AUSTRALIAN ECONOMIC UPDATE

Australian economy ekes out modest growth

NAB Group Economics 7 June 2017

- **Australia's economy eked out modest growth of 0.3% the March quarter,** following growth of 1.1% in the December quarter and a contraction of 0.4% in the September quarter 2016. Modest growth was in line with market expectations, but stronger than our forecast for a slight fall, with the production and income measures of GDP a little stronger than anticipated, and household consumption a fraction higher. **The year-ended pace of growth eased to 1.7% y/y,** the weakest rate since 2009 in the aftermath of the global financial crisis. The pace of non-mining GDP growth has slowed in year-ended terms, while mining GDP appears to have stabilised somewhat (see charts on page 2).
- **Measures of income growth meanwhile were strong,** thanks to a 6.6% surge in the terms of trade, as well as stronger wages growth. This is unlikely to continue, given our forecasts for iron ore and coal prices to retreat.
- **A number of one-offs contributed to the softness in Q1 and the decline in Q3 last year -** including weather-related disruptions to exports and dwelling construction. Unfortunately, the volatility in exports is likely to continue given cyclone disruptions to coal in Q2, **raising the likelihood of another soft GDP print in Q2.** Volatility in the GDP data complicates assessment of current economic momentum and the implications for the outlook. **At this stage, we continue to expect a rebound through the second half of 2017 as LNG exports surge and government investment strengthens, but a softening in growth in 2018 as LNG exports and the dwelling construction cycle peak.** The pace of household consumption and business investment will be key.
- **There was an encouraging (albeit small) lift in business investment (0.7% q/q).** This suggests that the worst of the drag from the mining investment "cliff" is behind us, and implies a rise in non-mining investment this quarter. This is **occurring in tandem with an encouraging lift in non-mining profitability** as indicated in Monday's business indicators release, and strength in NAB's measure of business conditions. **If this trend becomes more well entrenched, it will give greater confidence in our (and others') expectations of a moderate cyclical upswing in non-mining investment** in 2018 and 2019. The surge in mining profitability meanwhile, was in line with the 6.6% increase in the terms of trade thanks to a further surge in iron ore and coal prices, is viewed as temporary and is hence unlikely to stimulate a pick up in mining-related investment.
- Meanwhile, **household consumption remains subdued**. While slightly stronger than anticipated at 0.5% q/q, suggesting faster growth in services than retail, the year-ended pace of growth at 2.3% y/y remains below its historical average of around 3¼%. This is consistent with slow rates of wages and household income growth (despite some rebound this quarter), a backdrop of elevated unemployment and underemployment and relatively high household debt. As such, while households seemed a little less cautious this quarter (as evidenced this quarter by a decline in the household savings ratio to 4.7% from 5.1% in Q4 2016 and half the rate in Q1 2013), there remains uncertainty about whether this will continue going forward.
- **Dwelling investment meanwhile declined by 4.4% q/q, and while weather may have played a part, it raises the possibility that the dwelling investment cycle may have peaked earlier than expected.** While we are reluctant to draw that conclusion given the large number of projects in the pipeline, we note that such a scenario is possible depending on how quickly projects in the pipeline come on line.
- **Overall, today's data are consistent with unchanged monetary policy.** The RBA will look through the volatility in GDP, however mixed labour market outcomes and weak wages and inflation data will prevent any hike. Meanwhile, there is tentative evidence that macroprudential and policy changes are leading to a softening in dwelling price growth, which may help mitigate economic risks associated with rising household debt levels.

