# April 2016

# The Bigger Picture – A Global & Australian Economic Perspective

National Australia Bank

***<u>Global</u>: There was an improved tone in global markets this month. While this is welcome news that reduces the risk of a new slowdown in the global economy, sub-trend growth is expected to continue with the pace of global expansion remaining around 3% in 2016. March global business surveys are finally showing a lift in activity but it is too early to be sure that the better performance will be sustained and our tracking models are not pointing to any significant imminent upturn in the pace of expansion.***

- Equity markets in the main northern hemisphere advanced economies have regained around two-thirds of the losses they experienced in the opening 6 weeks of the year. The rising US market has driven much of that price lift; other big markets like Japan and the UK have been weighed down by domestic concerns. Improved market sentiment has also underpinned subsiding financial market volatility with the Vix index back around the low levels recorded through the first half of last year. The falling trend in global commodity markets has also been arrested with some increase in key prices like oil and iron ore. Recent assurances by Chinese policymakers has helped to stabilise the RMB, which along with an end to the downward trend in share prices, has done much to settle sentiment in global markets. Interest rates remain exceptionally low, pulled down by the below target inflation and weak growth in many advanced economies which has driven several central banks to run negative interest rates and asset buying programmes. The US is the only big economy facing imminent rate rises, the others are either still in easing mode or likely to wait a long time before lifting policy rates.
- The major advanced economies have not been very responsive to very low interest rates, a winding back in budgetary retrenchment and lower oil prices. Growth in the G7 group of big advanced economies actually slowed through most of 2015, with little sign of an upturn in early 2016. The increase in spending power for most major advanced economies (which tend to be energy importers) has led to less of an upturn in actual consumption than expected. Business investment has also stayed lacklustre. But while lower oil prices have not delivered as much benefit as expected, they have certainly eroded business investment in the energy sector and that has hit the aggregate numbers. The latest business surveys are consistent with continued modest growth in the big advanced economies, driven by a bounce-back in US activity alongside some disappointing numbers in Western Europe and Japan. The US has been the stand-out performer among the big economies, Canada has been hit by lower energy prices, Japan has struggled to recover from the rise in indirect taxes and Brexit hangs over the UK. Euro-zone growth looks better based, despite a higher euro/$US.
- Chinese growth has continued its slowing trend with industrial growth down to 5.4% yoy in early 2016, a rate last recorded in the 2008 global financial crisis. The big state owned firms have borne the brunt of the slowdown with their output actually falling below year earlier levels in early 2016. Investment growth has settled around 10% with retail sales volume expansion running at a similar pace. Weakness is concentrated in the industrial sector, accounting for around 40% of the Chinese economy, maybe a quarter of global manufacturing and around half of global metal processing. Sales growth has virtually stopped in Chinese industry as falling output prices offset continued volume growth. This absence of growth in sales represents more than just the pass-through of lower commodity input prices, it reflects fierce competition driven by over-capacity that has meant volume growth has often come at the expense of squeezed margins and lower profits.
- Elsewhere among the big emerging economies, India has become the fastest growing big economy and recent central bank rate cuts and other measures should supplement the benefit of lower oil import prices to sustain growth. Brazil (the 7th biggest global economy) is still mired in recession and political uncertainty. Across the rest of East Asia and Latin America growth remains lacklustre and region-wide measures of both industrial output and $US exports are running below year-earlier levels. Export driven economies like Taiwan and Malaysia and commodity reliant nations in the Middle East, Africa and Latin America are the most affected by the sluggish global economic environment.
- The global economic backdrop remains one of very sluggish sub-trend growth, inflation that is below target in major economies, difficulty in increasing revenue as margins are sacrificed to win modest volume gains, slow wage growth cramping spending increases, high levels of debt and central banks that have used up much of their policy ammunition. Despite the many risks, we still think global growth will muddle through 2016 at around the 3% rate seen last year but it could be a bumpy ride with plenty of further scope for volatility, reflecting the numerous triggers for further bouts of market jitters.

