

Crunch time for the Australian economy

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Key points

- > With the fading of the mining investment boom, the Australian economy is in for a bumpy ride in the short term, but recession is likely to be avoided.
- > More interest rate cuts and a lower \$A are likely to be required though, ultimately resulting in more balanced and stronger growth for the Australian economy in 2014.

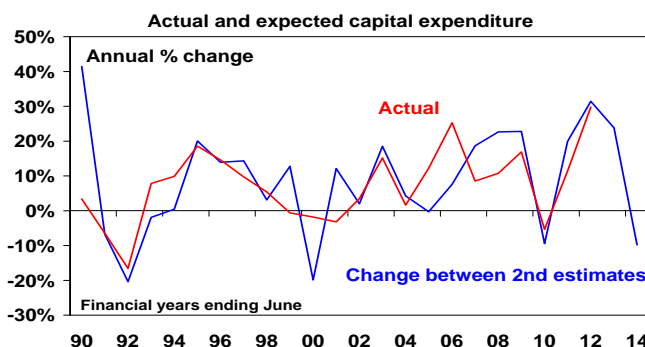
Introduction

Since around August/September last year, when the iron ore price fell sharply and mining companies started cutting investment projects, a cloud has been hanging over the Australian economy. In the last month or so it seems the cloud has got darker. It is increasingly clear China is not growing like it used to be, the mining investment boom has peaked and the rest of the economy has been slow to respond to lower interest rates. The need to transition from growth largely driven by the mining investment boom to more broad based growth is now upon us. Some even talk of recession. But how serious are the risks? And what does it mean for investors?

State of play

March quarter GDP data showed economic growth has fallen to 2.5%, which is well below trend (of around 3-3.25%). But more significantly, demand in the economy has fallen for two consecutive quarters as a result of subdued consumer spending, subdued housing investment and falling business investment. Were it not for a bounce in exports and fall in imports, the economy would be in recession.

Recent business investment data suggests mining investment may have peaked during the second half of last year. Comparison of the latest estimate of investment from Australian business' for the year ahead with the corresponding estimate a year ago, points to a fall in investment for the first time in four years.



Source: ABS; AMP Capital

It's now 19 months since the RBA first started cutting interest rates and it is quite clear that the response to date has been sub par. The next table shows the level or percentage gain in

key economic indicators 19 months after the first rate cut for the current and last three interest rate cutting cycles.

Key variables, 19 months into rate cutting cycles

Variable	July 1996	Feb 2001	Sept 2008	Avg	Latest
NAB biz confidence, index level	+5.7	+12.6	+16	+11.4	-1
Consumer conf, index level	108.7	106.6	116.1	110.5	102.2
Retail sales, % gain since first cut	+5%	+10%	+7.4%	+7.6%	+4.6%
Home approvals, % gain since first cut	+18%	+53%	+33%	+35%	+15%
Auction clear rate, % – Syd, 4 wk avg	NA	NA	69.6%	NA	73.0%
Auction clear rate, % – Melb, 4 wk avg	NA	NA	77.9%	NA	67.5%
Home prices, % gain since first cut	+14%	+32%	+14%	+20%	+0.7%
Employment, % gain since first cut	+2%	+3%	+1.7%	+2.2%	+2.0%
Private credit, % gain since first cut	+16%	+17%	+2.8%	+12%	+4.8%

Source: NAB; Westpac/Melbourne Institute; ABS; Australian Property Monitors; RP Data/Rismark, RBA, AMP Capital

Most variables are up from their lows but, apart from auction clearance rates and employment, remain below the average levels they attained this far into past easing cycles.

The risk case – recession & housing collapse

The current situation is leading some to talk of recession and fears of a scenario that has often been referred to by foreign commentators on Australia. Essentially, it's argued that Australia has been propped up by a huge mining boom which boosted national income and in turn underwrote a boom in residential property prices. With the mining boom fading, it's argued the economy will collapse and unemployment will surge triggering a sharp increase in mortgage delinquencies and a collapse in house prices. Ultimately leading to huge problems for the banks.

This scenario is plausible, but how realistic?

Recession is a risk, but as there is still plenty of scope for lower interest rates and a lower \$A to boost the economy we think it will be avoided. Just as high interest rates and a high \$A put many non-mining sectors of the economy into hibernation over the last few years to make way for the mining boom, this will now go in reverse allowing the pressure to come off these sectors and the economy to return to more balanced growth in 2014, led by the laggards of the last few years such as housing, retailing and domestic tourism. This is actually good news. As a result we put the risk of recession – in the absence of a sharp global slump, which seems unlikely – at a significant but low 15-20%.

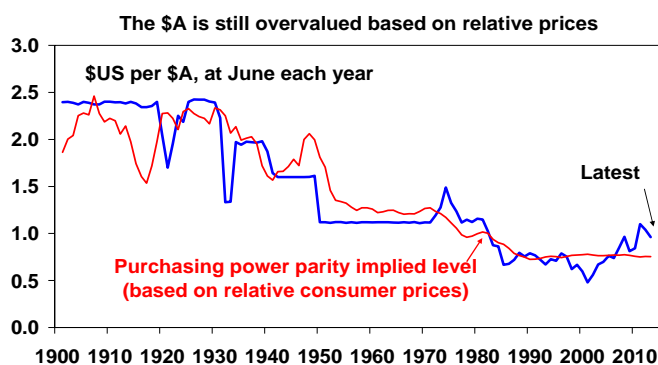
There are only a few levers that policy makers, ie, the RBA and the Government, can pull to help the economy in the short term – in fact in Australia (given we have a floating exchange rate) they are just fiscal policy (via the budget) and monetary policy (via interest rates).

