AUSTRALIAN ECONOMIC UPDATE

GDP Q4 2017 – a mixed bag

NAB Group Economics

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Bottom line: Australia recorded subdued economic growth in Q4, with the detail painting a mixed picture. On the upside, net exports should bounce back and the decline in business investment is not as troubling as it initially appears. Household consumption was particularly strong, although we question whether this pace can be sustained. Measures of wages were again weak, despite strong employment, as was labour productivity, both elements of the growth outlook which we would like to see improve. The data don't change our view that economic growth will pick up to around 3% by end-18 on the back of LNG exports, business and government investment. While this is good news, there is little to imply a sustained pickup in consumer spending and inflation - the RBA will remain on the sidelines for now.

- **Australian GDP growth disappointed in the final quarter of 2017,** easing to 0.4% q/q in real terms (Mkt: 0.5% q/q and NAB: 0.7% q/q). This saw the year-ended rate of growth dip down to 2.4% y/y.
- **The most encouraging aspect of the data was a rebound in household consumption** (+1.0% q/q), despite a small rise in the household savings ratio to 2.7% (from 2.5%). That said, while labour income was strong thanks to strong employment growth, the national accounts measure of average earnings was flat - this will continue to limit consumer spending through 2018, particularly given a less supportive wealth effect as housing prices cool.
- Meanwhile, **the decline in business investment is not quite as disappointing as it first appears.** In underlying terms (excluding transfers) business investment was down 1%, largely driven by a fall in engineering construction, which was concentrated in the NT and likely reflects the lumpy profile of LNG investment projects. Meanwhile, non-residential building was up 3.3% and machinery & equipment investment increased by 3% in underlying terms, the fourth consecutive increase. Government investment declined in the quarter in underlying terms, but remains higher over the year and will remain a key source of growth going forward. The small decline in dwelling investment meanwhile was unsurprising, having peaked in late 2016.
- **Net exports subtracted a large 0.5ppt from growth,** driven in large part by lower rural, coal and services exports, as well as stronger imports which was broadly consistent with decent domestic demand growth. Net exports should turn around in coming quarters as LNG exports ramp up.
- The state and industry detail was a little varied, but mostly consistent with a broadening recovery (see below).
- The RBA will likely look through some of the volatility and one-offs in these figures and retain a (somewhat) optimistic outlook for the Australian economy. However there was little to alleviate concerns about household spending and incomes, or suggest a sustained uplift in wages and inflation. Expect the RBA to remain on the sidelines until late this year.

HIGHLIGHTS

- **On the expenditure side,** household consumption added strongly to growth, more than offsetting the large subtraction from net exports. Business investment fell modestly, as did dwelling construction and government investment (in underlying terms), while government consumption was solid. Inventories were neutral for growth. The statistical discrepancy added 0.2ppts – indeed the expenditure (E) measure of GDP was weaker than the income (I) and production(P) measures in both quarterly and year-ended terms (see tables on page 2).
- **By industry**, gross value added down in 6 of the 19 groupings in the quarter, which does not gel with the broad-based strength in business conditions in the NAB business surveys. However in year-ended terms growth was positive in all industries except wholesale, other services and agriculture. Services industries outperformed in the quarter. Agriculture declined again, as did transport, utilities, manufacturing and admin services. On a year-ended basis, hospitality, health and construction were the top performers.
- **By state,** final demand growth improved in the ACT, NSW, QLD, SA and TAS but slowed in Vic and declined in WA and the NT. In year-ended terms, all states and the ACT reported stronger domestic final demand, although it remains weak in WA. While NT domestic demand fell, the decline in private investment was likely associated with the Icthys LNG construction and therefore temporary.
- **Income measures** such as real gross domestic income were broadly in line with real GDP growth in Q4 thanks to the terms of trade broadly stabilising, although declined in per capita terms and have slowed through the year. Labour income (compensation of employees) was up 1.1% q/q, although this was entirely driven by employment (hours worked), with average earnings flat at 0.0% q/q and 1.6% y/y. Growth in corporate profits (GOS) eased a touch to +0.6% q/q and 4.1% y/y. **Labour productivity declined** in the quarter, with hours worked outpacing economic growth.

