Australian Commercial Real Estate Markets – Q4 2023

SPOTLIGHT

Savills Research

Spotlight on 2024

Where are we headed? • Capital market impacts • Trends to watch in 2024 • Top strategies

Where are we?

Shifting goal posts

Resilient global economy
Global economic growth has been stronger than expected in 2023, with economic activity surprisingly resilient to the sharp shift to higher interest rates.

However, there have been divergences across the major economies, with particularly large upside surprises to growth in the US and Japan, while forecasts for growth in the Euro area and China have been downgraded.

In Australia, a strong rebound in overseas migration and international tourism is supporting services sector activity despite a slowdown in consumer spending, leading the IMF to upgrade its 2023 GDP growth forecast for Australia to 1.8%.

Inflation moderating but at a slower pace in Australia
Recent inflation data point to consumer price pressures in the US and Europe moderating more quickly than expected.

However, inflation in Australia is moderating more slowly, reflecting various factors, including strong population growth, which is contributing to strong growth in housing rents and services price inflation, as well as tight labour market conditions, leading to upward pressure on wage growth.

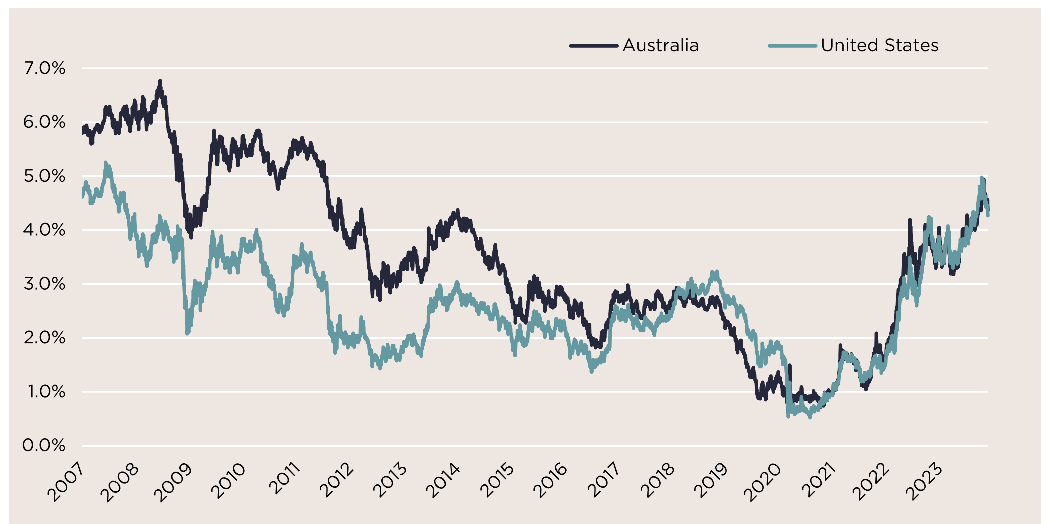
Volatility in bond markets points to uncertain outlook for interest rates ***but we're hedging our bets in the outlook on page 5!***
With major central banks at or very near the end of the tightening cycle, bond markets have become increasingly volatile as financial markets struggle to price the probability of interest cuts in 2024. For example, yields on 10-year Australian and US government bonds declined by around 50bps in November after having risen by nearly 100bps over the three months to October.

US and Australian 10-year yields are still up by around 50bps since mid-2023, suggesting that investors are still anticipating a higher growth and interest rate environment, with less scope to cut interest rates in 2024 than previously anticipated. However, the exceptional volatility in bond markets in recent weeks highlights the potential for rapid and abrupt changes to the outlook.

Rising geopolitical risks could complicate outlook
Geopolitical risks have escalated in recent weeks with the outbreak of the Israel-Hamas conflict. While the impact on the global economy should be limited, an escalation of the conflict could lead to higher oil prices. However, financial markets are yet to price in a high probability of this occurring at this stage, with oil prices having declined recently.

Any sustained rise in oil prices will increase inflation pressures in the near-term, but ultimately weigh on future economic activity, complicating the outlook for monetary policy.

