National Australia Bank

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Monthly Business Survey

February 2014

Recent recovery short lived? Business conditions back-pedalled sharply in February reversing around half post election gains. Confidence softened but still remains marginally above trend. Sales and employment fell markedly during the month, with the latter pointing to very weak labour market conditions (nearly all post election gains reversed) - and a jobless recovery. Manufacturing conditions deteriorated sharply, as did "bellwether" wholesaling conditions. Near-term outlook weaker with forward indicators softening. Inflation pressures well contained due to limited upstream pressures. Economic growth forecasts unchanged. Final RBA cut to occur in late 2014, with unemployment still expected to rise to 6½% by late 2014 and stay "higher for longer".

- Business confidence eased slightly in the month, but remains marginally above trend levels, suggesting firms remain hopeful of a recovery despite mixed signals on business activity. With conditions looking volatile (and currently soft), it may be difficult for firms to maintain these levels of confidence. Confidence in wholesale improved significantly in the month, while transport & utilities deteriorated sharply (both are bellwether industries). Confidence is positive across all states.
- Business conditions dropped sharply from the near 3 year highs seen recently, re-establishing the divergence between conditions and confidence. As expected, the sharp turnaround in manufacturing recorded last month was largely unwound, and is now more consistent with the difficult environment that continues to face Australian manufacturers. The next largest deterioration came from wholesale (now very weak), followed by services industries. Forward orders and sales both softened, but remain positive, while employment conditions are sobering – having reversed nearly all post election gains and pointing to further labour market deterioration.
- Our wholesale leading indicator suggests much weaker underlying conditions, pointing to further below trend economic growth in the first quarter of 2014 of around 2¾% and continuing weakness into Q2.
- Inflation pressures were a little more subdued in the month due to lower input cost pressures. Soft labour costs growth is consistent with increasing slack in the labour market. Purchase costs also eased.

Implications for NAB forecasts (See latest Global and Australian Forecasts):

- Bad weather hits activity in America and UK in early 2014 but underlying global growth set to continue and headline forecasts barely changed. Shift toward greater contribution to growth from advanced economies progressing as expected. Too early to assess impact of the evolving Ukraine, but energy and metals are most exposed.
- Solid GDP outcome for Q4 obscures weakness in domestic demand. Latest ABS survey of capex intentions highlights the coming drag from mining investment (-21% over 2 years), with little offset from other industries. Forward indicators still in retreat and labour market weak. Our forecasts are unchanged: GDP growth for 2013/14 of 2.7% and 3.0% for 2014/15. Unemployment rate still to peak at 6½% in late 2014, but will remain elevated for longer. RBA expected to cut rates (25bp) for the last time in November. We do not expect a rate hike until late 2015.

Key monthly business statistics*

	Dec 2013	Jan 2014	**Feb 2014**		Dec 2013	Jan 2014	**Feb 2014**
	Net balance				*Net balance*		
Business confidence	7	9	**7**	Employment	-4	0	**-6**
Business conditions	4	5	**0**	Forward orders	-2	6	**1**
Trading	12	8	**4**	Stocks	-3	0	**-1**
Profitability	6	3	**1**	Exports	1	2	**1**
	% change at quarterly rate				*% change at quarterly rate*		
Labour costs	0.6	1.0	**0.6**	Retail prices	0.2	0.5	**0.3**
Purchase costs	0.8	1.1	**0.7**		*Per cent*		
Final products prices	0.3	0.6	**0.3**	Capacity utilisation rate	80.2	80.6	**80.6**

* All data seasonally adjusted and subject to revision. Cost and prices data are monthly percentage changes expressed at a quarterly rate. Fieldwork for this survey was conducted from 24 February to 28 February, covering over 600 firms across the non-farm business sector.

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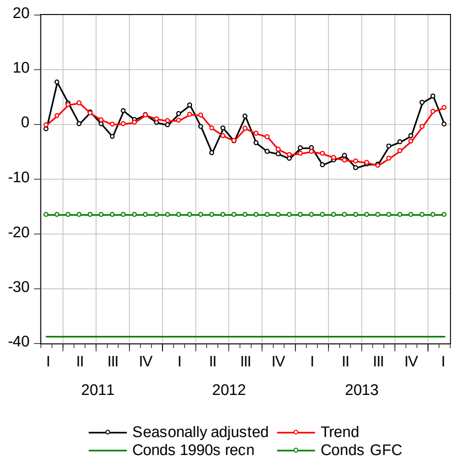
Next release:
8 April 2014 (March monthly)
17 April 2014 (March quarterly)

