National Australia Bank

Embargoed until:
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Monthly Business Survey

January 2014

More encouraging results. Business conditions maintained last months momentum and is approaching 3 year highs while confidence was up for the first time in 4 months – both near or above trend levels. Employment index much better, but still suggests soft labour market conditions. Sales and profits dipped slightly, but still healthy. Sharp turnaround in manufacturing – surprising in the current environment and will need a lift in domestic demand to be sustained. Better forward indicators give some comfort about near-term outlook. Price inflation still moderate, but driven higher by upstream pressures. Unemployment key to rate outlook. Upside risk to near-term growth forecast, but fundamental outlook unchanged. Final RBA cut to occur in late 2014.

- Business confidence recorded its first rise in four months in January, to be above long run average levels. Now that conditions are on the rise, confidence may continue its run of surprising (post-election) resilience for a while longer. Confidence is now positive for most industries, although wholesale (a bellwether industry) and mining are both negative – significant given the increased importance of mining to the Australian economy. Confidence is generally positive across all states.
- Business conditions consolidated the strong pick up in December, reaching an almost 3 year high. Overall conditions are still chasing confidence, but are now close to their long run average. Manufacturing recorded a surprisingly strong turnaround – somewhat counter to other industry indicators. The next best improvement was in construction, followed by retail. All other industries deteriorated. Forward orders look more supportive of better conditions, but capacity utilisation remains below long run averages, and the employment index still suggests a jobless recovery.
- Our wholesale leading indicator suggests much weaker underlying conditions, pointing to below trend demand growth continuing into the first quarter of 2014 at around 3%. Against that, the improving trend in business conditions (if maintained) implies underlying GDP growth of around 3¾% in Q1, well above our forecast.
- Inflation pressures remain subdued, but are building on the back of rising costs inflation. Labour costs growth is restrained, consistent with increasing slack in the labour market, but lifted in the month. Purchase costs have shown a similar trend.

Implications for NAB forecasts (See latest Global and Australian Forecasts released on 28 January 2014):

- The latest trade data and retail sales suggest that there is a little upside risk to our near-term forecasts. Indeed net exports could by itself contribute around ¾% in Q4 2013. While a strong Q4 will rise the stepping off point, our fundamental outlook (especially domestic demand and unemployment) is unchanged (see table on p9).
- Our activity forecasts are broadly unchanged: GDP for 2013/14 now 2.7% (was 2.5%) and 2014/15 now 3.0% (unchanged). Calender 2014 now 3% was 2.8%. Unemployment rate still to peak at 6½% in late 2014. RBA expected to cut rates (25bp) for the last time in November. We do not expect a rate hike until late 2015.

Key monthly business statistics*

	Nov 2013	Dec 2013	**Jan 2014**		Nov 2013	Dec 2013	**Jan 2014**
	Net balance				*Net balance*		
Business confidence	7	6	**8**	Employment	-7	-4	**1**
Business conditions	-2	3	**4**	Forward orders	-1	-2	**6**
Trading	3	12	**7**	Stocks	0	-4	**1**
Profitability	-3	5	**3**	Exports	0	1	**2**
	% change at quarterly rate				*% change at quarterly rate*		
Labour costs	0.7	0.6	**1.2**	Retail prices	0.4	0.2	**0.5**
Purchase costs	0.8	0.8	**1.2**		*Per cent*		
Final products prices	0.2	0.3	**0.6**	Capacity utilisation rate	79.8	80.2	**80.6**

* 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 28 January to 3 February, covering over 400 firms across the non-farm business sector.

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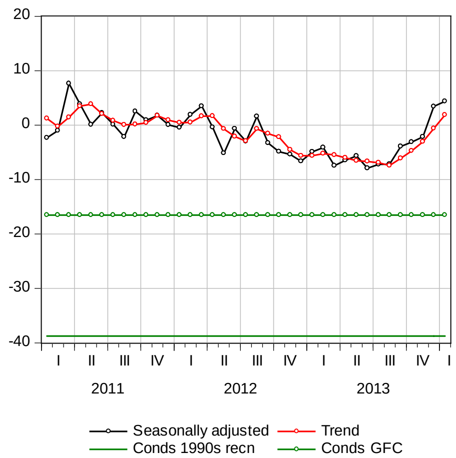
Next release:
11 March 2014 (February monthly)

