National Australia Bank

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Monthly Business Survey

May 2014

Business confidence survived the government's 'tough budget' intact, but business conditions eased again (reflecting sales). Employment and profits were steady at soft levels. Conditions are mixed across industries, but are generally negative outside of services: 'bellwether' sectors (wholesale, transport) still soft, but forward orders bounced-back from last month's drop. Inflation pressures muted, including lower retail prices, allowing the RBA to maintain accommodative policy. NAB forecasts marginally higher with unemployment to reach 6¼% by late 2014. Rate rises not till late 2015.

- Business confidence was unchanged in the month, at around long run average levels. That result was surprising, with firm's still discounting persistently soft levels of business conditions and the negative sentiment surrounding the Federal budget - including the post-budget collapse in consumer confidence. Against that business was relatively sheltered from the Budget. Some leading indicators from the survey improved (especially new orders), but generally remain soft. However capital spending plans remain subdued and capacity utilisation broadly unchanged at relatively low levels.
- Business conditions dipped slightly again in the month, revealing an emerging trend lower since the start of the year. Together with the poor conditions reported by wholesale – a bellwether industry – it suggests little scope for improvement in domestic demand. Conditions varied significantly across industries: looking through the monthly volatility service industries remain the stand out performers, while most other industries are reporting negative conditions (the weakest being mining). Employment and profits remains soft (the latter is negative), while sales eased (still positive).
- Our wholesale leading indicator suggests much weaker 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 and relatively low labour cost pressures. Retail prices also eased.

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

- Global growth levelled off through late 2013 and early 2014, partly due to bad weather hitting North America. Advanced economy upturn looks set to continue on low interest rates and with the peak in fiscal consolidation now passed. Mixed picture among emerging economies with China gradually slowing while India may improve on current poor performance. Europe and USA revised down in 2014. Global growth around 3.4% in 2014, slightly above next year.
- Australian forecasts revised up slightly (history stronger – largely net exports) with no more rate cuts expected, but unemployment to edge up, peaking at 6¼% in late 2014. Dwelling investment and exports likely to strengthen, but consumption weak and non mining investment still showing no signs of filling in the mining investment gap. Critically we see domestic demand no better than 1% in 2014 and less in 2015. Forward indicators still weak and a tight Budget add to mining headwinds. Overall GDP to grow at 3.0% (was 2.9%) in 2013/14 and 3.3% in 2014/15 (was 3.1%) but structural challenges to demand remain considerable.

Key monthly business statistics*

	Mar 2014	Apr 2014	**May 2014**		Mar 2014	Apr 2014	**May 2014**
	Net balance				*Net balance*		
Business confidence	5	7	**7**	Employment	-1	0	**0**
Business conditions	1	0	**-1**	Forward orders	2	-5	**0**
Trading	4	3	**2**	Stocks	-1	-1	**1**
Profitability	0	-2	**-2**	Exports	2	1	**1**
	% change at quarterly rate				*% change at quarterly rate*		
Labour costs	0.8	0.6	**0.6**	Retail prices	-0.3	0.1	**0.0**
Purchase costs	0.6	0.6	**0.4**		*Per cent*		
Final products prices	0.3	0.2	**0.1**	Capacity utilisation rate	80.2	80.3	**80.3**

* 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 26 May to 3 June, covering over 500 firms across the non-farm business sector.

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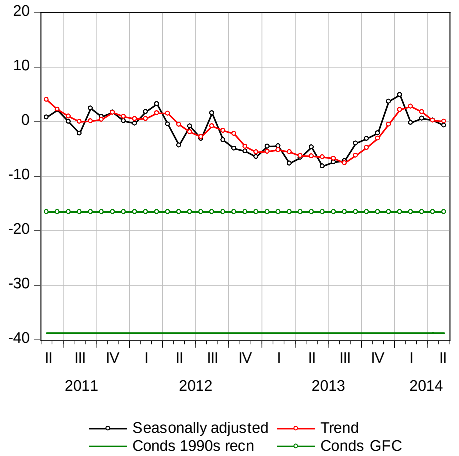
Next release:
8 July 2014 (June monthly)
17 July 2014 (June quarterly)

