Global & Australian Forecasts

by NAB Group Economics

Embargoed until:
11:30am Tuesday 10 November 2015

November 2015

National Australia Bank

Key Points:

- Although some of the risks hanging over global markets have abated, recent and forecast global economic growth remains lacklustre. Growth remains stuck in the 3 to 3¼% range seen since mid-2012 as lower commodity prices, capital flow reversals and central banks focused on getting inflation back toward target take a toll on the pace of expansion in emerging market economies that underpin most global output expansion. Growth should level out in the US and UK at a moderate 2 to 2½% pace and pick up slightly in the poorly performing Euro-zone and Japanese economies but this is not enough to fundamentally change a global outlook that remains dominated by the loss of momentum in the emerging economies. Inflation is low in the big advanced economies, allowing central banks to take a cautious and gradual approach to lifting interest rates to "normal" levels - but inflation is still a problem in some emerging economies.
- In Australia, we remain cautiously optimistic that the gradual recovery in the non-mining sector is gaining traction. Recent outcomes from the business survey support this contention with business conditions holding up at a high level in October, and the unemployment rate holding steady. In addition, partial indicators for Q3 GDP suggest a high outcome, which would retrace the temporary weakness in Q2. The RBA appears to concur with this assessment, and chose to hold off further monetary policy easing in the month despite some tightening of financial conditions. Low inflation however does provide room for the RBA to ease, although this would require evidence that local demand conditions are deteriorating again (not our or the RBA's central case scenario), and more concrete evidence that housing demand is easing. As such the RBA is expected to remain on hold for an extended period, although we have pushed out the timing of the first hike until mid-17. Real GDP is forecast to expand by 2.6% in 2015/16 and 3.0% in 2016/17, with El Niño only subtracting marginally. The unemployment rate eases gradually but remains elevated for an extended period.

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.4	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	6.9	6.7	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	3.0	3.2	3.3
Australia	2	2.7	2.3	2.9	3.2
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.2	2.5	2.5	2.5
Domestic demand		1.0	0.9	1.6	1.6
GDP		2.5	2.4	2.6	3.0
Core CPI (*% through-year*)		2.7	2.3	2.4	2.5
Unemployment rate (*% end of year*)		6.0	5.9	5.8	5.6

Contents

Key points	1
Global and Australian overview	2
Global forecasts	7
Australian outlook	8
Australian financial markets	13

For more information contact:
Alan Oster, Chief Economist: (03) 8634 2927 or 0414 444 652
Tom Taylor, Head of International Economics: (03) 8634 1883
Riki Polygenis, Head of Australian Economics : (03) 8697 9534

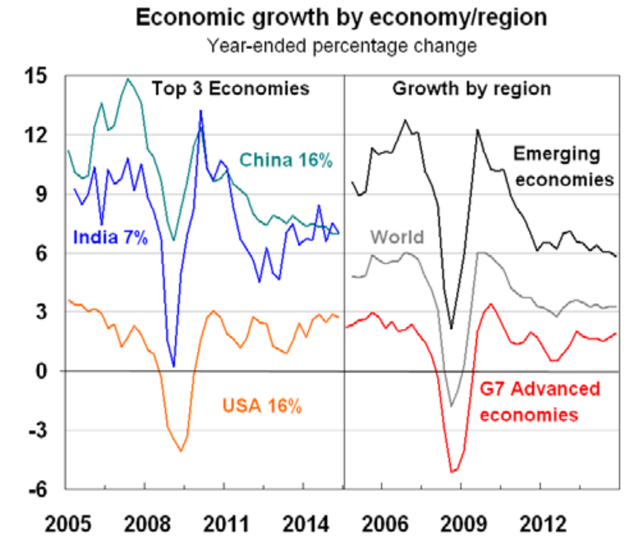
Global and Australian overview

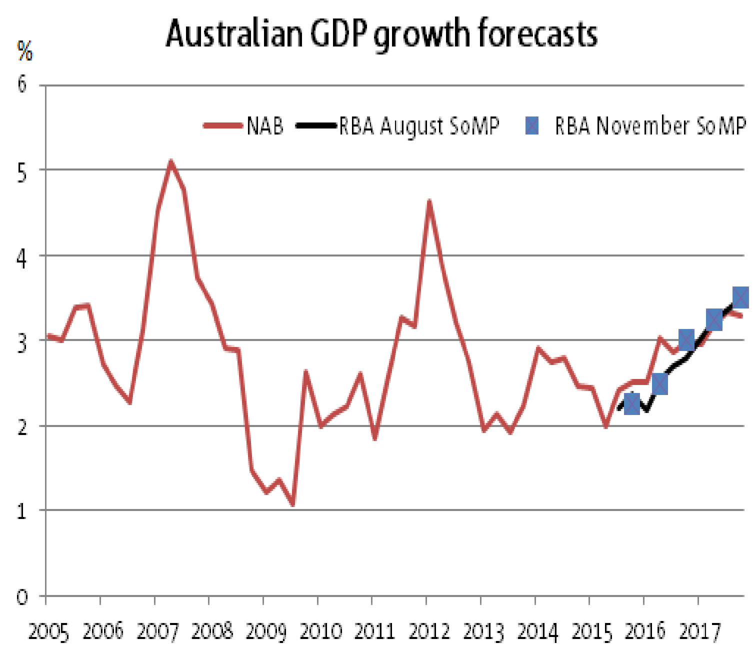
Global overview

- Global growth remains sub-trend and there is little sign of an imminent acceleration in the pace of expansion – which should stay around 3%. Some factors hanging over global markets have eased for now (political uncertainties in Southern Europe, deferral of the US debt limit, the Chinese share market) and this has helped share prices to rise. However, the combination of higher US interest rates and lower commodity prices has caused problems in the past for emerging market economies, which have been driving the bulk of global growth since 2009. The modest upturn forecast for Japan and the Euro-zone is not enough to markedly change the lacklustre economic outlook.
- This outlook underpins continuation of the low inflation environment that has allowed advanced economy central banks to sustain historically low interest rates for such a long time. With below target inflation in the US, UK, Japan and Euro-zone, central banks can afford to take a cautious measured approach to "normalising" interest rates in the US and UK and consider further easing in the Euro-zone and Japan. With the exception of China, inflation is more of a problem in the big emerging economies, limiting the ability of central banks to lift growth by aggressive rate cutting.

