

# Australian Economic Perspectives

## Housing outlook – a moderation, not a downturn

### Economics

#### Australia

#### Overview

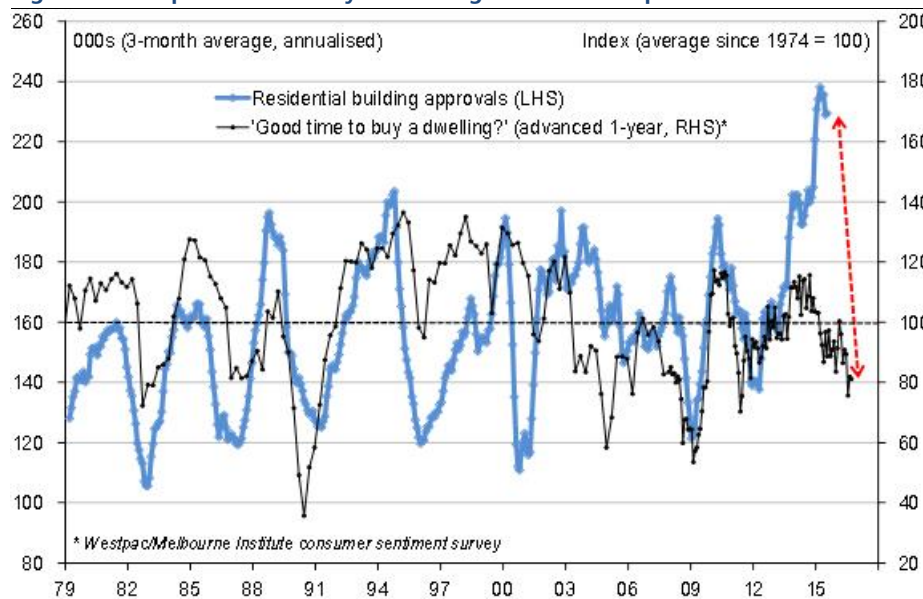
The outlook for housing depends on 'who' and 'what' you ask. Worryingly, a consumer survey asking if it's a "good time to buy a dwelling" has slumped to a 5-year low. Despite this, when asked the "wisest place for saving", the share of respondents citing 'real estate' rebounded to a 12-year high of 28%, albeit still only near its average.

Meanwhile, residential approvals remain near a record high at 232k, & renovations recently rebounded. So even as commencements ease to 200k in 2016, dwelling investment should lift in coming quarters, but flatten in 2H16. Elsewhere, prices are still booming 10% y/y, but growth likely peaked & should moderate, albeit we don't expect a large fall, given record low rates. While new RBA estimates of underlying housing demand fell to ~172k in 2014 (below UBS at ~190k), & population slowed to a 9-year low of 1.4% y/y, this still implies a large prior cumulative under-build. That said, with rental vacancy rates up to a decade high, rents may weaken further ahead.

Catching market attention is the fall in auction clearance rates, amid tighter APRA macro-prudential policy, and enforcement of Australian & particularly [Chinese foreign investment](#) rules. Unfortunately there is no definitive data to properly assess the impact. However, we note that ACRs still remain at a solid level, even as auction volumes surged to a record high, which hardly suggests a 'weak' market. Meanwhile, if [banks 're-price' mortgage rates ahead](#), this could be offset by more RBA easing, albeit the impact so far is only marginal. Overall our core housing view is for a 'moderation of strength', not a 'downturn', but these trends are a hard-to-quantify downside risk.

**Week ahead:** Focus will be on the extent Aug retail sales bounce after last month's drop, while resi building approvals are seen retracing after strength. Sep house prices should accelerate y/y & Q2 engineering starts provide some insight into 2H16 capex. Offshore, Fed's Yellen speaks again, with attention on payrolls, which are seen below the recent average. US core PCE & the mfg ISM are due, as is Japan's Q3 Tankan.

**Figure 1: Slump in 'time to buy a dwelling' sentiment implies downside risk**



Source: ABS, Westpac/Melbourne Institute, UBS

#### Data week 28<sup>th</sup> Sep – 2<sup>nd</sup> Oct

##### Wednesday

Credit (Aug)  
Building approvals (Aug)  
Engineering starts (Q2)

##### Thursday

ABS job vacancies (Aug qtr)  
Manufacturing PMI (Sep)  
CoreLogic-RP Data home prices (Sep)  
RBA \$A commodity prices (Sep)

##### Friday

Retail sales (Aug)

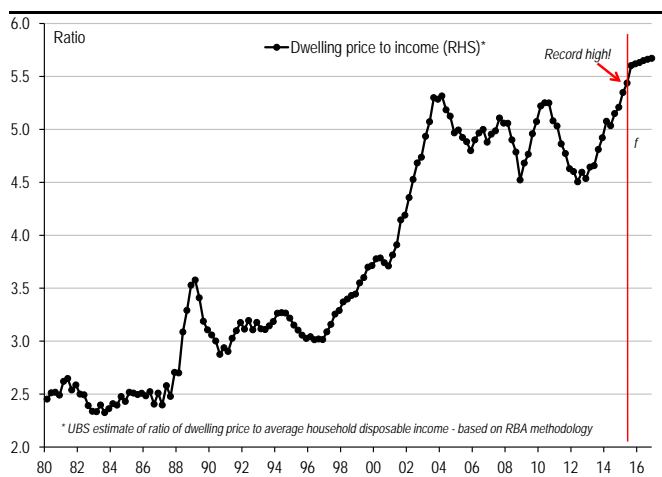
## Housing outlook – a moderation, not a downturn

The outlook for housing depends on 'who' and 'what' you ask. Firstly, the Westpac/Melbourne Institute consumer sentiment survey contains a stand-alone question asking if it is a "good time to buy a dwelling". Worryingly, this has been on a downtrend since mid-2013, which coincided with the time when house price growth really started to accelerate. In recent months, even after the RBA cut rates a further 50bp in 1H15, sentiment slumped further to now be trending around a 5-year low, and is a significant ~20% below its long-run average (Figure 1).

This recent pattern contrasts history. Previously, lower interest rates saw housing activity and prices start to lift, and sentiment improved as demand lifted to 'get in the housing market' before prices lifted even further. However, in this cycle, consumers are perhaps relatively more worried by the prospect of 'buying at the top', amid a spike in the dwelling-price income ratio to a record high of 5.6x (Figure 2), combined with record low wages growth – which has seen sentiment deteriorate despite ongoing strength in house price growth and record low interest rates.

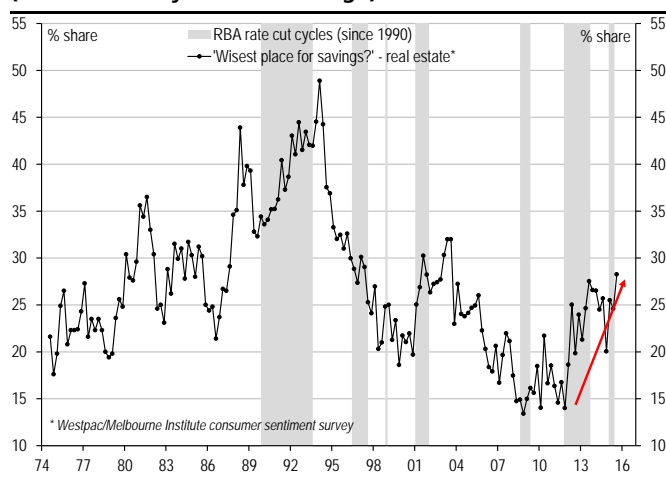
That said, given the relatively strong 40-year relationship where sentiment historically leads approvals by ~1-year, the deterioration in sentiment in the last 2 years should have already had a meaningful negative impact on residential building approvals (Figure 1). However despite this, there remains an unprecedented divergence of weak sentiment compared with still booming approvals. Perhaps the 'model is broken', or perhaps the lags are longer than normal, or perhaps 'this time is different'. We favour the latter and cite that foreigners are increasingly a key driver of Australia's housing cycle, and would likely be largely outside the scope of the (domestic) consumer sentiment survey.

**Figure 2: Dwelling price-income ratio spiked to a record high of 5.6x**



Source: ABS, RBA, CoreLogic-RPData, UBS

**Figure 3: 'Wiseest place for savings'? – share of consumers saying 'real estate' rebounded to a 12-year high of 28% (albeit still only around average)**



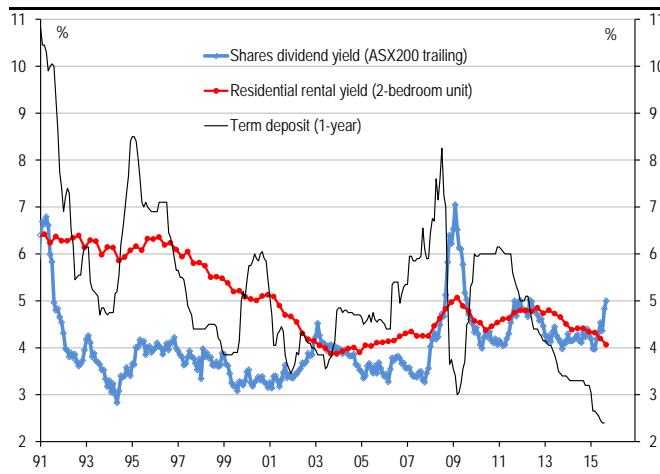
Source: ABS, Westpac/Melbourne Institute, RBA, UBS

Interestingly, in contrast to "time to buy a dwelling sentiment", when the same consumers are asked, where is the "wisest place for savings", the attitude towards housing is far more favourable. Indeed, the share of respondents citing 'real estate' has doubled from a record low of 14% in 2011, to 28% in August 2015, the highest level since 2003, albeit still only ~in-line with its average (Figure 3).

This increase in investment in housing likely reflects its 'relative' attractiveness amid record low interest rates, and the momentum in house price growth seeing

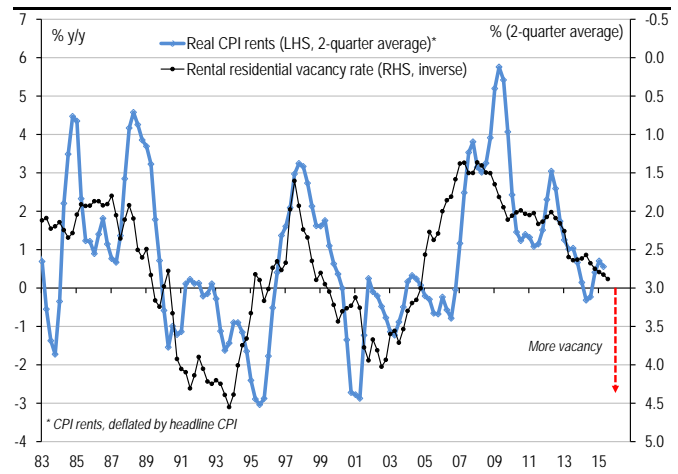
investors extrapolate their recent past into the future. Notably, the gross residential rental yield on a 2-bedroom unit (i.e. ignoring transaction costs and tax) has dropped to ~4% now, which is the lowest in a decade, and only modestly above the lowest on record. However, this remains much higher than term deposit which dropped more sharply to a record low of just 2½%. As an aside, the rental yield is now the furthest below the share market dividend yield since the GFC (Figure 4).

