2 September 2019

AUSTRALIAN MARKETS WEEKLY

Is office market risk adequately priced?

In this issue

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Analysis – Is office market risk adequately priced?

- Retail property conditions have been mixed given low wage growth and weak consumer demand. Amid the rise of online retailing, retailers continue to close stores, rationalise floor space, shorten leases, and modify their business models. Landlords have changed the mix of tenancies away from traditional fashion towards services. Valuations have been under pressure from the sale of non-core assets.
- In contrast, the Sydney and Melbourne office markets have performed strongly given positive supply factors (underinvestment in the sector, stock withdrawals for infrastructure projects and apartment conversions) and strong population growth driving rising white-collar employment. Limited cost pressures and falling funding costs have sent cap-rates lower and lifted book valuations, thereby reducing gearing levels.
- However, we think there are risks around a substantial east coast office supply pipeline, which is the largest since the 1990s. Office absorption is closely linked to the state of the economy, heightening the downside tisks to effective rents and vacancy rates. There are also cycle-specific risks that create additional uncertainty.

The week ahead – Substantial downside risks to Q2 GDP in Australia

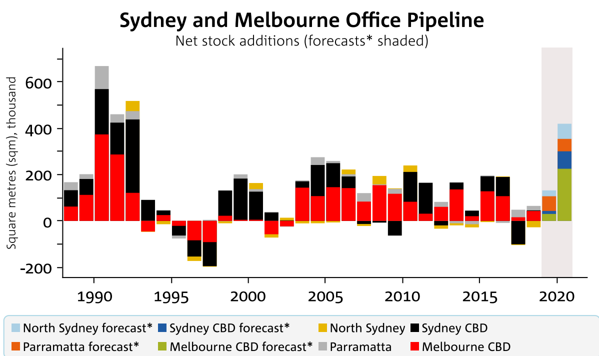
- In Australia, ahead of net exports and public demand data tomorrow, inventories fell sharply, posing a substantial downside risk to our forecast of a 0.5% rise in Wednesday's Q2 GDP. A weak result for GDP would greatly disappoint the RBA, which had forecast a rise of 0.8% in the quarter. This would likely trigger another downgrade to the RBA's outlook in November. Retail sales is expected to be little changed in July, even accounting for the start of the government's tax cuts.
- Internationally, the August US manufacturing ISM on Tuesday should show still-soggy activity, although the non-manufacturing ISM on Thursday may continue to hold up. Analysts expect another solid payrolls report on Friday. In Europe, PMIs may stabilise in September, but there is an increasing headwind from the escalating US-China trade war In the UK, PM Johnson's audacious decision to suspend parliament from 9 September for five weeks has set the scene for numerous challenges. Opposition MPs will attempt to move legislation that will aim to extend Article 50 past 31 October. We might also see an opposition-led confidence vote on Johnson's government.

Key markets over the past week

	Last	% chg week		Last	bp/% chg week
AUD	0.6730	-0.7	RBA cash	1.00	0.00
AUD/CNY	4.82	-0.7	3y swap	0.72	-0.03
AUD/JPY	71.5	-0.6	ASX 200	6579	2.16
AUD/EUR	0.612	0.3	Iron ore	86.0	-0.58
AUD/NZD	1.067	0.7	Brent oil	59.0	1.57

Source: Bloomberg

Chart of the week: Office supply looks heavy



Source: JLL Research, CBRE, NAB Credit Research
* Averages of forecasts provided to NAB.

Andrew Jones

Is supply risk in the office market adequately priced?