Australian overview

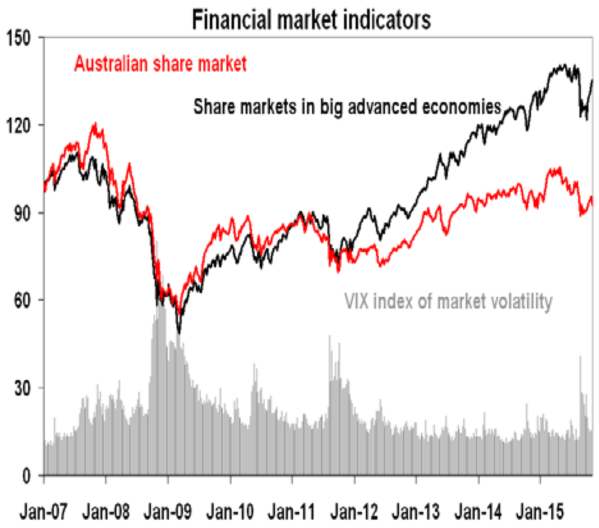
- NAB's forecasts continue to envisage a gradual recovery as the economy navigates considerable challenges (lower commodity prices, falling mining investment, slowing demand from China, consumer caution, financial market volatility), while also benefiting from stimulatory financial conditions (low interest rates and currency). Recent business survey outcomes suggest the recovery across the non-mining economy is becoming more resilient.
- As we published in the flash forecast update last Thursday, our GDP forecasts are now slightly higher for 2015/16 at 2.6%, largely reflecting the incorporation of a high expected Q3 print based on partial information to date – our preliminary Q3 forecast sits at 0.8% q/q due to a large contribution from net exports. Growth then recovers gradually to 3.0% in 2016/17, which should be enough to see the unemployment rate ease very gradually through the forecast horizon. The declaration of El Nino, while painful for the communities involved, will have a limited impact of aggregate GDP (see within).
- The RBA is expected to remain on hold for an extended period, with the first hike pushed out to mid-17. While low inflation and offshore risks will see the RBA retain an easing bias for some time, an actual cut would require evidence that the non-mining economy or the labour market is losing momentum again (not in today's business survey result). The RBA will also be reticent to cut until it is more confident that the housing market is losing some steam. The pushing out our RBA tightening forecast into 2017 has no immediate implications for our AUD forecasts (see below).

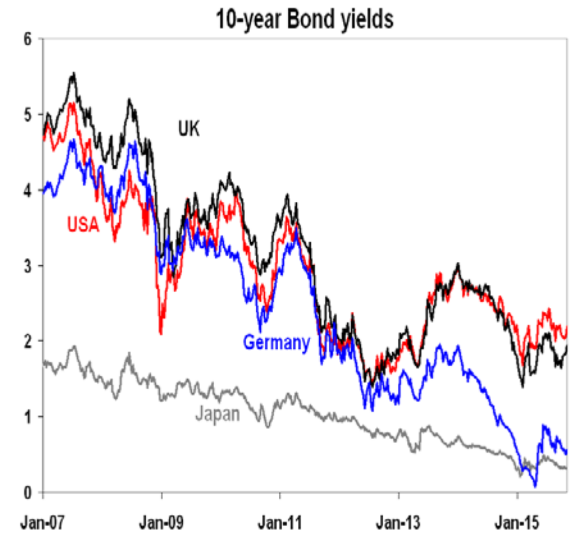


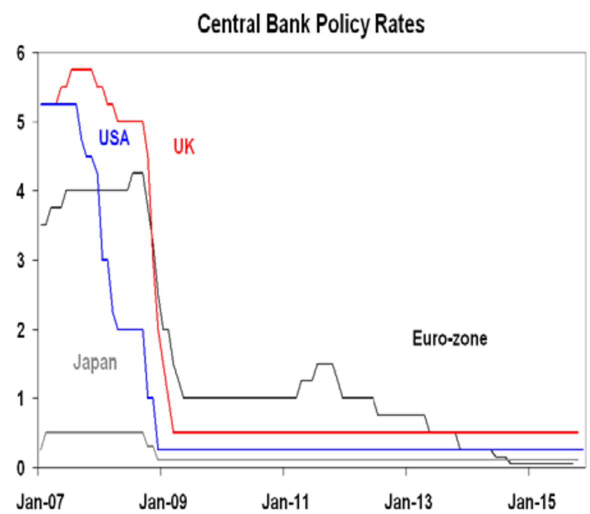


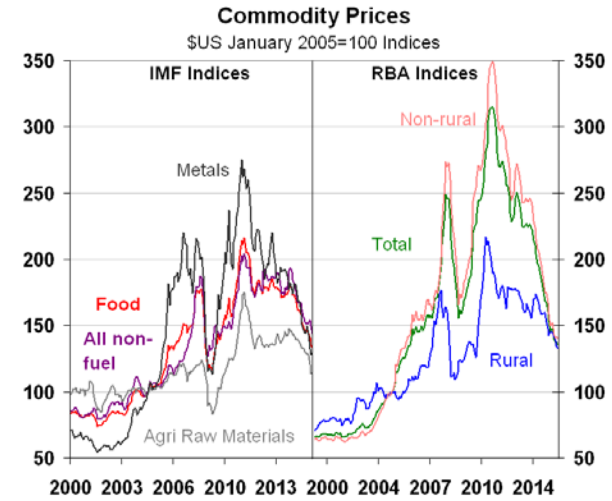
Financial and commodity markets

- Global share prices have risen as concerns over some of the risks overhanging the sub-trend economic recovery have receded. Despite ongoing questions over the political sustainability of austerity in peripheral members of the Euro-zone, markets have not been focussing heavily on the tensions in the currency union. Chinese share prices remain well below their earlier peak but have been recovering some of their losses and the Government has again stressed its determination to achieve solid rates of economic growth.
- Markets are pricing in a growing chance that the Fed will start to lift interest rates before the end of the year. The outlook is still for a gradual cautious approach to US policy rate increases that leaves them well below previous peaks in the Fed funds rate. We expect the first rate rise to occur in December, followed by a pause until mid-2016 with a total of three 25 bps increases in 2016.
- With inflation running well below the European Central Bank's (ECB) target of below but near to 2%, we expect the ECB to further ease its monetary policy by the end of the year. While there are concerns that the Euro-zone is close to deflation, we think that the ECB's concern is getting inflation closer to its target rather than having to ward off a Japanese-style deflation.
- The Bank of Japan kept its monetary policy unchanged at its end October meeting, despite continuing lower than target inflation and a postponement of achieving its 2% target to the end of next year. The central bank will continue buying assets (especially government bonds) to lift the monetary base by an annual 80 trillion yen.



