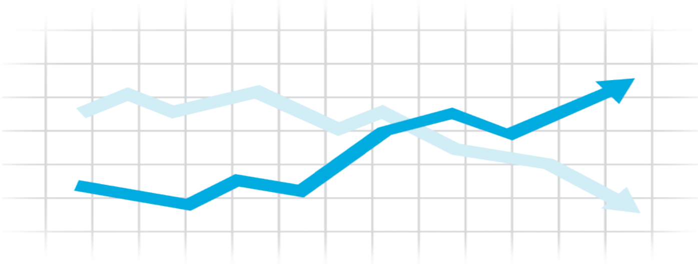
WEEKLY ECONOMIC COMMENTARY



Week beginning 28th March 2016

ECONOMIC DATA ROUNDUP

DATA RELEASED LAST WEEK

Economic Data	Period	Actual	Previous
ABS Established House Price Index	Dec/quarter	+0.2%	+2.0%
DEER Internet Vacancies Index	February	-0.9%	+0.4%

The ABS **Established House Price Index** increased by just 0.2% in the December quarter, the weakest result since September 2012, to be up 8.7% over the year. Within this aggregate, dwelling prices in Sydney fell 1.6% in the quarter (up 13.9% annually), the first decline in Sydney house prices since September 2012 and the largest decline in seven years. Conversely, Melbourne recorded a further 1.6% rise in the quarter to have prices up 9.6% annually. The strongest quarterly increase across the capital cities was recorded in Canberra, with a 2.8% rise leaving house prices up 6% over the year. The steepest fall during the quarter was in Darwin, where house prices fell 1.8%.

Department of Employment and Work Relations' **Internet Vacancy Index** fell by 0.9% in February but remained 4.7% higher than a year earlier. With the decline over the month, the level of vacancies is now 143,000 (or 46.7%) below the March 2008 peak. An 18.3% year-on-year decline in vacancies in Western Australia was the key drag on the index, whilst vacancies in New South Wales rose 11.6%.

February 2016 - Trend	Number of vacancies ('000)	Monthly change (%)	Annual change (%)
New South Wales	64.1	-0.5	11.5
Victoria	41.3	-1.1	7.1
Queensland	29.5	-0.5	3.0
South Australia	6.6	0.0	-2.9
Western Australia	13.2	-3.5	-18.3
Tasmania	1.4	-0.7	-4.9
Northern Territory	2.0	1.0	-4.8
Australian Capital Territory	4.8	0.3	20.7

Reserve Bank Governor Glenn Stevens spoke last week in Sydney and sounded comfortable with the domestic economic outlook, noting that the "the local economy has been improving" and adding that "in the case of business surveys, better conditions seem generally to have continued in the early part of 2016, though labour market data has been more ambiguous". His speech contained very few implications on the direction of near term monetary policy nor did it address any views on the elevated state of the Australian dollar.

Data over the next week

Economic Data	Date	Period	Forecast	Previous
ABS job vacancies	31 Mar	Feb/quarter	-0.1%	+3.5%
HIA New Home Sales	31 Mar	February	n/a	-1.8%
Private Sector Credit	31 Mar	February	+0.5%	+0.5%
RBA Commodity Price Index	01 April	March	n/a	+1.2%

ECONOMIC COMMENTARY

LAST WEEK

For the most part, it was a fairly quiet start to the holiday-shortened week for financial markets and it didn't get any better as the week progressed. The only moves in markets followed the news of bombings in Brussels at the airport and metro on Tuesday night. These attacks in the Belgian capital have killed at least 34 people and injured hundreds more prompting police to conduct raids across the country. The news prompted an immediate flight to quality (equities sold off while US dollar, government bond yields and gold rallied) but the reaction was short-lived and after a brief period of consolidation, markets reversed the moves by the end of the day's trading.

Three non-voting US Federal Reserve officials spoke last week and signalled comfort over the US inflation outlook and flagged the potential for near term US rate rises. James Bullard (the only voting member of the US Fed) grabbed the market's attention by commenting that "you could probably make a case for moving in April" which saw US treasuries sell off and global bond yields followed, more than offsetting the earlier rally.

