Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- **Despite the ups and downs of global financial markets in the first five months of the year, the underlying picture remains one of steady sub-trend growth and sub-target inflation. Neither the business surveys nor the monthly partial data on industrial output and exports show evidence of an imminent acceleration in growth but the rise in commodity markets off their recent lows and the wealth effects of higher share prices could support activity later this year. Despite the many risks, we still think global growth will muddle through 2016 at around the 3% rate seen last year but there are plenty of economic vulnerabilities that could spark further rounds of market volatility.**
- **In Australia, real GDP growth picked up to 3.1% y/y in Q1 and is expected to remain at around the 3% mark for the remainder of 2016 and 2017 before easing back to 2½% in 2018. While net exports are providing the largest contribution to growth (1.1ppt in Q1 alone) in real terms, our estimates also suggest non-mining activity is outperforming the aggregate economy. The ongoing above-average level of business conditions is also consistent with the rotation towards non-mining industries and states (with non mining GDP now growing at a rate around 3¾%). The unemployment rate is forecast to fall to around 5½% by late 2016 before ticking up to around 5¾% in 2018. Meanwhile, the weaker terms of trade and low wages growth will continue to challenge national income and government revenue. Low inflation will remain a feature (despite some early evidence of stronger price pressures in this month's business survey) but we are not persuaded at this stage that further monetary policy easing will be forthcoming. A cut would first require another very low core CPI reading, a sharply higher AUD (to say above 80c USD) and/or signs of weakness in the non mining economy.**

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2015	2016	2017	2018
United States	16	2.4	1.8	2.1	1.9
Euro-zone	12	1.5	1.5	1.5	1.6
Japan	4	0.6	0.5	0.7	0.5
China	17	6.9	6.7	6.5	6.3
Emerging East Asia	8	3.5	3.5	3.6	3.4
New Zealand	0.2	2.5	2.3	2.5	2.4
Global total	100	3.0	2.9	3.2	3.1
Australia	2	2.5	3.1	3.0	2.5
Australia (*fiscal years*)		14/15	15/16	16/17	17/18
Private consumption		2.7	2.9	2.4	2.5
Domestic demand		0.8	0.9	1.0	1.5
GDP		2.3	3.0	2.9	2.9
Core CPI (*% through-year*)		2.2	1.6	2.0	2.0
Unemployment rate (*% end of year*)		6.0	5.7	5.6	5.8

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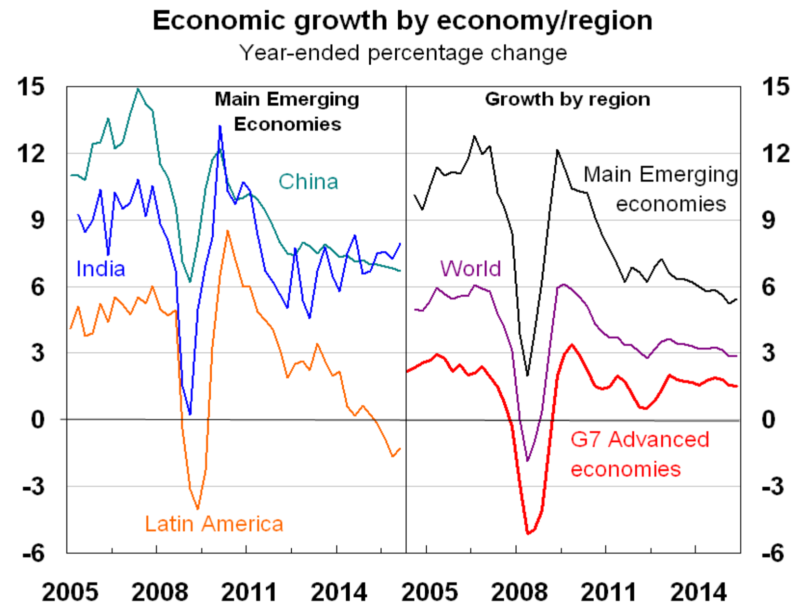
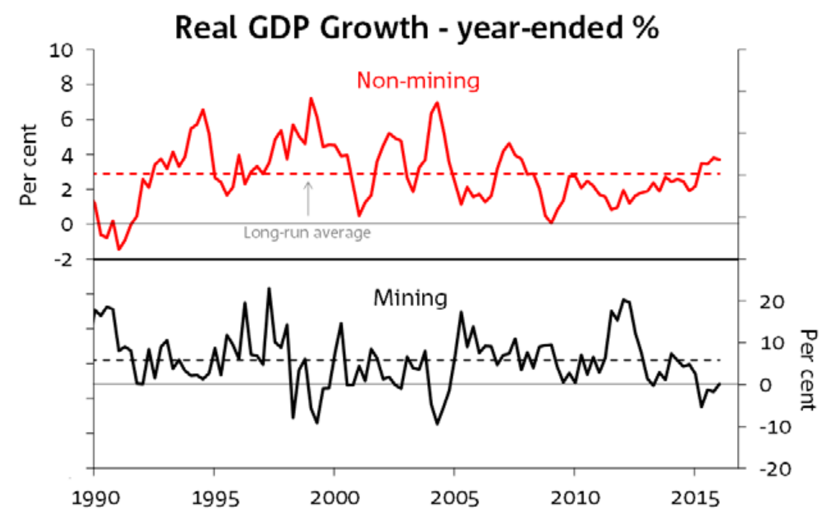
Global and Australian overview

Global overview

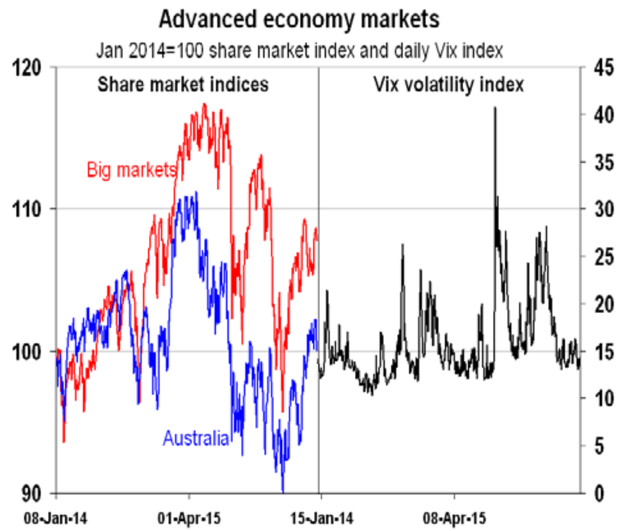
- While global financial markets slumped and then recovered in the early months of the year, global growth has continued to remain disappointing and sub-trend. March quarter global growth was just under 3% yoy, the same as in the final quarter of 2015. In particular, growth stabilised across the emerging market economies, following a long slowdown, with very rapid expansion in India offsetting weakness elsewhere.
- We expect more of the same for the global economy through the remainder of the year – sub-par growth of around 3%, below target inflation in key economies and divergences in monetary policy that reflect the disparate nature of the challenges facing big global economies. We expect US rates to rise later this year while another round of monetary easing looks likely in Japan, where growth and inflation remain weak.
- **Australian overview**
- Australia's economic transition towards non-mining sources of growth remains relatively smooth, while the inflation outlook is subdued.
- Our view remains that activity is successfully rotating towards non-mining sectors and states against a challenging economic backdrop. Low interest rates and a more competitive currency (despite recent appreciation) are helping, and LNG exports will support real GDP for the remainder of 2016 and 2017, with our real GDP forecasts at 3% for 2016 and 2017 before slowing to around 2½% in 2018 (see page 8 for more detail). This growth should see the unemployment rate edge lower to 5½% by end-16 and hold steady in 2017 before inching up in 2018.
- The risks to the outlook remain plentiful amidst a weak global economy and low commodity prices. In addition, measures of national income are unlikely to pick up substantively from current low/negative rates, which will continue to filter through to low corporate profits (largely in mining) and weak government revenue. Low wages growth will also remain a feature, which in conjunction with low global inflation, strong competition in the retail space and slowing rental growth, will see core inflation near or below the bottom of the 2-3% target band. Despite this, we are not expecting a follow-up rate cut by the RBA, although acknowledge the risk of further easing (see page 8 for further discussion).
- These forecasts are predicated on an assumption that the AUD will ease to USD 0.69 by end-2016 and a low of USD 0.67 by mid-2017, with some upside risk (and therefore downside risk to GDP and inflation) should the Fed not hike twice as we currently anticipate.

