Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- **Global growth remains sluggish and below trend and we have slightly lowered our forecasts to take account of weaker than expected outcomes in India, Canada and Brazil. The pace of growth in the big advanced economies has picked up, mainly reflecting a US recovery from weak first quarter growth. In contrast, Japan and the Euro-zone are not growing strongly and Canada is in recession. Emerging market economies drive most global growth and they are slowing - with falling world trade volumes and softer commodity prices eroding incomes, spending and output across much of East Asia, Latin America and S Africa. The bursting of the Chinese share market bubble and the authorities' confusing response adds further unwelcome volatility and uncertainty to an already uninspiring outlook and we expect growth to remain soft and below trend through the next two years with no sign of any imminent upturn in activity and sizeable downside risks. Continued downward pressure on commodity markets is to be expected, given this outlook.**
- **Q2 GDP showed the Australian economy growing at just 2% y/y as it struggles to transition to non-mining sources of growth amidst lower national income. Against that, there is increasing evidence that growth momentum is broadening across the non-mining economy – not limited to the dwelling sector – in response to the lower AUD and interest rates. Improvement is particularly evident in services sectors in both the NAB survey and the official national accounts. Due to the lower base, our 2015/16 GDP forecast is now 2.4% while the 2016/17 forecast is unchanged at 3.1%. The unemployment rate eases to 6% through 2015/16 and to 5¾ in 2016/17. While risks to the outlook stemming from financial market volatility and a slower China are front of mind, at this stage they are balanced by stronger local momentum in the non mining sector. There is little case on purely domestic grounds for easier monetary policy, with areas of economic weakness unlikely to respond to lower rates, although external risks suggest the RBA will retain an easing bias for some time.**

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.5	2.5	2.4
Euro-zone	12	0.9	1.3	1.7	1.9
Japan	4	-0.1	0.7	1.2	1.0
China	16	7.4	7.1	6.9	6.5
Emerging East Asia	8	4.0	3.7	3.8	4.1
New Zealand	0.2	3.3	2.4	1.9	2.0
Global total	100	3.3	3.1	3.2	3.4
Australia	2	2.7	2.3	2.7	3.3
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.2	2.5	2.5	2.7
Domestic demand		1.0	0.9	1.5	1.5
GDP		2.5	2.4	2.4	3.1
Core CPI (*% through-year*)		2.7	2.3	2.7	2.5
Unemployment rate (*% end of year*)		6.1	6.0	5.9	5.7

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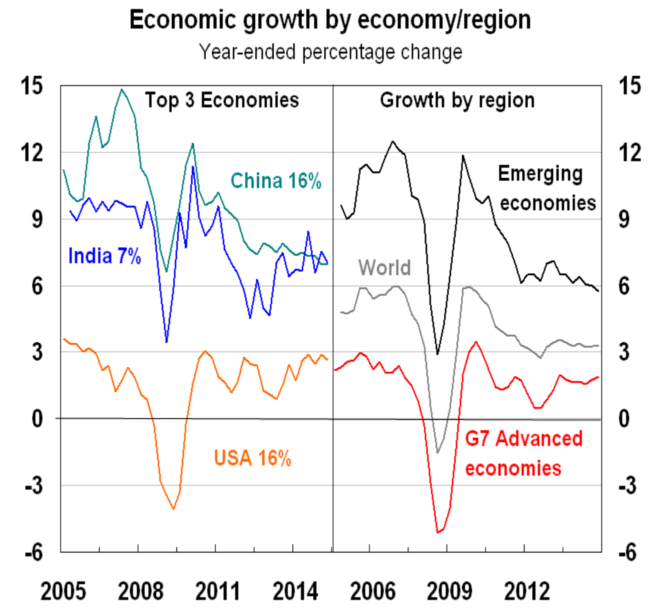
Global and Australian overview

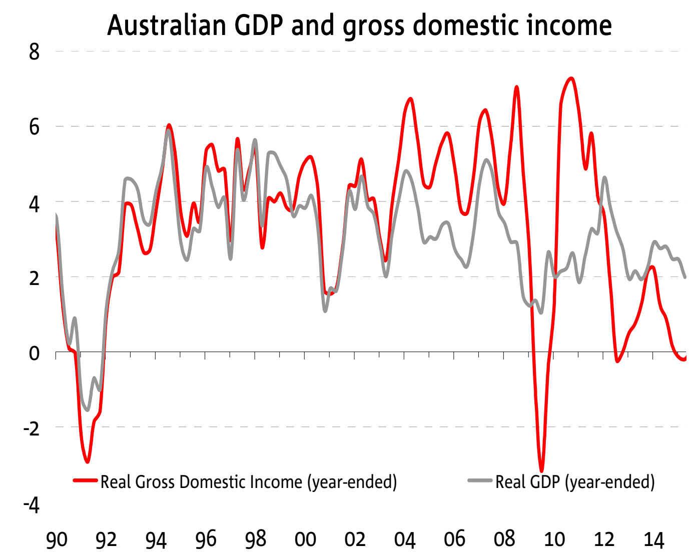
Global overview

- Global growth remained sluggish at around 3¼% yoy in the June quarter, below its long run trend pace of just over 3½%. Much improved second quarter US growth outweighed output falls in Canada and Japan as well as a disappointing Euro-zone growth outcome to produce a modest quickening in the pace of growth across the big advanced economies. This offset a slowdown in growth in the big emerging market economies, driven by weak outcomes in Brazil plus a slowdown in India and emerging market economies of East Asia. We expect growth to remain sluggish.
- With Greece taking less market attention, for now at least, the main risk centres on the Chinese economy. Having contributed to the development of a bubble in the share market, the authorities are having difficulties in calming things down with continued volatility in the huge Shanghai and Shenzhen equity markets. Assessing the extent of the slowdown under way in the Chinese economy is, however, far more important. Mainstream monthly indicators like industrial output, export deliveries, and fixed investment show gradually slowing growth, but harder data like steel and electricity output as well as rail freight show a much weaker picture. Achieving the 7% economic growth target will rely heavily on faster growth in services, but the limited monthly data for services does not show any recent ramping up in the pace of growth.

Australian overview

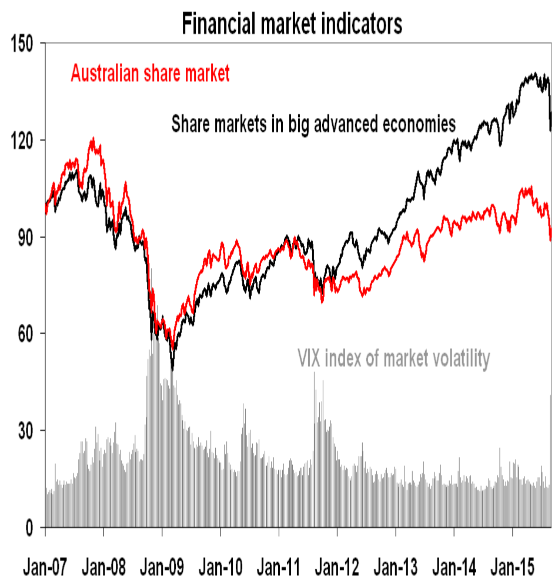
- Our GDP forecasts for 2015/16 have been revised downwards to 2.4% due to a lower base following the disappointing Q2 outcome, while the forecast for 2016/17 is broadly unchanged at 3.1%. Income growth will remain weak as lower commodity prices flow through to export earnings, corporate profits, government revenues and ultimately labour earnings. A sharp drop in mining investment will not be offset by investment in other sectors. Meanwhile, mining export volumes will contribute strongly to economic growth, and the lower AUD is providing a "natural hedge" and supporting net exports, particularly of services such as tourism. Business conditions are trending up with strength across services sectors (including propery) and retail. These are more labour intensive sectors and the unemployment rate should drift down to 6% by end 2015/16 and to 5 3/4% by end 2016/17, particularly given slower population growth.
- Growth forecasts are based on a now weaker trajectory for the AUD/USD to hit a low of 68c by Q1 2016 before gradually picking up. The risks to the forecasts from external factors have tilted to the downside again following jitters in financial markets and further slowdown in China, which presents significant downside to Australian export earnings, profitability and government revenues. That said there is clearly improving local momentum – especially in the service sectors. As a result there is still little case for easing based on domestic fundamentals. However we expect the RBA will retain an easing bias - with the path of the AUD a critical consideration.

