AUSTRALIAN ECONOMIC UPDATE

Recession fears overblown as GDP rebounds; income surges despite weak labour income

NAB Group Economics 1 March 2017

KEY POINTS

- **Real GDP rebounded in the December quarter 2016, with the contraction in the September quarter clearly a temporary blip. Real GDP increased by a stronger-than-expected 1.1% q/q** (NAB: 0.9% q/q, Mkt: 0.8% q/q), following the contraction of 0.5% q/q in Q3. **Year-ended growth picked up to 2.4% y/y,** from 1.9% y/y in Q3. This was arguably not a full rebound, with GDP increasing an average of just 0.3% per quarter in the second half of 2016. Farm GDP was particularly strong (+9.7% q/q) owing to a record grains harvest, while non-farm GDP was somewhat softer than headline GDP at 0.9% q/q and 2.0% y/y.
- **The bounce back was relatively broad-based across expenditure components, and across the states,** and our estimates of non-mining GDP (including non-mining investment) were solid. **Corporate profits benefited from a surge in the terms of trade, however labour income was particularly weak.** While GDP growth will be strong in coming quarters, should the terms of trade boost reverse as our commodity price forecasts imply while weakness in labour income continues, the economy's trajectory could be weaker than many (including the RBA) anticipate.
- **Solid economic momentum near-term will likely keep the RBA on the sidelines for much of 2017.** While there is clearly spare capacity in labour and product markets, the RBA aims to balance its inflation and employment objectives against financial stability considerations, particularly given the surge in house prices in key markets in late 2016 amidst already high household debt levels. **We are not as sanguine about growth in 2018 as the RBA,** and forecast a pull-back in 2018, as the contributions from LNG exports, temporarily higher commodity prices and residential construction fade, while household consumption remains constrained by weak labour income growth. Our year-ended growth forecasts do pick up to 3% by Q3 2017, but then drop to 2% by Q4 2018, much lower than the RBA's 2¾ - 3¾%. Current RBA optimism is expected to fade about the outlook later in 2017, and **we see a 25bp easing in November 2017 as necessary to prevent a rise in unemployment and inflation undershooting again in 2018.**

KEY DETAILS

Most expenditure components were stronger in Q4. Household consumption was solid (+0.9% q/q) despite weak household income growth (+0.2% q/q), with the household savings ratio dropping to 5.2% in Q4 from 6.3% in Q3. **Government investment was particularly strong** (+7.7% q/q), owing in particular to spending by defence and commonwealth public corporations. **Business investment also surprised on the upside, with our estimate of non-mining business investment rising 5.5% q/q and 12.6% y/y.** Engineering construction posted a small positive (+1.3% q/q) despite the continuing trend decline in mining-related investment. Non-residential building construction rebounded (+5.0% q/q) although this followed a 10.3% weather-related decline in Q3. **The rebound in dwelling investment (+1.2% q/q) was a little underwhelming**, only just reversing the weather-related decline of Q3, despite the large number of approvals in the pipeline. **Net exports added approximately 0.2ppt to GDP** with growth in LNG exports the main contributor.

Our estimates of non-mining GDP increased 1.3% q/q, to be 3.0% higher y/y, suggesting the gradual recovery is well-entrenched. The services industries continued to improve, however weak income growth possibly contributed to a decline in hospitality output while construction output declined for another quarter.

State final demand (SFD) was positive across all states and territories. The NT grew the fastest (+3.7% q/q), driven by strong private investment, while Victoria also outperformed (+1.7% q/q) on stronger consumption and both private and public investment growth. Queensland, South Australia, Tasmania and NSW also experienced solid growth. WA underperformed, but did expand (+0.4% q/q).

Income growth was particularly strong, owing to a 9.1% q/q surge in the terms of trade as coal and iron ore prices soared. Profits were strong with non-financial corporate GOS up 15.4% q/q, driving an increase in real gross domestic income of 2.9% q/q and 5.4% y/y. Real net national disposable income per capita gained 2.5% q/q, to be 5.3% higher over the year, and has now improved for four consecutive quarters, after declining in most quarters between Q4

