

AUSTRALIAN MARKETS WEEKLY

Budget preview



In this issue

Budget Preview	1
The past week	4
This week	4
Calendar of economic releases	5
Forecasts	6

- The Federal Budget is just eight sleeps away! We expect an underlying cash balance of \$23-25bn in 2017-18, some \$4-6bn better than predicted at the Mid-Year Budget review (MYEFO).
- The Government is likely to continue to focus on gradual improvement in the balance, so as to build fiscal flexibility, maintain the AAA credit rating (which we think is unlikely to be affected after this Budget) and not upset the recovery.
- The global economic backdrop is improving which will be helpful. Most focus/debate is likely to be over the extent to which the government assumes wages growth and consumption will strengthen, given current low wages growth. The Treasurer has already re-committed to using conservative commodity price assumptions, which is good practice and delivered an upside surprise last year in place of the downside surprises that have been commonplace in the past 4-5 years.
- Three initiatives likely in this budget are: (i) a Housing Affordability package; (ii) an increased focus on the Net Operating Balance (which compares recurrent expenditures and revenues); and (iii) a related categorization of debt into good and bad debt, the latter designed to highlight that borrowing is OK for infrastructure and productivity-enhancing purposes, but not for day-to-day spending.
- It's also quite likely that the Government will announce or foreshadow increased infrastructure spending (eg Sydney's Second Airport, the Inland Rail project), some of which may be "off-budget". Ratings agencies will likely continue to focus on general government sector debt when considering Australia's AAA rating, not government business enterprises, such as the NBN.
- Markets last week were most influenced by Australia's low CPI and President Trump's tax plans (equities up, no change in interest rates in Australia in the next year priced and the \$A a bit weaker as a result of the latter).
- Locally this week it's all about the RBA (Board Meeting Tuesday – no change expected); Speech by the Governor on Household Debt, Housing Prices and Resilience on Wednesday (this will be important); and the May Statement on Monetary Policy on Friday (little change to CPI forecasts expected; GDP forecasts to be impacted by Cyclone Debbie, but not in a policy-significant way. More favourable global backdrop likely to be highlighted).
- Offshore, there is a raft of US data and events, with an FOMC meeting expected to see no change in US rates announced early on Thursday morning Australian time. NAB sees the next US rate hike in June and continues to see the market as underpricing the extent of US rate hikes over the next couple of years. Updates on how well the US economy is travelling will be provided by the important ISM (Mon), Non-Manufacturing ISM (Wed) and Non-Farm Payrolls on Friday. Tonight sees an update on how close to the Fed's mandate US inflation is getting, with the PCE deflator.

To contact NAB's market experts, please click on one of the following links:

[Ask the Economists](#)

[Ask the FX Strategists](#)

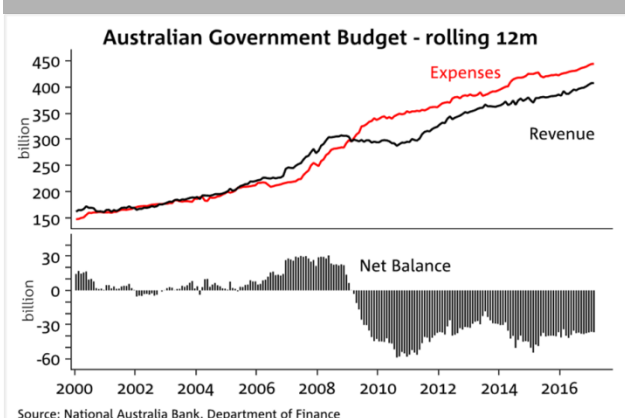
[Ask the Interest Rate Strategists](#)

Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7484	-1.1	RBA cash	1.50	0
AUD/CNY	5.16	-1.1	3y swap	1.99	-2
AUD/JPY	83.6	0.1	ASX 200	5,941	1.5
AUD/EUR	0.687	-1.6	Iron ore	68.8	0.9
AUD/NZD	1.091	1.2	WTI oil	49.2	0.0

Source: Bloomberg

Chart of the week: spending faster than revenue



Budget preview: good vs bad debt

The 2017-18 Federal Budget will be handed down at 7.30pm on Tuesday 9th May. This week will likely see further budget measures revealed in the press as has become practice in recent years. The broad parameters and some of the main measures seem clear and were strongly hinted at in Treasurer Scott Morrison’s [Speech to the Australian Business Economists](#) last Thursday:

- The government will continue to focus on improving Australia’s budget position to provide policy flexibility for the next inevitable downturn in the economy. A forecast for a return to budget surplus in 2020-21 will be maintained, the intention of which is to preserve Australia’s AAA credit rating. Treasurer Morrison also hinted that the budget is travelling a little bit better than expected at the MYEFO revision in December. As shown in the chart of the week, the main challenge for the Government remains to restrain the growth rate of government spending, until revenue growth recovers more strongly (in the short-term) and to place government spending growth on a more sustainable footing in the medium term, to deal with the ageing population pressures on the budget;
- The Budget will contain a special focus on Housing Affordability, which has become a hot political topic in recent times as house prices in many (but not all) parts of Australia have continued to rise strongly. The Government is also seeking to create a distinct political choice with the Opposition, which favours restricting negative gearing to newly constructed dwellings and dropping the capital gains tax discount from 50% to 25%. Measures that might be announced in the budget include allowing first-home buyers temporary access to some of their superannuation for a deposit and/or salary-sacrifice savings accounts to save for home deposits. It’s also possible that there may be some pension limit exemptions for retirees that downsize;
- The Budget papers will contain an increased focus on the Net Operating Balance (a recurrent expenditure less recurrent revenue measure of the budget balance). The Treasurer made clear in his ABE speech that the Government should not be borrowing for day-to-day expenditures (represented by the Net Operating Balance), but that borrowing is appropriate for longer-term capital expenditure needs that either provide infrastructure and/or productivity enhancements (implicitly the difference between the underlying cash balance and the net operating balance).
- Budget debt related to net operating deficits will be considered and classified as “bad debt”, while debt related to capital expenditure/infrastructure will be considered “good debt”. It is hoped that the additional focus on recurrent expenditure – and the allocation of debt to ministers’ portfolios – will result in further restraint in government recurrent expenditure, which is a development that no doubt will be welcomed by economists. There will rightly be some debate about whether all “good debt” will turn out to be “good” in practice, with the inland rail project between Melbourne and Brisbane already attracting some criticism in the press. In reality,

economists won’t oppose this classification/development significantly as most believe in the concept of borrowing for infrastructure/capital. It’s also possible however, that some of the major new infrastructure projects (eg Sydney’s second airport at Badgery’s Creek, the Inland Railway) may be “off-budget” for budget balance and debt purposes (as the National Broadband Network is). This would allow the Government to increase infrastructure spending, while at the same time continuing to improve the budget balance and maintaining Australia’s AAA credit rating. Importantly, the ratings agencies are likely not to distinguish between good and bad debt, but continue to analyse the credit rating on the basis of debt of the general government sector (which excludes the debt of government-owned corporations).

For reference, the High Priority and Priority Infrastructure projects listed on Infrastructure Australia’s website, some of which may be announced on budget night, are shown in Tables 1 and 2 below.

Table 1: Infrastructure Australia High Priority Projects

Proposed project	Location	Problem description
M4 Motorway upgrade (Parramatta to Lapstone)	NSW	Connectivity in outer western Sydney
WestConnex	NSW	Sydney inner west road congestion
Melbourne Metro Rail	Vic	Melbourne rail network capacity
M80 Ring Road upgrade	Vic	Melbourne M80 Western Ring Road congestion
Ipswich Motorway Rocklea-Darra Stage 1c	Qld	Southern Brisbane-Ipswich road network capacity
Western Sydney Airport	NSW	Sydney aviation capacity
Perth Freight Link	WA	Perth freight network capacity

Table 2: Infrastructure Australia Priority Projects

Proposed project	Location	Problem description
	Qld	Road network capacity Brisbane-Gold Coast
The Northern Road Upgrade	NSW	Access to south-west Sydney growth area and construction access to Western Sydney Airport
Bringelly Road Upgrade Stage 2	NSW	Access to south-west Sydney growth area and construction access to Western Sydney Airport
Murray Basin Rail Project	Vic	Freight rail connection between north-west Victoria and the ports of Geelong and Portland
Bruce Highway Upgrade – Cooroy to Curra Section C	Qld	Road network capacity Wide Bay-Burnett region
Bruce Highway Upgrade – Mackay Ring Road Stage 1	Qld	Road network capacity Mackay region
	Qld	M1 Pacific Motorway capacity
Adelaide – Taree/ra Rail Upgrade Acceleration	SA	Rail reliability and axle loadings on the interstate rail network
Inland Rail (Melbourne to Brisbane via inland NSW)	National	Freight connectivity Melbourne-Brisbane
Eyre Infrastructure Project (Iron Road)	SA	Eyre Peninsula freight capacity
Hobart Science and Technology Precinct	Tas	Opportunity to stimulate economic growth and productivity in Tasmania

