Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- Global growth remains sluggish and below trend and, unlike the IMF, our forecasts do not envisage much pick-up in the next couple of years. Although the emerging economies are still growing much faster than the big advanced economies (around 5% versus around 2%), the focus of market attention has been shifting toward the former as falling commodity prices, the prospect of higher US interest rates, a build-up in debt and uncertainty over the pace of Chinese growth weigh on sentiment. By contrast, growth in the advanced economies picked up in mid-2015 and there is much less market focus on the problems with the Greek economy. Commodity exporting economies and their currencies have come under more pressure as sluggish global growth and the Chinese industrial slowdown lowers global commodity prices, impacting incomes and exports in some big primary producers which are heavily exposed to foreign investor sentiment.
- In Australia, the ongoing high level of business conditions and trend improvement in key leading indicators such as capacity utilisation supports our view that the gradual recovery in the non-mining economy is becoming more resilient (See latest Business Survey release). Low interest rates and the lower AUD are providing support, with strength particularly evident across services sectors of the economy, including but not limited to tourism-related activity. Our domestic forecasts are unchanged this month, with real GDP expected to expand by 2.4% in 2015/16 and 3.1% in 2016/17. The unemployment rate remains elevated for an extended period, but does ease to 6% by end 2015/16 and to 5¾ by end 2016/17, given the structural shift back towards more labour-intensive sectors. There remain clear downside risks from offshore, and weak commodity prices and falling mining investment will remain a drag. However, we find it difficult to mount a case for further policy easing on purely domestic grounds and view market pricing for another 25bp cut over the coming 6 months as overly pessimistic.

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.5	2.5	2.4
Euro-zone	12	0.9	1.3	1.7	1.9
Japan	4	-0.1	0.7	1.2	1.0
China	16	7.3	7.1	6.9	6.5
Emerging East Asia	8	4.0	3.7	3.8	4.1
New Zealand	0.2	3.3	2.2	1.8	2.0
Global total	100	3.3	3.1	3.2	3.3
Australia	2	2.7	2.3	2.7	3.3
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.2	2.5	2.5	2.6
Domestic demand		1.0	0.9	1.6	1.6
GDP		2.5	2.4	2.4	3.1
Core CPI (*% through-year*)		2.7	2.3	2.6	2.4
Unemployment rate (*% end of year*)		6.1	6.0	5.9	5.7

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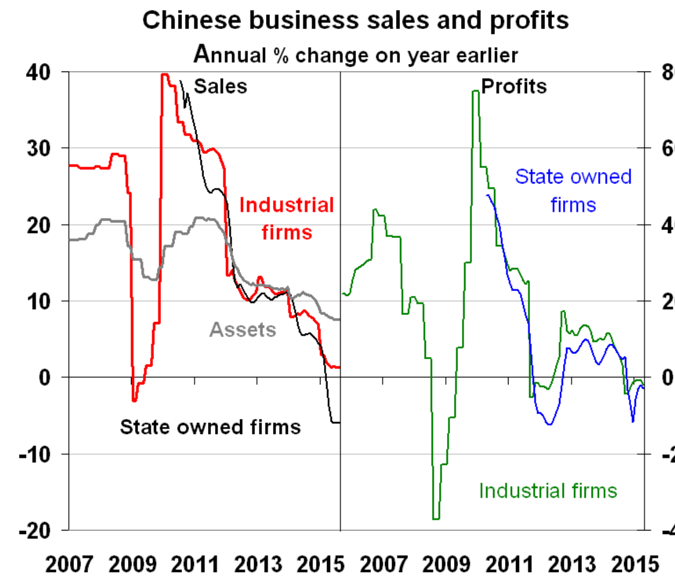
Global and Australian overview

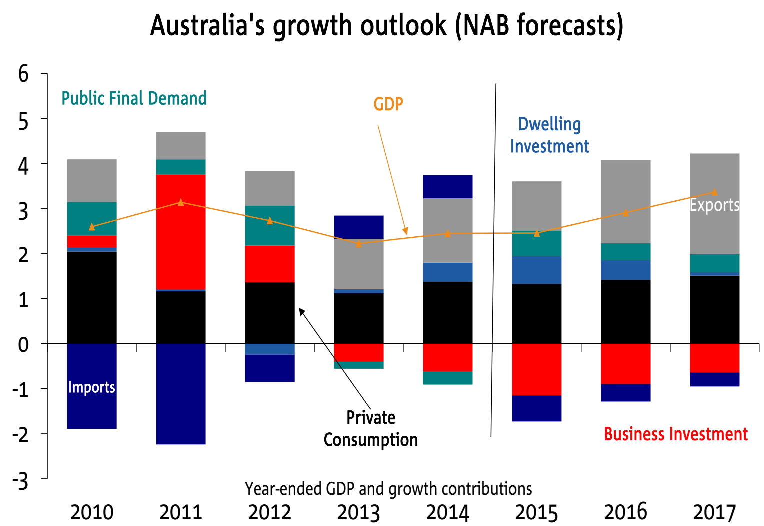
Global overview

- Global growth remains sub-trend and there is little sign of an imminent acceleration in the pace of expansion. A combination of high debt, falling commodity prices, slowing growth in China, recession in Brazil and Russia and the prospect that the US Fed will soon start a cycle of interest rate rises hangs over global financial markets. The outcome has been increased volatility as investor risk appetite shifts between asset classes and countries. Emerging markets have felt most of the financial stress and Euro-zone markets have avoided being at the epicentre this time.
- With China replacing the US as the world's biggest economy and dominating global commodity demand, its slowing growth has led to falling commodity prices and big losses in export earnings and income across both commodity exporting countries and its Asian neighbours. China's 7% overall growth rate is still a solid outcome but that masks the steep downward trend evident in the pace of expansion in the industrial sector's financial results (seen in the chart opposite). The Chinese authorities are acting to prop up demand and rebalance growth toward services and consumption, which should put a floor under demand and help offset the industrial slowdown.

Australian overview

- Our GDP forecasts are unchanged from last month, with growth of 2.4% in 2015/16 and 3.1% in 2016/17. The transition away from mining-investment led growth remains challenging amidst low commodity prices and a slower China. However high frequency data is supporting our contention that the recovery across the non-mining economy is becoming more resilient, and responding to easier financial conditions stemming from lower interest rates and the exchange rate. In particular, business conditions in the NAB survey are holding at an above average level for 7 consecutive months, and key leading indicators such as capacity utilisation are also trending upwards. Business conditions across services industries are particularly strong, including but not limited to tourism.
- Our unemployment rate forecasts are unchanged from the current peak of 6¼%, easing slowly to easing slowly to 6% by end 2015/16 and to 5¾ by end 2016/17, in line with the shift towards more labour-intensive industries. The outlook for business investment remains a key uncertainty, with firms continuing to demand very high rates of return on investment and growth concentrated in industries who are traditionally less capital intensive.
- Our forecasts are based on the assumption of further easing in the AUD/USD to a low of 68c by Q1 2016 before gradually picking up. The RBA is expected to remain on hold until late 2016, although global risks and financial market volatility are likely to see the RBA retain an easing bias for some time.

