

27 years and no recession

But just how strong is the economy?

AIA National Conference

Surfers Paradise: July 2018

Stephen Koukoulas
Market Economics



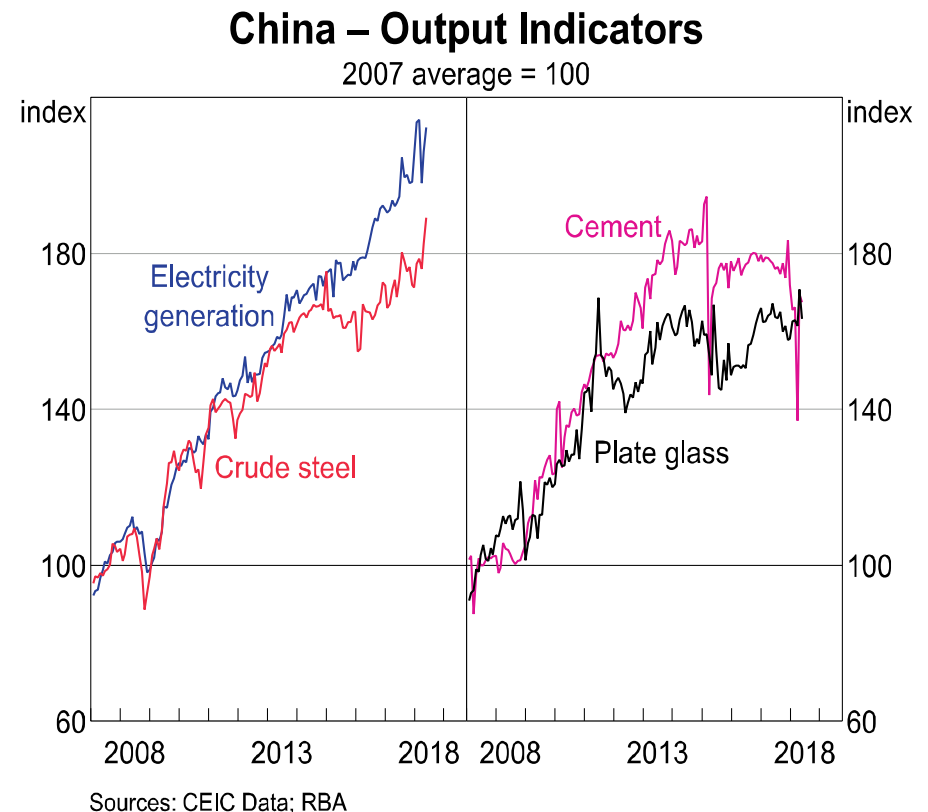
The global economy is OK, but is it slowing?

- 2018 has been a good year for Australia's trading partner growth, but there are signs 2019 growth will be a little slower
- This is still a solid result, but there are some global risks unfolding



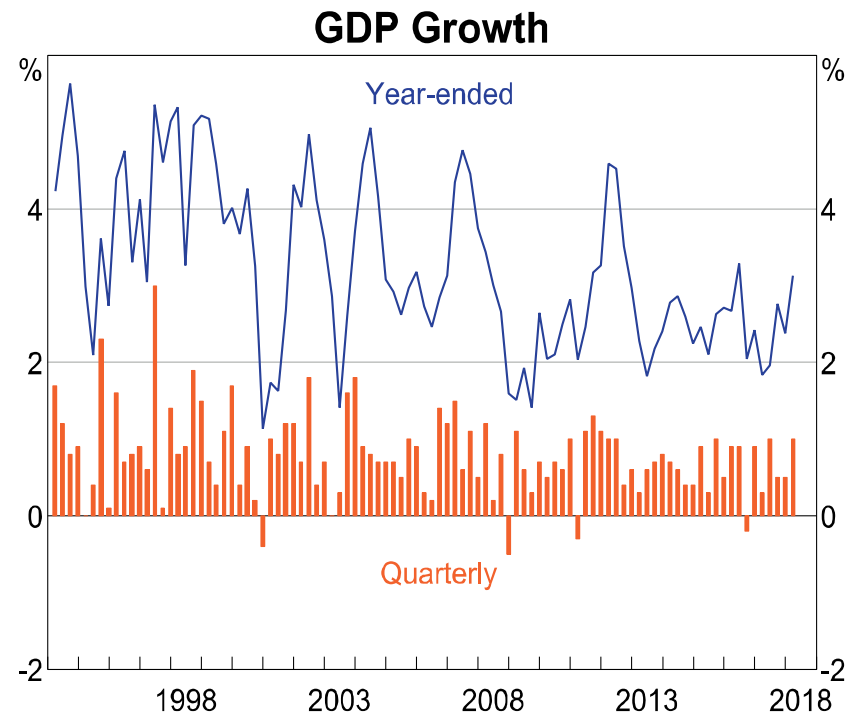
What is happening in China?

