National Australia Bank

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Monthly Business Survey — December 2013

Are we at a turning point? Business conditions jump to more than 2½ year high, while confidence broadly unchanged – both now near trend levels. Sales and profits up sharply – especially in wholesale, transport and services – reducing excess capacity slightly. Employment index better, but still imply flat job market. Soft forward indicators question the sustainability of the lift in conditions. Price inflation still moderate with margins under pressure as AUD increases input costs. Unemployment key to rate outlook. Domestic and global forecasts largely unchanged. But better near term business conditions and the CPI spike delays next RBA cut from May to late 2014.

- Business confidence was broadly unchanged in December and is consistent with long run average levels. Confidence has remained surprisingly elevated following the post-election jump, and could potentially remain at these levels for longer than previously thought given that the conditions index has begun to respond. Confidence appears relatively even across industries and the mainland states (unlike conditions).
- Business conditions jumped in December (up 7 points to +4 index points), moving more into line with confidence. Most industries recorded improved conditions for December – especially transport, wholesale and the services industries more generally – but, manufacturing and construction were both notable exceptions. The sustainability of the jump may be questionable given subdued forward orders, a run down in stocks (although this may be involuntary), and still low capacity utilisation. Employment conditions remain soft (-4 index points). Clearly the January reading (post seasonality) will give a better read on the growth momentum.
- Our wholesale leading indicator suggests much weaker underlying conditions and suggests below trend growth continuing into the first quarter of 2014. Against that the improving trend in business conditions suggest a more optimistic outlook - implying underlying demand growth and GDP growth (6-monthly annualised) of around 3% in Q4, above our forecast.
- Labour costs growth has held steady at restrained levels, consistent with increasing slack in the labour market. Similarly, subdued purchase costs have kept overall prices growth modest.

Implications for NAB forecasts (See latest Global and Australian Forecasts report also released today):

- Global upturn continues and forecasts little changed. Advanced economies seeing recovery after their prolonged weakness post 2008/9 recession. Mixed trends across Emerging markets with gradual slowing in China and uncertainty over speed of Indian rebound. While growth in the big emerging economies still easily outpaces that of the G7 advanced economies, the latter are driving the forecast improvement in global growth.
- More positive economic indicators for Australia hold out hope that a turning point may be near. However, the labour market is still weak and will remain a headwind as labour-intensive mining investment peaks. Other forward indicators generally still soft. Our forecasts are broadly unchanged: GDP for 2013/14 now 2.5% (unchanged) and 2014/15 now 3.0% (was 2.9%). Unemployment rate still to peak at 6½% in late 2014. The combination of near term better business conditions and (especially) the unexpectedly strong Q4 underlying inflation print has caused us to move our next rate cut call from May to November. We do not expect a rate hike until late 2015.

Key monthly business statistics*

	Oct 2013	Nov 2013	**Dec 2013**		Oct 2013	Nov 2013	**Dec 2013**
	Net balance				*Net balance*		
Business confidence	7	6	**6**	Employment	-3	-8	**-4**
Business conditions	-4	-3	**4**	Forward orders	-2	-2	**-2**
Trading	-2	2	**12**	Stocks	1	0	**-5**
Profitability	-6	-4	**6**	Exports	0	0	**1**
	% change at quarterly rate				*% change at quarterly rate*		
Labour costs	0.6	0.6	**0.6**	Retail prices	0.4	0.4	**0.1**
Purchase costs	0.8	0.7	**0.7**		*Per cent*		
Final products prices	0.3	0.2	**0.3**	Capacity utilisation rate	79.3	79.7	**80.1**

* 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 9 to 15 January, covering over 400 firms across the non-farm business sector.

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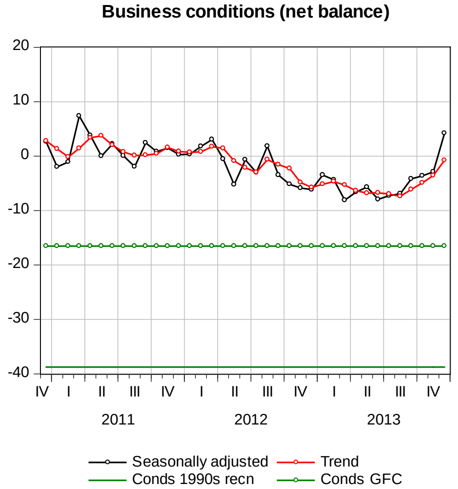
Next release:
6 February 2014 (December quarterly)
11 February 2014 (January monthly)

