Economic Views Australia – March 2016

Households & services drive growth in December

View from the top

The Australian economy grew by 0.6% in the December quarter to be 3% higher through the year. Growth was largely driven by broad-based strength in household spending, supporting less cautious saving, and a spike in public spending. While the property, retail and financial industries had another strong quarter, mining-linked industries, such as heavy construction and technical services, continue to wane. Overall annualised growth finished the year around trend, however further falls in the price of Australia's key commodity exports suppressed real per capita incomes.

This growth occurred against a backdrop of continuing volatility in the global market. Front and centre of this volatility is concern over Chinese growth prospects and the direction of US monetary policy.

Indicator	Dec quarter	FY-15	FY-16[f]	FY-17[f]	FY-18[f]
Real GDP growth	0.6%	2.2%	2.5%	2.6%	2.8%
Inflation	1.7%	1.5%	1.6%	2.3%	2.5%
Unemployment rate	5.8%	6.0%	6%	5.5%	5%
RBA cash rate	2.00%	2.00%	2.00%	▲	▲
General outlook	-	-	Negative	Stable	Stable

Source: ABS; RBA; PwC forecast (f), GDP growth expressed as a year average rate, inflation is through-the-year to June and the unemployment rate and interest rates are end of year.

Households & services drive growth in December

Potential forces shaping 2016

Global markets

- Over US$3 trillion was wiped from global equity markets in the first two weeks of 2016, with investors concerned by falling oil prices, China's economic transition and the direction of future US monetary policy.
- Financial markets have made a tentative recovery, but are still wary of a Chinese economic 'hard landing', as financial outflows threaten to undermine China's transition towards consumption led growth.
- Global volatility has reduced the likelihood of a US Federal Reserve rate rise in 2016, with markets pricing a 50% chance of a 25 basis point rise in 2016. Easing biases remain elsewhere, with the ECB and BoJ lowering rates in early 2016.

Impact on Australia

- Australia's equity markets followed global markets down in January. Resource exporters were hardest hit, reflecting the strain of low commodity prices.
- However, prices for iron ore, Australia's largest export, bounced back in February and March, up over 30% from end January prices. The ASX200 also reversed all January losses, and crude oil prices also hit a three month high.
- The health of Australia's traded sector will ultimately depend on stability in China, who receive almost one-third of all Australian exports, and the ability for domestic industry to capitalise on its transition to consumption led-growth.

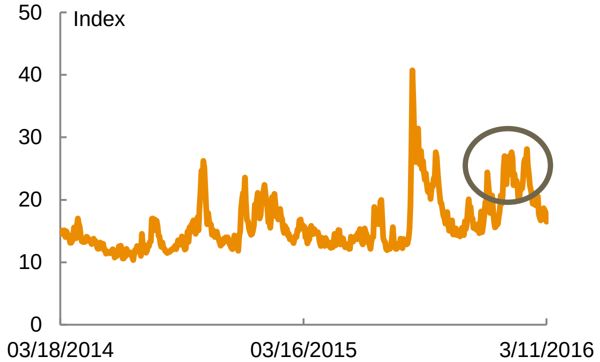
Domestic adjustments

- Notwithstanding global volatility, expanding LNG production and household demand should see moderate growth over 2016. However, further falls in commodity prices and mining investment will weigh on real per capita income and expenditure.
- Household and business services will support growth over 2016, however, an extended focus on cost cutting is impeding growth in capital expenditure and labour utilisation.
- Subdued labour demand and wage growth mean household spending will be supported by declining rates of saving, which are returning to historical norms.

More financial volatility, but a recession seems unlikely …

Early 2016 saw a period of heightened volatility in global equity markets, with concerns over Chinese economic growth, US monetary policy and falling commodity prices worrying investors and dragging on global economic activity (Figure 1). Financial markets made a tentative recovery in early March, however global growth remains fragile. The IMF is forecasting growth of 3.4% for 2016 after 3 consecutive downgrades.

Figure 1: VIX implied volatility index



Note: The CBOE Volatility Index (VIX) is a measure of expected volatility in the market, and is implied from S&P500 options.
Source: CBOE

China is pivotal to the world economic outlook, having accounted for almost one third of global growth in 2015. China is Australia's largest trading partner and will continue to play an important role in Australia's long term economic prosperity.