Analysis

Conditions ease further

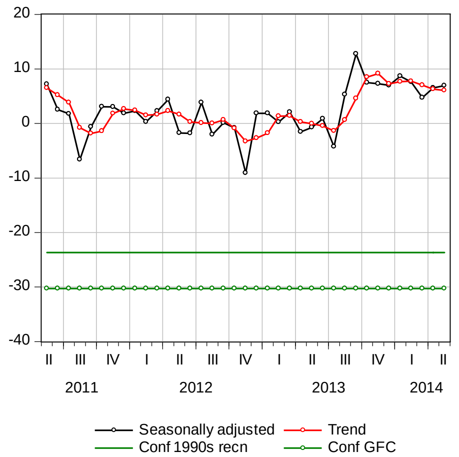
Business conditions (net balance)



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

Confidence still holding up

Business confidence (net balance)



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

Business conditions eased slightly in May (down 1 to -1 index points) to be well below the long-run average of the series (+5 since 1997); consistent with expectations for soft domestic demand. Looking through monthly volatility, the index reveals a clear easing trend in conditions since the start of the year. While the Australian economy recorded good GDP growth in Q1 (consistent with the long run average of 3½%), strong mineral exports mask some rather mixed results for domestic demand. Additionally, some of the pockets of strength that emerged in the domestic economy over the past year – particularly building approvals and consumption – are starting to show some signs of simmering down, which will add to the structural headwinds already facing the economy. Low interest rates will be supportive, but the AUD remains stubbornly high on the back of rising mineral exports and global investors search for yield. In terms of what is driving our conditions index, sales eased back in the month but remain the most positive of the components. In contrast, profitability and employment held steady, but at soft levels – consistent with only modest employment growth in the near term. On a more positive note, forward orders bounced back from the sharp deterioration last month, but remain at 0 index points, seemingly prompting some re-stocking activity. Services sectors remain the best performers, although there were improvements elsewhere. There were however significant deteriorations in conditions in manufacturing and wholesale.

Despite apprehension over the public's reaction to the recent Federal budget, **business confidence** remained unchanged in May at +7 index points, consistent with long run average readings. This is a little surprising given consumer reactions to the budget and the persistently soft business conditions that firms are reporting. Improvements in the labour market may be offsetting some of the political uncertainty and drop in consumer confidence, but one would need to see a stronger lift in forward orders and conditions to justify current levels of business confidence. The greatest optimism is coming from the construction sector, which likely reflects the rise in residential building commencements lately. Mining is the only industry with negative confidence levels.

Business conditions by industry. The moderate fall in conditions was driven by declines in just a few industries, the largest of which was in the manufacturing and wholesale industries (both down 9). Financial/ property/ business services also recorded a mild deterioration (down 2 points), but is still one of the better performing industries – likely a beneficiary from the strong property market outcomes over the past 12-18 months. Retail and transport & utilities reported better conditions (both up 7), although the level of conditions in retail remain particularly soft. The mining sector is continuing to feel the strain of the mining boom transition, reporting the softest conditions of all industries (-20). This is followed by the bellwether industry of wholesale trade (-16), although the broader economy has generally shrugged off the sustained weakness in this sector to date. Recreation and personal services report the strongest business outcomes, at +20 index points – somewhat surprising given the slowdown in services consumption reported in the National Accounts.

Analysis (cont.)

Business conditions by state. Business conditions were again mixed across the states, with only the two largest mainland states reporting positive business conditions. They were also the only mainland states to see an improvement in conditions from last month. Looking through the monthly volatility in mainland state conditions, the trend index shows that conditions are currently best in Victoria (+3) followed by NSW and Western Australia (both +1). Trend conditions are currently weakest in Queensland, reflecting a pull back in public spending and a contraction in private investment – a trend that is likely to continue given the importance of the mining sector to the state. Conditions in South Australia also eased (down to 0 index points in trend terms), which seems more consistent with some of the economic headwinds coming from public sector spending and the manufacturing and mining sectors.

