



The Australian Economy – how are we really doing? 27.02.2014

Earnings season in Australia has given analysts plenty to mull over, with results in general showing impressive profitability but fairly weak headline growth.

Whilst the markets focus has been on corporate profitability, now is also an opportune time to take a look at some of the underlying trends in the domestic economy to see how Australia is placed in 2014 and beyond.

Business confidence and industry surveys

Starting with business confidence and it must be stated that optimism is definitely on the rise, with the NAB survey rising to 8 points (from 6) in its latest reading, alongside a rise in business conditions.

Dun and Bradstreets latest surveys also show business is more confident about 2014, with expected sales hitting their highest level in years.

Whilst NAB and Dun & Bradstreet business surveys have impressed in the last two months, Australian Industry Group surveys paint a more troubling picture for the domestic economy, with their monthly manufacturing, services and construction reports all currently in 'contractionary' territory, with readings below 50.

Manufacturing has been in contraction for most of the last 3 years, with the news that Toyota is following Holden and Ford in shutting down domestic car production likely to exacerbate weakness in the sector.

Services, which are a far bigger component of the Australian economy, have also been weak, contracting for over 2 years now, whilst construction (the great hope of the economy as the mining boom unwinds), recently fell back into negative territory after 3 months of growth. Prior to that 3-month period of positive readings, the construction survey had been in contractionary territory since 2011.

More troublingly, ABS data on the value of construction work done for the December quarter of 2013 showed a fall of 1% in total, and a rise of only 0.2% across the year. Residential construction fell 1.7% in the quarter and was negative year on year, although it must be stated that building approval numbers

are very positive, rising 21.8% in the year to December in seasonally adjusted terms, according to the ABS.

It must also be mentioned that whilst business confidence and conditions have risen of late, consumer confidence is moving in the opposite direction, with the latest figures from Westpac showing a fall of 3%, whilst unemployment expectations rose.

Consumer confidence is down 7.5% on a year ago and nearly 10% from its September 2013 post election high.

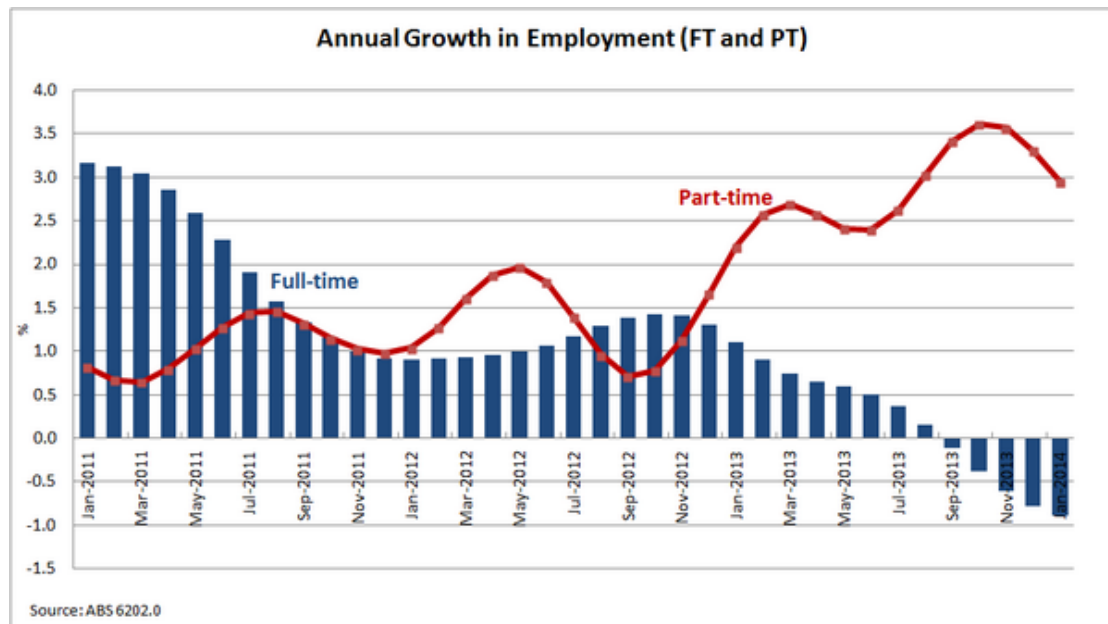
With today's news that QANTAS will be shedding 5,000 jobs in the years ahead, expect consumer confidence to fall again in the coming weeks.

