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Inside

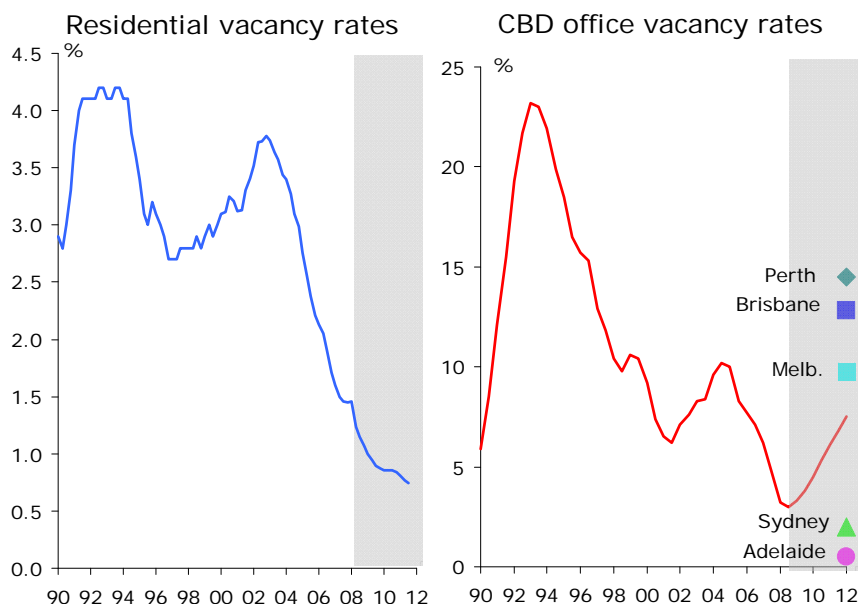
Economic Overview

An increasingly uncertain economic and financial market outlook combined with rising interest rates, rents, and food and fuel prices has driven both consumer and business sentiment sharply lower. As a consequence, economic growth will slow sharply in 2008-09. But the good news for the economy and property markets is that it appears official interest rates have peaked and we expect another 25 basis point rate cut before year-end.

Residential Property

With evidence of a slowing economy, a series of interest rate rises to digest and falling house prices in overseas markets, the question needs to be asked: are house prices going to fall in Australia? We think not.

Property markets are extremely tight



Sources: Property Council of Australia, REIA, ANZ Economics and Markets Research

Commercial Property

Office markets can expect a further modest softening in yields over 2008 but the underlying supports are good in most capitals - for the time being. Over the medium-term, diverse conditions across the major centres will weigh heavily on perceptions of relative risk.

Retail property yields are expected to ease further with weak retail spending and increasing 'forced' sales likely to weigh on the market in 2008-09.

Limited new supply will continue to underpin improved occupancy and room rates in the **tourist accommodation** sector.

Buoyant conditions in **industrial property** markets are being threatened by a solid supply response.

Economic Overview

Sentiment is fragile...

The Australia economy has been insulated from the worst of the global turmoil. Nonetheless growth slowed to a below trend 2.7% over the year to June.

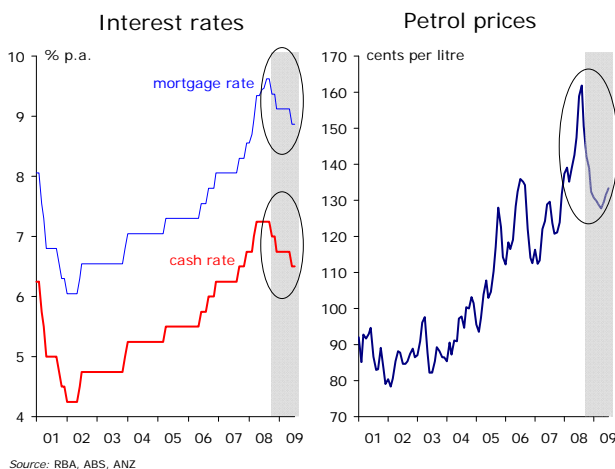
An increasingly uncertain economic and financial market outlook combined with rising interest rates, rents and food and fuel prices has driven both consumer and business sentiment sharply lower. This has been reflected in very soft retail spending and a marked slowdown in business and household credit. Pressure on household budgets has been exacerbated by independent increases in mortgage rates following a renewed deterioration in global credit markets which pushed wholesale funding costs higher once again in July/August.

Weakened sentiment will continue to weigh on domestic demand and property markets in the year ahead and we expect real GDP growth to slow to just 2.1% in 2008-09 (down from 3.9% in 2007-08).

...but light at the end of the tunnel

However, despite a further acceleration of inflation in the June quarter, official interest rate expectations have been wound back considerably following less hawkish Reserve Bank rhetoric and clear signs of a slowdown of domestic demand. The good news for the economy and property markets is that it appears official interest rates have peaked and we expect another 25 basis point cut before year-end. The Reserve Bank will continue ease the pressure on the monetary brakes in order to avert a 'hard' economic landing, but will maintain policy on the tight side of neutral until they see clear signs of a marked deceleration of consumer prices.

Relief ahead



Pressures on household budgets will be reduced significantly in the second half of the year by less restrictive monetary conditions. Falling interest rates (5 year swap rate already down 140 basis points from the June peak), reduced fuel prices, tax cuts and the boom in bulk commodity prices will all help to

alleviate restricted household cash flow. Consumer sentiment has already bounced off its lows on the back of lower petrol prices and improved prospects for interest rate cuts.

The sharp fall in the Australian dollar (down over 15 cents since peaking in July) will boost commodity returns and moderate the competitive pressures facing exporters and import competing industries.

The labour market remains the key to the outlook and despite early signs of a softening of labour market conditions and difficult times in the finance sector; ongoing skilled labour shortages and low corporate gearing suggest employment will remain resilient.

Property markets hang tough

While market *sentiment* has clearly weakened, property *prices* continue to defy the doomsayers. After booming last year, house prices stalled in the first half of 2008 - but we have yet to see any reliable evidence of significant falls and a critical shortage of housing and surging rents in most capital cities will maintain a floor under prices. Similarly, despite some slippage in capitalisation rates, commercial property valuations have been supported by solid rental growth.

