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Australia:
Mixed present, decent future

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Summary

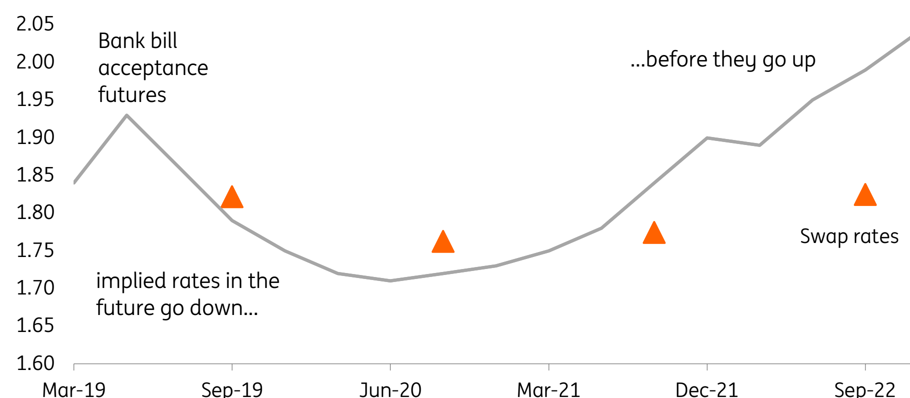
Australia sits as one of the most robust economies in the developed world

Australia suffers more from a surfeit of unfulfilled optimism than any genuine issues. Sure, there are some areas of economic softness, and some longer term structural features that will bear watching over the medium term. Moreover, the near term is hard to call, even for the Reserve Bank which is now hedging its guidance bets. Australia remains exposed to the Chinese economy and an unforecastable trade war. But the near-term signs here are more encouraging and, unless you anticipate a China collapse, in which case, there are far bigger problems to worry about, then Australia sits as one of the most robust economies in the developed world. Residential property weakness is not as alarming as some make out. And the medium to longer term prospects for economic growth compare favourably to the US or almost anywhere in Europe.

Near-term prospects

Reserve Bank of Australia (RBA) Governor, Phillip Lowe, noted in the latest monetary policy statement that the next move in the cash rate (currently only 1.5%) could be up or down. Markets have perhaps over-reacted a little to this in the FX space, as money markets have rushed to price in rate cuts. Though in the process, equities have remained supported, so there's no panic.

Fig 1 Implied rates (%)



Source: Bloomberg

Risks to the economy appear to be evenly balanced

What we think Governor Lowe is really saying is that the risks to the economy are at present evenly balanced, even with cash rates at their current low level of 1.5%. That's hardly a damning indictment, unless you can only deal with outright positive news or wanted this point in the business cycle to come at a far higher level of policy rates.

After the recent monetary policy statement, Lowe also testified to the Australian parliament, sounding very relaxed about the economy and downplaying the risks from the property market and China. We don't take issue with any of Lowe's remarks. Yes, in the near term, the Australian economy does look hard to call. But further out, this is still an economy with enormous potential.

Economy – Some good, some bad, some neither

First the good

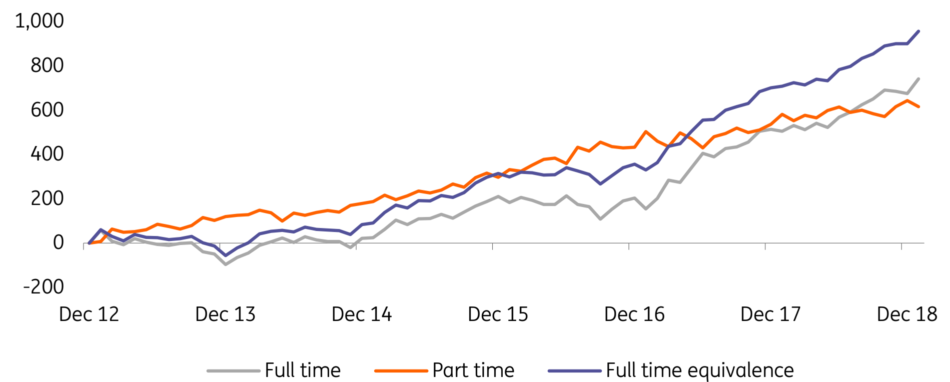
Labour market

Current unemployment rate of only 5.0% is not far off the all-time low of 4.0%

Let's be absolutely clear about the state of the economy, on some measures, it is in extremely good shape. Take the labour market. The current unemployment rate is only 5.0%. That is almost as low as the 4.9% trough in unemployment reached in December 2010. The all-time low of 4.0% met in October 2009 is not that far off.

Moreover, on a three month average basis, employment is increasing at just shy of 30,000 per month, with a great many of these jobs being full time. This doesn't feel like an economy that is on the turn.

