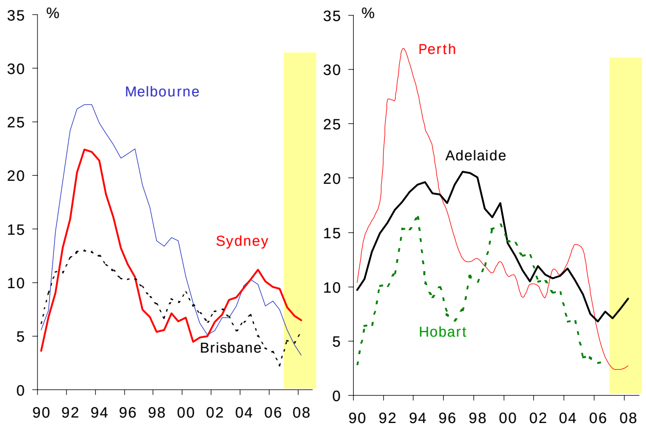
A strong labour market and improved migration are underpinning the ACT housing market. Building approvals have doubled in the past year to quite healthy levels but a dip in recent months now sees approvals running slightly below underlying demand levels. Given there is already some pent-up demand, the ACT market is likely to remain well supported. Canberra house prices growth has picked up, rising 6.6% in the year to September 2006. Net migration improvement appears to have fed into rental demand, with vacancy rates falling sharply in the past year. Interest rate rises in 2006 will place further downward pressure on building approvals over the first half of 2007 before recovery commences later in the year.

Commercial Property

CBD Office

Major capital city CBD office markets continue to tighten with vacancy rates now having fallen continuously since 2004. Despite some markets experiencing solid capital growth recently, yields have edged down only slightly, reflecting quite healthy rental market adjustments in some capitals. A continued tightening in conditions and associated rental adjustments will, despite the 'nuisance' of interest rate rises this year, underpin further strong growth in capital values, particularly in those centres enjoying healthy growth and where the supply response has been a little sluggish.

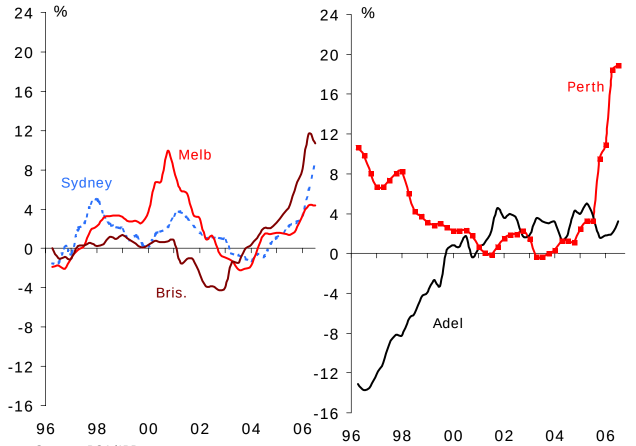
CBD office vacancy rates



Source: Property Council of Australia, Economics@ANZ

Rentals in Australia's CBD office markets have lifted around 3.6% in the year to September 2006. Further tightening in rental markets over 2006/07 will also generate additional momentum in rentals over this period, enabling capital growth to continue without much resistance from yields. Given office market yields remain stubbornly high, there is upside to an already favourable outlook for values.

CBD office capital returns



Source: PCA/IPD

The **Sydney CBD** office market is tightening but at a more measured pace than other centres. Office vacancies were still around 9.4% of total office space in mid-2006, down from 11.2% in early 2005. This is not surprising for an economy that is in technical recession. Absorption is expected to slow over the coming year from recent levels but subdued levels of additional capacity will allow vacancies to decline further. What has surprised is Sydney office values, which according to PCA/IPD have jumped by a solid 8.9% over the year to September 2006. This 'firming' in yields (from 7.3% to 6.7%) has occurred over a period flat rentals, suggesting a hint of investment optimism. The Sydney CBD office vacancy rate is expected to fall from around 9.4% to around 6.5% by 2008.

Melbourne's CBD office market has tightened more aggressively than expected just six months ago, reflecting a quadrupling in absorption in the six months to July this year compared to the previous six months (213,000 square metres over the year), more than matching the quite healthy level of new supply (187,000 square metres). Even with a sharp drop in absorption assumed for 2006/07, further tightening in the Melbourne CBD office market is likely. Contrary to many other capitals, investment performance has remained pedestrian, with capital returns increasing only 4.3% in the year to September 2006. On the other hand, rentals have jumped sharply. Yield improvement and a further tightening in conditions should offer good support to prices over the next year.