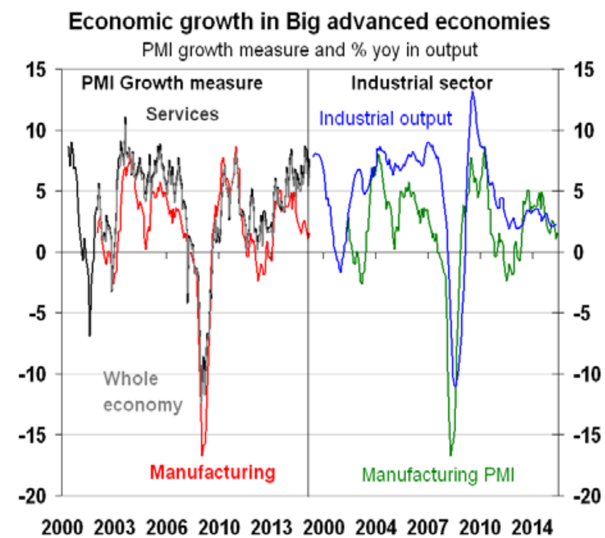


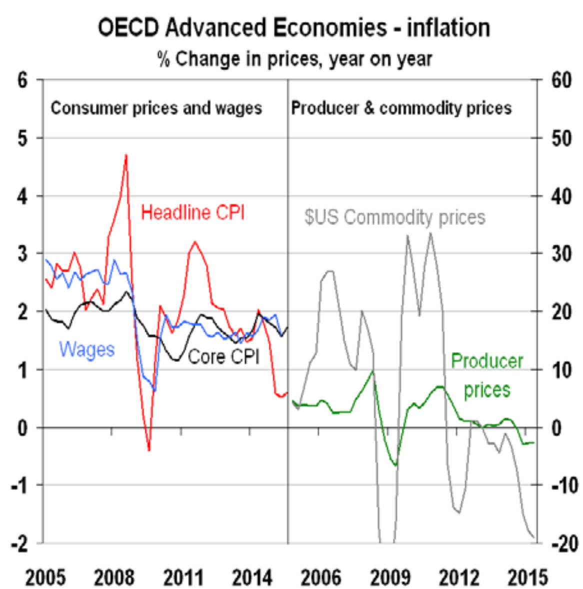


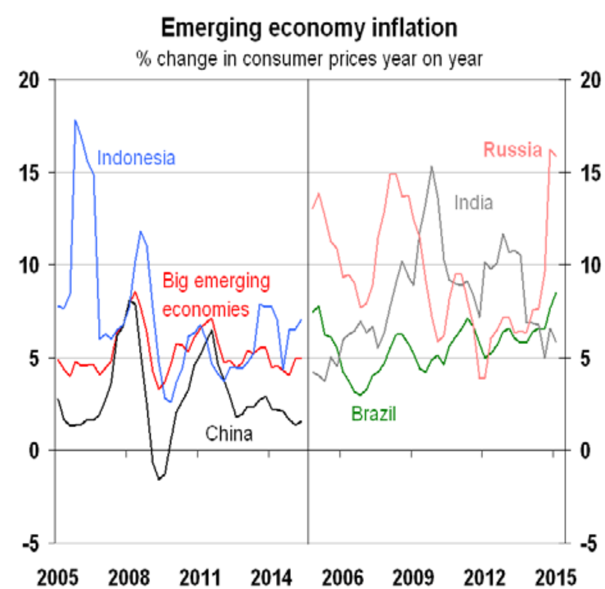


Global Economic Trends

- Growth in global GDP, the broadest measure 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 only modest growth. Global industrial growth in the 3 months to August was running at an annualised rate of around 2% and world export growth remained very weak.
- While there is far more hard data on output and trade available for goods producing industries like manufacturing, the service sector forms by far the largest part of most economies and services data is thinner on the ground. The monthly business surveys give timely indications of the diverging growth momentum in industry and services.
- These surveys show much stronger and improving activity levels in service industries in the US, Japan and W Europe. India shows a similar picture with faster growth in its service sector while manufacturing growth fades.
- Sluggish global growth and falling commodity prices have eroded inflationary pressures in the big advanced economies. Headline CPI inflation in the OECD has fallen under 1% yoy but that owes much to the transitory effect of lower oil prices and both wage growth and core inflation are closer to 2% yoy. Producer prices are falling, reflecting the role of commodities in industrial inputs.
- The inflation story is quite different in several of the big emerging economies where CPI inflation averages around 5% yoy. Chinese inflation is very low but among other big emerging economies inflation of 5% or more is evident in Brazil, India and Indonesia.

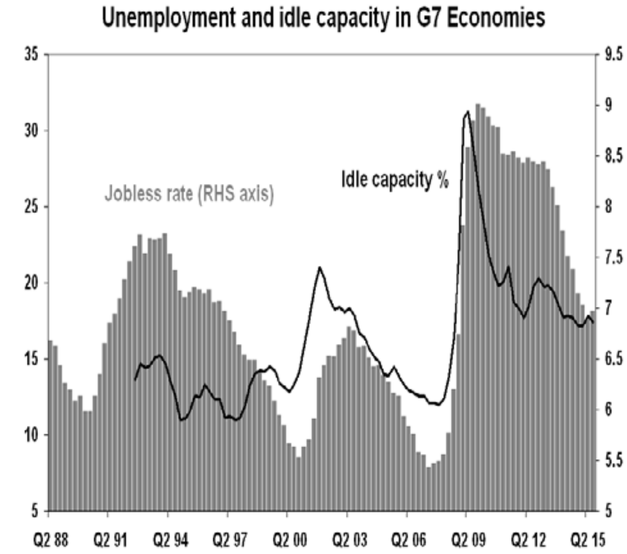


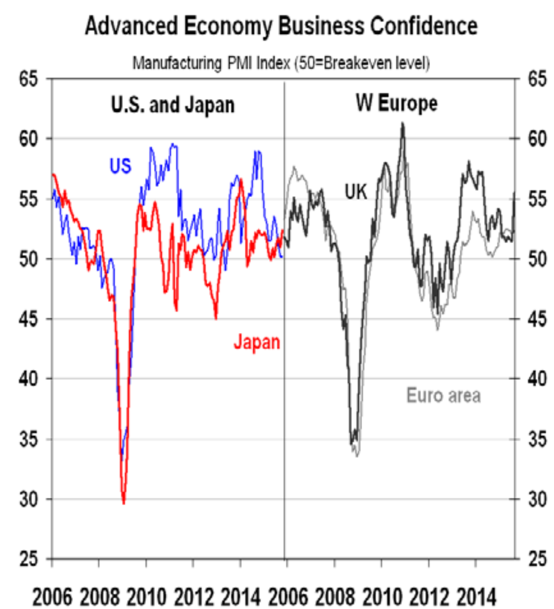


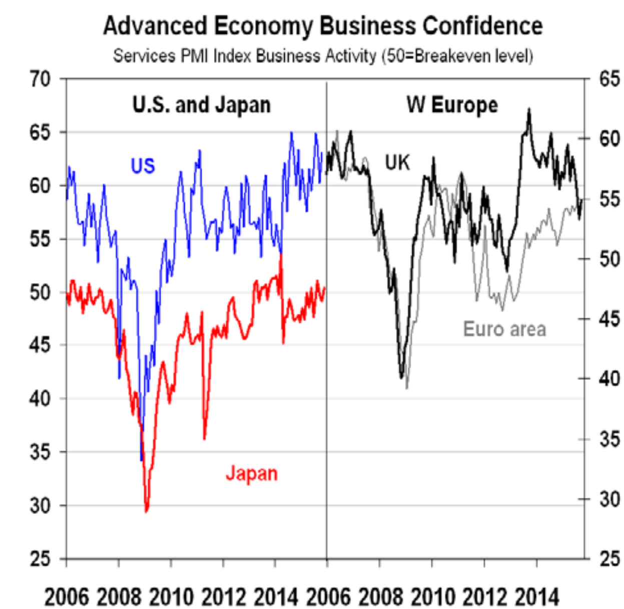


Advanced Economies

- There has been a gradual lift in the pace of expansion in the big advanced economies from 1½% yoy in late 2014 to 1¾% yoy in March 2015 and 2% yoy in June. Unemployment in the G7 biggest economies has declined from a peak of 9% in the wake of the global financial crisis to 7% in September 2015, only around 1 percentage point above its pre-recession level. The amount of idle capacity is well below its peak but it has stopped falling in the last year.
- There are marked differences in the strength of activity between individual advanced economies and between sectors. The US, Canada and UK have made the strongest recoveries from the deep recession of 2008/9 with mid-2015 output up by 10%, 11% and 6% respectively from its March 2008 level. By contrast, mid-2015 output in both Japan and the Euro-zone was still marginally below its early 2008 level, marking over 7 lost years for economic growth.
- Service sector growth has been the mainstay of this relatively strong performance in both the US and UK with PMI business survey readings for services generally outperforming manufacturing results. Recently US industrial growth has been held back by the strength of the $US while services growth has been very solid. UK industry recorded a surprisingly strong lift in growth in October, based largely on increased demand for the products of large firms rather than SMEs.
- A promising looking Japanese upturn was de-railed by higher consumption taxes last year and the economy has struggled to regain growth momentum. Euro-zone growth has also disappointed with the annualised pace of expansion staying around 1½% in the June quarter and little evidence of any acceleration since then.

