

Australian Markets Weekly

The impact of oil complicates the outlook

- Markets and economies impacted simultaneously by oil price falls, Chinese policies and divergences in growth and monetary policy among the major economies, leading to significant volatility and uncertainty
- Net effect to date has been low inflation and interest rates, stronger US\$, weakness in commodity prices and non-US\$ currencies and lower unemployment in advanced economies
- It's crucial whether the oil price weakness is supply or demand driven. The latter would be reflected in higher global unemployment and would suggest low inflation and bond yields for longer – the former suggests low inflation and bond yield effects are likely to be transitory as there would be a significant positive offset from consumer spending. That's what NAB's modelling and the literature suggests.
- Either way, in the near-term, there remains pressure on the \$A, which we see trading in the US\$0.66-0.70 region this year.
- The RBA left cash rates unchanged in February – as expected. The Bank is watching closely whether Australian employment growth continues and also whether the financial markets turbulence of recent times warns of weaker global and Australian demand.

Volatile markets, the impact of oil and employment all being closely watched

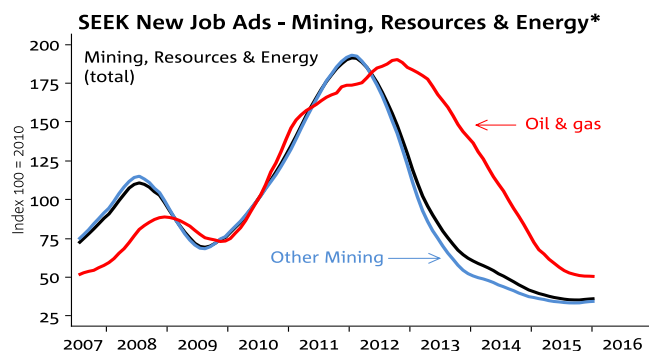
It was another volatile week in markets, with commodities, currencies and equity markets all experiencing significant intra-week rises and falls, but finally ending up on the weak side. The RBA kept rates unchanged at the February Board meeting – as widely expected – as the Bank continued to see reasonable prospects that the Australian economy would continue expanding. The Statement following the Board Meeting and Friday's February Statement on Monetary Policy singled out two important factors the Bank is watching closely to see how they impact on the growth outlook, namely: (i) whether employment growth continues in Australia (this is important for sustaining consumer spending); and (ii) whether recent financial market turbulence leads to weaker global and local demand. These assessments will likely take a number of months to make in each case, but highlight that the RBA still has a bias to ease policy and has room to ease policy should either of these factors disappoint.

Key markets over the past week

	Last	% chg week		Last	bp / % chg week
AUD	0.7069	-0.6	RBA cash	2.00	0
AUD/CNY	4.67	0.3	3y swap	2.07	0
AUD/JPY	82.7	-3.9	ASX 200	4,976	-0.6
AUD/EUR	0.634	-2.9	Iron ore	45.7	9.6
AUD/NZD	1.068	-1.6	WTI oil	30.9	-8.1

Source: Bloomberg

Chart 1: SEEK new job ads Oil & Gas vs Other Mining



* Trend
Source: SEEK, National Australia Bank

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The Statement contained a nice summary of the sources of the current turbulence in financial markets that accords well with NAB's thinking outlined in 10 themes to watch in 2016 (and which were also the main themes running through Nouriel Roubini's op-ed in today's Australian Financial Review entitled "The new abnormal is now the world's economic routine"). The RBA sees global economies and markets as currently being influenced by:

- Divergent monetary policies among the major economies;
- China's policy challenges; and
- The significant fall in oil prices (which importantly the Bank sees as largely being supply driven – we agree).

With numerous feedback loops and interdependencies arising from these forces, markets have been whipsawing as various indicators suggest one trend and other indicators suggest another. The common theme evident in the US, China and Australia is of some weaknesses in the industrial/mining sectors of economies and relative strength in the non-mining and services sectors of the economy.

