

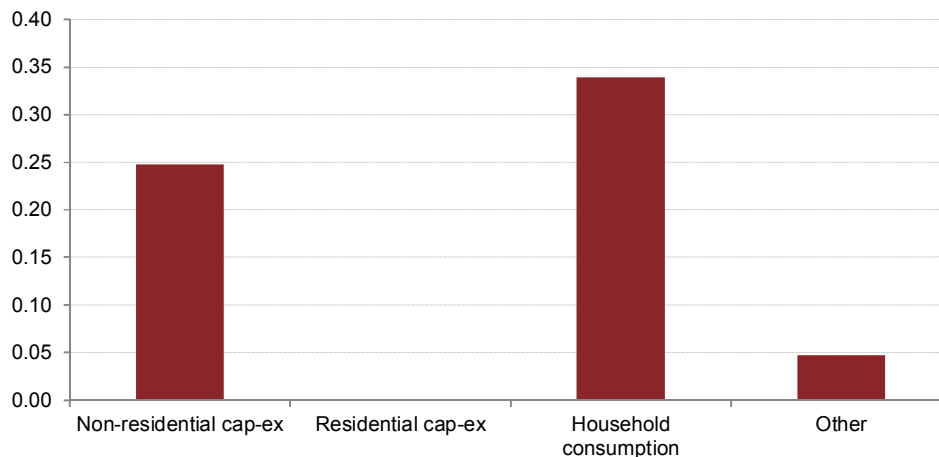
## Australian outlook – some relief from housing, but not enough

- **RBA holds out prospect of another cash rate target cut**
- **Stronger housing activity should boost growth in H2 and in 2014**
- **But not by enough to compensate for weaker corporate cap-ex**

Although the Reserve Bank of Australia left interest rates unchanged at its June meeting (having cut the cash rate target by 25bps in May), the minutes of the Monetary Policy meeting hold out the likelihood of a further rate cut if necessary and assuming inflation behaves itself. Australia's attraction for investors currently belies its size. With a policy interest rate at 2.75% and 10-year bond yields at 3.4%, it is one of the few developed markets where there is still a decent yield. The possibility that interest rates may fall further also holds out the possibility of a capital gain on fixed income at a time when most other bond markets are nervously awaiting the Fed's QE taper and its accompanying bond sell-offs. However, this attraction is balanced by the prospect of a weaker currency.

The Australian outlook is dominated by the likely future weakness of corporate cap-ex. Over the past six years (ie, since the financial crisis began) business investment has contributed one-third of growth, (just below 0.2 percentage points per quarter to total average quarterly GDP growth of 0.6%).

**Contributions to average Australian GDP growth, 2007 Q3 - 2013 Q1, percentage points**

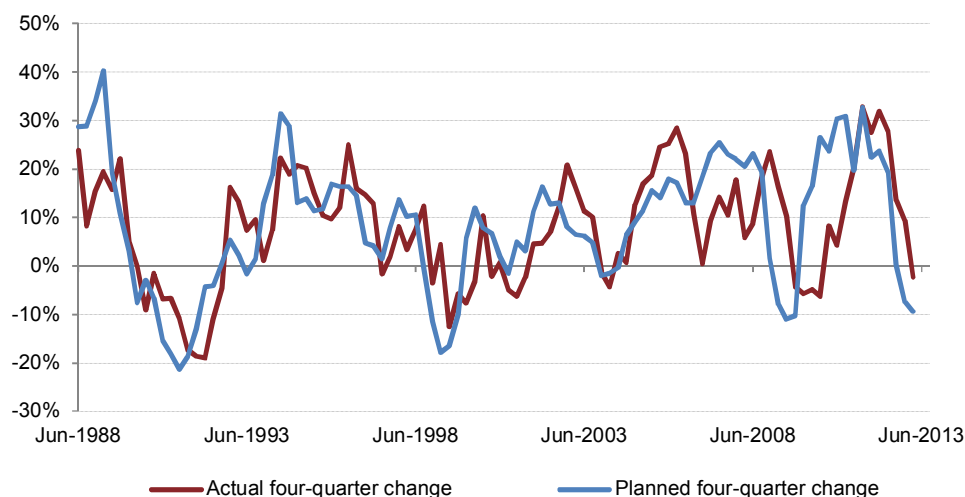


Statistics Australia's latest survey shows total corporate cap-ex (long- and short-term) is forecast to fall by 9% over the next four quarters. While not perfect, this survey has a reasonable relationship with the eventual turnout. Although the survey measures current price changes, we can estimate as a bad scenario the impact of a 10% volume fall in corporate cap-ex over the next four quarters. This would drag down GDP over the year by 1.7%.