Key figures

Key aggregates	q/q % ch		y/y % ch
	Sep-17	Dec-17	Dec-17
GDP (A)	0.7	0.4	2.4
GDP (E)	0.7	0.1	1.8
GDP (I)	0.7	0.6	2.6
GDP (P)	0.6	0.4	2.7
– Non-Farm GDP	0.9	0.4	2.7
– Farm GDP	-6.5	-3.3	-10.0
Nominal GDP	0.7	0.8	3.5
Real gross domestic income	0.7	0.3	2.1
Real net national disposable income per capita	0.6	-0.3	0.0
Terms of trade	-0.2	0.1	-1.0

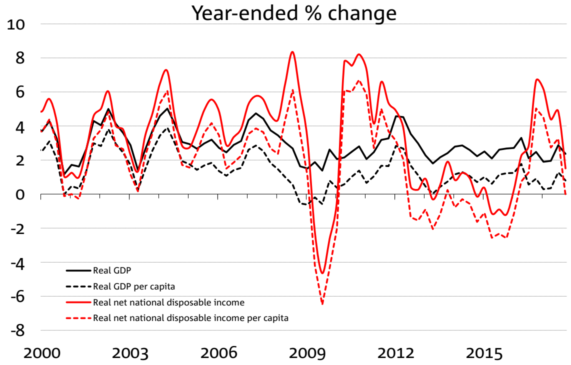
GDP (E) by component

GDP Expenditure Components	q/q % ch		y/y % ch	Contribution to q/q % ch
	Sep-17	Dec-17	Dec-17	Dec-17
Household Consumption	0.5	1.0	2.9	0.6
Dwelling Investment	-1.7	-1.3	-5.8	-0.1
Underlying Business Investment^	3.2	-1.0	5.8	-0.1
Machinery & equipment	2.6	3.0	8.4	0.1
Non-dwelling construction	5.0	-4.5	4.6	-0.3
New building	3.3	3.3	12.3	0.1
New engineering	6.4	-10.3	-1.2	-0.4
Underlying Public Final Demand	1.6	1.1	4.9	0.3
Domestic Demand	**0.9**	**0.6**	**3.1**	**0.6**
Stocks (a)	0.1	0.0	-0.1	0.0
GNE	**1.0**	**0.6**	**3.0**	**0.6**
Net exports (a)	**-0.2**	**-0.5**	**-1.3**	**-0.5**
Exports	1.2	-1.8	0.8	-0.4
Imports	2.2	0.5	6.6	0.1
GDP	**0.7**	**0.4**	**2.4**	**0.4**

(a) Contribution to GDP growth ^ Excluding transfers between the private and public sector