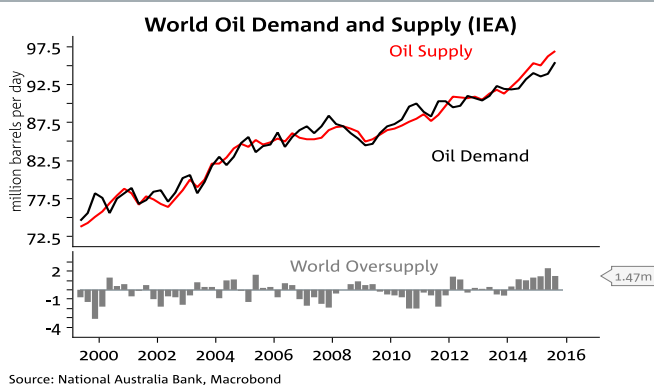
How should we think about things?

Markets (and economists) find it difficult to analyse countervailing forces, especially when there are more than two and they are occurring simultaneously. Let's consider the separate influences and then try to summarise the net effect.

Taking oil first, it's important to decide whether the drop is demand-driven (in which case the price fall reflects a weakening global economy and would suggest significantly lower inflation for an extended period, sustained lower interest rates and bond yields, higher global unemployment and problems for oil producers – both companies and nations) or supply driven (in which case while many of the above effects still occur in the short term, the effects on inflation and interest rates should be transitory and unemployment should not rise as there will be a large offsetting positive benefit to net oil consuming nations and agents (ie. consumers and businesses).

Chart 2 shows little evidence of any significant demand shock to oil, but highlights that oil supply continues to run ahead of oil demand, suggesting oil prices will broadly remain low for an extended period and not rise significantly on a 1-2 year horizon. There will still be a significant impact

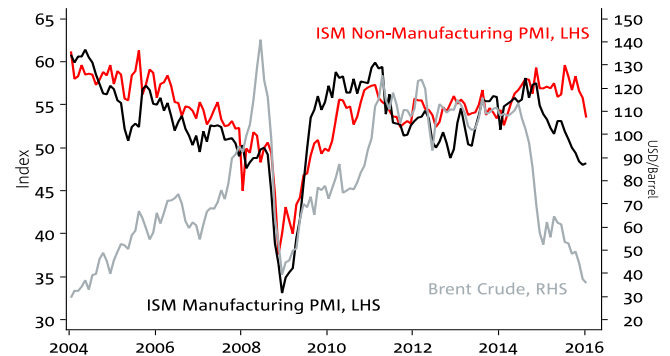
Chart 2: No sign of demand shock in oil demand numbers



on Oil & Gas producers worldwide – something that has been in evidence in elements of US statistics in recent months (likely exacerbated to an extent by the stronger US\$), but the positive effects of which are likely to be harder to ascertain as they are more diffuse and likely take a little longer to show up.

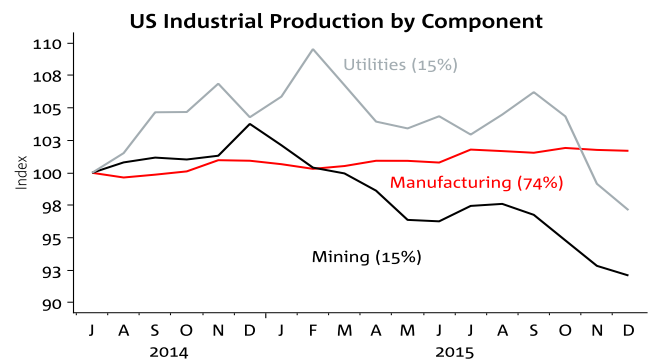
The key trend to monitor, in our opinion, is whether the non-manufacturing ISM can continue to hold up relative to the manufacturing ISM as the former benefits from consumers having more disposable income, while the latter is impacted by weaker Oil & Gas spending and related flow-on effects to parts of manufacturing (see charts 3 and 4).

Chart 3: Oil affects ISM; can non-manuf. ISM hold up?



