National Australia Bank

November 2013

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Global growth rose from 2.4% to 2.8% between March and June quarters and we are expecting 2.9% for 2013 overall, increasing to 3.5% next year. The national accounts and business surveys show a quickening pace of growth in the big advanced economies with the UK and Japan the standout performers. The US's moderate recovery continues and Euro-zone output has started to slowly recover after a long period of weakness. The emerging economies present a mixed picture with solid outcomes in China, a disappointing record and outlook for activity in India and only moderate growth across Latin America and the export-oriented economies of East Asia.

- The markets are still watching the US Federal Reserve to assess when it is likely to start winding back its asset purchases. The outlook for these asset purchases depends on the labour market improving and inflation moving back towards its 2% goal (it is currently 1¼% yoy). Our assessment is that this process of tapering back purchases will start next March and finish in the second half of next year. The Fed has also said that a Fed funds of zero to ¼% is "appropriate" while the jobless rate is above 6½%, inflation is below 2½% and inflation expectations remain under control. We think the Fed will start lifting its target funds rate in September quarter 2015. Other central banks are also signalling that their policy rates will stay low for quite some time. The European Central Bank has just cut its policy rate to 25 bps and said it is likely to keep its rates at current or even lower levels for "an extended period of time". The Bank of Japan intends to keep its rates near zero and to continue buying large amounts of assets until inflation gets to its 2% target, which they forecast to occur in fiscal year 2015.
- The pace of growth in important measures of global economic activity remains quite modest with world industrial production expanding by 2.2% yoy in August and world trade rising by only 1.8% yoy. Growth in global services output has outstripped that in goods but the 2.8% yoy growth seen in global GDP in the June quarter is still a sub-trend outcome, especially given the incomplete recovery from the 2008/09 recession in the level of output across key advanced economies. Economic growth is still spread very unevenly across the globe with big disparities in performance between key advanced and emerging economies. Industrial growth in the advanced economies was only 0.2% yoy in August whereas it was around 4% yoy in the emerging market economies.
- The business surveys show that the broad-based upturn in activity that was seen in the first half of the year continued into recent months. After being flat in the closing months of 2012, GDP in the 7 biggest advanced economies grew by 0.3% in the March quarter and 0.6% in the June quarter. Limited data for the third quarter show a mixed picture with US and UK growth picking up steadily through the first three quarters of 2013 but third quarter Japanese growth could well prove slower after a very strong first half. The business surveys show a ramping up in activity and confidence across all of the big advanced economies since early 2013. Industrial activity is now growing in all regions with a particularly solid upturn in Japan and the UK. Activity is also now increasing in the Euro-zone and Japan (where we use the Shoko Chukin bank index) while US service sector activity survey readings show a volatile pattern.
- The big emerging market economies continue to present a very mixed picture with the Chinese economy faring better than expected, India lagging and Brazil, which had reported solid growth in the June quarter, likely to slip back a little in the third quarter judging by its partial economic data. Growth in both exports and industrial output looks to have picked up slightly across Latin America and the East Asian emerging market economies. The latter tend to be highly export-dependent and modest growth in industrial output resumed through August and September at the same time as $US export earnings stabilised. Latin America shows a similar pattern for exports and industrial output.
- In aggregate, business surveys across the main advanced economies show positive net balances of firms expecting growth to continue through the next year. Sentiment is not very positive in the big emerging economies with especially weak numbers in the Indian business surveys. While the emerging economies should continue to account for the bulk of growth in global output, their rate of growth should remain at around 5% through the next couple of years while growth in the advanced economies rises from 2013's 1¼% to 2014's 2¼% and stays there in the following year as the effects of Japan's stimulus wear off. Global growth should rise from 3% to around 3½%, taking it back to just slightly below trend.

***Australia:* Our GDP forecasts are broadly unchanged this month: GDP growth to soften to 2.3% in 2013 before gradually rising to 2.4% in 2014 and 2.9% in 2015. Unemployment to nudge 6% by end 2013, a touch above 6½% by end 2014, before easing to 6.3% by late 2015. Given the soft outlook, core CPI is expected to edge down to 2.3% by end 2013 and 2.4% by end 2014. Rising asset price trends and higher confidence likely to see RBA wait to see how labour market trends play out before cutting cash rate again. We expect next rate cut in May (was February), by which time labour market conditions are likely to have deteriorated sufficiently to prompt further policy easing. Unemployment will be the key to the timing and extent of further cut(s).**

- Business and consumer confidence both weakened in October but remain elevated by the standards of the past two years or longer. The sharp improvement in sentiment in September now looks like something of an over-reaction to the change of federal government and perhaps to better news from China. It also appears that firms have reassessed their confidence on the outlook in the face of still weak activity outcomes. Nevertheless, business confidence is still in positive territory for all industries except for wholesale.
- Low interest rates continue to work slowly through the economy. Asset prices lifted again in October, although house price growth has been largely confined to the (admittedly large) markets of Sydney and Melbourne. The ASX200 share price index also rose by a solid 4.0%, representing the fourth consecutive monthly rise. The improvement in household wealth implied by higher asset prices should contribute to stronger consumer demand. This is consistent with recent modest improvements in retail trade, although official data may be overstating the extent of recovery.
- The NAB business survey for Q3 indicated little change in capital expenditure expectations for the next twelve months. Broadly, there is still little evidence that business investment outside the mining sector is likely to pick up strongly any time soon.
- The labour market remains weak. Total hours demanded is broadly stable at a low level and heads employment is failing to keep pace with growth in the working-age population. The unemployment rate remained at 5.7% in October but there has been a clear upward trend in unemployment and underemployment rates in recent quarters. The prospective transition of many major mining projects from construction to export delivery is expected to place considerable downward pressure on mining sector employment. This is likely to be only partly offset by increased employment in mining operations. The NAB employment index from the business survey improved again in October but is still deeply in negative territory.
- 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. We expect the AUD to drift down to $US0.95 by the end of 2013 and $US0.86 by the end of 2014.
- We have left our GDP growth forecasts broadly intact this month. We still expect quarterly growth to soften to 0.4% in Q3, before strengthening to 0.6% in Q4, yielding 2.3% in 2013. Given the October reading for the unemployment rate, we now expect the unemployment rate to rise to just below 6% before the end of this year, before peaking at a touch above 6½% in mid-2014. Our forecasts see unemployment falling to around 6.3% by late 2015 – albeit largely driven by falling participation rates.
- The RBA decided for a third consecutive month to leave the cash rate on hold at 2.50% in November. In its accompanying statement, the RBA appeared to have maintained its easing bias but there is a suggestion that that Board is awaiting more evidence of slowing activity before deciding to cut again. Given the recent improvement in business and consumer sentiment and rising housing and equity prices, it is likely that the RBA wants to wait and see how labour market trends play out before lowering the cash rate again (inflation is off the menu for the time being). It is our view that economic activity will remain soft over coming quarters and current economic optimism will fade, prompting the RBA to lower the cash rate again in May (previously February) by which time we think labour market conditions will have deteriorated sufficiently to prompt further policy easing to stem the rise in unemployment.

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