Flashnote

HSBC Global Research

Macro
Australian Economics

Downunder Digest

Australia's weak investment outlook

- **Mining investment is falling and is set to decline further in coming years, acting as a drag on growth**
- **A lack of business confidence has meant that the outlook for non-mining business investment also remains weak**
- **A pick-up in non-mining investment is a necessary part of Australia's rebalancing act and encouraging it should remain a high priority for policymakers**

Waiting for the next stage of the rebalancing act

After driving growth for several years, mining investment has peaked and is declining significantly, in line with falling commodity prices. The rebalancing of growth away from mining investment is progressing, but only slowly. Low interest rates have sparked greater housing investment and stronger household demand, but the next stage of the rebalancing of growth – a ramp-up in non-mining business investment – has, so far, been tepid. This is despite low interest rates, strong population growth and limited investment in recent years: the key ingredients in the usual recipe for a business investment upswing.

Indeed, non-mining business investment has barely grown since 2008. This is not just a story in Australia, but one that is reverberating around the world. One of the major factors has been low business confidence. Years of uncertainty over the state of the global economy, the domestic outlook and government policy have contributed to this.

The collection of forward-looking indicators of non-mining business investment intentions continue to suggest little growth over the coming year. But, because there is significant herd behaviour in investment planning, these measures need to be watched carefully as small changes in sentiment can often presage large swings in investment intentions. There are also measurement challenges. The often-cited ABS capital expenditure (capex) survey showed weak forward-looking readings for 2015-2016 in February, but only covers about half of all non-mining capex and suffers from severe measurement error. Watching employment trends is also important, as capital investment often goes hand-in-hand with hiring. The recent lift in jobs growth is a positive sign.

For Australia's growth to return to trend, greater investment in new capacity will be needed. The level of interest rates does not appear to be a constraint. This year's more positive fiscal plans, including support for small businesses, may help lift investment. But, overall, what is clearly needed is a lift in business confidence. How to spark that remains highly uncertain, though when it comes, it usually does so quickly.

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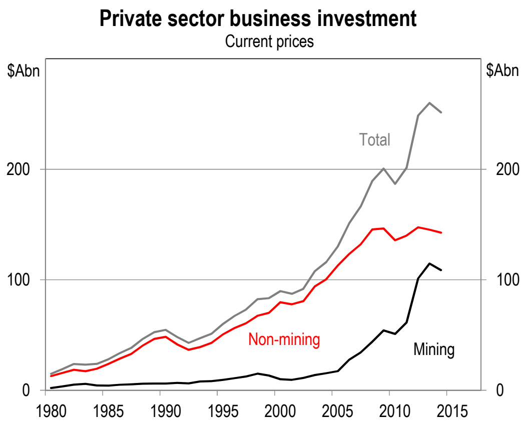
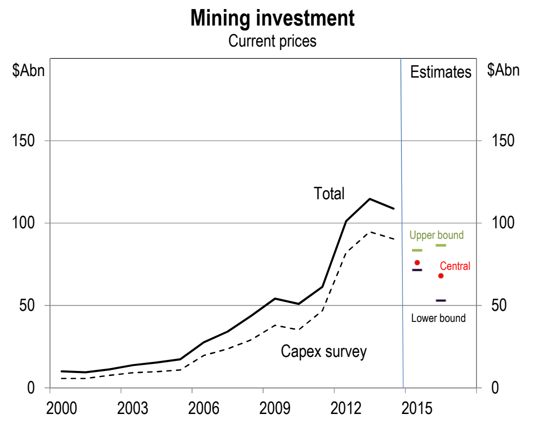
1. Mining investment is falling, so non-mining needs to rise



Source: ABS

2. Forward-looking estimates suggest more mining falls



Source: ABS, RBA, HSBC estimates

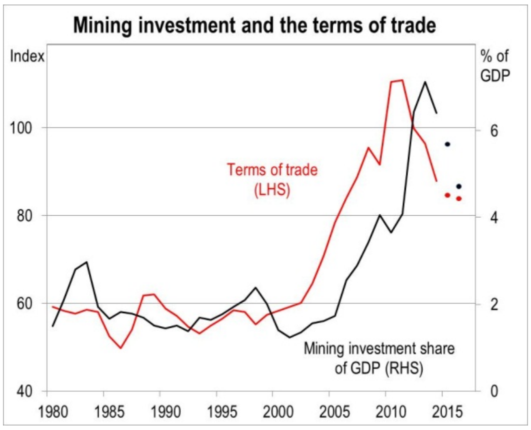
Mining investment to keep falling for some time yet

Mining investment rose rapidly in 2005-2012 (Chart 1). Indeed, after averaging 1.5% of GDP over the previous two decades it peaked at its highest level in history at around 7.5% of GDP in 2012-2013. This lift in activity provided a large impetus to overall GDP growth, particularly in 2011 and 2012. But now the process has gone into reverse. As projects reach or come near completion, mining investment is falling rapidly, acting as a drag on overall growth.