By the close of trading on Friday, the 90-day bank bill was trading at 2.30% compared to 2.33% the previous Friday while in the long term maturities, 3 and 10 year bond yields closed lower at 1.9% and 2.59% respectively, from 1.95% and 2.55% a week earlier.

CURRENCY

The US dollar continues to recover from the sell-off after the US Federal Reserve meeting, rallying against most of the G10 currencies. The US dollar was further supported by "flight to quality" buying after the terrorist attacks in Brussels. The Australian dollar initially fell to a low of USD0.7535 on the day but bounced to once again trade just below USD0.76.

A fall in commodity prices and book squaring of positions before the Easter break saw the Aussie take another slide, dropping almost one cent and trading once again below USD0.75.

By the close on Friday, the Australian dollar was trading at USD0.7506 compared to USD0.7607 a week earlier.

EQUITIES

A rally in the Chinese share market last Monday failed to boost other markets early last week. The Shanghai composite index rallied over 2.5% following news that controls on margin lending were loosened, which came as a surprise given recent comments about China's rising debt levels.

European equity markets sold off immediately following the deadly bomb attacks in Brussels last Tuesday night (down close to 2% at one stage) before recovering over the course of the trading session to close virtually flat.

A fall in commodities and light trading volumes due to the Easter holiday break saw our share market weaken last Thursday, once again energy and resource stocks led the sell-off.

By the close on Friday the S&P/ASX200 Index was trading at 5,079.0 compared to 5,183.1 a week earlier.

THIS WEEK

Another holiday-shortened week with a couple of second-tier data releases but nothing to create significant market attention. Focus will remain on developments in Brussels and how things unfold.

INTEREST RATE VIEW

Over the course of March so far, improving global sentiment and strong domestic data including GDP and labour market figures have led the market to discount the chance of further RBA rate cuts. The RBA have also elected not to target the strengthening currency with further "jawboning", which is helping suppress expectations of a cut

Futures market pricing of rate cuts is likely to be reduced, particularly before September given we have the May budget, a possible election in July and the retirement of the RBA Governor in September.

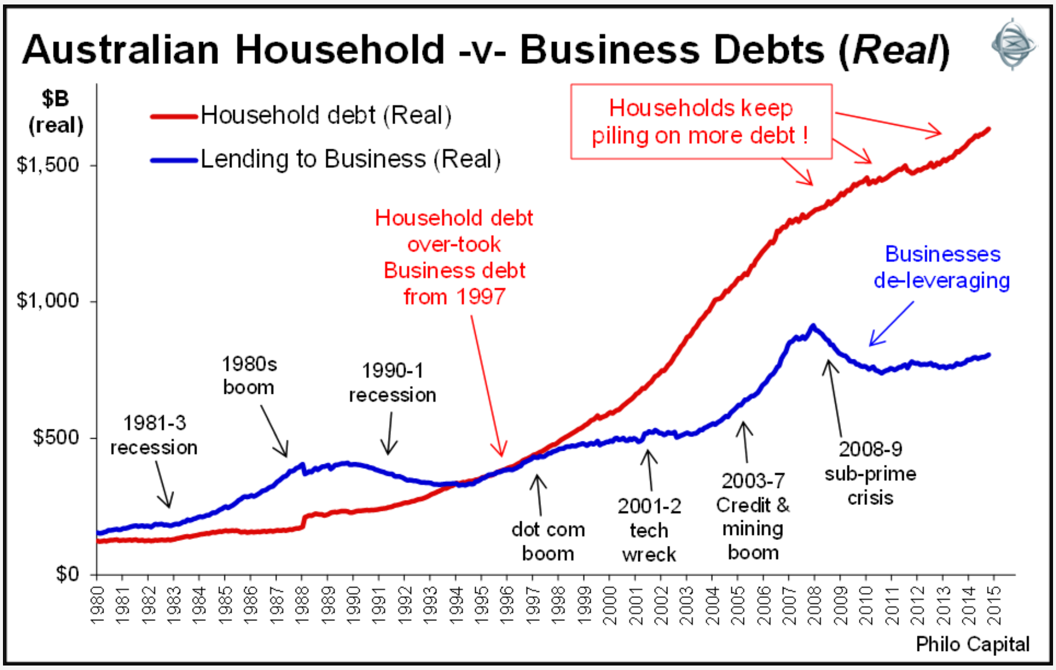
Only one 25 basis point rate cut is fully priced in by the futures markets before year-end, down from 45 basis points (i.e. getting close to two full rate cuts) at the start of the month.

