

The global and Australian economies

Bank of America 
Merrill Lynch

Presentation to a luncheon hosted by
the Australia-Israel Chamber of Commerce

Brisbane, 21st February 2013

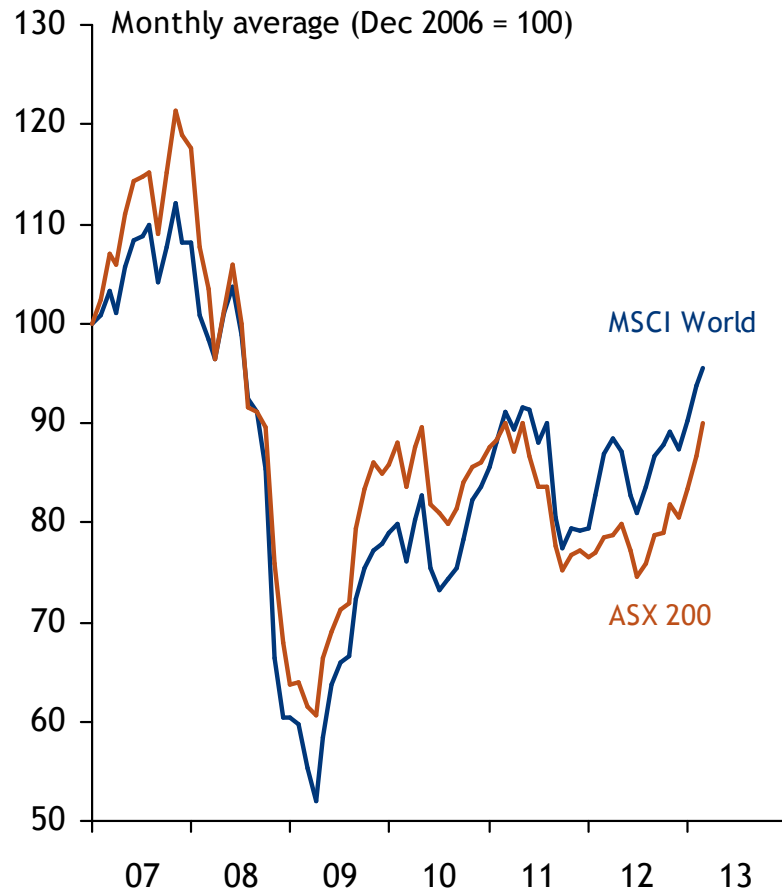
Saul Eslake

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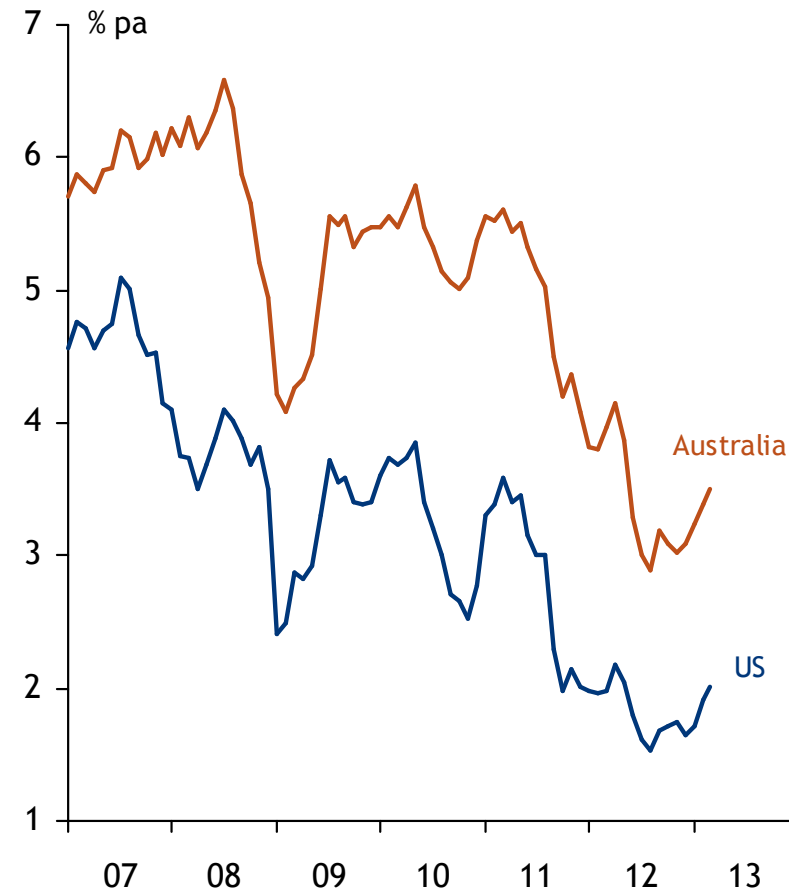
Refer to important disclosures on page 64-68.

Financial markets have enjoyed a strong start to 2013

Stock markets



10-year government bond yields

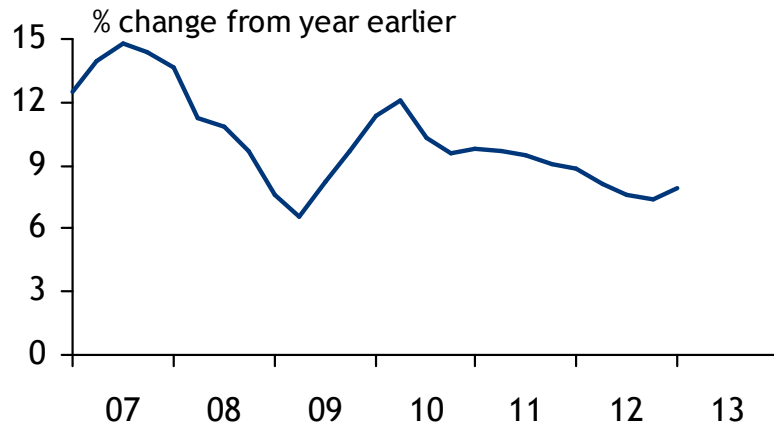


Sources: Thomson Reuters Datastream; BofA Merrill Lynch Global Research.

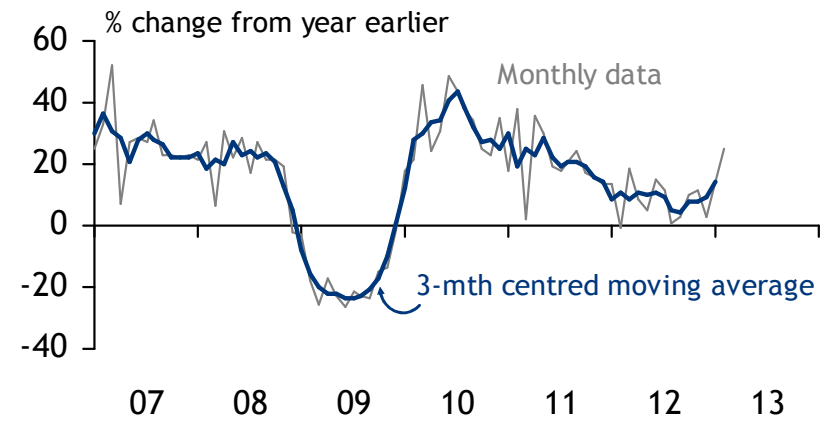
China's economy 'bottomed out' in Q3 last year

Chinese economy

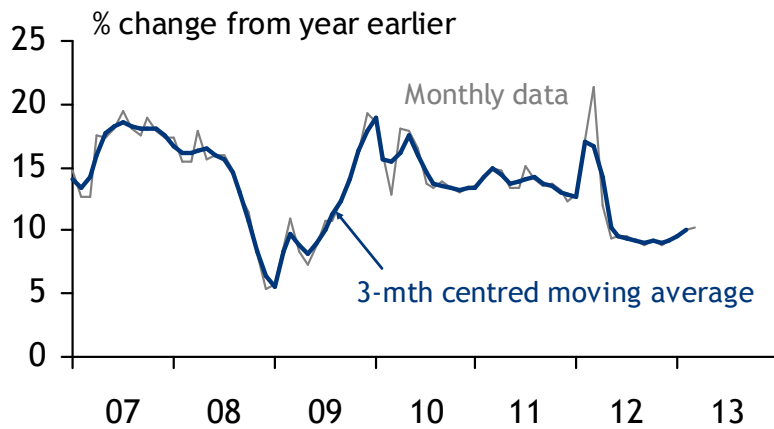
Real GDP



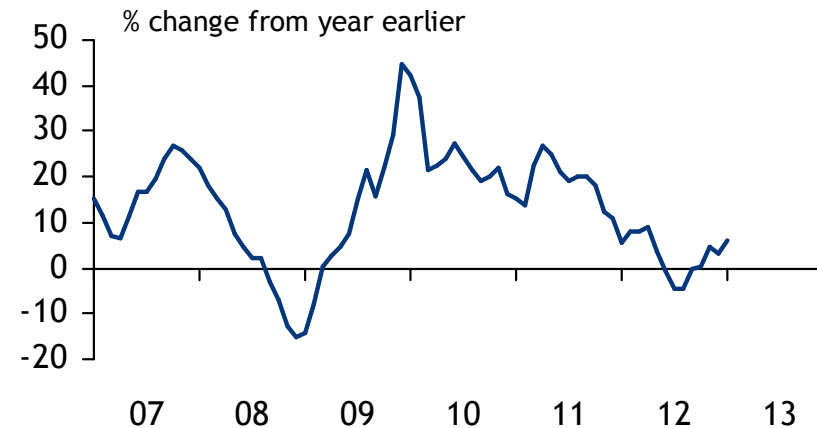
Merchandise exports



Industrial production



Property construction

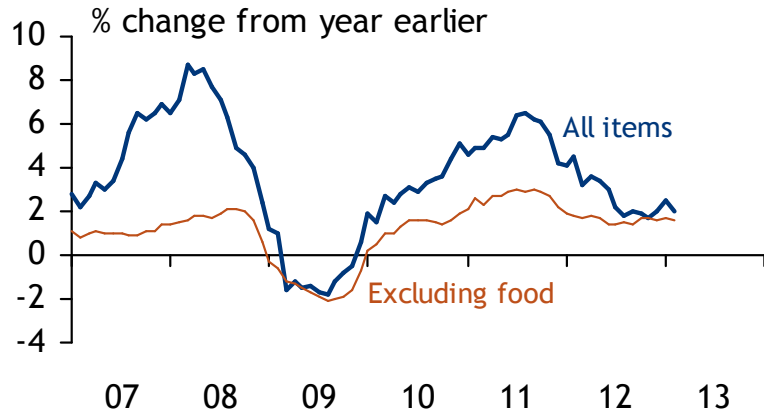


Sources: China National Bureau of Statistics; UBS; BofA Merrill Lynch Global Research.

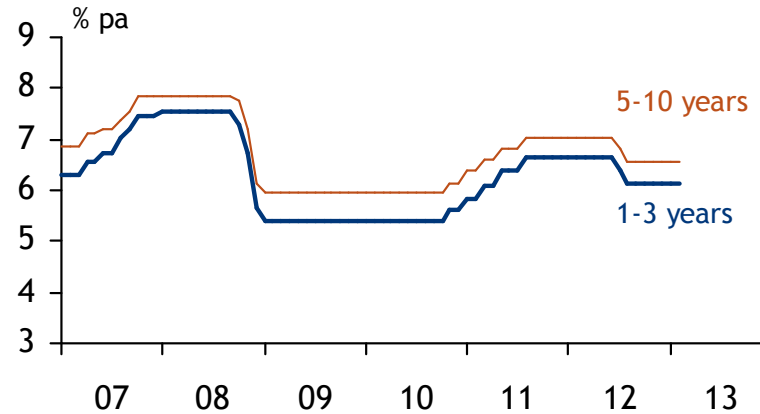
Chinese authorities have been reluctant to implement large stimulus measures

Chinese inflation and monetary policy

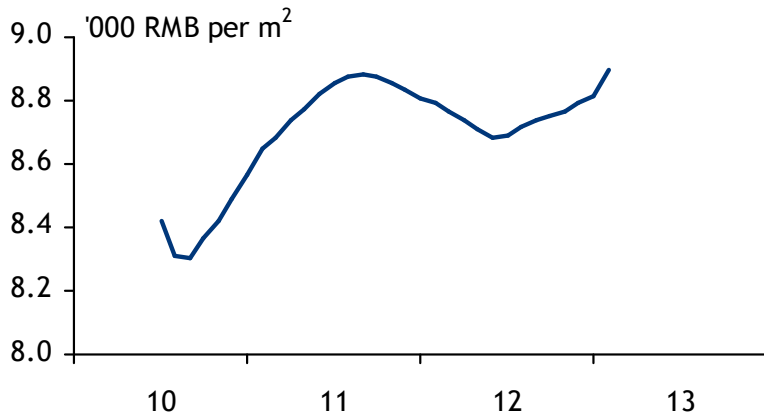
Consumer prices



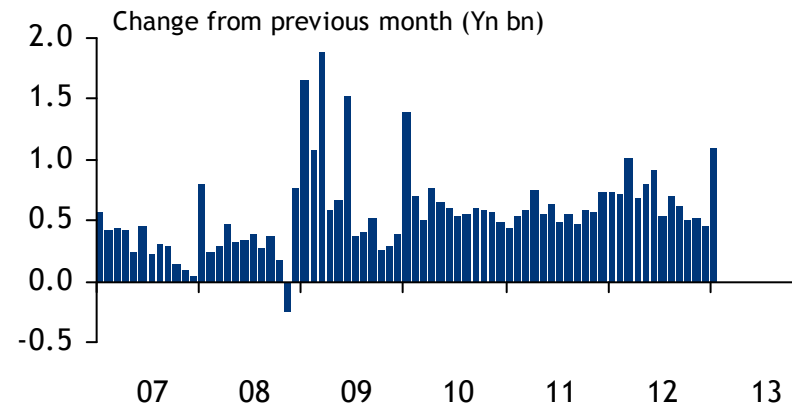
Capital construction loan interest rates



Residential property prices - 100 cities



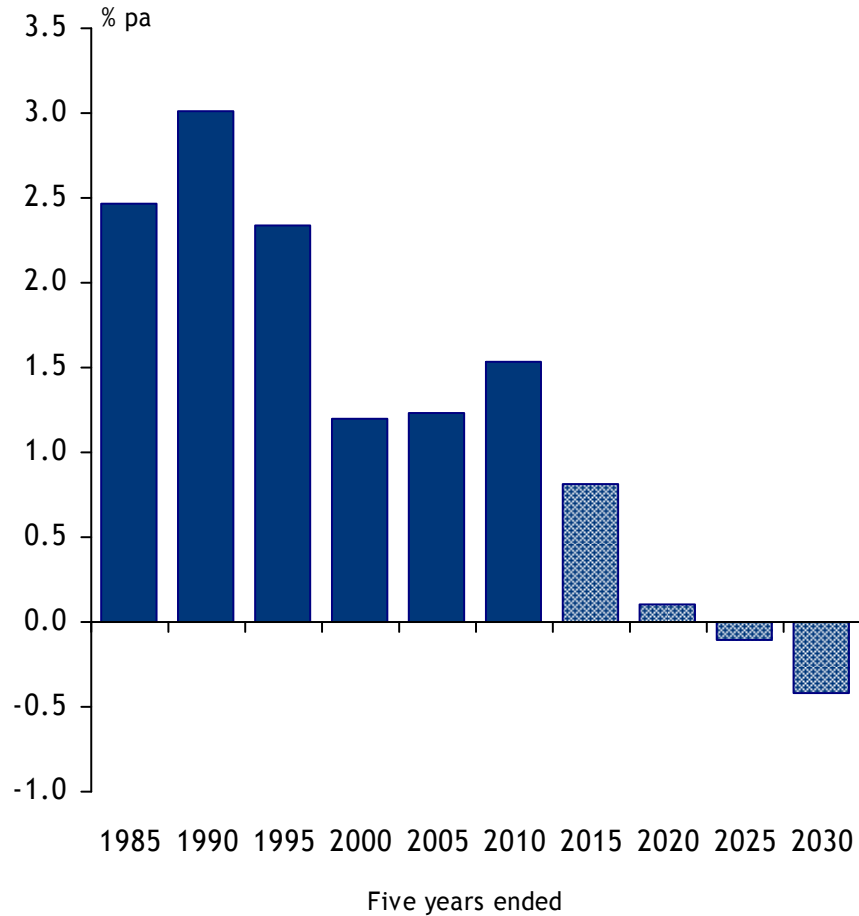
Lending growth



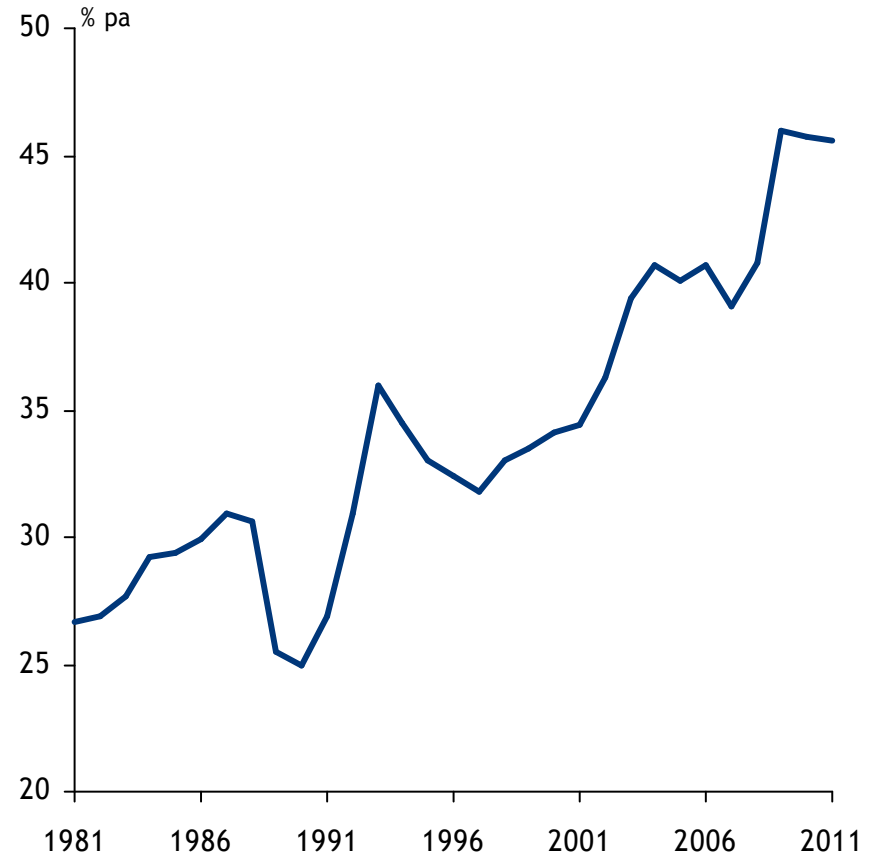
Sources: China National Bureau of Statistics; Soufun; People's Bank of China.

And longer-term factors slowing Chinese growth will re-assert themselves ...

