more give, less take

Global & Australian Forecasts

by NAB Group Economics

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August 2015

National Australia Bank

Key Points:

- Global growth is running below trend and looks set to remain lacklustre, limiting the pace of expansion in commodity demand. Output has been growing faster recently in some of the big advanced economies (notably the US and UK) and the Greek crisis has had little impact on activity across the rest of the Euro-zone. Stagnation in growth across the emerging market economies, the principal drivers of recent global output expansion, is the main area of disappointment and reflects the sluggish growth in world trade volumes and falling commodity prices. The bursting of the share market bubble will probably only worsen China's trend slowdown, recent Indian data is again disappointing and there is weakness across large parts of East Asia and Latin America –not a good environment for commodity prices.
- The Australian economic outlook remains mixed and patchy. Mining investment is declining sharply, public spending is limited and national income growth is weak amidst declining commodity prices. Meanwhile, monetary policy is highly stimulatory and the AUD is acting as a shock absorber, with tentative evidence of further recovery in non-mining activity. House prices are growing strongly, particularly in the eastern states, and consumer spending has picked up recently. Non-mining investment remains the missing ingredient – with firms demanding very high rates of return before investing – 13% according to our survey. Our GDP forecasts are marginally stronger than last month – 2.4% in 2014/15, 2.8% in 2015/16 and 3.2% in 2016/17 – with domestic demand weak and net exports making a large contribution. The unemployment rate hovers near the current 6¼% before easing slightly into 2016/17. With rates already low, this outlook is not sufficiently weak to prompt further monetary policy easing. Equally, expectations for elevated unemployment imply that rate hikes are unlikely until the recovery in non-mining activity is more entrenched (late 2016 on our view). Risks emanating from offshore are overwhelmingly to the downside, while stronger local data if sustained suggest some modest upside risk.

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.3	2.6	2.5
Euro-zone	12	0.9	1.4	1.8	2.1
Japan	4	-0.1	0.9	1.2	1.1
China	16	7.4	7.1	6.9	6.5
Emerging East Asia	8	4.0	3.8	4.0	4.2
New Zealand	0.2	3.3	2.4	2.2	2.1
Global total	100	3.3	3.2	3.3	3.4
Australia	2	2.7	2.6	3.0	3.3
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.2	2.6	3.0	2.8
Domestic demand		1.0	0.8	1.5	1.3
GDP		2.5	2.4	2.8	3.2
Core CPI (*% through-year*)		2.7	2.3	2.6	2.5
Unemployment rate (*% end of year*)		6.0	5.9	6.0	5.8

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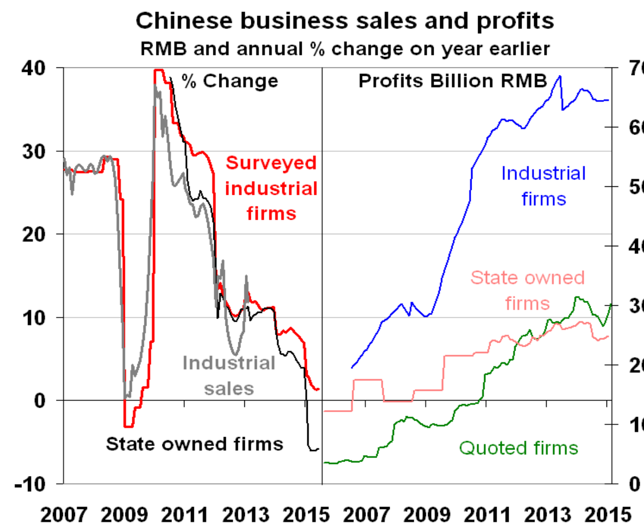
Global and Australian overview

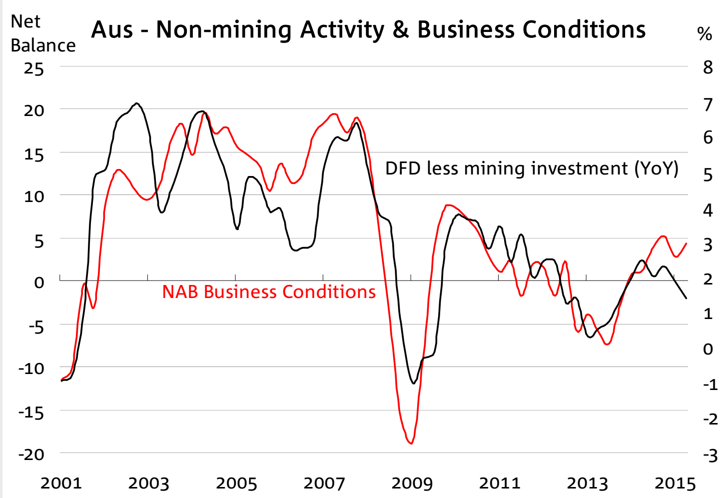
Global overview

- Behind the usual volatility in the quarterly economic numbers, there was little evidence of the long forecast pick up in global economic growth through the first half of the year. There were positive signs in some of the big advanced economies - second quarter US and UK output growth accelerated and Euro-zone business survey readings were quite positive, despite the Greek crisis. However, the bulk of global growth has been coming from the emerging market economies in recent years and these have been looking softer. The Chinese economy continues its trend slowdown, Indian data continues to disappoint hopes for a solid upturn and weak primary product markets and sluggish world trade is hitting incomes and output across East Asia, Latin America and commodity exporters generally.
- With the Greek crisis controlled for now, attention is focussed on the Chinese equity market as the biggest and most obvious immediate risk for the global economy. The slide in revenue growth among Chinese businesses and the levelling out in profits are clearly hard to reconcile with the first half surge in share prices, suggesting that a bubble formed and the authorities are now intervening to support an overvalued market to stop a price spiral downwards.

Australian overview

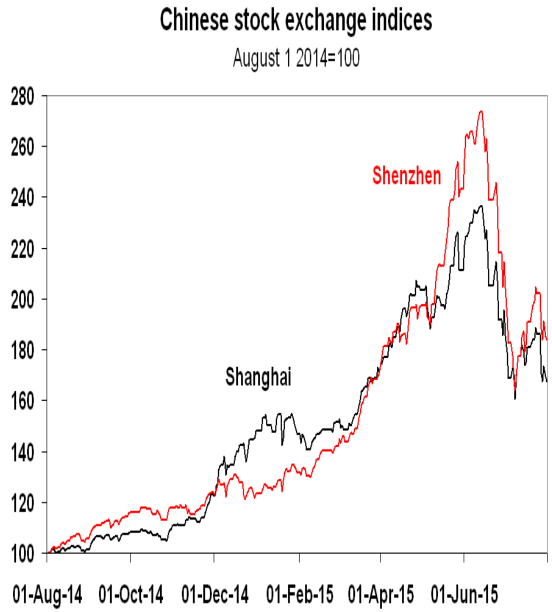
- Our GDP forecasts are marginally stronger than last month, with growth of 2.8% in for 2015/16 and 3.2% in 2016/17. Our unemployment rate forecasts are unchanged from a peak of 6¼% following revisions last month. The divergence between weak medium-term expectations (particularly for non-mining investment) and stronger short-term indicators has become more pronounced. In particular, employment has been stronger than anticipated, and business confidence, conditions and capacity utilisation are all trending upwards (despite the dip in July). Meanwhile, the AUD is acting as a stabiliser and helping to offset the impact of further declines in commodity prices and the terms of trade, with evidence of a pick up in net services exports (particularly tourism). The housing market in the eastern states remains strong, both in terms of construction and prices, while consumer spending indicators improved in June.
- These forecasts are based on the assumption of further easing in the AUD/USD to a low of 71c by Q1 2016 before gradually picking up. The RBA is expected to remain on hold until late 2016, although is likely to retain an easing bias until the non-mining recovery is further entrenched. The risks to these forecasts are broadly balanced; further improvement in the domestic data flow (and a rebound in business conditions and confidence in coming months following the dip in July) would suggest upside risk, while global risks (particularly emanating from China) are to the downside.

