CUSHMAN & WAKEFIELD

AUSTRALIAN CRE GLIDE PATH

PARTIALLY CLOUDY BUT CLEARED FOR TAKEOFF

SEPTEMBER 2024



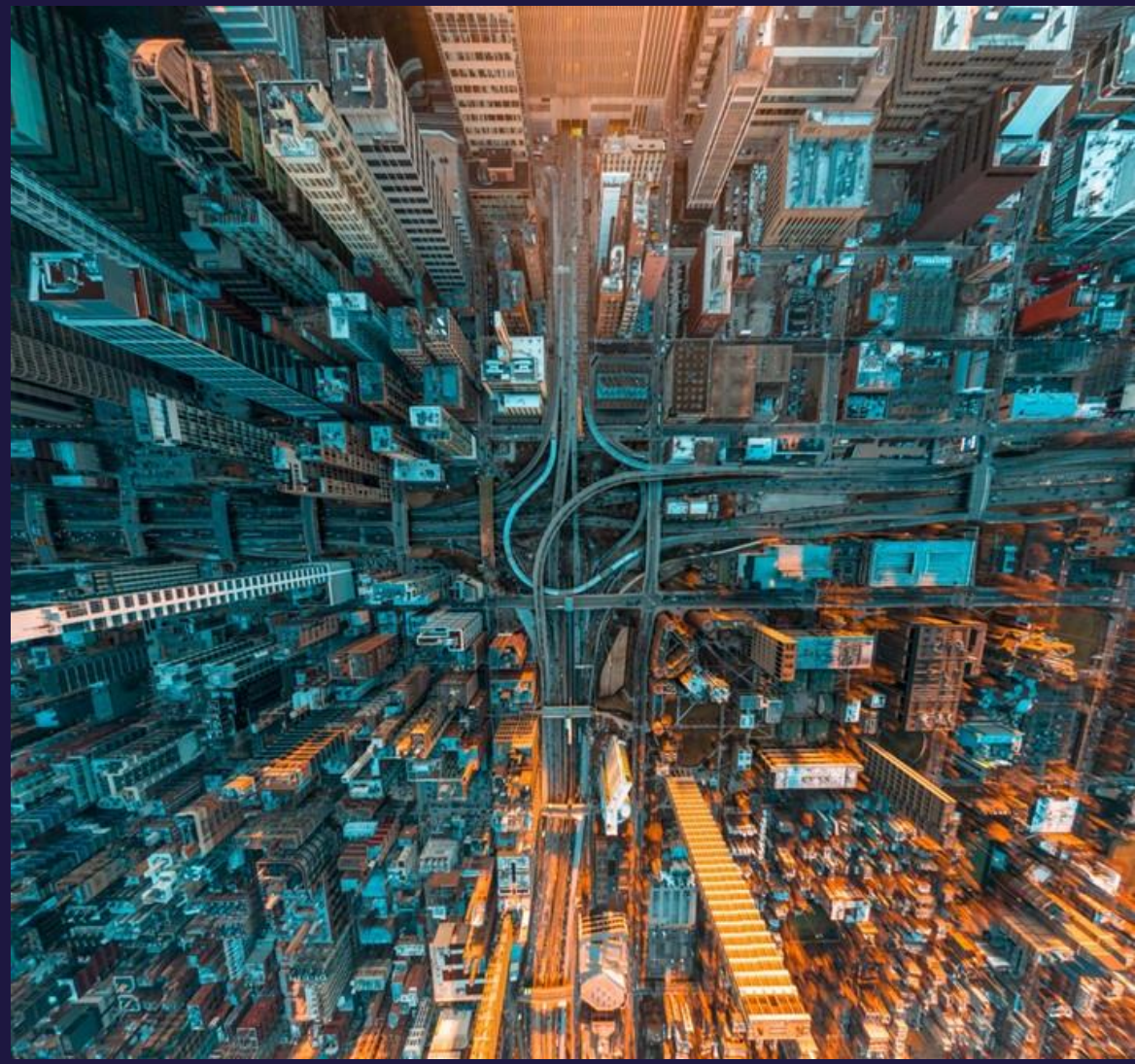
Better never settles

Contents

Sticky Isn’t Stuck

Beyond Peaks

The Path Forward




STICKY ISN’T STUCK

INFLATION HAS PROVEN TO BE STICKY

But sticky doesn't (necessarily) mean stuck

It is fair to say that for many, 2024 has not progressed as had been expected.

Entering 2024, there appeared to be a broad consensus that the pace of disinflation would continue, allowing the Reserve Bank of Australia (RBA) to shift its policy stance and begin cutting interest rates. Many had multiple rate cuts forecast for 2024, with some forecasting a rate cut by the RBA as early as March.

Calls for multiple rate cuts were always going to be incompatible with a soft landing for the economy. The RBA's own forecasts did not have inflation returning to the target band of 2% to 3% until the end of 2025, meaning that a recession would have almost certainly been a precondition for a rapid succession of interest rate cuts in 2024. Although economic growth has slowed, it has remained positive thanks to population growth and a gradual improvement in productivity. The Australian economy has once again proven to be resilient.

It should be noted that Cushman & Wakefield held a substantially more cautious outlook than many in the market. We recognized that many of the factors driving disinflation – namely the unwinding of pandemic-era disruptions to supply chains – had already run their course while inflationary pressures in non-tradable services, such as insurance and healthcare, would persist until at least mid-year. As such, we had forecast one rate cut in Q4 2024.

The RBA is in the unenviable position of having to make forward-looking policy decisions based on backwards looking economic data. Complicating this is the breakdown in economic relationships that have underpinned monetary policy for the past several decades, reducing the efficacy of the RBA's (and everyone else's) economic models.

Against this backdrop, the RBA's assessment of risks becomes paramount in determining monetary policy. Currently, conditions in the labour market remain tight while progress on disinflation has stalled. This is an indication that price stability is currently more of a risk than full employment, suggesting that the RBA will maintain a hawkish stance until more progress on disinflation is made and/or material weakness emerges in the labour market. As such, Cushman & Wakefield now sees H1 of 2025 as more realistic timing for a rate cut, with the risk of a Q4 2024 move evenly skewed between a cut and a hike.

The nature and timing of the RBA's next move are critical to commercial real estate (CRE) capital markets. As we discussed almost a year ago, historically pricing trends follow central bank interest rate cycles – pricing recovery begins once central banks begin cutting rates. And almost a year out from the previous release of this report, it may seem like we find ourselves at a similar juncture, expecting a cut on the horizon, though the timing is clouded by uncertainty.

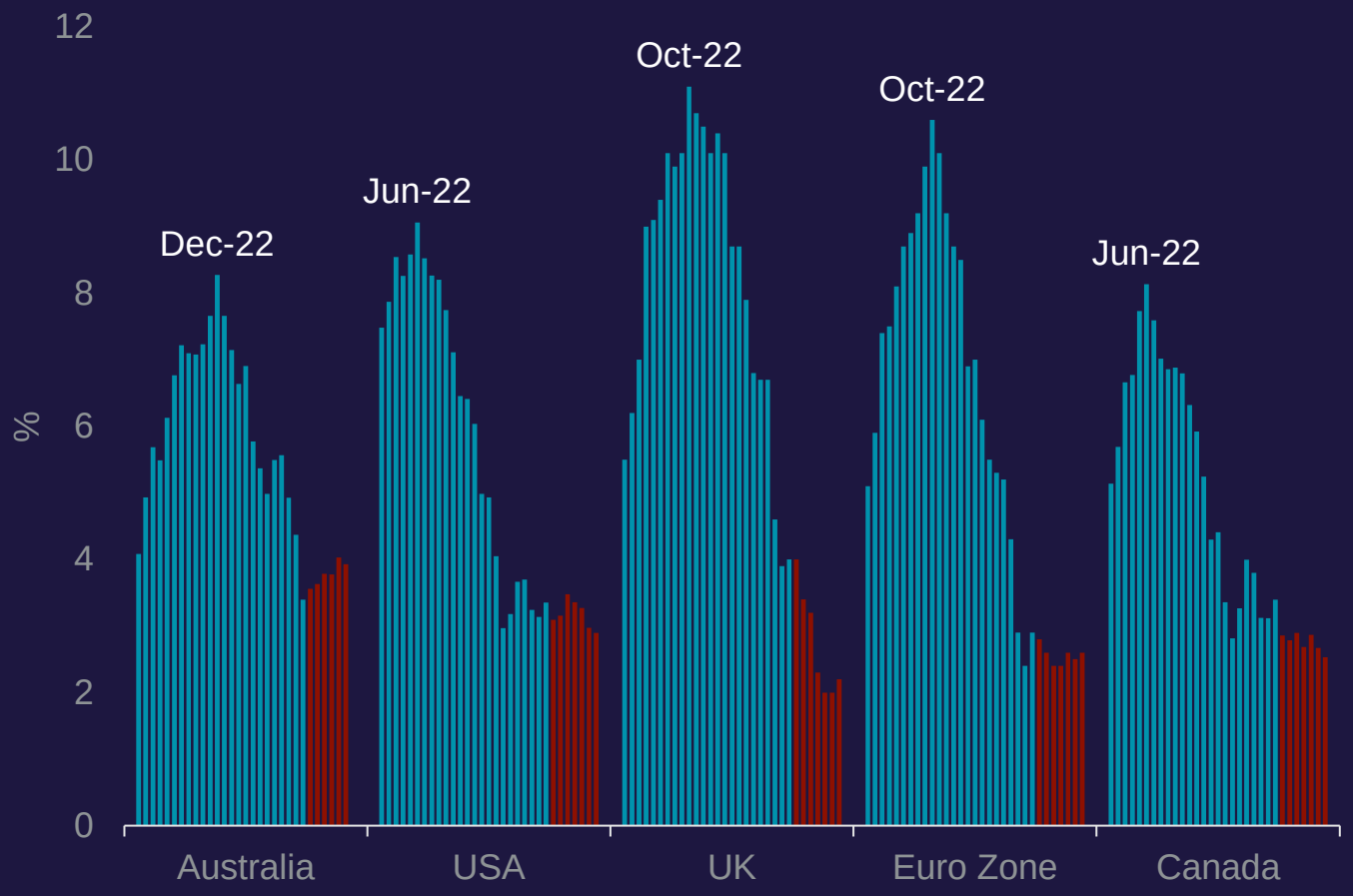
Not quite. There are some key differences between 2024 and 2025. Perhaps most significant is that other major central banks have begun to cut policy rates, with the first cut by the US Federal Reserve imminent. There has been further adjustment in CRE pricing across asset classes, which will help to limit downside risks moving forward.

Although inflation has proven sticky, this doesn't necessarily mean stuck. With productivity growth beginning to show signs of life, supply-constrained price pressures should continue to ease, while labour market uncertainty could induce households to save more, thereby lowering overall levels of demand.

This report aims to bring clarity to the current macro environment and how it is likely to evolve over the next cycle.

HEADLINE CPI, NSA, YOY %, 2022-2024

Red bars are from January 2024 onwards



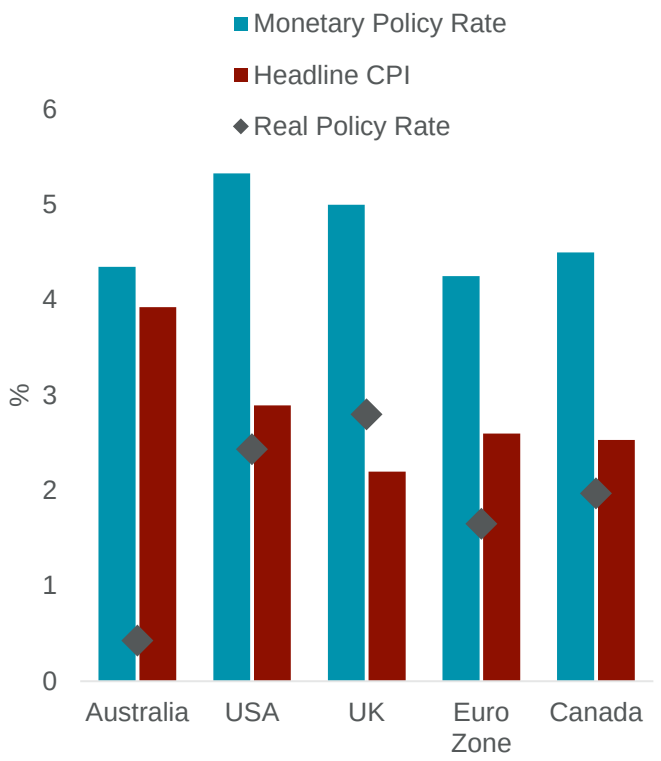
Source ABS, BLS, ONS, EuroStat, Stats Canada, Moody's Analytics, Cushman & Wakefield

- During the most recent cycle, inflation in Australia peaked 3 to 6 months after international peers. This appears to have lulled many commentators into believing that Australia's disinflationary path will naturally follow that of other advanced economies. However, as sources of inflation have shifted from global (tradeable) factors to local (non-tradable) factors such as housing and services there is a risk that Australian inflation may decouple from the global cycle.
- Inflationary pressures have proven to be sticky thus far in 2024 as real interest rates remain much less restrictive in Australia relative to other advanced economies. Demand remains at high levels as households continue to spend, in part driven by a depressed household savings ratio. Savings rates tend to increase with the unemployment rate as households become uncertain of future income. Future budget deficits are also inflationary; these are at risk of increasing should commodity prices come in below Treasury forecasts.

