AUSTRALIAN ECONOMIC UPDATE

Business and government led growth

NAB Group Economics

6 December 2017

Bottom line: **Moderate growth momentum in Q3, mainly led by business and government investment. Households are restraining their spending amidst further weakness in wages and household income growth, despite strong employment. Overall the data are consistent with our view that while growth will be strong in coming quarters thanks to LNG and business/government investment, wages and household spending will need to lift in order for these growth rates to be sustained.**

- Growth in the Australian economy slowed a touch in Q3 to 0.6% q/q (NAB and Mkt: 0.7% q/q), although overall the last 6-months has been solid. The year-ended pace of growth shot up to a respectable 2.8% y/y, a little below the long-run average, largely because the negative in Q3 2016 dropped out of the calculation.
- Encouraging aspects of the details included particular strength in government investment (+7.4% q/q in underlying terms). There was further evidence that business investment is starting to fire, consistent with strong corporate profitability (despite a fall in the terms of trade this quarter). There was perhaps also some spillover to the private sector from government infrastructure investment. Growth has also been reasonably broad-based across industries (as foreshadowed by the NAB Business Survey), which in turn is a positive signal for investment going forward.
- Household sector dynamics remain of concern. Household consumption was even weaker than expected at 0.1% q/q (NAB: 0.3% q/q), with weakness evident in spending on both retail and services. This is unsurprising given that average labour earnings only increased 0.3% in the quarter and 0.6% over the year. While total compensation of employees was solid at 1.2% q/q and 3.0% y/y, this is almost entirely due to strength in employment rather than wages. Household disposable income meanwhile only rose by 0.5% q/q and 1.8% y/y, barely above the rate of inflation. The household savings ratio rose to 3.2% from 3.0% in the previous quarter (the first rise in five quarters), suggesting consumers are understandably cautious.
- Other surprises included the failure of net exports to add to growth, although this partly reflected strong capital imports (consistent with strong investment) and volatility in non-monetary gold exports. Dwelling construction was surprisingly weak, although this was largely due to a much larger fall than expected for renovations activity rather than new building, although it still appears the housing construction cycle has peaked in a trend sense.
- The RBA will be encouraged by business and government investment, but retain its concern about households. With house prices (especially in Sydney) now slowing and alleviating some concerns around rising household debt, the RBA is unlikely to move rates until there is resolute evidence that wages growth is responding to strong employment, particularly given that measures of inflation in today's data and in the CPI remain subdued.

HIGHLIGHTS

- **On the expenditure side**, both private business and public investment were solid in underlying terms, while inventories also made a meaningful contribution to growth. Meanwhile, household consumption was disappointingly weak. Dwelling investment fell once again thanks to a sharp fall in alterations & additions, while net exports made no contribution as exports were offset by higher capital imports.
- **Non-mining GDP** is estimated to have increased by 0.7% qoq in Q3, to be up 3.4% yoy, indicating a solid trend that is broadly expected to improve. Meanwhile, mining GDP looks to have been relatively flat.
- **By industry**, growth was again focussed on services, especially accommodation and food, administration, finance & insurance, professional services and healthcare. Manufacturing and construction also performed well. Agriculture was the weakest performer, largely reflecting a weaker season for winter crops. On a year-ended basis, growth was positive in all but 2 of the 19 industry sectors in year-ended terms.
- **By state,** final demand growth slowed down in most states except for NSW, WA and the NT. NSW led final demand growth nationally, expanding by 1.0% q/q. Domestic final demand growth slowed somewhat in VIC, QLD and SA, while falling into negative territory in TAS and the ACT. Over the year, NT led the country on the back of strong LNG investment. VIC and SA also enjoyed above average growth, at 4.7% and 3.9% respectively. While having recovered strongly, WA state final demand growth was the slowest at 1.3% y/y.
- **Income measures** such as real gross domestic income were generally a little weaker than real GDP growth in the quarter thanks to the lower terms of trade, although remain healthy in year-ended terms.
- There were no gains in **labour productivity** in the quarter or over the year, as growth in hours worked has broadly matched GDP growth.

