NAB Monthly Business Survey

by NAB Group Economics

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June 2015

National Australia Bank

Key Points:

- Firms appear to have shrugged off risks in the global economy as the business environment continued to improve into June. While there were some unexpected variations across industries, business confidence lifted again from +8 to +10 index points in the month – the highest level since September 2013. Confidence is now positive in all industries except mining, which is currently zero.
- Business conditions improved even more, lifting 5 points to +11 index points in June – the highest level since last October. Improvements in both confidence and conditions over recent months are starting to suggest a more convincing turnaround in the non-mining sectors is underway. Nevertheless, a number of hurdles remain. The more sluggish rise of the employment component is a concern, but the other components (trading and profits) have been strong for a number of months. Conditions still vary greatly across industries as the service sectors continue to outperform. The 'bellwether' wholesale industry eased a little and remains at weak levels. Nevertheless, it is encouraging to see leading indicators improve, including forward orders and capacity utilisation.
- Given ongoing concerns over sluggish non-mining investment, and following a recent RBA bulletin article into the issue, this month we asked firms a new question on the anticipated rate of return they require before committing to a new investment (the hurdle rate). Hurdle rates tend to be slow to adjust, which can impact the potency of RBA rate cuts. Indeed, the average hurdle rate reported by firms was more than 13%, which is extremely high in the current low return environment. Hurdle rates also vary by industry (see p4 for details).
- Our Australian economy forecasts for GDP are unchanged. Domestic demand is still weak, but near term data have strengthened. A better starting point means unemployment will peak lower than previously expected (around 6¼%), but will remain elevated. Our forecasts suggest no more cuts from the RBA. While recent global turmoil (especially in Chinese equity markets) present some downside risk, the strength of local data suggests upside risks. Hence we still see the next move in rates as up – but not till late 2016 (with a terminal cash of around 3.5%).

Table 1: Key monthly business statistics*

	Apr 2015	May 2015	**Jun 2015**		Apr 2015	May 2015	**Jun 2015**
	Net balance				*Net balance*		
Business confidence	3	8	**10**	Employment	-2	-1	**1**
Business conditions	4	6	**11**	Forward orders	-1	2	**5**
Trading	11	12	**20**	Stocks	1	0	**-2**
Profitability	5	8	**10**	Exports	0	2	**1**
	% change at quarterly rate				*% change at quarterly rate*		
Labour costs	0.6	0.6	**1.2**	Retail prices	0.4	1.2	**0.5**
Purchase costs	0.8	0.8	**0.8**		*Per cent*		
Final products prices	0.4	0.4	**0.2**	Capacity utilisation rate	80.2	80.9	**81.3**

* 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 24 June to 30 June, covering over 400 firms across the non-farm business sector.

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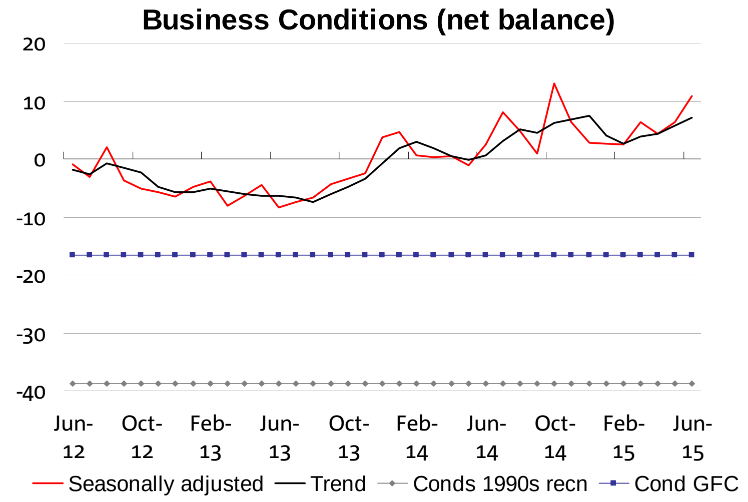
Analysis

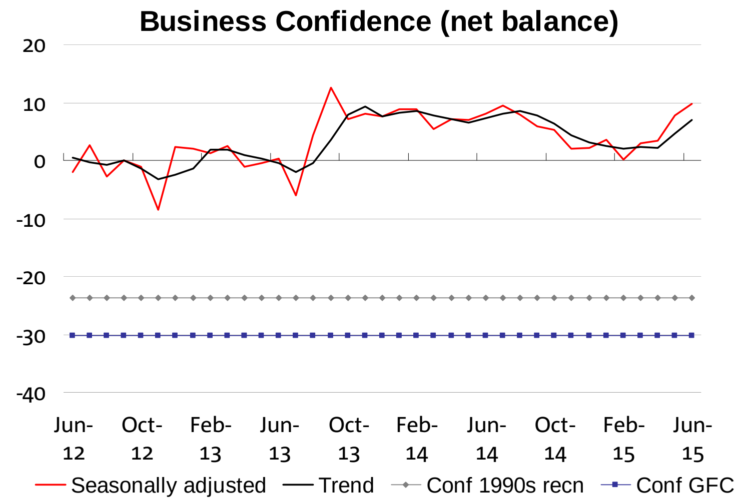
- Business conditions rose by another 6 points in June, to be +11 index points – its highest level since October of last year and above the series long run average (+5). The trend in business conditions in now decisively positive, suggesting the long anticipated recovery in the non-mining economy is finally gaining some traction. Indeed in trend term business conditions are at an equal high since May 2010. In trend terms business conditions is still strongest in service sectors, but weak in mining, wholesale and manufacturing (-18, -6 and -4 respectively).   Elsewhere low interest rates continue to support the housing sector, and housing credit growth, while business credit has also been gaining momentum. Equally the cyclical sectors continue to improve from poorer levels. However the consumer continues to be cautious and it was somewhat surprising that conditions in retail edged down a touch – especially as the Budget's small business tax deduction initiatives was expected to have a positive impact on retailers. Turning to the industry details for the survey in seasonally adjusted terms, there was a surprising improvement in June in both mining (up 36) and transport/utilities (up 31), although the low weighting afforded to the former means it had minimal impact on the overall result. The biggest deterioration was in construction (down 4), although the index remains positive.

