National Australia Bank

11 January 2013

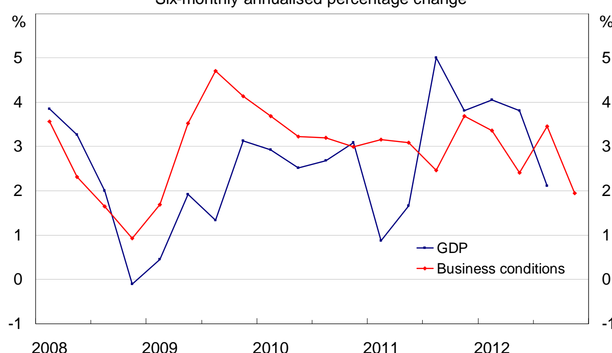
NAB changes interest rate forecasts for 2013 – RBA now expected to cut by 75 points to 2¼% as economy struggles.

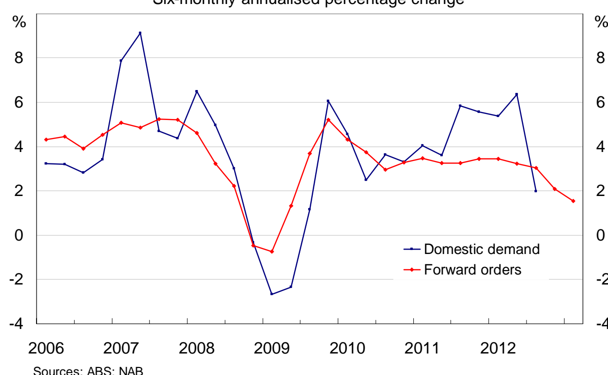
- **With the economy continuing to weaken and unemployment set to rise noticeably through 2013 the RBA will need to cut significantly further than previously expected in 2013.**
- **We have reviewed our GDP forecasts and currently see 2013 at around 2% (2½% previously) with unemployment rising to around 5¾% by late 2013. That would see, on a no policy change basis, a budget deficit in the $10-15bn range for 2012/13.**
- **We still expect GDP growth of 2.8% for 2013/14 and a touch above 3% in 2014 helped by new rate cuts. However that implies a larger output gap and unemployment remaining elevated (around 5 ¾ - 6%) with the Government fiscal position near balance.**
- **The weaker activity outlook will also help contain inflation to below 3% even including the carbon tax impact. Nor do we see the AUD offering much relief to a struggling economy.**
- **We have put the first cut in Q1 – where the Q4 CPI outcome in late January will be important as to exact timing. Thereafter we expect the RBA to wait to see the impact of recent policy moves but will need to react further by mid year. We have tentatively put further cuts in May and August.**
- **We now expect a terminal cash rate of 2¼% in the September quarter of this year**
- **We continue to expect the Australian dollar to track gradually lower during 2013, as the combination of continuing RBA rate cuts and a firmer US dollar weigh on the currency. Nonetheless our forecast of around parity in late 2013 still represents a strong currency.**

As was evident in our November monthly survey the Australian economy continued to slow into the back end of 2012 with forward indicators (such as forward orders and confidence) pointing to further slowing ahead. Over the summer, the run of data has confirmed the Australian economy finished 2012 in a parlous state and leading indicators suggest the first half of 2013 is likely to be a difficult period for many firms and households across the economy. Recent readings on retail sales, private sector credit, house prices and job vacancies clearly underline a weak starting point.

Preliminary readings from our full quarterly business survey (to be released 7 February) suggest that the economy's momentum in late Q4 may have slowed to only around 2% (on an annualised basis). Certainly the evidence suggests that small business is struggling even more than big business with cash flow issues a real concern. That is also apparent in the credit statistics with both business and consumers very wary about taking on new debt. Indeed our judgement is that growth in both business and personal (credit card) debt is at best flat.

The following chart shows our indicator of GDP growth based on these preliminary findings – see left hand panel. Perhaps more disturbingly if forward orders where to be maintained at its current level into early 2013 demand growth would slow below the 2% level – see right hand panel.

