National Australia Bank December 2013

The Bigger Picture – A Global & Australian Economic Perspective

Global: ***September industrial output and broader measures of quarterly GDP are finally showing economic growth starting to lift in line with both the business surveys and our forecast for a global upturn in 2014 (growth at 3½% unchanged). That is largely driven by the advanced economies (especially the US and Europe). Despite the faster growth in sight, central banks across the big advanced economies are expected to keep interest rates very low by historical standards. The beginning of US 'tapering' is likely to be accompanied by further interest rate guidance to avoid a repeat of the June 2013 bond sell-off. Emerging market central banks face more of a dilemma with some raising rates recently to combat inflation (Indonesia, Brazil) and disappointing growth outcomes across large parts of SE Asia, India and Latin America.***

- Policy interest rates in the big advanced economies are expected to remain very low for a long time to come and central bank asset holdings should stay high by historical standards. Markets continue to look for clues as to when the US Federal Reserve is likely to begin tapering their quantitative easing program. Our assessment is that the Fed should wind back asset purchases from early 2014 but it will want to hold down bond yields and will hold off from any interest rate rises until the jobless rate has fallen below 6½%. That means that the Fed funds rate is unlikely to start rising until the latter half of 2015 and possibly until mid-2015. As for the other major central banks, with inflation remaining well below target, the Bank of Japan plans to continue buying large volumes of assets until at least the end of 2014, meaning that policy rates should remain near zero for years yet; CPI in Japan is now around 1%, compared to the BoJ target of 2%. In the Eurozone, inflation is also running below target and the ECB plans to keep interest rates at very low levels for "an extended period of time". Finally, the Bank of England also plans not to consider raising its 0.5% Bank Rate while the jobless rate (currently 7.6%) remains above a 7% threshold.
- Monthly industrial output and trade give the most up to date hard data for the pulse of global economic activity and they show growth picking up in September to a still sub-trend 2¾% from the 2% or less that it had generally been averaging before. The service sector – usually a far larger share of output – has been stronger across both advanced and emerging economies. This has boosted global GDP growth which has increased from 2.4% yoy in March to 2.9% yoy in June and then to 3.1% in September. The advanced economies show the strongest upturn, following their long period of subdued growth.
- The acceleration in output growth was first signalled in the business surveys. Most of the national purchasing manager surveys across manufacturing and services in the big advanced economies began turning more positive in the latter half of 2012 and this continued through 2013 but that took some time to feed into the hard data on output. The quarterly pace of economic growth in the 7 biggest advanced economies has accelerated from 0.5% in March to 1.1% in June and 1.3% in September. Nevertheless, there is a big backlog of lost output. GDP remains well below its early 2008 pre-recession level in the UK and Euro-zone, Japanese output is just getting back to its early 2008 peak and North America has seen the strongest recovery with US and Canadian GDP up by over 5% since early 2008.
- Growth has also picked up slightly in the big emerging economies that have been driving most of the expansion in global output, commodity demand and Australasian exports in recent years. The Chinese Government's 7½% growth target for 2013 and its focus on rebalancing activity away from what have been the leading growth sectors underpin a consensus view that the economy should be cooling. However, growth picked up from 7.5% yoy to 7.8% yoy between June and September and the partial data on industrial output, investment and retail trade remains solid. Indian economic performance has repeatedly disappointed in recent years but the September GDP result was stronger, above expectations and in line with some of the partial data (but not many of the business surveys which remain weak).
- We expect global growth to accelerate from 2.9% in 2013 to 3.5% next year, driven by an upturn in advanced economy growth from 1.3% to 2.2%. Recent GDP outcomes as well as partial indicators show that an upturn has already commenced in the advanced economies. Forward looking questions in business surveys show firms becoming slightly less optimistic in November but they are still expecting growth. Emerging economy growth is expected to settle at around 5¼% through the period 2012 to 2015 with a forecast slowing in China offsetting stronger growth elsewhere.

