

Australian Markets Weekly

A weekly outlook for Australia, key global economies and markets

27 July 2015

A different answer to Glenn's conundrum!

This week we focus on two important developments from last week:

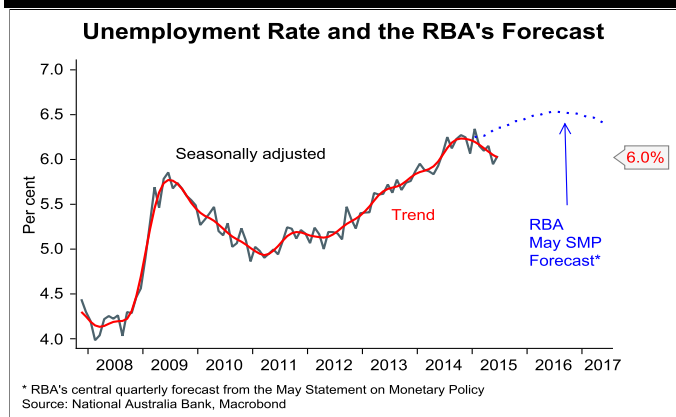
- First, the Governor (and Board's) conundrum, whereby the Bank is unsure why the unemployment rate is falling, against expectations of a continuing rise; and
- Second, the implications for Australian markets, if the reason for the fall is indeed a reduced trend rate of growth.

We also preview this week's events, of which the FOMC meeting is key.

Why is unemployment falling?

Both the [Board Minutes](#) and a [speech by the Governor](#) last week highlighted that the RBA has been surprised by the recent stabilisation and even slight decline in the unemployment rate. As our first chart shows, this runs contrary to expectations, with the May Statement of Monetary Policy forecasting the June unemployment rate would be close to 6½% compared to the latest ABS estimate of 6%. The recent decline in the unemployment rate has been underpinned by a strengthening in employment growth from around October last year – i.e. well before the last two interest rate reductions by the RBA.

Chart 1: Labour market outcomes improving

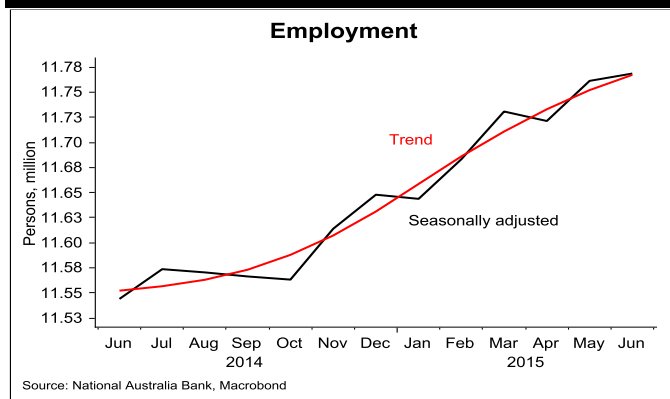


Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7273	-1.3	RBA cash	2.00	0
AUD/CNY	4.52	-1.3	3y sw ap	2.15	-15
AUD/JPY	90.0	-1.7	ASX 200	5,566	-1.8
AUD/EUR	0.663	-2.6	Iron ore	51.4	1.5
AUD/NZD	1.106	-1.5	WTI oil	48.1	-4.7

Source: Bloomberg

Chart 2: Employment still growing despite below trend growth



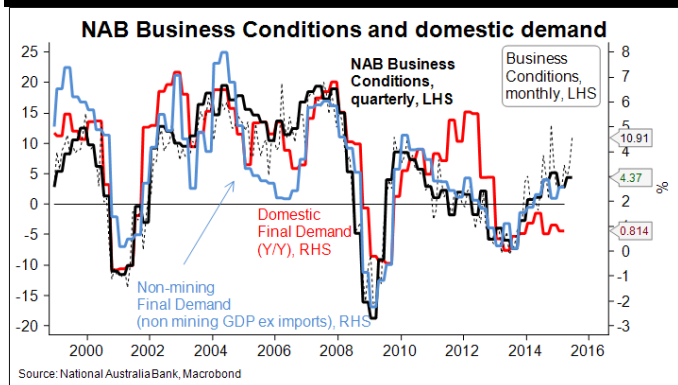
This led the Governor to posit a number of reasons that might explain this occurrence, namely:

- GDP growth has been stronger than reported and will be revised up;
- The vagaries of the labour force sample have produced this outcome and revisions will see the unemployment rate data ultimately revised up. Note the Governor also referred to the re-benchmarking that will occur when July data are released in August. This will see the recent trend rates of employment growth revised down somewhat as the Statistician incorporates slower population growth due to reduced immigration. However, this should not significantly alter the trend in either the unemployment rate or the employment to population ratio as the re-benchmarking will affect both the numerator and denominator of these calculations;
- Australia's potential or trend growth rate may now be lower than the 3-3.25% growth rate previously assumed. Therefore what the RBA previously forecast as below-trend output growth may in fact be closer to trend growth (or arguably a little above trend growth, given the unemployment rate is beginning to decline). A slowdown in productivity growth is the most likely candidate here – though population growth is also slowing, albeit from recently elevated levels that arguably may have boosted trend growth in recent years (especially in the mining sector); or
- Perhaps slower wages growth explains stronger employment growth with below-trend output growth.

Our reading of recent data adds another possible answer, namely, that stronger employment growth is consistent with an improvement in the non-mining economy, which in GDP terms, and overall demand is being masked by the weakness in mining. The relative intensity of employment in each sector means the improvement in non-mining growth is more important for the labour market. In support of this possible candidate as the answer to Glenn's conundrum, we would

refer the reader to charts 3 and 4, below. Chart 3 suggests non-mining domestic demand growth has been stronger than overall demand growth – and closer to historical trend rates of growth - a trend which is mirrored by improvement in business conditions in the NAB Business Survey.

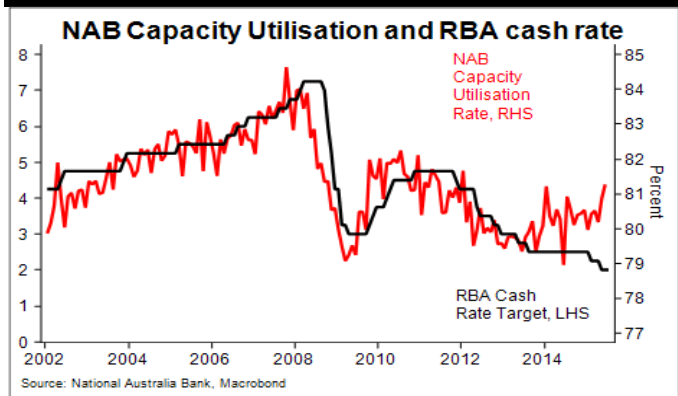
Chart 3: Non-mining demand stronger than total demand



Interestingly, one could also argue – and the chart supports this contention – that this is the reverse of the situation that occurred after the GFC when the RBA was overly-focused on the strength of the mining economy and for a time missed the slowing in non-mining. It has obviously been the case recently that the Bank and most of the market have been preoccupied with the prospective slowdown in mining investment (though the RBA Minutes last week do examine quite a few reasons why non-mining growth may be doing better than expected).

The fourth chart reminds that trends in capacity utilisation historically have been closely correlated to trends in the RBA cash rate – and that the current trend in capacity use would ordinarily be more supportive of the market beginning to price a slow tilt to higher cash rates!

Chart 4: Pick up in capacity utilisation diverges with rates



In terms of reconciling these developments with slower potential output growth, we'll examine those issues shortly however in the short term we would recommend that customers continue to follow the trend for the unemployment rate. This measure will provide the short cut answer as to whether growth is above or below trend or – as we posit above-non-mining growth is above or below trend and therefore this more labour intensive sector is overwhelming the drag that is occurring from weakness in mining investment and employment. If the unemployment rate continues to decline, the RBA will likely conclude that growth is above trend (or as

we suggest – growth in that part of the economy that matters most for the labour market – is above trend) – irrespective of what that trend rate of growth now is.

This contention, if it turns out to be correct, would reinforce the NAB view that no further monetary policy easing will occur in this cycle and that the market may begin to think about when the RBA might begin to remove monetary accommodation, especially as the turn in the non-mining economy appears to have begun some time ago.