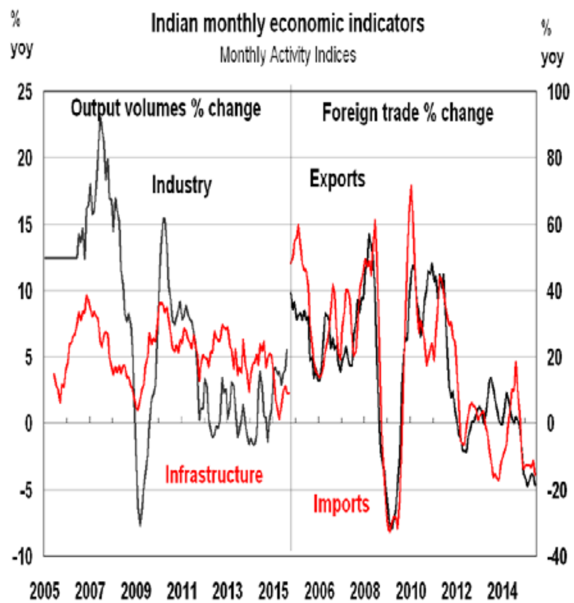






Emerging Market Economies

- The emerging market economies – especially the biggest ones like China, India and Brazil – were the main drivers of growth as the global economy moved out of recession after 2009. Growth rates in the emerging market economies have slowed from 7% in 2011 to around 5% this year and the slowdown in the biggest economies has also been quite marked, largely because of China's trend slowing and the much sharper move by Brazil into severe recession. Indian growth picked up strongly after the global downturn in 2008/9 but since then its performance has been disappointing.
- Monthly trade and industrial output trends across the emerging market economies show at best only a slight improvement in the pace of industrial growth in the September quarter along with still surprisingly weak exports. The business surveys are not pointing to a marked upturn in activity with Indian results mixed, yet more soft survey results in South Korea, still very poor results in Brazil and mixed outcomes in China.
- The monthly trade and industrial output data for the main emerging market economies has been similarly mediocre. Export deliveries and fixed investment spending in China continue to slow sharply, industrial output growth continues to trend down more gradually. Retail trade expansion remains solid, an encouraging sign for the Chinese authorities who want to reorient the composition of economic growth towards household consumption.
- Indian trade data remains very weak, but that partly reflects lower commodity prices and the higher $US. Output trends in industry and infrastructure have picked up slightly but growth remains sluggish by previous standards. Both exports and industrial output continue to fall across the rest of East Asia and Latin America.



Global forecasts

We have slightly lowered our Chinese growth forecasts, taking predicted global growth in 2015 down to 3% - well below trend. We do not expect to see much of an acceleration through the next couple of years. Growth in Japan and the Euro-zone should pick up modestly, adding just over 10 bps to global growth between 2014 and 2016. Canadian growth should quicken but US and UK expansion is expected to level out.

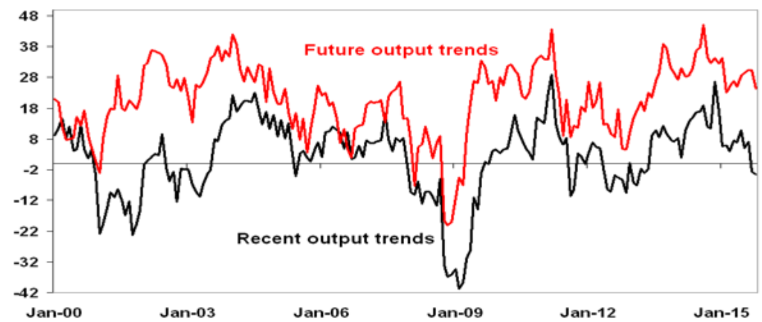
The loss of momentum in emerging market growth largely explains why global economic growth has been stuck around 3-3¼% for most of the last few years. The modest upturn predicted in emerging economy growth in 2016 and 2017 reflects the ending of recession in Brazil rather than a recovery in emerging market growth engines because there is nothing obvious in the outlook for global capital flows, interest rates or commodity prices that would produce a sustained broad-based acceleration in the emerging economies.

This pattern of global expansion is less favourable for commodity exporters like Canada, Australia and New Zealand than the emerging economy led growth seen previously. This reflects the commodity intensity of demand in big emerging economies, whose slower growth generally results in less robust expansion in commodity demand at precisely the time that new commodity supply is coming on stream in response to past high prices.

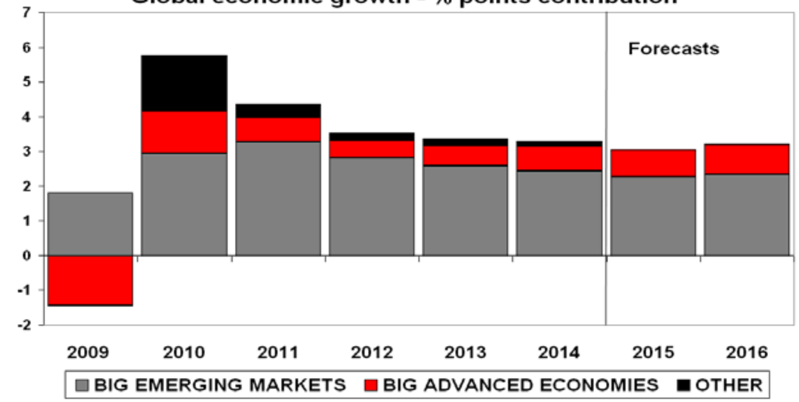
Global growth forecasts % change year on year

	2011	2012	2013	2014	NAB Forecasts 2015	2016	2017
US	1.6	2.2	2.2	2.4	2.4	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	6.9	6.7	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*	*3.0*	*3.2*	*3.3*
memo							
Advanced Economies	1.7	1.2	1.4	1.8	1.8	2.1	2.1
Big Emerging Economies	7.0	5.6	5.5	5.1	4.7	4.9	4.9
Major trading partners	4.6	4.3	4.6	4.5	4.4	4.5	4.4

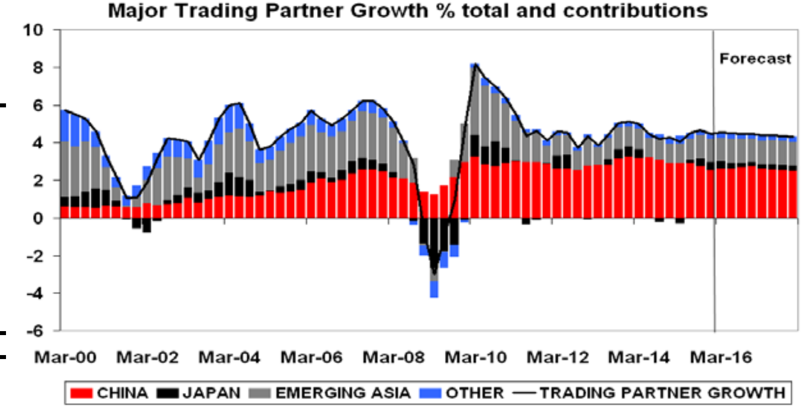
Business surveys in US, UK, Germany and France