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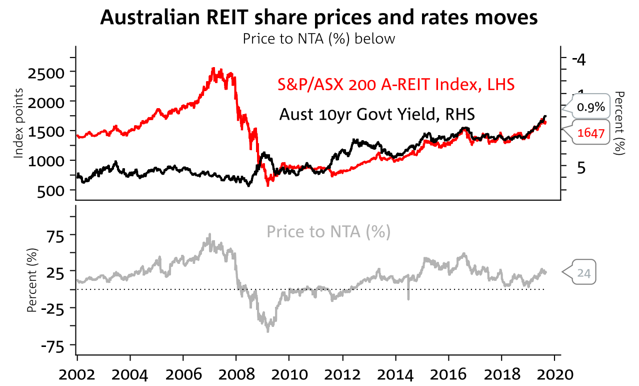
Equity valuations and credit spreads have diverged within the property sector

Bond yields fall, lifting the sector's valuations

The S&P/ASX 200 A-REIT Index's rise in 2019 has closely followed a sharp fall in Commonwealth bond yields, as shown in the below chart.

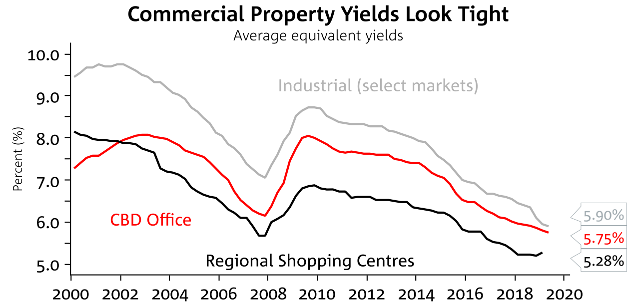
The interest rate-sensitive sector has been one of the best performing this year. The rally in government bonds provides support to commercial property yields and cap-rates that were already at low levels relative to past cycles.

Chart 2: A-REIT equity prices track rates moves



Source: Bloomberg, NAB Credit Research

Chart 3: Face commercial yields are below global financial crisis levels ...



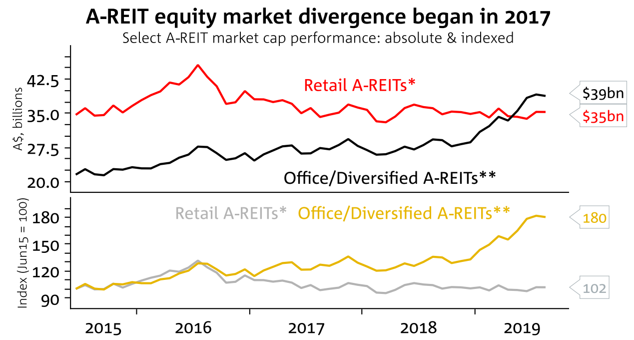
Source: JLL Research
Regional Shopping Centres & CBD Office averages include 5 major capitals.
Industrial includes Melb. SE, Perth East, Adel. Inner E/W, Bris. Southern, Syd. Outer C West.

Australian averages calculated by NAB.

Retail A-REITs have lagged office and industrials given the rental picture

The divergence in rents has meant that the valuation boost from falling bond yields and shifting interest rate expectations has not been equally spread. This is reflected in the next chart, which shows the outperformance of major office-owning A-REITs.

Chart 4: ... although retail REITS have lagged offices and industrials



Source: NAB Credit Research

* 'Retail' A-REITs includes SCG, VCX, CQR, SCP.
** 'Office/Diversified' A-REITs includes DXS, GPT, MGR.

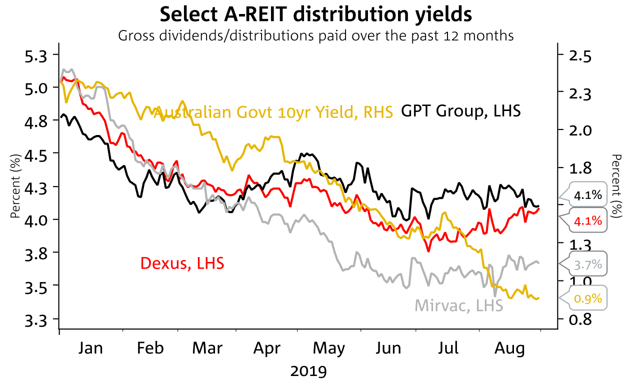
Equity raisings to fund acquisitions and developments have followed

A number of equity raisings by A-REITs near the end of the last financial year was observed following the bond-led decline in distribution yields. GPT, Mirvac, Cromwell and others successfully raised equity via institutional placements and share-purchase plans. The new equity is being used to fund acquisitions and development pipelines.

