Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- Global share markets have regained much of their early 2016 losses, financial market volatility has subsided and both commodity prices and the Chinese currency have stabilised – helping to reduce the risk of a renewed downturn in global economic activity. However the backdrop to these market movements remains one of very sluggish sub-trend growth, inflation that is below target in major economies, difficulty in increasing revenue as margins are sacrificed to win modest volume gains, slow wage growth cramping spending increases, high levels of debt and central banks that have used up much of their policy ammunition. Despite the many risks, we still think global growth will muddle through 2016 at around the 3% rate seen last year but it could be a bumpy ride with plenty of further scope for volatility, reflecting the numerous triggers for further bouts of market jitters.
- In Australia, recent business survey outcomes suggest the recovery across the non-mining economy is on track or indeed gathering speed. While the downturn in mining regions (especially WA) is becoming more pronounced and the global backdrop remains challenging, activity appears to be broadening across non-mining sectors and states. Overall, our real GDP forecasts are broadly unchanged at 2.7% in 2016 and 3.0% in 2017, before easing to 2.5% in 2018 as the large contribution from net exports dissipates. The unemployment rate is forecast to fall to 5.6% by end-16, ease a touch further to 5.5% by end-17 before ticking up in 2018. While recent AUD appreciation presents a downside risk to economic activity, we doubt whether this move higher will be sustained and expect the downward trend to resume as the year progresses. Meanwhile, we retain our view that the RBA will remain on hold through 2016, although this will depend on the path of the currency, inflation and whether the labour market continues to improve as anticipated. Lower than target inflation in conjunction with an AUD above 80 US cents and any evidence of a faltering non-mining recovery would quickly see further rate cut(s).

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2014	2015	2016	2017
United States	16	2.4	2.4	2.2	2.3
Euro-zone	12	0.9	1.5	1.6	1.7
Japan	4	-0.1	0.5	0.5	0.8
China	16	7.3	6.9	6.7	6.5
Emerging East Asia	8	4.1	3.5	3.5	3.7
New Zealand	0.2	3.7	2.5	2.4	2.5
Global total	100	3.3	2.9	2.9	3.2
Australia	2	2.6	2.5	2.7	3.0
Australia (*fiscal years*)		14/15	15/16	16/17	17/18
Private consumption		2.7	2.9	2.9	2.3
Domestic demand		0.8	1.0	1.0	1.1
GDP		2.2	2.8	2.8	2.8
Core CPI (*% through-year*)		2.2	2.0	2.0	2.6
Unemployment rate (*% end of year*)		5.9	5.8	5.8	5.5

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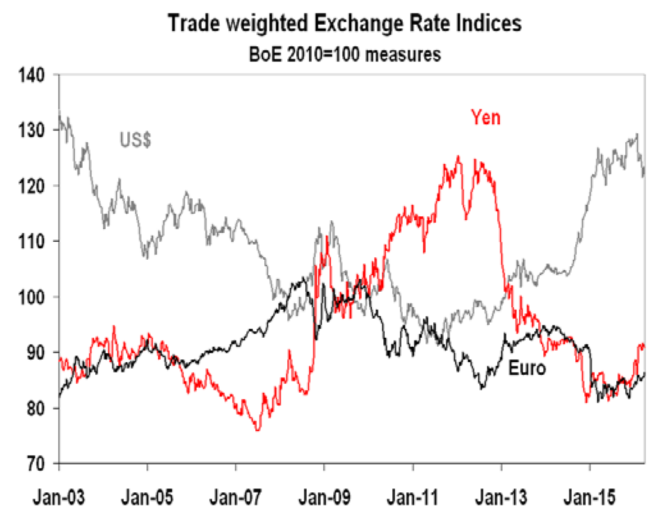
Global and Australian overview

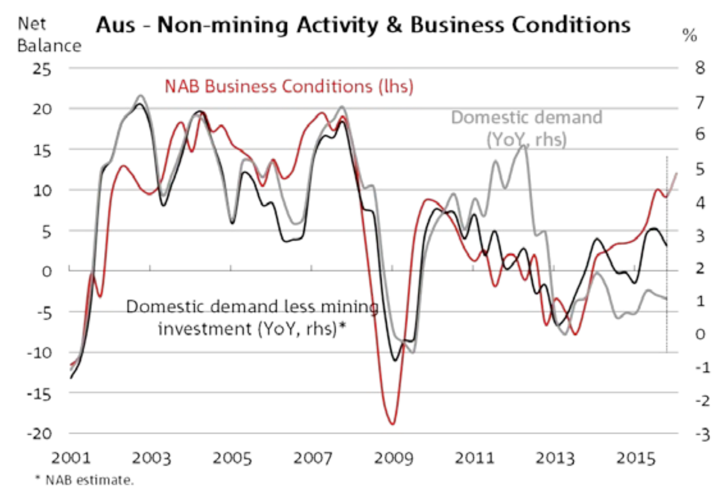
Global overview

- Global equity markets have recovered some of their early 2016 losses and volatility has fallen considerably, commodity markets have stabilised with increases in a few key products and sentiment has generally improved after a very shaky start to the year. The $US has reversed some of its sizeable gains against other key currencies as markets expect the Fed to be even more cautious in lifting US policy rates and further easing of monetary policy in both Japan and the Euro-zone (involving negative rates and even more central bank asset buying) has failed to lower either the yen or euro.
- Behind these market fluctuations lies a global economy that is still growing below trend and where there is no shortage of risks. Many problems are now concentrated in formerly fast growing emerging economies facing a world of low commodity prices, minimal trade volume growth and capital flowing back to the big centres. Persistently sub-target inflation and sub-trend growth highlights the key problem facing many global businesses – revenue growth is very hard to get as tough competition forces sacrifices in margins to gain even modest increases in volumes and the same lack of growth in incomes and revenues ensures that debt stocks and asset prices look set to remain high relative to income, adding to risks.



