



Headwinds for the Australian Economy and Financial System

Leith van Onselen

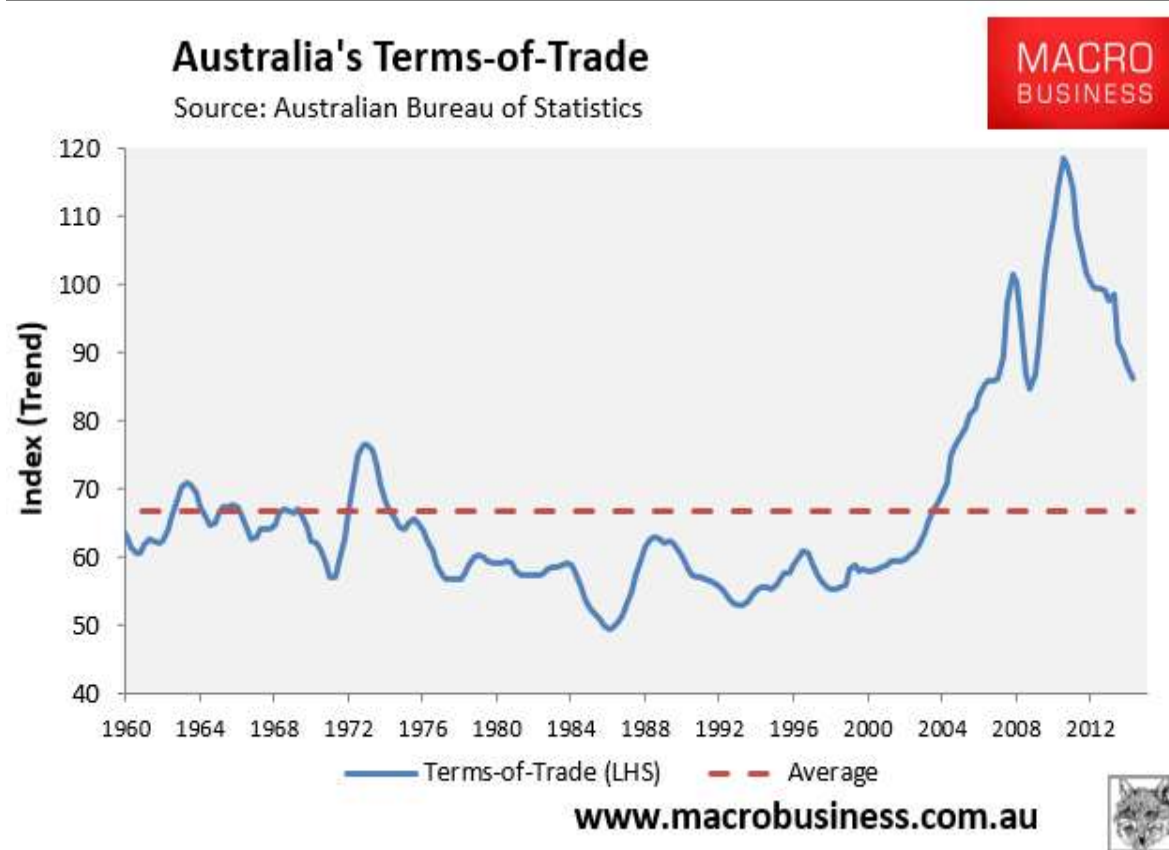
Overview of Australian housing market

- After 24 years without a technical recession, Australia finds itself at a critical juncture.
- With its economy 'hollowed-out' and broadly uncompetitive, Australia is facing stiff headwinds from multiple forces, which threatens to raise unemployment, reduce incomes, and ultimately lower standards of living.
- These risks are made worse by Australia's record household debt and a housing market that is commonly regarded as one of the world's most over-valued.



The key beneficiary of the China boom

- China's rapid rise, and insatiable appetite for commodities, led to the biggest boom in commodity prices and the terms-of-trade in Australia's history.

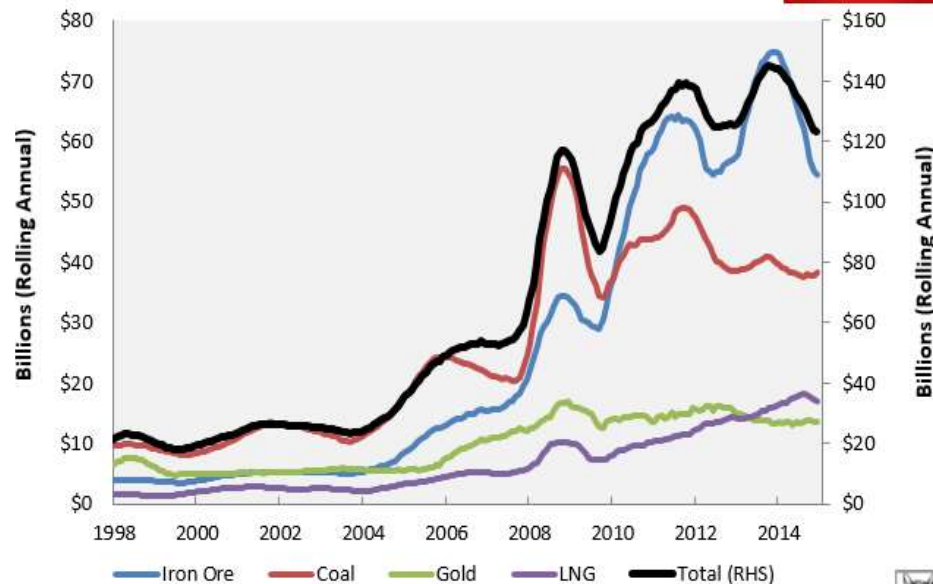


Commodity exports boomed

Iron Ore, Coal, Gold & Natural Gas Exports

Source: Australian Bureau of Statistics

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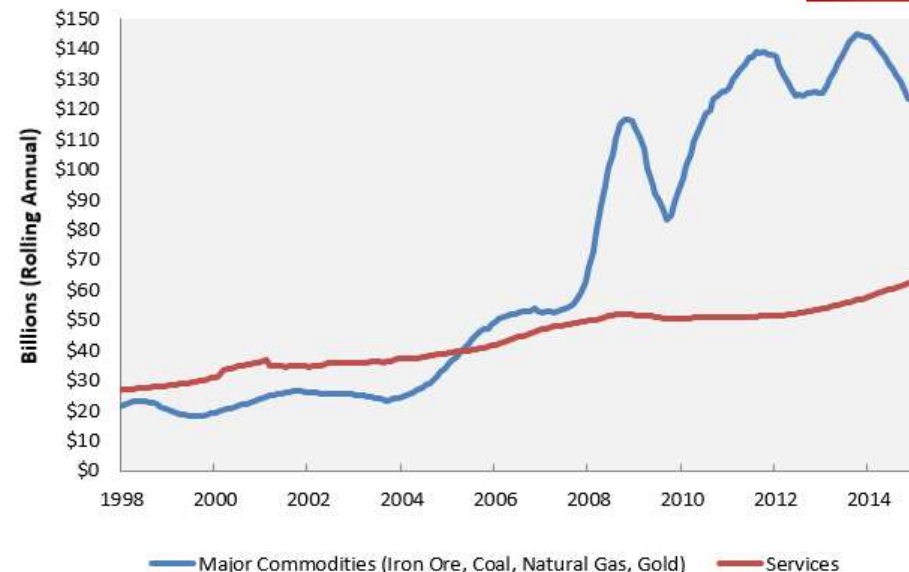
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Exports: Major Commodities versus Services

