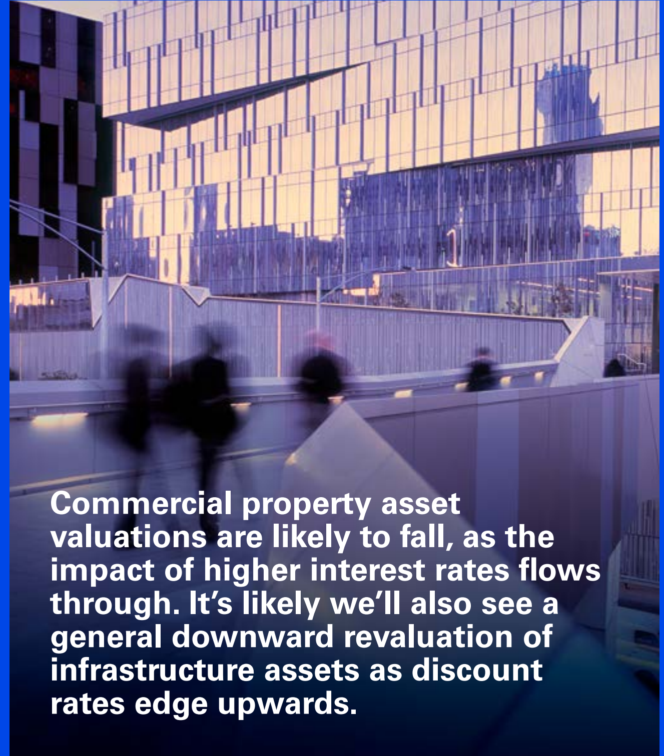
The Australian Real Asset Economy

Quarter Ended
30 September 2022

Key takeaways

Solid economic growth and the tight labour market are supporting occupational demand across the commercial property market although the office sector continues to experience sluggish demand due to impact of WFH.



Commercial property asset valuations are likely to fall, as the impact of higher interest rates flows through. It's likely we'll also see a general downward revaluation of infrastructure assets as discount rates edge upwards.

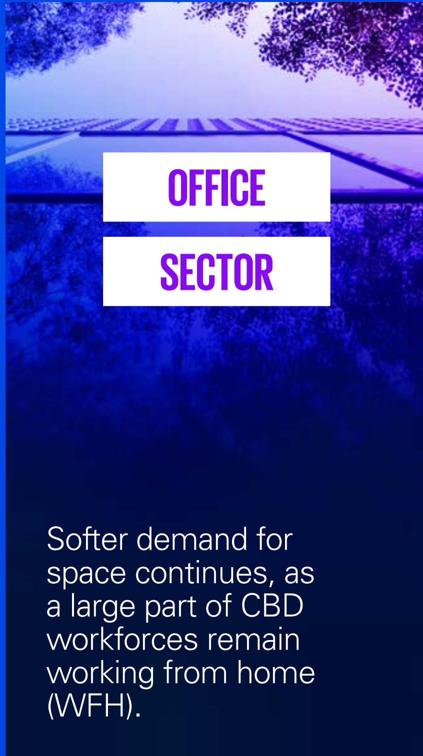
KPMG expects construction cost inflation to slow down – some global benchmark prices for timber and steel are already falling. Prices are not expected to return to pre-COVID levels, and developers will continue to face a margin squeeze for now.

KPMG expects the Reserve Bank of Australian (RBA) cash rate to reach a cyclical peak of 3.35% in early 2023. Average residential prices have already declined by c5% since March 2022 (almost 10% in Sydney), and a further decline of c10% is expected nationally over the next 12 months.

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Key takeaways



©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.
Liability limited by a scheme approved under Professional Standards Legislation.

Executive summary

Solid economic growth and the tight labour market are driving occupational pressure across each key property sector. However, the outlook for a cooling economy will weigh on lease activity and demand for space.

Rising interest rates will adversely affect capital market conditions across most asset classes, including real asset markets. Future commercial property asset revaluations are likely to move down, reflected through the softening of capitalisation rates. And, as discount rates edge upwards, we're also likely to see a mild downward revaluation of infrastructure assets.

Investment performance for commercial property has started to ease, with total returns showing signs of softening. In contrast, infrastructure returns are less likely to be adversely affected due to their sheltered exposure to the economic cycle. However, return profiles are likely to vary noticeably given the wide array of infrastructure sub-sectors.

THE RESIDENTIAL SECTOR

This sector is a key driver of economic activity due to its multiplier effect.

The cyclical upsurge in residential construction activity and residential prices during the pandemic was due to a combination of rising demand (particularly for detached houses), the accumulation of savings during the pandemic, the government's HomeBuilder initiative and low mortgage lending rates.

Despite a tight labour market and solid household balance sheets, the rise in interest rates will translate into a moderate downturn in the residential market, seen through lower housing market churn, slowing construction activity and retreating asset prices.

However, work under construction remains at historic highs, with supply unable to keep up with demand. Developers are facing a perfect storm of cost pressures. Construction material supply chain disruptions and global shortages coupled with a lack of available skilled workers domestically have driven up input costs, yet fixed price contracts are making it hard to pass these costs on to customers.

The adverse income and wealth effects from a downturn in the residential sector will lead to softer economic growth via negative wealth effects. At an aggregate level the impact on spending is small, but for big ticket discretionary items (e.g. cars) it's more pronounced.

This report provides insights from KPMG Real Estate experts, Senior Economists and Real Investment Analytics.

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.
Liability limited by a scheme approved under Professional Standards Legislation.

COMMERCIAL PROPERTY SECTORS

- Office property sector: Investor demand for office buildings appears to have softened as transactional activity has been slowing over recent quarters. Furthermore, capitalisation rates are likely to edge upwards as interest rates move sharply higher.
- Retail property sector: With capitalisation rates likely to edge upwards, investor demand will concentrate on non-discretionary focused shopping retail centres and down-weight allocations to discretionary retail shopping centres.
- Industrial property sector: Asset pricing is likely to be relatively favourable for the industrial sector when compared with the office and retail property sectors. However, interest rate rises are likely to trigger a slower pace of capitalisation rate compression as well as a widening spread across product types.

BUILD-TO-RENT SECTOR

- The build-to-rent (BTR) sub-sector, also known as multi-family residential, is an emerging sector within the Australian commercial property market.
- A key attractive investment feature of BTR to investors is the longer term stabilised cashflow which is underpinned by a steady net rental revenue stream throughout the life of the asset, similar to a multi-tenanted office or retail asset.
- The prospective attractive investment income yield profile combined with anticipated favourable market conditions, has seen rapid growth in the number of institutional players participating in the sector over the last few years. As a result, there's an increasing flow of permanent capital entering the sector.
- There are various business models that have evolved in the Australian marketplace for BTR, ranging from some groups acquiring, developing and operating sites, to others that are owners of properties that are managed by third party operators.
- Key barriers to BTR sector growth include: rising construction costs, shortage of suitably located and priced land sites; financing arrangements are still evolving; reducing favourable feasible market opportunities with rising interest rates, and Australia's tax makes BTR returns less appealing relative to other of commercial property sectors.

INFRASTRUCTURE SECTOR

- Infrastructure expands the investment opportunity set as it offers exposure across a broad range of sectors like transport, energy and utilities, communications and social infrastructure. The unifying feature of the asset class is the relative stability and predictability of demand and therefore revenues over time.
- The diversity of investments across this sub-sector provides wide-ranging risk-return attributes. This diversity makes infrastructure attractive to a broad range of investors with varying risk appetites.
- Infrastructure investments are likely to perform better with any cyclical market downturn due to their long lease structures, less volatile demand profiles, and partly regulated income streams.
- Airports are a major sub-sector of the transport sector. While there was a notable downturn during COVID19 lockdowns, the easing of restrictions late last year has seen a resurgence in travel. Airport revenue streams should improve markedly and result in strengthening investment returns.

