CommSec
Economics
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Smaller retailers hit by consumer strike

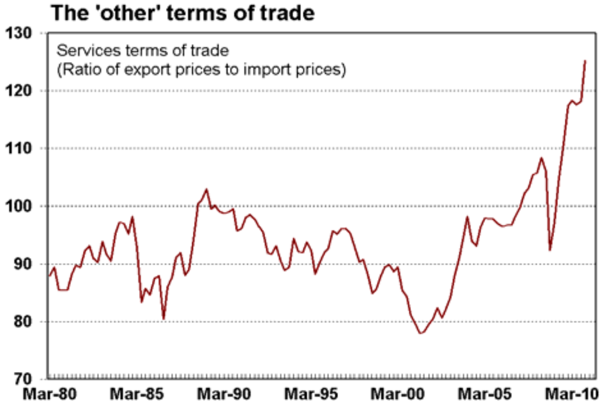
Retail trade; Performance of Manufacturing; BOP

- **Retail spending grew by 0.4 per cent in January – in line with the Commonwealth Bank Business Sales Indicator which was released two weeks ago. Over the past year retail trade lifted by just 1.8 per cent.**
- **Non-food retailing fell by 1.0 per cent in the month with annualised growth of just 0.3 per cent – marking the weakest growth rate in 26 months. Sales at smaller retailers fell by 1.6 per cent in February. In annual terms growth was just 0.2 per cent – a 10 month low.**
- **The Performance of Manufacturing index improved from 46.7 to 51.1 in February – marking the first expansion in the sector in six months. Key sub-indexes were mixed with new orders surging to seven month highs, while production, and employment contracted at a faster pace.**
- **The broad measure of Australia's external position - the current account – deteriorated in the December quarter due to higher income payments. The deficit rose by $809 million to $7.3 billion.**
- **In calendar 2010 the current account deficit stood at 2.6 per cent of GDP – the smallest deficit in eight years.**
- **The terms of trade (ratio of export to import prices) hit a record high in the December quarter, courtesy of lower import prices. The services terms of trade soared 6.0 per cent to record highs. Overall CommSec expects that the economy grew by around 0.9 per cent in the December quarter.**

What does it all mean?

- The Australian economy has certainly lost momentum over the last couple of months. Not only are house prices going backwards, but retail spending is barely growing. And even the latest improvement in manufacturing activity comes after an extended period of weakness, and can hardly be claimed as a full blown turnaround given the weakness in sub components.
- The domestic economy is certainly facing headwinds, with the higher Australian dollar curbing tourism and making exports less competitive. At the same time the conservative attitudes of consumers have ensured that retail activity remains weak. Especially when you consider that non-food retailing fell by 1.0 per cent in February

Source: ABS, CommSec



Source: ABS, CommSec

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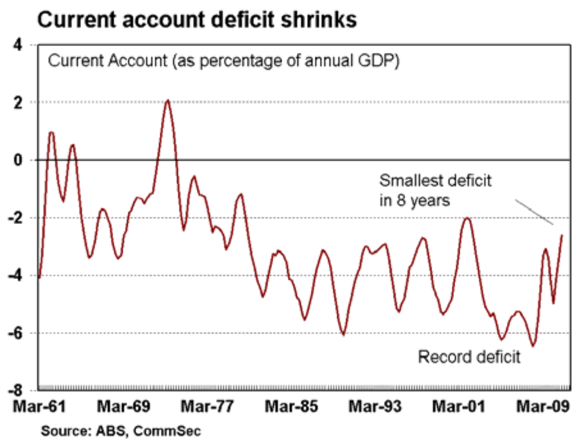
and held at the weakest annual growth rate in over two years.

- Retailers have certainly done it tough over the past year. Annualised growth in sales is holding at a paltry 1.8 per cent – a far cry from the decade average growth of 6 per cent. In fact retail activity levels were much more buoyant during the global financial crisis, with annualised growth rates of around 6-7 per cent. It is clear that the cumulative rate hikes have taken their toll on the household budget, and as a result discretionary spending is being pared back.
- The tightening of monetary policy and unwinding of stimulus has been the key reason for the turnaround in the fortunes of the retail sector. The domestic economy is not shooting the lights out and retail activity is virtually non-existent. The larger department and chain stores have fared better, given the ability to discount to a greater degree. In fact monthly sales fell by 1.6 per cent at the smaller retailers, while annualised growth is just 0.2 per cent – the weakest growth rate in 10 months.

