April 2015

The Bigger Picture – A Global & Australian Economic Perspective

***Global**: Global growth remains stuck at a sub-trend pace. After 3.3% in 2014 we now expect only 3.4% in 2015. While the Euro-zone and Japan are experiencing upturns, recent US data has disappointed. We have delayed the Fed starting till September (or later) and reduced US GDP in 2015 to 2.7%. March quarter business surveys do not suggest any acceleration in advanced economy growth – which we require to achieve the 2015 forecast. There is no evidence of an upturn in emerging market economy growth either.*

- Divergence in economic conditions between the big advanced economies has been highlighted in recent central bank decisions on monetary policy. The Fed is still preparing the ground for a gradual rise in US policy interest rates but recent soft activity data and an absence of inflation pressures give the Fed discretion over when to start raising rates. We think the first 25 bps rise will come in September with another by year end. 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 by buying assets (especially government bonds). They will maintain these policy settings until confident inflation has settled at the target 2%. With Euro-zone CPI inflation turning negative in late 2014, little growth in output and double-digit unemployment, the ECB stepped up its asset buying policy with the decision to purchase government bonds. Divergent underlying conditions between the big advanced economies are reflected in the fall in the Yen and Euro and the appreciation of the $US.
- Global GDP growth continues at a sub-trend pace of just over 3%. Partial data available for February shows industrial output growing at just over 3% yoy, around the same rate as averaged over the previous 6 months. Advanced economy business survey results for March quarter show a mixed picture. Recent poor results for the US have depressed overall sentiment in the advanced economy industrial sector. Economy-wide surveys show activity growth holding up but not accelerating in the first quarter. Emerging economy conditions also vary with positive results in India (third biggest global economy), soft outcomes across much of East Asia - including China (possibly now the world's biggest economy) and recessionary conditions in Brazil (the seventh biggest global economy).
- Annualised growth in the big 7 advanced economies accelerated across the first three quarters of 2014 before slowing slightly in the final quarter. The US accounted for most of this slowing in late 2014 as Japanese and Euro-zone growth was faster. March quarter business surveys show measures of manufacturing and services activity trending down in the US, picking up in the Euro-zone and mixed signals in the UK and Japan. The surveys are, however, consistent with solid growth in the UK and US plus continued, albeit still weak, growth in Japan. Some of the recent weakness in the US reflects bad weather and port strikes but, as softer than expected data has gradually accumulated through recent weeks, there are concerns that growth could continue to weaken. The stronger $US is now curbing activity with reports of heightened competitive pressure on exports and import competing industry. Elsewhere, the Euro zone seems to have commenced a long awaited economic upturn and there is plenty of scope for further catch-up. The jobless rate across the G7 Advanced economies has fallen to around 7%, not far off its 25 year average and the amount of idle industrial capacity has halved. However, unemployment rates in the UK, US and Japan have fallen to below their 25 year average, Euro-zone unemployment is still 10%.
- Emerging market economy growth remained around 6% yoy through 2014 and, taken overall, neither the business surveys nor the partial data on trade volumes or industrial output suggest a pickup. Business surveys give a mixed picture. Confidence levels in Indian business have picked up but Brazilian surveys are at recession levels and survey readings across East Asia are not very strong. The sluggishness in world trade and falling commodity prices have depressed income and activity in many key emerging markets. Chinese industrial output and fixed investment spending continues to slow, while retail trade has held up much better (in line with policy objectives). Indian data on trade and output is not as solid as recent buoyant business surveys might suggest.
- We are now forecasting a more muted upturn in the global economy than was the case a few months ago. Although our forecasts are below those of the IMF and Consensus, their direction of risk is probably still downwards. This reflects the notable risk that the long awaited acceleration in global growth gets postponed again. Indeed, our tracking indicators of current world economic activity are still not showing much sign of an impending upturn.