However, it's not completely the end of the easing story, as there is still the issue of spare capacity to be considered – ie. the fact that the unemployment rate is 6%, not closer to 5%. As the Bank has eased policy twice after the turn in the non-mining economy – and the \$A continues to decline – this should still be sufficient to mean that the RBA has reached the bottom in interest rates this cycle, barring some major negative development occurring in major offshore economies. That said, with spare capacity, the Bank can afford to run the economy at above-trend growth for a time.

The Bank will no doubt continue to puzzle the conundrum of falling unemployment and below-trend output growth – it's unlikely to make further policy adjustments while it has not come to a definitive judgement on what is going on.

The recent increase in risk weights for housing lending for five significant banks in Australia is also something that needs to be considered for monetary policy. If this move resulted in a significant rise in interest rates for borrowers in Australia, as occurred when funding costs rose, this could become a consideration for the RBA. Our expectation, however, is that the development is not significant enough to cause a large rise in home lending rates – though a number of banks have increased rates for investor loans in recent days. This is unlikely to be the same cause for concern for the RBA as the more widespread increase in home lending and indeed business lending rates that occurred when funding costs last rose in 2012. To be sure, the RBA will react to, rather than pre-empt, any change in lending rates that occurs.

In that regard, a possible downgrade of Australia's sovereign credit rating if budgetary repair does not occur seems a greater risk to consider.

What about trend growth?

One way to think of trend growth is as the long-term growth of the labour force plus the productivity of the labour force in transforming labour into output. While we plan to take a more detailed look at what drives long-term trend growth in coming weeks, a few recent trends are worth observing.

Firstly, population growth is slowing. As population growth drives the growth rate of the labour force (along with the participation rate), this may result in a slowing in Australia's trend growth. If trend growth has slowed because of slower population growth this may in part explain why the unemployment rate has been able to decline despite what seems to be apparently below trend rates of economic growth.

Interestingly, the slowing in population to date has been concentrated in the mining states of WA and QLD, where migrants were drawn to on the back of the mining boom.

With the mining boom waning, net overseas migration has been the slowest it's been in many years in the December quarter of 2014. If that rate were sustained for the next three quarters, total population growth would be back at levels seen before the mining boom (charts 5 and 6).

Chart 5: Population growth slowing due to slowing in migration

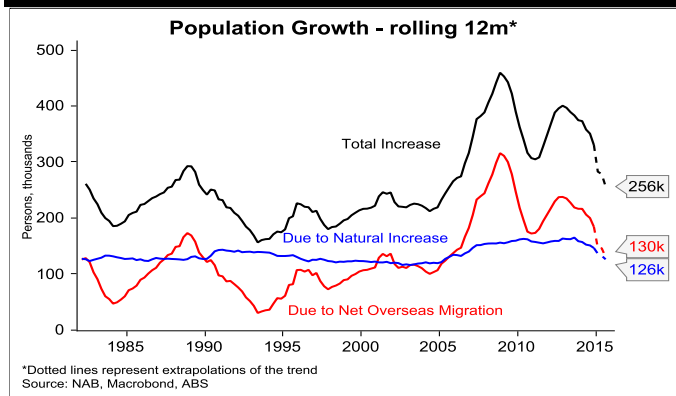
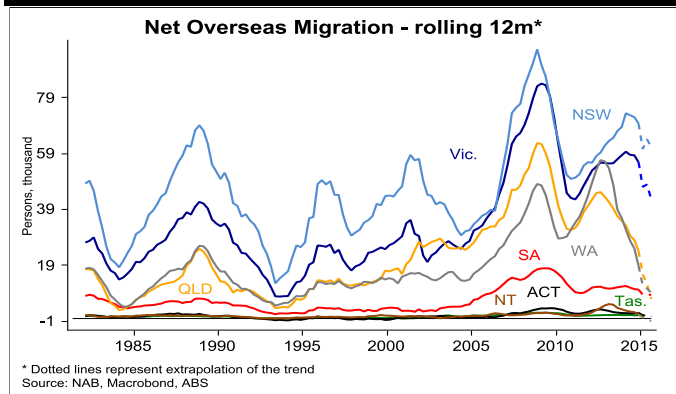