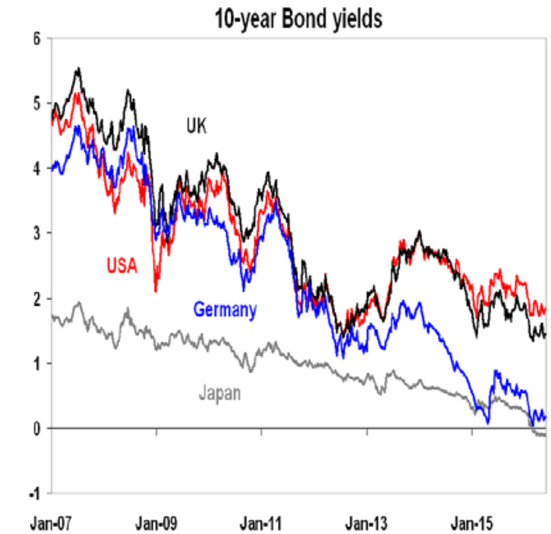


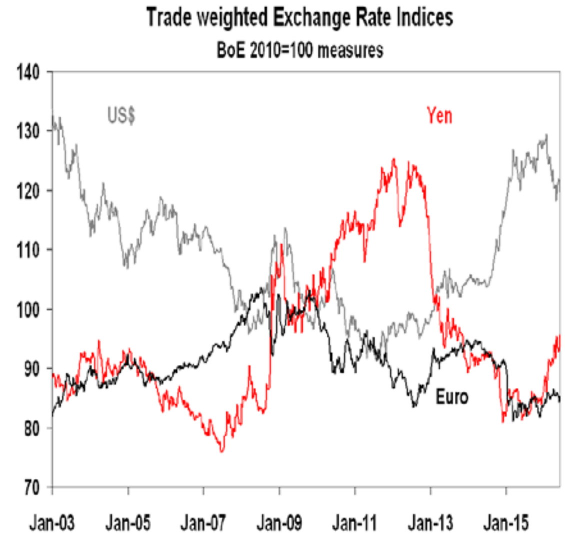


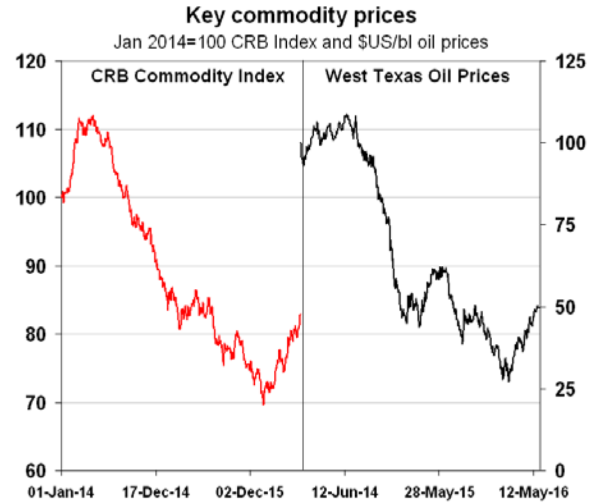
Financial and commodity markets

- Financial market pricing looks consistent with a continuation of sub-trend global growth and modest inflation that we have seen in recent years. Equity markets have recovered much of the losses they experienced early in the year but remain below last year's peaks. This looks consistent with the winding back of the risks of a global slowdown that were causing so much concern around February.
- While the rise in global share prices is a brighter note, the falling trend in bond yields across big advanced economies points to expectations of moderate growth at best with little inflationary pressure. Japanese government bond yields have been negative for some time and the broad measure of German bond yields has recently gone negative.
- Recent currency movements show a partial unwinding of the appreciation of the USD that has weighed on US manufacturing as well as a sharp upturn in the Yen, probably very unwelcome to the Japanese authorities as it dampens both the growth and inflation they are trying to stimulate.
- The different settings of monetary policy across the big economies reflects their disparate economic challenges. The Fed still looks set to lift its policy rate twice again in the second half of the year, although the latest disappointing US jobs figures mean July or even September are more likely candidates for the first rise than June.
- The European Central Bank looks set to wait until much later in the year before it eases further, as it waits to see how much stimulus its March easing is giving to growth and inflation. Japanese growth and inflation remain uncomfortably low for the central bank – which already has a negative policy deposit rate and a large scale asset buying programme. We expect another round of easing around July, involving further asset buying.



