more give, less take

Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- The Chinese share market correction and concerns that Greece could exit from the Euro-zone have raised both financial market volatility and the downside risks to (already sub-trend) global growth. Unlike the IMF, we are not expecting much of an acceleration in the pace of global growth through the next few years and recent partials do not provide any evidence of this either. Soft economic outcomes across much of East Asia and Latin America, the trend slowing in China and the lack of growth momentum seen in recent Indian data are weighing on global growth, as these economies have been the main drivers of output increases in recent years. We have not changed our forecast for global growth this year (3.2%), but a softer outlook for Japan & India prompted a slight downward revision for 2016 and 2017.
- We have not changed our activity forecasts – 2014/15 2.4%, 2015/16 2.6% and 3.0% in 2016/17. The big picture is still one where the domestic economy is struggling to offset the impact of sharply lower mining investment. However near term data has continued to strengthen. Lower interest rates and the AUD (which we have lowered marginally), strong housing prices (especially in NSW and Victoria) and a post Budget kick in confidence appears to have driven better business outcomes. Against that consumers remain cautious and business remain reluctant to hire. It also appears they are demanding high rates of return – above 13% – before investing. It is difficult to assess the impact of recent international events such as Greece and more importantly China – especially equity market volatility and further falls in commodity prices. Given its better start point we now expect a lower peak in unemployment of 6¼ - but remaining high for a considerable period. We still see the RBA as having finished cutting – the market priced cut depends on downside surprises to our forecasts. We see the next move in rates as up – but not till late 2016 (and with a lower end point for the Official Cash rate of 3.5%). And it is worth noting that while the international volatility create risks to the downside on the forecasts, local data is pointing to upside risks.

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.4	2.7	2.5
Euro-zone	12	0.9	1.4	1.8	2.1
Japan	4	-0.1	0.9	1.2	1.1
China	16	7.4	7.1	6.9	6.5
Emerging East Asia	8	4.0	3.9	4.1	4.2
New Zealand	0.2	3.3	2.4	2.2	2.1
Global total	100	3.3	3.2	3.3	3.4
Australia	2	2.7	2.5	2.7	3.2
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.2	2.5	2.5	2.6
Domestic demand		1.0	0.8	0.9	1.0
GDP		2.5	2.4	2.6	3.0
Core CPI (*% through-year*)		2.8	2.2	2.7	2.5
Unemployment rate (*% end of year*)		6.0	5.9	6.2	5.9

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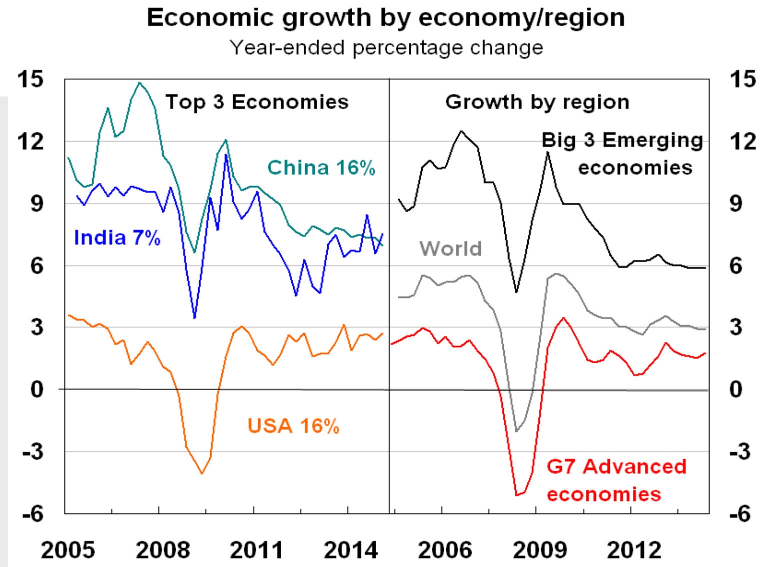
Global and Australian overview

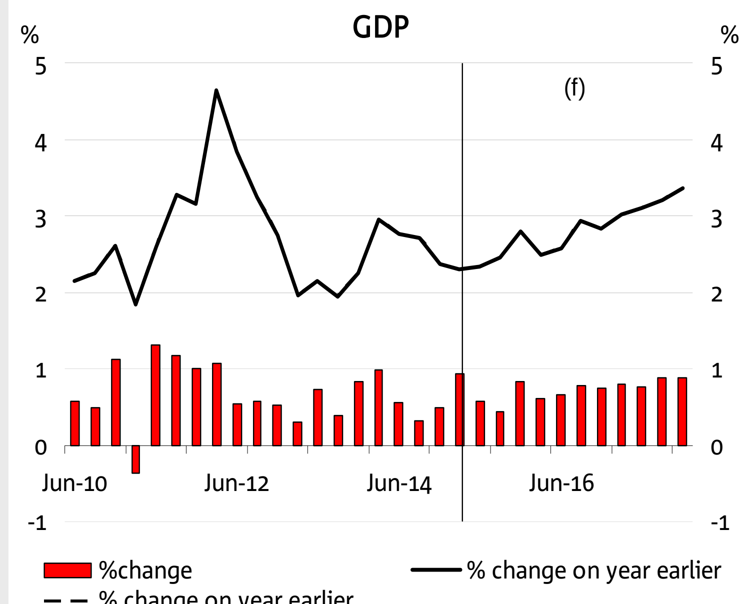
Global overview

- Hopes for a quickening in global growth through the first half of 2015 have not been realised. Quarterly growth in the big 7 advanced economies fell heavily, partly reflecting bad weather and port strikes in the US. However, according to the business surveys, the trend behind this volatile data is one of ongoing modest growth in the advanced economies. The main growth disappointment has been in the emerging market economies where Indian growth does not seem to be accelerating to the degree anticipated while conditions across much of East Asia and Latin America remain soft.
- The bursting of the Chinese equity market bubble and the uncertainty over Greece's membership of the Euro-zone add an unwanted degree of volatility and risk to an already uninspiring global picture of stagnating economic growth. So far, the financial consequences of the latest Greek economic crisis for other Euro-zone debt markets have been muted by the standards of past crises and the Chinese share market decline poses a greater threat to growth.

Australian overview

- We have not changed our forecasts – 2014/15 2.4, 2015/16 2.6, and 3.0% in 2016/17. We have however marginally lowered our expectation of the peak in unemployment to 6.2% (from 6.4%) reflecting a better start point.
- The difference between poor medium term expectations (especially for non mining investment) and better short term outcomes continues to widen. Lower interest rates and the AUD, strong housing prices (especially in NSW and Victoria) and a post Budget kick in confidence appears to have driven better business outcomes (NAB Monthly Survey for June). Against that consumers remain cautious, while business is still reluctant to hire and appears to want very high rates of return – above 13% – before investing. Also it is difficult to access the impact of recent international events such as Greece and more importantly China – on confidence and further falls in commodity prices.
- It is worth noting that while the international volatility create risks to the downside on the forecasts, local data is pointing to upside risks. On inflation, pressure remain low with wages growth if anything slowing further
- In the current environment we see the RBA as finished cutting – albeit they could still cut if our (and their) forecasts are not achieved. We also see the next move in rates as up – but not till late 2016 (and with a lower end point for the cash rate of around 3.5%). We have also marginally lowered our AUD/USD forecasts

