



The Australian economy – seven reasons not to be too gloomy

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Key points

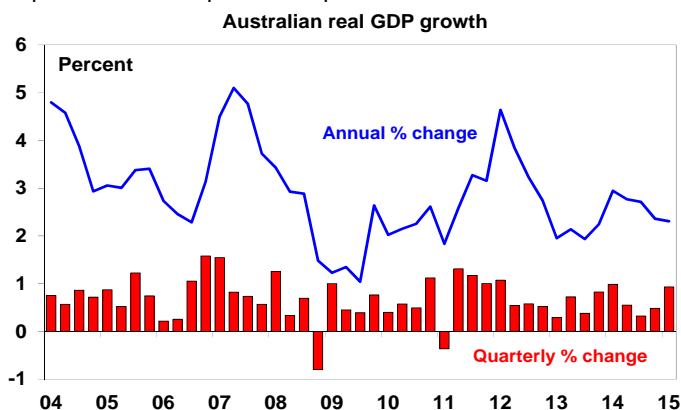
- > Australian economic growth came in at a stronger than expected 0.9% in the March quarter, but remains sub-par on an annual basis at 2.3% and demand remains very weak.
- > More help is likely required via a lower \$A (expect to see \$US0.70 by year end) and maybe another rate cut.
- > Record low borrowing rates, rising wealth levels, lower petrol prices than last year, relatively high household saving, the lower \$A, rising export volumes and better management of the last boom are reasons not to get too gloomy on Australia.

Introduction

Ever since the mining boom ended around 2011/2012 there have been constant predictions of doom for Australia. Foreign commentators and investors seem to have been particularly bearish on this front. I seem to constantly come across an ad on the internet titled “Australian Recession 2015 – Why it’s coming, what to do and how you can profit. FIND OUT MORE”. Never mind that last year the same ad referred to 2014! The mining collapse is still unfolding and growth has not been great, but the bust for the Australian economy many have been foreshadowing has not occurred. This note looks at the latest growth figures and seven reasons not to be too gloomy.

First the bad news - growth is too slow

March quarter GDP growth in Australia was much stronger than expected at 0.9% quarter on quarter.

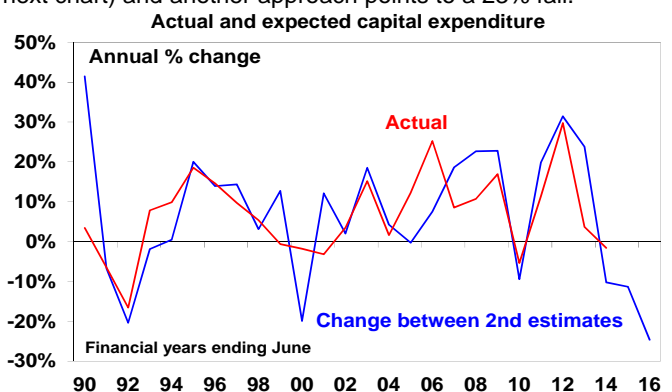


Source: ABS, AMP Capital

However, on an annual basis it has slowed to just 2.3%, which is well below potential growth of around 3-3.25%. What’s more, inventories contributed 0.3 percentage points to growth and net

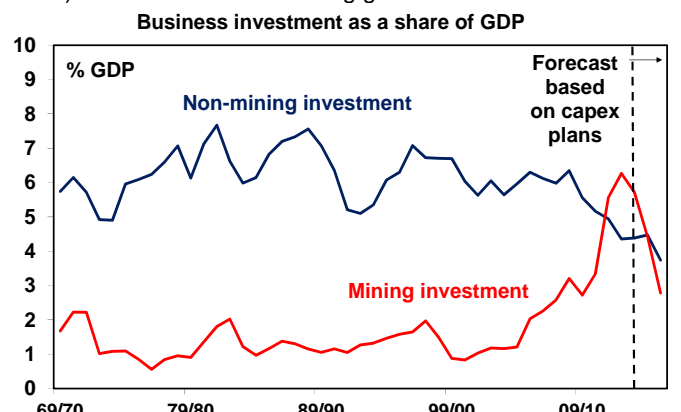
exports contributed 0.4 percentage points so domestic final demand was actually flat in the quarter or just 1.1% year on year. While home construction has picked up (+9.2% year on year) and consumer spending is okay (+2.6% year on year), public demand is weak (-0.2% year on year) and business investment is falling sharply (-6.1% year on year) led by mining investment.