- The boost to confidence from interest rate cuts, ,a lower AUD, better conditions and a better received federal Budget, continued into June – the index jumped to +10 index points (from +8). There also appears to have been little reaction to concerns over the Chinese equity market bubble (and its partial unwinding) and ongoing issues with Greece – although the Survey was conducted prior to the escalation of Greek concerns following the recent referendum. Positive confidence was relatively broad based across industries, which could suggest greater sustainability, although growing jitters on global matters (especially in regards to China) suggests that current levels may be hard to sustain. Confidence dropped notably in retail (down 10), as well as wholesale (down 8), although both remain firmly in positive territory. Most other industries posted an improvement – the largest, unexpectedly, coming from mining (up 30). Despite the drop, trend confidence is now the highest in retail (+10), and still lowest in mining by a significant margin (-12).

Conditions trending higher



Confidence back near post election peak

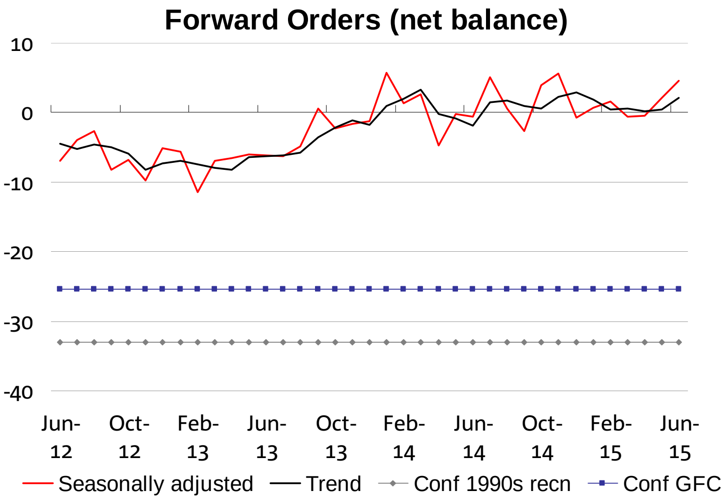


Excluding normal seasonal changes, how do you expect the business conditions facing your industry in the next month to change?

Forward indicators

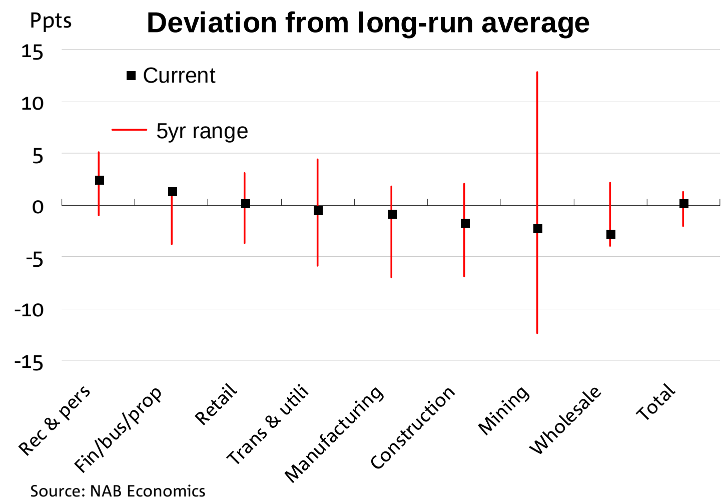
- The forward orders index was up to +5 points in June (from +2), which is above the long run average but not quite at its post-GFC highs. This suggests some pick up in demand is in train for the near term. There was a surprisingly strong spike in mining orders (up 27 points), which followed a similarly strong rise last month. The improvement may reflect newly completed mining investment (soon to be exporting), but the index still remains at subdued levels. Consistent with this – and the broader improvement in the survey – orders in the transport industry also rose strongly (up 16 points to +12) and is now showing the highest orders by industry (although not in trend terms). Orders deteriorated the most in construction (down 10), followed by retail (down 5). After transport, orders are next highest in Fin/ prop/ bus services (+8). Orders, in trend terms, are still the weakest in mining (-30) and wholesale (-4), and highest for construction (+6).
- A lift in forward orders and stronger trading conditions coincides with a notable pick-up in capacity utilisation, to 81.3% (up from 80.9%). Following last months gains, the trend appears to have resumed its previous upward trajectory – a welcome sign given the growing reliance on non-mining investment to drive economic growth. Nevertheless, capacity utilisation remains well down on previous peaks and is only slightly above the long-term average. The rise in June was reasonably broad-based, with only construction reporting a decline (down 0.5 ppts). The rise was particularly pronounced in mining (up 6.9 ppts), corresponding with rising volumes of commodity shipments. Utilisation rates across industries are now generally much closer to their long-run averages, although the majority remain slightly below (see chart).
- The capital expenditure index dropped (down 4) in June to +6 index points – above its long-run average level (+5). The trend index also eased (down 1) to +7 index points, although this is still close to its post-GFC high. This points to a stronger expansion of non-mining business investment (which has a higher weighting in the survey) than ABS data currently indicate. Trend recreation & personal services capex is the highest (+19 points) and mining is the lowest (-14 points).
- Elsewhere in the survey, cash flow (not seasonally adjusted) was the strongest in fin/ prop/ bus services, and the weakest in mining.