Analysis

Business conditions recorded a surprising jump to a more than 2½ year high in December – cementing the upward trend seen over recent months – supported by the low interest rate environment, higher asset prices and less elevated AUD. This has now brought conditions more into line with the lofty (albeit softening) level of confidence that followed last years federal election. But despite the significant improvement in December, lifting 7 points to +4 index points, this level still points to a marginally sub-trend rate of business activity. Conditions have been particularly buoyant in services industries, although most industries recorded at least some improvement in December, with manufacturing and construction both notable exceptions. The largest improvements were in transport & utilities, fin/ prop/ bus services and wholesale, which is a relatively mixed collection suggesting a number of factors could be underlying the step up in activity. Manufacturing was the only industry to record a decline in conditions during the month. The sustainability of the jump in overall business activity may be questionable with forward orders remaining subdued, stocks being run down (although this may be involuntary), and capacity utilisation remaining low. Unsurprisingly, employment conditions remain soft (-4 index points), consistent with the recent weak labour market reports from the ABS and our outlook for ongoing deterioration of the labour market.

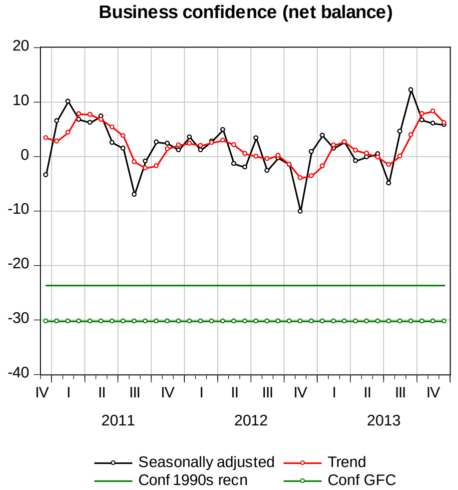
Business confidence was broadly unchanged in December at 6 index points, consistent with long run average levels. Confidence has remained surprisingly elevated following the post-election jump, and could possibly remain at these levels for longer than previously thought given that the conditions index has begun to respond. Nevertheless, the increasing slack in the labour market and limited signs of a turn around in real activity indicators – in light of the looming declines in mining investment – suggests these improvements may be fleeting, although higher building approvals and recent signs of life in the retail sector are encouraging. Confidence is now positive for all industries, including wholesale which had previously demonstrated strong sensitivity to the AUD outlook.

Surprising jump in conditions



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

Confidence looks to be stabilising



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

Business conditions by industry. Conditions improved noticeably for transport & utilities (up 16 points), supported by solid improvements in the wholesale and (to a lesser extent) retail sectors (up 12 and 6 points respectively). Conditions in personal and recreational services have risen to very strong levels (+21 points). In contrast, the manufacturing sectors malaise deepened in December following 4 consecutive months of improvement (down 4 points to -11 index points). Manufacturers are yet to see any material benefit from falls in the AUD, while many are facing higher purchasing costs as a result. The construction and mining industries showed little to no improvement in the month, despite healthy activity in residential property markets and robust commodity demand from China. Recreation and personal services continue to outperform other sectors by a considerable margin (followed by finance/ business/ property firms). The lower AUD may be helping to promote domestic travel and other services (although raising imported energy costs), but these sectors have also proven to be much more resilient to external headwinds in recent years. Overall, conditions remain extremely weak in manufacturing (-11), construction (-11), and to a lesser extent retail and mining (both -4).

Analysis (cont.)

Business conditions by state. Queensland was the only state not to record a noticeable improvement in business conditions in December (up 1 point to -4 index points), which could be partly attributable to recent drought conditions as well as prevailing headwinds to the retail sector. Queensland was the worst performing state in December. Conditions in WA rose by 17 points, SA improved by 11 points and conditions in both NSW and Victoria lifted 7 points. Following these changes, WA jumped back into first position in the rankings of current business conditions among the mainland states (up 17 points to 11 index points), having slipped into fourth position last month. Victoria and NSW follow in second and third respectively (6 index points; 4 index points).

Business confidence by industry. Aggregate business confidence was broadly unchanged in the month, but outcomes varied across industries. Improvements were recorded for wholesale (up 6 points) – often considered a bellwether for the broader economy – with construction and financial/ property/ business services both recording more modest increases (+2 points). Low interest rates and rising property prices have helped to support confidence in the construction sector, but this has been slow to flow through to conditions and actual construction activity, which remain sluggish. Increased confidence in these industries were largely offset by a sharp deterioration in transport & utilities (down 12 points) and small declines in retail and recreation/ personal services (down 1 point). With signs of ‘green shoots’ in the retail and wholesale industries, a deterioration in transport is somewhat unexpected, although rises in fuel costs over December and recent downsizing in the aviation industry may have contributed. In levels terms, finance/ property/ business services are the most confident (+11 index points), followed by construction and (surprisingly) manufacturing. On balance, most industries remain relatively confident, although transport & utilities are the least confident with an index of zero (despite having relatively favourable business conditions). Despite the relative optimism of most industries, forward orders have remained quite subdued, particularly for construction, wholesale, retail and manufacturing.