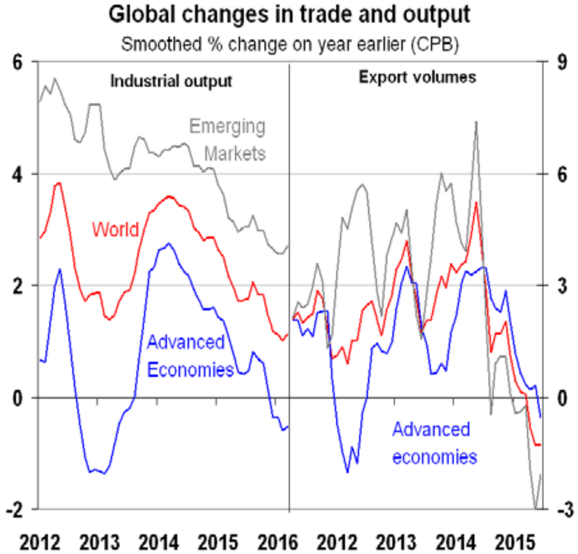


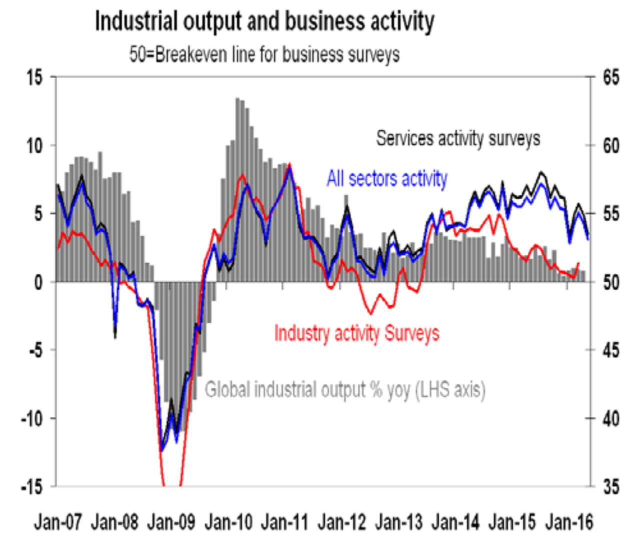


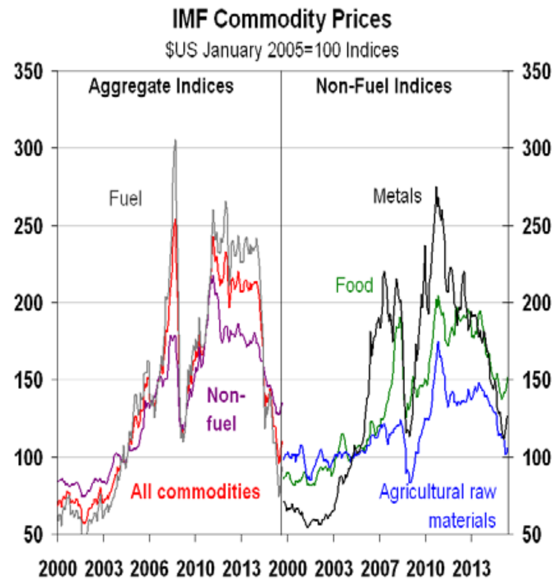


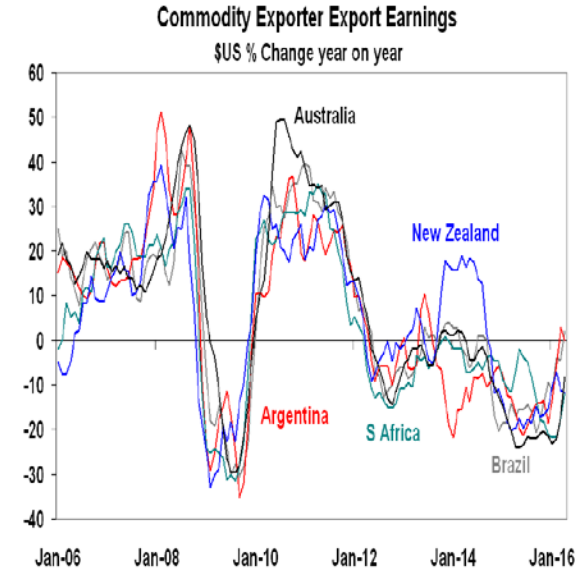
Global Economic Trends

- While financial and commodity markets have settled down and recovered some losses, the background is still one of subdued global growth. In fact, the pace of quarterly growth in industrial output has continued to slow from 0.5% last September to 0.3% in December and 0.3% in March 2016. There is no evidence of any upturn in the data for the first four months of 2016 either with our measure of industrial growth in 19 big economies showing growth in April staying under 1% yoy for the fifth month in succession.
- The picture for world trade is even weaker with the CPB measure of trade volumes falling by 1.7% in the March quarter, continuing last year's trend slowdown into negative territory. While the export volume figures for advanced economies fell through the latter half of last year and early 2016, they began to improve slightly through February and March. The export trends for emerging economies are much worse – down by 2.7%, 2.4% and 1.8% in the two final quarters of 2015 and March 2016. Moreover, unlike the advanced economies, there is no sign of growth resuming in the early months of this year.
- Until recently, the emerging economies were being hit by weaker commodity prices as well as lower export volumes. The downturn in global commodity markets was broad-based and severe and its effects can be seen in the form of lower export receipts across the big commodity producers of the Southern Hemisphere.
- Soft global growth both predated and follows this year's period of financial market weakness, suggesting that the post February upturn in markets reflects a "relief rally" rather than an imminent upturn in growth. Central bank action helped convince markets that the most severe down-side risks to global growth would not eventuate.



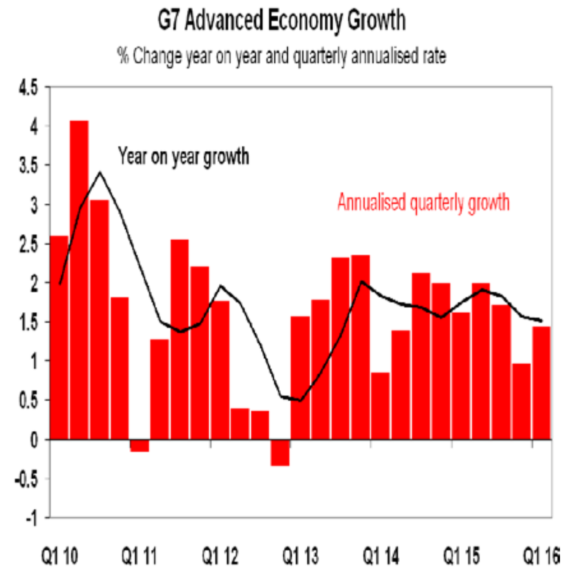


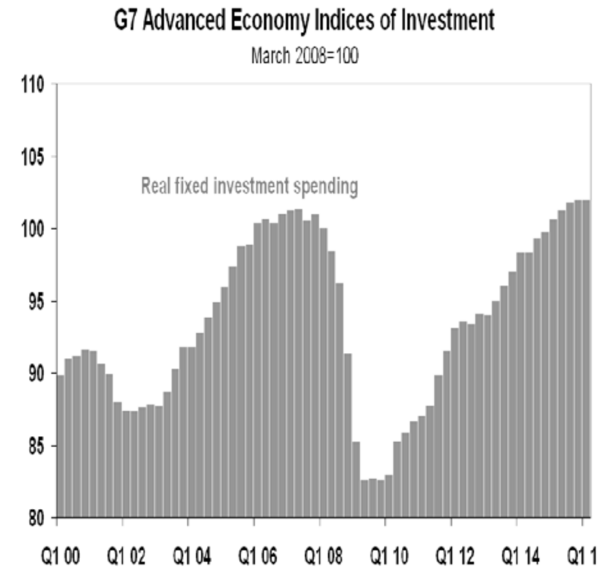


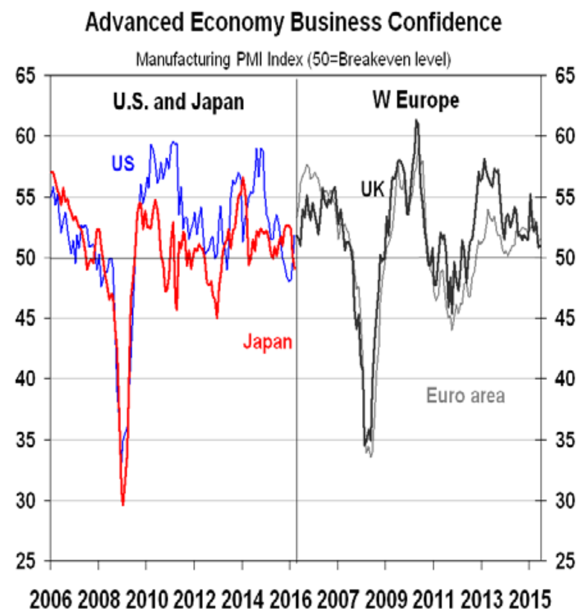


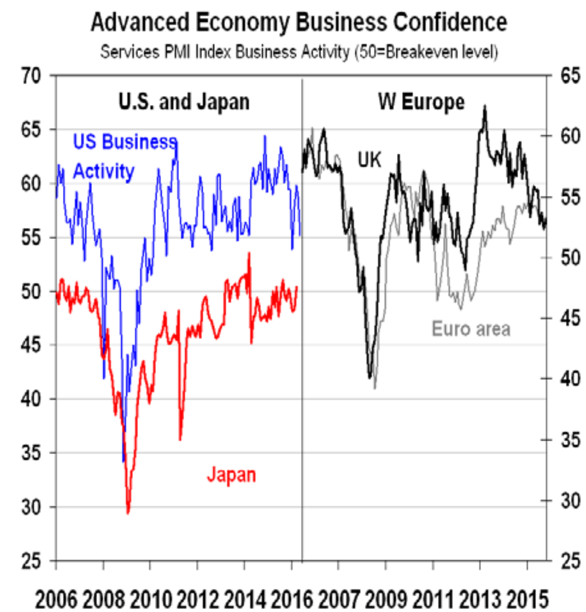
Advanced Economies

- Growth remained moderate in early 2016 in the big advanced economies. G7 growth was around 0.3% in the March quarter, better than the previous quarter's 0.2% growth rate, but still only resulting in growth of under 1.5% between early 2015 and early 2016. The latest monthly purchasing manager business surveys are not pointing to acceleration in growth through the first four months in 2016 across the big advanced economies.
- Conditions vary between the big economic blocks but volatility in the quarterly GDP data has made it hard to identify a clear trend in their growth. Japanese output fell through the last three quarters of 2015 before picking up in early 2016 but recent indicators and surveys are highlighting areas of weakness. Consequently, the Government has deferred the planned indirect tax rise to October 2019.
- US growth has also been very lumpy, triggering alternating positive and negative moods in the markets. March quarter 2016 saw a disappointing 0.2% quarterly growth rate, but the start of last year was also weak and it was followed by a very big second quarter growth number. After many years of under-performing, Euro-zone growth finally looks set for a sustainable lift with March quarter showing 0.5% growth and positive business survey outcomes in recent months.
- Investment has been the weak link in advanced economy growth as firms hold off spending. Capital expenditure has only recently risen above its early 2008 level, held back by uncertainty, risk aversion, funding shortages and excess capacity. Even where profitability recovered, firms were often inclined to hoard cash rather than lift investment, waiting for more settled conditions – which did not appear as volatility continued.



