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The Bigger Picture – A Global & Australian Economic Perspective

National Australia Bank

***Global**: Our forecasts for global growth to stay around the 3¼% yoy mark remain basically unchanged; a sub-trend outcome that falls well short of the IMF's rosier predictions. The hard data provides no evidence that overall global growth has picked up and our leading indicators suggest further stagnation through to September. The bursting of the share market bubble will probably only worsen China's trend slowdown.*

- The main issues of market focus are the likely timing of US/UK interest rate increases, the recent devaluation of the CNY (intended to align the currency more with market expectations and support exports), and the implications of measures Chinese authorities have used to prop up the share market. Apart from that, bond yields have reversed some of their recent recovery from exceptionally low levels. Facing an improving labour market, we think the Fed will start lifting rates in September, although they have signalled that the process will be gradual. Given recent USD strength, it is not yet clear whether the devaluation of the CNY will have any consequences for the timing of Fed rate hikes. The decline in Chinese share prices from the mid-June bubble peak has wiped out a significant amount of market capitalisation. However, as investors only held recent paper gains for a short time the consequences on spending behaviour may prove to be relatively limited. If investors have borrowed heavily on margin to then face margin calls, there is potential for broader problems.
- The disappointing trends in global industrial output and trade have continued. Industrial growth was disappointing in March quarter 2015 and the June quarter is shaping up to be even weaker. World exports are faring even worse with volumes trending down, mainly because of poor Asian data. The strong $US has depressed trade flows but there is also an underlying weakness. There is, however, a more fundamental problem at work with export volumes falling below year-earlier levels and faring worse than global trade. Commodity prices have fallen heavily, lowering export earnings and national income across a range of primary exporting countries. Lower commodity prices do boost incomes and spending power in importing economies but the immediate impact on global activity could be negative.
- After a disappointing start to the year, economic growth in key advanced economies picked up in the June quarter. Business survey results look better in the Euro-zone, despite the Greek crisis, with the upturn broadening out to include services activity. Monthly Japanese business surveys also look slightly better, but the quarterly GDP figures are volatile and kicked up in March, posing the risk of a slowdown in June. Canada is the weakest G7 economy with GDP falling through the first 5 months of the year as investment activity falls. The acceleration in US and UK growth in June continues the trend recovery trajectories seen through the last few years in their economies. Timely monthly business surveys generally point to ongoing moderate growth. This growth is generally broad-based with upturns in both the manufacturing and services sectors with the US and UK service sectors being the stand-out performers for growth, whereas Japan has been the laggard when it comes to growth in all areas.
- Given that the emerging market economies have been the main drivers of global output growth in recent years, the slowdown in China along with very weak outcomes in Brazil and disappointing data in India all present a major headwind to the world economy. The monthly trade volume and industrial output data that allows us to track how the emerging economies are faring does not look positive, signalling that there is little sign of an imminent upturn in their growth momentum. The monthly data for China and India continues to show a slowing trend in the pace of growth. Recent trade figures have been particularly soft but there is also evidence of a softening in expansion across key sectors of activity like fixed investment spending in China and infrastructure output in India. The People's Bank of China surprised markets with a large devaluation of the renminbi in mid-August – signalling a greater role for markets in setting the exchange rate in the future. This move may also provide support for struggling exporters. The picture is even worse when we turn to the other emerging market economies in East Asia and Latin America. Industrial output and exports are falling in both regions as sluggish global trade and weaker commodity markets take their toll.
- Overall our global forecasts have been left broadly unchanged in 2016 (3.3%) and 2017 (3.4%), although this sub-trend outcome falls well short of the IMF's rosier predictions. The hard data provides no evidence that overall global growth has picked up and our leading indicators suggest further stagnation through to September.

