TierONE Capital

AUSTRALIAN PROPERTY MARKET VIEW

MAY 2020

EXECUTIVE SUMMARY

In reviewing the potential impact on values in the Australian residential property market, we have examined the following:

- Household income and balance sheets coming into the COVID-19 crisis and what a prolonged shutdown could mean to those household balance sheets.
- The effect of rising unemployment on that income, with a focus on the sectors most affected.
- The unprecedented fall in migration numbers.
- A historical perspective – the key to growth in a post COVID-19 world.
- An explanation on the reason house prices continued to grow through to April 2020.

These factors are assessed in close consideration by examining well documented releases of Government treasury and IMF statistics, namely:

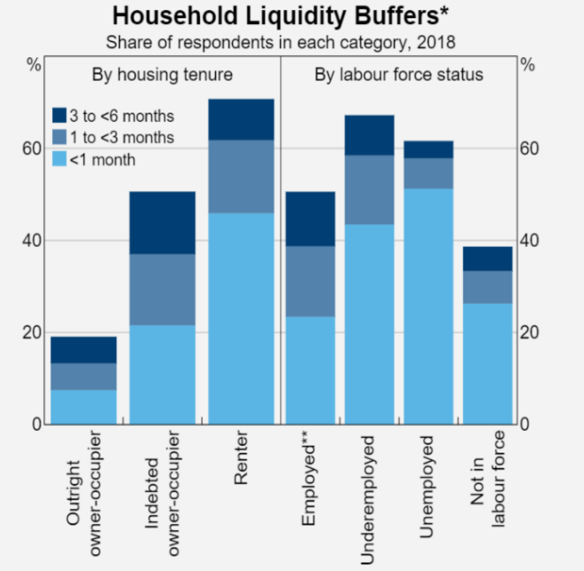
- The Australian economy is anticipated to shrink by as much as 6.7% in 2020.
- Modelling suggests that the unemployment rate will jump from 5.1% to 10% in the next 3 months.
- These predicted numbers do not consider the level of underemployment (adults that were working less than 35 hours a week but wanted to work more). The level of underemployment is expected to rise from 8.1% to 15%.
- These numbers mean a 1/4 of the workforce – or roughly 3.4 million Australians – would either be jobless or in need of more work.
- So far in excess of 1 million businesses have registered for the governments Job Keeper program.

HOUSEHOLD FINANCES

Australian households were mostly well placed coming into the large contraction in economic activity. The extent of shutdowns will however test the financial resistance of these households.

The survey results by the RBA examined the ratio of liquid assets to cover basic living expenses and current obligations such as mortgage and rent repayments over a 3 month period:

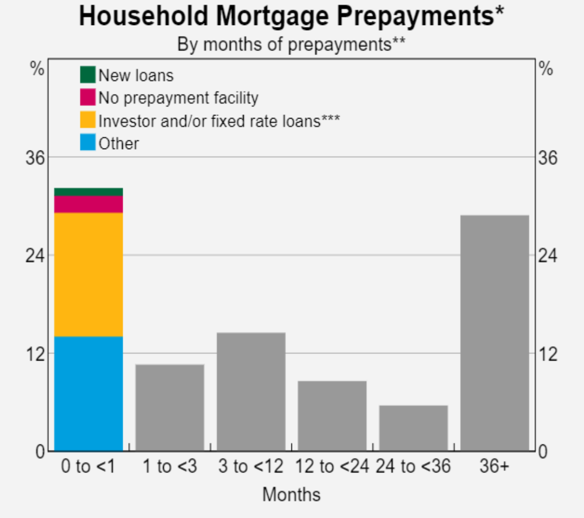
- Households with mortgage debt typically have sizeable liquidity/equity buffers. Among these borrowers over $^{1}/_{2}$ of these loans have enough prepayments to service their loan repayments for at least 3-months.
- 1 in 5 households only have enough liquid assets to get from one salary payment to the next.
- Just under $^{1}/_{3}$ of households with mortgages have less than 1-month of prepayments and about $^{1}/_{2}$ of these appear vulnerable to a sharp decline in income.
- Households with small liquidity buffers are much more likely to report being in financial stress. More than $^{1}/_{3}$ of renting households report that they have experienced financial stress in the last year.
- The most likely damage to property values will essentially end up coming from those with mortgage debt losing their jobs or having salaries reduced. This will lead to financial stress where an insufficient buffer exists with the worst affected states being VIC and NSW.