**Figure 4: Residential rental yield has dropped to a decade low of 4%, but still relatively attractive vs TD's at 2½%**



Source: ABS, RBA, REIA, Factset, UBS

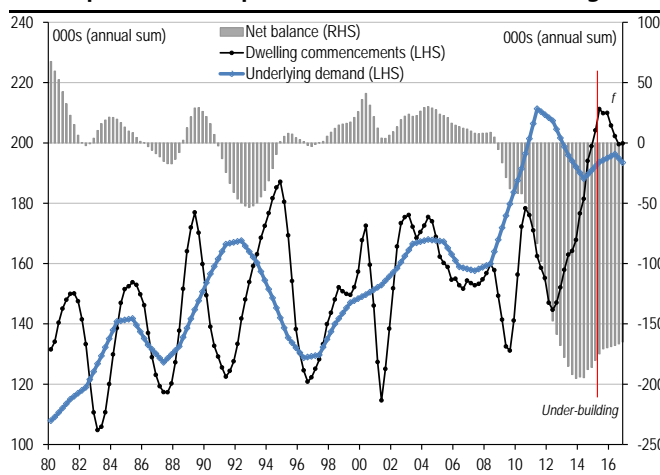
**Figure 5: The rental vacancy rate has been trending higher, reaching a decade high of 2.9%**



Source: ABS, REIA, UBS

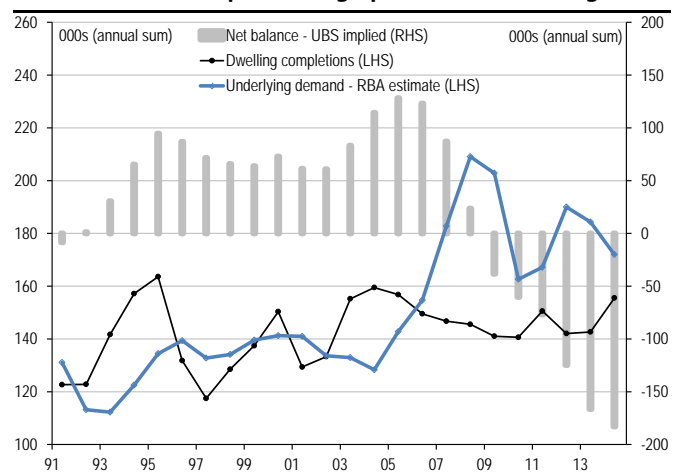
The fall in the rental yield reflects the sharp slowing in real rents to a flat trend in the last year or so. This in turn reflects the rising trend of the rental vacancy rate to a decade high of 2.9% (albeit still only around the long-run average, Figure 5). Looking forward, given the unprecedented surge in dwelling completions due to come in the coming 2 years (Figure 17), the vacancy rate should continue to tick higher, and rents are likely to slow further (and may even fall by 2017).

**Figure 6: UBS model of underlying demand is now ~190k, and implies massive prior cumulative under-building**



Source: ABS, UBS

**Figure 7: RBA model of underlying demand fell to ~172k in 2014, but still implies a large prior under-building**

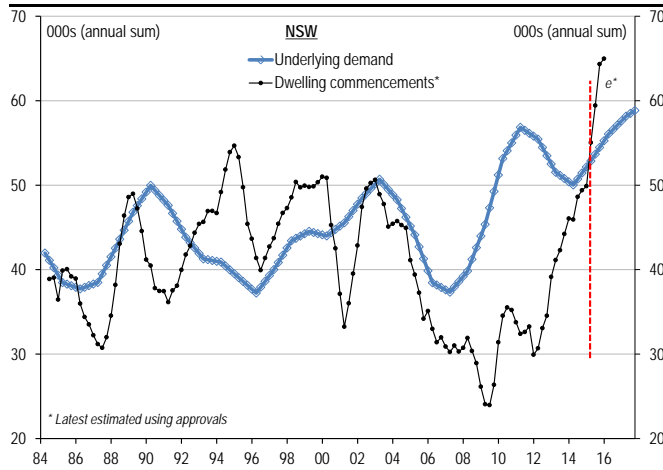


Source: ABS, RBA, UBS

Notably our model of underlying housing demand is ~190k, and suggests a massive prior cumulative stock of under-building in prior years (Figure 6). Much of this under-building was in NSW (Figure 8); whereas Victoria has been in line for a long-time (Figure 9), but commencements recently rebounded, despite weaker underlying demand; while QLD (Figure 10) and WA (Figure 11) both had some

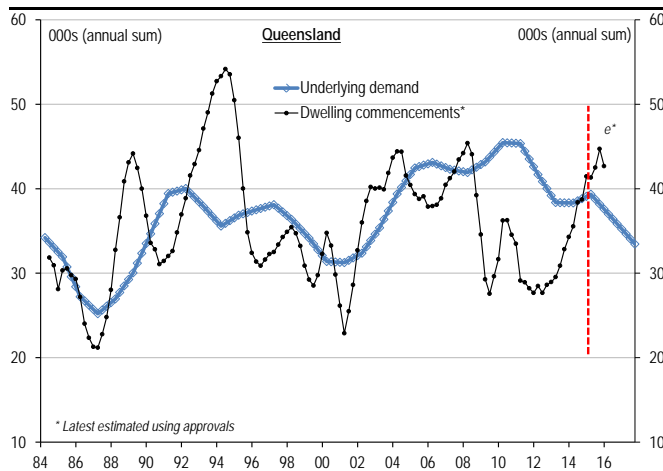
under-building in prior years, but our models show underlying demand is set to collapse post the mining boom; and finally SA remains relatively in-line or slightly under-building (Figure 12).