Sales orders lift, trend is up



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

Capacity utilisation slightly above average



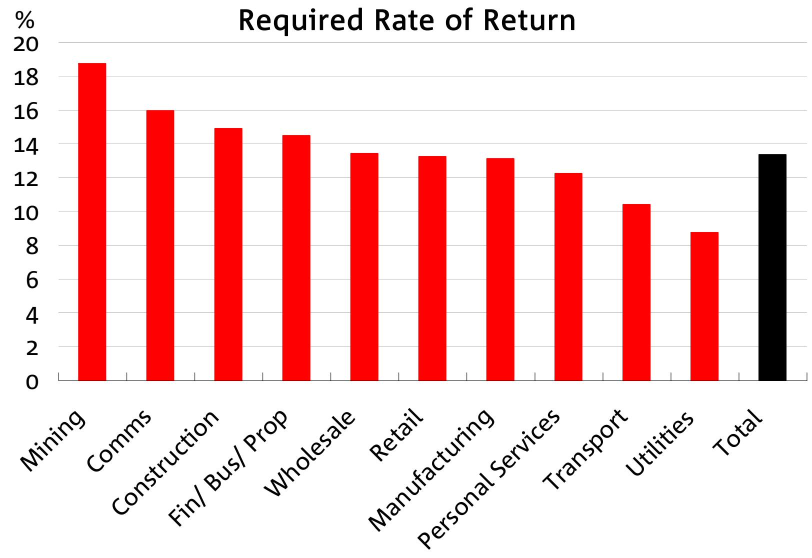
Source: NAB Economics

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

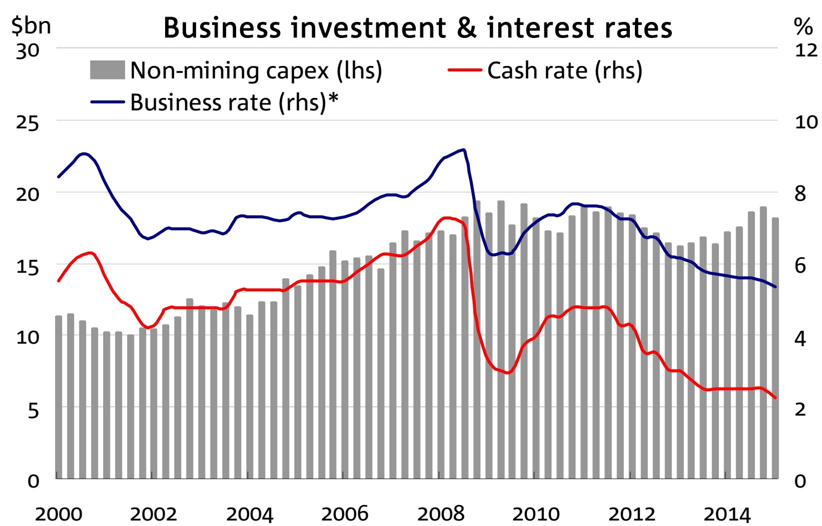
Question on Required Rate of Return

- As mining investment turns sharply lower, the economy is becoming increasingly reliant on an upturn in non-mining investment to drive growth and productivity. While there has been a marginal response in non-mining investment to lower interest rates, spending intentions in the non mining sector has taken a step backwards in H1 2015. Why is this the case?
- In the survey, we asked firms about their required rates of return (or 'hurdle rates'). Average response was around 13½%, which is significantly above the current cost of capital – this finding is consistent with RBA and other survey findings reported in the RBA's Q1 Bulletin.
- There is, however, a notable dispersion across industries. Given the phase of the commodity cycle, it is not surprising to see mining with the highest hurdle rate and this is also consistent with the capital intensive nature and long lag times of mining projects. Interestingly, utilities have the lowest hurdle rate, but this may reflect the regulatory environment and a higher degree of certainty over potential returns.

"Hurdle rates" are high and varied

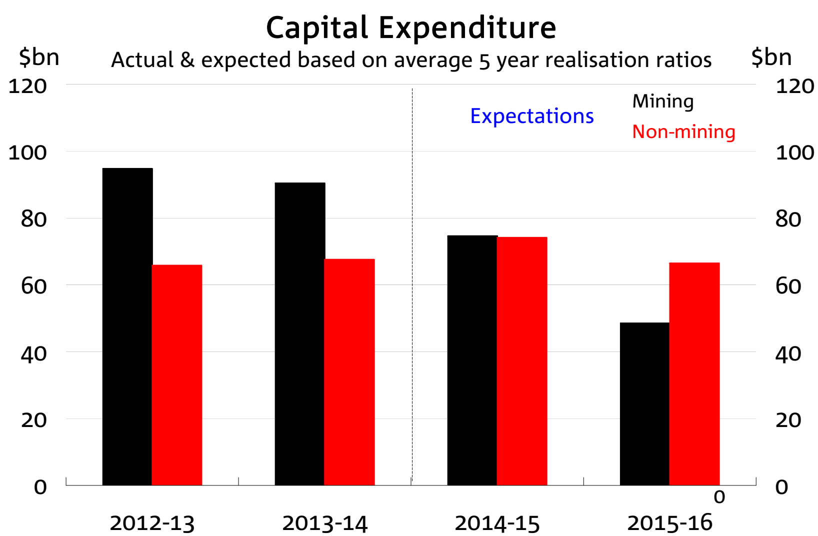


Investment response to rate cuts has been limited



* Average of small and large business variable interest rate
Source: ABS; RBA; NAB Economics

