November 2015

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global</u>: Global growth remains sub-trend and there is little sign of an imminent acceleration in the pace of expansion – which should stay around 3%. Some factors hanging over global markets have eased for now and this has helped share prices to rise. However, the combination of higher US interest rates and lower commodity prices has caused problems in the past for emerging market economies, which have been driving the bulk of global growth since 2009. The modest upturn forecast for Japan and the Euro-zone is not enough to markedly change the lacklustre economic outlook.

- Global share prices rose as concerns over economic risks receded. Markets in the Euro-zone have been less focused on the sustainability of austerity in the periphery economies. Chinese share prices remain well below their earlier peak, but have been recovering some of their losses and the Government has again stressed its determination to achieve solid rates of economic growth. Markets are pricing in a growing chance that the Fed will start to lift interest rates before the end of the year (we expect December), particularly following the recent bumper payrolls print, but the outlook is still for a gradual cautious approach by the Fed. With inflation running well below the European Central Bank's (ECB) target, we expect them to further ease policy by the end of the year. The Bank of Japan kept its monetary policy unchanged at its end October meeting, despite continuing lower than target inflation and a postponement of achieving its 2% target to the end of next year. The central bank will continue buying assets (especially government bonds) to lift the monetary base by an annual 80 trillion yen.
- Growth in global GDP, the broadest measure 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 only modest growth. Data on services activity is limited, despite being more important to many economies. The business surveys show much stronger and improving activity levels in service industries in the US, Japan and W Europe. India shows a similar picture with faster growth in its service sector, while manufacturing growth fades. Sluggish global growth and falling commodity prices have eroded inflationary pressures in the big advanced economies. Headline CPI inflation in the OECD has fallen under 1% yoy but that owes much to the transitory effect of lower oil prices and both wage growth and core inflation are closer to 2% yoy. Producer prices are falling, reflecting the role of commodities in industrial inputs. The inflation story is quite different in several of the big emerging economies – Chinese inflation is very low, but inflation above 5% is evident elsewhere (e.g. Brazil, India and Indonesia).
- Growth in the big advanced economies has improved and unemployment in the G7 biggest economies has also declined from a peak of 9% in the wake of the global financial crisis to 7% currently – only around 1 percentage point above its pre-recession level. The amount of idle capacity is well below its peak but it has stopped falling in the last year. The US, Canada and UK have made the strongest recoveries, while both Japan and the Euro-zone are still marginally below early 2008 levels. Service sector growth has been the mainstay of this relatively strong performance in both the US and UK with PMI business survey readings for services generally outperforming manufacturing results. Recently US industrial growth has been held back by the strength of the $US while services growth has been very solid. UK industry recorded a surprisingly strong lift in growth in October, but Japan has struggled to regain growth momentum after last year's consumption tax hike. Euro-zone growth has also disappointed.
- Growth rates in the emerging market economies have eased and the slowdown in the biggest economies has also been quite marked, largely because of China's trend slowing and the much sharper move by Brazil into severe recession. Monthly trade and industrial output trends across the emerging market economies show at best only a slight improvement in the pace of industrial growth in the September quarter along with still surprisingly weak exports. Export deliveries and fixed investment spending in China continue to slow sharply, industrial output growth continues to trend down more gradually. However, retail trade expansion remains solid, an encouraging sign of economic rebalancing. Indian trade data remains very weak, but that partly reflects lower commodity prices and the higher $US. Output trends in industry and infrastructure have picked up slightly but growth remains sluggish by previous standards. Both exports and industrial output continue to fall across the rest of East Asia and Latin America.
- We have slightly lowered our Chinese growth forecasts to 6.9% for 2015 and 6.7% for 2016, taking predicted global growth in 2015 down to 3% - well below trend. We do not expect to see much of an acceleration through the next couple of years. This outlook underpins a continuation of the low inflation environment that is allowing advanced economy central banks to sustain historically low interest rates.

