Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- **Brexit, the latest in a series of shocks to global financial markets, leads up to shave our global growth forecasts by 10 to 20 bps in 2016 and 2017. Annual global growth should average around 3% over the forecast horizon, a lacklustre performance that falls well below its long run trend. China, India and the US remain key drivers of growth with softer conditions across Japan and the rest of E Asia, Latin America and W Europe. With little evidence of inflation pressures central banks can keep interest rates very low by historical standards. The global trading environment for Australian business looks set to remain subdued but the degree of global softness should be kept in perspective – this is a long flat period for growth as the global economy recovers from the GFC, it is not a recession.**
- **Australian real GDP continues to be supported by solid non-mining activity and strong growth in the volume of LNG and services exports. Consistently above-average business conditions in non-mining appear to supporting business confidence (despite Brexit), which is encouraging as we enter a period of political uncertainty. The divergence between mining sectors and geographies is increasingly stark however, with low commodity prices to be an enduring feature. Our real GDP forecasts are 2.9% for both 2016 and 2017 and to 2.5% in 2018. The unemployment rate eases to just above 5½% in coming quarters, then holds steady before drifting up to 5.8% in 2018. Meanwhile, low wages growth and weak commodity prices are consistent with a subdued inflation outlook and are a testing combination for government revenue, as evidenced by S&P placing Australia's AAA credit rating on negative outlook. Our central case remains for the RBA to hold, although this is data dependant and the central bank is keeping its options open. Brexit will have minimal direct effect given Australia's goods trade has re-oriented to Asia, although services trade and investment flows are larger.**

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	1.3	1.3	1.5
Japan	4	0.6	0.5	0.6	0.6
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	2.9	2.9	1.9
Global total	100	3.0	2.8	3.0	3.1
Australia	2	2.5	2.9	2.9	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	1.6
GDP		2.3	3.0	2.7	3.0
Core CPI (*% through-year*)		2.2	1.7	1.9	1.8
Unemployment rate (*% end of year*)		6.0	5.7	5.6	5.7

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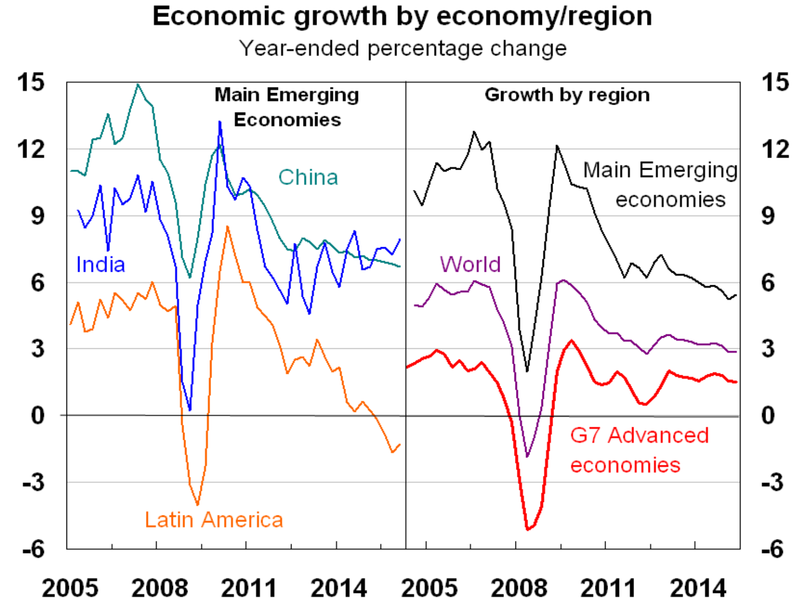
Global and Australian overview

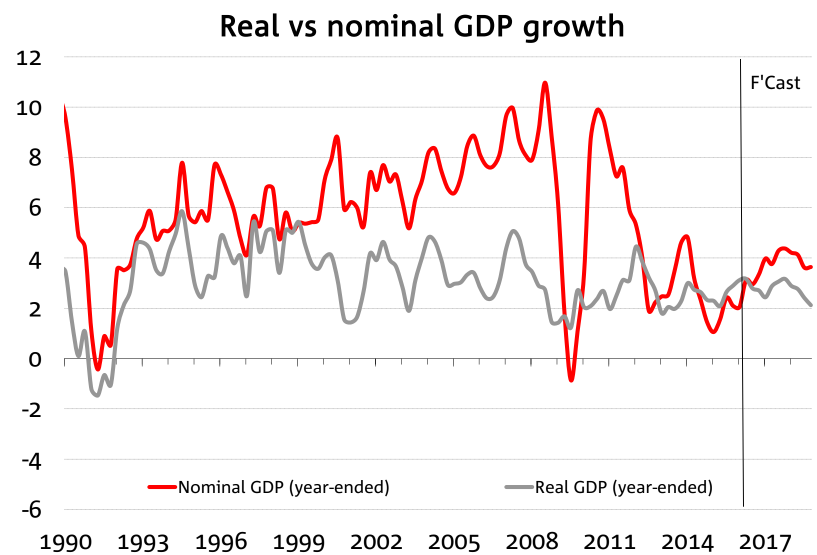
Global overview

- Global growth remains subdued and below trend and there are big differences between regions in terms of economic performance (China, India and the US are stronger: Latin America, Japan and the rest of East Asia and the Euro-zone have been weaker). With neither the business surveys nor our tracking model pointing to a sustained upturn in growth and Brexit hitting economic prospects in Western Europe, we have cut our global growth forecasts by 10 to 20 bps annually in 2016 and 2017.
- The disappointing pace of recovery in the big advanced economies from the deep recession of 2008/9 has been a major drag on the global economy. This owes much to a lack of growth in income generation as wage growth stayed low, eroding real pay and household incomes in economies as diverse as the US, UK and France. Sluggish income growth has weighed on spending and kept debt/income ratios high.