Mining investment is expected to fall by around 15% this year and a similar amount in 2016 (Chart 2). Where it will eventually settle is uncertain, but given that a large stock of mining capital has now been built up, a steady stream of investment will be needed to maintain it. Annual mining investment will, therefore, likely settle at a rate above its long-term average, potentially at around 3-4% of GDP (Chart 3).

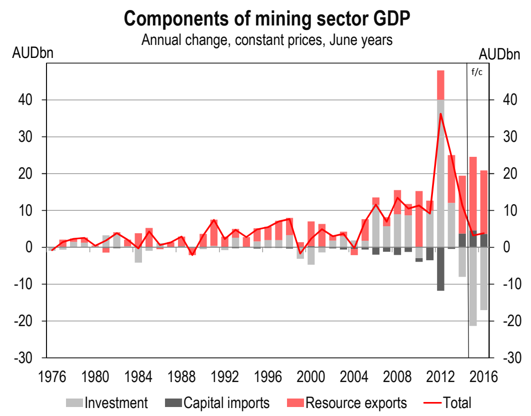
Importantly, although mining investment is falling, overall mining GDP is not. This reflects that over half of the capital used in the mining investment boom was imported, so the impact on the domestic economy of the decline in investment is partly offset by falling capital imports. In addition, the ramp-up in resources exports, as new capacity comes on line, is more than offsetting the investment fall (Chart 4).

3. Mining investment is falling with declining commodity prices



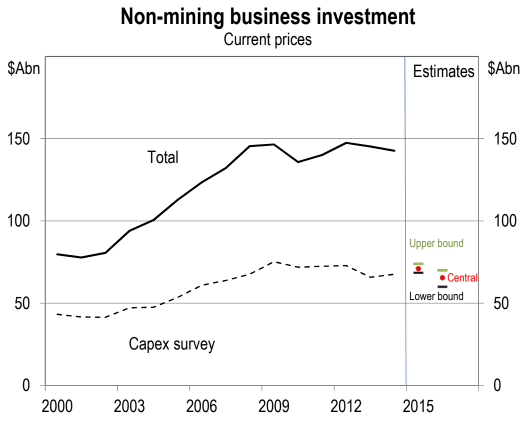
Source: ABS, HSBC estimates

4. Mining GDP is still rising, as exports grow and imports fall



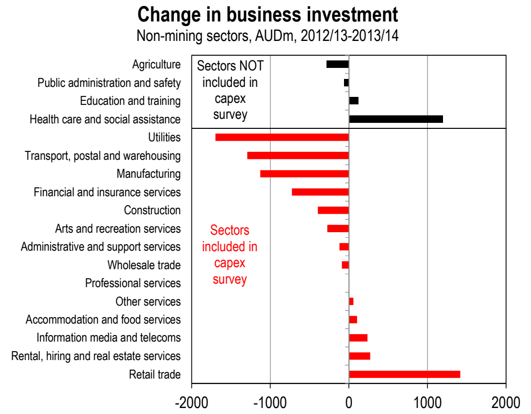
Source: ABS, HSBC estimates

5. Non-mining capex is weak, but is also only a partial measure



Source: ABS, RBA, HSBC estimates

6. Some evidence of rising investment in the services sector



Source: ABS

Non-mining investment outlook surprisingly weak

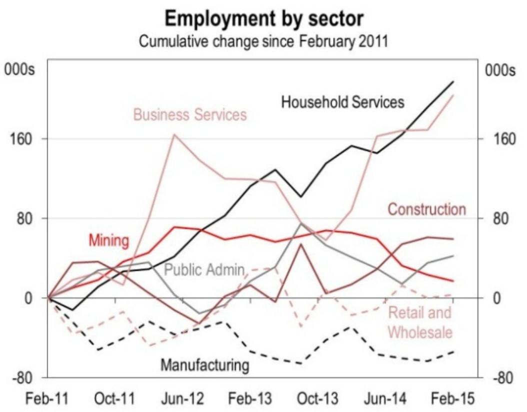
With mining investment falling, a pick-up in non-mining investment is needed. Many of the pre-conditions are in place for this to happen. Interest rates are low, population growth is strong (1.5% y-o-y), the Australian dollar has fallen (boosting competitiveness), and there has been little new investment in recent years. Indeed, in the year to June 2014, non-mining business investment was actually -2% lower than in the year to June 2008 in nominal terms. This partly reflects that interest rates were raised in 2009 and 2010 to slow growth in the non-mining sectors to make way for the mining investment boom without stoking inflation. But it also reflects a lack of appetite for risk since 2008. This is a global phenomenon, but is also affecting Australia.

