RESEARCH

CAPITAL MARKETS INSIGHT: LOWER RATES, LONGER CYCLE

LOWER INTEREST RATES TO SUPPORT DEMAND AS CAPITAL GROWTH MODERATES

The economic outlook has softened and the RBA has cut interest rates to support growth and help to lower unemployment. Lower interest rates will act to support pricing, and may lead to further yield compression in some markets, prolonging the growth cycle.

Highlights

The pace of capital growth for commercial property assets eased in the March quarter, although growth remains strong in the office and industrial sectors.

The economic outlook has softened recently and in response the RBA has cut interest rates to 1.25% to help stimulate the economy.

Lower interest rates will provide support to commercial property valuations and underpin low yields for longer.

Investment turnover has slowed in 2019 to date after record sales volumes in 2018.

BEN BURSTON

Partner, Head of Research & Consulting

Follow at @KnightFrankAu

CHRIS NAUGHTIN

Associate Director, Research

Follow at @KnightFrankAu

Capital growth moderates in Q1

As predicted in our 2019 capital markets outlook, capital growth for commercial property assets has stared to moderate from elevated levels. Overall, capital growth slowed to 3.9% year-on-year in the March quarter from 4.6% in the December quarter and 5.5% a year ago.

	Capital growth (%yoy) (Source: MSCI)	
	Dec 18	Mar 19
All property	4.6	3.9
Office	7.9	7.2
Industrial	8.1	7.4
Retail	0.7	-0.2

Capital growth in the office sector remains high but eased from 7.9% year-on-year in the December quarter to 7.2% in the March quarter driven by slower growth in the Sydney and Melbourne CBDs. By contrast, capital growth strengthened in Perth.

Capital growth for industrial property also edged down to 7.4%, although the sector continues to perform very strongly. The retail sector continues to struggle with subdued consumer spending and structural challenges, and retail capital values declined in year-on-year terms for the first time since 2010.

RBA cuts rates as growth moderates

The easing in capital growth coincides with a softening economic outlook, with sluggish growth in household income and the downturn in the housing market weighing on household consumption and GDP growth.

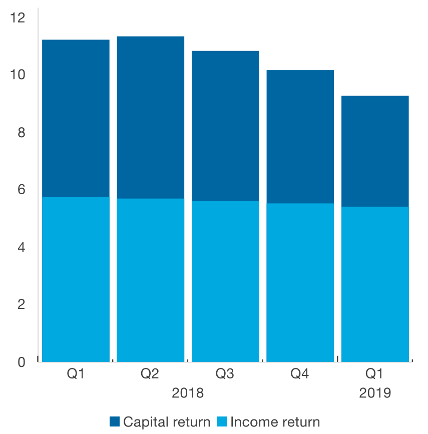
In response to this softening economic outlook, the RBA has cut interest rates to 1.25% citing ongoing low inflation, and the lack of further tightening in labour market conditions. Another 25 basis point cut to 1% is expected as early as August.

Additional monetary policy easing is likely to be less effective than in the past given

FIGURE 1

Commercial Property Returns

Total return, per cent change yoy



Source: MSCI

FIGURE 2

Market Interest Rates

Per cent

Source: Macrobond

the already high level of household debt and low level of interest rates. Some banks have already shown reluctance to pass on interest rate cuts in full at such low levels. These factors may lead to the RBA to cut interest rate cuts more aggressively.

Sharp downward shift to underpin low property yields

Yields on some commercial property assets, notably prime office property in Sydney and Melbourne, have tightened to record lows, causing many to question how long the current cycle of yield compression has to run.

However, the shift to further easing by the RBA, and guidance by major global central banks that policy will remain very accommodative for the foreseeable future, has seen rates in short-term money markets and long-term bond yields decline dramatically. Yields on 10-year Australian government bonds have declined from 2.9% to 1.5% over the past 12 months, a historic low, and this represents a significant change in the contextual setting for property yields.

Lower funding costs: A lower interest rate environment, both domestically and globally will clearly lower funding costs for leveraged investors.

