# 10 themes for 2016
by NAB Group Economics

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National Australia Bank

As we enter 2016, NAB Economics' core view is for lacklustre global growth at around 3¼%, despite some of the risks hanging over global markets abating. In Australia, a gradual recovery is anticipated with real GDP growth increasing modestly to 2¾% as momentum in non-mining activity gathers traction. This is despite the stronger headwinds to national income stemming from lower commodity prices, and a less beneficial mix of global growth for Australia as China and other key markets in Asia slow. For the forecast detail, please see our latest Global & Australian Forecasts.

As always, risks abound and our forecasts depend critically on the assumptions underpinning them. In this article, we identify 10 global and domestic themes which will have bearing on the economic and financial market outlook:

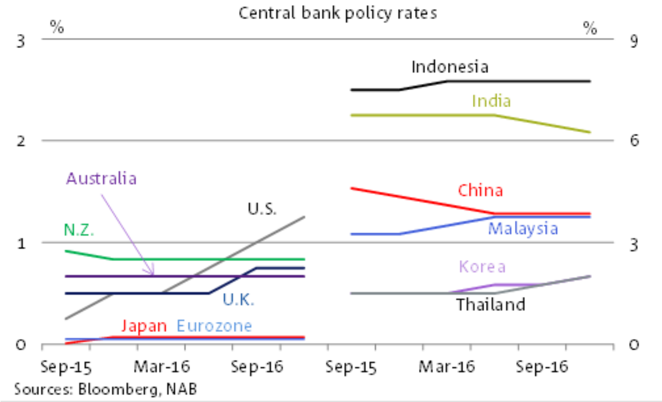
1. **Global monetary policy divergence –** Higher US rates, while balance sheet expansion by the ECB and BoJ continues. The RBA will sit on its hands.
2. **A turning point for global inflation?** Will 2016 be the year that deflationary pressures ease? Much will depend on commodity prices as well as the degree of spare capacity, wages and aggregate demand across the global economy.
3. **Global trade slowdown: cyclical or structural?** Either way, global trade volumes and prices are likely to remain low as a share of global growth.
4. **Services activity holding the baton – a global and Australian story.** Growth (including in the US, China and Australia) will be increasingly driven by services activity. Services industries are typically more labour intensive (which is good for employment), but less capital intensive and have lower productivity.
5. **Risk of China hard landing.** While we anticipate a "soft-landing", downside risks persist into 2016.
6. **Commodity prices – how low can they go?** Risks appear tilted to the downside amidst stubborn oversupply and weak demand.
7. **AUD – overvaluation returns.** In periods in which commodity price movements and the AUD have diverged, history suggests the AUD is the one to adjust. Expect further downward pressure into 2016.
8. **Non-mining investment – the missing ingredient?** While business confidence is patchy and the outlook is lacklustre, the official capex survey may be presenting an overly pessimistic picture.
9. **Fading impetus from property?** The long lead time between approvals and construction will still see dwelling investment contribute (somewhat) to growth. While property prices will not provide the same support to household spending, strong employment outcomes will provide some offset.
10. **Changing the growth narrative: tax reform and the "innovation nation".** Australia's next phase of growth will be defined by our ability to foster a culture of innovation and reform (with much of the focus in 2016 to be on taxation). This will be a key determinant of business confidence and important in generating the productivity growth necessary to offset the impact of weaker population growth and an ageing population profile.

## 1. Global monetary policy divergence

Monetary policy divergence across economies will continue through 2016. The U.S. lifted rates in December 2015 and further gradual tightening is expected through 2016 (with the Fed indicating 100bp of hikes). In contrast, the Eurozone eased monetary policy in December 2015 and speculation continues that Japan will expand its QE programme. Closer to home, further easing is anticipated in China and India. The RBA meanwhile will remain on hold through 2016 absent a global shock or a surprise derailment of the gradual non-mining recovery.