Similar valuation outcomes have been seen in the bond market

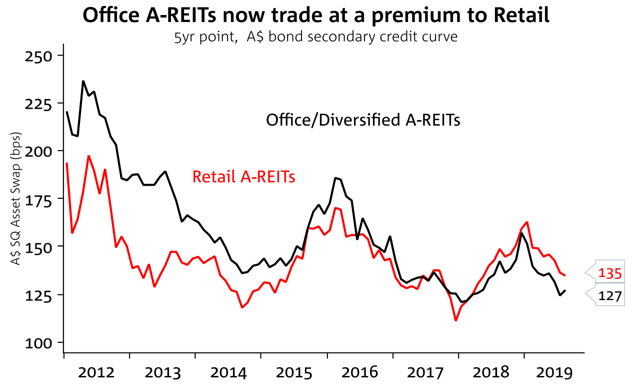
The credit spread performance of A-REITs has changed since 2017 with issuers with office and industrial assets now trading at a premium to retail A-REITs. This reflects structural, and in some cases liquidity, pressures facing that selection of bond issuers.

Chart 5: Office and industrial distribution yields follow government bond yields lower



Source: Bloomberg, NAB Credit Research

Chart 6: The cash credit market tells a similar story



Source: NAB Credit Research

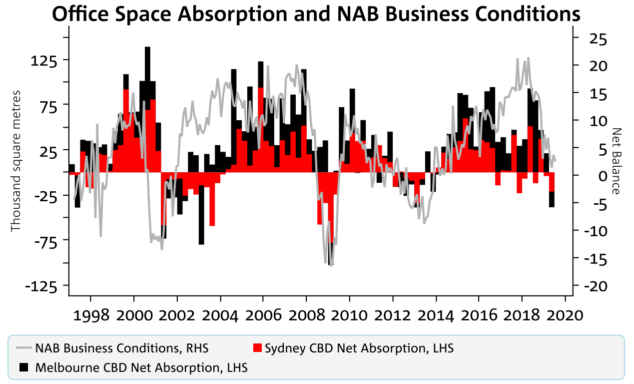
Risks of oversupply in the office market have increased

The recent experience of the Sydney and Melbourne office markets has seen business absorb vacant and new space. However, this positive absorption cycle has only been in place since 2014 or so and prior to that there was a relatively shallow period of negative net absorption. Recent strong absorption has resulted in a building supply pipeline, while there are other risks specific to this cycle that warrant consideration.

Weaker business conditions is a potential issue for landlords given conditions drive floor space absorption

As noted in recent research reports, office absorption in the Sydney and Melbourne CBD was negative in the first half of 2019. This was consistent with the weaker NAB survey measure of business conditions, where the slowdown over the past year raises uncertainty on the demand side.

Chart 7: Business conditions drive office demand



Source: JLL Research, NAB

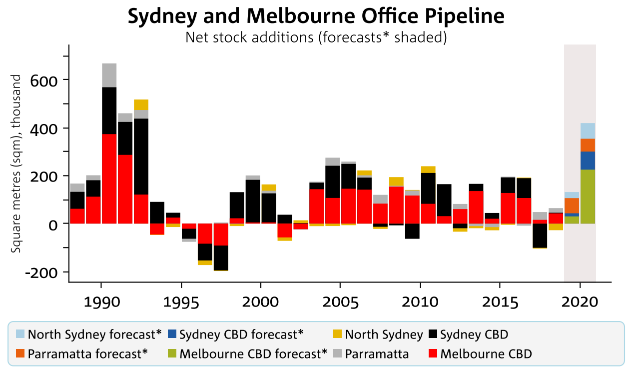
Risks on the supply side are rising and the first speculative build in Melbourne for 30 years in Melbourne raises flags

Despite press coverage focused on retail's woes, a significant pipeline of office projects has been building. The first wave of construction will be completed next year and forecasts suggest 2020 will bring the largest net addition of floorspace for Sydney and Melbourne since the 1990s.