A booming Western Australian economy is underpinning **Perth's office** market. Current levels of office demand are already eating into spare capacity, particularly in the premium grade (according to PCA/IPD, only 293 sqm of vacant space is left). Vacancy rates in lower-grade buildings remain higher but are too falling quite rapidly. The Perth CBD vacancy rate has fallen to 3.5% in mid-2006. Given strong competition for state resources in a booming economy, office supply expansion is having difficulty keeping up with demand. Even with some slowing in absorption assumed, it is very difficult to see vacancy rates move higher in the next year. Perth office values have risen sharply in the year to September 2006 with capital returns increasing by 19%, a growth rate not seen since 1989. Interestingly, rents too have risen around 18% over this period, leaving yields largely unchanged. Despite fundamentals being strong, there are clear risks down the track, particularly if a strong front of committed developments comes on stream when the economy and demand have cooled.

The **Brisbane CBD office** market is in good shape although no further tightening in the physical market is expected with the vacancy already hitting 2.3% in mid-2006. A moderate slowing in absorption combined with around 140,000 sqm of new space coming on in the next 18 months suggests a reversal in Brisbane CBD vacancy rate but not to worryingly high levels. Capital values in Brisbane CBD offices have kicked up by a solid 11%

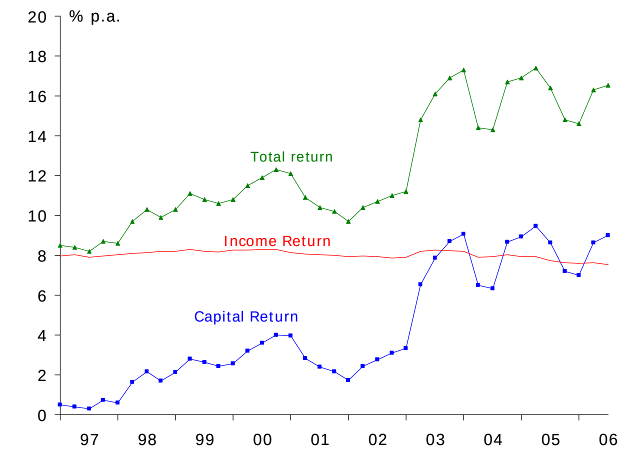
in the year to September 2006, causing yields to firm from 8% to 7.2%. Given the prospect of a slight weakening in fundamentals, however, recent interest rate rises and no evidence of any significant growth in rentals, 2007 is likely to record more moderate outcomes for values.

Along with other capital cities, **Adelaide core** office market is tightening but this is unlikely to be sustained as new supply for the coming year will amount to a very high 6% of total office stock. Even if absorption continues at recent healthy levels vacancies are set to rise. The vacancy rate of 6.8% recorded earlier this year was the cyclical bottom, with a rebound towards 9% very likely by 2008. Reflecting weaker fundamentals and economic performance generally, Adelaide office values have remained fairly subdued in the year to September 2006, lifting 3.2%. An expected deterioration in office market fundamentals and only minimal rental momentum suggest there will be limited capital values growth in the year ahead.

Retail markets

The outlook for retail sales is for a moderation in growth as the impact of three interest rate hikes in 2006 filters through the economy. Nevertheless, low unemployment and solid wages growth are likely to limit the slowdown in turnover. Household spending is also likely to be cushioned by the possibility of further tax cuts, with 2007 being an election year and the budget surplus likely to remain strong. We expect nominal retail sales to rise by 5.4% in 2007 from an estimated 5.8% in 2006. This is in line with its 15-year average.