Growth rate of China's working-age population



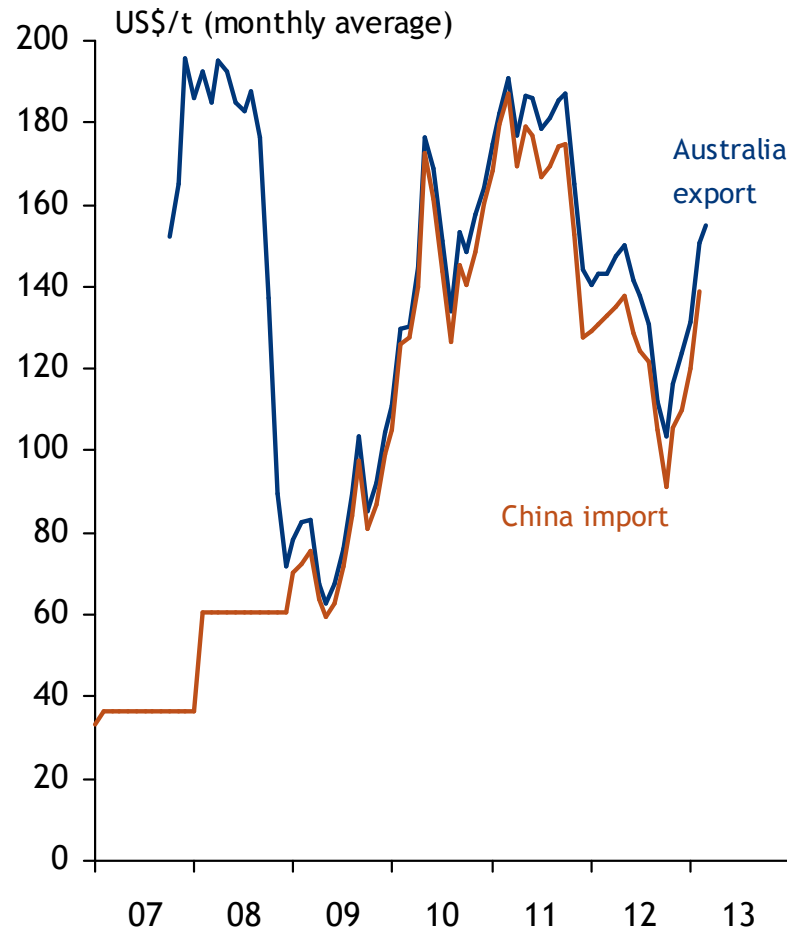
Fixed capital investment as a pc of China's GDP



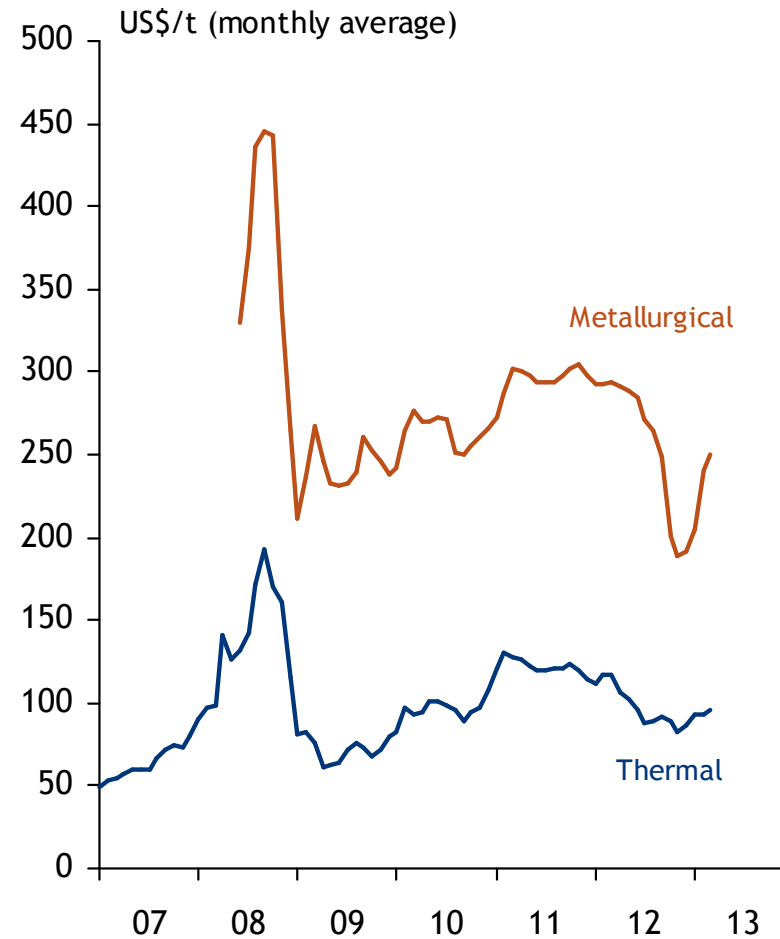
Sources: United Nations: CEIC.

... So the recent rebound in commodity prices probably isn't sustainable

Iron ore prices



Coal prices

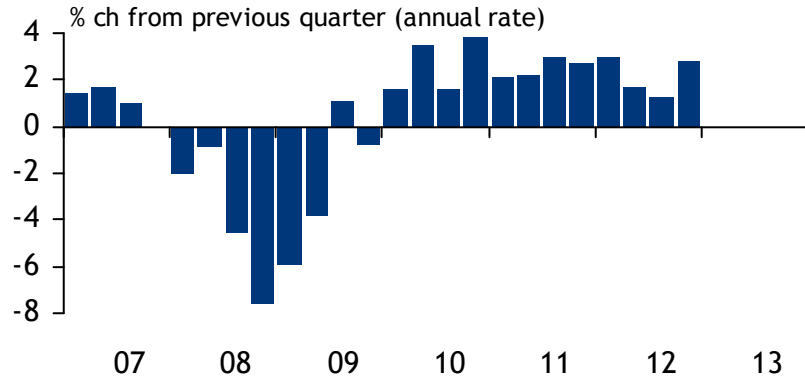


Sources: Thomson Reuters Datastream; IMF; BofA Merrill Lynch Global Research.

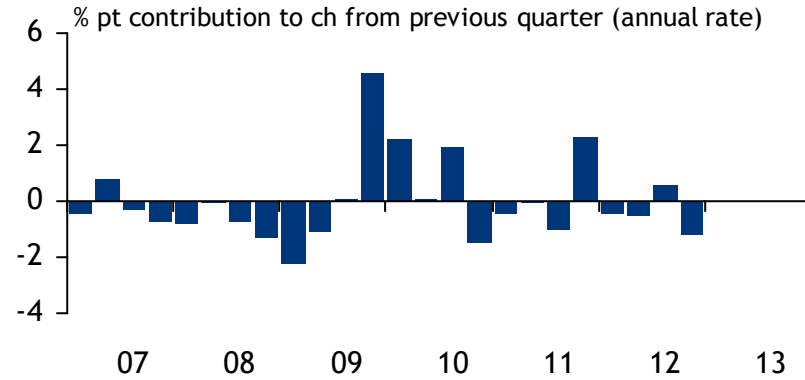
In the US, private sector spending is gradually picking up

US national income and expenditure

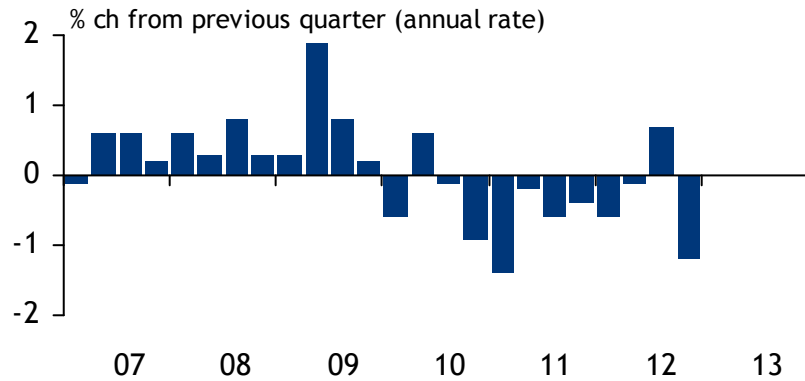
Private sector final demand



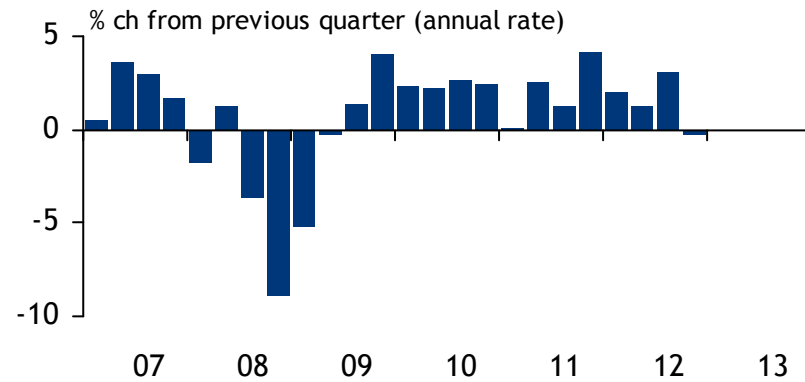
Changes in stocks



Government spending



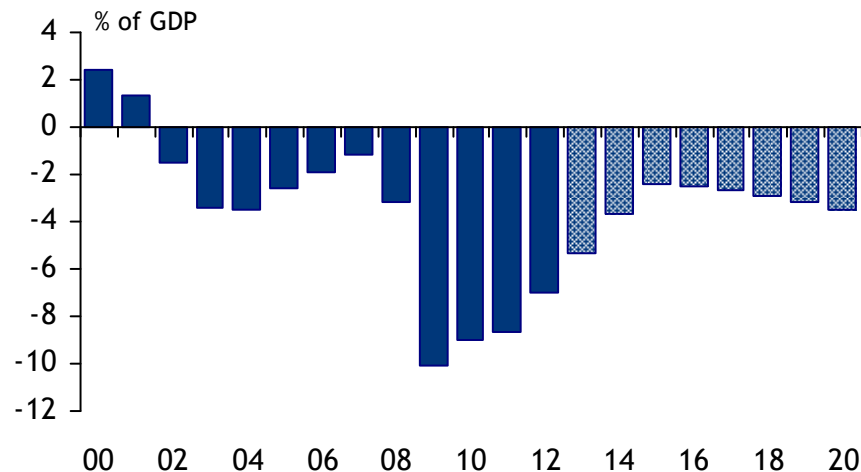
Real GDP



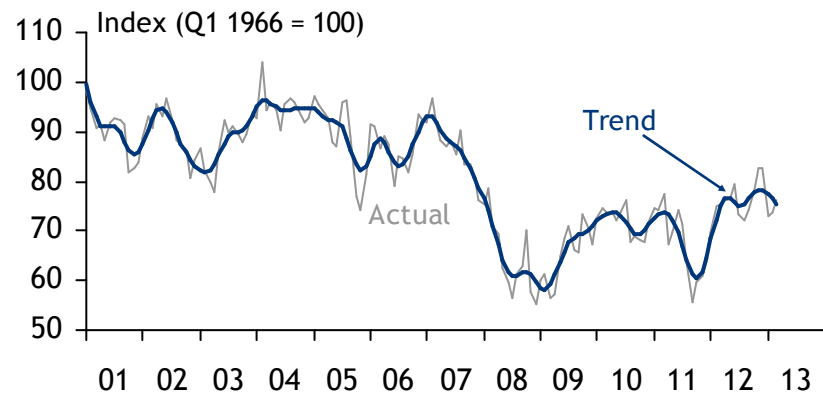
Note: 'Private final demand' is household consumption + residential investment + business fixed capital investment. Source: US Bureau of Economic Analysis.

So far US consumers don't appear to have been fazed by higher taxes

Federal budget balance



Consumer sentiment



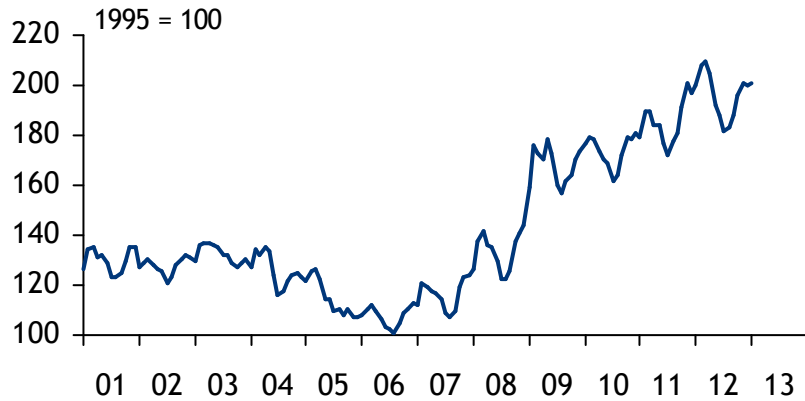
- The New Year's Eve deal to avert the 'fiscal cliff' entailed a fair bit of fiscal tightening, including a 2pc pt increase in payroll tax as well as higher taxes on 'rich' households
- So far households haven't reacted much to these tax increases
- Further fiscal tightening is coming - the 'sequester' (mandatory spending cuts) on 1st March (unless there's an agreement on alternative measures between now and then) ...
- ... and there could be further 'brinkmanship' when the 'continuing resolution' funding this year's budget expires on 27th March, or when the debt ceiling becomes binding again on 18th May
- The US is still a long way from reaching a lasting solution to its budget problems

Sources: Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2013 to 2023* (February 2013); Michigan University Survey Research Center.

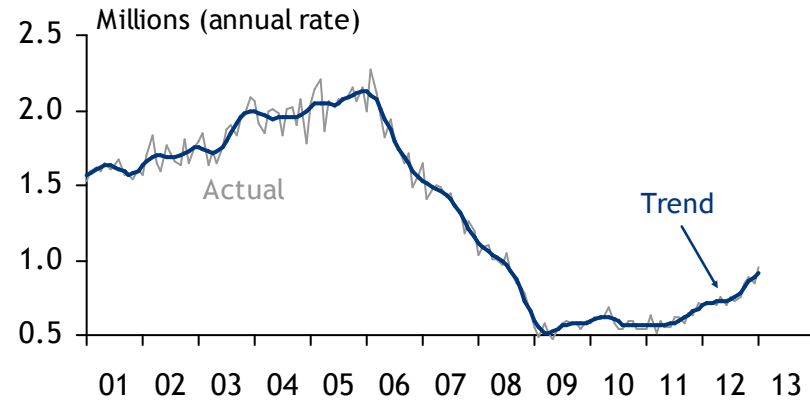
The US housing sector is turning the corner

US housing market

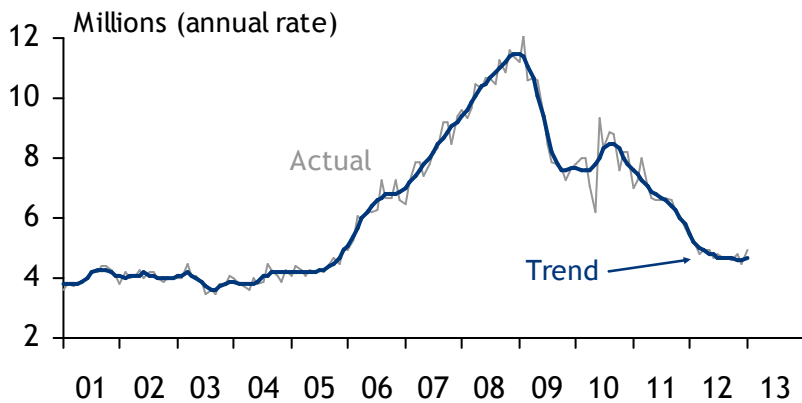
Housing affordability



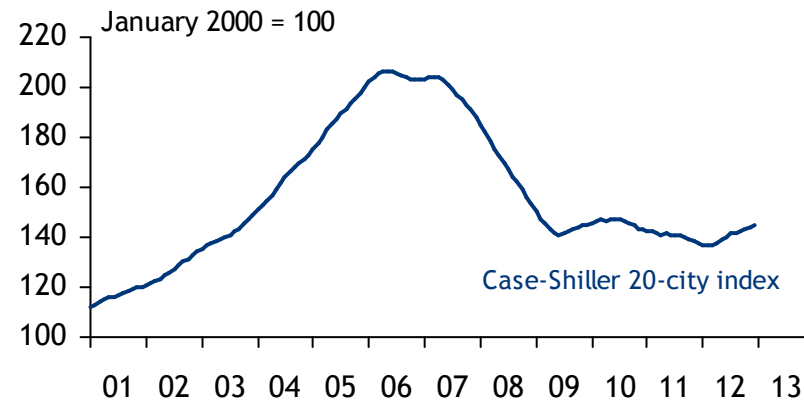
Housing starts



Inventory of unsold homes



House prices

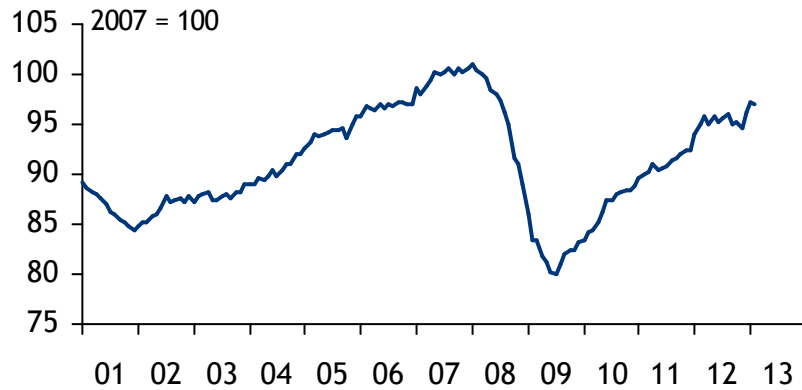


Sources: US National Association of Realtors; US Commerce Department; Standard & Poor's.

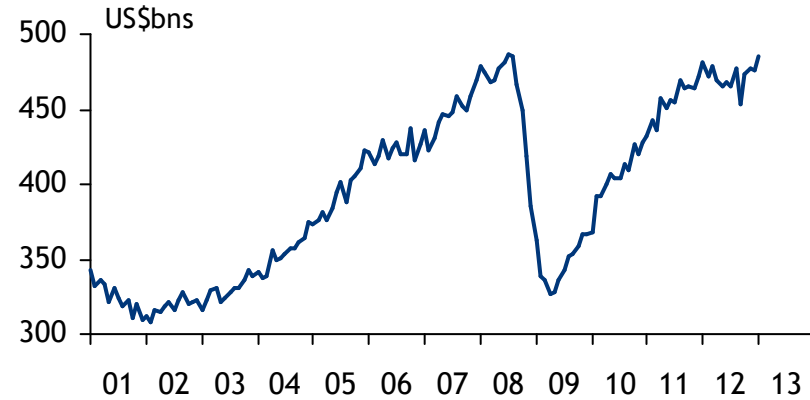
US manufacturing is enjoying something of a revival ...

US manufacturing sector

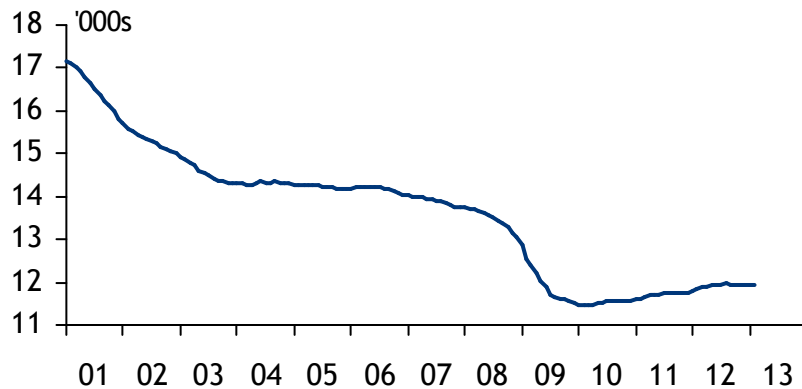
Manufacturing production



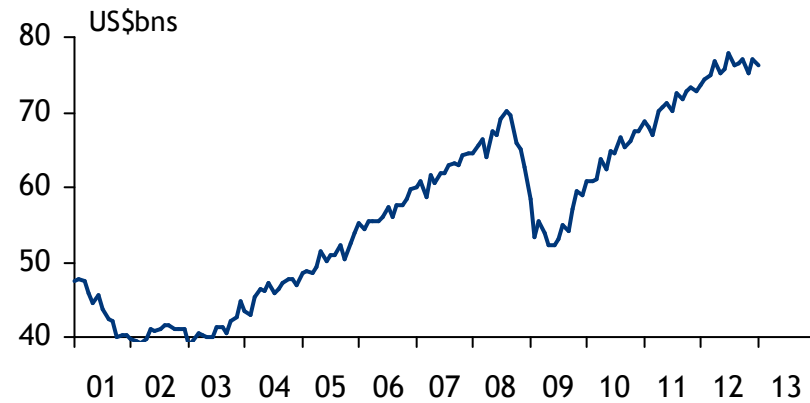
Factory orders



Manufacturing employment



Manufactured exports

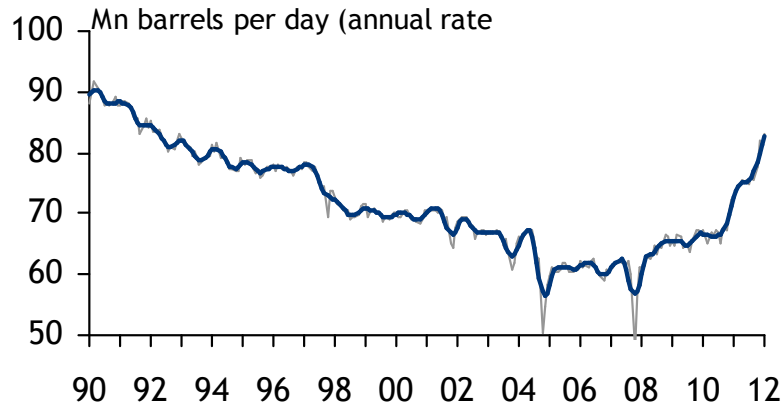


Sources: US National Association of Realtors; US Commerce Department; Standard & Poor's.

