Upturn in credit points to better times

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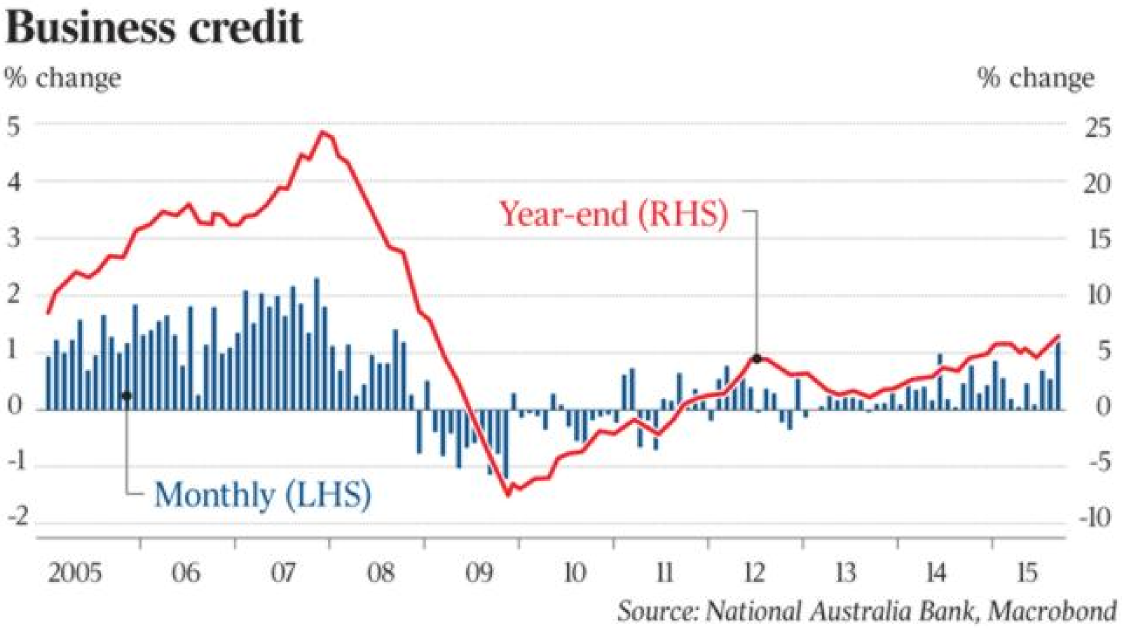

Business credit upturn. *Source:* TheAustralian

For much of this year, investors have taken a highly negative view on the outlook for the Australian economy and sharemarket.

They've worried about three major headwinds.

• The sharp decline in mining investment, which needs to be offset by increases in other forms of spending.

• A much-feared hard landing in China, the destination for a third of Australia's exports.

• The potential for a bubble, and then a collapse, in housing prices that would destabilise the economy, in part by weakening the banks.

In my view, these concerns have been taken to exaggerated levels. In coming months, investors can expect to find opportunity — and fun — in spotting the green shoots of the next economic upswing. The transitioning to non-mining growth has received short-term help from the cyclical pick-up in home building.

However, with pent-up housing demand now being satisfied, bank lending for investment - housing slowing and rental returns falling, we should see house construction likely to plateau in 2016.

Public spending on infrastructure will be boosted, particularly as funds from the privatisation of government-owned “poles and wires” in NSW are spent.

And the marked fall in value of the Australian dollar — in two years it has declined by more than a fifth against the US dollar and Chinese currencies — is helping to lift economic activity.

What’s also needed is a good increase in investment by non-mining companies.

Maybe, the unexpected rise of 1.2 per cent in business credit in September — the fastest increase since 2008 — is the first green shoot of that recovery.

Of course, one month’s figure can’t be relied on as a predictor of a turning point in the economic cycle. In coffee shop chatter, the lift in business credit in September is attributed to the “Turnbull effect”, or to the accelerated depreciation allowance for small business included in the May budget, or to other causes — no one is sure.

As Hugh Harley, financial services Asia leader at PricewaterhouseCooper, puts it: “The strong growth in business credit in September certainly warrants attention. The optimists will say it is a precursor to a sustained pick-up in business investment; the pessimists will ask whether it reflects an unexpected run down in working capital.”

But I like the way Tapas Strickland, an economist at National Australia Bank, relates the strong figure for business credit to signs of the better business conditions the bank has been finding in its monthly surveys.

He writes: “The pick-up in business credit is consistent with above average business conditions recorded in the NAB survey. If business credit continues to print at these rates, it would underpin a prospective recovery in non-mining business investment which remains the missing piece in the (Reserve Bank’s) transition story to non-mining led growth.”

Investors should keep a close watch on monthly figures for business credit (they’re readily available in the financial aggregates table on the RBA’s website). The stronger the growth in business credit, the brighter the outlook for the economy, and the sharemarket.

Where should investors look for other possible sightings of the green shoots of recovery? In the next few months, some monthly statistics are likely to dispel fears of a hard landing for the Chinese economy. Among other consequences, this will make it clear the low commodity prices we’re experiencing are more the result of increased global production, and owe less to China’s growth slowdown than is usually claimed.

I’m encouraged by the increasing number of comments along the lines of “China has hit the cyclical trough. We expect further improvement in coming months.” The words I’ve quoted are from a report released by Danske Bank. This point of view is catching on.

The third area of concern is fear of boom-bust in house prices. In Australia, “unsustainable” increases in average house prices are usually corrected via prices making a lengthy sideways move rather than by collapsing. Several quarters of near-stability in average house prices would be good for confidence.

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