Analysis

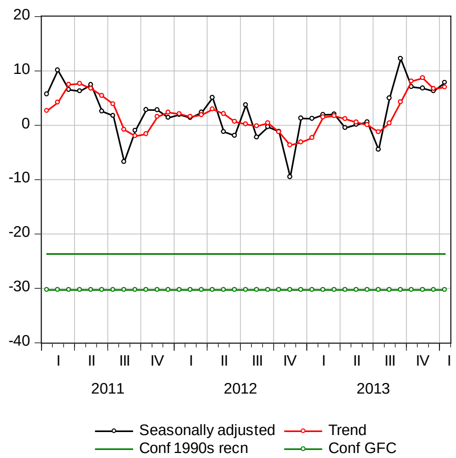
Business conditions rose again from the surprising pick up recorded in the previous month, to be at an almost 3 year high. Conditions look to have turned around a little faster than we had expected just a few months ago, with low interest rates and depreciating AUD gaining surprisingly good traction in some non-mining sectors of the economy. The improvements over recent months have established a clear upward trend in business activity, suggesting some upside potential to our current growth outlook, although indicators of employment continue to point to a soft labour market. Overall conditions are still lagging behind confidence, but lifted 1 point to +4 index points in the month – close to the long run average of the series (+5 since 1997). Services sectors have been a standout in recent months, but this month it was manufacturing that recorded a surprisingly strong turnaround – somewhat counter to other industry indicators. After manufacturing, the next best improvement was in construction, followed by retail. All other industries showed deterioration from the previous month. It is probably still too soon to call the end of sub-trend economic growth in Australia based on these outcomes, but a rise in forward orders and capacity utilisation certainly provides some comfort. However, the employment index is still showing a jobless recovery, contributing to our subdued outlook.

Conditions approaching trend



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

Confidence showing resilience



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

Business confidence recorded its first rise in four months in January, increasing by 2 points to 8 index points, to be above long run average levels. Now that conditions are on the rise, confidence may continue its run of surprising (post-election) resilience for a while longer. Growth in forward orders will be supportive of the near term outlook, but the lack of much evidence of a turnaround in real activity indicators will probably keep confidence levels sensitive to any sign of headwinds from certain pockets of the economy (particularly mining investment or potential disappointment in housing construction). A continuation of slack labour market conditions will also constrain confidence in consumer driven industries. Confidence is now positive for most industries, although wholesale (a bellwether industry) and mining are both negative – significant given the increased importance of mining to the Australian economy.

Business conditions by industry. Conditions improved noticeably for manufacturing (up 13 points), followed by construction (up 5 points); retail was the only other industry to record an improvement in the month (up 1 point). Despite recording a deterioration relative to last month, conditions in the services sector have continued to outperform – with consumers more prepared to spend on services (especially those considered non discretionary e.g. utilities, education and housing costs). Conditions are highest in recreation & personal services (+14 index points), followed by finance/ property/ business services (+5 points). Following a period of pronounced weakness, lasting a number of years, conditions in the manufacturing sector apparently improved rapidly in January – the extent of this rebound is surprising and doesn't sit well with talk of further on going retrenchments in this sector. It will be important to see whether this jump is maintained or rather whether it just represents statistical noise. Conditions in the mining industry also remain soft (-6 points), but firms are reporting notably better exports, consistent with the final phase of the mining boom (as investment projects reach completion). Finally, conditions remain very weak and deteriorating in wholesale (-11), which is somewhat inconsistent with improvements in other industries.

Analysis (cont.)

Business conditions by state. Western Australia was the only mainland state to record a worsening in conditions during the month (down 9 points to +4 index points), which could reflect the impact of cyclone Christine in late December/early January, which caused the temporary closure of the Port Hedland iron ore export terminal; although mining firms continued to record robust exports in the month. Queensland conditions improved modestly, but drought conditions, retail headwinds and flow-on effects from the softer mining sector, kept it the worst performing state in January (up 2 point to -3 index points). Conditions in NSW rose by 3 points in January, Queensland improved by 2 points and conditions in Victoria lifted just 1 point. Following these changes, the mining related states (Qld, WA, and to a lesser extent SA) are again showing the worst conditions, while the more services driven economies (Victoria and NSW) jumped back into first and second position respectively of the mainland states.

Business confidence by industry. Aggregate business confidence was up 2 points in the month, but outcomes varied across industries. Improvements were recorded for transport & utilities (up 16 points), while retail and finance/ property/ business services also reported solid increases (both up 7 points). Sentiment surrounding the retail sector has steadily improved in recent months, supported by the strong holiday shopping period at the end of last year; real retail sales growth was 0.9% q/q in the December quarter, well above the 0.5% average for the past five years. Low interest rates and higher asset prices appear to be having the desired effect on consumer behaviour, offsetting muted wages growth. The wholesale industry – often considered a bellwether for the broader economy – recorded the largest fall in business confidence (down 14), while mining and recreation & personal services fell as well (down 7 and 3 points). In levels terms, finance/ property/ business services are the most confident (+18 index points), followed by retail and transport & utilities (both +14 points). On balance, most industries remain relatively confident, but wholesale remains extremely downbeat (-11 points), which seems inconsistent with improvements in other industries with which wholesale is integrated. This could represent current and expected margin pressure from the depreciation to the currency.

