Economics & Markets Research

Economic Update

Is the business investment boom just beginning?

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ANZ Macro and Interest Rate Research

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Key Points

- **Business investment came in at the top of market expectations**, rising by 5.7% in Q2 (mkt median was +2%). Combined with an upward revision to the Q1 numbers, it appears that business spending retains a great deal of momentum in 2008.
- The strength was concentrated in plant and equipment spending (+8%qoq), which feeds almost directly into next week's GDP calculations. This will more than offset yesterdays soft construction numbers and **has forced an upward revision to our Q2 GDP forecast from 0.1% to 0.4%.**
- The investment intentions survey was extraordinarily strong. **The 3rd estimate for 2008/09 business investment increased by 15%.** Based on 5yr historical realisation ratios the intentions survey suggests business investment will grow by a whopping 34% next year.
- **With business investment approximately 16% of GDP and assuming nothing else in the economy grows or contracts, this sector alone would drive GDP growth to 4% this financial year.** These intentions seem to be unbelievable in the midst of the recent collapse in business confidence, tightening financial conditions and weak equity markets. But the results indicate that **market expectations (and the RBA's expectations) for GDP growth 2008-09 are probably too low.**
- These results highlight that the RBA faces many challenges over the year ahead. While consumers gloom; business booms. **At the very least a strong corporate sector will put a floor under employment growth. With inflation above 4%, the RBA will needs to be very cautious in cutting rates over the next six months.**

Figure 1: Key Figures

	Actual			Expected[a]
	Jun-08	Mar-08	2007-08[b]	2008-09
Total new capital expenditure	5.7	1.0	11.4	33.8
Buildings & structures	-0.5	1.5	17.4	44.4
Equipment, plant & machinery	8.0	1.4	6.6	21.5
By Industry				
Mining	8.1	7.1	23.6	58.1
Manufacturing	-3.9	0.1	1.0	9.0
Other Selected Industries	7.2	-2.0	8.3	25.6
Non-Mining	4.7	-1.5	6.5	20.4

Source: ABS and ANZ
[a] Calculated using 5-year average realisation ratios, in nominal terms
[b] In nominal terms

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Business spending surges in June quarter

New capital expenditure shrugged off higher interest rates, record petrol prices and cooling domestic demand to rise by a strong 5.7% in the June quarter. This was led by an 8.0% surge machinery and equipment. Investment in building and structures in contrast fell by 0.5%.

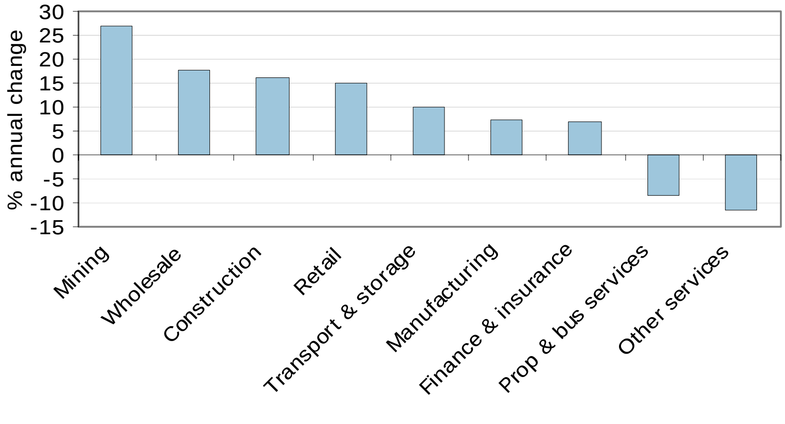
Once again we can thank mining for our good fortune with expenditure in this sector up a strong 8.1% in the quarter. However, **spending was also strong across a range of non-mining industries,** including (surprisingly) retail and finance and insurance. Ex-mining, capital expenditure was still up a solid 4.7% in the quarter. Manufacturing in contrast dropped 3.9%. An on-going appreciation of the Australian dollar in recent years is clearly impacting manufacturing investment.