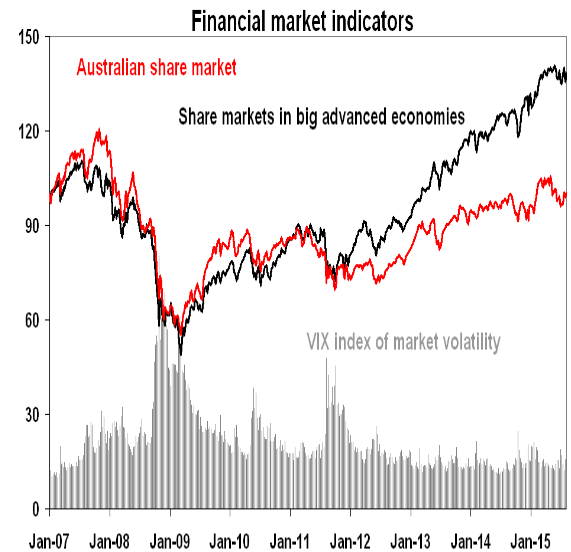


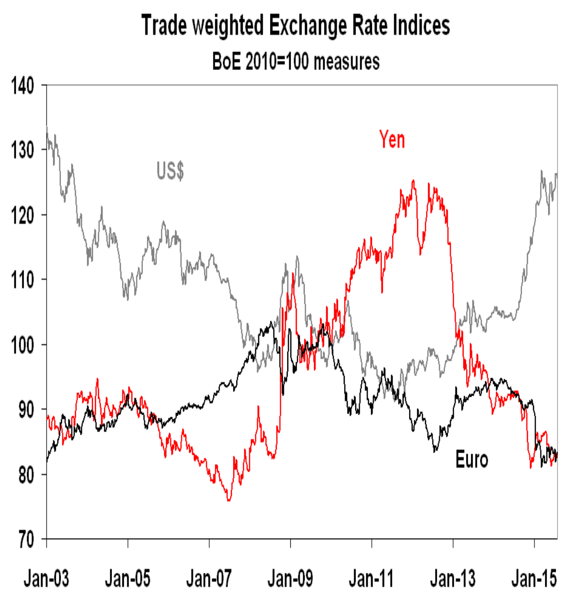


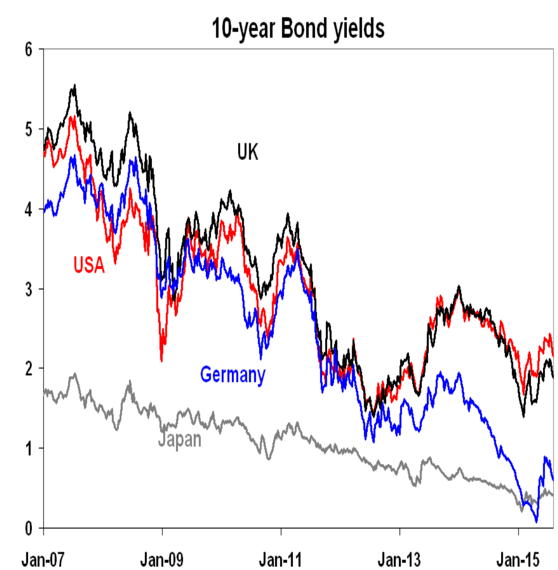
Financial markets

- The two big issues of market focus are the likely timing of US/UK interest rate increases and the implications of the array of measures the Chinese authorities have introduced to prop up the share market. Apart from that, bond yields have reversed some of their recent recovery from exceptionally low levels and US$ appreciation has marked time on a trade weighted basis.
- Facing an improving labour market, we think the Fed will start lifting rates in September. The Fed has signalled that this process of rate increases should prove to be gradual by the standards of previous monetary tightening cycles and the peak rate reached at its end lower than in the past.
- The decline in share prices has wiped almost RMB 20 trillion off market capitalisation since the bubble's mid-June peak, a massive sum in relation to 2014's RMB 64 trillion in GDP or 2013's household financial assets of RMB 76 trillion. As investors only held those paper gains on their share portfolios for a short time, they may not have had enough time to adjust their wealth perceptions and spending patterns, limiting the consequences from the swing in asset values.
- If investors have borrowed heavily on margin to then face margin calls, illiquid markets and worsening balance sheets. falling equity prices can cause broader problems. The value of share market transactions involving margins doubled to around RMB 2.3 trillion through the first half of 2015, roughly 3% of market capitalisation but a much higher share of shares available to trade. Little data is available on the amount of debt backing up those trades but the authorities are boosting liquidity, curbing margin selling and acting as a share buyer of last resort.