Business confidence by industry. Like business conditions, business confidence remains mixed across the industries – albeit confidence trends tend to be more positive. The largest rise in confidence was in transport & utilities (up 10 points), followed by construction (up 8) – in the latter sector rising approvals and activity over the past 6-12 months has helped to push confidence to the highest levels (+17 index points). As such construction confidence has overtaken finance/ property/ business, with the latter recording a deterioration of 7 points in the month (the largest fall across industries). Retail also recorded a sizeable drop in confidence during the month (down 4), but nothing compared to the significant falls reported in the major Australian consumer confidence indicators post the Federal budget. That may in part reflect little change in retail trading conditions in the month – with retailers more focussed on actual sales than what confidence measures say. Of course much will depend on whether those confidence falls eventually flow into reduced sales. Overall, confidence is positive for all industries but mining (-3 points), which is consistent with lower commodity prices (particularly iron ore's recent drop below US$100 per tonne) and a reduced investment pipeline.

Business confidence by state. Confidence remains positive in all mainland states, despite a notable fall in the month for Queensland and South Australia (both down 4). Confidence appears to be quite similar across the states, although looking at the trends reveals that Western Australia (+3) is lagging a little behind the other mainland states. 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.

The **forward orders** index rebounded from the dramatic drop last month (up 5 to 0 points), although these levels still suggest 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 -1 index point). By industry there were a few deteriorations, particularly in mining (down 26), but these were more than offset by increases in transport & utilities (up 19), construction (up 16), recreation & personal services (up 10) and retail (up 9). Orders are now quite mixed across industries. Orders in May were negative in the following sectors: mining (-39), wholesale (-15), retail (-4) and manufacturing (-2). Transport & utilities is reporting the strongest orders by a large margin (+16). Looking through the monthly volatility, the story is fairly similar in trend terms – with the weakest results in mining and wholesale. Finance/ property/ business services, construction, transport and personal & recreational services all report similar, mildly positive, orders.

Capacity utilisation was unchanged in May (at 80.3%), which is up on last year's lows but below the long-run averages for most industries – with the exception of rec & pers services and construction. Mining capacity utilisation is farthest below long-run averages following another sharp fall in the month, while transport and wholesale are the next worst. Low levels of capacity utilisation are reflecting in a contraction in mining capital spending expectations reported in the recent ABS Capex Survey. The Capex Survey also shows that despite improving, non-mining capex expectations have been slow to take up the slack. In the month, the sharp fall in utilisation rates for mining (down 4.3 ppts) and wholesale (down 2.4 ppts) was offset by more moderate rises elsewhere (the strongest being in manufacturing, up 1.3 ppts). Utilisation rates remain the lowest in mining (71.4%) and manufacturing (76.7%).

The **stocks** index – also a good indicator of current demand – rose slightly to a net balance of +1, indicating that firms are tentatively restocking – although the index has been volatile. However, wholesalers are continuing to heavily de-stock, reporting -11 index points for the month.

The **capital expenditure** index rose by 2 points to +5 index points, although the trend was unchanged at slightly lower levels. While this is somewhat inconsistent with the drop in business investment recorded in the Q1 National Accounts, this is 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. As expected, mining capex in the NAB survey is weakest by a significant margin, dropping 25 to -39 index points. The wholesale, retail and manufacturing industries also recorded more modest declines in the month and are also negative in levels terms (-4, -1 and -4 points respectively.

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 May to our model for Q2 (-1), 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 May 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 mining and construction.

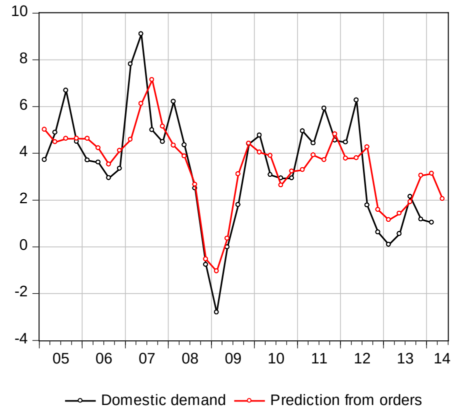
Labour costs growth (a wages bill measure) remained unchanged at 0.6% in May, consistent with other indicators of relatively subdued wage pressures. The result for May reflected mixed outcomes across industries. Labour costs accelerated the most in the transport & utilities industry (up 1.1 ppts), which recorded the strongest growth at 2.2%. Mining (up 0.4) and wholesale (up 0.2 ppts) also accelerated. Labour cost inflation is now weakest in construction, recording 0%, followed by mining at 0.1%. 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 0.2 ppts) to 0.4% in May (at a quarterly rate), continuing the downward trend exhibited over recent months – a likely reflection of the still elevated AUD. Stronger imports in April – pushing the trade balance back into deficit – tend to support this. Purchase costs decelerated across a majority of industries, with the largest occurring in wholesale (down 1.0 ppts) and manufacturing (down 0.8 ppts). Purchase costs growth was strongest in transport & utilities (1%, at a quarterly rate), but were weakest for mining (-0.2%).