Today's result was more than double expectations (+2.0%) and will have the local forecasting fraternity **upgrading the Q2 GDP outlook**. This data is due on Wednesday and we now think GDP growth of around 0.4% (+2.9% YoY) looks likely – a solid result given the tumultuous backdrop.

There were also some **significant upward revisions to capital spending growth in Q1**, from -2.5% to +1.0%. This suggests we could see an upward revision to Q1 GDP growth, from +0.6% to around +0.7%.

For 2007-08 as a whole, capital spending in nominal terms grew by 11.4%. This was the strongest result in two years. This result was driven mainly by big spending on buildings and structures, up 17.4%. Despite the higher A$, spending on equipment, plant and machinery rose by a more subdued 6.6%. Figure 2 below shows that strong CAPEX in mining, wholesale and construction sectors more than offset a weak year for investment by the services industry.

Figure 2: Capital expenditure, June 2008



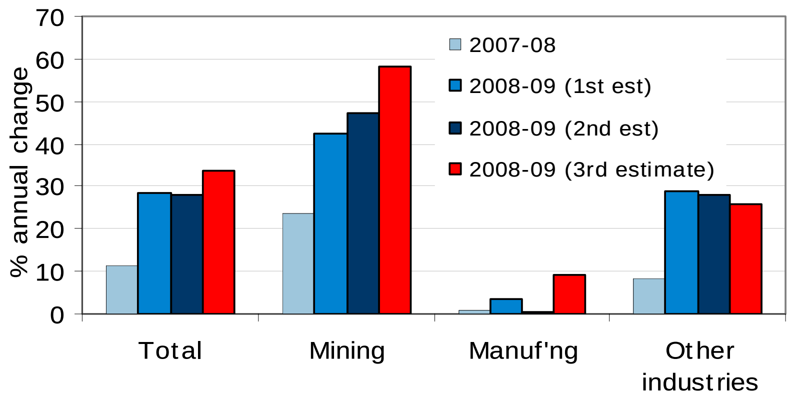
Source: ABS and ANZ

Outlook revised up sharply!

The most astounding part of today's data was that business spending intentions for 2008-09 were revised up by a mammoth $12.7bn (see Figure 3). **This is the largest upward revision from the 2nd to 3rd estimate of year-ahead intentions in 21 years!** Not a bad result in the midst of a slowing economy, collapsing business confidence and a global credit squeeze!

Analytically, what this implies is that **the rebalancing of growth, from consumer spending to business investment remains in train. This is crucial to expanding the capacity of the Australian economy that in turn is required to fight the broad-based inflationary pressures.**

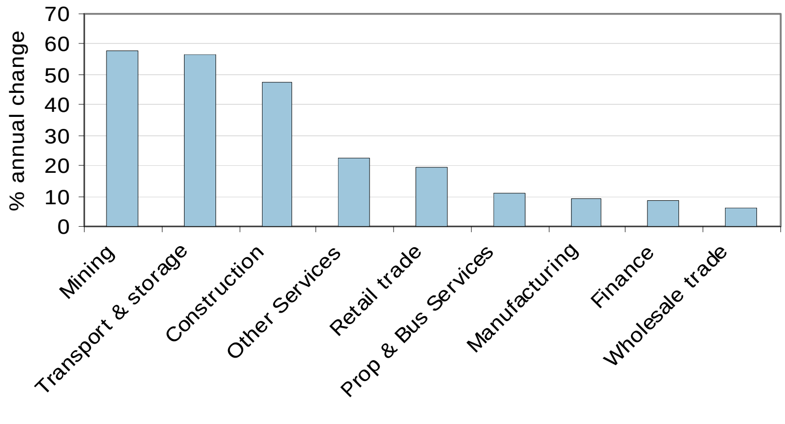
Figure 3: Businesses keep revising up expectations



Source: ANZ and ABS

Using 5-year average realisation ratios implies some pretty phenomenal (and frankly unbelievable) growth figures - 34% growth in total CAPEX, 45% growth in buildings and structures and 22% growth in machinery and equipment (see Figure 1 on p1). **While mining accounts for most of the expected investment growth in 2008-09, (+58!) non-mining also looks pretty strong (+20%) (Figure 4).**