Australian overview

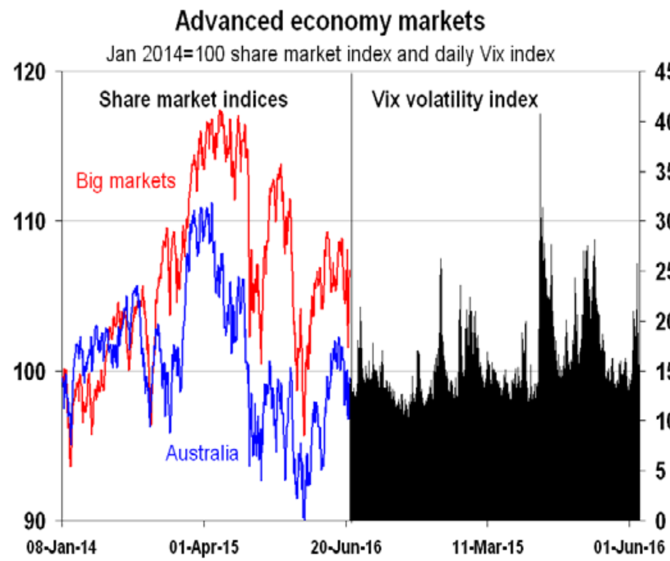
- Australia's economic outlook is largely unchanged from last month, despite some minor downgrades to our GDP forecasts stemming from slightly weaker trading partner growth forecasts and marginally higher currency forecasts. Real GDP is expected to expand by 2.9% in both 2016 and 2017 before slowing to 2.5% in 2018. The unemployment rate is expected to resume its modest downward trajectory later in the year, easing to 5½%, before stabilising in 2017 and inching up to o5.8% in 2018.
- Our forecasts assume conditions across the non-mining economy remain reasonably solid. Incoming data is supporting this view for now, with business conditions up to +12 and consistently above average for the past 14 months. This seems to be assisting business confidence, which is welcome as we enter a period of political uncertainty.
- The outlook for income growth and government revenue meanwhile remains challenging, with S&P placing Australia's AAA credit rating on negative outlook. S&P has given the government of the day 6 to 12 months to pass savings and expenditure measures, amidst what remains a challenging fiscal backdrop. Key commodity prices are likely to remain low for an extended period (see our latest forecasts), leading to further declines in the terms of trade, while the outlook for wages is subdued with spare capacity to remain in the labour market.
- These forecasts are based on slightly weaker trading partner growth forecasts and a slightly higher trajectory for the AUD than last month. The AUD is now expected to ease to USD 70c by end 2016 (previous 69c), with a move sub-70c sometime next year before re-appreciating into 2018. The also assume the RBA cash rate remains at 1.75%, although a further cut is possible and is highly data dependent.