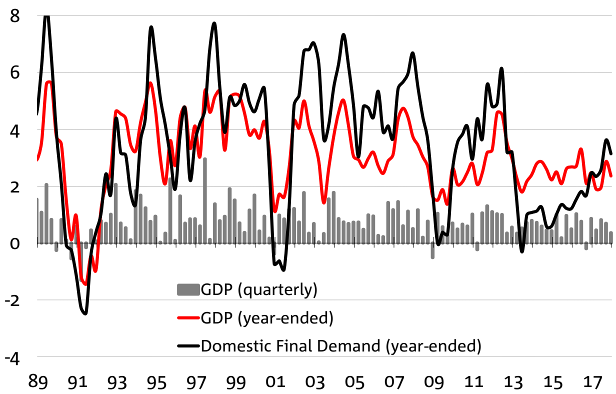
GDP and national income growth

Year-ended % change



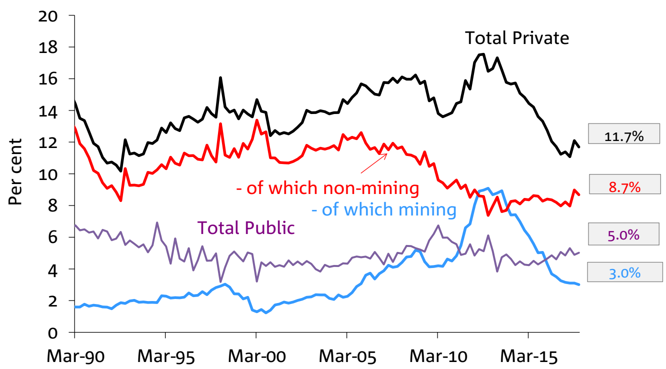
Income measures	q/q % ch		y/y % ch
	Sep-17	Dec-17	Dec-17
Real GDI	0.7	0.3	2.1
Real net disposable income per capita	0.6	-0.3	0.0
Compensation of employees	1.5	1.1	4.8
Average compensation of employees (average earnings)	0.6	0.0	1.6
Corporate GOS	1.2	0.6	4.1
Non-financial corporations	1.2	0.6	3.0
Financial corpoarations	1.3	0.6	7.7
General government GOS	0.8	0.7	2.8
Productivity & unit labour cost			
GDP per hour worked	-0.4	0.0	0.1
GVA per hour worked mkt sector	-0.2	0.0	1.0
Non-farm nominal unit labour cost	0.6	0.8	2.0
Non-farm real unit labour cost	0.5	0.5	1.1

Real GDP and domestic demand



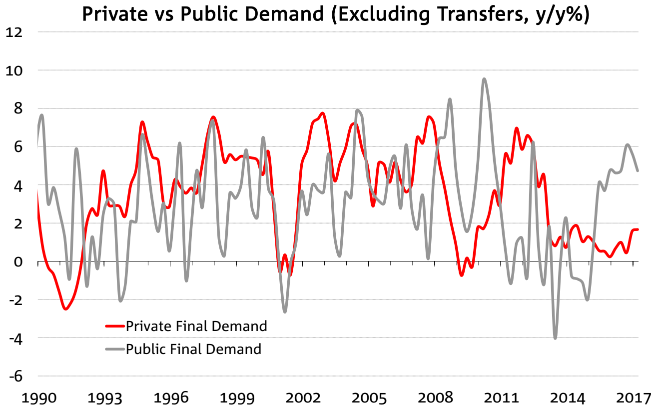
Source: ABS

Investment Share of GDP

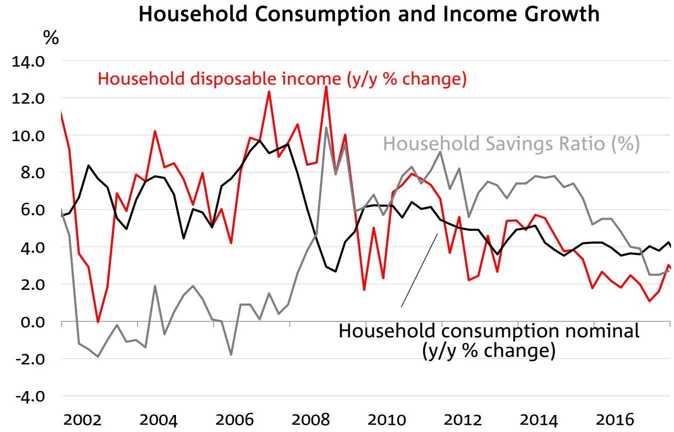


Source: ABS, National Australia Bank

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



Household Consumption and Income Growth



Source: ABS, NAB Group Economics

EXPENDITURE COMPONENTS - REVERSAL OF BUSINESS-HOUSEHOLD DIVIDE

Household consumption growth was a strong 1.0% q/q in line with our expectations. There was also a large revision to the previous quarter's growth from 0.1% q/q to 0.5% q/q.

The step up in growth was driven by growth in discretionary goods and services consumption. In particular, consumption was above 1% q/q in clothing & footwear, furnishings & household equipment, recreation & culture, and hotels, cafes and restaurants.

In contrast, growth in spending on 'essential' items was a bit slower compared to last quarter. This was despite a large 3.4% q/q rise in health services as electricity, gas & other fuel consumption recorded a large fall (3.1% q/q) – suggesting that consumers are adjusting to the rise in utility prices – as did food (-0.7%) and growth in education services and insurance & other financial services moderated.

