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The Bigger Picture – A Global & Australian Economic Perspective

National Australia Bank

<u>Global:</u> Moderate sub-trend global growth continues with a diversity of economic conditions (solid expansion in US, UK, India and China, weakness in Euro-zone, Japan, Latin America). Falling oil prices should boost global activity, although the impact varies between oil exporting and importing countries. Our estimates are conservative but lower oil prices still boost our forecasts for the US, Japan, Euro-zone, India, China and non-Japan Asia while Russia and other big energy suppliers are revised down. Adding in the other (mainly negative) recent changes in the environment gives growth going from 3% last year to 3½% in 2015 and 2016.

- Divergent economic conditions between the big advanced economies are reflected in recent central bank decisions on monetary policy. With growth looking solid, the Fed is still preparing the ground for a gradual rise in US policy rates, although low inflation means that tightening could start later than we previously expected. The Bank of Japan's policy remains focussed on promoting inflation and a recovery in output by keeping zero interest rates through boosting the money supply. Policy rates in the Euro are near zero, but negative inflation and a weak economy prompted the ECB to step up its asset buying policy to include government bonds. Currencies also reflect the divergence in conditions, with the yen and euro weakening as the $US appreciates, which should rebalance growth toward the weaker economies. Bond yields have also fallen sharply across key economies, reflecting the drop in world inflation, safe haven effects and sluggish growth, but we expect US bond yields to rise back to 2¾% by early 2016.
- Global economic growth appears to be continuing at a sub-trend pace and business survey readings are consistent with moderate growth. Key $US commodity prices have been falling sharply with the CRB measure down by almost 10% since late November. The biggest falls have been for industrial raw materials, whereas falls in food and agricultural raw materials have been more modest. Demand growth, while lacklustre, has held up, implying price falls are due to a supply response to previously high non-fuel commodity prices alongside the higher $US in which many commodities are traded. Lower commodity prices will feed into already softening global inflationary pressures. Inflation pressures in big emerging market economies like Brazil, India, S Africa and Mexico are supporting overall CPI inflation but price pressures are minimal in the big advanced economies. The Euro zone is concerned by deflation, Japan is still focused on finally getting out of its deflationary trap, while US and UK CPI inflation is well below target.
- Although quarterly growth in the big advanced economies picked up through last year, the recovery remains lacklustre overall with big variations between regions. North America and the UK have been the out-performers in the G7, although the recoveries have been muted. Looking at the timely business surveys: results have been strong in the US, signs of a slowdown following a solid UK upturn, virtual stagnation in the Euro-zone and a Japanese economy that is still struggling to recover from last April's tax hike. The combination of much lower oil prices, Euro depreciation, a reduced pace of fiscal austerity, more central bank asset buying and better credit supply and demand conditions should help the Euro-zone, but the recovery will be very gradual. Similarly, lower oil prices and yen depreciation will drive a modest upturn in Japanese growth, at least until the planned April 2017 hike in indirect taxes. Despite the resumption of growth elsewhere, the US will remain the main driver of advanced economy growth.
- Emerging market growth slowed last September quarter, but monthly trade data for late 2014 showed a modest upturn commencing. As in the advanced economies, the monthly partial indicators show conditions are mixed across the emerging markets. There is weakness across much of Latin America and parts of East Asia, a trend slowing in Chinese growth while the anticipated upturn in India is still to show up in the export and industrial output data. While the fall in oil prices is a net positive for activity in most advanced economies, many emerging market economies are important oil exporters. Consequently, GDP in entire regions like North Africa and the Middle East as well as important economies like Russia, Venezuela and Indonesia will eventually be hit by a protracted period of price weakness. Other emerging market economies like China and India should derive considerable benefits from lower prices
- Forecasts have been revised only modestly, reflecting our cautious initial assessment of the impact from (largely supply driven) falls in the oil price, given the rather downbeat global environment in which this shock has occurred. Despite downside risks, we see growth accelerating from around 3% in 2014 to near 3½% this year and next, still slightly below trend. If this oil shock had a similar impact to previous episodes, there is scope for the acceleration in growth to be greater, especially given the scope to keep interest rates lower than usual.

