National Australia Bank

September 2014

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Weakness in Japan, stagnation in the Euro-zone and a hard landing in Latin America have resulted in a slowdown in the pace of global growth through the first half of 2014. World GDP growth reached 3.4% yoy in late 2013, it slowed to 3.1% yoy in March quarter 2014 and 2.9% yoy in June quarter. We have trimmed our 2014 global forecasts to take account of weaker than expected June quarter data in the Euro-zone and Latin America (Brazil, Argentina). Economic upturns look secure in North America and the UK, Indian growth has finally picked up and we may revise our numbers higher, China's gradual slowing continues and we are counting on monetary stimulus to eventually get faster growth in the Euro-zone and Japan as the latter's tax rise effects wear off.

- After a long period of stimulatory monetary policies in all of the big advanced economies, growing divergence in their economic outlooks should lead to variations in central bank interest rate policies and that should impact on currencies (higher $US). The US Fed appears convinced that sustained moderately paced growth should continue. Fed guidance has rates staying low "for a considerable time" after the Fed finishes its asset purchase program (in October). The Bank of England has also stopped loosening policy with some MPC members now voting for rate rises. Elsewhere, the Bank of Japan has confirmed that it will continue its zero interest rate and big asset buying programmes for as long as necessary to get its 2% inflation target. Facing deflationary risks and a sluggish Euro-zone economy, the ECB announced another easing in its monetary policy with a 10 bp cut to its policy rates (taking its refi lending rate to 5 bps) and plans to buy assets to boost its balance sheet to early 2012 levels (implies a €1 trillion rise).
- Global industrial growth has remained in the 2¾ to 3% yoy range since late 2013 as robust Chinese manufacturing expansion and the start of cyclical upturns in India and across the emerging market economies of East Asia offset weakness in Japan, the Euro-zone and Latin America – helping to support global commodity demand. Weakness in Japan and the Euro-zone explains mid-2014s sharp downturn in industrial growth in the advanced economies – previously their rate of expansion had matched that of the emerging market economies. However, overall, business surveys in the advanced economies have continued to trend up. This reflects solid outcomes in the US and a partial recovery from a post-tax-rise slump in Japan. Readings across Western Europe are still weakening.
- Although G7 advanced economy annualised growth quickened in June, almost all of this occurred in North America (plus a very small contribution from the UK) while Japanese output fell and Euro-zone production stagnated. June quarter's divergence in output growth between the US/UK and Euro-zone/Japan continued a divergence in performance dating back to early 2013. The monthly purchasing manager surveys provide one of the more timely measures of growth momentum and the August results show the solid US performance continuing into the third quarter. Elsewhere, results are mixed. Industry is still growing in the UK and Euro-zone, but more slowly. UK services look even stronger while the Euro-zone services sector has lost momentum. National business surveys across the Euro-zone also point to weakness. The August purchasing manager surveys for Japan show output struggling to regain its pre-tax rise level in both services and industry.
- Emerging market growth has slowed from 6% yoy in mid-2013 to 5.3% in June 2014 and the slowdown has been broadly-based with softer growth in China, the rest of East Asia and a particularly hard landing for Latin America. India is the only big emerging market economy that has gone against the trend: its monthly indicators of trade and output have turned upwards, business surveys look more positive and leading indicators suggest faster growth. Unlike its quarterly national accounts, Chinese monthly activity indicators are consistent with a very gradual trend slowing in growth, but conditions are mixed across the economy.
- With the upturns in the US, UK and Canada looking securely established and monetary stimulus in Japan and the Euro-zone finally helping their economies, we expect advanced economy growth to pick up in 2015 and 2016. The lacklustre responses to forward looking questions in Euro-zone national business surveys suggest that its upturn will be muted. Emerging market growth should also pick-up as faster expansion in India, Latin America and East Asian emerging market economies outweighs China's slowing trend growth. Global growth should accelerate from 3% in 2014 to 3½% next year and 3¾% in 2015 – taking it back to around its long-run trend.

- ***<u>Australia:</u>* There are signs that growth may be strengthening in Q3. NAB business conditions have been well into positive territory since June. In August, business conditions retraced much of their recent sharp gain, although the environment remains better than earlier in the year and business confidence is still solid. However, employment still looks like a soft spot. Domestic forecasts revised marginally: 2014/15 2.9% (was 3.1%); 2015/16 3.4% (was 3.2%). Unemployment rate still to peak at 6½% by end-2014. Inflation at the bottom of the RBA target band. Cash rate still on hold until late 2015.***
- The national accounts confirmed that the Australian economy grew at sub-trend pace in Q2 (GDP 0.5%, domestic demand 0.4%). Growth was constrained by sluggish household consumption as well as falls in underlying business investment and public demand and strong import growth. The main area of support was from dwelling investment. Reflecting the weakness in commodities, the terms of trade fell again to be 7.9% lower than a year ago. Nominal GDP actually fell marginally in Q2.
- The August NAB business survey eased back, but suggests a strong start to Q3. Business confidence remains resilient, supported by positive forward orders, subdued cost pressures and more stable consumer confidence. Positive business conditions are also helping despite falling back in the month. The jump in business conditions last month was surprising, so some payback in August was expected. The employment index was unchanged at low levels, conforming to expectations of a relatively jobless recovery.
- Forward indicators remain positive. Capex, capacity utilisation and forward orders all improved over the past 12 months, but trend conditions in the 'bellwether' wholesale industry remain weak. Retail confidence remains positive, but fell sharply from last month (down 15 points) – consistent with our reservations over the optimism in July. Meanwhile, other consumer confidence indicators have generally recovered from sharp deteriorations post 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.
- Consumers remain cautious, with consumer anxiety rising again in Q2. Real consumer spending grew at a relatively modest 0.5% in Q2, compared with a decline of 0.2% in retail trade volumes. The decline in retail is difficult to align with the national accounts, where the only goods components to record declines were clothing & footwear and other goods & services. The household saving ratio edged up to 9.4% but remains broadly in line with its recent, historically high, trend. In July, retail trade grew 0.4% to be 5.9% higher than a year ago, still representing a modest rate of growth.
- New property demand improved in Q2 according to the NAB Residential Property Survey, but the peak in the current construction cycle may be approaching. Building approvals for detached houses have flat-lined and multi-unit approvals remained off their recent peaks in July, especially for large apartment projects. HIA new home sales fell back sharply in July. Dwelling price growth continued largely unabated in August, up 1.8% in Sydney and 0.8% in Melbourne. Elsewhere, price growth was muted, although Adelaide prices sprang back. The latest capital expenditure survey expectations confirm the looming decline in mining investment. Based on average 5-year realisation ratios, mining capex is expected to decline by almost 25% in 2014/15, compared with a projected 9% rise in other surveyed industries.
- Since July, partial indicators for the labour market have improved modestly. While the NAB employment index was unchanged at a weak zero balance in August, internet vacancies rose by 0.6% in July and ANZ job ads by 1.5% in August. We still expect the unemployment rate to peak at around 6½% by the end of 2014 before showing signs of improvement. There has been no growth in mining employment for two years (even longer for construction employment). We expect a sharp weakening in employment in mining and related construction activity over the next two years as major resource projects are commissioned.
- Marginal adjustments to GDP forecasts: 2014/15 2.9% (was 3.1%); 2015/16 3.4% (was 3.2%). Unemployment rate still to peak at around 6½%. We still expect no change in the cash rate until the end of 2015. The Governor's most recent remarks suggest that the next rate move will be up, even if it is a long way off – tougher than expected impact on the labour market from the mining adjust is a key risk to the policy outlook.

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