Bond yields rise as financial markets adjust interest rate outlook
Daily rate of 10-year bond yields in Australia and the US, per cent



Source Savills Research / Macrobond (bond price as at 29 November 2023)

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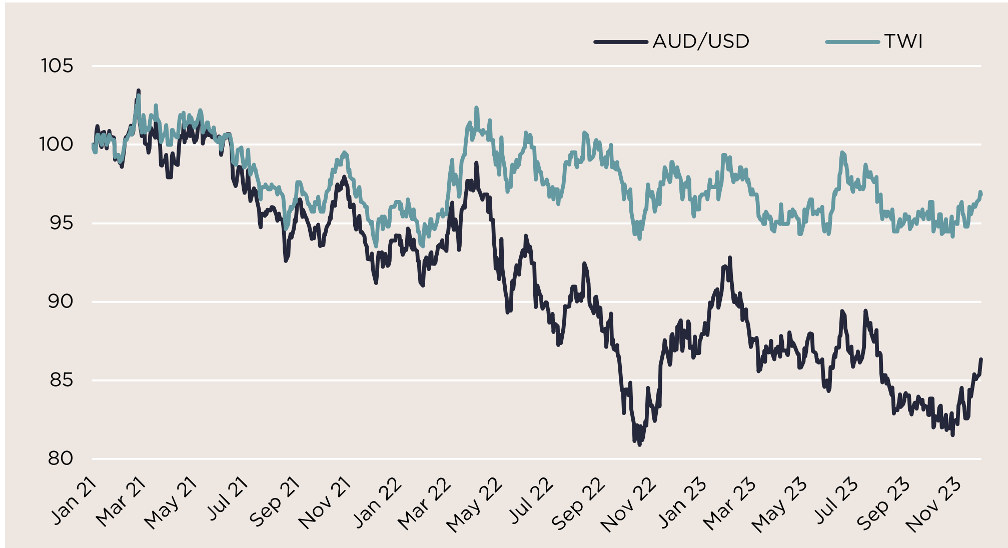
AUD/USD vs Trade Weighted Index (TWI*)

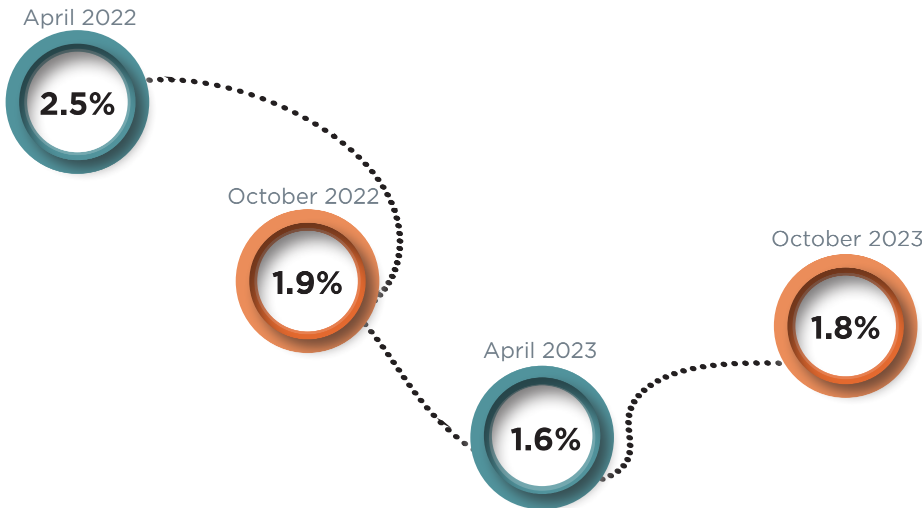
Index, January 2021 = 100



Source Savills Research / Macrobond (as at 29 November 2023)
*TWI is an index of the weighted average of the value of the AUD in a broader trading perspective (using a basket of Australia's major trading partners' currencies)

The evolution of the IMF 2023 GPD growth forecasts for Australia

Previous April 2022 forecast versus October 2022, April 2023 and October 2023



Source Savills Research using IMF World Economic Outlook

AUD vs The Greenback

The Australian dollar has depreciated significantly against the US dollar over the past few years, with the domestic currency falling around 14% against its US counterpart since the beginning of 2021. The strength of the US dollar in recent years reflects the Federal Reserve leading central banks in raising interest rates, and the greater magnitude of monetary policy tightening in the US.

Heightened geopolitical uncertainty could exacerbate the Australian dollar's depreciation against the US dollar in other safe haven currencies in a risk-off environment. A lower Australian dollar could boost exports, and further enhance Australia's appeal as an investment destination, but would also place pressure on the RBA through higher tradeable goods and services inflation.

