Australian Economic Update

by NAB Group Economics

2 December 2015

National Australia Bank

Non-mining recovery gaining traction

- **Variable economic growth outcomes continued into Q3, with real GDP picking up strongly to 0.9% q/q,** following a revised weak 0.3% outcome in Q2 and a strong 0.9% increase in Q1. Year-ended growth picked up moderately to 2.5% y/y, but remained below trend.
- **Looking through the quarterly oscillations, underlying momentum has been broadly unchanged** – not a bad achievement given significant structural change as the economy adjusts to a sharply lower terms of trade and mining investment trajectory.
- **Indeed, the detail was relatively encouraging and consistent with a gradual cyclical recovery across the non-mining economy.** In particular, growth outcomes are broadening, consistent with business conditions reported in the NAB business survey. Industry data suggests services industries are benefiting the most, particularly ITC, real estate, finance & insurance, as well as health, public administration, while retail and hospitality are benefiting from a slightly less cautious consumer and net tourism inflows.
- **Also noteworthy was the smaller-than-expected decline in business investment.** While still substantive (-4.6% q/q), the decline was far less pronounced than indicated by last week's capex figures, suggesting better outcomes for sectors such as education and health and/or stronger intangibles investment.
- **Otherwise, the general themes on the expenditure side were as expected and in line with the broad trends we have been flagging.** That is, the much anticipated (and ongoing) sharp decline in mining investment is being offset by strength in export volumes. Household consumption growth is running at just below-trend as the savings rate eases further and dwelling construction is contributing moderately to growth in line with the high level of dwelling approvals. Public investment declined in Q3 after spending was brought forward to Q2.
- **The most disappointing aspect of today's release were weak state final demand in NSW and Victoria.**
- **Overall, today's data is consistent with our forecasts for a gradual economic recovery in 2016 and 2017, although a weaker outlook for commodity prices may prompt some moderate revisions (see next Tuesday's Global & Australian Forecasts document).** Incoming information is also printing in line with the general thrust of the RBA's forecasts, with GDP growth this quarter actually printing higher than its forecast in November. Global risks remain pronounced, and if anything have intensified in recent months given the slowdown in East Asia, while domestic data suggest greater resilience in the domestic economy.

Headline GDP growth bounced back from last quarters low as the temporary factors constraining growth abated, with net exports making a substantial contribution, driven by resources exports. Looking through the quarterly movements, however, we are still seeing an economy that is growing at a sub-trend pace (2½% over the year), while domestic demand remains modest given the significant drag stemming from mining sector (and related) investment. This however should be viewed in the context of the significant drag on national income due to the decline in the terms of trade, which has fallen 10.5% over the past year, and a cumulative 32% from its peak in Q3 2011.

Expenditure components conform with mining v non-mining narrative

Indeed, there were further encouraging signs that the non-mining segments of the economy are on an improving track. Household consumption and dwelling investment both posted modest growth, while the contraction in government spending was less than expected given last quarters jump (which we attributed to the launching of the first Air Warfare Destroyers (HMAS Hobart)).

GDP (E) summary table

Australian National Accounts (a)	Q/Q		Y/Y	Contribution to Q/Q
	Jun-15	Sep-15	Sep-15	Sep-15
Household Consumption	0.6	0.7	2.7	0.4
Dwelling Investment	0.4	0.9	10.3	0.0
Underlying Business Investment	-2.2	-4.6	-11.0	-0.7
Machinery & equipment	-2.7	-5.7	-11.4	-0.3
Non-dwelling construction	-1.7	-5.5	-13.7	-0.4
New building	0.7	-2.8	2.6	-0.1
New engineering	-3.0	-7.1	-21.5	-0.3
Underlying Public Final Demand	2.2	-0.9	2.6	-0.2
Domestic Demand	**0.6**	**-0.5**	**0.8**	**-0.5**
Stocks (a)	0.0	-0.1	-0.6	-0.1
GNE	**0.5**	**-0.6**	**0.2**	**-0.6**
Net exports (a)	**-0.8**	**1.5**	**1.6**	**1.5**
Exports	-3.3	4.6	6.5	1.0
Imports	0.1	-2.4	-1.2	-0.5
GDP	**0.3**	**0.9**	**2.5**	**0.9**

(a) Contribution to GDP growth

Household consumption growth was a little stronger in the quarter, rising by 0.7%. Growth in household income has remained very weak of late, but this appears to have been more than offset by strong employment growth and a decline in the household savings rate (falling to 9%, from 9.4%) – consistent with improvements in some consumer confidence measures. Consequently, compensation of employees increased by 1.1% in the quarter, its strongest gain since December of 2013.

