National Australia Bank

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Quarterly Business Survey — December quarter 2013

Business confidence in the December quarter was at its highest in more than 2½ years. Business conditions lifted to their highest level in more than 12 months suggesting activity is starting to catch up – albeit still below trend. Forward indicators remain soft, including forward orders, keeping labour demand weak. The survey measures of price pressures remain muted. Special question on the impact of currency now showing increased pressures on transport but less on wholesale.

- Business confidence lifted to its highest level in more than 2½ years, although monthly measures show a levelling off late in the quarter. Conditions are now starting to catch up with confidence, but remain soft.
- Better sentiment was felt across most states and industries (excluding retail). The post-election 'honeymoon' continued well into the December quarter, helping to prop up confidence, although a better housing sector (predominately driven by investors), higher asset prices and a lower AUD and interest rates are all contributing. However, with the AUD stabilising at elevated levels, our special question shows that the impact on competitiveness is affecting transport and manufacturing (particularly firms in Victoria and Tasmania), while wholesale and retail benefit from reduced inflationary input cost pressures.
- Business conditions rose to their highest level in more than a year. The Survey points to six-month annualised GDP growth in the December quarter of around 3% (ie. below trend). While forward orders and capacity utilisation lifted a little in the quarter, they remain at subdued levels, and combined with weak employment conditions, suggest little improvement in near-term demand.
- Business conditions rose across all industries in Q4, but most remain quite weak. Services are a stand out with recreation & personal services, and finance/ property/ business services recording a positive net balance. Conditions are weakest in wholesale – a bellwether for the economy – followed by construction and mining. Conditions rose across all states, but Victoria is the only state were the index is positive.
- Business investment intentions (next 12 months) rose unexpectedly in the December quarter to around their long-run average. Mining intentions kept falling (to -19 points) but is under-weighted in the survey. Near term employment expectations remain soft, consistent with NAB's view for a rising unemployment rate.
- Product price inflation lifted a touch in the quarter, recording annualised inflation of 0.7% (0.2% in the quarter). Retail price inflation in the Survey was unchanged in the quarter in contrast to the unexpected pick up in underlying CPI inflation for Q4. Labour and purchase costs growth remain modest – with margin pressures easing.

Implications for NAB forecasts:

- No change to latest Global and Australian Forecasts (released 28 January).

Key quarterly business statistics**

	2013q2	2013q3	**2013q4**		2013q2	2013q3	**2013q4**
		Net balance				*Net balance*	
Business confidence	-1	5	**8**	Trading	-4	-5	**1**
Business conditions				Profitability	-7	-8	**-3**
Current	-6	-7	**-3**	Employment	-7	-9	**-6**
Next 3 months	3	3	**6**	Forward orders	-7	-5	**-2**
Next 12 months	13	16	**24**	Stocks	-1	-3	**1**
Capex plans (next 12)	15	14	**20**	Exports	-3	0	**1**
		% change				*% change*	
Labour costs	0.5	0.4	**0.4**	Retail prices	0.0	0.2	**0.2**
Purchase costs	0.4	0.5	**0.4**			*Per cent*	
Final products prices	0.0	0.1	**0.2**	Capacity utilisation rate	79.6	80.0	**80.3**

** All data seasonally adjusted, except purchase costs and exports. Fieldwork for this Survey was conducted from 25 November to 13 December 2013, covering over 900 firms across the non-farm business sector.

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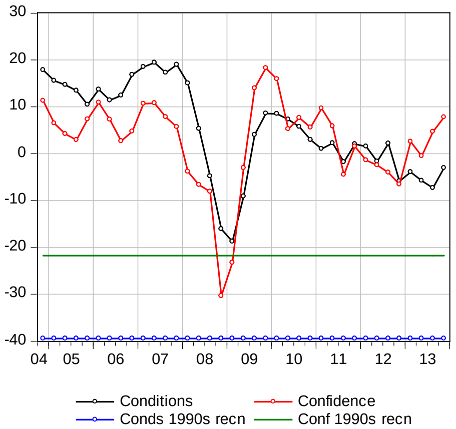
Next release:
11 February 2014 (January Monthly)

Analysis

The business environment in Q4 has remained very difficult since the start of the year, but is now showing some signs of green shoots. In the quarter, the level of **business conditions** picked up from -7 in the September quarter to -3 points. Despite still lacklustre business activity, businesses became more confident in Q4, with the **business confidence** index lifting from +5 points to +8 points. It appears as though the post-election 'honeymoon' period continued well into the December quarter, helping to prop up confidence, although relative improvements in the housing sector (predominately driven by investors), higher asset prices and a lower AUD and interest rates are all contributing. At +8 points, business confidence is now well above the series long-run average of +4 points since 1989. While confidence rose in the quarterly business survey, the monthly survey suggests it has lost some momentum.

Activity slow to respond to higher confidence

Confidence & conditions (net balance., s.a.)



Confidence = excluding normal seasonal changes, how do you expect the business conditions facing your industry in the next 3 months to change?

Conditions = average of the indexes of trading conditions, profitability and employment.

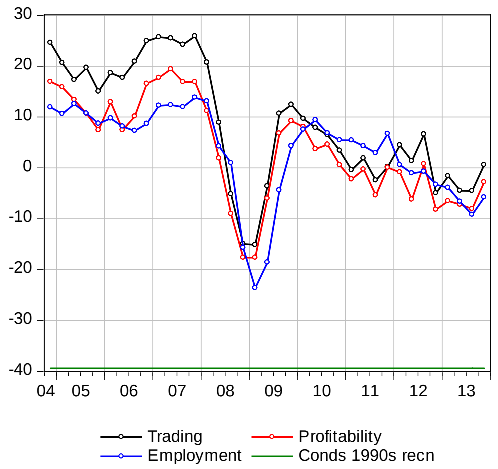
The divergence in conditions and confidence measures remains wide, but narrowed slightly in the quarter. Business activity is starting to respond to the relative optimism and signs of improvement in pockets of the economy, although broader conditions remain at lacklustre levels. Business conditions, at -3 index points, have been negative for 5 consecutive quarters.