**Figure 8: Much of the prior under-building has been in NSW, but starts are now rising strongly in response**



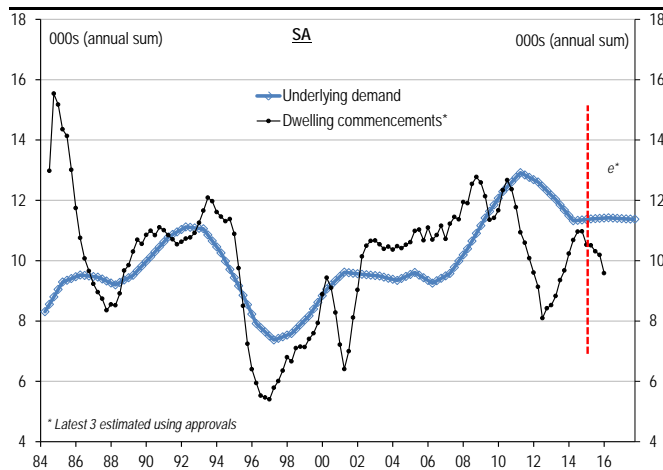
Source: ABS, UBS

**Figure 10: QLD had been under-building, but underlying demand is dropping post the mining boom**



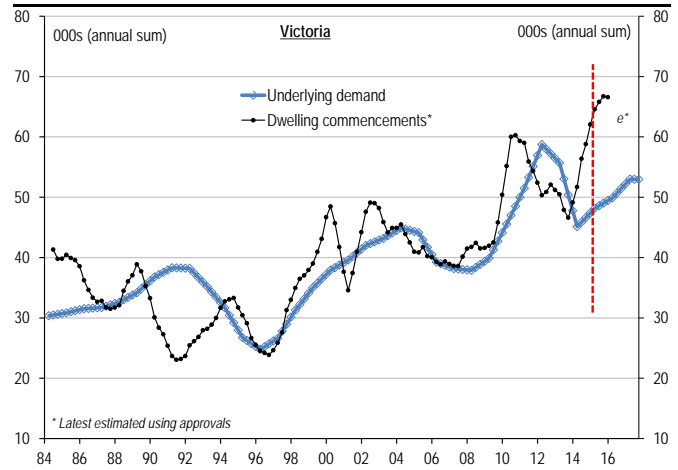
Source: ABS, UBS

**Figure 12: SA has been building broadly in line, though starts look likely to be lower in the period ahead**



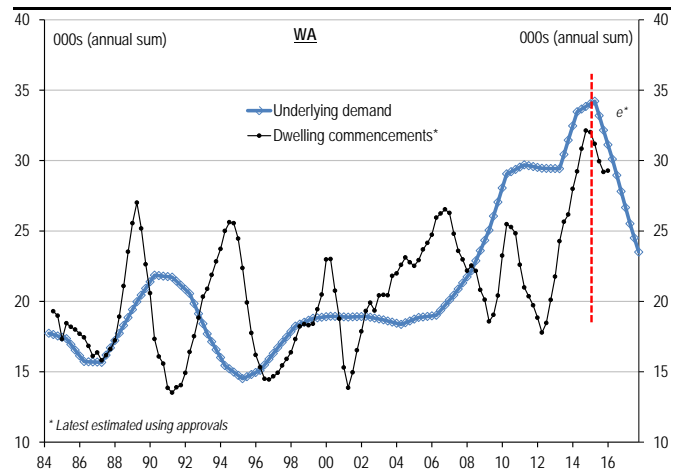
Source: ABS, UBS

**Figure 9: Victoria had built ~in line, while starts have now also rebounded to new highs**



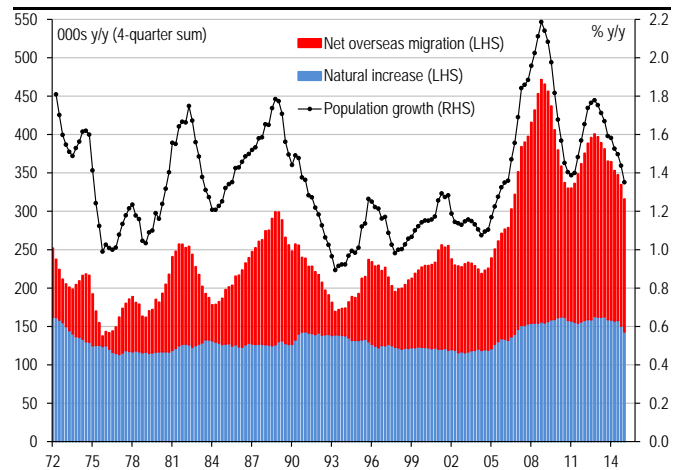
Source: ABS, UBS

**Figure 11: WA had been under-building, but underlying demand will likely collapse post the mining boom**



Source: ABS, UBS

**Figure 13: Population growth dropped to 1.4% y/y in Q1-2015 (+316 k/ y/y)\* – the slowest in 9 years**

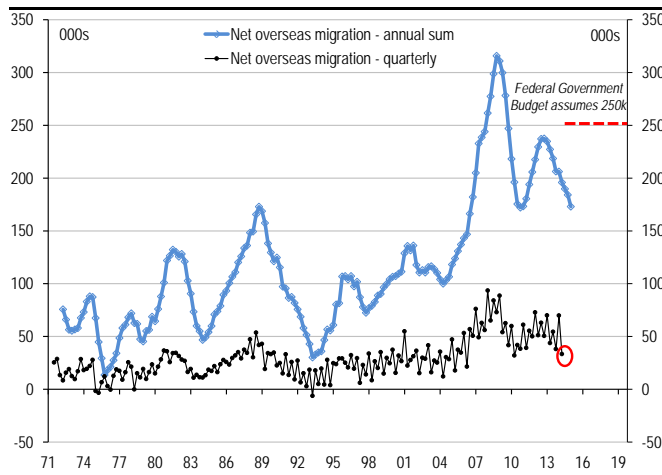


Source: ABS, UBS \* Data is preliminary and subject to upward revisions

Notably, while new RBA estimates of underlying demand fell to ~172k in 2014 (Figure 7), UBS analysis shows this still implies a large prior under-build. Nonetheless, with a rising rental vacancy rates contrasting our models showed under-building, and that the current *flow* of supply is clearly above demand – across most of the States – for the first time in a ~decade, we consequently don't rest our views solely on these models.

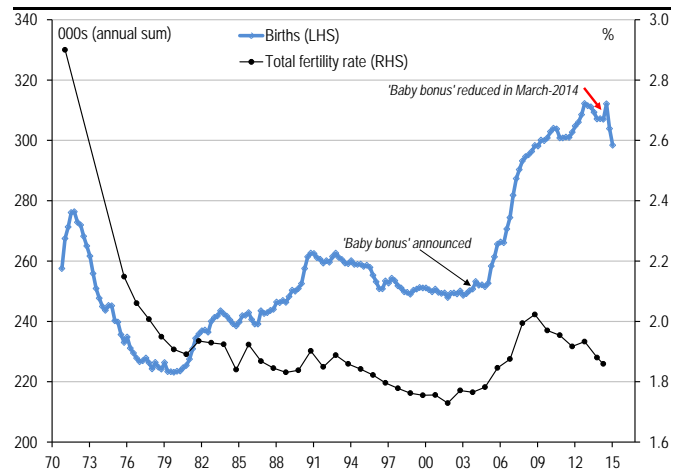
Importantly, population growth slowed further in Q115 to 1.4% y/y (+316k y/y), the slowest growth since 2006 (Figure 13). The slowdown has been led by a slump in net overseas migration slumping to 173k, also near the lowest since 2006, and far below the Federal Budget assumption of 250k over coming years (Figure 14). Meanwhile, births also retraced to under 300k, the weakest since the GFC (Figure 15), but we note this is still subject to ongoing upward revisions (as is total population growth) in subsequent releases, given the ABS again flagged "processing delays may have led to lower than usual [birth] registrations".

**Figure 14: Net overseas migration only 173k, near the slowest since 2006 (& far below the Budget assumption)**



Source: ABS, UBS

**Figure 15: Births fell back recently from a record high, but still subject to upward revision due to processing lags**

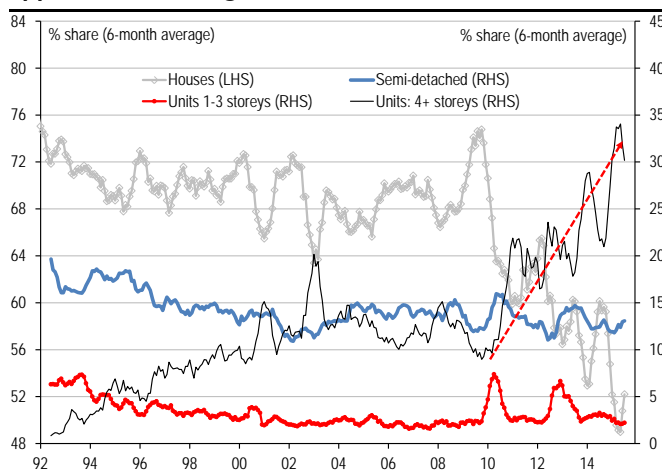


Source: ABS, UBS \* Data is preliminary and subject to upward revisions

Given that net overseas migration is so far below the Government target, and births may be revised up ahead (albeit still with a likely negative impact ahead following a Government policy change in March 2014 which reduced the payment received from the 'baby bonus'), we expect a moderating pace of population growth ahead, rather than a further slump.

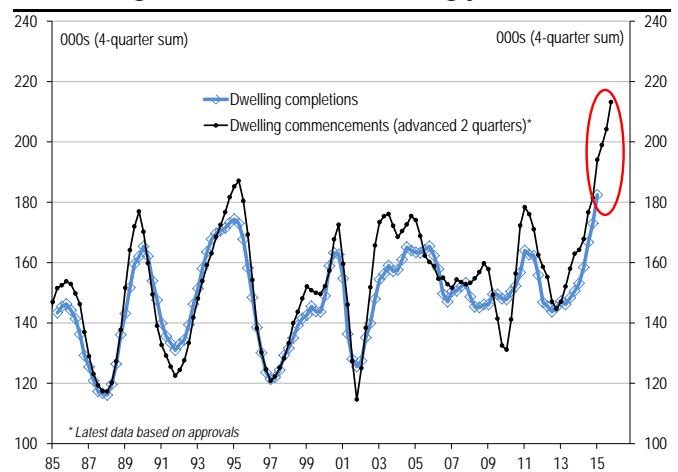
Nonetheless, if the end of the mining boom led to a more sustained weakening in migration than expected, under a scenario where it completely reverts to its long-run pre-boom average of around ~100k, then migration would be ~75k lower than our assumptions, and underlying demand (after also adjusting for 2.5 persons per household) would be ~30k lower than the base-case behind our model (see Figure 6 again) – i.e. a fall in underlying demand to ~160k. If over time lower migration was also joined by lower births – there would likely be a large *flow* of over-supply hitting the market in 2017.

**Figure 16: Medium-density has surged to ~half of total approvals, while high-rise alone is a ~30% share**



Source: ABS, UBS

**Figure 17: Dwelling completions likely to surge further to a record high above 200k in the coming year**

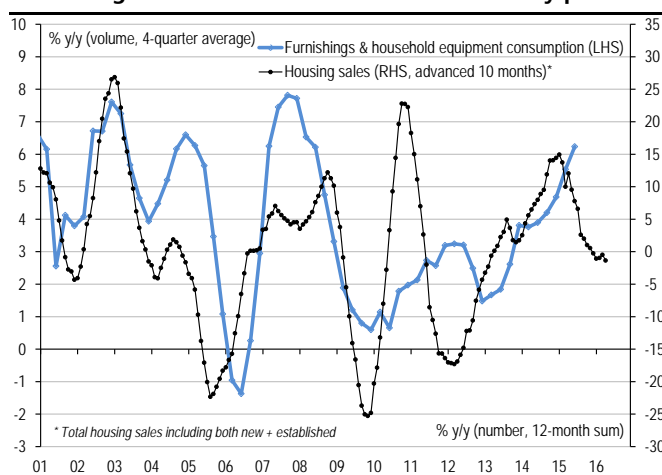


Source: ABS, UBS

Meanwhile, for now, the 'hard data' shows ongoing momentum in activity. ABS residential building approvals remain near a record high level at 232k in July (Figure 1). This is actually tracking above our forecast for commencements of 210k in 2015, before some moderation to another still strong year of 200k in 2016 (Figure 6). That said, given this cycle has seen a record high share of medium-density (~half of the total) and especially high-rise units (~30% of the total, Figure 16), there is a longer than normal lag between commencements and completions.

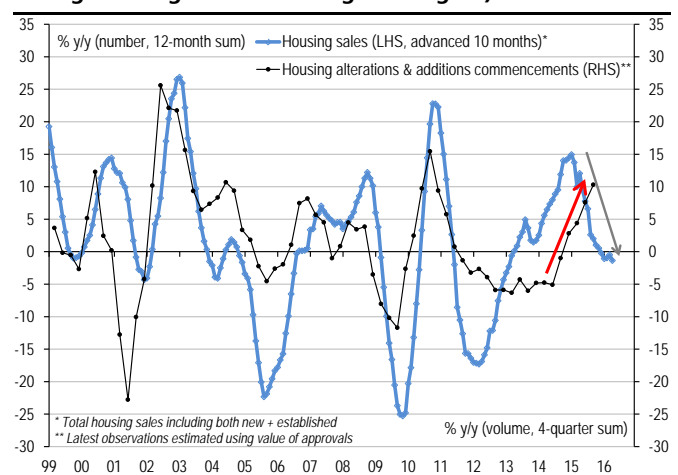
Hence, despite a moderation in commencements next year, completions are still likely to surge further to a record high peak above 200k in 2016 (Figure 17). This suggests a positive spill-over to consumption on furnishings & household equipment, albeit the fall in total housing sales (with established housing sales dropping) implies the peak in momentum is already passed (Figure 18).

**Figure 18: Rising completions to support consumption, but falling sales indicate momentum has already peaked**



Source: ABS, CoreLogic-RPData, UBS

**Figure 19: Renovations have rebounded recently (albeit falling housing sales are a negative signal)**



Source: ABS, CoreLogic-RPData, UBS

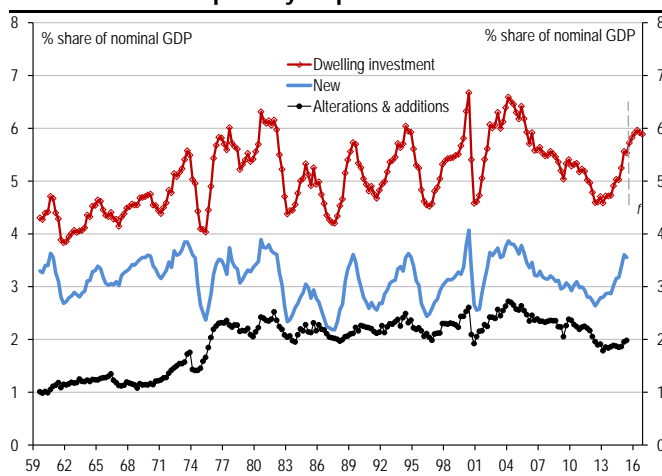
Notably, housing renovations (i.e. alterations & additions) recently rebounded, with commencements up ~10% y/y, after being relatively depressed since the GFC (Figure 19). Barring an unexpected spike in unemployment (above our base case for a renewed moderate uptrend to 6½% ahead), renovations should continue an improving trend ahead amid rising house prices and record low interest rates. That



said, the ongoing modest falls in total housing sales implies a negative signal ahead, and suggest the pace of growth has probably peaked.

