Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- We have lowered our 2016 global forecasts to 3.0% (from a revised down 2.9% in 2015) in the face of a continuing sharp recession in Brazil, lower commodity prices, global equity market uncertainty and rising spreads – weakness in late 2015 in the USA has also not helped. Global growth continues to disappoint and remains sub-trend as the slowdown continues across many emerging market economies. The latest bout of financial market volatility and sliding commodity prices illustrate the risks hanging over even this sub-par growth path – albeit we still believe the most likely outcome remains that the global economy will again "muddle through". The risks are, however, weighted to the downside with little to inspire confidence on the upside. Nor do we see much sign of a pick up in 2017 (3.3% forecast). These numbers remain significantly lower than recent IMF revised (down) global forecasts.
- The outlook for the Australian economy is essentially unchanged despite global risks and we continue to anticipate further recovery across the non-mining economy. The AUD (now expected to depreciate to USD66c by mid-2016) will continue to act as a pressure valve, the tilt towards services activity will support employment, and lower petrol prices will support the cash flow position of most households and businesses. Resource export volumes will remain strong, although the associated income and government revenue will of course be challenged by low commodity prices. Overall, real GDP is forecast to pick up gradually to 2.7% in 2016 and 3.0% in 2017. The unemployment rate track has been revised given the lower starting point, and is now expected to ease to 5.6% by end-16 and 5.5% by end-17. For the RBA, unless financial market volatility translates into substantive negative real economic outcomes offshore, the central bank is likely to remain on the sidelines and observe developments, while continuing to focus on solid momentum in non-mining economic activity.

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.4	2.3	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	4.1	3.6	3.6	3.8
New Zealand	0.2	3.7	2.4	2.4	2.5
Global total	100	3.3	2.9	3.0	3.3
Australia	2	2.6	2.3	2.6	3.0
Australia (*fiscal years*)		13/14	14/15	15/16	16/17
Private consumption		2.6	2.5	2.9	2.7
Domestic demand		1.3	0.7	0.9	1.5
GDP		2.5	2.2	2.6	2.9
Core CPI (*% through-year*)		2.7	2.3	2.0	2.7
Unemployment rate (*% end of year*)		6.0	5.9	5.8	5.5

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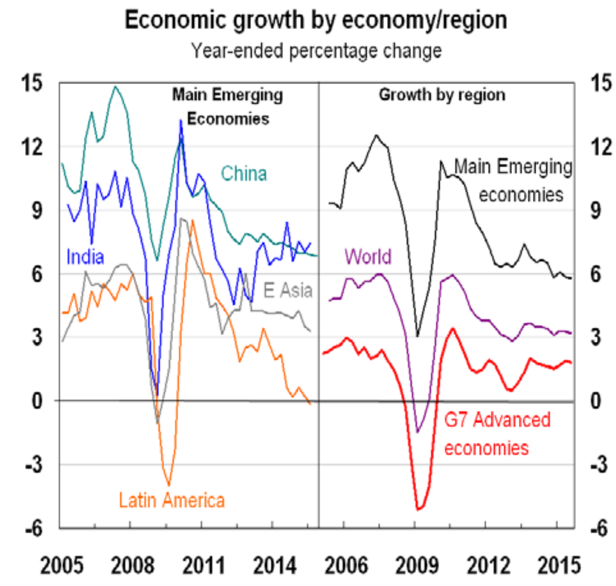
Global and Australian overview

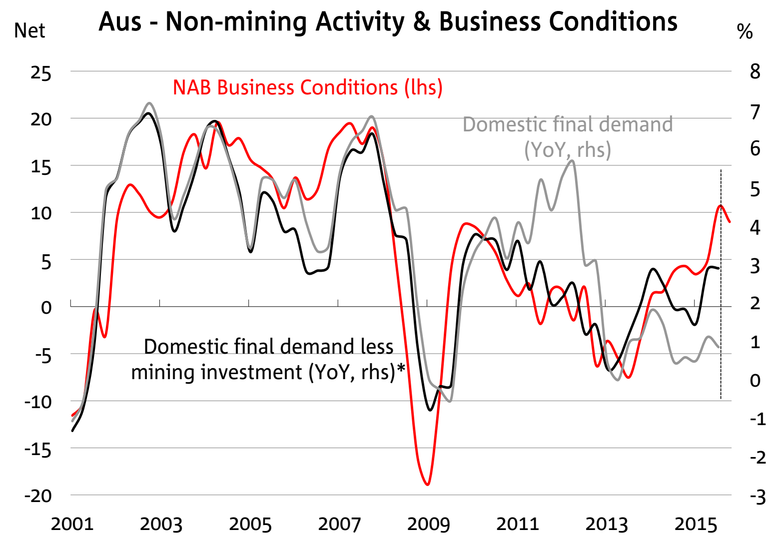
Global overview

- There is no evidence that sub-par global growth is about to accelerate, meaning that price pressures should stay low, commodity markets stay weak and – with the exception of the US – central banks can keep their interest rates at historic lows and maybe even ease monetary policy further in the Euro-zone and Japan. With emerging market economies driving the bulk of global growth, the slowing trend across East Asia and Latin America outweighs continued solid expansion in India. Combined with ongoing moderate growth in the advanced economies, the outcome is only 3% global growth, probably not enough to lift commodity prices or help cut debt burdens. More is there much expectation of a significantly better outcome in 2017.
- While early 2016's slide in commodity prices and bout of financial market volatility could turn out to be another temporary "risk off" episode, it does highlight the many risks still hanging over even a sub-par upturn. Past periods of rising US interest rates, capital flows back to safe havens and falling commodity prices did not end well for the emerging market economies. This time there is also the added issue of slowing growth and policy uncertainty in China. Risks seem skewed toward worse outcomes, it is much harder to see what could produce faster growth than in our base case.

Australian overview

- NAB's GDP forecasts are little changed at 2.7% in 2016 and 3.0% in 2017. Export volumes are offsetting the sharp decline in mining investment, despite some further downgrade to the already low outlook for the latter. Household consumption growth is expected to run a little below trend as the savings rate eases further, supported by a strong labour market and now lower petrol prices, while dwelling construction will contribute moderately to growth in line with the high level of dwelling approvals. The shift in growth outcomes towards services industries will support employment, but is unlikely to translate into a substantive pick up in mining investment. The rotation in economic activity towards the eastern seaboard will continue, although the outlook for mining states has become more challenging amidst lower commodity prices (see our latest States Economic Handbook for more details). A further 10% decline in the terms of trade will weigh on national income and government revenues.
- Global volatility and risks to China's growth prospects in particular suggest the balance of risks is tilted to the downside. Confidence channels are also important, but a sustained deterioration in business/consumer confidence and equity markets is necessary before we see feedback effects into the real economy. Meanwhile, lower oil prices are beneficial for household and business cash flow, as outlined in our recent note The Impact of Lower Oil Prices on Australia.
- These forecasts are based on recentlyrevised AUD/USD forecasts to a low of 66c by mid-2016 before gradually picking up. The RBA is expected to remain on hold until late 2016, although is likely to retain an easing bias until global volatility settles and a clearer picture of the global economic outlook (particularly growth path) emerges.