Source: Australian Bureau of Statistics

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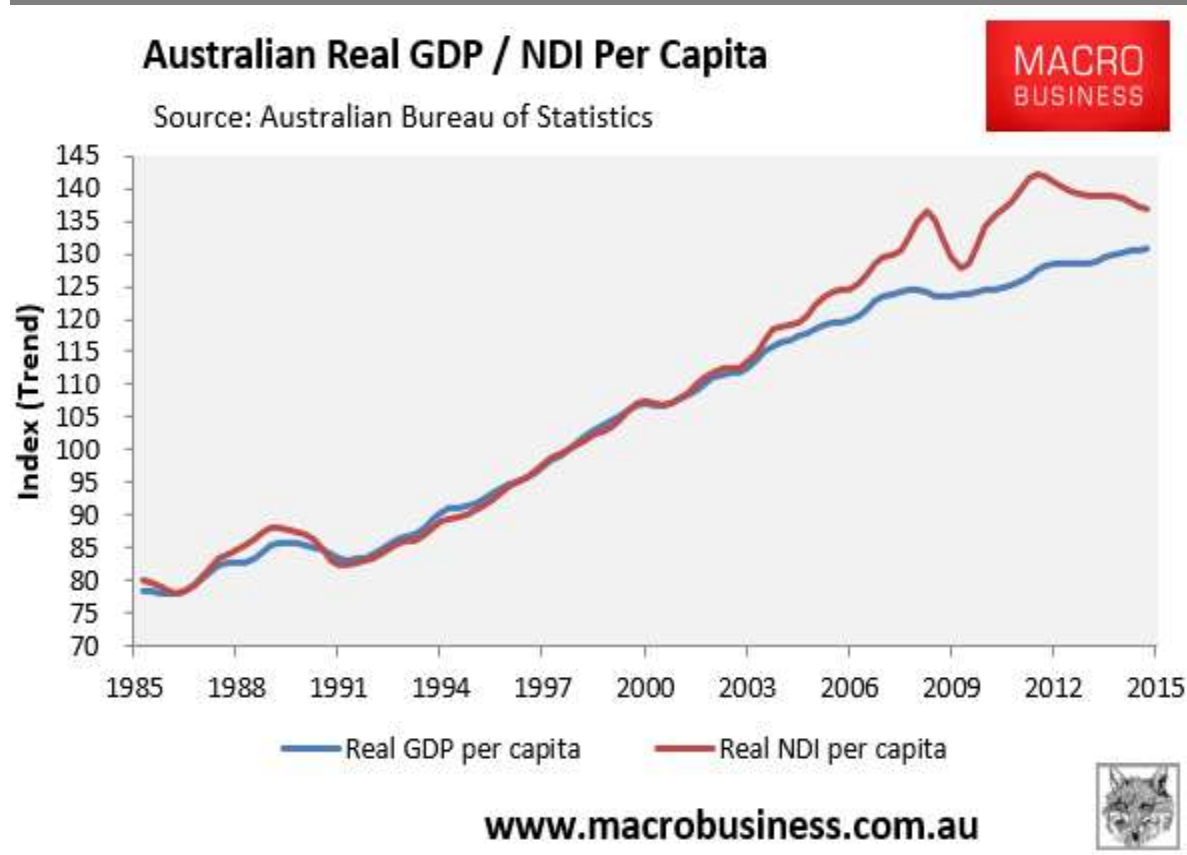
- Australian commodity exports have soared since 2003 on the back of China.
- Iron ore, in particular, has been the biggest winner.

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National income surged

- Strongly rising commodity prices from 2003 meant that national income grew at a much faster rate than output (GDP).
- This made Australians richer, since we could buy more imports from a given volume of exports.

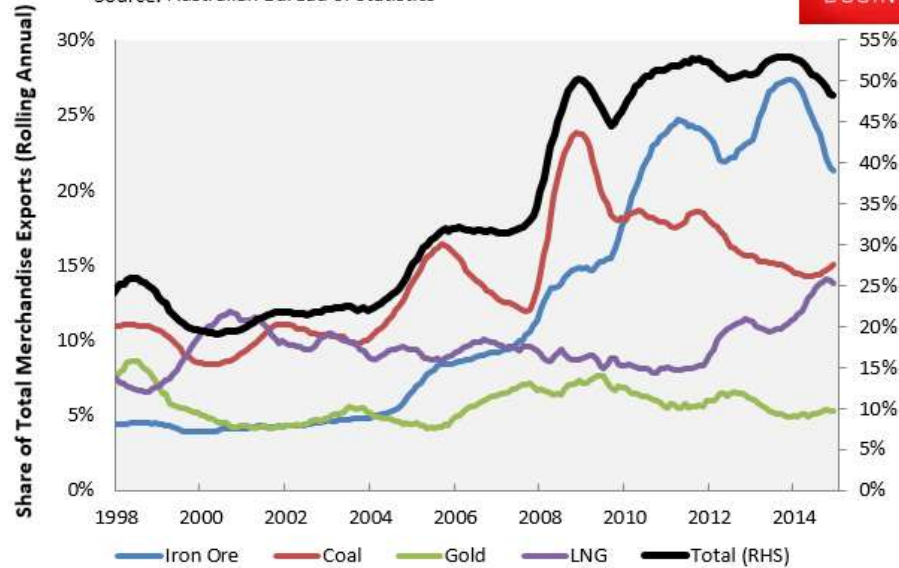


Dark side of the boom

Iron Ore, Coal, Gold & Natural Gas Exports

Source: Australian Bureau of Statistics

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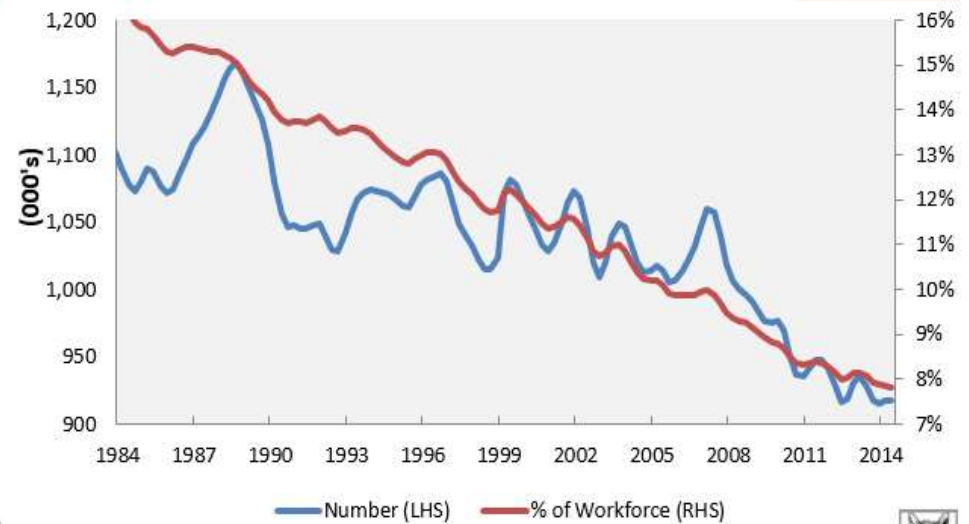
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Australian Manufacturing Employment

Source: Australian Bureau of Statistics

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- But Australia's non-mining economy has been crowded-out, narrowing our economic base.
- The manufacturing industry, in particular, has suffered immensely and Australia's economy now lacks diversification.