* Buffers measured as a ratio of liquid assets to monthly living expenses. Liquid assets include bank accounts, cash investments, equity investments, and housing loan prepayments; monthly expenses include minimum repayments on owner-occupier debt, rental payments, and living expenses

** Does not include underemployed

Sources: HILDA Release 18.0; RBA

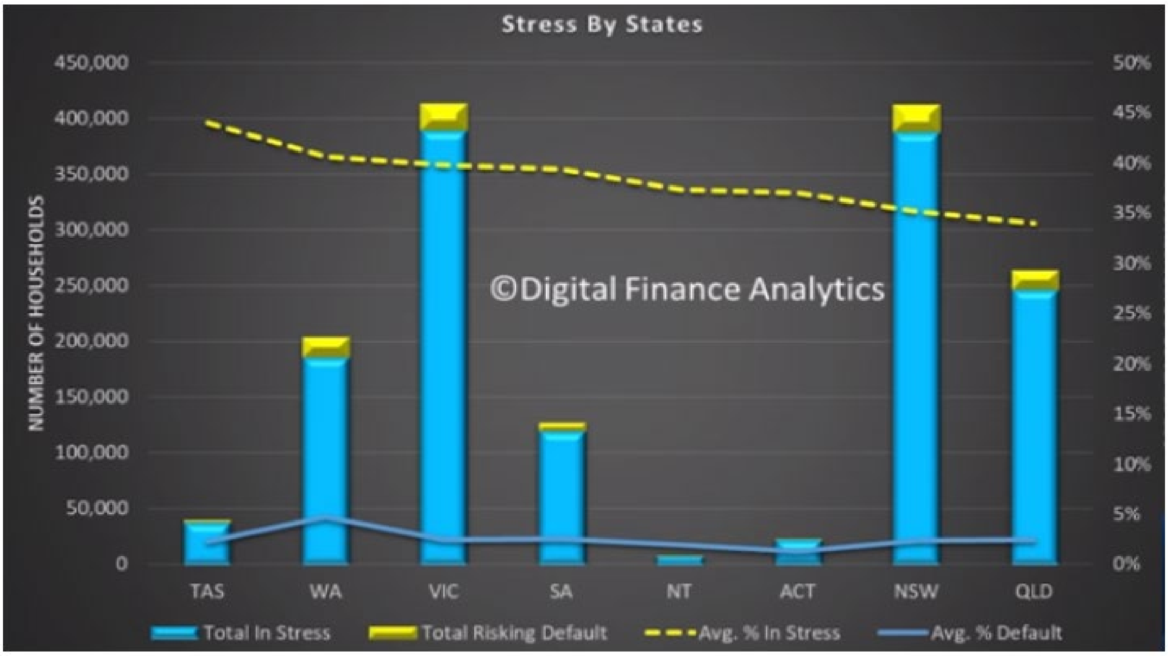


* Available redraw plus offset account balances

** Share of loan groups as at February 2020; calculated with principal and interest repayments

*** These loans have features which discourage prepayments

Sources: RBA; Securitisation System



The housing picture is getting more precarious by the day the longer the coronavirus shutdown drags on.

- Historical analysis suggests that for every 1% increase in the unemployment rate, mortgage arrears increase by 0.8%.
- Over 700,000 Australians have registered with the ATO to withdraw $20,000 from their superannuation fund.

Our conclusion from the above chart would suggest that a 3-month shutdown would severely impact household balance sheets and quickly eat into any liquidity buffers. The most likely damage to property values will result from those with mortgage debt losing their jobs or salaries reduced which will lead to financial stress where an insufficient buffer exists. This may likely lead to an increase in forced sales activity over the next 3 – 6 months.

UNEMPLOYMENT

The latest research released by Roy Morgan regarding the impact of the COVID-19 Crisis on Australia's employment market shows over $^{2}/_{3}$ of working Australians (68%) have had 'a change to their employment due to the pandemic' according to interviews with 1,444 Australians aged 14+ conducted over the last week.

