Consumer caution in Australia

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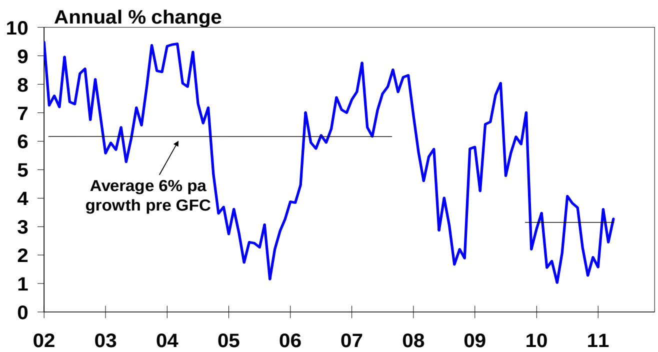
Key points

- Consumer caution is clearly evident in Australia with soft retail sales growth, a return to mid 1980s savings rates and a slowdown in household debt growth to a crawl. The 20 year booming consumer economy from the mid 1980s is over.
- This reflects a combination of factors: renewed awareness post the global financial crisis (GFC) of the dangers of excessive debt, increased sensitivity to higher interest rates, strong increases in the cost of necessities and rising levels of overseas and online spending.
- Look for some relief going forward as household savings rates have now been rebuilt, providing a huge buffer for consumers. However, the mining boom probably means consumers will have to stay cautious, whether they want to or not, to avoid an overheating economy (with higher interest rates providing the ultimate enforcement mechanism). It's hard to see the growth rate in retail sales going back to pre GFC levels.

Introduction

Over the last year or so there has been much talk of consumer caution in Australia. This has been evident in sluggish annual retail sales growth of around 2 to 3% per annum, compared to a norm prior to the GFC of just over 6% per annum. It's also evident in a household savings ratio which has increased to 11.5% from zero or below just six years ago. So why have consumers become so cautious? What is the outlook?

Sluggish nominal retail sales growth



Source: ABS, AMP Capital Investors

Why all the caution?

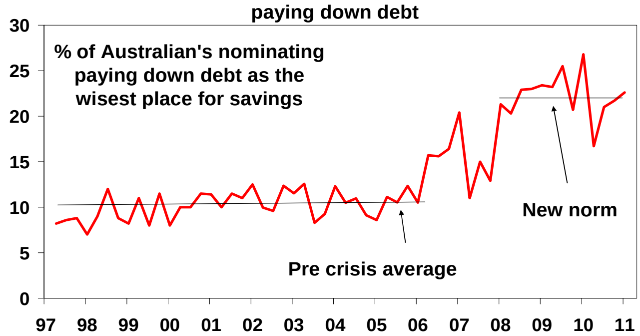
There are several factors at play behind the new found caution of consumers. The first is an attitudinal change towards debt and savings. From the mid 1980s until about five years ago, consumer spending was supercharged by a combination of rising household debt levels and a fall in the household savings rate from around 15% to around zero. See the next chart. Debt was in, saving was out. This was driven by a combination of easy credit post financial deregulation, falling interest rates making debt more affordable, younger generations becoming more comfortable with debt as memories of serious economic problems faded, and rapidly rising wealth levels making active savings seemingly less necessary.

Household savings and household debt

Source: RBA, ABS, AMP Capital Investors

This has now reversed with the GFC providing a long overdue reminder that debt is risky, jobs are not as secure as thought and people cannot rely on rapid asset price growth alone to provide for retirement. As a result, savings are back in vogue, with the savings rate running at 11.5% and the pace of increase in household debt slowing to a crawl. Of course, the relationship between savings and debt is not perfect (eg households can boost savings and use this to increase their investments without paying down their debts), but the previous chart shows a rough relationship which also gels with the high proportion of Australians now responding to the Westpac/Melbourne Institutes' consumer sentiment survey that paying down debt is the "wisest place for savings". Over the years, up until 2006, only around 10% of surveyed consumers nominated paying down debt as the wisest place for savings, whereas now it's around 22% of consumers.

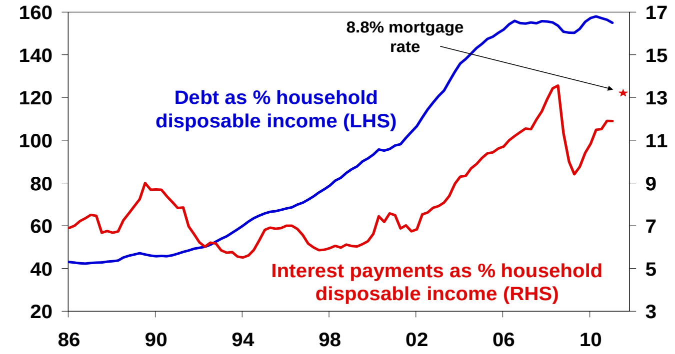
A higher proportion of Australians' are focussed on paying down debt



Source: Westpac/Melbourne Institute, AMP Capital Investors

Second, the debt build up of the past has left households very vulnerable to higher interest rates. This is particularly so for those who entered the housing market on the back of the first home owners' boosts and generational lows in mortgage rates in late 2008 and 2009. So talk and the reality of higher interest rates have only added to a more cautious attitude on the part of consumers.