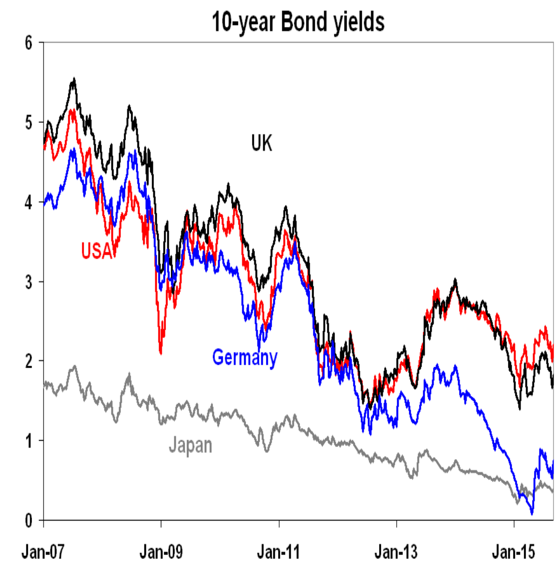


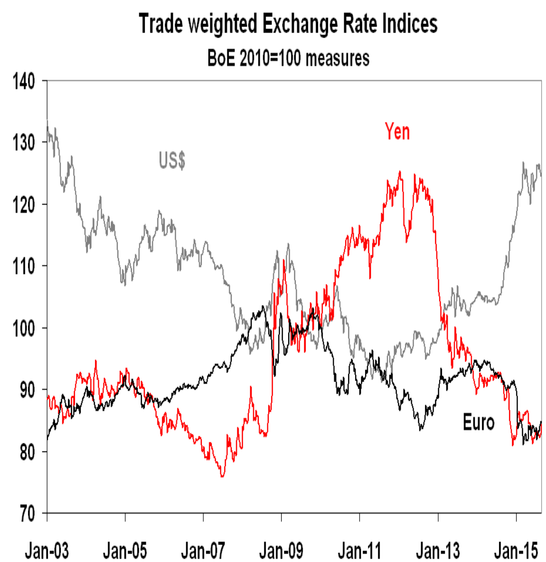


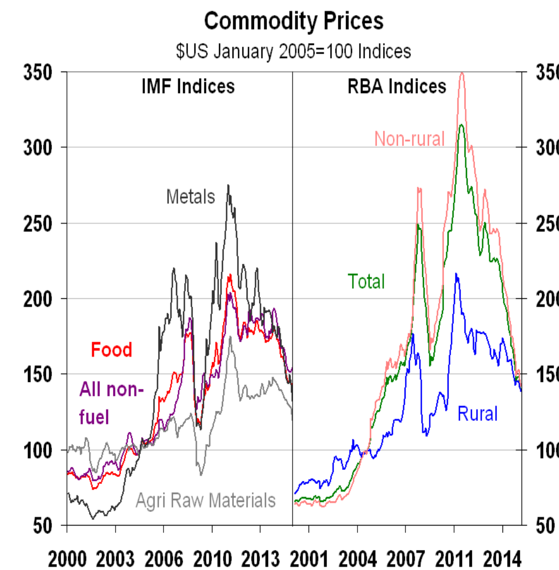
Financial and commodity markets

- The bursting of the Chinese share market bubble, the timing of US interest rate rises by the Fed and the continued slide in global commodity markets remain key areas of concern to the markets.
- The Shanghai share market fell from its mid-June peak of 5166 to 3160 in early September, not much above the rate at which it opened in 2015. Around 30 trillion RMB ($US4½ billion) has been wiped off share market capitalisation, equal to almost half of GDP in 2014. While the impact of this seemingly huge fall on household wealth and business funding should not be exaggerated, the failed efforts of the Chinese authorities to stabilise the market has raised deeper concerns about their appetite for economic reform and the true strength of growth in the economy. Volatility in the Chinese market has spilled over into other equity markets, depressing prices.
- While recent market volatility may cause the Fed to delay lifting its policy interest rates, we still expect this process to start by the end of the year. This expected tightening is underpinned by continued labour market improvement which should eventually drive inflation up to the Fed's 2% target rate. This process of rate increases should prove to be gradual by the standards of previous monetary tightening cycles and the peak rate reached at its end lower than in the past.
- Sluggish world economic growth is capping the pace of expansion in commodity demand at precisely the time that new supply is being added in some sectors as a lagged response to the previous commodity boom. The outcome has been steep falls in many commodity prices with Australian commodity price measures falling particularly heavily.



