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The Australian economy – looking beyond the gloom

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Key points

> While headline news regarding the economy has been bleak, December quarter GDP showed the economy is not collapsing and lower interest rates & the lower $A do seem to be boosting forward indicators for the economy.

> As a result growth should pick up to around 3% by year end which should help profit growth continue to improve.

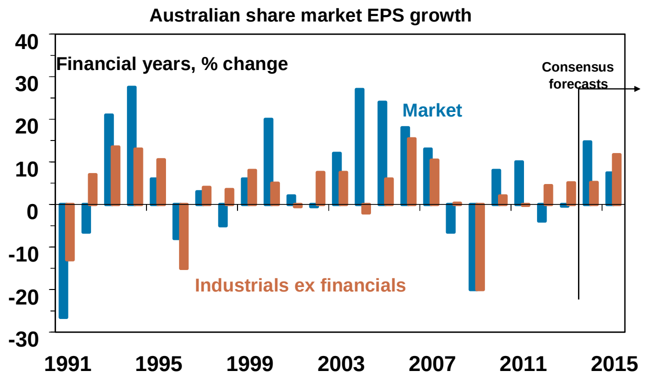
> Improving growth but from a soft base is likely to see interest rates remain on hold for an extended period.

Introduction

February seemed full of bad news in Australia with layoffs coming from various companies including Toyota, Alcoa and Qantas, unemployment rising to 6% and very poor business investment intentions. And yet, the share market rose 4.2% last month and has had two good years and December quarter GDP growth even perked up a bit. So is the outlook as bad as the headlines suggest or has the share market got it right? In part the share market has taken comfort from earnings results released in February so we will start there.

Profits turning up

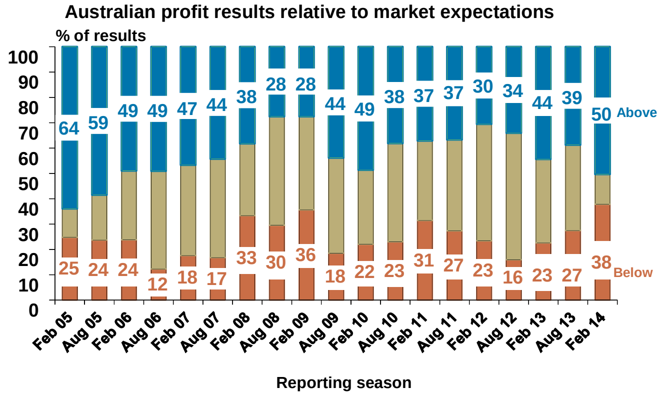
The December half profit reporting season just ended was effectively make or break because for market expectations for a circa 13% uplift in profits to be delivered this financial year, after two years of falls, profits needed to have started to turn up in the December half led by resources stocks.



Source: UBS, AMP Capital

In the event, the profit cycle has turned up right on cue, albeit led by the large miners and the banks, and so market expectations look to be on track. Overall results were solid:

- 50% of companies exceeded expectations (compared to a norm of 43%);
- 66% of companies saw their profits rise from a year ago, with strong results from miners and banks seeing overall earnings rise nearly 15% over the year to the December half, with a near 40% gain for miners. This compares to a 0.5% fall over the year to the June half;



Source: AMP Capital

- 64% of companies have increased their dividends from a year ago and only 13% have cut them. A year ago only 53% were boosting dividends. Aggregate dividends rose nearly 14% over the year to the December half; and
- 56% of companies have seen their share price outperform the day they released results.