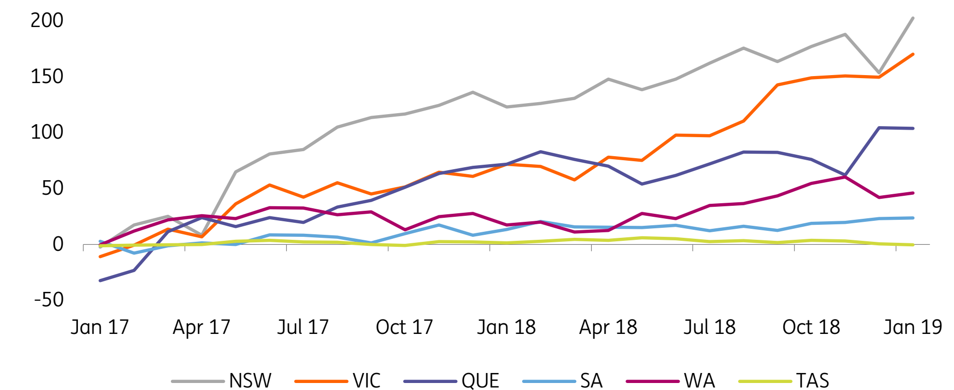
Fig 2 Employment by type (000)



Source: CEIC

If you wanted to be pedantic, you could point out that many of the jobs are being created in just a few key areas – NSW, Victoria and Queensland. Though that also constitutes the larger concentrations of the population, so even then it is hard to get too concerned.

Fig 3 Cumulative regional employment growth (December 2016=0)



Source: CEIC

Public finances

Another area in which Australia has reason to be highly satisfied is the state of public finances.

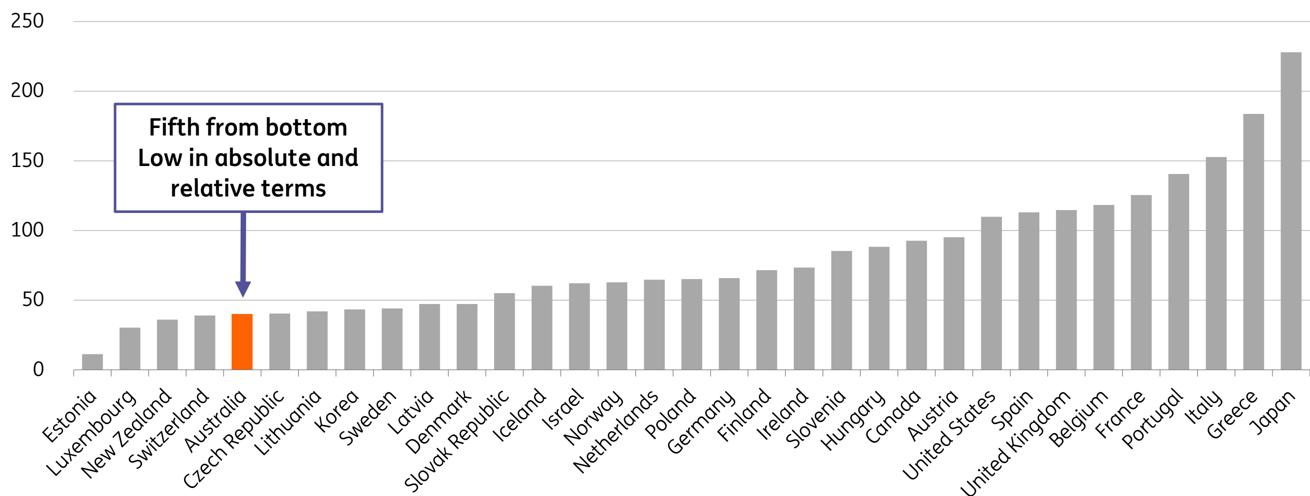
Gross government debt as a percentage of GDP will be about 33.5% for 2019 (OECD figures put this about 10 percentage points higher, owing to a different accounting methodology). Most international comparisons of public debt focus on gross public liabilities. But you will struggle to find these figures on the Australian Treasury Department's website. Here, the focus is almost entirely on net debt. Given Australia's extremely far-sighted approach to intergenerational budgeting, such net debt figures are probably more insightful.

Latest budget projections show current deficit of about 1.1% of GDP moving to a small surplus by 2021 and beyond

The low net and gross debt figures are supported by disciplined budgeting, with the latest budget projections (2017/18) showing the current deficit of about 1.1% of GDP moving to a small surplus by 2021 and beyond[1].

All such projections rely on forecasting assumptions, and some of those look a bit optimistic to us. We think that the 3% targeted real GDP growth between now and 2020/21, is a little too high. But something like 2.5% next year (2020) is reasonable, and over the longer run, we believe Australia has the potential to grow at a real rate of more like 2.7%. So the assumptions are optimistic, not unrealistic.

Fig 4 Gross government debt to GDP (%)



Source: OECD

Inflation and revenue projections likewise are also likely a little high, and expenditure a little low, resulting in a somewhat higher path of underlying cash balance relative to the official forecast.

But even if the Treasury's fiscal projections are a bit generous, with net debt only about 19% of GDP currently, even making some allowances for optimism, by our reckoning, net debt might not be much more than 10% by 2025 (OECD puts it as a surplus).

RBA Governor Lowe is right to caution that fiscal policy may have to provide the bulk of policy support in any theoretical future crisis. Monetary policy has run out of room. But Australia is surely in a better position than almost anywhere else in the OECD to do this.

