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## **The Wealthiest Country on Earth, but No Longer the Lucky Country!**

Australia has the highest median wealth on the planet, according to the latest Credit Suisse *Global Wealth* report. At US\$225,000 a head, Australians are in the gold-medal position, a culmination of more than two decades of uninterrupted economic growth and the largest commodity boom in the nation's history.

Complementing this has been an unprecedented and seemingly never-ending rise in national property values, with the total value of the nation's housing stock climbing above A\$5 trillion in early 2014.

To put the scale of Australian house price appreciation over the past two decades in perspective, consider that Down Under, prices have risen by 285% since the end of 1995. This compares to 193% in the UK, 180% in New Zealand, and 118% in the United States.

No surprise then, that Australia's housing stock now represents the majority of the nation's "wealth".

But with the recent crash in iron ore prices, a deteriorating federal budget deficit, unemployment at a decade high, and cash-rates already 50bps below the "emergency" levels seen during the global financial crisis (GFC), many are wondering whether the luck has run out for the "lucky country."

### **How Big Was That Mining Boom Anyway?**

Australia's four main commodity exports are iron ore, coal, natural gas, and gold. China consumes over 30% of these exports as a whole, up from just 8.5% a decade ago.

Since the turn of the century, prices for these four commodities have boomed, with iron ore (which accounts for 20% of total Australian export income alone) rising from roughly US\$10 per tonne to over US\$175 a tonne at its peak. But since 2011, we've seen a major correction in most of these commodities, as the following table shows.

Note that whilst Australia's terms of trade peaked in 2011, the same is not true for all the individual commodities. Thermal coal spiked above US\$190 per tonne in 2008, and natural gas briefly surpassed US\$13 per MMBtu back in 2005.

Commodity	End 1999 price	2011 price	2014 Price	Gain 1999 to 2011	Loss 2011 to 2014
Iron Ore, \$/tonne	\$11.93	\$187.18	\$80.09	1,468%	-57%
Thermal Coal, \$/tonne	\$25.10	\$141.94	\$68.45	465%	-52%
Natural Gas, \$/ MMBtu	\$2.33	\$4.54	\$3.87	95%	-15%
Gold, \$/oz	\$283.07	\$1757.21	\$1222.49	520%	-30%

*Source: Index Mundi. 2014 prices are end of October. 2011 prices are highest monthly close that year. Prices are US dollars.*

The impact of large commodity price swings on Australia's terms of trade has been severe. It provided a windfall for over a decade, but that is fast turning into a nightmare, as the below chart highlights clearly.

From the September 2011 peak to June 2014, Australia's terms of trade has fallen over 20%. It will worsen substantially when the next set of results are released, particularly in light of iron ore's persistent decline in the past few months.

## Terms of Trade: Australia



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Source: Bloomberg

### Mining Capex Will Hurt Too!

Australia's mining boom wasn't just about booming prices for key commodity exports. Arguably more important was the explosion in capital expenditures linked to the industry, especially in the wake of the GFC, when China twisted its fiscal and monetary spigots wide open.

At its peak, business investment in the mining sector singularly accounted for 8% of total Australian GDP—approximately four times its historical average—and roughly 50% of all business investment in the country. A casualty of this extremely lopsided capital expenditure picture was a dearth of investment in other parts of the economy.

Going forward, mining investment is set to decline. The Reserve Bank of Australia (RBA) estimates that lower mining capex will shave 1.25% annually off Australian GDP in both 2015 and 2016. The National Australia Bank forecasts that total investment in the sector will drop 50% in the coming years, with the loss of up to 100,000 highly paid jobs the inevitable outcome.

Australia will continue to benefit from the final phase of the mining boom, which is the surge in production volumes. This phase can best be seen at Port Hedland, the world's largest bulk tonnage export port, located in Western Australia, where roughly 38 million tonnes of iron ore a month is currently shipped, up some 30% in the past year alone.

The bulk export tonnage number is only likely to climb. Both BHP Billiton and Rio Tinto have affirmed their expansion plans, and the Roy Hill mega project will go into production in 2015, grinding out 55 million tonnes of iron ore a year.

Add all this together, and whilst we don't expect a complete mining bust per se, it's beyond doubt that the "golden days" of this cycle are behind us. Indeed, we suspect that some of Australia's resource companies have begun to price in a worst case scenario.

Sadly, there is little left to fill the mining void and support a smooth rebalancing of the Australian economy.