UPSIDE RISKS TO PRICES REMAIN

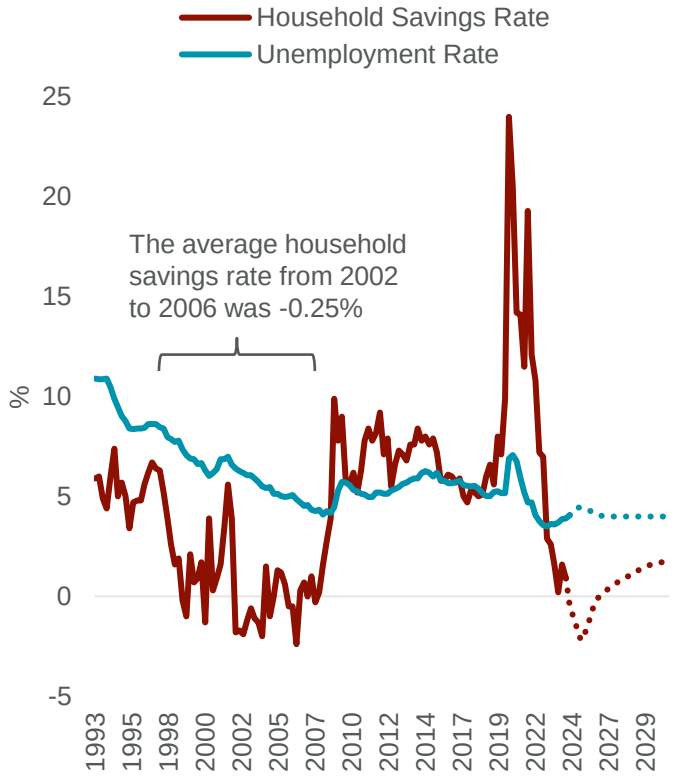
High levels of consumption characterized by low savings rates, and budget deficits will maintain upward pressure on prices and slow disinflation

Real Interest Rates



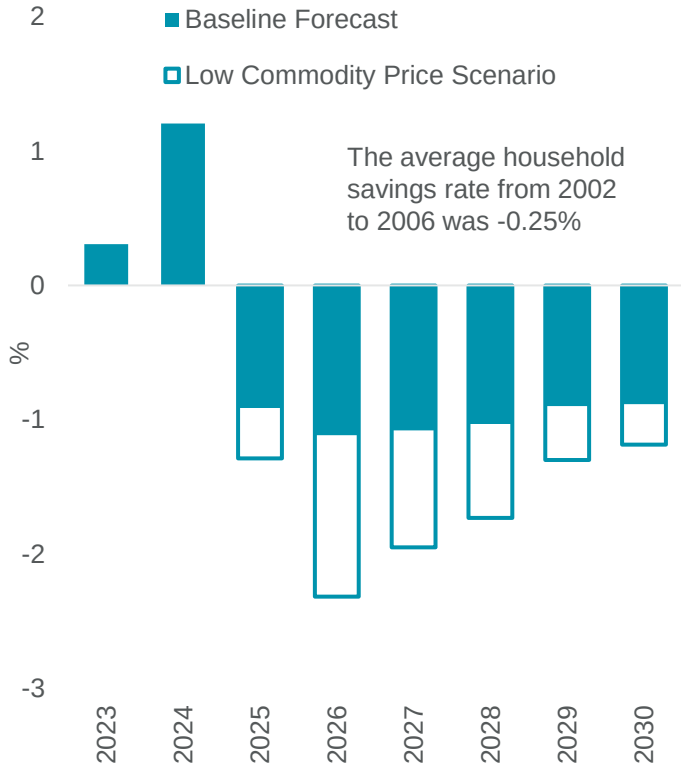
Source: National Stats Agencies, National Central Banks, Moody's Analytics, Cushman & Wakefield

Household Savings & Unemployment



Source: ABS, Oxford Economics, Cushman & Wakefield

Government Budget Deficit/Surplus, % of GDP

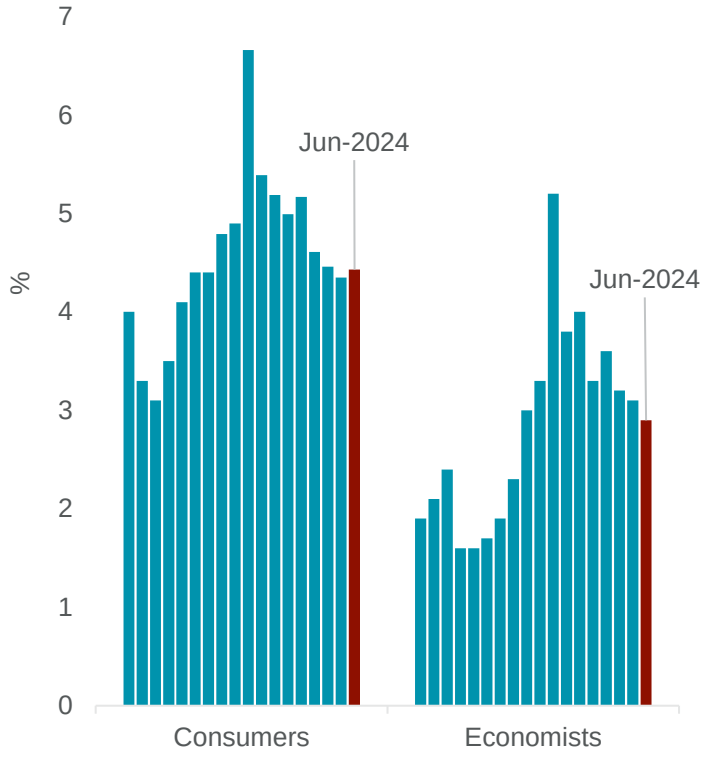


Source: ABS, Moody's Analytics, Cushman & Wakefield

PRICE, RATE RISKS SKEWED TO THE UPSIDE

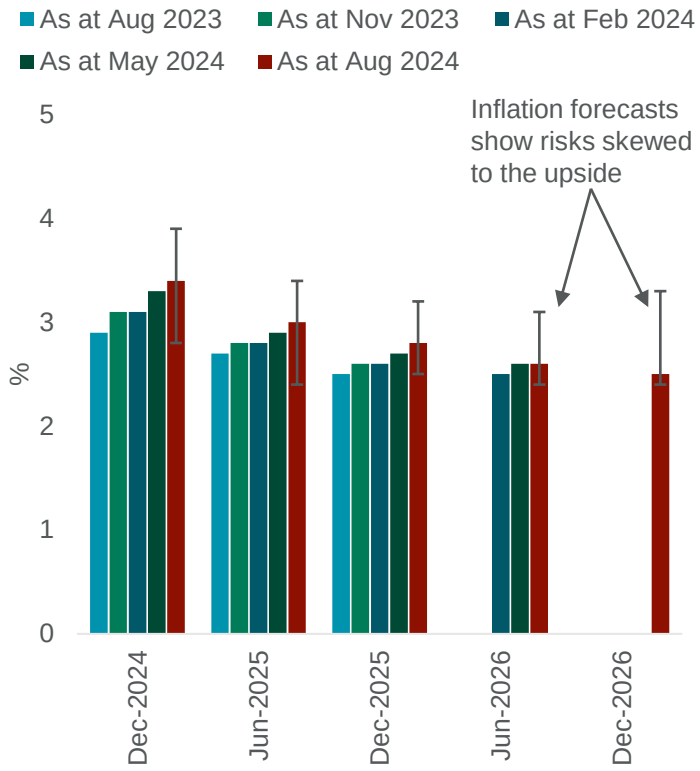
Risks of a rate rise in 2024 have come down from mid-year, but price pressures are likely to keep rates above market pricing in the near term

Headline Inflation Expectations: One Year Ahead



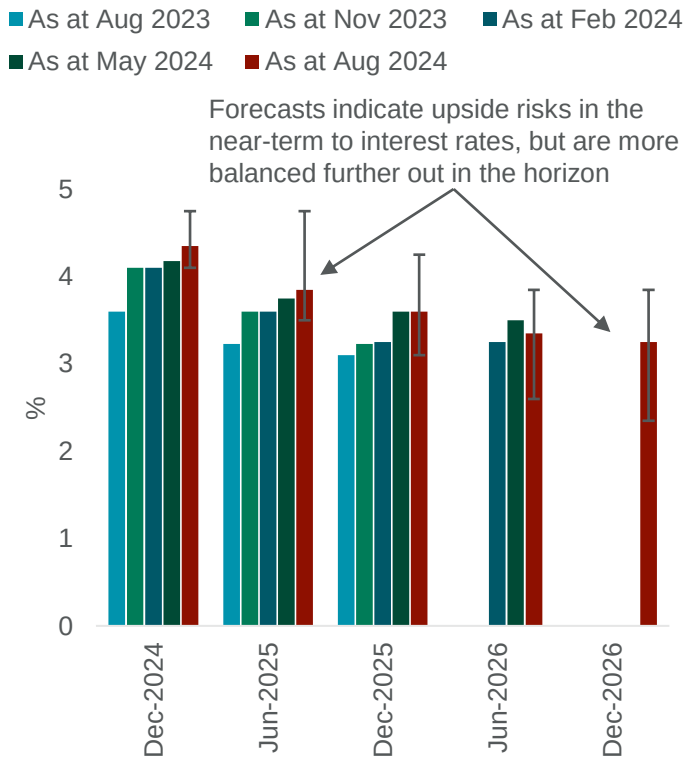
Source: RBA, Cushman & Wakefield

Economists' Median, High & Low Forecasts of Core Inflation



Source: RBA, Cushman & Wakefield

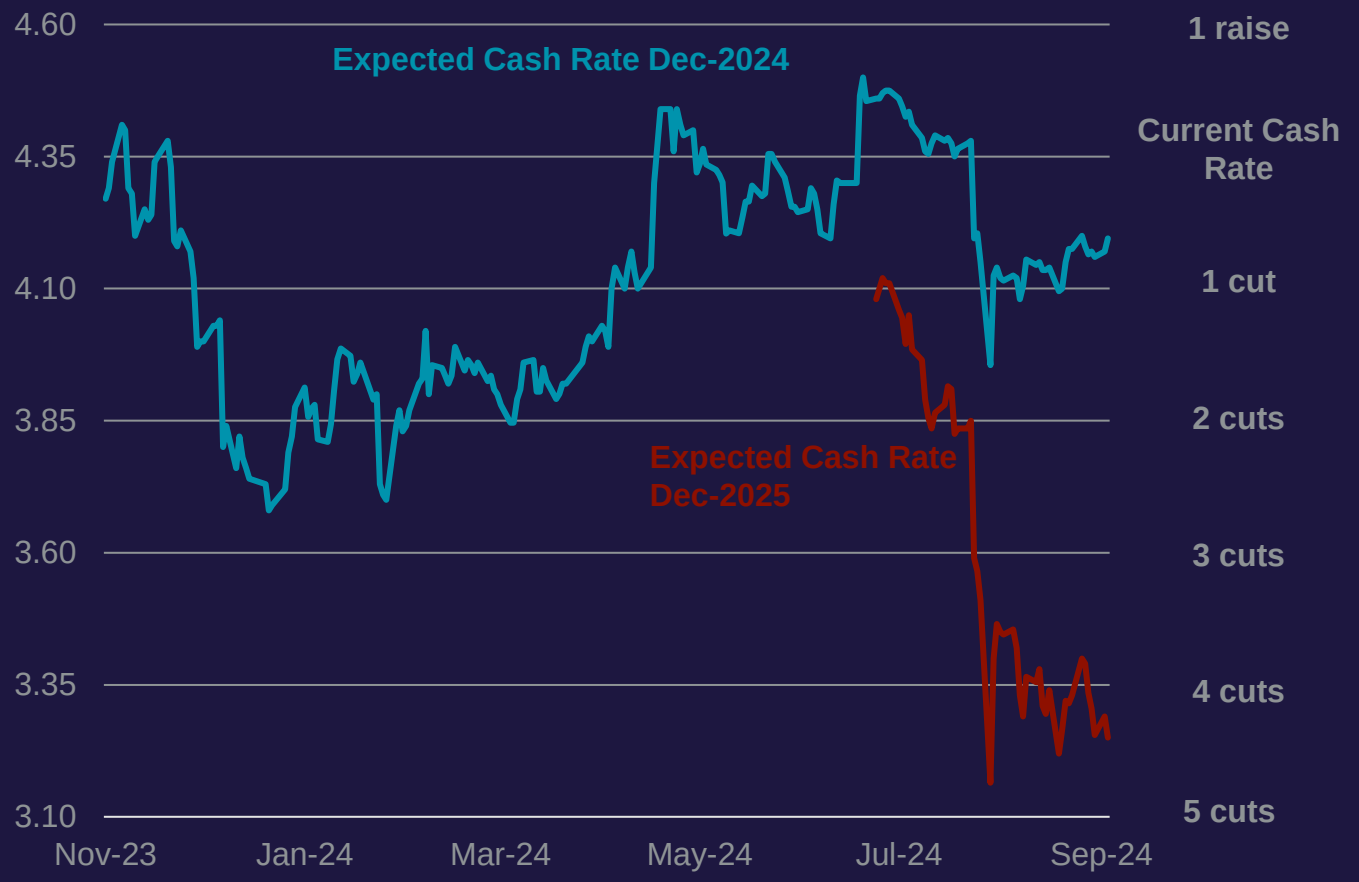
Economists' Median, High & Low Cash Rate Forecasts