	Quarterly					*Monthly*				
	2012q4	2013q1	2013q2	2013q3	**2013q4**	2013m08	2013m09	2013m10	2013m11	2013m12
Confidence	-7	3	-1	5	**8**	5	12	7	6	6
Conditions	-6	-4	-6	-7	**-3**	-7	-4	-4	-3	4

The moderate improvement in **business conditions** in the December quarter reflected better outcomes across all the major components (trading conditions, profitability and employment). By industry, the conditions index rose most sharply in the mining sector, although the level of conditions remained uninspiring – suggesting ongoing consolidation of Australian mining operations. Conditions reported in transport & utilities – a bellwether of demand – improved as well, but also remain at very subdued levels. All other industries reported improvements in the quarter, with rec & pers services, and wholesale showing the smallest rises; although rec & pers services is the strongest industry in levels terms. Conditions were weakest in wholesale – where the depreciating AUD can be most damaging – followed by construction, with 'green shoots' in housing unable to offset the passing peak in mining investment.

Activity measures tick higher, but remain poor relative to history

Business conditions components (net bal., s.a.)



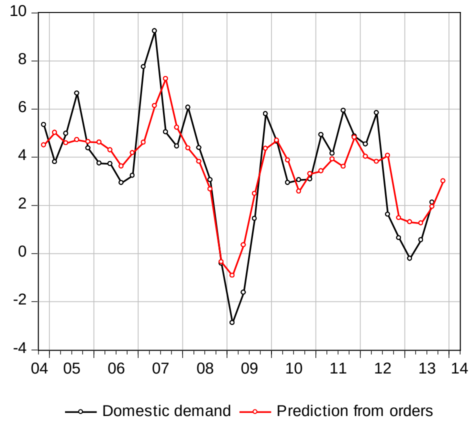
Net balance of respondents who regard last 3 months' trading / profitability / employment performance as good.

	Quarterly					*Monthly*				
	2012q4	2013q1	2013q2	2013q3	**2013q4**	2013m08	2013m09	2013m10	2013m11	2013m12
Trading	-5	-2	-4	-5	**1**	-5	-2	-2	2	12
Profitability	-8	-7	-7	-8	**-3**	-9	-4	-6	-4	6
Employment	-3	-4	-7	-9	**-6**	-9	-6	-3	-8	-4

Analysis (cont.)

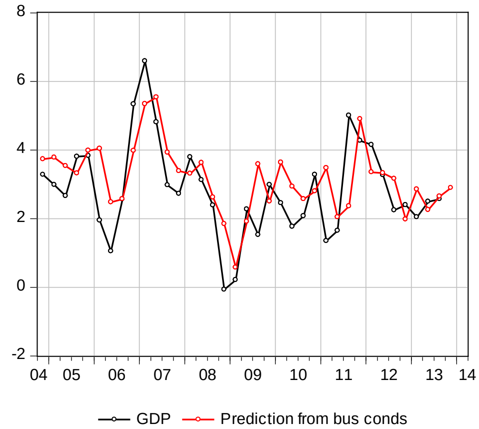
Demand growth picking up

Forward orders (change & level) as an indicator of domestic demand (6-monthly annualised)



GDP growth still below trend

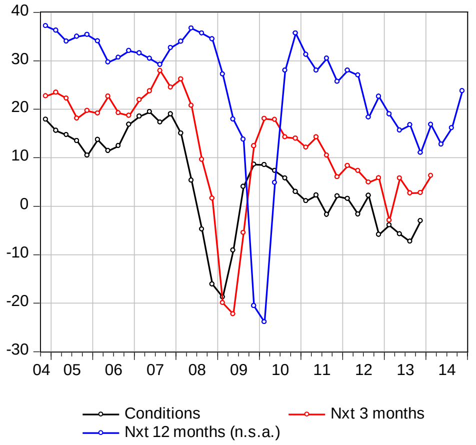
Business conditions (change & level) as an indicator of GDP (6-monthly annualised)



Based on forward orders in Q4, the survey implies that 6-monthly annualised demand growth remained modest at around 3% in Q4. Using forward orders as a leading indicator for Q1 2014, the survey implies 6-monthly annualised demand growth will rise modestly to 3¼%. Similarly, based on business conditions in Q4, the survey implies that 6-monthly annualised GDP growth was a below-trend 3% in Q4. If Q3 business conditions drive economic activity during Q1 2014, the implied growth rate would remain slightly below 3%.

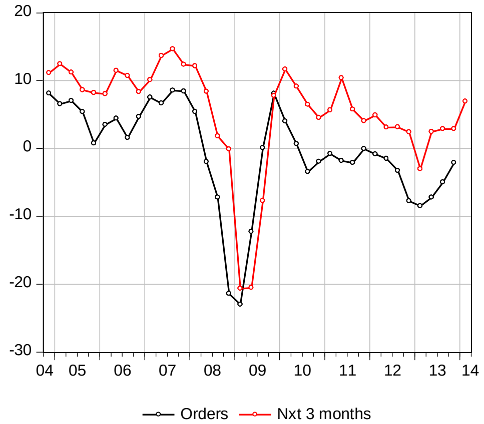
Longer term expectations improve

Business conditions & expectations (net balance)



Orders rising but still soft

Forward orders & expectations (net balance, s.a.)



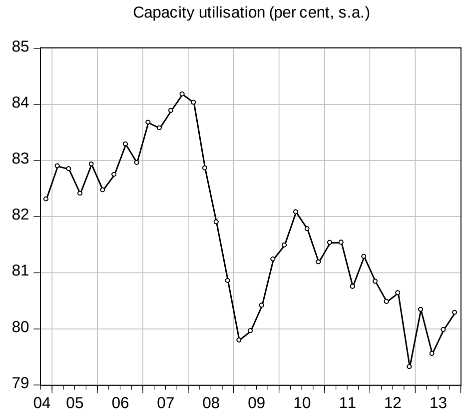
Expectations for conditions over the next three months picked up, in line with the improvement in actual conditions and higher confidence, while longer term expectations (next 12 months) improved noticeably as well. There is a slight definitional difference around expected conditions and confidence; expected conditions refer to expectations around a firms' individual performance, while confidence refers to expectations about the industry in which the firm operates. So while current conditions have been slow to improve, firms are now expecting activity in their business to lift in the near term – consistent with elevated confidence since the federal election. Forward orders were stronger – up 3 points – but at -2 points, the index remained subdued implying muted improvement in near-term demand. However, near-term expectations for orders rose in the quarter, pointing to stronger activity in coming months.

