The Big Issues 2003-2016

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The Big Issues 2003-2016

Forward

For the past 14 years we have produced “The Big Issues” report – a report that has sought to highlight the issues that are expected to influence the economy over the forthcoming 12 months.

The aim has been to produce a report that discusses trends, issues and ‘big picture’ influences that could act as threats or opportunities for consumers, investors and businesses alike.

Certainly the key economic and financial issues have varied markedly over time. And to highlight these trends we have compiled each of the reports into the Big Issues book. We hope you will enjoy looking back over the ‘hot button’ issues of the past 14 years.

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The Big Issues 2016

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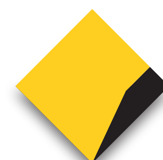

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The Big Issues of 2016

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BIG ISSUES OF 2016

Will we need to worry about inflation again?
China: Hard landing or soft landing?
How aggressive will the US be in lifting interest rates?
What is 'normal' economic growth in Australia?
When will 'animal spirits' return?
Housing: Hard landing or soft landing?
What will out tax system look like in five years' time?
Will oil prices ever see US$100 a barrel again?

The Big Issues of 2016

- For the past 12 years we have produced *"The Big Issues"* report – a report that has sought to highlight the issues that are expected to influence the economy over the forthcoming 12 months.
- Now this is no crystal ball gazing exercise. The aim is not just to forecast where certain economic variables are likely to be in a year's time. Rather the focus has been to highlight trends, issues and 'big picture' influences that act as threats or opportunities for consumers, investors and businesses alike.
- The aim has been to produce a highly readable, relatively jargon-free document. Probably today we could call this a blog. But the intention over time has been to produce commentary that causes people to think and ask the 'so what' question – that is, to determine what this means for their own circumstances.
- And we undertake this analysis by providing a healthy amount of graphs and pictures in addition to the text to best highlight the issues we think will prove important in 2016. Certainly one of the great innovations over recent years has been the infographic and other developments that have sought to bring subject matter 'alive'. They say that a picture should tell a thousand words, and that should be the basis for all economic and financial commentaries – make the subject matter more alive and relevant to readers. The real value of economics is when people say 'so what?' and relate the commentary and forecasts to their own situation.

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…But First…The Economic 'State of Play'

Review of the Past Year

- In addition to our 'Big Picture' analysis of key economic issues we feature a recap of the past year's economic performance together with an outlook for the economy for the coming twelve months.
- This economic assessment largely sets the scene for the discussion of the *Big Issues*. Because there are themes and trends that have evolved over the past year or years to affect economic performance. And clearly each one of us wants to know whether the same factors or indeed new factors are likely to dominate in the coming year.

RECAP: LAST YEAR's FORECASTS		
	2014	*2015*
Economic Growth	2.75-3.25%	2.75-3.25%
Underlying inflation	2.25-2.75%	2.25-2.75%
Unemployment	5.75-6.25%	5.50-6.00%
	mid 2015	*end 2015*
Cash rate	2.25-2.75%	2.50-3.00%
Sharemarket (All Ords)	5,800-6,000	6,000-6,200
Australian dollar	US80-87c	US79-86c

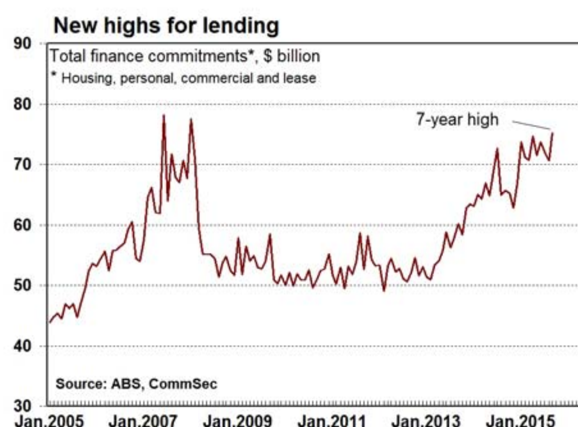
- Last year we wrote the following: *"The past year has been characterised by cautious consumers and businesses. Spending, investing and employment have been relatively unremarkable. As a result, the economy has grown near, or slightly below the 'normal' pace.*"
- Sound familiar? The difference in the past year is that economic growth has been below 'normal' – in the words of the Reserve Bank Governor, the economy is growing, but *"not as fast as we would like"*. In response, rates were cut twice – in February and May. Both our forecasts and the forecasts of the Reserve Bank weren't met over the past year. Economic growth disappointed; inflation was lower than forecast; and as a result our forecasts for the sharemarket and Aussie dollar proved too high. Only unemployment looks to have fallen in the target band.

The Year Ahead

- In recent months the economy has gathered momentum, led by home building and home purchase activity. Building approvals are at record highs as are tourist arrivals and new vehicle sales. Retail spending is growing around the 'normal' pace; businesses are reporting favourable business conditions, they are hiring more workers and are starting to borrow again.
- If momentum continues into 2016 then economic growth should lift closer to the longer-term average pace. But much will depend on a continuation of solid home building activity. Businesses will need to start investing again, and early indications are cautiously optimistic. Certainly businesses appear to be borrowing again.

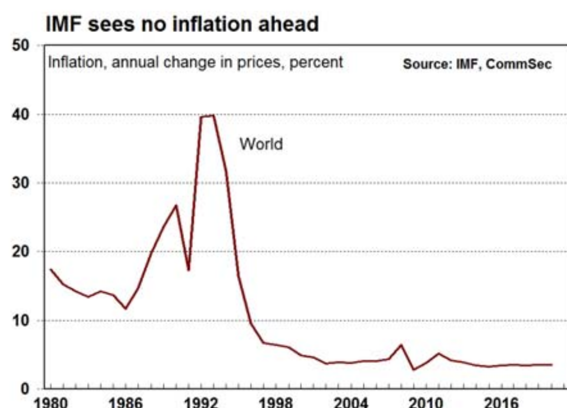
FORECASTS		
	2015	*2016*
Economic Growth	2.00-2.50%	2.50-3.00%
Underlying inflation	2.25-2.75%	2.50-3.00%
Unemployment	5.50-6.00%	5.50-6.00%
	mid 2016	*end 2016*
Cash rate	1.75-2.00%	1.75-2.00%
Sharemarket (All Ords)	5,200-5,400	5,500-5,700
Australian dollar	US64-72c	US68-75c

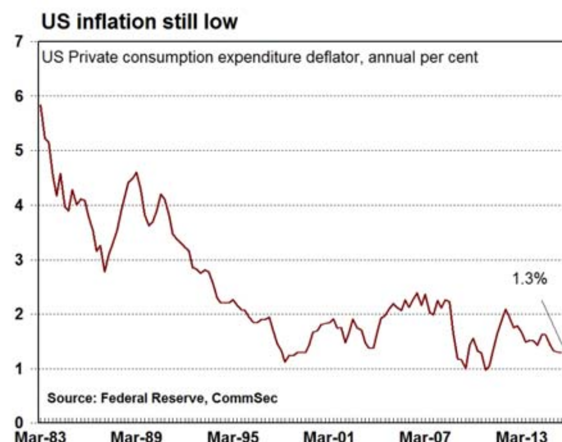
- Inflation shouldn't be a problem over 2016 although the main issue that the Reserve Bank is monitoring is the "pass-through" of a lower Aussie dollar into higher prices for imported goods. So far, the "pass-through" has been weak with retailers preferring to cut costs and margins to stay competitive especially against foreign retailers.
- At present we think the Reserve Bank will stay on the interest rate sidelines over 2016. But the Reserve Bank has made it clear that it has the ability to cut rates should it become necessary given that underlying inflation is at the low end of target band.
- Unemployment is expected to gradually improve over the year, easing towards 5.50 per cent, especially if economic growth improves as we expect.
- The Australian dollar has fallen US 9 cents over 2015 and the pressure is unlikely to let up in 2016. The US Federal Reserve is tipped to lift rates over the year while our analysts remain negative on prospects for commodity prices.

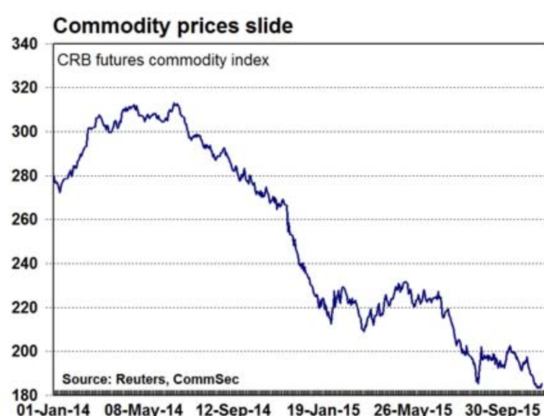


Will we need to worry about inflation again?

- Inflation has featured in our *Big Issues* for a number of years. Last year we asked *'Is Inflation dead?'* – clearly tempting fate. And in the previous year's *Big Issues* we also included a similar item: *"Inflation or Deflation?"*
- We continue to find it remarkable, that with interest rates close to zero across many parts of the world and some central banks still injecting stimulus via bond buying, that concerns about deflation still abound.
- It may be reasonable to expect deflationary concerns in under-performing economies like Europe and Japan. But in the United States, consumer prices are up just 0.2 per cent over the year. Excluding food and energy, prices are up 1.9 per cent over the year. And the Federal Reserve's favoured measure – the personal consumption expenditure deflator (price index), excluding food and energy – was up just 1.3 per cent over the year. The Fed target is 2 per cent.
- Certainly inflationary pressures are being capped by low and falling commodity prices like oil. While central banks generally strip out oil when monitoring inflation, falling energy prices are keeping downward pressure on broader measures of goods and services prices.
- But commodity prices rise and fall and economies speed up and slow down over time. The question we raise is *'Will we need to worry about inflation again?'* That is a bigger question and it relates to the fact that businesses are increasingly facing greater global competition through lower trade barriers, the ability to sell goods over the internet, and especially the growing consumer acceptability to purchase goods from abroad through electronic payment methods. But there is also the advance of technology through 3D printing, adding a further imperative on businesses to accept a new lower 'normal range' for margins. The jury is still out, but there are few signs of inflation reviving any time soon.

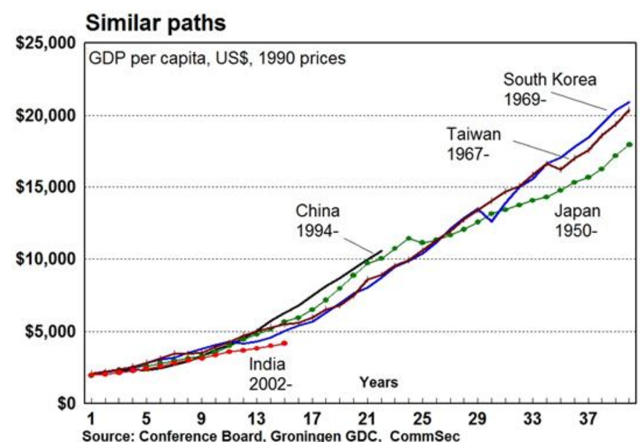


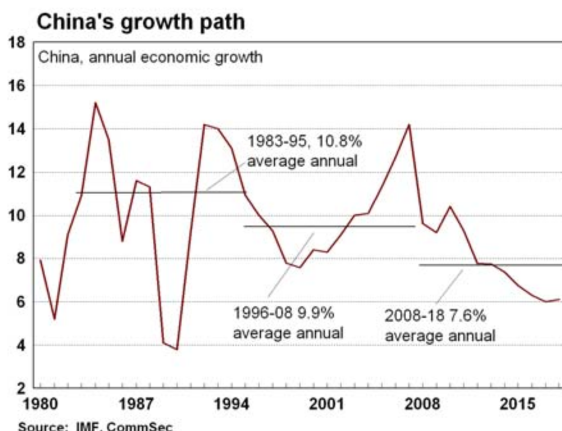


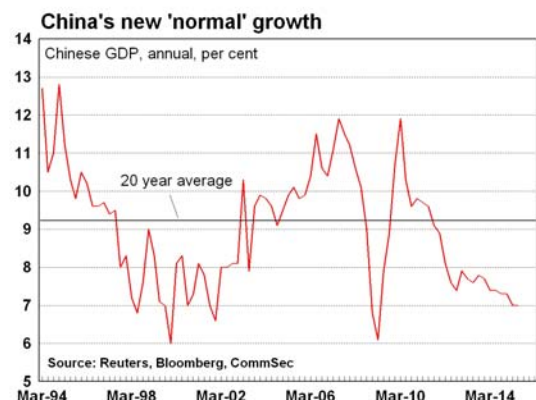


Will China face a hard landing or soft landing?

- China is Australia's largest trading partner. Further, recently the number of tourists to Australia from greater China (mainland China and Hong Kong) outnumbered those from New Zealand. China is also providing the biggest contribution to global economic growth of any nation. China may still only be the second largest economy on the planet but with growth rates near 7 per cent rather than 2 per cent in the US, it is expected to contribute 1 percentage point of the expected 3.6 per cent growth of the global economy in 2016.
- But China is transforming. Whereas the industrial sector drove growth in past years, in future years it will be services and household spending that is expected to lead the way.
- This is hardly a remarkable situation. All major industrialised economies have followed the same path. It has happened more recently in South Korea, Taiwan and even Japan. And the US and Australia have also trekked the same path. Rural and mining sectors initially drive economies, and infrastructure is put in place. But as incomes rise and businesses are priced out of markets, they move on to more elaborately-transformed manufactures and services industries.
- Chinese authorities have made no secret of the fact that growth drivers are changing and that growth rates will slow. Chinese authorities refer to it as the "new normal". Economic growth rates are more likely to be in a range of 6.0-7.0 per cent.
- Such transformations are by no means easy. Some businesses will need to close as industries retreat in importance while other businesses will take their place. And the impact is by no means local. Australian resource providers will need to get used to lower prices and will need to adjust supply to the slower pace of expected demand. Commodity prices have trended lower for a century, interspersed with relatively short-lived upturns as new economies industrialise – like Japan and China.
- While there will be some pain in Australian mining and energy sectors, there are other businesses and industries that will benefit from rising Chinese incomes, as well as the rising middle class in Asia. Business such as those in food production, tourism, education, health and financial services.
- We expect China to experience a relatively soft landing. But that doesn't mean that there won't be bumps along the way as Chinese authorities attempt to transform the nation from a developing economy into a developed economy.

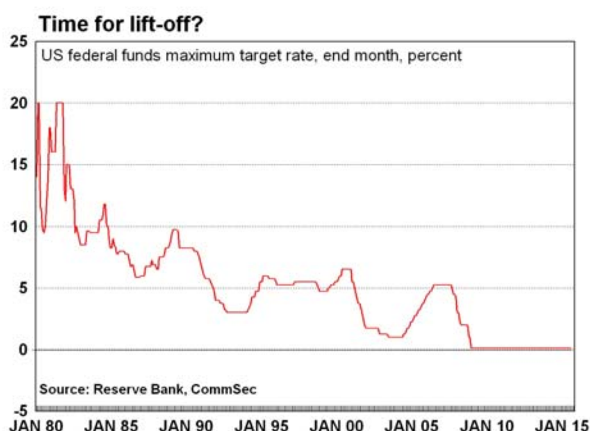


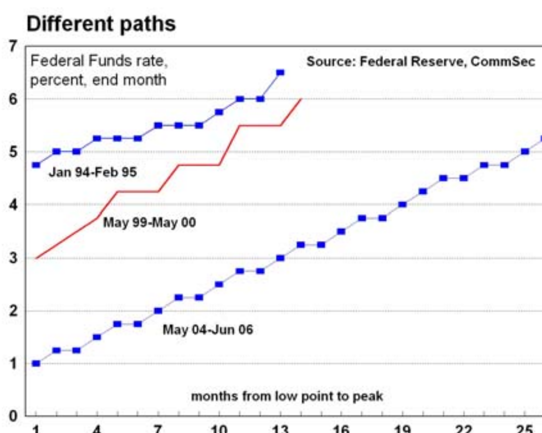


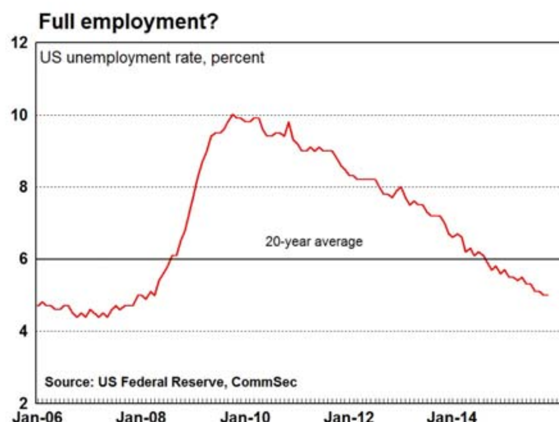


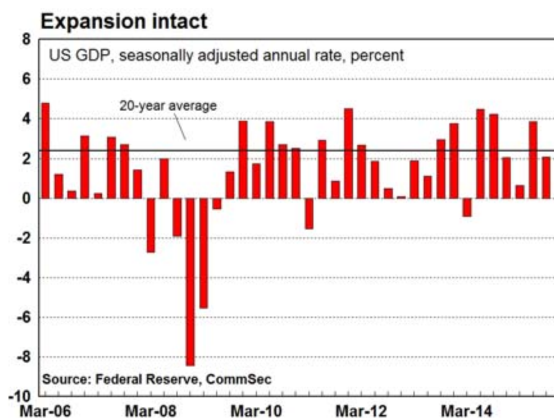
How aggressive will the US Federal Reserve be in lifting interest rates?

- Last year we posed the question *"When will the US start lifting interest rates?"* We rationalised that all the ingredients seemed to be in place for the Federal Reserve to start the 'normalisation' process – that is, lift rates to more 'normal' levels. And our advice was that *"investors need to stay alert to the timing and size of US rate hikes over 2015."*
- Well it's taken longer than we, and most other analysts, thought. But at the time of writing it looks like rates will start rising on December 17. Given that it is a sign of how much the economy has recovered, Federal Reserve chief Janet Yellen recently said "*it is a day that I expect we all are looking forward to*."
- The question now is what form will the 'normalisation' process take? As you would hope and expect, the Fed chief has indicated that the central bank won't be in a rush to lift interest rates. Much will depend on the flow of economic data, as to whether the process needs to be quickened or moderated. And certainly with inflation still below the Fed's target, there is no need to rush.
- Janet Yellen noted in her recent speech: *"Given the persistent shortfall in inflation from our 2 per cent objective, the Committee will, of course, carefully monitor actual progress toward our inflation goal as we make decisions over time on the appropriate path for the federal funds rate."*
- The path of interest rate increases is one thing investors will be watching over 2016. The other issue is the end-point. That is, at what point will the Federal Reserve be satisfied that interest rates have risen enough?
- Back in the 1994-1995 period, the Federal Reserve lifted the federal funds target rate from 3.00 per cent in February 1994 to 6.00 per cent in February 1995. In the 1999-2000 period, the fed funds rate lifted from 4.75 per cent in May 1999 to 6.50 per cent in May 2000. And between 2004 and 2006, fed funds rose from 1.00 per cent in May 2004 to 5.25 per cent in June 2006.
- All Janet Yellen can say at present is that the 'neutral' federal funds rate is historically low – that may suggest that rates of 2-3 per cent would cause the Fed to pause in its rate-hiking process.



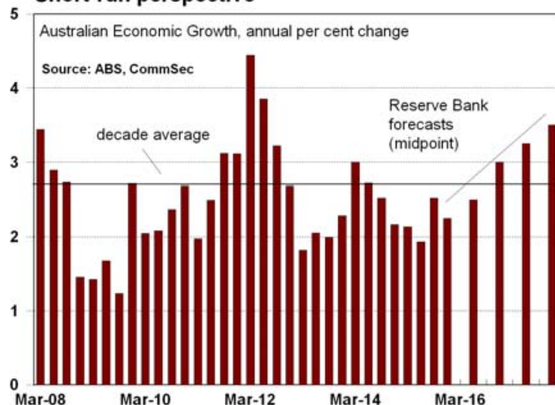


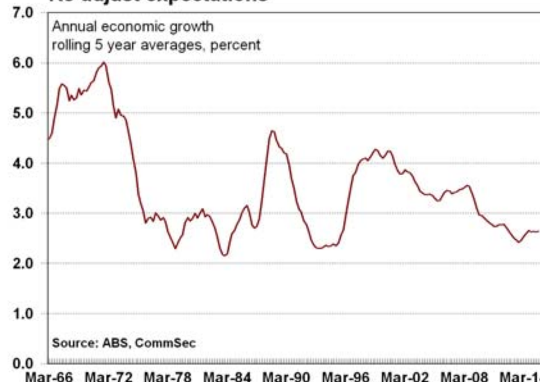


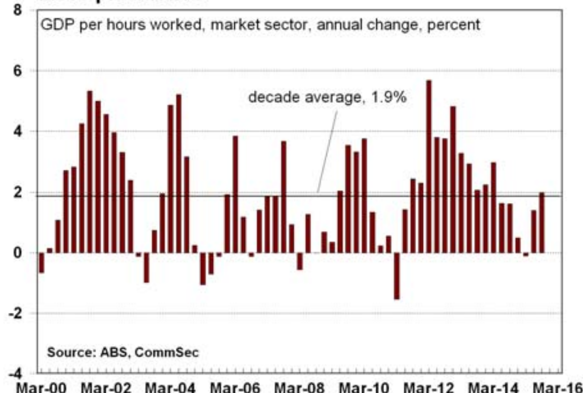


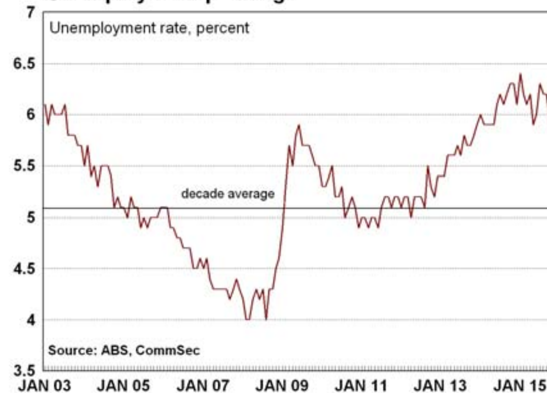
What is “normal” economic growth in Australia?

- This has been one of the more interesting questions raised in 2015. And it is a question that will be posed more and more over 2016. Certainly it is an issue that CommSec has been focussing on for some time, so we are pleased to see that it is being discussed more widely by analysts, investors and policymakers alike.
- The general assumption had been that the Australian economy can grow around 3 per cent without sparking inflation. That ‘speed limit’ is broadly the by-product of population growth of around 1.5 per cent and productivity growth of around 1.5 per cent. And it is generally assumed that the economy needs to be growing broadly around 3 per cent or higher to create enough job opportunities to cause the unemployment rate to fall.
- Over the past five years annual economic growth has averaged 2.6 per cent, down from a decade average of 2.7 per cent and 15-year average of 2.9 per cent. So the growth rate has been trending lower. And indeed Federal Treasury has now locked in 2.75 per cent for the new ‘normal’ growth rate.
- The Reserve Bank expects that the long-term trend or ‘normal’ pace of the economy has come down, but it is keeping an open mind on the issue. Perhaps lower wage growth accounts for the stronger job market. And the low wage growth on top of stronger productivity growth may have also enticed employers to take on extra staff rather than work existing staff more intensively.
- But the good news is that jobs are being created; inflation remains low; and economic growth, while low, is starting to lift.
- Still, if the ‘speed limit’ has come down, then this has broader implications. It may be that the Reserve Bank starts worrying about a lift in inflation when the annual economic growth rate approaches 2.75 per cent rather than 3.00 or 3.25 per cent – and that’s not far below the current 2.5 per cent growth rate. Further, companies may need to factor in slightly slower ‘normal’ profit growth if growth in the broader economy has ratcheted lower.
- As noted, the Reserve Bank hasn’t yet locked in new lower estimates for ‘trend’ or ‘normal’ economic growth, but certainly it will be an issue it will watch carefully over 2016.



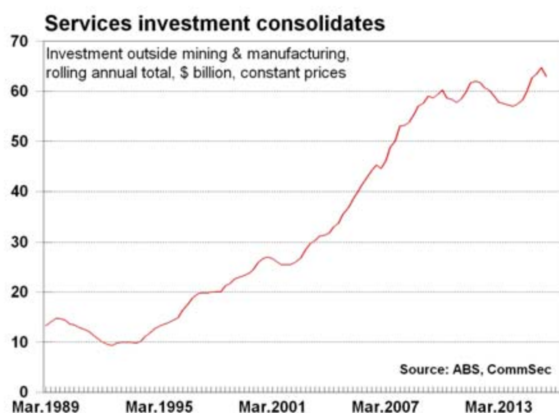


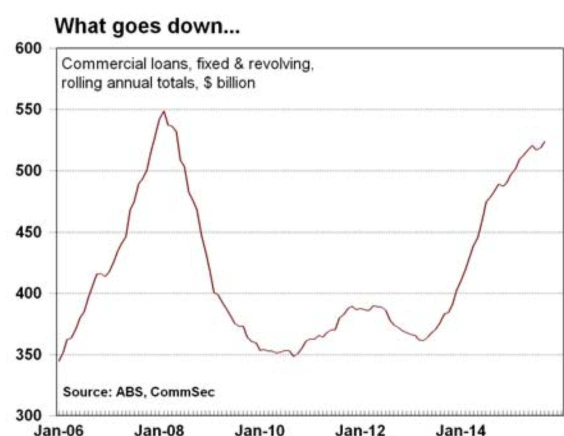


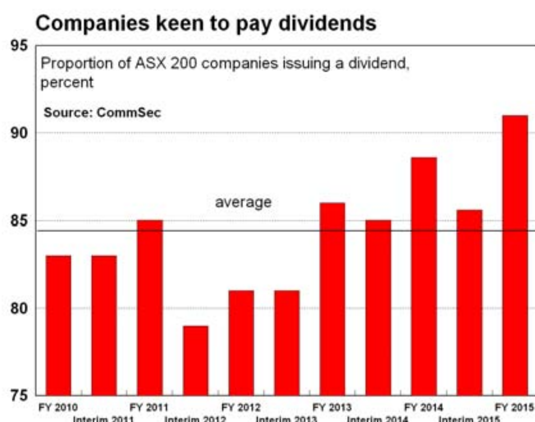


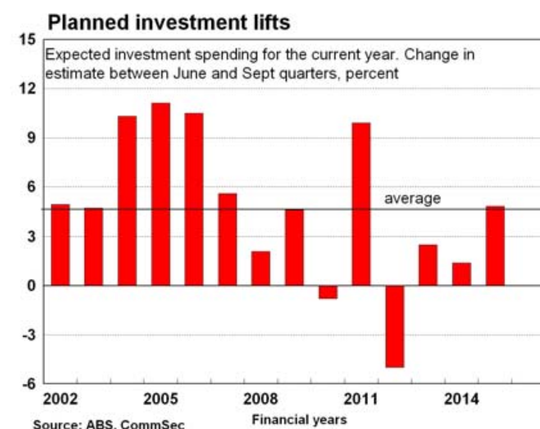
When will the ‘animal spirits’ return?

- The term ‘animal spirits’ is commonly attributed to luminary economist, John Maynard Keynes. Keynes wrote in his 1936 book *The General Theory of Employment, Interest and Money:*
  - *“Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."*
- Unfortunately one of the lingering consequences of the global financial crisis is that consumers and businesses have become a little too cautious. Interest rates are historically low and policy settings generally are super-stimulatory, but spending, borrowing and investment haven’t lifted as much as policymakers had hoped.
- This criticism is generally directed more at businesses than consumers. But even Aussie consumers are more conservative than in the past. While people are borrowing to buy and build homes, borrowing for other reasons is low. And whereas home borrowers in the past would seek to reduce loan repayment and boost spending in response to rate cuts, now they are paying off debt at a faster rate.
- Still, consumers continue to spend at a ‘normal’ rate. Annual growth of household spending stands at 2.7 per cent, not far from the 2.8 per cent decade average.
- But business spending, borrowing and investing have been historically modest despite generally favourable corporate finances. The Reserve Bank has been somewhat critical of businesses for maintaining high hurdle rates of return for new investments and a desire to pay dividends in preference to ploughing funds back into the business.
- There are signs though of a “thawing out”. Business spending is lifting; borrowing levels have risen and investment plans are improving. Business investment is currently the missing ingredient in the economic uptrend and it is the issue that investors will watch carefully over 2016.



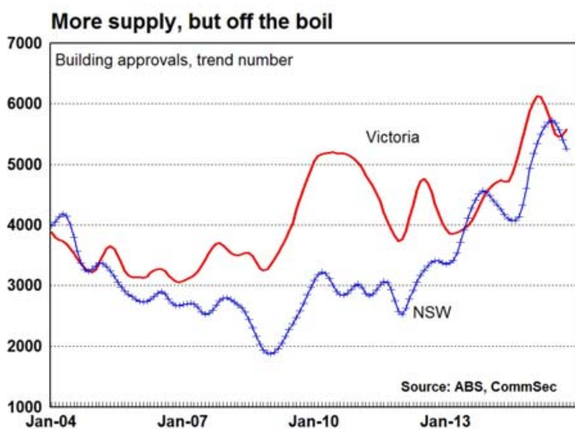


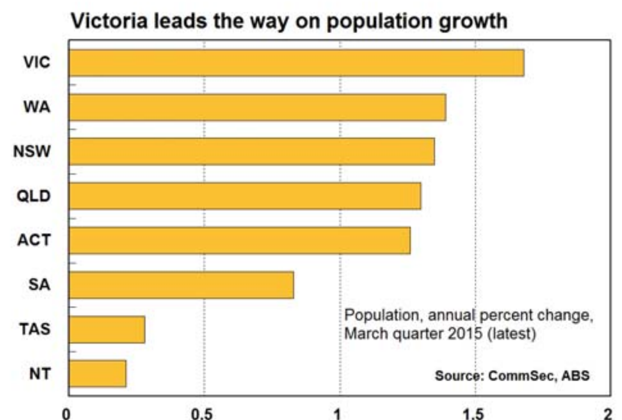


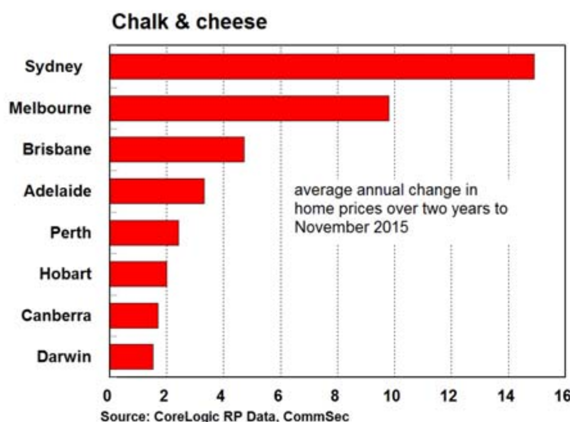


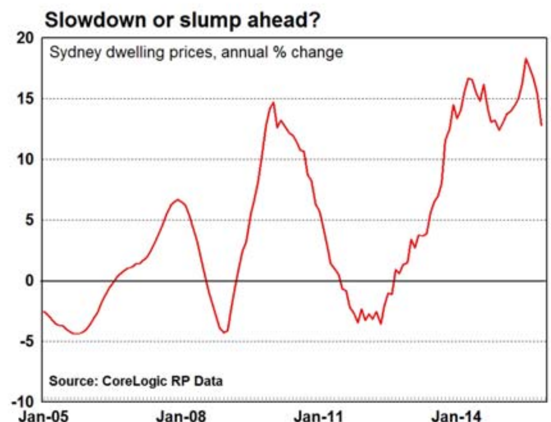
Housing: Hard landing or soft landing?

- For many parts of Australia, this issue is very much a non-issue. Why talk about a landing at all – this implies that home prices have been soaring to necessitate a landing at some point?
- Over the past two years, Sydney home prices have recorded average annual growth of almost 15 per cent. And Melbourne home prices recorded average annual growth of 10 per cent. But across the other capital cities, growth has averaged just 2.6 per cent. Growth in home prices of that magnitude has actually been lower than the average rate for the past decade.
- So the issue of 'hard landing or soft landing?' is primarily relevant for Sydney and Melbourne. And while the answer will be revealed over 2016, it does look as though the start of this correction process is underway. In November, CoreLogic RP Data figures showed that Sydney home prices fell by 1.4 per cent while Melbourne home prices fell by 3.5 per cent in the month.
- The drop in Sydney home prices in November was the biggest in almost five years – although it was only the second fall in prices in 18 months. And the drop in Melbourne home prices was the biggest in 18 months.
- The simple reason why Sydney and Melbourne home prices have been rising is that population growth in both capital cities has been strong and demand for homes has been outstripping supply. While population growth has eased in NSW, it still remains 7 per cent above decade averages – the only state/territory above longer-term averages. And Victorian population growth leads the nation for the first time since 1888.
- But more homes are being built – supply is rising to meet higher demand. And as noted, home prices are coming off the boil. Indeed the recent slowdown in trend building approvals in NSW and Victoria shows that supply is also easing to prevent a 'hard landing'.
- It's also important to note that over-supply is being prevented by lending practices – banks won't lend to developers unless a high proportion of properties are pre-sold before building work is started. This is another factor pointing to a soft, rather than hard landing for home prices.



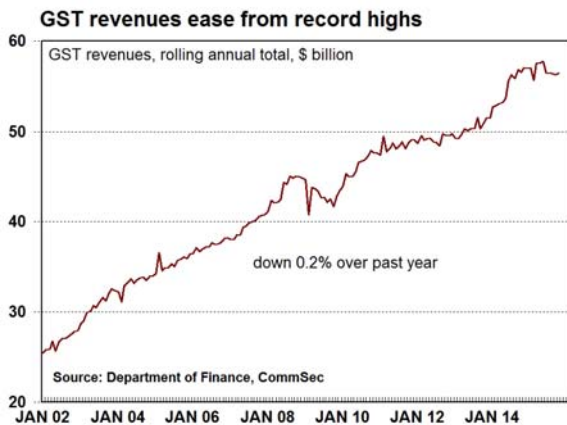


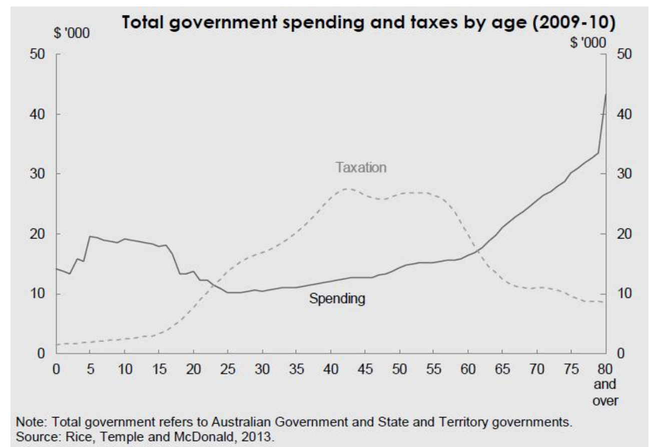


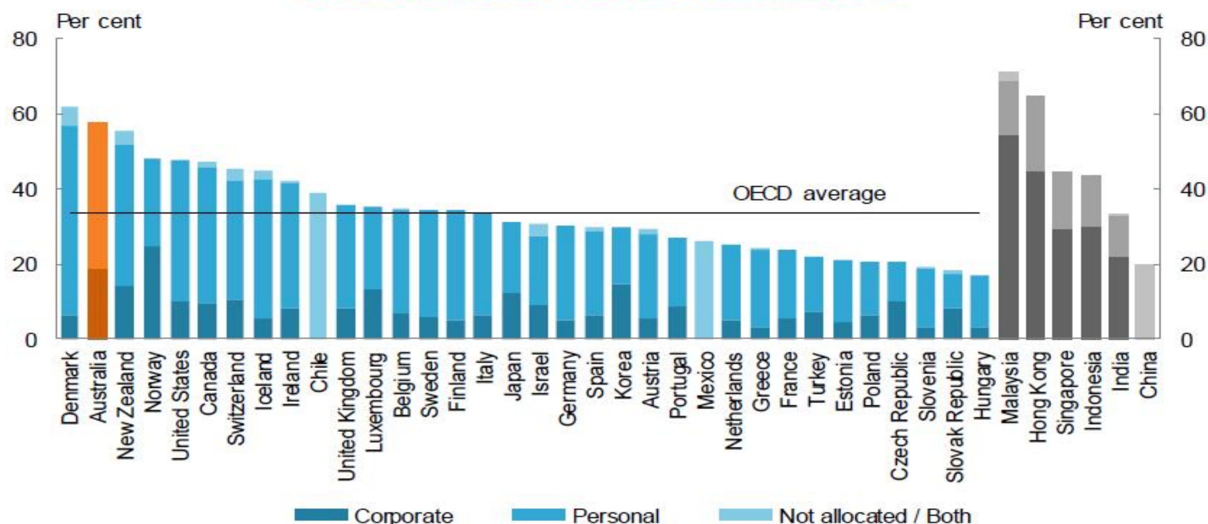


What will our tax system look like in five years' time?

- The big discussion point that emerged in late 2015 was tax reform. Almost unheralded, the NSW Premier raised the issue of raising the goods and services tax (GST) rate from 10 per cent to perhaps 12½ per cent or 15 per cent from the current level of 10 per cent. And as more voices have been added to the discussion, others have questioned the appropriateness of the tax base – the question of whether the base needs to be broadened to include food, health and/or education.
- Discussion of changes to the rate and composition of the GST isn't being conducted with the principal aim of raising more tax, rather because the tax system needs to change to meet the demands of an ageing population. Over time, a smaller proportion of the population will be in the workforce. And unless changes to the tax system are made, then those left in the workforce will take on a higher burden of generating the revenue needed for health and social security spending.
- It's important to remember that while an increase in the GST from 10 per cent to 15 per cent is being discussed, that is only part of the discussion. One aim of any change to the tax mix should be to encourage more people into the workforce or encourage them to stay in the workforce for longer. And that means lowering income tax rates or changing the tax bands.
- Also part of the discussion could be changes to business tax rates and changes to, or removal, of state government taxes and charges like stamp duty and payroll tax. Most businesses would like to see the end of payroll tax – a tax on employing more workers!
- Australia does rely on income taxes to a greater extent than most advanced countries. All political parties need to embrace change in the tax mix, with less weight on income taxation. Australia successfully implemented a GST without negative equity effects and we can do so again.

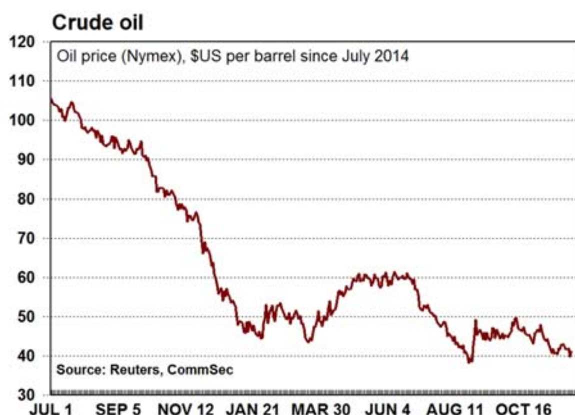


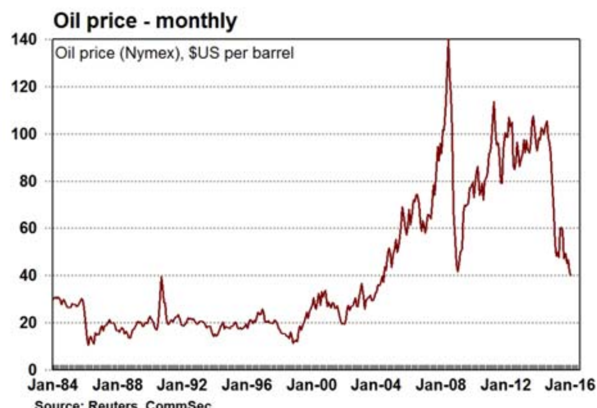


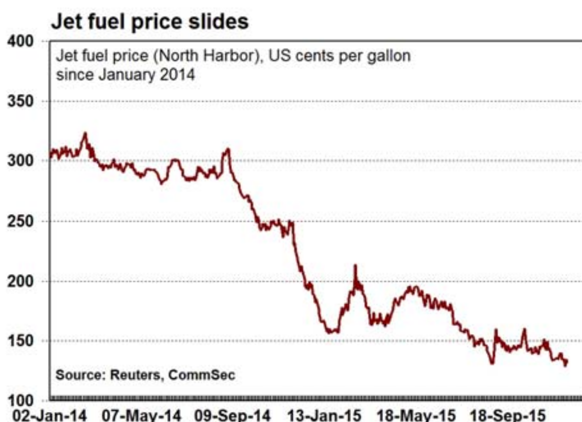


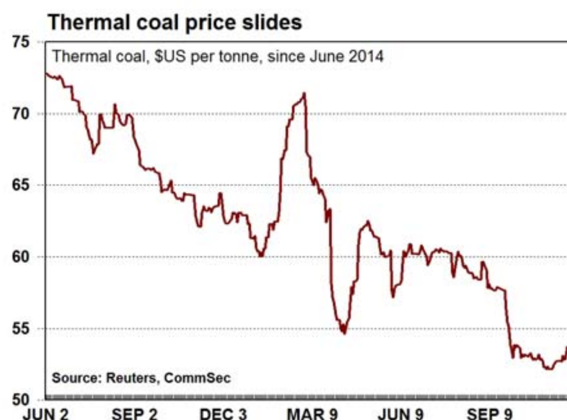
Will oil prices ever see US$100 a barrel again?

- This issue has major implications for an energy producer like Australia. And clearly the issue is multi-faceted.
- The simple reason why crude oil is trading near US$40 a barrel than at higher levels is because the major swing producer, Saudi Arabia, is trying to protect its market share, and ultimately its income and standard of life. Higher cost producers such as the US and Canada have been taking market share from the OPEC oil cartel. In part, because production became attractive at the higher prices prevailing up to mid-2014. But also continued advances in technology have reduced the cost of extracting more marginal reserves such as oil sands, shale oil and deep-water oil.
- But, in addition, oil use itself is threatened by alternate energy resources such as Liquefied Natural Gas (LNG) and new age energy for cars such as electric power and hydrogen. So it is clear that oil producers like Saudi Arabia have threats on multiple fronts.
- Saudi Arabia will be encouraged at the cancellation of some Canadian oil sands projects; ConocoPhillips will cancel all deep-water exploration from 2017. But Saudi Arabia and other OPEC oil producers are not yet satisfied. In early December OPEC agreed to maintain the current production quota. That is despite the world remaining massively over-supplied with oil. World oil stockpiles are at record highs. The Iranian oil minister believes the market is oversupplied by 2 million barrels per day.
- When Saudi Arabia believes it has seen off the threat from marginal non OPEC oil producers then it will start to trim oil quotas. But that point still appears some way off.
- Investors clearly need to do their homework on energy producers, determining their ability to reduce costs and generate profits at sustained lower prices. Investors need to calculate (bet) how long they are prepared to wait for energy prices to recover and whether there are stocks that could provide more reliable returns in the short to medium term. Airlines, transport companies and consumer stocks will benefit in an environment of low energy prices. LNG, oil and coal companies face challenges.









Rewind: The Big Issues for 2015

BIG ISSUES OF 2015

Is Inflation dead?
The end of corporate pricing power?
When will the US start lifting interest rates?
Where should investors put their money?
What is the 'fair value' for the Aussie dollar?
Does Europe still matter?
Home prices to slip or slump?
What shape is the job market really in?