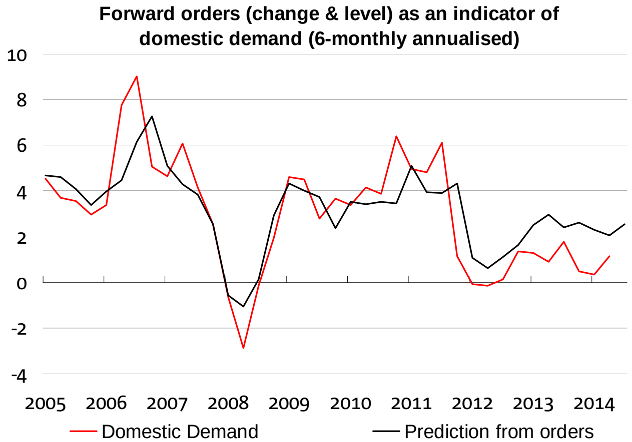
Expectations also continue to weaken

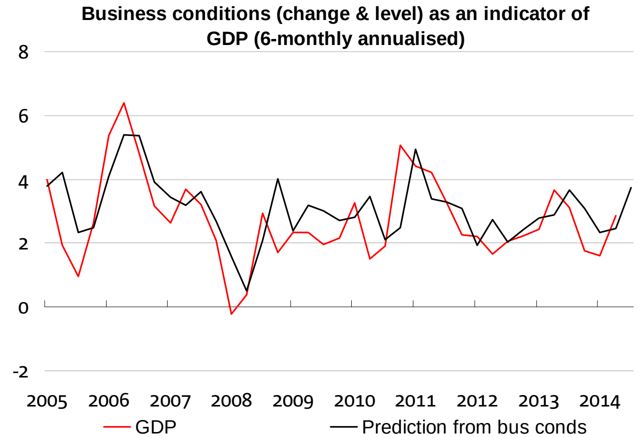


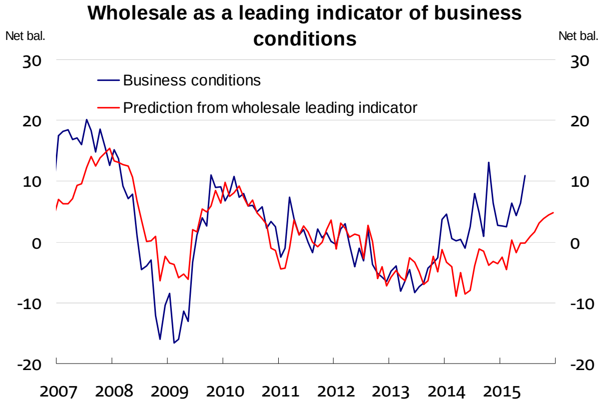
Source: ABS & NAB calculations

Implications for forecasts For more information see latest Global & Australian Forecasts

- The Chinese share market correction and concerns that Greece could exit from the Euro-zone have raised both financial market volatility and the downside risks to (already sub-trend) global growth. Unlike the IMF, we are not expecting much of an acceleration in the pace of global growth through the next few years and recent partials do not provide any evidence of this either. Soft economic outcomes across much of East Asia and Latin America, the trend slowing in China and the lack of growth momentum seen in recent Indian data are weighing on global growth, as these economies have been the main drivers of output increases in recent years.
- On Australia, we have not changed our activity forecasts – 2014/15 2.4%, 2015/16 2.6% and 3.0% in 2016/17. The big picture is still one where the domestic economy is struggling to offset the impact of sharply lower mining investment. However near term data has continued to strengthen. Lower interest rates and the AUD (which we have lowered marginally), strong housing prices (especially in NSW and Victoria) and a post-Budget kick in confidence appears to have driven better business outcomes. Against that consumers remain cautious and business remain reluctant to hire. It is difficult to assess the impact of recent international events such as Greece and more importantly China – especially equity market volatility and further falls in commodity prices.
- Given its better starting point we now expect a lower peak in unemployment of 6¼ - but remaining high for a considerable period. We still see the RBA as having finished cutting – the market priced cut depends on downside surprises to our forecasts. We see the next move in rates as up – but not till late 2016 (and with a lower end point for the Official Cash rate of 3.5%). It is worth noting that while heightened international volatility creates risks to the downside on the forecasts, local data is pointing to upside risks.
- Our model of 6-monthly annualised demand growth, using forward orders as a predictor, has continued to suggest stronger growth than the national accounts, although the gap narrowed in Q1 2015. Nevertheless, applying trend forward orders from June to our model suggests that predicted demand growth will lift a little more in Q2. In contrast, our business conditions model under-predicted GDP growth in Q1. Based on robust business conditions in June, our model implies further improvements in GDP growth for Q2. However, applying business conditions derived from our 'wholesale leading indicator' (below) would imply somewhat weaker GDP growth in the coming quarter than the actual index.