Business confidence by state. Confidence remains reasonably positive in all mainland states, despite declines in the month for Victoria (down 2), Queensland and SA (both down 4). NSW and WA were the only mainland states to record a rise, up a modest 1 index point. Despite the weak business conditions facing Queensland firms, the state is reporting the highest degree of confidence of the mainland states in levels terms (9 index points). Firms are least confident in Victoria (+2), followed by NSW and SA (+6).

The **forward orders** index remained unchanged at -2 index points, which is close to the highest levels seen since 2011, but still points to relatively subdued activity in coming months. By industry, a sharp deterioration in construction (down 16) and finance/ property/ business services (down 4) was offset by solid improvements in mining (up 17) as well as wholesale (up 8). Forward orders are highest in mining (+6 index points), followed by finance/ business/ property (+4 index points), while construction is now the weakest (-12) despite the solid rise in dwelling approvals last year. **Capacity utilisation** rose again in December (up 0.4 ppts to 80.1) having reached its equal lowest level since June 2009 in October. Current readings for capacity utilisation are well below the long run averages and imply considerable slack in the economy – which will continue to depress business investment for some time and compound the looming drag from lower mining investment. This month’s outcome reflected improvements across most industries, offsetting declines in manufacturing (down 2.8) and financial/ property/ business services (down 1.2). Mining recorded the largest increase in capacity utilisation (up 2.8), but utilisation remains quite low at 78%. Similarly capacity utilisation in manufacturing is just 73% which is likely to keep business investment in the sector very depressed for a long period – consistent with subdued investment intentions by manufacturers in both our own business survey and the ABS Capex survey. Capacity utilisation is highest in construction (83%), financial/ business/ property (82%) and recreation & personal services (82%).

The **stocks** index – also a good indicator of current demand – fell by 5 points to a net balance of -5, indicating that there may have been an involuntary destocking by firms as trading conditions jumped but firms remain reluctant to replenish inventories in light of soft demand over previous months and soft forward orders.

The **capital expenditure** index fell by 4 points to 1 index point, unwinding much of the jump recorded in the previous month. A sharp increase in capex by the mining sector (up 27) was more than offset by declines in transport & utilities (down 15), finance/ property/ business services (down 11), retail (down 6) and manufacturing (down 5). In levels terms, capital expenditure was highest in mining (+19), followed well behind by recreation & personal services (+5). Capex is soft among the other industries, with construction the weakest at -7 index points. The capex series is quite volatile and remains relatively subdued in trend terms. A broad based improvement in this series in coming months will be critical for a smooth rebalancing of the economy as mining investment begins to decline.

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. However, the models accuracy did improve in Q3 with actual growth picking up to 2.1%, compared to the models prediction of 2%. If we apply the December trend forward orders outcome to our model for Q4, the implied demand growth would strengthen further to around 3% – above our forecast.

Based on average business conditions for the September quarter, the survey implied 6-month annualised GDP growth of around 2¾% in Q3, close to the actual growth rate in the national accounts. Based on trend business conditions from the December Survey, the survey implies GDP growth will rise to around 3% in Q4, also above our forecast. For early 2014, our wholesale based leading indicator points to a similar level of business conditions, implying a comparable rate of GDP growth for Q1.

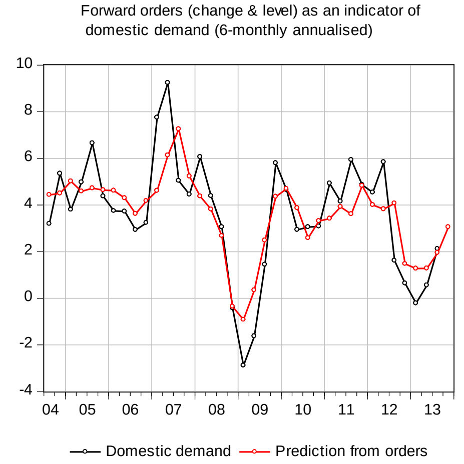
Elsewhere in the survey, cash flow (not seasonally adjusted) was strongest in rec. & personal services, and weakest in mining, manufacturing & wholesale.