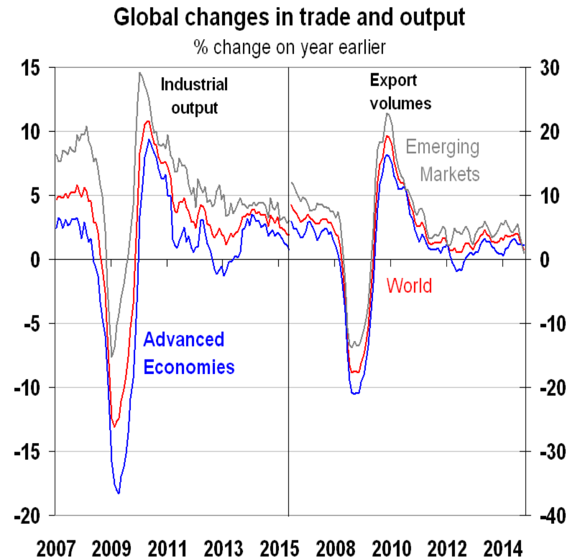


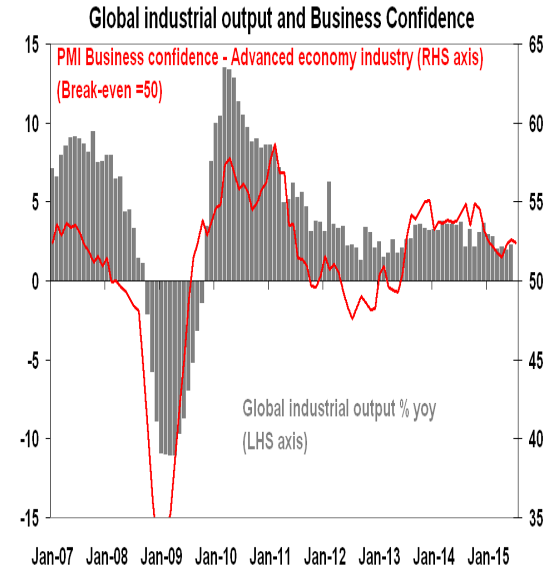


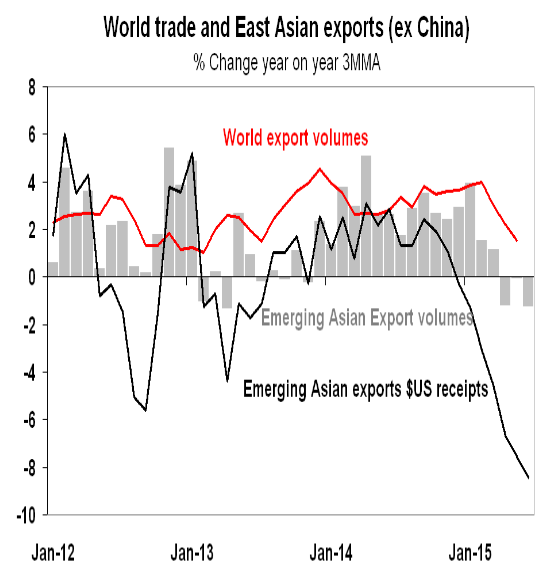


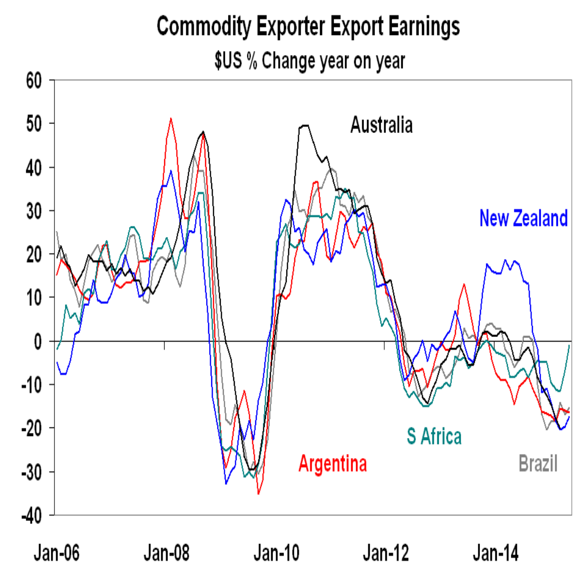
Global Economic Trends

- The disappointing trends in global industrial output and trade have continued. Industrial growth was running at an annual rate of only 1¼% in March quarter 2015 and the June quarter is shaping up to be even weaker. World exports are faring even worse with volumes trending down, mainly because of poor Asian data.
- The strong $US has depressed trade flows and commodity prices denominated in that currency but there is also an underlying weakness. For instance, exports in $US terms from a group of trade dependant East Asian emerging economies (S Korea, Taiwan, Thailand, Malaysia and Singapore) are running around 8% below year earlier levels – partly reflecting the direct valuation effects of depreciation of their currencies and lower commodity prices. There is, however, also a more fundamental problem at work with export volumes falling below year-earlier levels and faring worse than global trade.
- Commodity prices have fallen heavily, lowering export earnings and national income across a range of primary exporting countries. Non-fuel commodity prices have fallen by almost 20% in $US terms and by 12% in the SDR basket of currencies since mid-2013 and the impact on export receipts across key primary exporters like Australia, Brazil, Argentina and S Africa has been severe.
- Australian commodity export prices have fallen by almost 40% in $US terms in the last two years and export earnings in $US terms have fallen sharply, despite increased volumes. Lower commodity prices do boost incomes and spending power in importing economies but the immediate impact on global activity could be negative.



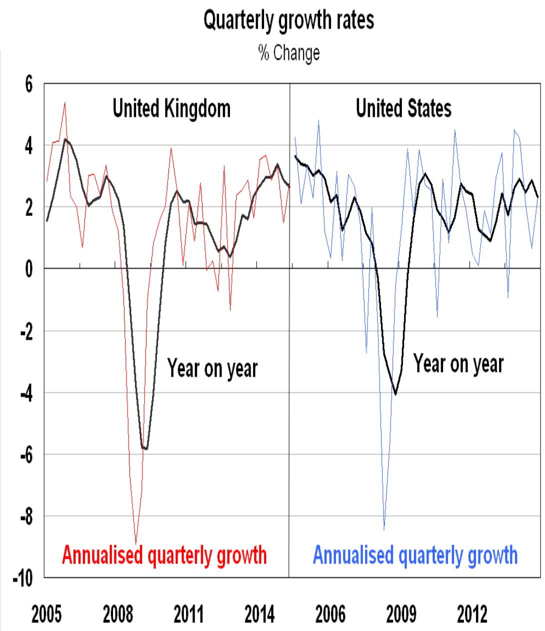


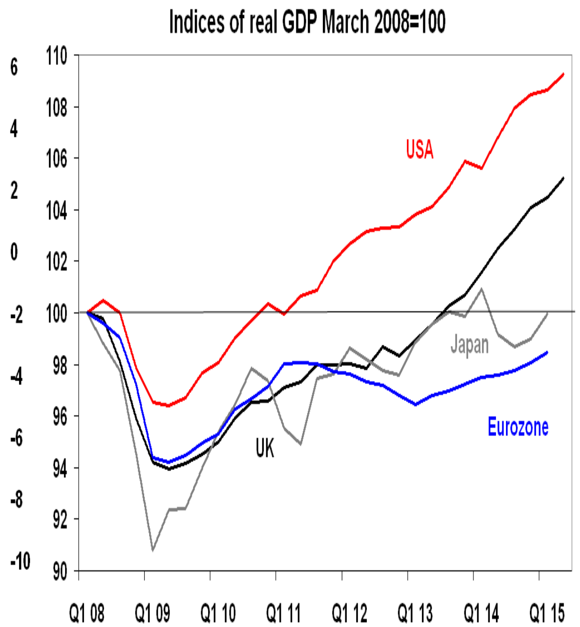


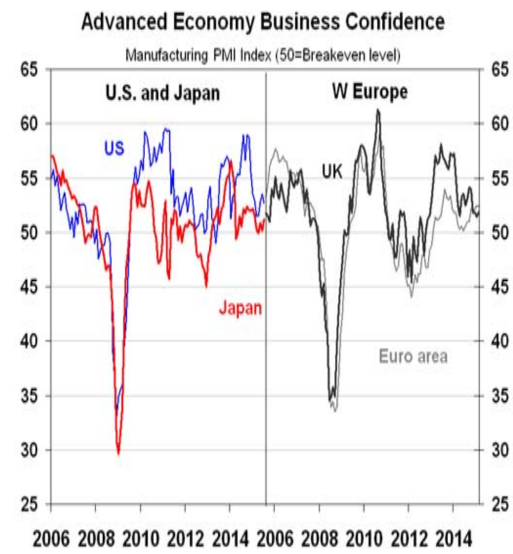


Advanced Economies

- After a disappointing start to the year, economic growth in key advanced economies picked up in the June quarter. Annualised US growth picked up from the first quarter's 0.6% to 2.3% in June and comparable figures for the UK increased from 1.5% to 2.8%. Business survey results look better in the Euro-zone, despite the Greek crisis, with the upturn broadening out to include services activity. Monthly Japanese business surveys also look slightly better but the quarterly GDP figures are volatile and kicked up in March, posing the risk of a slowdown in June. Canada is the weakest G7 economy with GDP falling through the first 5 months of the year as investment activity falls.
- The acceleration in US and UK growth in June continues the trend recovery trajectories seen through the last few years in their economies. Output in the US is up by almost 10% from its pre-crisis level in early 2008 while the UK economy is around 5% bigger. Considering that it covers a 7 year period, this cumulative growth rates is far from impressive but it is far better than has been seen in the Euro-zone and Japan. The level of output in the Euro-zone in early 2015 was around 1½% below that recorded in early 2008 while Japanese GDP was unchanged, marking 7 lost years of economic growth and a huge waste of potential.
- The monthly business surveys provide the most up to date indication of how growth is faring in the big advanced economies and they generally point to ongoing moderate growth. This growth is generally broad-based with upturns in both the manufacturing and services sectors with the US and UK service sectors being the stand-out performers for growth whereas Japan has been the laggard when it comes to growth in all areas.

