THINK: Australia
Finding resilience in industrial

Better growth outlook in 2018…

We hold a broadly positive view of the Australian economy over the medium-term for a number of reasons. Firstly, despite lingering uncertainty over the strength of the consumer sector, the broader economy has continued to perform well. Even while projections for consumer spending continue to stay rather soft (running at a stable 2% growth without much upside), consensus is still looking at a positive contribution to overall real GDP growth from the household sector. Therefore, we expect domestic final demand to contribute positively to overall medium-term growth, also taking into account the positive secular demographic trend foreshadowing the economy.

Secondly, the business sector, has outperformed due to the improvement in world growth over the past year (in particular the better than expected performance of the Chinese economy) as well as the recovery in the commodities market. The recent capital expenditure surveys suggest that an ongoing pick-up in machinery and equipment capex will persist, buttressed in part by strong government spending on infrastructure alongside the solid build-up of the corporate balance sheet over the past few years.

Business surveys also corroborate an optimistic outlook for private investments, although new dwelling construction is likely to stay soft due to a pullback in investor activity from tighter bank lending conditions and the imposition of taxes on foreign buyers. While quite a significant output gap still remains, the build-up in inventories in response to capacity tightening should supplement overall growth in 2018. In turn, productivity growth is expected to reverse the slight drop in 2017, to rise by 0.9% and 1.5% in 2018 and 2019, respectively (Fig.1).

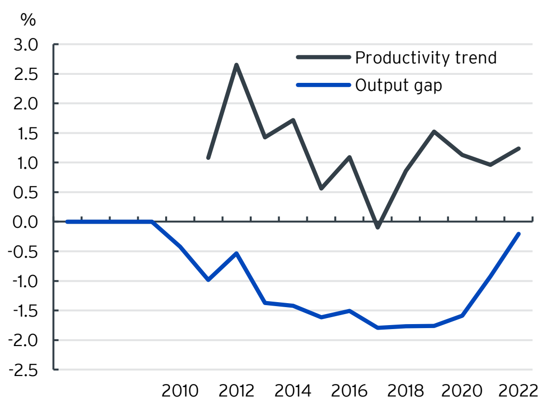
Thirdly, export volume growth has also risen to underpin the current robust economic landscape.

The steady pick-up in global growth and ongoing recovery in the commodities market on top of the weak Australian dollar should help continue to drive a solid merchandise and services export growth performance in 2018. The pick-up in commodities prices from the 2016 trough should also buttress the net export contribution to growth, especially as rather soft consumer environment continues to limit import demand.

Finally, overall monetary conditions will stay supportive of growth in the near to medium-term, in light of subdued inflation, below trend operating capacity and ongoing concerns over the housing market. The Reserve Bank of Australia (RBA) is not expected to tighten policy until late 2019, leaving it behind the Federal Reserve and many OECD central banks in the current rate hike cycle.

In summary, most consensus forecasts are looking at a pick-up in real GDP growth to around 2.8% for 2018 (based on Consensus Economics), from an estimated 2.2% in 2017 (Fig.2).

Fig.1: Improving aggregate demand



Source: Oxford Economics, February 2018

Fig.2: Better growth outlook

Source: Consensus Economics, January 2018

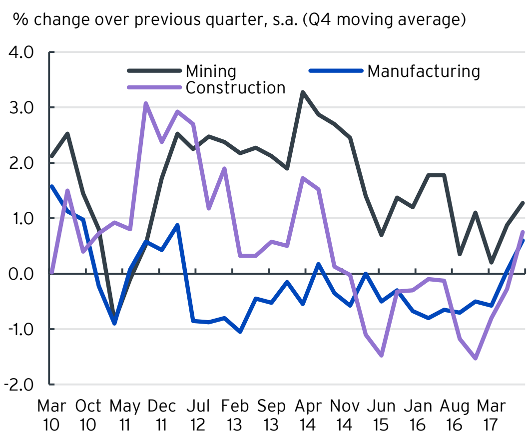
> Australian logistics can help provide global institutional investors with better income security and uplift, as concerns surface over pricing and fundamentals in the more traditional office and retail sectors globally.

