National Australia Bank

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Monthly Business Survey

July 2014

Business confidence again surprised on the upside, supported by better business conditions (largely reflecting sales and profits) and a surge in retailer confidence. Firms still unfazed about the Budget (for now). Conditions jumped to a four year high, but major improvements were narrowly based – with construction a standout. Employment improved modestly, but remains subdued. Stronger sales saw higher utilisation rates and positive capex. Forward orders suggest the better start to Q3 may continue. NAB forecasts softer in 2014/15, stronger on 2015/16. Unemployment rate on slightly higher track. Rates still on hold till late 2015 but risks of a cut rising.

- Business confidence improved again in the month, reverting back to post-election highs. Firms still appear unfazed by the Federal government's 'tough budget', possibly taking comfort in the bounce back in consumer confidence. A solid jump in business conditions and better forward orders is supporting the relatively optimistic position. Stronger sales and profits are driving the trend, but the recovery continues to be relatively jobless with the employment index seeing more moderate gains (remaining at subdued levels). Higher capacity utilisation rates suggest that the improvement is relatively capital intensive.
- Business conditions rose in the month to their highest level since early-2010 – implying a strong start to Q3 demand. That said, much of the improvement is narrowly based. Construction surged again, propped up by high levels of building approvals that will drive construction activity for many months. Wholesale (a bellwether industry) also improved, but remains slightly negative – and are somewhat contrary to the kick up in forward orders. Changes in conditions varied across industries, as do the levels – construction and service industries are the stand out (mining and retail are weakest). In contrast to very strong readings for sales and profits, business is still very reluctant to employ.
- Our wholesale leading indicator improved, but still suggests weak underlying conditions and below trend economic growth in the second quarter of 2014 – with moderate near term growth in prospect for demand.
- Firms report moderate inflation pressures, although input cost prices accelerated. Both purchasing costs inflation and labour cost pressures lifted, but expected to be temporary. Retail inflation also accelerated.

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

- Global growth remains moderate but monthly trade and industrial growth continues to slow. Economic conditions mixed between regions with solid upturns in the UK and US, weakness in Japan and signs of slowing in the Euro-zone. Emerging market economies still driving most global growth with rapid Chinese growth, brighter signs in India but weakness in Latin America. Signs of improvement domestically with conditions up and confidence even better, but Q2 looking softer.
- Weak retail trade and net exports point to soft GDP growth in Q2. Employment continues to drift. Partial indicators better but headwinds remain from high AUD, falling mining investment and fiscal restraint. Australian forecasts revised down in 2014/15 (3.1%, was 3.3%), up in 2015/16 (3.2%, was 3.0%). Official unemployment rate to peak at 6½% by end 2014 (was 6¼%) reflecting weaker growth and changes to ABS measurement (which probably added 0.2 points to unemployment). Cash rate on hold until late 2015 but more risk of a cut.

Key monthly business statistics*

	May 2014	Jun 2014	**Jul 2014**		May 2014	Jun 2014	**Jul 2014**
	Net balance				*Net balance*		
Business confidence	7	8	**11**	Employment	0	-3	**0**
Business conditions	0	2	**8**	Forward orders	0	1	**5**
Trading	2	7	**14**	Stocks	1	3	**2**
Profitability	-2	3	**10**	Exports	1	0	**2**
	% change at quarterly rate				*% change at quarterly rate*		
Labour costs	0.7	0.7	**1.0**	Retail prices	0.0	0.2	**0.8**
Purchase costs	0.5	0.4	**0.5**		*Per cent*		
Final products prices	0.1	0.2	**0.2**	Capacity utilisation rate	80.3	79.1	**81.0**

* 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 25 to 31 July, covering over 400 firms across the non-farm business sector.

