National Australia Bank

Embargoed until: 11:30am Tuesday 8 July 2014

Monthly Business Survey

June 2014

Business confidence showing no ill effects from the government's 'tough budget', rather improving in line with better business conditions (reflecting sales and profits) – albeit conditions remain sub trend. Most industries showed better outcomes but heavy lifting done by surge in construction. Employment and capacity utilisation, however, weakened significantly. The 'bellwether' sectors (wholesale, transport) are giving mixed signals, while forward orders suggest little fundamental change in activity. Inflation pressures remain muted. NAB forecasts unchanged with unemployment to reach 6¼% by late 2014. Rates still expected to be on hold till late 2015.

- Business confidence recorded an unexpected increase in the month, with firms apparently shrugging off the sharp deterioration in consumer confidence that followed May's Federal budget. Firms are sticking to their expectation for stronger activity despite business conditions remaining below long-run averages and no change to forward orders. Stronger sales are contributing to elevated confidence levels, with the survey suggesting this has encouraged firms to invest and rebuild their inventories. However, capacity utilisation eased further from relatively low levels.
- Business conditions rose in the month to their highest level since January, ending the downward trend that emerged since the start of the year. Nevertheless, conditions remain below the long-run average for the monthly series, which along with soft conditions in wholesale (a bellwether industry), suggests little momentum for domestic demand in the near term. Although conditions improved for all industries, levels vary significantly – service industries remain the stand out, followed by construction (wholesale and manufacturing are weakest). Sales and profits are stronger, but employment is yet to respond.
- Our wholesale leading indicator suggests weak underlying conditions, pointing to further below trend economic growth in the second quarter of 2014 – and little near term improvement in prospect in demand.
- Firms continue to report relatively benign inflation pressures, assisted by lower purchasing costs inflation and relatively low labour cost pressures. Retail inflation accelerated, but remains at low levels.

Implications for NAB forecasts (See latest Global & Australian Forecasts):

- Moderate global growth continues after early 2014's slowing, resulting in slightly lower growth forecasts in 2014 but nearer trend in out years. Mixed picture among advanced economies as US & Euro-zone growth disappointing expectations but UK expansion stays solid & Japan has coped with April's tax hike better than some feared. Mixed picture in emerging economies too as trend slowing in China continues, other East Asian economies & Latin America stay sluggish & India disappoints.
- Australian forecasts unchanged: business confidence still unaffected by Budget, conditions better but still below average, but employment down & forward indicators soft. Cash rate on hold until late 2015; unemployment to edge up. Domestic indicators continue to point to jobless growth and no certainty that declining mining investment will be replaced quickly. Retail looks softer and property (price) market seems near a plateau. While the degree of fiscal retrenchment is still uncertain, consumers are clearly unsettled and that in turn could produce a slow negative burn on demand (and ultimately business outcomes).

Key monthly business statistics*

	Apr 2014	May 2014	**Jun 2014**		Apr 2014	May 2014	**Jun 2014**
		Net balance				*Net balance*	
Business confidence	7	7	**8**	Employment	0	0	**-3**
Business conditions	0	-1	**2**	Forward orders	-5	0	**0**
Trading	3	2	**7**	Stocks	-1	1	**3**
Profitability	-2	-3	**3**	Exports	1	1	**0**
		% change at quarterly rate				*% change at quarterly rate*	
Labour costs	0.6	0.7	**0.6**	Retail prices	0.2	0.0	**0.2**
Purchase costs	0.7	0.4	**0.3**			*Per cent*	
Final products prices	0.2	0.1	**0.1**	Capacity utilisation rate	80.2	80.2	**79.3**

* All data seasonally adjusted and subject to revision. Cost and prices data are monthly percentage changes expressed at a quarterly rate. Fieldwork for this survey was conducted from 24 to 30 June, covering over 400 firms across the non-farm business sector.

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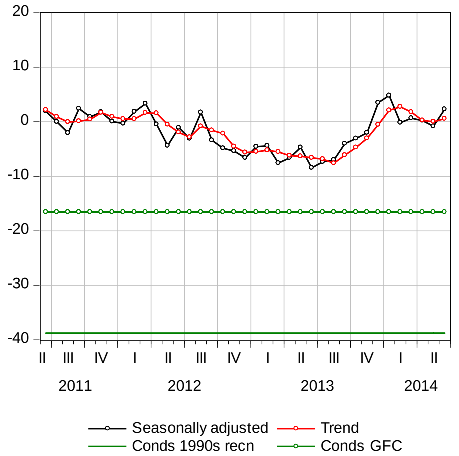
Next release:
17 July 2014 (June quarterly)
12 August 2014 (July monthly)

