The Australian economy still in the doldrums with more help from the RBA and $A needed

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EDITION 8

Key points

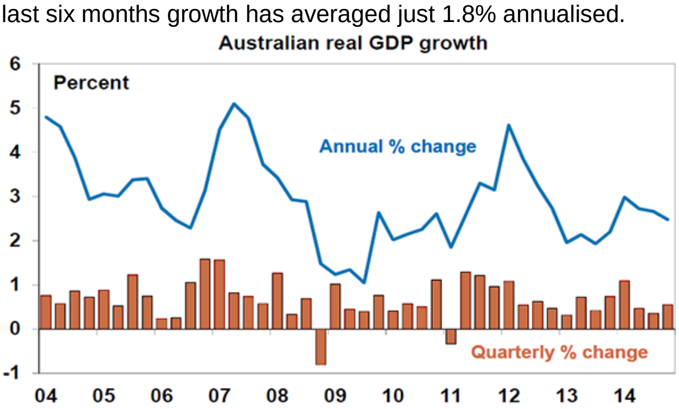
- Australian economic growth remains weak at 2.5%.
- Expect another one or two RBA cash rate cuts and the $A to fall to around $US0.70 by year end.
- Record low borrowing rates, the falling $A, lower fuel prices and rising wealth should help boost growth to 3% or just over next year.
- The recent profit reporting season was better than feared, but stronger economic growth will be needed to meet market expectations.

Introduction

Through 2013-14 it seemed the Australian economy was starting to transition away from a reliance on mining investment to more broad based growth. Unfortunately this transition has wavered a bit recently and growth has remained below trend. Fortunately, the RBA has recognised the problem and resumed cutting interest rates. This note looks at the outlook for growth and rates and what it means for profits and investors.

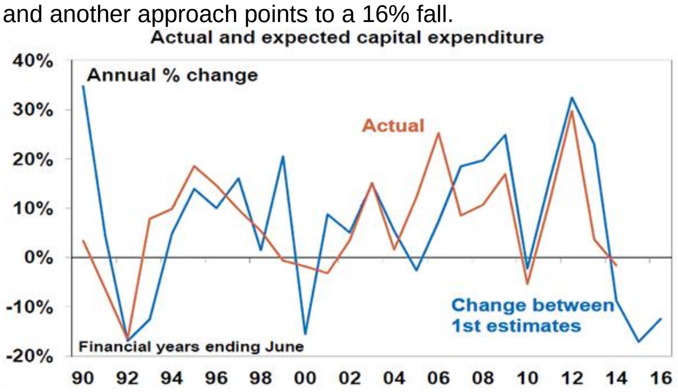
Growth remains too slow

December quarter GDP growth in Australia was soft at just 0.5% quarter on quarter or 2.5% year on year. In fact over the last six months growth has averaged just 1.8% annualised.



Source: ABS, AMP Capital

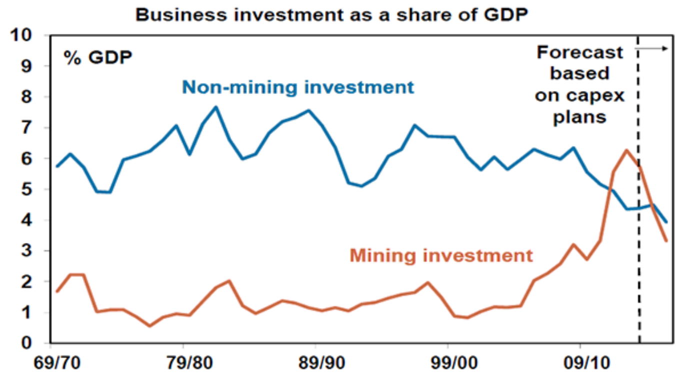
This is well below potential growth of 3-3.25% and explains why unemployment is trending up. While home construction has picked up (+8.1% year on year), consumer spending is solid (+2.8% yoy) and net export volumes contributed 1.5 percentage points to GDP growth through 2014, this has been partly offset by a rundown in inventories, weak public spending (-1.1% yoy) and falling business investment (-3.2% yoy). While the negative contribution from de-stocking is likely to be temporary, the weakness in business investment is more concerning. Business investment (or capex) plans from ABS surveys point to more weakness ahead. Comparing the first estimate of investment for 2015-16 with that made a year earlier for 2014-15 points to a 12% fall in business investment in 2015-16 (see the next chart) and another approach points to a 16% fall.



