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The Bigger Picture – A Global & Australian Economic Perspective

National Australia Bank

<u>Global</u>: Despite the ups and downs of global financial markets in the first five months of the year, the underlying picture remains one of steady sub-trend growth and sub-target inflation. Neither the business surveys nor the monthly partial data on industrial output and exports show evidence of an imminent acceleration in global growth but the rise in commodity markets off their recent lows and the wealth effects of higher share prices could support activity later this year. Despite the many risks, we still think global growth will muddle through 2016 at around the 3% rate seen last year but there are plenty of economic vulnerabilities that could spark further rounds of market volatility.

- Equity markets have recovered much of the losses from earlier in the year but remain below last year's peaks. This looks consistent with the winding back of the risks of a global slowdown that were causing so much concern around February. In contrast, the falling trend in bond yields across big advanced economies points to expectations of moderate growth at best with little inflationary pressure. Recent currency movements show a partial unwinding of USD appreciation that has weighed on US manufacturing as well as a sharp upturn in the Yen, probably very unwelcome to the Japanese authorities as it dampens both the growth and inflation they are trying to stimulate. The Fed still looks set to lift its policy rate twice again in H2 2016, although the latest disappointing US jobs figures mean July or even September are more likely candidates for the first rise than June. The ECB looks set to wait until much later in the year before it eases further, as it waits to see how much stimulus its March easing is giving to growth and inflation. Japanese growth and inflation remain uncomfortably low for the BoJ – which already has a negative policy deposit rate and a large scale asset buying programme. We expect another round of easing around July, involving further asset buying.
- Growth remained moderate in early 2016 in the big advanced economies. The latest monthly purchasing manager business surveys across the big advanced economies are not pointing to acceleration in growth through the first four months in 2016. Conditions vary between the big economic blocks but volatility in the quarterly GDP data has made it hard to identify a clear trend in their growth. Japanese output fell through the last three quarters of 2015 before picking up in early 2016, but recent indicators and surveys are highlighting areas of weakness. Consequently, the Government has deferred the planned indirect tax rise to October 2019. US growth has also been very lumpy, triggering volatility in the markets. March quarter 2016 saw a disappointing 0.2% quarterly growth rate, but the start of last year was also weak and it was followed by a very big second quarter growth number. After many years of under-performing, Euro-zone growth finally looks set for a sustainable lift with March quarter showing 0.5% growth and positive business survey outcomes in recent months. Investment has been the weak link in advanced economy growth as firms hold off spending. Capital expenditure has only recently risen above its early 2008 level, held back by uncertainty, risk aversion, funding shortages and excess capacity.
- Global growth has been running at around 3% annually and emerging market economies have contributed over 2 percentage points of that expansion in output. Industrial growth has slowed to well below the 5½% trend growth seen in the last 25 years. Trade outcomes have been even weaker with trend exports falling below year-earlier levels through early 2016. Chinese growth has remained solid, supported by policy measures to boost activity, sizeable household income gains boosting consumer spending power and a gradual shift in the drivers of economic expansion. While the outlook is for only a gradual slowing in Chinese growth rates, the use of credit to support activity raises medium term concerns. India has become the fastest growing big global economy with an above expectation growth rate of almost 8% yoy in early 2016. Unfortunately, things may not be as rosy as they seem with questions over the accuracy of the Indian GDP numbers and much weaker outcomes for the partial economic indicators. Despite these concerns, India's economy appears to be growing strongly.
- While the improved tone in global markets 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 and not much better in the out years. With many central banks having already run their policy lending rates down to around zero, policymakers are increasingly turning to less reliable and often untested "unconventional" approaches. Fiscal policy is also constrained given higher debt accumulated during the GFC by many governments. As the scope to use standard macro-economic policy to lift growth or stave off any new downturn has dwindled, agencies like the IMF have become increasingly vocal about the need to lift the pace of economic reform – involving not just further supply side measures to give incentives to produce more but also demand side measures to make sure that the income derived from growth goes to people who will spend it on goods and services, helping drive both activity and inflation higher.

