

Real Estate Outlook

Australia – Edition 2020



Digging deep



Fundamentals remain
supportive.

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Australia has been on an enviable - almost three-decade long - growth streak, and that has helped power the year-on-year rental growth story in key property markets. Despite this, there are signs that the economy is slowing. Notwithstanding, fundamentals remain supportive of real estate themes in the medium term.

Australia



Signposts

- Commitment to fiscal discipline
- Rollout of ongoing tax reforms
- Infrastructure projects completion progress



Threats

- Resurgence in home prices is unsustainable
- Record high household debt
- Labor market softness may persist



Opportunities

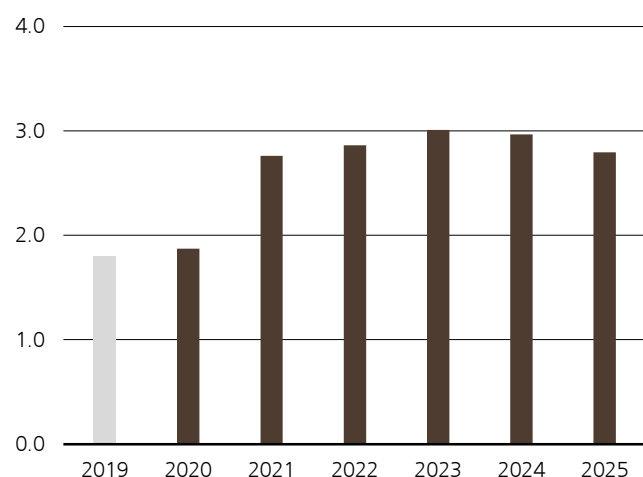
- Prime logistics returns to stay strong
- Built-to-rent sector nascent but high potential
- Regional office markets catching up

The run continues, albeit on an uneven terrain

Having been on an almost three decade growth streak is an enviable feat for any advanced economy, and Australia has so far managed that hat-trick on the back of a confluence of factors, from rich natural resources and favorable commodity prices, a diverse services sector, a skills-based immigration policy which has led to growth of the population and labor force, amongst other factors.

Figure 1: GDP forecast

(Real, annual, %)



Source: Oxford Economics (as at 24 February 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2020
Note: Data for the period 2020-2025 are forecasts.

Despite this, there are signs that the economy is in a soft patch, with most of the weakness stemming from the domestic side, with businesses holding back on investments and households similarly starting to curtail spending on the back on an increasingly bearish external outlook. The bright spots in 2019 were public sector consumption and net exports, and while these are likely to continue contributing to growth in the near-term, they cannot be relied on forever. Net exports, in particular, will soon be put to the test amid the COVID-19 outbreak, given the heavy reliance on demand from China.

Signposts we are watching out for

The Reserve Bank of Australia (RBA) has been on an easing cycle and most recently trimmed interest rates to a historical low of 0.25%, in a pre-emptive move catalyzed by the COVID-19 outbreak. Fiscal support has similarly been instrumental to growth but going forward, the question is how much of a part that would continue to play. Prime Minister Scott Morrison has made returning a budget surplus in the near and medium term a key campaign pledge in his re-election bid in 2019, promising to undo what he calls the fiscal mismanagement of the previous government while still delivering on a stronger economy and job creation. His commitment to fiscal discipline is now coming under pressure given the double whammy of the devastating bushfires and the COVID-19 virus. Will the current administration abandon this commitment?

In November 2019, it was announced that AUD 3.8 billion worth in spending on rail and road projects will also be brought forward to boost jobs and wages. The calls for stimulus spending will likely continue to grow stronger as the effects of reduced demand from China and disruption in global supply chains start to be felt, and the authorities' position on public spending will be an important factor in determining the near-term outlook for the economy.

An adjacent policy issue is that of the Morrison government's proposed tax reforms, which centers on a AUD 158 billion income tax relief plan that aims to reduce the tax burden of more than 10 million workers. In July 2019, the Senate voted to pass the changes, leading to the start of a multi-year, phased plan that will simplify and flatten the tax system by 2024/25. Rebates for low- and middle-income earners have already kicked in and over the next five years, the government will gradually lower the middle tax rate such that the majority of taxpayers will face a marginal tax rate of 30% or less by FY2024/25.

With a sluggish economy and household consumption stalling, the extra cash will likely provide support to consumers over the coming years, despite criticism that the changes will result in low-income earners shouldering a larger share of the total income tax burden. Plans are also in the pipeline for small businesses, where FY2021/22 will see the tax rate for small and medium-sized companies fall from 27.5% to 25%, which will benefit about 970,000 companies employing about 5 million workers.

The next five years will also see several major multi-year infrastructure projects across different states in Australia gradually reach completion. Many of these are rail projects, both inter-state and inter-city, and include the likes of the Sydney Metro, the Melbourne Metro Tunnel and the Melbourne to Brisbane Inland Rail. Most of the major infrastructure plans are in New South Wales and Victoria, the states with the largest economies, but there are also investments to improve the networks in Queensland and Western Australia, which would raise the investment prospects of the regional cities of Brisbane and Perth.