	Quarterly [(a)]					*Monthly*				
	2013q3	2013Q4	2014q1	2014q3	2014q4	2013m08	2013m09	2013m10	2013m11	2013m12
Conditions	-7	**-3**				-7	-4	-4	-3	4
Conds. next 3m	3	3	**6**							
Conds. nxt 12m	17	11	17	16	**24**					
Orders	-5	**-2**				-5	1	-2	-2	-2
Orders next 3m	3	3	**7**							

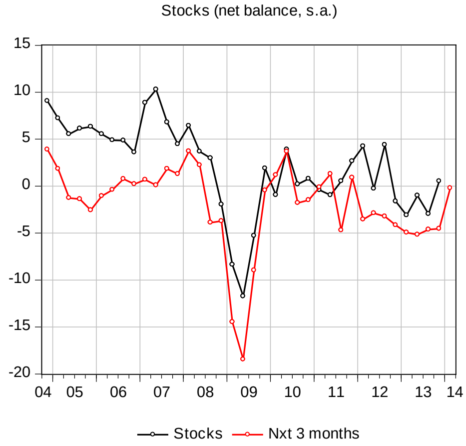
(a) Quarter to which expectation applies. Business conditions next 12 months not seasonally adjusted.

Analysis (cont.)

Low capacity utilisation – limiting capex and inflation pressures



End to de-stocking, consistent with expected rise in trading conditions

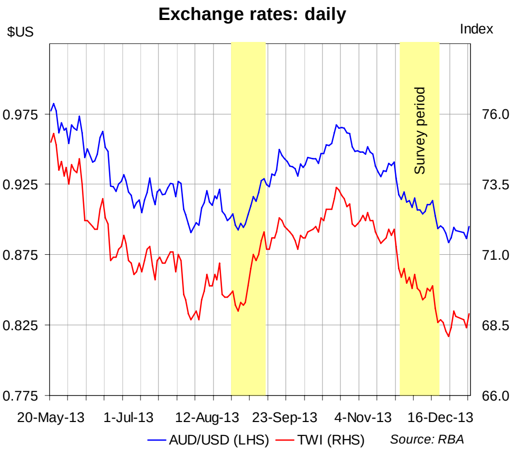


Capacity utilisation improved slightly in the December quarter (up 0.3 ppts), helping to unwind the considerable fall in the June quarter. The current rate, at 80.3%, is 0.3 ppts below the series long-run average, and is only marginally above the post-GFC lows. Ongoing sluggishness in domestic demand is contributing to low utilization rates in the economy, although improving trading conditions suggest capacity utilisation may be past its bottom. The stocks index rose in the December quarter, reaching its highest level in 12 months, consistent with firms positioning their businesses for stronger trading activity over coming months. Expectations for stocks (3 months ahead) jumped to 0 points, suggesting an end to the voluntary de-stocking cycle.

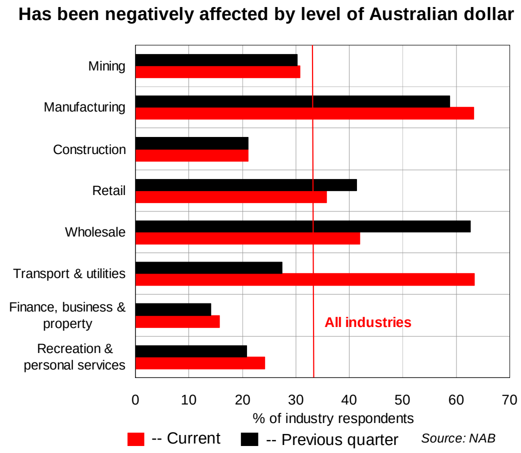
	Quarterly [(a)]					*Monthly*				
	2013q1	2013q2	2013q3	2013q4	**2014q1**	2013m08	2013m09	2013m10	2013m11	2013m12
Capacity utilis.	80.3	79.6	80.0	**80.3**		80.0	80.2	79.3	79.7	80.1
Stocks current	-3	-1	-3	**1**		-2	3	1	0	-5
Stocks next 3m	-5	-5	-5	-5	**0**					

(a) Quarter to which expectation applies. All data are seasonally adjusted.

Exchange rate has been volatile



Wholesale better, transport worse



In last quarter NAB Business Survey, we asked businesses how they have been affected by the level of the Australian dollar, and what strategies they have been using to mitigate the negative impacts. The interviews for this question were conducted between 25 November and 13 December, when the exchange rate averaged $US 0.909 and 69.8 on a TWI basis. These levels are broadly similar to the September survey period. With some stabilisation of the AUD at elevated levels, the respondents indicated that inflationary input cost pressures on wholesale and retail have eased, but that competitiveness difficulties have intensified for transport/utilities, manufacturing and personal services.

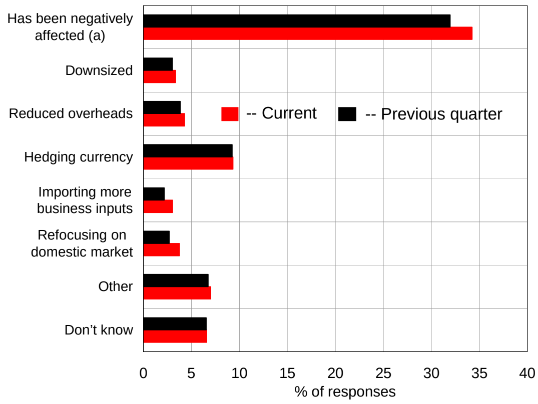
Analysis (cont.)

According to the survey, 34% of non-farm businesses reported an adverse impact from the AUD (up from 32% in Q3), with transport & utilities, wholesale, manufacturing and retail most affected. All industries show some proportion that have been negatively affected by the level of the AUD, but finance/ business/ property services appear to be most insulated from the AUD, reflecting less import competition and few foreign input costs.

The mining sector reported a slightly smaller proportion than the national average that are feeling adverse effects form the $A. Commodities tend to be bought and sold in USD, limiting the direct impact AUD has on demand, but a lower AUD can improve mining profitability by reducing costs (eg. Labour costs, which tend to be priced in AUD).

AUD hedging a common strategy

Responses to negative effects of level of Australian dollar

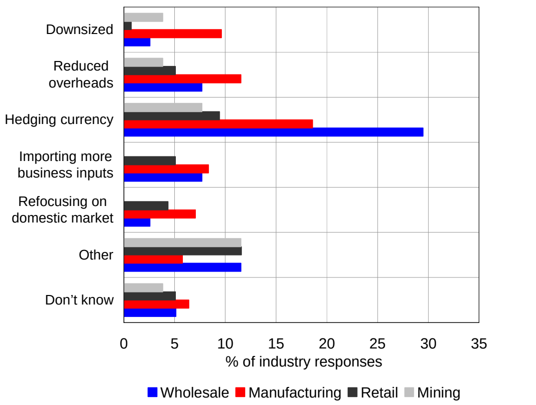


(a) % of respondents. All others are % of responses — *Source: NAB*

In terms of how businesses are responding to the negative effects, hedging remains the most common strategy used by affected firms, especially in wholesale and manufacturing, although downsizing and reducing overheads are prevalent strategies for manufacturing as well. Retail, manufacturing and wholesale were the main industries to increase their use of imports, while manufacturers were also keen to refocus on the domestic market.