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Economic update

KEY ECONOMIC EVENTS FROM THE LAST QUARTER

- The Australian economy continues to perform strongly against both domestic and global headwinds. Quarterly growth momentum in GDP stayed above trend at 0.9% Q/Q, taking annual growth to 3.6%. Notably, the Australian economy continues to relatively outperform most developed economies.
- The labour market appears to have reached full employment, with the unemployment rate holding broadly steady at 3.5% since June. Growth momentum in employment and hours worked have slowed sharply since May, suggesting little additional capacity.
- Retail demand has been strong over recent quarters, with moving annual turnover (MAT) growth strengthening to 9.1% against its long-term average of 4.9% .
- With a further rise in consumer inflation to 7.3% for the September quarter, the Reserve Bank of Australia (RBA) has continued to tighten monetary policy. The cash rate was increased from 1.35% to 1.85% in August, to 2.35% in September, and once again to 2.6% in October. With the RBA returning to 'normal' cash rate increments, the pace of tightening has now slowed and it's likely the Board will soon pause to assess the impact of the tightening already implemented on the economy.
- Despite the rapid rate rises, the resilience of the Australian economy is likely to see it enter a cooling phase (rather than a recession) while other developed economies are expected to enter recessions over the next 6-12 months.

WHAT THIS MEANS FOR REAL ASSETS

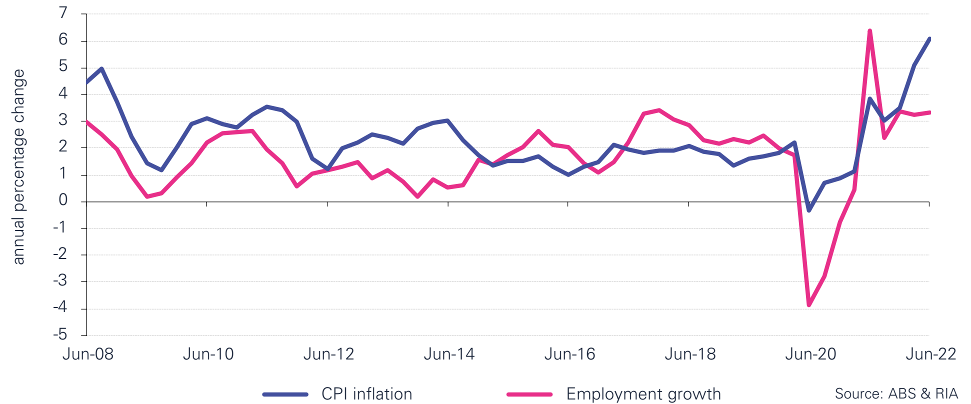
- Space market conditions: Currently, the continued strength in the economy and tight labour market are supporting occupational demand across the broader commercial property market although the office sector continues to experience sluggish demand due to impact of WFH.
- Capital market conditions: Rising interest rates will adversely affect capital market conditions across most asset classes, including real asset markets. Future commercial property asset revaluations are likely to fall, which will be reflected in a softening of capitalisation rates. Similarly, we are likely to see a mild downward revaluation of infrastructure assets as discount rates edge upwards.
- Investment performance: Investment performance for commercial property has started to moderate with total returns showing signs of softening. In contrast, infrastructure returns are less likely to be adversely affected due to their sheltered exposure to the economic cycle. However, return profiles are likely to vary markedly across investments given the wide array of infrastructure sub-sectors.

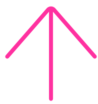
©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.
Liability limited by a scheme approved under Professional Standards Legislation.

13.6m

LABOUR MARKET REMAINS ROBUST

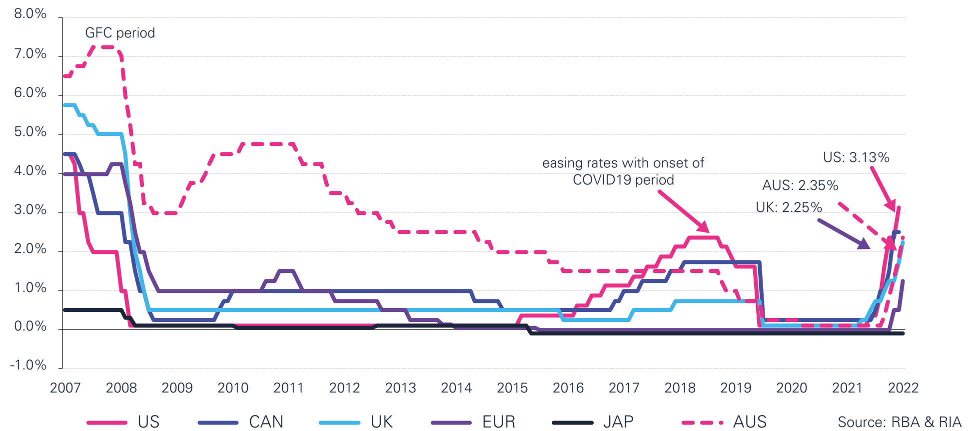
National employment remained steady at 13.6 million persons employed in September 2022, and the unemployment rate was also steady at 3.5%.

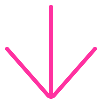




INTEREST RATES ARE ON THE RISE

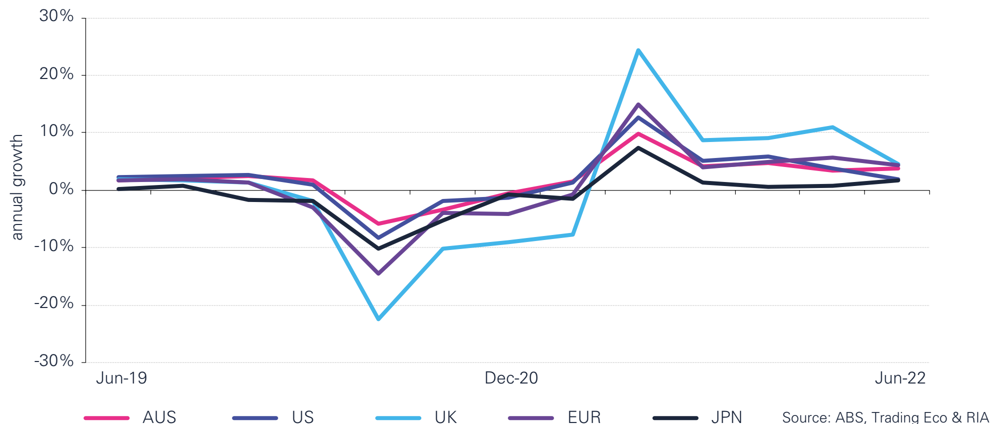
Across the developed world, we've seen official interest rates rise sharply in an attempt to quash the strong consumer inflationary pressures. Official interest rates across many economies are currently around or approaching 3.0%.





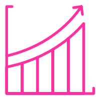
GLOBAL ECONOMIC GROWTH IS SLOWING

Global economic growth momentum across developed economies remains positive but continues to moderate. Notably, the Australian economy continues to perform relatively strongly with higher annualised growth in the June quarter than most developed economies.



©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

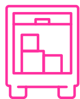


INFLATION RISK

- Entrenched consumer price inflation is likely to occur if wage rises are linked to consumer price index (CPI) increases.
- Relatively tight labour markets are likely to put upward pressure on wages due to a skilled labour shortage.
- Persistent supply-side constraints will continue to see elevated prices for raw materials.