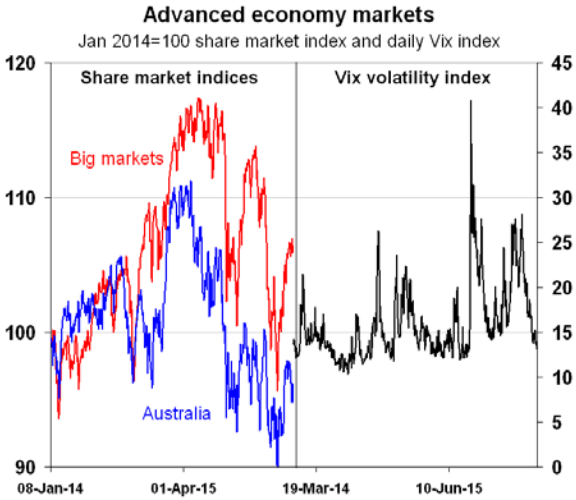
Australian overview

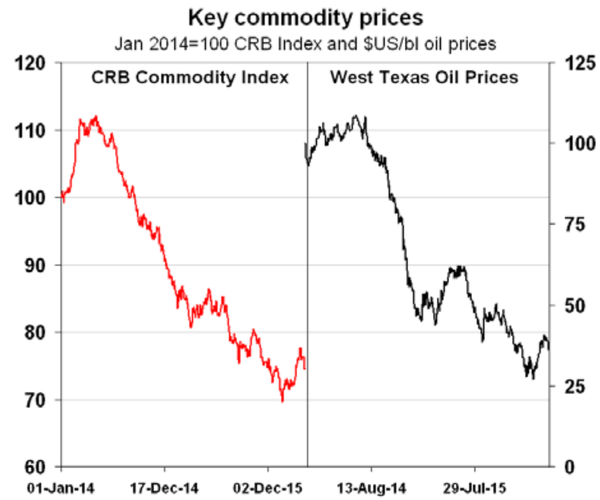
- Despite some loss of momentum in high-frequency indicators such as business conditions, retail sales and employment in early 2016, the latest business survey outcome for March suggests this lull was temporary. As such, we retain our expectation that the non-mining economy will continue to recover through 2016, supporting domestic demand, while net exports contribute strongly to growth on the back of LNG export volumes and services exports.
- That said, the divergence in growth outcomes across geographies is becoming more apparent, with a range of activity and labour market indicators strongly negative in Western Australia. Meanwhile, business conditions in NSW and Victoria have returned to recent highs, and data for Queensland (while mixed) suggests strength in tourism and property-related sectors is offsetting weakness in regions affected by the mining-investment downturn.
- We continue to expect real GDP growth of 2.7% in 2016, followed by 3.0% in 2017. Growth will then start to slow in 2018 as net exports contribute less to growth and the dwelling construction cycle turns. We continue to expect the unemployment rate to drift down to 5.6% by end-16 and to 5.5% in 2017 before ticking back up in 2018. We have tweaked our AUD forecasts for 2016, with the currency to now hit a low of 69 US cents in late 2016.
- We expect monetary policy to remain on hold in Australia, although the outlook does appear more data dependant. In particular, the RBA has highlighted that the recent AUD appreciation (if sustained) is a complication, and is giving itself some wiggle room by flagging that it is looking for further labour market improvement, and is watching inflation a little more closely.

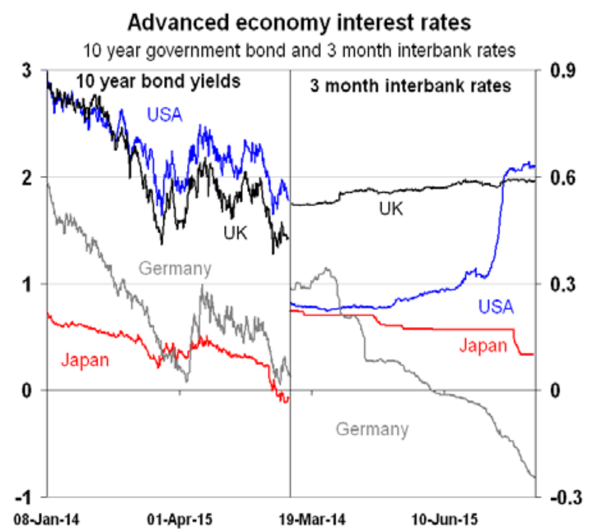


Financial and commodity markets

- While the Australian share market has languished, equity markets in the main N. Hemisphere advanced economies have regained around two-thirds of the losses they experienced in the opening 6 weeks of the year. The rising US market has driven much of that price lift; other big markets like Japan and the UK have been weighed down by domestic concerns. Improved market sentiment has also underpinned subsiding financial market volatility with the Vix index back around the low levels recorded through the first half of last year. The falling trend in global commodity markets has also been arrested with some increase in key prices like oil and iron ore.
- Volatility in the Chinese equity and currency markets alongside uncertainty over government policies toward deregulation and currency setting drove big “risk-off” phases of global market weakness seen in the last year. Currency appreciation led to a 30% loss in Chinese competitiveness since 2010 and large parts of its industrial sector would benefit from a lower currency. Against that, the Chinese stress that they have large reserves and are not planning a big depreciation of the RMB- which could trigger “currency wars” of competitive currency devaluation across Asia and add to deflationary pressures across the world. The recent stabilisation in the RMB and an ending in the downward trend in share prices have done much to settle sentiment in global markets.
- Interest rates remain exceptionally low, pulled down by the below target inflation and weak growth in many advanced economies which has driven several central banks to run negative interest rates and asset buying programmes. The US is the only big economy facing imminent rate rises, the others are either still in easing mode or likely to wait a long time before lifting policy rates.

