National Australia Bank

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Quarterly Business Survey — March quarter 2014

Business confidence eased from its recent high but remained elevated in the March quarter. Business conditions were soft, but are now much better than 6-months earlier. Forward indicators point to further modest improvements over coming months, but still indicate below trend rates of growth and soft demand for labour. The survey measures of price pressures remain muted. Special question on the impact of currency still showing wholesale and manufacturing most affected by the level of the AUD.

- Business confidence eased in Q1 from recent highs, with the monthly survey showing a steady deterioration over the quarter. Conditions closed some of the gap with confidence, but remain soft relative to long-run historical averages.
- All states and most industries felt a drop in sentiment (retail and finance/ property/ business were the only exceptions). Nevertheless, confidence has remained at relatively elevated levels since the lead up to the Federal election, supported by accommodative monetary policy (low interest rates and lower AUD) – contributing to healthy housing sector activity and robust asset prices. However, with the AUD stabilising at elevated levels, the competitiveness of some industries will continue to come under pressure. Our special question shows that wholesale and manufacturing remain most affected by the AUD, while recent AUD strength has probably eroded mining profit margins.
- Business conditions rose to their highest level in 18-months. The Survey points to six-month annualised GDP growth in the March quarter of around 3% (ie. below trend). Forward orders lifted in the month and suggest much stronger domestic demand in Q1, but capacity utilisation remains subdued indicating little impetus for business investment.
- Business conditions rose across most 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, as did transport & utilities. Conditions are weakest in wholesale – a bellwether for the economy – followed by construction and mining. Conditions rose across all states except WA.
- Business investment intentions (next 12 months) dipped slightly in the March quarter, but remain surprisingly elevated. However, mining intentions are still negative (-3 points), despite an improvement, and are under-weighted in the survey. Near term employment expectations lifted.
- Product price inflation remained subdued in the quarter, recording an annualised rate of 0.7% (0.2% in the quarter). Retail price inflation in the Survey lifted slightly, but is more subdued than CPI inflation for Q4. Labour and purchase costs growth remain modest.

Implications for NAB forecasts:

- Forecasts unchanged since latest Global and Australian Forecasts (released 8 March).

Key quarterly business statistics**

	2013q3	2013q4	**2014q1**		2013q3	2013q4	**2014q1**
		Net balance				*Net balance*	
Business confidence	5	8	**6**	Trading	-5	2	**5**
Business conditions				Profitability	-8	-2	**1**
Current	-7	-2	**0**	Employment	-9	-6	**-5**
Next 3 months	3	8	**9**	Forward orders	-5	-2	**2**
Next 12 months	16	24	**24**	Stocks	-3	1	**0**
Capex plans (next 12)	14	20	**18**	Exports	0	1	**1**
	% change					*% change*	
Labour costs	0.4	0.4	**0.4**	Retail prices	0.2	0.2	**0.3**
Purchase costs	0.5	0.5	**0.4**			*Per cent*	
Final products prices	0.1	0.2	**0.2**	Capacity utilisation rate	80.0	80.2	**80.1**

** 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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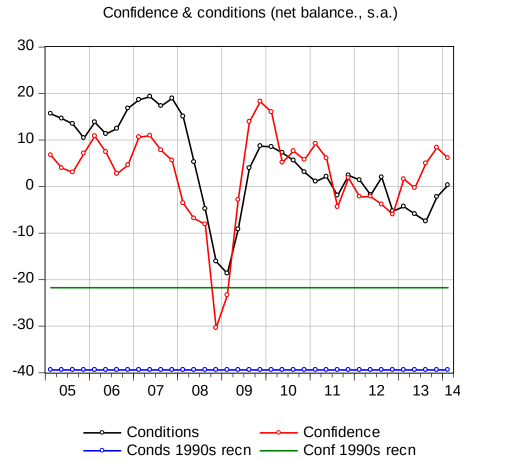
Next release:
12 May 2014 (April Monthly)
17 July 2014 (June Quarterly)

Analysis

The business environment improved further in Q1 and forward indicators are looking more positive, although still suggesting a modest and 'jobless' economic recovery. In the quarter, the level of **business conditions** picked up from -2 in the December quarter to 0 points. However, this lacklustre level of business activity has started to weigh a little on business confidence in Q4, with the **business confidence** index edging down from +8 points to +6 points. Nevertheless, conditions have remained at relatively elevated levels, supported by perceptions of greater political stability, low interest rates – contributing to solid performance in housing and equity markets – and a lower AUD. Although confidence has eased slightly, it is still above the series long-run average of +4 points since 1989. The drop in confidence in the quarterly survey was consistent with a steady decline shown in the monthly survey (to +4 points).

Confidence wanes, but activity gradually improving



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

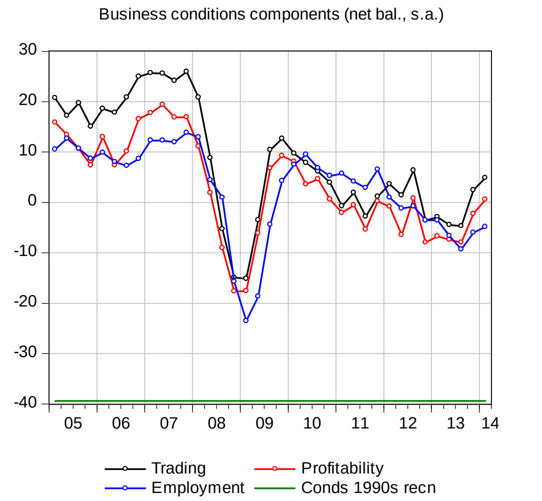
Conditions = average of the indexes of trading conditions, profitability and employment.

The divergence in conditions and confidence measures remains wide, but narrowed slightly in the quarter. Business activity is starting to recover with signs of improvement in pockets of the economy, although broader conditions remain at lacklustre levels. Nevertheless, at 0 index points, business conditions are at their highest for 6 quarters.