<u>Australia:</u> National accounts for Q3 confirmed weak state of domestic economy with annual growth at 2.3%. GDP forecasts broadly unchanged: GDP growth to soften to 2.3% in 2013 before lifting to 2.7% in 2014 and 3.0% in 2015. Critically domestic demand not expected to exceed 1% in the forecast period. Unemployment to nudge 6% by end 2013, around 6½% by end 2014, before easing towards 6% by late 2015. No signs of non-mining sector filling in prospective mining investment gap. Core CPI in lower half of target range (2.5% by end 2014, 2.3% be end 2015). RBA biding its time as low interest rates make their mark on asset prices, but deteriorating labour market likely to force another cut (May 2014). Second cut possible if labour market even weaker.

- The September quarter national accounts confirmed the ongoing weakness of the Australian domestic economy. GDP growth was a tepid 0.6% (2.3% through the year). The major aggregate demand components remained weak: private consumption grew by just 0.4%, and new private business investment by 1.1%. The main contribution to GDP growth came from a sharp decline in imports, particularly capital and intermediate goods (especially fuels, lubricants and processed industrial supplies) that implies weak industrial demand.
- The latest capex survey data suggest continuing high levels of mining investment, outside the mining sector non-dwelling investment declined in 2012/13. The latest BREE report on the resource and energy sector paints a weakening picture for major new projects and identifies a large number of major LNG projects due for completion in the next two years. Overall, we still anticipate a substantial decline in mining construction activity with no sign yet that other sectors are likely to fill the gap. The terms of trade declined by 3.3% in Q3, reflecting continuing weakness in commodity prices, to be 3.6% lower than a year ago
- Looking ahead to Q4, the latest NAB business survey implies limited improvement in business conditions. The post-election improvement in business confidence, although now more muted, has lingered, but conditions remained poor. The monthly net balance for business conditions averaged 6 in Q3 and, if it remains unchanged in December, will average 3 for Q4. A worrying aspect of the November survey is the deterioration in conditions in wholesale and transport, which tend to be bellwethers of merchandise trade. Overall capacity utilisation remains at low levels, although forward orders look unlikely to improve much in Q4 over the previous quarter.
- One of the big constraints on business conditions in the month was a sharp deterioration in employment conditions, suggesting a weak labour market that is keeping wage inflation subdued. It appears the recent improvement in September/October labour market partials has now been unwound. Our labour market outlook is broadly unchanged (at the margin, slightly stronger than expected GDP growth means a slight increase in employment growth early on). We expect the unemployment rate to peak at 6.5% in late 2014 (previously 6.6%) before edging down from mid-2015.
- Our GDP forecasts are broadly unchanged: in through-the-year terms, we expect growth to edge up from 2.3% in Q3 to 2.5% (was 2.2%) by mid-2014, the higher forecast largely reflecting our expectations of weaker growth in Q3. In financial year terms, GDP growth forecasts are 2.5% (was 2.2%) in 2013/14, and 2.9% (was 2.8%) in 2014/15. However, with GDP increasingly driven by the capital-intensive minerals energy sector, we see little acceleration in employment growth 0.6% (was 0.4%) in 2013/14, and 0.9% (was 0.7%) in 2014/15.
- As widely expected, the RBA decided for a fourth consecutive month to leave the cash rate on hold at 2.50% in December. The RBA Board continues to signal that it is prepared to wait to see how past cash rate cuts pan out. Household credit growth and changes in "savers' behaviour," code for increased appetite for shares and investment housing, will be important. However, the RBA appears relaxed about the pace of asset price growth, seeing it as "supportive of investment" in the longer term, but has remained focussed on the high value of the AUD. We still expect the next cash rate cut in May 2014, by which time we think labour market conditions will be sufficiently weak to prompt further policy easing. This will take the cash rate to 2.25%. There is a risk that they could act sooner, or make additional cuts, if the economy and the labour market backslides more than currently expected.

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