March 2015

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global</u>: Global growth remains around 3% and, although the business surveys show a lift in sentiment in key advanced economies, there is still no clear evidence that the expected upturn in global growth to 3½% by the end of the year has commenced. Weaker prices for oil and other commodities will benefit spending power in most big advanced economies as well as in China, but that same weakness is weighing on demand across a range of primary exporting nations. World trade remains sluggish, holding down growth in export-oriented areas like East Asia but the lower Euro should help towards its predicted recovery in growth.

- Divergent economic conditions between the big advanced economies are reflected in recent central bank decisions on monetary policy. With growth looking solid, the Fed is still preparing the ground for a gradual rise in US policy rates, although low inflation means that tightening could start later than previously expected. The Bank of Japan's policy remains focussed on promoting inflation and a recovery in output by keeping zero interest rates through boosting the money supply. With Euro-zone CPI inflation turning negative in late 2014, little growth in output and double-digit unemployment, the ECB has stepped up its asset buying policy to purchase government bonds. Policy interest rates are already near zero but the big depreciation in the Euro against the $US, lower bond yields, easier access to finance by business and rising loan demand should combine with the announced lift in asset buying to boost activity. Divergent underlying conditions reflected in the fall in the Yen and Euro as well as the appreciation of the $US, which should rebalance growth toward the weaker economies. Bond yields have also been falling sharply across key advanced economies.
- Global economic growth appears to be continuing at a sub-trend pace and business survey readings are consistent with moderate growth. Business surveys and limited data on output and trade show these trends continuing into the early months of 2015 with a hint of some pick-up in the pace of growth. February global readings from the purchasing manager surveys show service sector activity reaching a 5 month high while manufacturing got to a 6 month high. Some of this brighter tone probably reflects the impact of lower oil prices, a net benefit to incomes and household spending in most advanced economies. The decline in oil prices is part of a broader drift down across a range of commodity markets, which is having an impact on export revenues in key primary producers. Income losses could potentially be bigger across net oil exporting countries, dragging on global growth and forming the counterpart to the income gains seen in big energy/commodity importers like Japan, China India and the Euro-zone. Nevertheless, the net effect of lower oil prices on the global economy is expected to be positive.
- After picking up through most of 2014, the pace of growth in the big 7 advanced economies fell slightly in Q4. The business surveys and partial indicators of activity portray a mixed picture since the end of last year. Business surveys available to March month suggest that conditions are finally recovering in Japan, following a post-tax rise downturn. Following a pick up during much of 2014, US growth slowed in Q4 2014 and recent partial economic data (retail trade, construction, business investment) have been on the weak side. The purchasing manager surveys are also off last year's peaks but both they and the job market point to ongoing growth at an above-trend pace. We have slightly lowered our US growth forecast to reflect the softer nature of recent data. Recent surveys and partial data point to a pick-up in Euro-zone activity.
- The trade and industrial output data shows growth in emerging economies stabilising at a moderate pace through the latter half of last year. The softness in industry and trade is evident across large parts of the emerging market block of economies, with the welcome exceptions of China and India. Latin America has been particularly weak, reflecting the combined impact of falling exporter incomes and weak domestic demand. East Asia, outside Japan and China, has also turned in a disappointing performance with year on year growth in output volumes virtually stalling in late 2014 and US$ export growth turning negative around the turn of the year.
- We have modestly revised US and Emerging Asian growth down to take account of softer than expected recent data and revised Euro-zone growth up to reflect the trade benefits of the weaker Euro. Our forecasts imply a gradual acceleration in the pace of global growth from the 3% yoy recorded in late 2014 to around 3½% yoy by the latter half of the year, mainly reflecting a pick-up in the big advanced economies (US, Japan and Euro-zone) and India. Currency changes shifting global demand toward the Euro-zone and the benefits of lower oil prices to national income in general and households in particular will help lift advanced economy activity.

