Global & Australian Forecasts

by NAB Group Economics

Embargoed until:
11:30am Tuesday 8 December 2015

December 2015

National Australia Bank

Key Points:

- **Although some of the risks hanging over global markets have abated, recent global economic growth and the outlook remains lacklustre. Global growth remains stuck around the 3¼% 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 the big emerging market economies that have underpinned most global growth.**
- **In Australia, Q3 GDP figures were consistent with our view that the recovery across the non-mining recovery is broadening, and recent business survey results suggest this momentum continued into Q4. Despite this, downgraded commodity price forecasts have prompted a lowering of our real GDP growth forecasts, and another 11½% drop in the terms of trade in 2016 will weigh further on national income. Real GDP is now forecast to pick up more gradually to 2.7% in 2016 and 3.0% in 2017 (previously 2.9% and 3.2% respectively). Our unemployment rate forecasts are only a fraction higher however - as the composition of growth tilts towards more labour-intensive sectors - easing gradually to 5.8% by end-16 and 5.7% by end-17. At this stage, the RBA has indicated that providing "stable" monetary policy and allowing greenshoots to flourish may be more helpful for the economy. An easing bias does remain amidst low inflation, weak commodity prices and concerns about trading partner growth. But at this stage, the central bank is unlikely to ease further absent a global shock, a surprise deterioration in the non-mining economy or a sharp re-appreciation of the AUD.**

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.5	2.4	2.3
Euro-zone	12	0.9	1.4	1.7	1.9
Japan	4	-0.1	0.6	1.1	0.9
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	2.6	2.4	2.7	3.0
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.6	2.5	2.7	2.6
Domestic demand		1.3	0.7	1.0	1.6
GDP		2.5	2.2	2.7	2.8
Core CPI (*% through-year*)		2.7	2.3	2.5	2.6
Unemployment rate (*% end of year*)		6.0	5.9	5.8	5.7

Contents

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

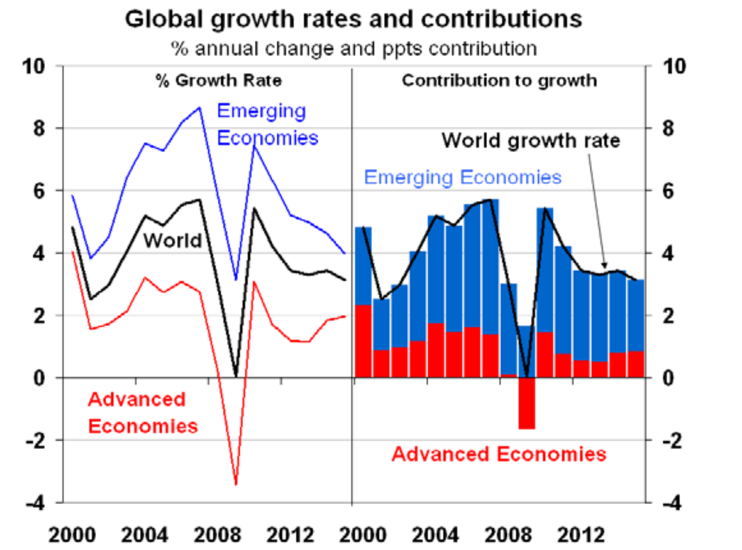
Global and Australian overview

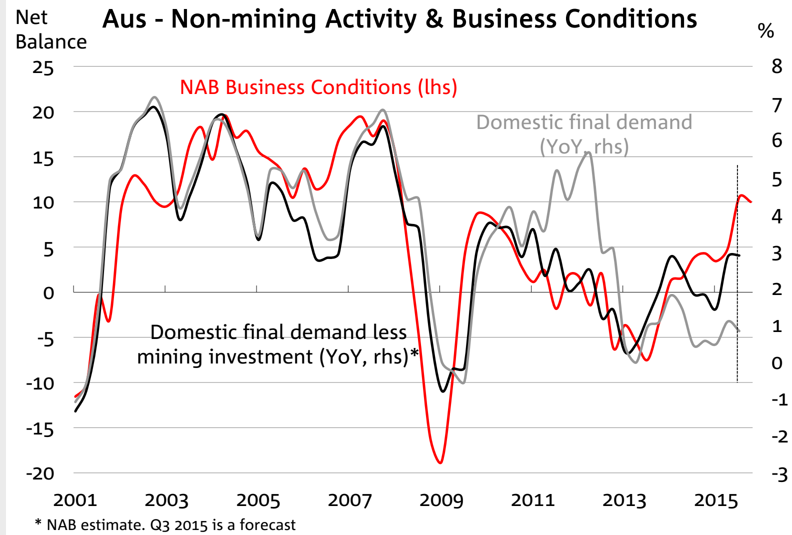
Global overview

- Global growth remains sub-trend and there is little sign of an imminent acceleration in the pace of expansion – which should stay in the 3% to 3½% range next year. The emerging market economies have been the cause of more sluggish growth as these economies generally make by far the biggest contribution to global economic expansion. We have lowered our forecasts for important emerging market economy regions like Latin America and East Asia, reflecting a deep recession in Brazil, falling commodity prices and lacklustre world trade. Some of the big risks hanging over global growth have receded, at least for now, with the impending lift in US rates being the main concern.
- Conditions remain mixed in the big advanced economies with solid upturns in the UK and US alongside continued weakness in the Euro-zone and Japan and this divergence is being reflected in monetary policies as the ECB has recently eased its policy again while the Fed is preparing to lift US interest rates. With little evidence of inflation in these advanced economies, there is no urgency to lift rates in any of them and concern in the UK, Euro-zone and Japan is focussed on below target inflation.

Australian overview

- NAB's GDP forecasts have been revised down moderately to reflect a downward revision to the outlook for some key commodity prices including iron ore, with the terms of trade now anticipated to drop another 11½% in 2016. That said, we continue to anticipate a gradual recovery in economic activity, as the non-mining economy gradually gathers momentum in response to stimulatory financial conditions (low interest rates and further AUD depreciation). Our real GDP forecasts have been revised to 2.7% in 2016 and 3.0% in 2017 (previously 2.9% and 3.2% respectively).
- Real GDP was strong in Q3 at 0.9% q/q, although this followed a weak 0.3% q/q increase in Q2. Looking through the quarterly oscillations, underlying momentum has been broadly unchanged – not a bad achievement given significant structural change as the economy adjusts to a sharply lower terms of trade, national income and mining investment trajectory. The industry detail in particular was consistent with a gradual cyclical recovery across the non-mining economy. Services industries servicing both households and business are faring well, while retail and hospitality are benefiting from a slightly less cautious consumer and net tourism inflows. This tilting composition of growth towards more labour-intensive areas will support the labour market. Our unemployment rate forecasts are only fractionally higher despite the downward revisions to GDP – easing gradually to 5.8% by end-16 and 5.7% by end-17.
- The RBA is expected to remain on hold for an extended period, with the first hike not expected until mid-17. There is some risk that the AUD will bounce near-term, however our medium-term forecast for a drop below USD70c by mid-16 remains.

