Down Under Daily, 7 February 2014

The Carnival Is Over

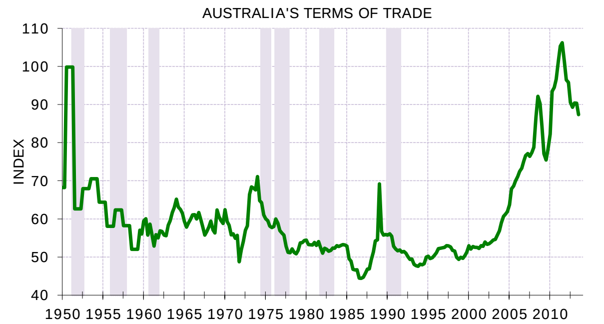
Australia faces the end of a once-in-a-century commodity boom. The outlook is for lower (non-mining) growth, weak income growth, and pressure on public finances. For investors this points to a still-lower A$, under-performance of Australian equities, and a structurally lower policy rate.

The Boom's Three Phases

It's now well understood that the mining boom is fading. The boom came in three overlapping phases. It's important to quantify the benefits of the boom to assess the effect of the boom ending. The first phase was the rise in the terms of trade (ratio of export prices to import prices – Exhibit 1).

Exhibit 1

The Unprecedented Rise In Terms Of Trade

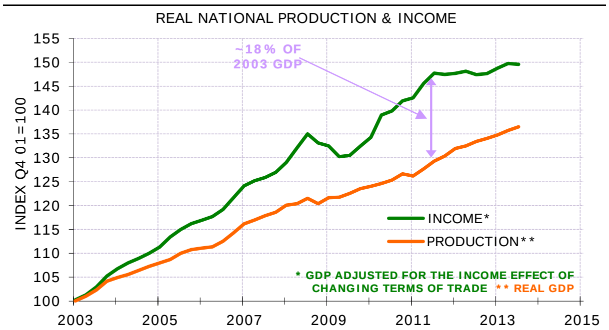


Source: ABS, Melbourne Institute; Minack Advisors

Price movements do not directly affect real GDP, but rising terms of trade lift real national income: it requires a lower volume of exports to buy a given volume of imports. Consequently, real national income increased much faster than GDP (Exhibit 2).

Exhibit 2

The Terms Of Trade Boost To National Income

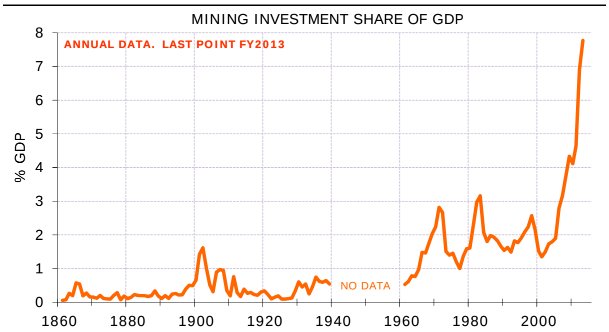


Source: ABS; Minack Advisors

The second phase of the boom was a surge in mining-related investment (Exhibit 3).

Exhibit 3

The Unprecedented Rise In Mining Investment

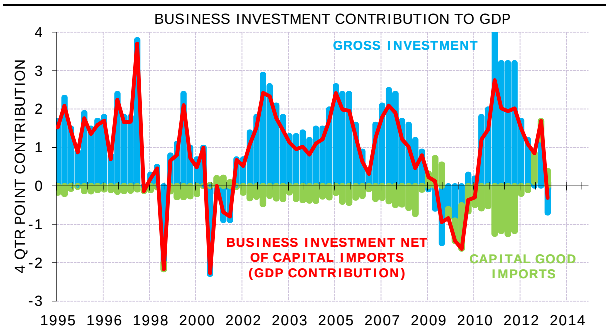


Source: ABS, RBA, Butlin; Minack Advisors

Investment has been a large contributor to GDP growth, even after allowing for the import of capital equipment (Exhibit 4).

Exhibit 4

Investment Contribution To GDP

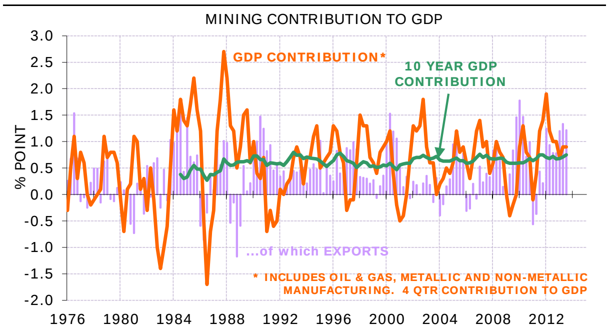


Source: ABS; Minack Advisors

The third phase of the boom is the already-apparent – and set-to-continue – export growth (Exhibit 5).