	Quarterly					*Monthly*				
	2013q1	2013q2	2013q3	2013q4	**2014q1**	2013m11	2013m12	2014m1	2014m2	2014m03
Confidence	2	0	5	8	**6**	7	7	9	7	4
Conditions	-4	-6	-7	-2	**0**	-2	4	5	0	1

The moderate improvement in **business conditions** in the December quarter reflected better outcomes across all the major components (trading conditions, profitability and employment), although employment has seen a much more modest rise. By industry, the conditions index rose most sharply in the transport & utilities sector – a bellwether industry – although the level of conditions is still soft. Conditions in the other bellwether industry, wholesale, continue to point to an extremely poor business environment. All industries recorded either no change, or an improvement in conditions during the March quarter. Conditions were unchanged in fin/ prop/ bus services, while rec & pers services recorded a very modest rise – but remains the strongest industry by a significant margin in levels terms. After wholesale, conditions were weakest in mining and construction, with 'green shoots' in housing unable to offset the passing peak in mining investment.

Activity looking better, but employment remains poor

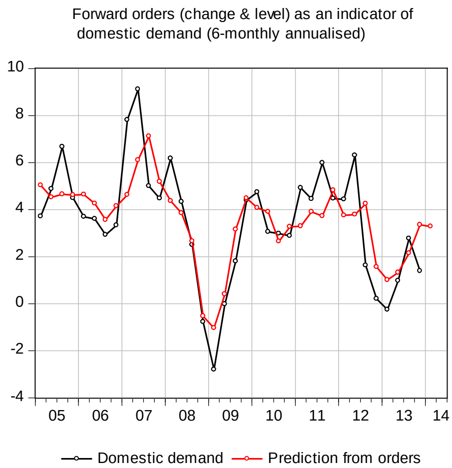


Net balance of respondents who regard last 3 months' trading / profitability / employment performance as good.

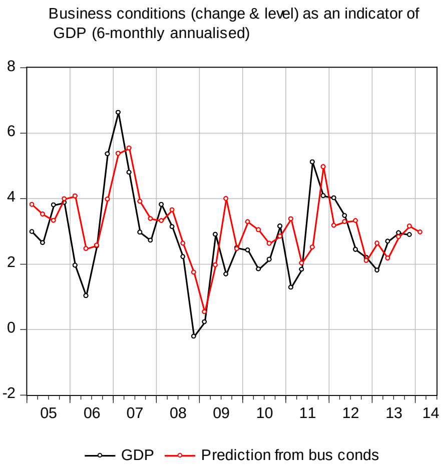
	Quarterly					*Monthly*				
	2013q1	2013q2	2013q3	2013q4	**2014q1**	2013m11	2013m12	2014m1	2014m2	2014m03
Trading	-3	-4	-5	2	**5**	3	11	8	4	3
Profitability	-7	-7	-8	-2	**1**	-3	6	3	1	1
Employment	-4	-7	-9	-6	**-5**	-7	-4	2	-7	-1

Analysis (cont.)

Demand growth to pick up?

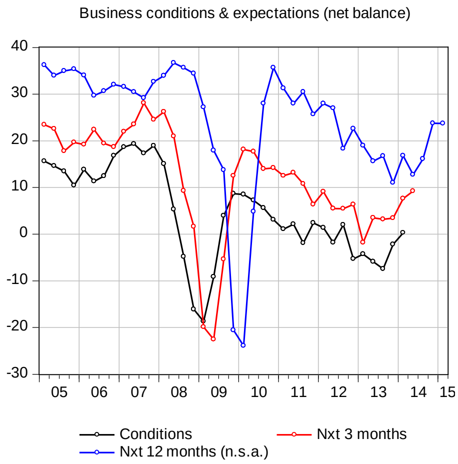


GDP growth still slightly below trend

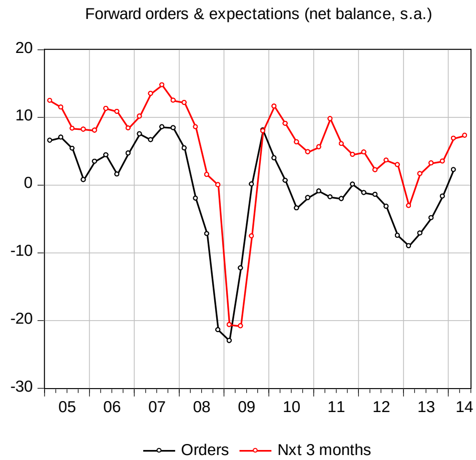


Based on forward orders, the survey implied that 6-monthly annualised demand growth would pick up much more than actually occurred, to around 3¼%. Using forward orders as a leading indicator for Q1 2014, the survey again implies 6-monthly annualised demand growth of around 3¼%. Similarly, business conditions in Q4 imply that 6-monthly annualised GDP growth would be slightly stronger, but still below-trend at 3%. Applying Q1 business conditions to our model for economic activity in the quarter, the implied growth rate would remain around 3%.

Longer term expectations positive



Orders are starting to grow



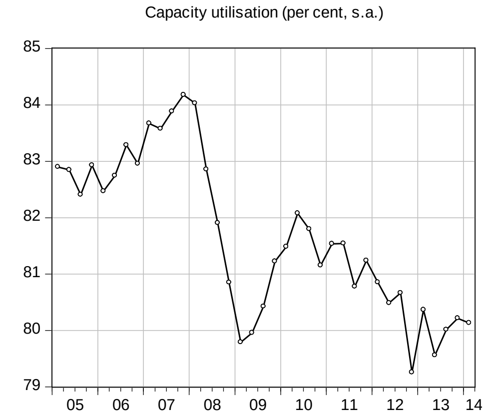
Expectations for conditions over the next three months picked up, in line with the improvement in actual conditions and more elevated confidence, while longer term expectations (next 12 months) are positive as well. There is a slight definitional difference around expected conditions and confidence; 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 4 points – and at +2 points the index (although subdued) implies a moderate improvement in near-term demand. Near-term expectations for orders remain positive, pointing to stronger activity in coming months.