- While the official news on the Chinese economy remains solid, key output indicators are with signs of a slowdown
- Given China is Australia's dominant export market, any slowdown would present a risk to the outlook



In Australia: Start with the big picture

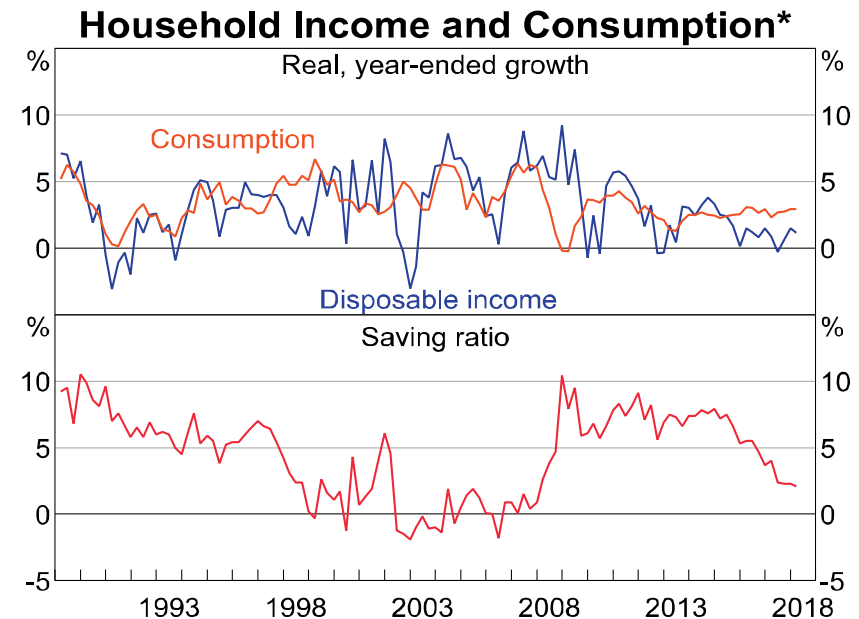
- 27 years and no recession
- BUT... GDP growth is moderate & is hovering around 2.75%
- Current drivers of growth suggest the next year or two will deliver more of the same – no hard landing, but no meaningful pick-up either



Source: ABS

Consumer demand remains fragile

- Household spending growth continues but it is based on weak foundations – lower savings & higher debt
- Income growth is weak
- Wages growth **must** pick up for consumer spending growth to contribute more to the economy