Chart 6: Migration slowing most in WA and QLD



Secondly, productivity growth has slowed. The slowing in productivity growth if sustained will also decrease trend rates of growth. Rather paradoxically, it could be argued that the slowing in Australia's trend growth rate was masked previously by the marked pick-up in population growth over the past decade. That could explain why the unemployment rate started to increase slowly in recent years. By the same token, mining productivity is no doubt also complicating assessment of the underlying trend for productivity growth, in the same way as it

may be disturbing assessment of demand growth and labour market trends. Again, the short cut for readers will be to watch trends in the unemployment rate as that will indicate whether growth is above or below trend growth, whatever the trend rate of growth turns out to be!

FOMC the focus of the week ahead

Australia has only second-tier releases this week: the volatile monthly building approvals release and the June quarter NAB SME (Small-Medium Enterprises) Business Survey on Thursday and credit data on Friday.

The credit data are worth a closer look this month, as they may pick up some strength in small business lending as businesses take advantage of the Government's small business budget initiatives ahead of the June 30 end of Australia's financial year. It's also worth noting that while some of this spending may leak into retail sales, most of it should be measured as capital spending, not retail sales, given small businesses are not final consumers. The RBA Governor's speech on Thursday should not be a market-mover (this week), being within the blackout period ahead of next week's Board meeting, and stick to a theme more closely aligned with the Asia Financial Cooperation Conference that he is addressing.

The big event this week is of course the next FOMC meeting – with the policy announcement early on Thursday morning Australian time (4am AEST). There are now only four meetings left this year for the Fed to begin to raise interest rates as it continues to suggest is likely. For this meeting, there is little expectation that even the Fed's arguments will develop too significantly, apart from perhaps noting some firming in underlying inflation.

NAB continues to look for two rate hikes from the Fed this year, the first in September and a follow-up move in December. The market has a considerably less strong view of the Fed, with just one hike priced by the end of the year. Both of our forecasts will require a run of at least moderately strong payroll numbers – there are still two prints before the September meeting and an additional three releases before the December FOMC – to support the case. Fed tightening remains part of the expectation for further easing in the \$A to the low US\$0.70s by end year, a forecast that remains on track.

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Calendar of Economic Releases

