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AMP capital INVESTORS

Australia enters recession

Oliver's insights

Key points

- The Australian economy finally succumbed to the global downturn in the December quarter with GDP falling 0.5%. We are now effectively in recession. In the absence of Government stimulus the fall would have been even steeper.
- The recession probably has another 6 to 12 months to run. The global slump has yet to really hit our exports and leading indicators are continuing to slide. On average, Australian recessions last approximately 12 months.
- Unemployment is likely to rise to 7% by year end before peaking next year around 9%. The recent up-tick in the housing market is likely to be just a false dawn before more weakness, company profits are likely to fall 20 to 30% this year and the cash rate has more downside. The decision by the RBA to leave interest rates on hold was premature.
- Fortunately, the absence of housing oversupply, the fall in the $A and quick stimulatory action by the authorities should mean that the recession in Australia will be milder than that already underway in most other developed countries.

Australia has effectively entered recession

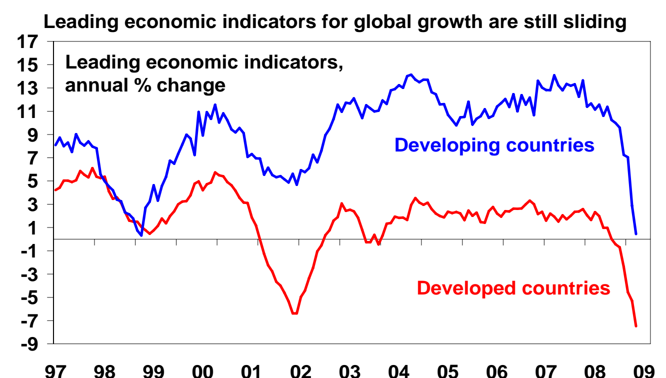
The December quarter national accounts showed GDP falling 0.5% (after +0.1% growth in the September quarter), which took growth for the year to the December quarter to just 0.3%. **While Australia hasn't yet met the so-called technical definition of recession (entailing two consecutive negative quarters) for all intents and purposes Australia has entered recession** – non-farm GDP has fallen for two quarters in a row and other measures of economic activity such as employment and industrial production are now falling consistent with a recession having commenced. While net exports added strongly to growth in the December quarter, both business investment and consumption were softer than expected and growth generally was dragged down by a continuing slump in dwelling investment, falling profits and broad based falls in production. Australia's 0.5% slump in GDP is a far better outcome than the December quarter slumps of -1.6% qtr on qtr in the US, -1.4% in Europe and -3.3% in Japan. Unfortunately, though there is more bad news ahead for Australia.

Expect more weakness ahead

There are several reasons to expect the recession to deepen over the next six months.

Firstly, the global economy is continuing to worsen. Leading indicators for developed and developing economies are still falling & show no signs of recovery yet.

Leading economic indicators for global growth are still sliding



Source: Thomson Financial. AMP Capital Investors

During past recessions, the slump in the global economy normally led the Australian economy by around 6 to 12 months. The table below provides an indication of what is coming down the line in terms of the likely hit to our resources exports. The table shows growth in GDP and exports for our top ten trading partners (which account for roughly 75% of our exports).

Growth & exports in Australia's top ten export markets

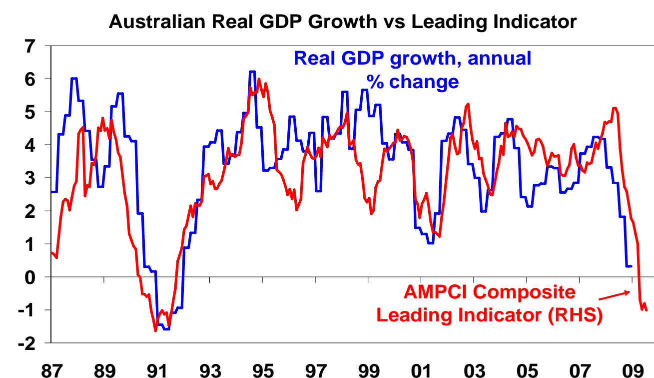
Country	% of Australian exports	December quarter GDP growth, %	GDP growth over year to December quarter, %	% change in exports over the last year
Japan	22.6	-3.3	-4.6	-45.7 (Jan)
China	14.8	+0.5 (est)	+6.8	-17.5 (Jan)
Korea	8.3	-5.2	-3.4	-17.1 (Feb)
India	6.1	0.0 (est)	+5.3	-15.9 (Jan)
USA	5.4	-1.6	-0.8	-12.9 (Dec)
NZ	4.2	-0.4 (Q3)	-0.1 (Q3)	+4.4 (Dec)
UK	4.2	-1.5	-1.9	+3.0 (Dec)
Taiwan	3.8	-5.6	-8.4	-44.1 (Jan)
Singapore	2.8	-4.1	-4.2	-20.4 (Dec)
Thailand	2.4	-5.7	-4.3	-23.3 (Jan)
Australia	*NA*	*-0.5*	*+0.3*	

Source: ABS, RBA, AMP Capital Investors

Eight of our top 10 export destinations are now in recession. Only China and India are still recording positive year on year growth, but both saw growth virtually stall in the December quarter. More worryingly, all bar two of these countries have seen their exports fall over the last year, in

some cases very sharply. It's only a matter of time before this hits Australia. Most of these countries export processed items like cars and electronics. Australia's raw material exports are key inputs and so will be hit hard over the year ahead. So while our export volumes are still up over the past year, a sharp fall is likely this year.