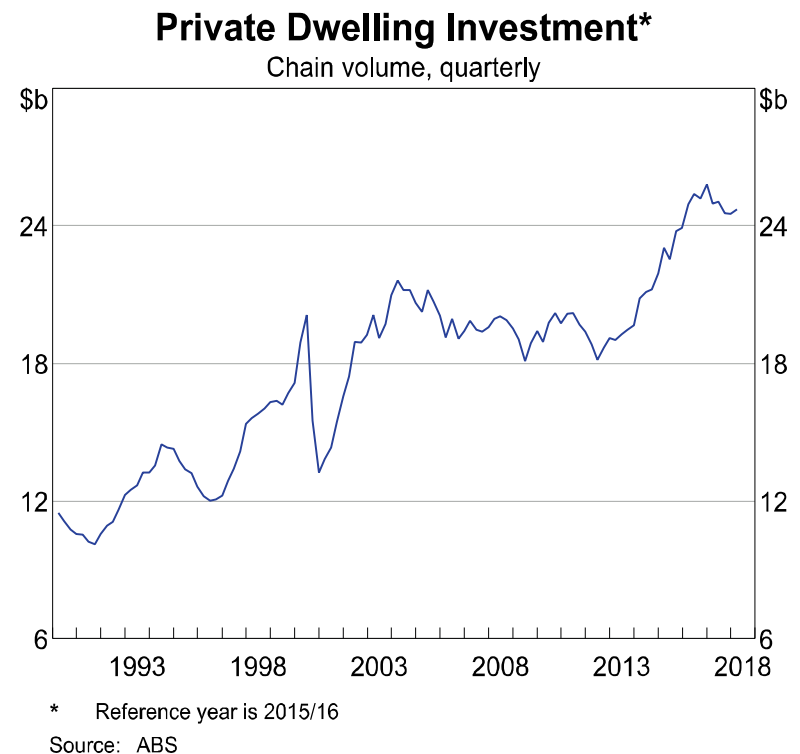


* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

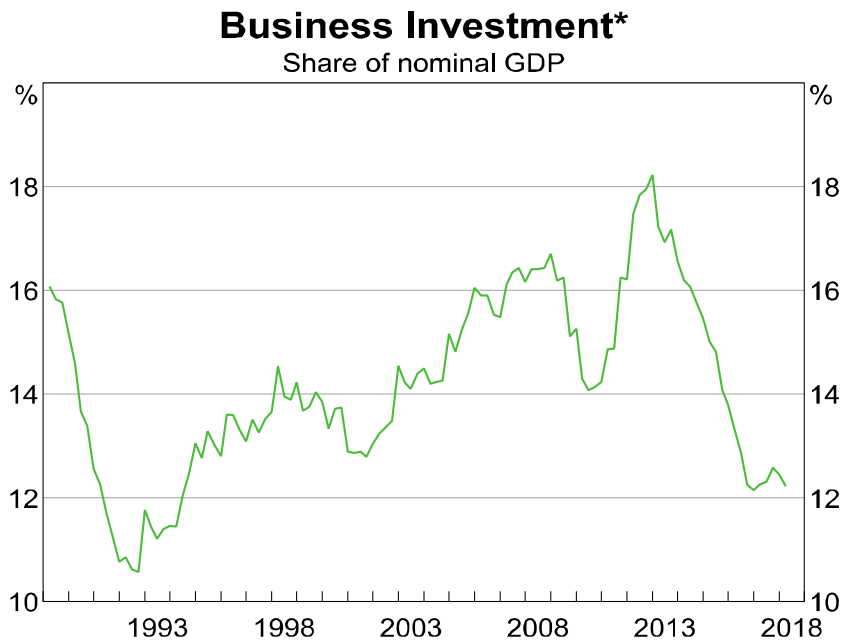
Sources: ABS; RBA

Dwelling investment is turning down

- New dwelling construction was in a boom, but there are now clear signs of a slowdown
- The prior building boom saw record levels of new construction in high-density housing
- Will there be too much supply for underlying demand?



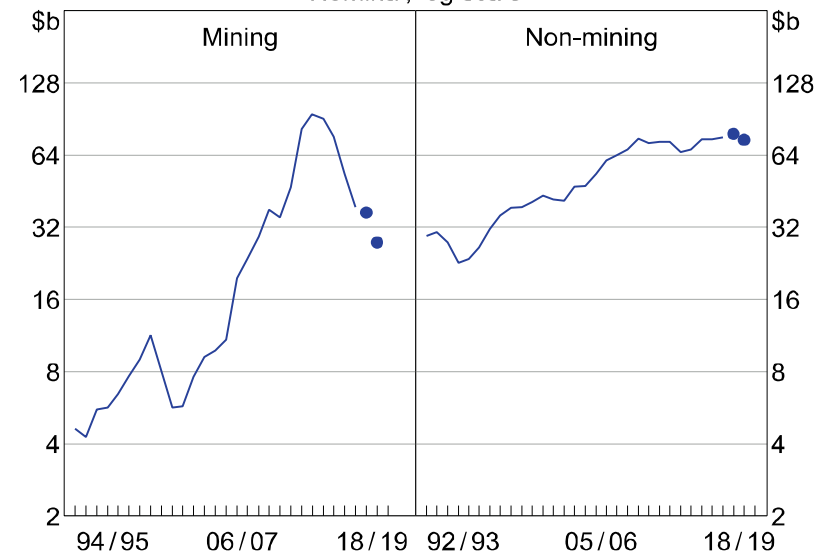
Business investment has bottomed but the outlook remains soft



