National Australia Bank

July 2013

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Equity and currency market volatility reflects uncertainties over the pace at which the Fed might alter US monetary policy, Chinese authorities might clamp down on shadow banking and the potential impact of the Bank of Japan's move to greater monetary easing. Recent industrial and trade data plus business survey readings show slightly better activity outcomes in big advanced economies but growth in India and Brazil remains disappointing and there are growing concerns that China might be unable to manage a smooth transition to slower more consumer-led economic growth. After two years of growth around 3%, we still expect global growth to move back to trend in 2014.

- There was previously a disconnect between sluggish global growth and the big rise in equity values, rationalised by a flood of central bank liquidity boosting investor appetite for higher yielding assets and risk. Recently this has reversed with G7 equity markets falling at the time when there are some brighter signs for their growth outlook. This reflects the fear that there will be less central bank liquidity injected to support asset values as the economic situation improves. The withdrawal of central bank stimulus from global economic activity should be a long and gradual affair – the Fed's likely timetable would not see an end to QE until next year with no rate rises until 2015 and the Japanese central bank has ramped up its stimulus.
- Global industry and trade experienced a marked slowing in growth through the last couple of years. By the early months of this year global industrial production and trade volumes were both growing below 2% yoy, a sub-trend outcome. Comprehensive figures on global activity show a mixed picture – the momentum of industrial growth seemed to be picking up slightly through the closing months of 2012 and early 2013 but world trade growth remained very weak. This modest up-tick in industrial growth was centred on the previously weak advanced economies with growth in the emerging economies still slowing. More recent – but less comprehensive – data suggest that activity continued to strengthen through May and June. The sluggish pace of economic expansion combined with the overhang of unemployment and idle capacity left from the deep recession of 2008/09 has led to very little inflationary pressure around most of the world, enabling central banks to keep interest rates down.
- Growth remains subdued in the big advanced economies with output growing by only 0.4% in the March quarter. Continental Europe remains the worst performing area, while the US remains one of the best performing big advanced economies with moderate expansion continuing. The UK and Japan have experienced a prolonged period of weak demand and there are finally signs that conditions are improving. The performance of the Japanese economy is attracting particularly close attention as investors assess the impact of "Abenomics" – the combination of monetary and fiscal easing plus reform intended to end deflation and boost growth. Yen depreciation will boost exports, output and profits as well as help re-start inflation but getting sustained recovery requires a broader upturn in domestic demand.
- The three big emerging market economies of China, India and Brazil are still driving our 3% global growth forecast for 2013 but they too have experienced a slowdown. This reflects the lagged effects of past policy tightening and sluggish global trade. There is clear evidence of a major slowdown in Chinese exports but domestic market oriented measures of demand still show solid growth. Market anxieties focus on the problems of fast credit growth and the shadow banking system and the dangers of financial instability and policy error by authorities. We have lowered our 2013 and 2014 Chinese GDP forecasts to 7½% and 7¼% respectively.
- The export oriented economies of East Asia and Latin America also experienced a sharp slowdown through 2011 and 2012 with a period of renewed softness in the last 6 months.
- While recent activity trends have been generally disappointing, firms in most of the big advanced economies remain optimistic that things will improve. Our measure of current trading conditions in these big advanced economies shows a sizeable improvement in sentiment in June and there is still plenty of optimism that demand in the big advanced economies will recover through 2014. We expect global growth to remain fairly sluggish through much of 2013 with the full-year figure staying around 3% before strengthening to 3¾% in 2014. The contribution of the big advanced economies is expected to increase as Euro-zone recession ends and Abenomics lifts Japanese growth.

<u>Australia:</u> Domestic weakness, softness in China and financial volatility have encouraged us to revise down our USD/AUD outlook (reaching 88c by end 2013 and 83c by end 2014) and bring forward our next expected rate cut to the next meeting on 6 August, assuming no surprises from unemployment or inflation. We expect the bias to easing to continue beyond August. We have left our GDP growth forecasts unchanged at 2.3% in 2013 and 2.8% in 2014 but with greater downside risk to the outlook. The unemployment rate is still expected to exceed 6% by the end of this year.

- The Australian economy appeared to have weakened further in June in the face of the combined effects of softness in Chinese growth and minerals commodity prices, volatility in financial markets and weaker domestic partials, including our own survey. Two prominent issues are how quickly the labour market can absorb the frictions associated with the winding down of mining investment and whether the non-mining sector can assume the role of growth engine. The decline in the AUD should provide some relief for trade-exposed sectors, but the exchange rate nevertheless remains historically elevated.

- The June NAB Monthly Business Survey paints a worrying picture of the Australian economy; business conditions slumped in June to their lowest level since May 2009 and business confidence remained lacklustre. Weaker trading conditions and profitability combined with still poor employment conditions drove business conditions lower, with each of these indicators remaining well below average levels. Conditions deteriorated heavily in mining, retail and manufacturing (despite a tumbling AUD). Weak forward indicators – including forward orders, stocks, capacity utilisation and employment conditions – remain concerning and suggest little improvement in near-term demand.