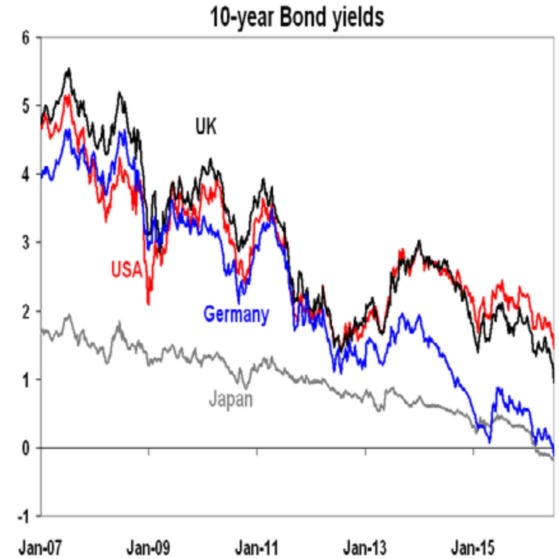


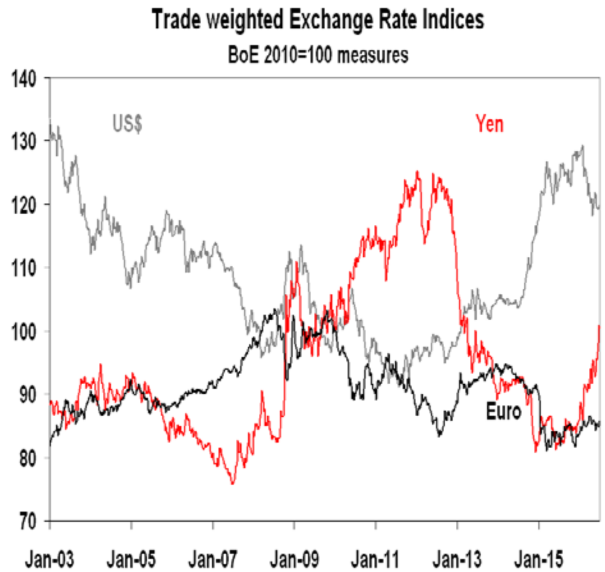


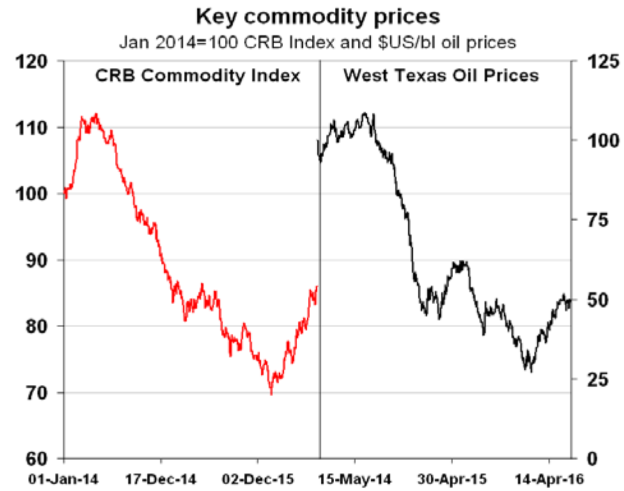
Financial and commodity markets

- The UK referendum outcome to leave the EU has provided yet another shock to global financial markets. While its impact has remained largely concentrated within Western Europe, it has spilled over into a focus on "safe" assets that has given an unwelcome boost to the yen and lowered Japanese share prices as exporting firms are hit.
- Markets are settling down now with the Vix index of financial volatility going back below its pre-referendum level and US equities buoyed by a likely postponement of the Fed's rate rising track and some favourable economic data.
- Behind these short term ups and downs of daily trading, financial markets are sending signals that are concerning. An increasing share of advanced economy sovereign bonds are trading at negative yields, hardly a sign of strength for global growth and inflation. Currency movements have not been very helpful with the big rise in the Yen looking set to dampen growth in an already soft economy and a halt in the US$ depreciation that had been helping the emerging economies by boosting commodity prices and helping curb their $US foreign debts.
- With sub-trend global growth, subdued inflation frequently running below central bank target levels and no shortage of risks hanging over the world economy, central banks look set to err on the side of caution before unwinding their very loose monetary policies. We expect the Fed to delay its next rate hike to the end of the year and follow up with a gradual 3-hike rate increase profile through 2017. The Banks of Japan and England look set to ease rather than tighten policy, initially through higher asset purchases. The European Central Bank is still working through its last (March 2016) easing and looks more likely to ease than tighten its policy.



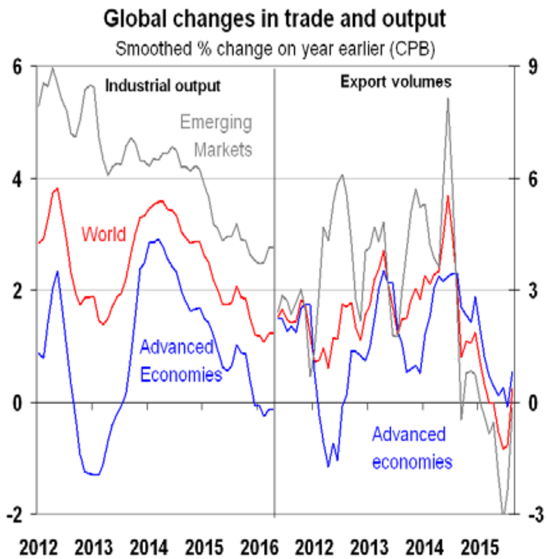


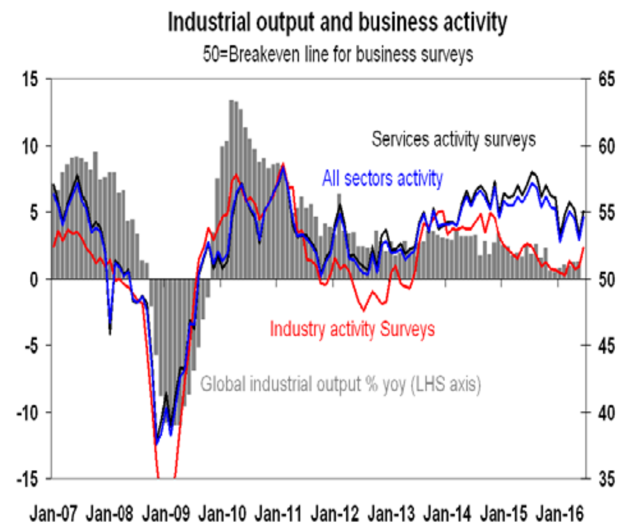


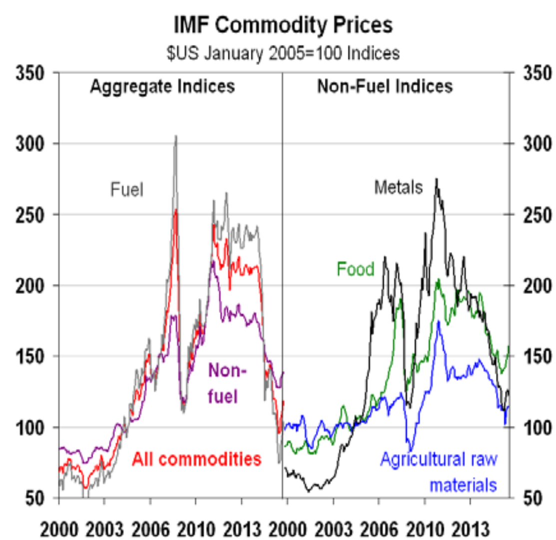


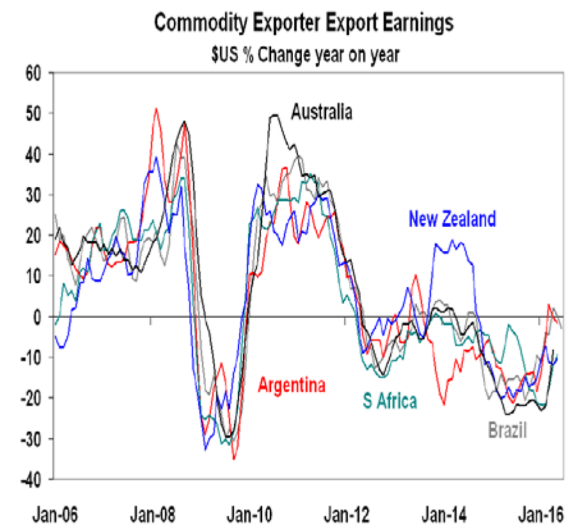
Global Economic Trends

- The background is still one of subdued growth in global activity. Quarterly growth of global industrial output slowed from 0.6% in September quarter 2015 to 0.3% last December and 0.2% in the March quarter 2016. The latest (April 2016) data shows global industrial growth still trending under 1%. World trade has been even softer with quarterly export growth slowing from 0.6% to 0.3% and then zero through the latter two quarters of last year and March quarter 2016.
- Industrial output data is available up to May for countries representing a sizeable chunk of the world economy and it shows growth settling at just over 1% yoy, slightly better than at the start of the year, mainly because of a modest recovery in very weak manufacturing activity in the emerging economies of East Asia (excluding China).
- Business survey data is even more timely and we now have June outcomes for a range of countries. On average, survey outcomes are consistent with continued modest economic growth in the big advanced economies and key emerging market economies. Manufacturing survey readings from the big advanced economies suggested a modest pick-up in the pace of growth between March and June quarters but readings for services, easily the biggest part of output, were quite flat. Taken overall, then, the business surveys do not show much change in growth in the June quarter – it should have stayed modest and sub-trend.
- Weak commodity prices have weighed heavily on growth through the last few years across a raft of Southern Hemisphere primary producers. Recently, commodity markets had been turning, helped by a previously falling trend for the $US, limiting the decline in export receipts among primary producers.