Return on retail property



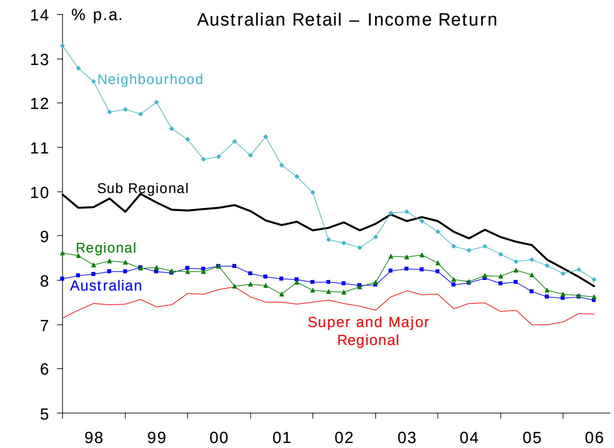
Source: Property Council, Economics@ANZ

The divergence in retail spending between states & territories is expected to persist in 2007 with resource-based states benefiting from a solid commodities profile and net interstate migration. Over 2006, Western Australia and the Northern Territory have seen the strongest increase in turnover, up 8-9% while sales in the South eastern states have grown at around 4.5-5%.

On the supply side, the pace of shop building activity is likely to moderate in the months ahead. For the first ten months of 2006, shop building approvals were down 15% from the same period in 2005. This, however, comes after a strong building approvals phase in 2004 and 2005. Retail building activity is likely to feature bulky goods centres as well as the expansion and/or refurbishment of neighbourhood and sub-regional shopping centres.

In particular, the increasing number of inner-city residents and worker population is likely to keep retail tenant demand strong and together with limited stock, will continue to support growth in CBD rents. The bulky goods sector could, on the other hand, experience limited scope for rental growth given the large supply coming on stream and only a mild pick-up in dwelling construction.

Income return by retail-type



Source: Property Council, Economics@ANZ

While overall income returns have held steady, a breakdown by type of retail shows a gradual decline in yields over recent years underpinned by strong investment demand for retail assets. Relatively healthy retail turnover and low vacancy rates will continue to underpin rental growth, particularly in CBD areas, and this should support capital value growth. Capital returns ticked up in the June and September quarters.

The retail stock in **Victoria** is expected to expand further over the coming year with a huge spurt of construction already underway in Melbourne's north and south-east, driven largely by growing residential and commercial development. Projects include the 30,000sqm University Hill project in Bundoora, bulky goods centres in Coburg and Thomastown, Chadstone and Westfield Bay City Plaza extensions, $150mn homemaker centre in Mentone and further development in the Docklands precinct. Rents are expected to hold steady despite the coming on-stream of new supply, reflecting solid investment demand as well as strong tenant demand particularly in suburban shopping centres.

Growth in retail turnover has been the weakest in **New South Wales**, rising by just 4.4% during January-October 2006 compared with the corresponding period in 2005. Household consumption is likely to be adversely affected by the interest rate hikes in 2006, sluggish population and employment growth. That said, low vacancy rates in Sydney CBD and prime retail strips will underpin growth in rents. The downturn in the housing market, however, will mean that the bulky goods segment is not expected to fare as well. In terms of retail construction, building approvals data signal a softening in activity in the months ahead with approvals down almost 30% in the ten months to October compared with the same period in 2005.

Retail construction activity in **South Australia** has been driven largely by the development of neighbourhood centres and bulky goods stores, supporting new residential developments in the north and southern suburbs of Adelaide. However, building approvals data indicate a decline in activity in the coming year after solid growth in 2005. The coming on-stream of retail space and moderation in retail sales growth are likely to limit scope for stronger rental growth.

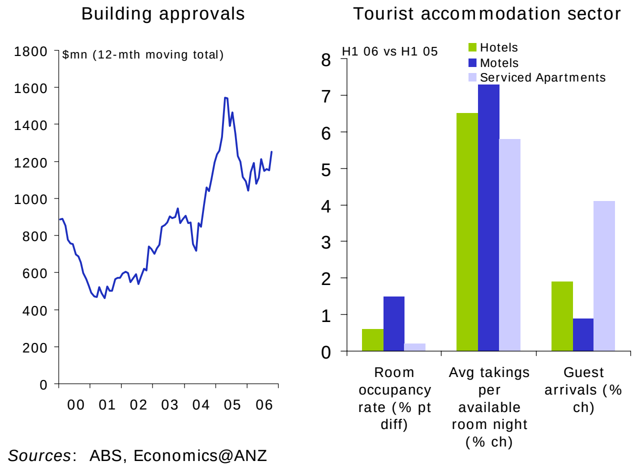
Retail sales in **Queensland** have risen by 7% during January-October 2006, well above the national average. The rise in inner-city living and visitor arrivals have underpinned strength in retail tenant demand in Brisbane CBD and supported the expansion of retail space. The outlook is for some slowdown in building activity but medium-term plans to lift the quality of stock will underpin construction. As part of the council's CBD masterplan, a 5-year redevelopment project of a part of the city's CBD, to be called the North Quarter, is being planned and will include retail, commercial and residential mix. Other projects underway include the upgrading of sub-regional shopping centres, the extension of Harbour Town outlet shopping in the Gold Coast, which is due for completion by April 2007, and new bulky goods centres (eg. Bunnings in Toowoomba) scheduled for completion by mid-2007.