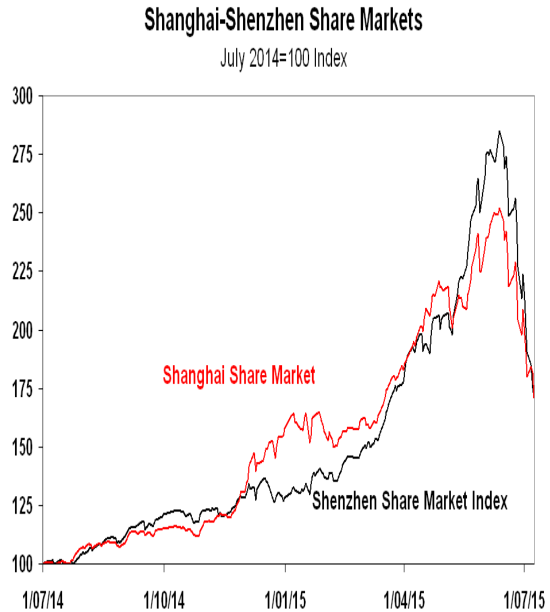


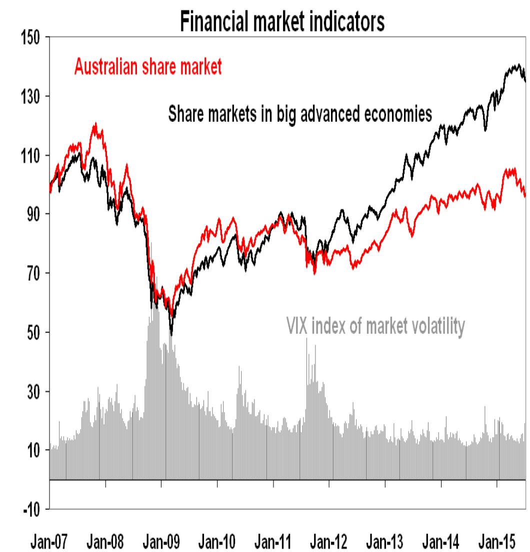


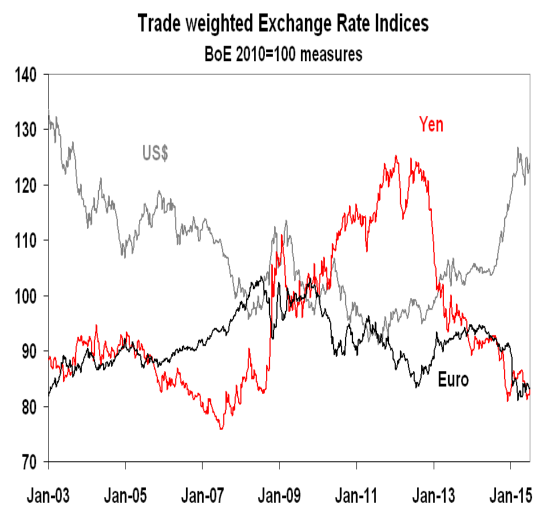
Sources: ABS, NAB estimates

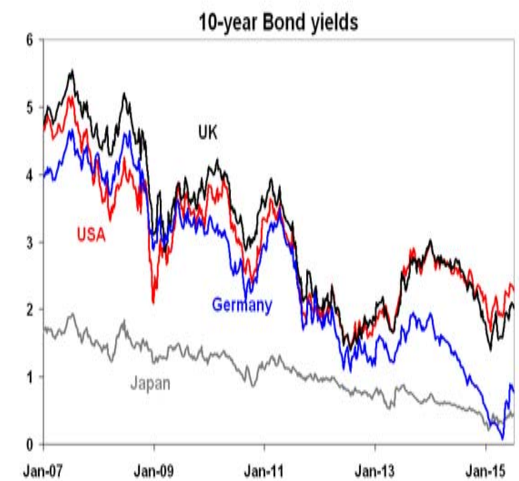
Financial markets

- The big falls in Chinese share markets and the threat that Greece could leave the Euro-zone have led to a modest increase in volatility in global financial markets and a heightened degree of risk aversion. The problems in Greece have had much less impact than earlier episodes and it is the apparent bursting of the Chinese equity market bubble that should cause the most concern.
- Market capitalization at Shanghai and Shenzhen rose from RMB 38 trillion at the start of 2015 to peak at RMB 70 trillion in mid-June, before falling to RMB 49 trillion in early July, a loss equal to $US3½ trillion. Such a loss of wealth, even with short lived paper gains, should have an impact on the economy, partly through margin lending deals going sour as the share market fell.
- The near tripling in Chinese share prices between mid-2014 and mid-2015 was accompanied by a rush of individual investors into the market (82 million individual investors in early May, 91 million by early July), many of whom were probably not sophisticated investors (one survey found most had little education). However, equities accounted for only 15% of surveyed household financial wealth in 2012 (non-financial wealth formed the bulk of household assets so the impact on household balance sheets should not be exaggerated). Net equity only accounts for RMB4 trillion out of the RMB125 trillion in total social financing, business loans total RMB53 trillion – of far more importance to firms' funding.
- Outside China and its effects on global equity markets, previous trends continued in global financial markets – policy rates remain historically low, bond yields have trended up and the US$ trend appreciation has marked time against the euro and yen.