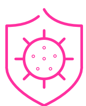
FINANCIAL RISK

- A rapid rise in market interest rates caused by central banks undertaking aggressive monetary policy tightening to control inflationary expectations.
- Corrections in asset markets. Listed equity price indices are on a downward adjustment path to factor in higher interest rates and a lower growth scenario.
- A global recession caused by slower global trade and overly aggressive monetary tightening policies across multiple countries.
- The rising cost of government debt remains a challenge, while many countries are imposing discretionary fiscal policy to rein in budget deficits.



SUPPLY-CHAIN RISK

- Supply constraints due to supply and distribution bottlenecks as economies continue to normalise post-COVID and deal with relatively tight labour markets.
- Geo-political turmoil is likely to persist with the ongoing Ukraine-Russia conflict, which is causing disruptions to food and resource markets.



PANDEMIC RISK

- The world continues to face sporadic outbreaks of virulent mutations.
- Persistent COVID-19 outbreaks in China, with limited steps to move away from zero-COVID.

SHORT-TERM OUTLOOK (12 MONTHS)

- Economic growth to slow in the coming quarters.
- The labour market will remain tight but show some softening: employment growth will slow and unemployment is expected to edge upwards.
- Consumer demand will moderate with curbs to discretionary spending.
- Housing market activity to slow and house prices decline.
- CPI inflation to remain elevated against higher market interest rates.

MEDIUM-TERM OUTLOOK (3 YEARS)

- Economic growth will revert to trend, with a recovery in construction and discretionary sectors.
- The labour market will improve with employment strengthening and unemployment falling.
- Rebound in consumer demand with stronger moving annual total (MAT) growth.
- Housing sector will enter a recovery phase with rising house prices.
- CPI inflation to hover around the upper range of the RBA target zone and an end to rate rises.
- A rebound in the share market.

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

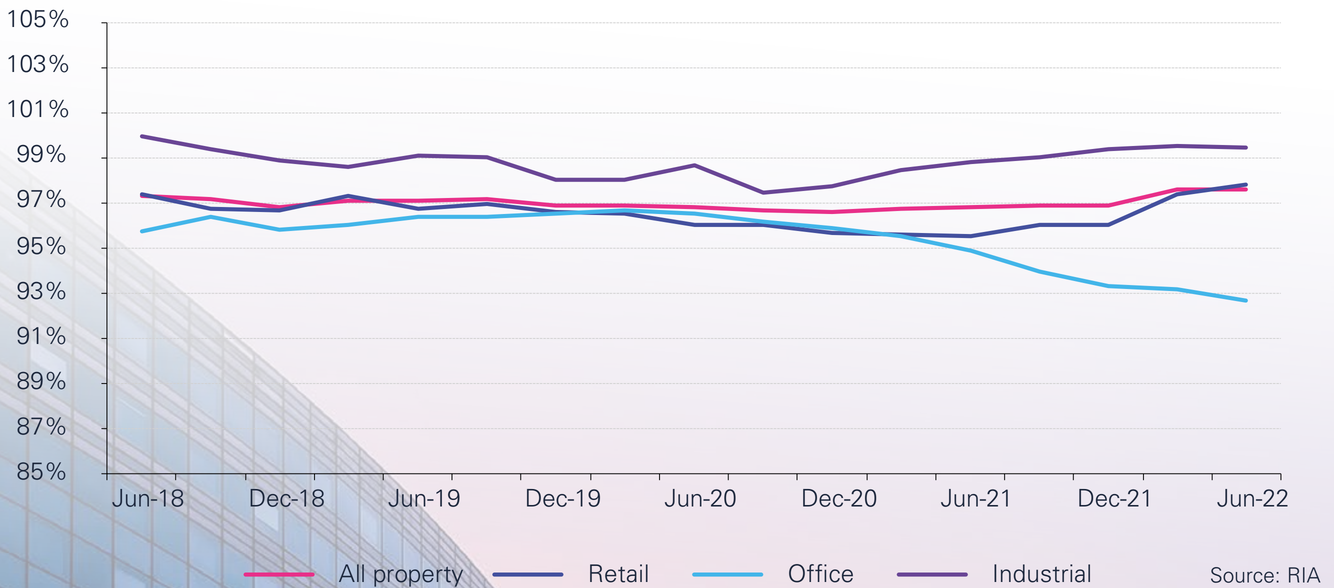
Liability limited by a scheme approved under Professional Standards Legislation.

Commercial property: key themes

SPACE MARKET CONDITIONS ARE EVALUATED BY EXAMINING MOVEMENTS IN OCCUPANCY RATES.

- Demand has stabilised over the quarter, with occupational demand supported by a strong labour market.
- While occupancy rates are steady across the total commercial property market, they differ markedly across sectors. Occupancy rates remain relatively tight for industrial property, mildly improving for retail property and softening for office property.
- Overall demand for space is likely to soften in the short-term as rising interest rates curb aggregate demand, slow employment growth and ultimately decrease net absorption of space.

Occupancy rate across property sectors
quarterly period ending Jun 2022



Source: RIA

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.
Liability limited by a scheme approved under Professional Standards Legislation.

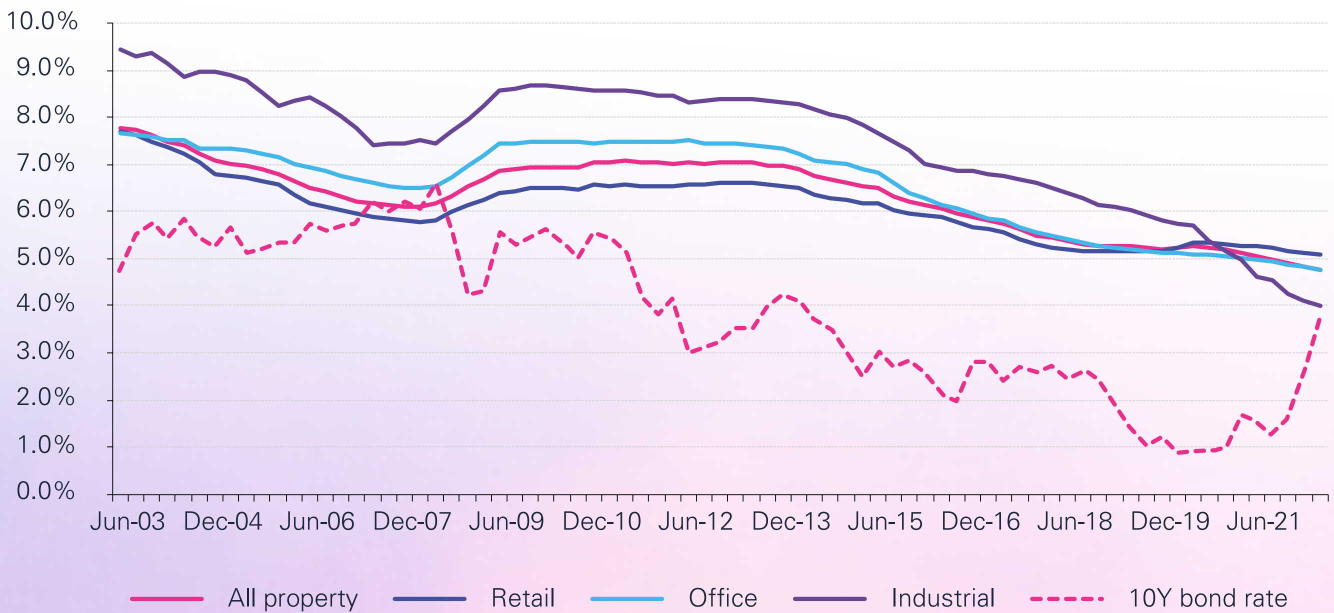
Commercial property: key themes

ASSET PRICING DYNAMICS ARE EVALUATED BY EXAMINING MOVEMENTS IN PROPERTY CAPITALISATION RATES.