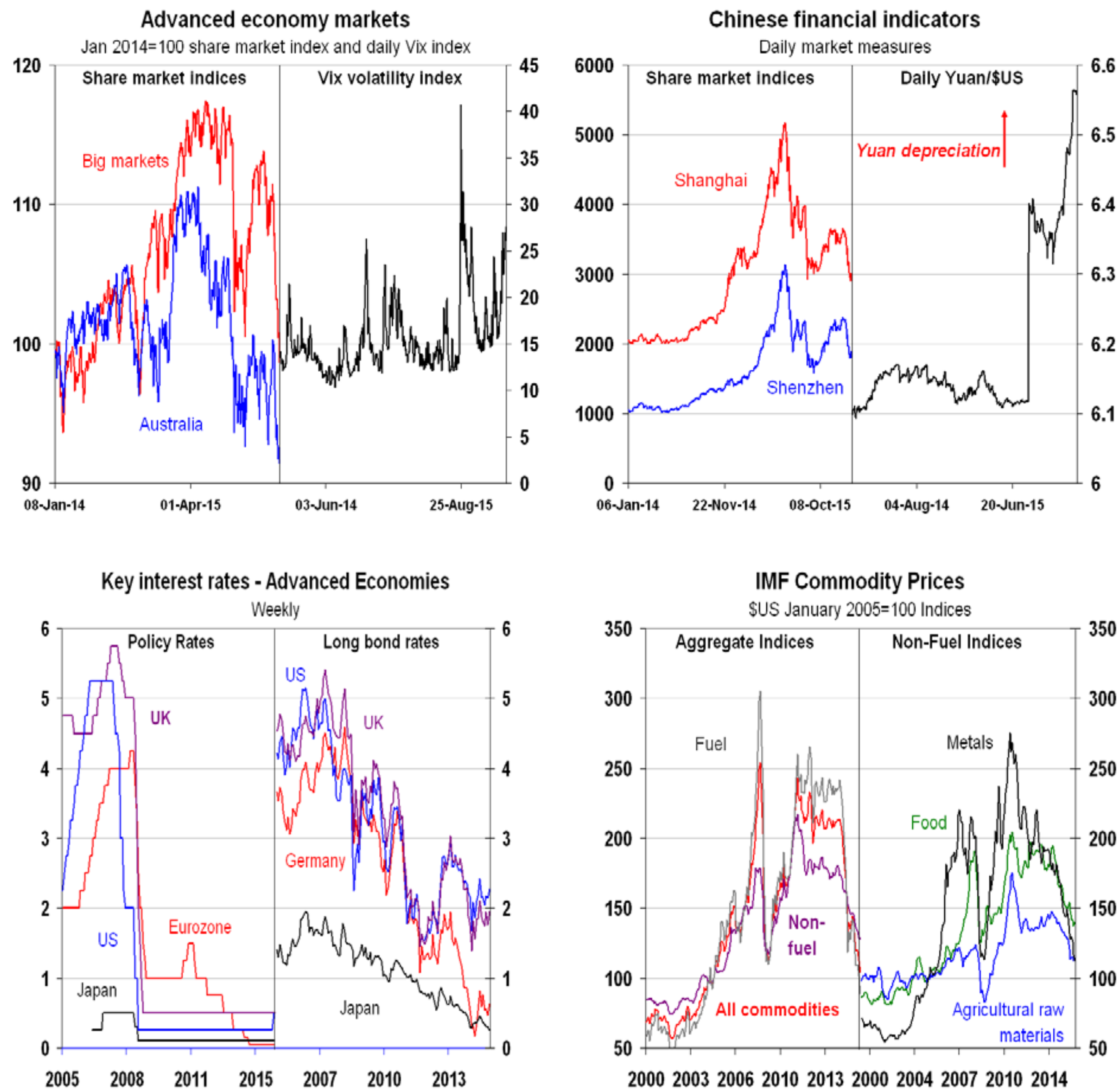




* NAB estimate. Q3 2015 is a forecast

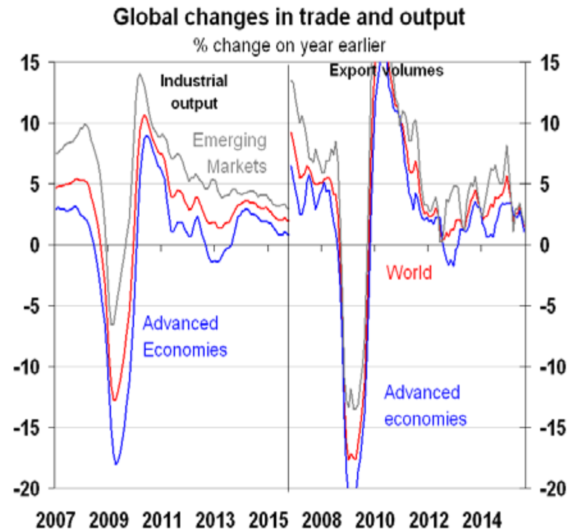
Financial and commodity markets

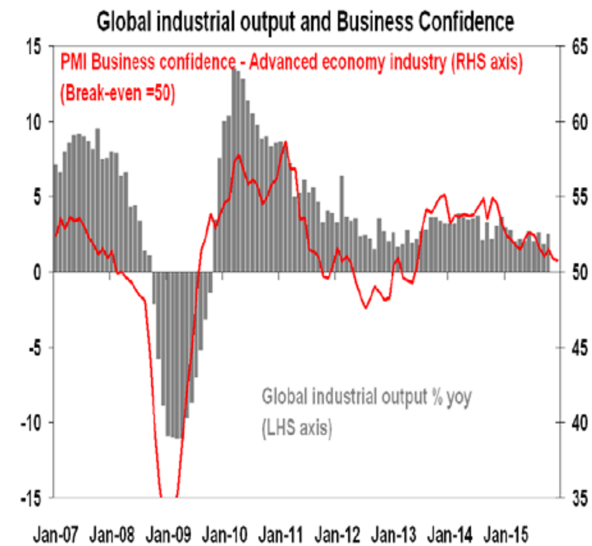
- 2016 has got off to a bad start in global equity and commodity markets. Although the biggest falls since end 2015 have been in oil and Chinese equities (down by over 20% and 16% respectively), the price decline has been broad-based. The CRB index of non-oil commodities is down by almost 5% and the Economist price measure was down by over 3% in the first fortnight of the year. Equity price declines have also been widespread with markets in the big advanced economies falling by over 10% since end 2015 and the Australian market some 9% lower. Volatility has also increased in the market.
- Equity market fluctuations like this have been seen before, notably in the middle of last year when the Chinese share market bubble started to implode and questions began over just what the Chinese authorities were planning to do with their currency (depreciate it, change the method of setting it or just allow it to be more flexible). Last year's spike in volatility was much bigger than what was seen recently and the fall in major advanced economy equity markets just as big.
- This could turn out to be just another transitory period of "risk off/head for the exit" financial market turbulence associated with the unsettling effect of the US fed starting rate tightening, low primary produce prices affecting commodity producers and uncertainty over Chinese policy. So far the disruption has mainly affected certain weak sovereign credits and energy producers and the Fed could postpone its rate rises. Oil price changes generally redistribute income but big falls in asset prices erode wealth and confidence, setting back business plans to hire and invest and hit consumer spending. Consequently, unless markets stabilise soon there could well be adverse effects for an already lacklustre global economy.

