National Australia Bank

July 2014

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> After rising through 2013, the main business surveys have gone sideways in 2014 and the pace of global growth has slipped slightly. We have lowered our global GDP forecasts for 2014 from 3.4% to 3.2%. In part bad weather in North America explains some of early 2014's disappointing outcome but the Euro-zone upturn also faltered and Japan's economy has to digest the April rise in indirect taxes. Despite these headwinds, we expect global growth to quicken to 3.7% in 2015 and 2016 as the US recovers and expansion picks up in long-time under-performing economies like India and the Euro-zone.

- After a long period in which the focus of most central banks in the big advanced economies has been on low interest rates and injecting liquidity to stave off deflation, boost growth and repair the consequences of the GFC, we are now entering a period of greater diversity in monetary policy. The Fed is still winding back its asset purchases at a rate that should see them end this year but it is still signalling low interest rates into 2015. The Bank of England recently surprised the markets saying that rate rises could come sooner than generally expected. By contrast, the ECB and the Bank of Japan are focussed on ending or avoiding deflation with the former recently loosening policy and the latter continuing its ultra-easy policy as inflation finally starts to rise.
- The pace of growth in global industrial output has settled at a moderate pace of around 3¾% yoy since late 2013, a clear improvement on the sub-2% yoy growth rates seen at the start of 2013. This pick-up through 2013 reflected an improvement in conditions in the big advanced economies alongside a slowing trend in the main emerging economies. World trade, on the other hand, has been more volatile with a distinct slowdown since the end of last year. It is too early to sound the alarm bells that shrinking global trade could signal a weakening in output - but the monthly data should now be closely watched in case of ongoing weakness.
- Revised US data has magnified the slowdown in G7 advanced economy growth that was recorded in early 2014. Some of the early 2014 weakness should be discounted as it reflected the impact of bad weather and other shocks in North America. Also business surveys have not been as weak as GDP – so business is not sensing a sudden move toward recessionary conditions. Elsewhere conditions are mixed. Euro-zone growth in early 2014 was very disappointing and the business surveys since then have not shown much of an improvement. In fact, recent European Commission and PMI industrial surveys for the Euro-zone have been trending down as ongoing weak conditions in France and Italy weigh on sentiment. However the Belgian central bank's business survey – a useful guide to conditions across the region – is not showing any collapse in firms' demand expectations, so things should at least stabilise. Elsewhere, the UK is finally recovering strongly from its deep and protracted downturn and Japanese business is adjusting to the shock to demand caused by the April hike in sales taxes.
- The slowing trend in the big emerging economies has continued into 2014 with March quarter growth slipping to 5.4% yoy, down from the 6% yoy recorded in mid-2013. Industrial growth has settled at around 4% yoy since mid 2013 but a couple of soft monthly numbers early this year have cut the trend annualised growth rate to below 3%. Services are the biggest single sector in the emerging market economies and growth there has been gradually trending down for years. Services growth was around 6% yoy in March quarter, well below the over 8% yoy growth rates seen a few years ago. The emerging market slowdown is also widespread with recent monthly data showing China continuing its gradual slowing trend, India still disappointing the optimists and modest outcomes in Latin America and East Asia.
- Downward revisions to US March quarter history have flowed into a cut in our 2014 US growth forecasts, but growth should recover next year. The other big downward revision is for Latin America where new data shows Argentinean GDP (the 22nd biggest global economy) fell in early 2014 as the economy faced a new debt crisis. There is also uncertainty surrounding the impact of the World Cup on the recently soft Brazilian economy. Global growth is forecast to quicken from 3.2% this year to 3.7% in both 2014 and 2015, which is around or slightly above the long-run trend. The emerging economies should still account for the bulk of the increase in global output but the contribution from advanced economies should pick-up this year and next as the latter's growth accelerated from 2013's 1¾% to 2¾% this year and next. Emerging market growth should remain over 5% as India's growth finally picks up.

<u>Australia:</u> Domestic indicators continue to point to jobless growth and no certainty that declining mining investment will be replaced quickly. Retail looks softer and the property (price) market seems near a plateau. Extent of fiscal consolidation remains uncertain and the unsettled state of consumers, post the Budget, could be a slow negative burn on demand and ultimately business outcomes. Forward indicators from survey still weak. Australian forecasts unchanged: 3.3% in 2014/15, 3.0% in 2015/16. But jobless growth still sees unemployment rate peak at 6¼% by end-2014. Cash rate unchanged until late 2015. On rates our judgement is that the risk of a further easing has risen but so far hasn't satisfied the high hurdle necessary to get the RBA to do anything about it.

- The domestic economy continues to experience relatively jobless growth. So far, Q2 has seen a continuation of weak demand for labour, particularly in terms of hours worked. Retail trade fell in May following a soft April. This is in line with the plunge in consumer confidence in the lead up to, and after, the federal budget. Residential building approvals are showing signs of stabilising following their decline since the start of the year. Non-residential building approvals are very bouncy with the May jump helping to partly moderate the extent of the recent trend down. The latest engineering construction data confirms a weakening trend for mining construction and a declining pipeline of work yet to be completed. While the level of mining construction remains high by historical standards, the data are only for Q1 and we expect several major projects to be commissioned during the remainder of 2014.

- The latest NAB business survey reveals encouraging improvements in sales and profitability in June, especially in mining and construction, but overall employment weakened again. Conditions remain challenging in wholesale and manufacturing. The survey shows limited response by firms to the recent "tough budget", but the true impact remains uncertain. The change in the composition of the Senate on 1 July will lead to further negotiations over several major federal budget measures. We are unlikely to have a firm view on the macroeconomic impact of the budget until these negotiations have been concluded. Nevertheless, it seems likely that fiscal restraint will provide a headwind to growth in coming quarters.

- Forward indicators are mixed, with possible evidence of restocking offset by flat orders and weaker capacity utilisation. Nevertheless, confidence has held up reasonably well around long-run averages, despite headwinds from weak business conditions and a negative reaction from consumers to the budget. NAB survey data for Q2 imply stronger predicted GDP growth but weaker predicted demand growth compared with Q1. Our 'wholesale leading indicator' points to soft business conditions in coming months – not consistent with a strong Q2 GDP outcome.

- Labour market forward indicators, while generally much better than a year ago, remain mixed. The NAB employment index from the business survey declined to -3 points in June, to be consistent with further upward drift in the unemployment rate. The unemployment rate was unchanged at 5.8% for the third consecutive month in May and hours worked per capita regained most of the ground lost in April. Employment in mining and construction has begun to show signs of a sustained decline, with a sharp downward correction still likely as mining construction winds down. We still expect the unemployment rate to peak at around 6¼% by the end of 2014 before progressively declining during 2015 as displaced mining construction and services labour is absorbed into new infrastructure projects, dwelling construction and associated activities.

- Our GDP forecasts are unchanged: for 2014/15 3.3%; for 2015/16 3.0%. We still expect the unemployment rate to peak at around 6¼% by the end of this year. With GDP increasingly driven by the capital-intensive minerals energy sector, we still see modest employment growth in the near term before it begins to recover: 0.8% (was 0.9%) to mid-2014, and 1.6% (was 1.7%) to mid-2015.

- The RBA is reluctant to raise the cash rate so long as growth is likely to remain below trend and uncertainties persist about the impact of lower mining investment. A higher cash rate would give unwanted support to the AUD, while a cut to already historically low cash rates is just as unlikely, particularly given the recent re-ignition of house price growth. These cross-currents are likely to see the cash rate on hold for the remainder of the year and well into next.

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