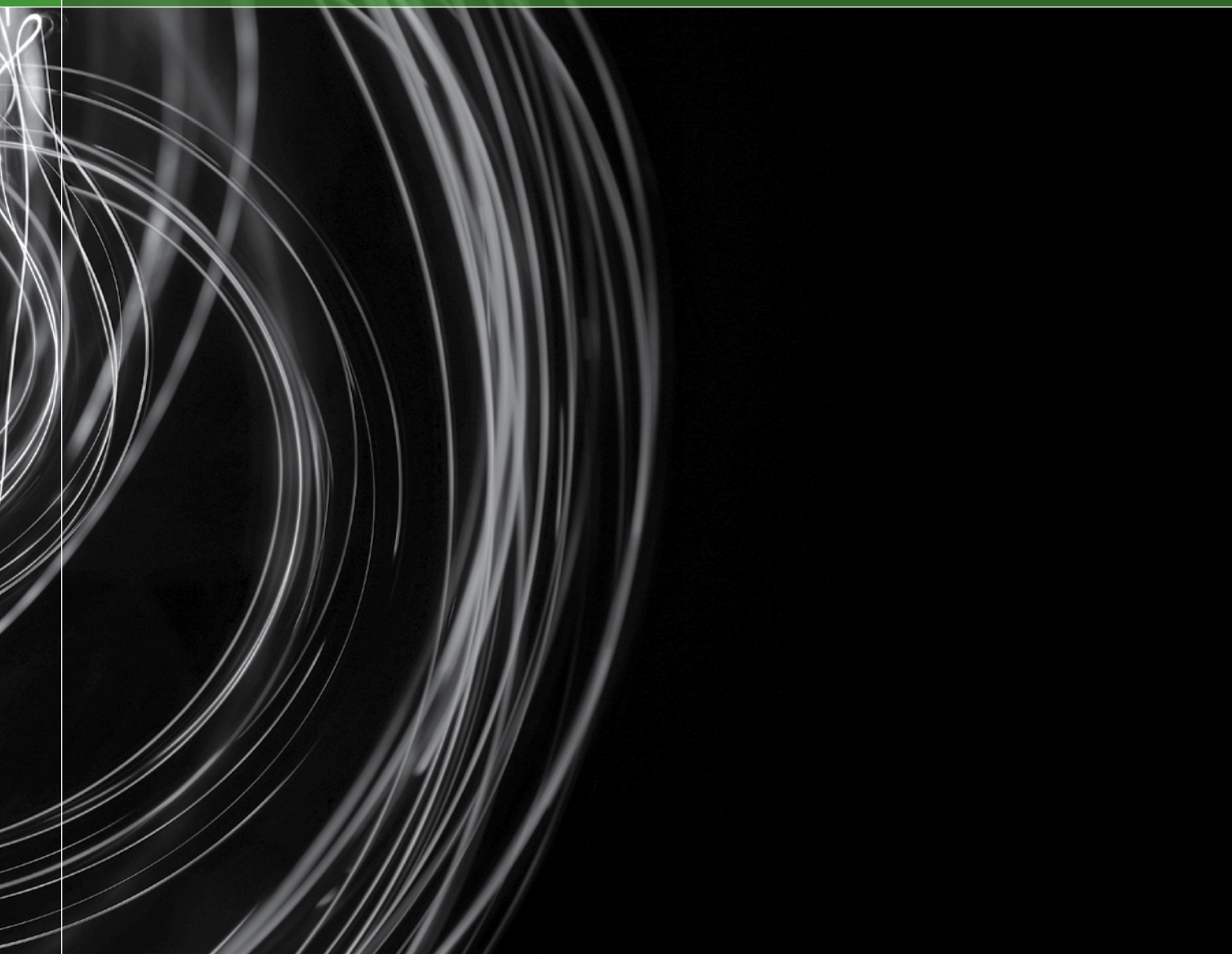


Market Focus 2010

MACQUARIE RELATIONSHIP BANKING
EXECUTIVE SUMMARY



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Managing shorter, sharper business and investment cycles

Australia has emerged in relatively good shape from the global financial crisis. But the dynamics of the global economy have shifted and business cycles are becoming shorter and sharper. This volatility is affecting consumer and business confidence, and will determine Australia's future economic performance.

How will these global economic changes impact the commercial and residential property market, and how can your business maximise the opportunities available?