<u>Australia</u>: We have fine tuned but not fundamentally changed our forecasts– 2014/15 2.3% and 3.0% in 2015/16. The non mining sector is still struggling to offset the impact on domestic demand of sharply lower mining investment. Further falls in commodity prices are lowering income flows. A particular concern is the weak medium term outlook for non mining investment, while the consumer remains cautious. As a result we still see unemployment rising to 6.7% by end 2015. Another rate cut is expected – most likely May but could be delayed if the economy improves (tentative signs of this in the March NAB Business Survey). We see the probability of a cut to below 2% being around 35-40% - well below market expectation (fully priced). Rate rises to start in late 2016.

- There were some tentative signs of improvement in the NAB Monthly Business Survey for March, with the post RBA cut fall in confidence reversed in March. Surprisingly, the lift was particularly pronounced in mining, although confidence is still lowest for this industry. Elsewhere outcomes were mixed, suggesting some industry specific factors are also at play. Business conditions recorded a notable lift, with each component (trading, profit, employment) posting an improvement – although employment continues to be relatively muted. This level of conditions is pointing to a slightly above average rate of activity, although the trend is somewhat softer. If maintained it could well boost confidence further. There was a surprisingly strong improvement in conditions for the 'bellwether' wholesale industry, although the export index is yet to respond to the more favourable AUD, while orders are soft (and down slightly). Capacity utilisation and capex, encouragingly, both improved.
- While there is still considerable noise in the labour market indicators, recently some partials such as job ads and vacancies appear to have marginally softened. That said, many of the partials still suggest stronger labour demand than the official employment series, which has also weakened. NAB's employment series (from the Survey), which leads official statistics by around 6 months, suggests some near term softness. For the next 6 months the index is pointing to employment growth of around 180k jobs per annum or around 15k per month – a rate of employment growth that, at the margin, might be insufficient to stabilise the unemployment rate (unless the participation rate falls). Clearly confidence will need to improve before business is prepared to significantly hire. We continue to expect unemployment to reach 6.7% by end 2015 and remain stubbornly high – still above 6% by end 2016/17.
- The pattern of retail sales has been volatile, affected by special events – such as the release of the iphone 6 in September 2015. Thus much of the strength in Q4 real consumption reflected the iphone base effect. Similarly, despite better nominal sales in early 2015, Q1 2015 consumption will be lowered by base effects of very weak retail sales in late 2015. To date reasonable retail sales growth in January / February is encouraging, although indications from the NAB Business Survey are not as promising. Online retail has also been somewhat volatile, but the latest reading for February was strong. Generally consumer anxiety is up and appetite for discretionary spending is still lacking. Consequently, personal credit growth is also weak.
- According to RP Data-Rismark dwelling prices in Australia rose 7.4% in the year to March – with the strongest markets very much Sydney (up 13.9%) with the next best Melbourne (up 5.6%). Outside of Sydney it appears that the heat is coming out of the housing market. In contrast it appears that the February rate cut has lifted Sydney prices in year on year terms. Clearly the investor market in Sydney is driving this momentum, and based on loan approval data, is unlikely to pull back any time soon. On credit, housing credit growth continues to run at 0.5% per month or 7.2% in the year to February. However investor credit is much stronger at 0.7% per month or 10.1% annually. The latter is still above APRA's maximum growth rate.
- Very high levels of approvals for dwellings construction – especially apartments – means dwelling investment will be strong over the next year. While recent attempts to tighten foreign investment rules may slow demand eventually, the reality is that the existing approvals will be built – and contribute to the reallocation of resources from mining to the non mining sector. With mining work yet to be done falling, the expected declines in mining investment are well underway. The latest NAB monthly survey points to some rises in near term non mining investment and business credit is now significantly stronger. That said it is difficult to be sure if the trend will be short lived or not. Certainly the medium term expectations data is much more concerning.
- Our forecasts have not fundamentally changed: GDP growth of 2.3% in 2014/15 and 3% in 2015/16. The non mining sector is still struggling to offset the impact on domestic demand of sharply lower mining investment. Unemployment to reach 6.7% by end 2015 and remain stubbornly high – still above 6% by end 2016/17. Another rate cut is expected – most likely May but could be delayed if the economy improves. An additional cut is possible, but likelihood is less than market expectation (fully priced). Rate rises to start in late 2016.

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