Source: RBA, Cushman & Wakefield

MARKETS LACK DIRECTION ON RATES

ASX Cash Rate Futures since Nov-2023 RBA rate hike*



Source: ASX, Cushman & Wakefield

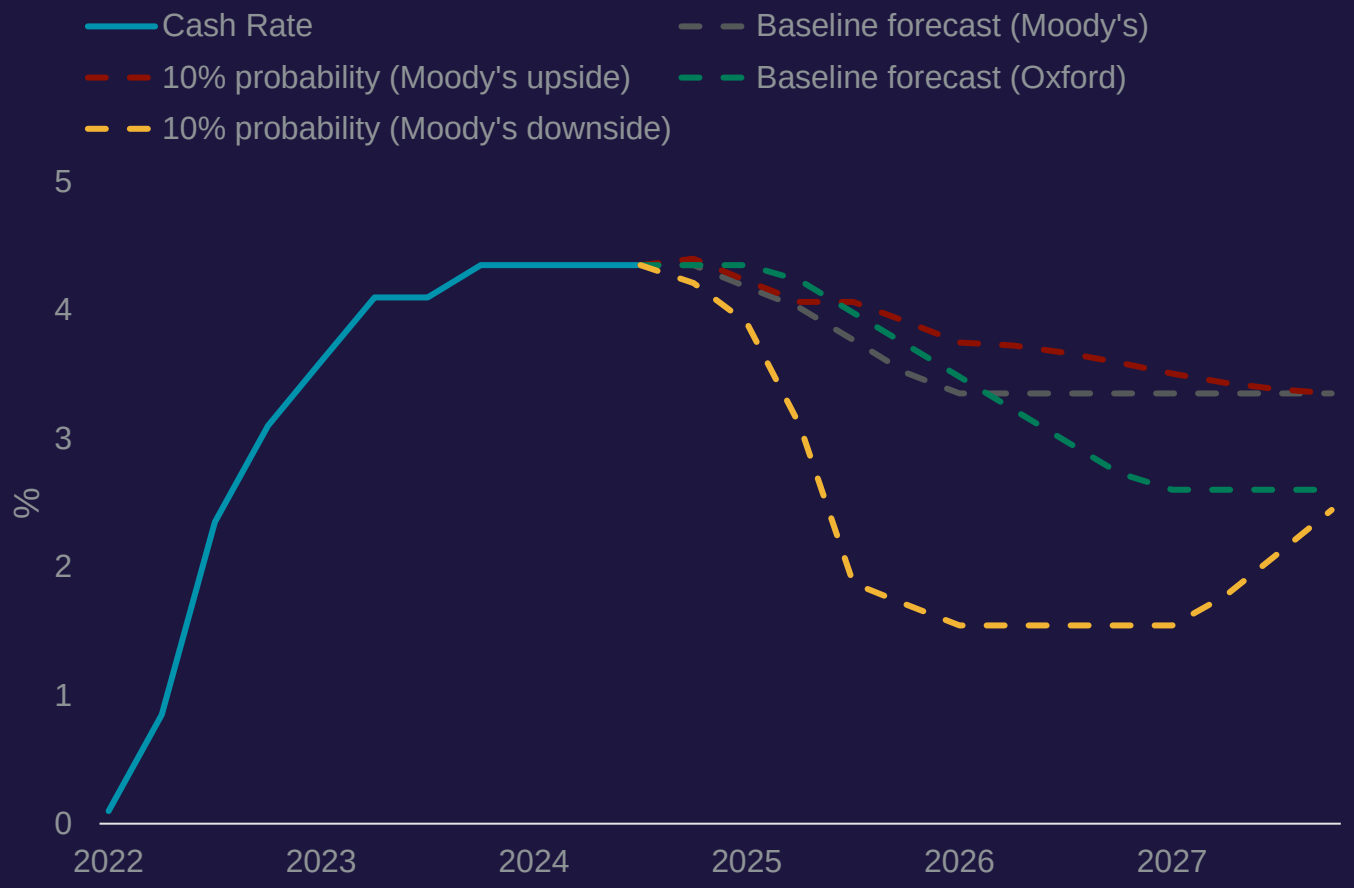
**Through at 10/09/2024*

CUSHMAN & WAKEFIELD

- Following the RBA's 25 bps increase to the cash rate in November, markets were pricing in 2 to 3 cuts in 2024. Since the first quarter of 2024 the distribution of rate expectations has broadened as markets have been particularly sensitive to inflation data.
- After Q2 CPI came in more benign than expected markets are pricing in one 25 bps cut in 2024 and an additional three-to-four by the end of 2025. This seems like an overshoot, similar to early 2023 when a peak Cash Rate of 3.85% was priced in.
- The likelihood of a rate cut in Q4 2024 appears low; one cut in H1 2025 and one or two cuts in H2 2025 appears more realistic. The chances of a rate increase remain non-negligible if inflationary pressures persist, and the labour market remains strong.

CASH RATE SCENARIOS

No clear consensus on path of interest rates



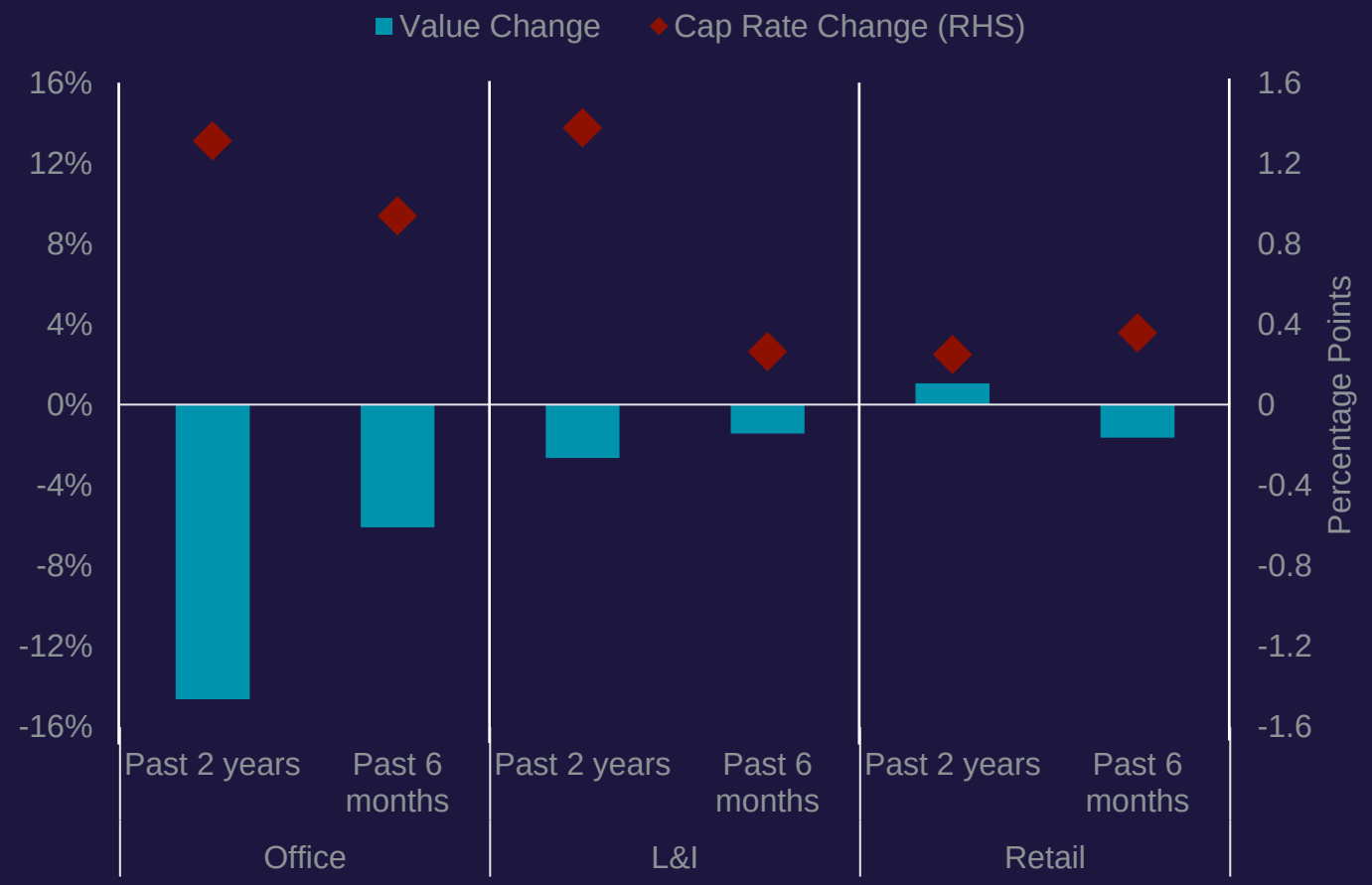
Source: RBA, Moody's Analytics, Oxford Economics, Cushman & Wakefield

- Although the majority of forecasts now expect the first cut by the RBA to come in either Q1 or Q2 2025, there is still no clear path on the pace of cuts or where interest rates settle at the end of the cycle.
- Two scenarios considered here, the upside and downside, show very different paths for the economy. Moody's Analytics assigns a 10% chance to each scenario, roughly the same odds as drawing a straight in a game of Texas Hold'em.
- The upside scenario would be a very soft landing for the labour market. The downside scenario would be associated with a recessionary environment, where rates need to be reduced at a much more rapid pace.
- Where rates settle in the long term depends on productivity growth, demographics, as well as global factors.