Economic Data	12 months ago	6 months ago	3 months ago	1 month ago	Now
Official Cash Rate	2.25	2.00	2.00	2.00	2.00
90 day Bank Bill	2.23	2.19	2.37	2.29	2.30
180 day Bank Bill	2.27	2.26	2.48	2.39	2.46
1 year swap	2.01	2.03	2.23	2.06	2.20
3 year swap	2.08	2.11	2.26	1.97	2.19
5 year swap	2.38	2.46	2.60	2.22	2.43
10 year swap	2.80	2.98	3.03	2.52	2.71
AUD/USD	0.7800	0.7027	0.7249	0.7217	0.7506
S&P/ASX200 Index	5,919.9	5,113.5	5,207.6	4,880.0	5,079.0

CHART OF THE WEEK

The pace and structure of lending stifles Australia

Lending patterns can often provide valuable insights into likely future trends. Two key indicators are the pace and type of lending. The first chart shows lending to businesses (blue) and to households (red) in Australia since 1980, in real terms after CPI inflation.



Pace of lending

Rapid growth in business lending almost always indicates profligate wasteful acquisitions at the tops of booms. These booms tend to be followed by economic contractions and 'de-leveraging' when companies collapse and banks write off bad debts.

Business lending has been in recession for the past seven years since the sub-prime crisis. Despite Australia's population growing by 10% over the period, lending to business has contracted by 10% in real terms after inflation. Long periods of lending recession mean businesses have not been investing for future growth. Likely consequences of this include lower jobs growth, lower productivity growth, lower living standards and lower earnings per share growth in future if the trend continues.

Business lending has only recently shown early signs of life but there are usually long time delays between lending, business investment and resultant growth in productivity and earnings.

Structure of lending

In 1997 lending to households overtook lending to business for the first time in Australia's history, aided and abetted by bank deregulation, bank capital rules that artificially favoured housing lending (because house prices never fall, do they?!) and by the rapid growth of mortgage securitisation. The level of household debt has expanded rapidly ever since and is now more than twice the level of business lending.

Why is this important? Lending to business is usually productive as most (apart from wasteful acquisitions at the height of booms) is spent on new staff, plant & equipment, technology and R&D. On the other hand lending to households is mostly unproductive. Mortgage lending mostly just pushes up the prices of existing housing, and personal lending is mainly spent on consumption, mostly supporting foreign jobs, not local.

