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Leading Index shows momentum stalling

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 in the future, declined from +0.19% in April to –0.02% in May.

Westpac Senior Economist, Matthew Hassan commented, "The Australian economy appears to have suffered a loss of momentum. After a promising start with four months of above-trend reads, the Leading Index growth rate has effectively dropped back to zero in May indicating a more subdued growth pulse in line with long run averages.

"That still marks an improvement on 2014 which saw the Index stuck firmly in negative territory and an average growth rate of –0.54%. However, the stalling momentum mid-year is a concern given the recent reduction in interest rates and hopes that this would help generate a more convincing upswing in Australia's consumer and non-mining business sectors.

"The component detail highlights the crosswinds currently pulling on the economy. Overall, the Index growth rate has lifted from –0.61% in December to –0.02% in May. Component-wise, the 0.59ppt improvement has been mainly due to a turnaround in aggregate hours worked (+0.55ppts), a widening yield spread (+0.50ppts) and a better performance from the sharemarket (+0.24ppts). There have been some significant drags though, particularly from the external sector with declining US industrial production taking 0.59ppts off growth and continued falls in the AUD value of commodity prices an additional 0.16ppts. Aside from these external factors, the more recent loss of momentum over the last three months has been due to a combination of slower growth in dwelling approvals and a drop in consumer sentiment.

“The Index declined 0.13% in the May month, from 98.05 to 97.93. Nearly every component contributed to the decline. Consumer sentiment posted a large reversal – the Westpac-Melbourne Institute Expectations Index slumping 11.3% and the Westpac-Melbourne Institute Unemployment Expectations index rising 3.8% (a deterioration, the rise indicating more consumers expect unemployment to move higher). The month also included negatives from US industrial production (–0.2%), commodity prices (–2.1% in AUD terms) and dwelling approvals (–4.4%). The S&P/ASX 200 dipped 0.2% in May with a very weak start to June (–4% month to date) suggesting sharemarket falls may become more of drag in coming months.

The sole positive in the month was a widening yield spread (+0.58bps) courtesy of lower short term rates following the RBA’s May cut and higher bond rates globally – the rate mix broadly indicative of more expansionary financial settings.

“The Reserve Bank Board next meets on July 7. We expect that the Board will hold rates steady at this meeting as it looks to assess the impact of recent rate cuts, the pace of consumer demand through the middle of the year and, in turn, prospects for growth in 2016. The Bank will also be watching for confirmation that regulatory measures are working to contain potential risks in parts of the housing market.

"Our current view is that rates will remain on hold throughout 2015 and 2016. Today's Leading Index result adds to recent evidence of disappointing growth momentum and casts more doubt over prospects for a pick-up in 2016. Recent comments from the RBA Governor confirm that the Bank has been disappointed by recent economic data, noting that 'the economy could do with some more demand growth over the next couple of years' and that the RBA remains 'open to the possibility of further policy easing'.

"The case for even lower rates is strengthening. That may see the RBA Board shift to an 'explicit easing bias' in coming meetings but this is unlikely to be acted on unless there is clear evidence that growth is likely to significantly undershoot the Bank's forecasts for 2016." Mr Hassan said.

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