HIGHLIGHTS

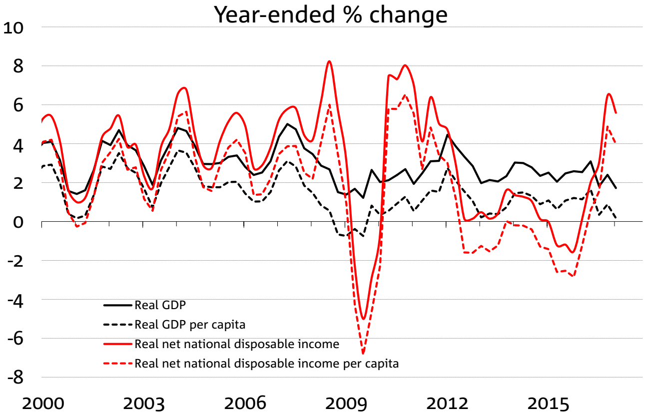
- On the **expenditure side**, the main contributors to growth were inventories, government consumption (while government investment subtracted), and a modest contribution from household consumption. Net exports and dwelling investment meanwhile subtracted, while a marginal rise in business investment was broadly neutral.
- **By industry**, growth appeared to be relatively broad based across the economy, with 17 out of 20 industries growing in the quarter. Gross value added grew fastest in utilities, transport, wholesale, and administrative services. Farm GDP fell notably (down 6.4%), but that follows strong growth in Q4 and is well up over the year.
- **By state,** state final demand was especially strong in Victoria and South Australia in the quarter (both up 1.4%). In contrast, both NSW and Queensland were flat in the quarter, while Western Australia saw a contraction (-0.2%).

Key figures

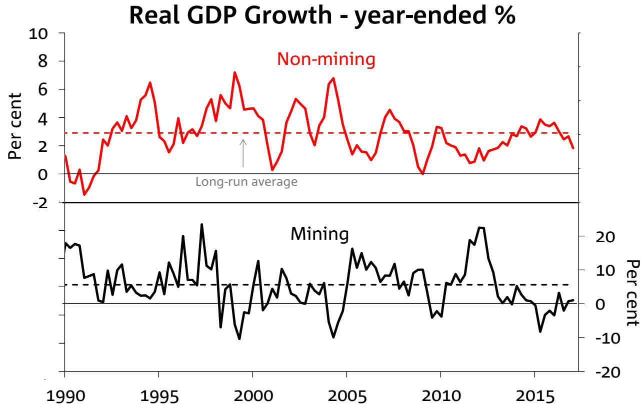
Australian National Accounts (a)	Q/Q		Y/Y
	Dec-16	Mar-17	Mar-17
GDP (A)	1.1	0.3	1.7
GDP (E)	1.2	0.1	1.9
GDP (I)	1.1	0.2	1.2
GDP (P)	1.0	0.5	2.1
– Non-Farm GDP	1.0	0.4	1.4
– Farm GDP	8.4	-6.4	16.3
Nominal GDP	3.2	2.3	7.7
Real gross domestic income	3.1	1.7	6.5
Real net national disposable income per capita	2.6	0.8	4.0
Terms of trade	9.6	6.6	24.8