	Quarterly [(a)]					*Monthly*				
	2013q4	2014q1	2014q2	2014q4	2015q1	2013m11	2013m12	2014m1	2014m2	2014m03
Conditions	-2	**0**				-2	4	5	0	1
Conds. next 3m	3	8	**9**							
Conds. nxt 12m	11	17	13	24	**24**					
Orders	-2	**2**				-1	-2	6	1	2
Orders next 3m	3	7	**7**							

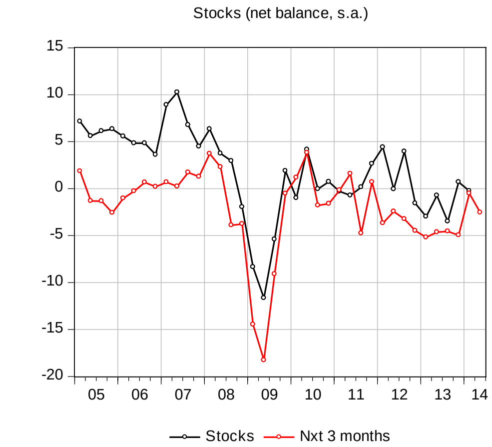
(a) Quarter to which expectation applies. Business conditions next 12 months not seasonally adjusted.

Analysis (cont.)

Low capacity utilisation – limiting capex and inflation pressures



Stronger trading conditions could suggest involuntary de-stocking

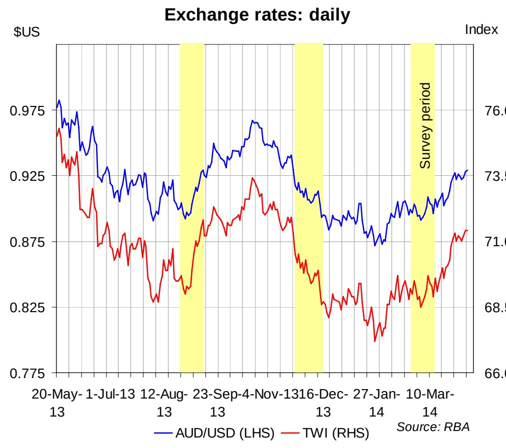


Capacity utilisation eased slightly in the March quarter (down 0.1 ppts), remaining only marginally above the GFC lows. The current rate, at 80.1%, is 0.5 ppts below the series long-run average, and is only marginally above the 2012 lows. Improvements in trading conditions suggest that capacity utilisation may be past its bottom, but sub-trend growth in domestic demand and a 'jobless' recovery is likely to keep utilization rates low in the economy. The stocks index fell in the March quarter from a 12 month high in December. With trading conditions and forward orders up, this could suggest involuntary de-stocking, but may also suggest that firms are still cautious and are reluctant to replenish stocks. Expectations for stocks (3 months ahead) dropped to -3 points, suggesting that the de-stocking cycle is set to continue.

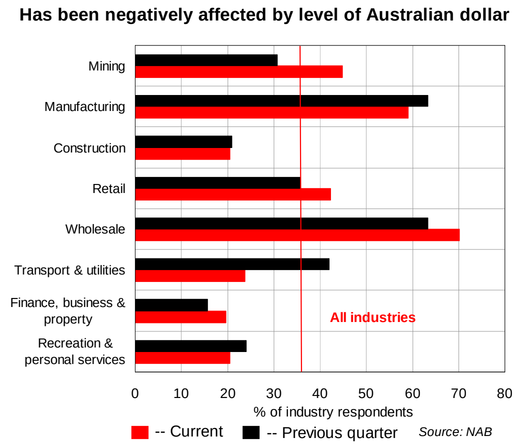
	Quarterly [(a)]					*Monthly*				
	2013q2	2013q3	2013q4	2014q1	**2014q2**	2013m11	2013m12	2014m1	2014m2	2014m03
Capacity utilis.	79.6	80.0	80.2	**80.1**		79.8	80.2	80.6	80.5	80.2
Stocks current	-1	-3	1	**0**		1	-3	0	-1	-1
Stocks next 3m	-5	-5	-5	-1	**-3**					

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

Exchange rate has been volatile



Transport better; mining worse

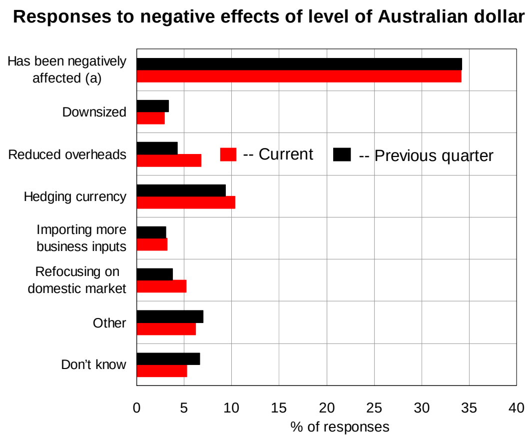


In the last three NAB Quarterly Business Surveys, we asked businesses how they have been affected by the level of the Australian dollar, and what strategies they have been using to mitigate the negative impacts. The interviews for this question were conducted between 24 February and 12 March, when the exchange rate averaged $US 0.898 and 69.1 on a TWI basis. These levels are broadly similar to the December survey period, but the trend had reversed. Despite a turn around in the AUD recently, it appears as though the lagged impact of previous depreciations is still feeding input cost pressures for wholesale & retail. In contrast, the recent AUD strength has probably seen transport & utility cost pressures ease, but has weighed on mining margins.

Analysis (cont.)

According to the survey, 34% of non-farm businesses reported an adverse impact from the AUD (unchanged from Q4 2013), with wholesale, manufacturing, mining 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 an increased proportion 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 rising AUD can have a negative impact on profitability by lifting costs (eg. labour costs, which tend to be priced in AUD).