The most obvious benefit of these infrastructure projects will be to improve connectivity. Production capacity will be increased, such as the Cross River Rail in Queensland that is expected to free up a major transport bottleneck. These new developments will also serve as needed infrastructure to cope with growing areas, such as the Western Sydney Infrastructure Plan and the Western Sydney Airport which will benefit the region's expanding population. This is likely to keep the building and construction sector busy in the coming five years, which will continue to support the prospects for occupier demand in the industrial property market. Certain office markets have also seen an uptick in demand from the engineering industry, although the positive spillover benefits are likely less direct.

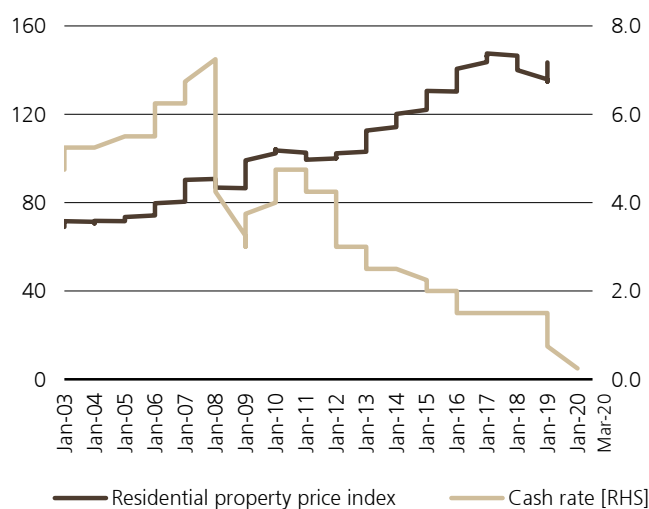
Imminent threats

One of the key risks to watch over the next five years is the resurgence in home prices, raising fears of a property bubble. To be fair, the existence of a bubble is difficult to identify until after it bursts, as former US Federal Reserve chairman Alan Greenspan puts it, given that rising prices could be a reflection of the increase in fundamental demand – as is the case in Australia given the healthy levels of population growth seen there. Nevertheless, the residential property price index (RPPI) has generally only been on an upward trend since the earliest available data in 2003.

Despite continued record low interest rates and strong population growth in major cities, the housing boom slowed from 2017 onwards, mainly on the back of tighter investor lending rules (interest-only loan cap of 30%) introduced by the Australian Prudential Regulation Authority (APRA) in March 2017. The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry also stemmed credit growth in the personal housing mortgage sector as banks started to apply greater scrutiny on lending activities.

This led to a 5% fall in the residential property price index over the course of 2018 and while the price correction continued into early 2019, the trend started to reverse in mid-2019 after APRA eased off on its macroprudential measures. This came amid growing weakness in the economy and ran parallel to the start of the RBA's own easing cycle, leading to a resurgence in home prices and raising concerns of a credit-fueled housing price boom (Figure 2).

Figure 2: Australia home price index vs cash rate
(2011-12 = 100, %)



Source: CEIC, UBS Asset Management, Real Estate & Private Markets (REPM), March 2020

While the latest RPPI data showed a strong-but-still-manageable 2.4% quarter-on-quarter (QoQ) pick-up in 3Q19, other more granular data indicate that this recent recovery is the strongest on record, propelled by double-digit increases in Sydney and Melbourne over a period of only about half a year. Furthermore, the run-up in home prices have exceeded that of wages over the years, where the RPPI rose about 60% between 2009 and 2019 while the seasonally adjusted wage price index only increased by about half of that at ~32% over the same period. The natural question that follows would then be how these developments affect housing affordability.

What makes a housing bubble particularly worrisome is the fact that household debt levels are around record highs, a risk that is concerning enough on its own. The household debt-to-disposable income (DTI) ratio has been rising over the past few decades and recently hit a high of 188% in 2Q19, making Australian households among the most indebted worldwide.

Unsurprisingly, the increase has been driven largely by property loans and this then makes the risk of a major housing market correction even more significant, with the illiquid nature of real estate placing over-indebted households at risk of default. Negative gearing is a common feature in Australia, and while it reduces the overall tax burden of home owners and investors, a sharp fall in property prices could compound losses for over-leveraged households.

In a somewhat assuring sign, 3Q19 saw the household DTI slip slightly and the recent rebound in home prices has not been accompanied by a sharp rise in credit growth, which seems to suggest that households are paying down their mortgages with the tax refunds they have received from the Morrison government. Nevertheless, the elevated household debt levels still increases the vulnerability of consumers particularly in the event of an economic shock, and also poses risks to financial stability.