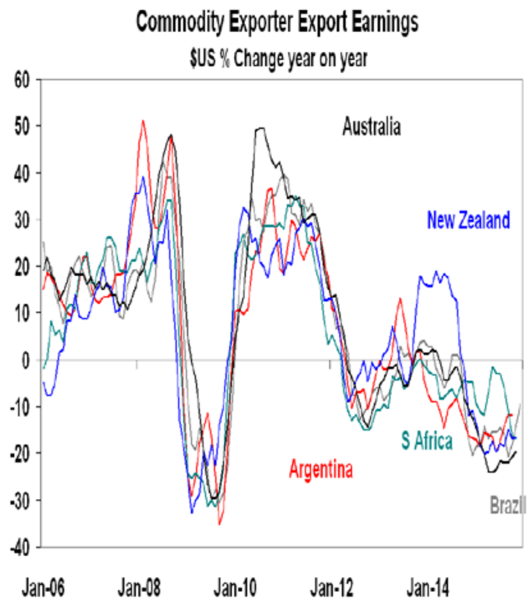


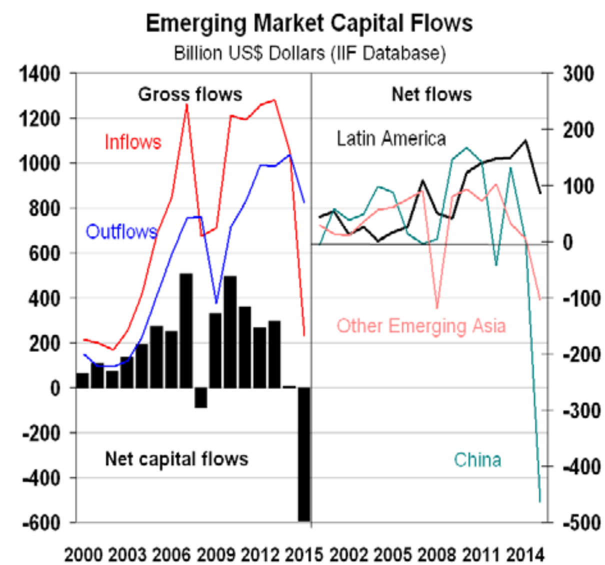
Global Economic Trends

- The latest episode of financial market instability has occurred against a backdrop of continued sluggish growth - but not recession. Monthly measures of economic activity, which generally reflect activity in goods rather than in the stronger services sector, show growth of only 2% yoy or less for global industrial output and world trade. Business survey results up to December are also consistent with continued, albeit very modest, rates of expansion in global industrial output. Service industry activity is faring better, which explains why GDP growth is a higher 3%.
- Growth of around 3% is below both the long-term trend of global output expansion and the likely rate of increase in potential output, helping explain why price pressures are remaining so low with sub-target CPI inflation in many countries, falling producer prices and a general absence of wage pressures across the advanced economies. This outlook for continued excess capacity should mean a prolonged period of low inflation, allowing central banks to keep rates low by historical standards and ease further if needed.
- Sharp falls in commodity prices are contributing to the deflation in producer prices and putting pressure on incomes across a range of countries (oil exporters, Southern Hemisphere commodity producers). Lost export income has hit growth from Argentina to Indonesia and several key commodity producers have also been hit by the reversal of capital movements with funds now being pulled out of the emerging markets and back into the main financial centres as US rates rise and investors seek safe havens. IIF data shows, however, that the biggest reversal in capital flows has been in China where large sums are now exiting at a time when the RMB looks like it could continue to fall to help Chinese growth.



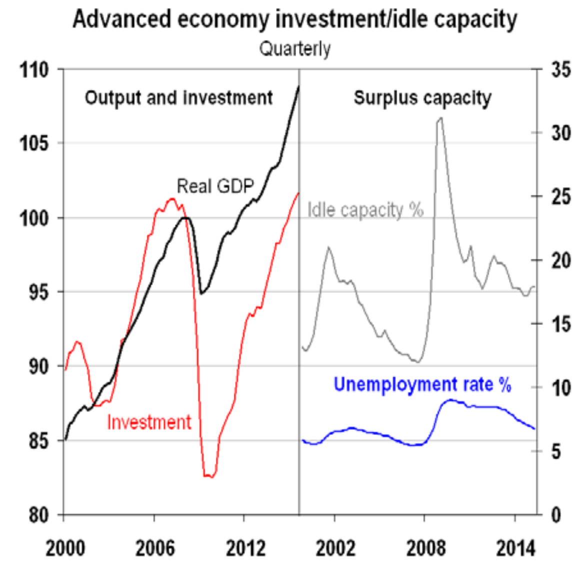


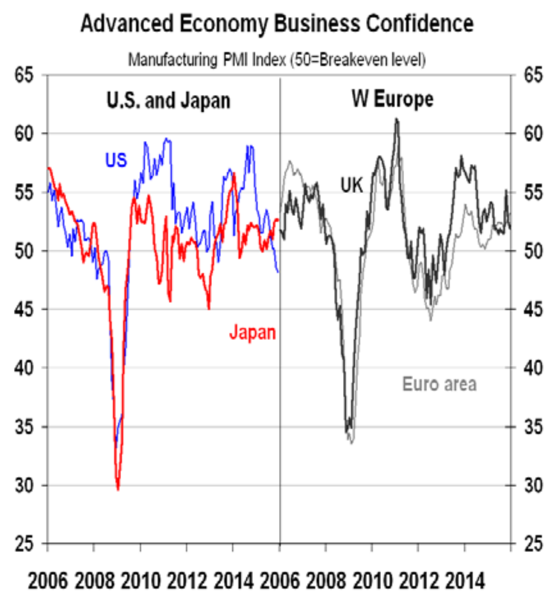


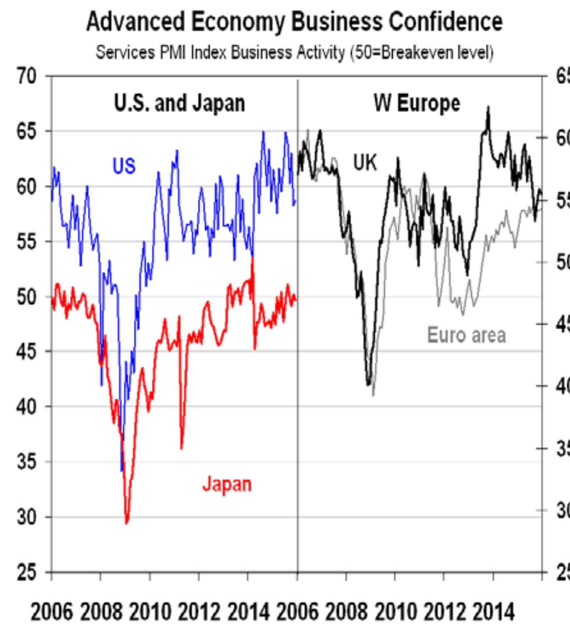


Advanced Economies

- Moderate economic growth has continued across the 7 big advanced economies with, behind the quarterly volatility in the pace of expansion, a trend rate of growth of around 1¾% into the second half of last year. There were even signs of a slow return to normal across these economies as they recovered from the Global financial crisis (GFC) and the subsequent deep recession as well as the Euro-zone financial crisis. Fixed investment spending finally regained its pre-GFC level last year, credit began to flow more freely and further progress was made in lowering unemployment. Both the jobless rate and rate of unused capacity remained above their pre-crisis levels, showing the extent of the setback to growth imposed by these crises.
- Considerable variation remains in the strength of economic conditions between the big economies. The US and Canadian economies have experienced the strongest upturns but US growth slowed in the latter half of last year and Canada has been hit by weaker commodity prices. By contrast, the Euro-zone, where economic activity was depressed by the long-running Euro crisis, is looking stronger with the business surveys showing sustained expansion.
- The December purchasing manager surveys provide the most up to date reading of business activity and they show the stronger $US and weaker energy prices taking a toll on US manufacturing while services activity growth remains solid. Euro-zone surveys show faster growth, with manufacturing benefiting from previous Euro depreciation and services growing strongly to produce the best growth results for 4½ years. The UK surveys are also positive, showing ongoing growth, but Japanese results remain weak. Taken overall, the latest results are consistent with moderate growth, not recession.