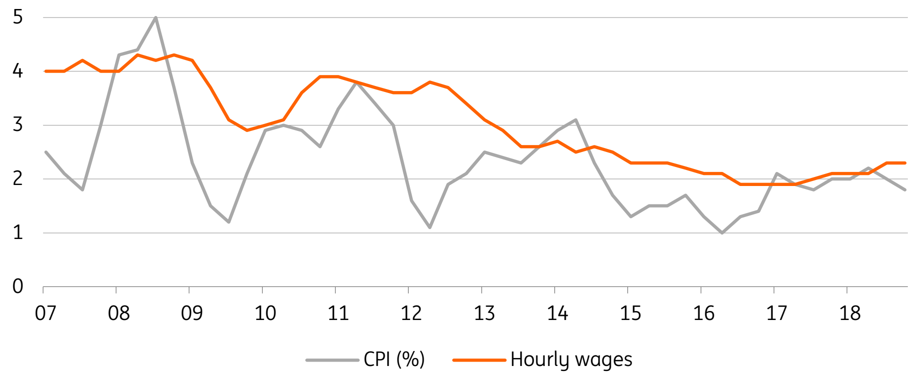
Price stability

Inflation is also extremely well behaved in Australia. The RBA has a slightly higher inflation target than most countries, with the target being the mid-point of a range of 2-3% (so 2.5%). This is not even close to being achieved, though transportation costs are pushing higher as OPEC stabilises crude oil prices, and we expect the overall series to push above 2.0% briefly during 2019, though maybe not enduringly.

Australia's low inflation relative to its stage of the business cycle, is far from unique, and is a very common feature amongst developed market economies. Some central banks regard this as a sub-optimal outcome (recent Fed officials for example have fretted about inflation expectations becoming anchored at too low a level). Some of us, in contrast, don't accept that there is anything special about the arbitrary target rates central banks have chosen. History may well show us that 2.0% or 2.5% was unachievably high if we are living in a world with much flatter, and probably also lower Phillips curves.

[1] https://treasury.gov.au/budget/

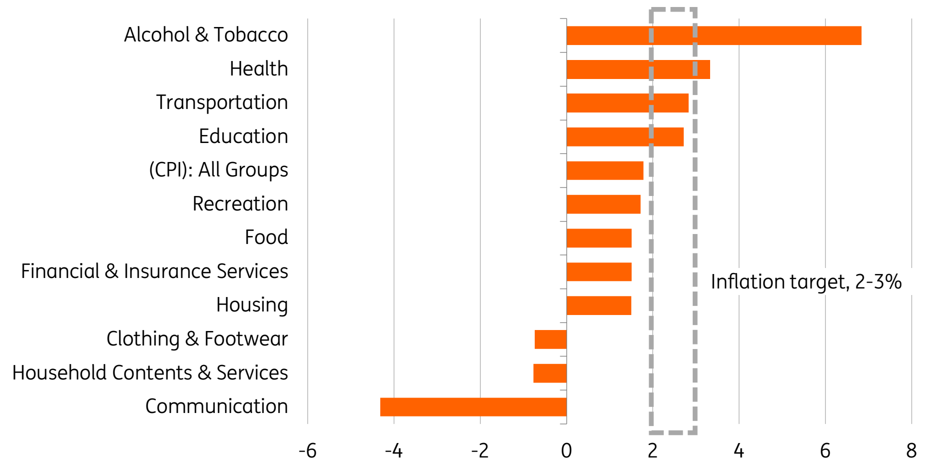
Fig 5 Inflation and wages growth (%YoY)



Source: CEIC

To a large extent, this is exactly the same issue working its way through disappointingly low wages growth, and with both wages and prices interdependent, we are probably observing the same phenomenon in both markets.

Fig 6 Inflation components (%)



Source: CEIC

And then the bad...

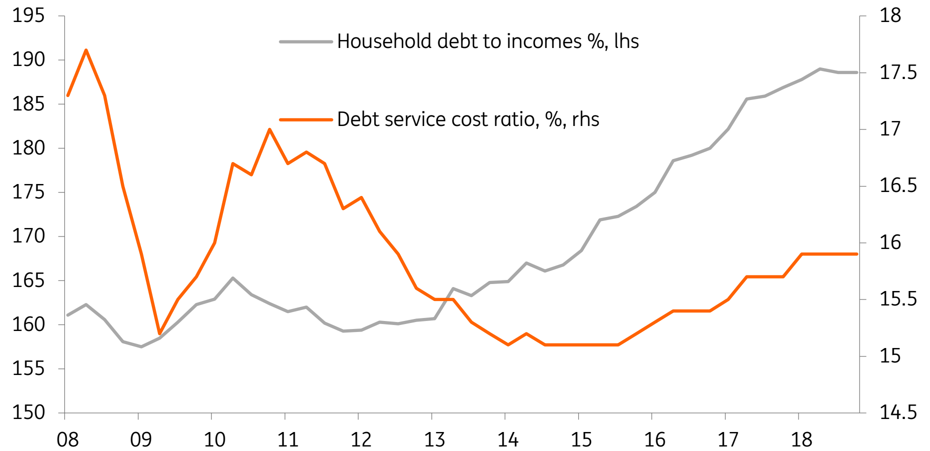
But while there is plenty to be upbeat about, there are also some areas of concern.

Household balance sheets

Australian household indebtedness seems uncomfortably high at 190% of incomes...

Australian household indebtedness is nothing new, but at 190% of incomes, it certainly seems uncomfortably high. Household indebtedness in the US, for example, peaked at about 135% just prior to the financial crisis. At the moment, Australian household debt remains sustainable owing to low market interest rates and protected by ongoing monetary accommodation that has left the key cash rate of the RBA unchanged at 1.5% since August 2016.