We are monitoring for indications of softness in the labor market. To be sure, jobs growth is still healthy with an average net addition of close to 22,000 jobs per month in 2019 – higher than the 10-year average of 16,000 jobs per month – but looking at aggregate numbers alone are not enough to give a nuanced picture of the employment scene. A distinction needs to be made between full-time and part-time jobs, and data in the later months of 2019 seem to suggest a plateauing of the growth of full-time positions.

Part-time jobs taking up the mantle is just one hint of the spare capacity in the labor market; a recent survey by the Australian Bureau of Statistics also shows that around a quarter of the respondents who were employed part-time wished to be working 14 more hours per week. Job mobility is also at its lowest in decades with the average time that an employee stays on in a job rising, which is the opposite of what a tight labor market would exhibit.

Wage growth remains sluggish as a result, but this is an issue common across many countries right now and there are no quick fixes in sight. The impact of a soft labor market will manifest itself in the retail sector which is already struggling with declining shopper traffic and spending, affecting the performance of retail real estate across Australia.

Opportunities in the next five years

Despite the risks facing the domestic sector, Australia's medium term outlook still remains positive on the back of drivers such as population inflows, continued strength in the resources industries and growth of the services sectors.

We have a positive outlook on the prime logistics market. Total returns in the prime Sydney and Melbourne warehouse markets are projected to be among the highest across all real estate sectors in the key developed APAC cities over the next five years, bolstered by a combination of relatively high yields and moderate levels of projected rent and capital value growth. Not only will the expanding population lead to increased demand for goods, the spatial layout of Australian cities also lends itself to a natural inclination towards online shopping, which Property Market Analysis expects to rise from ~10% of total retail sales in 2019 to about 15% by 2024.

On the business side, upgrading activity is also seeing increased demand for high quality warehouse space as occupiers seek efficiency gains. Vacancy rates have been trending downwards over the past few years but supply is now picking up, with a growing proportion of speculative developments. This has so far not posed too much of a concern, with robust demand resulting in even speculative space being filled up in a matter of months. In the medium term, with new supply coming in, there will inevitably be a divergence between better-located, high specs space and those which are not so well-located, but the major infrastructure projects could also eventually improve the connectivity of further away locations.

The challenges of the housing market have also resulted in the emergence of an asset class which we think is ripe for development – and that is the multi-family, or built-to-rent, sector. Years of rising home prices have seen more and more people turn to the rental market for accommodation, but alongside this is the structural trend of increased in-migration, supported by Australia's liberal immigration policies.

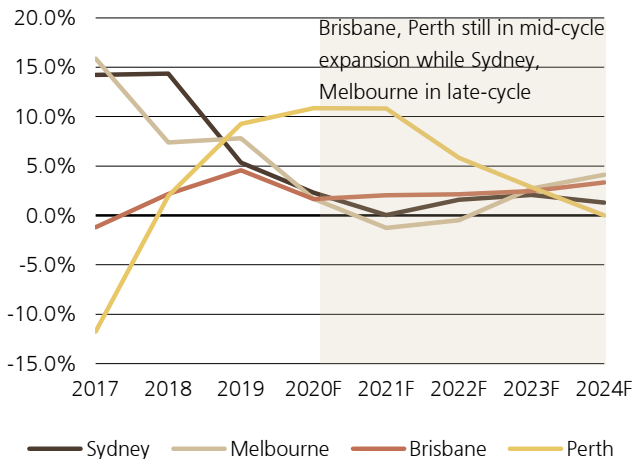
New migrants are likely to turn to the rental market when they first arrive, and the upwardly mobile might even choose to rent in a high-rise apartment in the city center which offers proximity to amenities, a preference that the younger generations might also have, at least temporarily amidst delayed marriage and homeownership. Although regulatory hurdles exist, and the initial economics may not add up, we think that there is immense potential within the nascent Australian multifamily sector, which is likely to benefit early movers.

The office markets of Sydney and Melbourne have been strong outperformers in APAC in recent years. Sydney is typically the first port of call for investors, being the country's commercial center, while Melbourne follows closely behind. That said, having already seen multi-year rental growth, we think that the next few years could see opportunities come up in the regional office markets of Brisbane and Perth instead.

After years of lagging behind Sydney and Melbourne, net effective rental growth in the Brisbane and Perth office markets are now starting to play catch-up, buoyed by improvement in commodity prices and a resurgence in mining investments which lifted their economies.

This has led to a recovery in demand for office space, which is set to continue given strong population inflows, healthy white collar employment growth and the expansion of the services sector in Brisbane, as well as a pipeline of mining investments in Perth. And while the next cycle of office completions is about to kick in in Sydney and Melbourne, the dearth of completions in Brisbane and Perth will likely provide some upward momentum to rents. The next few years will thus see net effective rental growth in Brisbane and Perth overtake Sydney and Melbourne (Figure 3), although some caution is warranted for Perth given its heavy reliance on the resources sector.

Figure 3: Australia office net effective rent growth
(%, YoY)



Sources: CBRE, UBS Asset Management, Real Estate & Private Markets (REPM), March 202

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