Business confidence by state. Confidence remains reasonably positive in all mainland states, despite a slight fall in the month for WA (down 2). Victoria (up 2), Queensland (up 2) and NSW (up 1) all recorded a rise, with SA unchanged. Despite the weak business conditions facing Queensland firms, the state is reporting the highest degree of confidence of the mainland states in levels terms (12 index points). Firms are least confident in Victoria (+4).

The **forward orders** index jumped noticeably (up 8) to +6 index points – its highest level since 2009 – putting a bit more comfort in the sustainability of the recent rise in business conditions in the near term. By industry, a sharp deterioration in mining (down 27), and a more moderate fall in wholesale (down 1) was offset by solid improvements in construction (up 18) as well as manufacturing and retail (both up 15). Forward orders are (surprisingly) highest in manufacturing (+9 index points), followed by finance/ business/ property and retail (both +8 index points), while mining is now the weakest at -19 points (having had the strongest orders the previous month), while wholesale has remained soft (-10). **Capacity utilisation** rose again in January (up 0.4 ppts to 80.6) – its highest level since mid 2012 – having recently equalled the lowest level since June 2009 in October. Current readings for capacity utilisation are still below the long run averages – although this varies across industries – and imply considerable slack in the economy. Mining capacity utilisation is furthest below long run averages, consistent with our expectations for a significant drag from mining capex that will depress business investment for some time. This month's outcome reflects mixed results across industries. Manufacturing rose the most (up 2 ppts), while transport & utilities, retail, and services recorded more modest increases. Mining had the largest decline (down 1.2 ppts), with construction and wholesale also declining. Following the months decline, utilisation in mining is just 77%, but manufacturing is still the weakest at 75%. Capacity utilisation is highest in construction, recreation & personal services and fin/ prop/ bus (all 82%).

The **stocks** index – also a good indicator of current demand – rose by 5 points to a net balance of +1, indicating that the destocking cycle may be coming to a close – although the index has been volatile in recent months. Wholesale recorded the most notable change, up a staggering 48 points to +25 points.

The **capital expenditure** index rose by 3 points to 4 index point, unwinding much of last months fall. Sharp declines in capex by the mining sector (down 45) and construction sector (down 23), were more than offset by increases in the service sectors; finance/ property/ business services (up 9) and recreation & personal services (up 5). In levels terms, capital expenditure was highest in recreation & personal services (+11), followed by finance/ property/ business services (+10). Capex is soft among most other industries, with construction the weakest at -30 index points. The capex series is quite volatile and under represents mining investment, but overall remains at relatively subdued levels. Non-mining investment will clearly need to pick up more substantially if it is to offset the coming mining investment 'cliff'.

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 model's accuracy did improve in Q3 with actual growth picking up to 2.1%, compared to the models prediction of 2%. If we apply the forward orders outcome to our model for Q4, the implied demand growth would strengthen further to around 3% – above our forecast. Similarly, applying trend forward orders in January to Q1 implies even strong demand growth of 3.8%.

Based on 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 business conditions from the December quarter Survey, the survey implies GDP growth will rise to almost 3% in Q4, also above our forecast. Applying trend conditions for January implies stronger growth again in Q1 at 3¼%. In contrast, for early 2014 our wholesale based leading indicator points to a much softer level of business conditions, implying GDP growth of around 3% for Q1.

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

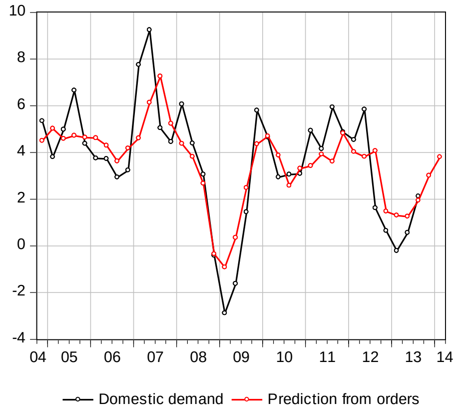
Labour costs growth (a wages bill measure) rose sharply in January to its highest rate since 2011 (excluding months affected by minimum wage increases). This reflected stronger labour cost pressures in manufacturing (up 1.4 ppts), mining (up 1.2 ppts), and construction (up 0.6 ppts). Retail and services recorded more modest increases. Labour costs growth is now strongest for manufacturing (1.7%) and softest in mining (-0.8%).

Purchase cost growth also rose (up 0.4 ppts) to 1.2% in January (at a quarterly rate), having trended up since mid-2013 with the depreciation of the AUD. Purchase costs picked up most in mining (up 1.1 ppts) and retail (up 1.1 ppts), partly offset by softer growth in wholesale. Purchase cost growth was strongest in retail (2.1%, at a quarterly rate) and manufacturing (1.7%), while purchase costs pressures were more moderate for construction (0.4%) and mining (0.5%).