* Adjusted for second-hand asset transfers between the private and other sectors

Source: ABS

Capital Expenditure – Mining and Non-mining*
Nominal, log scale

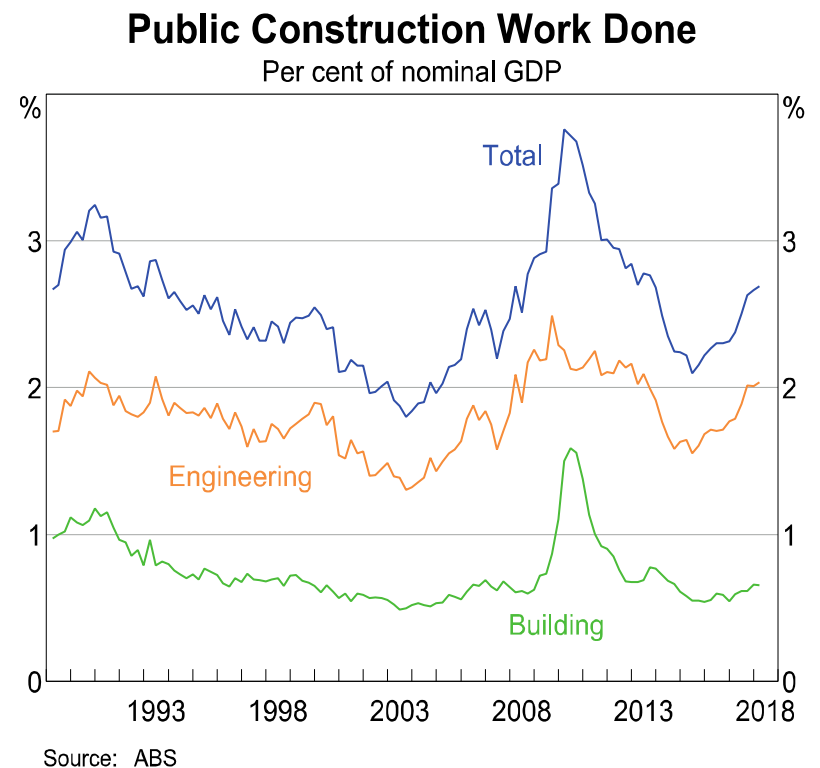


* Dots are firms' expectations for 2017/18 and 2018/19, adjusted for historical differences between expected and realised spending

Sources: ABS; RBA

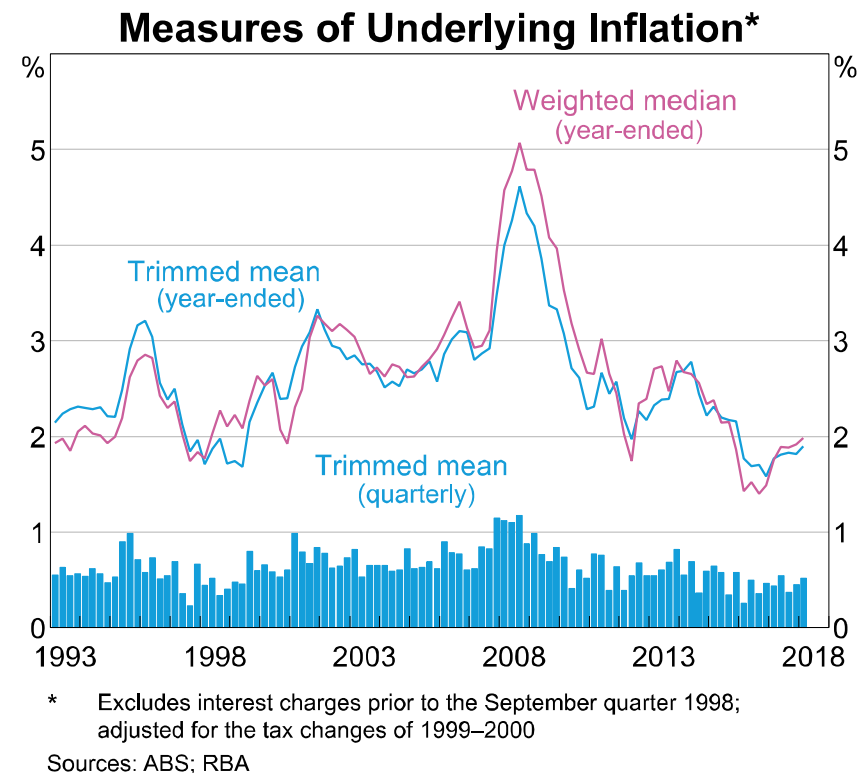
Government infrastructure spending is strong

- An area of clear strength in the economy is public infrastructure spending – this is good news
- While the next 12 months has a solid pipeline of additional activity, the 2019 - 2020 outlook is less robust as projects are completed