Source: ABS, AMP Capital

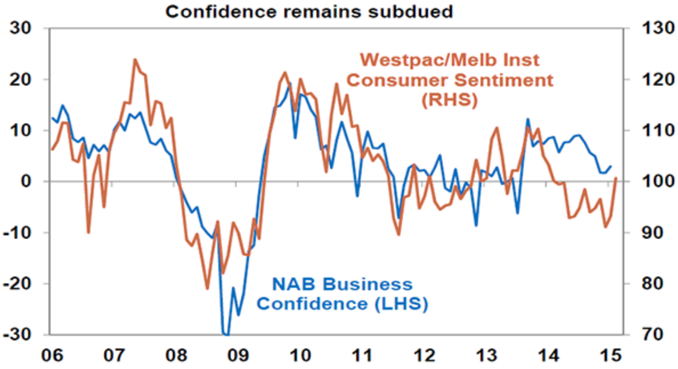
While the investment plans have tended to exaggerate the actual weakness lately, what is concerning is that the outlook for non-mining investment has turned back down.

The basic dynamic now in Australia is that mining investment, having risen from around 2% of GDP to 6%, is now falling rapidly back to 2% as large projects complete, with falls running at around 20% pa. 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 springing to life and more recently, improvement in tourism and higher education. However, non-mining investment remains disappointing. While it was starting to stabilise, it now looks to be turning back down again (see the next chart). This in turn is threatening growth.



Source: ABS, AMP Capital

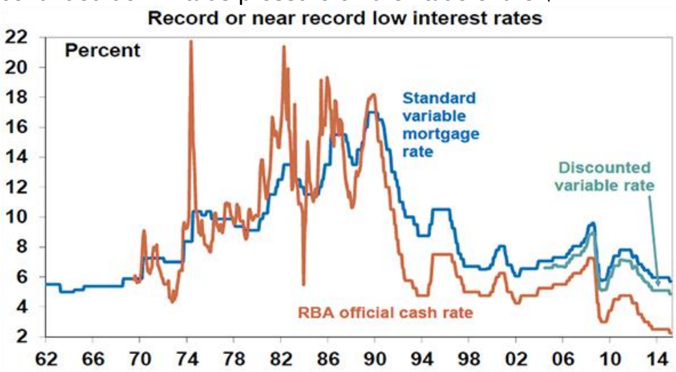
More broadly, several factors seem to be behind continued sub-par growth in the economy, including: steeper than expected falls in commodity prices that have cut into nominal growth (nominal GDP growth was just 1.7% through last year); the ongoing threat of more budget austerity; and too tight monetary policy, as particularly reflected in the $A remaining too high. Indeed business confidence has now followed consumer confidence back down after an election-related boost in 2013.



Source: Bloomberg, AMP Capital

RBA rate cuts

Reflecting the continued delay in the return to decent growth, the RBA cut rates again in February to 2.25% and signalled a clear easing bias after its March meeting, with the comment that "further easing of policy may be appropriate over the period ahead". We expect at least one more cut in the cash rate in the months ahead. This is necessary to boost confidence and spending power in the economy both directly and indirectly via continued downwards pressure on the value of the $A.