Underlying fundamentals in both residential and commercial property markets remain tight and vendors have so far remained unwilling to accept lower price outcomes. In particular, the upper-end commercial property market remains at an impasse with transactions virtually drying up in 2008, creating considerable uncertainty and providing scant evidence for valuations.

Commercial property markets will remain under pressure in the near term as the market struggles to digest a number of major forced sales driven by the de-leveraging of the REIT sector. However, strong fundamentals, rising rents and the intransigence of (non-forced sale) vendors will limit the downside to valuations.

Recent sharp declines in the \$A will boost international interest in both residential and commercial property and we continue to believe the current market uncertainty provides good opportunities for savvy investors as medium term economic and property fundamentals remain very supportive.

Volatility in global credit and oil markets still present substantial downside risks to the economy and property markets. However, lower interest rates, a falling \$A, \$11bn of tax cuts, a \$55bn windfall from coal and iron ore prices and tight property market fundamentals will provide significant protection from the global tumult.

Paul Braddick

Residential Property

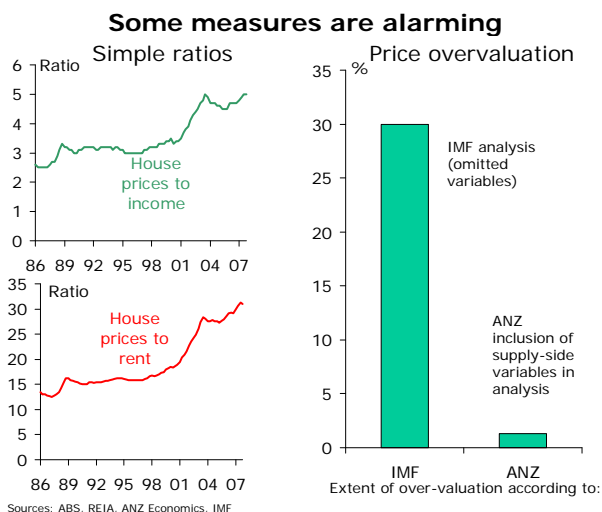
House prices, where to from here?

If the bulls have ever had to stand up and be counted, now's the time. With evidence of a slowing economy, a series of interest rates rises to digest and falling house prices in overseas markets, the question needs to be asked: are house prices going to fall in Australia?

We think not. Australian established house prices rose almost 8% in the year to June 2008 and are up nearly 10% per annum over the past decade. Following a brief respite in 2004, triggered by two interest rate rises in late 2003, house prices re-accelerated for a few years before softening into 2008, again in response to interest rate rises. Some commentators claim a speculative 'bubble' has established and that prices are significantly over-valued, having risen well beyond what fundamentals would dictate, and that what we are witnessing now is the beginning of the end.

How do you judge whether prices have gone too far? And if they have gone too far, does it *necessarily* mean they have to fall? Of course, prices did fall substantially in the 1890s and again in the 1930s but the economic circumstances over these periods were dire compared to the 'soft-landing' we are predicting this time around.

The idea that prices need to return to 'normal' levels is fine if we could measure what 'normal' is. Simple ratios such as 'price to income' and 'price to rent' are at historic highs presently and a return to, say, their long-term average, or to some point in history that one can (probably incorrectly) judge as an 'equilibrium' point, would require a substantial decline in prices. However, such ratios ignore most of the fundamental drivers of house prices which justify current price levels.



Of course, while incomes and rents do matter, they are but single dimensions within a very complex system of relationships. True, others (including the IMF) have used methods that include a broader

range of drivers, but they still generally ignore critical investment, behavioural and physical market fundamentals.

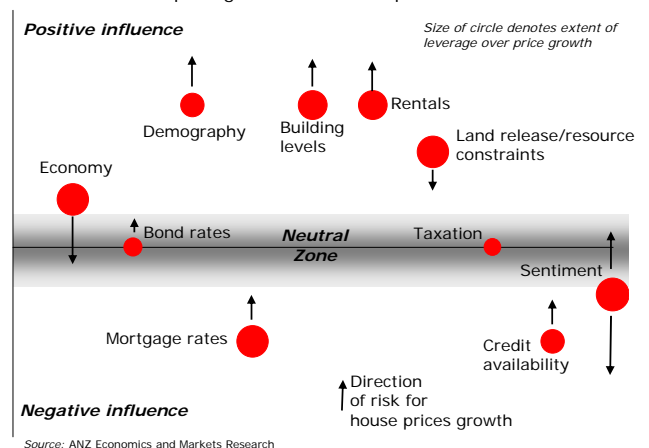
We identify the key drivers of house prices growth over the past decade to include:

- a structural decline in real bond rates which has justified a tightening of rental yields. In other words, investors are now prepared to pay more for houses for any given dollar of rental income;
- the rapid growth in population, economic and household incomes that have underpinned housing demand;
- a restrained supply response from the building sector (nervousness about interest rates, developer charges and restrictive land release policies);
- the halving of capital gains tax in 1999 (lowered the before-tax hurdle rate on investments);
- a shift in credit eligibility criteria; and
- heightened preferential demand for property in locations that have limited scope for additional supply (inner-urban).

There are both structural and cyclical elements in these drivers - some are easily quantifiable and some less so - but they all point to 'legitimate' reasons for prices rising beyond the 'comfort zones' of many.

On balance, prices growth will be supported

How the various price growth drivers are positioned at the moment



Looking forward, while it is reasonable to argue the impact of some of these drivers is waning, some drivers are as potent as ever. For example, expanding migration targets, particularly in the skilled category will add significantly to an already high demand for housing (well beyond current estimates of 180,000 dwellings per annum) at a time dwelling supply is being constrained by both land and labour shortages and prohibitive development charges. Consequently, the tightening

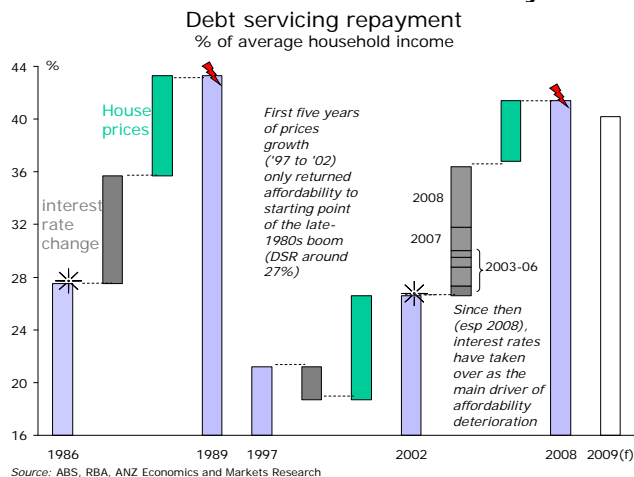
of market conditions, reflected in historically low rental vacancy rates, *will* get worse. Advertised rentals are up strongly and new leasing benchmarks will filter through to a greater percentage of the rental stock, providing a tangible and fundamental underpinning for house prices.