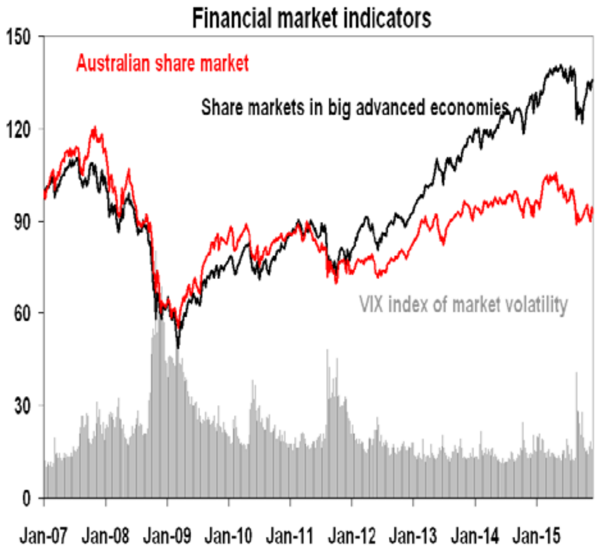


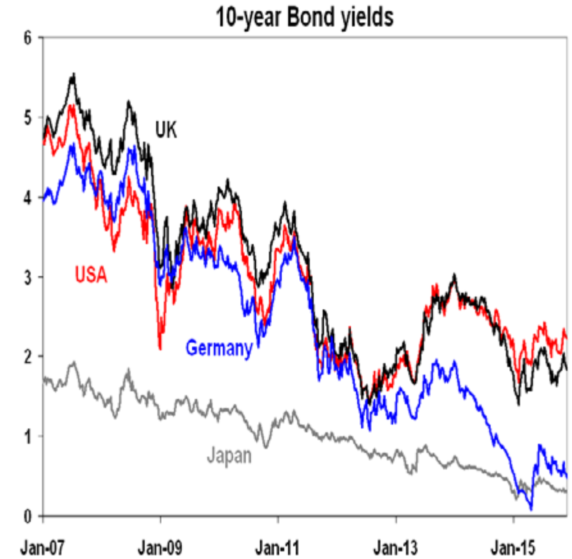


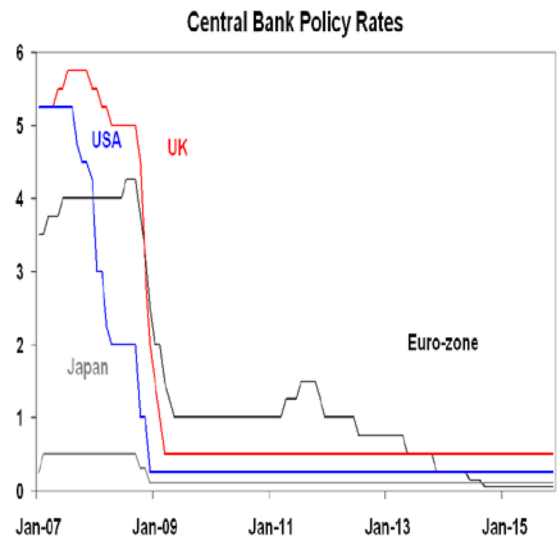
* NAB estimate. Q3 2015 is a forecast

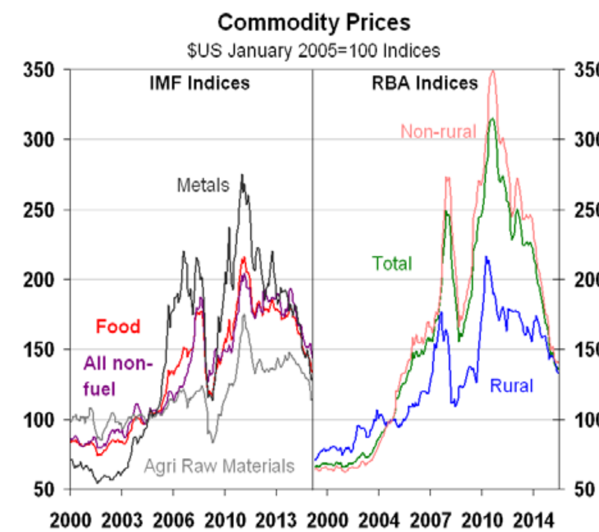
Financial and commodity markets

- The divergence in economic conditions between the big advanced economies is reflected in their monetary policies. Although US inflation has been running well below its 2% target, the Fed is preparing to lift its policy interest rate after keeping them close to their floor for 7 years. This tightening reflects confidence that less drag from energy and import prices plus further improvement in the job market will be enough to get inflation back to 2%.
- Fed leaders are anxious to avoid delaying the inevitable “normalisation” of interest rates too long, raising the risk of a more abrupt and disruptive series of rate rises later on. Their preference seems to be to start lifting rates this month, followed by a gradual tightening through next year (we expect three more 25 bps hikes). The Fed is signalling its cautious approach by saying that they may keep rates below “normal” levels for some time, even after inflation and the job market are back at satisfactory levels.
- Euro-zone inflation is also below target and the European Central Bank (ECB) has announced another round of policy easing (lowering the rate it pays commercial banks depositing funds to -0.30%, extending the range of assets bought and timing of asset purchase programme, continuing its generous provision of funds to commercial banks needing liquidity and reinvesting the proceeds of assets that mature back into more purchases). The ECB has again cut its inflation projections and sees inflation not back around target until 2017. The Bank of Japan also faces inflation running well below target but has not announced another round of policy easing as it still seems convinced that it has done enough for now, a view which looks doubtful.