Low vacancy and healthy effective rental growth in Melbourne has brought with it the reportedly first speculative office tower in 30 years, with Poly Australia set to build a 40k sqm A-grade office tower in Docklands. Office projects typically secure an anchor tenant(s) prior to commencement, so speculative building activity creates additional risks.

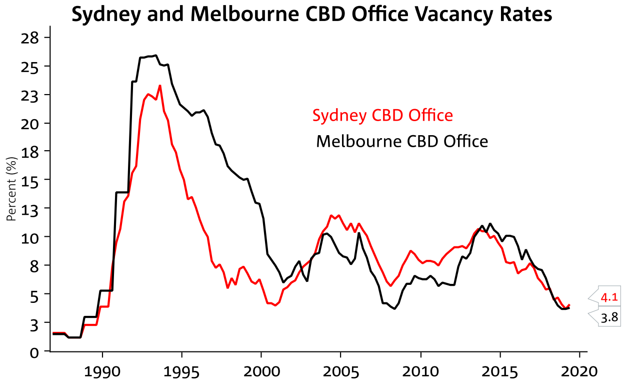
In Sydney, the supply response has involved heavy building in non-CBD markets such as North Sydney and Parramatta. The CBD market has been constrained in recent years by infrastructure projects, such as the Sydney Metro.

Chart 8: Office supply looks heavy



Source: JLL Research, CBRE, NAB Credit Research
* Averages of forecasts provided to NAB.

Chart 9: Office vacancy rates are at cyclical lows



Source: JLL Research

Other risks to the outlook

In addition to heavier forecast supply, there are several other risks to the outlook:

1. Retail rationalisation plans could add to the office stock

While previously highly unlikely, the rationalisation plans of large retail anchor tenants (Myer, David Jones, BigW, Target, etc.) have created more office space.

The conversion of more anchor retail space into office cannot be downplayed given a co-working hub is set to replace Myer's lease at Emporium in May 2020 and with WOTSO's entry last year into Scentre's Westfield Chermside, which is a non-CBD shopping centre in Brisbane

2. The impact of co-working in a downturn

Co-working fexibility may accelerate negative net absorption in a downturn. The rise of WeWork, which is currently accelerating plans for an IPO, and other 'workspace solutions' providers has been a phenomenon of the current cycle, consistent with broader economic and structural trends. However, we note that the ability of counterparties to service leases is only as strong as the sub-leasees.

3. Apartment downturn impacts

The downturn in the apartment market could also see a substantial switch in developer focus to office projects, with recent reports of slowing residential conversions.

History tells us this may not end well

The major east coast office markets of Sydney and Melbourne have been in balance relative to the recession of the early 1990s. That correction featured double-digit vacancy rates and a near-90% decline in net effective rents in the Sydney CBD market over several years, which took more than a decade to recover. Since that painful experience, supply additions have been relatively modest and vacancy rates have, per the below chart, oscillated in a tight range.

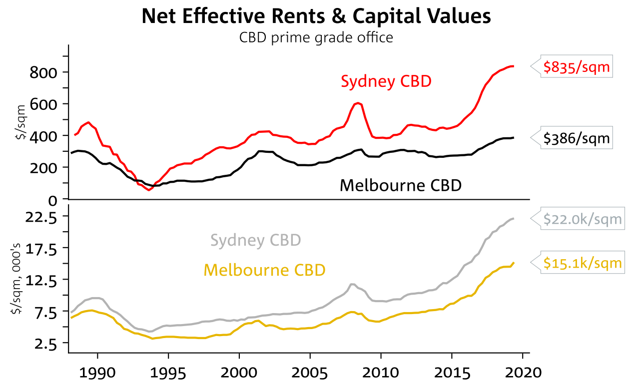
One notable observation from prior cycles is that the economic conditions can change from the time development decisions are made to when a multi-year project is completed. Although most new builds come with pre-commitments, increased 'backfill' space ultimately affect rents. We think the risks have increased on that front, particularly if backfill space is not aborbed in an orderly fashion.

