

Dec 2009

## Economic quarterly

### Key points

#### Statistics, statistics and more statistics

#### Australia and the ROW



The last three months of 2009 saw a continued repeat of conflicting data, with most signs pointing to a tepid recovery in global terms, contrasted by data reflecting the opposite. While economists search amongst the debris of data and try to make some sense of what it all means, it now seems evident a broad based recovery in the global economic framework is underway. This could be merely sentiment driving markets through fear of a world recession but tellingly, China continues to forge ahead strongly following its stimulus.



Job ads; unemployment; business confidence, dwelling starts; new car sales.



Construction, exports; consumer sentiment; personal finance commitments; household debt; credit growth.

With 2010 arriving it's opportune at this juncture – mid way through FY10 – to pause and reflect on the dynamics of the economic recovery (both here and overseas) and try and identify the key themes and trends that will shape the next 6-12 months. The flyer stays closer to the facts and look at possible outcomes given history and a sound basis in Economics #101.

#### **What we know (or can surmise with some comfort):**

- Most of Asia (excluding Japan which coincidentally just recorded its fastest drop in population since WW2) is rebounding back to its pre GFC trend growth rates. The IMF forecasts growth in Asia of 5.75% in calendar year 10 (c/f 2.75% in CY09). China is targeting an 8% uptick this calendar year (independent forecasts are as high as 10%) and has just recorded its biggest manufacturing margin in five years in December.
- Australia has enjoyed better fortunes than all developed nations and will enjoy debate as to why so by budding economists in the years ahead. What we do know is that either through good fortune or the combination of Fiscal stimulus and fleet footedness by the RBA, Australia experienced one quarter of negative growth and more or less sailed through the worst global economic crisis since the Great Depression. The legacy though is high underemployment, some (albeit modest) elevation in unemployment record debt and a return to hawkishness by the Central Bank.
- The IMF recently observed that “the European economic recovery is under way but remains relatively fragile”. It is predicting 0.3% growth in the 16 euro nations in 2010. That said, UK manufacturing activity grew at its fastest pace in more than two years in December (yet the economy remains mired in recession)
- Data released in late December shows that the US grew 2.2% (July to September) on downward revised forecasts. The revised figure follows four successive quarters of decline and while the second quarter was positive, it was artificially buoyed by massive government spending, including the "cash-for-clunkers" programme. Yet the economic signs remain ambivalent at best: business investment remains weak, bank lending is down, consumer spending has been tepid and unemployment is stuck around 10% and still advancing. A challenge to say the least buoyed by sharemarkets looking for positive news.
- Equity markets have powered ahead in calendar year 10, with the ALLORDS up by 33% for the year; DOW (22%) and FTSE (28%). And all this on the basis that the anus horribilis of the GFC was about spent and that the recovery was within shooting range.

#### **The elephant in the room (what should keep us awake at night):**

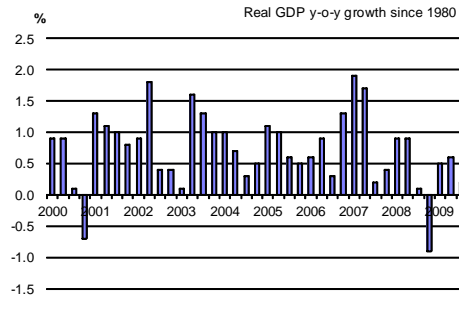
- Debt, debt, and more debt, withdrawal (in whole or in part) of public stimulus programs, structurally unsound banking system and higher interest rates – all enough to feed the Bears amongst us.
- The world's Government's have created a debt mountain and stabilised a badly fractured banking system through massive bailouts (loans and equity stakes), while Central Banks have wound back cash rates (Australia now in an exclusive club and out of step with the ROW) to historically low levels. There are many doomsayers (official and unofficial, such as “the national debt clock” [US]) pointing at the debt mountain and drawing some frightening conclusions. Some right wing think tanks are even suggesting the US could default on its public debt – a scenario not worth thinking about.
- But the real issue for public debt is not the absolute amount but the relative amount (measured as a proportion of GDP). These statistics provides a sobering perspective for CY10: Japan (223%); Greece (125%); the US (99%); UK (52%); Italy (117%); France (82%); China (16%) and Australia (21%). Moreover, the IMF forecasts a further deterioration in the fortunes of the Advanced G20 economies with this ratio to reach 120% by 2014 (c/f below 40% for the Emerging G20 economies). In a paper presented by Reinhart and Rogoff in December, it was stated that debt/GDP ratios above 90% heavily emasculated GDP growth.
- In a more temperate assessment the unavoidable conclusion is that the world was saved by replacing private debt (owned by a few) with public debt owned by everyone and creating more debt. This analogy has led to some bitterness by those who lament that the institutions that caused the problem in the first instance were saved by the taxpayers who are now jobless, while the perpetrators of this calamity again line their pockets with fat bonuses. This has led to policies being introduced and considered by several European Governments (and the US) to aggressively tax these bonus payments.

