

PROPERTY MARKET UPDATE

THE AUSTRALIAN PROPERTY SECTOR - HOW WILL IT HOLD UP TO THE GLOBAL CREDIT CRUNCH?

March 2008

The New Year has carried over several woes of 2007. That is, the US sub-prime crisis that hit markets last August continues to play out, with weaker investor sentiment driving domestic equities lower, while credit markets have remained tight. These events bear implications for the property sector as they affect incomes and interest rates. Adding further upward pressure to the latter is the RBA's firm tightening bias, with further increases in the Official Cash Rate possible. So a key question this year is, to what extent will these events affect Australia's property market?

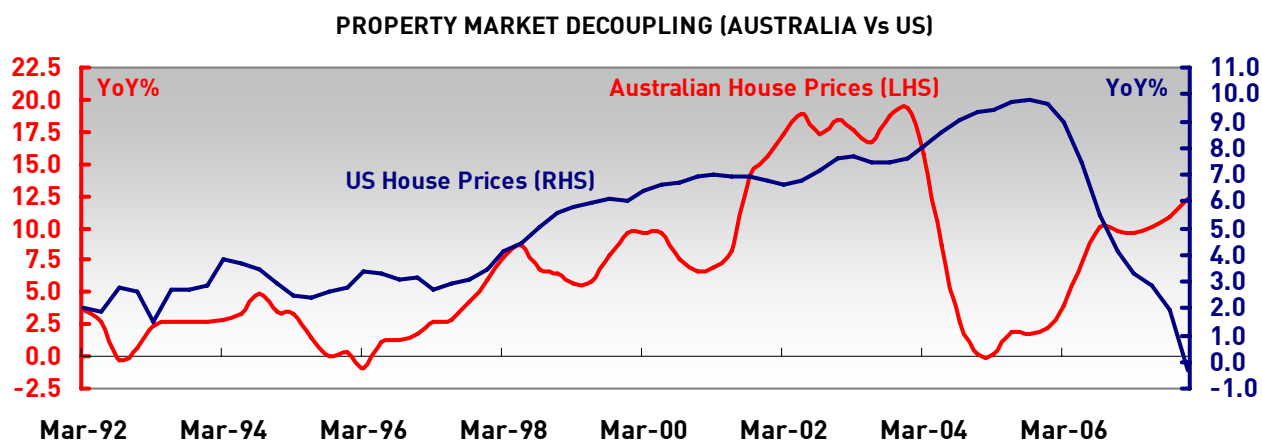
Key Points:

Domestic economic and market conditions: As we commence 2008, the overall economy remains in a healthy state. Helping to boost incomes and spending are our elevated terms of trade (i.e. price of exports over the price of imports) with additional gains expected this year. Jobs growth has been very strong, with solid increases in average earnings. Looking forward, such trends are expected to continue given substantial increases in job vacancies. So, robust household 'spending power' should be a major benefactor in the property growth equation. But, as mentioned earlier, there are uncertainties denting the landscape such as share market losses, ongoing credit market tightness and the possibility of further monetary policy tightening.

The outlook for interest rates: It is no surprise that the RBA remains firmly in tightening mode given the robust state of the domestic economy. In the RBA's latest forecasts, annual inflation was projected to remain above the central bank's 2-3% target band for the next 2 years. Accordingly, there is a chance that the RBA could lift rates even further in May. Moreover, ongoing credit market tightness raises the risk of higher lending rates, independent of any RBA action.

Residential property sector: It is unlikely that the housing market will remain unscathed. For this reason, despite fundamentals such as lower vacancy rates and higher population growth rates, we have downgraded our forecasts for average house prices. We now expect house price growth of 5-10% in most markets over the year ahead, with the possible exception of Perth, which may be below the 5% mark. In trying to forecast the likely timing of the next housing peak, the past 5 housing cycles show an average duration of 5 years from trough to peak. The trough of the current cycle was end-2004 so the possible timing of the next peak is end-2009.

Non-residential property sector: Looking briefly at the non-residential property markets, aspects such as strong employment growth, rising imports, healthy consumer spending and buoyant tourism have lifted the demand for space in the various non-residential market sectors. In most cases, however, supply continues to fall short of demand. Accordingly, further rent/revenue increases can be expected and should translate to capital growth, even in the absence of further yield compression. Yields may indeed back a little as a result of greater risk aversion.



Data Source: ABS, EcoWin, OFHEO

RESIDENTIAL PROPERTY OUTLOOK

Crosscurrents are currently at work for the property market...