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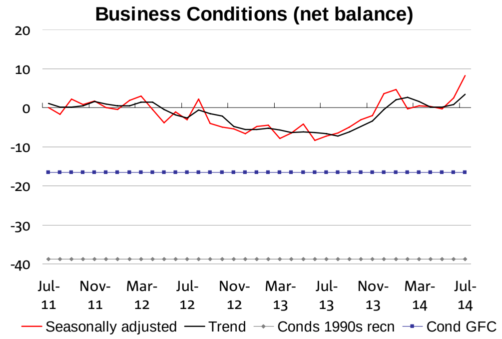
Next release:
9 September 2014 (August monthly)

Analysis

Business conditions were particularly strong in July (up 6 to +8 index points), the index reaching its highest level since early 2010 – above the long-run average of the series (+5 since 1997). Looking through monthly volatility, the previous easing trend has now fully reversed. That is in contrast to limited signs of improvement in the domestic economy (outside of the construction sector) in the first half of 2014. While indicative of a good start to Q3 activity much of the strength in conditions July remains confined to the construction and services sectors – which are seeing the benefits of low interest rates and a surge in apartment construction (in part associated with foreign investment). In contrast, structural challenges, political uncertainty and an elevated AUD are creating difficulties for other industries. Additionally, a fall in retail sales for Q2 2014 may signal renewed caution by consumers – consistent with still soft conditions reported by retailers.

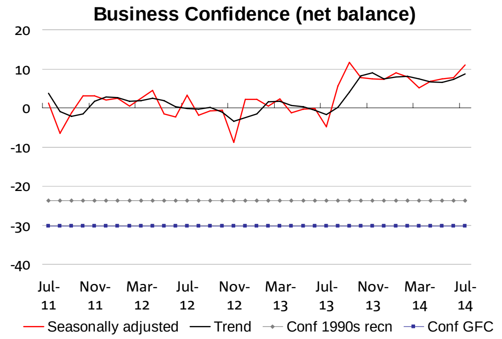
Nevertheless, both firms and consumers have shrugged off the negative reactions to the federal budget. **Business confidence** rose a further 3 points to +11 index points in July. Business confidence has been resilient for the better part of a year, and conditions appear to be responding. However, the composition of confidence may provide some cause for reservation about this optimism, at least in the medium-term. Outside of construction, only retail is showing especially high confidence. Yet, soft wages growth, a rising unemployment rate and a decline in June quarter retail sales suggests that this confidence may be tested ahead. Nevertheless, stronger forward orders, low interest rate expectations and further gains in house prices (albeit slowing), are key offsets. Bellwether industries (wholesale and transport) improved, but both retail and wholesale conditions remain negative. That said, the degree of negativity (both confidence and conditions) in mining was even more pronounced (-7 and -29 points respectively).

Conditions at more than 4-year high



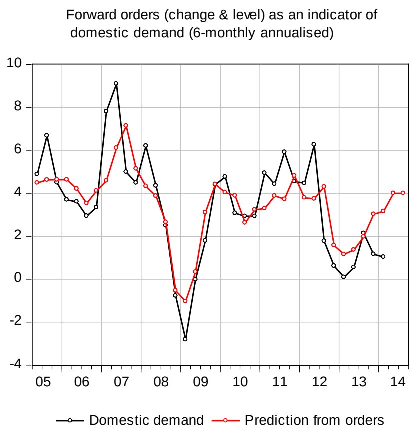
Average of the indexes of trading conditions, profitability and employment.

Confidence surprisingly robust

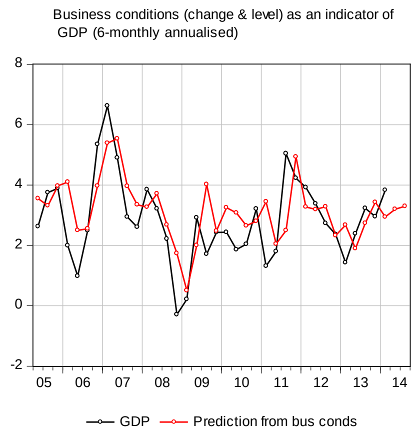


Excluding normal seasonal changes, how do you expect the business conditions facing your industry in the next month to change?

