National Australia Bank

October 2013

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> After a period where the data showed accelerating growth in the big advanced economies, the latest numbers have been more mixed. Although an upturn is still under way, the pace of industrial growth and business sentiment in some big advanced economies has stopped improving. Trends in the emerging market economies have been mixed with Chinese growth showing signs of stabilising, India remaining weak and signs of a very modest improvement across emerging Asia and Latin America. Global growth forecasts remain at 3% this year and 3½% in both 2014 and 2015. We are assuming that US political uncertainties over its government shut-down and debt ceiling do not have a marked impact on its rate of economic growth – this assumption will clearly need to be carefully monitored as a worse case scenario would have significant global ramifications for both growth and especially financial markets.

- The US Federal Reserve surprised markets by not announcing the start of asset purchase tapering and that boosted share prices. We expect the Fed to announce in December that it will gradually cut back on its asset buying but the US Fed funds interest rate is only expected to start rising in H2 2015. Central banks in the other big advanced economies are not expected to lift policy rates for a long time but the Reserve Bank of New Zealand may begin lifting its cash rate in March. US 10 year bond yields, which had risen from 1.7% in April to 2.9% in early September, moderated to 2.6% by the end of the month. As global bond markets have been moving in parallel with US yields, this shift in the US market fed into other nation's bond markets and their yields fell too. Commodity markets have continued their downward trend with the Economist and CRB falling through the last month.
- Global growth remains only moderate and many productive resources still lie idle in the wake of the deep recession of 2008/09. World export volumes were up by only 1½% yoy in July while growth in industrial production was around 1¾% yoy, both rates well below their long-term trend. Global GDP is, however, growing more rapidly than either exports or industrial output, reflecting the buoyancy of the service industries that dominate output in most economies. Three-month annualised growth rates show this acceleration in advanced economy growth with the seven big advanced economies recording GDP growth of around 2½% in the second quarter. The trend slowing in the emerging economies through the last few years has been broad-based. There have, however, been signs of a stabilisation or even acceleration in the pace of activity in some big economies recently, notably Brazil and China.
- The first half of 2013 saw a clear upward trend in activity across the advanced economies. Industrial output started rising toward the end of 2012, coinciding with much stronger business surveys across all of the big advanced economies. The latest data show a modest setback to this picture; the rate of three-month annualised industrial growth fell slightly in July and the level of industrial output levelled out or dipped slightly in North America and the Euro-zone. Purchasing manager surveys for the UK and the Euro-zone turned down slightly. On the other hand, US and Japanese business surveys have kept rising. It is too early to become overly concerned by the dips in advanced economy industrial growth. The US Government shutdown is an added uncertainty hanging over the growth outlook – the direct effect of a four week closure could reduce quarterly growth by around 0.1 percentage points.
- Recent trends have been mixed across the big emerging markets. The Chinese economy has fared better than many feared with recent indicators of industrial output, fixed investment and retail trade showing no evidence of an economic "hard landing". While the Chinese authorities want to achieve a gradual re-balancing of the economy's growth away from investment spending towards consumption, they do not want to unduly depress the rate of growth. The Indian economy continues to under-perform with growth down to around 4½% yoy in the June quarter. Partial data on output and trade remain weak and the business surveys are mixed.
- While some of the latest data on global trade and industrial output and some business surveys show a modest slowing in advanced economy growth, national surveys on firms' expectations still show very buoyant results. Our measure averaging business sentiment across industry in the US and Western Europe shows a widespread expectation that things will either keep getting better (UK, US, Germany) or not be quite as bad (France). In the emerging markets, Chinese surveys are better than they were and the Indian surveys are a mixed bag. So are readings from across East Asia with South Korea slightly better, Thailand worse and little change in Taiwan, Indonesia or Singapore.

<u>Australia:</u> Our GDP forecasts are unchanged this month: GDP growth to soften to 2.3% in 2013 before gradually rising to 2.5% in 2014 and 2.9% in 2015. Unemployment is expected to exceed 6% by end 2013 and reach 6¾% by end 2014. Consistent with this soft outlook, we see core CPI edging down to 2.2% by end 2013, lifting modestly to 2.5% by end 2014. The RBA appears less dovish on the back of better confidence and improving asset prices. But AUD is still elevated and the labour market continues to weaken. We still see a need for another 25 bp rate cut – probably in February (was November), allowing the RBA time to pause and watch the data.

- Business and consumer confidence rose to more robust levels in September and forward indicators and capacity utilisation from the NAB survey also improved. These may be the first portents of stronger growth in the Australian domestic economy. The key issues are whether the improved tone will continue and, if so, how long it will take to translate into business activity and investment. For the time being, business conditions remain weak.

- Up until very recently, there was little indication that loose monetary policy settings were helping to support interest-sensitive spending and asset values. Retail turnover grew by 0.4% in August, while in September the Westpac-Melbourne Institute measure of consumer sentiment increased sharply to its highest level in almost three years. Despite the increased confidence of consumers, which may well have been temporarily boosted by the Federal election outcome, personal credit grew by only 0.2% in August, suggesting households are still cautious. According to the NAB business survey, conditions in retailing remained difficult in September. Consistent with the weakness in traditional retailing, online retail sales have also softened over recent months, falling by 0.1% in August, following growth of 2.1% in July.

- There are still no signs that non-mining investment has begun to rise to compensate for the progressive decline in mining investment. The lower track for the AUD does not yet seem to have reduced pressure on manufacturing. Data are at best mixed: in September, while the Australian PMI rose sharply it still implies tepid growth in the sector and the NAB business survey reported manufacturing business conditions still deeply negative at -18.

- The unemployment rate edged up to 5.8% in August after the second consecutive month of declining employment numbers. The rise would have been greater had it not been for a decline in the participation rate and is in line with our expectations for the labour market. The labour market outlook remains soft. The NAB employment index from the business survey improved in September but is still deeply in negative territory.

- We have left our GDP growth forecasts broadly unchanged. We still expect quarterly growth to soften to 0.4% in the September quarter, before strengthening to 0.6% in Q4, yielding 2.3% in 2013 (was 2.2%). Consistent with this, the unemployment rate is expected to exceed 6% before the end of this year, before rising to 6½% or a touch higher by late 2014. Export volumes should help drive growth in 2014 as major minerals and energy projects begin the transition from construction to production and export. GDP growth is expected to improve a little in 2014 to 2.5% (was 2.6%), though this still represents below-trend growth. But it is likely to be a relatively jobless expansion because of the lower labour-intensity of mining exports relative to mining investment.

- Since our last report we have revised the track for the AUD partly in light of the delay in tapering of bond purchases by the US Fed. The AUD is now expected to drift down to $US0.92 by the end of this year, and $US0.84 by the end of 2014.

- The RBA decided for a second consecutive month to leave the cash rate on hold at 2.50% in October. While its accompanying statement implied little change in view since its previous meeting, there was a sense that the RBA has become less dovish and is now comfortably on hold. This month's statement noted that business and consumer confidence had improved but the Board said it was too early to judge how persistent this will be (and we would add, to what extent this leads to stronger activity). The statement also noted that household savings behaviour had shifted in response to declining returns on low-risk assets. Based on the most recent RBA statement, we have decided to delay our rate cut call from November to February, allowing the RBA time to pause and watch the data. With the big picture still unmoved, we continue to see a cut coming but right now there is no rush.

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