BEYOND PEAKS

PRICING

Average value and cap rate changes across AREIT assets to June 2024 (peak value June 2022)

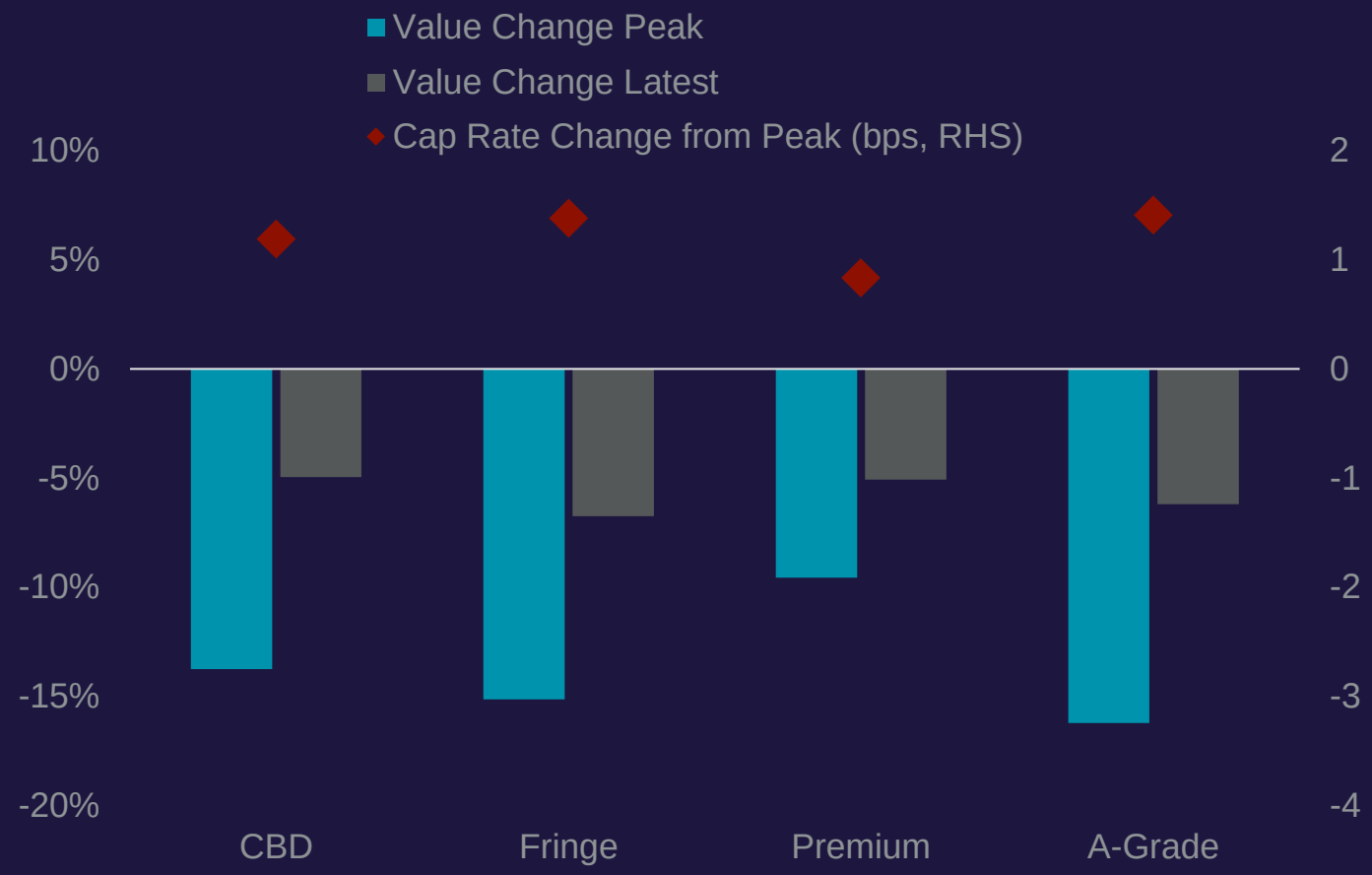


Source: Company financial statements, Cushman & Wakefield

- The AREIT market shows some evidence that both capitalization rates and values have begun to stabilize in the logistics and industrial (L&I) market. Cap rate expansion has slowed over the past six months and appears to be near or at its peak, while values have been cushioned by income growth and low vacancy rates.
- The value of retail assets have begun to decline as retail sales have stalled. However, volatility is likely to be minimal given that most of the price adjustment occurred in the pre-COVID period.
- Office appears to be more of a laggard, with book values and capitalization rates still seeing larger adjustments than other asset classes. There may still be some more scope for adjustment in office valuations during the February 2025 AREIT reporting period.

LISTED OFFICE

The spread between Premium grade and A-grade offices has widened amid a flight to quality



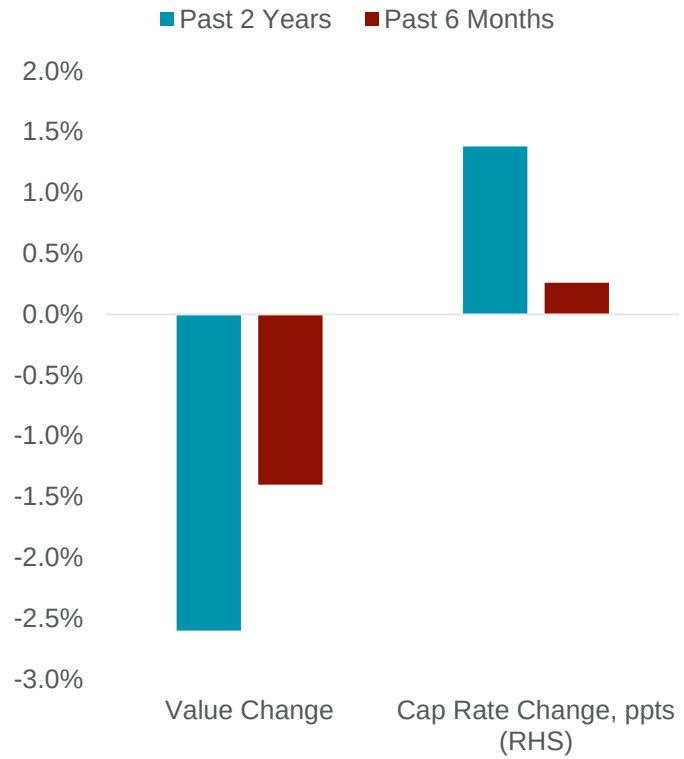
Source: ASX, Cushman & Wakefield

- The divergence between office and other sectors in the listed market has been evident since the beginning of the rate hike cycle in May 2022.
- Other sectors have been able to offset rising cap rates to a degree with increased income, however rising vacancy rates and incentives in the office market have hindered this.
- As a result, AREITs with more office exposure currently trade at a ~20% discount to the broader index; the gap between office-exposed AREITs and those more exposed to the industrial market is even larger.
- However, there is evidence of the flight-to-quality. Subsequent pages slow that Premium grade offices have seen a much smaller decline in value than A-grade assets. The expansion in cap rates has also been more modest in Premium grade assets, evidence of a higher risk premium being priced in for A-grade assets.

LISTED LOGISTICS & INDUSTRIAL

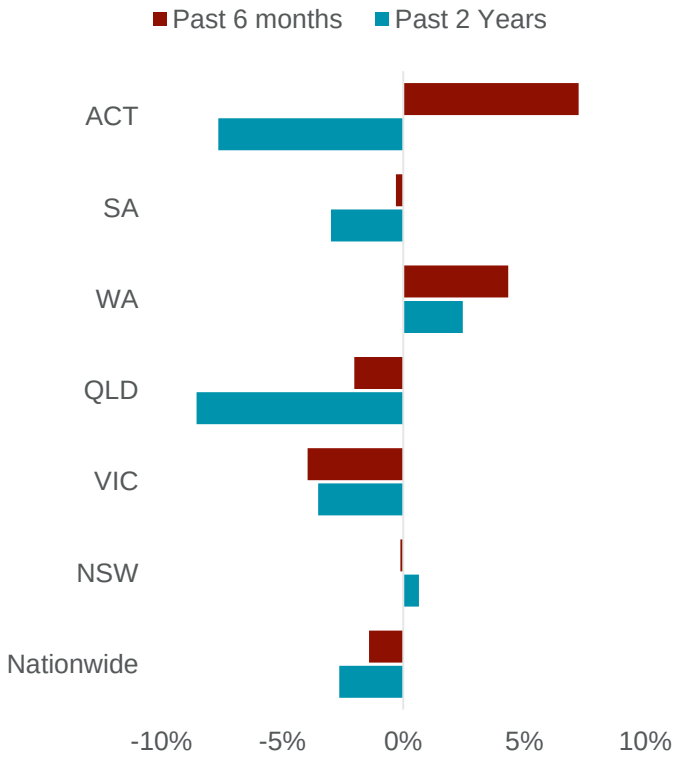
Rental growth has offset much of the decline in values, with some states already showing value increases

Value & Cap Rate Change



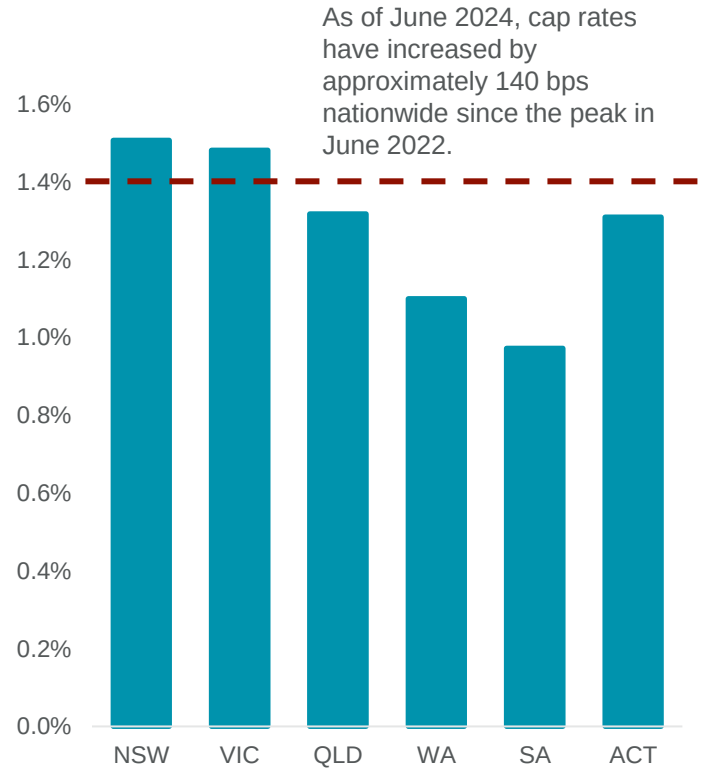
Source: Company financial statements, Cushman & Wakefield

Value Change by State



Source: Company financial statements, Cushman & Wakefield

Cap Rate Change by State

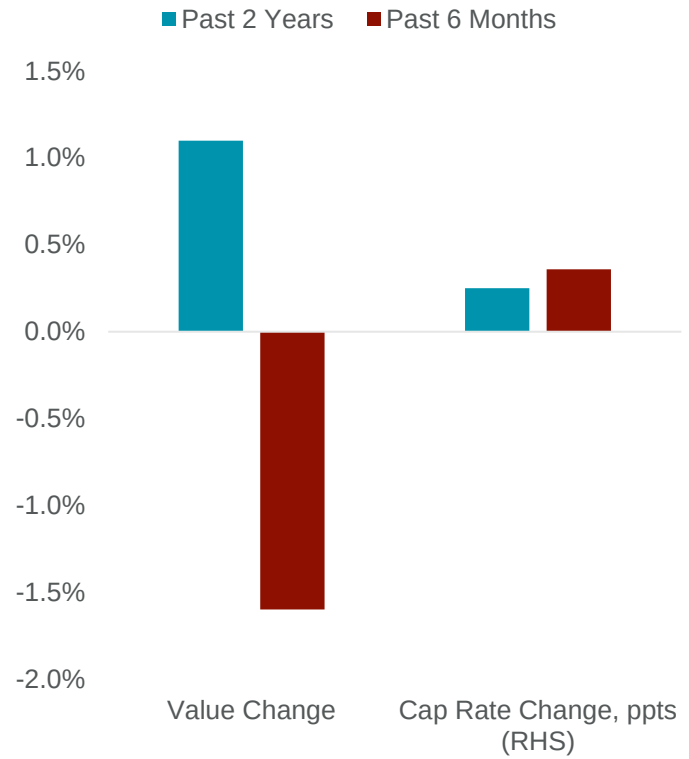


Source: Company financial statements, Cushman & Wakefield

LISTED RETAIL

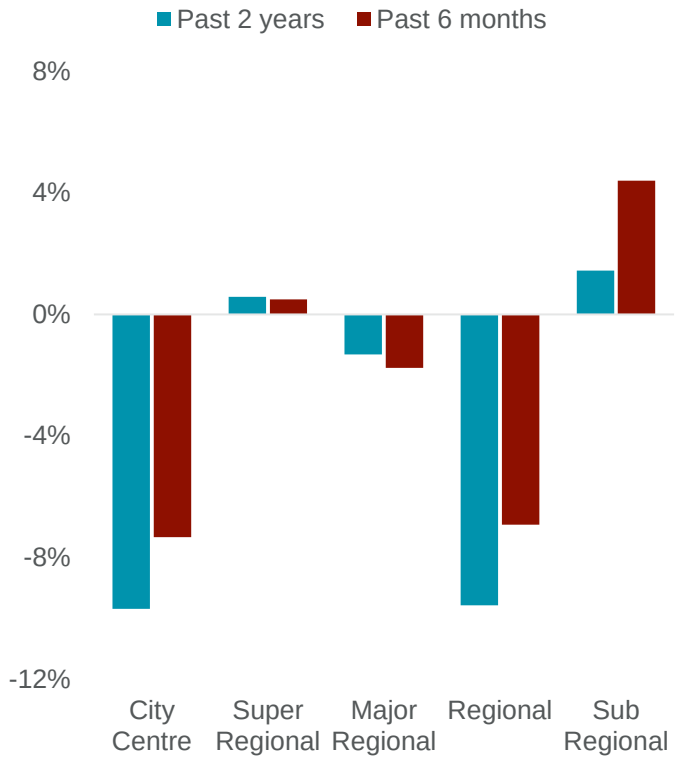
Consumer spending offset cap rate expansion early in the cycle, but has begun to ease as savings rates have declined