Exhibit 5

The Mining Export Contribution



Source: ABS; Minack Advisors

The key point is simple: *the prospective decline in the terms of trade and mining investment will likely overwhelm the benefit from the rise in export volumes.* In other words, the mining boom is over.

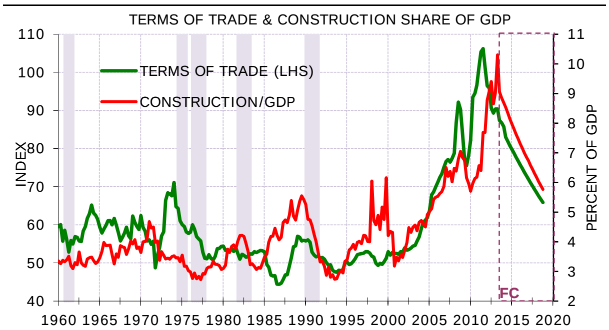
Assume A Gentle Bust…

I've put some numbers on the likely changes. The three key variables are: the rate of decline in the terms of trade; the rate of decline in investment; and rate of increase in export volumes. *I have deliberately used what I consider to be optimistic numbers.* The risk is the outcome is worse.

Exhibit 6 shows forecast decline in terms of trade and non-residential construction. In both cases the rate of decline is less rapid than the ascent; and both the terms of trade and construction spending are above long-run average at end-2018.

Exhibit 6

The Decline In Terms Of Trade & Investment

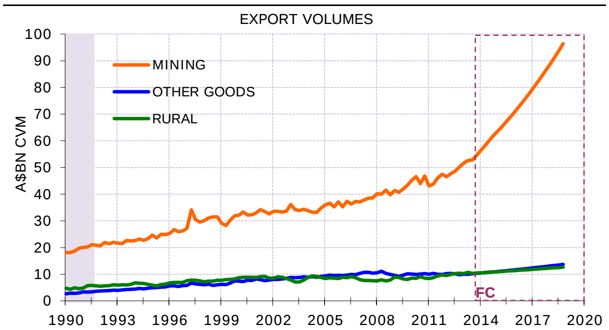


Source: ABS, Melbourne Institute; Minack Advisors

Exhibit 7 shows the assumption for mining export volumes (annual growth of 11½%).

Exhibit 7

Mining Export Volumes

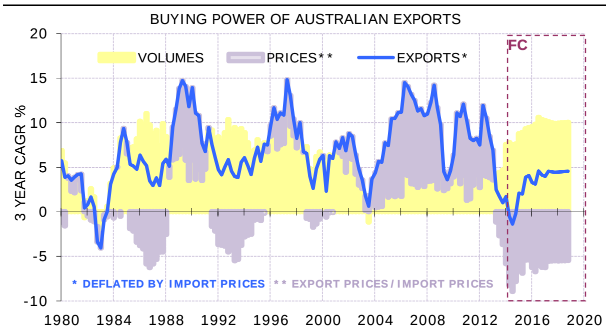


Source: ABS, Melbourne Institute; Minack Advisors

To repeat: I think these assumptions are more likely to be optimistic than pessimistic. Nonetheless, they imply several important changes. First, the purchasing power of exports – that is, the volume of imports that can be purchased by export revenues – slows sharply compared to the past decade (Exhibit 8). This reflects the assumed 5½% annual average decline in the terms of trade.

Exhibit 8

How Many Imports Exports Will Buy

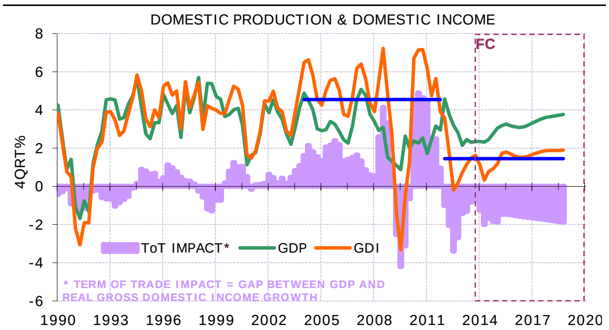


Source: ABS, Melbourne Institute; Minack Advisors

Second, while real GDP growth appears reasonable – driven by the strong growth in mining export volumes – average growth in real national income is likely to be *one-third* of the boom period (Exhibit 9). Just as the boom was not fully reflected in real GDP, neither will be the bust. The key change will be in national income.