Final product price growth picked up modestly in January (up 0.3 ppts), suggesting that consumer price pressures are unlikely to prompt an interest rate rise by the RBA any time soon. Nevertheless, the momentum has been building from upstream pressures, and at 0.6% (quarterly rate), price inflation is now above the series average of 0.5%. Across industries, the mining sector is continuing to experience price deflation (-1.4%), while prices growth ranges from 0.3% to 1% for the other industries. Prices increased most strongly in recreation & personal services (1%).

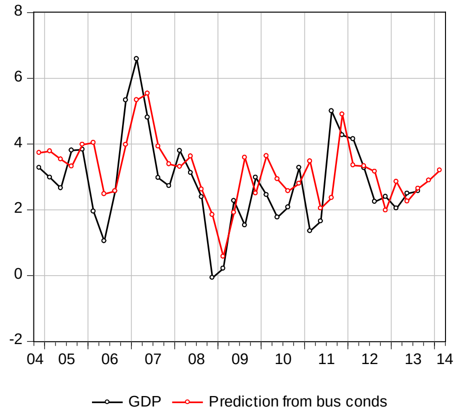
Implies demand growth approaching trend

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



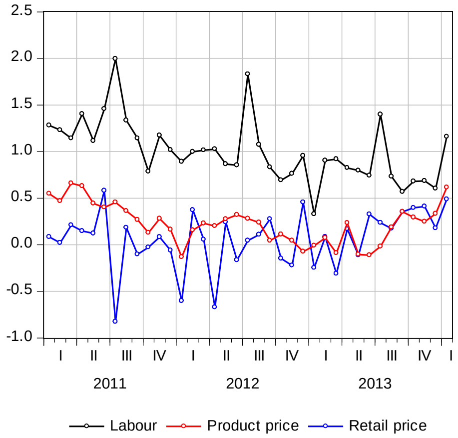
GDP growth to rise in Q1

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



Prices growth rising due to upstream pressures

Costs & prices (% change at a quarterly rate)



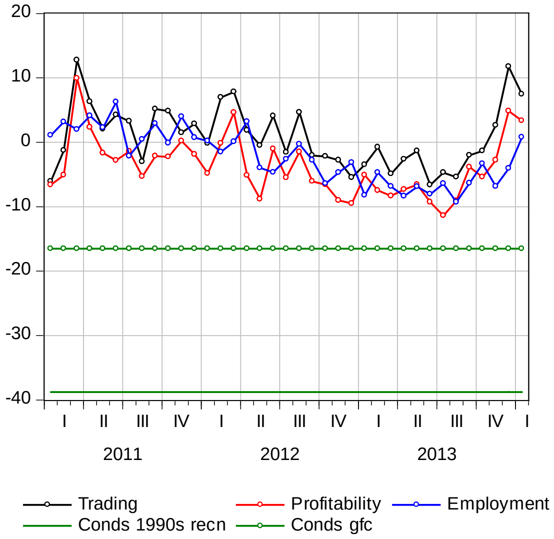
Based on respondent estimates of changes in labour costs and product. Retail prices are based on retail sector product price estimates.

Current business conditions

The business conditions index rose again in January (up 1) to +4 points, holding on to the surprisingly strong gains recorded in the previous month. Conditions are still lagging confidence, but look to be on the way to catching up. 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 provide some upside risk to our view for a deteriorating labour market, although the survey's employment index is still subdued.

Trading and profits backtrack slightly, employment up

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

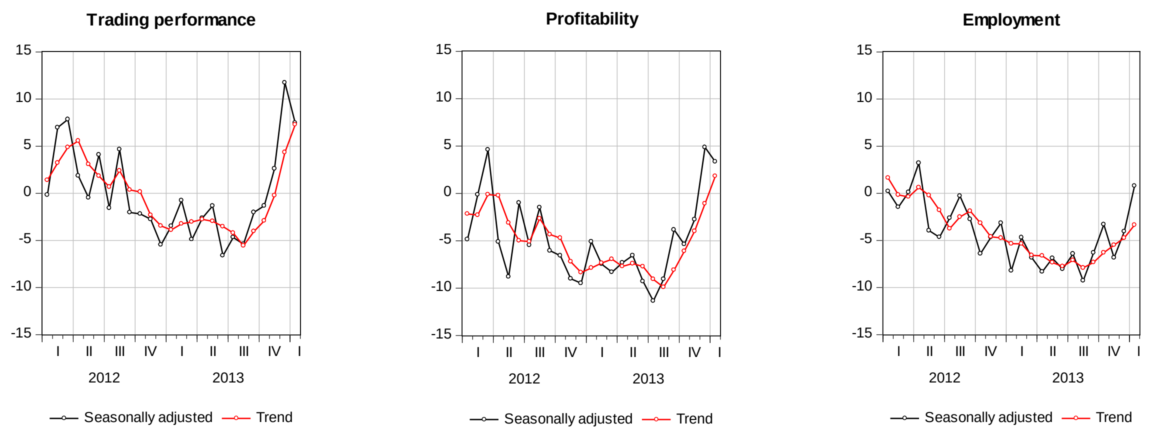
The sharp improvement in business conditions reflected a jump in employment conditions, offsetting a slight back-track in trading and profitability from the previous month's highs. All the components have steadily improved since mid-2013, possibly suggesting an approaching turning point. However, employment has been slow to respond suggesting a 'jobless recovery' that could stifle sectors reliant on domestic demand. Nevertheless, none of the components is negative, the first time since early 2012.