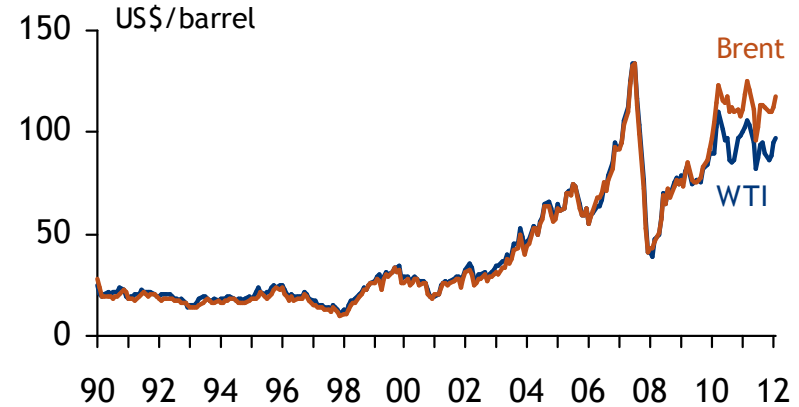
... partly on the back of the 'shale revolution'

US energy markets

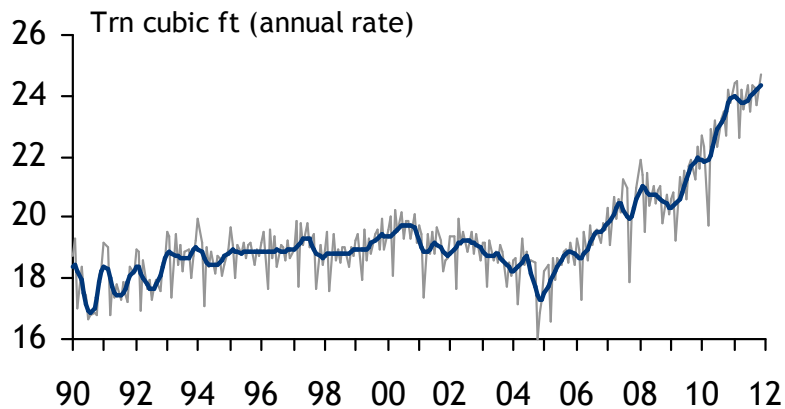
US crude oil production



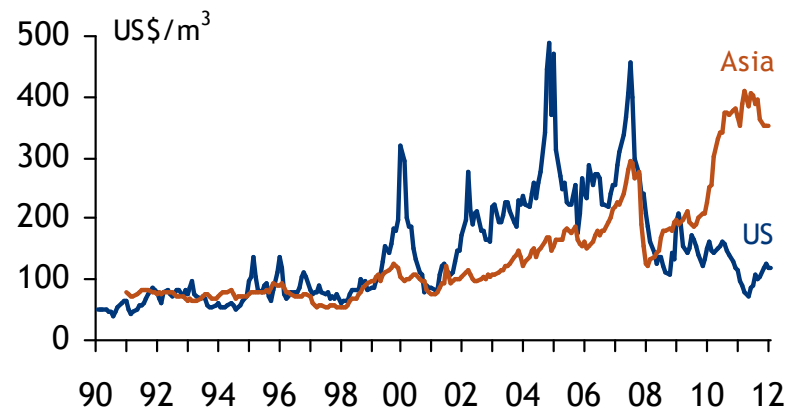
Crude oil prices



US natural gas production



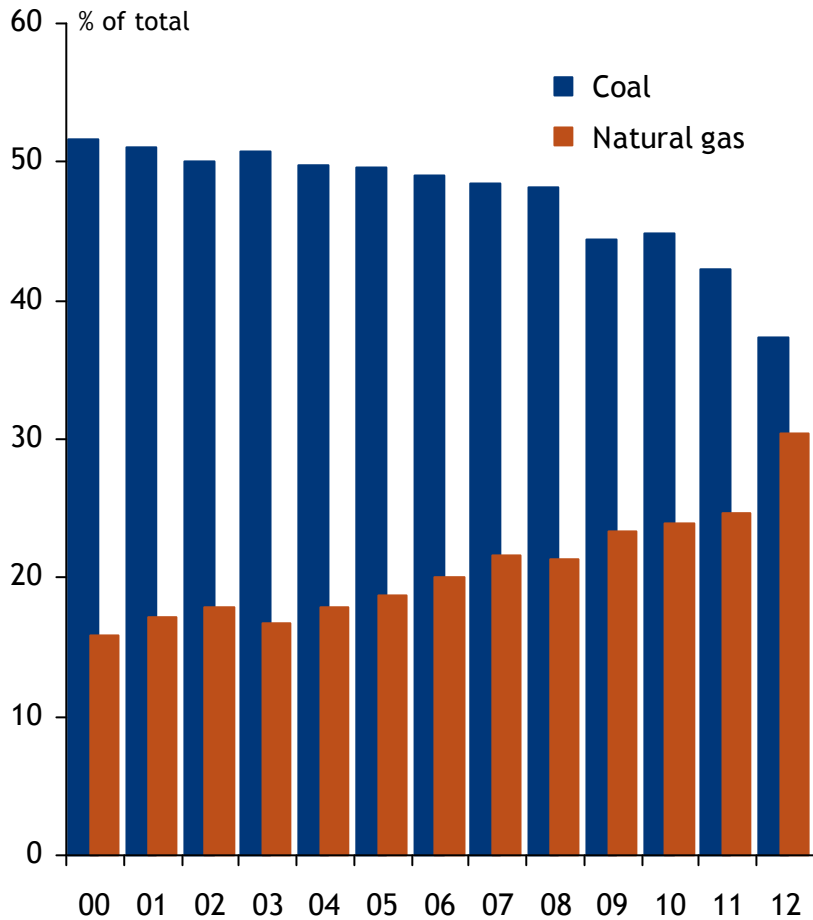
Natural gas prices



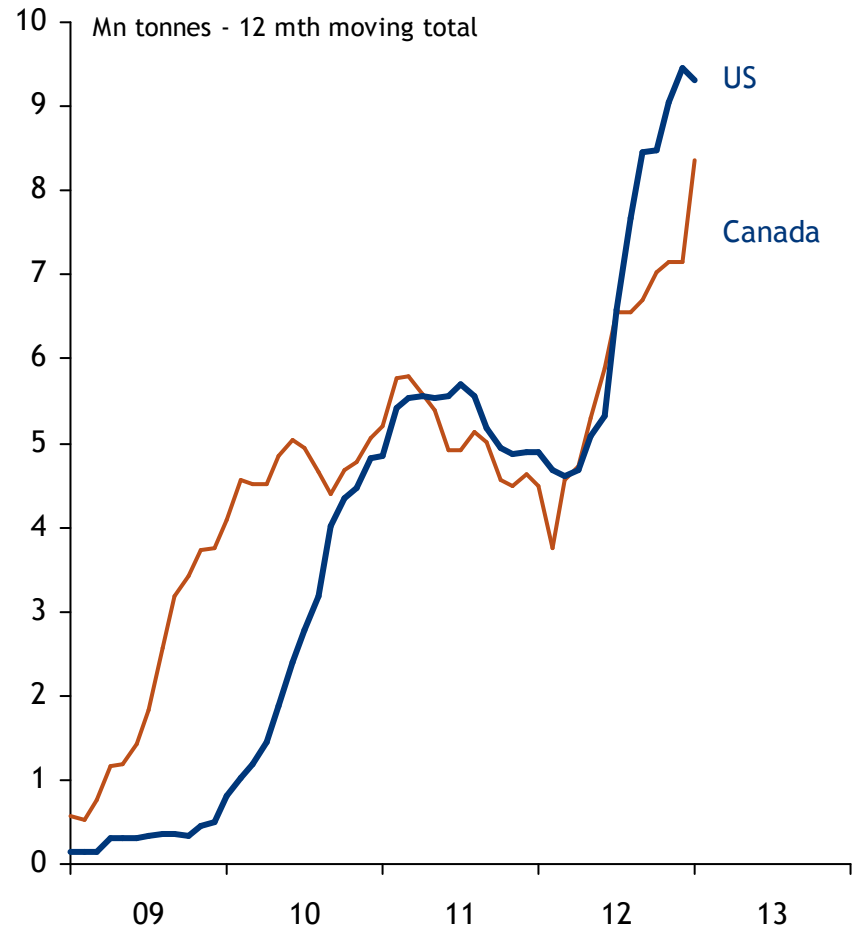
Source: US Energy Information Administration; International Monetary Fund.

Increased US electricity generation from gas is seeing coal diverted into Chinese market

Sources of US electricity generation



Chinese coal imports from North America

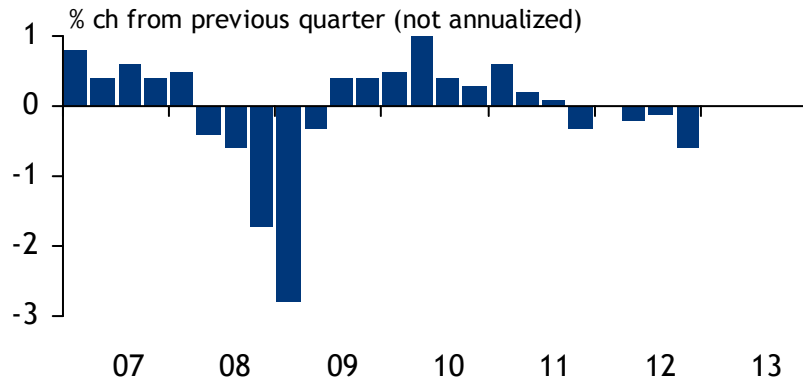


Note: 2012 electricity generation is for 12 months ended November. Sources: US Energy Information Administration; CEIC; BofA Merrill Lynch Global Research.

Europe's economy is in recession again

The Euro zone economy

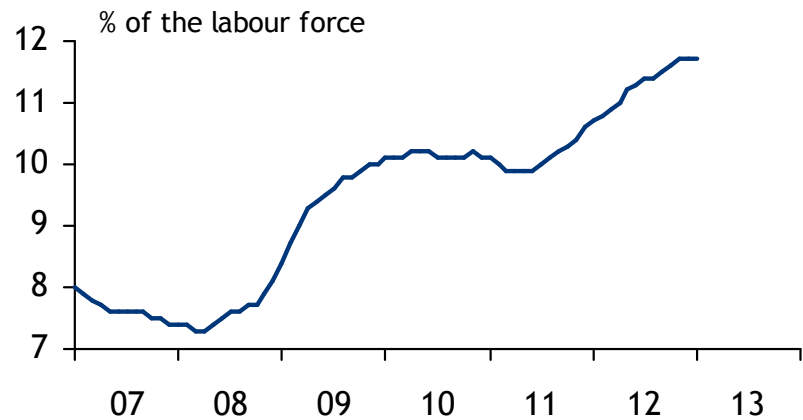
Real GDP



Pc change in real GDP, Q4 2006 - Q4 2012

Germany	+2.4
France	-0.8
Italy	-7.3
Spain	-5.9
Portugal	-8.3
Ireland	-7.7*
Greece	-16.4

Unemployment



Unemployment (%), Q4 2012

Germany	6.6
France	-9.9*
Italy	11.2
Spain	26.0
Portugal	16.9
Ireland	14.6
Greece	24.6*

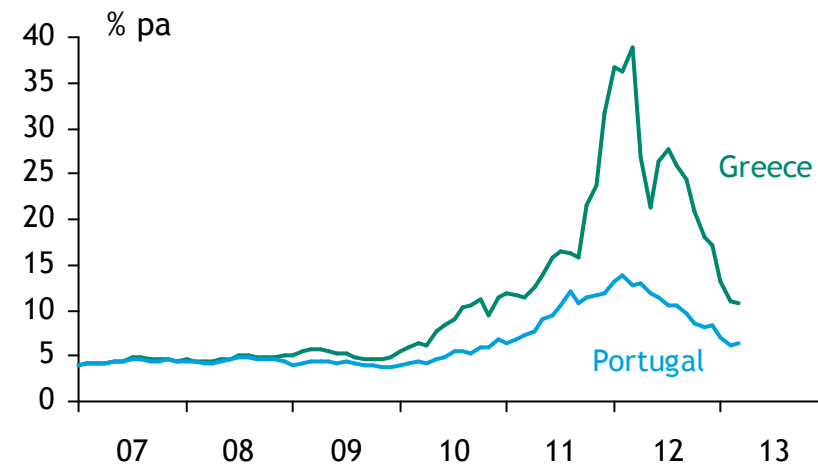
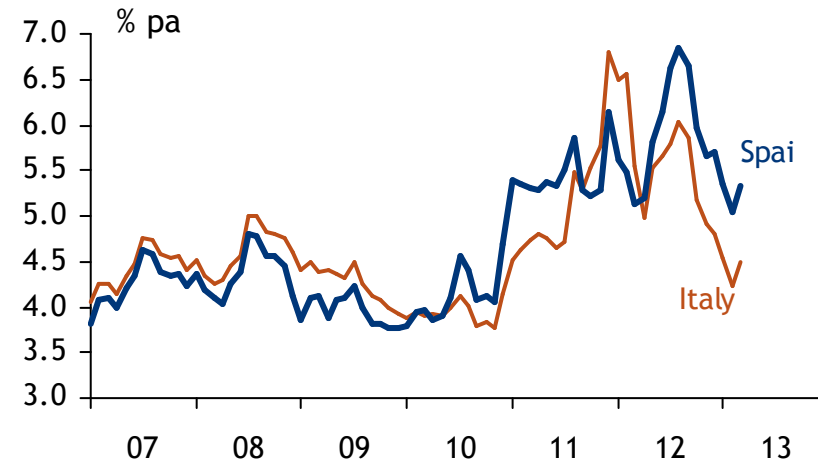
Sources: Eurostat; Hellenic Statistical Authority; BofA Merrill Lynch Global Research.

* Q3 2012

Near-term risks of another European meltdown have been reduced

- Last (northern) summer the ECB pledged to do ‘whatever it takes’ to save the euro, including
 - ‘European Stability Mechanism’ buying bonds in primary market (when issued)
 - ECB buying bonds in secondary market ‘without limit’
- So far, the ECB hasn’t actually done either of those things, but its promise to do them combined with austerity measures and reforms implemented in worst-affected countries has calmed financial market fears
- Risks still exist around this weekend’s Italian elections, the financial scandals affecting Spain’s governing Popular Party, and the likely eventual need for further restructuring of Greek debt
- Europe is still a long way from fixing the fundamental flaws in the euro area’s design

10-year government bond yields

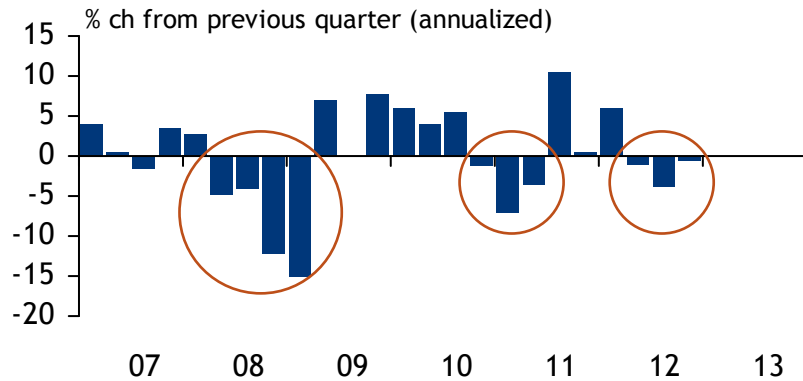


Source: Datastream.

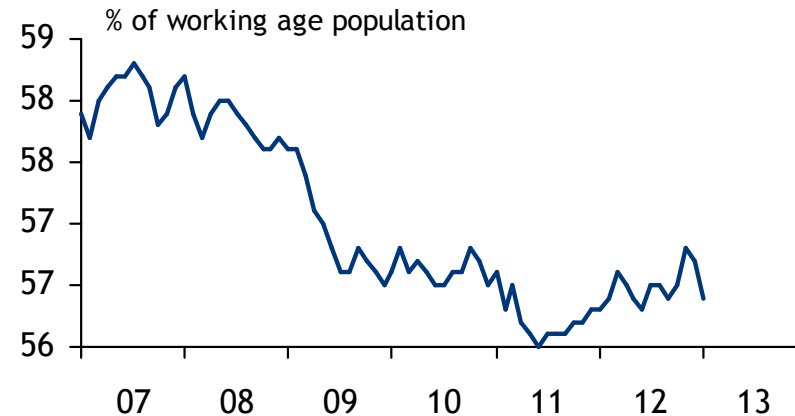
Japan's economy is in its third recession in five years

Japanese economy

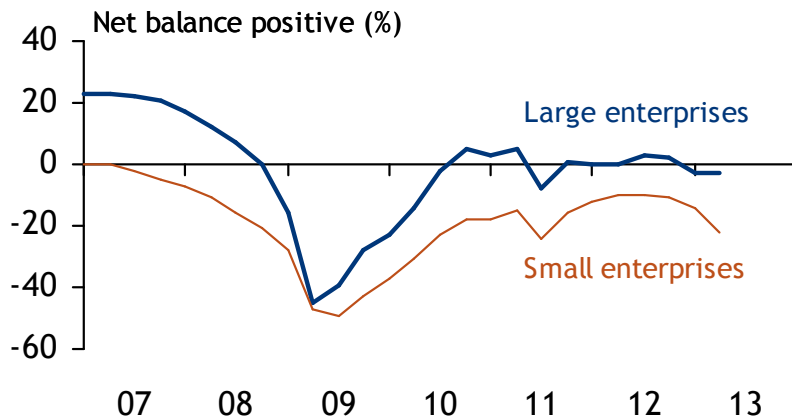
Real GDP



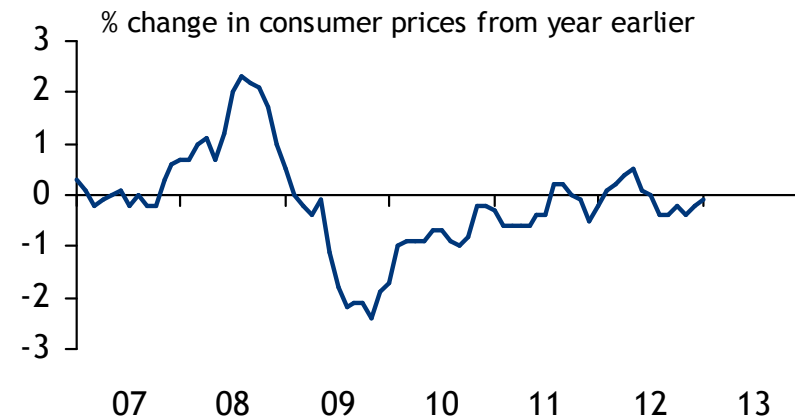
Employment - population ratio



Business conditions



Inflation

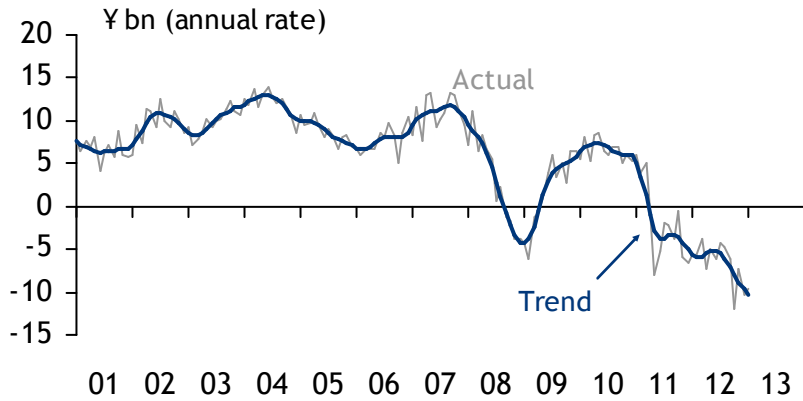


Sources: Japan Economic & Social Research Institute; Bank of Japan *Tankan* survey; Labour Ministry; Home Ministry.

