National Australia Bank

March 2014

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> The upward trend in the advanced economy business surveys faltered toward the end of 2013 and this has continued into early 2014. Nevertheless, this softer note probably reflects bad weather disrupting supply chains and there is no evidence in either the financial markets or forward looking questions in the business surveys that the predicted gradual upward trend in global growth has been called into question. Advanced economy growth has picked up, largely reflecting trends in industry and other sectors whereas service sector activity in the latter half of 2013 was held back by government shutdowns, fiscal austerity and consumer caution. Emerging economy growth has flat-lined as expected and that looks set to continue.

- Interest rates look set to remain very low in the big advanced economies for some time yet. The US Federal Reserve has said that it looks likely to keep interest rates low well past the time when the jobless rate falls below 6½%, provided that inflationary pressures are under control. We expect the Fed to begin lifting its funds rate in the latter half of next year. Ahead of that the Fed should continue to gradually wind back new asset purchases ("tapering") through the rest of 2014. Other central banks look set to keep their policy rates low as well. The ECB faces inflation running well below its target rate and is keeping its policy rates at or below their current level for "an extended period of time". The Bank of England set a 7% jobless rate as a threshold for considering the evidence on whether it was time to consider increasing its bank rate (and certainly not a trigger for starting to lift its very low policy interest rate). The UK jobless rate fell to 7.2% in late 2013, near the threshold, but the central bank has concluded that there is still scope to keep rates low.
- The pace of global growth picked up steadily through 2013 – from 2.5% yoy at the start of the year to 3.6% yoy by the December quarter. Recovery in the big advanced economies accounted for this global upturn – their growth rising from only 0.5% yoy in March to just over 2% yoy by December. Growth remained stable in both China and India through 2013 while there was a modest acceleration across Latin America and the emerging economies of East Asia. The recovery in advanced economies has varied across sectors, with industry generally outperforming the service sector (held down by consumer caution and government cutbacks).
- The upward trend in industrial sector business surveys across the big advanced economies petered out at the end of last year with quite large falls in early 2014 in some big economies (notably the US). This softness in the last few months probably largely reflects bad weather, disrupting production schedules, as there are few signs that the underlying level of business confidence or demand have turned down. Forward looking questions that focus on firms' expectations of future trading conditions suggest that the industrial upturn is set to continue.
- The average pace of growth in service sector business activity in the big advanced economies dipped very slightly in February, but the results were still consistent with solid growth. Looking at individual economies, February growth in service sector activity slowed noticeably in the US (possibly weather affected) and Japan (unexpected, given the impending lift in indirect taxes – but early readings for March rebounded). The UK service sector was strong and essentially unchanged while the Euro-zone improved.
- The pace of Indian economic growth in December quarter was 4.7% yoy, below market expectations and slightly slower than recorded in the previous quarter. This outcome lines up with the poor performance shown in late 2013's monthly output and international trade data, where there was no sign of a rebound in activity. Nevertheless, the main business surveys are pointing to an upturn starting in the first half of 2014 and a General Election is likely to be held in April. The official Chinese data is held up by the usual start of the year delay but the monthly industrial business surveys for early 2014 are consistent with trend slowing in manufacturing. Elsewhere in East Asia slow growth continued into early 2014 for exports and industrial output.
- Global growth is forecast to rise from last year's 3% to 3½% this year and then reach an around trend 3¾% in 2015. Growth in the emerging market economies is expected to barely pick up as the predicted slower growth in China offsets faster expansion elsewhere. However, we will now be reviewing our Chinese forecast in the light of the recently announced 7½% official growth target for 2014. Although the emerging economies still drive most of the world's increase in output, the contribution of the advanced economies is recovering to more "normal" levels.

<u>Australia:</u> GDP growth of 0.8% in Q4 obscured weakness of domestic demand (up 0.1%). Capital expenditure expectations point to a two-year decline of 21% in labour-intensive mining investment, with little offset from other industries. Australian forward indicators largely in retreat as NAB business conditions and orders fell in February. The labour market adjustment task over the next few years continues to grow as the persistently high AUD and cost structures take further toll on trade-exposed manufacturing. Stronger dwelling approvals, particularly for apartments, should be supportive in the near term, but fiscal restraint will not. The case for a rate cut in late 2014 (November) unchanged: while unemployment rate should reach 6½% by the end of 2014, we now expect it to remain elevated into 2015. Our expected track for the AUD is unchanged. Our growth forecasts are unchanged: GDP growth of 2.7% in 2013/14 and 3.0% in 2014/15.

- The Australian economy grew at 0.8% in Q4 despite a decline of 0.4% in hours worked, largely in line with our expectations. This pattern of jobless growth is set to continue as labour-intensive mining construction is replaced by capital-intensive mining production over the next few years. Annual GDP growth of 2.8% is still below the rate needed to prevent rising unemployment. However, given the capital intensity of exports, it is domestic final demand growth that is more relevant to the labour market and, at 1.2%, it remains particularly soft. Private business investment continues to be the weakest area of domestic demand, declining by 3.4% in underlying terms in Q4. There was a sharp decline in new machinery and equipment investment (8.2%), which is now 16.6% lower than a year ago. The capex survey points to a 14.6% fall in nominal mining equipment investment in Q4 along with falls in other industries.

- Forward indicators beyond Q4 signal little likelihood of an improvement in growth. The tentative improvement in NAB business conditions since late 2013 fell away in February driven by poorer conditions in manufacturing and wholesale (a bellwether industry) and forward orders weakened. On a positive note, business confidence remains better than during much of last year, although it drifted down a little in February.

- Business conditions for February imply GDP growth will rise to around 3% in Q1, 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. In contrast, our wholesale leading indicator suggests much weaker underlying conditions, pointing to further below trend economic growth in the first quarter of 2014 of around 2¾% and continuing weakness into Q2.

- Labour market indicators are mixed and suggest that an improvement in January may have been unwound in February. The unemployment rate rose to 6.0% in January and continues to be suppressed by weakness in the participation rate, currently 64.5%, probably in part reflecting discouraged worker effects. The labour adjustment task from the mining sector appears to have been magnified by recent announcements of the end of automotive manufacturing and several other high-profile operations as well as labour-shedding in aviation over the forecast horizon. Our forecast profile for the unemployment rate is broadly unchanged until 2015, when we have slowed the rate of improvement marginally to be 6.1% by end-2015 (was 5.8%).

- Our GDP forecasts are broadly unchanged: in through-the-year terms, we expect growth to be broadly constant at 2.8% from Q4 to mid-2014 (was 2.6%) and 2.9% to mid-2015. In financial year terms, GDP growth forecasts are unchanged: 2.7% in 2013/14, and 3.0% 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: 0.3% (was 0.2%) to mid-2014, and 2.0% (was 1.5%) to mid-2015.

- We still expect the next rate cut in the second half of 2014, possibly November, but 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. 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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