## **Record Wealth, Record Debt**

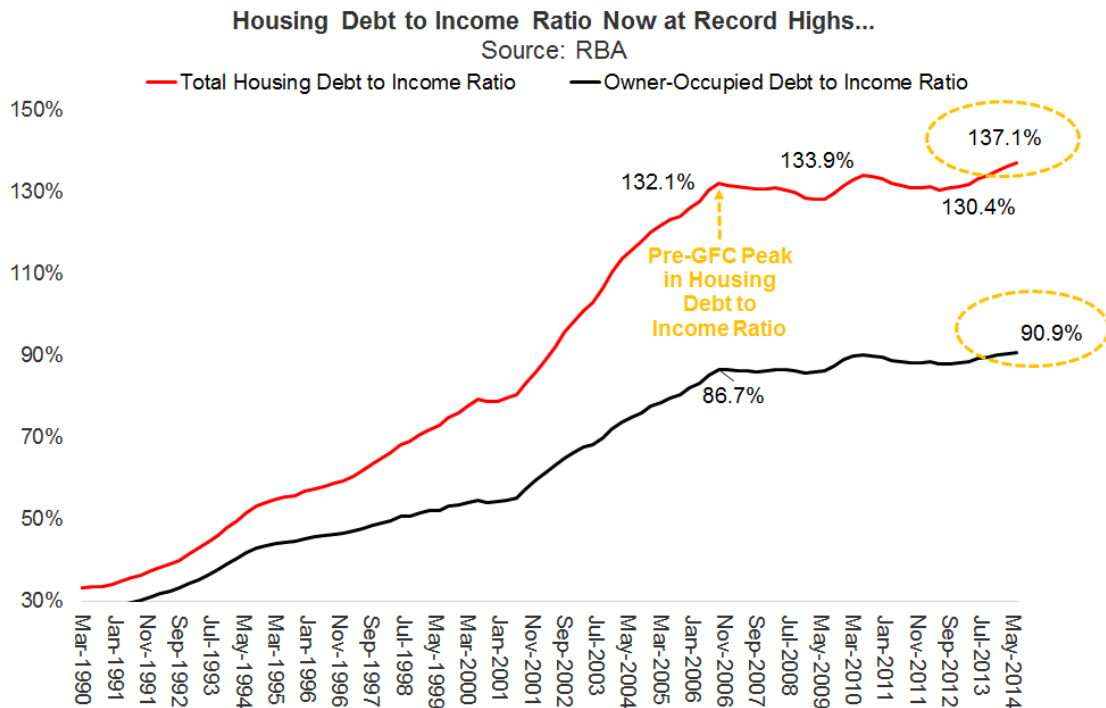
As stated above, Australia's housing stock is the bedrock of the nation's wealth. Over the past decade or so, real estate has become a national obsession, with TV shows about home renovations and house flipping amongst the most highly watched.

In many ways, this is not a surprise. Property has been extraordinarily kind to my parents' generation, many of which emigrated from Europe in the decades after the Second World War. The property market also survived the GFC relatively unscathed, avoiding the extreme price declines that were seen in the US, Ireland, Spain, and other countries.

This resilience was largely the by-product of China's response to the GFC, with commodity prices rallying hard between 2009 and 2011, and helped keep Australian unemployment low. A dovish RBA and a helpful federal government also contributed.

The problem, of course, is that this incredible run in Australian house prices has gone hand in hand with a blow out in personal debt levels. Mortgage debt now stands at a record 137% of annual disposable income, according to the RBA.

The growth in this metric is captured neatly in the graph below, which plots its rise since 1990.



Australians now spend more of their disposable income to service a mortgage or rent than they did in the early 1990s, even though mortgage rates back then were closer to 15%, rather than the 5% they are today.

The unprecedented private debt burden is the major reason why the Australian economy has not rebalanced as key policymakers would like. Personal debt has reached a saturation point, and low interest rates are no longer enough to encourage consumers to spend, let alone borrow more, whilst businesses are reluctant to invest.

Evidence of a weak Australian economy is everywhere. Consumer confidence, which had jumped last year on the back of an incoming Coalition government, has eased substantially, with concerns over rising unemployment and negative real wage growth the major culprits.

### **Triple Threat: Jobs, Wages, and Inflation**

Australians are rightly concerned. Not only is the official 6.3% unemployment rate at its highest level in more than 10 years, but underemployment is also rising, sitting just below 14%, its highest reading since the late 1990s.

While those numbers would be music to the ears of any European finance minister, they represent a significant deterioration over the past few years Down Under, with young Australians particularly hard hit. Currently, over 15% of those under the age of 24 are unable to find a job.

With the outlook for employment uncertain and businesses overwhelmingly focused on cost control, Australians are also faced with slower wage growth. The latest data indicates that nationwide, wages grew by only 2.5% for the year. This is the lowest reading on record and becomes effectively negative after official inflation and taxes. The latest GDP and national account figures, released on December 3, confirmed this, highlighting a declining real gross disposable income per capita.