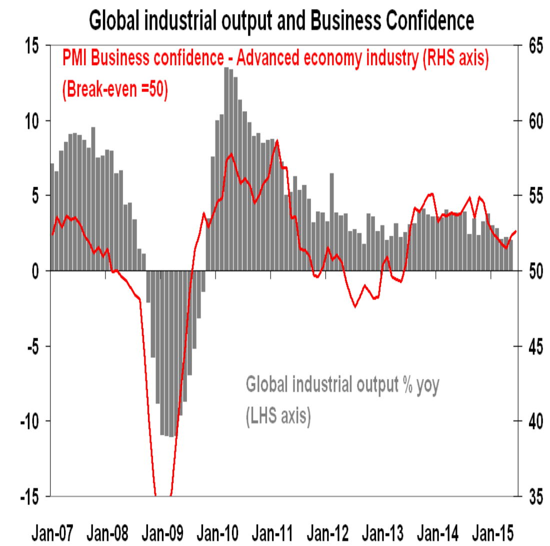


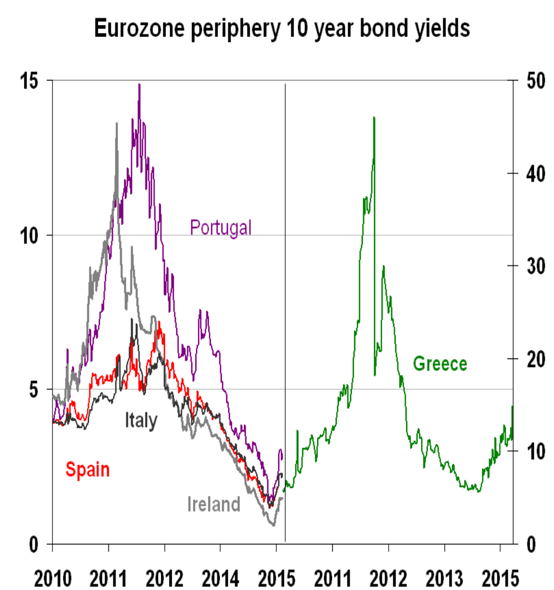


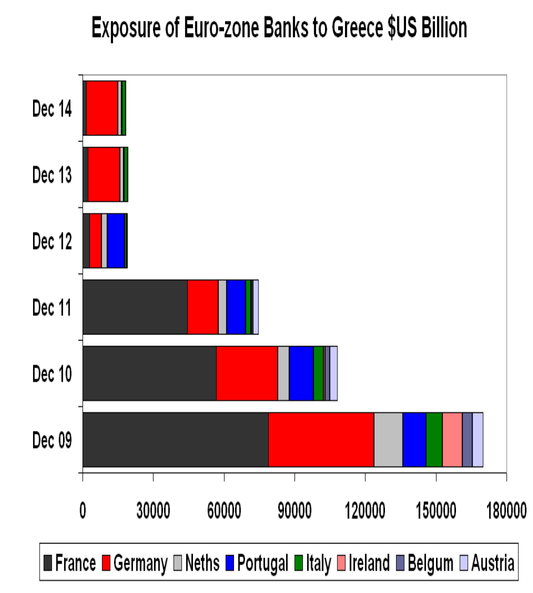


Global Economic Trends

- There is still little evidence in the hard data of an acceleration in global growth. Global industrial output only grew at an annualised rate of around 1¼% in March quarter and the month of April was around the same pace. More recent preliminary May month data shows year on year trend growth in industrial output slowing to around 2%, down from 2¼% yoy in April, 2½% yoy in March and over 3% yoy before that.
- World trade has been even softer with a modest dip in the volume of global exports in the opening months of 2015. The downturn has been largely focused on Asia where exports have been weak in many key emerging market economies. A higher $US would be expected to hit the commodity earnings of key players across the region but their export weakness reflects more than that as volumes look soft as well.
- The Euro-area has been one of the weakest big global economic regions with an anemic recovery from its deep 2007/8 recession. Previous stresses over sovereign debt as well as banking liquidity and solvency diverted attention from measures to boost growth and the latest Greek crisis has continued that pattern.
- Financial fall-out from the risk that Greece could become the first Euro-zone country to leave the currency union has been muted by comparison to previous crises. This partly reflects improved support systems for sovereign debt (ECB bond buying and EFSF lending) that have resulted in much lower upward pressure on Euro-zone periphery bond yields. The pattern of exposure to Greek debt has also changed with Euro-zone agencies now holding most of Greece's government debt and banks winding back their once sizeable exposure to the country.

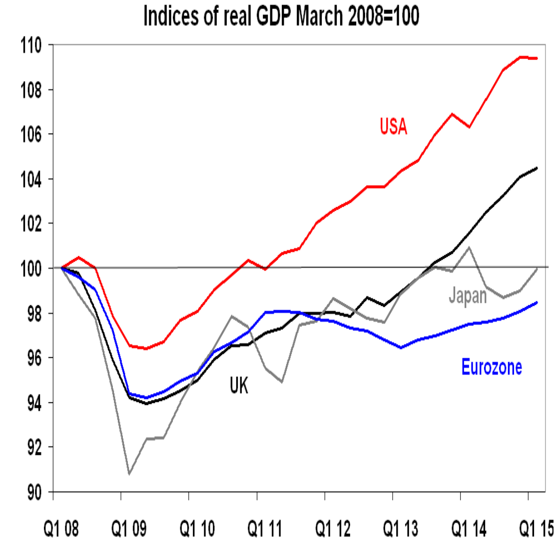


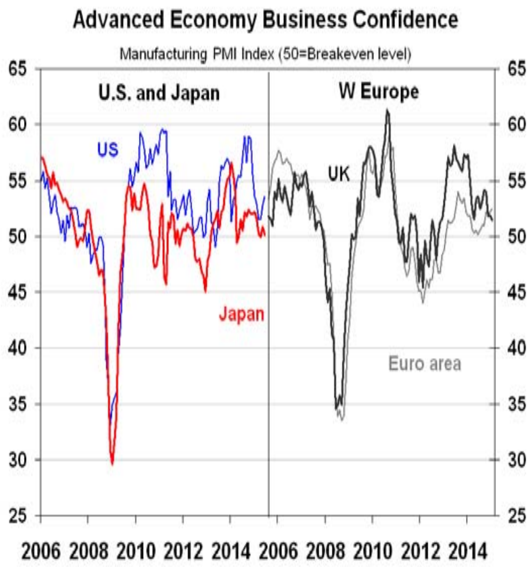


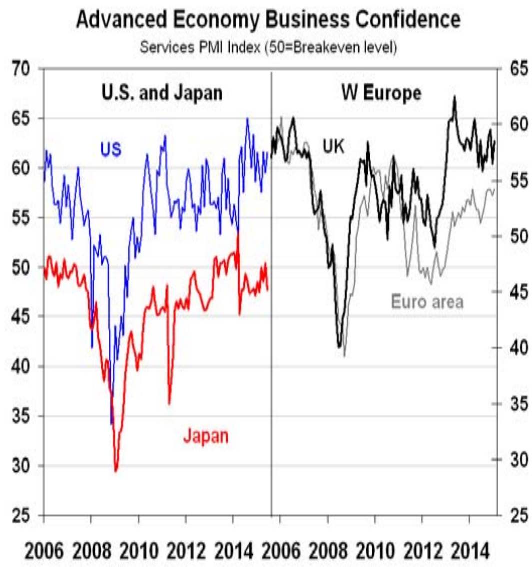


Advanced Economies

- The March quarter saw falling output in the US and Canada, which along with a halving in the UK growth rate, dampened the impact of solid growth in parts of the Euro-area and Japan. The outcome was a halving in output growth across the G7 advanced economies in the opening months of 2015 – with annualised growth slipping from the 2% seen in late 2014 to only 1% in March quarter. As the US and UK have been the standout performers in the G7 upturn, the early 2015 output figures show a shift in the regional composition of global growth away from the US and UK.
- Weakness in the US explains a large part of the loss of momentum in advanced economy growth with US GDP contracting slightly in March after showing growth of 0.5% in late 2014. Part of this setback to the US recovery is only temporary and due to "special factors" and consumer spending is looking solid . The US Federal Reserve has stressed that the US upturn has not been de-railed and it should continue, supporting the case for the Fed to lift policy interest rates, but the impact of the latest volatility in global financial markets is unclear.
- Monthly surveys of purchasing managers give one of the most accurate and up to date measures of the pulse of economic growth. These show growth continuing across the manufacturing and services sectors across W Europe, the US and Japan – but at widely varying rates. Most of these survey readings are consistent with at most moderate rates of economic expansion with the strongest results for services in the US and UK, a setback to Japanese service activity levels and ongoing recovery in the Euro-zone. Manufacturing shows a moderate upturn in Western Europe but softness in Japan.