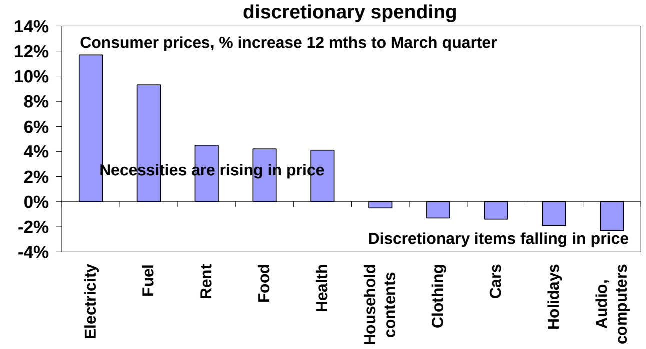
High household debt means greater interest rate sensitivity



Source: RBA, AMP Capital Investors

Third, the portion of the household budget allocated to necessities such as power and water bills, fuel, rent, insurance and health is rising rapidly. Utility costs are up nearly 50% over the last four years alone, and top the list of concerns identified by Australians in the latest AMP Shopping Intent survey. This is a real issue as the bottom fifth of households by income spend nearly 9% of their income on electricity, and the bottom fourth spend 5%. Rising prices for necessities means less money left over to spend on more discretionary items such as household goods, clothing, cars, holidays and computers even though they have been falling in price. See the next chart.

The rising cost of necessitities is leaving less room for discretionary spending



Source: ABS, AMP Capital Investors

Finally, while the importance of online spending is only small at around 3% of consumer spending, it is growing rapidly, and more importantly Australians are spending more and more time overseas thanks to a boom in international holidays on the back of the strong $A. Over the last year tourist arrivals in Australia are up by 4%, but Australians holidaying aboard have increased nearly 25%. What's more, Australian tourists abroad are spending roughly $800 million per month more than international tourists are spending in Australia. In short, Australians are becoming much more aware of how much lower retail prices are in other countries and along with increasing technological familiarity it's all likely to further fuel online spending growth going forward.

So what's the outlook?

The good news is with savings having been rebuilt, the retailing environment may improve a bit over the next six months. The fact the household savings rate has already rebounded, and many households are now paying debt down more quickly, is important as **it's the change in the savings rate, not its level, which is more important for growth in consumer spending**. Over the 20 years to 2005, the fall in the savings rate meant household spending was growing faster than incomes. The reversal in the savings rate over the last few years has meant consumer spending has had to grow more slowly than growth in incomes in order to boost savings. Now with savings having been rebuilt, households can grow their spending more in line with their income and continue to pay down their debt at the new higher savings rate. However, the bad news is a sustained return to the pre GFC average growth rate of 6% or more in annual retail sales is unlikely.

First, the pressure from higher spending overseas and online is likely to continue to intensify. In some ways this is becoming self reinforcing. While generation Y and those following has contributed to the closure of local CD and book stores, this has forced relative technological Neanderthals like me to go online for Elvis, The Partridge Family and Lady Gaga.

Second, the strength in prices for necessities is unlikely to show any let up. Electricity suppliers have underinvested, and state pricing regulators have allowed utility tariffs to rise to make up for this. This in turn will be reinforced by carbon pricing, resulting in further double digit price increases. Rents will remain subject to upwards pressure from the housing shortage. Health costs will continue to surge, reflecting new technologies and the aging population. Fuel costs will continue to rise solidly over time, reflecting emerging world industrialisation and constrained global oil supply.

And, finally, the Reserve Bank won't want to see a complete return to strength for consumer spending because it will add to the risk the economy could overheat at a time when the boom in mining investment is getting underway. The maths for the RBA is simple. Mining investment looks like rising between 50 to 80% over the year ahead. It currently amounts to 4% of GDP. This implies a real 2 to 3 percentage point contribution to economic growth. The speed limit for real economic growth in Australia is probably around 3.5 to 4%. Backing out the implication for the other 96% of the economy implies real growth of between 0.5% and 2%. This is well below historical norms. This means that while the Reserve Bank left interest rates on hold following its June meeting, the likelihood of more rate hikes ahead remains high. And with it also comes the risk that the RBA may end up going too far, tipping the non-mining parts of the economy into a deeper slump.

Concluding comments

On balance this suggests the pace of growth in nominal retail sales might step up a notch to around 4 to 5% per annum over the year ahead, but is unlikely to return to the average growth rate prior to the GFC of just over 6% per annum anytime soon.

This may all sound a bit bleak and for many retailers it is. As such, it's hard to get excited about retail stocks and related domestic cyclical shares even though valuations have become more attractive. The flip side though is if the Australian economy can grow 4% over the year ahead thanks to the mining boom without overheating. and at the same time reduce household debt or at least keep it under control, this will help reduce the vulnerability of the Australian economy going forward. It will also mean for once Australia will have managed a boom well, with less risk of the usual post boom hangover in the form of higher inflation or a trade deficit blowout.

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