

# More Spending. More Taxes.

## The 2017/18 Budget

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**May 2017**



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# Summary

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- **The Budget has not dramatically reshaped the fiscal landscape:**
  - the slow plod towards budget surplus continues;
  - the same difficulties in restraining spending and the same downside risks to revenue persist;
  - the reliance on revenue growth to close the budget gap is there in the underlying figuring; and
  - government debt marches on, albeit the peak is in sight.
- **What has changed is the shift in focus from the Budget as an accounting device to the Budget as a tool to engineer change. And this shift is to be applauded.**
- **The Budget themes of infrastructure, education, housing affordability and some elements of tax reform cut across a range of economic and social issues. We expect the net effect to be positive.**
- **The fiscal debate has been livened up by introducing the idea of “good” and “bad” debt. Beyond the theatrics, this distinction should prove useful in shifting the debt-is-evil mindset and allowing a sensible debate on how to fund the day-to-day running costs of government and longer-term infrastructure needs.**
- **All budget measures show an improvement over the next four years. The net operating balance is in surplus from 2019/20. And the underlying and headline budgets are in surplus from 2020/21.**
- **The improving trend reflects better economic parameters and new policy initiatives.**

## Summary (Cont'd)

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- The infrastructure push featured in the Budget is highly desirable. The Government is, however, a little late to the infrastructure party. And more could be done given low borrowing costs and our sizeable fiscal space.
- More education spending should help improve human capital, which is just as important as physical capital. Education spending should help improve labour market flexibility and job and income prospects.
- The Budget focus on improving housing affordability has trod a reasonable path through the political need to help first-home buyers vs the imperative of lifting supply.
- Tax reform has made little progress in the 2017 budget. The leftover parts of the Enterprise Tax Plan are a necessary economic reform and essential to maintaining international tax competitiveness. The extension to the \$20,000 immediate tax deductibility threshold is good policy that will help get non-mining capex moving
- Relative to the OECD average, Australian tax collections are “overweight” personal income and company taxes and “underweight” consumption taxes. So real tax reform needs to shift the tax mix.
- Savings measures are worth nearly \$10bn over the next four years. Some of them are politically difficult so the Government deserves some credit. And credit as well for axing the so-called “zombie” measures trapped in the Senate.

## Summary (Cont'd)

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- **The Budget economic parameters portray an economy where GDP growth rates improve as the commodity-related headwinds recede. Growth is expected to be sufficient to see some further modest reduction in unemployment. Inflation rates creep back into the lower end of the RBA's target band, eventually.**
- **The general shape of the forecasts are in line with the consensus among Australian economists and other forecasting organisations. They look appropriately conservative in a bottom-line sense.**
- **Revenue forecasts have proved to be disastrously off course in recent years. So while the income backdrop has improved, a cautious assessment of revenue projections remains appropriate. Some of the commodity price forecasts and wage projections look optimistic.**
- **Australia's AAA rating remains at risk. But some of the issues that the agencies worry about have receded.**
- **Post Budget Moody's announced Australia's fiscal strength is high and supportive of the Aaa rating.**



# Budget Overview

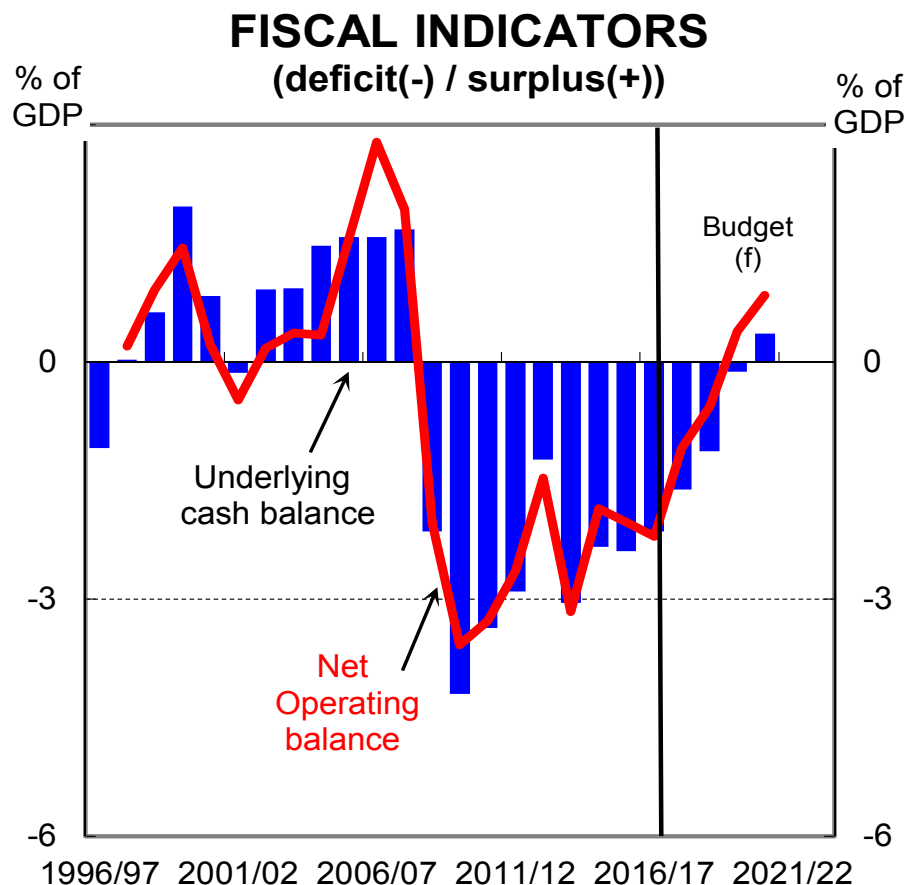
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## A quick primer

- **There is an expanded list of budget aggregates and concepts with Budget 2017.**
- **The traditional underlying and headline deficits remain a central focus.**
- **But the net operating balance now receives equal billing:**
  - the *net operating balance* is the balance between revenue and recurrent expenses. It excludes expenditure on the acquisition of capital assets ie public capex.
- **We recommend using:**
  - the *net operating balance* when assessing the sustainability of day-to-day government operations;
  - the *underlying budget balance* when thinking about the impact of the budget on the economy; and
  - the *headline budget balance* from a financing and financial market perspective.
- **The Budget also introduces the idea of “good” and “bad” debt:**
  - good debt is that used to finance an investment that will grow in value or generate long-term income;
  - bad debt is that used to finance recurrent spending.

# Budget Overview

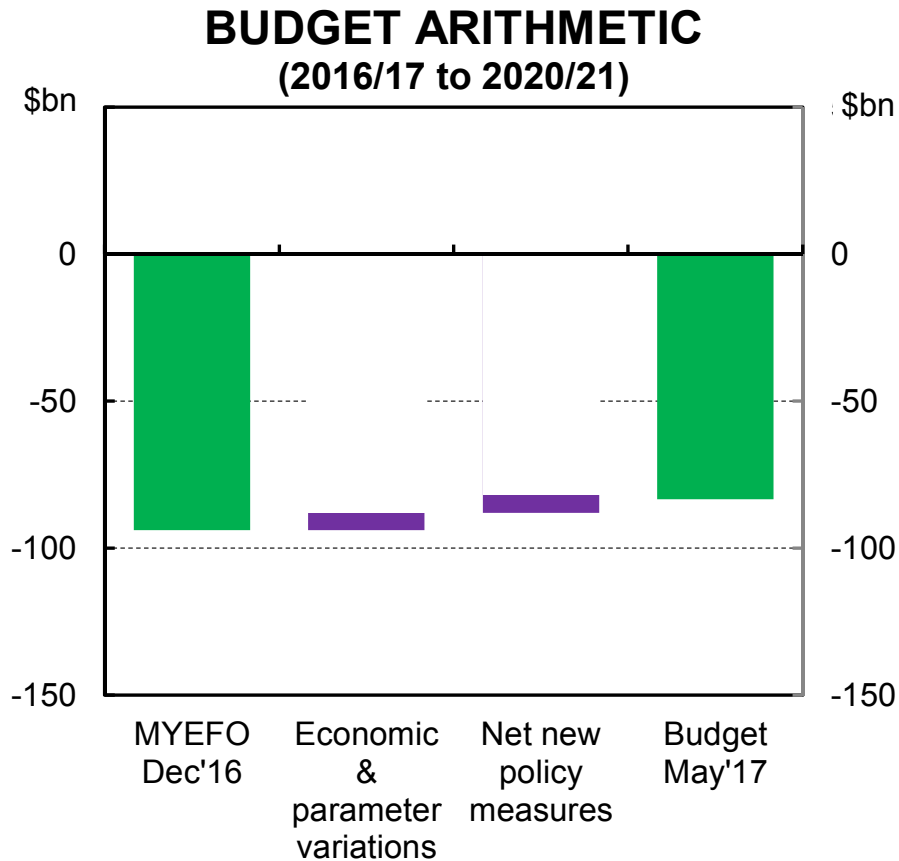
## Key numbers



- **Underlying cash deficit for 2017/18 put at \$29.4bn (1.6% of GDP) a reasonable improvement on the deficit of \$37.6bn (2.1% of GDP) now expected in 2016/17.**
- **Underlying cash deficit narrows from here, achieving a small *surplus* of \$7.4bn (0.4% of GDP) by 2020/21.**
- **The *net operating balance* reaches surplus a year earlier, in 2019/20.**
- **A *headline* deficit of \$48bn expected in 2017/18, narrowing thereafter before achieving a surplus of \$12bn in 2020/21.**
- **Net debt peaks (as a share of GDP) in 2018/19 at 19.8%.**
- **The improving bottom lines reflects better economic parameters and new policy initiatives.**
- **The outcomes require rising revenues and significant spending restraint.**

# Budget Overview

## The mathematics



- Budget net deficits total \$83.4bn for the four year period from 2016/17 to 2020/21.
- The decline in projected deficits since the mid-year review (MYEFO) is driven by:
  - economic and parameter variations of \$5.9bn; and
  - net new policy decisions of \$6.2bn.



# Budget Overview

Underlying Cash Balance (\$bn)						Cumulative deficits of \$43.6bn over four years to 2021 expected at the end of 2016.
	2016/17 (e)	2017/18 (f)	2018/19 (f)	2019/20 (f)	2020/21 (f)	
<b>Dec'16 MYEFO</b> (% of GDP)	<b>-36.5</b> (-2.1)	<b>-28.7</b> (-1.6)	<b>-19.7</b> (-1.0)	<b>-10.0</b> (-0.5)	<b>1.1</b> (0.1)	Parameter and other variations (mainly revenue weakness offset by payment reductions) improve the bottom line by \$5.6bn.
<i>Plus:</i> Parameter & oth ch	0.3	1.6	-0.4	4.4	-0.4	
<i>Equals:</i> <b>May'17 Budget starting point</b> (% of GDP)	<b>-36.2</b> (2.1)	<b>-27.1</b> (1.5)	<b>-20.1</b> (1.1)	<b>-5.6</b> (0.3)	~ ~	Implied starting point for 2017/18 was a deficit of \$36.2bn.
<i>Plus:</i> Policy decisions	-1.4	-2.3	-1.3	3.1	~	Policy initiatives net out at -\$6.3bn over the period.
<i>Equals:</i> <b>May'17 Budget</b> (% of GDP)	<b>-37.6</b> (-2.1)	<b>-29.4</b> (-1.6)	<b>-21.4</b> (-1.1)	<b>-2.5</b> (-0.1)	<b>7.4</b> (0.4)	
<b>Net Operating Balance</b>	<b>-38.7</b>	<b>-19.8</b>	<b>-10.8</b>	<b>7.6</b>	<b>17.4</b>	Cumulative deficits of \$45.9bn now expected over the next four years. Narrowing net operating balance means revenue eventually covers re current spending.
<b>Headline Balance</b>	<b>-51.1</b>	<b>-48.4</b>	<b>-37.1</b>	<b>-14.8</b>	<b>11.7</b>	
						Rising infrastructure spending keeps headline deficit large.

# Budget Overview

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## Key themes

### ■ **Adherence to the medium-term fiscal strategy:**

- Fiscal discipline will return Budget to surplus and then allow debt reduction.

### ■ **Infrastructure:**

- Large transport investment outlays will lift growth, jobs and productivity.

### ■ **Housing affordability:**

- Affordability will marginally improve by a limited lift in assistance to First Home Buyers, grants to lift new supply, reductions in investor tax deductions and the “ghost tax”.

### ■ **Company tax cuts:**

- Lower company tax with higher write-offs will lift investment.

### ■ **Education:**

- Needs-based funding for all schools. Higher education students face higher fees.

### ■ **Higher taxation**

- Higher Medicare levy, foreigner investors to pay more, higher levy on foreign workers, a new levy on banks.

# Budget Overview

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## Adhering to the medium-term fiscal strategy

- **The broad fiscal strategy is little changed from that in place since the original Charter of Budget Honesty – the aim is to achieve underlying cash surpluses, on average, over the cycle.**
- **Operationally, the strategy involves:**
  - reaching a surplus of 1% of GDP “as soon as possible”;
  - skewing spending towards initiatives boosting productivity and participation over time;
  - reducing the Government’s share of the economy;
  - new spending to be offset by savings elsewhere;
  - “banking” revenue gains due to any improvement in the economic cycle; and
  - improving the government’s balance sheet over time.
- **There seems no particular significance in the 1% of GDP target:**
  - it is large enough to provide some insurance against the vagaries of the economic cycle and the difficulty in forecasting budget aggregates; and
  - it matches that achieved during the Howard/Costello era.

# Budget Overview

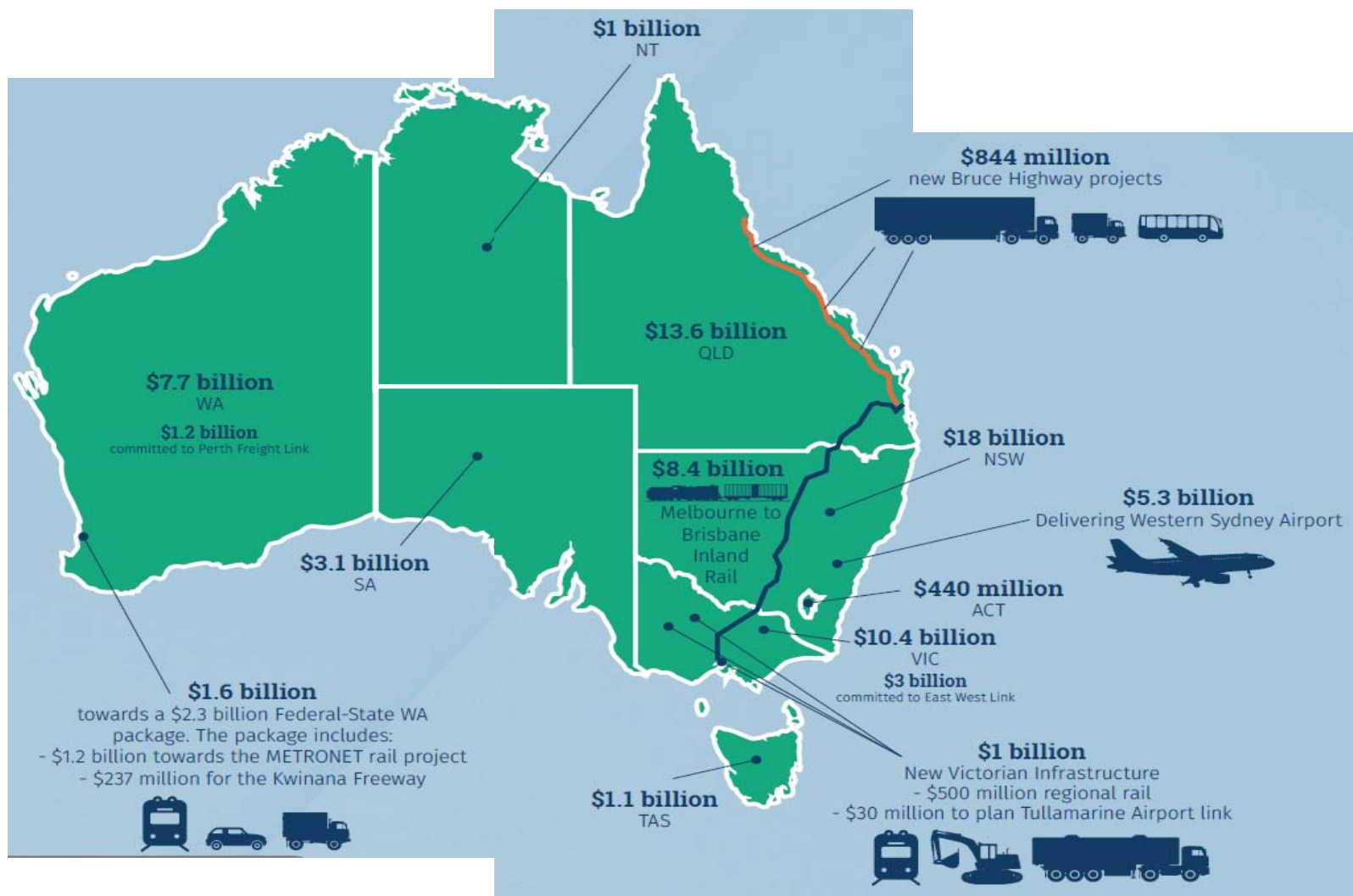
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## Infrastructure

- **Ramping up infrastructure spending is a major Budget theme.**
- **The Government's infrastructure plan involves investing \$75 billion in transport infrastructure between 2017/18 and 2026/27.**
- **The aim is to boost growth and productivity.**
- **The main infrastructure projects to get the go ahead are:**
  - Western Sydney Airport - up to \$5.3 billion committed for the Badgerys Creek Airport, commencing works in 2018;
  - Inland rail - \$8.4 billion to connect Brisbane with Melbourne;
  - \$1 billion infrastructure package for Victoria; and
  - \$1.6 billion for new Western Australian projects.
- **“Good” debt to be used to fund projects. The Government is currently using equity and debt financing for a number of major infrastructure projects.**

# Budget Overview

## Infrastructure



Source: Budget Papers

# Budget Overview

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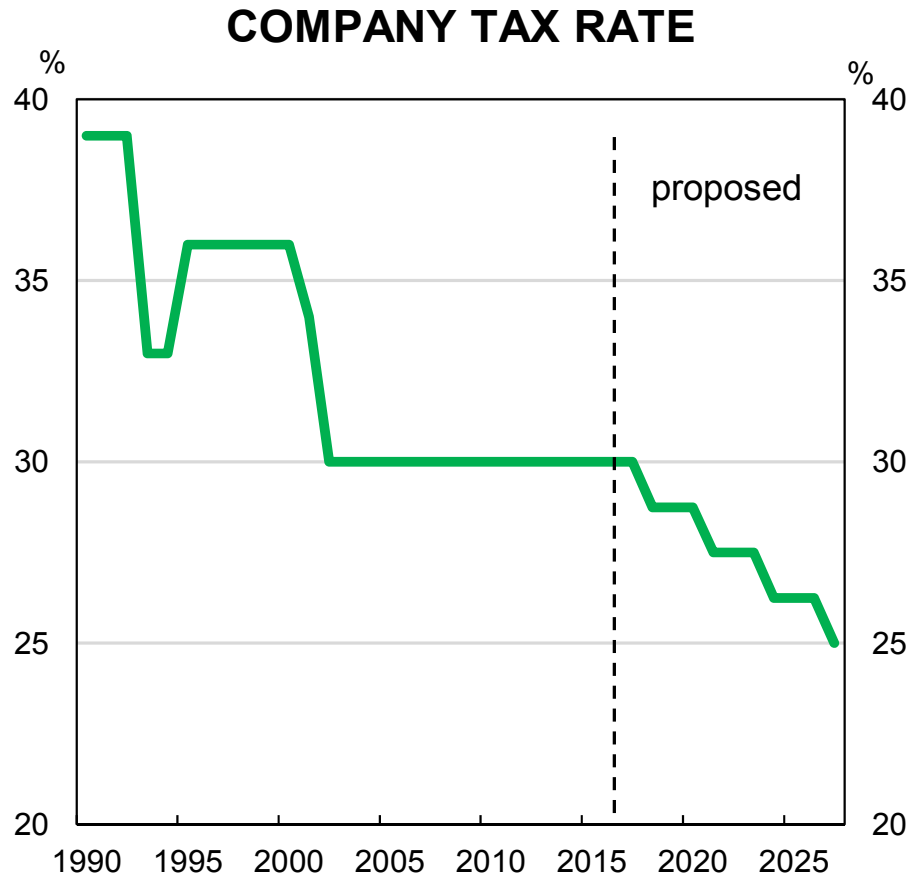
## Housing affordability

- **The Budget proposes measures to boost supply through land releases, more infrastructure and improvements to zoning and planning.**
- **First home buyers will be helped by allowing voluntary pre-tax contributions to super to help save for a deposit.**
  - individuals can make contributions of up to \$15,000 per year and \$30,000 in total to their superannuation account. Withdrawals are taxed at their marginal tax rate less a 30% tax offset.
- **The disincentives to downsize will be reduced for older Australians:**
  - over 65's can make a non-concession contribution into superannuation of up to \$300,000 from the proceeds of the sale of a principal residence.
- **Foreign investors are targeted by:**
  - the introduction of a 50% cap on foreign ownership in new developments;
  - a vacancy tax on foreign owners who leave their properties unoccupied; and
  - changes to capital gains tax rules for foreign tax residents.
- **Some investment property deductions are cut.**
  - no more deductions on travel expenses.
  - limits on the deductions of plant and equipment.



# Budget Overview

## Company tax cuts



- In March 2017 the Senate passed a tax cut for smaller businesses (turnover up to \$50 million).
  - taxes will be cut from 28.5% to 27.5% in 2016/17.
  - further cuts will then be phased in with the rate dropping to 25% in 2026/27.
- The Budget includes a similar phased in tax cut for all other businesses.
- There is also an extension to the \$20,000 instant asset write off for small businesses for a further 12 months.

# Budget Overview

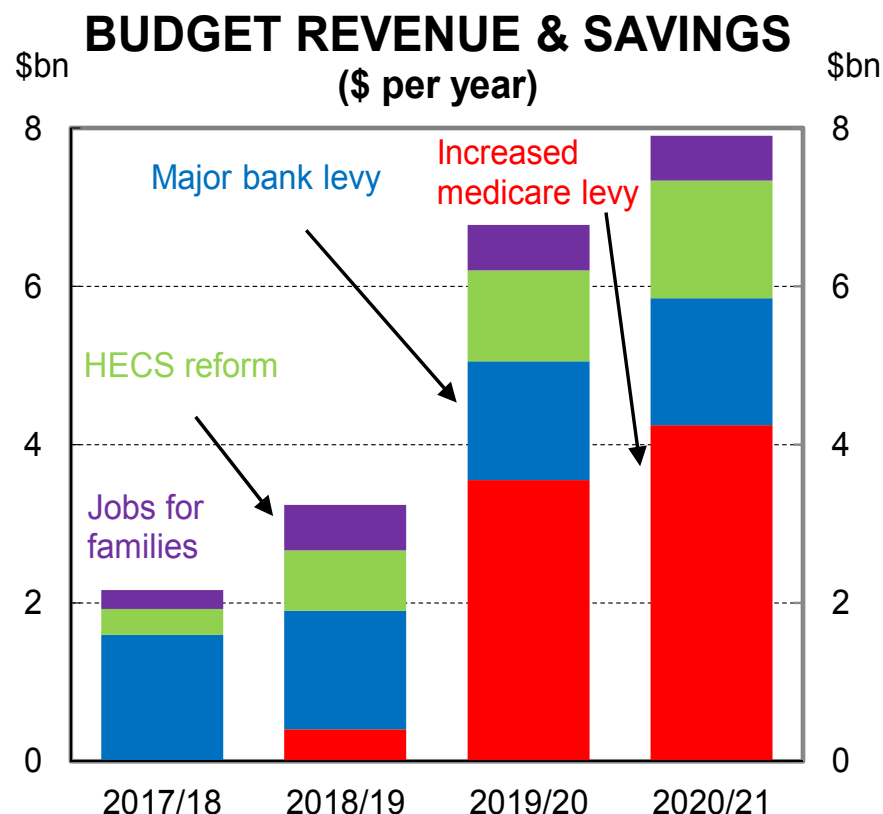
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## Education

- **Schools.** The Government will implement the original Gonski “needs-based” model for sharing the funding pool across public and private schools.
- The quantum of *future* funding, over the next decade, will be \$18.6bn above the Abbott 2014 Budget level but ~\$20bn below the original Gonski proposal.
- Around 99% of Australia’s 9,414 schools will receive the same or more total funding. Only a small number, around 50 schools, will receive less than proposed.
- **Higher education.** University fees will rise by 7.5% (by 1.5%/yr from 2018 to 2021) or between \$2k and \$3.6k in total for a four-year degree.
- Students with Higher Education Loan Program (HELP) loans will make higher repayments via the income tax system. The income threshold for repayments will be lowered on 1 July 2018 to \$42k from \$56k (then CPI indexed yearly). The extra (income tax) rate will rise from 1% on \$42k, to 10% on income above \$120k, for 2018/19.
- Outstanding HELP debt is \$48bn, with an average student debt near \$20k.
- Universities will be required to meet a 2.5% efficiency dividend in 2018 & 2019 to receive their full Federal funding.

# Budget Overview

## New Revenue & Saving Measures



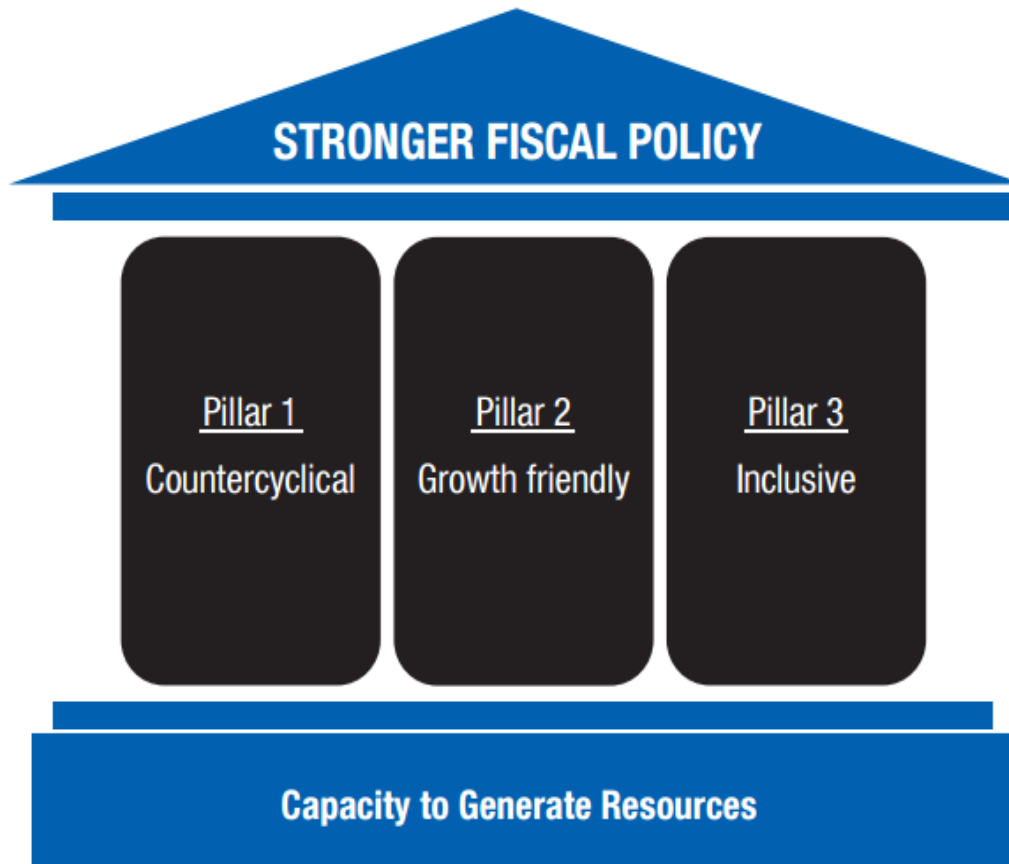
■ Over the next four years, four key revenue and savings measures will save \$20.1bn.

■ Measures include:

- Increase in the Medicare levy – estimated to raise \$8.2bn over the next four years;
- Major bank levy – estimated to raise \$6.2bn over the next four years;
- HECS reform – estimated to save \$3.7bn over the next four years;
- Jobs for families package – estimated to save \$2.0bn over the next four years.

# Judging The Budget

How does the budget fit into the big picture?

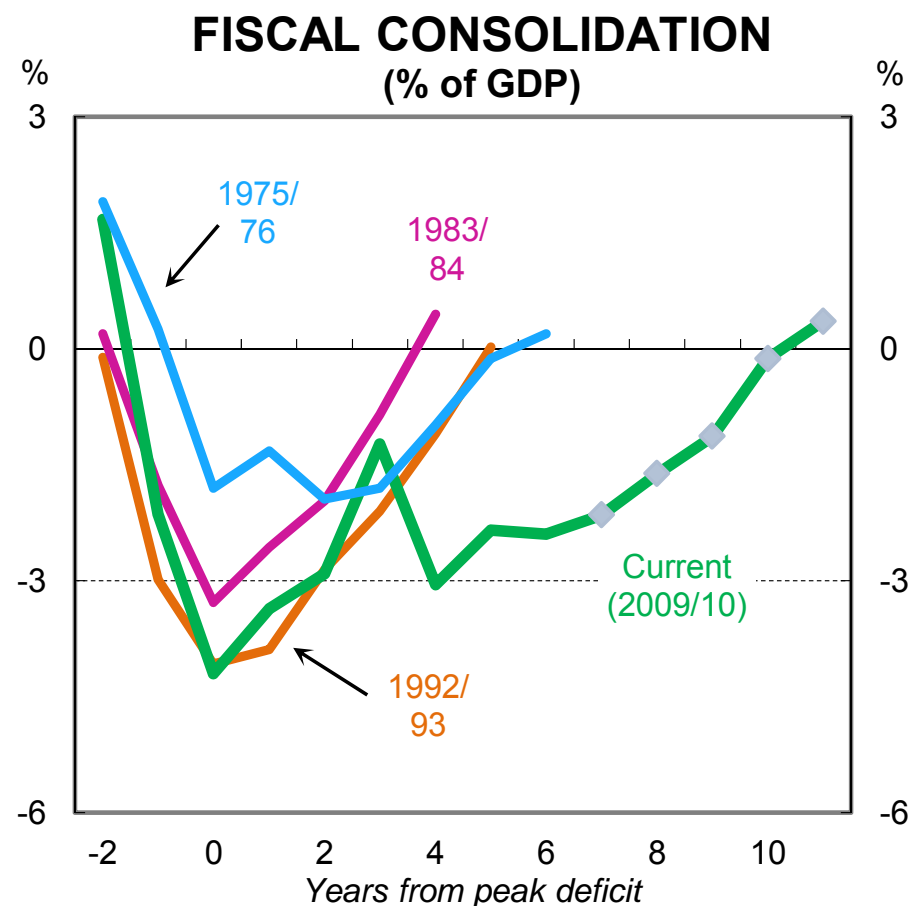
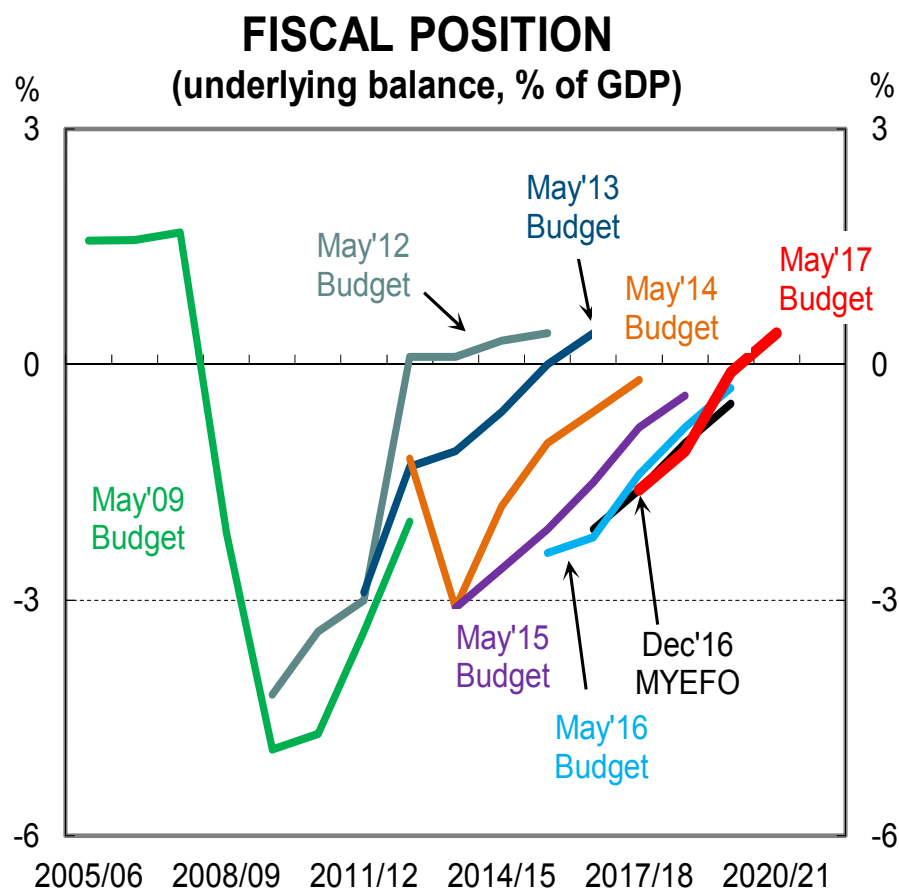


Source: IMF

- Budgets are typically judged on efficiency, effectiveness and equity.
- But the IMF suggest fiscal policy has a greater role to play in fostering sustainable and inclusive growth:
  - fiscal policy should be countercyclical, growth friendly and inclusive.
- From this broad perspective the 2017 Budget ticks the boxes:
  - the deficit is expected to decline as economic growth lifts so fiscal policy can be seen as countercyclical;
  - the focus on infrastructure and company tax cuts is growth friendly;
  - spending on education, training, affordability will help inclusion.