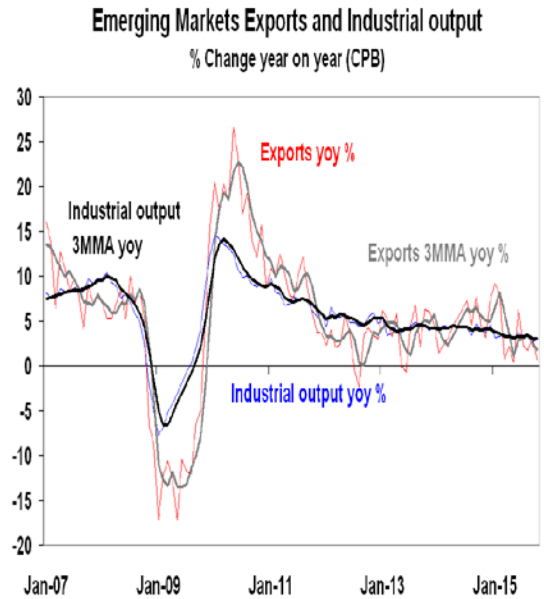


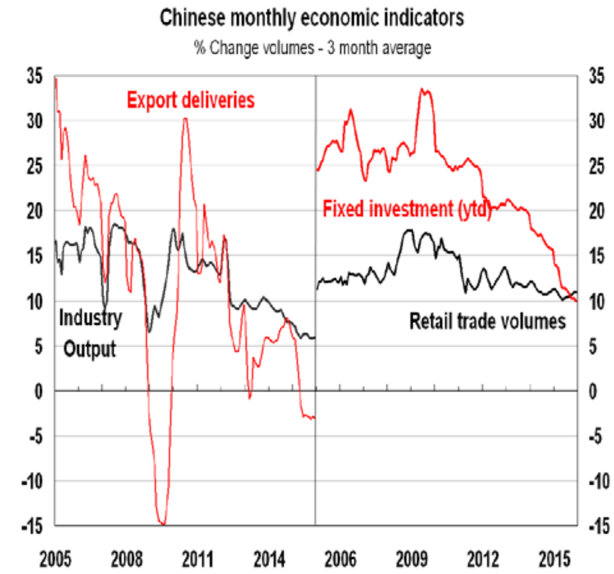


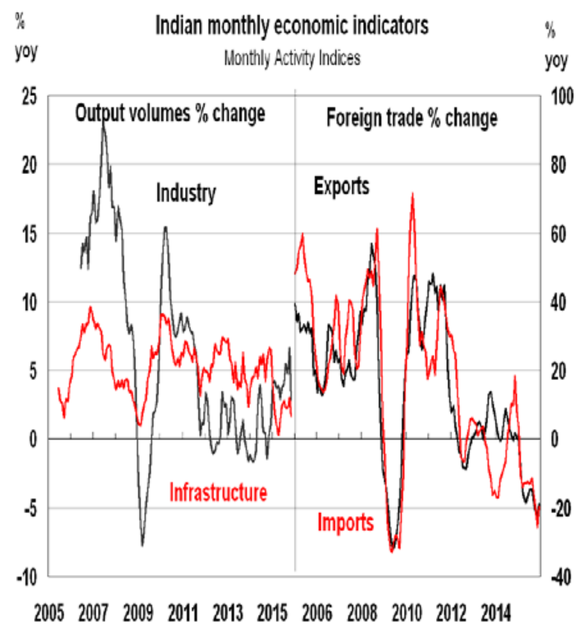


Emerging Market Economies

- As the emerging economies have driven the bulk of global expansion in the last few years, their slowdown has been the biggest contributor to the disappointing sub-trend global picture. Emerging economy GDP growth had already fallen from 7% yoy in mid-2013 to 5½% yoy in September 2015 and it looks likely to have slowed further toward the end of the year. Brazil and Russia have experienced very deep recessions and Chinese quarterly growth has continued slowing - with quarterly growth slipping from 1.9% in June to 1.6% in December.
- There was no consistent sign of any pick-up in either the business surveys or monthly measures of trade and output through late 2015. In fact, behind the volatility in the monthly data lies a slowing trend in emerging economy industrial output and trade. Industrial output's trend growth is now running around 3% yoy and export volumes are around 2% yoy, well below the rates seen prior to the GFC.
- The softening across the Emerging market economies is also broad-based. With the exception of India, still experiencing very rapid growth, the picture is generally one of either slowdown (China), sluggish growth (Much of East Asia, South Africa) or outright recession. Few regions have been spared with both industrial output and $US export earnings slipping below year earlier levels across Latin America and much of East Asia, outside China.
- This disappointing performance matters a lot for Australia and New Zealand as economic growth in the emerging economies is generally much more commodity intensive than is the case for advanced economy growth. Higher incomes lifting food demand (especially for protein), high levels of metal intensity as infrastructure is built and increased energy consumption in the emerging economies drove much of the lift in Australasian exports.







Global forecasts

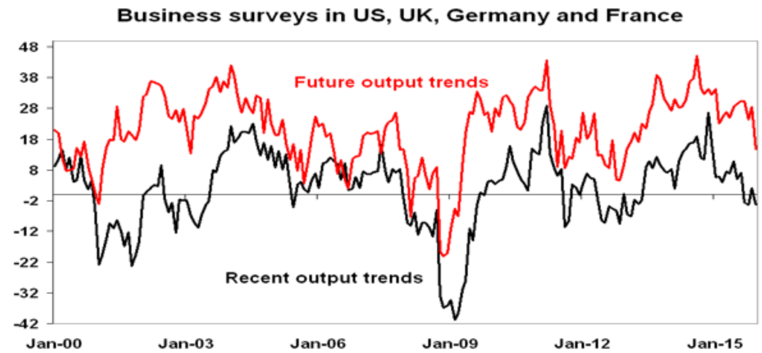
We have lowered our global growth forecasts to 3% for next year, principally reflecting our changed assessment that the very deep recession in Brazil (the world's 7th biggest economy) will be prolonged by political uncertainty, lower commodity prices and financial market turbulence. Other forecast revisions are minor and generally downwards.

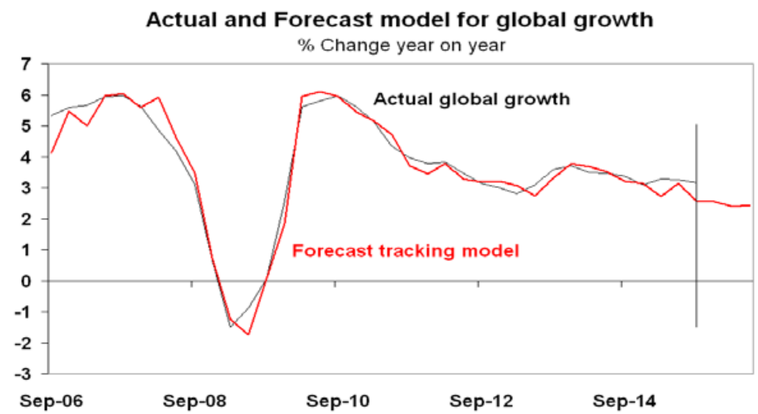
We are not expecting growth to revert back to its trend over the forecast period. Recent business survey expectations for industrial trading conditions in the big advanced economies do not point to much optimism there, but maybe services could do better. The emerging market business surveys do not inspire much optimism either. Finally, our global short-term forecasting model that uses a mixture of financial, business survey and hard data is not pointing to any acceleration in global growth.