- ***<u>Australia:</u> Fully factoring in lower oil and other commodity forecasts have created a larger "v" in the shape of our activity forecasts – softer in the near term (2014/15) as iron ore/coal effects dominate but stronger in the medium term (2015/16) reflecting oil prices, rate cuts and marginally stronger MTP growth and exports. Cuts to national incomes and lower inflation are key short term outcomes. Core CPI 1¾ % by Q1 2015. Unemployment to continue to deteriorate but peak lower (6.6%) and later (Q4 2015). Still expect two rate cuts in 2015 but timing very dependent on data flow and could start a touch later.***
- The Survey again shows a patchwork economy with little-to-no momentum building. In December, conditions eased for the second successive month after October's surprisingly strong result, to be a touch below the long run average. Additionally, forward orders fell back significantly (broad based) suggesting soft demand conditions will continue in the near term. On the other hand, levels of capacity utilisation edged up a touch. By industry, the deterioration was particularly pronounced in construction and mining. Business confidence improved a touch, but was flat to one decimal point. More importantly confidence remains well below long run averages. Falls in commodity prices underlie substantial declines in mining confidence. Lower oil prices appear have contributed to a kick in optimism in transport/utilities firms (now the most confident). The 'bellwether' wholesale industry remains very weak. Consistent with this, the recent strength in business credit eased back to 0.2% in November (but around 4.6% y/y).
- The employment numbers at the end of 2014 surprised on the upside, but could reflect statistical catch with traditional partial labour market indicators (such as job ads). That said, not all the labour market indicators are strong – especially hours worked and employment to population ratios. Going forward, the activity outlook is what matters for employment. On this, the December Monthly Business Survey suggested that, slowing business conditions, flat/weak confidence and falling new orders are weighing on employment (which fell back below its longer term trend). Overall, we expect the unemployment rate to gradually rise to around 6.6% by end 2015 (previously expected 6.8%) and coming later in the year. Unemployment is then expected to improve somewhat faster than previously expected on the back of rate cuts, falls in oil prices and better export volumes from improved major trading partner growth prospects.
- After a period of strength, both retail and online sales weakened in November. Generally consumer sentiment remains relatively weak (including into January) as does retail confidence. While consumer anxiety eased back a touch in Q4, consumers are still very much focussed on what might be called non discretionary purchases (such as utility costs, transport, medical expenses and paying off debt). It is early days re retail spend over the Christmas period, but NAB credit/debit card data suggest spending was not as strong as last year. Anecdotal evidence is that the lead into Christmas was particularly weak but was boosted by pre Christmas sales. Consistent with a weak lead into Christmas consumer lending in November was flat.
- According to RP Data-Rismark dwelling prices in Sydney and Melbourne started to flatten towards the end of 2014. Evidence of heat coming out of the housing market can be seen in the NAB Quarterly Australian Residential Property Survey, where expectations for house prices increases over the next year eased back considerable with fears of falls in Perth. On credit, housing credit growth maintained recent growth rates with owner occupied still around 0.5% (y/y 5.7%) in November and investor a touch lower at 0.8% (but still around 10% y/y).
- Dwelling investment recorded a surprise decline in Q3, partly due to softer apartment approvals mid-year. That trend has now reversed sharply, especially in the four storeys and above apartments. That is increasingly likely to show up in new starts and activity – albeit housing approvals and starts remain subdued. Further rate cuts are likely to help boost housing approvals and investment into 2016. Regarding non-residential construction, there is an emerging risk that the decline in mining construction this year will be steeper than anticipated. Against that, expectations in the non resources sector are being boosted by the lower AUD, expected rate cuts and continued aggressive apartment building construction. Overall, however, we see the scope for even faster falls in private investment. Low confidence and falls in new orders (across all sectors) are also not helping. Nor are concerns over the global outlook.
- Given our expectation for softer near term activity, we still expect two rate cuts in 2015 – although the timing is very dependent on data flow and could start a touch later than expected (March and August). Unemployment to continue to deteriorate but peak lower (6.6%) and later (Q4 2015). GDP forecasts cut in near term, but recovers faster: 2014/15 2.3% (was 2.5%); 2015/16 3.2% (was 3.0%).

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