Low unemployment, strong wage growth and wealth gains from rising house prices are likely to continue to underpin household spending in **Western Australia** in the months ahead. WA recorded the strongest retail spend this year, rising by 9.1% during the ten months to October compared with the same period in 2005. Against this healthy backdrop, the outlook for CBD retail is favourable and vacancy rates are expected to remain low. Construction activity is forecast to remain steady, with major projects including the Century City development and Ikea Super Store.

Tourist accommodation markets

The tourist accommodation sector continues to record healthy gains in terms of occupancy rates and room rates. For the first half of 2006, the average room occupancy rate for the hotels, serviced apartments and motels & guesthouses segment rose by 0.9 percentage points compared with the same period in 2005 to 62.6% - the strongest first half rate since 1997. Average takings per available room night rose by 6.6% during the same period to a solid $82.90. What has largely driven the recovery in this sector has been limited new development since the spurt of building activity in 2004 and 2005. The motels & guesthouses segment saw the biggest increase in room rates in H1 2006 and the largest improvement in occupancy rates. Considering that the increase in new supply has largely been in the serviced apartments sector, the increase in occupancy rates in this segment, albeit small, underscores the strength in market demand. The hotel segment fared well with average takings up 6.5% in the first half of 2006 compared with the same half in 2005.

Tourist accommodation sector strengthens



Sources: ABS, Economics@ANZ

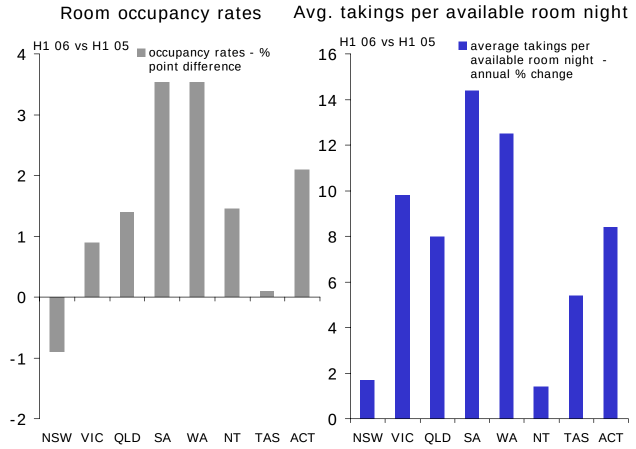
The outlook for 2007 remains positive. Rising building costs and limited supply of choice sites, particularly in CBD districts, for development combined with steady demand provide scope for further growth in room rates. Building approvals data for January-October 2006 suggest a mild pick-up in activity in the next few months. In terms of demand, growth in overseas visitor arrivals is expected to strengthen, underpinned by a more competitive exchange rate, a lower oil price track compared with what we experienced for the most part of 2006 as well as some expansion in airline capacity. The Tourist Forecasting Committee, in its October 2006 report, has forecast a 4.3% rise in visitor arrivals after an estimated contraction of 0.5% in 2006. However, growth in domestic travel is likely to be more subdued as business travel responds to the slower investment climate after the robust pace of expansion in recent years. In addition, the drought would have an adverse impact on tourism in rural regions with the dry landscape and concerns over water restrictions deterring tourists. This is likely to affect the motels & guesthouse segment in particular. Overall, investment interest in the accommodation sector, which has picked up over the year, is expected to stay positive as limited investment stock and an improvement in room rates enhance the attractiveness of this asset class.

