# March 2016

# The Bigger Picture – A Global & Australian Economic Perspective

***<u>Global</u>: We are not expecting any acceleration in global growth in 2016 - with another year of growth a touch below 3% (very sub trend). We have modestly cut our 2016 growth numbers to take account of a deeper than expected recession in Brazil. Nevertheless, a combination of factors continues to underpin our view that we will see downbeat but continuing growth. However, further periods of market volatility are a possibility and hence downside risks to our forecasts. Sustainably faster growth requires serious reforms (for which there appears little appetite). In the near term Australian MTP growth is likely to remain around 4¼%.***

- Financial markets have either stabilised or recovered some of their losses after a very shaky start to the year. Share markets in the big advanced economies have recovered around half their losses but remain over 5% below their end 2015 levels. Chinese share prices have also stabilised, although the market remains skittish. Financial market volatility has subsided back to its end 2015 level and the credit spreads on high yield corporate bonds, while still wider than before the latest round of market jitters, have stabilised and are well below GFC levels. Commodity markets have also stabilised after a long period of decline. Low commodity prices have played an important role in dragging down advanced economy inflation which - along with monetary policy still aimed at supporting demand and lifting inflation expectations – has underpinned very low interest rates. Policy rates remain near zero, interbank rates are historically low (some are even negative) and government bond yields are similarly low by historical standards. Many bonds in Japan and Germany now trade on negative yields, key policy deposit rates in Japan and several European countries are similarly negative.
- End 2015 growth was disappointing in the big advanced economies, slowing to less than half the rate averaged in the previous four quarters. This disappointing outcome was broadly based with US growth halving (albeit that is likely to be temporary), the Japanese economy recording a big fall in output and the Euro-zone's growth stagnated at 0.3%, despite buoyant business surveys readings in the latter half of last year. The outcome has been persistent double digit unemployment in the Euro-zone, whereas ageing has produced stagnation in Japan's labour force. It is not only the recovery in the volume of G7 Advanced Economy output that has been lack-lustre, inflation has run well below forecasts and targets, further dragged down by lower commodity prices. Consequently, nominal (money value of) economic growth has also been soft. Although growth should bounce back in both the US and Japan in early 2016, business surveys are not pointing to an acceleration in the underlying pace of growth. The surveys are consistent with manufacturing growth crawling along very slowly and moderate expansion in services.
- The trend slowdown in emerging market growth continued through to the end of 2015, while export volumes and industrial output were even weaker. Current growth rates are well below what has been experienced in the last 20 years with the exception of the GFC. The softening in emerging market economies has been broad based. The two biggest emerging economies of China and India saw modest slowdowns through late last year. Russia (the world's 6th biggest economy) was already in deep recession by mid-2015, and Brazil (the 7th biggest) is experiencing an exceptionally deep recession. Elsewhere growth is generally lacklustre with emerging Asia excluding China (which contains many of Australia and New Zealand's biggest trading partners) growing at 3¼% yoy in the latter half of last year, a modest rate by its historical standards. The emerging markets were hit by a perfect storm in 2015 as they faced a combination of slumping commodity prices, slow growth in world trade volumes, expectations of rising US interest rates and an outflow of capital back to the big financial centres. These shocks followed a period in which corporates across several emerging market countries had geared up to expand operations.
- We are not expecting any acceleration in global growth in 2016 with another year of growth around 3%, well below trend. Neither the business surveys nor our tracking model are pointing to an imminent lift in the pace of output expansion, if anything the trend is still a gradual loss of momentum through early 2016. Hard data and business surveys from late 2015 and the opening months of this year are still proving disappointing and we have modestly cut our 2016 growth numbers to take account of a deeper than expected recession in Brazil. Regarding the emerging markets specifically, we are expecting 2016 to be another difficult year with no pick-up in growth and the acceleration predicted for 2017 reflects the forecast ending of recession in Brazil rather than a marked pick-up in activity.