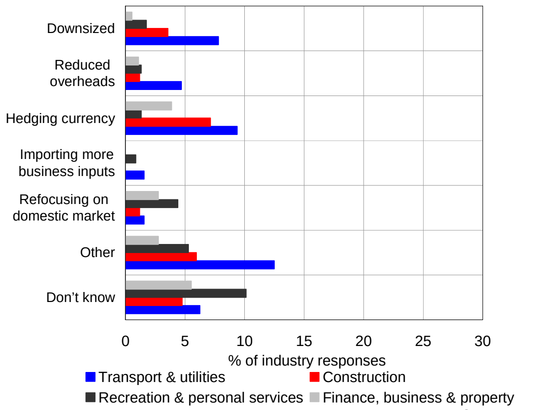
Hedging important for wholesalers and manufacturers. Transport & utilities and manufacturing are most inclined to resort to downsizing

Responses to negative effects of level of Australian dollar



Source: NAB

Responses to negative effects of level of Australian dollar

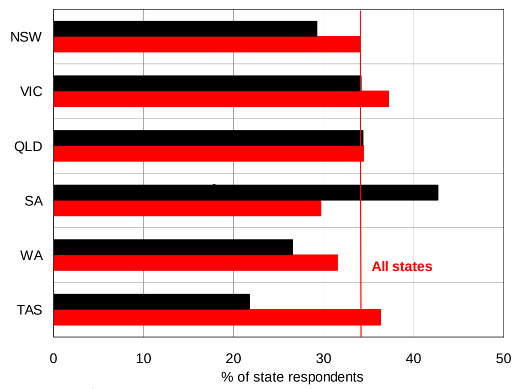


Source: NAB

Negative exchange rate effects were more prevalent in Vic and Tas than elsewhere, possibly reflecting the relative importance of manufacturing, particularly in Victoria. The dramatic changes in SA (much less affected) from the previous survey is surprising given that the level of the AUD was largely the same. However, this outcome for SA could reflect the downward momentum of the AUD during the interview period, which would assist manufacturers that are not overly reliant on foreign imports. Underlying strength of the USD – rather than AUD depreciation per se – may also be adversely affecting foreign demand for commodities, contributing to a higher recorded impact for WA.

Impact of $A mixed across states

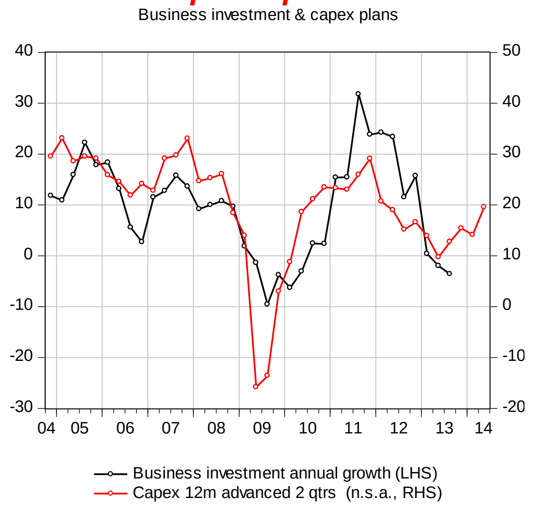
Has been negatively affected by level of Australian dollar



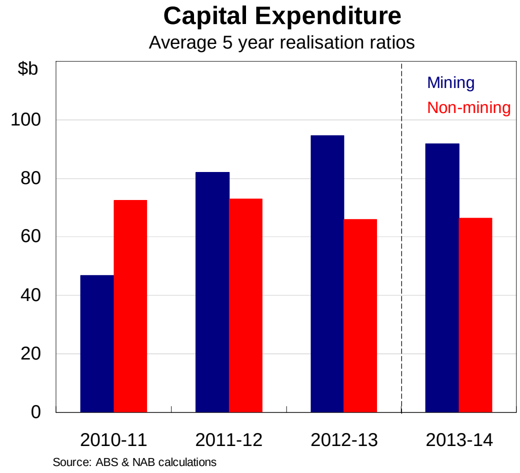
Source: NAB

Analysis (cont.)

Capex intentions show surprising pick up …

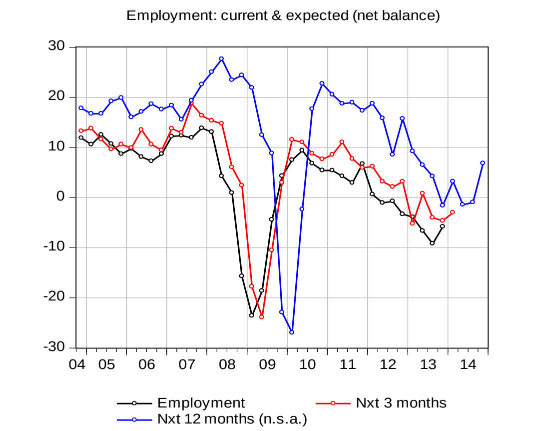


…but ABS survey still showing investment past its peak

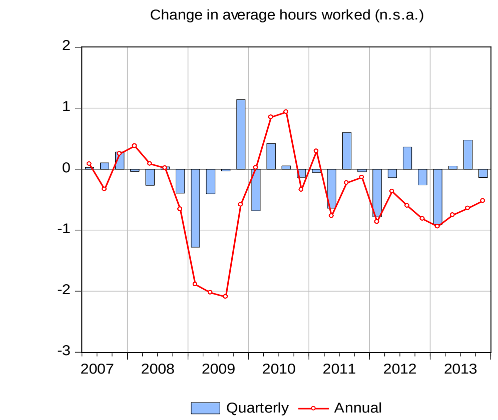


According to the NAB survey measure of business capital expenditure, business investment growth may lift modestly in the next 12 months. However, caution should be used when interpreting capex data as mining respondents are under represented in our survey, meaning the degree of slowing in mining investment may not be fully captured. Indeed, the mining capex index is the worst performing amongst the major industries, at -10 points (-19 points for 12 months ahead), consistent with expectations of a decline in the level of mining capex reported by the ABS. Capex across the non-resources sector generally softened, continuing to be crowded out by mining investment, although construction was a notable exception.