Fig 7 Household debt and service costs (%)



Source: Bloomberg

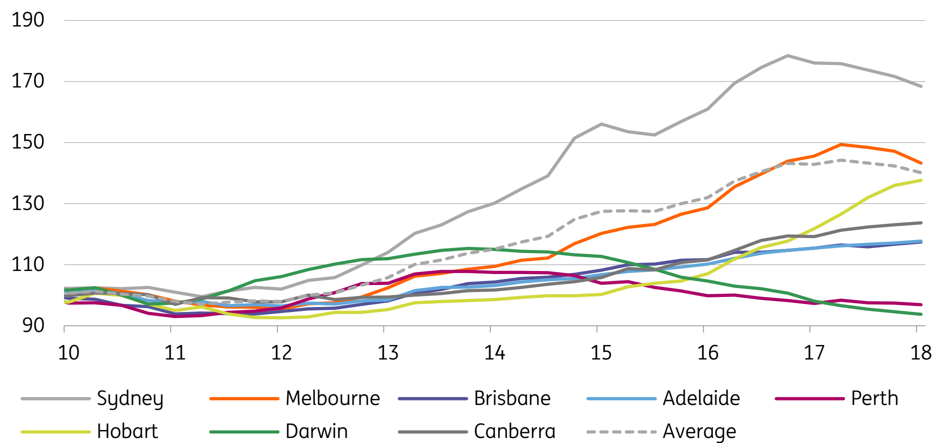
...but rates likely to remain unchanged for some time

Forward guidance from the RBA suggests that rates will remain unchanged this year, and probably next, and could even fall. So for the household and corporate sector, there should be little anxiety that additional borrowing could quickly lead to insolvency. Debt service costs for the household sector are 15.9% of disposable incomes - higher than they were on average last decade, but lower than the 2008 17.9% peak.

Housing market

So household debt service costs are manageable. But what about the asset side of the household balance sheet and the impact of falling house prices?

Fig 8 House price indices (2010=100)



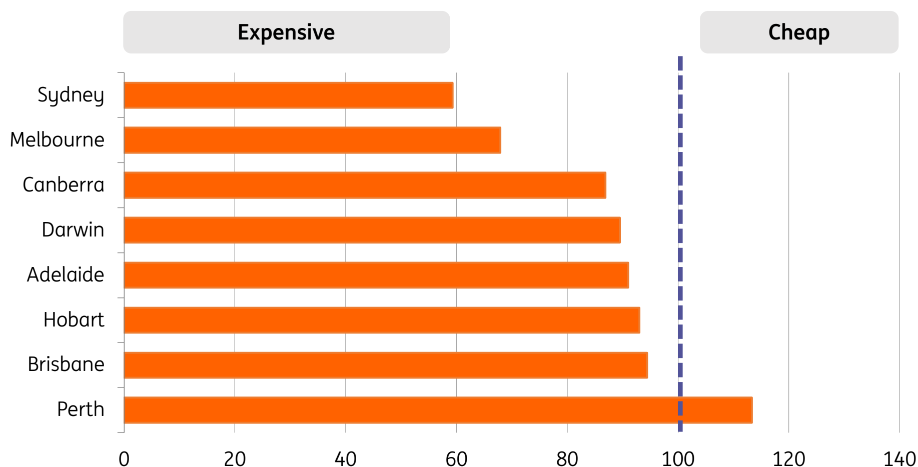
Source: CEIC

House prices in the big urban conurbations are not collapsing

The first thing to note is that house prices are not falling in every state. Admittedly, the weighted average of house prices is dominated by the big urban conurbations in Sydney and Melbourne. And after scaling unaffordable heights, prices here are now dropping steadily. But they aren't collapsing. And this looks a pretty orderly re-pricing which for many is a good thing as it improves housing affordability.

House prices in Darwin and Perth are also falling. But elsewhere, the property market remains, if not buoyant, at least stable, with positive gains in the price level in Adelaide, Hobart and Brisbane, the latter lifted by an LNG export boom that is drawing workers to the East Coast and pushing up demand for homes.

Fig 9 Housing affordability



Source: CEIC, CoreLogic

What has not happened yet, but which may yet become a cause for concern, is for the decline in house prices to spur a second round of retrenchment by the household sector. This will have to be watched closely. Consumer sentiment has shown some recent signs of softening. But so long as housing declines remain orderly and start to show some signs of moderation, then we believe any associated spill over to the rest of the economy should be limited.

Business investment

Business sentiment has been dipping, and with it the likelihood of additional robust investment growth has dimmed

One area of the economy that is quite worrying is business investment. Despite low interest rates, business sentiment has also been dipping, and with it, the likelihood of additional robust investment growth has dimmed.

One of the RBA's more optimistic assessments in recent times has been that the downturn in mining activity and investment that weighed on the economy from its peak during 2012-2014, would cease to be a drag and revert to something more positive. The reality is that this has merely ceased to fall, and with Chinese demand growth softening, there is little imminent prospect that this sector returns to robust growth. Recent bans of Australian coal to the port of Dalian aren't helping. It remains unclear what caused this ban, and whether it will be overturned at some stage.

Other non-mining capital investment surveys show a positive intent to invest, but this flies against falling business sentiment, and our best guess is that at least some of these intentions will never be acted on.

