National Australia Bank

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The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Global growth remains moderate and sub-trend with big variations between key economies. China and North America represent around one-third of global GDP but they currently account for around half of global growth. By contrast, Japan and the Euro-zone are the main drags on the global economy, accounting for one-sixth of world output but contributing very little to global growth. Low interest rates, less fiscal retrenchment, lower oil prices and a gradual recovery in investment in India should produce an acceleration in global growth from this year's 3% to 3.4% in 2015. Although the US and UK upturns look solid, the emerging markets economies continue to drive around three-quarters of the increase in global output in 2014 with China and India contributing around half, but that share should trend down.

- Divergence in economic conditions between the big advanced economies has been highlighted in recent central bank decisions on monetary policy. The US Fed is carefully and gradually moving toward less easy monetary policy while the Bank of Japan (BoJ) has eased again. The US Fed has decided to stop increasing its balance sheet through net purchases of Treasury and agency securities and it has outlined its plans for how US monetary policy will be "normalised". This will eventually involve interest rate increases but the Fed still says it should keep rates unchanged for "a considerable time". By contrast, the Bank of Japan has just ratcheted up its already massive purchases of Government bonds, aiming to inject even more liquidity to hopefully achieve its 2% inflation target. This divergence is also seen in Europe with pressure on the ECB to do more to curb deflation while the discussion at the Bank of England is over when rates should be increased.
- Global economic growth appears to be continuing at a moderate pace. Sluggishness in world trade growth is broad-based and the sub-1% growth rate in advanced economy exports shows the limited prospects facing countries hoping to rely on export-led growth to offset weak domestic demand. October business surveys show the divergence between the big advanced economies continuing, with improving conditions in the US and UK and weakness in the Euro-zone, although a few of the surveys are showing an upturn in Japan. A major factor holding down the advanced economies has been weak growth in real household incomes/wages. There are big differences between economies, with signs of an upturn in wage growth in the US, Germany and Japan, but a downward trend in wage growth in the other big European countries.
- Although G7 Advanced economy annualised growth quickened in June, it could well have slowed in September. Early measures of third quarter US and UK GDP growth, while still solid, were weaker. The Japanese economy is still struggling to digest the impact of the April rise in consumer taxes along with disappointing export outcomes. Business sentiment in the Euro-zone trended down through the six months to September, not a favourable sign for output. The October business surveys still show the strongest results in the UK and US across both manufacturing and services. Euro-zone purchasing manager survey readings have been trending down since the middle of the year and the European Commission survey showed a similar pattern until October, when it picked up slightly. The surveys also show a generally soft picture for the Japanese economy, although again some surveys are weaker than others and there is a slow recovery from the weak post-tax rise readings.
- Industrial growth in the emerging market economies is well below its long-term average, but double the pace seen in the advanced economies. Emerging Market Economy export growth is also well below its long-run performance. Growth performance varies considerably among the emerging market economies. Outside of the volatile trade data, most of the Chinese monthly economic indicators (and the quarterly national accounts) show a gradual slowing in growth. Most of the recent Indian data shows a trend upturn after some weak years. Higher imports point to increased domestic demand, while some of the business surveys are finally signalling better conditions. Latin America is showing greatest weakness – Q2 GDP fell in both Brazil and Argentina, minimal growth in regional $US exports and falling industrial output.
- Recent indicators remain consistent with our forecast for continued moderate sub-trend expansion: global growth expected to increase from 3% in 2014 to 3.4% next year. The strength of economic activity is patchy between regions, which is increasingly going to be reflected in monetary policy and currency markets. Historically low interest rates in big advanced economies, a relative slowdown in the pace of fiscal retrenchment and a gradual recovery in private sector willingness to invest (as risk fears recede) will assist the expected upturn. The recent fall in oil prices should also boost global economic activity.

<u>Australia:</u> Business conditions improved sharply in October except in transport and wholesale. Sales and profitability were much better but employment still lags. Forward orders ticked up and capacity utilisation improved. While this may point to a strong start to Q4, there are reasons to be cautious: business confidence is moderate, income remains under pressure and job security is still an issue. Retail trade grew more strongly in September (abstracting from iPhone6) and car sales were better, but personal credit demand still weak. While engineering construction in mining increased and business credit demand may be improving, there are signs that the building construction cycle has begun to turn down. GDP forecasts up slightly: 2014/15 2.9% (was 2.8%) and 2015/16 3.2% (unchanged). Unemployment still to peak at around 6½% and no change in cash rate expected until tightening begins near the end of 2015. Inflation to slow further in near term.

- The ABS now believes it has pinned down the seasonal adjustment issues facing the labour force survey. Having revised the underlying data, it now appears that seasonally adjusted employment fell in both August and September and the unemployment rate rose to 6.2%. Employment rose 0.2% in October but a compensating rise in the participation rate left the unemployment rate unchanged at 6.2%. The new ABS method continues to point to quite tepid labour demand. Some forward indicators, such as ANZ job ads and the NAB employment index, have gained momentum, although the overall outlook for the labour market remains quite soft.
- The most surprising feature of the October NAB Business Survey was the sharp jump in business conditions (one of the largest monthly increases in the history of the survey). The improvement, driven by sales and profits, was relatively broad based – unlike the (short-lived) jump in July. While welcome we remain cautious re the sustainability of the improvement. For example, it does not sit well with further falls in business confidence and only marginal improvement in capacity utilisation. While the falling AUD may have helped many sectors, it is probably also behind the large falls in the wholesale and transport/utilities sectors. The jump in conditions also saw employment improve somewhat – consistent with other labour market partials. In that context the further fall in business confidence was surprising. This is the first time since 2012 that confidence has dropped below conditions, suggesting firms remain uncertain over near-term demand in their industry. Confidence levels vary greatly across industries, but services have consistently been the most optimistic. To complete the mixed messages about the future, forward orders improved significantly but conditions in the 'bellwether' wholesale industry are still quite weak.
- While there are signs of an improvement in retail trade (up a strong 1.2% in September), household goods were positively affected by the release of the iPhone6: excluding electrical & electronic goods, retail trade rose 0.6% in the month. In October retail conditions in the NAB survey (especially sales) lifted strongly to be in positive territory for the first time in more than 4½ years. However, it is too early to be confident that stronger growth in consumer spending is about to become entrenched. The improving climate was supported by higher online retail trade growth and vehicle purchases. RP Data-Rismark dwelling price data indicated solid rises again in Melbourne (1.9%) and Sydney (1.3%) with more subdued rises or falls elsewhere. Investor interest in housing is still strong, but the data do not yet suggest a debt-fuelled housing bubble. However, with the cost of finance low, household gearing has begun rising relative to income and has stabilised relative to asset values.
- Forward indicators for building activity weakened in September and the recent strength now looks to have been something of a local peak. Private house approvals declined for the second consecutive month in September and the bumpy 'other dwelling' sector gave up its gains from the previous month (about half of them from large apartment projects). HIA house sales declined in September, although new multi-unit sales recorded a strong rise. Despite a pickup in private commercial approvals, the value of total non-residential approvals also fell in September. Mining engineering construction is enjoying something of an Indian summer having picked up in Q2, but the pipeline of mining engineering work continued to decline. We expect engineering construction to weaken more as major resources projects are commissioned.
- Jump in Australian business conditions points to strong start to Q4 but growth still constrained by weak terms of trade, soft labour market and signs of a softening building cycle. GDP forecasts up slightly: 2014/15 2.9% (was 2.8%) and 2015/16 3.2% (unchanged). Unemployment to peak at around 6½%. Cash rate unchanged until tightening in late 2015.

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