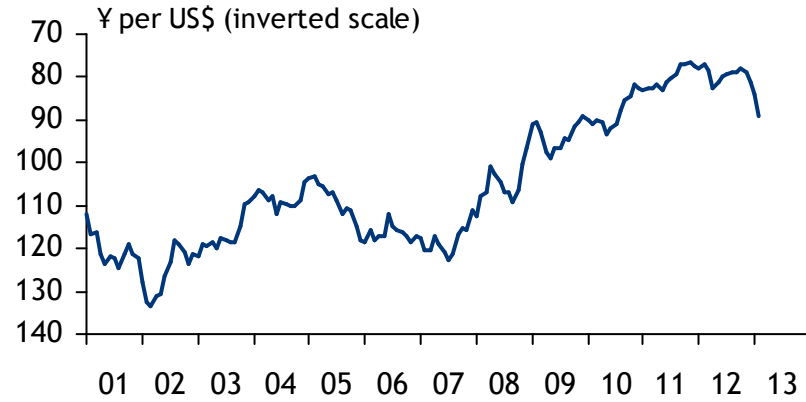
Yen could weaken a lot more, and bond yields rise, when Japan goes into deficit

Japanese external accounts, yen and long-term bond yield

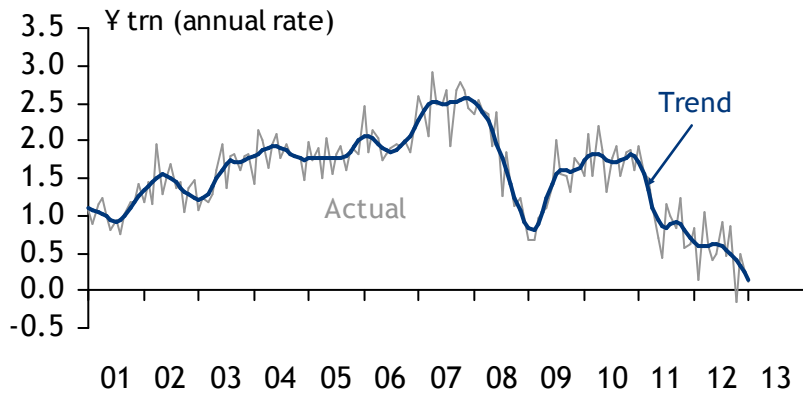
Merchandise trade balance



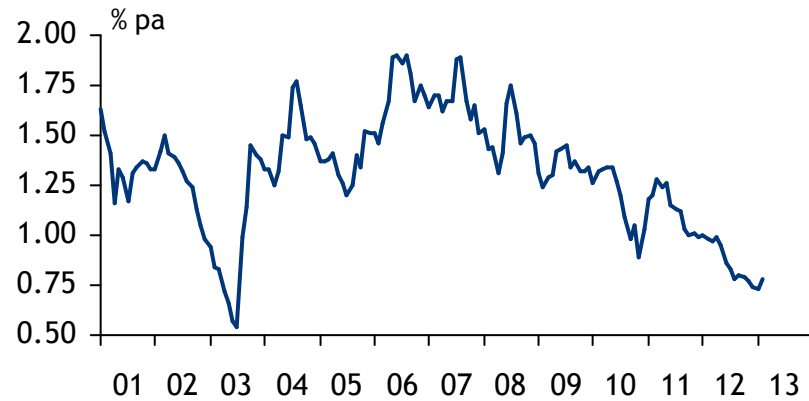
Yen vs US\$



Current account balance



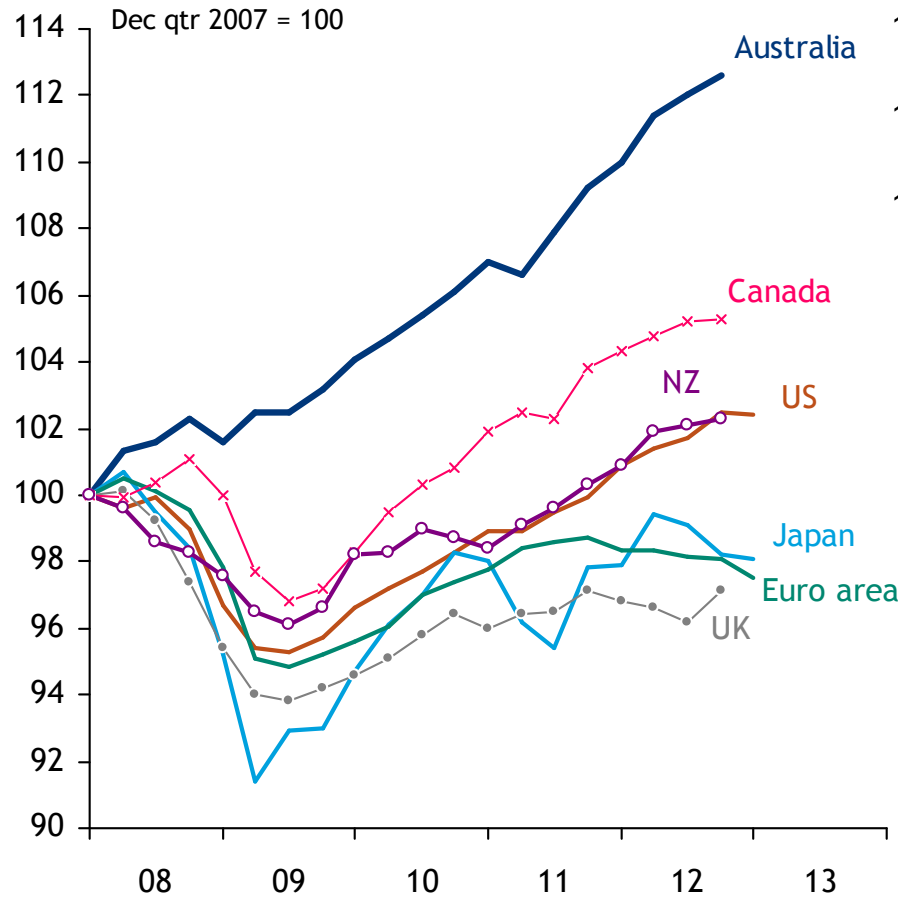
10-year Japanese government bond yield



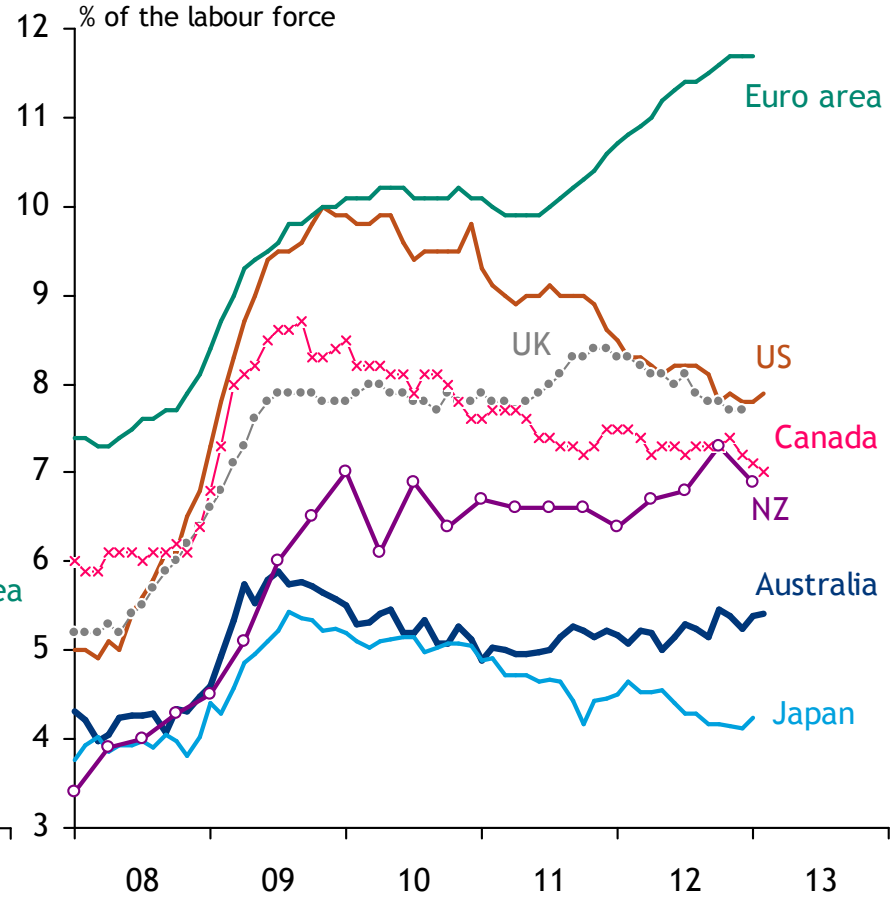
Sources: Japan Ministry of Economy, Trade & Industry; Bank of Japan; Datastream.

Australia's economy has performed much better than its peer group since the GFC

Real gross domestic product



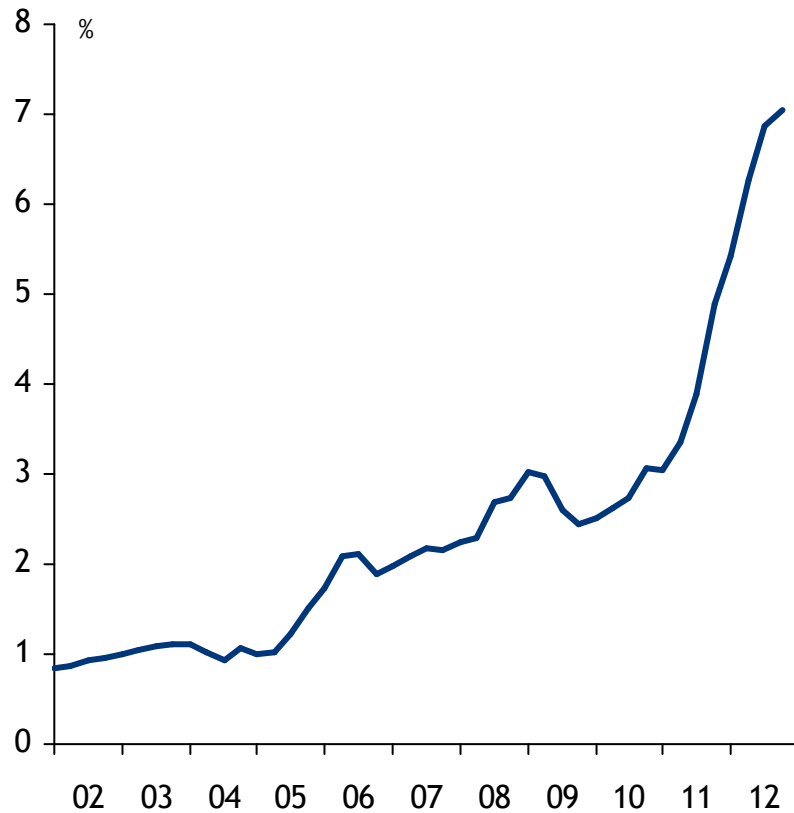
Unemployment rate



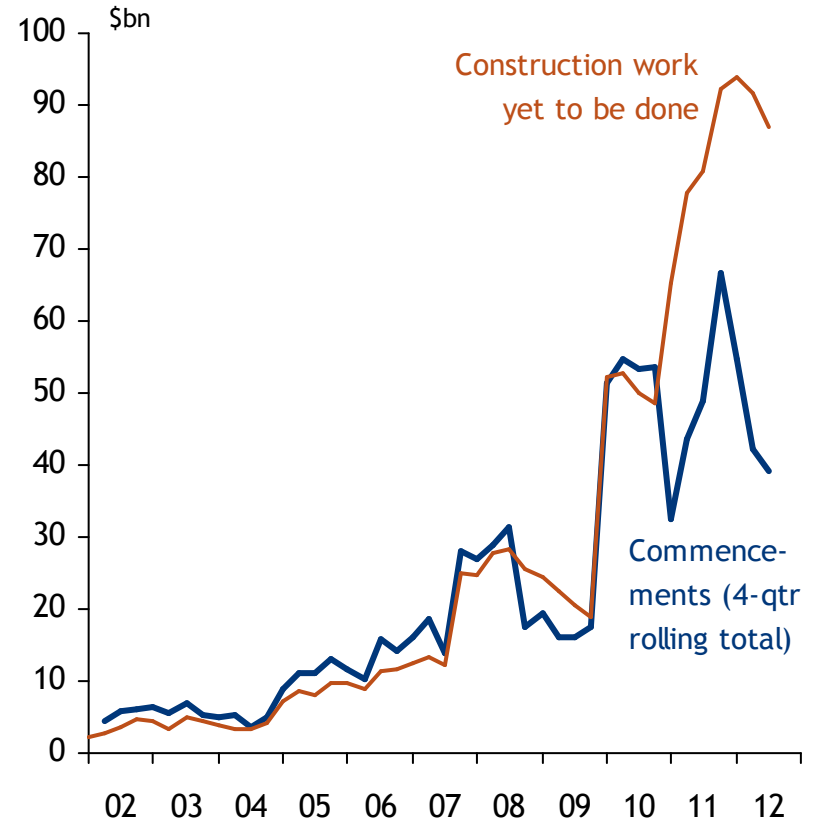
Sources: Australian Bureau of Statistics; US Bureau of Economic Analysis; Japan Economic & Social Research Institute; Eurostat; UK Office of National Statistics; Statistics Canada; US Bureau of Labor Statistics; Japan Home Ministry; Statistics New Zealand.

Mining investment looks likely to peak this year (if it hasn't already)

**Mining investment
as a pc of GDP**



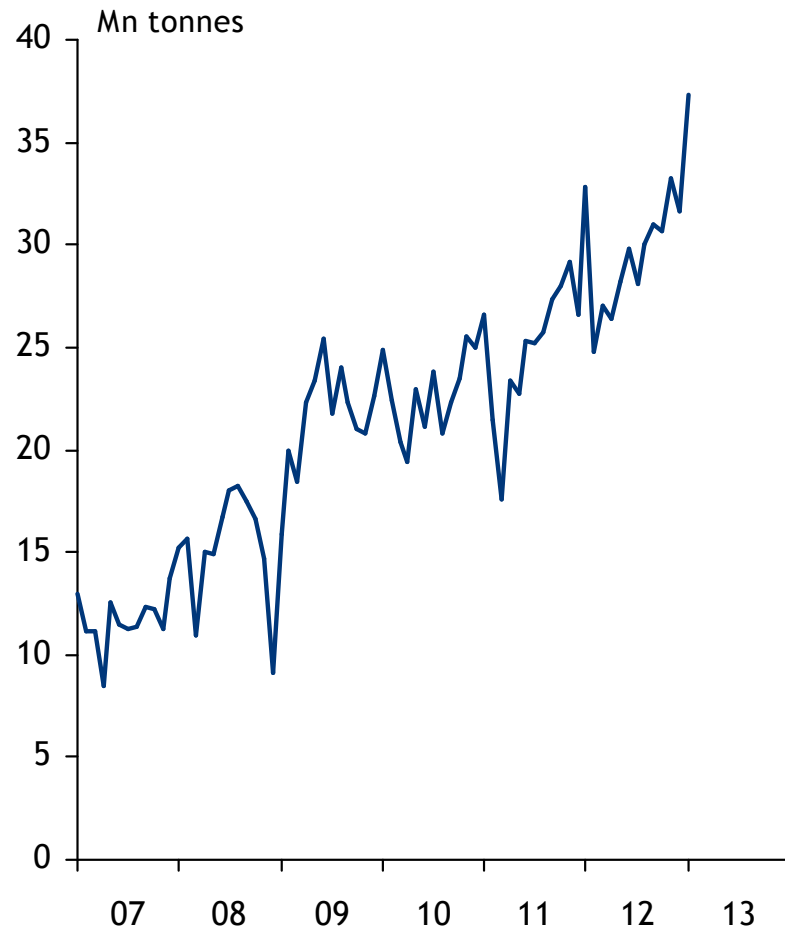
**Engineering construction work -
oil & gas fields and mines**



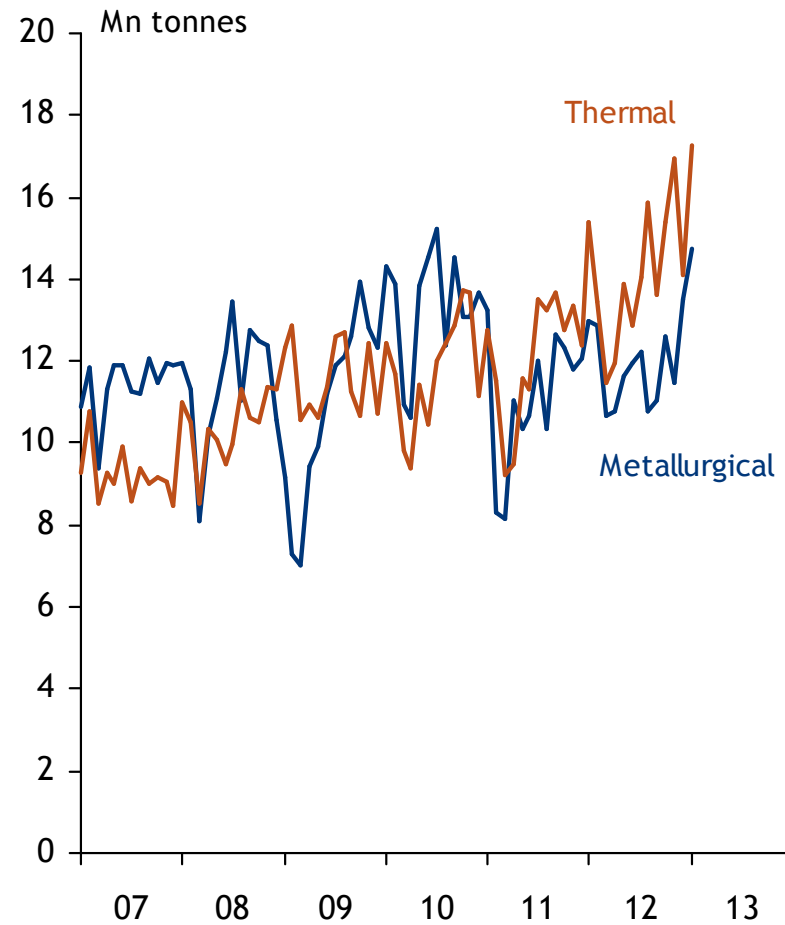
Sources: ABS; BofA Merrill Lynch Global Research.

Some of the subsequent decline in mining investment will be offset by higher exports

Iron ore export volumes



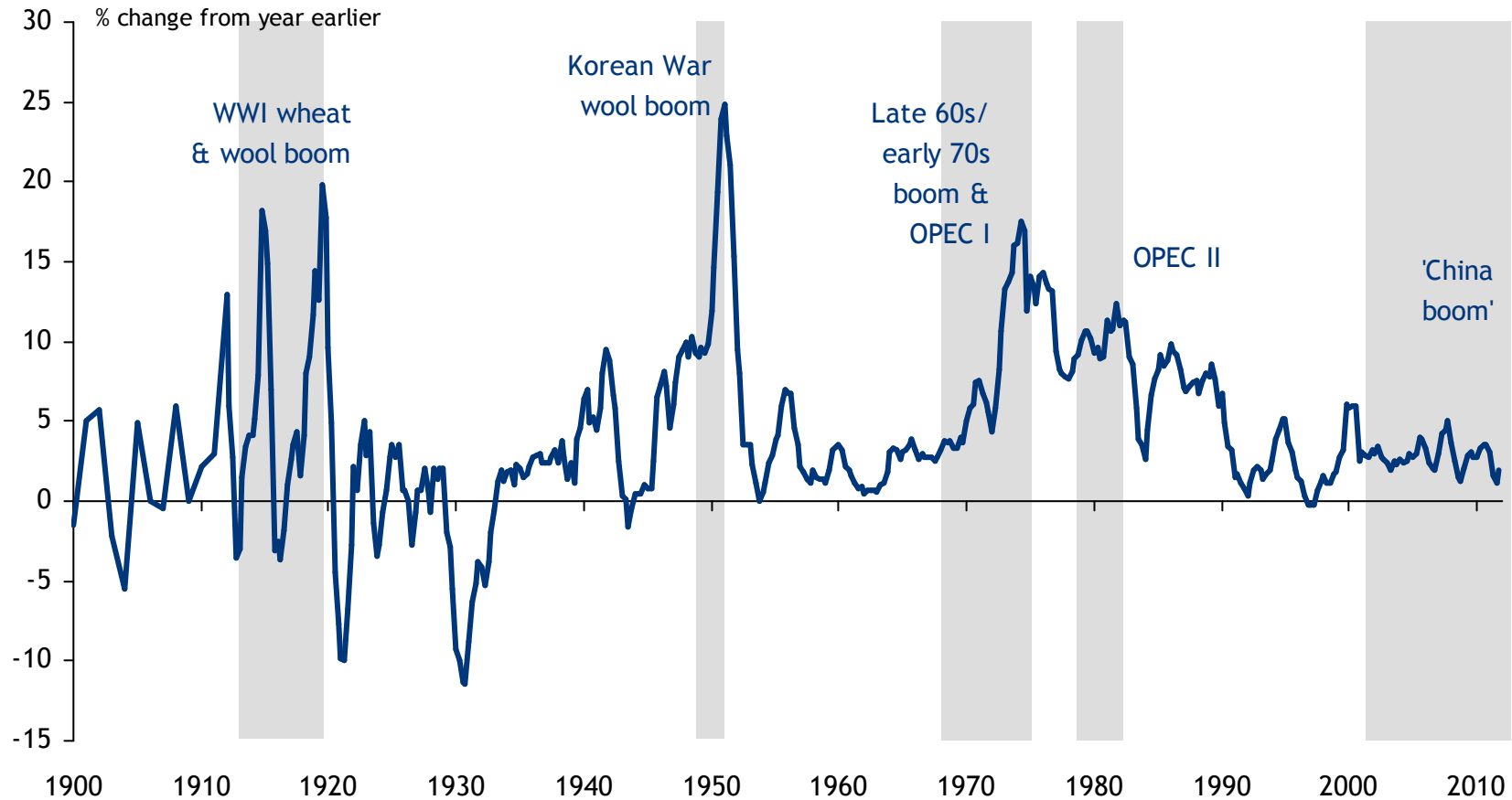
Coal export volumes



Source: Bloomberg.