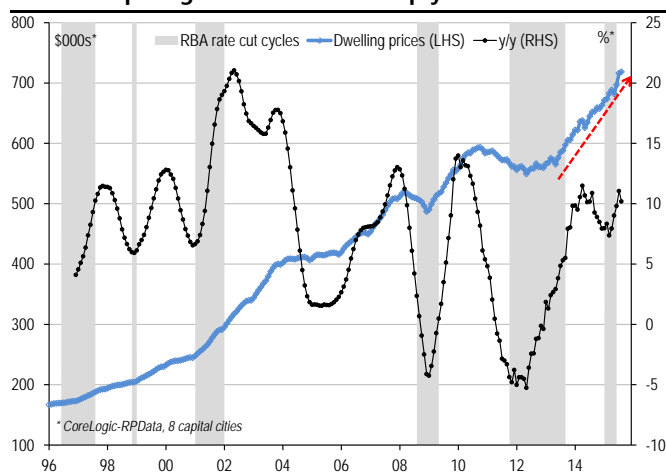
Overall, our outlook for GDP-basis dwelling investment (i.e. real housing activity) growth is still solid in coming quarters (+10% y/y in CY2015 and +5% y/y in CY2016), albeit activity is likely to slow sharply to be broadly flat by 2H16. This sees dwelling investment peak around 6% of GDP, which is above average, but broadly in line or below prior cycle peaks (Figure 20). This view reflects 1) the peak level in new approvals is likely already passed, but we expect a moderation, rather than a slump ahead; & 2) with renovations accounting for ~35% of GDP dwelling investment, their uptrend provides some offset to weaker new housing activity in 2016. That said, if approvals fall noticeably below 200k ahead, total dwelling investment would probably be negative as well.

**Figure 20: Housing investment to peak around 6% of GDP – in-line or below prior cycle peaks**



Source: ABS, UBS

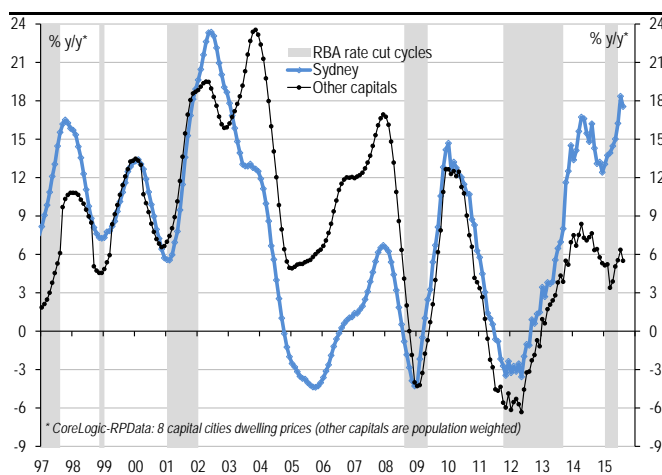
**Figure 21: House prices are still booming at 10% y/y, but we still expect growth to slow sharply ahead**



Source: CoreLogic-RPData, RBA, UBS

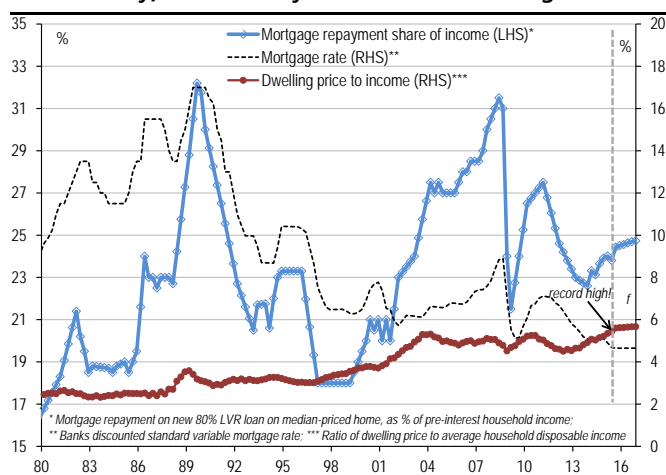
Elsewhere, dwelling prices continue to boom at 10% y/y in August (Figure 21) – clearly led by Sydney at ~18% y/y, while other capitals are much more moderate at ~5% y/y (Figure 22). But given the large increase in supply coming over the coming couple of years, we think growth has likely already peaked & will slow significantly ahead towards low single digits in the coming year, & even flat into 2017. But, we still do not expect substantial price falls, given ongoing record low interest rates.

**Figure 22: Sydney prices surging 18% y/y, but other capital cities still more subdued around 5% y/y**



Source: CoreLogic-RPData, RBA, UBS

**Figure 23: House price-income lifted to a record high of 5.6x, but mortgage repayments (i.e. housing affordability) are still only a bit above its average**

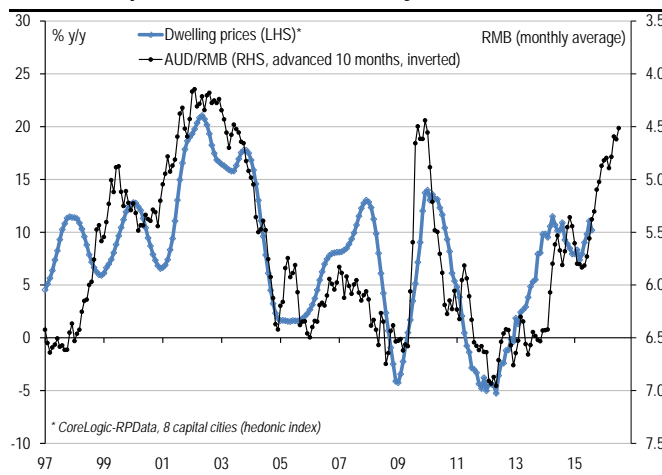


Source: ABS, RBA, CoreLogic-RPData, UBS

The valuation of the housing market is clearly stretched, with the dwelling price to (average) household income ratio lifting to a record high of ~5.6x now. However, with record low interest rates, housing affordability – proxied by the mortgage repayment share of income – is still only a bit around its long-run average, albeit the worst since Q112 (Figure 23).

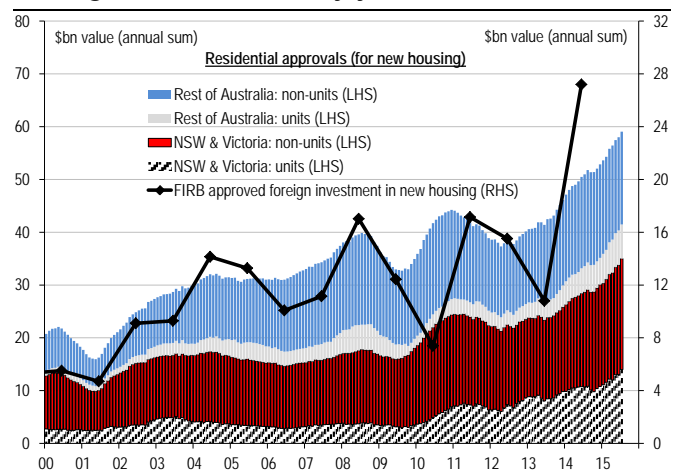
The deteriorating (domestic) fundamentals of the housing market are why we expect a sharp slowing in house price growth ahead. However, given the unusually tight relationship of house price growth vs the AUD/RMB – which could be correlation that the AUD falls when the RBA cuts, or perhaps causality given the persistence of the trend), the recent further sharp depreciation of our currency argues for ongoing strength of house prices (Figure 24). As we have highlighted previously, foreigners are increasingly a key driver of Australia's housing market, with approved investment more than doubling in 2013/14 (Figure 25).

**Figure 24: House prices have an unusually tight relationship (correlation or causality?) to the AUD/RMB**



Source: ABS, Factset, UBS

**Figure 25: Foreign approved investment in Australian housing more than doubled y/y in 2013/14**



Source: ABS, RBA, FIRB, UBS

Despite some high profile stories of 'forced' selling of unapproved foreign purchases (of established homes), the numbers are tiny relative to total turnover in the housing market, and we still don't expect a material tightening of the rules by Australian policymakers. The bigger risk is China stopping capital outflows into Australia's housing market. However, our economics colleagues' base case is for relatively little depreciation in the RMB ahead. Hence, we don't expect an overt intensification of capital controls, which could have a materially negative impact on Australian housing if there was such a policy shift.

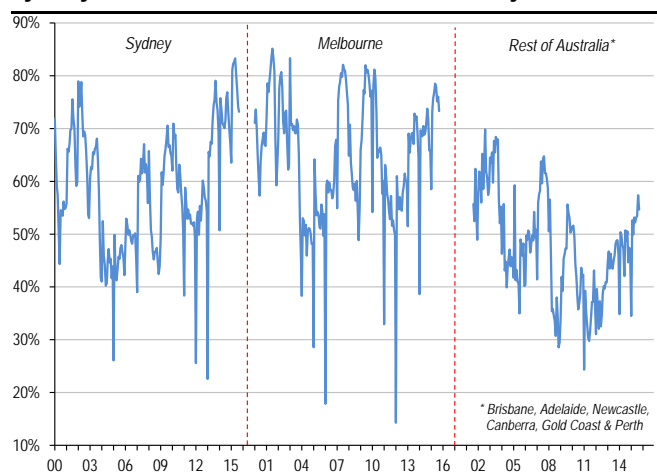
Also recently catching market attention has been the 'drop' in auction clearance rates, reportedly providing evidence of tighter APRA macro-prudential policy, and enforcement of Australian, and particularly, Chinese foreign investment rules. Unfortunately there is no definitive data to 'confirm or deny' this impact, at this stage. However, we note ACRs remain at a solid level in September, still above average in Sydney and Melbourne (~73%), while other capitals have been on an improving trend (Figure 26). Indeed, the relatively small fall in ACRs is a solid result given auction volumes surged 30% y/y in August to a record high level (Figure 27).