Country	Economic Indicator	Time Period	NAB Forecast	Consensus	Actual	Previous	GMT	AEST
Monday, 27 July 2015								
JN	PPI Services YoY	Jun		0.70%		0.6%	23.50	9.50
CH	Industrial Profits YoY	Jun				0.60%	1.30	11.30
GE	IFO Business Climate/Current Assessment/Expectations	Jul		107.5/113/102		107.4/113.1/102	8.00	18.00
EC	M3 Money Supply YoY	Jun		5.10%		5.00%	8.00	18.00
UK	CBI Trends Total Orders	Jul		-5		-7		
US	Durable Goods Orders	Jun		3.00%		-1.8%	12.30	22.30
GE	Retail Sales MoM/YoY	Jun					14.00	0.00
US	Dallas Fed Manf. Activity	Jul		-4		-7	14.30	0.30
Tuesday, 28 July 2015								
AU	ANZ Roy Morgan Weekly Consumer Confidence Index	Jul-26				111.8/+4.5%	23.30	9.30
UK	GDP QoQ/YoY	2Q A		0.7%/2.6%		0.4%/2.9%	8.30	18.30
UK	Index of Services MoM	May		0.30%		0.20%	8.30	18.30
CA	Industrial Product Price MoM	Jun				0.50%	12.30	22.30
CA	Raw Materials Price Index MoM	Jun				4.40%	12.30	22.30
US	S&P/CS 20 City MoM SA	May		0.20%		0.30%	13.00	23.00
US	Markit US Services PMI	Jul P		55		54.8	13.45	23.45
US	Consumer Confidence Index	Jul		100		101.4	14.00	0.00
US	Richmond Fed Manufact. Index	Jul		6		6	14.00	0.00
Wednesday, 29 July 2015								
NZ	RBNZ Governor Wheeler speaks at private event; speech on RBNZ web site						21.00	7.00
JN	Retail Sales MoM	Jun		-1.00%		1.70%	23.50	9.50
CH	Westpac-MNI Consumer Sentiment	Jul				112.3	1.45	11.45
JN	Small Business Confidence	Jul				46.9	5.00	15.00
GE	GfK Consumer Confidence	Aug		10.1		10.1	6.00	16.00
UK	Mortgage Approvals	Jun		66.3K		64.4K	8.30	18.30
UK	CBI Reported Sales	Jul		30		29		
US	MBA Mortgage Applications	Jul-24					11.00	21.00
US	Pending Home Sales MoM	Jun		1.1%		0.9%	14.00	0.00
US	FOMC Rate Decision	Jul-29		0-0.25%		0-0.25%	18.00	4.00
Thursday, 30 July 2015								
NZ	Building Permits MoM	Jun				0	22.45	8.45
UK	GfK Consumer Confidence	Jul		5		7	23.05	9.05
JN	Industrial Production MoM/YoY	Jun P		0.30%		-2.10%	23.50	9.50
AU	RBA Governor Stevens speaks to Asia Financial Cooperation Conference, Sydney						1.00	11.00
AU	Export/Import prices QoQ	2Q	-5%/0.5%	-4%/1.5%		-0.8%/-0.2%	1.30	11.30
AU	Building Approvals MoM/YoY	Jun	1.5%/21.8%	-0.9%/19.5%		2.4%/17.6%	1.30	11.30
AU	NAB SME (Small Business) Business Survey	2Q					1.30	11.30
GE	Unemployment Rate / Change (000s)	Jul		6.4%/-5K		6.4%/-1K	7.55	17.55
EC	ECB Publishes Economic Bulletin						8.00	18.00
EC	Business Climate Indicator	Jul				0.14	9.00	19.00
GE	CPI MoM/YoY	Jul P		0.2%/0.3%		-0.1%/0.3	12.00	22.00
US	GDP Annualized QoQ	2Q A		2.5		-0.20%	12.30	22.30
US	Initial Jobless Claims	Jul-25				255K	12.30	22.30
Friday, 31 July 2015								
UK	GfK Consumer Confidence	Jul					23.05	9.05
JN	Jobless Rate/Jobs-Applicants ratio	Jun		3.3%/1.20		3.3%/1.19	23.30	9.30
JN	Overall Household Spending YoY	Jun		1.80%		4.80%	23.30	9.30
JN	Natl CPI YoY	Jun		0.30%		0.50%	23.30	9.30
JN	Tokyo CPI YoY	Jul		0.30%		0.30%	23.30	9.30
NZ	ANZ Business Confidence	Jul				-2.3	1.00	11.00
AU	PPI QoQ/YoY	2Q				0.5%/0.7%	1.30	11.30
AU	Private Sector Credit MoM/YoY	Jun	0.5%/6.0%	0.5%/6.0%		0.5%/6.2%	1.30	11.30
NZ	Credit Aggregates, Household YoY	Jun				5.50%	3.00	13.00
EC	Unemployment Rate	Jun		11.10%		11.10%	9.00	19.00
EC	CPI Estimate YoY	Jul		0.20%		0.20%	9.00	19.00
US	Employment Cost Index	2Q		0.6%		0.7%	12.30	22.30
CA	GDP MoM/YoY	May		0.00%		-0.10%	12.30	22.30
US	ISM Milwaukee	Jul				46.55	13.00	23.00
US	Chicago Purchasing Manager	Jul		50.5		49.4	13.45	23.45
US	UoM Consumer Sentiment	Jul F		94		93.3	14.00	0.00
Saturday, 1 August 2015								
CH	Manufacturing PMI	Jul				50.2	1.00	11.00
CH	Non-manufacturing PMI	Jul				53.8	1.00	11.00
Upcoming Central Bank Interest Rate Announcements								
US	Federal Reserve	30-Jul						
Australia	RBA	4-Aug	2.00%	2.00%		2.00%		
UK	BOE	6-Aug				0.50%		
Japan	BoJ	7-Aug	0.0%-0.1%	0.0%-0.1%		0.0%-0.1%		
Europe	ECB	3-Sep				0.05%		
New Zealand	RBNZ	10-Sep	2.75%			3.00%		
Canada	BoC	10-Sep				0.50%		