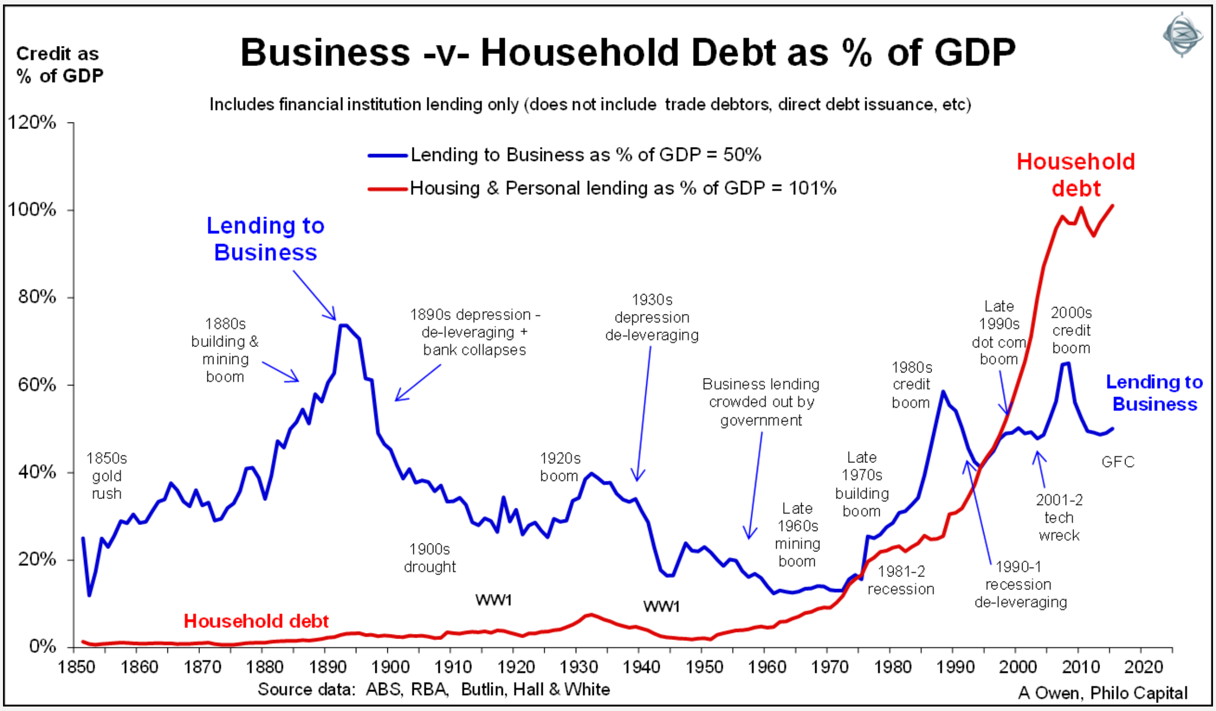
Since the financial crisis, households have piled up debt fuelled by unsustainable record low interest rates. Weak growth in jobs and productivity are incompatible with high household debt levels and high house prices propped up by unsustainably low interest rates. Something has to give – either a housing bust or a long decline in living standards.

Broadly-based housing busts are usually caused by high interest rates and high unemployment levels but these are unlikely in the near future, so a sudden housing crash is not likely. Interest rates are very low and unlikely to rise soon and foreign demand for housing remains strong. There will however be severe declines in concentrated apartment markets that are being over-built, notably in Melbourne and Brisbane.

CHART OF THE WEEK

Long term trends

The chart below shows the levels of business lending and household lending in Australia since 1850 relative to gross national income.



Business debt levels over time

Here we see the great corporate debt build-ups in the 1880s property and mining boom, in the 1980s 'entrepreneurial' boom and in the 2003 to 2008 credit and mining boom. Each of these lending binges collapsed quickly and were followed by painful de-leveraging, economic contractions, and debt write-offs by the banks.

Not all booms were financed by massive surges in debt. Notably, the late 1960s speculative mining boom and the late 1990s 'dot-com' boom were both financed largely by equity. Most of the money came from 'investors' who threw money at hundreds of speculative floats of new companies. In each case almost all of these speculative floats had nothing but hype and hope and they disappeared very quickly, taking their investors' equity capital with them.
We can see from the chart that the recent seven year period of business de-leveraging has not been inconsistent with other long periods of de-leveraging after the collapses of debt-fuelled booms. The current level of business lending is not low by historical standards.

Today banks are still writing off bad debts from financing over-priced acquisitions and unproductive projects undertaken in the recent mining boom. There is likely to be more bad debts to come, notably where LNG prices are collapsing due to global over-supply and weak demand growth, and costs are blowing out severely.