If APRA's requirement for higher capital sees banks 're-price' mortgage rates ahead, it would be a negative for sentiment towards housing, but it could be offset by more RBA cash rate cuts. The impact on the banks ~27bp hike to investor rates so far is only marginal. Further, reports of massive reductions in 'discounts'

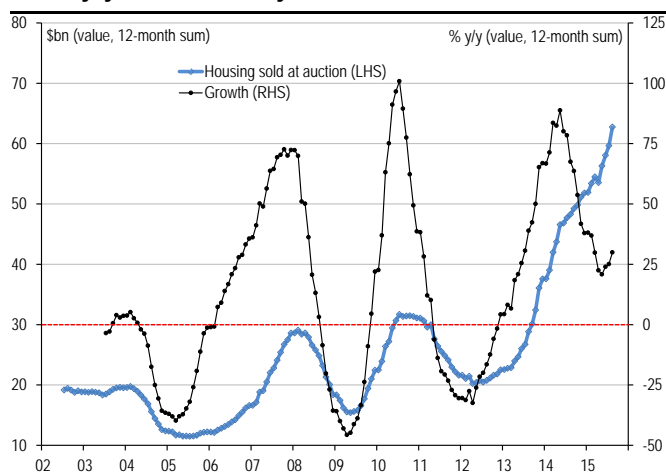


off the standard variable mortgage rate seem overblown. RBA data report discounted mortgage rates are still near a record low at 4.65% for owner-occupiers and 4.9% for investors in August (Figure 28). Indeed, their data still shows a minimal ~5bp reduction in discounts off the standard variable rate to a still large ~80bp for both owner-occupiers and investors (Figure 29). That said, looking forward, UBS's banks team expect the discount for investors (which is also currently 80bps) to reduce given the pressure on bank margins.

**Figure 26: Auction clearance rates have eased to ~73% in Sydney and Melbourne, but remain relatively solid**

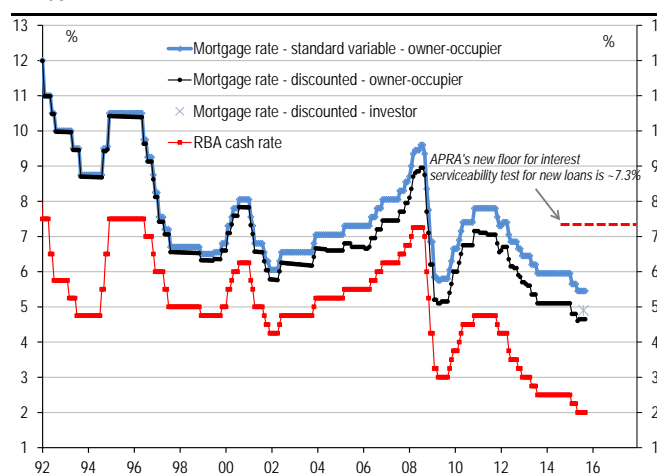


**Figure 27: The value of housing sold at auctions surged ~30% y/y – which hardly indicates a weak market**

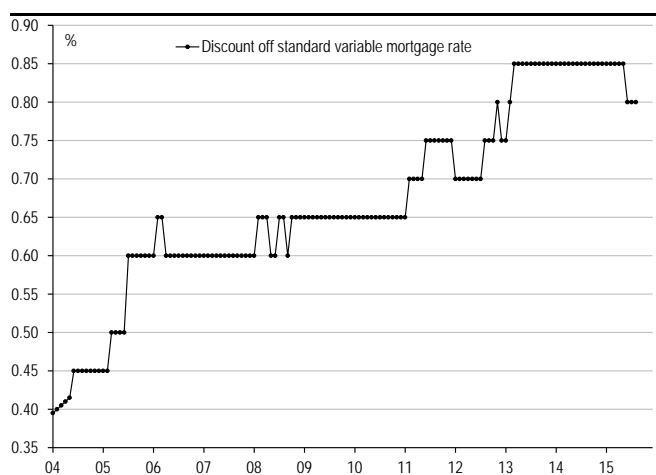


A related issue – and at least as important – is that APRA seems likely to have raised the 'floor' lenders are required to use for interest serviceability tests on NEW loans only (as well as tighter rules regarding the assumptions of interest only loans). After a long-run historical rule of thumb of ~2% buffer above the current borrowing rate, APRA rules introduced in late-2014 implied a harder floor of ~7%, while in recent months this was increased further to ~7¼% - 7.4% (Figure 28). This should help cool the housing market over time, particularly investors, but not necessarily automatically lead to a sharp drop.

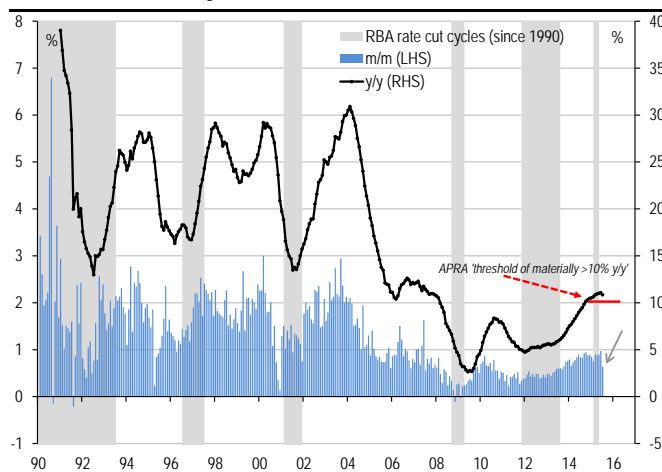
**Figure 28: RBA report discounted mortgage rates are still near a record low at 4.65% for owner-occupiers, and 4.9% for investors**



**Figure 29: Discount off the standard variable mortgage rate is still large at ~80bps**

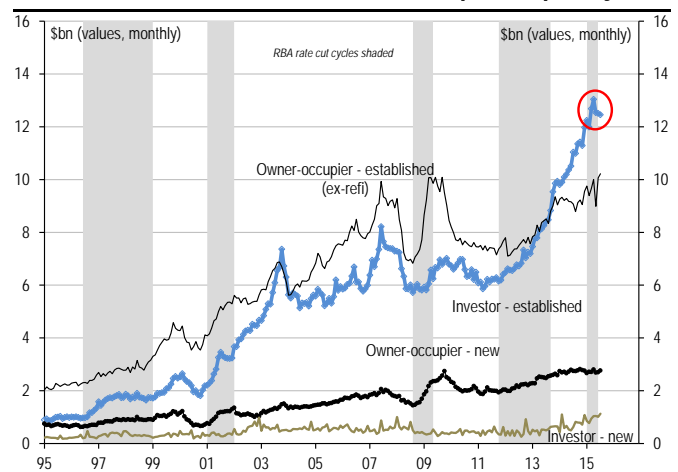


**Figure 30: Investor housing credit still >APRA's 10% y/y threshold, but July's 0.6% m/m was slowest since mid-13**



Source: ABS, RBA, APRA, UBS

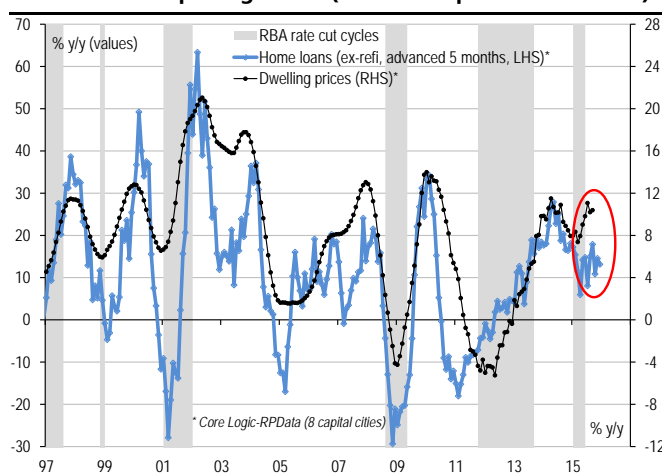
**Figure 31: Home loans to investors has eased back in recent months, after an unsustainable spike in prior years**



Source: ABS, RBA, UBS

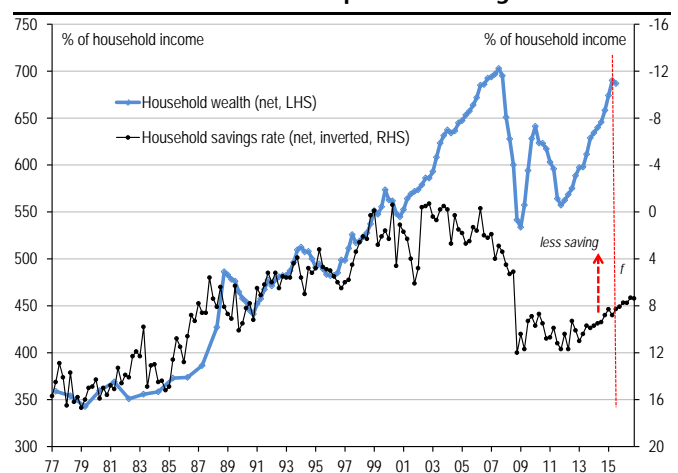
Another reason to expect investor loans to be re-priced is that APRA clearly still wants investor housing credit growth to slow below its 10% y/y 'threshold'. In July it remained strong at 10.8% y/y, only marginally below June's 8-year high of 11.1% y/y. However, the m/m did drop to just 0.6%, the slowest since mid-2013, which suggests APRA's policy measures are having some impact (Figure 30). Indeed, the gross flow of home loans to investors has eased back in recent months, after an unsustainable spike in prior years (Figure 31). Looking forward, if investor home loans – and particularly total home loans – were to start falling more materially, it would be a negative signal for house prices (Figure 32).

**Figure 32: Home loans growth has slowed, and suggest moderation of price growth (albeit still positive for now)**



Source: ABS, RBA, UBS

**Figure 33: House prices a key risk as rising wealth likely needed to drive a further drop in the savings rate**



Source: ABS, RBA, UBS

So overall our core housing view is still 'moderation of strength', not a 'downturn' – both in construction & prices. But, we don't deny the downside risks, particularly given the hard to quantify impact of untested macro-prudential policy, and unprecedented foreign investment and supply response. This particularly matters given rising house prices are likely needed to lift household wealth, and drive a further drop in the household savings rate to support consumption and jobs growth, given falling real wages (Figure 33). If housing weakened more than expected, particularly if lenders increased owner-occupier home loan interest rates 'out of cycle', it would raise the risk of further RBA rate cuts.