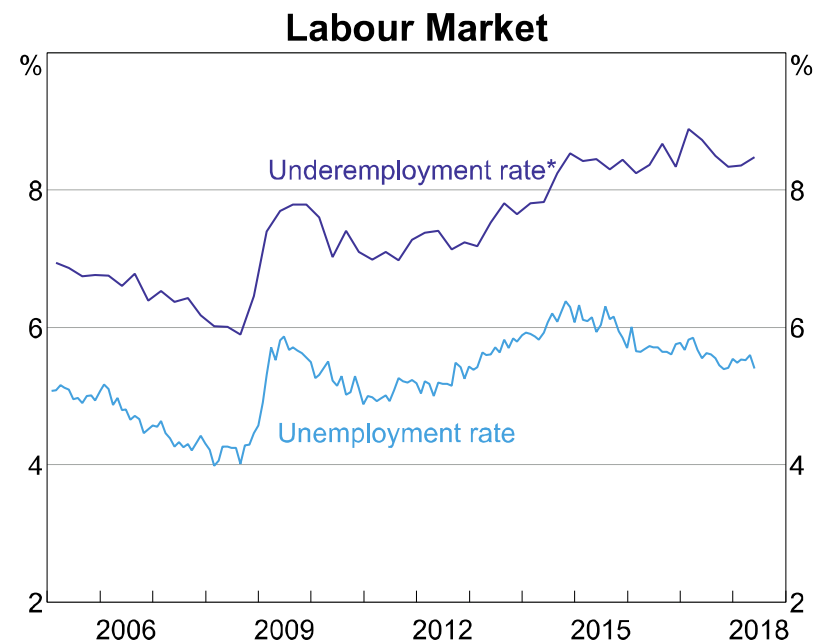
The RBA keeps on missing its inflation target

- Inflation has been below the bottom of RBA 2-3% target range for almost 3 years
- The economy needs to record 3%+ GDP growth on a sustained basis for inflation to get back to the target range
- Low inflation is the simple reason why interest rates are likely to remain at record lows



The labour market presents mixed news

- Employment growth was very strong in 2017, but growth has weakened, markedly, in the first half of 2018
- The level of both unemployment and underemployment suggest there is significant spare capacity in the market and is why wages growth is so low

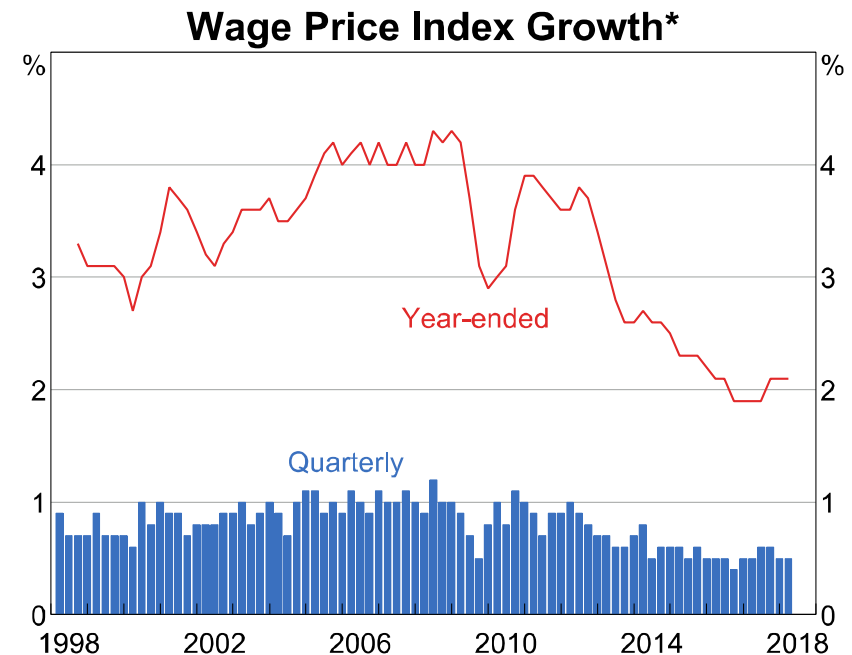


* Full-time workers on reduced hours for economic reasons and part-time workers who would like, and are available, to work more hours

