

Australian Investment Strategy

ECONOMICS AND STRATEGY

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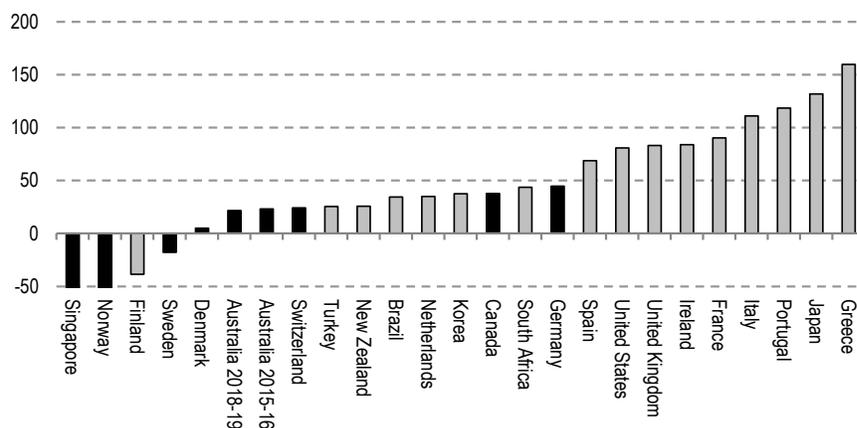
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Budget FY16: More work for the RBA

- Low growth:** The FY16 budget represents a modest drag on economic growth. The underlying budget deficit is expected to shrink to 2.1% of GDP over the next year from 2.6%. While the government recognises the steepness of the mining capex cliff, it is optimistic on consumption. Yet there is very little in this budget to support the consumer. There is also little in the way of initiatives to boost non-mining investment.
- RBA rate cuts:** The government has not taken the opportunity to ease fiscal policy, even though it is not funding constrained. Ongoing austerity in a slowing loan growth environment is supportive of the Aussie dollar via the channel of relative scarcity. With fiscal policy and the exchange rate failing to adjust to economic conditions, we believe the RBA must do more of the adjustment.
- Multiple expansion:** While we believe the budget fails to provide support to the profits growth outlook, it does support Australia's status as sound destination for international capital. Australia is one of nine countries with a AAA credit rating by the three main rating agencies. The budget reiterates our view that the outlook for Aussie equities is one of multiple expansion, and a destination for global income seeking capital, in a slow growth environment.

Figure 1: Australia has one of the best fiscal positions in the world
Net debt to GDP (2015). Countries with AAA rating from 3 main credit rating agencies in black.



Source: IMF, Commonwealth of Australia, S&P, Moody's, Fitch

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More work for the RBA

In this report we provide our first thoughts the 2015-16 budget and what it means for Aussie asset markets. The government's plan to move back to a balanced fiscal position will be a drag on growth for some time to come. We expect the budget to be positive for the Aussie dollar and it reinforces our expectation of further rate cuts from the RBA. It also underlines our outlook for Aussie equities being one of multiple expansion, and a destination for global income seeking capital, in a slow growth environment.

