National Australia Bank

August 2014

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> We have trimmed our global forecasts to take account of the impact of default in Argentina on Latin American growth and unexpectedly soft Japanese exports and post-tax consumption which led us to significantly lower our Japanese forecast. Elsewhere, solid growth numbers are coming from the UK and US but the Euro-zone presents downside risks (with soft recent business surveys and Q2 GDP in Italy and Belgium) to growth and a clear threat of deflation. The emerging economies now drive around 70% of global output growth but present a mixed picture. China's growth remains robust, India's has disappointed but could be about to pick up and East Asian economies are likely to remain subdued pending faster world trade. Overall, world growth in 2015 to rise to 3.6% (nearer trend) from a mixed and disappointing 3.1% in 2014.

- After a long period in which the focus of most central banks in the big advanced economies has been on low interest rates and injecting liquidity to stave off deflation, boost growth and repair the consequences of the GFC, we are now entering a period of greater diversity in monetary policy. The Fed is still winding back its asset purchases at a rate that should see them end this year but it is still signalling low interest rates into 2015. The Bank of England recently surprised the markets saying that rate rises could come sooner than generally expected. By contrast, the ECB and the Bank of Japan are focussed on ending or avoiding deflation with the former loosening policy and the latter continuing its ultra-easy policy as inflation finally starts to rise.
- The pace of growth in global industrial output has been steadily slowing since the start of the year. World trade has been surprisingly weak, even in this environment of sluggish world demand, falling in the March quarter and growing only modestly through the following two months. However, service industries make up by far the largest part of global output and data limitations make them much harder to track. Business surveys show ongoing growth in services across the US, UK and Euro-zone, Japanese firms struggling through the post-tax rise slump in demand and disappointingly soft readings in China and India.
- The divergence in economic conditions between the big advanced economies seems to be widening again. The US economy recovered strongly in June quarter from its early 2014 weather-related weakness, and the partial data and business surveys point to a solid moderately paced upturn — keeping the Fed comfortable enough with the outlook to progress cautiously toward ending its very loose monetary policy. The situation is quite different in the Euro-zone and Japan. Although they still point to growth, Euro-zone business surveys have been softening and the slowdown is broad-based. Industry surveys in big economies like France and Germany, as well as bell-wethers like Belgium, began turning down recently and there are signs in some economies of less buoyancy in their services sector too. The Japanese economy is expected to contract significantly in June quarter (more than offsetting Q1 increases) as demand falls in the wake of the April 1st hike in consumption taxes. Japanese exports are also soft, despite solid growth in its important Chinese export market. We have accordingly lowered our 2014 growth forecast (by 0.3% to 1.3%) to take account of that.
- The slowing trend in the big emerging economies has continued with 3-month annualised industrial growth slipping from over 5% in late 2013 to around 3½% in May. Export volumes from these economies actually fell in early 2014, remained weak in April, but then rose in May. Monthly partial data on economic activity shows a clear variation between regions. Chinese growth remained solid in June with good growth in industrial output, while YTD investment and retail sales volume growth are up by double digits. Growth finally picked up in India in early 2014 and third quarter surveys of industry look brighter. Growth remains modest in the other emerging economies of East Asia and should stay like that until world trade accelerates. Latin American growth has faded as Argentina moves into recession and we have lowered our forecasts now it has defaulted.
- Forward looking questions in business surveys vary across the big advanced economies, but generally point to ongoing moderate growth. The most disappointing results come from the Euro-zone, while Japanese firms think they can weather the recent weak period. The most buoyant results come from the US and UK. We expect global growth to quicken from 3.1% in 2014 (revised down from 3.2%) to 3.6% in 2015 (revised down from 3.7%), which is around the long-run trend. The emerging market economies should still account for the bulk of global output growth, but the contribution from advanced economies will rise. Emerging market growth should return to over 5% in 2015 as India's growth finally picks up.

- ***Australia:*** ***Weak retail trade and net exports point to soft GDP growth in Q2. Employment continues to drift: jump in unemployment rate looks like quirk from ABS measurement changes (which probably added 0.2 points to unemployment). Partial indicators generally better: business conditions jump to four year high, while, business confidence, orders and capacity utilisation all looking better. But headwinds remain, especially high AUD, declining mining investment and fiscal restraint. Australian forecasts revised down in 2014/15 (3.1%, was 3.3%), up in 2015/16 (3.2%, was 3.0%). Official unemployment rate to peak at 6½% by end 2014 (was 6¼%) and only slowly improve (6.2% by end 2015). Cash rate on hold until late 2015 but risk of cut(s) rise if unemployment is worse than forecast.***

- There are signs that GDP growth in Q2 will be very subdued. In volume terms, retail trade fell by 0.2% in Q2 and will be a potential source of softness for private final consumption. Monthly international trade values and price data imply that net export volumes will make a potentially large detraction from GDP growth (of the order of 1 percentage point). However, it is conceivable that some of this weakness, particularly in minerals export volumes, may be offset by inventory accumulation.

- The July NAB business survey however points to a strong start to Q3. Business conditions jumped to a four year high and have now more inline with steadily improving levels of confidence. That said the improvement in conditions is still narrowly based in services and construction (the latter reflects the surge in approvals in apartments in particular – in part driven by offshore investment). The bellwether wholesale sector improved strongly in July but transport fell back and both sectors continue to languish. Mining conditions remain very poor.
- Forward indicators generally improved this month, with forward orders and capacity utilisation looking better, although the soft employment index from the NAB survey suggests a continuation of 'jobless growth'. Business confidence continued its steady improvement since earlier in the year to be well above its long-run average, influenced by a surge in retail confidence in stark contrast to the relatively tepid recovery in consumer confidence following the federal budget. The NAB survey data imply that demand and GDP growth are likely to strengthen later in the year – as is built into our forecasts.
- Residential building approvals continued to edge down in July. Signs of a resurgence of non-mining investment are still lacking: non-residential building approvals fell further to quite low levels. Business credit growth jumped 1.0% in June, apparently because of the presumably temporary effects of bridging finance associated with a corporate restructure. Housing credit continued to grow steadily (0.6%), but personal finance grew by 0.6% (strongest since 2009).
- The official labour market data for July indicate that labour demand remains weak, broadly confirming the picture from our survey. The employment-population ratio continues to decline, while hours worked per capita are still moving broadly sideways. Partial indicators, such as ABS job vacancies, ANZ job ads and Department of Industry internet vacancies, have continued to improve, pointing to moderate employment growth during the remainder of the year.
- The official unemployment rate jumped to 6.4% in July (6.0% in June), but the size of this increase was significantly affected by a change in the definition of active job search by the ABS in July (increasing the participation rate). We are expecting some payback in unemployment but not much. We have increased our expected track for the unemployment rate to now peak at around 6½% by the end of 2014. This change reflects the likely ongoing impact of the changed definition of job search and expected softness in Q2 GDP.
- Our near-term GDP forecasts were revised down, longer-term revised up: 2014/15 3.1% (was 3.3%); 2015/16 3.2% (was 3.0%). Unemployment rate to peak at around 6½% (was 6¼%) by the end of this year reflecting weaker growth and revised methodology.
- We still expect no change in the cash rate until the end of 2015. Labour demand remains tepid but there are encouraging signs from forward indicators, including our own survey. However, the potential near term weakness in GDP represents a clear risk that the cash rate may need to be cut if conditions worsen again. A pain point for the RBA would be unemployment at 6¾%.

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