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The Bigger Picture – A Global & Australian Economic Perspective

National Australia Bank

<u>Global</u>: Brexit has had less impact on the global economy than many feared. Financial markets are generally either back to pre-referendum levels or even stronger, and the direct economic fall-out looks like being largely restricted to a UK recession and modest spill-over to European trading partners. Having dodged yet another bullet, the global economic upturn continues along at its sub-trend pace with only a few inconclusive signs that things are finally about to get better. We have marked down our US forecasts in the wake of disappointing second quarter data but East Asia is doing slightly better and the outcome is 2016 forecast global growth stays at 2.8%. Inflation generally remains sub-target, central banks have used up much of their policy ammunition (although very unorthodox measures like "helicopter money" remain) and the structural factors that have weighed on global growth remain. China and India are driving more than half of global growth, the former by returning to time-honoured pump priming measures that pile up debt and the latter by printing statistics that many view as erring on the side of optimism in measuring GDP.

- Global financial markets have digested the latest shock – the UK's "Brexit" vote – quite well. Equity markets fell in the big advanced economies initially in the wake of the Brexit vote, but are back above their pre-referendum level. Market volatility spiked as the unexpected poll outcome became clear but it soon subsided and is now not only below pre-referendum levels but is very low by historical standards. Interest rates are also exceptionally low with negative Government long bond rates and either very low or negative central bank policy rates in several key economies. Corporate bond spreads have fallen below pre-Brexit levels in the US and UK. Bank lending surveys do not point to much impact of Brexit outside the UK either. Central bank policy has tended to disappoint those looking for quick action to either address deflation and/or slow growth risks (in the Euro, Japan and UK) or move the US further along on its much anticipated rate tightening cycle. The Bank of Japan's monetary easing measures disappointed the market, the ECB preferred to wait and see how its last raft of asset buying fared. The Bank of England has cut rates but will need to move again and the Fed will not raise rates until December.
- Global growth remains sub-trend and moderate, but there are a few brighter signs. Although the monthly data bounces around, the pace of growth in the CPB's measure of world industrial output has picked up slightly, following a soft March quarter. Production in the Asian emerging market economies – who buy the bulk of Australia's exports - has been looking less subdued. Export volumes from the emerging markets have also been climbing out of a particularly soft patch whereas exports from advanced economies remain very weak.
- We track industrial growth across a large sample of big economies and some data is available up to June. This data confirms that industrial growth, while still subdued by historical standards, has been gradually rising since the start of the year. Industrial output growth in the 3 months to January was only 0.6% yoy, by June it was up to 1¼% yoy – far from strong and well below its long-run annual average of around 3%, but better than it was.
- The monthly business surveys are also consistent with ongoing moderate growth. Purchasing manager surveys for the big advanced economies show July readings not far off those in June, despite a big post-Brexit hit to UK business sentiment. Activity was better maintained in services than in manufacturing in the big advanced economies and the former is by far the biggest sector in these economies. Turning to the big emerging markets, latest Chinese business reports are consistent with unchanged growth but they point to slightly more optimism for the future. Indian surveys remain little changed and well below what would be expected in such a fast growing economy. Taken overall, the surveys suggest global growth staying around its moderate pace.
- Growth in the big S. Hemisphere commodity exporters has been hard hit by the weak primary product prices that stem from subdued global growth and supply growth. Recent $US weakness has helped lift some commodity markets and their $US export receipts are stabilising.
- Our view of the world economy has not changed. There have been downward revisions to US data as well weaker than expected second quarter US economic numbers, reflecting the way that US firms met demand by running down stocks. We expect this to be only a temporary disappointment with growth running around 2% through the next couple of years. Nevertheless, the low second quarter reading still contributes to a cut in our 2016 US growth forecast from 1.8% to 1.5%. We have also cut our Euro-zone numbers for 2017 as the predicted UK recession hits demand for their exports and rising populist sentiment delays investment plans. East Asian emerging market growth is looking a little stronger.