However, confidence in China's economy continues to be destabilised by mixed data reports. February's data showed weakness in manufacturing (PMI < 50) and exports (down 16.3% over the year), which, combined with spare capacity in the housing market, is placing downward pressure on the Chinese Government's 2016 growth target of 6.5%. While some strength was observed in private consumption and fixed asset investment, record financial outflows (US$713 billion in 2015) are threatening China's medium-term transition to domestic led growth.

China's economic outlook, however, must be viewed against its recent economic performance over the past two decades. Chinese GDP growth of 6% in 2016 is the equivalent of 9% five years ago, and disposable incomes are growing solidly in real terms (up 7.9% over the course of 2015). Additionally, government support for expansionary fiscal policy, signals of exchange rate stability by the People's Bank of China and a weaker Yuan are likely to stem the impact of high financial outflows and absorb some spare capacity.

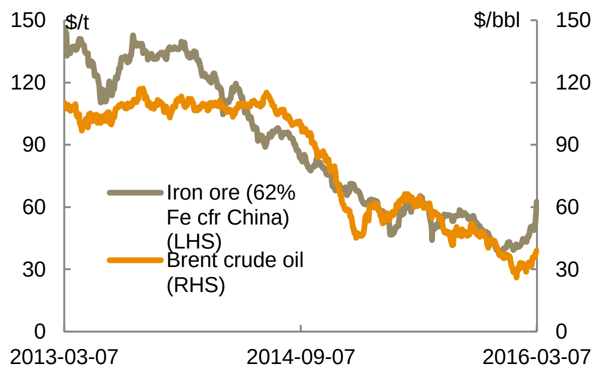
Households & services drive growth in December

Against this fragile backdrop, the US Federal Reserve has shown signs of softening its tightening cycle started in late 2015. With subdued inflation and wage growth offset by a tightening labour market (4.9% unemployment rate), the Federal Reserve has room to be cautious and delay rate rises.

... Australia looks to be able to weather the storm ...

A key channel through which this uncertainty plays domestically is through the price of Australia's largest export commodities - iron ore and coal. After a period of steady decline over 2014 and 2015, a recent rally in the iron ore price, following bullish comments from Chinese authorities (Figure 2) and strong fixed asset investment, will bring welcome reprieve to Australian miners and government tax receipts.

Figure 2: Iron ore and crude oil price



Source: EIA, Wall Street Journal

However, analysts are pessimistic about whether a sustained recovery in commodity prices can be realised given expected demand for steel in China. This would be exacerbated in the case of a Chinese 'hard landing'. Modelling undertaken by Oxford Economics indicates that a 'hard landing' scenario in China could wipe over 1.5% off Australia's annual GDP growth, or $64 billion in level terms. However, such a scenario would likely see the downturn moderated by a depreciation of the AUD and a further easing of monetary policy, stimulating non-resources exports and domestic demand.

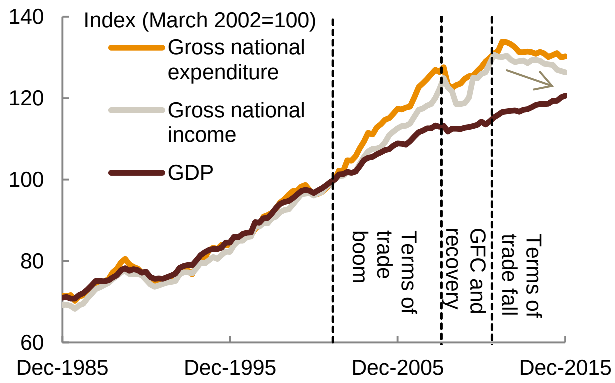
... with more domestic adjustment for the year ahead ...

Against this global backdrop, several domestic trends will likely persist throughout 2016.

1. Moderate growth, but below trend income
GDP grew by an annualised rate of 3% to December 2015 - around its trend rate. Moderate growth is expected over 2016 on the back of expanding LNG exports and continued subdued demand from households.

However, as highlighted in recent PwC analysis,[1] real per capita income and expenditure will be suppressed by the further expected declines in commodity prices and mining investment. In essence, the commodity price windfalls observed over the last decade are unwinding, with an average dollar of exports able to buy less goods and services compared to before (Figure 3). The impact of falling commodity prices on national income will gradually become smaller as commodity prices normalise over the forecast period.