Implies much better demand growth



But, GDP growth slightly below trend

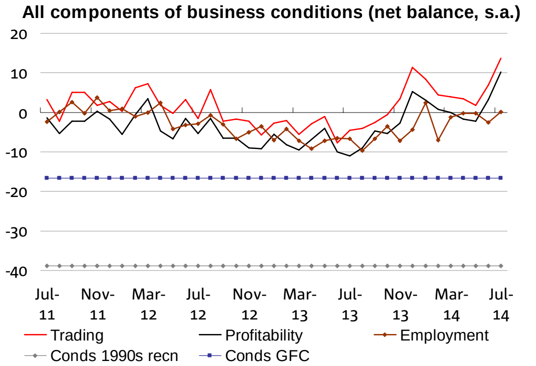


Our model of 6-monthly annualised demand growth, using forward orders as a predictor, has been suggesting stronger growth in recent quarters than the national accounts. Nevertheless, applying trend forward orders for July to our model for Q3 (+2) suggests that predicted demand growth will strengthen. On the other hand, business conditions have been under predicting GDP growth recently. Based on trend business conditions from the July monthly survey, our model implies slightly stronger predicted GDP growth in Q3. Applying business conditions derived from our 'wholesale leading indicator' (see below) implies a smaller increase in GDP growth in Q3.

Current business conditions

The business conditions index rose in July (up 6) to +8 points, which is well above the recent peak (+5 index points in January). While such a strong increase in conditions was unexpected in the prevailing economic environment, the move brings the index more into line with the more elevated levels of business confidence. As indicated above, much of the strength in July was concentrated in the construction sector, although conditions are positive in the majority of industries. With building approvals and house prices expected to slow over the next 12 months, we will need to see a more broad based improvement to maintain conditions at (or above) current levels. Current conditions suggest that domestic demand growth is lifting above trend; the long-run average for conditions is zero since 1989 (+5 for the monthly series since 1997). However, a soft employment index points to relatively 'jobless growth', which is consistent with our soft labour market outlook.

Trading and profits up sharply; employment soft



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

Trading, profitability and employment

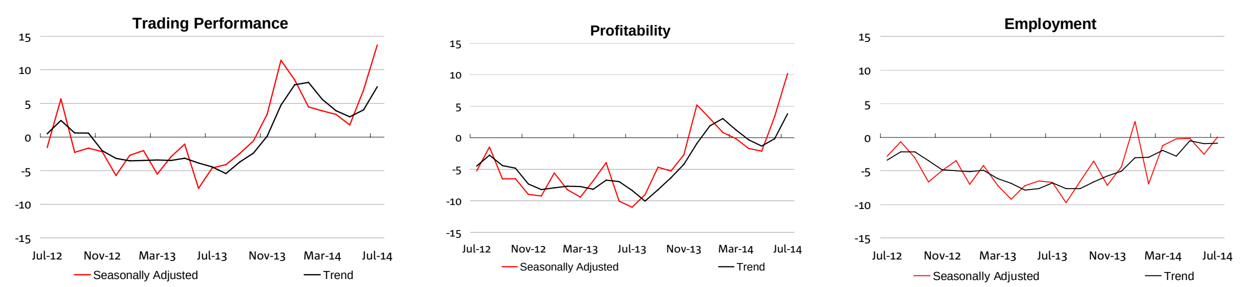
The rise in business conditions reflected strong gains in both trading conditions and profitability, while employment rose more modestly. The employment index has been volatile this year, but despite rising in July, the index (at 0 index points) suggests soft labour market conditions will continue in Australia. The lift in trading conditions and profits are in stark contrast to the recent trend.

The jump in **trading conditions** was driven by a significant improvement in wholesale (up 25) and manufacturing (up 21), while construction improved on already positive trading conditions (up 19). Elsewhere, changes in trading conditions were relatively mixed across industries, with mining deteriorating the most (down 29). In levels terms, trading conditions are strongest in construction (+31) and weakest in mining (-20). In trend levels terms, trading is still strongest in recreation & personal services (+23), but weakest in mining (-12).