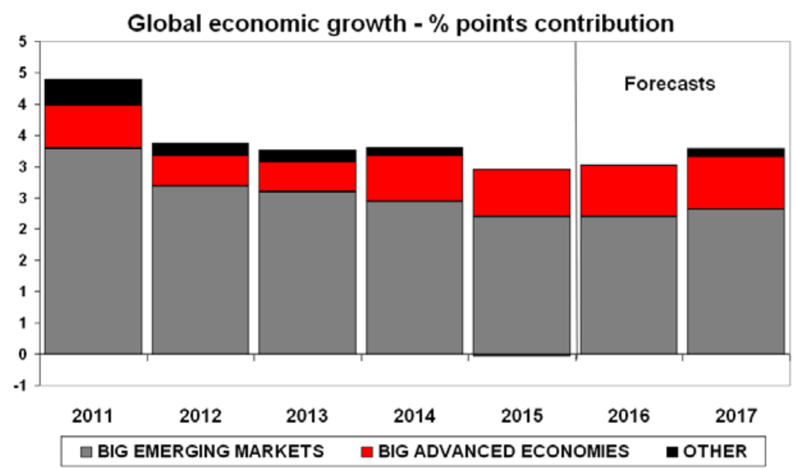
Consequently, we see "more of the same" sluggish sub-trend growth. It is weighed down by heavy debt burdens, a lack of will to ease policy very aggressively in key advanced economies, higher US rates and their associated market turbulence. Lower oil prices have also hit activity in exporters but cheaper oil has produced less stimulus in the importing economies than might have been expected. Risks seem skewed to the downside, especially for energy producers and indebted emerging economy commodity producers who import capital.

Global growth forecasts % change year on year

	2011	2012	2013	2014	NAB Forecasts 2015	2016	2017
US	1.6	2.2	1.5	2.4	2.4	2.3	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	2.2	2.2	2.2
Canada	3.0	1.9	2.0	2.5	1.2	1.7	2.0
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	-0.4	-0.3	1.2
Emerging East Asia	4.4	4.6	4.2	4.1	3.6	3.6	3.8
New Zealand	1.8	2.4	2.4	3.7	2.4	2.4	2.5
World	*4.4*	*3.4*	*3.3*	*3.3*	*2.9*	*3.0*	*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	4.5	4.5	4.8
Major trading partners	4.7	4.3	4.2	4.0	3.8	3.8	3.8







Australian outlook

- The outlook for the Australian economy is largely unchanged despite global risks, further commodity price and equity market declines. We continue to anticipate an ongoing recovery across the non-mining economy.
- The AUD is acting as a pressure valve and our forecasts have been revised down moderately to a low of USD66c by mid-16. This will be particularly helpful for services sectors, including those benefiting from tourism and international student arrivals such as hospitality, retail and education. A risk, but not our core view, is that a sharper global slowdown than forecast could lower demand for travel to Australia, education exports and Australian property, particularly if the households in China and East Asia come under stress.
- This tilt towards services activity 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. The flipside is that these sectors are typically less capital intensive, and the outlook for non-mining investment remains weak. Productivity growth has also tended to be lower in services industries, which together with slower population growth will weigh on Australia's potential growth rate (recently downgraded by the Federal Treasury to 2¾% from 3¼%).
- Strong employment outcomes will support household spending, despite soft wages growth, as will lower petrol prices (see The Impact of Lower Oil Prices on Australia). This will be helpful as the impetus to household consumption from the housing market wanes through 2016 as house price growth slows - both directly through to household goods spending and indirectly through the wealth channel.
- Meanwhile, resource export volumes will continue to add strongly to growth, although the associated income and government revenue will be challenged by low commodity prices. That said, we have only made minor adjustments to our terms of trade forecasts given Australia is a net importer of oil and gas products, while iron ore prices have been broadly stable over the past month (and we incorporated substantial downgrades to iron ore prices in December).
- Overall, real GDP growth is expected to pick up gradually to 2.7% in 2016 and 3.0% in 2017. The unemployment rate has been revised given the lower starting point, and is now expected to ease to 5.6% by end-16 and 5.5% by end-17. The RBA is expected to remain on hold through 2016.
- The balance of risks is tilted to the downside at present and confidence channels will bear close watching (as discussed on page 2).

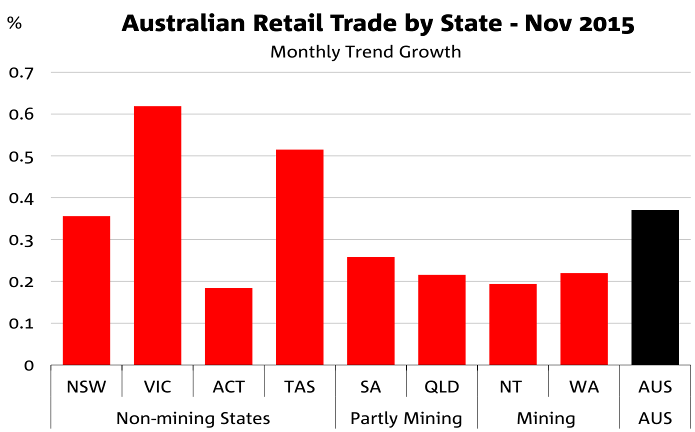
Australian economic and financial forecasts (a)

	Fiscal Year			Calendar Year		
	2014-15 F	2015-16 F	2016-17 F	2015-F	2016-F	2017-F
Private Consumption	2.5	2.9	2.7	2.6	3.0	2.4
Dwelling Investment	7.7	8.1	2.7	9.1	5.6	-0.3
Underlying Business Fixed Investment	-7.1	-13.2	-7.2	-10.8	-10.4	-6.4
Underlying Public Final Demand	-0.4	2.7	2.3	2.0	2.0	2.5
Domestic Demand	**0.7**	**0.9**	**1.5**	**0.9**	**1.3**	**1.3**
Stocks (b)	0.2	-0.2	-0.1	-0.1	-0.2	0.0
GNE	**0.8**	**0.7**	**1.4**	**0.8**	**1.1**	**1.3**
Exports	6.6	7.6	9.5	6.4	9.0	9.8
Imports	0.1	-0.5	2.5	0.9	0.8	2.4
GDP	**2.2**	**2.7**	**2.8**	**2.3**	**2.7**	**3.0**
– Non-Farm GDP	2.2	2.8	2.9	2.4	2.8	3.0
– Farm GDP	-0.5	-3.4	0.1	-0.1	-3.0	1.6
Nominal GDP	1.5	1.7	4.5	1.4	2.7	5.3
Federal Budget Deficit: ($b)	40	30	30	NA	NA	NA
Current Account Deficit ($b)	59	89	82	75	91	73
(-%) of GDP	3.6	5.4	4.8	4.6	5.5	4.2
Employment	1.3	2.4	2.0	2.0	2.2	2.0
Terms of Trade	-10.4	-13.5	-3.7	-12.2	-10.4	-1.0
Average Earnings (Nat. Accts. Basis)	1.4	1.4	2.1	0.8	1.9	2.3
End of Period						
Total CPI	1.5	1.6	3.1	1.4	2.8	2.6
Core CPI	2.3	2.0	2.7	2.0	2.6	2.6
Unemployment Rate	5.9	5.8	5.5	5.8	5.6	5.5
RBA Cash Rate	2.00	2.00	2.50	2.00	2.00	3.00
10 Year Govt. Bonds	3.01	3.30	3.65	2.88	3.35	3.65
$A/US cents :	0.77	0.66	0.70	0.73	0.69	0.73
$A - Trade Weighted Index	63.8	58.5	62.5	62.7	61.8	64.2