GDP and national income growth

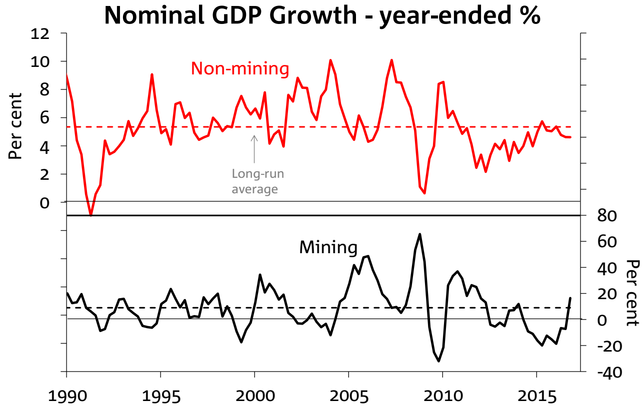
Year-ended % change



Real GDP Growth - year-ended %



Nominal GDP Growth - year-ended %



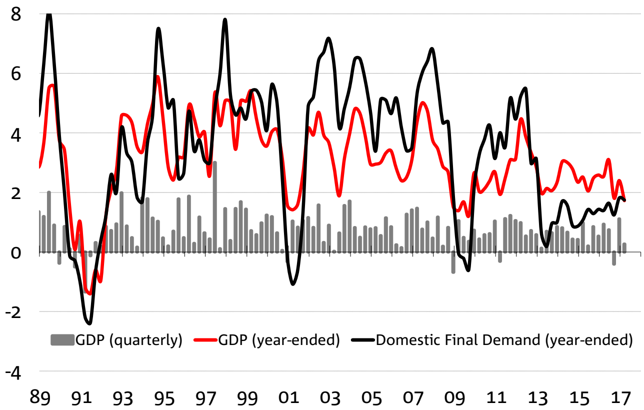
EXPENDITURE COMPONENTS SHOW MILD EXPANSION

GDP (E) by component

	Q/Q % ch		Y/Y % ch	Contribution to Q/Q % ch
	Dec-16	Mar-17	Mar-17	Mar-17
Household Consumption	1.0	0.5	2.3	0.3
Dwelling Investment	1.9	-4.4	-2.5	-0.3
Underlying Business Investment	1.4	0.7	-2.8	0.1
Machinery & equipment	**0.0**	**-2.2**	**-0.6**	**-0.1**
Non-dwelling construction	**2.4**	**2.5**	**-8.5**	**0.1**
New building	**7.0**	**0.2**	**-4.6**	**0.0**
New engineering	**-1.2**	**4.3**	**-11.4**	**0.1**
Underlying Public Final Demand	0.9	0.5	4.1	0.1
Domestic Demand	**1.1**	**0.3**	**1.7**	**0.3**
Stocks (a)	-0.3	0.4	0.6	0.4
GNE	**0.8**	**0.8**	**2.4**	**0.8**
Net exports (a)	**0.4**	**-0.7**	**-0.4**	**-0.7**
Exports	3.7	-1.6	5.6	-0.4
Imports	1.9	1.6	7.9	0.3
GDP	**1.1**	**0.3**	**1.7**	**0.3**

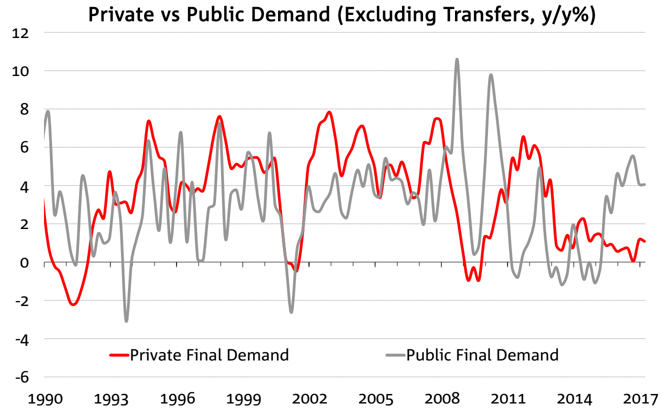
(a) Contribution to GDP growth

Real GDP and domestic demand



Source: ABS

Private vs Public Demand (Excluding Transfers, y/y%)

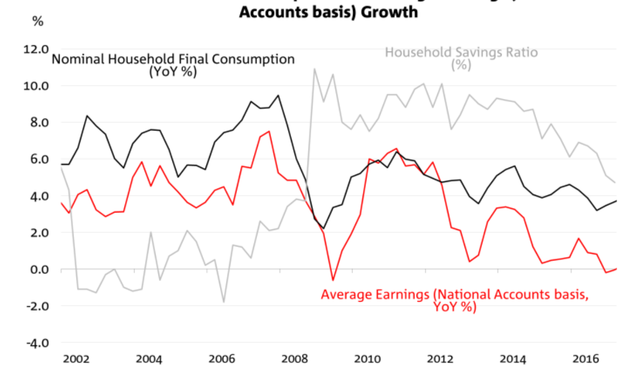


Household consumption growth remained in positive territory in Q1 2017, up 0.5% q/q (2.3% y/y). This growth was driven by yet another drop in the household savings ratio to a post-GFC low 4.7% - the fourth straight fall in a row. Income growth remains muted, although total compensation of employees (a measure of the national wage bill, a function on wages and employment) grew 1.0% q/q – the best result since Q3 2015 and following a dismal -0.7% q/q (revised) in Q4 2016. Public sector employees continue to enjoy better pay rises than those in the private sector (up 2.1% q/q and 0.7% respectively)