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**Australian corporate cap-ex, four-quarter change, % - planned vs. actual**



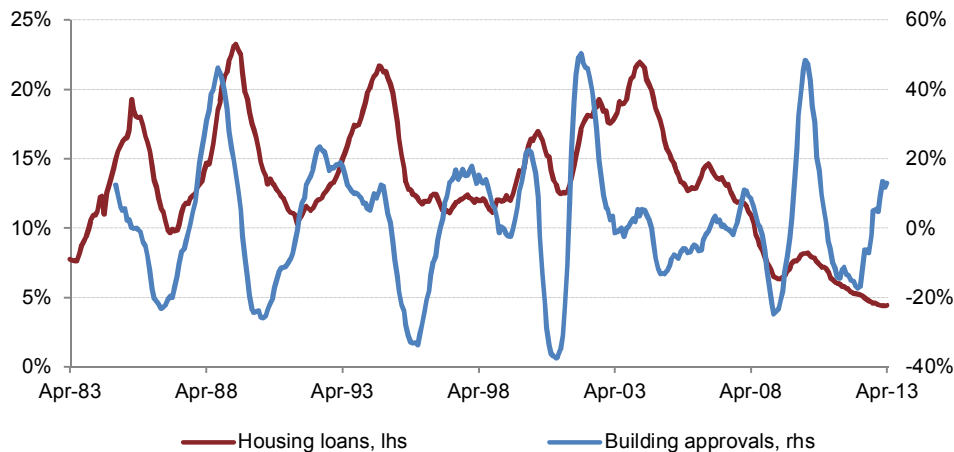
The offsetting hope for the Australian economy instead comes from household consumption and from the housing market. Although the household savings rate has risen sharply since Q3 2007, from 12.7% of disposable income to 17.4% by Q1 2013, household consumption has actually contributed more to overall output growth than business cap-ex (an average of 0.3 percentage points). Recent data on household activity, eg, retail sales and consumer confidence, but also a strong labour market, point to a further pick-up in household spending.

By contrast residential real estate spending – new building as well as alterations and additions – has contributed nothing to overall output growth since the financial crises began. However, there are some signs that this could now be changing, as successive interest rate cuts are working their way through the economy. Over the past 18 months there has been a marked acceleration in the *number* of total residential building approvals. The *value* of approvals is more volatile, but this too is trending up. More to the point, the value of building approvals tends to lead housing loan growth. Although the latter is weak by historical standards – the 30-year average of annual housing loan growth is 13.3%, while the latest number is 4.5% – it has levelled out and moved sideways since last autumn. The latest interest rate cut (and possibly another one to come) should further stimulate housing activity.

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**Building approvals \$A mn, 6-month moving average of 12-month change, vs housing loans, 12-month change**



So housing market activity should provide some succour for the Australian economy in the near term. However, welcome though that is, the housing sector is not large enough to compensate for a sharp drop in corporate cap-ex. While residential investment (house-building as well as alterations and additions) is about ten times the size of minerals and petroleum exploration, it is only 27% of total business cap-ex. The biggest sustained drop in corporate cap-ex in recent Australian history was over the three years from 1989 Q2 to 1992 Q2 when it fell by a total of 25%. By contrast, the largest fall in corporate cap-ex in the recent cycle was an 8% fall from 2008 Q3 to 2010 Q2. Assuming, as above, a 10% fall in corporate investment over the next four quarters, total dwelling investment would have to rise by 35% merely to offset the impact. That would not be unprecedented – but, judging by historical data, housing loan growth would have to be in excess of 20% and building approvals rise by around 40% for this to be even remotely likely.

The likelihood is therefore that Australian output growth will remain below-trend over the next year. Growth should remain positive and probably in the 1½-2% range, ie, healthy by current developed market standards. But, since the RBA is now taking a more active role in weakening the currency, the yield gap vis-à-vis the rest of the world and the attraction of Australian equities should both diminish.

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