Employment expectations still poor, but longer term picked up



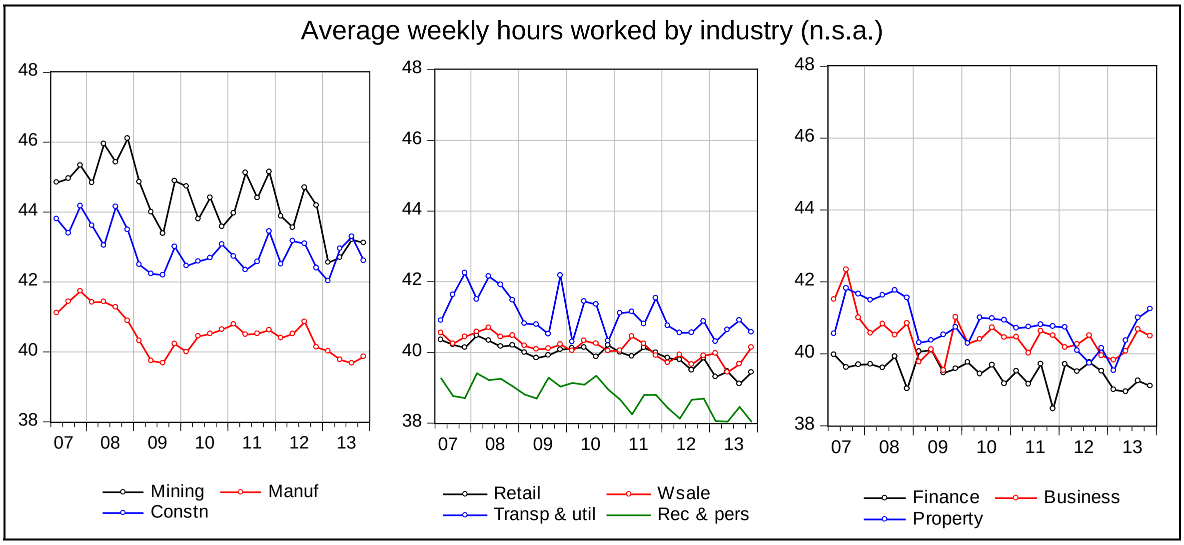
Average hours tick down – limited upside in employment data?



The employment index ebbed slightly higher in the December quarter (up 3 points to -6 index points), up from a four-year low in September. The index remains the softest component of current business conditions, consistent with the expected jobless recovery and the growing slack in the labour market we have already observed. Average hours worked declined slightly to 39.8 hours in the December quarter (from 39.9 hours in Q3). Near-term employment expectations are also weak (-3 index points), indicating very little relief for labour markets in coming months, although there was a modest improvement in the quarter (up 2 points). Official labour force data for December quarter showed a slight increase in the unemployment rate. However, a fall in the participation rate masked the true extent of the deterioration, with employment flat in quarterly terms. Recently, full time employment has fallen, while part time employment picked up, which historically has been a precursor to significant labour market deterioration. The only positive was in longer-term employment expectations (12 months ahead), which recorded a sharp increase in the quarter to +7 index points (a 7-month high).

Analysis (cont.)

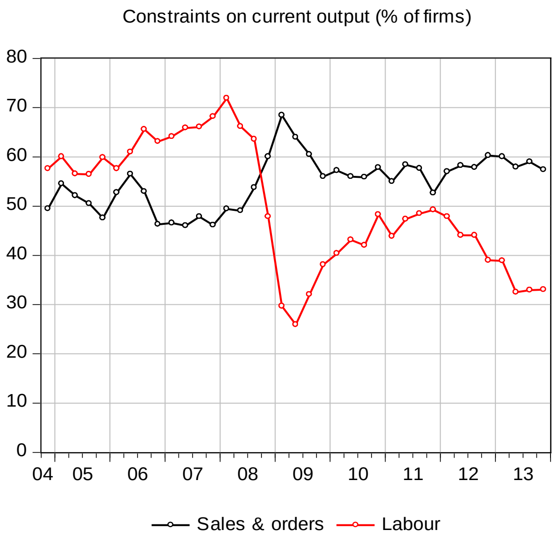
Average hours highest in mining and construction; much lower in recreation & personal services & retail, probably reflecting part-timers

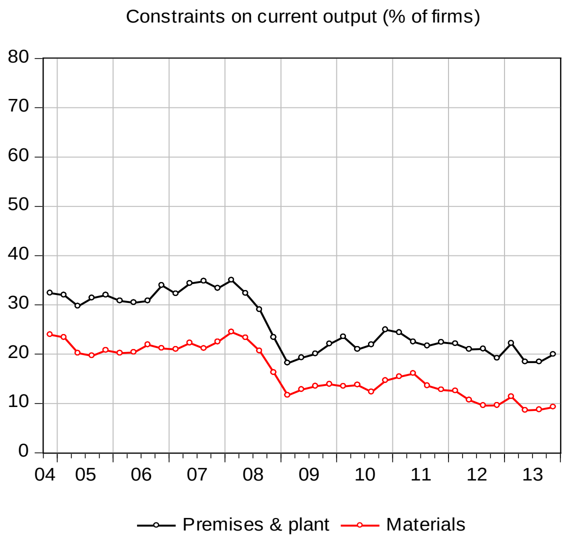


	Quarterly[a]					Monthly				
	2013q3	2013Q4	2014q1	2014q3	2014q4	2013m08	2013m09	2013m10	2013m11	2013m12
Empl current	-9	**-6**				-9	-6	-3	-8	-4
Empl next 3m	-4	-5	**-3**							
Empl nxt 12m	4	-2	3	-1	**7**					

(a) Quarter to which expectation applies. Employment conditions next 12 months not seasonally adjusted.

Labour availability still less of a constraint on output. It's all about demand.