Employment conditions are still soft at 0 index points, despite improving modestly in July (up from -3). Abstracting from the volatility of previous months, the improving momentum in the labour market appears to have run out. Trend conditions held steady 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 not being fully offset by rising employment in residential construction. Employment is mixed across industries in trend levels terms; mining is weakest at -28 index points, followed by wholesale (-13 points). Rec & pers services (+6 points), fin/ prop/ bus (+3), and transport & utilities (+2), are strongest in trend terms.

Consistent with trading conditions, **profitability** jumped higher (up 7 to +10 points). The improvement was driven by large rises in construction (up 23), manufacturing (up 22) and wholesale (up 17). Profitability is weakest in mining (-16) and highest in construction (+34).

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).

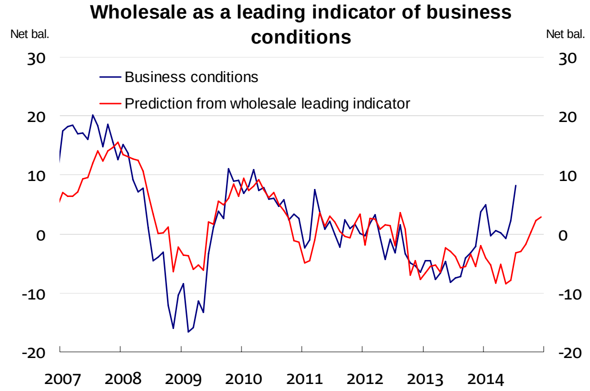
Current business conditions (cont.)

Wholesale: conditions lift, pointing to a more stable domestic economy

Wholesalers look to be clawing their way out of the doldrums that have plagued the industry for the better part of 3½ years. Wholesale conditions lifted to more neutral levels in July, although in trend terms they remain soft (-12 points), suggesting more time is needed for the recovery to gain traction.

Based on past relationships, wholesale conditions have been a reasonably good predictor of overall business conditions – exhibiting strong statistical evidence of a leading relationship (Granger causality). However, the measures have diverged since late last year as broader conditions improved. While wholesale improved in July, this indicator predicts on going soft business conditions in Q3, and then gradually turning positive in late 2014.

Wholesale activity suggest conditions closer to trend over coming months



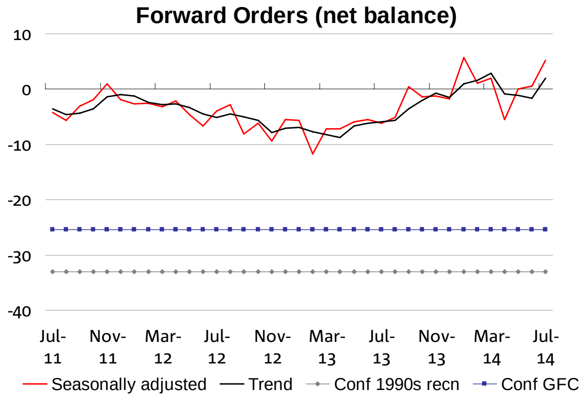
Indicator = f(business conditions_wsl, business conditions_wsl(-1 to -4), const.)

Forward orders

The forward orders index rose by 4 to +5 index points, which is well above the average of the monthly series and suggests reasonably solid activity in coming months; trend orders a little softer at +2 points. The outcome reflected a surprisingly sharp rise in manufacturing (up 25), despite the high AUD, followed by transport (up 13). This was partially offset by a sharp fall in construction orders (down 27), which could reflect slower growth in (already elevated) building approvals. Orders remain very weak in trend terms for mining (-13 points) and wholesale (-8). Trend orders are currently strongest for transport and manufacturing.