Has the rise of non-bank lenders increased risks in the market this cycle?

Unlike the previous cycle, bank lending has been relatively constrained, with increased participation from superannuation funds and other non-bank lenders, who now hold a greater proportion of office market risk. Importantly, capital decisions are now less reliant on bank funding, which raises the question of whether a lack of regulatory oversight is leading to imprudent investment in the office sector.

In any event, the growth outside of the banking system has been balanced by growth in the net debt of A-REITs, which had been relatively constrained to this point. In this respect, the experience of the global financial crisis appears to linger in the minds of many in management.

Chart 10: Effective rents are volatile

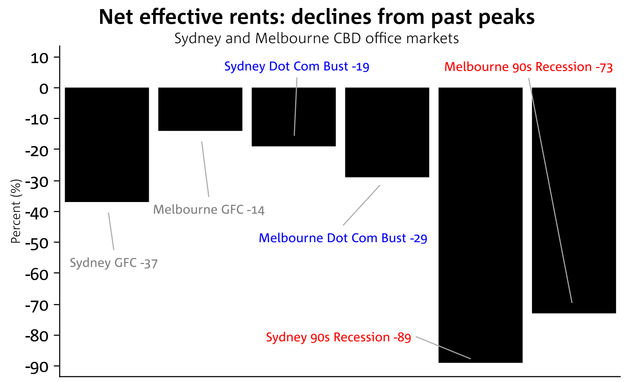


Source: JLL Research

How bad can downturns get?

Past cycles have featured significant volatility in CBD office markets. For example, the downturns of the early 2000s and the global financial crisis saw net effective rental decline between 14% and 37%, taking about 2-3 years before rents bottomed. However, rents would have fallen more sharply during those episodes if they had been coupled with significant overbuilding. Such a scenario played out in the 1990s with the Sydney and Melbourne markets taking about 4 years to bottom with massive declines in net effective rentals. While the current supply pipeline may not yet be at those lofty levels, approvals of office projects have been elevated for some time.

Chart 11: The 1990s experience shows how a supply shock adds to a cyclical downturn

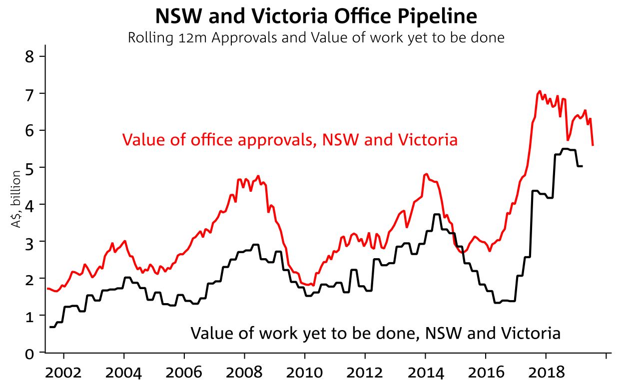


Source: JLL Research, NAB Credit Research

Pricing appears justified for now, but next year will be critical for the major office markets

With the business cycle at a mature stage and the economy slowing over the past year, 2020 is shaping as a critical year for the market. Some slowing of the rapid increase in returns to the sector appears likely with respect to both rents and valuations, but the scale of any downturn remains to be seen. Current levels may be justified on recent rents, but growth in rents may not continue at the same pace based on what we know is coming.