So far, there has been little indication of any noticeable lift in non-mining business investment in the forward-looking indicators. One of the most closely watched measures is the ABS quarterly capex survey, which includes questions about capital spending intentions up to five quarters ahead. The latest survey, published in February, included the first estimate for 2015-2016, which was surprisingly weak. Overall, the survey suggested that non-mining investment could rise 8% in 2014-2015, but then fall -9% in 2015-2016.

However, there are great uncertainties around forecasting business investment. For a start, the early estimates in the capex survey are imprecise (despite adjusting the estimates based on historical differences between responses and actual investment). The survey also covers less than half of total non-mining investment (Chart 5). There are significant sectors that are not covered by the capex survey, the most notable being health, education and agriculture (Chart 6). The survey also has incomplete coverage of some of the sectors that it includes.

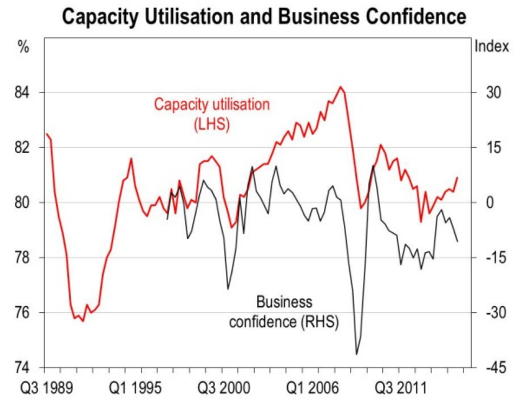
Overall, the capex survey is a somewhat unreliable guide to actual business investment, but with few other forward-looking surveys, markets still focus on it. Digging into the sub-industry details does, however, reveal some interesting patterns. The sub-industries with the strongest investment intentions are the sectors that have shown the strongest growth recently, including rental, hiring and real estate, retail and financial services. Some of the excluded sectors are also areas of the economy that have shown strong employment growth in recent years, including health and education (Chart 7).

7. Employment is rising in the services sectors



Source: ABS

8. Capacity utilisation is edging higher, but confidence is weak



Source: Thomson Reuters Datastream

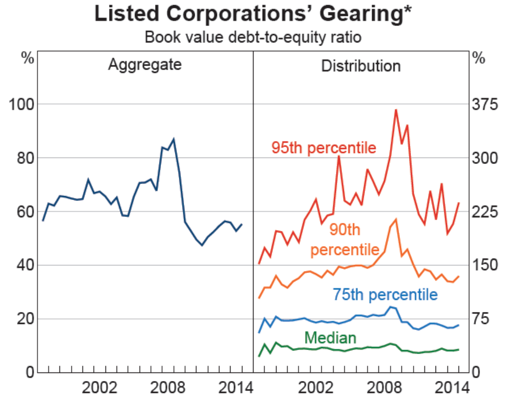
Still lacking confidence

For a meaningful lift in non-mining business investment to occur, higher confidence is almost certainly necessary. Business confidence has fallen to below average levels in recent quarters (Chart 8). However, is also worth noting that capacity utilisation has been edging higher, suggesting there may be a need for new investment at some point.

Confidence appears to have been held back by a number of factors. Although the currency has depreciated significantly over the past couple of years, it still remains above most estimates of fundamental value and is, therefore, limiting Australia's competitiveness and potentially discouraging investment. There has also been heightened uncertainty around government policy and, of course, the global environment remains uncertain in the wake of the financial crisis, Europe's debt crisis and more recent signs of slowing in China.

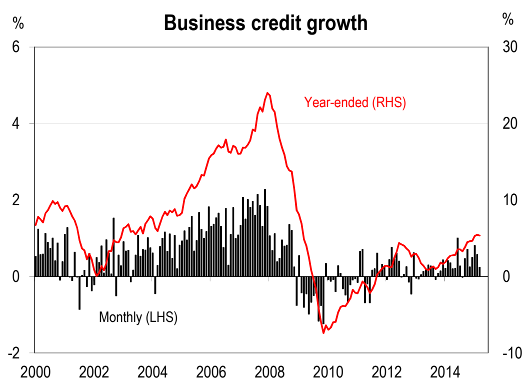
There are also questions around how much scope there is for investment to increase. The sectors that growth is shifting towards are largely services-based, where growth is less capital-intensive than in mining and manufacturing. New and disruptive technologies, such as storage of information in the 'cloud' and greater usage of mobile devices, may also mean that the economy can effectively do more with less

9. Corporate leverage is low, so there is room for gearing



Source: RBA

10. Business credit growth is picking up, but only modestly



Source: RBA

capital. For example, in years gone by, the ramp-up in investment may have involved personal computers and office space, but new technologies favour mobile workers with smartphones.