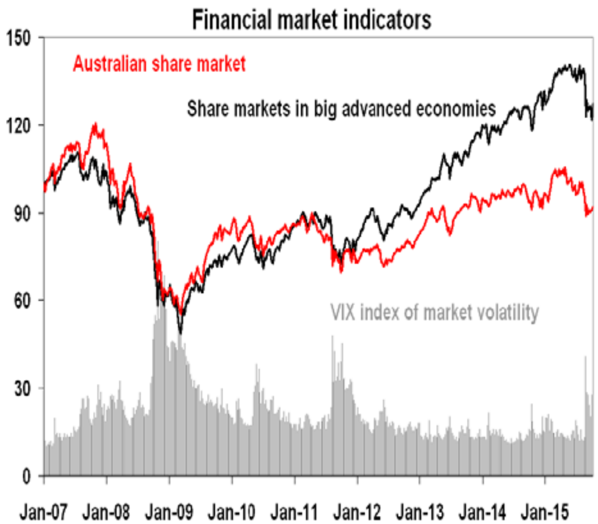


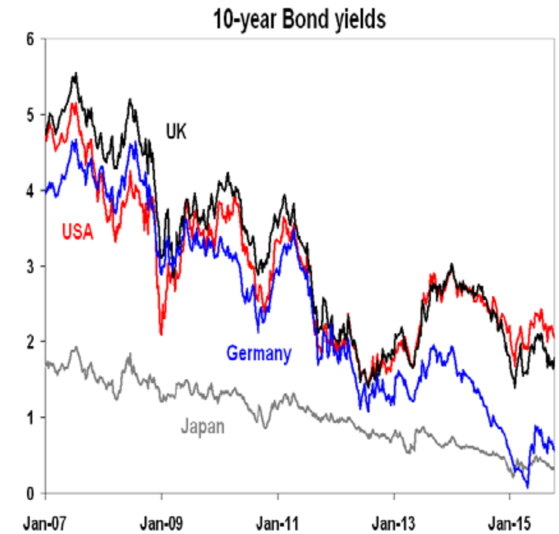


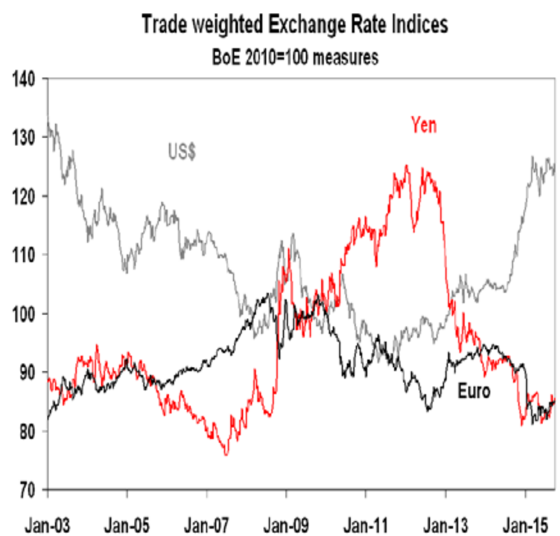
Source: NAB, ABS

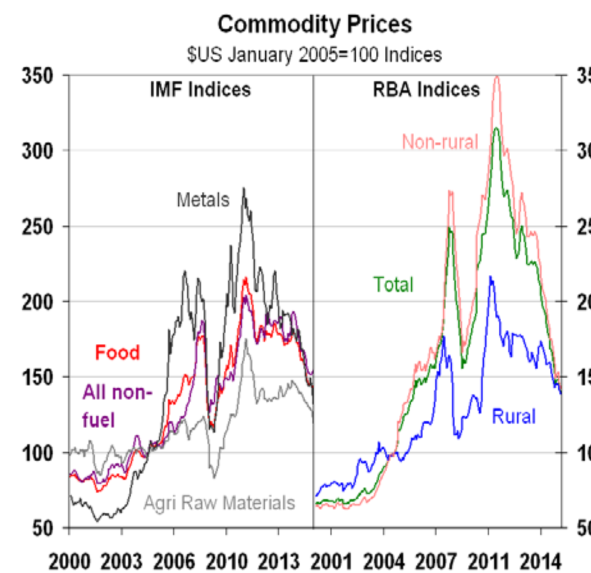
Financial and commodity markets

- Following a period of increased volatility, global equity markets have stabilised in the last few weeks but commodity markets remain weak. Uncertainty over the timing of Fed rate increases, the slowing in Chinese economic growth and their impacts on emerging market economies underpinned this volatile period and these concerns have not yet been resolved.
- Persistent sluggishness in global economic growth has ensured that inflationary pressures have remained low, allowing central banks to keep their policy rates at historically low levels for an extended period and long bond rates in the big advanced economies to settle around 2% or less. Exchange rate markets have already seen big changes in the values of key advanced economy currencies but there has been an at least temporary halt to the previous trend appreciation in the $US and depreciation in the yen.
- Facing differing macro-economic conditions, central banks in the big advanced economies look set to follow different monetary policies. We expect the Fed to start lifting its policy rate in December and continue the monetary tightening with further rate rises next year. The Bank of England and European Central Bank appear unlikely to start lifting their interest rates until late 2016 and mid-2017 respectively while market uncertainty in Japan is focused on whether the Bank of Japan could again loosen its monetary policy by lifting its target level of asset purchases.
- Some emerging market central banks have been cutting their rates to boost growth, most recently the 50 bps cut by the Indian Reserve Bank. We expect to see two more rate cuts next year in India and a 25 bps cut in China by end-2015 but Brazil is likely to raise rates next year.