Final product price growth remains subdued, edging down 0.1 ppts to a quarterly rate of 0.1%, suggesting further squeeze on firm's margins. This means the RBA can maintain their loose stance on monetary policy to allow greater traction for domestic demand. The deceleration of retail prices in the month (down 0.1 ppts) further cements this position. Upstream price pressures (manufacturing and wholesale) also eased (down 0.3 ppts and 0.1 ppts respectively). The mining sector recorded the most price deflation (-2.1%), while prices growth is highest in wholesale (0.6%).

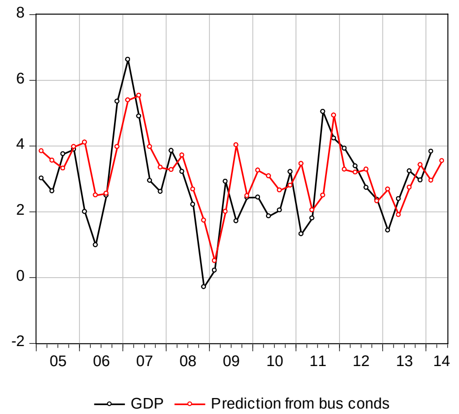
Implies higher demand growth

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



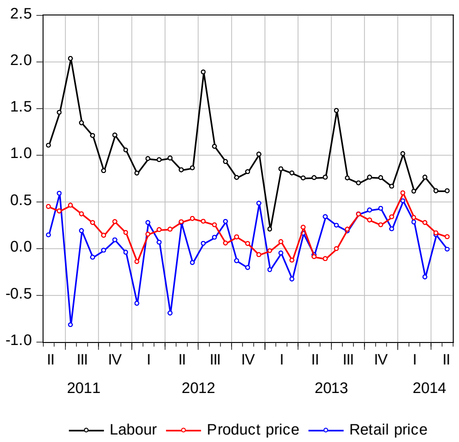
GDP growth remaining slightly below trend in Q2

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



Prices pressures benign, partly assisted by upstream costs

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

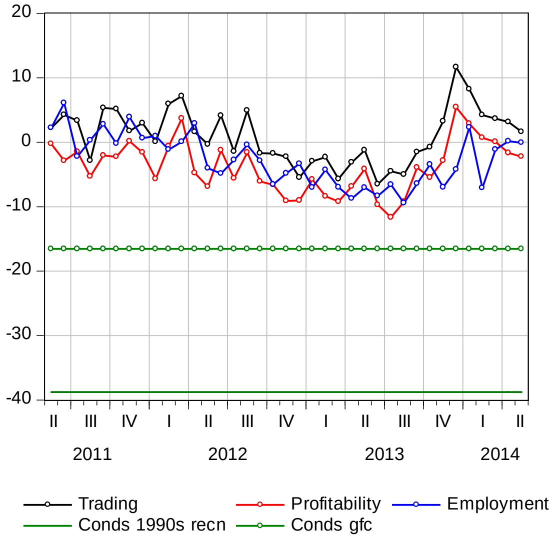
The business conditions index eased slightly in May (down 1) to -1 points, still well below the recent peak (+5 index points in January). In contrast, confidence remains at around long run average levels levels, again widening the divergence seen since the Federal election late last year. Although there have been pockets of improvement in the economy, partial data suggest these have lost some steam, while a more broad 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 just the monthly series since 1997). This is consistent with our soft labour market outlook.

Trading, profitability and employment

The fall in business conditions reflected a drop in trading conditions, although these are still positive, while employment and profitability were unchanged at soft levels. The employment index has been relatively volatile since the start of the year, but appears to have stabilised at neutral levels, while the trend in sales and profitability has been steadily lower.