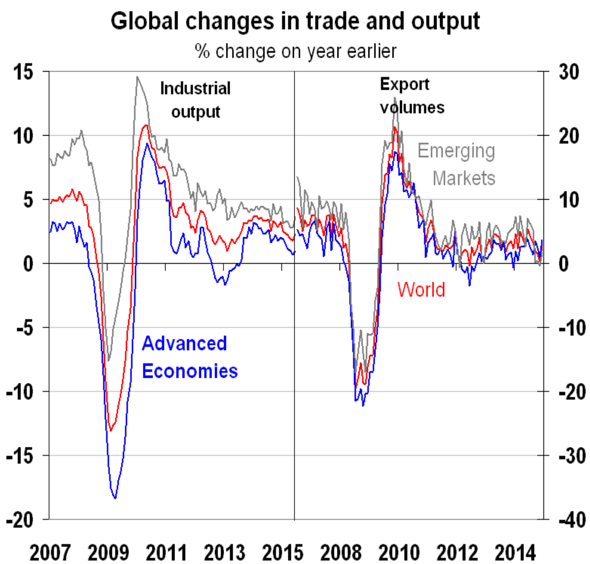


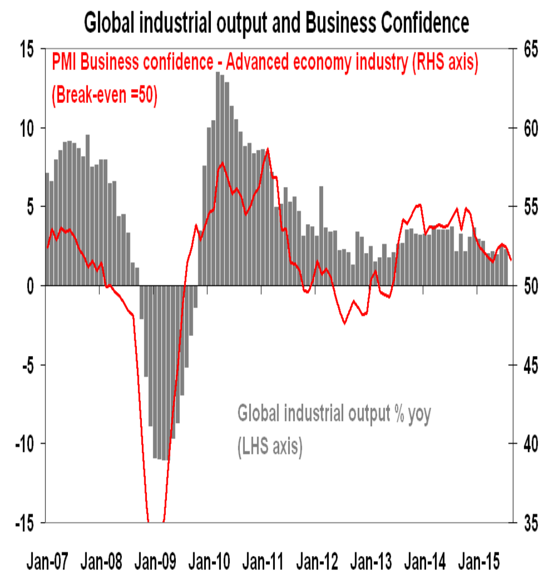


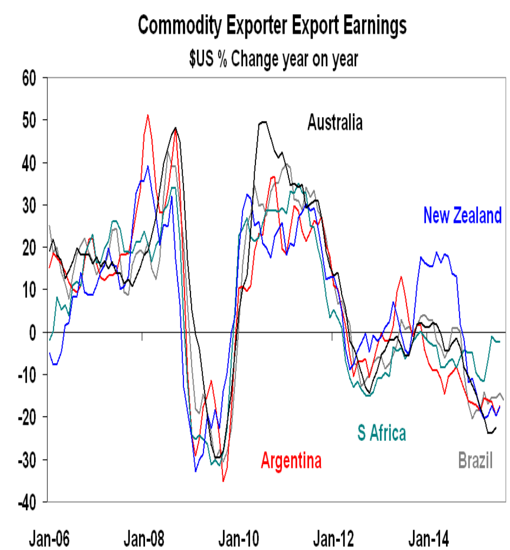


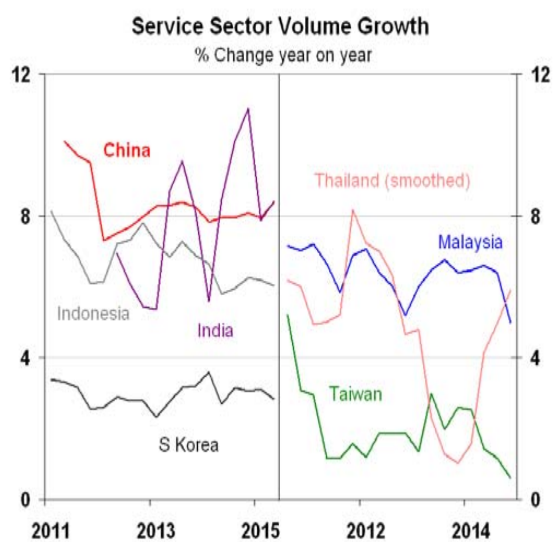
Global Economic Trends

- Growth in global GDP, the broadest measures of output, has disappointed by staying around 3¼% yoy since mid-2014 rather than picking up. The latest data for industrial output and world trade still show weak growth. Global industrial output grew by only 0.1% in the June quarter, down from the growth of 0.3% in March and 1% last December. World trade is faring even worse with volumes falling by 0.5% in the June quarter after a 1½% drop in the March quarter.
- Partial data for industrial activity does not show any pick-up in global activity since June. Industrial output growth in a sample of big economies remained around 2% yoy in July, while the August industrial purchasing manager surveys across the largest advanced and emerging market economies pointed to slower rather than faster growth.
- At the same time, falling commodity prices are eroding export earnings in key primary producers, undercutting incomes, spending and output. Brazil and Canada are in recession, South Africa's economy shrank in the second quarter, and Australian GDP proved weaker than expected. Argentine GDP was still growing in early 2015 as the government, facing an election, boosted demand to offset lower export prices.
- While timely data makes it easy to track growth in the industrial sector, services usually comprise the bulk of output. The limited data available shows service sector growth easily outpacing industry. Advanced economy business surveys for services are consistent with solid growth and services expansion remains buoyant in many Asian emerging market economies. This service sector growth is lifting incomes in Asia and fuelling demand for Australasian food and service exports.



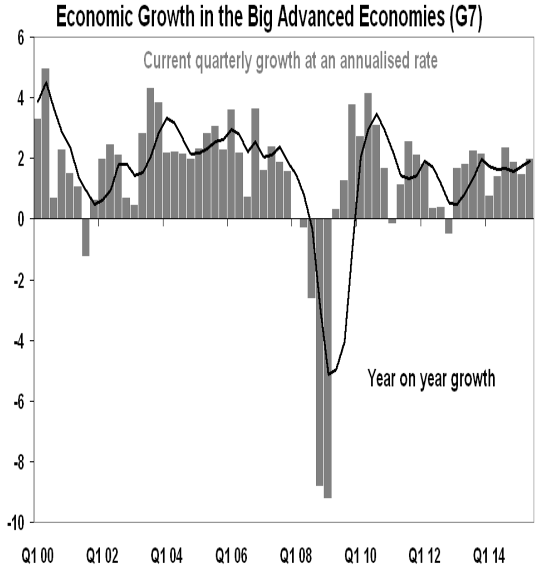


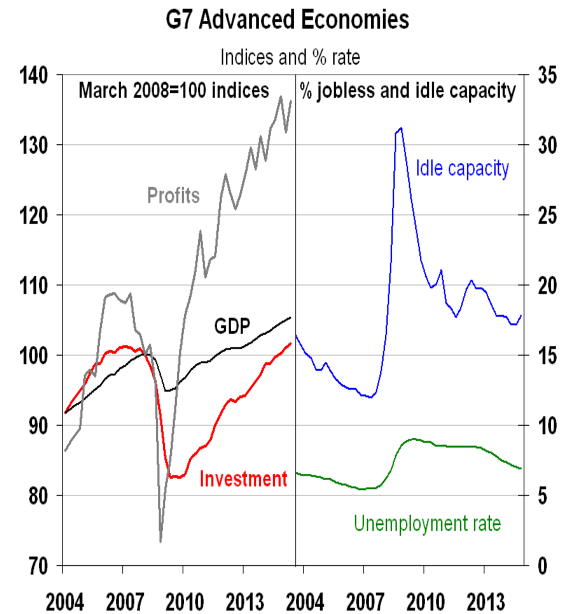


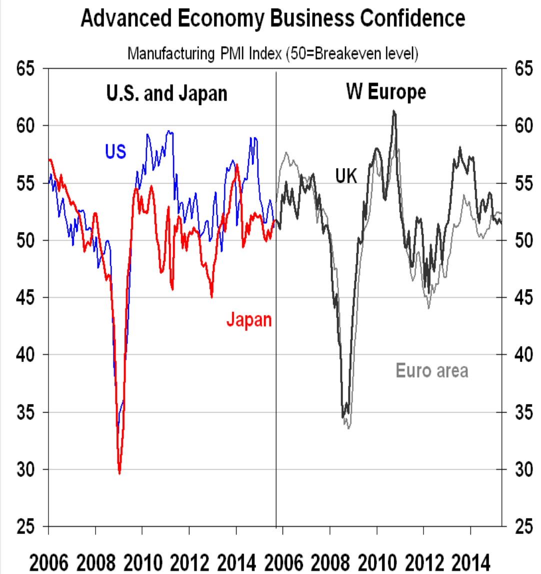


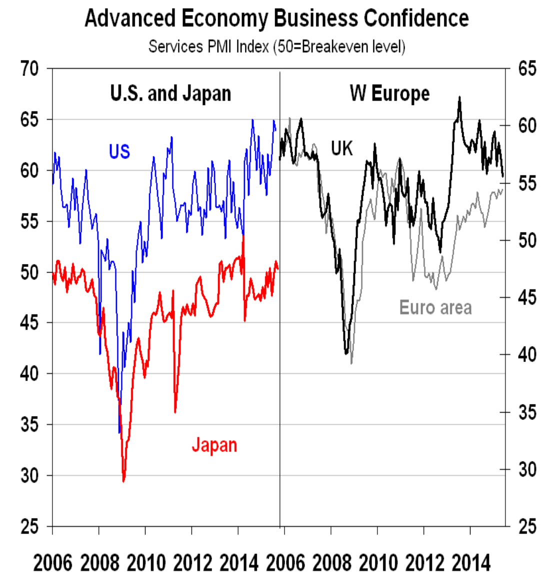
Advanced Economies

- Growth in the G7 advanced economies accelerated from an annualised rate of 1½% in the March quarter to 2% in the June quarter. This principally reflected a rebound in US growth, which was dragged down by temporary factors in the first quarter. The UK was the only other bright spot with growth accelerating in the June quarter after a weak first quarter outcome. Elsewhere advanced economy growth was generally disappointing with falls in output in Japan and Canada and a modest drop in Euro-zone growth.
- This diversity of performance between the big advanced economies is a continuation of recent trends. June 2015 quarter output in the G7 was only around 5% above its early 2008 pre-GFC level, easily the worst outcome for growth in the postwar period. North America has been the standout performer, with output up by around 10% since early 2008 in the US and Canada, while the comparable UK growth figure is around 5%. By contrast, mid-2015 output in Japan and the Euro-zone is lower than it was in early 2008.
- The recovery in advanced economy investment has been particularly lacklustre - it took almost 7 years to regain its early 2008 level, despite an upturn in business profits and a drop in the extent of idle capacity. This reflects the risks and volatility in the global economic environment as well as a lack of confidence in business that is partly an overhang of previous financial crises and deep recessions.
- The business surveys provide the most up to date assessment of current economic conditions and they show solid growth continuing in services (albeit clearly slowing in the UK) alongside generally disappointing results for manufacturing that are consistent with modest growth at best.