- As we noted at the start of this report, we have been producing ***Big Issues*** for the past 14 years. And it is interesting – and perhaps even instructive – to rewind over the past year and assess what we had on the radar screen in December 2014.
- Looking ahead into 2015, we highlighted eight issues. And the first issue was "*Is Inflation dead?"* Clearly there was a big risk – the risk of Murphy's Law – in framing the first issue. Usually when you suggest that something is dead and buried, it comes back on the screen with gusto. But not inflation.
- We actually have highlighted inflation as an issue in various guises for quite some time. And why? Because it is central to interest rates, economic growth, corporate strategy and investment returns. Indeed inflation - or the lack thereof - dominated as an issue in 2015.
- Somewhat related were the issues: "*The end of corporate pricing power?"* and "*When will the US start lifting interest rates?* Companies have indeed found it hard to raise prices. In part because of low global inflation as well as 'disruption' and globalisation.
- Certainly the issue: *"Where should investors put their money?"* was amazingly relevant in 2015. Interest rates fell further, hitting record lows, and thus presenting a major problem for conservative long-term investors. Sharemarkets trended sideways, global shares were attractive because the Aussie dollar fell and the housing market was a magnet for investors, especially in Sydney and Melbourne. And while the issue doesn't make a return for our *Big Issues in 2016*, clearly it will remain a key discussion point in 2016.
- The Aussie dollar usually is a key source of debate, but the failure of the Aussie dollar to fall in line with commodity prices was a focus of concern for the Reserve Bank and highlighted in our issue: *"What is the 'fair value for the Australian dollar?"* Up until September, the Reserve Bank noted in the commentary accompanying its interest rate decisions that the Aussie had scope to fall further. With the Aussie dollar near US71 cents, the Reserve Bank dropped calls for a lower currency in announcing its September 1 rates decision. Seemingly, 'fair value' is in the early 70s against the greenback.
- An issue that hadn't featured previously in our reports came on the scene in 2015: *"Does Europe still matter."* And certainly it was a talking point over the year as people re-assessed whether it was worth worrying about Greece to the same extent as in the past. European interest rates turned negative and the European Central Bank printed more money, but importantly the world didn't stop turning.
- Interest rates, inflation and the Aussie dollar are key talking points. But so are home prices. We questioned *"Home prices to slip or slump?"* As it turns out, prices have started to ease late in 2015 – more slip, than slump. The issue will clearly dominate discussion again in 2016.
- And finally we raised the issue: *"What shape is the job market really in"* As it turned out, this was more of an issue than we assumed. Unemployment eased despite seemingly weak economic growth. That led to re-assessment about the true 'normal' rate of economic growth or the 'speed limit'. But the improvement in the job market caused the Reserve Bank to adopt a 'neutral policy stance. As we noted last year: *"Whether the Reserve Bank elects to cut rates again or hold rates steady, much will depend on its assessment of the job market, where it's headed, and what it means for wages and prices; more challenging for investors.*

Craig James, Chief Economist, CommSec
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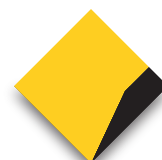
The Big Issues 2015

CommSec



The Big Issues of 2015

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BIG ISSUES OF 2015

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What shape is the job market really in?

The Big Issues for 2015

- For over a decade we have produced *"The Big Issues"* report – a report that has sought to highlight the issues that are expected to influence the economy over the forthcoming 12 months.
- Now this is no crystal ball gazing exercise. The aim is not just to forecast where certain economic variables are likely to be in a year's time. Rather the focus has been to highlight trends, issues and 'big picture' influences that act as threats or opportunities for consumers, investors and businesses alike.
- The aim has been to produce a highly readable, relatively jargon-free document. Probably today we could call this a blog. But the intention over time has been to produce commentary that causes people to think and ask the 'so what' question – that is, to determine what this means for their own circumstances.
- And this year we have continued the initiative that we started last year, by reducing the amount of text and letting the pictures speak for themselves. Certainly one of the great innovations over recent years has been the infographic and other developments that have sought to bring subject matter 'alive'. They say that a picture should tell a thousand words, and that should be the basis for all economic and financial commentaries – make the subject matter more alive and relevant to readers. The real value of economics is when people say 'so what?' and relate the commentary and forecasts to their own situation.

Craig James – Chief Economist (Author)

Savanth Sebastian – Economist (Author)

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…But First…The Economic 'State of Play'

Review of the Past Year

- Each year we kick off the *Big Issues* with an outlook for the economy and then finish the report with a recap of the past year.
- But this year we will roll the two sections together. Quite simply, because the past year has been largely unremarkable and the coming year looks more of the same.
- Now some would say that the relatively benign environment is the reason that our forecasts turned out to be rather quite accurate. And we accept that.

RECAP: LAST YEAR's FORECASTS	2013	2014
Economic Growth	2.25-2.75%	2.75-3.25%
Underlying inflation	2.25-2.75%	2.50-3.00%
Unemployment	5.50-6.00%	5.50-6.00%
	mid 2014	*end 2014*
Cash rate	2.25-2.50%	2.25-2.75%
Sharemarket (All Ords)	5,300-5,500	5,400-5,700
Australian dollar	US88-94c	US87-92c

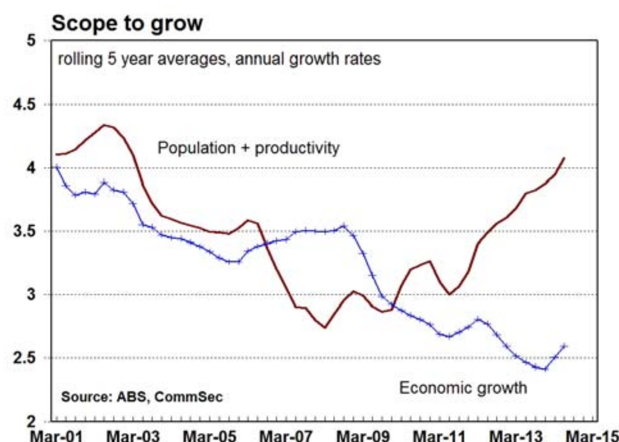
- The past year has been characterised by cautious consumers and businesses. Spending, investing and employment have been relatively unremarkable. As a result, the economy has grown near, or slightly below the 'normal' pace. Unemployment has drifted higher and inflation has remained under control. The cash rate hasn't budged. And the Aussie dollar has ebbed and flowed, but drifted lower over the second half of the year.
- Over 2014 the Aussie dollar tracked over a US12.5 cent range – from US82.53c to US95.04c. The currency is ending the year at the low end of the range and around US3-4 cents below the lower boundary of our forecast band.

The Year Ahead

- The coming year may prove more of the same. Economic growth should stay close to 3 per cent, below the sort of growth that will cause unemployment to fall markedly. Inflation should hold in the Reserve Bank's 2-3 per cent target band. Risks are to the low end of the range in the early part of the year, held down by low oil prices.
- As a result, the cash rate will not budge until the second half of 2015. We tip the Reserve Bank to start the 'normalisation' process (lift rates) in August and follow that with another rate hike in November.

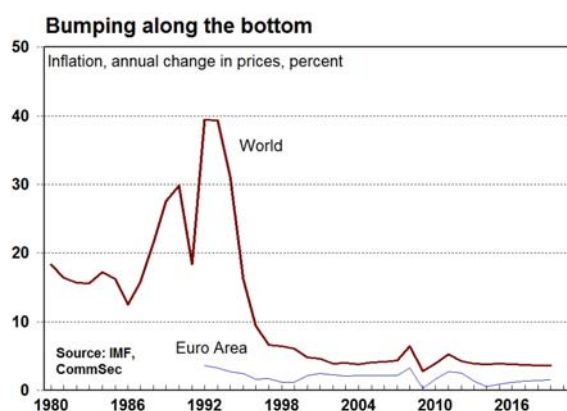
FORECASTS	2014	2015
Economic Growth	2.75-3.25%	2.75-3.25%
Underlying inflation	2.25-2.75%	2.25-2.75%
Unemployment	5.75-6.25%	5.50-6.00%
	mid 2015	*end 2015*
Cash rate	2.25-2.75%	2.50-3.00%
Sharemarket (All Ords)	5,800-6,000	6,000-6,200
Australian dollar	US80-87c	US79-86c

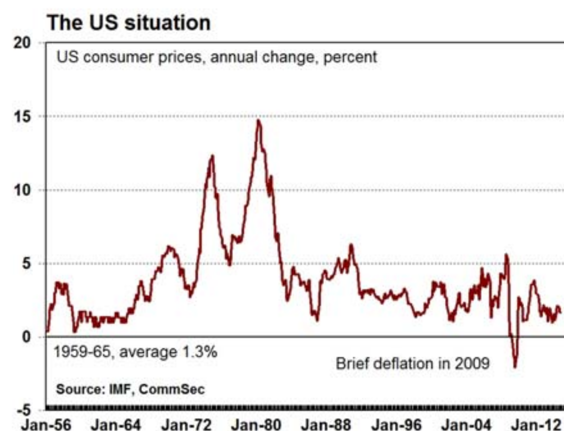
- The risk is that the Reserve Bank does nothing. With solid productivity and population growth, arguably the speed limit of the economy is closer to 3.5-4.0 per cent. And if the economy does pick up pace, inflation may not budge – influenced by lower oil prices and one of our key themes: absence of business pricing power. In fact, one of the left-field questions is: if the speed limit does remain high, the economy drifts and inflation eases – not rises – does the cautious Reserve Bank conclude that this is a new era, and keep interest rates low?
- The Aussie dollar should drift lower in line with softer commodity prices and a start to the rate-hiking process in the US. The European Union will continue to muddle along. The US economy will continue its path to 'normality'. China will continue its transition from industrial-driven growth to an economy underpinned by services sector development, rising household incomes and rising household spending.

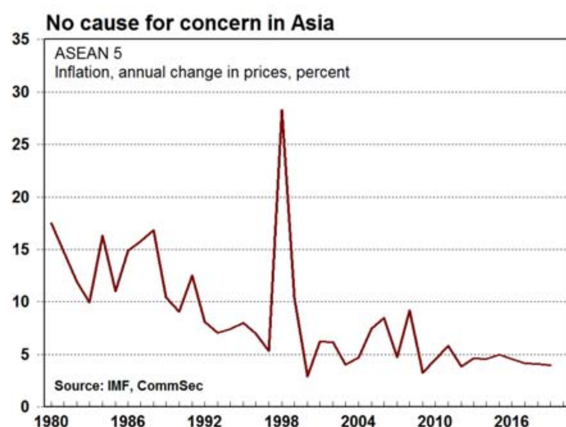


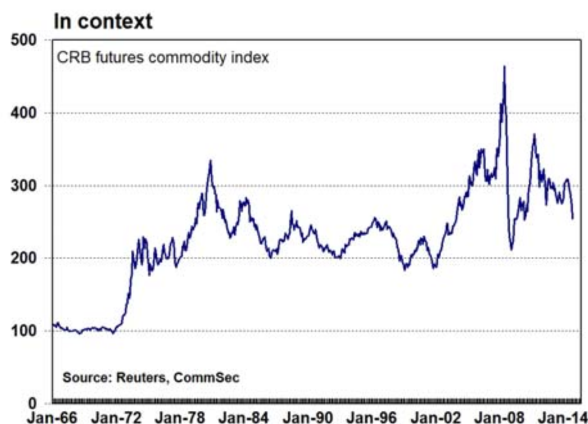
Is inflation dead?

- Murphy's Law would advocate that merely suggesting the possibility that inflation is dead would cause prices to starting spiking higher. But the issue that is occupying the minds of central bankers in the Northern Hemisphere is the potential for deflation.
- In last year's *Big Issues* we also included a similar item: *"Inflation or Deflation?"* It is quite remarkable, that with interest rates close to zero across many parts of the world and many central banks injecting stimulus via bond buying, that concerns about deflation still abound.
- In part it gets down to the sluggishness of economic growth in regions such as Europe, Japan and parts of Latin America. Central bankers are finding it hard to kick-start growth. This has occurred in the past, especially following financial crises. Confidence remains shaky; consumers and businesses are reluctant to take on debt; and governments are unsure the best way to move forward. Do they focus on kick-starting growth, say through infrastructure spending, or do they repair budgets and get debt under control first.
- But low inflation is also a consequence of a change in the commodity price cycle. China has largely moved through the ramp-up phase of industrialisation where demand for resources runs ahead of supply. Supply has now caught up, and rather than commodity prices pushing higher, they are moving south, injecting a deflationary pulse.
- Lower oil prices are adding to the deflationary concerns. But here the issue is different. Saudi Arabia is effectively trying to support its competitive position, and the position of OPEC more generally, in the global oil market. US energy production has been ramped up through shale oil, and in other economies, gas, 'green' energy solutions, and nuclear fuel.
- Another element in the overall mix is a change in the global business environment, and that brings us to the next issue…



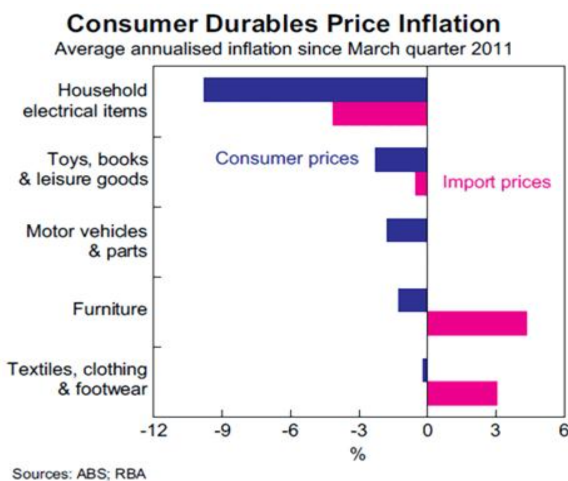


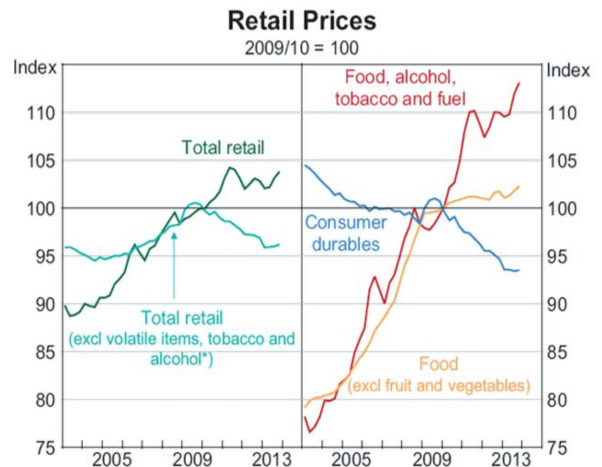


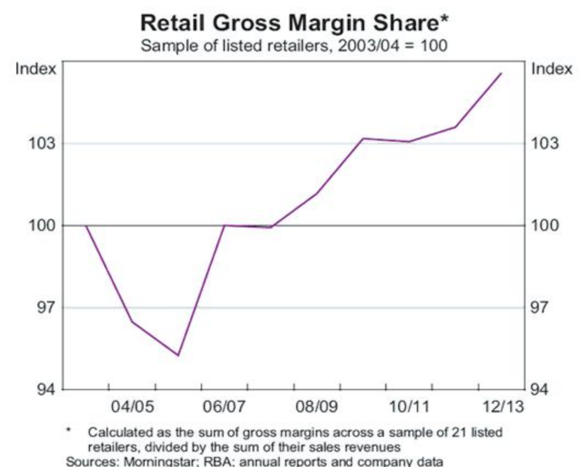


The end of corporate pricing power?

- We live in extraordinary times. A few years ago, only the tech savvy would consider buying goods over the internet. Initially most purchases were tech goods like software. But then consumers progressed to other relatively low value items including clothing. Now effectively anything within reason can be purchased on-line.
- Before internet shopping really began to take off, most retail-focussed small businesses were concerned with what their competitors in the same suburb were doing or competitors in neighbouring suburbs. Then that concern extended to competitors in the city, then the same state, the same country and now competitors can be found over the other side of the world.
- In the past the secret to successful businesses was pricing power. One definition of pricing power is: *"Pricing power measures the extent to which a business can pass on the increases in input costs to consumers through increases in the prices of finished goods." (Reserve Bank of India).*
- But while it is simple enough to get a definition of pricing power, obtaining data in an attempt to show trends over time is much harder to find. Certainly, anecdotally, many businesses will claim that it has become harder to pass on costs in terms of higher prices.
- The Australian Reserve Bank has looked at the issue of retail margins and retail prices on a number of occasions since 2012. A persistent focus of the discussion has been that recent declines in consumer durable prices have been more significant than traditional relationships such as with the exchange rate. The Reserve Bank observed that *"In particular, liaison with businesses suggests that competitive pressures have been particularly pronounced in the past few years, which may in turn be partly attributable to the increasing presence of online vendors, based in Australia and overseas."*
- While retail prices, especially durables, have fallen more than expected, the Reserve Bank suggests that it hasn't been at the expense of margins. Retailers have cut costs, improved efficiency and productivity and some have tried to reduce prices to wholesalers to keep costs down. So while increased competition may have increased downward pressure on prices, there are still responses open to businesses to keep profits growing.

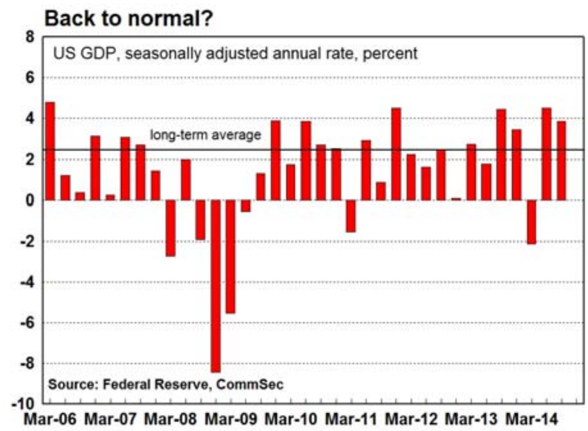


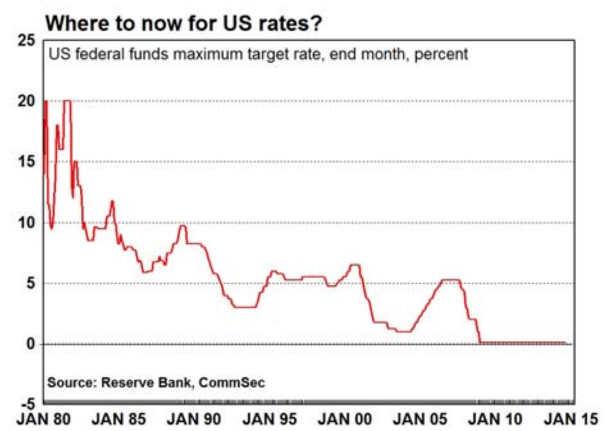


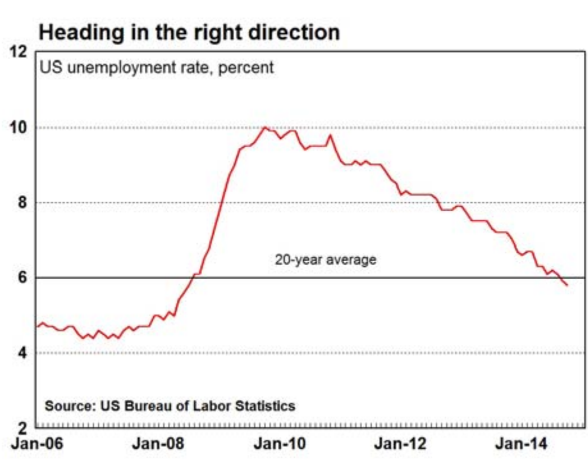


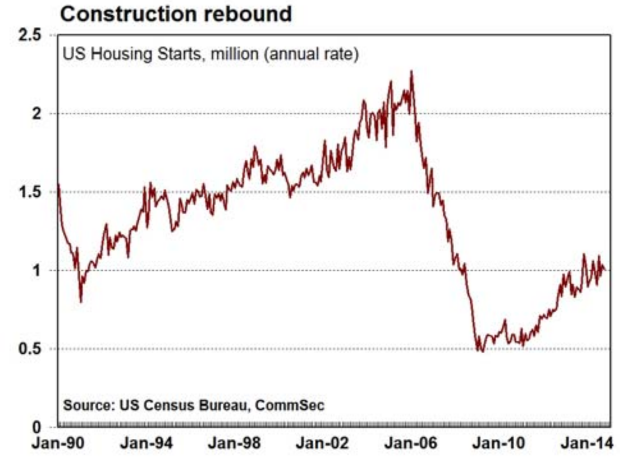
When will the US start lifting interest rates?

- It is a case of so far, so good for the US Federal Reserve. The economy is growing, in fact the current growth pace is above the long-term average. Unemployment has dropped below 6 per cent – lower than the jobless rate in Australia. Home building and manufacturing are expanding, sustaining economic momentum
- The Federal Reserve has also finished the extraordinary period of monetary stimulus – Quantitative Easing – or the bond buying program.
- With interest rates near zero, seemingly there are few obstacles to starting the 'normalisation process' of lifting rates to the 2-3 per cent region. But despite all the stimulus that has been applied, inflation remains historically-low. And the Federal Reserve believes that the labour market is not as tight as the unemployment rate would suggest.
- So the Federal Reserve has left open the timing of the first rate hike in the new cycle, indicating it is "data dependent". In a 'normal' cycle the risk of leaving rates too low for too long is that inflation could quickly take hold and it could prove hard to eradicate. But if rates are lifted too quickly then the risk is that the fledgling recovery could be put at risk.
- There is no mathematical model that can determine the right time to lift interest rates. But the bottom line is that the Federal Reserve's decision-making process will have consequences. A decision to lift rates could stem momentum in the sharemarket or serve to induce volatility. Higher US interest rates – either actual rate hikes or the threat of higher interest rates – may serve to push up the value of the US dollar and in turn drive down commodity prices.
- In short, investors need to stay alert to the timing and size of US rate hikes over 2015.



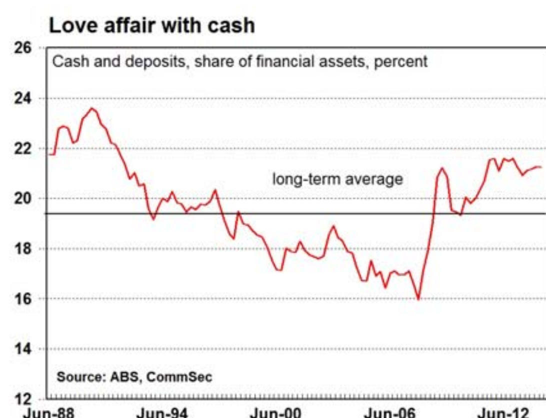


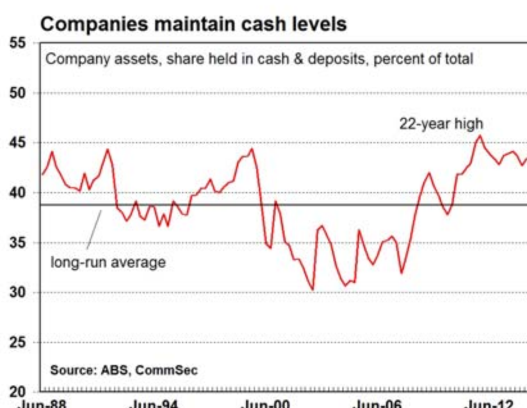


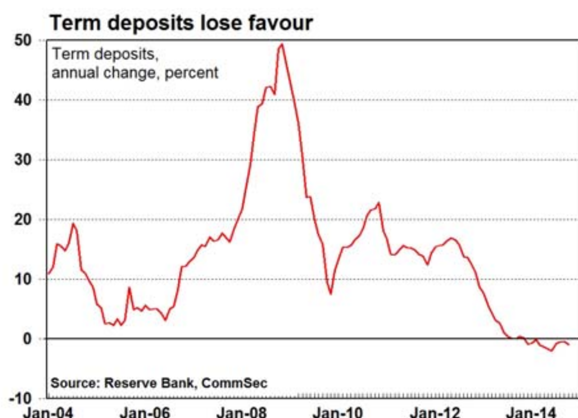


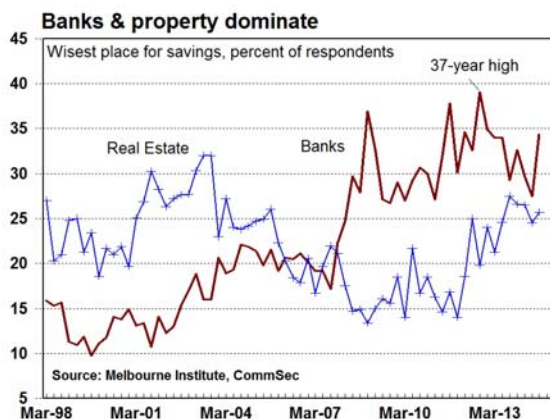
Where should investors put their money?

- Now some may say that determining the best place to invest is hardly one of the big issues for 2015 – isn't it an issue that comes up every year? But what makes the issue arguably more important in 2015 than in a normal year is the extent of conservatism that exists. Ever since the Global Financial Crisis (GFC), consumers, businesses and even fund managers have been maintaining a higher than 'normal' proportion of assets in cash or bank deposits.
- As at June 2014, 21.2 per cent of financial assets in Australia were held in cash or deposits. Over the previous 22 years the highest proportion of assets that had been held in these safe-haven investments was 21.6 per cent, so it is clear that conservatism reigns. And the share of assets currently held in cash or deposits is well above the long-term average of 19.6 per cent.
- The extent of caution is remarkable because it has been around six years since the GFC. And rather than the share of funds held in safe-haven assets easing toward the long-term average, it has held at remarkably stable levels near historic highs.
- Now certainly many Australians have embraced property over the past year, as evidenced by the angst over the growth of investment housing loans. But this has effectively led to is a polarisation of investment choices. When asked in September 2014 to select the 'wisest' place for saving, 60 per cent of respondents identified Banks (34.3 per cent) or Real Estate (25.7 per cent). That is the greatest extent of polarisation of investment choices in 20 years.
- Interestingly, while investors nominated Banks as the wisest place for savings, it is clear that many aren't keen on locking the funds away. The amount of money held in term deposits is lower than a year ago, and in fact negative annual growth has been maintained for the best part of a year. In contrast 'other deposits' with banks have grown at a 16 per cent annual rate over the past two years.
- In 2015, investors will have to give serious thought to greater diversification of their investments – especially as the easy gains in home prices now appear behind us. Returns on shares and property have tended to coalesce over time – over the past 15 years returns on both assets have averaged 10 per cent per annum.



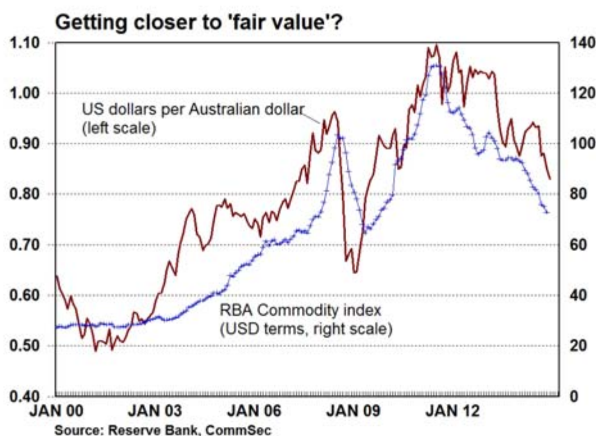


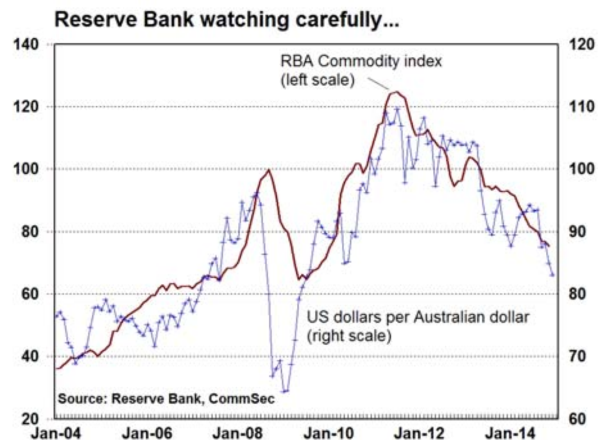


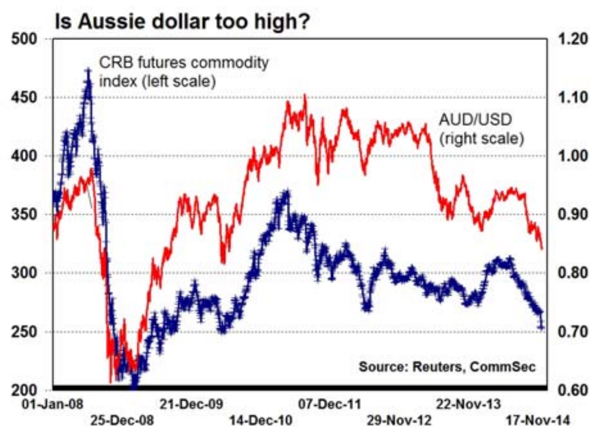


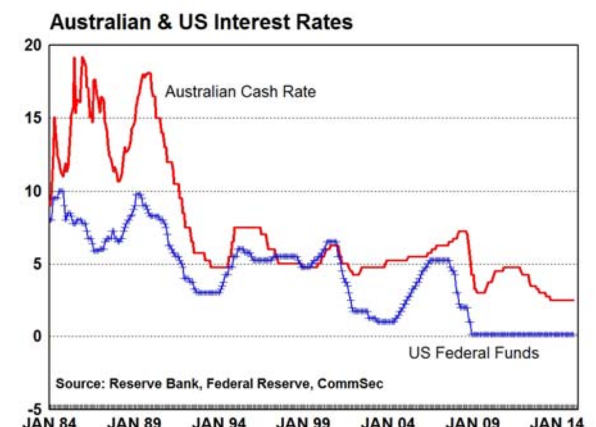
What is the 'fair value' of the Australian dollar?

- As with most of the *Big Issues*, we largely pose the questions, rather than providing definitive answers. What we are looking to identify are the main talking points in 2015. And just like in 2014, the value of the Aussie dollar will be uppermost in minds, affecting the sharemarket, interest rate and broader economic growth.
- The Reserve Bank clearly feels that the Aussie dollar is still too high. In announcing the last interest rate decision, the RBA noted: *"But the Australian dollar remains above most estimates of its fundamental value, particularly given the significant declines in key commodity prices in recent months. A lower exchange rate is likely to be needed to achieve balanced growth in the economy."*
- At the November decision when the Aussie was just over US87c, the RBA noted *"It is offering less assistance than would normally be expected in achieving balanced growth in the economy."* At the December decision the Aussie was near US85c. It is currently near US82.5c. So the RBA acknowledged that the currency had come down, and would offer some assistance in boosting growth, but explicitly suggested it should fall further.
- How far should it fall? The Reserve Bank hasn't told us. And of course the 'appropriate' level is a moving target. Commodity prices, economic statistics, politics and interest rates are constantly changing – here and overseas. And then there are geopolitical factors to consider.
- Measures of purchasing power parity, such as the Big Mac and CommSec iPad indexes suggest that the Aussie dollar is 'fairly' priced. Of course, these are more light-hearted approaches to assess currency valuations. Tracking a key daily commodity index such as the CRB Futures index since 2008, suggests that the Aussie dollar should be in the US70-80c range rather than between US80-85c.
- Using the Reserve Bank's commodity index – either in US dollar terms or 'currency-neutral' SDR terms – suggests an Aussie dollar in the US75-85c range seems more appropriate. No doubt the RBA would argue that a currency in the bottom of the range would be more helpful in rebalancing the economy from mining to non-mining sectors.









Does Europe Still Matter?

- The International Monetary Fund updated its database in October. And the latest data shows that the US still dominates the list of the world's largest economies. That is, if you express the data in US dollar terms. If you use purchasing power parity as a means for comparison, the IMF data shows China with a 16.5 per cent share in 2014, ahead of the US with 16.3 per cent.
- But if we stick to US dollars for comparison, there were seven European economies in the list of the 20 largest global economies. That group includes the UK, but excludes Russia and Turkey. Together, these seven nations accounted for around 19 per cent of the global economy.
- But when it comes to assessing the countries that are largely responsible for driving global growth (share of world economy times economic growth) only the UK and Germany are listed as major contributors in 2014. And indeed the major seven European nations will add just 0.24 percentage points out of the 3.3 per cent expected growth for the world economy.
- So does Europe matter? At present, it is clear that the focus is elsewhere – largely in Asia. The European Union accounts for 23.7 per cent of the global economy and the Euro Area 17.1 per cent, well behind *Emerging market and developing nations* at 39.3 per cent. In 2008, the EU was bigger. In 2016, the EU will represent a smaller share of world GDP than Asia. Investors need to adjust their view.

World's largest economies estimate 2014, US$ billion

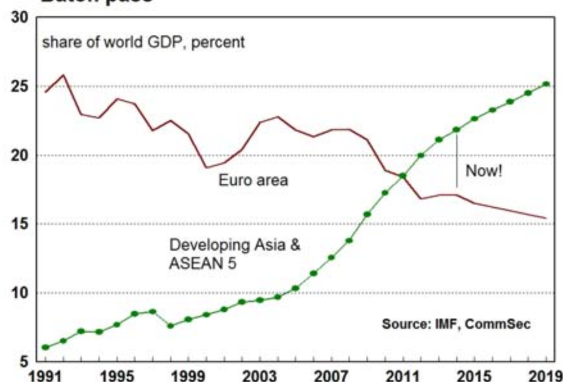
1	United States	$17,416.3
2	China	$10,355.4
3	Japan	$4,769.8
4	Germany	$3,820.5
5	France	$2,902.3
6	United Kingdom	$2,847.6
7	Brazil	$2,244.1
8	Italy	$2,129.3
9	Russia	$2,057.3
10	India	$2,047.8
11	Canada	$1,793.8
12	Australia	$1,482.5
13	Korea	$1,449.5
14	Spain	$1,400.5
15	Mexico	$1,295.9
16	Netherlands	$880.4
17	Indonesia	$856.1
18	Turkey	$813.3
19	Saudi Arabia	$777.9
20	Switzerland	$679.0

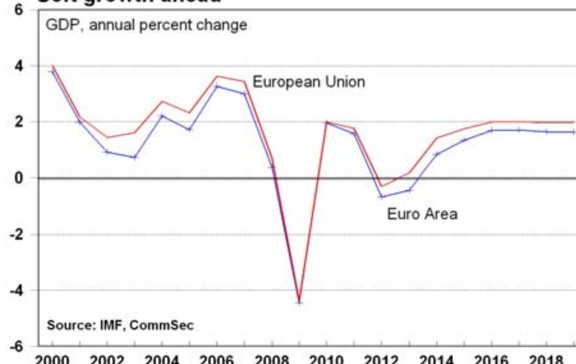
Source: IMF, CommSec

Drivers of world economy
Contribution to growth 2014 percentage points

China	0.99
United States	0.50
India	0.15
United Kingdom	0.12
Korea	0.07
Germany	0.07
Indonesia	0.06
Japan	0.06
Nigeria	0.05
Australia	0.05
Canada	0.05
Saudi Arabia	0.05
Mexico	0.04
Turkey	0.03
Other countries	1.10
WORLD	***3.3***

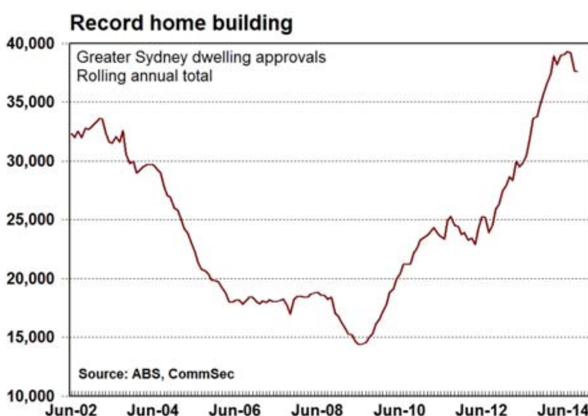
Source: IMF, CommSec

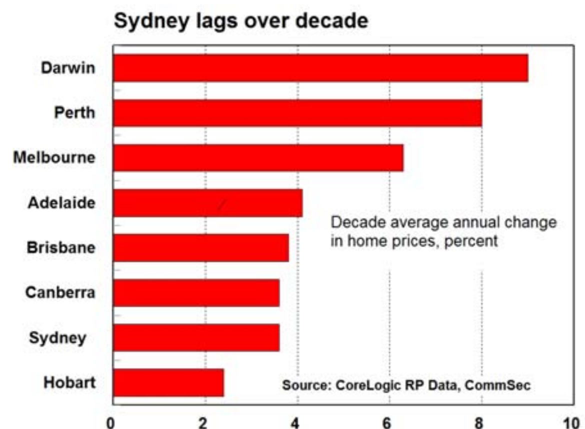


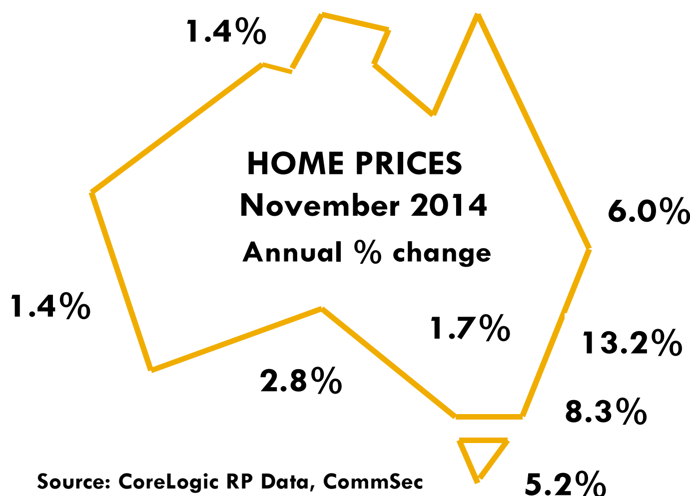


Will home prices slip or slump?

- It doesn't seem to matter what shape the broader economic environment is in, there will always be some concern about the housing market. Seemingly home prices are always either running too hot, or alternatively prices are falling and putting at risk the wealth levels of Australians. Or there are concerns that home building is either too strong, creating the risk of over-supply, or that there is not enough building occurring, leading to rental auctions.
- And indeed over the past five years we have probably heard all these assertions. In the current environment, the main worry is that home prices are rising too strongly, resulting in some weakening of affordability levels of first home buyers.
- Worries about the strength of home prices are largely centred on Sydney, and to a lesser extent Melbourne. In November, Sydney home prices were up by 13.2 per cent on a year ago with house prices up by 14.3 per cent. And while this is lofty price growth, it is actually slower than the 16.7 per cent annual growth pace in April.
- But Sydney home prices are merely responding to a shortage of supply as well as strong demand. A year ago the rental vacancy rate in Sydney was 1.6 per cent – an 18-month low and not far from the record low of 1.3 per cent.
- Interest rates are low, new building has been weak, returns outside housing have been low for investors and population has been rising. So Sydney home prices have just been playing catch-up. Over the last decade Sydney home prices have risen by just 3.6 per cent on average per year, the second lowest of the capital cities.
- But the supply is starting to rise. In the year to July just over 39,000 new dwellings were approved for construction. Over the next 12-18 months a record supply of stock will flood the market, leading to softer growth of home prices and potentially softer rents. In just four years, home building has doubled. But with the rental vacancy rate still low in Sydney, prices seem more likely to slip, rather than slump, and this will serve to reduce home price momentum in other regions.

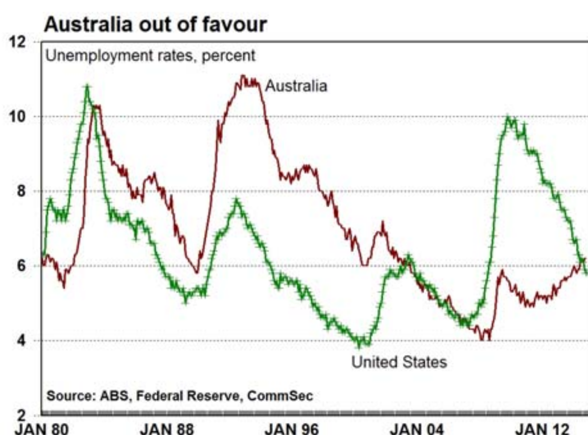


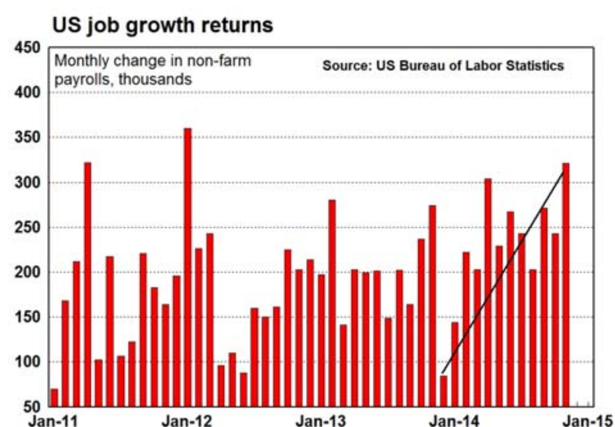


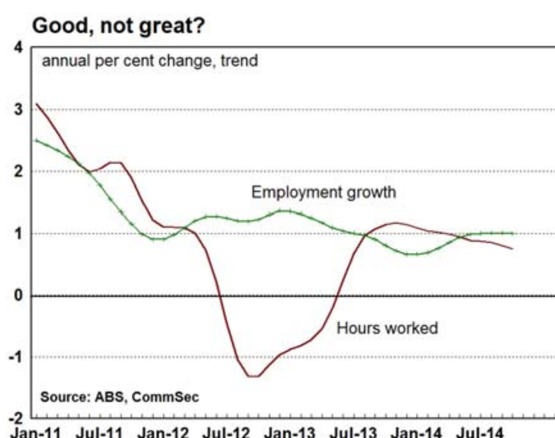


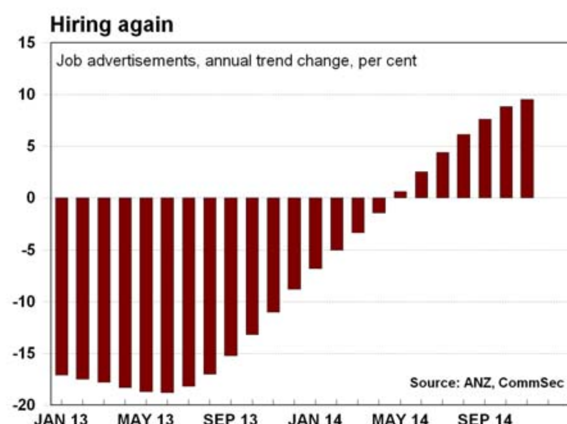
What shape is the job market really in?

- In both the US and Australia, the fate of interest rates remains very much in the hands of the job market. In the US, the Federal Reserve policymakers have taken the view that there is still is considerable slack in the job market despite stronger job gains and lower unemployment.
- After the out-sized 321,000 lift in November non-farm payrolls (employment), the Federal Reserve will no doubt re-assess its views. Not only was employment up the most in three years but there were upward revisions in previous months' data and hourly wages rose. In short, the Fed may be getting closer to raising interest rates.
- In Australia, the job market has proved volatile, leading many to question the veracity of the data. For some, it's the definition of employment. According to the survey conducted by the Bureau of Statistics, someone is classified as "employed" if they *"worked for one hour or more for pay, profit, commission or payment in kind in a job or business, or on a farm (comprising employees, employers and own account workers)."*
- If it only takes an hour of work for someone to be classified as employed, then that clearly overstates the level of unemployment. Or does it? The same definition has been in place for over 20 years. So if unemployment has been understated, it's been understated over the entire period.
- And one of the best ways to cross-check the jobs data is to use the Census results – a 'population' survey rather than a 'sample' survey. At the time of the Census on August 9 2011, the proportion of people who reported that they were over 15 years of age, in the workforce and unemployed was 5.6 per cent. The unadjusted monthly unemployment estimate in the Labour Force Survey in August 2011 was 5.1 per cent while the seasonally adjusted estimate was 5.3 per cent. In other words, the results were very close despite numerous differences in the scope and methodology of the two surveys.
- Whether the Reserve Bank elects to cut rates again or hold rates steady, much will depend on its assessment of the job market, where it's headed, and what it means for wages and prices.









Rewind: The Big Issues for 2014

- As we noted at the start of this report, we have been producing ***Big Issues*** for over a decade. And it is interesting – and perhaps even instructive – to rewind over the past year and assess what we had on the radar screen.
- Looking ahead into 2014, we highlighted eight issues. And the first issue was *The US 'taper'.* The reason why we highlighted it, is because we felt that uncertainty about the size and pace of the winding back of bond purchases would affect interest rates, sharemarkets and exchange rates. And indeed there has been volatility around the time of Federal Reserve meetings and when Federal Reserve members have given speeches. Interestingly, now that the taper has ended, the issue that has taken its place is the uncertainty about when rate hikes will begin.