At our recent Market Focus events around Australia, Richard Gibbs, Global Head of Economics at Macquarie Economics Research, outlined the likely scenario that the Australian economy will see shorter business cycles over the next few years. Rod Cornish, Real Estate Strategist at Macquarie Capital Advisers, then discussed the implications of future forecasts on local markets.

How will these global economic changes impact the commercial and residential property market, and how can your business maximise the opportunities available?

Global growth ahead, but not as we know it

As we enter the second half of 2010, it's clear that the balance of power has shifted in the global economy. Over the past six months, the growth paths of major economies have become increasingly divergent. Many developed economies are yet to enter a recovery phase, and the UK, Spain and Greece are facing high levels of public debt and concern over sovereign risk.

"Global GDP growth is expected to be at least four per cent during 2010, but its composition will be quite different to recent years," says Richard Gibbs. "Public spending and inventory rebuilding will be at the forefront of activity, rather than consumer spending and services. In developed economies, industrial production, exports, infrastructure and hard assets will dominate."

Countries that supply emerging economies with their commodities, such as Australia, Canada and Brazil, are expected to lead the growth table in 2010.

Regulatory reform, particularly in the financial sector, and increased public investment in infrastructure, suggests that the State will also play an increased role in managing markets.

A three-speed world

The power behind economic growth has shifted from west to east. Australia, China, South-East Asia, Hong Kong, Japan, Korea and Taiwan are all at the top of the growth table. Brazil, New Zealand, Canada, the US and strong Euro economies such as France and Germany are in a mid-cycle acceleration phase. Other Euro economies, including Greece and Portugal, and the UK and South Africa are still struggling to maintain an upswing (see Figure 1).

Developing economies, primarily China, are expected to fuel the bulk of global GDP growth over the next two years. China and India, and other developing economies, are currently contributing 74 per cent to the rate of global growth.

Meanwhile, investors are concerned with the sovereign risk in countries burdened with debt. Richard describes the UK, US, Greece and Spain as lying in the 'ring of fire' of sovereign debt risk. "These countries will define capital funds investment as we move forward."

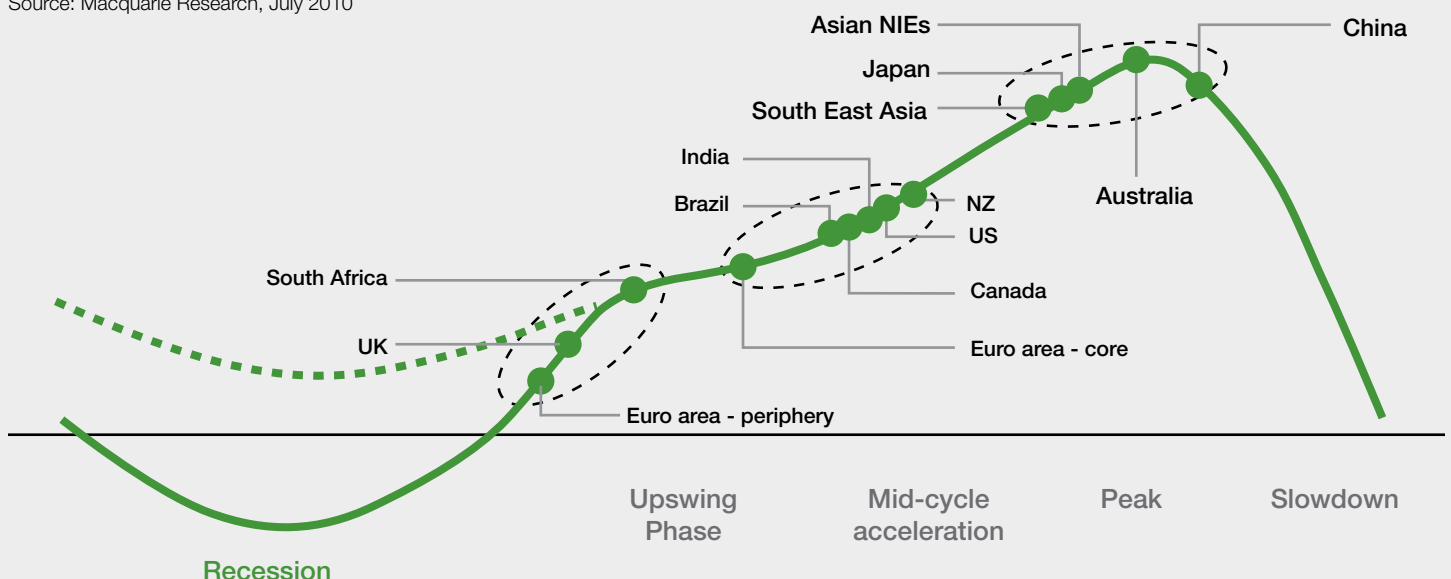
Although investor confidence is not as low as experienced following the collapse of Lehman Brothers in 2008, many are weary of ongoing volatility in equity markets. They may be more willing to engage with risk, but are still concerned with preserving capital.