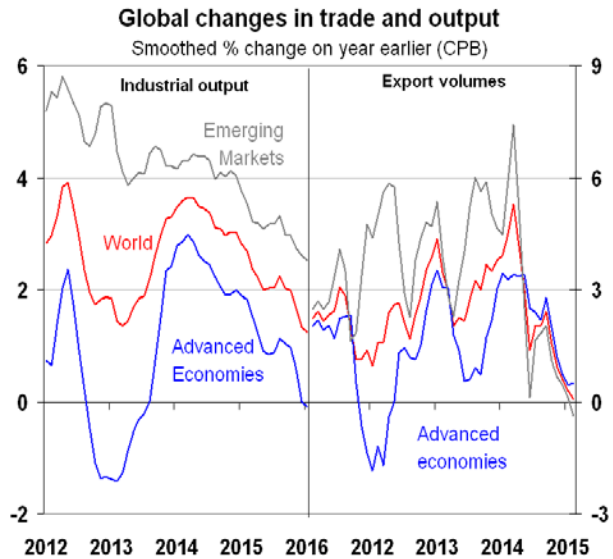


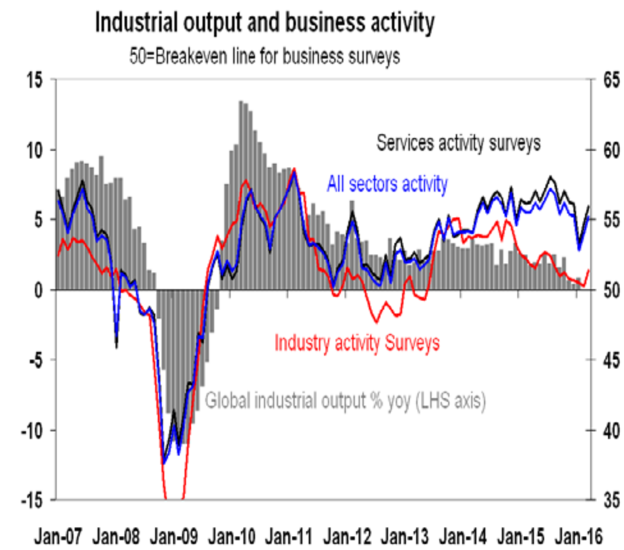


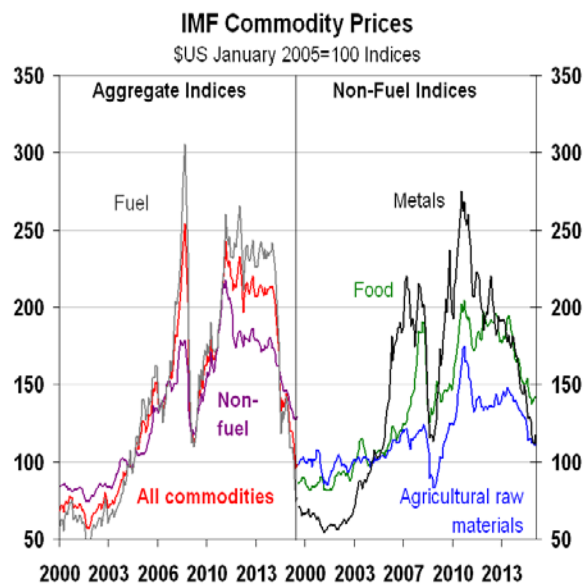


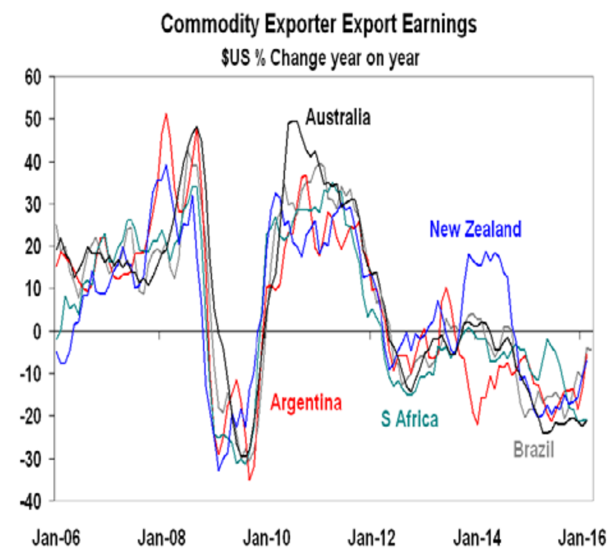
Global Economic Trends

- While financial and commodity markets have settled down and recovered some losses, the background is still one of subdued global growth. World industrial output was only growing by around 1% yoy in early 2016, well below its long run trend, with output essentially flat in the big advanced economies and still trending down in the emerging markets. The record for world trade was even weaker with flat exports, well short of the 5% yoy trend, due to persistently weak shipments out of the emerging markets.
- While the hard data on global industrial output and trade volumes remains subdued overall, the pace of growth in the much larger and less well measured services sector has generally been better. Business surveys generally provide the only timely measures of how well firms in the services sector are faring and the answer is “much better than in manufacturing”. Service sector responses to business surveys in the big advanced economies have been far more upbeat than for industry through the last few years. Service sector activity growth has also easily outstripped industrial growth in China (the world’s biggest economy) and India (number 3).
- While the limited hard data on output etc in the early months of the year has remained soft, there has been a lift in the business surveys – especially for March month. While that only represents one month of data and it is too early to identify a turning point, the latest surveys are certainly an improvement on what has been seen recently.
- Commodity exporting countries – particularly the oil exporters – have been hard hit by the sharp downturn in primary product prices. National incomes have fallen and budget positions have worsened but prices have stopped falling recently.



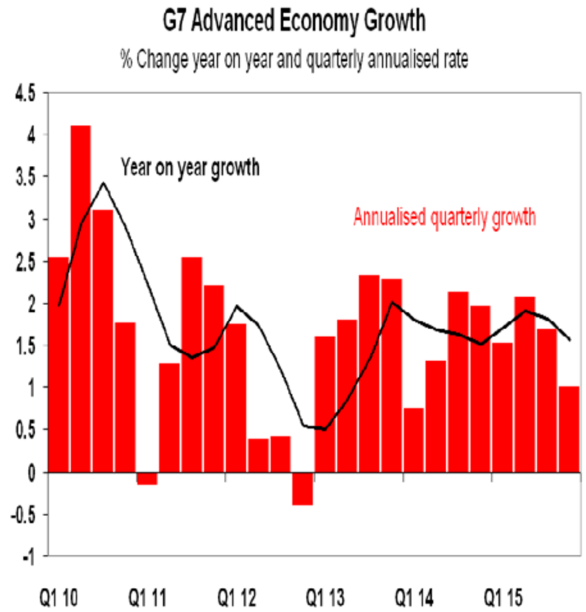


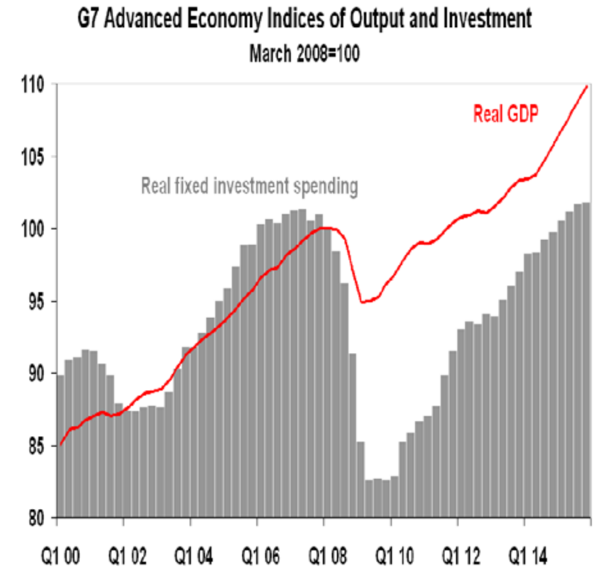


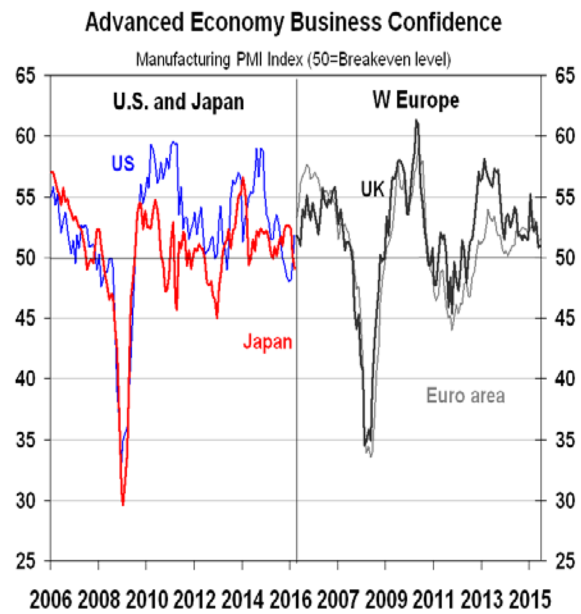


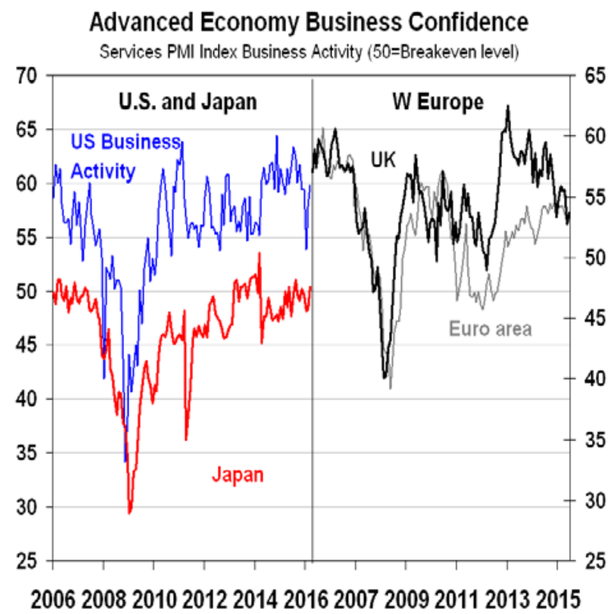
Advanced Economies

- A combination of very low interest rates, a winding back in budgetary retrenchment and lower oil prices would normally have been expected to result in a solid pace of growth in the big advanced economies. In the event, the outcome has been disappointing with growth in the G7 group of big advanced economies actually slowing through most of 2015 and not much sign of an upturn in early 2016.
- Lower oil prices boost effective incomes in most advanced economies as they are net oil importers but the increase in spending power has lead to less of an upturn in actual consumption than expected. The volume of consumer spending rose by only 0.3% in the final quarter of 2015, barely half the pace of the previous two quarters and retail trade measures for the first two months of this year do not show much, if any, upturn.
- Business investment has also stayed lacklustre in the biggest advanced economies with the volume of G7 capital spending in the latter half of 2015 less than 2% above its early 2008 level and not much sign of acceleration since then. While lower oil prices have not delivered as much benefit as expected via higher consumption, they have certainly eroded business investment in the energy sector and that has hit the aggregate numbers.
- The latest business surveys are consistent with continued modest growth in the big advanced economies, driven by a bounce-back in US activity alongside some disappointing numbers in Western Europe and Japan. The US has been the stand-out performer among the big economies, Canada has been hit by lower energy prices, Japan has struggled to recover from the rise in indirect taxes and Brexit hangs over the UK. Euro-zone growth looks better based, despite a higher euro/$US.