# Judging The Budget

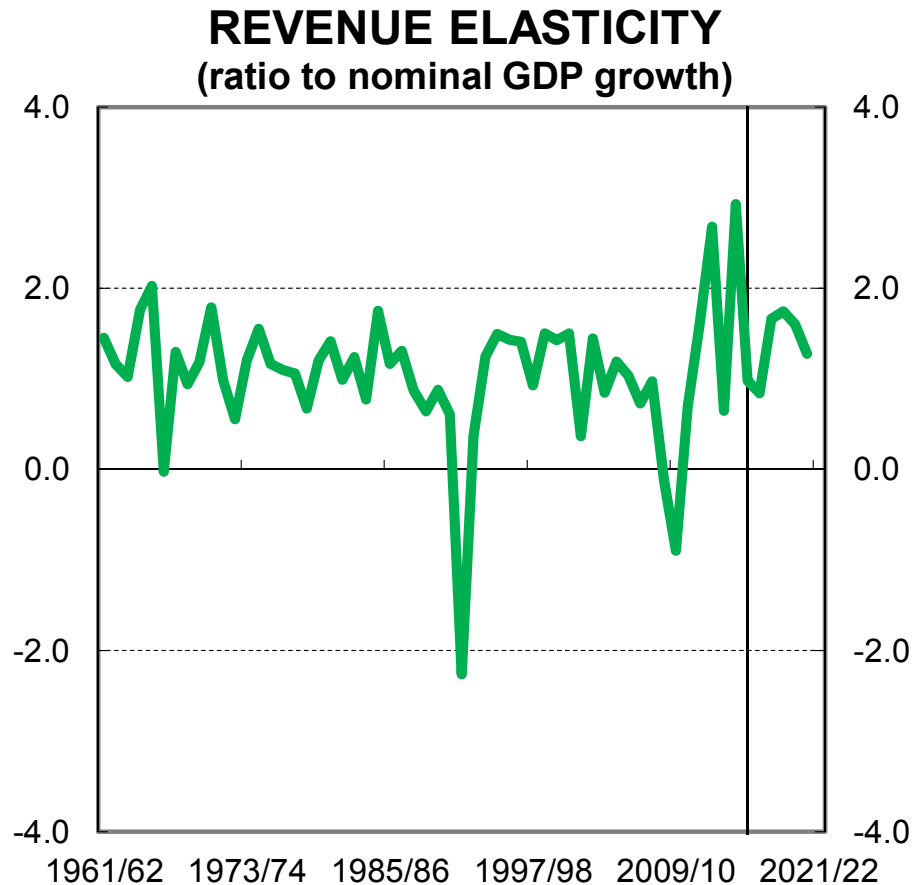
Is the medium-term fiscal strategy on track?



- **Budget 2017 shows an upgrade to budget projections for the first time in a number of years.**
- **Nevertheless, the planned surplus for 2020/21, if achieved, would still represent the most drawn out period of Budget repair in at least 60 years.**

# Judging The Budget

Is the revenue there?

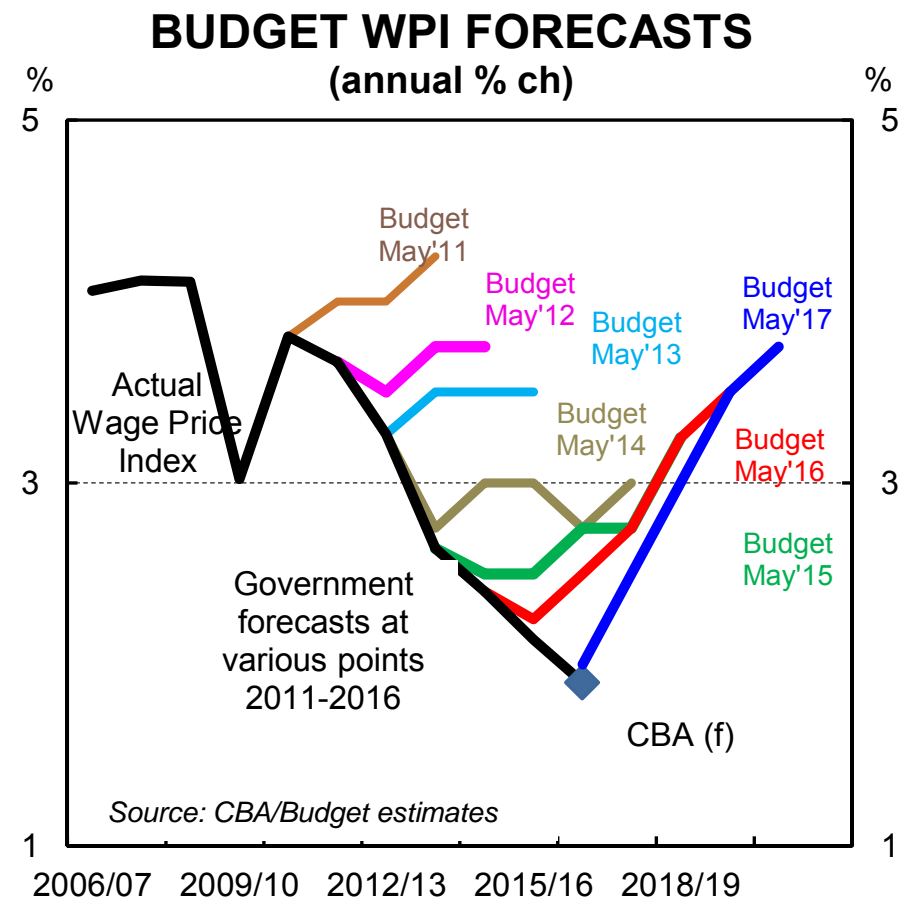
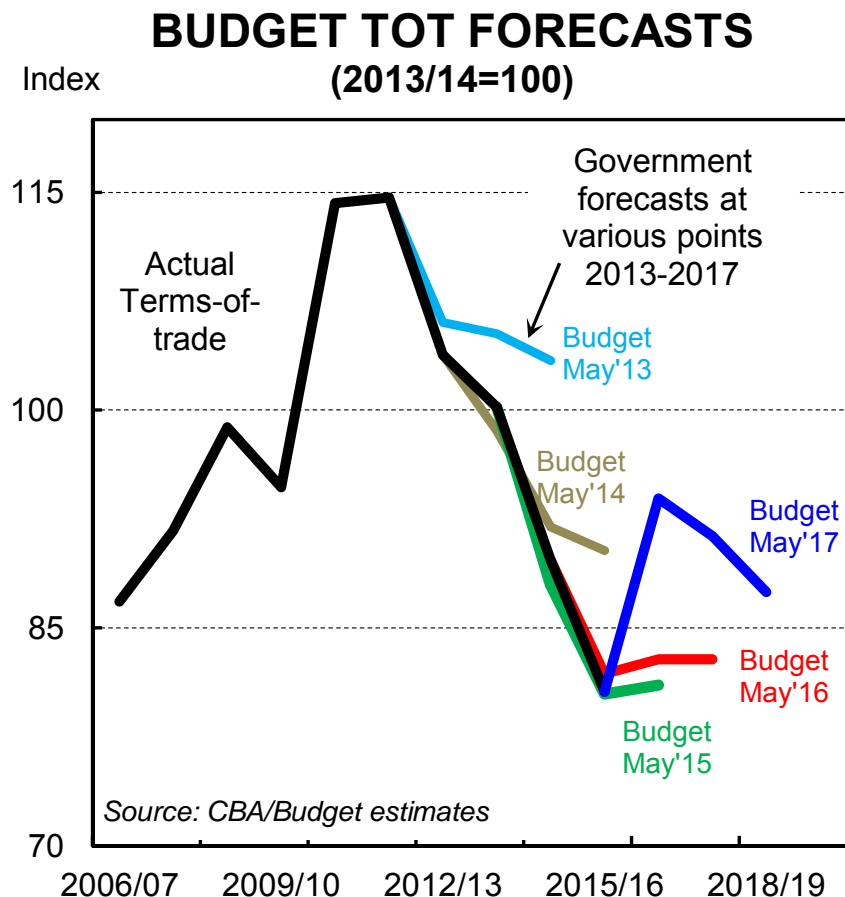


- The Budget projections reflect a steady rise in the revenue share of GDP.
- Nominal GDP – or the tax base – is projected to grow at 4.1% in 2017/18 and 3.8% in 2018/19.
- The implied revenue elasticities (ie what sort of rise in revenue do you get from a given increase in nominal GDP) are in the range of the past 50 years over the forward estimates period.
- The risk areas for the revenue forecasts are the assumptions about the terms-of-trade and wages.



# Judging The Budget

How critical are the commodity price and wage forecasts?



- Commodities drive the terms-of-trade which drive nominal GDP which drives revenue.
- Wages are the main driver of personal income tax revenues.
- A lack of forecast success, common across all forecasters, explains the succession of revenue write-downs in recent years.

# Judging The Budget

Are the commodity price assumptions credible?

## Budget Commodity Price Forecasts

Iron ore US\$55/t (FOB)

Metallurgical coal US\$120/t (FOB)

Thermal coal US\$85/t (FOB)

Oil (TAPIS) US\$55/bbl

■ Budget assumptions look high relative to our FY19 forecasts

■ Budget assumes downtrend until prices reach a sustainable level by the March quarter. Still too high (CBA: ~US\$40/t)

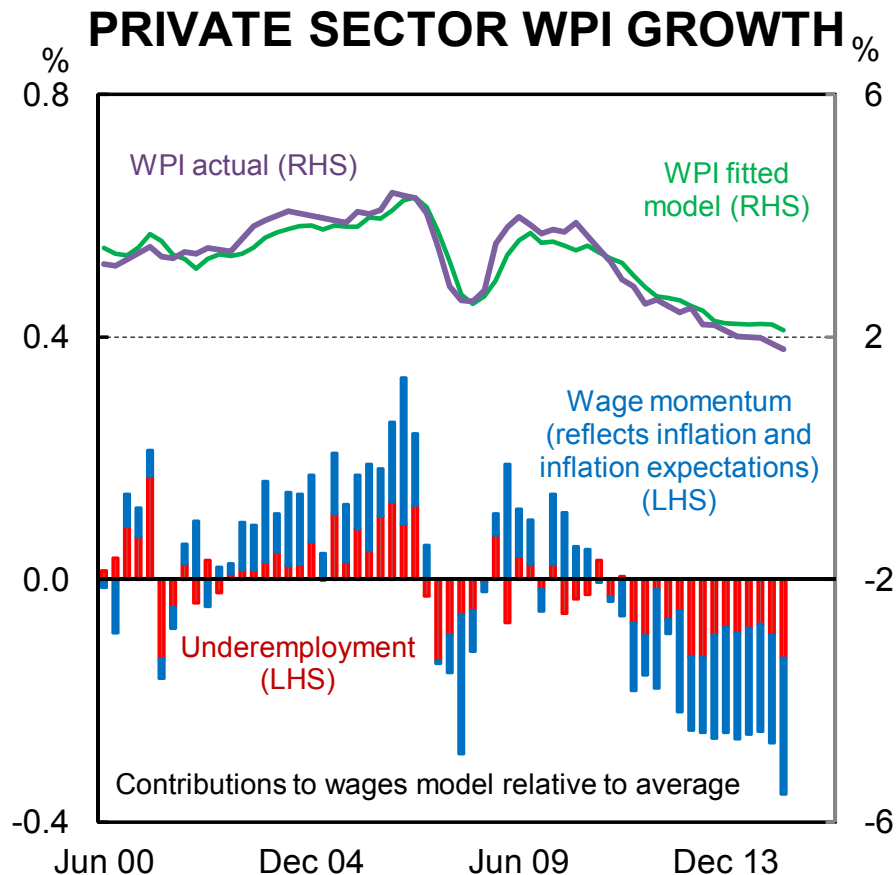
■ Similar downtrend assumption for metallurgical coal. Budget forecasts similarly too high (CBA: ~US\$95/t)

■ Budget forecasts appear high (CBA: ~US\$55/t)

■ Budget assumptions look reasonable (CBA: US\$52/bbl). LNG contracts are indexed to oil prices

# Judging The Budget

Are the wage assumptions plausible?



- The Budget projects wages growth to run at 2.5% in 2017/18. This looks credible.
- But wages growth is forecast to progressively accelerate and to be running at 3.75% in 2020/21. This is an optimistic assumption and represents a best case scenario.
- Wages outcomes have undershot Budget forecasts over the past six years
- Risks are skewed to the downside given there is elevated slack in the labour market and underutilisation (i.e. unemployment plus underemployment) is high.

# Judging The Budget

How sensitive are the 2017/18 budget forecasts to commodities and wages?

## Impact of a $\pm$ US\$10 change in iron ore prices

Terms-of trade	$\pm 1\%$
Nominal GDP	$\pm 1\frac{1}{2}\%$ or $\pm \$6.5\text{bn}$
Government revenue	$\pm \$1.3\text{bn}$
Underlying balance	$\pm \$0.5\text{bn}$

Source: Commonwealth Treasury

## Impact of a $\pm 1\%$ change in wages growth

Outlays	$\pm \$1.4\text{bn}$
Government revenue	$\pm \$2.8\text{bn}$
Underlying balance	$\pm \$1.5\text{bn}$

Source: Deloitte Access Economics

### ■ Commodity price movements have significant impacts on the tax base (nominal GDP)

- A 10% rise in the iron ore price over Budget assumptions will add \$6.5bn to nominal GDP and \$1.3bn to tax revenues.

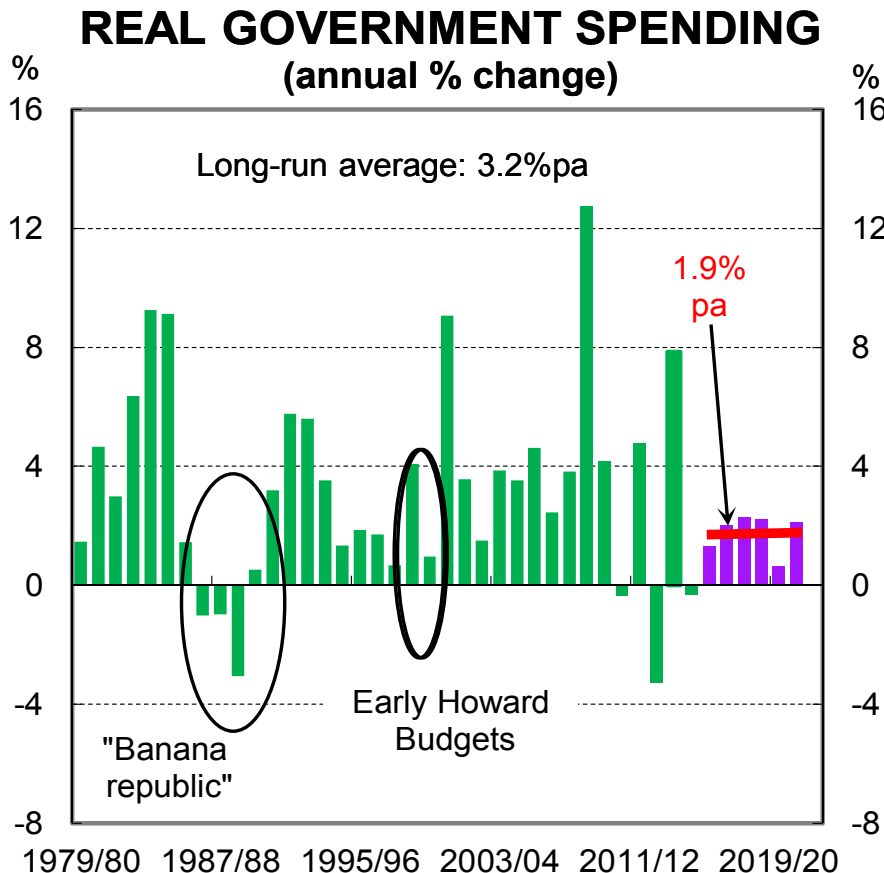
### ■ Changes to wages growth assumptions also impact outcomes

- If wages growth is  $1\frac{1}{2}\%$ , not  $2\frac{1}{2}\%$  then revenues are  $\sim \$3\text{bn}$  lower.

### ■ If there is zero wages growth then revenues will be \$7bn lower and the underlying balance \$3.8bn worse.

# Judging The Budget

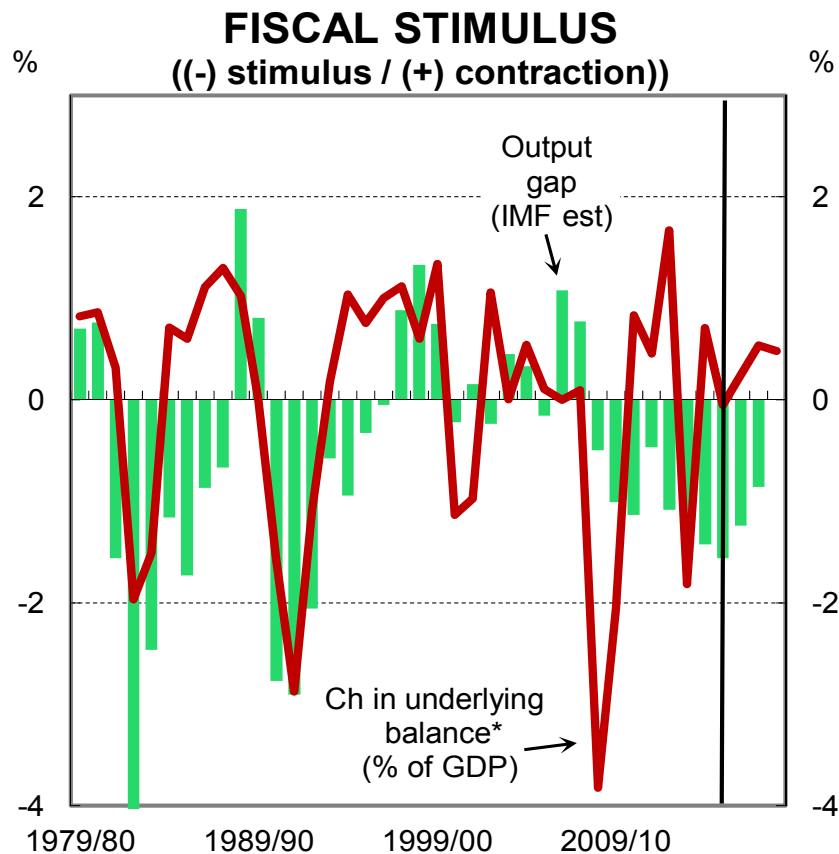
Can the spending targets be achieved?



- Real government spending is forecast to rise by 2.1% in 2017/18.
- But real spending rises are forecast to be under 2%pa in the outer years which looks a challenge relative to past outcomes.
- The Budget forecasts have expenditure growth running below nominal GDP growth which sees expenditure fall as a share of GDP – a challenge.
- The big question is whether the Government can stick with the proposed spending restraint in the outer years with another Federal election due by mid 2019.
- The past few Budgets have always presented lower deficits, only to revise them up as desired growth has failed to materialise.

# Judging The Budget

Is it right for short-term economic needs?

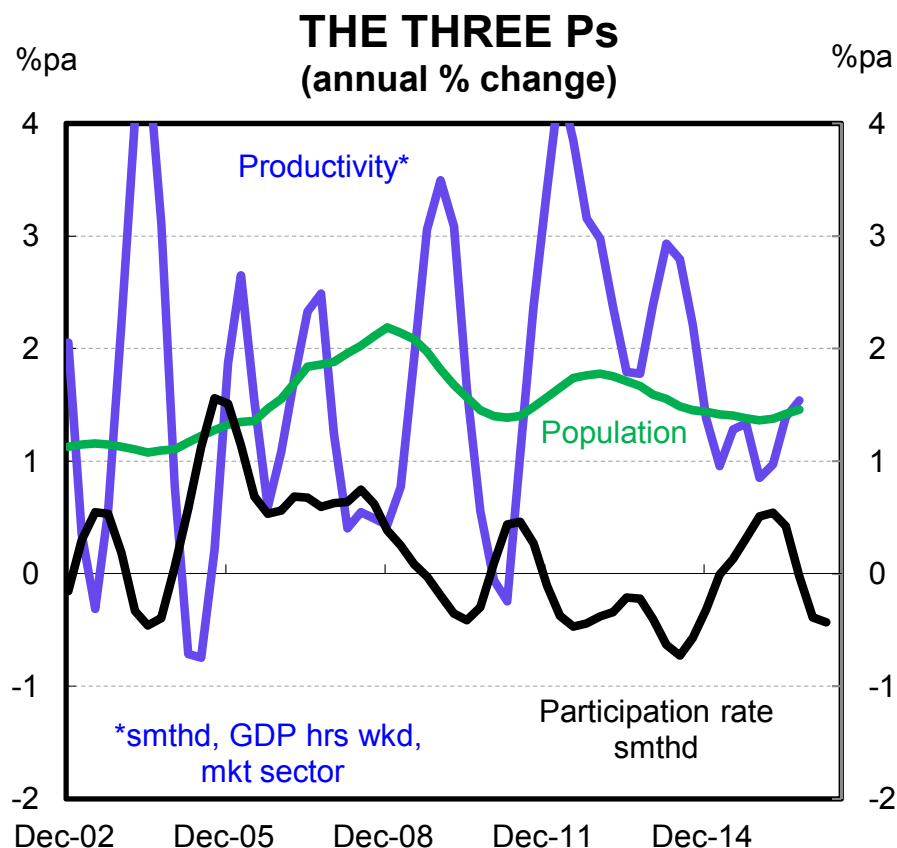


- IMF estimates imply that Australia will run an output gap equivalent to 0.9% of potential GDP.
- This gap is consistent with:
  - spare capacity in the labour market; and
  - below trend growth.
- One of the roles of fiscal policy is to help “fil in” output gaps by stimulating aggregate demand.



# Judging The Budget

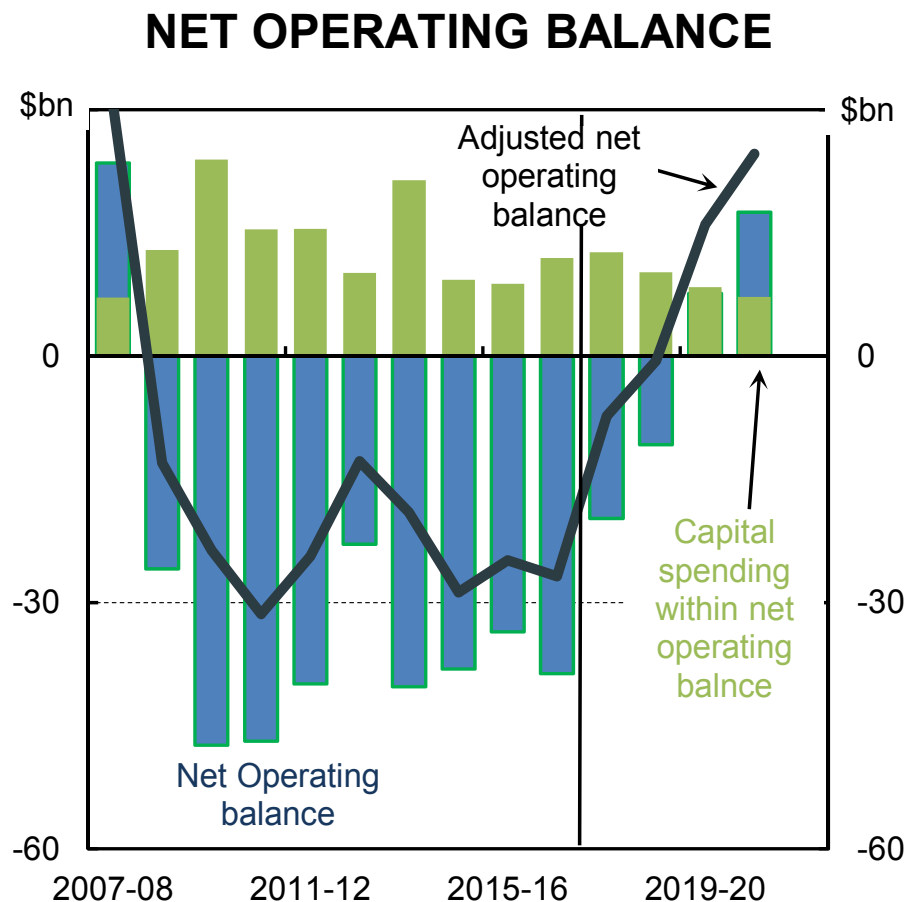
The 3P's: is the budget right for longer-term economic needs



- **Longer-term growth, income and fiscal sustainability depend on the 3P's (population, productivity and participation).**
- **Forecasts in this budget:**
  - *population growth to stay near 1.5%pa, and permanent net migration of 190k.*
  - *productivity enhanced via more infrastructure and funding for training.*
  - *participation rate to be stable around 64½% over the forecast period. Welfare obligations plus childcare initiatives.*
- **Australia's long term labour force issues are an ageing workforce and declining participation.**
- **Both trends lower potential GDP growth and raise the tax burden.**
- **Population growth is holding up via high immigration.**

# Judging The Budget

Is the new focus on the operating balance appropriate?

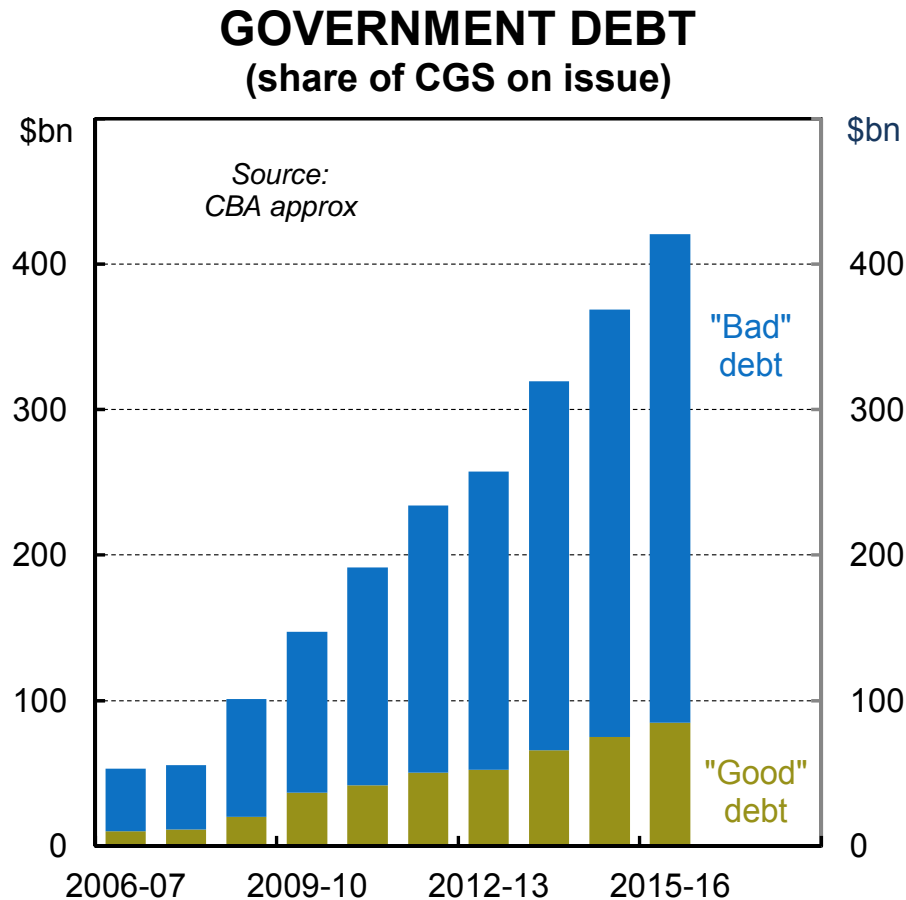


- The headline net operating balance includes some capital items eg capital grants to the States. The adjusted balance excludes these items.

- Most *Commonwealth* budget analysis focuses on the underlying budget balance as the “cleanest” read on the budget position and economic impact.
- But *State* budget analysis tends to focus on the separation between capex and ongoing operations (the operating balance).
- A case can be made for separating day-to-day operations from the capex task where the benefits and burdens are spread over time.
- From that perspective, the Government is covering the day-to-day costs of its operations from 2019/20.

# Judging The Budget

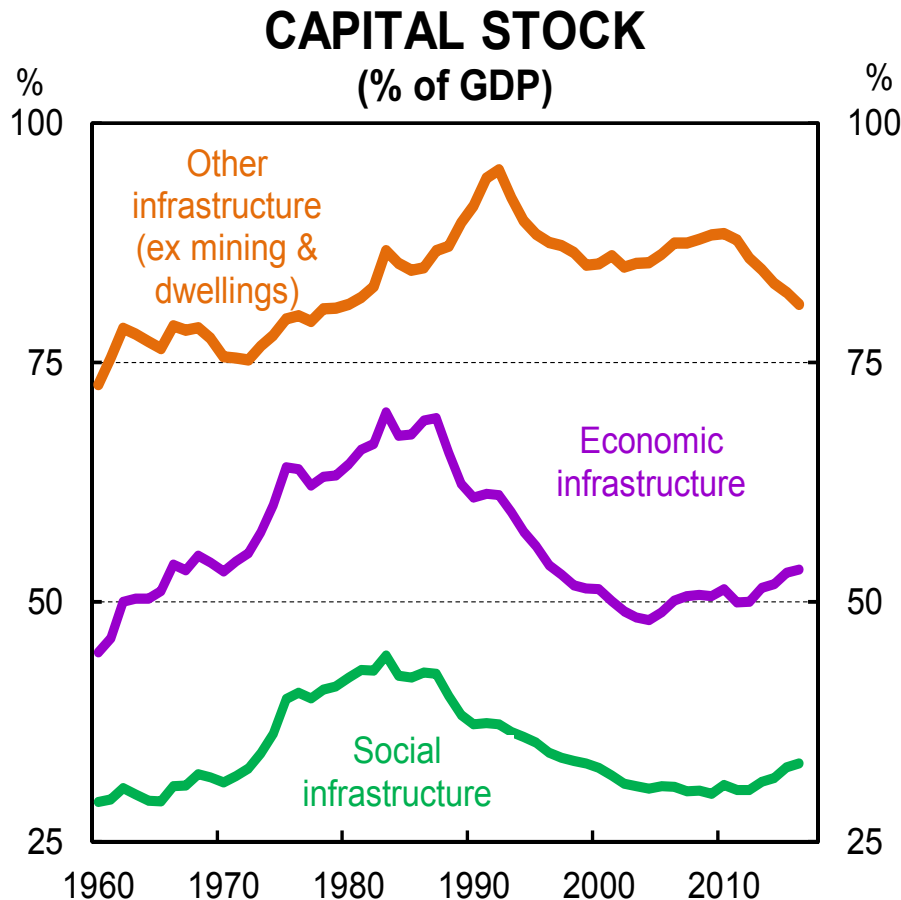
Does the focus on “good” and “bad” debt help?



