ECONOMICS & MARKETS RESEARCH
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INSIDE

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ECONOMIC UPDATE: Q4 INVESTMENT LOOKING STRONGER, WITH MORE POSITIVE SIGNALS FROM THE LABOUR MARKET

- Public and private sector investment looks to have grown strongly in Q4, with all of the private-sector activity centred on plant and equipment investment, while the public sector focused on non-residential building such as schools.
- Wages and earnings data for Q4 tell a rather mixed, but largely positive story.
- Despite the apparent easing in wage inflation pressures, the strength of real activity in Q4 increases the risk of a near-term rise in the RBA's cash rate.

PUBLIC AND PRIVATE SECTOR INVESTMENT PICKED UP PACE IN Q4

This week saw two important partial indicators of investment point to stronger investment activity in Q4, from both private and public sector sources.

In the private sector, total capital expenditure (CAPEX) rose by 5.5% in the quarter (seasonally adjusted real growth), well above market expectations (2.0%) and wholly unwinding the 5.2% drop in the previous quarter. While investment in the mining sector – which typically accounts for over half of all private sector CAPEX - fell by another 1.2% QoQ (and 12.8% YoY), manufacturing CAPEX rose by a very pleasing 13.7%, to be almost level with last year's real investment (-1.5% YoY). The strong manufacturing result was probably supported by investment in downstream mineral processing, related to the mining industry. This bodes well for future improvements in capital-related productivity in manufacturing. Combined with the labour shedding over the past year, it shows the manufacturing sector is making a concerted effort to reduce its costs and boost productivity in preparation for the next cycle upswing. In industries outside both mining and manufacturing, CAPEX rose by a strong 7.9% in the quarter, to finish 4% higher than last year, again indicating that many businesses have probably gotten in early to prepare for future expansion.

Across all industries, CAPEX growth in Q4 was wholly in plant and equipment (+12.4%) rather than buildings and structures (-1.7%). The 12% growth in plant and equipment feeds directly into GDP calculations and will help to boost the final GDP number for Q4 due for release next Wednesday. Much of this spending went on new vehicles, which saw a huge boost in sales to business buyers. The effect may be temporary however, since plant and equipment investment spending was deliberately — and it seems successfully — targeted by a temporary increase in business tax allowances until 31st December.

Looking ahead to the rest of 2010, the rise in business confidence seen during H209 should translate into a pickup in business investment as the year progresses. However, at this early stage in the cycle, the high level of business confidence isn't yet feeding into sustained growth in spending by the business sector, as indicated by more forward-looking indicators such as CAPEX intentions for 2010-11 (up 15.3% on this first estimate, compared to estimate 1 for 2009-10) and non-residential building approvals.

The recent reporting season shows that businesses remain cost-focused, although top-line revenue growth now appears to be picking up and this will add to the upswing in earnings as the recovery matures. The strong pickup in employment seen last year is a further positive sign that businesses are positioning themselves for the upswing.

While the private sector has been spending up on plant and equipment, the public sector continued to increase its investment in non-residential buildings, including schools but also large-scale engineering works in Q4 (see figure 1). Indeed, public-sector investment is likely to be strong contributor to Q4 GDP growth. Non-residential construction work done in Q4 rose by 18.6%, wholly on the back of strong growth in stimulus-induced public sector building projects, despite a small fall in private sector non-residential work done (-0.4%) in the quarter.

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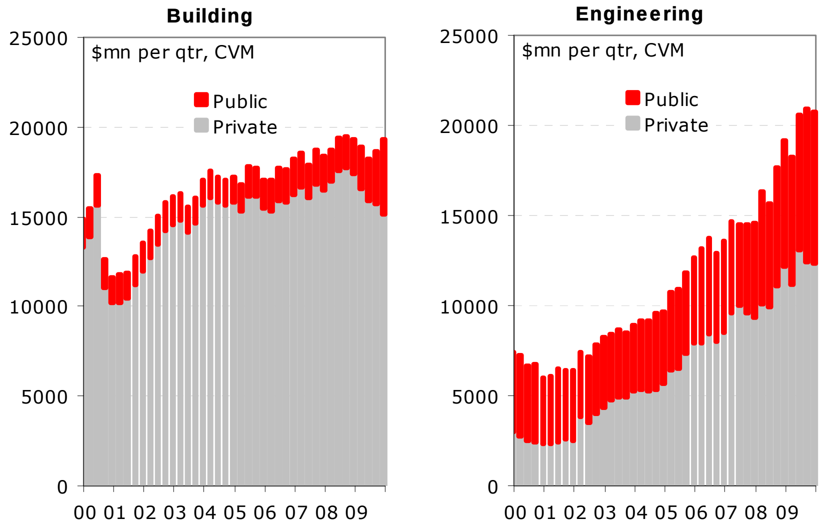
In engineering construction however, the public-sector increase was not enough to counter the continued falls in private sector engineering construction. Total engineering construction work done fell by 0.5% in the quarter as a the rise in public sector spending (+1.5%) was more than offset by a fall in the much larger private sector spending component (-1.8%).