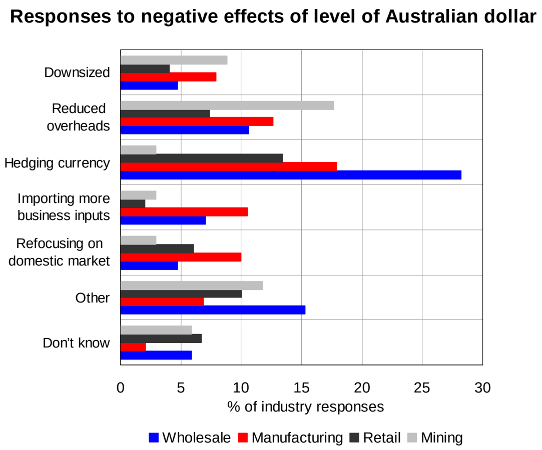
More firms respond by reducing overheads



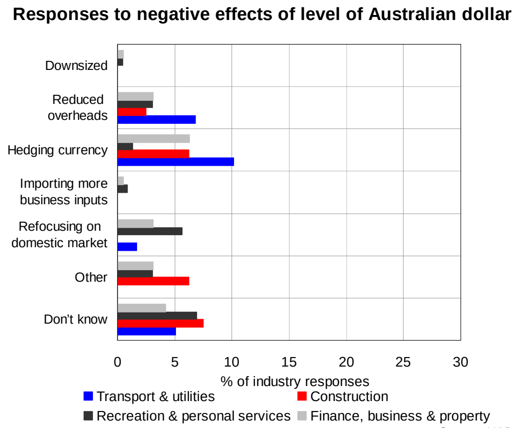
(a) % of respondents. All others are % of responses Source: NAB

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 these industries as well, along with the mining sector. Manufacturing and wholesale were also the main industries to increase their use of imports. Unsurprisingly, the industries reporting the least adverse impacts from the AUD are also less active in managing currency risks.

Hedging important for wholesalers and manufacturers, but downsizing also a strategy for these industries (as well as mining).



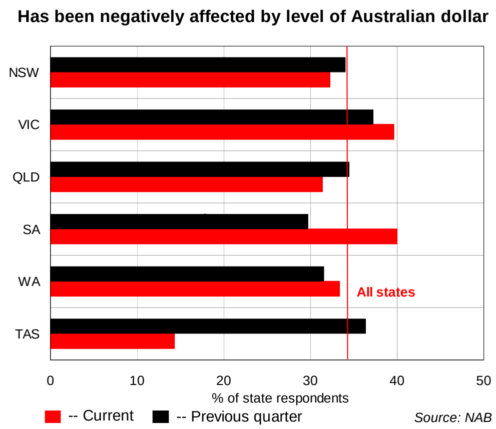
Source: NAB



Source: NAB

Negative exchange rate effects increased and were more prevalent in South Australia than elsewhere, possibly reflecting the relative importance of manufacturing. The dramatic changes in SA (much more affected) from the previous survey was to be expected given that the level of the AUD remains at a level that is likely affecting the competitiveness of the states industries. Victoria also experienced an increase in negative effects although to a much smaller degree. The improvement in Queensland is a little surprising given the deterioration recorded by the mining industry and likely negative effects on tourism – more firms reported a negative impact from the AUD in the other major mining state of WA.

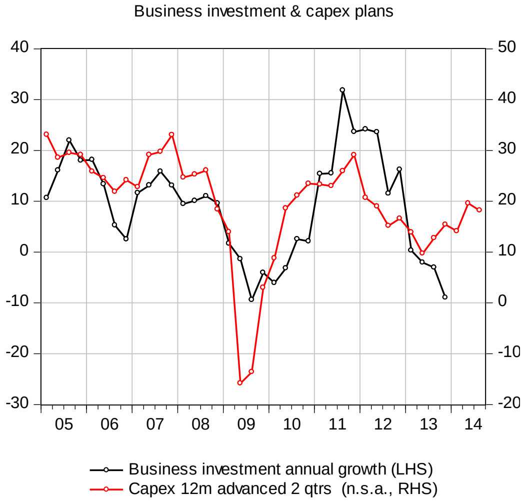
Impact of $A mixed across states



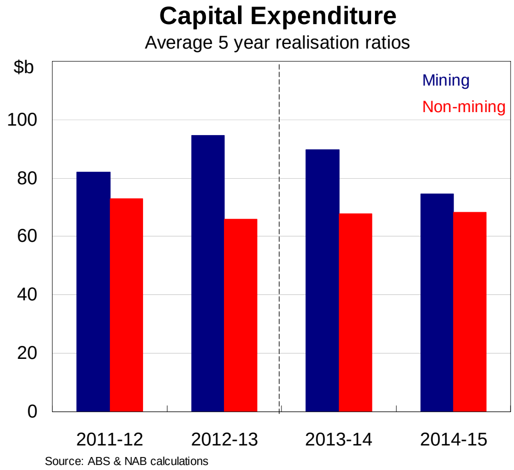
Source: NAB

Analysis (cont.)

Pick up in capex intentions not seen in other indicators

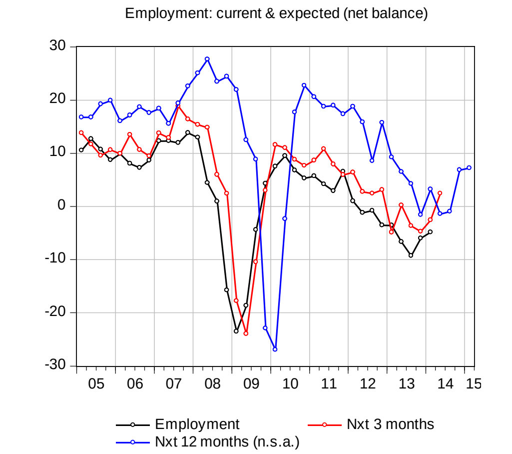


ABS survey still showing flat non-mining investment growth

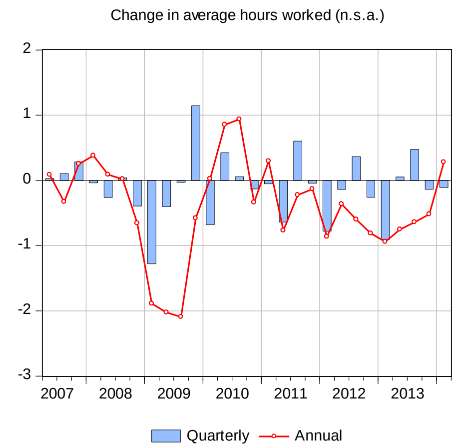


According to the NAB survey measure of business capital expenditure, business investment growth may lift modestly in the next 12 months. However, caution should be used when interpreting capex data as mining investment is under represented in our survey, meaning the degree of slowing may not be fully captured. Indeed, the mining capex index is one of the worst performing amongst the major industries, at -5 points (-3 points for 12 months ahead), consistent with expectations of a decline in the level of mining capex reported by the ABS. The construction capex index is lowest, which probably reflects the slowdown in new mining engineering construction as well. Capex is mixed across the rest of the non-resources sector.

