National Australia Bank

March 2013

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Financial markets have lifted as confidence in the global growth outlook has firmed but late 2012 data for world exports and industrial output remained soft, showing modest expansion in activity at best. GDP fell at the end of last year in Western Europe and Japan, was flat in the USA, while the pace of growth in some of the biggest emerging market economies was sluggish by their standards. Business surveys suggest that conditions are expected to improve in several of the most important advanced and emerging economies (notably the US, Germany, Brazil and India). We expect growth to increase modestly this year, held back by ongoing weakness in the Euro-zone, followed by a more sizeable acceleration in 2014.

- Share markets have risen strongly since late 2012 and by the end of February they were over 10% above their levels of last November. The amount of financial market volatility has fallen substantially. Commodity markets have not shown quite the same degree of optimism. There are probably a number of factors driving this disconnect – market perception that the "tail risk" of really bad outcomes like a Euro-zone collapse has been reduced, leading to a relief "risk-on" rally; the injection of liquidity by global central banks which is driving up financial asset prices and lowering spreads across many markets and, finally, the equity market looking forward to an upturn in the global economy that will lift earnings.
- Although economic conditions were far from strong through the latter half of 2012, there was a modest acceleration in the pace of global growth toward the end of the year. Industrial production rose by 0.8% in December quarter, up from the 0.3% seen in September quarter. However, global industrial output rose by only 3.4% in 2012, one-third of the pace seen in 2010, with output flat for much of the year. The slowdown in world trade has been even more marked – from growth of 15% in 2010 to just over 2% in 2012. The soft patch seen in global activity through the middle of last year resulted in an increase in the amount of idle capacity in the big advanced economies; the G7's unemployment rate has been around 8½% since early 2011 with a fall in the US jobless rate offsetting higher unemployment in the Euro-zone.
- Growth in the advanced economies was disappointing in late 2012; output fell in the Euro-zone, UK, and Japan and was just about flat in the US. By the end of 2012, output in the big advanced economies was less than 1% above its year-earlier level and recessions seemed to be under way across Japan and the Euro-zone. This poor result follows a prolonged period of weak economic performance in the advanced economies. North America is the only region among the big advanced economies where GDP has convincingly climbed above its pre-crisis level. Elsewhere, real GDP remains below its early 2008 level with, in late 2012, GDP standing 3% below its pre-GFC level in the UK and Euro-zone and around 2½% below in Japan.
- The slowdown in global growth through 2012 was not just caused by weaker conditions in the big advanced economies. There was also a softening through much of last year in the pace of economic expansion across several important emerging economies. Brazilian GDP grew by only 1% in 2012, Indian GDP expanded by just over 5% last year – the slowest for around a decade – and Chinese growth was slowing until it started picking up in late 2012. Chinese industrial output began growing faster towards the end of last year but sentiment has suffered recently as tighter policy on housing is again being announced.
- The export oriented economies of East Asia and Latin America outside Brazil also saw a sharp slowdown through much of 2012 but conditions started to stabilise or even improve toward the end of last year and into early 2013.
- The national business surveys across the big advanced economies are pointing to an upturn in activity. Global growth is forecast to accelerate from the latter half of 2013 as activity finally starts to recover in Western Europe and Japan alongside the quickening in growth in the emerging market economies. Year-average growth is only expected to rise from 3% in 2012 to 3.3% in 2013 before climbing to 3.9% in the following year. The contribution of the big advanced economies to global growth over the period 2012 to 2014 has risen from 0.6% points to 1.2% points. The bulk of global growth is, however, still expected to come from the emerging market economies.

<u>Australia:</u> While there are signs of improvement, the Australian economic outlook is still subdued. A high AUD, declining terms of trade and a large structural adjustment task will remain headwinds. Outlook a little stronger reflecting history: GDP growth to be 2.3% in 2013 (was 2.0%) and 3.1% in 2014 (was 3.3%). RBA now expected to cut by 50 bps in 2013 (possibly June & Nov). This reflects RBA's "comfort" with current activity, signs previous cuts have gained traction in housing markets & retailing, and a "so far" resilient labour market. But with weak underlying demand continuing, we still see unemployment rising to 5.7% by mid year, with little sign that non-mining investment will ramp up.

- GDP grew by 0.6% in Q4, down marginally from an upwardly revised 0.7% in Q3, to be 3.1% higher than a year ago. Household consumption growth remained soft at 0.2% in Q4. Domestic final demand grew by 0.3%, with the private component up by 0.6%, helped by underlying private business investment (1.2%) and the underlying public component down 0.7% reflecting the continuing tightness of fiscal policy. Net exports contributed 0.6% points, largely reflecting exports of metals & minerals (up 6.4%), but this was partly offset by a subtraction from stocks.
- The NAB survey has shown some improvement in current business conditions, rising from -6 in Q4 to -2 and -3 in the first two months of 2013. For the period ahead, the February NAB survey continues to paint a weak picture, with forward orders at historically low levels across a swathe of industries, capacity utilisation still below 80% and the employment index persistently in negative territory. It is clear that business remains concerned about the outlook (NAB business confidence fell in February and at +1 remains well below its long-run average of +5).
- The ABS New Private Capital Expenditure Survey showed a pull back in total capital expenditure of 1.2% in the December quarter. By industry, mining capital expenditure rose by 2.9% in the quarter, but this was more than offset by falls in spending in manufacturing and 'others' (down 2% and 7.5% respectively). Of particular interest in this survey was the first estimate of mining capital spending for 2013/14, which implies that mining capex is expected to increase by 12.5% in 2012/13. Overall, this outcome suggests that mining investment will be reasonably buoyant in 2013/14, but the numbers look superficially positive and mask considerable downside risk.
- Official ABS data suggest that labour market conditions remained resilient in January, despite macroeconomic data indicating that the domestic economy slowed into the new year. ABS Labour Force Survey data suggest that around 10,400 jobs were created in January, while the participation rate ticked down to 65.0% and the unemployment rate was unchanged at 5.4%. Given our expectation for underlying demand to remain weak, we see unemployment rising to 5.7% by mid year.
- Consumers appear to have started the year a little more upbeat, with lower borrowing rates, rising property prices and a recovery in equity markets likely to be having an effect. Following three months of consecutive declines, retail turnover grew by 0.9% in January, supported by household goods, cafes, restaurants and take-away food and 'other' retailing. This trend is evident was evident in the NAB business survey, with retail and wholesale conditions strengthening in early 2013 – albeit conditions in these industries remain poor overall.
- The RBA left the cash rate unchanged at 3.0% at its March meeting, though it appears to have maintained its easing bias. The Board's decision reflected a combination of reduced downside risks to the outlook for global growth, as well as signs that monetary policy easing is beginning to yield stronger private consumption spending and dwelling investment growth.
- Like us, the RBA seems unperturbed about the outlook for inflation. While the RBA is seeing positive straws in the wind, it has acknowledged that "growth (is) likely to be a little below trend over the coming year". Our estimates for GDP suggest that growth will slow to a 2.3% annual pace over 2013, with unemployment rising to 5¾% by the end of the year. Combined with a soft inflation outlook, we have pencilled in a 25 bp rate reduction in June. Thereafter, we believe the RBA will wait and see how the non-resource sector performs as mining investment begins to retreat. In our view, an additional 25 bp rate cut will be needed (in November) to help support weakening labour market conditions. Beyond that, monetary policy is likely to remain very accommodative for sometime.

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