There was a slight backtrack in **trading conditions**, driven by recreation & personal services (down 19), financial/ property/ business services (down 16), and wholesale (down 16). In contrast, manufacturing recorded a notable improvement (up 18). In levels terms, trading is strongest in recreation & personal services (+18) and manufacturing (+12). Trading conditions are weakest in wholesale (-11).

The improvement in **employment conditions** was unexpected given recent weakness in official labour market statistics, although the index level remains consistent with a sub-trend labour market. The improvement was supported by a large (and surprising) rise in manufacturing (up 13). Recreation & personal services and financial/ property/ business services also showed a good improvement (both up 5). Employment conditions remain tough in wholesale (-10 index points), but are even worse for construction (-12). Employment conditions are most favourable in recreation & personal services (+4).

Consistent with the dip in trading conditions, **profitability** also ticked down in January (down 2 points). The largest falls in profitability came from transport & utilities (down 17), rec & pers services (down 15) and fin/ prop/ bus (down 10). Manufacturing recorded the strongest improvement (up 9). In levels terms, very weak profitability in most industries has been more than offset by extremely strong profitability in rec & pers services (+17). Fin/ prop/ bus services (+6) is also strong, while mining is weakest (-28).

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).

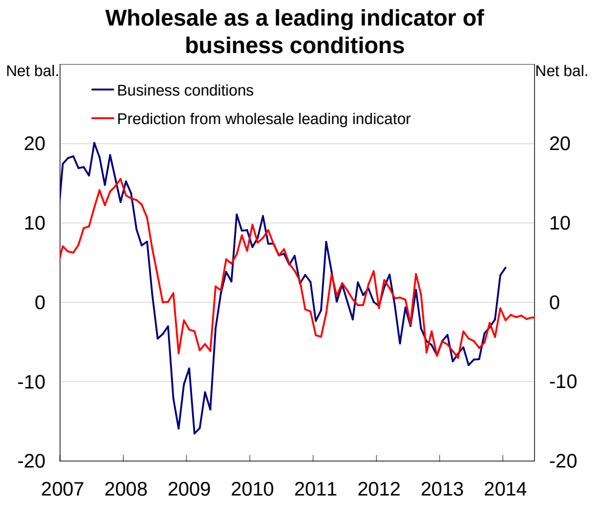
Current business conditions (cont.)

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 -8 points in January.

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 improved. Our analysis suggests that if wholesale trend conditions in January (-8) were to continue into this year, overall business conditions could be expected to remain soft, averaging -2 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 much weaker conditions



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

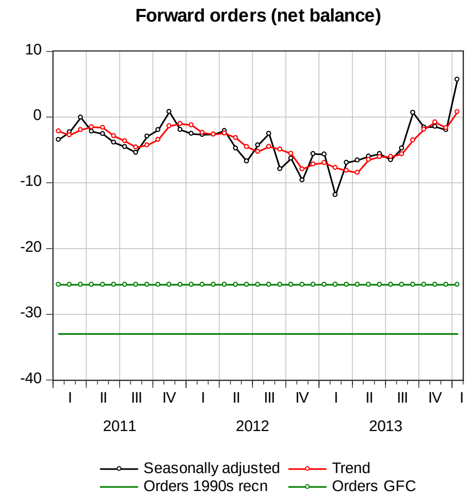
Forward orders

The forward orders index was up sharply (8 points) in January. At +6 points, the index is now well above the series long-run average of zero points since 1989 and has hit a four year high.

The large jump in orders largely reflected big increases in construction (up 18), retail (up 15) and manufacturing (up 15). Wholesale was the only industry to record a decline in the orders index in the month (down a modest 1 point). Orders remain very weak for wholesale (-10 points) and particularly for mining (-19 points). All other industries are reporting robust orders, the strongest of which are in manufacturing (+9), retail (+8) and fin/ bus/ prop (+8).