Analysis

Business conditions fell noticeably from the near 3 year highs recorded recently. The previous improvement in conditions appeared to move ahead of itself given the broader economic environment. Consequently, the fall in conditions this month probably reflected a realignment of conditions with underlying fundamentals. While conditions have given back around half of their post election gains, lower interest rates should help trading and sales conditions improve. At the same time, we have long been flagging the jobless nature of the recovery, which is backed up by persistently weak employment conditions in the survey. Indeed employment has given nearly all their post election gains. Overall, business conditions are lagging well behind confidence, dropping 5 points to 0 index points in the month – below the long run average of the series (+5 since 1997). Services sectors remain the major standout performers among the industries, but the biggest improvement this month came from the transport & utilities industry. Conditions in most other industries were either unchanged, or deteriorated in the month. As expected, the sharp turnaround in manufacturing conditions recorded last month was largely unwound. Near-term indicators suggest little improvement over coming months, with forward orders softening, while firms have resumed de-stocking. Capacity utilisation suggests there is still significant slack in the economy, further illustrated by poor investment expectations in the ABS capex survey.

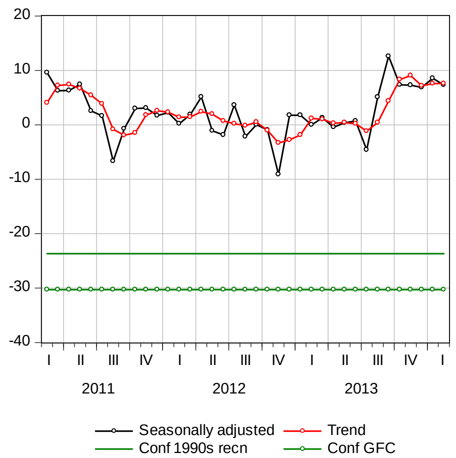
Business confidence eased off slightly in the month, unwinding the previous months gain, but remains at levels somewhat above average. Confidence declined by 2 points to +7 index points. Confidence has managed to remain resilient despite volatility (and presently weak) business conditions. Soft forward orders and headwinds from weak business investment and a deteriorating labour market may make it difficult for firms to maintain their optimistic outlook – particularly in light of growing global uncertainties.

Conditions dropped sharply



Average of the indexes of trading conditions, profitability and employment.

Confidence remains resilient



Excluding normal seasonal changes, how do you expect the business conditions facing your industry in the next month to change?

There are, however, a handful of bright spots emerging, particularly in the construction sector. Confidence is now positive for most industries, including wholesale (a bellwether industry), although transport & utilities and mining are both negative – significant given the importance of mining to the Australian economy.

Business conditions by industry. The fall in conditions was driven largely by a sharp deterioration in manufacturing (down 13 points), which largely unwound the surprising improvement recorded the previous month. Wholesale (down 5 points), finance/ property/ business services (down 3 points) and recreation & personal services (down 2 points) also deteriorated in the month, although conditions remain quite strong in the last of these. Transport & utilities was the only industry to record an improvement in business conditions during the month. Conditions are still highest in the services sectors – with consumers more prepared to spend on services (especially those considered non discretionary e.g. utilities, education and housing costs). Recreation & personal services are highest (+12 index points), followed by finance/ property/ business services (+2 points). Conditions remain very poor and deteriorating in wholesale (-17), which points to ongoing weakness in the broader economy. The mining sector is clearly shifting into the next phase of the mining boom, with firms reporting solid exports despite weak conditions for the industry (-7 points).

Analysis (cont.)

Business conditions by state. Business conditions deteriorated across a number of mainland states in the month. The most significant decline occurred in Victoria (down 8 points to 0 index points), followed by NSW (down 7 points to -1 index points). Western Australia also reported weaker conditions (down 5 points to -1 index points). This suggests that the major eastern states felt the brunt of the deterioration in manufacturing conditions during the month, while WA continues to be held back by a softer mining sector. Nevertheless, conditions remain weakest in the state of Queensland, despite an improvement in the month (up 3 points to -2 index points); drought conditions, retail headwinds and flow-on effects from the softer mining sector, kept it the worst performing state. Surprisingly, South Australia is reporting the highest conditions index (+4 points) of the mainland states, despite the underperformance of its economy in recent years, and headwinds to local manufacturing and mining sectors.

Business confidence by industry. Total business confidence was down 2 points in the month, with most industries recording a decline. The largest falls were in transport & utilities (down 16 points), manufacturing and mining (down 6 points) and retail (down 5 points). The retail sector appears to have lost some steam following the strongest holiday trading period for a number of years. Soft labour market conditions – and muted wages growth – are likely to be an ongoing headwind to the industry, particularly for discretionary spending. However, wholesale – often considered a bellwether for the economy – recorded a significant improvement in business confidence (up 21), while recreation & personal services was the only other industry to record an (modest) increase (up 2). In levels terms, finance/ property/ business services are the most confident (+17 index points), followed by wholesale (+10 points) and retail (+9 points). On balance, most industries remain relatively confident, but mining remains extremely downbeat (-9 points), which is consistent with lower commodity prices and the transitional phase of the mining boom that is underway. Confidence is also negative for transport & utilities (-2 index points).