The official interest rate is now higher. The RBA's most recent tightening phase began in May 2002, with rates now having been taken up 12 times to a near 12-year high of 7.25%. This includes this month's and February's move as well as the two OCR increases last year in August and November. As the first chart on the right shows, the recent round of tightening appears to have already stifled the demand for housing finance.

Interest rates could potentially move even higher from now, with and/or without RBA action. In raising rates this year, amid the international volatility, the RBA illustrated the importance it attaches to curbing domestic inflation (which is well above their 3% ceiling). Moreover, in the RBA's latest forecasts, they project annual inflation to remain above their 2-3% target band for the next two years. Accordingly, the Reserve Bank could continue tightening until a slowdown in inflation or growth occurs. Financial markets are pricing in around a 20% chance of another 25bp interest rate hike to 7.50%, post the Q1 inflation data on the 23rd of April.

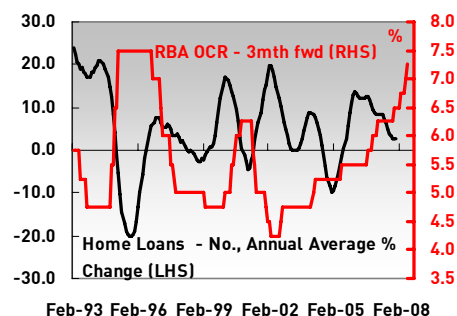
Even if the RBA does not make a move, ongoing credit market tightness is feeding through to higher lending rates, independent of central bank action. As the second chart shows, since the sub-prime crisis hit markets mid 2007, the gap between the 3mth bank bill rate and the RBA OCR has increased significantly. This spread impacts funding costs and has blown out amid expectations for RBA rate hikes, increased funding requirements and risk aversion. Currently, the spread is hovering around near long-term highs of more than 80bp above the OCR. So there remains the risk that interest rates could move higher even if the RBA decides to hold its fire on the monetary policy front. This has the potential to affect all property markets.

The sub-prime crisis could have quite a significant impact on buyer sentiment. The third chart shows the VIX Volatility Index, a measure of US share market volatility. A higher index level indicates greater risk in financial markets or increased uncertainty about what will happen next. Although the index applies to the US share market, it could equally apply to the local stock market given the strong influence Wall Street has on a day-to-day basis. Basically, what this chart shows is that the unusually low volatility in markets throughout most of 2004 - 2006 came to an end mid last year, when heightened sub-prime concerns first surfaced. As volatility levels increased, equities declined (see last chart) with the ASX200 now down 23% from the peak reached last November. Rising risk aversion suggests that people may be less willing and able to bid vigorously at auctions. It also indicates that property yields could back up a little and hamper capital growth.

Higher interest rates could constrain dwelling construction further. It appears that the recent interest rate hikes have also impacted the construction of dwellings, with building approvals data and AiG's Performance of Construction Index both falling in recent months. That is, despite rising house prices and rents (as an indicator of demand) supply has lagged far behind with BIS Shrapnel estimating the nationwide shortage of dwellings to be around 60k homes. Further interest rate increases will add to the high level of construction costs and thus, could stifle dwelling construction further.

Higher interest rates and the sub-prime related factors are negatives for domestic growth. In the words of an International Monetary Fund official, "no country will entirely escape the fallout" from the sub-prime crisis. Accordingly, most market forecasters as well as the RBA are expecting domestic growth to ease moving forward.