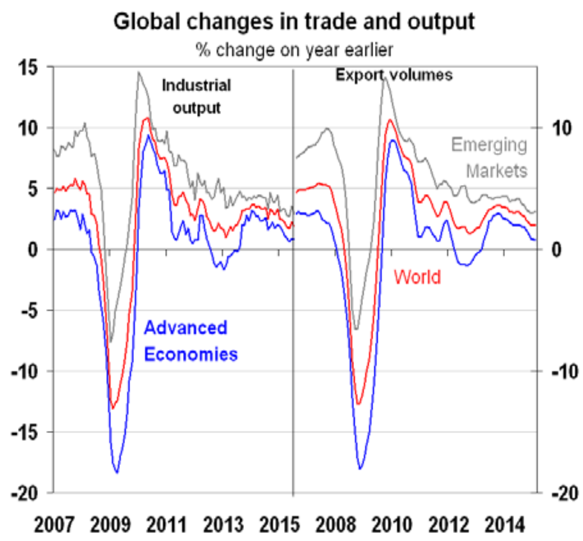


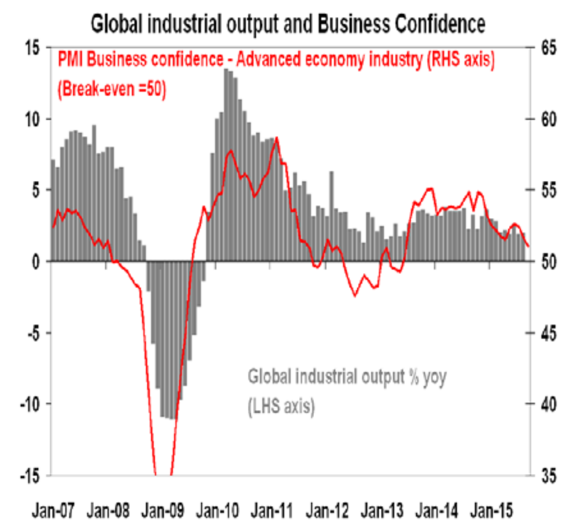


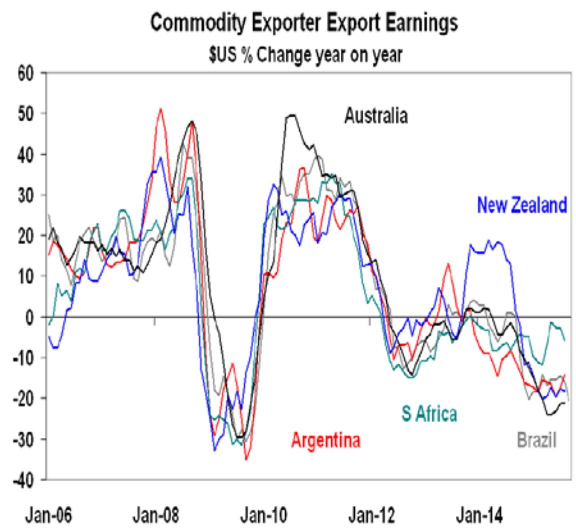


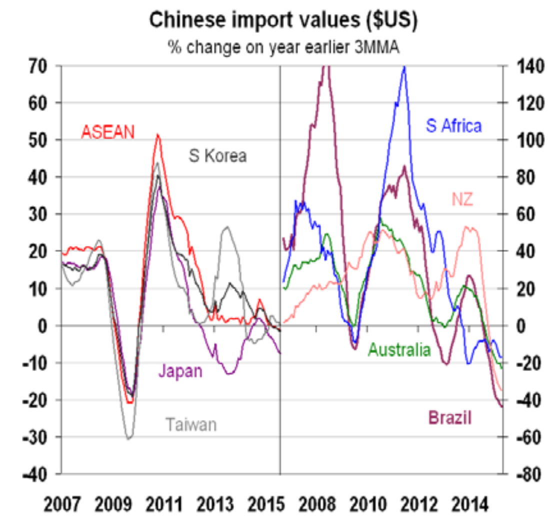
Global Economic Trends

- Growth in global GDP, the broadest measures of output, has disappointed by staying around 3¼% yoy since mid-2014 rather than picking up. The latest data for industrial output and world trade still show weak growth. Global industrial growth in the 3 months to July was running at an annualised rate of around 2½%, before settling between 2 and 2¼% yoy between May and August – well below its long run trend. World trade has been even weaker recently but it picked up slightly in July.
- Business surveys give the most up to date measure of the pulse of economic activity and they are not signalling any imminent upturn. Industrial sector readings for business conditions in the big advanced economies have been trending down for the last year and there was little growth shown by the September surveys.
- Emerging market business surveys are also failing to register any solid acceleration in growth. The latest Indian business survey showed fading growth, South African surveys are trending down, Brazilian surveys show continued recession, the Caixin Chinese business surveys were weak and results were mixed for the official business survey.
- The slowing in China's industrial growth has had a profound impact on global commodity markets as it is the biggest consumer of most raw materials. Global commodity prices have fallen heavily through the last few years, eroding the $US value of export earnings in key commodity countries like Australia, Brazil, Argentina, New Zealand and South Africa. The slowing in Chinese growth has been reflected in reductions in its $US imports from both commodity suppliers and regional traders like Japan and South Korea.



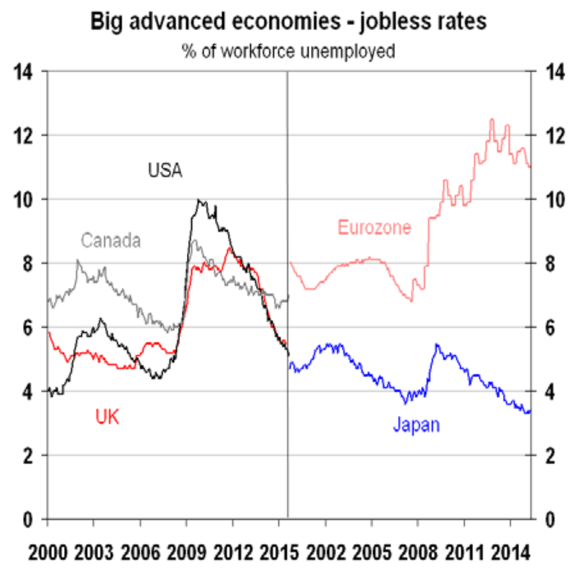


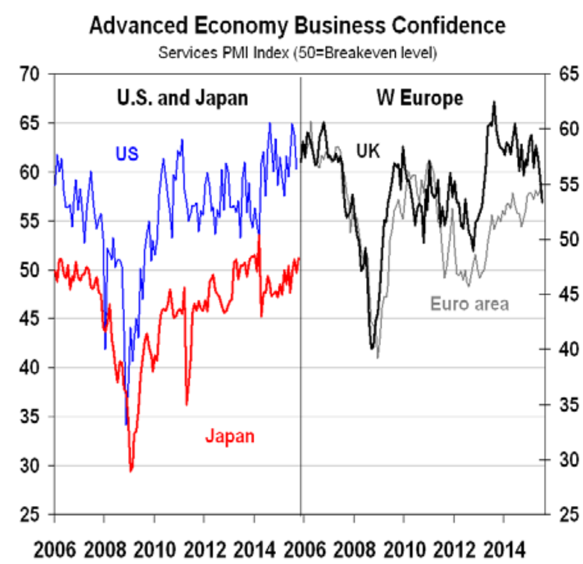




Advanced Economies

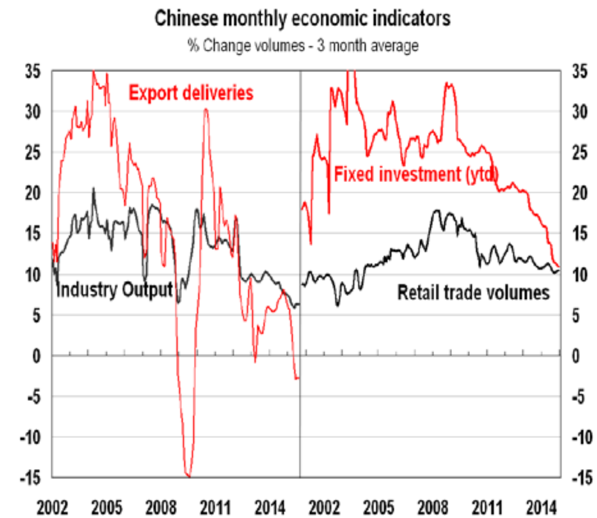
- A recovery in US and UK quarterly growth from weak first quarter outcomes saw the pace of annualised GDP expansion in the G7 advanced economies rise from 1½% in March to over 2% in June. By contrast, growth outcomes in the Euro-zone and Japan were disappointing with a slowdown in quarterly GDP growth between March and June quarters from 0.5% to 0.4% in the former and a shift from quarterly growth of over 1% to a contraction in output of 0.3% in the latter.
- The monthly business surveys show mixed conditions continuing across the big advanced economies through to September. US services growth is solid but the high $US is hitting industry, UK growth looks to be slowing, Euro-zone growth is modest and Japan's economy still looks weak.
- These differences in recent growth performance between the big advanced economies follow the pattern of trends seen since the onset of the global crisis and recession in 2008. By mid-2015 output was above its early 2008 level by 11% in Canada, 10% in the US and 6% in the UK but it was still just below its March 2008 level in Japan and the Euro-zone.
- This differential growth performance is only partly reflected in jobless rates with the stronger US and UK upturns leading to big falls in their unemployment rates and the weak Euro-zone outcome underpinning a continued double-digit jobless rate. Japan's jobless rate, however, has trended down despite its weak output record, highlighting demographic challenges of a declining and ageing population. Canada's jobless rate has also stayed higher than might be expected, given the strength of the growth in its output.