### Summary

The response to the GFC by Central Banks and Governments was to throw a financial stimulus party to avoid a repeat of the 1930's. For all the protestations of conservatives, that appeared to be a legitimate and welcome intrusion to save the world from collapse. However, banks in Europe and the US – the mainstays of global banking – are far from healthy and at some point someone has to pay the piper. That means higher interest rates, a reversion of economic stimulus and cuts in Government spending. All of this points to another challenging year ahead in CY10.

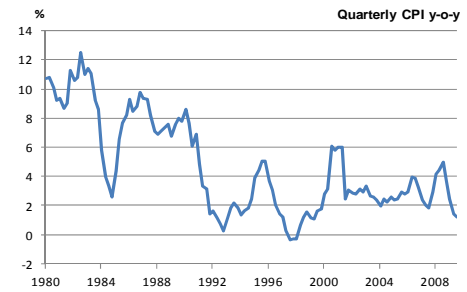
## Big picture indicators

### GDP



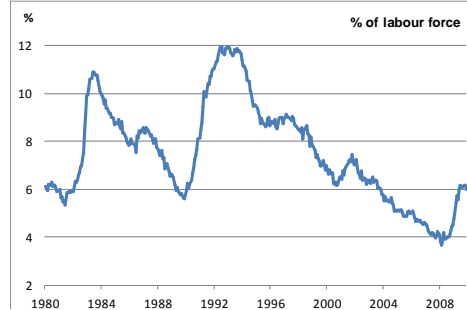
Source: RBA

### CPI



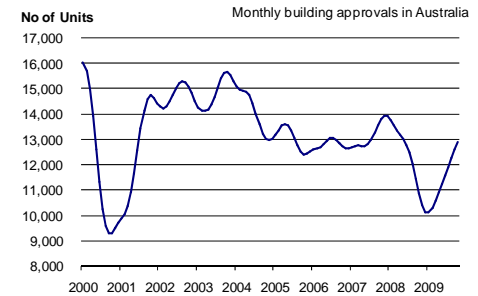
Source: ABS

### Australian monthly unemployment rate



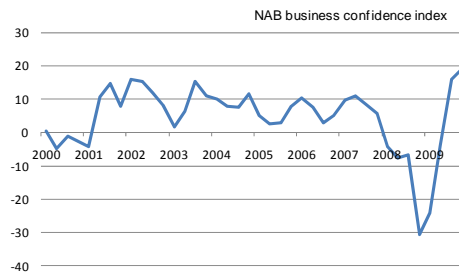
Source: ABS

### Monthly building approvals in Australia



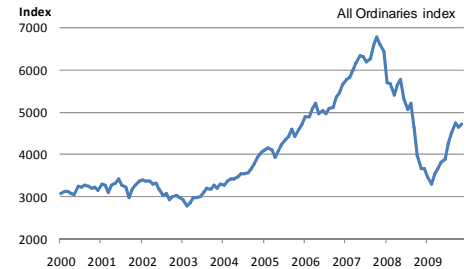
Source: ABS

### Business sentiment index



Source: NAB

### Stock market



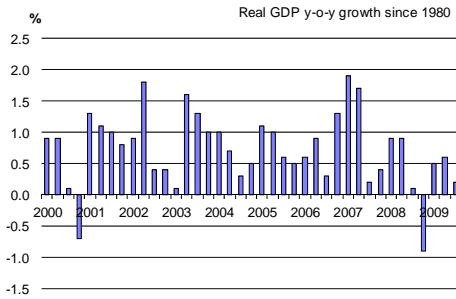
Source: IRESS

### KEYPOINTS

- Building approvals on the ascendancy are a necessary component of a recovering economy and reflect a combination of factors: increasing confidence; low interest rates; population growth; pent up demand (a legacy of the downturn) and a generous hand out by the Federal Government to first home buyers.