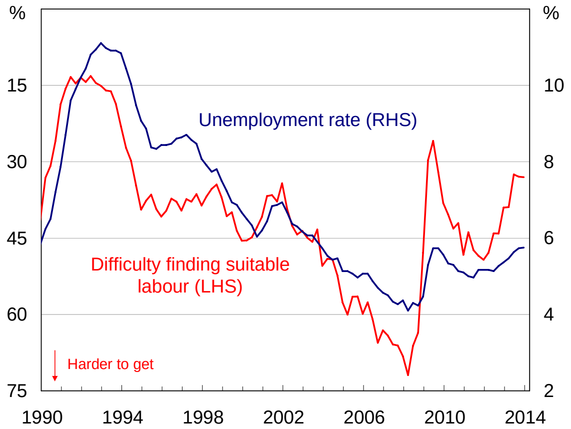
A lack of demand continues to be the biggest constraint on output, with almost 60% of firms reporting a want of sales and orders. This is consistent with reports of persistently weak (albeit improving) forward orders, but while trading conditions remained soft for much of the quarter, there was a pronounced pick-up in December. The survey continues to showcase the lack of tightness in the labour market, with just one-third of firms reporting difficulty in finding suitable labour as a primary constraint on their business' output. This is much lower than the peak in the lead up to the GFC, where the availability of suitable labour was a concern for more than 70% of firms. Premises & plant and materials continued to be viewed as fairly minor constraints on output in the September quarter. These factors also remain significantly less constraining than they were in the lead up to the GFC, when capacity utilisation was fairly tight (especially compared to the current level).

Analysis (cont.)

The survey measure of labour as a constraint on output (reversed) has historically moved quite closely with the unemployment rate. Just prior to the GFC in late 2008, over 70 per cent of firms reported that labour was a significant factor constraining output. The unemployment rate rose rapidly following the GFC and, consistent with this, firms were reporting significantly less difficulty finding access to suitable labour (less than 30 per cent of firms reported it as a constraint on output at the end of 2009). After the unemployment rate peaked in late 2009, it became increasingly more difficult for firms to obtain suitable labour in the face of improving labour market conditions and the recommencement of hiring. As of now, the ease of finding suitable labour points to an ongoing deterioration in labour market conditions.

Labour relatively easy to find; consistent with rising unemployment

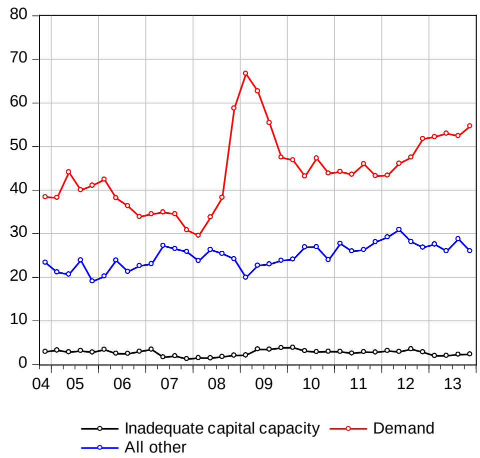
Unemployment rate & labour constraints



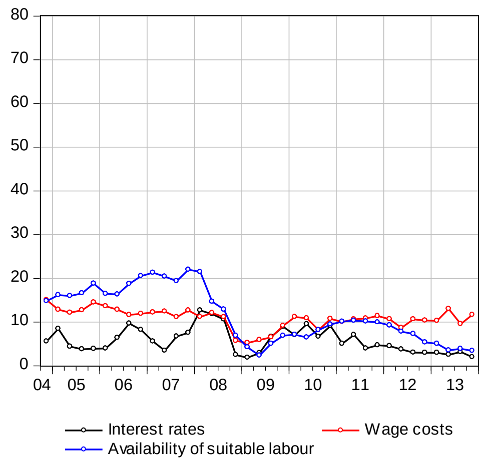
Sources: ABS; NAB

Firms demand outlook worsening, seen as constraint on profitability

Main constraint on profitability (% of firms)



Main constraint on profitability (% of firms)



In the face of a sub-trend demand outlook, firms continue to regard costs as relatively less important restriction on profit margins. Around 55% of firms report demand as a major constraint on profitability over the next 12 months – a proportion that has trended steadily higher from around 45% in early 2012. Around a quarter of firms also reported 'all other' factors as relatively constraining in the quarter; a large share of this category represents concerns about tax & government policy on future profitability. Last quarter, slightly more firms were concerned about the exchange rate being too low, than too high – the first time since 2010. This reversed again in the December quarter with 3% concerned that exchange rates are too high and 2% saying too low. Consistent with historically low borrowing rates as well as the relatively low rate of capacity utilisation in the economy at present, respondents view interest rates, inadequate capital capacity and the availability of suitable labour as relatively minor constraints on future profitability. Despite more easily available labour, the proportion of firms reporting wage costs as a constraining factor has remained relatively constant.

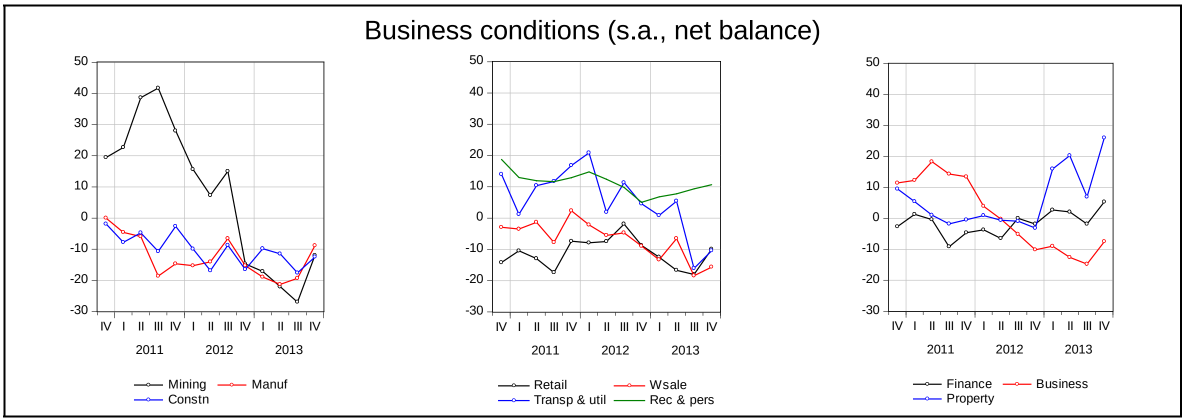
Constraints on output (% of firms)*	2012q4	2013q3	2013q4
Sales & orders	57.9	59.0	**57.4**
Labour	32.5	32.9	**33.0**
Premises & plant	18.4	18.4	**19.9**
Materials	8.6	8.7	**9.3**

Main constraints on profitability (% of firms)*	2012q4	2013q3	2013q4
Interest rates	2.5	3.1	**2.0**
Wage costs	13.0	9.6	**11.7**
Labour	3.5	3.9	**3.4**
Capital	2.0	2.3	**2.3**
Demand	53.0	52.4	**54.6**
All other	26.0	28.7	**26.0**