On the inflation front, despite benign official numbers, and the lack of wage growth and pricing power that will help keep it relatively controlled, there is still cause for concern.

First, the potential for a much lower Australian dollar will lift tradeable inflation going forward. Since 2000, prices for tradeable items have only risen by 1.7% per annum on average, less than half the 4% increase in non-tradeable items.

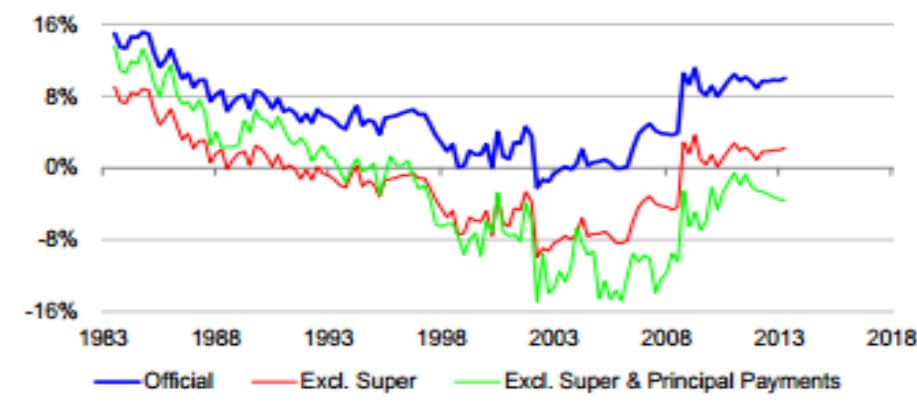
Second, inflation in the must haves (health, education, and housing) has been running between 4.5% and 5.5% annually since 2008, while electricity bills have risen by just under 9% per annum over the same period

## Super... But Not Duper

Compounding all of these obstacles is the lack of genuine discretionary income that plagues everyday Australians. For this, we can not only blame sky high housing prices, but also the compulsory superannuation system, which by law compels employers to pay 9.5% of everyone's salary into managed funds, which workers can't touch until they retire.

Economists Down Under often tout Australia's "high" savings rate, which currently sits around 10%. However, this number is a bit of a furphy, or what non-Aussies would call a rumor.

### Australia's Household Savings Rate



Source: ABS, RBA, Credit Suisse

As the chart shows, once the impact of compulsory super (superannuation) is removed, the savings rate is closer to zero. In fact, it is below zero when excess mortgage principal repayments are subtracted.

In theory, Australians could resort to more credit card debt to increase their spending. So far, they have refused to do so, with average credit card debt actually falling by over 5% during the past 18 months or so.

As such, Australians are likely to disappoint Federal Treasurer Joe Hockey, who recently urged, “We want Australians to go out there and spend for Christmas. Don’t let Santa down, go out there and spend for Christmas.”

The jury is out on whether that will be remembered as Australia’s equivalent of former Dallas Fed President Robert McTeer’s infamous “go out and buy an SUV” moment.

## **Bright Spot Will Soon Need New Batteries**

Job insecurity, a lack of discretionary income, and a corresponding drop in consumer confidence has taken its toll on local industry, especially services and manufacturing. The auto industry is in the process of shutting down, and business surveys for the services sector have been persistently weak.