The impacts on workers include:	ALL employment changes mentioned*	MOST SERIOUS employment change mentioned
Having work hours reduced	3.8m (25%)	1.9m (12%)
Stood down for a period of time	2.7m (18%)	2.4m (15%)
Had an increase in their work hours	2.5m (16%)	1.5m (10%)
Not had any work offered	2.4m (16%)	1.2m (8%)
Working from home**	1.6m (10%)	1.4m (9%)
Had their pay reduced for same number of work hours	1.4m (9%)	320,000 (2%)
Been made redundant	670,000 (4%)	670,000 (4%)
Some other change to employment	1.8m (11%)	1.3m (8%)
TOTAL Had a change to employment	10.5m (68%)	10.5m (68%)

Source: Roy Morgan

- This table suggests an estimated 10.5 million Australian workers have had their employment situation changed by the impact of the COVID-19 crisis including:
    - 3.8 million with work hours reduced.
    - 2.7 million stood down of which 2.4 million have not had any work offered.
    - 1.4 million have had their salaries reduced for the same number of work hours and 670,000 have been made redundant.
- A large amount of this unemployment was in safe service sectors like real estate, tourism, airlines/airports, hospitality etc.
- Morgan has discovered that if you work in a large organisation you have a better chance of retaining your job and becoming part of the income elite.
- In organisations employing more than 1,000 employees, 46% have not had their employment impacted in some way by the crisis.
- By contrast $^{3}/_{4}$ of sole traders have been impacted as have many smaller enterprises.
- Industries which have felt the least impact from the COVID-19 crisis include agriculture, wholesale trade, transport/storage, construction, electricity and gas followed by public servant-dominated sectors like water, public administration and defence.
- Few primary and secondary school teachers have been stood down but the sharply reducing numbers of foreign students is causing a predicament in universities. Most of those stood down have been casuals and lesser paid staff. By 2021 the full extent of the COVID-19 crisis will be fully apparent, and we can assume many universities will not be able to maintain their current staff levels.

- The lower number of overseas students will have a significant impact on the demand for the small student apartments that dominate Sydney and Melbourne. The added risk of outspoken criticism of China by Australian Government politicians could mean China may curb the number of students coming here.
- Given that the hospitality industry employs about 8% of the workforce (or 1.2 million people) it is not hard to see where the focus of the Job Keeper payments will reside. It is important to highlight that 11.7% of people that work in hospitality reside in Sydney's Inner West with 35% of those being renters. This shows that property values will be impacted in areas traditionally thought of as 'safe havens' given that rental reductions and mortgage deferrals will be applied in those areas.
- Retail is the other obvious sector which has been hit hard, employing approximately 9.7% of the workforce. The below table highlights the percentage of the workforce employed across sectors.
- Even healthcare and social assistance sectors have seen a significant reduction in working hours including dentists (closed except for emergencies), podiatrists (closed), occupational therapists (closed), psychologists (closed to routine consults, GP's (fewer routine consults) and anaesthetists (elective surgeries cancelled).

Industry	% of Total Employment
Health Care & Social Assistance	13.8%
Retail Trade	9.7%
Construction	9.1%
Professional, Scientific & Technical	8.9%
Education	8.6%
Accomodation & Food Services	7.2%
Manufacturing	7.1%
Public Admin & Safety	6.4%
Transport, Postal & Warehousing	5.0%
Other	3.8%
Finance	3.6%
Administration	3.4%
Wholesale Trade	3.0%
Agriculture	2.5%
Arts & Recreation	1.9%
Mining	1.9%
Rental Hiring & Real Estate	1.7%
Information & Telecommunications	1.6%
Utilities	1.1%