***Australia*: Recent business survey outcomes suggest the recovery across the non-mining economy is on track or indeed gathering speed. Overall, our real GDP forecasts are broadly unchanged at 2.7% in 2016, 3.0% in 2017, and easing to 2.5% in 2018 as the large contribution from net exports dissipates. The unemployment rate is forecast to fall to 5.6% by end-16 and 5.5% by end-17 before ticking up in 2018. We retain our view that the RBA will remain on hold through 2016, although this will depend on the path of the currency, inflation and the labour market. Lower than target inflation in conjunction with an AUD above 80 US cents and any evidence of a faltering non-mining recovery would see further rate cut(s).**

- This NAB Business Survey revealed a significant improvement in both business conditions and confidence, suggesting the domestic business environment not only remains favourable but appears to be strengthening further. In March, business conditions jumped to its equal highest value since early 2008, reflecting above-average conditions in most industries. All three components of conditions (trading, profits and employment) improved during the month, with the employment index particularly encouraging (the highest read since mid-2011), and indicative of ongoing labour market strength. Forward indicators were a little mixed. Confidence improved and spare capacity fell, but forwards orders were softer.
- Employment grew modestly in February, but the unemployment rate fell to 5.8% on a lower participation rate. Despite the loss in momentum, this followed exceptionally strong employment in late 2015. Other indicators of labour market health, such as the employment to population rate and the participation rate, continued to suggest solid underlying conditions. While we may see some volatility in the monthly figures, moderate employment growth in trend terms is expected owing to low wages growth and a shift towards labour-intensive jobs. The unemployment rate is forecast to ease to 5.6% by end-16 and 5.5% by end-17, before returning to 5.6% by end-18. Slowing population growth also suggests a slightly lower rate of job creation will be necessary to keep up with population growth.
- Strong employment appeared to support household consumption in H2 2015, despite falling wages growth. Meanwhile, the effects of a "two-speed" Australian economy have become more apparent in retail spending data, with a growing drag from weakness in WA. Retail spending growth in NSW and Victoria, while still positive, also lost some momentum in the first two months of 2016. ABS retail turnover growth for February was flat, consistent with the slowing momentum in the retail sector shown in the monthly NAB Business Survey. Meanwhile, NAB's Online Retail Sales Index for February recorded a 0.8% m/m (10.4% y/y) rise in online spending. The fundamentals for household consumption are mixed amidst solid employment growth but subdued wages. A decline in the household savings ratio remains necessary to satisfy our moderate household consumption forecasts.
- The housing market was once again a mixed bag in March, with prices in the two largest markets (Sydney and Melbourne) diverging. Dwelling prices in Sydney managed to defy our expectation for further softening, while prices in Melbourne fell. Overall, however, price gains in Q1 have been a little better than expected in the context of weakening fundamentals and restraint in investor credit – although uncertainty over Government policy could be a potential explanation. Nevertheless, we have maintained our expectation for property prices to cool in 2016/17, particularly in the apartment market where the supply response has been largest.
- Additional information on non-mining investment has been limited this month, but timely indicators such as the NAB Business Survey suggest reasonable rates of capex growth – albeit softening recently. Levels of capacity utilisation are also reassuring. In contrast, non-residential building approvals have been subdued. Overall, however, we remain hopeful that non-mining investment will improve gradually. On dwelling investment, signs of moderation in the housing market are having flow on effects to residential construction activity. Both housing finance and building approvals have turned lower, driven by a pull-back in investor spending and medium density construction projects (primarily in NSW and Victoria). Nevertheless, the large construction pipeline will continue to drive a positive contribution to growth over 2016, even as the housing market continues to cool.
- After dropping below USD 0.69 in mid-January, the AUD has re-appreciated to over USD 0.75. This can be explained by USD weakness as Fed rate hike expectations have been pared back, some recovery in commodity prices (particularly iron ore), and (perhaps most importantly in our models) an improvement in global risk appetite (as measured by the VIX). We have adjusted our 2016 forecasts slightly to reflect the evident dovish-ness of the Fed, and now see the AUD bottom at around 69 US cents by late 2016, and then picking up very gradually to 73 cents by late 2017.
- Based on incoming information, we have modestly revised our GDP forecasts to 2.7% in 2016 and 3.0% in 2017, followed by an easing to 2.5% in 2018. Our forecast continues to envisage weak domestic demand, and a large contribution from net exports. We continue to expect the RBA to remain on hold for a considerable period. That said, the outlook will depend on how the data fall, with the central bank seemingly allowing itself some room to move.

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