Our leading indicator points to Australian GDP falling further. This reflects the fall in consumer and business confidence, the continuing slump in housing related indicators and the slump in global growth.



Source: Thomson Financial. AMP Capital Investors

Finally, in terms of the specific components of growth:

- While lower interest rates and Government payments to households will help consumer spending, this will likely be offset by low consumer confidence, the deteriorating labour market and the continuing slump in household wealth since 2007 highs (which so far amounts to a 10 to 15% decline). The caution on the part of households is indicated by the rise in the household savings ratio to 8.5%, its highest level since 1990, which indicates that households are saving the bulk of the payments to them from the Federal Government. A further rise is likely in the current quarter. The good news is that boost to the household sector from the Federal Government is allowing households to pay down debt without having to chop as much into their spending.
- Falls in home building approvals point to a further drop in dwelling investment out to mid year at least.
- The slump in profits, business confidence, capacity utilisation and the credit crunch point to a sharp fall in business investment over the year ahead.

How deep the recession?

The big question is now how deep and how long the recession will be? The table below indicates what has happened in the past five recessions in Australia.

What happened in past Australian recessions?

Recession	Fall in GDP, %	Length, qtrs	Fall in inflation % points	Rise in unemploy-ment, % points	Fall in cash rate, % points
1960-61	-2.4	4	-5.2	+2.7	NA
1975	-2.1	2 *	-11.2	+3.2	-14.1
1977	-0.6	2	-5.4	+2.3	-2.4
1982-83	-3.8	7	-5.7	+4.9	-12.4
1990-91	-1.7	5	-4.6	+5.2	-13.5
Average	**-2.1**	**4**	**-6.4**	**+3.7**	**-10.6**

* It can be argued that the mid-1970s recession was much longer as GDP peaked in 1973 and spent several quarter just bouncing up and down in a declining trend. Source: ABS, RBA, AMP Capital Investors

On average recessions have seen GDP fall around 2%, spread over 4 quarters, sharp falls in inflation and cash rates and sharply higher unemployment.

Thanks to the severity of the credit crunch and the synchronised nature of the downturn, the global recession now underway is shaping up to be the worst in the post war period. For Australia, however, there are several reasons to believe it will not be the worst post war recession:

- there is still a reasonable (albeit diminishing) pipeline of yet to be completed investment projects;
- we have a shortage of houses in contrast to the US which has an oversupply;
- Australia does not have an inventory overhang. In fact the stocks to sales ratio is at a record low;
- Australian banks are in relatively good shape;
- the transmission mechanism from lower official interest rates to private sector borrowing rates has been working far better than in other countries;
- the plunge in the $A will provide a huge boost to exporting and import competing industries; and
- the Government and RBA have recognised the threat and undertaken fiscal & monetary stimulus far earlier than was the case in past recessions. Official firepower is also stronger in Australia given the starting point of zero net public debt and still relatively high cash rates.

That said, a recession as bad as that in the early 1990s now looks to be on the cards.

Implications

The key implications are likely to be as follows:

- Unemployment is likely to rise to 7% by year end, and to around 9% next year.
- Inflation is likely to fall sharply thanks to spare capacity in factories and in the labour market.
- While the first home owners grant and lower interest rates are currently providing a boost to house prices, this is unlikely to be sustained in the face of rising unemployment and we see further falls in house prices.
- Company profits are likely to fall further. Profits fell about 20% during the 1982-83 recessions and by 45% during the early 1990s recession. This year they are likely to fall by around 20 to 30%.
- Despite the RBA's decision to pause at its latest meeting, further rate cuts are likely in the months ahead, ultimately taking the cash rate to 2.25%.

The risk of a current account deficit blow-out

The combination of a slump in imports and yet still high export prices and volumes saw the current account deficit shrink to just 2.2% of GDP in the December quarter. A risk going forward though is that as a result of fiscal and monetary stimulus Australia is successful in holding up domestic demand relative to that in other countries and hence imports, but that depressed global growth hammers exports resulting in a blow-out in the trade deficit. In a capital starved world this could prove difficult to finance without a substantial fall in the value of the $A. This is not our base case but is worth keeping an eye on.

Concluding comments

Australia is in for a rough ride over the year ahead. After falling over 50% and with interest rates and bond yields down sharply, shares are already discounting a greater than 50% slump in profits, but the economic recession likely suggests that it's still too early to ring the all clear bell for shares.

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