The economic backdrop

The Treasurer’s speech also revealed that the Budget will be framed with a more positive global economic backdrop than has been the case for some years, with the IMF upgrading its global growth forecasts in recent times and the US, Europe, Japan and China all experiencing better business conditions over the past six months. The Treasurer is also more optimistic about the Australian growth outlook: “growth in the Australian economy is expected to strengthen in coming years as the detraction from mining investment eases and as

growth in household consumption and non-mining business investment improves”.

The main debates economists will have over this broad characterisation of growth will likely be:

- The global debate as to whether to believe the soft data (such as much improved business surveys) or the hard data (which have not been as strong as the soft data have suggested in recent times); and
- the extent to which Australian consumption growth can be assumed to strengthen given the current slow rate of wages growth in Australia.

These debates always tend to be present at turning points, which recent developments in the global economy increasingly look like. The Government has noted that modest wages growth remains a challenge, but seems likely to forecast somewhat stronger wages and employment growth on the back of some improvement in labour market indicators in recent months.

Table 3 shows NAB’s current economic forecasts compared to those that were contained in MYEFO, which was released in December.

The Government is likely to feel confident with its improving forecast for world GDP (with perhaps some possibility of forecasting a 3.5% growth rate for 2017-18). Domestic GDP growth seems likely to be around the 3.25% mark, in part because of a weaker than expected 2016-17 – since the MYEFO update - which is in turn partially due to the impact of Cyclone Debbie, which may subtract around 0.25 percentage points from growth in the June quarter.

The Budget will likely benefit a little both this year and next year from stronger nominal GDP growth associated with higher commodity prices, though NAB expects much of these benefits to be temporary as commodity prices are not expected to be sustained at these higher prices. Encouragingly, the government has again signalled that it will take a conservative approach to its commodity price assumptions, wanting to be surprised on the upside (as has occurred this year) rather than the downside (as occurred in the years after the terms of trade peaked).

Table 3: MYEFO vs NAB Economic Forecasts

Table: Economic Assumptions						
	2016-17			2017-18		
	Budget May '16	MYEFO Dec-16	NAB Apr-17	Budget May '16	MYEFO Dec-16	NAB Apr-17
Economic						
Real GDP	2.50	2.00	1.80	3.00	2.75	3.20
Employment	1.75	1.25	1.10	1.75	1.50	1.50
Unemployment Rate	5.50	5.50	5.80	5.50	5.50	5.70
Inflation (CPI)	2.00	1.75	2.50	2.25	2.00	2.10
Wages (WPI)	2.50	2.25	1.80	2.75	2.50	1.70
Nominal GDP	4.25	5.75	6.10	5.00	3.75	4.80
World GDP (**)	3.25	3.00	3.00	3.50	3.25	3.30
Commodity Prices*/Financials			(***)			
Iron Ore	55	55	72	--	--	60
Coking Coal	91	120	168	--	--	105
Thermal Coal	52	62	81	--	--	65
10 year bond rate			2.8			3.2

(*) Long-run assumption. (**) Cal. years, 2016, 2017. (***) YTD average, spot. Current prices (27 Apr '17): \$66.60, \$260.5, and \$83.8 for iron ore, coking and thermal coal. Sources: Budget papers, NAB

The major difference from NAB’s forecasts is likely to be on the unemployment rate, where the government is

likely to continue to forecast a decline in the unemployment rate to around 5.5%. NAB’s forecast is for a relatively stable unemployment rate around 5.75%. Recent official data suggest the rate is even higher than this, however leading indicators such as the NAB Business Survey’s questions on Employment, Capacity Utilisation and Difficulty Finding Suitable Labour and Seek job ads all suggest the unemployment rate is not currently deteriorating and might even be improving slightly.

The budget challenge and numbers

The chart of the week highlights that the main challenge that continues to face the government remains some combination of slowing the growth rate of expenditure at the same time as increasing the growth rate of revenues. Both of these have proven something of a challenge politically in recent times, though the Treasurer has noted that some \$25bn of cumulative budget savings have been passed since the election, notwithstanding the less favourable position in the Upper House.