Analysis

Business conditions showed a surprising improvement in June (up 3 to +2 index points), reaching its highest level since January, albeit below the long-run average of the series (+5 since 1997). Looking through monthly volatility, the clear easing trend since the start of the year appears to have bottomed, despite mixed signals for domestic demand. The domestic economy continues to face a number of challenges from structural changes in the mining boom, a stubbornly high AUD and fiscal tightening. The hit to consumer confidence that followed the Federal Budget, despite subsequently retracing a little, may have contributed to a recent contraction in retail sales. But despite these challenges, low interest rates and a somewhat improving global environment are generating pockets of strength – most notably in residential construction – that are becoming a little more apparent in this months business survey. In terms of what is driving our conditions index, sales bounced back in the month along with profitability, but employment slipped significantly – suggesting that the recovery remains relatively 'jobless'. Forward orders were unchanged at 0 index points, which along with stronger sales is prompting re-stocking activity. Services sectors remain strong performers, but rising residential construction has boosted construction conditions – although the trend is more subdued. Nevertheless, improvements were recorded across all industries in June.

Conditions lift, but below 2014 peak

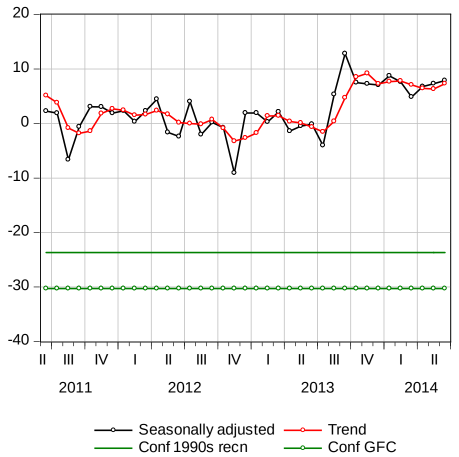
Business conditions (net balance)



Average of the indexes of trading conditions, profitability and employment.

Confidence up again

Business confidence (net balance)



Excluding normal seasonal changes, how do you expect the business conditions facing your industry in the next month to change?

Firms still appear to have shrugged off the negative consumer reaction to the Federal budget, with **business confidence** actually rising 1 point to +8 index points in June. Business confidence has remained resilient for the better part of a year despite below average business conditions. Low interest rates are expected to remain in place for a considerable time with the absence of more positive forward orders suggests soft conditions will remain in the near term. The construction sector for the second month running has reported the highest confidence, reflecting the upturn in residential activity. Service (especially recreational & personal) sectors report the next strongest levels of confidence. Indeed all industries are currently reporting positive confidence readings. Interestingly bellwether industries, such as wholesale and transport, are least confident - despite their high integration with other industries – raising a slight question mark on the sustainability of current readings.

Business conditions by industry. Conditions improved across industries, with the largest changes occurring in the construction (up 17) and mining (up 15) industries, although conditions remain negative in the latter as the industry continues to feel the strain of the mining boom transition. Transport & utilities, retail and wholesale each recorded solid improvements of 7, 5 and 4 points respectively, while the remaining industries recorded more moderate improvements. But despite the improvement, wholesale trade, which has traditionally been a bellwether industry for the economy, recorded the lowest business conditions at -16 index points. The divergence between wholesale conditions and other industries has been present for a number of months suggesting that industry specific factors may be at play, although soft retail conditions would be a contributing factor. Recreation and personal services report the strongest business outcomes, at +19 index points, followed by the construction industry at +10 index points.

Analysis (cont.)

Business conditions by state. Business conditions generally improved across the mainland states, with only NSW reporting no change in the month. Despite the improvement, Queensland was the only mainland state still recording negative business conditions. Looking through the monthly volatility in mainland state conditions, the trend index shows that conditions are currently best in Western Australia (+4), which was unexpected given declines in commodity prices and mining engineering construction – both of which have been major drivers of the state's economy. WA was followed by Victoria (+3) and New South Wales (+2). Queensland has the weakest trend conditions of the mainland states, suggesting that the pull back in public spending and contraction in private investment seen in the most recent state accounts are continuing to bite. Conditions in South Australia also rose slightly (up to +1 index points in trend terms), although this is surprising given recent increases in the states unemployment rate.

Business confidence by industry. Business confidence in June was positive across all industries, although some are less positive than last month. Surprisingly, the largest rise in confidence was reported in mining (up 8 points), but looking through the monthly volatility shows that confidence is still negative (the only industry to report negative business confidence in trend terms; -2 points). The next largest improvement came from recreation & personal services (up 5). Although confidence eased slightly for construction (down 2 to +15 points), it continues to be the most confident industry, spurred on by strong residential building approvals. The service sectors are generally quite confident as well, but it is the resilience of retail confidence (+8) that is most puzzling given recent declines in retail sales and sharp falls in retail confidence – a number of Australian retails have also downgraded their earnings forecasts.

