Australian Corporates Vulnerable To A Thrifty Consumer

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Key Takeaways

− We believe that a rise in the household savings rate poses the greatest near-term risk to Australian corporates.
− Households are under pressure from stagnant wage growth, rising costs of living, and falling wealth.
− Domestic factors weigh on the outlook for Australian corporates. This is in contrast to past slowdowns that have been associated with global cycles, often via the resource sector.

Australian consumer sentiment is listless. But for Australian corporates it has hardly mattered. A migration boom and consumers' penchant to live beyond their means have underwritten corporate profitability. However, deteriorating household conditions are beginning to drag down consumer demand. S&P Global Ratings believes Australian companies exposed to greater discretionary expenditure and competition are at greatest risk. Still, companies have financial levers to manage their credit quality, including reducing dividends.

Australian corporates managed to avoid the worst of the mining downturn in 2012 despite households having to contend with stagnant wage growth and cost of living pressures. That's because consumption remained propped up by population growth and households' willingness to draw down savings to support living standards.

These countervailing forces appear to have reached their natural limits. A residential property correction threatens to unravel the wealth effect that has kept consumers spending and cash flowing into adjacent parts of the economy. In addition, opinion polls suggest that stretched infrastructure and public services are testing community support for high immigration.

Outlook For Australian Corporates Has Darkened

Australian corporates are vulnerable to a confluence of domestic risks. This is in contrast to past slowdowns that have been associated with global cycles, often via the resource sector. In particular, deteriorating household conditions foreshadow tougher times for industries that rely on consumer demand.

As household conditions worsen, it's likely that consumption will pull back and savings rates increase. Household saving rates are near their lowest point in a decade (see chart 1). Over the past five years, household consumption growth has averaged 2.5%, whereas household disposable income growth has averaged only 1.9%.

We believe that a rise in the household savings rate poses the greatest near-term risk to Australian corporates. A re-run of the 2009 fallout from the global financial crisis is the worst-case scenario. However, such a rapid run-up in savings would likely require an employment shock, which we do not anticipate.
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Chart 1
Household Savings Rate Near Decade Lows
Household savings ratio*

*Per cent of household disposable income net of depreciation. §Superannuation/pension and workers' compensation contribution.

Chart 2
Australian Corporates' Exposure To Consumer Downturn By Sector


spglobal.com/ratingsdirect
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Our base-case operating scenario is more chronic than acute. We forecast that consumer-facing companies will muddle through an extended period of subdued demand. In particular, companies exposed to greater competition and discretionary expenditure are at greater risk. This includes retailers and their landlords, media and telecommunications, consumer product companies, and airlines (see chart 2).

We expect any reduction in headline expenditure to remain manageable, but consumers are likely to demand greater value for money. This means elevated price competition for "everyday" supermarket items, lower rents at second-tier shopping centers, higher data allowances on mobile plans, substitution of branded or luxury goods, and downward pressure on airfares.

Australian corporates have been here before. The country successfully traversed the global financial crisis with an unprecedented policy response and deepening links with China. Much of the stimulus, both Australian and Chinese, made its way to Australian households and the businesses that serve them. Good policy and good luck saved the day.

Chart 3

**Chinese Stimulus Created Demand For Australian Commodities**

Chinese *free liquidity* vs. Australian commodity prices

*Free liquidity comprises M1 money supply growth minus industrial production growth minus producer price inflation.


We do not see any white knight on the horizon this time around. The current rebound in commodity prices hasn’t made its way to households to the same extent as past episodes. We therefore expect pressures facing households to build.

In our opinion, fiscal policy has the greatest capacity to support households. Monetary policy support is restricted to 1.5%, even if we assume that rate cuts are fully passed on to borrowers. Similarly, a wide variety of opinion polls suggest that community support for population levers has waned. The timing and effectiveness of fiscal policy will, therefore, be of critical importance. Consumer spending accounts for almost 60% of GDP.

We expect companies to adhere to their publically articulated financial policies during periods of financial stress. This may require placing creditor interests over those of shareholders. Ratings stability, therefore, implies lower dividend payments should weaker consumer expenditure weigh on earnings. The problem of weak domestic demand could be exacerbated if corporates collectively respond with large-scale redundancies.
Previous Commodity Boom Made Its Way To Households

The industrialization and urbanization of China generated unprecedented demand for Australia’s key steelmaking ingredients: iron ore and coking coal. As a result, Australia’s terms of trade boomed for the longest period since the mid-nineteenth century gold rush (see chart 4).

Chart 4

The Biggest Terms Of Trade Boom Since The 1850s Gold Rush

Australia’s terms of trade


The transition to resource-led growth prompted a structural adjustment of historic proportions. How this affected Australia’s resource and resource-related sectors is well understood. What has received less attention is how high commodity prices made their way from the mining-focused economy in the west coast to the east coast, and from miners to households (see Appendix A).