<u>Australia</u>: We remain cautiously optimistic that the gradual recovery in the non-mining sector is gaining traction. Recent outcomes from the business survey support this contention, while the unemployment rate is also holding steady. The RBA has so far refrained from easing policy further despite some tightening of financial conditions. Low inflation however does provide room for the RBA to ease, although this would require evidence that local demand conditions are deteriorating again. As such the RBA is expected to remain on hold for an extended period, although we have pushed out the timing of the first hike until mid-17. Real GDP is forecast to expand by 2.6% in 2015/16 and 3.0% in 2016/17, with El Niño only subtracting marginally. The unemployment rate eases gradually but remains elevated for an extended period.

- The NAB Business Survey still points to a reasonably resilient recovery in the non-mining sector, despite stubbornly sluggish business confidence in the past six months. Better business conditions are not being felt uniformly across the economy, as industries that are better positioned to benefit from lower interest rates (especially those closely tied to residential real estate) and the AUD remain the clear outperformers – personal and business services are the main standouts. Despite a number of downside risks (mostly stemming from offshore), should non-mining sectors continue to improve, we maintain the view that further RBA cuts are unlikely. Monetary policy is expected to remain on hold for an extended period, although the timing of the first hike has been pushed out till mid-2017.
- The unemployment rate is forecast to stabilise in coming months, and then drift slightly downwards to around 5¾% by end-2016. Slower population growth, suggests a slightly lower rate of job creation will be necessary to keep up with population growth. Job vacancies have been gaining traction in non-mining states of NSW, Victoria, Tasmania and ACT for a while, the improvement in QLD labour market is a relatively new phenomenon – possibly reflecting the pick-up in tourism and education sectors which outweighs job losses in the mining sector. Other forward indicators have become more consistently positive. The NAB Business Survey employment index held up at +3 in October, while capacity utilisation has also been rising. This level of employment conditions points to an annual employment growth of around 200k in six months' time. That said, a substantial amount of spare capacity remains in the labour market, which will continue to weigh on wages growth.
- National retail spending has remained at a resilient level. The main contributors to growth in Q3 were "household goods retailing", followed by "cafes, restaurants and takeaway food". "Department stores" was the main detractor. "Household goods retailing" has been a notable outperformer since late 2014, reflecting robust housing activity in NSW and VIC, however this trend is likely to moderate on the back of the expected deceleration in house prices nationally in 2016. The September NAB Online Retail Index accelerated in September (possibly iPhone 6S related), to be up 1.1%m/m in the month. 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, retail business conditions as indicated by the NAB Business Survey are above long-run average levels, although retail confidence has moderated in recent months. A lower AUD should also re-direct spending onshore.
- Dwelling price growth has stabilised somewhat, with the pace of growth easing to 10.1% y/y in October (11% y/y in September) – Sydney continues to see the fastest rate of growth, followed by Melbourne. Dwelling prices are not expected to outpace household income growth indefinitely, and with population growth slowing, scope for further gains is limited. Consequently, forecasts for house price growth in 2016 have been lowered (see link). Housing credit growth accelerated in September, and while this was mostly driven by owner occupier loans, a reclassification of loans has had an impact. The pipeline for new dwelling investment remains large, which means residential construction activity should make a positive contribution to the economy for now, but this is expected to diminish through 2016 and 2017 – residential building approvals have steadily slowed in recent months..
- The outlook for non-mining business investment is a key uncertainty. The NAB Quarterly Business Survey hinted at an improvement in non-mining business investment, although uncertainty around the economic outlook is still keeping many firms on the sidelines. The drag from mining capex, however, is expected to remain significant over the coming 12 months or more – although mining capex tends to be lumpy, meaning some quarters will be more affected than others.
- Aside from the well-known headwinds to commodity exports and markets, there are signs that the lower AUD is supporting exports, particularly in services – tourism exports are improving in net terms and we expect this process to continue going forward.
- Our GDP forecasts are now slightly higher for 2015/16 at 2.6%, largely reflecting the incorporation of a high expected Q3 print based on partial information to date. Growth then recovers gradually to 3.0% in 2016/17, enough to see the unemployment rate ease very gradually through the forecast horizon. The RBA is expected to remain on hold for an extended period, with the first hike pushed out to mid-17. The changed RBA cash rate profile has no immediate implications for our AUD forecasts.

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