- The government has livened up the fiscal debate by introducing the idea of “good” and “bad” debt.
- Beyond the theatrics, this distinction should prove useful in shifting the debt-is-evil mindset and allowing a sensible debate on how to fund the day-to-day running costs and longer-term infrastructure needs.
- We have argued this proposition for a while.
- But the focus must be more than just physical infrastructure. And not all infrastructure is good. The *quality* of spending matters.
- The ratings agencies will focus on total debt – good and bad.

# Judging The Budget

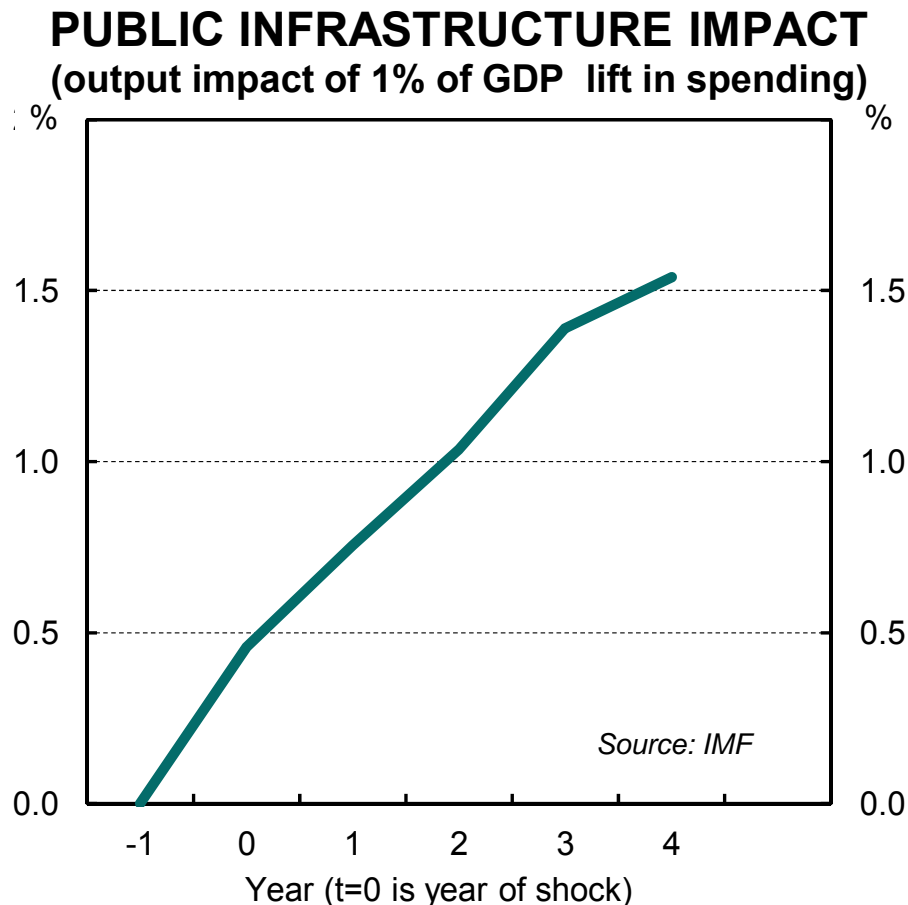
Is the infrastructure push desirable?



- The infrastructure push is highly desirable.
- Australia's economic and social infrastructure relative to the size of the economy is around 1970's levels.
- The stock needs to be refurbished and expanded.

# Judging The Budget

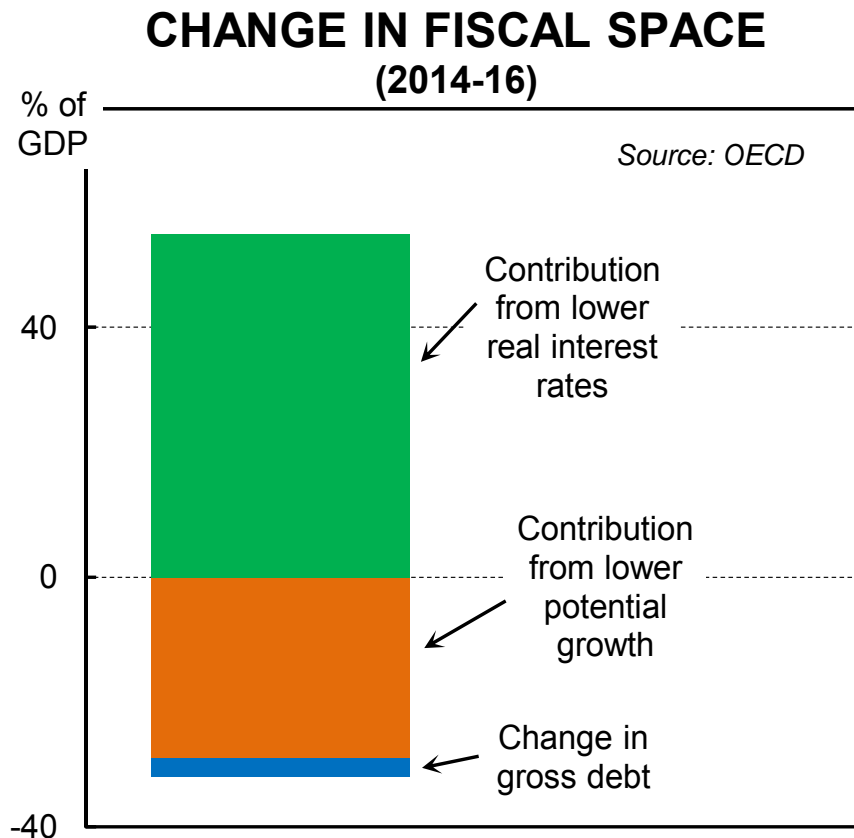
Will the infrastructure push help boost economic activity?



- Infrastructure spending boosts activity in the short term by lifting aggregate *demand* and in the longer-term by raising aggregate *supply*.
- IMF estimates show a 1% of GDP lift in infrastructure spending would boost output in the G-20 by 0.4% in Year 1 and 1.5% after four years.
- The best outcomes are achieved if:
  - spending occurs in periods of economic slack and easy monetary policy;
  - public investment efficiency is high; and
  - spending is financed by debt rather than tax increases / spending cuts.

# Judging The Budget

Infrastructure: should we worry about rising debt?



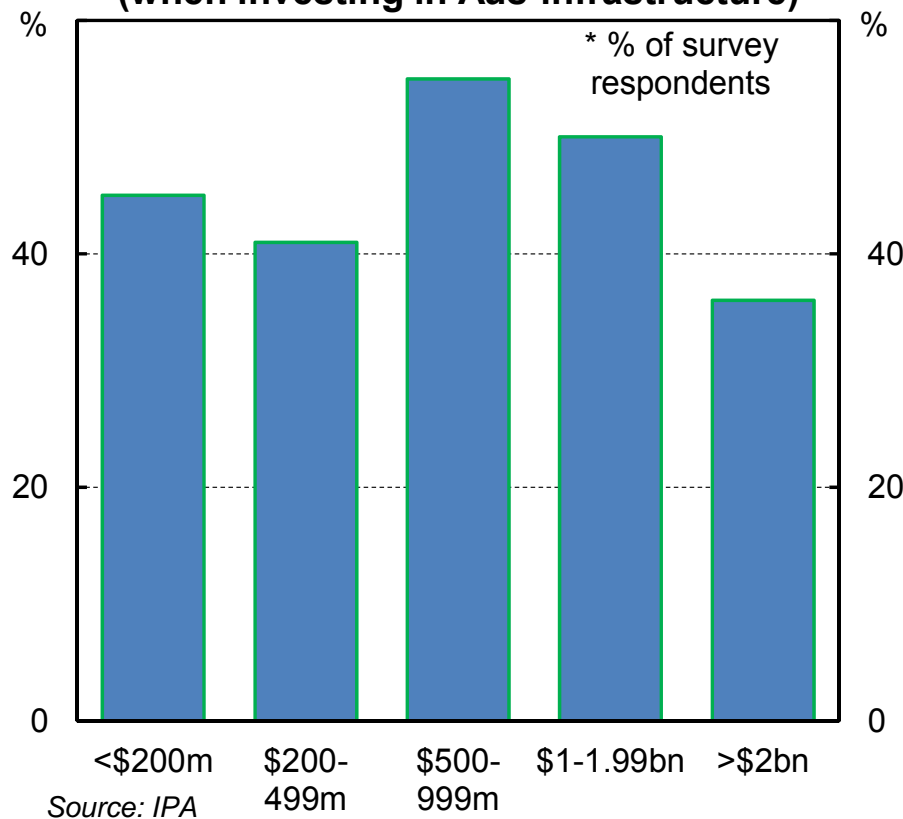
- The infrastructure push means debt levels will be higher than otherwise but Australia has significant unused borrowing capacity.
- The OECD estimates that Australia has significant “fiscal space” (the gap between actual debt and market tolerance for more debt).
- Fiscal space has increased by 23% of GDP between 2014 and 2016 as the impact of lower interest rates more than offsets the impact of a slower potential GDP growth rate. *Source: OECD Working Paper No 1352 Nov'16*



# Judging The Budget

Infrastructure: a missed opportunity – strong demand?

## SIZE OF PROJECTS CONSIDERED\* (when investing in Aus infrastructure)

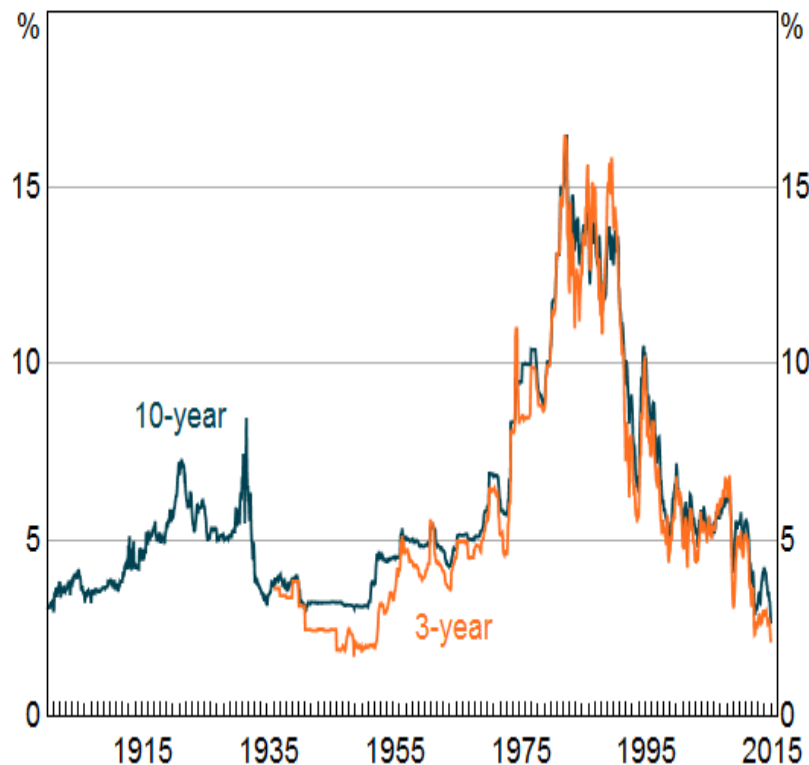


- A survey of sovereign wealth funds, pension funds, fund managers, developers, banks and insurance companies by Infrastructure Partnerships Australia shows a healthy appetite for Australian infrastructure investments.
- Some 50% of respondents were ready to invest more than \$1bn in any single project and 36% were ready to invest more than \$2bn.
- Favoured assets are roads, water & energy infrastructure and ports.

# Judging The Budget

Infrastructure: a missed opportunity – low interest rates?

**Australian Commonwealth  
Government Bond Yields\***



- Exceptionally low borrowing rates are an attraction for more infrastructure spending.
- Borrowing and paying interest is an effective way of sharing the cost of long-life assets among the users over time.

# Judging The Budget

Have the right infrastructure projects been selected?

## Infrastructure Priority List

### High Priority Projects

M4 Motorway Upgrade (NSW)

WestConnex (NSW)

Melbourne Metro Rail (Vic)

M80 Ring Road Upgrade (Vic)

Ipswich Motorway (Qd)

Western Sydney Airport (NSW)

Perth Freight Link (WA)

### Priority Projects

M1-Gateway Motorway (Qld)

The Norther Road Upgrade (NSW)

Bringelly Road Upgrade (NSW)

Murray Basin Rail Project (Vic)

Brice Highway Upgrades (Qld)

M1 Pacific Motorway Upgrade (Qld)

Adelaide-Tarcoola Rail Upgrade (SA)

Inland Rail (Melb-Bris) (National)

Eyre Infrastructure Project (SA)

Hobart Science & Technology Precinct



A key requirement is a mechanism to make sure the projects selected are the ones with the highest payoffs.



*Infrastructure Australia* have identified a list of priority projects to guide government decision making.



But there was no mentioned of *Infrastructure Australia* in the Budget.



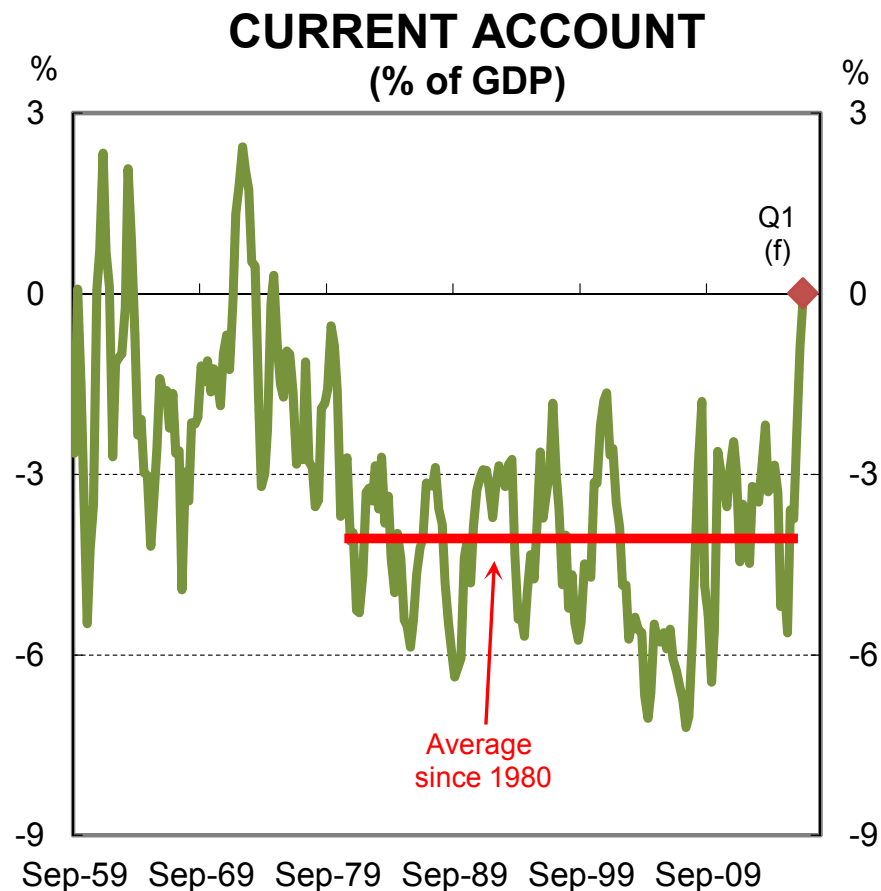
The Government has committed to providing funding for four of the seven *high priority* projects in the 2017/18 Budget. It looks like the remainder of these projects will need to be funded at the State level.



A further three projects on the *priority* list will receive some funding.

# Judging The Budget

Will it cost the AAA?



■ **Credit rating risks persist. But some of the issues that the agencies worry about have receded:**

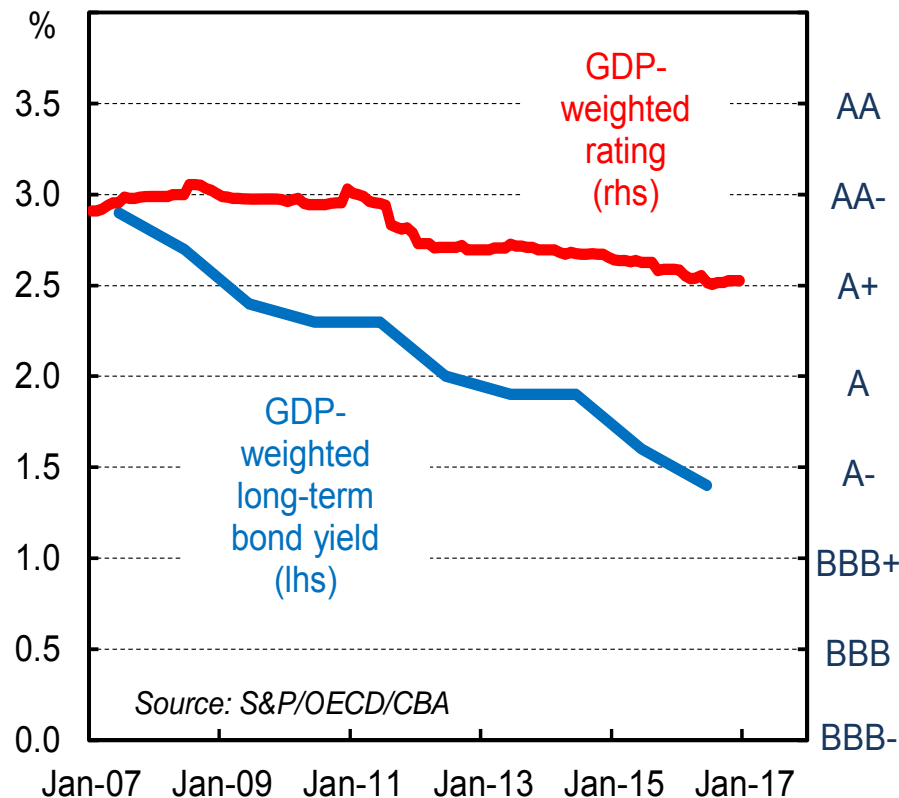
- the budget projections show some improvement;
- some tax increases are on the agenda;
- the current account deficit, a measure of the exposure to global funding markets, has narrowed sharply;
- the Government has been more successful in Senate negotiations than expected after the 2016 Election –77% of measures put to the Senate since the 2016 Election have passed; and
- so called “zombie” measures have been removed from budget figuring.

■ **Post Budget, Moody's have noted that Australia's fiscal strength is high and supportive of the Aaa rating.**

# Judging The Budget

Would losing the AAA matter?

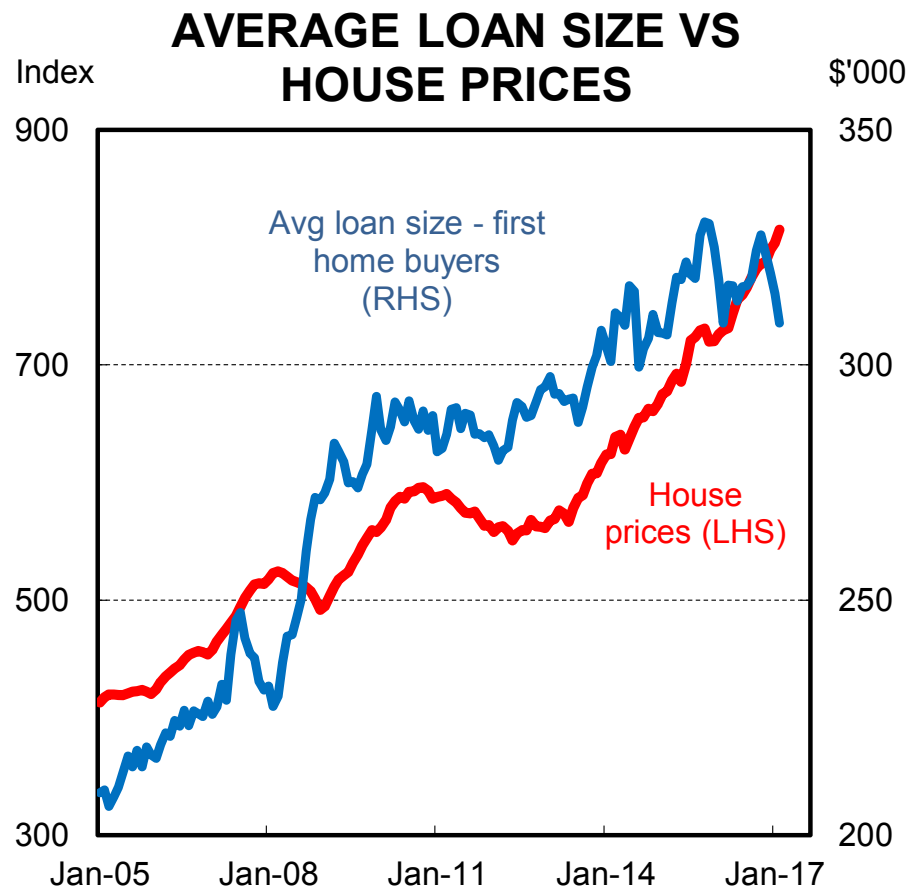
## GLOBAL SOVEREIGN RATING



- **The benefits of a AAA have diminished:**
  - number of AAA sovereigns has fallen from 19 in 2010 to 12 in 2016;
  - average rating has fallen from AA- to A+;
  - bond yields in former AAA economies are lower than when they were AAA's.
- **Any downgrade would still leave Australia highly rated and attractive to foreign investors.**
- **AA is the new AAA!**

# Judging The Budget

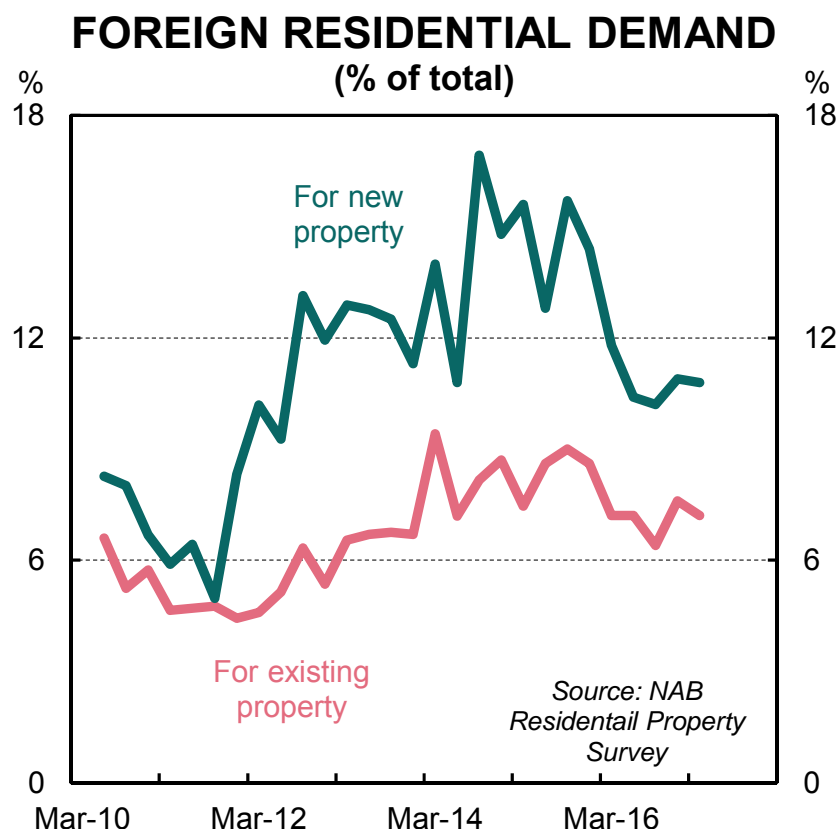
Housing affordability – will the first home owner super saver measures help?



- The Budget focus on salary sacrificing super contributions to help first-home buyers runs the risk of boosting demand.
- Budget figuring suggests a couple taking full benefit of the scheme would be about \$12k better off. This is higher than the old first home owners scheme of \$7k. Albeit incomes and house prices were lower then.
- Policies which boost demand (eg the succession of first-home-owners grants) typically just push house prices higher.
- RBA Governor Lowe noted “you don’t address housing affordability by adding to demand”.

# Judging The Budget

Housing affordability – will measures to reduce foreign demand help?

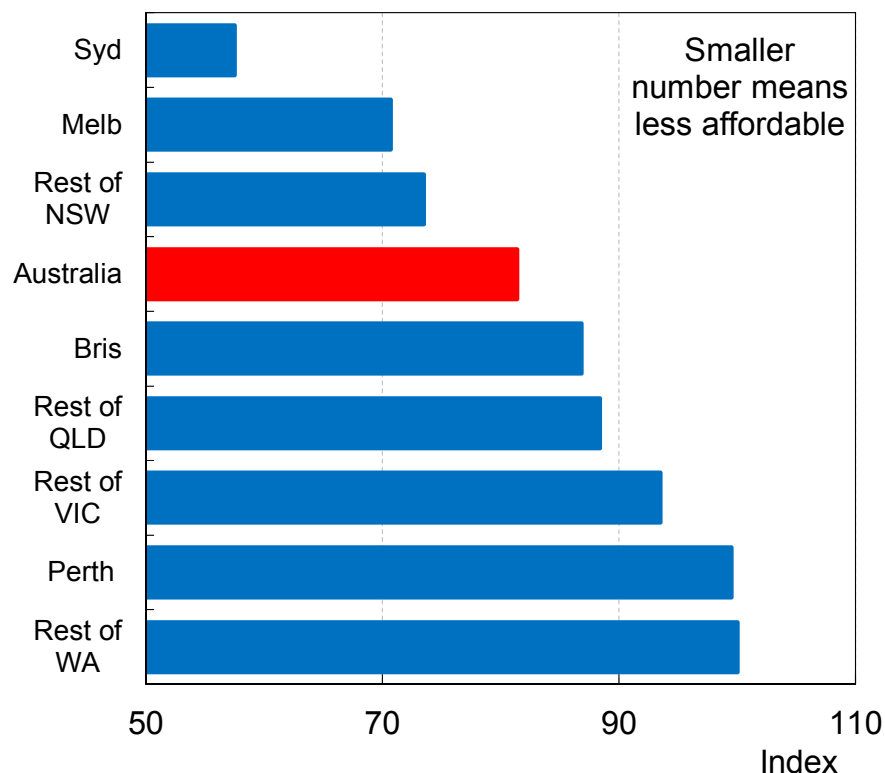


- A 1% tax on vacant properties was introduced in Vancouver (Canada) at the beginning of 2017.
- The effects are hard to determine as a 15% tax on foreign investors was introduced five months prior to this which had already helped to cool the market.
- The NSW, VIC and QLD State governments have all introduced additional stamp duty on foreign buyers. Available data suggests that foreign demand has remained steady following the stamp duty changes.
- Data from the NSW Office of State Revenue showed that most foreign residents buying property were permanent residents. Therefore the changes to capital gains tax are likely to effect only a small proportion of property buyers.

# Judging The Budget

Housing affordability – where should the focus be?

## HIA HOUSING AFFORDABILITY



- The affordability problem is most acute in Sydney and Melbourne.
- This divergence across Australia suggests measures to improve affordability should focus on supply. Improving transport infrastructure, for example, can boost the supply of desirable land.
- The Budget has a strong focus on infrastructure. Measure to boost land supply and improve zoning and planning laws will also help.

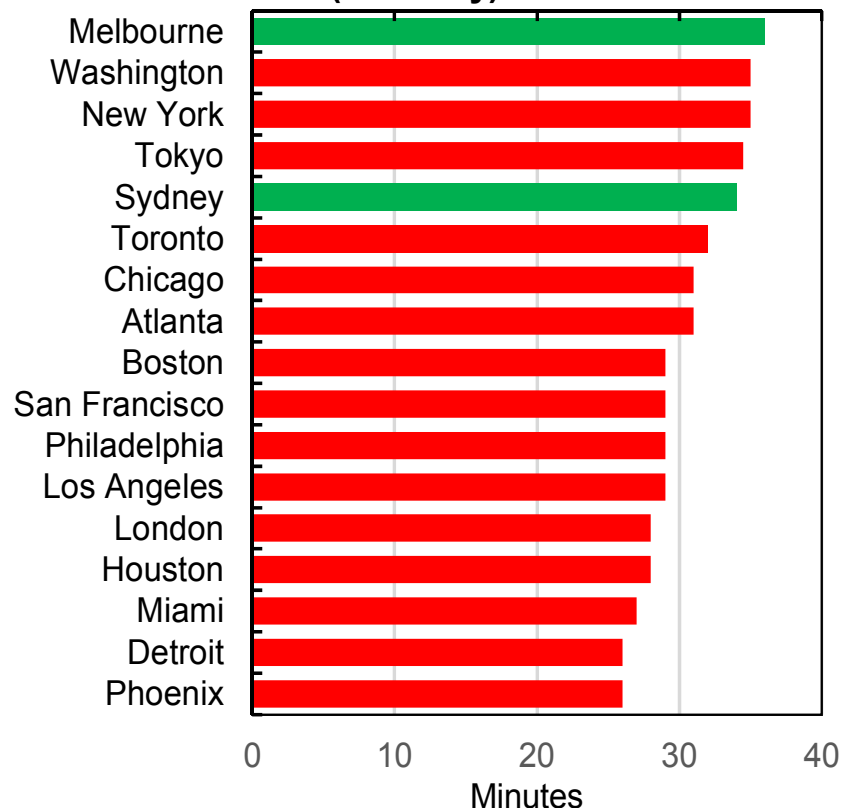


# Judging The Budget

Housing affordability – will the infrastructure push help?