GMT: Greenwich Mean Time; AEST: Australian Eastern Standard Time

Forecasts

Economic Forecasts

	Annual % change				Quarterly % change														
	2013	2014	2015	2016	2013		2014				2015				Q2	Q3	Q4		
Australia Forecasts					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Household Consumption	1.7	2.5	2.5	2.7	0.3	0.4	0.8	0.6	0.5	0.7	0.5	0.8	0.5	0.5	0.5	0.7	0.5	0.5	0.7
Underlying Business Investment	-4.5	-6.4	-10.2	-10.2	-4.9	-1.5	0.8	-3.5	-2.4	-0.9	-1.0	-1.5	-4.6	-2.1	-4.1	-2.0			
Residential Construction	0.5	7.9	11.7	6.5	-2.7	3.0	0.3	1.3	4.3	1.7	-1.2	3.9	4.7	2.8	2.3	2.5			
Underlying Public Spending	0.4	0.8	0.0	1.1	2.7	-0.2	-0.5	1.3	0.3	0.5	-1.4	0.1	0.2	0.2	0.2	0.2			
Exports	6.3	6.8	10.6	8.6	0.9	3.7	-0.6	1.7	4.1	-1.6	3.1	1.6	5.0	2.0	1.9	2.1			
Imports	-1.8	-1.6	2.4	1.2	-3.3	2.8	-1.4	-0.5	-2.5	3.1	-1.2	-1.6	3.1	0.4	-0.2	0.6			
Net Exports (a)	1.6	1.7	1.8	1.7	0.9	0.1	0.2	0.4	1.4	-0.9	0.9	0.7	0.5	0.4	0.5	0.3			
Inventories (a)	-0.3	0.0	0.1	0.0	-0.2	0.3	-0.3	-0.2	-0.3	0.9	0.1	-0.7	0.5	-0.2	-0.1	0.1			
Domestic Demand - qtr%					-0.1	0.2	0.5	0.2	0.3	0.6	-0.4	0.5	0.0	0.3	0.0	0.4			
Dom Demand - ann %	0.5	1.1	0.8	1.0	0.5	0.0	0.6	0.7	1.1	1.5	0.7	1.0	0.8	0.5	0.9	0.8			
Real GDP - qtr %					0.3	0.7	0.4	0.8	1.0	0.6	0.3	0.5	0.9	0.6	0.4	0.8			
Real GDP - ann %	2.1	2.7	2.5	2.7	2.0	2.1	1.9	2.2	2.9	2.8	2.7	2.4	2.3	2.3	2.4	2.8			
CPI headline - qtr %					0.4	0.4	1.2	0.8	0.6	0.5	0.5	0.2	0.2	0.5	0.8	0.9			
CPI headline - ann %	2.4	2.5	1.7	3.1	2.5	2.4	2.2	2.7	2.9	3.0	2.3	1.7	1.3	1.4	1.7	2.5			
CPI underlying - qtr %					0.5	0.6	0.6	0.9	0.6	0.7	0.4	0.6	0.6	0.5	0.6	0.7			
CPI underlying - ann %	2.4	2.6	2.3	2.6	2.3	2.4	2.3	2.6	2.7	2.8	2.5	2.3	2.4	2.2	2.4	2.4			
Wages (Pvte WPI -ann %)	2.9	2.5	2.2	2.2	3.1	3.0	2.8	2.5	2.6	2.4	2.4	2.5	2.2	2.2	2.2	2.2			
Unemployment Rate (%)	5.7	6.0	6.3	6.3	5.6	5.7	5.7	5.9	5.8	6.0	6.2	6.1	6.2	6.3	6.3	6.4			
Terms of trade	-3.8	-7.4	-10.6	-2.1	1.0	-0.3	-1.3	0.4	-1.9	-4.6	-2.9	-1.5	-2.9	-5.9	-0.4	1.2			
G&S trade balance, \$Abn	-10.4	-9.2	-21.8	-4.7	-3.0	-2.8	-3.3	-1.3	2.7	-5.1	-4.0	-2.7	-3.7	-7.6	-6.3	-4.2			
% of GDP	-0.7	-0.6	-1.3	-0.3	-0.8	-0.7	-0.9	-0.3	0.7	-1.3	-1.0	-0.7	-0.9	-1.9	-1.5	-1.0			
Current Account (% GDP)	-3.3	-2.8	-3.1	-2.0	-3.3	-3.4	-3.6	-3.1	-1.9	-3.6	-3.1	-2.5	-2.7	-3.6	-3.3	-2.7			