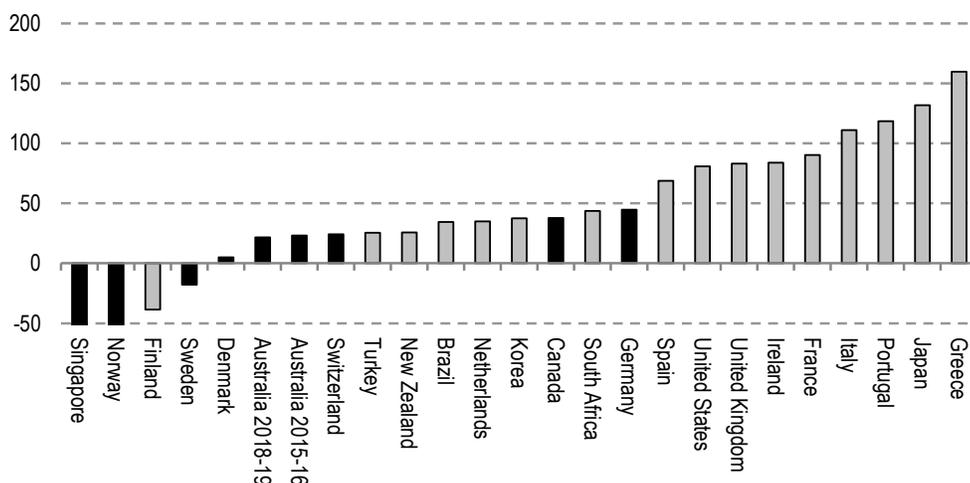
Economic outlook

The government intends to shrink the underlying budget deficit in FY16 to 2.1% of GDP from 2.6%. This is notionally a drag on growth of roughly 0.5%. Fiscal policy will not support economic activity over the next year. Indeed, fiscal policy will probably not support growth for some time, considering that the government intends to return the budget to surplus over the next five years. The Treasury is forecasting real GDP growth of 2.75% in FY16. It believes that the unemployment rate will peak out at around 6.5%. These forecasts are broadly in line with the RBA's forecasts. But it is interesting to note that the Treasury is forecasting further weakness in commodity prices and the terms of trade, while the RBA is projecting a flat profile from here.

The Treasury is expecting mining investment to contract by 60% from the peak in 2013 to June 2017. This should mean mining investment to GDP gets back down to 3% which should be in line with sustainable levels. The Treasury believes the combination of solid consumption growth and an improving trade balance will offset contracting mining investment. The Treasury does not expect to see material contributions to growth from residential investment, nor non-mining business investment. We see downside risk to the Treasury's growth outlook, considering that so much of it hangs on the consumer — yet very little is delivered in this budget to support the consumer, in our view (see below).

The Australian government has no funding issues. For the traditionalists, the government has one of the lowest debt-to-GDP ratios in the world, with very low funding costs. For the non-traditionalists, the monetary system is explicitly designed to remove revenue constraints for the government. Yet notwithstanding these considerations, and the clear opportunity to ease fiscal policy to support growth, the government has once again chosen austerity, albeit in a less explicit, and perhaps more saleable form.

Figure 2: Australia has one of the best fiscal positions in the world
Net debt to GDP (2015). Bars in black our countries with AAA rating from three main credit rating agencies



Source: IMF, Commonwealth of Australia, S&P, Moody's, Fitch

The government's commitment to move the fiscal balance back into surplus notionally supports its credit rating. It also props up the Australian currency to the extent that austerity contributes to the [marginal scarcity of AUDs in a slowing credit growth environment](#). In our view, the combination of an austere budget and an elevated currency means that the RBA's easing cycle is not over yet.

While the budget fails to provide support to the growth outlook, it does support Australia's status as sound destination for international capital. Australia is one of nine countries where the government has a AAA credit rating by the three main rating agencies. The others we highlight in black in Figure 2 (Luxemburg is not included). The current budget reiterates our view that the outlook for Aussie equities is one of multiple expansion, and a destination for global income seeking capital, in a slow growth environment.

Consumption

It is notable that all of the initiatives delivered in this budget are in the millions per annum — not billions. They are marginal in size as a percentage of GDP. In this context, we believe that the budget does very little for the consumer. One of the key selling points is the \$3.5 billion families package. But this figure is spread out over five years, and is heavily back-loaded. In the details, the package is more redistributive than stimulatory. For example, households earning more than \$65K will not be eligible for child care subsidies. Also, changes to families assistance are contingent upon the Senate passing last year's cuts to the Family Tax Benefits.

There have also been changes made to the pension system from 2017 and beyond. Fortnightly pension payments will be reduced by \$3 for every \$1000 of assets over a certain threshold. Also, indexation of pension payments has been eroded. These initiatives represent a longer-term drag on household discretionary income, which could be capitalised today.

Investment

There is no material boost to public sector investment. This is a real hindrance to re-balancing efforts, and increases the downside risk to economic growth. To be sure, the government has announced a Northern infrastructure plan and tax cuts for small business (companies with annual turnover below \$2 million). But these measures are fairly small in size, and are unlikely to materially boost investment.

Disclosure Appendix

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