Source: ABS

Wage acceleration remains elusive

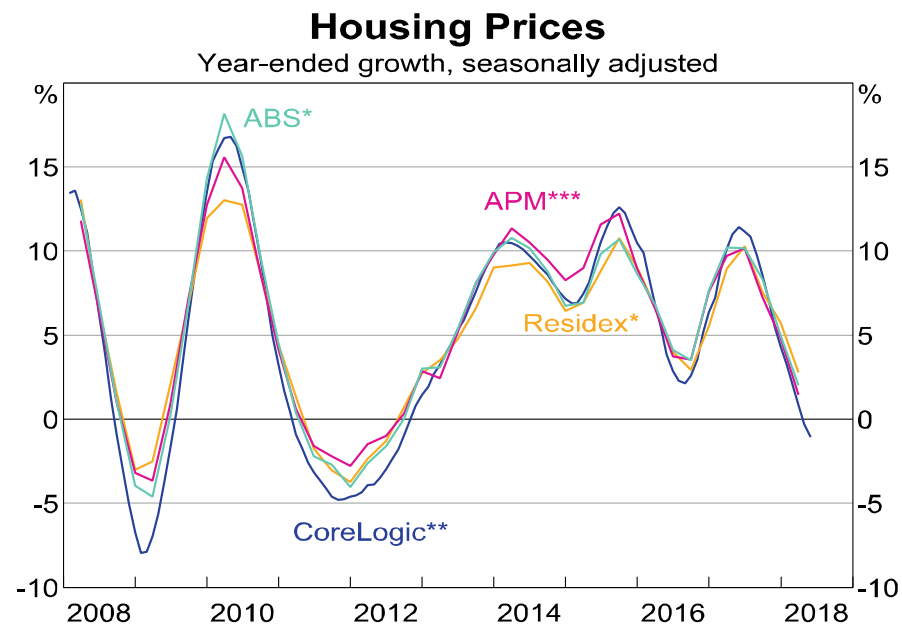
- Wages growth is the dominant issue for policy makers. The RBA, Treasury are expecting a lift – and soon
- This looks unlikely, not least because of the slack in the labour market, but also because award increases in the bulk of the economy are commonly 2-2.5%



* Total pay excluding bonuses

Source: ABS

Wealth “destruction” threatens

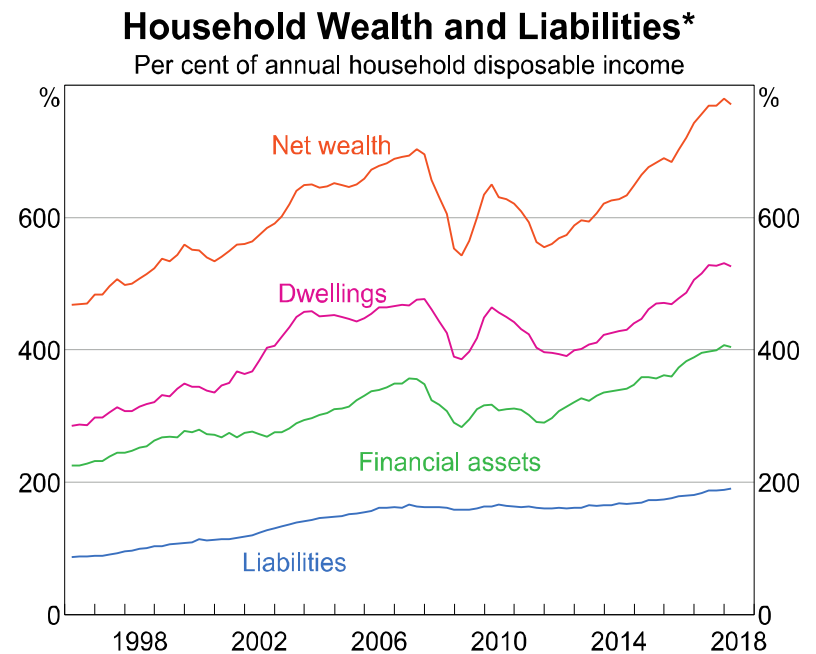


* ABS is a quarterly stratified median price index; Residex is a quarterly repeat sales price index

