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THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

***Global**: After a disappointing first quarter, the pace of global upturn picked up in the June quarter as preliminary GDP results for China, the US and the Euro-zone – which collectively account for 45% of the world economy – showed faster growth. A combination of favourable financial conditions, still-stimulatory monetary policy and no head-winds from budget austerity have underpinned the ongoing moderate growth in the big advanced economies. Conditions in the emerging economies have been more mixed with solid growth in China and India whereas Russia and Brazil have experienced tough economic times. We expect global growth to rise from 3.2% in 2016 to 3.4% this year and an around-trend 3.5% in 2018. China and India remain the stand-out global performers, accounting for around half of global growth between them, with a promising looking upturn in the Euro-zone and growth of around 2% in the US driving much of the rest of global expansion.*

- Reflecting the improvement in the global economy, major equity markets have moved higher this year. At the same time, measures of financial market volatility have moved to very low levels, probably in part reflecting some risks receding such as Euro political risk. Credit spreads have also been falling, contributing to an underlying easing in financial conditions. Commodity prices which had been in decline since early this year have stabilised recently, supported by an improving demand outlook and USD weakness.
- Rising asset prices, easing financial conditions and a sounder global outlook were noted by advanced economy central banks. While the US Federal Reserve has been tightening policy for a while (with more expected) the Bank of Canada recently raised its policy rate for the first time since 2010. Other central banks signalled an end to their easing bias, contributing to a rise in long-term government bond yields. In July, the ECB deferred discussions on the future of its QE program, trying to get the tightening in financial conditions under control, although we still expect them to announce a future tapering of QE at its next meeting. The Bank of England also remained on hold in its August meeting, but continues to point to 'gradual' and 'limited' policy tightening down the track. Political factors and a recent slowdown in inflation have seen financial markets lower their expectations of future Fed rate rises. However, for now the Fed is sticking to its line that if the economy evolves as expected, further gradual rate hikes will be needed. The Bank of Japan (BoJ) is expected to persist with its very loose monetary policy for an extended time, but appears to have little appetite for further easing measures.
- After picking up through 2016, global growth levelled off at around 3¼% yoy through late 2016 and early 2017 – better than the 3% seen through late 2015 and early 2016 but below the long-term pace of 3½%. Timely partial measures of economic activity – which focus on industrial output and international trade – point to moderate ongoing growth. Indicators of industrial output for a collection of big economies show growth stayed around 3.6% yoy through June with especially solid growth in East Asia (including China). Monthly business survey results across the big advanced economies are available to July and these are consistent with growth persisting through the middle months of the year but at a slightly slower pace.
- Growth in the big advanced economies through late 2016 and early 2017 disappointed some, but available indicators point to a re-acceleration in growth in the June quarter. Monthly business surveys (the most timely measure of economic activity) generally show the 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, the services surveys have tended to show the highest sustained readings. However, there was a large fall in the US non-manufacturing ISM in the last month (although it remains well in positive territory), which provides a cautionary note to the outlook. At the same time the Euro-zone services indicator continues to track at a high level.
- The emerging market economies that have released their Q2 growth rates showed expansion continuing at a solid rate. Industrial output growth in emerging markets broadly stabilised in Q2 after a slowdown through end-2016 and early 2017. Meanwhile, growth in export volumes was solid in December 2016/March 2017, although the monthly trade data (while volatile) is suggesting a slowdown in the second quarter.
- Overall, we expect global growth to rise from 2016's 3.2% to 3.4% this year and 3.5% in 2018 – taking the pace of global expansion back to around its trend pace. Forward looking measures in the business surveys remain consistent with solid rates of growth in the advanced economies but our leading indicator of global growth dips in the final quarter of 2017. The reduction in risk overhanging the upturn is more important than the minor (upward) changes in growth forecasts we have adopted in the last 6 months. Market concerns over such high-impact "tail risks" to global growth as a Euro-zone collapse or Chinese hard landing have faded through the last 6 months, contributing to the low levels of the VIX index of volatility.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

Alan Oster (Group Chief Economist), Ph: +(61 3) 8634 2927 or M: 0414 444 652
Alt: Tom Taylor (Head of International Economics), Riki Polygenis (Head of Australian Economics)

***Australia**: The aggregate outlook for the Australian economy remains somewhat bland, despite solid activity in non-mining sectors outside of retail. While there will be some oscillation in the through-the-year growth rate as LNG exports and dwelling construction ramps up (in H2 2017) and then taper off over the course of 2018, the broad thrust remains for annual average growth to remain between 2½% - 2¾% until 2019. Our early estimate of GDP in Q2 is for growth of 0.6% q/q (1.6% y/y), with even stronger rates expected for Q3 and Q4 as LNG exports ramp up further. We have revised up our employment forecasts in the near-term based on strength in partial indicators (such as NAB Survey employment), which will see some downward pressure on the unemployment rate through the remainder of 2017. Employment growth then eases a little through 2018, as economic growth loses momentum. Despite the RBA's discussion of the neutral cash rate, there is no urgency in starting to return to neutral (the point at which monetary policy is neither expansionary or contractionary). Spare capacity in both the economy and the labour market provides lots of time for the RBA to remain in "watch and see" mode. We continue to expect no change to the cash rate until 2019, with some risk of an earlier hike if current strength in employment is sustained.*