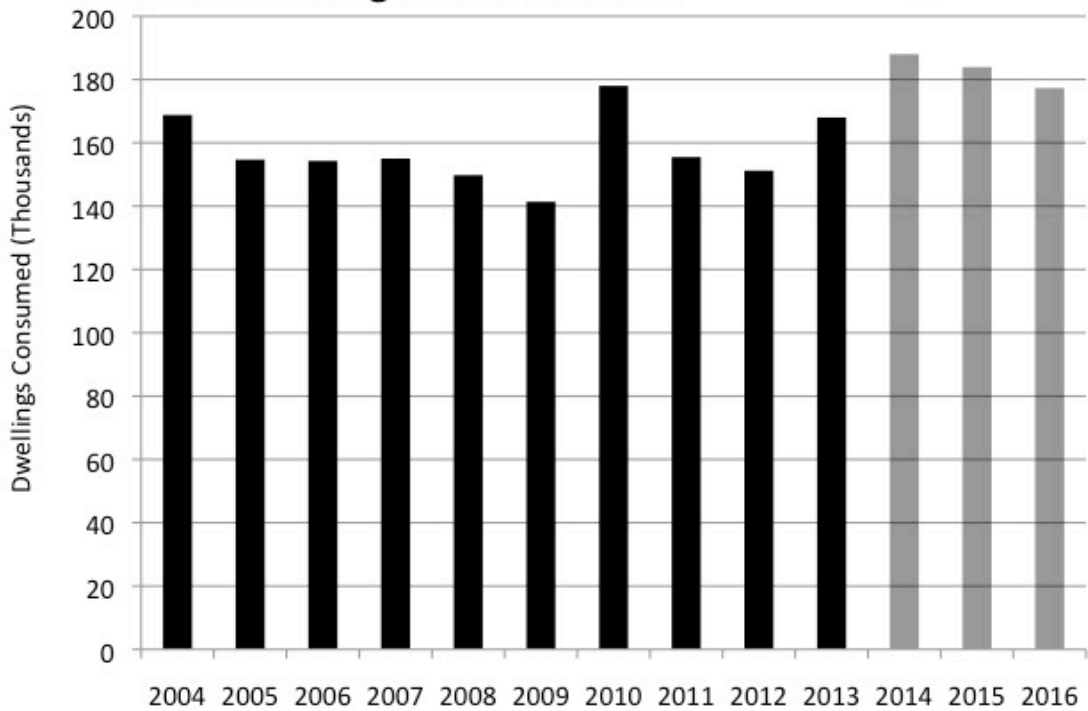
Commercial vacancy rates—a highly underrated metric, in my opinion—are also telling. Despite some improvement in Sydney, national vacancy rates recently hit a 15-year high of 10.7%. This number has doubled since the GFC.

The one bright spot has been building permit approvals and home construction, which has lifted markedly in the past three years. For 2014, Australia’s Housing Industry Association (HIA) projects that total home construction will hit 188,000 homes, the highest annual level since 1994.

That is an impressive reading, no question. Yet, it’s worth bearing in mind that the Australian population was some 30% smaller 20 years ago. On a per capita basis, the current readings aren’t so impressive.

Finally, as even the HIA acknowledges with the following chart, new home construction appears to be “peaking out,” even though numbers should stay relatively strong for the next two years at least.

## Australia Housing Starts Forecasts



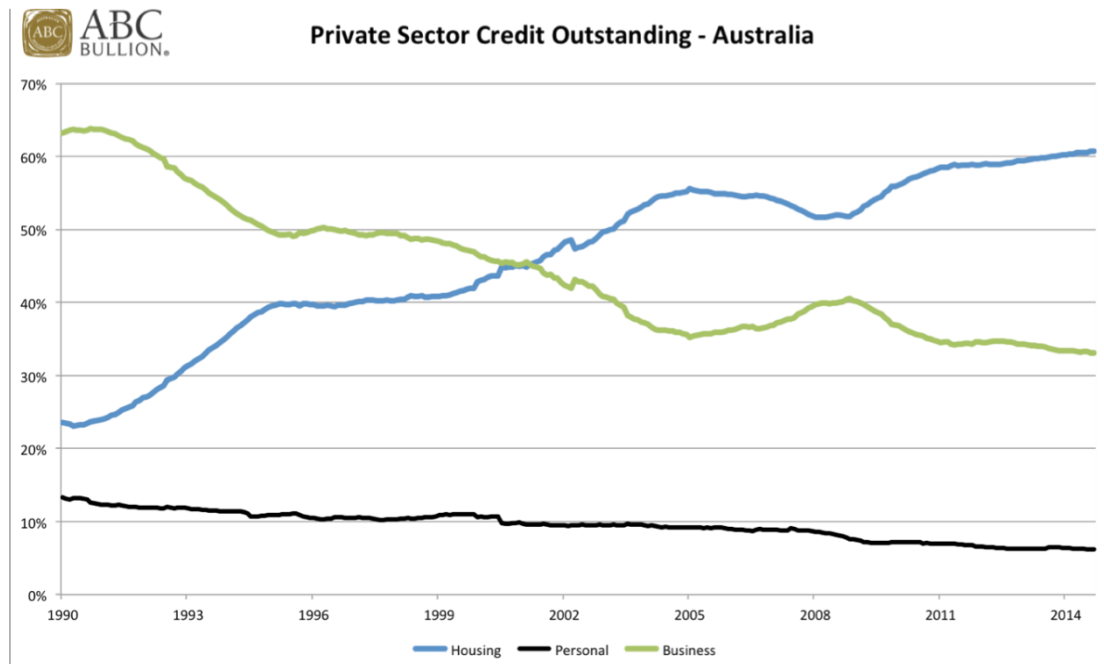
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Source: HIA Economics

### Financial System Risks

The escalation in both house prices and private debt levels has distorted the Australian economy. This was only possible because major banks chose to direct an ever-larger percentage of their loan books toward the Australian residential market, at the expense of productive enterprise.