What about affordability limits?

The impact of higher interest rates on housing affordability in the first instance and on economic and employment growth down the track clearly has some leverage over prices growth. In 2007, we argued that most of the deterioration in affordability over the decade was price-induced, reflecting to varying degrees the positive influences listed above.

However, the balance of forces has shifted, intensifying in 2008 (see chart below). The greater than expected lift in interest rates over 2007/08 (both policy and out-of-policy adjustments), has created an affordability condition that is approaching that of the late-1980s.

Rates overtake demand as affordability driver



However, it needs to be re-iterated that even with a severe recession and a 10% unemployment rate in the early 1990s imposing mercilessly on this affordability condition, none of the house price gains over the boom period (1986-89) were eroded. Thankfully, this economic cycle is shaping up *very* differently to the early 1990s. The economy *is* slowing and the unemployment rate *is* expected to rise over the coming year *but* even at its expected peak (5½% by 2010) unemployment will still be below the *strongest* phase of the labour market in the late 1980s (before any significant loss in economic or housing momentum had occurred).

Why house prices tend not to fall

Market adjustment to a policy-driven deterioration in affordability depends critically on behavioural shifts on the demand side, the depth of demand for individual dwellings and importantly, supply-side responses. On each of these, there are considerable built-in market-protecting mechanisms. On the demand side, deteriorating affordability generally manifests in shifting patterns down the 'quality' spectrum. The bulk of this market-protection

transmits through the shift of individual demand into and out of particular properties (e.g. from landed properties to apartments, from 3BR to 2BR, from the high side of the street to the low side of the street).

While a net aggregate fall in buyer demand could ensue as interest rates rise, this occurs primarily because sellers do not allow the market to clear at any price (if prices did fall, the burden of the interest rate rise would be neutralised). Falls in turnover are often fully attributed to demand shifts. But vendors digging their heels in on price either through inelastic reserve prices or de-listing are also critical to market outcomes. In doing so, vendors price out a considerable share of buyers or equilibrate for reduced demand by withdrawing stock for sale.

To date, it appears most of the sales turnover adjustment has been driven by inelastic reserve prices rather than a withdrawal of stock, evidenced by lower clearance rates on above-average listing levels. The next stage that serves to protect value involves 'stock withdrawal'. The supply-side might resort to more of this if difficult interest burdens and poor sentiment persist.

Of course, if the weight of stressed sales jumps sharply and is sustained like in the US, the power of this final backstop protection for values diminishes and exposes the market to a 'fire sale' scenario (i.e. supply does not withdraw). This is where Australia's economic and housing market fundamentals are critical as key supporters. We expect the incidence of forced sales to remain low and net effective demand to hold up on the back of continued household formation and interest rate cuts. Vendors will, by and large, operate in an environment offering considerable discretion to sell.

Sentiment is a wild-card

The biggest battle to be played out over the remainder of 2008 is for home-buyer sentiment. While we are comfortable with the logic and process used to arrive at our house price view, we recognise shifting sentiment as a powerful driver of market outcomes.

Commentaries predicting substantial price declines (by impacting on price expectations) can bear on outcomes even though the analysis upon which these conclusions have been based upon may be flawed or superficial. There *are* risks to sentiment in the short-term but given we are now past the peak of the interest rate cycle, a 'soft' landing for economy is still in prospect and that housing market fundamentals are the tightest on record, there is a strong probability that the market will avoid a doomsday outcome.

Ange Montalti

New South Wales

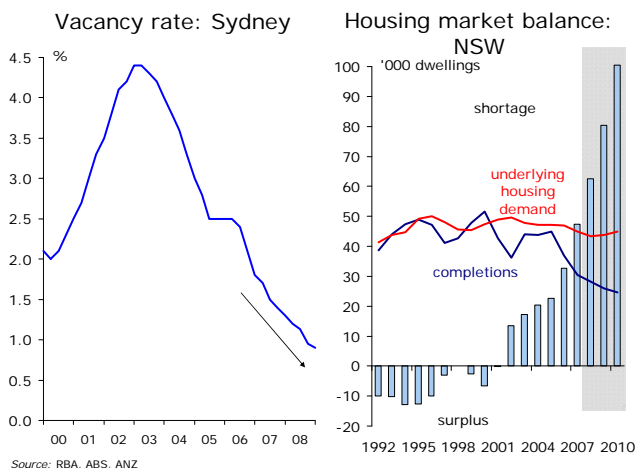
After languishing for several years, Sydney's median house price finally recovered in 2007 rising by 8.8%. However, since then, prices have stalled in the wake of a 160 basis point increase in mortgage rates. In relative terms, since 2003, Sydney house prices have slipped by around 40% relative to Melbourne, Brisbane, Adelaide and Hobart.

But despite several years of sluggish house prices, Sydney's housing affordability has deteriorated and sales activity and prices are expected to remain soft over the balance of 2008. Nonetheless, market fundamentals are tightening rapidly which will protect house prices on the downside and eventually underpin a solid rebound in prices and building activity.

Excessive infrastructure charges continue to weigh on NSW home building activity with building approvals currently at their lowest level in 24 years of data. The fact that building approvals in most other states remain close to their long-term averages, points to the urgent need for NSW to reassess their infrastructure-charging models.

NSW faces a critical shortage of housing that is becoming worse by the day. Buoyed by strong international migration and reduced net interstate outflows, underlying housing demand is running well ahead of new housing supply and this gap will widen in coming years. The supply shortfall has already driven rental vacancies down to just 1.1% in June and boosted advertised rents by 15.3% over the past year.

Housing shortage becoming critical



The Australian economy is expected to slow sharply in 2008-09 and with the resource states (Queensland, Western Australia and now South Australia) continuing to outperform, NSW will be squeezed.

