National Australia Bank

Embargoed until: 11:30am Thursday 17 July 2014

Quarterly Business Survey — June quarter 2014

Business confidence eased a touch, but remains at relatively resilient levels post-budget. Business conditions improved marginally as underperforming industries improve. Forward indicators point to further modest improvement over coming months, but the economy will remain sub trend with soft labour demand. Medium term expectations for conditions flat. Capex expectations up somewhat. The survey measures of price pressures suggest lower inflation – especially retail prices. Special question on the impact of currency shows retailers and wholesalers benefiting from strengthening AUD.

- Business confidence eased in Q2, the second consecutive fall from the election driven high of 2013. The monthly survey also showed some deterioration recently, but lifted unexpectedly in June. Conditions edged up a point – reducing the gap with confidence further – but are still at levels consistent with moderate (and uneven) economic growth.
- Most states experienced a drop in sentiment, while business outcomes were mixed across industries. Low interest rates are helping to strengthen interest sensitive sectors of the economy (particularly residential property). Indeed property and construction now the most confident going forward.
- The recent strength in the AUD is having a mixed impact on industries. Clearly import competing and trade exposed sectors see the currency as a headwind. But retailers and wholesalers now appear to be seeing benefits from AUD strength, via reduced purchase costs. (See our special survey question.)
- Business conditions, in level terms, remain soft outside of the services sector. Recreation & personal services and finance/ property/ business services report the most positive business conditions, while mining continues to be very weak.
- Forward orders were little changed in the quarter, suggesting slightly softer domestic demand growth in Q2, consistent with capacity utilisation rates that are still below long-run averages. There was no change in 12 month expected outcomes for business conditions.
- Business investment intentions (next 12 months) rose in the June quarter, unwinding the previous decline. Intentions are approaching levels consistent with improved non-mining capex, although this isn't supported by the most recent ABS Capital Expenditure Survey.
- Product price inflation remained subdued in the quarter - an annualised rate of 0.7% (0.2% in the quarter), reflecting weaker purchase cost growth and subdued labour costs. Retail prices sharply lower.

Implications for NAB forecasts:

- Forecasts unchanged since latest Global and Australian Forecasts (released 8 July).

Key quarterly business statistics**

	2013q4	2014q1	**2014q2**		2013q4	2014q1	**2014q2**
		Net balance				*Net balance*	
Business confidence	8	7	**6**	Trading	2	5	**4**
Business conditions				Profitability	-2	0	**0**
Current	-2	0	**1**	Employment	-6	-5	**0**
Next 3 months	8	12	**11**	Forward orders	-2	2	**2**
Next 12 months	24	24	**24**	Stocks	1	0	**2**
Capex plans (next 12)	20	18	**21**	Exports	1	1	**2**
	% change						
Labour costs	0.4	0.4	**0.4**	Retail prices	0.2	0.3	**0.0**
Purchase costs	0.5	0.5	**0.3**				
Final products prices	0.2	0.2	**0.2**	Capacity utilisation rate	80.2	80.1	**80.3**

** All data seasonally adjusted, except purchase costs and exports. Fieldwork for this Survey was conducted from 26 May to 12 June 2014, covering over 900 firms across the non-farm business sector.

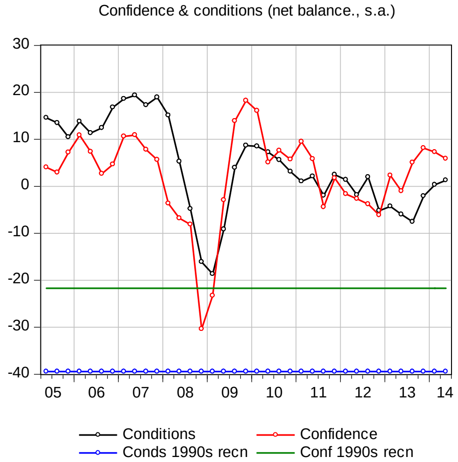
For more information contact:
Alan Oster, Chief Economist
(03) 8634 2927 0414 444 652

Next release:
12 August 2014 (July Monthly)
23 October 2014 (September Quarterly)

Analysis

The June quarter was a continuation of the gradual improvement in **business conditions** we have seen over recent months, although at current levels the index is still pointing to relatively subdued domestic demand (up 1 to +1 points). Nevertheless, forward orders have remained mildly positive and firms are tentatively starting to rebuild inventories. This is a reflection of the relative resilience seen in the **business confidence index**, which eased slightly in the June quarter (down 1 to +6 points), but remains positive. Conditions and confidence have been converging recently, but the latter has been higher for six consecutive quarters. With business activity seemingly on the rise, business may be able to maintain confidence at these levels for longer. However, an immediate risk stems from the recent collapse in consumer confidence and the rise in consumer anxiety that followed the government's 'tough budget' handed down in May. If this flows into consumer spending behaviour – tentative signs of which have already become evident – then it would only be a matter of time before firms react with a similarly negative response. On a more positive note, low interest rates and solid momentum in residential construction will remain a source of support. An anticipated depreciation of the AUD will also be a welcome development for export industries over the medium-term.

Confidence wanes, but activity gradually improving

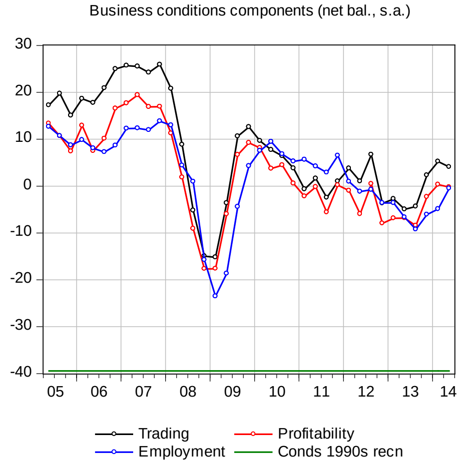


Confidence = excluding normal seasonal changes, how do you expect the business conditions facing your industry in the next 3 months to change?