Labour costs growth (a wages bill measure) was unchanged in December at subdued levels. This reflected softer labour cost pressures in mining (down 2.1 ppts), manufacturing (down 0.3 ppts) and construction (down 0.2 ppts), offset by modest increases in wholesale and retail labour costs growth (0.4 and 0.1 ppts higher). Labour costs growth remains strongest for transport & utilities (1.1%), recreation & personal services (1.0%), and fin/ bus/ prop (0.7%), and softest in mining (-2.1%), and construction (0.2%).

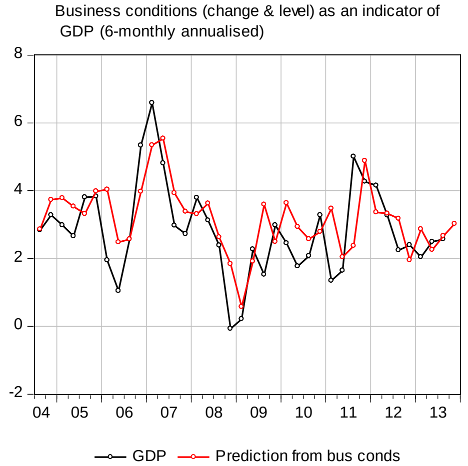
Purchase cost growth was unchanged at 0.7 ppts in December (at a quarterly rate), having gained momentum since mid-2013 with the depreciation of the AUD. Purchase costs picked up most in wholesale (up 2.1 ppts) and transport & utilities (up 0.5 ppts), offset by softer growth in most other industries. Purchase cost growth was strongest in wholesale (3.1%, at a quarterly rate), transport & utilities (1%), manufacturing and retail (both 0.9%), while purchase costs pressures were more moderate for mining (-0.6%) and construction (0.1%).

Final product price growth picked up only slightly in December (up 0.1 ppts), suggesting that consumer price pressures are unlikely to prompt an interest rate rise by the RBA any time soon. Nevertheless, at 0.3% (quarterly rate), price inflation remains slightly more elevated than average growth over the previous two years (of 0.1%), but is still below the series average of 0.5%. Across industries, the mining sector is continuing to experience price deflation (-1.2%), while prices are broadly flat for retail and manufacturing. Prices increased most strongly in wholesale (0.5%), which could reflect pass-through from AUD depreciation causing higher purchase costs.

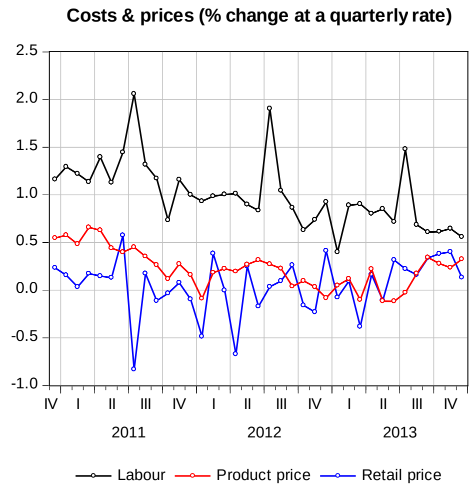
Demand growth rising, but staying below trend



GDP growth below trend in Q4



Prices growth still soft and outpaced by input cost growth



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

Current business conditions

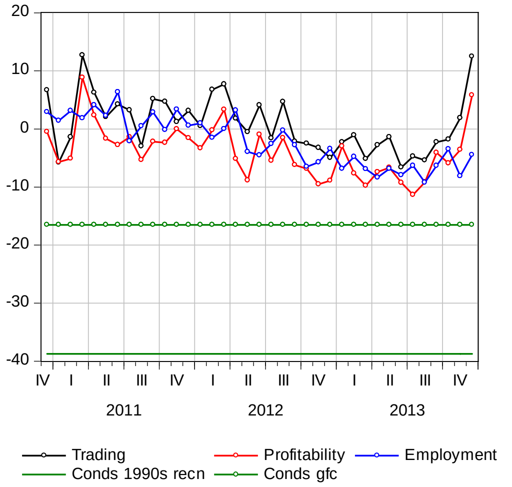
The business conditions index rose sharply to +4 points in December, coming more into line with the lofty confidence since the federal election. This suggests that domestic demand growth may be returning to trend; the long run average for conditions is zero since 1989 (+5 for just the monthly series since 1997). Conditions at this level could provide some upside risk to our view for a deteriorating labour market, although the survey's employment index has remained soft.

Trading, profitability and employment

The sharp improvement in business conditions reflected a jump in both profitability and trading conditions, both of which have been steadily improving since mid-2013. However, there has been an apparent 'jobless recovery' taking place, with employment conditions lagging well behind, although there was some improvement in the month. Only employment conditions are showing a negative index that is also below the long-run average.

