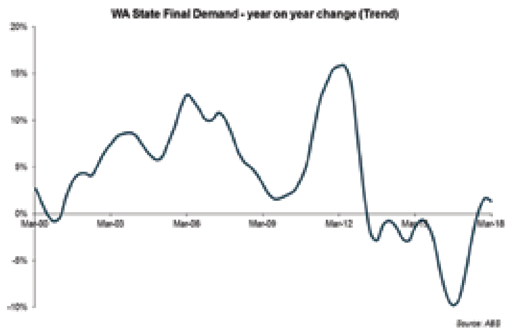
Time to invest in the West?

By Dermot Woods Executive Director, Westoz Funds Management

Economic growth in Western Australia has returned and we believe this is occurring beneath the radar of news headlines and investor interest. The economic trend from here should continue upwards and the strength of this upturn could surprise due to the low base level of activity and the capacity for growth once sentiment improves on a consistent basis. To this end, it is interesting to note that survey data has been showing consistent signs of improvement with consumer confidence in WA currently at its highest level in over four years *(Source: CCIWA)*. Business confidence is also now above the national average *(NAB Monthly Business Survey)*.

So, how bad have conditions been in WA? Gross State Product (GSP), the number politicians love to quote as it includes the benefit of our resources driven trade surplus, suggests WA will only experience recession in 2017. However, exclude the export benefit and you get state final demand (SFD) which gives a fairer reflection of the health of the economy. Economic growth in WA has recently turned positive following what has effectively been five years of a domestic recession.



Four components make up state final demand:

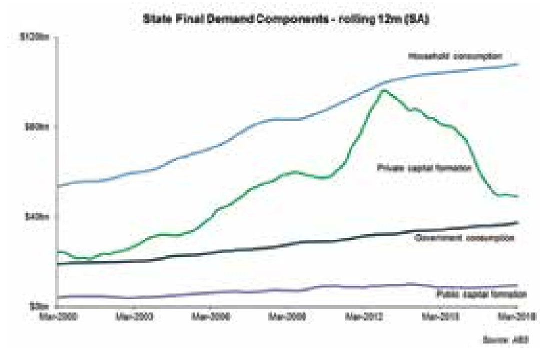
- Household consumption;
- Private capital expenditure;
- Government expenditure; and,
- Public capital works.

Government total spend (including public capital works) is a relatively predictable contributor to economic demand growth and should increase as WA follows the Australian trend of infrastructure catch up. So, the swing factors for growth will come from household consumption and private capital expenditure which represents 75-80% of the economy.

Household consumption, the largest component of the WA domestic economy, has trended upwards slowly during the last 5-6 years. This trend should accelerate as population growth and consumer expenditure both lift from cycle lows. Population growth in WA is currently running at a miserly 0.8% per annum compared to a pre-boom average of 1.8% pa. The main driver of this slowdown was declining net migration which briefly turned negative for the first time in 2017. Retail sales in WA are negative for the first time in over 35 years. Accordingly, the base for household expenditure growth is set at historically very low levels.

The potential capacity of the WA consumer gives cause for optimism. Firstly, Western Australians enjoy the highest pay packets in the nation after Canberra. Secondly, WA consumers are not as constrained by housing affordability as many on the East Coast. A decade ago the ratio of median dwelling price to average annual earnings in Sydney, Melbourne and Perth was equal at 6.5x *(HIA)*. Today that ratio sits at 9x for Sydney, 7.5x for Melbourne and less than 6x for Perth.

We discuss underinvestment in fixed asset capital below but private companies have also underinvested in human resources through the downturn in WA. Skill shortages are now occurring in areas such as mining engineering and heavy vehicle maintenance and we expect this to spread more broadly as activity rebounds. At the Diggers & Dealers conference in Kalgoorlie this year several speakers noted mining engineering student enrolments in Australia have declined sixfold over the last six years! Labour market tightness will gradually result in private sector wage price increases which should lead to further boosts in consumer confidence.



As can be seen from the graph above, private capital expenditure decline has been the key driver of negative growth in WA economy in the last five years. We believe this is dissipating with the run-off in LNG construction activity now all but over. Other areas of the private investment are at unsustainably low levels, for example: iron ore majors are about to embark on multi-billion dollar construction activities to simply maintain production levels; WA dwelling approvals are at 20 year lows and in line with a time when 25% less people lived in the State; Contractor tender pipelines are healthy, gear utilisation is high; and, equipment capital spend is increasing whilst lead times for orders have blown out.

In summary, we believe the WA economy may be on the verge of a sustained period of recovery which could surprise people on the upside. This growth will be driven by acceleration in household expenditure and a turnaround in private capital expenditure. ASA members that are self-directed investors may wish to consider how best to get exposure to this theme.

Westoz Funds Management will be participating in the ASA Listed Investment Companies Showcase Days to be held in Brisbane 5 October, Sydney 10 October and Melbourne 12 October. Please go to www.australianshareholders.com.au/seminars_workshops for more information.