July 2017

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

***Global**: The global economic upturn continues, despite some disappointing output data from the big advanced economies in early 2017. The business surveys and the timely monthly updates on industrial output and world trade show expansion continuing at a moderate pace. Inflation remains below central bank targets in several key advanced economies and price pressures coming through the pipeline from commodities and manufacturing are waning. Despite ongoing low inflation, the growing evidence that advanced economy growth is being consolidated at a reasonable rate and the passing of earlier fears of price deflation is causing a policy rethink among several central banks. They seem to be reconsidering the need for such low interest rates and such extensive asset buying. We expect global growth to pick-up from the near 3% rate reached in 2016 to 3¼% this year and 3½% in 2018.*

- Reflecting the improvement in the global economy, major equity markets have moved higher this year, although the same gains have not been seen in emerging markets. With some risks receding – particularly Euro political risk and fears of a China/US trade war, measures of volatility (such as the VIX) have moved to low levels. Credit spreads have also been falling, contributing to an underlying easing in financial conditions. However, commodity prices have come off recent peaks, as supply constraints have eased and Chinese demand is expected to soften.
- Rising asset prices, easing financial conditions and a sounder global outlook have not gone unnoticed by advanced economy central banks. The US Federal Reserve has been tightening policy for a while (with more expected) and this month the Bank of Canada raised its policy rate for the first time since 2010. However, for some other central banks it is more a case that they are planning to stop adding to stimulus rather than removing it any time soon. The ECB recently removed its interest rate easing bias and markets are focussed on when the ECB will start winding down its QE asset purchase program, although this probably won't occur until early 2018. The change in direction has had an effect on markets, reflected in a marked rise in 10 year government bond yields – across many countries – starting around late June. The Bank of Japan (BoJ) is somewhat of an exception as, with inflation still well below target, it is expected to persist with its very loose monetary policy for an extended time.
- After picking up through 2016, global growth levelled off at around 3¼% yoy through the first half of 2017 – better than the 3% seen through late 2015 and early 2016 but below the long-term pace of 3½% and a disappointment for those who hoped to see the acceleration in the rate of global expansion continue unabated. The most timely partial measures of economic activity – which focus on industrial output and international trade – also point to a levelling out in the pace of growth. May industrial output numbers for a range of key global economies confirm that there has not been much change in the pulse of expansion – it remains just over 3% yoy. News on inflation has been less positive. While deflation fears have largely gone, the promising upturn in advanced economy CPI inflation toward the 2% or so targeted by most central banks has faded as well.
- Growth in the big advanced economies in late 2016 and early 2017 has disappointed those who expected a lift in the pace of economic expansion. Meanwhile, monthly business surveys provide a more timely measure of economic activity and they show expansion continuing at a moderate pace across the big advanced economies. Consistent with its tendency to show bigger movements through the business cycle, manufacturing activity has rebounded especially strongly in places like the US, UK and Euro-zone. The upturn in Japan has been more muted. While manufacturing has seen the biggest lift in activity, it is still services that tend to show the highest sustained readings and this is particularly the case in the US. Taken overall, economy-wide surveys show growth staying quite stable through the last few months in the big advanced economies as a group.
- Economic performance varies between the big emerging markets. China, India and Indonesia generally show rapid rates of economic expansion whereas Brazil and Russia were hit by deep and prolonged recessions, although both of these economies are starting to climb out of these recessions. The latest monthly data on industrial output and trade does not show growth accelerating in the emerging market economies.
- Expectations for future output in the latest business surveys of big advanced economies remain consistent with moderate growth – but they have softened a little. Our leading indicator of global economic activity shows growth trending down rather than up through the latter half of the year, driven by two especially volatile components of the measure – the drop in industrial metals prices and a subsiding in air freight volume growth to more normal levels. Their volatility means it is too early to move away from our forecast that the global economic upturn continues, with growth lifting from 2016's 3.1% to a predicted 3.3% this year and another rise to a trend-pace of 3.5% in 2018.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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***Australia**: Revisions to real GDP growth forecasts this month largely reflect a stronger than expected rebound in coal exports following disruptions from Cyclone Debbie in Q1. Further out, we have not fundamentally changed the tone of our outlook. We still expect lacklustre growth in household consumption, and a moderate cyclical upturn in non-mining investment, while government investment will help to fill some of the void left by mining investment. Growth is forecast to rise from 2¼% in 2017 to around 2¾% in 2018 and 2019, however, this masks some of the volatility in the profile. The second half of 2017 will see real GDP growth further bolstered by a ramp up in LNG exports, but momentum will fade by end-2018 as LNG peaks and dwelling construction drags. For 2019, growth is forecast to lift again as non-mining investment and public spending strengthens. Given the lingering risks to the outlook, signs of moderation in the housing market, and a reluctance to see the AUD strengthen further, the RBA should be content with keeping interest rates on hold for an extended period (mid 2019). Recent data flows have however been more encouraging, and if maintained could raise the prospect of a change in the balance of risks.*

