Westpac Institutional Bank

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Leading Index signals slowdown ahead

The six month annualised deviation from trend growth rate of the Westpac Melbourne Institute Leading Index which indicates the likely pace of economic growth three to nine months into the future rose to –0.75% in May from –1.12% in April.

Westpac Senior Economist, Matthew Hassan commented, "Despite an improvement over the last month, the Leading Index continues to point to a significant loss of momentum. The growth rate has now been below trend for four months in a row and is consistent with a slowdown over the second half of 2014 carrying into early 2015".

"Last month we noted that some of the some factors contributing to the current slowdown may prove to be temporary – a sharp fall in consumer sentiment following the Budget, holiday-related shifts in hours worked and adverse weather conditions in the US. The May update confirmed this with the combined effect of a modest bounce in sentiment, a strong uptick in hours worked and a rise in US industrial production driving the month to month improvement."

"Even with this improvement, the broader picture from the Leading Index is still of a slowdown. At this stage, the Leading Index growth rate is not overly weak. It is similar to the sub-trend readings in late 2012 but comfortably above the lows in 2011 and well above the levels seen heading into economic contractions.

However, the evidence of a turning point is strong with a clear swing from above trend growth late last year to below trend growth now. Moreover, that turnaround has been consistent across nearly all of the Index's components. The 1.7ppt drop in growth from +0.95% in December to –0.75% in May has centred on five main components: interest rate spreads (–0.61ppts); dwelling approvals (–0.43ppts); commodity prices (–0.41ppts); the Westpac-MI Expectations Index (–0.22ppts); and the ASX (–21ppts). There has been a minor offset to these drags from improvements in aggregate monthly hours worked (+0.18ppts) and US industrial production (+0.06ppts).

"The May reading saw the Index rise 0.07pts from 98.01 in April to 98.08. Amongst the components, there were notable monthly improvements in aggregate monthly hours worked (+1.68%), the Westpac-MI Expectations Index (+1.64%); US industrial production (+0.59%) and the Westpac-MI Unemployment Expectations Index (–1.14% indicating an improved outlook for unemployment). Working against this were further declines in commodity prices (–1.01%), dwelling approvals (–5.57%), and a sharp narrowing in the yield spread (–0.26ppts). The ASX was up slightly in May (+0.07%) but has declined significantly since then (–1.7% in June to date). Commodity prices have also moved lower so far in June with a further narrowing in the yield spread as well.

"The Reserve Bank Board next meets on July 1. The minutes to the June Board meeting repeated the line that the "current accommodative stance of policy was likely to be appropriate for some time yet" but struck a less confident tone, placing more emphasis on the uncertainty of the transition from mining to non-mining led growth.

The sustained high AUD in the face of falling commodity prices, the sharp fall in consumer sentiment since May and signs of slowing in consumer spending and housing markets have all added to the Bank's unease. This month's Leading Index highlights just how much these and other shifts have affected growth momentum with a slowdown likely over the remainder of 2014 and early 2015. On balance, the slowdown does not look to be sufficiently threatening for the RBA to shift its stance. We expect the Bank to again leave rates on hold at its July meeting and through the remainder of 2014 and the first half of 2015. ", Mr Hassan said.

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