RBA OFFICIAL CASH RATE Vs HOUSING FINANCE



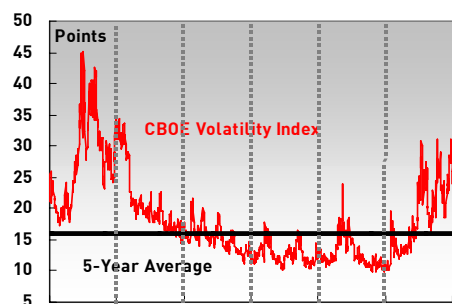
Data Source: EcoWin

90 DAY BANK BILL RATE - RBA OCR SPREAD



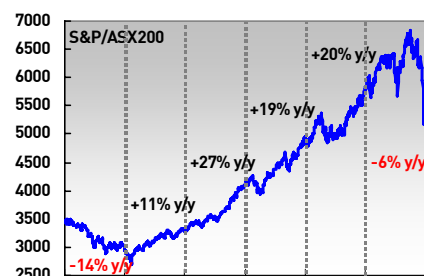
Data Source: EcoWin

VIX - CBOE VOLATILITY INDEX



Data Source: EcoWin

S&P/ASX200



Data Source: EcoWin

...but the demand-supply fundamentals are supportive

The property fundamentals remain favourable. Strong underlying demand (based primarily on demographic factors, including the current high rate of overseas immigration), combined with a low level of building (as a result of land constraints and high development costs) has resulted in a nationwide shortage of dwellings. BIS Shrapnel estimates this deficiency to be around 60k homes. Accordingly, rental vacancy rates across most states have dropped to long-term lows, with the latest REIA data (for Q3 '07) revealing a national vacancy rate of 1.7%. This has pushed rents higher with that for 3-bedroom houses up an average 12.6% in the year to September, while rents for 2-bedroom other dwellings rose 17.7%. Meanwhile, house price data from various sources have accelerated across most capital cities.

There is little chance that we will soon experience a US-type housing bust.

The RBA's current tightening cycle, which has gone on for 6 years may appear to be considerably drawn out. But the Reserve Bank has been much less aggressive when compared to the US Fed. While the prior has lifted rates by a cumulative 300bp in its current cycle, the Fed, in its most recent mid-04 to mid-06 tightening cycle, took interest rates up by a much larger 425bp within the space of just 2 years. Moreover, the US had the added impact of their homegrown sub-prime mortgage crisis (which evolved from poor lending standards). Domestically, our 'closest' equivalent of sub-prime (i.e. non-conforming loans) of around 1% of all outstanding housing loans is well below that of the US (of 15%). Note that we refer to non-conforming loans as the 'closest' equivalent because even this is considered not as risky as US sub-prime, i.e. they usually do not include features such as low introductory interest rate periods. Our housing market has also already been through its cyclical downturn and is now in the midst of solid recovery.

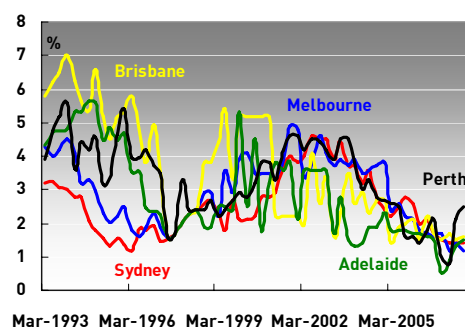
The housing market retains a degree of momentum. After the downturn of 2003-2005, sentiment has since improved with the median house price up by 3.2% in Q4 '07 and in year-on-year terms (+12.3%) now growing at its fastest annual pace since Q1 '04.

The economy looks well placed to absorb the sub-prime crisis. While higher interest rates and the sub-prime crisis are likely to have a dampening influence on domestic growth, we are not forecasting a major slowdown. Rather, we project this to be more a soft landing from strong growth (greater than 4% on a GDP basis) to a little below trend (around 3% or a touch lower).

There is a low correlation between share and house prices. At first blush, the financial volatility may be negative for the housing sector. Statistically, however (as the last chart on the right shows), there is a low correlation (in fact a negative correlation) between share and house prices; that is, the data suggest that these markets are not necessarily linked. In fact, a contrary argument is that share corrections lead to a flight to safety, with 'bricks and mortar' actually a beneficiary.

Overall, forecasts tempered but still positive. On balance, it is unlikely that the housing market will emerge unscathed. For this reason, we have lowered our forecasts for house price growth to 5-10% in most markets over the year ahead, with the possible exception of Perth, which may be below the 5% mark. It should be noted, however, that a cooling in Melbourne, Brisbane and Adelaide (where prices increased by a minimum of 18% over the past 12 months) might actually assist in avoiding a boom-bust cycle. In trying to forecast the likely timing of the next housing peak, the past 5 housing cycles show an average duration of 5 years from trough to peak. The trough of the current cycle was end-2004 so the possible timing of the next peak is end-2009.