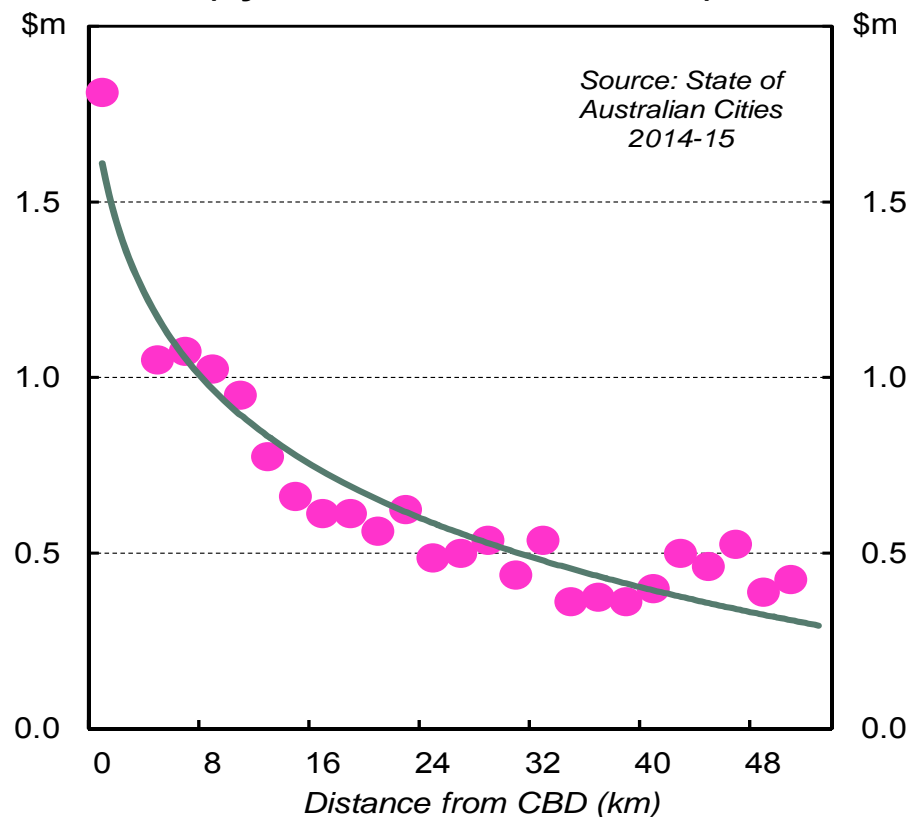
## WORK TRIP TRAVEL TIMES

(one way)



## MELBOURNE HOUSE PRICES

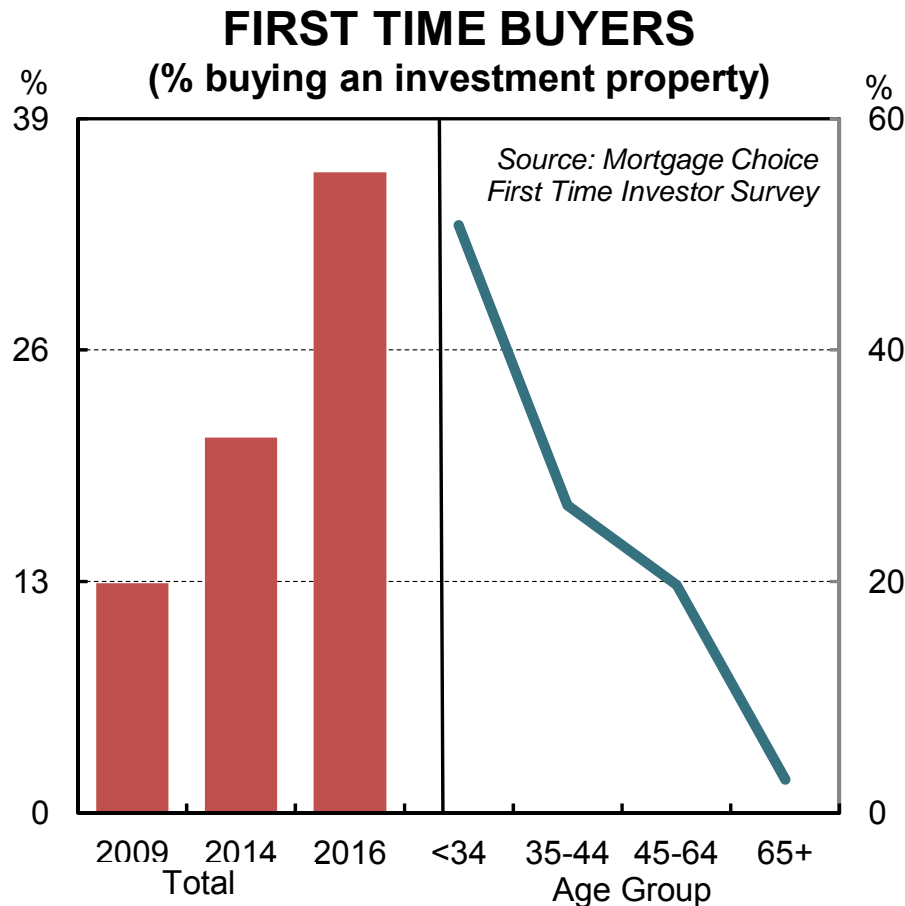
(by distance to CBD in 2013)



- Marchetti's constant is the maximum commute time that workers will travel (about 30 mins). Travel times in Sydney and Melbourne are at the high end of the range.
- Reducing travel time and expanding the acceptable commute distance would open up more land and help with housing affordability – infrastructure the key.

# Judging The Budget

Would changing housing tax arrangements help affordability?

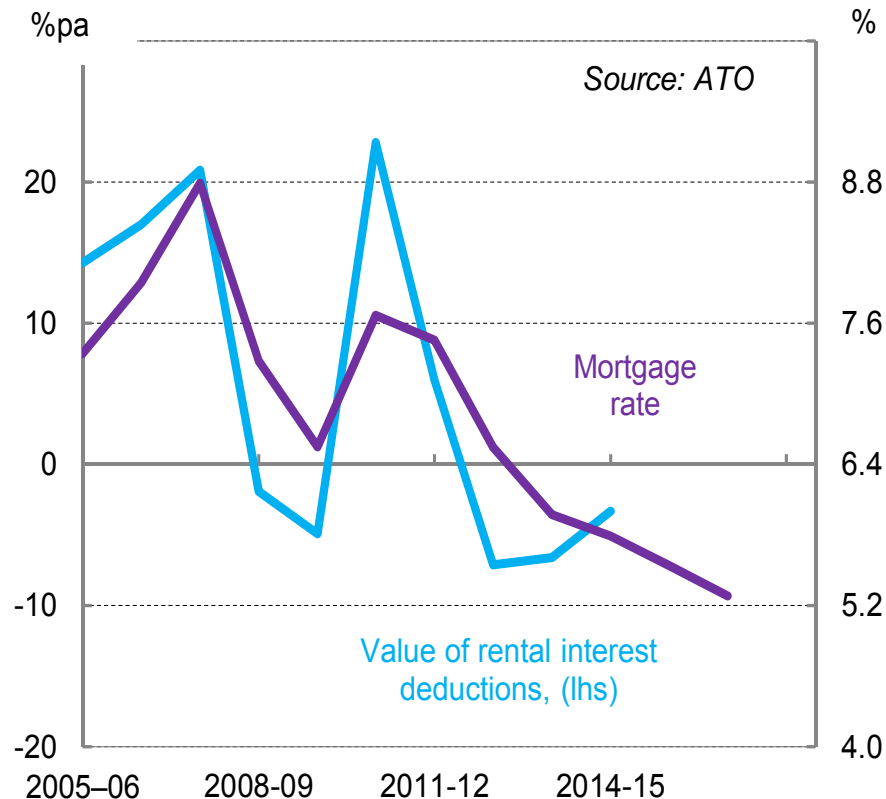


- There were no changes to the taxation arrangements for housing investment.
- Such changes are often touted as a way of reducing investor interest and taking some of the pressures off house prices.
- But we suspect some investors are actually concealed first home buyers.
- Affordability issues mean they enter the market initially as investors to take the benefits of rental income and tax treatment.
- A high proportion of first-time investors are at the low end of the age range where first-home owners are typically found.

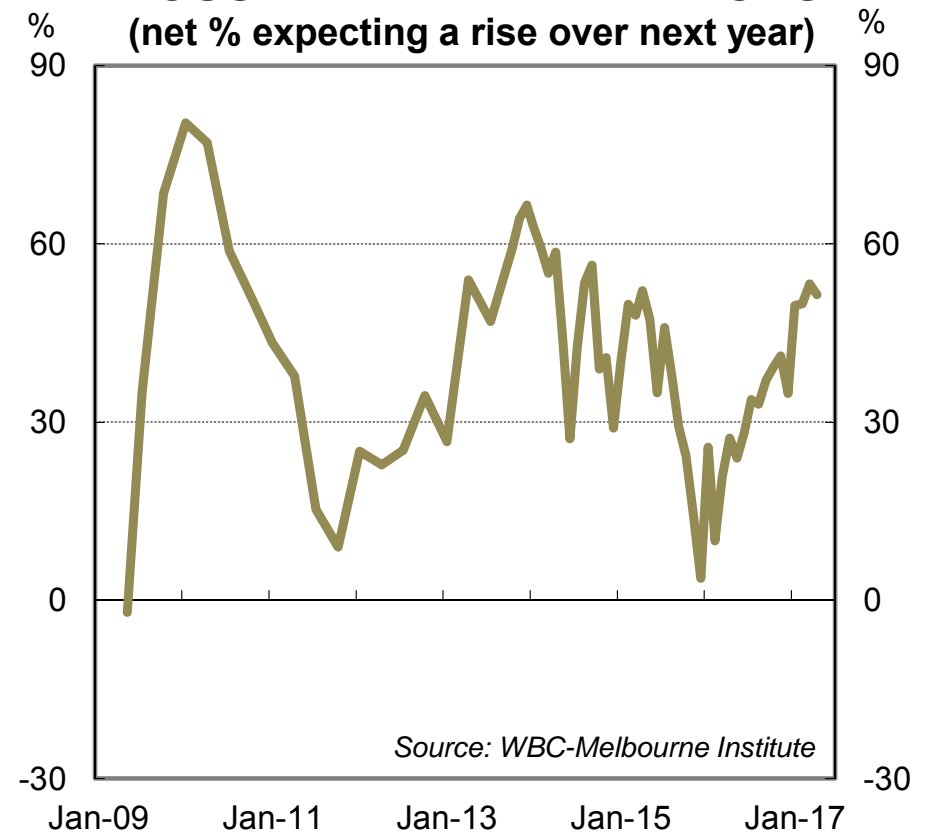
# Judging The Budget

Would changing housing tax arrangements help affordability?

## NEGATIVE GEARING INDICATORS



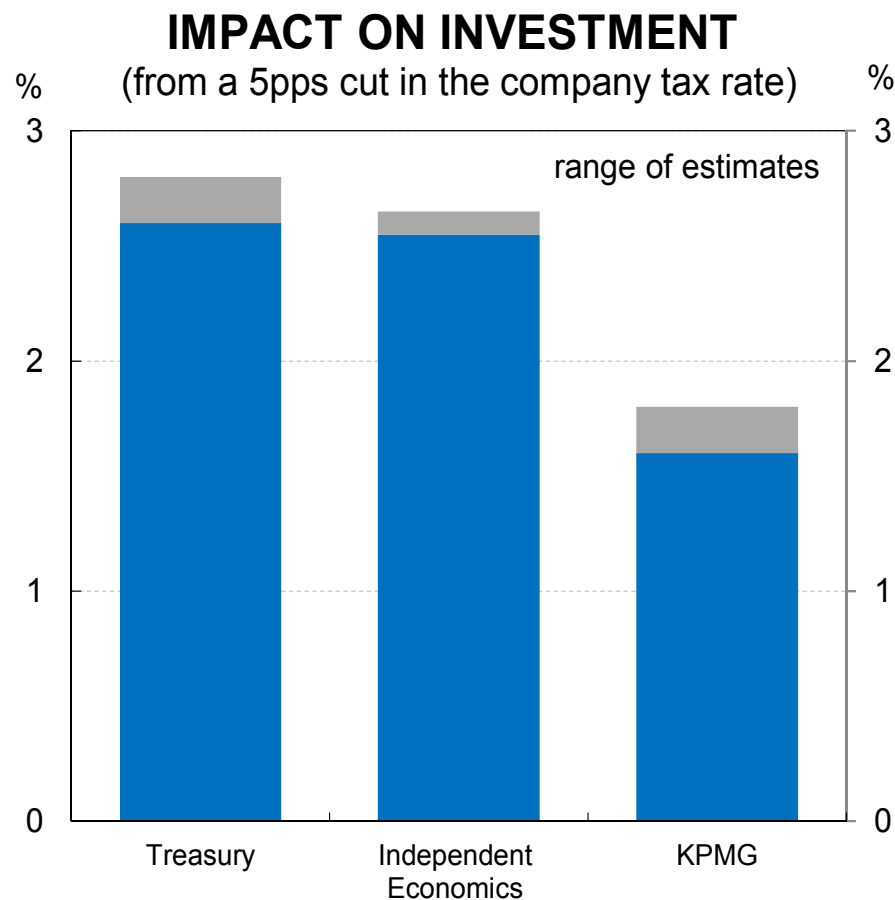
## HOUSE PRICE EXPECTATIONS (net % expecting a rise over next year)



- Low interest rates have eroded the value of negative gearing.
- Negative gearing only works if there is a capital gain – changing the capital gains tax is one way to influence house price growth expectations.

# Judging The Budget

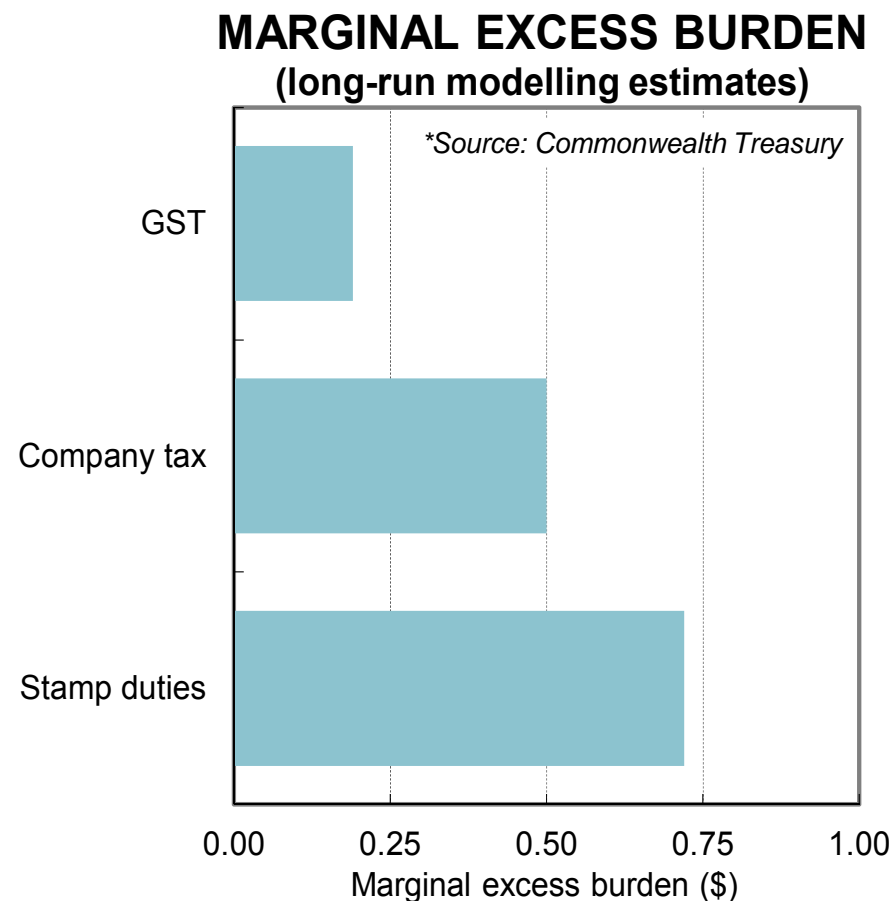
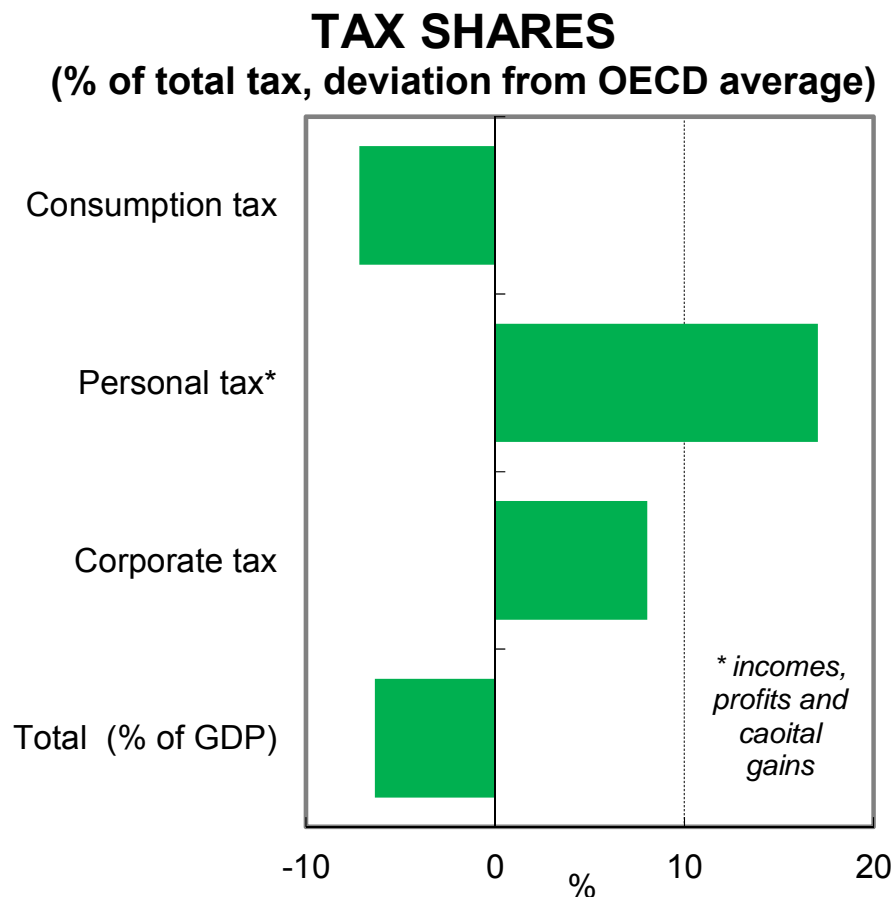
Are further company tax cuts desirable?



- In 2017 only four OECD countries have a corporate tax rate higher than 30%. And two of these, France and the US have implemented or announced lower tax rates in the future.
- A cut in the company tax rate increases the incentive to invest and lifts the overall level of investment for both domestic residents and foreigners.
- The IMF models a cut in the company tax rate to 25% for all companies. In this scenario personal income taxes are cut and the GST is increased so the impacts on the Budget are revenue neutral.
- The model says that the level of GDP will be 1.4% higher after 10 years.

# Judging The Budget

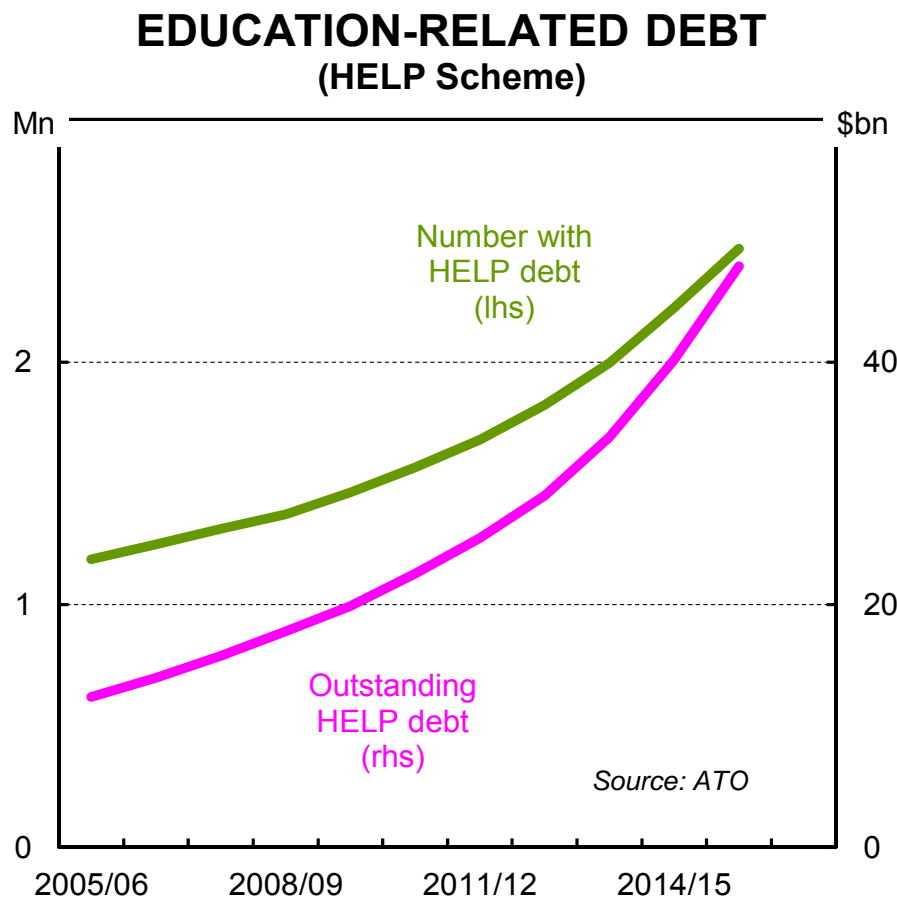
Should tax reform be more than just cutting corporate taxes?



- Relative to the OECD average, Australian tax collections are “overweight” personal income and company taxes and “underweight” consumption taxes.
- Company tax and stamp duties impose the largest cost on living standards over time.
- Tax reform needs to shift the tax mix more broadly.

# Judging The Budget

Will the changes to education help?



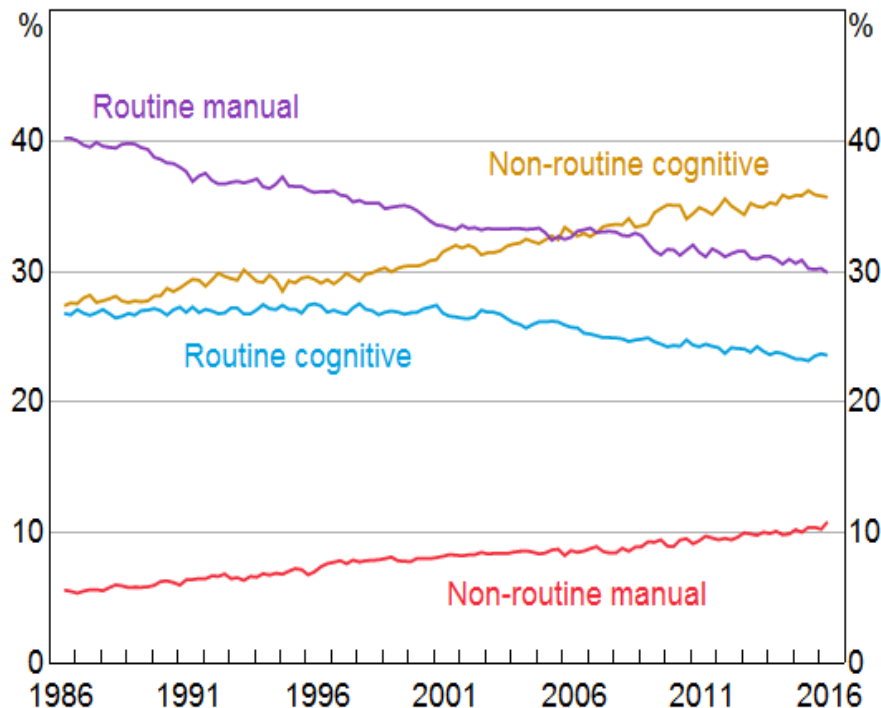
- More education spending helps improve human capital, just as important as physical capital.
- RBA Deputy Governor Lowe has noted the critical importance of investment in human capital to improving the nation's productivity – part of the 3P's that drive growth and income over the longer haul.
- Education spending should help improve labour market flexibility and job and income prospects.
- Fiscal sustainability requires a greater contribution from the beneficiaries.
- Housing debt the main focus. But education-related debt is growing rapidly (up 19%pa in the past two years and now accounts for 2¼% of household debt).

# Judging The Budget

Does education spending help labour market flexibility?

## Employment by Skill Type\*

Per cent of total

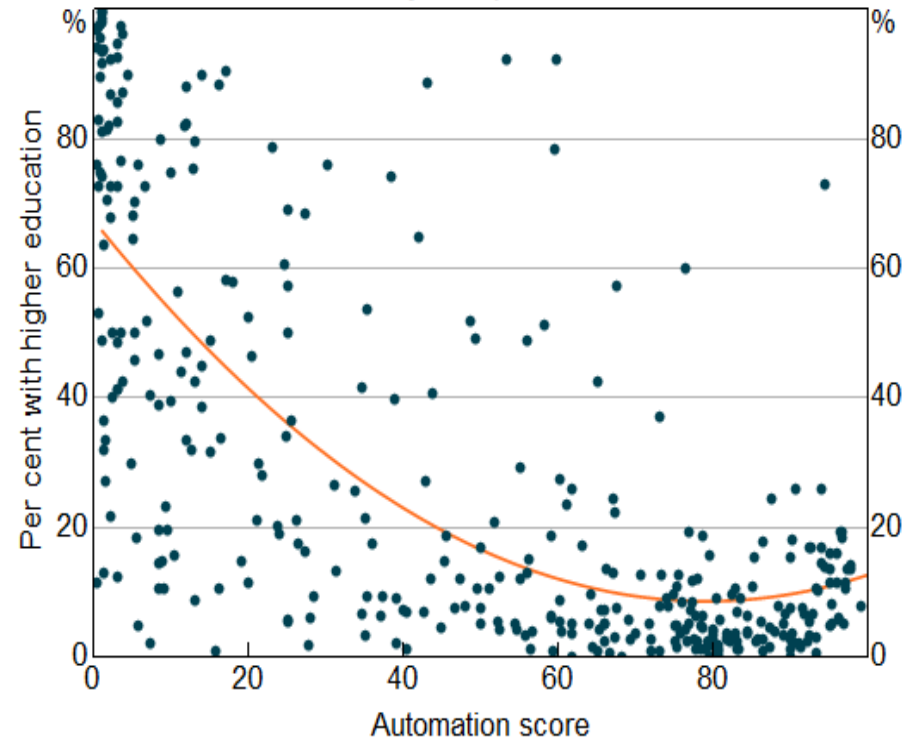


\* Non-seasonally adjusted

Sources: ABS; RBA

## Higher Education and Automation

By occupation



Sources: ABS; Department of Innovation, Industry and Science; RBA

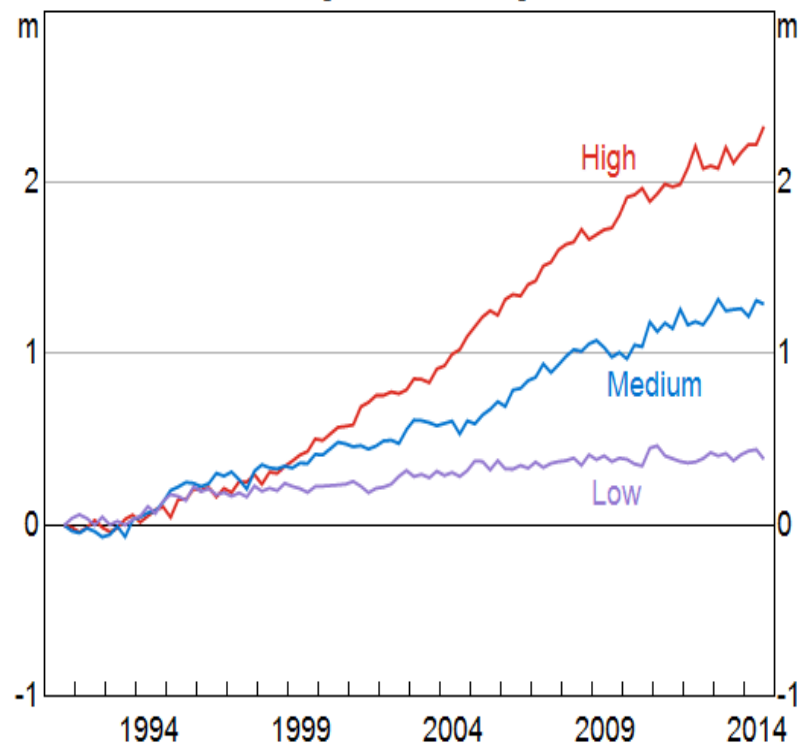
- The share of workers in routine manual jobs is declining, partly due to automation. There is a strong negative relationship between a job's automation potential and the share of workers in that job with post-school qualifications.
- So spending on higher education and vocational training needs to increase.

# Judging The Budget

Does education spending help job and income prospects?

## Employment by Qualification Requirement\*

Cumulative growth since August 1991

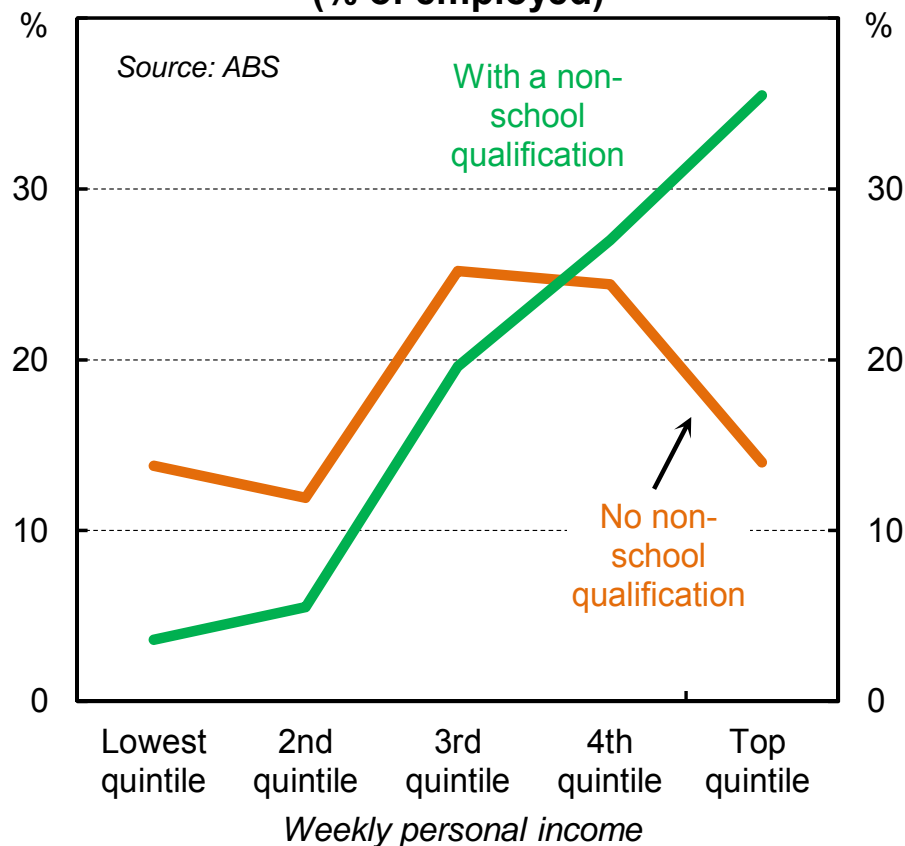


\* Categories are based on occupations (as defined in ANZSCO) that require skill levels commensurate with certain levels of education, training or experience; 'high' indicates Diploma or higher or equivalent experience; 'medium' indicates Certificates II to IV (as defined by the Australian Qualifications Framework) or equivalent experience; 'low' indicates Certificate I or compulsory secondary school education

Sources: ABS; RBA

## INCOME & QUALIFICATION

(% of employed)

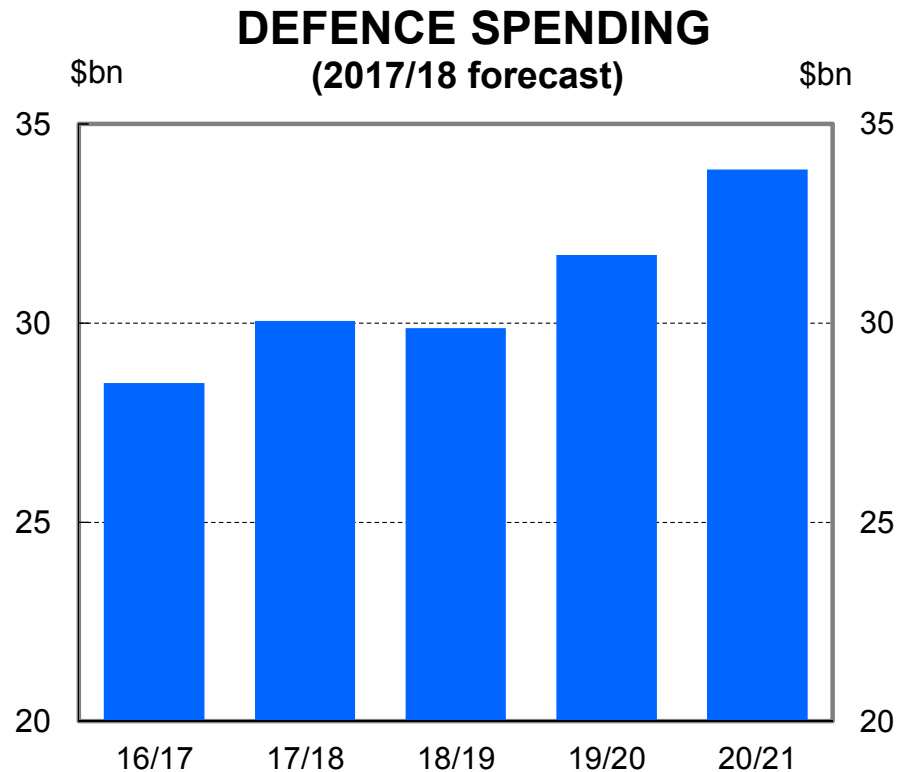


■ Employment and income opportunities improve with educational attainment.



# Judging The Budget

Is there a defence multiplier?



Source: 2017/18 Budget

- The Budget allocates \$50 billion over the forward estimates to the Defence Integrated Investment Program.
- Defence expenses are projected to grow by 5.3% in real terms (12.7 per cent in nominal terms) over the four years to 2020-21 (to reach 2% of GDP).
- Research on government spending multipliers (ie the change in output due to an exogenous change in then fiscal balance) are positive (around 0.9 for Australia).
- While there are no estimates available for Australia, the multipliers for defence spending from other studies tend to be lower (although this result depend critically on the underlying assumptions).