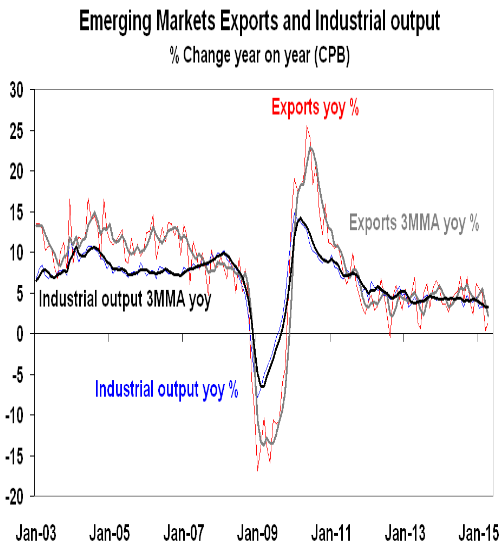


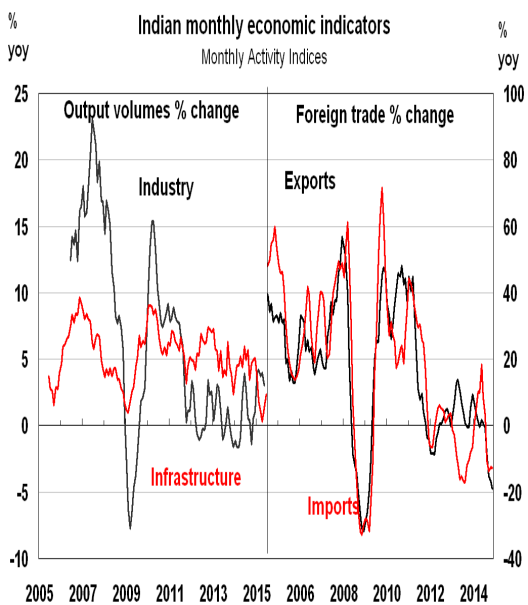




Emerging Market Economies

- Given that the emerging market economies have been the main drivers of global output growth in recent years, the slowdown in China along with very weak outcomes in Brazil and disappointing data in India all present a major headwind to the world economy.
- China is now the world's biggest economy, India ranks third and Brazil seventh and these three economies in combination have accounted for more than half of global growth in the last few years. The monthly trade volume and industrial output data that allows us to track how the emerging economies are faring does not look positive, signalling that there is little sign of an imminent upturn in their growth momentum.
- There was a clear loss of momentum in emerging economy industrial growth around the turn of the year when it slipped from the 4% annualised quarterly pace of growth recorded through the latter half of 2014 to only 0.8% in the March quarter. Preliminary data for June quarter do not show much of an upturn. Trade outcomes were even weaker with declines in emerging market imports and exports in the first quarter and very weak imports continuing into the June quarter, which is consistent with weak domestic activity.
- The monthly data for China and India continues to show a slowing trend in the pace of growth. Recent trade figures have been particularly soft but there is also evidence of a softening in expansion across key sectors of activity like fixed investment spending in China and infrastructure output in India. The picture is even worse when we turn to the other emerging market economies in East Asia and Latin America. Industrial output and exports are falling in both regions as sluggish global trade and weaker commodity markets take their toll.





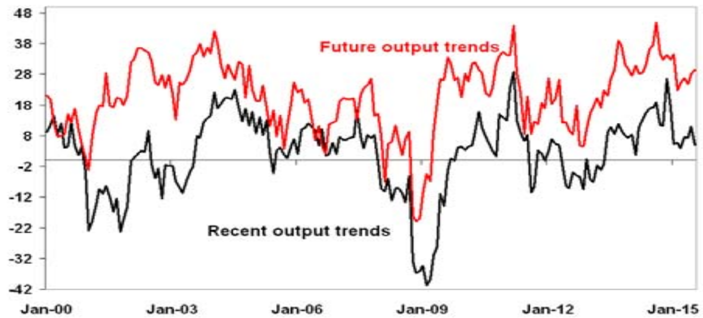
Global forecasts

- Our forecasts for global growth to stay around the 3¼% yoy mark remain basically unchanged, a sub-trend outcome that falls well short of the IMF's rosier predictions. The hard data provides no evidence that overall global growth has picked up and our leading indicators suggest further stagnation through to September. Revisions to data history have led us to lift our UK growth numbers. We have cut our US forecasts as the June quarter was softer than expected and we expect an inventory correction. The business surveys for the big advanced economies are consistent with ongoing moderate growth that is quite broadly based.
- The emerging market economies remain the principal area of disappointment in the global economy and they are the main drivers of expansion. Monthly data shows that the much awaited lift in Indian growth has not been delivered and China is slowing much as expected (and the bursting of its share market bubble will not have helped). Elsewhere, conditions are often soft with poor results in much of East Asia, Latin America and Russia.
- Lacklustre global growth inevitably weighs on commodity demand at a time when supply is coming on stream in response to earlier high prices. The outcome is downward pressure on commodity prices that affects Australia and New Zealand, even though their exports are focussed on markets like China where growth remains well above the global average.

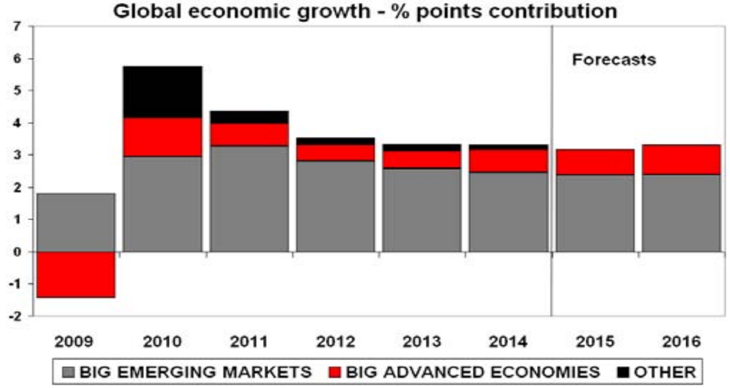
Global growth forecasts % change year on year