FIGURE 1. PUBLIC SECTOR DOMINATES NON-RES CONSTRUCTION GROWTH BUT CANNOT COMPENSATE FALL IN PRIVATE INVESTMENT



Source: ABS.

MIXED SIGNALS ON WAGES AND EARNINGS WEAVE A POSITIVE STORY

The swag of wages and earnings data released this week gave, on first reading, a mixed and rather contradictory story about recent wages and earnings growth, with the wages price index (WPI) continuing to decelerate, while average weekly earnings (AWE) and average weekly ordinary time earnings (AWOTE) accelerated further ahead. The wage price index rose by 0.6% in the December quarter led by a soft 0.6% increase in private sector wage costs. Public sector wage cost growth remains strong, with a 1.0% rise in the quarter. In contrast, AWE accelerated to 1.9% QoQ (5.0% YoY) in Q4 from 1.6% QoQ (4.2% YoY) in Q3, and AWOTE accelerated to 2.0% QoQ (5.9% YoY) in Q4 from 1.1% QoQ 5.2% YoY) in Q3 (see figure 2).

This apparent contradiction in the data can be explained by several factors, not least being the difference between average *wage* levels (that is, the hourly rate of pay) and average *earnings* levels (that is, the amount actually earned by employees). While the former is simply an index of the price of labour per hour, the latter also reflects the number and composition of hours worked and skill and occupation levels.

Pleasingly for the inflation outlook, the WPI indicated that at this stage, there is little upward pressure on inflation from the strengthening labour market. By industry, private sector quarterly wage cost growth (nsa) was weak in professional services (0.2%), real estate services (0.2%), administration (0.2%), and food services (0.2%). However, it was strong in utilities (1.0%), transport (1.0%) and recreational services (0.8%).

Wage costs are a lagging indicator of labour market strength, so it's not surprising that they remain subdued at this stage of the cycle, despite the pickup in employment growth and the fall in the unemployment rate during the December quarter. Moreover, this data along with the generally strong corporate reporting season shows that corporate profit growth is rising as costs remain contained and demand continues to pickup.

One of the key reasons why underlying inflation is returning to the RBA's target band is that private sector wage pressures have eased and today's data support further disinflation in the near term. However, as the labour market continues to tighten, cost pressures will likely pickup in H2 2010 and begin to put upward pressure on inflation.

AWE and AWOTE are more volatile than the WPI (since they reflect a broader range of factors) and are telling a more complex story. Aggregate work hours stayed relatively flat

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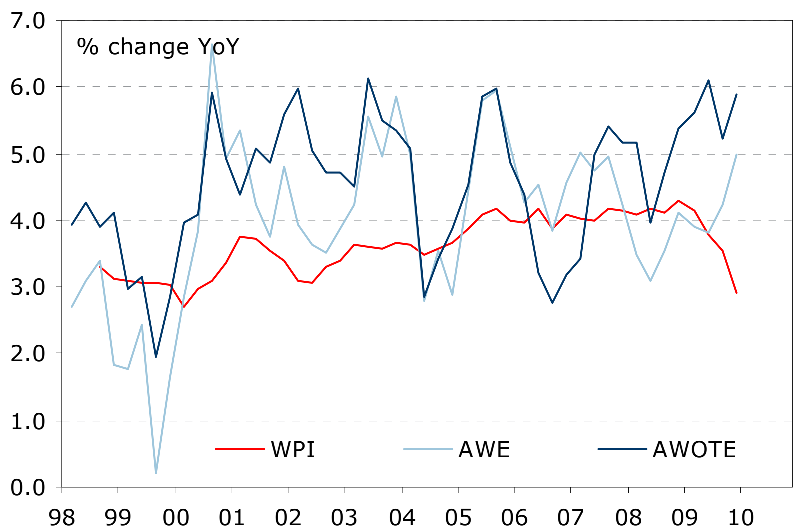
through Q3 and Q4 2009, so average earnings are unlikely to have been boosted from increased work hours alone. Indeed, aggregate work hours appear to have actually fallen in Q4, as the proportion of workers on part-time hours continued to rise. A more likely (but more difficult to quantify) explanation lies in the changes in our employment composition since the upswing in jobs growth began in Q3, with more jobs being created in high-paying sectors such as mining, finance and insurance, professional services, education and health, and continuing jobs cuts in sectors with lower average pay such as manufacturing and retail trade. For example, around 12,700 jobs were added to mining in H2 2009 (with the top industry AWOTE of $1945 in November 2009), 28,800 were added to education (with an industry AWOTE of $1195) and 8,300 added to health (with and industry AWOTE of $1295). At the same time, several sectors with much lower average pay rates shed jobs, including manufacturing (-8,100 jobs in H2 2009 and down nearly 60,000 from 2 years earlier, with an industry AWOTE of $1125 in November) and retail trade (-19,900 jobs in H2, with an industry AWOTE of $931 in November 2009).