The next chart plots the changing nature of private sector credit outstanding in Australia, and where money is being lent.



In many ways, this is the saddest chart of Australia and highlights how in the span of just 25 years, productive business lending—the type that creates jobs and opportunities—has plummeted over 50%.

The source of funding is another concern. Australian banks have been able to build their depositor bases since the GFC, but they’ve also had a heavy reliance on wholesale funding, at least relative to many international peers.

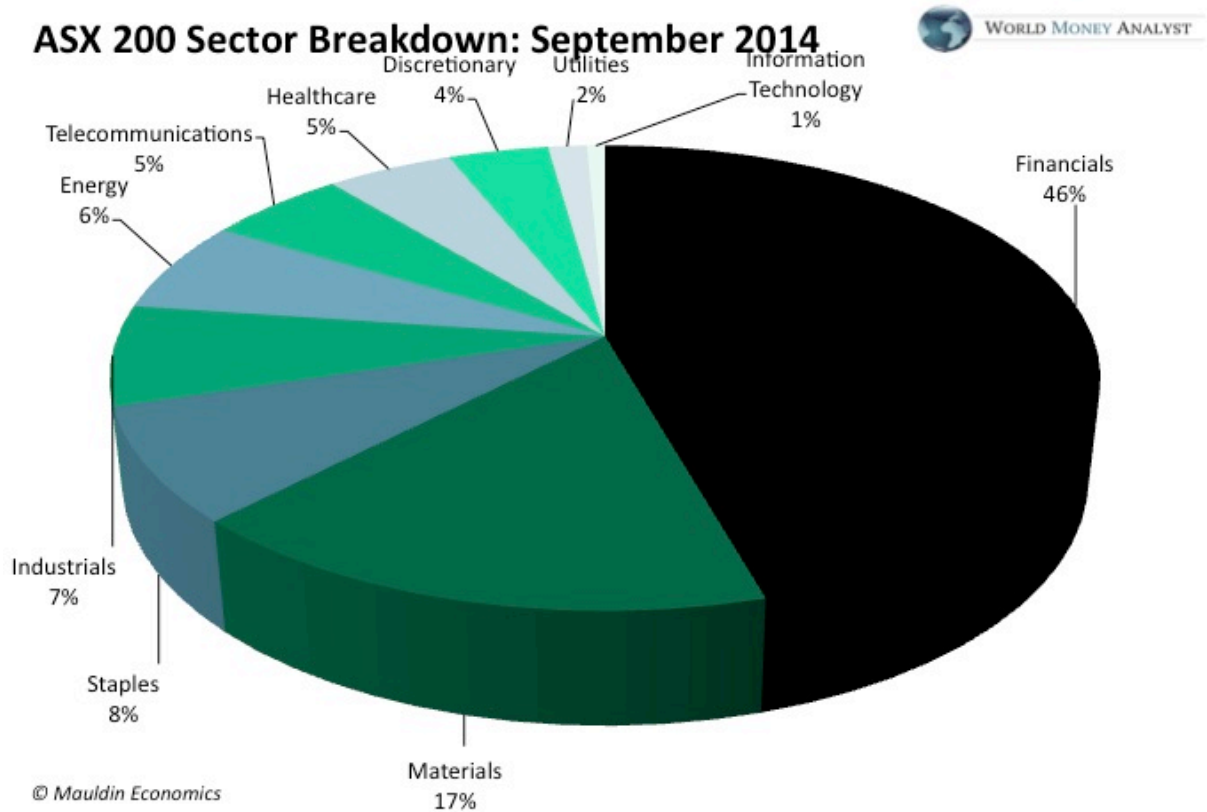
This type of funding can be less secure than deposits made by households, and harder to source when, inevitably, the next “market shock” occurs. In Australia’s case, adverse sourcing conditions will be magnified, because a large portion of its wholesale funding is sourced from overseas. A report by the Australian Bankers’ Association in July 2013 states that 70% of Australian banks’ long-term funding is sourced from offshore.

To date, rising house prices and the mining boom have glossed over these imbalances, but the tide is undoubtedly turning. In the years ahead, Australia could well face its own “financial crisis” moment.

## Equities and Economy at Risk

The fall in commodity prices and capital investment will lead to lower nominal income growth and rising unemployment. Combine those with record high debt levels, and it spells financial stress for everyday Australians. This poses a direct risk to not only house prices and the stock market, but to the economy as a whole.

The next chart shows the sector breakdown of the ASX 200, an index of the 200 largest stocks by market capitalization that trade on the Australian stock exchange. Today, there is an almost unprecedented level of concentration in its listed markets, with over 60% of the market in just two sectors.