Source: National Australia Bank, Macrobond

Chart 4: US data reflecting oil weakness and weather



Source: National Australia Bank, Macrobond

The second force is what the RBA describes as the challenges faced by Chinese policy makers. Markets have been on edge about developments in the Chinese economy and the intentions of Chinese policy makers, particularly since the Chinese modestly devalued the RMB in August. There is little conviction in markets that the Chinese authorities can successfully manage China's slowdown and growth transition and significant uncertainty about the intention of the authorities towards the Chinese currency, particularly as capital outflows from China continue apace requiring continuing elevated levels of FX reserve sales to counteract.

To the extent we can summarise the net of these Chinese effects for Australia, they continue to place downward pressure on the \$A in the near term given the generally close correlation of the Australian dollar (and other Asian currencies) to the Chinese currency. By the same token, Chinese growth transition is likely to contribute to slower growth in demand for commodities, likely keeping commodity prices generally low, but is likely to support

Chart 5: Chinese tourist arrivals remain very strong



continuing relatively stronger growth in the consumer-related elements of Chinese demand. These trends continue to be evident in the Australian data, with the growth rate of iron ore volumes having slowed (but importantly not declining in levels terms), while Chinese tourist arrivals growth remains very strong (chart 5).

Finally, we have the impact of divergent monetary policies among the major economies – in clear evidence with the US having raised interest rates in December, Japan moving to negative interest rates just over a week ago and expectations that the ECB will provide further stimulus to Europe’s economy in March.

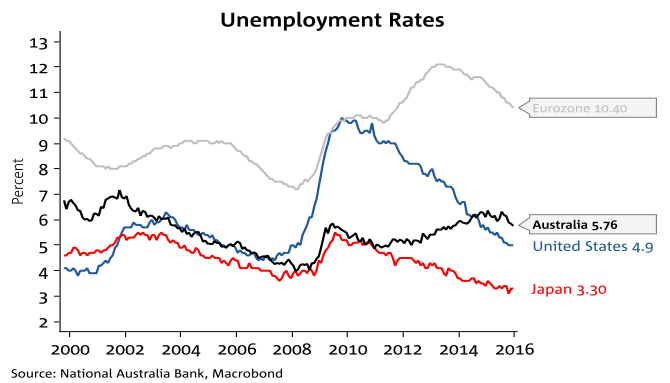
The divergence in policies (effectively growth divergences) is likely to have been a significant part of the prior appreciation of the US\$ (and part of the relative weakness in commodity prices and most currencies against the US\$) and also some part of the weakness in equity markets, which generally have been boosted by low US interest rates and global QE.

Further growth and policy divergence would likely reinforce these prior trends (US\$ strength, commodity price weakness), to the extent the US continued to raise interest rates. However, following the latest bout of global financial market volatility and some softer economic indicators of late, the markets have sharply marked down the prospects of further US interest rate increases this year. Now, the markets are ascribing only around a 50% chance of one further interest rate increase by the Federal Reserve over the next twelve months. This compares to NAB’s forecast of three further increases in 2016. Our forecast assumes markets stabilise and that much of the recent weakness in US activity indicators is transitory.

This pricing highlights the degree of negative sentiment currently permeating markets. Much will depend on whether the Chinese authorities can manage their growth transition without being forced to resort to a significant currency devaluation (note NAB expects only a moderate further RMB depreciation of 3.5% until 2017).

Our final global chart (chart 6), shows that despite the negative sentiment circling the world and markets at the present time, the unemployment rate in advanced nations continues to decline, though the same is unlikely to be true in emerging nations, especially oil producers. However, it’s generally the case that global recessions are sourced in the

Chart 6: Unemployment falling in advanced nations



main advanced economies, meaning current developments are encouraging from a medium-term perspective.

Implications for Australia

We have covered some of the implications for Australia above, noting that relative strength in the US economy, weakness in China and tighter US monetary policy relative to other major economies will tend to maintain downward pressure on the \$A and constrain commodity price upside. This should tend to support the import-competing sectors of the Australian economy and boost the incentive to export, while also keeping interest rates and bond yields relatively low. Commodity-producing regions will tend to experience weaker growth, relative to the non-mining sectors and regions of the Australian economy, with lower oil prices acting to support consumer spending.