Business confidence by state. Confidence remains positive in all mainland states, despite falls in the month for Queensland (down 4), NSW (down 3) and SA (down 1). Victoria (up 3) and WA (up 1) recorded rises. Despite the weak business conditions facing Queensland firms, the state is reporting the equal highest degree of confidence of the mainland states in levels terms (+9 index points); matched by WA. Firms are least confident in SA (+5).

The **forward orders** index slumped in the month (down 5) to +1 index points, suggesting very little impetus for conditions to improve over the coming months. By industry, the decline in new orders was relatively broad based. Finance/ property/ business services recorded the largest fall (down 6), followed by construction (down 5) and recreation & personal services (down 4). Forward orders are (surprisingly) highest in manufacturing (+9 index points), followed by retail (+5 index points), while mining is the weakest by a significant margin at -21 points (despite strong commodity export volumes in recent months), while wholesale has remained soft (-3). **Capacity utilisation** was unchanged in February (remaining at 80.6%) – its highest level since mid 2012 – having equalled the lowest level since June 2009 in October. Current readings for capacity utilisation are still below the long run averages – although this varies across industries – and imply considerable slack in the economy. Mining capacity utilisation is furthest below long run averages, consistent with expectations for a significant drag from mining capex – confirmed in the recent ABS capex survey expectations for 2014/15, which imply a decline in mining investment of 17 per cent for the year. In the month, capacity utilisation fell for construction (down 1.5 ppts), mining (down 1.3 ppts), retail (down 0.9 ppts), recreation & personal services (down 0.4 ppts) and wholesale (down 0.2 ppts). These were offset by increases in manufacturing and finance/ property/ business services (both up 0.6 ppts) as well as transport & utilities (up 0.1 ppts). Following the months decline, utilisation in mining is just 75.7%, the weakest across the industries. Capacity utilisation is highest in finance/ property/ business (83%).

The **stocks** index – also a good indicator of current demand – fell by 1 point to a net balance of -1, indicating that the de-stocking cycle resumed in the month – although the index has been volatile. Wholesale recorded the most notable change, down 31 points to -6 points.

The **capital expenditure** index fell by 1 point to +3 index points, although this is not as much of a decline as recent falls in business investment might suggest. Sharp increases in capex by the mining sector (up 20) and construction sectors (up 22), were more than offset by declines in the service sectors; finance/ property/ business services (down 5) and recreation & personal services (down 5). In levels terms, capital expenditure was highest in recreation & personal services (+7) and manufacturing (+7), followed by finance/ property/ business services (+5) and transport & utilities (+5). Capex is relatively muted (although positive) amongst most of the other industries, but wholesale and construction are especially weak (at -9 and -7 index points respectively). The capex series is quite volatile and under represents mining investment, but overall remains at relatively subdued levels.

Analysis (cont.)

Our model of 6-monthly annualised demand growth, using forward orders as a predictor, has been suggesting stronger growth in recent quarters than the national accounts, although following recent revisions, actual growth overshot the model in Q3 2013. In Q4, actual growth dropped to 1.4%, compared to the model's prediction of 3¼%. If we apply February's forward orders to our model for Q1, it still implies that demand growth will strengthen to around 3% – well above our forecast.

Based on business conditions for the December quarter, the survey implies 6-month annualised GDP growth of around 3% in Q4, close to the actual growth rate in the national accounts. Based on business conditions from the February Survey, our model implies GDP growth will rise to near 3% in Q1, also a little above our forecast. However, applying business conditions for the quarter derived from our 'wholesale leading indicator' (see below) implies weaker growth in Q1 at 2¾% – in line with our forecast.

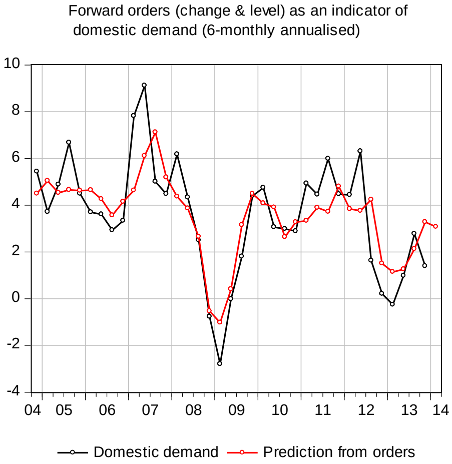
Elsewhere in the survey, cash flow (not seasonally adjusted) was strongest in wholesale, and weakest in construction and manufacturing.