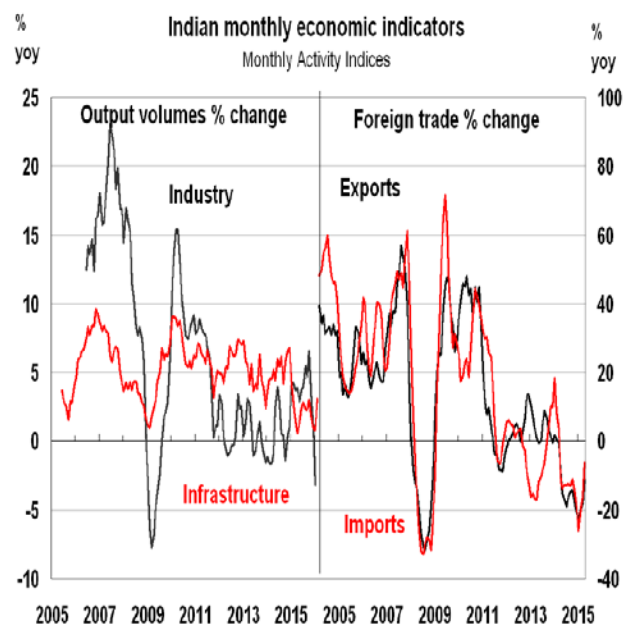






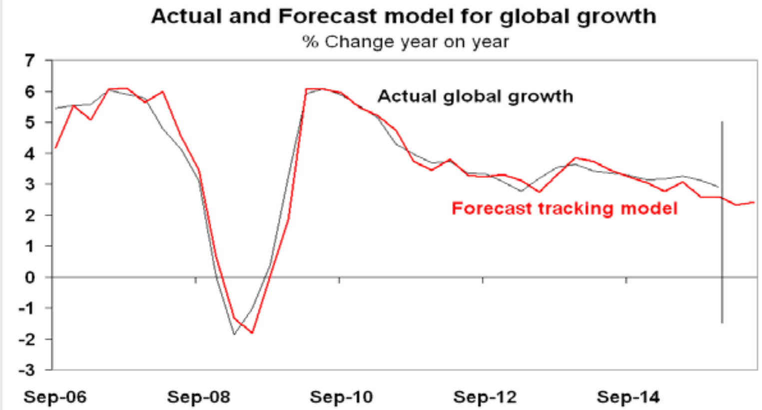
Emerging Market Economies

- Most global growth occurs in the emerging economies, especially China and India which have accounted for over half of all of the expansion in output through the last few years. Chinese growth has continued its slowing trend with industrial growth down to 5.4% yoy in early 2016, a rate last recorded in the 2008 global financial crisis. The big state owned firms have borne the brunt of the slowdown with their output actually falling below year earlier levels in early 2016. Investment growth has settled around 10% with retail sales volume expansion running at a similar pace.
- Weakness is concentrated in the industrial sector, accounting for around 40% of the Chinese economy, maybe a quarter of global manufacturing and around half of global metal processing. Sales growth has virtually stopped in Chinese industry as falling output prices offset continued volume growth. This absence of growth in sales represents more than just the pass-through of lower commodity input prices, it reflects fierce competition driven by over-capacity that has meant volume growth has often come at the expense of squeezed margins and lower profits.
- Elsewhere among the big emerging economies, India has become the fastest growing big economy and recent central bank rate cuts and other measures should supplement the benefit of lower oil import prices to sustain growth. Brazil (the 7th biggest global economy) is still mired in recession and political uncertainty. Across the rest of East Asia and Latin America growth remains lacklustre and region-wide measures of both industrial output and $US exports are running below year-earlier levels. Export driven economies like Taiwan and Malaysia and commodity reliant nations in the Middle East, Africa and Latin America are the most affected by the sluggish global economic environment.



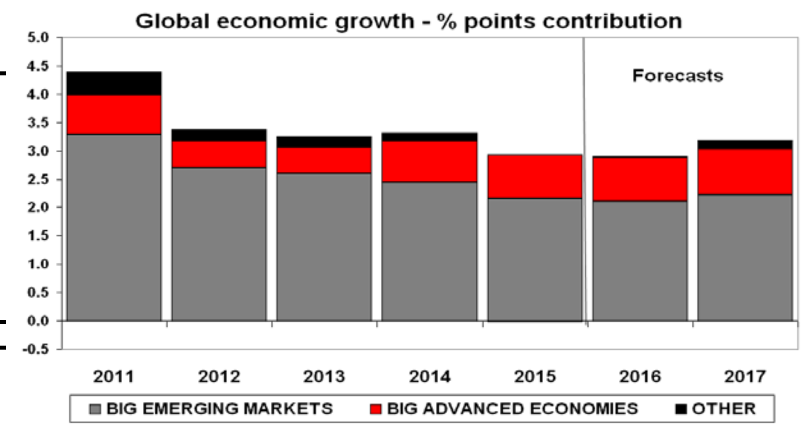
Global forecasts and policies

- While the improved tone in global markets is welcome news that reduces the risk of a new slowdown in the global economy, sub-trend growth is expected to continue with the pace of global expansion remaining around 3% in 2016. March global business surveys are finally showing a lift in activity but it is too early to be sure that the better performance will be sustained and our tracking models are not pointing to any significant imminent upturn in the pace of expansion.
- With many central banks having already run their policy lending rates down to around zero, further support from monetary policy for the global economy increasingly relies on less reliable and often untested “unconventional” approaches like negative deposit interest rates. Further measures like “helicopter money” (where central banks print money and transfer it to governments or individuals to spend) are even being mentioned as a potential last resort for monetary policy. With many governments having already ramped up their debt during the global financial crisis, they are also constrained in lifting spending or cutting taxes to lift activity.
- As the scope to use standard macro-economic policy to lift growth or stave off any new downturn has dwindled, agencies like the IMF have become increasingly vocal about the need to lift the pace of economic reform – involving not just further supply side measures to give incentives to produce more but also demand side measures to make sure that the income derived from growth goes to people who will spend it on goods and services, helping drive both activity and inflation higher.



Global growth forecasts % change year on year

	2011	2012	2013	2014	2015	*NAB Forecasts* 2016	2017
US	1.6	2.2	1.5	2.4	2.4	2.2	2.3
Euro-zone	1.6	-0.8	-0.3	0.9	1.5	1.6	1.7
Japan	-0.4	1.7	1.4	-0.1	0.5	0.5	0.8
UK	2.0	1.2	2.2	2.9	2.3	2.2	2.2
Canada	3.1	1.7	2.2	2.5	1.2	1.4	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	2.6	2.6	0.9	-0.6	-0.8	1.0
Emerging East Asia	4.4	4.6	4.2	4.1	3.5	3.5	3.7
New Zealand	1.8	2.4	2.4	3.7	2.5	2.4	2.5
World	*4.4*	*3.4*	*3.3*	*3.3*	*2.9*	*2.9*	*3.2*
memo							
Advanced Economies	1.7	1.2	1.2	1.8	1.9	1.9	2.0
Big Emerging Economies	7.0	5.4	5.6	5.1	4.4	4.3	4.7
Major trading partners	4.7	4.3	4.2	4.1	3.8	3.7	3.8



Australian outlook

- **The forces shaping the economic outlook are broadly unchanged.** The economy is transitioning away from mining investment towards non-mining sources of growth. This is particularly challenging at a time in which our largest trading partner is experiencing a slowdown in industrial output, and commodity prices are low, which will weigh on national income, corporate profits, and government revenue.
- But while the downturn in mining appears to be deepening(as reflected in very poor recent economic outcomes in WA), **the recovery across the non-mining economy remains on track or could be accelerating further. Business conditions in March increased to the highest level since early 2008,** with trading conditions, profitability and employment all strong. Business conditions are now above-average conditions in most industries - service industries remain the best performers, although construction also closed the gap in March, manufacturing is looking more upbeat, and transport appears to be responding positively to lower fuel prices. Retail however, appears to be losing some momentum.
- **Based on incoming information, we have modestly revised our GDP forecasts to 2.7% in 2016 and 3.0% in 2017, followed by an easing to 2.5% in 2018. Our forecast continues to envisage weak domestic demand, and a large contribution from net exports** – mostly from resource exports as well as tourism and other services exports. Domestic demand remains subdued - the mining investment adjustment is about half way through and government spending is limited. Consumer spending is expected to grow at slightly below average rates, although remains dependant on further easing in the household savings rate as household income growth remains weak owing to slow wages growth. The forecasts contain some contribution from dwelling investment in 2016 before the cycle turns in mid-2017, although this is offset by slightly less weak business investment into 2017 and 2018.
- **We continue to expect the RBA to remain on hold for a considerable period. That said, the outlook will depend on how the data fall, with the central bank seemingly allowing itself some room to move**. In particular, the RBA has flagged the recent strength of the AUD as a complication to the non-mining recovery, re-emphasised the inflation outlook following its latest decision and has repeated that it is watching for further evidence of "improvement" in labour market conditions, with the implication that a stabilisation or deterioration in the unemployment rate would be unwelcome.