** Monthly hedonic price index; non-seasonally adjusted

*** Monthly stratified median price index

Sources: ABS; APM; CoreLogic; RBA; Residex

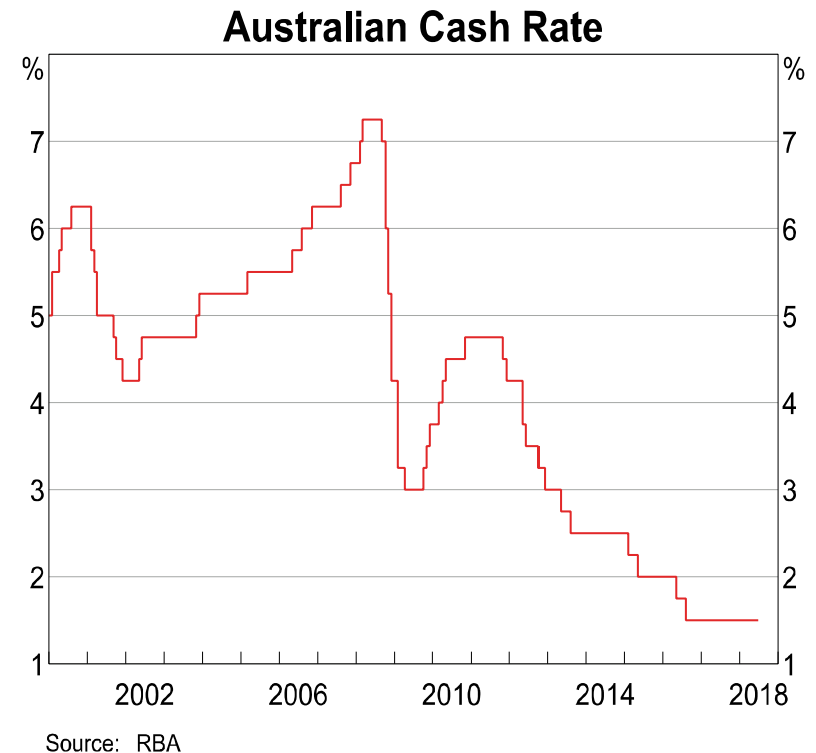


* Household disposable income is after tax, before the deduction of interest payments, and includes income of unincorporated enterprises

Sources: ABS; RBA

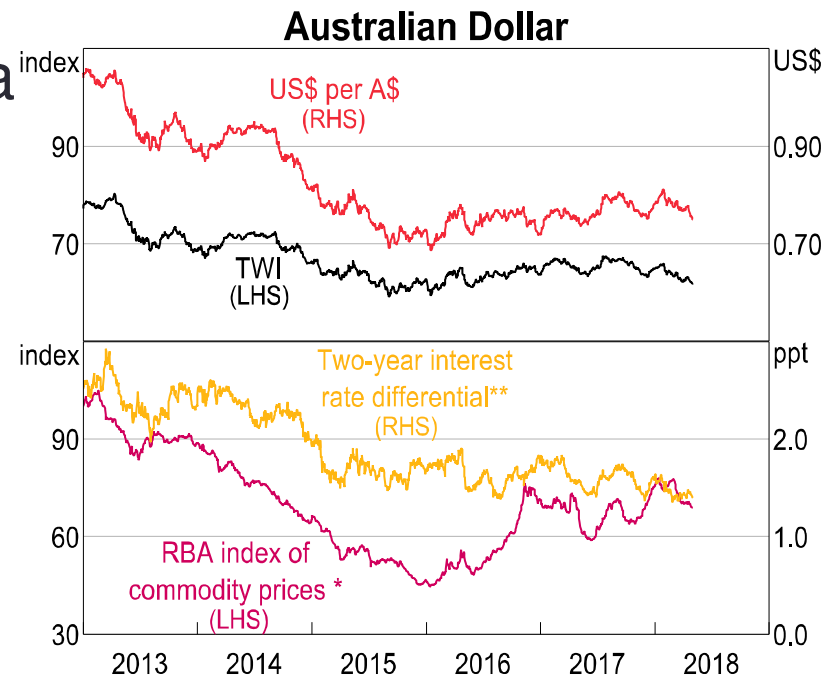
Interest rates are low & steady

- The last official interest rate cut was in August 2016
- Low inflation, only moderate economic growth & excess spare capacity in the labour market means rates will remain low for longer
- Is the next move down?



The Aussie dollar – stable for how much longer?

- Since 2015, the AUD has been in a relatively tight range around 0.75
- A negative interest rate gap to the US should have seen it fall, but rising commodity prices should have seen it rise
- The battle of these two issues will determine if we see 0.70 or 0.80 next