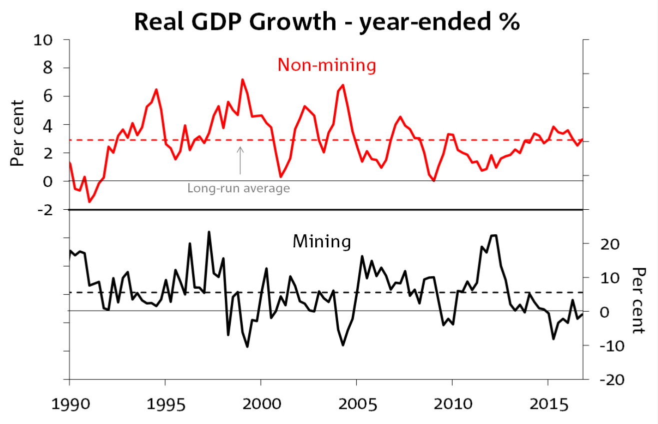
Date **March 2017** | Author **Riki Polygenis – Head of Australian Economics**

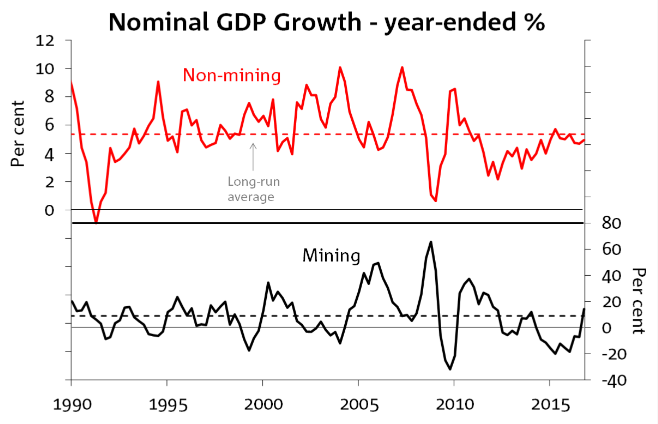
2011 and Q4 2015. **Labour income was particularly weak,** with total compensation of employees down 0.5% q/q and average compensation of employees (a broad-measure of wages) down 0.9% q/q. This suggests further compositional shift in the labour market towards lower-paid jobs.

Price indicators in the National Accounts were mixed in the quarter. The GDP deflator – the broadest measure of inflation – rose 1.9% q/q and 3.6% y/y thanks to the higher terms of trade. However measures of consumer prices were subdued overall to be consistent with the modest outcome seen in the CPI.

Key figures

Australian National Accounts (a)	Q/Q		Y/Y
	Sep-16	Dec-16	Dec-16
GDP (A)	-0.5	1.1	2.4
GDP (E)	-0.4	1.2	3.4
GDP (I)	-1.0	1.2	1.4
GDP (P)	-0.1	0.9	2.5
– Non-Farm GDP	-0.8	0.9	2.0
– Farm GDP	13.8	9.7	26.9
Nominal GDP	0.7	3.0	6.1
Real gross domestic income	0.5	2.9	5.4
Real net national disposable income per capita	0.5	2.5	5.3
Terms of trade	5.1	9.1	15.6





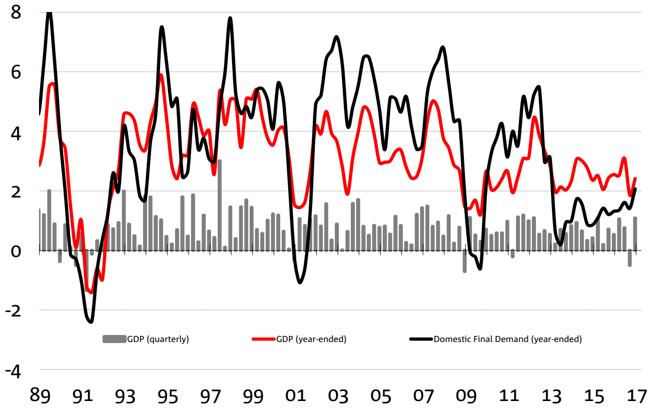
EXPENDITURE COMPONENTS SHOW BROAD-BASED REBOUND

GDP (E) by component

	Q/Q % ch		Y/Y % ch	Contribution to Q/Q % ch
	Sep-16	Dec-16	Dec-16	Dec-16
Household Consumption	0.4	0.9	2.6	0.5
Dwelling Investment	-1.3	1.2	5.6	0.1
Underlying Business Investment	-3.8	1.9	-5.5	0.2
Machinery & equipment	-0.5	1.0	2.5	0.0
Non-dwelling construction	-8.9	2.9	-15.3	0.2
New building	-10.3	5.0	-9.4	0.1
New engineering	-7.8	1.3	-19.5	0.0
Underlying Public Final Demand	0.2	1.3	4.8	0.3
Domestic Demand	-0.4	1.2	2.1	1.2
Stocks (a)	0.1	-0.2	0.2	-0.2
GNE	-0.3	1.0	2.2	1.0
Net exports (a)	0.0	0.2	1.1	0.2
Exports	1.0	2.2	8.9	0.5
Imports	1.2	1.4	3.3	0.3
GDP	-0.5	1.1	2.4	1.1