RENTAL VACANCY RATES



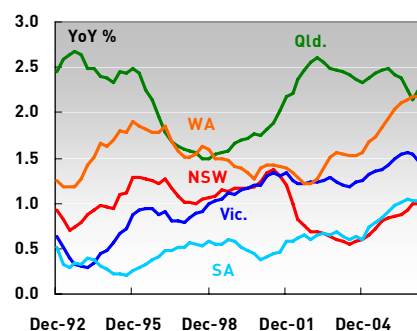
Data Source: REIA

DWELLING DEMAND & SUPPLY

	Underlying Demand	Building Activity	Pent Up Demand
	Forecast Avg (to June 2012)	Annual Dwelling Commencements (June 2007)	Stock Deficiency (June 2007 est.)
NSW	49,200	29,300	22,200
VIC	46,300	38,500	13,200
QLD	44,900	40,800	20,500
SA	11,100	11,100	600
WA	23,800	24,600	1,200
TAS	2,400	2,900	-700
NT	1,900	1,400	250
ACT	2,800	1,300	800
Aust.	182,400	149,900	58,050

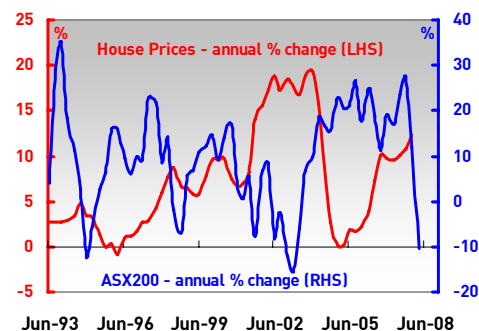
Source: BIS Shrapnel Residential Property Prospects 2007

POPULATION GROWTH RATES



Data Source: ABS

HOUSING VS SHARE MARKET CYCLES

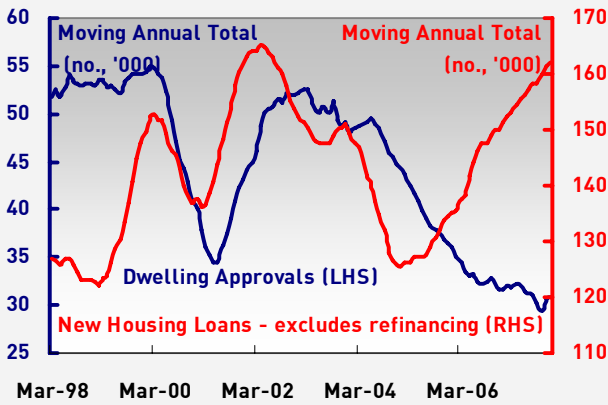


Data Source: EcoWin, ABS

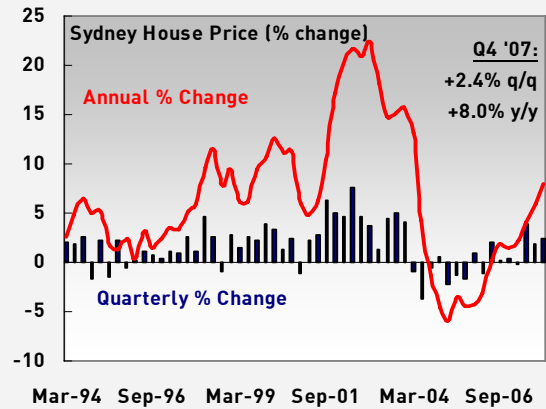
RESIDENTIAL PROPERTY – STATE TRENDS

The following state charts and commentary highlight the different performances between the major states at present. Please note that house prices refer to the capital city.