The power behind economic growth has shifted from west to east.

"Essentially, the financial crisis transferred high levels of debt from the private sector to the public sector, and this is especially clear in the UK and US," he says. The UK is facing a deficit of £163 billion, equivalent to 11.5 per cent of GDP. "Public sector spending cuts needed to service this debt will constrain spending on education, health and other essential services, and could put the UK economy into a tailspin."

Figure 1: Economic growth rate

Source: Macquarie Research, July 2010



The local impact of growth

“The key thing that will determine future growth is the capacity of economies to grow internally - the capacity of households and businesses to spend.” says Richard.

“Following an economic downturn, the residential property market is usually the first to pick up.”

Australia’s level of public debt, in comparison to other developed economies, gives us ample opportunity to grow internally. As business investors start to take measured risks, confidence will stabilise.

Australia will grow over the next year. But there is little spare capacity in the employment market to sustain increased activity.

Staffing costs may rise. New housing construction is not keeping pace with rapid population growth, placing additional cost pressures on housing – especially in Sydney. “Net migration growth, and an increasing number of single person households, means we simply need more housing stock.”

Although interest rates are not expected to rise significantly, following the most recent CPI result, mortgage rates are already now at levels that could impact household confidence and spending. “New mortgage holders are already at a payment pain threshold, and further cash rate rises will place pressure on household budgets,” says Richard.

Yet a recent consumer sentiment analysis shows that consumers still believe that property and banks are the best use of savings. In fact, the number of respondents with a preference for bricks and mortar grew in the last quarter (see Figure 2).

Balancing future risks

“It’s highly probable that we’ll see a return of shorter business cycles globally,” says Richard. “Fragile business and consumer confidence, volatile asset markets and commodity prices and higher official cash rates will determine the growth paths of major economies, and those growth paths will be increasingly divergent.”

He also presented three other scenarios, with lower probabilities.

“There’s also a smaller chance that growth will flatline, along with deflation. Stagnant asset markets, deflating commodity prices and depressed business and consumer confidence would result.”

Optimists may believe in a ‘stronger for longer’ scenario. “Strong above-trend growth, buoyant business and consumer confidence, and rising commodity prices. Nice to have, but only about a 10 per cent chance of occurring.”

Pessimists may be more concerned with a return to global risk aversion – again, Richard gives this a 10 per cent probability rating.

Implications for the Australian property market

We’re also seeing these shorter, sharper cycles in the property market. The time lag between indicators and actual events is shorter, so it’s increasingly important for investors, buyers, sellers and agents to move swiftly.

“Following an economic downturn, the residential property market is usually the first to pick up, and we’ve already seen growth in China, Singapore, Hong Kong, Australia and California in the residential property market,” says Rod Cornish (see Figure 3).

Variability in the Australian market

Until 2004, residential market growth by state was reasonably synchronised. We’re now seeing greater variability between state markets.

“Locally, our view is that affordability in Melbourne is at a tipping point and prices have peaked,” says Rod. In the past 12 months Melbourne residential prices grew 27 per cent. Sydney prices grew 16 per cent, but this followed a five to six year period of falling and then flat prices. Perth price growth peaked in 2007 as the market hit an affordability ceiling and prices have rebalanced since that time. Brisbane house price growth has been subdued recently as a result of reduced affordability and slower state economic growth.

Affordability, migration, interest rates and economic growth drive the Australian residential markets.