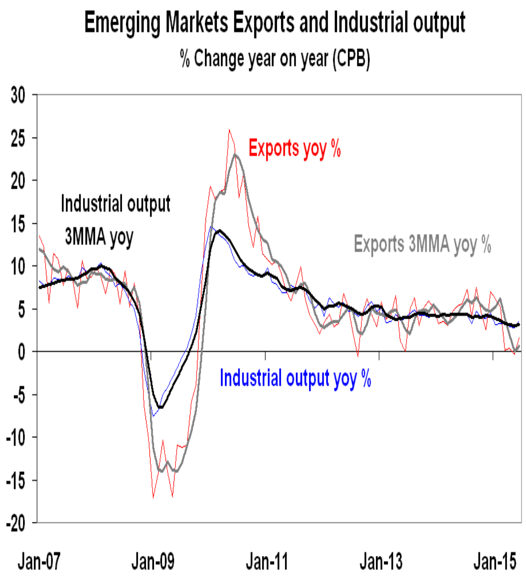


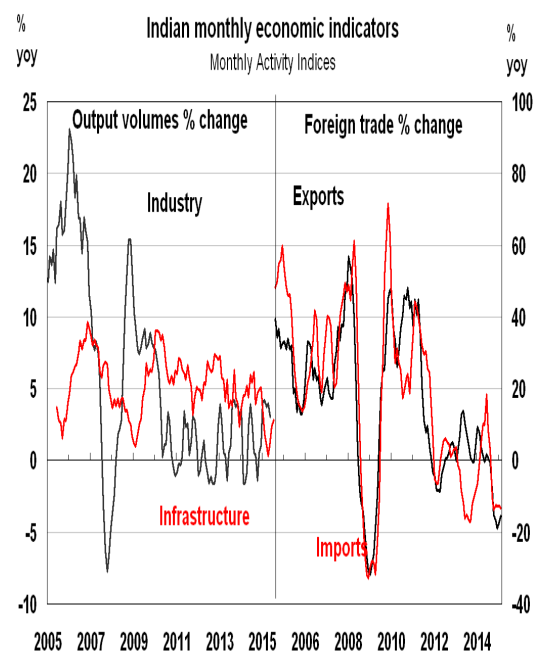


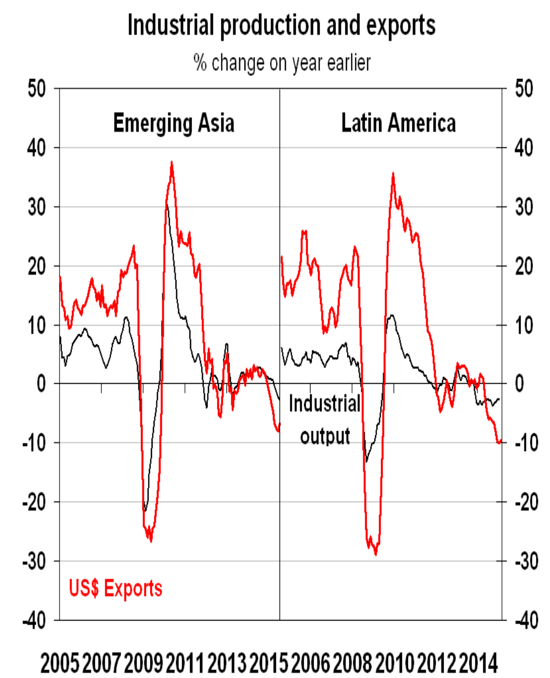


Emerging Market Economies

- A slowdown in emerging market economy growth from 6% yoy in March to 5.7% yoy in June has offset the lift in the advanced economies, leaving world growth flat. The headwinds facing emerging market growth (falling commodity prices, weak world trade) remain and new problems have appeared in the last couple of months (notably the bursting of the Chinese share market bubble).
- Emerging market exports and industrial output failed to show much growth through the first half of the year with export volumes falling by 2% and 0.7% respectively in the first two quarters and industrial output growth of only 0.2% and 0.8% respectively (with a bounce-back in African and Middle Eastern output driving much of the upturn in industry). As the emerging market economies of East Asia are generally export-driven, the weakness of world trade has weighed on output while falling commodity prices have hit exports and incomes in big Latin American primary producers like Brazil.
- Uncertainty surrounding the pace of Chinese growth hangs over financial markets. The acceleration in quarterly GDP growth from 1.4% in March to 1.7% in June owed much to the stock market bubble. Most partial indicators point to slowing growth with a clear softening trend in industrial output, export deliveries, fixed investment and (until recently) the real estate sector. Chinese leaders have also previously focussed on hard data covering steel output, rail freight and electricity generation and they are all faring much worse than the partial indicators of activity. Surveyed business sales and profit growth also look very weak. This all points to quite soft growth in the industrial sector, helping explain the fall in global commodity prices. The extent to which service activity is picking up is far from clear with business surveys trending down.