Trading and profits down; employment steady, but still soft

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



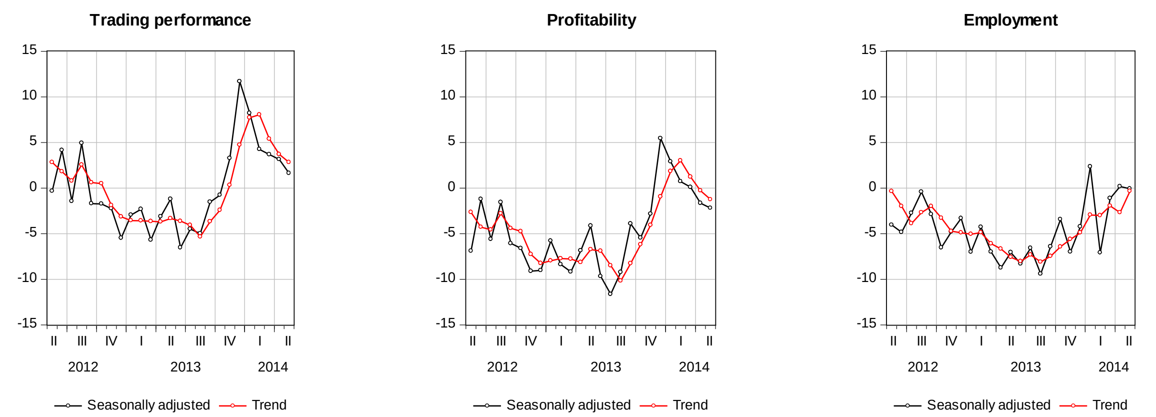
Net balance of respondents who regard last month's trading / profitability / employment performance as good.

The backtrack in **trading conditions** was largely driven by a sharp deterioration in wholesale (down 27) and manufacturing (down 23), although the majority of industries recorded a deterioration in trend terms. In contrast, transport & utilities recorded a solid improvement (up 35), while rec & pers services (up 9) and construction (up 7) also rose. In trend levels terms, trading is strongest in recreation & personal services (+22) and weakest in mining (-13).

Employment conditions were unchanged at 0 index points in May. Looking through some of the volatility in previous months suggests that the improving momentum in the labour market has slowed, with conditions stabilising around relatively neutral levels. This level is still consistent with an unemployment rate of around (or slightly above) 6% in the near-term, reflecting 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; wholesale is weakest at -17 index points, followed by mining (-12 points). Rec & pers services (+7 points) and Fin/ prop/ bus, construction and transport & utilities (all at +4), are strongest.

Despite lower trading conditions and product prices, **profitability** was steady (albeit at a soft -2 points). A large drop in manufacturing (down 16) was offset by retail (up 19). Profitability is weakest in mining (-23) then manufacturing (-19). All industries are negative except rec & pers and fin/ prop/ business.

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).

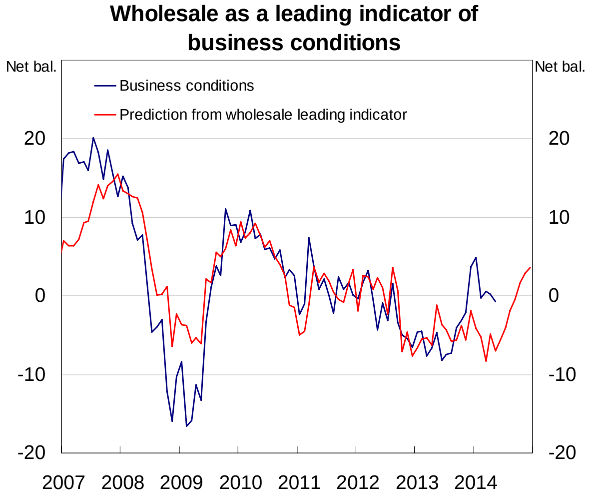
Current business conditions (cont.)

Wholesale: Drops again, signalling 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 May.

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 little change 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 suggesting soft conditions over coming months



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

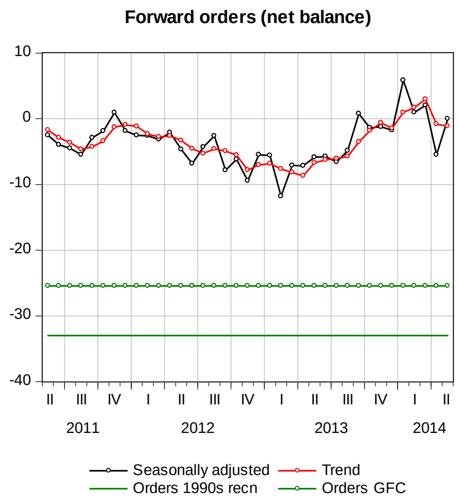
Forward orders

The forward orders index bounced back from the sharp contraction in April (up 5 points). At 0 points, the index is in line with the series long-run average since 1989, suggesting only moderate activity in coming months; trend orders are softer at -1 point.