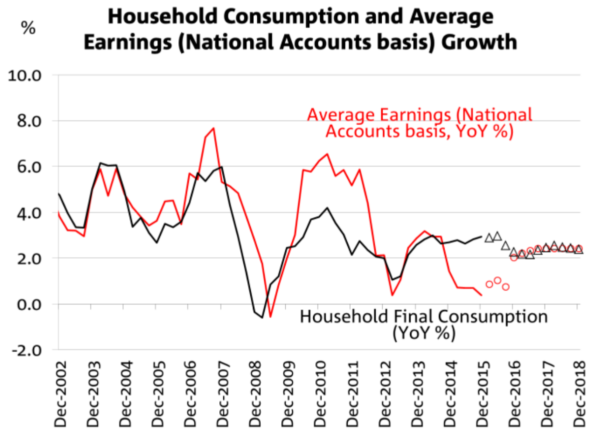
Australian economic and financial forecasts (a)

	Fiscal Year			Calendar Year			
	2015-16 F	2016-17 F	2017-18 F	2015	2016-F	2017-F	2018-F
Private Consumption	2.9	2.3	2.5	2.8	2.7	2.3	2.5
Dwelling Investment	8.5	2.2	-1.9	9.5	5.4	-0.6	-2.6
Underlying Business Investment	-11.9	-7.8	-2.9	-10.1	-9.6	-6.4	1.0
Underlying Public Final Demand	2.5	2.3	2.6	1.9	2.0	2.5	2.6
Domestic Demand	**1.0**	**1.1**	**1.6**	**1.0**	**1.1**	**1.2**	**2.0**
Stocks (b)	0.0	0.1	0.0	0.0	0.1	0.1	0.1
GNE	**1.0**	**1.2**	**1.6**	**1.1**	**1.2**	**1.2**	**2.0**
Exports	6.5	9.2	8.0	6.1	7.4	9.7	5.8
Imports	-0.5	1.4	3.3	1.0	0.0	2.0	4.3
GDP	**2.8**	**2.8**	**2.8**	**2.5**	**2.7**	**3.0**	**2.5**
– Non-Farm GDP	2.9	2.9	2.8	2.5	2.8	3.0	2.5
– Farm GDP	-2.6	0.4	2.0	0.3	-2.3	1.6	2.0
Nominal GDP	2.7	4.5	4.6	1.8	3.5	4.8	4.5
Federal Budget Deficit: ($b)	-37	-34	-23	NA	NA	NA	NA
Current Account Deficit ($b)	82	71	69	75	79	68	72
(-%) of GDP	5.0	4.1	3.8	4.6	4.7	3.9	3.9
Employment	2.5	2.2	2.0	2.0	2.3	2.1	1.9
Terms of Trade	-10.4	-3.4	-3.1	-11.4	-7.0	-3.1	-1.9
Average Earnings (Nat. Accts. Basis)	0.7	1.8	2.4	0.6	1.2	2.3	2.4
End of Period							
Total CPI	1.7	3.1	2.4	1.7	2.7	2.5	2.2
Core CPI	2.0	2.6	2.4	2.0	2.5	2.5	2.3
Unemployment Rate	5.8	5.5	5.5	5.9	5.6	5.5	5.6
RBA Cash Rate	2.00	2.50	3.50	2.00	2.00	3.00	3.50
10 Year Govt. Bonds	3.00	3.55	3.45	2.88	3.25	3.55	3.65
$A/US cents :	0.74	0.70	0.75	0.73	0.69	0.73	0.76
$A - Trade Weighted Index	63.6	61.2	63.8	62.7	60.5	62.9	64.1

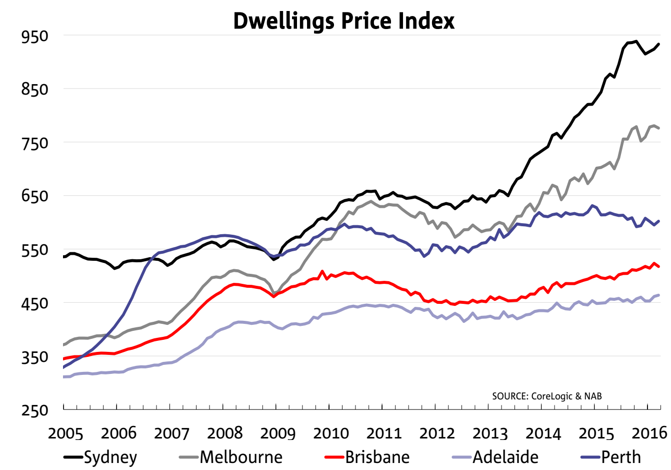
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.
(b) Contribution to GDP growth

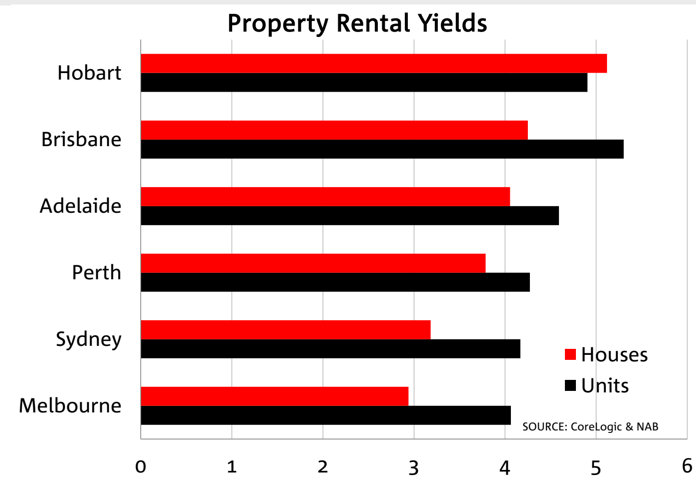
Australian consumer demand and housing market