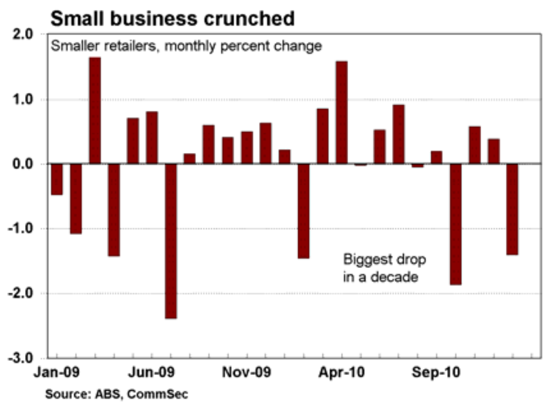


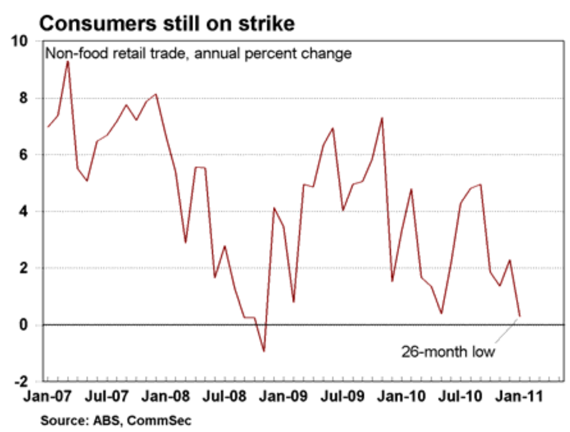
- No doubt part of the slide in retail sales can be blamed on lower prices, rather than weaker spending, given the widespread discounting taking place across the retail sector. However weaker volumes are clearly playing their part. Prices of some goods are coming down because our dollar is strong, but plenty of retailers are cutting prices because consumers refuse to spend.
- The general perception is that Australians are getting richer courtesy of the mining sector – rising iron ore and coal prices. But that view forgets the other parts of the terms of trade story. The terms of trade compares export prices to import prices. But in the latest quarter it was falling prices for imported goods that helped to catapult the terms of trade to record highs.
- And the terms of trade is divided into physical goods like coal as well as services like tourism and education exports. And it turns out that a big reason for the lift in the terms of trade was a sharp improvement in the services component. In the past two years the goods terms of trade has lifted by 11 per cent but the services terms of trade has soared by almost 29 per cent.
- The mining sector has been touted as Australia's saviour – driving the economy higher and boosting income levels. But it is not just a China boom driving the economy, but an Asia boom, and the rising income levels in the region are contributing to a big demand for Australian services. At the same time the rising exchange rate has sharply cut the cost of overseas travel, improving the quality of life for all Australians
- Given that all the backward looking data that plugs into the economic growth calculations has now been released, focus will turn to the tomorrows growth result. Overall CommSec expects that growth is likely to be around 0.9 per cent.

What do the figures show?

<u>Retail trade:</u>

- Retail trade rose by 0.4 per cent in January after a 0.2 per cent slide in December. Non-food retailing fell by 1.0 per cent in January after the 0.5 per cent rise in the prior month. Over the past year retail trade lifted by just 1.8 per cent.
- Sales by chain stores and other large retailers rose by 1.4 per cent in seasonally terms in January while sales by





smaller retailers fell by 1.4 per cent. In annual terms sales at chain stores were up 2.7 per cent on a year. Sales at smaller retailers were up just 0.2 per cent on a year ago – the slowest growth rate in 10 months.

- During January, sales increased most at other specialised food retailers – including butchers, seafood retailers and fruit & vegetable shops. Other retailing groups like newsagencies, stationary shops and florists recorded healthy gains up 6.8 per cent in the month. Sales fell most at other recreational good retailers - including sporting, entertainment and toy retailers – (down 8.5 per cent), followed by electronic goods retailers (down 7.7 per cent).
- Across the states sales lifted most in Northern Territory (up 4.7 per cent), followed by Western Australia (up 2.7 per cent), South Australia (2.4 per cent), ACT (up 2.2 per cent), and Queensland (up 0.3 per cent), and NSW (up 0.1 per cent). Sales fell in Victoria and Tasmania (both down 1.0 per cent).

Performance of Manufacturing Index

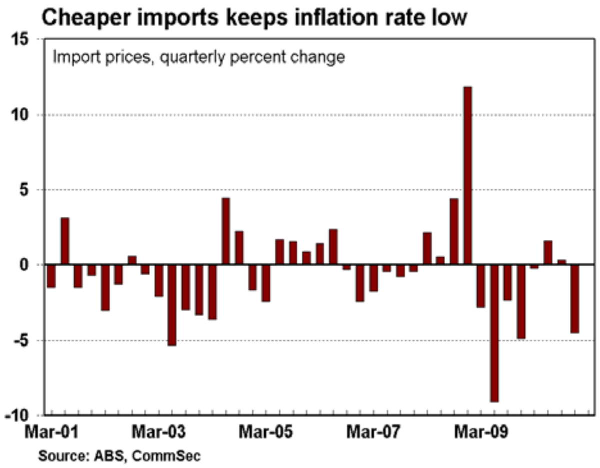
- The Performance of Manufacturing index rose sharply from 46.7 to 51.1 in February, marking the first expansion in the sector in six months.
- Key activity components of the PMI were mostly higher in January. New Orders recorded a healthy improvement, while production has contracted once again. Employment still contracted at a faster pace.
- The production sub index fell 1 point to 49.3; new orders rose by 7.2 points to 52.3 – a seven month high; the employment index fell 4 points to 45.0; exports rose by 0.3 points to 49.2; the index of selling prices rose modestly from 50.7 to 51.0, while input prices rose by 4 points to 75.2 and wages also rose marginally.
- In seasonally adjusted terms just seven of the 12 sectors recorded a decline in activity in February.