The sharp rebound in orders reflected rises in transport & utilities (up 19), construction (up 16), rec & pers services (up 10) and retail (up 9). This was only partly offset by a sharp fall in mining (down 26) and fin/ prop/ bus (down 6). Orders remain very weak in trend terms for mining (-23 points), followed by retail and wholesale (-6). The trend orders index is currently strongest for finance/ property/ business (+6).

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

Sales orders bounce back

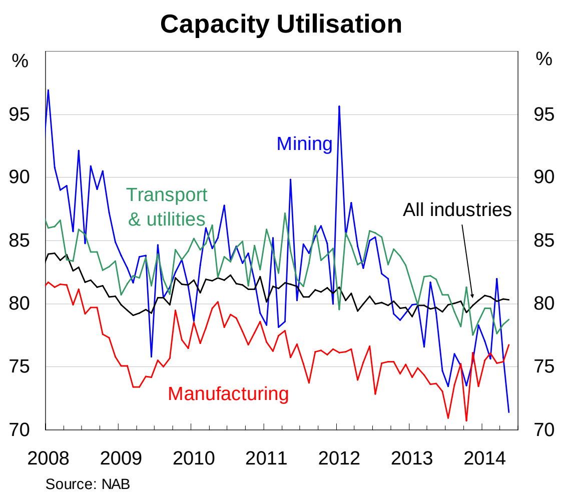


Capacity utilisation

Capacity utilisation was unchanged in May at 80.3%, down from the recent peak, but above the average levels seen since the start of 2013. Utilisation has been below the monthly survey average of 81.1% (since 1997) since early 2012, but is in line with the long-run average of 80.4% (since 1989). In the month, a sharp fall in utilisation rates for mining (down 4.3 ppts) and wholesale (down 2.4 ppts) was offset by more moderate rises in other industries. Utilisation rates remain the lowest in mining (71.4%), while recreation & personal services is highest at 83.3%.

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

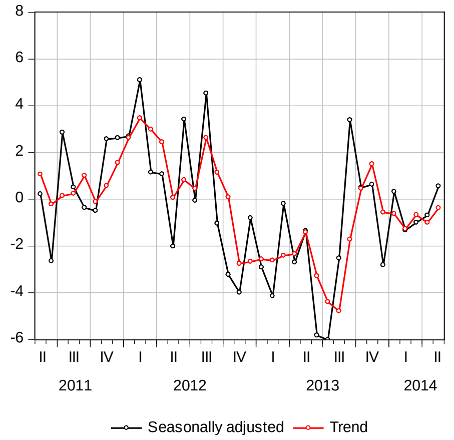
Capacity usage varies across industry



More details on business activity

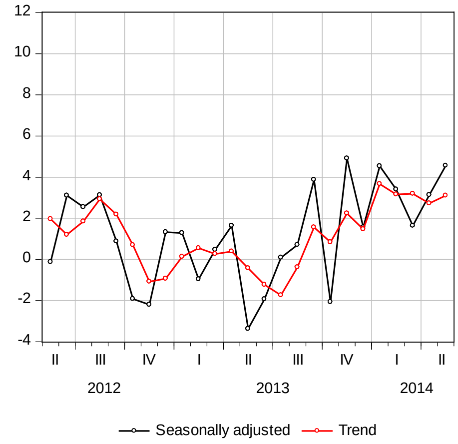
Stronger orders appear to be encouraging firms to re-stock

Stocks (net balance)