Chart 12: The pipelione of offices under construction has been high for some time



Source: ABS, NAB Credit Research

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CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
Monday, 02 September 2019								
GE	Markit/BME Germany Manufacturing PMI	Aug F		43.6		43.6	7.55	17.55
EC	Markit Eurozone Manufacturing PMI	Aug F		--		47	8.00	18.00
UK	Markit UK PMI Manufacturing SA	Aug		49.5		48	8.30	18.30
Tuesday, 03 September 2019								
AU	Retail Sales MoM	Jul	0.1	0.2		0.4	1.30	11.30
AU	BoP Current Account Balance	2Q	2.5	1.5		-3	1.30	11.30
AU	Net Exports of GDP	2Q	0.5	0.3		0.2	1.30	11.30
AU	RBA Cash Rate Target	Sep 3	1	1		1	4.30	14.30
CA	Markit Canada Manufacturing PMI	Aug		--		50.2	13.30	23.30
US	Markit US Manufacturing PMI	Aug F		--		49.9	13.45	23.45
US	ISM Manufacturing	Aug		51.3		51.2	14.00	0.00
US	Construction Spending MoM	Jul		0.3		-1.3	14.00	0.00
US	Fed's Rosengren speaks in Easton, Massachusetts						21.00	7.00
Wednesday, 04 September 2019								
NZ	Dairy Auction Avg. Winning Price MT	Sep 3		--		3255		early am
NZ	QV House Prices YoY	Aug		--		2.2	17.00	3.00
NZ	ANZ Commodity Price	Aug	-1.8	--		-1.4	1.00	11.00
AU	GDP SA QoQ	2Q	0.5	0.5		0.4	1.30	11.30
AU	GDP YoY	2Q	1.4	1.4		1.8	1.30	11.30
CH	Caixin China PMI Services	Aug		51.7		51.6	1.45	11.45
GE	Markit Germany Services PMI	Aug F		54.4		54.4	7.55	17.55
EC	Retail Sales MoM	Jul		--		1.1	9.00	19.00
EC	ECB's Lane speaks in London						11.00	21.00
US	Trade Balance	Jul		-54.8		-55.2	12.30	22.30
US	Fed's Williams speaks in New York						13.25	23.25
CA	Bank of Canada Rate Decision	Sep 4		1.75		1.75	14.00	0.00
US	Fed releases Beige Book						18.00	4.00
US	Fed's Evans speaks on North American Trade						19.15	5.15
Thursday, 05 September 2019								
NZ	Building Work Put In Place	Q2	0	1.3		6.2	22.45	8.45
AU	Trade Balance	Jul	8800	7200		8036	1.30	11.30
GE	Factory Orders MoM	Jul		-1.1		2.5	6.00	16.00
US	ADP Employment Change	Aug		140		156	12.15	22.15
US	Durable Goods Orders	Jul F		--		2.1	14.00	0.00
US	Factory Orders	Jul		0.8		0.6	14.00	0.00
US	ISM Non-Manufacturing Index	Aug		54		53.7	14.00	0.00
CA	BoC's Schembri gives Economic Progress Report						15.45	1.45
Friday, 06 September 2019								
NZ	Wholesale Trade	Q2	0.9	--		0.7	22.45	8.45
GE	Industrial Production SA MoM	Jul		0.3		-1.5	6.00	16.00
EC	GDP SA QoQ	2Q F		--		0.2	9.00	19.00
CA	Net Change in Employment	Aug		--		-24.2	12.30	22.30
CA	Unemployment Rate	Aug		--		5.7	12.30	22.30
CA	Hourly Wage Rate Permanent Employees YoY	Aug		--		4.5	12.30	22.30
US	Change in Nonfarm Payrolls	Aug		162		164	12.30	22.30
US	Unemployment Rate	Aug		3.7		3.7	12.30	22.30
US	Average Hourly Earnings MoM	Aug		0.3		0.3	12.30	22.30
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		Sep 3	1.00	1		1		
Europe, ECB		Sep 12	-0.5	-0.5		-0.4		
Japan, BoJ		Sep 19	-0.1	-0.1		-0.1		
US, Federal Reserve		Sep 18	1.75/2	1.75/2		2/2.25		
UK, BOE		Sep 19	0.75	0.75		0.75		
New Zealand, RBNZ		Sep 25	1	1		1		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