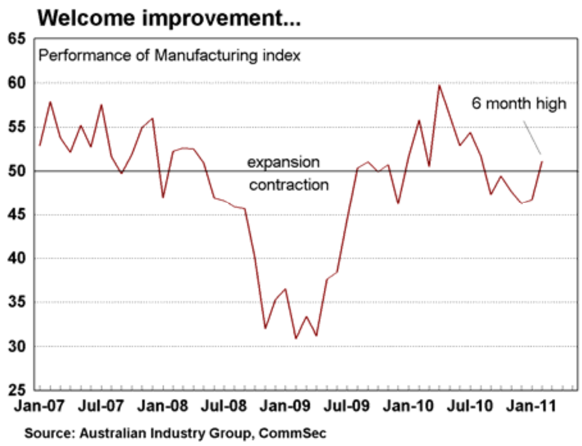
Government Finances

- Government consumption spending rose by 1.1 per cent in the December quarter after a 0.5 per cent lift in the September quarter. But public investment rose by just 0.2 per cent in the December quarter after a 1.9 per cent lift in the September quarter. General government investment rose by 0.3 per cent in the quarter while spending by public corporations was flat.

Balance of Payments

- The broad measure of Australia's external position - the current account – worsened in the December quarter. The current account deficit widened by $809 million to $7.3 billion in the December quarter. The balance of goods and services surplus widened by $726 million to $6.76 billion. But the net income deficit widened by $1.55 billion to a deficit of $13.7 billion.
- In the December quarter the current account deficit widened from 1.9 per cent to 2.1 per cent of GDP. But the rolling annual figures showed the current account deficit at 2.6 per cent of GDP in 2010, the lowest deficit in eight years.
- In the December quarter exports of goods and services rose by 3.0 per cent, exactly matching a 3.0 per cent lift in imports. The trade sector (exports less imports) will make no contribution to economic growth in the December quarter.
- Export prices fell by 3.4 per cent in the December quarter (goods down 4.4 per cent, services up 0.3 per cent) but import prices fell more, down by 4.5 per cent (goods down 3.8 per cent, services down 5.2 per cent).
- The terms of trade (ratio of export prices to import prices) rose by 1.1 per cent to a record high of 110.7 in the December quarter – courtesy of lower import prices. The services terms of trade rose by 6.0 per cent to record highs.
- Net foreign debt fell by $26.7 billion to $650.3 billion in the December quarter. A stronger exchange rate served to





cut $17.9 billion from debt in the quarter.

What is the importance of the economic data?

- The Bureau of Statistics' **Retail trade** publication contains the most current readings on the performance of consumer spending. The ABS surveys 500 'larger businesses' and 2,750 'smaller businesses'. Retail trade covers spending at a broad range of retail outlets but excludes both petrol and motor vehicle sales. A weak retail trade result may point to a slowing economy as well weighing on the share prices of listed retail stocks. But retail trade estimates can't be assessed in isolation – it is important to look at the influences determining future trends in consumer spending, such as income, employment and confidence levels.
- The monthly **Performance of Manufacturing Index** is the Australian equivalent of the US ISM manufacturing gauge. The PMI is one of the timeliest economic indicators released in Australia. The PMI is useful not just in showing how the manufacturing sector is performing but in providing some sense about where it is heading. The key 'forward looking' components are orders and employment.
- The quarterly **Balance of Payments** figures have few short-term effects on financial markets. The importance of the data is merely to highlight Australia's trading position with the rest of the world as well as the contribution of foreign trade (exports less imports) to the latest estimates of economic growth. Trade has been a drag on economic growth over the past four years with a lack of productive capacity holding back exports while rising incomes have boosted imports.

What are the implications for interest rates and investors?

- There is no doubt that the domestic economy is limping along at present. Activity has been subdued with consumers keeping a tight rein on spending, while domestic businesses are also feeling the pinch of higher interest rates. We just don't know how long the current bout of consumer conservatism will last. The longer-term outlook for retailers is positive though with the job market still healthy, wages rising and wealth at record highs.
- The expansion in the manufacturing sector is encouraging but it is only early days and a few more months of improvement will be required to claim a turnaround.
- Given the sustained contraction across an array of sectors and recent weakness in other indicators such as house prices, business and consumer credit and sluggish retail sales, the Reserve Bank would be hard pressed to justify a near term rate hike - especially considering the tame inflation environment

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