The View From The Outer

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EVANS & PARTNERS

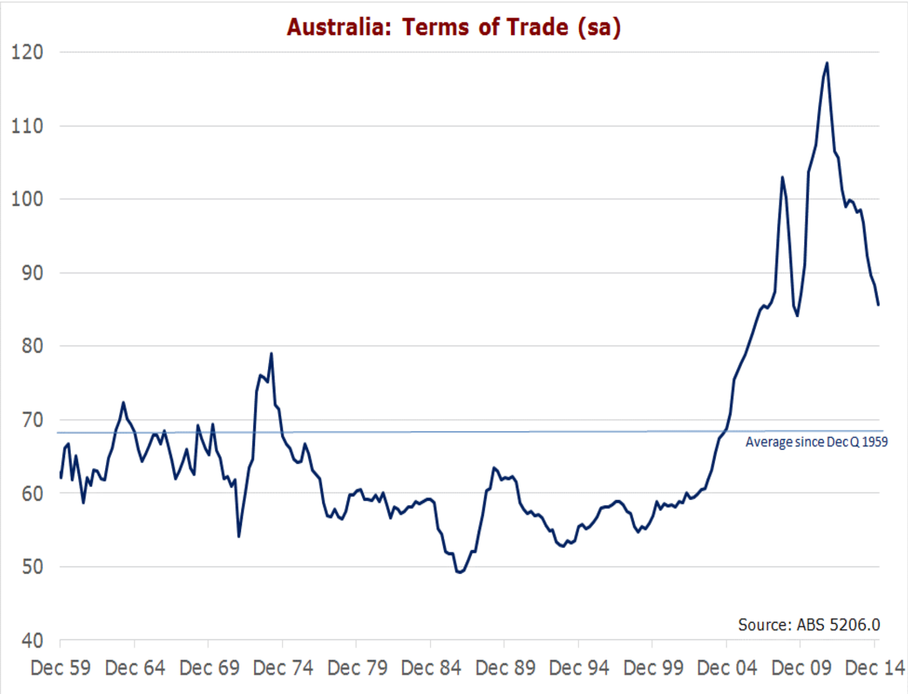
The subdued outlook for growth

Post the March quarter National Accounts, we review the outlook for growth. Viewed in isolation, the 0.9% real seasonally adjusted increase in GDP in the March quarter might look a good result. It does not take much digging into the detail to uncover a less ebullient perspective; indeed, even that 0.9% increase in the March quarter left growth on year earlier levels at a subdued and sub-trend 2.3%

Inventory Accumulation contributed 0.3% of the 0.9% increase, while Domestic Final Demand was flat. Export volumes in the March quarter were strong (+5.0%); underpinning a 0.5% Net Export contribution to quarterly GDP growth. Even that may have been flattered due to less than normal weather related disruptions to export shipments. The commodity price driven weakness in the Terms of Trade, however, dragged down growth in Real Gross Domestic Income in the March quarter to +0.2% and -0.2% on year earlier levels.

We view the ABS Trend Estimate of GDP, growing by 0.6% in the March quarter and by 2.2% over year as a reasonable read through on how the economy is currently tracking.

Understanding the inevitable cross-currents in Australia's latest National Accounts essentially returns to understanding the impact of collapsing commodity prices and the monetary policy response they have enabled in our current low interest rate world.



The Terms of Trade fell a further 2.9% in the March quarter and by 11.4% on year earlier levels. After the largest commodity price boom and boost to national income in over a hundred years, the Terms of Trade have now fallen 27.7% from the peak in the September quarter 2011. They are still 24% above the longer term average (see chart left).

