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Leading Index points to material drag on growth

The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, fell from –1.07% in February to –1.53% in March.

Westpac Senior Economist, Matthew Hassan commented, “The Leading Index continues to point to a material loss of momentum and growth pulling back to below trend rates through the middle of the year. A negative Index growth rate indicates below trend momentum. At –1.53% the March reading is below the lows seen in 2014 and the weakest print since late 2011.” Mr Hassan said.

“However, some of the causes of the current weakness in the Leading Index are likely to be transitory. In particular, the Index growth rate – a six monthly measure – is still being heavily impacted by the sharp fall in Australian commodity prices in the second half of 2015. Prices have since posted a solid rally and although it remains to be seen how well this will be sustained, even a pull-back that left prices flat overall would see the drag on the Index from this component ease.

“Between October and March the six month annualised growth rate of the Index has slowed from 0.33% below trend to 1.53% below trend. The main components driving the slowdown have been: the AUD value of commodity prices (contributing –0.39ppts); US industrial production (–0.33ppts); aggregate monthly hours worked (–0.33ppts); a narrowing yield spread (–0.30ppts); and the Westpac MI Unemployment Expectations Index (–0.25ppts). These sizeable negatives have been partially offset by a reduced drag from the ASX (+0.35ppts). Notably, all eight components are generating a 'below trend' growth signal.

"The bulk of the weakness continues to come from external factors. Commodity prices, US industrial production and the yield gap account for over two thirds of the negative deviation in the Index growth rate (i.e. 1.1ppts of the 1.53% below trend headline read). Note that the commodity price measure also captures some of the negative impact from the recent AUD rise – the AUD commodity price index used is down 2% since November despite a 2.5% rise in commodity prices in USD terms.

"The Index declined 0.12pts in the March month, from 96.71 to 96.59. Amongst the components: the S&P/ASX 200 index was up 4.1%; dwelling approvals rose 3.1% and the Westpac-Melbourne Institute Unemployment Expectations Index fell 1.8% (indicating an improvement); but the Westpac-Melbourne Institute Consumer Sentiment Expectations index fell 6.1% and hours worked declined 1.1%. Commodity prices and the yield spread were largely unchanged in the month.

"The Reserve Bank Board next meets on May 3. The Leading Index continues to point to challenging conditions near term, emphasising the downside risks to growth from external developments and the 'complicating' effect of the recent rise in the currency. A continued easing bias from the RBA is clearly appropriate. However, the stronger than expected performance of the domestic economy over the second half of 2015, which the RBA assesses as having continued into early 2016, is expected to see the

Bank again leave rates on hold in May. Although there are significant risks around the outlook we remain comfortable retaining our call that interest rates will remain on hold for the rest of 2016”, Mr Hassan said.

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