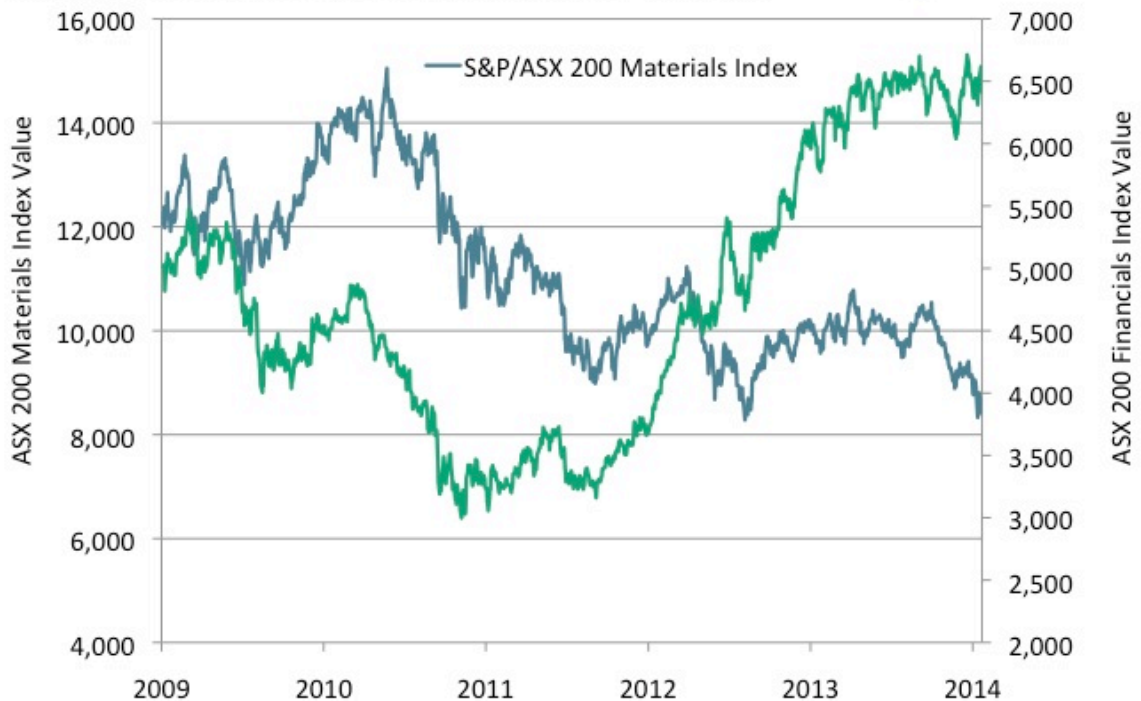


Australia has become a nation entirely reliant on financials and materials—two sectors that carry a material chance of suffering financial loss in the years ahead. (Puns intended.)

And whilst buying into companies linked to the resources sector is akin to an attempt at catching a falling knife right now, there will likely be greater risk in financials in the years ahead.

Indeed, the performance of the material and financial market sectors could hardly have differed more in the past few years, as shown in the next chart.

## Australia's Financials and Materials Sectors



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Source: Bloomberg

The S&P/ASX 200 Materials Index (ASX:XMJ) has fallen nearly 35% since 2011. The move reflects both the pullback in commodity prices and the up-till-now severe underperformance of the Chinese stock market. Gold stocks were off 80% at their nadir.

The S&P/ASX 200 Financials Index (ASX:XFJ), on the other hand, has gone from strength to strength, rising by over 60% in the past three years, as the local chase for yield and an unstoppable housing market has sent the capitalized values of Australian bank stocks to all-time highs. Undeniably, the financial sector is single-handedly responsible for ensuring that the domestic market is back at all-time highs on an accumulation basis (including dividends).

But that party might soon end, with property price growth already cooling and a raft of measures in the just-released *Financial System Inquiry* aimed at improving the resilience of the financial system. The report suggests that banks need to build their capital reserves and limit lending into the Australia mortgage market. This will limit their profitability.

As such, Australians may also see the “wealth effect” reverse in the coming years. Real property prices could decline, whilst “super” funds could also take a hit, especially as the standard portfolio is, on average, 50%-60% invested in equities, much of which is concentrated in domestic markets.

### Systemic Risk, Sovereign Response

Although this is not a base case, severe housing market turmoil, where nominal prices fell 20% or so, could lead to a genuine risk of an effective bank nationalisation, as the major Australian banks are, on average, effectively leveraged at over 20:1. There is no way the government will allow any of them to fail.

This, of course, forces an investor to consider the true nature of Australia's sovereign debt position. It is often recited that Australia is a low-debt nation. Comfort is found in the fact that it is one of the few developed market sovereigns with an AAA rating from all the major agencies. But how true is this "low debt" argument?