Apart from the political challenge in placing the budget on a more sustainable footing, the government has also faced the economic challenge of not cutting too aggressively in the short term and hence impacting the recovery of the economy. And in the out-years, the Budget is likely to have to fund the remainder of the government’s planned tax cuts for larger businesses as this legislation is to be reintroduced to Parliament after the Budget is brought down. With US President Trump signalling he will reduce the US corporate tax rate to 15% - and the UK already having proposed a further cut in their already very low 19% corporate tax rate to 17% from 2020 – there is therefore likely to be increased pressure for reduction in Australia’s corporate tax rate, which is currently 30% for large businesses.

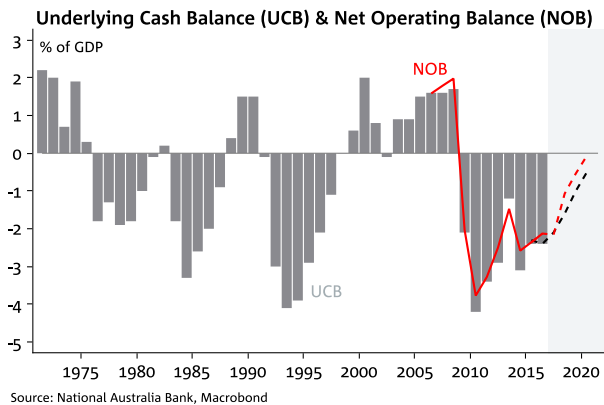
Table 4 presents NAB’s expectation for the Underlying Cash Balance measure of the budget for 2017-18, which is expected to be around \$4-6bn better at around \$23-25bn than at the time of the MYEFO in December last year. Apportioning the forecast improvement in the UCB to the Government’s previously released Net Operating Balance measure, suggests a NOB surplus is likely to be predicted, perhaps as early as 2019-20. As Chart 2 shows, the difference between the NOB and the UCB is not especially large at the current time.

Table 4: Underlying Cash Balance Forecast

Table: Underlying cash balance						
	2016-17			2017-18		
	Budget May '16	MYEFO Dec-16	NAB Apr-17	Budget May '16	MYEFO Dec-16	NAB Apr-17
\$A bn	-37.1	-36.5	-34	-26.1	-28.7	-23
(% of GDP)	-2.4	-2.1	-2.0	-1.4	-1.6	-1.3

Sources: Budget papers, NAB

Chart 2: Underlying Cash vs Net Operating Balance



The bottom line seems to be that the Government will continue to seek (and forecast) gradual improvement in the budget situation across time, so as to build policy flexibility, while attempting to maintain Australia's AAA credit rating. The latter seems likely, given the economic backdrop at this time.

The past week

Last week's key event from an Australian perspective was the release of the Q1 CPI. Importantly, while another low quarterly CPI resulted (dragged down by weak inflation readings in the mining-state capitals), the result was at or higher than the RBA's expectations and so will not result in any downgrade to the Bank's forecasts in this week's Statement on Monetary Policy. This is a far cry from the Q1 CPI result of 2016, when the Bank became concerned that inflation was in danger of becoming too low, though in part this reflected global concerns of deflation.

In markets, the low CPI outcome cemented the view that the RBA was unlikely to be changing interest rates any time soon (no change to the official cash rate is effectively priced for the next year, with gradual pricing for a single hike by the end of 2018). The low CPI saw the \$A lose ground, trading down to the US\$0.7450-0.75

region. The equity market continued to advance, this week buoyed by President Trump's announcement that the US company tax rate will be reduced from 35% to 15%.

This week

The main domestic focus this week will be RBA-related: (i) the May Board meeting tomorrow – where no change is unanimously expected; (ii) Governor Lowe's speech at 1.10pm on Wednesday: "Household Debt, Housing Prices and Resilience". This could be the most interesting RBA action of the week as it should clarify once and for all the possibility of the RBA using interest rates to calm the housing market as some have suggested. We think this unlikely while unemployment remains somewhat elevated and inflation below target; and (iii) the May Statement on Monetary Policy on Friday, which will include update economic and inflation forecasts. With the headline CPI at expectations and core inflation at or marginally above the Bank's forecast, we see little change to the inflation forecast. There may be slight but non important changes to the Bank's GDP forecasts to reflect the impact of Cyclone Debbie.