Growth in consumer spending appeared stronger for essentials than non-essentials. The biggest contributor to HFCE growth was electricity, gas and other fuel (up 2.9%) followed by the operation of vehicles. Alcohol and clothing were the biggest negatives (down 1.0% and 0.7% respectively). The impact of LNG exports from Queensland on the east-coast gas market will likely see higher electricity and gas costs in the coming years, which may increase utilities costs in nominal terms at the expense of other spending categories.

Looking ahead, we continue to expect that subdued wages growth, slower wealth accumulation (via property) and elevated levels of household debt will weigh on consumption growth. With yet another fall in the household saving ratio this quarter, lower saving is approaching its limits as a driver of growth.

Nominal Household Consumption and Average Earnings (National Accounts basis) Growth

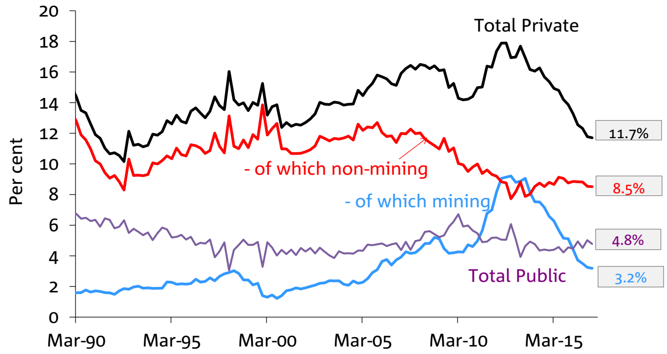


Source: ABS, NAB Group Economics

Dwelling investment declined sharply in the March quarter (down 4.4%), leaving dwelling investment down 2.5% over the year. While that could suggest that the housing construction cycle is (or is close to) peaking, the pipeline of construction remains near record highs and weather related disruptions may have also contributed to the result. That said, recent analysis of the construction sector by NAB Economics found that various supply constraints are likely to elongate the construction cycle – peaking at a lower level, but perhaps holding up at somewhat elevated levels of activity for longer than otherwise expected. According to today's National Accounts, declines were seen across both new & used dwellings (down 4%) and alterations & additions (renovations, down 5.2%). We still expect to see the dwelling construction cycle contribute to growth over coming quarters, but recognise some downside risk to the outlook given reads on building commencements and the fall in new approvals from their peaks.

Underlying **private business investment** rose by 0.7% q/q, which was more modest than the previous quarter, but still points to a continuation of the improving trend for business investment – consistent with solid outcomes for company profits and elevated levels of business conditions in the NAB Business Survey. Private engineering construction posted a solid increase in the quarter, up 4.3%, its first increase since 2013, while separately released data from the ABS suggested that mining did not a drag on investment in Q1 – for the first time since mid-2014. This suggests that the worst of the drag from the mining investment "cliff" is behind us, while NAB estimates suggest that non-mining investment also rose in the quarter – consistent with encouraging indications from the NAB Business Survey.

