The Big Issues for 2013

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?

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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%
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

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

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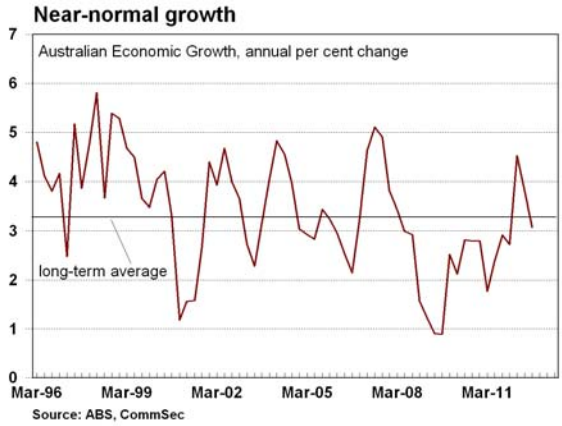
the hope that the US politicians deal with their budget issues, Chinese economic growth continues to recover and there are no new major debt or deficit issues out of Europe. But we don't believe there are major domestic issues to serve as serious threats to the economy in 2013.

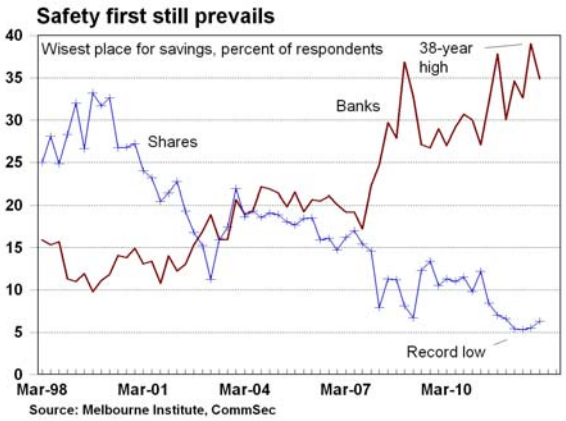


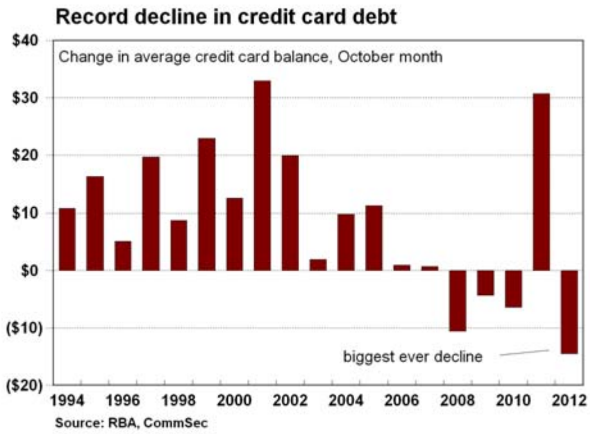
- Actually consider what shape the Australian economy is in heading into 2013. Economic growth is near trend at 3.1 per cent and we still haven't sighted a recession for 21 years; inflation is under control; unemployment is at 5.2 per cent; interest rates are historically low; there is no housing boom 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?

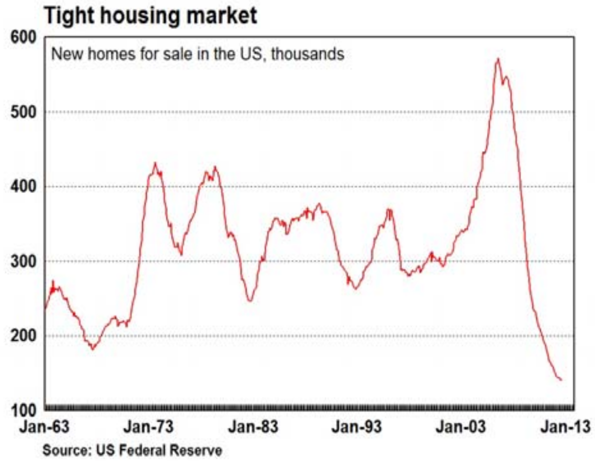
- The GFC, the European Debt Crisis and the "Fiscal Cliff" have all caused ordinary consumers, businesses and investors to lose faith. Faith has been lost in banks, broader financial systems, central banks and governments.