If such structural shifts have contributed to recent AWOTE growth (as seems likely), then they may represent a more permanent increase in employee earnings than is suggested by recent growth in headcount or the WPI alone. This shift to higher-paid industries would be good news indeed for our future household (and national) earnings capacity.

Such a shift may also indicate much sharper skills shortages in the future, if most of the growth in labour demand is coming from high-skill (and high-pay) industries and occupations. Combined with the pickup in business investment in the near-term, this will place renewed pressure on resources and suggests that labour constraints could soon re-emerge and put upward pressure on inflation. Indeed, taken together, this will probably require a near-term increase in the cash rate by the RBA, possibly at the March Board Meeting. However more positively, the longer-term the pickup in investment and skills will add to the productive capacity of the economy and lower inflationary pressures.

FIGURE 2. Q4 WAGE INFLATION MODERATES, BUT AVERAGE (AND AGGREGATE) EMPLOYEE EARNINGS STILL GROWING STRONGLY



WPI = wage price index (index of hourly pay rates for all adult employees). AWE = Average weekly earnings for all adult employees. AWOTE = Average weekly ordinary time earnings of full-time adult employees.
Source: ABS.

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DATA WRAP

- **New vehicle sales** for the month of January fell 3.4% MoM (seasonally adjusted), but remained 15.6% higher than the same month a year ago.
- The **wage price index** (WPI) for all adult employees slowed to 0.6% QoQ (2.9% YoY) in Q4 from 0.7% (3.5%) QoQ in Q3 (seas. adj.).
- **Average Weekly Earnings** (AWE) for all adult employees accelerated to 1.9% QoQ (5.0% YoY) in Q4 from 1.6% QoQ (4.2% YoY) in Q3.
- **Average Weekly Ordinary Time Earnings** for full-time adult employees (AWOTE) accelerated to 2.0% QoQ (5.9% YoY) in Q4 from 1.1% QoQ (5.2% YoY) in Q3.
- **Construction work done** in Q4 increased by 2.6%, a stronger increase then the 1.6% in Q3.
- **Conference board leading index** for December rose by 0.6%, up from -0.3% in November.
- **Private capital expenditure** in Q4 increased by 5.5%, a strong increase from -5.2% in Q3 (real, seasonally adjusted data).

FORECASTS

AUSTRALIAN ECONOMIC INDICATORS		2008	2009 F	2010 F	2011 F
Economic activity (annual % change)					
Private final demand		4.1	0.3	3.4	4.6
Household consumption		2.4	1.6	2.5	3.0
Dwelling investment		2.6	-5.3	11.5	5.6
Business investment		12.4	-2.2	3.4	9.2
Public demand		6.7	2.1	7.0	4.6
Domestic final demand		4.5	0.8	4.2	4.6
Inventories (contribution to GDP)		-0.4	-0.5	0.6	-0.1
Gross National Expenditure (GNE)		4.3	0.2	4.8	4.5
Exports		3.8	1.1	2.3	5.4
Imports		11.4	-6.7	12.8	9.2
Net Exports (contribution to GDP)		-1.6	1.7	-2.2	-1.0
Gross Domestic Product (GDP)		**2.2**	**0.9**	**3.1**	**3.3**
Prices and wages (annual % change)					
Inflation:	Headline CPI	4.4	1.8	2.4	2.8
	Underlying *	4.4	3.8	3.0	2.7
Wages		4.1	3.6	2.9	3.3
Labour market #					
Employment (annual % change)		2.2	0.3	2.6	2.0
Unemployment rate (annual average %)		4.2	5.6	5.2	4.8
External sector					
Current account balance:	A$bn	-54.3	-54.3	-71.7	-68.9
	% of GDP	-4.4	-4.3	-5.5	-4.9

* Average of RBA weighted median and trimmed mean statistical measure.
# Actual labour market data for 2008 and 2009, forecasts for 2010 and 2011.