On the other hand, the slower moderation in inflation in Australia and the possibility of further tightening in monetary policy from the RBA – coupled with expectations that the Federal Reserve is at the end of its tightening cycle – has the potential to drive the Australian dollar higher. The shifting outlook for inflation and interest rates has already led to a c.6% appreciation of the Australian dollar against the US dollar since the recent low in late October.

Last year we set about predicting trends to watch in 2023. We now find ourselves reflecting on those predictions and how closely this aligned with reality...

Markedly different macro environment now compared with late 2022 expectations

Growth and inflation have moderated but more slowly than anticipated, with major economies such as the US avoiding the recession that had been commonly predicted.

Like many others, we had anticipated the possibility of central banks pivoting and cutting interest rates in mid to late 2023, but resilient economic activity and persistent inflation have kept interest rates at more restrictive levels for longer, with central bank policy rates only now at or near their peaks, and expectations of cuts pushed out.

Similarly, our expectation that bond yields would fall in anticipation of interest rate cuts and reduce pressure on property yield expansion hasn't played out yet due to stronger than expected growth and inflation. In contrast to that expectation, bond yields have risen sharply as investors pushed back expectations of central bank cuts.

Going into 2023, we thought that investment activity would begin to pick-up in the second half of the year as greater clarity on the interest rate outlook emerged. That clarity, particularly around the timing of interest rate cuts, has not emerged in 2023. This continues to weigh on investor confidence and hamper investment activity.

But... many key property market trends we predicted have played out broadly as expected

Investment capital remains directed toward sectors benefiting from structural tailwinds, notably in industrial and logistics, hotels, multi-family, and student accommodation.

Those same sectors remain attractive to investors due to ongoing structural factors, including robust overseas migration, population growth, and a rebound in the tourism and international education sectors.

While overall investment activity has seen a decline this year, the industrial sector has exhibited smaller declines than the average.

Noteworthy deals have emerged in the hotel, multi-family, and student accommodation sectors.

For industrial, there has been a focus on unlocking the reversionary potential from shorter WALE assets.

Emphasis has been on rental growth and normalising supply chains, which reflect changing dynamics compared to the pandemic-led demand era.

The office sector has experienced a multi-speed leasing market with a flight to quality. However, on the investment side, there is no widespread shift towards core assets and away from non-core assets at present.

Retail, buoyed by demographic tailwinds, offers opportunity for shopping centres to regain market share, aligning with observed investment trends this year.

Hotels have benefited from a strong recovery in overseas migration and tourism, while student accommodation and Build-to-Rent (BTR) serve as counter-cyclical investments and potential hedges against inflation.

Where are we headed?

2024 & beyond

Slow growth in 2024
The global economy is losing momentum as the impact of higher interest rates begins to bite.

Factors that have supported growth this year are now losing potency. The savings buffer that households accumulated during the pandemic is diminishing, while the strong rebound in services consumption following the easing of Covid restrictions is waning.

But global recession is unlikely
Although slowing, the global economy is unlikely to enter recession, and a soft landing is the most likely scenario.

The IMF predicts that the global economy will grow by a below-average 2.9% in 2024, only marginally lower than the 3.0% estimated for this year, while advanced economy growth is expected to slow slightly from 1.5% in 2023 to 1.4% next year.

Australia to remain in expansion
The Australian economy is also set to remain in expansionary territory but grow at a below-average pace, with the consensus forecast from FocusEconomics projecting the economy will grow by 1.4% in 2024.

Population growth to boost consumer demand
The ongoing strength in the labour market makes a hard landing unlikely, with economists expecting the unemployment rate to rise only modestly to 4.4%.

Strong population growth will also continue to boost consumer demand and help to soften the impact of higher interest rates on household consumption.

Inflation moderating slowly amid elevated services price growth
The downside of the resilience in economic activity is that inflation will be slower to return to target.

In particular, population growth in Australia will continue to add to consumer demand and hamper the slowdown in services price inflation, as well as driving further strong growth in housing costs.

A softening but still relatively tight labour will see wage growth moderate but only slowly and still outpace productivity growth, potentially adding to inflationary pressure.