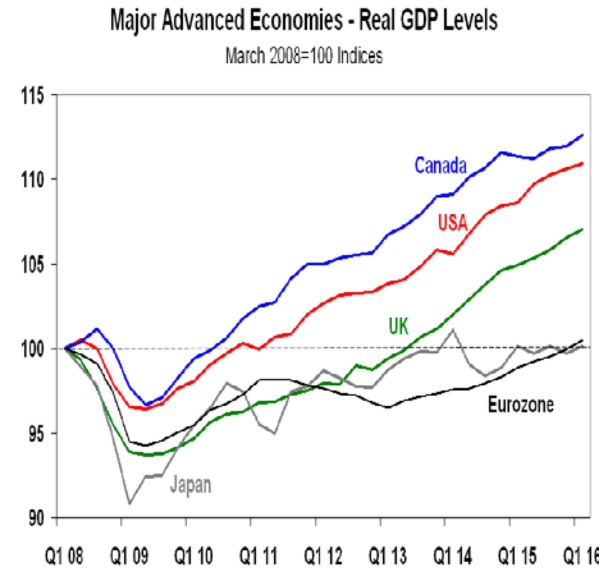


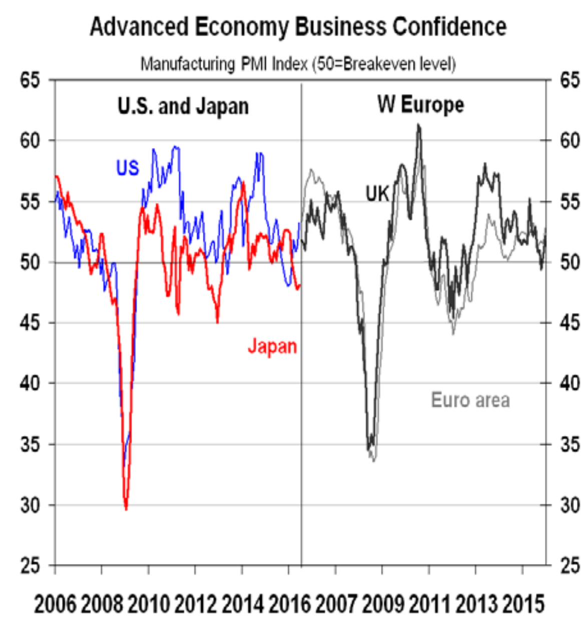


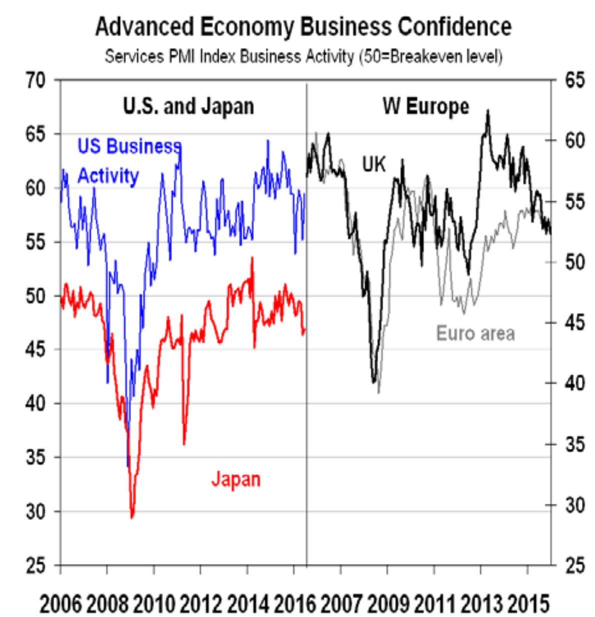


Advanced Economies

- Moderate growth continues in the big advanced economies, which account for just over one-third of the world economy. Output in the G7 grew at an annualised rate of 1.6% in the March quarter and the business surveys suggested something similar in June. Many of the results of these surveys were collected prior to the vote for Brexit and probably overstate the degree of optimism now prevailing in business in the EU.
- Conditions remain mixed between the big advanced economies. The size of the Japanese and Euro-zone economies has only recently got above their early 2008 level, marking almost 8 lost years for growth. Over the same period, GDP in North America and the UK has risen. Business survey results and partial data indicate that US economic growth remains solid. We do not believe that recent disappointing labour market outcomes mean US growth has slowed noticeably.
- Euro-zone economic growth was picking up prior to the Brexit vote, rising from 0.3% in September 2015 to 0.4% in December and then 0.6% in March 2016. June business surveys showed an upturn in Euro-zone manufacturing combined with the worst service sector outcome for 18 months, suggesting that growth is unlikely to have ramped up further from March quarter's outcome.
- The UK economy looks set to experience the worst economic fallout from the Brexit vote with reports of business deferring hiring and investment. We have revised our UK forecasts down heavily in the wake of the referendum and expect to see a shallow technical recession in the UK around the turn of the year. Lower Sterling will help UK export competitiveness but the likely erosion of business confidence will erode investment, outweighing any export gains.