	2011	2012	2013	2014	NAB Forecasts 2015	2016	2017
US	1.6	2.2	2.2	2.4	2.3	2.6	2.5
Euro-zone	1.7	-0.7	-0.4	0.9	1.4	1.8	2.1
Japan	-0.4	1.7	1.6	-0.1	0.9	1.2	1.1
UK	1.6	0.7	1.7	3.0	2.6	2.4	2.3
Canada	3.0	1.9	2.0	2.4	1.5	2.1	2.0
China	9.3	7.8	7.7	7.4	7.1	6.9	6.5
India	7.7	6.8	6.4	7.1	7.6	7.6	7.8
Latin America	4.9	2.5	2.5	0.9	0.5	1.1	1.4
Emerging East Asia	4.4	4.6	4.2	4.0	3.8	4.0	4.2
New Zealand	1.8	2.4	2.2	3.3	2.4	2.2	2.1
World	*4.4*	*3.5*	*3.3*	*3.3*	*3.2*	*3.3*	*3.4*
memo							
Advanced Economies	1.7	1.2	1.4	1.8	2.0	2.2	2.2
Big Emerging Economies	7.0	5.6	5.5	5.1	4.9	5.0	5.0
Major trading partners	4.6	4.3	4.6	4.5	4.4	4.5	4.4

Business surveys in US, UK, Germany and France



Global economic growth - % points contribution



Major Trading Partner Growth % total and contributions

Australian outlook

- The Australian economic outlook is clouded by end of the mining investment boom and weak income growth as commodity prices decline. That said, the AUD is acting as a stabiliser and supporting trade-exposed sectors, particularly in services. We are a little more confident that the long-awaited rotation towards non-mining activity is transpiring, despite coming in fits and starts. This is evident in the trend increase in business conditions and capacity utilisation in the monthly NAB Business Survey (although the deterioration in these indicators in July bears watching), as well as the pickup in employment. The improvement is most apparent in NSW and Victoria (in both cases reflecting the strength of house price growth and services), while the mining states are lagging.
- While consumers are cautious and sentiment is patchy, spending measures were robust in June . (This may partly reflect spillover from spending by micro-businesses following recent Budget measures). The depreciation of the AUD should re-direct consumer spending onshore in time, and is supporting net tourism expenditure. Consumption growth however will remain below trend due to weak household income growth, and our forecasts are reliant on the savings rate easing further.
- Meanwhile, weak investment intentions in non-mining continue to weigh on the medium-term outlook. Our survey suggests firms require a very high rate of return – above 13% – in order to invest. It is difficult to generate satisfactory domestic demand against a backdrop of falling mining investment and constrained government spending, and growth is skewed towards exports.
- Our GDP forecasts are marginally stronger than last month – 2.4% in 2014/15, 2.8% in 2015/16 and 3.2% in 2016/17. Despite recent volatility in the labour market figures, our peak unemployment rate is unchanged at 6¼%, although spare capacity in the labour market is expected to remain for an extended period.
- Further monetary policy easing is unlikely, absent an external shock or a surprise deterioration in non-mining activity. Our central case is for the RBA to sit on its hands until late 2016 when a gradual tightening cycle begins. Downside risks emanating from offshore (especially China) are pronounced, while better domestic data, if sustained, suggest some risk of an earlier move.

Australian economic and financial forecasts (a)

	Fiscal Year			Calendar Year		
	2014-15 F	2015-16 F	2016-17 F	2015-F	2016-F	2017-F
Private Consumption	2.6	3.0	2.8	2.8	2.9	2.8
Dwelling Investment	8.9	14.9	4.3	13.8	9.6	1.0
Underlying Business Fixed Investment	-7.5	-11.3	-8.8	-10.2	-9.6	-8.3
Underlying Public Final Demand	-0.2	1.2	1.7	0.2	1.4	1.9
Domestic Demand	**0.8**	**1.5**	**1.3**	**1.1**	**1.6**	**1.2**
Stocks (b)	0.2	-0.1	0.0	0.1	-0.1	0.0
GNE	**1.1**	**1.4**	**1.3**	**1.2**	**1.5**	**1.3**
Exports	7.7	7.7	9.3	8.0	8.3	9.7
Imports	-0.2	1.4	0.9	1.7	0.8	1.0
GDP	**2.4**	**2.8**	**3.2**	**2.6**	**3.0**	**3.3**
– Non-Farm GDP	2.5	2.8	3.2	2.6	3.0	3.3
– Farm GDP	-2.3	2.9	2.0	2.0	2.0	2.0
Nominal GDP	1.6	3.5	4.7	1.7	4.8	4.5
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	50	49	34	55	39	26
(-%) of GDP	3.1	2.9	1.9	3.4	2.3	1.5
Employment	1.5	2.1	2.3	2.0	2.2	2.1
Terms of Trade	-10.8	-5.7	-3.3	-10.5	-2.0	-4.4
Average Earnings (Nat. Accts. Basis)	1.2	1.6	2.8	0.6	2.6	2.8
End of Period						
Total CPI	1.5	3.1	2.7	2.6	3.0	2.3
Core CPI	2.3	2.6	2.5	2.5	2.6	2.5
Unemployment Rate	5.9	6.0	5.8	6.2	5.9	5.8
RBA Cash Rate	2.00	2.00	3.00	2.00	2.50	3.50
10 Year Govt. Bonds	3.01	3.25	3.50	3.20	3.50	3.50
$A/US cents :	0.77	0.71	0.75	0.72	0.73	0.76
$A - Trade Weighted Index	63.8	61.2	63.3	61.5	62.4	63.3

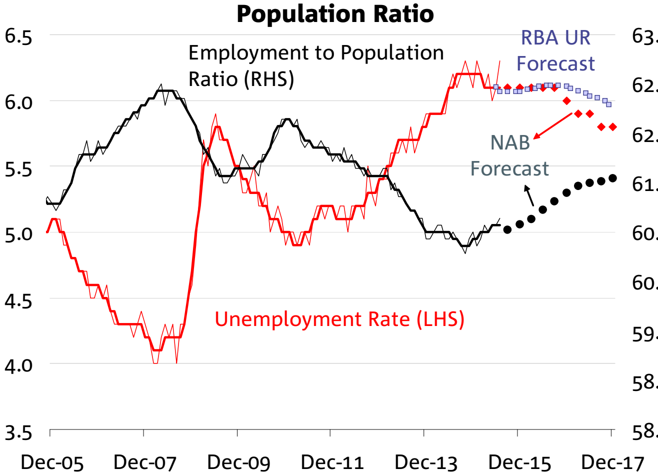
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through