This should contribute to the RBA keeping interest rates on hold, though the Bank is likely to face further challenge from the divergence in growth between WA and NSW (of course something that would be better tackled with fiscal policy).

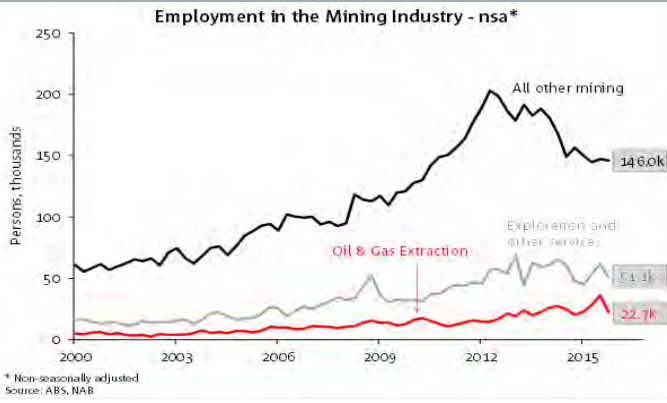
In our final charts, we take a look at how significant the hit to the Australian economy might be from the recent further fall in Oil & Gas prices. Chart 1 (on the front page) highlights that for the labour market, demand for new workers in the Oil & Gas sector has been adjusting for the past three years – and for other mining jobs for over three and a half years (the difference in timing reflecting the fact that coal and iron ore prices began falling well before oil prices).

The interesting part, however, is that these declines in job advertising are relatively well advanced and have not shown much further weakness in recent months, though some further decline in advertising is to be expected in coming months given recent future weakness in oil. The levels of job advertising in these sectors are, however, relatively low already, especially compared to total job advertisements in the non-mining sectors of the economy, mining job ads representing only around 1.5% of total job ads and oil and gas job ads an even smaller 0.2% of the total.

That said, even though job advertising does not seem to be dropping away significantly further, there is still the drag on total employment to come through in the next twelve or so months as major LNG projects complete. This could well be in the 30-40,000 range. Even still, our final chart notes, that

directly oil and gas extraction employs only 23,000 Australians, exploration and other services a further 50,000 and other mining around 146,000. This compares to total employment of nearly 12 million persons. Like the US, we suggest that the direct impacts of weaker oil prices will be relatively small and we must monitor the spill over effects to other sectors. Our final two charts show these are large in WA, but that a very different picture is unfolding in Australia's largest state economy (NSW, which is nearly a third of national GDP).

Chart 7: Mining and Oil & Gas relatively small



Key events this week

It's a relatively quiet week for Australian events, with the NAB business survey (Tuesday), Consumer Sentiment (Wednesday) and the RBA Governor's Semi-Annual Testimony on Friday, the key events.

ANZ job ads have already been released (+1% m/m), which so far allays one part of the RBA's watch list, suggesting for now that employment will continue to grow, though the ANZ data lags the SEEK data by a month (January SEEK data released Thursday 18 February).

It will also be important to watch Westpac Consumer Sentiment to try to gauge the extent to which consumers perceive they are benefiting from lower oil prices, given this should be an important offset to the negative impact flowing from the Oil & Gas sector. The Governor's semi-annual testimony is rarely market moving, but may provide some extra information as to the degree of the RBA's concerns on each of these topics.