(a) Contribution to GDP growth

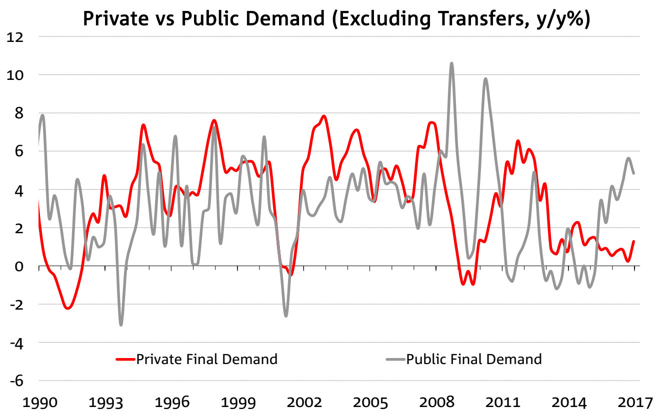
Real GDP and domestic demand



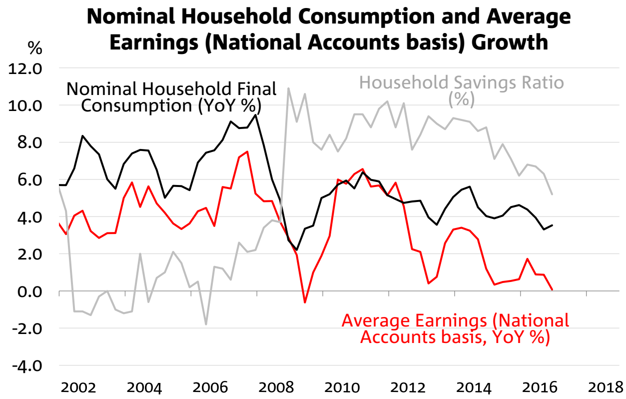
Source: ABS

On the expenditure side, the rebound in growth was relatively broad-based and largely consistent with early reads from the partial data. Growth rebounded somewhat from last quarter's decline (up 1.1% q/q, 2.4% y/y), only a little more than we expected, driven primarily by stronger consumption and construction activity. The relative volatility created by temporary disruptions in recent quarters makes it more difficult to make a true assessment of how the non-mining economic recovery is progressing, although NAB estimates suggest non-mining GDP growth did accelerate in the quarter. However, there are some indications that previous pillars of strength may be losing momentum. Dwelling investment in particular, while showing positive growth, has not been as strong as we might have expected a year ago and could suggest the record construction cycle will peak sooner rather than later. That said, the pipeline of residential construction projects remains large, which will continue to underpin dwelling construction activity for some time yet. Similarly, the pipeline of public construction/infrastructure projects and anticipated defence spending is very large (especially in NSW and

Vic), suggesting the solid growth in public investment for Q4 will likely continue. Consumption growth was also solid in Q4, as was the contribution from net exports, bolstered by higher commodity export volumes.



Household consumption growth reaccelerated from the lacklustre growth of Q3, to rise 0.9% q/q in Q4 (2.6% y/y), reflecting a notable drop in the household savings rate to 5.2% (from 6.3%) – helping to offset weakness in household income measures. The growth in total compensation of employees (a measure of the national wage bill, a function on wages and employment) fell by 0.5% in the quarter, it's first decline since 2012, to be just 1.5% y/y higher, compared to 0.9% q/q (2.8% y/y) in Q3. The contribution to growth came from both goods retail and services, with food (1.2%), recreation and culture (1.2%) and insurance & other financial services (1.3%) making big contributions to growth in the quarter. Only tobacco, operation of motor vehicles and hotels, cafes & restaurants made a small subtraction from growth.