Nick Evans
Executive Director, Head of Australia

... driven by stronger industrial performance

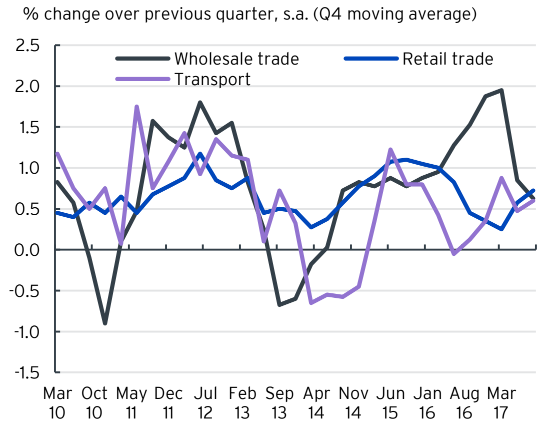
Beyond the headline numbers, it is also very encouraging that growth is diversified across many industrial sectors. Strong aggregate demand is strengthening Australia's industrial economy with good performance seen across many industries, such as mining, manufacturing and construction (Fig.3). In particular, rising investment into new infrastructure projects is helping to drive and support the construction sector, while continued rationalisation of the manufacturing sector, post the Global Financial Crisis (GFC), has helped to raise production activities in other key sectors such as chemicals, metals, machinery and equipment as well as food products. Together with the resilience in wholesale and retail trade, the transport, postal and warehousing sector has recorded near 0.6% quarter-on-quarter growth in Q3 2017 (on four-quarter moving average basis) - the fifth quarterly increase since Q3 2016 (Fig.4).

Fig.3: Robust industrial performance



Source: CEIC, February 2018

Fig.4: Need for transport, warehouse



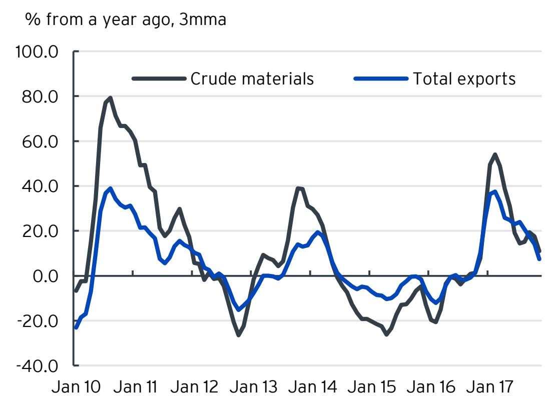
Source: CEIC, February 2018

These broad outcomes corroborate with the index of total industrial industries, which has posted only three quarters of negative growth since 2010 (Fig.5). The broad trends we are seeing across the economy support the view that the industrial sector in Australia has revived and strengthened since the GFC. This positive trend is likely to continue in the medium-term, in line with the general market consensus for better world growth translating into greater external demand. While there has been some measure of technical payback in total exports and exports of crude materials in recent months from super-charged growth for the most part of 2017, the general trend for exports is still expected to mirror the broader improvement in global demand, particularly from China (Fig.6). Indeed, exports of crude materials are running at around 11% over a year ago (3mma), even though slowing from a peak of 37.5% in February 2017. Together with a sizable domestic demand base continually supplemented by strong immigration, we believe the vibrancy of the logistics sector will persist.

Fig.5: Industries standing on two legs

Source: CEIC, February 2018

Fig.6: Benefiting from China



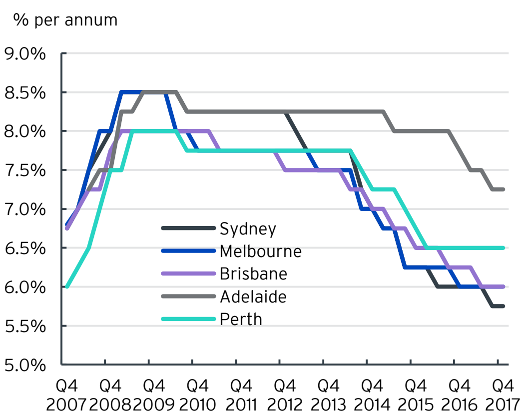
Source: CEIC, February 2018

Hot and getting hotter

In view of the positive industrial performance in recent years, from sturdy exports and domestic demand, investment demand from institutional investors has unsurprisingly continued to strengthen. Yields have compressed sequentially over the past 10 years, reflecting in part robust capital market sentiment from Australia's highly regarded position as a transparent, institutional and developed real estate market (Fig.7). That is also on top of the visible improvement in economic conditions from restructuring undertaken post the GFC.

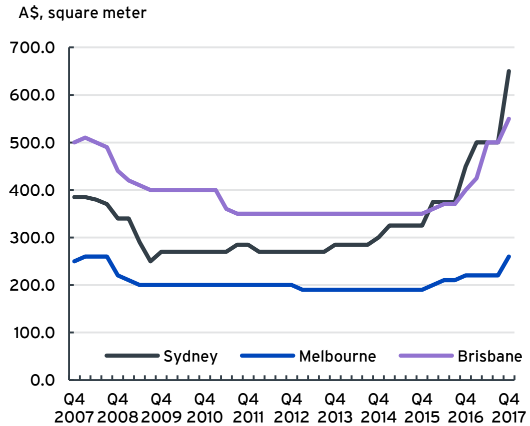
In the two core industrial markets, Sydney and Melbourne, as well as Brisbane, yields have fallen to historical lows, clearly reflecting a strong interest from global investors into this slightly more niche and less accessible but strongly yielding alternative sector to complement their interests in the office and retail segments. We believe yields have yet more room to compress still in the short term.