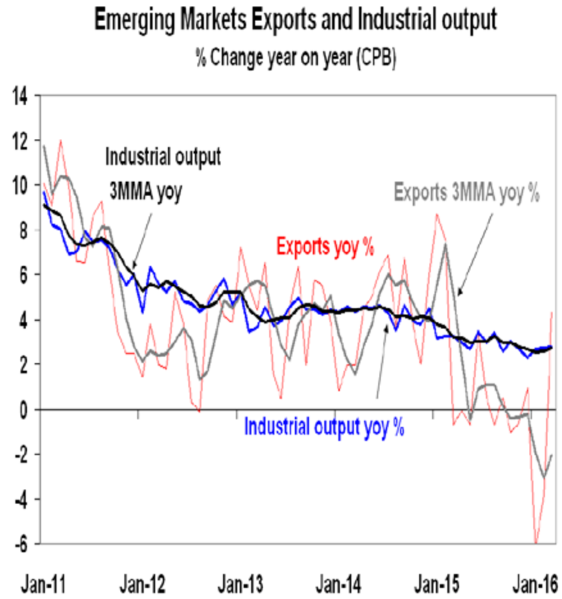


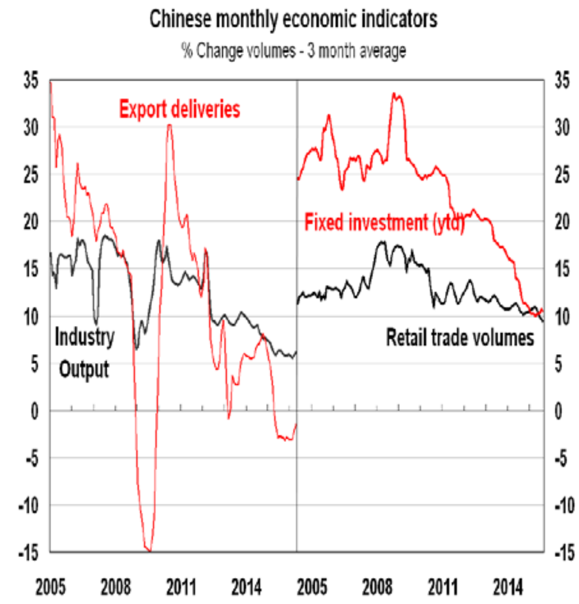


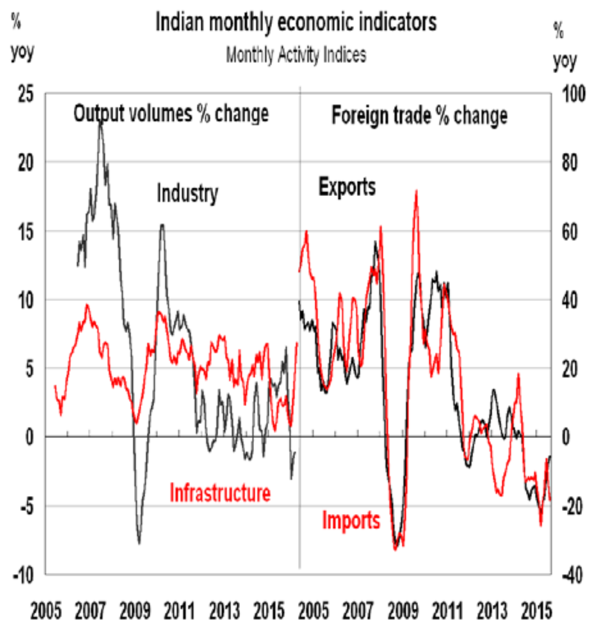


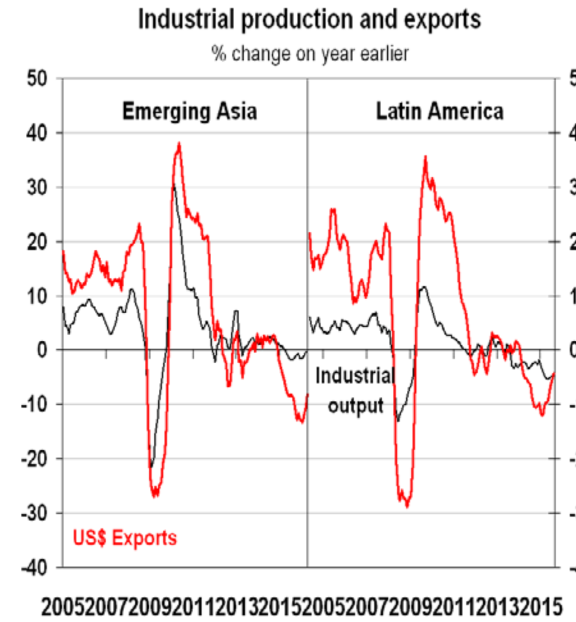
Emerging Market Economies

- It is now the emerging market economies that drive most of the world's output growth. These emerging markets now account for around 58% of global output, China is increasingly outstripping the US as the world's biggest economy and India is ranked as number 3 for world GDP. Global growth has been running at around 3% annually and emerging market economies have contributed over 2 percentage points of that expansion in output.
- Industrial growth has slowed in the emerging markets from over 7% yoy in 2011 to less than 3% yoy in late 2015 and early 2016, well below the 5½% trend growth seen in the last 25 years. Trade outcomes have been even weaker with trend exports falling below year-earlier levels through early 2016.
- Chinese growth has remained solid, supported by policy measures to boost activity, sizeable household income gains boosting consumer spending power and a gradual shift in the drivers of economic expansion from manufacturing to services and from fixed investment to consumption. While the outlook is for continued, albeit slowing, Chinese growth rates that are well above the global average, the use of credit to support activity raises medium term concerns. China is already a highly indebted economy, especially the business sector, and further increases in an already high debt to GDP ratio raises concerns over just how productive some of this new credit-fuelled spending will be.
- India has become the fastest growing big global economy with an above expectation growth rate of almost 8% yoy in early 2016. Unfortunately, things may not be as rosy as they seem with questions over the accuracy of the Indian GDP numbers and much weaker outcomes for the partial economic indicators. Despite these concerns, India's economy appears to be growing strongly.









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. Expectations measures in big advanced economy business surveys have recovered some of their earlier losses but our tracking indicator of global growth points to growth stabilising rather than accelerating.

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.

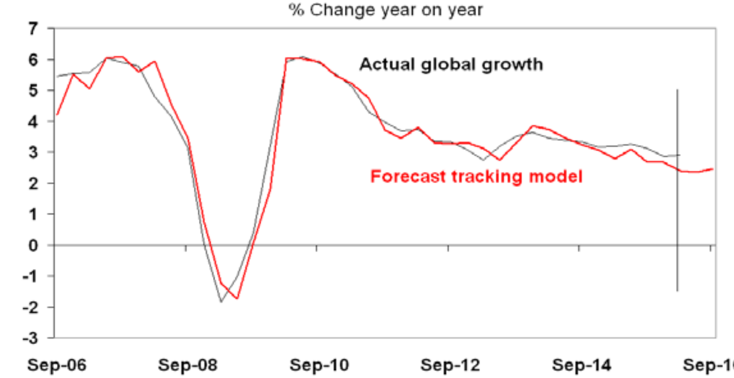
As the scope to use standard macro-economic policy to lift growth or stave off any new downturn has dwindled, agencies like the IMF have become increasingly vocal about the need to lift the pace of economic reform – involving not just further supply side measures to give incentives to produce more but 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