Investment Share of GDP



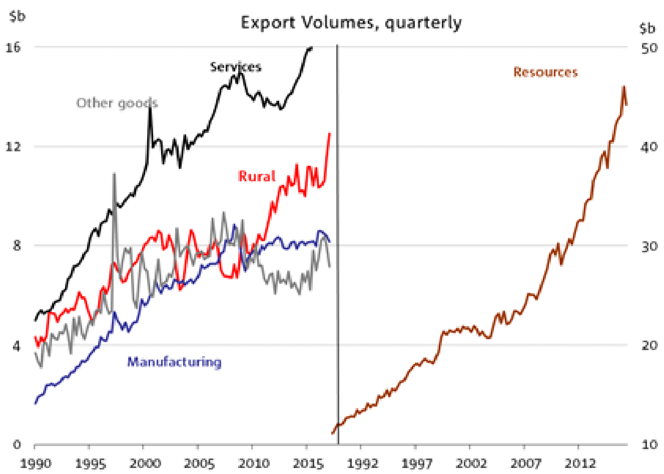
Source: ABS, National Australia Bank

Non-residential building construction rose only modestly in Q1 (up 0.2%), but that built upon a solid rebound in Q4 2016 following temporary disruptions observed in the previous quarter. Meanwhile, machinery and equipment investment fell by 2.2%, seemingly not seeing much support from the lift in engineering activity.

Government spending was a little softer in Q1, rising at around half the pace seen in the previous quarter. Government consumption was up 1% in the quarter, while underlying public investment dropped 1.7% q/q, reflecting declines in both defence and non-defence spending and sharp falls in investment by Commonwealth public corporations. General government defence spending increased 0.3% q/q (defence investment down 2.2% and defence consumption up 1.3%). Non-defence national general government spending rose 0.5%.

The contribution from **inventories** to GDP in Q4 was 0.4 ppts. Most of the increase in private inventories during the quarter came from mining stocks, but most categories were flat-to-higher. Wholesale stocks were the main exception.

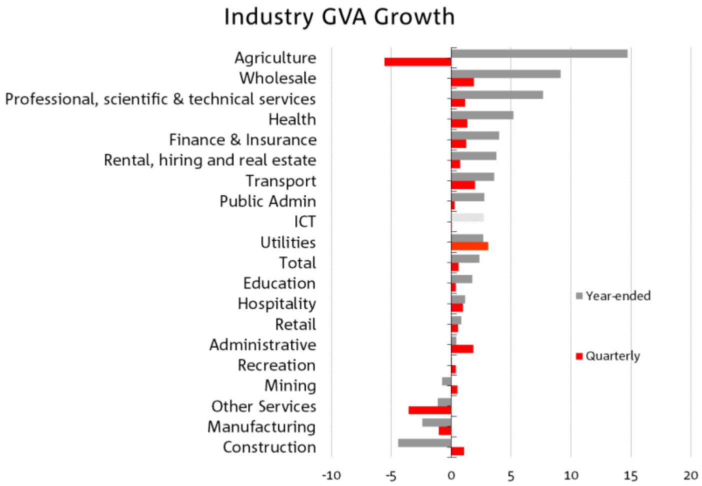
Net exports detracted 0.7 ppts from GDP growth in Q1. Exports declined 1.6% q/q after a strong Q4, while imports continued to rise, up 1.6% q/q. Despite rural goods exports posting another strong result, overall goods exports were down 2.6%, as resources, manufacturing and other goods exports were all lower. The fall in resources exports alone took out 0.4 ppts from GDP growth. Iron ore, coal and metals exports were down significantly, only partly offset by a small increase in LNG exports over the quarter. Iron ore production and shipments in the Pilbara were disrupted by cyclones but all operations have now recovered. Cyclone Debbie also hit Queensland and northern New South Wales in late March, flooding mines and damaging railways, with more loss of coal exports expected to show up in Q2. Services exports were up 2.5% q/q despite the higher AUD. Both goods and services imports rose, up 1.8% and 0.9% respectively. Both consumption and capital goods imports rose strongly, pointing to a potential pickup in domestic demand.