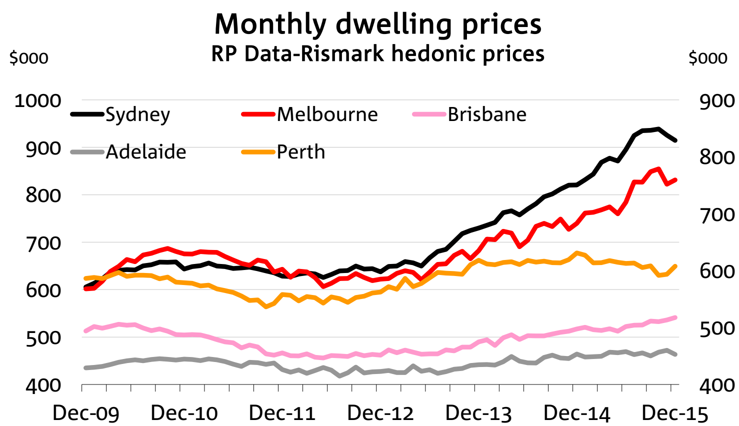
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.
(b) Contribution to GDP growth

Australian consumer demand and housing market

- 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 November (0.4%) was slightly below October (0.6%) to be 4.1% y/y, around the trend seen since late 2014. Meanwhile, NAB's Online Retail Sales Index for November showed a 0.7% m/m rise in online spending.
- Despite soft wages growth, we expect a modest pick-up in consumer spending growth through to 2016, driven by a gradual reduction in households' saving ratio and strong employment growth.
- The Sydney housing market has clearly turned, having recorded two consecutive months of price declines (falling 1.2% in December alone). Other timely measures, such as auction clearance rates, also pointed to a significant pull back in demand in late 2015 with rates well down on the levels seen at the same time the previous year. Surprisingly, declines in the last two months were larger for Sydney houses (down 3%) than apartments (down ½%), despite concerns of a mounting oversupply of apartments amidst high rates of construction activity. Momentum has also slowed in the Melbourne market, where prices have fallen by a similar amount from their recent peak (although they rose 1% in December) – again, apartments were surprisingly robust given the shifting fundamentals. Other capital cities experienced mixed outcomes in December. Adelaide prices were down most (-1.5%) in the month, while Perth recorded a surprising uptick (2.3%). Housing credit growth remained at 0.6% in October, but is increasingly driven by owner occupier loans.
- Recent property market outcomes are consistent with our view that prices growth will increasingly come under pressure as credit restrictions on investor lending bite (especially in Sydney), in combination with subdued incomes and slowing population growth. For now, we have maintained our previous forecast for much slower house price growth in 2016 (2%), although risks to the downside have escalated even more, especially in the apartment market. (for more details, see our recent house price update at the following link).



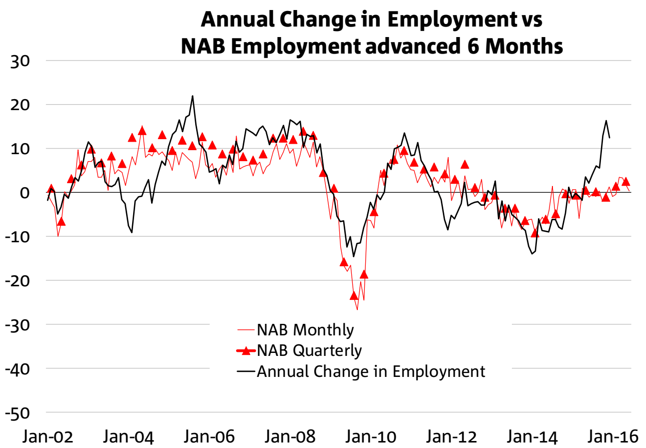
Source: ABS, NAB



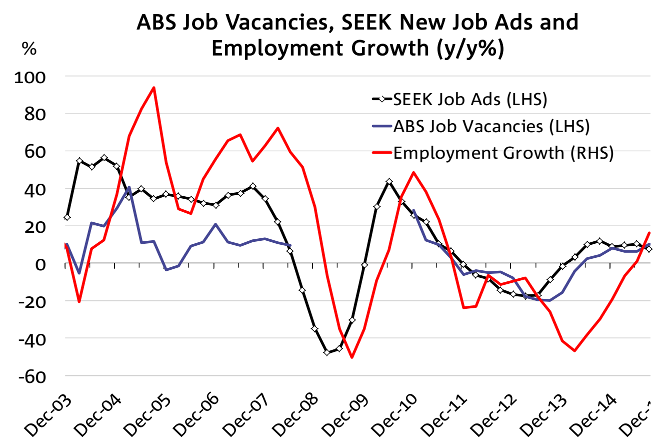
Source: RP Data-Rismark

Australian labour market

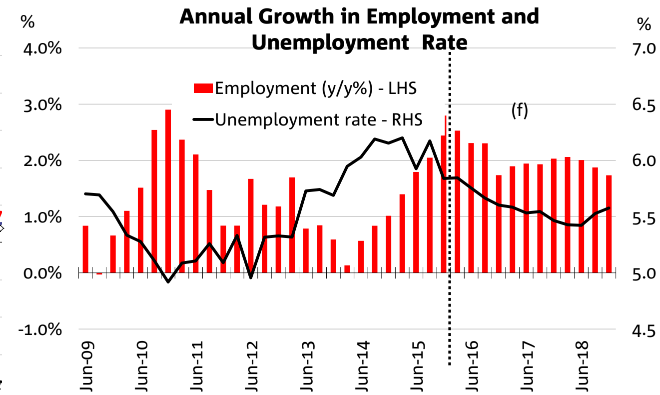
- In November and December, trend employment data continued to point to a robust pace of job creation of around 30k each month, which was significantly higher than the 17k which we had forecast and the 14 to 15k needed to keep the unemployment rate constant. The underlying strength in the labour market is further supported by other measures, such as a pick-up in employment to population ratio and the participation rate, which are indicative of stronger labour demand and a positive encouraged worker effect.
- As such, the trend unemployment rate has fallen at a quicker rate than previously expected to 5.8% in December, which prompted us to revise our unemployment rate forecasts lower this month. In trend terms, unemployment is declining in NSW, Victoria, Queensland and Tasmania: has declined in recent months and potentially reached a turning point in SA and NT; but is clearly still increasing in WA (and the ACT). Meanwhile, the rising trends in employment growth are broad-based - except for WA and TAS. The strengthening trend in Queensland employment growth is an emerging but important trend in the national data, as it has the potential to more than offset the mining induced downturn in WA.
- Overall, forward-looking indicators look mixed. The SEEK job ads series continue to paint a picture of strong divergence between mining and non-mining states, with the number of job ads in non-mining states of NSW, VIC, TAS and ACT currently higher than post-GFC levels, while those for mining and partly-mining states/territories, with the exception of NT, have fallen below those levels. The NAB Business Survey employment index fell for the third consecutive month in December to the neutral point, a trend that is at odds with the official ABS data. Official employment data from the ABS picked up strongly in H2 2015, with an unusually strong contribution from rotation effects during these months causing some uncertainty. Nevertheless, the NAB Business employment index indicates that annual employment growth will be around 180k (or 15k per month) in 6 months' time despite weaker correlation with actual data since H2 2015, which will still be sufficient to see unemployment rate stabilise.
- 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. A lower starting point for unemployment rate due to stronger-than-expected actuals in recent months prompted us to revise our unemployment rate forecasts moderately lower - easing gradually to 5.6% by end-16 and 5.5% 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.



