National Australia Bank

October 2014

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Global growth was around 3% in the first half of 2014, below trend and with marked variations in performance between major economies. North America continues to perform strongly with solid growth in both the US and Canada. Although the UK's pace of growth could have peaked, it continues to run at a solid rate while recovery in Japan and the Euro-zone has faltered. Conditions are mixed across the emerging market economies with an upturn in India after some disappointing years, continuing trend slowdown in China, falling output in key Latin American nations like Brazil and Argentina and sluggish growth across most of emerging market East Asia (as the weakness of growth in world trade affects export-driven Asian economies). Global growth should quicken next year to a still sub-trend 3.4%, largely driven by the US and India.

- There is a growing divergence in monetary policy across the major central banks. The US Federal Reserve seems confident that moderate economic growth will continue and that inflation should be at or below the 2% goal by 2017, allowing for a gradual tightening in policy. The Fed's asset buying program is nearing its end but the fed funds interest rate should remain unchanged for a "considerable time" (rate hikes to commence in mid-2015). In contrast, softer than expected activity in Euro-zone and Japan has constrained inflation pressures, keeping rates and bond yields exceptionally low. Deflation is a risk in the Euro-zone and the Bank of Japan is still trying to escape deflation by getting inflation up to 2% as soon as possible (but core inflation is only 1¼% yoy). Neither the ECB nor the Bank of Japan looks set to end their asset buying programmes soon and a lift in their policy interest rates is probably still years away. Divergent economic and policy conditions are fuelling the long awaited $US appreciation.
- Softness in economic activity in the Euro-zone, Japan and Brazil alongside the trend slowdown in China has offset solid growth in North America and some recovery in India. The result has been a slowing in the pace of global industrial growth through 2014. This slowing, concentrated in post-tax rise Japan and the Euro-zone, mirrors a winding back in confidence levels seen in business surveys, although the results are still consistent with ongoing moderate growth. Global growth in services output has also slowed recently, mainly reflecting lower Japanese spending in the wake of the April tax hike and a slowdown in the Euro-zone. Services output continues to grow rapidly in the UK and big emerging market economies like China, India and Indonesia. Recent business surveys show a modest slowdown in global service sector growth in Q3.
- Although G7 Advanced economy annualised growth quickened in the June quarter, 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. Recent business surveys point to continued growth in the big advanced economies, but suggest a loss of momentum in the September quarter. Nevertheless, the surveys show a marked difference across the big advanced economies. The principal concern at present is the extent to which advanced economy growth is being driven by just one big economy – the US – with recent GDP releases, partial economic indicators and surveys highlighting continued weakness in Japan and the Euro-zone.
- Emerging market economies are growing much faster than the advanced economies, but the pace of expansion has steadily eased. Latin America has seen the sharpest slowing, with GDP falling in both Brazil and Argentina in Q2 – confidence in the latter was hit by a default on its external debt. India has picked up through mid-2014. In contrast, Chinese growth is gradually slowing and growth across the rest of emerging East Asia has gradually eased and is well below long-run average growth. The monthly economic indicators show emerging economy industrial growth running around the trend pace seen through the last few years but well below pre-GFC levels. World trade growth remains sluggish, but exports growth from emerging market economies has accelerated, largely reflecting better Chinese exports.
- Continuation of the economic upturns in North America and the UK looks reasonably assured, but the Euro-zone and Japan remain in doubt and we expect growth to remain modest for both; April's tax hike hit Japanese growth harder than expected and another rise is planned for next October. Moreover, recent economic indicators in the core countries of the Euro-zone look disturbingly soft. Emerging market growth is expected to pick-up, reflecting stronger Indian growth and a recovery in Latin America. Global growth should accelerate from 3% in 2014 to just under 3½% next year and slightly over 3½% in 2016 – leaving it still slightly below its long-run trend. Consequently, inflation pressures will be limited, allowing central banks to keep policy interest rates low.