- Property capitalisation rates have shown a steep firming since 2016, with the average rate across key property sectors now historically low at 4.9%.
- The current capitalisation rate for industrial property is now much firmer than that for retail and office property sectors by about 100 basis points.
- There is ongoing narrowing of the capitalisation rate-bond rate spread. Over the last 12 months, with tightening monetary policy, the 10-year Treasury bond rate has climbed sharply to sit near the industrial sector capitalisation rate.

Cap rates across property sectors

quarterly period ending Jun 2022



Source: RBA & RIA

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Commercial property: key themes

INVESTMENT PERFORMANCE IS EVALUATED BY EXAMINING PROPERTY TOTAL RETURNS.

- Recent annualised property returns show notable variations across key sectors. Industrial returns have delivered very strong absolute returns, peaking at around 30% in Dec 2021 due to a strong uplift in asset value. In contrast, both retail and office returns have posted significantly lower absolute returns, sitting below 10% and now moderating.
- The divergence in property sector returns can be traced back to 2018 with the fall-away in retail property returns caused by online retailing. And again, in early 2020 where the fall-away in office property returns was due to the onset of COVID19.

Asset property returns across property sectors

rolling annualised returns, quarterly periods ending Jun 2022

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Commercial property sector:
Office property sector

SPACE MARKET CONDITIONS:

This sector will continue to see softer demand for space as a large part of the CBD workforce continues to work from home.

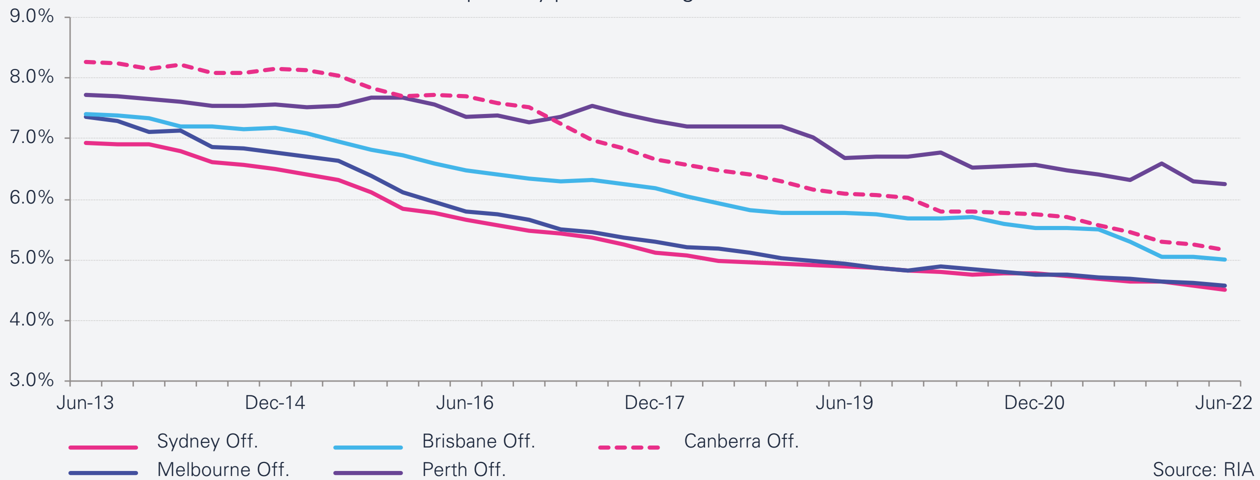
ASSET PRICING:

Office markets experienced a mild firming in capitalisation rates through 2021-22, but are now stabilising around 4.5% for Sydney and Melbourne CBDs. Capital flows remain relatively strong, and investors are focussed on high-quality office spaces with 'green' credentials.

INVESTMENT PERFORMANCE:

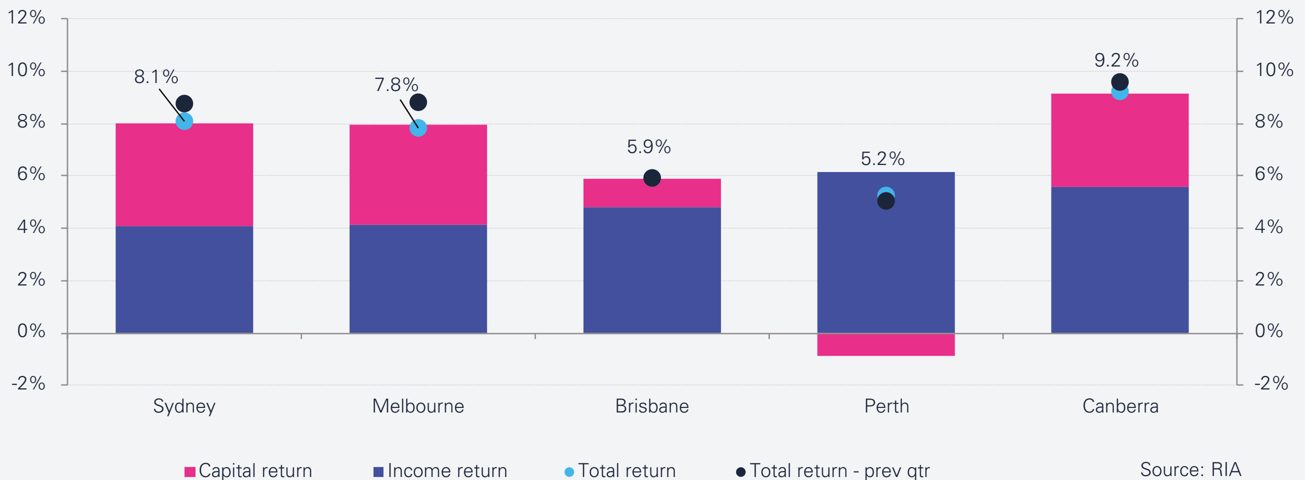
CBD markets deliver a solid total return at around 8% for the Sydney and Melbourne markets.

Cap rates across office property CBD markets
quarterly period ending Jun 2022



Source: RIA

Office property returns by CBD market
based on annualised return as at June 2022



Source: RIA

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Commercial property sector: Retail property sector

SPACE MARKET CONDITIONS:

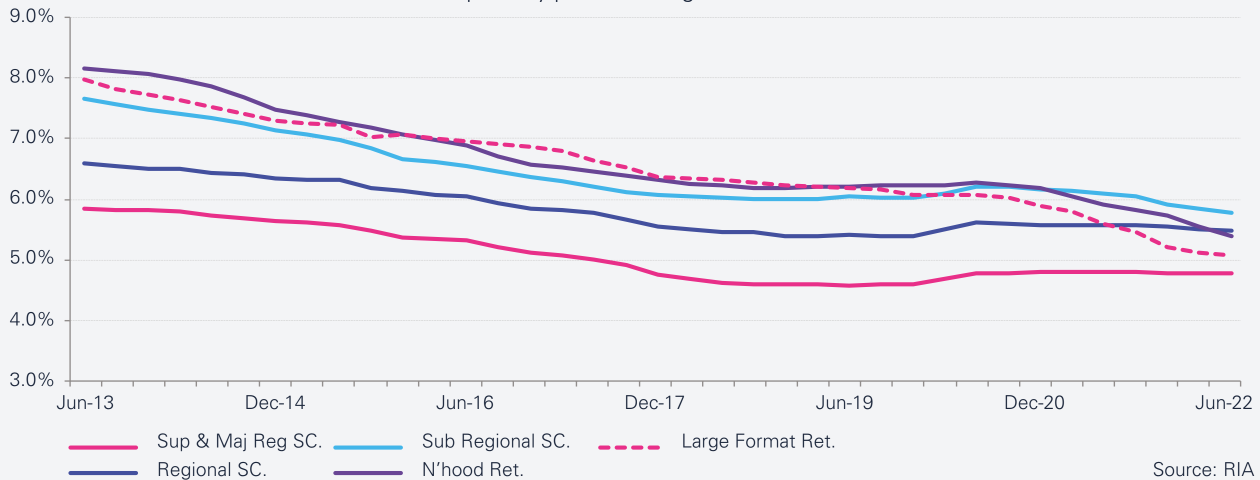
Conditions have improved as consumer spending has rebounded post-lockdown. However, the outlook for a cooler economy will soften retail spending.