Neither good nor bad

GDP growth

GDP growth may remain weak

The last reading of GDP growth (3Q18) was 2.8% year-on-year, not exactly a slovenly rate, though the quarter-on-quarter growth rate did ease back to only 0.3%. Overall growth was supported by consumer spending, reflected more broadly in similar growth rates of retail sales and strong auto sales growth.

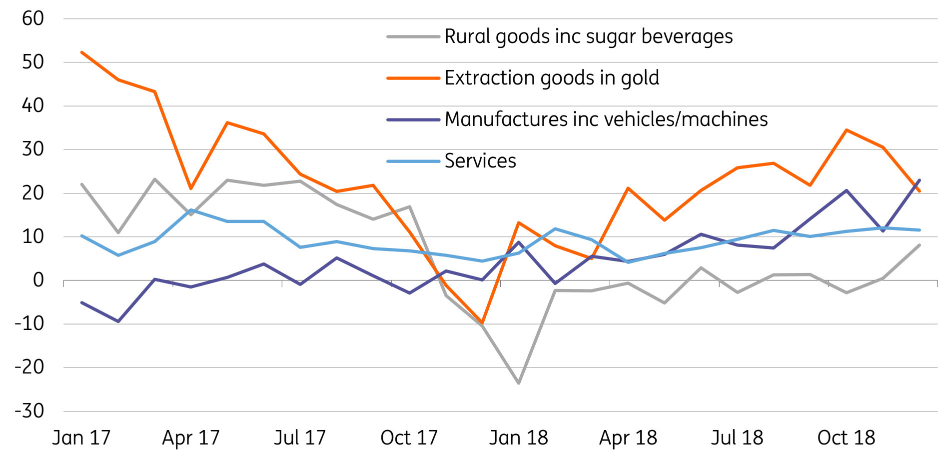
4Q18 is likely to be affected by extremes of weather – droughts and extreme heat at one end of the country hurting Australia's agricultural output, and flooding at the other end. This may keep GDP on the weaker side. But such effects tend to be transitory, though admittedly, loss of larger livestock may take longer to replace.

Exports

Given the slowdown in exports elsewhere in the Asia Pacific region, Australia's export picture doesn't look too bad. Extraction industry exports continue to grow at a decent, though slowing pace, and manufactured goods are trending higher, as, to a lesser extent are services.

Agricultural goods exports are lagging behind a little, though even here the trend is higher, though that may be affected by recent extreme weather and we could yet see this turn sharply lower again.

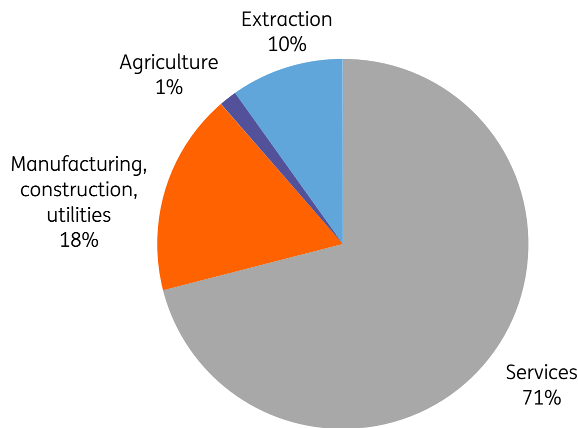
Fig 10 Exports by type (%YoY)



Source: CEIC

That shouldn't worry us unduly if so, with agriculture accounting for only a few percent of Australian GDP, even if it is more highly represented in exports.

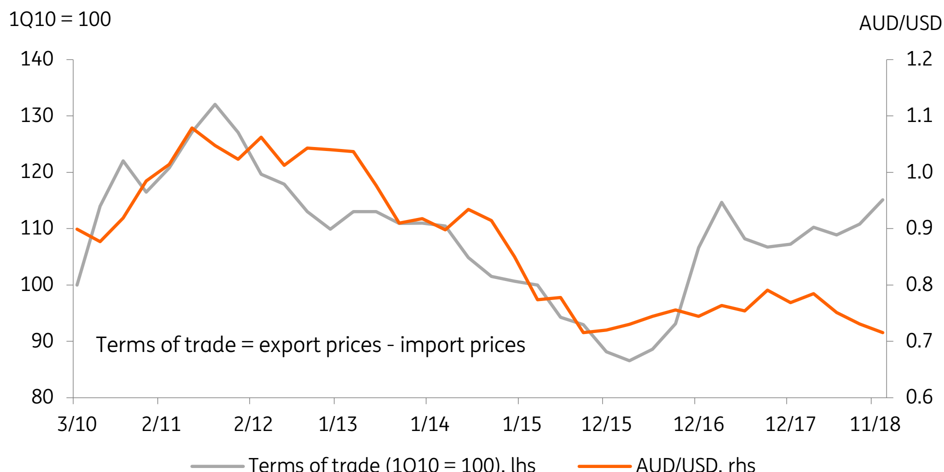
Fig 11 GDP by output type



Source: CEIC

Moreover, we cannot really blame the Australian dollar for any disappointment that we may see in the current export figures. Thanks to the RBA's apparent lack of concern over the value of the Australian dollar, current AUD/USD exchange rates remain well below where you might expect them to sit based purely on relative terms of trade shifts. Valuation is evidently not a problem.