(b) Contribution to GDP growth

Australian labour market

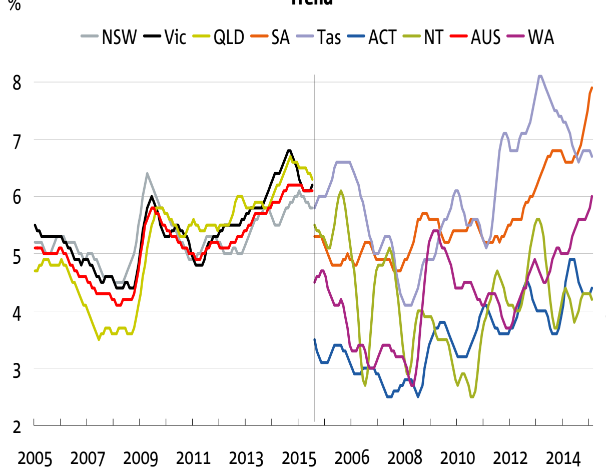
- The labour market appears to be performing more strongly than suggested by traditional relationships with economic activity at present. Looking through the statistical noise, has been a strengthening in the average pace of employment growth, which has been enough to stabilise the unemployment rate between 6 and 6.3% over the past year. The July reading of 6.3% for the unemployment rate likely reflects some statistical noise (as it was accompanied by an unusually sharp increase in the participation rate) and we expect some retracement. The employment-to-population ratio, which is not impacted by shifts in participation, has recently edged higher to 61.0%.
- Such better outcomes are likely a combination of slower population growth (which prevents updrift in unemployment) and lower wages growth. The shifting composition of growth towards non-mining (and more labour intensive) areas of the economy is also supporting aggregate employment, with indicators such as the monthly NAB survey suggesting relative outperformance in services sectors such as finance, business & property services and recreation & personal services. This also gels with strengthening employment growth in the eastern states, and declining unemployment (middle panel).
- Readings from various forward-looking measures of the labour market are mixed, but in general suggest employment growth should be sufficient to stabilise the unemployment rate in coming months. Capacity utilisation, which has historically led the unemployment rate, continues to trend upwards (despite easing in the month of July, see right panel below). The employment series in the NAB survey is painting a softer picture and has diverged a little from the official statistics in recent months, but is nevertheless suggesting job creation of 170k jobs per annum or 15k per month - this should be enough to keep pace with now slower population growth.
- Further out, we retain our revised forecast for the unemployment rate to remain elevated near 6¼% until late 2015, before inching down to 6% by late 2016 and 5¾% by end 2017. These forecasts are broadly similar to the RBA's on the whole, although are slightly more pessimistic near-term and suggest a little more improvement into 2017.

Unemployment Rate and Employment to Population Ratio



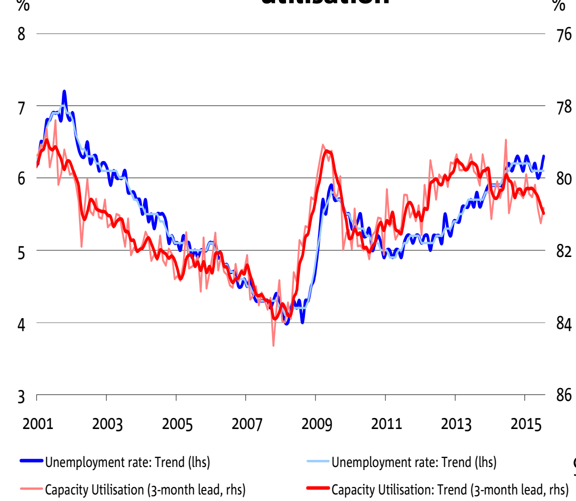
Source: ABS, NAB

Unemployment Rate
Trend



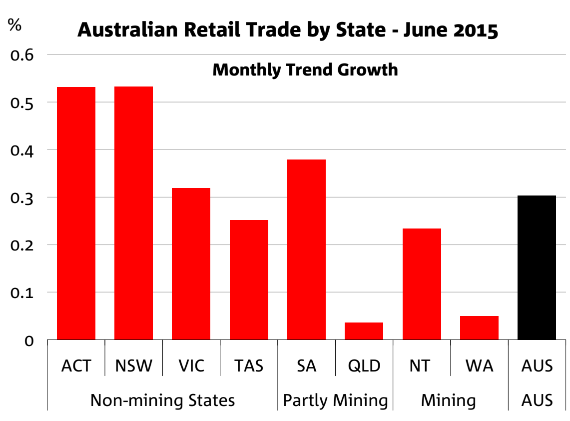
Source: ABS, NAB

Unemployment and capacity utilisation

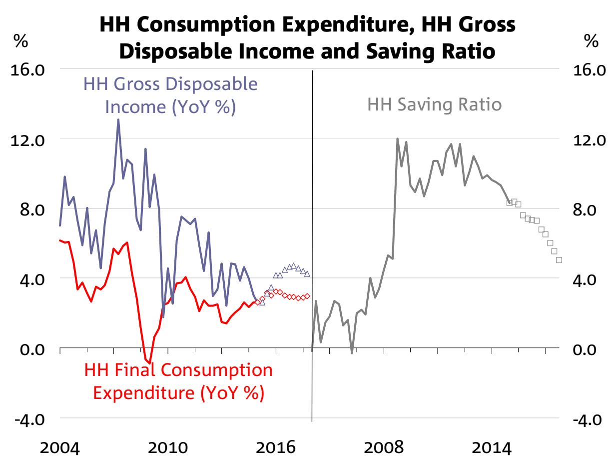


Australian consumer demand and housing market

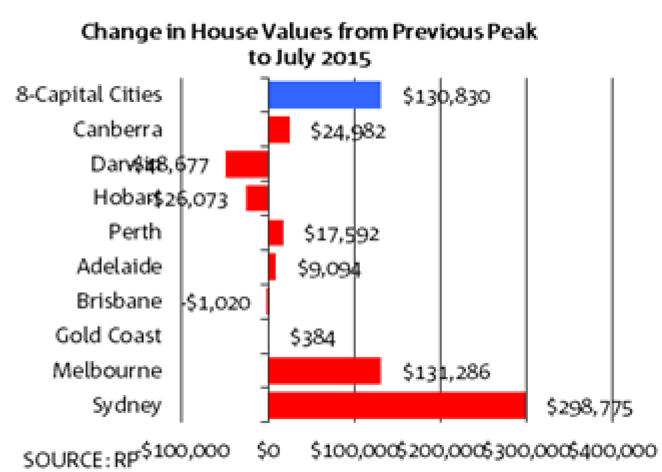
- While consumers remain cautious, consumer spending appears to have picked up moderately with the volume of retail sales up by 0.8% in Q2 following an increase of 0.6% in Q1. The month of June was particularly strong, with retail trade increasing 0.7% m/m in value terms. It is possible that this improvement partly reflects leakage from small business spending into the retail data following the measures targeted at spending by micro-businesses in the Budget, with spending on household goods particularly strong (2.2% m/m in sa terms, 0.8% m/m in trend terms). This could also reflect rising dwelling investment in the Eastern states. Meanwhile, other “discretionary” spending categories such as clothing & footwear and department store retailing remain weak in trend terms, with price growth flat to negative despite AUD depreciation. Weak price growth for consumer durables was also evident in the Q2 CPI, suggesting limited pricing power for retailers and a very competitive environment in which it is difficult to pass on cost increases stemming from the lower AUD. By state, consumer spending is stronger in NSW and Victoria (who are less impacted by the decline in mining investment and slower population growth) and surprisingly SA and the ACT. The NAB On line Retail Index was also exceptionally strong in June (+2.4% m/m).
- Nevertheless, consumers are nervous, with unemployment expectations high. Against a backdrop of subdued household income growth, we expect a modest pick up in consumer spending growth through to 2017, underpinned by a gradual decline in the household savings rate. Low levels of consumer sentiment could be a risk near-term, although this likely reflects equity market volatility, and a negative reaction by consumers to the weaker AUD (which lowers their spending power for imported and online goods). In contrast, confidence of retailers in the NAB monthly business survey is holding up at above its long-run average, and the lower AUD should re-direct spending onshore.
- Dwelling prices in Australia have risen to 11.1% in the year to July (10.4% previously) according to RP Data-Rismark. Strength remains concentrated in Sydney (18.4% y/y) and Melbourne (11.5%), but more moderate in the other states and negative in Perth (-0.6%) and Darwin (-5.3%). Undersupply of housing is particularly prevalent in Sydney, and to a lesser degree Melbourne. These markets are also being supported by foreign demand, as well as investor demand, which should slow somewhat as APRA attempts to limit growth in investor housing credit to 10% y/y (currently at 10.7%). Overall we see Australian house price increases to be around 6.1% in 2015 and slowing to 3.0% in 2016, a rate more consistent with household income growth. There will however continue to be wide variations in growth rates across states. The primary channel through which a house price correction could eventuate is via a jump in unemployment, which is not our central case scenario.