All components picked up, but employment still soft

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



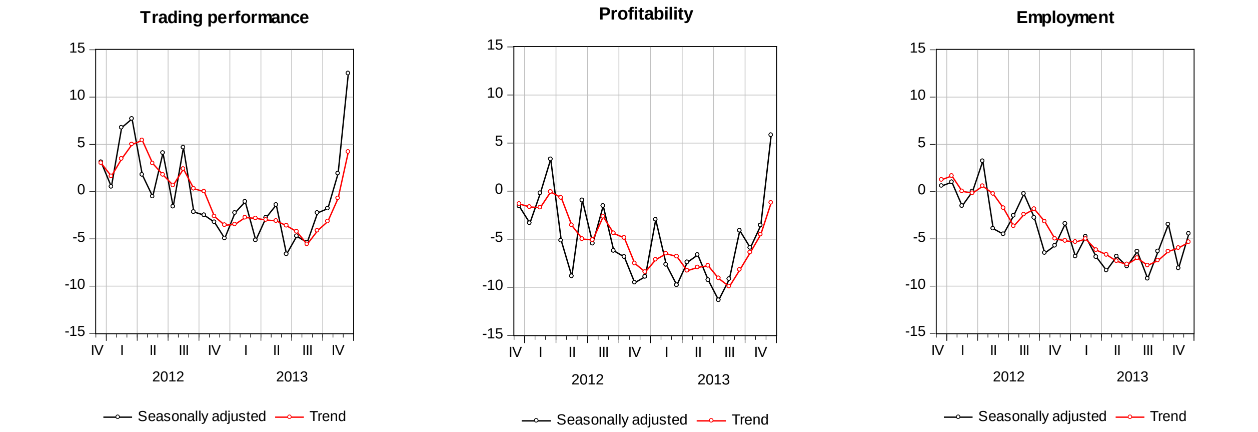
Net balance of respondents who regard last month's trading / profitability / employment performance as good.

There were significant improvements in **trading conditions** for financial/ property/ business services (up 20), recreation & personal services (up 17) and wholesale (up 13), while manufacturing and construction were the only industries to record a deterioration (down 7 and 9 points respectively). In levels terms, trading was particularly poor in construction (-9), mining (-8) and manufacturing (-7). Trading conditions are considerably better in recreation & personal services (+36) and fin/ prop/ bus services (+24).

The improvement in **employment conditions** was unexpected given recent weakness in official labour market statistics, although the index level remains consistent with a soft labour market. The improvement was supported by a large rise in wholesale (up 21) and transport & utilities (up 13). Nevertheless, employment conditions remain tough in wholesale (-4 index points), but are even worse for manufacturing (-16) and construction (-12). Employment conditions are most favourable in mining (+9), despite approaching the peak of the investment cycle and recent efforts to cut costs.

Consistent with the rise in trading conditions, **profitability** also improved significantly in December (up 10 points). The largest improvements in profitability came from transp & util (up 36) and rec & pers services (up 17). Mining (down 8) and wholesale (down 1) were the only industries to record declines. In levels terms, very weak profitability in most industries has been more than offset by extremely strong profitability in rec & pers services (+31), reflecting both stronger demand (supported by the lower AUD) and relatively benign cost pressures. Fin/ prop/ bus services (+16) and transp & util (+11) are also strong.

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.)

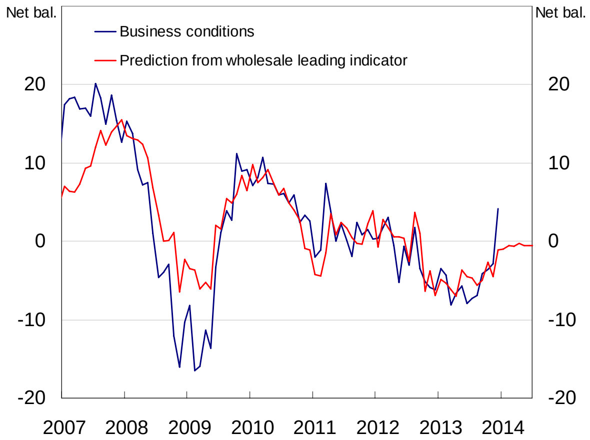
Wholesale: Signalling softer domestic economy than conditions suggest

The weakness in wholesaling that has persisted for the best part of 3½ years remained for much of 2013. While conditions have been volatile in recent months, wholesale trend conditions remained subdued, at -6 points in December.

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 significant divergence in recent months as business conditions has improved. Our analysis suggests that if wholesale trend conditions in December (-6) were to continue into this year, overall business conditions could be expected to remain soft, averaging -1 index points in early 2014. That in turn suggests an economy still running below trend - and would continue to do so into the first quarter of 2014.