The Fed lifting interest rates doesn't always prompt higher long term bond yields – for example, during the 2004-2005 Fed tightening bond yields actually fell. Forces won't be all

**Chart 1: Policy rates on different paths**



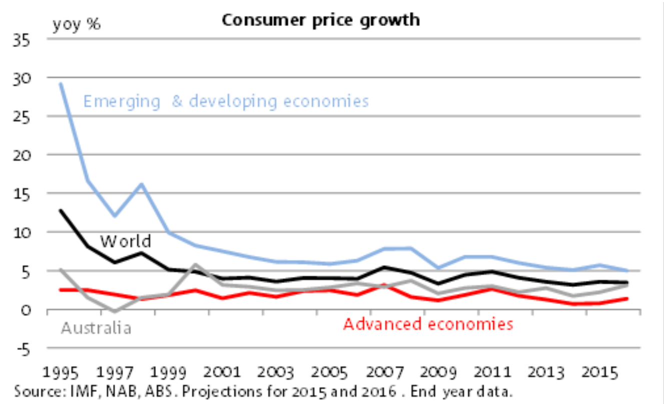
one way through 2016 either - QE in the Eurozone and Japan and quiescent inflation pressures will likely be factors pushing down on global yields. Even so, if the US Fed eventually deliver on their 2016 and 2017 "dots" (board member projections) then US bond yields should grind higher as tightening progresses. We favour US 10 year bond yields making a multi-year high around mid-next year at 2.75%-3%. With the RBA on hold alongside record bond issuance in 2015/16 by AOFM, Australian Government bond yields should follow US yields higher.

Monetary policy divergence should sustain relative USD strength vis-à-vis the euro and the yen through 2016. Increasing U.S. rates will also have implications for emerging markets holding a high level of USD denominated debt. For much of Asia, healthy current account balances and strong FX reserves positions should enable the impact of outflows to be contained. In a worst case scenario however, there may be pressure on emerging economies to increase rates to head off concerns of capital outflows or currency depreciations. The Bank of England is likely to significantly lag the Fed, and together with 'Brexit' risk related to the promised EU referendum, Sterling is likely to be among the weakest major currencies in 2016.

## 2. A turning point for global inflation?

Will 2016 be the year that deflation concerns ease? These concerns have been most pronounced in advanced economies, where inflation in 2014 and, according to IMF projections, 2015 was at a 20 year (or more) low. It is also low in Australia, even for tradable goods and services despite more than 20% depreciation of the AUD in trade-weighted terms since February 2012. Some of the disinflationary pressure has stemmed from lower oil prices which are likely to be stimulatory to activity in the medium term. Going forward, much will depend on commodity prices as well as the degree of spare capacity and aggregate demand across the global economy. We expect commodity prices to stabilise at low levels which should produce higher inflation as fuel price falls in particular drop out of the calculations, and associated input costs stop declining. Any increase in global inflation will be moderate however. The global economy is lacklustre, while high unemployment will continue to suppress wages growth. Structural factors – rapid technological change, automation and population ageing - may also act to keep inflation low.