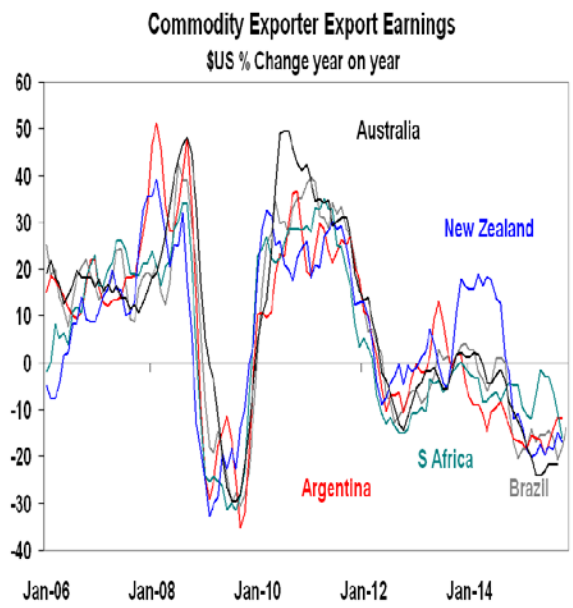






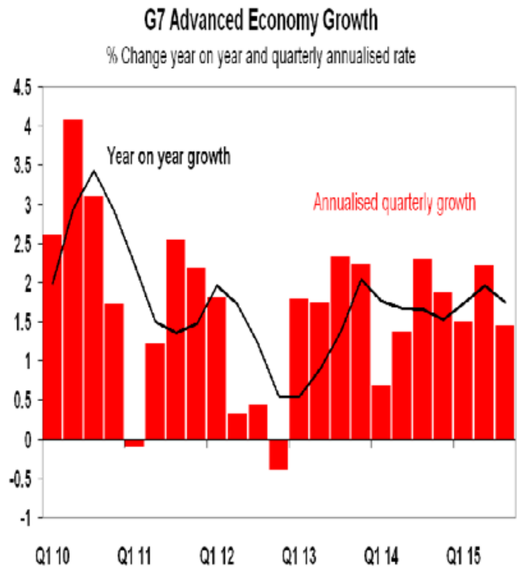
Global Economic Trends

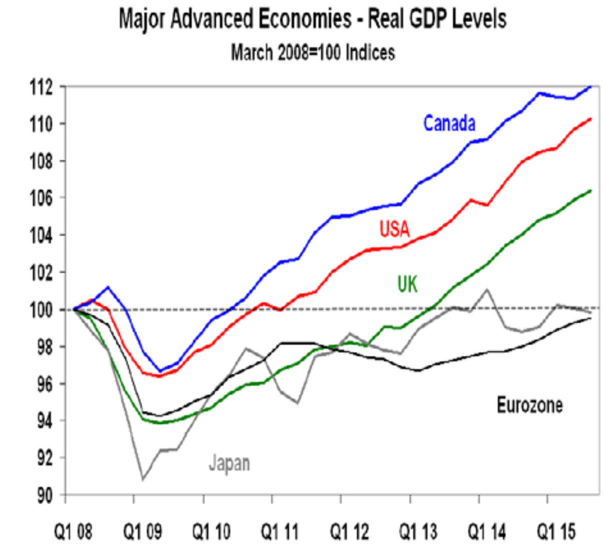
- Growth in global GDP, the broadest measures of output, has disappointed by staying around 3¼% yoy since mid-2014 rather than picking up. The latest data for industrial output still shows only modest growth. Global industrial growth in the 3 months to September was running at an annualised rate of around 2% - well below trend.
- World trade has been surprisingly weak, even taking into account the sluggish nature of growth in global economic activity. Trade volumes fell through the first half of the year and turned up only slightly in the September quarter to result in practically no growth in year on year terms. The weakest outcomes have been recorded in the emerging market economies where export volumes have been flat to down in year on year terms – normally only seen in a global recession.
- This weakness in emerging economy exports is mirrored in their imports while demand for foreign goods has been far better maintained in the advanced economies. East Asian exporters have fared the worst through this soft patch for global trade as they have suffered sizeable falls in their export volumes. Latin American exporters, by contrast, have lifted their trade volumes – reflecting a ramping up of commodity export tonnages at a time of falling prices, similar to what has been seen in Australia. A downturn in intra-Asian regional trade, largely centred on China, has driven weakness across East Asia with falling export volumes across in China and the rest of the region and falling Chinese import volumes.
- While commodity producers have been lifting their export volumes as new capacity comes on stream, weak commodity prices have eroded their earnings with large falls in the $US value of exports across Southern Hemisphere producers.

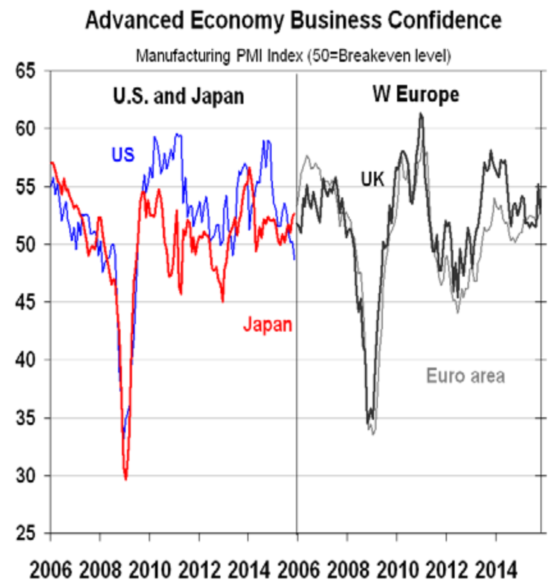


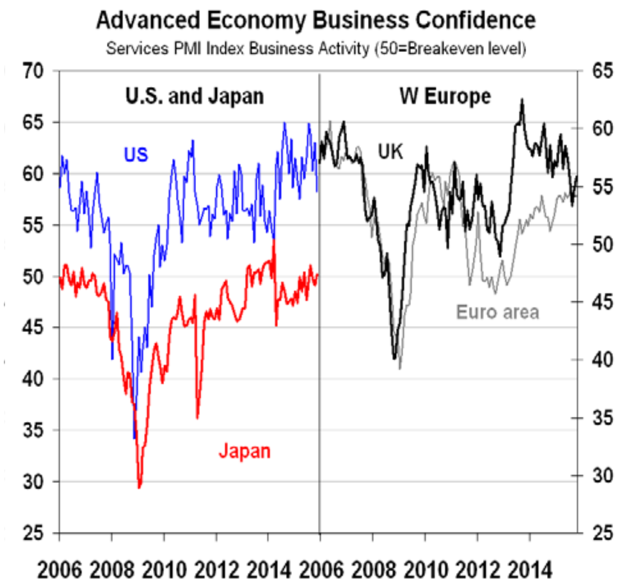
Advanced Economies

- Quarterly growth in the big advanced economies remained volatile but a moderate trend upturn has continued. G7 growth has stayed within a corridor of around 1½% to 2% since late 2014. Quarterly growth slowed in the US and UK but picked up in Canada. Euro-zone growth stayed lacklustre and Japanese output shrank for the second consecutive quarter.
- The marked disparity between the pace of the upturn in North America and the UK, on one hand, and Japan and the Euro-zone, on the other, has continued. By the latter half of 2015 output had risen above its pre-GFC level by 12% in Canada, 10% in the US and just over 6% in the UK while GDP remained below its early 2008 level in both Japan and the Euro-zone, an exceptionally long period without any expansion in production.
- The monthly purchasing manager surveys give the most up to date measure of the pulse of activity across the big 7 advanced economies and it showed modest growth in manufacturing continuing into November. The strength of the US$ is hitting US industry increasingly hard with the surveys showing a clear loss of momentum since late 2014. The business survey readings for November across Western Europe and Japan are consistent with moderate growth in industrial output.
- Business survey results for services have shown faster growth than for manufacturing, especially in the US and UK. Nevertheless, US and UK services growth dipped in November while growth in the Euro-zone and Japan has been picking up. Overall, combining the manufacturing and services surveys shows continued moderate growth in late 2015.