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.

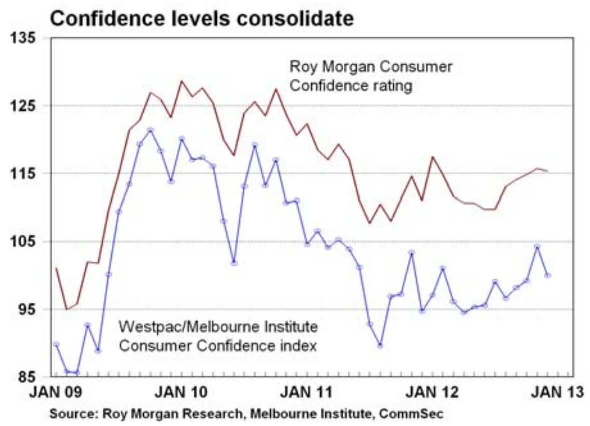


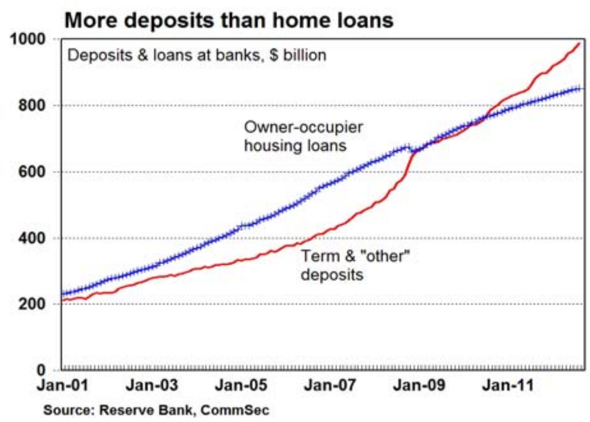
- In fact the US economy is recovering nicely. The housing oversupply situation has been addressed. Home prices are rising and new construction is lifting. Add in the export sector, underpinned by a weak greenback. All of a sudden you have key momentum factors for the economy.
- Certainly much work is 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

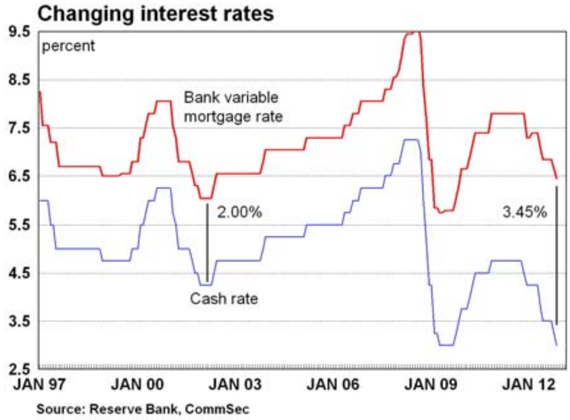
- The rolling crises in the advanced economies since 2008 have certainly produced fundamental changes in Australia. Investors have piled their money into cash-based investments rather than property or shares. As a result the value of term and other deposits exceeds that of owner-occupied home loans.
- 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.

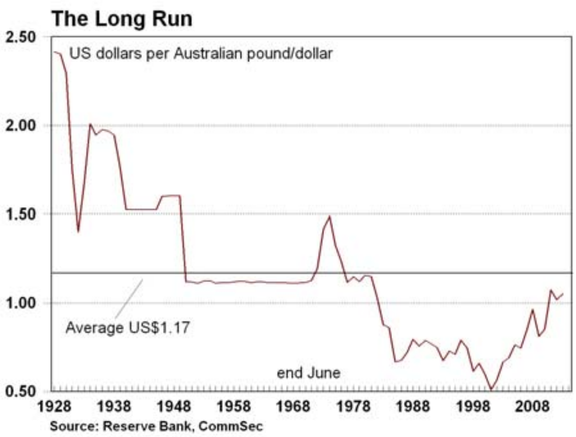
How low could interest rates go?