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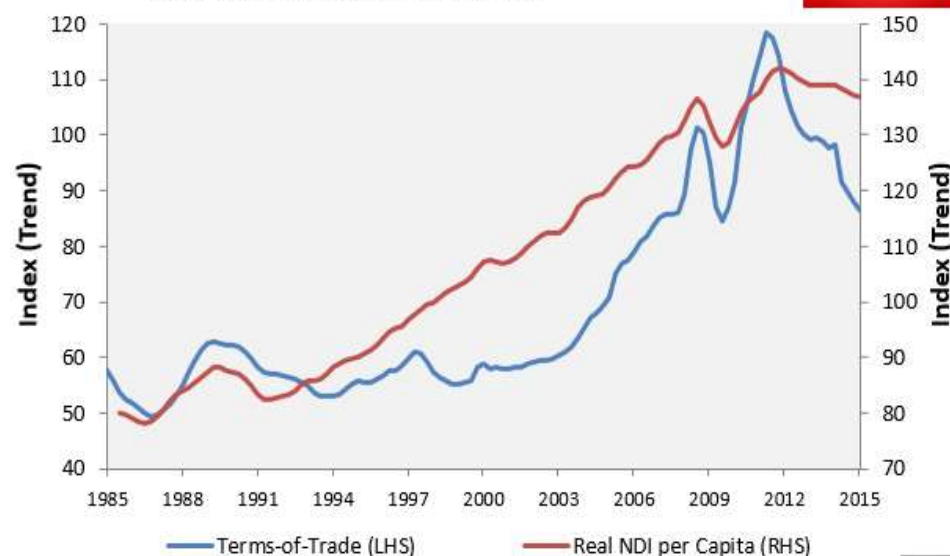


Our luck is running out

ToT vs National Disposable Income

Source: Australian Bureau of Statistics

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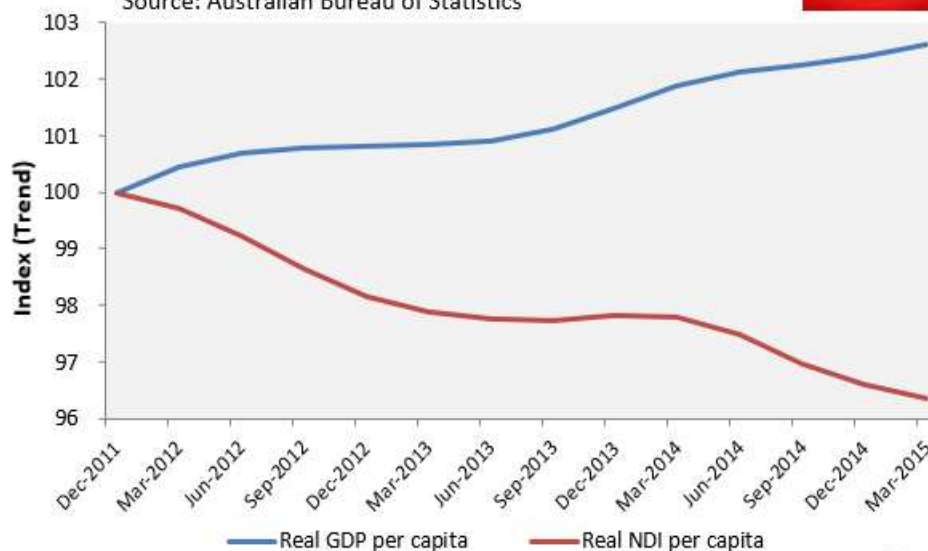
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Australian Real GDP / NDI Per Capita

Source: Australian Bureau of Statistics

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- Commodity prices peaked in 2011 and are now falling, dragging-down the terms-of-trade and national disposable income.
- If falls persist, which we believe they will, incomes will grow at a much slower rate than GDP going forward.

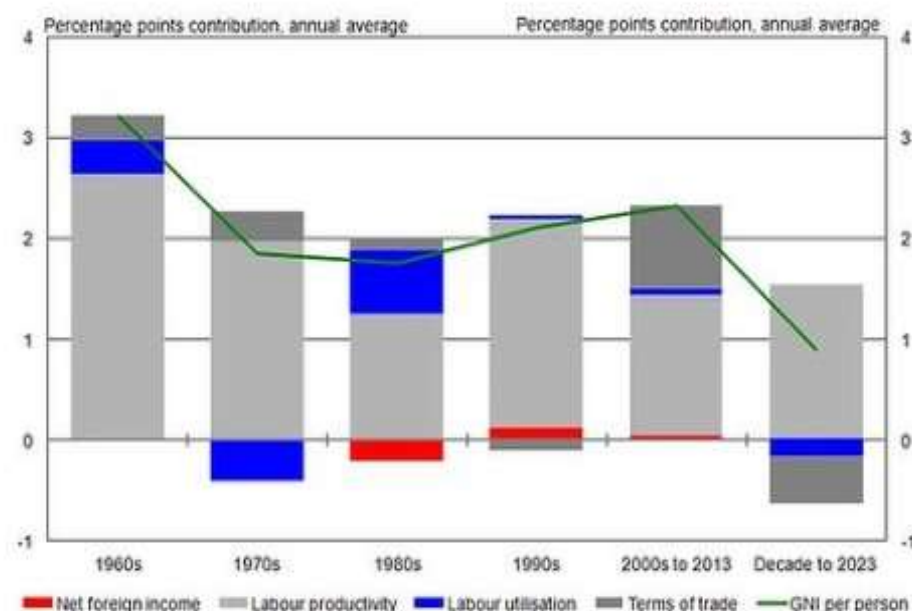
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An income shock in the making



Contributions to annual income growth

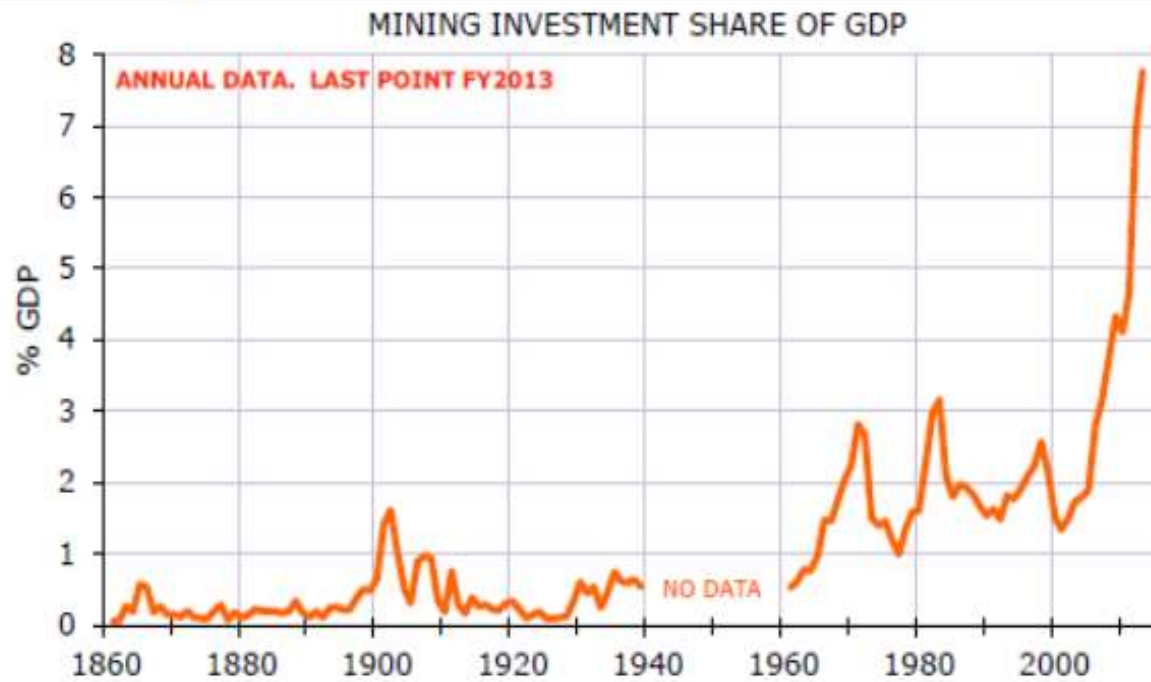


- Household income growth is slowing fast.
- Australian Treasury forecasts that average per capita income growth would halve over the next decade to the lowest rate of growth experienced in at least 60 years, weighed down by the falling terms-of-trade.