Key themes have been:

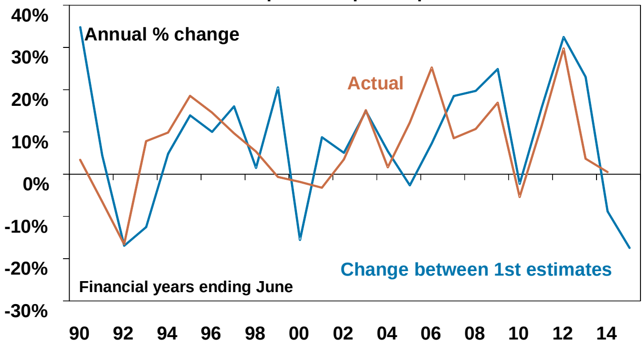
- a continued focus on cost control, but also a 7% rise in revenue, versus less than 2% revenue growth over the year to the June half. Industrials saw sales growth of 5%;
- help from a lower $A, which boosted the value of foreign earnings & makes Australian firms more competitive;
- a massive turnaround for resources stocks leaving them on track for circa 40% earnings growth this financial year;
- signs of life in cyclicals like housing related stocks (Boral, Stockland) and retailers (JB HiFi, Harvey Norman);
- continuing strong results from the banks; and of course
- strong dividend growth, which is usually a sign companies are confident about the outlook.

Consensus earnings expectations for 2013-14 rose slightly through the reporting season with earnings now expected to gain 15%, led by 40% from resources. This is expected to slow to 7% in 2014-15 with resources slowing and non-resources picking up. A key driver of whether this will be delivered will be whether the economy picks up.

Growth still soft, but signs of improvement

Since the June quarter 2012 Australian economic growth has been poor, averaging around a 2.5% annualised pace. This is well below the level necessary to absorb workforce entrants and hence unemployment has risen from 5% to 6%. A recent spate of layoff announcements is only adding to fears, not helped by the rapidly deflating mining investment boom. This is also highlighted by the latest ABS survey of investment intentions with a conventional interpretation of investment intentions that adjusts for the average gap between actual and expected investment pointing to an 11% contraction in investment next financial year. An alternative approach based on comparing the estimate of investment for the next financial year to the corresponding estimate made a year earlier points to a 17% fall – worse than seen in the early 1990s recession. See the next chart.

Actual and expected capital expenditure

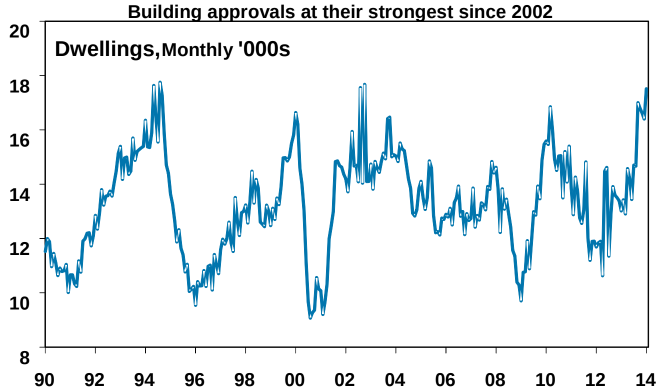


Source: ABS, AMP Capital

This has all led to a sense of gloom about Australia. However, the time to be really gloomy was two years ago – when the RBA was stubbornly slow to cut interest rates. Now interest rates are at generational lows and the $A is down more than 20%. And household wealth is up. Importantly, the normal play out from falling interest rates is unfolding:

1. House prices have risen solidly over the last year. Auction clearances holding at 80% in Sydney and 72% in Melbourne despite bad news in February is a good sign.
2. This has flowed on to near record building approvals, which will see rising housing construction this year.