Figure 2: Consumer sentiment - wisest place for savings

Source: Westpac M.I, Macquarie Research, July 2010

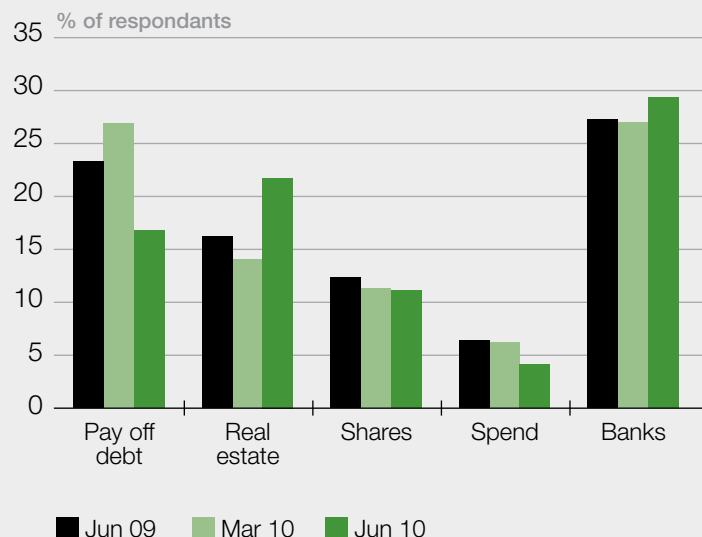
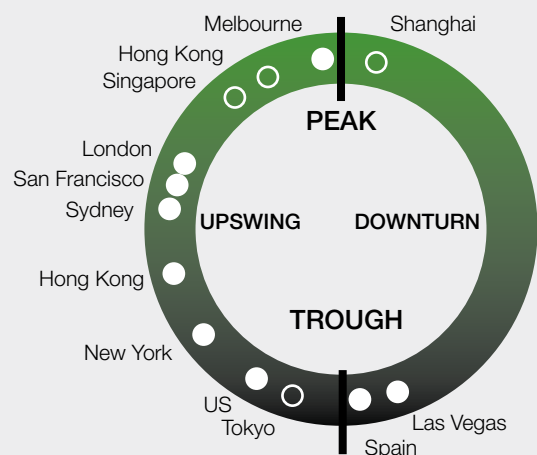


Figure 3: Residential markets

Source: Macquarie Real Estate Strategy



Key drivers for housing prices

Affordability, migration, interest rates and economic growth drive the Australian residential markets. While affordability improved in early 2009 with lower interest rates and the increased First Home Owners Grant, it has now dropped. The impact, though, varies city by city. In Melbourne, once mortgage repayments as a percentage of household income reach 40 per cent, house prices tend to fall - Melbourne is now approaching this level. Sydney has not reached its tipping point, although the shift in affordability is sufficient to soften housing demand.

Yet demand still outstrips supply in Sydney, where net migration is still strong (although off its peak) while housing construction is at a 30 year low. New building approvals have remained stagnant in Sydney while in Melbourne, building levels are above record highs. "Developable land is more tightly held in Sydney," explains Rod. "Also, those Melbourne projects were funded prior to the GFC. Development financing is harder to obtain today."

Where will your business growth come from?

Rod predicts a flattening of house prices in Sydney and price falls in Melbourne. Excess demand persists in most residential markets, but by 2011 annual supply may just outstrip demand in Melbourne.

"As rates have increased, first home buyer demand has lessened substantially. Investors are back, but they're looking at affordable opportunities. And they're increasingly looking beyond their own backyard."

Investors are more mobile, searching for properties in other states where they see stronger growth potential and higher yields. "Access to property information, online or in magazines, has made this a viable option for investors."

If this is the case, where will your business growth come from?

"In the medium-term, migration-led demand will continue to drive the price cycle in a number of cities once rates stabilise, although some markets will need to rebalance further" concludes Rod. "Debt funding is a major hurdle for developers and will remain tight for at least two years. After this rebalancing period, there should be opportunity for investors looking for medium to long-term growth, especially at more affordable price points in markets where supply is still low."

Commercial property reflects capital market volatility

Global Real Estate Investment Trusts (REITs) are showing signs of recovery in line with US financial share prices.

In the Australian commercial office market, tenant demand has risen over the past nine months. Real Sydney and Melbourne office rents are at cyclical lows and these markets are in an upswing, although equity markets and business conditions continue to impact commercial real estate demand, and there is currently volatility in these markets.

Looking ahead, these cycles should push out and yields should firm during the next three to four years. The eastern states are the focus of investors and should deliver the best opportunities for growth here.

In the retail market, sub-regional centres should also benefit from a firming of yields over a two to three year time frame, particularly those centres with potential for new development or upgrades. The focus for industrial investors is on prime logistics sites and major transport hubs, in line with predicted growth from commodity exports.

Position your business for the future

In an increasingly volatile market, acting quickly is essential – and good cash flow management will be key.

To help ensure your business is in a position to take advantage of growth opportunities in Australia, as well as for the possibility of increased staffing and borrowing costs, talk with your Macquarie Relationship Manager.

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