Unemployment and the outlook for jobs

News on the unemployment front has been particularly disturbing of late, with the last two jobs reports seeing more than 25,000 jobs shed across the economy, pushing the unemployment rate up to 6%, it's highest level since 2003.

Worse than the deteriorating headline number is the fact that full time jobs are being shed and replaced with part time roles, with just under 40,000 full time jobs lost in the last two months alone.

The Australian economy now has negative year on year full time employment growth, and even the part time numbers are rolling over now, portending tougher time's to come.



Source: Australian Bureau of Statistics

It must also be stated that the headline rate has 'benefited' from a declining labour force participation rate, a trend that is muddying unemployment readings the world over and leading to some central banks and mainstream economists potentially underappreciating the weakness in their economies.

Comparing a range of other economic factors between now and 2003 also highlights that the economy is in a more precarious position today. Nominal GDP growth was 6.3% in 2003 vs. only 2.5% today, whilst our terms of trade were growing by 1.5% then, vs. -9.8% now.

Most importantly, real gross domestic income grew 3.4% in the year to 2003, vs. only 0.4% in the 12 months to June 2013. Wages growth is very weak.

ANZ Job Ads surveys won't provide much encouragement either for Australian job seekers, with job ads at multi-year lows, down 25% since February 2012 and now below the level they reached at the bottom of the GFC.

The latest CFO survey from Deloitte also showed that only one third of businesses were planning on adding staff, whilst another third were planning on reducing headcount.

Retail sales and household finances

Retail sales have actually performed quite strongly in the last few months, up 0.5% in December, following a rise of 0.7% in November and 0.5% in October.

Despite the positive headlines this has generated, on a per-capita basis, retail sales have essentially flat-lined in the past 6 years, as Australians have begun shunning their plastic and living within their means.

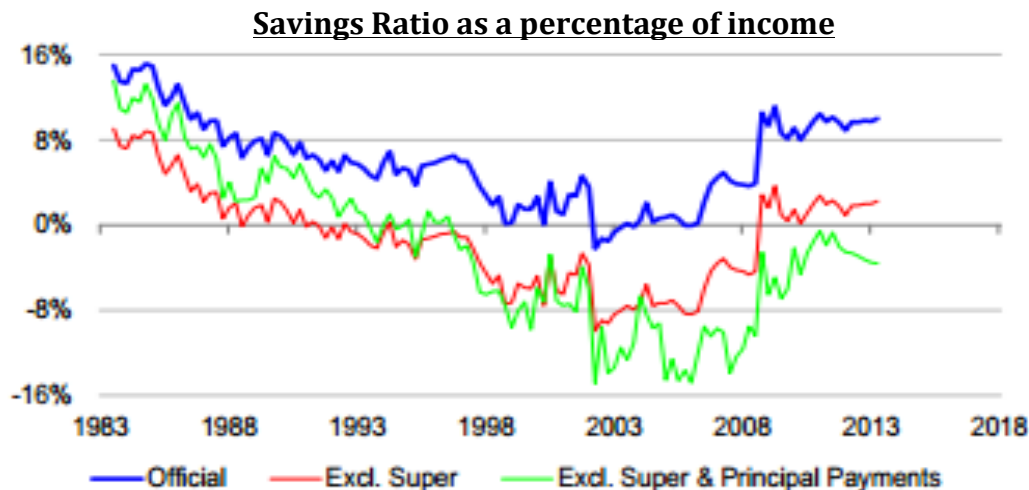
In fact the average credit card balance has declined by 6% in the past 18 months or so and according to COMSEC, the average credit card balance is now just above \$3,100, a near four year low.

This trend likely has a lot further to play out, with Australians household debt to income ratio essentially unchanged in the past few years (133.6% currently vs. 134.2% in the middle of 2010).

This shows that households have not deleveraged and are still highly exposed to changes in interest rates.

The much-touted household savings rate is also a bit of a furphy, as the majority of it is made up of compulsory superannuation and extra payments on household mortgages.

Indeed analysis by Credit Suisse in late 2013 showed that once these factors are stripped out, the actual household savings rate is negative 3.6%.