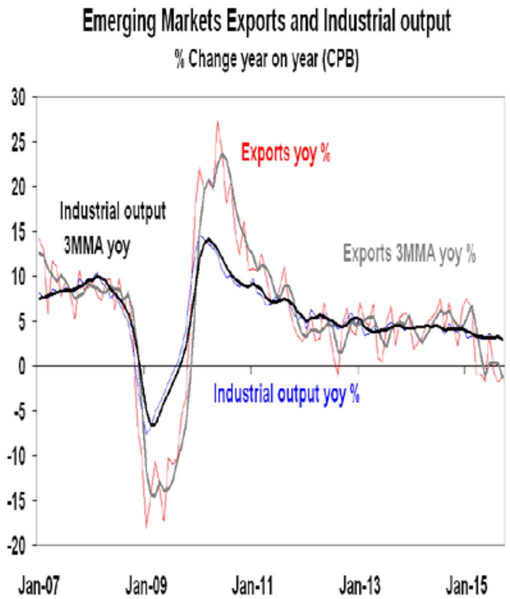


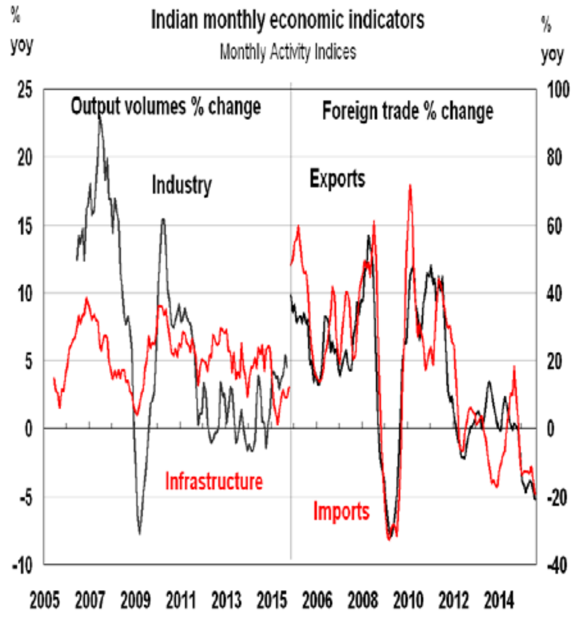




Emerging Market Economies

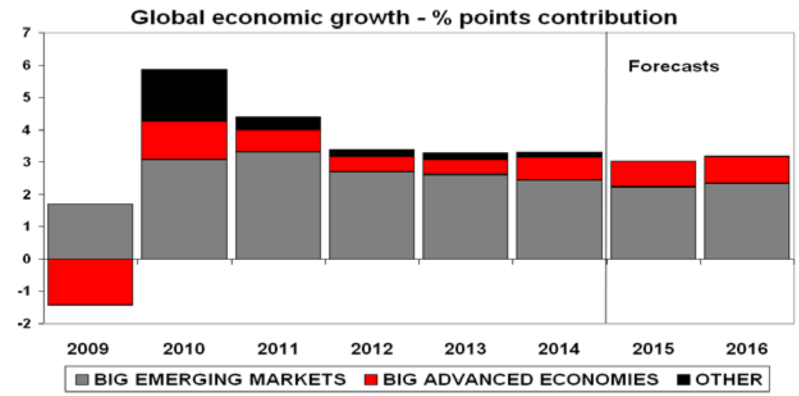
- The slowdown in growth in the main emerging economies has continued into the second half of the year with growth softening to 5.6% yoy in the September quarter, down from 7% yoy in mid-2013 and 6% in late 2014. The monthly data on trade volume and industrial output trends show a few signs of less weakness in output, exports and imports in some regions in the September quarter but it is too early to get overly optimistic.
- The slowdown in emerging market economy growth is broad based with Chinese growth slipping from 7.2% yoy in late 2014 to 6.9% yoy in September 2015 while over the same period other emerging East Asian economies growth slowed from 3.9% yoy to 3.3% and Latin America slipped from growth of 0.6% yoy in late 2014 to a recession of -0.8% in September 2015 – mostly because of a deep recession in Brazil. India is the only big emerging economy to buck the trend with growth picking up from 6.6% yoy in late 2014 to 7.4% yoy in September 2015.
- The monthly partial data on foreign trade, output and domestic spending confirms that the September quarter has seen a continuation of trends evident throughout the year. Industrial output, fixed investment and export deliveries of industrial goods have all continued to either drop or show slowing growth in China while retail trade has held up, in accordance with the government's aim to re-balance the composition of economic growth away from investment and toward consumer spending.
- After disappointing for much of the last few years, output in the Indian industrial and infrastructure sectors seemed to be trending higher since mid-year but the November PMI survey was disappointing and trade flows still look weak. Elsewhere, the trade-driven economies of East Asia and the commodity economies of South America remain weak.





Global forecasts

- While we have slightly lowered our growth forecasts for Japan, Brazil and a few East Asian economies to take account of worse than expected September quarter outcomes, the changes are not big enough to alter either the global forecasts or the main themes. Unlike the IMF, 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 around 15 bps to global expansion between 2014 and 2016.
- 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 Australia and New Zealand than the emerging economy led growth seen previously. This reflects the commodity intensity of demand in big emerging economies, where 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	2015 (NAB Forecasts)	2016 (NAB Forecasts)	2017 (NAB Forecasts)
US	1.6	2.2	1.5	2.4	2.5	2.4	2.3
Euro-zone	1.7	-0.8	-0.2	0.9	1.4	1.7	1.9
Japan	-0.4	1.7	1.6	-0.1	0.6	1.1	0.9
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	7.9	4.9	6.4	7.1	7.5	7.6	7.4
Latin America	4.9	2.5	2.6	0.9	-0.2	1.1	1.6
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*	*3.4*	*3.3*	*3.3*	*3.0*	*3.2*	*3.3*
memo							
Advanced Economies	1.7	1.2	1.2	1.8	1.9	2.0	2.1
Big Emerging Economies	7.0	5.3	5.6	5.1	4.6	4.9	4.9
Major trading partners	4.6	4.3	4.6	4.5	4.4	4.5	4.4

Australian outlook

- The Australian economy continues to grow moderately despite the significant challenges stemming from mining investment boom at a time in which the outlook for commodity prices and associated income growth continues to deteriorate. Economic growth was strong in the September quarter at 0.9% q/q, although this was partly a retracement of one-offs which weighed on growth in the previous quarter (0.3% q/q). Averaging the past two quarters suggests real GDP growth of 0.6% per quarter or 2.4% annualised, below the economy's trend rate.
- However, evidence that the non-mining economy is gradually on the mend continues to mount, with business conditions holding steady at a high level for the fourth consecutive month in November. The industry detail in the Q3 GDP figures also suggests that services sectors are outperforming, including ITC, real estate, finance & insurance, as well as health and public administration. Retail and hospitality are benefiting from a slightly less cautious consumer and growth in tourism.
- Otherwise, the general themes in the GDP figures were in line with the broad trends we have been flagging. That is, the ongoing sharp decline in mining investment is being offset by strength in export volumes. Household consumption growth is running at just below-trend as the savings rate eases further and dwelling construction is contributing moderately to growth in line with the high level of dwelling approvals. Public investment declined in Q3 after spending was brought forward to Q2, and will bounce again as HMAS Adelaide is commissioned in Q4.
- Looking forward, we have revised down our real GDP forecasts in response to downgrades to our commodity price forecasts. This includes iron ore remaining in the low US$40s/tonne region for the next few years, with the terms of trade now expected to drop a further 11½% in 2016 (see page 12 for further details). The broad sprit of the forecasts including a gradual recovery in the non-mining economy, remains unchanged. We now expect real GDP growth of 2.4% in 2015, 2.7% in 2016 and 3.0% in 2017 (previously 2.3%, 2.9% and 3.2% respectively).
- The trajectory for the unemployment rate is only marginally higher at 5.7% for end-16 and 5.7% for end-17, notwithstanding the slower recovery in real GDP. This largely reflects the changing industry composition of growth towards more labour-intensive services industries. Wages growth however will remain suppressed for some time, with spare capacity in the labour market remaining.