Figure 3: Per capita growth in real GDP, income and expenditure



Source: ABS catalogue 5206.0, PwC

A lower real exchange rate has helped mitigate these effects by supporting trade exposed industries (such as tourism, manufacturing and agriculture). While this supports GDP growth, further productivity improvements will be required if living standards are to be maintained in the face of falling commodity prices and an ageing workforce.

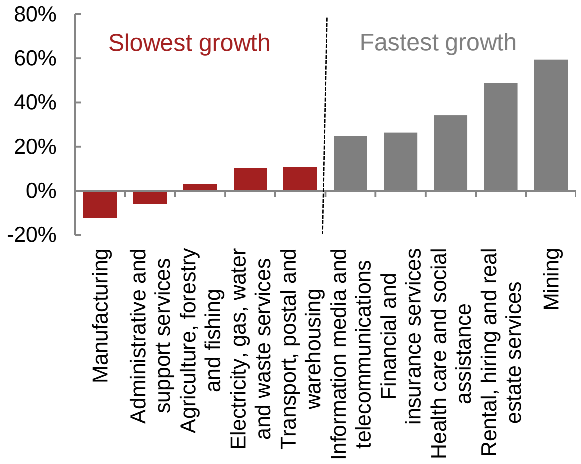
2. Services are driving non-mining growth
The transition of growth to non-mining industries has been gradual, but is well underway. Mining linked industries (e.g. heavy construction and technical services) and traded exposed goods industries (such as manufacturing and agriculture) continue to flat line or decline, while household and business services (such as health, information, media and technology, and financial services) have grown strongly (Figure 4). Job creation has been

[1] https://pwc.docalytics.com/v/pwc-whitepaper-is-australia-facing-the-risk-of-complacency?channel=blog&source=post_content&cid=blog-post_content

Households & services drive growth in December

particularly strong in health, education, and hospitality, which have accounted for more than half of jobs created in the past five years. After a year of strong growth, real estate linked industries are expected to moderate over the coming year.

Figure 4: Fastest and slowest growth since the Lehman Brothers collapse (September 2008)



Source: ABS catalogue 5206.0, PwC

3. But many firms are focusing on costs

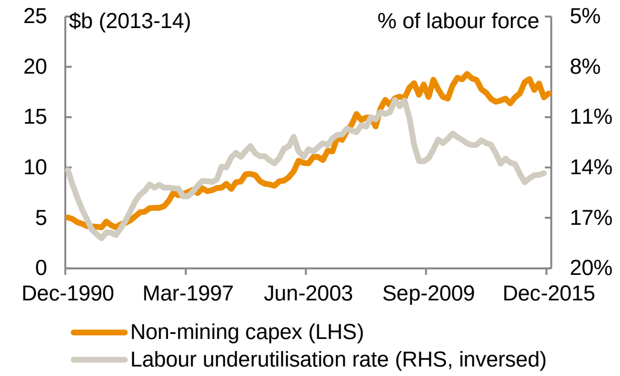
However, this is yet to translate into broad-based expansion plans, with recent ABS surveys of capital expenditure (capex) and the labour force, and PwC's Global CEO Survey[2] suggesting that Australian businesses remain focused on costs in the face of uncertain economic conditions, changing technological requirements and high hurdle rates.[3]

Accordingly, while aggregate demand has been sufficient to generate a pick-up in employment growth and labour market participation over 2015, it was largely contained to part-time employment, and measures of labour force utilisation suggests that demand is still falling short of the supply of labour (Figure 5). Capex by non-mining business also remained weak, but is expected to gradually recover as aggregate demand accelerates in coming years.