A triple headed employment shock is coming

The Unprecedented Rise In Mining Investment

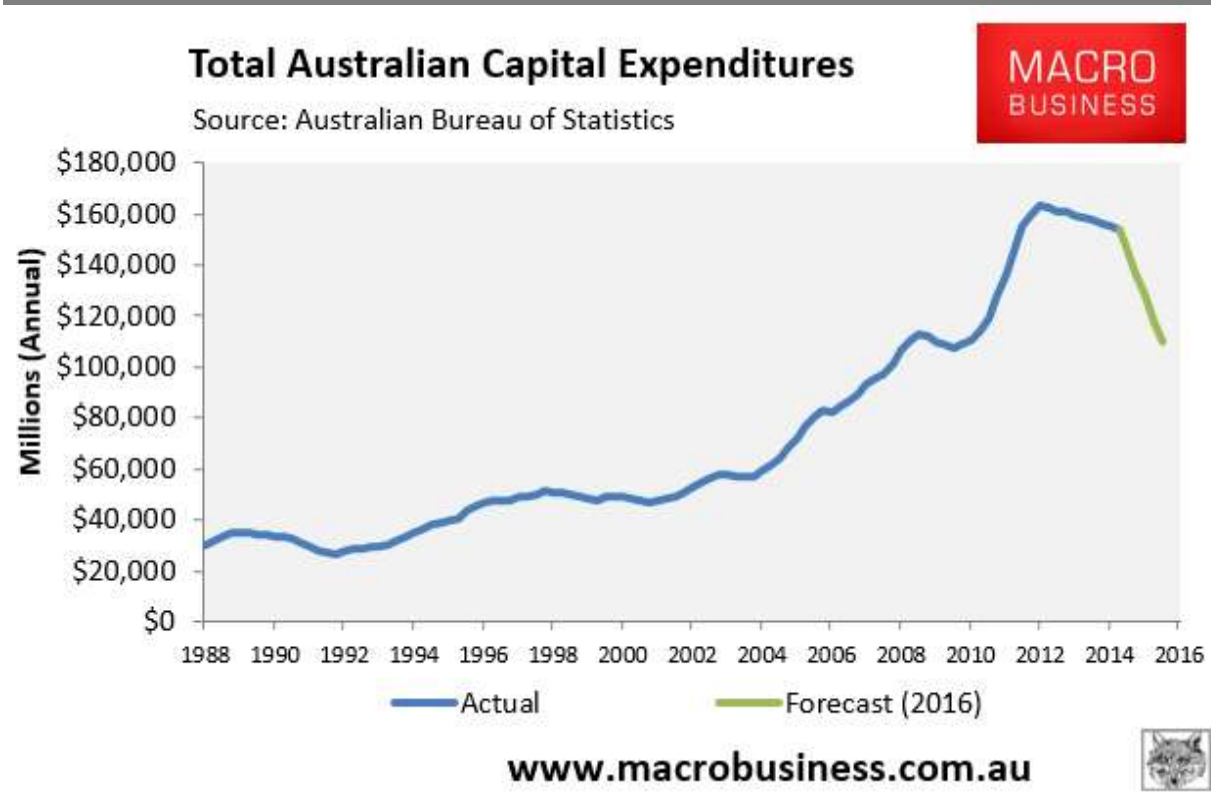


Source: ABS, RBA, Butlin; Minack Advisors

- Australia's economy had been supported by the biggest mining investment boom in the nation's history.
- According to the RBA, around 10% of employment was mining-related in 2012, with most employed in areas directly related to capital investment.



A triple headed employment shock is coming

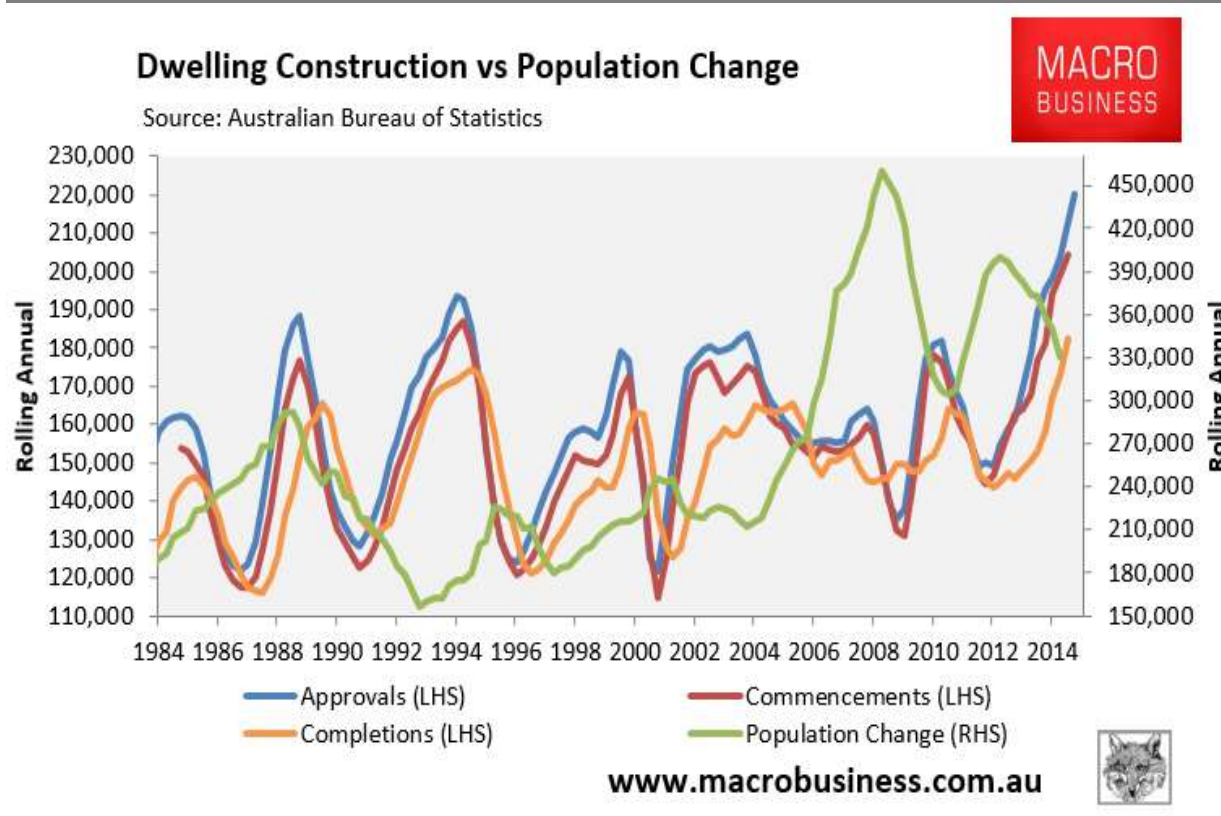


- Most forecasters expect large falls in mining capex from 2015 to 2017.
- This will weigh heavily on employment, particularly construction workers, engineers, and other mining services .



A triple headed employment shock is coming

- The shuttering of the local car industry by 2017 places at risk another 50,000 manufacturing jobs, accentuating these pressures.
- Dwelling construction will likely also begin to fall from 2016 as population growth slows.