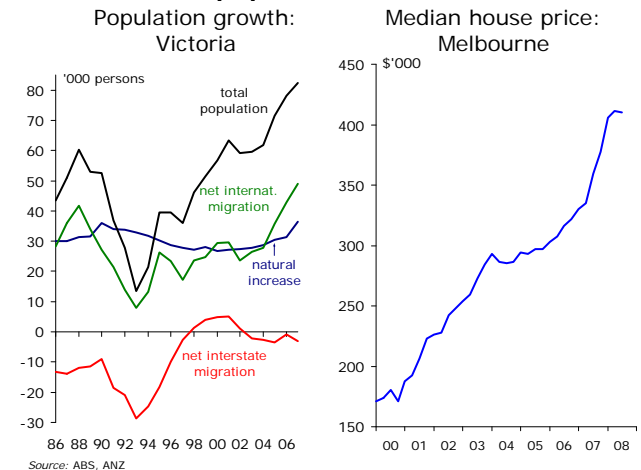
However, falling interest rates in 2008-09 could be the trigger for a turnaround in NSW property market fortunes. An ongoing shortfall of housing supply will see rental vacancies effectively approach zero in the years ahead, and improving affordability as interest costs fall and incomes grow, could be the catalyst

for a long awaited upswing in home building activity and house prices.

Victoria

A marked tightening of the Melbourne housing market is reflected in the 18.8% surge in advertised rents over the year to June. Rental vacancies have fallen to their lowest levels in 25 years and we expect further tightening in the year ahead as underlying housing demand continues to outstrip dwelling completions.

Victorian population has accelerated



Victorian population growth has accelerated in recent years (buoyed by a mini baby boom and a sharp increase in international migration) lifting physical housing demand well above new supply.

Nonetheless, after rising 23% last year, house prices stalled in the first half of 2008 and are expected to remain subdued in the months ahead. Home-buyer sentiment has weakened and is temporarily outweighing the positive underlying market fundamentals. Auction clearance rates have retreated from the boom conditions experienced in 2007 but remain above 60%.

While negative sentiment and a slowing economy present some downside risks in the near term, interest rate cuts should buoy housing markets in 2009 and we continue to believe current market conditions provide opportunities for shrewd purchasers, particularly in inner suburbs. Inner urban markets continue to outperform and high fuel costs, increasing road congestion and inadequate public transport infrastructure suggest the inner urban premium will widen further in the years ahead.

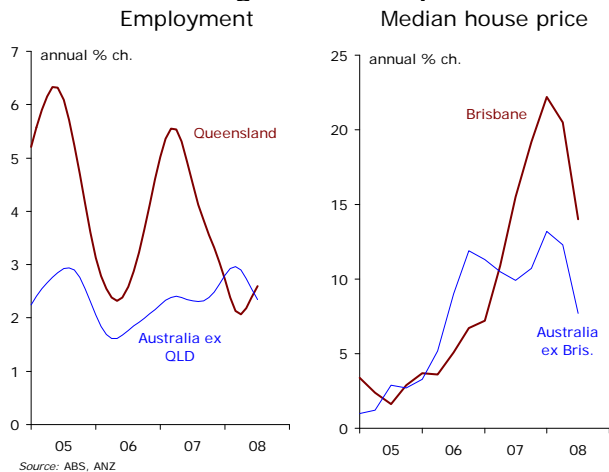
The Victorian economy performed strongly in recent years, but like NSW, will be squeezed in the current economic downturn. Employment growth has slowed from 3.3% in 2007 to just 1.6% over the year to June. Nonetheless, unemployment remains at historically low levels and unless unemployment jumps sharply, the doomsday scenario of a 'bursting of the house price bubble' remains highly unlikely. Positive underlying economic and property market fundamentals should support ongoing resilience in house prices in the near term and see prices grind higher in 2009.

Queensland

Despite the ongoing boom in commodity prices, Queensland economic growth moderated in the first half of 2008. Employment growth slowed from a remarkable 5.6% early last year, to a still healthy 2.6% over the year to June but retail sales have stalled. Nonetheless, a booming resources sector and a healthy investment pipeline will ensure Queensland continues to outperform and growth is forecast at a solid 3¼% in 2008-09.

Despite strong economic growth and buoyant employment opportunities, difficult housing affordability has seen Queensland's share of both international and interstate migration fall sharply in recent years. Nonetheless, underlying housing demand remains in excess of new supply and housing markets will continue to tighten in the years ahead.

Coming back to the pack?



Like Melbourne, after performing very strongly in 2007, Brisbane house prices stalled in the first half of 2008. Market sentiment has weakened sharply and housing finance commitments slumped by 36% over the year to June. Nonetheless, above average economic growth, low unemployment, solid household income gains, tightening rental markets and falling interest rates will all protect house prices on the downside and underpin a renewed upswing in the years ahead.

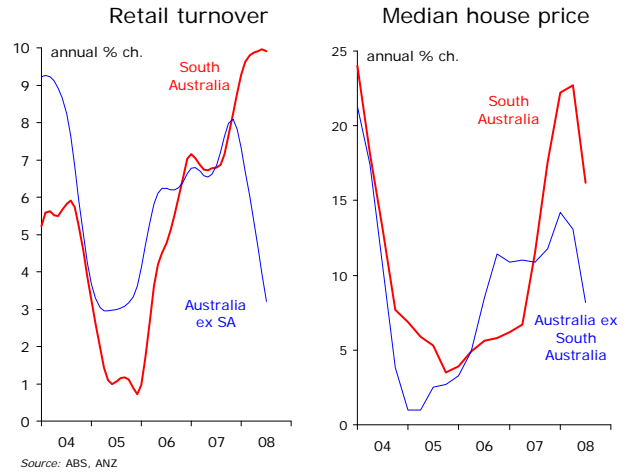
South Australia

The South Australian property market has outperformed all expectations. Despite a lacklustre economic performance, house prices have doubled in the last six years supported by a tightening of the housing demand/supply balance. After surging 22% in 2007, house prices have effectively stalled in 2008, however, the medium term outlook remains positive.