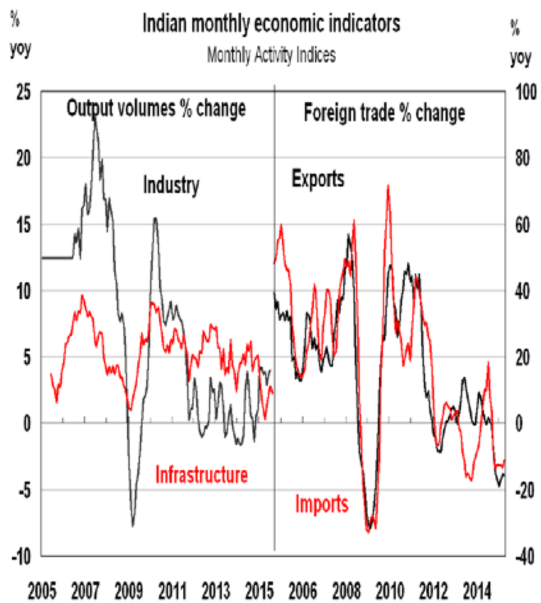




Emerging Market Economies

- A slowdown in emerging market growth from 6% yoy in March to 5.7% yoy in June 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 the last couple of months (notably the bursting of the Chinese share market bubble).
- Although some of the latest monthly trade and industrial data shows a modest lift in emerging market growth, the numbers are volatile and it is too early to conclude that a sustained acceleration in growth has begun. Annualised industrial growth increased from 2.8% in the 3 months to June to 3.2% in the 3 months to July. Emerging economy exports fell heavily in late 2014 and early 2015, flattened out in the June quarter and rose slightly in the 3 months to July compared to the previous 3 months. Import volumes into emerging market economies were still falling in the 3 months to July but the rate of decline was well below the big falls seen through late 2014 and early 2015.
- This slightly better tone in emerging market data seen through mid-2015 is far from uniformly evident across the biggest economies. Chinese trade and industrial output continued its trend decline, Indian industrial output has picked up but trade flows remain weak. Brazilian economic conditions remain weak with inflation running above target, falling commodity prices eroding national income and political tensions over the Government's accounts. Modest growth continues across East Asia (excluding China) with GDP growing by around 3½% yoy, well below the region's long-run trend and with falling levels of industrial output and $US exports.

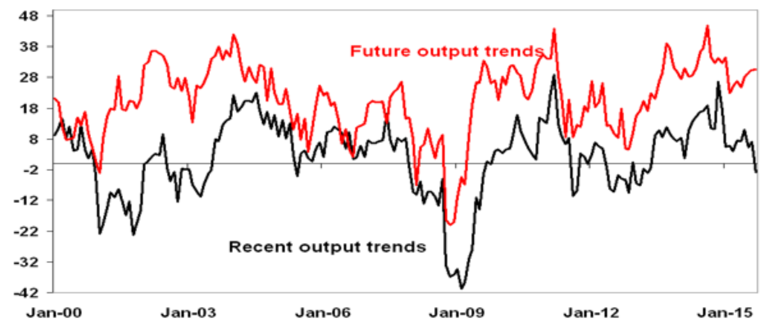




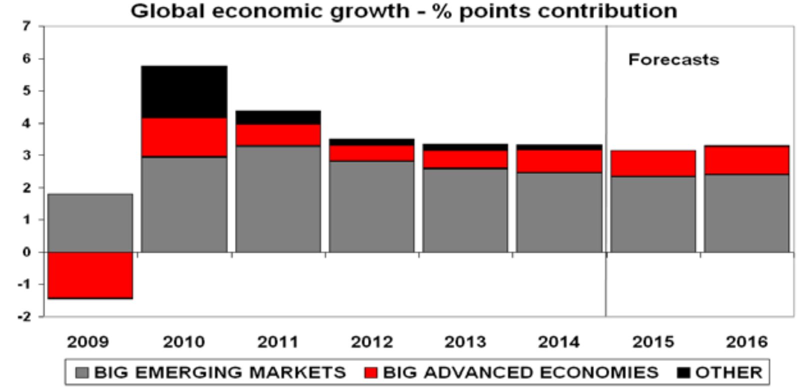
Global forecasts

- We are still forecasting little to no pick up in the pace of global growth. Global growth should remain just over 3% through the next couple of years, a disappointing sub-trend performance. The IMF has consistently been more optimistic and predicts a pick-up to 3.6% next year but it has also just revised its 2015 numbers down again as outcomes fall short of its expectations.
- A modest upturn in Japan and the Euro-zone drives the forecast lift in advanced economy growth from 1.9% to 2.1% between 2014 and 2016 Emerging market economy growth should slow this year to less than 5% for the first time since 2009 with a broad-based weakening across most of Asia and Latin America. Big economies like Brazil and Indonesia have been hit by financial market volatility previously when cycles of rising US interest rates coincided with falling commodity prices and markets are sensitive to their vulnerability as these conditions could soon recur.
- China is now the biggest global economy and dominates many global commodity markets, highlighting its importance for export price trends in Australia and New Zealand. Recent Chinese GDP growth is close to the 7% official target but growth is already well below that rate in key sectors of importance for Australian commodity demand and there is also debate over the accuracy of the Chinese GDP estimates.

Business surveys in US, UK, Germany and France



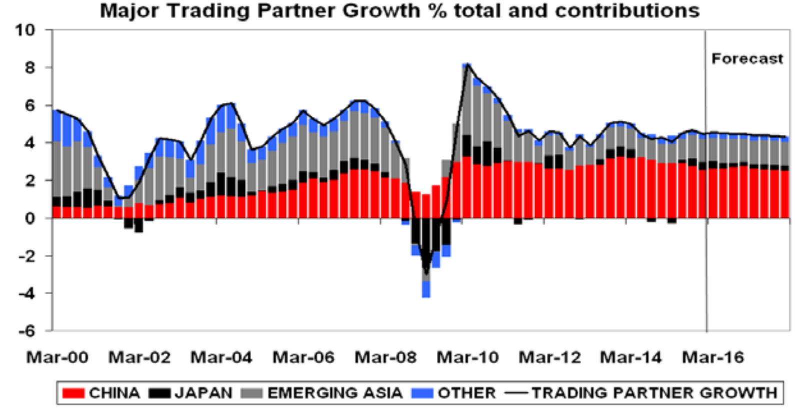
Global economic growth - % points contribution