There was a slight dip in the occupancy rate in the **New South Wales**' accommodation sector in the first half of 2006. However, considering the increase in guest rooms, which exceeded 2000 in the 12 months to June 2006, this was a respectable result. Room rates, on the other hand, were higher in the first half of 2006 compared with the same period in 2005. This could have reflected the higher quality of stock as upgraded properties re-opened for business. Limited new supply is likely to support a further increase in room rates though the lack of a strong marketing campaign and a likely slowdown in growth in business travel over the coming year could limit the scope to raise rates. Construction projects underway include the new 5-star Sofitel Sydney Olympic Park and a 2-star Formule1 hotel, also in the Olympic precinct, is in the pipeline.

Prospects for **Victoria**'s tourist accommodation sector are favourable with a strong events calendar ahead, particularly in the first quarter of 2007 with the Australian Tennis Open and the Grand Prix events. Again, limited new supply will underpin growth in occupancy rates and room rates. Also, the potential withdrawal of supply as hotel redevelopment projects get underway over the next couple of years, such as the redevelopment of the Grand Hyatt, will support growth in room rates.

Data on building approvals for the first ten months of 2006 indicate a strong increase in activity in **Queensland** in the months ahead. This is likely to concentrate largely on resort development with projects in Port Douglas, Mission Beach and Broadbeach slated for construction. Average takings per available room night edged up by 8% in the first half of 2006. The opening of the international cruise terminal in Brisbane as well as an increase in air capacity should underpin growth in visitor arrivals and support further improvements in room rates over the coming year.

Accommodation trends by state



Sources: ABS, Economics@ANZ

The strong resource sector in **Western Australia** has continued to underpin rises in room rates in the tourist accommodation sector. Average takings per available room night rose by 12.5% in the first half of 2006 compared with the corresponding period in 2005, supported by a strong pick-up in the occupancy level which rose by 3.6 percentage points to 63.6%. Subdued growth in building activity in the months ahead, reflected by building approvals data, coupled with relatively healthy economic activity is expected to support a further improvement in room rates. However, the extent of future rate increases could be limited by slower growth in mining investment which, in turn, may see a slowdown in growth in business travel.

South Australia's tourist accommodation sector has performed particularly well, recording the highest growth across all States in terms of the average takings per available room night. This was up 14.4% in the first half of 2006 compared with the same period in 2005. However, building approvals data for hotels, serviced apartments and motels suggest that construction activity is likely to accelerate sharply in the months ahead and this is likely to limit the pace of a further increase in room rates over the medium term.

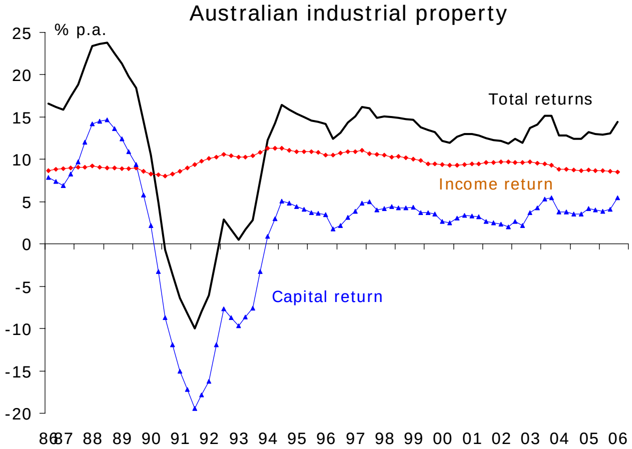
Industrial markets

The manufacturing industry remains in the doldrums with real gross product falling at an annualised rate of 4.1% in trend terms in first half of 2006. A buoyant A$ has increased competitive pressures and the housing downturn has weighed on domestic demand for manufactured products. Wholesale trade activity has also softened this year but a strengthening of real retail turnover and a positive outlook for household disposable income growth foreshadow some pick-up in the year ahead.

Industrial property markets returns continue to strengthen, registering a solid 14.4% over the year to June. Returns were strongest in Brisbane (+18.6%) and Melbourne (+15.4%) with Sydney still solid at 13.6%. Investment demand for industrial property remains strong and industrial property yields continue to firm.

Building activity is increasingly focused in the warehouse/distribution sector, with the real value of building work done rising sharply by 23% to just under $3 billion in 2005-06. The building surge has been centred in New South Wales and Victoria.

Industrial market returns remain strong



Source : Property Council

Strong growth in investable funds will continue in the year ahead, buoyed by the recent changes to superannuation (contribution limits and taxation rates) and robust household income gains. Moreover, industrial property will continue to benefit from ongoing portfolio diversification.

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