- The June NAB Monthly Business Survey gave a very strong read on the business sector. Business conditions jumped to a new multi-year high, returning to around their pre-GFC levels, while confidence also ticked a little higher. Capacity utilisation rates eased in the month, but are still elevated, while the Survey's indicator of capital expenditure rebounded.
- Official ABS data continues to show strengthening in the labour market, with seasonally adjusted employment adding another 42K jobs in May (25k in trend terms), following a 46K increase in April. The unemployment rate moved lower to 5.5% (with participation rate steady at 64.9%). An improvement in trend full-time employment is particularly welcoming. The continual strength in the official employment numbers seems to be catching up with the more upbeat leading indicators such as the NAB Business Survey and job vacancies data. The latest NAB Business Survey for June showed steady employment conditions at +7 points, well above the long-run average. This outcome points to an annual job creation rate of around 240k (around 20k per month) in coming months, which is sufficient to see the unemployment rate push lower (all else unchanged). This suggests some downside risk to our current forecast for the unemployment rate to remain broadly unchanged at around 5½% this year. However, despite the decline in the unemployment rate and encouraging increases in full time employment, underemployment is still elevated at close to 9% -- this spare capacity is keeping wages growth subdued.
- We continue to expect a lacklustre outlook for household consumption given the headwinds from elevated household debt, and a continuation of subdued wages growth. However, it was encouraging to see retail conditions improve of late in the NAB Monthly Business Survey. Retail sales have also been a little better than expected, while the NAB Online Retail Sales Index (NORSI) rebounded in May (+1.3% mom s.a.), following the April contraction (-0.7%,mom s.a.).
- Indicators of business investment remain mixed. Reads from the NAB Business Survey are still upbeat, however, and other timely indicators of capital expenditure suggest firms have become a little less reluctant to commit to big ticket capital expenditures. The value of non-residential building approvals has trended higher for the past few months and increased 4.6% m/m in May (trend terms) to be up nearly 15% over the year. In contrast, the value of capital goods imports fell nearly 5% in May, although they are up 11.7% over the year, while the recent completion of LNG platforms may boost capital imports in coming months. Leads on the longer-term outlook are just as mixed as NAB Quarterly Business Survey expectations for capex in the next 12-months have held up, while reads on non-mining investment from the ABS Private Capital Expenditure Survey remain stubbornly subdued.
- Property prices rebounded somewhat from the seasonal soft patch seen in May, indicating that the market pulse actually remains fairly resilient. That said, there are signs that the market has entered a cooling phase, although trends to date remain consistent with an orderly unwind of market exuberance, rather than a sharp and painful correction. Our latest forecasts were published yesterday in our Quarterly Residential Property Survey. New building approvals were a little weaker than market expectations in May, but that is consistent with our prediction that the housing construction cycle may be peaking and will soon turn lower. The decline in May was largely driven by a sharp fall in apartment approvals for NSW and Qld. Our economic modelling points to significant downside risks to the housing construction outlook.
- After a stronger than expected bounce back in coal exports in May, and with LNG exports continuing to ramp up, we now expect net exports to make a positive contribution to GDP growth in Q2, at 0.3 ppts. Exports growth is expected to be strong, while imports are likely to be up as well in the quarter driven by some large capital goods imports, however the timing of which is hard to determine. Commodity prices have come off their peak in Q1. Coking coal prices retreated from its April peak following production restarts in Queensland. Iron ore prices have also declined. This means the terms of trade should resume its gradual descent in the second half of this year.
- Our own forecasts have been revised a little higher in the near-term, but we continue to see downside risk to the RBA's forecasts for growth of 2¾ - 3¾% into 2018 and 2019. Additionally, with significant slack still in the labour market, wages and inflation data looking subdued and the housing market apparently cooling, there appears to be no urgency for the RBA to hike – although there will be some near-term inflation shocks that need to be monitored (such as the recent hikes in retail energy prices). The RBA should be content with keeping interest rates on hold for an extended period (a hike not expected until mid-2019), although recent data flows have been more encouraging, and if maintained, could raise the prospect of an earlier Reserve Bank starting date.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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