# Australian Economic Outlook

	Calendar Year (%y/y change)				Fiscal Year (%y/y change)			
	2013	2014	2015 (f)	2016 (f)	2012/13	2013/14	2014/15 (f)	2015/16 (f)
<b>REAL:</b>								
GDP	2.1	2.7	2.2	2.6	2.5	2.5	2.4	2.1
Private Consumption	1.7	2.4	2.5	2.5	1.9	2.2	2.5	2.4
Dwelling Investment	0.4	8.0	10.0	5.0	-3.8	5.3	8.3	8.8
Business Investment *	-3.8	-4.7	-7.2	-7.6	5.0	-4.9	-5.9	-8.0
- Machinery & equipment *	-11.8	-2.3	-1.3	-4.2	-3.2	-11.5	2.8	-4.7
- Non-residential construction *	-0.3	-8.0	-12.3	-12.4	10.8	-2.9	-12.1	-12.2
Domestic Final Demand	0.6	1.2	1.1	0.7	1.6	1.0	0.9	0.8
- Private Final Demand *	0.5	1.2	1.0	0.7	2.3	0.9	1.0	0.8
- Public Final Demand *	0.3	0.6	1.4	0.5	-0.9	1.6	0.4	1.0
Stocks (%pts contribution)	-0.4	0.0	0.0	0.0	-0.1	-0.3	0.2	-0.1
GNE	0.1	1.1	1.1	0.7	1.4	0.7	1.1	0.7
Exports	6.2	6.7	5.3	7.3	6.0	5.8	6.6	5.2
Imports	-1.8	-1.7	1.0	-1.4	0.7	-1.8	-0.4	-0.4
Net Exports (%pts contribution)	1.6	1.7	0.9	1.9	1.0	1.5	1.4	1.2
<b>Nominal GDP</b>	3.2	3.2	1.9	3.7	2.2	4.1	1.9	2.7
<b>OTHER KEY INDICATORS</b>								
Headline CPI	2.4	2.5	1.7	2.2	2.3	2.7	1.7	2.2
RBA 'underlying' CPI **	2.4	2.5	2.3	2.3	2.4	2.6	2.3	2.3
Wage Price Index	2.9	2.5	2.3	2.7	3.3	2.6	2.4	2.5
Employment	0.9	0.7	1.6	1.4	1.2	0.6	1.2	1.6
Unemployment Rate (quarterly, % at year-end)	5.8	6.2	6.3	6.5	5.7	6.0	6.1	6.5
Dwelling Commencements (000s)	168	199	210	200	163	181	213	200
Current Account Balance (% of GDP)	-3.4	-3.0	-4.0	-2.9	-3.9	-3.2	-3.5	-3.8
<b>QUARTERLY</b>								
	Mar-15	Jun-15	Sep-15 (f)	Dec-15 (f)	Mar-16 (f)	Jun-16 (f)	Sep-16 (f)	Dec-16 (f)
GDP (% q/q)	0.9	0.2	0.5	0.5	0.6	0.8	0.9	0.9
(% y/y)	2.5	2.0	2.1	2.0	1.7	2.4	2.8	3.3
	Mar-15	Jun-15	Sep-15 (f)	Dec-15 (f)	Mar-16 (f)	Jun-16 (f)	Sep-16 (f)	Dec-16 (f)
Headline CPI (% q/q, nsa)	0.2	0.7	0.8	0.4	0.6	0.2	0.8	0.3
(% y/y, nsa)	1.3	1.5	1.8	2.0	2.4	2.0	2.1	2.0
	Mar-15	Jun-15	Sep-15 (f)	Dec-15 (f)	Mar-16 (f)	Jun-16 (f)	Sep-16 (f)	Dec-16 (f)
RBA 'underlying' CPI * (% q/q, sa)	0.7	0.5	0.6	0.6	0.6	0.6	0.6	0.6
(% y/y, sa)	2.4	2.2	2.4	2.4	2.2	2.3	2.4	2.4
<b>FINANCIAL MARKETS (at end qtr)</b>								
	Mar-15	Jun-15	Sep-15 (f)	Dec-15 (f)	Mar-16 (f)	Jun-16 (f)	Sep-16 (f)	Dec-16 (f)
- Cash (%)	2.25	2.00	2.00	2.00	2.00	2.00	2.00	2.00
- 90 Day Bills (%)	2.21	2.14	2.10	2.10	2.10	2.10	2.15	2.15
- 3-year Commonwealth Bonds (%)	1.74	2.02	1.90	2.00	2.10	2.10	2.30	2.50
- 10-year Commonwealth Bonds (%)	2.34	3.03	2.70	2.90	3.00	3.00	3.10	3.20
- S&P/ASX 200 (Index)	5395	5396	5350	5550	5650	5750	5850	5950
<b>Exchange Rates (end qtr):</b>								
AUD/USD	0.76	0.77	0.70	0.70	0.69	0.68	0.68	0.68
AUD/EUR	0.71	0.69	0.64	0.66	0.65	0.63	0.62	0.62
AUD/JPY	91.4	94.0	86.1	86.3	86.8	86.7	87.2	88.4
TWI	63.3	63.8	59.9	60.5	60.7	60.6	60.8	60.3

Source: ABS, Datastream, RBA, UBS estimates \* new – adjusted for asset transfers \*\* 3-core average, sa

# UBS Australian Forecasts: What & Why?

## Forecasts vs. Consensus

- Our forecast for real GDP growth of 2.2% y/y in 2015 remains below Consensus of 2.3% y/y (was 2.4%), while 2016 of 2.6% y/y is also still under Consensus of 2.7% y/y (was 2.9%).

## Latest forecast changes

- On September 4, we edged down our mid-16 AUD forecast from USD0.70 to USD0.68.

## Key growth drivers

- Ongoing record low interest rates will drive a housing boom which adds solidly to growth ahead, with dwelling commencements lifting to a record 210k in 2015.
- Real consumption is driven by rising household wealth, dragging down the savings rate, a pick-up in housing-related consumption, and the lower AUD seeing a fading drag from net tourism departures.
- The export supply pick-up, post the mining capex boom, should add further to real growth amid a lower AUD; while weak capex also restrains imports.
- Better employment growth should reflect the pick-up of growth in more labour intensive retail, housing & tourism sectors (on a lower AUD) – despite the loss of mining jobs. While the unemployment rate remains elevated, it should not spike further, and hence we should avoid a negative feedback loop to asset prices and the real economy.
- Weak nominal GDP growth: slowing to a 'recessionary' 1.3% in 2015, before bouncing moderately to 3.7% in 2016. This reflects a slower China and lower commodity prices resulting in a (mining) capex cliff, plus fiscal repair & slower wages, which constrains GDP to 'below' trend in coming years. The composition of GDP will also have more '(net) exports', but much less domestic demand.

## Key inflation drivers

- Headline CPI should remain low in 2015 at 1.8%, but then bounces in 2016 to 2.2% on a lower AUD – albeit still below the mid-point of the RBA's 2-3% target.
- Further ahead, for underlying CPI, very low wages and weak domestic demand (as well as global trends) should be dragging down inflation. However, poor productivity, stickiness of domestic prices and a lower AUD is expected to hold core inflation near its current 2¼% y/y.

## Monetary & fiscal policy outlook

- RBA – global disinflation amid the slump in commodity prices (particularly oil) – plus 'recessionary' indicators like capex commencements and the ABS capex intentions survey raises the risk the RBA cuts again. But we think

sticky core CPI (and likely AUD depreciation expected ahead) limits the RBA's willingness to ease further.

- Government – we see fiscal policy as an increasing drag on growth in the period ahead, as the Federal Coalition attempts to return the budget to structural balance.

## Key forecast risks

- Downside risk: A delay of US Fed hikes into 2016, causing the AUD to fail to adjust as 'necessary', would likely undermine the still fragile lift in some parts of domestic activity and business conditions. Meanwhile, a deeper China property downturn could further sharply lower commodity prices and export income. The weaker nominal income environment, ongoing fiscal drag, record debt leveraging, and negative offshore news, could see consumers become more cautious given that a drop in the household savings rate is needed to deliver decent consumption growth. These scenarios could see the RBA trim the cash rate again.
- Upside risk: AUD <USD0.70 would provide more stimulus to the domestic economy, as could more RBA rate cuts. A pick-up in China, EU & Japan could support business confidence. Consumer debt appetite could strengthen further, driving stronger spending & non-mining capex.

## Key growth signposts

- The AUD depreciating towards our USD0.68 target, which would support the rebalancing of growth.
- A recovery in business and consumer confidence, which has been mixed recently.
- A peak in the unemployment rate, which is key to easing still elevated job insecurity (as well as boosting consumer confidence).

## Positions on key controversies

- Consumer caution – we expect some stabilisation in confidence and real consumption growth – amid record low interest rates dragging down the household savings rate – despite still high unemployment and ongoing weak wages growth.
- Terms of trade – a much lower level for commodity prices will mean Australia's growth will be more led by export volumes, with a more sluggish domestic economy. However, that does not ensure a recession.

# Bond yield trends

## Monetary policy: RBA unlikely to ease from 2%

- **Cash:** Should the RBA ease again to stimulate better growth than our forecast sub-trend 2% outlook? It's not clear this is likely. The AUD has belatedly fallen to USD0.70, a level the RBA deems desirable, and unemployment – at least for this year – seems unlikely to spike higher. And it's not clear lower rates can change the mining capex outlook, the epi-centre of the growth shortfall, while lower interest rates have the potential to make worse an already leveraged consumer and over-heated housing sector. Nor is it clear Australia's inflation rate will be low enough to allow it, given some pass-through from a lower AUD. We see the RBA on hold at 2% until at least end-16, with risks to the downside in 1H16 if growth proves weaker (or unemployment higher) than we forecast.

## Australian 10-years – rising, but out-performing

- **US 10-years:** The US Fed funds rate is forecast to rise very gradually, starting with a December hike, and moves up 'every other' meeting in 2016, taking the funds rate to 1.25%-1.50% end year. We target US 10 year yields of 2.4% end-15 and 2.8% end-16, a little below our 'fair value' range (Figure A).
- **Australian 10-years:** Aussie 10-years remain expensive relative to our model (Figure B), possibly reflecting market perceptions that trend growth, and thus the RBA neutral cash rate, is lower. Given our forecast for higher US yields, we expect Aussie 10-year yields to follow that direction. But we see ongoing out-performance ahead, due to relatively soft domestic growth, and the RBA staying at a record low (in contrast to Fed rate hikes). Hence, we target 2.9% for end-15 and 3.2% for end-16.

## Australian 3-years – rising, but capped by the RBA

- **Australian 3-years:** Aussie 3-years continue to yield below the current 2% RBA cash rate, and are expensive relative to history (Figure C). While 3-year bond yields are likely to remain near cash for this year, a late year US Fed tightening and the eventual pricing-out of further RBA cuts should see yields rise above cash rate, albeit remaining capped as the RBA stays at its cycle low for a prolonged time. We target 2.0% end-15, rising to 2.5% end-16.