Source: RBA, Bloomberg, AMP Capital

While interest rates have fallen to record or near record lows, it is clear that lower rates aren't generating quite the same response they used to. This reflects more cautious attitudes to debt, the difficulty in turning non-mining related activity up again after it was supressed through the mining boom and the fact that the $A has been very high until recently. In short, the neutral cash rate has fallen from the 5% or so norm that prevailed prior to the GFC. It is probably now closer to 3%, implying a 2.25% cash rate is not really that easy. While our base case is that rates will bottom at 2%, there is a good chance rates will slip below 2% by year end.

But what about surging Sydney property prices? No doubt this was again a point of debate at the RBA's March Board meeting, but strong property price gains are concentrated in Sydney with prices rising only around 4% year on year, on average, elsewhere. So this should be seen as more of an issue for the prudential regulator APRA to bring under control.

But it's not all gloomy

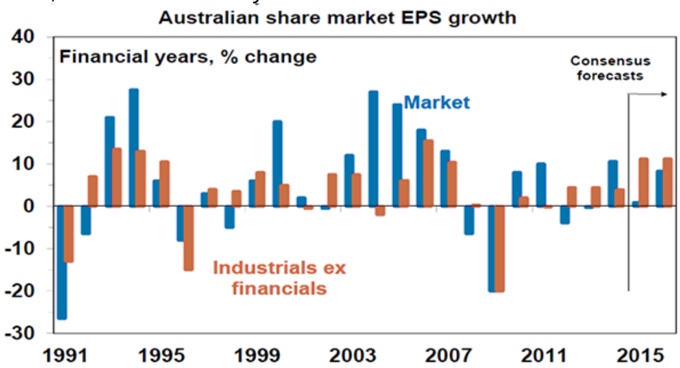
While growth is sub-par it's not the recession some continue to fear and there are reasons for optimism.

- Borrowing rates are at generational lows. Australians owe the banks $1.2 trillion more than the banks owe them, so the household sector is a net beneficiary of low rates.
- The fall in the $A is a big positive for manufacturing, tourism, higher education, services, farming and mining. As BlueScope CEO Paul O'Malley said recently: "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 collapse in oil prices has delivered savings to businesses and households.
- Rising wealth levels are benefiting spending.
- The household savings rate remains relatively high at 9% and has scope to drift down supporting spending.
- Export volumes are rising solidly on the back of completed resource projects and as the lower $A makes exports more competitive. In fact, the current account deficit as a share of GDP is around its lowest in the last 30 years.

So growth should pick up in time. We see the economy returning to a 3% pace, or slightly above, by early next year. But this does assume another rate cut and a lower $A.

Profits better than feared

While the economy has remained sluggish, earnings reports for the second half of 2014 were better than feared. Yes overall profit growth this financial year looks flat thanks to a roughly 25% fall in resources profits on the back of lower commodity prices and revenue growth is sluggish at around 2%. But banks are seeing solid profit growth of around 8% and industrials around 10%. 55% of December half profit results beat expectations against a norm of 45%, 66% saw profits rise from a year ago, 52% saw their share price outperform the day results were released, and 62% increased dividends. Key themes include ongoing cost control and solid growth in dividends of around 5% which is resulting in a rising payout ratio, albeit this is mainly in the resources sector.



Source: UBS, AMP Capital

While market expectations for 8% earnings growth next financial year look optimistic, providing overall economic growth does start to improve a bit going into 2016, as expected, profit growth should improve. The fall in the $A alone over the last year should add at least 3 percentage points to profit growth.

Implications for investors

There are several implications for investors. First, bank term deposit rates are likely to get even lower, further fuelling the search for yield.

Second, further rate cuts will contribute to the downtrend in the $A. Expect a fall to $US0.70 by year end. So continue to favour unhedged over hedged global shares.

Third, overweight Australian versus global bonds as the gap in yields is likely to narrow further.

Finally, Australian shares have run ahead of earnings taking the forward PE to 16 times, which is above its long term average of 14, resulting in the risk of a short term correction. However, the broad trend in shares is likely to remain up supported by low rates and an eventual pick-up in economic growth.

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