For the first time, a commodities boom hasn't led to double-digit inflation

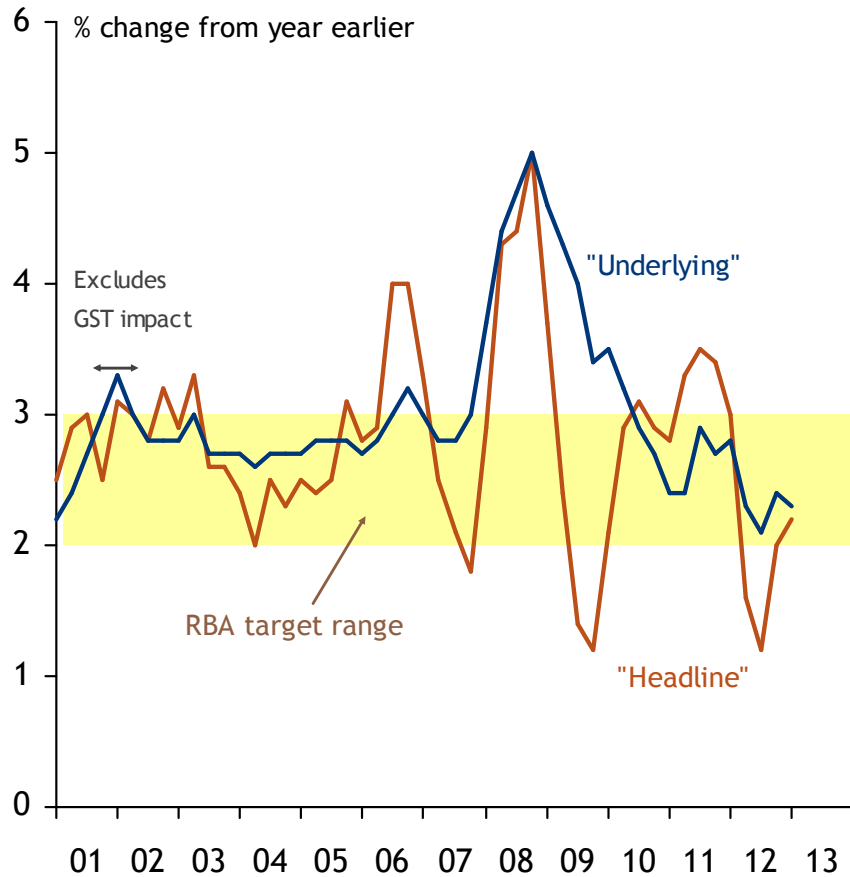
Consumer prices 1900-2012



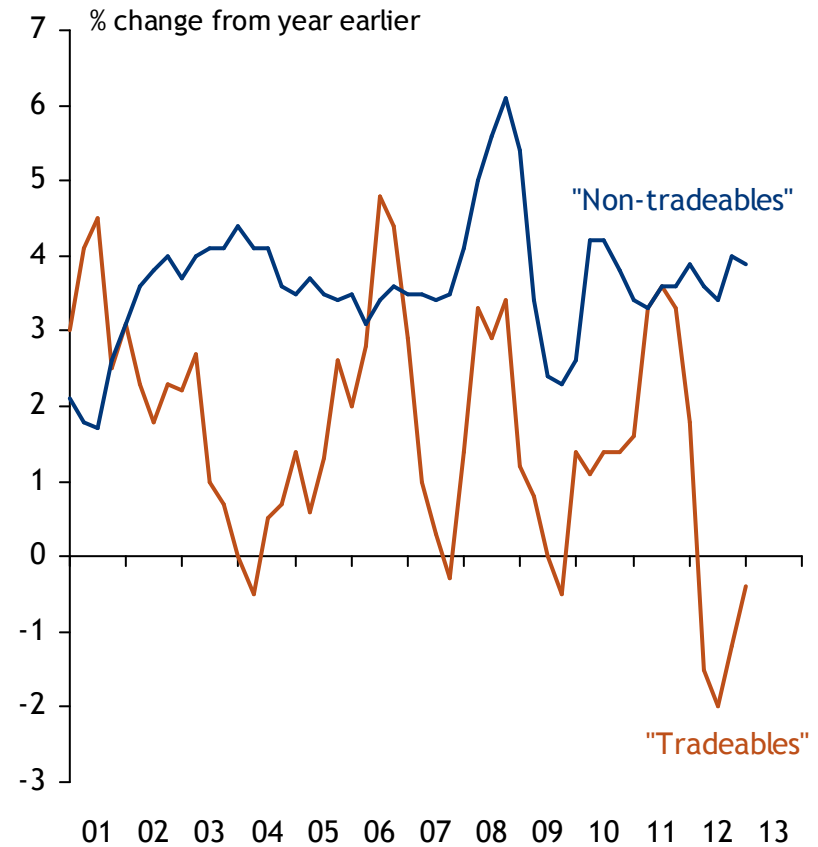
Note: Shaded areas denote 'commodities booms'. Sources: ABS; Global Financial Data; BofA Merrill Lynch Global Research

The strong A\$ has played a major role in containing inflationary pressures

Inflation



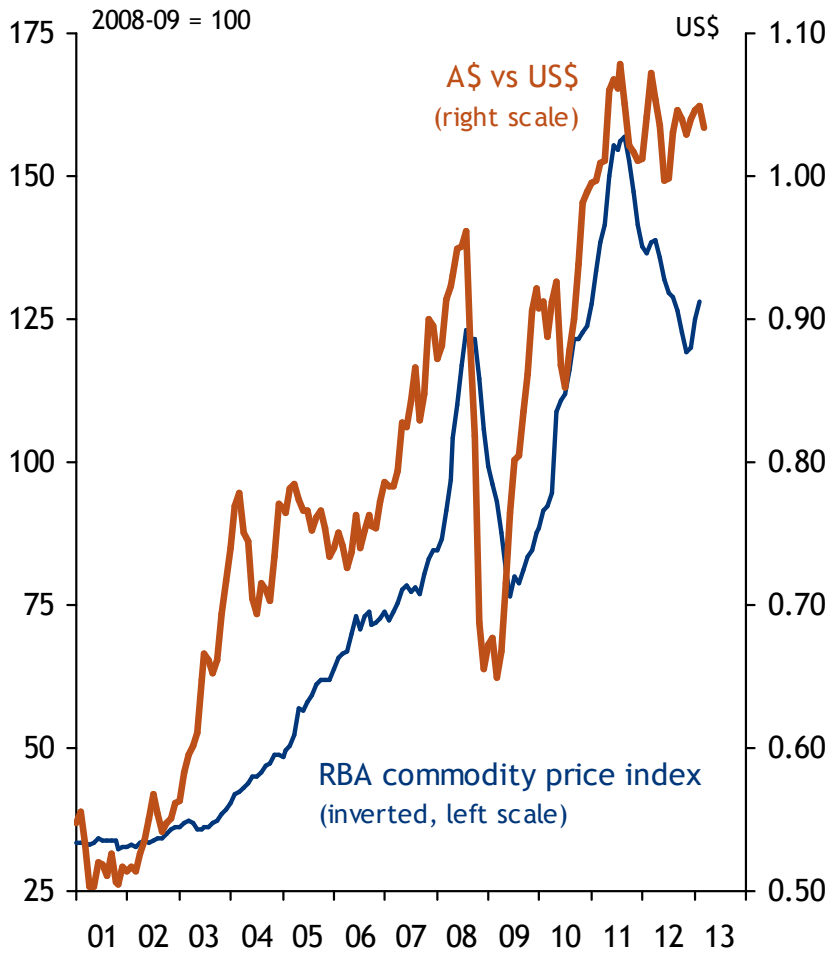
'Tradeables' vs 'non-tradeables' prices



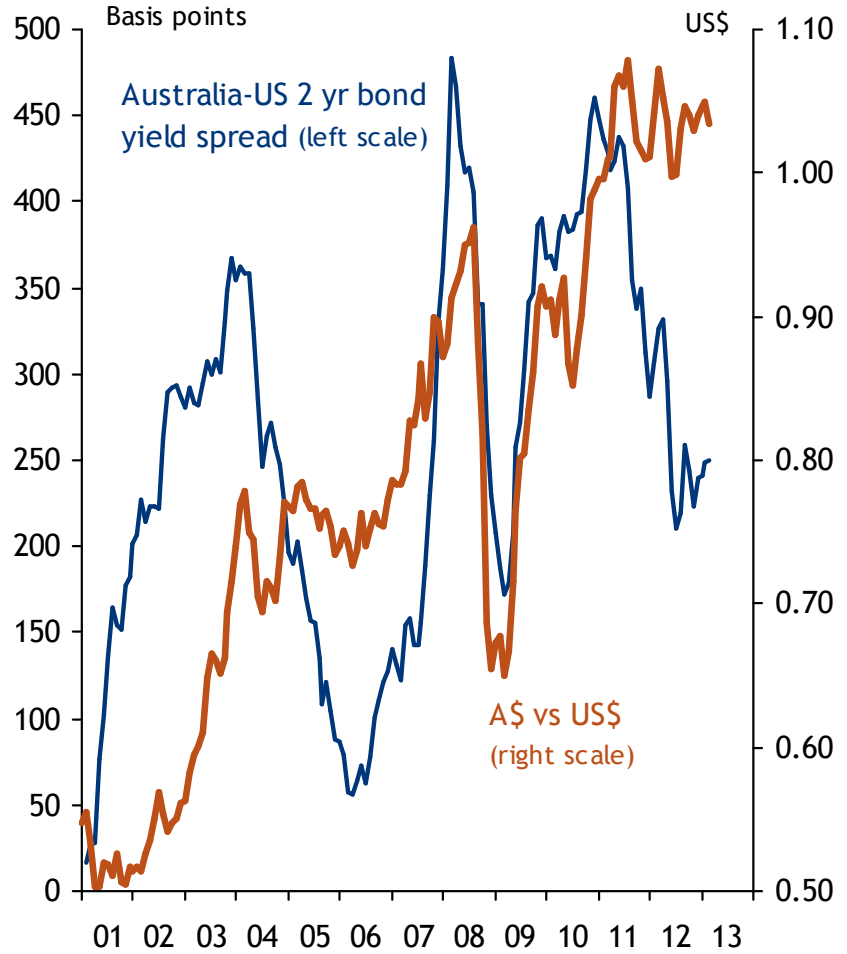
Note: 'underlying' inflation refers to the average of the RBA's 'trimmed mean' and 'weighted median' measures. Forecast for 'underlying' inflation excludes the expected impact of the carbon tax commencing on 1 July 2012. *Sources:* RBA; ABS; BofA Merrill Lynch Global Research.

But the A\$'s continuing strength is becoming increasingly problematic

Commodity prices and the A\$



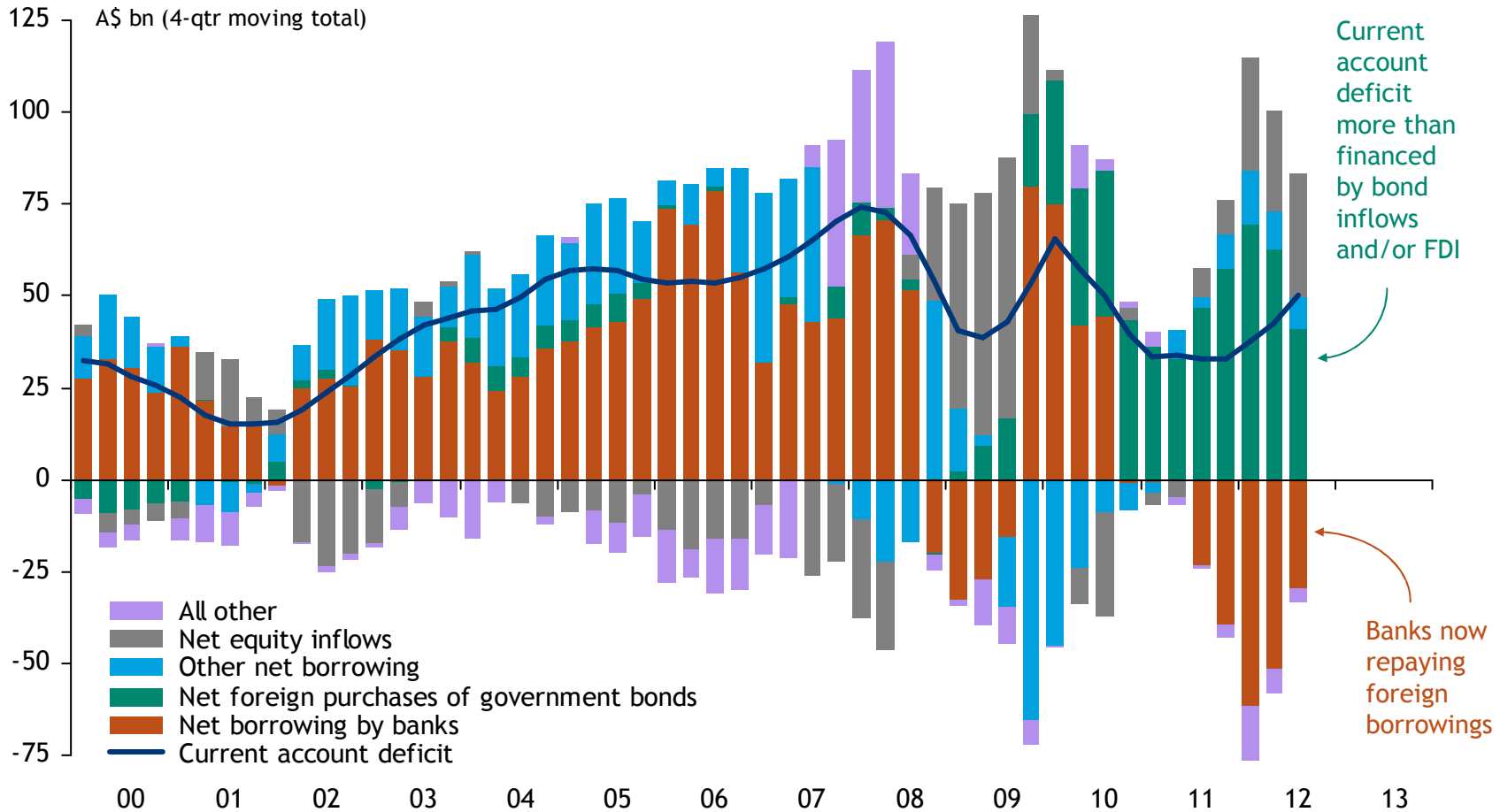
Interest rate differentials and the A\$



Note: RBA commodity price index is in US\$. Sources: Datastream; Bloomberg; RBA.

Foreign bond purchases and FDI now easily financing Australia's current account deficit

Financing Australia's current account deficit (CAD)

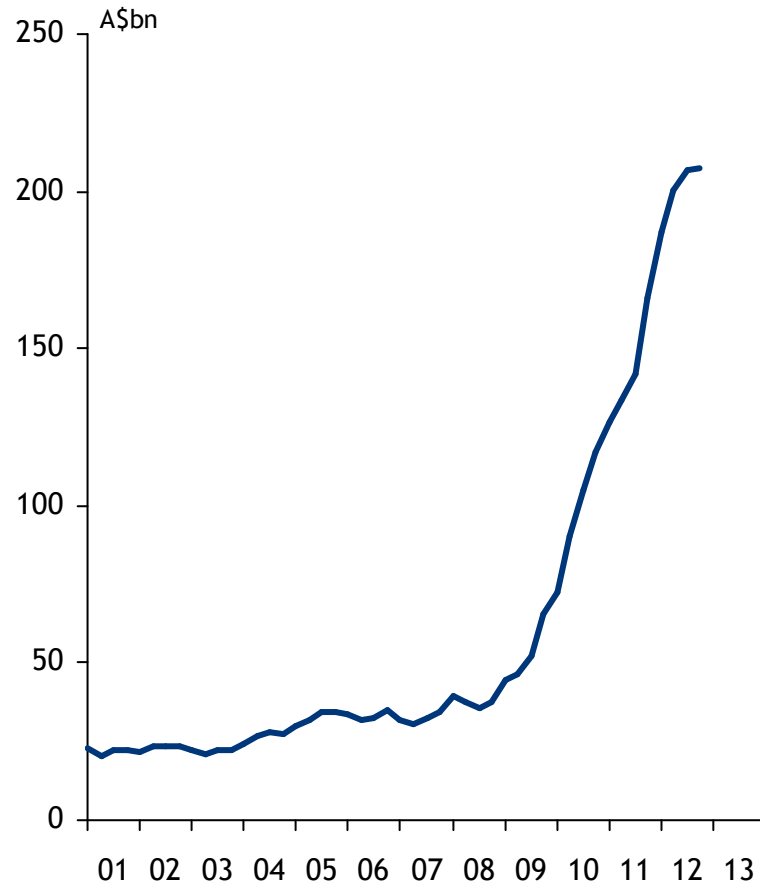


Note: FDI = foreign direct investment. Sources: ABS (balance of payments data); BofA Merrill Lynch Global Research



The A\$ is being boosted by foreign central banks' efforts to diversify their FX reserves

Foreign holdings of Australian Government bonds and notes



Source: Australian Office of Financial Management.

- One of the common explanations for the persistent strength of the A\$ in the face of falling commodity prices and lower Australian interest rates has been the buying of Australian bonds by foreign central banks
 - foreign central banks (in Europe, Asia and Latin America) have been diversifying out of traditional 'reserve currencies' for fear that zero interest rates and 'quantitative easing' policies made these currencies less 'safe'
 - and Australia - as one of only 8 countries left with a stable AAA rating from all three major agencies, and of those the highest interest rates - has been a particularly attractive alternative
- However, foreign central bank buying of A\$ bonds appears to have peaked around March last year, and they haven't been net buyers since
 - European central banks, at least, are more likely to be net sellers of A\$ (at the margin) from now
- The more recent strength of the A\$ seems due to inward capital flows associated with financing large LNG and CSG projects - which could persist for some time yet

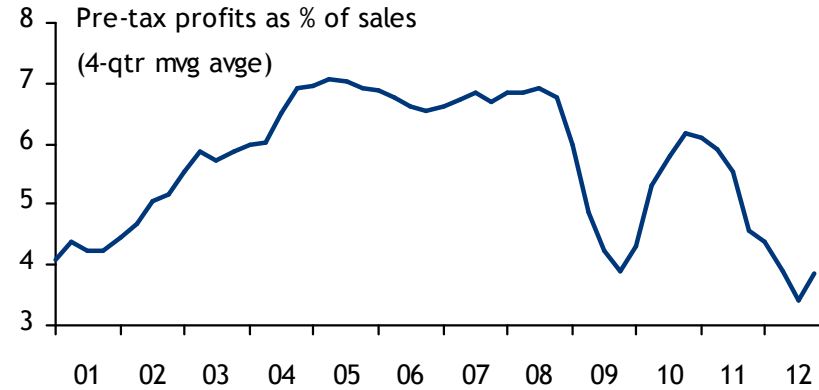
The strong A\$ is causing significant problems for manufacturers ...

Australian manufacturing: competitiveness, profitability and employment

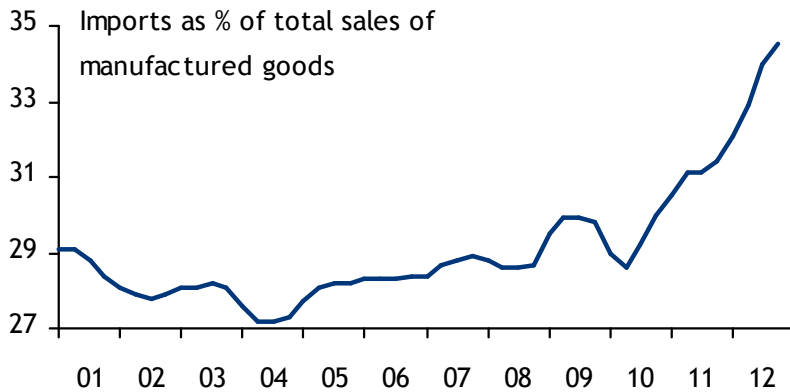
Exports share of manufacturers' sales



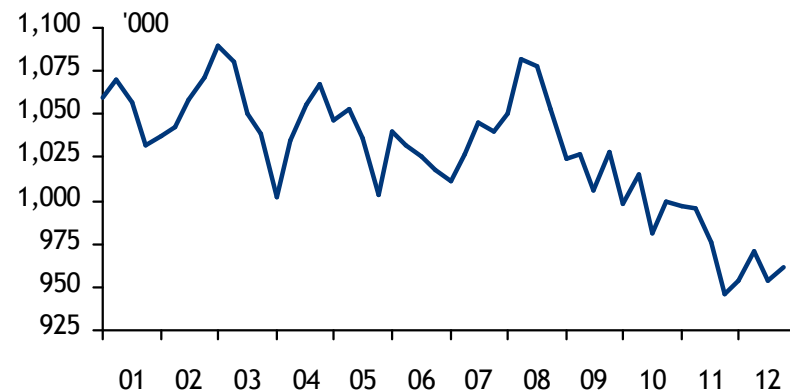
Manufacturers' profit margins



Import share of domestic market



Manufacturing employment

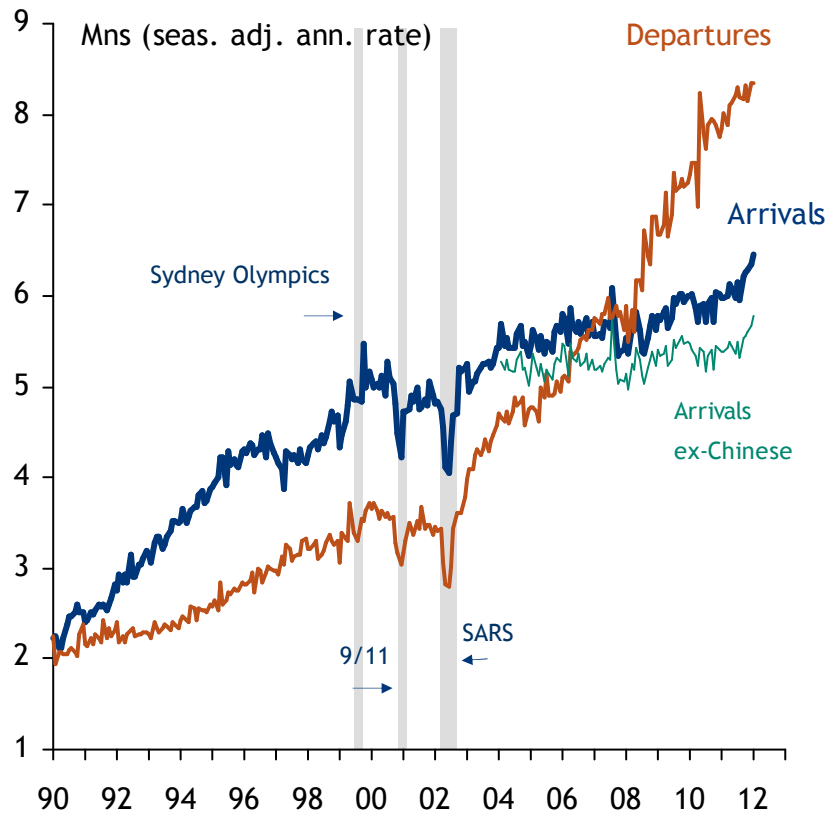


Sources: ABS; BofA Merrill Lynch Global Research.

