ECONOMICS: AUSTRALASIAN PERSPECTIVES—JAN 16, 2015

Australia: Still Fundamentally Bearish

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Despite a couple of better jobs readings, we remain downbeat about Australia's prospects for the next few years. The long shadow of the commodity price bust remains the key theme. The next phase? Weaker LNG prices and, perhaps, the long-anticipated housing correction.

A Better Trend?

This week's better-than-expected labor market figures, which showed a second consecutive solid gain in employment and a drop in the unemployment rate, raise the question of whether we are seeing a fundamental turnaround. If so, our rate cut case would be thrown into doubt. But, in our view, it would be unwise to be swayed by these recent data, for a couple of reasons.

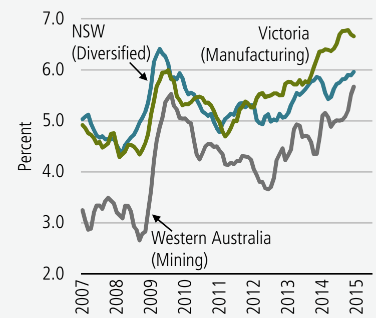
First, the nature of the employment survey itself. As we've seen several times over the past year or so, there's a lot of noise in these figures. When we dig down into the detail, it's hard to discern a shift in trend. For example, **Display 1** shows unemployment rates by region—Victoria (think "manufacturing"), Western Australia (think "resources") and New South Wales, think "diversified"). Not much change in the message there: mining is still deteriorating; manufacturing is struggling, too; and the more diversified parts of the country are doing a bit better. The better performance in New South Wales (NSW) is partly a function of housing—more on that later.

The second, more substantive, point is that the drag from the commodity price correction is a multiyear affair. The end is not yet in sight. And there are two dimensions of this worth keeping an eye on over the next six months.

Oil-LNG Linkage

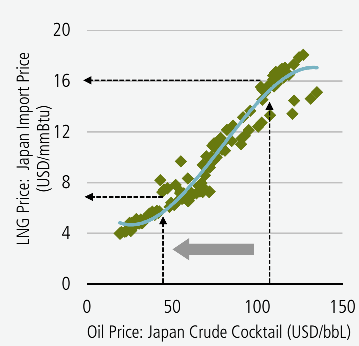
The first aspect is the impact that the fall in oil prices will have on liquefied natural gas (LNG) pricing in Asia. After iron ore and coal, oil and gas come in at number three in Australia's resource export basket. And they are set to expand very rapidly over the next three years, with LNG exports rising threefold, as seven LNG mega-projects come on stream. While most of the output is already contracted to be sold, LNG export prices are subject to the vagaries of oil prices because of the way those contracts are set. **Display 2** shows the tight linkage between the two prices. With oil at US$100/barrel, LNG is around US$16/mmBtu. But at today's oil

Display 1
Mining and Manufacturing Still Struggling



As of December 2014
Source: Australian Bureau of Statistics and Thomson Reuters Datastream

Display 2
LNG Prices Set to Fall by Midyear



As of January 16, 2015
Source: Bloomberg and Thomson Reuters Datastream

price of around US$50, the implied LNG price is somewhere around the US$7/mmBtu mark. A substantial correction is likely.

To be clear, there's no suggestion that the projects already well underway will be canceled. But their profitability has been curtailed, and any new projects are most likely non-viable at the lower prices. So there are implications here for tax revenue and capital spending (a steeper drop than anticipated as no new projects are commenced) as well as for expenditure on exploration and support services. In turn, that has ramifications for employment—a further shake-out lies ahead.

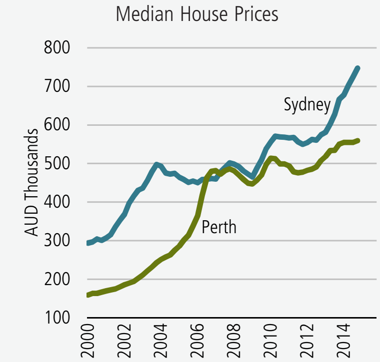
Looming Housing Correction

With employment likely to be under pressure, attention will turn to the shape of the housing correction over the next year. Yes, people are still talking about the upswing phase, but we suspect that will change in the coming months. There's an obvious impact on the Western Australian housing sector. Perth has already been underperforming, relative to Sydney at least, after outperforming dramatically through the commodity-boom phase **(Display 3)**. More of that is likely to come.

But part of that relative story has also been the boom (bubble?) in Sydney prices, up 30% over the past two years. Much of that reflects investor activity—in aggregate, lending growth to investors is running at 10% year on year **(Display 4)**. But with signs of oversupply starting to emerge in pockets of the market, and with APRA (the prudential regulator) starting to offer "guidance"—a weak form of macroprudential policy—one wonders how long this can continue. There's a clear risk that falling house prices may be the next phase in the post-commodity-boom adjustment story. ■

Display 3

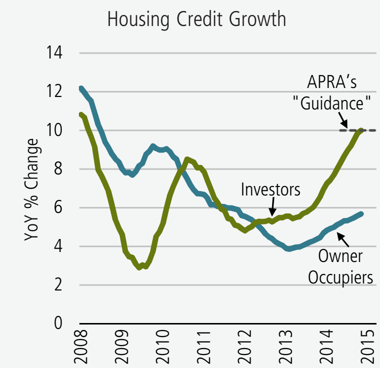
Sydney-Perth House Price Gap Widens



As of December 2014
Source: Australian Bureau of Statistics and Bloomberg

Display 4

Will Investor Activity Slow?



As of November 2014
Source: Australian Bureau of Statistics and Bloomberg