Conditions = average of the indexes of trading conditions, profitability and employment.

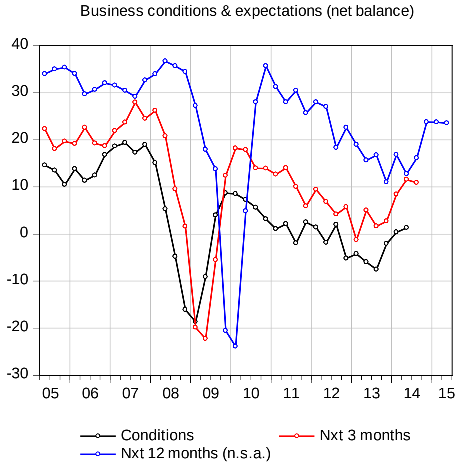
	Quarterly					Monthly				
	2013q2	2013q3	2013q4	2014q1	**2014q2**	2014m2	2014m3	2014m4	2014m5	2014m06
Confidence	-1	5	8	7	**6**	8	5	7	7	8
Conditions	-6	-8	-2	0	**1**	0	1	0	-1	2

Activity still positive, but relatively jobless recovery



Net balance of respondents who regard last 3 months' trading / profitability / employment performance as good.

Expectations point to improvement, but still below LR average



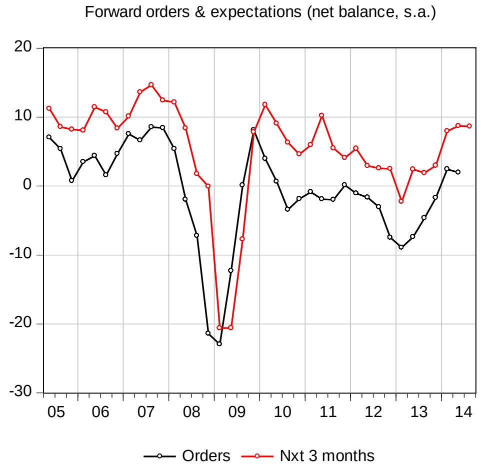
	Quarterly					Monthly				
	2013q2	2013q3	2013q4	2014q1	**2014q2**	2014m2	2014m3	2014m4	2014m5	2014m06
Trading	-5	-4	2	5	**4**	4	4	3	2	7
Profitability	-7	-8	-2	0	**0**	1	1	-2	-3	3
Employment	-7	-9	-6	-5	**0**	-7	-1	0	0	-3

Analysis (cont.)

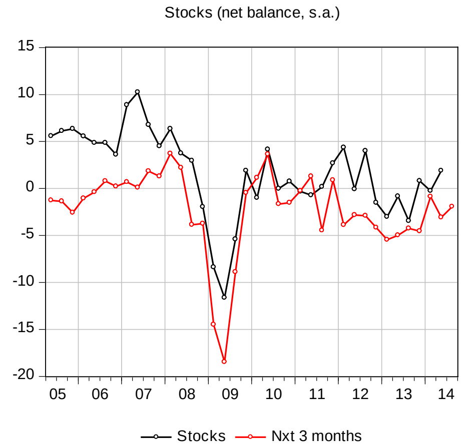
	Quarterly [(a)]					*Monthly*				
	2014q1	2014q2	2014q3	2015q1	2015q2	2014m2	2014m3	2014m4	2014m5	2014m06
Conditions	0	**1**				0	1	0	-1	2
Conds. next 3m	8	12	**11**							
Conds. nxt 12m	17	13	16	24	**24**					
Orders	2	**2**				1	2	-5	0	0
Orders next 3m	8	9	**9**							

(a) Quarter to which expectation applies. Business conditions next 12 months not seasonally adjusted.

Orders recovery stalls, but at reasonable levels



Solid trading conditions encouraging some re-stocking

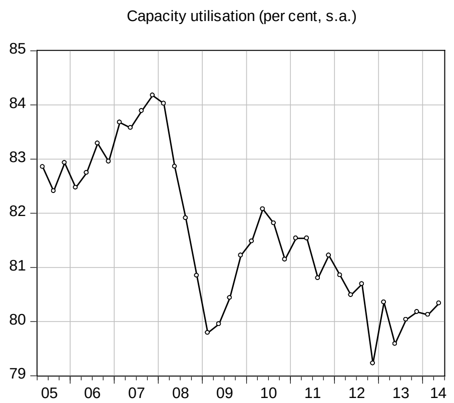


Current conditions, although still soft, have steadily improved in recent quarters. However, the positive momentum in firm's expectations for activity in their own business has subsided a little, consistent with easing confidence levels since the start of the year. Similarly, forward orders were unchanged at +2 points the index implying only a moderate improvement in near-term demand. On a positive note, near-term expectations for orders remain positive, pointing to stronger activity in coming months. Stocks can also be an indicator of near-term activity. With trading conditions and forward orders positive, firms appear to be tentatively re-stocking in anticipation of stronger demand. However, expectations for stocks (3 months ahead) remain negative, despite some improvement, suggesting that any re-stocking may be limited.

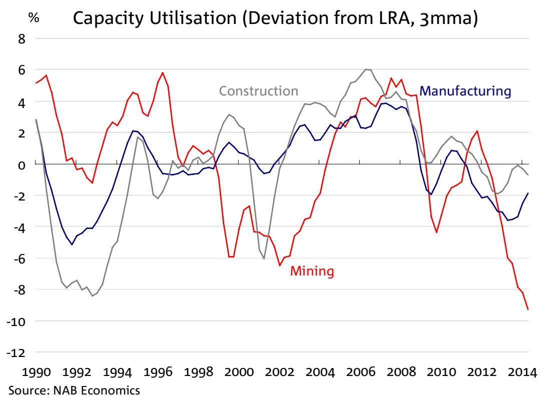
	Quarterly [(a)]					*Monthly*				
	2013q3	2013q4	2014q1	2014q2	**2014q3**	2014m2	2014m3	2014m4	2014m5	2014m06
Capacity utils.	80.0	80.2	80.1	**80.3**		80.5	80.2	80.2	80.2	79.3
Stocks current	-3	1	0	**2**		-1	-1	-1	1	3
Stocks next 3m	-4	-5	-1	-3	**-2**					

(a) Quarter to which expectation applies. All data are seasonally adjusted.