BIG ISSUES OF 2014
The US 'taper'
Inflation or Deflation?
Housing boom or just a 'normal' recovery?
The rebalancing of China
The reshaping of Australia
Aussie dollar to slip or slump?
Will New Conservatism continue?
A new glory era for interest rates?

- Another of the Big Issues was *Inflation or Deflation?.* And as is clear from preceding pages, this issue has made a return this year with good reason – it still occupies the thinking of Northern Hemisphere central banks more than any other issue.
- We were right to highlight the issue: *Housing boom or just a 'normal' recovery?.* Because while other central banks have worried about inflation, the Reserve Bank has debated whether so-called Macro-Prudential controls were needed to deal with exuberant borrowing by property investors.
- Again, we believe that we were right in highlighting *The rebalancing of China* as a Big Issue for 2014. China is transitioning from an industrial powerhouse to an economy driven by the services sector. The economy has slowed over 2014 but the absolute contribution to the world economy remains bigger than any other economy.
- Along a similar theme we highlighted the issue: *The reshaping of Australia.* It may not have elicited the same focus and attention as some of the other issues, but in February, Toyota followed the lead of Holden and Ford in announcing the closure of car manufacturing in Australia. But more positively was the November announcement of the China-Australia free trade agreement that further threw the spotlight on industrial change.
- For financial markets, the fluctuations of the Aussie dollar held court and many echoed our Big Issue: *Aussie dollar to slip or slump?.* We noted *"Over 2014 our currency strategists expect a similar trading range (to 2013), with the Aussie likely holding from the low US80s to the mid US90s."* We were in the 'slip' not 'slump' camp and this proved to be the case.
- Last year we posed the question: *Will New Conservatism continue?* In the end, the answer was in the affirmative – much to the chagrin of the Reserve Bank Governor – he delivered a speech as recently as mid November, encouraging businesses to invest more in their operations rather than sitting on cash reserves.
- And we also posed another question: *A new glory era for interest rates?*. While we neglected to answer the question, we did note: *"If inflation remains under control, there is no fundamental need to lift interest rates markedly."* And simply inflation was well contained in 2014, resulting in the cash rate remaining unchanged for the entire year. At present the jury is out on whether deflationary tendencies will dominate in 2015. So we could very well be headed for an era like the 1950s and 1960s when interest rates consistently held at low levels. Good news for borrowers; more challenging for investors.

Craig James, Chief Economist, CommSec

Savanth Sebastian, Economist, CommSec

The Big Issues 2014

CommSec

The Big Issues of 2014

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BIG ISSUES OF 2014

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The Big Issues for 2014

- For over a decade we have produced *"The Big Issues"* report – a report that has sought to highlight issues that are expected to influence the economy over the forthcoming 12 months.
- Now this is no crystal ball gazing exercise. The aim is not just to forecast where certain economic variables are likely to be in a year's time. Rather the focus has been to highlight trends, issues and 'big picture' influences that act as threats or opportunities for consumers, investors and businesses alike.
- The aim has been to produce a highly readable, relatively jargon-free document. Probably today we could call this a blog. But the intention over time has been to produce commentary that causes people to think and ask the 'so what' question – that is, to determine what this means for their own circumstances.
- And this year we are simplifying it even further by reducing the amount of text and letting the pictures speak for themselves. Certainly one of the great innovations over the past year has been the infographic. They say that a picture should tell a thousand words. That is the principle behind the infographic. And that should be the case for economic charts more generally.

Craig James – Chief Economist (Author)

Savanth Sebastian – Economist (Author)

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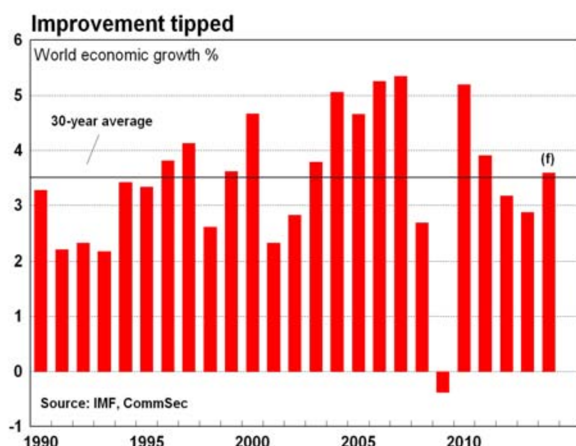
…But First…The Economic Outlook for 2014

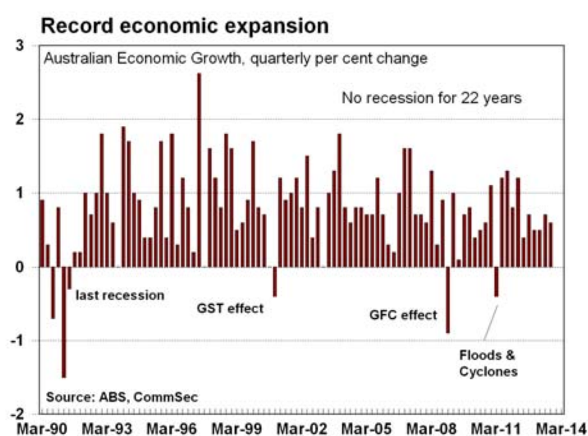
- Quite simply, the Australian economy struggled to get out of third gear over much of 2013. But we are hopeful that the economy will finally find fourth gear over the 2014 year.
- The main culprit holding back the economy in 2013 was the election. Businesses and consumers simply weren't prepared to ramp up spending, investment and employment until the election was out of the road. But the economy was also in the transition phase with mining investment topping out while home construction and mining exports were just starting to find their feet.

FORECASTS

	2013	*2014*
Economic Growth	2.25-2.75%	2.75-3.25%
Underlying inflation	2.25-2.50%	2.50-3.00%
Unemployment	5.50-6.00%	5.50-6.00%
	mid 2014	*end 2014*
Cash rate	2.25-2.50%	2.25-2.75%
Sharemarket (All Ords)	5,300-5,500	5,400-5,700
Australian dollar	US88-94c	US87-92c

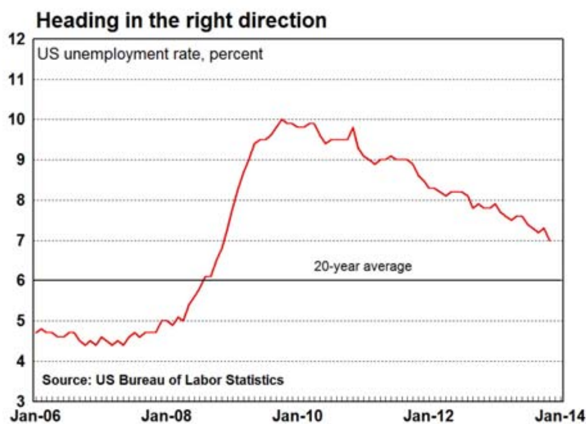
- There were also the budget problems in the US with enforced spending cuts serving to slow economic growth. And China struggled to get past issues in the financial system. But by the end of 2013, growth had picked up in the US and China, and it was looking more promising in Europe.
- In line with other forecasters such as the International Monetary Fund, we expect that global economic growth will return to near 'normal' around 3.5 per cent in 2014. One of the main risks is central bank 'tapering' or the winding back of stimulus. Take too long to 'taper' and you risk higher inflation. And if you 'taper' too early you may risk de-railing the economic recovery.
- In Australia, we expect that home building and mining exports will pick up the baton from mining construction in 2014 to drive economic growth. And with the election out of the road, home prices rising and a better tone in evidence in the global economy, we expect that consumers will open their wallets a little wider while businesses should respond by lifting hiring and investment. Unemployment could prove reasonably stable with upside risks earlier in 2014 giving way to downside risks as 2014 progresses.
- One of the main risks domestically is that the Federal Government is too aggressive in tightening budget spending, rather than relying on stronger economic growth to boost government revenues and thus reduce the size of the budget deficit.
- If fiscal or budget policy is too tight, the Reserve Bank may provide some offset by cutting interest rates. But while there is the risk that the Reserve Bank will cut rates one more time in the first half of 2014, in the second half of 2014 the risk will shift to higher interest rates as economic growth returns to "normal".
- Turning to the Aussie dollar, over 2013 the currency tracked a US17.5 cent range. For 2014, our currency strategists warn about similar volatility and "expect a similar range (to 2013) and should see mid-0.9000s and low 0.8000s trade."

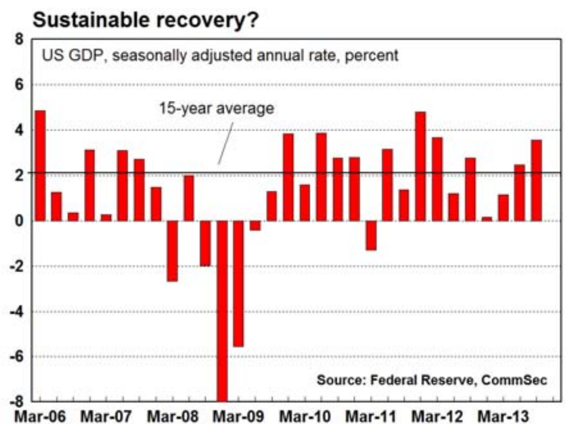


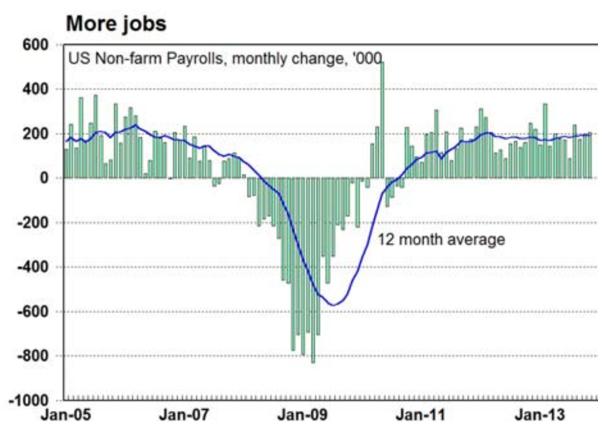


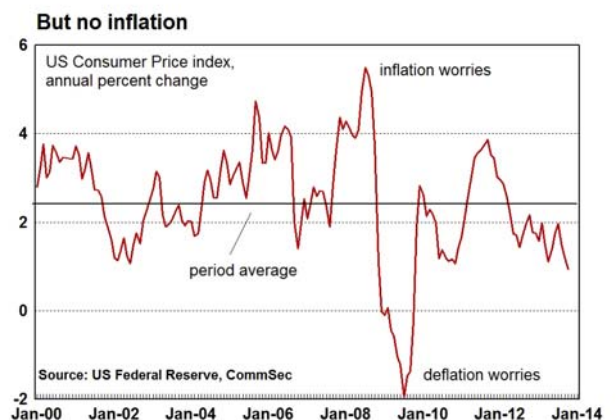
The US ‘taper’

- There have been numerous column inches devoted to the US ‘taper’, that is the winding back of monetary stimulus or the ‘tapering’ of bond purchases. Everyone is agreed that the Federal Reserve needs to pull back stimulus at some point; the hard part is in working out when is the ‘right’ time to do it.
- Well the issue could get resolved on Thursday morning (Sydney time). Or the Federal Reserve could wait a little longer. But overall we shouldn’t get too worked up about the timing – unless you are a financial markets trader making bets on when it will happen.
- As the Reserve Bank Governor counsels, the ‘taper’ will lead to short term volatility on financial markets but the longer-term implications are more positive. Sharemarket investors may fret that the days of cheap money (free money?) are coming to an end, but if the Federal Reserve is toying with the idea of taking the foot off the throttle – even just modestly – that signifies that the economy is doing better. And in a better-performing economy, spending grows and businesses invest and hire staff, and that clearly is positive for revenue and profits.
- What it also means is that global investors will favour the US as an investment destination, perhaps to a greater extent than emerging nations. Following the global financial crisis it has been the emerging nations that have had healthier economies than western nations – that is, Europe and the US.
- As has been apparent since talk of the ‘taper’ has heated up, the greenback is back in favour, and as a result safe havens such as the Aussie dollar (yes, hard to believe, but Australia has been in favour due to economic strength) have lost support. Many Aussie businesses would argue that this is good news – clearly the Reserve Bank governor does, favouring a currency near US85 cents.



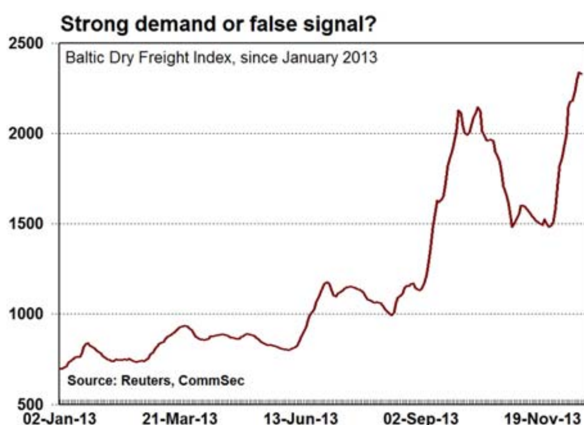


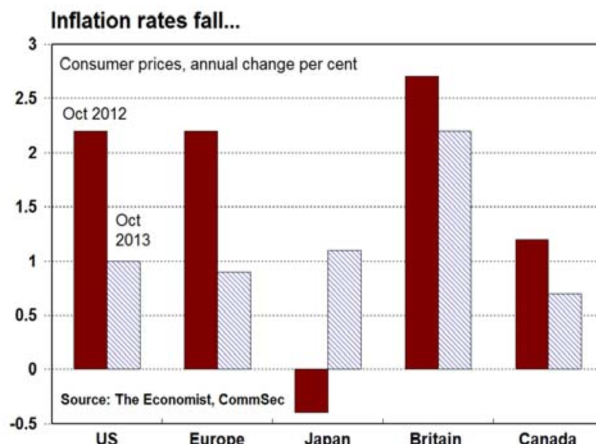


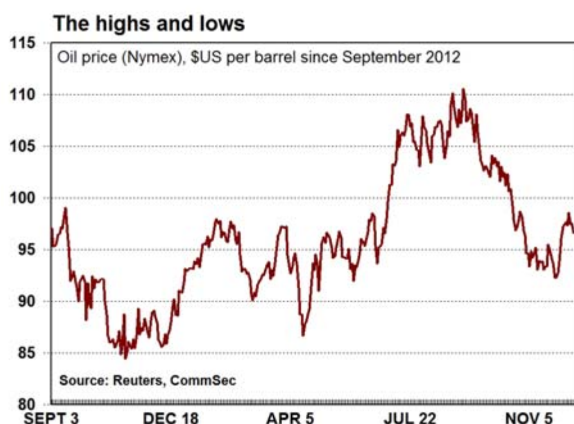


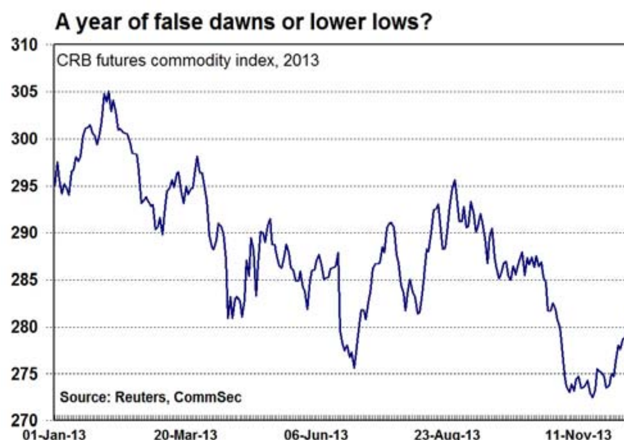
Inflation or deflation?

- In many parts of the so-called 'advanced' world, interest rates are at or near zero. And in the US, Japan and the UK, central banks have gone further to stimulate economies, buying securities from financial institutions in exchange for cash (quantitative easing). But despite all their efforts, inflation rates in many parts of the western world are lower now than a year ago. One exception is Japan where Prime Minister Abe is determined to get the economy going and end the period of deflation – so-called 'Abenomics'. And he has achieved some success with consumer prices up 1.1 per cent on a year ago after falling by 0.4 per cent in 2012.
- With more money circulating and chasing fewer goods, the assumption is that inflation will follow. To date, it hasn't really happened. That doesn't mean that inflation won't return though – much depends on animal spirits or confidence. If consumers get confident that the bad news has finally ended, then they will start to spend with more gusto. And clearly central banks must be watchful, closely monitoring any indicators that suggest that inflation is making a return.
- In terms of nascent inflation, some analysts would highlight a major lift in the Baltic Dry freight index, an index of shipping costs for dry commodities like iron ore, coal and wheat. The Baltic Dry index has lifted 57 per cent in the space of three weeks. If freight costs are rising because there is stronger demand for commodities, then it's possible that actual raw material costs will also rise, leading to higher prices for consumer finished goods.
- If inflation starts creeping higher, it's a positive development, not negative. It means that economic growth is returning. But it also means that central banks need to be vigilant and make sure that a little inflation doesn't become a lot, necessitating sharply higher interest rates that could actually choke off economic recoveries.



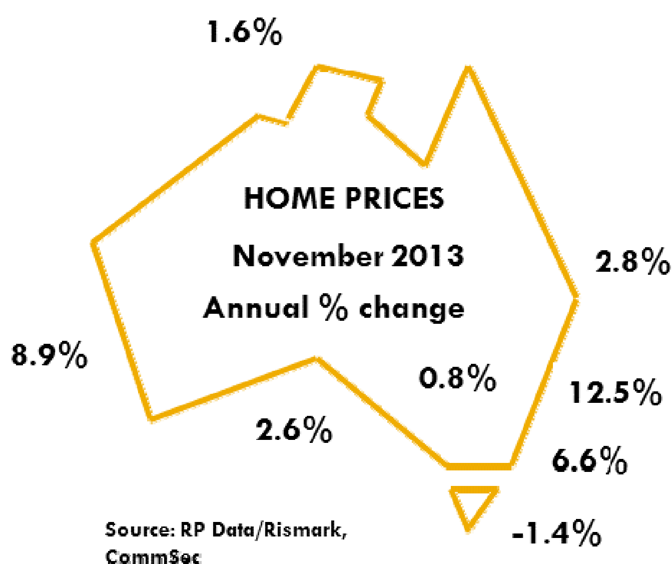


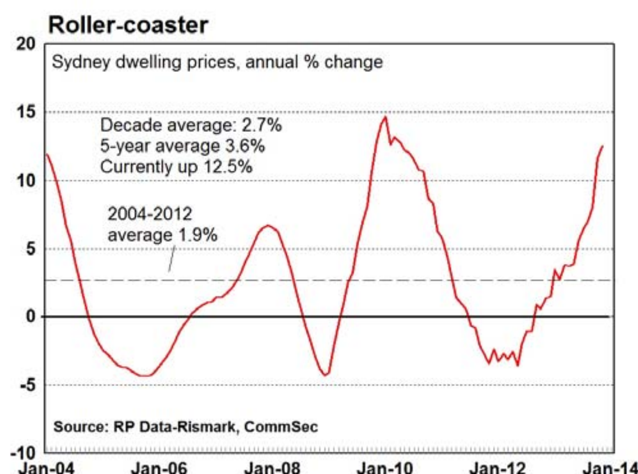


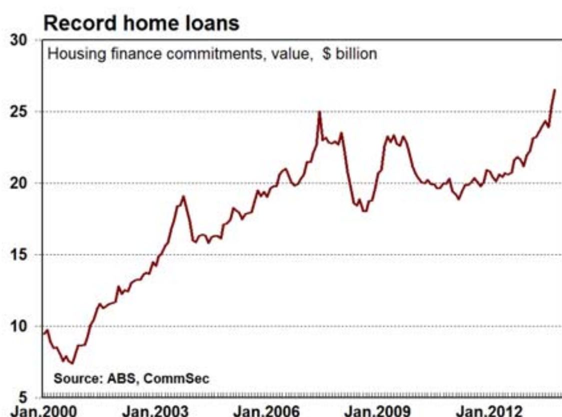


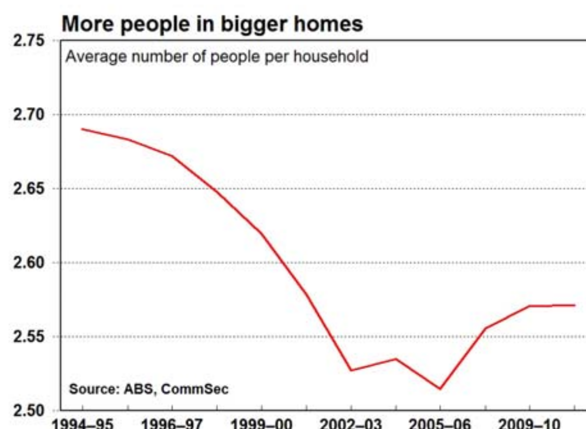
Housing boom or just a 'normal' recovery?

- Some commentators are looking at the Sydney housing market and concluding that a boom is underway. And the perception is that, as sure as night follows day, if there is a boom, clearly there follows that there will be a bust.
- But home owners and buyers in other parts of the country will say that if there is a boom or bubble in the Sydney housing market, why isn't there similar trends elsewhere. Because similar drivers are at play across Australia. Housing interest rates are low; state governments are providing grants for new construction; rental markets are tight in many parts of the country; and investors are actively diversifying into housing from cash-based investments.
- But interestingly the Reserve Bank isn't worried about a housing boom – not yet anyhow. Still, it is warning investors not to pay over the top and to realise that property prices can go up as well as go down.
- Also Sydney is an 'outlier' with home prices growing at a slower rate than inflation for a long time. It was only 16 months ago that home prices were falling on an annual basis. Also, encouragingly, new home construction (supply) is lifting to meet the higher demand. And once that supply comes on to the market then growth in home prices is likely to ease.
- It will also be important to watch trends like the number of people in each home. If household size continues to increase, then the extra supply could actually lead to a marked softening of home prices.



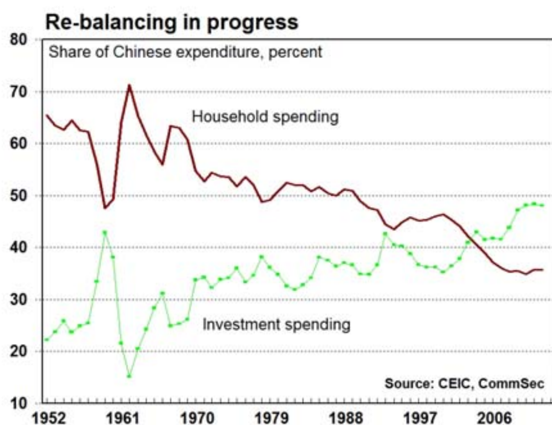


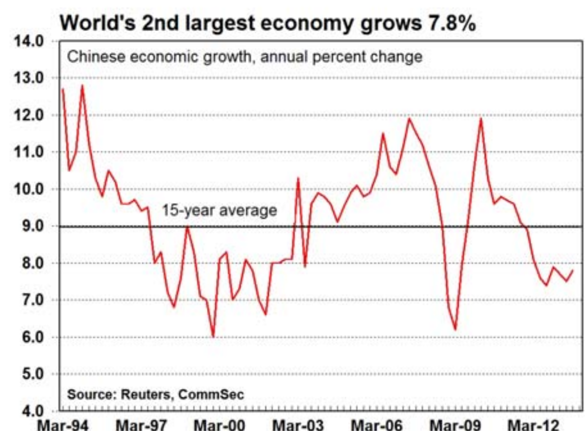


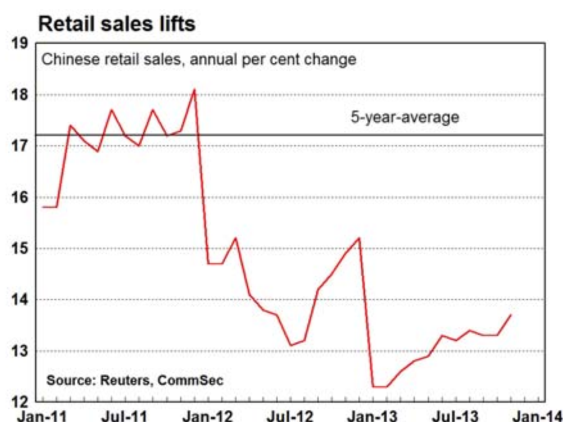


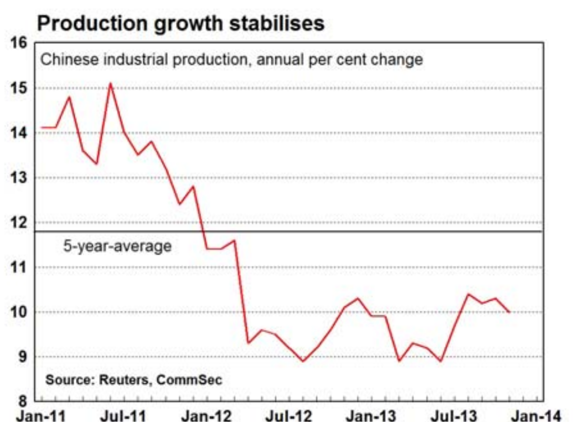
The rebalancing of China

- The new Chinese leadership wants the country to more closely emulate western industrialised nations where household spending plays a greater role in driving economic growth. For instance in the latest national accounts in Australia, household consumption accounted for 55 per cent of the economy (GDP or Gross Domestic Product). In China, the available 2012 data indicated that household spending accounted for almost 36 per cent of the economy with the government sector at 13.5 per cent of GDP; investment at 48 per cent of GDP and net exports at almost 3 per cent of GDP.
- If consumer spending grows at a faster rate, then Chinese consumers are more likely to feel that they are benefitting from the expansion of the economy. And in terms of social stability, that is an important factor. Further, there is concern that some provinces may be over-investing in the cities, and those concerns are more likely to be dispelled if growth of retail sales exceeds that of production or fixed-asset investment.
- Encouragingly after the Third Plenum, the Chinese leadership quickly unveiled a 60 point reform plan. The plan includes provisions allowing for farmers to directly sell land holdings as well as permitting the private sector to compete with state-owned enterprises and allowing market forces to play a greater role in the provision of resources and infrastructure.
- Implementation of reforms, and progress on boosting household spending in preference to the industrial sector, will be important considerations for Australia's resource producers.









The reshaping of Australia

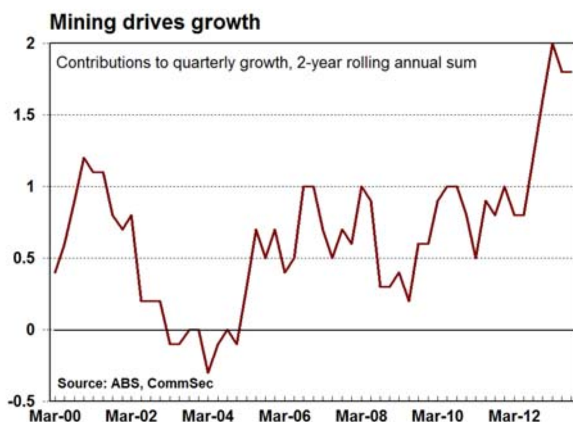
- Since 2008 the Australian economy has grown by 14.3 per cent. Of that growth, Mining has contributed 3.2 percentage points (pp) of which iron ore alone has added 2.3pp. But not far behind is Health Care (1.7pp), Professional services (1.6pp) and Construction (1.4pp).
- At the other end of the scale, Manufacturing has sliced 0.4pp off growth, while Arts, Agriculture, Transport, Education and Utilities all added nothing to Australia's economic growth.
- So it is clear that Australia has been riding on the back of iron ore (as opposed to riding the sheep's back in the 1950s).
- In the coming year Mining will pull back, but there is plenty of scope for other sectors to grow. In the equivalent five year period before 2008, from 2002-2007, the economy grew 19.8 per cent with Finance (3.1pp), Construction (2.6pp) and Health Care (1.4pp) the main contributors to growth.
- The drivers of the Australian economy regularly change and indeed they will again over coming years as the mining construction boom fades and mining exports take over. But clearly other sectors will pick up the slack, with Construction – in particular home construction – the most likely candidate.

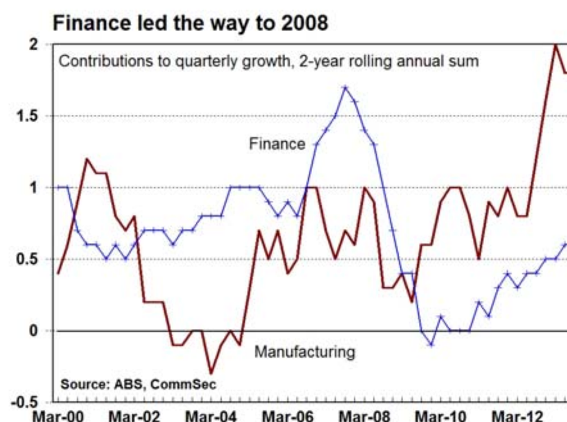
AUSTRALIAN INDUSTRY

Selected Industry Sectors, share of GDP %

	1975	1985	1995	2005	2013
Mining	6.8	6.8	8.5	7.9	9.8
Finance	4.1	4.1	6.0	7.2	8.0
Construction	6.5	6.0	5.5	6.5	7.6
Manufacturing	13.8	11.8	10.2	8.6	6.8
Professional services	3.6	3.8	5.1	5.8	6.6
Public Administration	6.4	6.2	6.0	5.3	5.2
Transport	3.8	4.3	4.4	4.7	4.8
Education	4.7	5.5	5.4	4.7	4.5
Retail Trade	4.5	4.5	4.1	4.6	4.5
Wholesale trade	5.0	4.2	4.0	4.2	4.2

Source: ABS, CommSec



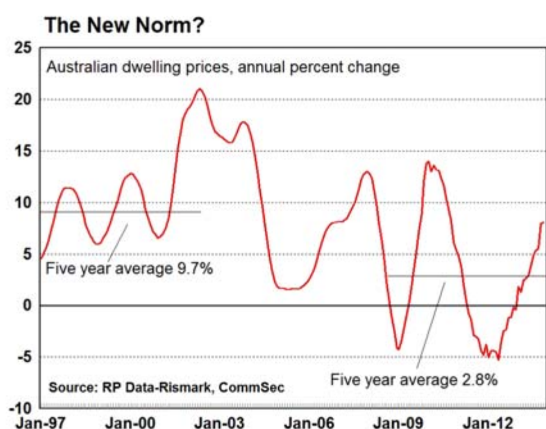


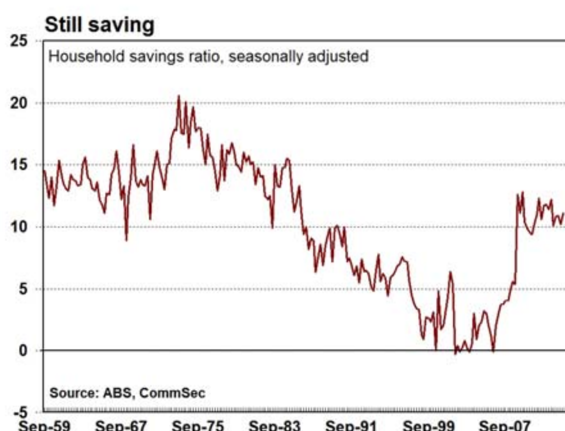
Aussie dollar to slip or slump?

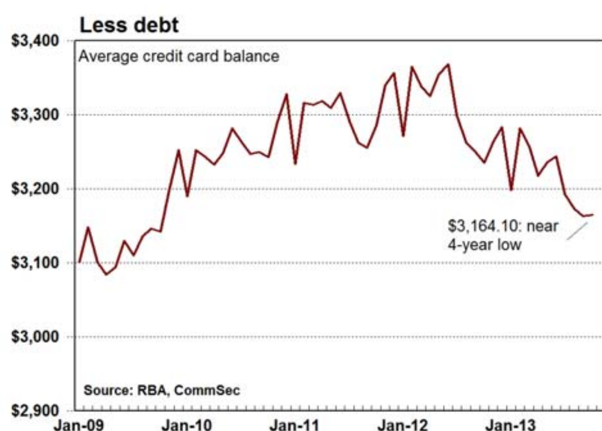
- Over the past 40 calendar years the Aussie dollar has, on average, tracked a range of US13.7 cents a year or 17.1 per cent. Since the dollar floated the range has been US14.3 cents a year or 18.8 per cent. And over 2013 so far the range has been US17.5 cents or 16.9 per cent. In short, the Aussie dollar is volatile and 2013 has been a year of above-average volatility.
- Over 2014 our currency strategists expect a similar trading range, with the Aussie likely holding from the low US80s to the mid US90s. Certainly the Reserve Bank Governor has recently indicated that he thought the Australian dollar should be closer to US85 cents, rather than near US90 cents currently. Much will depend on the recovery path of the US economy and the extent of tapering undertaken by the Federal Reserve.
- While the factors holding up the Aussie dollar were numerous in early 2013, now they largely amount to relatively high domestic interest rates, high credit rating and relatively low budget deficit and government debt. Clearly many businesses would love to see an Aussie dollar settling in the low to mid US80s. The extent of currency depreciation will be important for companies with significant overseas earnings including major miners, building material companies, property owners and healthcare product companies. A softer Aussie dollar could lead to some import good inflation but it may mean that Aussie consumers stay closer to home, rather than travel, and buy locally, than overseas.

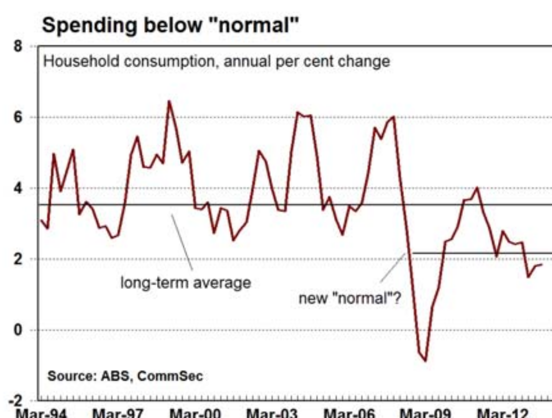
Will new conservatism continue?

- The conservatism of Australian consumers has been one of the big trends of the past five years. Aussies are saving, not spending. They are more likely to leave money in the bank rather than put money to work elsewhere (although more recently investors have become keen on property again).
- Consumers will also shop around for bargains. And it hasn't just been inherent fiscal conservatism but the internet that has driven this tendency together with a relative firm currency. The internet has allowed consumers to do product comparisons and undertake online shopping – not just in Australia and overseas. Of course the high Aussie dollar has opened the world to shoppers, keeping downward pressure on retail prices and margins here in Australia.
- Some will claim that the new-found conservatism began with the global financial crisis. But it actually began a few years earlier, in part because of slower growth in home prices – and asset prices more generally, lower inflation and lower interest rates.
- From 1997 to 2004, Australian home prices grew by 12.6 per cent a year. Since mid-2004, home prices have grown by 4.2 per cent a year. And price growth averaged 6.2 per cent – half that of 1997-2004 ahead of the GFC, from 2004-2007.
- If the conservatism continues, then this will mean a continuation or more thoughtful spending and reduced debt levels, meaning that inflation remains under control and interest rates stay lower for longer. Retailers will need to keep costs down, together with margins and they will have to compete harder to improve customer service to lift revenues. Because simply, global competition is here to stay, even if the Aussie dollar eases further.
- Certainly Generation Y is a big driver of the New Conservatism, shunning debt, preferring "experiences" to home ownership, and using technology extensively to select and purchase goods. But baby boomers and Gen X have also had to change, not able to rely on the high growth of home prices of the past.



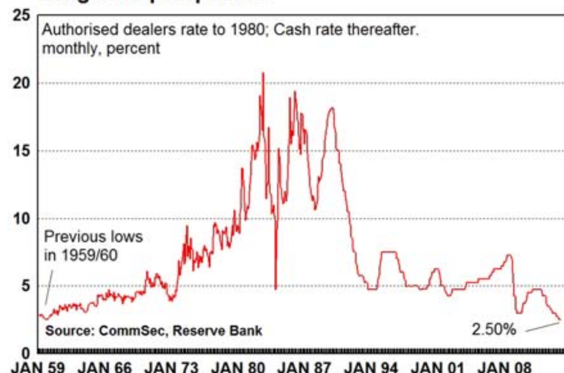


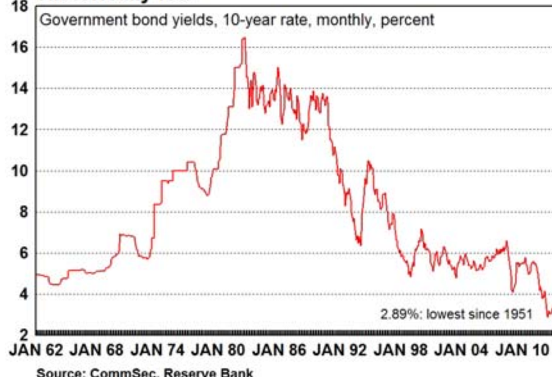


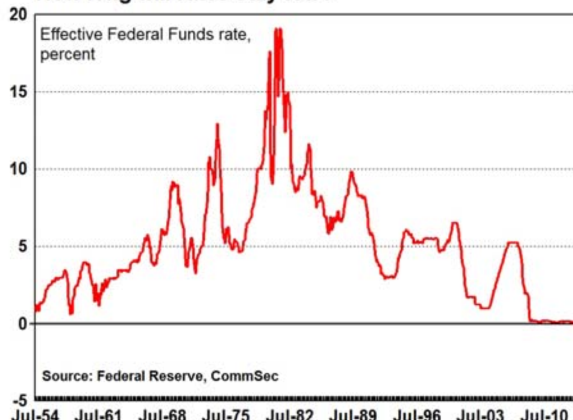


A new glory era for interest rates?

- Over 2013, the cash rate has averaged 2.75 per cent. – the lowest calendar year average since 1959. So while people can debate whether rates are at record lows or not, there is no debate about the last time period that rates have been this low – it was 54 years ago, back in 1959.
- But while cash rates, bank bill rates and short-term government bond/interest rate swap yields hit historical lows on average over 2013, yields on medium to longer-term securities were slightly higher. Yields on 10-year bonds have averaged 3.70 per cent in 2013, up from 3.42 per cent in 2012.
- Simply, investors and traders perceive that the global economy is in recovery mode, although, as it has been noted earlier, this hasn't been reflected in higher inflation rates across the developed world. And indeed that is an important consideration. As just as we noted above that global competition is a key factor causing Aussie retailers to keep margins and prices down, clearly the same factor is in operation in open economies.
- If inflation remains under control, there is no fundamental need to lift interest rates markedly. But certainly cash rates are close to zero in many western nations, so it is hoped that rates can rise to at least modest nominal levels to give central banks a degree of flexibility in the future, rather than being forced to rely on the new tools like quantitative easing.
- Currently the consensus is that the US federal funds rate won't rise until perhaps 2015. But longer-term rates are tipped to rise across western nations by between 60-70 basis points over 2014 as global economic growth lifts closer to longer-term averages of around 3.5 per cent. The hard part for central banks will be to get the timing right for lifting policy rates.







Rewind: The Big Issues for 2013

- As we noted at the start of this report (blog), we have been producing ***Big Issues*** for over a decade. And it is interesting – and perhaps even instructive – to rewind over the past year and assess what we had on the radar screen.
- Looking ahead into 2013, we sought to highlight one issue in particular: *"How quickly will confidence be restored?"* While we were optimistic, our principal worry was US politicians. *"If politicians do come to their senses and hammer out a sustainable solution to the problem, then there are few if any other key issues to take its place."*
- In the end the budget and debt issues did hold back the US economic recovery.

BIG ISSUES FOR 2013

How quickly will confidence be restored?
The return of confidence in Australia
How low could interest rates go?
How high could the Aussie dollar rise?
How fast will the Chinese economy grow?
Is the China boom really over or is it just another phase?
Will there be a new housing boom?
Inflation or deflation - which is more likely?
Will Europe matter in 2013?
How will the domestic political situation play out?

- And we were right to question *"How fast will the Chinese economy grow"* over 2013 as the slower-than-expected growth pace restrained growth for both the global and Australian economies.
- One issue that we got wrong was interest rates *("How low could interest rates go*"). We said *"While interest rates could go lower, that doesn't mean that they should go lower."* In the end, the global and domestic economies lost momentum and inflationary pressures eased. So the Reserve Bank concluded that rates *should* indeed go lower.
- Still, on the question of *"Will there be a new housing boom?"* we can claim greater success. We noted: *"Given the raft of positive influences that exist to drive housing demand, we can't rule out a new boom or boomlet in housing – especially if confidence levels quickly return."*
- In asking the question *"How will the domestic political situation play out?"* we highlighted the risks: "*Elections do cause some consumers, businesses and investors to sit on their hands until the uncertainty is removed. It shouldn't be the case but invariably it is the case. Retailers and builders are amongst those vulnerable to any election-driven "strike" by consumers and businesses".* Unfortunately the risks proved too prescient and were manifest in slower-than-normal economic growth.

Rewind: Economic forecasts for 2013

- Overall, our forecasts for 2013 were generally too positive. While we thought the economy would slow to a 'below trend' (normal) pace, the expected 2.9 per cent growth pace still looks likely to be too high – the most likely outcome being around 2.5 per cent.
- One of the main restraining factors in 2013 was the election. In January 2013 the former Prime Minister Julia Gillard indicated that the election would occur in September. And unfortunately many consumers and businesses took this as a signal to coast over the year.

FORECASTS		
	2012	***2013***
Economic Growth	3.6%	2.9%
Underlying inflation	2.5%	2.7%
Unemployment	5.3%	5.0%
	mid 2013	***end 2013***
Cash rate	3.00%	3.50%
Sharemarket (All Ords)	4,750	4,900
Australian dollar	US110c	US107c

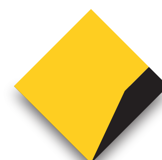
- The slower-than-expected economic growth pace resulted in our inflation rate forecast being too high and our unemployment rate forecasts being too low. And, as a result, the expected 'normalisation' of interest rates didn't occur. Rather the opposite – the Reserve Bank cut rates further to try and boost growth and reduce the Aussie dollar.
- Certainly we had highlighted the downside risks for rates, but with provisos: *"In terms of interest rates, the risks will be skewed to the downside in the first half of the year. But if Chinese and US economies lift as we expect and there is improved confidence and activity in the Australian economy, the Reserve Bank won't leave rates at low levels for an extended period. So the risk is that cash rates start rising late in 2013."*
- Certainly the efforts to restrain the Aussie dollar did work, and even with the currency currently near US89 cents, the Reserve Bank still believes that it has further to fall.
- The sharemarket forecasts were a little more successful. And given the sogginess of the bourse over the past few weeks, the All Ordinaries could indeed ease to the project end-year target of 4,900 points. (Certainly we did revise up our sharemarket forecasts over 2013, and our current forecasts envisage that the All Ords & ASX 200 will end the year at 5,400 points. That is likely to prove too high.) However we also did correctly stress that dividends would prove increasingly important for sharemarket investors.
- And our forecasts for home prices actually look like being too low, even though we were criticised for forecasts that appeared too high:

"Investors are expected to diversify their investments over 2013, gradually taking on more risk. The All Ordinaries/ASX 200 is expected to lift to 4,900 points by the end of 2013, but dividends will again be important. And home prices are expected to lift by 3 per cent over the year."

Craig James, Chief Economist, CommSec

Savanth Sebastian, Economist, CommSec

The Big Issues 2013

CommSec 

The Big Issues for 2013

BIG ISSUES FOR 2013

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The Big Issues for 2013

- For the best part of the past decade we have produced *"The Big Issues"* report – a report that has sought to highlight issues that are expected to influence on the economy over the forthcoming 12 months.
- Now this is no crystal ball gazing exercise. The aim is not just to forecast where certain economic variables are likely to be in a year's time. Rather the focus has been to highlight trends, issues and 'big picture' influences that act as threats or opportunities for consumers, investors and businesses alike.
- The aim has been to produce a highly readable, relatively jargon-free document. Probably today we could call this a blog. But the intention over time has been to produce commentary that causes people to think, ask the 'so what' question and then determine what this means for their own circumstances.
- And while we have identified a range of questions or issues that should feature over 2013, really there is just one issue that is likely to dominate – how quickly will confidence be restored?