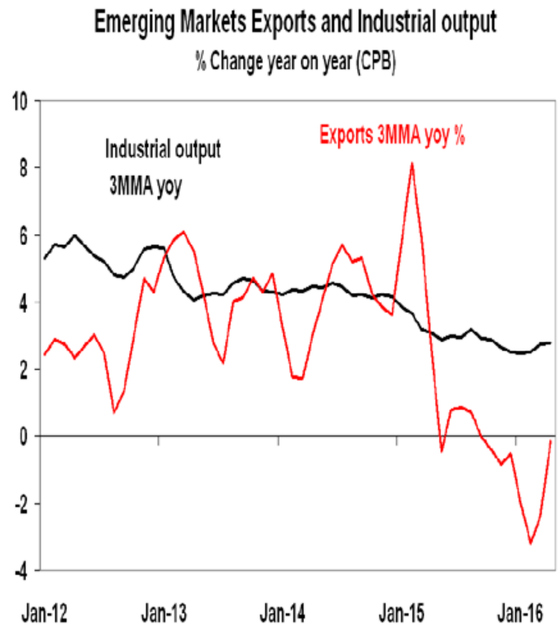


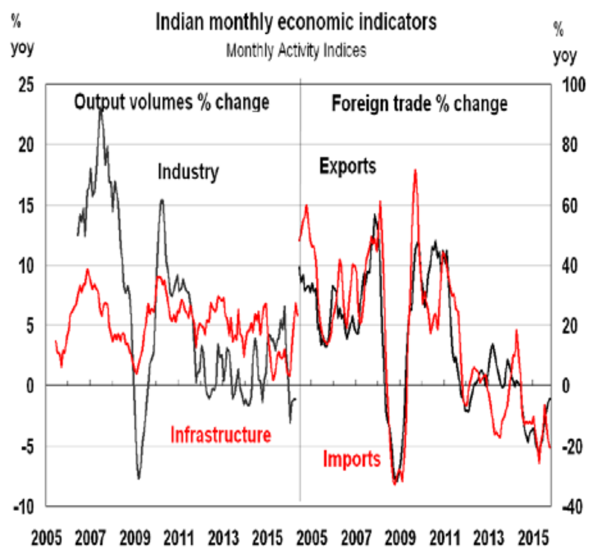




Emerging Market Economies

- 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 growth 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.





Global forecasts and policies

While Brexit - the latest shock to hit the global economy - should not have much impact on economic activity outside W Europe, the consequences are still enough for us to lower our world growth forecasts by around 10 to 20 bps through 2016 and 2017. The UK economy is predicted to enter recession but as it only accounts for 2.4% of the world economy the impact on global growth is small.

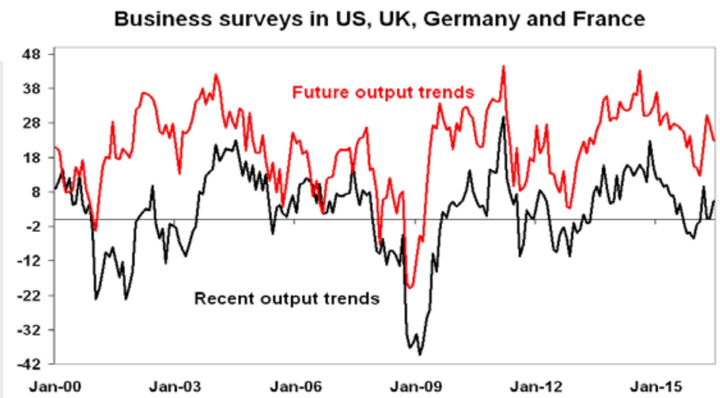
The Euro-zone, on the other hand, represents almost 12% of world GDP so any spillover via heightened instability and risk aversion there would have a much greater impact on the outlook. Markets will probably be increasingly fearful of the growing risk of sudden reversals in economic policy, driven by populist parties attracting voter support in several EU countries.

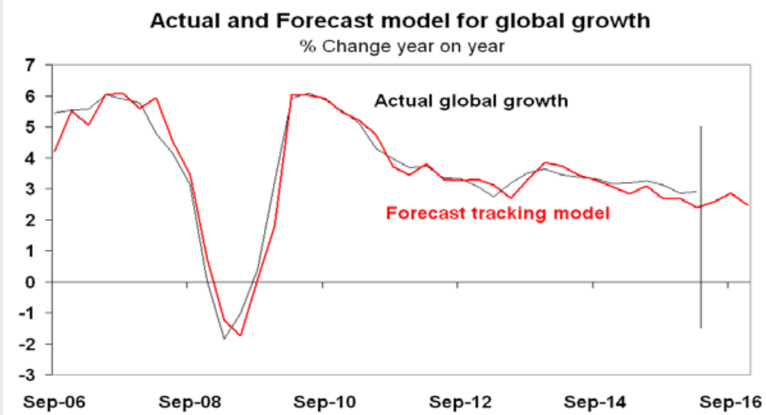
The outlook is still one of moderate sub-trend economic expansion at around 3% annually, concentrated in China and India among the emerging markets and the US among the big advanced economies. Inflationary pressures remain very weak in many key economies, allowing central banks to sustain very low policy interest rates and underpinning historically low bond yields. The US Federal Reserve is about the only central bank in the big advanced economies thinking of lifting its interest rates and it has proved very cautious in its approach to tightening policy.