<u>Australia</u>: Australian economic growth is expected to remain resilient at 2.9% in 2016 and 2017, despite significant variation across industries and states. However the risks to the outlook going into 2018 are becoming increasingly apparent, as LNG exports flatten off at a high level and the dwelling construction cycle turns down. Against these headwinds, the economy may require additional policy action to support growth, especially if the RBA hopes to see inflation return to within its 2-3% target band. We now expect the RBA will see the need to provide further support through two more 25bp cuts in May and August 2017 (to a new low of 1%), which should be enough to stabilise the unemployment rate at just over 5½% and prevent economic growth from dropping below our forecast of 2.6% in 2018. Monetary policy deliberations may then turn to the possible use of non-conventional policy measures if the outlook deteriorates further. Additionally, persistent weakness in CPI inflation could potentially trigger a rate cut even sooner than expected.

- Business sentiment has shown great resilience to external shocks in the July NAB Monthly Business Survey, with firms choosing to remain focussed on the positive trends within their own business. The business confidence index remained positive, despite easing slightly. Business conditions dropped back as well, but are still at an elevated level that is well above the long run average. While trading conditions and profitability have been the main driver of elevated business conditions, both of these contributed to the deterioration during the month. Encouragingly, the employment component managed to hold onto the gains seen in June, suggesting ongoing employment growth. Inflation measures in the Survey generally stayed soft, although there was a surprise spike in retail prices. Leading indicators were mixed, with forward orders a little softer but spare capacity was down.
- Employment growth for June was moderate (7.9k), although there was a notable detraction from sample rotation effects. The moderate increase and a rise in the participation rate saw the unemployment rate edge up modestly to 5.8%. Additionally, average hours worked continued to trend lower, pointing to a build-up of spare capacity. By state, labour market conditions remain mixed, with further evidence that mining states are lagging further behind. Forward indicators are generally quite positive. The employment index from the June NAB Survey was consistent with employment gains (of 18k per month) in the next six months. In light of our forecasts for economic growth, and subdued wages growth, we expect the unemployment rate to stabilise at around 5.6% from end-17.
- Overall, household spending has been holding up relatively well, despite the recent slowdown in employment growth and low wages growth. That said, higher frequency data such as retail sales, our monthly NAB Online Retail Index and NAB Business Survey have lost some momentum. While soft wages growth will remain a constraint, we continue to expect reasonably resilient household consumption growth in coming quarters, supported by the recent RBA rate cut (albeit only partially passed on by banks) and resilient house prices, especially in Sydney and Melbourne.
- National dwelling prices (hedonic) continued their rise in July, although recent strength reflects adjustments made for the quality of houses hitting the market. Prices may continue to see support in the near term from the recent RBA rate cut and solid population growth in NSW and Victoria. However, we still believe that the major eastern housing markets will see relatively flat / modest growth in prices into 2017 as affordability, slowing rents and prudential constraints, as well as the growing supply of housing (especially apartments) begin to bite.
- Lower interest rates, less spare capacity and positive business confidence should all lend support to non-mining business investment, which was relatively lacklustre in Q1 2016. Indeed, the NAB Survey is showing good rates of non-mining capex activity and future capex plans. Also, growth in business credit has steadily improved in the last two years, although it appears to have lost momentum in the past two months. Other indicators suggest a more mixed outlook for business investment. The value of non-residential building approvals has not been very responsive to interest rate cuts, although the trend has started to improve modestly. We remain optimistic that non-mining investment will improve, albeit gradually. 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.
- New shipments of LNG and fewer supply disruptions should boost export figures from July onwards. However, depressed LNG prices threaten the export outlook. Other commodity prices have risen over the month to be well above the low levels at the turn of the year. Meanwhile, the lower AUD and rising wealth in Asia continue to support short term visitor arrivals and international student enrolments.
- With inflation forecasts still very low and the RBA showing its hand as a committed inflation targeter, it is seemingly less worried reducing its valuable monetary policy ammunition than we thought. We now expect two cuts of 25bps in May and August 2017 – although persistent weakness in CPI inflation could trigger a rate cut sooner. By that time, the RBA will be looking towards 2018, for which our forecasts also suggest some loss of momentum in economic activity (although the RBA's forecasts are more optimistic for now). Our forecast for more aggressive easing next year than priced in the market provides a counter to other upside AUD risks. This leaves us comfortable maintaining our existing AUD forecasts, with AUD/USD falling to just below 70 cents in H2 2017 before gradually recovering.

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