Capacity utilisation low, despite upward trend – limiting capex and inflation pressures



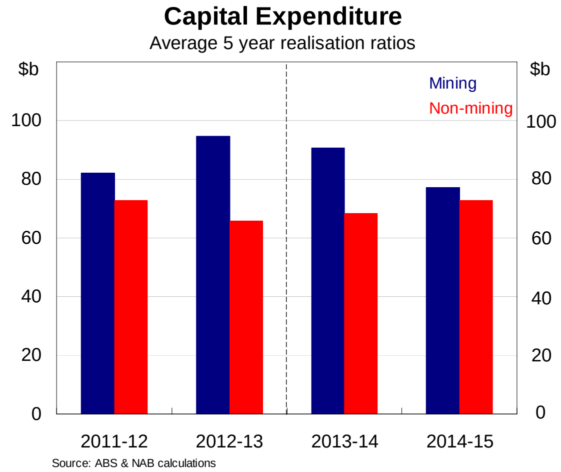
Spare mining capacity rising as investment boom ends



Analysis (cont.)

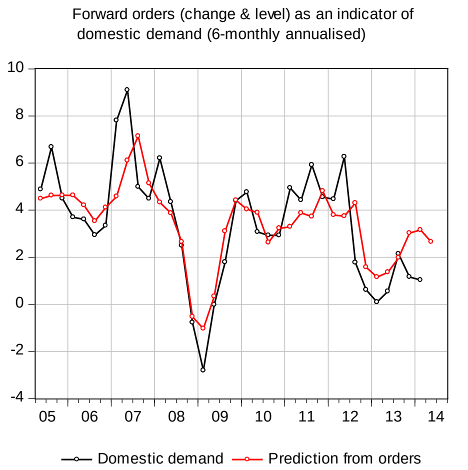
Capex intentions suggests a return of non-mining investment

ABS survey showing only minimal non-mining investment growth

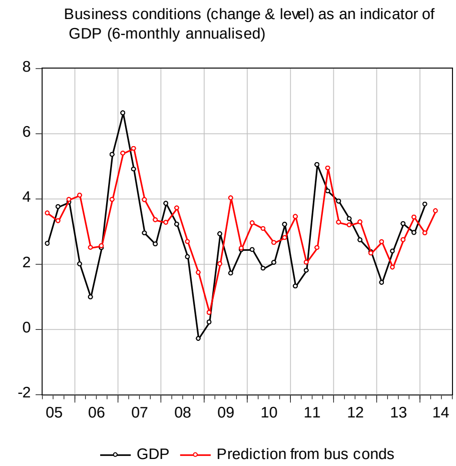


According to the NAB survey measure of business capital expenditure, business investment growth may lift modestly in the next 12 months. However, caution should be used when interpreting capex data as mining investment is under represented in our survey, meaning the degree of slowing may not be fully captured. Indeed, the mining capex index is one of the worst performing amongst the major industries, at -40 points, consistent with the pullback we have already seen in the level of mining capex reported by the ABS. Curiously, however, 12 month ahead mining capex expectations have shown an improvement, although they remain soft relative to history (up 11 to +8 points). The construction capex index is next lowest, which may reflect the slowdown in new mining engineering construction, offsetting stronger demand for residential construction. Capex is slightly positive across the rest of the non-resources sector.

Demand growth to ease?



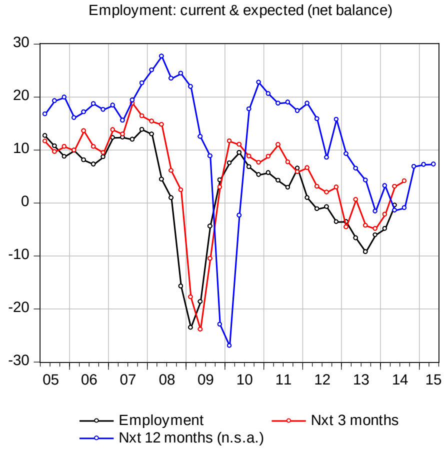
GDP growth to be around trend



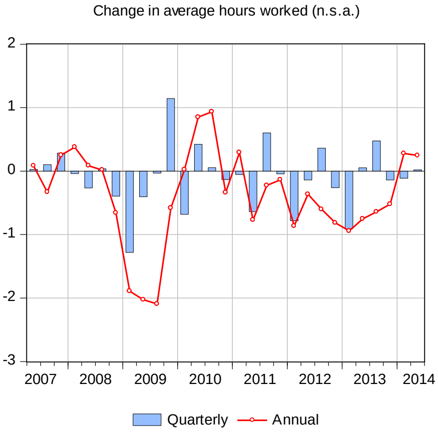
Based on forward orders, the survey implied that 6-monthly annualised demand growth would pick up much more than was the case in Q1, to around 3¼%. Using forward orders as a leading indicator for Q2 2014, the survey implies a slight easing in 6-monthly annualised demand growth. Applying Q2 business conditions to our model for economic activity in the quarter points to an acceleration in growth in Q2.