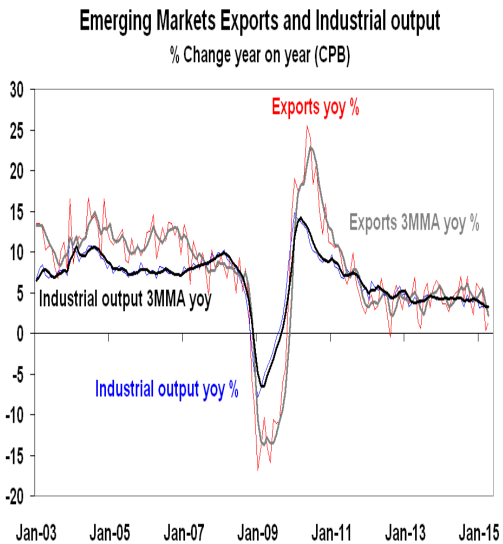


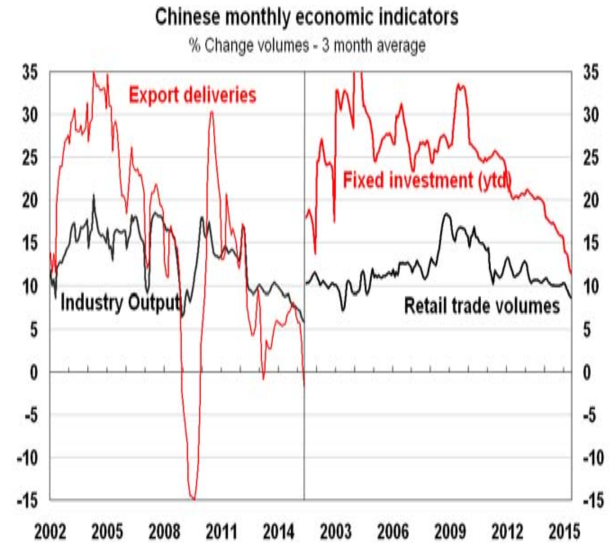


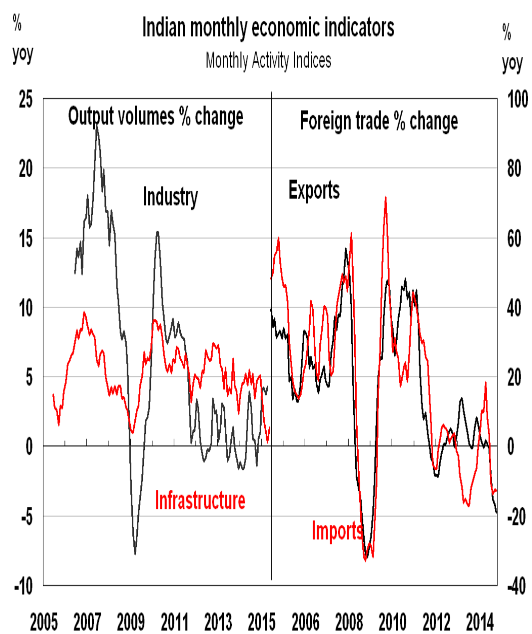


Emerging Market Economies

- The main emerging market economies lost growth momentum in the first half of 2015. Industrial output was trending upwards at an annualised rate of 4% around the turn of the year, by April that growth was under 2%. Export volume outcomes have been weaker with the level of emerging economy trade falling through the opening months of the year, which is reflected in a big slowing in the pace of growth from year earlier levels.
- The trend slowdown in Chinese growth has continued through the first half of 2015 and the bursting of the equity market bubble will dampen growth. Quarterly growth has slipped from around 2% in mid-2014 to 1.3% in March 2015 and a range of partial indicators show signs of softening. Industrial output growth is down to around 6% yoy, expansion in retail trade and fixed investment remains solid but is slowing and foreign trade shows evidence of weakness with falls in both export and import volumes.
- India is the other strongly growing big emerging market economy and here too the recent monthly data shows little evidence of an upturn. Foreign trade is weak and neither industrial nor infrastructure production shows evidence that a sustained upturn has commenced and we have lowered our growth forecasts slightly.
- Activity across the other emerging market economies of East Asia is not picking up either. $US appreciation translates into weaker returns for these regions' commodity exports but the softness in both industrial output and export volumes shows that there is more going on than simply US$ strength to dampen activity.



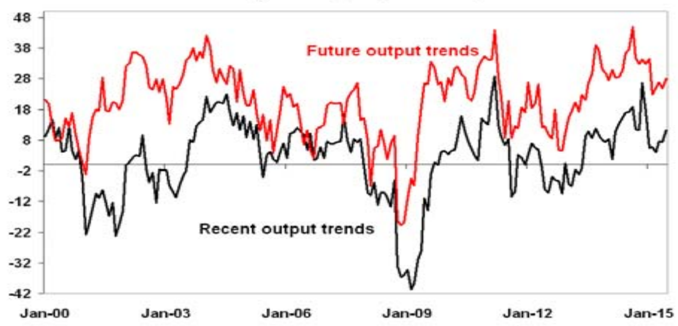




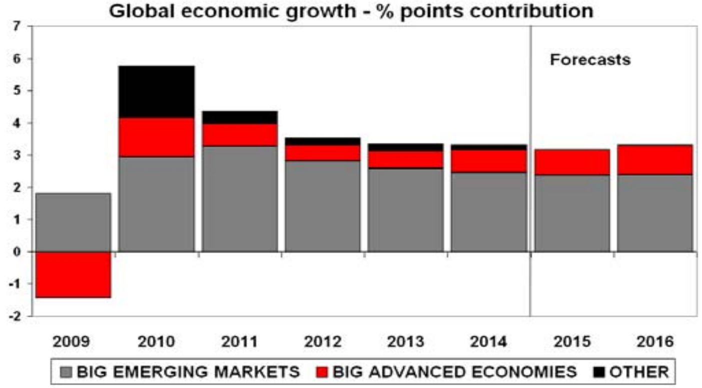
Global forecasts

- Overall our global forecasts have been cut by 10bps in 2016 and 2017 with minor cuts in Japan and India outweighing increases elsewhere that mainly reflect revised data for early 2015. Unlike the IMF – who predict that global growth will rise to 3.8% by 2016 – we see global growth consolidating at around 3¼% through the period 2014 to 2016.
- Neither the business surveys nor recent monthly partial data on trade and output point to an imminent acceleration in growth and IMF expectations for such a ramping up in the pace of expansion through the last few years have been repeatedly disappointed. While the upturn may finally come, we prefer to see it as an upside risk to our forecasts rather than build it into the base case.
- China and India combined are driving around half of the total expansion in global output. The emerging economies as a group contribute almost three quarters of the total output increase, marking a continuation of the falling share of the big advanced economies in the world economy. Growth in these economies is commodity intensive and their failure to gain the expected momentum has weighed on commodity demand.

Business surveys in US, UK, Germany and France



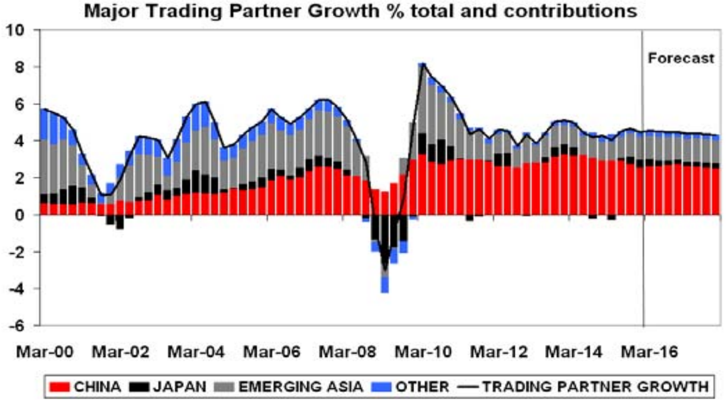
Global economic growth - % points contribution