Exhibit 9

The Drop In National Income Growth

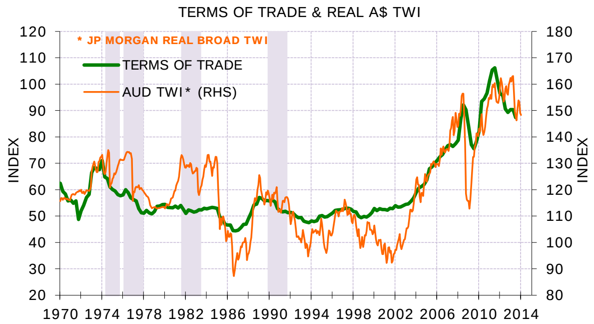


Source: ABS; Minack Advisors

The decline in the terms of trade has at least two important implications for investors. First, the long-standing correlation between the terms of trade and the A$ suggests that the currency will continue to head lower (Exhibit 10).

Exhibit 10

Falling Terms Of Trade Point To A Lower A$

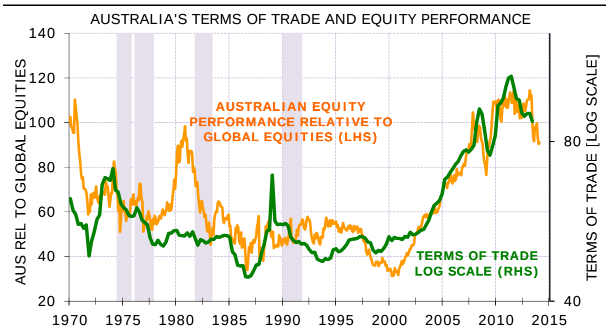


Source: ABS, Melbourne Institute; Minack Advisors

Second, the relative performance of Australian equities has historically followed the terms of trade (Exhibit 11). To be fair, this is in part due to the correlation with the currency (the relative performance is in common-currency terms).

Exhibit 11

Coming Australian Equity Under-performance

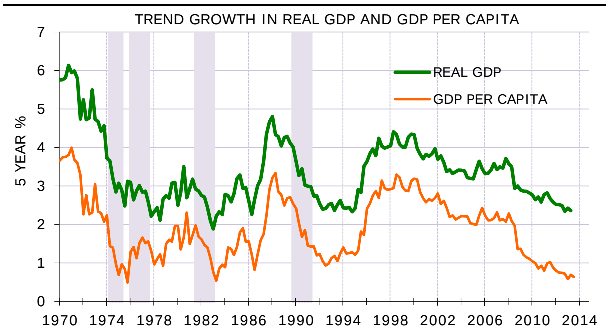


Source: MSCI, ABS, Melbourne Institute; Minack Advisors

These changes will occur against a backdrop of a structural slowdown in growth. Trend growth in per capita GDP is already very low (Exhibit 12).

Exhibit 12

Per Capita GDP Growth At Multi-Decade Low

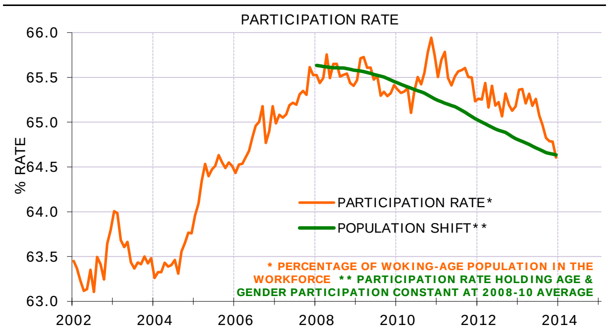


Source: ABS, Melbourne Institute; Minack Advisors

The slowdown in GDP partly reflects weak productivity, but is also due to demographics reducing labour force participation. Much as in the US, weak employment growth has not fully translated into higher unemployment because of declining labour participation (the proportion of the working-age population either in work or looking for work). However, all of the decline in Australia's participation rate from 2008 can be explained by demographic change (Exhibit 13 – and see note).

Exhibit 13

Participation Falls As Workers Age



Note: the 'population shift' series reflects the change in the average participation rate due to changing demographic mix. It assumes that participation rate by gender and age group (for ages 15-19, 20-24, 25-34, 35-44, 45-54, 55-59, 60-64 and over 65) were unchanged from the 2008-10 average. So the resultant change in aggregate participation rate solely reflects the changing population mix between those buckets.

Source: ABS; Minack Advisors

2014 Outlook

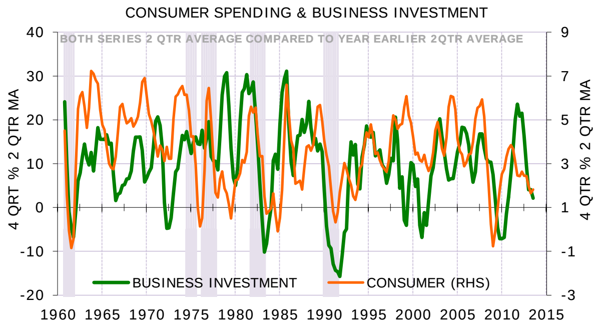
The risks around the end of the mining boom are now well known. The issue for 2014 is how much these effects will be felt this year, and whether the easing in financial conditions – easier RBA policy and a lower A$ – can provide an offset.