In contrast with most other states, indicators point to a strengthening of economic activity with employment and retail spending growth now well in excess of the national average. Even population growth has firmed, supported by remarkable gains in South Australia's share of international migration. Further gains will be supported by booming business

investment which will be underpinned by several major projects in the mining and ship-building industries. In particular, BHP's massive planned expansion of the Olympic Dam copper/gold/uranium project could lift South Australian economic growth above the national average for many years to come.

South Australia outperforms



Relatively affordable housing, solid household income growth and falling interest rates will support renewed gains in Adelaide house prices in 2009-10.

Western Australia

The commodity-fuelled Western Australian economy rolls on with economic growth accelerating to 7½% in 2007-08. While growth is expected to slow marginally in 2008-09, due in part to the disruptions to gas supplies, strong economic prospects should ensure the WA property market remains well supported.

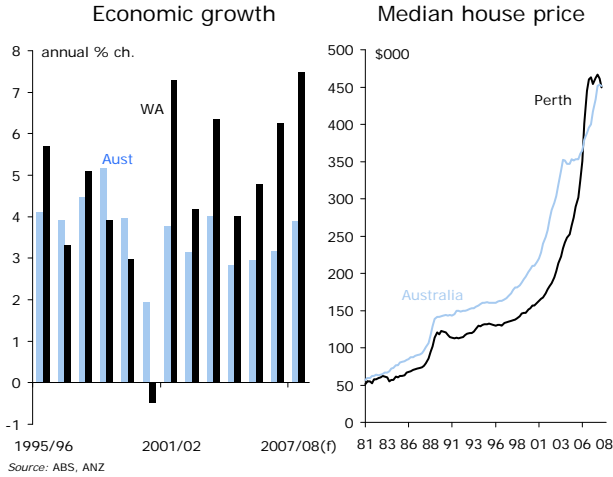
Overwhelmingly positive economic prospects continue to bring both interstate and external migrants to WA in droves. The WA population grew by 2.4% last year, the fastest pace of any state and the fastest in WA for over 20 years. Despite building approvals numbers softening somewhat, strong demand for housing has supported building levels that are still above long-term averages. However, this has not been enough to keep pace with underlying demand. As a result, the shortfall in construction is serving to exacerbate the imbalance in the residential market and tighten already low vacancy rates that are hovering just over 1%.

'Advertised' housing rents reflect this tightness with 13% and 18% annual growth reported in Perth and country WA respectively. Continued strong rental growth points to rental yields for houses and units continuing to improve (after bottoming out in late-2006). Further, current soft house prices should also support yields in what is a relatively small investor market.

Despite strong underlying fundamentals and ongoing solid economic performance in WA, the massive run-up in house prices over recent years combined with higher interest rates has seen affordability deteriorate significantly. Poor

affordability and negative sentiment have overwhelmed market fundamentals to see median prices ease 2.4% in the June quarter. The top end of the market still appears to be performing solidly with growth just under 5%, yet lower priced housing has been hit hard.

WA outperforms the rest of Australia



In our view, the potential for ongoing softness in prices in coming quarters should be put in the context of a doubling of median prices in the past 5-years. With continued exposure to the mining boom, cuts in interest rates and the fastest wages growth in the country, we anticipate that housing market conditions in WA will improve in 2009.

Tasmania

The Tasmanian economy has been humming along at a solid pace in recent years, with the manufacturing sector underpinning average growth of around 3%. We anticipate this rate of growth will continue in 2008-09 with a stimulatory state budget supporting the economy.

A conservative fiscal stance has allowed for a projected \$1bn additional government spending on infrastructure and services. Overall spending has reached \$4bn for the first time. A solid property sector has assisted in boosting government coffers, with stamp duty revenues from increased sales numbers climbing by 11% in 2007-08.

The labour market remains solid with employment reaching record levels in July and the unemployment rate hovering around 4¼%. Population growth was picking up in the latest figures, but at 0.8% per year is still only half the rate experienced on the mainland. Building approval numbers have remained solid, near the long-term average and as a result, a significant amount of new stock has recently come on to the market. This, combined with weak sentiment, has seen median house prices ease marginally in recent quarters.

Northern Territory

The Northern Territory economy continues to perform solidly underpinned by the resources boom, with economic growth averaging over 5% in the last 3-years. It is anticipated that ongoing strength in

investment and development in the mining sector will drive economic and population growth in the coming year. This is already reflected in annual employment growth of over 5% that has persisted for over 6-months. As a result the unemployment rate in July fell to just 2.9%.

With labour markets tight, disposable income growth has been accelerating for some time lifting income per employee to the second highest in the country (after the ACT). These strong labour market prospects are driving rapid population growth of just under 2.4%.

The buoyant economy has underpinned strong house price growth in recent years. Despite this, high interest rates have seen activity in the property market slow and price growth ease in recent quarters. Growth in Darwin house prices in the June quarter came in at 1.9% offsetting a 1.5% fall in the previous quarter, yet annual growth remained solid at 7.0%. Tight rental markets have seen rents climb 13% in the year to June. Higher rental yields have buoyed unit prices in particular which expanded by 14% in the year to June, compared with capital growth in housing running at just under 8% in annual terms. Solid economic fundamentals, and a growing shortfall in dwellings, will shield the market in NT from any significant price softness in coming quarters.

Australian Capital Territory

After a solid performance in 2006-07 when the ACT economy posted 5% growth the brakes are now on. High interest rates are one thing, but the incoming federal government has also reprioritised spending away from the public sector. Both of these factors will take the shine off the economy going forward with a broad-based slowdown already in train.

Despite this easing of growth, the labour market has remained solid, employment growth is above 2% per annum and the unemployment rate is stable at 2.7%. Yet population growth has slowed and a significant outflow of persons to other states has occurred in the second half of 2007.

Limited additional supply of dwellings recently has resulted in a shortfall of housing in the ACT. However, slowing population has eased pressure in what is still a tight housing market. Vacancy rates have edged up marginally and rental growth has slowed markedly. The owner-occupier market has also softened with price growth now relatively flat, slowing to 7% in annual terms. Negative sentiment has overwhelmed solid fundamentals. This is especially pertinent in a city that has high proportion of non- or semi-permanent population. And although housing is still amongst the most affordable (as a % of income) it is difficult to entice a relatively short-term buyer into what is a relatively soft market.