- Strong employment over 2015 appeared to have supported household consumption in H2 2015, which grew at a robust average rate of 0.8% per quarter (or 2.9% y/y) despite falling wages growth. Meanwhile, the effects of a "two-speed" Australian economy have become more apparent in the more frequent data on retail spending, with a growing drag from weakness in WA -- of which growth has declined in trend terms for the third consecutive month in February. Meanwhile, retail spending growth in NSW and Victoria, while still positive, also lost some momentum in the first two months of 2016. ABS retail turnover growth for February was flat (0.0% m/m, 3.3% y/y) to be below the trend seen in 2015. The slowing momentum in the retail sector is also demonstrated by the monthly NAB Business Survey, which has showed a downward trend in retail business conditions since late 2015 to be around the neutral mark in March. Meanwhile, NAB's Online Retail Sales Index for February recorded a 0.8% m/m (10.4% y/y) rise in online spending. According to NAB's estimates, online retail was equivalent to only 6.6% of total spending at traditional bricks & mortar retailers as measured by the ABS in the 12 months to January 2016.
- The fundamentals for household consumption are mixed amidst solid employment growth but subdued wages. A decline in the household savings ratio remains necessary to satisfy our moderate household consumption forecasts.
- The housing market was once again a mixed bag in March, with prices in the two largest markets (Sydney and Melbourne) diverging. Dwelling prices in Sydney managed to defy our expectation for further softening, increasing around 1% in the month, led by house prices. In contrast, prices in Melbourne fell by a little more than ½% (both houses and units down), which was broadly as expected in light of growing housing supply and worsening affordability – although annual growth remains faster than any other capital city. But while Sydney 'hedonic' prices continued to rise, the median prices – the prices paid by punters in the market – actually fell further. In fact, median house prices in Sydney are now more than 14% below last years' high and unit prices are 5% lower, although there may be an element of seasonality in these prices. Rental yields in Melbourne and Sydney are also extremely low, although this is consistent with low returns across other asset classes – the rental yield spread to term deposit rates is actually well above the 10 year average for both cities. Elsewhere, Brisbane prices were disappointing, falling in March despite recent optimism in the NAB Residential Property Survey. Housing credit growth remained at 0.5% in February, with owner occupier loans holding up, while investor loans posted a surprising rebound.
- We have maintained our expectation for the housing market to cool in 2016/17 - despite better than expected price growth in some capital cities over Q1 2016 - given softening fundamentals (especially for apartments) in the Sydney and Melbourne markets. Additionally, the ongoing drag from mining employment will continue to weigh on markets in mining-affected regions (including Perth). Restrictions on investors and uncertainty over potential policy changes are additional considerations. House price growth is expected to slow in 2016 (to 1½%), but expectations for unit prices are weaker (-1%).



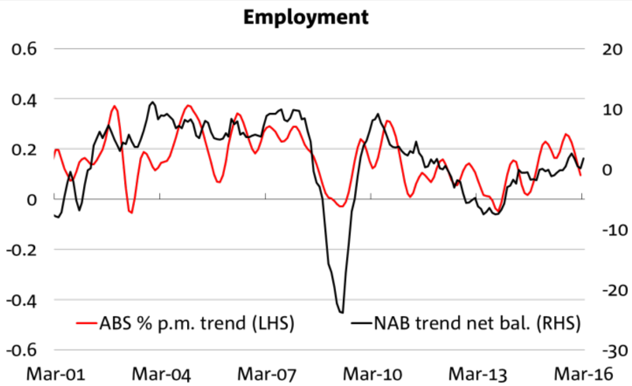
Source: ABS, NAB Group Economics



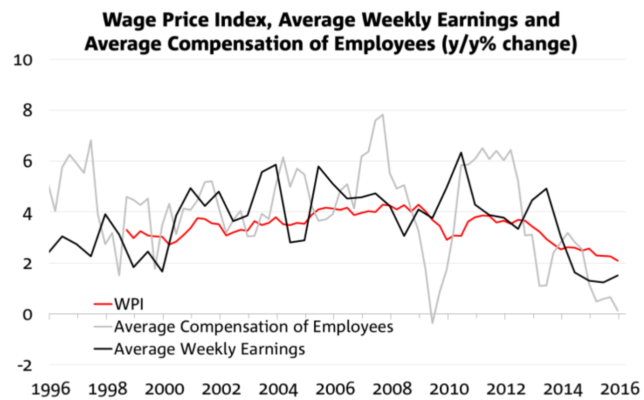


Australian labour market

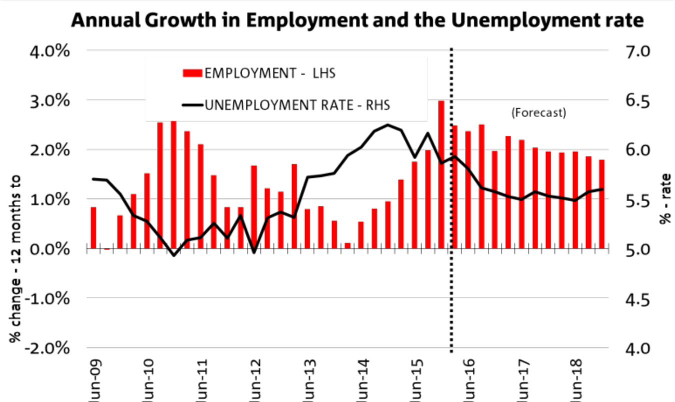
- In February, employment grew only modestly (+0.3k in seasonally-adjusted terms compared to market expectations of +13.5k). However, the unemployment rate (seasonally adjusted) fell in the month to 5.8% on a lower participation rate. Despite the loss in momentum of jobs' growth, this followed exceptionally strong employment numbers in late 2015. Other indicators of labour market health, such as the employment to population ratio and the participation rate, continued to suggest solid underlying conditions. Trend unemployment was unchanged at 6.1%.
- By state, employment growth in trend terms is now dominated by the major states on the eastern seaboard, with the recovery in Queensland gaining further traction. In February, Queensland tied with Victoria to have generated the most number of jobs across states. The broadening improvement in the labour market is further demonstrated by a greater number of states showing a sustained amelioration in unemployment: NSW, Victoria, Queensland and more recently, SA. Meanwhile, the trend unemployment rate in Tasmania has crept up slightly in recent months following a notable downward trend since mid-2013. Unemployment appears to have stabilised somewhat in the NT, but continues to rise in WA and the ACT. The divergent trends between mining and non-mining states are also apparent in some of the leading indicators, with the SEEK job ads series showing WA falling further behind other major states and increasingly dragging on the national results, while NSW continues to be the standout performer.
- Solid GDP outcomes in Q3 and Q4 2015 offered support to the strength in employment growth witnessed in H2 2015. And while we have recently seen some softening in headline employment, the employment index from the NAB monthly business survey surged to +5, the highest reading since mid-2011. This suggests strong employment gains (of 19k per month) which would be more than sufficient to see unemployment edge down over the course of 2016. Sample rotation is also a critical factor in the labour force statistics, and is expected to support employment growth in the month of March (NAB: +40K, Mkt: +20K).
- Short-term oscillations aside, our expectation remains that employment growth will continue to grow moderately on the back of low wages and a shift towards labour-intensive jobs. The unemployment rate is forecast to ease gradually to 5.6% by end-16 and 5.5% by end-17, before returning to 5.6% by end-18. Slowing population growth (currently 1.3% 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. This should be sufficient to keep the RBA on the sidelines, although the RBA has made it clear that it is looking for the "improvement in labour market conditions evident last year continuing".
- Overall wage growth remains tepid despite the pick-up in employment. Wages growth is either slowing or remaining weak in most industries, reflecting the dominance of part-time jobs in employment growth since late 2014. We expect the gap between the growth in part-time jobs and full-time jobs to narrow as the non-mining recovery broadens, creating a positive impetus for wage growth going forward.