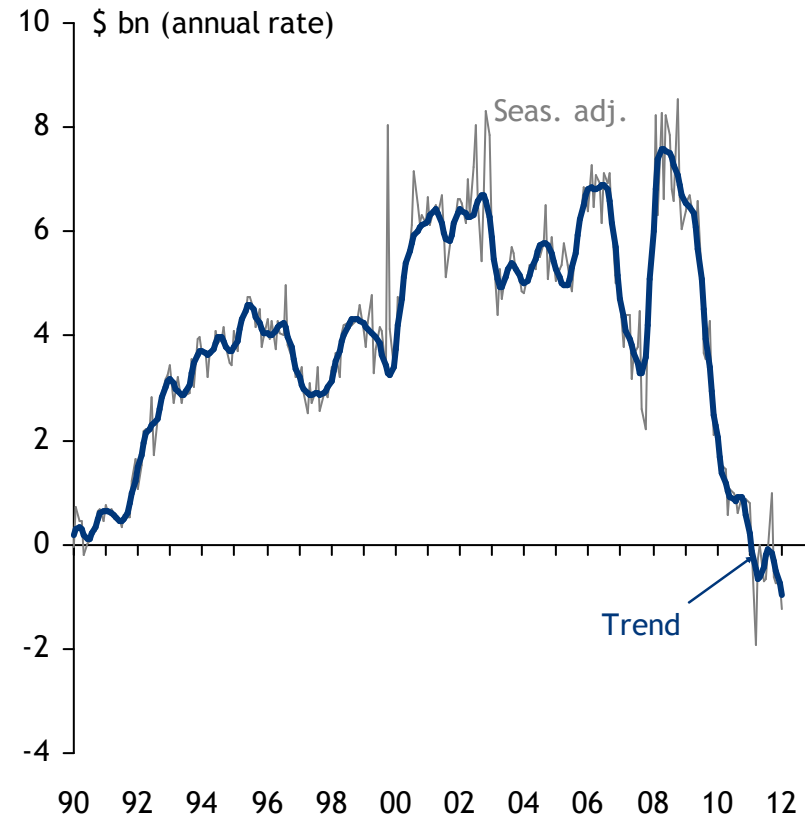
Persistent A\$ strength has also been a negative for Australia's tourist industry

Australia's tourism trade

Short-term arrivals & departures



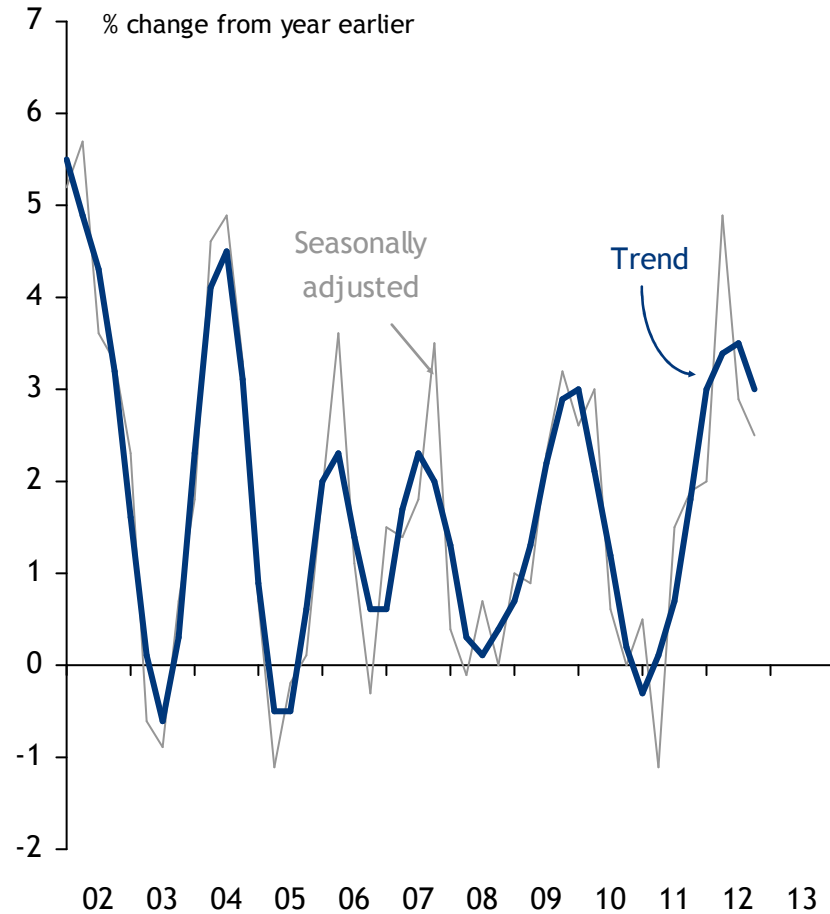
Balance on tourism services trade



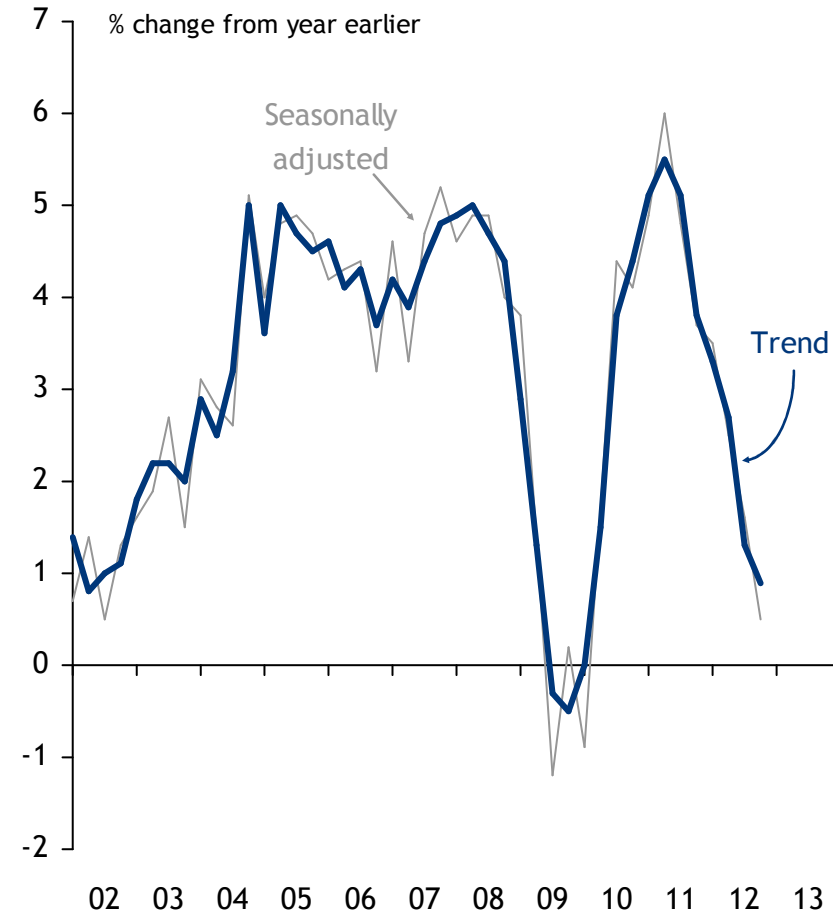
Sources: ABS; BofA Merrill Lynch Global Research.

Firms are increasingly recognizing the need to lift productivity and cut costs

Labour productivity



Unit labour costs

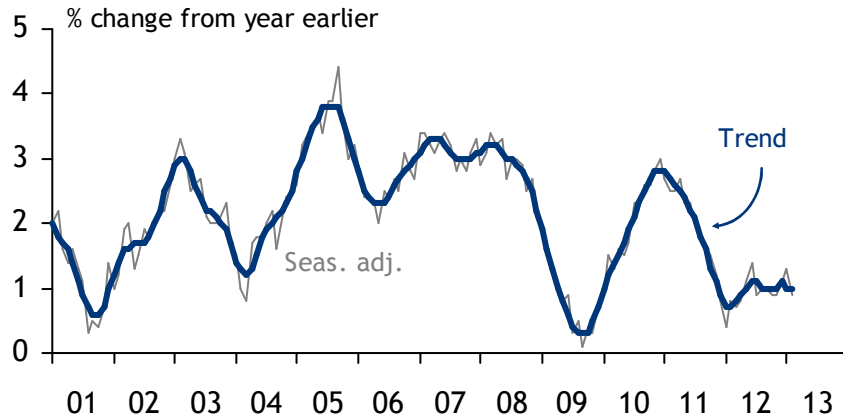


Sources: ABS; BofA Merrill Lynch Global Research.

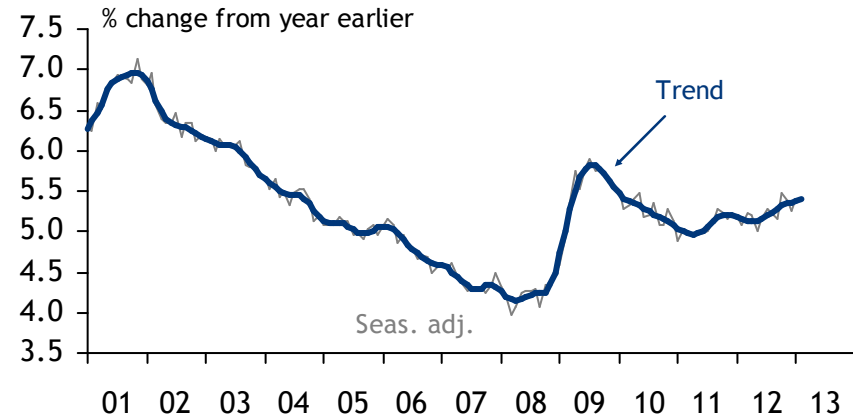
Inevitably, this means job losses and higher unemployment

Labour market indicators

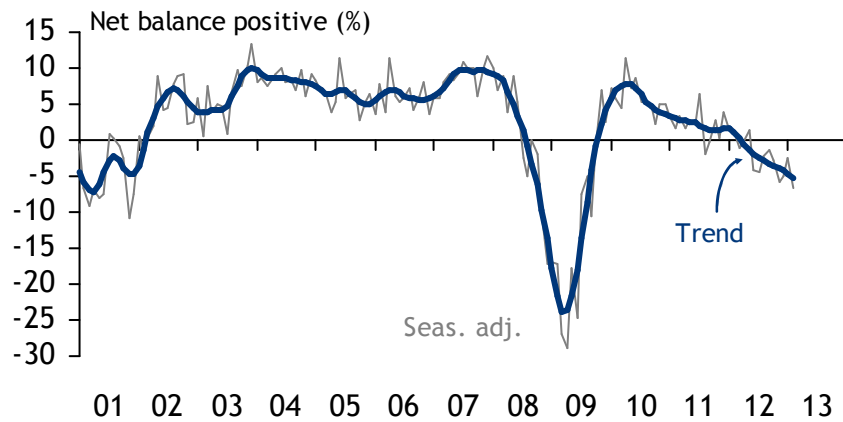
Employment growth



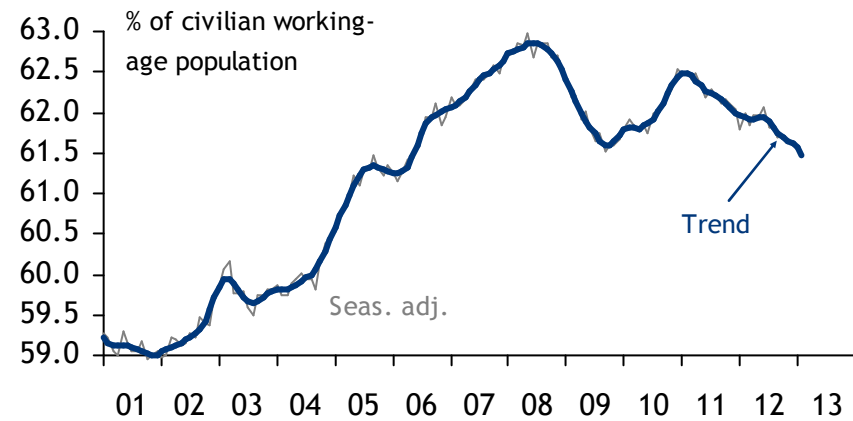
Unemployment rate



Business' employment intentions



Employment-population ratio

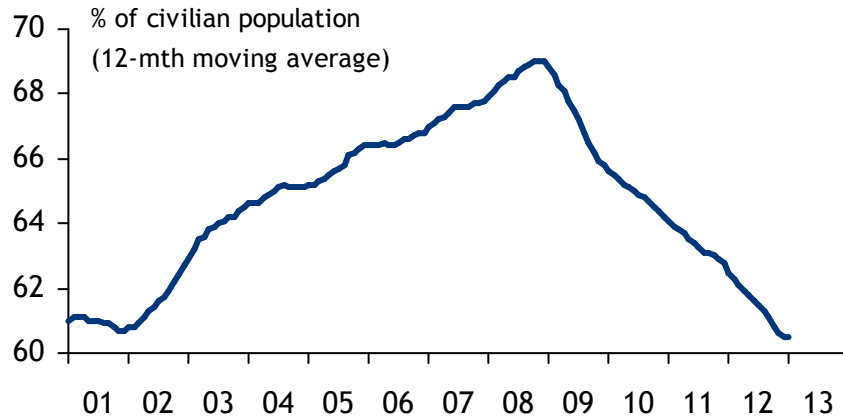


Sources: ABS; National Australia Bank; BofA Merrill Lynch Global Research.

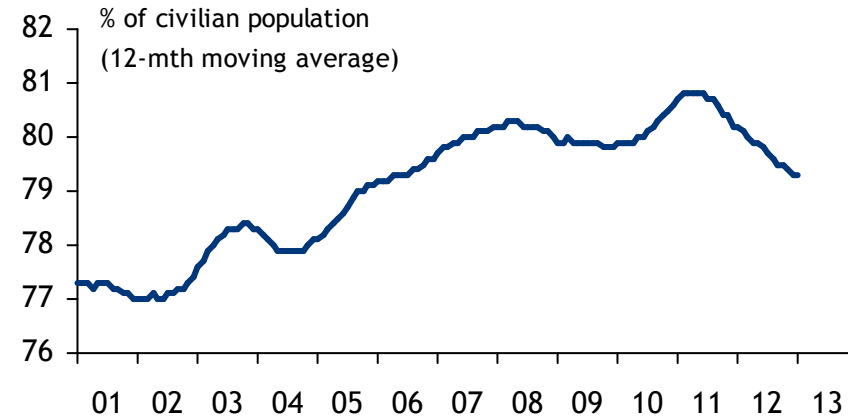
The labour market is turning particularly sour for younger people

Employment-population ratios by age group

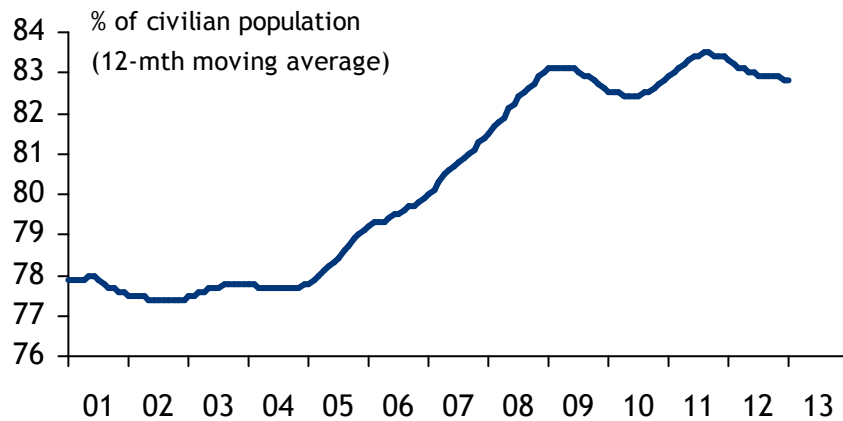
15-24 year olds



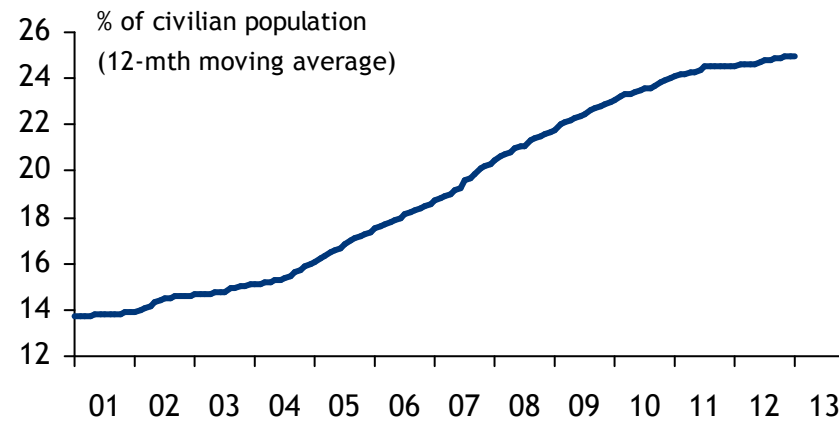
45-60 year olds



25-44 year olds



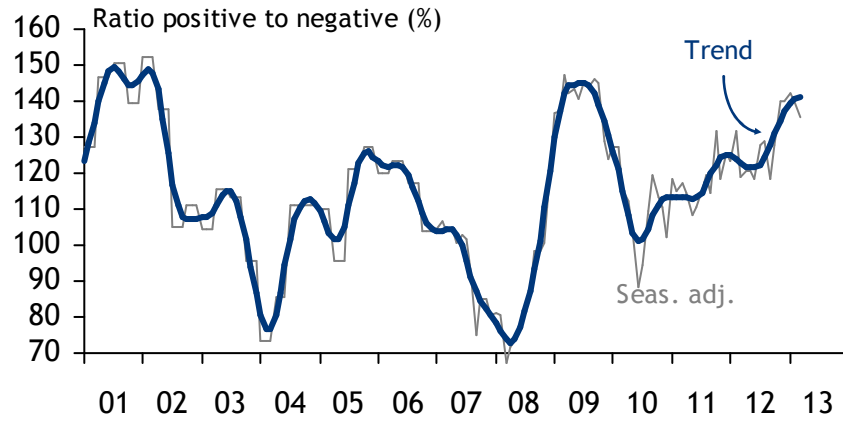
60 and over year olds



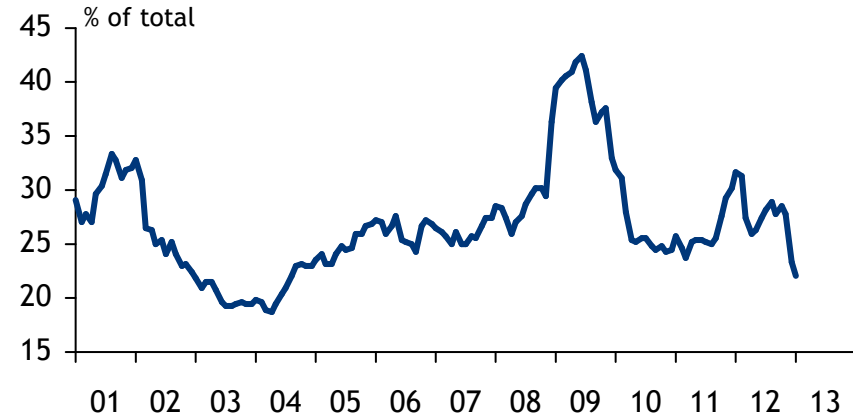
Sources: ABS; BofA Merrill Lynch Global Research.