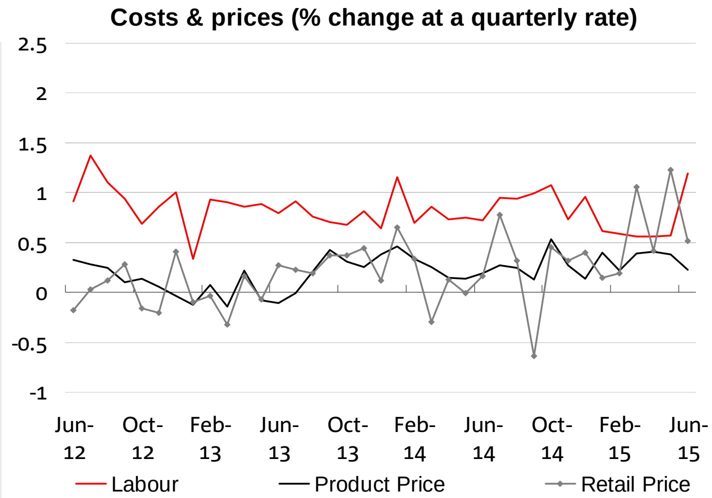


Indicator = f(business conditions wsl, business conditions wsl(-1 to -4), const.

Costs and prices

- Growth in labour costs (a wages bill measure) jumped noticeably in June to 1.2% (a quarterly rate). This could be a pre-emptive response by firms to the recent rise in minimum wages to $17.29 per hour – although these were not effective until the start of July – but, official data also suggest a degree of labour market tightening recently. Labour cost inflation accelerated the most in mining (up 2.4 ppts), followed by recreation & personal services (up 1.1 ppts). In contrast, there was a deceleration in wholesale wages costs (down 1 ppts) and a smaller easing in fin/ prop/ bus (down 0.3 ppt) and retail (down 0.2 ppts) labour cost growth. We suspect the dramatic improvement in mining wages may be an anomaly given the significant weakness in the sectors labour market of late (more than 30,000 mining jobs lost over the year to Q2 2015). According to ABS data, the labour market has shown some improvement recently. However, as domestic demand is expected to remain sluggish, a persistently elevated unemployment rate – along with well-contained inflation expectations – will keep wage pressures subdued in the near term. In terms of current employment conditions in the Survey, mining (-18 points), wholesale (-14 points) and transport (-11) reported the most modest demand in trend terms. Fin/ prop/ business services is strongest, at +9 points.
- Purchase costs growth was unchanged at 0.8% in June (at a quarterly rate), which is broadly consistent with the average rate seen since the GFC. The lack of a sharp up tick suggests that pass-through from a lower AUD has been relatively limited so far – or possibly offset elsewhere. Purchase costs growth decelerated the most in wholesale (down 1.1 ppts), but picked up the most in mining and transport (both up 1.1 ppts as well). Growth in purchase costs was mixed across most industries. Purchase cost pressures facing manufacturers and transport firms are strongest (both 1.1%, quarterly rate), and are weakest for mining (-0.7%, quarterly rate).
- Final product prices growth was down slightly in June at a quarterly rate of 0.2%. Prices growth was generally more subdued across industries, with rec & personal services recording the only acceleration (up 0.3 ppts). Final retail prices growth pulled back notably from last month's spike (down 0.7 ppts), although the trend does appear to be on a modest incline -- suggesting some moderate upward pressure on Q2 CPI. Mining price continued their contraction (down -2.7%), while upstream price pressures (e.g. manufacturing and wholesale) are now mixed (following a fall in manufacturing.

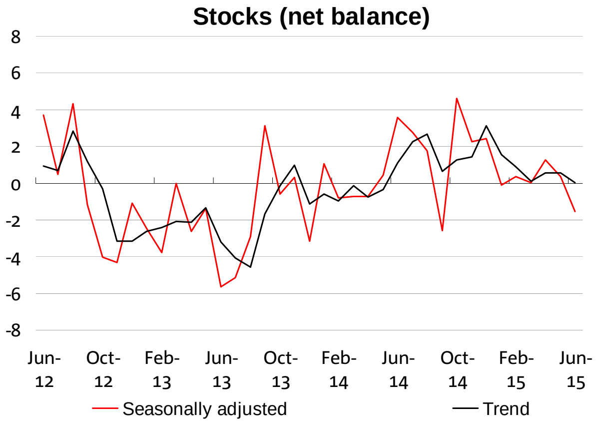
Price pressures build, but still contained



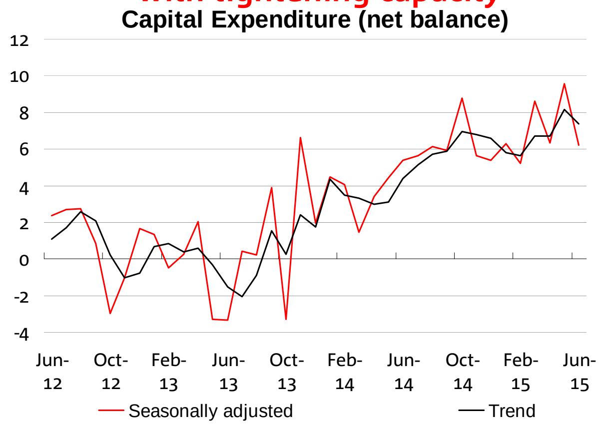
Based on respondent estimates of changes in labour costs and product prices. Retail prices are based on retail sector product price estimates.