Global economic growth - % points contribution



Major Trading Partner Growth % total and contributions



Australian outlook

- **The forces shaping the outlook are broadly unchanged, although incoming data suggests a greater degree of resilience across the non-mining economy.** These include high reported business conditions (+9 compared with a long-run average of +4 in October) with particular strength in services sectors.
- **Based on incoming information, we have modestly reviewed our GDP forecasts to 2.6% in 2015/16 and 3.0% in 2016/17.** The change to our 2015/16 forecast largely reflects the incorporation of a more volatile quarterly profile – including a relatively strong bounceback in Q3 following a surprisingly weak Q2 due to temporary factors. Our unemployment rate trajectory is largely unchanged.
- **Our forecast continues to envisage weak domestic demand, and a large contribution from net exports** – mostly from resource exports as well as tourism and other services exports in response to the weak AUD. Domestic demand remains subdued - the mining investment adjustment is about half way through, government spending is limited and consumer spending is expected to grow at slightly below average rates.
- **The forecasts contain somewhat weaker dwelling investment, although this is offset by slightly higher (though still weak) non-mining business investment.** Our house price forecasts have been reviewed, with a small national increase of 2% expected for 2016.
- **El Niño is an emerging risk to the economic outlook.** The relatively late onset (outside Victoria) of the rainfall deficiency associated with this year's El Niño however has spared winter crops from a serious calamity, although conditions in Victoria are very challenging. The beef industry is already experiencing a production slowdown. This will place some pressure on farm GDP irrespective of climatic conditions over summer. Many previous El Niño events have been associated with lower farm GDP. Real farm GDP declined between 0.7% and 25.4% during the last five El Niños. **We forecast farm GDP (2% of the total economy) to be flat to moderately lower (0 to -5%) in 2015-16, which will only marginally subtract from headline GDP.**
- **We continue to expect the RBA to remain on hold for a considerable period.** Risks to the outlook are largely stemming from offshore, including slower growth in East Asia (especially in China) and ongoing financial market volatility. Our AUD forecasts are unchanged (see below).

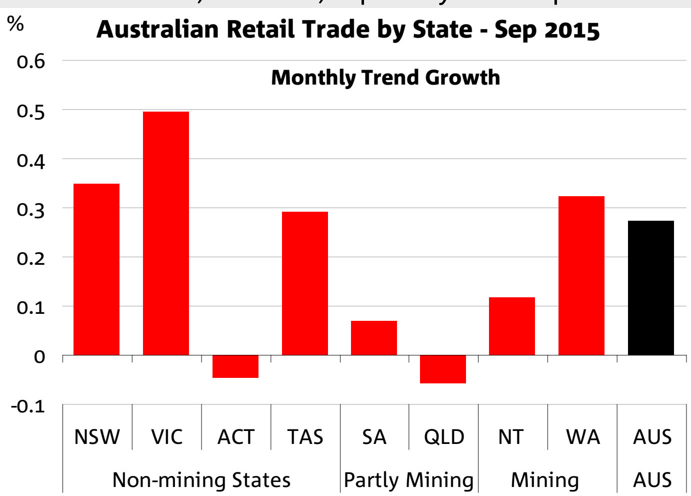
Australian economic and financial forecasts (a)

	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	2.5	2.5	2.4	2.6
Dwelling Investment	8.3	11.0	2.3	10.9	7.0	-1.2
Underlying Business Fixed Investment	-7.1	-7.9	-4.6	-8.1	-6.6	-1.9
Underlying Public Final Demand	0.4	2.3	2.3	1.9	1.9	2.5
Domestic Demand	**0.9**	**1.6**	**1.6**	**1.4**	**1.5**	**1.8**
Stocks (b)	0.2	-0.2	0.1	0.0	0.1	0.0
GNE	**1.1**	**1.5**	**1.7**	**1.3**	**1.6**	**1.8**
Exports	6.6	7.9	8.9	6.5	8.6	9.5
Imports	-0.4	2.1	3.3	1.7	2.5	3.8
GDP	**2.4**	**2.6**	**3.0**	**2.3**	**2.9**	**3.2**
– Non-Farm GDP	2.4	2.7	3.1	2.4	2.9	3.2
– Farm GDP	3.4	-1.0	0.1	2.1	-1.4	1.6
Nominal GDP	1.9	3.4	4.7	2.1	4.3	5.0
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	57	64	55	66	61	47
(-%) of GDP	3.5	3.9	3.2	4.0	3.6	2.7
Employment	1.3	2.3	2.5	1.9	2.4	2.5
Terms of Trade	-10.5	-6.3	-2.2	-9.8	-3.2	-1.4
Average Earnings (Nat. Accts. Basis)	1.2	1.0	2.1	0.4	1.7	2.3
End of Period						
Total CPI	1.5	2.8	2.7	2.2	3.0	2.4
Core CPI	2.3	2.4	2.5	2.3	2.6	2.5
Unemployment Rate	5.9	5.8	5.6	6.0	5.7	5.7
RBA Cash Rate	2.00	2.00	2.50	2.00	2.00	3.00
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	60.6	63.9	60.2	62.1	64.5

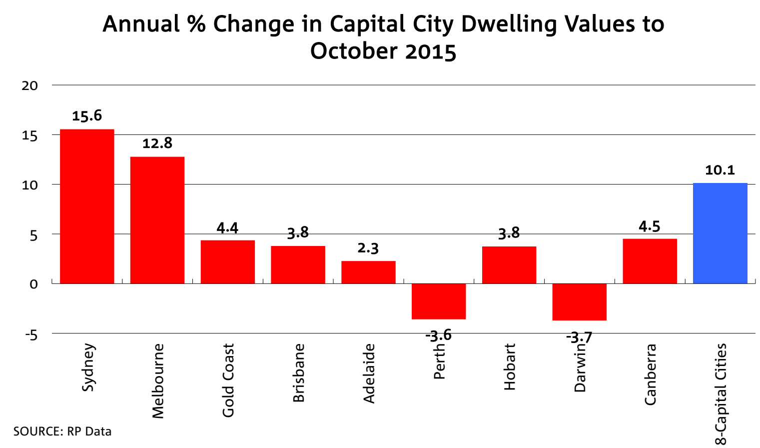
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent
(b) Contribution to GDP growth