- The July NAB Monthly Business Survey showed a continuation of the strong run enjoyed by the business sector. Business conditions rose to their highest level since early 2008, while confidence also strengthened. Despite that, capacity utilisation rates were unchanged, although at elevated levels, while the Survey's indicator of capital expenditure, dropped sharply.
- The June ABS employment report showed that employment rose by another 14K in June in seasonally adjusted terms, after three months of solid growth. The trend monthly employment gain was +26k, which saw trend unemployment rate decline to 5.6% from 5.7%. Employment growth has also been relatively broad-based across states. Leading indicators also point to continued improvement. The employment conditions index in the July NAB Monthly Business Survey remained solid, pointing to annual job creation of around 240K (or about 20K per month) in the next 6 months, sufficient to see the unemployment rate push lower. The ABS job vacancies data and SEEK job ads for June also point to improved employment conditions. Despite the decline in the unemployment rate and encouraging increases in full-time employment, underemployment remains prevalent in the Australian labour market. The rate of underemployment remains high at close to 9% (with total underutilisation at 14.4%). We have revised our unemployment rate forecasts modestly lower (to 5.4% by year end, from 5.7%), in light of strong official readings in recent months and consistent strength in leading indicators
- A confluence of stronger employment growth and price discounting appears to have supported retail sales in Q2 -- the ABS estimated a rise in volumes of 1.5%, while prices declined 0.1% q/q, which will support total household consumption in Q2 (our early forecast is 1.0% q/q and 2.9% y/y). In June, the value of retail sales rose 0.3%, following robust of 1.0% and 0.6% m/m in April and May. NAB's new Cashless Retail Index, also implied a slowing in June, easing to 5.6% y/y from 8.7% in May. Into Q3, energy price hikes will likely weigh on discretionary spending, while foreign competition will ramp up over time. Indeed, retail conditions in the NAB Monthly Business Survey dropped sharply in July (to -3 index points), although remains positive in trend terms (at +3), with margin pressure (with growth in final prices lower than purchase and labour cost prices) weighing on profitability. We continue to expect a lacklustre outlook for household consumption given the headwinds from elevated household debt, and a continuation of subdued wages growth.
- Indicators of business investment are fairly encouraging. The NAB Business Survey remains very upbeat and despite a drop in the value of non-residential building approvals for June, strong growth in previous months means the trend was is still up. Meanwhile, the value of capital goods imports rose sharply in June (up 13.2%), to be 21.3% higher over the year, suggesting strong demand for machinery and equipment. The recent completion of LNG platforms may also 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.
- Despite expectations for a cooler housing market, there are signs that conditions actually regained momentum (especially in Melbourne). CoreLogic's hedonic price measure for 8 capital cities rose by a solid 1.5% in July (down from 1.8% in June), but Melbourne dwelling prices jumped 3.1%, to be up nearly 16% over the year. Additionally, Auction clearance rates also show tight conditions in Melbourne, trending higher in recent weeks, and sitting slightly above last year's levels. Despite the trend, we have maintained our forecast for a further moderation in price growth (see, Quarterly Residential Property Survey for details). New building approvals saw a surprisingly strong rebound in June, largely driven by medium density approvals, which appears to have arrested the negative trend. However, we do expect medium density approvals to resume their decline – maintaining our prediction that the housing construction cycle will soon peak.
- It is estimated that net exports made a flat to small positive contribution to GDP growth in Q2. Exports volumes look to have increased by around 1.8% q/q while imports look to have risen 2.2%. Goods exports are estimated to have increased by 1.6% while goods imports look up 1.8%. Services exports and imports are both expected to have risen strongly in Q2. Net exports are expected to make a greater contribution to GDP growth in Q3 and Q4 on the back of increased LNG exports, before flattening off in 2018.
- The AUD has continued to strengthen to just shy of US0.80 cents at the time of writing. This largely reflects surprising USD weakness (thanks to a "Trump discount factor" and lower rate expectations for the US Fed). However, we are yet to revise our forecasts for AUD depreciation into year-end to USD 0.70 owing to an expected USD revival (driven perhaps by a large policy "win", lower commodity prices and some reversal in the current very low risk aversion. The risk to our AUD forecasts however is clearly to the upside.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 2) 9237 8017

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Behavioural & Industry Economics

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(61 3) 9208 2929

International Economics

Tom Taylor
Head of Economics, International
+(61 3) 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Director, Economics
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Fixed Income Research
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Joelene Simoes
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055