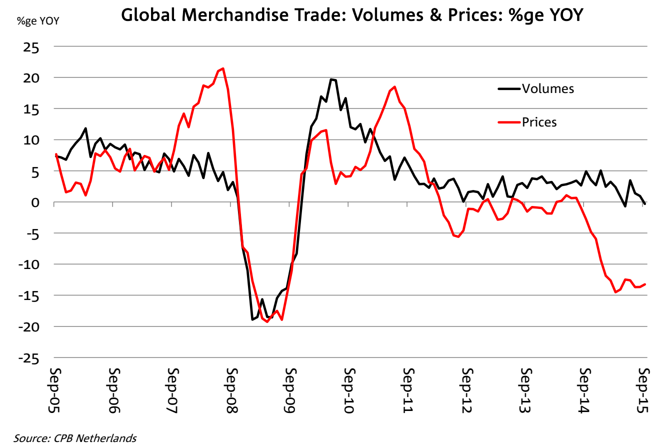
**Chart 2: Consumer price inflation**




## 3. Global trade slowdown: cylical or structural?

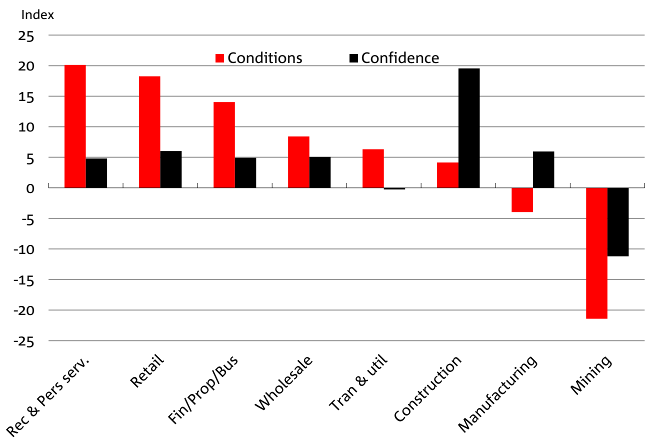
Global trade flows are the weakest since 2009 with no signs of a recovery heading into 2016. The most recent data show trade volumes increasing 0.7% in yoy terms, less than half the 3.7% a year ago, and significantly below the 7% pre-GFC average. Prices have fared far worse: declining 13.2%, reflecting weak commodity prices. The slowdown in trade can be partly explained by cyclical factors including most recently emerging economy weakness and ongoing weak intra-regional trade within the Euro zone. However, structural forces are also at play: as global value chains evolve, there is a move towards greater domestic production, and less cross-border fragmentation. For example, the domestic value added share of China's gross exports has risen from 24.7% in 2008 to 51.2% in 2011, according to WTO data. Greater trade protectionism is not a major driver in our view, with academic literature suggesting this is only a key factor for certain product groups.

**Chart 3: Global merchandise trade volumes and prices**




## 4. Services holding the baton – a global and Australian story

**Chart 4: Services outperform in terms of business conditions and confidence in Australia**



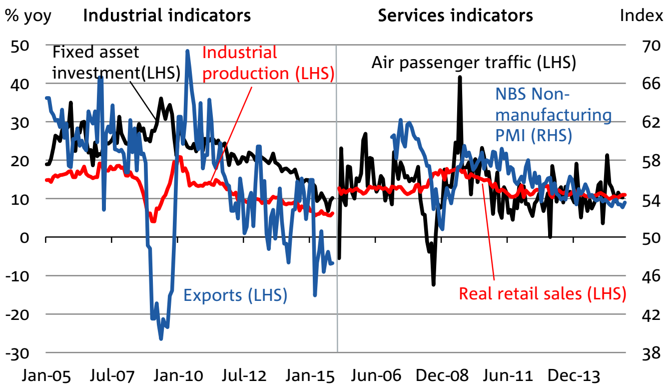

With industrial production and global trade expected to remain weak through 2016, focus will increasingly turn to whether services activity (which represents the bulk of output) holds up. This will be particularly pertinent in China as it attempts to re-balance its economy towards consumer spending, and in the US where a stronger USD will continue to weigh on manufacturing activity. So far, advanced economy business surveys for services are consistent with solid growth, including in many Asian emerging market economies.

Services activity is also driving the non-mining recovery in Australia, with business conditions particularly strong for household services and business services. This tilt towards services activity will continue into 2016, and has implications for productivity, and the relative use of labour/capital as inputs. Services sectors are more labour intensive, which should continue to sustain employment growth through 2016 and see the unemployment rate at 5.8% by end-2016. The flipside to this is that these sectors have historically been less capital intensive (see point 8 below on non-mining investment). Productivity growth has also tended to be weaker in services industries, which together with slower population growth will weigh on Australia's potential growth rate (currently downgraded by the Federal Treasury to 2¾% from 3¼%).

## 5. China hard landing – risk has diminished, but it is still there

China's economic growth will continue to slow in 2016. While we anticipate a soft landing (growth at 6.7% next year as services activity holds up), fears of a hard landing persist in the market. Concerns stem from a number of sectors. The property sector (an engine for growth in recent years) slumped in 2015 and is unlikely to recover next year. Should construction fall further, it would impact China's embattled steel industry and Australian iron ore exporters. In the finance sector, high levels of debt for Chinese business and elevated risk of corporate bond defaults have raised concerns of a financial crisis. Interest rate cuts are likely in 2016 – reducing pressure on indebted firms – but the impact on savers could prove counter-productive to the transition towards a more consumption driven economy. Capital outflows also pose a threat to growth, however the Yuan's inclusion in the IMF Special Drawing Rights Basket may alter the outflow trend. The Yuan is forecast to soften across 2016 – in part as monetary policy diverges in direction between the US and China.