More details on business activity

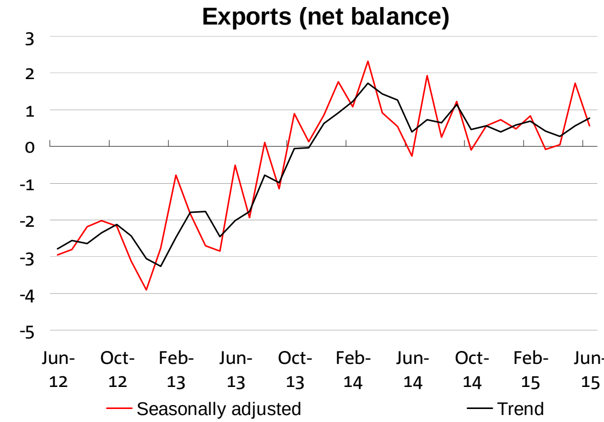
Sales up, but stocks down



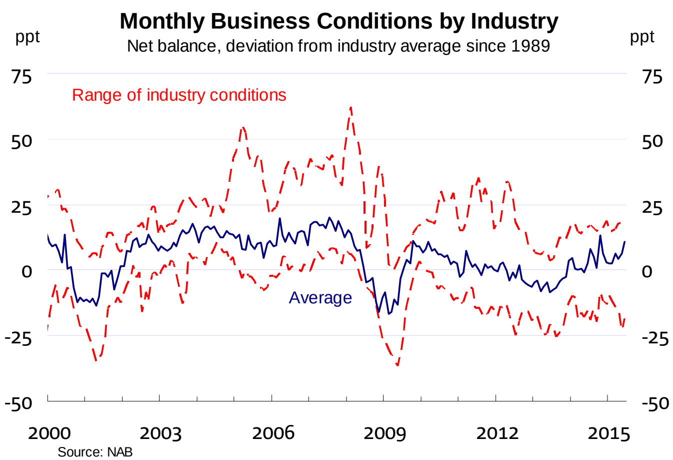
Capex ease, but still solid. Consistent with tightening capacity



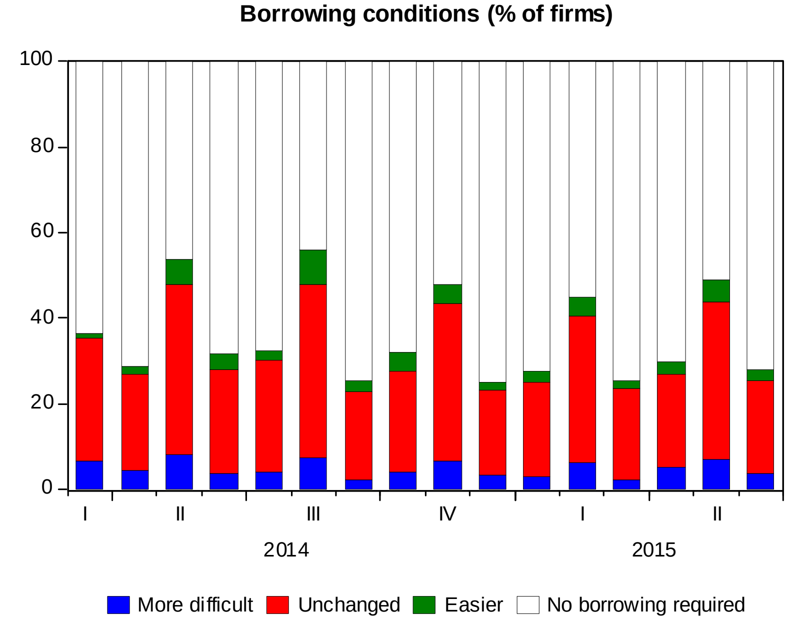
Support for exports from AUD depreciation seems minimal



Range of conditions narrowed in June, due to better mining and transport

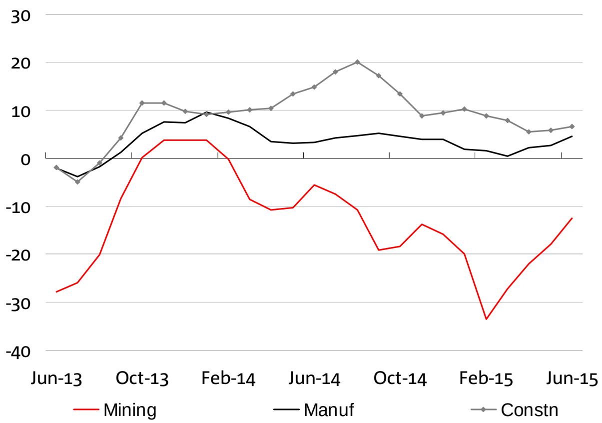


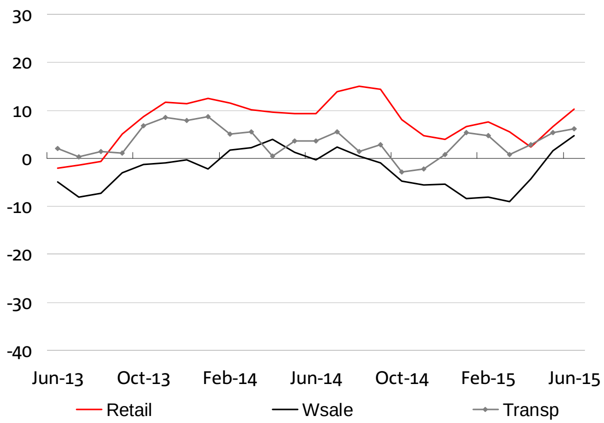
Borrowing conditions worsened, but demand for credit Modestly improved in the past 3 months