FORECASTS		
	2012	***2013***
Economic Growth	3.6%	2.9%
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Cash rate	3.00%	3.50%
Sharemarket (All Ords)	4,750	4,900
Australian dollar	US110c	US107c

But first, the economic forecasts for 2013

- Before tackling the Big Issues for 2013, let's set the scene by mapping out our economic assumptions. Overall we expect the economy to do well over 2013 with "normal" or trend growth near 3 per cent, underlying inflation near 2.5 per cent and interest rates broadly stable over the first half of the year. Certainly these forecasts are built on

Craig James – Chief Economist (Author)

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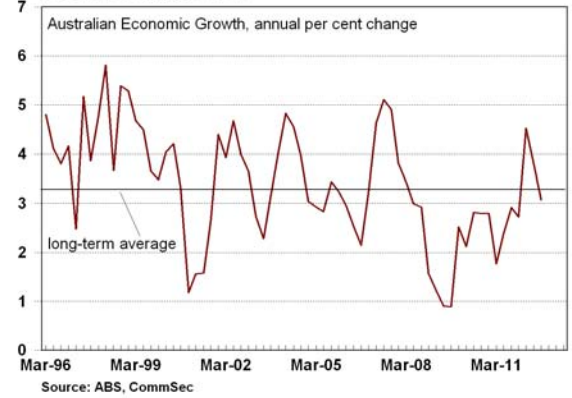
the hope that the US politicians deal with their budget issues, Chinese economic growth continues to recover and there are no new major debt or deficit issues out of Europe. But we don't believe there are major domestic issues to serve as serious threats to the economy in 2013.

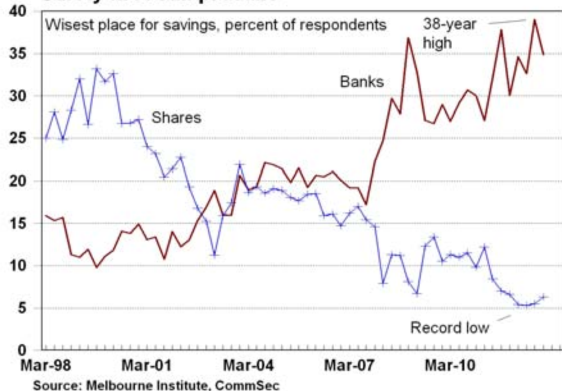


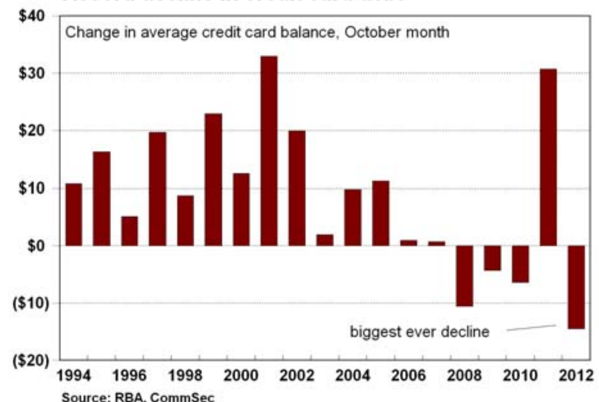
- Actually consider what shape the Australian economy is in heading into 2013. Economic growth is near trend at 3.1 per cent and we still haven't sighted a recession for 21 years; inflation is under control; unemployment is at 5.2 per cent; interest rates are historically low; there is no housing boom or bust; and consumers and businesses are reluctant to take on debt. The biggest issue is whether the Government should plough ahead with the goal of balancing the Budget this year or whether we should wait a little longer. Remarkable.
- There are a few other issues exercising minds as well. The Aussie dollar remains firm, creating challenges for businesses. The mining sector continues to power higher but miners are dealing with cost issues and attempting to divine the trajectory of the Chinese economy over the next few years. But clearly that is to be expected – this is the biggest industrialisation and urbanisation of an economy ever seen and, at the same time, there is a general lifting of income levels across Asia. If there weren't adjustment issues and broader structural change associated with the rise of China, then most people would have been surprised.
- Investors are expected to diversify their investments over 2013, gradually taking on more risk. The All Ordinaries/ASX 200 is expected to lift to 4,900 points by the end of 2013, but dividends will again be important. And home prices are expected to lift by 3 per cent over the year.
- In terms of interest rates, the risks will be skewed to the downside in the first half of the year. But if Chinese and US economies lift as we expect and there is improved confidence and activity in the Australian economy, the Reserve Bank won't leave rates at low levels for an extended period. So the risk is that cash rates start rising late in 2013.
- The Aussie dollar is expected to rise over 2013. The US economy is already lifting, underpinned by housing and export activity. Chinese economic activity is also lifting after an engineered slowdown. Global interest rates are expected to remain low over 2013, but if overseas activity lifts as we expect, there will be upward pressure on Australian interest rates. And, in turn, there will be upward pressure on the Australian dollar.
- While there is a raft of factors that could propel the Aussie dollar higher, there are far fewer downside risks. If there was a hiccup in the Chinese recovery; the US went over the "fiscal cliff"; or there was a major break-up of the European Union, then the Aussie would lose altitude.
- CommSec expects the Aussie to scale US110c during 2013 and settle near US107 cents by end year.

So What? Consumers, investors and businesses need to be responsive to the changes in the domestic and global economies. There were a number of dark periods over 2012 but we are actually exiting the year with some optimism. Much can change in a short period so the key message is to stay alert.

Now, The Big Issues: How quickly will confidence be restored?

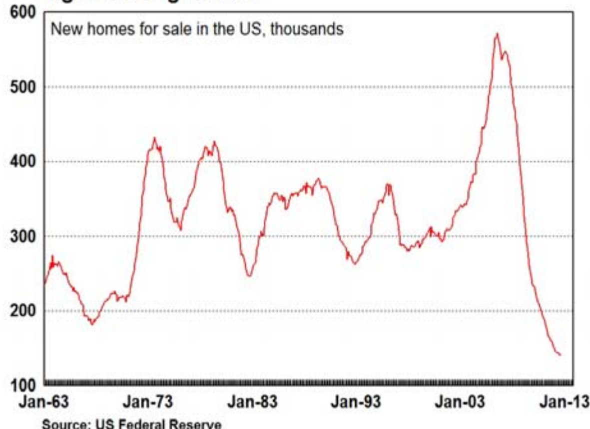
- The GFC, the European Debt Crisis and the "Fiscal Cliff" have all caused ordinary consumers, businesses and investors to lose faith. Faith has been lost in banks, broader financial systems, central banks and governments.





As a result investors have retreated from riskier assets like shares and embraced what is perceived to be 'safe haven' assets like government bonds.

- The old adage is that two factors drive all financial behaviour – fear and greed. And at present fear is still dominating. In fact consumers, investors and businesses had gravitated to the polar extreme of fear, embracing bonds. But there is some thawing occurring in the current environment, shares have been grinding higher since lows in June. If confidence indeed returns quickly this could have dramatic consequences for bond yields, which in many economies are near to historic lows.
- At the time of writing, there really was only one factor on most people's lips – the US fiscal cliff. If politicians do come to their senses and hammer out a sustainable solution to the problem, then there are few if any other key issues to take its place.

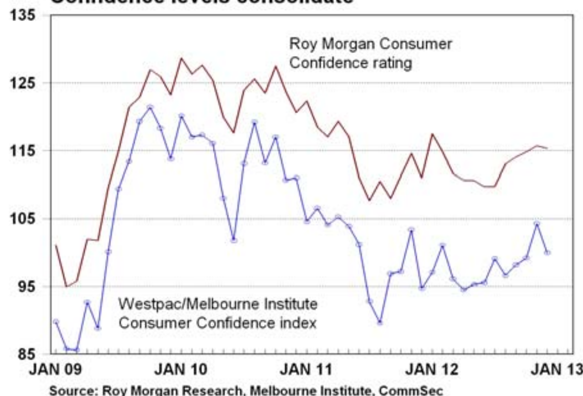


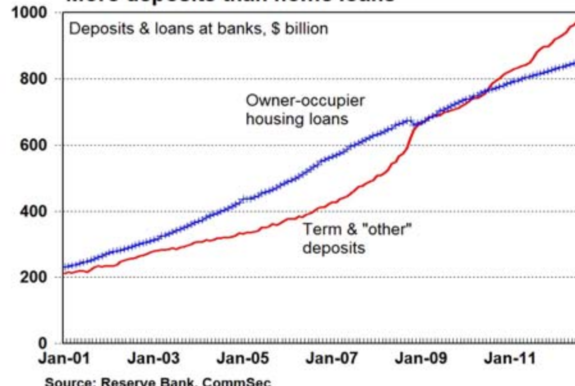
- In fact the US economy is recovering nicely. The housing oversupply situation has been addressed. Home prices are rising and new construction is lifting. Add in the export sector, underpinned by a weak greenback. All of a sudden you have key momentum factors for the economy.
- Certainly much work is required in reducing unemployment, lifting spending, sustaining the economic expansion and reducing the size of the budget deficit. Low interest rates will be needed for some time to allow the budget deficit to be reined in.
- But if the fiscal cliff is removed as a key issue or constraint, and the economic recovery gains pace, then conceivably confidence could return quickly, posing risks for the bond market. In many countries bond yields are historically – and perhaps unsustainably – low. A quick return of confidence could cause the bond boom to turn to bust.

So What? Confidence is the swing variable. If the global economic recovery moves to a more sustainable footing and the US avoids going over the fiscal cliff, then investors will shift away from bonds to other asset classes like shares. A stronger global economy has a raft of implications such as higher oil prices, stronger commodity prices more generally, and a firmer Aussie dollar.

The return of confidence in Australia

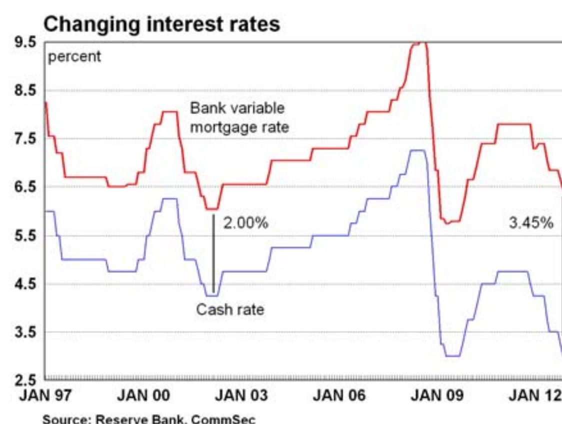
- The rolling crises in the advanced economies since 2008 have certainly produced fundamental changes in Australia. Investors have piled their money into cash-based investments rather than property or shares. As a result the value of term and other deposits exceeds that of owner-occupied home loans.
- In addition, consumers and businesses have shied away from debt. Consumers shop around for cheapest prices – whether they are found abroad or locally. And they have become selective about purchases. Cars, travel and electrical goods have been favoured whereas books, newspapers and clothing have been shunned. Businesses have become more reluctant to invest and employ staff.
- We have also recently seen the remarkable situation where consumer confidence has dropped sharply after a rate cut because savers have been more disappointed by rate cuts than home buyers have been encouraged.
- Still, there are early signs that a thawing in community attitudes is occurring. Investors are starting to embrace





property investments again and more savers are looking to switch away from bank term deposits. Consumers have taken out record loans to buy new or used cars. And the sharemarket has lifted to 17-month highs.

- If the global gloom disappears from view, Australians will find out fairly quickly that there are few worries here at home. The budget deficit is low on a global scale; interest rates are historically low; unemployment is not far from longer-term averages and inflation is solidly in the Reserve Bank's 2-3 per cent target band.
- If investors do shift to residential property they will find an asset class where supply and demand are well balanced and where home affordability is near decade lows.



So What? A return of confidence has a raft of implications: firmer consumer spending; a stronger housing market; greater inflows into property; desire to take on debt again; increased employment.

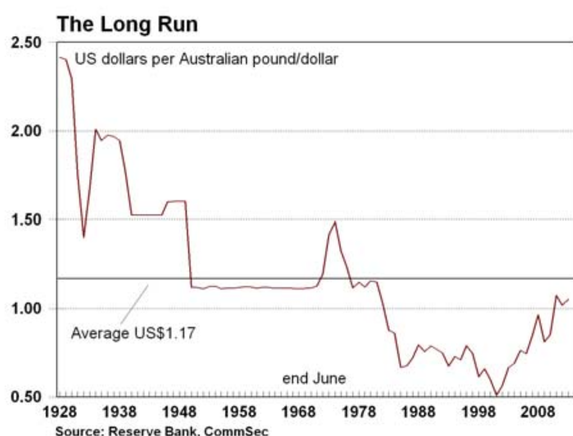
How low could interest rates go?

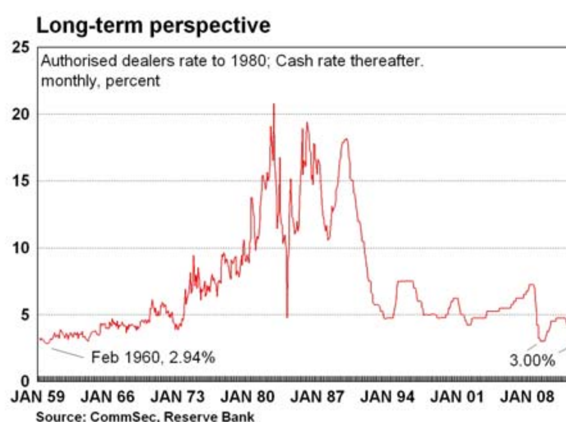
- The cash rate stands at 3 per cent – the same level that existed from April-October 2009 when the Reserve Bank was trying to protect the economy during the global financial crisis. But what matters most is the interest rate applying to borrowers. In the GFC the variable mortgage rate fell to 5.75 per cent, but today it stands at 6.45 per cent.
- In simple terms higher funding costs have prevented banks from passing on all the rate cuts that have occurred over the past year. Even back in 2002 the mortgage rate fell to 6.05 per cent. So interest rates would need to fall further to reach the same super stimulatory settings that we have witnessed over the past decade.
- But while the Reserve Bank has plenty of ammunition left, the question is whether the central bank wants to, or believes it needs to, cut rates further. Unemployment is still low and underlying inflation is in the middle, not at the lower bound, of the 2-3 per cent target band. At the same time there are reasons for optimism on the Chinese and US economies. And it is clear from recent moves that the economy is far less responsive to rate cuts than in the past. But that doesn't mean that rates should be cut further, rather a different mix of fiscal and monetary policies may need to be contemplated.
- So while the Reserve Bank is expected to retain an easing bias in coming months, we are sceptical that it will act on that bias.
- The overnight indexed swap rate is pricing in just a 30 per cent chance of another 25 basis point rate cut in the next three months.

So What? While interest rates could go lower, that doesn't mean that they should go lower. If monetary policy is less effective than in the past, fiscal (Budget) policy may play more of a role.

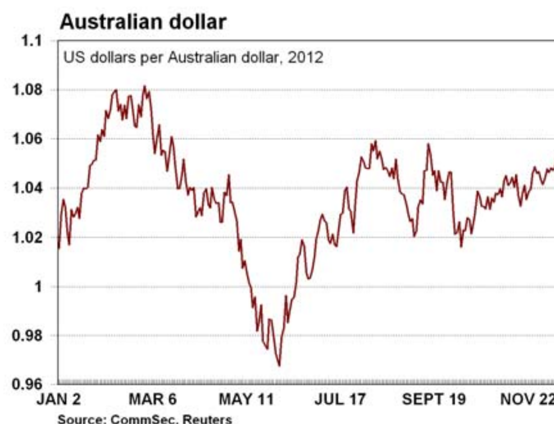
How high could the Aussie dollar rise?

- From the float of the Australian dollar in 1983 through to 2006 the Aussie dollar averaged US71 cents. But in the period since the Aussie dollar has averaged US91 cents. More recently – over the past two years – the Aussie dollar has regularly been perched above parity against the greenback, averaging US103 cents.





- Clearly the upward shift of the Australian dollar in recent years has been dramatic, representing gains for consumers but tougher times for many businesses, especially across retailing, manufacturing and tourism sectors.
- While many businesses are still in the process of adjusting to the stronger currency, the risk is that it could go even higher. China has only started down the industrialisation road and it will increasingly step up its spending on Australian resources and services over time. When the Japanese economy was treading the same path of industrialisation over the 1970s, the Aussie dollar was regularly above parity against the US dollar. In the decade prior to the floating of the currency, the Aussie dollar averaged US116 cents.

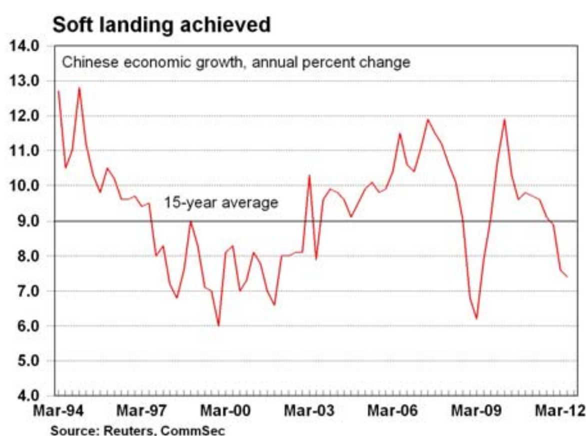


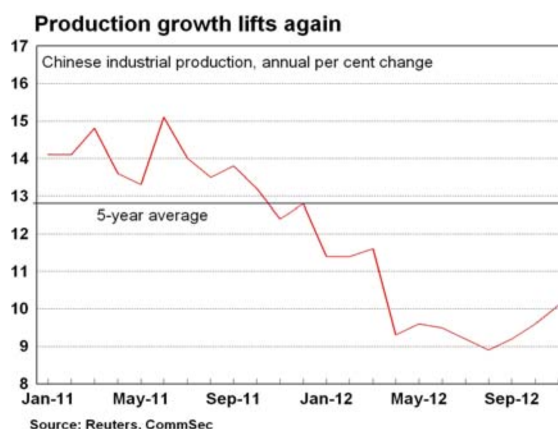
- Could the Aussie dollar revisit the highs near US$1.50 recorded in the 1970s? From the current vantage point, it appears fanciful. But consider the fact that US interest rates will remain near zero through to 2015, Australian interest rates are relatively high compared with advanced nations, there is increasing foreign demand for Australian assets and economic growth is again lifting in China.
- The strength of the Aussie dollar again looks to be a key issue for consumers, investors, businesses and the Reserve Bank over 2013. While we are tipping the Aussie to rise to US110c, it certainly could go higher.

So What? Businesses in particular need to do their sums on the assumption that the Aussie dollar remains stronger for longer, and indeed could rise even further over the coming year. The strength of the Aussie dollar is likely to feature regularly in Reserve Bank interest rate deliberations.

How fast will the Chinese economy grow? Is the China boom over?

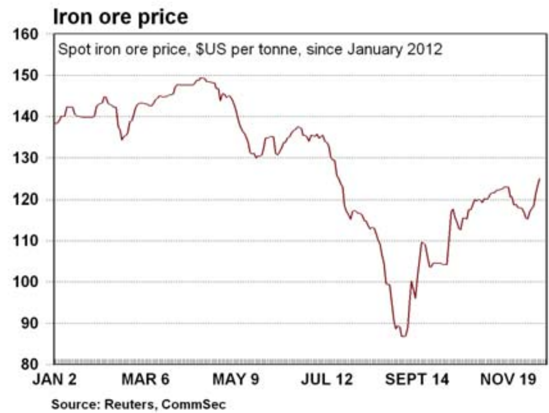
- There is a new leadership group taking power in China in 2013. And the timing is fortuitous as the engineered slowdown appears to be over. The latest economic data showed a lift in industrial production and stronger retail spending in November but with inflation still contained.
- There is scope for stimulus should it be necessary. But the aim is to avoid another bout of speculative activity in the property sector as well to avoid over-investment in infrastructure.
- Quite simply the world has never seen industrialisation and urbanisation on the scale currently underway in China. A nation of 1.3 billion people, especially people experiencing growing wealth and income, will continue to place significant demands on the world's resources.
- According to the latest consensus survey from Emerging Markets Economic Data (47 economists), the Chinese economy is tipped to grow by 8.0 per cent in 2013 after estimated growth of 7.7 per cent in 2012. The IMF expects the Chinese economy to grow by 8.2 per cent in 2013 after 7.8 per cent growth in 2012. The IMF expects the Chinese economy to grow 8.5 per cent on average from 2014-2017.
- While the Chinese economy won't replicate the 10.1 per cent average economic growth rate that existed from 2004-2008, growth of around 8.5 per cent still translates to a sizeable contribution to the global economy.
- So is the China boom over? In short, no, unless of course the Chinese authorities want to prevent their people enjoying the same lifestyles that exist in Western nations. But the first phase of the boom is over – the early stage





of industrialisation with the unsustainable lift in resource prices.

- In 2007 and 2008 the Chinese economy accelerated and the world played a game of catch-up. Demand for resources outstripped available supplies and prices went through the roof, especially iron ore and coal.
- But following investment in recent years, supply has caught up with demand. As a result prices have eased to more sustainable levels. But ongoing investment will be required to ensure that production keeps up with resource demand.
- And Chinese spending will evolve over time as it has in other industrialising countries, such as South Korea and Taiwan. Rather than just basic materials, demand for services will lift. Indeed this has already occurred with tourism demand and China is now Australia's second largest source of tourists.

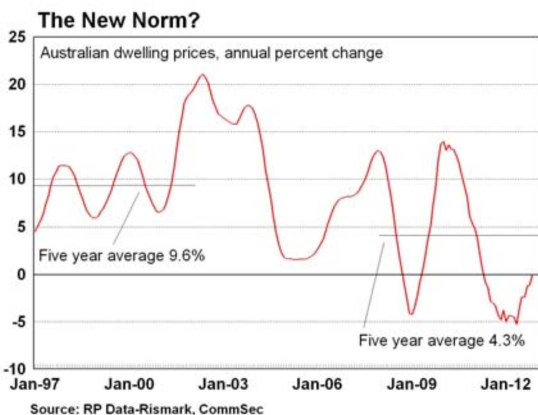


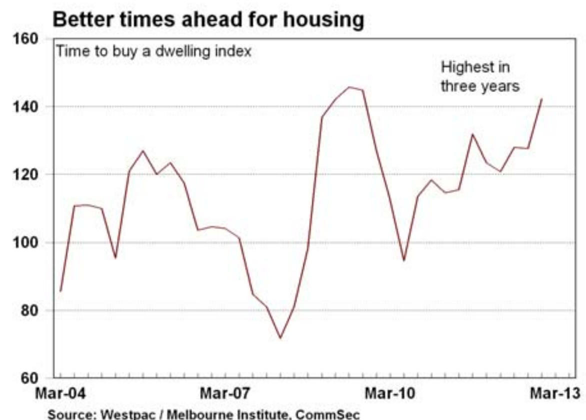
So What? Chinese industrialisation is still in relative infancy. As a result forthcoming demand for resources remains significant. Businesses need to focus on the future opportunities that exist.

Will there be a new housing boom?

- Since 1997 Australian home prices have grown on average by 8 per cent a year. But over the past four years, growth of home prices has averaged just 2.3 per cent. So which growth rate will apply in the future?
- We favour the latter. Simply, growth of home prices much above growth of wages (around 3.5-4.0 per cent a year) is not sustainable. Especially given the fact that Australians are now opting for smaller dwellings than in the past. If home prices rise in excess of 4 per cent a year for a prolonged period the risk of a painful correction increases markedly.
- And it's clear that many consumers are intending to switch funds from cash-based investments to property. Aussie consumers conclude that it is the best time to buy a new home in three years. In fact the "time to buy a new dwelling" index is approaching decade highs. And real estate is now regarded as the second wisest place to put new savings with the latest reading just below seven year highs.
- All the pointers suggest that there are better times ahead for the housing market, representing good news for builders, tradespeople, material supplier and a raft of retailers. Lower interest rates, improved affordability, state government grants, rising migration and tight rental markets are all serving to encourage new home construction. The positive trends in home lending should lead to a lift in new construction, with apartments leading the way from free-standing homes.
- Given the raft of positive influences that exist to drive housing demand, we can't rule out a new boom or boomlet in housing – especially if confidence levels quickly return. But given that banks are reluctant to provide funds for new developments unless there is a high level of pre-commitments, the risk of a US style construction boom and bust is unlikely.

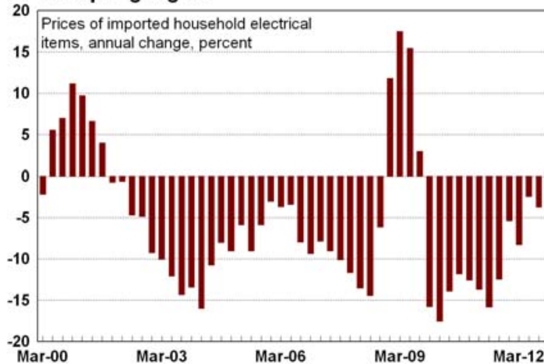
So What? Property is back in vogue. We can't rule out another housing boom, but the pre-conditions don't exist to the same extent that we've seen in the past.

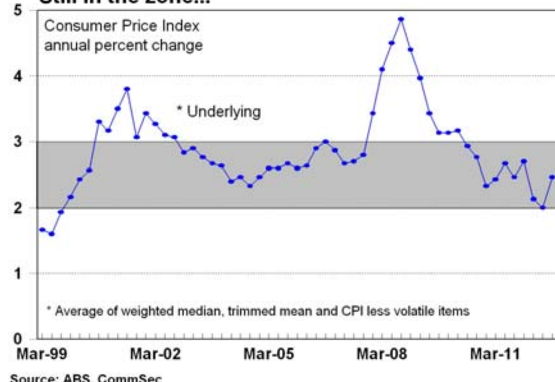




Other Issues

- There are a number of other issues likely to exercise minds in 2013. For instance, ***"Will Europe matter in 2013?"***; ***"Inflation or Deflation – which is more likely"*** and ***"How will the domestic political situation play out?"***
- Clearly the European debt problems haven't been solved, but we like the "do whatever it takes" attitude of European policymakers. The recent agreement to provide bail-out funds to Greece is a case in point and was very encouraging.
- But while there is still the risk of new problems in Europe, we take the view they won't have the same impact as in recent years provided that US and Chinese economies gain pace over 2013.
- Inflation is still far more likely in 2013 than deflation. Central bankers are determined that deflation doesn't take hold, and are applying maximum monetary stimulus. But having said that, deflation is still a problem for Australian retailers, especially those focussed on electrical goods. And if the Aussie dollar rises sharply over the year, we will see references to both inflation and deflation over the year.
- And then there is the question that regularly pops up in our economic presentations: what impact will the election have on the economy. It is always important to remember that the Reserve Bank will still set interest rates, no matter which party wins power. The Aussie dollar and bond rates will still be set by financial markets. And Federal Treasury will still be providing advice to government, no matter which party is in power.
- Elections do cause some consumers, businesses and investors to sit on their hands until the uncertainty is removed. It shouldn't be the case but invariably it is the case. Retailers and builders are amongst those vulnerable to any election-driven "strike" by consumers and businesses.





Rewind: The Big Issues for 2012

- As we noted at the start of this report (blog), we have been producing ***Big Issues*** for the best part of a decade. And it is interesting – and perhaps even instructive – to rewind to last year and assess what we had on the radar screen.
- Last year Europe was on top of the list of concerns, and as the year played out, its place was clearly justified.
- We noted: "*We assume that the European Debt Crisis will still dominate over the first few months of 2012. Clearly the 'end game' could take a number of forms include the collapse of the euro zone. We assume that self-interest will predominate and that the euro zone will remain intact. Countries will set about the task for reining in deficits and stabilising debt levels as a proportion of GDP."*
- International factors dominated and we questioned the strength of the US recovery. Again with good reason as the economy still staggered through 2012.
- We also focussed on home prices, expecting at best a slight rise in prices with Sydney leading the way. Some questioned our optimism, but it turned out to be the case.

BIG ISSUES FOR 2012

What will be the end game in Europe?
How real and sustainable is the US recovery?
Is there some 'X-factor' that will derail China?
What will be the impact of the carbon & mining taxes?
How long will it take for investors to return to shares?
How strong will be the lift in home prices?
Will inflation remain contained?
Will natural disasters be as prevalent as 2011?
Will higher oil prices derail the global recovery?
How important will politics be for economies?

- On the issue of carbon and mining taxes we noted: *"In a year's time we may look back and wonder why we were so worried about the carbon and mining taxes."*
- On the issue of how long it would take investors to return to equities we observed: "It would only take a more stable period for European and US economies for equities to be back in favour." That stability did return late in the year, prompting a modest updrift in equities.
- Fortunately other issues such as inflation, oil prices, a crisis in China and natural disasters didn't turn out to be 'X-factors' derailing our recovery.

Rewind: Economic forecasts for 2012

- Economic growth: √
- Inflation: close
- Unemployment: √
- Sharemarket: close
- Overall, reasonable so far. We noted: "*We tip 3.6 per cent economic growth over 2012 – above the norm of around 3.0-3.25 per cent, but from a low base. Underlying inflation should drift up over the year but remain below 3.0 per cent, thus allowing interest rates to remain low. Unemployment should hold in a 4.5-5.5 per cent range over the year.*

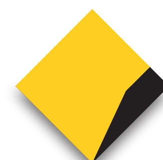
FORECASTS		
	2011/12	***2012***
Economic Growth	3.2%	3.6%
Underlying inflation	2.6%	2.9%
Unemployment	5.3%	5.2%
	mid 2012	***end 2012***
Cash rate	4.25%	4.25%
Sharemarket (All Ords)	4,450	4,650
Australian dollar	US95c	US100c

- But that is where the good forecasting record comes to an end. The weakness of the global economy and lack of confidence domestically prompted the Reserve Bank to cut rates more than we thought. And the Aussie dollar proved to be more resilient than we thought.
- But as we pointed out last year: *"As always, it is not the numerical forecasts that matter most. Rather the importance lies in the assumptions taken, the likely direction for the variables and the risks."*
- And our caution was very apparent in the commentary: *"Risks abound – and mostly to the downside. Political wrangling could lead to the collapse of the euro zone while politics may also stifle the US economic recovery. In Australia, there are also some upside risks. Rate cuts could cause Aussies to spend again and buy and build homes. As a result stronger consumer and housing activity may coincide with strong business investment, especially in mining regions."*

Craig James, Chief Economist, CommSec

The Big Issues 2012

CommSec



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December 5 2011

The Big Issues for 2012

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Will higher oil prices derail the global recovery?
How important will politics be for economies?

Tumultuous Times

- Murphy's Law states: Whatever can go wrong, will go wrong. And clearly 2011 could be best described as the year when Murphy's Law reigned.
- First there were significant floods across eastern Australia as well as disruptive cyclones across northern Australia. Coal production in mid-north Queensland was hampered over much of the year while banana production was decimated again in north Queensland.
- There were earthquakes in Japan and Christchurch, New Zealand. And it wasn't just an earthquake in Japan, but it precipitated a tsunami and nuclear disaster. Japanese production of cars and car parts was severely disrupted, only getting back to near normal late in 2011.

FORECASTS

	2011/12	*2012*
Economic Growth	3.2%	3.6%
Underlying inflation	2.6%	2.9%
Unemployment	5.3%	5.2%
	mid 2012	***end 2012***
Cash rate	4.25%	4.25%
Sharemarket (All Ords)	4,450	4,650
Australian dollar	US95c	US100c

- There were also volcanic eruptions in Chile that resulted in ash clouds moving across Australia, disrupting air traffic.
- And it wasn't just natural disasters that dominated but fresh economic crises. The European Debt Crisis reigned over the second half of the year and political wrangling was also able to precipitate fresh problems for the US economy over the year, prompting one rating agency to downgrade the US credit rating.
- Not only did Australian businesses, investors and consumers have to contend with overseas issues, there was also the uncertainty caused by proposed carbon and mining taxes. Is it any wonder then that Australian consumers refused to spend, that economic growth proved sub-standard, that the sharemarket failed to fire and that the Reserve Bank switched its focus from rate hikes to rate cuts?

Craig James – Chief Economist (Author)

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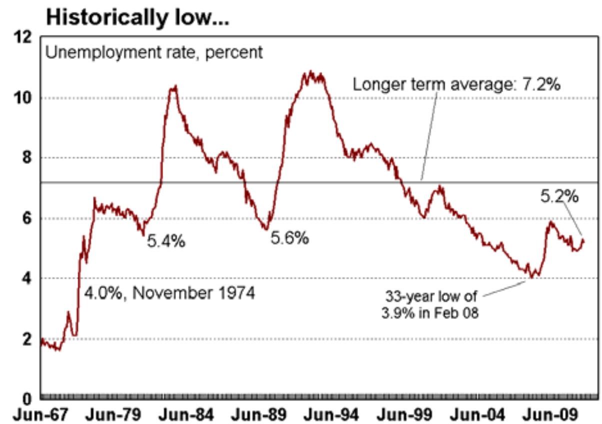
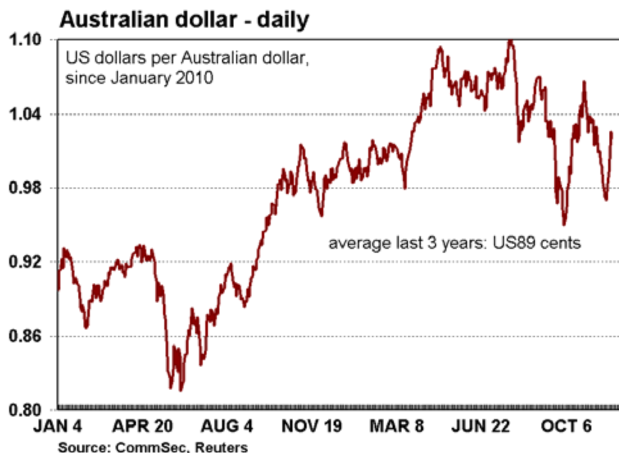
Economic and financial forecasts miss targets

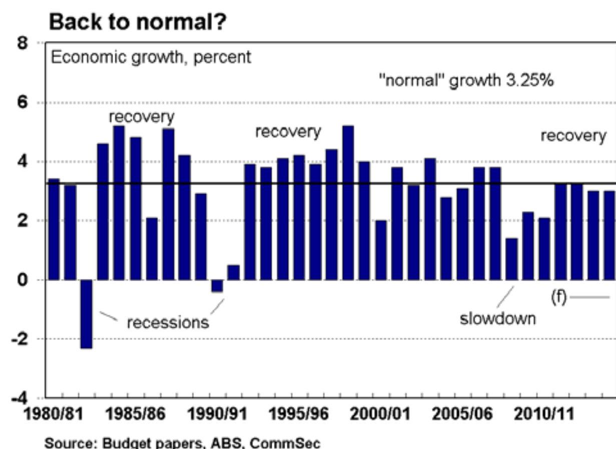


- With the benefit of hindsight it is clear that our economic and financial forecasts were overly optimistic.
- Economic growth was tipped at 3.5 per cent in 2011, with unemployment seen at 4.5 per cent by the end of 2011 with the cash rate at 5.5 per cent and sharemarket at 5,400. In a 'normal' year without the European Debt Crisis and natural disasters these forecasts would have stood a good chance of success. In fact around mid year they were still largely on track.
- The economy may have expanded 2.75 per cent in 2011 while unemployment will be nearer to 5.25 percent, the cash rate will be 4.25-4.50 per cent and the sharemarket will be closer to 4,400 points.
- The good news is that inflation will probably end 2011 near the forecast of 2.75 per cent. But the Aussie dollar forecast of US92c will be exceeded with the currency near US102c. We had expected the US recovery to be underway with investors looking to higher US interest rates and thus underpinning a stronger greenback. Still it's worth noting that just a few days ago the Aussie was below US97c, and seemingly headed lower.

Forecasts for 2012

- As always, it is not the numerical forecasts that matter most. Rather the importance lies in the assumptions taken, the likely direction for the variables and the risks.
- We assume that the European Debt Crisis will still dominate over the first few months of 2012. Clearly the 'end game' could take a number of forms include the collapse of the euro zone. We assume that self interest will predominate and that the euro zone will remain intact. Countries will set about the task for reining in deficits and stabilising debt levels as a proportion of GDP.
- We also expect that the US economic recovery will continue and China will ease monetary policy, thus boosting growth prospects. The Australian economy should remain in balance with strong investment spending weighed against "average" growth in consumer spending and housing activity.
- Risks abound – and mostly to the downside. Political wrangling could lead to the collapse of the euro zone while politics may also stifle the US economic recovery. In Australia, there are also some upside risks. Rate cuts could cause Aussies to spend again and buy and build homes. As a result stronger consumer and housing activity may coincide with strong business investment, especially in mining regions.
- We tip 3.6 per cent economic growth over 2012 – above the norm of around 3.0-3.25 per cent, but from a low base. Underlying inflation should drift up over the year but remain below 3.0 per cent, thus allowing interest rates to remain low. Unemployment should hold in a 4.5-5.5 per cent range over the year.
- The Aussie dollar is expected to drift lower to around US95c in the first half of 2012 as weak European economic growth restrains global economic growth. But the Aussie is expected to again be near parity with the greenback in late 2012.
- While we would like to be more positive about sharemarket prospects, we retain a "soft" target for the All Ordinaries of 4,650 at the end of 2012. Aussie investors are expected to only slowly embrace stocks again over 2012 while global economic uncertainty and a firmer Aussie dollar will also restrain enthusiasm of foreign





investors for Australian stocks.

The Big Issues for 2012

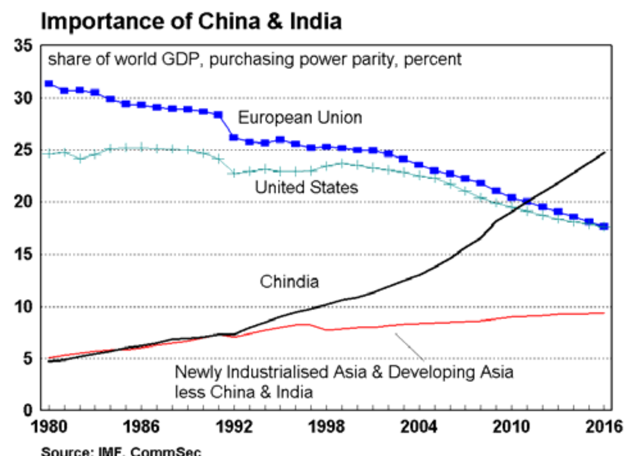
What will be "end game" in Europe?

- Clearly if investors wanted an answer to one question, this would probably be it – the likely "end game" in Europe. If you had utmost confidence that the euro zone would break up in the next few months, then no doubt you would be positioned for sharp falls in Australian interest rates, the Aussie dollar and the sharemarket.
- But clearly it is possible that European nations would elect for closer fiscal integration and a more active role for the European Central Bank. In the US and Australia there are significant differences in economic conditions and incomes across states, territories and regions. But there is still a common federal tax base in both countries together with a federal budget and debt position. A United States of Europe clearly needs to move to the next step of a more centralised fiscal position while the European Central Bank needs to have similar powers to the Reserve Bank or US Federal Reserve.
- If the European Central Bank had a stated determination to buy Euro debt in unlimited quantities, then the crisis of confidence would end. Investors would have confidence that they would get their money back. But that ECB commitment would require individual countries to deal with deficit and debt problems, and presumably would need some central enforcement to ensure countries were meeting their commitments.
- Self interest will play a strong role in keeping the euro zone together. Germans may decry the lack of fiscal discipline in southern Europe but if Germany left the euro and adopted the Deutschemark, exporters would no doubt have to contend with a far stronger currency.
- And countries like Greece and Italy would clearly face far more difficult economic problems if they left the euro zone and didn't have access to the wider group's resources and support mechanisms.
- But while the "end game" in Europe is the number one issue moving into 2012, we also need to keep it in perspective. The fundamental worry is one of contagion. That is, if Greece or another country defaults on its financial obligations then banks and other investors lose money and are forced to call in loans, liquidate assets and withdraw from financial markets. The knock-on effects will be felt across the globe.
- But in terms of economic growth, China, India and other countries in Asia and the emerging nation grouping, still hold the whip hand. While on-going problems in Europe could restrain global economic growth, emerging nations would respond by stimulating activity. A raft of countries survived Global Financial Crisis Mark I and there's no reason why they can't deal with GFC II.

So What? Arguably this is the biggest issue for investors in the early months of 2012. Of course the seemingly impossible could happen and European nations could fundamentally deal with the issues over the next few weeks. But the European "end game" will affect the trajectory of the global economy and may ultimately decide if investors stay in cash-based assets or move back into shares.

How real and sustainable is the US economic recovery?

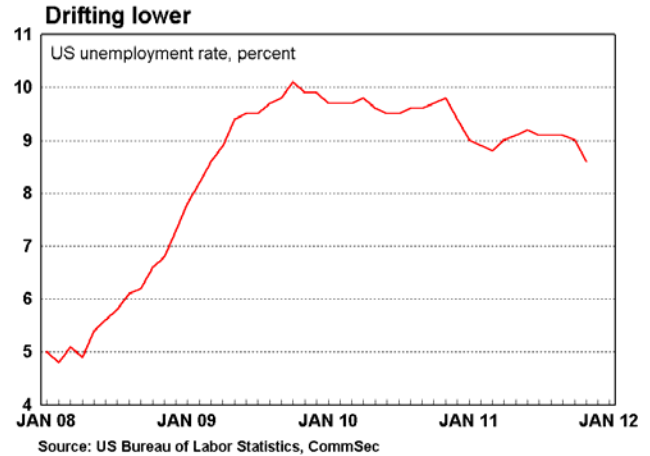
- Recent economic data has proved encouraging. Consumers are spending, jobs are being created, companies are still making money and are well cashed-up and housing markets appeared to have stabilised. The sharp fall in the unemployment rate from 9 per cent to a 2½ year low of 8.6 per cent is certainly encouraging.
- Still, on the other hand there is still an over-supply of US homes, more foreclosed housing stock could be pushed onto the market as prices stabilise, the budget deficit remains high and 2012 is an election year – adding more



uncertainty to financial markets, especially in the latter half of the year.

- Economies are influenced by "fundamentals" like population growth, productivity and the supply-demand balance in markets, such as labour and housing markets. But economies are also influenced by "animal spirits" or confidence. If the European Debt Crisis is resolved, China continues on the path of industrialisation and there are no new "crises" in the US, businesses and consumers will get greater confidence to spend, employ and invest again.

<u>*So What?*</u> If the US economic recovery proves sustainable and actually gathers pace, this may lead to a stronger US dollar and that would provide headwinds for the Aussie dollar. A pick-up in the US would also be positive for US-reliant stocks like Westfield, News Corp, James Hardie, Billabong and CSL.



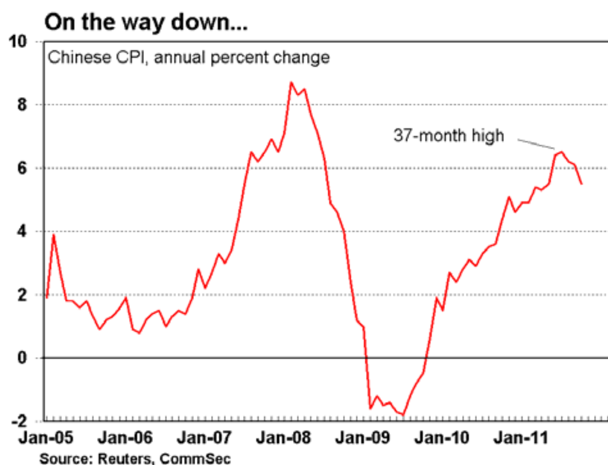
Is there some 'X-factor' that will derail China?

