WA MONTHLY
JUNE 2018

REQUIEM FOR A CONSTRUCTION BUBBLE

LEADING AUSTRALIAN INDICATORS & THEMES
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REQUIEM FOR A CONSTRUCTION BUBBLE

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EXECUTIVE SUMMARY

In our experience, too many analysts take their cues from metrics such as the unemployment rate and inflation figures. While these figures are important, they tend to be lagging indicators and as such are of limited value when trying to anticipate future trends, generate trade themes, or make informed asset allocation decisions.

In this month's report, we have isolated two of the leading indicators in Australia's economy, namely building approvals and money growth, and highlighted some key themes arising from our findings. Our analysis is independent and takes account of evidence through liaison with industry contacts, combined with data.

The market has generally been positive about recently reported data. Commentary has often focused on strong employment growth and the ongoing budget repair, which has seen the deficit narrow to the lowest level since April 2009 at just $12.1 billion or 0.7 per cent of GDP[1] maintaining Australia's AAA-rating.

However, strong employment growth in 2017 and the rolling budget deficit as taxation revenues have increased are backward-looking. Instead, we look towards trends such as jobs advertisements, which are now showing signs of softening after 17 consecutive gains and a 31 per cent increase from the cyclical nadir, and money growth which is slowing[2]. Key findings are as follows:

Housing credit growth has slowed: Housing credit growth has slowed significantly and may be expected to slow further as a result of tighter lending standards and findings arising from the Royal Commission into Misconduct in the Superannuation, Banking, and Financial Services Industries ("Royal Commission"). Deposit growth and broad money growth have declined to 25½ year lows[3]

Housing market investor activity slowing: Our liaison with mortgage brokers shows that investor activity is expected to be considerably slower in H2 2018 than it was a year earlier. Major banks are at risk of losing market share to non-bank lenders and intermediaries

Dwelling prices now in decline: Dwelling prices in Sydney are now rolling over, with Melbourne set to follow, and a potentially negative impact expected on household consumption. Dwelling prices have already been in a multi-year decline in Perth and Darwin, and Brisbane apartment prices have also declined, significantly so in some cases

Detached house approvals robust: Building approvals are still tracking at reasonably robust levels, especially for detached houses, driven by strong population growth and demand in Greater Melbourne and Greater Brisbane

Apartment construction to fall sharply: We have significant evidence to show that new apartment projects are struggling to get finance approved, and therefore total residential construction is expected to slow in H2 2018. Dwellings approved but not yet commenced have already increased to the highest level on record, driven by apartment project approvals

Apartment defaults rising: Liaison with industry contracts indicates that settlement defaults for some of the major developers have increased, particularly in relation to offshore buyers. The resale market is considered healthy enough at this juncture for most developers not to be materially impacted, however there is a strong likelihood that residential construction activity will now fall

Employment growth to fall: Construction now directly employs just under 1.2 million persons in Australia, recently capturing a record high in absolute terms and at 9.6 per cent of employment the construction sector is at its most bloated in approximately a century.[4] About ¾ of construction jobs are accounted for by the residential sector.[5] There is significant potential for employment growth to slow sharply over the next 12 months

IMPLICATIONS AND TRADE THEMES

Key implications and trade themes are as follows:

Yield curve to flatten: Futures markets imply that rate hike expectations should be scaled back or pushed out to at least H2 2019 or beyond

Wealth effect and construction multiplier to fade in Sydney and Melbourne: There appears to be a danger that declining dwelling prices will negatively impact dwelling commencements, household consumption, and demand for some classes of household goods