Value & Cap Rate Change



Source: Company financial statements, Cushman & Wakefield

Values



Source: Company financial statements, Cushman & Wakefield

Cap Rates

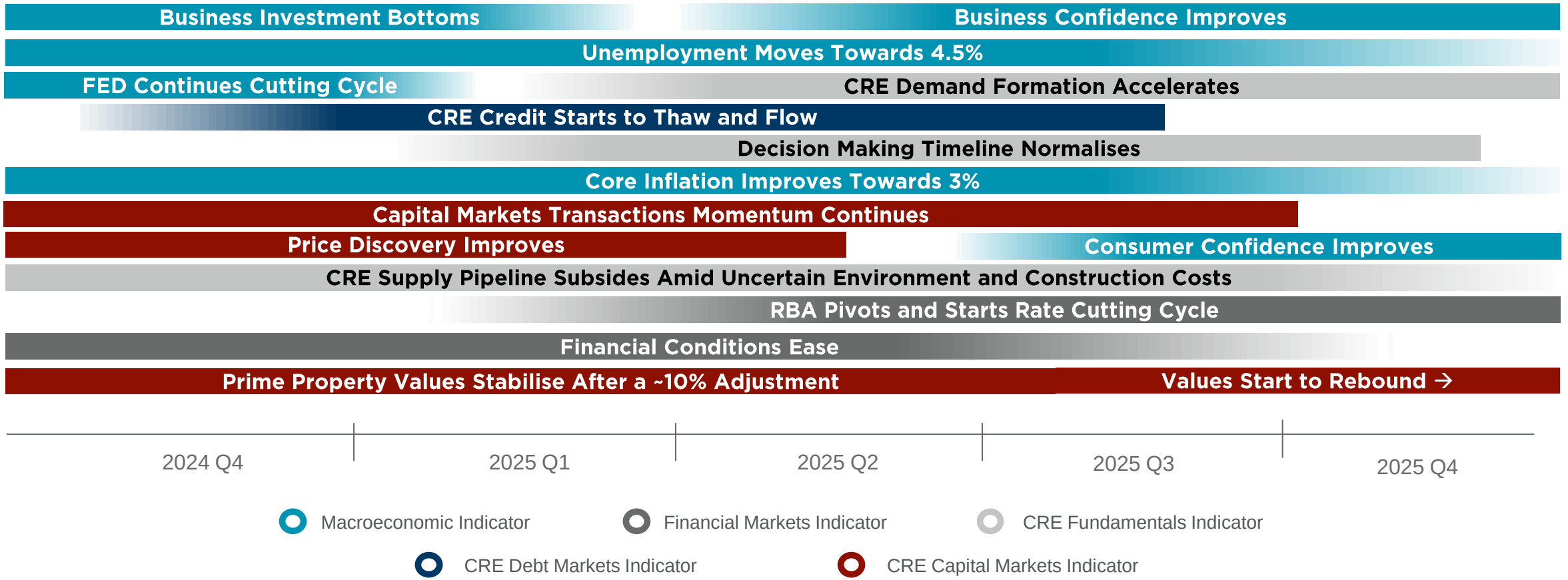


Source: Company financial statements, Cushman & Wakefield


THE PATH FORWARD

C&W's Baseline Glide Path

The path forward.

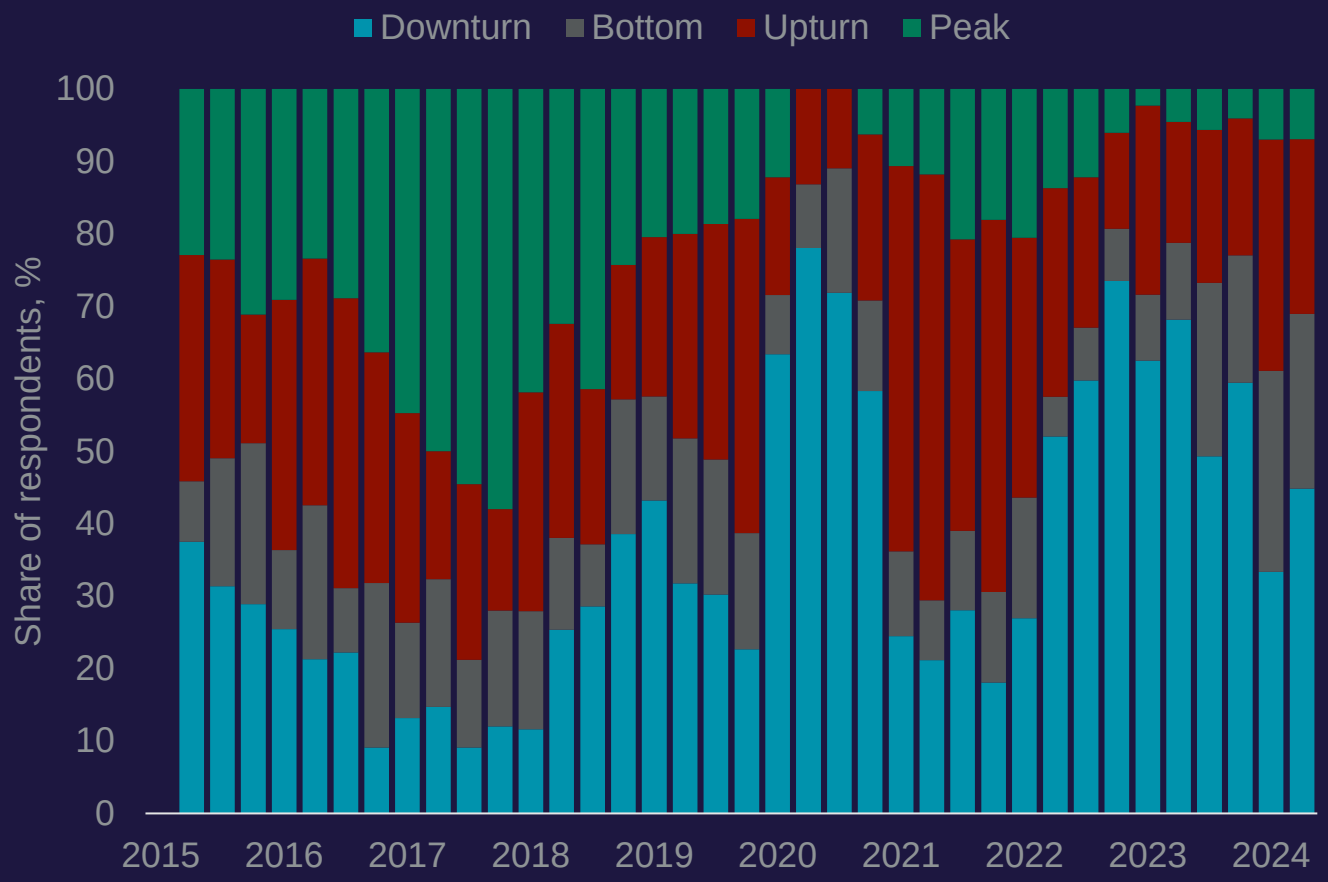


Source: Cushman & Wakefield Research

*Subject to no further interest rate rise in 2024

PERCEPTIONS OF THE PROPERTY CYCLE

Fewer property professionals viewing the market as currently being in a downturn vs an upturn



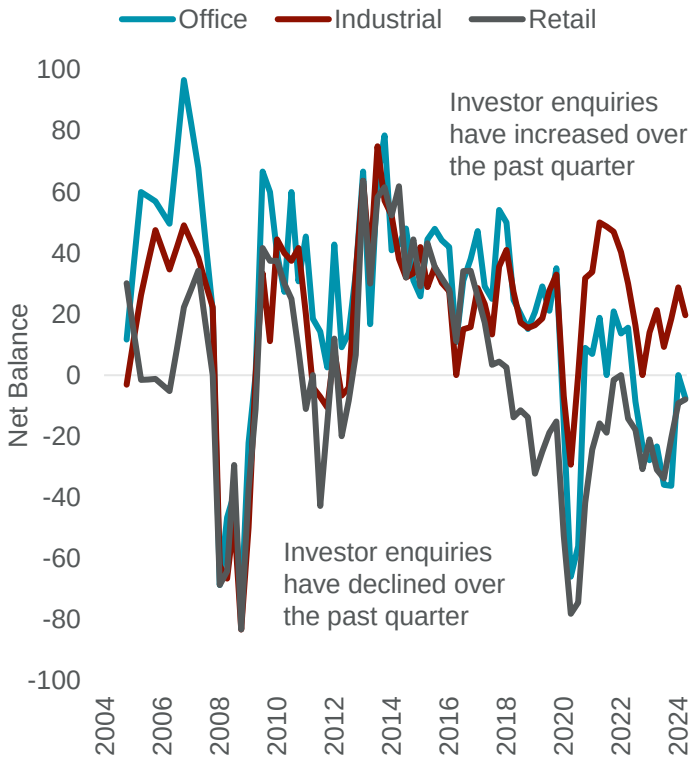
Source: RICS, Cushman & Wakefield

- Australian investors have broadly rotated out of property since the beginning of 2023 as the trajectory of the interest rate cycle became clear.
- Most of the 'bad news' appears to be broadly priced into listed property funds, which will help to limit the downside. However, this will also serve to amplify any upside surprises to the sector.
- Investor demand for office and retail assets has stabilised, while that for industrial has begun to trend higher. Against this backdrop, expectations for capital growth for office and retail assets have improved over the past year.
- Fewer market participants are also perceiving CRE to be in some stage of a downturn, a sign that sentiment may have bottomed, and the market is poised for recovery.

MARKET SENTIMENT SHIFTING TOWARDS RECOVERY

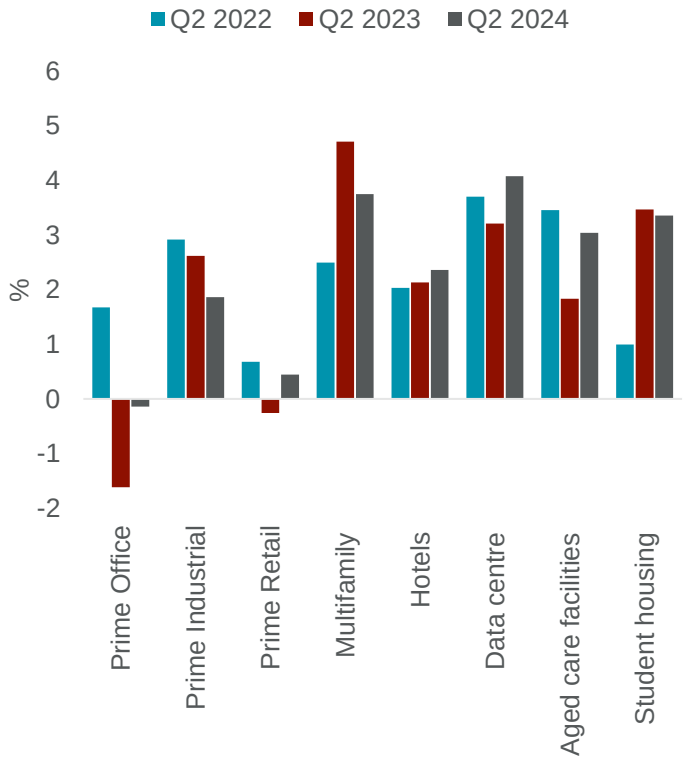
Investment demand appears to have bottomed, though investors have yet to significantly rotate back into property