## Curve – modest flattening as RBA steady in 2016

- **Yield curve:** The 10-3s curve has bear steepened modestly through the year. From here, we look for a modest bear flattening through 2016, as a steady RBA dominates a modest rise in global long-yields.

## AU-US 10-year spread – tightening pressure stays

- **Australian-US 10-year spread:** The Australian-US spread has tightened to 50bp this year, as forecast. We anticipate further, albeit modest, tightening from here (Figure D), and target 40bp end-16.

Source for text and charts: Bloomberg, Factset, UBS

\* UBS forecasts for end 2015 & 2016

Figure A: US 10-year bond yield

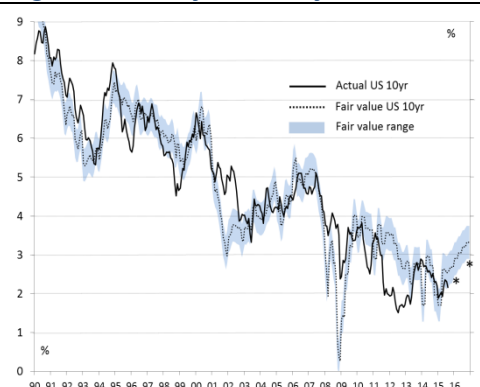


Figure B: Australian 10-year bond yield

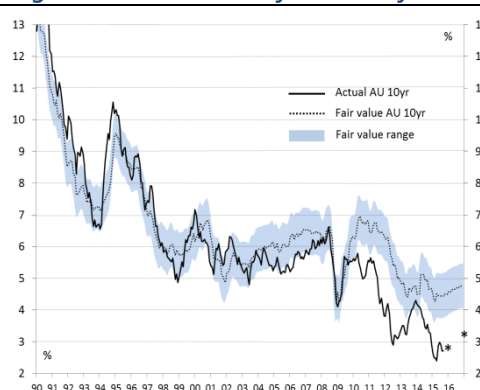


Figure C: Australian 3-year bond yield

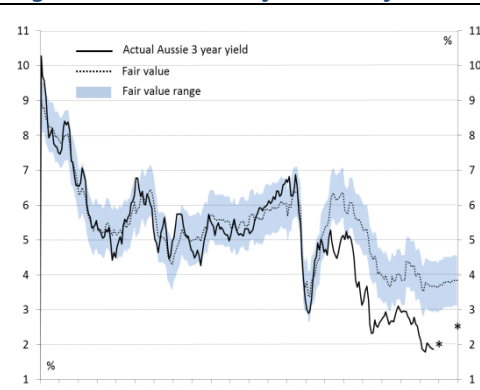
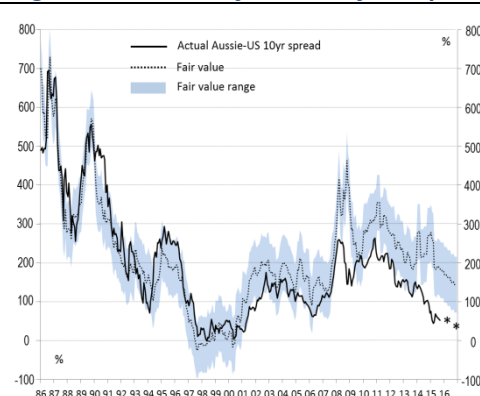


Figure D: AU-US 10-year bond yield spread



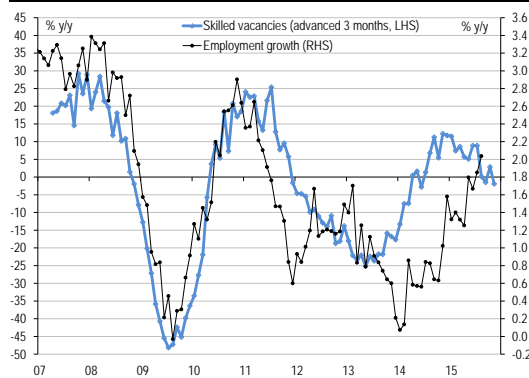
## Week in Review: 21<sup>st</sup> – 25<sup>th</sup> September

The Commonwealth Government Final Budget Outcome for 14/15 showed an underlying cash deficit of \$37.8bn. Data was mixed. Q2 ABS residential prices re-accelerated as expected, but Q1 population rose at its slowest y/y pace in nearly a decade. The Q2 non-financial debt-GDP ratio remained at a record 244%. August skilled vacancies retraced. The weekly ANZ Roy Morgan consumer confidence series jumped 9% following the change in Australia's Prime Minister.

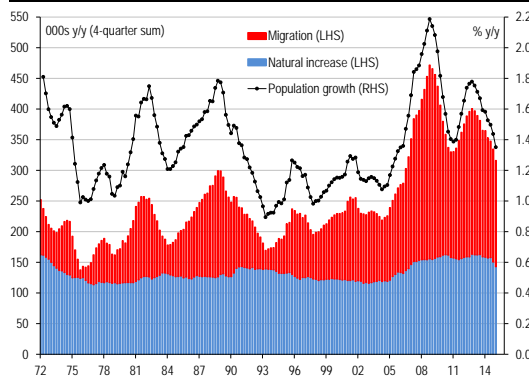
Offshore, Fed chair Yellen said that "it will likely be appropriate to raise the target range for the federal funds rate sometime later this year". US data was mixed. August existing home sales retraced, while new home sales and July house prices rose more than expected. August durables retraced, but the September mfg PMI stayed positive. Elsewhere, EU mfg and composite PMI's fell and the CH mfg PMI signalled a deeper contraction. Aug JP core CPI turned negative.

Over the week to noon, the AUD retraced 2.5% to 0.700, the ASX 200 fell 2.3% to 5042 and 10-year bond yields rallied 9bp to 2.68%.

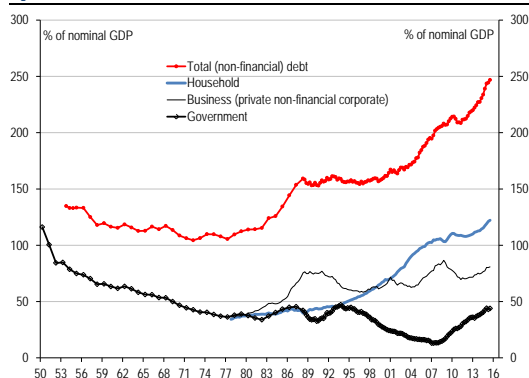
### August skilled vacancies retraced 1.0% m/m, dragging the y/y negative (-1.9%)



### Q1 population slowed to near decade y/y lows



### A strong rise in household borrowing kept the Q2 debt-GDP ratio at a record 244%



Source: ABS, BIS, Department of Employment, UBS

- Q2 **ABS residential prices** rose 4.7% q/q, the fastest q/q rise since the Q4-09 post GFC rebound, with the y/y re-accelerating sharply to 9.8%. Strength was concentrated in Sydney, where residential prices bounced the most on record (+8.9% q/q and +18.9% y/y) and Melbourne (+4.2% q/q and +7.8% y/y).
- August Department of Employment **skilled vacancies** retraced 1.0% m/m (after +1.7% m/m in July), dragging the y/y to -1.9%, the weakest since Mar-14. However, recent weakness may be overstated due to measurement difficulties.
- The Commonwealth Government's **Final Budget Outcome** for 14/15 showed an underlying cash deficit of \$37.8bn, \$3.3bn better than the \$41.1bn at the Budget. However the total non-financial public sector fiscal balance was \$0.7bn worse than in the Budget, with a \$44.7bn deficit for 14/15.
- Q1 **population** rose 0.4% q/q, with the y/y slowing to the lowest since Q4-06, up just 1.4% (+316k y/y) – as net migration and births slowed to near decade y/y lows. However, the [ABS](#) note that the lower than usual number of birth registrations could be due to new data processing systems in NSW and VIC.
- Total Q2 **non-financial debt** (household + business + government) remained at a record 244% of GDP, with weakness in business and government offset by a strong rise in household borrowing.



## Week Ahead: 28<sup>th</sup> September – 2<sup>nd</sup> October

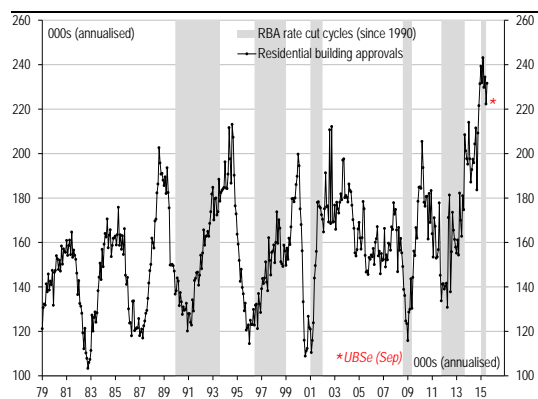
Data is likely mixed. The focus will be on the extent Aug retail sales (Fri) bounce after last month's surprising drop, while resi building approvals (Wed) are seen retracing after last month's strength. Aug credit (Wed) growth likely stayed around 6% y/y, but Sep house prices are seen still accelerating y/y (Thu). Q2 engineering starts (Wed) will provide some insight into 2H16 capex. Elsewhere, Sep RBA \$A commodity prices (Thu) and the manufacturing PMI (Thu) are also due.

Offshore, Fed's Yellen (Wed) speaks again, with attention on Friday night's jobs payrolls, which are seen below the recent average (+145k), albeit the UR is expected to drop further to 5.0%. US Aug spending (Mon) likely rose, but core PCE (Mon) is expected to only tick up 0.1%. The mfg ISM (Thu) and PMI (Thu) are seen mixed. Elsewhere, Sep EU CPI (Wed) is seen flat y/y. JP Aug IP (Wed) is out, while the Q3 Tankan (Thu) may retrace modestly. CH & EU PMI's (Thu) update global growth.

