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PROPERTY COUNCIL OF AUSTRALIA-ANZ PROPERTY INDUSTRY CONFIDENCE SURVEY, DECEMBER QUARTER 2012

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AUSTRALIAN ECONOMY

An uncertain global economic backdrop and China's slowing economy in particular, have caused sharp falls in iron ore and coal prices. This, coupled with a high Australian dollar, is producing challenging conditions for the Australian economy and the mining sector. The latest PCA-ANZ Property Industry Confidence Survey has reflected the impact of a softer economic outlook on the property sector, with the property industry confidence index falling to 102 in the December quarter (from 106 in the September quarter), the third consecutive quarter of weaker property industry confidence.

In line with the net balance of PCA-ANZ survey respondents expecting Australian economic growth to slow in the next year, we expect economic activity will remain relatively soft in the short-term as Australia transitions to slower real income growth, with the terms of trade returning to pre-crisis levels. Nonetheless, the medium-term domestic economic outlook remains solid and will continue to be underpinned by strong growth in business investment.

Overall weaker national income growth coupled with fiscal tightening will see the RBA likely retain an easing bias even after the modest interest rate cuts that we expect to see in coming months. This bias is also likely to be necessary because of an elevated post-GFC aversion to debt across household and business sectors.

RESIDENTIAL PROPERTY

While house prices remain soft in most Australian capital cities, prices have shown tentative signs of reaching a floor following the May and June RBA rate cuts. Residential auction activity has increased with auction clearance rates at the highest level since 2010. The PCA-ANZ survey results for residential price expectations have improved, with the net balance of survey respondents expecting residential capital values to increase in the next 12 months.

On balance, New South Wales, Queensland, Western Australian and Northern Territory respondents expect house prices to rise. We expect Darwin, Perth and Brisbane house prices are likely to increase, reflecting the linkages these cities have with the mining and resources sector and Sydney house prices will likely remain well supported by tight market demand/supply fundamentals. The outlook for Hobart, Adelaide and Melbourne is less encouraging as these economies are likely to underperform over the next 12-18 months.

Demand/supply fundamentals continue to tighten. Residential vacancy rates remain low across most capital cities, driving real rents higher, and building activity remains well short of underlying housing demand. While upward pressure on rental yields will attract investor activity, interest rate cuts, along with a modest fall in house prices, have driven a significant improvement in affordability across all states, presenting favourable conditions for first home buyers.

COMMERCIAL PROPERTY

Heightened investor uncertainty has seen the nascent commercial property market recovery plateau in 2012 (with the exception of Perth and Brisbane). Rents in Sydney, Melbourne, Adelaide and Canberra have stalled and cap rates remain near post-GFC highs. Soft retail turnover will restrict rental gains and investor uncertainty continues to inhibit yield compression.

The December quarter PCA-ANZ survey shows confidence has waned across most states and sectors, with retail property the hardest hit. Retail has substantially outperformed other commercial property sectors in recent decades but is now a victim of its own success. Retail rents have risen to a very high share of turnover by global standards, and restricted sales growth will cap growth in rents. Secondary and discretionary retail appear particularly vulnerable.

However, market fundamentals still suggest the broader commercial property market is at the early stages of a multi-year cyclical upswing. Low vacancy and elevated incentives present considerable upside to effective rents, particularly in the office and industrial sectors. Moreover, current yields belie the positive fundamentals and will firm as investor sentiment rebounds. A robust economic backdrop will underpin tenant demand, while supply will be constrained by rising development costs, heightened risk aversion and tight credit conditions. Elevated pre-commitment requirements significantly reduce the risk of surplus speculative capacity.

NSW

At 104 (compared to 106 in the September quarter), the PCA-ANZ confidence index reveals a moderately positive view of the NSW property market in the December quarter 2012 (an index value of greater than 100 is positive). NSW property industry confidence, third only to WA and the NT across all state and territories, continues to be supported by tightening property market demand/supply fundamentals in both residential and commercial markets. Combined with lower mortgage rates improving housing affordability, lower residential rental vacancy rates are expected to drive rents and yields higher in the year ahead, attracting first home buyer and investor residential sales activity. As a result, house prices, commercial property capital values and property market confidence in NSW should increase through the remainder of 2012 in the absence of further deterioration in the global economy.