Source: ABS, NAB Group Economics



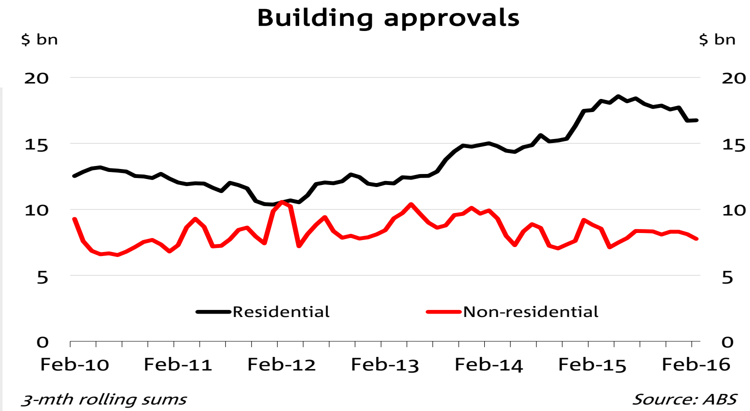
Source: ABS, NAB Group Economics

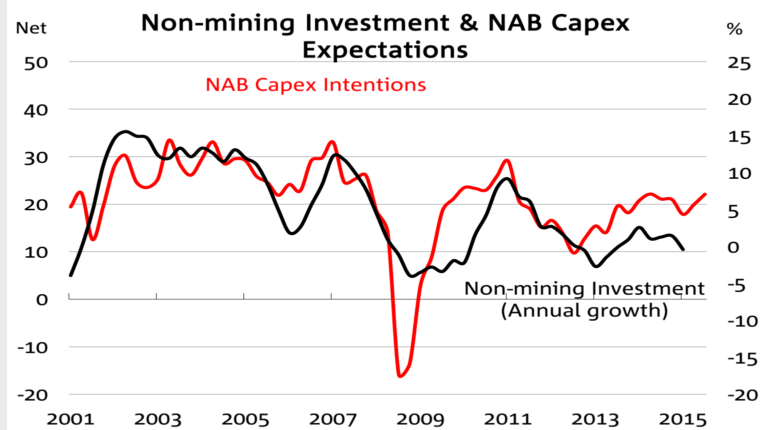


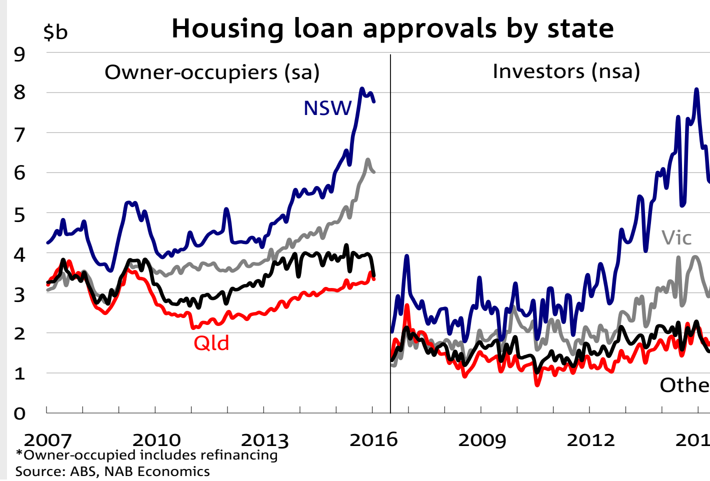
Source: ABS, NAB Group Economics

Australian investment

- The outlook for non-mining investment remains critical to the economy and is a major consideration for the RBA when setting monetary policy. Additional information on the strength of non-mining investment has been limited this month, although timely indicators such as the NAB Business Survey suggest reasonable rates of capex growth – albeit softening recently. Levels of capacity utilisation are also reassuring, suggesting that firms may be more encouraged to invest in capital to expand capacity. In contrast, non-residential building approvals suggest building capex has been subdued.
- In terms of the longer term outlook, firm's intentions to invest have perhaps not picked up as much as was hoped – although outcomes appear to vary across the various survey's. Weakness is particularly apparent in the ABS's Private New Capital Expenditure (Capex) Survey, which provides one of the few indication of investment intentions for 2016/17. The most disappointing aspect of the Capex survey was that it not only showed no improvement in non-mining capex intentions, but they actually pointed to a further contraction in spending. Unsurprisingly, mining capex intentions also fell further.
- However, limitations of the Capex survey – such as its coverage – means that expectations from the Capex survey can be somewhat misleading. Other indicators of business investment intentions include the NAB Quarterly Business Survey, which has generally been more upbeat. Capex expectations for the next 12 months in the NAB Survey improved in Q4, which is consistent with the falls seen in spare capacity. Commercial property market sentiment also hit a new high in the NAB Commercial Property Survey during Q4. Another promising indication has come from business credit, which has been gaining momentum.
- The housing market has been showing signs of moderation, which is having flow on effects to residential construction activity. Indeed, both housing finance and building approvals have turned lower, driven by a pull back in investor spending and medium density construction projects (primarily in NSW and Victoria). Nevertheless, the construction pipeline remains very large and will add considerably to the housing supply over the next 18 months or more. Consequently, residential construction is expected to continue making a positive contribution to growth over 2016, even as the housing market continues to cool.
- The profile of dwelling construction is expected to remain volatile given the large share of apartment construction. Nevertheless, given the state of market over-supply, approvals should remain soft, suggesting that overall contribution of dwelling investment to GDP should begin to diminish over the course of 2017.
- Overall, business investment is forecast to decline by around 10% in 2016 and 6% 2017. Positive dwelling investment is providing some offset (up over 5% in 2016), but only accounts for around 5% of GDP versus 12% for business investment.