* With spot bulks; 1 January 2013 = 100

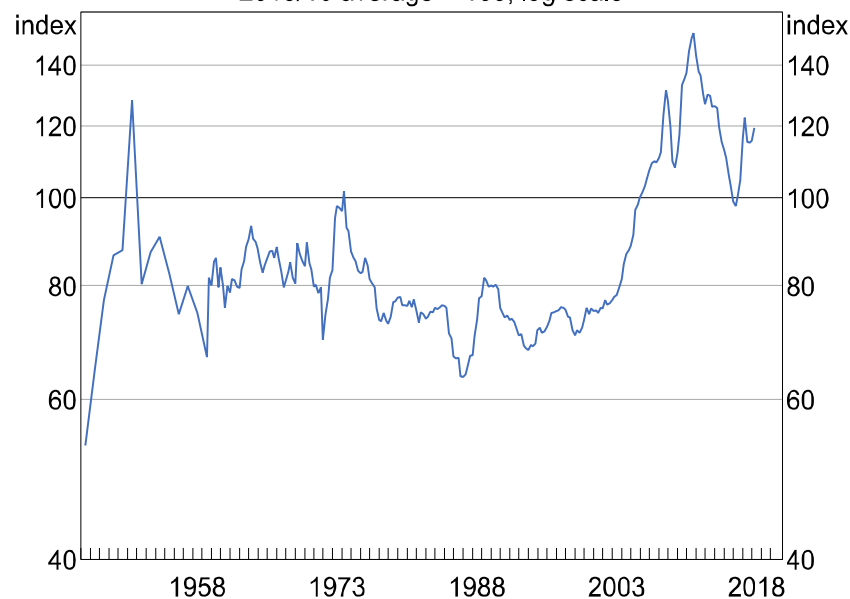
** Spread to equally-weighted nominal yields in Germany, Japan, United Kingdom and United States

Sources: Bloomberg; RBA

Commodity prices & the terms of trade

Terms of Trade*

2015/16 average = 100, log scale

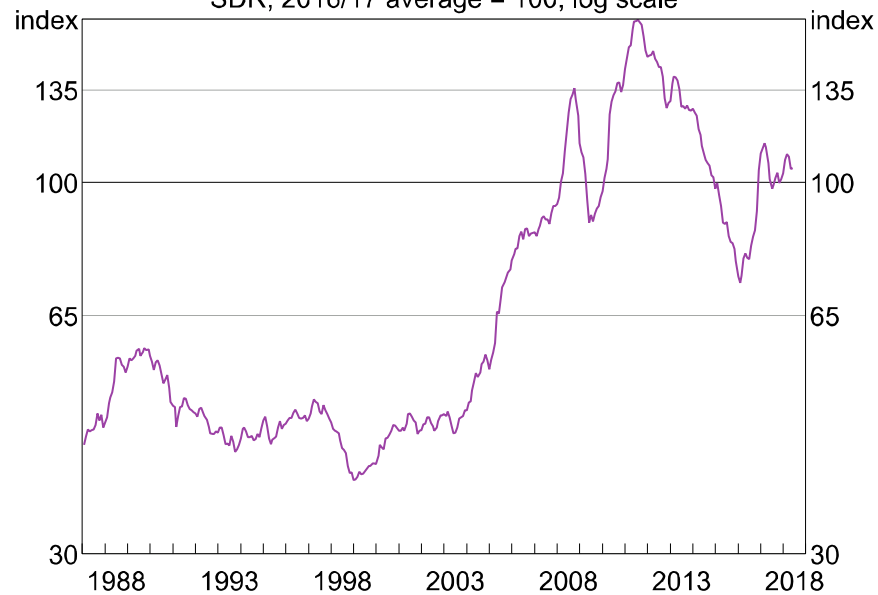


* Annual data are used prior to 1960

Sources: ABS; RBA

RBA Index of Commodity Prices

SDR, 2016/17 average = 100, log scale



Source: RBA

Policy and politics

- Election is due soon
- Coalition running on income and company tax cuts & a medium term trajectory for lower government debt
- Labor running on tax reform which yields more revenue which will fund extra spending & lower government debt



Politics and investment strategies

- These policy differences will have implications for investors
- Which side wins will make a difference to investment strategies and plans
- Labor are ahead in polls and remain warm favourites in betting markets

What each side means – The Coalition

- If the Coalition retains office, it will be largely “business as usual” as the company and income tax cuts are slowly rolled out and impact the economy
- As the budget showed, they are relying on further solid economic growth, strong company profits & higher wages to give the revenue to fund the cuts
- Government debt levels will gradually decline

What each side means - Labor

- Bigger investment implications from a Labor win
- Negative gearing will be less attractive which will encourage investors to look elsewhere
- Dividend imputation changes makes investing in high yielding 100% fully franked dividend shares less attractive – investors to look elsewhere
- Labor are likely to have a faster pace of debt reduction

QUESTIONS