Business confidence by state. Confidence remains positive in all mainland states, despite a notable fall in the month for Western Australia (down 5) and a more moderate decline in NSW (down 1). There is not a lot separating confidence between the eastern states (ranging from +7 to +12), but Western Australia is lagging behind them (+1). South Australian firms remain surprisingly confident (+7), but this may reflect hopes that the worst has passed, rather than anticipation of much stronger growth to come. Looking through monthly volatility, confidence is now highest in Queensland (despite having weakest conditions).

The **forward orders** index was unchanged from last month (at 0 points), although these levels it still suggests only moderate activity over coming months. Monthly movements in the index can often be volatile, but even looking through the volatility the trend measure points to soft sales activity in coming months (at -2 index points). By industry there were a few deteriorations, particularly in transport & utilities (down 15), manufacturing (down 8) and recreation & personal services (down 7). These were offset by a rebound in mining (up 40) and increases for construction (up 25), wholesale (up 12) and retail (up 2). Orders in June were negative in the following sectors: manufacturing (-10), wholesale (-5), retail (-2) and recreation & personal services (-2). Construction is reporting the strongest orders by a large margin (+28). Looking through the monthly volatility, the story is fairly similar, but construction, transport & utilities and finance/ property/ business services are all reporting the strongest orders (+5) – the weakest results are in mining, wholesale and retail. The remaining industries of manufacturing and recreation & personal services are reporting more moderately negative orders.

Capacity utilisation eased in June (to 79.3%), which is its lowest level since January 2013 when utilisation rates first began to turn more positive. Capacity utilisation is now below long-run averages for all industries. Mining capacity utilisation is farthest below long-run averages despite a slight rise in the month, while manufacturing, retail and transport are the next worst. Low levels of capacity utilisation are reflecting in a contraction in mining capital spending expectations reported in the most recent ABS Capex Survey and falls in mining engineering construction in Q1. The Capex Survey also shows that despite improving, non-mining capex expectations have been slow to take up the slack, although capex reported in the NAB survey was above the long-run average in June. Utilisation rates remain the lowest in mining (71.9%) and manufacturing (74.7%) and highest in fin/prop/bus (81.8%) and construction (81.1%).

The **stocks** index – also a good indicator of current demand – rose to a net balance of +3, indicating that firms are restocking in response to stronger trading conditions – although the index has been volatile. However, wholesalers are continuing to heavily de-stock, reporting -13 index points for the month.

The **capital expenditure** index rose by 1 point to +6 index points – above long-run average levels. While this is somewhat inconsistent with the drop in business investment recorded in the Q1 National Accounts and this month's fall in capacity utilisation, it is partly a reflection of the larger weight placed on non-mining investment in the survey; the ABS Capex Survey showed a modest rise in manufacturing and other non-mining investment in Q1. Manufacturing capex in the NAB survey is weakest, dropping 4 to -8 index points. Mining reported a surprising jump, although it followed a sharp decline the previous month (up 43 to -3 points).

Analysis (cont.)

Our model of 6-monthly annualised demand growth, using forward orders as a predictor, has been suggesting stronger growth in recent quarters than the national accounts. In Q1, actual growth dropped to 1%, compared to the model's prediction of growth of over 3%. If we apply trend forward orders for June to our model for Q2 (-2), it suggests that predicted demand growth will weaken.

Based on business conditions for the March quarter, the survey implied 6-month annualised GDP growth of around 3% in Q1, almost a percentage point below the actual growth rate in the national accounts. Based on trend business conditions from the June monthly survey, our model implies higher predicted GDP growth in Q2. Applying business conditions for the quarter derived from our 'wholesale leading indicator' (see below) implies an even smaller increase in GDP growth in Q2.

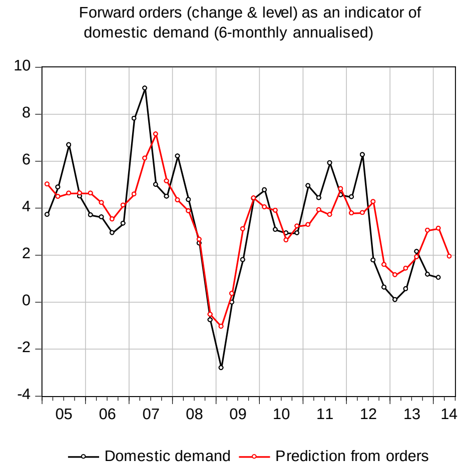
Elsewhere in the survey, cash flow (not seasonally adjusted) was strongest in recreation & personal services, and weakest in manufacturing.