** not s.a.*

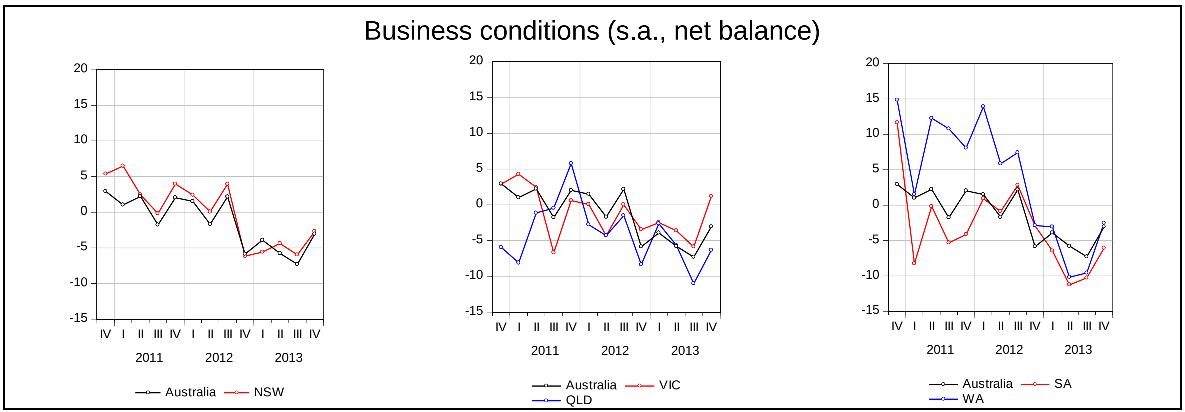
Industry and state analysis

Business conditions: all industries up, property services outperform



Business conditions improved across all industries in Q4, although most remain quite weak outside of recreation & personal services and finance/ property/ business services, which are the only industries to record a positive net balance. Mining conditions recorded a strong improvement, supported by solid commodity demand from China, but remain soft relative to recent history; commodity prices have been mixed, but a number of industrial commodity prices ended 2013 on a positive note. The deterioration in mining over recent years has coincided with the slowing in Chinese growth, a trend that looks set to continue into 2014, as well as the slowing in mining investment. There has been a marked dispersion in conditions within finance/ business/ property services; activity was significantly stronger in property services, while business services have lagged far behind reporting very weak activity. Conditions were weakest in wholesale (-16) – often considered a bellwether of the economy – followed by construction and mining, recording -13 and -12 index points respectively.

Business conditions: soft across most states, VIC holding up best



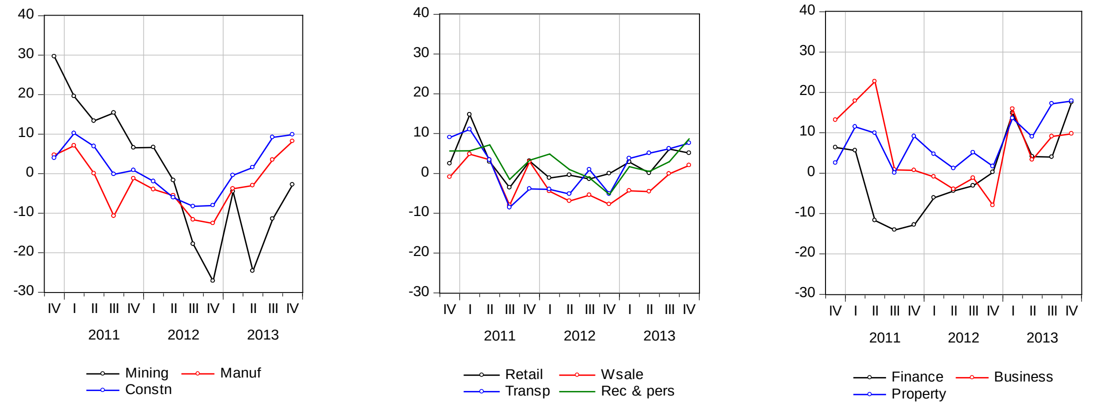
Business conditions improved across all states, but continue to point to soft business activity. Victoria reported the equal best improvement in the quarter (along with WA, up 7), and is the only mainland state to record a positive net balance (+1 index point). A combination of drought conditions, slowing mining activity/investment and various headwinds to manufacturing, are likely weighing on activity in South Australia, Queensland and (to a lesser extent) WA, which reported among the weakest conditions of the mainland states (-6, -6 and -3 points respectively). However, the solid improvement in WA during the quarter has brought it back into line with business conditions in NSW. Tas conditions rose (up 10 to +6 points) and are strongest overall.

	Quarterly					*Monthly*				
	2012q4	2013q1	2013q2	2013q3	2013q4	2013m08	2013m09	2013m10	2013m11	2013m12
Business conditions										
NSW	-6	-6	-4	-6	**-3**	-9	-8	-6	-3	4
VIC	-3	-2	-4	-6	**1**	-2	-1	1	-1	6
QLD	-8	-3	-6	-11	**-6**	-8	-9	-7	-5	-4
SA	-3	-6	-11	-10	**-6**	-9	-5	-16	-9	1
WA	-3	-3	-10	-10	**-3**	-9	10	3	-6	11

Industry and state analysis (cont.)

Business confidence: mining still poor; property/finance most optimistic

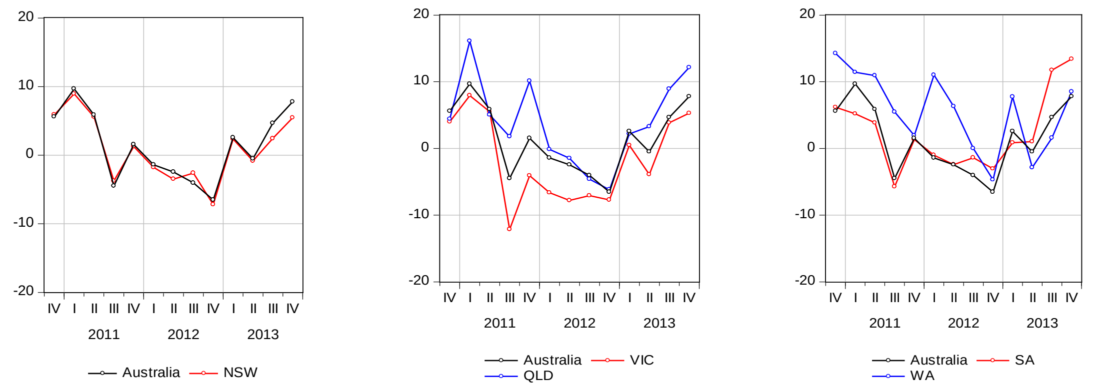
Business confidence (s.a., net balance)



All industries, except retail and fin/ prop/ bus services, reported greater confidence in the December quarter, and most have been trending higher since 2012. However, mining is still the only sector to have a negative confidence index (up 8 to -3 index points). An anticipated ramp up in the supply of many commodities (as large mining investment projects become operational) and a moderating demand outlook for China, are weighing on the commodity price outlook – prompting mining firms to return capital to shareholders rather then invest in further expansions. On a more positive note, a lower AUD should help profitability in the mining sector as many inputs (labour costs etc) are priced in AUD, while outputs are generally sold in USD. Confidence is highest for construction (+10 points) due to low interest rates, while finance/ business/ property services have also been strong (+9 points), possibly supported by rising asset prices.

