



Commodities boost for Australia

Its years of strong fiscal management and robust response to the financial crisis stand it in good stead for a strong economic outlook

by Celine Tan

Australia has entered the limelight for a unique feat — out of the 30 countries in the Organisation for Economic Co-operation and Development (OECD), it is the only one to post growth in the current crisis. A heavy reliance on the most basic of exports such as coal and iron ore, a poor household savings record (among the worst among the world's richest countries) and less-than-aggressive banks are often thought of as economic weak points. But Australia has turned vices into virtues, and successfully weathered the worst effects of the global economic storm to emerge with an economic outlook that is brighter than that of most other advanced economies. In tandem, Australia's share market has powered back to its highest level in 18 months, pushing the S&P/ASX200 Index through the 5,000 level in mid-April.

But will the economy continue to stay resilient?

Economic prospects

The outlook for the Australian economy remains positive. "Unlike much of the developed world, the Australian financial system did not get caught up in the excesses of some of its global peers and is therefore in robust health," says Martin Conlon, head of Australian equities, Schroders Investment Management. A lack of competition and high profitability kept Australian banks off the risky path that destabilised their foreign counterparts.

The Australian government has also been responding to the global financial

crisis in a robust and timely manner due to its years of strong fiscal management. "With the budget situation still in a healthy state, this flexibility remains," says Conlon. The country's current account averages at 4.5% of gross domestic product (GDP), with a net investment income deficit, based on a policy brief by the OECD.

Trade relations and the continuation of pump-priming implementation activities by global governments will lift the Australian economy through its natural-resources sector. "Huge fiscal stimulus packages announced by the US and China, which have explicitly stated a focus on expanding infrastructure spending, are expected to support demand for raw materials such as iron ore and coal, of which, Australia is a key exporter," says David Ng, chief investment officer of

HwangDBS Investment Management Bhd. In addition to the availability of resources such as iron ore and copper, says Campbell Tupling, CEO of CIMB-Principal Asset Management Bhd, Australia has mining corporations that know how to process and get them to where they are needed.

The Australian cash rate has been raised six times since last October, standing at 4.50% now. "In the near term, Australia has also been given a boost as its terms of trade [export prices compared with import prices] are rising sharply, reflecting higher prices of Australia's commodity exports and weak growth in the prices of manufactured imports," says Conlon. "With the prices of the things Australia sells rising relative to what it buys, it will provide a large income boost that will underpin the economy."

Though the mining industry currently contributes 7% to Australia's GDP, the industry represents 40% of its exports, says Shane Oliver, head of investment strategy and chief economist at AMP Capital. What happens if the prices of iron ore, coal, copper and gold begin to slip? Ng of HwangDBS says, "Should commodities remain low for an extended period of time, the Australian economy would be impacted to a certain degree. On our part, we believe that the possibility of demand for commodities remaining low for an extended period is relatively low. But, it is important to note that the Australian economy is not purely dependent on commodities alone."

Tupling concurs that Australia is not overdependent on natural resources but a broad-based economy. "Besides mining and manufacturing sectors, we foresee the banking, consumer and telecommunication sectors

to eventually pick up and lead to expansion of economic activity, as the economy strengthens through the natural resources boom."

Australia's geographical distance from areas like the US and Europe used to be considered a bane, but in a twist of fortunes, its proximity to Asia means it is now closer to the centre of economic activity and stands to benefit from the growing needs of emerging Asia. "The economy is also greatly supported by its trade in terms of manufacturing goods, services such as education and

growth for some time to come," says Conlon. Australia's current population stands at just over 22 million. The latest figures from the Australian Bureau of Statistics show a growth of 2.1% a year, and nearly half a million people were added to the population in the last one year. Two-thirds of that growth was attributed to immigration.

With the combined factors, the Australian economy, whose GDP grew 2.7% last year, will continue to flourish. In its latest *World Economic Outlook 2010*, the International



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tourism, and high-quality food and wine. For instance, it is estimated that by 2025, about one million Chinese tourists are expected to visit Australia annually," says Ng. "Australia will continue to move along with Asia in the next five to 10 years," says Tupling.