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

Sales orders higher again

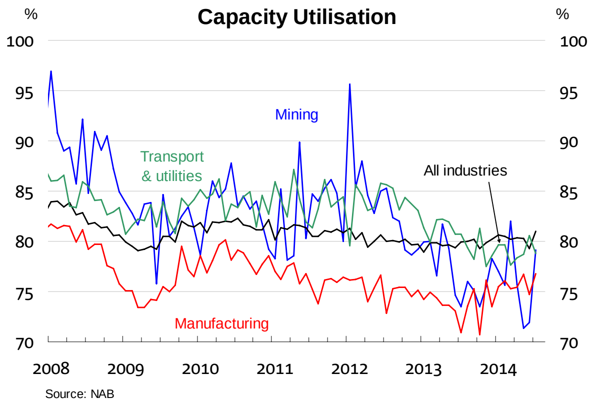


Capacity utilisation & capex

Capacity utilisation jumped notably in July to 81.0%, following a sharp fall last month, reaching its highest level since early 2012. This level is consistent with the monthly survey average of 81.1% (from 1997), and is above the long-run average of 80.4% (from 1989). Utilisation is highest for larger firms, while the mining industry recorded the largest gains (up 7 ppts). Transport and wholesale posted the only declines, down 1.8 and 1 ppts. In light of the surge in building approvals over the past year, utilisation rates are highest in construction (84%). But while most industries increased utilisation, only mining and personal services are above long run averages.

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

Capacity usage improved broadly



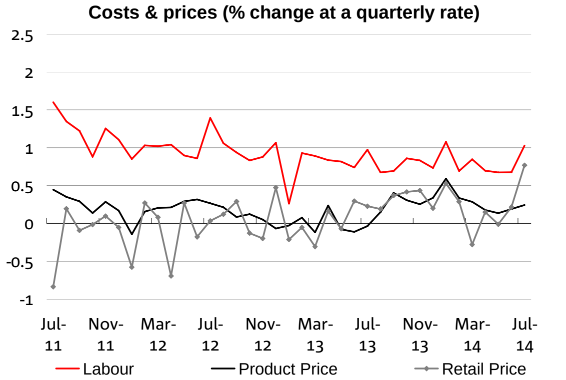
The **capital expenditure** index eased back 2 points to +4 index points – slightly below long-run average levels. The trend index was unchanged in July, at +5 index points, suggesting a moderate expansion of non-mining business investment (which has a larger weighting in the survey) as mining investment is winding down. This trend is consistent with signs of improving investment intentions outside of the mining sector in the Q1 ABS Capex Survey. Mining capex in the NAB survey is weakest in trend terms, dropping to -12 index points, while recreation and personal services are highest (+15 points).

Prices Analysis

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

Labour costs growth (a wages bill measure) accelerated to 1% in July, from 0.7%, although this may partly reflect a hike in the minimum wage to $16.87/hr from 1 July. Consistent with this, the acceleration in wage cost growth was largest for retail (up 2.6 ppts) – one of the largest employers of minimum wage workers. Labour costs accelerated for most industries, with construction and manufacturing the exceptions, while costs declined in mining (-0.6%) and construction (-0.4%). After retail, labour cost growth was strongest in recreation & personal services (1.6%) and financial/ property/ business services (1.1%). Labour market indicators in Australia remain soft, with the trend unemployment rate rising to 6.1% in July, suggesting limited wage pressures ahead.

Prices pressures lift, but are likely to be temporary



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

Purchase cost growth rose (up 0.1 ppts) to 0.5% in July (at a quarterly rate), stemming the downward trend exhibited over recent months. Purchase costs accelerated across most industries, with the largest occurring in wholesale (up 1.8 ppts). Construction was the only industry to record a deceleration (down 1.3 ppts), which might suggest that the winding down of the mining investment boom is helping to keep construction costs low. Purchase costs growth was strongest in manufacturing and recreation & personal services (both 1.0%, at a quarterly rate), but were weakest for construction (-0.2%).