- While we may lament the misfortunes of the global village, Australia has remained largely unscathed by the debris of the global financial crisis and most economic indicators remain positive.

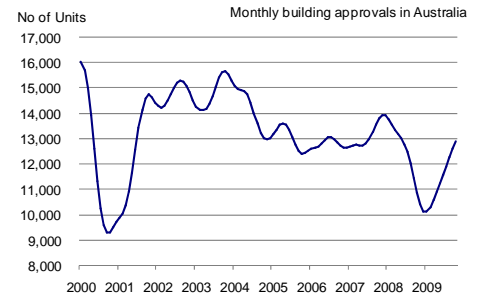
## Economic Activity

Real GDP



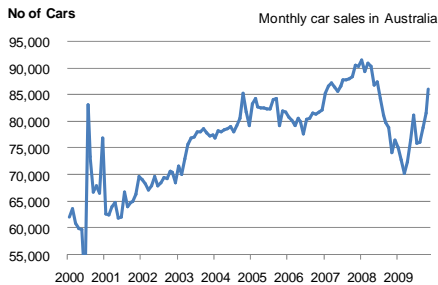
Source: RBA

Monthly building approvals



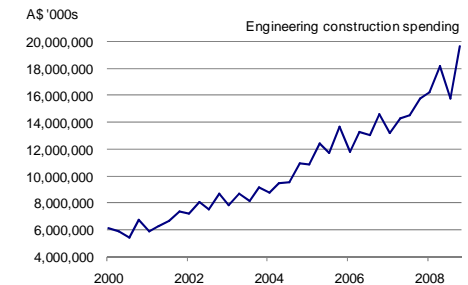
Source: ABS

Monthly car sales



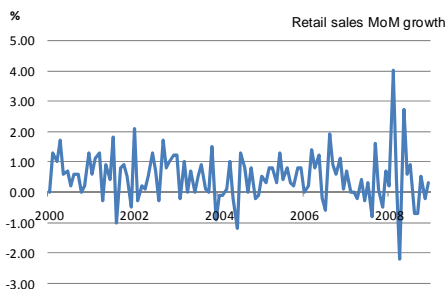
Source: ABS

Engineering construction spending



Source: ABS

Real monthly seasonally adjusted retail sales



Source: ABS

ANZ job ads



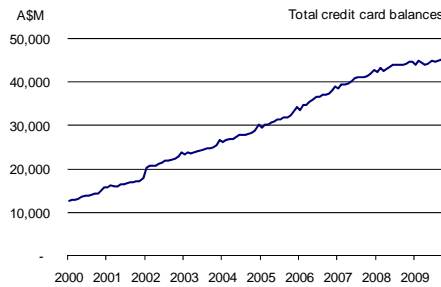
Source: ANZ

### KEYPOINTS

- Car sales have been stimulated by the 31 December 2009 end of the generous investment allowance afforded by the Federal Government for small business; heavy discounting and A\$ appreciation. Retail sales maintain a strong upwards trend, also assisted by favourable exchange rate movements (favouring consumer durables) and improving consumer confidence;
- The official job market belies the adverse under-current of underemployment, although we can all breathe a collective sigh of relief that the predicted unemployment rate of 8%+ is now unlikely to be breached.