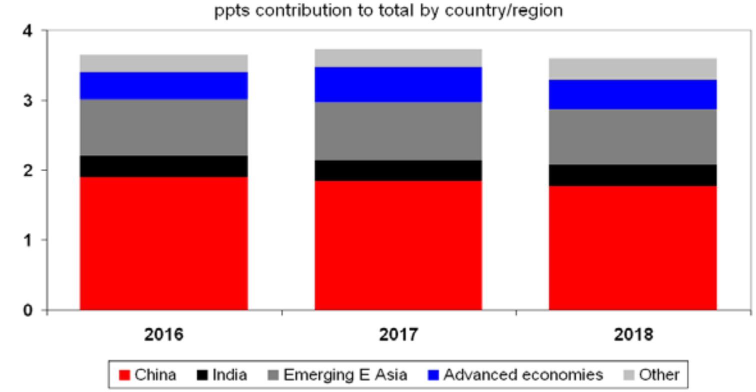
	2011	2012	2013	2014	2015	*NAB Forecasts* 2016	2017	2018
US	1.6	2.2	1.5	2.4	2.4	1.8	2.1	1.9
Euro-zone	1.6	-0.8	-0.3	0.9	1.5	1.5	1.5	1.6
Japan	-0.4	1.7	1.4	-0.1	0.6	0.5	0.7	0.5
UK	2.0	1.2	2.2	2.9	2.3	1.8	2.0	2.0
Canada	3.1	1.7	2.2	2.5	1.2	1.4	1.8	2.0
China	9.5	7.7	7.7	7.3	6.9	6.7	6.5	6.3
India	7.9	4.9	6.3	7.0	7.2	7.7	7.7	7.5
Latin America	4.9	2.6	2.6	0.9	-0.6	-0.8	1.0	1.7
Emerging East Asia	4.4	4.6	4.2	4.1	3.5	3.5	3.6	3.4
New Zealand	1.8	2.4	2.4	3.7	2.5	2.3	2.5	2.4
World	*4.5*	*3.4*	*3.3*	*3.4*	*3.0*	*2.9*	*3.2*	*3.1*
memo								
Advanced Economies	1.7	1.2	1.2	1.8	1.9	1.6	1.8	1.8
Big Emerging Economies	7.1	5.3	5.6	5.1	4.4	4.3	4.7	4.8
Major trading partners	4.7	4.3	4.2	4.1	3.8	3.7	3.7	3.6

Business surveys in US, UK, Germany and France

Actual and Forecast model for global growth
% Change year on year



Economic growth in major trading partners
ppts contribution to total by country/region



Australian outlook

- National accounts figures for Q1 revealed sound growth in real GDP of 1.1% q/q and 3.1% y/y. This was in large part thanks to a 1.1ppt contribution from net exports although this somewhat overstates the boost from the mining sector given the sharp decline in mining investment (detracting around 0.5 points from Q1 growth). Meanwhile, household consumption growth was solid at 0.7% despite a simultaneous rise in the household savings ratio (although the trend is down), supported by apparent strength in services consumption. Government spending and dwelling investment also made more modest contributions to growth.
- A key feature which has been largely overlooked has been the strength in the non-mining economy (especially services sectors). Our estimates of real non-mining GDP in Q1 were strong at 3.7% y/y, in contrast with mining GDP growth of 0% y/y (with lower investment offsetting stronger exports). The difference is starker in nominal terms – aggregate nominal GDP printed at 2.1% y/y in Q1, with our assessment that nominal non-mining GDP was running at 6% y/y compared with nominal mining falling -20% y/y.
- Going forward, we estimate that Australia is only half-way through the mining investment downturn (see note). This will be more than offset by the boost from mining exports/production (and therefore productivity) through the remainder of 2016 and 2017, with our real GDP growth forecasts at approximately 3% in annual average terms.
- By 2018 however, growth in exports will slow. At this point, with the dwelling cycle having turned, and the economy receiving less impetus from exchange rate depreciation, we expect economic growth to revert to a rate closer to our revised estimate of potential growth of around 2½% (please see detailed note) – in the absence of an unexpected productivity boost.
- These rates of growth, together with weak wages growth, should be sufficient to maintain downward pressure on unemployment. Despite an estimated 50K further job losses to come out of the mining sector (see note), we forecast the unemployment rate to ease to 5½% before ticking up in 2018.
- Meanwhile, the inflation outlook is tepid despite some evidence of an uptick in this month's business survey. A combination of low wages growth, low global inflation, strong retail competition and lower rental growth suggests core inflation will hover near the bottom of the target band till 2018. We expect that the RBA will take a "flexible" approach towards its target and are not expecting further easing, but do acknowledge the risk if inflation continues to print below expectations, inflation expectations fall, the AUD surprises to the upside and/or the non-mining economy loses momentum.

Australian economic and financial forecasts (a)

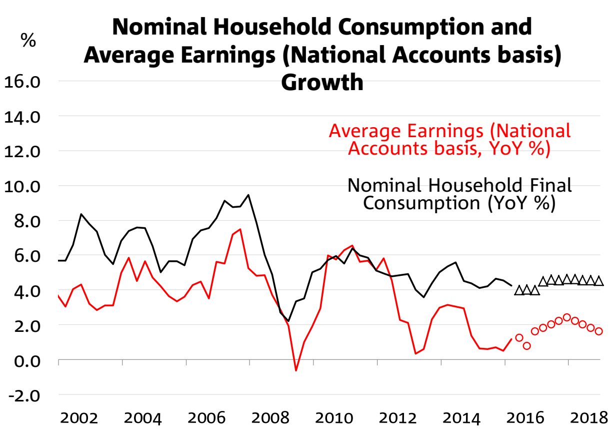
	Fiscal Year			Calendar Year			
	2015-16 F	2016-17 F	2017-18 F	2015	2016-F	2017-F	2018-F
Private Consumption	2.9	2.5	2.6	2.8	2.7	2.5	2.5
Dwelling Investment	8.7	2.7	-1.9	9.8	5.5	0.4	-3.5
Underlying Business Investment	-13.9	-10.4	-3.5	-10.5	-13.1	-7.5	0.9
Underlying Public Final Demand	2.8	2.6	2.6	2.1	2.5	2.6	2.6
Domestic Demand	**0.9**	**1.1**	**1.7**	**1.1**	**0.8**	**1.3**	**1.9**
Stocks (b)	0.0	0.0	0.0	0.0	0.1	-0.1	0.0
GNE	**0.9**	**1.0**	**1.7**	**1.1**	**0.9**	**1.3**	**2.0**
Exports	7.9	10.6	7.8	5.9	10.4	9.6	5.7
Imports	-0.5	1.1	3.3	1.5	-0.8	2.3	4.1
GDP	**3.0**	**2.9**	**2.9**	**2.5**	**3.1**	**3.0**	**2.5**
– Non-Farm GDP	3.1	2.9	2.9	2.5	3.1	3.0	2.5
– Farm GDP	-0.6	2.5	2.0	0.0	2.5	1.6	2.0
Nominal GDP	2.6	4.2	4.3	1.8	3.4	4.4	4.1
Federal Budget Deficit: ($b)	-37	-34	-23	NA	NA	NA	NA
Current Account Deficit ($b)	79	59	57	78	67	56	59
(-%) of GDP	4.8	3.4	3.2	4.8	4.0	3.2	3.2
Employment	2.2	2.1	2.0	2.0	2.0	2.2	1.8
Terms of Trade	-9.7	-1.9	-3.1	-11.5	-4.8	-2.9	-1.9
Average Earnings (Nat. Accts. Basis)	0.9	1.6	2.2	0.6	1.2	2.1	1.9
End of Period							
Total CPI	1.3	2.8	2.8	1.7	2.0	2.7	2.9
Core CPI	1.6	2.0	2.0	2.0	1.8	1.9	2.1
Unemployment Rate	5.7	5.5	5.7	5.9	5.6	5.6	5.8
RBA Cash Rate	1.75	1.75	2.00	2.00	1.75	1.75	2.25
10 Year Govt. Bonds	2.45	2.75	2.75	2.88	2.65	2.75	2.75
$A/US cents :	0.73	0.68	0.70	0.73	0.69	0.68	0.73
$A - Trade Weighted Index	62.0	58.9	59.3	62.7	59.8	58.4	61.0

(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.