Investment Enquiries – Core Sectors



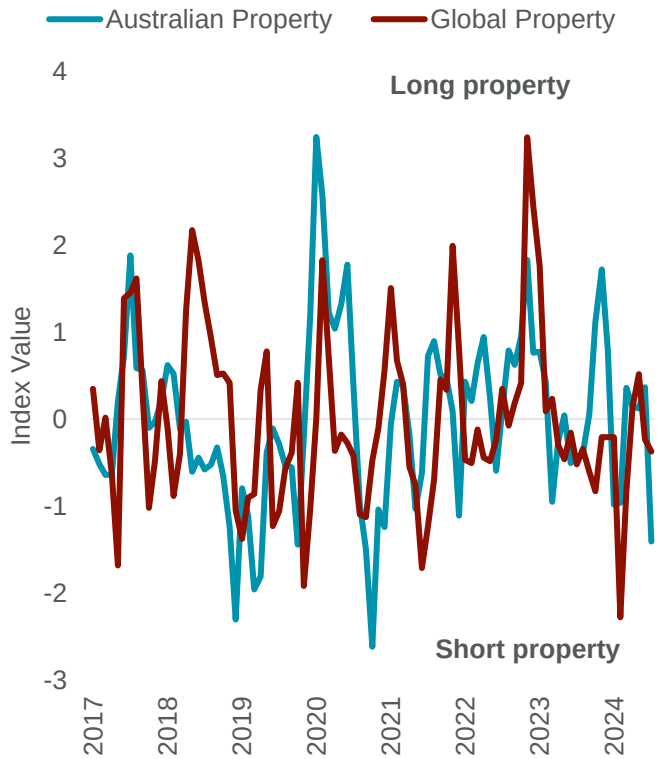
Source: RICS, Cushman & Wakefield

12-month Capital Value Growth Expectations



Source: RICS, Cushman & Wakefield

CW Australian Investor Positioning Indexes, Fund Flows



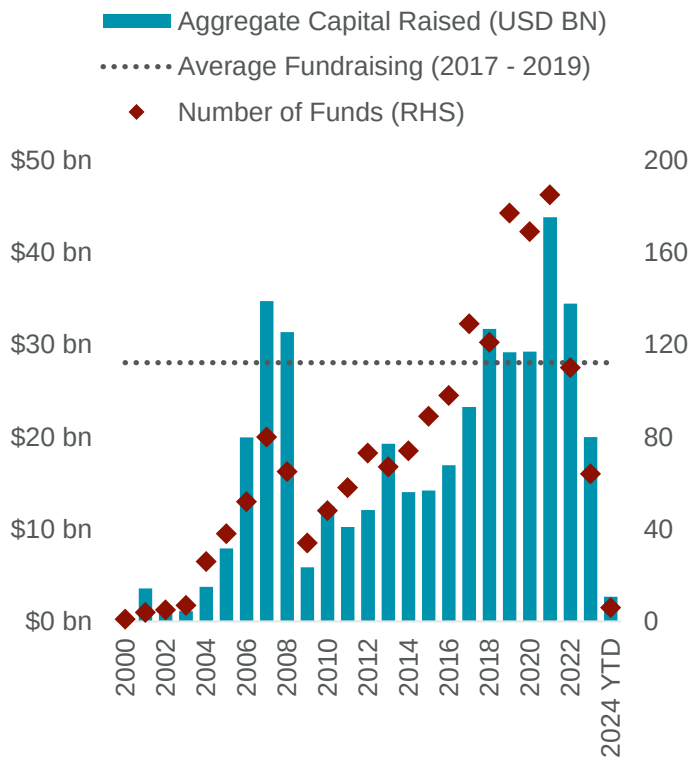
Source: ASX, Cushman & Wakefield

CAPITAL WAITING TO POUNCE

Fundraising and dry powder – APAC

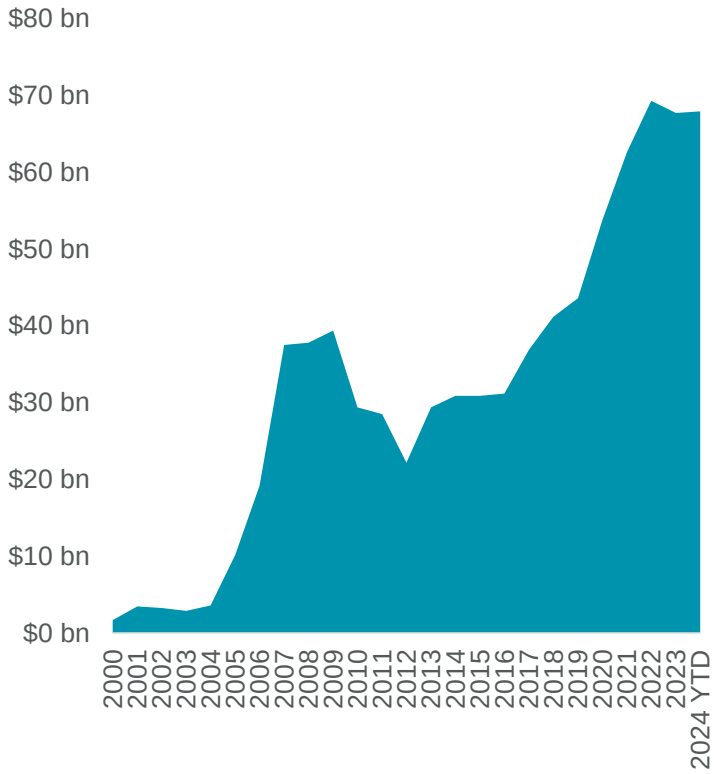
Plenty of dry powder seeking yield waiting to be deployed

Fundraising Down, But Not Out



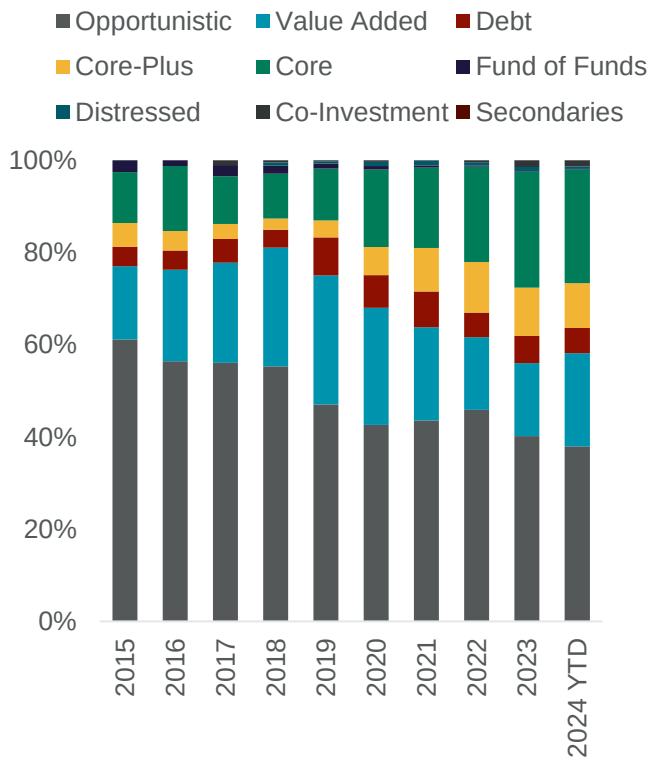
Source: Preqin (data through Q1 2024), Cushman & Wakefield