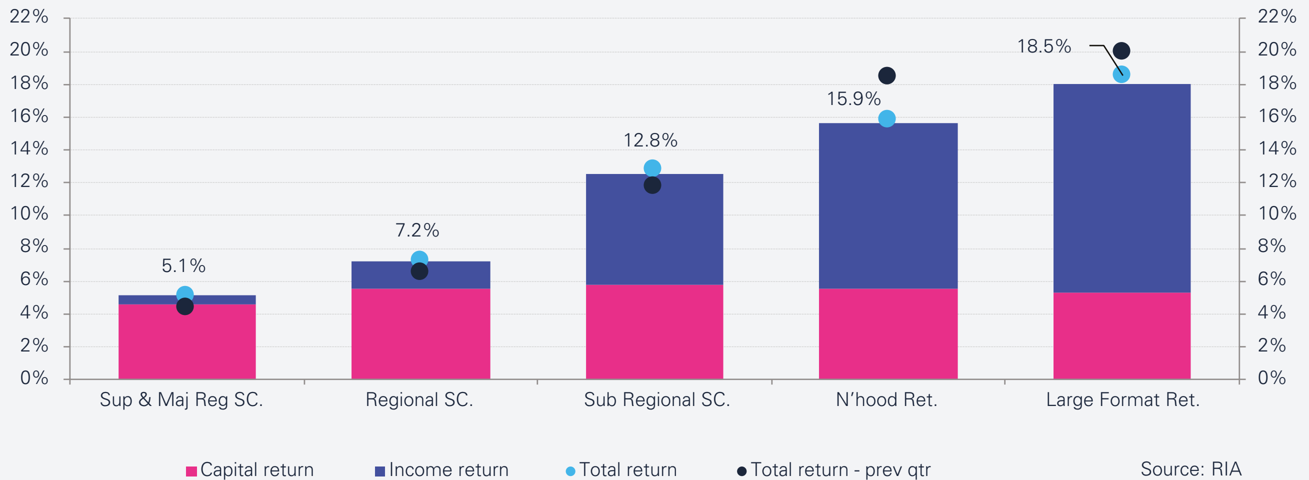
ASSET PRICING:

Capitalisation rates are stabilising for prime shopping centres (super, major regionals and regional) but continue to firm for convenience retail and large format. These segments are a sign of investors' changing risk appetites and are reflected in asset pricing.

INVESTMENT PERFORMANCE:

Total returns are strongest for convenience and large format retail, while relatively softer for prime shopping centres.





©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Commercial property sector: Industrial property sector

SPACE MARKET CONDITIONS:

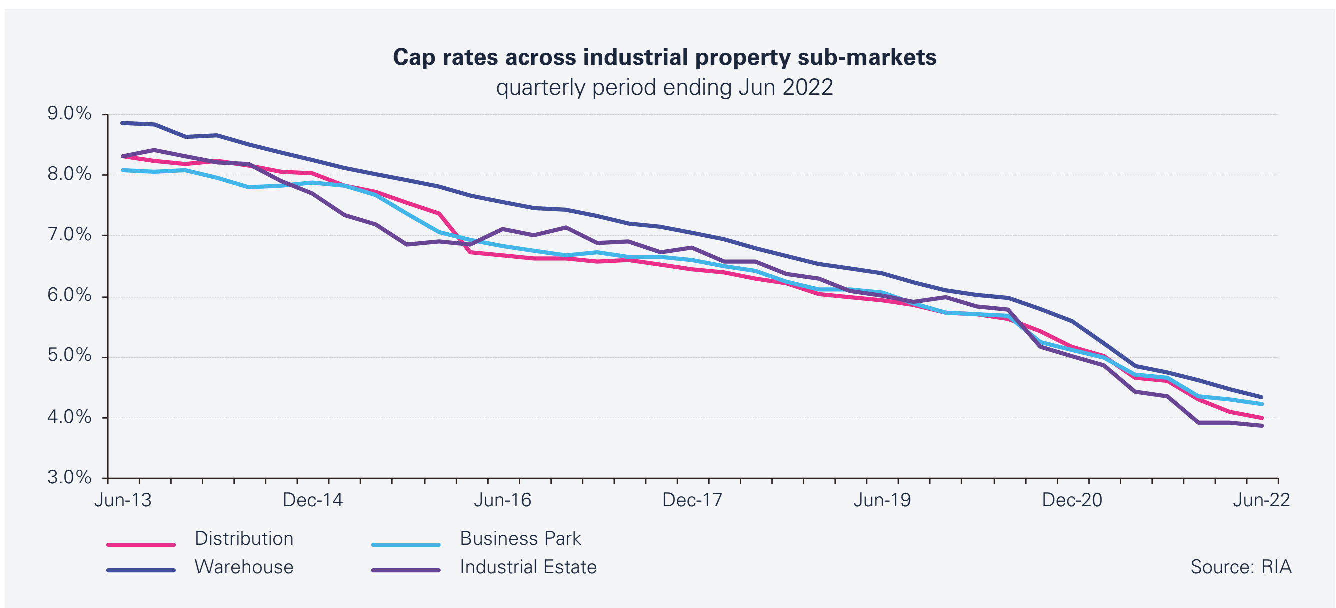
There are favourable space market fundamentals with demand out-pacing available space in this sector. Strong demand is underpinned by e-commerce and disruptions to retail sales and delivery platforms.

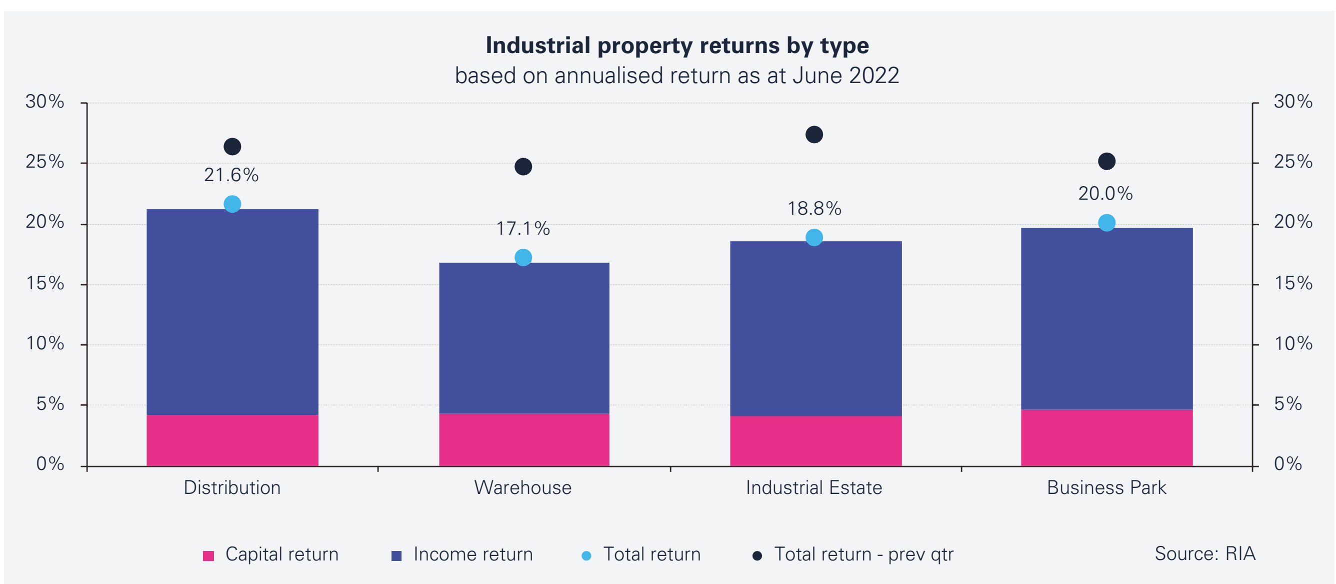
ASSET PRICING:

Capitalisation rates across industrial sub-sectors have firmed over the year and range between 4.30%-3.80%, supported by strong capital flows. The spread in capitalisation rates reflects the different risk profiles across product types.