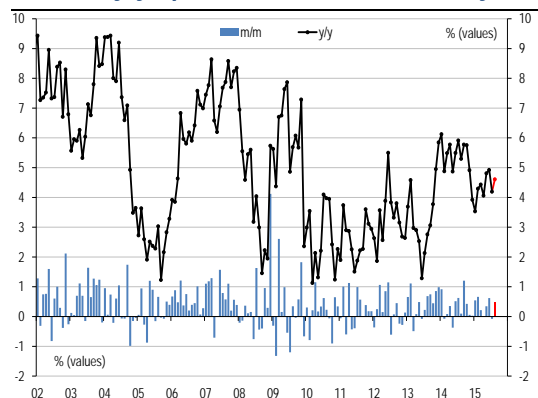
Date	Time (AEDT)	Data/Event	UBS	Market*	Previous
30-Sep	11:30	Credit (Aug)	+0.4%	+0.5%	+0.6%
30-Sep	11:30	Residential building approvals (Aug)	-4.0%	-2.0%	+4.2%
30-Sep	11:30	Engineering construction commencements (Q2)	nf	nf	-15.0%
1-Oct	9:30	Manufacturing PMI (Sep)	nf	nf	51.7
1-Oct	10:30	CoreLogic-RP Data dwelling prices (Sep)	+0.4%	nf	+0.3%
1-Oct	11:30	ABS job vacancies (Aug qtr)	-0.5%	nf	+2.0%
1-Oct	16:30	RBA \$A commodity prices (Sep)	nf	nf	-1.0%
2-Oct	11:30	Retail sales – values (Aug)	+0.5%	+0.4%	-0.1%

Source: ABS, Bloomberg, RBA, Reuters, Dow Jones \* Market may not be final

### Sep residential building approvals may retrace ~4% m/m to a still solid 222k a.r.



### Aug retail sales are seen bouncing 0.5%, with the y/y up to 4.6% (after 4.2% in July)



Source: ABS, RBA, UBS

### Credit (Aug)

In-line with our long standing view that credit growth has peaked, we expect credit to rise 0.4% m/m in August, holding the y/y at 6.1%.

### Building approvals (Aug)

After the July bounce in residential building approvals, we expect a 4% retracement in August to a 222k a.r., which sees approvals flat over the last 2 months. This sees the y/y falling to a still above average 5.1%.

### Retail sales (Aug)

Retail sales (values) are seen bouncing 0.5% in August (after -0.1% in July was the first negative print since May 2014), with the y/y rising to 4.6% (after 4.2%).

### Job vacancies (Aug qtr)

ANZ job ads suggest that ABS job vacancies likely retraced 0.5% q/q in August, partly offsetting the 2.0% rise in May. This moderates the y/y to a below average 5.9% (after May rose 6.3% y/y).

### CoreLogic-RP Data dwelling prices (Sep)

Daily data show CoreLogic-RP Data dwelling prices likely lifted 0.4% m/m in September (after +0.3% in Aug). This still sees the y/y bouncing to 10.5% (after 10.2% in Aug was near the fastest pace in a year).

# Economic Calendar

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
----- 21 September -----	----- 22 September -----	----- 23 September -----	----- 24 September -----	----- 25 September -----
NZ TOURIST ARRIVALS (Aug) Act: +0.2%, Pre: -2.7%	AU ABS RESIDENTIAL PRICES (Q2) Act: +4.7%, Pre: +1.6%	AU SKILLED VACANCIES (Aug) Act: -1.0%, Pre: +1.7% r	AU POPULATION (Q1, y/y) Act: +1.4%, Pre: +1.4%	JP CORE CPI (Aug) Act: -0.1%, Pre: +0.0%
NZ CREDIT CARD BILLS (Aug) Act: +1.1%, Pre: +1.7%	US FHFA HOUSE PRICES (Jul) Act: +0.6%, Pre: +0.2%	US MFG PMI (Sep p) Act: 53.0, Pre: 53.0 (Aug f)	AU FINANCIAL ACCOUNTS (Q2) RBA HEATH SPEECH	US GDP (Q2 f) UBS: +3.7%, Pre: +3.7% (Q2 p)
NZ WBC CONS. CONF. (Q3) Act: 106, Pre: 113		CH CAIXIN MFG PMI (Sep p) Act: 47.0, Pre: 47.3 (Aug f)	NZ TRADE BALANCE (Aug) Act: -\$1035mn, Pre: -\$726mn r	US UM CONS. CONF. (Sep f) UBS: 87.0, Pre: 85.7 (Sep p)
US EXISTING HOME SALES (Aug) Act: -4.8%, Pre: +1.8% r		EU MFG PMI (Sep p) Act: 52.0, Pre: 52.3 (Aug f)	US DURABLE GOODS (Aug) Act: -0.2%, Pre: +2.1% r	
		EU COMPOSITE PMI (Sep p) Act: 53.9, Pre: 54.3 (Aug f)	US NEW HOME SALES (Aug) Act: +5.7%, Pre: +12.0% r	
			FED CHAIR YELLEN SPEECH	
			GE IFO (Sep) Act: 108.5, Pre: 108.4 r	
----- 28 September -----	----- 29 September -----	----- 30 September -----	----- 1 October -----	----- 2 October -----
US SPENDING (Aug) UBS: +0.3%, Pre: +0.3%	US S&P/CS HOME PRICES (Jul) UBS: +0.1%, Pre: +0.1%	AU CREDIT (Aug) UBS: +0.4%, Pre: +0.6%	AU MANUFACTURING PMI (Sep) Mkt: nf, Pre: 51.7	AU RETAIL SALES (Aug) UBS: +0.5%, Pre: -0.1%
US CORE PCE (Aug) UBS: +0.1%, Pre: +0.1%	US CB CONS. CONF. (Sep) UBS: 95.0, Pre: 101.5	AU BUILDING APPROVALS (Aug) UBS: -4.0%, Pre: +4.2%	AU CL-RP DWELLING PRICES (Sep) UBS: +0.4%, Pre: +0.3%	NZ ANZ COMMODITY PRICE (Sep) Mkt: nf, Pre: -5.2%
US PENDING HOME SALES (Aug) UBS: +0.3%, Pre: +0.5%		AU ENGINEERING STARTS (Q2) Mkt: nf, Pre: -15.0%	AU ABS JOB VACANCIES (Aug, qtr) UBS: -0.5%, Pre: +2.1%	US PAYROLLS (Sep) UBS: +145k, Pre: +173k
		NZ DWELLING CONSENTS (Aug) Mkt: nf, Pre: +20.5%	AU \$A COMMODITY PRICE (Sep) Mkt: nf, Pre: -1.0%	US UNEMPLOYMENT RATE (Sep) UBS: 5.0%, Pre: 5.1%
		NZ ANZ OWN ACTIVITY (Sep) Mkt: nf, Pre: 12.2%	US MFG PMI (Sep f) Mkt: 53.0, Pre: 53.0 (Sep p)	US FACTORY ORDERS (Aug) Mkt: -0.6%, Pre: +0.4%
		NZ HOUSEHOLD CLAIMS (Aug) Mkt: nf, Pre: +0.7%	US MFG ISM (Sep) Mkt: 50.6, Pre: 51.1	JP UNEMPLOYMENT RATE (Aug) UBS: 3.2%, Pre: 3.3%
		US ADP PAYROLLS (Sep) Mkt: +188k, Pre: +190k	CH OFFICIAL MFG PMI (Sep) Mkt: nf, Pre: 49.7	
		FED CHAIR YELLEN SPEECH	CH CAIXIN MFG PMI (Sep f) Mkt: nf, Pre: 47.0 (Sep p)	
		EU UNEMPLOYMENT RATE (Aug) Mkt: 10.9%, Pre: 10.9%	EU MFG PMI (Sep f) UBS: 52.3, Pre: 52.0 (Sep p)	
		EU CPI (Sep p, y/y) Mkt: +0.0%, Pre: +0.1% (Aug f)	JP TANKAN (Q3) UBS: 14, Pre: 15	
		JP IP (Aug p) Mkt: +0.9%, Pre: -0.8% (Jul f)		
		UK GDP (Q2 f) UBS: +0.7%, Pre: +0.7% (Q2 p)		
----- 5 October -----	----- 6 October -----	----- 7 October -----	----- 8 October -----	----- 9 October -----
AU SERVICES PSI (Sep) Pre: 55.6	AU TRADE BALANCE (Aug) Pre: -\$2460mn	AU CONSTRUCTION PCI (Aug) Pre: 53.8	AU EMPLOYMENT (Sep) Pre: +17.4k	AU HOME LOANS O/O NO. (Aug) Pre: +0.3%
AU ANZ JOB ADS (Sep) Pre: +1.0%	AU VISITOR ARRIVALS (Aug) Pre: -0.1%	AU HIA NEW HOME SALES (Aug) Pre: -1.8%	AU UNEMPLOYMENT RATE (Sep) Pre: 6.2%	AU HOME LOANS VALUES (Aug) Pre: +1.1%
AU HOLIDAY AU Markets open	RBA DECISION (Oct) Pre: 2.00%	BOJ DECISION (Oct) Pre: 0.1%	FED MINUTES (Sep) ECB MINUTES (Sep) BOE DECISION (Oct) Pre: 0.50%	NZ ELECTRONIC CARDS (Sep) Pre: +0.1%
US NON-MFG ISM (Sep) Pre: 59.0	NZ QSBO EXP TRADING (Q3) UBS: 0%, Pre: 12.7%	UK IP (Aug) Pre: -0.4%		CA EMPLOYMENT (Sep) Pre: +12.0k
EU COMPOSITE PMI (Sep f) Pre: 53.9 (Sep p)	US TRADE BALANCE (Aug) Pre: -\$41.9bn			
----- 12 October -----	----- 13 October -----	----- 14 October -----	----- 15 October -----	----- 16 October -----
AU FINANCE COMMITMENTS (Aug) Pre: -1.0%	AU NAB BIZ CONDITIONS (Sep) Pre: +10.7	AU WMI CONS. CONF. (Oct) Pre: -5.6%	AU CAR SALES (Sep) Pre: -1.6%	RBA FIN STABILITY REVIEW (Oct)
	AU NAB BIZ CONFIDENCE (Sep) Pre: +0.7	US RETAIL SALES (Sep) Pre: +0.1%	NZ MFG PMI (Sep) Pre: 55	NZ CPI (Q3) UBS: +0.2%, Pre: +0.4%
	RBA LOWE SPEECH	US PPI (Sep) Pre: +0.3%	NZ ANZ-RM CONS. CONF. (Oct) Pre: 110.8	US IP (Sep) Pre: -0.4%
	NZ FOOD PRICE INDEX (Sep) Pre: -0.5%	FED BEIGE BOOK (Oct)	US CORE CPI (Sep) Pre: +0.1%	US UM CONS. CONF. (Oct p) Pre: 85.7 (Sep p)
	CH TRADE BALANCE (Sep, USD) Pre: \$60.2bn	CH CPI (Sep, y/y) Pre: +2.0%	JP IP (Aug f) Pre: -0.8% (Jul f)	EU CPI (Sep, y/y) Pre: +0.2%
	UK CPI (Sep, y/y) Pre: +0.0%	EU IP (Aug) Pre: +0.6%		
		UK UNEMPLOYMENT RATE (Aug) Pre: 5.5%		
UBS: UBS Forecast Pre: Previous Release Act: Actual Mkt: Market a: advanced r: revised p: preliminary f: final nf: no forecast Note: Dates subject to change				

## Global Economics

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