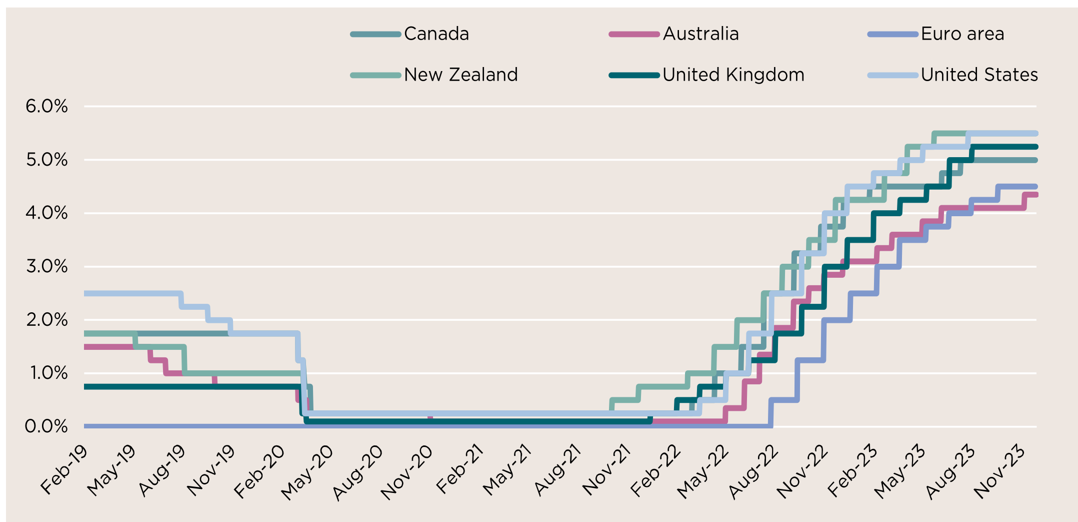
Central banks to remain on hold until at least mid-2024
Resilient economic activity and above-target inflation reduce the scope for central banks to cut interest rates in the near-term, with rates set to remain at relatively restrictive levels in H1 2024.

The US Federal Reserve will lead the easing cycle. FOMC members have scaled back their projections of interest rate cuts in 2024, with the median official anticipating the federal funds rate will fall from the current level of 5.25%-5.50% to 5.1% by end of 2024, up from the 4.6% projection in June 2023. Meanwhile, market pricing suggests the Federal Reserve will cut interest rates by 75bps in 2024, with the first cut occurring mid-year.

RBA to ease later
The RBA will ease later reflecting the typical lag between monetary policy changes in Australia compared to major overseas economies, persistent services inflation pressure domestically, and the RBA's lower policy rate compared to many of its peers.

Pivot to cuts late 2024
Economists generally expect several cuts towards the end of next year, with a median expectation that the cash rate will be 3.85% by the end of 2024. However, market pricing suggests the cash rate will remain on hold throughout next year.

Central bank policy rates
Major economies central bank policy rates 2019-2023, per cent

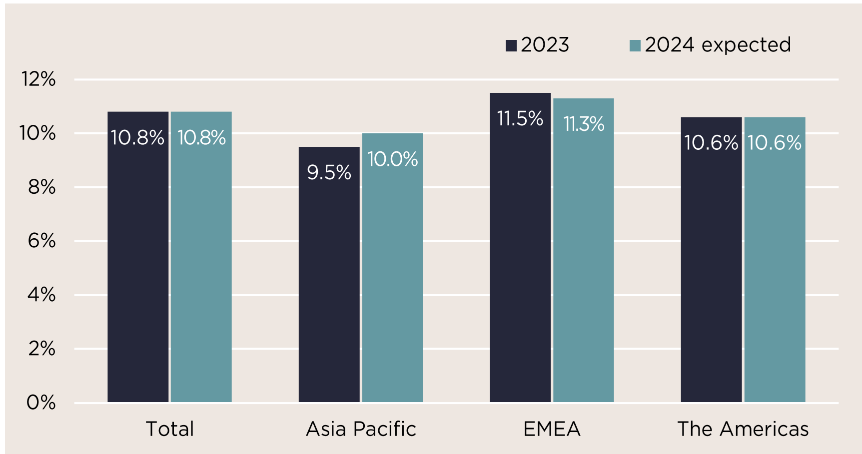


Source Savills Research / Macrobond (as at 29 November 2023)

