Australia – the going gets tough for the lucky country

6 SEPTEMBER 2012

Key points

- Australian economic growth was solid at 3.7% over the year to 30 June. However, the best has been seen with growth set to slow to below 3% over the year ahead. To boost growth and guard against a slump, the Reserve Bank of Australia (RBA) is likely to cut rates to 2.75% in the next six months.
- A mining sector collapse triggering near recessionary conditions, a crash in house prices and problems for banks is not our base case but cannot be ruled out. However, such a scenario would be combated by even lower interest rates and a sharp fall in the Australian dollar to $US0.80 or below.

Introduction

Until recently it seemed that investors didn't really have to worry much about the Australian economy as all of the big macro concerns were global and the Australian economy was seen as being in good shape. However, Australia has been steadily growing as a concern, evident in the underperformance of the Australian share market versus global shares since late 2009 (by 3% p.a.), after having spent last decade outperforming dramatically (by 10% p.a.).

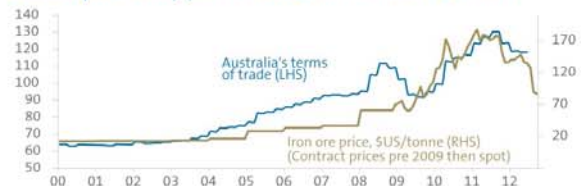
While the RBA still appears reasonably comfortable regarding the Australian economic outlook, seeing growth around trend and the glass as 'half full', the fraying of the mining boom at a time when key non-mining sectors such as retailing, housing and manufacturing are struggling, suggests the economy will be weaker than it is allowing for. What's more, some foreign commentators are questioning whether Australia's luck is running out.

The growth outlook

According to the June quarter national accounts the Australian economy is performing reasonably well with annual growth of 3.7%. While June quarter growth of 0.6% was well down from the March quarter's 1.4% pace, this was inevitable. Averaging the two quarters is probably the best guide to the underlying pace of growth and it comes in at a solid 1% quarterly rate. Unfortunately though, growth is unlikely to be sustained at this pace:

- The boost to retail sales over May and June from $2 billion worth of government payments to households has largely run its course with retail sales declining in July. Retail sales are running around 3% below where they would normally be this far into an interest rate easing cycle and with confidence remaining sub-par, job insecurity running high and interest too high, it's hard to see a strong pick-up yet.
- While housing related indicators have probably bottomed they are yet to trace out a strong recovery. Housing approvals are about 20% below where they would normally be this far into an interest rate easing cycle.
- The jobs market remains soft, with falling job vacancies pointing to soft employment and rising unemployment ahead. Whereas anecdotal news of job layoffs was previously limited to the non-mining sectors of the economy, it has now spread to the mining sector with, for example, Fortescue Metals announcing the loss of around 1000 jobs. This is likely fuelling ongoing household caution, acting to constrain retail sales and housing demand.
- Consumer confidence is sub-par reflecting that, while interest rates have fallen since November last year, the decline has not been enough to offset the flow of poor global economic news and feelings of job insecurity. Consumer confidence is running around 6% below where it would normally be this far into an interest rate easing cycle. This points to continued soft household spending.
- Mining investment is still rising, with the peak in mining investment's share of gross domestic product (GDP) around 1-2 years away. However, momentum is waning. For the first time in years the June quarter survey of mining investment intentions did not show an upgrade in plans for the current financial year and projects under consideration have peaked. Falling mining sector profits suggest mining projects remain at risk.
- Investment outside the mining sector remains weak.
- Australia's terms of trade looks like it will fall further in the current quarter, largely reflecting a 35% slump in the iron ore price since June. This is a dampener on the economy via constrained cash flows for miners, which will threaten employment and investment, and reduced tax revenue.

Iron ore price slump points to a further terms of trade fall



Source: Bloomberg, AMP Capital

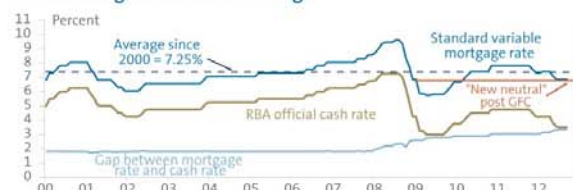
- Finally, having seen the budget handouts over the last few months, fiscal tightening will now kick in and may even intensify if the government seeks to retain its projected surplus for the current financial year.

We see growth settling around a 2.5% annual pace over the year ahead - below the RBA's forecast for trend growth.