Business investment (or capex) plans from ABS surveys point to more weakness ahead. Comparing the latest estimate of investment for 2015-16 with that made a year ago for 2014-15 points to a 25% fall in business investment in 2015-16 (see the next chart) and another approach points to a 23% fall.



Source: ABS, AMP Capital

Mining investment is now falling rapidly back to 2% of GDP as large projects complete. To offset this we need to see growth in other parts of the economy pick up and we have seen some success with housing and consumer spending. However, non-mining investment remains disappointing; with capex plans pointing to renewed weakness in the year ahead (see the next chart). This in turn is threatening growth.



Source: ABS, AMP Capital

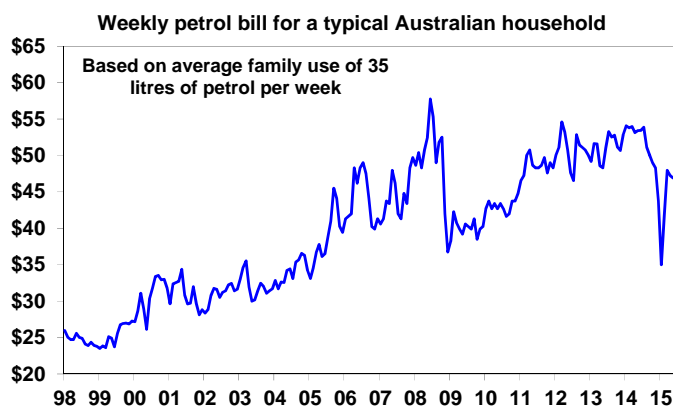
More broadly, several factors seem to be behind continued sub-par growth in the economy including: steeper than expected falls in commodity prices that have cut into nominal growth (nominal GDP growth was just 1.2% over the last year); the ongoing threat of more budget austerity; understandable household reluctance to take on more debt post the GFC; the \$A remaining too high; and non-mining companies understandably taking a while to turn around from the battering they took through the mining boom (thanks to the strong \$A, high and interest rates and competition for labour).

Against this backdrop an even lower \$A is probably still needed (expect it to fall in \$US 0.70 by year end) and to ensure this occurs the RBA needs to continue trying to jawbone it lower and, if need be, cut rates again. The chance of another rate cut is now around 50/50 with the August RBA meeting at which it will next review its economic forecasts being the one to watch.

Seven reasons not to get too gloomy

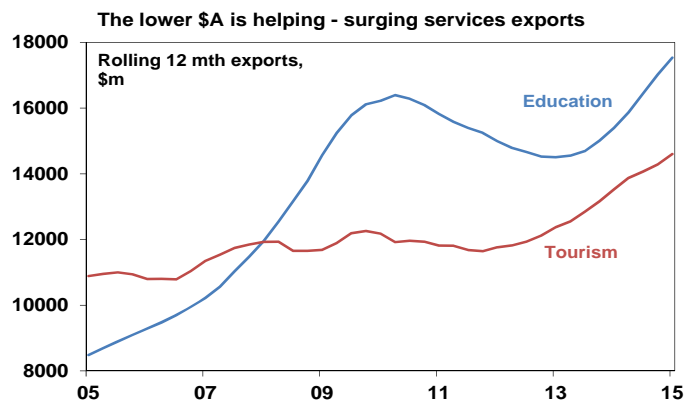
While growth is sub-par and growth in domestic demand is particularly weak it's not the recession some continue to fear. There are seven reasons for optimism.