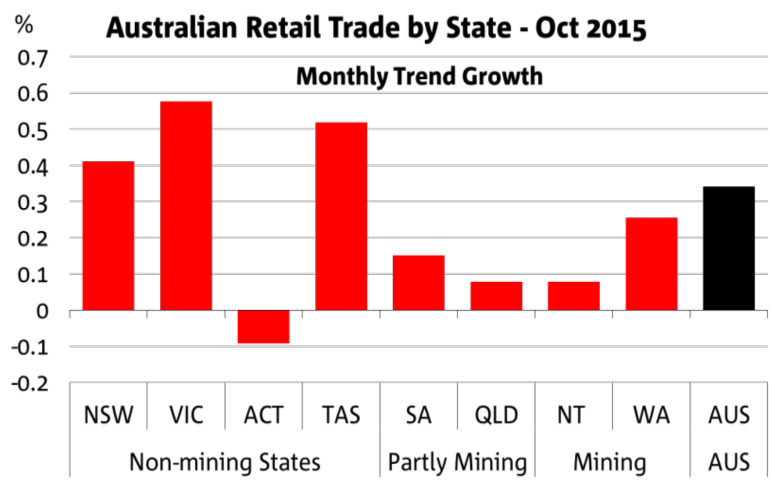
Australian economic and financial forecasts (a)

	Fiscal Year			Calendar Year		
	2014-15 F	2015-16 F	2016-17 F	2015-F	2016-F	2017-F
Private Consumption	2.5	2.7	2.6	2.6	2.8	2.5
Dwelling Investment	7.7	8.1	2.7	9.1	5.6	-0.3
Underlying Business Fixed Investment	-7.1	-11.8	-5.6	-10.4	-8.3	-4.9
Underlying Public Final Demand	-0.4	2.7	2.3	2.0	2.0	2.5
Domestic Demand	**0.7**	**1.0**	**1.6**	**0.9**	**1.4**	**1.5**
Stocks (b)	0.2	-0.2	-0.1	-0.1	-0.1	0.0
GNE	**0.8**	**0.9**	**1.5**	**0.9**	**1.3**	**1.4**
Exports	6.6	7.3	9.0	6.4	8.3	9.6
Imports	0.1	-0.3	2.9	1.0	1.1	2.9
GDP	**2.2**	**2.7**	**2.8**	**2.4**	**2.7**	**3.0**
– Non-Farm GDP	2.2	2.8	2.8	2.4	2.8	3.0
– Farm GDP	-0.5	-3.4	0.1	-0.1	-3.0	1.6
Nominal GDP	1.5	2.1	4.3	1.6	2.7	5.2
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	59	89	90	74	97	82
(-%) of GDP	3.6	5.4	5.3	4.5	5.8	4.7
Employment	1.3	2.2	2.0	1.9	2.1	2.1
Terms of Trade	-10.4	-12.9	-5.1	-11.7	-11.4	-1.3
Average Earnings (Nat. Accts. Basis)	1.4	1.4	2.1	0.8	1.9	2.3
End of Period						
Total CPI	1.5	2.9	2.8	2.2	3.1	2.4
Core CPI	2.3	2.5	2.6	2.3	2.8	2.5
Unemployment Rate	5.9	5.8	5.7	6.0	5.8	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

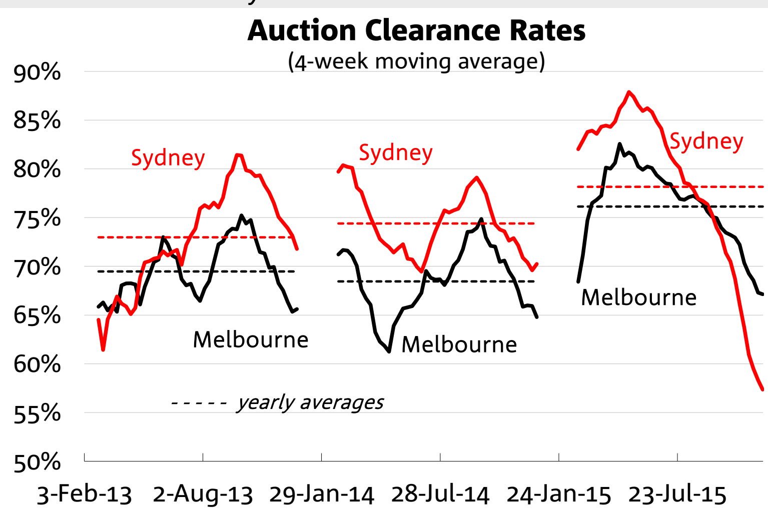
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent
(b) Contribution to GDP growth

Australian consumer demand and housing market

- According to Q3 National Accounts, household consumption growth was a little stronger in the quarter, rising by 0.7% q/q to be 2.7% y/y. Growth in household income was particularly weak, but it appears that strong employment growth encouraged spending, while savings were also run down with a decline in household savings rate (falling from 9.4% to 9.0%) – consistent with improvements in some consumer confidence measures. In the past three years, quarterly growth in household consumption has been significantly weaker than retail turnover due to the slower momentum in certain services captured in consumption but not retail trade, such as utilities, transport as well as insurance and financial services. Meanwhile, a Sydney and Melbourne housing boom-led surge in household goods spending has contributed disproportionately to the growth in retail sales. However, there are signs that the strength in household goods expenditure is losing steam, possibly reflecting the recent cooling of the housing market spearheaded by Sydney.
- That said, the more recent data on retail spending continues to be relatively resilient, underpinned by improving trading conditions while a lower AUD has encouraged tourism spending. ABS retail turnover growth for October (0.5%) was slightly higher than in September (0.4%) to be 3.9% y/y, around the trend seen since late 2014. Meanwhile, NAB's Online Retail Sales Index for October showed a 0.6% m/m contraction in online spending. 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.
- The Melbourne and Sydney housing markets appear to have cooled despite posting double digit rates of growth over the year. Prices fell by 1.4 per cent in Sydney during November, while Melbourne prices were 3.5 per cent lower. Auction clearance rates have fallen, especially in Sydney, where they have dropped to their lowest levels seen in recent years (chart RHS). Other capital cities continue to experience relatively modest dwelling price growth, with Brisbane, Adelaide and Perth prices all rising by less than 1% in the month. Housing credit growth remained at 0.6% in October, and while this was mostly driven by owner occupier loans, a reclassification of loans by financial institutions may still be distorting the numbers.
- A deterioration in affordability measures, in combination with expectations for subdued income and slowing population growth, scope for further gains in house prices is quite limited. Consequently, house price *growth* is expected to be considerably lower in 2016, especially in Sydney – where affordability measures have deteriorated the most. 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 our recent house price update at the following link). Risks have increased, however, especially in the apartment market which has seen a sharp increase in construction activity.



