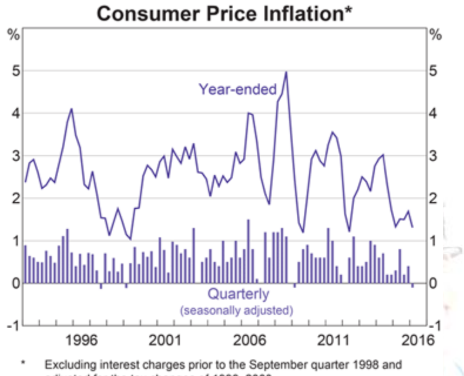
Economic Update – Stagnation or Bust for the Australian economy

The Australian economy is clearly in a state of flux at present. With inflation dwindling, the RBA easing, and the looming federal election, some can be mistaken for a being a little confused as the direction of the economy.

Inflation and RBA

Recent inflation data spooked the RBA in to cutting rates, the first cut to rates in 12 months. The data was negative for the March quarter, but was driven by a few key items - sharp falls in petrol and fruit prices.



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

The RBA was less concerned about the components, rather they were concerned about inflation expectations and wanted to ensure very low inflation expectations didn't become embedded, prime example being wages growth, which has fallen for the last few years. The rate cut was mostly passed on by banks to mortgage holders.

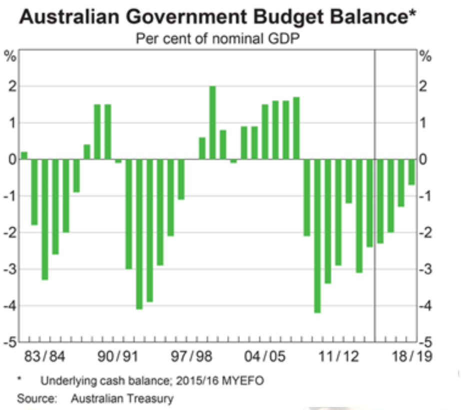
Source: ABS

Outside of that direct effect, any further cuts are really about directing inflation expectations, rather than about affecting asset prices. The RBA is less concerned about re-stoking property prices given banks' lending growth is now constrained due to regulatory measures. Thus, potential further rate cuts are on the agenda – at least one, maybe two.

Budget and election

The budget was fairly lame from an economic perspective over the short term. It had plenty of aspirational long term policies, but the government will need to be re-elected with a majority in both Houses of Parliament for those policies to come to fruition.

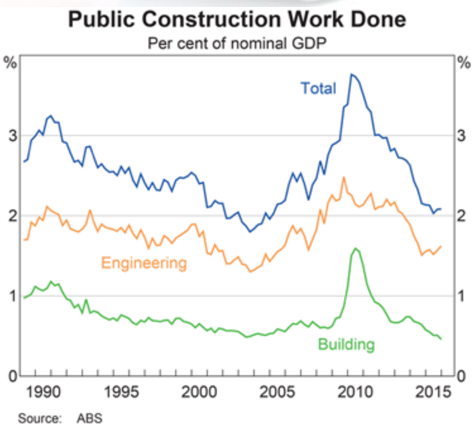
The budget deficit did increase slightly, so can be seen as somewhat stimulatory given the government is still trying to attain a budget surplus by 2020/21.



The budget largely addresses savings through pretty severe changes to superannuation, not entirely surprising leading into an election, given the aim of an election budget is to displease the smallest number of voters.

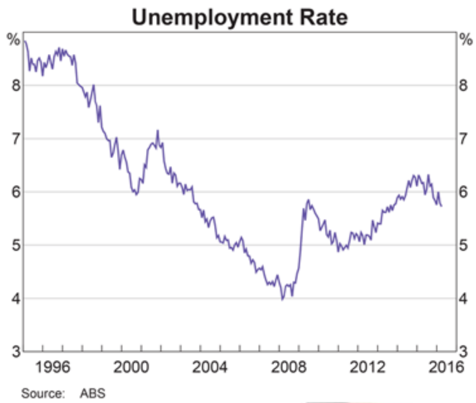
In terms of the election, PM Turnbull and the Coalition are hoping to return to power with a majority in both houses. At present, polls are 50/50. What we won't see this time around is micro parties gaining seats in parliament due to a change in voting laws earlier in the year.

The budget needs to remain stimulatory as the economy transitions away from the mining sector so that the RBA doesn't have to do any more heavy lifting. Tax reform is greatly needed, possibly on the agenda for the next election after this on, and productive spending (eg. infrastructure) is needed to take a load off the RBA’s shoulders in terms of stimulating the economy.

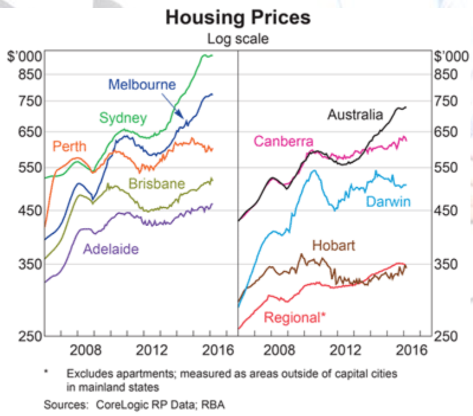


Unemployment and housing

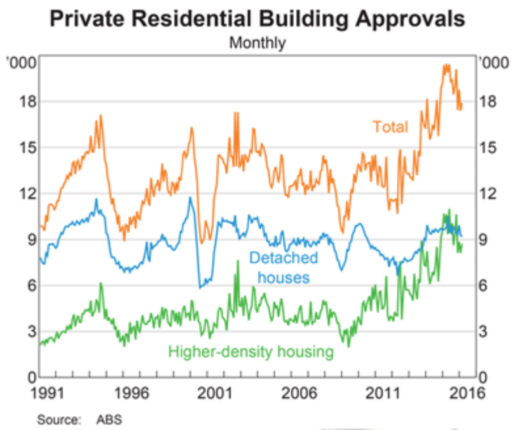
Unemployment has remained low of late much to the surprise of many. Positively, job vacancy rates have been rising which shows businesses are willing to hire. Most of the new jobs have been created in services sector such as healthcare and retail, in addition to the property construction boom, whilst there's been a large decline in resource and resource related jobs. There is a concern that as the property construction boom is now mature, we could start to see job losses in that sector as things begin to slow.