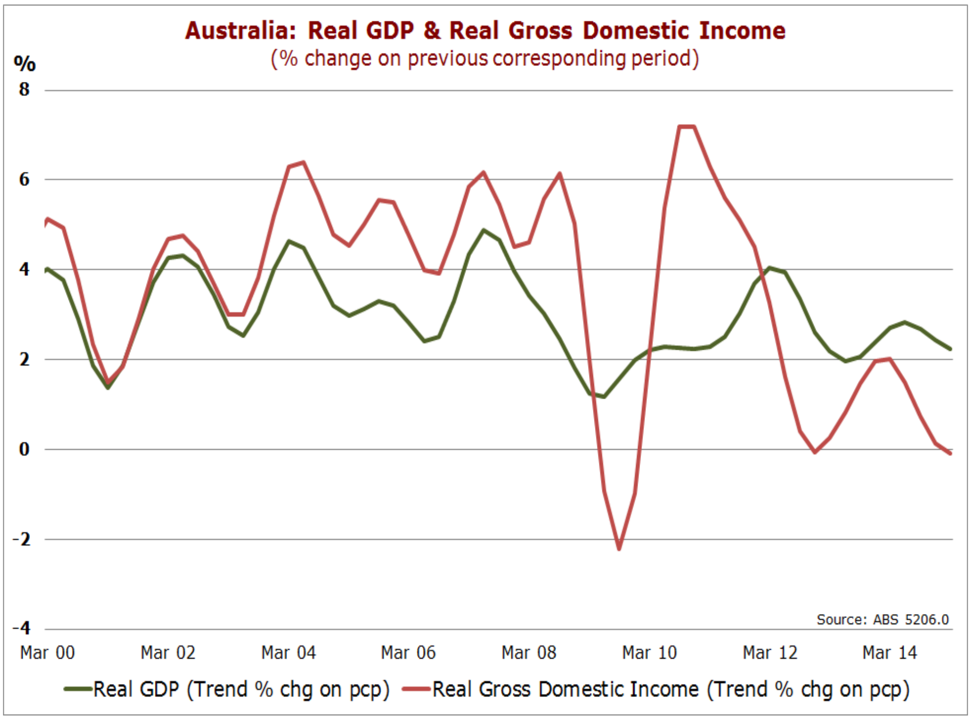
We expect the Terms of Trade to decline further, reflecting weakness in the demand side from China's industrial and property sectors. Together with excess supply in the bulk commodities and the unrelenting downward pressure on production costs, the poor price outlook remains intact.

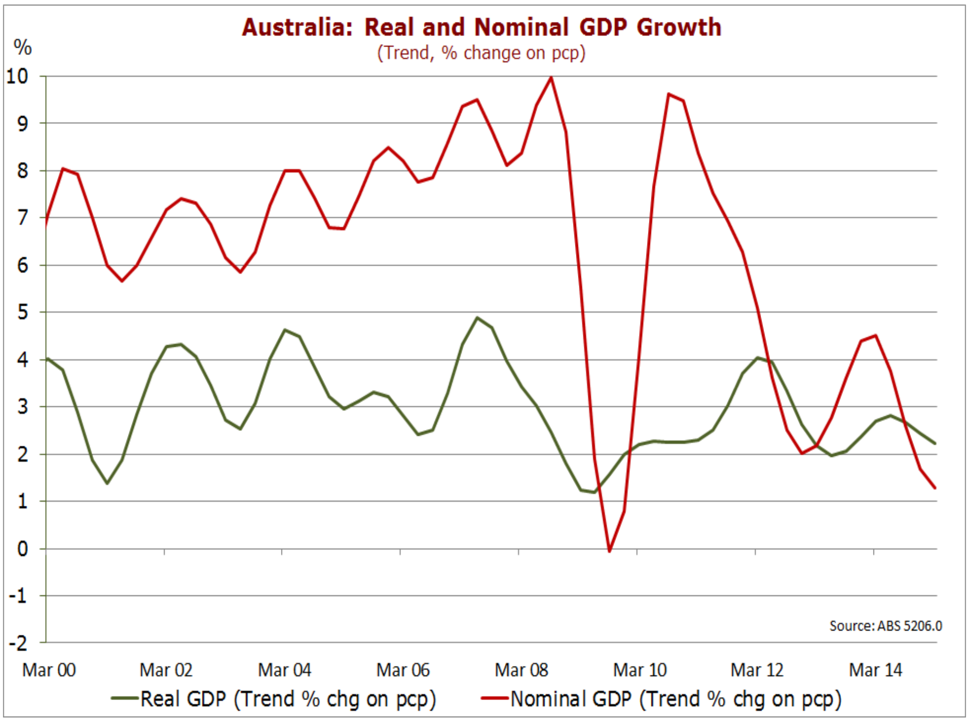
We are surprised however, by the recent resilience of the spot iron ore price above $US60 per metric tonne. We expect the apparent disconnect between the recent pricing of China steel (weaker) and the major input, iron ore (stronger) to be resolved by iron ore price weakness. Were this not to be the case it would be supportive of national income, Budget revenues ($US48/MT assumed in the Budget papers) the diversified miners and all else equal the Australian dollar.