- First, borrowing rates are at generational lows. Interest payments on a \$350,000 mortgage are now around \$730 a month below what they were four years ago. While those relying on bank deposits have lost income, Australians owe the banks \$1.2 trillion more in debt than the banks owe them via deposits, so the household sector is a net beneficiary of low rates. Some of this freed up income is being spent.
- Second, rising wealth levels are benefiting spending. Over the year to May average capital city home prices are up 9% (although skewed to Sydney), the Australian share market has returned 10% and average balanced growth superannuation funds have returned around 14%.
- Third, while petrol prices have bounced back from the lows seen earlier this year, they remain well down on the highs seen over the last few years, providing savings to businesses and households.



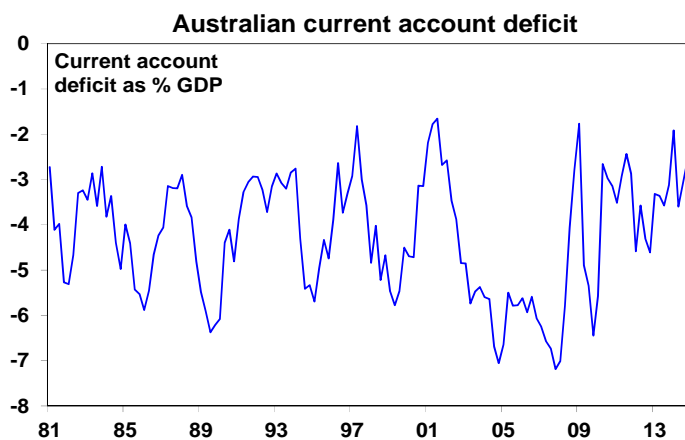
Source: AMP Capital

- Fourth, the household savings rate remains relatively high at 8.3% and has scope to drift down further supporting spending.
- Fifth, the lower \$A is a big positive for manufacturing, tourism, education, services, farming and mining. The boost is evident in education and tourism exports which took a hit when the \$A went above parity, but are now at record levels. It's also worth recalling the comment from BlueScope CEO Paul O'Malley from earlier this year: "As the \$A gets into the 70s we get competitive, and with a year or two of that...you start to get the confidence to invest." The point is that it takes a while for this to feed through so we shouldn't be too depressed as non-mining companies take their time to get more confident on this front.



Source: ABS, AMP Capital

- Sixth, export volumes are continuing to rise strongly (+8.1% year on year) on the back of completed resource projects and as the lower \$A makes exports more competitive. Reflecting this, the current account deficit as a share of GDP is around its lowest in the last 30 years, despite plunging prices for resources exports.



Source: ABS, AMP Capital

- Finally, Australia has arguably managed the boom a bit better than it has in the past when booms led to inflation or trade deficit blow-outs or both and all sectors of the economy boomed together and so went bust together. This time there was no major build-up of imbalances in the economy and sectors suppressed by the mining boom have the potential to bounce back and are starting to.

So while growth remains sub-par, the risk of a recession remains relatively low and growth should start to move back to around trend at some point next year. In other words there is no reason to get overly gloomy on Australia.

Implications for investors

With the commodity tailwind now a headwind for the Australian economy and the Australian dollar likely to remain under downwards pressure it makes sense for Australian investors to have more in offshore investments than was the case a decade or so ago. Interest rates are also set to remain very low.

However, there is no need to get too gloomy on the outlook for Australian assets. The economy is likely to avoid recession or a severe slump as growth continues to gradually rebalance. And the yields on Australian bonds, shares, commercial property and infrastructure remain relatively attractive globally.

While the Australian share market ran ahead of itself earlier this year and has been in correction mode for the last few months, by year end it should be able to push up to the 6000 level.

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