Global growth forecasts % change year on year

	2011	2012	2013	2014	2015 *NAB Forecasts*	2016	2017
US	1.6	2.2	2.2	2.4	2.5	2.5	2.4
Euro-zone	1.7	-0.7	-0.3	0.9	1.3	1.7	1.9
Japan	-0.4	1.7	1.6	-0.1	0.7	1.2	1.0
UK	2.0	1.2	2.2	2.9	2.4	2.3	2.2
Canada	3.0	1.9	2.0	2.4	1.0	1.7	1.8
China	9.3	7.8	7.7	7.3	7.1	6.9	6.5
India	7.7	6.8	6.4	7.1	7.4	7.5	7.5
Latin America	4.9	2.5	2.5	0.9	0.3	1.2	1.5
Emerging East Asia	4.4	4.6	4.2	4.0	3.7	3.8	4.1
New Zealand	1.8	2.4	2.3	3.3	2.2	1.8	2.0
World	*4.4*	*3.5*	*3.4*	*3.3*	*3.1*	*3.2*	*3.3*
memo							
Advanced Economies	1.7	1.2	1.4	1.8	1.9	2.1	2.1
Big Emerging Economies	7.0	5.6	5.5	5.1	4.8	5.0	4.9
Major trading partners	4.6	4.3	4.6	4.5	4.4	4.5	4.4

Major Trading Partner Growth % total and contributions



Australian outlook

- We remain cautiously optimistic that the Australian economy will experience moderate economic growth through 2015/16 before picking towards its historical average growth rate in 2016/17.
- As well canvassed, the economy is challenged by the transition away from mining investment towards non-mining sources of economic growth. This is occurring at a time in which our largest trading partner is experiencing a slowdown in industrial output, while commodity prices have fallen sharply. As such, the income flowing from sharply higher resource export volumes will be more limited, and will weigh on corporate profits, government revenue and ultimately labour earnings.
- That said, recent policy easing from the RBA in early 2015 is continuing to be supporting economic activity, and typically does so with a 12-18 month lag. Meanwhile, the further 24c depreciation of the AUD/USD from 92c in Sep-14 to 68c on our forecasts by mid-16 will support trade-exposed industries; while some of this is offsetting the decline in the terms of trade, it is beneficial for industries not as directly exposed to lower commodity prices.
- High frequency data continues to support our view that the non-mining recovery is becoming more well entrenched. Business conditions in the NAB survey holding at an above average level for 7 consecutive months, and key leading indicators such as capacity utilisation are also trending upwards. Services industries are particularly strong, including but not limited to tourism.
- The outlook for non-mining business investment is a key uncertainty. While the resilience in employment can be explained by the tilt towards labour-intensive industries, these industries are also less capital-intensive. Moreover, firms continue to demand high hurdle rates on investment, despite much lower borrowing rates. Dwelling investment meanwhile is already at a high level, and will add less to economic growth in 2016/17 than in 2015/16.
- Consumer spending will remain below-trend, constrained by low wages growth, with forecasts dependent on a decline in the household savings rate.
- On balance, our GDP forecasts are unchanged at 2.4% for 2015/16 and 3.1% for 2016/17. The unemployment rate eases to 6% through 2015/16 and to 5¾ in 2016/17.

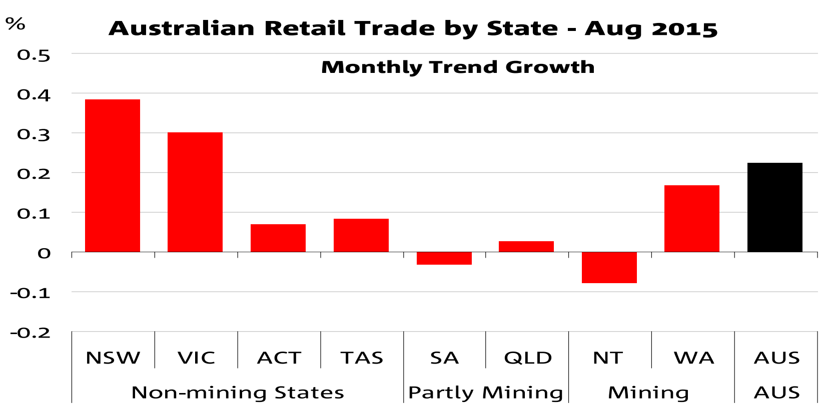
Australian economic and financial forecasts (a)

	Fiscal Year			Calendar Year		
	2014-15 F	2015-16 F	2016-17 F	2015-F	2016-F	2017-F
Private Consumption	2.5	2.5	2.6	2.5	2.5	2.7
Dwelling Investment	8.3	12.0	7.1	11.0	10.1	3.6
Underlying Business Fixed Investment	-7.1	-9.1	-7.8	-8.4	-8.5	-7.2
Underlying Public Final Demand	0.4	2.5	1.8	2.0	1.8	1.9
Domestic Demand	**0.9**	**1.6**	**1.6**	**1.4**	**1.6**	**1.5**
Stocks (b)	0.2	0.0	0.0	0.1	0.0	0.0
GNE	**1.1**	**1.6**	**1.6**	**1.4**	**1.6**	**1.5**
Exports	6.6	5.5	8.8	5.4	7.3	9.5
Imports	-0.4	1.3	2.0	1.4	1.5	1.7
GDP	**2.4**	**2.4**	**3.1**	**2.3**	**2.7**	**3.3**
– Non-Farm GDP	2.4	2.5	3.1	2.3	2.8	3.3
– Farm GDP	3.4	0.1	2.0	2.1	1.2	2.0
Nominal GDP	1.9	3.8	4.9	2.2	4.9	4.7
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	57	60	44	66	51	36
(-%) of GDP	3.5	3.6	2.5	4.0	2.9	2.0
Employment	1.4	2.3	2.7	2.0	2.6	2.5
Terms of Trade	-10.5	-4.0	-1.4	-9.3	-0.1	-3.0
Average Earnings (Nat. Accts. Basis)	1.2	1.0	2.1	0.4	1.7	2.3
End of Period						
Total CPI	1.5	3.2	2.7	2.6	2.9	2.3
Core CPI	2.3	2.6	2.4	2.5	2.6	2.4
Unemployment Rate	6.0	5.9	5.7	6.1	5.8	5.8
RBA Cash Rate	2.00	2.00	3.00	2.00	2.50	3.50
10 Year Govt. Bonds	3.01	3.10	3.50	3.10	3.25	3.50
$A/US cents :	0.77	0.69	0.72	0.70	0.70	0.73
$A - Trade Weighted Index	63.8	61.2	62.9	61.3	62.0	62.4

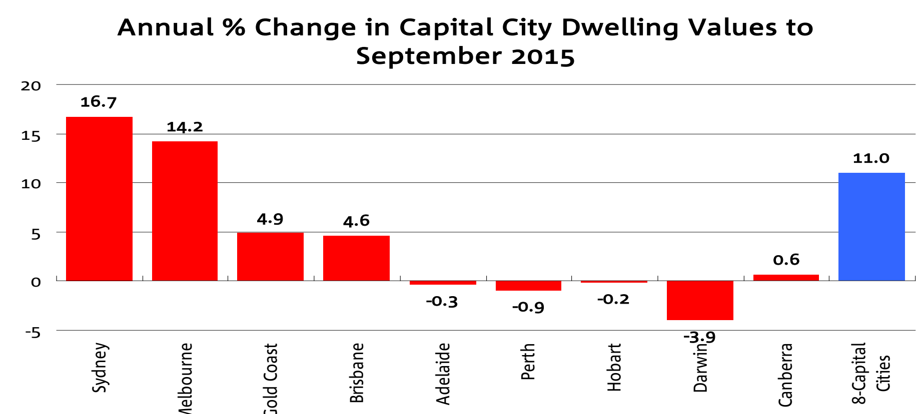
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through
(b) Contribution to GDP growth