Times were good. Accelerating domestic income set off a virtuous spiral that pushed per capita living standards well above those in the U.S. Resource income provided government with the capacity to provide households with successive tax cuts and new transfer payments. The investment boom also created labor and skills shortages that sustained a period of wage growth, even on the east coast. Soaring share prices also spread income to the broader economy.

Households Disproportionately Shouldered The Burden Of Adjustment

Australia’s terms of trade peaked in 2012. As it unwound, so too did many of the benefits accruing to households. The same transmission mechanisms that created a virtuous upward spiral also worked in reverse.

With limited help from a depreciating currency, the Australian economy had to restore its competitiveness from within (see Appendix B). In retrospect, it was Australia’s wage earners who shouldered a disproportionate share of the structural adjustment. This is reflected in the diverging share of income between wages and profit (see chart 5), as well as dampening consumer confidence, which decoupled from positive business sentiment through much of the mining downturn (see chart 6). More recently, business confidence has also taken a turn for the worse.
Recent Commodity Rebound Did Little For Households

Commodity prices rebounded in 2016. Yet, income did not flow through to households to the same extent as past episodes. Although government tax receipts have improved, fiscal repair took priority over expenditure measures directed at households. The government's fiscal response to the global financial crisis was to "go hard, go early, and go to households". However, it is these same households that are increasingly relied upon to fund fiscal repair (see chart 7).

Chart 7
Household's Effective Income Tax Rate Is Rising

Australian household effective income tax rate


Iron ore prices have benefited from Chinese easing as well as supply constraints following tailing dam failures in Brazil. Coal prices have been robust, too. That said, higher commodity prices have done little to elicit new supply—noting that it is the construction phase that stimulates the
greatest demand for labor. Rather, there are recent examples of major mining houses downsizing their workforce despite higher margins. We expect prices for Australia’s key commodity exports to steadily decline over coming years (see chart 8).

Chart 8

We Do Not Expect Iron Ore Prices To Be Sustained

Benchmark iron ore prices

Liquefied natural gas (LNG) volumes have also ramped up over the past few years. Nonetheless, supply imbalances are likely to weigh on revenue growth (see chart 9). And high depreciation rates and past write-downs mean there is little near-term taxable income for the federal government to reallocate to other parts of the economy.

In addition, existing price mechanisms have buoyed gas and energy prices on the east coast, adding to households’ cost of living (see chart 10). Higher energy prices and an otherwise stronger currency have also affected the competitiveness of east coast businesses more generally.

Chart 9

LNG Market Imbalances Are Likely To Persist

S&P Global Platts global LNG demand outlook

Chart 10

East Coast Gas Prices Are Hurting Households

Domestic wholesale gas prices
Population Growth Has Propped Up Consumer Demand

Immigration policy has been instrumental in propping up consumer demand. Net overseas migration has materially outpaced its long-term average, adding 1.0% to total population growth of 1.7%. This is extremely high by global standards. Most migrants arrive in either Sydney or Melbourne (see chart 11). The government recently announced a cut in its permanent migration cap. However, the cap remains above current levels and a sizable growth in temporary visas is likely to maintain migration at elevated levels. It does, however, suggest that the government has become more sensitive to community concerns.

Chart 11
Migrants Prefer Sydney And Melbourne

Net overseas migration

Headline employment figures have been strong, particularly in New South Wales (NSW) and Victoria. Unemployment is currently at an eight-year low. But the combination of rapid population growth, sectoral shifts, automation, and changing forms of labor market attachment (i.e., casualization) have given rise to a persistent amount of labor market slack (see chart 12), putting downward pressure on wages (see chart 13). The underemployment rate remains stubbornly high and Australia had endured one of the highest output gaps among OECD members, albeit improving somewhat of late. The topic du jour is whether recent employment growth and the uptick in wage growth might be a harbinger of a broader economic recovery.
Australian corporates have been the clear beneficiaries of population growth via higher consumer demand, filling skills shortages, and keeping a lid on wages. Households, however, have had to contend with the increasing demands placed on public services, infrastructure, and housing, as well as a diluted share of the country’s natural resource endowment.

Sluggish productivity has resulted in GDP per capita growth that has become increasingly flat. This, however, likely understates the impact on living standards which, despite the most recent rebound in the terms of trade, has barely improved since the terms of trade peaked seven years ago (see chart 14). It is probably no coincidence that Australian politics has experienced a period of instability; there have been five Prime Ministers during this period, and a further election is likely on or before May 18, 2019.

Chart 14

**Population Growth Has C Living Standards**

Real net national disposable income

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Residential Property Correction Likely To Weigh On Consumer Demand

Population growth in Australia's major capital cities combined with lower interest rates, supply constraints, loose lending standards, and offshore demand to unleash a residential property boom. Sydney and Melbourne house prices peaked in 2017, and Brisbane and Adelaide are now falling too.