Wholesale activity points to continued weak conditions

Wholesale as a leading indicator of business conditions



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

Forward orders

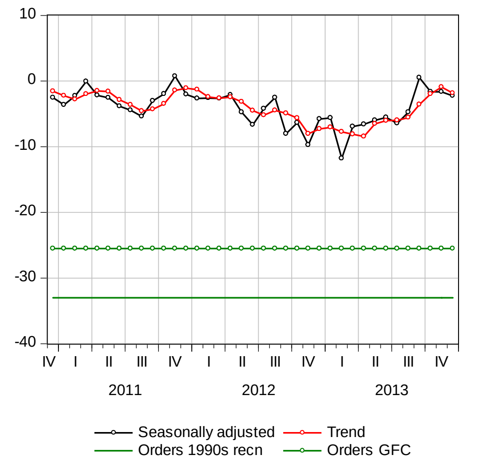
The forward orders index was unchanged at -2 points in December. At -2 points, the index is now marginally below the series long-run average of zero points since 1989. Nonetheless, the index is higher than the index average of the past two years (-5 points).

No change in orders largely reflected big falls in construction (down 16) and finance/ property/ business investment (down 4) orders, offset by strong increases in other industries, with mining increasing the most (up 17). Orders were strongest (and positive) in mining (+6) and fin/ bus/ prop (+4), and weakest in construction (-12), wholesale (-8), retail (-8) and manufacturing (-7).

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

New orders down from two year high

Forward orders (net balance)



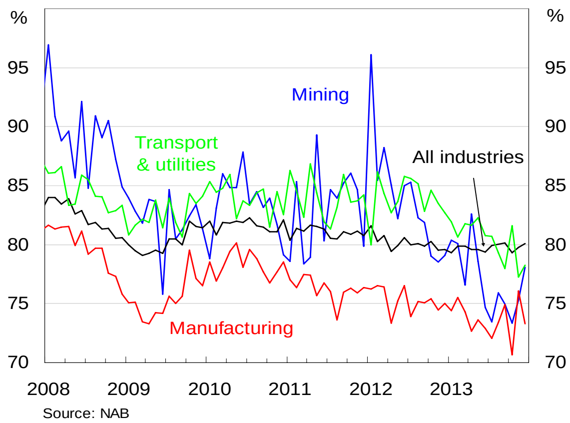
Capacity utilisation

Capacity utilisation recorded a moderate increase in December (up 0.4 ppts to 80.1%), similar to the increase in the previous month. Although utilisation has been relatively stable, it has been at a subdued level that is low relative to the monthly survey average of 81.1% (since 1997), and the long-run average of 80.4% (since 1989). This month's outcome reflected a solid pick up in mining (up 2.8 ppts), rec & pers services (up 1.6 ppts) and construction (up 1.4 ppts), which more than offset a decline in manufacturing (down 2.8 ppts) and fin/ prop/ bus (down 1.2 ppts). Manufacturing capacity utilisation remains very low (73%). Utilised capacity was highest in construction (83%).

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

Capacity usage low in manuf. & mining

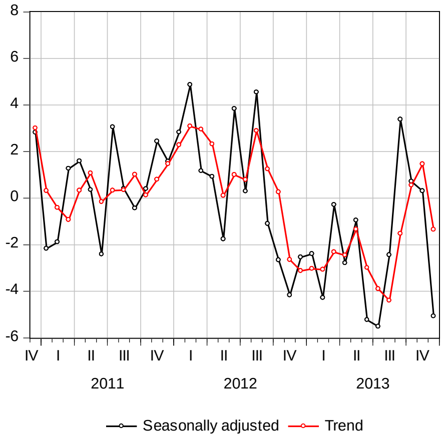
Capacity Utilisation



More details on business activity

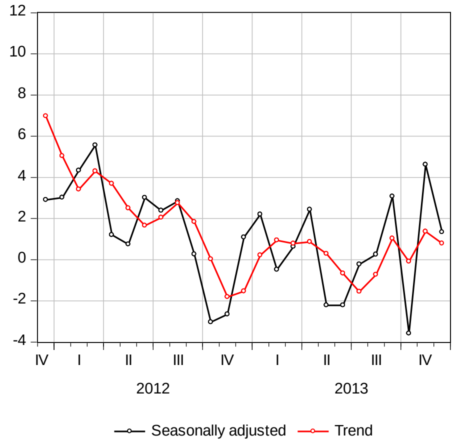
Sharp de-stocking, possibly involuntary?