Dry Powder Mounting



Source: Preqin (data through Q1 2024), Cushman & Wakefield

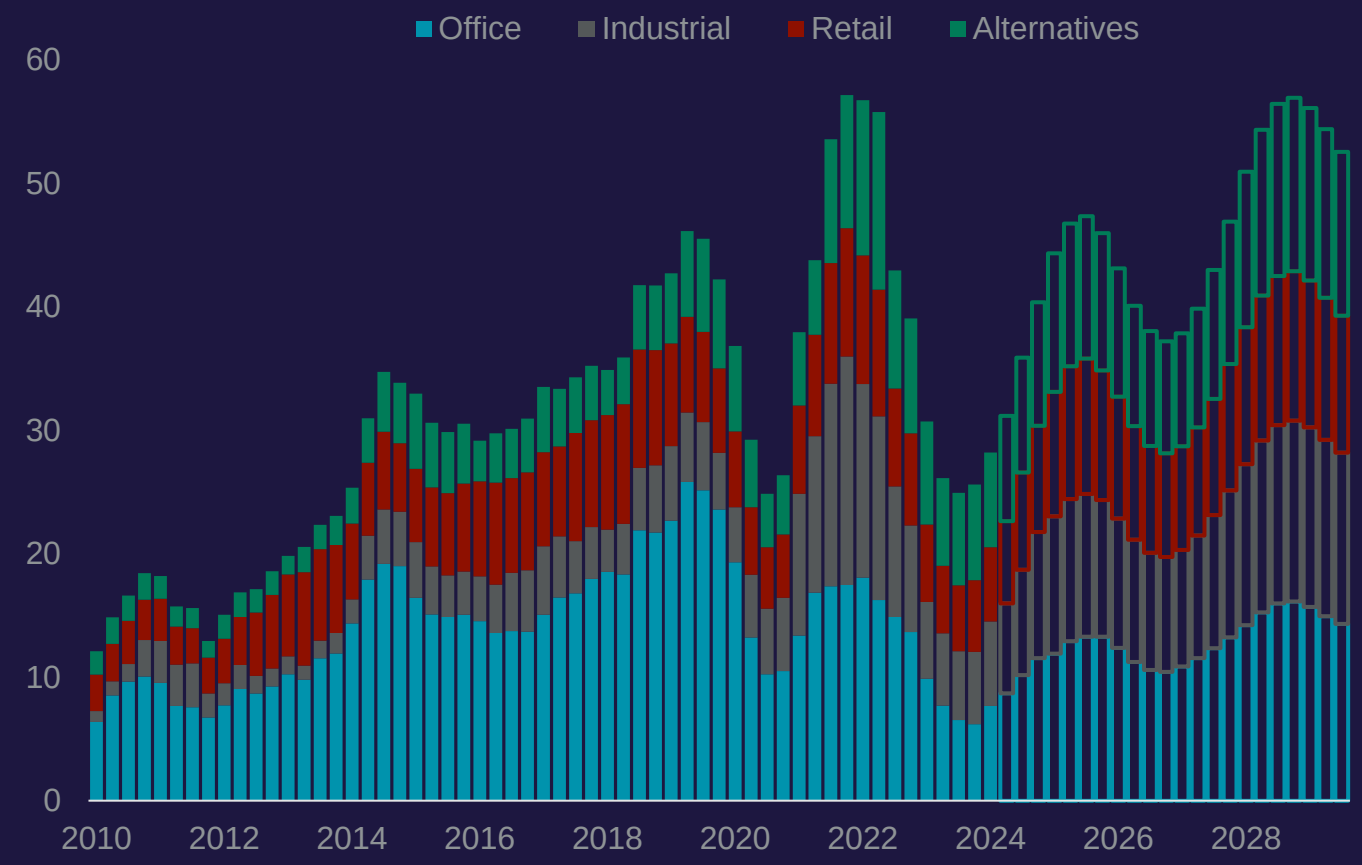
Capital is Seeking Yield



Source: Preqin (data through Q1 2024), Cushman & Wakefield

VOLUMES RECOVER

Rolling Annual Investment Volumes, A$ Billions

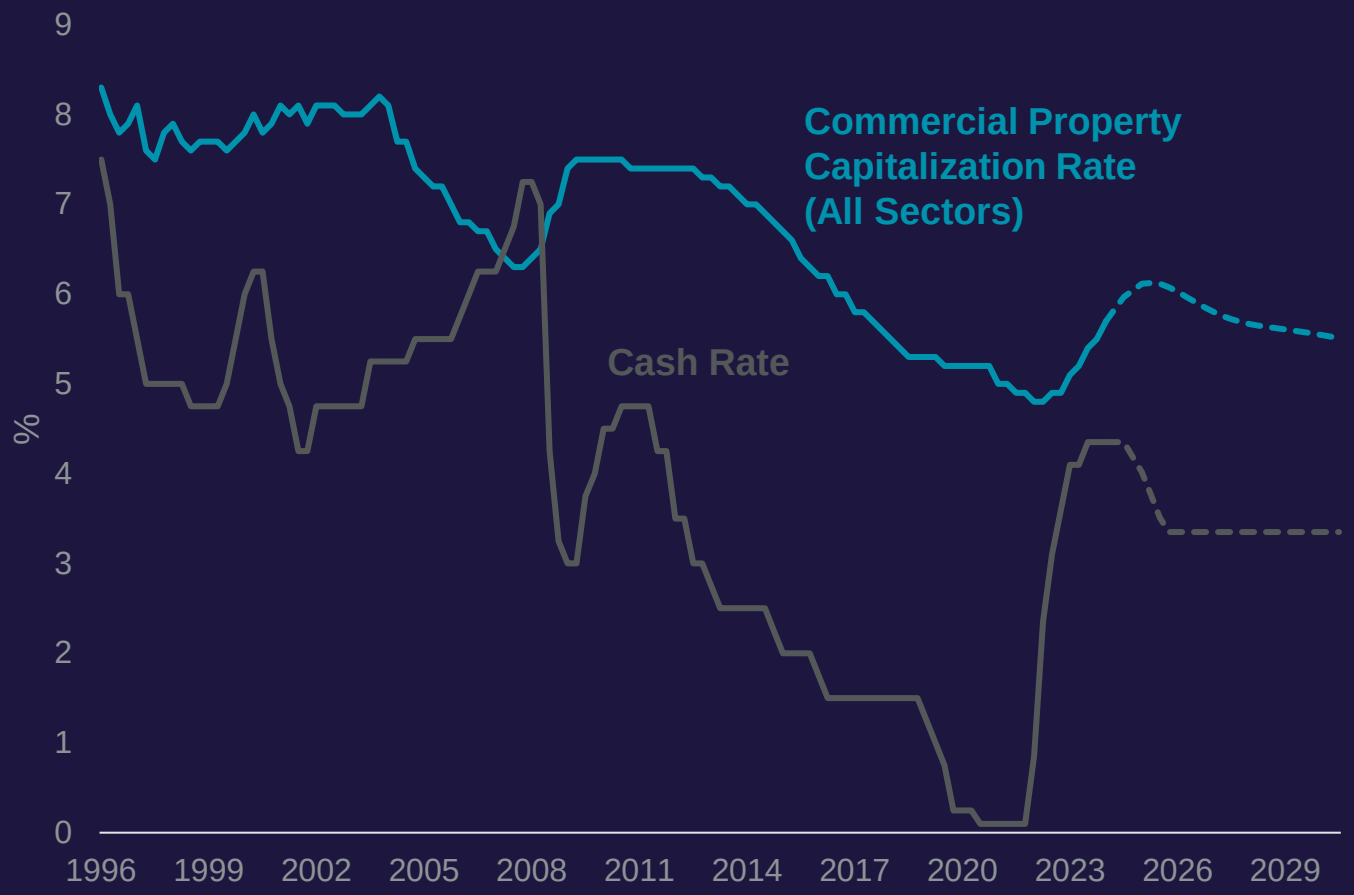


Source: MSCI, Cushman & Wakefield

- Nationally, volumes have shown signs that they are beginning to recover on a quarter-on-quarter basis. Volumes appear to have bottomed on a cyclic basis sometime around Q2 of 2024 and have since begun to gain traction.
- Rolling annual volumes are expected to continue to recover through 2025 supported by a large amount of regional capital looking to be deployed.
- As the way forward for interest rates gains clarity, this will ease price discovery, helping to close the gap between buyers and sellers.
- Regionally, Sydney and Melbourne consistently rank amongst the top three locations where regional investors want to deploy capital, alongside Tokyo. Cross-border investment is likely to continue to target these two locations.
- The recovery in volume is allowing for prices to fully adjust. Values will stabilise once book values adjust to market pricing.

PRICING ADJUSTS

Cap rates to stabilise in 2025 before cap rate compression commences in 2026



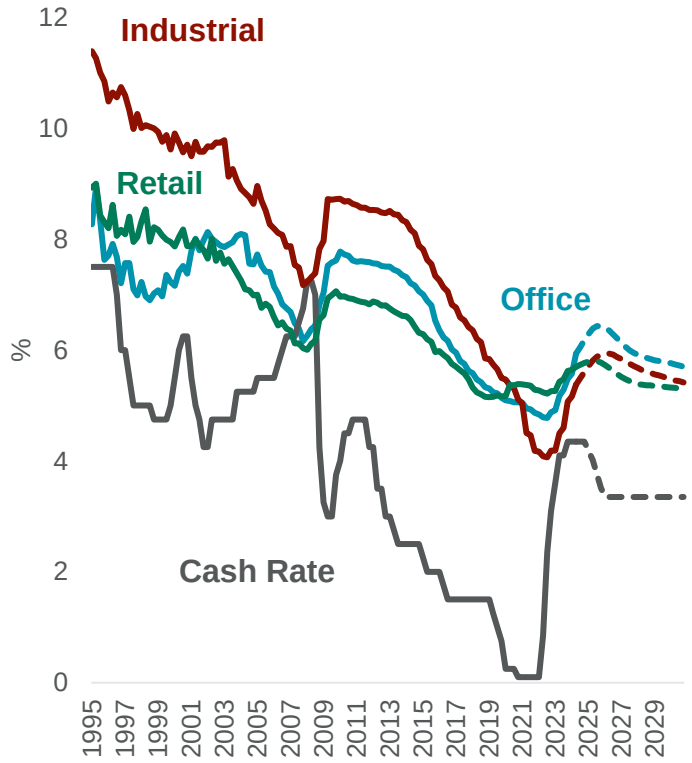
Source: MSCI, RBA, Cushman & Wakefield

- Cap rates appear to be nearing their peaks. Note that cap rates typically trail market yields by 6-12 months, current deal evidence suggests that market yields are already at peak levels; a stabilisation is likely to occur as more deals become finalised.
- Spreads between asset classes tightened in the post-GFC period as interest rates declined. This peaked during the pandemic when assets were trading at historically low cap rates against the backdrop of ultra-low interest rates.
- Spreads have expanded since the RBA began raising interest rates in May 2022; they are likely to settle at a narrower band than during the post-GFC period.
- Structural changes have impacted some asset classes: industrial is likely to trade at a tighter spread than office once rates settle, and neighbourhood retail also looks to trade at a premium.

CAP RATES

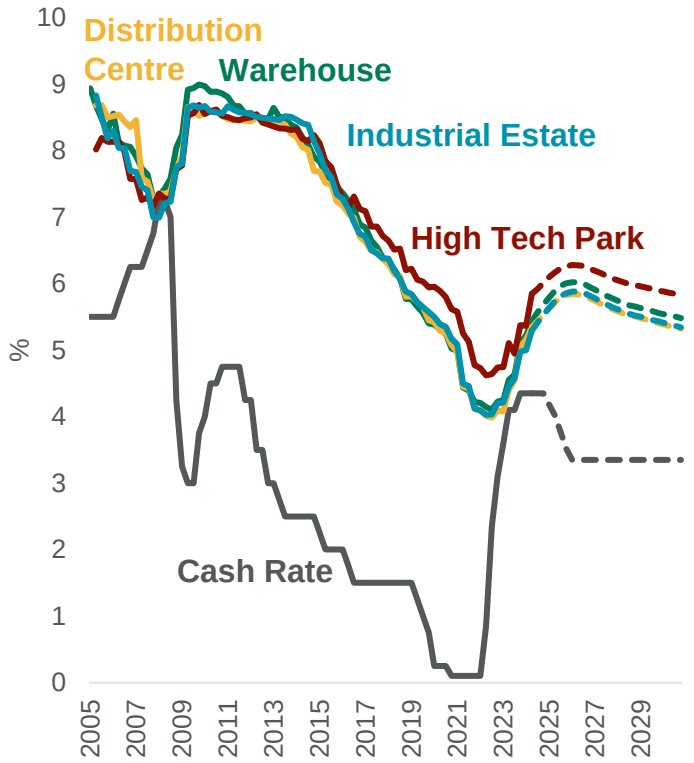
Spreads between L&I, retail sub-sectors to remain stable

Cap Rates



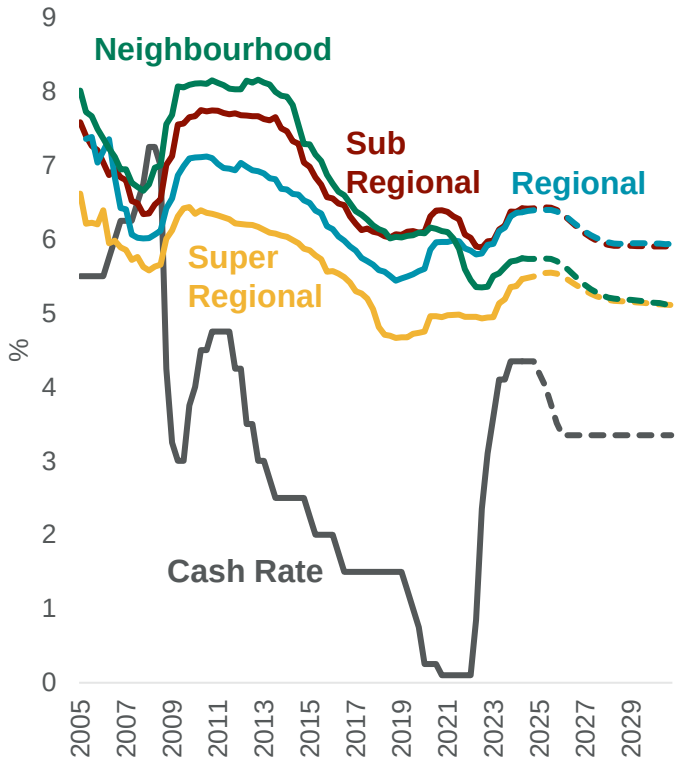
Source: MSCI, RBA, Cushman & Wakefield

Industrial Cap Rates



Source: MSCI, RBA, Cushman & Wakefield

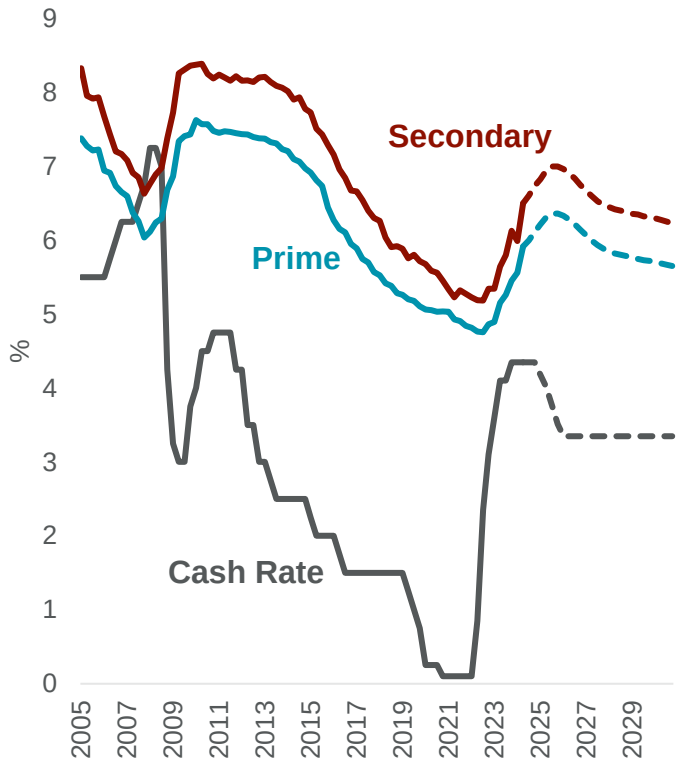
Retail Cap Rates



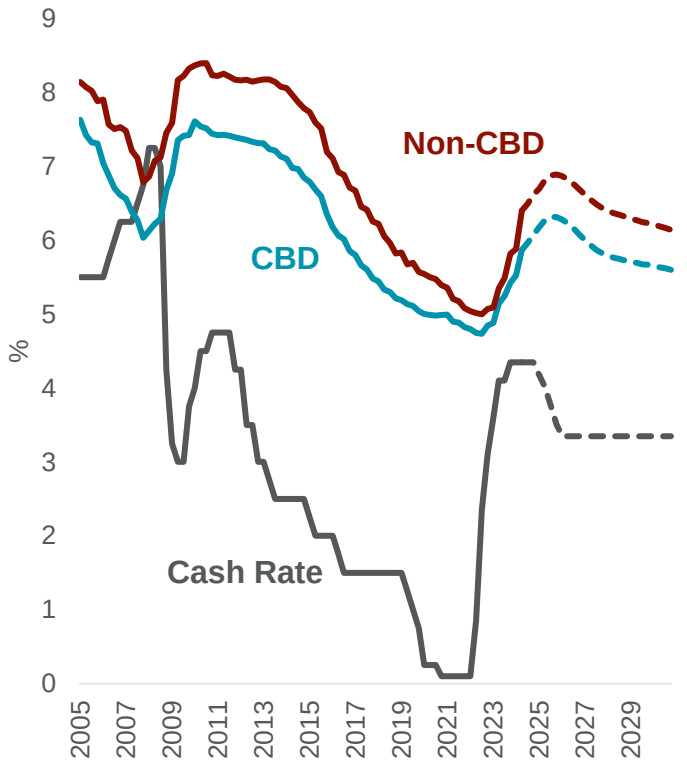
Source: MSCI, RBA, Cushman & Wakefield

OFFICE CAP RATES

Spreads to widen relative to period of ultra-low rates but narrower than post-GFC period; repricing of CBD assets has more-or-less already occurred.

