AMP CAPITAL

MARKET WATCH

AUSTRALIAN HOUSING: VULNERABLE BUT NOT CRASHING

DR SHANE OLIVER
Head of Investment Strategy and Economics and Chief Economist, AMP Capital

The big picture view on Australian residential property is well known: Australian housing is expensive by global standards and the surge in home prices has gone hand-in-hand with a surge in household debt.

Key points

- Expensive housing and high household debt leave Australian housing vulnerable; but without a recession or much higher interest rates a property crash is unlikely.
- The surging supply of apartments and the continuing strength of the Sydney and Melbourne property markets pose an increasing risk. Average dwelling prices in these cities are likely to see another cyclical 5-10% price downswing around 2018, with unit prices in oversupplied areas likely to decline 15-20%.
- The combination of high house prices, huge gains in Sydney and Melbourne, low rental yields and a coming surge in the supply of apartments mean property investors need to be careful. It is best to focus on undersupplied, less-loved parts of the property market.

Crash remains unlikely

Nationwide price falls are unlikely until the Reserve Bank of Australia starts to raise interest rates again and this is unlikely before 2018 at which point we are likely to see a 5% or so pullback in property prices as was seen in the 2009 and 2011 down cycles. Anything worse would likely require much higher interest rates or recession both of which are unlikely.

However, the risks on the supply front are clearly rising in relation to apartments where approvals to build more apartments are running at more than double normal levels. Apartments in parts of Sydney and Melbourne are probably least attractive but for those who want to look around there are pockets of value.

The surging supply of apartments and the continuing strength of the Sydney and Melbourne property markets pose an increasing risk.

What does this mean for investors?

Over the very long term residential property adjusted for costs has provided a similar return to Australian shares. Its low correlation with shares, lower volatility but lower liquidity makes it a good portfolio diversifier with shares. So there is clearly a role for property in investors' portfolios.

Final thoughts

There remains a case to be cautious regarding housing as an investment destination for now. It is expensive on all metrics and offers very low income (rental) yields compared to other growth assets. This means a housing investor is more dependent on capital growth.

TOURIST ATTRACTION: INVESTING IN AUSTRALIA'S SURGING VISITOR NUMBERS

MAURIZIO VIANI
Portfolio Manager, AMP Capital

Record numbers of visitors pouring into Australia suggest flights full of free-spending tourists landing at crowded airports around the country, cramming through immigration to dash to the nearest shopping centre and lift the nation's retail sales figures as quickly as possible.

How busy are we?

A record 7.8 million short-term visitors arrived in Australia over the year to June 2016, up 44% from June 2006. New Zealand remained the top contributor to our short-term visitor numbers, with 1.3 million people arriving from across the Tasman, up 23% from 1 million a decade ago.

However, the number of visitors from China was a close second at 1.15 million, nearly quadruple the 294,000 visitors just 10 years ago.

Given the robust visitor data, investing in airline shares such as Qantas Airways (QAN) and Virgin Australia Holdings (VAH) might seem a no-brainer. However, airlines in general have a long track record of delivering poor returns through the business cycle, mainly because its two largest costs – oil and labour – are difficult to control.

Capturing the investment theme of visitor spending

Nonetheless, inbound travellers from China are the key target market for Australia's tourism sector due to their sheer numbers and track record for growth so it would be beneficial to pinpoint a way to invest in this trend.

Chinese tourists make a large contribution to Australia's economy, spending on average five times as much as tourists from other countries. And while most tourists from China are destined for our major cities, there is growing evidence that Chinese tourists are regionalising their visits. For example, Gold Coast Airport expects growth of 7-8% a year from China over the next five years and is opening a new international terminal in 2018 to accommodate them.

Final thoughts

Australia's record visitor numbers may point to airlines as a way of gaining investment exposure to the nation's influx of arrivals but AMP Capital prefers non-airline beneficiaries of tourism. We prefer travel agents, as well as certain food and health brands embraced by visitors from China, transported back home and promoted by word of mouth.

Enthusiastic Chinese visitors seeking out Australia's reputation for safety and quality have turned their personal consumption into unprecedented demand for certain Australian brands of baby formula, vitamins and skincare. This demand, in addition to ongoing Australian consumption and exports elsewhere in the world, make these companies a less risky play on Australia's tourism theme than airlines, in our view.