Stocks (net balance)



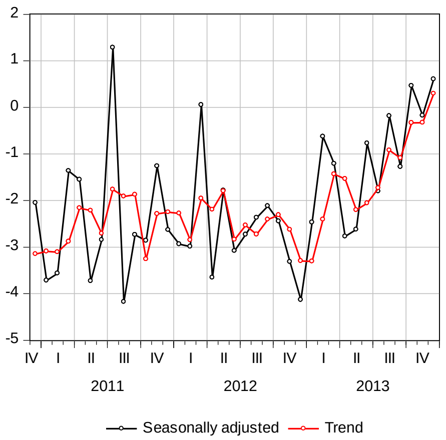
Capex flat to lower, but strong in transport

Capital expenditure (net balance)



Exports better, but still soft

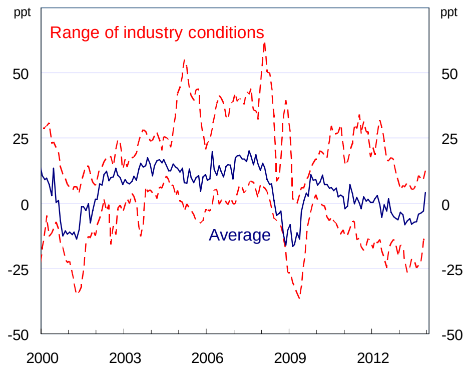
Exports (net balance)



Range of conditions skewed to upside

Monthly Business Conditions by Industry

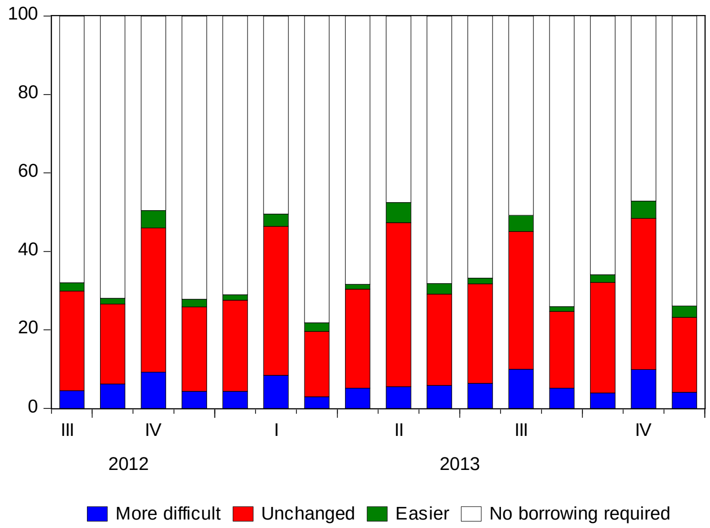
Net balance, deviation from industry average since 1989



Source: NAB

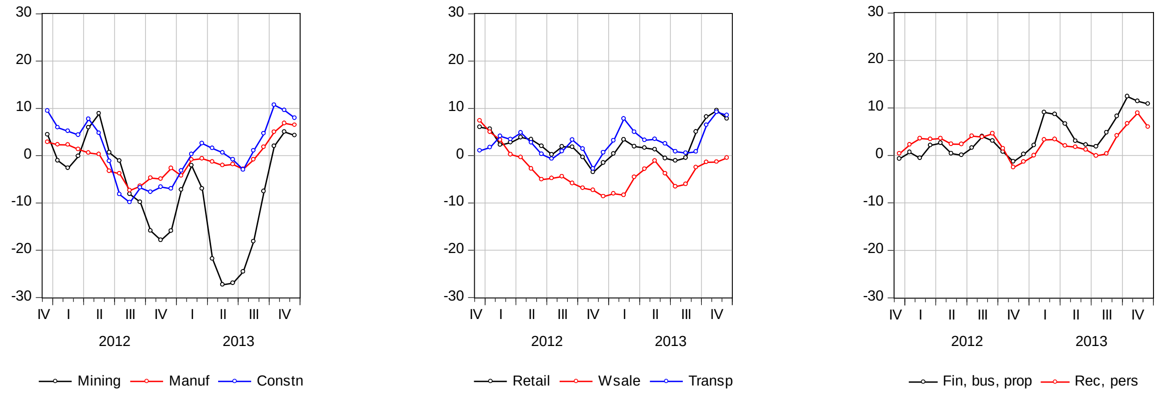
Fewer firms reporting tighter borrowing conditions, but demand for credit fell

Borrowing conditions (% of firms)