Labour costs growth (a wages bill measure) eased slightly to 0.6% in June, consistent with other indicators of relatively subdued wage pressures and a soft labour market. The result for June reflected mixed outcomes across industries. Labour costs accelerated the most in recreation & personal services (up 0.4 ppts), which recorded the strongest growth at 1.4%. Finance/ Property/ Business (up 0.3) and construction (up 0.2 ppts) also accelerated. Labour cost inflation is now weakest in mining, recording -0.7%, followed by wholesale at -0.5%. Although many labour market indicators in Australia have improved, they generally remain at soft levels suggesting limited wage cost pressures ahead.

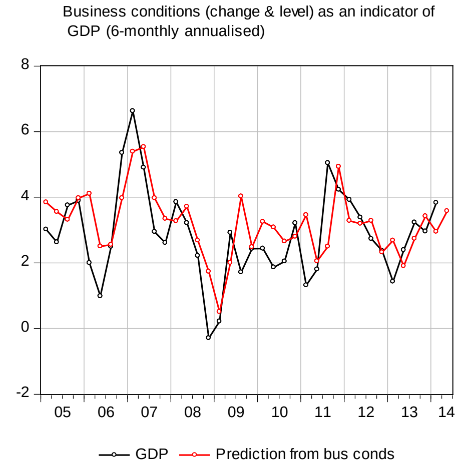
Purchase cost growth eased (down 0.1 ppts) to 0.3% in June (at a quarterly rate), continuing the downward trend exhibited over recent months – a likely reflection of the still elevated AUD. Purchase costs decelerated across a number of industries, with the largest occurring in wholesale (down 1.7 ppts) and transport & utilities (down 0.9 ppts). Purchase costs growth was strongest in construction (1.1%, at a quarterly rate), but were weakest for wholesale (-1.2%).

Final product price growth remains subdued, staying unchanged at a quarterly rate of 0.1%, suggesting little relief for firm's margins. This means the RBA can maintain their loose stance on monetary policy to allow greater traction for domestic demand. The acceleration of retail price inflation in the month (up 0.2 ppts) is probably of little concern given growth in retail prices is still relatively subdued (0.2%, quarterly rate). Upstream price pressures (manufacturing and wholesale) are mixed however (up 0.8 ppts and unchanged respectively). The mining sector recorded the most price deflation (-0.6%), while prices growth is highest in manufacturing (1.0%).

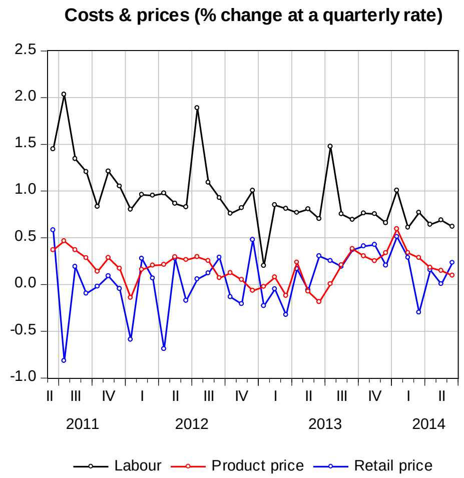
Implies softer demand growth



GDP growth remaining slightly below trend in Q2



Prices pressures still soft, although retail prices accelerated



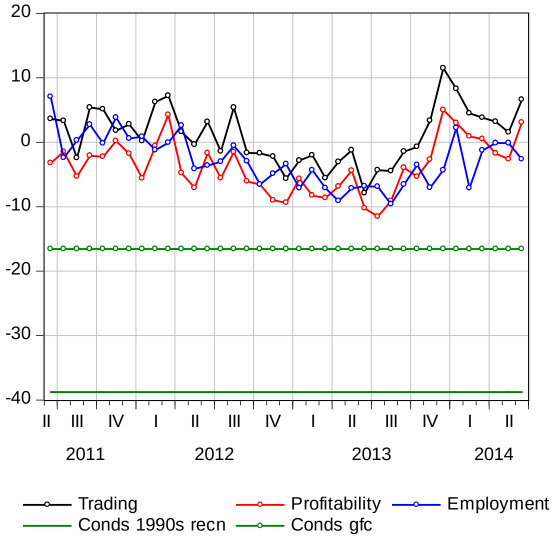
Based on respondent estimates of changes in labour costs and product. Retail prices are based on retail sector product price estimates.

Current business conditions

The business conditions index rose in June (up 3) to +2 points, although this is still well below the recent peak (+5 index points in January). In response to the rise, confidence lifted slightly to be marginally above long run average levels. The divergence between the two indicators narrowed slightly, but remains wide. Despite pockets of improvement in the economy, partial data suggest the economic environment remains mixed and a broader based pick up is needed to sustain current confidence levels. Current conditions suggest that domestic demand growth is at or below trend; the long-run average for conditions is zero since 1989 (+5 for the monthly series since 1997). This is consistent with our soft labour market outlook.