# Judging The Budget

Are the economic assumptions credible?

- Potential GDP growth is 2¾%pa. But a return to 3% looks reasonable give earlier below-trend growth. Weak household income growth could undermine consumption.
- Household consumption has some downside risks if weak wages growth persists.
- Dwelling investment set to weaken as construction peaks over 2017. A&As to help.
- Business investment underpinned by hopeful rising non-mining investment.
- Public demand driven by infrastructure spending.
- Net exports may be larger if trading partner growth beats expectations.
- Inflation realistic but wages forecasts have been much higher than outcomes for past 6 years.
- Terms-of-trade correction on the cards given supply increases underway.
- Unemployment rate to grind slowly lower.
- Current account deficit forecast pessimistic given recent trends. Imports could be flat.

## Key Economic Forecasts

	2016/17 (e)	2017/18 (f)	2018/19 (f)
<b>Real GDP (% ch)</b>	<b>1¾</b>	<b>2¾</b>	<b>3</b>
<i>Of which:</i>			
H/hold consumption (% ch)	2½	2¾	3
Dwelling Investment (% ch)	4½	1½	-4
Business Investment (% ch)	-6	0	3
Public demand (% ch)	4	2½	3
GNE (% ch)	1¾	2½	2¾
Net exports (contrib)	½	½	½
<b>CPI (% ch yr to June)</b>	<b>2</b>	<b>2</b>	<b>2¼</b>
WPI(% ch yr to June)	2	2½	3
<b>Terms of trade (%ch)</b>	<b>16½</b>	<b>-2¾</b>	<b>-4¼</b>
Nominal GDP (% ch)	6	4	4
Employment (% ch)	1	1½	1½
<b>Unemployment (%, June)</b>	<b>5¾</b>	<b>5¾</b>	<b>5¾</b>
Current A/c def (% GDP)	-1½	-1½	-2

# Judging The Budget

Are the global assumptions realistic?

## Budget Global Growth Forecasts

	2016 (a)	2017 (f)	2018 (f)
United States	1.6	2.25	2.25
Euro area	1.7	1.25	1.25
Japan	1	0.75	0.5
China	6.7	6.5	6.25
India	7.5	7	7.75
Other East Asia	3.9	4	4.25
<b>Major trading partners</b>	<b>3.9</b>	<b>4</b>	<b>4</b>
World	3.1	3.25	3.5

■ U.S. and Eurozone GDP forecasts are slightly more conservative than the latest IMF projections.

■ Forecasts for Japan and India's GDP forecast are modestly lower than the IMF projections.

■ China's GDP forecasts are plausible and roughly in line with the IMF projections.

■ Australia's major trading partner growth is anticipated to remain faster than world economic growth.

■ World economic forecasts are slightly lower than the IMF's latest world economic growth forecasts.

# Judging The Budget

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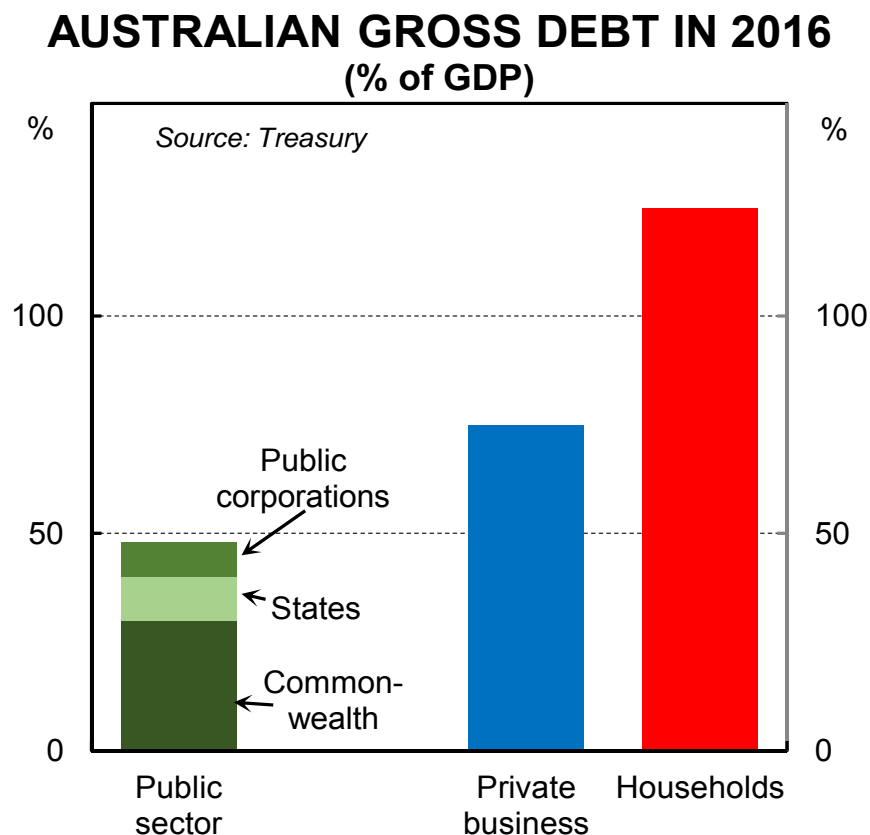
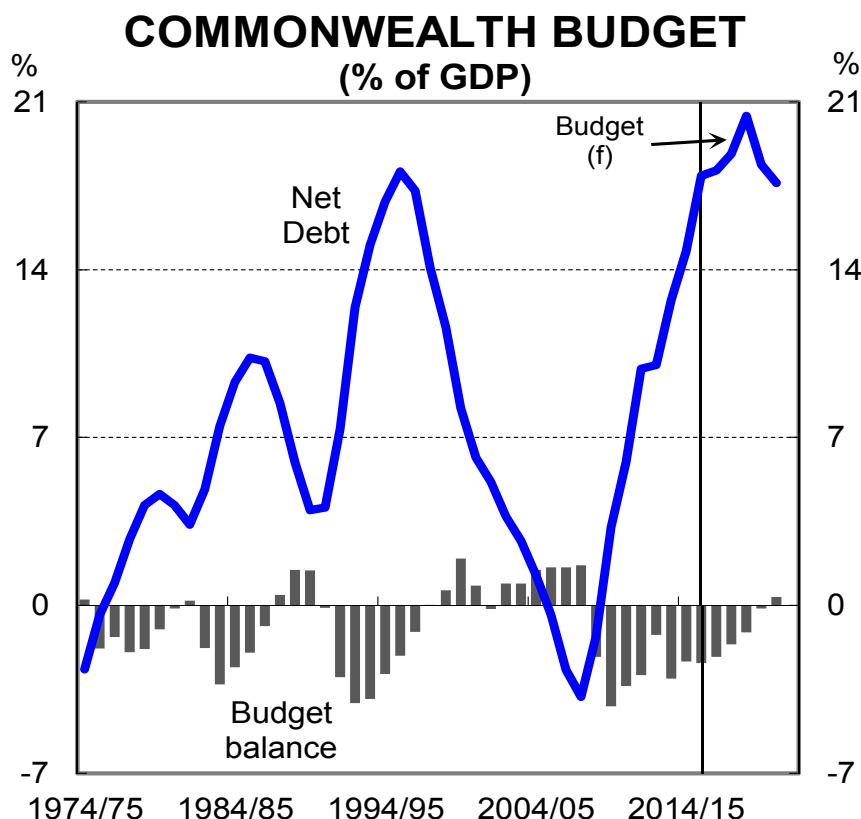
## Global risk assessment

**Downside risk to global growth flagged by the government include:**

- **Growing support for policies that could restrict global trade and hence growth.**
- **High levels of debt, potential financial imbalances and overcapacity in some sectors of China's economy.**
- **Europe continues to face legacy issues following the GFC.**
- **The recalibration of interest rates in the United States.**
- **Greater concern surrounding a number of regional and global strategic issues.**

# Judging The Budget

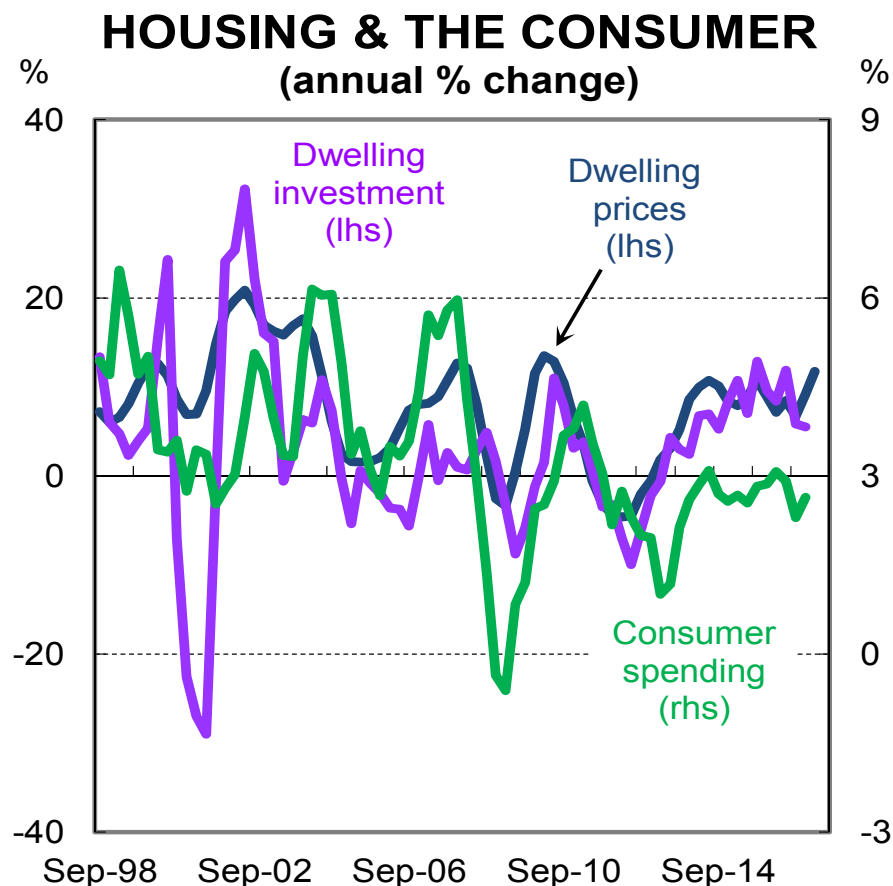
Where is the debt?



- Ongoing deficits plus an infrastructure push mean Commonwealth net debt will climb further to 19.5% of GDP in 2017/18 before peaking at 19.8% of GDP in 2018/19 thereafter tracking lower to 17.6% of GDP by 2020/21.
- This number will remain the focus of attention by policymakers, markets and rating agencies.

# Judging The Budget

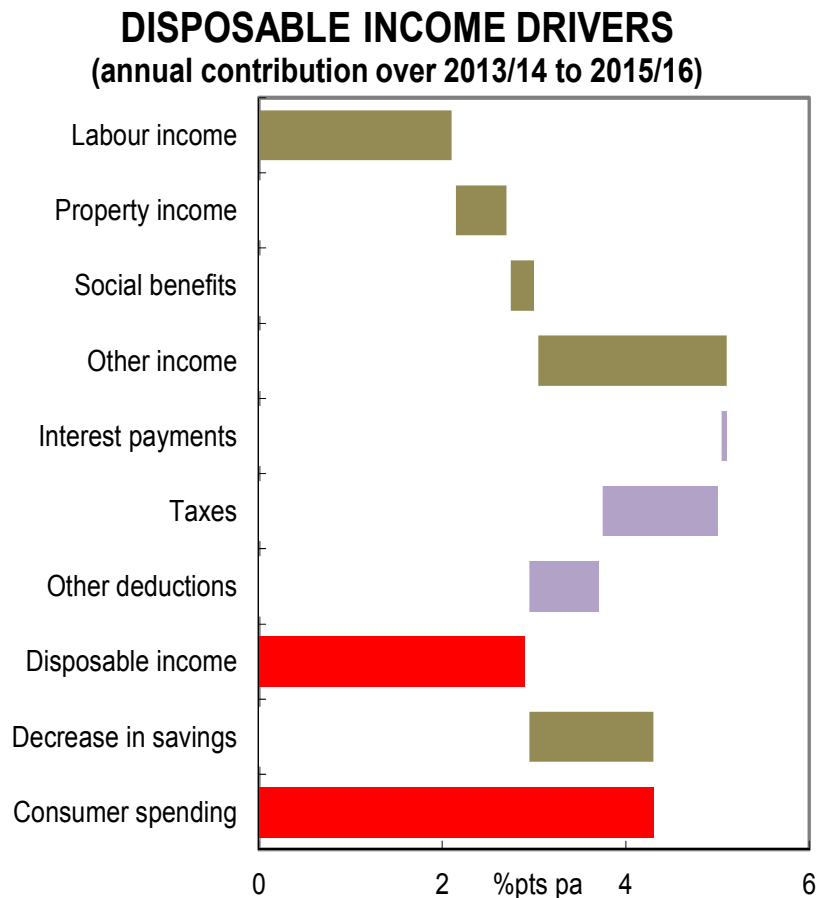
Does household debt matter?



- **High household debt is a risk to financial stability.**
- **But there is also a macro risk that high debt sees consumers scale back spending, accentuating any downturn.**
- **Slow income growth accentuates the risks:**
  - household debt:income ratios and house price: income ratios are higher than otherwise; and
  - Income tax revenues have fallen short of expectations.
- **The Budget assumes 2017/18 consumer spending growth of 2¾%, picking up to 3% in 2018/19. The saving rate is forecast to decline to 3¼% by 2018/19:**
  - these assumptions are needed to prevent debt-income ratios rising further.
- **The income story is a significant risk to fiscal aggregates and economic outcomes.**

# Judging The Budget

Where will the income come from?



## Looking ahead:

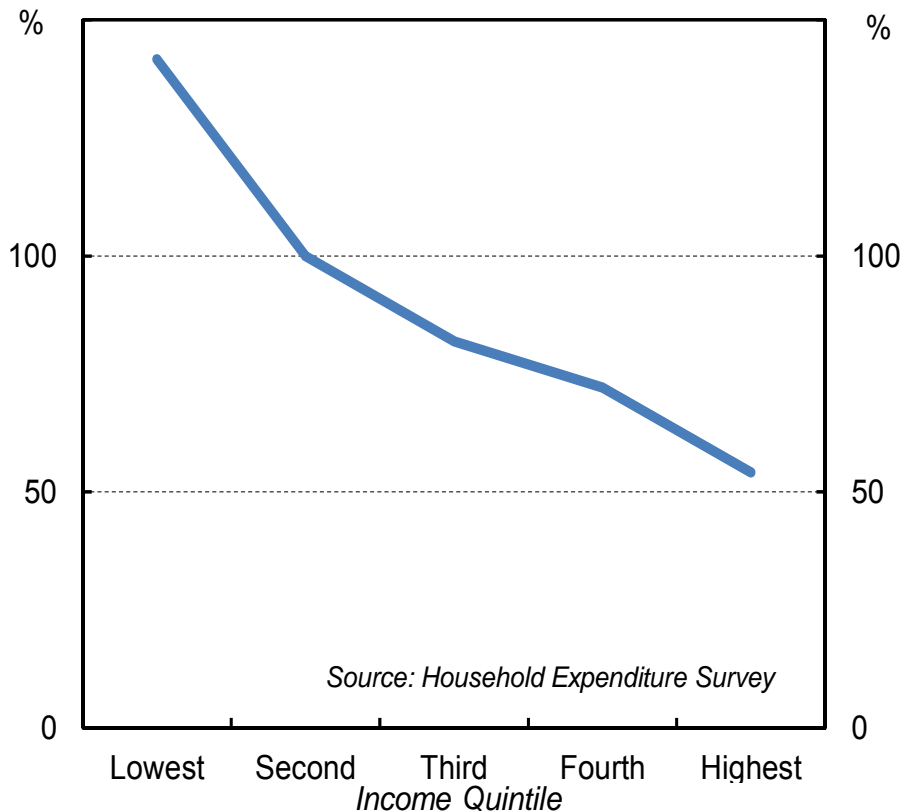
- low deposit rates and slowing rental growth limits the contribution from property income;
- the unusually large rise in unincorporated enterprise incomes is unlikely to be repeated (although rising farm incomes will help); and
- tax cuts, social benefit increases and rate cuts are off the policy agenda.

## If household income is to lift, then labour income (ie wages) must rise.

# Judging The Budget

A policy response to a market failure?

## SHARE OF INCOME SPENT

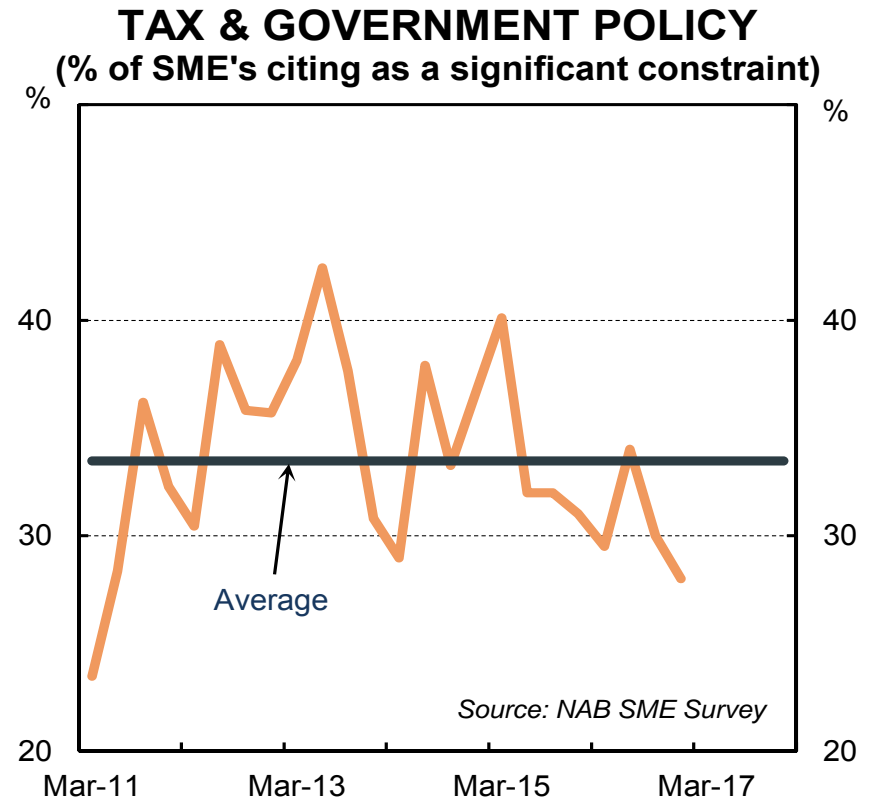
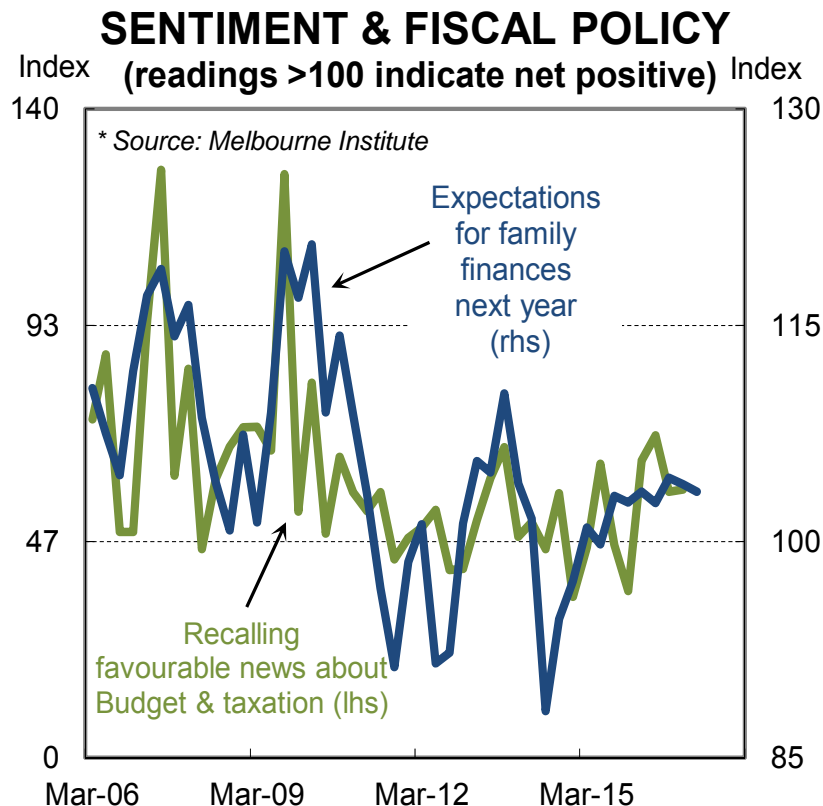


- Policy makers used to exert a fair amount of influence on labour incomes through the centralised wage fixing system.
- A return to a centralised system is not desirable. But a national wage increase would deliver additional spending power to the group most likely to use that benefit:
  - wages & salaries are the biggest component of income; and
  - the benefits are proportionately larger in the lower half of the income distribution where a larger share of income is spent.
- Treasurer Morrison notes “hard working Australians haven’t had a pay rise for a long time”. Governor Lowe argues that “some pickup in wages growth would be welcome”.
- BoJ Governor Kuroda has called on business to lift Japanese wages.



# Judging The Budget

Will it help consumer and small business confidence?



- Household perceptions about the impact of the Budget on their personal finances have been subdued in recent years. But this budget is more consumer/household friendly and should lift sentiment. This is in sharp contrast to confidence sapping 2014 Budget which depressed low and middle income earners.
- Earlier company tax changes favour SME's and concerns about government policy have receded as a result.

# Judging The Budget

Will it sustain big business confidence?

## What do corporates want from the Budget?

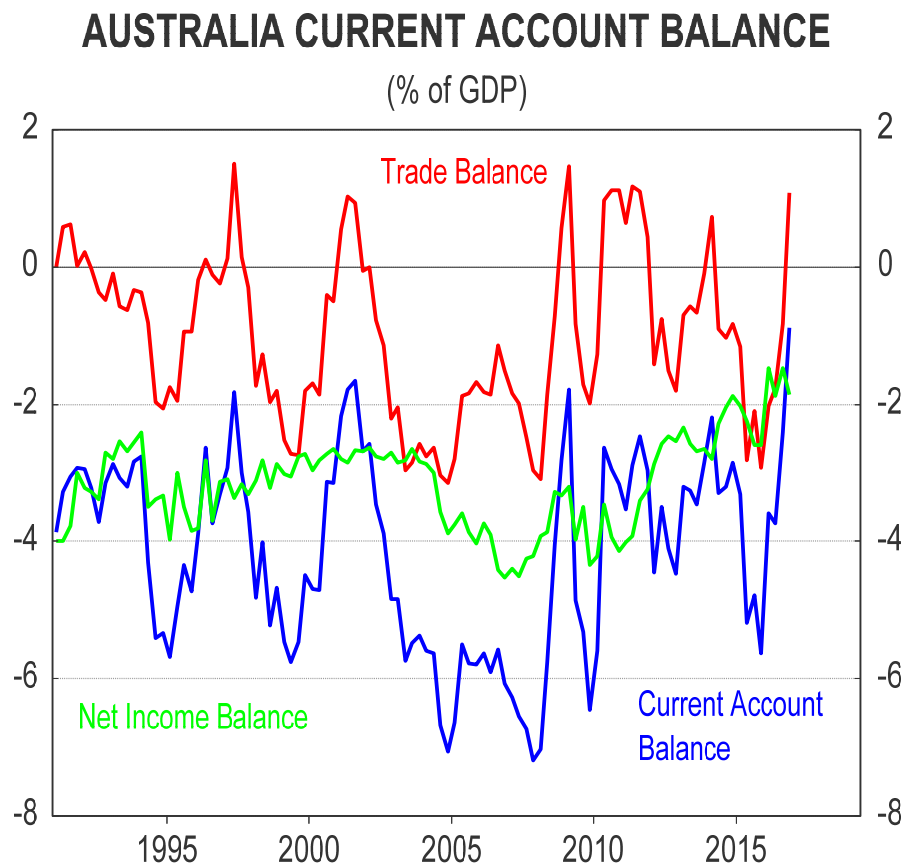
Tax reform (49% of respondents)	✓
Infrastructure (46% of respondents)	✓
Productivity growth (36% of respondents)	✓
International competitiveness (29% of respondents)	✓
Industrial relations reform (19% of respondents)	✗
Energy policy (48% of respondents)	✓
Dealing with an aging population (22% of respondents)	✗
Climate change (31% of respondents)	✗
Education (29% of respondents)	✓

Source: AICD Director Sentiment Index

- Big business confidence is at elevated levels.
- Company directors favour tax reform, energy policy, productivity and infrastructure spending as priorities.
- So should be pleased with prospective company tax cut even if a fair way off and focus on infrastructure.
- More education spending should help improve human capital.
- Little focus on IR (preference for modernising award system and penalty rate changes) – but hardly surprising given the politics.
- All up, the Budget should help sustain business confidence in economic prospects.

# Judging The Budget

## The Budget & the AUD



- **The Budget is based on the standard forecasting assumption of a steady AUD (76 US cents and a trade-weighted index of around TWI of 65).**
- **CBA Research forecasts the AUD to be 76 US cents at end 2017 and 80 cents by end 2018.**
- **The government sees improvement in Australia's current account deficit from 4.4%, to 1.5% of GDP by 2017-18 which should be AUD supportive.**
- **The terms of trade is expected to stabilise, a plus for the AUD.**

# The Budget & Politics

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Will the Budget navigate the Senate political shoals?

- **The Coalition Government has 29 seats - well short of the 39 seats needed for an overall majority (of total 76 Senate seats) needed to pass legislation or support motions in Senate.**
- **The votes of Labor (26 seats) and Greens (9 seats) combined (ie 35 seats) are not sufficient to block or pass legislation, or support motions.**
- **Since the July 2016 double dissolution election, the balance of power rests with an increased pod of populist independents and minor parties. Complicating matters has been the extinction of PUP at the election and its replacement by 4 One Nation Party Senators.**
- **To this political potpourri add 3 Xenophon Senators, Australian Conservatives' Bernardi and Independent Senators Lambie, Hinch and Gichuhi (previously Family First) and you have a very mixed bag of 12 Senators with conflicting ideas and ideologies. So negotiations on contested Budget Measures will be complex.**
- **If Labor and Greens oppose Coalition legislation, 10 of the 12 crossbench Senators will be required to support a Coalition bill or motion. Up to 9 of these 12 cross benchers are needed to defeat non-government motions including motions of disallowance.**
- **Like all Federal Budgets since 2008, a substantial degree of negotiation or horse trading will likely be required to ensure key government fiscal measures are “greenlighted” by the upper house. The stance of the Independents on many issues is not yet clear and remains a “work in progress”.**

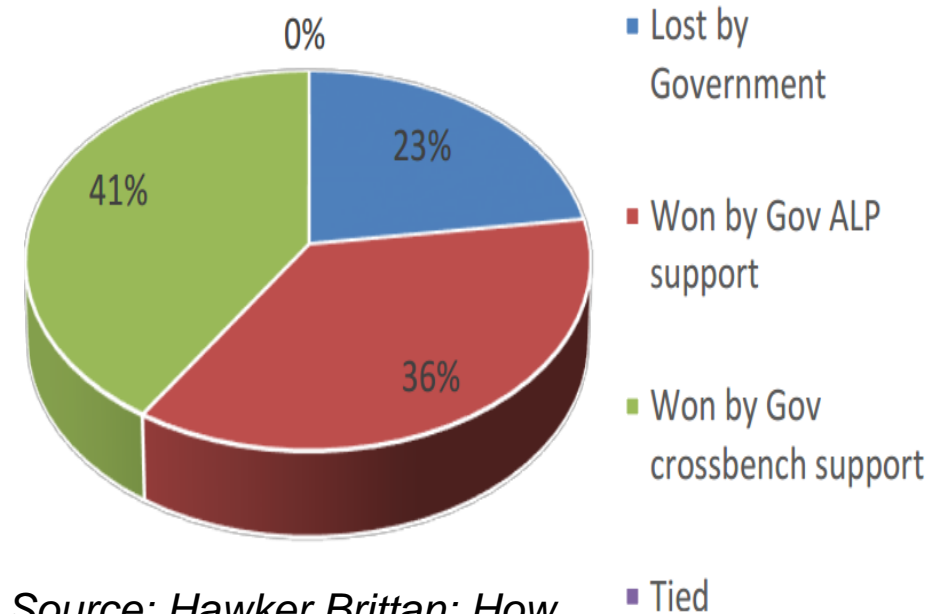
# The Budget & Politics

Will the Budget navigate the Senate political shoals?

## 45<sup>th</sup> Senate Makeup as at May 2017

<i>Coalition</i>	29
<i>Australian Labor Party</i>	26
<i>Australian Greens</i>	9
<i>One Nation</i>	4
<i>Nick Xenophon Team</i>	3
<i>Liberal Democrats</i>	1
<i>Jacqui Lambie Network</i>	1
<i>Derryn Hinch's Justice Party</i>	1
<i>Australian Conservatives</i>	1
<i>Independent Gichuhi (prev. Family First)</i>	1
<b>Total Senate</b>	<b>76</b>

## Won/Lost by Government 45th Parliament



Source: Hawker Brittan: How the Senate has voted Apr'17

- The government has had some success in navigating legislation through the Senate.

# The Budget & Politics

Where they Stand? Likely Senate Crossbench positions on key issues

	Labor	Greens	Xenophites	One Nation	Other 3 Indep.	Australian Conservative Party	Liberal Democrat Party
<b><i>Infrastructure spending</i></b>							
• Badgery's Creek, Sydney Airport	yes	yes	yes	yes	yes	yes	?
• Brisbane – Melbourne Inland Rail	yes	yes	yes	yes	probable yes	yes	?
• Energy- Snowy River Scheme 2.0	yes	yes	yes	yes	yes	yes	?
<b><i>Health</i></b>							
• Medicare package/ changes	yes	yes	yes	yes	?	?	?
• Medicare levy changes	yes	yes	yes	yes	?	?	?
• PBS package/new measures.	yes	yes	yes	yes	yes	yes	yes
<b><i>Black Economy</i></b>							
• Measures to claw tax from black economy	yes	yes	yes	yes	yes	yes	?

# The Budget & Politics (cont)

Where they Stand? Likely Senate Crossbench positions on key issues

	Labor	Greens	Xenophites	One Nation	Other 3 Indep.	Australia Conserv. Party	Liberal Democrats
<b>Personal Tax</b> <ul style="list-style-type: none"> <li>Removal of Temporary Budget Repair Levy</li> </ul>	yes	?	?	?	?	yes	yes
<b>Education Reforms</b> <ul style="list-style-type: none"> <li>University funding cuts</li> </ul>	no	no	no	?	?	yes	yes
<ul style="list-style-type: none"> <li>7.5%lift in student fees &amp; changes in student debt repayment rules</li> </ul>	no	no	no	?	?	yes	yes
<ul style="list-style-type: none"> <li>Gonski Mark II: rejigged school funding</li> </ul>	probable yes	probable yes	probable yes	yes?	?	yes	?
<b>Housing Affordability</b> <ul style="list-style-type: none"> <li>Negative gearing measures to limit deductibles</li> </ul>	yes	yes	yes	yes	yes	yes	yes
<ul style="list-style-type: none"> <li>First home super saver scheme</li> </ul>	yes	yes	yes	?	?	?	?