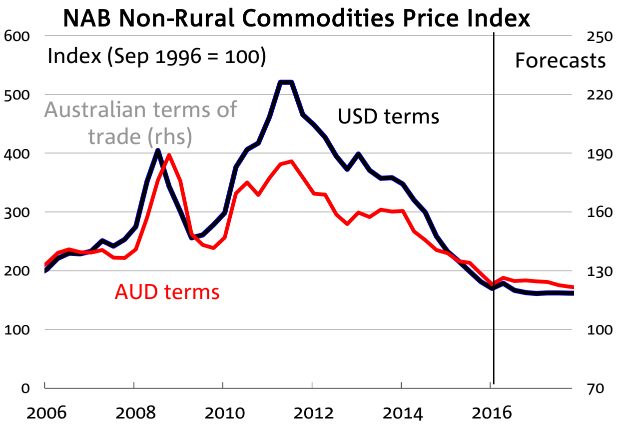




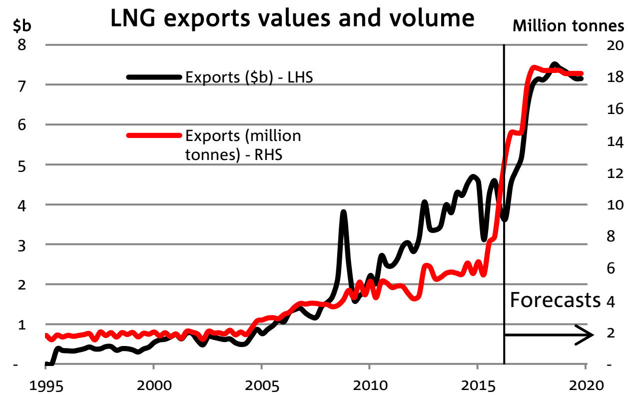


Australian commodities, net exports and terms of trade

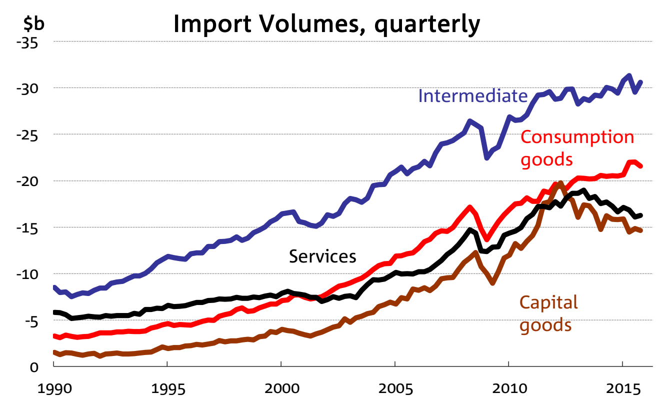
- In the medium term, exports are forecast to grow strongly while import growth will remain moderate. Overall, net exports are expected to contribute 1.6, 1.8 and 0.6 ppt to total GDP growth in 2016, 2017 and 2018 respectively. The ramp-up in exports from several large scale LNG projects will contribute most to Australia's total export growth. While only representing under 6% of total export volume in 2015, LNG's rapid growth will drive the majority of total export growth (which is forecast to grow by 7.4% in 2016, with more than half of that growth, 4.9 ppt, coming from LNG exports). Despite some recovery and a short rally in iron ore prices, our iron ore export forecasts are largely unchanged, growing at 6.2% in 2016 and 4.4% in 2017. Similarly, coal export growth is to remain weak, as a result of slowing global demand. While iron ore and coal export volumes are expected to hold up due to Australian producers' cost competitiveness, lower prices imply the associated income and government revenue receipts will be lower compared to previous years.
- While the transition in the Chinese economy is negative for resources exports, growth in services exports is expected to improve. International arrivals are growing faster than departures, with net tourism exports increasing, in line with the weaker AUD and we expect this process to continue.
- Imports subtracted 0.2 ppt from overall GDP growth in 2015, and are expected to be neutral on GDP growth in 2016. The lower AUD is limiting services imports growth, while goods imports, especially intermediate and consumption goods, are growing solidly on the back of household consumption growth and strong residential construction activity. Capital goods imports, on the other hand, have been on the decline as business investment remains subdued.
- The NAB non-rural commodity index fell both in USD and AUD terms in Q1, down 6.3% and 9.3% respectively, the latter magnified by the appreciation in the AUD over the quarter. The index in USD is forecast to improve by 5.1% in Q2 before declining again. Combined with a forecast pull-back in the AUD, the AUD non-rural commodity index is expected to rise by a bigger 6.3% in Q2. In the medium term, the USD price index is forecast to fall another 10.2% in 2016 before stablising in 2017. The index in AUD terms is expected to fall 5.7% and 6.2% in 2016 and 2017 respectively, with the AUD expected to appreciate from June 2017. This will flow through to an average 7.0% decline in the terms of trade in 2016 and a further 3.1% decline in 2017.
- Agricultural commodity prices have fallen since February, with the higher AUD putting further pressure on local prices in a subdued global environment. The NAB Rural Commodities Index fell 1.1% in February and 1.2% in March. In USD terms, the index was up 3.4% in March. The beef export outlook has deteriorated. Since mid-2015, Australian cattle slaughter rates have retreated due to a shortage of stock, while the key US 90cl beef export benchmark has fallen. Domestic saleyard prices will stay high this year, but with volumes down, the value of beef exports is forecast to fall in 2016-17. There appears to be little upside for US export prices given growing US beef supply. Meanwhile, global wheat prices continue to trend lower in response to very strong global wheat supply. For 2016, we do not see a significant upside for wheat prices in USD terms. The latest three month rainfall outlook points to a generally dryer than average April for Australia. With sowing getting into full swing after Anzac Day, a lack of forecast rainfall presents a risk to the outlook for planting.



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



source: ABS, Bloomberg, NAB



source: ABS

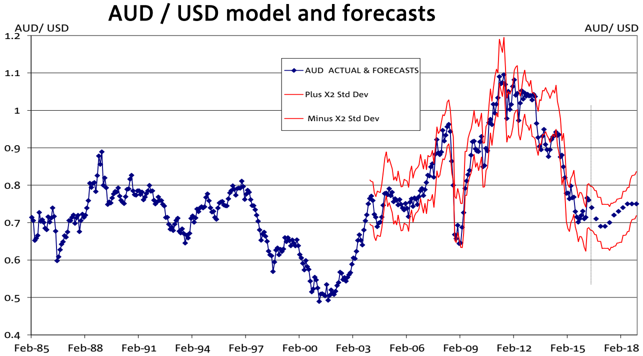
Australian financial markets

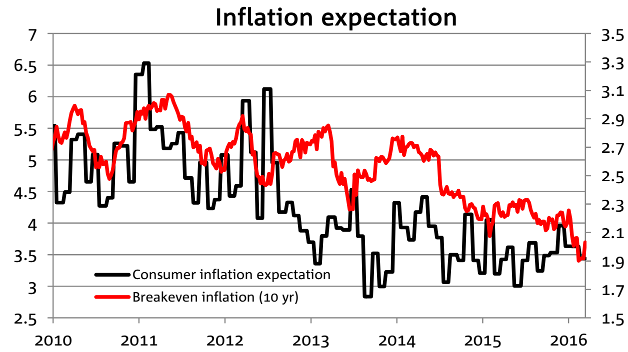
Exchange rate

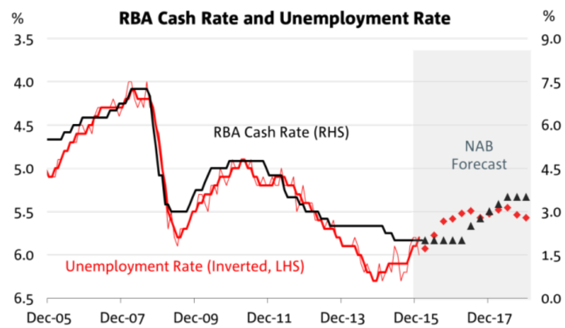
- After dropping below USD 0.69 in mid-January, the AUD has re-appreciated to over USD 0.75. This can be explained by USD weakness as Fed rate hike expectations have been pared back, some recovery in commodity prices (particularly iron ore), and (perhaps most importantly in our models) an improvement in global risk appetite (as measured by the VIX). We have adjusted our 2016 forecasts slightly to reflect the evident dovish-ness of the Fed, and now see the AUD bottom at around 69 US cents by late 2016, and then picking up very gradually to 73 cents by late 2017. While there is upside risk to these forecasts, a move towards 80 US cents would not be sustained for long, as any such move is likely to see expectations for additional RBA rate cut(s) ratchet higher. We are also sceptical that the current high global risk appetite/low volatility environment will be able to maintain such lofty levels indefinitely.

Interest rates and inflation

- We continue to forecast unchanged monetary policy through 2016. However, the risks to the policy outlook appear to have tilted towards further easing, particularly given the recent appreciation of the AUD which presents a renewed downside risk for the non-mining recovery. The RBA appears to be keeping its options open at present, flagging that it is looking for further improvement in labour market conditions. While further declines in the unemployment rate are in RBA's forecasts and our forecasts (see page 10), this suggests that the outlook for monetary policy is somewhat more data dependant than it was at the end of last year. And on this note, the latest improvement in business conditions (and the employment sub-component of business conditions) is likely to provide reassurance to the central bank.
- In addition, some subtle language changes in the past three RBA statements seem to suggest the central bank is watching inflation and inflation expectations more closely, especially given the concerns of other global central banks. Some market-based measures suggest inflation expectations are running lower, however we note that consumer inflation expectations have not shifted much. Certainly, the forecast outlook for inflation remains moderate. As an inflation targeting central bank, this could provide reason for the RBA to ease rates should the need arise. Our forecasts of an improving labour market and a lower AUD would see the RBA on hold. More focus will however be placed on low inflation. Lower than target inflation in conjunction with an AUD above 80 US cents and any evidence of a faltering non-mining recovery would quickly see further rate cut(s).
- Our forecasts for inflation are largely unchanged. Non-tradeable inflation remains subdued, amidst weak wages growth and spare capacity in the labour market. Rental vacancies in the housing market are also keeping residential rent inflation contained. On the tradeables inflation side, there was some evidence of pass-through from higher import prices to consumer prices in Q4. In the near term, the recent appreciation of the Australian dollar may ease pressure on retailers to pass on cost increases, however renewed depreciation by late 2016 will eventually lead to further pass-through into tradeables inflation in 2017 and 2018, with core inflation to return closer to the middle of the 2-3% target band. The RBA's forecasts for the trimmed mean however, based on an unchanged exchange rate, are likely to remain closer to 2¼% y/y or be revised downwards.







Source: ABS, NAB

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