<u>Australia</u>: Real GDP growth picked up to 3.1% y/y in Q1 and is expected to remain at around the 3% mark for the remainder of 2016 and 2017 before easing back to 2½% in 2018. While net exports are providing the largest contribution to growth in real terms, our estimates suggest non-mining activity is outperforming the aggregate economy. The unemployment rate is forecast to fall to around 5½% by late 2016 before ticking up to around 5¾% in 2018. Meanwhile, the weaker terms of trade and low wages growth will continue to challenge national income and government revenue. Low inflation will remain a feature, but we are not persuaded at this stage that further monetary policy easing will be forthcoming.

- This month's NAB Business Survey is still consistent with on-going strong growth in non-mining sectors of the economy. Business conditions remained at levels well above long run average in May (+10 index points vis-à-vis long run average of +5 points). Services are continuing to lead the way, which now includes distributional services such as retail, while manufacturing has pulled back and mining (and related sectors) still look weak. A notable improvement in trading (sales) and profitability kept business conditions at elevated levels, offsetting a relatively disappointing moderation in employment demand. Confidence dropped back further in May, with varied outcomes across industries suggesting only a modest impact from the upcoming election. Other leading indicators are generally positive, with forward orders improving and spare capacity still declining.
- In April, the weakening trend in employment growth (evident since late 2015) continued. That said unemployment has trended lower and then stabilised at around 5.7%. Other indicators of labour market health, such as the employment to population ratio and the participation rate, continue to point to relatively stable underlying conditions. By state, employment growth in trend terms continued to be dominated by the major states on the eastern seaboard, although there are now signs that the recovery in Queensland could be running out of puff. In the coming months, our expectation remains that employment will continue to grow moderately on the back of low wages and a shift towards labour-intensive jobs. The unemployment rate is forecast to ease gradually to 5½% by end-16 and stabilise at around the same level until the end of 2017, before inching up to 5.8% by end-18.
- Household consumption growth in Q1 was relatively resilient at 0.7% q/q despite a rise in the savings rate. The outcome was supported by a solid pickup in household income, despite slowing employment growth. Nevertheless, slowing retail trade growth was evident in April, partly reflecting lower prices (especially for food), but also the weakening trend in the mining states. Against that, our monthly NAB Business Survey suggests a modest improvement in the trading conditions of retailers in May (albeit after weak readings from late 2015). Going forward, the fundamentals for household consumption are mixed with solid employment growth but subdued wages and ongoing consumer caution, while the housing market is expected to cool. Even to satisfy our (moderate) household consumption forecasts requires a decline in the household savings ratio – and hence involves potential downside risks.
- National dwelling price growth has eased from previous highs, but surprisingly has started to pick up again in recent months, especially in Sydney. Despite unexpected recent strength we still believe that the major eastern housing markets will see relatively flat / modest growth in prices as affordability and prudential constraints, as well as the growing supply of housing (especially apartments) begin to bite. That said, better than expected price growth recently in some capital cities suggests upside risk to our near-term price forecasts.
- As expected, the Q1 National Accounts printed yet another weak outcome for business investment, driven by large declines in both building and engineering construction. While the ABS Capex survey suggests that non mining investment intentions remain disappointingly weak, the NAB Business Survey – which has broader industry coverage – has been looking relatively more upbeat (especially in areas such as health and education which are excluded from the ABS series). Also diminished rates of spare capacity are encouraging as is on-going strength in business credit. Accordingly we are more optimistic that non-mining investment will improve. On dwelling investment, the pipeline in apartment construction continues to be substantial, which is expected to fuel strong rates of dwelling investment well into 2017, but will drag on activity from 2018.
- The AUD has recently re-appreciated above 74 US cents after the USD fell on revised expectations for US Fed rate hikes. Despite this, we retain our forecast for the AUD to be around 69 US cents by late 2016, easing to 67 US cents by mid-2017, and then picking up very gradually to 73 cents by end 2018. While there are upside risk to these forecasts, a move towards 80 US cents would not be sustained for long, as it would increase the probability of a further RBA cut.
- Our forecasts for growth are largely unchanged, with real GDP growth forecast at 3% for 2016 and 2017 before slowing to around 2½% in 2018 (more consistent with potential). This growth should see the unemployment rate ebb to 5½% by end-16 and hold steady in 2017 before inching up in 2018. We continue to expect the RBA to remain on hold for a considerable period, although the outlook will depend on how the data fall, particular with regard to the inflation outlook.

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