Trading and profits up sharply; employment weaker

All components of business conditions (net bal., s.a.)



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

Trading, profitability and employment

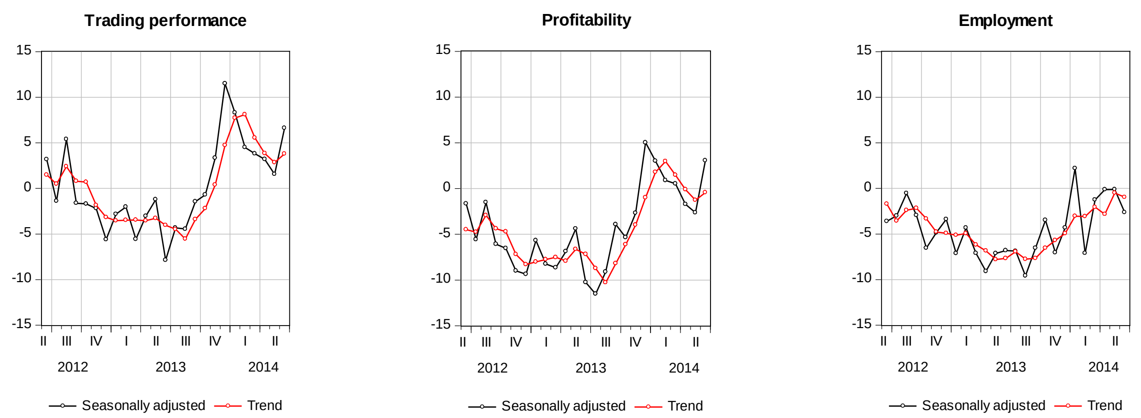
The rise in business conditions reflected solid gains in trading conditions and profitability, offsetting another decline in employment. The employment index has been volatile this year, but the dip back into negative territory may suggest a continuation of soft labour market conditions in Australia. The lift in trading conditions and profits are in stark contrast to the recent trend.

The jump in **trading conditions** was largely driven by a sharp bounce back in mining (up 34) and construction (up 22), although all industries recorded an improvement in the month. In levels terms, trading conditions are strongest in recreation & personal services (+30) and weakest in wholesale (-18). In trend levels terms, trading is still strongest in recreation & personal services (+25), but weakest in mining (-12).

Employment conditions were softer at -3 index points in June (down from 0). Looking through some of the volatility in previous months suggests that the improving momentum in the labour market has slowed, with trend conditions stabilising slightly below neutral levels. This level is consistent with an unemployment rate of around (or slightly above) 6% in the near-term, reflecting the effects of the transition to less labour-intensive mining operations and lower public sector employment that is not fully offset by rising employment in residential construction. Employment is mixed across industries in trend levels terms; mining is weakest at -22 index points, followed by wholesale (-16 points). Fin/ prop/ bus (+7), Rec & pers services (+4 points) and transport & utilities (+3), are strongest in trend terms.

Consistent with trading conditions, **profitability** jumped higher (up 6 to +3 points). The improvement was driven by large rises in construction (up 33), mining (up 25) and transport & utilities (up 22). Profitability is weakest in wholesale (-17) and highest in rec & pers (+26).

Business conditions components (net balance)



Net balance of respondents reporting trading performance / profitability / employment as good or very good (rather than poor or very poor).

Current business conditions (cont.)

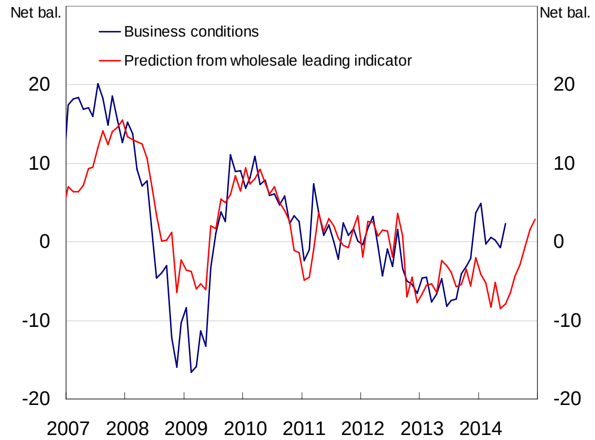
Wholesale: conditions lift, but still point to softer domestic economy

The weakness in wholesaling that has persisted for the best part of 3½ years continued into 2014. While conditions have been volatile in recent months, wholesale trend conditions remained weak, at -15 points in June.