Source: ABS, NAB

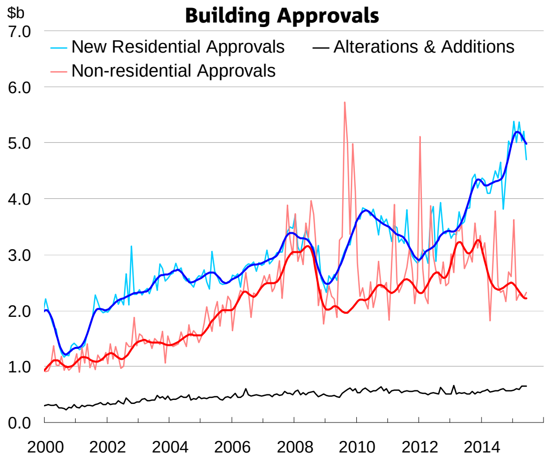


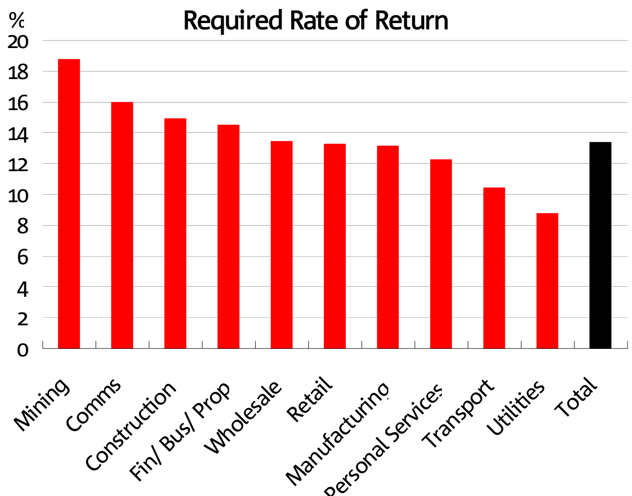
Source: ABS, NAB

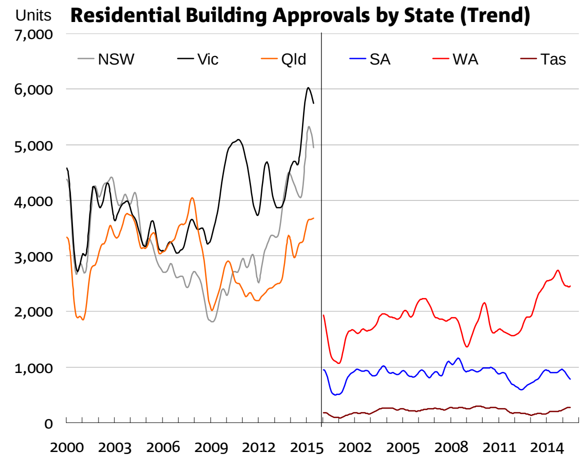


Australian investment

- The outlook for mining investment remains starkly negative, with recent falls in commodity prices further questioning the viability of marginal projects. Meanwhile mining confidence and conditions are strongly negative (at -19 and -21 respectively in trend terms), as is trend capex from the monthly survey (-24). 12-month capex expectations from the Quarterly Business Survey are also weak (-13), and hurdle rates for investment in the sector are exceptionally high at around 18%.
- With faster growth in non-mining investment necessary to plug the gap, we are cautiously encouraged by the gradual trend improvement in business conditions, confidence and capacity utilisation, despite the payback in July. In addition, AUD depreciation should support investment in trade exposed industries, particularly in services such as tourism. However, non-residential building approvals remain weak and the improvement in business conditions is out of sync with weak medium-term expectations. In particular, the ABS capex survey suggests an outright decline in non-mining capex in 2015/16, although does exclude sectors such as education and healthcare for which investment should be stronger. Capex expectations from our Q2 Quarter Business Survey suggest a slightly less pessimistic outlook.
- The clouded investment outlook is perhaps not surprising against a backdrop of weak national income growth. This dictates that the margin for error for an individual business seeking to invest is narrow. Accordingly, firms continue to require a high nominal rate of return to invest – 13% according to a new question in the Monthly Business survey, although this varies somewhat by industry (middle panel).
- Dwelling investment has picked up sharply in recent quarters, although its ability to drive aggregate economic growth is limited given its small share of GDP (5%). This is primarily being driven by higher-density development (4 storeys and above), for which building approvals are running at record highs in Sydney and Melbourne. The high level of approvals should drive further growth in construction until late 2016, with the lag between approvals and construction longer for larger projects. A significant driver of that demand is coming from foreign investors - 16.1% for new apartment sales according to our Q2 Residential Property Survey, and as high as 28.3% in Melbourne and 16.5% in Sydney).
- Overall, we are forecasting business investment to decline by around 10% per annum in 2015/16 and 2016/17, only partially offset by stronger dwelling investment.

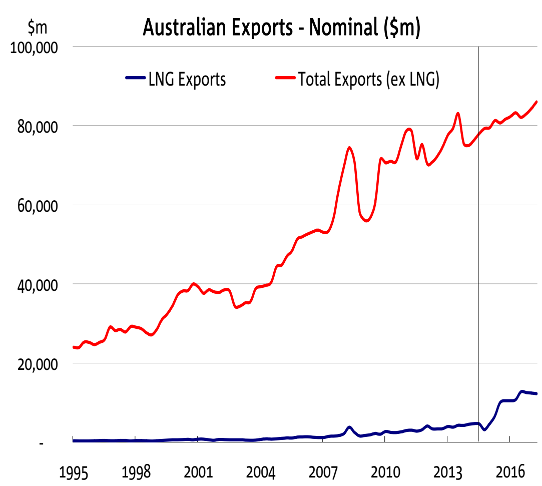


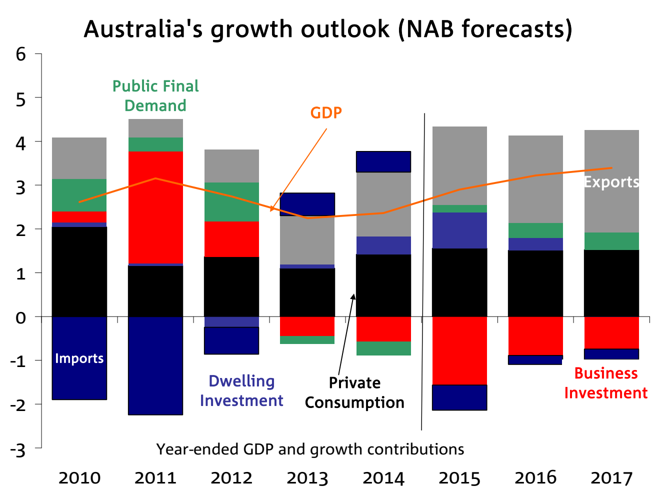




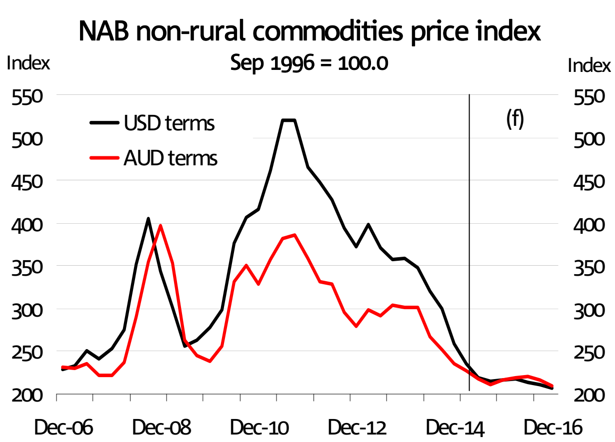
Australian commodities, net exports and terms of trade