Australian consumer demand and housing market

- A general improvement in the trading environment for retailers, including a lower AUD and strength in the housing market in some states, is helping to sustain national retail spending at a resilient level. ABS retail turnover for September showed a similar momentum as in August at 0.4% in the month (to be 3.7% y/y). The main contributors to growth in Q3 were “household goods retailing”, followed by “cafes, restaurants and takeaway food”. “Department stores” was the main detractor. “Household goods retailing” has been a notable outperformer since late 2014, reflecting robust housing activity in NSW and VIC, however this trend is likely to moderate on the back of the expected deceleration in house prices nationally in 2016. By state, retail spending growth (in trend terms) was again driven mostly by the non-mining states (except for WA), with Victoria leading the pack at 0.5%, followed by NSW, TAS and WA (all at 0.3%). Growth was modest in NT and SA (both at 0.1%), neutral in ACT and negative in Queensland (-0.1%). The September NAB Online Retail Index accelerated in September (possibly iPhone 6S related), to be up 1.1%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, retail business conditions as indicated by the NAB Business Survey are above long-run average levels, although retail confidence has moderated in recent months. A lower AUD should also re-direct spending onshore.
- Dwelling price growth appears to be stabilising somewhat, with the pace of growth easing to 10.1% y/y in October (11% y/y in September) – having hovered around this levels for around 6 months. Sydney continues to see the fastest rate of dwelling price growth at 15.6% y/y, although the pace has been steadily easing in recent months (chart RHS). Melbourne is the only other capital city to record double digit growth in dwelling prices at 12.8% y/y – its fastest pace of growth since 2002. Housing credit growth accelerated in September, and while this was mostly driven by owner occupier loans, a reclassification of loans by financial institutions has distorted the numbers. In last months Financial Stability Report, the RBA expressed some concern about risks in the housing and mortgage market (stating they were ‘above average’), but we still see the risk of significant disruption to the market as being relatively remote.
- Nevertheless, dwelling prices can not continue to outpace household income growth indefinitely, and with population growth slowing, scope for further gains is likely to be more limited. Consequently, NAB Economics has reduced its forecasts for house price growth in 2016. Nationally, prices are now forecast to increase 2% in 2016 (revised down from 3% and slowing from almost 10% anticipated over 2015), largely reflecting a slower pace of growth in Sydney and Melbourne. While price growth will slow, a sharp correction in prices is still not expected given supportive market fundamentals (for more details, see link). Risks have increased, however, especially in the apartment market which has seen a sharp increase in construction activity.



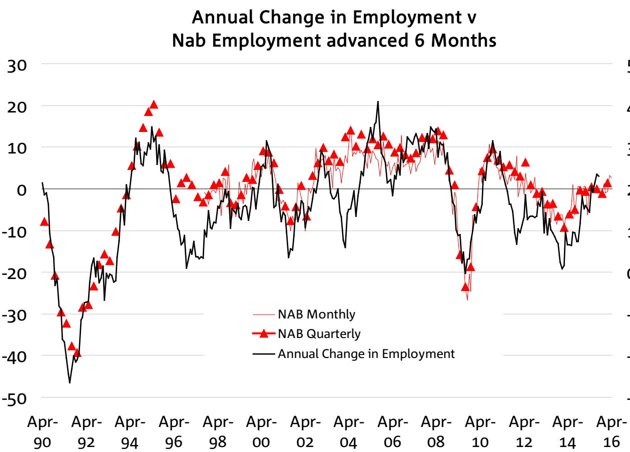
Source: ABS, NAB

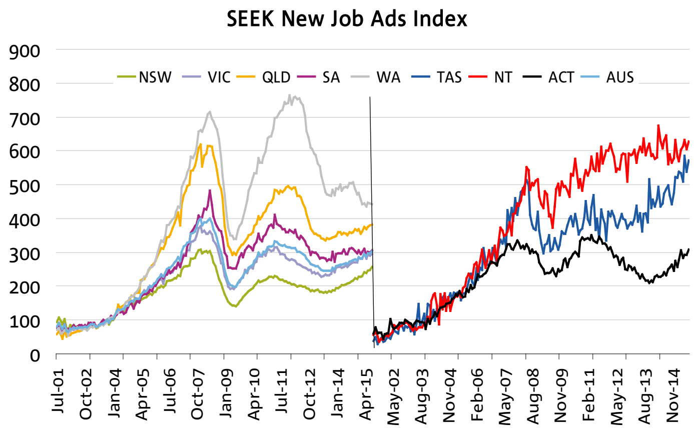


SOURCE: RP Data

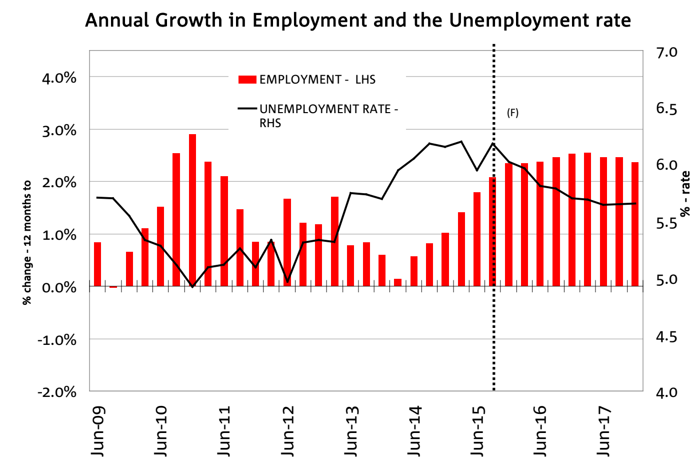
Australian labour market

- The latest September ABS labour force data continued to point to stability in the unemployment rate. In the month, a small net fall in employment (-5,100 seasonally adjusted) was offset by a decrease in participation rate (from 65.0% to 64.9%) to keep unemployment rate unchanged at 6.2%. In trend terms, unemployment is stable in NSW, declining in Queensland and Tasmania, rising marginally in Victoria, and more clearly increasing in Western Australia, the Northern Territory, the ACT and South Australia (though in trend terms, employment is broadly stable in each of these states except SA (see middle panel).
- While labour demand as indicated by measures of job vacancies have been gaining traction in non-mining states of NSW, Victoria, Tasmania and ACT for a while, the improvement in QLD labour market is a relatively new phenomenon. The latter possibly reflects the pick-up in tourism and education sectors which outweighs job losses in the mining sector. Given that QLD's labour market is around 70% larger than WA, the tentative recovery of QLD, if sustained, may be sufficient to offset the expected further weakening in WA's labour market.
- Apart from job ads, other forward-looking measures of the labour market have become more consistently positive. For example, the NAB Business Survey employment index held up at +3 in October after recording the first positive reading since late 2014 in September, while capacity utilisation has also been rising. Based on our model, the former points to an annual employment growth of around 200k in six months' time (see left-hand panel). That said, there remains a substantial amount of spare capacity in the labour market, as evidenced by the high underutilisation rate (unemployment plus underemployment) which will continue to weigh on wages growth. The slowing in wages growth is in turn being exacerbated by weak inflationary expectations. The September quarter Wage Price Index to be released in mid-November by the ABS is expected to continue to show all industries (combining private and public firms) experiencing wage growth of below 3% over the year to the quarter. 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.
- 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 (see right-hand panel).