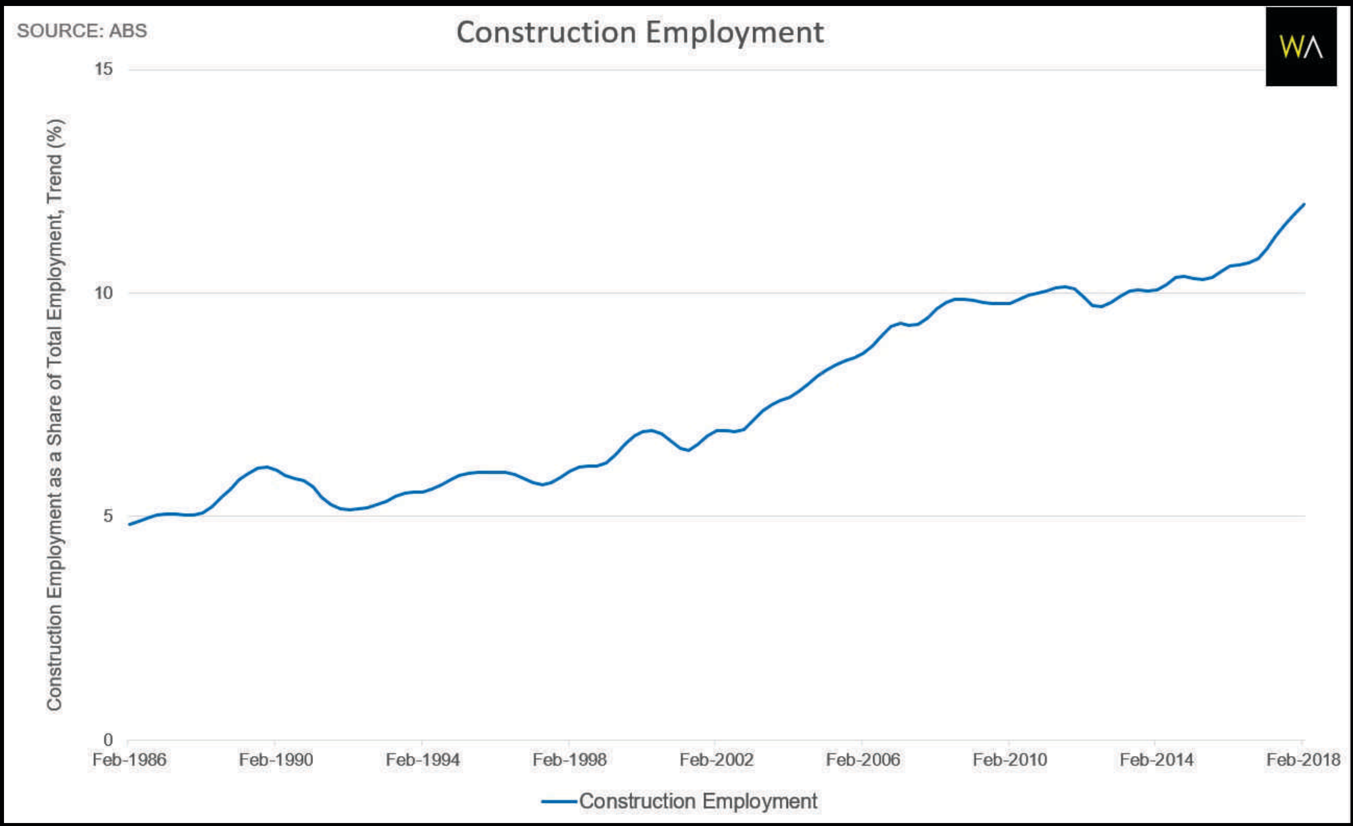
Settlement defaults rising: Developers are reporting rising settlement defaults. It is unclear at this stage how significant this will prove to be, but the trend should be monitored carefully

Materials demand solid but should be watched carefully: Materials companies have delivered strong returns to fund managers since Q1 2016, but exposure should be carefully monitored and managed in H2 2018 and beyond. Although a range of significant infrastructure projects should keep demand robust and detached house approvals are rising in Melbourne and Brisbane, the residential sector is set to slow significantly as the apartments pipeline shrinks