INVESTMENT PERFORMANCE:

Total returns for industrial investments remain strong but have been moderating from their peaks in December 2021. The strong returns were due to an uplift in capital values, reflected in large capital return values.





©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Built-to-rent
Property sectors

SECTOR OVERVIEW

- The build-to-rent (BTR) sub-sector, also known as multi-family residential, is an emerging sector within the Australian commercial property market. BTR is where individual units, in typically large residential apartment buildings, are rented to residents rather than sold to individuals. Importantly, the buildings are institutionally owned by property fund managers/developers and a growing interest from super funds and other institutional investors.
- A key investment feature of this sub-sector is that the cashflow is underpinned by steady rental revenue streams, offset by maintenance costs throughout the life of the asset. It's this net revenue stream which makes the sub-sector potentially appealing to institutional investors.
- The market has experienced strong activity over recent years. Currently, 13,000 units are being built across 40 projects. Furthermore, underlying residential market conditions linked to population growth, housing affordability and household formation, are likely to support strong growth over the medium-term.
- The prospective attractive investment yield profile coupled with anticipated favourable market conditions has seen rapid growth in the number of institutional players participating in the sector over the last few years. Looking ahead, the announcement of the National Housing Accord in the October Federal Budget should further increase the flow of capital entering the sector in the medium term.

BARRIERS TO GROWTH

- Rising construction costs are viewed as a challenge for new developments. Although they are likely to be a short-term concern only, as they're due to the slowdown in the supply and availability of resources caused by Covid-19 lookdowns and rising world raw material prices.
- Availability of suitably located and priced land is considered another challenge to development as the target market for BTR developments are in areas located close to urban centres and various public and recreational amenities, depending on the demographic cohort being pursued. Expected investor returns vary between high single to low double digit returns depending on the type of product being delivered and source of capital.
- Financing for the BTR sector is still evolving. This is mainly due to the infancy of the sector and its lack of investment performance data in assessing and pricing of risk. Traditional bank lenders view the asset class in a similar manner to an "in one line" approach to residential build to sell product which generally limits the amount of debt that can be used, whereas non-bank lenders are becoming more comfortable with higher leverage levels during the construction and operational phases.
- While yield spreads to the long-term bond rate were positive over recent years, the recent rise in the bond rate has seen this spread turn negative for specific city markets. However, this may be partly offset by the normalisation of rental yields as apartment prices retreat and rental growth strengthens.
- Australia's tax rules have acted as a significant barrier to entry for institutional investors looking to develop BTR. Relative to commercial property, BTR is subject to the higher rates of tax associated with residential properties. This had made BTR returns less appealing compared to other commercial property sectors.

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Infrastructure market: Infrastructure investments

- Infrastructure is another key asset class within the real asset space. Similar to property, infrastructure has seen strong growth since the onset of the global financial crisis, viewed by institutional investors as a risk diversifier in standard 'balanced' investment portfolios. As such, the asset class has seen not only strong growth in capital flows due to increased target capital allocations, but also increased available products caused by increasing population demand for infrastructure services.
- Investments within this asset class are typically grouped into four main sectors: transport, energy and utilities, communications and social infrastructure - as shown in the table. However, like property, these investments can be very diverse across the sub-sector, providing wide-ranging risk-return attributes.

Importantly, investing in infrastructure not only increases the investor's opportunity set but its diversity of investments makes infrastructure attractive to a broad range of investors with varying risk appetites. What's more, social infrastructure overlaps with commercial property's alternative sectors. And it's via this pathway, that we see property fund managers expand their opportunity set.

- One interesting distinction between infrastructure and commercial property investments is the longer lease profiles in infrastructure. This, in conjunction with their more predictable demand for their services and partly regulated income streams, these assets are likely to perform better through cyclical market downturns.

Infrastruture sectors & sub-sectors

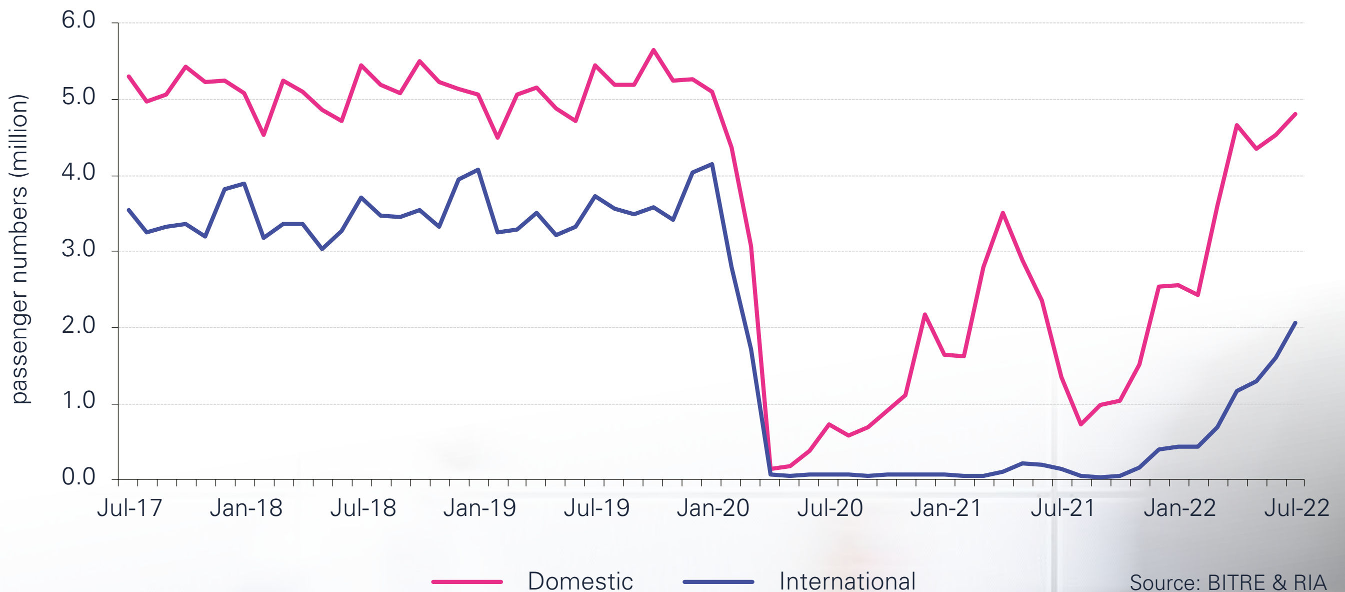
	SECTOR			
	TRANSPORT	ENERGY & UTILITIES	COMMUNICATIONS	SOCIAL INFRASTRUCTURE
SUB-SECTORS	Toll Roads Airports (passenger & cargo) Bridges & Tunnels Seaports (Marine Terminals) Rail (passenger & freight)	Power Generation (Eletricity & Gas) Power Transmission / Distribution Renewable Power Water (includes water management) Waste management	Telecommunication (TV / Radio) transmission stations Power Transmission / Distribution (Fibre networks) Satellites	Aged Care Carparks Childare & Early Learning Education facilities Medical facilities (public hospitals) Sport, Recreational & entertainment Facilities Judicial & Corrective Services Facilities Social Housing Student Accommodation

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Infrastructure market: Airports sector

- The airport industry is a major sub-sector within the transport sector, with a much higher allocation due to its core-plus investment style features. The airport sector's core return attribute is underpinned by a combination of steady demand linked to population growth and an enhanced return profile linked to discretionary travel and retail spending at airports.
- With the onset of COVID19, airport investment performance was adversely impacted due to a decline in domestic and overseas travellers. This is highlighted in the figure below where the number of passengers flying on domestic and international commercial flights dropped to almost nil thanks to flight bans. In contrast, passenger activity has surged significantly with the easing of lockdown restrictions late last year. This should see airport revenue streams improve markedly and be reflected through strengthening investment returns.