INDUSTRY DETAIL: SERVICES OUTPERFORM AS AGRICULTURE RETREATS

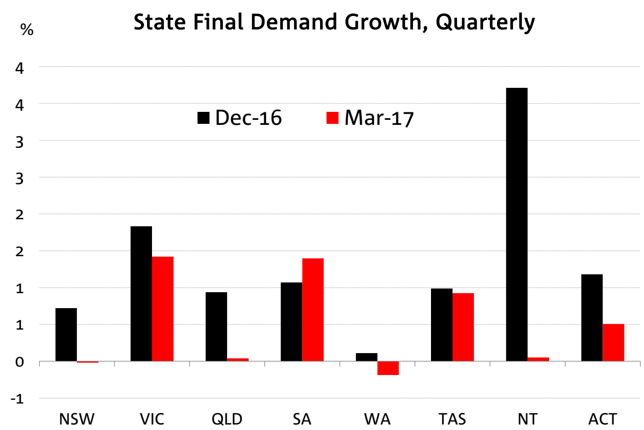
By industry, growth appeared to be relatively broad based across the economy, with 17 out of 20 industries growing in the quarter. Services saw the strongest gains in Q1 2017, particularly electricity, water and waste services was up 3.1% q/q. All service sectors apart from "other services" gained in the quarter. Transport, wholesale and administrative services also performed well.

On the other hand, agriculture, forestry and fishing, which saw huge gains in Q4 2016, fell back to be the worst performing industry in Q1 2017 (off 5.6% q/q. This reflects the effects of a massive winter crop boosting Q4 2016 but wearing off by Q1 2017. Last season Australia harvested a record 35 million tonnes of wheat, more than 5 million tonnes greater than the previous record. On a year on year basis, agriculture remains the pest performing industry, up 14.7%.



DOMESTIC DEMAND SLOWED IN ALL STATES EXCEPT FOR SOUTH AUSTRALIA

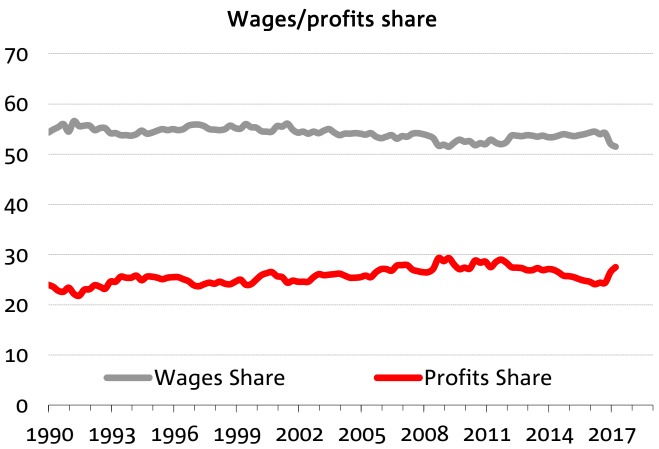
Domestic demand growth in Q1 was weaker in all states and territories, apart from South Australia. The biggest declines happened in the NT, and to a lesser extent QLD and NSW, with the three recording near zero growth in domestic demand during the quarter. Significant declines in investment in the NT, both public and private, contributed to the weakening. Queensland suffered a drop in private investment while household consumption growth was subdued. Public investment levels in NSW declined by over 19%, driven by public corporations investment. Due to the lumpy nature of some investment projects, growth rates could vary significantly quarter to quarter. Victoria continued to grow strongly, with healthy consumption, boosted by an increase in public investment. Investment levels in WA continued to fall, but consumption has started to recover. Over the year, the biggest increases in domestic demand were in the NT, followed by the ACT and VIC, with the mining states of QLD and WA still lagging behind.



State final demand			
	Q/Q		Y/Y
State/ Territory	Dec-16	Mar-17	Mar-17
NT	3.7	0.1	10.0
ACT	1.2	0.5	5.0
VIC	1.8	1.4	4.5
SA	1.1	1.4	3.3
TAS	1.0	0.9	3.3
NSW	0.7	0.0	1.9
QLD	0.9	0.0	1.6
WA	0.1	-0.2	-6.6

INCOME AND PRODUCTIVITY

Drivers of income were stronger this quarter, thanks in large part to another surge in the terms of trade of 6.6%, which supported corporate profits (+6.2% q/q following a 12% gain last quarter). Growth in labour income improved meanwhile (1.0% q/q in from -0.7% in Q4, see below), although is not keeping pace with profits growth, resulting in the wages share of national income declining in recent quarters.