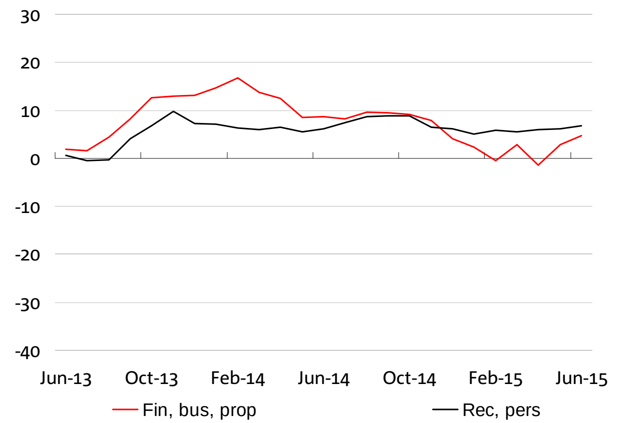


More details on industries

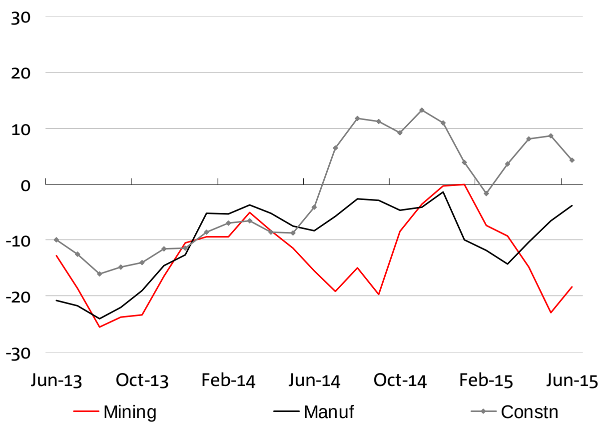
Business confidence by industry (net balance): 3-month moving average