Australian consumer demand and housing market

- A general improvement in the trading environment for retailers, including the lower AUD and strength in the housing market in some states, is helping to sustain national retail spending at a resilient level. ABS data on retail turnover showed growth rebounded to 0.4% in August (to be 4.5% y/y) after recording a 0.1% decline in July. This is higher than overall household consumption growth in recent times, which rose by just 0.5% in the June quarter (to be 2.5% y/y in real terms). The divergence in the momentum of the two measures may be partly explained by a pick-up in international tourism spending, which falls under services exports rather than consumption (see tourism exports chart on p11). Meanwhile spending on services not captured in retail trade (such as utilities, transport and insurance & financial services) detracted from consumption growth in the June quarter. The loss of momentum in household consumption is also consistent with persistently weak growth in household income – average compensation per employee rose just 0.2% q/q– and high consumer caution. The household savings rate lifted back to 8.8%.
- By state, retail spending growth (in trend terms) was the strongest in the largest non-mining states of NSW and Victoria in August, moderate in WA and NT, and neutral in Qld and SA (left-hand panel). Relatively strong housing activity in NSW and Vic has led to a surge in the spending on household goods nationally, which is evident in the superior performance by the household goods retail category relative to other categories since late 2014. The August NAB Online Retail Index also partly reversed its 1.4% fall in July, to be up 0.6%m/m in the month.
- Amidst subdued household income growth, we expect a modest pick-up in consumer spending growth through to 2017, driven by a gradual decline in the household savings rate. Subdued consumer sentiment could be a risk near-term. In contrast, business conditions of retailers as indicated by the monthly NAB Business Survey remain above their long-run average, although retail confidence has moderated in recent months. A lower AUD should also re-direct spending onshore.
- The pace of dwelling price growth lifted slightly to 11% y/y in September (10.2% y/y in August). Sydney continues to see the fastest rate of dwelling price growth at 16.7% y/y, although the pace has eased a little in the past two months (chart RHS). Melbourne is the only other capital city to record double digit growth in dwelling prices at 10.6% y/y – its fastest pace of growth since 2010. Growth in owner-occupier loan approvals is subdued, and housing credit growth remains well below previous boom cycles, suggesting financial stability risks remain contained. Supply side constraints have been supportive of prices in certain markets, especially Sydney, but dwelling prices can not continue to outpace household income growth indefinitely. Investor housing credit growth has dropped below the regulators 10%, although this partly reflects a reclassification of loans by banks. Foreign investor demand is a major uncertainty, especially in light of emerging market risks.



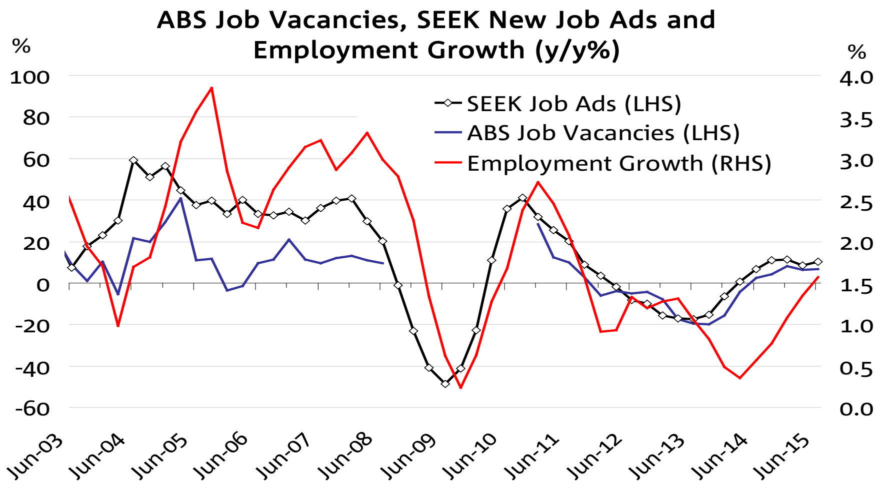
Source: ABS, NAB



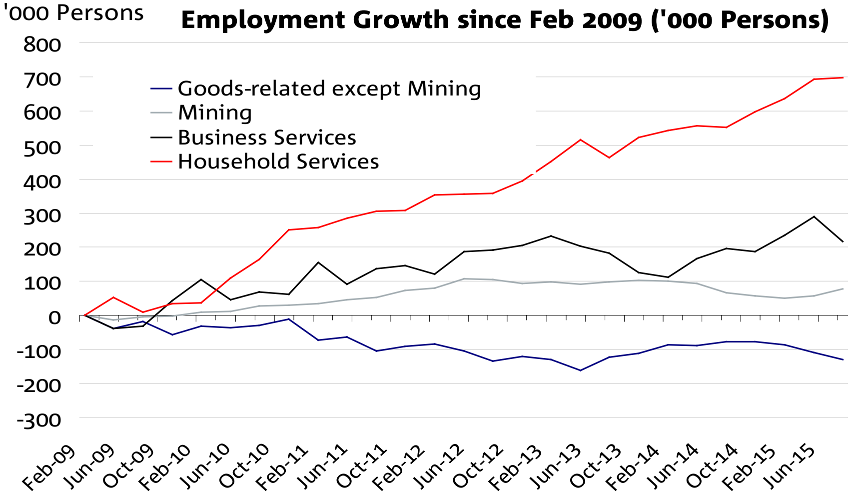
SOURCE: RP Data

Australian labour market

- The unemployment rate is forecast to stabilise in coming months, and then drift slightly downwards to around 5¾% by end-2016. Slower population growth (currently 1.4% y/y, down from 1.6% at the start of 2014 and a recent peak of 1.8% in late 2012), 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 have become more consistently positive. Measures of job advertisements (see LHS chart) and capacity utilisation having been rising for some time, while the monthly NAB Business Survey employment index also turned positive September, the first time since late 2014. The recovery in national job vacancies in the past 2 years has been largely dominated by NSW and Victoria. According to the latest ABS data for the August quarter, job vacancies in NSW and Victoria surged by 22% and 19% in year-ended terms respectively, rose moderately in the smaller states of SA (+5%) and TAS (+9%), but were much weaker for the mining states of Qld (unchanged) and WA (-11%).
- 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. Job creation in the household services sector has been particularly strong, adding around 700k jobs since early 2009 (see RHS chart), followed by business services (+200k), while the goods-related sector has shed more than 100k jobs over the same period. Indeed, the NAB employment index is the strongest in services sectors such as finance, business & property services and recreation & personal services. Mining jobs have rebounded notably since the start of this year, possibly reflecting the fast-tracking of existing mining projects, as indicated by a relatively resilient level of engineering construction activity.
- Ongoing spare capacity in the labour market is evidenced by the slowdown in wages growth. The wage price index increased by a modest 0.6% in the June quarter, to be just 2.3% higher over the year, to only just keep pace with underlying inflation. No industries are experiencing wages growth of 3%, and three industries are experiencing wages growth below 2% (construction, business & professional services and administrative & support services). Broader measures of the wages bill are growing at an even slower rate, as employment shifts away from higher paid industries such as mining, towards lower paid industries. Average compensation per employee grew just 0.2% in the June quarter and 0.5% over the year.