Direct impetus from housing market strength on consumption appeared to subside in the quarter, with spending on dwelling services remaining subdued, while furnishing and household equipment growth eased notably (to 0.2%, from 1.2% last quarter). Elsewhere, there was a pick-up in utility spending, while motor vehicle sales lifted and the drag from hotels, restaurants & cafes eased compared to last quarter. The largest contributions to growth came from food, dwelling services, utilities, vehicle operation, recreation, insurance and other items. Strength in recreation & personal services according to the NAB Business Survey had perhaps suggested stronger momentum for consumption, however, this may partly be explained by improvements in international tourism as spending in this area would fall under service exports rather than consumption.

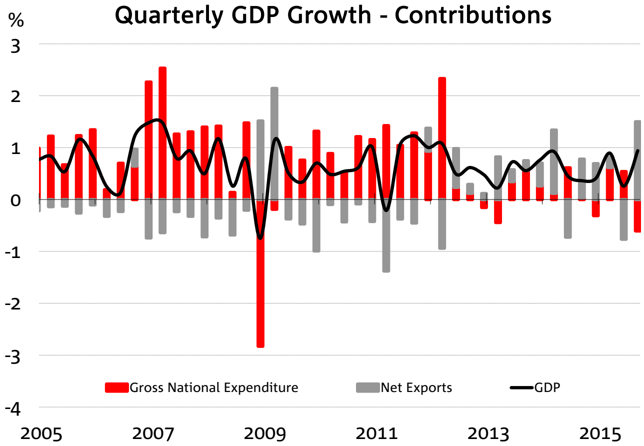
The rise in **dwelling investment** was largely as expected, following a surprise decline last quarter, but may still be considered on the soft side given elevated building approvals and a very elevated stock of residential projects in the construction pipeline. New dwelling construction rose 0.9% in the quarter, and was up by a solid 10.3% over the year. We expect dwelling investment to continue to rise over coming quarters, although growth is likely to be lumpy given the significance of medium-density construction in the pipeline.

Private business investment declined 4.6% in the quarter, which was a more subdued decline than had been heralded by the recent ABS Private New Capital Expenditure (Capex) Survey and Construction Work Done release (which pointed to a decline closer to 7% in the quarter). The stronger result is likely a reflection of the fact that the Capex survey has a relatively limited scope in terms of the industries it covers. In particular, the survey excludes firms classified to agriculture, forestry and fishing, education, and health and community services industries. The survey also does not cover intangible items, which is a reasonably large component of investment.

By component, machinery & equipment fell by 5.7% and intellectual property declined by 0.1%. Non-residential construction dropped by 5.5% q/q, with engineering construction driving much of the decline – consistent with the ongoing downturn in the mining investment cycle. Engineering construction was down 7.1% following a downward revised 3% decline last quarter (this was the eight consecutive quarterly decline). Our estimates suggest that the mining investment ‘cliff’ has run around half its coarse, meaning further significant declines are expected in coming quarters – although lumpiness in the profile can be expected given the nature of these mining projects.

Government spending held up much better than many had expected given anticipated declines in equipment spending after last quarters jump – likely associated with the launching of the first Air Warfare Destroyers (HMAS Hobart). After providing the single largest contribution to GDP growth in Q2, underlying public final demand fell by 0.9% in the quarter, subtracting 0.2 ppts from GDP. General government consumption was up 0.7%, likely assisted by solid employment growth, but capital spending was down 9.2% (underlying down 8.2%). General government defence spending fell considerably, down 33% q/q, but non-defence spending also contributed to the decline in public capital spending (down 25%).