Labour costs growth (a wages bill measure) eased back in February, having reached its highest rate since 2012 in January (excluding months affected by minimum wage increases). This reflected weaker labour cost pressures in manufacturing (down 1 ppts), retail (down 0.9 ppts), and construction (down 0.5 ppts). Most other industries recorded more modest decreases, exceptions being mining (up 0.4 ppt) and wholesale (up 0.1 ppts). Labour cost inflation is highest for transport & utilities (1%) and recreation and personal services (1%), softest in mining (-0.5%).

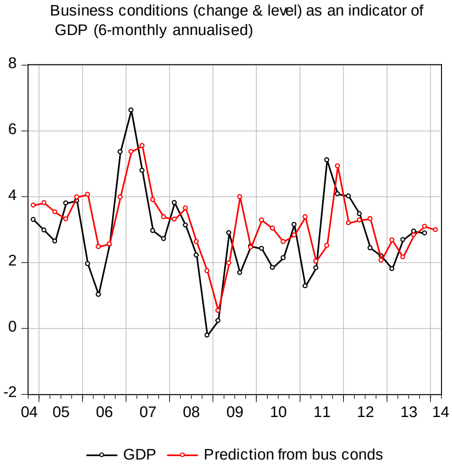
Purchase cost growth also eased (down 0.4 ppts) to 0.7% in February (at a quarterly rate), its softest rate in 8 months – possibly reflecting more stability in the AUD. Purchase costs fell the most in retail (down 1.3 ppts) and mining (down 0.7 ppts), partly offset by stronger growth in wholesale (up 0.7 ppts). Purchase cost growth was strongest in wholesale (2.1%, at a quarterly rate) and manufacturing (1.3%), while purchase costs pressures remain moderate for mining (-0.2%) and construction (0.2%).

Final product price growth softened modestly in February (down 0.3 ppts), suggesting that consumer price pressures are unlikely to prompt an interest rate rise by the RBA any time soon. Labour cost pressures have been in trend decline (disinflation) for some time, but final price inflation has been edging up in line with higher upstream prices. At 0.3% (quarterly rate), price inflation is below the series average of 0.5%. Across industries, the mining sector is continuing to experience price deflation (-1.4%), while prices growth ranges from -0.1% (construction) to 0.8% (wholesale) for the other industries.

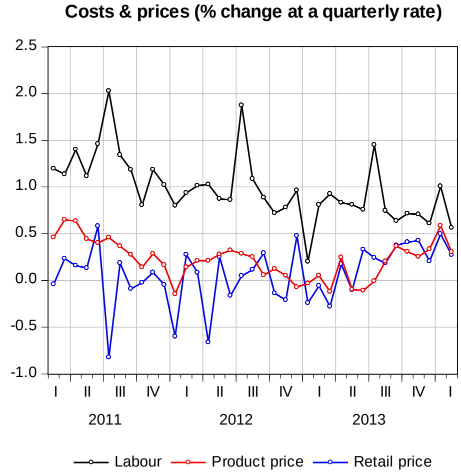
Implies demand growth a little above trend



GDP growth to rise to trend Q1



Prices growth eased on softer upstream pressures



Based on respondent estimates of changes in labour costs and product. Retail prices are based on retail sector product price estimates.

Current business conditions

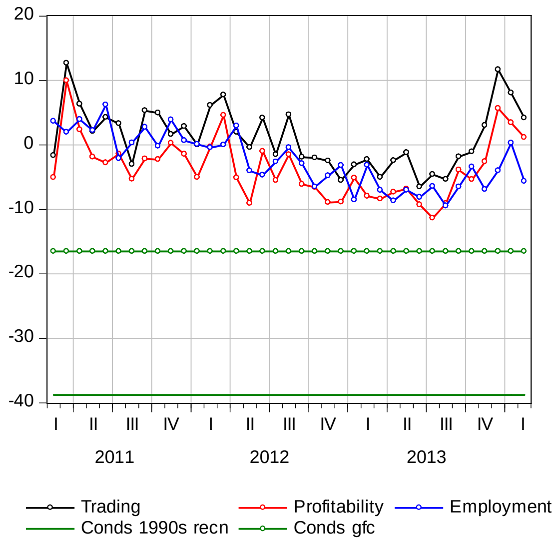
The business conditions index fell noticeably in February (down 5) to 0 points, having reached a near 3 year high in the previous month. Although confidence also fell, the divergence with conditions opened up again in the month, suggesting the exuberance of firms since mid last year may be difficult to sustain. Current conditions suggest that domestic demand growth is at or below trend; the long run average for conditions is zero since 1989 (+5 for just the monthly series since 1997). This correction in conditions during the month helps to reinforce our view for a deteriorating labour market and sub-trend growth.

Trading, profitability and employment

The sharp deterioration in business conditions reflected a fall across all the components (trading, profitability and employment). The move in the month has completely unwound any sign of improvement in the employment index, but only partly unwound the trend improvement in trading conditions – consistent with our expectation for a jobless recovery. Both trading and profitability remain positive, while employment conditions are very weak, pointing to ongoing deterioration of the labour market.