Labour market & constraint analysis

Employment expectations levelling

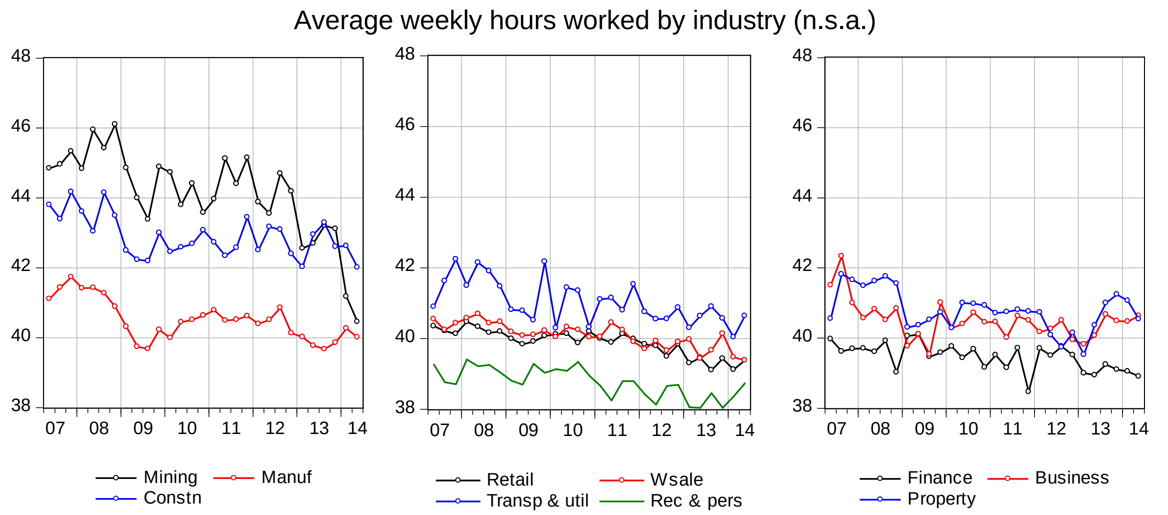


Average hours marginally higher



The employment index lifted in the June quarter (up 5 points to 0 index points), although this is still only suggesting relatively modest rates of employment growth. These levels are consistent with some additional slack in the labour market that will see the unemployment rate lift a little further from its current level, which was 6% in June. Average hours worked lifted only slightly (remaining at 39.8 hours after rounding) in the June quarter. On a positive note, near-term employment expectations remained positive (albeit still soft at +4 index points). However, the positive momentum in employment expectations appears to have slowed, levelling out well below previous averages. Official labour force data for June showed a slight rise in the unemployment rate (from 5.9% to 6.0%) that was assisted by a lift in the participation rate. While the unemployment rate was up for the month, trend unemployment was unchanged at 5.9% -- its highest level in over a decade. For the longer term (12-months ahead), employment expectations remained positive, at +7 index points, but this is still historically soft.

Average hours drop most for mining; highest in construction but much lower in recreation & personal services, finance, wholesale and retail



	Quarterly [(a)]					*Monthly*				
	2014q1	2014q2	2014q3	2015q1	2015q2	2014m2	2014m3	2014m4	2014m5	2014m06
Empl current	-5	**0**				-7	-1	0	0	-3
Empl next 3m	-2	3	**4**							
Empl nxt 12m	3	-1	-1	7	**7**					

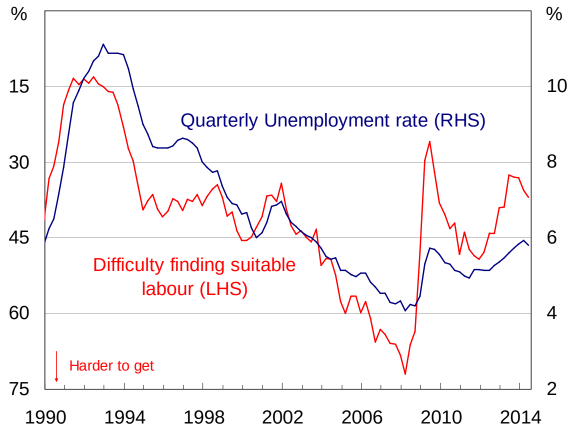
(a) Quarter to which expectation applies. Employment conditions next 12 months not seasonally adjusted.

Labour market & constraint analysis (cont.)

The survey measure of labour as a constraint on output (reversed) has historically moved quite closely with the unemployment rate. Just prior to the GFC in late 2008, over 70 per cent of firms reported that labour was a significant factor constraining output. The unemployment rate rose rapidly following the GFC and, consistent with this, firms were reporting significantly less difficulty finding access to suitable labour (less than 30 per cent of firms reported it as a constraint on output at the end of 2009). After the unemployment rate peaked in late 2009, it became increasingly more difficult for firms to obtain suitable labour. As of now, the ease of finding suitable labour points to an ongoing deterioration – or at best a stabilisation – in labour market conditions.

Labour relatively easy to find;

Unemployment rate & labour constraints

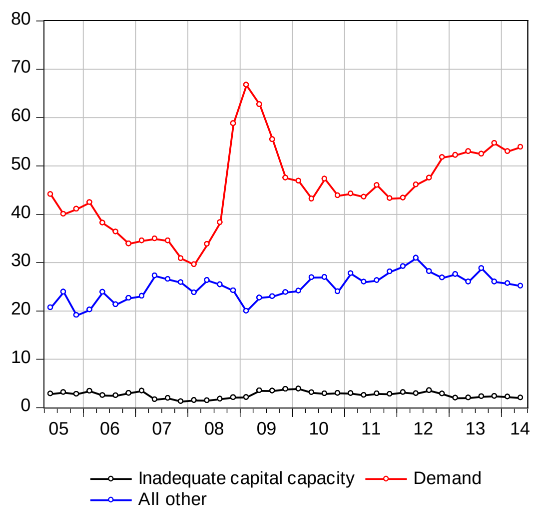


Sources: ABS; NAB

Demand still biggest constraint on output & profits. Spare capacity and loose monetary policy keeping other constraints manageable

