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The Bigger Picture – A Global & Australian Economic Perspective

<u>Global</u>: Business surveys and measures tracking the volume of activity suggest that the global economic upturn lifted a notch toward the end of last year and that trend seems to have continued into early 2017. After years of worrying about sub-target inflation or deflation, there are finally a few signs that price pressures are returning, but only mildly. Having worked for years to generate this upturn, the authorities should be reluctant to nip it in the bud and avoid tough budgetary measures or premature monetary tightening. We expect a moderate upturn in global growth that takes it back to its long-term trend level by 2018. China and India are still big drivers of global growth but there is also an important forecast lift in the US as President Trump's fiscal agenda is pursued. One big risk hanging over this predicted upturn is that political events and policy U-turns see markets turn risk averse and business confidence erode.

- After spending years worrying about how to lift sluggish economic growth and ward off deflation, central banks in the big advanced economies seem to have gone about as far as they plan to in easing their monetary policy. Equity markets, bond yields and some commodity prices have moved higher, symptoms of better economic times, and market volatility is very low. Policy interest rates are near zero or negative, central banks have bought huge stocks of bonds and we seem well past the peak in monetary easing. The US Federal Reserve and the Bank of England appear unlikely to further increase existing targets for asset stocks, the European Central Bank plans to cut its monthly asset buying from €80 billion to €60 billion from April and the Bank of Japan has kept the same rate of asset buying since mid-2016.
- While the pace of world economic growth remains moderate, after several false dawns the evidence is accumulating that conditions are finally improving. Global industrial output growth picked up toward the end of last year, while business surveys confirm the pick-up in industrial activity in the big advanced economies continued into the New Year with January delivering the highest reading on activity since the middle of 2011. This strength is quite broad-based with January showing the strongest reading for US and UK manufacturing since late 2014 and mid-2014 respectively, the biggest improvement in Japanese industrial operating conditions for three years and the best outcomes for Euro-zone industry for almost six years. World trade has also turned up, after a number of very weak years as have trade prices – linked to the resurgence in producer price inflation which, in turn, reflects the upturn in global commodity prices.
- While recent trends in industrial output and trade confirm that the upturn in the business surveys is flowing into increased manufacturing activity, the overall pace of growth remains only moderate across the big advanced economies. While output growth remains modest, it has been sufficient to lower unemployment rates across the big economies and that tightening in labour market conditions seems to be producing an increase, albeit modest, in wage growth. Tighter labour markets have generally delivered smaller wage gains than historical experience suggested likely and, as a result, central banks have revised down their views of the jobless rates consistent with running acceptable rates of inflation. While growth in the big advanced economies has finally improved, risks focus on the way that marked political changes can prompt U-turns in economic policy, unsettling business confidence and curbing growth. Markets are already digesting the uncertainty caused by the Brexit and President Trump's trade and tax policies and there are a series of important elections this year.
- The late-2016 upturn in trade and industry in the big advanced economies was much less evident for the emerging market economies. Emerging market growth has been held back by the sluggish performance of world trade and the income losses that earlier falls in primary product prices imposed on commodity exporting countries. However, the situation has improved for these trade and commodity reliant economies more recently. World trade volumes are growing again, albeit modestly, and commodity prices have risen off their early 2016 lows. The outcome has been a reinjection of income into commodity exporters like Brazil and South Africa – but at the cost of big commodity importers like India and China – and a better trading environment for places like Taiwan or Malaysia.
- We expect global growth to accelerate modestly from just under 3% in 2016 to 3.2% in 2017 and 3.4% in 2018. This is still only a moderate pace of growth around the average of the last 35 years, but it is better than we have seen in the last couple of years. The main risk hanging over this projected upturn is sharp changes in economic policy unsettling financial markets and eroding business confidence and this comes down to politics.

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<u>Australia</u>: A recent upturn in partial indicators suggests economic activity is likely to be solid as we enter 2017. Real GDP in Q4 2016 is likely to print at a strong 0.9%q/q, following the 0.5% q/q contraction in Q3. Momentum is expected to remain solid through 2017, which will keep the RBA on the sidelines this year – we no longer expect mid-year rate cuts. We do however remain concerned about the economy's trajectory in 2018, as the contribution from residential construction, LNG exports and temporarily higher commodity prices fade and household consumption remains constrained by weak labour income growth. We now expect a 25 basis point cut to the RBA's cash rate in November 2017 to 1.25% - necessary to help prevent the unemployment rate from rising and underlying inflation from undershooting the bottom of the target in 2018.