Source: ABS, NAB

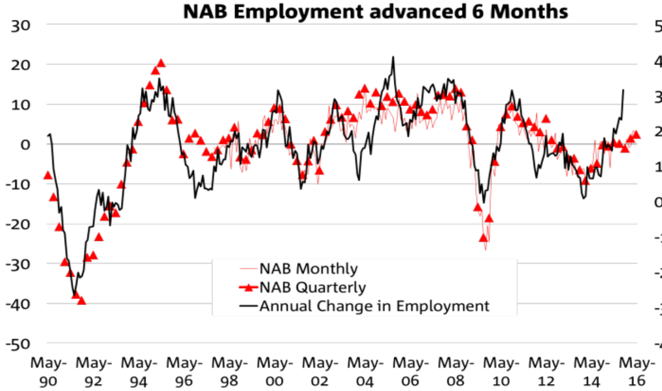


SOURCE: CoreLogic

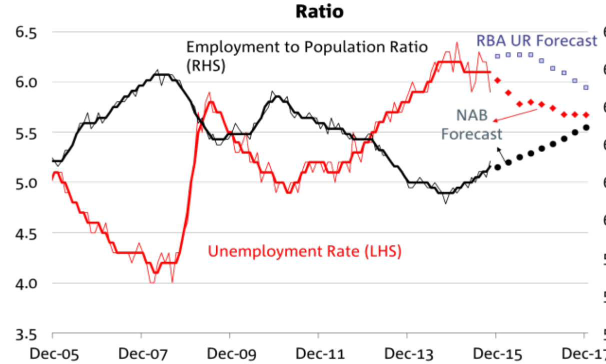
Australian labour market

- The latest October ABS labour force data was an upside surprise with a significantly stronger employment outcome (+58,600) relative to market expectations (+15,000), which resulted in a notable fall in unemployment rate (5.9% compared to 6.2% last month) despite an improvement in the participation rate (from 64.9% to 65.0%). While there is known volatility in the monthly series, suggesting a possible statistical payback next month, the underlying trend in employment growth and unemployment rate is nevertheless a gradually improving one. In trend terms, unemployment is declining in NSW, Victoria, Queensland and Tasmania, stabilising somewhat in SA and NT, and clearly increasing in WA and the ACT. Meanwhile, the rising trends in employment are more broad-based to be evident in all states and territories except for WA and SA. In particular, the strengthening trend in Queensland employment growth is an emerging but important trend for the national data, pointing to the resilience of its more diversified economic base in withstanding the mining investment downturn relative to WA, of which the industry structure is more concentrated in resources.
- The underlying strength in employment data is also supported by a suite of forward-looking measures, such as job ads and indicators the NAB Business Survey. The NAB Business Survey employment index fell slightly in November to +1 from +but remains in positive territory for the third consecutive month. Based on our model, the former points to an annual employment growth of around 190k 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 which will continue to weigh on wages growth. The latest September quarter Wage Price Index continued to demonstrate subdued wages growth to be around historically low levels. The education sector was the only industry to breached the 3% wage growth mark over the year to the quarter, followed closely by the financial and insurance sector (2.7% y/y). 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. However, there are some tentative signs that the slowing in wage growth could be bottoming out on the back of robust employment gains over the past year, with average compensation per employee growing by 1.1% in the September quarter (2.6% y/y), its strongest gain since December 2013.
- Given our expectations that employment growth will continue to be underpinned by a shift towards more labour-intensive sectors, we continue to forecast further improvements in unemployment rate going forward. However, the downward revisions to our GDP forecasts for 2016 and 2017 have prompted us to revise our unemployment rate forecasts a touch lower - easing gradually to 5.8% by end-16 and 5.7% by end-17 (see right-hand panel). Slower population growth (currently 1.4% y/y, down from 1.6% at the start of 2014) also suggests a slightly lower rate of job creation will be necessary to keep up with population growth.