# The Budget & Politics (cont)

Where they Stand? Likely Senate Crossbench positions on key issues

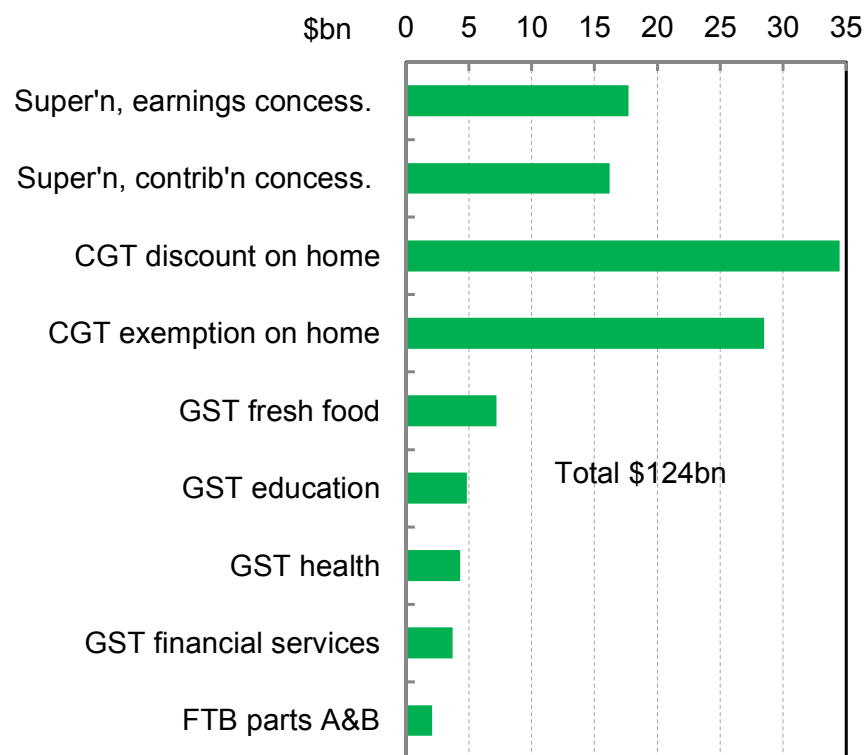
	Labor	Greens	Xenophytes	One Nation	Other 3 Indep.	Australian Conservative Party	Liberal Democrat Party
<b>Welfare Savings</b> • Tightened compliance measures	no	no	no?	yes	no	yes	yes
<b>Company Tax Cuts</b> • Large Companies (turnover>\$50mn)	no	no	no	no	?	yes	yes
<b>Bank Tax/Levy</b> • 4 Majors & Macquarie on deposits/liabilities >\$250k	yes	yes	yes	yes	?	?	?
<b>Skilled Aust. Funds Levy</b>	yes	yes	yes	yes	?	?	?
<b>Tax measures</b> • re multinational companies.	yes	yes	yes	yes	yes	yes	?



# Judging The Budget

Concessions: from little things, big things grow

## TAX EXPENDITURES 2017/18f (for one year, \$bn)

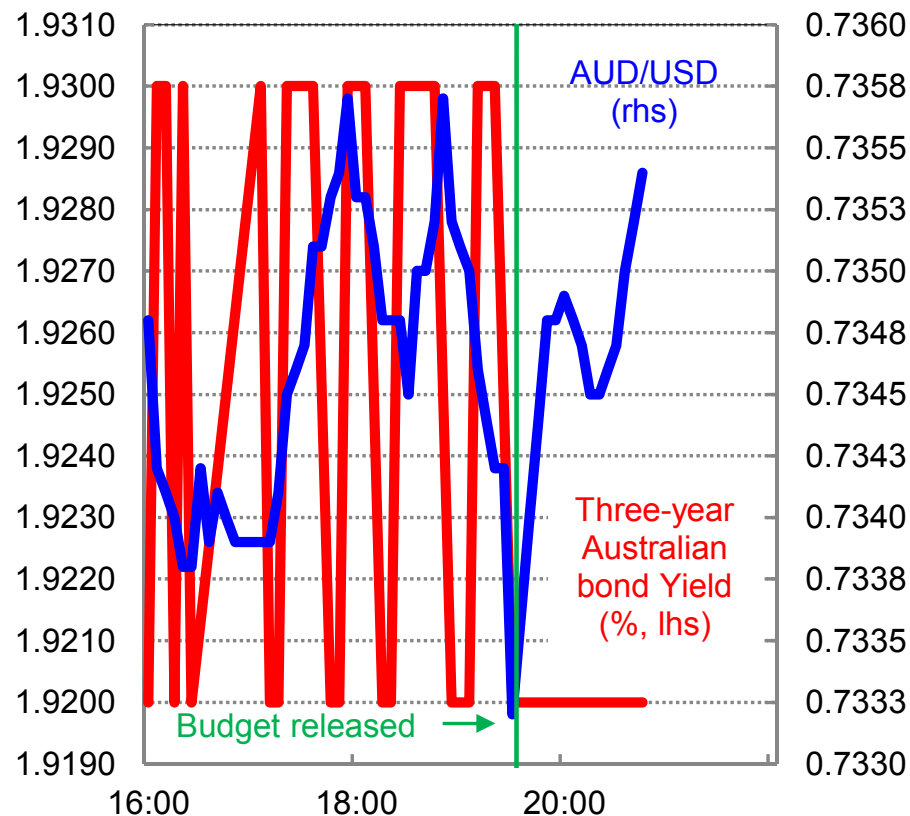


- **Tax expenditures** are potential tax lost via concessional treatment of items, like super contributions or earnings, or the GST-free status of fresh food, health and education.
- **Tax revenues** are \$124bn lower per year (outlined in Table A1 of Statement 5) via:
  - Superannuation concessions ~ \$34bn
  - CGT exemption on housing ~ \$62bn
  - GST widening ~ \$20bn;
  - Negative Gearing ~ \$4bn ;
  - Family Tax Benefit – untaxed ~ \$2bn
  - Diesel fuel rebate costs ~\$5bn.
- **Incremental changes** to concessions and GST exemptions can make significant contributions to revenue growth and fiscal stability over coming years.

# Financial Market Issues

Market reaction typically benign

## TRADING AT RELEASE OF BUDGET

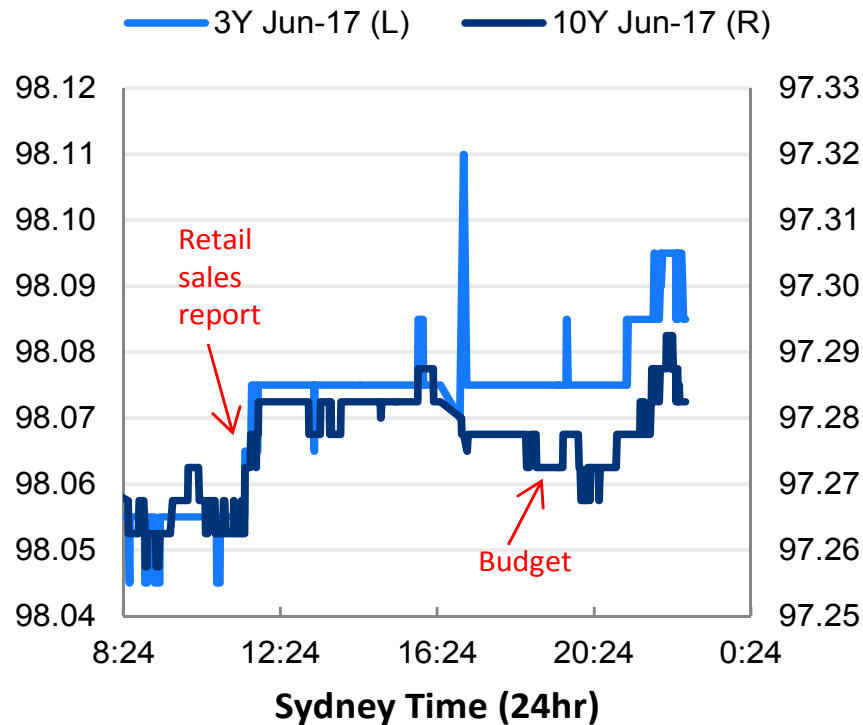


- AUD/USD dipped briefly to a low of 0.7326 following the Budget release but recovered quickly to near its pre-budget release level of 0.7350.
- International credit rating agency Moody's said Australia's budget is consistent with a stable outlook for AAA rating.
- Australian three-year bond futures contract was largely unchanged at 1.92%.

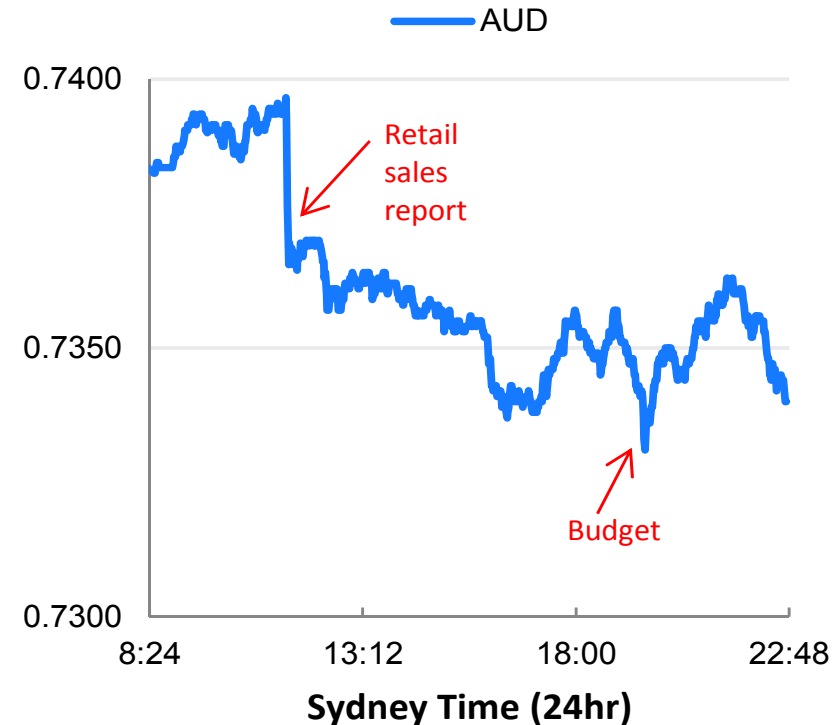
# Financial Market Issues

## Coupon Bond Issuance

Intraday bond futures pricing



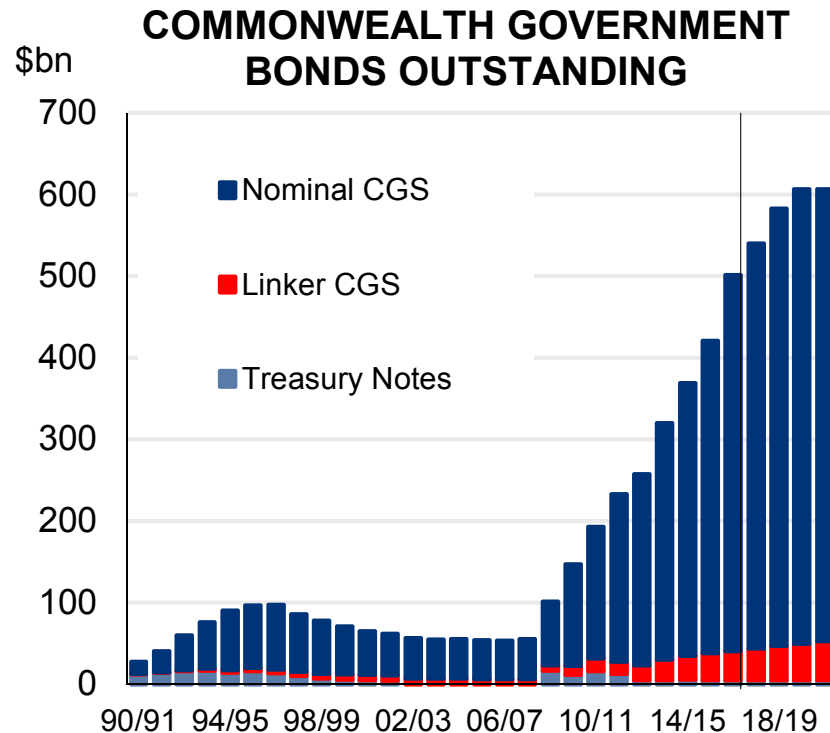
Intraday AUD pricing



- AUD/USD briefly dipped marginally following the Budget, before recovering.
- Bond futures were little changed, but subsequently rallied slightly – perhaps following Moody's confirmation of the Aaa rating.

# Financial Market Issues

CGS Outstandings continuing to grow at solid pace



- Ongoing deficits see an upward trend in total bond outstandings, though the final year of the forecasts is flat.
- Total nominal Coupon bond outstandings are expected to grow from \$382bn at 30 June 2016 to \$460bn at 30 June 2016 and to \$497b by 30 June 2017.
- Linker outstandings will rise \$3bn to \$38.9bn.
- T-notes are expected to remain very low, which provides scope for extra issuance if needed.

# Financial Market Issues

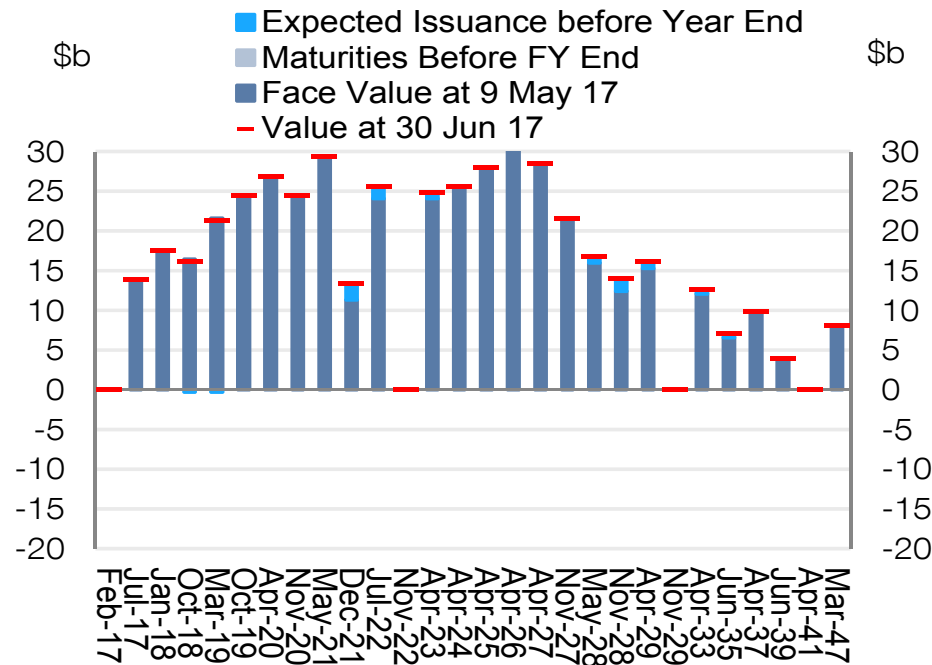
## Funding requirement

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
	(a)	(a)	(a)	(a)	(f)	(f)	(f)	(f)	(f)
<b>NET FUNDING REQUIREMENT:</b>									
Headline Budget deficit	21.0	52.5	38.9	49.1	51.1	48.4	37.1	14.8	-11.7
Bond maturities	25.6	24.7	29.3	34.5	11.8	31.3	32.7	37.2	44.9
Sequestered Funds / AOFM Liquidity	2.4	9.6	10.3	2.6	29.5	-9.4	4.9	9.2	11.7
<b>Total</b>	<b>53.5</b>	<b>86.8</b>	<b>78.5</b>	<b>95.4</b>	<b>104.5</b>	<b>84.3</b>	<b>88.7</b>	<b>75.2</b>	<b>59.0</b>
<b>FINANCED BY</b>									
Debt issuance									
- Treasury bonds (net issuance excl mats)	58.0	80.0	73.5	92.6	100.0	81.3	85.7	72.2	56.0
- Indexed bonds	2.9	7.3	4.0	3.8	3.0	3.0	3.0	3.0	3.0
- Treasury notes (net)	-7.4	-0.5	1.0	-1.0	1.5	0.0	0.0	0.0	0.0
<b>Total</b>	<b>53.5</b>	<b>86.8</b>	<b>78.5</b>	<b>95.4</b>	<b>104.5</b>	<b>84.3</b>	<b>88.7</b>	<b>75.2</b>	<b>59.0</b>
- net change Debt Outstanding	23.4	62.1	49.3	51.7	80.6	39.0	42.0	24.0	0.0
<b>AOFM Liquidity Management</b>									
Sequestered Funds (mainly cash at bank, M)	2.4	9.6	10.3	2.6	29.5	-9.4	4.9	9.2	11.7
Cumulative Sequestered Funds	2.4	12.0	22.3	24.9	54.4	45.0	49.9	59.1	70.8
<b>MEMO:</b>									
Coupon bonds outstanding	234.5	289.8	334.0	382.9	459.0	495.0	534.0	555.0	552.1
Indexed linked bonds	17.8	25.1	29.1	32.9	35.9	38.9	41.9	44.9	47.9
Treasury Notes	5.1	4.6	5.6	4.6	6.1	6.1	6.1	6.1	6.1
<b>Total Gross Debt</b>	<b>257.4</b>	<b>319.5</b>	<b>368.7</b>	<b>420.4</b>	<b>501.0</b>	<b>540.0</b>	<b>582.0</b>	<b>606.0</b>	<b>606.0</b>
Net debt	161.1	153.0	153.0	153.0	153.0	153.0	153.0	153.0	153.0

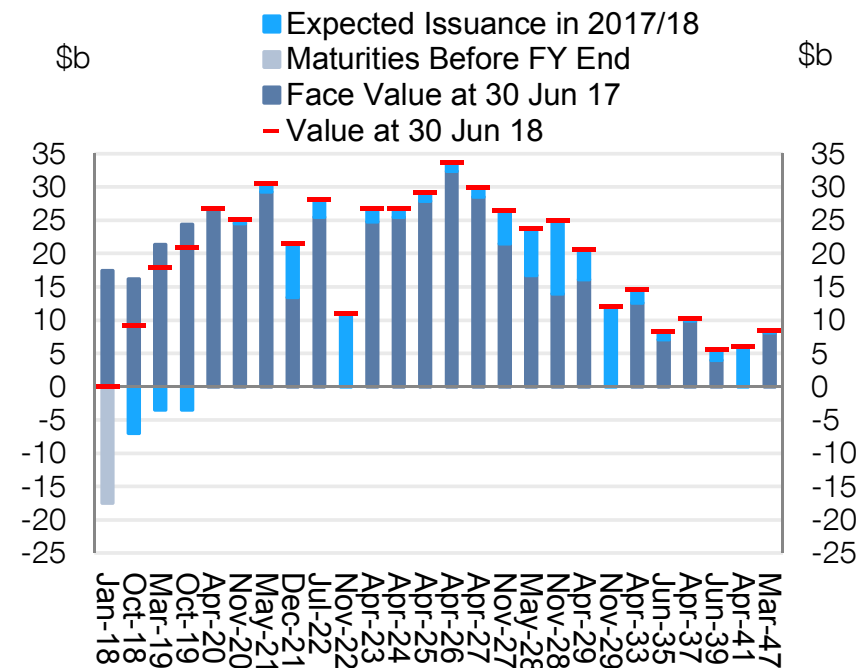
# Financial Market Issues

## Coupon Bond Issuance

### Issuance over remainder 2016-17



### Issuance over 2017-18

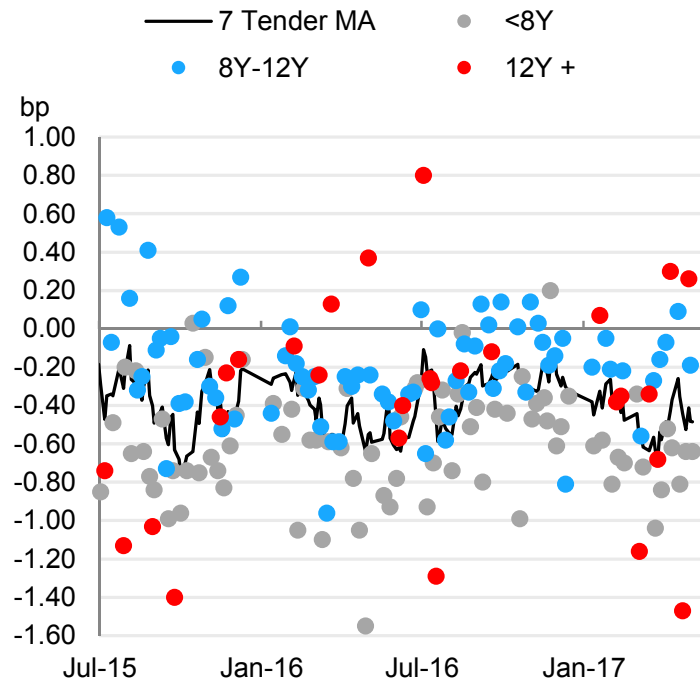


- AOFG nominal issuance in 2016/17 likely to be as estimated at \$100b. Linkers will add a further \$3b for \$103b in total term issuance.
- The AOFG is likely to only open three new lines next financial year. We expect a Nov-22, an Nov-29 and an Apr-41.
- Total term issuance in 2017-18 is likely to be \$84.3b

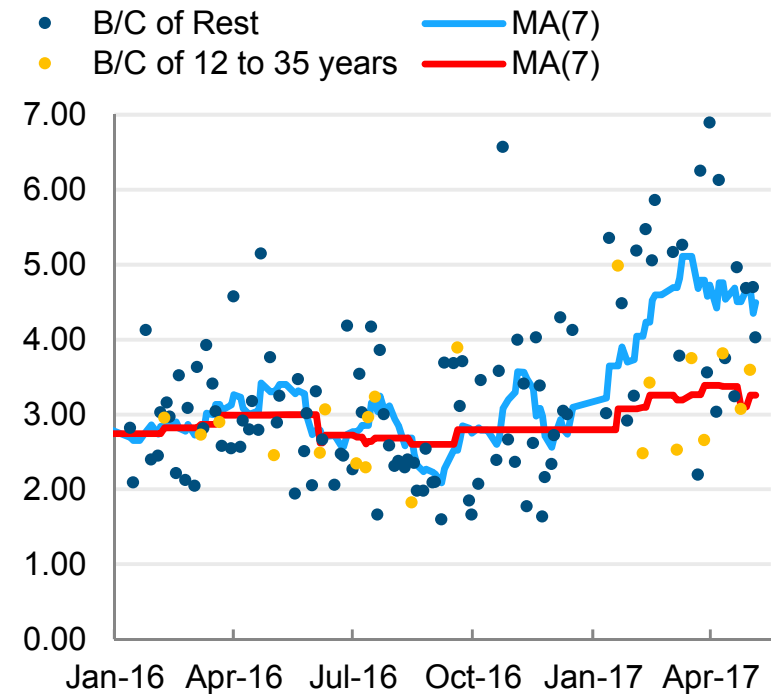
# Financial Market Issues

## Appetite

### ACGB tender spreads to mid



### ACGB tender bid/cover ratios



- ACGB tenders are becoming more volatile – particularly the longer dated ones.
- Many tenders go very well, but occasionally one “falls through the cracks”.
- The smaller volumes of long-dated bonds being tendered frequently appear to drive this behaviour.

# Sovereign Rating

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## ■ Australia's sovereign rating remains borderline AAA on S&P metrics:

- Our updated shadow analysis of S&P's rating methodology (which is clearer and generally tougher than Moody's) shows a credit score on the edge of the AAA foreign currency band;
- S&P's prior assessment of the gross debt metrics was somewhat lenient;
- But forecasts for improvement remain on track and have been supported by some revenue decisions, which helps meet the qualitative 'political will' assessment;
- Wage growth (and hence revenue) forecasts look optimistic but the forecast return to surplus is on track for now, so a holding pattern (of negative outlook) is most likely;
- We don't think local currency AAA (key for banks) *should* change, but S&P suggesting it would if they choose to act on the foreign currency negative outlook.
- Bond issuance task coming down, so recent tightening of bond pricing (to swap and futures) is likely to hold (though some slippage as we approach issuance of a new 20yr bond is likely);

## ■ AAA NSW & Victoria would also be downgraded if S&P moves:

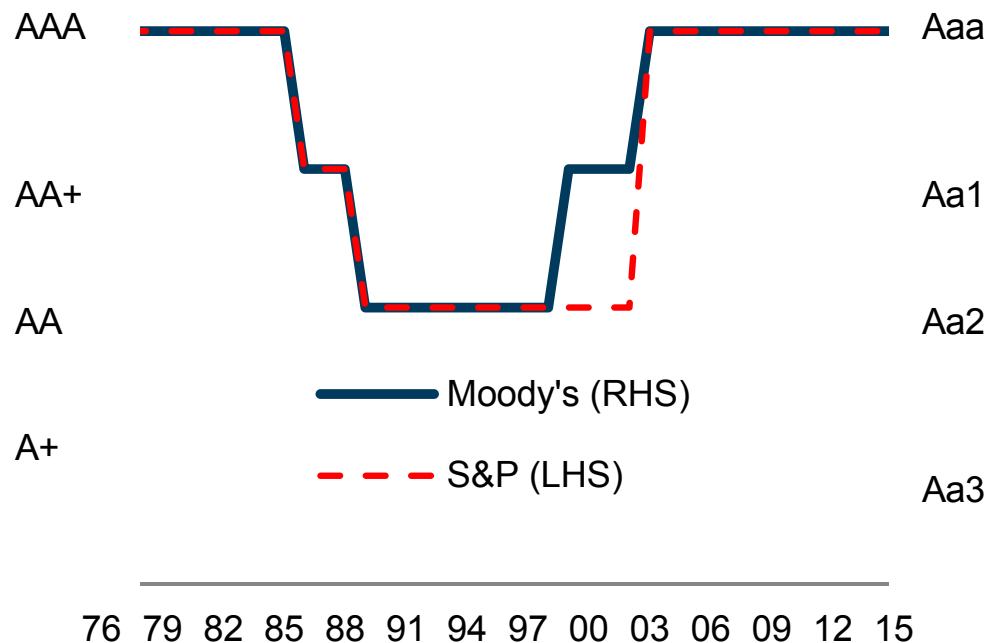
- This also looks to be on the back-burner for now;
- We expect this would have only a minimal (5-10bp) impact on semi-govt spreads because it would not impact relative credit performance and assessment of the states, or supply;
- Our research & experience indicates that fiscal credibility and bond supply are more important;
- Semi-govt supply/demand dynamics remain strong but are coming off from a very strong base;
- A greater impact would be possible in times of market stress.



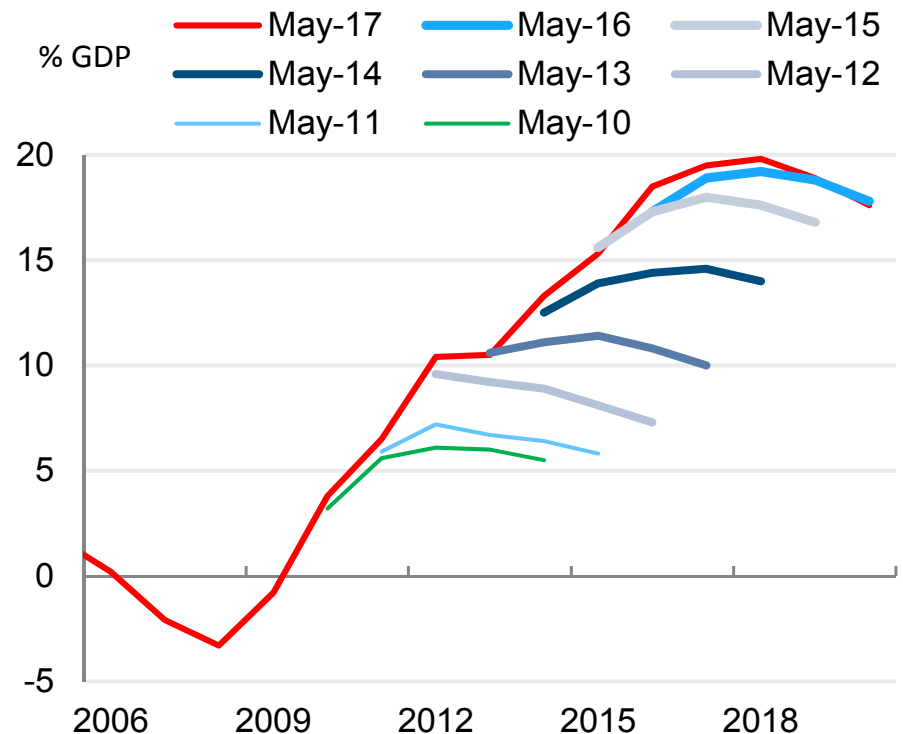
# Sovereign Rating

## Strong ratings

### Commonwealth government ratings history



### Commonwealth net debt revisions

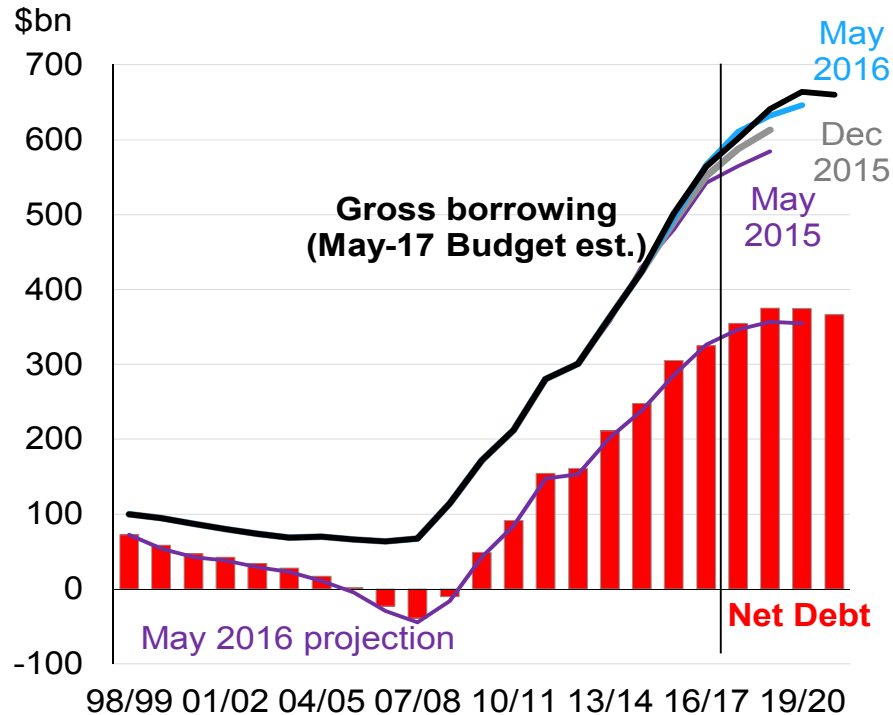


- Australia's sovereign rating has been AAA/Aaa for more than a decade.
- Debt forecasts continue to steadily rise.
- S&P's AAA rating is less secure than previously, but borderline to the aaa zone.