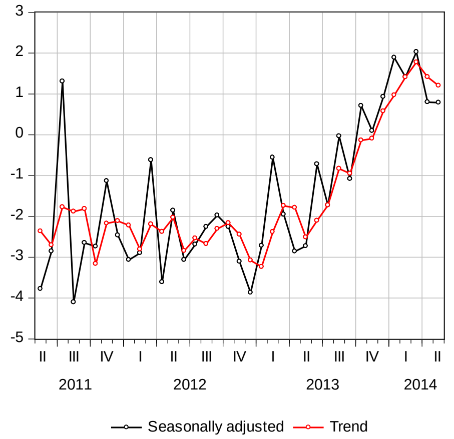
Capex is more positive, helping to offset headwinds from mining

Capital expenditure (net balance)

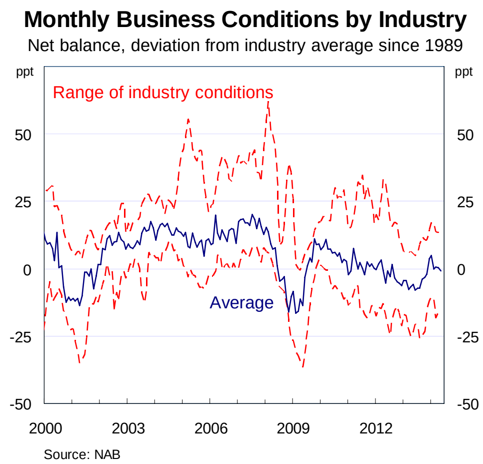


Exports eased further from recent high

Exports (net balance)

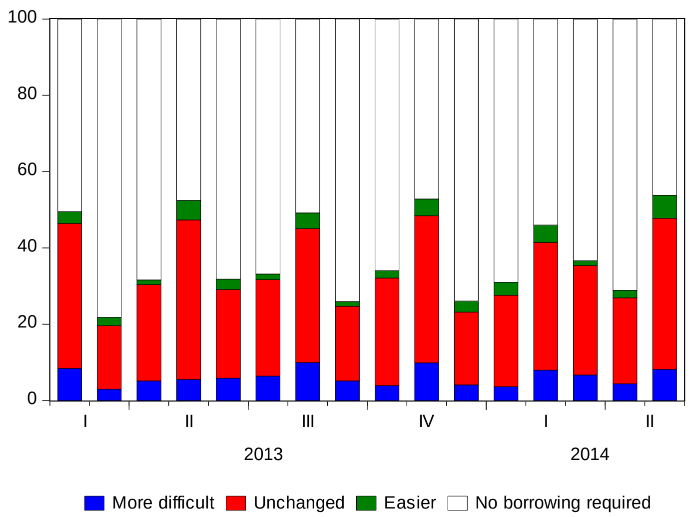


Range of conditions widened slightly



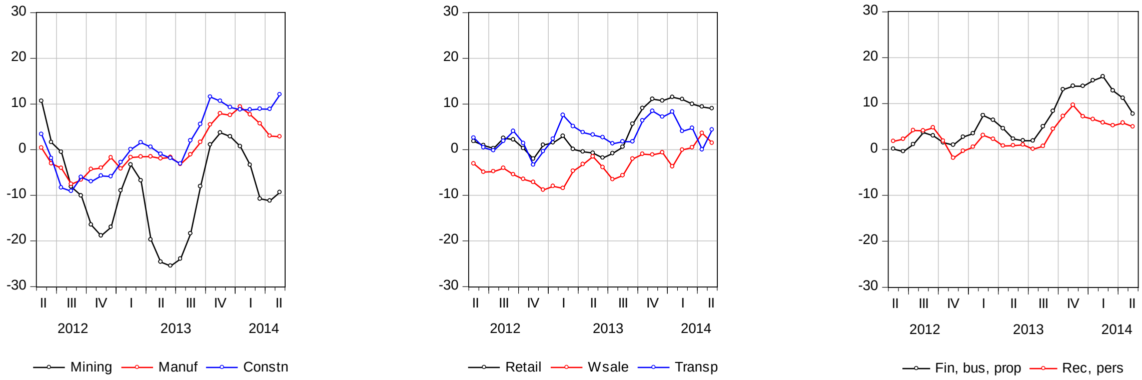
Borrowing conditions improved in last 3 months and demand for credit rose

Borrowing conditions (% of firms)