Based on historical relationships, wholesale conditions appear to be a reasonably good predictor of overall business conditions – certainly there is strong statistical evidence of a leading relationship (Granger causality). However, there has been a noticeable divergence since late last year as conditions improved – this spread, while still wide, has closed a little. Our analysis predicts only a small lift in business conditions in Q2. If wholesale conditions revert to trend over the rest of the year, overall business conditions could still be expected to remain soft for the remainder of 2014. That in turn suggests an economy running well below trend.

Wholesale activity still points to soft conditions over coming months

Wholesale as a leading indicator of business conditions



Indicator = f(business conditions_wsl, business conditions_wsl(-1 to -4), const.)

Forward orders

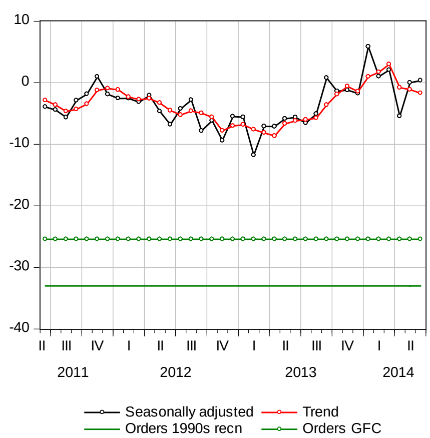
The forward orders index was unchanged at 0 points, which is in line with the long-run average since 1989, but suggests only moderate activity in coming months; trend orders are softer at -2 point.

The outcome reflected sharp rises in mining (up 40), construction (up 25) and wholesale (up 12). This was fully offset by falls in transport & utilities (down 15), manufacturing (down 8) and recreation & personal services (down 7). Orders remain very weak in trend terms for mining (-16 points), followed by wholesale (-12) and retail (-7). The trend orders index is currently strongest for construction, transport and finance/ property/ business (+5).

Net balance of respondents with more orders from customers last month.

Sales orders more positive

Forward orders (net balance)



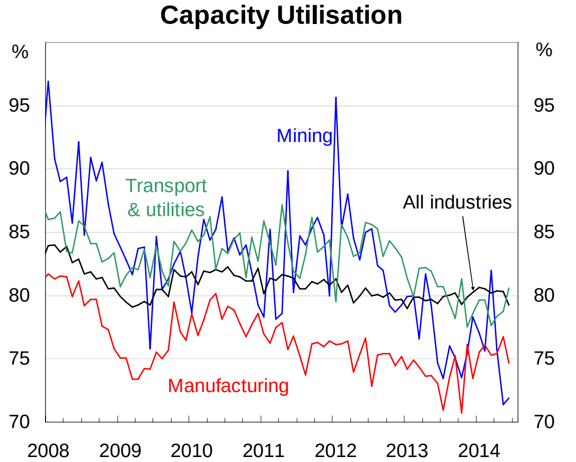
Capacity utilisation

Capacity utilisation eased notably in June to 79.3%, which is its lowest level since utilisation rates first began to turn more positive in January 2013. Utilisation has been below the monthly survey average of 81.1% (from 1997) since early 2012, and is again below the long-run average of 80.4% (from 1989). In the month, there was a sharp fall in utilisation rates for recreation & personal services (down 3.6 ppts) and more moderate falls in manufacturing, construction and retail. These were only partly offset by a rise of 3.1 ppts for wholesale and moderate rises in the remaining industries. Utilisation rates remain the lowest in mining (71.9%), while fin/ prop/ bus services is highest at 81.8%.

Full capacity is the maximum desirable level of output using existing capital equipment.

Capacity usage varies across industry

Capacity Utilisation

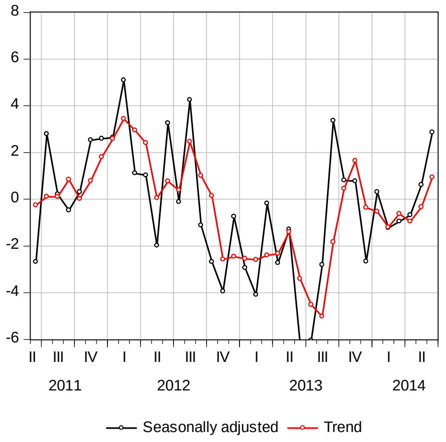


Source: NAB

More details on business activity

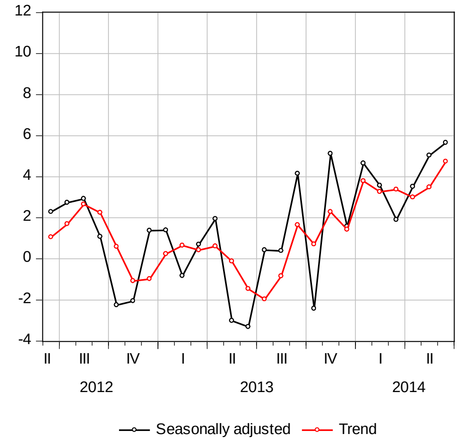
Stronger sales appear to have triggered more re-stocking