Constraints on current output (% of firms)

Main constraint on profitability (% of firms)



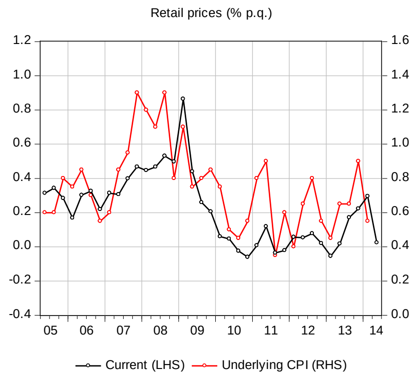
Constraints on output (% of firms)*	2013q2	2014q1	2014q2
Sales & orders	57.4	57.1	**56.3**
Labour	33.0	35.5	**36.9**
Premises & plant	19.9	19.7	**21.5**
Materials	9.3	8.9	**9.4**

Main constraints on profitability (% of firms)*	2013q2	2014q1	2014q2
Interest rates	2.0	2.5	**1.7**
Wage costs	11.7	12.3	**13.4**
Labour	3.4	4.5	**3.9**
Capital	2.3	2.2	**2.0**
Demand	54.6	53.0	**53.9**
All other	26.0	25.6	**25.1**

** not s.a.*

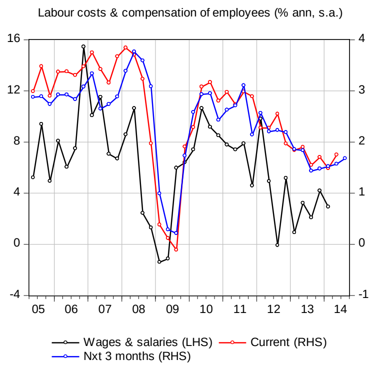
Inflation and costs

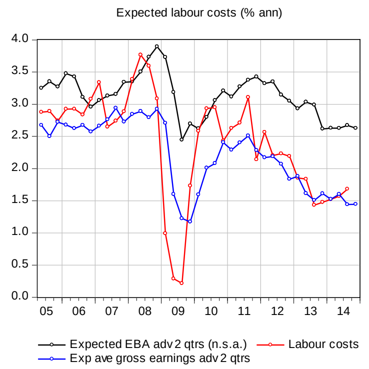
Price growth eases notably, consistent with softer underlying CPI



Trading conditions are positive implying better demand, but the prevailing slack in the economy (evidenced by below average capacity utilisation) is helping to keep inflationary pressures well contained. Final product prices growth eased slightly to a modest 0.7% annualised (down from 0.8%). Prices growth only lifted for mining and manufacturing in the quarter, although the former continues to indicate quarterly deflation (-0.8%) – consistent with easing commodity prices. Stronger prices growth in construction was more than offset by softer growth in retail and manufacturing – the easing generally coming from lower purchasing cost inflation. Quarterly prices growth was strongest in recreation & personal services (0.4% in the quarter), followed by wholesale (0.3%). Labour and purchase costs have continued to outstrip growth in firm's final product prices, although the spread between them (particularly purchase costs) narrowed – suggesting some modest relief to profit margins. However, with the AUD expected to continue on a downward track, importing firms are likely to experience renewed pressure from purchase costs. Removal of the carbon tax could provide some cost inflation relief.

Soft labour market restrain labour cost pressures, but expectations stable





Annualised **labour costs** growth picked up pace to 1.7% in the quarter, although this is still well below the series average of 3.0% since 1989. The subdued pace of growth is consistent with soft employment conditions, with the ABS labour force survey posting a rise in the unemployment rate back to the previous high of 6%. Other indicators of labour market conditions, such as the employment to population ratio, are also soft, although job vacancies have somewhat improved. Wage pressures will remain fairly benign, with wage increases under EBAs expected to average just 2.6% over the next year, or 1.7% after allowing for productivity offsets.

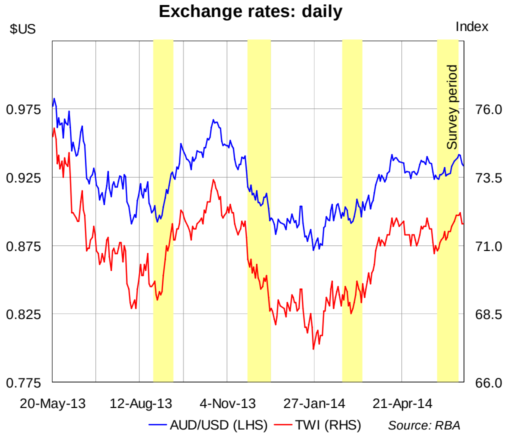
On average, businesses maintained their expectation of a rise in short-term interest rates, unchanged at 13 bps, which is consistent with economists' forecasts for the next cash rate move to be up. Exchange rate expectations (6-months-ahead) rose noticeably to US$0.91 in the June quarter, from US$0.88, reflecting surprisingly strength in the currency to date.

Medium-term inflation expectations remained soft, with 57% of respondents expecting inflation to remain below 3% (up from previous quarter) and 36% expecting inflation of 3-4% (was 38%). Only 2% of firms believe inflation is a serious problem (3% previously), while 26% believe it is a minor problem (31% previously).