The government's debt burden, expressed as a percentage of GDP, is certainly low, especially relative to most developed market sovereigns. Even here, though, the picture is deteriorating, with the budget position declining rapidly. In the 2012/2013 fiscal year, the budget deficit was only A\$18.8 billion. In the year just gone, that number rose to A\$48.5 billion.

That might only represent 3% of GDP, but a deficit of nearly A\$50 billion means the government must decrease spending by a staggering 13% to balance the books. Or take drastic measures on the revenue side.

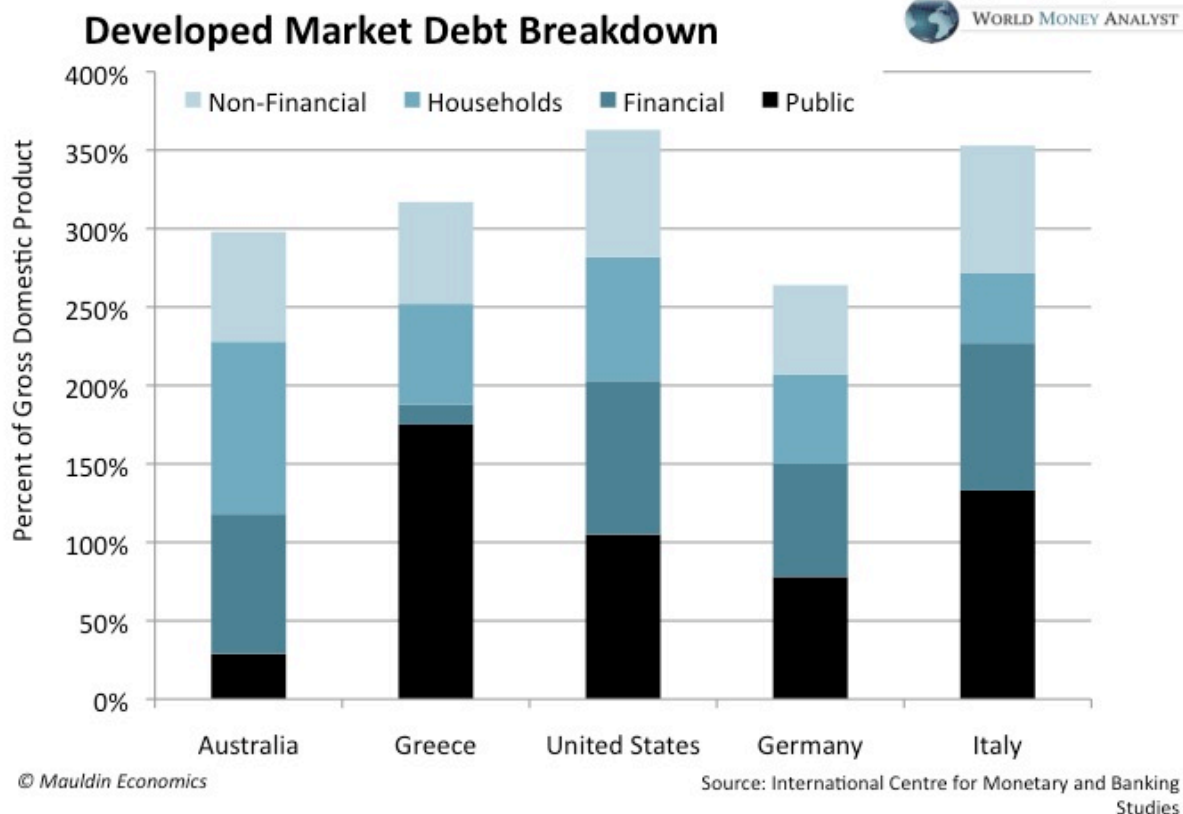
*Neither will happen.*

Instead, with a slowing economy, we could see the incumbent government abandon all pretense of returning to surplus (a major policy promise when they were elected last year) and embark on a "nation building" infrastructure spree. Even without said spending spree, Australia faces budget deficits as far as the eye can see.

This will eventually (though not imminently) threaten its AAA credit rating, as lead sovereign analyst for Standard and Poor's, Craig Michaels, alluded to in May 2014, noting that, "Australia is fairly unique among AAA-rated sovereigns in that its external position is very weak. ... What that means is that to retain the AAA rating, everything else needs to remain very strong, including public finances."

If the nation's AAA rating were affected, it would negatively impact the major banks' access to capital from international markets that flow through to domestic borrowing.

On that note, let's peer beyond government debt and look at the broader Australian debt landscape. If we aggregate financial sector, non-financial sector, government, and, most important, private debt, Australia looks more Greek than great, as the chart below illustrates.