Source: ABS, NAB Group Economics



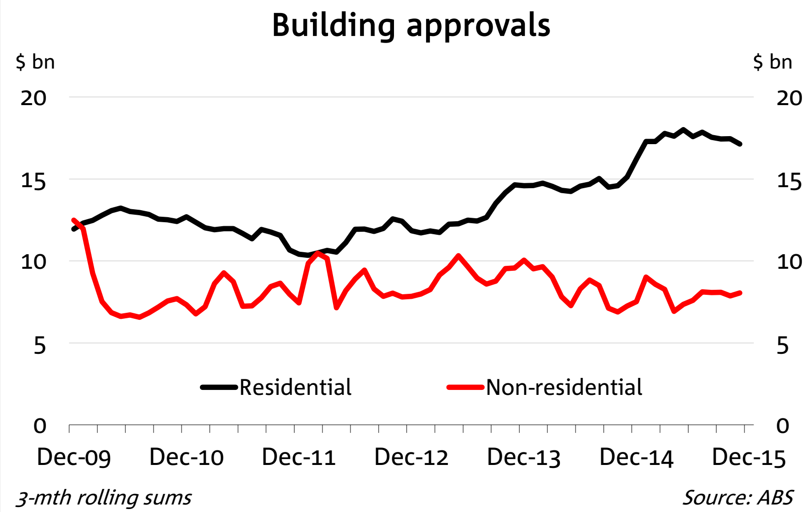
Source: ABS, SEEK, NAB Group Economics

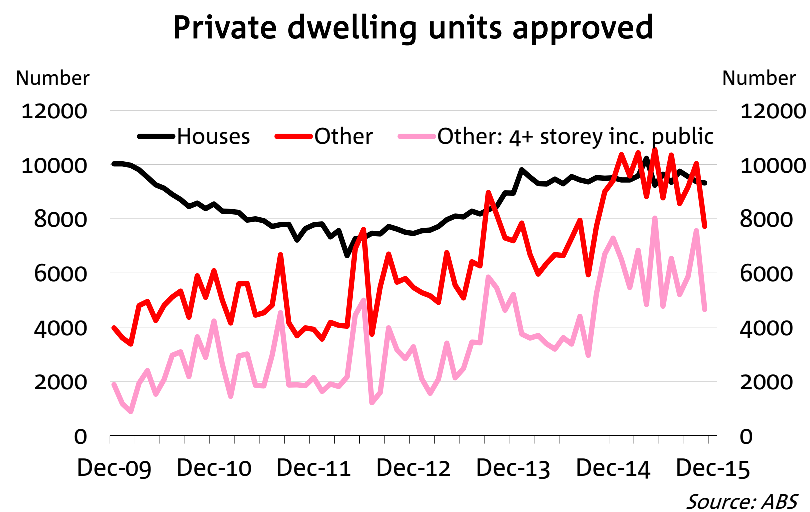


Source: ABS, NAB Group Economics

Australian investment

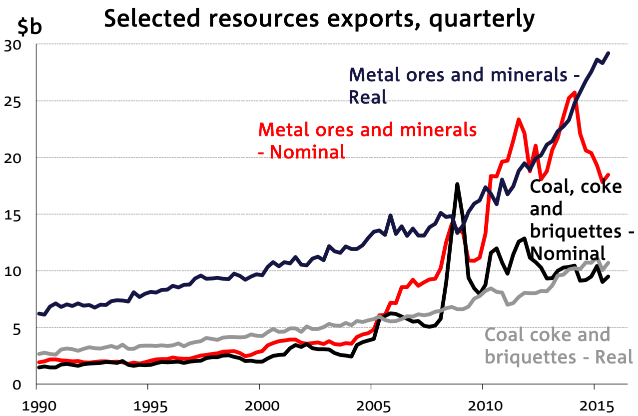
- Signs of more robust growth in non-mining investment remain hard to find in the official data (especially the expectations data), while inevitable declines in mining capex continue – and could well become more pronounced given further falls in commodity prices.
- Despite significant signs of improvement in the business landscape, the NAB Business Survey reports that firms in the non-mining are still apparently gun-shy on investment. A fall in capacity utilisation in the December Monthly business survey has probably not helped, nor would recent financial market uncertainties. However, structural factors are also at play, given that much of the reported improvement in business conditions has come from traditionally less capital intensive services sectors.
- Expectations for non-mining capex in 2015-16 have disappointingly shown little improvement. Depending on the realisation ratio used, the latest official Q3 capex survey suggested a likely fall of around 8½%. This may be painting an 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, forward looking partial indicators – such as non-residential building approvals – are also muted. Sentiment also eased in the NAB commercial property survey during Q3, particularly in CBD hotels, while office vacancy rates are elevated and still rising in some states – Sydney is a notable exception. That said, we remain hopeful that AUD depreciation will eventually assist investment in trade exposed industries.
- Dwelling investment has been a little softer than expected in recent quarters, yet record high numbers of dwellings in the construction pipeline suggest the positive contribution to growth is likely to continue. However, now that much of the heat has come out of the housing market, the flow of new projects into the pipeline appears to be slowing, especially as concerns of a looming oversupply (primarily in the apartment market) continue to escalate.
- The profile of dwelling construction is expected to remain volatile given the large share of apartment construction, which by definition tends to be lumpy. Nevertheless, given the state of market over-supply, approvals are expected to continue to soften, suggesting that the trend contribution of dwelling investment to GDP should begin to diminish over the course of 2016-17.
- Overall, business investment is forecast to decline by around 13% in 2015/16 and 7% 2016/17. Positive dwelling investment is providing some offset, but only accounts for around 5% of GDP vs 12% for business investment).