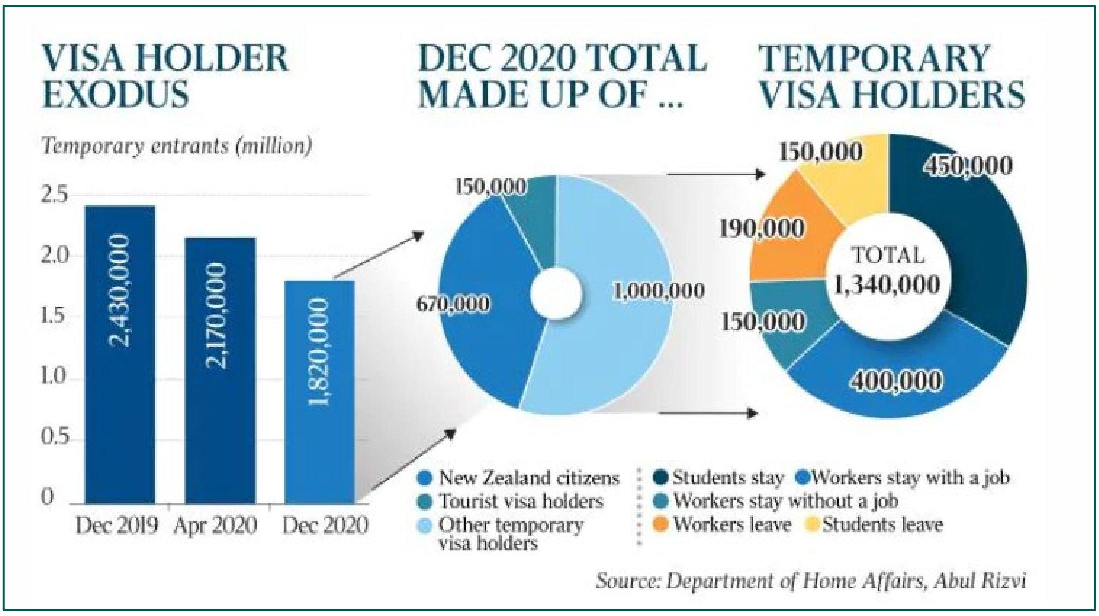
Source: ABS Quarterly Employment Survey, August 2019

In trying to gauge the potential impact on falls in property values we note the worst performing property market in Australia since 2015 has been WA. The unemployment rate in WA has increased by over 2% to 2.5%, since peak full employment below 4% in 2014, to consistently above 6% unemployment since. This was coupled with a decrease in migration of the same period resulting in an oversupply of housing stock. As a result, housing prices in WA fell by 20% since their peak in 2014.

POPULATION

The number of temporary visa holders in Australia dropped by 260,000 in the first 3 months of this year with a further 50,000 departing in the first 2 weeks of April, as advised by the Immigration Minister.

- Research by the Immigration Department predicts a further 300,000 people could leave Australia by the end of the year.
- That would mean the total number of temporary visa holders could drop to 1.82 million from more than 2.4 million at the start of 2020.
- The most recent budget had pencilled in net migration of 271,000 this year and a net 800,000 new immigrants were forecast over the next 3 years.
- A similar trend was observed during the 90's and 80's recession when net migration fell sharply further impacting the economic recovery.



UBS analysis pinpoints a sometimes-overlooked element of the Australian property story: the role played by migrants in driving demand.

- Much of the demand from foreigners went into buying high-rise apartments, a major feature of the previous boom. UBS expects much of the coming correction to be felt as result in the apartment market.
- UBS expects house prices to decline at least 10% in the coming year in line with their 'full pandemic scenario'. UBS writes, “Indeed, without an easing of mobility restrictions, and/or more direct policy support, the price falls will likely be larger."

LIFE POST COVID-19

SPANISH FLU AND THE PROPERTY MARKET

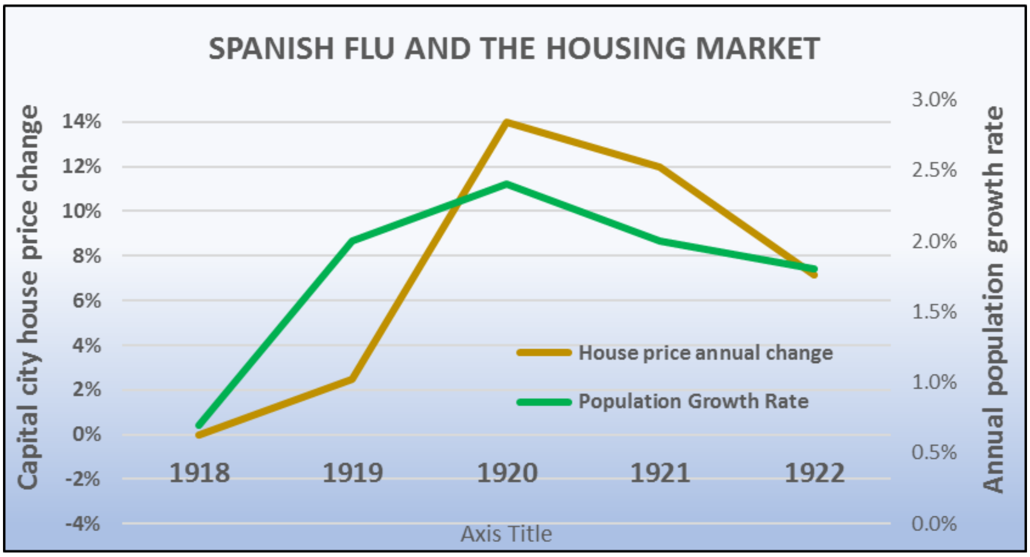
The Spanish flu pandemic of 1919 has some striking similarities to the current pandemic.