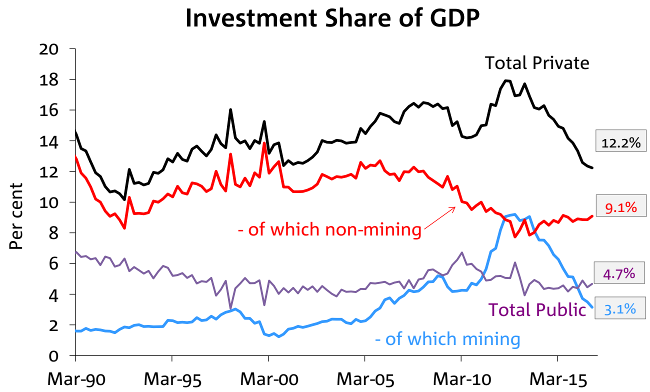


Source: ABS, NAB Group Economics

Looking forward, subdued wages growth, slower wealth accumulation (via property) and elevated levels of household debt are likely to weigh on consumption growth. There may be some more offset from a further decline in household saving ratio – although that has its limits and is not our (or the RBA's) central case assumption.

Dwelling investment recorded a rise of 1.2% in the December quarter, although that only partly unwinds the decline experienced in the previous quarter – a subdued result given the anticipated rebound from temporary weather related disruptions and the record level of construction projects in the pipeline. This might partially reflect the calendar around Christmas this year or some voluntary slowing of projects given a slight rise in settlement delays. This outcome was nonetheless consistent with results from last week's Construction Work Done release. According to the ABS. Increases were seen across both new & used dwellings (up 0.7%) and alterations & additions (renovations, up 2.2%). Growth in dwelling investment over the year was reasonably solid at 5.6% y/y. The dwelling construction cycle is still expected to contribute more to growth over coming quarters, supported by the record level of (mainly apartment) construction projects). However, reads on new approvals and building commencements suggest some risk that the cycle could peak sooner than expected and at a lower level.

Underlying **private business investment** rose by a better than expected 1.9% q/q - this is the first quarter of positive growth since 2013. Engineering construction posted a surprising increase in the quarter, up 1.3%, which was counter to the contraction shown in last week's ABS Construction Work Done release. Nonetheless, NAB estimates suggest that overall mining investment may have still fallen in the quarter and that the mining investment 'cliff' still has a little further to go. That said, there are tentative signs that higher commodity prices are helping to introduce some stability.



Source: ABS, National Australia Bank

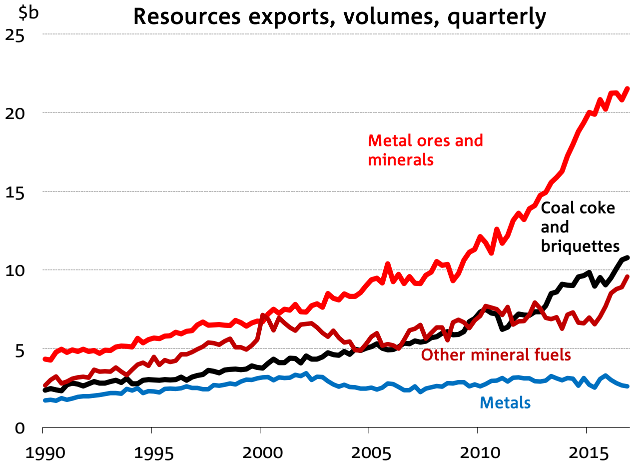
Non-residential building constructed rebounded from the temporary disruptions seen in Q3, albeit not fully unwinding the previous quarter's decline, rising 5% q/q. That outcome was largely as expected following last week's ABS releases. Machinery and equipment investment rose by 1%, which was slightly stronger than indicated by the ABS Private New Capital Expenditure (Capex) Survey. Indications on non-mining investment were generally encouraging, with NAB estimates pointing to a strong acceleration in growth for the quarter.

Government spending was solid in Q4, following a fairly subdued result last quarter. Government consumption was relatively flat in the quarter, while underlying public investment jumped 7.5% q/q, reflecting a sharp increase in both defence spending and investment by Commonwealth public corporations. Overall defence spending rose in the quarter, driven entirely by defence investment, but the largest contribution to the increase in government spending came from non-defence expenditure. General government defence spending rose 1% q/q (defence investment up 34% and defence consumption down 8.2%). All other general government spending rose 1.1%.

The contribution from **inventories** to GDP in Q3 was -0.2 ppts. Most of the decrease in private inventories during the quarter came from mining stocks, but most categories were flat-to-lower. Retail trade stocks were the main exception.