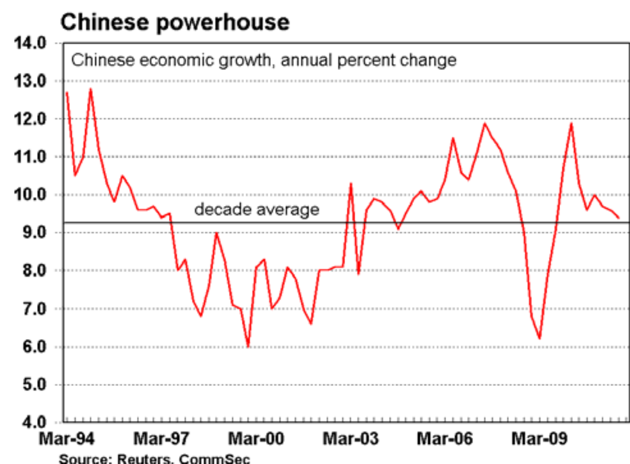
- When it comes to China, investors can't seem to win. If the Chinese economy is growing strongly then there are fears of 'bubbles' developing, such as in property markets, as well as fears that the economy will 'overheat', leading to higher inflation.
- And when authorities take the necessary steps to slow the pace of the economy, the concern is that they end up being too successful, causing momentum to stall. So investors can't win – either the economy is growing too quickly or too slowly.
- However even excluding the polarisation of views on the economy, there are still other concerns. Some worry about social and political stability. And indeed authorities are mindful that they do need to keep the Chinese people happy in an economic sense, otherwise they will start to compare personal and social liberties with those of other countries. Authorities need to ensure that people have jobs, incomes are rising, and quality of life continues to improve.
- Apart from social stability, other 'X factors' include banking sector failures, failure of local or regional governments or other bodies due to scandal or financial crisis, ethnic violence or uprising or geopolitical disputes with foreign powers.

<u>*So What?*</u> China is the second largest global economy. It is also the biggest driver of the global economy and Australia's largest trading partner. Arguably a crisis in China that serves to derail economic momentum would prove more damaging for Australia that a break up of the euro zone.

What will be the impact of carbon and mining taxes?

- Certainly across Australia there is much trepidation about the forthcoming carbon and mining taxes. And even before the taxes are formally introduced, they are already having an impact, weighing on consumer and business confidence levels, and thus impacting spending and investment decisions.
- But it may end up that the biggest impact of the taxes is the 'fear' element, rather than implementation. The





Government estimates that nine out of every 10 families will get some of financial assistance. And four million families (out of Australia's estimated eight million families) are claimed to get "120 per cent of their expected average price impact". Some families will actually be better off as a result of the carbon tax.

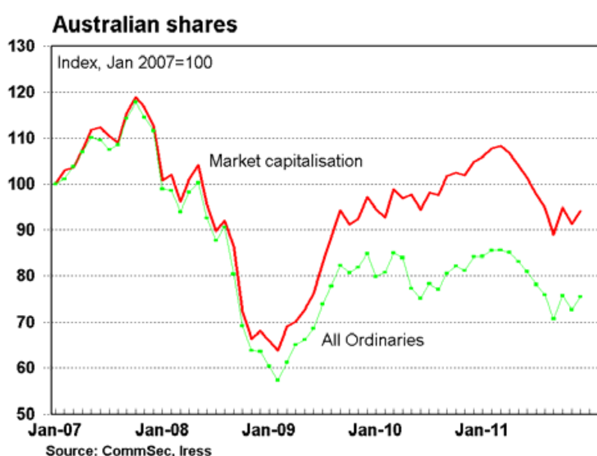
- The carbon tax will only apply to 500 businesses – especially in energy producing, waste disposal and some manufacturing areas like cement, chemicals and metal processing. At the same time assistance plans are in place to support the coal sector, manufacturing and the steel sector.
- Rather than adversely affecting the economy, the actual impact may prove far more modest. So rather than slowing down the economy, the risk is that the level of super-compensation results in little change of behaviour by consumers or businesses. That is, the goal of reducing carbon emissions may not be achieved.
- While politically the Government was forced to agree to the carbon tax to maintain support from the Greens, the watering down of the tax through compensation has ensured that it is less damaging for the economy but at the expense of environmental goals.
- The mining tax has also been watered down from the original proposals to the extent that major miners believe it will have a negligible impact on their operations. In response to demands by one of the independent members of Parliament – Andrew Wilkie – the profit threshold of the tax was raised from $50 million to $75 million. The mining tax will actually be a net cost to the Budget of $1.7 billion in the 2012/13 year. State-based royalties can be deducted from the tax and state governments have been active in lifting royalties in the past year (and probably will lift them further in coming years).
- The most efficient outcome – and one supported by mining groups – was removal of state production-based royalties and replacement by a revenue or dollar-based model. But the most efficient outcome wasn't pursued.

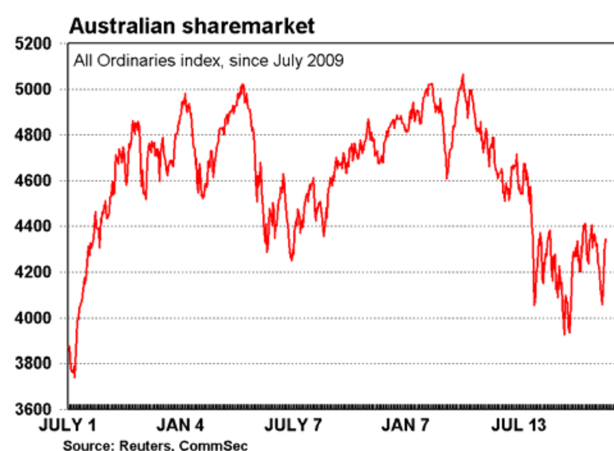
So What? In a year's time we may look back and wonder why we were so worried about the carbon and mining taxes. But once implemented, the risk is that they will be tinkered with over time, increasing the impact on the most affected businesses and industries and the economy as a whole.

How long will it take for investors to return to shares?

- After the 1987 sharemarket crash it took seven years for the sharemarket to return to peak levels. In response to a financial shock, clearly it took some time for investors to again embrace shares. And a similar situation is occurring now.
- However after the 1987 sharemarket crash, investors quickly embraced residential property. However in the current environment, not only are share prices under downward pressure, but home prices are also correcting lower after solid growth over 2009/10. Now cash-based assets such as term deposits are the investment of choice.
- However, it is important to consider the different relativities currently in place. The All Ordinaries index is almost 37 per cent below the peak level of 6,853 points set on November 1 2007. That is, the market would have to grow by almost 60 per cent from current levels to return to record highs.
- Interestingly the total capitalisation of the sharemarket is just over 20 per cent down from peak levels, meaning that the market needs to grow by 26 per cent to reach record highs.
- Similarly the All Ordinaries Accumulation index (includes share prices and dividends) is 23 per cent down from record highs, meaning that it needs to grow by just over 30 per cent to reach record levels.

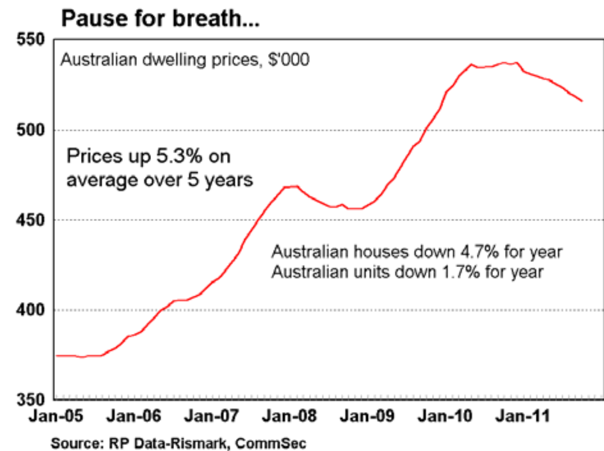
So What? Investors need to focus on total shareholder return (TSR) not just share prices to determine the value of their investments. While returns on shares fell 40 per cent in 2008, they rose by almost the same margin in 2009. It would only take a more stable period for European and US economies for equities to be back in favour.





How strong will be the lift in home prices?

- In 2009 Australian home prices rose by 12.1 per cent – well above long-term averages. In 2010 home prices grew by a further 5.1 per cent, while in 2011 it is likely that home prices will fall by around 4.5 per cent.
- Over the past six years home prices have grown by around 6 per cent a year – largely in line with growth of household incomes.
- Clearly home prices will vary across the country in line with the fundamentals of demand and supply. Melbourne home prices have posted stronger gains than many other markets in recent years, supported by strong population growth. But home construction has also been far stronger than many other states, suggesting less upside potential for prices in 2012.
- A common factor across capital city housing markets is tight rental markets and rising total property market returns. Unemployment also remains historically low across the country.



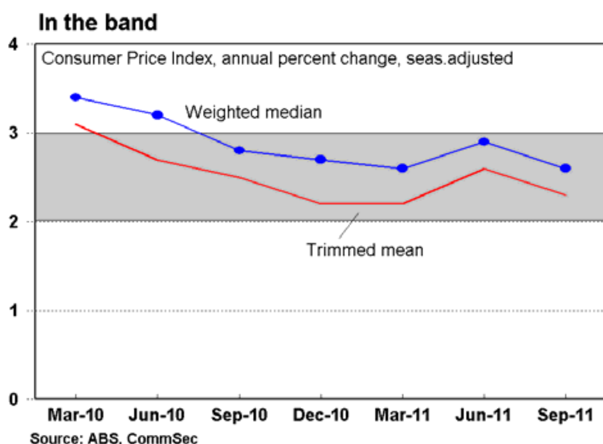
- Overall home prices are likely to grow between 0-3 per cent in 2012 with the Melbourne market likely to record flat price growth while Sydney should record above-average gains.

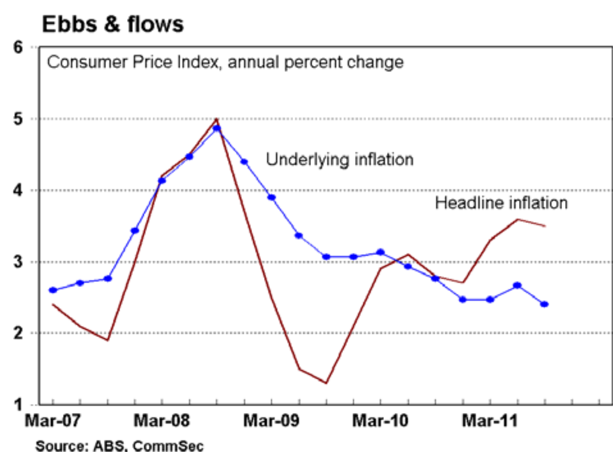
So What? As is the case with the sharemarket, property investors need to focus just as much on potential price growth as on the sustainability of the tenancy, current rents and future rental growth.

Will inflation remain contained?

- The current “headline” rate of inflation stands at 3.5 per cent. That relatively high rate of inflation has been boosted by flood-induced increases in fruit and vegetable prices as well as utility fees (electricity, gas, water) and higher petrol prices.
- The “underlying” inflation rate is currently around 2.5 per cent. The Reserve Bank wants to keep inflation between 2-3 per cent over time, so clearly the Reserve Bank would have good reasons to be happy with the current situation. In fact the Reserve Bank expects the underlying rate of inflation to remain between 2-3 per cent through to the end of 2013.
- As always special factors could push the “headline” rate of inflation higher in 2012 such as floods, drought and cyclones and their impact on fruit and vegetable prices. Sharp changes in the value of the Australian dollar also have an influence on prices of imported goods. Then there are factors like rising utility costs and changes in petrol prices.
- But overall, provided that consumers continue to shop around – locally and offshore – this will keep price pressures under control. Also wage increases need to be restrained in line with productivity changes and general price increases of 2-3 per cent. At present there are good reasons to suspect that inflation can remain contained.

So What? If inflation is contained, then the Reserve Bank has no reason to lift interest rates. And given the current risks in the global environment, if inflation is contained, then the Reserve Bank has greater flexibility to cut rates and support economic activity.





Will natural disasters be as prevalent as 2011?

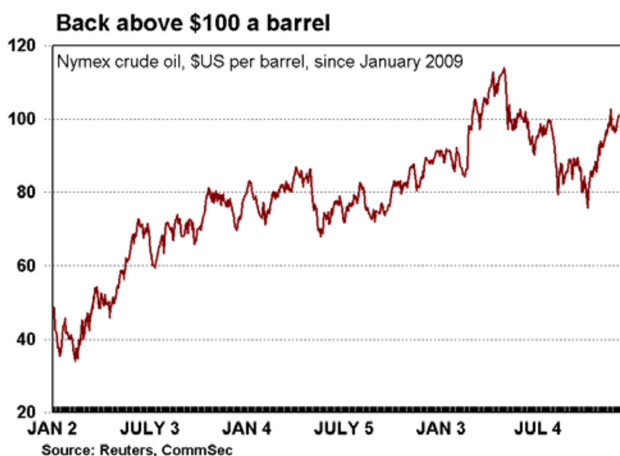
- Who wouldn't love to know about the likelihood about natural disasters before they strike? Sadly no one does, but clearly natural disasters or climate events can change the economic landscape quite markedly.
- At the start of 2011, how many people predicted that there would be an earthquake, tsunami and nuclear accident in Japan? Few hands in the air I suspect.
- The best that we can do in Australia to guard against the risk of events like floods, cyclones and droughts is to watch the traditional El Niño and La Niña indicators.
- Currently a La Niña event is developing with the Southern Oscillation index above a reading of +8-10 points. But the SOI is still well below the levels reached last year when the east coast of Australia was severely affected by floods.
- According to the Bureau of Meteorology: *"Climate models surveyed by the Bureau suggest this event is likely to peak near the end of the year and persist into early 2012. Current observations of this La Niña show that it is considerably weaker than the very strong 2010-11 event."*

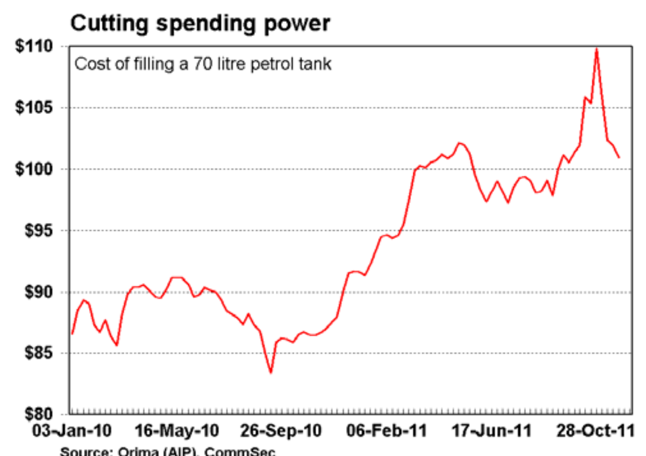
<u>So What?</u> Investors have to stay aware of weather-related events – not just floods and droughts, but also the potential for unseasonal weather, affecting construction companies, insurance companies, retailers as well as rural producers.

Will higher oil prices derail the global recovery?

- Investors always need to keep a close watch on the oil price. Every US recession since the 1970s has been associated with a sharp run up in the price of oil. And it is important to note that, despite the ongoing turmoil in Europe and the US, the Nymex oil price has pushed above US$100 a barrel.
- Fortunately for Australian motorists the oil price has been tracking closely in line with the Australian dollar, thus dulling the impact on household budgets. Further, the Singapore gasoline price has not been tracking higher in line with Nymex or Brent prices as a result of plentiful supplies in the Singapore market.
- Clearly oil demand is also changing across the globe, especially for automotive use. Not only are more cars using more efficient diesel fuel, but there are continuing advances in hybrid car production and LNG and electric powered vehicles.
- Still, the world remains dependent on fossil fuels and the global economy is vulnerable to sharp increases in oil prices, especially at a time when other stresses are taking place such as debt problems in advanced nations such as Europe and the US. And there are always risks of geopolitical events that could serve to push oil prices higher even without normal demand influences.

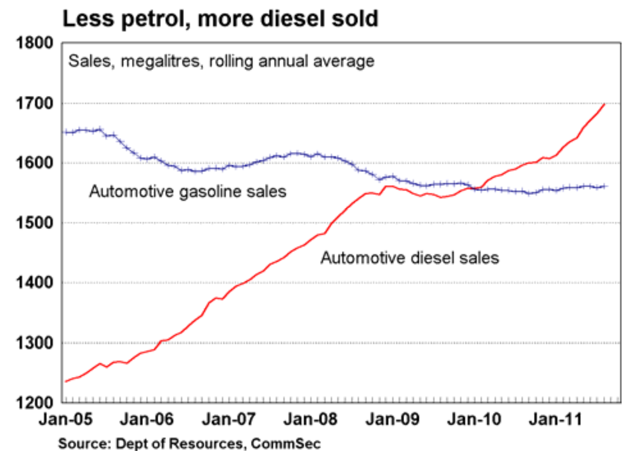
<u>So What?</u> Rising oil prices are important not just for the broader economy. Certainly filling up the car with petrol is the single biggest purchase that most Australian households make each week. So the rising cost of fuel is especially important for consumer-focussed companies such as retailers.





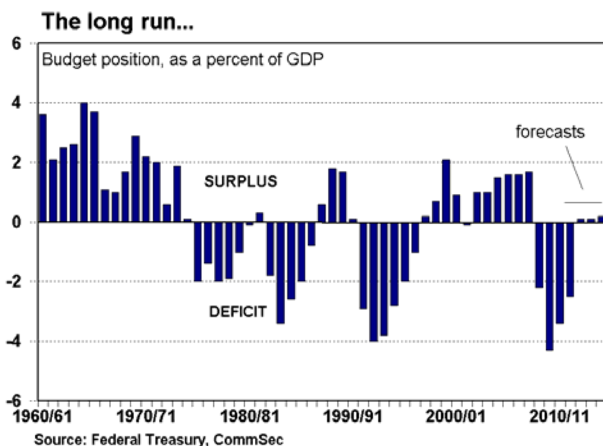
How important will politics be for economies?

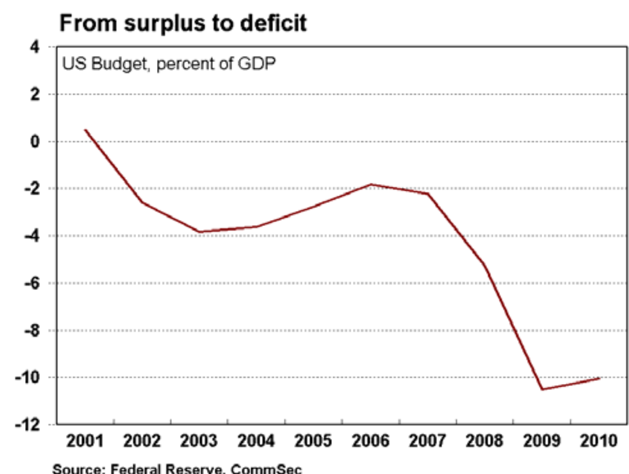
- This could be considered somewhat of a "left field" issue. That is, it is not a traditional economic issue. But clearly economics and politics go arm in arm – much to the chagrin of traditional or textbook economists. To get agreement on economic problems, frequently compromises have to be achieved. Not only are we seeing this in Europe, but also in the US with discussions on addressing budget deficits, and here in Australia on issues such as the carbon or mining taxes.
- In the coming year, politics and economics are likely to be even more entwined. European governments must cut budget deficits despite opposition from their constituents, especially public service workers. Some governments – such as Italy – are now controlled by economic technocrats.
- And in the US, the Presidential election will be held in November. Democrats remain fundamentally opposed to spending cuts in areas like health and social security. Republicans remain opposed to higher levels of taxation to address budget shortfalls. Economists are well aware that both spending and taxing measures need to be employed to address high budget deficits.
- At the end of the day the success or otherwise achieved by economists to get US voters to understand the fundamental budget issues may affect the result of Congressional and Presidential voting results.
- Here in Australia a range of issues in 2012 could be affected by the tug-o-war between political and pure economic considerations such as immigration, the pursuit of a budget surplus as a goal in itself, balance between fiscal and monetary policies and design of taxes like carbon and mining taxes.



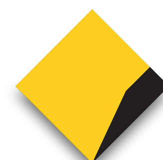
So What? Politics will always get in the road of efficient economic solutions. But the interplay between politics and economics will be especially prominent over 2012, ultimately affecting decisions made and thus affecting financial markets such as currencies, interest rates and sharemarkets.

Craig James, Chief Economist, CommSec





The Big Issues 2011

CommSec 

The Big Issues for 2011

BIG ISSUES FOR 2011

Has consumer spending fundamentally changed?
Is the US economy about to take off?
Will China continue to dominate?
Will the Aussie dollar be stronger for longer?
How high will interest rates go?
Is there a housing bubble?
What we will be the impact of climate change policies?
Will inflation or deflation rule?
How long before shares return to record highs?
How tight is the job market?

First a recap

- If there were one word to sum up 2010 it would be "recovery". Not that recovery occurred at the same pace in every industry and region. It certainly didn't. But rebuilding is like that. Sometimes there are fundamental issues that need to be addressed and navigated. And that has been the case with the budget deficits and debt loads in the Euro area. And in the US the issues have included the weakness of the job market, the high budget deficit, deflationary risks and over-supply of housing.
- But in Australia and Asia the issues have been different. Our region was dragged down by the problems in Europe and the US, but fundamentally there were few concerns. So recovery has been swift – with many economies notching up fabled 'V-shaped' recoveries. But entering 2011 the issues are different. It is all about sustainability. That is, maintaining solid economic growth without letting the inflation genie out of the bottle.
- China has certainly dominated the radar screen over 2010. Get used to it. The biggest ever industrialisation in world history has really only just begun – 1.3 billion people aspiring to the standard of living that we enjoy in the West. And when the next 5-year plan is handed down in early 2011 expect the Chinese consumer to be the centre of attention. The aim will be to continue to improve the lot of the Chinese people.
- Last year when we compiled the Big Issues for 2010 we outlined our forecasts for the Australian economy. And we can claim a

FORECASTS

Economic growth	2.75% in 2010 3.50% in 2011
Inflation	2.75% in 2010 3.00% in 2011
Unemployment	5.00% mid-2011 4.50% end-2011
Cash rate	5.00% mid-2011 5.50% end-2011
Sharemarket	5,100 points mid-2011 5,400 points end-2011
Australian dollar	US99c in mid-2011 US92c in end-2011

Craig James – Chief Economist (Author)

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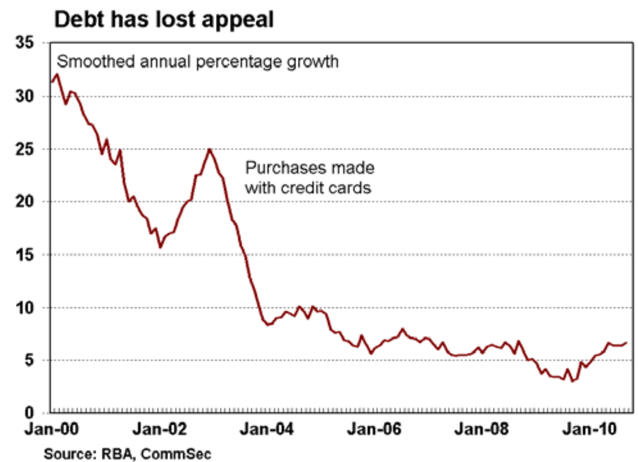
measure of success.

- Inflation was tipped at 2.75 per cent, unemployment at 5.25 per cent and the cash rate at 4.75 per cent. The final figures won't be available for a few months but the estimates were pretty much spot on. That is the good news. We also tipped the sharemarket to reach 5,600 and economic growth to be 3.25 per cent. These forecasts have turned out to be too optimistic. The sharemarket will finish near 4,800 points and economic growth will be around 2.75 per cent.

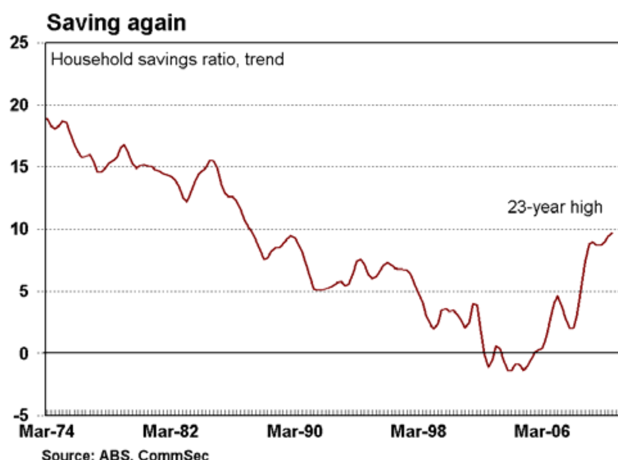


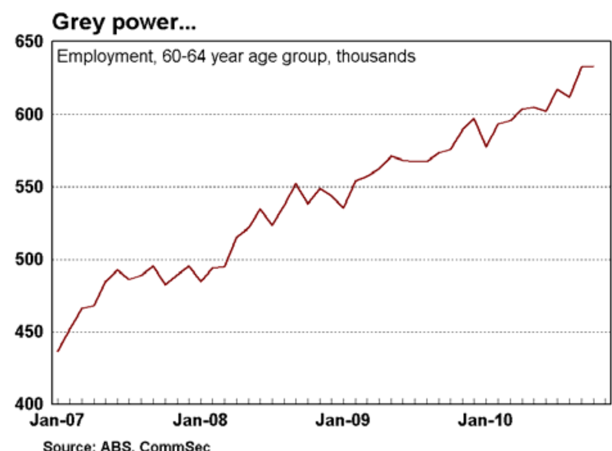
- The Aussie dollar was tipped at US98c in June and US90c in December. Both forecasts weren't bad but not spot on. A fundamental assumption was that the US economic recovery would be further advanced by now. In fact we think that this will prove to be the main disappointment of most forecasters – that the US recovery has lacked momentum. We blame confidence in large part – cashed-up businesses haven't had the confidence to invest, employ and grow again.
- At this time last year we suggested that the Shape of Economic Recovery would be amongst the key issues for 2010. Certainly that was indeed the preoccupation for investors and policymakers alike. We also noted China, India, Taxation, Superannuation, Commodity Boom and Housing Cost & Supply as key issues. Superannuation didn't feature as much as we thought but the other issues were very much in focus over the year.
- On our "What's Out" list for 2010 there were the no-brainers: Recession, GFC, Rate cuts & Debt. But we also thought that the US wouldn't hog the spotlight as much, and volatility would ease. While on balance that did occur, some would doubt the extent of the moves.
- Our left-field issue was the 9-5 workday. We felt that the workplace flexibility demonstrated in 2009 would continue in 2010. The evidence coming through now shows that this flexibility is certainly being embraced. It may not have dominated consciousness but it is where we start off our look at 2011.

The Big Issues for 2011

Has consumer spending fundamentally changed?

- One issue that began to grab more attention as 2010 progressed was the weakness of consumer spending. Even the Reserve Bank has spent more time in the past few months focussing on the changes underway in consumer land.
- There certainly have been fundamental changes to consumer attitudes. In part these changes were prompted by the global financial crisis (GFC). But the changes have also been coming for some time. Over the past seven years Aussie consumers have been making more purchases with debit cards rather than credit cards. And people have been adding less to credit card balances. During 2009 growth in credit card debt turned negative. It currently is up just 3.3 per cent on a year ago. Further, over the past four months, the average credit card balance has been slashed by $39.10. Apart from the GFC period in early 2009 this is the biggest reduction in credit card debt for over 15 years.
- The warnings about the risk of high debt loads have been getting through and the messages were reinforced during the GFC. Consumers are now more likely to pay off debt with extra savings or put it in the bank. And while





the Bureau of Statistics has recently revised up the estimates of the household saving ratio, it has merely brought it into line with other indicators. In trend terms the household saving ratio is at 23-year highs but it's been rising for the past five years in line with the slowdown in the growth rate of credit card debt.

- Certainly household debt is much higher than in the past (but then again so is wealth) but small changes in interest rates do have a much bigger impact on behaviour. Reserve Bank Assistant Governor Philip Lowe suggests that this may mean that rates don't have to rise too much in the future. We'll see.
- There is also the issue of on-line shopping. Effectively this has provided more competition for Australian retailers, thus keeping downward pressure on prices. And certainly the higher Australian dollar has also influenced consumers to shop overseas websites as well as reducing prices for imported goods.
- Over the past two years changes in employment patterns have also led to changes in consumer spending. The job market peaked during 2007 and 2008, weakened in 2009, before turning higher in 2010. And there have been some major changes. Employment for those between 15-19 years peaked in December 2007 and job numbers haven't recovered – there are over 105,000 less young people with jobs compared with the peak. And for those between 20-24 years, employment is only 13,000 higher than the December 2007 peak.

Job market winners & losers

Age group	Change in jobs ('000) past 2 years*
25-34	111.3
60-64	95.0
45-54	84.6
55-59	74.3
65+	66.7
35-44	32.6
20-24	27.8
15-19	-57.5
TOTAL	***434.7***

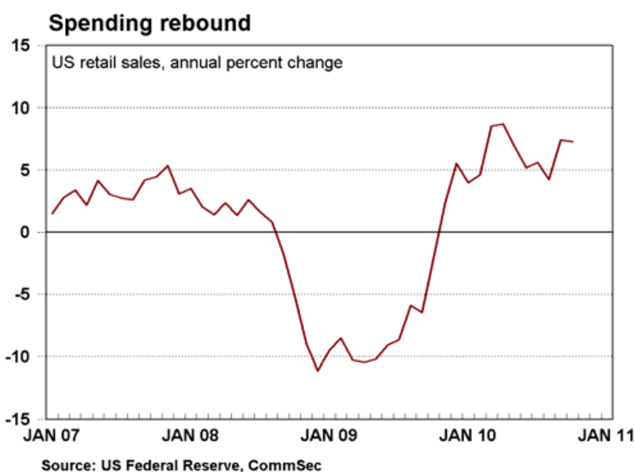
Source: ABS, CommSec
* to October 2010

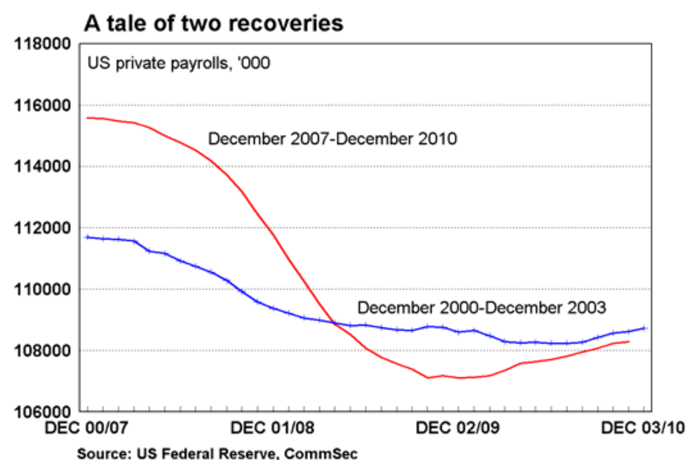
- So who has been getting all the jobs? Amazingly, over the past two years 75 per cent of all the jobs created have been taken but those over the age of 45. In fact almost 162,000 positions have been created for those over 60 years.
- No doubt the GFC caused a big dent in the incomes and saving levels of senior Australians, prompting them to either stay in jobs longer or return to the workforce. But older Australians are also adjusting attitudes to retirement, staying in the job market longer. And employers would also have played a role in older workers finding and retaining jobs, selecting them for positions ahead of younger workers.
- Whatever the case, more seniors have been employed in recent years, and they have decidedly different spending habits than Gen Y or Gen X workers and they are more likely to save rather than spend. Perhaps what we have been getting is a glimpse of some of the changes that are associated with an ageing population. And that represents a wake-up call for retailers.
- So has consumer spending fundamentally changed? The short answer is that consumer spending patterns are always changing with societal changes, demographics and 'big picture' events like the GFC. Consumers are currently focussed on saving rather than spending and have more conservative spending preferences. But with wealth levels rebounding, the job market strengthening and provided there is an extended period of interest rate stability, then consumers will indeed spend again. But conspicuous consumption is not ready for a comeback any time soon.

So What? Australian retailers will gradually see an improvement in fortunes over 2011 as consumer attitudes thaw and the job market continues to tighten.

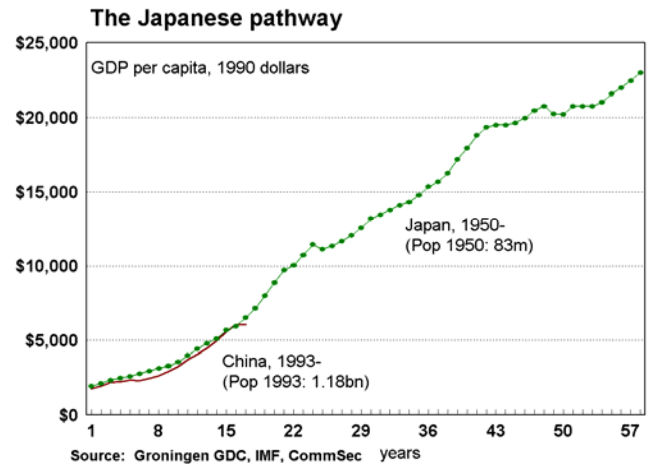
Is the US economy about to take off?

- Certainly analysts are getting more positive about prospects for 2011. And with good reason. The federal funds





rate is close to zero; the Federal Reserve has embarked on another round of quantitative easing (buying bonds in exchange for cash); and Congress appears poised to extend Bush-era tax cuts. This tax cut package also involves a temporary cut in payroll tax and extension of unemployment benefits. And the federal government is ramping up spending on infrastructure. In short there is not much more stimulus that could be applied.



- And still there are factors like the low US dollar, boosting exports. And the strength of Asian economies, providing a spur to growth in other parts of the globe. Company balance sheets are also in good shape and private companies are sitting on US$2 trillion of cash.
- So what are the factors holding back the US economy? The housing market is still over-supplied with stock, constraining new building. Unemployment stands at 9.8 per cent. State government finances are in bad shape. And the federal budget deficit is near 10 per cent of GDP.
- Overall though the economic indicators have been improving, even retail sales have increased despite an unemployment rate near 10 per cent. Job growth has been an Achilles heel for the economy but that is largely because businesses haven't had the confidence to grow. Once the animal spirits do turn more positive – and indeed there is evidence that this is happening – the US economy could indeed accelerate.

So What? If the US economy does take off there is a raft of implications. A stronger US economy may lead to a stronger US dollar and that would provide headwinds for the Aussie dollar. A pick-up in the US would also be positive for US-reliant stocks like Westfield, News Corp, James Hardie, Billabong and CSL.

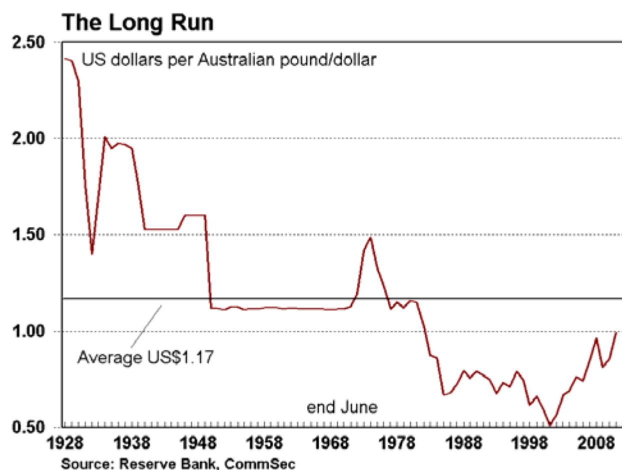
Will China continue to dominate?

- The short answer is yes. When measured in terms of GDP per capita, China is at the same point that Japan was in the early 1970s. Japan continued to industrialise and expand through to the late 1980s, at which time economic growth slowed to rates that were more consistent with other so-called advanced nations.
- Despite strong economic growth over the past decade and the emergence of impressive global cities like Shanghai and Beijing, China still has more in common with developing nations than advanced nations. China is the world's biggest car buyer but only 1 in 50 people own a car rather than 1 in 2 people in countries like Australia and the US.
- Given the fact that China is continuing to expand at a near 10 per cent annual rate, there will always be risks for the authorities in sustaining the expansion without imbalances developing such as high rates of inflation or a housing bubble.

So What? Australia has already become very reliant on the Chinese economy and this reliance is set to extend further in coming years. At its height in 1995, Japan took 25.1 per cent of Australian exports. China now accounts for 24.4 per cent of exports and its importance continues to grow strongly. Reliance on China provides significant opportunities for the Australian economy but also poses significant risks.

Will the Australian dollar be stronger for longer?

- Since the Australian dollar was floated in 1983, it has averaged US73 cents. But over the past three years it has



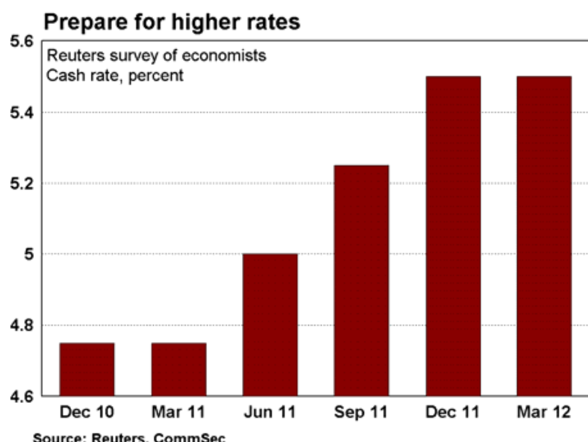
averaged US86 cents. And currently the Aussie is not far off the highest levels recorded in 28 years.

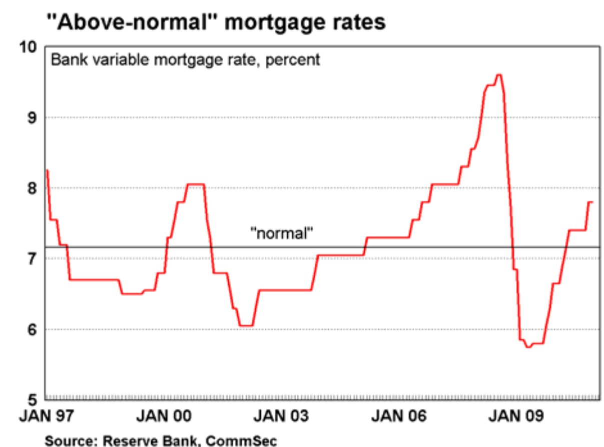
- Part of the lift of the Aussie dollar can be explained by the growth of China, reflected in rising demand and higher prices for commodities. The 'China effect' has served to keep the Australian economy strong and caused the Reserve Bank to lift interest rates.
- But the other side to Aussie dollar strength is US dollar weakness. US official rates are close to zero and the economy has been struggling for momentum. But that could be all about to change. Longer-term US bond yields are rising on expectation of stronger economic growth in 2011.
- Chinese industrialisation has much further to go. And the resource demands are huge, keeping upward pressure on commodity prices. So while a resurgent US dollar would provide headwinds for the Aussie dollar, the 'China effect' should keep the Aussie dollar stronger for longer.
- It's interesting to note that the Aussie dollar held above parity with the greenback until July 1982. But the long-term decline in world commodity prices dragged the Aussie lower over time, culminating with the low point of US47.73 cents in April 2001. It has been the industrialisation of China that has been responsible for arresting the long-term decline of both commodity prices and the Australian dollar.
- Our currency strategists believe that the Aussie could lift to US$1.02 in March 2011 but retreat to US92c by December 2011. In 2012 our strategists expect the Aussie dollar to ease to US85c in the September quarter and find a new base at these levels.

So What? Exporters and importers can't take their eyes off the currency for a second. Just when you think a new paradigm is emerging, something can come from left field. Note that the Aussie was heading for parity in mid 2008 before the GFC emerged and dragged the Aussie to US61 cents in October 2008. If the US economy was to rebound markedly in 2011 and the Chinese economy over-heated, then the Aussie would quickly lose altitude.

How high will interest rates go?

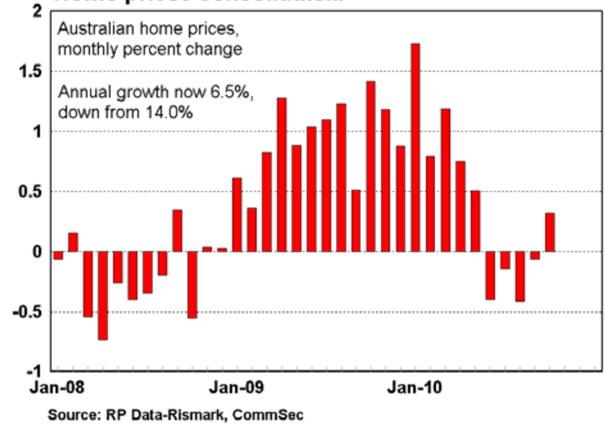
- The Reserve Bank never used to comment directly on the level of interest rates. But some subtle shifts have occurred. In recent testimony, the Reserve Bank Governor did give views on where rates were headed and how high rates could go – at least in the short-term.
- *"At the moment, most commentators do not anticipate and market pricing does not anticipate any further near-term change by us for quite some time. I think that is probably a reasonable position for them to have based on the information we have now."*
- *"We may need some more (rate hikes) than we have at the moment at some point, but at this stage the expectations are for only fairly gradual and not very close together increases. At this point, I certainly do not want to steer people away from that today."*
- Even RBA Assistant Governor Philip Lowe weighed in, claiming that Aussie consumers may continue with their conservative habits "for quite a while yet", thus capping inflationary pressures and interest rates.
- The Reserve Bank appears to be working on the assumption of around two rate hikes in 2011. Economists





assume three rate hikes. But it's important to note that the RBA is already maintaining tight monetary policy and that small changes in rates have a big impact on consumer spending because debt levels are much higher than in the past.

So What? We expect cash rates to peak at 5.75 per cent in 2012. Much will depend on the migration policies of the Federal Government. If the Government continues to restrict migration and limit business and working holiday visas then labour supply may not be allowed to adjust to meet higher demand. Clearly a tight job market increases the risk of higher wages, prices and interest rates.



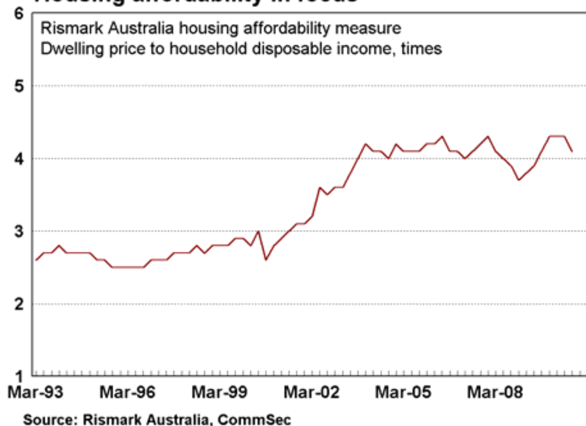
Is there a housing bubble?

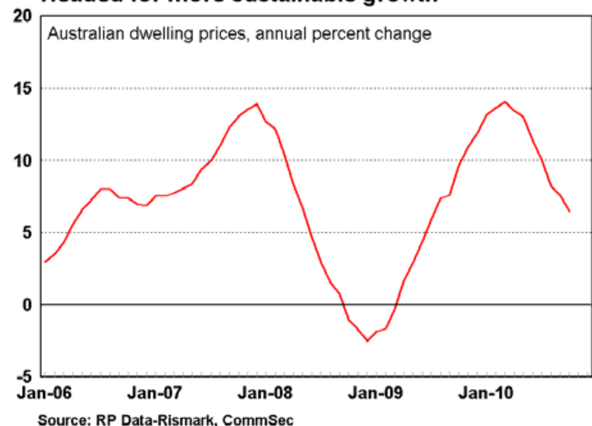
- A housing 'bubble' refers to a situation when there is an unsustainable lift in housing prices. And because it is unsustainable, eventually prices plunge back to more appropriate levels.
- Australian home prices lifted sharply in 2007 and 2008 because population growth was outpacing supply of new homes. Interest rates rose to choke off some of the demand and dwelling starts rose. Again in late 2009/early 2010 there were double-digit gains in home prices. Super-low interest rates and government grants fed the lift in prices but they have since come back to earth in response to higher interest rates.
- While there have been ebbs and flows over time, over the past five years annual growth of home prices averaged 7.3 per cent – slightly below the long-term average growth rate. There hasn't been any excessive home building, as reflected in tight rental markets across the country. In short there hasn't been any evidence that there has been a housing bubble and none to suggest that one is likely.
- Property markets are adjusting to reflect their relative supply/demand balances. Nationally home prices are up 6.5 per cent on a year ago. But while Melbourne prices are up 10.7 per cent and Sydney prices are up 8.4 per cent, Brisbane prices are down 0.7 per cent and Perth prices are down 1.8 per cent.

