June 2015

The Bigger Picture – A Global & Australian Economic Perspective

Global: Weak GDP results in the US, UK and Canada have outweighed a pick-up in Japan and the Euro-zone and similarly mixed trends among the big emerging economies saw China slowing, India picking up and Brazil still very weak. The monthly manufacturing output and world trade numbers were soft, particularly the latter, and the business surveys do not show any clear evidence yet of an imminent lift in growth momentum. Our forecast is for more of the same this year with global growth staying around 3¼ % in 2015, followed by a modest upturn in 2016 (largely driven by the US).

- 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 and we expect the first rise in September. 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 this setting until confident inflation has settled at its target 2%. Although Euro-zone headline CPI inflation turned positive in May, the European Central Bank remains committed to its policy of very low interest rates and monthly asset purchases of €60 billion which should continue until September 2016 at the earliest. The Euro-zone recovery is proving weaker than the ECB hoped, adding to the case for it to keep policy stimulatory. Divergent underlying conditions between the big advanced economies have been reflected in the fall in the Yen and Euro and the appreciation of the $US. Foreign exchange markets marked the $US down through April and early May but it has since regained ground.
- Global growth has not ramped up to around its long run trend as was expected. Monthly data on world production and trade flows suggests that growth in manufacturing output has lost momentum, while the volume of trade actually shrank in early 2015. Preliminary data for April shows global manufacturing output growing by around 2% yoy, less than half its long-run trend rate. There was a modest rise in business confidence in advanced economy manufacturing but it is too early (and the data sufficiently volatile) to read much into it. The limited information available on service sector activity does not point to an upturn either (with the possible exception of Japan, where the economy is gradually recovering from last year's tax rise).
- The March quarter saw falling output in the US and Canada, which along with a halving in the UK growth rate, was sufficient to almost offset solid growth in the Euro-area and Japan. The outcome was a near stagnation in output across the G7 advanced economies in the opening months of 2015. As the US and UK have been the standout performers in the G7 upturn, the softer early 2015 output figures show a marked shift in the regional composition of global growth. The extent to which this setback in the US recovery is only temporary and due to "special factors" has been much debated. Our forecast lines up with public guidance from the US Federal Reserve that the US upturn has not been de-railed and it will continue through the remainder of the year – making the case for the Fed to lift policy interest rates. Timely surveys of purchasing managers show growth continuing across the manufacturing and services sectors across W Europe, the US and Japan – but at widely varying rates. Most of these survey readings are consistent with at most moderate rates of economic expansion but there are a couple of stand-out sectors – especially in the services sector where results across the UK, US and Euro-zone appear more buoyant than for manufacturing. Japan has been the weak link in service sector activity but it appears to be finally picking up.
- There is no evidence that growth in the main emerging market economies accelerated in early 2015. The monthly trends in trade and manufacturing output volumes do not show evidence of any pick-up either. Export volumes fell quite heavily in the quarter and export receipts were even more depressed as commodity prices softened, hitting incomes in the big commodity producing countries across Latin America, Africa and SE Asia. Chinese growth is gradually slowing, while the monthly partial economic indicators show a mixed picture – most are consistent with a softening in growth. The weakness shown in world trade is reflected in exports from big emerging economies in Latin America and East Asia. Lower commodity prices have eroded receipts in major economies like Brazil, Argentina and Indonesia.
- We have revised our forecasts downwards to take account of the weak first quarter US results and the longer than expected downturn in Brazil. Although our forecasts are below those of the IMF and Consensus, their direction of risk is probably still downwards. This reflects the risk that the long awaited acceleration in global growth gets postponed again.

<u>Australia</u>: We have fine tuned but not fundamentally changed our forecasts– 2014/15 2.4% (was 2.3%), 2015/16 2.6% (was 2.9%) and 3.0% (unchanged) in 2016/17. The domestic economy is struggling to offset the impact of sharply lower mining investment – as again highlighted in the Q1 National accounts. Subsequently some recent data- such as the Nab Survey - has improved, but capex expectations in the non mining sector have weakened, business are reluctant to employ and consumers remain cautious. With future domestic demand still weak, unemployment is expected to rise a touch to around 6.4% by end 2015 and remain relatively for some time. Given our forecasts, we see the RBA keeping interest rates on hold, with the next move to up – but not till late 2016.

- The recent Federal Budget and interest rate cut appears to have had a positive impact on business confidence, which moved up significantly in May to its highest level since August 2014. Confidence was significantly higher in retail / wholesale (possibly associated with expectations from the Small Business Package) and finance, business and property services. Mining confidence, on the other hand, fell significantly. The pick-up in confidence could also reflect improved business conditions, which further cementing the upward trend seen over recent months. All components of the conditions index (trading, profitability and employment) improved in the month. The 'bellwether' wholesale industry improved, but remains weak (transport was weak also). Encouragingly, leading indicators such as forward orders improved, as did capacity utilisation and capex spending. Business credit eased back a touch – flat in April but is still up 5% over the year.
- It appears that moderate growth in employment has continued and there has been some flattening out of labour market partials. Looking at the employment series in the Nab survey – which provides a strong 6 month lead on annual employment growth – the current reading would be consistent with growth in employment of around 15k jobs per month over the next 6 months – a rate of employment growth insufficient to stabilise unemployment (unless participation rates fall). More encouragingly, there has in recent months been a significant increase in hours worked per employee, albeit with no real change in the employment to population ratio. With employment expected to rise around 15k per month for the rest of 2015, the unemployment rate is forecast to edge up marginally to around 6.4% by years end. Thereafter employment growth edges higher and the unemployment rate starts to move down but at a very moderate rate – remaining above 6% till mid 2017.
- The pattern of retail sales continues to be volatile. That said, real consumption growth in the Q1 National Accounts continued to disappoint – indicative of a still wary consumer, who at present is also facing falls in average earnings per employee (according to the National accounts). More recently retail sales have slowed, although the Nab survey does suggest retail improved in May. Online retail has also been volatile. In trend terms, on line retail has been running around 0.6% per month - but April sales were much stronger. Consumer anxiety has increased in Q1 2015 and remains relatively high, although monthly measures have improved. Personal credit remains flat – up just 0.6% in the year.
- According to RP Data-Rismark dwelling prices in Australia have risen 9.6% in the year to May - but with radically different outcomes across Australia. Thus Sydney was up 16.4% in the year to May, Melbourne 9.8%, Brisbane 3.1%, Adelaide 3.4%, Perth 1.0% and Hobart a fall of 1%. The Sydney market in particular is facing severe undersupply issues as well as low interest rates – with similar issues evident in Melbourne. These markets have been driven by investor activity which is difficult to restrain in the face of low interest rates and high tax rates. On credit, housing credit growth continues to run around 0.5% per month or 7.2% in the year to April. However investor credit is much stronger at 0.8% per month or 9.9%% annually – just below APRA's maximum growth rate.
- Dwelling investment was solid in Q1 2015 and with very high building approvals – especially apartments – we expect to see similar or stronger growth in dwelling investment over the forecasting horizon. A significant driver of new apartment demand has come from foreign investors. Indeed property developers estimate around 15% of new sales are to foreigners with much concentrations in both Melbourne and Sydney (around 20% – anecdotal reports are even higher). Recent attempts to tighten foreign investment rules may slow demand eventually, but existing dwelling approvals will still contribute to a 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.
- Our forecasts have been fine tuned: GDP growth of 2.4% in 2014/15 (was 2.3%) and 2.6% in 2015/16 (was 2.9%). Our activity and labour market forecasts suggest that the rate cutting phase is finished with rates on hold for a considerable period and then rise from late 2016.

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