AUD analysis

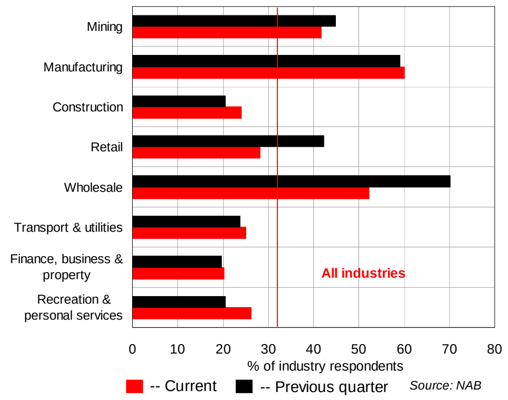
Exchange rate has strengthened

Exchange rates: daily



Wholesale & retail better; manuf. worse

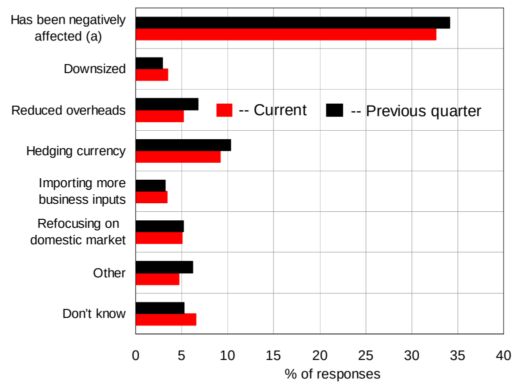
Has been negatively affected by level of Australian dollar



For the past year we have asked businesses in our Quarterly Business Survey how they have been affected by the level of the Australian dollar, and what strategies they have been using to mitigate the negative impacts. The interviews for this question were conducted between 26 May and 12 June, when the exchange rate averaged $US 0.93 and 71.5 on a TWI basis. These levels are higher than the March survey period. Less than 33% of non-farm firms were adversely affected by the AUD, down from 34% in Q1. Wholesale and retail were less affected, but most other industries reported a worsening. Manufacturing remains most affected.

Fewer firms hedging and reducing overheads, but still important

Responses to negative effects of level of Australian dollar

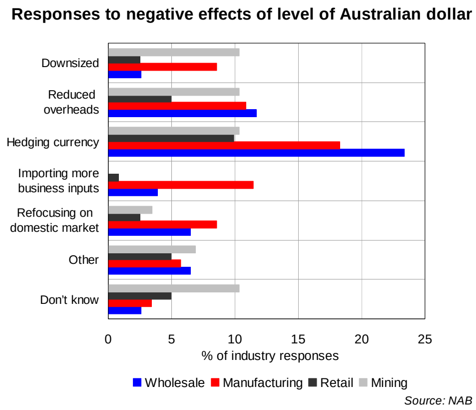


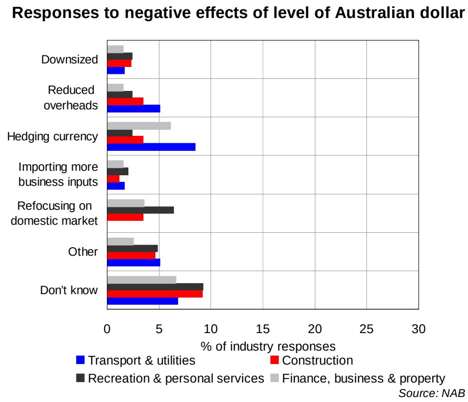
(a) % of respondents. All others are % of responses Source: NAB

According to the survey, less than 33% of non-farm businesses reported an adverse impact from the AUD (down slightly from Q4 2013), which is a little surprising given the AUD rally since the last survey. Wholesale and retail reported the most improvement, offsetting deterioration in most other industries, suggesting that lower import costs are most important to these firms. Nevertheless, wholesalers are still second most negatively affected by the AUD (behind manufacturing). Fin/ bus/ prop services appear to be most insulated from the AUD, reflecting less import competition and few foreign input costs. Surprisingly, the mining sector reported a slightly lower impact. Commodities tend to be bought and sold in USD, limiting the direct impact AUD has on volumes, but a rising AUD could be expected to have a negative impact on mining profitability by lifting costs and reducing revenue in AUD. In terms of how businesses are responding to the negative effects, hedging remains the most common strategy used by affected firms, especially in wholesale and manufacturing, although reducing overheads is another prevalent strategy for these industries. Downsizing remains a more important strategy in manufacturing and mining than in any other industry. Unsurprisingly, the industries reporting the least adverse impacts from the AUD are also less active in managing currency risks.

AUD analysis (cont.)

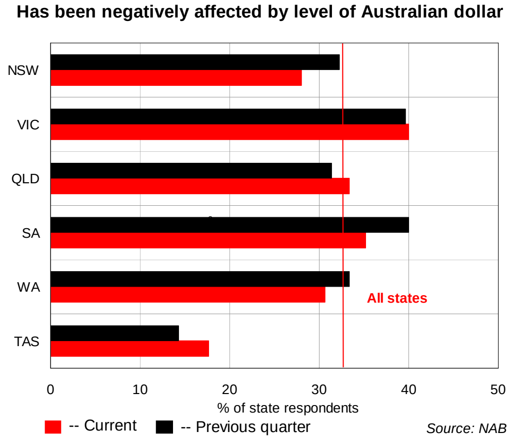
Hedging important for wholesalers and manufacturers; Downsizing most prevalent in mining and manufacturing.





Negative exchange rate effects increased and were more prevalent in Victoria than elsewhere, possibly reflecting the relative importance of manufacturing. But by the same token, the notable improvement in SA from the previous survey was surprising given that the level of the AUD is likely affecting the competitiveness of that state's industries (also more concentrated in manufacturing than most other states. The deterioration in Queensland is a little surprising given the improvement recorded by the mining industry, but this could reflect likely negative effects on tourism – personal and recreation services deteriorated. The other mining state of WA was less affected than last quarter, consistent with the (surprising) improvement in mining.

