

Australian economy gains momentum quickly

Economic research note

1 September 2010

- The Australian economy grew by 1.2%/qtr in Q2 2010, from an upwardly revised 0.7%/qtr in Q1 2010. The annual pace of growth has accelerated to 3.3%/yr, which is now back above trend growth.
- Economic growth on the quarter was driven by gains in private consumption, particularly the purchase of motor vehicles. Net exports also contributed strongly to growth.
- The terms of trade increased by a strong 12.5%/qtr, helping drive a 5.1%/qtr rise in real net national income. As this income continues to flow through the economy, we would expect to see a continued pick up in private sector capex, company profits and consumer spending.

Australian economy gains momentum:

The Australian economy grew by 1.2%/qtr in Q2 2010. This was up an upwardly revised pace of growth of 0.7%/qtr in Q1 2010 (was 0.5%/qtr) and with the annual pace of growth rising to 3.3%/yr from a revised 2.6%/yr, this represents a very good outcome. This is the fastest pace of annual GDP growth since Q1 2008, but still below the peak of 5.4%/yr reached in Q2 2007.

Economic growth in the quarter was driven by strong final consumption expenditure by both the government and households, contributing 0.3% points and 0.9% points to growth respectively. The main driver of household final consumption was the purchase of vehicles, which rose 11.2%. Recreation and culture also rose 3.3% and indicates that consumers are lifting their willingness to spend.

Net exports contributed 0.4% to GDP growth, this compared to subtracting -0.5% in Q1 2010 and reflects the record Australia's trade balance recorded in June given strong volume and prices for iron ore and coal. Private dwelling investment also contributed 0.3% points to growth, reflecting a long awaited uptick in housing construction. Offsetting growth was inventories, which subtracted 0.7% points.

Importantly, Australia's terms of trade rose by a very strong 12.5%/qtr in Q2 2010, following on from a 5.7%/qtr gain in Q1 2010. This helped drive a massive 5.1%/qtr increase in real net national income which is now well above real GDP pace. It is this increase in national income that is beginning to flow into the economy and will continue over the years ahead, This will help drive private sector capex, profits and consumption and support the RBA's monetary policy tightening cycle that is expected to resume in late 2010, or early in 2011 dependent on global economic conditions.

Of most interest has been the surge in nominal GDP, which has now accelerated to 10.0%/yr and as the chart below shows, it is this strong growth the RBA is looking at when considering interest rates over the coming year. This surge in nominal growth will also benefit the Federal Government fiscal position and will provide further help for the return of the budget to surplus in 2012/13.

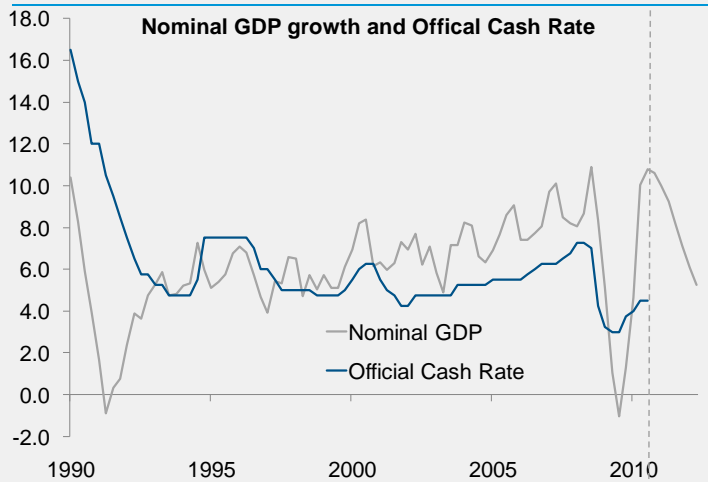


Stephen Halmarick
Head of Investments Research

Belinda Allen
Analyst, Investment Markets Research

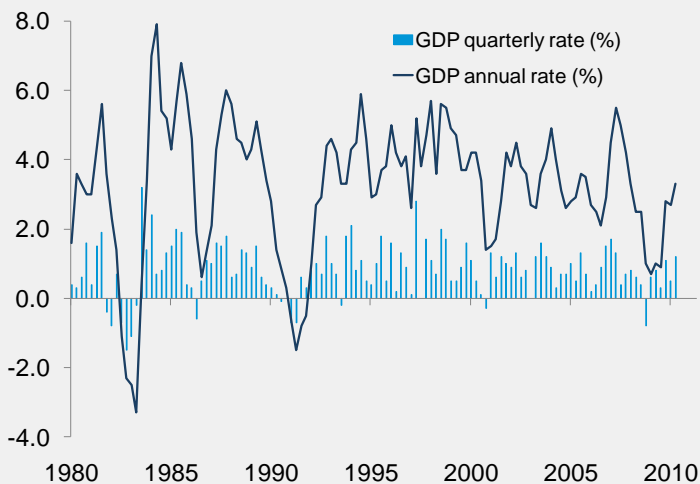
James White
Analyst,
Investment Markets Research

Australian nominal GDP and cash rate:



Source: ABS, RBA and Commonwealth Treasury

Australia quarterly and annual economic growth rates:



Source: ABS

Other highlights:

Other highlights from the Q2 2010 national accounts include:

- On an industry basis, the strongest gains over Q2 2010 were in construction (+0.3% contribution) while mining, information, media & telecommunications, financial & insurance services, rental, hiring & real estate services, Professional, scientific & technical services and Health care & social assistance all contributed 0.1% points to growth.
- These positive contributions were offset by declines in wholesale trade and other services (-0.1% contribution),
- For Q2 2010, inventories contracted \$514mn, after three quarters of positive gains and post the destocking process that took place from Q4 2008 to Q2 2009. The contraction in inventories occurred in the wholesale trade sector.
- Compensation per employee rose 5.8%/qtr in Q2 2010, contributing 1.4% points to GDP. This was

driven by a rise in average earnings of 2.5%/qtr. The share of total factor income accounted for by wages continues to fall and now sits at 52.7% from a peak of 54.8% in Q2 2009.

- This fall in wages shares was due to gains in gross operating surplus (private), which rose 19.8% in Q2 2010, contributing 1.9% points to GDP. This reflects the sharp gain in company profits, especially from the mining industry. Company profits recorded an 18.9% increase in Q2 2010. This has now seen a rise in the profits share of total factor income ratio which rose to 28.2%, up from the low of 26.3% in Q3 2009.
- The household savings ratio fell to 1.5% from 3.4% (revised up from 2.6%) and now is much lower than the peak of 6.9% during the height of the GFC. But the Q2 2010 reading still remains well above the average of around 0.6% seen before the onset of the GFC and the large negative rates seen in 2004 and 2005 at the height of the housing boom.
- The savings ratio will have to be watched closely to ensure the household sector continues the push to lift savings. It is no surprise that this savings rate is starting to fall given the very strong labour market outcomes experienced in the Australian economy over the past 12 months and fits with the slow signs we are now seeing of a pickup in private consumption.
- One of the big issues for the Australian economy over coming years is how this massive income boost flowing into the Australian economy from the Terms of Trade shock will be managed. This income can either be spent or saved and will be an important decision for policy makers over coming years, as well as how this increased wealth will be distributed between the resource rich states to the rest of Australia.
- With regard to prices, the chain price index for household final consumption spending rose by 0.4%/qtr. Private gross fixed capital formation prices fell 0.3%/qtr on the quarter. This was driven by a fall in machinery and equipment prices. Export prices rose 12.6%/qtr but are now 14.1% higher over the year. Import prices also rose, up 1.5%/qtr.
- Looking at the states, all recorded positive growth for Q2 2010. NSW, Victoria and Western Australia were the strongest contributors to national growth for the quarter, with state final demand growth of 1.3%/qtr, 1.9%/qtr and 3.0%/qtr, respectively. The Australian Capital Territory recorded growth of 5.0%/qtr, while Queensland (+1.4%/qtr), South Australia (+1.3%/qtr), Tasmania (+0.6%/qtr) and Northern Territory (+0.7%/qtr) also rose.
- The strong growth in Western Australia (+3.0%/qtr) was driven by strong gains in public investment, non-dwelling private construction and engineering work. This is reflecting the strong mining and gas investment work taking place in that state. Imports

rose 4.0%/qtr reflecting the start of strong capital imports to support investment in the region.

- NSW benefited from strong growth in government and private sector consumption while gross fixed capital formation (investment) fell 2.0%/qtr after a very strong 27%/qtr gain in Q1 2010.
- In contrast, the growth in Victoria was driven by a 16%/qtr gain in public gross fixed capital formation, with government stimulus efforts still boosting growth in Victoria. Both household and government consumption also rose marginally while private investment fell 0.5%/qtr.

Implications for the RBA:

Today's GDP data does show the Australian economy has stronger momentum than expected by the RBA at this point in the cycle. The data is now more reflective of the strong labour market outcome witnessed over the past 12 months.

In the RBA's statement on Monetary Policy released in early August, the RBA forecast GDP growth of 3.0%/yr in Q2 2010 (and that was revised up from 2.5% in the release). The composition for growth is also improving, showing the move from public sector spending to the private sector. Although this was driven by household consumption it does serve to reinforce the pre-emptive moves by the RBA earlier in 2010.

While the Australian economy appears to have more momentum than expected at this stage in the cycle, it is likely that continued offshore concerns over the state of the global economy, particularly the US will see the RBA on the sidelines at least until November. This gives the RBA another look at price pressures in the Australian economy with Q3 CPI data released in late October.

Where the RBA could still see some concern about the path of Australian growth, is the lack of improvement in private business investment, with machinery and equipment investment contracting 3.1%/qtr. Some improvement in this sector would seem necessary for the RBA to lift interest rates. However, the capex intentions data released last week did show an update to 2010/11 plans, with \$123.3bn of work expected to be completed this financial year.

The RBA is, however, expected to resume its tightening cycle later in 2010. Markets have become much more bearish of late and are now pricing in a 50% risk of a monetary policy easing before year-end. Given the public comments from the RBA about the medium term outlook for the Australian economy and the very strong income shock flowing through into the Australian economy from the terms of trade, it is hard to imagine they are contemplating such a scenario. This market pricing largely reflects offshore concerns rather than any home grown fears.

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them. This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Colonial First State Global Asset Management is the consolidated asset management division of Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © (2010) Colonial First State Group Limited.
All rights reserved.