Building approvals at their strongest since 2002



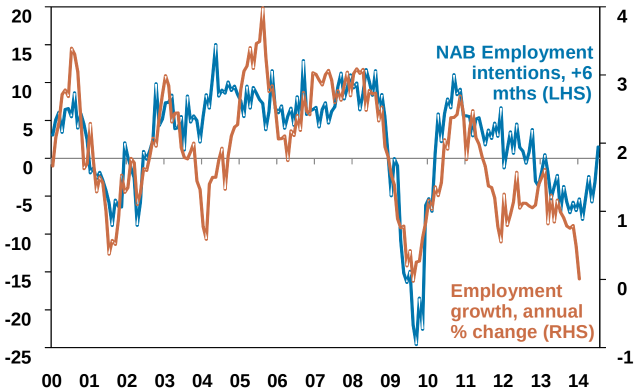
Source: Bloomberg, AMP Capital

3. Partly reflecting this, consumer and business confidence are trending up particularly the latter.
4. The lower $A should start to boost demand for local goods and services, eg US tourists to Australia seem to be rising again. This is likely to occur as the third and final phase of the resources boom – rising export volumes from completed projects – is getting underway.
5. Lower interest rates, rising wealth levels and rising housing construction is likely to drive a pick-up in retail sales. In fact retail sales growth did pick up last year.
6. Eventually this is likely to help non-mining investment.

We appear to have reached the fourth or fifth points, which provides grounds for confidence. What's more December quarter GDP saw an uptick in GDP growth to 0.8% quarter on quarter and 2.8% year on year, but more importantly it showed growth is far from collapsing and that other sectors of the economy – notably consumption, housing and trade - are helping the economy grow despite falling investment. But what about the weak jobs and investment outlook news?

- The jobs headlines lately have certainly been bleak but: the labour market always lags the economic cycle; the announced job losses (totalling less than 20,000 across the car makers, Alcoa, Qantas, etc) are small relative to total employment of 11.5 million and are spread over several years; and leading employment indicators such as ANZ job ads and employment intentions according to the National Australia Bank's business survey are all stabilising or pointing up. See the next chart.

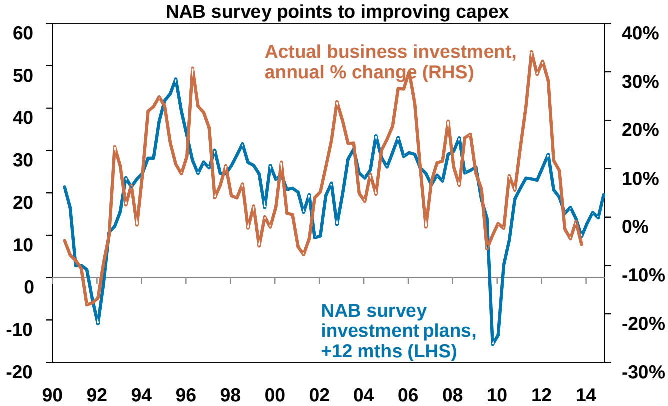
NAB survey points to a lift in employment growth



Source: ABS, NAB, AMP Capital

- Mining investment is falling off a cliff, but the broader investment outlook may not be as bleak as suggested by recent data. First, the approach of comparing estimates exaggerated the weakness this financial year initially pointing to a 9% decline, which now looks like coming in flat. Secondly, investment intentions in industries outside of mining are starting to improve. In fact, the NAB business survey's investment intentions index has actually started to rise. See the next chart. Thirdly, the impact on overall economic growth of the slump in mining investment will be partly offset by a slump in imports of mining equipment. This is already occurring.

NAB survey points to improving capex



Source: ABS, NAB, AMP Capital

Drawing these factors together and allowing for a tough May budget focussed on spending cuts, our assessment remains that Australian economic growth will rise to 3% by year end.

Concluding comments

First, the outlook for the economy is not nearly as gloomy as headlines of job layoffs and the end of the mining investment boom suggest. Growth is likely to pick up this year to 3%.

Second, the improving growth outlook should help head off further RBA rate cuts. But 3% growth by year end may still not be enough to make much of a dent on unemployment so while we expect rate hikes later this year the risk is that they will not occur till next year.

Finally, the combination of rising economic growth and continuing low interest rates should underpin a pick-up in non-resources earnings growth over the year ahead, which in turn should support further gains in the Australian share market. Our year-end target for the ASX 200 remains 5800.

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