Employment expectations to improve in near and longer term



Average hours tick down, but ABS labour data better than expected

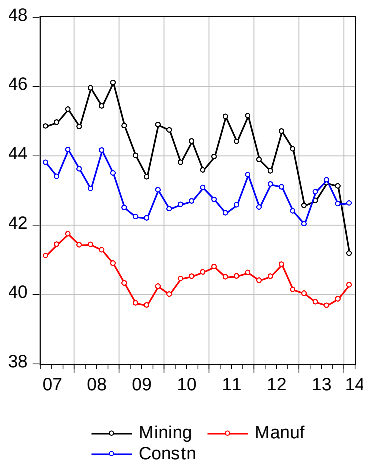


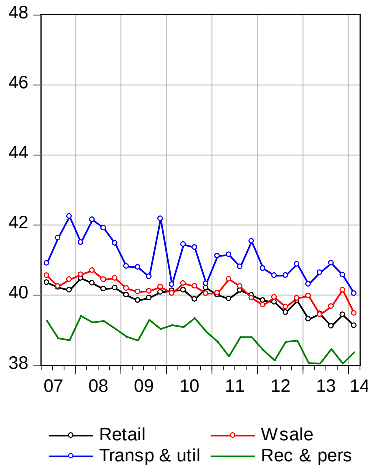
The employment index ebbed slightly higher in the March quarter (up 1 point to -5 index points), marginally up from a four-year low in September. The index is by far the softest component of current business conditions, consistent with the expected jobless recovery – as the mining boom moves to the capital-intensive export phase – and the slack in the labour market we have already observed. Average hours worked declined slightly (remaining at 39.8 hours after rounding) in the March quarter. However, near-term employment expectations shifted into positive (albeit still soft) territory (+2 index points), indicating some minor relief for labour markets in coming months, consistent with positive employment growth already recorded in recent months. Official labour force data for March showed a slight decrease in the unemployment rate, although a fall in the participation rate assisted, while the drop in the trend unemployment rate was also more modest. Interestingly, full time employment has remained weak, while part time employment picked up, which historically has been a precursor to significant labour market deterioration. Longer-term employment expectations (12 months ahead), remained positive, +7 index points, but this is still soft relative to previous years.

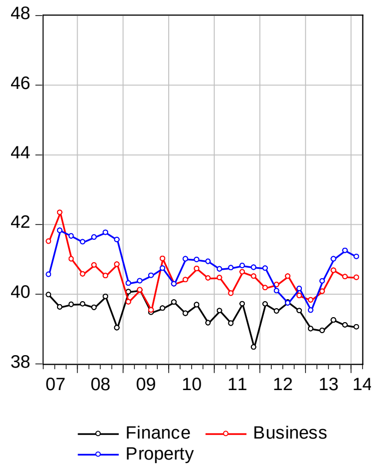
Analysis (cont.)

Average hours drop sharply for mining; highest in construction but much lower in recreation & personal services, retail and finance

Average weekly hours worked by industry (n.s.a.)







	Quarterly [a]					*Monthly*				
	2013Q4	2014q1	2014q2	2014q4	2014q1	2013m11	2013m12	2014m1	2014m2	2014m03
Empl current	-6	**-5**				-7	-4	2	-7	-1
Empl next 3m	-5	-3	**2**							
Empl nxt 12m	-2	3	-1	7	**7**					

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

Labour availability still less of a constraint on output, but ticked up.

Constraints on current output (% of firms)

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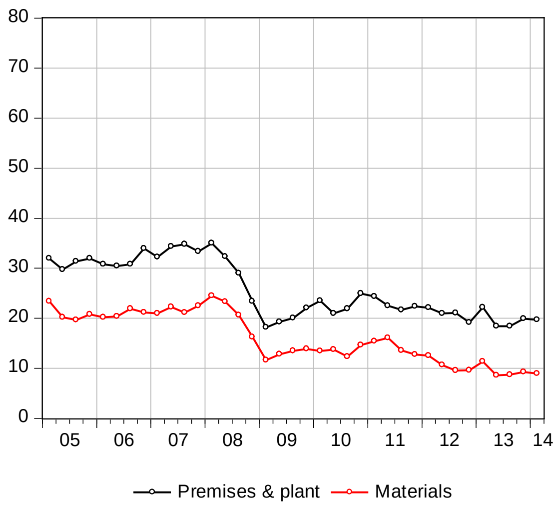
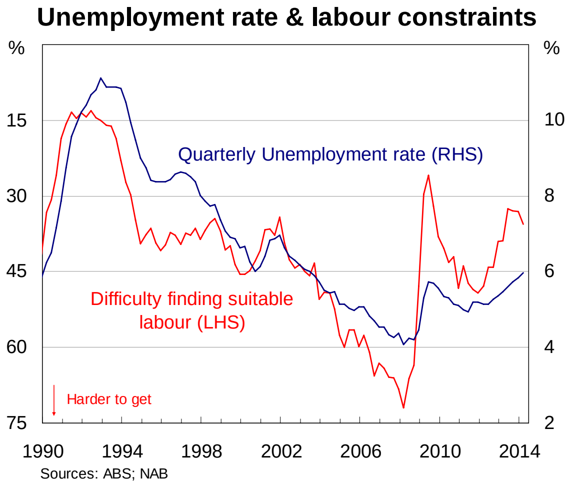


Despite a lift in trading conditions, weak demand continues to be the biggest constraint on output, with almost 60% of firms reporting a want of sales and orders. This may start to ease over coming quarters with firms starting to report improving forward orders. The current slack in the labour market is reflected in the fact that only around one-third of firms reported difficulty in finding suitable labour as a primary constraint on their business' output. This is much lower than both the pre and post-GFC peaks, where the availability of suitable labour was a concern for more than 70% and 50% of firms respectively. Premises & plant and availability of materials continued to be viewed as fairly minor constraints on output in the March 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).