VICTORIA

Victoria's property industry confidence was weighed down by a soft outlook for the Victorian economy, with the Victorian PCA-ANZ property market confidence index remaining moderately weak in the December quarter 2012 (97). With a diverse state economy that has minimal direct benefit from the strength of the Australian mining investment boom, Victorian property industry sentiment has been dampened by weak employment growth and soft private business investment, especially compared to the mining states. While Victorian dwelling approvals remain elevated (dominated by medium to high-density dwellings), the recent weakness in the Victorian housing sales market appears to be driven by a slowing economy. Nonetheless, a soft state economic outlook and an extended period of price weakness present downside risks to the outlook for Victorian housing construction in 2013.

QUEENSLAND

Queensland property industry confidence took a decidedly negative turn in the December quarter, with Queensland PCA-ANZ property market confidence index decreasing to 96 (compared to 113 in September quarter). This is the first time Queensland has reported “negative” confidence since the PCA-ANZ survey has been conducted. This result likely reflects Queensland’s economic dependence on a weakening coal mining sector and the impact of the delivery of a conservative state budget in September. In addition, regions driven by exposure to inbound international tourism (i.e. Far North Queensland, Gold Coast) are continuing to feel pressure from the elevated AUD. The outlook for the Queensland property market and economy appears vulnerable. PCA-ANZ survey results show the net balance of Queensland survey respondents expect state economic growth to slow in the year ahead and negative capital growth across the office, retail and tourism property sectors.

SOUTH AUSTRALIA

South Australian respondents had an increasingly negative view of the property market with the PCA-ANZ confidence index decreasing to 92 in the December quarter (compared to 98 in the September quarter). While expectations for the residential property market are being weighed down by weak sentiment and an uncertain state economic outlook, the survey result was also driven by a negative outlook for commercial property. With the exception of retirement property, the net balance of respondents expects capital values in all other commercial property sectors to be lower in the next year. Cancellations and delays of a number of large uncommitted mining and energy projects, including the proposed Olympic Dam expansion and the Clinton (coal-biomass-to-liquid) Project, have weighed on general business confidence and housing market confidence in South Australia, particularly for the regions and sectors exposed to directly to the mining and energy industries.

WESTERN AUSTRALIA

Despite moderating in the December quarter on a softer outlook for the mining sector, property market confidence in Western Australia remains positive on balance, reflecting an economy benefiting from significant growth in the mining sector and associated services. The PCA-ANZ confidence index in WA decreased to 120 in the December quarter (from 136 in the September quarter), reflecting the sensitivity of the state economy to the mining sector outlook. Nonetheless, the property industry outlook for Western Australia remains positive. 44% of survey respondents expect Western Australian house prices to be higher in the next year. The economic benefits of significant WA mining infrastructure spending and tight market fundamentals should also drive solid growth in construction activity through 2012. PCA-ANZ survey results show respondents expect residential (52%), commercial office (48%), industrial property (46%) and tourism (64%) construction activity to increase over the next year.

TASMANIA

While the PCA-ANZ confidence index for Tasmania increased in the December quarter, Tasmanian respondents, on balance, continued to report a pessimistic view of the state property market with an index reading of 87 in the December quarter. This is the fifth consecutive quarter the Tasmanian property industry has reported negative sentiment. This continues to reflect weak economy activity in Tasmania, with negative trend state final demand (-3.0% in the year to June 2012), trend unemployment rate of 6.8% in August 2012 (compared to national average of 5.2%) and house prices 6.3% lower in the year to August. A subdued outlook for the Tasmanian economy for 2012-13 and weak construction activity expectations presents some further downside risk to Tasmania’s property industry going forward.

NORTHERN TERRITORY

While property market confidence in the Northern Territory moderated slightly in the December quarter, respondents in the Northern Territory maintained the highest confidence index (130) across all states and territories. This result reflects a positive economic outlook, underpinned by the economic benefits from the \$34 billion Itchys gas project to demand for labour, property market returns and household income.

ACT

Respondents in the ACT maintained a negative view of the property sector in the December quarter, with a confidence index of 92 reflecting a soft economic outlook for ACT. With existing budget pressures, the potential for public sector job losses in 2013 and a sharp unwinding of the 2011 dwelling construction boom weighing on the ACT economic outlook, respondents revealed the second weakest confidence index across all states and territories in the December quarter.