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ONE WAY TO ASSESS POLICY OPTIONS AND LIMITS

ILAN DEKELL
Head of Macro

ANDREW SCOTT
Senior Portfolio Manager, Macro

Faced with the difficulty of what to do when cash rates reach the lower bound of zero, central bankers have responded with attempts to twist the yield curve; purchases of government bonds, corporate bonds and equities; direct loans into the banking system; and most recently, negative interest rates. In some countries, these moves have been accompanied by explicit requests from the central bank that governments become more active in fiscal policy.

These non-traditional policy tools reflect a degree of desperation, as the traditional tool of monetary policy - cash rates - have reached their effective limits. When a central bank reduces interest rates, it limits its ability to provide further stimulus going forward.

The policy inflexibility index

At AMP Capital, our belief is that a rigorous and robust investment process is the key to delivering great investor outcomes. We have developed a method of analysing economies and markets using quantitative analysis as the foundation. We are continuing that tradition by introducing our Policy Inflexibility Index, which we have developed and calculated across a range of countries. Through this

Index we seek to model the degree of policy choices, available to any given country, that support growth and inflation expectations in a systematic way. The index is based on the following inputs:

> Does the (relevant) central bank still have room to cut, or has a lower bound been reached?

> Are long term yields relatively high compared to the cash rate?

> Is the currency expensive versus fair value?

> Has the government been running surpluses, or only small deficits?

> What is the overall debt level of the government?

Australia, with the highest cash rate, has not had to engage in any unconventional monetary policy and has the most favourable starting point from a fiscal point of view.

The US has significantly more policy flexibility than either Europe or Japan.

Consequently, Australia has considerably more policy flexibility than the other countries.

The US has significantly more policy flexibility than either Europe or Japan. This is partly due to having commenced a hiking cycle. What has been more impactful in terms of future flexibility has been the substantial rise in the value of the USD; while this has a tightening impact on policy now, the rally provides scope for a more substantial decline should growth expectations falter.

Both Europe and Japan have low cash rates and relatively flat yield curves owing to extensive asset purchase programs. However, the Yen remains more expensive against valuation models, allowing greater potential for future weakness. For Europe, the overall fiscal position of the Eurozone is somewhat more positive, allowing for further stimulus from government spending.

4 REASONS WHY LISTED REAL ESTATE IS NOW SAFER IF A DOWNTURN HITS

JAMIE O'DONNELL
Portfolio Manager / Analyst, Global Listed Real Estate

Advisers who moved their clients into listed real estate after the GFC made a brave call, given that investors in the sector suffered terribly during the economic turmoil.

However we believe that the global listed real estate sector is much better prepared and has heeded the bitter lessons learnt during the last global economic slowdown.

There are four key factors that support the notion that global listed real estate offers resilience.

1. Financial leverage is much more disciplined

Leverage was clearly a significant factor in the relative underperformance of listed real estate during the GFC. In many cases, real estate companies were over-levered and exposed to an economic downturn.

In contrast, the average leverage ratio of US REITs today is around 30 per cent – roughly half what it was at the peak of the GFC.

Four key factors that support the notion that global listed real estate offers resilience

2. Reduction in development risk

The magnitude of development exposure (or risk) on the balance sheets of listed real estate companies is also lower today than prior to the GFC. In addition, the nature of this exposure has changed with a reduction in the higher risk, so-called "speculative" development component of the overall development book.

Since the depths of the GFC, banks have been less willing to lend for development, particularly speculative development. That has had the effect of holding the supply of global real estate in check. Whilst supply is expected to pick up over the medium term, it is from a relatively low base and considerably below the long-term average.

3. Payout ratio headroom

The third factor underscoring the defensive positioning of global listed real estate today is that of payout ratios. Prior to the GFC, payout ratios in the US were around 85 per cent. In contrast, the present payout ratios in the US are at near historic lows of around 72 per cent.

4. A new pillar of demand with the emergence of sovereign wealth funds

The representation of sovereign wealth funds in global commercial real estate transactions has grown from less than 1 per cent in 2011 to 6 per cent in 2015. The proportion of the funds investing in the asset class has increased by almost 10 per cent in the past two years alone, a trend likely to continue given that on average, these funds remain underinvested relative to strategic targets.