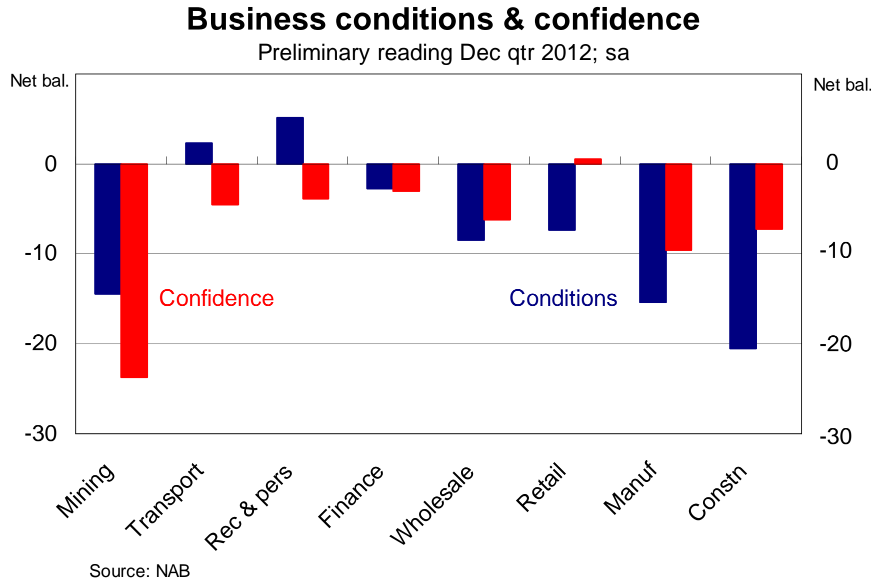




The other feature of the Australian economy is the continuation of "its 10 speed nature". Struggling sectors – such as manufacturing, discretionary retail, construction, wholesale and small transport – continue to under-perform. However, there has now been a significant deterioration in mining sentiment - with that sector in November having the worst confidence levels of any sector. Clearly the substantial boost to iron ore prices will

help confidence in that sector, albeit we suspect that part of that story may be related to aggressive restocking in China after such a sharp run down in July/August 2012 and also the loss of some Indian supply. But the latter in particular should be easily offset by higher production elsewhere in the world this year and hence we doubt the recent sharp price run up will be permanently sustained. Based on the preliminary survey results for the December quarter activity levels in mining are now in significantly negative territory. Indeed business conditions in both mining and construction are now at record lows for the post GST period (i.e. the lowest in more than a decade).

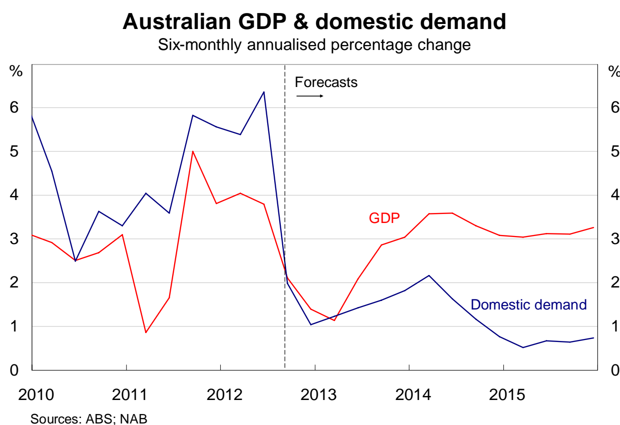
Because of the lumpiness of resources investments and the substantial increase in supply in the pipeline our base case remains that mining investment will plateau before falling over the coming year and other drivers of economic activity will be needed to ensure ongoing growth in Australia's economy.

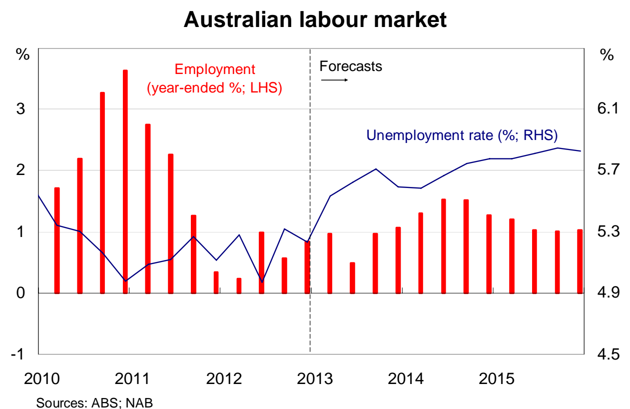


Drawing the above together we clearly see the loss of momentum lowering near term economic forecasts. For 2013 we now expect growth of only 2% (previously 2.5%) with a significant flow through to a larger output gap. Unlike in mid 2011 when GDP slowed there is little prospect of an offset through a significant surge in mining investment. As a result we see unemployment rising to around 5.7% by late 2013. Interestingly the particularly slow patch we are currently experiencing (and expect to continue till mid 2013) would on a no policy change basis result in a fiscal deficit of around $10 - 15 bn in 2012/13.

Moving out into 2014 we expect growth to be around 2.8% which is unchanged from previous forecasts but relies very much on more stimulatory monetary policy. More importantly the new forecasts involve a significantly higher output gap and hence higher unemployment.