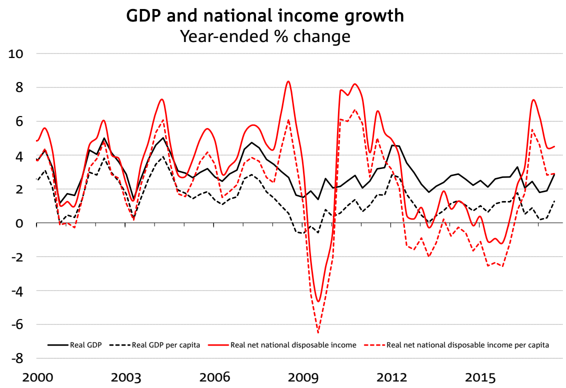
Key figures

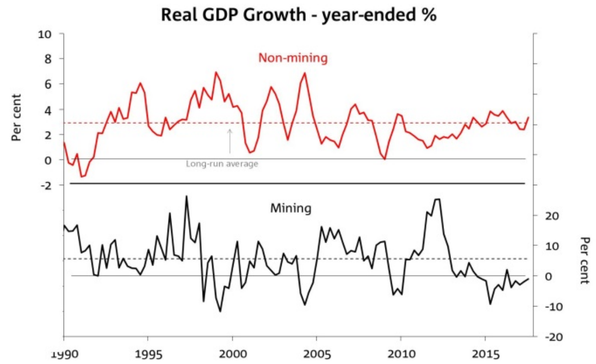
Key aggregates	qoq % ch		yoy % ch
	Jun-17	Sep-17	Sep-17
GDP (A)	0.9	0.6	2.8
GDP (E)	0.8	0.7	2.6
GDP (I)	1.2	0.5	2.8
GDP (P)	0.8	0.5	3.1
– Non-Farm GDP	1.1	0.7	2.9
– Farm GDP	-3.4	-4.2	0.1
Nominal GDP	0.0	0.6	5.9
Real gross domestic income	-0.4	0.5	5.0
Real net national disposable income per capita	-1.2	0.4	2.9
Terms of trade	-6.0	-0.4	9.7

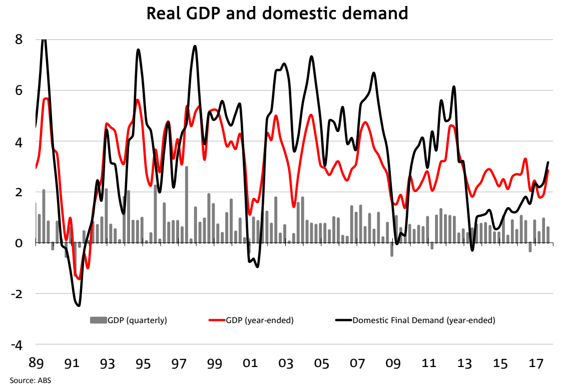
GDP (E) by component

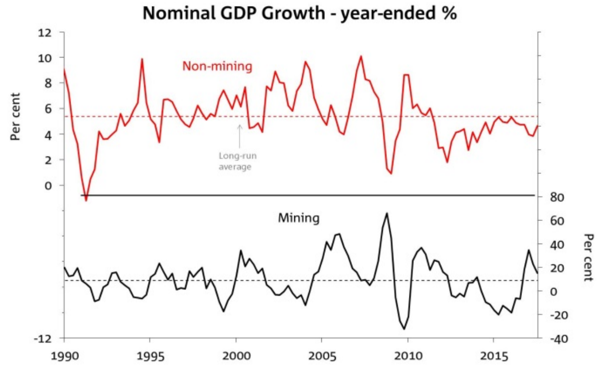
GDP Expenditure Components	qoq % ch		yoy % ch	Contribution to qoq % ch
	Jun-17	Sep-17	Sep-17	Sep-17
Household Consumption	0.8	0.1	2.2	0.1
Dwelling Investment	-0.5	-1.0	-2.3	-0.1
Underlying Business Investment	0.5	2.0	7.5	0.3
Machinery & equipment	2.5	1.1	2.9	0.1
Non-dwelling construction	-1.4	3.6	12.0	0.2
New building	-0.3	0.1	11.0	0.0
New engineering	-2.3	6.3	12.7	0.2
Underlying Public Final Demand	1.2	1.5	4.5	0.4
Domestic Demand	**0.8**	**0.6**	**3.2**	**0.6**
Stocks (a)	-0.5	0.2	-0.2	0.2
GNE	**0.3**	**0.7**	**3.0**	**0.8**
Net exports (a)	**0.5**	**0.0**	**-0.4**	**0.0**
Exports	3.3	1.9	6.4	0.4
Imports	0.5	1.9	7.7	0.4
GDP	**0.9**	**0.6**	**2.8**	**0.6**