Capital markets impacts

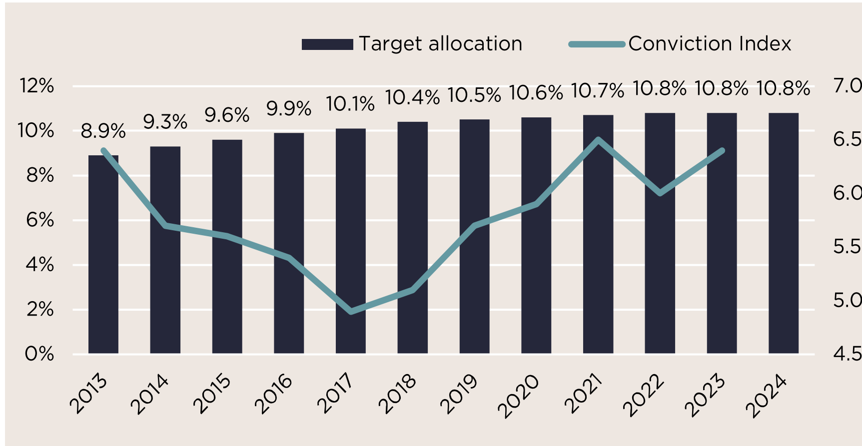
Survive until 2025

Weighted average target allocation
By location of institution, per cent



Source Savills Research using Cornell University's Baker Program in Real Estate and Hodes Weill & Associates 2023 Institutional Real Estate Allocations Monitor

Weighted average target allocation and Conviction Index*
All institutions, per cent (LHS), index (RHS)



Source Savills Research using Cornell University's Baker Program in Real Estate and Hodes Weill & Associates 2023 Institutional Real Estate Allocations Monitor

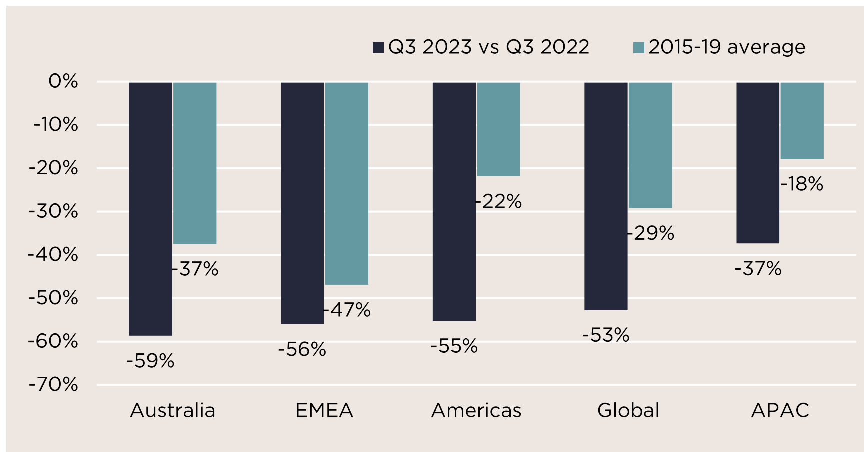
Real estate allocations to remain stable in 2024
According to the 2023 Institutional Real Estate Allocations Monitor*, institutional investors expect to hold target allocations to real estate steady in 2024 at 10.8% globally. Asia Pacific-based investors, who have the lowest allocation to real estate among the major regions, expect to increase their target allocation by 50bps to 10.0% in 2024, while EMEA-based investors (who have the highest allocation) anticipate a 20-basis-point reduction to 11.3%.

Investors beginning to see improving risk-return prospects
While investor target allocations to property are expected to be stable in 2024, investor perceptions of real estate investment opportunities are improving. The "Conviction Index", which measures institutions' view of real estate as an investment opportunity from a risk-return perspective, increased from 6.0 to 6.4 (on a scale of 1 to 10), the second highest level since the index inception in 2013. Improving sentiment reflects increasing optimism that buying opportunities will emerge as valuations continue to adjust to higher interest rates.

Asset recycling to add to capital market liquidity
Major property investors will continue to look for opportunities to dispose of lower quality assets in less desirable locations to redeploy capital to opportunities with stronger risk-return prospects. Some of the largest transactions in 2023 have involved large institutional investors selling out of relatively low-quality assets exposed to significant leasing risk to fund future development pipelines. Liquidity will be boosted by more motivated sellers, including open-ended funds under pressure from cash redemptions and capital recycling for redeployment opportunities. We expect this trend to gain further momentum in 2024 as investors look to rebalance their portfolios, adding to investment market liquidity.

*The Institutional Real Estate Allocations Monitor covers 175 institutional investors from 25 countries with over US$10.2 trillion in total assets and real estate assets of approximately US$1.1 trillion.

