

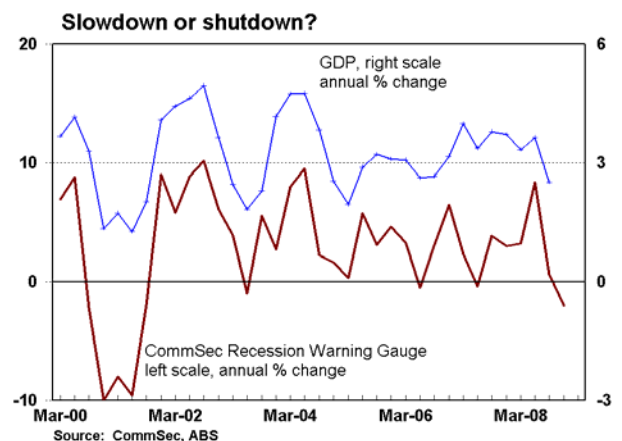
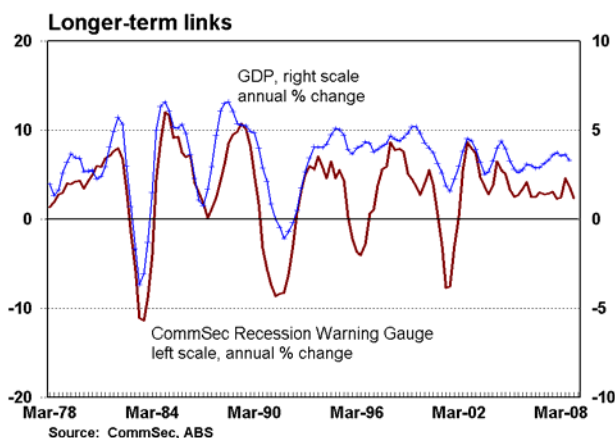
Slowdown or shutdown?

CommSec Recession Warning Gauge

- Despite the gloom abroad, a key warning indicator for the Australian economy is only pointing to a slowdown in activity, not a recession.
- The CommSec Recession Warning Gauge – a simple measure of manufacturing activity that has closely tracked movements in the broader economy for over 40 years.

What does it all mean?

- The CommSec Recession Warning Gauge clearly indicates that the economy has softened but is not showing the sort of weakness associated with past recessions in Australia.
- The CommSec Recession Warning Gauge is deceptively simple – tracking just three, but fundamentally important manufacturing commodities. Portland cement and pre-mixed concrete are essential to almost all construction activities – residential, commercial and engineering projects. And electricity production is fundamental to all household and business activity in the economy.
- Amazingly, an index based on production data for just three manufacturing commodities has an enviable record of tracking the broader Australian economy for more than 40 years. CommSec compiled production indexes for each of the three commodities and the annual rate of change was compared with the annual growth of the Australian economy.
- A recession hasn't occurred in Australia without the CommSec Recession Warning Gauge slumping into negative territory. However, the converse is not true. The CommSec Recession Warning Gauge has fallen below the zero line in the past and the economy has managed to avoid recession (going backwards for two straight quarters). Examples include the 2001 slowdown and the "growth recession" of 1995/96.
- The correlation, or measure of the relationship, between the CommSec Recession Warning Gauge and GDP (economic growth) over the past 45 years is around 65 per cent. That is a R squared ratio of 0.65 exists between GDP and the recession warning gauge, where perfect co-movement is defined by a ratio of 1.0.
- Data on Portland cement and electricity production extends back to March 1956 while figures on pre-mixed concrete date back to June 1976.
- To better assess longer-run trends, annual averages were used to 'smooth' the series. To gauge short-term



Craig James – Chief Economist (Author)
 (612) 9312 0265 (work)

Produced by Commonwealth Research based on information available at the time of publishing. We believe that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made as at the time of its compilation, but no warranty is made as to accuracy, reliability or completeness. To the extent permitted by law, neither Commonwealth Bank of Australia ABN 48 123 123 124 nor any of its subsidiaries accept liability to any person for loss or damage arising from the use of this report.

The report has been prepared without taking account of the objectives, financial situation or needs of any particular individual. For this reason, any individual should, before acting on the information in this report, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice. In the case of certain securities Commonwealth Bank of Australia is or may be the only market maker.

This report is approved and distributed in Australia by Commonwealth Securities Limited ABN 60 067 254 399 a wholly owned but not guaranteed subsidiary of Commonwealth Bank of Australia. This report is approved and distributed in the UK by Commonwealth Bank of Australia incorporated in Australia with limited liability. Registered in England No. BR250 and regulated in the UK by the Financial Services Authority (FSA). This report does not purport to be a complete statement or summary. For the purpose of the FSA rules, this report and related services are not intended for private customers and are not available to them.

Commonwealth Bank of Australia and its subsidiaries have effected or may effect transactions for their own account in any investments or related investments referred to in this report.

activity and turning points the raw production data was used.

- In the year to December quarter 2008, production of Portland Cement fell by 7.4 per cent – the biggest fall in 2½ years. Similarly production of pre-mixed concrete was down 6.1 per cent – the biggest fall since the last major slowdown in the Australian economy in 2001. By contrast electricity production rose by 5.5 per cent over the past year – the strongest gain in 4½ years. Other manufacturing indicators (not part of the CommSec Recession Warning Gauge) were beer (up 3.2 per cent on a year ago), clay bricks (up 1.9 per cent) and gas, down 1.5 per cent.

Past recessions

- In the 1990/91 recession, the CommSec Recession Warning Gauge fell for eight straight quarters, at its trough down 8.6 per cent on a year ago. In the 1982/83 recession, the warning gauge fell for six straight quarters, at its trough slumping by 11.4 per cent.
- In the 2001 slowdown, the CommSec Recession Warning Gauge fell for four straight quarter, down 7.6 per cent at the lowest point.
- While every recession has been associated with a slump in the Warning Gauge, not every downturn in the Warning Gauge has led to a recession.
- Currently the raw CommSec Recession Warning Gauge is down just 2.0 per cent on a year ago, the biggest drop since September quarter 2001. But the smoothed Warning Gauge (measuring rolling annual averages) still shows growth of 2.4 per cent.

Longer-term measure

- A longer-term measure of the CommSec Recession Warning Gauge has been calculated to 1958 using just cement and electricity production. Amazingly the smoothed growth measures show a correlation of 0.60, where a perfect relationship equals 1.0.

Targeted stimulus to avoid recession

- Given the dependency of the economy on the construction sector, it is understandable that interest rate cuts, first home owner grants, government handouts to councils and infrastructure spending have been at the heart of Australian stimulus efforts.
- While production of both concrete and cement have fallen over the past year, a revival is likely over 2009, driven by Government and Reserve Bank efforts to boost housing and engineering activity.
- In light of its simple foundations, the close relationship of the CommSec Recession Warning Gauge with GDP over a long period is quite staggering. However the old adage is that ‘the simple things in life are always the best’. But clearly the Australian economy has a long road to travel before anyone claims that recession will be avoided. With most western nations in or close to recession, it would be a remarkable feat if Australia avoids a similar fate.
- Still, the Government and Reserve Bank are applying significant stimulus to the economy and Australia has the advantage of a more balanced housing market, debt-free government and massive boost provided by the terms of trade over many years.

Craig James, Chief Economist, CommSec
Work: (612) 9312 0265;