- The labour market remained weak during the June quarter, according to partial indicators. Official ABS labour force data also paint of soft picture on the labour market at present. ABS employment data have been subject to significant revision affecting the growth rate of employment. What may have been interpreted as the commencement of a reasonably strong expansion in employment using the April release now looks like the start of a flat period using the May publication. In addition, there are clear signs that employment in the mining sector is weakening. Mining sector employment has declined in three of the past four quarters and mining hours worked have not risen for a year.

- Retail trade barely grew in value terms in May, growing by just 0.1%, and the level remains 0.5% below its most recent peak in February. For June, the NAB survey indicated that retail trading conditions worsened sharply (from -18 to -34 index points), while capacity utilisation fell to 78.4%. Personal credit, contracting since mid-2011, had been showing signs of stabilising earlier this year, but fell away again in May (down 0.2%). It seems likely that June quarter retail volumes (abstracting from price movements) will turn out to be quite weak.

- The mining sector has been the key driver of overall business investment but there are clear signs that it is no longer contributing to growth and that mining investment is now in decline. While there are several major LNG projects under way that will keep mining construction elevated, these should all be completed by early 2017. There was some resurgence in the March quarter, when an above average $12.7 billion of engineering construction projects were commenced. However, in the absence of the commencement of a new mega project, there is a risk that mining investment will fall sharply in 2014 and beyond.

- The RBA left the cash rate on hold again in July, with a statement that was broadly similar to the previous month. The weakness in the domestic economy confirmed by the latest NAB survey, along with the softness in Chinese activity data, the lower track for the terms of trade and the heightened volatility in financial markets have encouraged us to bring our next expected rate cut forward to the next meeting on 6 August (previously November). In making this call, we expect that the June monthly labour force release will be soft and the June quarter CPI will not surprise on the upside. While the lower AUD is acting to take pressure off the non-mining sector, it is largely providing a buffering role. Beyond 2013, monetary policy is likely to remain very accommodative for some time as the full impacts of stimulus take effect.

Alan Oster
Group Chief Economist
National Australia Bank
03 8634 2927 (Mobile 0414 444 652)

Macroeconomic, Industry & Markets Research

Australia

Alan Oster	Group Chief Economist	+(61 3) 8634 2927
Jacqui Brand	Personal Assistant	+(61 3) 8634 2181
Rob Brooker	Head of Australian Economics & Commodities	+(61 3) 8634 1663
Alexandra Knight	Economist – Australia	+(61 3) 9208 8035
Vyanne Lai	Economist – Agribusiness	+(61 3) 8634 0198
Dean Pearson	Head of Industry Analysis	+(61 3) 8634 2331
Gerard Burg	Economist – Industry Analysis	+(61 3) 8634 2788
Robert De Iure	Economist – Property	+(61 3) 8634 4611
Brien McDonald	Economist – Industry Analysis & Risk Metrics	+(61 3) 8634 3837
Tom Taylor	Head of International Economics	+(61 3) 8634 1883
John Sharma	Economist – Sovereign Risk	+(61 3) 8634 4514
Tony Kelly	Economist – International	+(61 3) 9208 5049
James Glenn	Economist – Asia	+(61 3) 9208 8129

Global Markets Research - Wholesale Banking

Peter Jolly	Global Head of Research	+(61 2) 9237 1406
Robert Henderson	Chief Economist Markets - Australia	+(61 2) 9237 1836
Spiros Papadopoulos	Senior Economist – Markets	+(61 3) 8641 0978
David de Garis	Senior Economist – Markets	+(61 3) 8641 3045

New Zealand

Tony Alexander	Chief Economist – BNZ	+(64 4)474 6744
Stephen Toplis	Head of Research, NZ	+(64 4) 474 6905
Craig Ebert	Senior Economist, NZ	+(64 4) 474 6799
Doug Steel	Markets Economist, NZ	+(64 4) 474 6923

London

Nick Parsons	Head of Research, UK/Europe & Global Head of FX Strategy	+(44 20) 7710 2993
Tom Vosa	Head of Market Economics – UK/Europe	+(44 20) 7710 1573
Gavin Friend	Markets Strategist – UK/Europe	+(44 20) 7710 2155

	Foreign Exchange	Fixed Interest/Derivatives
Sydney	+800 9295 1100	+(61 2) 9295 1166
Melbourne	+800 842 3301	+(61 3) 9277 3321
Wellington	+800 64 642 222	+800 64 644 464
London	+800 747 4615	+(44 20) 7796 4761
New York	+1 800 125 602	+1877 377 5480
Singapore	+(65) 338 0019	+(65) 338 1789