- Shifting to the production phase of the resources boom will see exports make the largest contributor to economic growth for the remainder of the forecast period, adding 1¾ppt to GDP in 2015/16 and 2% in 2016/17. LNG exports will be the primary driver of export *growth* going forward – we estimate that LNG exports will add around $12-13bn to Australian exports per quarter by end 2017 (left hand panel).
- The weaker AUD will also support net exports of services, including tourism, through the forecast period. Short-term visitor arrivals continue to trend higher, while short-term domestic departures have flattened off and are expected to start declining. Currency depreciation should also help improve the competitiveness of manufactured exports although labour costs remain high. Meanwhile, imports growth will remain weak, with capital imports the main drag as mining investment trails off.
- The non-rural commodity index denominated in USD, is expected to fall by around 31% during 2015 and a further 5% fall during 2016 after falling 18% in 2014 (in year-average terms). The AUD is now expected to depreciate to around US71c by the end of Q1 2016, which helps to offset some of the weakness in commodity prices in local price terms, with the non-rural commodity index expected to fall by 17% in AUD terms for the year. Implicit in these forecasts are iron ore prices weakening further, trending down from around US$55 a tonne in late 2015 to US$51 by the end of 2016. Oil prices are now expected to trade below $US60 a barrel by late 2015 – and around the mid to high $US60s by the end of 2016. Elevated levels of price volatility in global markets continue to cast a high degree of uncertainty over the forecast outlook.
- The NAB Rural Commodities Index continues to rise in AUD terms (up 4.1% in July), supported by a lower dollar and higher beef prices. Prices have seen greater tumult on international markets as stormy US weather affects major grains and continued sluggish international demand continues to punish dairy auction results. Overall the index was down 0.4% in USD terms in July. We forecast the index to grow in AUD terms (up 8.5% in 2015 and 4.9% in 2016) but to remain muted in USD terms (-7.8% in 2015 and -2.1% in 2016).





Source: NAB, ABS



Source: ABS; ABARES; Bloomberg; NAB; Thomson Datastream

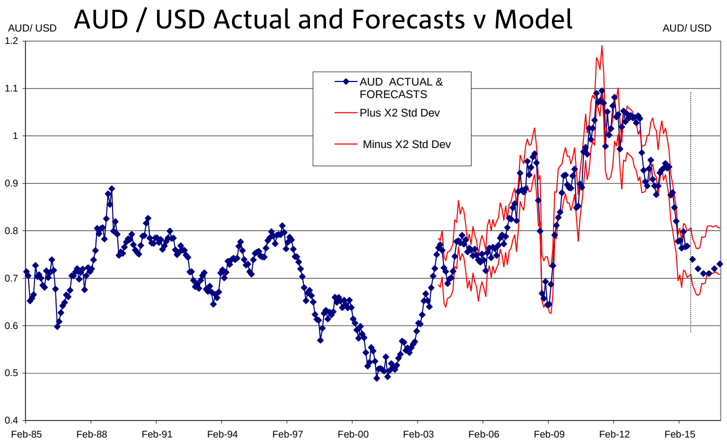
Australian financial markets

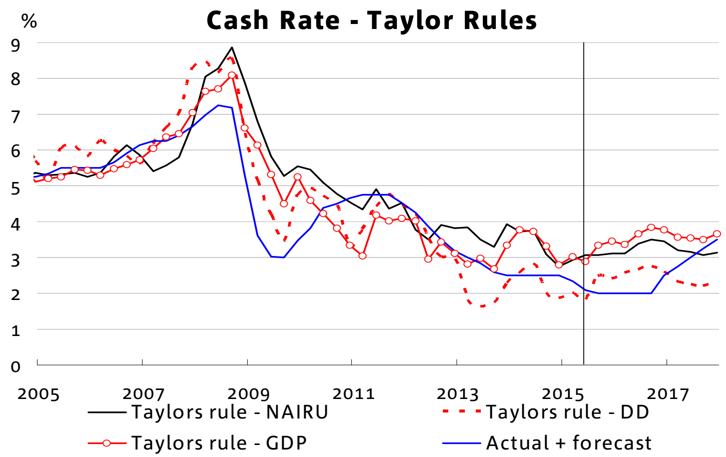
Exchange rate

- A confluence of factors has driven a sharp drop in the AUD to USD73-74c over the past month,. These include a further appreciation of the USD, downward pressure on commodity prices and negative atmospherics surrounding the Chinese economy and equity market. Such movements are consistent with our (modestly lower) AUD/USD forecast trajectory published last month, and we retain our forecasts at 72c by end 2015, before reaching a low of 71c in H1 2016 (previously 73c) and then appreciating gradually through 2016 to around 75c. By late 2017, we continue to expect the AUD/USD to recover to 78c, as interest rate normalisation progresses. These forecasts are consistent, but at the lower end, of estimates from our fundamental model, which is in turn incorporates continued (though less rapid) USD appreciation. The RBA is no longer actively calling for further depreciation of the currency, although continues to expect some downward pressure.

Interest rates

- The RBA is likely to sit on its hands as it assesses the cumulative impact of monetary policy easing this year and the weakening of the AUD. The trend improvement in the labour market and signs of improved business confidence, business conditions and capacity utilisation (despite some softening in July) have reduced the likelihood of a rate cut in the near term. And while the RBA continues to rely on macro-prudential measures to cool the housing market, it will be reluctant to fuel further housing demand.
- Inflation is providing no impetus to cut or hike, with core inflation currently at 2¼% y/y in Q2. Core inflation forecasts remain are near the middle of the 2 to 3% target band until 2017. Amidst low wage growth, the inflation target is unlikely to be threatened even if the AUD falls more sharply.
- The most likely path is for a period of unchanged rates, before a fresh tightening cycle starts in late 2016 in anticipation of a stronger pick up in activity into 2017. That said, confidence remains fragile, downside risks to China and emerging markets are pronounced, and our (and the RBA's) expectation is for unemployment to remain elevated. In this environment, the RBA will retain an easing bias, and we cannot fully rule out the possibility of a further cut to further provide support should the current tentative cyclical upswing in non-mining indicators fizzle out.
- As a cross-check, Taylor's rule analysis (in the chart below right) does not suggest a sub-2% cash rate, and implies rate rises earlier from mid-2016. Our forecast of 3.5% by 2017 is towards the top end of various rules, despite being a relatively low terminal rate by historical standards.





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