Trading, profits and employment all down; employment weak

All components of business conditions (net bal., s.a.)



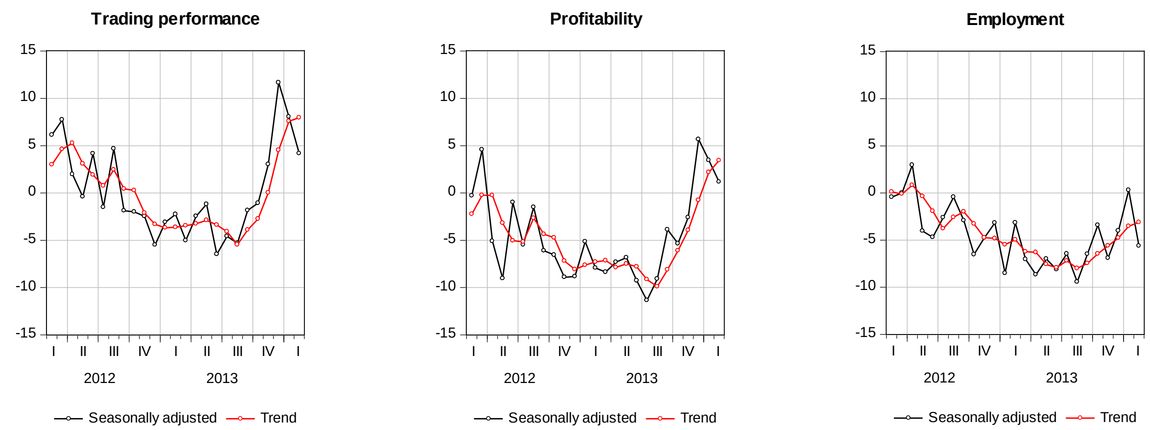
Net balance of respondents who regard last month's trading / profitability / employment performance as good.

There was a further backtrack in **trading conditions**, driven by manufacturing (down 15), mining, financial/ property/ business and recreation & personal services (all down 3). In contrast, transport & utilities recorded an improvement (up 5). In levels terms, trading is strongest in recreation & personal services (+16) and weakest in wholesale (-10).

The improvement in **employment conditions** in January was short lived, dropping 6 points in February to a very weak -6 index points. This level is consistent with ongoing weakness in official labour market statistics and the transition to less labour-intensive mining operations (yet to be offset by labour demand elsewhere). The deterioration was driven by a large fall in wholesale (down 15) and mining (down 13). Construction and transport & utilities recorded improvements in the employment index (both up 2). Employment conditions remain tough in most industries (particularly wholesale at -26 index points), but recreation & personal services is the only industry in positive territory (+2 index points).

Consistent with the dip in trading conditions, **profitability** also dropped further in February (down 2 points). The largest falls in profitability came from manufacturing (down 14). Mining recorded the strongest improvement (up 28). In levels terms, profitability remains soft across a number of industries. Rec & pers services has outperformed (+16), while manufacturing is weakest (-13).

Business conditions components (net balance)



Net balance of respondents reporting trading performance / profitability / employment as good or very good (rather than poor or very poor).

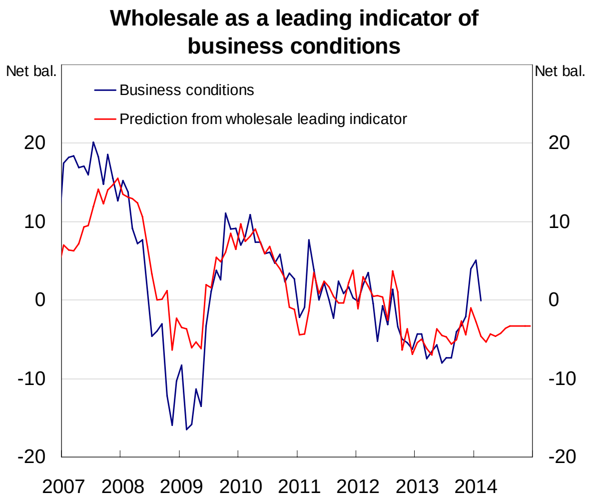
Current business conditions (cont.)

Wholesale: Signalling softer domestic economy than conditions suggest

The weakness in wholesaling that has persisted for the best part of 3½ years remained for much of 2013. While conditions have been volatile in recent months, wholesale trend conditions remained weak, at -10 points in February.

Based on historical relationships, wholesale conditions appear to be a reasonably good predictor of overall business conditions – certainly there is strong statistical evidence of a leading relationship (Granger causality). However, there has been a significant divergence in recent months as business conditions improved. Our analysis suggests that if wholesale conditions revert to trend over coming months, overall business conditions could be expected to remain soft, averaging -4 index points in H1 2014. That in turn suggests an economy still running well below trend - and would continue to do so into the first quarter of 2014.