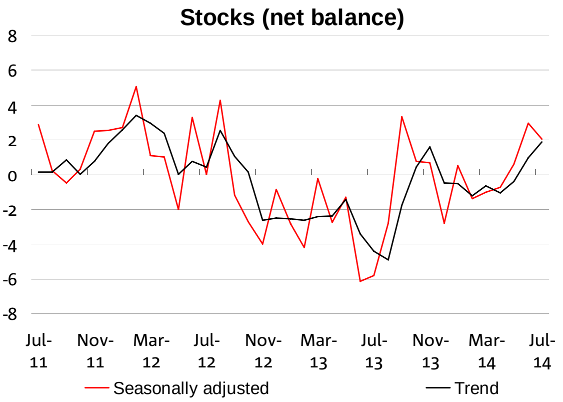
Final product price growth remains subdued, staying unchanged at a quarterly rate of 0.2%, suggesting little relief for firm's margins. This means the RBA can maintain their loose stance on monetary policy to allow greater traction for domestic demand. However, strong acceleration in retail price inflation in the month (up 0.6 ppts) is a possible concern as growth in retail prices hit 0.8% (quarterly rate), the highest since mid-2009. Upstream price pressures (manufacturing and wholesale), however, are mixed (up 0.6 ppts and 0.1 ppts respectively). The mining sector recorded the most price deflation (-0.8%), while prices growth is highest in manufacturing (1.4%).

Prices & costs by industry (% change at a quarterly rate)

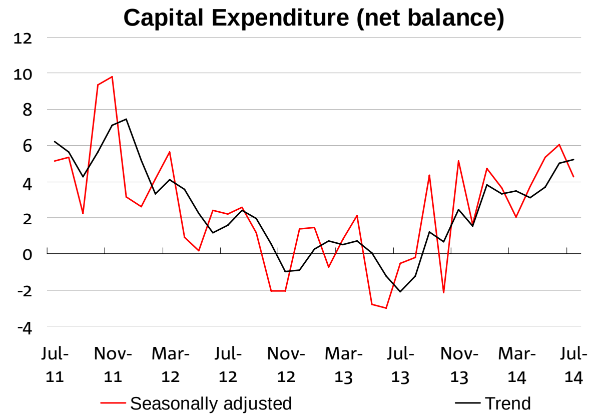
	Mining	Manuf	Constn	Retail	Wsale	Tran. & utils	Rec. & pers.	Fin. prop. & bus.	Australia
Labour costs: current	-0.6	0.6	-0.4	2.6	0.1	0.9	1.6	1.1	1.0
Labour costs: previous	-0.8	0.8	0.2	0.0	-0.3	0.3	1.2	0.8	0.7
Labour costs: change	0.2	-0.2	-0.6	2.6	0.4	0.6	0.4	0.3	0.3
Prices (final): current	-0.8	1.4	0.1	0.8	0.2	0.6	0.3	-0.3	0.2
Prices (final): previous	-0.8	0.8	0.8	0.2	0.1	0.1	0.0	-0.3	0.2
Prices (final): change	0.0	0.6	-0.7	0.6	0.1	0.5	0.3	0.0	0.0
Purchase costs: current	0.5	1.0	-0.2	0.6	0.7	0.4	1.0	0.3	0.5
Purchase costs: previous	0.3	0.5	1.1	0.6	-1.1	0.1	0.6	0.2	0.4
Purchase costs: change	0.2	0.5	-1.3	0.0	1.8	0.3	0.4	0.1	0.1

More details on business activity

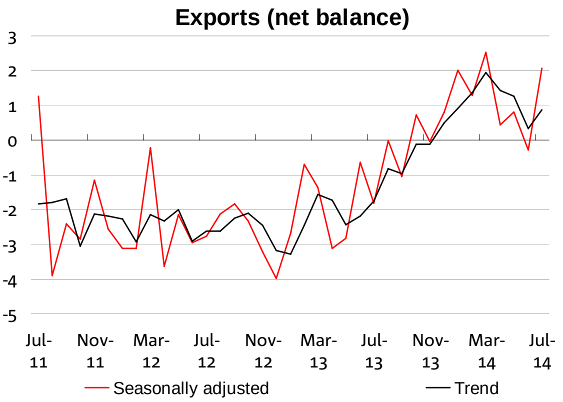
Stronger sales still encouraging re-stocking