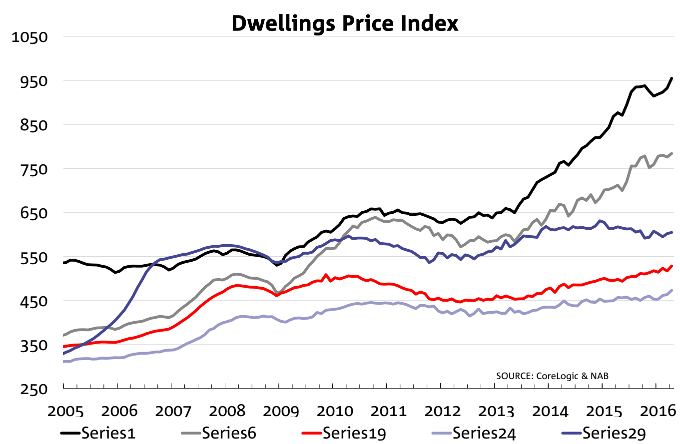
(b) Contribution to GDP growth

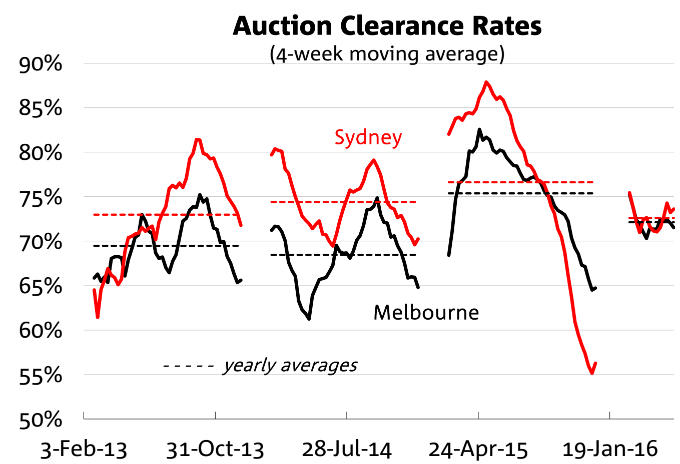
Australian consumer demand and housing market

- Household consumption growth in Q1 was relatively resilient at 0.7% q/q despite a rise in the savings ratio, following growth of 0.8% in Q4. Household income picked up strongly in Q1 despite slowing employment growth, but the overall trend is still downwards due to a compositional shift in the labour market towards lower-paid jobs and adverse effects from the declining terms of trade. Total compensation of employees (a measure of the national wage bill, and a function of wages and employment) rose by a solid 0.8% in Q1 to be 3.6% y/y. The biggest contributors to household consumption in Q1 were essentials: food, rent and insurance and financial services - which points to continuing consumer caution. Going forward the wealth impact from higher house prices on consumption are likely to constitute another headwind to overall spending growth. A slowing in retail trade growth was also evident in April, partly reflecting lower prices (especially for food), but also the weakening trend in the mining states of WA and QLD. NAB's latest Online Retail Sales Index showed growth for April fell to 0.3% m/m (10.8% y/y) and continues to trend lower. Against that – and on a more positive note – our monthly NAB Business Survey suggests a modest improvement in the business and trading conditions of retailers in May (albeit after weak readings from late 2015).
- The fundamentals for household consumption are mixed with solid employment growth but subdued wages and on going consumer caution. Even to satisfy our (moderate) household consumption forecasts requires a decline in the household savings ratio – and hence involves potential downside risks.
- National dwelling price growth has eased from previous highs, but surprisingly has started to pick up again in recent months. Sydney prices were particularly strong in May, rising 3.1% m/m – primarily driven by house prices. Given recent increases, price growth for the year is in double digits in both Sydney and Melbourne, at 13% and 13.9% respectively. Outside the major eastern cities, price growth has been mixed. Hobart prices have done well over the year and Adelaide is improving, while Perth continues to fall. Housing credit growth continues to run around 7% y/y – with owner occupied housing credit accelerating to 7.3% y/y offsetting further falls in investor credit – now 6.5% y/y.
- Despite unexpected recent strength we still expect that the major eastern housing markets will see relatively flat / modest growth in prices as affordability and prudential constraints, as well as the growing supply of housing (especially apartments) begin to bite. That said, better than expected price growth recently in some capital cities suggests upside risk to the near-term forecast – our national price growth forecasts for 2016 are 1½% for houses, -1% for units. While it is early days the recent RBA cut does seem to have given eastern seaboard markets a kick up – a development the RBA will be closely monitoring. That said mining related markets remain fragile. It could well be that other election related factors (e.g. concerns about potential changes to negative gearing) are also affecting the market. It is possible that near-term strength will ultimately see housing prices flatter for longer.



Source: ABS, NAB Group Economics

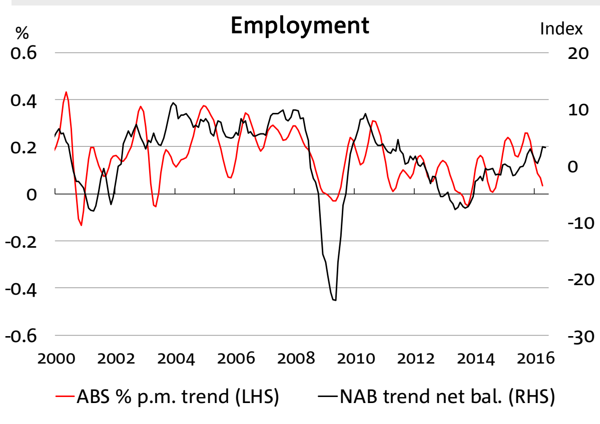


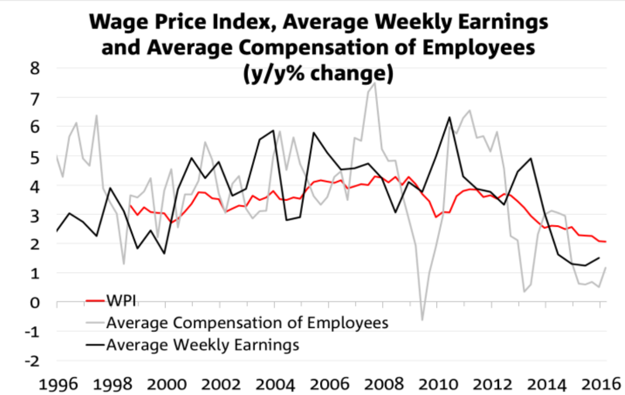


SOURCE: CoreLogic

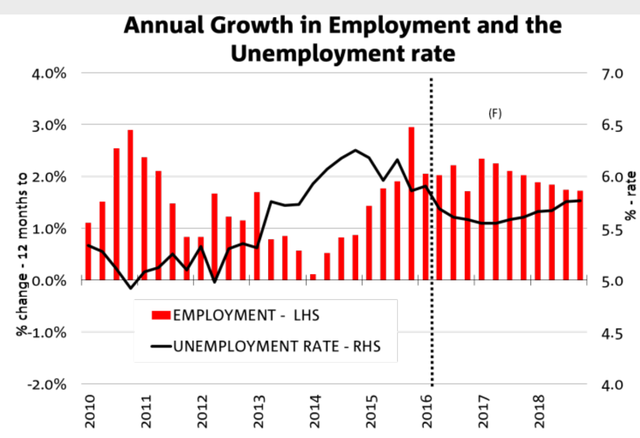
Australian labour market

- In April, the weakening trend in employment growth (evident since late 2015) continued,. That said unemployment has trended lower and then stabilised at around 5.7%. The recent slowdown is largely attributable to a moderation in the growth of full-time jobs. Aggregate and average hours worked by full-time employees have declined notably since the start of this year, suggesting rising spare capacity in existing jobs which warrants further monitoring. Meanwhile, the growth in part-time jobs was relatively more resilient. Other indicators of labour market health, such as the employment to population ratio and the participation rate, continue to point to relatively stable underlying conditions.
- By state, employment growth in trend terms continued to be dominated by the major states on the eastern seaboard, although there are now signs that the recovery in Queensland could be running out of puff. On a trend basis, NSW's employment growth was the strongest in the month (+120k y/y), followed by Victoria (+58k y/y) and QLD (+35k y/y). The unemployment rate was unchanged in NSW at 5.3%, while it declined in Victoria to 5.6% (from 5.7%). The unemployment rate rose in the more mining-orientated states with QLD rising to 6.5% from 6.2%, WA to 5.6% from 5.5%. In the research note on the evolution of mining employment (see note) which we published last week, we concluded that around 50k more mining jobs are expected to be shed going forward, with most of them likely to stem from WA. This portends a further deterioration in WA's labour market conditions.
- The employment index from the Nab monthly business survey softened somewhat in May – falling from a very strong +4 to around the long run average reading of +1. While somewhat disappointing these readings are consistent with employment gains (of 15k per month) which would be more than sufficient to see unemployment edge lower over the course of 2016.
- In the coming months, 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 stabilise at around the same level until the end of 2017, before inching up to 5.8% by end-18. Slowing population growth also suggests a slightly lower rate of job creation will be necessary to keep up with population growth.
- Overall wage growth remains surprising low given the relatively low reading for unemployment. Employees obviously still feel concerned about there job prospects. While most focus on the wages debate relates to the ABS Wage Price Index it could well be that, going forward, measures such as the national accounts wages per employee will be more useful in that they are likely to better reflect any signs of increased labour market tightness. That is these measures would better pick up any signs that strong non mining sector activity start to show up in increased bonus and incentive payments. Interestingly it is apparent that recruitment surveys – such as Hays Annual Salary Survey – suggest employees are signalling a marked increase in the number who intend to ask for wage rises next year (42% of respondents). Clearly labour market trends will be closely watched.