Global growth forecasts % change year on year

	2011	2012	2013	2014	NAB Forecasts 2015	2016	2017
US	1.6	2.3	2.2	2.4	2.4	2.7	2.5
Euro-zone	1.7	-0.7	-0.4	0.9	1.4	1.8	2.1
Japan	-0.4	1.7	1.6	-0.1	0.9	1.2	1.1
UK	1.6	0.7	1.7	2.8	2.2	2.4	2.3
Canada	3.0	1.9	2.0	2.4	1.5	2.1	2.0
China	9.3	7.8	7.7	7.4	7.1	6.9	6.5
India	7.7	6.8	6.4	7.1	7.6	7.6	7.8
Latin America	4.9	2.5	2.5	0.9	0.6	1.1	1.4
Emerging East Asia	4.4	4.6	4.2	4.0	3.9	4.1	4.2
New Zealand	1.8	2.4	2.2	3.3	2.4	2.2	2.1
World	*4.4*	*3.5*	*3.3*	*3.3*	*3.2*	*3.3*	*3.4*
memo							
Advanced Economies	1.7	1.2	1.4	1.8	2.0	2.2	2.2
Emerging Economies	7.0	5.6	5.5	5.1	4.9	5.0	5.0
Major trading partners	4.6	4.3	4.6	4.5	4.4	4.5	4.4

Major Trading Partner Growth % total and contributions



Australian outlook

- The Australian economy continues to grapple with the impact of the passing of the investment phase of the mining boom – and a relatively flat domestic demand. But the contrast between relatively weak medium term non mining intentions and a kick up in near term performance indicators continues to widen.
- The strength of the near term data is most clearly evident in the June Monthly Business Survey results. Business confidence has now risen to its highest level since the change of Government in late 2013 and, more importantly, business conditions continues its trend improvement (and at +11 is significantly above the long run average levels (of +4.5). Equally, capacity utilisation has risen to its highest level since early 2012 with both capex and new orders now above long run averages.
- Of course there are still large question marks about the outlook – notably the kick to business conditions is very much driven by trading and profits. Business remains reluctant to hire and appears to be demanding very high rates of return before investing – above 13% according to new data from our Survey. Consumers also still remain very cautious
- Recent international uncertainties – both in Greece and more importantly in China (via equity market wobbles and falling commodity prices) could also undermine confidence and the improved dynamics. We have marginally lowered our AUD/USD forecasts
- The pattern of recovery is still very much driven by NSW and Victoria – with the mining states still lagging. House prices continue to accelerate in the former and deteriorate in the West.
- Overall we have not changed our forecasts– 2014/15 2.4%, 2015/16 2.6and 3.0% in 2016/17. We have however lowered our unemployment peak to 6¼% (from 6.4%). That said we still see unemployment remaining high (above 6%) till well into 2016.
- Based on our forecasts for activity, the labour market and inflation, we see the RBA as finished cutting – for a cut activity levels would need to considerably undershoot. And while international volatility points to downside risks, the local data is pointing to upside risks to the forecasts. We still see the next move in rates as up – but not till late 2016.

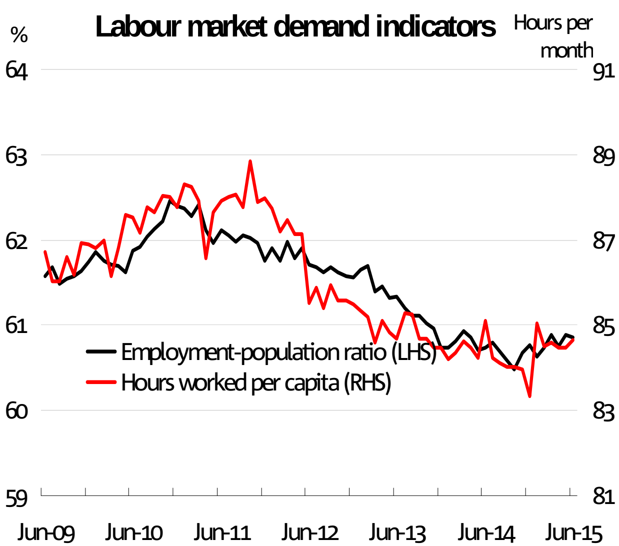
Australian economic and financial forecasts (a)

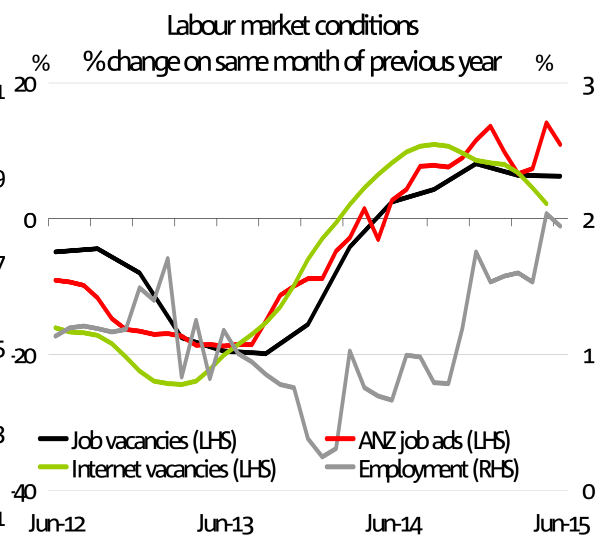
	Fiscal Year			Calendar Year		
	2014-15 F	2015-16 F	2016-17 F	2015-F	2016-F	2017-F
Private Consumption	2.5	2.5	2.6	2.4	2.6	2.5
Dwelling Investment	8.7	10.8	3.6	11.7	6.5	2.0
Underlying Business Fixed Investment	-7.5	-11.5	-9.5	-10.3	-10.1	-9.0
Underlying Public Final Demand	-0.3	0.8	1.4	0.0	1.1	1.6
Domestic Demand	**0.8**	**0.9**	**1.0**	**0.7**	**1.0**	**1.0**
Stocks (b)	0.2	-0.1	0.1	0.0	0.0	0.1
GNE	**0.9**	**0.8**	**1.1**	**0.7**	**1.0**	**1.1**
Exports	8.7	9.7	9.3	10.6	8.6	9.8
Imports	0.0	1.9	1.2	2.3	1.2	1.1
GDP	**2.4**	**2.6**	**3.0**	**2.5**	**2.7**	**3.2**
– Non-Farm GDP	2.5	2.6	3.0	2.5	2.7	3.2
– Farm GDP	-2.3	2.9	2.0	2.0	2.0	2.0
Nominal GDP	1.5	3.2	4.5	1.6	4.5	4.4
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	48	43	27	50	34	20
(-%) of GDP	3.0	2.6	1.6	3.1	2.0	1.1
Employment	1.4	1.9	2.2	1.9	2.0	2.3
Terms of Trade	-10.9	-6.0	-3.3	-10.7	-2.1	-4.4
Average Earnings (Nat. Accts. Basis)	1.2	1.6	2.8	0.6	2.6	2.8
End of Period						
Total CPI	1.4	3.2	2.7	2.5	3.0	2.3
Core CPI	2.2	2.7	2.5	2.4	2.7	2.4
Unemployment Rate	5.9	6.2	5.9	6.2	6.0	5.7
RBA Cash Rate	2.00	2.00	3.00	2.00	2.50	3.50
10 Year Govt. Bonds	3.01	3.25	3.50	3.20	3.50	3.50
$A/US cents :	0.78	0.71	0.75	0.72	0.73	0.76
$A - Trade Weighted Index	65.0	61.2	63.3	61.5	62.4	63.3