**Chart 5: Industrial production to remain weak into 2016**



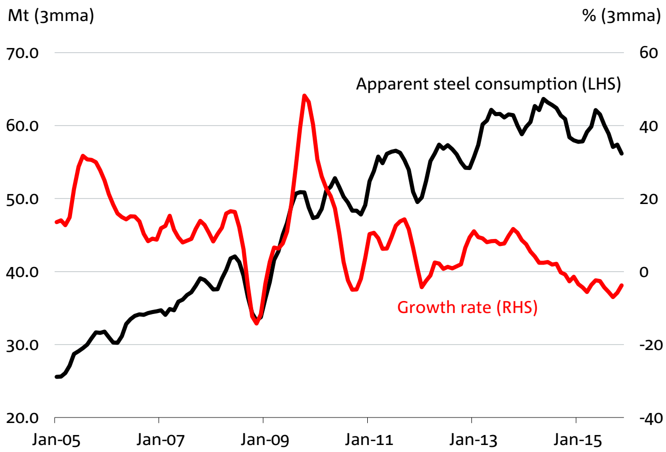

Source: CEIC, NAB Economics

## 6. Commodity prices – how low can they go?

NAB Economics continues to expect commodity prices to drift lower in 2016, driving a 11.4% decline in Australia's terms of trade in annual average terms in 2016. However risks remain tilted to the downside amidst stubborn oversupply and weak demand conditions. For iron ore in particular, a sharper slowdown in global steel output (especially in China, see point 5 above) could potentially drive iron ore prices closer to US$30/tonne – roughly the breakeven prices for major Australian miners - compared with our current forecast average of US$42/tonne. Chinese iron ore production will also remain the swing factor - while production has fallen 8.5% so far in 2015, this remains stronger than previously anticipated despite its lower grade and higher cost of production (above the current spot price).

The global oil glut is also expected to continue into 2017 as market competition becomes more decentralised, with major producers from the US and Middle East continuing to supply at a robust rate in a bid to defend market share and sustain revenue. There now appears significant downside risk to our forecast for oil prices in the high US$40s/bbl to low US$50/bbl in the first half of 2016. Significant upside risks to production from OPEC, accompanied by further expected appreciation in the USD, suggest that oil prices could go as low as in the US$20s in 2016 under a worst case scenario. . That said, prices would not maintain those levels for very long, given that they are significantly below the cost of production for most high-cost producers.

**Chart 6: China steel consumption already declining**




Sources: CEIC, Bloomberg, NAB Economics

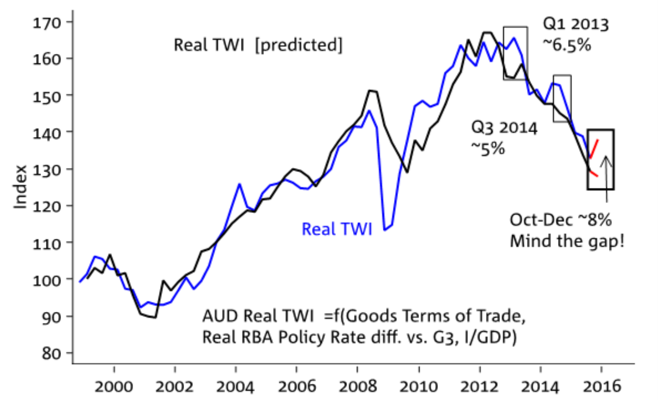
Lower oil prices are a boon to net oil importers, which include most of Australia's major trading partners, through lower input costs in production. They also increase the discretionary income of consumers, including in Australia. That said, the benefits accrued to oil importers and consumers so far have been more muted than previously anticipated, diluted by exchange rate depreciation and partial pass-through to retail energy prices. In the meantime, protracted weak oil prices are delivering a terms of trade shock to net oil exporters, as well as their savings pools.

