September 2015

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global</u>: Global growth remains sluggish and below trend and we have slightly lowered our forecasts to take account of weaker than expected outcomes in India, Canada and Brazil. The bursting of the Chinese share market bubble and the authorities' confusing response adds further unwelcome volatility and uncertainty to an already uninspiring outlook and we expect growth to remain soft and below trend through the next two years with no sign of any imminent upturn in activity and sizeable downside risks.

- The bursting of the Chinese share market bubble, the timing of US interest rate rises by the Fed and the continued slide in global commodity markets remain key areas of concern to the markets. Around 30 trillion RMB ($US4½ billion) has been wiped off Chinese share market capitalisation, equal to almost half of GDP in 2014. While the impact of this seemingly huge fall on household wealth and business funding should not be exaggerated, the failed efforts of the Chinese authorities to stabilise the market has raised deeper concerns about their appetite for economic reform and the true strength of growth in the economy. Volatility in the Chinese market has spilled over into other equity markets, depressing prices. While recent market volatility may cause the Fed to delay lifting its policy interest rates, we still expect this process to start by the end of the year. This process of rate increases should prove to be gradual and the peak rate lower than in the past.
- Growth in global GDP has disappointed by staying around 3¼% yoy since mid-2014 rather than picking up. Partial data for industrial activity has not shown any pick-up in global activity since June and the August industrial purchasing manager surveys across the largest advanced and emerging market economies pointed to slower rather than faster growth. At the same time, falling commodity prices are eroding export earnings in key primary producers. Brazil and Canada are in recession, South Africa's economy shrank in the second quarter, and Australian GDP proved weaker than expected. The limited data available on the service sector shows growth easily outpacing industry. Advanced economy business surveys for services are consistent with solid growth and services expansion remains buoyant in many Asian emerging market economies.
- Growth in the G7 advanced economies accelerated in the June quarter primarily reflecting a rebound in US growth, which was dragged down by temporary factors in the first quarter. The UK was the only other bright spot with growth accelerating in the June quarter after a weak first quarter outcome. Elsewhere advanced economy growth was generally disappointing with falls in output in Japan and Canada and a modest drop in Euro-zone growth. The recovery in advanced economy investment has been particularly lacklustre – it took almost 7 years to regain its early 2008 level, despite an upturn in business profits and a drop in the extent of idle capacity. This reflects the risks and volatility in the global economic environment as well as a lack of confidence in business that is partly an overhang of previous financial crises and deep recessions. The business surveys show solid growth continuing in services (albeit clearly slowing in the UK) alongside generally disappointing results for manufacturing that are consistent with modest growth at best.
- A slowdown in emerging market economy growth in the June quarter has offset the lift in the advanced economies, leaving world growth flat. The headwinds facing emerging market growth (falling commodity prices, weak world trade) remain and new problems have appeared in recent months (notably the bursting of the Chinese share market bubble). As the emerging market economies of East Asia are generally export-driven, the weakness of world trade has weighed on output while falling commodity prices have hit exports and incomes in big Latin American primary producers like Brazil. Uncertainty surrounding the pace of Chinese growth hangs over financial markets. Most partial indicators point to slowing growth with a clear softening trend in industrial output, export deliveries, fixed investment and (until recently) the real estate sector. Indicators all points to quite soft growth in China's industrial sector, helping explain the fall in global commodity prices. The extent to which service activity is picking up is far from clear with business surveys trending down.
- We have shaved our 2015 and 2016 forecasts down by 10 bps to take account of weaker than expected outcomes in Canada and Brazil with global growth set to remain sub-trend through the entire forecast horizon. Growth is expected to fall from 3.3% in 2014 to 3.1% this year and remain much the same in 2016 with our global tracking indicator showing no sign yet of any upturn in growth.