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through
(b) Contribution to GDP growth

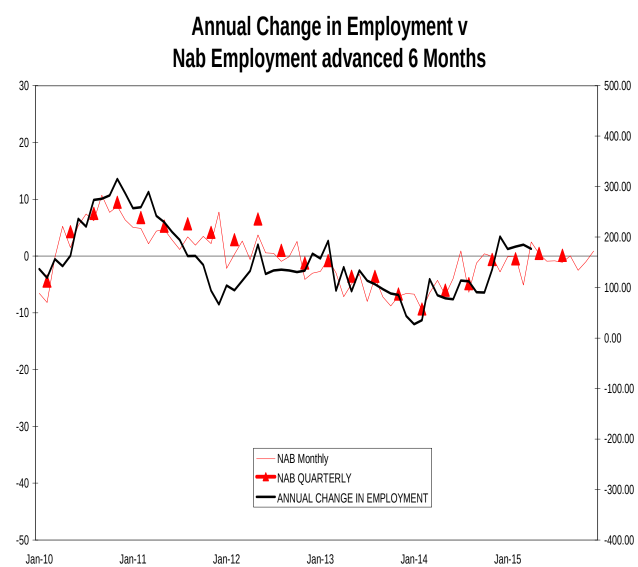
Australian labour market

- Looking through the monthly noise in the labour market indicators, it appears that moderate growth in employment is continuing – with the June employment surprisingly robust given the unlikely excessive growth of May. Unemployment however marginally edged higher.
- Looking to core measures such as the employment to population ratio and hours worked per capita are no longer falling and that the gap to some of the employment partials – such as job adds – has reduced. See charts below left hand and middle panels.
- Looking at the employment series in the NAB survey – which provides a strong 6 month lead on annual employment growth – the current reading, as shown in the right panel below, would be consistent with annual growth in employment of around 170k per annum (in the year to December 2015) or around 15k jobs per month over the next 6 months. That is broadly not quite enough jobs to stabilise unemployment at current levels.
- Our growth and domestic demand forecasts (like the NAB Survey results) suggest on going growth of employment of around 15k per month for the rest of 2015. That would see the unemployment rate edge up marginally to around 6.2% by years end. Thereafter employment growth edges higher and the unemployment rate starts to move down but at a very moderate rate – unemployment remains above 6% till early 2017 – and is still around 5¾% by end 2017.
- Obviously employment changes by sector are continuing to reflect activity trends. It is interesting to see that over the last 12 months the accelerating falls in direct mining employment are higher than the jobs added in the construction industry – a fall of 33k jobs in the year to June in mining vis a vis a rise of 17k jobs in construction.



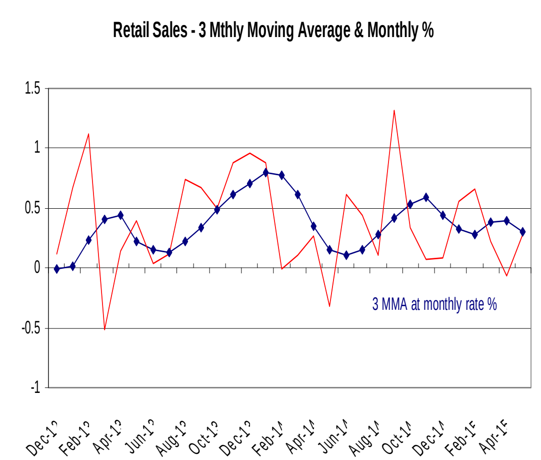


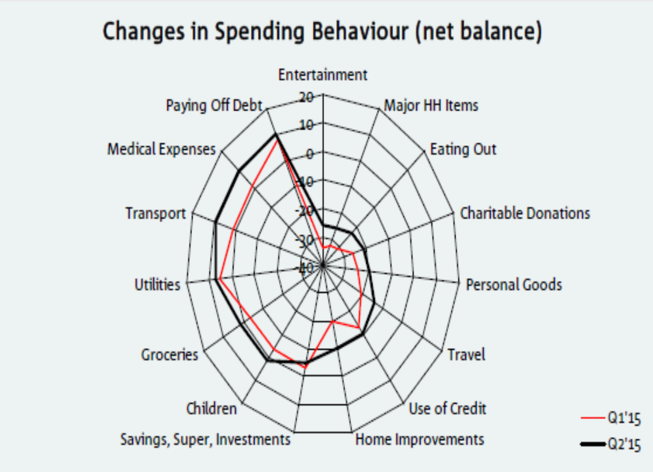
Sources: ABS, Datastream, Department of Employment

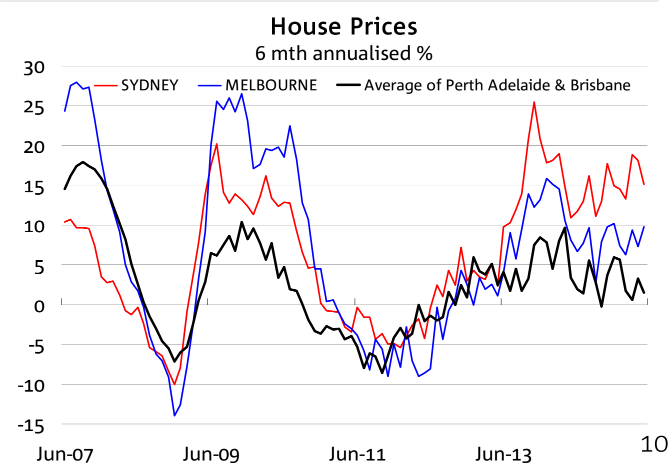


Australian consumer demand and housing market

- The Australian consumer continues to be very cautious – as witnessed by the continued high savings ratio and subdued real consumption. The latest NAB Consumer Anxiety Report for the June Quarter suggest this trend has continued. As shown by the cart below – middle panel – consumers are still spending more on necessaries (left side of the circumflex) rather than discretionary items. As always retail sales are volatile. The chart below – left hand panel – suggests that while retail sales improved in May it was not sufficient to raise the underlying trend. While the May retail sales were a touch disappointing in lieu of the Budget, a fairer reading of possible Budget effects on retailing will need to await the June reading. But here the June Monthly Survey does not point to a strong underlying improvement – with trading conditions largely unchanged. The May NAB On line Retail Index was also disappointing – with a broadly flat result slowing the annual growth rate to 9%.
- According to RP Data-Rismark house prices in Australia have risen to 10.4% in the year to June (9.6% previously). But there are large and growing variations across Australia. Thus Sydney was up 17.8% in the year to June, Melbourne 11.2%, Brisbane 3.7%, Adelaide 4.7%, and Hobart 0.8% and Perth a fall of -0.6%. All these markets – with the exception of Perth – rose relative to the year to June. The rate of rises in Sydney and to a lesser extent Melbourne are starting to accelerate – as witnessed by the annualised 6 monthly growth rates shown in the chart below – right hand panel. The Sydney market in particular is facing severe undersupply issues as well as low interest rates – with similar issues evident in Melbourne. These markets have been driven by investor activity which is difficult to restrain in the face of low interest rates and high tax rates. With this in mind APRA is attempting to limit the growth in investor credit supply (to less than 10%). Our expectations are that these measures may help at the margin but the primary reason to expect slower house price rises is via higher unemployment. Overall we see Australian house price increases to be around 6.1% in 2015 and 3.0% in 2016. There will however continue to be radical differences across states – with Sydney (increases of 10 and 4%); Melbourne (6½ and 3%); Brisbane (4 and 5%) still strong but further falls in Perth.
- On credit, housing credit growth continues to run at 0.5% per month or 7.2% in the year to May. However investor credit is much stronger at 0.8% per month or 10.4% annually – still above APRA's maximum growth rate. Business credit also bounced back – up 0.4% in May or 5.2% over the year. Personal credit fell a touch again – up just 0.8% in the year. Elsewhere equity markets were pounded by Greece and Chinese developments in June – the ASX 200 down 5.5% – with banks down 2.2%, industrial -4.8% and resources down 9.0% (-21% from mid 2014 highs).