Australia is a marginal importer of oil, suggesting lower oil prices are for the most part beneficial, lowering local cost pressures and supporting domestic spending. However, lower oil prices can also have negative implications for natural gas prices, which are of increasing significance to the Australian economy given the impending surge in LNG exports. Overall, this suggests downside risk to our terms of trade forecast for Australia's, with further flow on risks to government revenue, corporate profits, mining-related employment and investment and government revenue.

## 7. AUD – overvaluation returns

As of Q3 2015, the Australian dollar looked very slightly overvalued in (real) trade weighted terms, judging from NAB's imitation of the RBA's preferred currency model, incorporating real policy rate differentials, the (goods) terms of trade and business investment. Since then, the AUD has appreciated by over 4%, despite the terms of trade likely falling by over 5%, largely reflecting a re-pricing of expectations for the RBA cash rate, with overly bearish views in the market priced out. Equally as at present, our AUD/USD model (based on commodity prices, relative interest rates and unemployment, together with the VIX) points to a fair value of around AUD/USD67-68c (see our latest forecast document for further details). Both measures imply an 'overvaluation gap' in the order of 7-8%. Since the commodity price cycle peaked in 2011, significant valuation gaps - such as we saw in early 2013 and mid-2014 - have always resolved via a weaker currency. We look for history to repeat itself in 2016.

**Chart 7: Models suggest downward pressure on AUD**



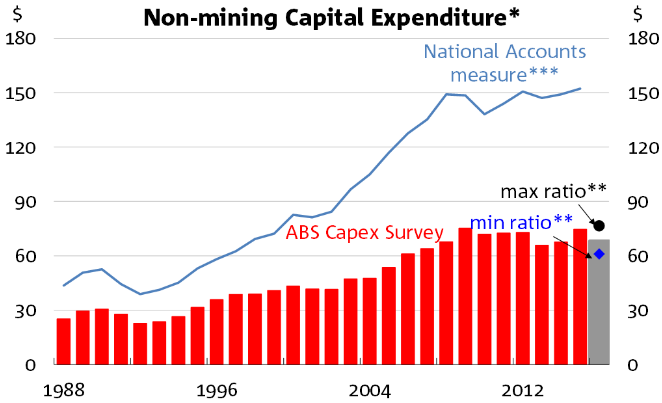

Source: National Australia Bank, Macrobond

## 8. Non-mining investment – the missing ingredient?

Non-mining investment remains the missing ingredient in Australia's economic landscape. Official reports from the ABS show that capex intentions for the non-mining sector remain noticeably weak, suggesting further declines through FY 2015-16. This implies other sectors of the economy are still required to undertake most of the 'heavy lifting'. Despite improvements in business conditions and capacity utilisation rates, its arguable that soft investment intentions are consistent with generally patchy business confidence, as well as the broader shift in growth drivers towards industries traditionally thought to be more labour intensive (and less reliant on capital expenditure for growth).

However, official capex expectations data only covers around 50% of non-mining investment, and actually excludes many of the sectors that are now outperforming – especially health and education. Consequently, the most recent data suggest that real non mining capex is already helping to offset the significant falls in mining. Indeed, the measure of capex intentions for the next 12 months from the NAB Quarterly Business Survey, which has good coverage of the service sectors, suggests non-mining investment over the coming year could potentially pick up more notably than currently factored into our forecasts.

**Chart 8: Non-mining capital expenditure**

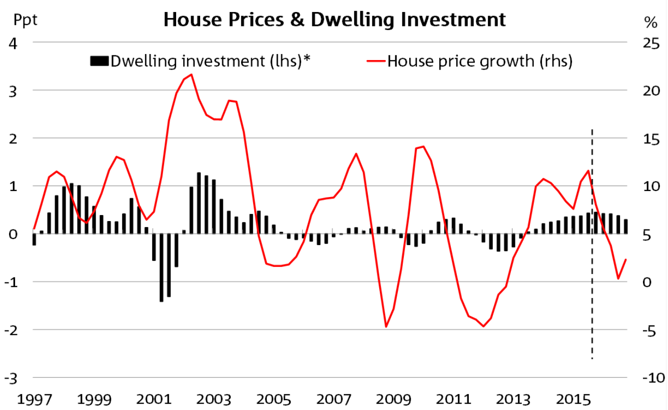



* Grey bars are the latest expectations adjusted by the RBA's preferred realisation ratio measure
** The max and min estimates based on historical max-min realisation ratios
*** Estimated by NAB
Source: NAB, ABS

