Profit slump but Government still upbeat

NAB business survey; Mid Year Economic and Fiscal Outlook (MYEFO)

- **NAB business confidence index eased from +10.1 to +8.1 in October. The business conditions index fell from +6.7 in September to +1.6 in October – a 15 month low.**
- **CommSec has been highlighting for some time that the economy was far softer than the Reserve Bank appeared to be suggesting. And that weakness was clearly evident in the business survey. Profits, orders and trading conditions are slumping with retailing and construction particularly hard hit.**
- **The Federal Government forecasts are clearly more optimistic about the longer term outlook for the economy. The budget deficit is expected to rise modestly over the coming year but be back in surplus by 2012/13. The economy is tipped to grow by an upwardly revised 3.25 per cent this year, inflation is to hold at 2.75 per cent and unemployment is expected to fall to 4.75 per cent by June 2011.**

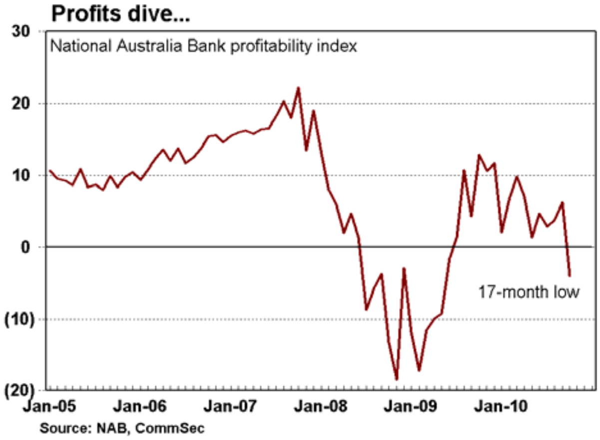
What does it all mean?

- It is clear that the conservative spending attitudes of consumers are affecting Corporate Australia as well. The NAB Business survey has reaffirmed that confidence levels are easing while business conditions are far from rosy. In fact business conditions are now holding at the lowest levels in 15-months. The sluggish retail activity and impact of the stronger Australian dollar has added to the weaker trading environment.
- It is important to highlight that the latest businesses survey effectively predates the surprise interest rate hike that took place last week. And given the additional increase in borrowing costs, and slowdown in activity that will take place in the near term, confidence and conditions are likely to take a further downward leg.
- More concerning is the added weakness in forward looking indicators. Business owners are trimming future orders, while profitability is once again tracking backwards and now holding at 17-month a low – a far from ideal situation given that borrowing costs are rising and retailers are still aggressively discounting. The negative momentum is clearly worrying, meaning that the Reserve Bank could face an extended stay on the interest rate sidelines.
- The latest Government forecasts are certainly more optimistic about the longer term outlook for the economy. Federal Treasury has largely tinkered with its budget forecasts and economic assumptions rather than make major surgery. Treasury still believes that the budget is on track to surplus in just under three years time, but given

New 2010/11 Budget Forecasts

	*Previous Estimate**	*New Estimate*	*2011/12*
Underlying Budget ($ billion)	-40.7	-41.5	-12.3
Underlying Budget (% GDP)	-2.9	-3.0	-0.8
Headline Budget ($ billion)	-49.2	-48.5	-15.1
GDP (%)	3.00	3.25	3.75
Inflation (%)	2.75	2.75	3.00
Unemployment (Jun Qtr%)	5.00	4.75	4.50

Source: Federal Treasury, CommSec * July 2010



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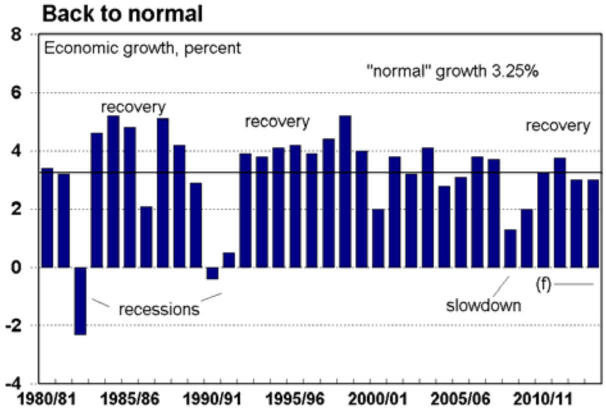
that the shortfall in the year to September is just over $63 billion, it's clear that it has some work to do. Still, there is some comfort in the fact that Treasury is very conservative, tending to under-estimate budget surpluses in recent years and over-estimate the recent deficits.

- While the Treasurer crows about the potential for a sharp improvement in the budget in the next few years, it's always important to acknowledge that they are just forecasts. The government must be disciplined in keeping spending under control. And the government has to rely on the Reserve Bank getting it right with setting interest rates. It is a difficult balancing act - ensuring that the economy keeps on growing near a trend rate of 3.25 per cent while at the same time absorbing the terms of trade shock and keeping inflation under control. It's a case of so far, so good.