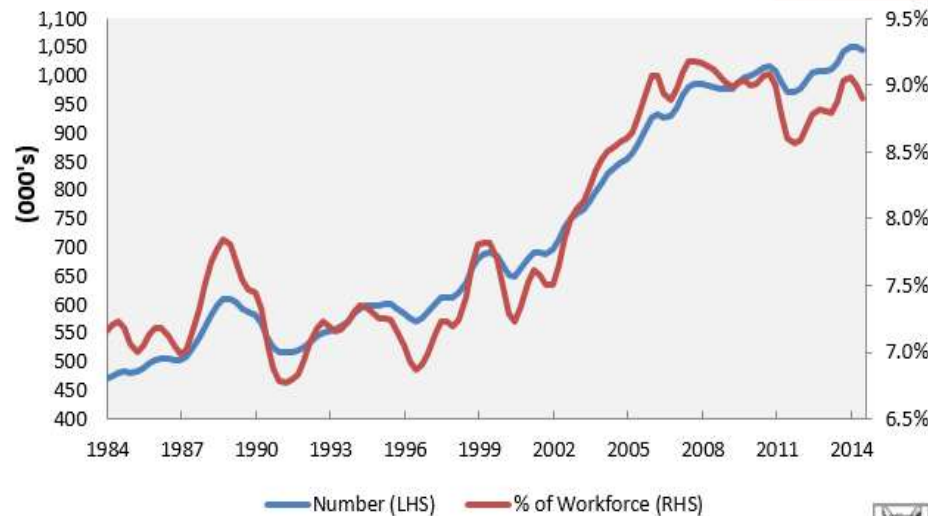


Construction & Manufacturing jobs will get spanked

Australian Construction Employment

Source: Australian Bureau of Statistics

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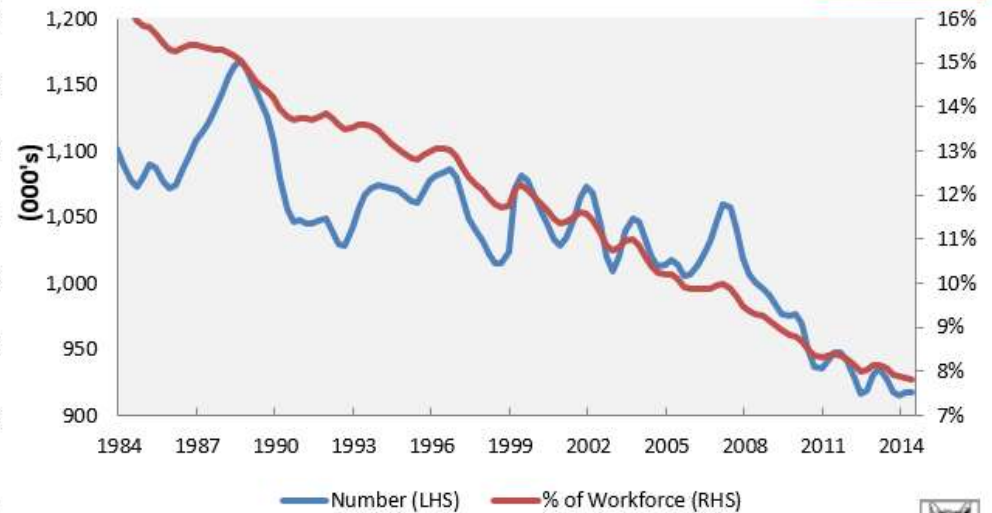
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Australian Manufacturing Employment

Source: Australian Bureau of Statistics

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- Construction (8.9% share) and manufacturing (7.8% share) are major employers.
- Both sectors will take a hit as the three employment headwinds take hold.

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Aussie housing valuations are at a record high

Total Value of Housing Stock vs Total Employee Income*

Sources: RBA; Australian Treasury



* Value of dwelling stock owned by households

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Value of Housing Stock to GDP*

Sources: RBA; ABS; Australian Treasury



* Value of dwelling stock owned by households

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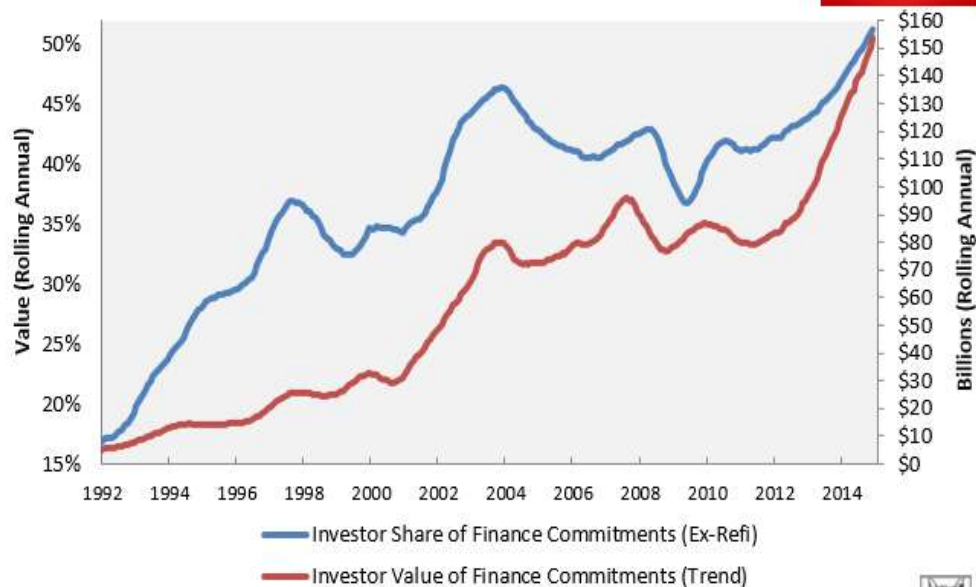
- Dwelling values in Australia are at record highs against GDP, incomes and rents [charts above are as at March 2015 – situation is worse now].



An unprecedented speculative bubble

Investor Housing Finance Commitments

Source: Australian Bureau of Statistics

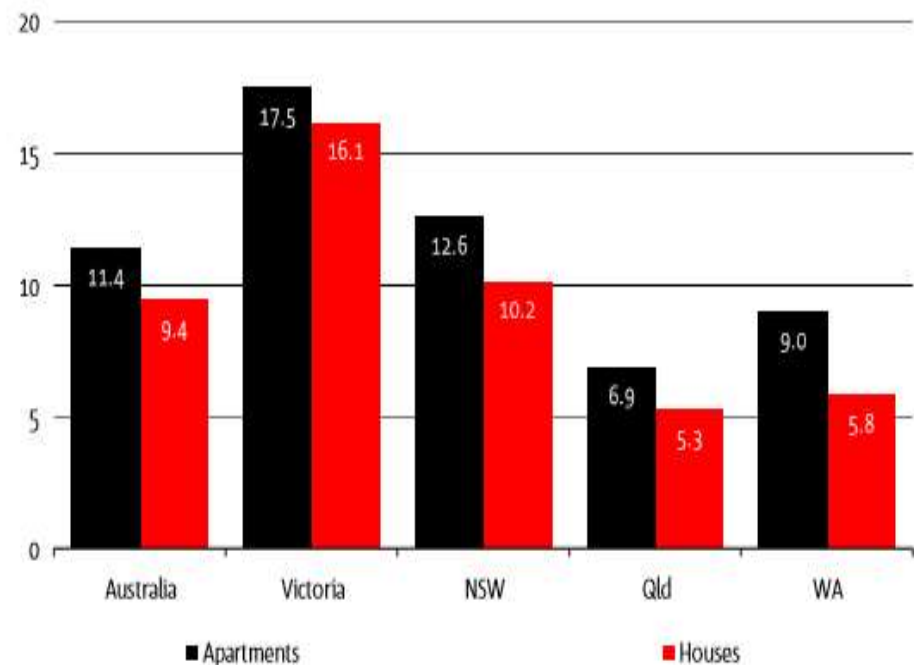


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Overseas Buyers: Share of Established Property Sales (%)



- Housing market propelled by unprecedented demand by investors – both domestic and foreign.

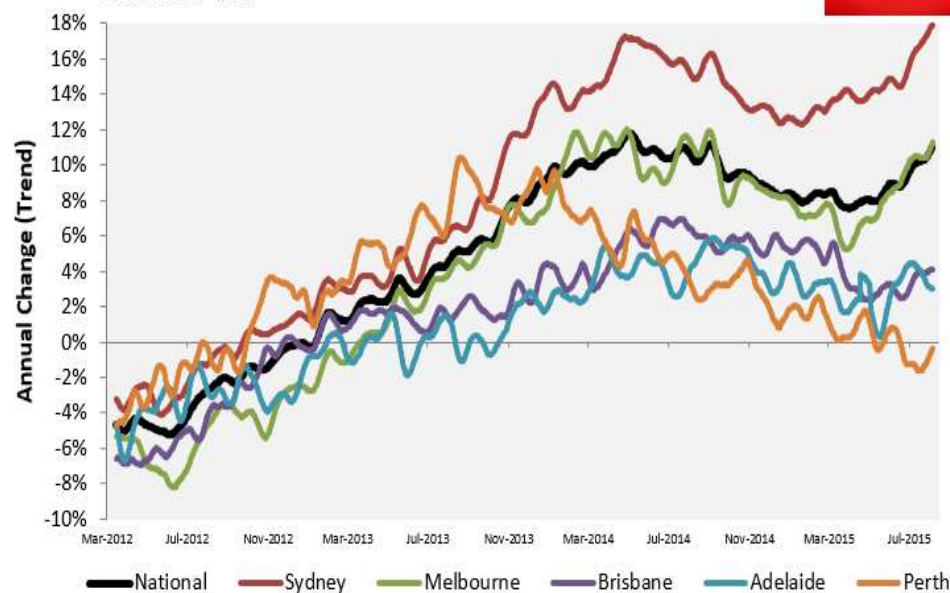
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Led by Sydney and Melbourne