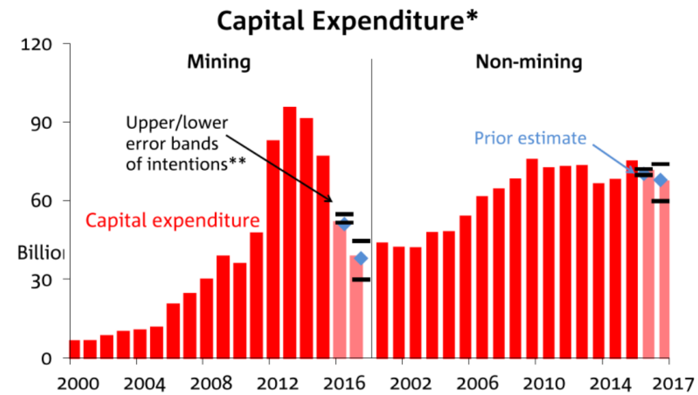


Source: ABS, NAB Group Economics

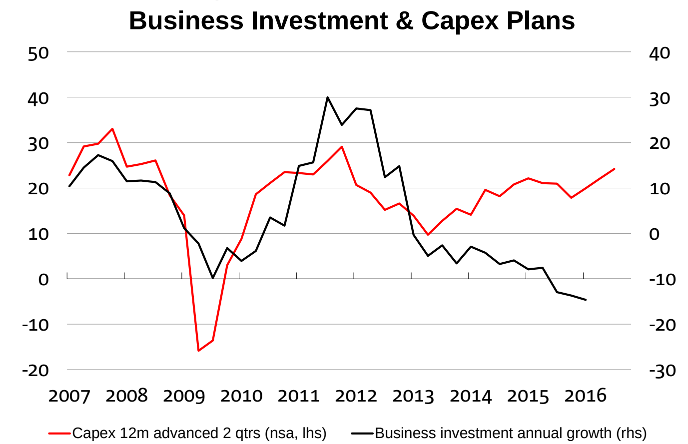


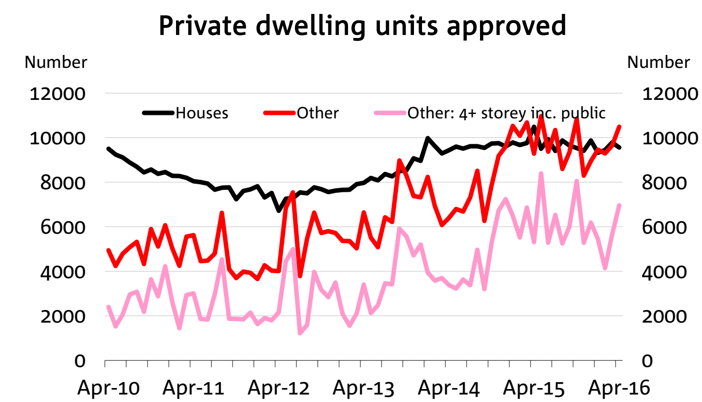
Australian investment

- As expected, the Q1 National Accounts printed yet another weak outcome for business investment, which fell 4.3% in real underlying terms, driven by large declines in both building and engineering construction. While most of the weakness was driven by a contraction in mining investment, this outcome was only moderately better than what was in the ABS Private Capital Expenditure Survey, which showed investment by non-mining firms remained tepid as well – although declines were mostly in manufacturing investment, with other non-mining industries rising modestly.
- In this context, the outlook for non-mining investment remains critical to future growth and monetary policy. The Capex Survey shows a further contraction in mining investment plans in 2016/17. This is to be expected considering our recent estimate (see note) that we are only around half way through the current mining investment downturn. However, expectations for non-mining capex remain particularly disappointing – although much of the weakness is focussed around the manufacturing industry (rather than being broad-based). Soft company profits may help to explains subdued investment intentions, although deconstruction of the data suggests that it is mostly a reflection of mining and related industry weakness, with other industries (real estate, distribution services, accommodation etc.) showing an improved trend – more consistent with strength in NAB Survey's profitability index.
- That said the ABS Capex Survey's non mining intentions need to interpreted carefully as it excludes around 50% of all non mining sector investment – and critically excludes fast growing services sectors – such as health and education. The broader based Nab Survey Investment expectations (12 months ahead) suggest reasonable strength in non mining - , consistent with positive business conditions, and above normal capacity utilisation. These finding also sit better with accelerating demand for business credit (now up 7½% y/y).
- Commercial property market sentiment also remained at above average levels according to the NAB Commercial Property Survey for Q1, although it did deteriorate relative to the previous quarter – a large drop in office market sentiment coincides with very elevated vacancy rates in mining affected regions such as Perth.
- The pipeline in apartment construction continues to be substantial – with unit approvals again exceeding housing approvals (a situation we have not seen in previous building cycles). The result is that the already massive construction pipeline is getting bigger and is expected to fuel strong rates of dwelling investment well into 2017.   That said by 2018 the pipeline is expected to be largely eroded and will most likely become a drag on economic activity.
- Overall, business investment is forecast to decline by around 13% in 2016 and 7½% 2017. Positive dwelling investment is providing some offset (up over 5% in 2016) – albeit the latter only accounts for around 5% of GDP versus 12% for business investment.



* Pink bars are the latest forecast adjusted by the RBA's preferred realisation ratio measures
** The historical root mean squared error of the forecast