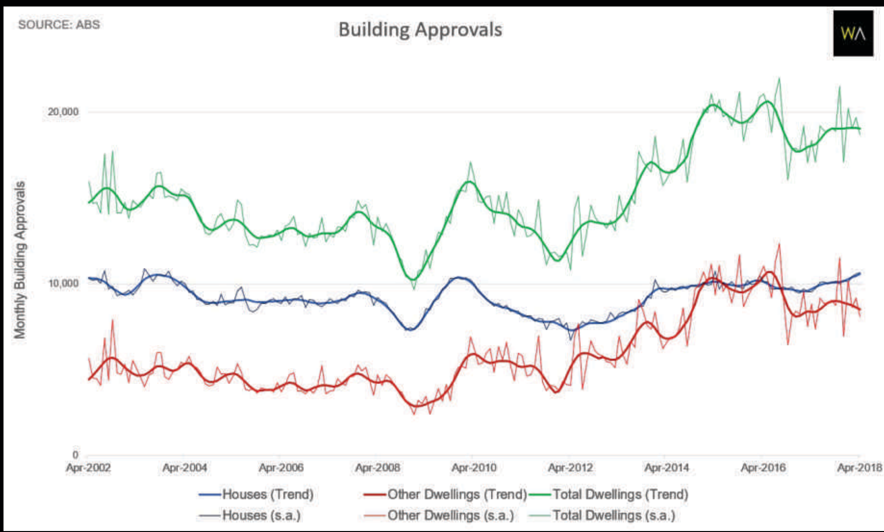
AUD downside risk: If employment growth and the housing market slow as expected there is downside risk from US$0.76

US valuations remain stretched: Equities valuations in the US remain at high levels, and there is a risk that tighter policy in the US sees share markets revert lower, with implications for other global stock market indices

Construction bubble: The sector looks severely bloated, with construction employment as a share of total employment at the highest level in a century. The sector swelled through the mining boom, and even further through the apartment boom. We see this as the biggest risk for the economic outlook