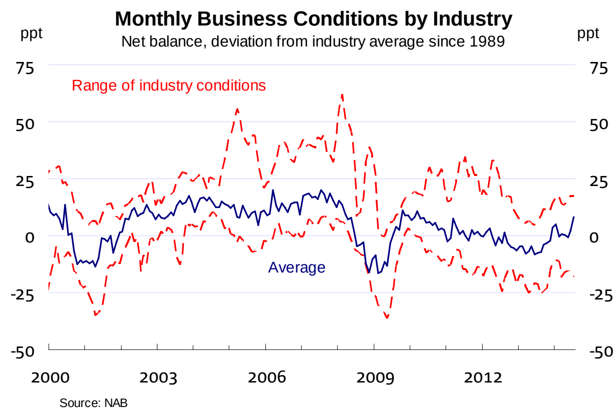
Capex remains slightly positive; good sign for non-mining investment



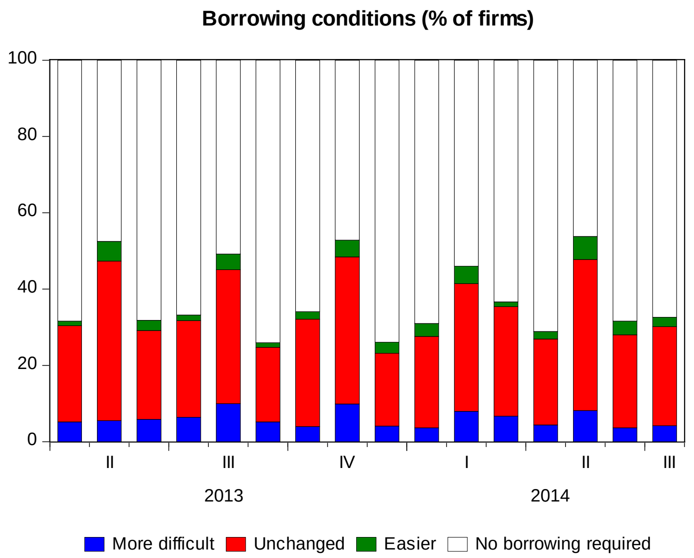
Exports post surprise recovery



Range of conditions remains wide

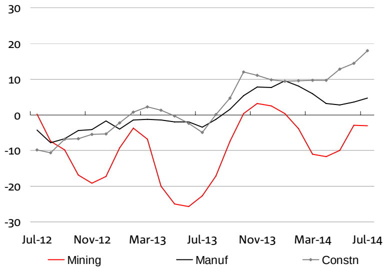


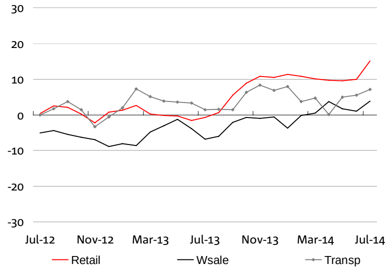
Borrowing conditions improved in last 3 months, as did demand for credit

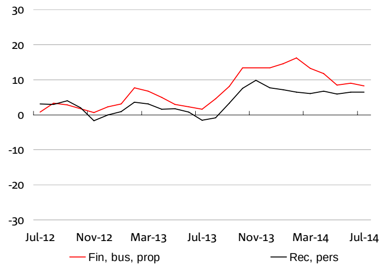


Industry sectors and states

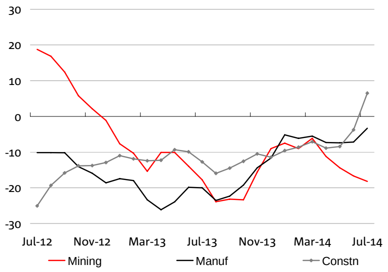
Business confidence by industry (net balance): 3-month moving average