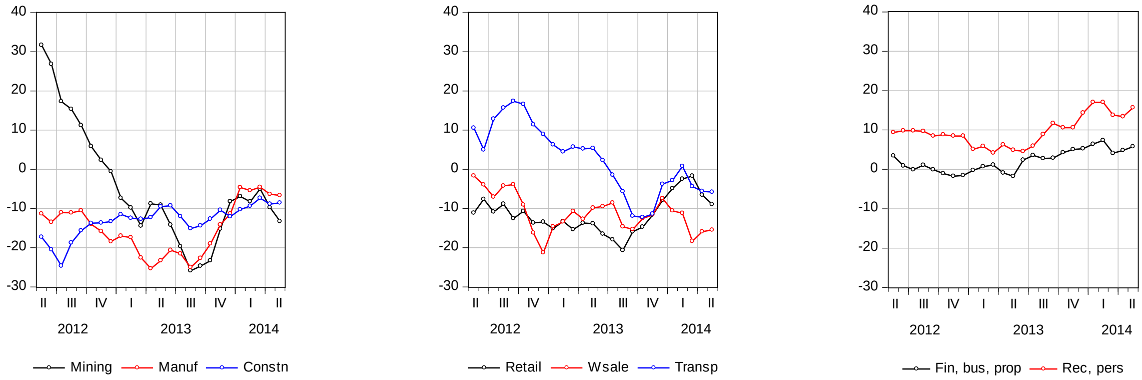


Industry sectors and states

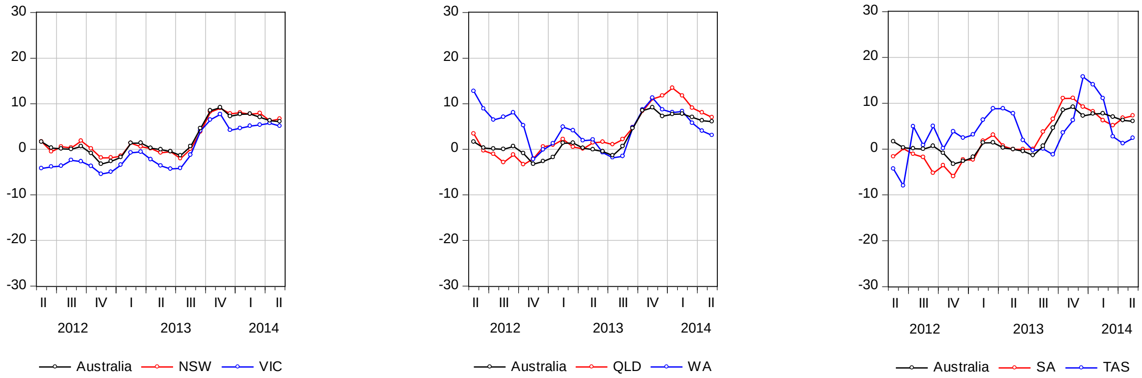
Business confidence by industry (net balance): 3-month moving average



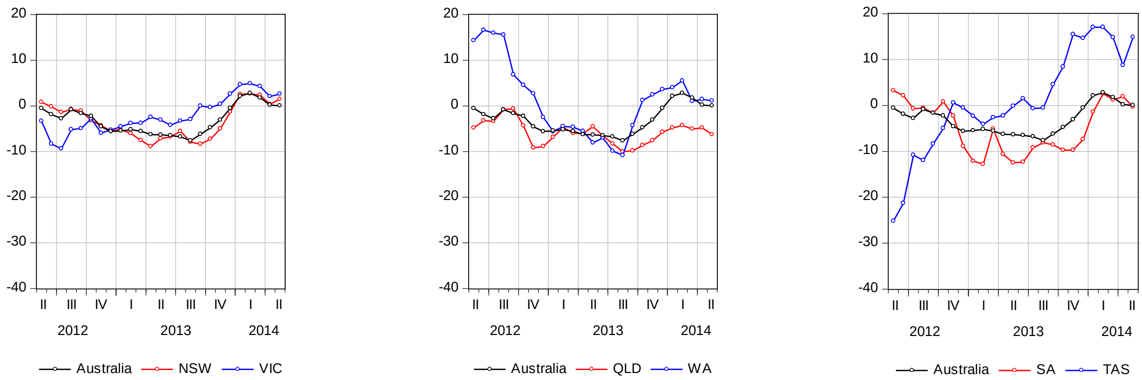
Business conditions by industry (net balance): 3-month moving average



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



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



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