The impact of the rapidly rising Terms of Trade through the 2000's is apparent in the chart right.

Real Gross Domestic Income (GDI) growth is substantially stronger than Real Gross Domestic Production growth, but also supports strong GDP growth.

As the Terms of Trade started to decline from late 2011, growth in Real GDI slowed sharply, falling below Real GDP growth and subsequently constraining economic growth. (See chart right).





This is also reflected in the recent sharp slowing in nominal GDP growth shown in the chart at left.

The ABS Trend measure of Nominal GDP growth peaked at 10.0% in the year to the September quarter 2008. Over the year to the March quarter 2015 it increased by a mere 1.3%.

Weak nominal GDP bears down on nominal wages growth (the Wage Price Index +2.3% over the year) household income growth and domestically sourced profits.

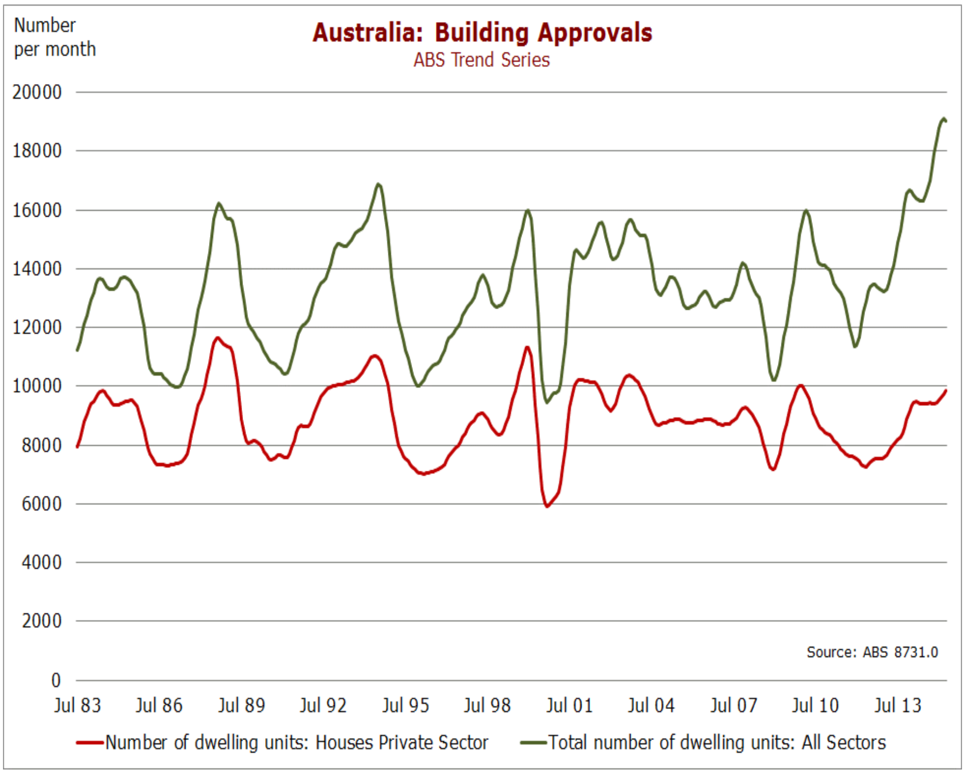
In this context, Real Household Consumption Expenditure at +2.6% is growing as well as could be expected.

To be fair, monetary policy is working in the areas it is reasonable to expect its impact to be most obviously manifested.