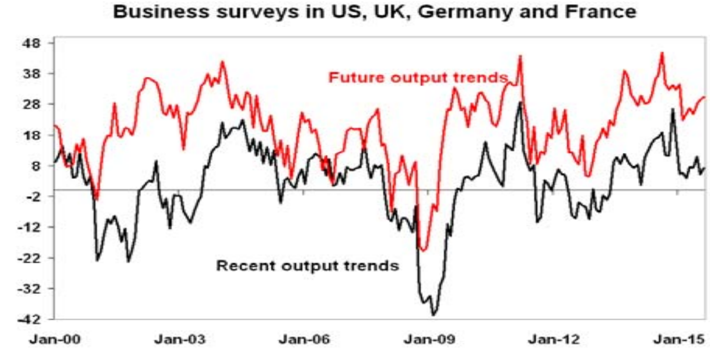


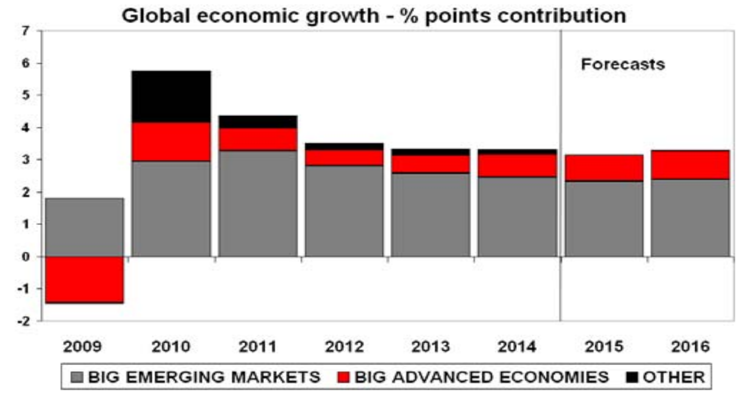


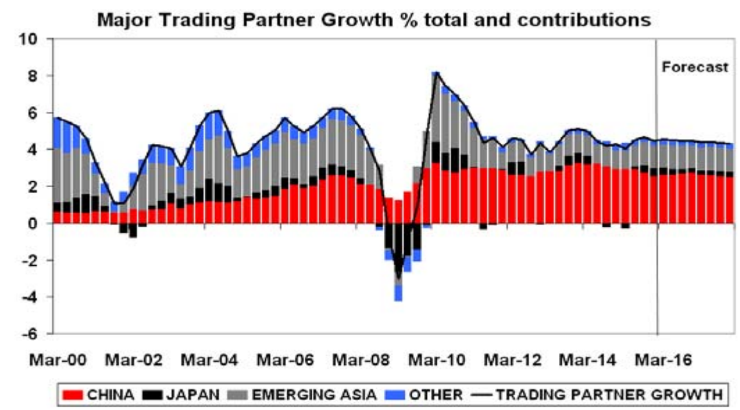


Global forecasts

- We have shaved our 2015 and 2016 forecasts down by 10 bps to take account of weaker than expected outcomes in Canada and Brazil with global growth set to remain sub-trend through the entire forecast horizon. Growth is expected to fall from 3.3% in 2014 to 3.1% this year and remain much the same in 2016 with our global tracking indicator showing no sign yet of any upturn in growth.
- A modest upturn in Japan and the Euro-zone drives the forecast lift in advanced economy growth from 1.8% to 2.1% between 2014 and 2016 Emerging market economy growth should slow this year to less than 5% for the first time since 2009 with a broad-based weakening across most of Asia and Latin America. India is the only big emerging market economy predicted to see faster growth this year and, even here, recent data has disappointed with a loss of growth momentum in the June quarter.
- China is now the biggest global economy and dominates many global commodity markets, highlighting its importance for export price trends in Australia and New Zealand. Recent Chinese GDP growth is close to the 7% official target but growth is already well below that rate in key sectors of importance for Australian commodity demand and there is also debate over the accuracy of the Chinese GDP estimates.







Global growth forecasts % change year on year

					NAB Forecasts		
	2011	2012	2013	2014	2015	2016	2017
US	1.6	2.2	2.2	2.4	2.5	2.5	2.4
Euro-zone	1.7	-0.7	-0.3	0.9	1.3	1.7	1.9
Japan	-0.4	1.7	1.6	-0.1	0.7	1.2	1.0
UK	1.6	0.7	1.7	3.0	2.6	2.4	2.3
Canada	3.0	1.9	2.0	2.4	1.0	2.0	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	7.4	7.5	7.5
Latin America	4.9	2.5	2.5	0.9	0.1	1.1	1.4
Emerging East Asia	4.4	4.6	4.2	4.0	3.7	3.8	4.1
New Zealand	1.8	2.4	2.2	3.3	2.4	1.9	2.0
World	*4.4*	*3.5*	*3.4*	*3.3*	*3.1*	*3.2*	*3.4*
memo							
Advanced Economies	1.7	1.2	1.4	1.8	2.0	2.1	2.1
Big Emerging Economies	7.0	5.6	5.5	5.1	4.8	4.9	4.9
Major trading partners	4.6	4.3	4.6	4.5	4.4	4.5	4.4

Australian outlook

- Australian real GDP is struggling to regain momentum, against a weak income backdrop and significant structural change at the industry and geographic level. The economy expanded by just 0.2% in the June quarter and 2.0% over the year.
- Australian income growth is weak as the terms of trade declines further. This is flowing through to weak corporate profits, government revenue and expenditure, as well as labour earnings. Real gross domestic income fell 0.2% over the year, while real net national disposable income has declined by 1.1% y/y (and -2.3% y/y on a per capita basis).
- That said, there have been a number of one-offs causing volatility in recent quarterly figures, and we are hesitant to extrapolate all of the weakness in Q2 out further.
- In addition, there is some evidence that momentum in the non-mining sector (beyond dwelling construction) is taking place and responding to lower rates and the weaker AUD. Gross value added in services industries such as ITC, finance & insurance and hospitality was solid in Q2. Net tourism exports continue to expand and business conditions and capacity utilisation are trending up, despite the understandable dip in confidence amidst global volatility.
- The outlook for consumer spending and non-mining investment are the biggest swing variables. While household consumption growth is expected to remain below trend, it continues to rely on a further modest decline in the household savings ratio which is vulnerable at present to weak consumer confidence. Meanwhile, recent readings of expected non-mining capital expenditure remain weak, although we do expect some gradual improvement over time if the improvement in business conditions is sustained.
- Due to the lower base, our 2015/16 GDP forecast is now 2.4% while the 2016/17 forecast is unchanged at 3.1%. The unemployment rate eases to 6% through 2015/16 and to 5¾ in 2016/17. These forecasts are based on the AUD depreciating to USD68c by mid-2016. The risks to the economy, the RBA cash rate and the currency have tilted to the downside again as China slows and volatility on global markets remains elevated.

Australian economic and financial forecasts (a)

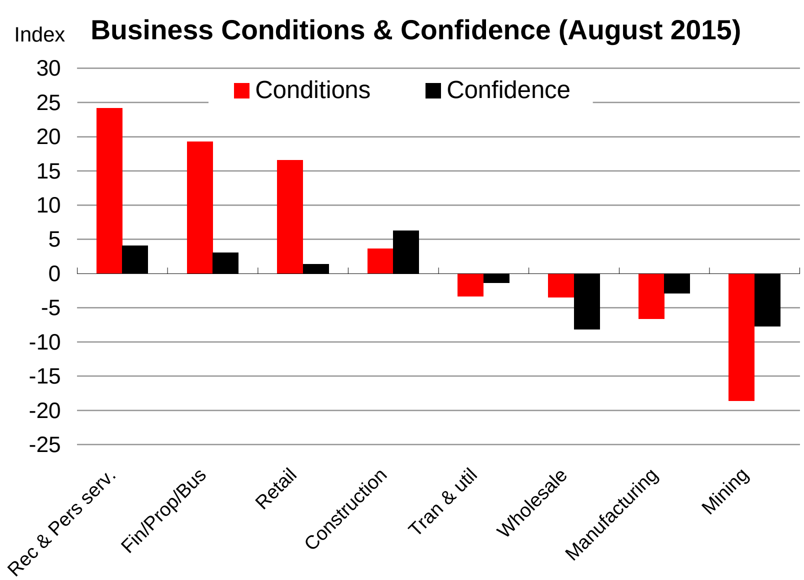
	Fiscal Year			Calendar Year		
	2014-15 F	2015-16 F	2016-17 F	2015-F	2016-F	2017-F
Private Consumption	2.5	2.5	2.6	2.5	2.5	2.7
Dwelling Investment	8.3	12.0	7.1	11.0	10.1	3.6
Underlying Business Fixed Investment	-7.1	-9.1	-7.8	-8.4	-8.5	-7.2
Underlying Public Final Demand	0.4	2.5	1.8	2.0	1.8	1.9
Domestic Demand	**0.9**	**1.6**	**1.6**	**1.4**	**1.6**	**1.5**
Stocks (b)	0.2	0.0	0.0	0.1	0.0	0.0
GNE	**1.1**	**1.6**	**1.6**	**1.4**	**1.6**	**1.5**
Exports	6.6	5.5	8.8	5.4	7.3	9.5
Imports	-0.4	1.3	2.0	1.4	1.5	1.7
GDP	**2.4**	**2.4**	**3.1**	**2.3**	**2.7**	**3.3**
– Non-Farm GDP	2.4	2.5	3.1	2.3	2.8	3.3
– Farm GDP	3.4	0.1	2.0	2.1	1.2	2.0
Nominal GDP	1.9	3.8	4.9	2.2	4.9	4.7
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	57	60	44	66	51	36
(-%) of GDP	3.5	3.6	2.5	4.0	2.9	2.0
Employment	1.4	2.3	2.7	2.0	2.6	2.5
Terms of Trade	-10.5	-4.0	-1.4	-9.3	-0.1	-3.0
Average Earnings (Nat. Accts. Basis)	1.2	1.0	2.1	0.4	1.7	2.3
End of Period						
Total CPI	1.5	3.2	2.7	2.6	2.9	2.3
Core CPI	2.3	2.6	2.4	2.5	2.6	2.4
Unemployment Rate	6.0	5.9	5.7	6.1	5.8	5.8
RBA Cash Rate	2.00	2.00	3.00	2.00	2.50	3.50
10 Year Govt. Bonds	3.01	3.10	3.50	3.10	3.25	3.50
$A/US cents :	0.77	0.69	0.72	0.70	0.70	0.73
$A - Trade Weighted Index	63.8	61.2	62.9	61.3	62.0	62.4