The RBA has more work to do

The bottom line is that interest rates are still too high and will need to fall further. The standard variable mortgage rate at 6.8% is just below its long-term average of 7.25%, but normally rates need to fall well below their long-term average to be confident of stronger growth. In an environment of household and business caution since the global financial crisis, the neutral rate has likely fallen, probably to around 6.75% which would suggest that current mortgage rate levels are not stimulatory at all. In the last two easing cycles the mortgage rate had to fall to around 6%. Given the ongoing issues with bank funding, to achieve around a 6% mortgage rate the cash rate will need to fall at least as low as 2.75

Bank lending rates remain too high



Source: RBA, AMP Capital

Our assessment is that the RBA will come around to this view and as a result we expect the cash rate to fall to 3.25% in October or November, followed by a cut to 3% in December and then to 2.75% in the March quarter next year.

Based on the assumption that the RBA cuts interest rates further, the global economy stabilises and growth in China stabilises around 7.5% next year, then Australian economic growth should pick up again by the end of next year.

Trying to work out where the iron ore price will go is anyone's guess. However, much of the recent fall has been exaggerated by destocking in the face of softer-than-expected steel demand and it's a reasonable bet that once destocking has run its course and with high cost suppliers cutting production the price will stabilise and recover, perhaps towards $US100/tonne next year as China's growth rate stabilises. This would still be high in a long-term context – see the first chart. However, forecasts relying on a return to $US120/tonne or more may be risky given the outlook for rising iron ore supply over the medium term.

Is the lucky country out of luck?

While our base case sees a reasonable outcome for the Australian economy, albeit weaker than the RBA and government are assuming, the slump in the iron ore price poses a significant short-term risk for the Australian economy, particularly if the slide continues. This brings us to an alternative scenario worth considering. Essentially, this scenario would have four elements:

Firstly, a continuing slump in the iron ore price could bring forward the peak in mining investment from 2014 to early next year, as a cash flow crunch in response to falling iron ore prices and hefty capital spending forces miners to slash current investment. With an earlier timing of the peak, other sectors of the economy may not be in a position to fill the breach.

Secondly, the associated sharp fall in the iron ore price would lead to a loss of national income, job losses and reduced tax revenue for state and federal governments, possibly triggering further fiscal tightening.

Thirdly, rising unemployment could trigger increased mortgage delinquency and hence a collapse in house prices at a time when house price-to-rent and house price-to-income ratios remain high by global standards as home owners struggle to service their loans in the face of job losses.

Finally, rising mortgage defaults could trigger problems for banks at a time when they would also struggle to fund themselves, further reinforcing the economic downturn and possibly requiring public assistance in the form of a recapitalisation and funding assistance.

Such a scenario is currently doing the rounds (again) from foreign commentators. Having observed for years that the combination of excessive house prices and its counterpart, in the form of excessive household debt, amounts to Australia's Achilles heal with the key trigger for problems being a collapse in the terms of trade, I cannot completely dismiss such a scenario. It is certainly a risk. However, there are several good reasons why I think it is unlikely.

Firstly, while overvaluation suggests the risk of a house price collapse, it is offset by significant under-building and undersupply, low loan-to-valuation ratios, the absence of any deterioration in lending quality and full recourse loans in Australia. The most likely scenario for house prices remains an extended period of range-bound prices in real terms.

Secondly, if house prices don't crash, the risk for banks is far less, in any case they have already substantially reduced their reliance on non-deposit funding and even if funding did become difficult again it would be easy to re-introduce the government guarantee for bank borrowing.

Thirdly, some seem to think that as the mining sector has been a key driver of Australian growth recently, once it goes there will be nothing to replace it. In reality, the past few years amounted to a structural adjustment constraining growth elsewhere in the economy via high interest rates and the Australian dollar to allow the mining investment boom to occur without overheating the economy. If the mining investment boom evaporates the non-mining economy can pick up again, for example, housing investment where there has been an undersupply of dwellings relative to underlying demand for years.

Finally, Australia possesses significant shock absorbers. Interest rates are still a long way from zero. And the Australian dollar can fall a long way – to $US0.60 as it did in 2008 – to help boost growth. This makes Australia very different to Eurozone economies, where there has been no currency relief.

But the risk is certainly there and cannot be ignored. The best way to minimise it though, would be for the RBA to aggressively cut interest rates.

Implications for investors

There are a number of implications for investors.

- Under the base case and the risk case, interest rates need to fall a lot further. This means that term deposit rates are likely to fall further in the years ahead.
- While record-low bond yields mean bonds are poor value for long-term investors, yields will likely remain lowish under our base case as the RBA cuts interest rates. However, if we see a serious mining driven slump, weak growth would be positive for bonds, but if foreign investors start to panic about Australia, international bonds will do better than Australian bonds.
- Shares should benefit from interest rate cuts and cheap valuations. As such, we continue to see the Australian share market being higher by year end. However, shares will be vulnerable under the risk scenario.
- The Australian dollar is vulnerable under both scenarios, possibly falling below $US0.80 in the risk case.

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