Business confidence: up everywhere, post-election elation continues

Business confidence (s.a., net balance)

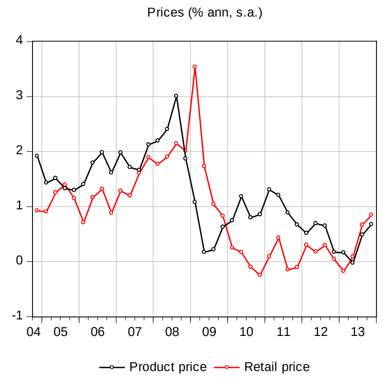


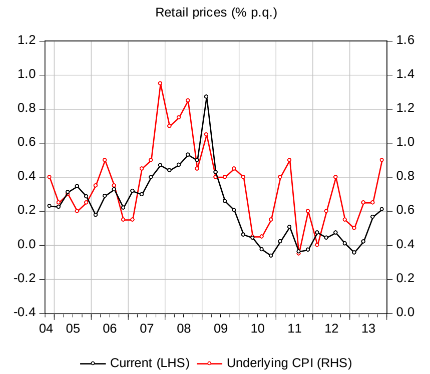
Business confidence strengthened across all mainland states in the December quarter, continuing the post-election improvement recorded in the September quarter – although monthly data show that confidence generally softened late in the quarter. SA remained the most confident state in the quarter (up 1 to +13 points), a surprising result given the economic malaise the state has experienced (along with high profile announcements of factory closures) relative to the rest of the country. Confidence lifted notably in WA (up 7), NSW (up 3) and Queensland (up 3). After SA, confidence is highest in levels terms for Queensland (+12) then WA (+9), while it was softest in NSW and Vic (both +5). Confidence lifted moderately in Tasmania to +12 points.

	Quarterly					*Monthly*				
	2012q4	2013q1	2013q2	2013q3	2013q4	2013m08	2013m09	2013m10	2013m11	2013m12
Business confidence										
NSW	-7	2	-1	2	**5**	4	11	8	5	6
VIC	-8	0	-4	4	**5**	2	12	3	4	2
QLD	-6	2	3	9	**12**	6	10	7	13	9
SA	-3	1	1	12	**13**	11	12	9	10	6
WA	-5	8	-3	2	**9**	0	16	8	6	7

Inflation and costs

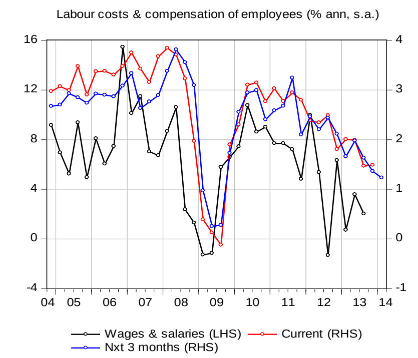
Price growth lifts a touch, but actual Q3 underlying CPI much stronger

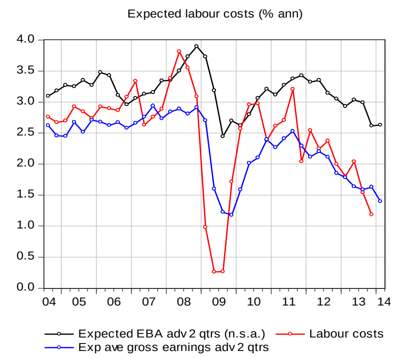




Consistent with a solid improvement in trading conditions in the December quarter, final product prices growth was a touch firmer, at 0.2% (the strongest growth in almost 2 years). Prices growth lifted (or deflation eased) or was flat for most industries in the quarter. Prices growth was strongest in wholesale (0.4% in the quarter) and recreation & personal services (0.3%), while consistent with softening commodity prices, final product prices fell notably in mining (down 0.9%). Labour and purchase costs have continued to outstrip growth in firm's final product prices, although the spread between them has narrowed in recent quarters to around (or slightly below long-run averages), suggesting some modest relief to profit margins. However, with the AUD expected to continue on a downward track, importing firms are likely to experience renewed pressure from purchase costs. Underlying CPI surprised on the upside in the December quarter, with the lower AUD contributing to higher tradables inflation.

Labour cost pressures remain subdued; consistent with soft labour market





Quarterly annualised **labour costs** growth remained subdued at 1.5% in the quarter, unchanged from the previous quarter, which is well below the series average of 3.0% since 1989. The relatively subdued pace of growth is consistent with still weak employment conditions, which indicate continued shedding of jobs in the quarter. Given the weakness in domestic demand, wage pressures will remain fairly benign, with wage increases under EBAs expected to average just 2.6% over the next year, or 1.9% after allowing for productivity offsets.

On average, businesses reversed their short-term interest rate expectations to a modest rise of 11 bps (after an expected fall of 8 bps last quarter); the first rise in 2½ years. This suggests that businesses now believe that the recent pick-up in residential construction activity (at least in the leading indicators) and improvements in the global economy will be enough to support the economy later in the year, removing the need for additional rate cuts by the RBA. However, we suspect that businesses may be underestimating the significant drag that the looming mining investment 'cliff' is likely to have on the economy. Exchange rate expectations (6-months-ahead) rose slightly to US$0.90 in the December quarter, from US$0.89 in the September quarter.

Medium-term inflation expectations remained soft, with 55% of respondents expecting inflation to remain below 3% (down from 56% in the previous quarter) and 38% expecting inflation of 3-4% (was 37%). Only 2% of firms believe inflation is a serious problem (1% previously), while 26% believe it is a minor problem (27% previously).

House prices are expected to rise by 3.2% over the next 12 months, up from 2.4% previously.

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