Despite the strength in consumption, household spending grew at a slower pace than disposable incomes (1.6% q/q compared with nominal consumption growth of 1.4% q/q). As a result, the household savings ratio increased for the first time since early 2016 (see chart above).

Dwelling investment declined for the second consecutive quarter by 1.3% q/q, and is down by 5.8% over the year. This provides further evidence that the housing construction cycle has peaked. In contrast to Q3, the decline was due to new house building (-2.5% q/q) with alterations & additions/renovations (1.3% q/q) reversing some of the previous quarter's decline. That said, the construction pipeline remains elevated; while new building approvals have come off their peak, they remain at high levels with no clear downwards trend.

There was a pause in the upwards trend in **underlying private business investment** in the quarter; it fell by 1% q/q, following a large rise in Q3 of 3.2% q/q. However, it is still up 5.8% over the year.

The decline in underlying business investment reflected a large fall in new engineering construction of 10.3% q/q. As a result overall non-dwelling construction fell 8% q/q although some of the weakness was due to asset transfers and on an underlying basis the fall was a smaller -4.5% q/q. Moreover, a significant proportion of this appears to be due to a large fall in non-dwelling construction investment in the Northern Territory, which likely reflects the timing of imports of LNG facilities.

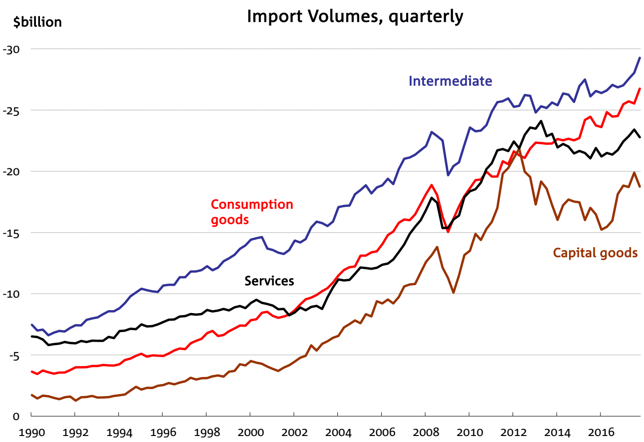
In contrast, there was another strong (3.0% q/q) rise in underlying machinery and equipment investment the fourth consecutive quarter of growth. As a result, there has been very strong growth over the past year (up 8.4% y/y).

Separately released data from the ABS shows that mining investment, after holding steady in Q3, again fell in Q4 and investment intentions point to more falls ahead. However, on a y/y basis the drag from mining investment has slowed.

Government spending recovered in Q4 after declining in Q3. However, the Q3 weakness reflected the impact of second hand asset transfers to the private sector. Allowing for this, underlying public demand growth moderated from 1.6% q/q in Q3 to a still solid 1.1% q/q in Q4, due to a fall in underlying public investment. In contrast government consumption was a strong 1.7% q/q with both national defence spending and non-defence spending growth strong (2.3% q/q and 3.3% q/q respectively).

Inventories were effectively a neutral factor in Q4 as there was only a marginal rise in inventory accumulation. A rise in mining inventories was offset by falls in other categories, in particular in retail trade and farm inventories.

Net exports detracted a smaller-than-expected 0.5 ppts from GDP growth in Q4, after Q3 was also revised down (-0.2 ppts from flat contribution). Exports were down 1.8% q/q and imports rose by 0.5% q/q.



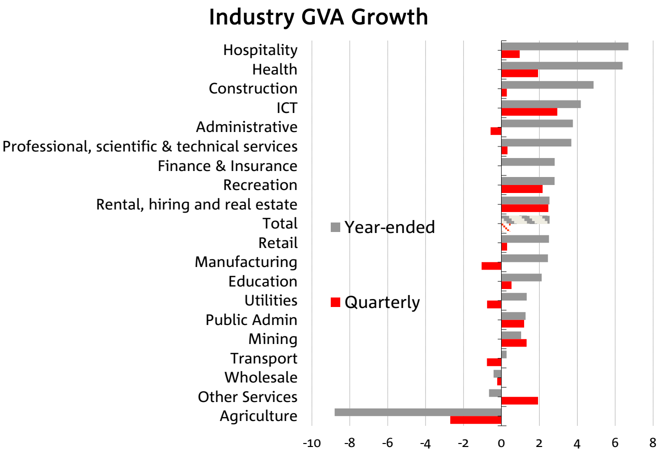
Both goods and services exports weakened. Rural goods exports were 9.7% lower q/q, weighed down by falls in wheat exports and unseasonably low fruit & vegetable and canola exports. Coal exports were also weaker, due to temporary supply disruptions. Services exports were 1.9% lower q/q.