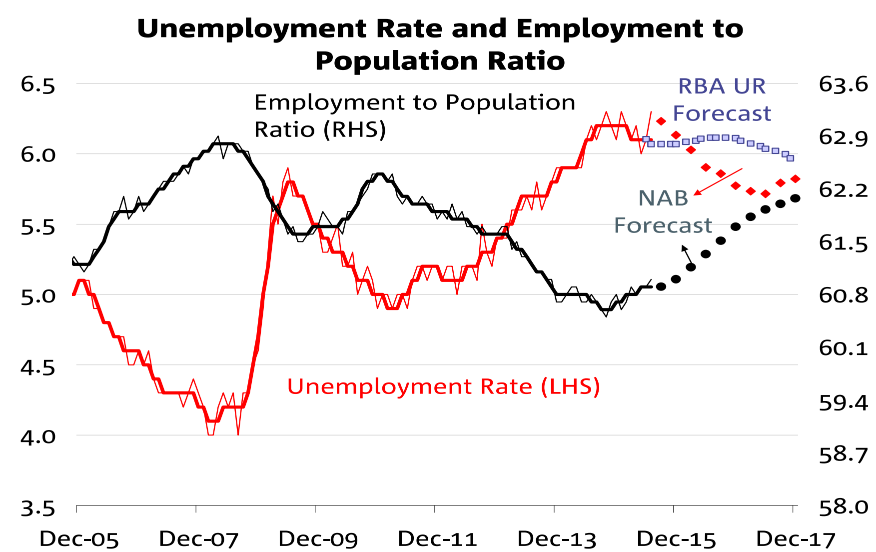
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through

(b) Contribution to GDP growth

Australian labour market

- The unemployment rate is forecast to stabilise in coming months, and then drift slightly downwards to around 5¾% by end-2016. Slower population growth (currently 1.4% y/y, down from 1.6% at the start of 2014 and a recent peak of 1.8% in late 2012) ,suggests a slightly lower rate of job creation will be necessary to keep up with population growth.
- Looking at the near term, forward-looking measures of the labour market are mixed, with the NAB survey employment index subdued, but measures of job advertisements and capacity utilisation painting a more positive picture. (Note the official labour market data for August will contain revisions due to population re-benchmarking, although this should be broadly neutral for historical labour market prints).
- The shifting composition of growth at an industry level appears to be supporting the Australian labour market, with growth more concentrated in labour-intensive sectors. Indeed the NAB employment index is strongest in services sectors such as finance, business & property services and recreation & personal services (left hand panel).
- Ongoing spare capacity in the labour market is evidenced by the slowdown in wages growth. The wage price index increased by a modest 0.6% in the June quarter, to be just 2.3% higher over the year, to only just keep pace with underlying inflation. No industries are experiencing wages growth of 3%, and three industries are experiencing wages growth below 2% (construction, business & professional services and administrative & support services). Broader measures of the wages bill are growing at an even slower rate, as employment shifts away from higher-paid industries such as mining, towards lower paid industries. Average compensation per employee grew just 0.2% in the June quarter and 0.5% over the year.