Reduced hedging costs: The main factor determining currency hedging costs for cross border investors into Australia is the interest rate differential between Australia and the source country. Interest rates have tended to be higher in Australia than in the domicile of major cross border investors such as the US, Canada, Hong Kong, and the Republic of Korea, but the recent move to lower rates has changed this dynamic, and lowered hedging costs.

AUD depreciation: The changing environment has seen the Australia dollar depreciate against the US dollar and other major currencies, increasing the attractiveness of investment in Australia, especially for cross border investors taking an unhedged position.

Relative value: While commercial property yields are historically low, the spread between property and bond yields has widened significantly. For instance, the spread between the Sydney CBD prime office property yield and the 10-year Australian Government bond yield increased from 1.9% in the December quarter 2018 to 2.8% in the March quarter 2019.

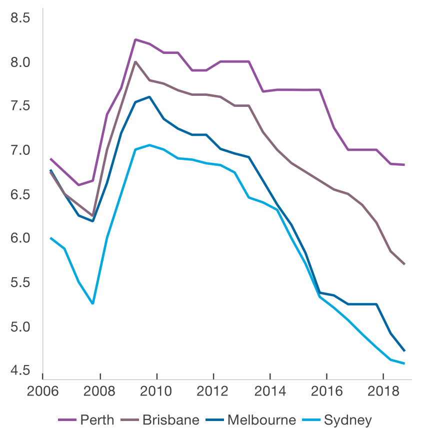
For all of these reasons, the change in the interest rate environment will boost demand for property as investors continue to search for higher-yielding assets with a fixed income return component. And if favourable leasing market conditions continue, this may drive yields to even lower levels in some markets and result in a longer asset price cycle than previously anticipated.

Investment volumes slow in early 2019

Reflecting slower growth momentum, transaction volumes have slowed in 2019 following record turnover in 2018. Investment in office, industrial and retail property totalled $9.4 billion over the first 5 months of 2019 compared with $10.9 billion for the same period last year.

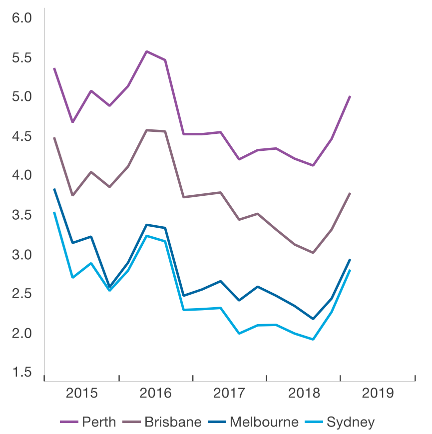
However, volumes are typically lower in the first half of the calendar year and with investor confidence remaining strong, supported by the fall in interest rates, we expect a much stronger level of turnover in June and into in H2 2019.

FIGURE 3
Prime Office Property Yields
Per cent



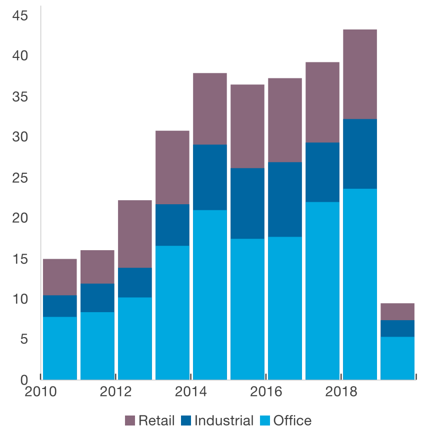
Source: Knight Frank Research

FIGURE 4
Prime Office Property Yields
Spread to 10-year Australian Government Bonds



Source: Knight Frank Research, Macrobond

FIGURE 5
Investment Volumes
2019 YTD, $b



Source: Knight Frank Research, RCA

RESEARCH & CONSULTING
Ben Burston
Head of Research & Consulting
+61 2 9036 6756
Ben.Burston@au.knightfrank.com

Knight Frank

Newmark Knight Frank Global