Key income and productivity measures

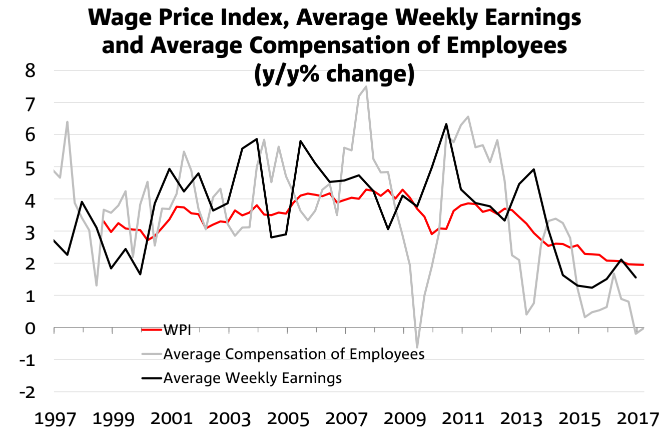
	Q/Q		Y/Y
Income measures	Dec-16	Mar-17	Mar-17
Real GDI	3.1	1.7	6.5
Real net disposable income per capita	2.6	0.8	4.0
Compensation of employees	-0.7	1.0	1.5
Average compensation of employees	-1.0	0.7	0.0
Corporate GOS	12.0	6.2	22.6
Non-financial corporations	15.3	7.3	27.9
Financial corpoarations	2.2	2.3	6.8
General government GOS	1.2	1.2	4.9
Productivity & unit labour cost			
GDP per hour worked	0.8	0.0	1.3
Non-farm productivity	0.9	0.2	2.1
Non-farm nominal unit labour cost	-1.7	0.0	-0.6
Non-farm real unit labour cost	-3.6	-2.0	-6.2

Overall, growth in real net disposable income was strong at 1.2% q/q in Q1, following growth of 3.0% in Q4 to be 5.6% higher over the year (see chart on page 2). Per capital net disposable income was also strong at 4.0% y/y, in stark contrast to the declines seen through H2 2012 till H1 2016, although this is unlikely to continue as commodity prices (particularly iron ore and coal) retreat going forward.

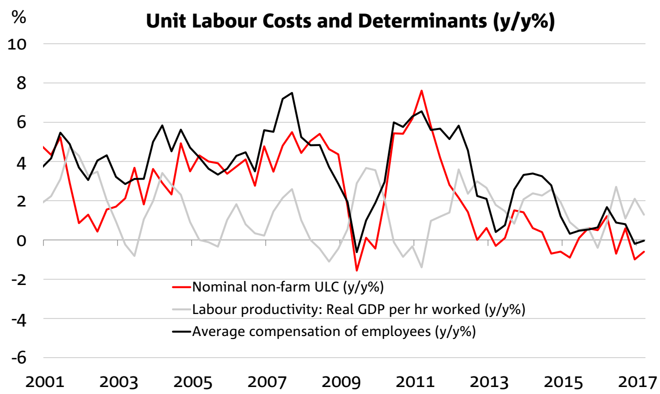
Labour income growth was surprisingly solid in the quarter. In particular, average compensation of employees was up 0.7%, stronger than the 0.5% increase in the wage price index, although this followed a decline last quarter and has not increased over the year (0.0% y/y). Total compensation of employees (which is a function of average earnings and hours worked) rose 1.0% q/q.

Hours worked rose by 0.3%, so GDP per hour worked, a measure of labour productivity, was unchanged. The increase in hours worked was faster for the market sector, suggesting the public sector was driving growth.

Real unit labour cost growth was also negative again at -1.7% q/q, from -3.7% q/,q, which suggests further softness in inflation going forward.



Source: ABS, NAB Group Economics



Source: ABS, NAB Group Economics

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