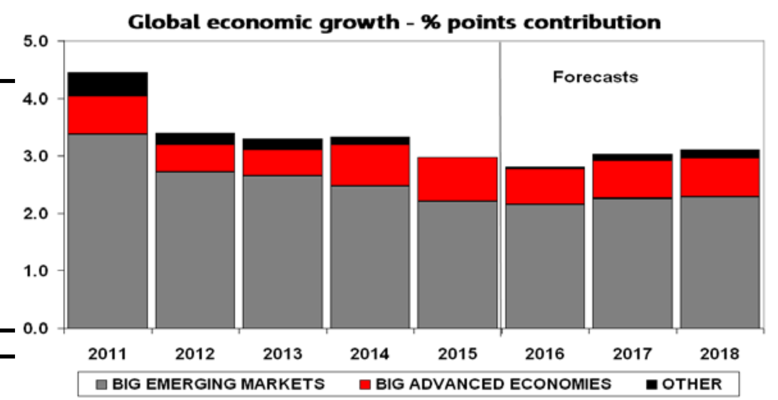
Neither the business surveys nor our global tracking model point to any sustained lift in global growth. Given the weakness of income growth, the prevalence of uncertainty in the business environment, the many vulnerabilities overhanging the economy (e.g. debt burdens), growing political risk as well as the lack of monetary and fiscal policy room to stimulate growth the most likely outcome is more of the same disappointing global performance.

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	1.3	1.3	1.5
Japan	-0.4	1.7	1.4	-0.1	0.6	0.5	0.6	0.6
UK	2.0	1.2	2.2	2.9	2.3	1.2	0.6	1.2
Canada	3.1	1.7	2.2	2.5	1.1	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	4.5	2.3	2.5	0.4	-0.6	-1.0	0.9	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	2.9	2.9	1.9
World	*4.4*	*3.4*	*3.3*	*3.3*	*3.0*	*2.8*	*3.0*	*3.1*
memo								
Advanced Economies	1.7	1.2	1.2	1.8	1.9	1.6	1.7	1.7
Big Emerging Economies	7.0	5.3	5.5	4.9	4.4	4.2	4.7	4.8
Major trading partners	4.7	4.3	4.2	4.0	3.8	3.7	3.7	3.6







Australian outlook

- Australia's real economy continues to be supported by resilience across the non-mining economy, as well as a pick up in services and LNG exports. This is translating into strong business conditions as reported in the NAB monthly business survey. It also appears to be helping business confidence, which bounced back to +6 in June despite financial market instability associated with Brexit, an encouraging sign as we enter a period of political uncertainty.
- Meanwhile, the divide between the non-mining economy and weakness in mining-affected areas and sectors continues to intensify – we estimated last month that mining investment boom unwind was about 50% complete, while the associated employment downturn was not yet at the half way point.
- On the flipside, inflationary pressures are weak, which may induce further easing from the RBA in August if the Q2 CPI weak again, although our central case remains for the RBA to hold steady for an extended period (see page 13).
- Looking forward, our real GDP forecasts are marginally lower at 2.9% for 2016 and 2017 before slowing to around 2½% in 2018. This growth should see the unemployment rate edge lower to 5½% by end-16 and hold steady in 2017 before inching up to 5.8% by end-2018. Inflation is forecast to test the bottom of the 2-3% target band for an extended period.
- The weakness in Australia's income growth and government revenue meanwhile continues to present challenges, with S&P placing Australia's AAA credit rating on negative outlook, meaning a one-in-three chance of a downgrade in the next two years. While we expect this "warning" to have limited material impact on yields or the economy at this point, it will increase pressure on the government of the day, which will struggle to ensure passage of legislation through both houses of parliament. S&P will be monitoring the ability to pass savings and expenditure measures over the next 6 to 12 months.
- A weakening of Australia's external position could also prompt a downgrade, although is unlikely given the volume of LNG exports coming on line. (Brexit is unlikely to alter this outcome substantially given that Australia has re-oriented much of its trade to Asia.) That said, income growth is unlikely to improve substantively in coming years, with weak wages growth to limit income tax receipts (even if employment holds up). Meanwhile, our latest forecasts show renewed price declines for Australia's key export commodities including iron ore, which will see the terms of trade decline another 3.9% in 2017 and 3% in 2018, and restrain corporate profits and corporate tax receipts. Of course the ratings agencies would also welcome targeted cuts to government spending, although infrastructure spending should remain a priority given Australia's slowing growth potential, which we recently downgraded to 2½%.

Australian economic and financial forecasts (a)

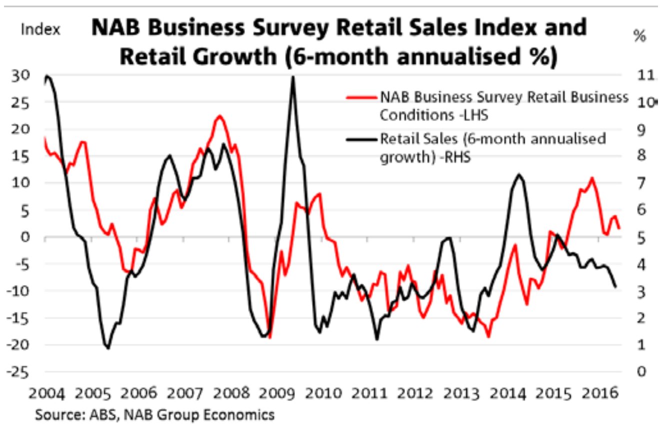
	Fiscal Year			Calendar Year			
	2015-16 F	2016-17 F	2017-18 F	2015	2016-F	2017-F	2018-F
Private Consumption	2.9	2.4	2.5	2.8	2.7	2.4	2.4
Dwelling Investment	8.7	2.7	-1.9	9.8	5.5	0.4	-3.5
Underlying Business Investment	-13.8	-10.8	-3.4	-10.5	-13.1	-8.0	1.4
Underlying Public Final Demand	2.8	2.6	2.6	2.1	2.5	2.6	2.6
Domestic Demand	**0.9**	**1.0**	**1.6**	**1.1**	**0.8**	**1.2**	**1.9**
Stocks (b)	0.0	0.0	0.0	0.0	0.1	-0.1	0.0
GNE	**0.9**	**1.0**	**1.6**	**1.1**	**0.9**	**1.2**	**2.0**
Exports	7.2	8.3	8.0	5.9	8.2	9.0	5.4
Imports	-0.9	-1.0	2.7	1.5	-2.4	1.2	3.3
GDP	**3.0**	**2.7**	**3.0**	**2.5**	**2.9**	**2.9**	**2.5**
– Non-Farm GDP	3.0	2.7	3.0	2.5	3.0	2.9	2.6
– Farm GDP	-0.6	2.5	2.0	0.0	2.5	1.6	2.0
Nominal GDP	2.4	3.5	4.2	1.8	2.9	4.1	3.9
Federal Budget Deficit: ($b)	-37	-34	-23	NA	NA	NA	NA
Current Account Deficit ($b)	82	70	66	78	75	66	72
(-%) of GDP	4.9	4.1	3.7	4.8	4.5	3.8	4.0
Employment	2.2	1.9	1.8	2.0	1.9	1.9	1.7
Terms of Trade	-10.2	-4.3	-3.3	-11.5	-6.7	-3.9	-3.0
Average Earnings (Nat. Accts. Basis)	0.9	1.6	2.2	0.6	1.2	2.1	1.9
End of Period							
Total CPI	1.6	2.9	2.6	1.7	2.3	2.6	2.7
Core CPI	1.7	1.9	1.8	2.0	1.8	1.8	2.1
Unemployment Rate	5.7	5.6	5.7	5.9	5.6	5.7	5.8
RBA Cash Rate	1.75	1.75	2.00	2.00	1.75	1.75	2.25
10 Year Govt. Bonds	1.98	2.25	2.60	2.88	2.10	2.45	2.65
$A/US cents :	0.73	0.69	0.72	0.73	0.70	0.70	0.75
$A - Trade Weighted Index	62.0	60.0	60.9	62.7	61.0	60.0	62.4