<u>Australia</u>: The Australian economy is still struggling to transition to non-mining sources of growth amidst lower national income. Against that, there is increasing evidence that growth momentum is broadening across the non-mining economy – not limited to the dwelling sector – in response to the lower AUD and interest rates, with improvement particularly evident in services sectors. Our 2015/16 GDP forecast has been revised down to 2.4%, reflecting a weaker than expected Q2 result, while the 2016/17 forecast is unchanged at 3.1%. The unemployment rate is expected to ease to 6% through 2015/16 and to 5¾ in 2016/17. While risks to the outlook stemming from financial market volatility and a slower China are front of mind, stronger local momentum in the non mining sector is expected to keep the RBA from cutting rates further.

- Business conditions in the NAB Business Survey point to a further improvement in the non-mining economy, even as jitters in financial markets weigh on confidence; the trend index lifted to its highest level since late 2009. This outcome adds to the mounting evidence that AUD depreciation and record low interest rates are having the desired effect and helping to offset the weakness in mining. Even so, outcomes vary significantly by industry, while confidence pared back further in August, unwinding the post budget gains. While confidence tends to track conditions quite closely, recent financial market ructions and China growth concerns appear to have had an unnerving effect on business.
- Australian real GDP is struggling to regain momentum, against a weak income backdrop and significant structural change at the industry and geographic level. The economy expanded by just 0.2% in the June quarter and 2.0% over the year. Australian income growth is weak as the terms of trade declines further. This is flowing through to weak corporate profits, government revenue and expenditure, as well as labour earnings. Real gross domestic income fell 0.2% over the year, while real net national disposable income has declined by 1.1% y/y (and -2.3% y/y on a per capita basis). That said, there have been a number of one-offs causing volatility in recent quarterly figures, and we are hesitant to extrapolate all of the weakness in Q2 out further. In addition, there is some evidence that momentum in the non-mining sector (beyond dwelling construction) is taking place and responding to lower rates and the weaker AUD. Gross value added in services industries such as ITC, finance & insurance and hospitality was solid in Q2. Net tourism exports continue to expand and business conditions and capacity utilisation are trending up, despite the understandable dip in confidence amidst global volatility.
- The unemployment rate is forecast to stabilise in coming months, and then drift slightly downwards to around 5¾% by end-2016. Slower population growth suggests a slightly lower rate of job creation will be necessary to keep up with population growth. Looking at the near term, forward-looking measures of the labour market are mixed, with the NAB survey employment index subdued, but measures of job advertisements and capacity utilisation painting a more positive picture. (Note the official labour market data for August will contain revisions due to population re-benchmarking, although this should be broadly neutral for historical labour market prints). The shifting composition of growth at an industry level appears to be supporting the Australian labour market, with growth more concentrated in labour-intensive sectors. Indeed the NAB employment index is strongest in services sectors such as finance, business & property services and recreation & personal services. Nevertheless, ongoing spare capacity in the labour market is evidenced by the slowdown in wages growth. Average compensation per employee grew just 0.2% in the June quarter and 0.5% over the year.
- The outlook for consumer spending and non-mining investment are the biggest swing variables. While household consumption growth is expected to remain below trend, it continues to rely on a further modest decline in the household savings ratio which is vulnerable at present to weak consumer confidence. Meanwhile, recent readings of expected non-mining capital expenditure remain weak, although we do expect some gradual improvement over time if the improvement in business conditions is sustained. In contrast residential markets remain strong, with dwelling prices continuing to grow more than 10% over the year to August. Surprisingly, dwelling investment surprisingly fell by 1.9% in Q2 despite strength in building approvals and a very elevated stock of residential projects in the construction pipeline. While this did follow growth of over 6% in each of the two preceding quarters, this weakness is likely only temporary given record levels of work to be done.
- Due to the lower base, our 2015/16 GDP forecast is now 2.4% while the 2016/17 forecast is unchanged at 3.1%. The unemployment rate eases to 6% through 2015/16 and to 5¾ in 2016/17. These forecasts are based on the AUD depreciating to USD68c by mid-2016. The risks to the economy, the RBA cash rate and the currency have tilted to the downside again as China slows and volatility on global markets remains elevated.

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