Fig.7: More room to compress?



Source: JLL REIS, Q4 2017

Fig.8: Rising land costs



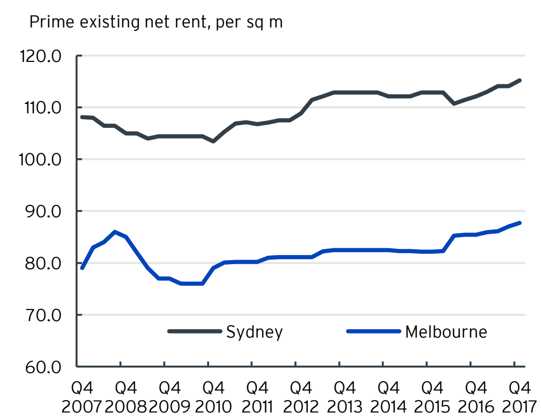
Source: JLL REIS, Q4 2017

While global monetary policy is on balance to tighten across many OECD countries in the next few years, interest rates are likely to stay below historical peaks under the new normal global growth environment. In particular, the Australian policy rate is likely to stay at the current 1.5% for longer, owing to a subdued inflationary outlook. That, together with higher yields recorded by industrial assets, provide for a wide yield spread and further room for more limited compression vis-a-vis the office and retail sectors in the near term. In the medium-term, prime yields are on balance likely to shift out. Industrial prices have reached record levels in Sydney and Melbourne and nearing historical peak in Brisbane.

Values have flattened out in recent months, due in part to slowing transactions nearing year-end and limited availability of prime investable warehouse stock for sale. However demand remains strong, as reflected in rising land prices (Fig.8). Also, institutional investors have become more selective, reflecting concerns regarding the pace of price increases, leading to overall elevated pricing levels. Although prime capital values are likely to stay toppish in the near-term, and elevated in the medium-term, rental growth is likely to outpace further marginal increases in pricing (Fig.9).

Across the three key industrial markets, Sydney, Melbourne and Brisbane, supply has stayed tight however overall take-up continues to exceed existing availability of prime space. For example, in Sydney, the additional new supply of 446,000 sq m of space in 2017 was a decline from the 585,000 sq m developed in 2016 and just about matches the average 483,000 sq m of new supply over the last seven years.

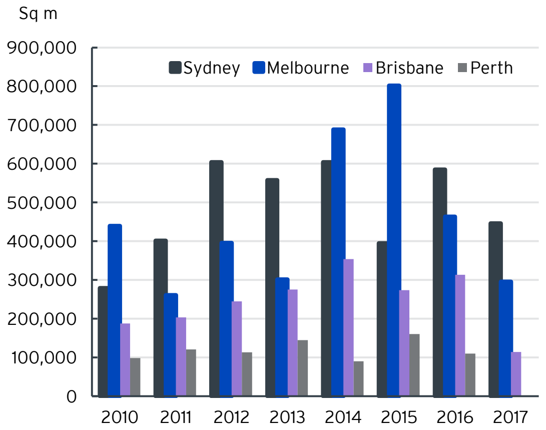
Fig.9: Rent divergence to narrow?



Source: JLL REIS, Q4 2017

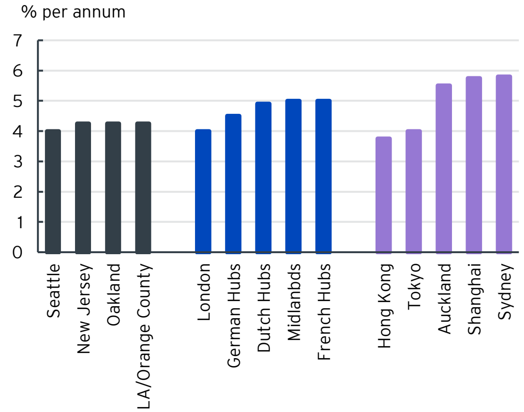
Supply also declined in Melbourne and Brisbane last year and is now below the seven year-average (Fig.10). Across the prime warehouse precincts in Sydney, Melbourne, Brisbane and to a lesser extent, Perth and Adelaide, it is our view that slowly rising land cost, land use constraints and, in particular, strong demand for housing developments, will either restrict new industrial developments or subtract from existing stock for lease. Therefore, the industrial rental cycle remains in a multi-year sweet spot. For core institutional investors, this sanguine landscape presents an attractive medium-term investment opportunity, especially considering, yields are among the highest in one of the most attractive global real estate investment markets (Fig.11).

Fig.10: Supply below or near historical



Source: Various reports

Fig.11: Prime yields by region



Source: CBRE, 2018

> Australian cities rank highly in our filtering framework and the logistic sector is among our most favoured globally, as epicentre of global trade continues to shift to the East.

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