Right now there is not much willingness to embark on fiscal stimulus, so that leaves lower interest rates. But is cutting

interest rates counterproductive because it simply takes money from depositors to give to debtors? I say no. Interest rate cuts help household demand in two ways. First, the Australian household sector owes way more to banks (around \$1.7 trillion) than it has in deposits (around \$0.75 trillion). So the savings on debt interest payments from lower interest rates are much greater than the loss of interest on deposits. Secondly, the spending of depositors such as self funded retirees tends to be far less sensitive to changes in their disposable cash flows than borrowers, particularly young families. Sure, initially when rates come down debtors tend to just increase their principal payments but eventually they start to spend some of their savings.

On top of this, lower interest rates help by lowering corporate borrowing costs and forcing investors into more risky assets that help the flow of funds through the economy. Lowering interest rates has the added advantage that it makes Australia a less attractive destination for capital inflows, leading to a lower \$A which is now starting to occur. And a lower \$A helps boost the competitiveness of industries like manufacturing, domestic tourism, agriculture, mining, etc.

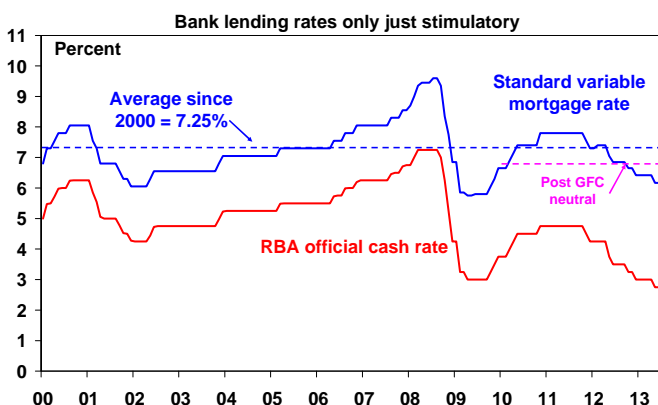
The high and rising \$A was less of an issue when national income was surging on the back of rising commodity prices, but it is now a big issue as commodity prices are trending down and the mining investment boom is fading. Our rough estimate is that to offset the relatively high prices and costs in Australia the \$A needs to fall to around \$US0.75-\$US0.80.



Source: Global Financial Data, Bloomberg, AMP Capital

There are always long lags in monetary policy but several factors have slowed the impact this time. Firstly, households became a lot more cautious from around 2010 and so the neutral interest rate, ie the rate of interest where the economy neither speeds up or slows, has likely fallen.

Second and related to this, the RBA was initially too slow to cut rates and it was only late last year they fell into stimulatory territory.



Source: RBA, AMP Capital

Third, the banks did not pass on the full amount of the initial interest rate cuts in order to maintain higher deposit rates to boost their funding reliance on deposits.

Finally, the \$A remained strong, partly because interest rates were too high. This left big chunks of the economy uncompetitive and struggling.

Given all these factors it's not surprising the response in the economy so far has been mediocre. But it is not true to say there has been no response. First we don't know how much worse things would have been were it not for the RBA's rate cuts. But more importantly home buyer demand has picked up, finance to buy homes has picked up and approvals to build new homes has also improved recently. This should all lead to a pick up in housing construction activity and increased retail spending over the year ahead.

However it's likely the RBA still needs to do more to reduce the cost of borrowing, as bank lending rates are arguably still not low enough if equilibrium levels for interest rates have fallen. Moreover lower rates are needed to ensure that the \$A continues to fall. We expect the RBA to cut the official cash rate to 2.5% in July/August and to 2.25% in September/October and for the \$A to fall to around \$US0.80 over the next few years.

After years of under building, running at around 30,000 dwellings a year, there is significant scope for housing construction to pick up. Similarly, a sharply lower \$A should allow sectors like domestic tourism, higher education and parts of manufacturing to start growing again. This along with a pick up in consumer spending should see growth start to gradually pick up as we go into next year, but possibly after a slowdown to 2% growth through the second half of this year.

This should be enough to avert recession and the much talked about house price collapse. Australian house prices are still overvalued suggesting significant risk. But the risks of a house price collapse are ameliorated to some degree by significant undersupply, low loan to valuation ratios, the absence of any deterioration in lending quality and full recourse loans providing a strong incentive to service them. Bubble like conditions in the housing market were evident, but mostly a decade ago! The most likely scenario for house prices remains continued modest gains over the year ahead reflecting improved affordability but within the context of an extended period of range bound prices in real terms.

What does it all mean for investors?

There are a number of implications for investors:

- Interest rates need to fall further and this in turn will drag bank term deposit rates decisively below 4%.
- Falling short term interest rates will help limit a back up in Australian bond yields being driven by higher global bond yields. Favour Australian bonds over global bonds.
- As the Australian dollar continues to trend down, unhedged international equities will outperform.
- The relative underperformance of Australian versus global shares even in local currency terms may have further to go in the short term, given the short term economic uncertainty about the end of the mining boom.
- However, Australian shares are still likely to end the year higher helped by a combination of low interest rates helping high yield stocks and as lower interest rates and a lower \$A drive improved expectations for profits.

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