(a) Contribution to GDP growth

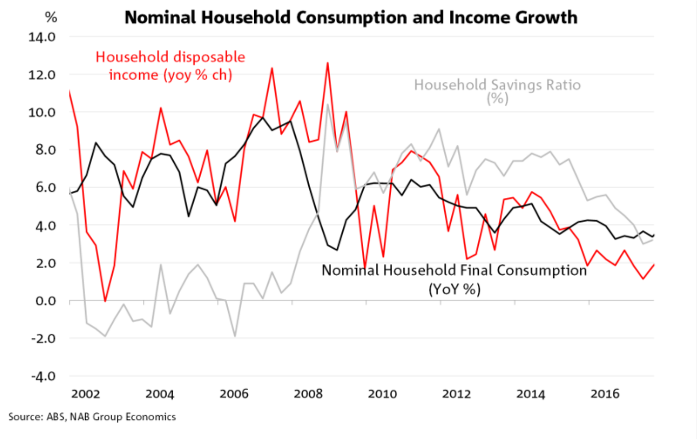




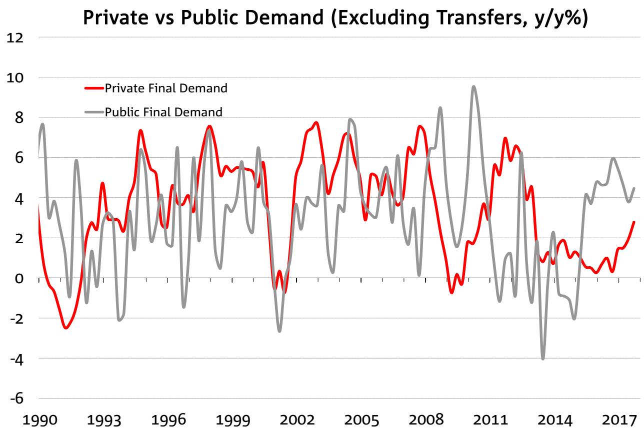




Income measures	qoq % ch		yoy % ch
	Jun-17	Sep-17	Sep-17
Real GDI	-0.4	0.5	5.0
capita	-1.2	0.4	2.9
Compensation of employees	1.2	1.2	3.0
Average compensation of employees	0.4	0.3	0.6
Corporate GOS	-2.0	1.0	15.5
Non-financial corporations	-3.4	1.0	17.8
Financial corpoarations	2.7	1.3	8.8
General government GOS	0.7	0.8	2.6
Productivity & unit labour cost			
GDP per hour worked	-0.4	0.0	0.1
sector	-0.2	0.0	1.0
Non-farm nominal unit labour cost	0.6	0.5	-0.1
Non-farm real unit labour cost	1.8	0.2	-2.9



EXPENDITURE COMPONENTS CONFIRM BUSINESS-HOUSEHOLD DIVIDE



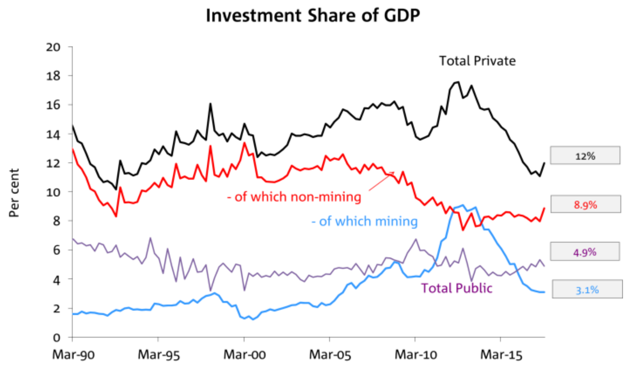
Household consumption growth was very muted in Q3 at just 0.1% qoq, which was even weaker than our already soft expectation of 0.3% and well down from 0.8% growth in Q2 to be 2.2% higher over the year in real terms (3.4% yoy in nominal terms). Retail consumption was relatively weak (outside of food) in the quarter, with cigarettes and alcohol doing particularly poorly. Meanwhile, spending on services was mixed with areas such as utilities as well as insurance & other financial services recording growth of over 1% q/q, while hospitality and recreation spending was down.

Over the past year, there has been particularly strong growth in insurance & financial services (+4.8% y/y), food (+4.3% yoy), communications (+4% y/y) and transport services (+3.2%). There are only very limited signs of strength in spending on discretionary items, with categories such as hotels, cafes and restaurants seeing a decline over the year (down 1.7%), somewhat strange given strength in tourism arrivals. Health and communications spending also fell in the quarter, which are quite rare occurrences and could well bounce back next quarter..

This quarter, household spending grew at a slower pace than disposable incomes (0.5% q/q, compared to 0.2% q/q for nominal household consumption), causing the household savings ratio to rise for the first time in over a year, to 3.2% from 3% in Q2 (see chart above).