The property boom has two aspects - residential and commercial. The residential boom began a few years ago and hit its heights in 2015, supported by easier bank lending conditions, low rates, and foreign buying.



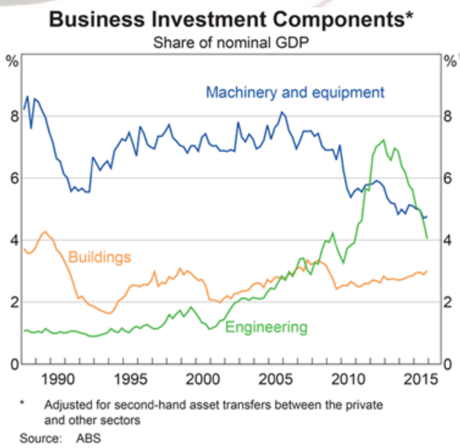
We've seen slower conditions in 2016, particular January and February, before a recovery in March and April. Price growth is lower now than it was in 2015, but at a more reasonable pace (i.e. mid-to-high single digits). The slowdown (very much welcome) is a function of increased bank regulation, tightened lending standards, and high prices. Whilst an oversupply is beginning to appear in some apartment markets, it doesn't appear to be the case in single dwelling property. As such, we don't think a correction is on the agenda, just much slower growth.



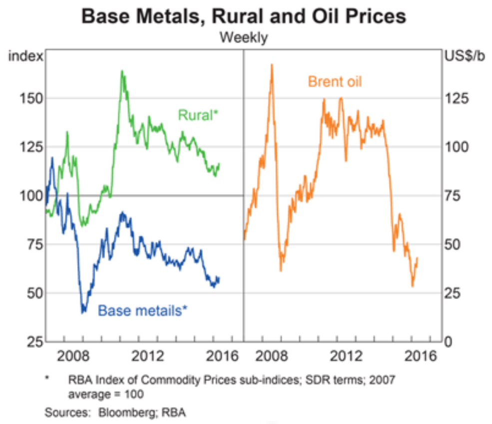
The commercial property boom begun around the same time, but continues unabated, as the demand from foreign investors continues to push prime property prices to all-time highs. This will likely continue given low borrowing rates globally, attractive yields relative to cash and bonds, and diversification of assets outside of the home country.

Mining, commodities and China

The mining boom has clearly come to an end from a capital expenditure and oversupply perspective in light of lacklustre global economic growth. However, export volumes are breaking through new highs more recently as China goes through a re-stocking phase, assisted by an increase in Chinese government stimulus.



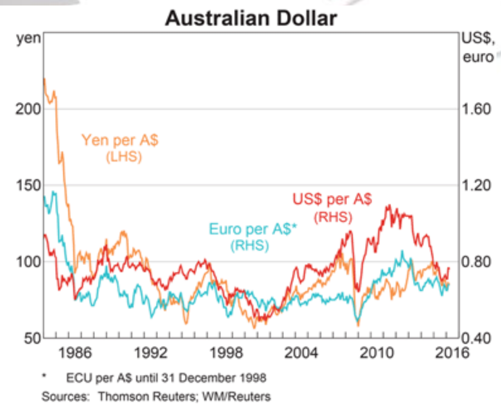
Given the oversupply in most commodities, commodity prices will remain relatively low, but higher than the lows they reached in 2015. Low cost producers should continue to take market share in this sort of environment, and those companies with better quality management will be using this period to get their positioning right for the future.



China will continue to grow, and will still need a significant amount of commodities, just not the level they've demanded in the past. In addition, their demand breakup will change going forward as their economy transitions from investment-led to consumption-led growth.

Dollar

The Australian dollar fell sharply over 2015, with falls continuing early in 2016, hitting lows of 67c against the US dollar. The dollar then bounced, hitting 78c, mainly the result of overseas buying of Australian assets and a falling US dollar on the back of a slowing in pace of US rate rise expectations. The bounce was somewhat reversed more recently, with the dollar falling to low 70s following the RBA’s rate cut and revised forecast for inflation. No doubt the RBA had the dollar in mind when it cut rates. The dollar will likely come under further pressure in the year ahead as the US dollar rises and the RBA considers further rate cuts.



Summary and thoughts

No doubt the Australian economy will slow over the coming 12 months, but we are clearly not in the recession camp as some may be. We think the RBA may lower rates one more time this year (possibly two), but this decision will be driven by data (inflation and employment), and by the levels of the Australian dollar.

We don't think unemployment moves much from here, possibly a little worse given anaemic wages growth, and we think property prices go through a period of much lower growth, rather than a sharp correction. We'd like to see the winner of the election have a majority in both houses so that things can actually get done to help buffer the economy rather than relying on the RBA to do the heavy lifting and them lambasting them when they do.

In all, a lower Aussie dollar, pressure to cut rates further, lower bond yields (higher prices), and China largely OK, equities and property should be well supported, but with active selection critical.