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

New orders up sharply; 4-year high

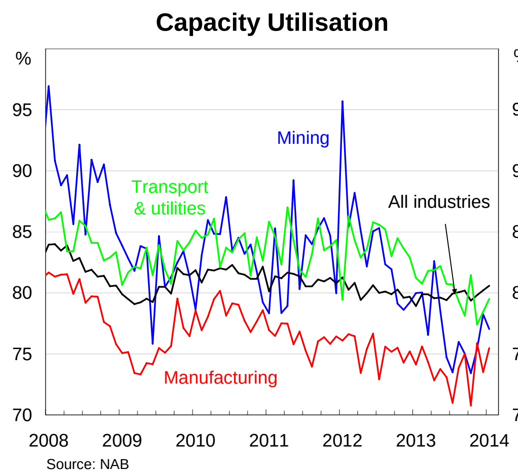


Capacity utilisation

Capacity utilisation increased for the third month in a row in January (up 0.4 ppts to 80.6%). Utilisation is below the monthly survey average of 81.1% (since 1997), but above the long-run average of 80.4% (since 1989). This month's outcome reflected a solid pick up in manufacturing (up 2.0 ppts), transport & utilities (up 1.0 ppt) and retail (up 0.6 ppts), which more than offset a decline in mining (down 1.2 ppts), construction (down 1.0 ppts) and wholesale (down 0.5 ppts). Manufacturing capacity utilisation remains very low (76%). Utilised capacity was highest in construction and services (82%).

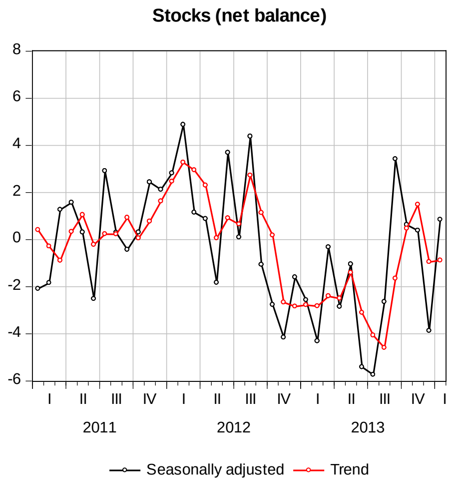
Full capacity is the maximum desirable level of output using existing capital equipment.

Capacity usage mixed, but improving

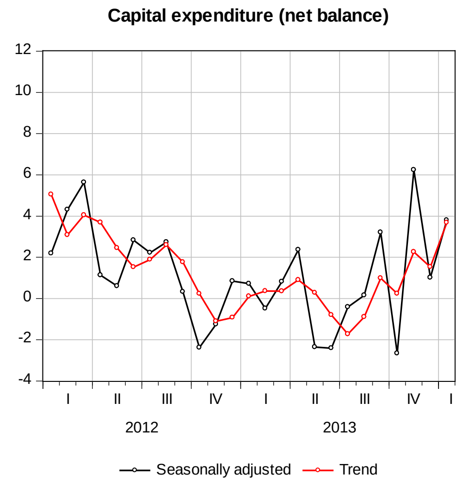


More details on business activity

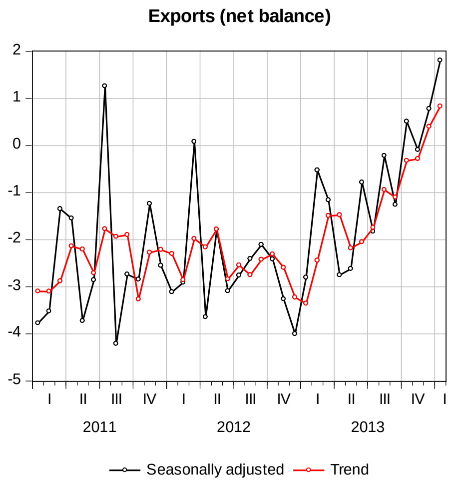
Moderate re-stocking, reflecting better orders?



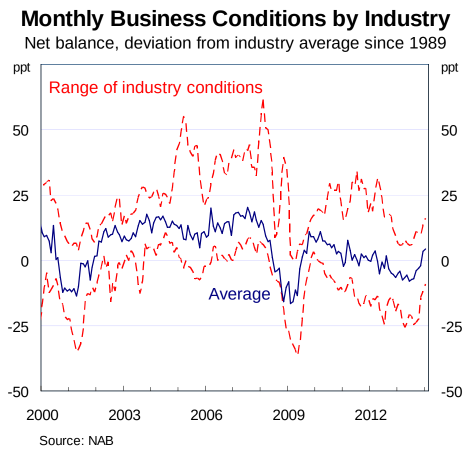
Capex improving, but still weak in mining and construction