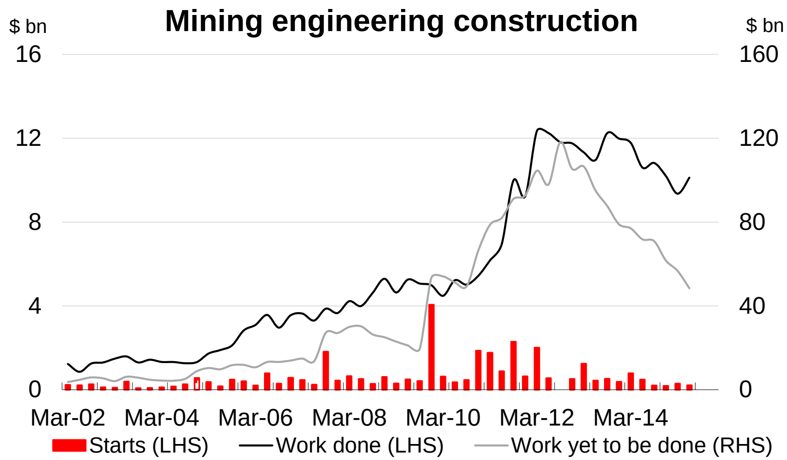


Source: SEEK, NAB Group Economics

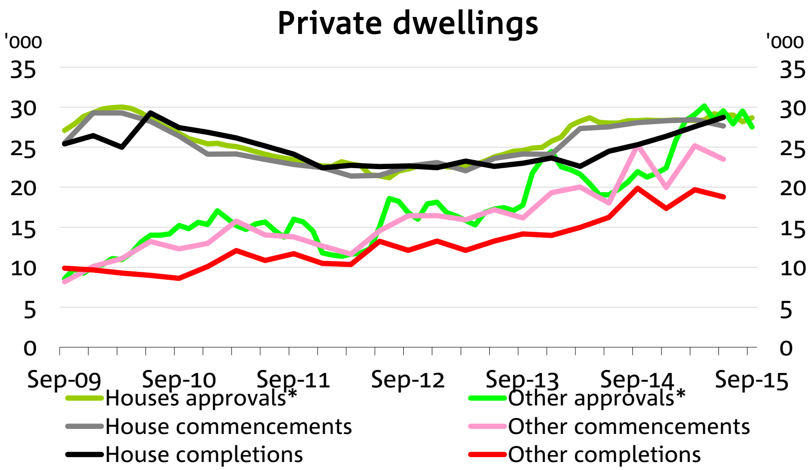


Australian investment

- The NAB Quarterly Business Survey hinted at an improvement in non-mining business investment, although uncertainty around the economic outlook is still keeping many firms on the sidelines. The drag from mining capex, however, is expected to remain significant over the coming 12 months or more – although mining capex tends to be lumpy, meaning some quarters will be more affected than others. But while the mining investment 'cliff' has long been anticipated, domestic conditions have become more favourable for non-mining investment.
- According to the NAB Quarterly Business Survey, capacity utilisation in Q3 was up slightly to 80.9%, which is above long-run average levels (80.6%), while the more timely monthly survey suggested spare capacity was depleted further into Q4. But, while less spare capacity provides an incentive to invest, firms are still requiring high rates of return before committing to new capex (around 14%). Nonetheless, the NAB survey's measure of business capex showed investment activity lifting from the lows of recent years to stabilise at around long-run average levels. Firm's were generally upbeat when asked about their future capex expectations as well, which contrasts with weak expectations in the ABS Capex Survey – although industries accounting for a large share of capital investment (including manufacturing) appear to be lagging in the NAB Survey. Despite better conditions, non-residential building approvals remain somewhat disappointing, suggesting little growth forthcoming in commercial building activity.
- The Annual National Accounts (released in late October) confirmed that mining investment is now in free-fall, with private gross fixed capital formation declining more than 17% in 2014/15. Interestingly, despite this decline, mining engineering construction (heavy industry: oil, gas, coal and other minerals) actually lifted in Q2 and has held up at relatively elevated levels (Chart). Despite this, new starts have remained weak given lower commodity prices, while the pipeline of construction has fallen more than two-thirds – mining investment will drop considerably once the pipeline is fully depleted.
- The pipeline for new dwelling investment remains large, seemingly due to long lead times for apartment construction, which means residential construction activity should make a positive contribution to the economy for now. However, the contribution is likely to diminish through 2016 and 2017, with buyer enthusiasm now showing signs of tiring and potential new supply starting to pull back – residential building approvals have steadily slowed in recent months. Also, residential "alterations and additions" approvals while up a little in September are well off their highs. Considering the current pipeline in light of the recent flow of new projects, we have revised down our expectations for dwelling investment in 2016 and 2017.
- Overall, we are forecasting business investment to decline by around 7% in 2015/16 and 8% 2016/17 (revised slightly). Dwelling investment is providing some offset (although it only accounts for around 5 of GDP% vs 12% for business investment), but growth will be softer than previously expected.