Household debt levels over time

Whereas business debt levels have remained well within the range of prior boom/bust cycles, household debt levels have exploded in recent years. After the speculative 'entrepreneurial' stock market boom collapsed in the 1987 crash, 'investors' switched their zeal to residential property, financed by cheap debt following interest rate cuts. This debt-fuelled boom soon collapsed in the deep 1990-1991 recession and Westpac and ANZ banks posted billion dollar losses and cut dividends.

The same pattern took place again over the past decade. After the 2003-2007 boom collapsed in the 2008-2009 sub-prime crisis, global credit crunch and sovereign debt crisis, the interest rate cuts starting in late 2011 have fuelled another debt-fuelled boom in residential property. This will end the same way as previous debt-fuelled booms. (There is also a serious boom underway in commercial property, but that is being financed largely by foreign equity capital, mainly from Asian funds, rather than by local bank debt).

CHART OF THE WEEK

How we compare

What level of household debt is productive or healthy for an economy? Probably it should be lower than the level of business lending, currently around 50% of GDP, which is where it is in Germany and the rest of Western Europe today.

Australia's household debt at 101% of GDP is lower than the UK (182%) but it is significantly higher than the US (80%) and Western Europe.

A more common measure of household debt is the ratio of household debt to the level of household net disposable income, because income is required to service the debt. The next chart shows this ratio in major countries over the past 20 years.

While households in most countries have de-leveraged since the financial crisis, households in some countries like Norway, Sweden and Australia are still gorging on cheap debt, encouraged by the ultra-loose monetary policies adopted by the world's central banks, including zero or negative interest rates and 'quantitative easing' (central banks buying bonds and other assets with newly printed money) to force interest rates down further.