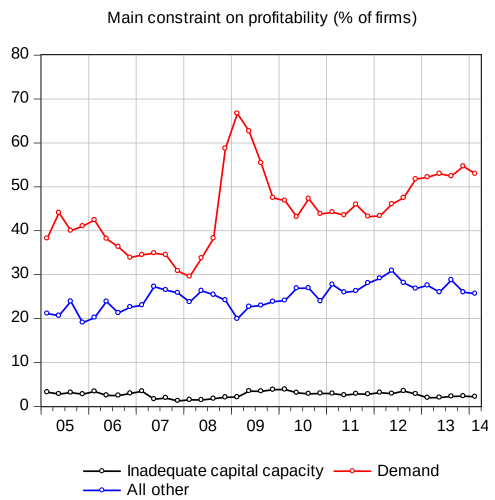
Analysis (cont.)

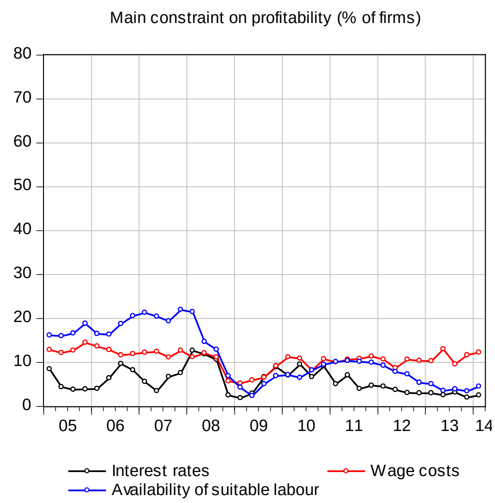
The survey measure of labour as a constraint on output (reversed) has historically moved quite closely with the unemployment rate. Just prior to the GFC in late 2008, over 70 per cent of firms reported that labour was a significant factor constraining output. The unemployment rate rose rapidly following 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 – or at best a stabilisation – in labour market conditions.

Labour relatively easy to find; consistent with high unemployment



Firms demand outlook a little better, but still major profitability constraint





High levels of spare capacity in the economy have kept inflation pressures subdued. Consequently, firms continue to regard costs as a relatively less important restriction on profit margins. Over 50% of firms report demand as a major constraint on profitability over the next 12 months – a proportion that has remained elevated for more than a year – lifting 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. This quarter, slightly more firms were concerned about the exchange rate being too low, than too high – only the second time since 2010. 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 and low wages growth of late (according to ABS WPI), the proportion of firms reporting wage costs as a constraining factor has ticked higher and is well above GFC lows.

Constraints on output (% of firms)*	2013q1	2013q4	2014q1
Sales & orders	59.0	57.4	**57.1**
Labour	32.9	33.0	**35.5**
Premises & plant	18.4	19.9	**19.7**
Materials	8.7	9.3	**8.9**

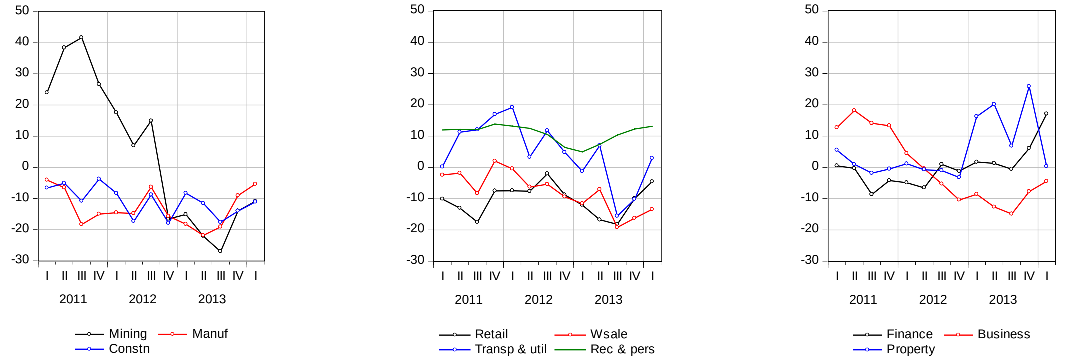
Main constraints on profitability (% of firms)*	2013q1	2013q4	2014q1
Interest rates	3.1	2.0	**2.5**
Wage costs	9.6	11.7	**12.3**
Labour	3.9	3.4	**4.5**
Capital	2.3	2.3	**2.2**
Demand	52.4	54.6	**53.0**
All other	28.7	26.0	**25.6**

** not s.a.*

Industry and state analysis

Business conditions: property services down sharply, other industries up

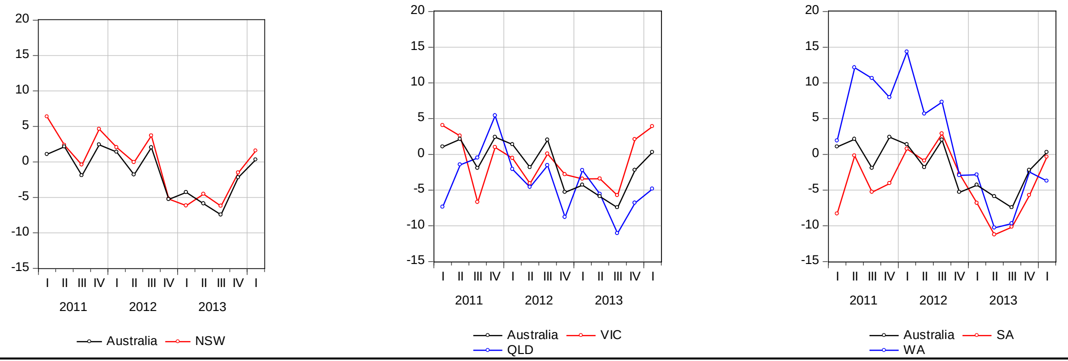
Business conditions (s.a., net balance)