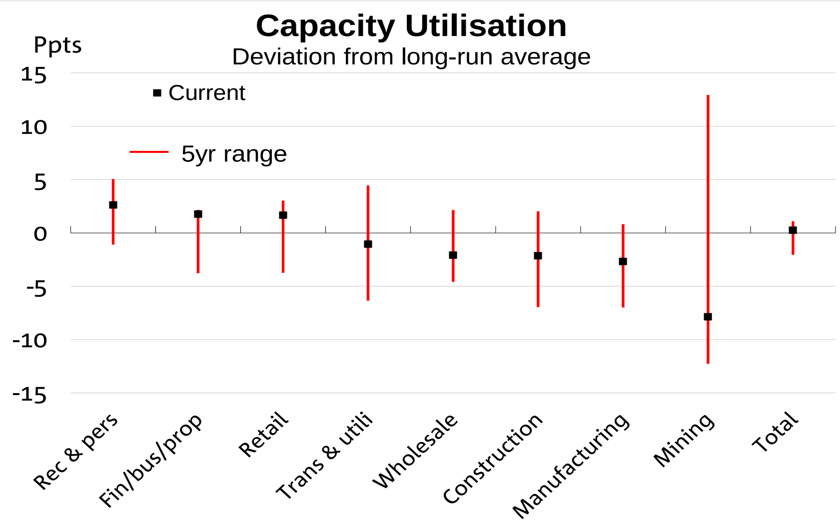
Source: ABS, SEEK, NAB Group Economics



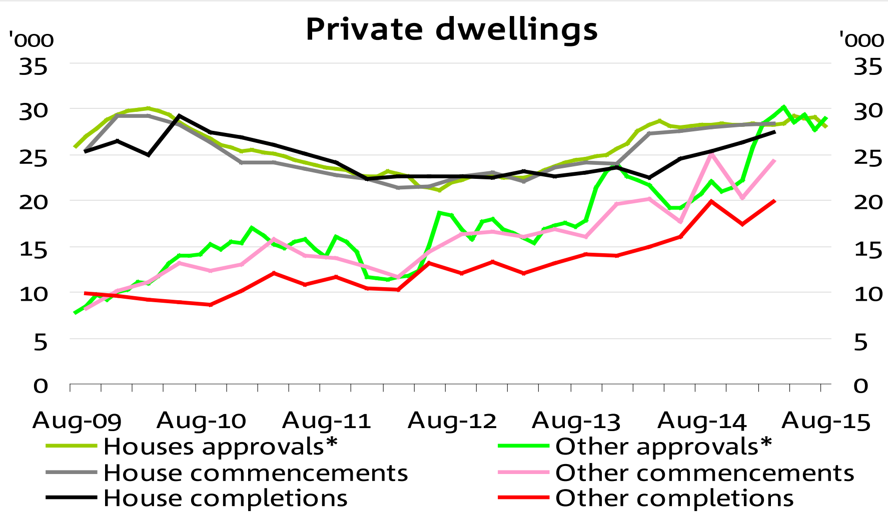
Source: ABS, NAB Group Economics

Australian investment

- Indicators of non-mining investment are looking mixed, while sharp declines in mining and related investment will continue to be a key feature of the economic landscape in coming years. Financial market uncertainties, and the implications for commodity markets, have likely contributed to tepid investment intentions. Nevertheless, domestic conditions for non-mining investment are looking a little more favourable, with export competitiveness gaining support from the lower AUD and capacity utilisation continuing to improve – although this varies considerably across industries.
- While domestic conditions suggest that non-mining investment should start to improve, significant uncertainty over the outlook (particularly for the global economy) appears to be keeping firms on the sidelines. In the NAB Business Survey, firms are reporting very high required rates of return (hurdle rates) before committing to new investment. Additionally, industries outside of mining that account for a large share of capital investment (including manufacturing) appear to be lagging, both in terms of business conditions and capacity utilisation. Indicators for commercial property markets are somewhat mixed, but soft non-residential building approvals are consistent with the weak Capex survey. In contrast, the NAB commercial property survey was generally upbeat, and is positive across all market sectors (office, retail, industrial and CBD hotels), although there are notable differences across states, with WA and SA/NT continuing to lag.
- 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. The number of new approvals also remains elevated even though growth appears to have stalled. We continue to expect some degree of volatility in the profile given the large share of apartment construction, which tends to be lumpy. Longer lead times for higher density construction (as evidenced by the gap between approvals and starts for non-housing dwelling construction on the right panel), suggests further growth in construction until late 2016.
- Overall, we are forecasting business investment to decline by around 9% in 2015/16 and 8% 2016/17. Stronger dwelling investment will provide some offset, but represents a much smaller proportion of GDP (around 5% vs 12% for business investment).