Inventories subtracted 0.1 ppts from GDP in Q3, with much of the drag coming from manufacturing and farm stocks. This outcome reflects a continuation of the tight rein firms are taking on inventory management.



Net exports – The contribution to growth was broadly in line with our expectations at 1.5% as exports jumped back from last quarters decline, and imports fell. The jump in exports largely reflects the unwinding of temporary factors that weighed on resource exports in Q2, suggesting potentially more moderate growth over coming quarters – depending on the timing of major resource project completions. Nevertheless, recent declines in commodity prices may be reflecting both supply ***and*** demand factors, as acknowledged in the most recent RBA policy statement – suggesting some downside pressures.

The rise in export volumes was largely concentrated in goods exports, which rose 5.4%, although services exports rose in the quarter as well (up 0.9%). Within the goods component, growth was particularly pronounced in commodity exports, with the largest increases occurring in “metal ores and minerals” and non-monetary gold (although all major hard commodity groups increased following declines in Q2).

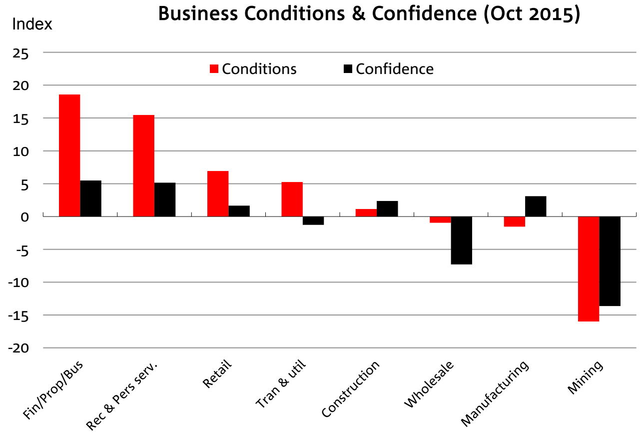
Imports declined in the quarter, down 2.4%, following a relatively flat result in Q2. Services imports fell more than goods, although the drag from goods was larger, with the lower AUD having predictable impacts on passenger transport (down 7.1%) and travel services (down 4.3%). On the goods side, weakness was largely confined to intermediate & other imports (down 5.3%) as both consumption and capital imports increased (both up 0.8%).

Services industries outperform

Production growth was positive in most industries in the quarter. Services industries continue to lead with the non-mining economy continuing to outperform; ICT, real estate services and finance & insurance again claimed the top three spots, while health and public administration also grew strongly. Hospitality and retail grew further, consistent with the solid growth in household consumption and strong net tourism inflows. Growth in construction was positive and last quarter’s negative growth was revised up to be a positive 0.5% - not surprising given strong dwelling approvals. These results are consistent with the NAB business survey, which has been suggesting outperformance by services industries.

Industry GVA Growth

Business Conditions & Confidence (Oct 2015)



In contrast, declines in GVA were recorded in wholesale (who are suffering from margin squeeze as the AUD depreciates), utilities and agriculture. While manufacturing recorded zero growth, the industry has been in a structural decline and has not recorded positive growth since mid 2011. Agriculture also shrank by 1.2% in the quarter while utilities declined 0.2%.

Domestic demand slowdown in most states

State final demand growth slowed down noticeably in Q3 in most states, apart from Queensland (still a negative -0.2%) and South Australia (small increase of 0.1%).

In particular, final demand shrank by 0.2% in NSW and was flat in Victoria, the two states that had enjoyed superior growth with more diversified economies. A large fall in private investment (-4.5%) in NSW contributed most to the decline, while household consumption held up (0.9% q/q). A 10.1% quarterly decline in new non-dwelling construction and a 8.5% decline in new investment in machinery & equipment could explain most of the decline in NSW's private investment, which detracted 0.8% from total final demand growth. It could be attributed to the completion of a few projects over the quarter.