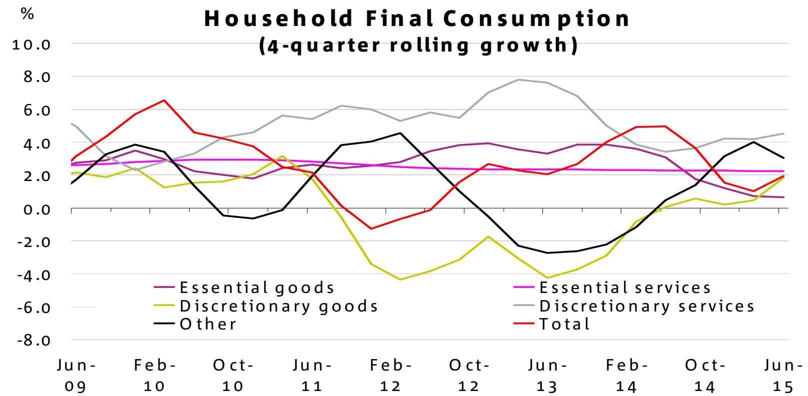




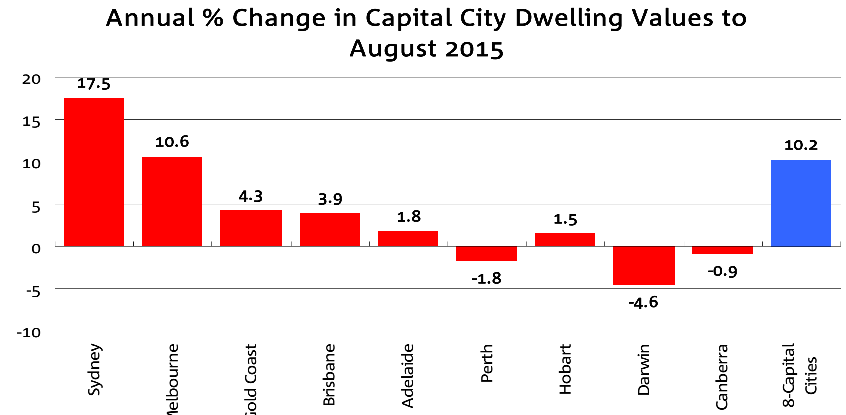
Source: ABS, NAB

Australian consumer demand and housing market

- According to Q2 National Accounts, household consumption growth was softer that expected, rising by just at 0.5% q/q and 2.5% y/y. This is slightly at odds with relatively stronger retail sales growth for the quarter (0.8%). The conundrum can be partly explained by a pick-up in expenditure on food and household goods, while spending on certain services not captured in retail trade, such as utilities, transport as well as insurance and financial services detracted from consumption growth in the quarter. The loss of momentum in spending is also consistent with persistently weak growth in household income – average compensation per employee rose just 0.2% q/q – and high consumer caution. The household savings rate lifted back to 8.8%.
- Strength in residential markets is somewhat apparent in the consumption numbers (growth in dwelling services and household furnishings). Interestingly however, hotels, cafes & restaurants consumption was weak in the quarter, which appears somewhat inconsistent with strength in recreation & personal services according to the NAB Business Survey, and retail sales data showing an increase in a similar category in Q2. This may partly be explained by improvements in international tourism as spending in this area would fall under service exports rather than consumption (see tourism exports chart on page 11). By state, consumer spending was surprisingly stronger in QLD and SA (which are challenged by mining and population slowdown respectively), somewhat resilient in NSW, and weaker in WA, VIC and TAS. A contraction in the growth of July NAB Online Retail Index (-1.4% m/m) offers a glimpse into what could be a slowing in retail spending growth in the coming quarter.
- Amidst subdued household income growth, we expect a modest pick-up in consumer spending growth through to 2017, driven by a gradual decline in the household savings rate. Subdued consumer sentiment could be a risk near-term. In contrast, business conditions and confidence of retailers in the NAB monthly business survey remains above its long-run average, and the lower AUD should re-direct spending onshore.
- The pace of dwelling price growth eased slightly to 10.2% y/y in August (11.1% y/y in July). Dwelling price growth in Sydney remains the standout at 17.5% y/y (chart RHS), with Melbourne in second place at 10.6% y/y, although both have come off a little in growth terms since July. Owner-occupier approvals and credit growth meanwhile remain subdued. Pent up demand will continue to provide fundamental support for prices, most notably in Sydney following years of undersupply, however we do expect house price growth to slow to a rate more consistent with household income growth. While foreign demand will remain strong, there is some evidence of a slowing in housing credit growth for investors as lenders gradually move to meet the regulator's 10% annual growth target. Monthly investor credit growth eased to 0.6% m/m in July, from previous monthly growth rates between 0.8% and 1%, and investor housing finance approvals declined by 0.7% in June.



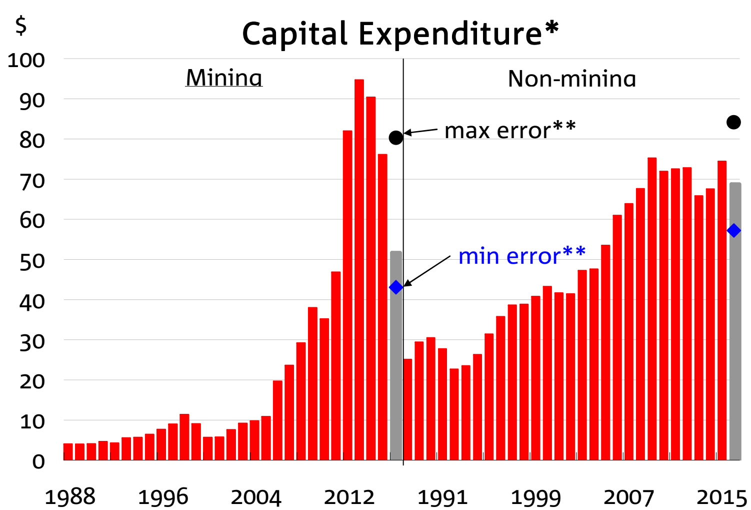
Source: ABS, NAB



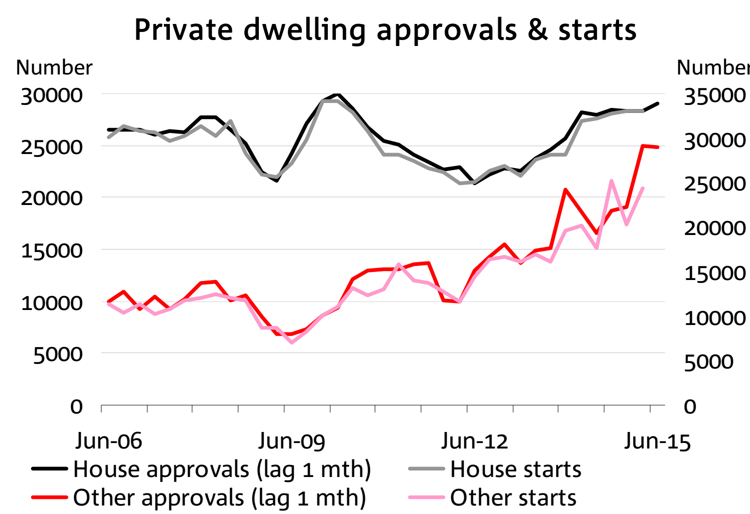
SOURCE: RP Data

Australian investment

- Sharp declines in mining and related investment will remain a key feature of the economic landscape in coming years. The risks to this difficult outlook have further tilted to the downside given recent declines in non-rural commodity prices and high volatility, although we note that the lower AUD and lower cost curves will provide some buffer. The official Q2 capital expenditure survey showed an expected 33% decline in mining investment in 2015-16, consistent with the sharply lower estimates for mining work yet to be done and low levels of business confidence and conditions for the sector in the NAB survey.
- While there remains some hope that non-mining investment will eventually fill some of the gap, expectations for non-mining capex in 2015-16 have disappointingly shown little improvement. Depending on the realisation ratio used, the latest official Q2 capex survey suggested a likely fall of around 8%. Non-residential building approvals are also weak, although confidence is improving according to the NAB commercial property survey, particularly in retail. That said, the gradual trend improvement in business conditions and capacity utilisation is encouraging, although we note that most of the strength has been concentrated in services industries who have traditionally been more labour than capital intensive. The AUD depreciation should also assist investment in trade exposed industries, particularly in services such as tourism.
- Dwelling investment surprisingly fell by 1.9% in Q2 despite strength in building approvals and a very elevated stock of residential projects in the construction pipeline. While this did follow growth of over 6% in each of the two preceding quarters, this weakness is likely only temporary given record levels of work to be done. We continue to expect some degree of volatility in the profile given the large share of apartment construction, which tends to be lumpy. Longer lead times for higher density construction (as evidenced by the gap between approvals and starts for non-housing dwelling construction on the right panel), suggests further growth in construction until late 2016.
- Overall, we are forecasting business investment to decline by around 9% in 2015/16 and 8% 2016/17. Stronger dwelling investment will provide an offset, but represents a much smaller proportion of GDP (around 5% vs 12% for business investment).



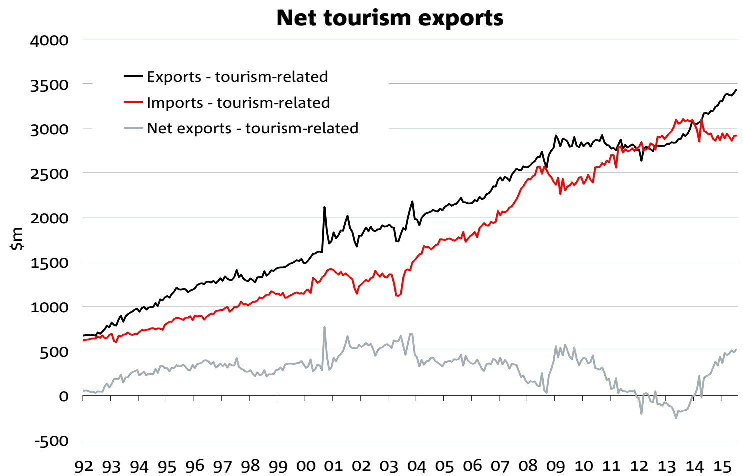
* Grey bars are the latest expectations adjusted by the RBA's preferred realisation ratio measure
** The max and min estimates based on historical max-min realisation ratios
Source: NAB, ABS