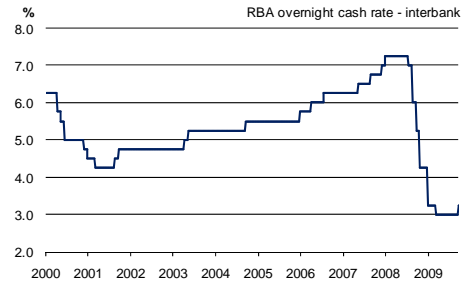
## Finance

Total credit card balances



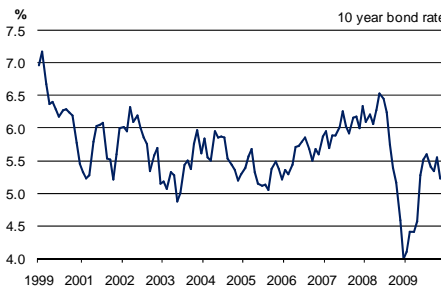
Source: RBA

RBA overnight cash rate



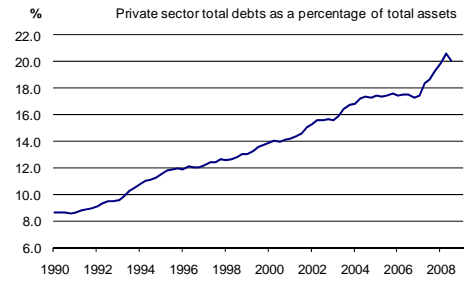
Source: RBA

10 year bond



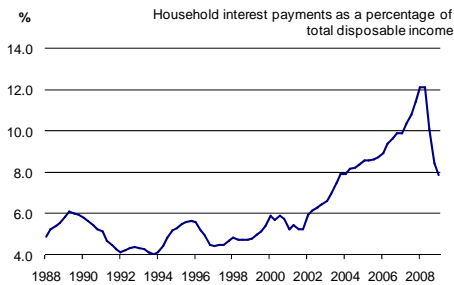
Source: RBA

Private sector total debts



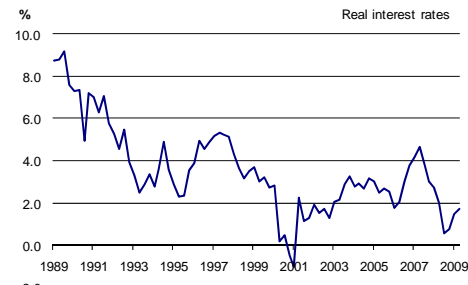
Source: RBA

Household interest payments as a %



Source: RBA

Real interest rates



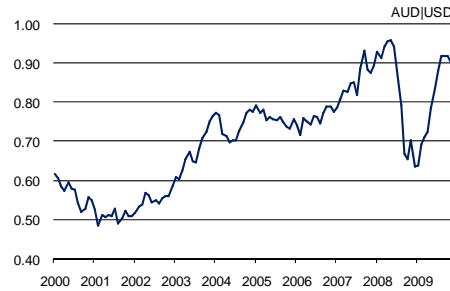
Source: RBA; KPM.

### KEYPOINTS

- The RBA has acted precipitously and without prejudice and hit the emergency inflationary button three times – the first pre-emptive strike was on 6 October with a lift in the benchmark cash rate by 25bps to 3.25%. It is unavoidable that this cycle has a fair way to play out and it is almost ironic that this Government may also face the people in a climate of increasing interest rates.
- The RBA has also recently opined that housing pressures are building, due (principally) to unrequited demand fed by population growth. We have made the point before but it is worth repeating and that is the desire of the RBA to balance the need between acting responsibly and sympathetically while also ensuring that the mistakes of the Keating/Fraser partnership are not repeated. That was when the “recession we had to have” was orchestrated by very aggressive monetary policy and the cash rate hit 17% in December 1989 (real rate 9.2%).