RP Data Capital City Home Price Growth

Source: RP Data

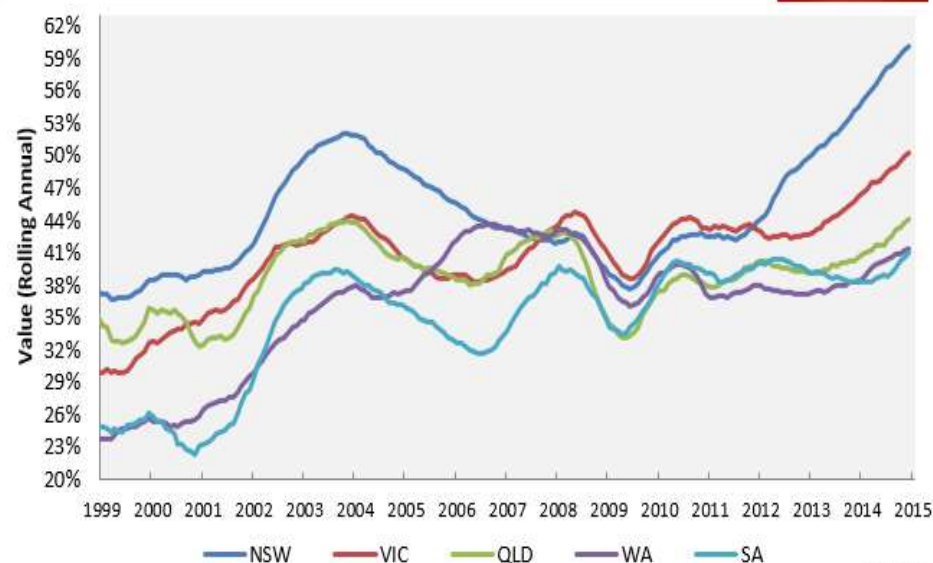


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Investor Share of Total Finance Commitments (Ex-Refi)

Source: Australian Bureau of Statistics



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- Melbourne and Sydney dwelling prices re-accelerating.
 - Investors account for 60% of housing finance in Sydney and 50% in Melbourne.
 - Foreign buyers account for 10% of house sales in Sydney, 16% in Melbourne.

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Perth is first domino to fall

Perth Dwelling Price Growth

Source: RP Data

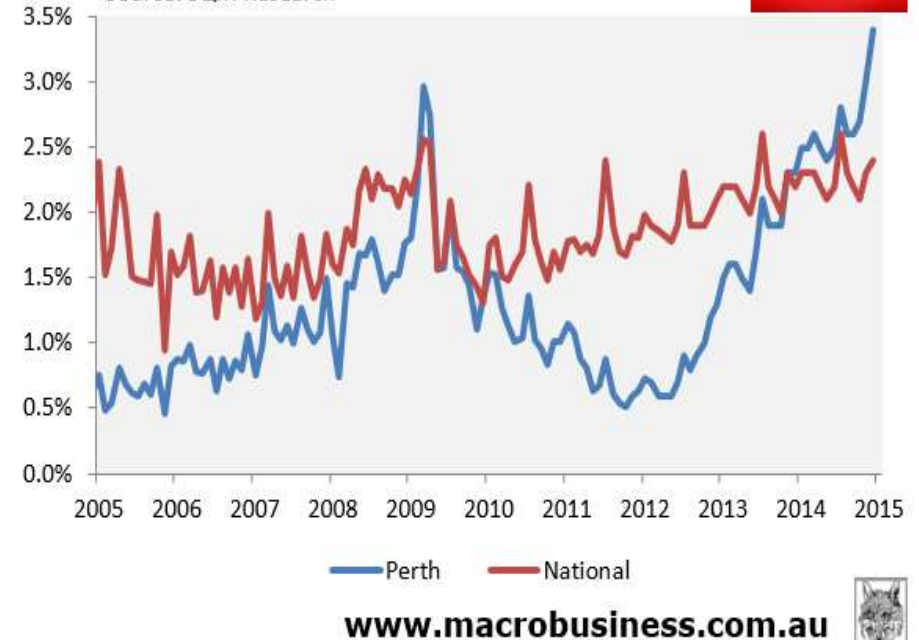
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Rental Vacancy Rate

Source: SQM Research

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- Perth dwelling values and rental market in the doldrums.
 - Dwelling values are falling.
 - Rents are falling as vacancy rates skyrocket.

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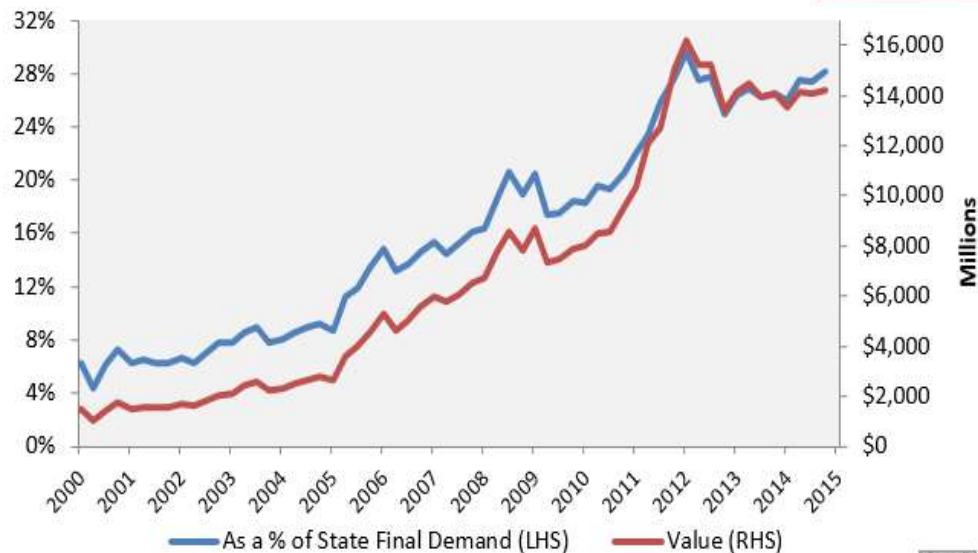


Worst yet to come for Perth

WA Mining Capex

Source: Australian Bureau of Statistics

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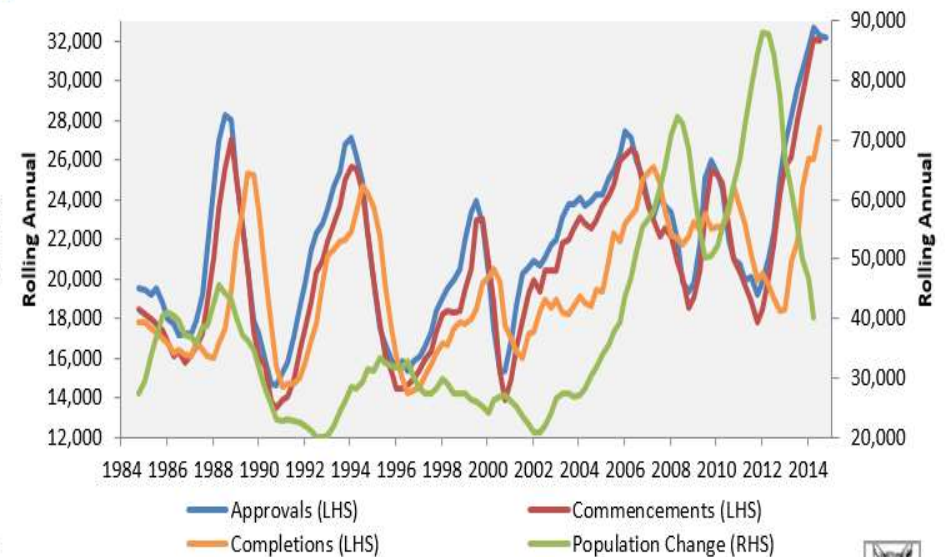
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WA Dwelling Construction vs Population Change

Source: Australian Bureau of Statistics

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- WA Mining capex will collapse.
- Dwelling supply set to rocket as population growth collapses.