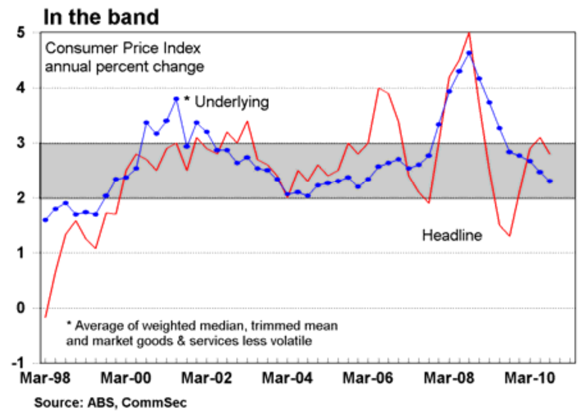
So What? There is so much misinformation on home prices. Some commentators and journalists make inaccurate and damaging comments about housing 'bubbles' and affordability without facing any consequences. While it may make an emotive story, inaccuracies can limit housing investment and prevent supply from adjusting to higher demand.

What will be the impact of climate change policies?

- This issue can be summed up as 'watch this space'. The Federal Government has in effect buried this issue until well into 2011. The Productivity Commission is examining carbon pricing policies in other countries but won't report until May 2011. Similarly Ross Garnaut has been asked to update his report on climate change and carbon pricing policies, again by May 2011.
- Clearly it's impossible for businesses to factor in potential carbon pricing issues into medium-term strategic plans. Still all businesses are already coping with a 'greener' landscape with policies affecting new building, renovations and maintenance issues. While strict carbon pricing doesn't currently exist, clearly greener practices are a common feature of the operating environment and serving to lift costs.







So What? Carbon pricing and climate change issues are likely return to the spotlight in the second half of 2011. It's not possible to make a judgement on likely effects. But any changes that do occur will have long phase-in times. Still it's important to note that environmental issues are already serving to affect business decisions and costs by stealth.

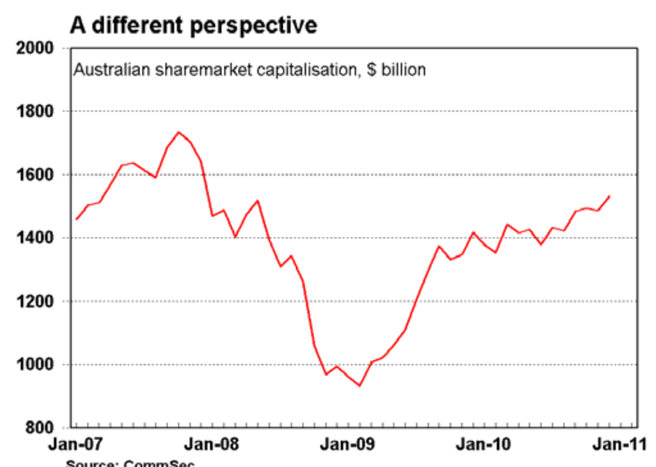
Will inflation or deflation rule?

- In Australia, the inflation rate sits comfortable inside the Reserve Bank's 2-3 per cent target band. The RBA assumes that inflation will remain in the band over 2011 but could lift to the top end of the band in 2012.
- At present a higher Australian dollar is pushing down prices of imported goods. On-line shopping is also serving to boost competitive pressures in the retail sector and keep prices low. Consumer conservatism is also an influence keeping prices low as consumers shop around for the best deal and retailers are forced to discount heavily. Even supermarkets are feeling the cool winds of deflation, rather than inflation.
- But prices of services are still rising, not falling. Workers are in demand, keeping upward pressure on wages and prices.
- In the US, the concern is still with deflation rather than inflation. In October, core consumer prices grew at 0.6 per cent annual rate – the lowest reading on record. But with all the stimulus being applied to the economy, inflation is seen as a greater risk in 2011.
- In China, food inflation has been soaring but non-food inflation has been contained. In November, China's inflation rate lifted to 5.1 per cent – the highest in 28 months. But while food inflation lifted to 11.7 per cent, non-food inflation stood at just 1.9 per cent.

So What? Inflation remains the greater risk in 2011, not deflation. With a few notable exceptions, central banks are maintaining exceptionally loose monetary policies. Strong growth in China, and Asia more broadly, continues to put upward pressure on commodity prices. The risk is that if central banks make policy mistakes – that is, they are not sufficiently alert and forward-looking and delay tightening monetary policies – this could allow inflation to take root.

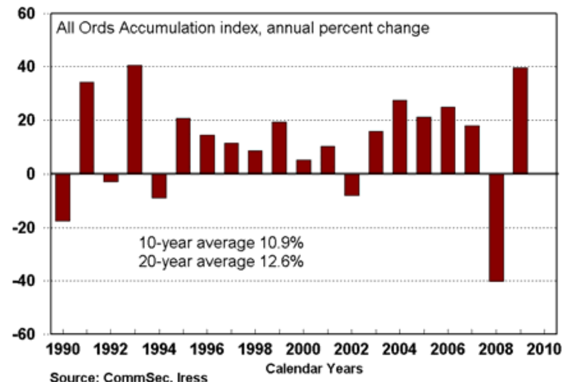
How long before shares return to record highs?

- On November 1 2007 the All Ordinaries index hit record highs of 6,853.6. On the same day the ASX 200 hit highs of 6,828.7. On Friday, the All Ords stood at 4,830 and the ASX 200 at 4,745.9. So broadly the sharemarket would need to lift just over 2,000 points or over 40 per cent to return to the highs.
- No doubt most observers would estimate that it would take another 3-4 years for the sharemarket to return to record levels – or at least six years after the levels were originally reached. Certainly we don't expect the highs to be reached any time soon – we tip the All Ords/ASX 200 to be at 5,400 at the end of 2011. It's also worth noting that it took a similarly long period to return to record levels after the 1987 sharemarket crash. The market peaked on September 21 1987 and didn't again hit record levels until February 3 1994.
- However the current situation is a little different. In 2009 companies were active in raising capital at the same time as shares were recovering from lows. So it's worth looking at the overall value of the sharemarket over time. Sharemarket capitalisation peaked at $1.73 trillion in late 2007 and now stands at $1.53 trillion. So it would only take a 13 per cent lift for sharemarket capitalisation – the broad value of the sharemarket – to reach new highs.



- The other important point is that investors are fundamentally interested in the return on shares (dividends and capital appreciation). While the sharemarket may end 2010 reasonably flat, over the past decade total returns on shares have averaged 10.9 per cent. And over the past 20 years returns have averaged 12.6 per cent a year.

So What? While it may make a good headline, record highs for the sharemarket mean little for investors. More important is the return on shares over time. And the old adage applies. It is time in the market that matters, not market timing.

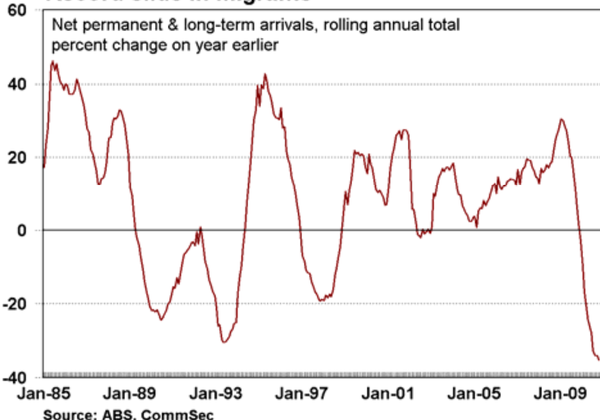


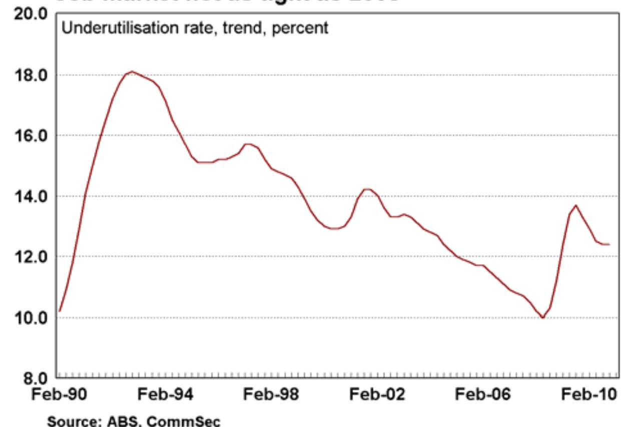
How tight is the job market?

- An issue that should regularly feature over 2011 is the state of the job market. Whenever a strong employment figure is announced, commentators waste no time warning that a lift in interest rates won't be far away. In most other countries a strong lift in jobs is celebrated but in Australia it tends to be commiserated.
- The concern of course is that if the job market is tight, employers may be forced to bid for the available workers. And if wages rise, employers may be forced to lift prices. But the job market is always about demand and supply. If labour supply is increased to meet the higher demand then there is less risk of inflationary pressures are emerging.
- The Federal Government clearly has a role here. In 2009 the Government cut the migrant intake target and tightened up on visa requirements. This may have been appropriate in 2009 but less appropriate in 2010. Employers are crying out for staff but fewer migrants are coming to our shores.
- In fact net permanent and long-term arrivals to Australia fell to 210,420 people in the year to October, down a record 35.2 per cent or 114,300 people on a year ago. Departures from Australia rose by 43,500 while arrivals plunged by 70,800. The number of permanent settlers entering Australia in October stood at 9,370 – the lowest monthly total in 6½ years.
- If the migrant intake is lifted over the coming year then there will be less risk of the job market tightening too rapidly.
- There are other factors to consider as well. More people are finding work but average hours worked in the economy are falling not rising. In addition productivity growth is poor. And then there is the under-utilisation rate. In November the under-utilisation rate stood at 12.4 per cent. While down from the high of 13.6 per cent in August, it is well up from 10.7 per cent in November last year. In short, the job market is not as tight as it seems.
- This is also the conclusion of the Reserve Bank. More people are getting jobs and the jobless rate is low, but the job market is nowhere near as tight as in 2007 and 2008.

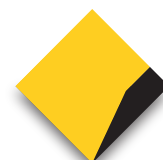
So What? Clearly the tightness of the job market will be a big issue for 2011. But it will be important to look at the trends more closely before jumping to conclusions.

Craig James, Chief Economist, CommSec





The Big Issues 2010



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Economics
December 7 2009

The Big Issues for 2010

BIG ISSUES FOR 2010

What's In

Shape of recovery; China; India; Taxation; Superannuation; Chinese Yuan; Commodity Boom, Federal Election; Climate change; Housing cost & supply

What's Out

Recession, GFC, All things US; Rate cuts/super-low interest rates; Volatility; 9-5 work-days; Debt

First a recap

- There's no question that 2009 was the year of the GFC – global financial crisis. But interestingly, just as some were ready to declare that a new Depression was upon us, the global economy bounced back. We can thank the aggressive stimulus applied by Governments and Central Banks. We can also give thanks to China – the global rebound wouldn't have occurred without China's 4 trillion yuan stimulus package.
- China has come from being an interesting sidelight to the subject of dinner party conversation. And this is just the start. The real question is when China will pass the US as the biggest economy in the world. It will happen in the next decade, but if China continues to expand at a near 10 per cent annual pace, it could happen much sooner.
- Economic debate always tends to extremes – and 2009 was a case in point. Depression didn't happen and neither did deflation. The point that seems to be lost on many analysts is the role that globalisation now plays. When the US turned down, across the rest of the globe – almost simultaneously and collectively – confidence levels dried up. People stopped spending, businesses stopped investing – the fear response.
- But once US financial conditions stabilised, confidence in the rest of the world rebounded – especially in Asia, which was fundamentally in good health before the crisis. And that's the rub. The US financial crisis became a global financial crisis because of globalisation and the fear response. Once the problem was isolated, then the rest of the world got on with business.
- Moving into 2010 the chief risks relate to the US: high unemployment; its ability to grow

FORECASTS

Economic growth	0.75% in 2009 3.25% in 2010
Inflation	2.50% mid-2010 2.75% end-2010
Unemployment	5.75% mid-2010 5.25% end-2010
Cash rate	4.25% mid-2010 4.75% end-2010
Sharemarket	5,300 by June 2010 5,600 by December 2010
Australian dollar	US98c in June 2010 US90c in December 2010

Craig James – Chief Economist (Author)

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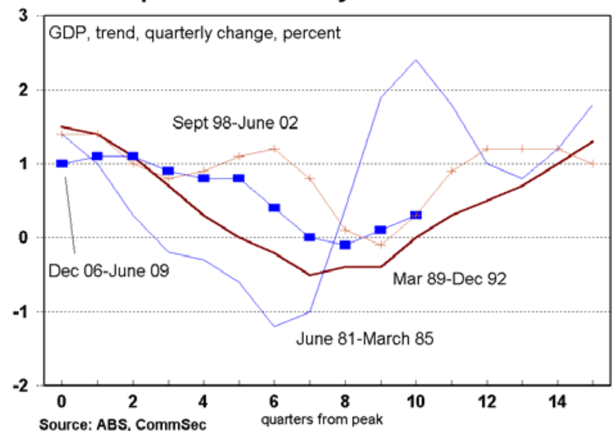
without props provided by the Government and central bank; the commercial & residential property markets; the world's preparedness to buy US debt; the path of the US dollar. And that's just the top-level factors. For Europe and Japan it's the absence of growth drivers that is the main concern. But for Asia and even Latin America, the outlook is more positive as emerging nations seek to bridge the gap with advanced nations. And that gap is indeed closing.



The Big Issues for 2010

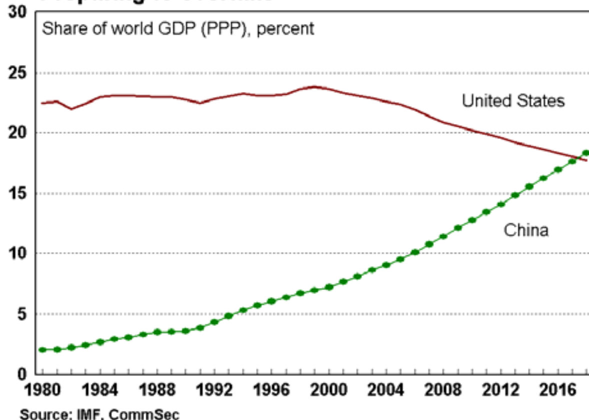
The Shape of Economic Recovery

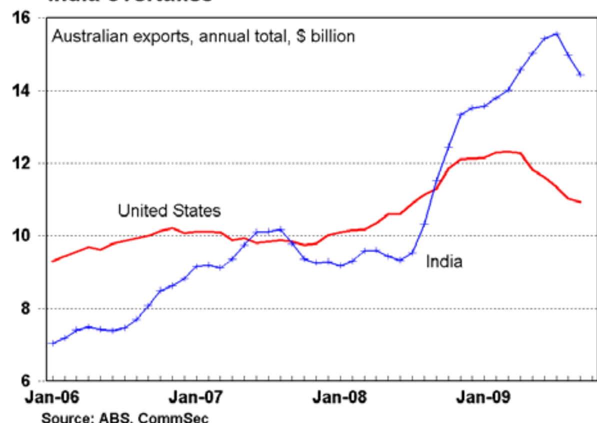
- A few months ago the general assumption was that the global economy would recover in 2010, but it would be 'U-shaped'. That is, the upturn would be slow, gradual or measured – there are various ways to express it, but a quick return to health wasn't on the agenda.
- But analysts are quickly revising that view. Some parts of the world – especially Asia – are experiencing 'V-shaped' recoveries. Of course that just leads the more gloomy economists to pronounce that the recoveries aren't 'V-shaped', rather the start of 'W-shaped' recoveries. That is, the upturn will be short-lived; disappointment will follow in the form of another downturn.
- There is no doubt that the US economy is at risk of a 'W-shaped' recovery. Europe and Japan are also at risk, especially as population growth is flat or negative in many countries and Chinese and Indian industrialisation doesn't confer the same benefits as for other parts of the world, such as Asia and Latin America.
- In Australia, the shape of recovery is expected to be 'U-shaped' to begin with, turning more into a 'J-shaped' expansion as the full benefits of Chinese and Indian industrialisation become realised.
- One issue that goes hand in hand with the **Shape of Economic Recovery** is the **Timing and speed of the withdrawal of economic stimulus.** If central banks act too quickly in lifting rates, 'V-shaped' recoveries can quickly turn into 'W-shaped' economic growth paths.

So What? US sharemarkets have more consolidation work ahead. Over 2010 sharemarkets are likely to experience periodic surges followed by periods of consolidation – more like two steps forward, two steps sideways.

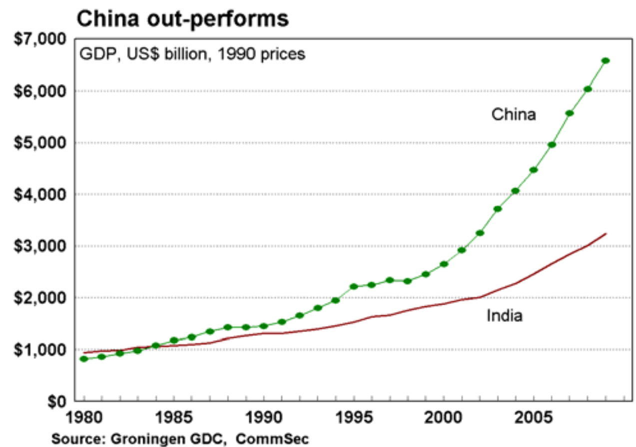
China

- China has featured on the 'What's In' lists for the past few years, and it no doubt will feature again next year in the 2011 list. The world has never before witnessed an economy with 1.3 billion people going down the path of industrialisation. And many find it hard to visualise until they go to China, experience the pace of change. And even then, they are only scratching the surface.
- China's demand for resources will no doubt amaze some commentators over the next few years, but the demand is entirely understandable when you consider the size of its population. The greatest limiting factor on China's growth will be its access to resources. And there is the very real prospect that commodity supply will again fall well short of demand, driving prices higher.
- Based on IMF projections, China will pass the US to be the biggest global economy in the next 8-10 years.





So What? There is the risk of a new commodity boom; resources companies, mining services and engineering face strong prospects; and the Aussie dollar could head towards parity with the greenback.



India

- When it comes to industrialisation and broader economic development, India is probably a decade behind China. India is effectively paying the price for restricting foreign investment in the 1990s and failing to invest in infrastructure.
- But each year, India's population grows by around 16 million people. And not only is India's population growing but its people are getting richer, buying more of the consumer durables that we take for granted in Western nations.

So What? The solid pace of economic expansion in India further supports the view that mining, energy and resources-dependent companies – especially coal – will experience above trend growth in the short to medium term.

Commodity boom

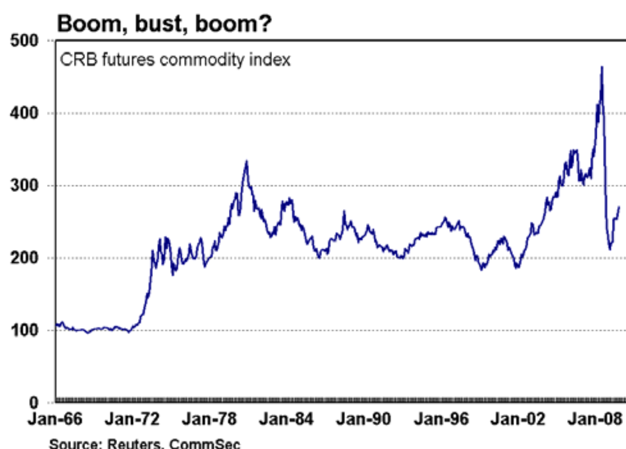
- If we're right with our view that China and India will continue to expand solidly in 2010, then this will translate into a pick-up in demand for commodities. Importantly it's not just the expansion in China and India but also solid growth rates for economies across Asia and the commensurate expansion of the middle class and demand for consumer durables.
- The key question is whether commodity supply can keep pace with demand. In 2006 and 2007 the scale of Asian expansion caught central banks and mining companies alike by surprise. The same could happen again – especially given that the GFC caused mining and energy companies to mothball facilities or curtail expansion plans.

So What? A sharp lift in commodity prices, or even a new boom, would lead to higher investment in the resources sector and greater demand for engineering services; the other risks include a revival of inflation and further appreciation of the Australian dollar. The real risk for Australian companies is that the Aussie dollar holds above US80c or US85c rather than returns to the long-term average of US72c.

Chinese yuan appreciation

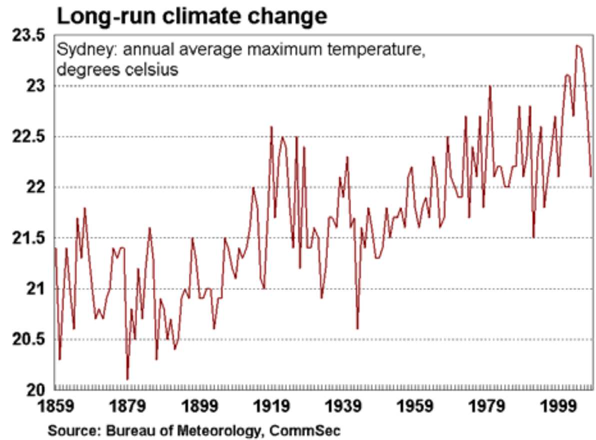
- The GFC served to silence calls for revaluation of the Chinese yuan (or renminbi). However Chinese authorities would only contemplate revaluation or further moves to free up the link to the greenback if they believed that it wouldn't lead to a major shake-out in the export sector and disrupt overall economic expansion.
- The US is certainly in no position to force the revaluation issue, well aware that it needs China to continue its regular purchases of US treasuries.
- And China will want to be confident that the global economy is on a much firmer footing before even contemplating changes to its currency.

So What? A stronger Chinese yuan would lift the purchasing power for Chinese commodity buyers, in turn, boosting the Aussie dollar.



Climate change

- Countries across the globe will determine their responses to climate change in 2010. Given that there is no common agreement on the extent or severity of climate change – and never will be – there is unlikely to be uniformity on the approach taken to the issue. The climate has been changing for centuries, but there are few signs that the process is accelerating.
- Some countries favour a tax on carbon emissions, others favour a market-based approach where carbon credits can be bought and sold.
- The fundamental principle is that carbon emissions – like pollution – create negative externalities. That is, carbon emissions lead to problems or costs for consumers or businesses. If a price were put on emissions then it is assumed that affected businesses would seek ways to reduce the costs or perhaps pass on the costs to consumers.



So What? Eventually the Australian parliament will decide on measures to address climate change. And understandably there will be winners and losers. Some investors jumped too quickly, reacting to the Government's proposed legislation on a carbon pollution reduction scheme. Other investors need to be careful not to fall into the same trap with any revised proposals. Any emission pricing scheme will be phased in over time – there can be costly mistakes for investors in trying to get ahead of the market.

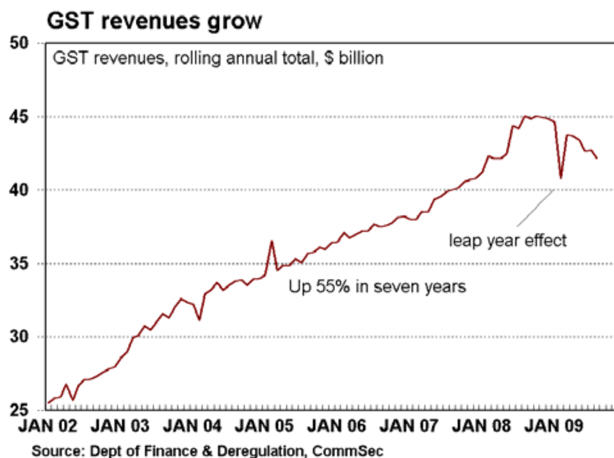
Housing cost & supply

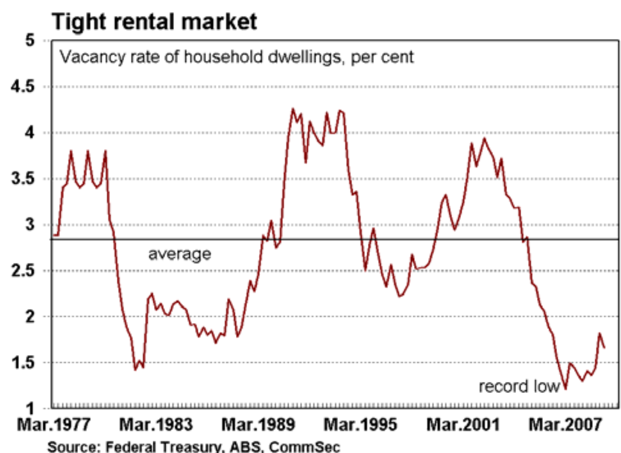
- Just how tight is the housing market? Over the last year Australia's population rose by 440,000 people – the biggest increase on record and the largest percentage increase in 40 years. The number of migrants increased by more than 285,000 people. But dwelling commencements only rose by just over 131,000. On this basis you would have expected more people to be on the streets and for the rental vacancy rate to approach zero. But it didn't happen. In fact some Sydney landlords complained that they had to reduce rents or offer rent incentives.
- CommSec found that Australia is building the biggest homes in the world, but at the same time there is new evidence that household size is increasing for the first time in at least a century, or perhaps since European settlement.
- The debate about housing costs and supply will go on in 2010. There is no doubt that rising housing costs are causing children to stay longer with parents and for more young people to share accommodation. State and territory governments have to pay more attention to produce more land, reduce costs for developers and revisit zoning laws.

So What? CommSec expects home prices to rise by 8-10 per cent over 2010. Population continues to grow and not enough homes are being built. For investors, rising rents and home prices is an attractive combination.

Taxation

- The review into Australia's tax system – the Future Tax System Review – will report to the Government by the end of the year. Headed by Treasury Secretary Ken Henry, the review panel has taken over 1,000 submissions, but interestingly, there have been little in the way of leaks. The review will probably recommend a reduction in business tax and will likely recommend measures to create a more level playing field on the taxation of savings.





- Could the review panel recommend a hike in the GST rate to fund other measures such as removal of state payroll tax? Certainly it's a possibility. And while a lift in the GST rate makes a great deal of sense, the question is how the Government would respond with an election drawing near. Clearly both sides of politics will need to agree about the sensibility of a proposal to increase the GST rate for it to get through the political process.
- It is uncertain when the Government will respond to the recommendations. The terms of reference states: *"The Government will respond in a timely way to the tax review's recommendations as they are released."*

So What? The tax recommendations will have far reaching implications for the economy. If a more favourable tax treatment were given to bank deposits then investors would require both higher returns and greater certainty of returns from alternative investments such as property and shares. Still, it is also entirely possible that the review could come up with proposals affecting dividend payments by companies. Unlike climate change the Government would need to make changes on taxation with immediate effect.

Superannuation

- The Super System Review has three parts: Governance; Operation & efficiency; and Structure. Headed by Jeremy Cooper, the review is due to release preliminary recommendations on Governance shortly. Recommendations on Operation & efficiency aren't due until March-April 2010. An Issues Paper dealing with the Structure of the Superannuation system is due on December 14. A final report is due by June 30 2010.
- What could the review come up with? Almost anything. But expect vigorous debate by industry bodies, fund managers and the Government. Clearly though Superannuation is an issue for 2010.

So What? Just like the Climate Change issue it's a case of watching the debate but not over-acting. Recommendations will need to be vigorously debated before the Government announces decisions, and lengthy phase-in periods are likely for any changes.

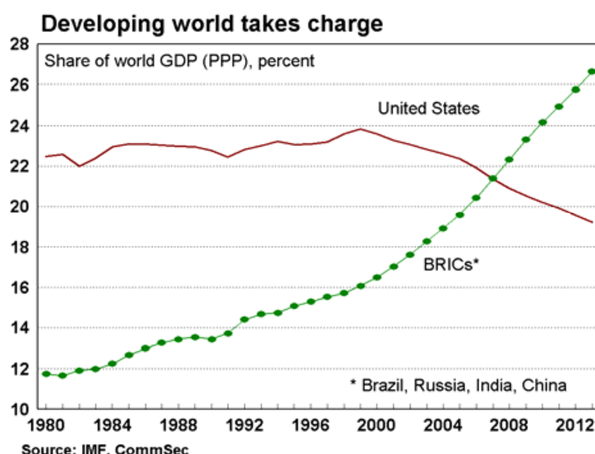
Federal Election

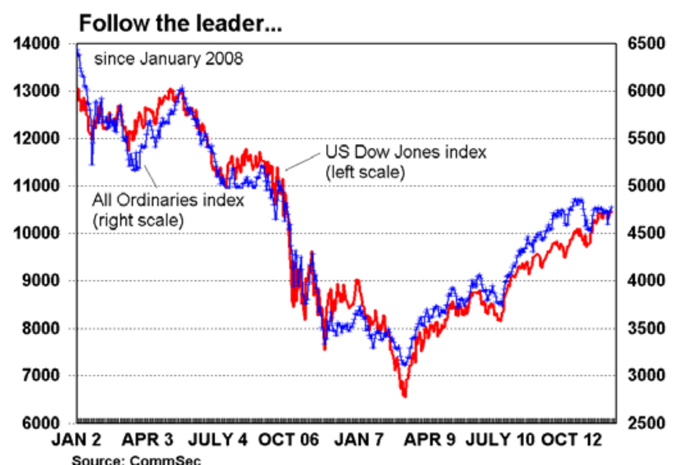
- A Federal Election must be held by April 16 2011. And the earliest date for a simultaneous half-Senate and House of Representatives election is August 7 2010. But there is the risk of an early poll given that the trigger for a double dissolution of both chambers exists – the carbon pollution reduction scheme bill being twice rejected by the Senate.
- On current opinion polls the Federal Government would easily be returned to power. The key issues to be debated by the major parties will be climate change, industrial relations and the size of the government economic stimulus measures. Taxation and superannuation may also emerge as key issues for debate.
- There are also state elections scheduled in South Australia, Tasmania and Victoria in 2010.

So What? Financial markets hate uncertainty so expect sharemarkets to trend sideways and perhaps under-perform other global markets once a poll is called.

What's out for 2010

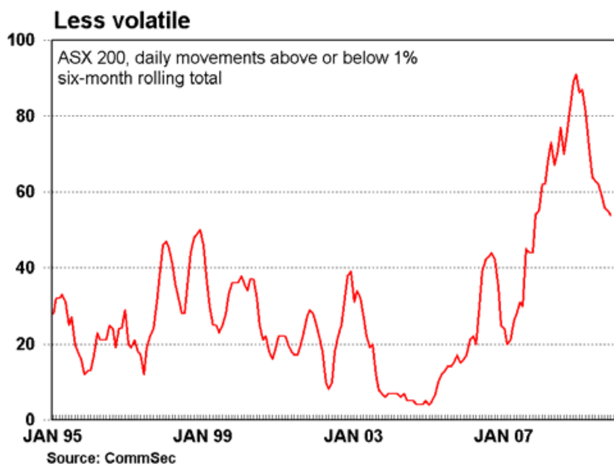
- **Recessions** have already ended in a number of major economies and we expect more countries to emerge from intensive care and move into the recovery ward in 2010. As we noted above, the path of recovery will be uneven – with emerging nations in Asia and Latin America offering best prospects.
- While the US is expected to experience a 'U-shaped' recovery, there is always the potential for surprises, as shown in the latest employment result. Once jobs start growing again, this will translate into increased confidence and consumer spending, creating momentum for the economy.

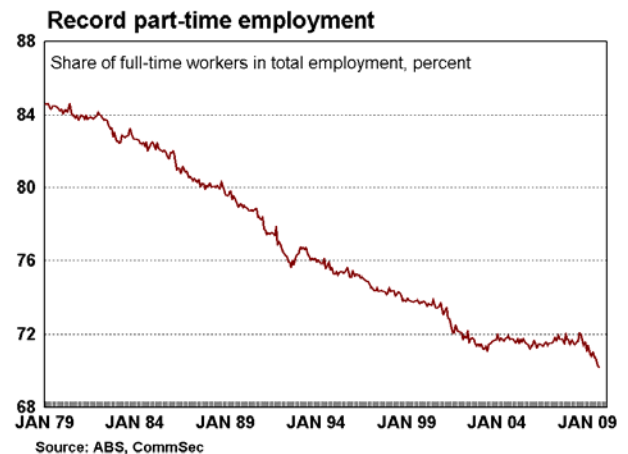




- Certainly we are likely to see fewer references to the **GFC or global financial crisis.** The GFC came as a major shock to companies and consumers across the globe, but now with the healing process underway, people are gradually getting back to business.
- With the GFC receding into the background, investors will have less need to be pre-occupied with **all things US**. The US really did dominate attention in 2009, its financial crisis spreading across the globe, causing sharemarkets to move in lock step with the US Dow Jones and S&P 500 indexes. Now investors can pay more attention to what's happening in their own backyards. As a result the tight correlations that existed between major share indexes and US share gauges should ease markedly.
- While the correlation ratio between the All Ordinaries and US Dow Jones was regularly near 0.95 in 2009 (where a perfect relationship would equal 1.0) it's important to remember that back in 2005 that ratio was around 0.50.
- With recessions ending and recoveries taking hold, clearly there will be fewer references to **rate cuts or super-low interest rates**. But here is where it becomes interesting – central banks must gradually lift interest rates and sell assets without derailing fledgling recoveries. Clearly the process is not without significant risks.
- One change that has already happened as a result of the GFC is that consumers and businesses are re-assessing their views on **debt.** It's not that debt will be shunned in 2010, rather people have long memories – companies will tend to favour equity over debt. Consumers will use their own funds rather than credit cards for regular purchases. It takes a shock for the GFC to change behaviours, and it will take some time before debt is regarded more positively.
- Arguably more settled financial markets might lead to less **volatility**. But clearly this can't be predicted with any great certainty. All it needs is something new from left field such a new geopolitical crisis and volatility will return with a vengeance. Still, there has already been a sharp drop in the number of days that the All Ordinaries rises or falls by more than 1 per cent.
- One of the interesting developments that has followed from the GFC is even greater labour market flexibility. Companies have become more accustomed to using a mix of full-time and part-time staff. And they have also become more amenable to changes in work-hours and workweeks.
- There are numerous anecdotes suggesting that those employees that have been forced to work fewer hours or different work hours like the change. While all this doesn't spell the death of the **9-5 work-day** or perhaps 8-5 work-day, employers recognise that different practices can prove more successful, reduce worker turnover and improve flexibility and productivity. The ageing population will require employers to adopt different practices with more senior workers requiring part-time rather than full-time positions.

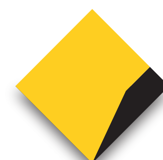
Craig James, Chief Economist, CommSec





The Big Issues 2009

CommSec



The Big Issues for 2009

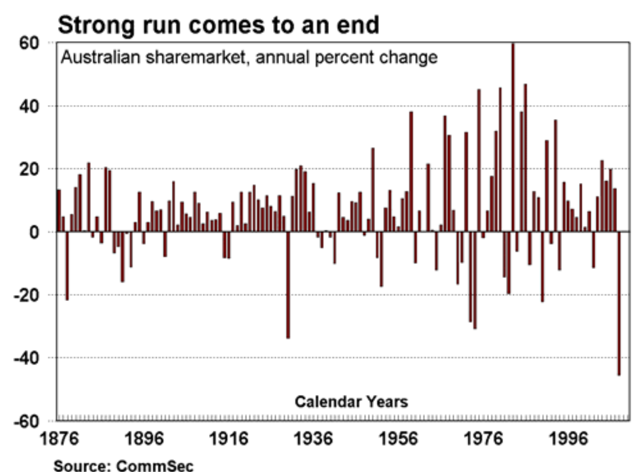
- Each year we attempt to identify the Big Issues for the coming year. There is no doubt that the US-originated **global financial crisis** was ***the*** issue of 2008. But what will dominate in 2009?
- CommSec identified **recession** as being one of the Big Issues for 2008. Unfortunately we were right and **recession** will again be a dominant issue for at least the first half of 2009. However CommSec believes that **economic recovery** will take over as the principal focus over the second half of 2009. Other key themes in 2009 are likely to include **infrastructure spending**, **rising unemployment**, **monetary policy and emissions trading.** As always, **China** will never be too far from investor thoughts over 2009**.**

THE BIG LIST

Big Economic Issues This year (2008)	*Big Economic Issues Next year (2009)*
Global Financial Crisis	Economic recovery
Recession	Recession
Sharemarket slump	President Obama
Strong US dollar	Infrastructure
Record low interest rates	Monetary policy
Commodity boom	Carbon trading
Tight job market	Rising unemployment
Inflation	Disinflation
Crisis of confidence	Financial regulation
China	China

The Big Issues Of The Past Year

- At the beginning of 2008 the US sub-prime crisis was occupying attention on financial markets. But no one predicted just how aggressively it would overwhelm financial markets over the year, dragging down otherwise healthy economies and producing recessions in many parts of the globe.
- The tragedy is that the sub-prime crisis – which became the **Global Financial Crisis** – again reflected failures by authorities in the world's largest economy – the United States – causing global economies to weaken and drying up sharemarket wealth.
- The key economic and financial issues of 2008 have all flowed from the Global Financial Crisis. Namely, **recessions** in major economies (barring Australia), massive **falls on global sharemarkets, interest rates hitting record lows** and a sharp **appreciation of the**



Craig James – Chief Economist (Author)

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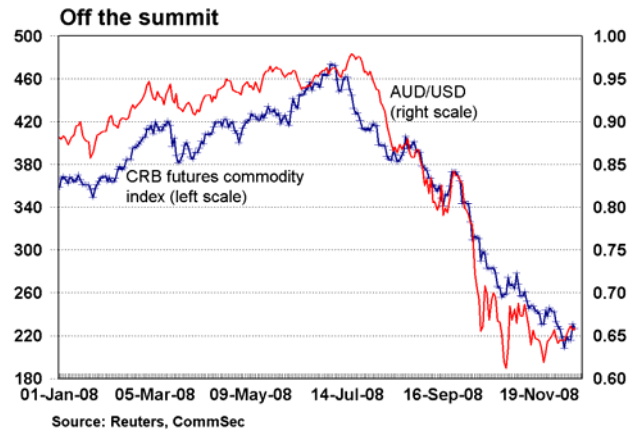
US dollar against major currencies.



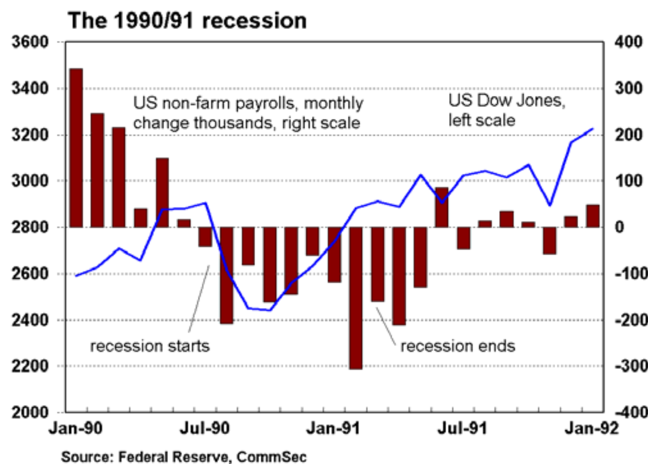
Source: Reuters, CommSec

- The scale of the falls on global sharemarkets is highlighted by the fact that the Australian sharemarket is on track to record its largest calendar year decline. The 45 per cent slide for the All Ordinaries compares with a 33.9 per cent fall in 1930.
- One of the only positives to have come out from the crisis is that inflation rates have dramatically eased. Reduced demand by consumers and businesses for goods has translated to less demand for raw materials or commodities, notably oil. And slower consumer spending has meant more discounting by businesses.
- The most remarkable aspect of the Global Financial Crisis has been the speed which it has enveloped the globe. In July, commodity prices were at record highs with oil almost US$150 a barrel, central banks were fretting about **rising inflation**, **labour markets across the globe were tight** and there were fears of overheating in **China**.
- But five months later, oil is nearer US$45 a barrel, deflationary fears have replaced concerns about high inflation, labour markets have weakened and there are worries about a 'growth recession' emerging in China.
- The reaction highlights the power of globalisation as well as the role that fear can play in shaping financial markets and economies. Fear caused banks to stop lending to one another. And fear caused investors to stop buying shares, opting for the relative safety of cash-based investments.
- Consumers responded to sharp falls on global sharemarkets by scaling back spending on discretionary purchases. And the same cautious attitude was expressed by businesses in hiring and investment plans. Central banks were forced to aggressively cut interest rates while governments unveiled major stimulus packages.
- Remarkably it took just 74 days for the Australian dollar to slide from US98 cents to US62 cents. The speed of the decline reflected similar sharp falls on commodity markets as large fund managers and hedge funds took the view that the five year **commodity boom** was over. At the same time, US businesses withdrew investments from all parts of the globe, buoying the greenback and, in turn, causing major currencies to slump.

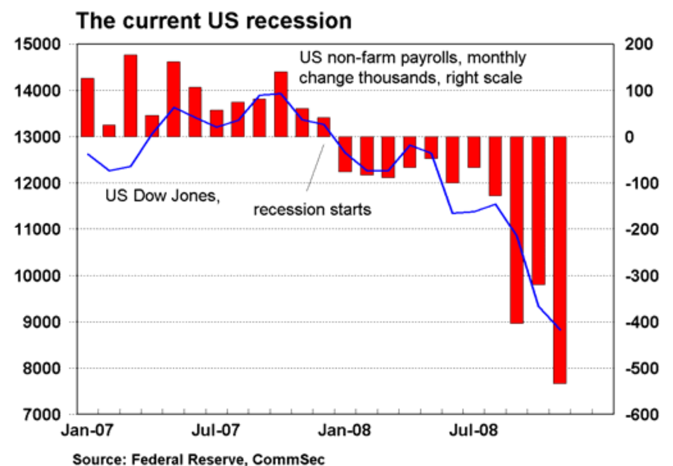
The Big Issues for 2009

What will be the issue of the year?

- As always, this is the most contentious question and invariably one that most analysts get wrong. And that's because there is always something that comes from left field and ends up becoming the dominant influence. Last year we listed a raft of issues that we thought would dominate in 2008 like **recession, labour shortages and climate change**. In the end we opted for climate change, believing that there was a sufficient groundswell of community support to force action by major global economies. However a combination of international inaction and the growing Global Financial Crisis saw climate change issues pushed to the background.



Source: Federal Reserve, CommSec



Source: Federal Reserve, CommSec

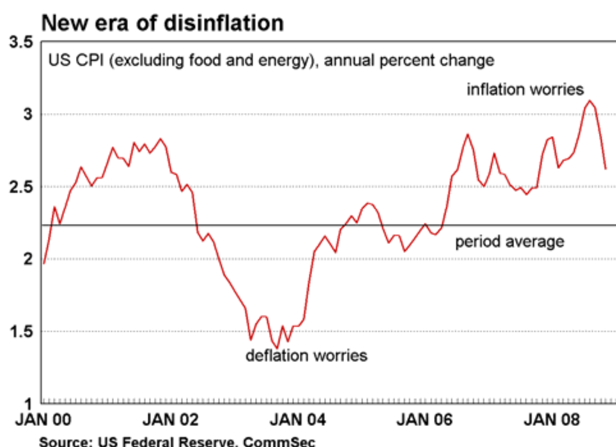
- While the sub-prime crisis was a key threat to the US economy in late 2007, at the same time commodity prices were still marching higher, driven by the strength of economies in Asia – especially China and India. The perception was that the sub-prime issue was containable with no one envisaging a scenario that US investment banks would fail or would have to be rescued. If anyone suggested that all US investment banks would cease to exist by end year they would have been quickly wrapped up in a tight white suit.
- Looking ahead to 2009, we would be reticent about identifying one issue that will dominate over the year. Rather we think **recession** will be the dominating issue early in 2009, giving way to **economic recovery** over the second half of the year. A key influence will be confidence. While central banks have slashed interest rates and governments are pumping money into economies, no one can make consumers spend or businesses invest or hire workers.
- In the US, past recessions have tended to end around 2-3 months before employment turns positive. So we would expect that the current recession will end around mid 2009, putting it on par with the 1973-75 downturn that lasted 16 months.
- In Australia, we still believe that recession will be avoided but it will be a close run thing. Still, a raft of stimulus factors such as lower petrol prices, falling interest rates, increased Government spending and the expanded first home owners grant will all be working to lift activity over the coming year.

