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Investa Inside: Trade Wars & Australia's Office Markets

Three key impacts of global trade wars on Australian office markets

Recent data is reflecting synchronised strength and/or improving performance across Australia's major CBD office markets. In particular, Australia's **global gateway cities of Sydney and Melbourne are leading the charge with CBD office markets that are pushing new 10-year highs in market conditions**. This has in part been driven by positive momentum in both domestic and global economic growth.

However, the **recent escalation in global trade tensions, as a result of the US imposing higher tariffs on imports from China, European Union, Canada and Mexico, creates some uncertainty** about the ongoing stability of economic growth and the strong fundamentals supporting Australia's major office markets.

While **we are not forecasting the full impact of this scenario to play out in the coming years**, the following points highlight how global trade wars are likely to shape Australian office market conditions.

Key impacts on Australian office markets:

- **Global growth**: tighter regulation of global trade flows is likely to weaken both global and domestic economic growth, employment and demand for office space.
- **Input and output prices**: higher tariffs on bulk commodity markets drive price increases in development material costs and create inflationary pressure.
- **Capital markets**: weaker investor sentiment softens global capital flows, softening cap rate compression.

Global growth: weaker growth softens underlying demand for office space.

While not as straightforward as a broad-based economic downturn, **a trade-war induced downturn would also weaken office demand and net absorption**, both being highly correlated with economic growth. In particular, sectors and Australian businesses that are dependent on global trade flows would experience weaker business conditions and increased pressure on profits and headcount. In fact, research from the Federal Reserve finds that a 5% tariff increase results in a 2-percentage point fall in both annual GDP per capita and wages.

Given most trade war activity to date has been bilateral and focussed on discrete products (ie. steel, aluminium, washing machines, solar panels) **the impact on Australia's economy and office markets so far has been, and is likely to remain largely muted**. This is because Australia is not a large exporter of these products to the United States and assumes that Australia doesn't enter bilateral, or multilateral trade wars itself impacting its major export products. Nonetheless, business conditions especially for the downstream industries exposed to markets impacted by higher tariffs and/or trade restrictions are expected to weaken.

In contrast to the weaker growth outlook, office net absorption from bulk commodity mining businesses, and the Perth CBD office market, in the near-term is sanguine. The downturn in mining activity in recent years has bolstered the market position of Australia's low-cost bulk commodity producers. This places them in a favourable market position in competing with foreign producers being impacted by higher tariffs. Consequently, **Australian mining businesses should benefit in the near-term from the current trade war in foreign aluminium and steel markets with Perth's CBD prime office market vacancy likely to tighten more sharply than otherwise expected**.

Chart 1: Australian Business Conditions & Office Markets

Source: JLL Research, NAB & Investa Research

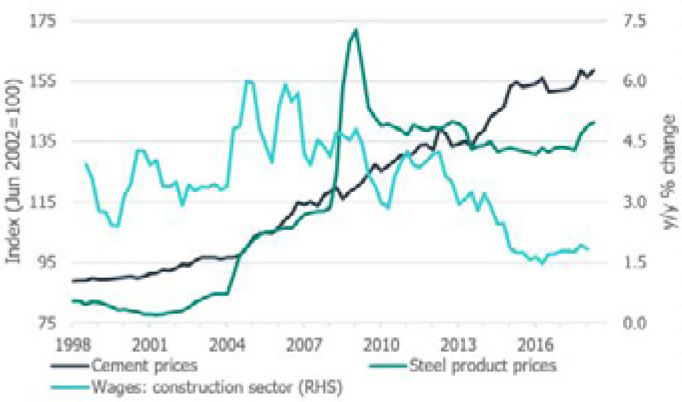
Input and output prices: tariffs to increase development costs and consumer prices

The first-round price effects of higher tariffs lead to both higher prices for the products directly impacted by the protectionist policy and upward pressure on broader inflation. While this policy protects select import-competing businesses from offshore competition, supporting employment and profits in these industries, higher prices negatively impact consumers of the downstream products. That is, **higher bilateral tariffs on steel products will create some degree of contagion across global steel product markets, increasing the price of steel, and the cost of office development**. We recently highlighted this an issue we are monitoring in Q2 2018 Investa Inside.

The subsequent second-round effects reflect the negative impact of higher tariffs through weaker economic growth, lower employment and lower wage growth. In the worst-case scenario, this occurs with persistently high inflation otherwise called 'stagflation', which hasn't occurred in the developed world since the 1970's.

Consequently, the objective of central bank monetary policy is somewhat compromised in attempting to both contain inflation and support weakening economic growth and wages. However, **in managing the medium-term view of weakening global growth, the net impact is likely to maintain low policy interest rate settings**[1].

Chart 2: Australian Building Materials Prices & Construction Wages



Source: ABS & Investa Research

Capital markets: weaker investor sentiment and capital flows

With the exception of the Global Financial Crisis, the most significant episode of slowing office capital market sales activity in the past 20 years was following the China stock market crash in 2015. During this time the total value of office sales declined around $4 billion and capital sourced from China decreased around 60%.

Chart 3: Financial Markets & Office Sales Transactions

Source: JLL Research, S&P & Investa Research

However, Australian office values barely drew a breath, with both offshore investors outside of China and domestic investors continuing to maintain downward pressure on Australian capital city office cap rates. Consequently, **while investor sentiment has already weakened in response to global trade tensions, solid underlying fundamentals and stable income growth are expected to somewhat offset softer capital flows to Australian office markets**.

While softer office capital market activity would likely pull-forward an easing in Australian office cap rates, **investor appetite for Australian direct office property is likely to remain relatively resilient**. In addition, solid underlying asset values are expected to support equity market outperformance of A-REITs through a global trade war.

[1] This does not account for the impact of policy-affected trade flows on currency exchange rates.

Further information

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About Investa Research

Investa Research focuses on understanding the drivers and analysing the movements and trends within the Australian commercial office market. The research function is fundamental in guiding group investment strategy and decision making, as well as providing a competitive advantage through insightful analyses and forecasting.

The research team publishes regular updates on the performance of the major Australian office markets, as well as occasional papers and reports examining a broader scope of topics that may be of interest to investors and other Investa stakeholders.

About Investa

Investa is a leading Australian real estate company managing more than A$11 billion of quality office real estate. As a specialist office manager of commercial office buildings Investa manages more than 37 assets in the key Australian CBD markets on behalf of ICPF, the ASX-listed Investa Office Fund (IOF) and private mandates. Its end-to-end real estate platform incorporates funds, asset, property and facilities management, development, sustainability, capital transactions and research.

Investa strives to create Australia's most valued working places be the first choice in Australian office, by delivering consistent outperformance for its investors and exceeding the expectations of its tenants and staff, while remaining an industry leader in sustainable building management and responsible property investment.