Business conditions improved across most industries in Q1, although property services recorded a surprisingly large drop, and the level of conditions remains quite soft for most industries. Finance and recreation & personal services are the main exceptions, both of which are reporting a conditions index above +10 points. Mining conditions recorded another improvement, despite volatile commodity markets since the start of the year and concerns over the near-term outlook for China. Political uncertainty and a mineral export ban in Indonesia have supported some commodities (particularly nickel and gold), but the risk-off attitude in markets weighed on growth commodities like copper. The mining sector is likely to experience cross-winds over coming months as slowing mining investment adversely affects some firms, while rising mine production assists others. Conditions are currently weakest in wholesale (-13) – often considered a bellwether of the economy – followed by construction and mining, both at -11 index points.

Business conditions: generally better across most states, but results vary

Business conditions (s.a., net balance)

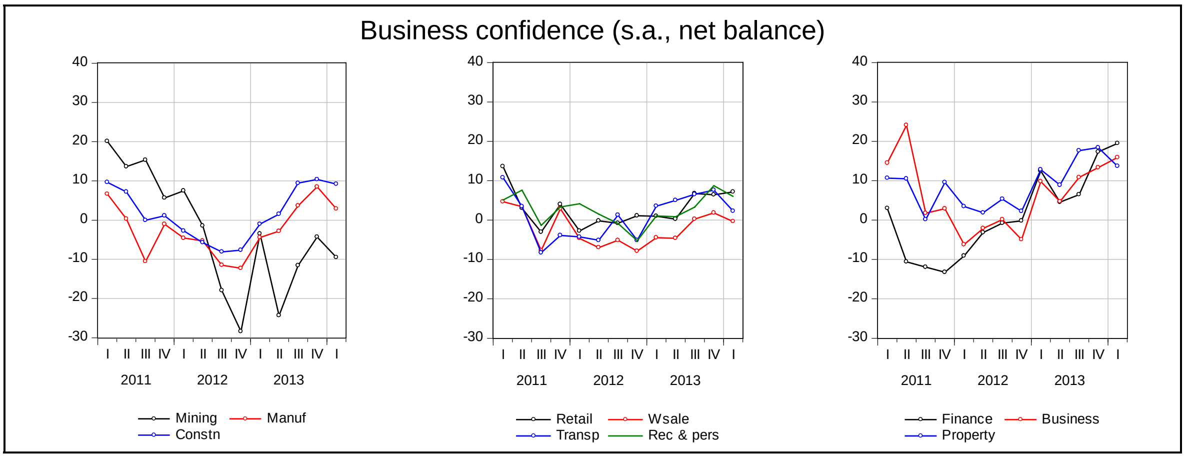


Business conditions improved across most states, with WA the only state to record a fall, but still suggest soft business activity. Surprisingly, South Australia reported the biggest improvement of the mainland states in the quarter (up 6), to record an index of 0 points – the highest in 1½ years. It appears as though a combination of drought conditions and slowing mining activity/investment are weighing on activity in Queensland and (to a lesser extent) WA, which reported among the weakest conditions of the mainland states (-5 and -4 points respectively). Solid improvements in recent quarters means that Victoria and NSW are the two best performing mainland states in that order – capitalising on better performing services sectors and tailwinds from the housing market. Tas conditions rose on a small sample (up 6 to +14 points) and are strongest overall.

	Quarterly					*Monthly*				
	2013q1	2013q2	2013q3	2013q4	2014q1	2013m11	2013m12	2014m1	2014m2	2014m03
Business conditions										
NSW	-6	-5	-6	-2	**2**	-2	3	6	-2	2
VIC	-3	-3	-6	2	**4**	0	6	8	1	4
QLD	-2	-6	-11	-7	**-5**	-5	-4	-4	-3	-5
SA	-7	-11	-10	-6	**0**	-12	7	3	4	-3
WA	-3	-10	-10	-2	**-4**	-5	13	4	-1	-1

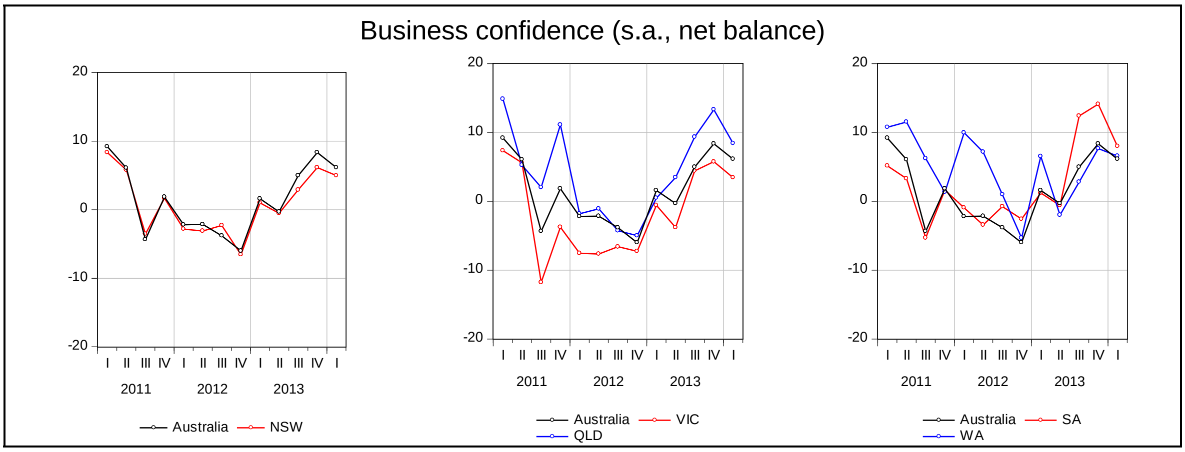
Industry and state analysis (cont.)