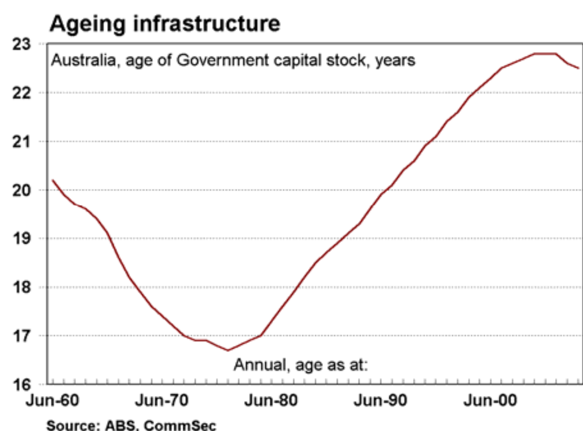
Infrastructure

- Increased spending on economic and social infrastructure is emerging as a key theme for 2009. In Australia, the Federal Government will unveil the priority list of infrastructure projects for the Government's $24 billion Building Australia Fund in early 2009. Projects like expansion of port facilities and enhancement of rail networks will be important to ensure Australia meets China's demand for resources in coming years. But at the same time, Australia's growing population is stretching demands on social infrastructure such as schools and hospitals. The average age of the Government's capital stock has risen from around 17 years to almost 23 years.
- In the US, infrastructure spending has also been identified by President-elect Obama as a priority issue in 2009. Not only is there an urgent need to upgrade the country's ageing infrastructure but the projects will be important in dragging the economy out of recession and kick starting growth. The American Society of Engineers estimated a year ago that it would take US$1.6 billion spent over five years to improve US roads, dams and bridges.
- And in other countries like China, again infrastructure will be a priority area in 2009. On November 9, the Chinese Government announced a 4 trillion Yuan stimulus package ($870 billion) focused in "10 key areas such as low-income housing, rural infrastructure, water, electricity, transportation, the environment, technological innovation and rebuilding from several disasters, most notably the May 12 earthquake."

President Obama

- It may appear odd to represent US President-elect Barack Obama on the list of big economic issues for 2009. But when it comes to identifying key influences on economic activity, the incoming President's role will be vital. Not only is President-elect Obama in the process of devising an economic stimulus plan, but he is seen as a major catalyst in boosting confidence levels.
- The assumption of power by President Obama could prove similar to the influence the second Gulf War had in sparking revival on the sharemarket. Back in March 2003 the 4½ year sharemarket bull run commenced when allied forces embarked on the second Gulf War. Uncertainty about whether conflict would occur had earlier





constrained investor buying. Investors took a more positive view on US economic conditions when the war began on the assumption that the conflict would prove relatively brief conflict – an assumption that proved correct.

- President Obama is likely to be viewed as a catalyst for change and a break with the past, potentially boosting investor as well as consumer and business confidence.

Disinflation

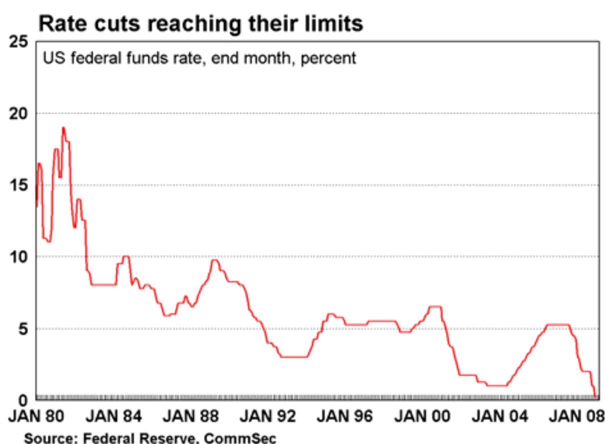
- Disinflation refers to slowing rates of inflation, while deflation refers to falling prices. A period of weaker economic growth is likely to lead to one of these factors holding sway, the $64 question is which one. Given that a deflationary environment tends to be associated with weak economic growth or contracting activity, disinflation is clearly preferable.
- Interestingly deflation was a concern in the US in 2002 and 2003 when the economy was emerging from recession but the concern receded from view with stronger economic growth in 2004. Inflation was a concern for the US central bank as it was for other central banks through most of 2008 as oil prices soared. But again the concern has shifted to deflation as economic growth slowed in the second half of 2008.
- The reflationary policies of major global economies are expected to be successful in ensuring consumer prices continue to grow over 2009, but at a more slower, more sustainable pace than in 2008.

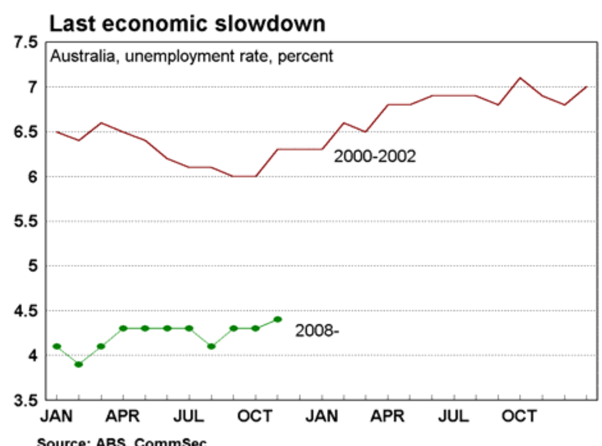
Rising unemployment

- If there is one factor to fear in 2009 it is rising unemployment. Job losses translate to slower spending and reduced business income, in turn feeding back into further job losses ("vicious circle"). In the current US recession so far, unemployment has risen from lows of 4.4 per cent to 6.7 per cent. In the previous recession in 2001, unemployment rose from 3.8 per cent to 6.3 per cent.
- While US unemployment has generally risen by 2.5-3 percentage points in past recessions, in the 1979-82 experience the jobless rate rose from 5.6 per cent to 10.8 per cent. Still that experience was associated with the peak of baby boomers hitting the job market whereas 2008/09 is characterised by an historically lower share of younger workers.
- In Australia, the unemployment rate has only risen modestly so far from a 33-year low of 3.9 per cent in February 2008 to 4.4 per cent in November. Just like the US, the share of young people in the working age population is low – hitting record lows in June. At the same time, migrant workers remain in demand to meet skill shortages.
- Overall CommSec expects Australia's unemployment rate to rise to around 5.25 per cent over 2009. However the risk is that businesses make knee-jerk decisions to trim staff numbers – a development that could spark a mild version of the "vicious circle" noted above. But a sharp rise in the jobless rate is not contemplated.

Monetary policy

- Across the globe, official central bank interest rates are at historically-low levels. As a result, questions are being raised about the future effectiveness of monetary policy. However the US is following the same route that Japan took in 2001 in applying "quantitative easing" – effectively buying securities from financial institutions in exchange for cash. The US Federal Reserve chairman Ben Bernanke has also outlined a raft of other measures that could be used to expand liquidity such as offering fixed-term loans to banks at zero interest rates.
- While other central banks have much further to go before approaching zero policy rates, clearly there will much





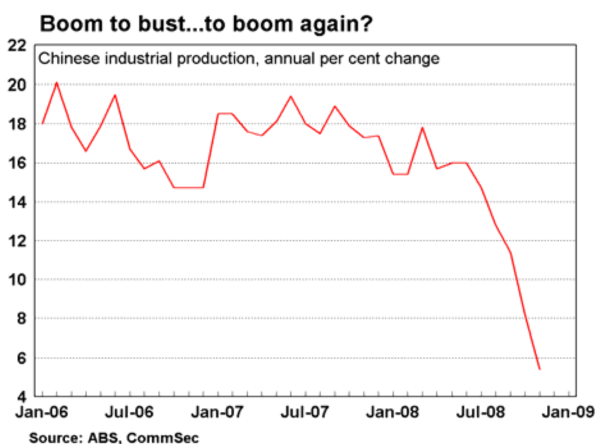
discussion and thought applied to alternative monetary policy tools during 2009. In Australia, the cash rate stands at 4.25 per cent and CommSec expects the Reserve Bank to cut rates another 50 basis points (half a percent) to 3.75 per cent in February.

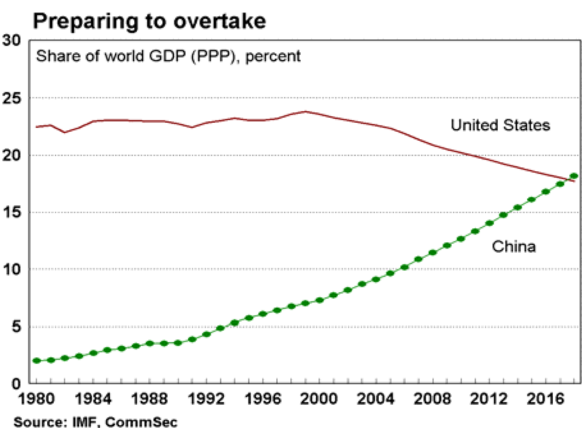
- It won't just be monetary policy tools in the spotlight over 2009 but also monetary policy frameworks. Most central banks use inflation as a guide for monetary policy actions but some policymakers believe that prices of assets like shares and houses should play a greater role in decision-making. For instance if house prices are booming as a result of strong demand, but inflation is still entrenched at lower levels, are central banks right to do nothing?

Other issues to watch in 2009

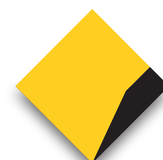
- The Federal Government has recently released its **emissions trading** White Paper with a proposed implementation date on July 2010. So while the discussion/debate on climate change policies has begun, clearly the issue will feature prominently in 2009. Investors will need to assess the impact on individual companies and industry sectors. Businesses will need to determine the impact on their costs and whether any strategic response is necessary. Consumers won't have to worry too much about **carbon trading** over 2009, especially as the Government is planning significant compensation. Still, the issue will generate plenty of debate with the uncertainty potentially affecting confidence levels.
- The speed and the extent of contagion flowing from the Global Financial Crisis surprised all and sundry in 2008. However while 2008 was notable for the crisis, 2009 will be notable for the post-mortem. Regulators, governments, central banks and financial institutions will need to work out what went wrong and how it can be prevented from recurring. As is common with previous financial crises, attention will centre on the adequacy of **financial regulation.** G20 countries have to report by March 31 2009 on a raft of issues associated with financial regulation. Greater international co-operation is essential to prevent a repeat of the current crisis.
- The chief risk is that regulators over-compensate by tightening regulation significantly, although we do acknowledge there is a need for greater transparency in some areas, especially in terms of operation of hedge funds.
- No doubt the debate on short selling will continue sell into 2009. The proponents of short selling still have not convincingly argued why the practice should be maintained. And as a result, regulators will remain poised to ban the practice. There are too many risks of manipulation associated with the practice as many Australian companies can attest.
- **China** will continue to occupy a prominent position on radar screens in 2009. Over 2008, it was the ascent of China that dominated in the first half of the year with its solid expansion driving commodity prices to record highs. However post-Olympics it has been the global-induced slowdown in China that has raised concern, especially as it has been a fundamental driver of global growth in recent years.
- We expect that recent efforts to stimulate the Chinese economy will be successful in 2009. The key factor complicating analysis at present is that economic data has been deflated by the factory shutdown at the time of the Olympics, suggesting that the Chinese economy is weaker than it otherwise is. Substantially firmer readings for key variables like production and fixed asset investment will be sighted around mid 2009.
- China remains on course to pass the United States as the largest economy over the next 5-10 years, especially with growth in the US likely to hold near 1-2 per cent over 2008 and 2009.

Craig James, Chief Economist, CommSec





The Big Issues 2008

CommSec 

Economics
December 17 2007

The Big Issues for 2008

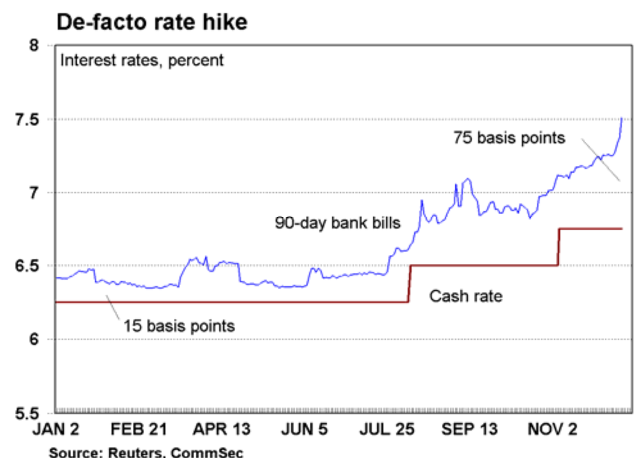
- **Climate change** is expected to be *the* Big Issue for 2008, dominating public consciousness, affecting company strategies and influencing other issues such as development of alternative energy sources.
- CommSec also believes that the apparent **trade-off between inflation and unemployment** will come under increased scrutiny in 2008. Unemployment rates in a range of industrialised countries are at 33-year lows and skilled labour shortages are increasingly appearing.

THE BIG LIST

Big Economic Issues Last Year (2007)	***Big Economic Issues Next Year (2008)***
Climate change	Climate change
Record oil prices	Inflation/unemployment trade-off
Sub-prime crisis	Agflation
Weak US dollar	Agvestment
Agflation	Industry consolidation
Drought	Nuclear energy
Private Equity	Global labour shortages
El Nino	La Nina
Rental crisis	Hillary Clinton
Tight job market	Recession

The Big Issues Of The Past Year

- Each year we seek to identify the big issues for the coming twelve months – issues that we believe will be of key importance for the economy and, in turn, for domestic investors. This is not so much an exercise in crystal ball gazing, but rather an attempt to highlight issues of potential risk and opportunity for investors.
- We don't always get it right. At this time last year we thought that **interest rates** had peaked. But the strength of the domestic economy was one of the big surprises of 2007.
- A year ago, a number of state economies were close to, or in recession, notably NSW and Tasmania. Drought also persisted, although there was optimism that seasonal conditions would improve over 2007. And the general view at the start of the year was that the Chinese economy would ease to a more sustainable rate, leading to slower commodity demand and prices. So we weren't alone in believing that rates had peaked.



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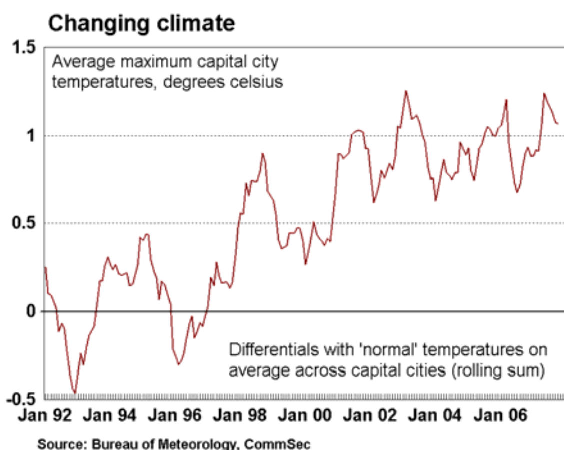
- But while drought lingered, China continued to boom, commodity prices held firm and Australian population growth hit 18-year highs. While interest rate settings were indeed stable until the second half of 2007, on-going strength in the global economy together with a resurgent domestic economy prompted the Reserve Bank to lift rates in August and November.
- We also thought **oil prices** would come down over 2007 and that capacity constraints would ease. And while oil prices were stable over most of the first half of the year, they certainly soared in the second half. Clearly we were too pessimistic about economic prospects and overly optimistic that supply disruptions and geopolitical issues wouldn't pose problems.
- Still amongst the blots on our copybook, we can claim some successes. We thought the **rental market** would remain tight, pushing rents even higher. And indeed rents rose at the fastest pace in 17 years. We also expected **tight job markets** to persist, that **consolidation** would continue **in the media sector**, **private equity investments** would remain in vogue and that **climate change / water security** would be *the* issue of 2007.
- But the two issues that really dominated over 2007 were **record oil prices** and the **US sub-prime crisis**. Both were certainly on the radar screen twelve months ago, however few could have predicted the influence they would exert on financial markets. And while both are clearly "hot" issues now, they should ease in importance over 2008.
- Fundamentals in the oil market have improved with fewer supply disruptions and a softening in demand – especially in the US. And in terms of the sub-prime crisis, the US Government rescue plan has bought some much needed time for workouts to be put in place. But clearly much work lies ahead.
- On the local front, probably the main surprise of 2007 was how strong the economy performed. And Australia is entering 2008 in good shape. The economy is growing at a 4.3 per cent annual pace, the budget is solidly in surplus and the job market is healthy. But domestic inflation, the US sub prime crisis and worries whether the Chinese economy will remain strong are the main radar screen issues.
- A pleasant surprise in 2007 was that the Australian sharemarket again produced above-normal returns. In 2008 we expect less stellar sharemarket returns, but expected growth of 15 per cent would again be slightly above the long-term average.

The Big Issues for 2008

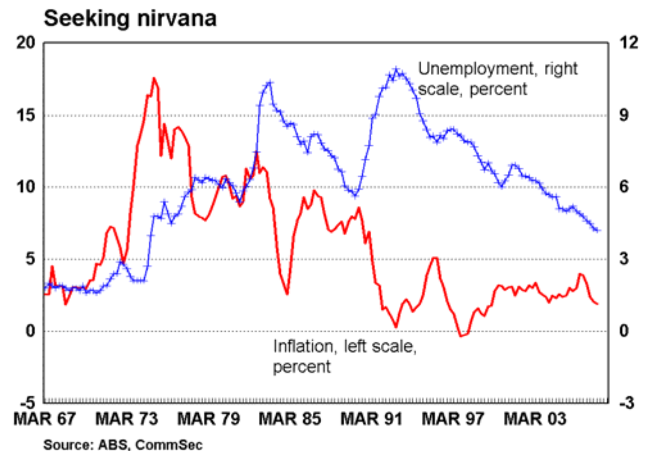
What will be the issue of the year?

- This is the most interesting question, basically because it is the most contentious. Last year we identified **climate change**, and more specifically to Australia, **water security**, as the issues of 2007. But while "hot issues" they didn't dominate all other. As noted, **oil prices** and the **US sub-prime crisis** were the surprise packets of 2007.
- In terms of identifying the big issues of 2008, this year we have done things a little differently – just compiling one list of big issues rather than an "In" and "Out" list. But as always, coming up with ***the*** issue of the year is the hardest task. In 2008, we believe that **climate change** will continue to dominate public consciousness.
- Climate change is certainly real. In Australia, maximum capital city temperatures are on average 1 degree Celsius above 'normal' temperatures recorded between 1961-90. Businesses and governments continue to respond to the challenges posed by climate change and that will continue in 2008. In rural Australia, while seasonal



conditions look more favourable, the combination of higher temperatures and increased water evaporation rates will keep the spotlight on water security issues.

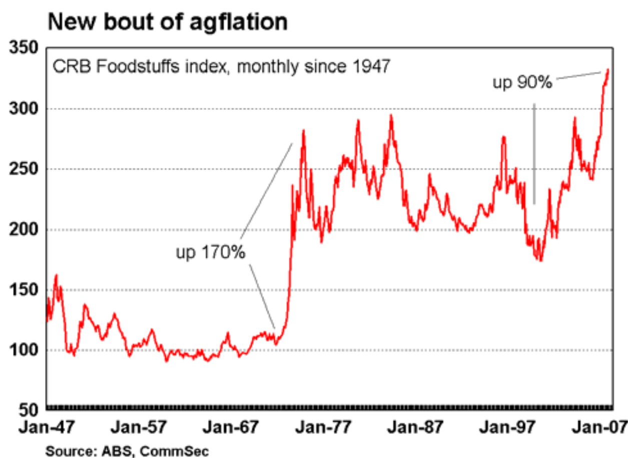
- In identifying Big Issues for 2008, we also are being a little courageous and identifying an issue not currently 'top of mind'. And that is the **trade-off between unemployment and inflation.**
- Not since the 1970s have industrialised countries been faced with the enviable problem of trying to maintain low unemployment rates and low inflation. In the UK, Canada and Australia, unemployment rates are the lowest since the 1970s while inflation rates in each country are holding at historically low levels of around 2-3 per cent.
- The challenge in 2008 will be for central banks and governments to push the job market even closer to fabled "full employment" levels in major countries, while at the same time maintaining the good record on inflation.

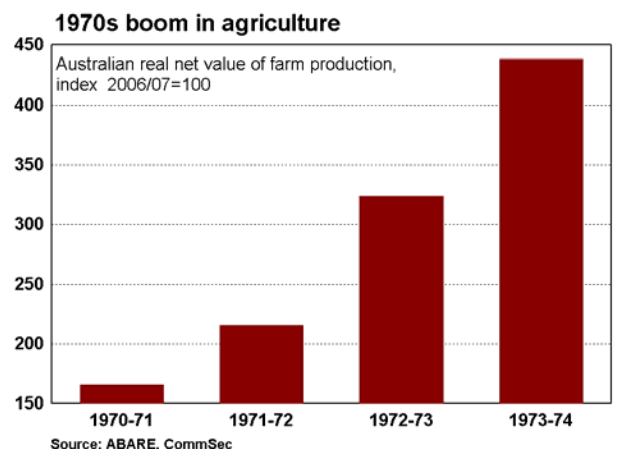


- With few exceptions – such as Australia – the issue of a trade-off between unemployment and inflation hasn't really emerged in major economies. That is, until the last six months as spare capacity gradually dried up, and unemployment rates fell to historical lows. In part this reflects favourable economic conditions, but with ageing populations and relative shortage of young, entry-level staff, demographics will also play a key role.
- Employers in Australia continue to complain of skilled labour shortages, but supply has responded to the higher demand through migration and increased participation of seniors and mothers in the workforce.
- Skilled labour shortages could prove a more global phenomenon in 2008. Already the problem exists in China and in the mining industry across the globe. Australia is well placed to attract labour from abroad but it will be important for the Federal Government to streamline the approval process.

Agflation

- Just like the 1970s, central banks face a number of challenges, including **agflation** and **high-energy** prices. The past three years has all been about the boom in resources, driven by industrialisation in China. But strong economic growth in China has boosted incomes and general economic prosperity through the Asian region, leading to changes in consumption patterns.
- Diets have been moving from grain-based to more meat-based products. And the improvement in diets has caused agricultural prices to rise – now generally known as agflation.
- Agflation was last observed when Japan was industrialising in the 1970s. From late 1971 to late 1974, the CRB foodstuffs index soared 170 per cent. While food prices have also soared over the past six years, coinciding with expansion in China, gains have fallen short of the early 1970s experience. From mid 2000, the CRB foodstuffs index has risen by just over 90 per cent. In the 1970s it took time for supply to respond to the increase in demand, and similar delays are again occurring, keeping prices high.
- Could a boom in the agricultural sector emulate that of mining? Not likely – mainly because rural production is more responsive to demand, given the lower infrastructure requirements of mining. But if the improvement in diets





and the shift to biofuels is more marked and widespread across the globe, there could be longer supply lags as land resources are switched from alternative uses.

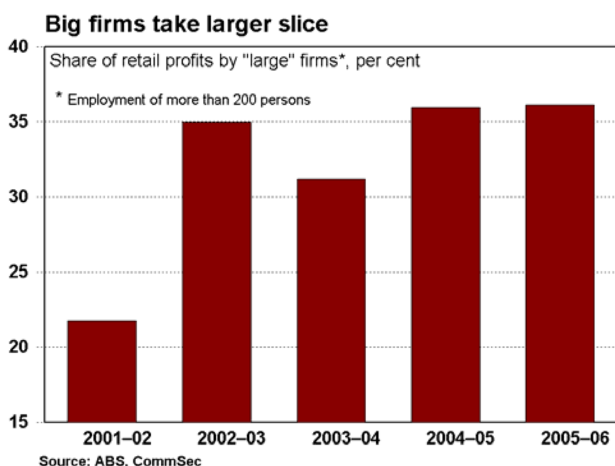
- In the early 1970s the real value of farm production almost tripled in the space of three years in response to soaring rural prices.

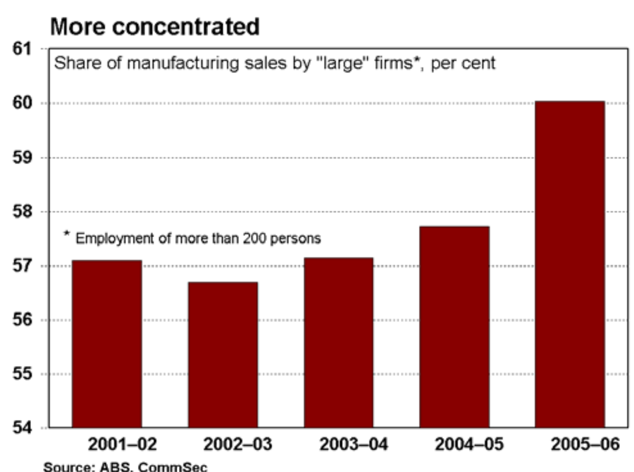
Industry consolidation

- When confronted with scarce resources, such as skilled labour, equipment and land, companies are more inclined to look for mergers and acquisitions (M&A). And we expect industry consolidation to be one of the big issues of 2008.
- Certainly in 2007 – and before the sub-prime issue – private equity deals abounded, many resulting in industry consolidation. And M&A transactions were particularly active in the mining sector. The key talking point at present in the mining sector is a potential tie-up between BHP Billiton and Rio Tinto.
- In 2008, industry consolidation is set to continue. The mining sector will remain in focus, but cashed up companies in a range of industries will be looking to boost productivity, cut costs and increase margins by taking over competitors.
- Construction, engineering, mining services, mining and service businesses are key candidates for M&A activity. And while productivity/efficiency issues dominate in mining, the cost and availability of labour will be a key consideration for service sector M&A activity. Simply it will be easier for companies to acquire the resources and factors of production they need by taking over other companies rather than trying to grow businesses organically.
- And while the Federal Government continues to rule out changes to the ‘four pillars’ policy in the banking sector, the issue won’t go away. Australian banks have avoided the sub-prime issues abroad and the Government must ensure that the banking system remains efficient, profitable and strong.

Oil prices and energy security

- The lift in oil prices to record highs was one of the big issues of 2007. And while oil prices are expected to ease modestly over 2008, the focus on future energy needs and energy security won’t recede.
- Consumers and central banks may not positively view the sharp lift in oil prices in recent months, but it has proved extremely important in boosting investment in the energy sector. Exploration and development of alternative fuels can only proceed when investment hurdle rates are exceeded, thus the sharp uptake in new energy projects in 2007.
- Energy from ‘green’ sources such as biofuels, solar and wind power will continue to attract attention and investment in 2008. And that’s because the issues of energy security and climate change have become increasingly linked. Companies and governments alike are keen to develop alternative fuels to crude oil but only if they are environmentally sustainable.
- To date, attention as tended to focus on ‘green’ energy rather than more efficient sources such as **nuclear energy**. But conservation and public interest groups and political paries are re-assessing views on nuclear energy and we expect that debate to accelerate in 2008.
- Patrick Moore, one of the founders of Greenpeace in the 1970s, has dropped his opposition to nuclear energy, encouraging the environmental movement to do likewise, *“because nuclear energy may just be the energy source that can save our planet from another possible disaster: catastrophic climate change.”*



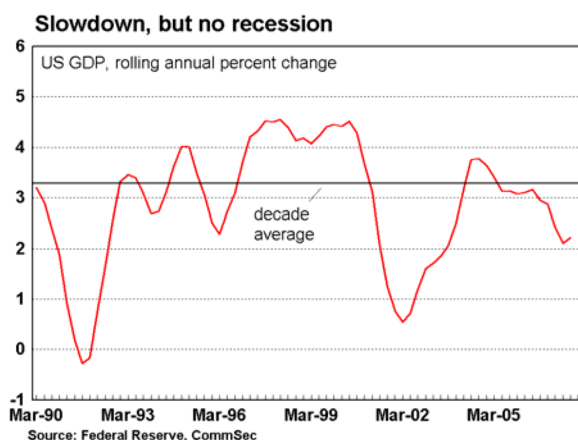


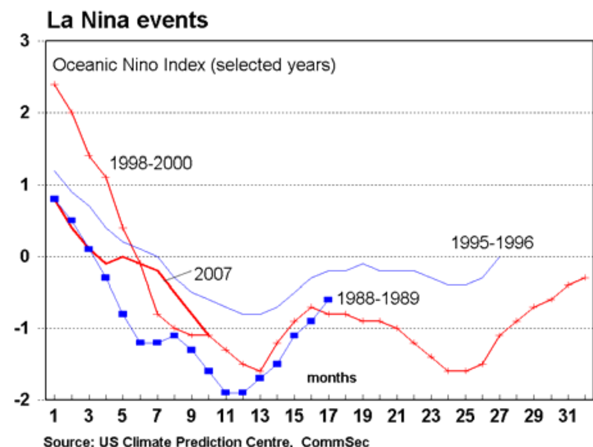
- While views on nuclear energy are firmly held, they could change quickly if oil prices continue to soar and the process of climate change is shown to be moving at a faster rate.

Other issues to watch in 2007

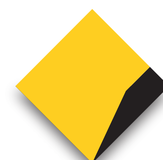
- For the past two years drought has been on our list of issues to watch. In 2007 there were grounds for hope that drought conditions would ease. But the encouraging rain early in the year was followed by dry conditions from July to September, providing further heartbreak for farmers.
- But meteorologists report that the "**El Nino"** conditions that are associated with drought are giving way to a **"La Nina"** event, associated with wetter conditions. Based on the US Climate Prediction Centre models, La Nina appears set to take hold, as climactic conditions are tracking previous events in the late 1980s and late 1990s.
- Better seasonal conditions and high global agricultural prices are the pre-requisites for Agvestment – investment in rural industries – to take place in 2008.
- Also on the radar screen in 2008 is the potential for **recession** in the US. Of course if recession takes hold, it would truly take its place as one of the **Big Issues** for 2008. But at present it looks like the American consumer will keep spending, exports will continue to respond to the weak US dollar and multinationals will benefit from solid activity in China and Asia more generally.
- Not only will the term 'recession' do the rounds over 2008, so will **'stagflation'** – characterised by weak economic growth and relatively high inflation.
- For Australia, it is the indirect effects of a **US recession** that matter most. That is, the effect where US businesses and consumers spend less, leading to less production in China and, in turn, less demand for resources in Australia.
- Recession seems an unlikely prospect in Australia, but still the current record expansion of 16 years must end at some point. The key risk is the sustainability of the Chinese economic expansion. If Chinese authorities were forced to become more aggressive to rein in the economy, the chances of a major slowdown in both China and Australia would increase markedly.
- The US Presidential Election doesn't occur until November, but clearly it will dominate the media over 2008. At present there is a Melbourne Cup field of both Democrat and Republican candidates seeking nomination. But the candidate that is dominating attention is **Hillary Clinton**. If Clinton is successful on the first Tuesday in November, not only would she become the first female President, it would extend the period to almost 20 years when either a Bush or Clinton was in the White House.

Craig James,
Chief Equities Economist, CommSec





The Big Issues 2007

CommSec 

Craig James, Chief Equities Economist

The Big Issues for 2007

- **Climate change**, and more specifically to Australia, **water security**, is expected to be *the* Big Issue for 2007, dominating both public consciousness and economic debate.
- Investors have enjoyed **excess returns on sharemarket investments** over the past four years. But CommSec believes that will come to an end in 2007. Returns of 13-15 per cent in 2007 will be more in line with longer-term averages.

DECEMBER 18 2006

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BIG ECONOMIC ISSUES FOR 2007	
IN	***OUT***
Climate change / water security	Two-speed economy
Tight global job markets	Rate hikes
Rental crisis	Soaring oil price
Private equity investments	Capacity constraints
Media consolidation	Excess returns on shares
TMT convergence	
China / India	
Elections	

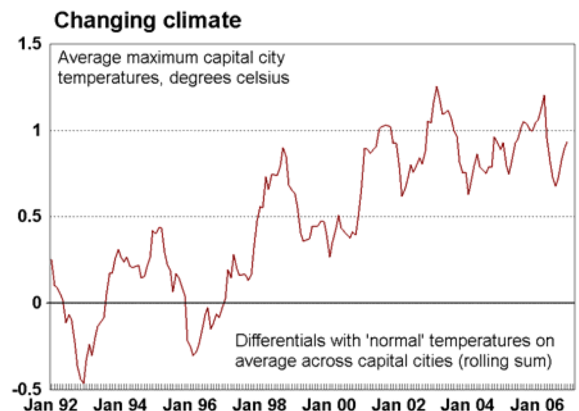
The Big Issues Of The Past Year

- Each year we seek to identify the big issues for the coming twelve months – issues that we believe will be of key importance for the economy and, in turn, for domestic investors. This is not so much an exercise in crystal ball gazing, but rather an attempt to highlight issues of potential risk and opportunity for investors.
- We don't always get it right. We thought inflation would be less of a concern in 2006. But fuel and banana prices emerged as major "X-factors", driving headline, and in turn, underlying inflation higher. We also thought that drought conditions would ease over 2006. But again the on-going warm, dry conditions proved a real surprise, buffeting the rural economy late in the year.
- Still amongst the blips of the radar screen, we can claim some successes. We thought the rental market would tighten, leading to sharp increases in rents. And indeed rents rose at the fastest pace in 15 years. We also identified skill shortages as the issue of 2006. And while it is arguable that this issue dominated all others, certainly the Reserve Bank fretted over 2006 about capacity constraints – that is, the economy hitting the ceiling with lack of labour and other resources constraining the economy's ability to grow.
- Other issues (some obvious, some less so) included the **All Ordinaries reaching 5,000** and **booming growth in China & India.** We also had **unemployment** and **rate cuts** on the Economic "Out" list.

The Big Issues for 2007

What will be *the* issue of the year?

- This is the most interesting question, basically because it is the most contentious. But we believe that **Climate change**, and more specifically to Australia, **water security**, will dominate both public



consciousness and economic debate.

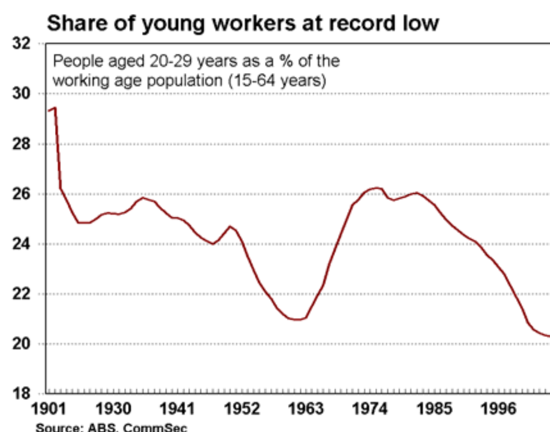
- Five years ago, global warming was merely regarded as an interesting theory. But now climate change is generally regarded as fact, not fiction. Certainly in Australia the proof is undeniable. Over the past decade, maximum capital city temperatures have been on the rise; to the extent that they now are on average around 1 degree celsius above “normal”.
- Not only has the weather been getting warmer but rainfall has also fallen short of longer-term averages. Eastern Australia has experienced six consecutive years of below normal rainfall. Now this may merely be just another of Australia’s long droughts, such as the Federation drought from 1895-1903 or the drought experienced from 1963-68. But the warm, dry levels have put incredible stress of Australia’s water storage levels.
- The implications of climate change in Australia are widespread. Retailers are forced to deal with different spending patterns. Rural Australia is experiencing – arguably – the most severe drought on record. Governments are forced to give greater priority to water infrastructure projects. Construction and insurance companies and utilities are all directly affected. And the day-to-day life of consumers has been directly affected.
- The solution to water security issues will include water recycling, desalination plants and water pipelines. But fundamentally, under-priced water will need to rise, with the cost potentially having to double or triple over the next five years, significantly affecting Australian industry and consumers alike.

Tight global job markets

- Weather is something that we have little control over. And so to a large extent are demographics or the make-up of the population. Across the globe, central banks are confronting the reality of ageing populations. In Australia, young people – that is, those aged 20-29 – now take up the smallest share of the working age population since European settlement.
- In simple terms, it is harder to find, and keep, entry-level workers, forcing employers to lift wages. At present the tighter labour markets haven’t led to a lift in economy-wide wage growth. In fact wage growth has slowed. And a key reason is that labour supply is not fixed, with employers looking offshore for staff. But other economies will also have to contend with ageing populations over 2007, increasing competition for available labour. And all this adds to Reserve Bank jitters about inflation.
- The Government has been seeking to lift the workforce participation of married females and senior Australians, and with some success. But more work is required given that Australia still maintains lower participation rates than countries with a similar demographic profile such as the US and Canada.
- In 2007, policies will focus on lifting immigration, increasing labour mobility, upskilling and re-skilling workers and lifting participation rates further.

Rental crisis

- Rental markets tightened considerably over 2006, forcing vacancy rates to 18-year lows, and pushing up rents at the fastest pace in 15 years. If markets worked seamlessly and efficiently it would be expected that investors would embrace the situation by funnelling money into property markets. But the sharemarket remains in the ascendancy and investors are still not sure that interest rates have peaked.
- So rental markets are poised to tighten ever further in the first half of 2007. In short, the rental crisis is likely to worsen, pushing up rents and raising the prospect of rental auctions becoming more commonplace.
- Higher rents will complicate the inflation situation, leading to a Catch 22 situation. That is, higher rents will

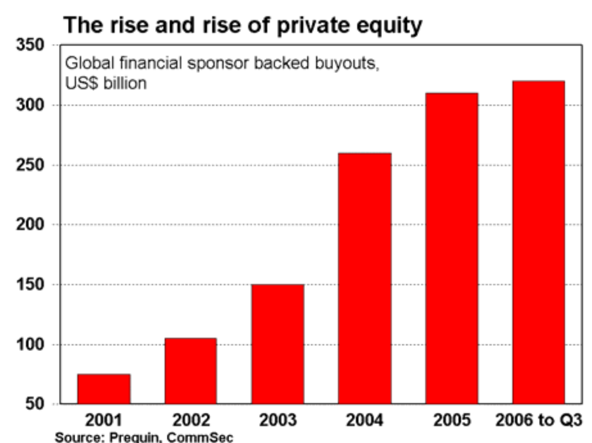


put upward pressure on inflation, raise the risk of more rate hikes, keep investors on the sidelines and, in turn, lead to tighter rental markets.

- But we believe that lower fuel and banana prices will drive headline and underlying inflation lower, offsetting any boost from higher rents, and allowing the Reserve Bank to cut interest rates around mid-2007. Investors should then respond by channelling more funds into residential property, boosting construction.

Media, TMT and Private equity

- The *Big Issues* identified so far clearly have implications for investors. But there are a number of issues that can be broadly grouped under a "sharemarket-specific" heading. These include **consolidation in the media sector**, the **convergence between technology, media and telecommunications** and the likelihood that **private equity** groups will launch more takeovers for major Australian companies.
- Both the Seven Network and PBL are cashed up and will drive media consolidation activity in 2007. News Corporation is unlikely to sit idly on the sidelines, John Fairfax will be the subject of intense interest and new owners are likely at Ten Network.
- But media companies and investors will not just focus on the current structure and assets but how the sector will evolve over time. Consumers are increasingly going online, and accessing pay television and mobile devices for their information and entertainment needs. So while **media consolidation** will be a key issue over 2007, so will be the ongoing **convergence of technology, media and telecommunications (TMT) sectors**.
- Convergence can cover a range of subjects such as use of mobile phones to play MP3 files, using phones to browse the internet, catch up on the latest news or listen to podcasts.
- While regulators may express concern over mergers between media and telecommunication companies, strategic alliances and partnerships are just some of the ways that companies will seek to circumvent any merger restrictions.
- Globalisation is also clearly an issue for media companies. Consumers are already accessing information and media content from abroad and this practice will only grow with the advance of technology leading to faster and cheaper downloads. Not only will foreign investors and private equity groups show interest in Australian TMT companies, but Australian companies and investors may also examine offshore tie-ups and alliances.
- There is little doubt that **Private equity** will also dominate the radar screen over 2007. Certainly 2006 was the sweet spot for private equity. The global economy remained in good shape, interest rates were still relatively low, and investors were cashed-up after three strong years for global sharemarkets. It was a case of act now or lose the opportunity forever.
- Private investors across the globe are still on the lookout for profit-making opportunities. Similarly, after years of strong profit growth, cashed-up companies also are aware that there has never been a better time to examine mergers or acquisitions.
- The coming year could prove especially busy for regulators and a nervous time for investors. The surge in private equity deals is a direct product of buoyant economic times. While the deals bring more capital to companies, they also invariably bring more debt. Higher risk/higher reward transactions look great in the good times. But if the bevy of corporate activity cause central banks to lift interest rates more than expected, some deals will certainly turn sour, creating the risk of a messy unravelling of transactions.



China & India…again…and Elections

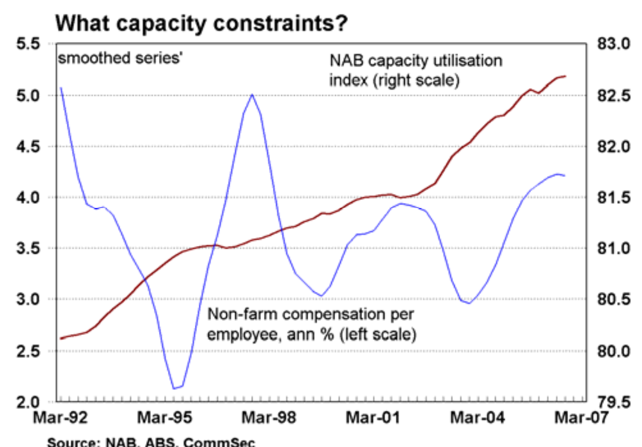
- Some of the *Big Issues for 2007* don't require a lot of thought.

China will again be a major consideration for investors, companies and governments alike, with the main issue being whether the solid growth pace can be maintained. Regulators are likely to discretely tighten policy over the year in order to keep growth in check, while depreciation of the renminbi is expected to continue, albeit at a snail's pace.

- Chinese authorities will need to step up efforts to promote greater domestic consumption. And at the same time, greater efforts will need to be taken to improve corporate governance and shore up the weak financial sector.
- China is certainly not exempt from the tightening of labour markets that is happening across the globe. Wage rates are slowly rising, causing many foreign companies to look to lower wage countries such as Vietnam for the production of simply manufactured goods.
- **India** also has the potential to gain global market share in manufactured goods if Chinese wages continue to rise. India is the second fastest growing country in the world, but to date the focus has been on services rather than industry. China has dominated the headlines but India could vie for prominence if the strong pace of industrialisation continues.
- Also dominating attention over 2007 – whether we like it or not – will be **elections**. The NSW election will be held in March while the Federal Election is likely to be held in October/November. Elections tend not to have major macro implications given the extent of control that financial markets and the Reserve Bank have over economic settings. But certainly there are considerations for companies and investors at a sectoral level, especially in terms of the Federal Election.

The "Out" list for 2007

- Last year we thought that **inflation** would move to the "out" list, principally because oil prices would be more restrained and global deflationary issues such as the "China effect" would come to the fore. Clearly if there was one factor that upset the apple cart in 2006, it was the soaring price of oil. Headline inflation rate rose, causing central banks to tighten monetary policy.
- Again we are nominating **soaring oil prices** to move to the "Out" list in 2007. But just like 2006 there are risks to this forecast. OPEC oil producers may cut production quotas too far, a geopolitical crisis may arise (Israel-Lebanon in 2006) or a major oil facility may face production problems (Prudhoe Bay in 2006). But oil producers are pumping more oil, OPEC is aiming to keep oil prices around US$60 a barrel and global economic growth is likely to ease over the year.
- If oil prices do stabilise as we expect, and global economic growth slows, then **rate hikes** should move to the "Out" list in 2007. Some countries such as Japan and Europe have potential to lift rates again as part of the "normalisation" process of monetary policy. But as the year progresses rate cuts are likely to be on the radar screen in both the US and Australia.
- While lower inflation and slower economic growth will be key drivers of lower interest rates, the Federal Reserve and Reserve Bank are also expected to be more comfortable about so-called **"capacity constraints".**
- The Reserve Bank, in particular, has been concerned that the economy was bumping against the ceiling. But the tight job market hasn't produced broad-based wage rises. Importantly, companies are operating at higher levels of capacity in order to better utilise resources and keep costs down. And for the most part they have been successful.
- In Australia, the term **"two speed economy"** is likely to be used less often as the year progresses. Western Australia is already showing signs of slowing while the laggard states



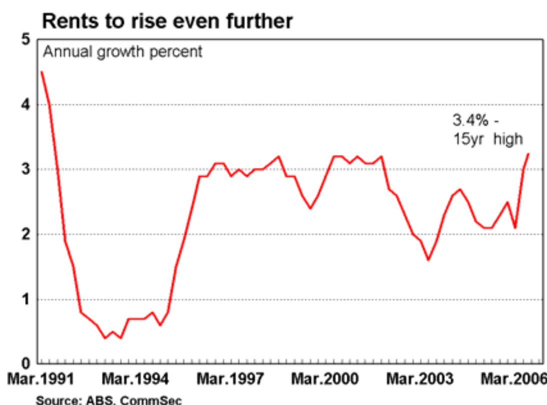
such as NSW should recover later in 2007 as housing construction recovers. Also we expect that the investment boom will start paying off in terms of higher non-rural exports in 2007, while household consumption will lift in the second half of the year. So overall we see a rebalancing across state economies as well as across economic sectors.