Having first spread through Europe in 1918, the pandemic was brought to Australia by soldiers returning home at the end of WW1, rapidly spreading through all our major capital cities.

- The death toll overseas was extremely high; estimated to be over 50 million and the local media raised fear with extremely alarming headlines. There was a run on food and essentials like what occurred at the onset of COVID-19.
- The Australian Government acted quickly by quarantining overseas arrivals, including all returning soldiers and nurses. They closed the schools, churches, theatres, restaurants and hotels and cancelled sporting events. People wore facemasks and those infected were isolated and hospitalised.
- By the end of 1919, the number of Australians that had died from the Spanish flu reached 15,000, even though 40% of the Australian population had caught the virus.
- Our extremely low mortality rate at the time was applauded as it was so low compared to the rest of the world. The Government had acted quickly, limiting the movement of people. This in turn delayed the spread of the virus and enabled those who needed intensive hospital care to receive it. The Australian response to the Spanish flu outbreak has since become an internationally accepted model for containing, limiting and ultimately eradicating such pandemics.

The effect on the property market during that pandemic was as follows:

- Capital city housing prices rose post the pandemic as the graph shows. They boomed in 1919 and then continued to rise by more than 10% each year until 1921.



- The growth in housing demand was clearly driven by a huge increase in population over this period. This coincided with low interest rates, money leaving the stock market and a flight to bricks and mortar, not dissimilar to what we are currently experiencing in Australia.
- During 1919 the population grew by over 100,000 people and the population continued to grow at this pace for 2 years. The key to curbing any downfall in property prices during and post COVID-19 will clearly be driven by how quickly we re-open international borders and allow population growth to resume. This clearly becomes a highly sensitive and political issue in an environment with such high unemployment with the likely prevailing argument being 'keep jobs for Australians'.

HOW DID PROPERTY PRICES STILL RISE IN MARCH AND APRIL 2020?

Monetary policy easing since June 2019 has seen fixed and variable interest rates fall between 75 to 150 basis points. In the RBA's modelling pre COVID-19 that would have seen house price growth of 20%-30%. As it stands, house prices nationally have risen 11% since July 2019.

- According to CoreLogic, Sydney house prices rose in March and April, whilst prices in Melbourne have remained flat since mid-March.
- Whilst auction clearance rates have fallen significantly because of the lockdown, stress thus far has been avoided as vendors have taken their houses off the market and are happy to hold on to them at this stage.
- Minimising the lockdown to another 4 weeks would be followed by workers keen to get back to work and reduce further arrears/mortgage deferrals.

In conclusion, Australia's likely scenario on property prices (assuming no significant re-occurrence of the virus and a gradual re-opening from June 2020) is the following;

- The Australian residential property market is highly interest rate-elastic.
- The Australian economy will be the likely beneficiary of any significant China stimulus packages aimed at boosting infrastructure
- Based on evidence discussed above, with respect to some likely forced selling coupled with spikes in unemployment, the residential market will likely give back most of the 11% gains (essentially, gains since July 2019) over the next 6 months.
- The key to limiting property price falls beyond this will be the resumption of population growth via the re-opening of our international borders. Extending border closures to the end of the year could potentially extend falls by a further 5%.
- The stock markets are currently stating that enough monetary and fiscal stimulus has been provided to fill significant shortfalls in GDP numbers in the coming 6 months.
- The property market is currently asserting a similar sentiment, although it is clearly too early in the downward cycle to draw likely conclusions with any high level of confidence.