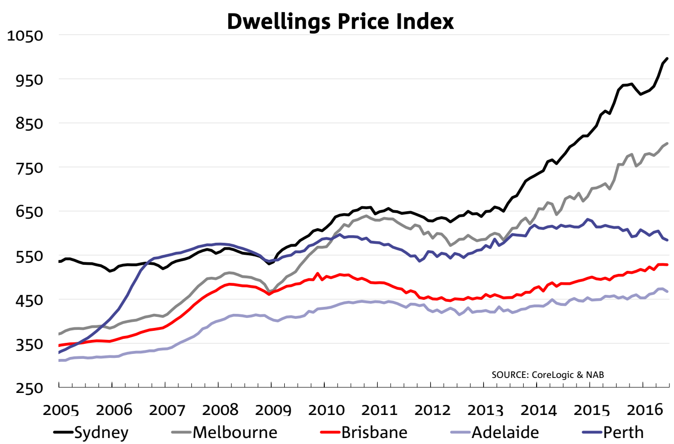
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

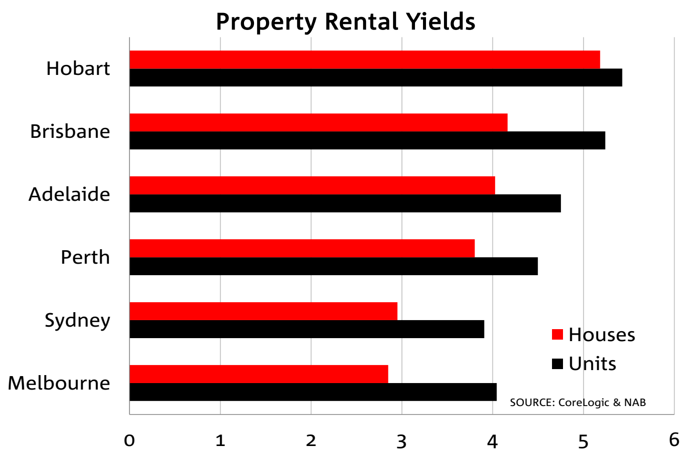
(b) Contribution to GDP growth

Australian consumer demand and housing market

- Household consumption growth in recent quarters has been somewhat resilient despite slowing employment growth, largely driven by spending on essentials: food, rent and insurance and financial services - which points to continuing consumer caution. Meanwhile, high-frequency data continued to show an easing trend in overall retail spending (which accounts for slightly more than one-third of overall consumer spending), pointing to some downside risks for consumption in Q2. This is consistent with readings from our monthly NAB Business Survey which suggests a downward trend in business conditions for retailers since late 2015. At the same time, wages growth has remained subdued. Meanwhile, stronger-than-expected house price growth in the year-to-date, especially in Sydney, could continue to support to consumer spending through the wealth channel. On a more positive note, NAB's latest Online Retail Sales Index showed that growth in May rebounded to 2.0% m/m (13.2% y/y) from the low growth of 0.3% in April.
- We continue to expect moderate growth in consumer spending through 2016 and 2017, supported by a broadening recovery of the non-mining sector, low interest rates and further easing in household savings rate. There has been a general improvement in consumer confidence, although it is unclear whether it will be sustained amidst the federal election and financial market volatility following Brexit.
- National dwelling prices (hedonic) continued their rise in June. Price growth was relatively strong in Sydney, rising 1.2% m/m in June, with unit prices rising the most, and despite a slight slowing from the previous month is running at a 19% pace in 6-month annualised terms. Despite the recent resurgence, fundamentals are still suggesting the market has peaked, while price measures that are not quality adjusted (median prices) point to a flat-to-falling market. Indeed, the average time on market has increased, while vendor discounts are generally up. Sales volumes have also fallen notably, although resilient prices suggest limited supply rather than falling demand. The situation is largely similar in Melbourne, where hedonic prices rose 0.8% m/m and 12% in 6-month annualised terms. Hobart was the only other capital to see prices rise in June, with the largest fall taking place in Darwin (-1.5% m/m). Housing credit growth continues to run around 7% y/y – with accelerating owner occupied housing credit to 7.4% y/y offsetting further moderation in investor credit – now 6% y/y.
- Prices are continuing to surprise on the upside, prompting us to revise up our forecasts for prices growth in 2016 – although outcomes vary by city, with mining related regions to remain weak. The recent RBA rate cut and solid population growth in NSW and Victoria are helping, however, large additions to supply, prudential (and other credit) constraints and poor affordability in some cities are all expected to bite eventually. Rental yields have also hit more than 10-year lows in the major markets, further discouraging investor demand. Our national price growth forecasts for 2016 are 5% for houses and 3½% for units. While quality adjustments will continue to prop up published prices, we still forecast growth to moderate to 0.5% for houses and -2% for units in 2017. The outlook is sensitive to our interest rate and other potential policy changes, but we maintain our expectation for the RBA to keep the cash rate on hold.