Source: ABS, RBA, Credit Suisse

Whilst the extra payments against the mortgage could be withdrawn (much of it is no doubt in offset facilities), this would effectively be a 're-leveraging' of sorts by households. This is highly unlikely in an era of elevated caution, especially with interest rate sensitivity still particularly high.

Obviously the money accumulators have in superannuation can't be spent in the real economy, so there will be no stimulus from this front either.

Bottom line, the average Australian has little in the way of free cash flow to go and spend. Sky-high housing prices and the debt required to fund them only exacerbate this problem, even though current homeowners obviously benefit from the 'wealth effect'.

Unless wages surprise to the upside (unlikely considering the outlook on the employment outlook), we can expect to see retail remain under pressure in 2014 and beyond, despite the positive news the last few months.

Office Space

Another point that doesn't get enough airplay in my opinion, is commercial vacancy rates, which is a very useful indicator of the overall health of corporate Australia.

On this front, the news isn't encouraging either, with Australia's CBD office vacancy rate rising to a 17 year high, according to an article published in late January 2014 in the Australian Financial Review.

Commercial vacancy rates are now over 10% and have more or less doubled since the GFC hit.

The sub-lease market is also particularly competitive, with the Property Council of Australia stating that they are seeing transactions where sub-tenants are being offered incentives of over 40%.

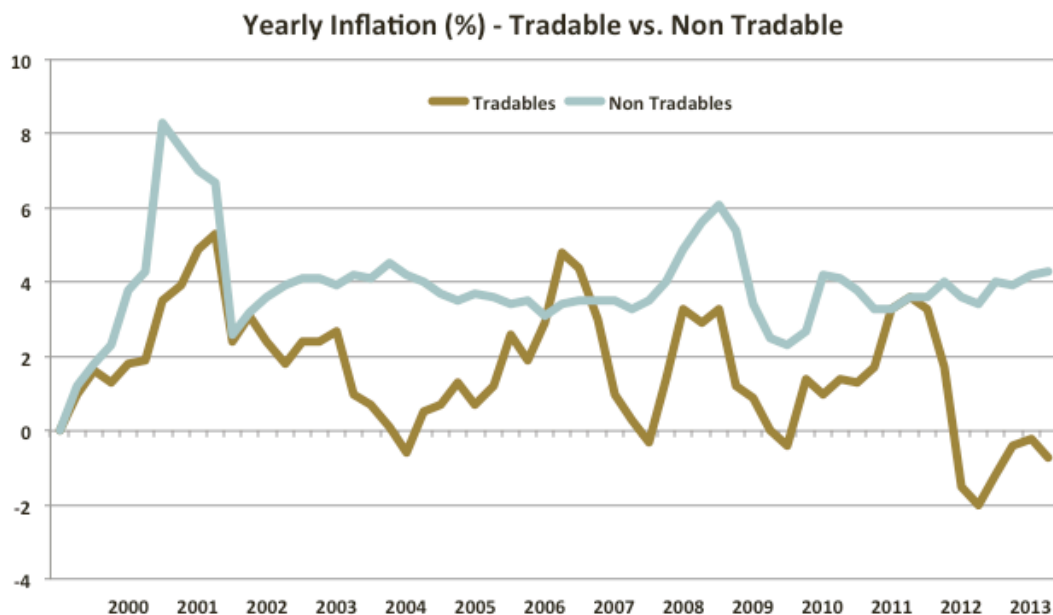
The RBA, Inflation and the AUD

Despite the pick up in inflation to 2.7% in December 2013, **official** cost of living increases in Australia has been relatively benign the past few years.

Be that as it may, many Australians are fretting over the rising cost of living, which is likely due to the fact that whilst the headline rate for inflation has been low, price increases for 'essential' items have not been quite so benign.

In the 5 years to the end of 2013, whilst official CPI only averaged 2.4%, the increase in prices for education (+5.7% p.a.), medical and hospital services (+6.6% p.a.), child care (+5.1% p.a.), property rates (+6% p.a.) and utilities (+11.5% p.a.) have been running at between 2 and 4 times the official CPI increases.

Inflation could get worse in the years ahead too, as one of the major benefits of a high Australian dollar (yes a strong currency does bring benefits) has been that tradable inflation has been low, as the following graph highlights.



Source: Australian Bureau of Statistics

If we do get a lower AUD, it might help some parts of our economy but it will mean higher prices for imported goods for everybody. You'll notice it every time you fill up your car.