Wholesale activity points to much weaker (GFC level) conditions



Indicator = f(business conditions_wsl, business conditions_wsl(-1 to -4), const.)

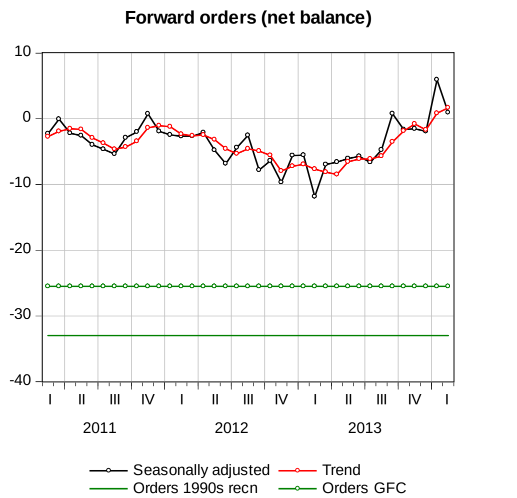
Forward orders

The forward orders index fell noticeably (down 5 points) in February. At +1 points, the index is now slightly above the series long-run average of zero points since 1989.

The slump in orders reflected falls across most industries, the largest being in finance/ property/ business (down 6), construction (down 5) and recreation & personal services (down 4). Wholesale was the only industry to record a rise in the orders index in the month (up 8 points). Orders remain very weak for mining (-21 points), followed by wholesale (-3). All other industries are reporting flat-to-rising orders, the strongest of which are in manufacturing (+9) and retail (+5).

Net balance of respondents with more orders from customers last month.

Orders down, but close to 4-year high

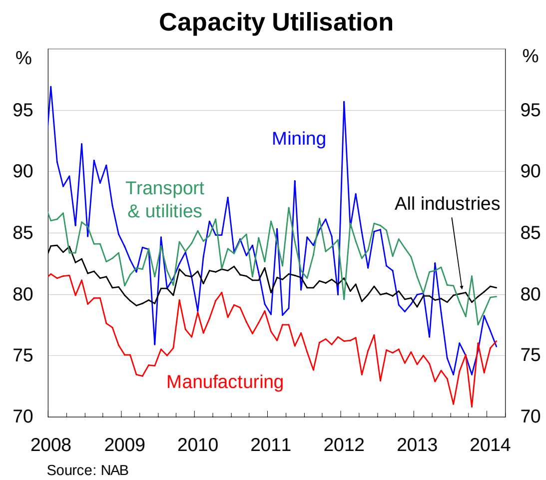


Capacity utilisation

Capacity utilisation was unchanged in February (80.6%), following three months of consecutive increases. Utilisation is below the monthly survey average of 81.1% (since 1997), but marginally above the long-run average of 80.4% (since 1989). This month's outcome reflected a solid pick up in manufacturing and finance/ property/ business (both up 0.6 ppts), which was offset by declines in manufacturing (down 1.5 ppts), mining (down 1.3 ppts), retail (down 0.9 ppts), recreation & personal services (down 0.4 ppts) and wholesale (down 0.2 ppts). Manufacturing capacity utilisation remains very low (76%). Utilised capacity was highest in finance/ property/ business (83%).

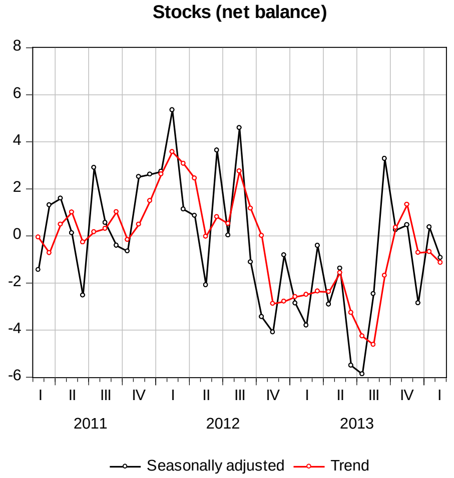
Full capacity is the maximum desirable level of output using existing capital equipment.