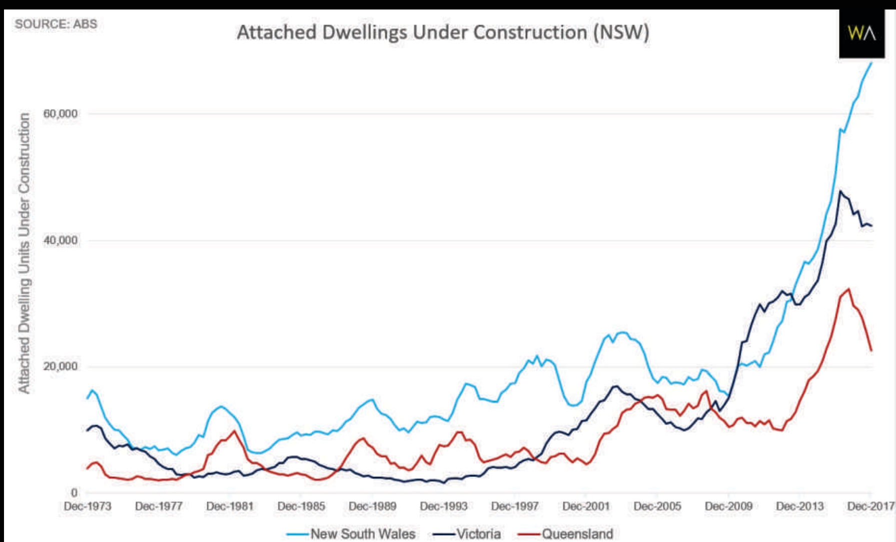


SECTION 1 – CONSTRUCTION CYCLE



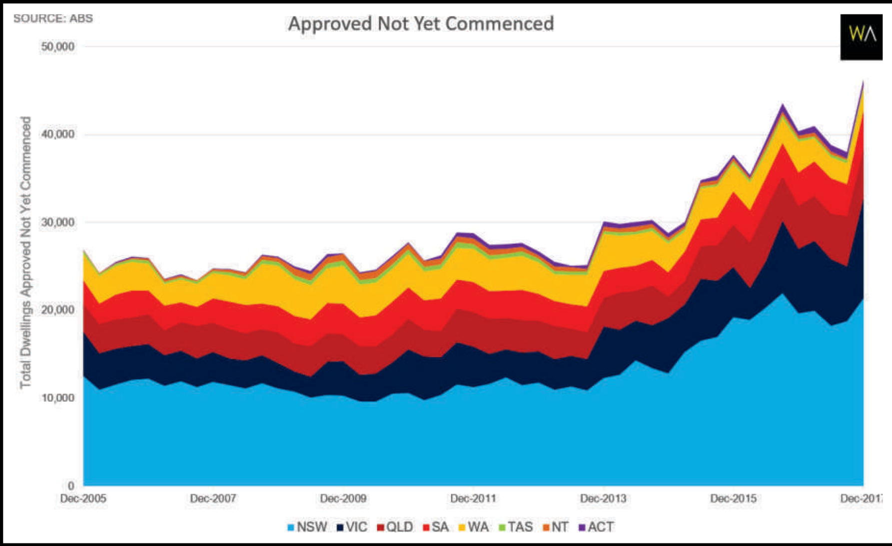
The trend for building approvals has held up at reasonably elevated levels, supported by strengthening detached house approvals in Brisbane and Melbourne, although apartment approvals are now falling.

Of the apartment markets, only Melbourne appears to have sufficient underlying demand to sustain high levels of construction activity going forward.



Sydney's apartment market is now suffering from severe indigestion with a record high number of units under construction in Q4 2017, but prices now in decline and settlement defaults now rising. In Brisbane construction activity is falling very fast, with fewer projects achieving the required pre-sales to secure financing, and completed projects offering significant discounts to buyers to shift excess apartment stock.

There are now more dwellings approved but not yet commenced than ever before in Australia's history. Regardless of the high number of building approvals, construction activity is now set to decline.



SETTLEMENT DEFAULTS RISING

Our liaison with industry contact has found that apartment settlement defaults are now rising, albeit from previously benign levels. Apartment developments in the east coast capital cities in particular are now experiencing higher defaults on deposits, largely related to non-resident investors from Asia and the Chinese mainland.

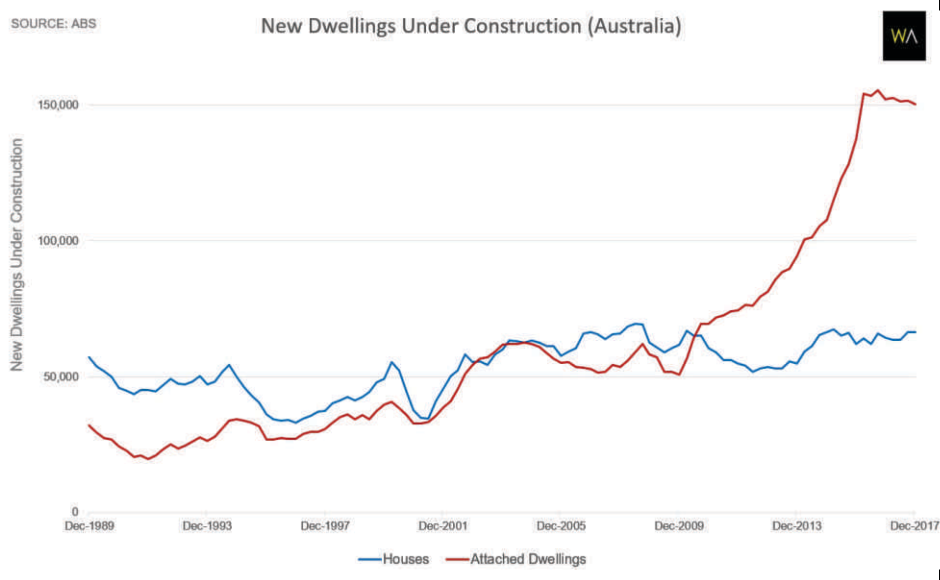
In the three most populous capital city markets population growth remains strong and developers have to date been able to clear this stock with only moderate discounting.