Paul Braddick & Alex Joiner

Office Property

Office market supports are good

Fundamentals in CBD office markets remain tight. While absorption has fallen in response to a slowing economy, the supply side has also been sluggish. As a result, CBD vacancy rates have continued their run down since 2004 from 10.2% to 3% in the mid-2008 (their lowest level since the late-1980s). Fortunately, the exuberance that fuelled the 1980s construction boom and the associated recession and double-digit interest rate environment that followed are likely to be averted this time. Given the difficult global economic environment, tougher financing conditions and generally heightened caution in most investment sectors, this cycle is likely to play out very differently.

On the *demand* side (i.e. take-up of space), there is room for optimism. Lower corporate gearing and the likelihood of a soft landing for the economy suggest that while we may see a slowing in absorption, this will be moderate. In particular, joblessness, insolvencies and bankruptcies are not expected to drive wholesale shifts in demand. On the *supply-side*, there is a healthy level of construction underway and the pipeline of mooted developments is long, but reticence among lenders (higher pre-commitment hurdles) and developers (higher return hurdles) should see a greater incidence of both voluntary and forced project shelving.

Nonetheless, while tight conditions are assured for 2009, fundamentals in some centres are expected to weaken in the out-years. This turn in the tide will present a subtle sway in bargaining power towards tenants with weaker effective rental movements threatening capital values, particularly in those centres that have experienced such phenomenal growth in recent years.

According to market data (albeit scant), prime office capitalisation rates have softened in the first half of 2008 by around 25 basis points on average¹. This is around the half-way point for our overall expected softening for the 'crisis period'. Office yields, at today's level are consistent with a 'property risk premium' that is higher than its long term average, suggesting on this criteria, yields remain well grounded. That short-term influences are working forcefully to counter these fundamentals is not surprising, given the severity of the global credit crisis, the less than ideal financial structures of some of the key institutional property owners and to a lesser extent, a slowing economy. These negatives weigh significantly on sentiment but need to be weighed against the likely spur from a lower exchange rate that will mobilise foreign funds and from the prospect of lower interest rates. While risks could emanate from institutional distress, the balance of influences point only to an additional small softening in yields (around 25bp) over the remainder of 2008 for the prime office sector.

The **Sydney CBD** office market remains tight. An unusually high level of new space came on to the market on the back of a substantial withdrawal six months earlier. These were both 'out of market' developments and have worked to lift vacancies temporarily. We expect a reversal to towards lower vacancies again as limited site development opportunities keep this market in fundamentally good shape despite subdued growth prospects for the economy. The risks for this market are low compared to most other capitals.

A rush of new office supply for the **Melbourne CBD** over the second half of 2008 and continued sluggishness in take-up of space will see the start of an extended but gradual weakening in Melbourne office fundamentals. Vacancies are expected to climb gradually, from an historic low of 3.1% of stock currently to a still respectable 7.5% by the middle of 2010. Nonetheless, the shift to the 'wrong side of balance' will challenge some owners particularly with a good share of 'back-fill' to achieve. While there is unlikely to be much support to stronger rental momentum, its relatively soft rental performance in recent years compared to some other capitals places Melbourne in a strong competitive position for corporate relocation strategies, offering a powerful protective mechanism in the event of a more substantial weakening in economic conditions.

Adelaide Core office market has been on a secular tightening trend for the last decade (vacancy rate has fallen from around 20% to 4% over this period). Strength in the resources sector is having spin-off benefits. Amazingly, Adelaide's core office market has experienced more net absorption in the past 2 years than it has in total over the previous 16 years! Not surprisingly, the supply-side has been caught napping. Further tightening in vacancies to around 1% is in prospect by end-2011. This suggests Adelaide could enjoy fairly rapid rental growth in the years ahead, far-outweighing any vulnerability to values from a sector-wide softening in yields.

Brisbane and Perth CBD office markets are an entirely different story. Extreme tightness is having the expected impact on rentals with prime rents up 90% and 130% in each centre respectively over the past two years. Brisbane rents are 50% higher than Melbourne prime rentals on a 'per square metre' basis whilst Perth rents are double Melbourne rentals. While high commodity prices are deepening pockets and fuelling a bidding war for space, there must be a question mark over the sustainability of these rents. When the supply-side has fully responded (vacancy rates 13% and 15% by 2011) or when income from resources softens, a sharp correction in effective rentals and capital values is likely. In the meantime, we continue to focus on softening yields, even though this will eventually pale as a second order issue compared to the basic fundamentals of supply, demand and affordability.

¹ A lack of depth in market transactions means reliability of yields is considerably reduced compared to 'normal' market conditions.

Retail Property

The retail trading environment since the start of the year has been weighed down by poor consumer sentiment, high oil prices and rising interest rates. Growth in the value of retail sales was weak in the first half of this year. Tightness in the credit market, which has lifted borrowing costs in an uncertain economic environment, and a softer retail sales climate have dampened retail property transactions. These conditions have led to a softening in retail yields across the sector in most states. Adelaide and Perth, however, have seen property yields hold steady.

CBD retail space trends

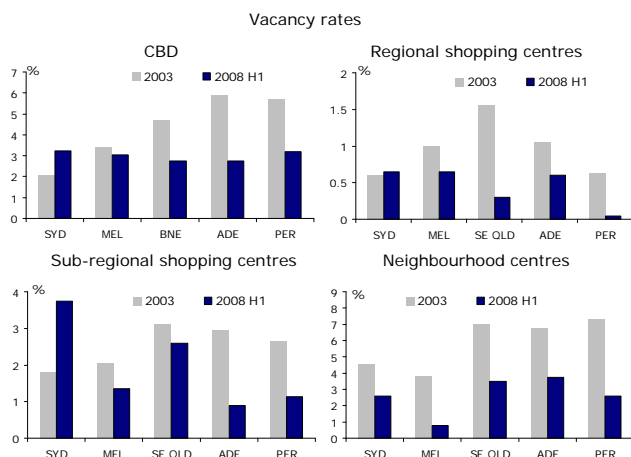
Prime CBD	Net rents Change 3 mth to Q2 2008	Equivalent Yields	
		Q2 2008	Q1 2008
Sydney	1.2%	5.38-7.5%	5.25-7%
Melbourne	0.6%	6.25-7.5%	6-7.5%
Brisbane*	0.5%	6-6.75%	6-6.5%
Adelaide	1.3%	6.25-8.25%	6.25-8.25%
Perth	2.3%	5.75-7.5%	5.75-7.5%

*: gross rents

Source: Jones Lang LaSalle

While the shift in RBA rhetoric towards a more accommodative policy bias lends support to the retail property sector, a more conservative start to the easing cycle, together with sluggish retail spending could see further pressure on property yields in the near term. Estimates indicate that yields could soften a further 25-75 basis points in the year ahead. However, yields are likely to firm over the medium term supported by stronger economic fundamentals, with retail spending expected to pick up. Economic growth is projected to return to above 3% by 2010, assisted by further interest rate reductions.