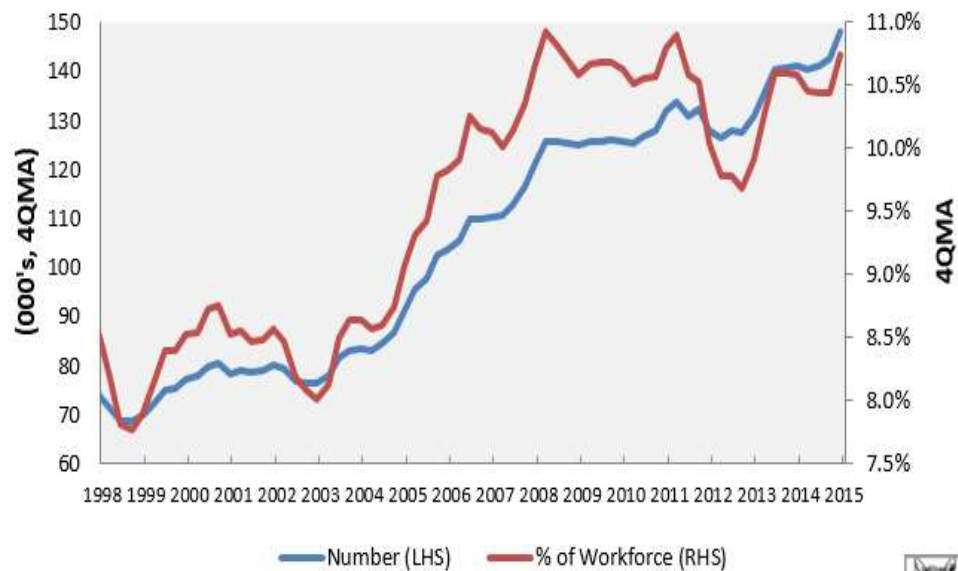
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Worst yet to come for Perth

WA Construction Employment

Source: Australian Bureau of Statistics

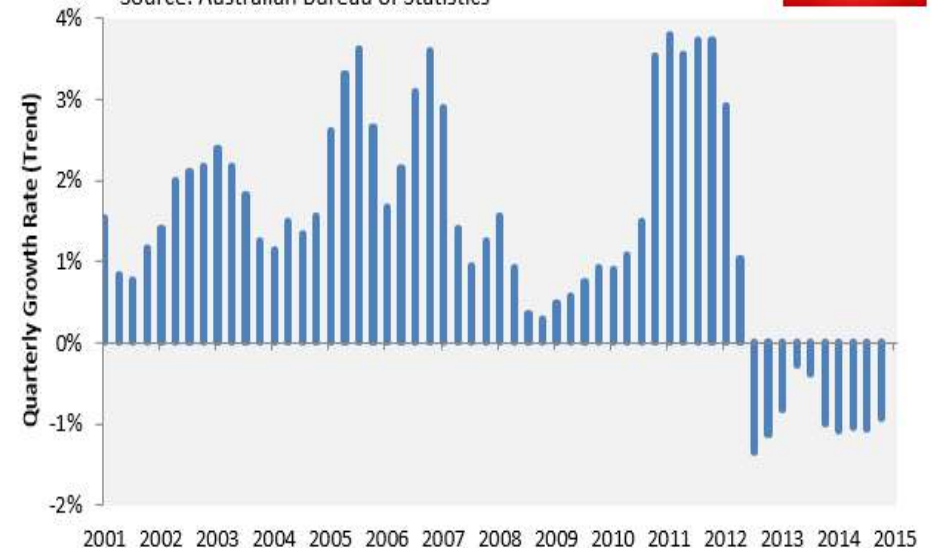


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WA State Final Demand

Source: Australian Bureau of Statistics



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- WA construction jobs will collapse as mining investment unwinds and dwelling construction boom reverses.
- WA final demand, which is already contracting, will worsen.

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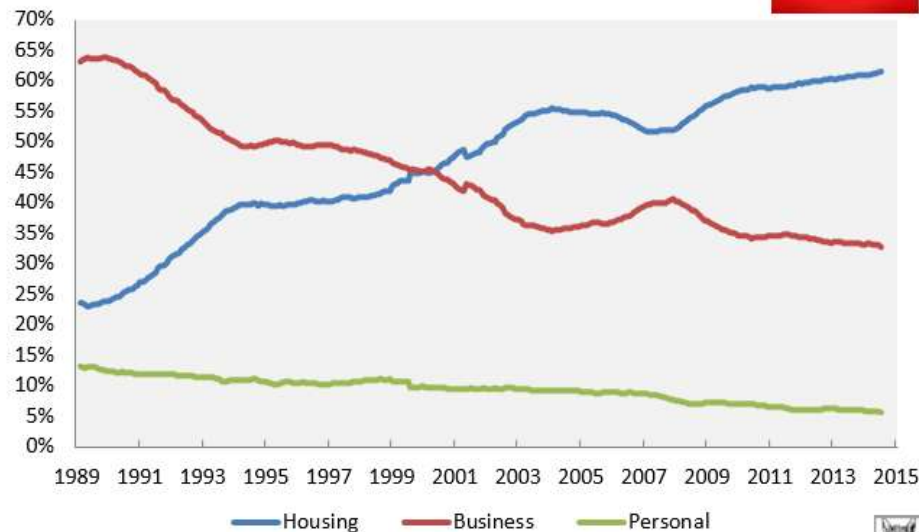


Banking system over-exposed to housing

Share of Outstanding Private Sector Credit

Source: Reserve Bank of Australia

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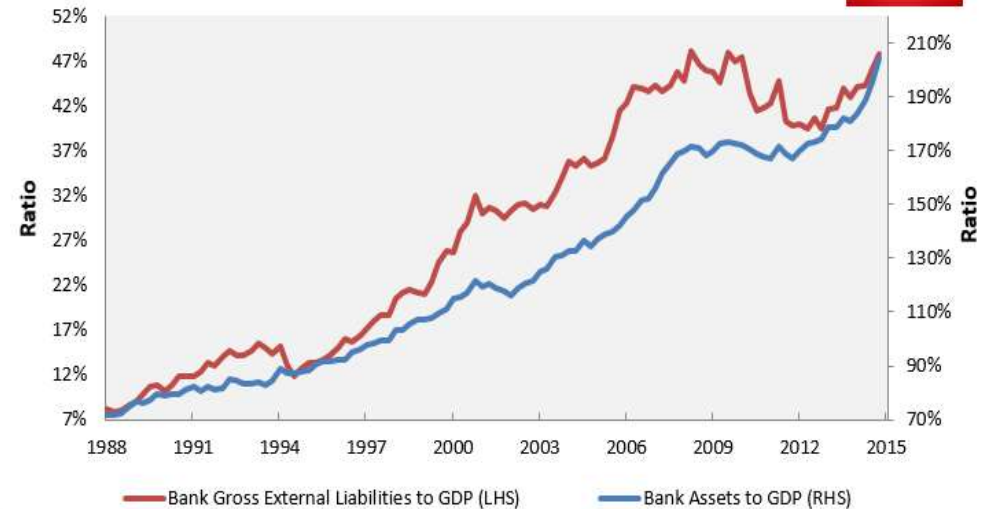
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Bank Offshore Funding & Assets to GDP

Source: Australian Bureau of Statistics

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- Share of loans into housing increased from 24% of total loans in 1990 to 62% currently. Business loans fallen from 64% to 33% over same period.
- The rapid expansion of mortgage debt and housing values has been funded, to a large extent, by heavy offshore borrowings by Australia's banks and is represented by a massive expansion in bank assets (mainly mortgages) relative to GDP.