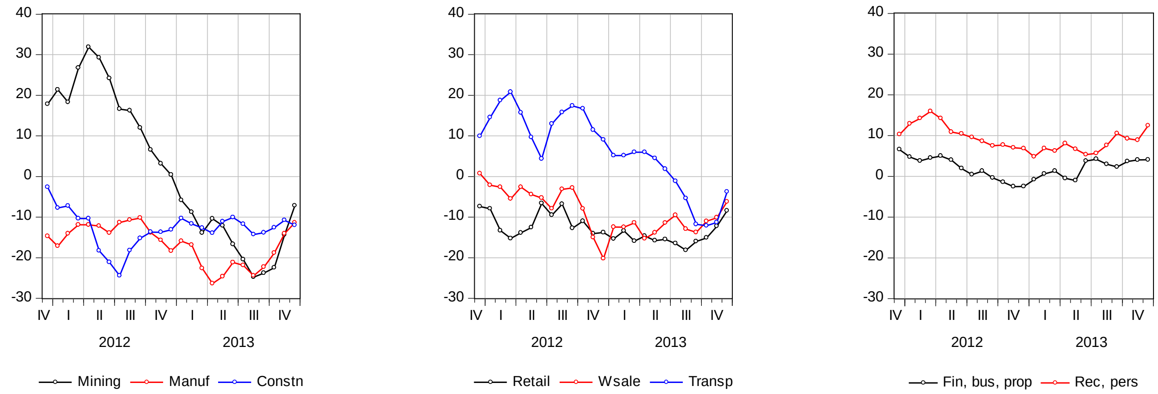


Industry sectors and states

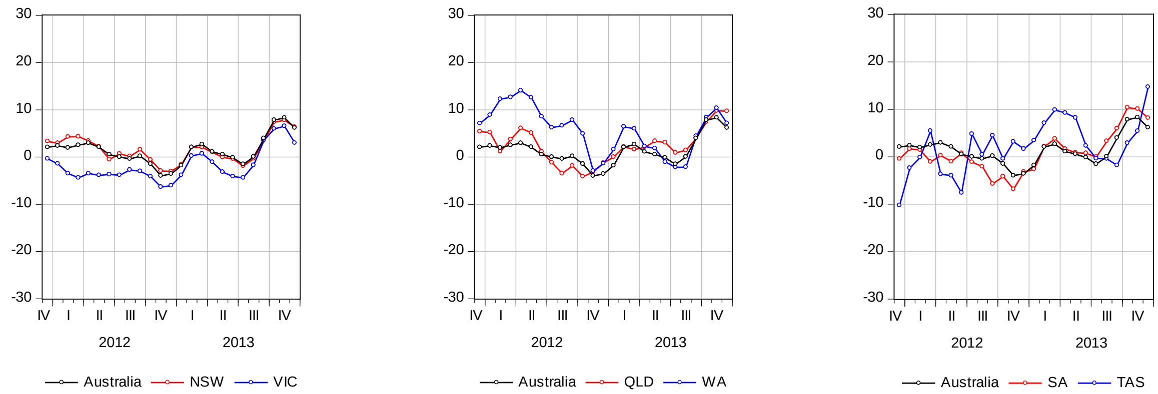
Business confidence by industry (net balance): 3-month moving average



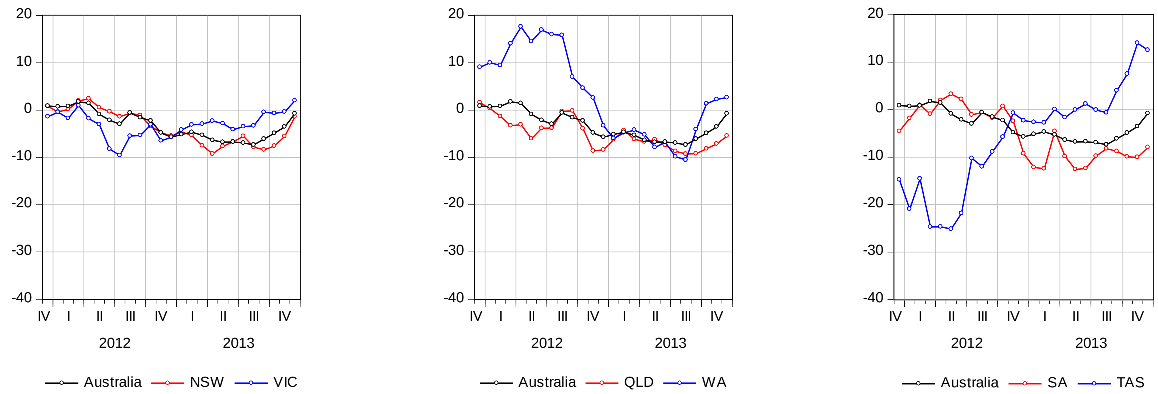
Business conditions by industry (net balance): 3-month moving average



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



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



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