People think it's a 'good time' to buy houses - but they're not buying them

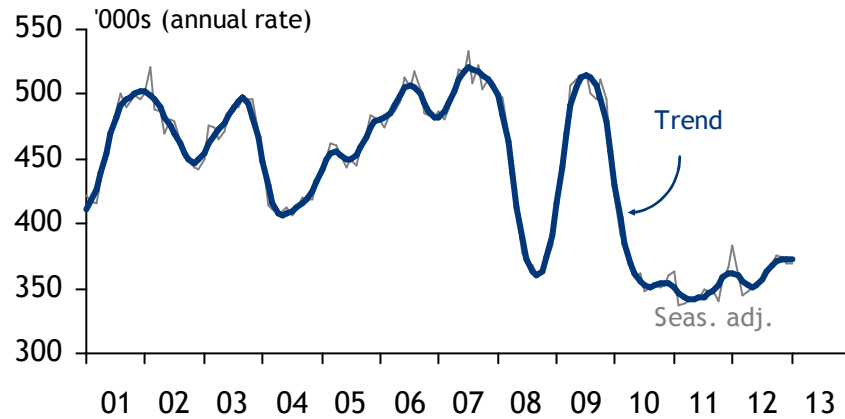
Households saying 'it's a good time to buy a house'



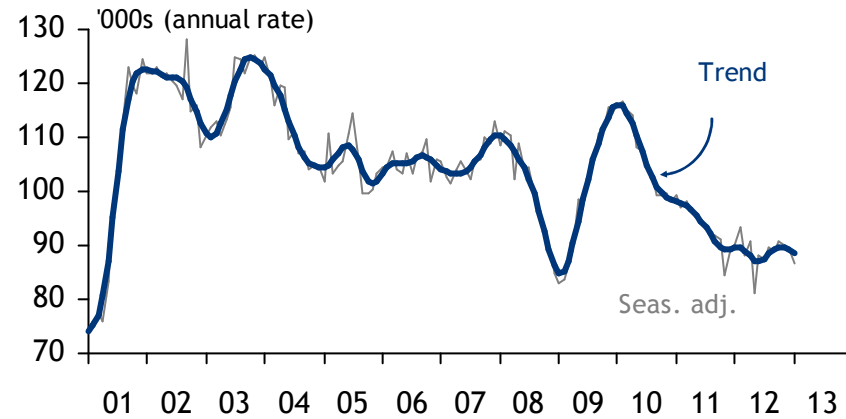
First-time buyers as a pc of total housing finance commitments



Housing finance commitments to owner-occupiers



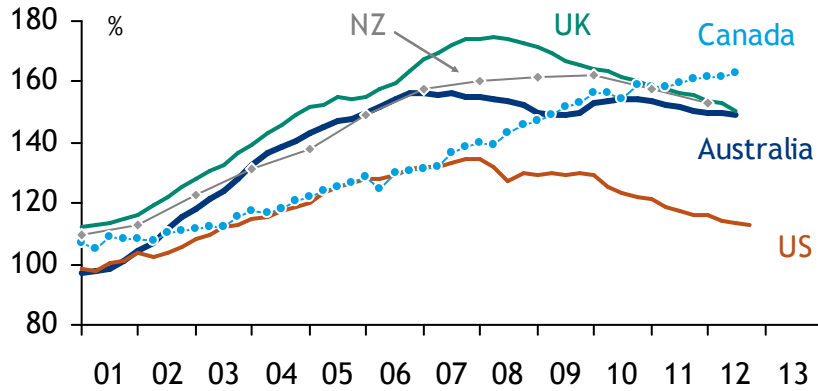
Residential building approvals - detached dwellings



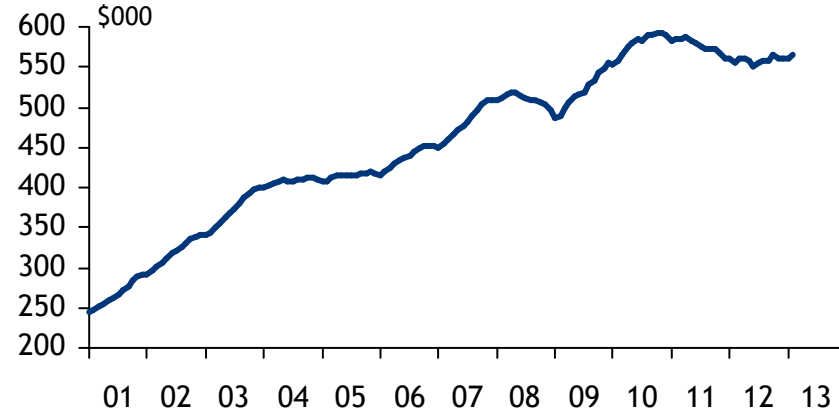
Sources: Westpac-Melbourne Institute consumer confidence survey; ABS; BofA Merrill Lynch Global Research.

People want to pay down debt; and they're not convinced house prices have bottomed

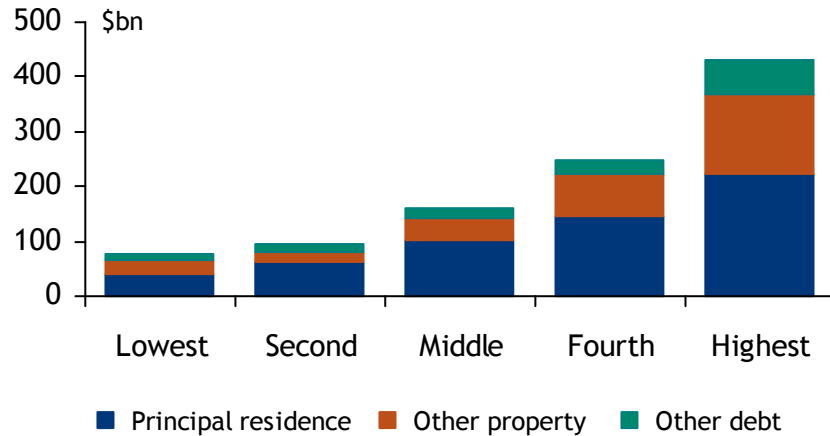
Household debt-to-income ratios



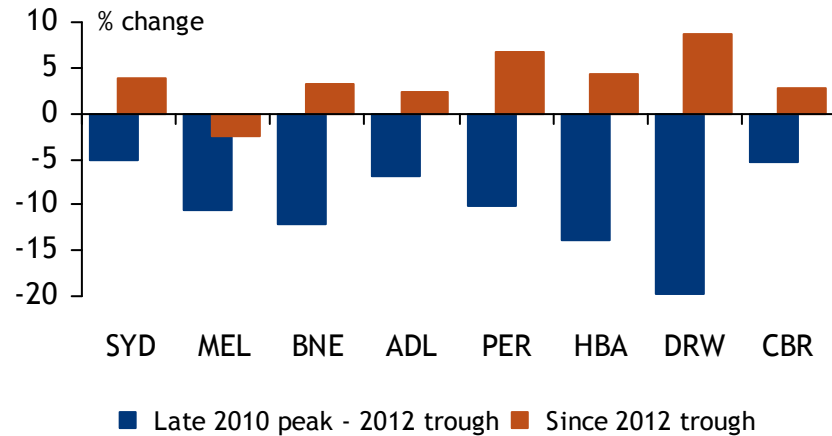
Capital city dwelling prices



Household debt by income quintile, 2009-10



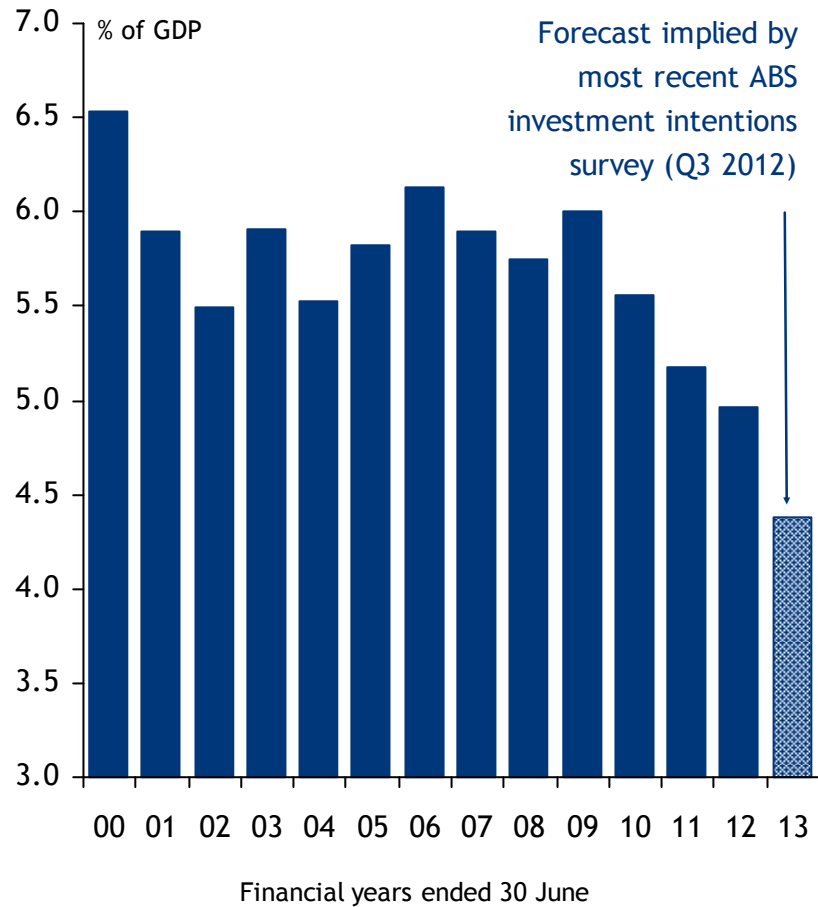
Dwelling prices by city



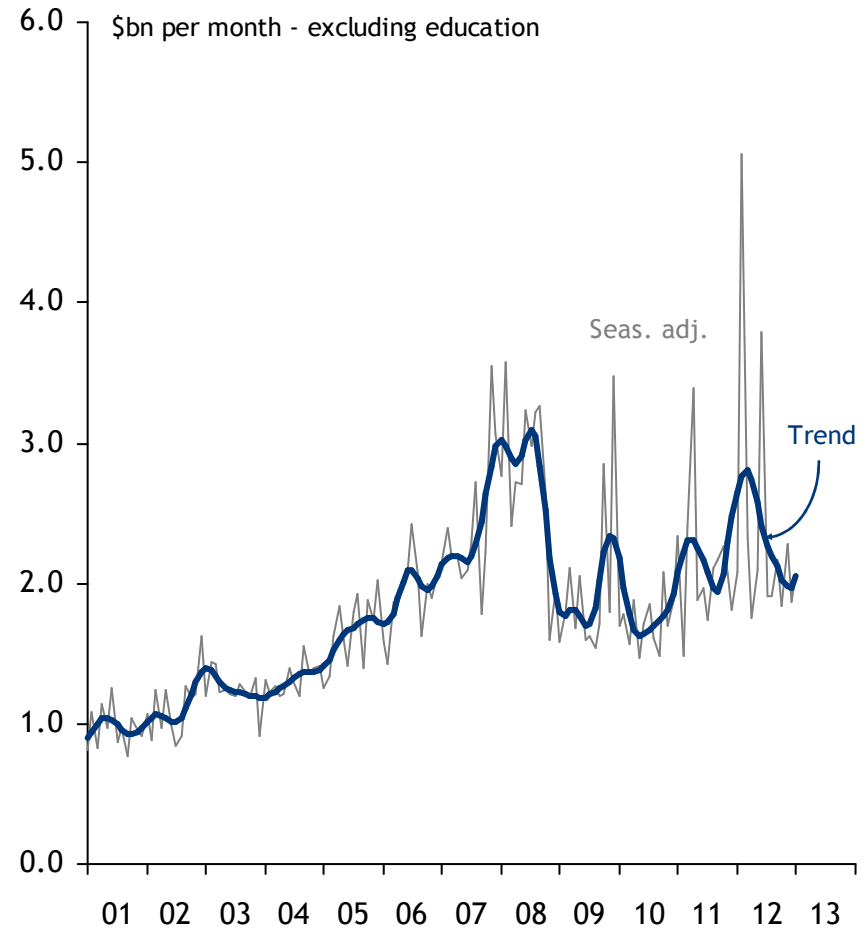
Sources: RBA; US Federal Reserve & BEA; UK Office of National Statistics; Statistics New Zealand; ABS; RP Data Rismark; BofA Merrill Lynch Global Research.

There's no evidence to suggest that non-mining business investment is picking up

Non-mining business fixed capital expenditure



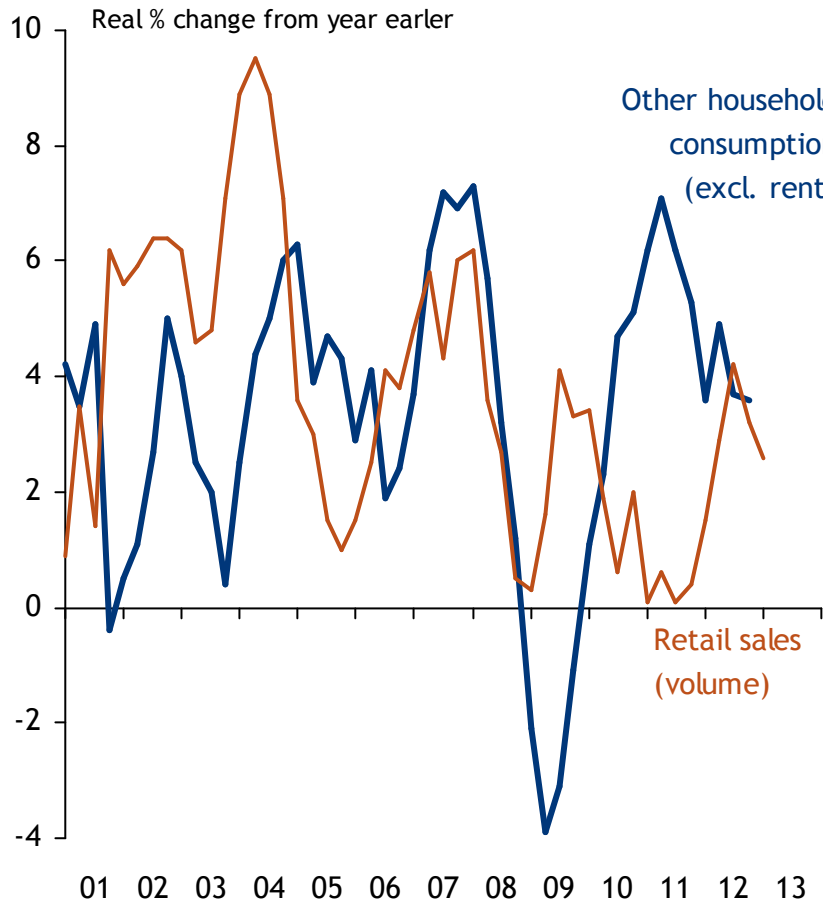
Non-residential building approvals



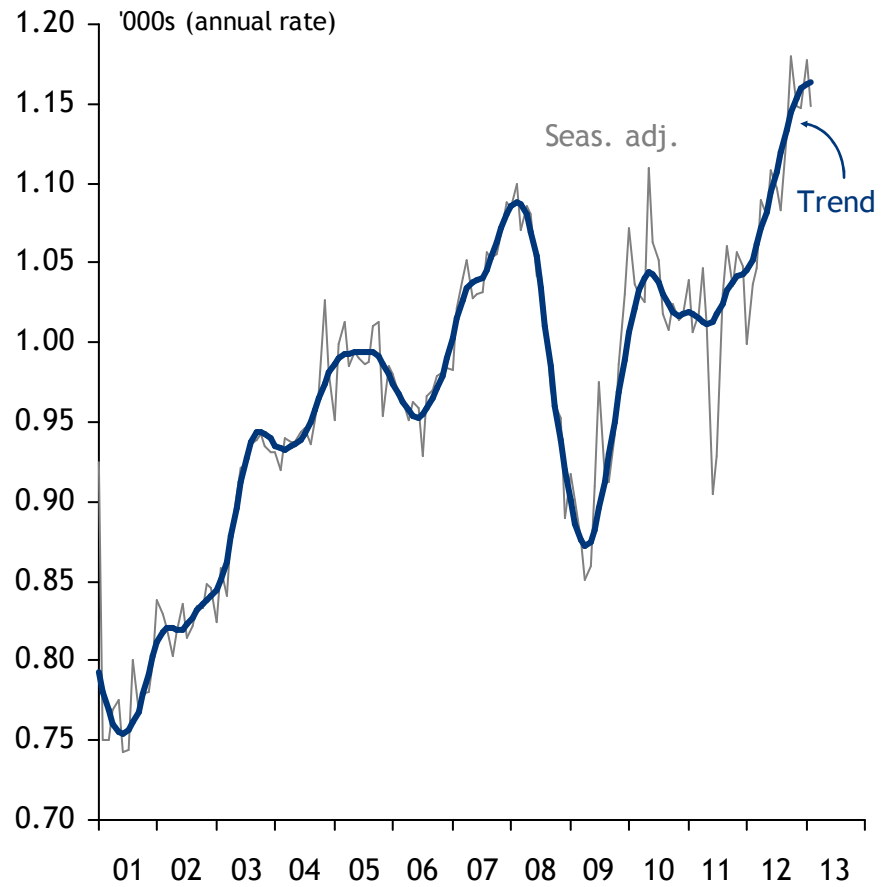
Note: ABS investment intentions survey data for 2012-13 are adjusted for the extent to which intentions from previous surveys taken at the same time of year have been 'realized', on average, over the past five years. Sources: ABS; BofA Merrill Lynch Global Research.

It's also hard to see consumer spending growing more strongly in 2013 than 2012

Retail vs other components of household consumption



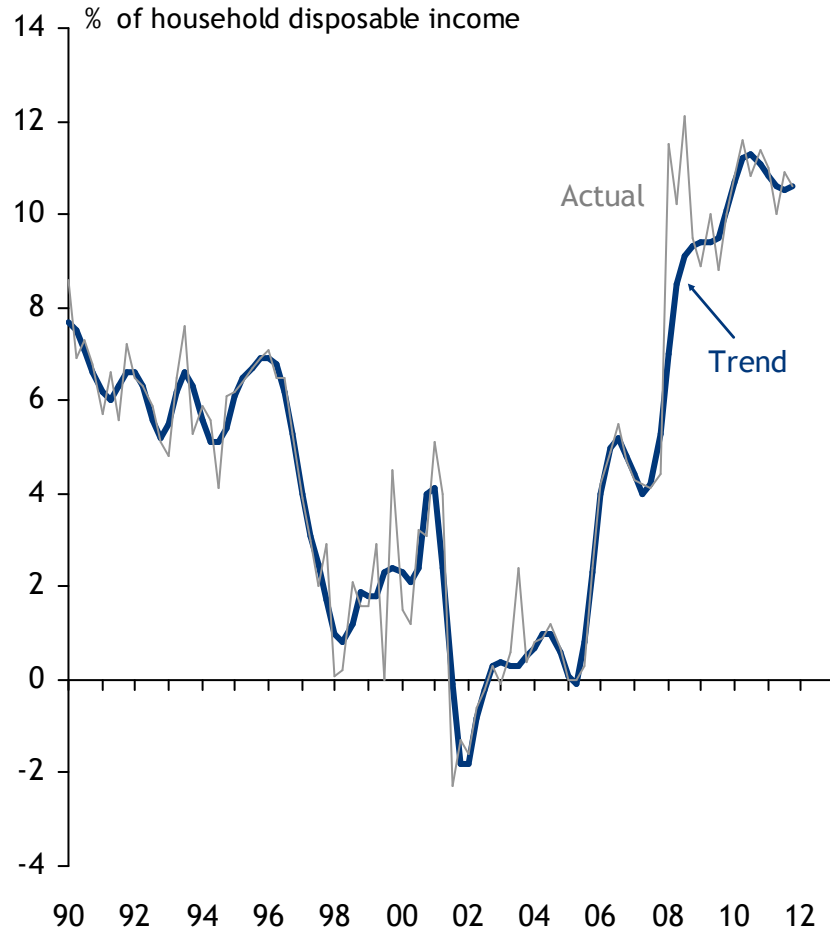
New motor vehicle sales



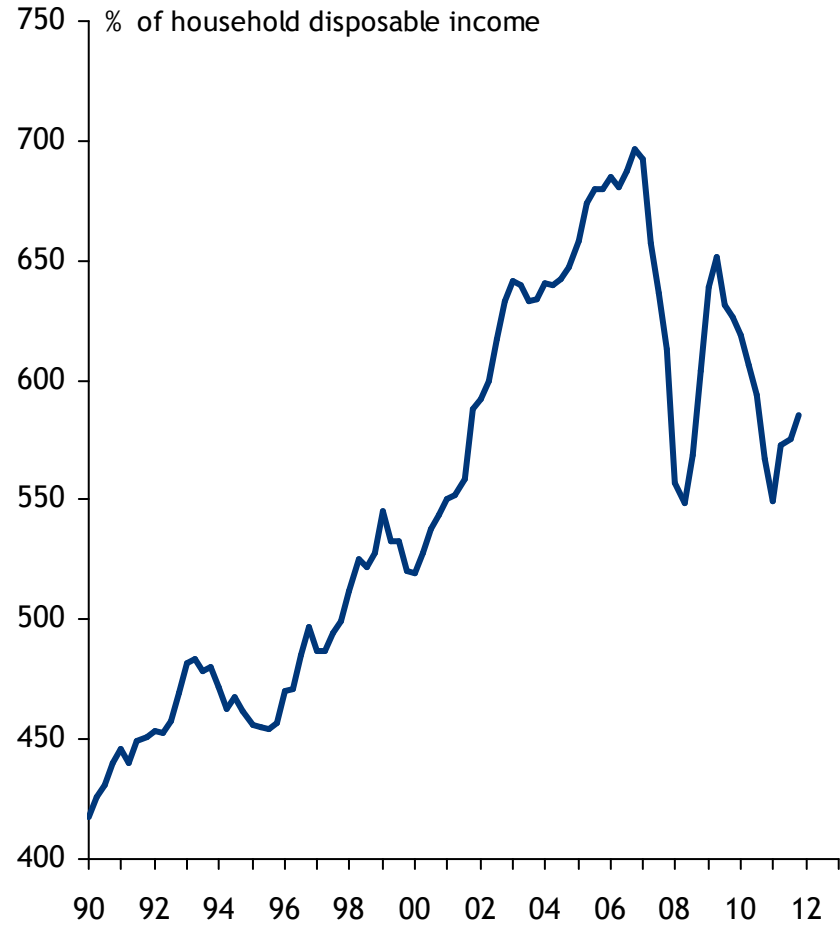
Sources: ABS; BofA Merrill Lynch Global Research.