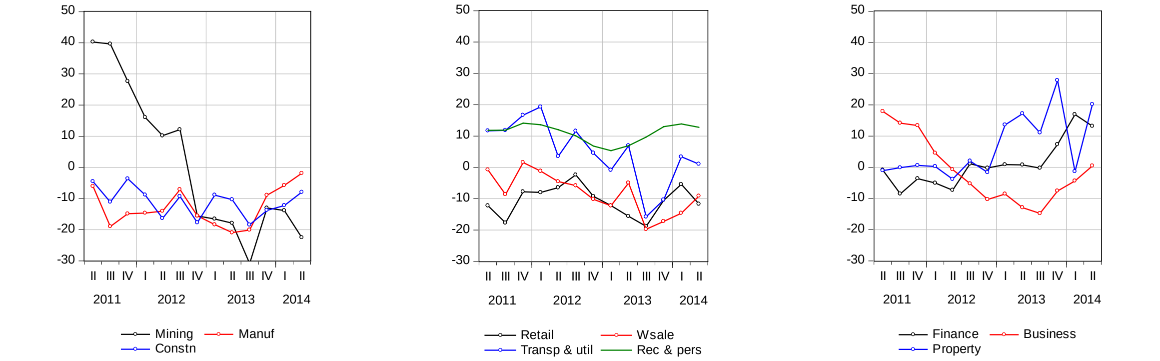
Impact of $A mixed across states



Industry and state analysis

Business conditions: mining down sharply, property bounces back

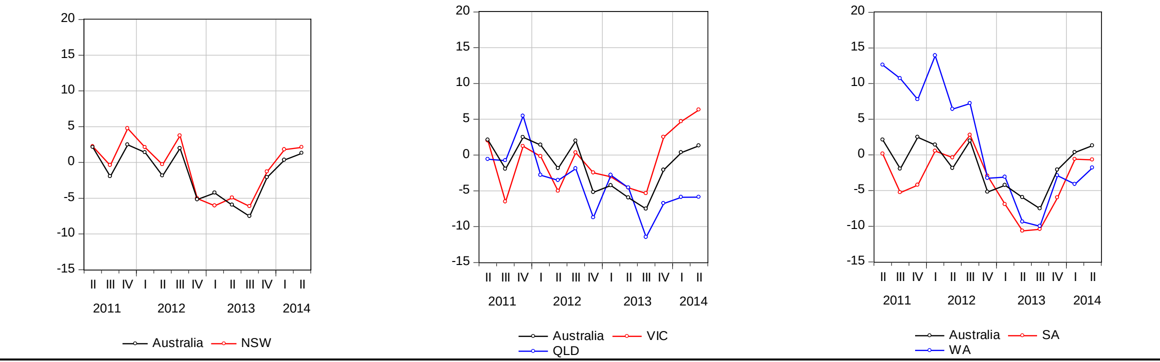
Business conditions (s.a., net balance)



Changes in business conditions varied across industries in Q2, although many industries with poor condition levels experienced solid improvements. Mining and retail were major exceptions, dropping a further 9 and 7 points respectively from already depressed levels. The mining sector is grappling with softer commodity prices and reduced mining investment. Recent signs that Chinese demand is stabilising have assisted some commodities, particularly those facing supply constraints (such as from Indonesia's ore export ban). Wholesale (up 6), manufacturing and construction (both up 4) all recorded solid gains, but levels remain weak. Construction firm expectations for business conditions (12 months) lifted noticeably, reflecting the pipeline of residential construction work that has accumulated. Finance/ property/ business services also recorded a solid improvement in the quarter, up 6 points. Conditions are currently weakest in mining (-23) and strongest in recreation & personal finance (+13 index points).

Business conditions: generally better (or stable) across most states

Business conditions (s.a., net balance)



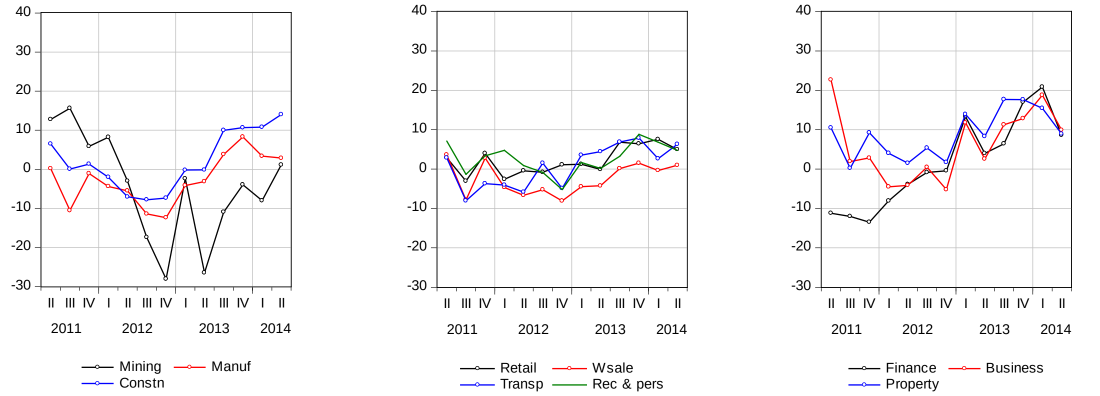
Business conditions improved or were unchanged across all states, with Victoria and WA recording the biggest gains (up 1 & 2 respectively) of the mainland states, although the level remains soft in the latter. Queensland is continuing to lag behind the rest of the mainland states, at -6 points, which could be a reflection of ongoing drought conditions, a tough market for coal producers, tighter fiscal spending and headwinds from an elevated AUD (particularly on tourism). Naturally, WA follows Queensland (-2 points) given similar headwinds to its mining sector. Solid improvements in recent quarters mean that the largest eastern states of Victoria and NSW are also the best performing mainland states – capitalising on better performing services sectors and housing markets. Tas conditions rose on a small sample (up 14 to +31 points).

	Quarterly					*Monthly*				
	2013q2	2013q3	2013q4	2014q1	2014q2	2014m2	2014m3	2014m4	2014m5	2014m06
Business conditions										
NSW	-5	-6	-1	2	**2**	-1	2	1	2	2
VIC	-5	-5	2	5	**6**	1	4	1	3	5
QLD	-5	-11	-7	-6	**-6**	-3	-7	-5	-9	-4
SA	-11	-10	-6	-1	**-1**	3	-1	4	-4	3
WA	-9	-10	-3	-4	**-2**	-1	0	6	-1	8

Industry and state analysis (cont.)

