National Australia Bank **June 2013**

The Bigger Picture – A Global & Australian Economic Perspective

Global: ***The consensus view is that the pace of global growth should accelerate through the course of 2013 as recessions end in Western Europe, Abenomics lifts Japanese growth, the US continues its moderate expansion and solid growth continues in the big emerging economies. So far neither the business surveys nor the monthly industrial and trade data show such a synchronised global upturn with soft data in the US, ongoing recession in the Euro-zone and uncertainty in global equity and currency markets over the future course and implications of US and Japanese monetary policy. We still expect global growth to move back to trend next year but downside risks have become more prominent in the last few weeks.***

- Despite an uninspiring global back-drop, there was until recently a very strong run-up in global financial markets. Equity prices in the big advanced economies rose by around 25% between last November and mid-May and measures of market volatility were low. Since then share markets have fallen back and quite sharply in places like Japan. Global commodity markets have been soft with a downward trend in both the CRB and Economist indices since last September. This disconnect between equity and commodity markets is explained by the latter remaining better anchored to the real economy with its sluggish demand growth and increasing supply while shares had benefited from money rotating into that asset class as interest rates were so low that holding cash became costly to yield-seeking investors. Such an outcome was precisely what central banks in the big advanced economies had been trying to engineer.
- Global data show a broad-based easing in growth through the last couple of years. Our measure of global industrial production has stagnated since late 2012 with weakness in Western Europe and Asian export-oriented economies offsetting output expansion in China and North America. Japanese output has, however, been looking stronger more recently. Emerging economy industrial growth is stronger but it has not started to accelerate yet. There has also been a marked divergence of inflation performance between economies with a trend slowing in inflation across the advanced economies but persistent price pressure in India and Brazil.
- The first half of 2013 has seen the continuation of very mixed trends across the big advanced economies. The Euro-zone remains in recession and we do not expect to see much growth there until the latter half of the year. The other advanced economies have been faring better with an upturn in Japanese activity while the UK looks set to continue growing slowly. The US has been the best performing of the big advanced economies but some of the recent partial data suggest that the pace of economic growth has slowed in the second quarter.
- The three big emerging market economies of China, India and Brazil are still driving around 1½ ppts of the total 3% global growth forecast for 2013 but they too have experienced a slowdown. This reflects the lagged effects of past policy tightening as well as the sluggishness of global trade. Chinese growth continues its downward trend and we lowered our forecasts a few weeks ago. Industrial growth is still around 9% yoy, retail sales volumes are up around 10% yoy, fixed asset investment is up by around 18% yoy but export delivery values have been slowing quite sharply. Indian growth has been disappointing on the back of weak confidence and investment intentions.
- The export oriented economies of East Asia and Latin America also experienced a sharp slowdown through 2011 and 2012 with a period of renewed softness in the last 6 months.
- While recent activity trends have been generally disappointing, firms in most of the big advanced economies remain optimistic that things will get better. Our measure of current and expected future trading conditions in these big advanced economies confirms that while the former remain soft, there is still a belief that there will be faster growth in a year or so. The most optimistic firms are in the US, UK and Japan while those in France are especially pessimistic.
- We expect global growth to remain fairly sluggish through much of 2013 with the full-year figure staying around 3% before strengthening to 3¾% in 2014. The emerging market economies still account for the bulk of global growth – around 2½ ppts – but the contribution of the big advanced economies is expected to increase as Euro-zone recession ends and Abenomics lifts Japanese growth.

<u>Australia:</u> Evidence that slowing in mining investment is well underway and weakness in gross national expenditure has led us to soften our medium-term GDP forecasts. While a lower AUD and rates should help to offset some of the impact on the Australian economy from structural adjustment, they will be insufficient to prevent unemployment from rising – we see unemployment exceeding 6% by the end of 2013 and remaining around 6¼% in the out years. We expect the RBA to cut again. We have revised down our currency forecasts for the AUD/USD to 93c by end 2013 and 87c by late 2014.

- As the year plays out, the immense impact structural change is having on the Australian economy is becoming increasingly apparent. However, the economy's ability to cushion the effects of this adjustment is becoming less certain and poses a downside risk to near and medium-term growth prospects.
- The March quarter national accounts showcased the acute and enduring effect the high Australian dollar is having on GDP growth. GDP grew by 0.6% in the March quarter, to be 2.5% higher over the year. Household consumption growth increased to a still modest 0.6% in Q1 but business investment (buildings and equipment) fell sharply (down 4.8%). With dwelling investment static and underlying public demand up 1.1%, domestic demand fell by 0.3%. A sharp decline in inventories (mainly wholesale) took a further 0.4 ppts away from growth, so that gross national expenditure fell by 0.6%, its second successive decline. Only a large contribution from net exports (1.0 ppt) was sufficient to prevent a contraction in GDP.
- The results highlight the fragility of the non-mining sectors of the economy at the start of 2013. At a mere 0.3%, annual GNE growth is at its weakest since the GFC. An improvement in the terms of trade was recorded in Q1, but this partly reflects a recovery in iron ore prices that is unlikely to be sustained beyond Q2. The outlook for mining investment continues to be negative, given the general weakness in metals and bulk commodity prices. Mining remains firmly in the weak economic conditions camp in the NAB survey, with mining capex in May at its lowest level for as long as this question has been in the survey (2002).
- The NAB survey showed that while the business environment improved a little in May, overall business conditions remained weak. Marginal improvements in profitability, employment and trading conditions helped to lift business conditions, though each of these indicators remained well below their long-run averages. Despite improvements in conditions of some weaker industries (wholesale, manufacturing and construction), mining slumped heavily. Forward indicators suggest near-term demand will stay weak. Business confidence remained poor in May (at -1 point), with mining still very pessimistic (-22 points). A lower dollar and the RBA's decision to cut the cash rate in May could have been expected to boost confidence in the month, but the weakness in the domestic economy appears to have offset to that impact.
- Forward indicators for the labour market have weakened appreciably in recent months. In April, DEEWR internet vacancies fell by 3.6%, to be 24.1% lower over the year. In May, ANZ job ads fell by 2.4%. Also in May, the NAB employment conditions index remained heavily in negative territory, at -6 points. This index has been depressed around these levels for eight months and this is the 13th consecutive month of negative readings. Official labour data have been volatile over recent months, making it difficult to get a true appreciation of labour market conditions.
- While retailers experienced a more promising start to the year, official sales growth weakened into March and April. Moreover, the strength in January and February retail sales followed a period of soft growth over the second half of last year, suggesting the overall volume of retail trade still has some catching up to do. Overall, the NAB survey indicates that conditions for retailers have remained subdued, consistent with weakness in consumer sentiment.
- The RBA left the cash rate at 2.75% in June. The Board noted that the exchange rate is still high suggesting the relief provided by a falling dollar may be limited. There was a clear omission of any discussion on the issue of the economic impact of the slowing in mining investment, which poses significant downside risk to the Australian economy. We believe an additional 25bp rate cut will be needed (in Nov) to help support a weakening labour market. However, stimulus could come earlier if the labour market weakens faster than anticipated.

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