## 9. Fading impetus from property?

Nab's expectation is for house price growth to be significantly more subdued in 2016 (see note for forecasts). This will have noticeable implications for the economy, both in terms of the direct impact on dwelling construction activity, as well as the wealth effects on household consumption. In respect to construction, the momentum in new approvals appears to have slowed, although they remain at high levels. However, the large pipeline of medium density residential construction projects (with lead times of 18-24 months) suggests the contribution to GDP growth will remain positive (0.3 ppts in 2016, relative to 0.4 ppts in 2015).

**Chart 9: Dwelling construction still adding to growth**




* Contribution to quarterly GDP growth.

Regarding household spending, strong house price growth has been associated with solid demand for household goods. However the wealth effect from property prices to household consumption overall has been more muted amidst high savings rates, and the RBA has recently stated that wealth channels may have become less powerful over time. With house price growth set to ease, the impetus for consumption will similarly start to fall back overall, however, this will likely be replaced by better outcomes for employment (continuing recent trends) and strength in tourism, which will be more supportive of income growth and consumer spending (with some lag).

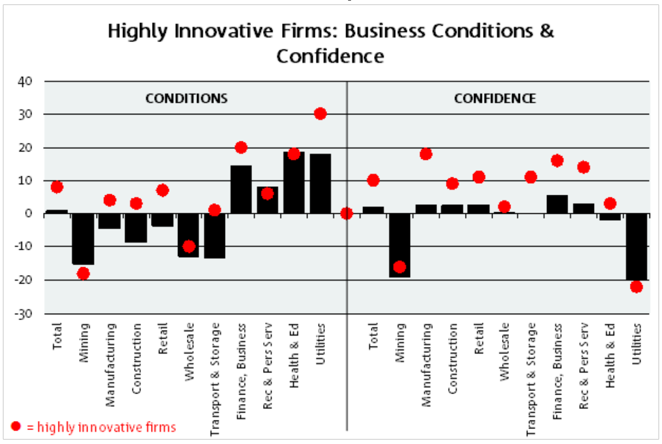
## 10. Changing the growth narrative: tax reform and the innovation nation

Australia's next phase of growth will be defined by our ability to foster a culture of innovation and reform (with much of the focus in 2016 on taxation). This will be a key determinant of business confidence and important in generating the productivity growth necessary to offset the impact of weaker population growth and an ageing population profile.

NAB research, based on a survey of 1,700 businesses, found that while Australian business (particularly big business) does not believe we are a particularly innovative nation, there is no shortage of firms (more than 1 in 4) that identify themselves as "highly innovative". (These same firms also report superior levels of confidence and conditions across a range of industries, see chart 10). This suggests business may be underestimating the true level of innovation, a fact supported by global recognition of Australia as among the best in the world in terms of research breakthroughs. However, we do not have the same track record when it comes to commercialisation of our ideas. Access to capital and skilled people are key impediments. With the Federal Government putting its focus on the need to transition towards a "smart economy", the challenge in 2016 will be for business, Government and research institutions to collaborate to make this a reality.

For Australia's governments, 2016 will provide clear opportunity to reform Australia's tax system, following final recommendations from the "Re-think" taxation review. This will be politically challenging and complex, given the need to achieve multiple objectives. These include: the need to ensure sufficient revenue is generated to address the medium-term fiscal challenge; encouraging productivity and workforce participation; ensuring Australia is an attractive place to invest; reducing regulatory burden on business; increasing the flexibility to address issues associated with multinational trade, global competition and the digital economy, and; maintaining an acceptable degree of fairness. We look forward to this ongoing national debate as the Taxation White Paper is released in February, and hope both sides of politics are courageous and bold in their attempts to take Australia forward.

**Chart 10: Innovative firms outperform**

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