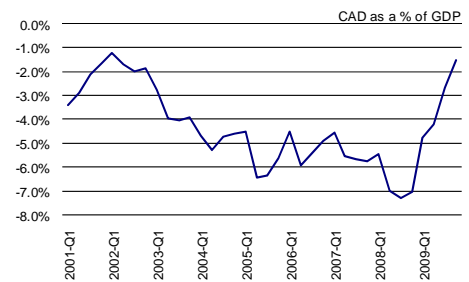
## External

A\$|US\$



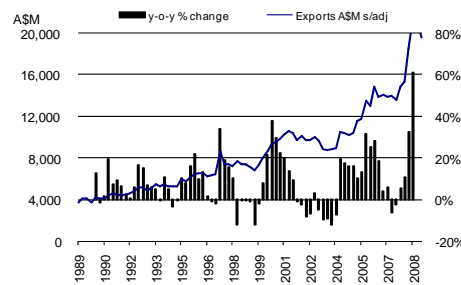
Source: RBA

CAD as a % of GDP



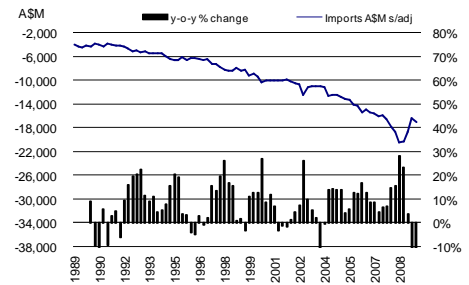
Source ABS, RBA, KPM

Exports



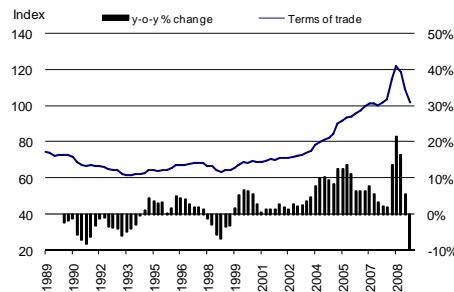
Source: ABS, RBA, KPM

Imports



Source: ABS, RBA, KPM

Terms of trade



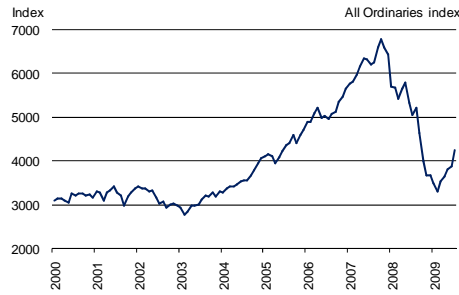
Source: RBA

### KEYPOINTS

- Probably the most significant chart above is that which relates to the A\$/US\$ exchange rate, which continues to move in Australia's favour. There are many factors that influence the A\$ exchange rate, although principally amongst these are interest rates; resources cycle (think gold for starters) and the leprosy-like taint attached to the US\$.
- A higher A\$ relative to other currencies is good for inflation as it means that imports are cheaper (feeding directly through to the consumer and indirectly as inputs into manufacturing) and exports are more expensive. The latter is harsh on produce and material exporters but also reduces stress on tight labour markets and leads to lower wage pressure. In this sense, the market takes some of the unpopular pressure off the RBA and can result in lower overall interest rates. However, that comes at a cost of local jobs in import competing sectors and export-orientated sectors.