FORECASTS

Economic Forecasts

	Annual % change				Quarterly % change															
					2018				2019				2020				2021			
Australia Forecasts	2018	2019	2020	2021	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Household Consumption	2.6	1.5	2.0	2.5	0.4	0.8	0.3	0.4	0.3	0.3	0.5	0.6	0.4	0.5	0.7	0.5	0.6	0.6	0.6	0.6
Underlying Business Investment	0.9	-0.3	2.2	2.1	0.6	-1.0	-2.1	0.0	0.6	-0.7	0.6	0.3	0.7	0.5	0.9	0.5	0.5	0.5	0.2	0.5
Residential Construction	4.7	-8.2	-8.1	-1.4	4.1	1.7	0.7	-2.9	-2.5	-4.4	-3.0	-2.2	-2.0	-1.7	-1.8	-0.8	-0.2	0.5	0.2	0.8
Underlying Public Spending	5.0	5.4	4.5	4.1	1.4	0.4	2.5	1.6	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0
Net Exports (a)	0.7	1.1	-0.1	-0.2	0.5	0.2	0.3	-0.2	0.2	0.4	0.2	0.2	0.1	0.0	-0.1	0.0	-0.1	-0.1	-0.1	0.0
Inventories (a)	0.1	-0.2	-0.1	0.0	-0.1	0.2	-0.3	0.2	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand (q/q %)	--	--	--	--	0.9	0.6	0.5	0.4	0.1	0.1	0.4	0.5	0.5	0.5	0.6	0.6	0.7	0.7	0.7	0.7
Dom Demand (y/y %)	2.9	1.3	2.0	2.6	3.4	3.2	2.8	2.4	1.6	1.1	1.2	1.3	1.6	1.9	2.2	2.3	2.5	2.6	2.7	2.8
Real GDP (q/q %)	--	--	--	--	1.0	0.9	0.3	0.2	0.4	0.5	0.6	0.7	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.7
Real GDP (y/y %)	2.8	1.8	2.3	2.4	3.1	3.1	2.8	2.4	1.8	1.4	1.7	2.2	2.3	2.4	2.3	2.2	2.3	2.4	2.4	2.5
CPI headline (q/q %)	--	--	--	--	0.4	0.4	0.4	0.5	0.0	0.6	0.4	0.6	0.4	0.4	0.5	0.7	0.5	0.5	0.6	0.7
CPI headline (y/y %)	1.9	1.5	1.8	2.2	1.9	2.1	1.9	1.8	1.3	1.6	1.6	1.6	2.0	1.7	1.8	1.9	2.1	2.2	2.3	2.3
CPI underlying (q/q %)	--	--	--	--	0.5	0.5	0.3	0.4	0.2	0.4	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5
CPI underlying (y/y %)	1.8	1.4	1.5	1.9	1.9	1.7	1.7	1.7	1.4	1.4	1.3	1.3	1.5	1.4	1.5	1.7	1.8	1.9	2.0	2.0
Private wages (q/q %)	--	--	--	--	0.5	0.6	0.6	0.5	0.5	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Private wages (y/y %)	2.1	2.3	2.5	2.8	1.9	2.1	2.2	2.3	2.4	2.3	2.3	2.4	2.5	2.5	2.6	2.6	2.7	2.7	2.8	2.8
Unemployment Rate (%)	5.3	5.2	5.3	5.4	5.5	5.5	5.1	5.0	5.1	5.2	5.2	5.3	5.3	5.3	5.4	5.4	5.4	5.4	5.4	5.4
Terms of trade	1.8	4.1	-7.6	1.8	3.2	-1.2	1.1	2.9	3.1	2.7	-4.4	-4.7	-2.6	-0.6	0.9	-0.2	1.2	0.6	-0.1	-0.1
Current Account (% GDP)	-2.0	-0.4	-1.8	-1.6	-2.2	-2.5	-2.1	-1.3	-0.6	0.5	-0.3	-1.1	-1.7	-1.8	-1.7	-1.8	-1.6	-1.5	-1.6	-1.6