New South Wales

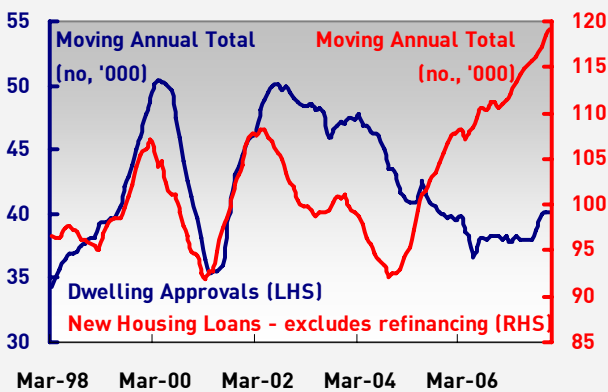


Data Source: ABS

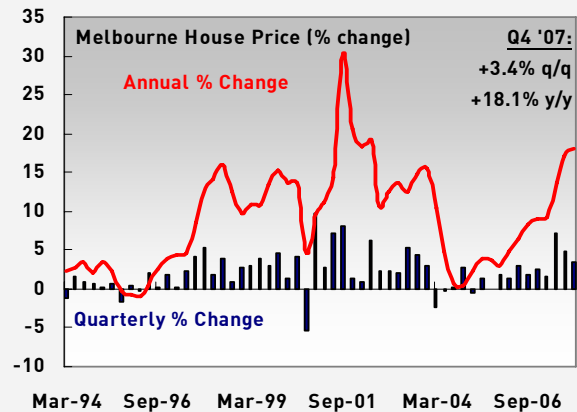


Data Source: EcoWin, ABS

Victoria

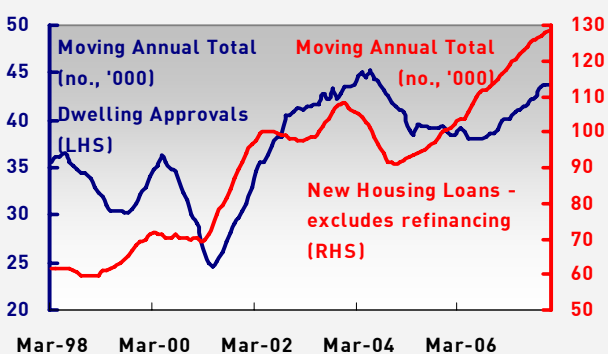


Data Source: ABS

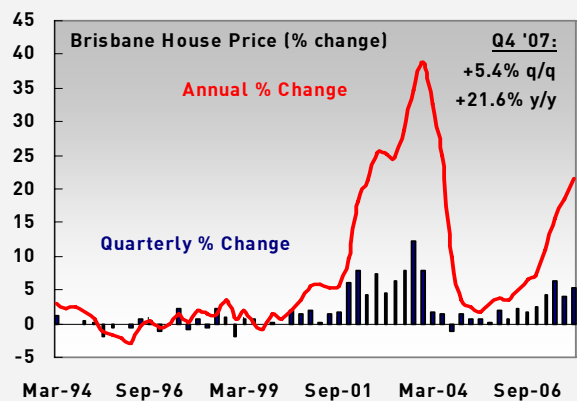


Data Source: EcoWin, ABS

Queensland



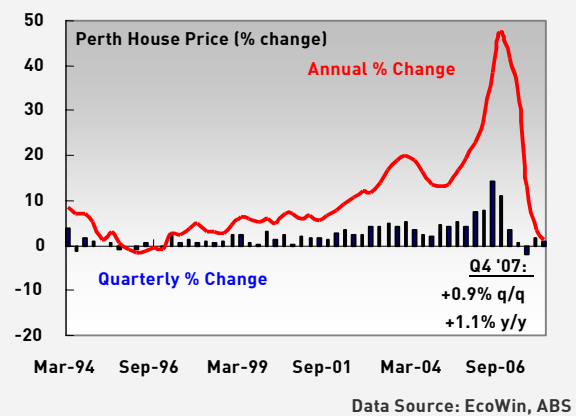
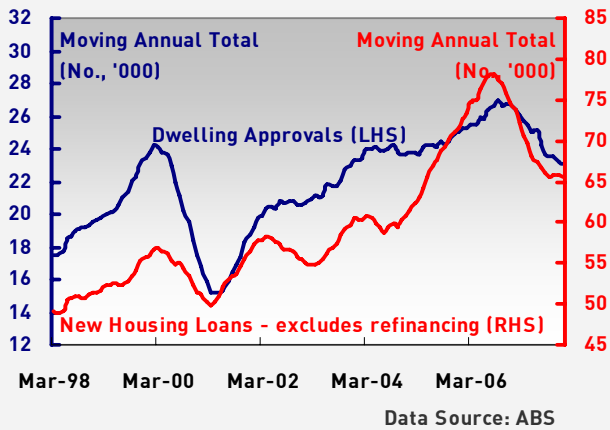
Data Source: ABS



