National Australia Bank

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The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> Business surveys and partial data on trade and industrial output show moderate global economic growth continuing through to the end of 2013. There are mixed trends across Emerging markets, with gradual slowing in China and uncertainty over speed of Indian rebound. While the pace of growth in the big emerging economies still easily outpaces that of the G7 advanced economies, it is the latter that drive the expected acceleration in global growth this year (3½%, unchanged). With advanced economy output well below its pre-crisis trend, unemployment and spare capacity remains high, curbing inflationary pressures and allowing central banks to keep policy interest rates historically low. These short-term interest rates are expected to stay low in the main advanced economies through next year, even as their economic growth accelerates.

- The Fed has started gradually "tapering" back its asset purchases and we expect that to continue through the remainder of the year. The Fed funds rate is unlikely to increase until well into 2015, even though the US jobless rate is falling close to levels the Fed require to review its near zero interest rate policy. The absence of much inflationary pressure gives the US central bank room to wait before preparing the market for higher short term interest rates. The ECB has said it will keep Euro-zone interest rates at or below their current low levels for as long as is needed to support recovery. This decision reflects the Euro-zone's combination of very low growth in prices, money and credit alongside high unemployment. The Bank of Japan is also running very accommodative policy aimed at getting inflation up to 2% by keeping interest rates near zero and buying assets.
- Global growth remained moderate in the latter half of 2013. The advanced economies have experienced a protracted period of sub-trend economic growth following their deep 2008/9 recession. As a result, GDP in the G7 advanced economies only grew by around 3% between early 2008 and the latter half of 2013 – the weakest outcome since the 1930s. This resulted in a jump in unemployment and idle capacity which lowered price pressures. There is, however, considerable variation between economies, with high inflation still posing problems in several big emerging economies of Asia and Latin America.
- Business surveys taken at the end of 2013 were consistent with continued moderate growth, although there was a slight dip in the degree of confidence in several countries. The main hurdle to get over now is the April increase in Japanese indirect taxes. Judging by past events, this will pull spending and activity into late 2013 and early 2014 but then create a softer period in consumer spending after the tax rise. So far, business expectations for 2014 remain quite buoyant and the government has announced a fiscal package to support demand.
- Business confidence came back a little in the December UK purchasing managers survey , but it remains at a high level, The January CBI reading on manufacturing also showed orders slipping from December 2013's 18 year high but shows investment intentions are finally picking up, with rising business investment a key element in the forecast UK recovery. Euro-zone business surveys are consistent with only a modest recovery from a very deep recession which has left the jobless rate at over 12% and inflation less than 1%- well below the ECB's target level.
- Mixed conditions continue to prevail across the main emerging market economies. Chinese GDP growth slowed modestly in the final quarter of 2013 (from 7.8% yoy to 7.7% yoy), a result that lined up with the easing trend seen in the central bank's main business survey and in partial indicators of activity like industrial output and fixed investment spending. 2013 proved a disappointing year for the Indian economy with tight monetary policy and supply problems coming to the fore. While the partial data on industrial output, imports and infrastructure activity remain weak, some of the latest business surveys are finally pointing to an improvement in activity.
- Our headline forecast remains unchanged from late 2013 with global growth expected to lift from 3% in 2013 to 3½% in 2014. With emerging market economy growth expected to remain around 5¼% yoy, it is the expected upturn in the pace of GDP expansion in the advanced economies from 1¼% to 2¼% that drives the pick-up in global growth between 2013 and 2014. The main uncertainties in our key export markets are the extent to which the Chinese economy slows down (our numbers have lower growth than either the IMF or OECD predict) and the speed with which Indian growth accelerates out of its 2013 soft patch. For India we are also more conservative than the IMF who forecast 5.4% and 6.4% growth in 2014 and 2015 respectively.

<u>Australia:</u> More positive economic indicators for Australia, including NAB business conditions (jumped to highest level in 2½ years), hold out hope that a turning point may be near. However, the labour market is still weak and will remain a headwind as labour-intensive mining investment peaks. Other forward indicators generally still soft. Our forecasts are broadly unchanged: GDP for 2013/14 now 2.5% (unchanged) and 2014/15 now 3.0% (was 2.9%). Unemployment rate still to peak at 6½% in late 2014. The combination of near term better business conditions and (especially) the unexpectedly strong Q4 underlying inflation print has caused us to move our next rate cut call from May to November. We do not expect a rate hike until late 2015.

- Over the summer there was more positive news on the domestic economic front. Business conditions in the NAB survey rose sharply in December to their highest level in more than 2½ years. The run up in asset prices continued until the vacation recess and there are indications that retailers experienced a better Christmas than last year. Housing approvals have strengthened and may soon begin to appear in starts and construction activity. The AUD plumbed new depths during the month, bringing some relief to exporters but imposing higher input costs on others. This has given some comfort that the Australian economy may be approaching a turning point.

- Despite some more positive data, the labour market remained largely in the doldrums and forward indicators do not suggest that this is likely to change any time soon. In December, the unemployment rate remained at 5.8%, but both the demand for and supply of labour continued to decline sharply. Partial employment indicators remained mixed at best and despite showing slower rates of decline in late 2013, they still point to weak labour demand. Employment and participation has been weaker than we expected, prompting us to revise down our track for both through 2014. However, we still expect the unemployment rate to peak at around 6½% in late 2014 before beginning to decline.

- Deterioration of the labour market will be a major constraint on the economy over coming quarters, particularly for household consumption, but there is some prospect of an improvement in consumer demand in the near-term following the increases in household wealth in the second half of 2013. The MLC Wealth Sentiment Index indicates that households are becoming slightly less averse to investment in shares. However, the NAB Consumer Anxiety Index shows that households are highly concerned about the cost of living.

- Business conditions in the NAB survey improved noticeably in December, but the spectrum of forward indicators cast some doubt over its sustainability. Trend business conditions in December imply GDP growth will rise to around 3% in Q4, but in our judgment growth will not be this strong once allowance is made for factors not captured in these simple relationships. In particular, we expect weakness in mining sector investment and public sector spending (largely outside the scope of the survey) to appear in the early part of 2014. Other forward indicators from the NAB survey, such as capacity utilisation and capital expenditure, remain subdued.

- Our GDP forecasts are broadly unchanged: in through-the-year terms, we expect growth to edge up from 2.3% in Q3 to 2.6% (was 2.5%) by mid-2014. In financial year terms, GDP growth forecasts are: 2.5% (unchanged) in 2013/14, and 3.0% (was 2.9%) in 2014/15. However, with GDP increasingly driven by the capital-intensive minerals energy sector and given the recent softness in the labour market, we see modest employment growth in the near term before it begins to recover: 0.2% (was 0.6%) through 2013/14, and 1.5% (was 0.9%) through 2014/15.

- We now expect the next rate cut in the second half of 2014, possibly November (previously May). As always, the precise timing is data dependent: in particular, it requires a further upward drift in unemployment, more stable asset prices and confirmation of subdued inflation. The most recent underlying inflation reading has raised questions about the last of these conditions and may give the RBA grounds for taking longer to assess the need for further monetary easing. We do not expect it to precipitate a rate increase given the state of the labour market. Our central scenario is for the unemployment rate to keep rising, the asset price spurt to run its course and the Q4 inflation outcome to prove something of an outlier. We do not expect a rate hike until late 2015.

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