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts

	2-Sep	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Majors						
AUD/USD	0.673	0.65	0.66	0.67	0.69	0.70
NZD/USD	0.63	0.62	0.62	0.63	0.65	0.65
USD/JPY	106.2	104	104	105	106	106
EUR/USD	1.10	1.12	1.11	1.13	1.14	1.15
GBP/USD	1.22	1.20	1.18	1.20	1.22	1.24
USD/CNY	7.16	7.40	7.40	7.30	7.20	7.10
USD/CAD	1.33	1.36	1.38	1.38	1.36	1.35
USD/CHF	0.99	0.97	0.95	0.96	0.96	0.96
Australian Cross Rates						
AUD/NZD	1.07	1.05	1.06	1.06	1.06	1.08
AUD/JPY	71.5	68	69	70	73	74
AUD/EUR	0.61	0.58	0.59	0.59	0.61	0.61
AUD/GBP	0.55	0.54	0.56	0.56	0.57	0.56
AUD/CNY	4.82	4.81	4.88	4.89	4.97	4.97
AUD/CAD	0.90	0.88	0.91	0.92	0.94	0.95
AUD/CHF	0.67	0.63	0.63	0.64	0.66	0.67

Interest Rate Forecasts

	2-Sep	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australian Rates						
RBA cash rate	1.00	0.75	0.75	0.75	0.75	0.75
3 month bill rate	0.96	0.85	0.85	0.85	0.85	0.85
3 Year Swap Rate	0.72	0.75	0.80	0.90	0.95	1.00
10 Year Swap Rate	1.11	1.05	1.05	1.20	1.35	1.45
Offshore Policy Rates						
US Fed funds	2.25	1.75	1.75	1.75	1.75	1.75
ECB deposit rate	-0.40	-0.60	-0.60	-0.60	-0.60	-0.50
BoE repo rate	0.75	0.75	0.75	0.75	0.75	1.00
BoJ excess reserves rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
RBNZ OCR	1.00	0.75	0.75	0.75	0.75	0.75
China 1yr lending rate	4.35	4.10	4.10	4.10	4.10	4.10
China Reserve Ratio	13.5	12.50	12.00	12.00	12.00	12.00
10-year Bond Yields						
Australia	0.92	0.90	0.90	1.00	1.10	1.20
United States	1.50	1.50	1.50	1.60	1.70	1.80
New Zealand	1.04	0.95	0.95	1.05	1.10	1.30

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

	2018	2019	2020	2021
Australia	2.8	1.8	2.3	2.4
United States	2.9	2.2	1.7	1.8
Eurozone	1.9	1.1	1.2	1.4
United Kingdom	1.4	1.2	1.2	1.5
Japan	0.8	1.2	0.3	0.9
China	6.6	6.3	6.0	5.8
India	6.8	6.3	7.0	7.1
New Zealand	2.9	2.4	2.6	2.5
World	3.6	3.1	3.3	3.5

Commodity prices ($US)

	2-Sep	Dec-19	Mar-20	Jun-20	Sep-20
Brent oil	59.1	70	70	75	75
Gold	1524	1450	1483	1518	1547
Iron ore	86	76	72	68	71
Hard coking coal*	154	170	165	160	155
Thermal coal	63	90	93	90	88
Copper	5656	6300	6225	6150	6125
Aus LNG**	9	12	12	12	12

* FOB quarterly contract prices (thermal coal is JFY contract)

** Implied Australian LNG export prices

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