Westpac Institutional Bank

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# Media release

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## Leading Index continues to weaken

The six month annualised deviation from trend growth rate in the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, decreased from –1.00% in December to –1.24% in January.

Westpac's Chief Economist, Bill Evans commented, "Disappointing results continue. The Index has now been growing below trend for the last nine months. It continues to signal that growth in the Australian economy in the first half of 2016 will be below trend. Today's print represents the largest negative deviation we have seen since the second half of 2011.

"As discussed below the components of the Index which reflect or are heavily influenced by international forces are weakening its growth whereas domestic sourced components particularly around the labour market and confidence are providing an offsetting boost.

"Recall that both Treasury and the Reserve Bank are now assessing trend (or potential) growth at 2.75%. Westpac's current forecast for 2016 entails an annual growth pace in the first half of 2016 of 2.75% (trend). The signal from the Leading Index is increasingly pointing to downside risks to that forecast.

"The Government's near term growth forecasts (2015/16 and 2016/17) are slightly weaker than our own forecasts after it revised down its May Budget forecasts following the Mid-Year Economic and Fiscal Outlook to 2.5% in 2015/16 and 2.75% in 2016/17.

"Westpac is expecting growth of 2.8% in 2015/16 and 2.7% in 2016/17.

"The Reserve Bank's forecasts, which were released on February 5, are 2–3% for 2015/16 (up from 2.25% in November) and 2.5%–3.5% in 2016/17 (unchanged from November). The Bank has a slightly more cautious outlook in the near term but is a little more optimistic further out than the Westpac and Government forecasts.

"Based on the Reserve Bank's forecast for GDP growth through to June 2016 (2–3%) we can impute that they are expecting growth in the first half of 2016 at an annualised pace of 2.5% – below trend and consistent with the signal from the Leading Index.

"Over the last six months growth in the Index has slowed from 1.04% below trend to 1.24% below trend.

"Components of the Index which have contributed to the slowdown are: the yield spread (–0.39ppts) and US industrial production (–0.26ppts). The drag from the AUD value of commodity prices has increased only slightly (–0.05ppts) with price falls mostly offset by declines in the AUD. Dwelling approvals have also been a slightly bigger drag (–0.04ppts). The impact of these components was partially offset by a positive contributions from: the Westpac–MI Consumer Sentiment Expectations Index (0.20ppts); the Westpac MI Unemployment Expectations Index (+0.19ppts) and aggregate monthly hours worked (+0.17ppts). The ASX has been a persistent drag on the Leading Index growth rate over the six months but its contribution is unchanged.

“The theme of international factors which are represented by the share market; the yield curve; US industrial production and commodities weighing on the Index while being partially offset by an improving labour market and solid confidence is clearly captured in the divergent movements of the components of the Index.

“The Reserve Bank board next meets on March 1. We expect that the Board will decide to keep rates on hold. We also expect that rates will be on hold for the remainder of 2016. Markets are confidently expecting at least one rate cut by the RBA through 2016.

“The picture of the economy which is encapsulated in the Index neatly summarises the key issues for policy. International factors are pointing to downward pressure on rates whereas domestic factors, partly due to the boost to the economy from the low Australian dollar and low interest rates, are sending positive signals. That interaction over the course of 2016 will determine whether markets are correct,” Mr Evans said.

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