# July 2016

# The Bigger Picture – A Global & Australian Economic Perspective

***<u>Global</u>*: Brexit, the latest in a series of shocks to global financial markets, leads up to shave our global growth forecasts by 10 to 20 bps in 2016 and 2017. Annual global growth should average around 3% over the forecast horizon, a lacklustre performance that falls well below its long run trend. China, India and the US remain key drivers of growth with softer conditions across Japan and the rest of E Asia, Latin America and W Europe. With little evidence of inflation pressures, central banks can keep interest rates very low by historical standards. The global trading environment for Australian business looks set to remain subdued, but the degree of global softness should be kept in perspective – this is a long flat period for growth as the global economy recovers from the GFC, it is not a recession.**

- The Brexit decision has provided yet another shock to global financial markets. After a big initial reaction, markets are now settling down, while US equities have been buoyed by a likely postponement of Fed tightening and some favourable economic data. Behind these short term ups and downs of daily trading, financial markets are sending signals that are concerning. More advanced economy sovereign bonds are trading at negative yields, hardly a sign of strength for global growth and inflation, while currency movements have not been very helpful. With sub-trend global growth, subdued inflation frequently running below central bank target levels and no shortage of risks hanging over the world economy, central banks look set to err on the side of caution before unwinding their very loose monetary policies. We expect the Fed to delay its next rate hike to the end of the year and follow up with a gradual 3-hike rate increase profile through 2017. The Banks of Japan and England look set to ease rather than tighten policy, initially through higher asset purchases. The European Central Bank is still working through its last (March 2016) easing and looks more likely to ease than tighten its policy.
- Moderate growth continues in the big advanced economies and the business surveys suggest this will remain the case in the near term Many of the results of these surveys were collected prior to the vote for Brexit and probably overstate the degree of optimism now prevailing in business in the EU. Conditions remain mixed between the big advanced economies. Business survey results and partial data indicate that US economic growth remains solid. We do not believe that recent disappointing labour market outcomes mean US growth has slowed noticeably. Euro-zone economic growth was picking up prior to the Brexit vote, while June business surveys showed an upturn in Euro-zone manufacturing combined with the worst service sector outcome for 18 months, suggesting that growth has not ramped up since Q1. The UK economy looks set to experience the worst economic fallout from the Brexit vote with reports of business deferring hiring and investment. We have revised our UK forecasts down heavily in the wake of the referendum and expect to see a shallow technical recession in the UK around the turn of the year. Lower Sterling will help UK export competitiveness but the likely erosion of business confidence will erode investment, outweighing any export gains.
- Global growth has been running at around 3% annually and emerging market economies have contributed over 2 percentage points of that expansion in output. However, industrial growth has slowed in the emerging markets and is tracking well below 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 from manufacturing to services and from fixed investment to consumption. While the outlook is for continued, albeit slowing, Chinese growth rates, the use of credit to support activity raises medium term concerns. China is already a highly indebted economy, especially the business sector, and further increases in an already high debt to GDP ratio raises concerns over just how productive some of this new credit-fuelled spending will be. India has become the fastest growing big global economy, with growth of almost 8% yoy in early 2016. However, doubts linger over the accuracy of the Indian GDP numbers given much weaker outcomes for the partial economic indicators.
- While Brexit should not have much impact on economic activity outside W Europe, the consequences are still enough for us to lower our world growth forecasts by around 10 to 20 bps through 2016 and 2017. The UK economy is predicted to enter recession, but it only accounts for 2.4% of the world economy. The Euro-zone, on the other hand, represents almost 12% of world GDP so any spillover via heightened instability and risk aversion there would have a much greater impact. The global outlook is still one of moderate sub-trend economic expansion at around 3% annually, concentrated in China and India among the emerging markets and the US among the big advanced economies. Inflationary pressures remain very weak in many key economies, allowing central banks to sustain very low policy interest rates and underpinning historically low bond yields. Neither the business surveys nor our global tracking model point to any sustained lift in global growth.