Stocks (net balance)



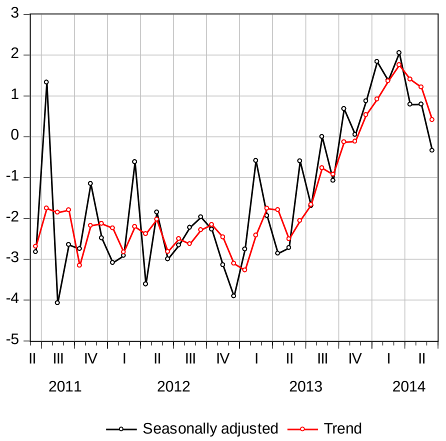
Capex further into positive territory; good sign for non-mining investment

Capital expenditure (net balance)



AUD appears to be hitting exports

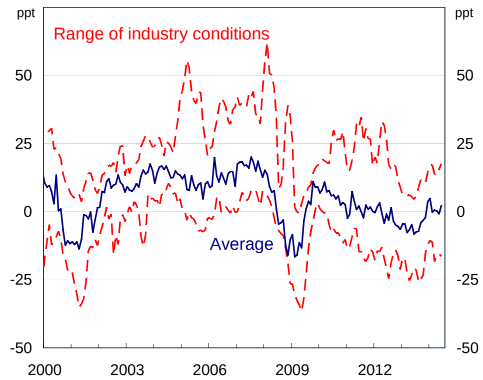
Exports (net balance)



Range of conditions widened further

Monthly Business Conditions by Industry

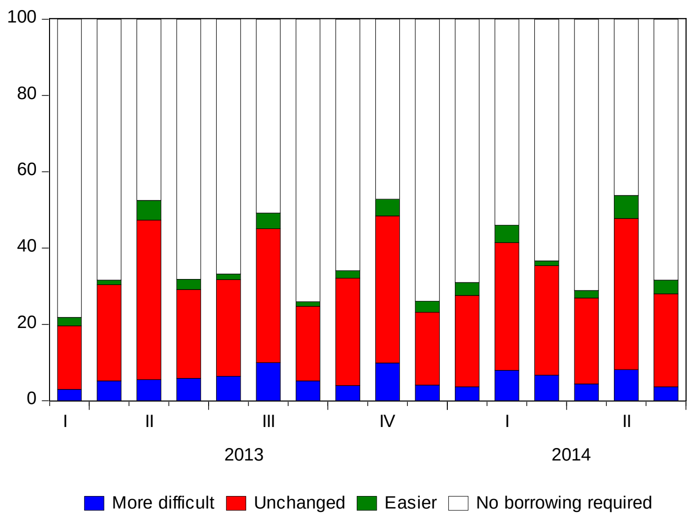
Net balance, deviation from industry average since 1989



Source: NAB

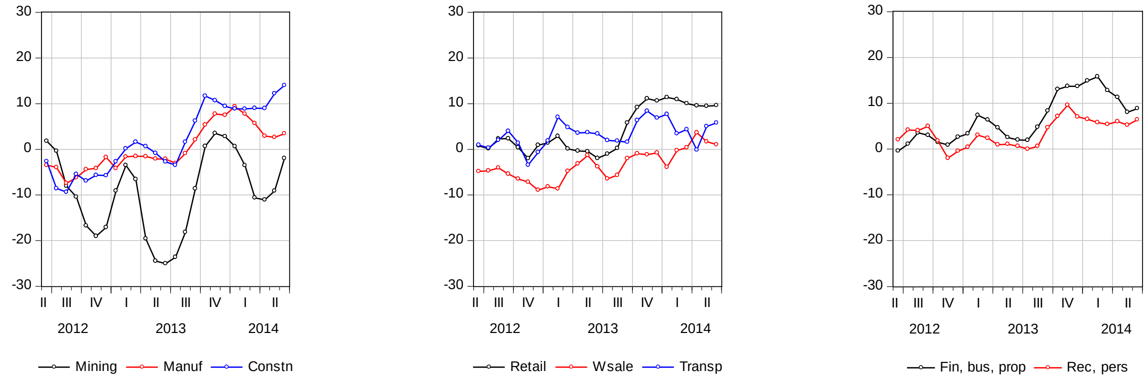
Borrowing conditions improved in last 3 months, but demand for credit eased

Borrowing conditions (% of firms)