There are some areas where resale markets are considerably thinner, and discounting is likely to be more material, most notably in inner-city Brisbane, where apartment construction activity has mushroomed in recent years.

At the national level the pipeline of new apartment projects is gradually declining, which will help market the market to rebalance in time. However, the number of apartments under construction remains highly elevated relative to the long run average.

Population growth was tracking back at close to the historic resources boom highs in 2017 at +1.6 per cent or +395,600 over the year to September, with an abnormally high focus on Melbourne and Sydney as the drivers of that growth.[6]

The growth in the estimated resident population has been tracking at a higher level than would otherwise be implied by the natural growth in the population (births minus deaths of +145,500) and permanent migration of around +190,000 per annum due to a surge in temporary migration, especially relating to international students.[7] There is now a record number of temporary visas on issue at 2.2 million, up from 1.63 million at the end of the December 2012 quarter.[8]



If the present high levels of permanent and temporary net overseas migration into Australia are maintained then any surplus apartment stock will be absorbed in time, but even at the current fast rate of immigration residential construction activity will slow from here.

Apartment development approved but not commenced in inner-city Brisbane. All of the apartment developments in shot have either been completed in this cycle or remain under construction as at June 2018.

SUMMARY OF SECTION 1

Some of the key issues and considerations arising from Section 1 of this report are summarised below:

Apartment settlement defaults have been tracking at low levels of around 2 per cent for some of the major developers

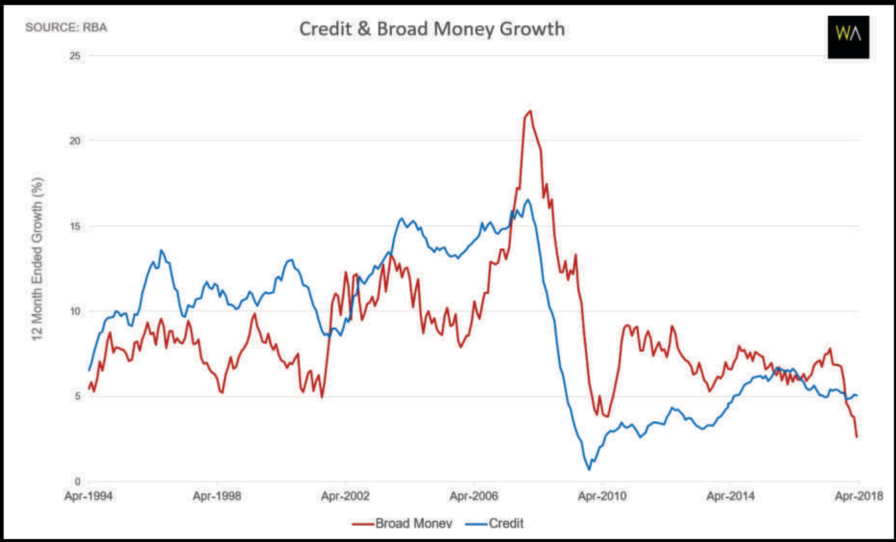
However, reportedly default rates are now rising, mainly in relation to non-resident off-the-plan buyers

There are many examples evident of non-conventional measures being used to both sell and lease properties in some of the apartment hotspots, with inner-city Brisbane the most glaring example