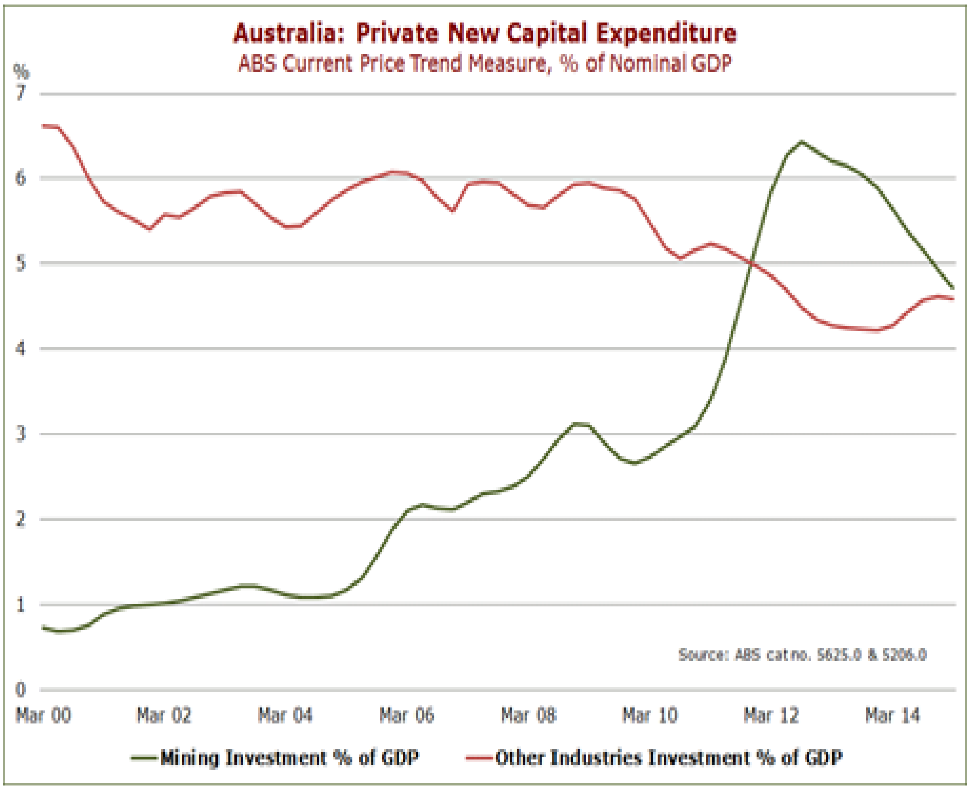
House prices have been rising, although not universally (and more recently unduly concentrated in parts of the Sydney and Melbourne markets).

Building Approvals are booming. While driven by multi-unit dwellings and apartments, the ABS Trend Estimate, currently running at an annualised 228,000 in April is 38% above the average rate since January 2000.

ABS Retail data and anecdotal evidence from Harvey Norman, Bunnings and others suggests retail areas related to housing have been very strong.



Lower rates may also have been supporting consumption via increased confidence or wealth effects, although the extent of this is uncertain. The Household Savings Ratio fell by 0.5% in the March quarter and by 1.3% over the year to 8.3%. The household sector, however, is a net saver. It may also be that very low interest rates have led to an increased propensity to run down savings to maintain consumption.



From a monetary policy perspective, there seems, at best very little to be gained via a further reduction in rates from the household sector.

Nor does it seem reasonable to expect much change in Business Investment Intentions from the first round effect of a reduction in financing costs. The issue here is the outlook for returns, rather than interest expense.

The decline in Mining Investment is broadly locked in by the dramatic change in commodity prices and the extraordinary peak from which it is now declining.