Source: Budget papers, ABS, CommSec

- The major changes in the economic numbers relate to unemployment and inflation. Unemployment is expected to be a touch lower, moving to 4.5 per cent next final year while inflation is expected to be a touch higher at 3 per cent. The bottom line is that Treasury sees a risk of interest rates continuing to move higher. While this should come as no surprise to anyone, it will keep home buyers on edge.
- While there will be the usual debate on the new budget and economic numbers, what isn't up for debate is the good position that Australia finds itself in. The key aim 'down under' is to maiontain the prosperity whereas most advanced nations are still struggling with economic weakness.

What do the figures show?

<u>The Latest Government Forecasts</u>

Budget Deficit:

- Expected to fall from $41.5 billion (3.0 per cent of GDP) to $12.3 billion (0.8 per cent of GDP) in 2011/12.
- Expected to be in surplus of $3.1 billion in 2012/13.

Economic Growth:

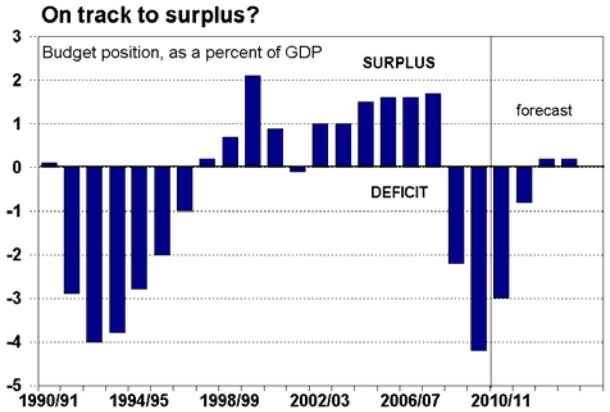
- Growth of 3.25 per cent is expected in 2010/11, up from the estimate of 3.00 per cent in the May Budget.
- The economy is tipped to grow by 3.75 per cent in 2011/12 and 3.0 per cent in 2012/13.

Unemployment

- The unemployment rate is tipped to fall to 4.75 per cent by June 2011 from 5.1 per cent currently.
- The jobless rate is tipped to fall to 4.5 per cent by June 2012.

Inflation & wages

- The inflation rate is expected to hold at 2.75 per cent by June quarter 2011. The CPI is tipped to rise to 3 per cent next financial year and then to 2.5 per cent in the following two years.
- The wage price index is tipped to rise by 3.75 per cent this year and 4 per cent in each of the following two years.



Source: Federal Treasury, CommSec

Source: NAB, CommSec

National Australia Bank Business Survey:

- The **National Australia Bank business confidence index** fell for the seventh time in eight months, easing from +10.1 to +8.1 in October.
- **The business conditions index** eased from +6.7 to +1.6 in October.
- The index of trading conditions fell from +12.9 to +4 – a nine-month low; profitability worsened from +6.2 to -4 – a 17-month low; employment rose from 12-month lows of +1.9 to +6; and forward orders fell from +3.2 to -3.0.
- The monthly reading of labour costs rose modestly from 1.1 per cent to 1.2 per cent in October. NAB noted that annual growth of labour costs stand at 4.3 per cent.
- Inflationary pressures are well contained. Retail prices rose at a 0.1 per cent annual rate in October. Purchase costs and final product prices rose by 0.5 per cent at a quarterly rate.
- **Capacity utilisation** fell slightly from 81.6 per cent to 81.2 percent in October, thus holding in line with the long-term average.

What is the importance of the economic data?

- The monthly **National Australia Bank business survey** is valuable in providing a timely reading on the health of Corporate Australia. Key indicators of business conditions such as orders, employment, profitability and capacity use are covered together with a gauge on confidence levels.

What are the implications for interest rates and investors?

- The frequency of the rate hikes earlier this year did take its toll on the household budget. Consumers aren't keen to spend, putting margins under pressure and causing retail prices to fall. While the environment is great news for conservative consumers, it represents more challenging times for Corporate Australia.
- The Government's forecasts will provide reassurance to consumers and businesses that the longer term outlook is looking more optimistic. CommSec believes that the Government's new projections are both credible and attainable. If anything the projections may be a touch conservative, but in the current environment that is entirely understandable and realistic.
- Investors couldn't ask for a better environment. The goal for any economy is solid, sustainable growth, and that is the expectation for Australia in coming years. Clearly the environment is not without its risks, but provided Federal Treasury and the Reserve Bank are on top of their games, then the future looks bright.
- The latest budget forecasts highlight the risk of higher interest rates in 2011. There is no need for panic, however, as inflation is contained. And the high Australian dollar will also play a key role in dampening economic growth and inflation.
- The other concern for investors is the high Australian dollar. Until there is far more encouraging economic news in the US, the greenback will remain depressed and the Aussie dollar will hover near parity. These are extraordinary times and times that exporters, tourism operators and overseas-dependent Australian companies will continue to find challenging. While the high Aussie dollar is potentially good for retailers (higher margins) it's certainly not the case at present with conservative consumers driving hard bargains.

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