Chart 15

The House Price Correction Has Been Orderly, So Far

Residential property prices

![House Price Correction Graph](chart15)


Housing activity spilled over to adjacent sectors of the economy via a high multiplier (see chart 16) as well as a "wealth effect" that has kept consumers spending (chart 17). Both appear to have reached their limits and are turning negative.

Chart 16

Housing Turnover Multiplies Throughout The Economy

Housing contribution to GDP

![Housing Turnover Graph](chart16)

Housing contribution includes dwelling investment, ownership transaction costs, and, furnishings and household equipment.


Chart 17

Household Net Wealth Drives The "Wealth Effect"

Gross disposable income

![Household Net Wealth Graph](chart17)


Note: Housing contribution includes dwelling investment, ownership transaction costs, and, furnishings and household equipment.

Household balance sheets became increasingly stretched as buyers chased rising house prices and households borrowed to support living standards. Offshore demand for Australian bank assets coupled with loose lending practices created the conditions where credit flowed freely to households. Australian households are now among the world’s most indebted (see chart 18), although low interest rates have kept servicing manageable.

Chart 18

Australia’s Household Debt Is High By International Standards

Household debt to GDP

The fallout of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has added to existing macroprudential measures to tighten lending standards. Banks have become more sensitive to ensuring their adherence to responsible lending standards, in addition to regulated restrictions on interest-only loans and the conversion of existing interest-only loans into principal and interest. Moreover, banks have successfully passed higher funding costs onto borrowers via out-of-cycle rate hikes, somewhat undermining Australia’s monetary policy stance.
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In addition, consumers are having to contend with rising costs of living. These have been most pronounced in the regulated sectors of the economy that traditionally were the preserve of government (see chart 20). By contrast, sectors exposed to greater competition have delivered better outcomes for consumers (see chart 21).

Chart 20
Price Rises Highest Among Regulated Sectors
Consumer price inflation

Chart 21
Competitive Sectors Delivered Price Falls
Average quarterly price change at Coles and Woolworths
The role that rising property prices played in supporting consumption expenditure in the wake of the commodity downturn appears to have run its course (see chart 22). Economic activity is increasingly driven by infrastructure projects in Sydney and Melbourne as these cities attempt to narrow infrastructure deficits built up over years of strong population growth. These two cities dominate employment growth, and there are some signs that wage growth is beginning to pick up. However, the infrastructure pipeline may not have long to run before it too begins to subtract from growth (see chart 23).

**Chart 22**

**Housing Activity Is Beginning To Slow**

Building approvals vs. dwelling investment

**Chart 23**

**Infrastructure Pipeline Likely To Peak Soon**

Infrastructure pipeline


Appendix A – How The Boom Transferred Income From Miners To Households

Part of the answer lies in the income side of the national accounts—the commodity boom was initially experienced as an income boom (chart 24) followed by an import volume boom (chart 25). Increased demand for Australian currency expanded household’s purchasing power. The export volume boom, which did much to drive headline GDP, arrived only after a mining investment boom increased productive capacity.

Commonwealth and state governments, replete with corporate tax and royalty receipts, passed much of the resource income through to households via tax cuts and transfer payments. The investment boom also created labor and skills shortages that spread throughout the economy, resulting in a sustained period of strong private and public sector wage growth. Some of Australia’s largest resource companies are headquartered in nonresource east coast capital cities and generate strong demand for professional services. Households also benefited from improved corporate profitability through share ownership, either held directly or via pension funds, which also spread income more broadly.

Accelerating domestic income set off a virtuous spiral that pushed per capita living standards well above those of the U.S. Life wasn’t so easy for the trade sector—such as manufacturing or agriculture—whose competitiveness was hampered by a strengthened Australian dollar. Those corporates that survived emerged leaner and more competitive. Others, including Australia’s car manufacturing industry, were permanently lost.
Appendix B – Australia Received Limited Assistance From A Depreciating Currency

Australia’s terms of trade peaked in 2012. As it unwound, so too did many of the benefits accruing to households. The same transmission mechanisms that created a virtuous upward spiral also worked in reverse.

However, prospects for Australia remained favorable against most major advanced economies. This meant that monetary policy settings were high versus other central banks that were pursuing zero rates and various forms of quantitative easing. Indeed, Australian policymakers showed a great deal of restraint during the global currency wars.

The positive spread against lower-yielding currency pairs supported a carry trade, limiting the extent to which Australia could boost its external competitiveness via a depreciating currency. Indeed, depreciation of the Australian dollar consistently lagged the terms of trade throughout the downturn (see chart 26).

Chart 26

The Australian Dollar Lagged Falls In Terms Of Trade

Terms of trade vs. trade-weighted index

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