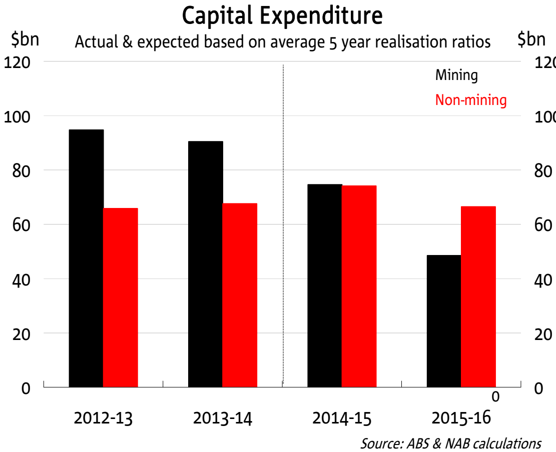




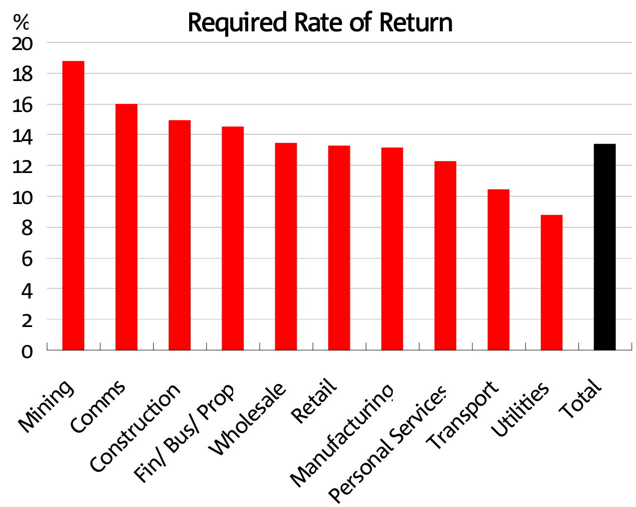


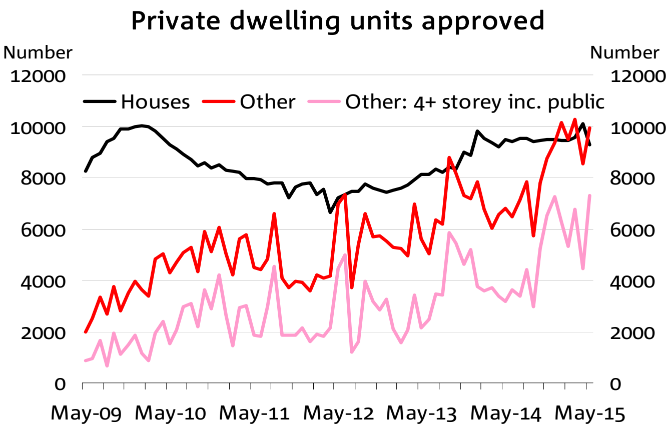
Australian investment

- While improved in the June NAB Business survey, the reality is that mining confidence and business conditions are still trending down at -12 and -18 points respectively – with trend capex levels in June at -14 (compared to the Australian average of +7points). While now somewhat out of date the latest Capital Expenditure Survey points to further significant falls in mining investment – see chart below left hand panel. Recent further falls in commodity prices can only be expected to worsen the falls in mining investment. As indeed are the now very high hurdle rates required to start new mining projects (around 18%).
- This puts more weight on the importance of non mining investment helping to fill in the mining investment hole. In our full March Quarterly Business Survey the responses were more encouraging than that implied by the ABS (non mining) Capital Expenditure Survey shown below. As noted previously the near term expectations and actual coming from the June Monthly survey also support that hypothesis (both capex and capacity utilisation)
- However it is also interesting to note that the non mining sector still has very high nominal (and hence real) expectations on what rate of return they require to invest in a new investment. As a new Question in the Survey reveals on average industries are looking for returns above 13%. See chart below – middle panel – including required rates of return by industry.
- One sector that is clearly helping fill in the gap is residential construction. That however is not being driven by house construction – rather its apartments and very much apartment towers (i.e. above 4 story) – see chart below – right hand panel. A significant driver of that demand has come from foreign investors. Indeed property developers estimate around 15% of new sales are to foreigners with higher concentrations in both Melbourne and Sydney (around 20%). Beyond that, anecdotal reports point to numbers nearer 60% in the CBD regions of these cities. While recent attempts to tighten foreign investment rules may slow demand eventually, the reality is that the existing approvals will be built – and contribute to the reallocation of resources from mining to the non mining sector
- Overall however we continue to expect business investment falling by around 10% per annum in the forecast period only partially offset by higher investment in dwellings – especially over the next 12-18 months.



Source: ABS & NAB calculations

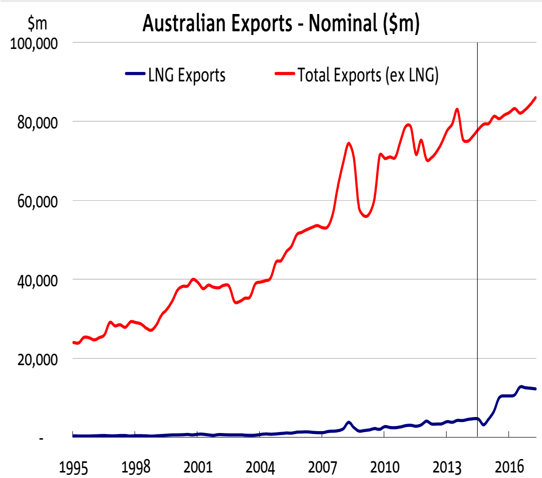


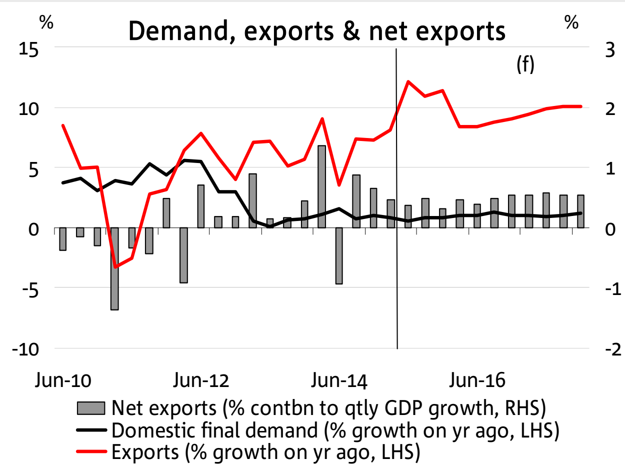


Source: ABS

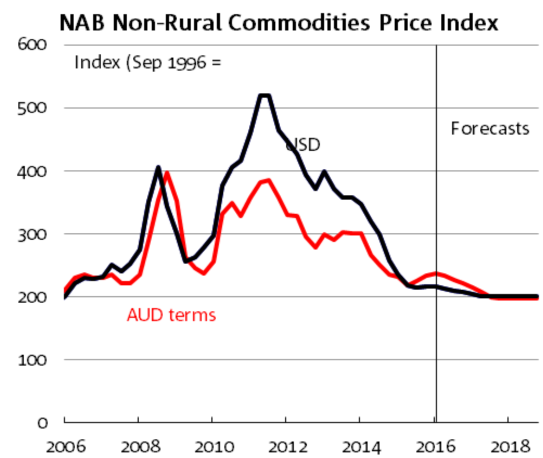
Australian commodities, net exports and terms of trade