Capacity usage varies across industry

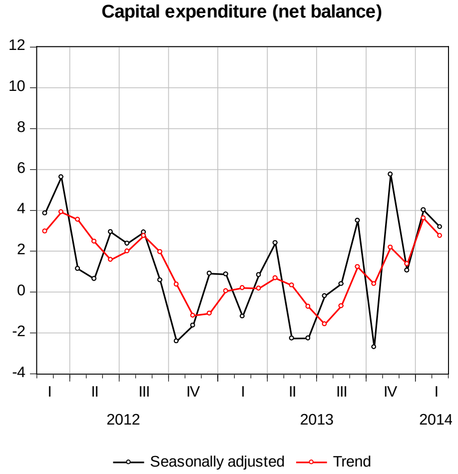


More details on business activity

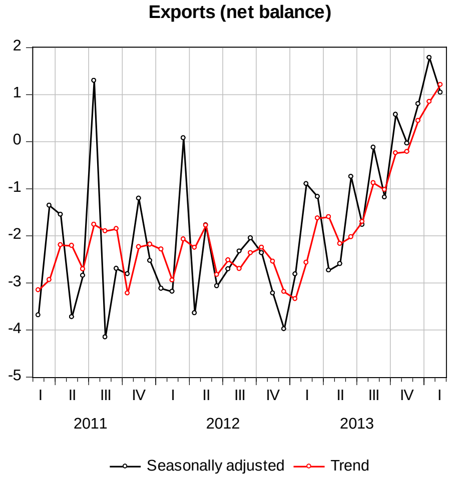
Moderate re-stocking was short lived. Reflects softer orders?



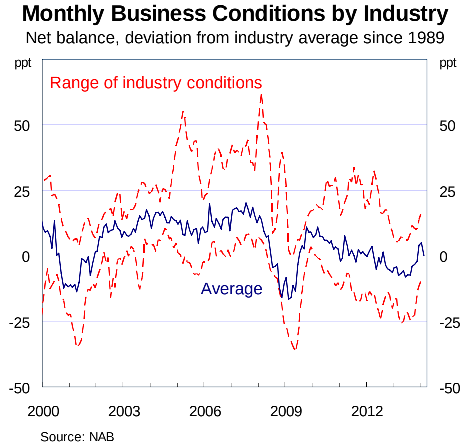
Capex positive, but varies across industries



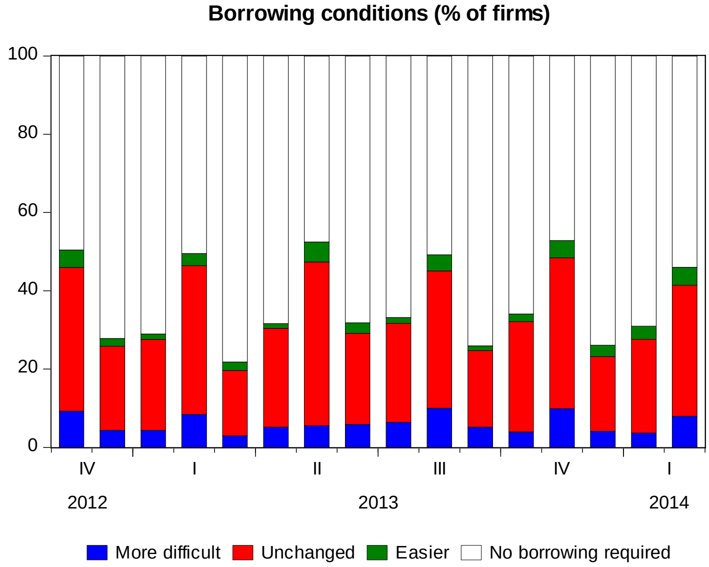
Exports remain close to post-GFC high



Range of conditions negatively skewed

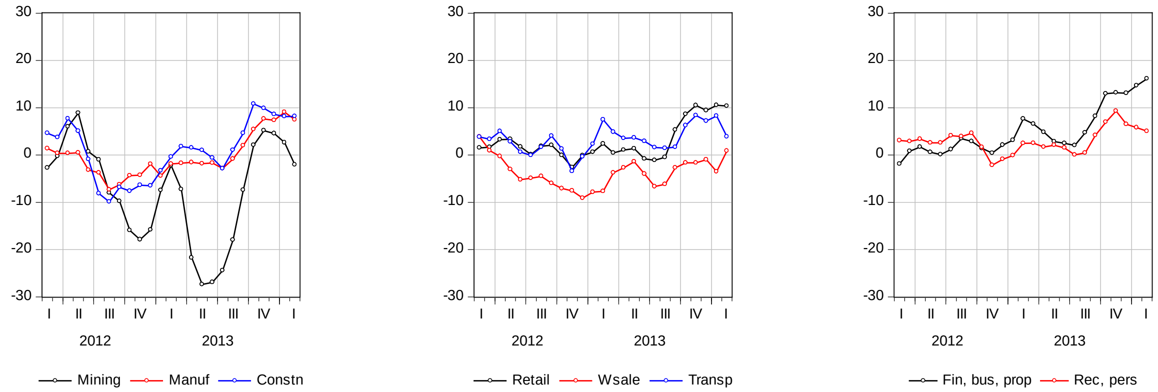


Slight advance in borrowing conditions in last 3 months, demand for credit softer