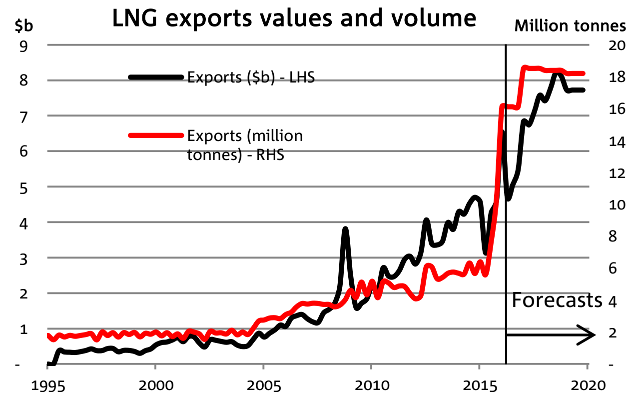


Australian commodities, net exports and terms of trade

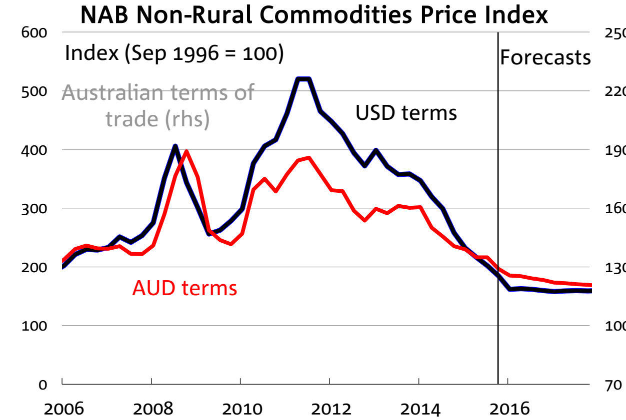
- In the September quarter, net exports added 1.5 ppt to total GDP growth. While these are partly a reversal from a surprisingly weak Q2, net exports are expected to add 2.6 and 1.8 ppt to GDP growth in 2015-16 and 2016-17 respectively on the back of strong LNG exports. While export volumes will hold up, the associated income and government revenue will be lower due to significantly lower commodity prices.
- Heightened market volatility since the start of 2016 has seen global commodity prices decline further. **Oil prices** have fallen below USD $30/barrel (see Impact of Lower Oil Prices on Australia). The NAB non-rural commodity index denominated in USD fell 29% in 2015 and is forecast to fall by another 13% in 2016. The index in AUD terms is forecast to fall by a lesser 10% during 2016 (reflecting the US66c forecast by mid 2016). Overall, the forecasts translate to a fall in Australian terms of trade of 10% in 2016 .
- With **LNG contract prices** tied to oil prices, the fall in oil prices will significantly impact the profitability of Australia's LNG projects. While contracts in place indicate strong export volumes, downside risks remain. These include uncertainty around whether there is sufficient coal seam gas well capacity to support contracted volumes in the medium term and around fulfilment of existing contracts given weaker global demand and prices. Meanwhile **coal prices** have drifted lower. While there have been more announcements of production cuts, to date that has largely involved marginal producers and as such is not expected to cause to cause large falls in export volumes (which are forecast to have limited growth in 2015-16 and to a lesser extent in 2016-17). **For iron ore**, prices have been stable in recent months and lower oil prices and efficiency gains have lowered production costs. As such, large scale iron ore production cuts have not yet occurred.
- On the imports side, capital goods imports continue to decline post the mining investment boom and as the impact of a lower AUD is being felt. Intermediate and consumption goods are slowly on the rise as household consumption and dwelling construction remain the brighter spots in the economic transition. Services imports are also declining, especially travel and other services, as the lower AUD alters the price relativities between domestic and international travel.
- Our forecasts point to Australian agricultural prices trending higher in AUD terms in 2016, despite challenging international conditions. We expect the NAB Rural Commodities Index to increase 7.1% in 2016, supported by a lower AUD. Beef prices have been hovering at record levels and the Eastern Young Cattle Indicator broke through the 600c/kg mark in mid-January. However, with volumes down after a prolonged period of elevated slaughter, export values are likely to contract in 2016-17. Wheat should find some support from the lower AUD amid plentiful global supply and low global prices. We forecast dairy prices to increase moderately and the value of Australian dairy exports to increase by 3.2% (AUD) in 2015-16. This comes despite tumult on global dairy markets last year and forecasts of slow growth in global prices.



source: ABS



source: ABS, Bloomberg, NAB



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

Australian financial markets

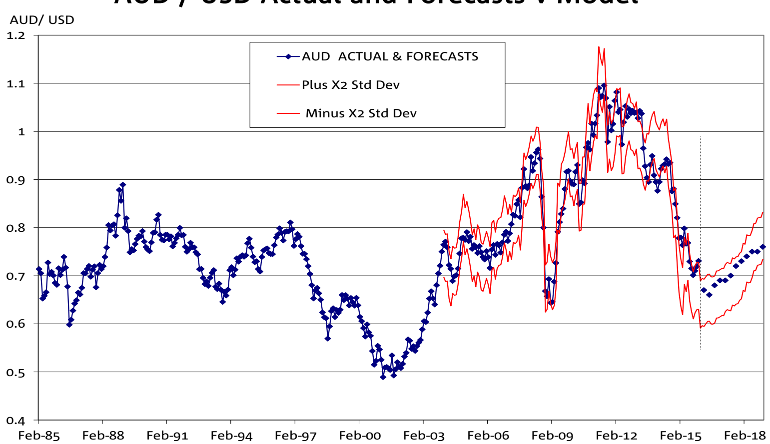
Exchange rate

- The AUD has fallen by around 4.5% in both trade-weighted terms and against USD since the end of 2015. Despite this decline, sharp falls in commodity prices continue to suggest a valuation gap between the currency and commodities. Partly for this reason, we expect further downward pressure on the AUD in coming weeks/months, though not to the extent that it seriously challenges our long-held view that the AUD/USD rate will for the most part remain within a 65-75 cents range during 2016. We have nudged our near-term forecasts very slightly lower, now forecasting 0.67 for end-Q1 and 0.66 for Q2 - from 0.68 and 0.69 respectively. We also expect the AUD to struggle to recapture a 70 cents handle later in the year, even with no further rate cuts (see below). Support from this source will only partly counter further support for the USD, in the face of more Fed policy tightening. Indeed our forecasts suggest that the market is probably under-pricing the extent of Fed moves over the coming year.

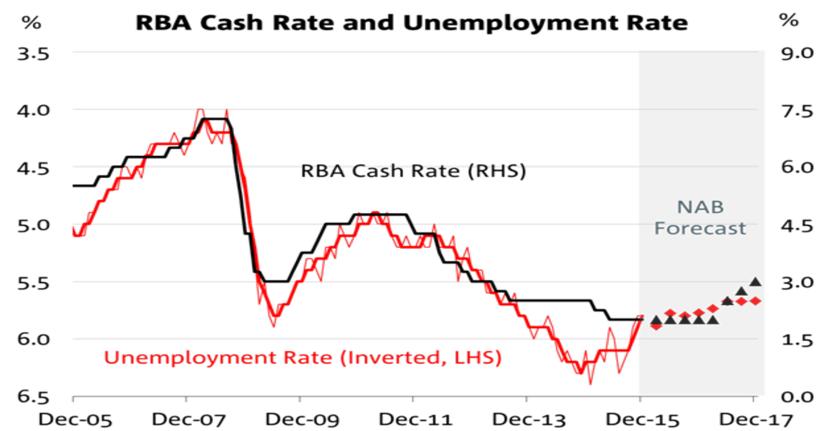
Interest rates

- Unless financial market volatility actually translates into substantively more negative real economic outcomes offshore, the RBA is likely to remain on the sidelines and observe developments. Locally, the RBA has continued to emphasise the building momentum across the non-mining economy, as evidenced in NAB business conditions and strong employment growth. Some downgrades to the RBA's forecasts for trading partner growth and the terms of trade are likely (last published in November), and may lead to some downgrade of the RBA's domestic growth forecasts (although that would simply bring them more in line with ours).
- There is scope to ease if necessary, particularly given unproblematic inflation, but this remains a risk rather than our core view. The most likely outcome remains for the RBA to hold the cash rate at historically low levels through 2016 before commencing a gradually hiking cycle in mid-17. It is rare for the RBA to cut rates while the unemployment rate is falling (see RHS chart).
- Inflation is forecast to remain very subdued. Spare capacity in the labour market will continue to keep wages growth supressed, and low oil prices will also reduce cost-push inflation. Tradables inflation has also been weaker than expected, which suggests only partial currency pass-through amidst strong competition between retailers. Growth in rents has also slowed down. As a result, NAB forecasts December quarter underlying inflation to be at 0.4% q/q and headline inflation to be 0.1%. In the medium term, we forecast underlying inflation to fall to 2.0% y/y by June 2016 before rising again to 2.7% in June 2017.

AUD / USD Actual and Forecasts v Model



RBA Cash Rate and Unemployment Rate



Source: ABS, NAB

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