As you can see, the compositional breakdown of Australia's debt is clearly different from that of its Northern Hemisphere counterparts. However, as a nation, Australia is over-burdened with debt, and the economy is likewise unable to cope with normalised borrowing costs, especially in light of the slowdown in mining.

## Help From the North?

China and Japan are Australia's two biggest customers, accounting for nearly half of its exports, with China alone consuming over 30% of the total.

In the decades ahead, Australia's proximity to Asia will likely be a huge bonus, and open up opportunities in not only agriculture and mining, but banking and wealth management too.

Although I don't necessarily buy the "China bust" argument, there's likely to be some trouble over the next few years. There is no question that China is attempting to rebalance its growth away from fixed capital investment, which has been the key to their previously insatiable demand for Australia's raw materials.

Nowhere is this more evident than in the iron ore price plunge of 2014.

Meanwhile, Japan—a country that gets scant attention Down Under due to our obsession with China—is approaching the Keynesian endgame, with the failure of Abenomics becoming ever more apparent.

With falling GDP, declining population trends, record levels of government debt, and a central bank forced to effectively nationalise the sovereign bond market, Japan is hardly a safe customer.

Australia's two biggest customers have problems of their own to deal with in the coming years.

## **Monetary Policy to the Rescue?**

While most market commentators and economists were predicting higher interest rates for Australia during 2014, weakness in the local economy prevented the RBA from hiking. With data weakening noticeably as the year ends, chances are growing that the next move in rates will be down, potentially as soon as February 2015.

While this will obviously improve debt serviceability, Australia is about to learn the same lesson much of the developed world faced years back, namely, that even looser monetary policy will only go so far. In Australia's case, the lesson could be a particularly harsh one.

At 2.50%, the RBA has already cut rates to their lowest level on record, giving it less wiggle room than the Fed enjoyed several years ago.

Back in 2006, right around the time US house prices were peaking, the Fed was actually hiking rates, hitting 5.25% by July of that year. Once housing rolled over, and the effects of sub-prime mortgages infected the whole economy, the Fed began slashing rates furiously.

Despite their efforts, even 500 basis points of easing wasn't enough to stop the housing market from losing 30% of its value by mid-2009, nearly bringing down the entire economy with it.

When one acknowledges that the Australian property bubble has inflated beyond its US counterpart, and that private debt levels are considerably higher in Australia than they were in the United States, it's cause for serious concern that the RBA only has 250 basis points left in its arsenal, at least 50bps of which it's likely to use by Q2 next year at the latest.

In a sense, Australia has already fired many of its stimulatory bullets, leaving it with less ammunition to use at a time when it's needed most.

## **Summary**

Following 20 years of continuous economic expansion, tougher times ahead in Australia should come as no major surprise. And while the nation is still endowed with many advantages—proximity to Asia, abundance of natural resources, well-developed financial markets—the next few years will likely be characterised by declining living standards for the majority of Australians. At best, expect a period of subpar growth in the coming decade.

Unfortunately, the confluence of rising unemployment, unprecedented private debts, elevated financial system stress, and the risks of a serious economic slowing in China, mean that severe economic dislocations in Australia are impossible to rule out.

The RBA will likely respond to lower rates of economic activity with additional monetary easing. At present, the base case is for interest rates to hit 2% in 2015, with downside risk to that forecast.

Budget deficits will deteriorate, with the very real possibility that Australia will end up losing its AAA credit rating. That will have a widespread impact across its financial system, especially with the major banks' reliance on wholesale funding from overseas.

The Aussie dollar sits at an interesting juncture, down about 10% for the year against the US dollar. Following the crowd is always a tenuous game, and the unanimity of opinion that expects a further fall in the AUD is cause for concern. Nonetheless, we must say that the path of least resistance for the currency is indeed lower.

The government and RBA are doing their best to jawbone it lower and will soon cut rates to add downside pressure. Should commodity prices like iron ore fall further, these factors, plus narrowing interest rate differentials at both the long and short end of the curve, will be all the market needs to push the AUD/USD exchange rate below .80 and into the mid-.70 range, though it will hold up better versus other currencies.

Though weakness in the AUD will lend some much-needed relief to what's left of Australia's trade-exposed industries, with a hollowed out manufacturing base, it will not be the panacea most are hoping for. And higher imported inflation will negatively affect every Australian, and potentially further dampen consumer confidence.

Globally, the myriad of economic problems that surfaced when the GFC hit have not been addressed in any meaningful way. A once-in-a-century mining boom allowed Australia to largely sidestep "Round 1" of that crisis.

Australia will not be so lucky next time.

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