

Australia's latest mining boom – very different to the last one

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Key points

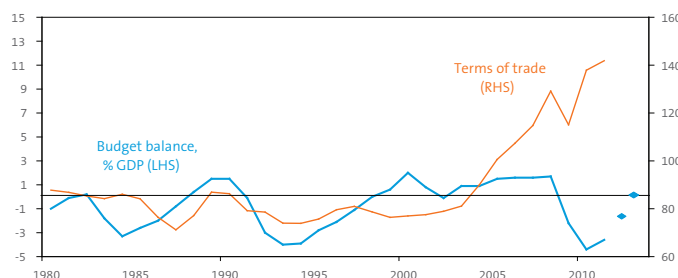
- Consumer caution, poor housing affordability, high interest rates and the high Australian dollar (A\$) are making the latest leg of the mining boom very different for the Australian economy than the first leg last decade. This is evident in the Federal Government's budget.
- This should help avoid excesses; however it makes for a tough time for sectors outside mining and could see Australian shares continue to lag global shares.

Introduction

The Federal Budget released this week is a good time to reflect on the Australian economy over the past year. Just over a year ago it seemed Australia was riding high - the economy had come through the Global Financial Crisis (GFC) in good shape, most sectors of the economy were strong or picking up, the mining boom was on the way back, and reflecting all this the Australian share market had pushed back above the 5000 level. It seemed the good times were set to roll again in Australia, much as they had through the first part of the mining boom last decade over the 2001-08 period.

One year down the track it all seems very different. While the mining boom is back with a vengeance, those in manufacturing, retailing, construction and tourism are starting to think this is the exact opposite to a boom. The weakness is mirrored in profit growth outside the mining sector. This has been reflected in the budget deficit for this year blowing out to \$49.4 billion from an estimate of \$40.8 billion a year ago. With the terms of trade at near record highs, one would think the Federal Government should be rolling in money.

Soaring terms of trade but near record budget deficit



Source: RBA, Australian Treasury, AMP Capital Investors

The malaise is also reflected in the fact that the Australian share market is still struggling below the 5000 level reached last April, whereas global shares have gone on to new recovery highs. Of course the floods have played a role, but the malaise extends well beyond flood-affected areas.

So what happened? Why is this mining boom feeling so different to the first one?

Drivers

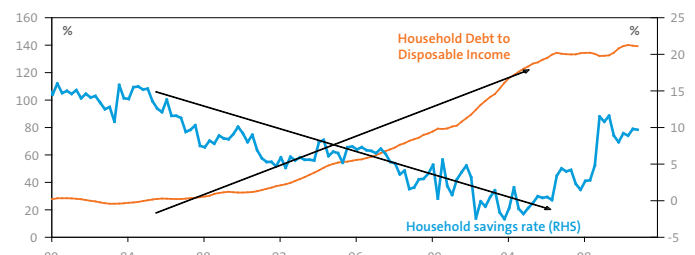
Several factors help explain the relative underperformance of Australian shares over the last year or so. These include concerns about China's outlook as authorities there battle to control inflation, Australia's relatively high and rising interest rates, the strong Australian dollar and the likelihood it has gone beyond a pinch point for many companies, and political uncertainty. The latter started with the controversial Resources Super Profits Tax, reinforced by the advent of a minority government in Australia and the more recent moves towards a carbon tax.

But at its core is an increasing realisation the latest incarnation of the mining boom (MB II) is turning out very differently to the first leg of the mining boom (MB I) that ran from 2001 to 2008.

Mining Boom I

The first leg of the mining boom saw the terms of trade, or the ratio of export prices to import prices, rise to its highest level since the early 1950s. While the two speed economy was clearly evident in mining sector strength relative to other sectors, the gap wasn't perceived to be that great, particularly with strong government revenue flows allowing the Federal Government to provide significant income tax cuts year after year at the same time it ran budget surpluses. However, the period was also associated with an ongoing fall in household savings and rise in household debt levels as households adjusted to low interest rates by 1980s standards, easy credit availability and an increasingly relaxed attitude to debt. This in turn helped fuel solid growth in consumer spending and continued strength in house prices.

Household savings and household debt



Source: RBA, ABS, AMP Capital Investors

This, along with tax cuts and solid jobs growth, helped ensure reasonable profit growth in the non-mining sector of the economy – banks benefited from solid credit demand and domestic cyclical stocks benefited from strong growth in domestic demand. The end result was a decade of outperformance by the Australian share market.

However, imbalances started to build up:

- The household debt-to-income ratio rose towards the top end of other comparable countries
- House prices became progressively overvalued, rising from around 20% overvalued in 2003 to around 29% overvalued by 2008 on our estimates
- Productivity growth slowed to a crawl as the benefit of the reforms of the 1980s and 1990s wore off and the huge boost to national income from surging export prices meant we didn't have to work as hard to keep living standards rising. Real gross domestic product (GDP) per hour worked rose 1.2% p.a. over the last decade compared to 3.6% p.a. in the 1990s

- The current account deficit (or Australia's reliance on external savings) as a percentage of GDP rose to a peak of 7% of GDP in the March quarter of 2008, its highest level since the early 1950s, and
- Inflation rose to its highest level since the early 1990s with underlying inflation rising to a peak of 4.7%.