Dwelling investment was down again in the quarter, falling 1%, continuing the trend that has seen investment fall 2.3% over the year. While weak results in previous quarters were partly put down to disruptive weather, the fall in Q3 could suggest that the housing construction cycle has peaked even sooner than what most were expecting. That said, new house building rose this quarter and it was a decline in alterations & additions/renovations (-4.8% q/q), that drove the fall in the quarter. The pipeline of construction also remains large and new building approvals have held up better than we had expected, meaning construction activity is likely to remain quite elevated.

In contrast to the falling trend in dwelling investment, **underlying private business investment** has been heading steadily higher – rising by 2% q/q, which was the fourth consecutive quarter of growth (up 7.5% over the year). Separately released data from the ABS shows that mining has become much less of a drag on investment, holding steady in Q2, although investment intentions do point to more falls ahead (yet the worst is clearly behind us).



Source: ABS, National Australia Bank

Meanwhile, NAB estimates suggest that non-mining investment growth was again solid in the quarter – consistent with persistent strength in business indicators such as the NAB Business Survey and a notable lift in measures of investment intentions. In terms of the components of business investment, private engineering construction saw solid growth of 6.3% in the quarter, which is likely seeing support from both infrastructure projects and some residual mining investment.

Non-residential building construction rose by only 0.1% in the quarter, but has seen very strong growth over the past year (up 11% y/y) –solid trends in non-residential building approvals suggest further growth over coming quarters. Meanwhile, machinery and equipment investment rose by 1.1%, which is a solid result, but softer than Q2.

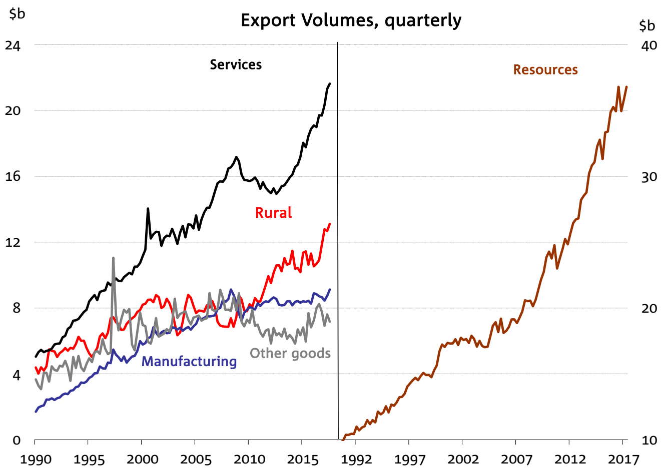
Government spending was much weaker in Q3, but that followed strong growth in the previous quarter and reflected the impact of second hand asset transfers to the private sector – the completion of the Royal Adelaide Hospital. Government consumption was up by only a modest 0.2% in the quarter, while headline public investment was down 7.5%, driven by state & local govt and public corporations. After accounting for second hand asset transfers, underlying public investment actually rose by a solid 7.4%. Both national defence spending and non-defence spending were up in the quarter. General government defence spending increased 3.7% q/q (defence investment up 5% and defence consumption up 3.3%). Non-defence national general government spending rose 0.3%.

The contribution from **inventories** to GDP in Q4 was 0.2 ppts. Most of the increase in private inventories during the quarter came from manufacturing, while mining inventories provided some offset.

Net exports were largely unchanged in Q3, making a flat contribution to GDP growth. Exports rose by a smaller-than-expected 1.9% q/q, with imports also expanding by the same growth rate.

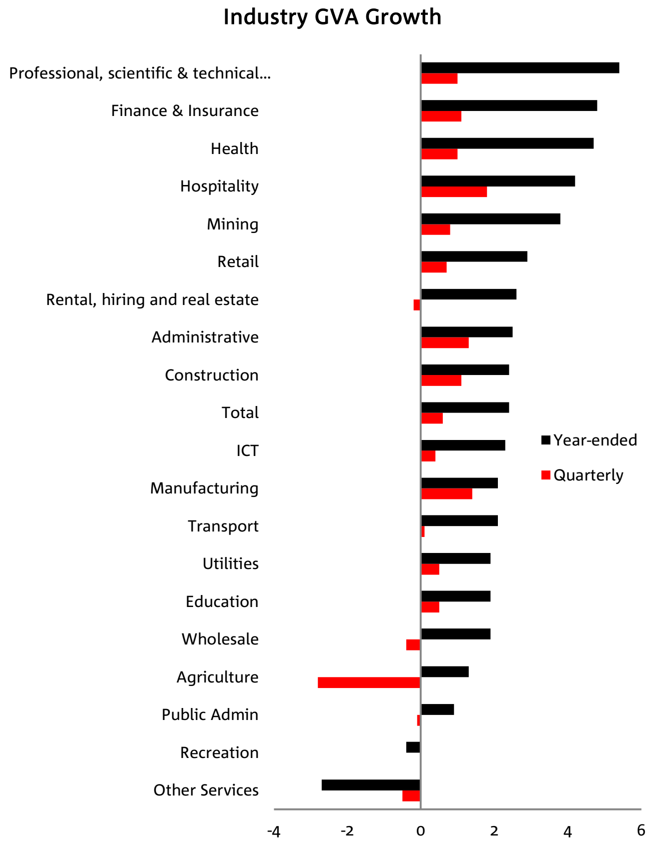
Goods exports rose 2.1%, as the volatile non-monetary gold component declined by 8.0% q/q, offsetting some of the strengths in other goods exports. Rural goods exports rose by a strong 3.5%, despite continued weakness in grains exports. Resources exports rose by 2.7%, as iron ore and coal exports continued to deliver, offset somewhat by the slower than expected ramp-up in LNG exports. Services exports were up by 1.5%.