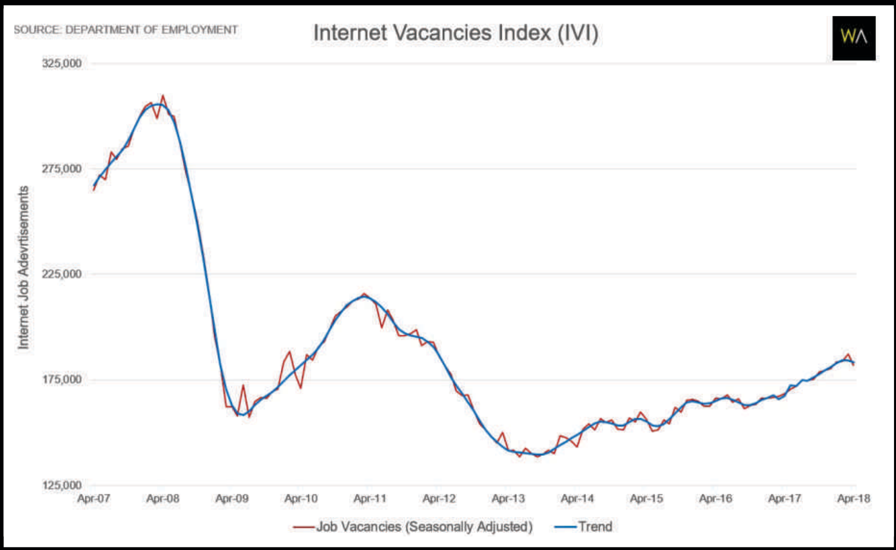
Population growth remains strong, especially in Sydney and Melbourne, but we expect to see more failed apartment projects and construction employment falling sharply

SECTION 2 – CREDIT CYCLE

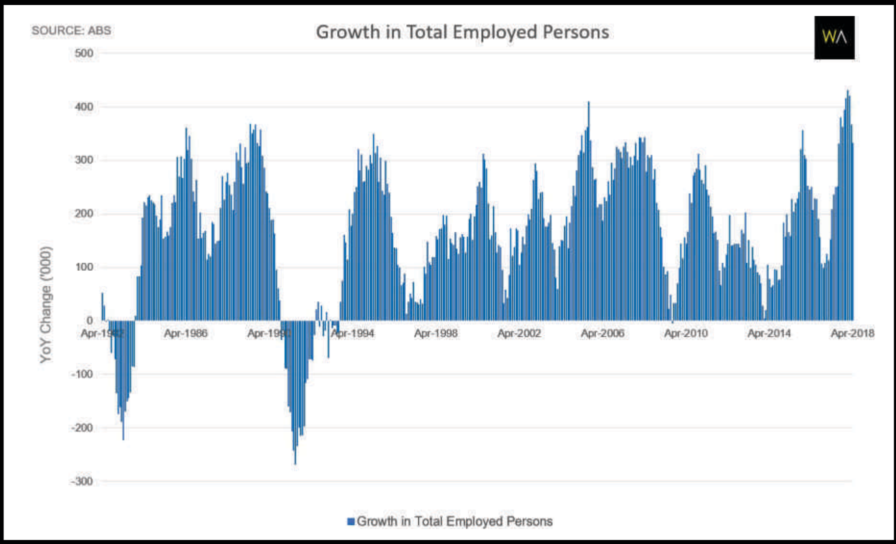
Another leading indicator we watch closely is money growth. While credit growth has held up reasonably well, supported by owner-occupier housing lending and a modest expansion in business credit, both bank deposit growth and broad money growth have declined to 25½ year lows.[9]



The skilled vacancies report shows that the 31 per cent recovery in jobs advertisements since October 2013 has now apparently lost momentum, decreasing by 0.5 per cent in April after 17 consecutive gains.[10]



Thus, while commentary has focused on the strong headline employment growth, we see the annual rate of employment growth[11] slowing significantly in H2 2018.