Net exports contributed 0.2 ppts to GDP growth in Q4. A strong bounce back in exports (up 8.9% q/q) from a weather affected Q3 more than offset a 3.3% increase in imports. Not surprisingly, resources exports grew strongly over the quarter (3.4% q/q) and alone contributed 0.4 ppts to total GDP growth. The strength was largely driven by the ramping up of LNG exports (up 7.7% q/q), while iron ore and coal exports increased moderately despite higher prices. Overall, goods exports were up 2.6%, while services exports were up only 0.6%. Goods imports rose by 1.2% q/q, driven by an increase in capital goods imports, while consumption and intermediate goods imports were weak. Services imports rose by 2.3% despite a weaker AUD during the quarter.

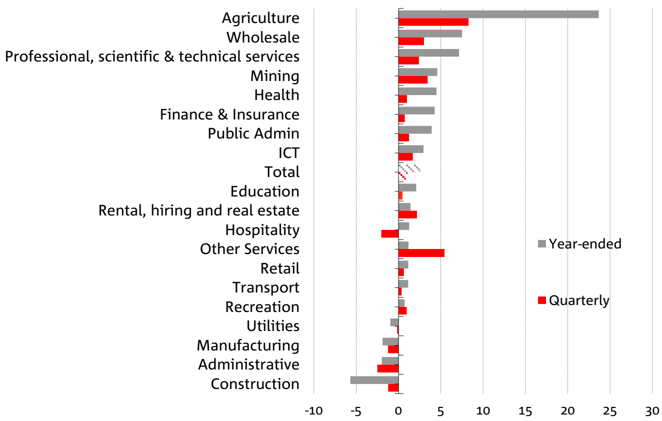
Resources exports, volumes, quarterly



INDUSTRY DETAIL: RECORD CROP HARVEST SAW AGRICULTURE OUTPERFORM

Favourable weather conditions in Eastern Australia delivered an unprecedented crop harvest, which saw agricultural output rise by over 8% q/q. Possibly facilitating the trade of more crops and bulk commodities, the wholesale industry also recorded an increase in output. Other services also stood out, leading the outperformance ofservices industries. However, hospitality and administrative services contracted in the quarter, while manufacturing continued to decline. Construction output was again negative, as the increase in dwelling construction activity was unable to offset the decline in mining related construction activity.

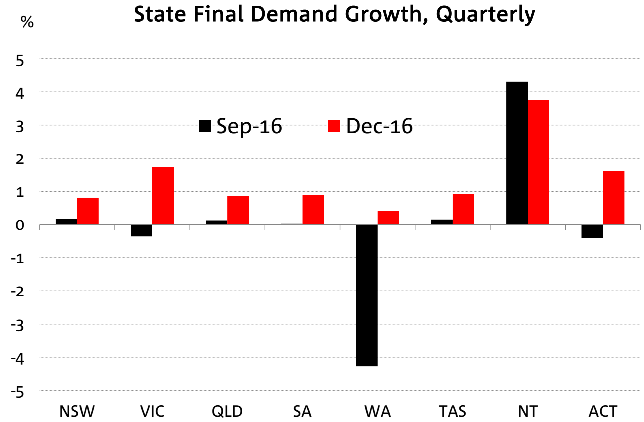
Industry GVA Growth



MOST STATES RECORDED STRONGER DOMESTIC DEMAND GROWTH IN Q4

All states and territories apart from the NT reported stronger final demand growth in Q4, following a weak Q3 result. While growth in NT moderated somewhat, it was still the strongest of the eight in year-ended terms. Victoria came in second in the quarter, showing continuing strength with its diversified economy and strongly growing population. Household consumption was especially strong in VIC. While household consumption was also strong in NSW, a lack of public and private investment saw it lagging behind VIC in the quarter, although NSW still outperformed the national average in year-ended terms.

State Final Demand Growth, Quarterly



QLD experienced another fall in private investment, while stronger household consumption and public investment helped produce a positive outcome. Even the weakest state WA, managed to record positive growth in the quarter, as higher investment offset weaker public and private consumption, although SFD remained strongly negative in year-ended terms.