Source: BITRE & RIA

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.
Liability limited by a scheme approved under Professional Standards Legislation.

Deep dive

The residential property market cycle and its impact on the macroeconomy

- The residential construction and property sectors are a key driver of economic activity due to the depth of their supply chain linkages through the economy.
- The cyclical upsurge in residential construction activity and residential prices during the pandemic is due to a combination of rising demand (particularly for detached houses, the accumulation of savings during the pandemic, the government's HomeBuilder initiative and low mortgage lending rates.
- Despite a tight labour market and solid household balance sheets, the rise in interest rates will create a moderate downturn in the residential market, in terms of lower housing market churn, slowing construction activity and retreating asset prices.
- Work under construction remains at historical highs, with supply unable to keep up with demand. Developers are facing a perfect storm of cost pressures. Construction material supply chain disruptions and global shortages coupled with a lack of available skilled workers domestically have driven up input costs. Fixed price contracts are making it hard to pass these on to customers.
- The adverse income and wealth effects from a downturn in the residential sector will lead to softer economic growth via negative wealth effects. At an aggregate level the impact on spending is small, but for big ticket discretionary items (e.g. cars) the impact is more pronounced.

The residential sector is a key driver of the Australian economy. New dwelling construction activity is linked to 100,000s of jobs and billions of dollars of activity, and the established housing market is also a major driver of the economic cycle. Overall, it provides an insight into the state of the broader economy due to the positive income and wealth effects when housing market construction activity is buoyant and asset prices are rising.

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Established housing market

Over recent years, the residential property market has experienced buoyant conditions, underpinned by historically low mortgage rates, an increase in demand for living space (particularly detached houses), and strong income growth, with the unemployment rate falling to 3.5%.

As a result, prices for houses and other dwellings have risen sharply in recent years, with houses very definitely leading the way. As shown in *Figure 1A*, the national average property price has risen by 34% since June 2020, with the pace of annual growth peaking at around 25% pa in December 2021. The historically unprecedented shift in preferences towards detached housing is also clear. The average price for free-standing dwellings across major cities has increased by 28% since June 2020, with apartments lagging well behind (+3.3%). Across state markets, price growth has also been strong but varies markedly, as shown in *Figure 1B*.

Figure 1A
Trends in residential dwelling prices for Australia

Mean prices, quarterly periods ending Jun 2022

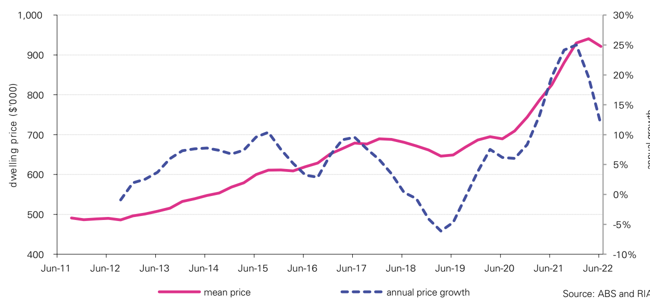
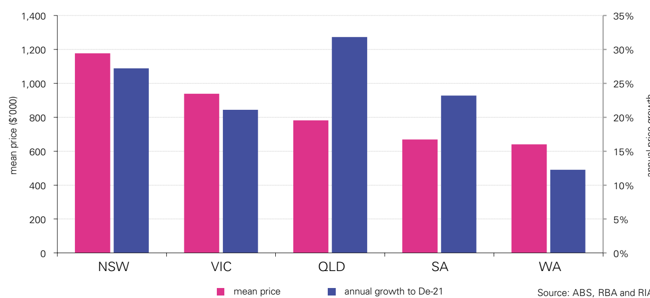


Figure 1B
Residential mean property price versus annual price growth

as at Jun 2022



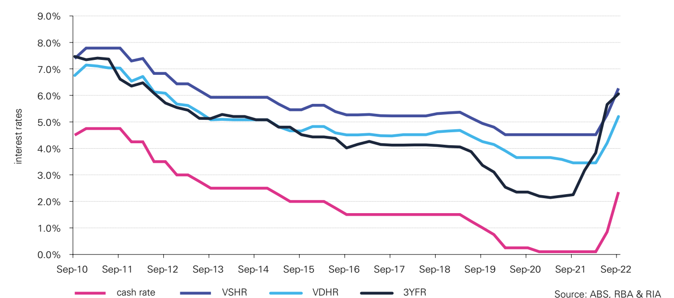
The relatively cheap cost of borrowing is a key driver of the buoyant activity in the residential sector over recent years. As shown in *Figure 2*, with the onset of COVID19, the RBA dropped the cash rate to just 0.10% by November 2020. Further support was provided to the banking system through the Term Funding Facility (which provided $188bn to domestic banks at cash rate-equivalent borrowing rates) and forward guidance, which depressed broader domestic borrowing costs.

Collectively these monetary supports prompted a fall in mortgage rates, which saw both variable rates (i.e. the variable standard housing rate (VSHR) and variable discount housing rate (VDHR)) and fixed housing rates (i.e. three-year fixed rate (3YFR)) fall to historical lows. Fixed rates in particular fell sharply, to below the average variable rate faced by households, as a result of local banks locking in cheap funding rates over the near-term.

Lower lending rates saw a dramatic upsurge in growth for home lending, both for owner occupier and investors. This was quickly followed by actual increases in the cash rate (and the end of other aspects of the RBA's COVID supports), which have increased borrowing rates sharply – average fixed and variable rates have now risen above their pre-COVID levels. This shift has been a major driver of the current downturn in property prices, and with the RBA signalling further increases in the cash rate – KPMG expects a cycle peak of 3.35% to be reached in early 2023 – the cycle has further to run. Average prices have already declined by around 5% since March 2022 (almost 10% in Sydney), and a further decline of around 10% is expected nationally over the next twelve months.

Figure 2
Movements in the cash rate and various housing rates

quarterly periods ending Sep 2022



©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

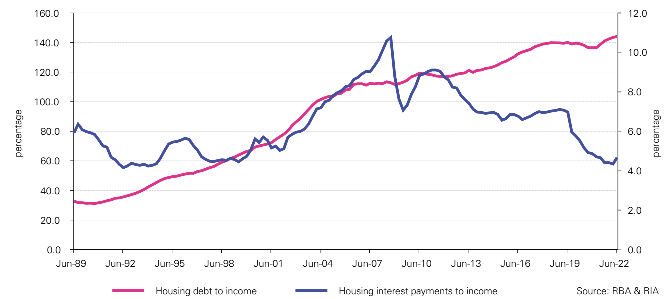
Real economy impacts

Such a significant increase in borrowing costs and asset price correction raises the risk of real economy spillovers that go beyond the impact of lower churn levels in the market. While there are concerns about the ability of households to service debt with rising rates, household balance sheets point to a strong debt situation with the current high savings rates and low debt servicing costs to household income. The lower debt servicing ratio with historically high debt levels is highlighted in *Figure 3.*

The impact of rate rises on household budgets will take time to materialise and is heavily influenced by the prevalence and timing of fixed mortgage rates. It will be late 2023 before the full effect is realised. Household spending is also influence by wealth effects – rising dwelling prices typically buoy consumption, while market corrections dampen momentum. However, this channel is narrowly focused on big ticket consumer durables, such as motor vehicles and household goods, so overall, the impact on spending is likely to be modest.