The rise in imports was driven by strong growth in consumption and intermediate imports, a sign that domestic consumption has been improving. On the other hand, capital goods and services imports fell.

SERVICES INDUSTRIES OUTPERFORMING WITH AGRI LAGGING

On a quarterly basis, ICT experienced the strongest growth, following a decline in Q3. It was followed by rental hiring and real estate services (which also had a decline in the previous quarter) and arts & recreation. Healthcare and other services also outperformed. Meanwhile, agriculture was again the weakest performer, marking its third consecutive quarterly decline amid unfavourable seasonal conditions. Transport, utilities, manufacturing and admin services also declined during the quarter.

Compared to a year ago, all industries expanded, apart from wholesale, other services and agriculture. Services industries dominated the league table, with hospitality, health, construction and the ICT leading the expansion, another sign the domestic economy has been improving. 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.

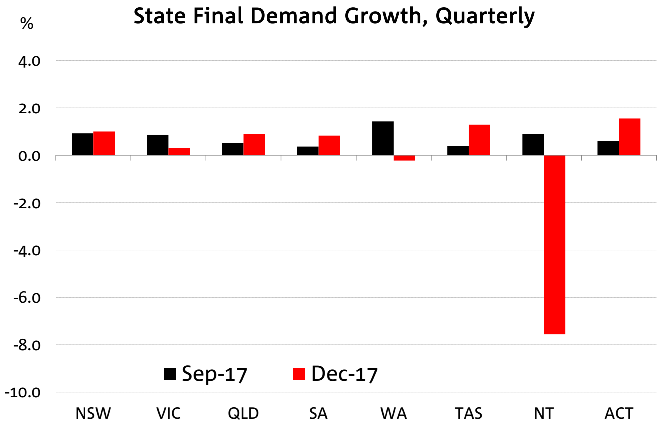


ACT LED IN STATE FINAL DEMAND GROWTH WHILE WA & NT CONTRACTED IN Q4

The ACT led the country in domestic demand growth in Q4. After four consecutive quarters of expansion, ACT's domestic demand was 5.0% higher in y/y terms. TAS and NSW also reported strong growth in Q4, expanding by 1.3% and 1.0% respectively.

On the other hand, WA domestic final demand decreased by 0.2% q/q, driven by a fall in non-dwelling construction. Domestic demand declined by the most in the NT in Q4 (-7.6% q/q and -3.1% y/y). The largest detractor from growth was private capital investment driven by non-dwelling construction, despite a healthy increase in household consumption, which likely relates to the lumpy profile of LNG investment projects in the state.

The numbers also show a broadening in growth over 2017, with all states and the ACT reporting higher final demand compared to a year ago. The ACT led the country (with domestic demand 5.0% higher y/y), followed by SA (4.9%), TAS (4.8%) and VIC (4.4%). The large fall during the quarter in NT private investment saw its final demand 3.1% lower than Q4 2016. Overlooking the temporary decline though, NT's domestic demand in annual average terms in 2017 was an impressive 4.6% higher than in 2016.



State final demand

State/ Territory	Q/Q Sep-17	Q/Q Dec-17	Y/Y Dec-17
ACT	0.6	1.6	5.0
SA	0.4	0.8	4.9
TAS	0.4	1.3	4.8
VIC	0.9	0.3	4.4
NSW	0.9	1.0	3.0
QLD	0.5	0.9	2.6
WA	1.4	-0.2	1.2
NT	0.9	-7.6	-3.1

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