Source: NAB Economics

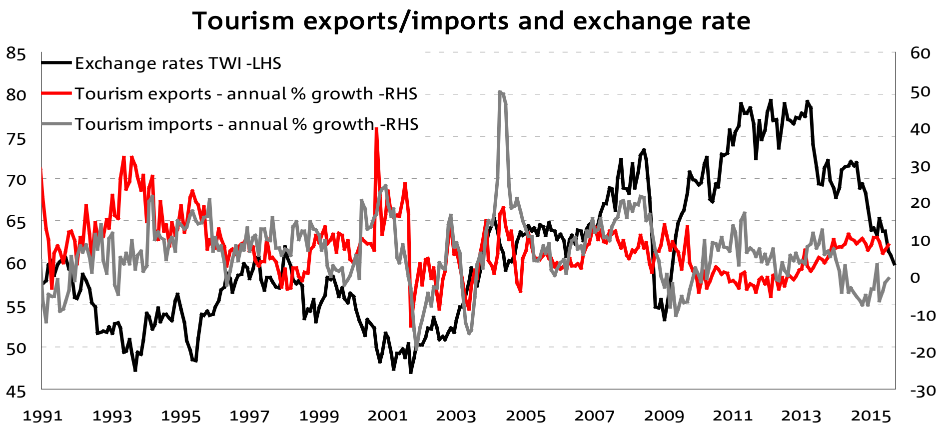


*Rolling 3-month sum lagged 1 month

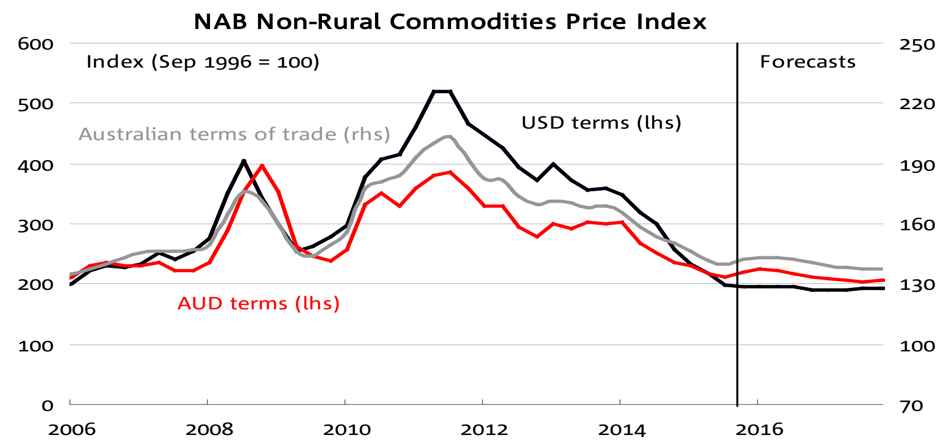
Source: ABS

Australian commodities, net exports and terms of trade

- At this stage, the evident slowdown in Chinese heavy industry, manufacturing and property sectors presents a significant downside risk to resource commodity export earnings. Further weakness would most likely come through the price channel; while there is some downside risk to production and export volumes, the lower AUD and oil price is also lowering cost curves for producers. At this stage, we continue to expect strong growth in export volumes, which is adding 1¾ppt to GDP in 2015/16 and 2016/17. LNG exports will be the primary driver of export growth going forward although will not replace iron ore as Australia's largest export – we estimate that LNG exports will add around $12-13bn to Australian exports per quarter by end 2017.
- Tourism exports are improving in net terms, in line with the weaker AUD (bottom left chart), and we expect this process to continue going forward. The weaker AUD will also aid the competitiveness of manufactured exports and go some way to improving relative unit labour costs between Australian and the rest of the world; it is unlikely to reverse decisions to offshore that have already been made however. Meanwhile, imports will remain weak, with some consumer spending re-directed back onshore as the AUD declines, and capital imports lower as mining investment trails off.
- The non-rural commodity index denominated in USD is expected to fall around 31% during 2015 and a further 7.2% during 2016. The sharper fall for 2016 incorporates further weakness in commodity prices in USD terms. The AUD is forecast to depreciate to US68c by the end of Q1 2016, which helps to offset commodity price weakness 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$47 a tonne in late 2015 to US$44 by the end of 2016. Oil prices are now forecast at $US50 a barrel by late 2015 – and around the mid to high $US50s by end 2016. Elevated levels of global price volatility continue to cast a high degree of uncertainty over the outlook.
- Agricultural prices continued to diverge in September. Most major grains fell (wheat was down around 10% in AUD terms), as did fruit, vegetables and trade lamb (reflecting seasonal trends). However, dairy prices strongly rebounded on supply concerns and sugar, beef and rice were also higher in AUD terms. Overall, the NAB Rural Commodities Index was off 1.5% (AUD) and 4.1% (USD). Continued AUD weakness will support the index in the coming year, with forecast growth of 6.7% in 2016 in AUD terms. In USD terms, the index is forecast to decline 0.6% in 2016.



Sources: RBA, ABS



Sources: ABARES, ABS, Bloomberg, Thomson Datastream, NAB Economics

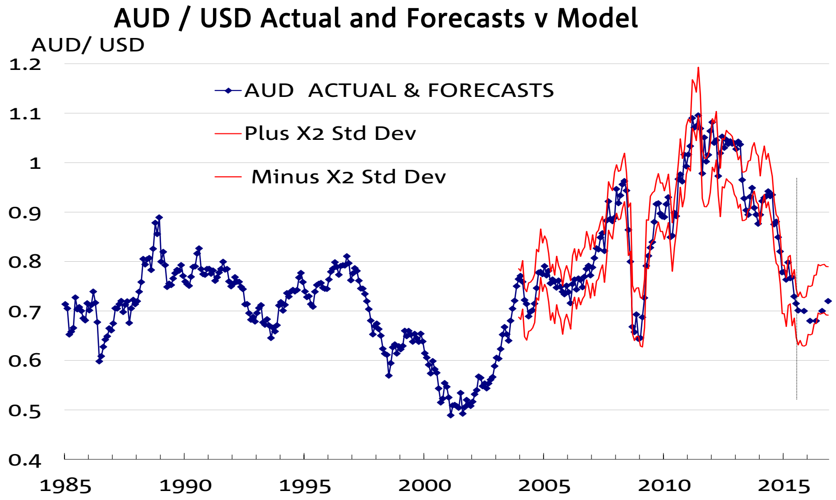
Australian financial markets

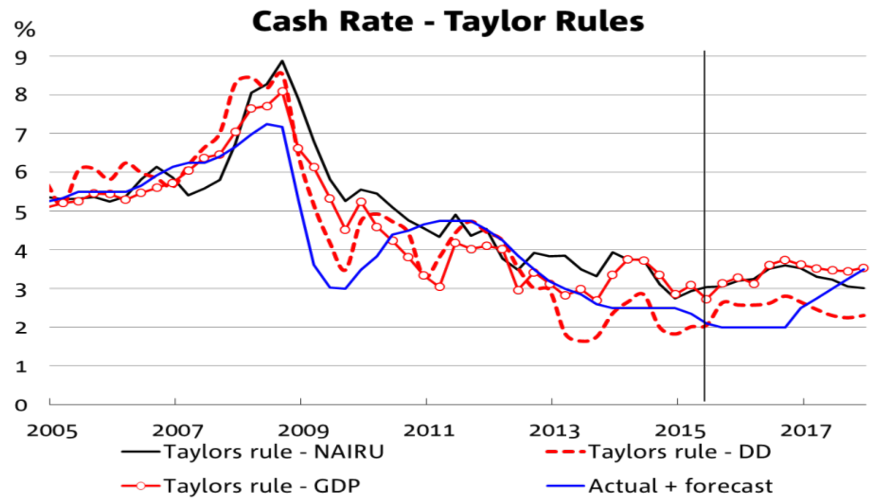
Exchange rate

- The AUD has bounced a little over the past month - USD73c at the time of writing from a very recent low of 69c. This partly reflects a weaker USD, with the Fed refraining from hiking rates in September and markets questioning the now consensus forecast for a December hike. A squeeze of short-positioning in the AUD also appears to be a driver. Our forecast for the AUD/USD to hit a low of 0.68 for H1 2016 remains. This largely reflects our expectations for a modestly stronger US dollar either side of year-end, and contagion effects from an expected resumption of CNY depreciation and broader pressure on Emerging Asia currencies in 2016 - to which the AUD remains highly correlated. That said, we also acknowledge the upside risks if NAB's view that the RBA has finished hiking takes hold in the trading community; as such we are reluctant to forecast levels in 2016 much below the 2015 YTD lows (0.6896).

Interest rates

- As flagged last month, global financial market ructions and a slower China are clear downside risks for the domestic economic outlook. While equity market volatility has settled a little, there is little further clarity around how the Chinese economy is responding to recent stimulus measures, and the RBA will continue to wait for a clearer global picture to emerge; it will be reactive rather than proactive in addressing these global risks.
- The case for further easing on purely domestic grounds is limited in our view amidst a trend improvement in business conditions, capacity utilisation, and leading labour market indicators. While macro-prudential measures are helping to cool investor housing demand, the RBA will remain reluctant to stimulate further housing demand via lower rates unless global influences become consistently more severe.
- Inflation is unlikely to have great bearing on monetary policy discussions at present. Underlying inflation has been around 2¼% for the past few quarters, and is expected to remain near the middle of the 2-3% target band through the forecast horizon. Weak wages growth will keep domestic inflationary pressures well contained. On the other hand, dwelling construction costs continue to rise, especially in Sydney. Tradable inflation has increased with the depreciating AUD, offsetting some of the weakness in domestic inflation. In particular, we note the pickup in retail price inflation in the September NAB survey.





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