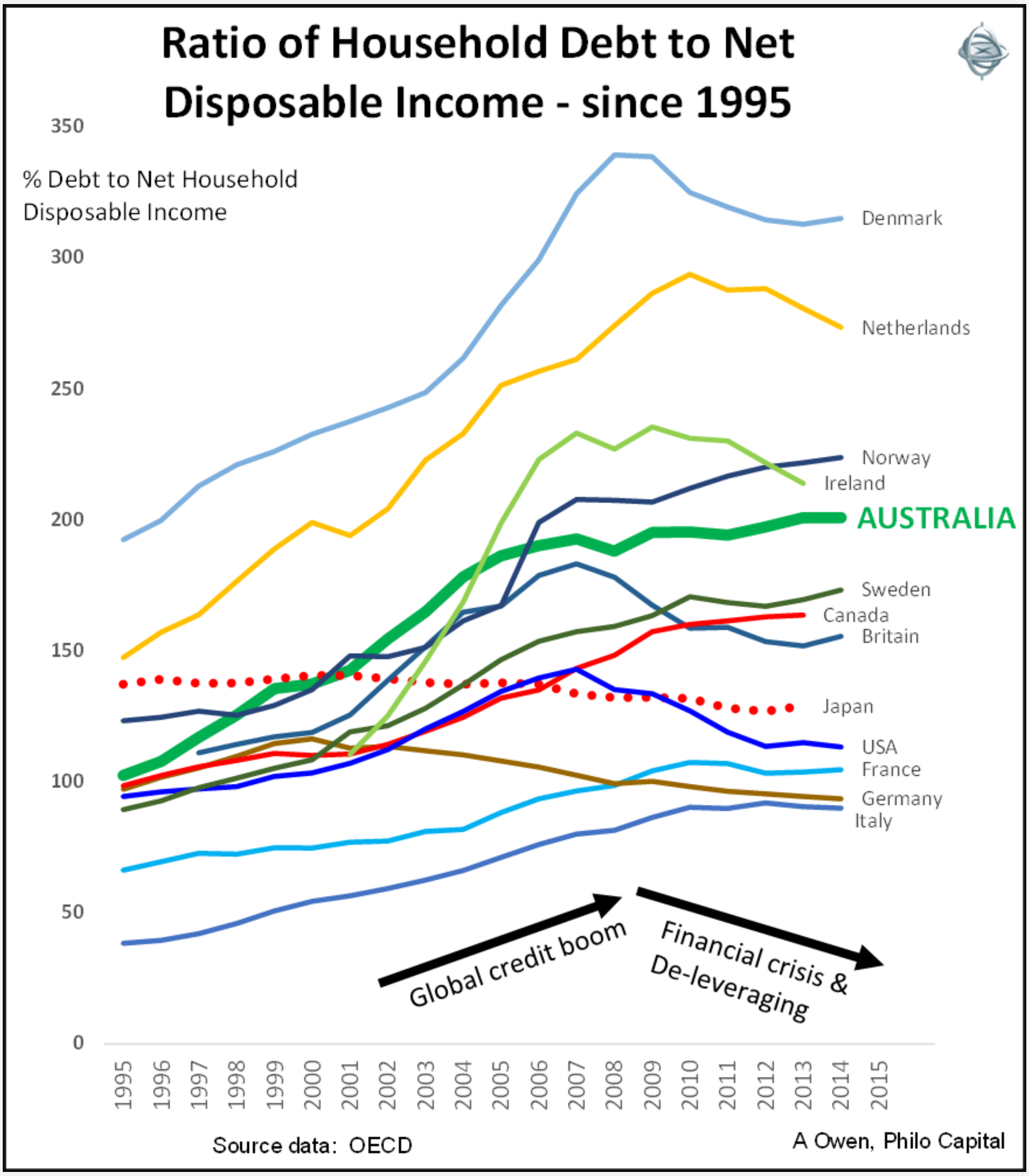


CHART OF THE WEEK

Scandinavian countries appear on the chart above Australia, but Australia's household debt burden is actually higher than theirs. How? Because our interest rates are much higher.

For example, Denmark has negative official interest rates and Danish mortgage interest rates are near zero. One bank (Nordea Credit) even offers mortgages with negative interest rates – yes they pay borrowers to take out a loan!

Household debts, current account and market volatility

Because Australia has higher inflation and higher population growth, and because our banks are a cosy oligopoly that protects their margins and fees, we are unlikely to see mortgage interest rates drop to Scandinavian levels.
When adjusted for the interest rates paid on household debt, Australia's household debt levels are the highest in the world. This, when combined with sluggish business lending and business investment, is likely to be a drag on growth in productivity and living standards in the coming years.

High household debt levels are also likely to prolong our reliance on foreign debt, to finance the mountain of mortgage debt (channelled into Australia via the banks and mortgage securitisers) and also to finance future growth. This is reflected in our persistent current account deficits. Heavy reliance on foreign debt makes us vulnerable to shocks in fickle foreign debt markets. It was this heavy reliance on foreign debt that caused the US sub-prime crisis (which had nothing to do with Australia) to rapidly and seriously infect our banking system and stock market in 2008-2009.

Australia's ongoing obsession with housing financed by a mountain of foreign debt continues this vulnerability to the impact of external shocks to our financial markets and it exaggerates our boom and bust cycles. This creates threats but also great opportunities for vigilant investors.

Source: Cuffelinks, Connecting Investors with Ideas
Article by: Ashley Owen on 12th November, 2015
Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.
This article is for general education only, not personal financial advice.

About Rural Bank and Rural Finance

Rural Bank has been a wholly-owned subsidiary of Bendigo and Adelaide Bank Limited since 2010 and is the only Australian-owned and operated dedicated agribusiness bank in the country.

From 1 July 2014, Victorian agribusiness lender, Rural Finance joined Rural Bank as a division of Bendigo and Adelaide Bank Limited. As a specialist rural lender, Rural Finance has been fostering the sustainable economic growth of rural and regional Victoria for more than 65 years.

Together, Rural Bank and Rural Finance are supporting farmers and farming communities by providing them with specialist financial tools, industry insights and investment into the future of the Australian agribusiness sector.

Rural Bank's specialist farm finance tools are available nationally via a network of banking partners, including Bendigo Bank and Community Bank® branches and Elders Rural Services. Additionally, Rural Finance has a network of offices across regional Victoria.

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We're backing farmers

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