Nonetheless, the local economic environment does remain favourable for a pick-up in investment. Corporate leverage is at low levels relative to history and interest rates are at record lows (Chart 9). There are some signs that firms are starting to increase their borrowing, with business credit growth picking up to its fastest pace since 2009 recently (Chart 10). Buoyant equity markets also lower the cost of equity financing, which should support investment plans.

The government's recent budget, which was more upbeat than the May 2014 budget and included a range of measures to support small business investment, may also help to spur a modest lift in capital spending. The government announced a 1.5ppt tax cut for small businesses and a temporary programme under which small businesses can receive an immediate tax deduction (that is, accelerated depreciation) for the full value of any new asset worth up to AUD20,000.

Residential boom underway, but infrastructure outlook in doubt

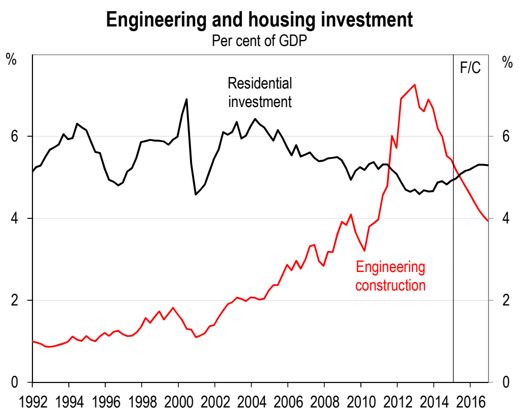
While business investment remains weak, the good news is that there is a strong upswing in residential investment underway. Dwelling approvals have totalled 210,000 over the past year, the highest total since the series began in 1983, which should lift residential investment (Chart 11). However, the lift in residential construction alone won't be enough to offset the fall in mining investment.

The outlook for public sector investment is also not particularly encouraging. The federal government's 'asset recycling' initiative, announced in the 2014 Budget, which incentivises state governments to sell existing assets and reinvest the proceeds into new infrastructure projects, has not been as successful as hoped. Elections in both Victoria and Queensland in the past six months have been won by parties opposing asset sales. That suggests that there could be less infrastructure investment than previously expected. At the federal level, the 2015 Budget did not feature much on infrastructure spending.

Summing up

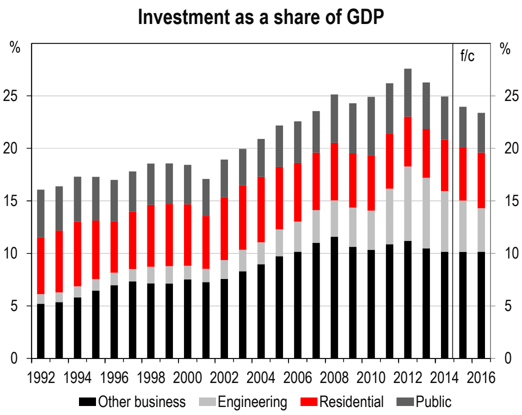
Although Australia's rebalancing act is clearly underway, with household demand picking up, the outlook for investment remains weak. Mining investment is set to fall in 2015 and 2016. Current indications

11. Housing investment upswing is not enough



Source: ABS, HSBC estimates

12. Total investment down, as non-mining investment flat



Source: ABS, HSBC estimates

suggest that the pick-up in housing, non-mining business and public investment will not be sufficient to offset this decline in 2015, leaving overall investment down this year (Chart 12). The forward-looking indicators also suggest that non-mining business investment could be weak in 2016, although there is significant uncertainty surrounding this outlook.

This week brings the latest instalment of the capex survey, due on 28 May. We expect the survey to continue to show weak investment intentions, with the non-mining business investment outlook still too weak to offset the expected decline in mining investment in 2015-2016.