Population growth can keep the Australian economy growing. In his speech titled "Mining booms and the Australian economy" to The Sydney Institute in February, Ric Battellino, deputy governor of the Reserve Bank of Australia, says each [mining] boom had high, or increasing, population growth in its early years, which added to the economic momentum. "Very strong population growth, driven by very high levels of immigration, will support potential

Monetary Fund (IMF) expects Australia to grow by 3% this year and 3.5% next year, a growth outlook that is stronger than that of other advanced economies, which are expected to grow collectively by 2.3% this year and 2.4% in 2011. The IMF report also noted that in the context of an uneven global recovery, Australia and the newly industrialised Asian economies are off to a strong start and will likely stay in the lead. For Oliver, the Australian economic growth is set to return to 4% this year and the next.

Market outlook and strategy

However, as many factors as Australia has on its side, don't expect a high growth scene. Australia, as a stable developed economy, tends to provide

PHOTOS: CONLON (SCHRODERS); TUPLING (SUHAIMI YUSUF/THE EDGE); NG (HWANGDBS INVESTMENT); OLIVER (AMP CAPITAL)

slower and steadier growth than Asia as a whole. "The massive amount of superannuation money in the market leads to long-term money in the Australian market, which is less susceptible to big swings, as compared to other smaller economies that have more speculative monies," says Tupling.

The Australian stock market index rose by 30.84% last year. "Arguably, the Australian stock market rallied last year, as it was undervalued and trading at eight times price-to-earnings ratio [PER]," says Oliver. "While shares are no longer dirt cheap, they are not expensive either. Australian shares are trading on a forward PER of 14 times, which is just below the average 14.5 times over the last decade. We expect to see a capital growth of 15% this year in the Australia stock market, in line with our expectation of 20% to 25% growth in earnings supported by low cost bases and with the rebound in revenue under way now. Nevertheless, Australia will lag the Asia market as a whole," he adds. Conlon concurs that earnings growth should be well supported over the next 12 months, given the rising terms of trade.

With the rebound well placed, investors in the Australian market will need to be more selective. "There remains risk in the short term. The focus is to identify companies with competent management and resilient business models that can take advantage of secular trends to generate significantly higher earnings and cash flows in the future, irrespective of whether markets are higher or lower. "Look to buy at pull-backs rather than turning immediately into the market now," says Oliver, who is looking at media stocks (due to the expectation that "advertising" is making a comeback), resources stocks (that are trading at

eight times PER, which is cheap and have the potential for an upturn) and banking stocks (that will benefit from the recovery). He also expects the Australian dollar to remain stronger than other Asian currencies because it is free floating. "Investors who allow for the currency appreciation coupled with a combination of higher interest rate, can expect strong return."

Nevertheless, the research team at Morgan Stanley Australia in a March report says the dollar could come under pressure at some stage in 2H2010. "This could come through macro data disappointment or the start of the US Federal rate hike cycle or withdrawal of stimulus. Our fixed-income team believes that the US dollar has hit its low against the yen, and expects the dollar-yen

THE PROPOSED MINING TAX

WITH major policies that may fundamentally change the rules of the game for key business sectors either yet to be unveiled or facing a deadlock in parliament, a growing number of companies are complaining about policy risk, says a Reuters report. In early May, the Australian federal government proposed a "super profit tax" of 40% on mining companies. The proposal still has to pass parliament and the tax will be imposed from July 2012 if it takes effect.

Following the announcement, mining stocks, which make up 31% of the Australian share market capitalisation, fell sharply. "The implementation of the mining tax will certainly bring a negative

effect on these Australian mining companies since it will be lowering the long-run profits of these companies. But, the tax can be set off against the tax rebate on mining exploration costs that were earlier set at 30%," says Shane Oliver, head of investment strategy and chief economist at AMP Capital. The new tax plan certainly raises concern around key government policies, he adds.

David Ng, chief investment officer of HwangDBS Investment Management Bhd, says the headlines would of course centre on the punitive taxes imposed on mining companies, but excluding resources, the whole idea of the tax is to provide "a fair return to the nation". There will be corresponding and progressive reductions in corporate tax rates and an increase in the superannuation levy, and the creation of a sovereign infrastructure fund to channel investment through state

governments to help them fund ports, roads and rail links, thus easing bottlenecks in the mining export industry. In terms of the impact on Australian exports, this will not affect the current situation as the tax will only take effect in July 2012."