Of course these problems were nothing compared to those seen in the US and parts of Europe. For example, Australia has not been saddled with excessive public debt. Nonetheless, they left a sense the mining boom could have been managed a lot better.

Enter Mining Boom II – very different to MB I

After a brief pause in 2008-09 the mining boom has returned with a vengeance. The terms of trade has risen to new near record highs, unemployment has fallen back below 5% with renewed talk of skilled shortages and we keep hearing about a boom. But this time around it feels very different. There are essentially four reasons why. These relate to consumers, house prices, interest rates and the Australian dollar.

Firstly, consumer attitudes have fundamentally changed.

Consumption is out and saving is in. After the GFC, consumers seem more aware that they can lose their jobs, are smarting under the impact of rising costs for necessities such as electricity, fearful of much higher interest rates and more conscious of the need to actively save for retirement, with passive saving via rising markets seemingly less reliable. All of these factors, combined with more cautious bank lending standards, have seen a renewed focus on savings and less interest in taking on debt. Consequently the savings rate has risen to around 10% and the debt-to-income ratio has stabilised around 150%. With savings rebuilt it's likely the adjustment is now largely over, but it's hard to see consumer spending growth returning to a pace above income growth as occurred up until the mid 2000s.

Secondly, house prices have arguably hit an affordability wall. The generational lows in mortgage rates seen in early 2009 combined with various first home owner "boosts" provided one last leg up in prices up until about a year ago. But the outworking has been affordability measures undergoing another collapse and first home buyers getting priced out of the market. Hence the boost to wealth from rising house prices that prevailed during MB I (except for those in western Sydney) is now a fading memory.

Thirdly, policy makers – and in particular the Reserve Bank of Australia (RBA) – seem determined to ensure we manage this boom much better than those of the past. Historically Australia has not managed booms well – they usually end with excesses and then a bust. We were fortunate last time around that thanks to a variety of things, a bust didn't come. But it looks like the RBA doesn't want to take the risk this time around. While the RBA may be overly concerned about inflation, at its simplest the RBA sees the economy staring down the barrel of a massive increase in mining investment over the next two years. Australian Bureau of Statistics investment intentions plans imply a 50% increase in mining investment this year and 90% in the next. Mining investment accounts for 4% of economic activity – so do the maths and you see it will contribute two percentage points or more to growth over the year ahead. So to stop the economy booming this means the rest of the economy needs to grow at a sub-par 2% p.a. or less. In other words consumers

will have to stay cautious, whether they want to or not, and to ensure this we have the ongoing threat of RBA rate hikes.

Finally, the A\$ dollar is starting from a much higher level. While a rise from US\$0.75 to US\$0.85 may have cut into the profitability of some businesses, a rise from US\$1.00 to US\$1.10 may see their profits turn to losses. Alarm on the back of this is being reflected in the weaker levels of business confidence now seen outside the mining sector. The strength in the A\$ has also now reached a level that has seen Australians holiday overseas en masse and shop overseas en masse (whether on holiday or online).

The outworking of all of this is while the mining sector is booming, ensuring the economy will grow solidly over the next couple of years (probably at a rate of around 3.5 to 4%), key sectors – manufacturing, discretionary retailing, housing construction, higher education and tourism, will continue to do it tough.

The tough conditions this time around in the non-mining sectors of the economy, combined with miners now investing massively and reducing their tax liabilities in the process, also means a much tougher budgetary environment as we have seen in this week's Federal Budget.

Implications for investors

This has several implications for investors. First, in an environment of overvalued house prices, more cautious attitudes towards debt, and a central bank determined to avoid any overheating, house prices are likely to struggle. This is a good thing because it increases the odds that the overvaluation of Australian house prices relative to incomes will deflate gradually rather than with a US style bust.

Secondly, constrained house prices and consumer caution are likely to ensure credit growth remains subdued compared to the pre-GFC norm. This is likely to be a constraint on the relative performance of banks.

Thirdly, high interest rates combined with a continuation of the global recovery and high commodity prices are likely to ensure the A\$ remains reasonably strong. My forecast for this year has been US\$1.10 for some time and even though we have now reached that I will stick with it. But the risks lie on the upside for the years ahead.

Finally, this all implies a somewhat difficult environment for Australian shares compared to that seen last decade. The positives for Australian shares for Australian-based investors compared to global shares are high dividend yields, franking credits and a solid medium-term growth potential on the back of high population growth and exposure to strong growth in Asia. The negatives are relatively high interest rates, the strong A\$ (which makes Australian shares expensive for foreign investors to buy), the risk monetary tightening may trigger a collapse in house prices, subdued productivity growth, and with the advent of a minority government a less favourable political environment than in the past. The absence of productivity enhancing reform in Australia arguably adds to these potential negatives. On balance I still lean towards Australian shares outperforming global shares on a medium-term basis, but am less confident in this view.

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