Figure 4: Business investment intentions for 2008-09 (average 5-year realisation ratios)

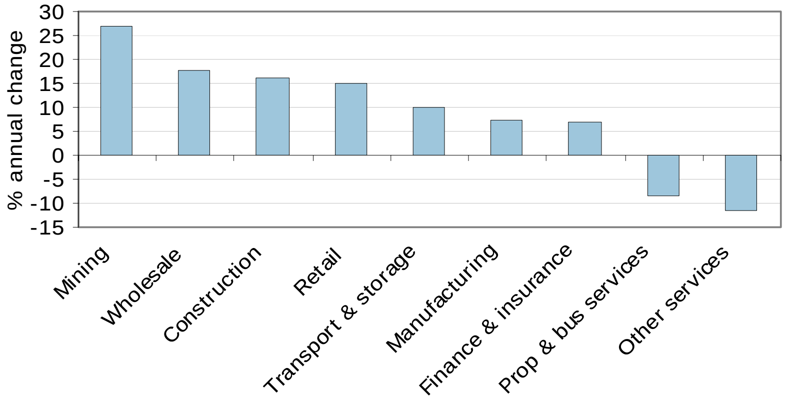


Source: ABS and ANZ

That said, not all industries are immune to the challenging backdrop. As expected, sectors that are sensitive to higher interest rates and weaker consumer spending have become more circumspect. **Investment intentions for 2008-09 were actually downgraded across the retail, property and business services and other services sectors.**

Even if we apply cyclically low (2000-01) realisation ratios, the picture for business investment still looks strong (see Figure 5). That said, the divergence between the services and 'goods' sector does become a little more stark.

Figure 5: Business investment intentions 2008-09 (200-01 realisation ratios)



Source: ANZ and ABS

It's the backlog

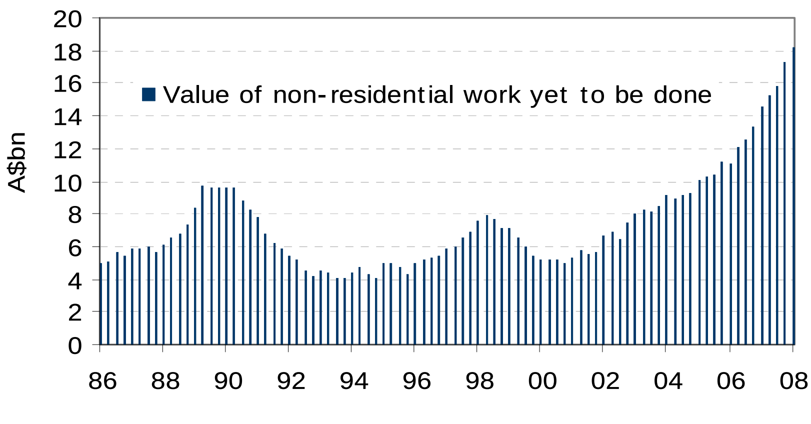
Today's survey is nothing short of phenomenal. As such, it should *not* be taken literally. But, it does suggest some serious upside risks to the conventional view that business investment will slow sharply in the year ahead. We believe the RBA is also factoring in a pretty sharp slowdown in business spending, in line with the collapse in other surveyed measures of confidence, so expect today's survey will have shaken the central bank's view of the world a little.

While we aren't taking today's data literally, we do believe that it is telling something important about the momentum in this economy. The survey backs up other data that shows an incredible backlog of work that is in train in construction, especially infrastructure (see Figure 6).

In our view, this strength will be crucial in maintaining the resilience of the Australian economy during the current global downturn. Importantly, it also highlights the balancing act that the RBA continues to face. With inflation at a 16-year high (and yet to peak!) we know the RBA cannot afford to re-ignite this economy.

A measured approach to easing policy now looks assured. Expect a 25bps cut next Tuesday. But watch the Statement – we believe the doves are in for some disappointment. While our forecast remains for a further 25bps cut in November with the RBA then on hold until mid-2009, we believe the risk continues to tilt towards *no* further rate cuts this year.

Figure 6: The pipeline of work is unprecedented



Source: ABS and ANZ

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