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13. HSBC's forecasts for Australia and New Zealand

	Year-average			Year-ended						
	2014	2015	2016	Q414	Q115e	Q215e	Q315e	Q415e	Q116e	Q216e
%*										
AUSTRALIA										
GDP	2.7	2.6	3.0	2.5	2.1	2.4	2.9	3.3	3.5	3.2
Consumption	2.5	3.1	3.2	2.8	3.0	3.0	3.2	3.2	3.2	3.3
Public consumption	2.0	1.9	1.6	2.0	2.2	2.2	1.6	1.6	1.7	1.6
Investment	-2.5	-1.4	0.5	-2.9	-3.1	-3.1	0.3	0.5	0.8	0.4
- Dwelling	7.9	7.2	6.9	8.1	4.1	6.0	9.8	8.9	9.4	7.9
- Business	-4.8	-3.2	-1.9	-4.2	-3.5	-3.9	-2.9	-2.3	-2.0	-2.3
- Public	-4.2	-4.6	1.4	-9.8	-9.1	-10.1	1.2	1.0	1.0	1.0
Final domestic demand	1.2	1.7	2.2	1.1	1.3	1.2	2.2	2.2	2.3	2.2
Domestic demand	1.2	1.6	2.2	1.0	1.7	0.8	1.6	2.2	2.3	2.3
Exports	6.7	7.7	7.8	7.2	4.9	9.0	7.8	8.9	9.2	8.2
Imports	-1.7	1.0	4.3	-2.6	-0.1	-0.9	1.0	4.2	3.8	4.0
GDP (% quarter)	--	--	--	0.5	0.7	0.8	0.8	1.0	0.9	0.5
CPI**	2.5	1.8	2.8	1.7	1.3	1.6	1.9	2.4	2.9	2.9
Trimmed mean**	2.7	2.4	2.8	2.4	2.3	2.2	2.5	2.5	2.8	2.8
Unemployment rate	6.1	6.4	6.2	6.2	6.3	6.4	6.5	6.4	6.3	6.2
Labour price index	2.6	2.6	2.9	2.5	2.3	2.5	2.6	2.6	2.6	2.7
Current A/C (%GDP)	-2.8	-2.3	-1.9	-2.4	-2.2	-2.4	-2.4	-2.3	-1.9	-1.9
Terms of trade	-7.5	-6.2	-1.7	-10.8	-8.9	-7.1	-4.6	-4.0	-3.9	-2.0
Budget balance (%GDP)	-3.1	-2.5	-2.4							
Capital city house prices	9.2	7.7	6.1	6.8	7.6	7.7	8.0	7.6	7.0	6.4
Private sector credit	5.1	6.6	7.1	5.6	6.1	6.4	6.8	7.0	7.2	7.3
USD/AUD (end period)	0.78	0.72	0.70	0.82	0.75	0.74	0.73	0.72	0.71	0.71
Cash rate (end period)	2.50	2.00	2.75	2.50	2.25	2.00	2.00	2.00	2.00	2.00
%*										
NEW ZEALAND										
GDP	3.2	3.0	2.8	3.5	3.4	3.2	2.7	2.7	2.6	2.8
Consumption	3.3	3.8	2.4	4.1	4.8	4.2	3.3	2.9	2.5	2.4
Govt consumption	3.6	1.9	1.6	3.3	2.4	1.8	1.8	1.6	1.6	1.6
Investment	9.4	9.8	5.9	10.5	10.0	10.7	9.6	9.2	8.1	6.6
Final domestic demand	4.8	4.9	3.1	5.5	5.6	5.3	4.6	4.2	3.7	3.3
Domestic demand	4.9	4.7	3.0	5.5	6.0	4.4	4.6	4.0	3.5	3.2
Exports	0.9	-0.5	2.3	-1.7	-4.2	0.2	0.8	1.6	2.3	2.6
Imports	7.4	5.1	3.1	6.1	5.4	3.9	5.2	5.8	5.1	4.1
GDP (% quarter sa)	NA	NA	NA	0.9	0.8	0.5	0.5	0.9	0.7	0.7
CPI	1.2	0.8	2.1	0.8	0.1	0.4	1.0	1.7	2.4	2.4
Unemployment rate	5.7	5.3	4.9	5.8	5.8	5.4	5.2	5.0	4.9	4.8
Labour price index	1.8	2.2	2.4	1.8	1.8	2.1	2.3	2.3	2.4	2.4
Current A/C (%GDP)	-3.4	-4.3	-4.3	-4.8	-4.5	-4.4	-4.2	-4.0	-4.3	-4.4
Budget balance (%GDP)	-1.1	-0.3	0.1							
NZD/USD (end period)	0.78	0.70	0.68	0.78	0.75	0.71	0.70	0.70	0.69	0.68
Cash rate (end period)	3.50	3.50	4.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00

Source: ABS, RBA, HSBC forecasts. *Unless otherwise specified. **Includes the effect of the carbon tax from Q312 and its removal from Q314

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