On the imports side, goods imports rose by 1.8% q/q, while services imports rose by a stronger 2.2%. Consumption goods imports were weak at -1.1% q/q, while capital goods imports rose strongly, up 6.6%.



INDUSTRY DETAIL: REASONABLY BROAD BASED GROWTH WITH SERVICES LEADING

On a quarterly basis, accommodation and food services experienced the strongest growth, followed (perhaps surprisingly) by manufacturing, although the latter result largely reflected gains in sugar and meat processing. Meanwhile, agriculture was the weakest performer, declining 2.8% q/q. This result is not unexpected, given that last season saw the largest grain harvest in Australian history while this season has been much more mixed for grain growers. On an annual basis, all industries save for arts and recreation and other services were in positive territory. The strongest performers were generally focussed on service industries, although mining also grew strongly. Looking ahead, we see ongoing strength in non-discretionary services such as healthcare. Construction will also be an area to watch, as strong infrastructure investment (especially in NSW and VIC) will continue for some time. Agriculture is likely to remain weak in coming quarters, largely reflecting the unassailable record set last year.

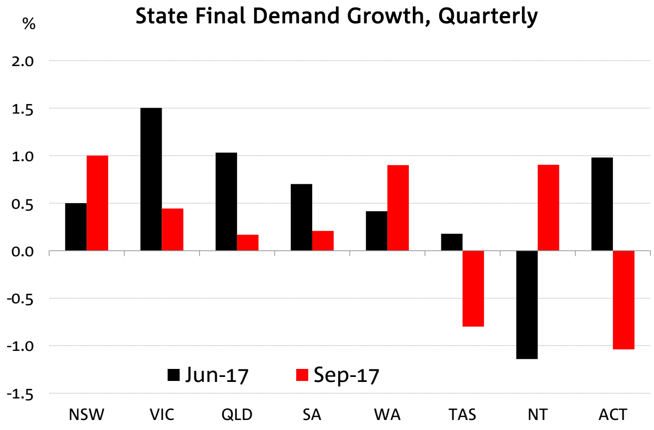


NSW LED THE GROWTH IN STATE FINAL DEMAND WHILE WA & NT ALSO STRENGTHENED

Domestic demand growth was the strongest in NSW, growing 1.0% q/q, to be 2.8% higher y/y. WA and NT also saw their state final demand expanded by 0.9% q/q. Growth slowed somewhat in VIC, QLD and SA, while falling into negative territory in TAS and the ACT.

NSW enjoyed broad based growth in the quarter. Public consumption and private investment were the biggest contributors to growth, driven by non-dwelling construction. VIC also enjoyed growth across the board. The increase in private investment was driven by non-dwelling construction but was offset by a fall in dwellings. TAS and the ACT had falling private and government consumption, while private investment held up.

Over the year, NT led the country in domestic demand growth (5.9% y/y) on the back of strong LNG investment. VIC and SA also enjoyed above average growth, at 4.7% and 3.9% respectively. While having recovered strongly, WA state final demand growth was the slowest across the country at 1.3% y/y.



State final demand

State/ Territory	Q/Q Jun-17	Q/Q Sep-17	Y/Y Sep-17
NT	-1.1	0.9	5.9
VIC	1.5	0.4	4.7
SA	0.7	0.2	3.9
NSW	0.5	1.0	2.8
QLD	1.0	0.2	2.7
TAS	0.2	-0.8	2.2
ACT	1.0	-1.0	1.7
WA	0.4	0.9	1.3

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