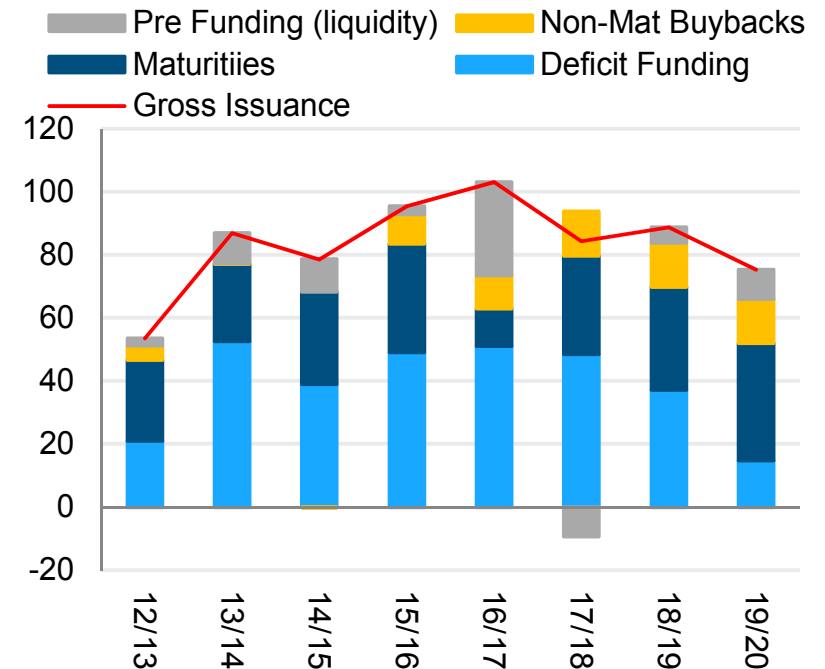
# Commonwealth Finances

## Debt growth

### Debt Outlook



### Annual bond issuance

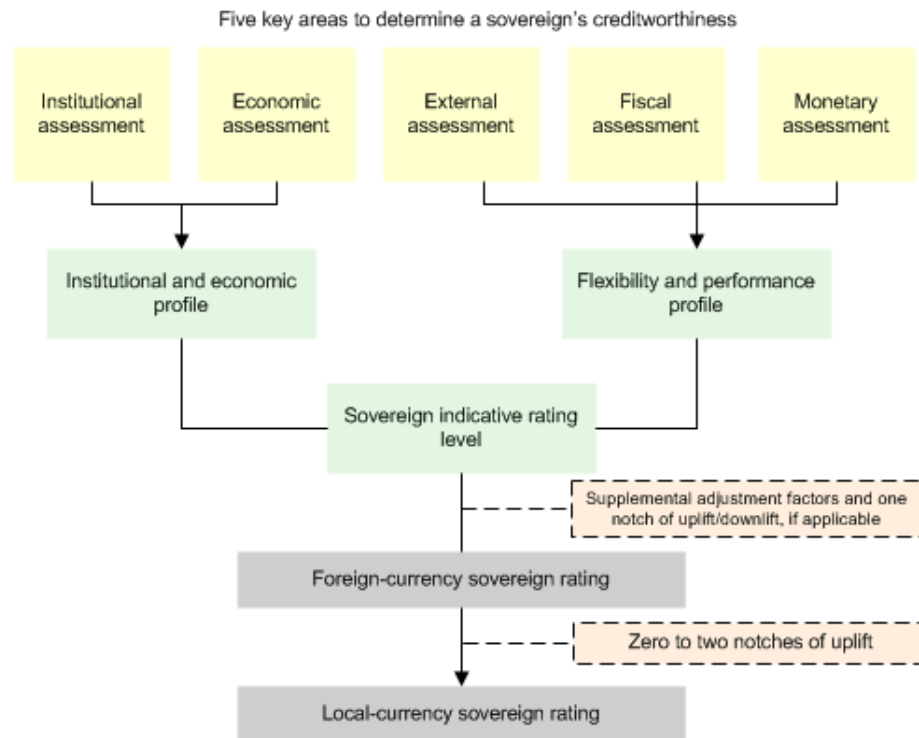


- Net debt forecast to grow only previously foreseen track.
- Total Borrowing also growing largely in line with previous forecasts.
- The AOFM will have an easier task in 2017-18 than 2016-17

# Sovereign Rating

## S&P analysis

### S&P Sovereign Credit Rating Framework



### Indicative Rating Levels

Institutional and economic profile												
Flexibility and performance profile	Category	Superior	Extremely strong	Very strong	Strong	Moderately strong	Intermediate	Moderately weak	Weak	Very weak	Extremely weak	Poor
Category	Assessment	1	1.5	2	2.5	3	3.5	4	4.5	5	5.5	6
Extremely strong	1 to 1.7	aaa	aaa	aaa	aa+	aa	a+	a	a-	bbb+	N/A	N/A
Very strong	1.8 to 2.2	aaa	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb-
Strong	2.3 to 2.7	aaa	aa+	aa	aa-	a	a-	bbb+	bbb	bb+	bb	b+
Moderately strong	2.8 to 3.2	aa+	aa	aa-	a+	a-	bbb	bbb-	bb+	bb	bb-	b+
Intermediate	3.3 to 3.7	aa	aa-	a+	a	bbb+	bbb-	bb+	bb	bb-	b+	b
Moderately weak	3.8 to 4.2	aa-	a+	a	bbb+	bbb	bb+	bb	bb-	b+	b	b
Weak	4.3 to 4.7	a	a-	bbb+	bbb	bb+	bb	bb-	b+	b	b-	b-
Very weak	4.8 to 5.2	N/A	bbb	bbb-	bb+	bb	bb-	b+	b	b	b-	b-
Extremely weak	5.3 to 6	N/A	bb+	bb	bb-	b+	b	b	b-	b-	'b-' and below	'b-' and below

\*

Assigning 'CCC+', 'CCC', 'CCC-', and 'CC' ratings is based on "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," Oct. 1, 2012.

- The 'Institutional and Economic' score remains extremely strong.
- The external and fiscal assessments within the 'Flexibility & Performance Profile' are the soft points.
- S&P's AAA rating is less secure than previously, and borderline to the aaa zone.



# Sovereign Rating

## Ratings vulnerability – rules vs sense

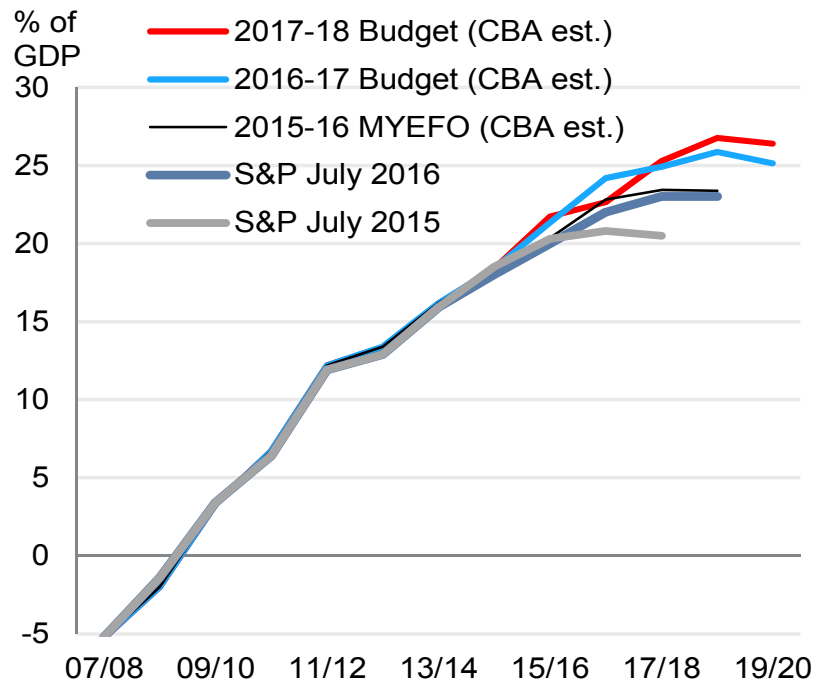
- **High external debt, mostly in the private sector, remains the key ratings weakness. The data suggests the worst score possible, but it is capped due to the currency being ‘highly traded’.**
- **Net debt remains below the 30% threshold. S&P expresses comfort on this measure.**
- **The Fiscal Assessment has deteriorated, as repeated Budget slips raise the average increase in debt each year to 4% of GDP. We believe S&P lowered this score in 2015 and removed the ‘political will’ uplift in 2016.**
- **Those changes left the rating on the borderline between AAA and AA+. A harsher judgement would be consistent with AA+.**
- **Any change *should* apply only to the foreign currency rating and not the local currency rating, but S&P has indicated it would impact both.**

	S&P 2015	S&P 2016	Risk
Institutional Effectiveness Assessment	1	1	1
Economic Assessment	1	1	1
<b>INSTITUTIONAL &amp; ECONOMIC PROFILE</b>	<b>1</b>	<b>1</b>	<b>1</b>
External Assessment			
Base Case - Active Traded Currency with very high external debt (280%>200%)	4	4	4
Modified by:			
External finance need > 150% CAR (250%)	0	0	0
Risk of marked deterioration fin sector	0	0	0
Significant volatility in Terms of Trade	0	0	0
High Current Account Deficits	1	1	1
Other (FX hedging, improving composition?)	0	0	0
Final External Assessment	5	5	5
Fiscal Assessment			
Base Case (chg in debt)	3	3	4
Modified by:			
Gov has short term ability to lift revenue	-1	0	0
<b>Final Fiscal Flexibility assessment</b>	<b>2</b>	<b>3</b>	<b>4</b>
Debt Burden			
Base Case (net debt % GDP)	1	1	1
Modified by:			
Non-Residents hold > 60% of debt	0	0	0
Final Debt Burden Assessment	1	1	1
Final Flexibility and Debt Assessment	1.5	2	2.5
Monetary Assessment			
Exchange Rate Regime	2	2	2
Monetary Policy Credibility & Effectiveness	1	1	1
Final Monetary Policy Assessment	1.5	1.5	1.5
<b>FLEXIBILITY &amp; PERFORMANCE PROFILE</b>	<b>2.67</b>	<b>2.83</b>	<b>3.00</b>
Matrix Outcome	aaa	aaa/aa+	aa+
S&P RATING	AAA	AAA (neg)	AA+

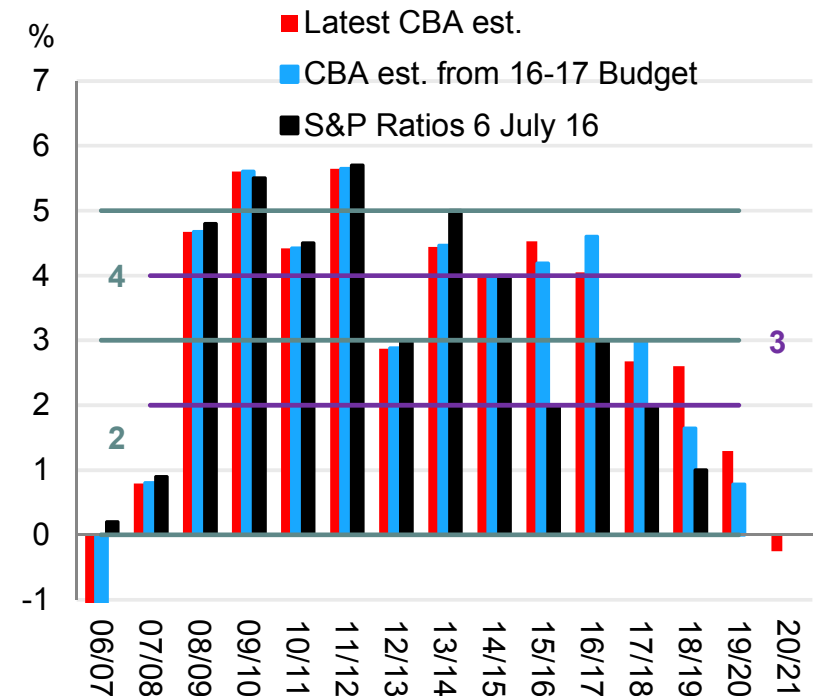
# Sovereign Rating

Ratings vulnerability – Trend up remains, but slippage largely halted

## General government net debt/GDP



## Change in general government debt / GDP



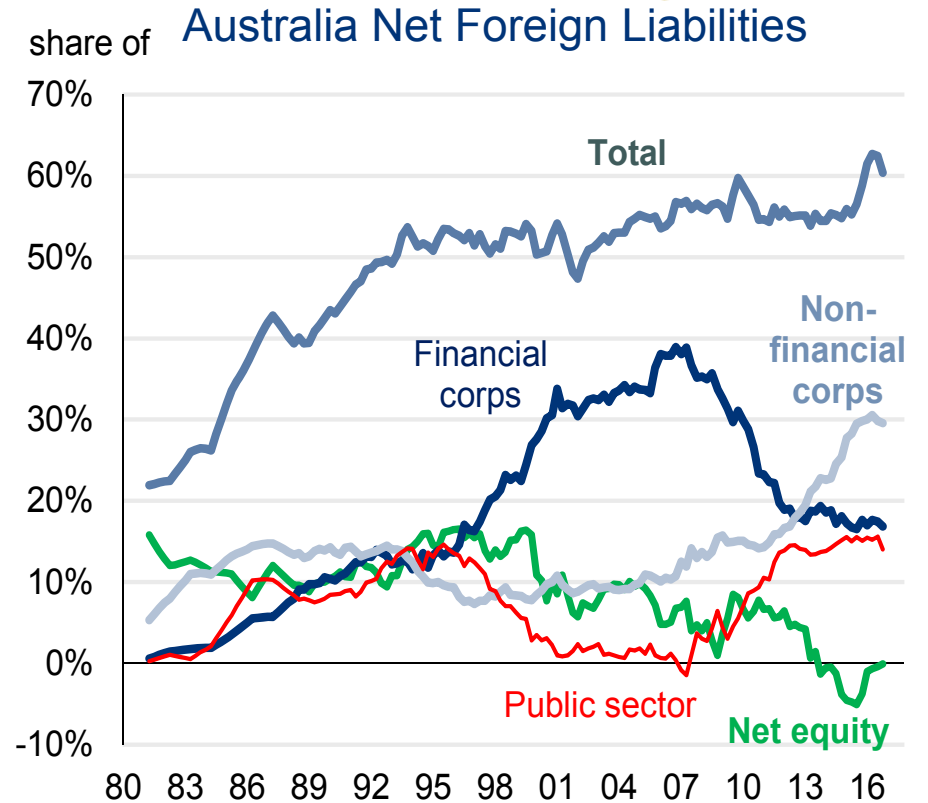
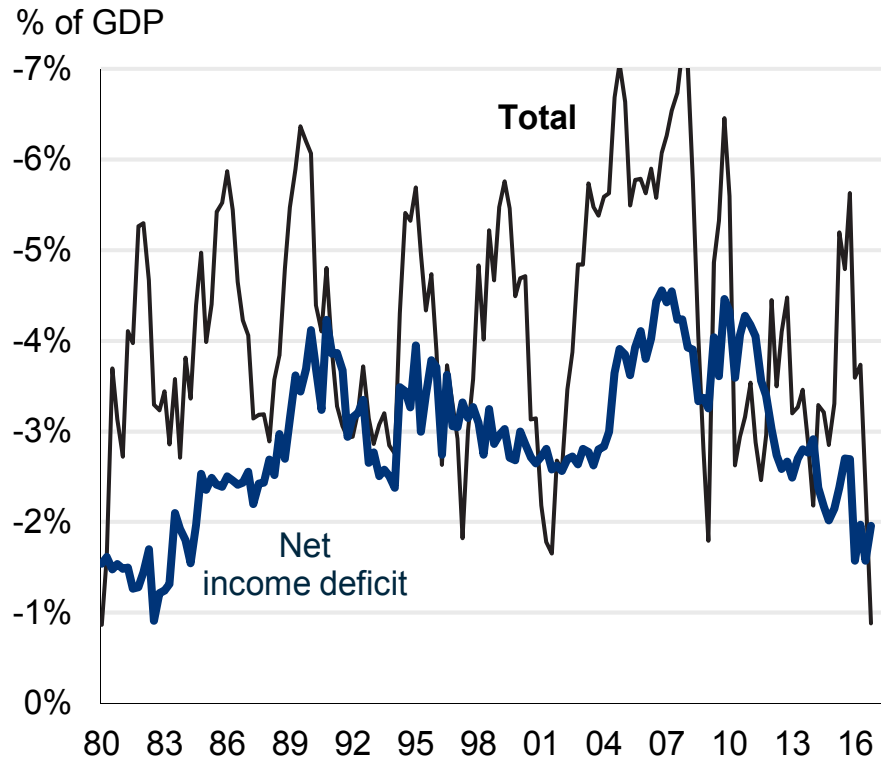
- Total gen govt. net debt remains well below 30% threshold.
- Although upward trend remains, the slippage has largely been halted. Now the Govt. just needs to repeat that three more times and get back to surplus.
- The accumulation of debt continues, but the slippage has halted and the pace of accumulation has slowed. Sticking to current forecasts would help the AAA stay.

# Sovereign Rating

## Funding investment

Measure of a country's external indebtedness: Narrow Net External Debt (assets) / CAR (%)*	Below (50)% (50)-0%	Sovereigns with a reserve currency	Sovereigns with an actively traded currency	Other sovereigns: measure of a country's external liquidity Gross External Financing Needs / (CAR + Usable Reserves) <sup>†</sup>			
				below 50%	50-100%	101-150%	over 150%
		1	1	1	1	1	2
		1	1	1	1	2	3
		1	2	1	2	3	4
		2	2	2	3	4	5
		2	3	3	4	5	5
		3	4	4	5	5	6
		3	4	5	6	6	6

## Current account balance

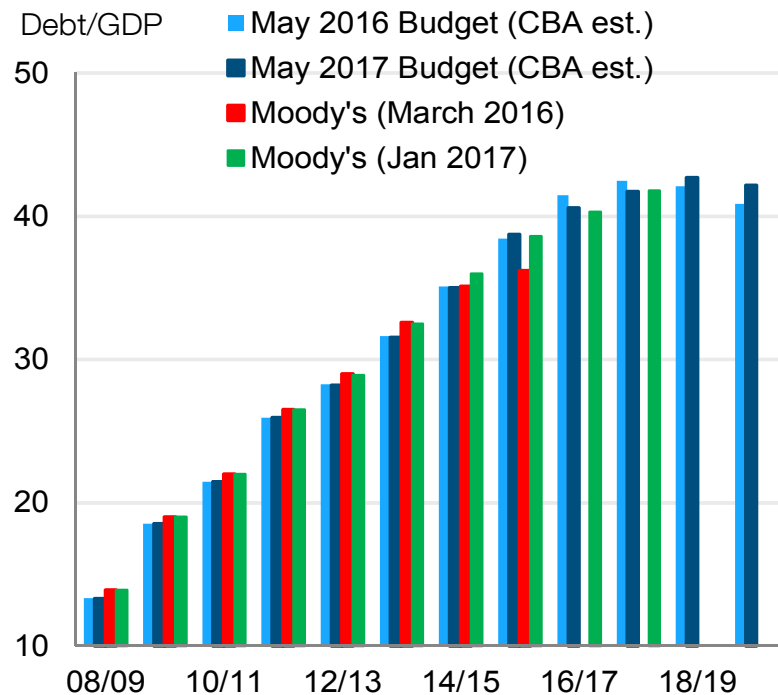


- Narrow net external debt is more than 240% of current account receipts and gross external financing needs are over 210% of CAR, putting Australia at the extremes.
- But score is already at weakest possible for countries with actively traded currencies.
- Australia's persistent current account deficit has been narrowing and the share of external debt accounted for by financial corporations has declined, so S&P may view this metric in a more benign way.

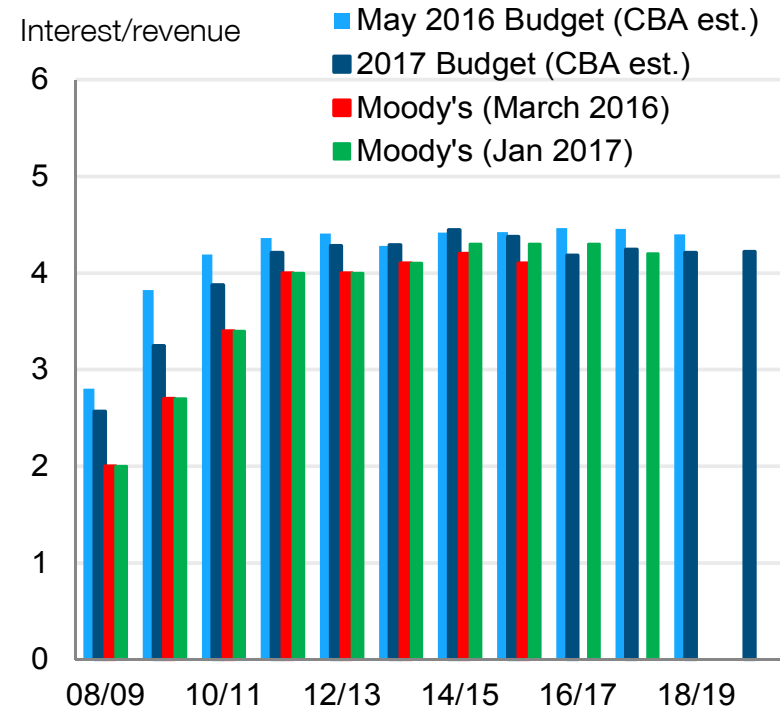
# Sovereign Rating

Moody's

Gen govt debt / GDP



Gen govt interest payments/revenue

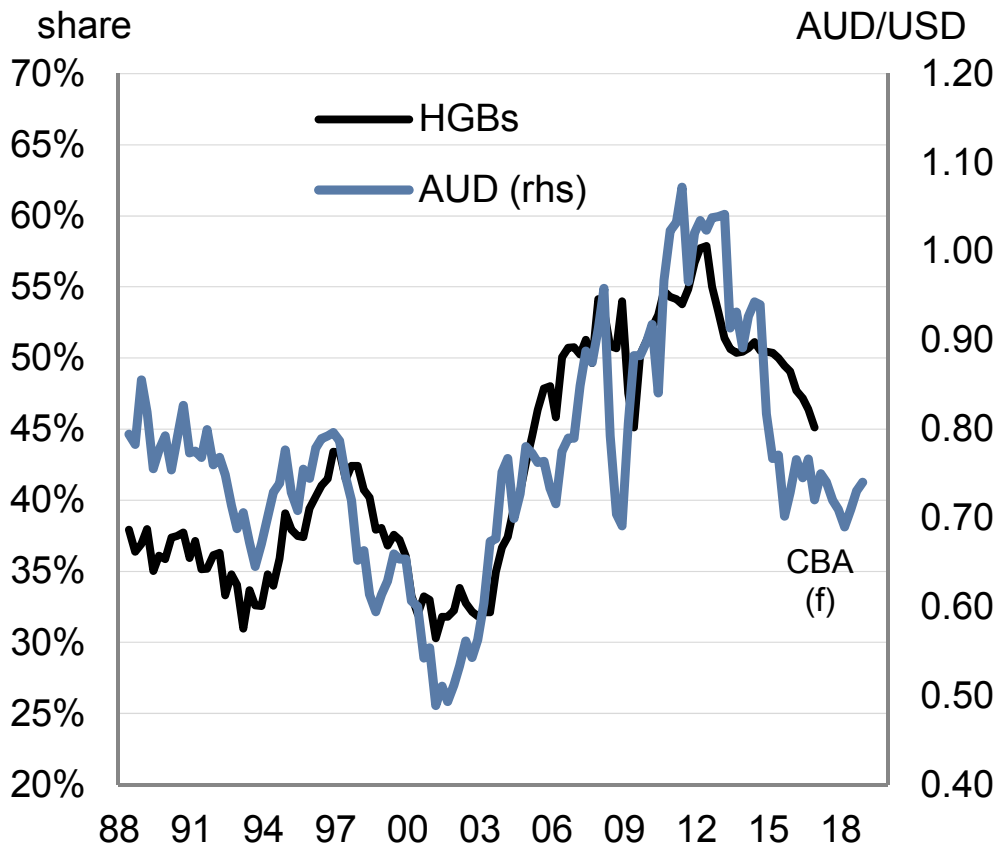


- Moody's typically rely on a qualitative approach, making it harder to anticipate.
- The key debt and interest payment metrics are showing signs of stabilising.
- We don't expect any change to the rating.

# Funding Australia

## Finding demand

### Foreign ownership vs AUD



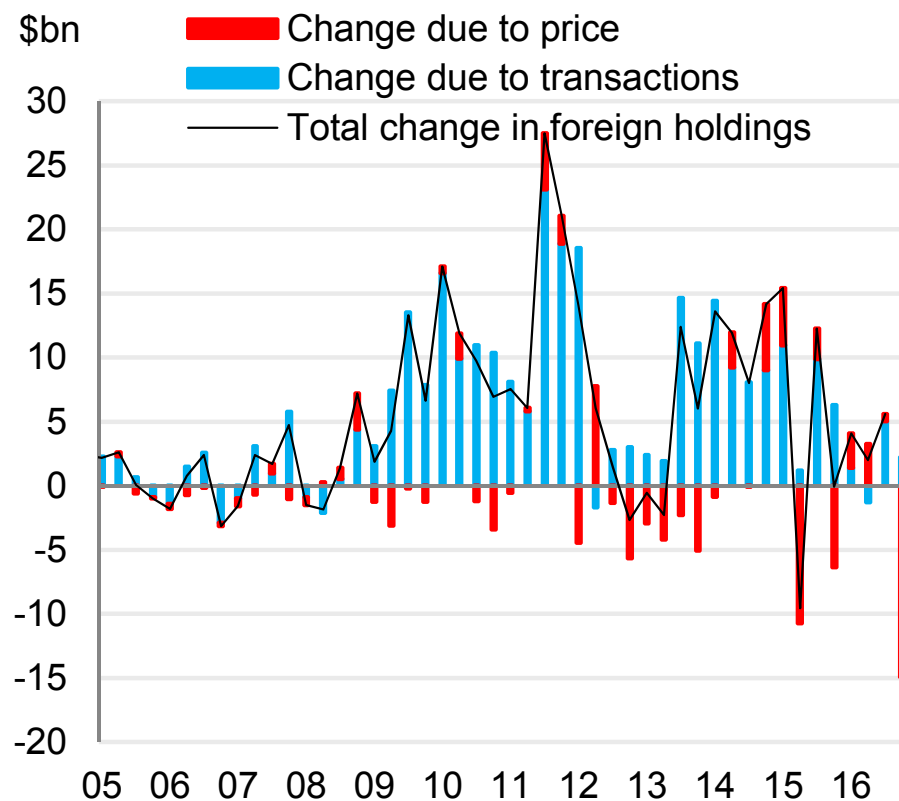
- **Highly rated and high yielding securities are sought after by global investors. Foreign buying of Australian government securities has been and should continue to be a source of AUD support.**
- **While S&P's AAA rating is less secure, Australia's fiscal position remains favourable from a global perspective.**
- **AUD denominated assets risk-adjusted return may be looking less attractive given the step-up in global volatility.**
- **Most investors seem cautious on the outlook for the AUD.**
- **Soft global growth, weak commodity prices, mixed success on Australia's economic transition and compression of interest rate spreads present risks for the AUD.**



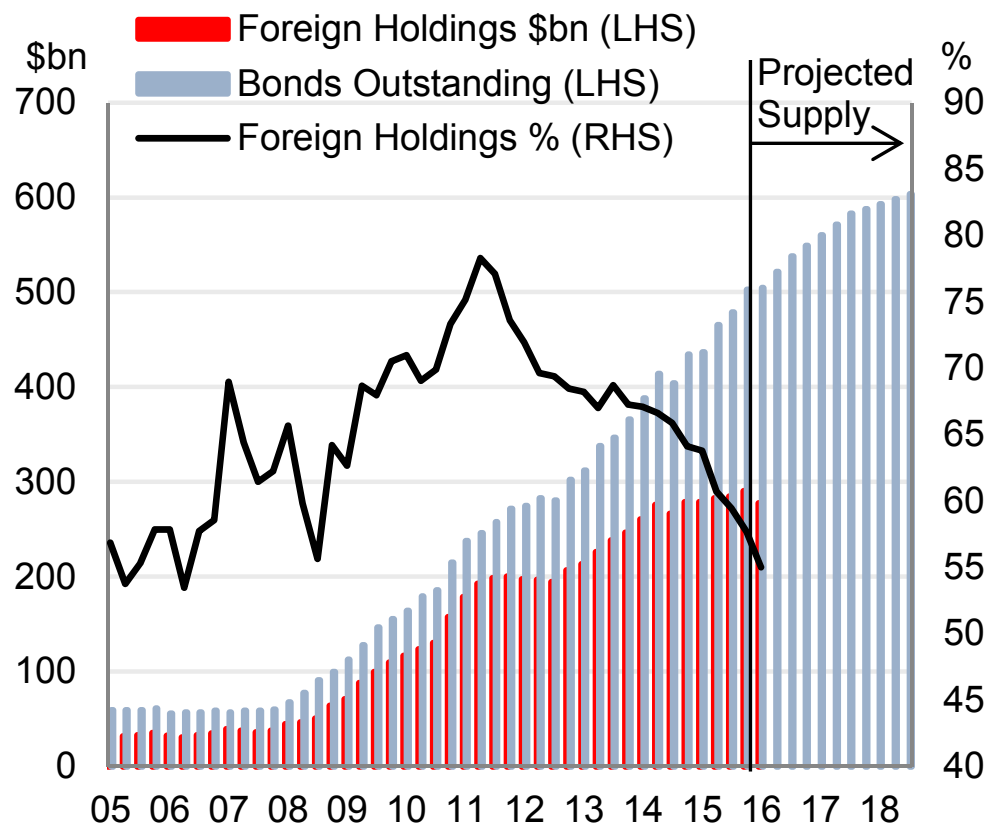
# Technicals

## Fading

### Change in foreign ACGB holdings



### Share of foreign ownership of ACGBs



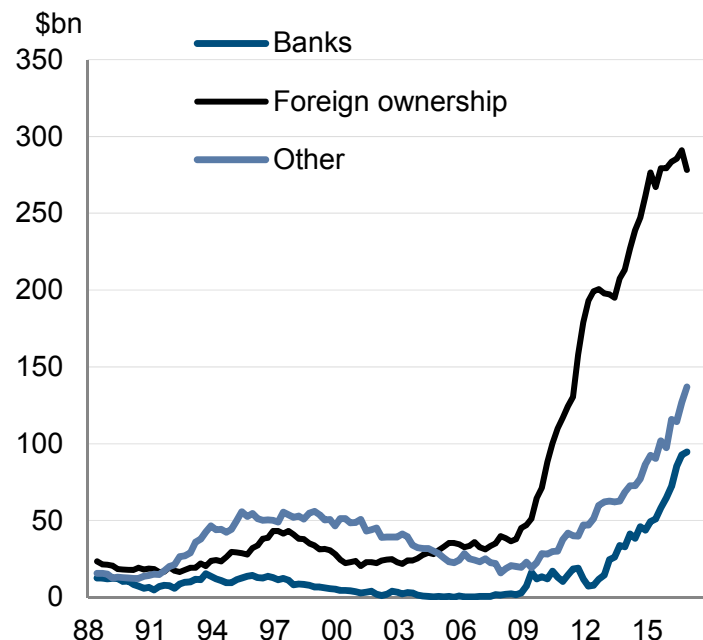
- Official data showing limited foreign buying in 2016.
- It did, however, pick-up slightly in 2H-16. Decline was due to price changes.
- But not as much as issuance – so foreign share of ACGBs still falling.



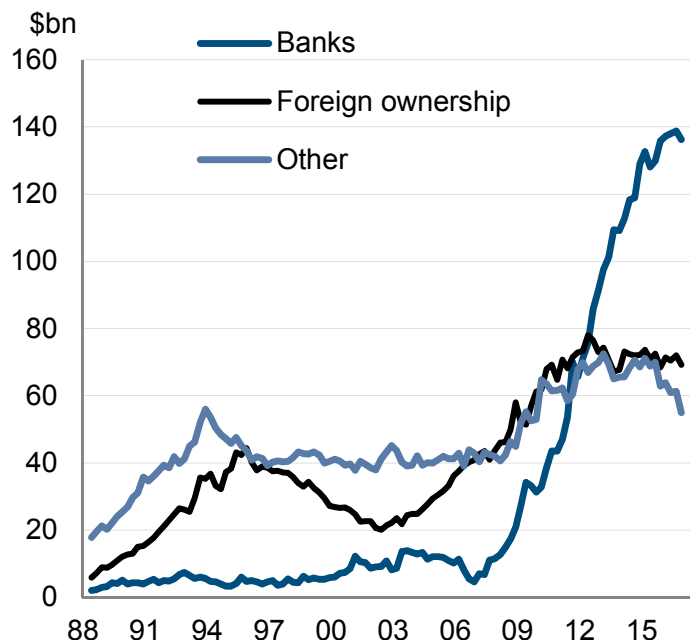
# Technicals

## Who's next?

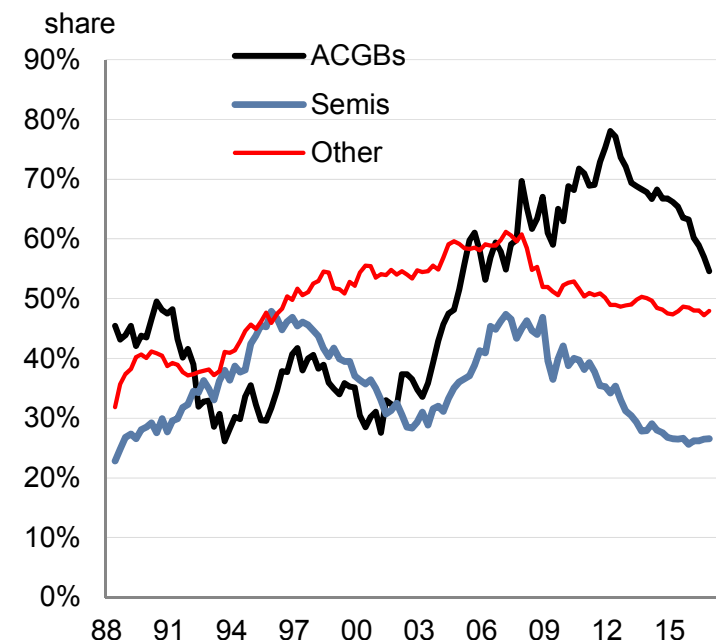
### Commonwealth bond ownership



### Semi-govt bond ownership



### Foreign ownership share

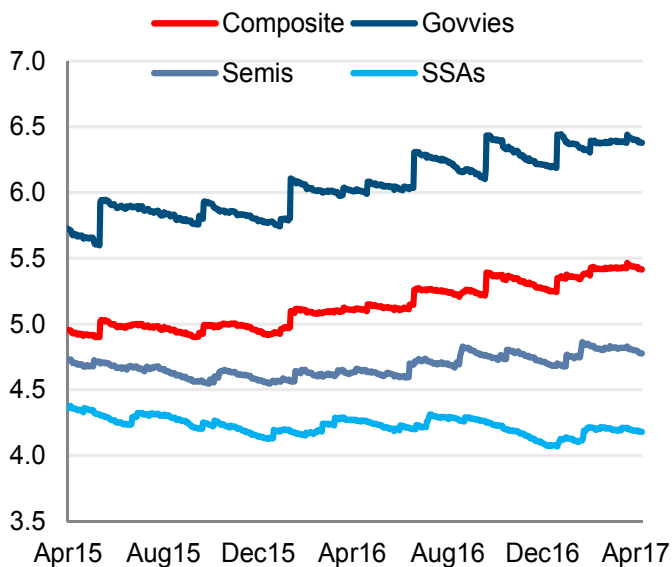


- Foreign demand overwhelmingly favours Commonwealth bonds. Estimate would be about 5% higher if included repo-funded offshore buying.
- But central bank diversification has slowed and overvalued AUD has been a headwind.
- Will banks step back from semis now that liquidity needs mostly met?
- What about supply, credit quality, diversification?
- ACGBs to be focal point of buying – but at a price.