Fig 12 Terms of trade and AUD/USD



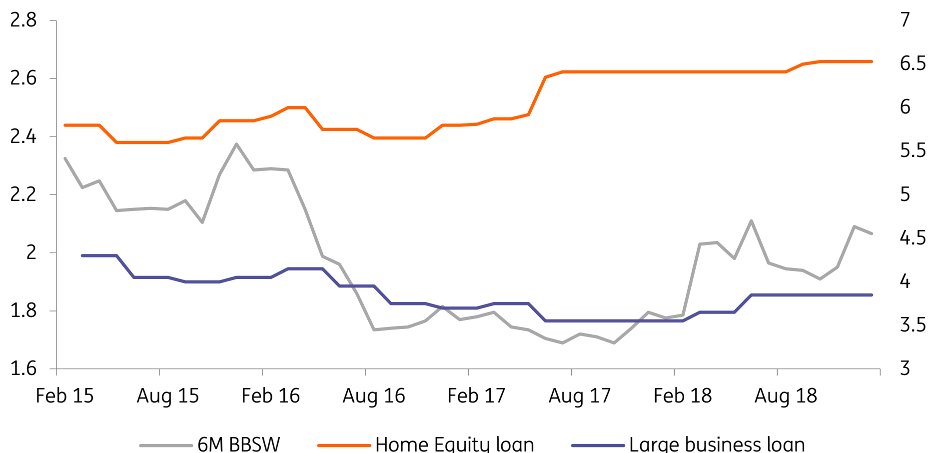
Source: CEIC, ING

Reading between the lines of statements and speeches, it looks like the RBA would be quite happy to see the AUD down in the 0.60s, which is why we forecast one quarter of 0.69 in 2Q19 this year. Thereafter, we see the AUD pushing slowly back up into the 0.70s, though with the RBA, as ever, providing a channel for it to depreciate if it goes too far or too fast.

Financial conditions

Of considerable interest in recent quarters has been the rise in the funding costs of Australian banks, which have been passed on to both households and corporates, respectively, through higher mortgage lending rates and business loan rates.

Fig 13 Bank bill swap and loan rates



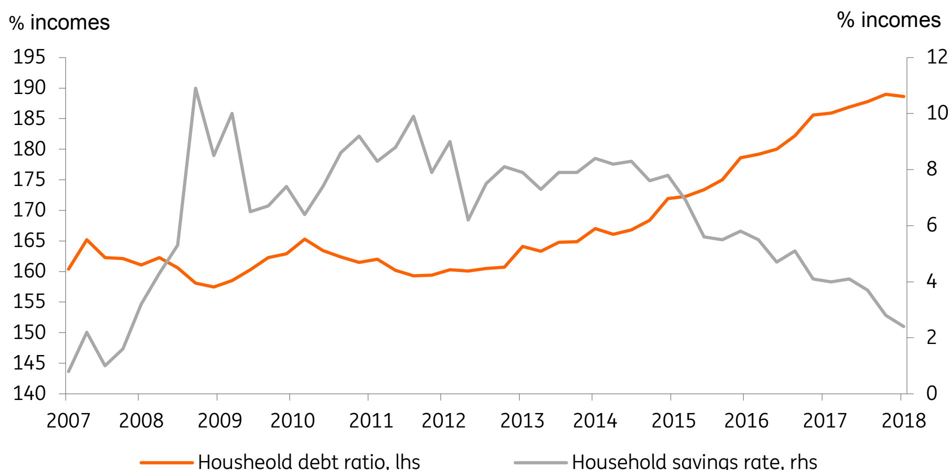
Source: Bloomberg

This increase in funding costs has delivered a non-negligible tightening of financial conditions despite the absence of any policy change from the RBA. As such, even if the RBA's bias had been towards a distant tightening prospect, this market move has now partly or maybe completely done their work for them.

Complicated money market with multiple influences, some of them from overseas

Low and falling Australian savings rates (high and rising household debt) mean that the pool of savings for banks to lend-on is insufficient to meet loan demand, resulting in an annual funding gap of about A$450 billion. This has been found from a variety of sources resulting in a complicated money market with multiple influences, some of them from overseas.

Fig 14 Household saving rate and debt ratio (% incomes)



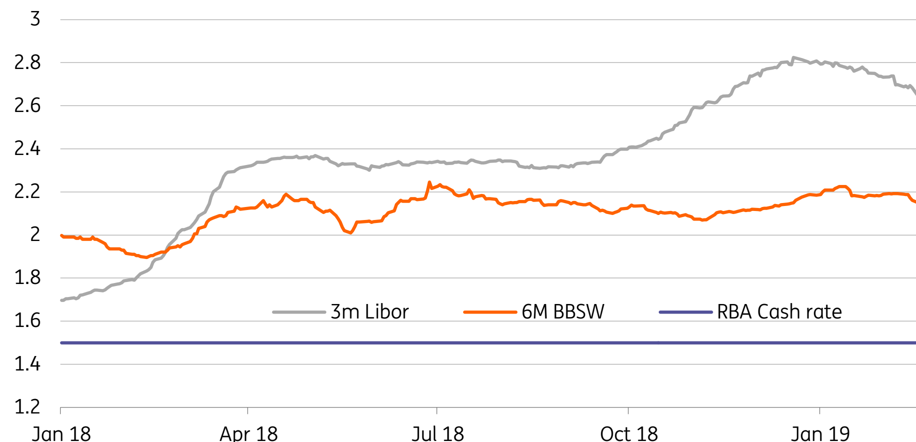
Source: Bloomberg

In the following charts, we focus on some of the drivers of market rates, specifically the bank bill swap rate (BBSW) for 3m and more liquid 6m tenors. What becomes apparent is that there are multiple influences on this, and making broad forecasts about its future path/spread with respect to the OIS curve is perilous.