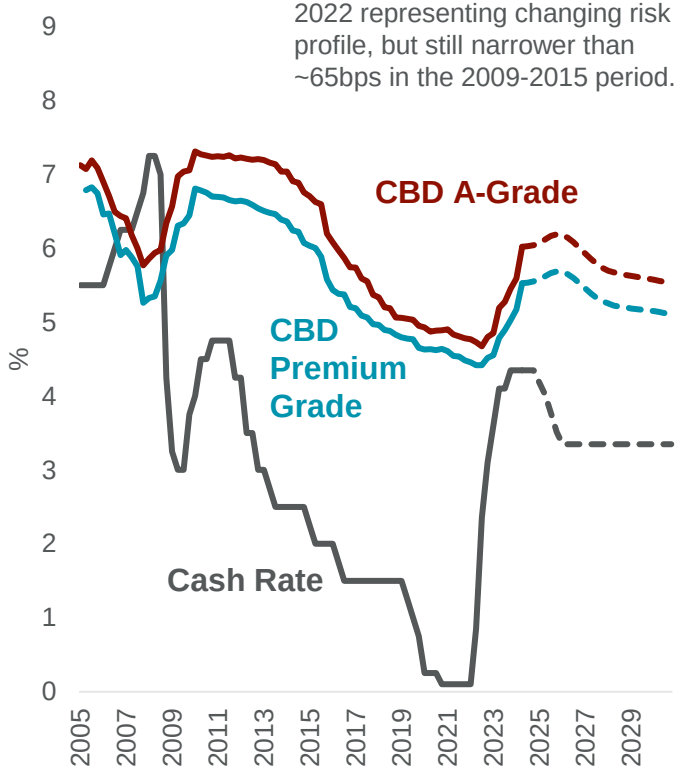


Source: MSCI, RBA, Cushman & Wakefield



Source: MSCI, RBA, Cushman & Wakefield

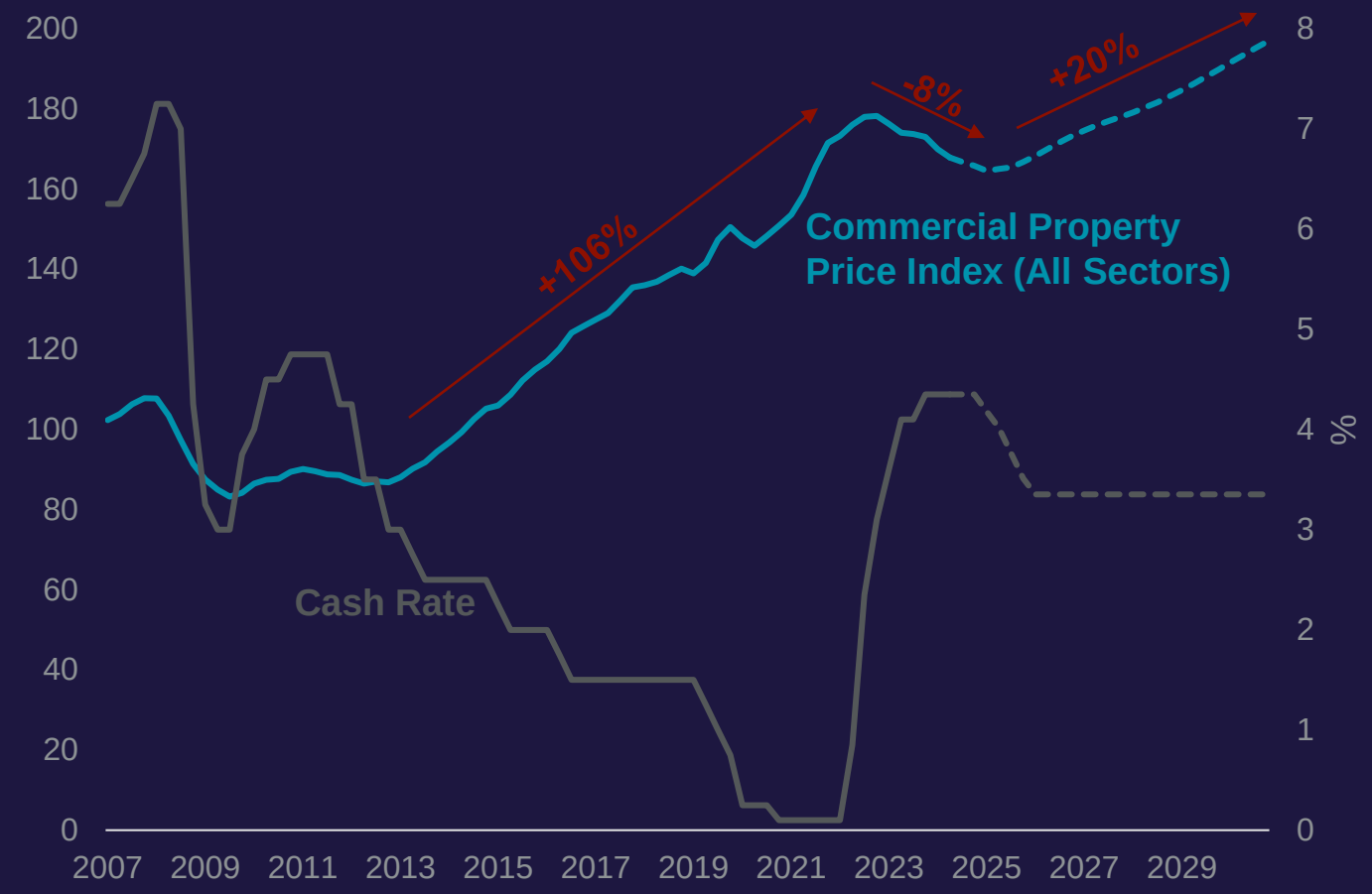
The spread between Premium and A-Grade assets to settle at ~45 bps vs ~25 bps between 2018-2022 representing changing risk profile, but still narrower than ~65bps in the 2009-2015 period.



Source: MSCI, RBA, Cushman & Wakefield

VALUES RECOVER

Commercial Property Price Index (LHS), Cash Rate (RHS)



Source: MSCI, RBA, Cushman & Wakefield

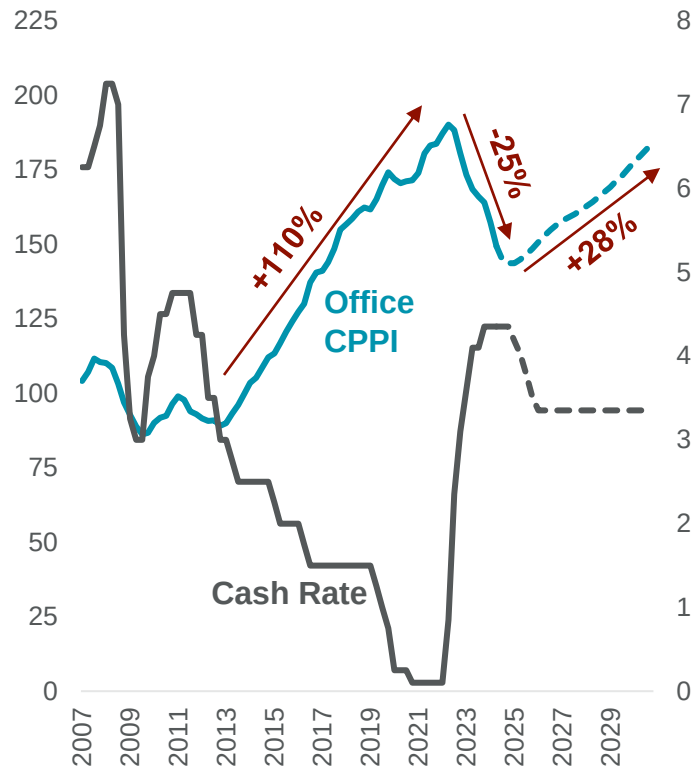
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- Aggregate values across all sectors appear to be nearing the bottom. Historically, values will begin to recover once the rate cut cycle begins, however this will vary by asset class.
- The adjustment in pricing has been uneven across sectors. Rising vacancy and negative effective rental growth has amplified the effect of cap rate expansion on office values. This looks to be at its nadir as vacancy stabilises and incentives begin to tighten.
- Cap rate expansion has had minimal impact on L&I assets as a result of strong rental growth and low vacancy. L&I values are expected to see strong growth through 2026 before stabilising at a more sustainable level.
- Much of the adjustment in retail valuations occurred pre-COVID, limiting the downside during the pandemic. Values appear to have stabilised and look poised to begin trending higher.

DIFFERENT SECTORS, DIFFERENT IMPACTS

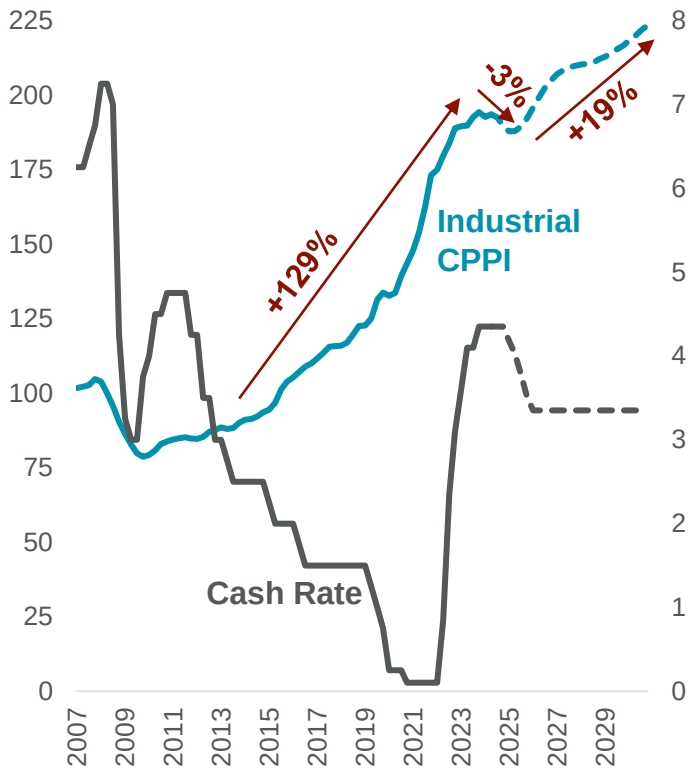
Offices have seen the largest repricing, but also likely to see the largest rebound; retail assets repriced prior to the most recent interest rate cycle

Office



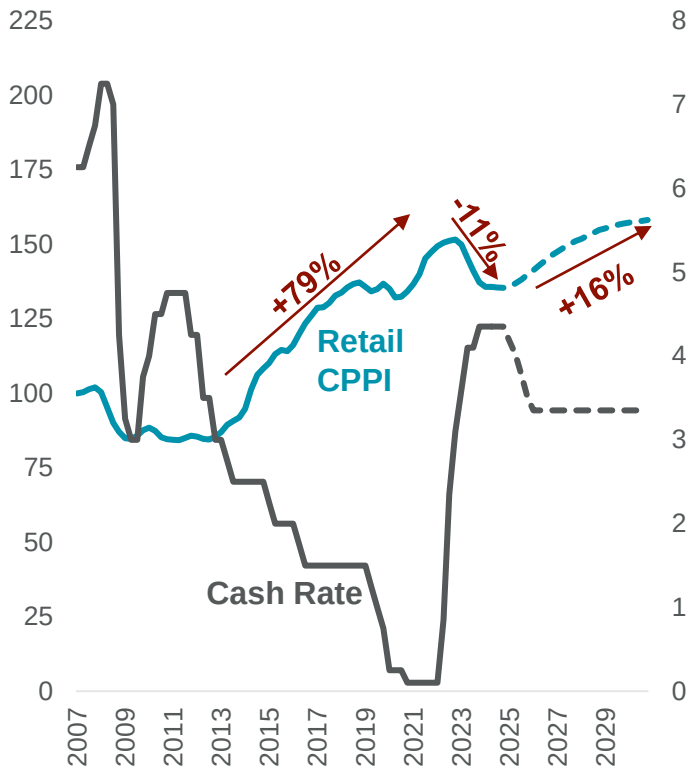
Source: MSCI, RBA, Cushman & Wakefield

Industrial



Source: MSCI, RBA, Cushman & Wakefield

Retail



Source: MSCI, RBA, Cushman & Wakefield

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CONTACTS



SEAN ELLISON
National Economics & Forecasting Manager
sean.ellison@cushwake.com



LIN LEE
Senior Strategic Research Analyst
lin.lee@cushwake.com



NICK RATHGEBER
International Director, Capital Markets
nick.rathgeber@cushwake.com



DR. DOMINIC BROWN
Head of International Research
dominic.brown@cushwake.com



JOSH CULLEN
International Director & Head of Capital Markets
josh.cullen@cushwake.com



LEIGH MELBOURNE
International Director, Capital Markets
leigh.melbourne@cushwake.com

About Cushman & Wakefield

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