Investment volume by region
Per cent change y/y and 2015-19 average



Source Savills Research / MSCI Real Capital Analytics

All sector capital growth by city
Per cent change y/y to Q2 2023

Source Savills Research / MSCI Real Capital Analytics

Slow pricing adjustment to higher interest rates hinders investment activity

Commercial property investment activity remains subdued globally, with investment volumes down by over 50% over the year to Q3 2023 and around 30% below the 2015-19 average. Australia has recorded a larger decline in activity year-on-year compared to the global average, reflecting the slower adjustment of capital values to higher interest rates, which has led to an ongoing gap between buyer and seller expectations, hindering investment activity.

Investment market recovery but not until late 2024

Interest rate stability and further pricing adjustment will reduce the gap between buyer and seller expectations and help fuel a recovery in investment market activity. We expect investment activity is likely to gain momentum only slowly in 2024, with ongoing subdued activity in the first half of the year and the recovery gaining more traction later in the year and into 2025.

Limited fundraising but ample dry powder

Underscoring the likely continuation of the lull in capital market activity in the near future, fundraising activity has fallen sharply this year and points to ongoing subdued activity in capital markets in the near term. According to RealfinX, around US$120 billion of capital has been raised so far this year by closed-ended real estate funds, down nearly 50% on 2022 levels. While fundraising has been weak, dry powder remains ample. According to RealfinX, around US$850 billion in unallocated capital is sitting in global closed-ended funds targeting real estate, highlighting the vast amount of capital ready to deploy. Most of this capital is sitting in value-add and opportunistic funds, ready to capitalise when the market moves. Sources of capital include Sovereign Wealth Funds and Pension Funds.

Sector trends to watch in 2024

Investment capital will chase assets with the strongest underlying demand fundamentals to take advantage of favourable tailwinds.

- **Continued focus on industrial, data centres and cold storage.** Population growth and ongoing expansion of e-commerce (and technology) will sustain the demand for industrial floor space.
- **A reweighting to alternatives, amongst others**. A reweighting towards industrial (and data centres), residential, and social infrastructure (childcare and healthcare).
- **Childcare and Healthcare investments.** Demographic trends and a growing focus on health and well-being will attract more investors to childcare and healthcare assets.
- **Selective hotel investment.** Migration boost will contribute to underlying domestic demand for tourism and hotel performance. This will drive investment demand for hotels, but buyers will be more selective as occupancy rates normalise.
- **Student Accommodation performance remains strong.** Strong investor interest in student accommodation, driven by the bounce back in international students, occupancy, and outperformance in rental growth.
- **Low vacancy of housing stock will drive rental growth.** Affordability will remain a challenge. Capital will chase scale in residential (multi-family, BTR, branded residence) and alternatives.
- **The economic outlook will reinforce the flight to quality in offices.** Prime offices will be resilient as a multi-speed leasing market continues to emerge, with secondary offices being more exposed to negative rental growth and leasing risk.
- **Office space evolution.** Hybrid office working will increase the appeal of core locations and may see the rationalisation of larger mandates, particularly outside of CBDs.
- **Capital values will adjust, but there is sector resilience.** Expect further contraction in capital values, but this will vary by sector, with greater resilience in beds (accommodation) and sheds (industrial).
- **Liquidity opportunities.** Motivated sellers and capital recycling could contribute to increased liquidity, presenting opportunities for redeployment.

Top investment picks

We expect a gradual resurgence of investment activity in 2024. Competition for assets will shift and fundamentals will start to normalise as capital markets begin to price in future growth.

Core/core plus
Emphasis on income

- Premium office – all CBDs: resilient demand in the face of structural headwinds; opportunity to deploy capital at scale
- Prime industrial – specifically markets with low vacancy (demand and tight supply), structural tailwinds, infill locations
- Hotels – CBD and gateway locations: recovery in tourism ongoing
- Residential (multi-family), student accommodation – near top-tier universities, gateway markets with appreciating home values, low vacancy
- Luxury retail, high-occupancy shopping centres

Value add
Emphasis on repositioning

- Secondary and/or short WALE industrial for reversionary upside potential
- Prime/secondary office in core locations subject to further pricing adjustment
- Data centres – land banking infill areas, increased target allocations
- Secondary residential in markets with low vacancy rates, low supply, reversionary upside
- Neighbourhood centre retail, low-occupancy shopping centres

Opportunistic
Emphasis on value creation

- Secondary and/or short WALE industrial for reversionary upside potential
- Secondary office for conversion to hotel or residential
- Residential – branded residences in gateway cities
- Student accommodation – near top-tier universities

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