If there were no overseas markets, Australia's money market rates would be driven purely by the mismatch between deposits and desired borrowing. This is, of course, still a factor in driving domestic rates, and to the extent that business sentiment is softening, and the housing market normalising, we may see Australia's chronic low household savings rates push higher, whilst demand for loanable funds eases back, taking some of the pressure off short term rates.

Australian banks have been driven to other markets to seek funds, and due to its size and liquidity, in many cases, to US dollar markets. Here, recent changes to global taxation have led to corporate pools of overseas USD drying up as they relocate back to the US. Added to last year's fiscal stimulus, paid for by record T-bill issuance, this has pushed up Libor rates relative to the Fed funds rate (or the OIS curve).

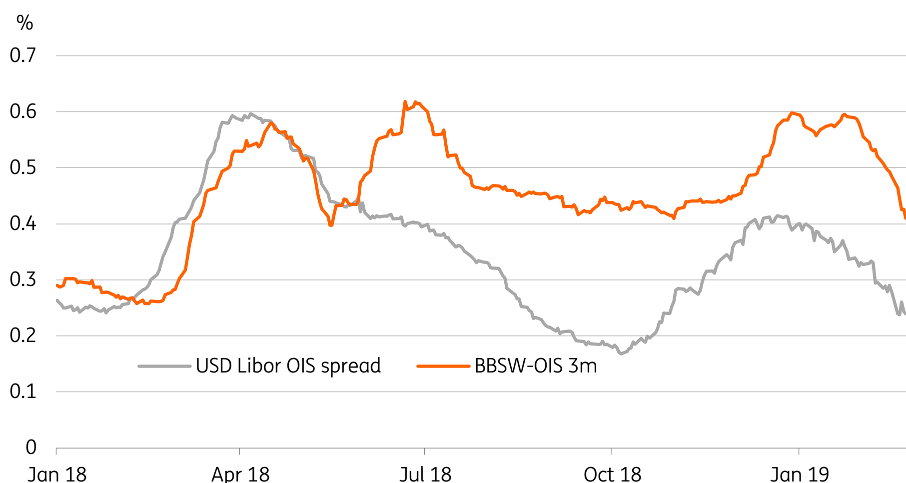
Fig 15 6M BBSW and 3m USD Libor (%)



Source: Bloomberg

Some of these increases have been channelled back into the Australian market, for instance, 3m and 6m BBSW. Though there are clearly more factors at work, as the multiple and not always coinciding bumps in the BBSW market attest. Rising rates in the US until recently have also pushed borrowers back towards the Australian domestic market, heightening pressures there.

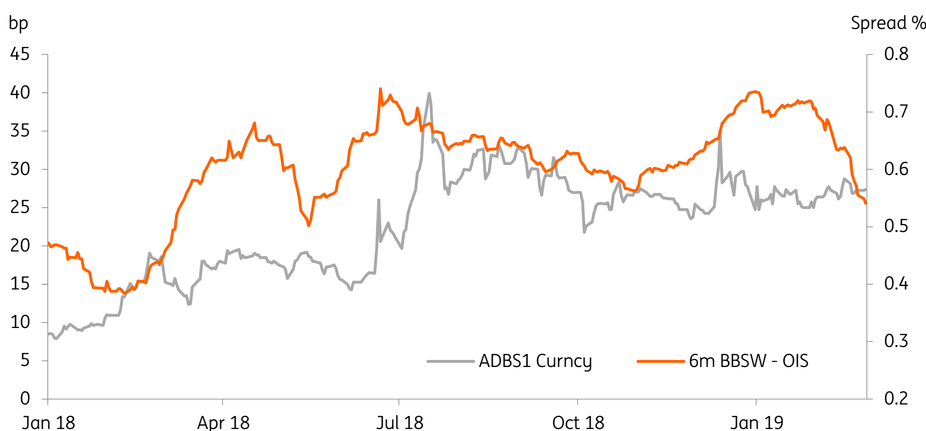
Fig 16 US 3M Libor or 3M BBSW OIS spreads



Source: Bloomberg

Additionally, the prevalence of Australian borrowers in USD money markets has led to a cross currency basis in swap markets raising the cost for Australian borrowers of swapping their USD back into AUD. To some extent, these and other funding costs have been passed on in higher lending rates to households and corporates.

Fig 17 BBSW-OIS spread and 1Y CCY basis



Source: Bloomberg

The good news is that on the US side, the prospects for further Fed tightening look quite limited and the outlook for rates locally also has flattened off. Add to that some moderation in USD Libor, and the funding cost backdrop has clearly improved a little. That said, there is little evidence that lower Libor rates or spreads are being passed on in lower lending rates (at least, not yet). Though these moves do make further borrowing rate increases look unlikely near term.