Annual Change in Employment vs NAB Employment advanced 6 Months

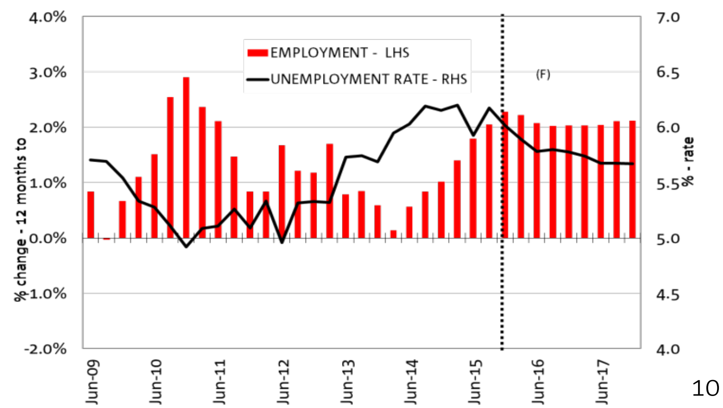


Unemployment Rate and Employment to Population Ratio



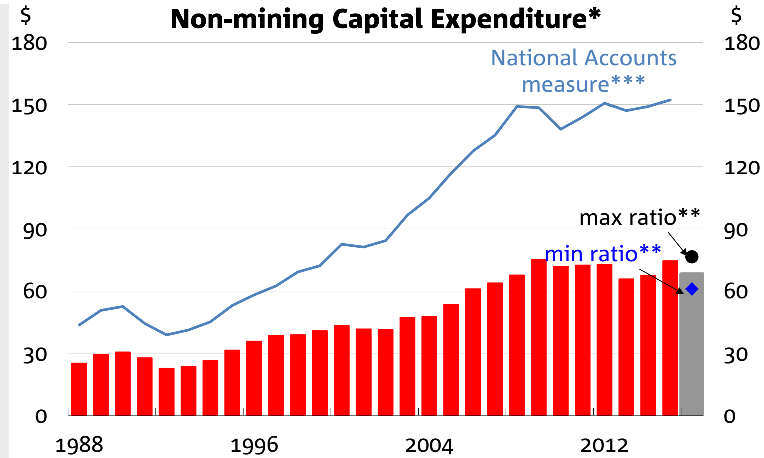
Source: ABS, NAB

Annual Growth in Employment and the Unemployment rate

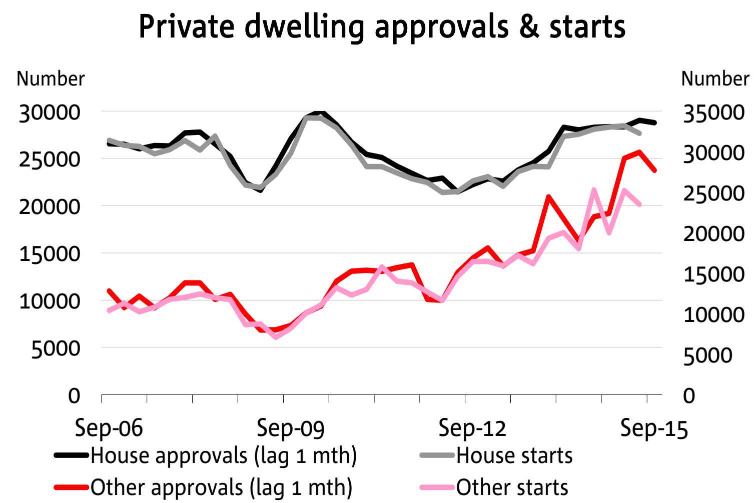


Australian investment

- Mining was again a significant drag on business investment in Q3, while the read on non-mining investment was somewhat mixed. The official capital expenditure survey showed a 10.4% decline in mining investment in Q3, but 'other selected industries' also declined more than 10% q/q – although engineering companies (not classified as mining) that have been impacted by the mining investment downturn may be included in this category. However, underlying business investment in the National Accounts only declined by 4.6%, which could suggest stronger investment in sectors not fully captured in the ABS Capex Survey (Chart, top). Business investment subtracting 0.7 ppts from GDP growth.
- Unsurprisingly, mining firm's expectations for capital spending in 2015/16 remained extremely weak in the Q3 ABS Capex Survey, pointing to a 32% decline (unchanged from expectations last quarter), consistent with the sharply lower estimates for engineering work yet to be done and low levels of business confidence and conditions for the sector in the NAB survey.
- While there remains some hope that non-mining investment will eventually fill some of the gap, subdued labour costs, excess capital capacity generated from the mining boom and the apparent outperformance of less capital intensive industries (in the services sector), could mean non-mining capital expenditure remains subdued for a while yet. Indeed, expectations for non-mining capex in 2015-16 have disappointingly shown little improvement. Depending on the realisation ratio used, the latest official Q2 capex survey suggested a likely fall of around 8½%. This may be painting on overly pessimistic picture – as the CAPEX survey excludes industries which appear to be experiencing faster growth in investment including education, and health, community services industries and agriculture. However, non-residential building approvals are also muted and sentiment eased in the NAB commercial property survey during Q3, particularly in CBD hotels. That said, the gradual trend improvement in capacity utilisation is encouraging. The AUD depreciation should also assist investment in trade exposed industries, particularly in services such as tourism.
- Dwelling investment rose by 0.9% in Q3, which is a relatively soft result given last quarters surprise decline and the very elevated stock of residential projects in the construction pipeline. Residential construction work yet to be done reached a record high in Q2, driven predominately by an extremely elevated pipeline on medium density projects. Given the large share of apartment construction , which tends to be lumpy and have longer lead times, we continue to expect some degree of volatility in the profile. The contribution from dwelling investment is likely to diminish through 2016 and 2017, with buyer enthusiasm waning and potential new supply starting to pull back – residential building approvals have also slowed.
- Overall, business investment is forecast to decline by around 12% in 2015/16 and 6% 2016/17 (revised slightly), with the fall in 2016 now expected to be a little sharper. Positive dwelling investment is providing some offset, but only accounts for around 5 of GDP% vs 12% for business investment).



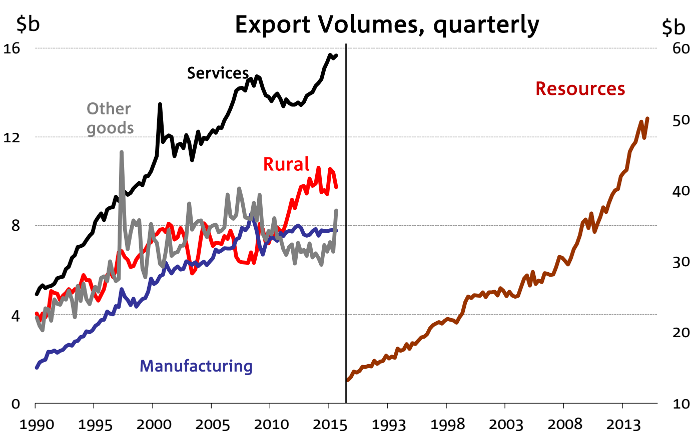
* Grey bars are the latest expectations adjusted by the RBA's preferred realisation ratio measure
** The max and min estimates based on historical max-min realisation ratios
*** Estimated by NAB
Source: NAB, ABS