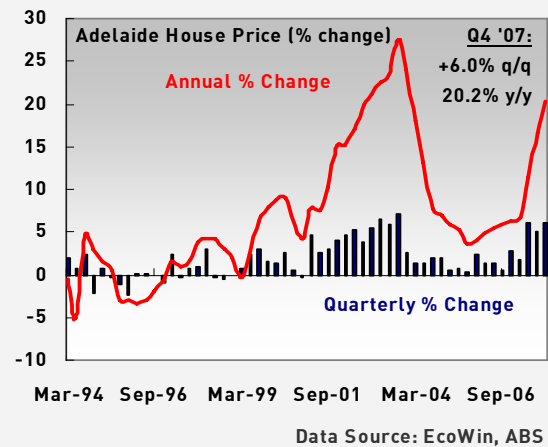
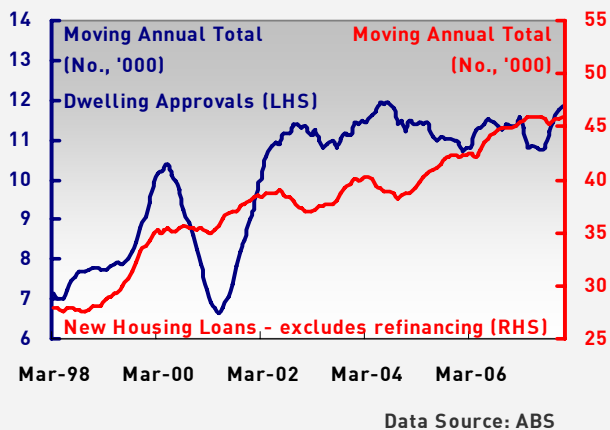
Data Source: EcoWin, ABS

RESIDENTIAL PROPERTY – STATE TRENDS (contd.)

Western Australia



South Australia



State Summary

After spending almost 2 years in negative territory, mid '06 saw **Sydney** house prices move into positive territory with further strengthening having since occurred. The construction side of the equation, however, continues to lag significantly behind, with BIS Shrapnel data revealing a backlog of dwellings equivalent to 5-6 months of demand in NSW. Looking forward, higher interest rates and the sub-prime related effects (e.g. share market losses etc.) will be a negative for Sydney as it has the lowest affordability levels of all the major cities. But offsetting this will be the improving NSW economy, and the fact that more investors could be encouraged into the market given very low vacancy rates and strong population growth rates. Meanwhile, although builders' sentiment could be hampered further by higher interest rates, the NSW government's Oct '07 30-40% cut in infrastructure charges (which provides a saving of at least \$25k per lot in the Western Sydney Growth Centres) could offset this.

The **Melbourne, Brisbane** and **Adelaide** housing cycles have been very similar. That is, their housing downturns occurred during similar periods and after that of Sydney's. Comparatively lower house prices, and hence, higher affordability levels had provided a cushion for the easing in prices, with house price growth avoiding negative territory. Now, these factors (along with low vacancy rates and higher population growth rates) are providing the impetus for the current upturn, with house price gains far exceeding that of Sydney. On the construction side, QLD has the highest backlog of dwellings (equivalent to Sydney's). VIC is behind, in terms of backlog, but still stands at 3-4 months of demand, helped by high levels of overseas immigration (currently around 50k per year). SA has the lowest backlog of dwellings, of around 1-2 months of demand.

The resource-intensive city of **Perth** has been quite unlike the aforementioned cities. That is, while Sydney, Melbourne, Brisbane and Adelaide are in the midst of an upturn, Perth is in the middle of a slowdown, this having begun towards the end of '06. So the impact of the resource boom and its affect on sentiment has peaked. The supply of dwellings in WA appears to be on par with the demand for dwellings. So, while vacancy rates had initially declined, they began turning up again in early '07, to now be at 2.5%, which is where they were in mid-2005. Looking ahead, the main uncertainty looks to be the extent of the pullback, particularly since state final demand in WA has also slowed over the latest 3 quarters (based on trend data).

NON-RESIDENTIAL PROPERTY

Returns for non-residential property have accelerated in recent years.

The major drivers have been growth in rents (reflecting tight market fundamentals and solid economic growth) as well as falling yields. In the year to September 2007, total returns were strongest for the office sector (at 20.0%), followed by the retail (15.5%) and industrial market (13.0%).

Strong investor demand has pushed CBD commercial property yields lower.

The compression of yields also reflects prior declines in the real 'risk-free' rate. However, rising interest rates and the decline in risk appetites post the sub-prime crisis suggests that a further reduction in yields on direct property is unlikely. We have of course, already seen a re-rating of the LPT sector as part of the global equity sell-off and issues related to individual over-gearred entities. Nonetheless, this should not significantly constrain rents and capital values given strong fundamentals.

CBD office markets have remained in a tightening phase.

Strong demand (as the strong labour market boosted white collar employment) combined with inadequate supply has seen office vacancy rates across most CBDs remain on a broad downtrend. Declines have been most pronounced in Brisbane and Perth, with their respective regions benefiting from the commodity boom. The vacancy rates for these cities are now down to record lows of 1.2% and 0.7% respectively. Meanwhile, Sydney (4.4%) and Melbourne (5.8%) are in the middle of the spectrum. Adelaide's vacancy rate is at the higher end, at 7.5% given the underperformance of SA's economic and population growth rates.