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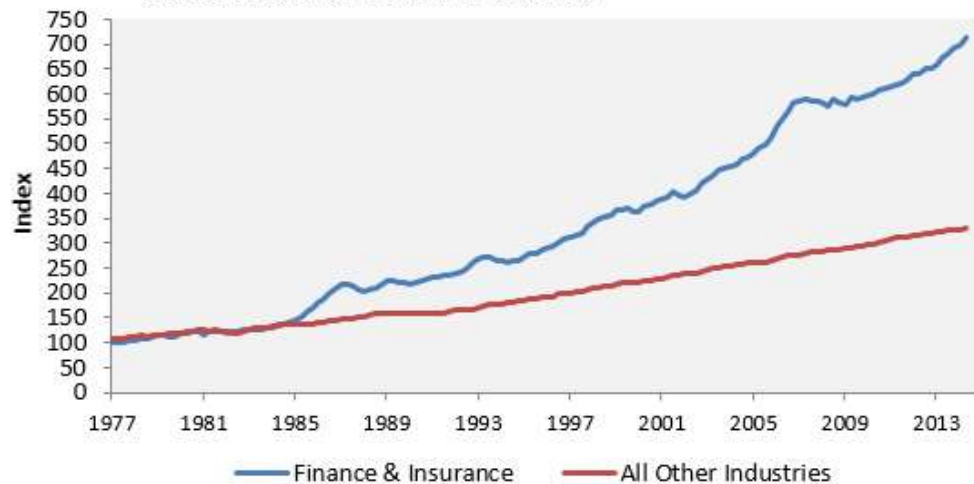


Housing choking-off other sectors

Growth of the Finance & Insurance Economy

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Source: Australian Bureau of Statistics



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Finance & Insurance as a % of GDP

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Source: Australian Bureau of Statistics



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- The Finance & Insurance industries have grown more than twice as fast as the rest of the economy since the mid-1980s, when financial markets were deregulated.
- Finance & Insurance's share of GDP has more than doubled to nearly 9%.

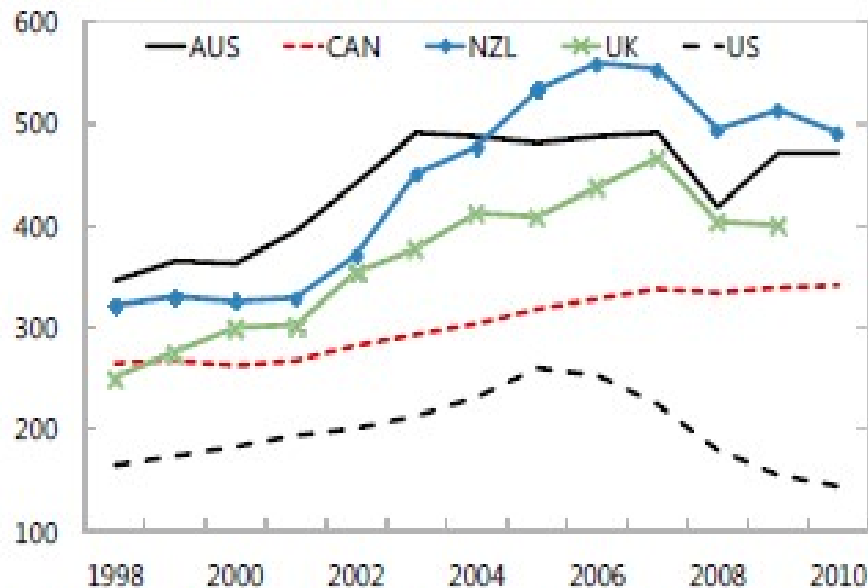
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Too much wealth tied-up in housing

Housing Wealth to Disposable Income

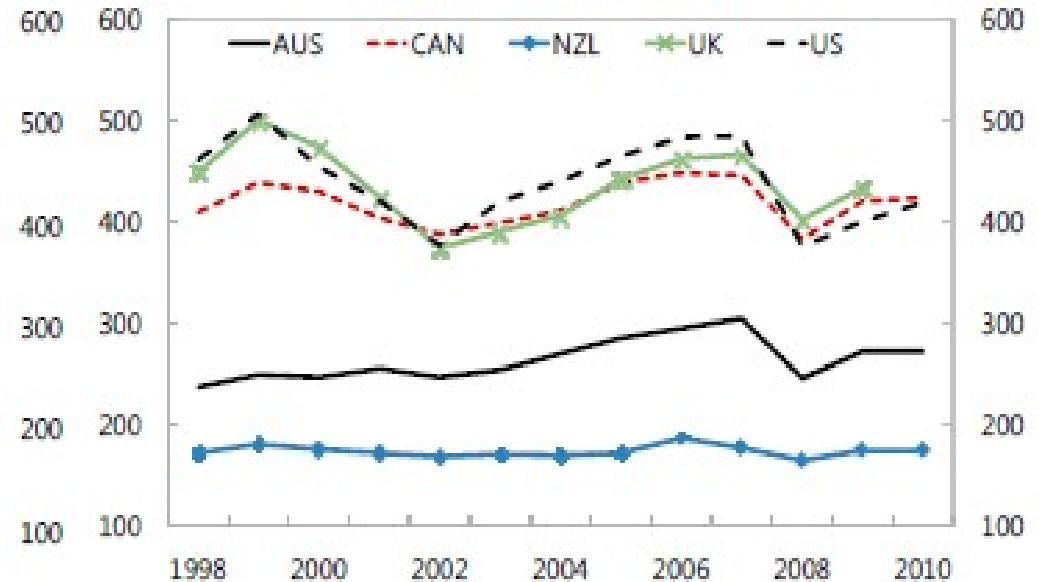
(In percent)



Sources: RBA; RBNZ; Eurostat; OECD; Haver; and IMF staff calculations.

Financial Wealth to Disposable Income

(In percent)



Sources: RBA; RBNZ; Eurostat; Haver; and IMF staff calculations.

- Aussies hold a disproportionate share of their wealth in housing, compared with other English-speaking nations.



Australia left facing a dangerous conundrum

- Australia is at a dangerous inflection point.
- The rivers of gold from the once-in-a-century mining boom, along with the shuttering of the local car industry and reversal of the dwelling construction boom, will likely create a shock to incomes and employment that could last a decade.
- Meanwhile, Australian housing values are accelerating into trouble and have hit their highest valuation ever, driven by an unsustainable surge in investor demand – both domestic and foreign.
- The risk of a substantial housing correction sometime in the near future is arguably greater now than at any other time in living memory.
- This has obvious implications for bank profitability and capital, along with financial system stability.



Known knowns

- Mining investment will collapse between now and 2017.
- The car assembly industry will shut down – Ford next year and Toyota and Holden in 2017.
- Population growth is falling just as housing supply is rising.
- Dwelling construction will very likely peak in 1H 2016 and then go into reverse.
- Macro-prudential tightening against property investors is underway.
- The Abbott Government has announced a crack down on illegal foreign property investment, which comes into effect on 1 December 2015.
- Perth's economy and housing market is stuffed. Unemployment in Adelaide is rocketing. Darwin is facing similar pressures.



Unknowns

- The RBA can cut rates further, perhaps by another 100 bps. But will banks be able to pass them on? And will rate cuts be enough to arrest a negative loop of falling house prices, sentiment and employment?
- Fiscal stimulus is possible – perhaps around half the size of Rudd's rescue - but with the ratings agencies warning that the Budget must aim for surplus across the cycle to support AAA rating, no more than that.
- Stimulus could buy the economy some time, but given China's ongoing slowdown and rising supplies, commodity prices will likely continue to fall, keeping pressure on the ToT, national income, and the Budget.
- The AAA sovereign rating could be stripped and passed onto the banks via the implied guarantee. Bank funding costs would begin to rise despite a chronically weak economy and, given interest rates would be as low as they can go, housing could continue to fall.
- There is also the reasonable prospect of a global shock over the next two years.



- Questions?