<u>Australia</u>: We have not changed our near term forecasts – 2014/15 at 2.3% – and have marginally lowered 2015/16 forecasts to 3% (was 3.2%). That largely reflects weaker business investment and a touch higher unemployment rate (6.7%) at end 2015 and hence a touch weaker consumption. On going weak global trade has lowered our expectations of much better non commodity exports. The domestic economy, in early 2015, has not gained momentum. Inflation will continue to slow. We still see another rate cut in coming months – most likely May but the April meeting is live and data dependent. We are not forecasting a second cut to below 2% but the chances of that happening are rising (35-40% chance).

- The RBA's 25bp cut to interest rates in February did not appear to have the desired effect on firms 'animal spirits', with confidence actually deteriorating in the month. The index is now at its lowest level since before the Federal election in 2013 and is well below the long run average. The fall was relatively broad based, suggesting common factors such as political and economic uncertainty, are driving this result. Business conditions were unchanged in February, with each of the components (trading, profit, employment) holding broadly steady – the employment index improved only marginally. This level of conditions is pointing to below trend rates of activity. Orders were up (albeit still soft), as is capacity utilisation, which is helping support reasonable levels of non-mining capex (although recent ABS data raises questions over the longer-term outlook). In contrast, the 'bellwether' wholesale industry weakened even further.
- There is considerable noise in the employment data and comparisons with other partial labour market indicators. Some partials showed renewed improvement, although internet jobs have flattened out recently. NAB's employment series (from the Survey) suggests that for the next 6 months employment growth should be around 170k jobs per annum or around 15k per month – a rate of employment growth insufficient to stabilise the unemployment rate. Other data in the ABS labour force statistics also suggests a soft labour market. The trend in the employment to population ratio continues to track down, while the hours worked per population ratio has fallen to very weak levels. Overall, we expect the unemployment rate to gradually rise to around 6.7% by end 2015, but moderately faster employment growth will see unemployment ease to around 6% by late 2017.
- While consumption was relatively strong in Q4 2015 (up 0.9% in real terms) that appears to have been heavily influence by the very strong retail sales readings in September and October. Subsequently retail sales have struggled. Similarly retail business conditions (from the NAB Survey) in February disappointed, causing retail business confidence to fall significantly. While online retail has recovered somewhat from a very poor November reading, the reality is that online trading remains very subdued – domestic online was particularly soft. Generally consumer sentiment has improved recently but still remains around long run average levels. Personal credit remained flat in January, for annual growth of 1%.
- According to RP Data-Rismark dwelling prices in Australia have risen 8.3% in the year to January – with the strongest markets very much Sydney (up 13.7%) and to a lesser extent Melbourne (up 7.4%). That said, the year on year growth rates have slowed – especially in the unit market. Further evidence of heat coming out of the housing market can be seen in the NAB Quarterly Australian Residential Property Survey – Q4 2014 – where expectations for house prices increases over the next 12 months eased back considerably with fears of falls in Perth. On credit, housing credit growth has moved up a touch with owner occupied around 0.6% (y/y 5.9%) in January and investor a strong 0.8% (10.4% y/y). The latter is running a touch higher than APRA's maximum growth rate.
- As expected dwelling investment increased by 2.6% in Q4 2016. With very high approvals in the dwellings – especially apartments – we expect to see similar or stronger growth in dwelling investment over the next year. Recent attempts to tighten foreign investment rules may slow demand eventually, but the reality is that the existing approvals will be built – and contribute to the reallocation of resources from mining to the non mining sector. With mining work yet to be done falling, the expected declines in mining investment are well underway. Yet, perhaps the most concerning read on the overall investment outlook was the surprise weakening in non mining expectations for 2015/16 – reported in the recent ABS Capex survey. Nevertheless, business credit has strengthened, increasing by 0.8% in January and 5.5% over the year.
- Given our expectation for softer activity in the near term, we still see another rate cut in coming months – most likely May but the April meeting is live and data dependent. We are not forecasting a second cut to below 2% in 2015 but the chances of that happening are rising (35-40% chance). We see rate rises starting again in H2 2016. Unemployment to continue to deteriorate, peaking around 6.7% by end 2015. GDP forecasts unchanged in near term, and recovery pared back: 2014/15 2.3%; 2015/16 3.0% (was 3.2%).

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