Expected further jobs growth suggests continued healthy absorption of CBD office space in the medium term.

The jobs market in WA has performed strongly in recent months while that for NSW and VIC have improved. Jobs vacancies figures as well as continued growth in these states suggest that these trends should remain in place, which means continued healthy absorption of CBD office space. In QLD, slower job vacancies may see some slowing in demand ahead for Brisbane office space although the very low vacancy rate remains supportive and suggests that additional supply will be absorbed. But demand in Adelaide looks set to be the laggard of all the cities given the combined effect of underperforming SA economic, population and employment growth rates as well as slowing job vacancies.

Tighter CBD office market conditions have pushed office values and rents higher, while ongoing tightness should add to this.

Adelaide, not surprisingly, has underperformed the other cities in terms of capital value growth and vacancy rates and may continue to do so. Elsewhere, while capital growth is still anticipated in Melbourne, it appears to be the market most susceptible to increased supply given the recent lift in commencements. Accordingly, the market can be considered more risky than Sydney, Brisbane and Perth.

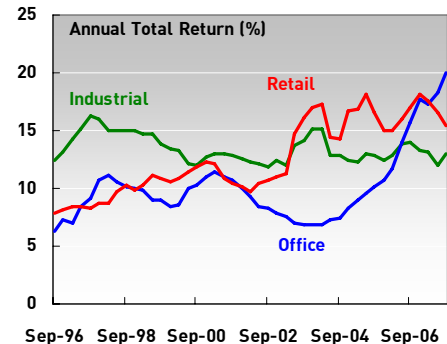
Nationwide, the construction of offices has gained momentum since 2006, while office approvals suggest still robust construction

(see first two charts on the following page). Builders have responded to rising office market returns, with the value of offices constructed up 34.9% in the year to September 2007. Meanwhile, approvals data indicate continued supply growth in the pipeline, with office approvals up 33.9% in the 12mths to Q3 '07 from the 12mths to Q3 '06. Given their low vacancy rates, Perth, Brisbane and Sydney look best able to absorb prospective new supply. Meanwhile, in Melbourne and Adelaide, the added supply could hamper capital growth.

The extent and duration of the commodity boom represents a particular risk for the Perth CBD office market.

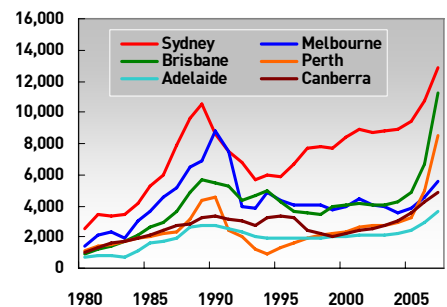
There are for instance, signs that the Perth residential market has peaked. However, continued commodity price gains are supportive of business conditions and the state economy.

COMMERCIAL PROPERTY TOTAL RETURNS



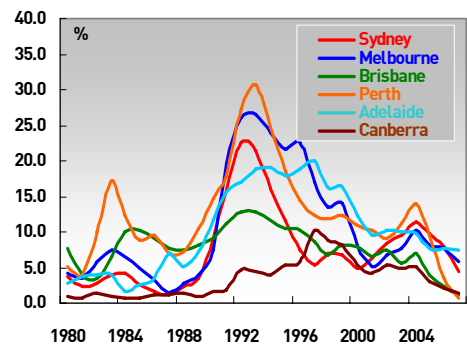
Data Source: IPD/PCA (Mar-07), EcoWin

CBD COMMERCIAL CAPITAL VALUES



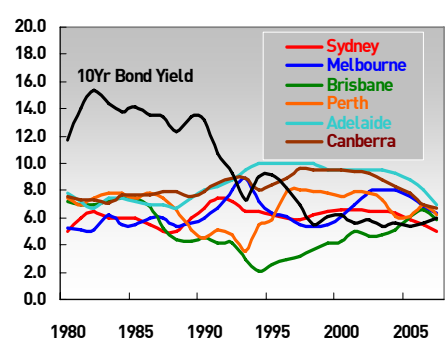
Data Source: BIS Shrapnel

CBD OFFICE VACANCY RATES



Data Source: BIS Shrapnel

CBD COMMERCIAL PROPERTY YIELDS



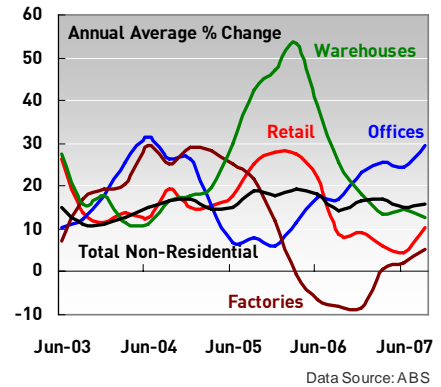
Data Source: BIS Shrapnel

NON-RESIDENTIAL PROPERTY (contd.)