- ***<u>Australia:</u> Retreating confidence and conditions and likely sharp decline in terms of trade point to weak Q3. In September, capacity utilisation continued falling, forward orders declined and employment slumped further into negative territory. Still few signs of a sustained increase in non-mining investment to fill the emerging mining investment cliff. However, the easing in the AUD should assist trade-exposed sectors. Business credit barely grew in August and remains very weak. Terms of trade profile weaker in response to sharp declines in commodity prices. Consequently, GDP forecasts revised down modestly: 2014/15 2.8% (was 2.9%) and 2015/16 3.2% (was 3.4%). Unemployment rate still to peak at around 6½%. No change in cash rate expected until near the end of 2015.***
- Statistical issues facing the ABS Labour Force Survey are making it difficult to gauge the Australian labour market. The ABS has effectively suspended the seasonal adjustment of most components of the survey from August on the grounds that there has been a shift away from "normal seasonal patterns" – the published unemployment rate for September was 6.1% (official and if seasonally adjusted). Looking through the volatility in the data, the official employment data still points to a weak labour market. While some forward indicators suggest employment growth will return there is little to suggest it will be strong enough to offset natural growth in job seekers – and hence the unemployment rate will rise further. In that context the weakening in employment in the NAB Survey in September was sobering.
- In the September NAB Business Survey, both conditions and confidence retreated from mid-year improvements, suggesting that Q3 was disappointing. The fall in business conditions brings the index back to its lowest level in 4 months, confirming our expectation that the (narrowly based) jump in July would be short lived. Most industries recorded a drop in September, although transport & utilities were surprisingly strong (falling oil prices and removal of carbon tax?). A drop in profits and employment drove conditions lower, with the latter moving significantly into negative territory (as noted above).
- Forward indicators of demand are soft. Capacity utilisation fell in September, forward orders declined and employment slumped further into negative territory. However, trend conditions in the 'bellwether' wholesale industry are a little less weak. Our wholesale leading indicator implies soft underlying conditions and below trend growth in Q3.
- An improvement in the NAB measure of household wellbeing in Q3 has so far not been reflected in stronger spending. That in part may reflect continuing high levels of consumer anxiety – especially related to long term financial sustainability. Retail trade struggled again in August, edging up by just 0.1%. After stepping up during 2013, retail trade has grown by an insipid 1.1% since January 2014, with department stores particularly weak, and softness in clothing/ footwear/ accessories and household goods. Not surprisingly, retail business conditions remain deeply in negative territory, especially sales and profits. Online retail trade growth, while still higher than traditional retailing, also slowed in August. The weakness in consumer spending is mirrored in soft demand for credit: personal credit grew just 0.2% in August (up 1.1% yoy).
- The housing market has been a source of strength over the past year or more. According to RP Data-Rismark dwelling prices rose again at a solid rate in Sydney (0.8%) and rises were also recorded in Adelaide (0.9%) and Brisbane (0.7%). Prices dropped in Melbourne and Perth. Housing credit growth remains historically subdued and continues to be tilted towards investors. The RBA expressed concern about the composition of housing and mortgage market activity in its recent Financial Stability Review and indicated that it was discussing with APRA measures to reinforce "sound lending practices" with respect to investor finance.
- Building approvals for apartments, especially large projects, have picked up recently but permits for detached houses remain subdued. HIA new home sales recovered some lost ground in August, predominantly through multi-unit dwellings, in line with trends in approvals. Forward indicators for the buildings component of business investment have improved modestly in recent months, and this is predominantly in the non-mining sector. We expect engineering construction to continue to weaken as more major resources projects are commissioned.
- Weaker terms of trade and Q3 mean GDP forecasts revised down modestly: 2014/15 2.8% (was 2.9%) and 2015/16 3.2% (was 3.4%). Unemployment rate still to peak at around 6½%. We still expect no change in cash rate until a tightening cycle begins near the end of 2015.

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