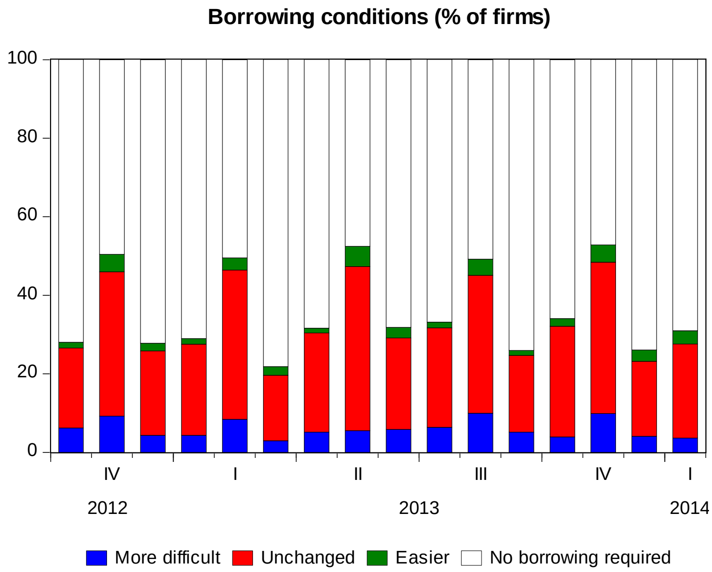
Exports much better, post-GFC high



Range of conditions shifting higher

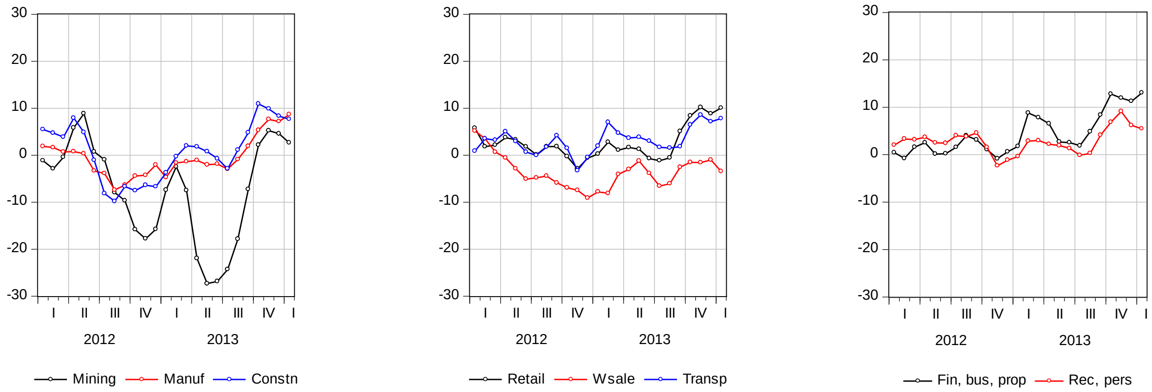


Little change in borrowing conditions in last 3 months, demand for credit still soft

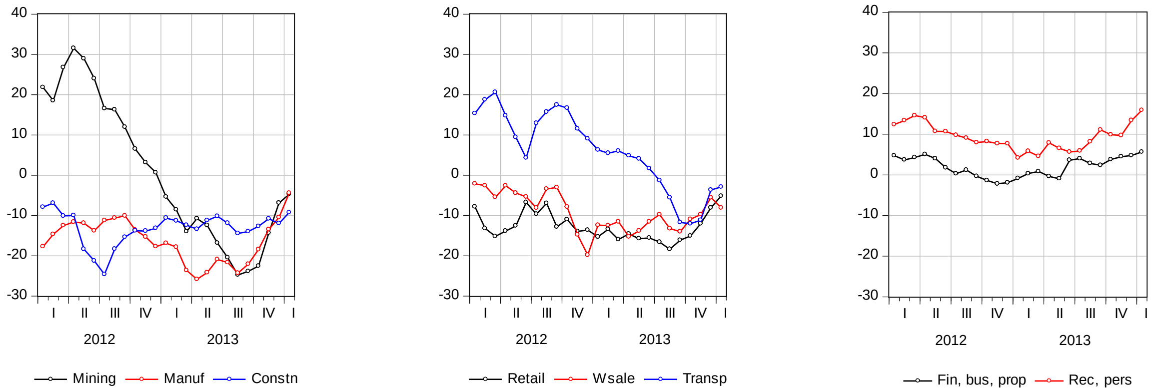


Industry sectors and states

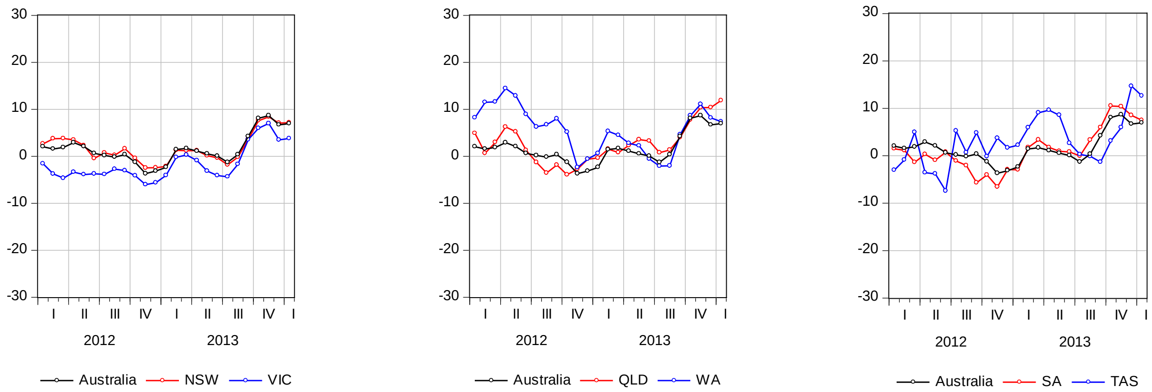
Business confidence by industry (net balance): 3-month moving average