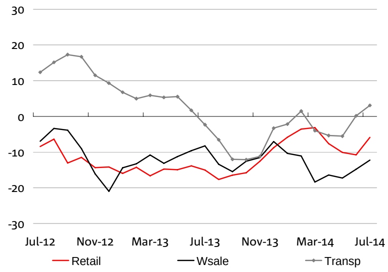


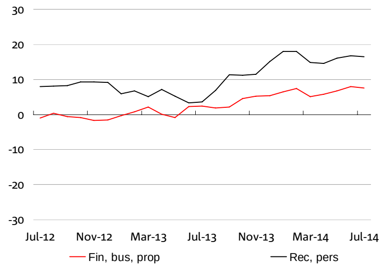




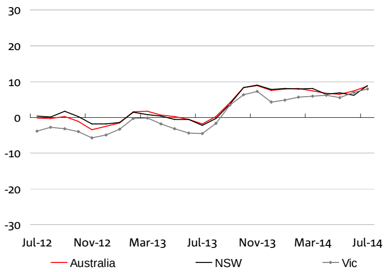
Business conditions by industry (net balance): 3-month moving average

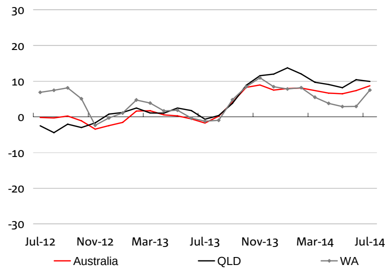


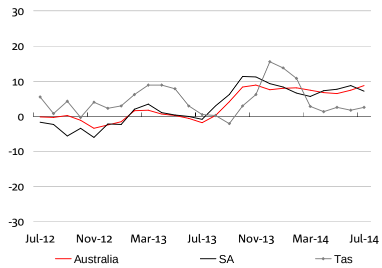




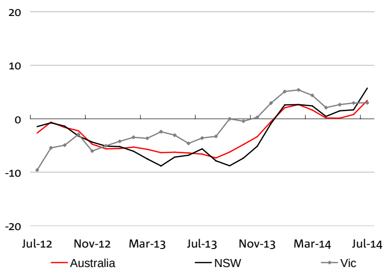
Business confidence by state (net balance): 3-month moving average

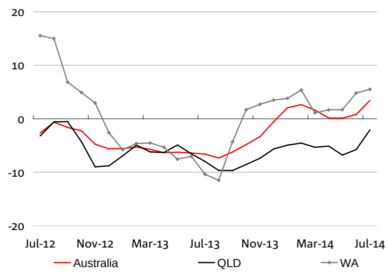


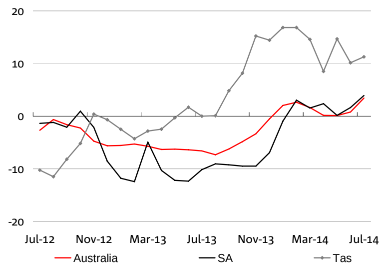




Business conditions by state (net balance): 3-month moving average







Key state business statistics for the month

	NSW	VIC	Qld	SA	WA	Tasmania	Australia
Bus. conf.: current	13	9	10	7	16	5	11
Bus. conf.: previous	6	8	12	7	1	-5	8
Bus. conf.: change	7	1	-2	0	15	10	3
Bus. conf: current - T	9	8	10	7	7	2	9
Bus. conf: previous T	6	7	10	9	3	2	7
Bus. conf.: change -T	3	1	0	-2	4	0	2
Bus. conds: current	13	2	6	12	8	-1	8
Bus. conds: previous	3	5	-4	3	9	-1	2
Bus. conds: change	10	-3	10	9	-1	0	6
Bus. conds: current -T	6	3	-2	4	6	11	3
Bus. conds: previous -T	2	3	-6	2	5	10	1
Bus. conds: change -T	4	0	4	2	1	1	2

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Melbourne	+800 842 3301	+(61 3) 9277 3321
Wellington	+800 64 642 222	+800 64 644 464
London	+800 747 4615	+(44 20) 7796 4761
New York	+1 800 125 602	+1877 377 5480
Singapore	+(65) 338 0019	+(65) 338 1789