***<u>Australia</u>: Australian real GDP continues to be supported by solid non-mining activity and strong growth in the volume of LNG and services exports. Consistently above-average business conditions in non-mining appear to supporting business confidence (despite Brexit), which is encouraging as we enter a period of political uncertainty. The divergence between mining sectors and geographies is increasingly stark however, with low commodity prices to be an enduring feature. Our real GDP forecasts are 2.9% for both 2016 and 2017 and 2.5% in 2018. The unemployment rate eases to just above 5½% in coming quarters, before inching up. Meanwhile, low wages growth and weak commodity prices are consistent with a subdued inflation outlook and are a testing combination for government revenue, as evidenced by S&P placing Australia's AAA credit rating on negative outlook. Our central case remains for the RBA to hold, although this is data dependant and the central bank is keeping its options open. Brexit will have minimal direct effect given Australia's goods trade has re-oriented to Asia, although services trade and investment flows are larger.***

- Business conditions increased from the already elevated level in June, confirming that the non-mining economy improved further in Q2. The index increased 2 points, to +12 index points in the month, which is around its highest since the GFC and well above the series long-run average of +5. The improvement in conditions was also seen in 7 of the 8 industry groupings included in the Survey, although retail conditions softened. The improvement was driven by notably better employment conditions, and a milder increase in the already elevated profitability index. Trading conditions remained elevated. Business confidence continued to see support from solid conditions in non-mining sectors, rising in the month despite market volatility. Leading indicators generally looked better, including forward orders and capex – although capacity utilisation eased.
- In May, the weakening trend in official employment data evident since late 2015 continued. Meanwhile, the unemployment rate has trended lower and stabilised at around 5.7%, partly driven by lower participation. Aggregate and average hours worked by full-time employees has also declined notably this year, although did rebound in May. Meanwhile, growth in part-time jobs has been relatively more resilient. By state, NSW and VIC continued to dominate employment growth in trend terms, with Queensland showing greater signs of weakness. We expect moderate employment growth in coming months on the back of low wages and a shift towards labour-intensive jobs. The unemployment rate is forecast to ease to 5.6% by end-16 before inching up to 5.7% by end-17 and 5.8% by end-18.
- Household consumption growth had been resilient despite slowing employment growth, largely driven by spending on essentials: food, rent and insurance and financial services - which points to continuing consumer caution. Meanwhile, high-frequency data is mixed, with most indicators (including the NAB Business Survey) showing an easing trend in overall retail spending (more than one-third of consumption). However, NAB's latest Online Retail Sales Index showed that growth rebounded in May. We continue to expect moderate growth in consumer spending through 2016 and 2017, supported by a broadening recovery of the non-mining sector, low interest rates and further easing in household savings rate. There has been a general improvement in consumer confidence, although it is unclear whether it will be sustained amidst the federal election and financial market volatility following Brexit.
- National dwelling prices (hedonic) continued their rise in June, although some of the strength seems to reflect adjustments made for the quality of houses hitting the market. Prices have surprised on the upside, supported by the recent RBA cut and solid population growth in NSW and Victoria, prompting us to revise up our forecasts for prices growth in 2016. However, we still believe that the major eastern housing markets will see relatively flat / modest growth in prices into 2017 as affordability and prudential constraints, as well as the growing supply of housing (especially apartments) begin to bite.
- There has been limited data following the disappointingly soft outcome for business investment in Q1. Non-residential building approvals suggest building capex has been modest, but the NAB Business Survey is suggesting reasonable rates of capex growth, regaining momentum in recent months. Levels of capacity utilisation are also reassuring, suggesting that firms may be more encouraged to invest in capital to expand operations, while business credit growth has been solid. Accordingly we are still optimistic that non-mining investment will improve. The effect of Brexit is uncertain, but is expected to be minimal. On dwelling investment, the pipeline in apartment construction remains substantial, and will fuel strong rates of dwelling investment well into 2017, but will drag on activity from 2018.
- Following volatility post the Brexit vote, the AUD settled at 74 US cents, but has since surged to 76 cents following the surge in equity markets and the strong NAB monthly business survey. Our AUD forecasts have changed slightly, with the AUD/USD holding at or above 0.70 through year-end (0.69 previously), aided by the change in view on Fed tightening (above). Meanwhile, even with commodity prices stabilising, the outlook for income growth and government revenue meanwhile remains challenging, with S&P placing Australia's AAA credit rating on negative outlook. S&P has given the government of the day 6 to 12 months to pass savings and expenditure measures.

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