Moving into 2015 the different phase of the mining boom is more apparent with domestic demand slowing to quite low growth rates (as mining investment contracts) but broadly offset by higher exports. The latter combination would however see a structural lowering in the demand for (mining) labour given the lower demands on maintaining mines / LNG platforms vis a vis building them. As a result in our forecasts the unemployment rate tends to drift higher again. These patterns are evident in the GDP / Domestic demand and employment / unemployment forecast charts set out below.

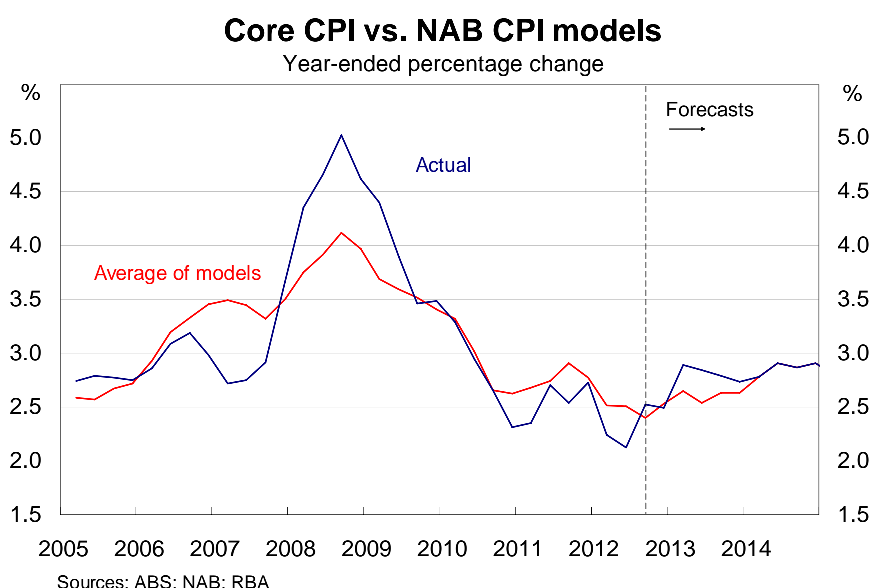




Turning then to the global situation, our world outlook looks little changed from previous forecasts albeit some fears re the fiscal cliff have at least been delayed. Also recent moves to delay the timing of Basel 3 liquidity requirements will help ease concerns of further credit rationing. Overall however we still see: the US as gradually improving but only at a growth rate a touch above 2% with further political dramas to come re debt issue; Europe continuing to double dip; and Japan to disappoint. On a more positive note China appears to have stabilised and there may now be some upside risks to the 8% forecast this year. In summary then our latest global forecast of around 3¼% still looks on track.

From an offshore investor's perspective (especially sovereign wealth funds and central banks) Australia still looks a good diversity strategy, with our sovereign debt one of only seven countries AAA stable rated, our economy still "relatively outperforming", rates still relatively high and a recovering China good for Australian commodity exports. That has led to the Australian dollar tracking above 'fair value' (albeit not dramatically so) and this clearly continues to place stress on non commodity trade exposed sectors – and as has been noted previously the expectation of a currency likely to remain around parity may be having larger impacts on employment than previously expected (as firms either give up or replace local production with imports).

Drawing this together the new forecasts imply a lower core CPI path as discounting continues, the AUD remains high and wage pressures ease. Thus we now do not see core CPI exceeding the 3% threshold even with the indirect impact of the carbon tax (probably worth around ¼% over the year to June). The chart below shows our forecasts and modelling of core CPI into the medium term (with the models essentially driving our longer term forecasts). In the near term model forecast differ from our expected outcomes due to the carbon tax.



That in turn eases the pressure considerably on the RBA and allows it to concentrate on using rate cuts to help stimulate the economy. It might also be noted that while these forecasts imply a "no policy change" fiscal deficit of around $10-15bn this financial year that very much reflects the deteriorating economy – and not active fiscal expansion. Further from an RBA perspective the implied sharp increase in unemployment (to around 5 ¾%) by mid to late 2013 will demand a more aggressive policy response.

Our judgement is that the scenario that now represents our base case forecast could be expected to see rates bottom in the range 2 to 2½%. Our point forecast of 2¼% should be seen as being in the centre of that range and still very much data dependent.

On timing the current rate of deterioration of the domestic economy would seem to require a response in the first quarter of 2013. Still, given that there is already a substantial amount of monetary easing coming down the pipeline (175bps in a little over a year) the RBA is likely to move with caution ahead.

Our forecast is for an underlying inflation outcome of 0.7% for Q4, due on 23 January. For policy, this may be on the high side, after the 0.75% print for Q3 2012 and taking account of the easing in the pipeline at present. Our judgement is that the RBA may pause in February and come back in March with a 25bps cut to 2.75%.