***<u>Australia</u>: The recovery across the non-mining economy remains on track – confirmed by both the Q4 National Accounts and the NAB Business Survey – despite elevated risks. The rotation towards services activity continues, supporting the labour market, but weak national income and wages growth will continue to cap household consumption growth. Overall, real GDP forecasts are largely unchanged, with growth picking up in 2016 and 2017 (see below), but losing momentum in 2018. The unemployment rate will ease gradually to just above 5½% by end-16 and then remain broadly steady. Domestic conditions suggest the RBA is very much on hold but retains an easing bias amidst global risks.***

- The NAB Monthly Business Survey recorded a rebound in business conditions in February, suggesting the non-mining recovery has not wavered. Business conditions hit a level that is well above the long-run average, more than unwinding the decline from last month which was primarily driven by Australia's mining states. All three components of conditions (trade, profit and employment) improved during the month. Forward indicators including capacity utilisation and forward orders also lifted to above-average levels. Business confidence did not appear to reap the benefits of higher conditions, but has remained encouragingly resilient in light of global volatility and concerns over emerging markets.
- Q4 GDP figures provided further evidence of the resilience of the Australian economy amidst an uncertain global backdrop and weak commodity prices. Both the headline figures (0.6% q/q and 3.0% y/y) and the compositional detail were encouraging. Household consumption was solid despite subdued wages, corporate profits were higher despite the lower terms of trade and business investment did not fall as sharply as expected (implying some growth in non-mining investment). Meanwhile, the rotation towards non-mining sectors continued. Indeed, our estimate of non-mining GDP is now running at above its long-run average in year-ended terms at around 4%.
- Employment was softer in January, but growth was solid in trend terms at close to 20k a month, exceeding the 14 to 15k needed to keep the unemployment rate constant. Despite the loss in momentum in January, measures such as the employment to population ratio and the participation rate continue to suggest solid underlying conditions. Meanwhile, the NAB Survey employment index points to employment gains (of 15k per month), sufficient to see unemployment stabilize and edge down over the course of 2016 - we still forecast the unemployment rate easing to 5.6% by end-16. That said, the magnitude of gains in H2 imply some possibility of "statistical payback" in employment in coming months. If that were to occur, we (and the RBA) would be careful in interpretation, and be cross-checking against other indicators of the labour market and non-mining activity.
- Household consumption growth was solid in the Q4, supported by employment growth over 2015. That said, slow growth in household income meant consumption was assisted by a decline in the household savings rate, which fell to 7.6% in Q3 – the lowest since the GFC. The fundamentals for consumption are mixed. Amidst subdued expectations for growth in income and wealth, we expect moderate consumer spending growth through to 2018, driven by a gradual decline in the household savings rate.
- Housing market activity ha picked up following the summer break. Auction clearance rates have increased sharply in recent weeks, although remain below year ago levels in Sydney and Melbourne, supporting our view of a more subdued market in 2016. That said, dwelling prices in Sydney rose in the past two months – albeit still below recent highs – with similar trends seen in Melbourne. Prices have also risen across most other capital cities except Perth. We still expect a considerable moderation in property price growth in 2016 – reflecting softening fundamentals and restrictions on investor credit.
- Business investment fell in Q4, but not as much as expected. Unsurprisingly, the ABS's Capex Survey suggested a further contraction in mining investment plans in 2016-17, but the lack of any pick up in non-mining investment intentions was disappointing, with firms actually cutting back for next year. Nevertheless, alternative indicators are generally more upbeat. Capex expectations for the next 12 months in the NAB Business Survey improved in Q4, while capacity utilisation in the monthly NAB Survey improved notably in February. Overall, we remain hopeful that non-mining investment will improve gradually. Dwelling investment was solid in Q4, and the record high construction pipeline suggests a positive (though smaller) contribution to growth will continue – although the cooling housing market has stemmed the flow of new projects.
- Net exports disappointed in Q4, but a lift in LNG was apparent. Going forward, export volumes will continue to ramp up on the back of strong LNG exports, while imports will accelerate but at rates of growth much slower than exports. Commodity markets have stabilised somewhat after recording big falls until recently, but further (more moderate) falls in the terms of trade are expected.
- We continue to expect real GDP growth of 2.7% in 2016, followed by 2.9% in 2017. There will however be some slowing into 2018 as the contribution from LNG exports dissipates and the dwelling construction cycle starts to unwind. The unemployment rate is forecast to drift down to 5.6% by end-16 and to 5.5% in 2017 before ticking back up in 2018. Domestic conditions suggest the RBA is very much on hold but retains an easing bias amidst global risks.

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