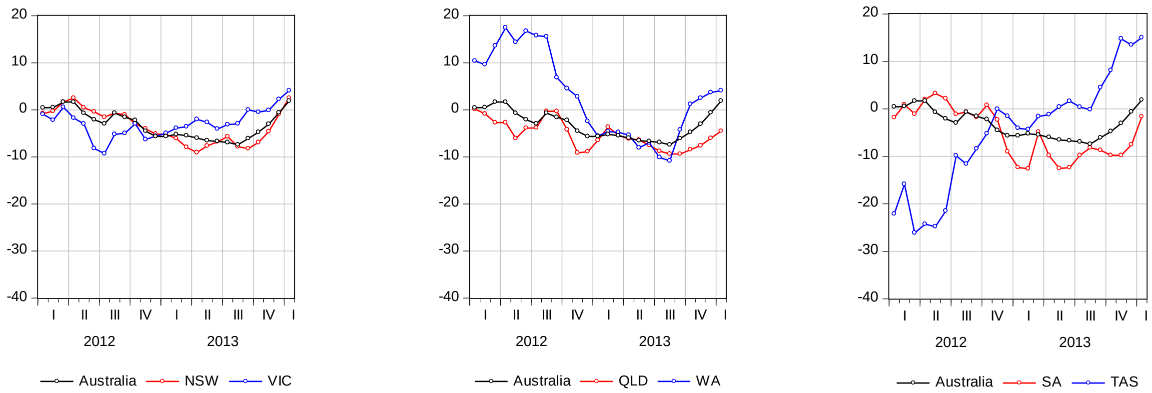
Business conditions by industry (net balance): 3-month moving average



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



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



Domestic Forecasts

	Fiscal Year			Calendar Year		
	2012-13 F	**2013-14 F**	**2014-15 F**	**2013-F**	**2014-F**	**2015-F**
Private Consumption	2.0	2.3	3.0	1.9	2.8	3.0
Dwelling Investment	-0.4	3.6	11.1	1.3	9.0	8.4
Underlying Business Fixed Investment	6.1	-5.2	-9.5	-3.3	-7.1	-10.1
Underlying Public Final Demand	-1.4	1.1	-0.5	-0.1	0.1	-0.5
Domestic Demand	**1.9**	**1.1**	**0.9**	**0.8**	**1.1**	**0.8**
Stocks (b)	-0.3	-0.5	0.1	-0.6	0.0	0.1
GNE	**1.6**	**0.6**	**1.1**	**0.2**	**1.1**	**0.9**
Exports	6.0	7.3	9.3	7.2	8.4	9.3
Imports	0.3	-2.5	1.0	-3.0	-0.1	0.8
GDP	**2.7**	**2.7**	**3.0**	**2.4**	**2.9**	**2.9**
– Non-Farm GDP	2.8	2.7	3.0	2.4	3.0	2.9
– Farm GDP	-3.9	4.2	2.0	3.5	1.6	2.0
Nominal GDP	2.5	4.1	4.2	3.5	4.2	4.1
Federal Budget Deficit: ($b)	21	40	30	NA	NA	NA
Current Account Deficit ($b)	55	41	29	44	36	21
(-%) of GDP	3.6	2.6	1.8	2.8	2.2	1.2
Employment	1.3	0.5	1.2	1.1	0.5	1.6
Terms of Trade	-9.8	-4.3	-4.3	-4.4	-5.2	-3.9
Average Earnings (Nat. Accts. basis)	1.7	2.5	3.0	1.4	3.0	3.0
End of Period						
Total CPI	2.5	3.4	2.2	2.8	2.7	2.6
Core CPI	2.5	2.8	2.1	2.6	2.5	2.3
Unemployment Rate	5.7	6.2	6.0	5.8	6.4	5.7
RBA Cash Rate	2.75	2.50	2.25	2.50	2.25	2.50
10 Year Govt. Bonds	3.76	4.15	4.70	4.24	4.20	5.10
$A/US cents :	0.93	0.87	0.82	0.89	0.84	0.80
$A - Trade Weighted Index	71.4	68.6	66.9	68.9	67.3	65.6

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

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