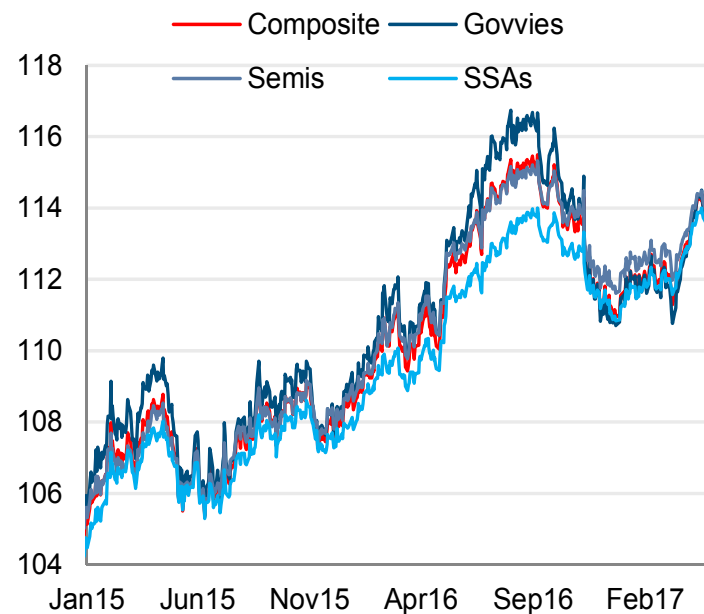
# Commonwealth Bond Pricing

## Fixed-rate bonds

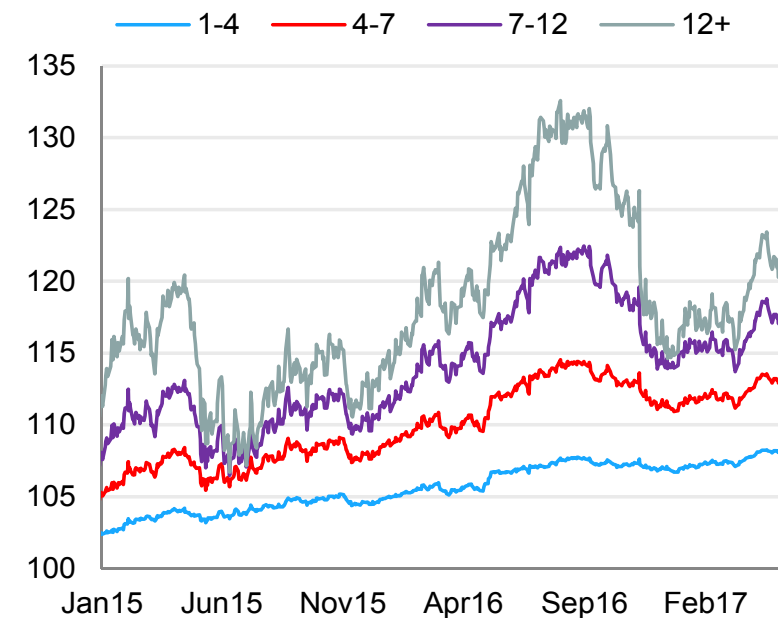
### Duration by sector



### Performance of bonds by sector



### Bond performance by maturity

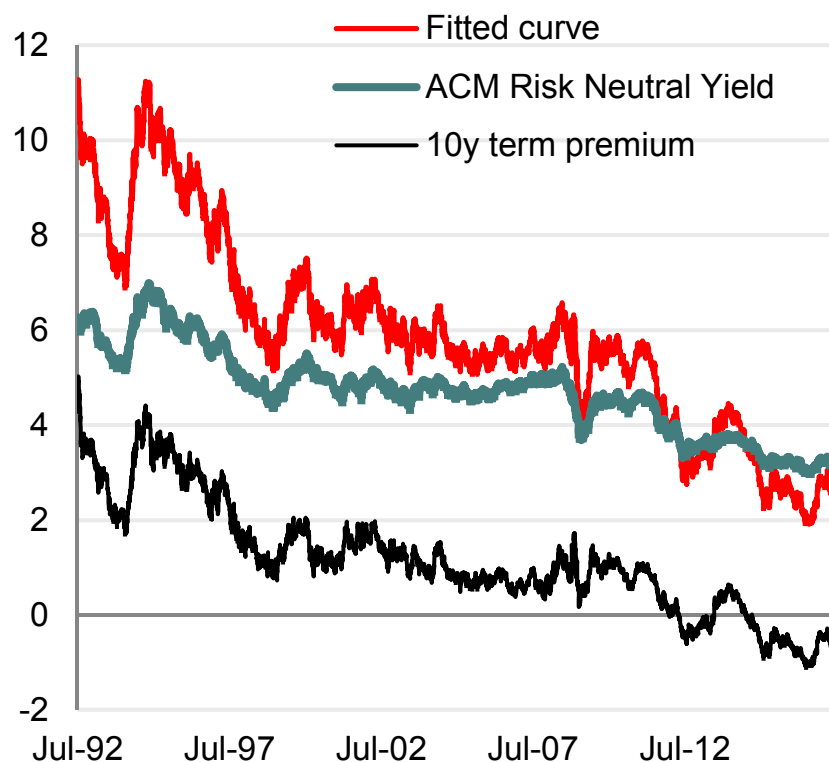


- Duration of the composite index rising due to longer Commonwealth bond issuance.
- ACGB index most sensitive to yield moves, corporates the least.
- Govvies underperformed in late 2016 on the Trump sell-off, but reasonably similar performance in 2017 so far.

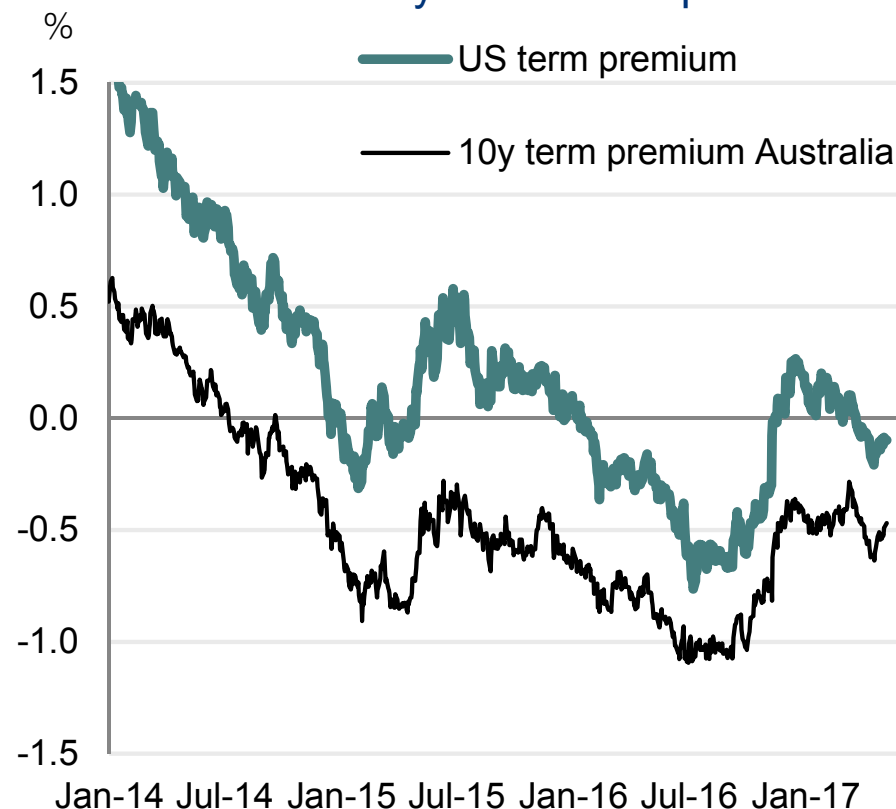
# CBA Fixed Income Views

More value

## CBA estimate of ACGB term premium



## US vs Aust 10yr bond term premium



- Have been expecting ACGBs to remain resilient against a drift up in US yields.
- Market implied terminal cash rate of 3.25% much more generous in Australia.
- Trump win less important for Australia, ands potentially damaging to region.
- Commodity prices and housing/debt the key.



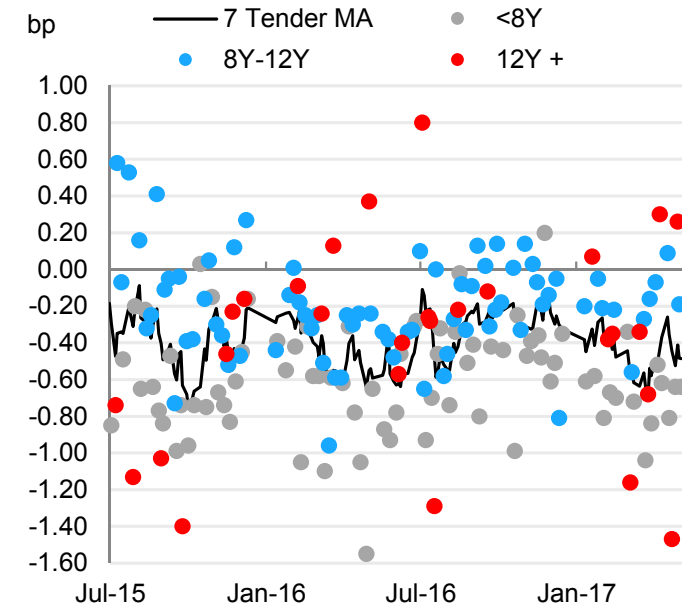
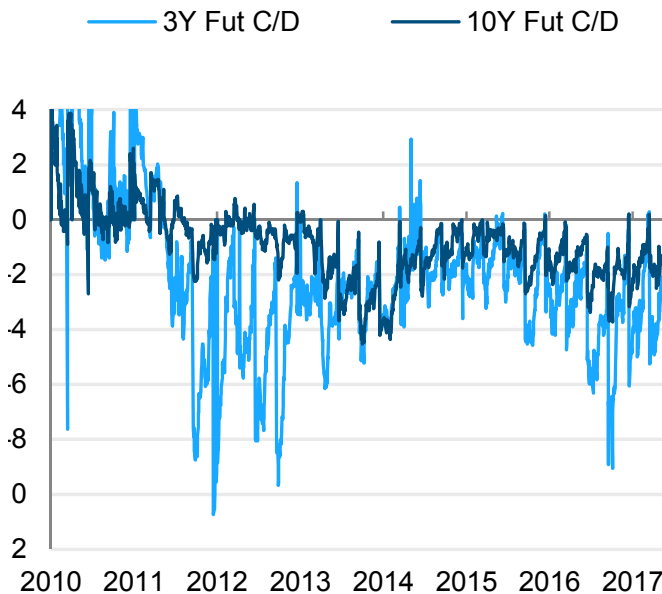
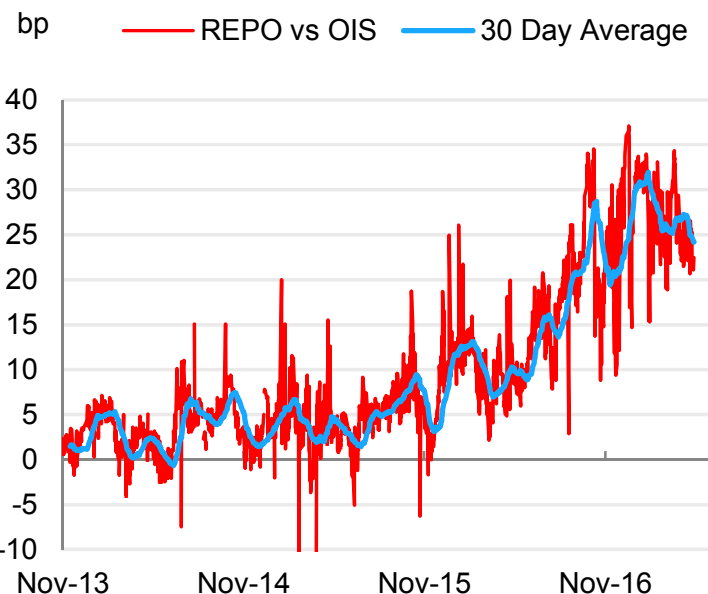
# Commonwealth Bond Pricing

Confusing

RBA repo spread to OIS\*

ACGB vs Futures cheap/dear

ACGB tender pricing to mid



\* Using CBA estimate of matched maturities

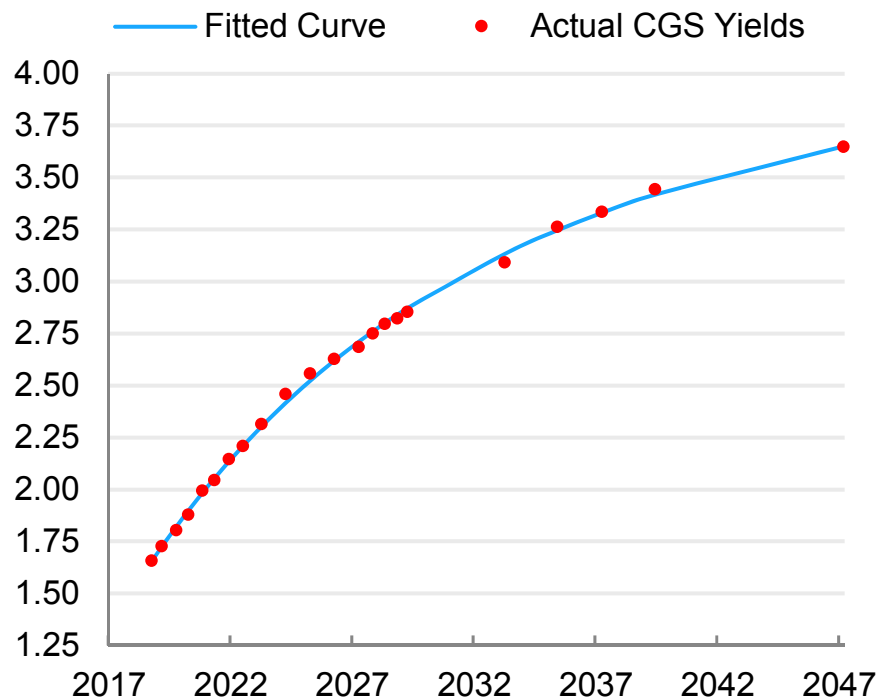
- Pressure on Repo Rates remains elevated, but has stopped moving wider.
- The market is now “tiered” with different participants facing different spreads.
- But the market also appears to be stable.
- Repo rates, Futures cheap/Dear and tender pricing are all moderate at present, indicating the bond market is in better balance than it was.
- The lower 2017-18 funding task should help keep it that way.



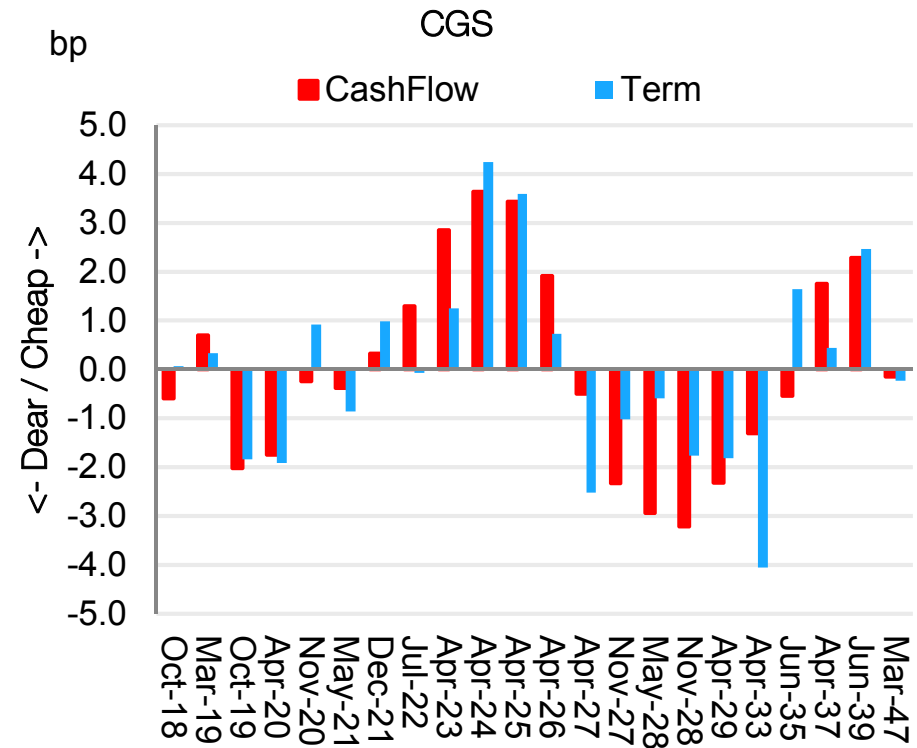
# Commonwealth Bond Pricing

## Demand vs supply

Nelson-Siegel Curve



ACGB cheap/dear

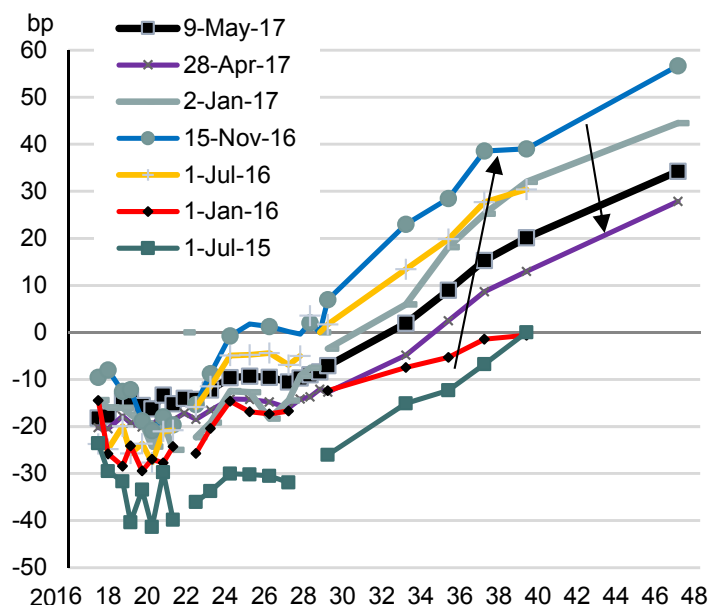


- Liquidity points around 3 and 10yr futures routinely show as expensive across variety of curve fits.
- Cheaper bonds at 5yr and 20yr points of the curve.

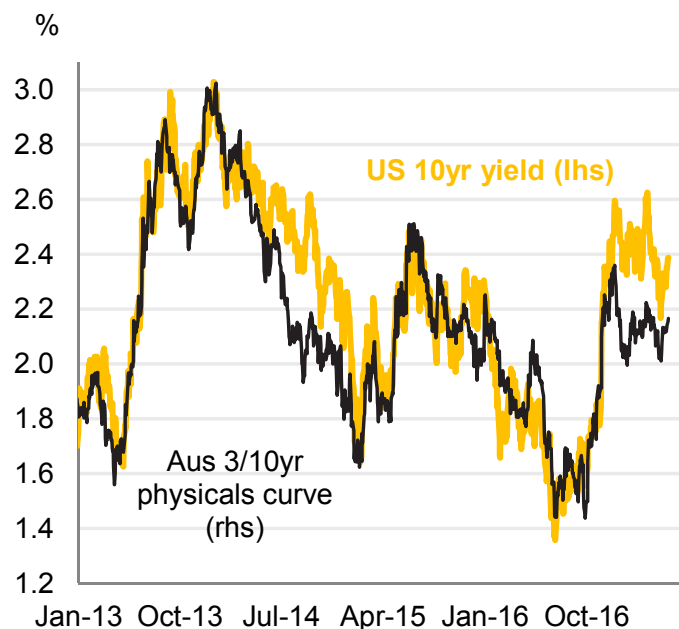
# Commonwealth Bond Pricing

Cheaper bonds?

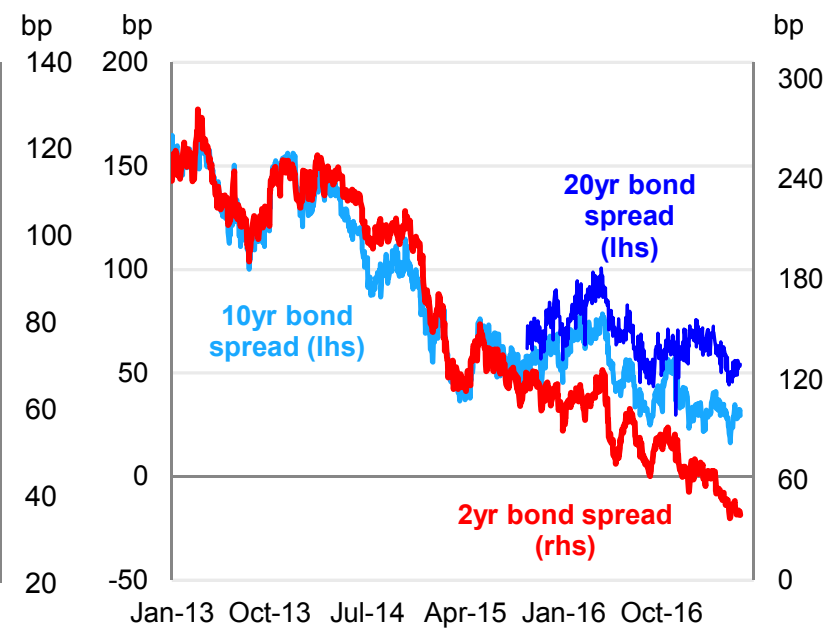
ACGB asset swap spread



ACGB yield curve



AUS-US bond spreads



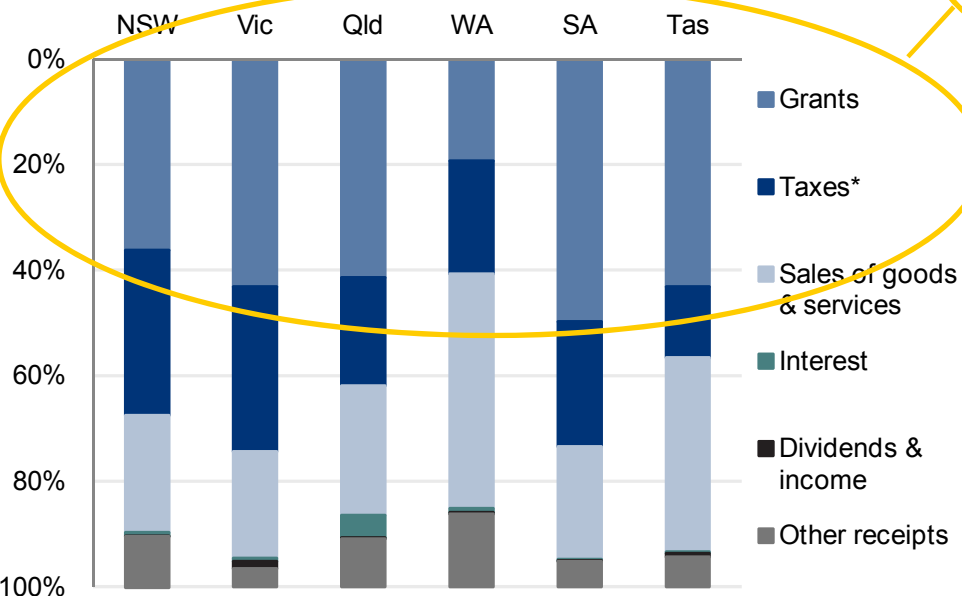
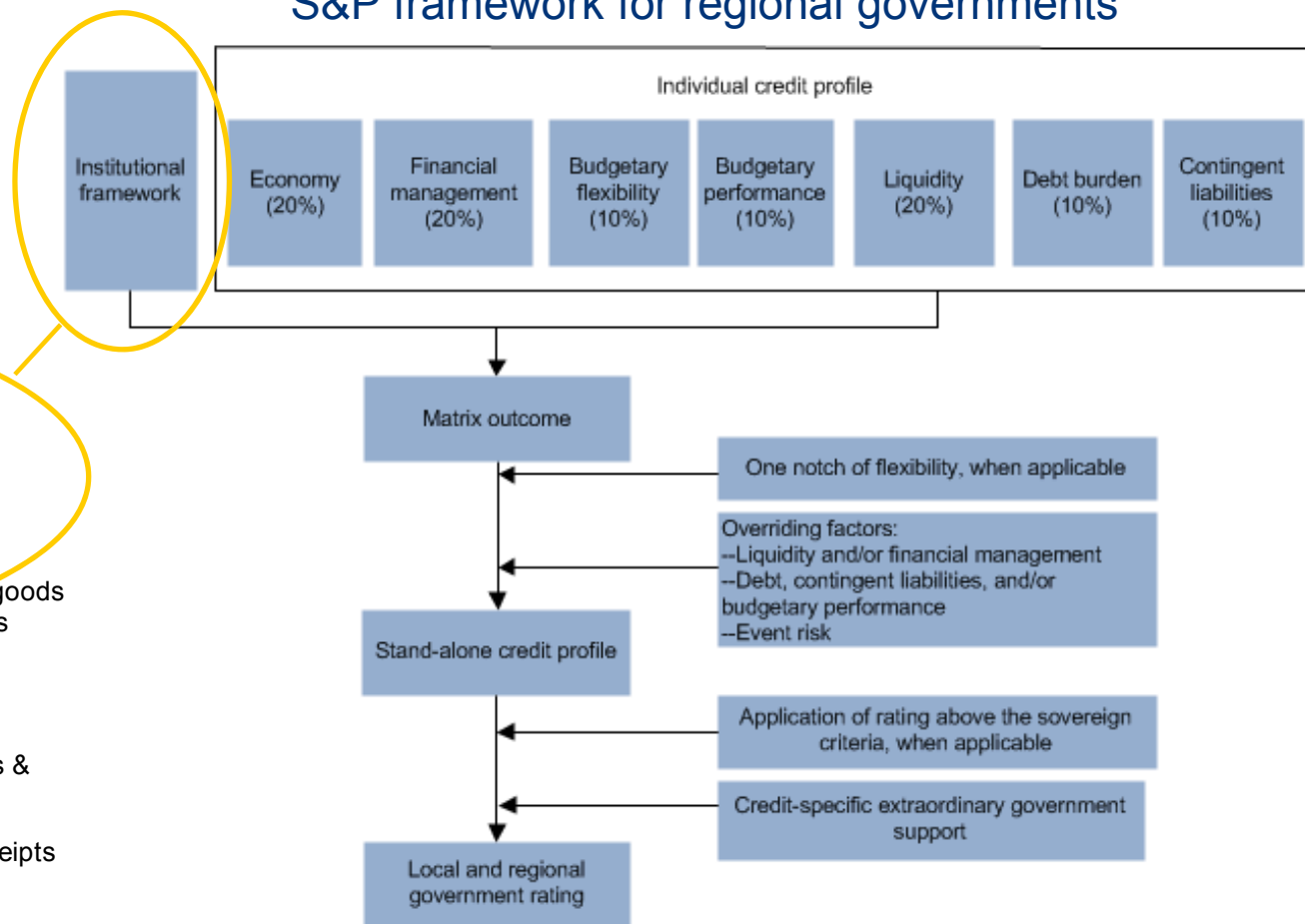
- 10-20yr AUS-US bond spread has failed to compress in line with the 2yr spread.
- Resistance higher as 10yr spread approached 0bp, presenting some digestion problems for the AOFRM.
- ACGBs have steadily and materially cheapened up versus swap over the past 3 years.
- However, market has been better bid recently

# State Ratings

Strong institutions

## S&P framework for regional governments

### State government revenues



- Commonwealth government provides strong institutional and financial support to State Governments that underpins very strong ratings for the sector.
- However, that support also means the states are very unlikely to be rated higher than the Commonwealth. So States AAA ratings at threat if Commonwealth is.



# State Ratings

## Differentiation

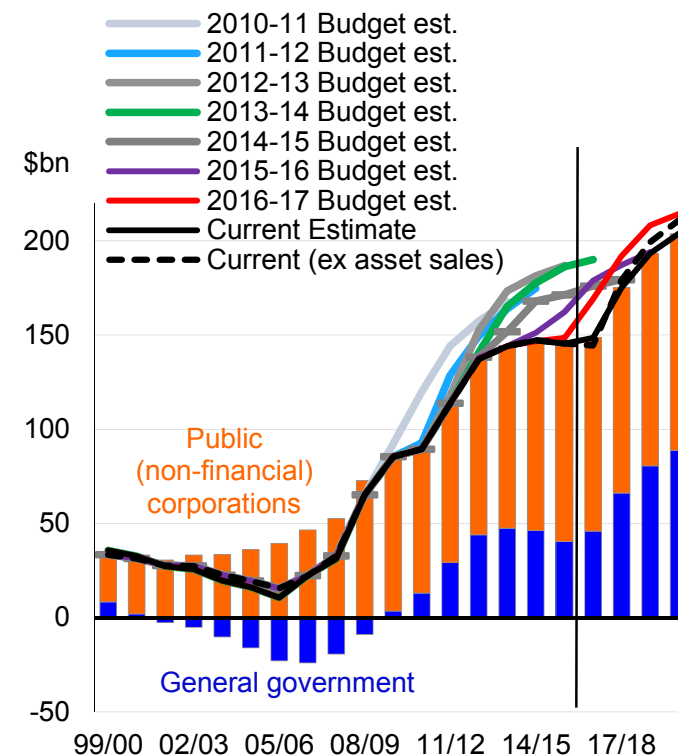
### State Government ratings

	Gen. govt Fiscal balance*	Gen. govt Net debt*	Total state Net debt*	S&P Rating	Outlook	Moody's Rating	Outlook
<b>NSW</b>	-0.6%	0.1%	4.4%	AAA	Negative #	Aaa	Stable
<b>VIC</b>	0.2%	4.6%	8.4%	AAA	Negative #	Aaa	Stable
<b>QLD</b>	0.3%	0.6%	11.3%	AA+	Stable	Aa1	Stable
<b>WA</b>	-1.6%	7.6%	14.4%	AA+	Negative	Aa2	Stable
<b>SA</b>	-2.4%	6.0%	13.2%	AA	Positive	Aa1	Stable
<b>TAS</b>	-0.6%	-1.1%	8.2%	AA+	Stable	Aa2	Stable
<b>NT</b>	-2.5%	5.7%	10.4%	Not Rated		Aa1	Negative
<b>ACT</b>	-1.9%	5.5%	1.7%	AAA	Negative #	Not Rated	

\* % of GSP, 2016-17 fiscal year forecast

# due to Commonwealth AAA rating being placed on negative outlook.

### State Government net debt



- Ratings for Australia's states remain very high.
- High wealth, strong economies, strong liquidity & access to markets, and low debt underpin ratings strength.
- The possibility of a sovereign downgrade is the most concerning risk for semi ratings at present.

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- Domestic Market Strategy
- Economic Analysis, and
- 2<sup>nd</sup> for Relative Value Research for bonds & semis



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