Low vacancy rates help underpin rental growth



Sources: Jones Lang LaSalle, ANZ Economics & Markets Research

While there is a link between retail turnover and rents, vacancy rates also play an important part in

determining rental growth. Rental growth is likely to ease given the expected slowdown in household consumption but low vacancy rates across the sector, particularly regional and neighbourhood centres and the CBD, should help to limit pressures.

Within **New South Wales**, CBD vacancy rates in Sydney have risen as a result of softer trading conditions although regional and sub-regional centres held steady. According to Jones Lang LaSalle data, yields for prime CBD ranged between 5.38-7.5% in Q2 2008 from 5.25-7% in Q1 2008. The outlook for retail sales remains subdued in NSW where employment is showing signs of slowing, wealth gains from equity and housing assets have deteriorated over the course of the year and the household debt servicing burden remains high.

Victoria is expected to see a strong pipeline of supply over the course of the next 12-18 months which is likely to soften the pace of rental growth. Close to 280,000 sqm of new supply is expected in Melbourne this year, higher than the 5-year average. In addition, 2009 is shaping up to be another strong year for retail supply with more than 350,000 sqm under construction or with plans approved.

Vacancy rates in the CBD, regional and sub-regional centres remain relatively healthy in southeast **Queensland**, thanks to strong population growth, tourist inflows and the mining boom. Nevertheless, new supply coming on stream is likely to put pressure on rental growth. Estimates indicate that over 150,000 sqm will be added to existing stock by the end of this year.

Retail supply in **Adelaide** is expected to top 100,000 sqm in 2009, the highest on record, and more than double the annual supply seen over the past five years. Current developments or projects in the pipeline include the Westfield Tea Tree Plaza extension and a number of homemaker centres. Growth in retail trade exceeded the national average in the first half of this year and outlook for the retail sector remains favourable, supported by the buoyant resources sector and a firming in population growth, which should help to mitigate any supply induced softness in rental growth.

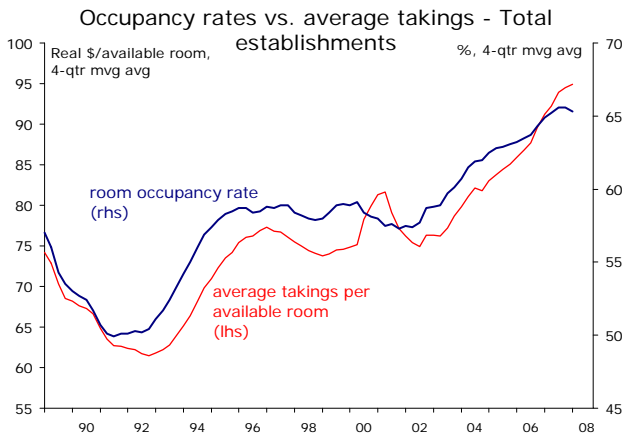
In **Western Australia**, robust economic activity, low unemployment and strong tenant demand is likely to keep rental growth relatively steady in Perth. New supply is expected to exceed 120,000, the highest increase since 1999, with projects including the extensions of Armadale and Joondalup Gate shopping centres and Claremont central development. Retail yields softened slightly in regional and sub-regional centres in Q2 08 from the previous quarter but were stable for prime CBD.

Jasmine Robinson

Tourist accommodation

The tourist accommodation sector has been a standout performer with room occupancy levels and room rates staying resilient over the past year despite challenging market conditions. Over the year to the March quarter, average takings per available room for all establishments were up 5.6% and the occupancy rate stayed above 65%. With limited new room supply coming on-stream in most markets, this sector is likely to preserve recent gains in the coming year despite a more difficult global and domestic economic environment.

Occupancy and revenue indicators resilient



Sources: ABS, ANZ Economics & Markets Research

Latest projections by the Tourism Forecasting Committee (TFC) are for international visitor arrivals to rise by 3.2% in 2009 after staying flat this year while domestic tourism, as gauged by domestic visitor nights, is expected to decline by 2.7%. With world growth forecast to remain below trend and Australia's main tourist-generating markets, namely New Zealand (accounting for 20% of total visitor arrivals) and the UK (12%) facing very weak economic growth prospects, attracting the leisure travel market will be tough. That said, China, India and the Middle East, which are increasingly important tourist markets, are likely to continue to record healthy rates of expansion.

Within the domestic travel market, the outlook for business travel is positive, particularly in resource-rich states. The environment for the leisure travel market, however, has become more challenging as domestic airlines consolidate routes, discretionary spending is tightened and as outbound travel remains attractive. Building approvals data in this sector has been relatively stable this year with approvals up 1.7% for the first half of this year compared with the same period in 2007. Overall, supply and demand conditions are now more evenly balanced, and with growth in new construction expected to be impeded by high land and construction costs, this gives scope for further room rate hikes over the coming year. Income growth, driven by the rise in average room rates, and only a moderate increase in supply suggest that investor

demand should build up but current tight global credit conditions and an uncertain domestic economic backdrop is likely to restrain activity. Still, recent sales producing yields of around 7% underscore the potential in this sector.

The lack of major developments in **New South Wales** will keep occupancy rates high and support further revenue growth. The Sydney market saw average takings per available room rise by 5.9% over the year to the March quarter with occupancy rates breaching 80%, the highest on record. Current forecasts estimate some 800 additional rooms (or about 2½% of existing stock) coming into the hotel market in Sydney over the next 12-18 months.