Figure 3
Household debt versus debt servicing

quarterly periods to Jun 2022

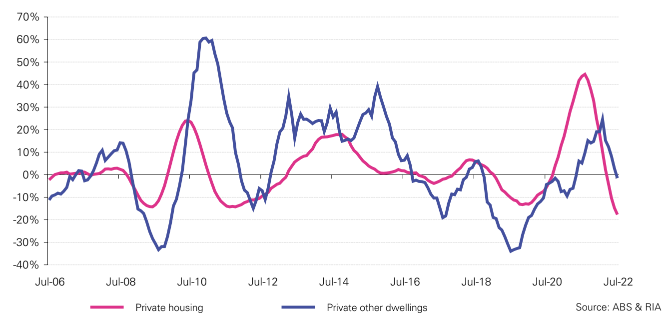


Spillovers to residential construction activity

Focusing on new residential construction, *Figure 4* shows the historical annual growth profile of private dwellings. Clearly, the sector experienced a strong spurt of demand between late 2020 and 2021, partly supported by the Federal Government's HomeBuilder policy initiative directed at owner-occupiers (including first home buyers). However, activity over the recent quarter is now moderating sharply with annual growth for private housing approvals falling from a peak of 44.5% in Aug 2022 to show an annual contraction of 17.5% in July 2022. A similar experience is playing out across state markets, including NSW, VIC, QLD and WA. The fall in approvals is now flowing through to construction activity, with commencements of new private houses declining by 16.9% over the year to March 2022.

Figure 4
Number of private dwelling approvals

rolling annual growth on MA, monthly periods ending Jul 2022



©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

The fall in new dwelling approvals would typically weigh heavily on actual construction activity, but there's still a substantial pipeline of work yet to be done from the previous upturn – the combination of rising costs, flood disruptions and supply chain delays has created a substantial backlog. This pipeline of work will soften the cycle and give the sector time to 'catch-up'. For instance, *Figure 5A* shows the number of dwellings under construction reached a record high of 240,000 in March 2022. This increase was driven by both private sector houses and other attached dwellings.

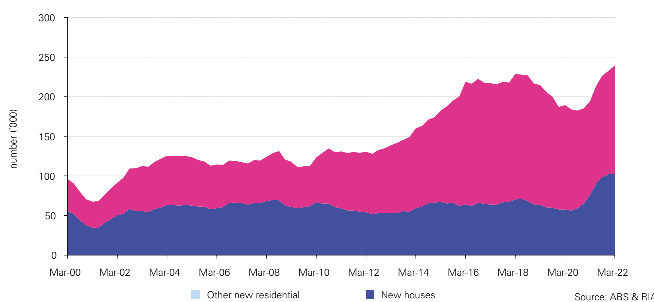
On the other hand, input costs remain well above the prices factored into contracts signed in 2020 and the first half of 2021, and ongoing supply chain delays are presenting significant headwinds. This is highlighted in *Figure 5B,* showing that over the twelve months to June 2022 input prices to housing construction have risen by 17.3%. The main contributors are the increased raw material timber and metal prices.

Looking ahead, KPMG expects the pace of input cost inflation to fall back – many material costs such as timber and steel have fallen sharply this year. But the price level is not expected to return to pre-COVID levels, and developers will continue to face a margin squeeze in the near-term.

Long-term demand for housing will continue to grow robustly, which will underpin valuations and new dwelling activity. In addition to the natural increase in the local population, the recent announcement by the federal government to increase the permanent migration program planning level to 195,000, will provide a medium-term boost, particularly if it's maintained beyond FY2022/23.

Figure 5A
Dwellings under construction

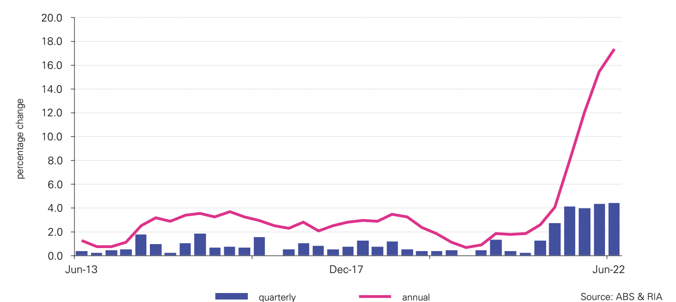
quarterly periods ending Mar 2022



Source: ABS & RIA

Figure 5B
Input prices to house construction

quarterly periods to Jun 2022



Source: ABS & RIA

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Contact us

Nigel Virgo
National Sector Lead – Property, Construction & Logistics
T: +61 2 9335 7156
E: nrvirgo@kpmg.com.au

Sarah Hunter
Economics
T: +61 2 9245 4754
E: sarahhunter@kpmg.com.au

Peter Zabaks
External Audit
T: +61 2 9455 9214
E: pzabaks@kpmg.com.au

Nicola Woodward
Property & Environmental Services
T: +61 7 3237 5501
E: nicwoodward@kpmg.com.au

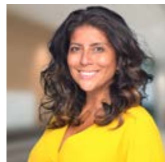
Ryan Eagle
Restructuring services
T: +61 2 9458 1559
E: ryaneagle@kpmg.com.au

Hoda Nahlous
Legal
T +61 2 9455 9315
E: hnahlous@kpmg.com.au

Mark Spicer
Sustainability
T: +61 2 9335 8020
E: markspicer@kpmg.com.au

Scott Farrell
Tax
T: +61 2 9335 7366
E: spfarrell@kpmg.com.au

Tony Moussa
Real Estate Capital
Tel: +61 2 9455 9842
E: tonymoussa@kpmg.com.au



Marcella Ugaz
Enterprise
T: +61 2 9335 8893
E: mugaz@kpmg.com.au

Jeff O'Sullivan
Risk Assurance and Internal Audit
Tel: +61 2 9335 8336
E: josullivan@kpmg.com.au

Jayne Parish
Operational Transformation
T: +61 2 9455 9439
E: jparish@kpmg.com.au

Mike McCloskey
Project Controls
T: +61 2 9295 3840
E: mccloskeym@kpmg.com.au

Paul Morris
Real Estate Advisory
T: +61 7 3233 9420
E: pmorris2@kpmg.com.au

Tom Eade
Transaction Services
T: +61 2 9455 9344
E: thomaseade@kpmg.com.au

Brett McAuliffe
Valuation
T: +61 7 3233 9462
E: bmcauliffe@kpmg.com.au

KPMG.com.au

RIA **Real Investment Analytics**

T: +61 438 506 284
E: Anthony.defrancesco@realinvestmentanalytics.com.au

The information contained in this document is of a general nature and is not intended to address the objectives, financial situation or needs of any particular individual or entity. It is provided for information purposes only and does not constitute, nor should it be regarded in any manner whatsoever, as advice and is not intended to influence a person in making a decision, including, if applicable, in relation to any financial product or an interest in a financial product. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

To the extent permissible by law, KPMG and its associated entities shall not be liable for any errors, omissions, defects or misrepresentations in the information or for any loss or damage suffered by persons who use or rely on such information (including for reasons of negligence, negligent misstatement or otherwise).

©2022 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

November 2022. 960073624EMP