- The January NAB Monthly Business Survey was much more encouraging in regard to both business activity and firms' investment behaviour in January. That said, there is a confluence of seasonal factors influencing the result, suggesting outcomes over coming months need to be monitored closely. Business conditions jumped for the second straight month, hitting multi-year highs that are well above the long-run average. Business confidence also improved markedly in January, spurred on by the financial market enthusiasm since late last year.
- Employment growth performed slightly above consensus in January (up 13.5k vs expectations of 10k), while a fall in the participation rate saw the unemployment rate drop by 0.1% to 5.7%. Volatility in monthly full-time and part-time jobs of -44.9k and +58.3k respectively warrant some caution against reading too much into data, but a pick-up in overall employment over the past three months is a welcome development. That said, trend employment growth in the non-mining states is still subdued, with the continuous easing in NSW of particular concern. Leading indicators of the labour market such as the employment index of the NAB business survey and job advertisements point to strengthening employment growth over the first half of 2017, although it is unclear whether this will be accompanied by lower unemployment given additions to labour supply. Going forward, we expect the unemployment rate to remain broadly unchanged near 5¾%.
- According to the latest data, household spending activity has been mixed at the national level, with momentum in the large eastern states easing – likely reflecting the recent moderation in labour market conditions more generally. Recent partial indicators were mostly subdued. The latest ABS retail trade data showed a small contraction in retail turnover in December, although this could partly reflect the one-off effects of the Masters hardware liquidation in the quarter. Meanwhile, retail trade in volume terms for the December quarter recorded a stronger result of 0.9%q/q, indicating the presence of significant price discounting. Going forward, household consumption is expected to grow only moderately, constrained by subdued wages growth and high household leverage.
- In terms of the timely indicators of business investment, the value of non-residential building approvals suggest relatively subdued activity going into late 2016, although there were some signs of life emerging last year in commercial building approvals – particularly approvals in retail/wholesale, offices and transport. That said, very weak business conditions in retail may constrain further construction activity for that segment in the near-term. Meanwhile, imports of capital goods have also weakened slightly in recent months (suggesting less investment). In terms of the outlook, expectations from the NAB Quarterly Business Survey (12-months ahead) have held up much better than other indicators, and suggest the loss of momentum in non-mining investment should be temporary. In contrast, the ABS Private Capital Expenditure Survey points to a very weak outlook.
- On dwelling investment, the pipeline of residential construction remains at record levels (largely driven by apartments), but there are signs that the contribution of dwelling investment to growth may soon peak – although we will likely see a rebound from the weather affected slowdown of Q3 2016. New medium-density approvals have come off sharply from their highs, although they are still at elevated levels and appear to have stabilised somewhat in recent months.
- Net exports are expected to detract from GDP growth slightly in Q4 2016. Despite sharply higher export prices, export volumes only rose moderately, while imports rose more strongly, resulting in a small contraction in net exports in the quarter. In 2017, net exports are expected to contribute significantly to economic growth on the back of higher LNG exports, but will wind-back in 2018. Higher bulk commodities and base metals prices have boosted the terms of trade and government revenues considerably. The terms of trade are expected to peak in Q1 2017, before declining thereafter, but are expected to remain above their recent trough.
- The RBA's latest Statement on Monetary Policy suggested the central bank remains relaxed about the state of the economy at present, and is very much in wait and see mode. That said, we remain more concerned about the economic outlook in 2018, and suggest that the RBA will be forced to cut later in 2017 as this impending softening becomes more apparent to the central bank. As such, while we no longer expect two cuts to the cash rate mid-year, we do expect one further 25bp cut to the cash rate in November 2017, taking it down to 1.25%. We continue to expect the AUD to depreciate through 2017 to a low of AUD/USD 0.70 in line with further anticipated USD strength and key commodity prices retracing.

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