Over the year to the March quarter, average takings per available room in Melbourne rose a healthy 8.7% with occupancy rates at around 78%. This was substantially more robust than the average for **Victoria** which increased 3.2% and 61.4% respectively. More than 1,500 rooms (or about 7% of existing stock) are expected to be added to room supply in Melbourne over the next 12-18 months as developments such as the third hotel in the Crown Entertainment Complex and the Hilton hotel are completed. This could put a dent on the pace of growth in room rates but is not forecast to severely erode market prospects as demand is expected to stay strong, driven by a strong events calendar and over the medium term, the demand from convention business.

The **Queensland** market remains mixed with Brisbane and the Gold Coast expected to continue to benefit from strong demand although performance in Tropical North Queensland (TNQ) is likely to be subdued by the uncertain outlook for international visitor arrivals. TFC forecasts show a double-digit decline in Japanese visitor numbers over 2008 and 2009. Rates in TNQ have softened with the average takings per available room down 2.3% in 2007.

Tight occupancy rates in **Western Australia** continue to underpin growth in room rates. Perth has seen occupancy rates average in excess of 75% over the past two years, contributing to a 16% rise in takings per available room in 2007. Corporate demand, particularly in the resources sector, is likely to stay healthy and supply constraints will help lift scope for further growth in revenue.

The impact of the mining boom is becoming more evident in **South Australia** with revenue and occupancy indicators strengthening significantly. Occupancy rates in Adelaide averaged 73.8% in 2007 against 63.6% in 2004 while average takings per available room jumped by almost 10% in 2007. Demand for accommodation is expected to remain healthy in the year ahead as activity in the resources sector expands.

Jasmine Robinson

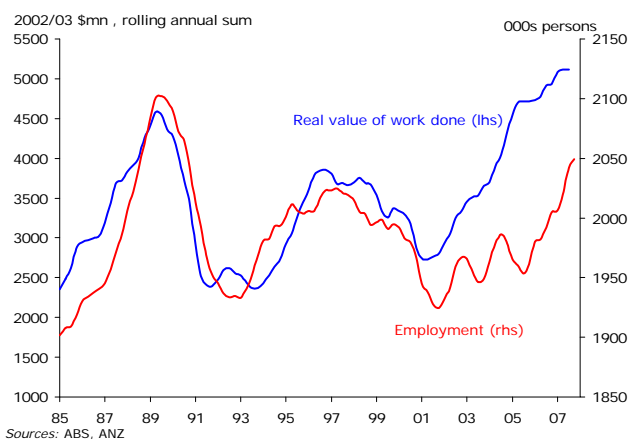
Industrial property

The industrial property sector has been supported by a solid performance from the manufacturing industry combined with strong growth in the storage & transport sector. Manufacturing sector output has averaged an annual rate of growth of 3.2% in the 18-months to March 2008, after contracting significantly in preceding years. Wholesale trade has not fared as well as the industry continues to consolidate, expanding only 2.3% over the same period, recording particularly soft growth in recent quarters. In contrast, the stand-out performer over the period has again been the storage & transport sector that has expanded 6.2%, well above the national GDP growth rate of 3.9%.

The consistent growth of these sectors has seen demand for industrial space increase significantly. The value of building work done over the past 12-months is more than double that of earlier peaks and employment levels are the highest in more than 18 years. Much of this growth has been driven by the warehouse/storage sector that has benefited from the Australian consumer's addiction to imported goods. Added to this has been increased infrastructure spending in capital cities that have furnished population growth corridors with industrial zones that were previously unfeasible.

Industrial space demand strong

Work done and employment in the industry sector



The supply response to meet the strong demand has added 2.6 million/m² of completed industrial space in 2007, well above the decade average of just over 1.5 million/m² per year. Another 2.8 million/m² of space is expected to be added in 2008. The majority of this stock is still in the pipeline with construction to be completed in the latter half of the year. Take-up activity in recent years has justified additional supply, however, we are starting to see some cracks appear. The combination of weak sentiment, softer economic growth, rising business overheads and elevated funding costs has seen prospects for further demand for industrial space begin to wane. This is especially true in the mature Sydney market, whereas figures in Melbourne were still relatively robust. Take-up in the resource-

fuelled economies of WA, QLD and increasingly SA has also continued at a solid pace. We anticipate that caution from tenants to expand or relocate in order to reduce real estate overheads will see demand continue to ease in the second half of the year.

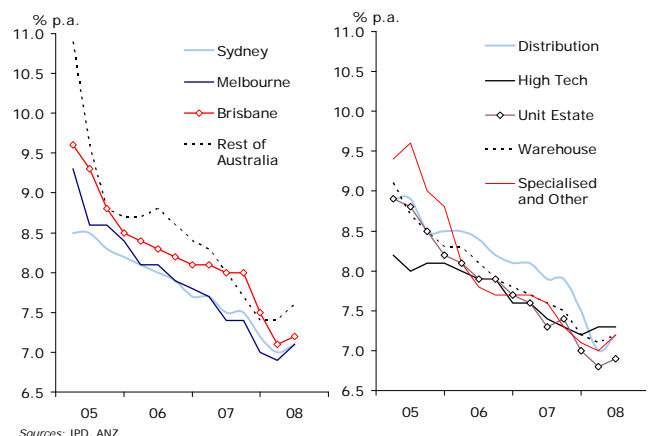
With such ample supply coming on stream in an environment of easing demand we expect that rental growth will stabilise or even ease in coming quarters. This comes after rental growth across most markets accelerated markedly amidst strong demand and relatively low vacancy rates in recent years. If economic conditions were to deteriorate sharply we may see instances of oversupply increase which could have a further negative impact on rental growth and yields.

However, the market may be shielded somewhat as much of the additional supply coming on stream this year is pre-committed, limiting any impact of oversupply in the short term. Further, due to shorter lead-times for construction of industrial property, developers have a greater capacity to withhold projects in response to shifts in the market.

Nonetheless, national industrial capital values have begun to ease in the June quarter with a patchy performance across the capital cities. This has prompted a widespread softening of capitalisation rates across the majority of sectors. The high-tech sector was the only market segment in which yields sharpened in the quarter, yet this only served to unwind a deterioration of yields in the March quarter. Average cap rates also eased across all capital cities, despite disparate economic performance. With commercial property market sentiment deteriorating significantly, coupled with the increase cost of credit, transaction volumes have fallen markedly. This has seen much of the speculative development in the market evaporate but has also put further pressure on yields.

Capitalisation rates ease in the June quarter

Capitalisation rates – by state & sector



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