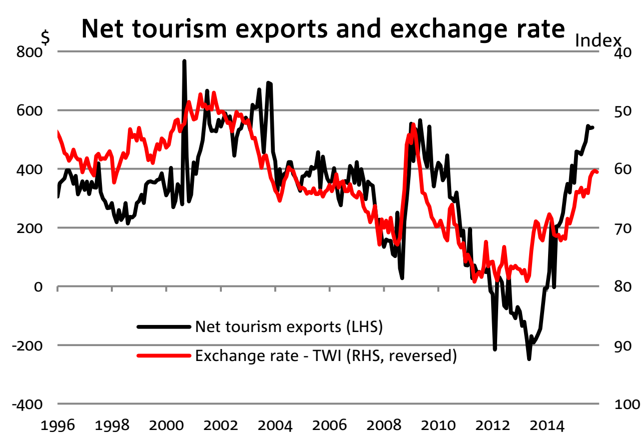
Source: ABS

Australian commodities, net exports and terms of trade

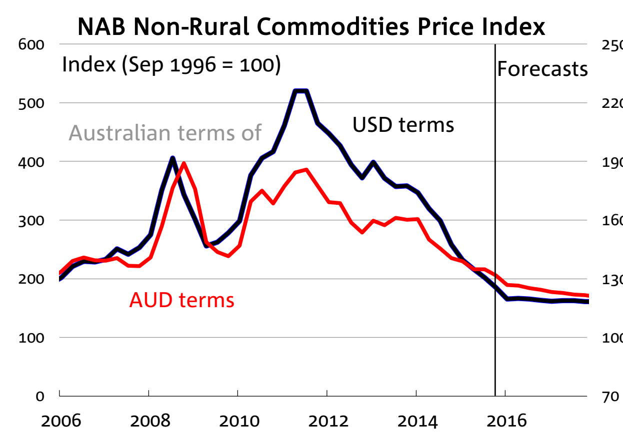
- In the September quarter, net exports added 1.5 ppt to total GDP growth and are expected to continue to contribute positively to economic growth, adding 1.4 and 1.7 ppt to GDP growth in 2016 and 2017 respectively.
- The strong Q3 exports numbers were largely driven by a bounce back in resources exports, which was negatively impacted in Q2 by temporary supply (weather related) disruptions. Going forward, exports growth will depend on the timing of several large LNG project completions. We estimate LNG exports will add $12-13bn to Australian exports per quarter by end 2017. However given the sharp fall in LNG prices recently, there remains the downside risk that producers may cut or delay production, which will negatively impact exports growth given the scale of these projects. Growth in imports remains weak as capital goods imports continue to decline as the mining construction boom ends and as the lower AUD raises import prices. Services imports have been on the decline since mid 2013. The decline in travel services imports is especially pronounced, as tourists are opting for domestic travel amidst a lower AUD.
- We have revised down our export price forecasts, in light of weaker global growth, especially in China. Falling steel output in 2016, allied with limited growth prospects in China's electricity sector, means that bulk commodity prices will continue to drift lower in 2016. Iron ore price forecasts have been revised lower again, to $41/t by December 2017. The NAB non-rural commodity index denominated in USD will continue to fall by another 20% on average in 2016 following a 32% average fall in 2015. The index in AUD terms is forecast to decline by a lesser 14% on average in 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. Overall, these trends suggest the Australian terms of trade will continue to trend lower, although at a slower pace than in recent years.
- Agricultural commodity prices were mixed in November. Cattle prices rebounded 7.2% in November and have returned to record levels. However, both Global Dairy Trade auctions for the month were broadly negative and wheat was off 1.8% in AUD terms. While the longer term global trend has been one of broadly lower agricultural prices since a peak in 2011, the lower AUD has seen the trend in local terms reversed, with prices trending broadly higher since 2012. Our forecasts for the NAB Rural Commodities Index are for prices to stabilise in USD terms before beginning to increase in mid-2016. In AUD terms, the forecasts reflect a falling AUD coming into 2016 and show an increase in prices until the September quarter 2016. Overall, we forecast the NAB Rural Commodities Index to increase 6.7% in AUD terms in calendar year 2016 but to decline 0.7% in USD terms over the same period.



source: ABS, NAB



source: ABS, Thomson Datastream, NAB



source: ABARES, ABS, Bloomberg, Thomson Datastream, NAB

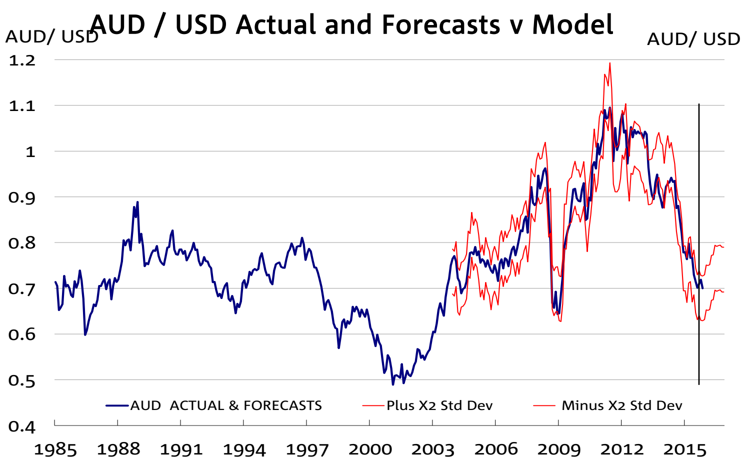
Australian financial markets

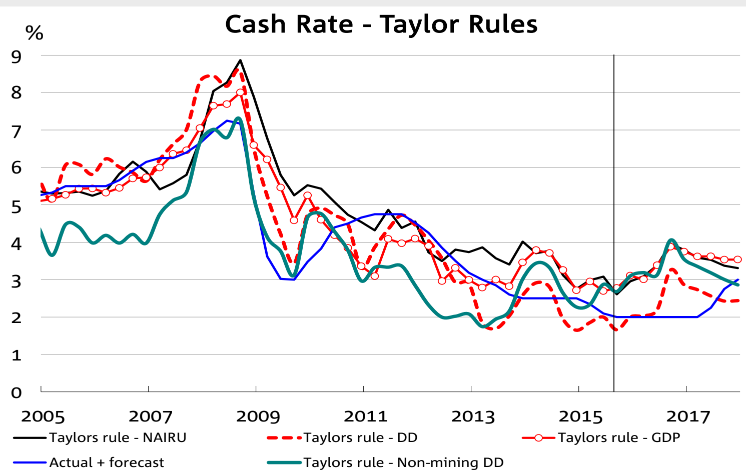
Exchange rate

- The AUD has re-appreciated over the past month to over USD73c in the face of both rising confidence that the Fed will this month announce its first interest rate rise in over nine years (and which has generally been supporting the USD) and fresh falls in key Australian commodity prices including iron-ore dropping to its lowest levels in over nine years. This largely reflects a reduction in global volatility, as well as re-pricing of RBA expectations from those expecting a cut this year or early next. In the absence of a quick return to higher levels of market volatility/risk aversion, or a significant near term strengthening in the US dollar, the AUD/USD is susceptible to a bigger correction in coming days and weeks, to at least the 74 cents area or even 75 cents. Notwithstanding this near term risk, we continue to expect the AUD/USD to return to below 70 cents next year in the context of modest additional US dollar strength and the feedback loop from weaker Asia Emerging market currencies if China allows the renminbi to weaken in 2016.

Interest rates

- The RBA appears relaxed coming into the end of the year, and continues to emphasise data suggesting a rebalancing of activity towards non-mining sources, including the strength in NAB's measure of business conditions and strong employment growth. Recent GDP figures (released after the December meeting) also showed stronger economic growth than the RBA anticipated at the time of the November meeting. The RBA will be watching the global economy closely, and the fresh bout of weakness in commodity prices may prompt some also drive some downward revision to the RBA's growth profile. However, the domestic data continues to conform with the broad gradual pickup in the RBA's growth forecasts for 2016 and 2017.
- The RBA is expected to keep the cash rate on hold for an extended period, with the first hike not anticipated until mid-2017. The RBA's subdued inflation forecasts imply there is scope for further easing over the coming year, however the RBA also sees a critical role in providing stability of policy in order to allow the greenshoots to flourish while not "hitting savers over the head". A rate cut would require a global shock and/or evidence that the non-mining recovery is fizzling out.
- The lower than expected Q3 CPI figures have left inflation at the lower end of the RBA's target band. NAB forecasts underlying inflation to be 2.5% y/y by June 2016 while headline inflation to be a higher 2.9% y/y. Tradables inflation was weaker than expected, despite the lower AUD. Competitive pressures among retailers and improvements in efficiency along the supply chain might have helped keep inflation low, although the NAB business survey has been suggesting cost pass-through, which might increase tradables inflation in the coming quarters, especially as consumer sentiment improves. More importantly, non-tradables inflation will remain subdued with spare capacity in the labour market and declines in input costs, including fuel and utilities.





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

Rodrigo Catril
Interest Rate Strategist
+61 2 9293 7109

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

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

Julian Wee
Senior Markets Strategist, Asia
+ 65 6632 8055

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