It doesn't seem likely that the household saving ratio will fall much any time soon

Household saving ratio



Household net worth

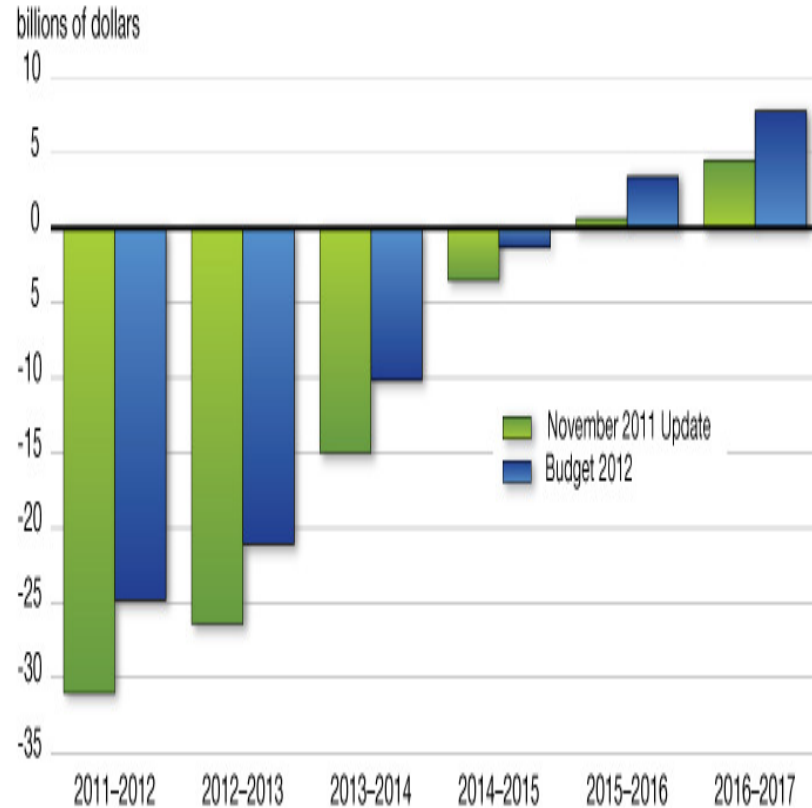


Sources: RBA; ABS; Bank of America Merrill Lynch Global Research.

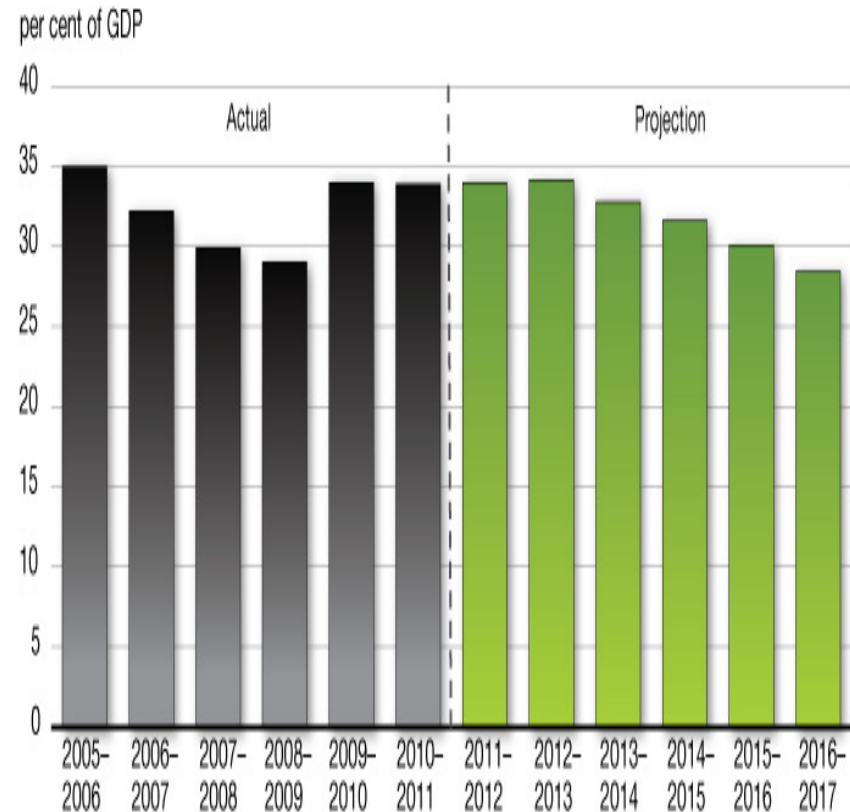
Fiscal policy *could* play a bigger role in boosting growth - but it won't

Canadian Government finances

Federal budget balance



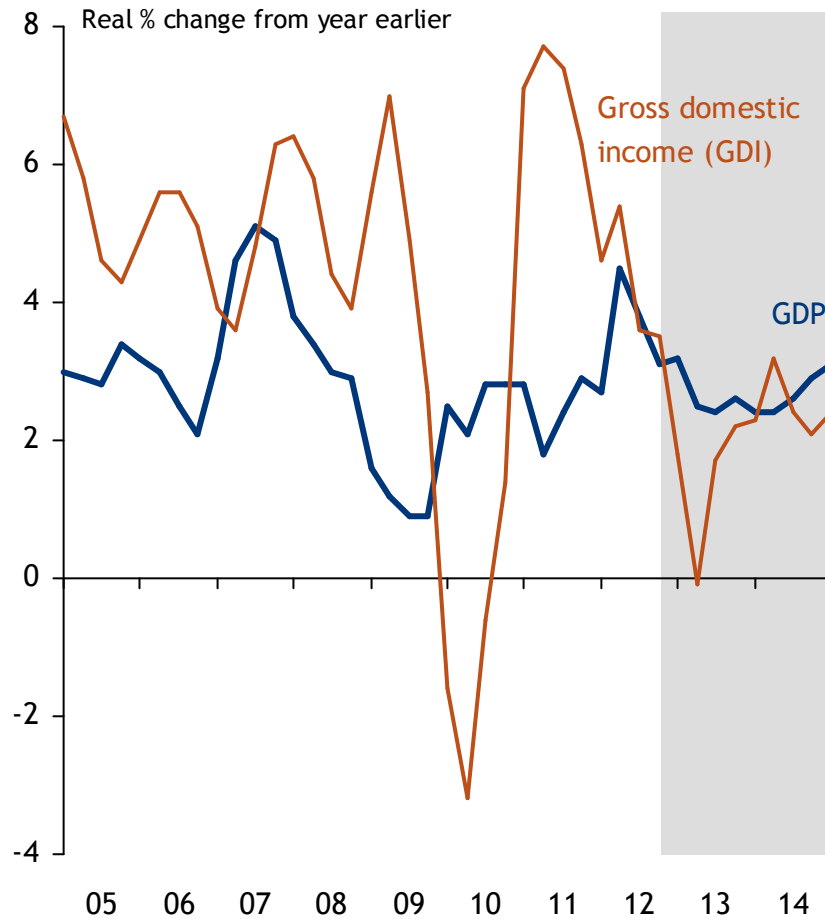
Federal net debt



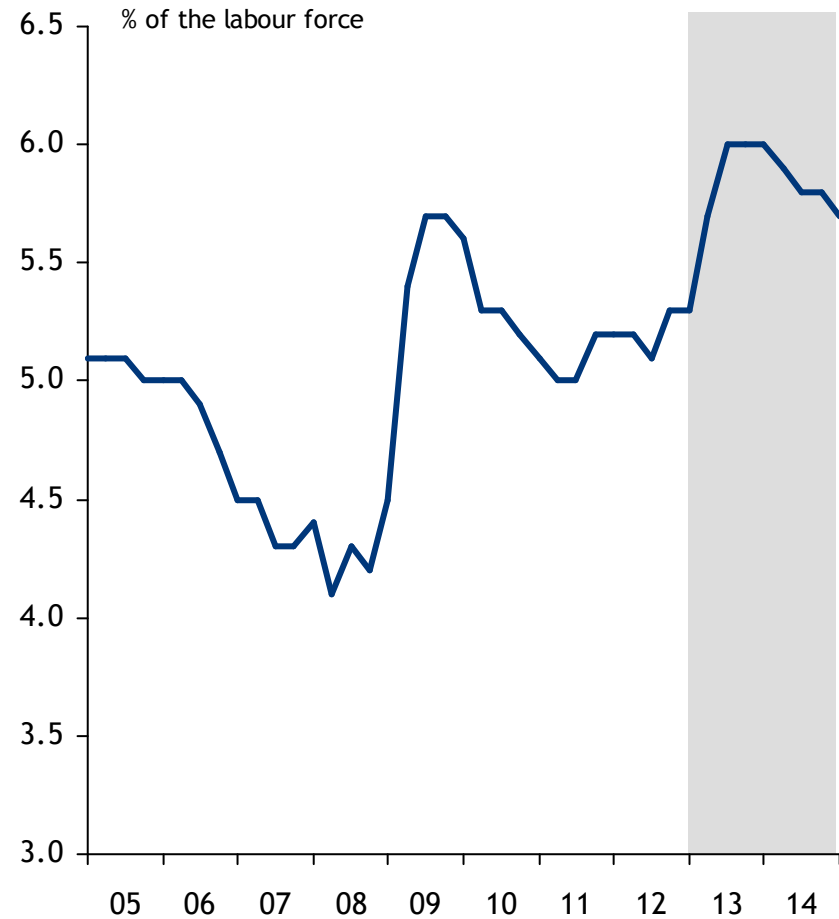
Source: Hon. James Flaherty (Canadian Finance Minister), *Jobs, Growth and Long-Term Prosperity: Economic Action Plan 2012* (March 29 2012), pp 230-231.

Hence growth looks like being below-trend and unemployment will rise in 2013

Real GDP growth



Unemployment rate

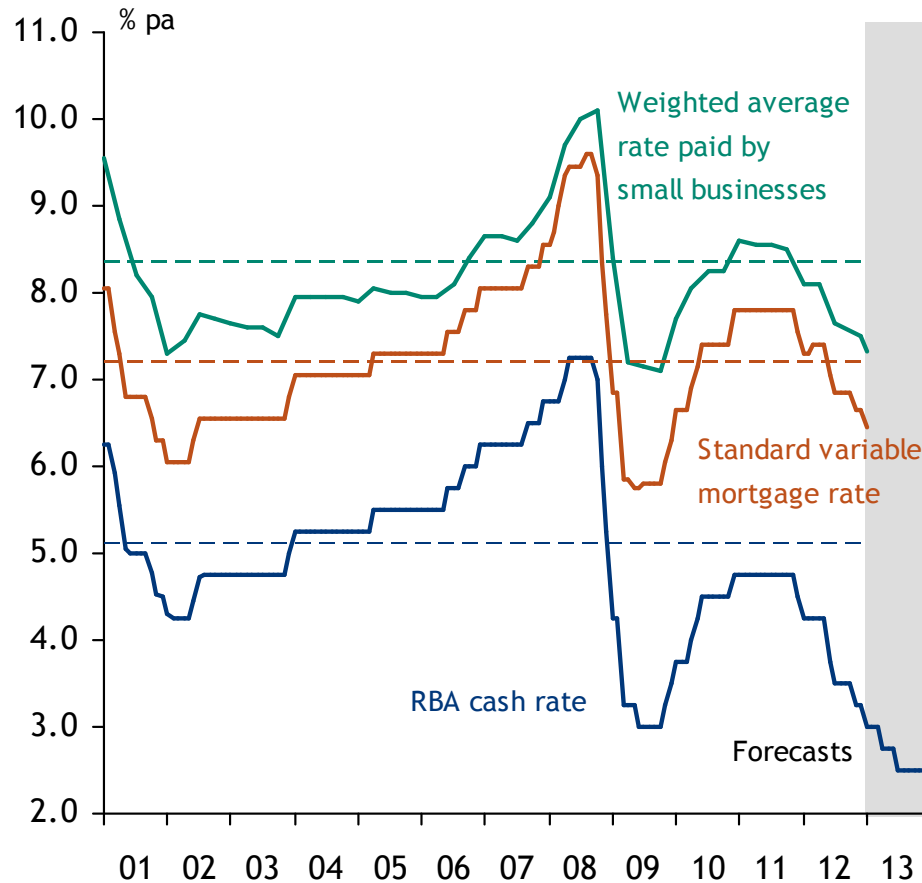


Note: Gross domestic income is GDP adjusted for changes in the terms of trade (export to import prices ratio). Shaded areas denote BofA Merrill Lynch Global Research forecasts, Sources: ABS; BofA Merrill Lynch Global Research.



The cash rate is now down to its post-GFC low (of 3%) - and may fall further next year

RBA cash rate and loan interest rates



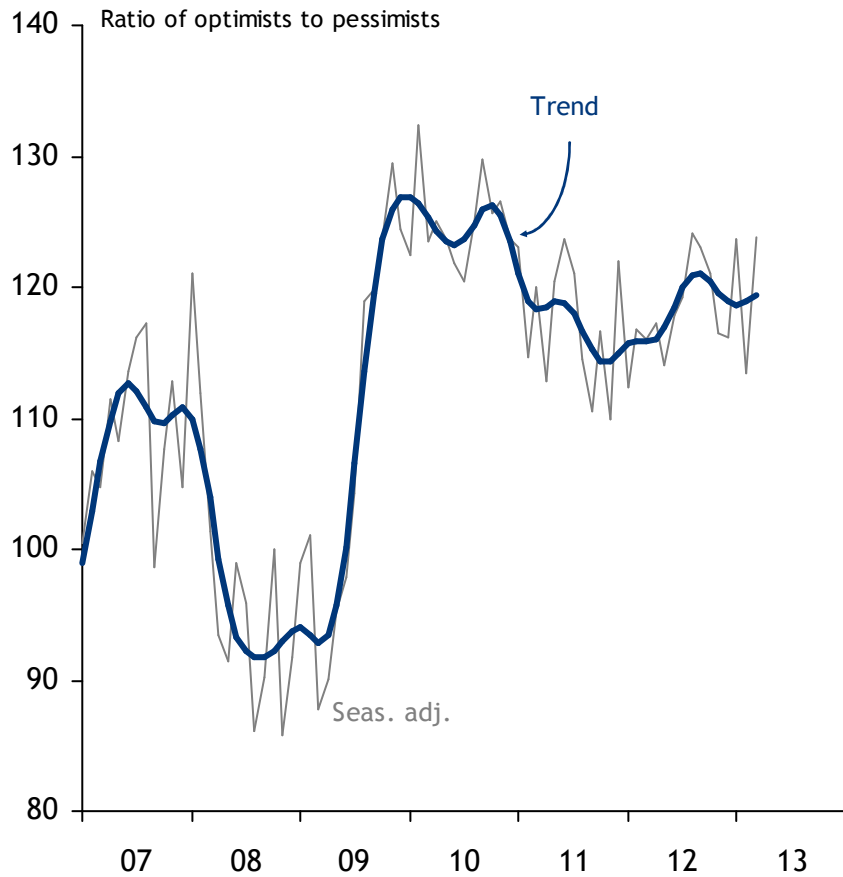
Note: Dotted lines indicate 15-year average of each interest rate shown.
Sources: RBA; BofA Merrill Lynch Global Research.

- With the mining investment boom approaching a peak, the RBA wants to foster faster growth in other areas of the economy so as to keep overall growth close to trend
- However the non-mining sector faces a lot of ‘headwinds’, including a persistently strong A\$, high household debt, low business confidence and ‘fiscal restraint’ at all levels of government
- There is not much the RBA can do about the persistent strength of the A\$ - and the other ‘headwinds’ aren’t going to ‘die down’ any time soon
- However the RBA can seek to offset these ‘headwinds’ by cutting interest rates further - as it did this week
- We still expect at least one more rate cut early next year (to 2.75%)

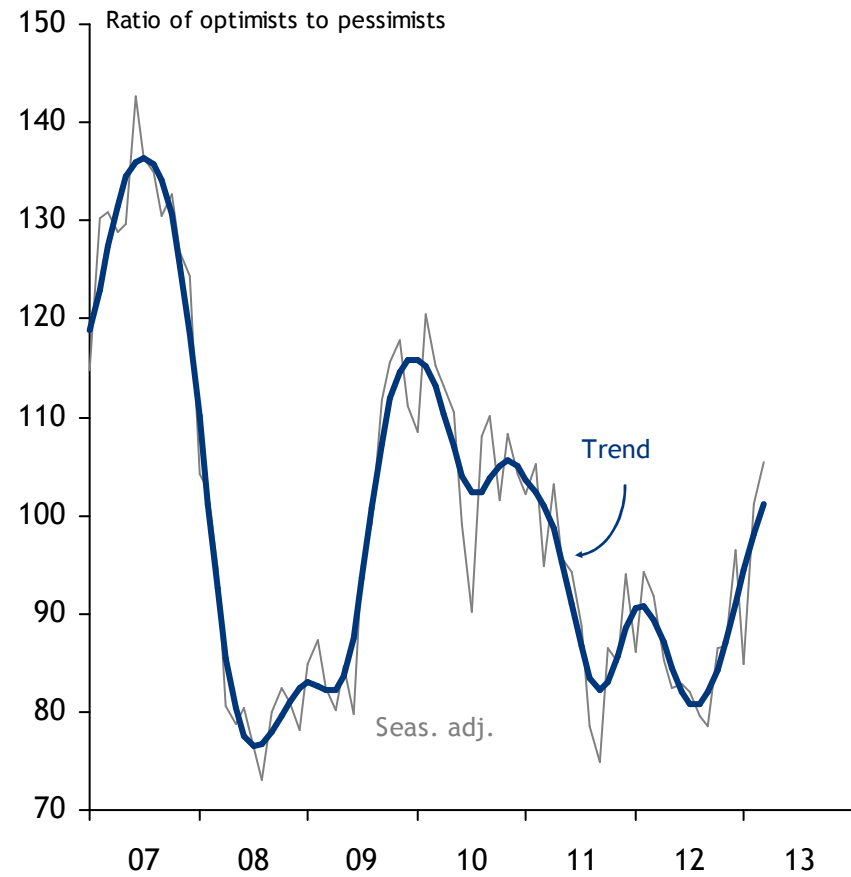
The recent improvement in consumer sentiment has been due to Coalition voters

Consumer sentiment by voting intention

Intending Labor voters



Intending Coalition voters

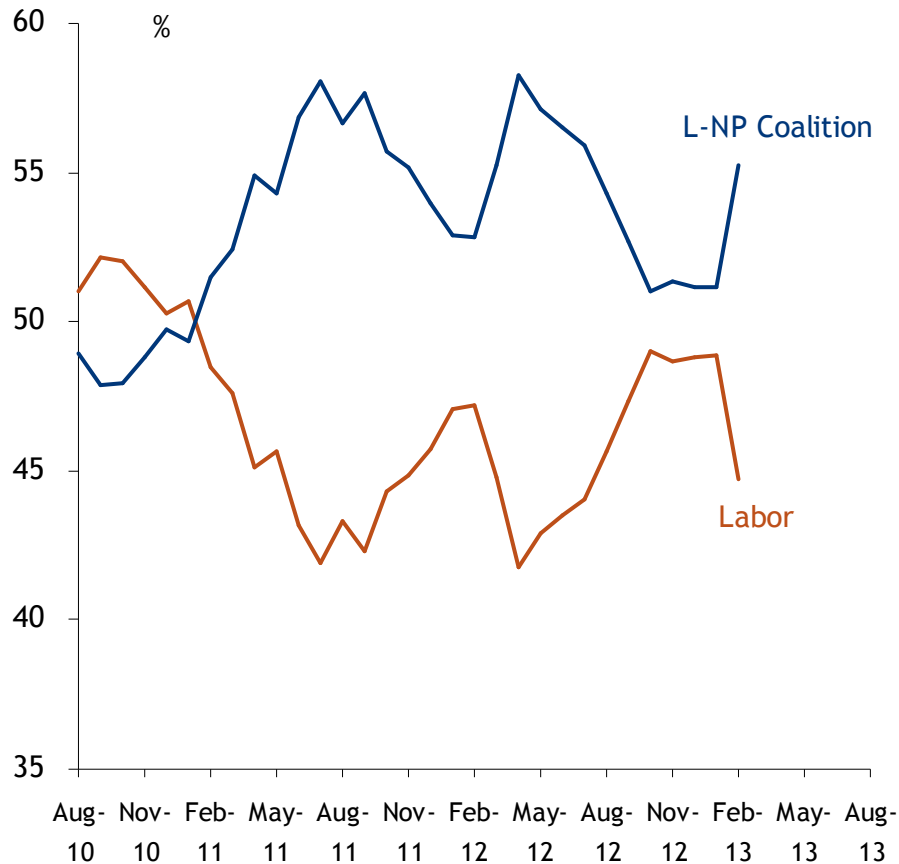


Sources: Westpac-Melbourne Institute; Bank of America Merrill Lynch Global Research.



Opinion polls indicate that a change of government is highly likely in September

Two-party preferred vote
(average of 3 major opinion polls)



Sources: Newspoll-The Australian; Neilsen-Fairfax Media; Roy Morgan Gallup Polls; BofA Merrill Lynch Global Research.

- All three opinion polls have picked up a renewed widening in the Coalition's opinion poll lead over Labor, reversing much of the narrowing that occurred last year
- While other incumbent governments have won elections after being initially well behind in the polls (Keating 1993, Howard 2001), it's hard to see Gillard 2013 repeating those outcomes
- Although the Opposition won't release much policy detail (including costings) until much closer to the election, the broad priorities of an Abbott Government are already clear
 - abolishing MRRT and carbon tax (if possible given Senate position)
 - earlier return to budget surplus through bigger cuts in spending
 - broad financial system inquiry
 - 1½% tax increase for big companies to pay for generous parental leave scheme
- An Abbott Government would not be a 'reforming government' like Hawke-Keating or Howard (in his first two terms)
 - the risk is that it would be more like the Fraser Government (1975-83)

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