Chart 8: WA job advertising: broad-based weakness

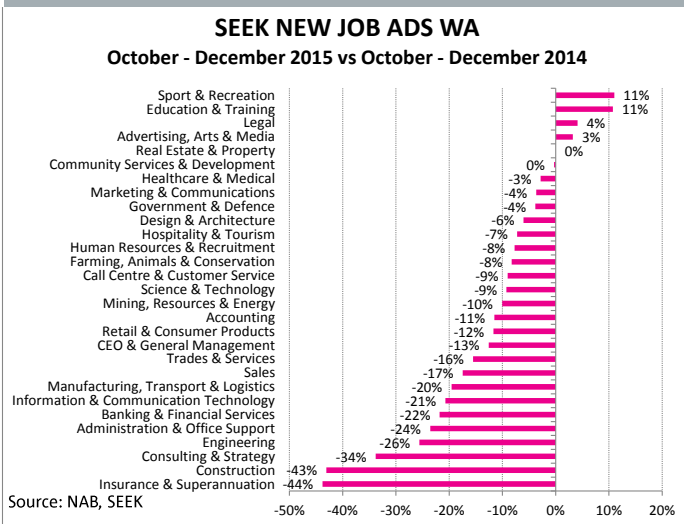
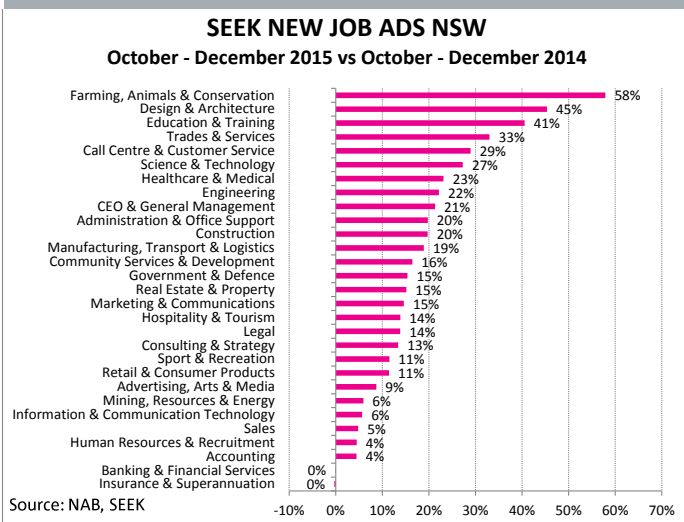