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



Many industries recorded a dip in confidence in Q1, although fin/ prop/ bus services and retail were the main exceptions recording moderate increases. Nevertheless, confidence has been generally trending higher across the board and is still positive for most industries. Mining is still the only sector to have a negative confidence index (down 6 to -10 index points), although wholesale is currently at 0 index points (down 2 in the quarter). An anticipated decline in many commodity prices, coinciding with rising global supplies and a moderating demand outlook for China, is weighing on mining firms. This is discouraging further capital expenditure, which is also negative for many mining services and construction firms. Confidence is highest for finance/ property/ business (+15 points), but low interest rates are contributing to solid conditions in construction as well (+9 points).

Business confidence: generally lower, but still elevated

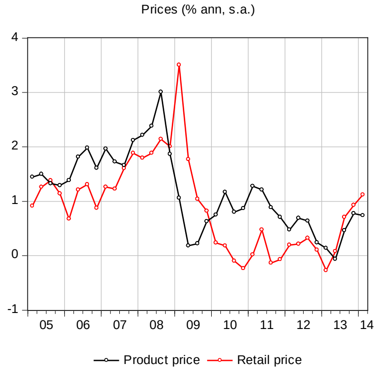


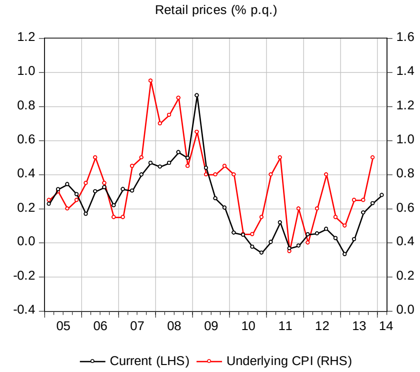
Business confidence weakened across all mainland states in the March quarter, dropping from the multi-year highs that were assisted by the Federal election. Monthly data show that confidence softened consistently over the March quarter as firms optimism was reined in by persistently soft business activity. Surprisingly, SA and Queensland were the most confident states in the quarter (+8 points), suggesting firms have largely been able to shrug off negative jobs news in SA (particularly in the auto sector) and the ongoing drought in Queensland. Nevertheless, confidence dropped most sharply in SA (down 6), followed by Queensland (down 5). Confidence is softest in Victoria (+3), despite having the highest business conditions.

	Quarterly					*Monthly*				
	2013q1	2013q2	2013q3	2013q4	2014q1	2013m11	2013m12	2014m1	2014m2	2014m03
Business confidence										
NSW	1	-1	3	6	**5**	7	8	9	6	8
VIC	-1	-4	4	6	**3**	7	3	5	8	2
QLD	0	3	9	13	**8**	15	12	13	9	4
SA	1	-1	12	14	**8**	11	7	6	5	3
WA	7	-2	3	8	**7**	8	9	7	9	0

Inflation and costs

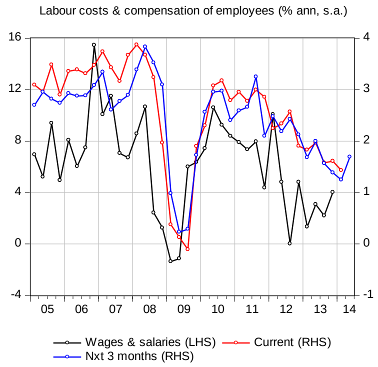
Price growth lifts a touch, but actual Q4 underlying CPI much stronger

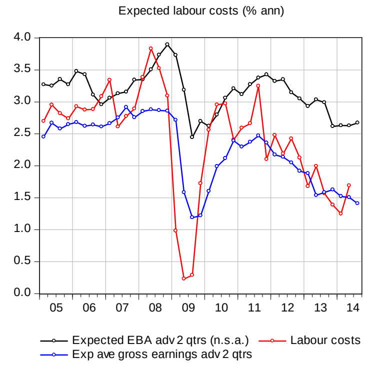




Despite a solid improvement in trading conditions, but consistent with a slight easing in capacity utilisation in the March quarter, final product prices growth remained relatively modest at just 0.2% (although this was still the strongest growth in almost 2 years). Prices growth only lifted for mining and manufacturing in the quarter, although the former continues to indicate deflation (-0.7%) in the quarter – consistent with easing commodity prices. Prices growth was strongest in recreation & personal services (0.4% in the quarter), followed by manufacturing and retail (both at 0.3%). Labour and purchase costs have continued to outstrip growth in firm's final product prices, although the spread between them has narrowed slightly 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 tradeables inflation.

Soft labour market easing labour cost pressures, but expectations turning





Annualised **labour costs** growth remained subdued at 1.4% in the quarter, down slightly from the previous quarter; also well below the series average of 3.0% since 1989. The subdued pace of growth is consistent with weak employment conditions, although the ABS labour force survey was surprisingly strong in recent months – partly due to sample changes and a fall in participation rates. Wage pressures will remain fairly benign, with wage increases under EBAs expected to average just 2.7% over the next year, or 1.6% after allowing for productivity offsets.

On average, businesses maintained their reversal of short-term interest rate expectations to a modest rise of 13 bps, after an expected rise of 11 bps last quarter which was 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 consumer spending will be enough to support the economy. Exchange rate expectations (6-months-ahead) rose slightly to US$0.88 in the March quarter, from US$0.91.

Medium-term inflation expectations remained soft, with 55% of respondents expecting inflation to remain below 3% (unchanged from previous quarter) and 38% expecting inflation of 3-4% (was 37%). Only 3% of firms believe inflation is a serious problem (2% previously), while 31% believe it is a minor problem (26% previously).

House prices are expected to rise by 3% over the next 12 months, down from 3.2% previously.

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