<u>Australia</u>*: The economic outlook remains mixed and patchy. Mining investment is declining sharply, public spending is limited and national income growth is weak amidst declining commodity prices. Meanwhile, monetary policy is highly stimulatory and the AUD is acting as a shock absorber, with tentative evidence of recovery in non-mining activity. Our GDP forecasts are marginally stronger than last month – 2.4% in 2014/15, 2.8% in 2015/16 and 3.2% in 2016/17 – with domestic demand weak and net exports making a large contribution. The unemployment rate is forecast to stay around 6¼% before easing slightly into 2016/17. Central forecast is for the RBA to hold rates steady, with the next move likely to be up, but not till late 2016.

- Recent exuberant readings on business confidence were pared back in July. While confidence eased in most industries, much of the change stemmed from mining and construction firms (which includes a large share on non-residential and engineering firms), suggesting an escalation in Chinese growth concerns could be putting firms on alert. Confidence fell back below the long-run average but remains positive and the trend has held up around average levels. Business conditions also dropped back. Looking through the volatility in conditions and confidence, however, suggests a turnaround in the non-mining economy. Yet, leading indicators from the Survey – such as forward orders and capacity utilisation – generally eased.
- The labour market appears to be performing more strongly than suggested by traditional relationships with economic activity at present. The average pace of employment growth has strengthened, which has been enough to stabilise the unemployment rate between 6 and 6.3% over the past year. The July reading of 6.3% likely reflects some statistical noise (as it was accompanied by an unusually sharp increase in the participation rate) and we expect some retracement. Readings from various forward-looking measures of the labour market are mixed, but in general suggest employment growth should be sufficient to stabilise the unemployment rate in coming months. Capacity utilisation, which has historically led the unemployment rate, continues to improve and the employment series in the NAB survey (while soft) is suggesting job creation of 15k per month - enough to keep pace with now slower population growth.
- Consumers remain cautious, but spending has picked up moderately with growth in retail sales volumes accelerating a little in Q2. Retail sales for the month of June were particularly strong (both traditional and online), which could partly reflect spill-over from small business spending encouraged by Budget measures targeted at micro-businesses. Rising dwelling investment in the Eastern states could be another factor behind strong household goods sales. Nevertheless, consumers are nervous, with unemployment expectations high. Against a backdrop of subdued household income growth, we expect a modest pick up in consumer spending growth through to 2017, underpinned by a gradual decline in the household savings rate.
- Dwelling prices in Australia have risen to 11.1% in the year to July according to RP Data-Rismark. Strength remains concentrated in Sydney (18.4% y/y) and Melbourne (11.5%), but more moderate in the other states and negative in Perth (-0.6%) and Darwin (-5.3%). Undersupply of housing is particularly prevalent in Sydney, and to a lesser degree Melbourne. These markets are also being supported by foreign demand, as well as investor demand, which should slow somewhat as APRA attempts to limit growth in investor housing credit to 10% y/y (currently at 10.7%). Overall we see Australian house price increases to be around 6.1% in 2015 and slowing to 3.0% in 2016, a rate more consistent with household income growth.
- The outlook for mining investment remains starkly negative, with recent falls in commodity prices further questioning the viability of marginal projects. Dwelling investment is helping to plug the gap, although it's potential to do so is limited by its small share of GDP (5%). Higher density developments (namely in Sydney and Melbourne) are contributing significantly to the construction pipeline, and the long lag times for these projects means high levels of approvals should drive further growth in construction until late 2016. In other sectors, trend improvement in business conditions, confidence and capacity utilisation (despite the payback in July), suggest an improving outlook for business investment. However, non-residential building approvals remain weak and firms are reporting very high required 'hurdle rates of return' (13%) before investing. Indicators of medium-term investment expectations are at best mixed, with the ABS capex survey suggests an outright decline in non-mining capex in 2015/16, while the NAB Business Survey measure of capex intentions suggest a slightly less pessimistic outlook.
- Our GDP forecasts are marginally stronger than last month – 2.4% in 2014/15, 2.8% in 2015/16 and 3.2% in 2016/17. Despite recent volatility in the labour market figures, our peak unemployment rate is unchanged at 6¼%, although spare capacity in the labour market is expected to remain for an extended period. Our central case is for the RBA to sit on its hands until late 2016 when a gradual tightening cycle begins.

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