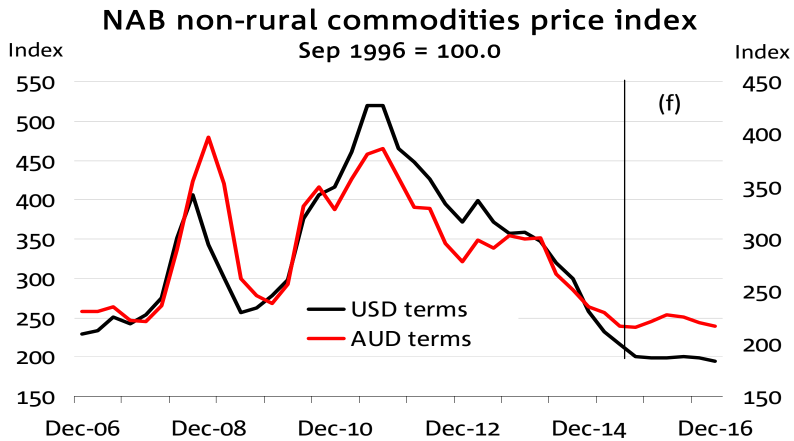


Source: ABS

Australian commodities, net exports and terms of trade

- At this stage, the evident slowdown in Chinese heavy industry, manufacturing and property sectors presents a significant downside risk to resource commodity export earnings. Further weakness would most likely come through the price channel; while there is some downside risk to production and export volumes, the lower AUD and oil price is also lowering cost curves for producers. At this stage, we continue to expect strong growth in export volumes, which is adding 1¾ppt to GDP in 2015/16 and 2016/17. LNG exports will be the primary driver of export growth going forward although will not replace iron ore as Australia's largest export – we estimate that LNG exports will add around $12-13bn to Australian exports per quarter by end 2017.
- Tourism exports are improving in net terms, in line with the weaker AUD (bottom left chart), and we expect this process to continue going forward. The weaker AUD will also aid the competitiveness of manufactured exports and go some way to improving relative unit labour costs between Australian and the rest of the world; it is unlikely to reverse decisions to offshore that have already been made however. Meanwhile, imports will remain weak, with some consumer spending re-directed back onshore as the AUD declines, and capital imports lower as mining investment trails off.
- The non-rural commodity index denominated in USD is expected to fall around 31% during 2015 and a further 7.2% during 2016. The sharper fall for 2016 incorporates further expected weakness in commodity prices in USD terms. The AUD is now expected to depreciate to around US68c by the end of Q1 2016, which helps to offset some of the weakness in commodity prices in local price terms, with the non-rural commodity index expected to fall by 17% in AUD terms for the year. Implicit in these forecasts are iron ore prices weakening further, trending down from around US$47 a tonne in late 2015 to US$44 by the end of 2016. Oil prices are now forecast at $US50 a barrel by late 2015 – and around the mid to high $US50s by end 2016. Elevated levels of global price volatility continue to cast a high degree of uncertainty over the outlook.
- The NAB Rural Commodities Index was largely unchanged in August. Beef prices continued to rise and are forecast to increase further owing to a shortage of stock. Ongoing weakness in Global Dairy Trade auction results saw our dairy price forecast revised downward. Continued AUD weakness will support the index, with forecast growth of 8.5% in 2015 and 4.9% in 2016 in AUD terms and more muted growth in USD terms (-7.8% in 2015 and -2.1% in 2016).





Source: ABS; ABARES; Bloomberg; NAB; Thomson Datastream

Australian financial markets

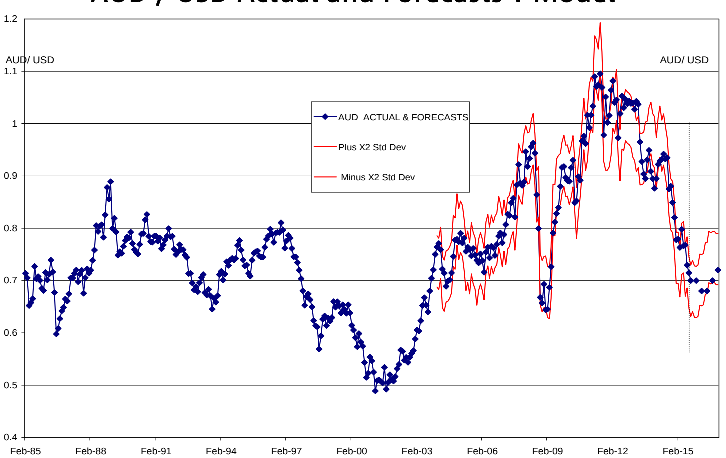
Exchange rate

- The AUD has depreciated by a further 2% over August and is trading at around USD69-70c at the time of writing. The AUD is now13% below its recent peak at end April. A combination of higher volatility in financial markets (which tends to weigh on the AUD) and the AUD's status as a liquid proxy for investing in China and other EM currencies been a perfect storm for the AUD. Our latest forecasts are for the AUD to ease to 0.68 in H1 2016 before slowly appreciating. This is consistent with higher expected volatility which is driving estimates of fair value lower (left hand panel), and the risk of further CNY depreciation and downward pressure on other Asian EM currencies. There is some risk that the AUD will drop below USD70c on a consistent basis this year, with the path of the USD and Fed monetary policy decisions influential. Indeed our model currently has fair value around USD 68c (+/- 5c).

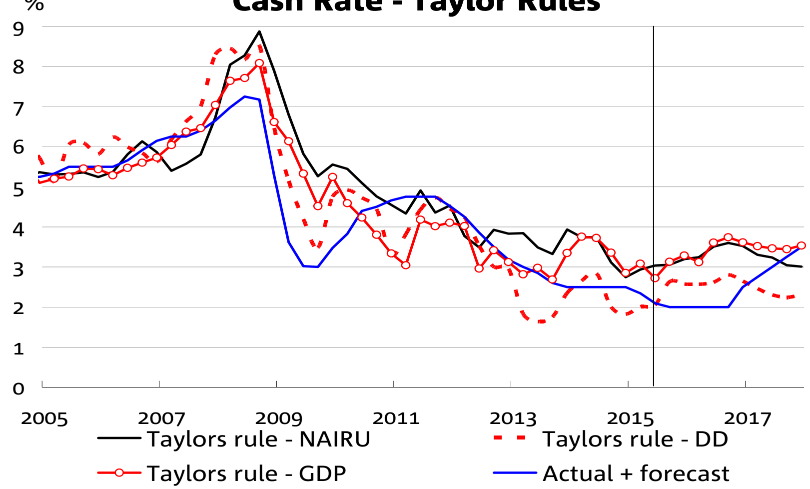
Interest rates

- Global financial market ructions and a slower China suggest the risks to the Australian economic forecast and the RBA cash rate are tilted to the downside near term. At this stage, however, the RBA is likely to sit back and wait for a clearer global picture to emerge, and will at least be comforted by the "natural hedge" being provided by the lower AUD.
- The case for further easing on purely domestic grounds is limited in our view amidst a trend improvement in business conditions and capacity utilisation and a stronger than expected labour market. While macro-prudential measures should help cool the rapid growth in house prices at the margin, and investor housing credit did slow in July, however the RBA will remain reluctant to stimulate further housing demand via lower rates unless global influences become consistently more severe.
- The path of the AUD remains critical to the outlook for monetary policy, and in turn will depend to some extent on whether the US Fed manages to undertake rates "lift-off" this year – the first hike is now more likely in December than in September.
- Our central case scenario remains for the RBA cash rate to remain unchanged until late 2016. Indeed, Taylor's rule analysis (in the chart below right) does not suggest a sub-2% cash rate, and implies rate rises earlier from mid-2016. Our forecast of 3.5% by 2017 is towards the top end of various rules, despite being a relatively low terminal rate by historical standards. Of course this analysis does not encapsulate the downside risks emanating from offshore at present, and the RBA will retain an easing bias for a considerable period.

AUD / USD Actual and Forecasts v Model



Cash Rate - Taylor Rules



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