SUMMARY OF SECTION 2

Some of the key issues and considerations arising from Section 2 of this report are summarised below:

Money growth is a leading indicator, and although annual business credit growth remains mildly positive at +4.3 per cent, broad money growth is falling sharply[12]

Housing credit growth is falling in response to tighter lending standards, particularly for portfolio investors[13]

For as long as tighter lending standards are applied there will be downward pressure on dwelling prices, particularly in Sydney being the most expensive housing market, and to a lesser extent Melbourne

With dwelling prices now officially in decline at the national level,[14] the chances of seeing a hike in the official cash rate any time soon have greatly diminished. There may even prove to be an easing bias, but only if the household debt-to-income ratio begins to ease (which will be challenging given that nominal annual growth in the wage price index is tracking close to record low levels[15])

Major banks risk losing market share to non-bank lenders as investors struggle to get access to credit

The latest available figures from APRA[16] suggest that non-bank lending has been increasing since late 2016

Headline annual employment growth was very strong through the 2017 calendar year,[17] but now looks set to set to fade

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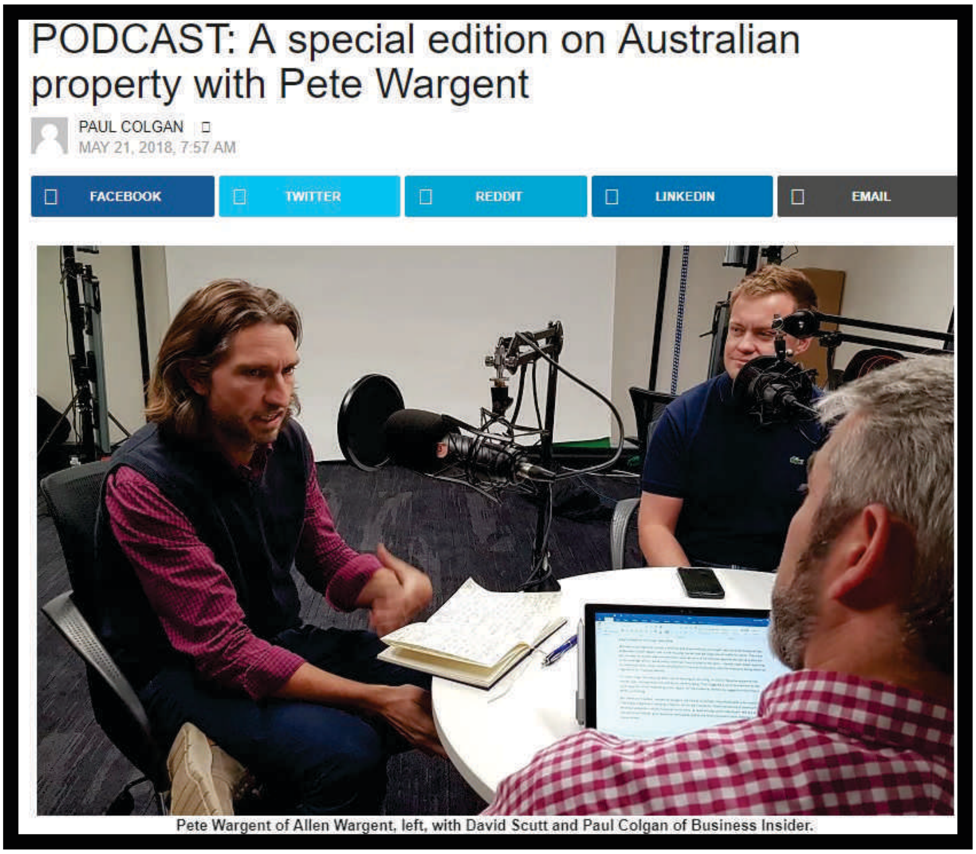
FURTHER INFORMATION AND CONTACT DETAILS



Pete Wargent of Allen Wargent, left, with David Scutt and Paul Colgan of Business Insider.

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