[2] https://pwc.docalytics.com/v/au-report-pwc-2016-annual-global-ceo-survey

[3] http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-1.pdf

Figure 5: Labour force underutilisation and real non-mining capex

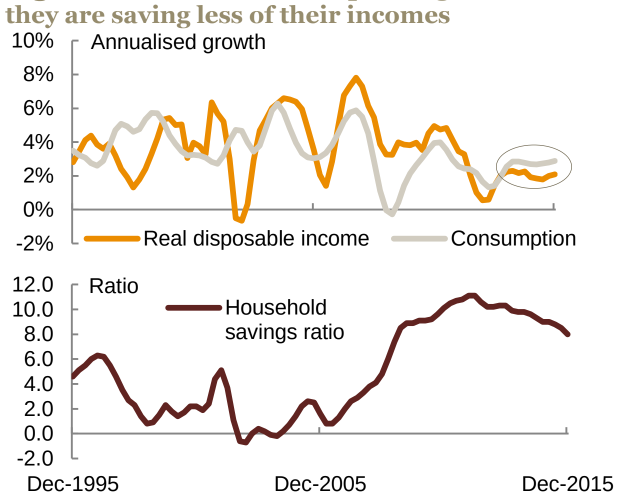


Note: Labour force underutilisation includes unemployed and underemployed (willing and able to work more hours than currently available). Non-mining capex does not include all industries reported in the ABS national accounts.
ABS catalogue 6202.0 and 5625.0

4. Households are saving less

Household consumption accounted for almost 70% of GDP growth in the December quarter, and nearly 50% of growth came from NSW and VIC households alone. This comes at a time when individuals are on average earning less due to both a shift to part-time employment and also sustained weakness in wage growth. Households have therefore been increasing spending by lowering the amount of disposable income that is saved (Figure 6).

Figure 6: Households are spending more because they are saving less of their incomes



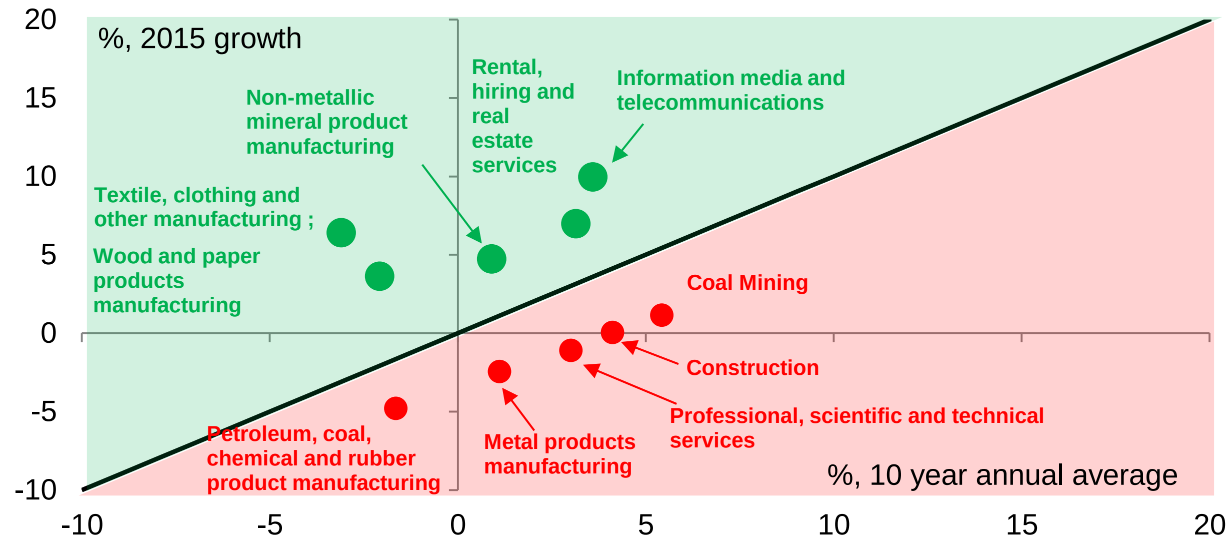
Note: The household savings ratio is the share of household disposable income that is saved after consumption). All series show trend values.
Source: ABS catalogue 5206.0

This is not in itself a bad thing – over the past 25 years, households have saved on average 5% of their disposable income, and so recent behaviour reflects a move towards historical rates. With wage and GDP growth to remain modest through 2016, for household consumption growth to remain steady, it is expected that this pattern to continue.

Households & services drive growth in December

Best and worst industry performers – Calendar year 2015

To understand industry performance over the past year, it is worth looking at how growth has compared with historical averages. The chart below illustrates the performance of the top five and bottom five industries in 2015 against annual performance over the past 10 years. Industries above the diagonal line have exceeded historical averages and those below have recorded below average growth in the quarter.



Note: Displays the five industries that grew slowest/fastest in the 2015 relative to a 10 year history; above the line indicates above trend growth while below the line indicates below trend growth.
Source: ABS catalogue number 5206.0.