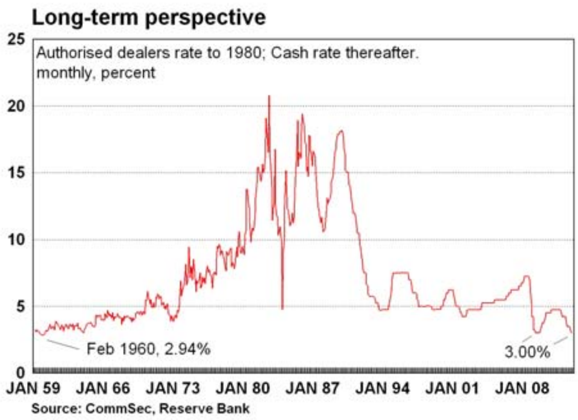
- The cash rate stands at 3 per cent – the same level that existed from April-October 2009 when the Reserve Bank was trying to protect the economy during the global financial crisis. But what matters most is the interest rate applying to borrowers. In the GFC the variable mortgage rate fell to 5.75 per 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.

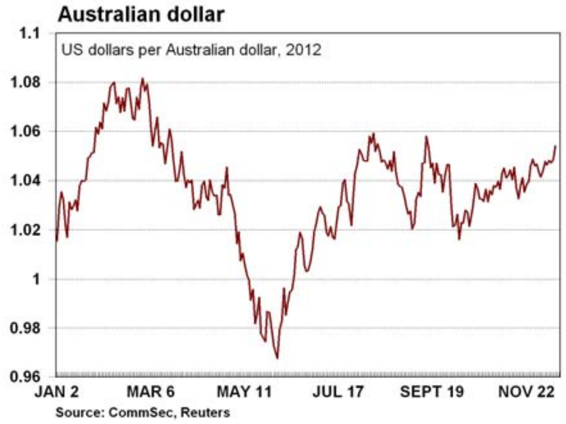
How high could the Aussie dollar rise?

- 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.

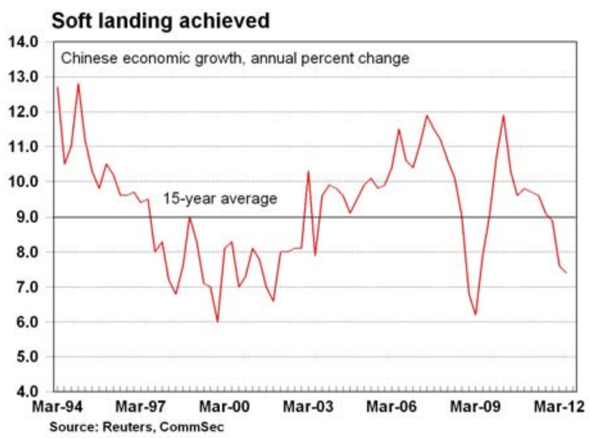


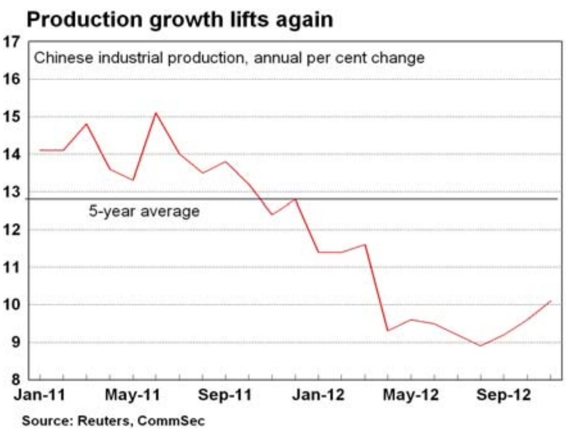
- Could the Aussie dollar revisit the highs near US$1.50 recorded in the 1970s? From the current vantage point, it appears fanciful. But consider the fact that US interest rates will remain near zero through to 2015, Australian interest rates are relatively high compared with advanced nations, there 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?