Sources: ABS, NAB estimates

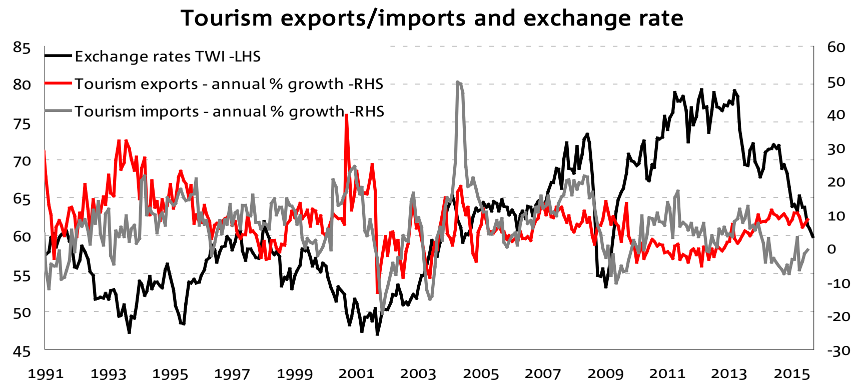


**Rolling 3-month sum lagged 1 month*

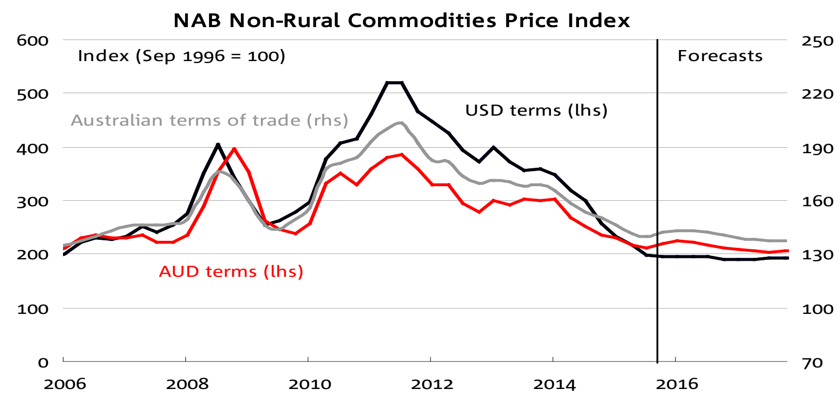
Source: ABS

Australian commodities, net exports and terms of trade

- We expect strong growth in export volumes to outweigh imports growth, with net exports continuing to contribute positively to GDP growth, adding 1 and 1½ ppt to GDP growth in 2015-16 and 2016-17 respectively. With a better-than-expected September trade figure, net exports is now expected to add 1 ppt to the September GDP growth, up from our previous forecast of 0.6% contribution.
- LNG exports will be the primary driver of export growth going forward although will not replace iron ore as Australia's largest export item – we estimate LNG exports to add $12-13bn to Australian exports per quarter by end 2017. Supply will be strong, but prices have fallen significantly since mid 2014 on the back of lower oil prices, to which LNG contracts are tied. Overall, global demand for bulk commodities are being negatively impacted by the noticeable slowdown in the Chinese real estate, manufacturing and heavy industries. While there is some downside risk to production and export volumes, most of the weakness is likely come through the price channel, with supply expected to continue to ramp up.
- The NAB non-rural commodity index denominated in USD is expected to fall 24% during 2015 and another 2.5% during 2016. Global economic uncertainty and major suppliers' unwillingness to cut production present further downside risks for prices in 2016. The index in AUD terms is forecast to fall by a lesser 7% during 2015 and 2.5% during 2016. 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. Implicit in these forecasts are iron ore prices weakening further, trending down from around US$46 a tonne in late 2015 to US$44 by the end of 2016. Oil prices are now forecast at $US49 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.
- Although the slowdown in China's industrial sector is proving challenging for commodity exports, the relaxation of its one-child policy might prove favourable for Australia's food products and services exports in the long run. Tourism exports are improving in net terms, in line with the weaker AUD and we expect this process to continue going forward. Imports growth will also remain subdued, as large capital imports trails off as the construction of large mining project finishes, while the lower AUD is redirecting consumer spending onshore.
- Agricultural markets continue to react to the unfolding El Niño event. Cattle prices tumbled in response to dry weather but have since partially recovered. Wheat price was up in October although abundant global supply has limited any significant upside. Dairy prices are mixed after rallying in response to El Niño related supply risks in New Zealand. Overall, the NAB Rural Commodities Index was stable in October - off 0.7% in AUD terms but up 0.9% in USD terms. Agricultural exports are likely to drag somewhat as the beef industry experiences a production slowdown following a prolonged period of elevated slaughter. Beef export volumes have fallen after peaking in July. Wheat exports are likely to be steady to slightly lower, while we expect dairy export volumes to remain flat.



Sources: RBA, ABS



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

Australian financial markets

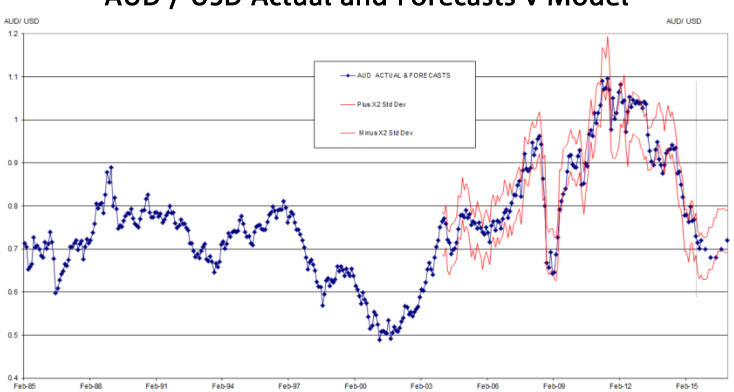
Exchange rate

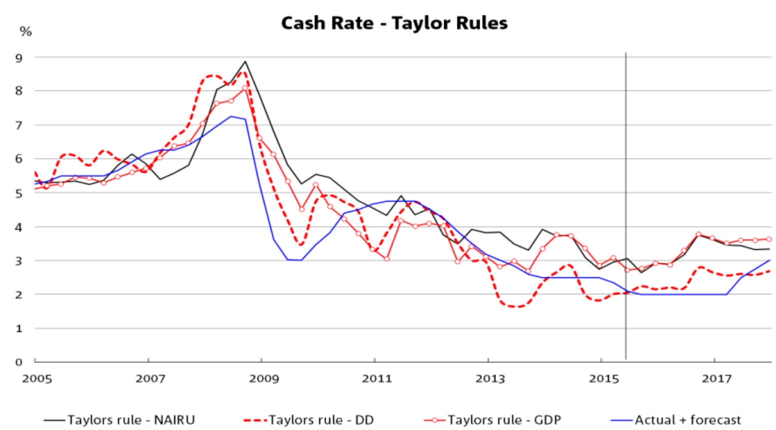
- After hitting a high of USD73.7c earlier in the month, the AUD has since retraced to USD71-72c at the time of writing. This largely reflects a strengthening USD as expectations of a Fed tightening in December have risen in response to Fed signalling. While the AUD did bounce temporarily last week following the RBA meeting, USD strength has since reasserted itself, weighing on the AUD. The pushing out our RBA tightening forecast into 2017 has no immediate implications for our AUD forecasts. We acknowledge that RBA inaction through 2016 is likely to delay any meaningful recovery in the currency until at least 2017 and may well mean more time spent below 70 cents than above in 2016 in the context of modest US dollar appreciation that NAB's FX Strategy team continues to expect. Yet our current forecasts for AUD at 0.70 at end-2016 and 0.73 by mid-2017 lie well within the 65-75 cent range that we contend should capture most if not all of the volatility in the AUD/USD rate in the next 18-24 months.

Interest rates

- While risks to the economic outlook are pronounced, the RBA appears more hopeful that the re-balancing in economic activity towards non-mining sources of growth is transpiring. The cash rate was maintained at 2.0% at its November meeting, despite some tightening of financial conditions in response to regulatory changes, although as Governor Stevens has noted, this followed broader (out of cycle) loosening by banks earlier in the year.
- The RBA is expected to keep the cash rate on hold for an extended period, although we have pushed out the timing of the first hike until mid-2017. The RBA's subdued inflation forecasts imply there is scope for further easing over the coming year. However that would require a more substantive global event, evidence that local demand conditions are deteriorating again (not our or the RBA's central case scenario), and/or more concrete evidence that housing demand is easing. The RBA is keeping a close eye on developments offshore, and has downgraded its trading partner growth assumptions. At this stage however, the RBA appears somewhat comforted by growth in China's services sector and the possibility that low cost commodity producers may cut production, which actually suggests upside risk to Australia's terms of trade.
- The lower than expected September CPI figures have left inflation at the lower end of the RBA's target band. NAB forecasts underlying inflation to be 2.4% by June 2016 while headline inflation to be a higher 2.8%, due to strong fuel prices growth in the near term and the tobacco exercise adding to headline but not underlying inflation. Overall, weak wages growth will keep non-tradables and overall inflation subdued as the economy adjusts to absorb spare capacity. The exchange rate pass-through suggested in the NAB business survey has not shown through yet (tradables inflation retraced in Q3 (-0.3% q/q), thanks to a decline in clothing and footwear prices of 1.1% q/q, but cost pressures may rise again as further weakness in the AUD is anticipated. Housing inflation has shown signs of subsiding, with rental growth to remain subdued and new dwelling costs inflation easing recently.

AUD / USD Actual and Forecasts v Model





Group Economics
Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities
Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Australia
+(61 3) 8634 0198

Amy Li
Economist – Australia
+(61 3) 8634 1563

Phin Ziebell
Economist – Agribusiness
+(61 4) 75 940 662

Industry Analysis
Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Karla Bulauan
Economist – Industry Analysis
+(61 3) 86414028

International Economics
Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research
Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia
Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 38641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand
Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Raiko Shareef
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

Asia
Christy Tan
Head of Markets Strategy/Research, Asia,
+ 852 2822 5350

UK/Europe
Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532