Chart 9: NSW job advertising: broad-based expansion



Calendar of Economic Releases

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEDT
Monday, 8 February 2016								
Asia	Lunar New year holidays this week							
NZ	Waitangi Day holiday							
JN	BoP Current Account Adjusted	Dec		1614.7		1423.5	23.50	10.50
AU	ANZ Job Advertisements MoM	Jan				-0.1	0.30	11.30
CH	Foreign Direct Investment YoY CNY (release from 8/2)	Jan		-2		-5.8	2.00	13.00
JN	Labor Cash Earnings YoY	Dec		0.5		0	1.30	12.30
JN	Eco Watchers Survey Current/Outlook	Jan		48.2		48.7/48.2	5.00	16.00
GE	Industrial Production SA MoM/YoY	Dec		0.5/-0.5		-0.3/0.1	7.00	18.00
EC	Sentix Investor Confidence	Feb				9.6	9.30	20.30
EC	ECB's Walter, Dutch CB's Sijbrand, Dijsselbloem speak						11.00	22.00
CA	Housing Starts/Building permits	Jan		185		172.965/-19.6	13.15	0.15
CA	Bloomberg Nanos Confidence	Feb 5				52.1	15.00	2.00
US	Labor Market Conditions Index Change	Jan				2.9	15.00	2.00
Tuesday, 9 February 2016								
NZ	ANZ Truckometer Heavy MoM	Jan				2.6	21.00	8.00
AU	ANZ Roy Morgan Weekly Consumer Confidence Index	Feb 7				111.2	22.30	9.30
NZ	QV House Prices YoY	Jan				14.2	23.00	10.00
AU	HIA New Home Sales MoM	Dec				-1.8	0.00	11.00
AU	NAB Business Conditions/Confidence	Jan				7/3	0.30	11.30
JN	Machine Tool Orders YoY	Jan P				-25.7	6.00	17.00
GE	Current Account Balance	Dec				24.7	7.00	18.00
FR	IEA Oil Market report	Feb					9.00	20.00
UK	Trade Balance	Dec		-2700		-3170	9.30	20.30
US	NFIB Small Business Optimism	Jan		94.5		95.2	11.00	22.00
US	JOLTS Job Openings	Dec				5431	15.00	2.00
US	Wholesale Inventories MoM	Dec		-0.1		-0.3	15.00	2.00
Wednesday, 10 February 2016								
NZ	Card Spending Retail MoM/YoY	Jan	0.3	0.3		-0.2/0.1	21.45	8.45
AU	Westpac Consumer Conf Index	Feb				97.3/-3.5	23.30	10.30
AU	HIA new home sales	Dec				-1.8	0.00	11.00
AU	NAB Commercial Property Survey	Q4					0.30	11.30
UK	Industrial Production MoM/YoY	Dec		0/1		-0.7/0.9	9.30	20.30
CH	Agg Financing CNY (these released from 10/2)	Jan		2300		1820		
CH	New Yuan Loans CNY	Jan		1865		597.8		
UK	NIESR GDP Estimate	Jan				0.6	15.00	2.00
US	Fed's Yellen to Appear Before House Financial Services Committee						15.00	2.00
US	Fed's Williams Speaks on Health and the Economy in LA						18.30	5.30
US	Monthly Budget Statement	Jan		10.1		-14.4	19.00	6.00
Thursday, 11 February 2016								
NZ	BusinessNZ Manufacturing PMI	Jan				56.7	21.30	8.30
AU	Consumer Inflation Expectation	Feb				3.6	0.00	11.00
UK	RICS House Price Balance	Jan				50	0.10	11.10
AU	NAB SME Business Survey	Q4					0.30	11.30
US	Initial Jobless Claims	Feb 6				285	13.30	0.30
CA	New Housing Price Index MoM	Dec				0.2	13.30	0.30
CA	New Housing Price Index YoY	Dec				1.6	13.30	0.30
US	Bloomberg Consumer Comfort	Feb 7				44.2	14.45	1.45
US	Fed's Yellen to Appear Before Senate Banking Committee						15.00	2.00
Friday, 12 February 2016								
NZ	Food Prices MoM	Jan	1.3			-0.8	21.45	8.45
AU	RBA Governor's appearance before the House of Representatives' Standing Committee on Economics						22.30	9.30
AU	Home Loans MoM	Dec	1.2	2.8		1.8	0.30	11.30
AU	Investment Lending	Dec				0.7	0.30	11.30
GE	CPI MoM/YoY	Jan F		-0.8/0.5		-0.8/0.5	7.00	18.00
GE	GDP QoQ/YoY	4Q P		0.3/1.4		0.3/1.7	7.00	18.00
EC	Industrial production MoM/YoY	Dec		0.3/-0.2		-0.7/1.1	10.00	21.00
EC	GDP QoQ/YoY	4Q A		0.3/		0.3/1.6	10.00	21.00
CA	Teranet/National Bank HPI MoM	Jan				-0.1	13.30	0.30
US	Retail sales MoM/ex autos and gas	Jan		0.1/0.3		-0.1/0	13.30	0.30
US	Import prices MoM/YoY	Jan		-1.5/-6.8		-1.2/-8.2	13.30	0.30
US	Business Inventories	Dec		0.2		-0.2	15.00	2.00
US	U. of Mich. Sentiment	Feb P		92.5		92	15.00	2.00
US	U. of Mich. 5-10 Yr Inflation	Feb P				2.7	15.00	2.00
Upcoming Central Bank Interest Rate Announcements								
Australia, RBA		1-Mar	2.00%	2.00%		2.00%		
New Zealand, RBNZ		10-Mar	2.50%	2.50%		2.50%		
Europe ECB		10-Mar				0.05%		
Canada, BoC		10-Mar				0.50%		
Japan, BoJ		15-Mar	-0.1% to +0.1%	-0.1% to +0.1%		-0.1% to +0.1%		
UK BOE		17-Mar				0.50%		
US Federal Reserve		17-Mar				0.25-0.50%		

GMT: Greenwich Mean Time; AEDT: Australian Eastern Daylight Saving Time

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