State final demand

State/ Territory	Q/Q Sep-16	Q/Q Dec-16	Y/Y Dec-16
NT	4.3	3.8	11.1
ACT	-0.4	1.6	7.3
NSW	0.2	0.8	4.1
VIC	-0.4	1.7	3.4
TAS	0.1	0.9	2.4
SA	0.0	0.9	2.1
QLD	0.1	0.9	1.8
WA	-4.3	0.4	-7.8

INCOME AND PRODUCTIVITY

Measures of income were very mixed in the quarter. While corporate gross operating surplus rose strongly on the back of higher commodity prices, labour income was negative.

Key income and productivity measures

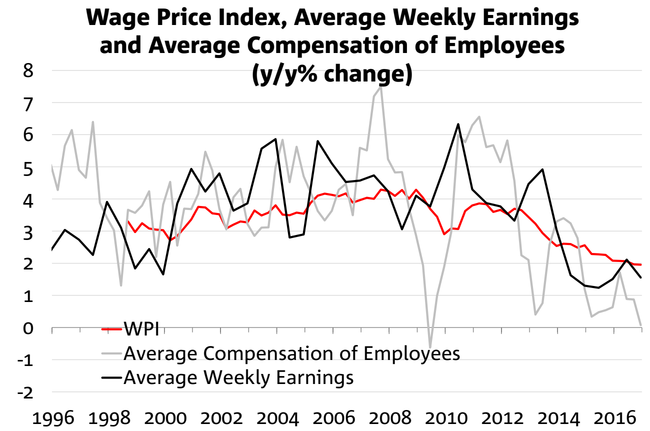
Income measures	Q/Q Sep-16	Q/Q Dec-16	Y/Y Dec-16
Real GDI	0.5	2.9	5.4
Real net disposable income per capita	0.5	2.5	5.3
Compensation of employees	0.9	-0.5	1.5
Compensation per employee	0.5	-0.9	0.1
Corporate GOS	0.8	12.0	13.5
Non-financial corporations	0.5	15.4	16.0
Financial corparoations	1.7	1.8	6.0
General government GOS	1.2	1.2	4.9
Productivity & unit labour cost			
GDP per hour worked	-0.9	0.4	1.9
Non-farm productivity	-0.6	0.7	2.4
Non-farm nominal unit labour cost	0.2	-0.1	-0.8
Non-farm real unit labour cost	-1.3	-1.5	-4.1

Real net disposable income rose 2.9% in Q4 (q/q sa) and 6.8% (y/y). Per capita net disposable income rose at a slightly slower pace (up 2.5% q/q) but was much stronger than the 0.5% increase in Q3. These results nonetheless suggest that population growth is supporting the aggregate figures.

Growth in non-financial corporate gross operating surplus (GOS) surged 16.5% (sa) in Q4 after a weak result in Q3, while GOS from financial corporations rose 1.8%.

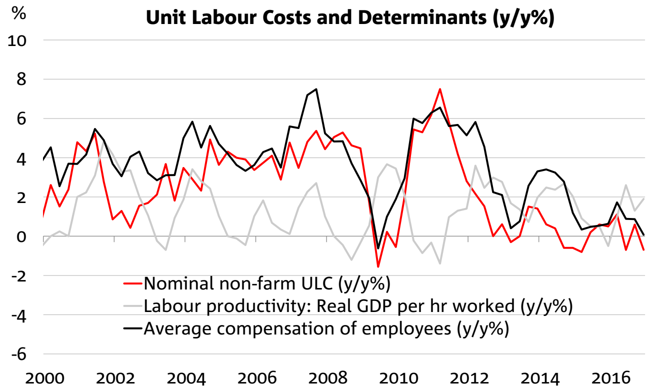
Labour income was very weak in the quarter, with both real unit labour costs, total compensation of employees and average compensation of employees all falling. The fall in total compensation of employees (-0.5% q/q sa in Q4) is particularly concerning. This was the first time compensation of employees has fallen since Q3 2012 and is in line with record low growth in the wage price index. Average compensation employees was 0.9% lower (q/q sa).

The fall in compensation of employees came largely from financial and insurance services, construction, wholesale trade, and administrative and support services.



Source: ABS, NAB Group Economics

Hours worked (0.7% q/q) and GDP per hour worked (0.4% q/q) continued to increase, but real unit labour costs fell (-3.4% q/q/ and -3.1% q/q non-farm). The increase in hours worked was slower for the market sector than the total (0.4% vs 0.7%), suggesting the public sector is driving growth. Overall, non-farm productivity was up in Q4.



Source: ABS, NAB Group Economics

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