Longer term

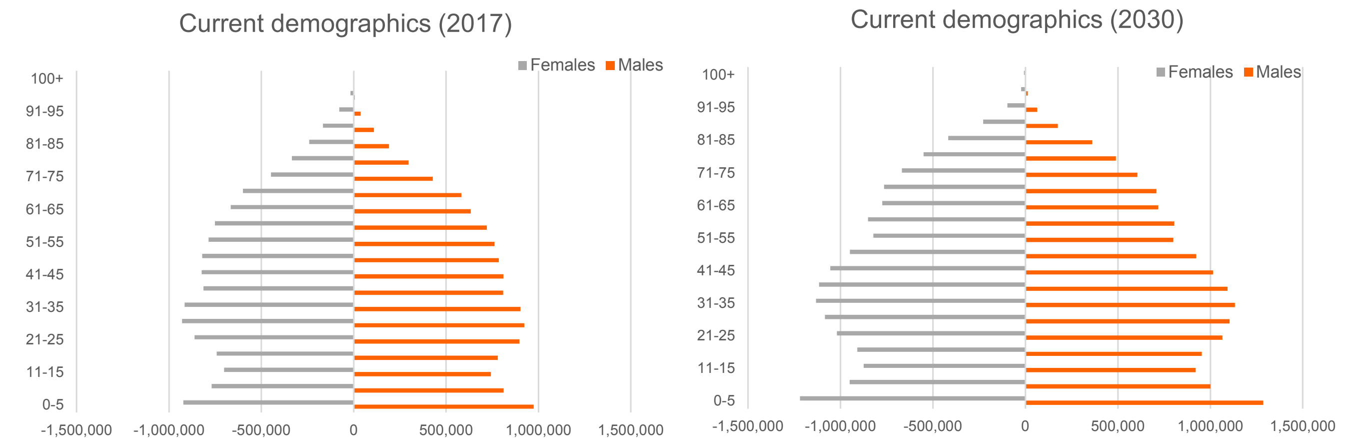
Australia may have an ageing population, but it does not have an old one, nor will it for some time

Like most developed economies, Australia has an ageing population. But this isn't as bad as some of its peer group. Net migration plays a role in keeping the population young. With a daily net migration rate of around 450, new births of 860 and deaths of 460 per day, the population rises at about a daily rate of 860, and should rise from 25 million today, to around 26.5million in 2025 and 28 million by 2030.

Currently, the ratio of the population that is 65 and above (elderly dependence ratio) is almost one in five (22.6%). That is only a little more than in the US (22.1%). And based on credible sources, it rises to 25% by 2030. In comparison, the UK elderly dependency ratio is already 28.2%, Germany's 32.1% and Japan's a whopping 42.7%.

Australia may have an ageing population, but it does not have an old one, nor will it for some time.

Fig 18 Population pyramids



Source: UN

Although there is some narrowing of the population pyramid for those aged 30 and under, the recently rising birth rate points to a normalisation of the population pyramid, and could in time help reverse any near-term rises in the elderly dependency ratio. Impacts in the meantime on public finances will be limited thanks to the farsighted intergenerational budgeting of successive governments.

Conclusion

Concerns need to be put into perspective and even if the very short term is rife with uncertainty, the longer term still looks very promising

At a time when being the number one supplier of raw materials to China has turned from being a very good thing, to being the cause of considerable market unrest, some market participants are sounding a more nervous note on Australia.

In this note, we have tried to put these concerns into perspective. Sure, not everything in the Australian economy is wonderful. But then neither is it anywhere else. And even if you take a really bleak view on the trade talks and the outlook for China (and we don't) there is more to Australia than just holes dug in the ground.

2019 will be a tough year for many economies, and Australia will not be immune. We are not pretending it will be. However, the domestic economy is still in pretty good shape, though of course, some bits look more resilient than others.

Looking further out, Australia looks in much better shape than many other OECD economies owing to its very favourable public finances offering policymakers genuine alternatives to monetary easing, and also to its better than average demographics. So even if the very short term is rife with uncertainty, the longer term still looks very promising.

Fig 19 Forecast summary for Australia

	1Q19	2Q19	3Q19	4Q19	2019	2020	2021	2022-25 (Avg)
GDP (YoY%)	2.2	1.8	2.1	2.2	2.1	2.4	2.5	2.7
CPI (YoY%)	1.7	1.7	2.1	2.0	1.9	2.0	2.2	2.2
Unemployment rate (eop)	4.9	5.1	5.2	5.4	5.4	5.3	4.9	5.1
Residential real estate YoY%	-1.5	-0.8	-0.4	0.3	-0.6	1.8	2.1	3.0
Fiscal balance (underlying cash balance)					-1.5	-1.0	-0.5	0.4
Gross debt/GDP (%)					33.5	33.5	32.5	30.0
Current a/c balance (% GDP)	-2.0	-2.0	-2.1	-2.2	-2.2	-2.4	-2.6	-2.5
RBA cash rate (eop)	1.5	1.5	1.5	1.5	1.5	1.5	1.75	2.0
10Y yields (eop)	2.15	2.15	2.30	2.30	2.30	2.30	2.50	2.60
AUD/USD (eop)	0.72	0.70	0.69	0.71	0.71	0.75	0.75	0.75

Source: ING, Bloomberg, CEIC

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