However, while higher commodity prices led to a strong pick-up in mining investment, the proposed tax will curtail new investments in the sector. "Companies will need to factor in the Resources Super Tax Profits (RSTP) in their evaluation of profitability. However, if prices were to remain sustainable, and given the vast amount of mineral resources and the geopolitical stability of Australia, mining companies may just have to accept that Australia still remains one of the best alternatives."

"At the margin, however, and given the scale of the mining industry to Australia,

there will be implications on job creation and consumer spending, where there will be less creation of jobs in the sector and related sectors," says Ng. "However, this should not be viewed in isolation as the 'income' raised from the RSTP, if channelled properly, would lead to job creation in other sectors. For instance, it will be positive for the wealth management and construction sectors. Also, the gradual reduction of corporate taxes would also increase the competitiveness of doing business in Australia."

Ng says there will be no near-term impact on exports as the existing producers will continue producing and exporting so long as prices are good and demand is strong, but the Australian market as a whole is unlikely to outperform given the negative headlines, and the heavy capitalisation of the large mining companies. ■

PROJECTED FIVE- TO 10-YEAR EQUITY RETURNS, % PA

	DIVIDEND YIELD	+ GROWTH	= RETURN
US	1.8	5.0	6.8
UK	3.3	4.0	7.3
Europe	3.3	3.8	7.1
Japan	1.6	2.8	4.4
Asia, ex Japan	1.9	8.0	9.9
Australia	3.7	5.7	9.4
World	2.7	4.7	7.4

Source: Bloomberg, AMP Capital Investors

cross to rally over the next year. Strengthening of the US dollar almost invariably leads to Australian dollar weakness."

Conlon remains positive on a broad range of industrial sectors in the market. "Across industrials, we believe there are attractive opportunities in the healthcare sector, which continues to benefit from strong underlying demand growth and a relatively consolidated number of players in most segments." He also favours a range of strongly positioned global businesses such as News Corp

(media conglomerate), Amcor (multinational packaging company) and Brambles (support services business). "A number of these Australian listed global businesses should be well positioned to benefit from global recovery over the course of the next year or two. Domestically, we prefer very strong franchises such as Woolworths (supermarket chain), and insurers such as Suncorp and IAG. The latter two are expected to benefit from reasonable rate increases after unusually unfavourable claims experience in the past year," he adds.

AUSTRALIAN STOCK EXCHANGE AND THE AUSTRALIAN CASH RATE TARGET



Source: RBA & Thompson Reuters

Local funds that have exposure to Australia are CIMB-Principal Australian Equity Fund, HwangDBS AUD Income Fund, PB China Australia Equity Fund and Public Australia Equity Fund.

Key risks

The importance of the Australian resources sector to the country's overall economy is undeniable; as a relatively small nation (by population) with large mineral wealth, buoyant commodity prices provide a significant impact on the

economy. "With the very high level of investment in the resource sector, the Australian economy is subject to more swings in commodity prices and makes the implementation of policy more difficult," says Conlon (see story above for the effects from the proposed mining tax). "The potential of a two-tier economy also makes monetary policy more difficult to implement effectively, raising the risk of policy mistakes."

The sentiment on the outlook for China continues to be a strong influence on the Australian equity market. "On the question of whether commodity prices will remain as buoyant as they are presently, this is largely dependent on the ongoing supply-demand situation, and in particular, the strength of China as a key customer," says Conlon. Thus, the Australian market is susceptible to unprecedented policy tightening by China and other emerging economies like India and Indonesia.

HISBC Ltd economists Frederic Neumann and Song Yi Kim noted in

the *Asian Economics Second Quarter 2010* report that they remain more pessimistic than most [other industry players] on the growth outlook for Australia, expecting growth to slow next year rather than accelerate further. But an even bigger risk lurks beneath the surface: a housing bubble renders the economy increasingly sensitive to rate hikes, complicating the job of the Reserve Bank of Australia, which needs to weigh the risks of inflation against a hard landing in the real estate market they said.

Oliver thinks that there is still a likelihood of an Australian property bubble occurring because house prices are very inflated right now. "Australian house prices rose 13.6% last year, and this strength appears to have continued into this year. The risk of falling house prices remains low but it can happen if there is a big surge in the supply of dwellings or a serious threat to the ability of Australians to service their loans [either through much higher unemployment or interest rates]." ■