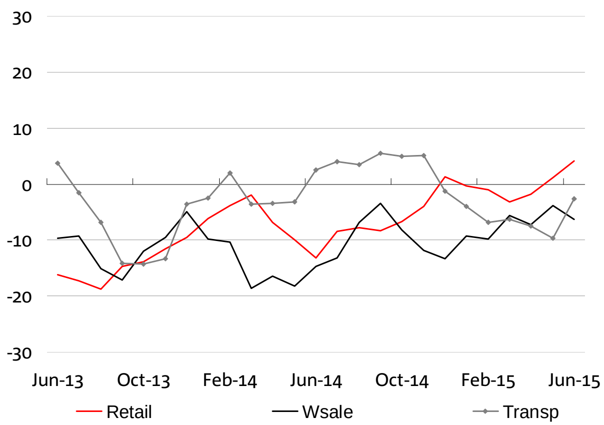


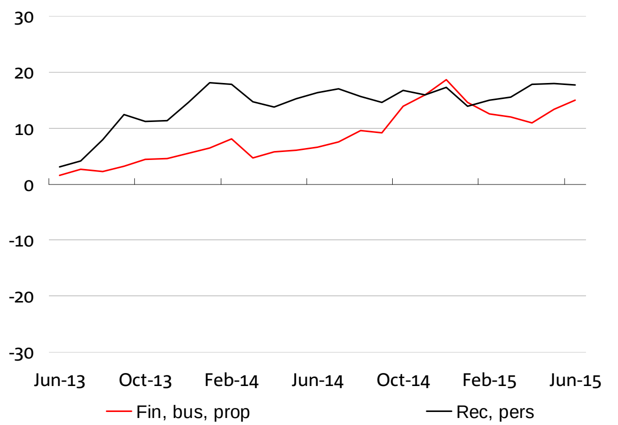




Business conditions by industry (net balance): 3-month moving average

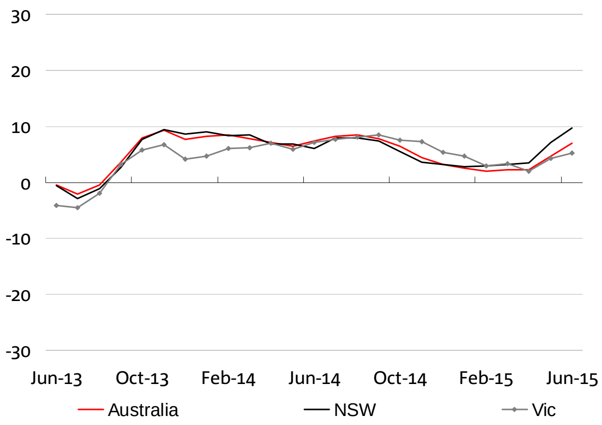


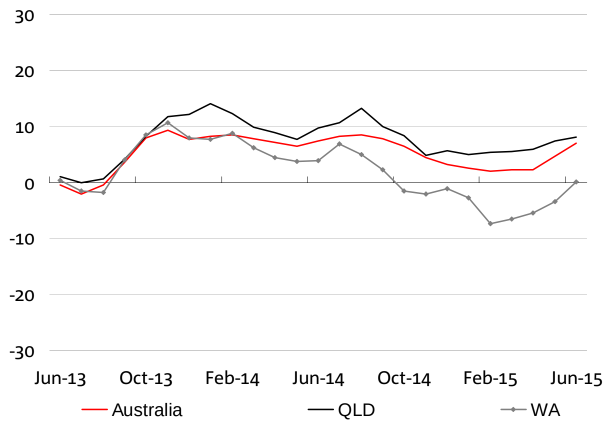


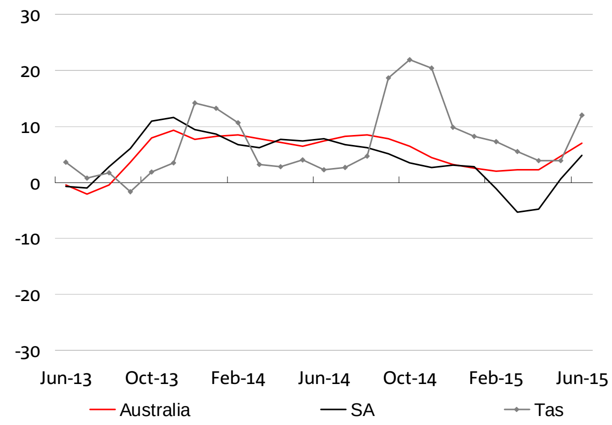


More details on states

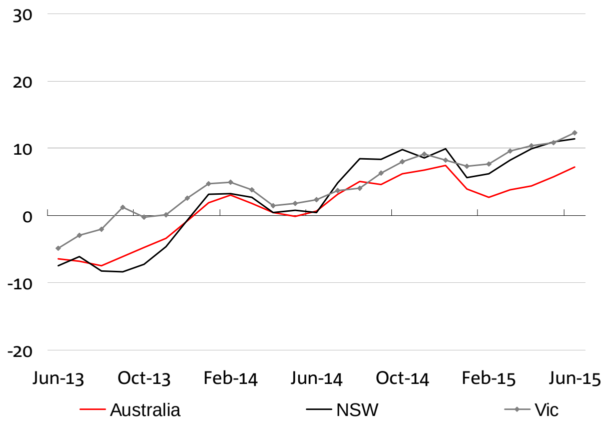
Business confidence by state (net balance): 3-month moving average

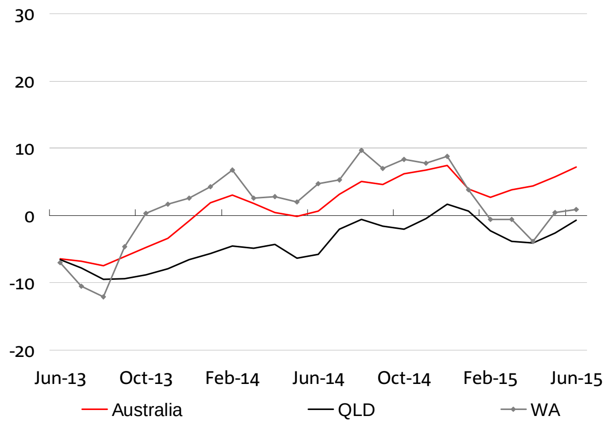


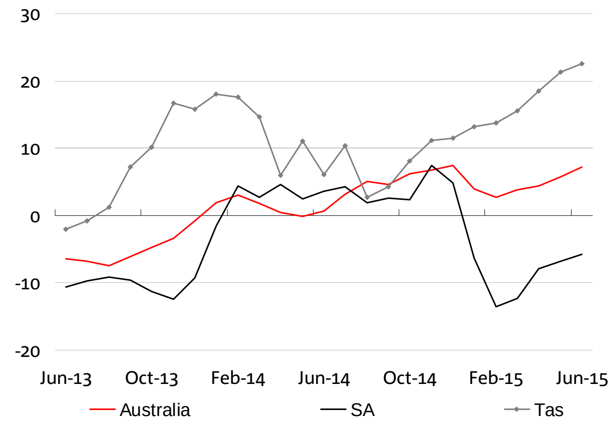




Business conditions by state (net balance): 3-month moving average







Data appendix

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

Jun-2015	Mining	Manuf	Constn	Retail	Wsale	Tran. & utils	Rec. & pers.	Fin. prop. & bus.	Australia
Labour costs: current	0.7	1.1	0.4	0.3	-0.5	1.8	2.0	0.9	1.2
Labour costs: previous	-1.7	0.2	-0.1	0.5	0.5	0.9	0.9	1.2	0.6
Labour costs: change	2.4	0.9	0.5	-0.2	-1.0	0.9	1.1	-0.3	0.6
Prices (final): current	-2.7	-0.2	0.1	0.5	1.1	-0.1	0.7	0.0	0.2
Prices (final): previous	-2.6	0.4	0.1	1.2	1.2	0.0	0.4	0.1	0.4
Prices (final): change	-0.1	-0.6	0.0	-0.7	-0.1	-0.1	0.3	-0.1	-0.2
Purchase costs: current	-0.7	1.1	0.4	1.0	0.6	1.1	1.0	0.1	0.8
Purchase costs: previous	-1.8	1.4	0.8	1.1	1.7	0.0	0.7	0.5	0.8
Purchase costs: change	1.1	-0.3	-0.4	-0.1	-1.1	1.1	0.3	-0.4	0.0

Key state business statistics for the month

Jun-2015	Monthly Business Survey Data: By State						
	NSW	**VIC**	**Qld**	**SA**	**WA**	**Tasmania**	**Australia**
Bus. conf.: current	12	7	6	4	10	24	10
Bus. conf.: previous	13	8	10	6	-8	7	8
Bus. conf.: change	-1	-1	-4	-2	18	17	2
Bus. conf: current - Trend	10	5	8	5	0	12	7
Bus. conf: previous Trend	7	4	7	1	-3	4	5
Bus. conf.: change -Trend	3	1	1	4	3	8	2
Bus. conds: current	12	18	0	3	5	14	11
Bus. conds: previous	12	9	-3	-10	9	27	6
Bus. conds: change	0	9	3	13	-4	-13	5
Bus. conds: current -Trend	11	12	-1	-6	1	23	7
Bus. conds: previous -Trend	11	11	-3	-7	0	21	6
Bus. conds: change -Trend	0	1	2	1	1	2	1

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