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts

	27-Jul	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Majors						
AUD/USD	0.7270	0.74	0.72	0.71	0.71	0.72
NZD/USD	0.6577	0.64	0.62	0.60	0.60	0.61
USD/JPY	123.72	124	125	126	126	127
EUR/USD	1.0976	1.07	1.05	1.03	1.03	1.04
GBP/USD	1.5519	1.53	1.52	1.51	1.51	1.53
USD/CNY	6.2095	6.22	6.22	6.25	6.28	6.30
USD/CAD	1.3041	1.28	1.28	1.25	1.25	1.23

Australian Cross Rates

	27-Jul	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
AUD/JPY	89.9	92	90	89	89	91
AUD/EUR	0.6624	0.69	0.69	0.69	0.69	0.69
AUD/GBP	0.4685	0.48	0.47	0.47	0.47	0.47
AUD/NZD	1.1054	1.16	1.16	1.18	1.18	1.18
AUD/CNY	4.5143	4.60	4.48	4.44	4.46	4.54
AUD/CAD	0.9481	0.94	0.92	0.89	0.89	0.89
AUD/CHF	0.6995	0.73	0.73	0.74	0.74	0.00

Interest Rate Forecasts

	27-Jul	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Aust rates						
RBA Cash rate	2.00	2.00	2.00	2.00	2.00	2.00
3 month bill rate	2.14	2.15	2.15	2.15	2.20	2.40
3 Year Swap Rate	2.15	2.4	2.6	2.8	2.9	3.2
10 Year Swap Rate	3.13	3.4	3.6	3.7	3.7	4.0
Offshore Policy Rates						
US Fed funds	0.25	0.50	0.75	0.75	1.25	1.50
ECB refi rate	0.05	0.05	0.05	0.05	0.05	0.05
BoE repo rate	0.50	0.50	0.50	0.75	1.00	1.25
BoJ overnight call rate	0.08	0.10	0.10	0.10	0.10	0.10
RBNZ OCR	3.00	2.75	2.50	2.50	2.50	2.50
China 1yr lending rate	4.85	4.60	4.60	4.60	4.60	4.60
China Reserve Ratio	18.5	18.0	17.5	17.0	17.0	17.0
10 Year Benchmark Bond Yields						
Australia	2.77	3.0	3.4	3.4	3.4	3.5
United States	2.26	2.50	2.75	2.8	2.8	3.0
Europe/Germany	0.69	0.4	0.6	0.7	0.8	0.0
UK	1.93	2.0	2.1	2.2	2.4	0.0
New Zealand	3.29	3.4	3.5	3.6	3.7	3.9

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP

Dec year	2013	2014	2015	2016	20 Yr Avge
Australia	2.1	2.7	2.5	2.7	3.4
US	2.2	2.4	2.4	2.7	2.6
Eurozone	-0.4	0.9	1.4	1.8	1.5
UK	1.7	2.8	2.2	2.4	2.4
Japan	1.6	-0.1	0.9	1.2	0.8
China	7.7	7.4	7.1	6.9	9.2
India	6.4	7.1	7.6	7.6	6.6
New Zealand	2.2	3.3	2.4	2.2	3.0
World	3.3	3.3	3.2	3.3	3.5

Commodity prices (\$US)

	27-Jul	Sep-15	Dec-15	Jun-16	Dec-16
WTI oil	48.14	55	60	65	70
Gold	1097	1150	1100	1060	1060
Iron ore	51	60	61	58	54
Hard cok. coal	112	98	95	93	97
Thermal coal	62	68	68	62	62
Copper	5253	6080	6260	6200	6170
Japan LNG	9.9	11.0	11.0	11.0	11.0

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