Business confidence: construction now most optimistic; services easing

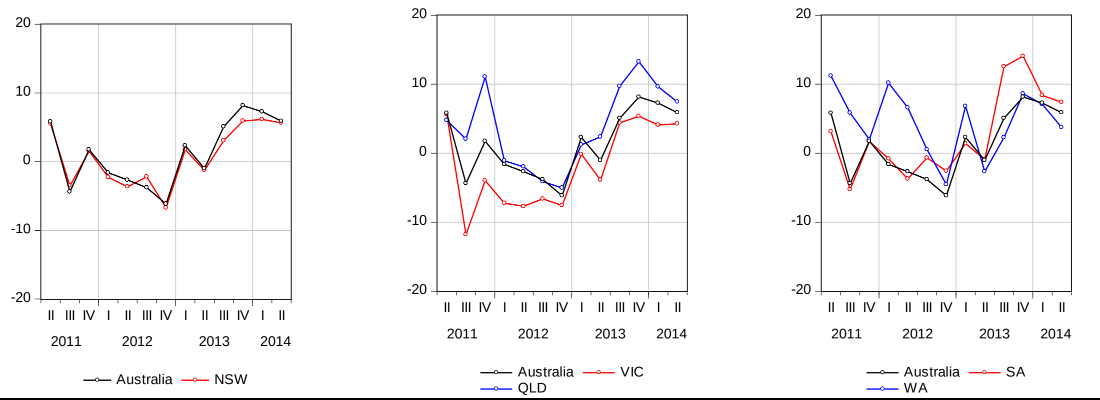
Business confidence (s.a., net balance)



Similar to changes in conditions, movements in confidence were mixed across industries in Q2. However, the key difference came from a marked improvement in mining confidence, which was up 9 points in the quarter. It is not clear what drove the improvement, but anticipation of AUD depreciation may have helped along with hopes of additional stimulus spending in China that would bolster commodities demand. Transport & utilities (up 3) and construction (up 3) also had solid improvements. The trend rise in confidence seen across industries since 2012 appears to have lost momentum, with some industries apparently reversing course. Nevertheless, confidence remains positive across the board. Confidence levels are currently weakest in mining and wholesale (both +1 points), but strongest in construction (+14 points), followed by finance/ business/ property (+8 points) – despite falling heavily in the quarter.

Business confidence: most states ease, but still elevated

Business confidence (s.a., net balance)



Business confidence generally weakened across the states, but is unchanged in Victoria. Confidence remains elevated across all states, although it has steadily eased since the election last year. Nevertheless, more timely monthly data showed an unexpected rise in confidence for some states in June, although it is questionable how long this will be sustained in light of poor consumer confidence levels following the Federal government's 'tough budget'. Surprisingly, SA and Queensland are the most confident mainland states (both +7 points), suggesting firms are anticipating a turnaround in the tough conditions that have faced these state economies. Confidence is lowest in Victoria (+4 points).

	Quarterly					*Monthly*				
	2013q2	2013q3	2013q4	2014q1	2014q2	2014m2	2014m3	2014m4	2014m5	2014m06
Business confidence										
NSW	-1	3	6	6	**6**	6	8	4	8	7
VIC	-4	4	5	4	**4**	8	3	6	7	8
QLD	2	10	13	10	**7**	10	5	11	7	12
SA	-1	13	14	8	**7**	5	4	12	7	7
WA	-3	2	9	7	**4**	9	1	2	6	1

Macroeconomic, Industry & Markets Research

Australia		
Alan Oster	Group Chief Economist	+(61 3) 8634 2927
Jacqui Brand	Personal Assistant	+(61 3) 8634 2181
Rob Brooker	Head of Australian Economics & Commodities	+(61 3) 8634 1663
James Glenn	Senior Economist – Australia & Commodities	+(61 3) 9208 8129
Vyanne Lai	Economist – Agribusiness	+(61 3) 8634 0198
Karla Bulauan	Economist – Australia & Commodities	+(61 3) 8641 4028
Dean Pearson	Head of Industry Analysis	+(61 3) 8634 2331
Robert De Iure	Senior Economist – Property	+(61 3) 8634 4611
Brien McDonald	Economist – Industry Analysis & Risk Metrics	+(61 3) 8634 3837
Amy Li	Economist – Industry Analysis	+(61 3) 8634 1563
Tom Taylor	Head of International Economics	+(61 3) 8634 1883
Tony Kelly	Senior Economist – International	+(61 3) 9208 5049
Gerard Burg	Senior Economist – Asia	+(61 3) 8634 2788
John Sharma	Economist – Sovereign Risk	+(61 3) 8634 4514
Global Markets Research		
Peter Jolly	Global Head of Research	+(61 2) 9237 1406
Spiros Papadopoulos	Senior Economist – Markets	+(61 3) 8641 0978
David de Garis	Senior Economist – Markets	+(61 3) 8641 3045
New Zealand		
Stephen Toplis	Head of Research, NZ	+(64 4) 474 6905
Craig Ebert	Senior Economist, NZ	+(64 4) 474 6799
Doug Steel	Senior Economist, NZ	+(64 4) 474 6923
London		
Nick Parsons	Head of Research, UK/Europe & Global Head of FX Strategy	+(44 20) 7710 2993
Tom Vosa	Head of Market Economics – UK/Europe	+(44 20) 7710 1573
Gavin Friend	Markets Strategist – UK/Europe	+(44 20) 7710 2155

	Foreign Exchange	Fixed Interest/Derivatives
Sydney	+800 9295 1100	+(61 2) 9295 1166
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