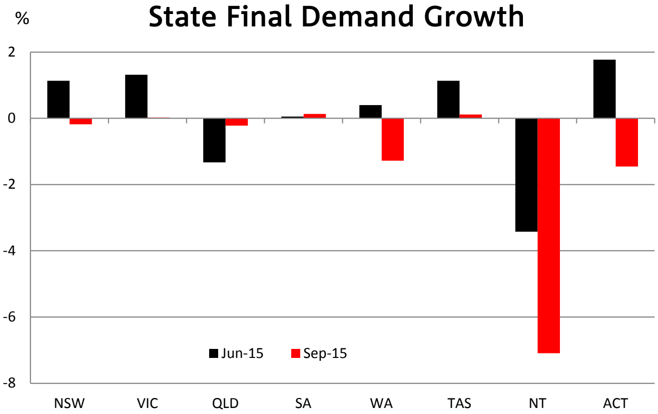
In Victoria, a sharp decline in public investment (-13.2%) detracted the most from growth. Significant declines in general government investment (national general government -30.1% and state & local 20.0%) in Victoria contributed to most of the weakness in state final demand.

Business investment (mostly mining) continued to fall in WA, and public investment also declined while consumption was positive. Similarly in the Northern Territory, a decline in private investment by 21% q/q more than offset the improvements in public spending.

In Tasmania, both public and private consumption were strong, offsetting falls in public and private investment, producing a growth of 0.1% in total final demand.

Queensland and South Australia enjoyed better growth than last quarter. While state final demand was still contracting in Queensland, the fall in private investment was less pronounced (-1.4%). Private investment (up 1.3%) contributed the most to growth in South Australia.

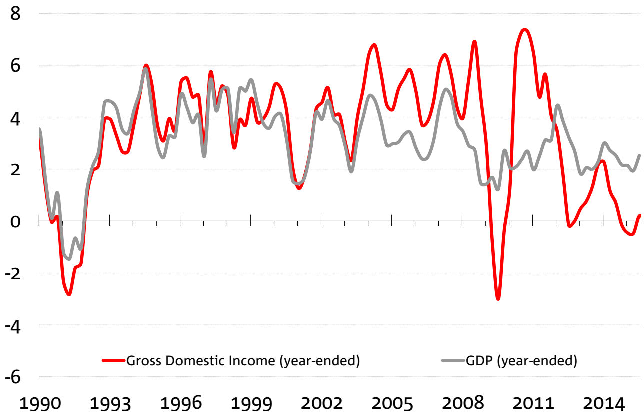
State Final Demand Growth



Income and productivity

Measures of income were weak in the quarter, but slightly better than expected given the 2.4% q/q decline in the terms of trade. Real gross domestic income (real GDP adjusted for the terms of trade) increased slightly (0.3% q/q and 0.2 y/y). Real net national disposable income declined slightly (-0.1% q/q and -1.0% y/y), although the declines remain more pronounced on a per capita basis (-0.5% q/q, -2.4% y/y), suggesting that population growth (while slower) is still supporting the aggregate figures.

GDP and GDI growth



Measures of corporate profitability were somewhat stronger than expected given the 2.4% q/q decline in the terms of trade. Private non-financial gross operating surplus eased just 0.1% in the quarter (-3.7% y/y), while profits for financial corporations (0.7% q/q) and the general government (1.3% q/q) also held up.

The wage bill only increased moderately, despite strong employment, with compensation of employees up 1.0%. Average compensation per employee increased 0.7% in the quarter, a faster pace of wage growth, although over the past year running at a slower rate than the wage price index with employment shifting back to lower paid industries, and away from the mining sector.

Labour productivity was surprisingly robust in Q3 with hours worked not rising as strongly as aggregate employment growth. GDP per hour worked rose 0.6% q/q and 0.6% y/y, while market sector productivity was stronger at 0.9% q/q and 2.0% y/y.

Measures of unit labour costs were moderately higher in the quarter, but subdued over the year. Nominal non-farm unit labour cost growth was up 0.4% q/q and 0.6% y/y. In real terms, non-farm unit labour cost growth is slightly higher at 0.7% q/q and 1.2% y/y, but still consistent with limited inflationary pressure stemming from labour costs.

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