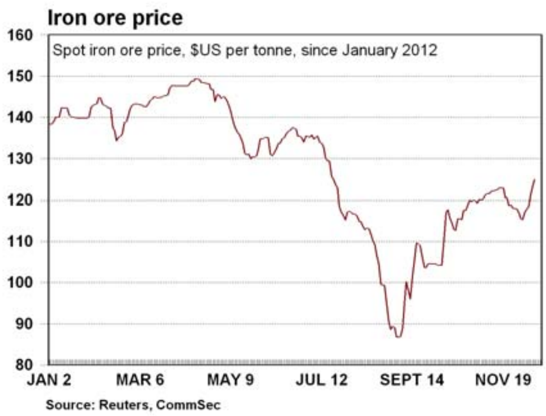
- There is a new leadership group taking power in China in 2013. And the timing is fortuitous as the engineered slowdown appears to be over. The latest economic data showed a lift in industrial production and stronger retail spending in November but with inflation still contained.
- There is scope for 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.

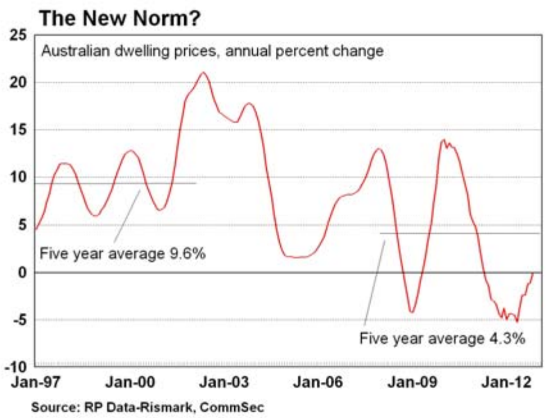


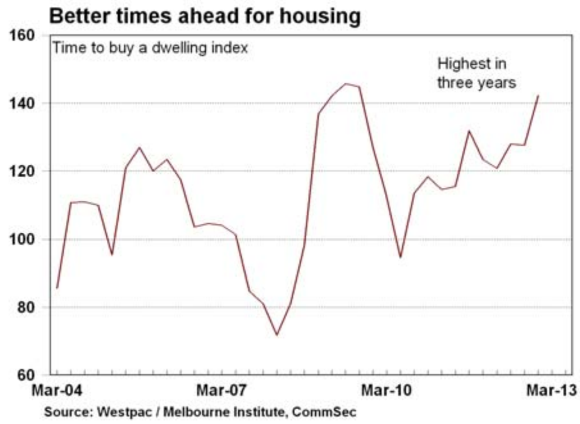
So What? Chinese industrialisation is still in relative infancy. As a result forthcoming demand for resources remains significant. Businesses need to focus on the future opportunities that exist.

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.

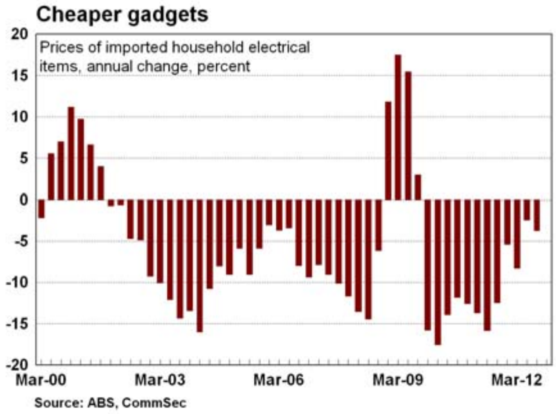
So What? Property is back in vogue. We can't rule out another housing boom, but the pre-conditions don't exist to the same extent that we've seen in the past.

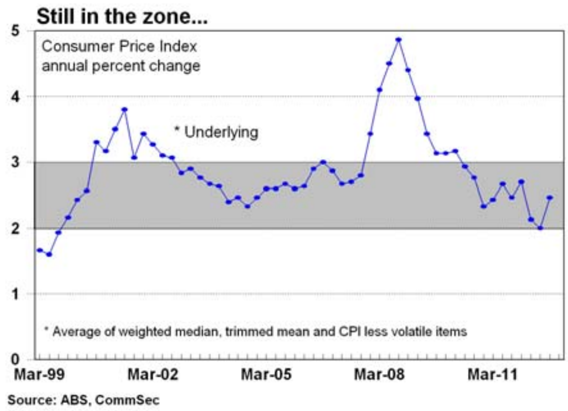




Other Issues

- 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."*

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