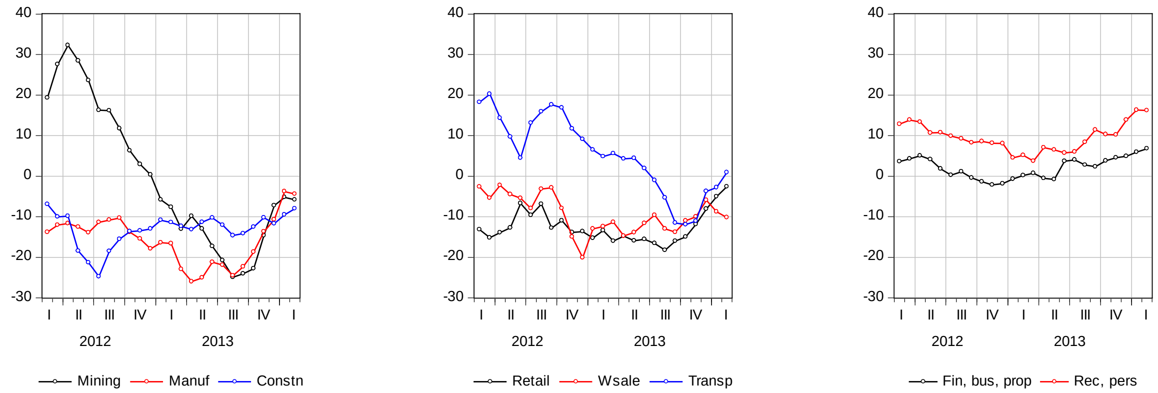


Industry sectors and states

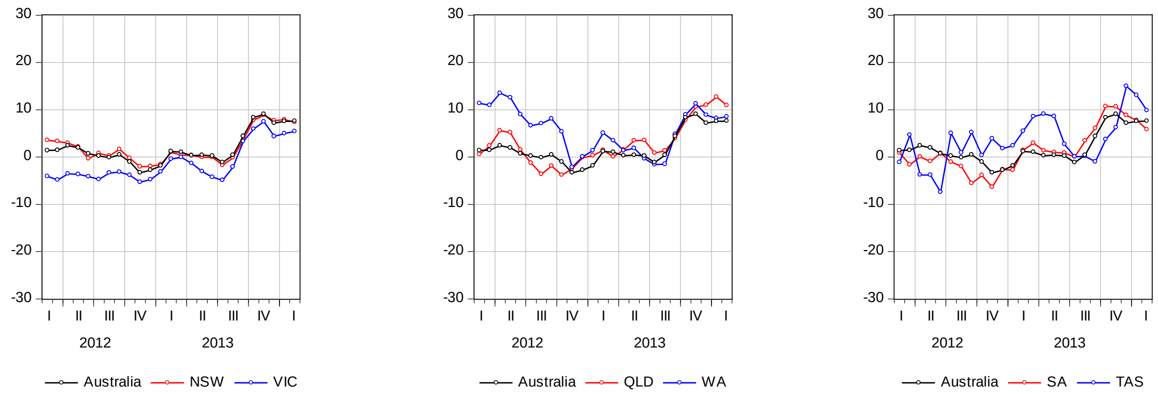
Business confidence by industry (net balance): 3-month moving average



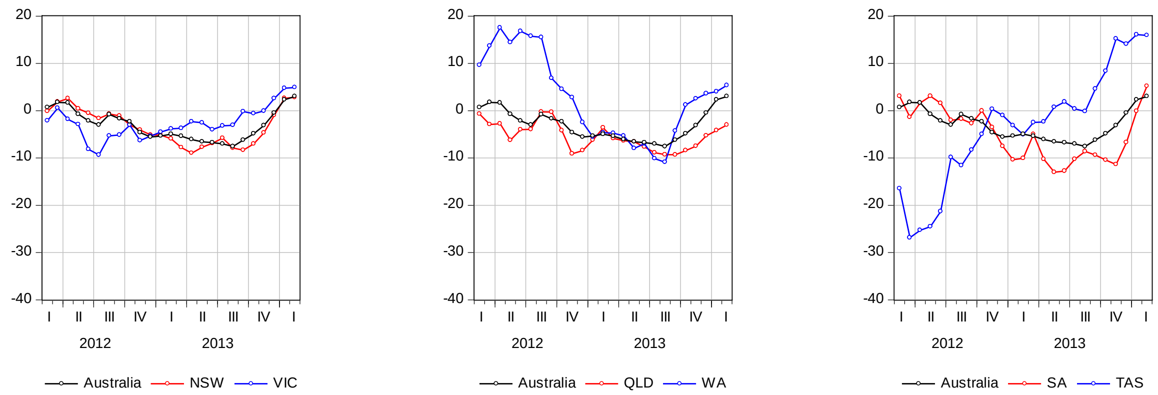
Business conditions by industry (net balance): 3-month moving average



Business confidence by state (net balance): 3-month moving average



Business conditions by state (net balance): 3-month moving average



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