- We continue to expect the external sector to perform the bulk of the heavy-lifting in Australia's growth this year and next, with net exports forecast to contribute 1.6 percentage points to GDP growth through 2015, 1.9% through 2016 and 2.2% during 2017. Indeed in the out year we have stepped up the contribution from exports as more capacity comes on stream. We now estimate that LNG exports will add around $12-13bn to Australian exports per quarter by end 2017. See chart below – left hand panel.
- Meanwhile domestic demand is only expected to grow by 0.8% in 2015, 1.0% during 2016 and 1.2% during 2017 – which, in each year, is below population growth.
- Reflecting our expectations of a weaker exchange rate against the backdrop of falling global commodity prices, the non-rural commodity index denominated in USD, after falling 28% in 2014 is expected to fall by around 16% during 2015 and a further 4% fall during 2016. The AUD is now expected to soften to around US72c by the end of 2015, thereby broadly offsetting the fall in AUD terms. Implicit in these forecasts are iron ore prices remaining comparatively weak, trending down from around US$60 a tonne in late 2015 to US$54 a tonne at the end of 2016 (with some downside risk). Oil prices are expected to remain around the mid to high $USD 60s a barrel by late 2015 – and around the mid $USD 70s by end 2016. We note considerable uncertainty in commodity markets at present, presenting a downside risk to our overall forecasts.
- The NAB Rural Commodities Index is expected to be relatively flat in USD terms during 2015, however a falling AUD combined with higher prices for beef, wool and a number of other commodities is forecast to provide support to local prices, with the index expected to be 7.8% higher in AUD terms in 2015 compared to the previous year. In 2016, we also expect to see a further increase in AUD prices (up 5.9%) but somewhat lower USD prices (down 1.6%).
- As mining investment slows and exports accelerate there is likely to be a significant improvement in Australia's trade account. Allowing for income flows we expect the current account deficit for 2014/15 to be 3.0% of GDP (or around $48bn), to around 2.6% of GDP (or around $43bn) in 2015/16 and to 1.6% of GDP in 2016/17 (or around $28bn).





Sources: ABS, NAB forecasts



Sources: ABARES, ABS, Bloomberg, Thomson Datastream, NAB

Australian financial markets

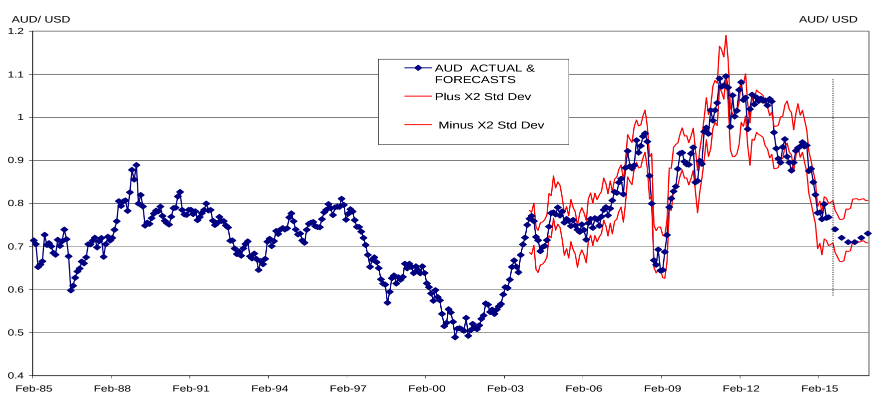
Exchange rate

- In light of recent uncertainty in Europe and potential headwinds in China we have marginally lowered our AUD/USD forecasts. We now expect the AUD to be around 72c (previously 74c) by end 2015, before reaching a low of 71c in H1 2016 (previously 73c) and ending 2016 at around 75c (previously 78c). By late 2017 we see some modest recovery to around 78c – as Australian rate rises gain more traction. As can be seen from the chart (below left) these forecasts are broadly consistent with our fundamental model.

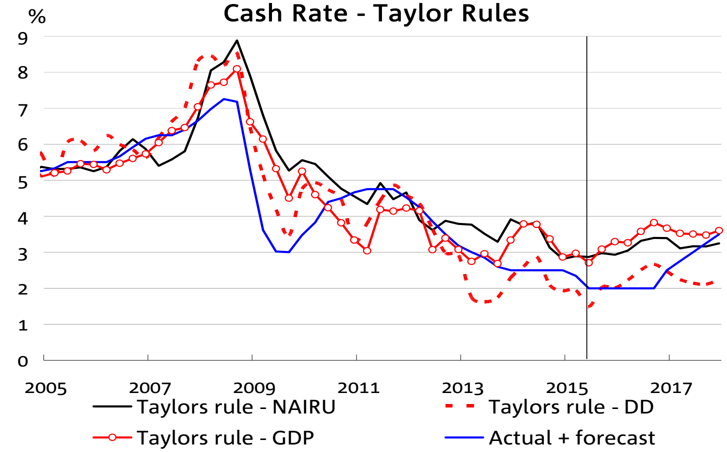
Interest rates

- We have not changed our interest rate forecasts. In light of recent improved conditions the RBA opted to “water the green shoots” by cutting in May. They are now very much in the phase of waiting to see the results of their previous actions and the impact of the Federal Budget – as confirmed by last weeks RBA decision. As noted previously, the June Monthly Business Survey has reinforced the tentative signs of improving business confidence and conditions, while above average levels of forward orders and capacity utilisation are encouraging. Also, there is little sign of a slowdown in Sydney and Melbourne house prices – with some risks that APRA’s restriction may prove less potent than hoped.
- However it is still early days and new headwinds to confidence and outcomes could still emerge from Europe and especially China..
- In the near term the hurdle to another cut is very high. Based on our forecasts for activity, the labour market and inflation, we see the RBA as having finished its cutting phase – albeit they could still cut if our (and their) forecasts are not achieved. While a lot of recent attention has focussed on downside risks from China (and to a lesser extent Greece) the reality is that the local data points to upside risks to the forecasts. We still see the next move in rates as up – but not till late 2016 (and with a lower equilibrium rate of around 3.5%)
- Interestingly the Taylors rule analysis (in the chart below right) is not really looking for a sub 2% cash rate – following the domestic demand and NAIRU rules. Those rules also see rates rising from mid 2016 – that is Taylors rules point to some risk that the RBA may move up earlier than we currently forecast – i.e. late 2016. Our cash rate forecast of a peak by end 2017 of 3.5% is towards the top of the various rules (but that clearly is a long time away).

AUD / USD Actual and Forecasts v Model



Cash Rate - Taylor Rules



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