It's also a big week of offshore events, especially in the US, with the important Manufacturing ISM (Monday), ADP and Non-Manufacturing (Wednesday), the latest FOMC interest rate decision Thursday morning Australian time (no change expected – NAB looks for the next US hike in June and continues to think the market is underpricing the risk of US rate hikes over the next two years). The week ends with the all-important non-farm payrolls figure on Friday. After a weak March result, the expectation is that payrolls will have bounced back to around the 200,000 mark, a figure that is big enough to reduce the US unemployment rate across time. There should continue to be focus on US wages – as reflected in payrolls' hourly earnings data, which as yet has not shown as much momentum as one might expect given the lowering in US unemployment. That likely lies ahead.

For full details please see our *What to Watch* publication (please email Tapas.Strickland@nab.com.au if you would like to subscribe to this publication).

CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
Sunday, 30 April 2017								
CH	Manufacturing PMI	Apr		51.7		51.8	2.00	11.00
CH	Non-manufacturing PMI	Apr				55.1	2.00	11.00
Monday, 1 May 2017								
<i>UK/EC May Day holiday</i>								
AU	AiG Perf of Mfg Index	Apr				57.5	0.30	9.30
AU	CoreLogic House Px MoM	Apr				1.4	1.00	10.00
JN	Nikkei Japan PMI Mfg	Apr F				52.8	1.30	10.30
AU	Melbourne Institute Inflation MoM/YoY	Apr		/		0.1/2.2	2.00	11.00
NZ	New Residential Lending YoY	Mar				15.2	4.00	13.00
AU	Commodity Index AUD/SDR YoY	Apr		/		138.5/50.1	7.30	16.30
CA	MLI Leading Indicator MoM	Mar				0.4	12.00	21.00
US	Personal Income/Spending	Mar		0.3/0.2		0.4/0.1	13.30	22.30
US	Real Personal Spending	Mar		0.5		-0.1	13.30	22.30
US	PCE Deflator MoM/YoY	Mar		-0.2/1.9		0.1/2.1	13.30	22.30
US	PCE Core MoM/YoY	Mar		-0.1/1.6		0.2/1.8	13.30	22.30
CA	Markit Canada Manufacturing PMI	Apr				55.5	14.30	23.30
US	Markit US Manufacturing PMI	Apr F				52.8	14.45	23.45
CA	Bloomberg Nanos Confidence	Apr 28				59.1	15.00	0.00
US	ISM Manufacturing/ISM Employment	Apr		56.5/		57.2/58.9	15.00	0.00
US	Construction Spending MoM	Mar		0.4		0.8	15.00	0.00
Tuesday, 2 May 2017								
AU	ANZ Roy Morgan Weekly Consumer Confidence Index	Apr 30				111.2	0.30	9.30
JN	BOJ Minutes of March 15-16 Meeting						0.50	9.50
JN	BOJ Kuroda speaks at Global Think Tank Summit in Yokohama						1.20	10.20
JN	Nikkei Japan PMI Services/Composite	Apr				52.9	1.30	10.30
CH	Caixin China PMI Mfg	Apr		51.3		51.7	2.45	11.45
AU	RBA Cash Rate Target	May 2		1.5		1.5	5.30	14.30
GE	Markit/BME Germany Manufacturing PMI	Apr F		58.2		58.2	8.55	17.55
EC	Markit Eurozone Manufacturing PMI	Apr F		56.8		56.8	9.00	18.00
UK	Markit UK PMI Manufacturing SA	Apr		54		54.2	9.30	18.30
EC	Unemployment Rate	Mar		9.4		9.5	10.00	19.00
US	Wards Total Vehicle Sales	Apr		17.1		16.5		
EC	ECB's Nowotny Speaks at Vienna University						17.00	2.00
NZ	Global Dairy Auction, GDT-weighted price index (early AM, NZT)			neutral		+3.1		
Wednesday, 3 May 2017								
NZ	QV House Prices YoY	Apr				12.9	18.00	3.00
NZ	Unemployment Rate	1Q	5.2	5.1		5.2	23.45	8.45
NZ	Employment Change QoQ/YoY	1Q	0.8/5.3	0.8/5.3		0.8/5.8	23.45	8.45