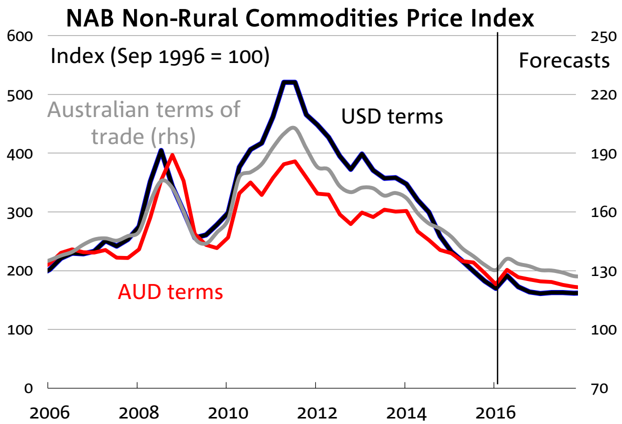




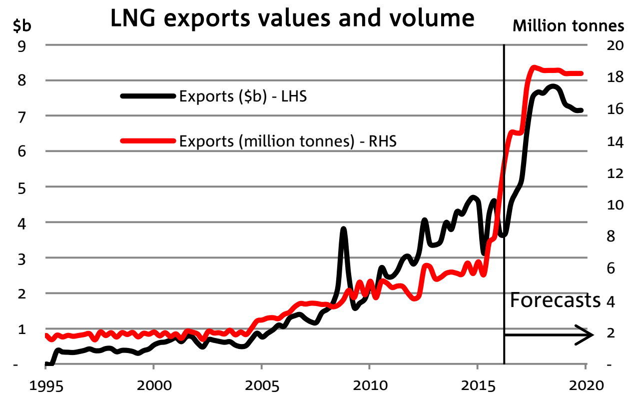
Source: ABS

Australian commodities, net exports and terms of trade

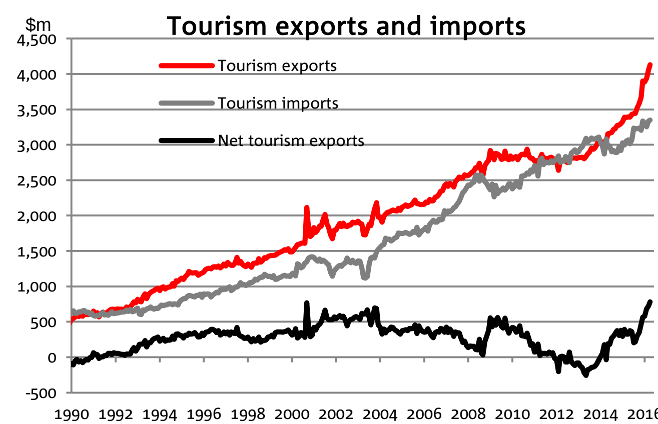
- In the medium term, exports are forecast to grow solidly on the back of strong LNG exports (see chart below – middle panel). Imports, on the other hand, are expected to increase only moderately, as the depreciation of the AUD dampens the effect of improving domestic demand. As a result our forecasts for net exports are expected to remain strong in the next two years but fade in the medium term - with net contributions to GDP of 2.5, 1.7 and 0.4 ppt in 2016, 2017 and 2018 respectively.
- The forecast ramp-up in **LNG exports** from several large scale projects is expected to contribute the most to Australia's total export growth. Given the bulky nature of these projects, the timing of their export starting will have move quarterly growth rate significantly, however it is hard to forecast accurately. In annual terms, the real volume of LNG exports is expected to increase by around 90% in 2016 and 30% in 2017, before slowing down to 9% in 2018. **Iron ore and coal exports** are forecast to grow slowly given subdued global demand. Significantly lower than expected commodity prices though will negatively impact on associated income and government revenue.
- The NAB non-rural commodity index is forecast to rise in Q2, supported by a temporarily stronger iron ore price forecasts (although we expect iron ore prices to settle lower at USD40 a tonne). Overall, the index in USD terms is forecast to fall by 10.1% in 2016 and another 1.2% in 2017. The depreciation in the AUD in 2016 will cushion some of the falls (down by a lesser 5.6% in AUD terms) while a forecast appreciation in 2017 will see the index in AUD fall by 6.6%. This will flow through to an average 0.5% decline in the terms of trade in 2016 and a further 3.8% decline in 2017.
- **Services exports** are expected to grow, supported by a lower AUD and stronger trade links with Asia and its rising middle class. Tourism exports in particular have grown strongly in the past year and are expected to continue improving with further AUD weakness expected.
- **Imports** declined slightly in Q1 and are expected to be flat in 2016, before rising again in 2017 with a higher AUD, improving consumption and a less negative business investment. Capital goods imports are expected to remain weak as business investment remains subdued. Intermediate goods imports have been growing on the back of strong dwelling activity, however recent evidence suggests it could be moderating.
- The outlook for **rural exports** has been boosted by good rain across much of eastern Australia and the Bureau of Meteorology's forecast for a wetter than average winter with the chance of La Nina developing around 50%. Our recently released outlook for the 2016-17 Australian wheat season places the crop at 26.1 million tonnes, with further upside if rainfall is above average. The rain has flowed through to cattle prices, with higher restocker demand pushing up the Eastern Young Cattle Indicator. Meanwhile, the price of major agricultural commodities remains mixed on global markets, but we continue to expect a downward drift in the AUD to provide some support locally.



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



source: ABS, Bloomberg, NAB



Australian financial markets

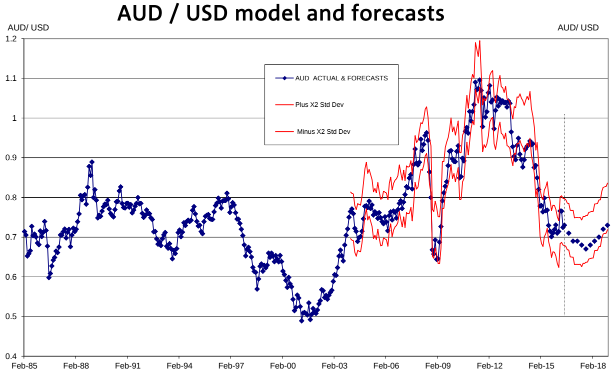
Exchange rate

- The AUD has recently re-appreciate above 74 US cents after the USD fell following the weaker-than-expected payrolls print which has re-ignited expectations that the Fed will remain lower for longer. Despite this, we retain our forecast for the AUD to be around 69 US cents by late 2016, easing to 67 US cents by mid-2017, and then picking up very gradually to 73 cents by end 2018. While there are upside risk to these forecasts, a move towards 80 US cents would not be sustained for long, as any such move would increase the probability of a further RBA cut given its negative implications for domestic growth and inflation. We are mindful of the risk that the current high global risk appetite/low volatility environment may not be sustained.

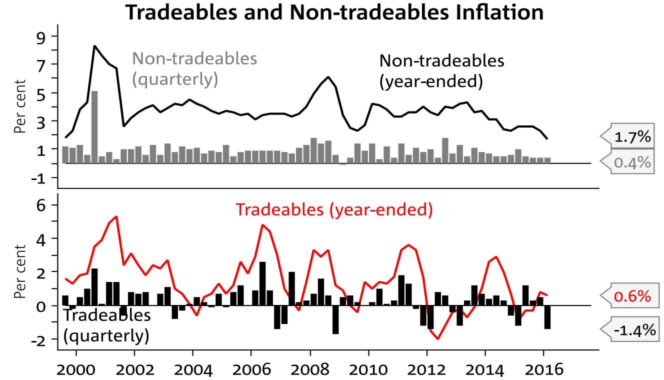
Interest rates and inflation

- The RBA’s cash rate cut to 1.75% indicated that the central bank does remain a committed inflation targeter. However we expect that the RBA will follow a more “flexible” approach to its target going forward, and fall into the “one and done” camp at this stage. This is particularly in light of the sound performance of economic activity measures. In addition, the surprise weakness in wages and inflation (both in Australian and globally) remains puzzling, while the RBA will remain mindful of the distortionary impact of exceptionally low rates on risk taking behaviour and the need to keep some ammunition up its sleeve in the instance of an economic shock (most likely stemming from offshore).
- That said, we acknowledge the risk that further rate cuts could occur should inflation continue to print below expectations, inflation expectations fall, the AUD surprises to the upside and/or the non-mining economy loses momentum earlier than anticipated.
- The lower-than-expected March CPI showed broad based weakness in domestic cost pressures which could not be explained by temporary factors alone, with both non-tradables and tradables inflation subdued. The Melbourne Institute monthly inflation gauge fell 0.2 per cent in May, after a 0.1 per cent rise in April. That said, and more encouragingly, this month’s Nab business survey showed increases in a range of price measures (perhaps as currency hedges wear off) which may suggest some pick up in inflation into Q3.
- That said, it is difficult to envisage a substantial pick up in inflation going forward. Space capacity in the labour market will keep wages growth contained. Furthermore, loosening conditions in the housing market are seeing rental and construction costs moderate. Meanwhile, weak wages growth and increased retail competition are keeping the cost pass-through from import prices contained. Low global inflation, and an ongoing low commodity price environment are also consistent with weak price pressures. This will see core inflation pick up slightly but remain near or below the bottom of the 2-3% target band through the forecast horizon.

AUD / USD model and forecasts

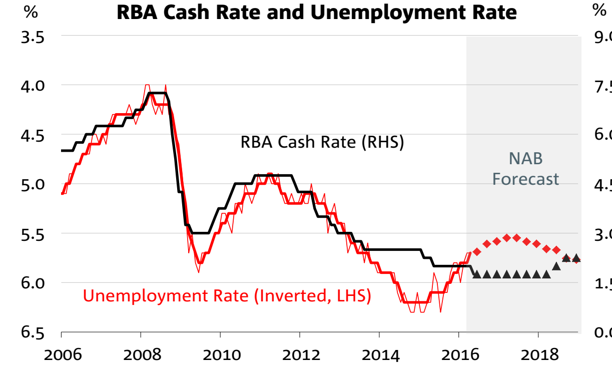


Tradeables and Non-tradeables Inflation



Source: National Australia Bank, Macrobond

RBA Cash Rate and Unemployment Rate



Source: ABS, NAB

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