AUSTRALIAN INTEREST RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
RBA cash rate	3.75	4.00	4.25	4.50	4.75	4.75
90 day bill	4.17	4.35	4.75	4.85	5.00	5.00
3 year bond	4.85	4.70	5.00	5.05	5.30	5.55
10 year bond	5.49	5.30	5.50	5.45	5.60	5.75
3s10s yield curve	0.64	0.60	0.50	0.40	0.30	0.20
3 year swap	5.22	5.15	5.45	5.50	5.75	6.00
10 year swap	6.05	5.90	6.05	6.00	6.15	6.30

INTERNATIONAL INTEREST RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
RBNZ cash rate	2.50	2.50	2.75	3.25	3.75	3.75
NZ 90 day bill	2.73	2.80	3.22	3.72	4.05	4.05
US Fed funds note	0.25	0.25	0.25	0.25	0.75	1.25
US 2 year note	0.84	1.20	1.50	1.75	2.20	2.65
US 10 year note	3.66	4.10	4.30	4.25	4.40	4.45
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.10
ECB refinance rate	1.00	1.00	1.00	1.00	1.50	1.75
UK repo rate	0.50	0.50	0.50	0.50	1.00	1.25

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

FORECASTS

FOREIGN EXCHANGE RATES	CURRENT	MAR 10 F	JUN 10 F	SEP 10 F	DEC 10 F	MAR 11 F
Australian exchange rates						
A$/US$	0.8874	0.89	0.87	0.86	0.85	0.82
NZ$/US$	0.6876	0.70	0.68	0.67	0.65	0.64
A$/¥	79.54	79.2	78.3	79.1	79.9	78.7
A$/€	0.6593	0.64	0.64	0.65	0.65	0.64
A$/£	0.5788	0.56	0.55	0.55	0.55	0.53
A$/NZ$	1.2906	1.27	1.28	1.28	1.31	1.28
A$/C$	0.9386	0.93	0.92	0.92	0.92	0.89
A$/CHF	0.9650	0.95	0.95	0.95	0.97	0.95
A$/CNY	6.0587	6.08	5.86	5.72	5.58	5.31
A$ Trade weighted index	69.80	68.9	67.9	67.0	66.5	64.0
International cross rates						
US$/¥	89.64	89.0	90.0	92.0	94.0	96.0
€/US$	1.3460	1.38	1.35	1.33	1.30	1.28
€/¥	120.65	123	122	122	122	123
£/US$	1.5330	1.60	1.58	1.57	1.55	1.55
€/£	0.8780	0.86	0.85	0.85	0.84	0.83
US$/C$	1.0576	1.05	1.06	1.07	1.08	1.08
US$/CHF	1.0875	1.07	1.09	1.11	1.14	1.16
US$ index	81.09	79.5	80.9	82.1	83.7	84.8
Asia exchange rates						
US$/CNY	6.8274	6.83	6.74	6.65	6.56	6.47
US$/HKD	7.7652	7.79	7.81	7.79	7.80	7.80
US$/IDR	9360	9300	9500	9300	9000	8800
US$/INR	46.41	45.5	46.0	45.0	44.0	43.5
US$/KRW	1163	1150	1175	1125	1100	1050
US$/MYR	3.4095	3.34	3.37	3.40	3.40	3.35
US$/PHP	46.290	46.0	46.5	46.0	45.0	45.0
US$/SGD	1.4125	1.39	1.40	1.40	1.41	1.40
US$/THB	33.070	33.00	32.50	32.50	32.50	32.00
US$/TWD	32.084	31.50	31.90	31.50	30.50	30.00
US$/VND	19050	18500	18500	18500	19300	19300
Pacific exchange rates						
PGK/US$	0.3697	0.392	0.381	0.395	0.386	0.372
FJD/US$	0.5121	0.516	0.507	0.502	0.495	0.484

IMPORTANT NOTICE

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