NZ	Pvt Wages Ex/Incl Overtime QoQ	1Q	0.4/..	0.4/0.5		0.4/0.4	23.45	8.45
AU	AiG Perf of Services Index	Apr				51.7	0.30	9.30
GE	Unemployment Change (000's)/Claims Rate	Apr		-10.5/5.8		-30.0/5.8	8.55	17.55
UK	Markit/CIPS UK Construction PMI	Apr		52		52.2	9.30	18.30
EC	GDP SA QoQ/YoY	1Q A		0.5/1.7		0.4/1.7	10.00	19.00
US	ADP Employment Change	Apr		175		263.0	13.15	22.15
US	Markit US Services/Composite PMI	Apr F		/		52.5/52.7	14.45	23.45
US	ISM Non-Manf. Composite	Apr		56		55.2	15.00	0.00
US	FOMC Rate Decision (Lower/Upper Bound)	May 3		0.75/1		0.8/1.0	19.00	4.00
Thursday, 4 May 2017								
NZ	ANZ Job Advertisements MoM	Apr				1.6	23.00	8.00
NZ	ANZ Commodity Price	Apr				0.4	2.00	11.00
AU	HIA New Home Sales MoM	Mar				0.2	2.00	11.00
AU	Trade Balance	Mar	3350	3300		3574	2.30	11.30
CH	Caixin China PMI Composite/Services	Apr		/		52.1/52.2	2.45	11.45
AU	RBA Governor Lowe Speech: Household Debt, Housing Prices and Resilience, Economic Society (QLD) Business Lunch						4.10	13.10
GE	Markit Germany Services/Composite PMI	Apr F		54.7/56.3		54.7/56.3	8.55	17.55
EC	Markit Eurozone Services/Composite PMI	Apr F		56.2/56.7		56.2/56.7	9.00	18.00
UK	Markit/CIPS UK Services/Composite PMI	Apr		54.6/55		55.0/54.9	9.30	18.30
UK	Mortgage Approvals	Mar		67.5		68.3	9.30	18.30
EC	Retail Sales MoM/YoY	Mar		0.1/		0.7/1.8	10.00	19.00
US	Challenger Job Cuts YoY	Apr				-2.0	12.30	21.30
US	Nonfarm Productivity/Unit Labour costs	1Q P		0/2.5		1.3/1.7	13.30	22.30
US	Trade Balance	Mar		-45.2		-43.6	13.30	22.30
CA	Int'l Merchandise Trade	Mar				-1.0	13.30	22.30
US	Initial Jobless Claims	Apr 29				257	13.30	22.30
US	Factory Orders/ex transport	Mar		0.6/		1.0/0.4	15.00	0.00
EC	ECB's Draghi Speaks in Lausanne, Switzerland						16.30	1.30
CA	Bank of Canada Governor Stephen Poloz Speech in Mexico						21.25	6.25
Friday, 5 May 2017								
AU	AiG Perf of Construction Index	Apr				51.2	0.30	9.30
AU	RBA Statement on Monetary Policy						2.30	11.30
NZ	RBNZ Survey of Inflation Expectations (2y ahead CPI expectations)					1.92	4.00	13.00
US	Change in Nonfarm Payrolls/Unemployment rate	Apr		193/4.6		98.0/4.5	13.30	22.30
US	Average Hourly Earnings MoM/YoY	Apr		0.3/2.7		0.2/2.7	13.30	22.30
CA	Net Change in Employment/Unemployment rate	Apr		20/6.7		19.4/6.7	13.30	22.30
CA	Ivey Purchasing Managers Index SA	Apr				61.1	15.00	0.00
US	Fed's Fischer Speaks at Hoover Event in Stanford						16.30	1.30
US	Fed's Williams Speaks in Keynote in New York						17.45	2.45
US	Fed's Rosengren, Evans and Bullard on Hoover Institution Panel						18.30	3.30
US	Fed's Yellen Speaks at Brown University						18.30	3.30
US	Consumer Credit	Mar		14		15.2	20.00	5.00
US	Fed's Williams Speaks in Stanford						20.00	5.00
Sunday, 7 May 2017								
FR	French Presidential Election - final round							
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		2-May	1.50%	1.50%		1.50%		
US Federal Reserve		4-May	0.75-1.00%	0.75-1.00%		0.75-1.00%		
New Zealand, RBNZ		11-May	1.75%	1.75%		1.75%		
UK BOE		11-May	0.25%	0.25%		0.25%		
Canada, BoC		25-May	0.5%	0.5%		0.5%		
Europe ECB		8-Jun	-0.4%	-0.4%		-0.4%		
Japan, BoJ		16-Jun	-0.1%	-0.1%		-0.1%		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

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