The current market debate is focussed on whether investment spending by non-miners will rise fast enough to offset the prospective decline in mining investment. This, in my view, misses the main game: consumer spending.

Consumers are central for two reasons. First, there are no examples – outside the current mining boom and the short-lived 'boom' of the late 1970s – of investment spending strength independent of robust consumer spending (Exhibit 14). In short, business won't spend unless consumers spend.

Exhibit 14

Consumer Spending Drives Business Investment



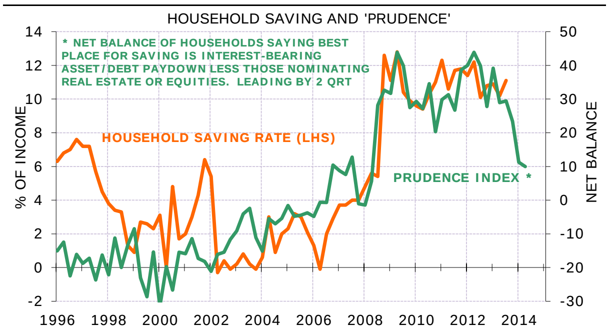
Source: ABS, Melbourne Institute; Minack Advisors

Second, consumers appear to have the wherewithal to lift spending – despite soft wages growth – given the high saving rate. In short, *it seems that the decisive issue for 2014 will be whether consumers are willing to lift spending by lowering saving.*

There are signs that that may happen. The big lift in household saving, amidst the global crisis, was led by defensive readings in consumer surveys. These indicators have now turned (Exhibit 15).

Exhibit 15

Household Saving: About To Come Down?



Source: ABS; Minack Advisors

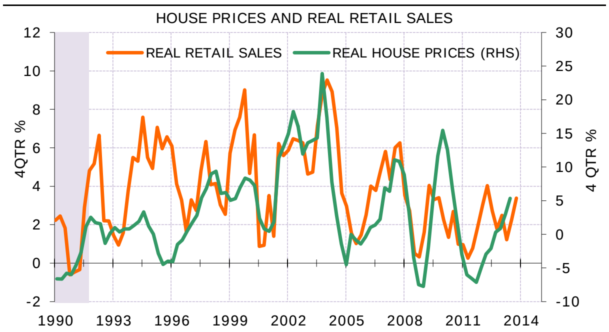
Similarly, there is an unsurprising correlation between real house prices and real consumer spending (Exhibit 16).

Market Implications

Rate markets are now pricing no change in RBA policy for 2014 (Exhibit 17). This seems a fair assessment. There is no need to ease if consumer spending picks up. Conversely, it seems unlikely that the RBA would tighten with the looming slowdown in mining-related capex. The wild-card is inflation, but my sense is that recent upside surprises will not persist.

Exhibit 16

Consumers Spend When House Prices Rise



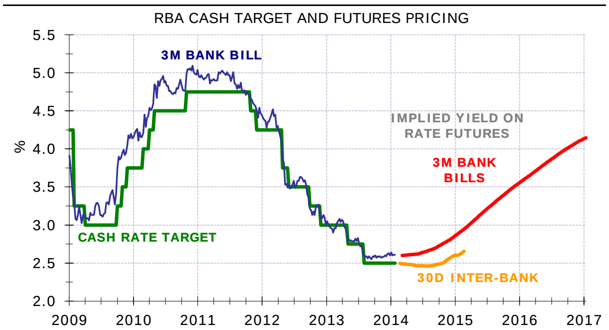
Source: ABS, Melbourne Institute; Minack Advisors

The A$ seems headed lower over the medium term. Large short-positions are now being cleaned out, but expect the downward trend to resume.

The equity market is average value by global standards. The mining sector, short rallies aside, will struggle in my view. Domestic cyclicals may have a little more to go, but have already run. Banks will benefit from rising credit demand and – despite appearing expensive – offer reasonable yield.

Exhibit 17

Market Pricing No Change To Cash Rate In 2014



Source: Bloomberg; Minack Advisors

Aside from global wild-cards, domestic risks include inflation continuing to surprise, and potential fiscal tightening by the Federal Government. But if these risks are avoided, it may be that growth will for a period beat against the headwinds of the mining boom ending. That, however, would not avoid what's likely to be difficult times further ahead.

Minack Advisors

Level 8, 167 Macquarie Street, Sydney NSW 2000, Australia
gerard@minackadvisors.com www.minackadvisors.com
Authorised Representative No. 443937
Minack Advisors Pty. Ltd.   ABN: 84 163 503 044