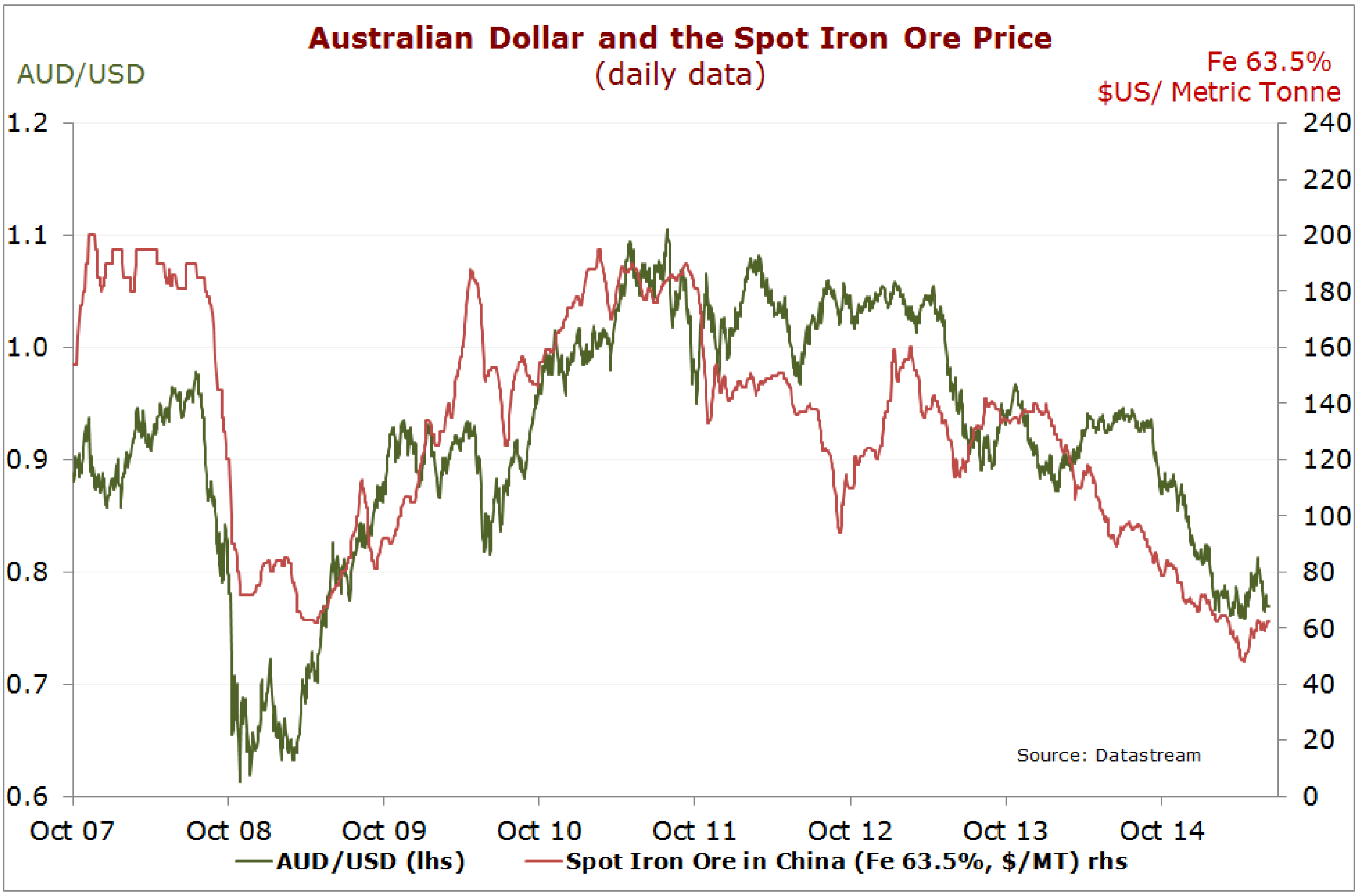
For Non-mining Investment, what is required is a better outlook for profitability based on a quantum shift in competitiveness. Absent an unexpected surge in productivity growth, this is most likely to occur via currency weakness.

The RBA Governor Glenn Stevens observed in a speech on 10 June, 2015: *"We remain open to the possibility of further policy easing, if that is, on balance, beneficial for sustainable growth."*

As we have noted previously, the subdued growth and inflation outlook are not an impediment to further easing, but to our mind there would be little to be gained from a further easing except to the extent it aided the required adjustment in the exchange rate. As we have seen so far this year, superficially at least, two easings in monetary policy (in February and May) have delivered little in this regard. The RBA TWI today is only 3% below the level at the end of 2014.

Fortunately, we expect two key drivers to work towards a lower Australia dollar over the second half of the year. Firstly, regardless of whether the Fed commences a gradual tightening of monetary policy at the September, October or December FOMC meeting, we expect sufficient strength in the US economy from mid-year to support a stronger US dollar. Secondly, as noted earlier (page 2), the spot iron ore price looks ripe for correction and should also push the AUD/USD lower. (See chart below). Yes an implicit bias to ease is seemingly in place at the RBA, but we view monetary policy as on hold until at least August.

By that stage, the AUD/USD should be weakening enough to allow the RBA to leave rates unchanged.



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