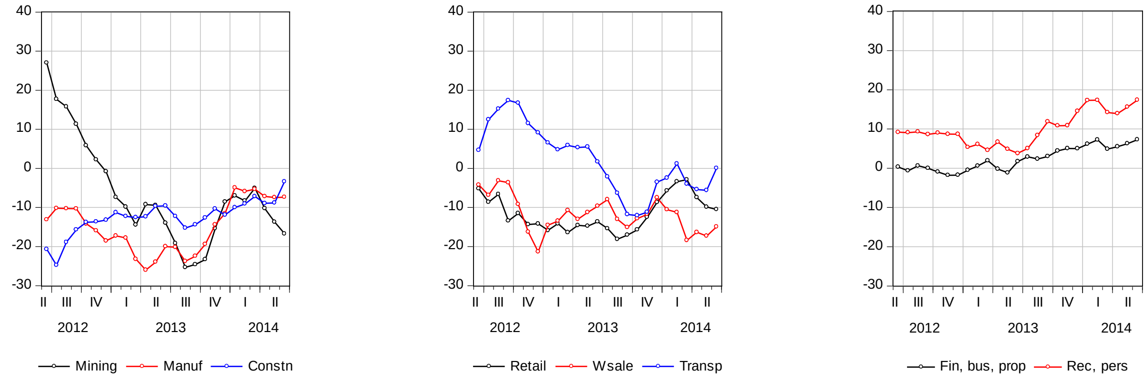


Industry sectors and states

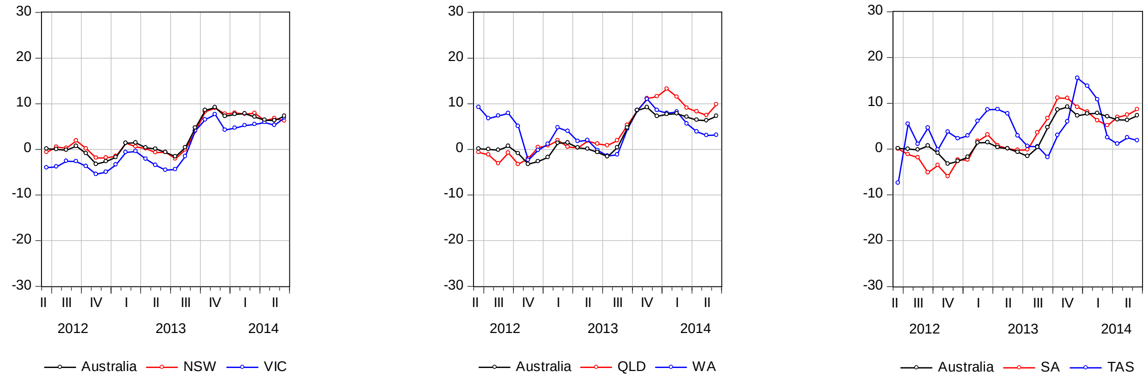
Business confidence by industry (net balance): 3-month moving average



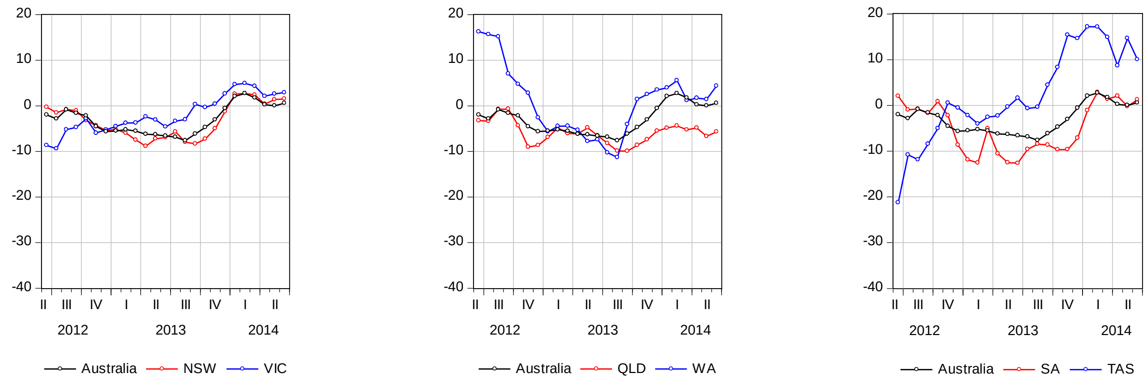
Business conditions by industry (net balance): 3-month moving average



Business confidence by state (net balance): 3-month moving average



Business conditions by state (net balance): 3-month moving average



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London	+800 747 4615	+(44 20) 7796 4761
New York	+1 800 125 602	+1877 377 5480
Singapore	+(65) 338 0019	+(65) 338 1789