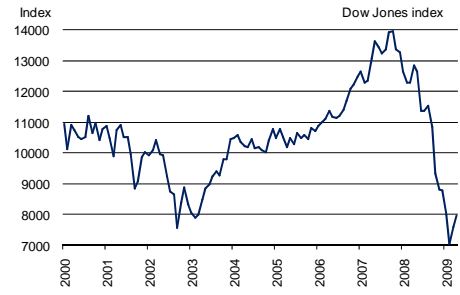
## Markets

### ASX



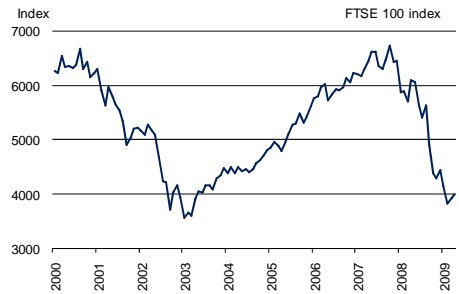
Source: IRESS

### DOW



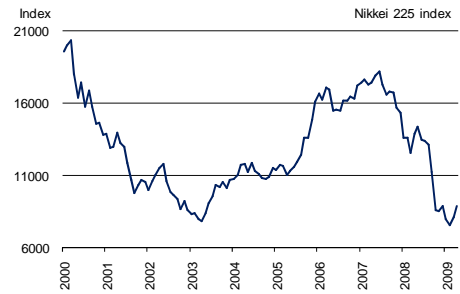
Source: IRESS

### FTSE



Source: IRESS

### Nikkei



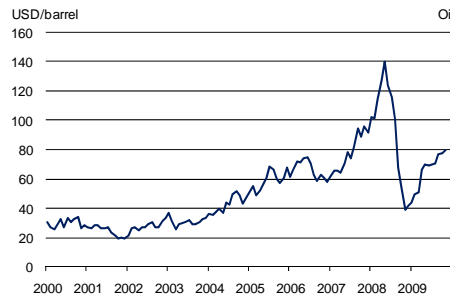
Source: IRESS

### KEYPOINTS

- All markets are off their respective bottoms and have maintained relatively robust momentum. The ALLORDS is up 33% for calendar year 2009 and most pundits are assuming a further 10% by June 2010. However, that is premised on a number of assumptions, all of which will be tested in the current report season (due to kick off in February for the first six months of FY10).
- However, as noted on the front page of this quarterly, we are a long way short of collecting a 'get-out-of-gaol-free' card and the debt mountains that have been created during the GFC is clearly the elephant in the room.

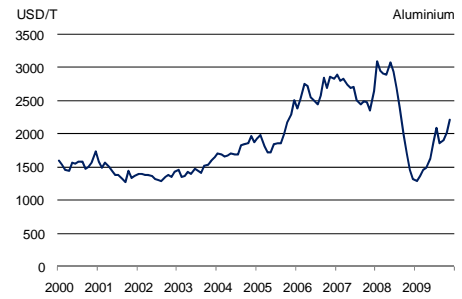
## Commodities

### Oil



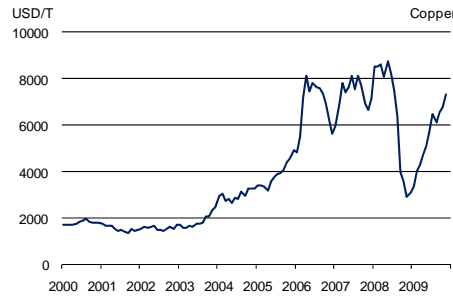
Source: LME

### Aluminium



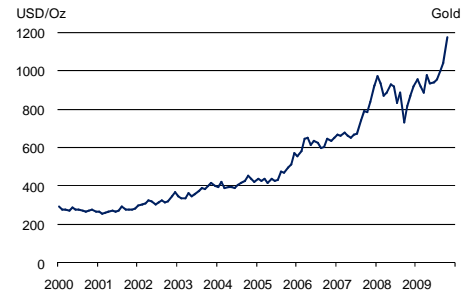
Source: LME

### Copper



Source: LME

### Gold



Source: LME

### Nickel



Source: LME

### KEYPOINTS

- All commodity prices have rebounded and most forecasts are bullish, premised on a recovery in the global economic fabric and, particularly, demand from China and India. And in all the uncertainty regarding the developed world, there is a lot less uncertainty regarding the growth prospects for our near ("developing") neighbours. And that clearly suggests Australia resource companies are likely to enjoy robust demand and higher prices (punctured by an unfavourable exchange rate however) for some time to come.

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