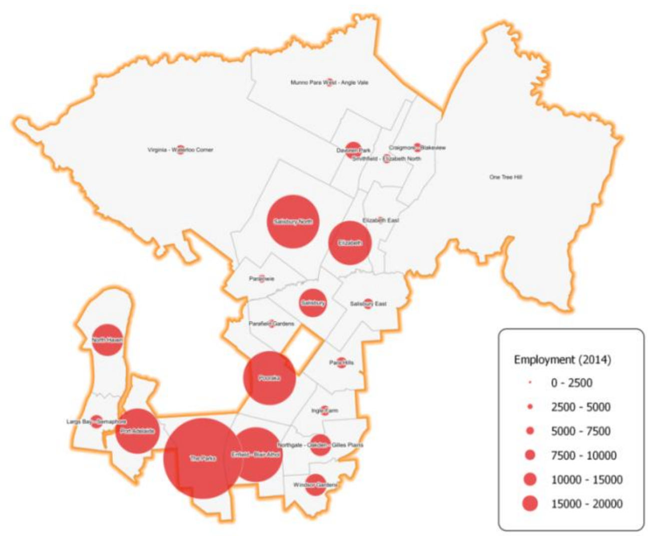
GEM spotlight: Economic profile of Northern Adelaide

Increasing unemployment has been a major issue for South Australia following the decline of the manufacturing industry (which, over the last decade, has shed 25% its South Australian workforce). While there are some tentative signs of growth over the last year, driven by household spending, policy makers remain heavily focused on how growth and job creation can be expanded to pre-GFC levels.

To help business and government understand economic trends and their policy implications, we have used PwC's Geospatial Economic Model (GEM) to look at growth and employment at a granular level for Northern Adelaide.

PwC found that economic outcomes for Northern Adelaide are diverse. Gross Regional Product varies considerably by region, with 80% of the output concentrated in the top 10 regions (out of 23). Economic activity and employment are concentrated in the South and South West of Northern Adelaide, while Elizabeth and Salisbury are some of the most disadvantaged sectors. This presents a challenge to policy makers to target those areas of greatest need.

Figure 7: Employment in Northern Adelaide



Source: PwC GEM

Households & services drive growth in December

PwC economic and policy consulting

The Economic Views reports are produced by PwC's Economics and Policy Consulting team. Working at the nexus of economics, policy, strategy and finance, we provide practical and empirically-supported solutions using the latest economic tools and industry leading expertise.

Our macroeconomic efforts have recently been focused on helping businesses to assess the most pressing risks and opportunities in their markets, understand the effectiveness of their forecasts and test their businesses' sensitivity to a range of economic scenarios. All these factors are essential to establishing the best strategy for business during times of economic turmoil.

We also provide microeconomic advice to a range of industry sectors, with a particular focus on transport, Government, health and social services, energy, water, and natural resources.

For more information about any of our services please contact one of the members of the team to the right.

How our macroeconomic team can support you:

- Prepare economic outlook reports on the country or industry you are interested in
- Prepare short term and long term forecasts of macroeconomic variables such as GDP, inflation, average earnings, consumer demand and interest rates
- Review and advise and develop short and long term forecasting methods for businesses based on key macroeconomic and industry sensitivities
- Advise on the impact of key events, such as the global financial crisis, emissions trading schemes or major changes in regulation, on your markets
- Assess the contribution your company or industry makes to the local economy in terms of economic variables such as employment, tax revenue and output
- Construct models to forecast prices and key market trends.

Contact details

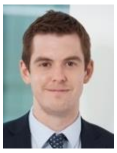
For more information about our services please contact one of the members of the macroeconomic consulting team below:

Jeremy Thorpe
Partner
+61 (0)2 8266 4611
jeremy.thorpe@au.pwc.com

Craig Fenton
Partner
+61 (0)7 3257 8851
craig.fenton@au.pwc.com

Rob Tyson
Director
+61 (0)2 6271 3260
rob.tyson@au.pwc.com

Iain Bain
Associate Director
+61 (0)2 6271 3213
iain.bain@au.pwc.com



Ben Greig
Manager
+61 (0)2 6271 3135
ben.greig@au.pwc.com

Rhett Wilcox
Senior Associate
+61 (0)2 8266 2463
rhett.wilcox@au.pwc.com

Sarah Duffy
Associate
+61 (0)2 6271 3133
sarah.duffy@au.pwc.com