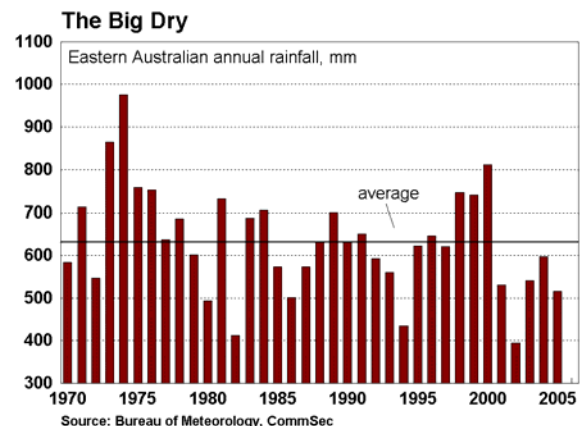
- The scenario we are painting is one of slower global economic growth, flat oil prices, an easing of inflationary pressures and rate cuts. Overall this all adds up to more "normal" returns on Australian shares.
- Over the past four years, total returns on Australian shares averaged 21 per cent per annum. Over the three previous years total returns averaged 2.4 per cent per annum. Over the entire seven-year period, average returns were just over 13 per cent – a result in line with long-term averages.
- We believe that the period for **excess returns on shares** is over, expecting total Australian sharemarket returns in 2007 to be around 13-15 per cent. The ASX 200 is expected to reach 6,150 by year-end.

"Left field" and other issues to watch in 2007

- Last year we were hopeful that **drought** would finally move to the "Out" list. But while we were hopeful the dry conditions would end, we also put it on the "left field" issues. Clearly predicting the weather is as difficult as economic prediction. But we noted that if drought continued, it would pose major implications for the economy.
- And just as in 2006, **drought** must stay on our list of issues to watch. We have already nominated the longer-term issue of climate change and water security on the "In" list, but if the drought persists, it would add further short-term downside risks to the economy.
- **Terrorism** is always a "left field" issue for investors – one that can't be properly quantified but must nevertheless be on the radar screen.
- Also keep a watch on the emergence of competitive manufacturing centres such as **Vietnam**, **Myanmar and Poland.** For many emerging nations it is merely political will and stability of governments that hinder the creation of low wage manufacturing centres.
- Another issue to keep on the radar screen is the power and influence of regulators such as the **Australian Competition and Consumer Commission (ACCC)**. Companies in mature industries are looking for growth opportunities but are being hindered by regulators. In particular, the objective of fostering competition is more frequently coming into opposition with industry concentration concerns. Clearly investors will be interested in how this issue gets resolved, because of the implications for the return on capital and share price growth of listed companies.

Craig James,
Chief Equities Economist, CommSec





The Big Issues 2006

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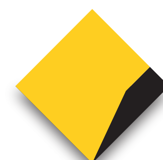

Craig James, Chief Equities Economist

The Big Issues for 2006

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The Big Issues Of The Past Year

- Each year we seek to identify the big issues for the coming twelve months – issues of key importance for the economy and, in turn, for domestic investors.
- This is not so much an exercise in crystal-ball gazing, but rather an attempt to highlight issues of potential risk and opportunity for investors. That said, we still can claim a fair success rate with our predictions for 2005.
- One reason for our success in 2005 is that we largely expected the year to be extension of 2004, and that turned out to be the case.
- Amongst the issues we identified for the "in" list in 2005 were **resources boom** and **infrastructure** while the **strong global economy, China, oil prices** and **tight labour market** were on our "still in" list.
- But not everything went to plan. We also thought the **US dollar would slide** and that **exports would recover.** Clearly both were wide of the mark. Still we also put **housing market fears** and **Europe** on our "out" list and those predictions were on the money.
- The **resources boom** and the linked issue of **soaring oil prices** were *the* issues of 2005. The other issue of prominence over 2005 was inflation, an issue that we failed to put on our "in" list. And while this may seem like a blot on our copybook, we did have it on our "left field" issues, noting *"But in terms of economic factors, one area to watch is* ***inflation.***"

BIG ECONOMIC ISSUES FOR 2006	
IN	***OUT***
Skill shortages	Unemployment
Disinflation	Inflation
Consumer boom	Consumer conservatism
China / India	Low volatility
Eastern Europe	Drought
Tax cuts/reform	Rate cuts
Housing revival	Defensive investments
Rising rents	
All Ordinaries 5,000	

The Big Issues for 2006

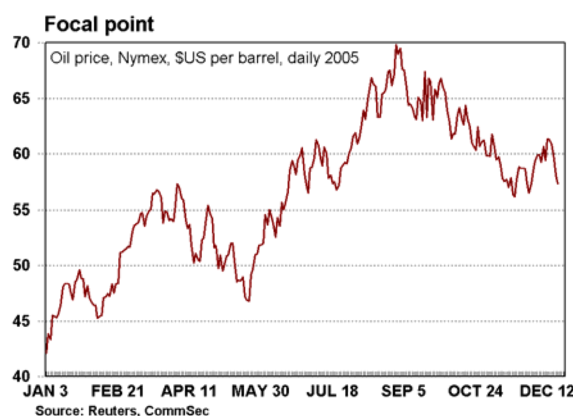
- This year we have decided – merely for simplification – on just an "in" and "out" list, rather than marking some issues as "still in" or "still out". And if we had to decide on just one issue that will dominate attention, we believe that **skill shortages** will be *the* issue of 2006.
- Over 2005 Australian employers have increasingly found it difficult to attract the necessary staff or to keep existing staff on the payrolls. And shortages of labour haven't just affected the booming construction or mining industries but have extended across the economy, particularly hospitality, medical and also accounting industries. The lack of suitable candidates to fill vacancies is causing employers to make greater use of temps, to retrain, train-up or work existing labour more intensively and even to scour offshore markets for staff.
- Given our view that the Australian economy will regain momentum in 2006 and the global economy will remain firm, then the issue of labour shortages will be an on-going challenge for Corporate Australia

during 2006.

- But labour shortages don't necessarily mean soaring labour costs. Over 2005, the labour market tightened and the unemployment rate fell to 29-year lows, but wage growth only crept higher over the year to around 4.5 per cent. A key reason is that Corporate Australia in the 'noughties' decade doesn't automatically enter into a bidding war to attract staff that is in short supply. If the labour is not available or costly, then businesses will assess other available options. The imperative is to keep costs down. And that fundamentally gets back to the fact to super-competitive conditions existing across a raft of industry sectors. If a company is faced with higher costs, it first looks to cut costs in other areas of the business before lifting selling prices.
- On the global front, skill shortages are also likely to emerge in fast-growing economies such as the US. But globally, the issue of shortages is likely to show up more as shortages of materials rather than labour.
- Overall, 2006 is likely to be another solid year for the global economy, translating to higher income and spending levels, especially throughout Asia. But as has been the case over 2005, we expect that the supply of materials like base metals, ores and energy products will struggle to keep up with demand. OPEC oil nations are still producing at the fastest rate since the late 1970s but crude oil prices remain relatively high. And the oil market remains vulnerable to weather-events such as hurricanes as well as geopolitical shocks.
- Commodity prices should remain historically high in 2006, especially in the first half of the year – consistent with our view of a stronger-for-longer commodity cycle. But prices should ease modestly over the year as the gap between demand and supply gradually closes. Most materials are currently characterised by under-supply, but greater balance between supply and demand is likely to emerge in the second half of 2006, before many commodities move into modest over-supply in 2007.
- We expect economies such as China and India to continue to grow at a rapid clip. The US economy is also projected to grow in line with its longer-term trend pace of 3.3 per cent. The Japanese economic outlook also remains promising and firm growth in Eastern Europe should lift the soggy economies in the west of the continent.
- **China** will again dominate radar screens during 2006. The Chinese economy should continue to expand by around 9 per cent, sucking in resources from countries like Australia and churning out high-quality, low priced goods. But while China will be a focus for commodity and manufacturing sectors, **India** will dominate attention for global services sectors. And we expect that **Eastern Europe** will have a similar role in boosting economic growth in countries such as Germany and France as the influence exerted by China in lifting growth in Japan and East Asia. The key ingredients being high productivity and low labour costs.

Inflation/Disinflation

- At face value, shortages of labour and tight commodity markets appear a recipe for rising inflation. But the three key factors preventing prices from marching higher in Australia are strong local competition, strong global competition in manufacturing and technological progress.
- Despite soaring fuel prices, underlying inflation in most developed economies held below 3 per cent in 2005. In Australia, underlying inflation has remained near 2.5 per cent over 2005 despite both higher petrol prices and rising wage costs.
- In 2006, the oil price is not expected to soar as it did over 2005, but nevertheless should remain relatively high, hovering near US$50-60 a barrel. Second-round price effects from high oil and material costs



should also be limited. So over 2006, the trend is more likely to be one of **disinflation**, rather than inflation. That is, a slower rate of price growth, say from a 3 per cent annual rate to 2 per cent.

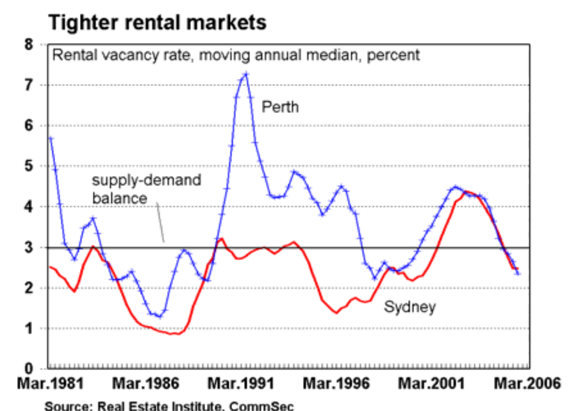
- It is important to recognise that the broader forces at work in the global economy are more skewed to lower, rather than higher prices. Increased output from low wage regions such as China, Eastern Europe and India is acting to restrain prices of manufactured goods. And continued technological progress is leading to lower prices for consumer electronic goods, cars and clothing.

Consumer boom & housing revival

- Over 2005, Australian consumers turned conservative, cutting spending, new borrowing and levels of existing debt. But CommSec expects that 2006 will be the year that consumers start to spend again. Falling prices for a range of manufactured goods, higher real incomes, a strong job market and more stable petrol prices all point to sharply higher consumer spending.
- In fact we would characterise the expected lift in spending as a **consumer boom**, especially for electrical and electronics items. Spending on a range of audio-visual, communication, photographic and computer-related items has been rising in recent years but is expected to become more mainstream during 2006.
- Another factor likely to drive consumer spending over 2006 is a **revival in the housing market**. Already demand for established dwellings is recovering, underpinned by stable interest rates, rising population growth and strong labour market conditions. But less building of new homes and units has led to tighter vacancy rates in many capital cities and **higher rent levels**. Vacancy rates are likely to fall further in 2006, creating the prospect of more dramatic increases in rent levels during 2006 and translating to a pick-up in property prices more generally.
- Overall, we believe that the Reserve Bank has made the right call in keeping a bias toward higher interest rates. We think that the stronger domestic economic conditions evolving through the first half of 2006 will cause the Reserve Bank to lift interest rates around mid year or early in the second half of the year. As always, the Reserve Bank will be forward looking. Inflation is unlikely to be a problem over 2006, but the Reserve Bank will lift interest rates to prevent it from becoming a problem over 2007. Just as it did in March 2005.

Tax cuts/reform and All Ordinaries 5,000

- The prospect of **tax cuts** is clearly one of the more obvious "in" issues for 2006. Federal Treasury is currently projecting a budget surplus of $11.5 billion for 2005/06. But Treasury tends to under-estimate, with the annualised budget surplus already just over $14 billion. So tax cuts are on the agenda for 2006. And if consumer spending and housing activity strengthens as we suspect, then the Government should have substantial scope, not just to provide for tax cuts, but to **reform the tax base**.
- The Government clearly needs to do more than just tinker with tax rates. Consideration needs to be given to not only reducing the tax burden but also adjusting tax scales so more people are both enticed into the workforce and stay in the workforce for longer. A range of flat tax proposals are being considered globally and the issue deserves attention in Australia.
- An environment of firm global growth, accelerating domestic activity and lower taxation should keeping the Australian sharemarket in the ascendancy over 2006. In fact we believe that key share indices such as the **All Ordinaries** and ASX 200 have scope to reach the **5,000 milestone** by the end of 2006.
- Certainly the prospect of the All Ords reaching 5,000 is only likely to surface as an issue late in 2006. But we expect the continued strength of the



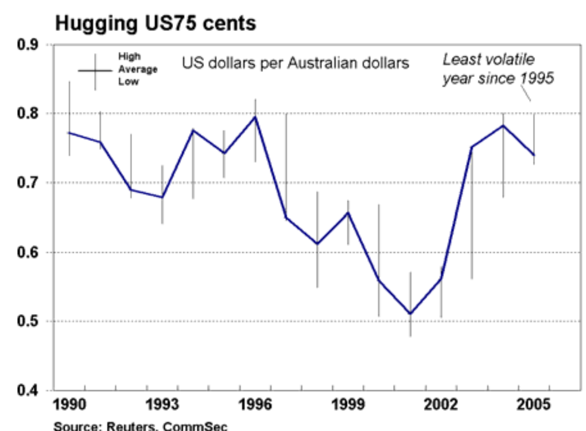
sharemarket to remain a focal point for investors, analysts and policymakers more generally over 2006.

The "Out" list for 2006

- Given our positive view about domestic and global economic conditions, it should be no surprise that concepts associated with economic weakness dominate our "out" list for 2006. For instance the 2006 job market is expected to be dominated by skill shortages rather than **rising unemployment rates.** Similarly discussion of **rate cuts** should stay off the agenda, especially as **consumer conservatism** morphs into a consumer boom and the sluggish housing sector gives way to a housing market revival.
- On the sharemarket, the buoyant economic environment should keep investors focussed on growth-dependent sectors rather than **defensive investments**, particularly over the first half of the year. So mining, energy and non-food retailing are on the "in" list with yield-dependent areas like property trusts on the "out" list. But as 2006 progresses, we expect that investors will opt for a better balance between growth and defensive-focussed investments.
- As noted previously we expect **inflation** to move to the economic "out" list over 2006. Oil prices are not expected to repeat the performance of 2005, soaring 63 per cent from the start of the year to the peak levels in early September. Similarly absent will be the stellar gains recorded by other commodity prices, especially base metals. While commodity prices are likely to remain high, the general trend will be sideways to modestly lower, imparting a disinflationary pulse through major economies. In addition, competition from high productivity/low wage countries will further keep a cap on price pressures.
- Overall a virtuous combination of solid growth and low inflation seemingly points to another stable year for financial markets, especially here in Australia. But we actually expect wider trading ranges on interest rate and currency markets, thus tipping **low volatility** to move to the economic "out" list.
- Recovering domestic economic momentum should put rate hikes back on the agenda around mid year. The Reserve Bank may only lift rates once during 2006, especially given that small changes in rates have a larger impact on debt-laden households. But financial markets are likely to expect more. And on currency markets, the Australian dollar has potential to trade over a wider US70-80 cent range during 2006. The domestic economy will perform strongly in the first half, before easing to a more sustainable pace late in the year. Meanwhile the global economy should also lose momentum late in 2006 under the influence of tighter monetary and fiscal policies in major countries.

"Left field" and other issues to watch in 2006

- We are hopeful that **drought** will finally move to the "out" list in 2006 after three historically dry years across Australia. But of course longer-term weather predictions are inherently more difficult than even economic projections. Still, water security issues will remain important for a number of major cities such as Brisbane, Sydney and Perth.
- **Industrial relations** will still be around as an issue on political radar screens over 2006. But for most Australians, industrial relations wasn't a major concern in 2005, nor is it likely to be over 2006. Changes to pay and conditions will occur over time, not as 'big bang' reforms, but in consultation between employers and employees.
- **Terrorism** is now a constant risk, so again it must be represented on a list of issues to watch. Further reforms of the **Chinese financial system** are also clearly on the cards for 2006, but we expect the authorities to continue to move in small steps for fear of de-railing the economic expansion.



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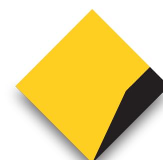
The Big Issues 2005

CommSec 

The Big Issues for 2005

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The Big Issues Of The Past Year

- Each year we seek to identify the big issues for the coming twelve months – issues of key importance for the economy and, in turn, for domestic investors.
- This is not so much an exercise in crystal-ball gazing, but rather an attempt to highlight issues of potential risk and opportunity for investors. That said, we still can claim a fair success rate with our predictions for 2004.
- Now the cynical may say we owe our success to the fact that there were few big surprises in 2004. And to an extent that's true, but its still nice to be on the right side of the forecasting ledger from time to time.

THE AUSTRALIAN ECONOMY IN 2005	
IN	***OUT***
Resources boom	Housing market fears
Infrastructure	Europe
Export recovery	Two-speed economy
US Dollar slide	
Consumer power	
STILL IN	***STILL OUT***
Strong global economy	Bear market for shares
China	
Tight labour market	
Oil prices	

- Amongst the issues we identified for the 'in' list in 2004 were **global boom, China, tight labour market, high migration** and **$A strength.** And on the "still in" list we had **Iraq/terrorism fears** and **oil prices.**
- The strength of the global economy, driven by a buoyant Chinese economy, was *the* issue of 2004, driving oil and base metal prices higher. And, at this stage, the risk is for a repeat performance in 2005.
- We also identified **"rate hikes"** as being one of the 'in' issues for 2004. On the surface this looks like a blot on our copybook. But we did say that a rate hike in early 2004 was merely "scribbled down in pencil, not pen." And while the Reserve Bank didn't touch official rates all year, the risk of higher rates was indeed an issue over the year. So, I'm going to put us down for half a tick on that one.

The Big Issues For 2005

- Year 2004 was the year that the global economy finally hit its straps, posting the fastest growth in almost 30 years. While economic recovery in the US and the on-going industrialisation in China were key factors behind the global expansion, numerous economies recorded faster growth in 2004, especially in Asia and Eastern Europe.
- It's fair to say that the strength of the global economy in 2004 caught many by surprise, especially the users and producers of basic materials and energy commodities. Demand soared across the globe and supply simply couldn't keep up. One closely-watched gauge of commodity prices, the CRB futures index, rose to its highest level in over 23 years.
- In 2005, we believe that the global economy will again be the key issue, but this time in the form of a **boom year for resources**. The global economy is showing no signs of slowing down, in fact monetary policies in many parts of the globe are still expansionary. Another solid year of growth is expected in the US, while the 'China story' will again be dominating the radar screen - as it will for a number of years to

come. However, 2005 will be a year in which mining and energy producers start to respond to buoyant demand by expanding output. The Australian Bureau of Agricultural and Resource Economics (ABARE) has identified a record number and value of minerals and energy projects, either committed or under construction. Over the next five years, 73 projects are expected to be completed, totalling $24.3 billion. In addition ABARE has highlighted another 134 'less advanced' projects totalling $72.5 billion.

- While mining and energy producers will respond to buoyant conditions by lifting output, we expect that the continued strength of global demand will ensure that metal and energy prices remain at historically-high levels over 2005.
- Courtesy of boom-like conditions in the resources sector, an **export recovery** is finally expected to be on the agenda in 2005.
- Certainly the performance of the export sector has been disappointing in recent years. Over the past two years, exports have grown on average by just over 1 per cent a year, compared with growth of over 6 per cent per annum through much of the 1990s and early noughties. That under-performance has been shared by both rural and non-rural commodities, reflecting factors like drought and capacity constraints.
- Waiting for a lift in export receipts has been much like waiting for the fabled Godot, but 2005 is expected to be characterised by both higher export volumes and higher prices.
- The main hurdle for Australian exporters in 2005 is likely to be a firmer Australian dollar. We expect **further weakness for the US dollar** in the early part of 2005, in turn translating to a higher value for the Australian dollar. We expect the Aussie dollar to peak at US82 cents by June 2005 before easing in the following six months and ending the year near US76 cents, little changed from 2004. Certainly the weaker US dollar emerged as a key issue in late 2004 and it will remain a key radar screen factor during 2005.
- **Spending on infrastructure** in Australia is also expected to be one of the big issues for 2005. Since the late 1990s, state and federal governments alike have focussed on reducing debt levels rather than ploughing extra funds into railways, roads, ports and other areas of infrastructure. This has left government debt levels in good shape but meant that infrastructure like railways, roads and port facilities has been left less able to cope with the demands of a faster-growing population as well as the increased global demand for Australian mineral and energy resources.
- With both state and federal government debt at historically low levels, increased spending on infrastructure is expected over coming years, most likely in partnership with private sector ventures.
- Another area that is likely to receive attention over 2005 is the **power of the consumer**. Over 2004, Australian consumers benefited from a number of favourable influences including higher wealth levels, rising real incomes, lower

unemployment and falling prices for imported consumer products. We expect that these favourable conditions will extend into 2005, so much so that Australian consumers may be facing something of a bonanza.

- The key issue is how consumers use their increased power. If Australian consumers collectively utilise their increased purchasing power by continuing to spend freely and add to debt levels then they will be more vulnerable to a deterioration in economic conditions. The Reserve Bank battled an unsustainable housing boom in 2003 and won. And it won't want to battle a consumer boom in 2005. The central risk is that consumers become over-confident, intoxicated by the buoyant economic times.
- One interesting issue for the Reserve Bank concerns inflation. Further declines in imported good prices may offset high domestic-generated inflation, thus keeping economy-wide inflation in the 2-3 per cent target band. But the increase in consumer purchasing power produced by higher real incomes and lower prices for imported goods may lead to unsustainable gains in spending and borrowing levels. And, just like the housing boom in 2003, a consumer spending boom may prompt the Reserve Bank to raise interest rates at a time when the inflation target is not immediately under threat.
- Its important to note that even if there is a consumer spending boom, retailers may not fully share in the gains or the gains may not be shared equally. This is especially the case if higher consumer spending is met by increased retail competition, either by the entry of more retailers, lower margins or both.

Issues That Remain "In" for 2005

- As noted above, we expect the **global economy to remain firm** over 2005, underpinned in part by the structural changes in the **Chinese economy**. Again the key concern in 2005 is that China could grow too quickly causing inflation to spike higher and, in turn, lead to a hard landing for the economy.
- We expect that further **tightening of the Australian labour market** will provide challenges for Corporate Australia over 2005. The risk is that the difficulty of attracting or retaining workers will cause businesses to lift wages, and in turn, prices.
- The **price of oil** has never been too far from the radar screen over the last two years and we expect that this will remain the case through most of 2005. OPEC oil producers will continue to struggle to keep up with demand through early 2005, meaning that oil prices are likely to remain historically high.

The "Out" List in 2005

- One of the key concerns in 2004 – the **risk of a sharp downturn in the housing sector** – will fall from the radar screen in 2005. The housing market is experiencing the softest of landings, largely due to the fact that supply and demand are now broadly in balance. House prices are likely to rise between 0-5 per cent over 2005 after the huge gains recorded over the previous five years.
- **Mainland European economies** will continue to struggle over 2005 given the failure of governments to

implement microeconomic reform. Australia will continue to focus on economic conditions and prospects in the US, China and Asia rather than economies like Germany, France and Italy. Still, eastern Europe holds plenty of promise with economies in the region growing at a fast pace, underpinned by low wages and high productivity.

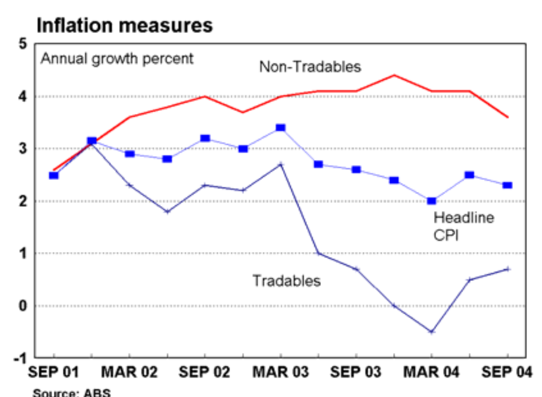
Still On The "Out" List in 2005

- The gloom and doom merchants have been peddling fears of **deflation** and a **new bear market for shares** for the past two years. The fears haven't materialised for the past two years and they won't materialise in 2005. The only evidence of deflation is in terms of global manufactured goods, especially in the consumer space. But this is actually beneficial deflation, occurring at the same time as a super-strong labour market and large gains in real incomes.
- A new bear market for shares is not on the horizon, either in Australia or abroad. In Australia, the economy is growing, profits are rising and sharemarket valuations are still favourable, pointing to further upside for share prices.

The 'Left-Field' Issues for 2005

- Every year seems to have a "left field" issue that upsets the economic apple-cart. In the past there have been issues such as SARS, corporate collapses and the Asian economic crisis that have caused economic forecasts to go awry. But there weren't too many surprises in 2004. The main 'left field' issue in 2004 was the sheer strength of global economic recovery.
- Possible 'left field' issues on the global stage in 2005 include a banking crisis in **China**, geopolitical tensions involving **North Korea** or **China/Taiwan**, and US dollar weakness becoming a US dollar crisis, leading to a downturn in the **US economy.**
- On the domestic front, the possibility of a **severe drought** is always a risk for the Australian economy. But in terms of economic factors, one area to watch is **inflation.** At present the inflation rate appears well under control. And if oil prices moderate and imported good prices continue to fall then there will be no threat to the Reserve Bank's 2-3 per cent target band. But the labour market is tight and expected to tighten further in 2005. Consumer spending is also likely to remain firm. And domestic-generated inflation is already high with non-tradable prices up 3.6 per cent on a year ago. So inflation is one factor to keep an eye on over 2005.

Craig James, Chief Equities Economist, CommSec



The Big Issues 2004

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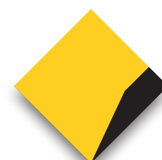

Commentary

Investment and Economic Perspective

The Big Issues For 2004

DECEMBER 18 2003

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The Big Issues Of The Past Year

- Each year we seek to identify the big issues for the coming twelve months – issues of key importance for the economy and, in turn, for domestic investors. And we can claim a reasonable degree of success with the economic 'in' list for 2003. We were certainly spot on in putting **rate hikes** and **global economic recovery** on the 'in' list, although it took until late in the year for the predictions to be fulfilled. Also on our 'in' list was **China,** currently the fastest growing major economy in the world. And we also identified **resources** as a potentially out-performing area of the sharemarket at the expense of **defensive stocks**.
- However our crystal ball let us down in predicting an end to the **two-speed Australian economy**, that is, the combination of a weak export sector and strong domestic activity. Also wide of the mark was our listing of the **housing boom** on the economic 'out' list. As 2003 draws to a close, there are some signs that the housing market is beginning to soften. But we certainly are not ready to claim that the housing boom has finally come to an end.

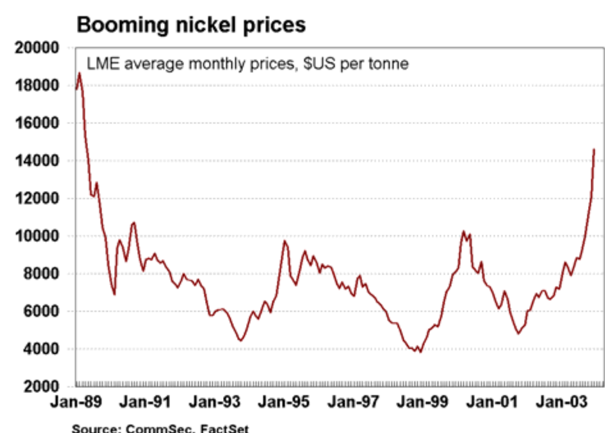
THE AUSTRALIAN ECONOMY IN 2004	
IN	***OUT***
Elections	Drought
Global boom	Housing boom
Tight labour market	Two-speed economy
China	Japan
Rate hikes	Rate cuts
$A strength	Bear market for shares
High migration	
STILL IN	***STILL OUT***
Iraq / terrorism fears	Deflation
Oil prices	

The Big Issues For 2004

- Year 2004 is an election year in both Australia and the US. In Australia, the Federal Election is likely to be held between October and December. But while the current Parliament expires on February 11 2005, an election for the House of Representatives can be held as late as April 16 2005. A half-Senate election must be held by June 30 2005. If the Government was to call a double dissolution election, both Houses must be dissolved by August 11 2004 with the election held on or before October 16 2004.
- In the US, there is no timing issue – the Presidential Election will be held on November 2. The first Caucus (Iowa) will be held on January 19 and the first Primary (New Hampshire) will be held on January 27. The economy, health insurance, social security and foreign policy (especially Iraq) are likely to be the key election issues.
- It is still a bit early to identify the key election issues in Australia. Taxation, spending on priority areas like health and education, security issues (including asylum-seekers) and the future of Telstra are expected to be the key issues.
- The factor that goes hand-in-hand with elections is uncertainty, namely the potential for a change of government, and thus change in policies. Election uncertainty has a range of effects, including the potential for thin trading on financial markets together with increased volatility. And election uncertainty may also cause consumers and businesses to delay major spending decisions, thus sapping growth momentum from the economy.
- But despite the presence of elections, we remain upbeat about prospects for the domestic and global economies. In fact the combination of super-low interest rates in major economies (especially the US), stronger domestic spending in Asia and robust

economic growth in China, creates the potential for **boom-like conditions in the global economy.**

- Consumer spending is expected to be a key driver of global activity over 2004. Increased production efficiencies across global manufacturing, especially technology goods, is leading to cheaper prices for a range of key consumer durables such as cars and electrical goods. In Australia alone, wages have risen by 18 per cent over the past five years while prices of cars and household appliances have fallen by 1-2 per cent and audio visual equipment has fallen in price by 47 per cent.
- **China** is expected to be a key driver of the global economy in 2004, just as it was during 2003. Rapid industrialisation, rising wealth levels and increased demand for infrastructure are underpinning the solid growth of the Chinese economy. China's seemingly insatiable demand for raw materials and the consequent need for bulk shipping vessels is expected to continue during 2004, lifting metal and freight prices globally.
- Solid global economic growth and the potential for even higher base metal prices, point to another strong year for mining companies in 2004. However it is unlikely to be one-way traffic for the resources sector, the speed-hump being provided by a stronger Australian dollar. We expect the Aussie dollar to reach US80 cents by June and US81 cents by September 2004 before easing to US78 cents by the end of the year. Investors will need to carefully dissect prospects in the mining sector, weighing demand and price effects against currency effects for each company.
- The **strength of the Australian dollar** could be a hot issue in 2004, especially if it soars to US81 cents as we expect. Farmers, miners, tourism businesses and manufacturers are already bemoaning the 'strong' Aussie, partly blaming higher Australian interest rates for the soaring currency. Exporters will only become less vocal about the currency if solid demand and higher prices for their products more than offsets Aussie dollar appreciation.
- The prospect of further **rate hikes** is expected to dominate the economic agenda over most of the early months of 2004. However we expect the Reserve Bank to tread especially carefully. The Reserve Bank wants to prevent the economy over-heating and engineer a soft landing for the housing sector while keeping the unemployment rate at its best level in 22 years. We have a quarter percent rate hike factored in for the first half of 2004 – but that rate hike is scribbled down in pencil, not pen.
- We expect that there will be greater focus on **high in-bound migration** in 2004, a key factor behind the success of the Australian economy in recent years. The high levels of in-bound migration have added extra momentum to the economy, especially in terms of housing demand, car sales and retail spending. If growth in in-bound migration starts to flatten out, then it is possible that economic activity will slow to a more sustainable pace without the need for significant rate hikes.
- The unemployment rate stands at 5.6 per cent, a rate that hasn't been bettered in 22 years. But further **tightness of the labour market** could cause problems in 2004. Already skill shortages are appearing and the unemployment rate in some regions has fallen to around 2 per cent. Migration



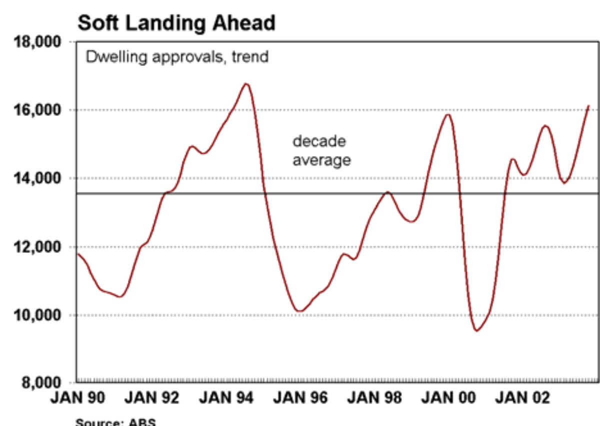
is likely to prove important in 2004 in addressing skill shortages. With capacity utilisation at 14-year highs and the labour market tightening, there is the risk of inflation and wage pressures emerging. Already non-tradables inflation stands at 4.1 per cent.

Issues That Remain "In" for 2004

- One factor that is constantly on the radar screen of policymakers, investors and businesses is the **price of oil**. The key reason being the tendency for global slowdowns and recessions to be associated with high oil prices. As 2003 draws to a close, world oil prices are hugging historically high levels near US$33 a barrel. But the US dollar is also far weaker, meaning that major economies are less restrained by current high oil prices than they would have been 12-18 months ago.
- Increased oil production from Iraq has potential to lead to lower world oil prices. But stability in Iraq is required first. So certainly **Iraq** will remain on investor radar screens in 2004.
- The threat of **terrorism** is also another constant for investors, but it is an issue that is difficult to incorporate in investment strategies and decision-making.

The "Out" List in 2004

- A key feature of the Australian economic landscape in 2003 was **drought,** the worst in Australian history. Seasonal conditions are becoming more normal across Australia, but unfortunately drought still exists in many areas. We are hopeful that drought conditions will recede completely in 2004, however it is impossible to forecast with certainty.
- The **housing boom** is expected to end in 2004. However while irrational exuberance is expected to end, it is likely to be replaced with firm but sustainable levels of activity and growth in property prices. Increased housing supply, high housing prices and the recent increases in official interest rates are expected to contribute to a soft landing for the housing sector over 2004. Effectively demand is softening and supply is rising to restore balance to the national housing market. No major housing oversupply exists Australia-wide or is likely to develop in 2004. As a result we expect annual growth in house prices to ease to the 5-10 per cent range over the year. Certainly there are 'hot-spots' in Australian property markets, such as inner-city Sydney and Melbourne. But while there may be localised weakness in housing prices in 2004, broad-based declines in property prices are not envisaged.
- Stronger global economic growth will mean that **rate cuts** will be removed from the economic agenda in most major economies in 2004. And we expect less references to the **two-speed economy** in Australia as 2004 progresses. A combination of robust global economic growth, higher commodity prices and an end to the domestic drought paints a positive picture for Australian exporters. The main remaining challenge for domestic exporters is likely to be a stronger Australian dollar.
- While we aren't tipping new bull market conditions for domestic and global sharemarkets in 2004, at least the term '**bear market'** will be removed from the investment lexicon in 2004. We expect the Australian All Ordinaries to reach 3,450 by June and 3,525 by end year. The US Dow Jones is tipped



to reach 10,700 by mid 2004 and 11,600 by end 2004. Investors are expect to opt for greater balance between growth-focussed and defensive sectors in their portfolios as the year progresses and as global central banks move to tighten monetary policy.

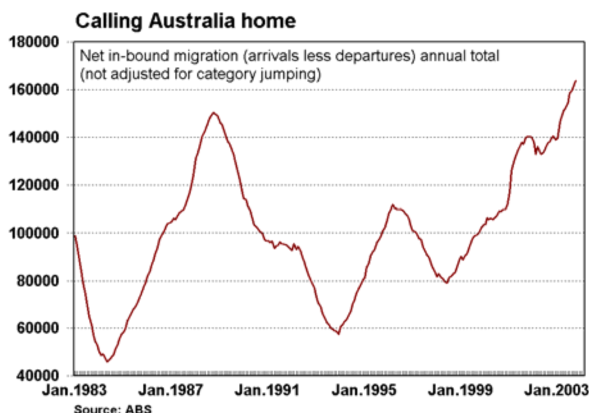
Still On The "Out" List in 2004

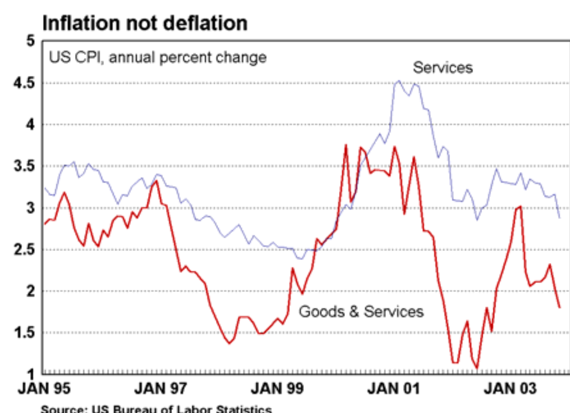
- **Deflation** didn't happen in the US, Europe or Australia in 2003 and we don't believe it is likely in 2004. Commodity prices are rising strongly, global economic growth is picking up pace, interest rates remain super-low in both the US and Europe and consumer spending is fuelling Asian economies. Low inflation in the US at present reflects the weaker economic growth environment that existed in late 2002/early 2003 as well as production efficiencies and strong global competition for a range of items like cars and tech goods. But inflation in the services sector has not eased markedly.

The 'Left-Field' Issues for 2004

- 'Left Field" issues or 'X' factors are those influences that are generally unexpected but end up having a big influence on the economic environment. In 2003 the 'X' factor was the Iraq War – not the war itself but uncertainty about how it would unfold. In the end, the effect was positive. Once it became clear that war would happen, global sharemarkets began to recover. The global sharemarket rally has continued through to the end of 2003 and further recovery is expected in 2004.
- Another 'X' factor in 2003 was **SARS**, resulting in a short, sharp shock to Asian economies in particular and to travel businesses globally.
- An outbreak of a major virus like SARS, or even a recurrence of SARS itself is clearly a potential 'X' factor for 2004. Health authorities are worried about a mutation of the SARS virus and are also bracing for any re-emergence of the virus in the Asian winter. As was clear with the SARS episode from March to June 2003, if a major geomedical event is not contained quickly and efficiently then it causes uncertainty amongst consumers and businesses, reduced spending and business activity and thus sharply weaker economic growth.
- Other 'left field' issues are more in the realm of risk factors. These include on-going weakness of the **US dollar**, a banking crisis in **China**, geopolitical tensions involving **North Korea** or **China/Taiwan**, a new **mining boom** (& bust), over-heating in the **Chinese economy**, revaluation or float of the **Chinese renminbi** and renewed weakness of the **US economy.**

Craig James, Senior Analyst, CommSec





The Big Issues 2003

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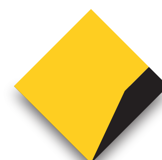

Commentary

Craig James, Senior Analyst, CommSec,

The Big Issues For 2003

- **Employment rose by 60,400 in November, well above expectations for a gain closer to 20,000. Full-time jobs rose by 57,300 and part-time jobs increased by 3,100. But with slightly more people looking for work (participation rate rose from 63.4 per cent to 63.8 per cent), the unemployment rate edged up from 6 per cent to 6.1 per cent.**
- **Annual job growth stands at 2.5 per cent – above the longer-term average of 2 per cent.**
- **The gap between Australian and US unemployment rates is now the smallest in over 19 years.**
- **The strong employment results confirms our positive outlook for domestic-focussed companies especially in consumer related, non-residential construction and media sectors.**

12 DECEMBER 2002

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The Big Issues of the Past Year

- A year ago we gazed into the crystal ball in an attempt to identify the big issues for 2002. And clearly we had mixed success. On the economic 'in' list was **"economic recovery"** – correct in terms of Australia but far too optimistic in respect to the global economy. We were also too early in putting **"growth/cyclical stocks"** on the 'in' list while placing **"defensive stocks"** on the economic 'out' list. **"Biotechnology"** also failed to justify its inclusion on the 'in' list.
- However while our tip of **"tighter monetary policy"** was hardly ground-breaking, the projected end year cash rate of 4.5 per cent was only slightly below the final outcome of 4.75 per cent. Again, our crystal ball was on the money with a warning of a boom in house prices.
- Over the past year, the big issues have been US corporate accounting scandals, on-going terrorism fears, the continued shake-out in the technology, media and telecommunications sector, the housing market 'bubble', and drought. The Australian economy defied the odds with another year of solid growth. In fact the economy probably grew by around 4 per cent in 2002, up from 2.9 per cent in 2001.

The Big Issues for 2003

- It appears that little has changed in the space of a year. At the start of 2002 the world economy occupied a central spot in the wall of worry. And entering 2003, the spotlight is still firmly focussed on the health of the global economy. While most analysts would have expected recovery to now be well underway, the key problem as been the influence of 'X-factors'.
- "X-factors" such as accounting scandals and major corporate failures together with terrorism fears and further unwinding of the 'new economy' served to batter

THE AUSTRALIAN ECONOMY IN 2003

IN	***OUT***
Global recovery	Global recession
Business investment	Deflation
Resource sector	Defensive stocks
Bilateral	Multilateral
China	Japan
Tighter monetary policy	Lows for interest rates
Low population growth	
STILL IN	***STILL OUT***
Oil prices	Biotechnology boom

confidence levels over 2002. Just when it seemed that the shoots of economic recovery were starting to blossom, investors, businesses and consumers became more uncertain about the outlook, in turn causing spending, investing and hiring decisions to be placed on hold.

- In effect Year 2002 was dominated by a crisis of confidence. A massive amount of fiscal and monetary stimulus was put in place but economic participaqnts, especially businesses, failed to respond. And as a result economies such as the US lacked momentum.
- While US confidence levels are slowly improving, the key influence standing in the way of sustainable economic recovery is fear about a war with Iraq. Analysts may warn against such short-terminism, but after a year of shocks, economic participants are seeking greater certainty before upping their spending and investing plans.
- Global recovery will gradually replace global recession on the economic 'in' list in 2003, but the transition process will be heavily influenced by the Iraq situation. Unfortunately no one can predict whether war will occur, its timing or likely duration. But we would expect that uncertainties about war will have cleared by mid year, enabling the US to drive global economic recovery in the second half of 2003.
- The timing and pace of US economic recovery will have a range of influences in Australia. Reserve Bank Governor Macfarlane has indicated that
- In November, total jobs ads fell only 0.4 per cent after four months of solid gains, suggesting that hiring intentions remain solid. Further, NAB reported in its latest business survey that employment conditions strengthened in November. And contrary to some reports, employment is strong not just in construction but in transport & storage, recreational & personal services and retailing.
- There are few shackles on the non-farm economy moving into the new year. Interest rates are low, businesses are confident and investment is taking over from housing as the key driver of the economy. Today's employment results together with solid forward indicators, point to the unemployment rate falling into the 5.5-6 per cent region in early 2003
- As always with the jobs figures, which tend to swing wildly from month to month, it is important to keep the results in perspective. In trend terms, employment is increasing by around 14,000 per month, not just over 60,000 as suggested by the seasonally adjusted figures. However this translates to annual growth of 2.1 per cent – above longer-term averages closer to 2 per cent. In trend terms, the unemployment rate stands at 6.1 per cent – equal to the lowest result seen in the past 12½ years. In short, smoothing out the numbers still shows that the labour market is in solid shape.
- There are clear signs that Australian businesses are prising open their wallets more widely. Corporate Australia is not only hiring more workers and lifting investment spending but forward indicators such as job ads and survey data point to further expansion. With solid indications of a recovery in advertising spending over 2003, we affirm our positive outlook on the media sector. The recovery in domestic business spending is seen especially favourable for John Fairfax (short term BUY).
- An interesting note is that the unemployment gap between Australia and the US is the smallest in over 19 years (June 1983). Australia's unemployment rate stands at 6.1 per cent versus 6 per cent in the US. The reduction in the unemployment gap highlights the

value of sustained strong expansion in the Australian economy over the past 11 years and the good governance by the Reserve Bank.

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