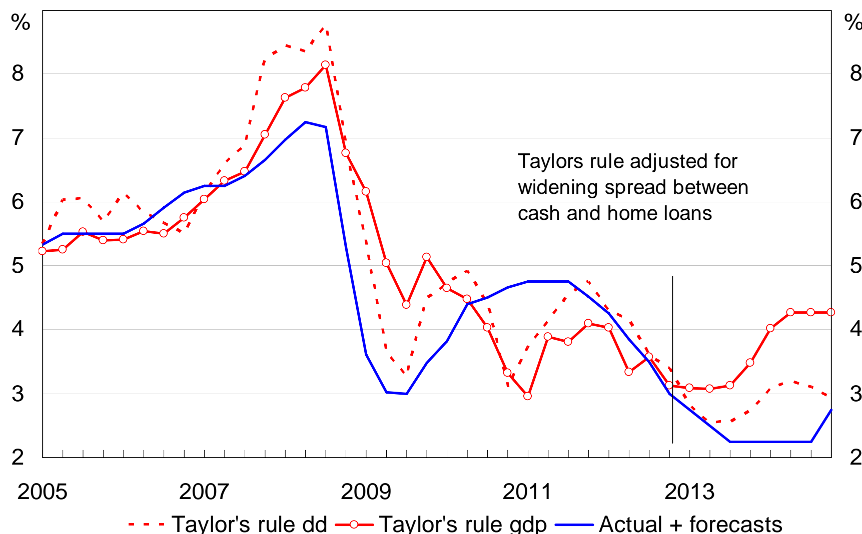
There is potential for market volatility in February as the 'fiscal cliff' debate re-ignites and we are expecting a bad European GDP print for Q4, due in February. Local activity indicators look likely to be weak. Moreover, the next Wages release is expected to point to a moderate inflation outlook (due 20 February), clearing the way for a cut in March.

While a March cut is our base case, clearly a low CPI (0.6% or lower for underlying) would most likely precipitate a February cut.

Thereafter we see the RBA waiting to reassess the impact of its actions. Our judgement is that only one more cut (our previous forecast) will be insufficient. In particular an unemployment rate rising to 5½% by mid year and beyond in late 2013 will see the need for two more 25 point cuts – which we have tentatively pencilled in for May and August.

Beyond that we see the RBA on hold at this very stimulative policy stance (which will see home loan variable rates at or around the same levels as that achieved during the global financial crisis). Part of the reason for this is the changing nature of the resource boom where mining employment demand will be significantly reduced as the boom moves from the construction to the export phase. That means, while long term GDP growth will be sustained at around 3%, domestic demand will be nearer 1%. All of which means little improvement in the unemployment rate. Tentatively we see the first move up in rates (as a move to start re-establishing more normal policy settings) in late 2014.

In many ways the dilemma for policy makers is summarised by Taylor rule calculations – and in particular differences in the rule calculated using demand v GDP. Basically both versions show an accommodative stance of policy (albeit not so extremely if domestic demand is the basis of the calculations) until at least end 2014.



As for the Australian dollar, the revision to our RBA call leave us a little more comfortable with our existing forecasts for the AUD/USD rate dropping to a little above parity by mid-2013 and perhaps a little below in H2 2013 (the latter in the context of what we expect will be a steady/firmer showing by the US dollar).

These forecasts were under pressure given the resilience in the face of the October and December reductions in the cash rate and what has been an effective 1.02 to 1.06 range since mid-2012. It is clear that the appeal of Australian yields and high credit standing is enduring in the face of rate cuts and that diversification into the AUD by global reserve managers is ongoing, as of Q3 2012 at least.

At the same time, the recovery in the iron ore price, though by no means fully reflected in other industrial metals and coal prices, does means that the 'valuation gap' between spot AUD levels and those consistent with Australia's terms of trade performance, is narrowing. That said, if we are now to see deeper cuts to the cash rate than currently discounted (currently only 40bps over the whole of 2013) we would expect this to have at least a mild dampening impact on the currency.

We are also very much on guard for more ugly scenes from Washington in the looming 'round two' of the battle over US fiscal spending and the debt ceiling and which we anticipate is likely to end with another downgrade of the U.S.' sovereign rating. In 2011, recall, the fight over deficit reduction and the debt ceiling, and the ensuing S&P downgrade, saw the US dollar rally by over 10% against the AUD in the space of a few weeks. While we do not anticipate a full repeat performance of 2011, a mini re-run, allied with more aggressive RBA easing than is currently discounted, is likely to be worth at least a few cents off the AUD in the coming months.

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