As regards the level of the AUD, the Reserve bank surprised quite a few market commentators and analysts when it dropped 'easing bias' as regards interest

rates, implying that they think the Aussie economy may have bottomed and is turning a corner, meaning further monetary stimulus is unnecessary.

The immediate impact of this was to see the AUD go back above USD \$0.90, a level the RBA previously referred to as 'uncomfortably high'. Watch this space.

The mining boom – best days behind us.

Whilst nearly everyone in Australia has heard the term 'mining boom' and is aware on some level that we've been living through one, not many would appreciate just how profound its impact has been.

Rising prices for commodities saw our terms of trade reach record highs, and account for roughly 50% of our national income growth in the previous decade.

Capital expenditure in the mining sector alone rose to previously unheard of highs, accounting for over 50% of total business investment at its peak and approximately 7% of GDP in total.

This was an unprecedented increase considering the long run average was closer to 1% of GDP, and was primarily responsible for Australia avoiding a recession, alongside the rest of the developed world when the GFC hit.

Going forward though, prices for many commodities may well ease and capital expenditure will most certainly decline, both of which will be negative for growth, and the highly paid employment that the sector offers.

That is not to say that it's all bad news though, with phase three of the mining boom likely to see exports volumes rise substantially, whilst imports of capital equipment will fall.

Net exports will therefore continue to underpin the Australian economy, which is needed as over 90% of the growth Australia recorded in the year to end September 2013 came from this one channel.

Trading Partners

Another point to note when looking at Australia is how well our major trading partners are performing. Looking to Asia, we see that the news is not so good. Japan (our second largest trading partner) just registered a quarterly growth rate of only 0.3%.

Annualised growth is now only 1% per annum, some 60% lower than the 2.8% that was expected by the market, despite the efforts of the Abe Government and the Bank of Japan.

Note, this is occurring before a planned sales tax hike in Japan, from 5% to 8%, comes into effect in April. This is a necessary policy for a country desperate to

show some semblance of fiscal restraint, with a sovereign debt burden of over 200% of GDP.

In China, the market everyone pays most attention too considering they consume roughly 30% of our total exports, things are slowing down also.

The latest manufacturing and services PMI's both weakened, although it must be noted that their latest export and trade figures were very strong. GDP growth in China, whilst still a highly respectable 7.7% year on year, has slowed from the 9-10% it was averaging between 2010 and 2012.

Australia also faces a challenge as China attempts to rebalance its economy away from its focus on exports and fixed capital investment (which was great for Australian natural resources) and drive more consumption.

Conclusion

All in all, we remain highly sceptical of the 'rebalancing' story and see considerable downside risk in the Australian economy in 2014 and beyond.

After over 20 years of constant economic expansion, tougher times are to be expected and a confluence of events, including rising unemployment, higher tradeable inflation, a slow-down in China and other major trading partners along with a prudent consumer will in all likelihood see lower, or essentially stagnant levels of growth in 2014 and beyond.

We expect that much like 2007 when the RBA didn't see the GFC coming and again in 2010 when they began hiking rates post GFC, the RBA has again misread the underlying weakness in the economy, and that the next move in interest rates will be down.

The only thing holding them back from this is the fear of a bubble developing in Sydney property, which they are obviously well aware of.

We also think that whilst home construction will continue to rise, it won't be enough to offset the capital expenditure cliff in the mining sector, or the lack of business investment elsewhere.

Furthermore, with the value of our residential land already topping \$5 trillion in this country, roughly 3 times our annual GDP and approaching 60% of the household 'net wealth', we're sceptical of the need to invest more in what for most is, at least in an economic sense, an unproductive and highly expensive asset.

We expect the government not to produce any major surprises in the upcoming budget. Facing a potential decade of deficits and with a pre-commitment to expensive social policies already in place, it will be difficult for them to provide further fiscal stimulus, despite pleas for a nationwide infrastructure boom.

At present, we expect the RBA will cut rates again in Q2 of this year and expect to see a 2% cash rate by late 2014 or early 2015.

We expect the unemployment rate to head higher this year and most likely into 2015 as well, whilst underemployment will become even more of an issue than it is today.

Investors should be thankful for the rally in risk assets that occurred in 2013, but should adopt a cautious approach this year and beyond.

The myriad of economic problems that first surfaced when the GFC hit have not been fully addressed meaning significant risks remain.

Warm Regards



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