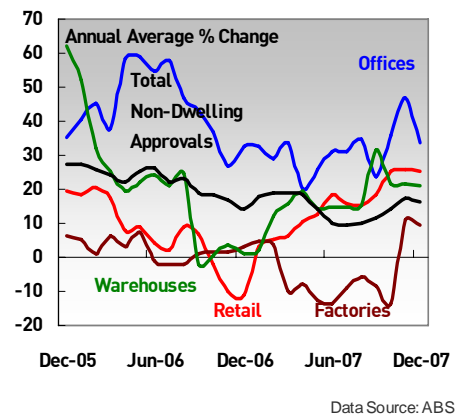
Firmer yields have seen strong returns in retail property and a pick up in construction activity (with approvals data suggesting more work in the pipeline). Although equity market losses, elevated petrol prices, higher interest rates and the potential for more interest rate increases present potential negatives for retailing, overall, the outlook still looks rosy. This is because, offsetting such negatives are expected continued strong jobs increases, steady wages growth, higher house prices and the announced tax cuts over coming years. Meanwhile, yields are still seen being maintained around current levels. Accordingly, these factors should sustain capital growth. Returns, however, are unlikely to be as strong as the last 5 years, due to the ongoing expansion of the retail property stock. BIS Shrapnel expects capital values to grow around 5% per annum. Meanwhile, retail construction activity has been picking up since around mid '07 with the value of construction work done for retail and wholesale trade buildings up +17.0% y/y in Q3 from +1.9% y/y in Q2. At the same time, approvals data reflect increasing impetus with the trend in retail/wholesale building approvals having increased since 2007 to +25.4% in the 12 months to December 2007 from December 2006.

Returns in the industrial property sector have lagged behind given the relatively soft performance of manufacturing activity in recent years. Of the two largest industrial property sub-sectors, factories have been the weakest market given the shift away to low cost manufactured imports in Asia and the elevated AUD. Accordingly, the lack of demand has seen factory approvals hover in negative territory for most of last year. But while demand in the factory sub-sector has been weak, that for warehouse and distribution space has been strong with the well performing domestic economy and high AUD boosting demand for imports. Listed property trusts (LPTs) are also dominating the large end of the market. Accordingly, a compression of yields has been observed in this sub-sector, while capital values have increased. Looking at construction, approvals data suggest continued solid growth in warehouse construction. Returns in this sector, therefore, may be dampened by the increased supply such that industrial property is seen underperforming commercial over the medium-term.

NONRESIDENTIAL WORK DONE



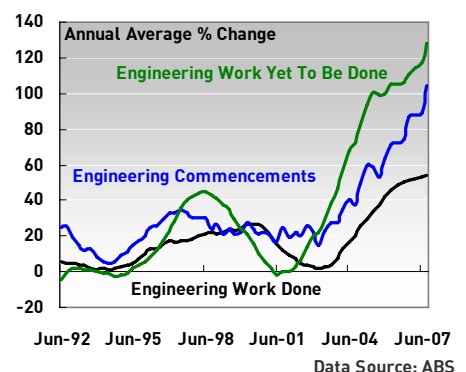
NONRESIDENTIAL APPROVALS



ENGINEERING CONSTRUCTION

Engineering activity remains a main area of strength in the economy, while commencements and approvals data suggest that this sector is set to accelerate even further. As a percentage of GDP, engineering activity stands at near record highs. This sector continues to be boosted by the mining sector (with oil, gas, coal and other minerals related construction taking up around 33% of the total). Infrastructure spending (mostly roads, ports, water supply and power generation) has also been a major contributor. The last chart on the right, which shows engineering commencements and work yet to be done, shows that there is still more in the pipeline for this sector. But there are also risks ahead. Access Economics projects this strong engineering cycle to turn during the course of 2009. The higher costs of construction and of debt given ongoing financial and credit market volatility could be another negative for this sector looking forward.

ENGINEERING CONSTRUCTION ACTIVITY



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