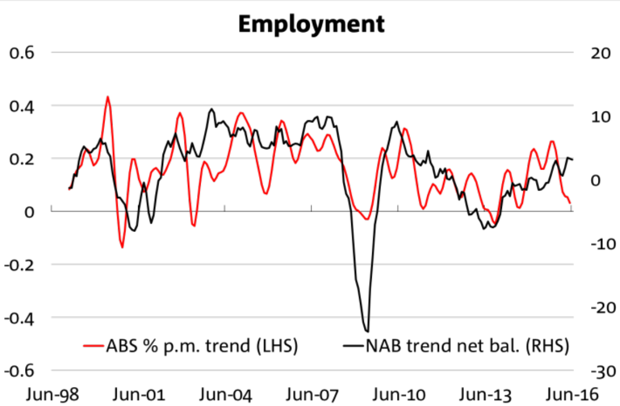




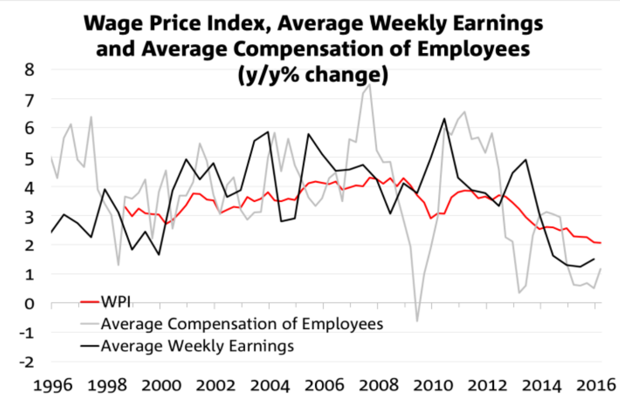


Australian labour market

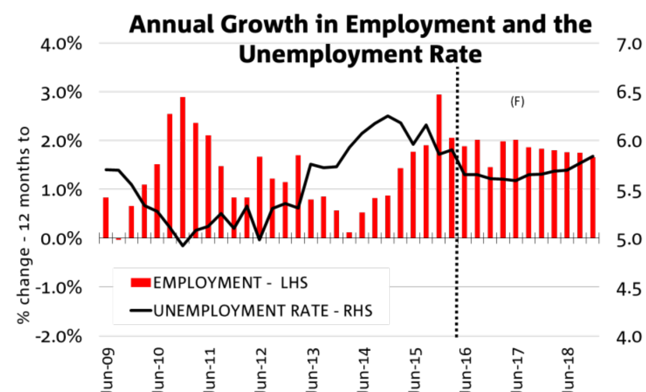
- In May, the weakening trend in employment growth (evident since late 2015) continued. Meanwhile, the unemployment rate has trended lower and stabilised at around 5.7%, partly driven by a lower participation rate. The recent slowdown is largely attributable to a moderation in the growth of full-time jobs. However this followed an exceptionally strong period of employment growth in the second half of 2015 which was unlikely to be sustained, and may be partly explained by sample rotation in the statistics which is now being unwound. That said, aggregate and average hours worked by full-time employees have declined notably since the start of this year, although did show a sharp rebound in May. Downward trending hours worked suggest rising spare capacity in existing jobs which warrants further monitoring. Meanwhile, the growth in part-time jobs has been relatively more resilient.
- By state, NSW and VIC continued to dominate employment growth in trend terms, with Queensland showing more entrenched signs of weakness. On a trend level basis, VIC's employment growth was the strongest in the month (+5.5k), followed by NSW (+3.6k) and WA (+1.9k), while Qld showed the largest decrease (-5.1k). The weakness in Qld labour market in the past few months appears to be largely driven by lower employment in manufacturing, mining and a number of services sectors such as health, education, finance and professional services. The trend unemployment rate was unchanged in NSW , VIC and WA at 5.3%, 5.8% and 5.6% respectively, and fell by a 0.1 ppt in SA (to 6.9%), TAS (to 6.5%), ACT(to 3.8%) and NT(to 4.1%). QLD was the only state to record an increase in trend unemployment rate to 6.4%. In the research note on the evolution of mining employment (see note) published a few weeks ago, we concluded that around 50k more mining jobs are expected to be shed going forward, with most of them likely to stem from WA.
- The employment index from the June NAB monthly business survey reversed most of the fall in the previous month– rising to +4 from +1 in May to be above its long-run average. At its current level, the index is consistent with employment gains (of 18k per month) in the next six months which would be more than sufficient to see unemployment edge lower over the course of 2016.
- In 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 before inching up to 5.7% by end-17 and 5.8% by end-18.
- Overall wages growth remains low despite a notable amelioration in unemployment to-date. The ABS Wage Price Index continued to trend downwards, but we believe measures such as average weekly earnings and compensation per employee (on a national accounts basis) are better at picking up turning points given that they include the effects of compositional changes in the labour market. Average compensation of employees did pick-up in Q1, but we will need more data points to decide if wages growth has reached an inflection point. Interestingly, recruitment surveys – such as Hays Annual Salary Survey – are signalling a marked increase in the number of employees intending to ask for wage rises next year (42% of respondents). Meanwhile, SEEK data is showing signs of wage pressure building in sectors such as construction, hospitality and tourism, government and defence and sales.



Source: ABS, NAB Group Economics

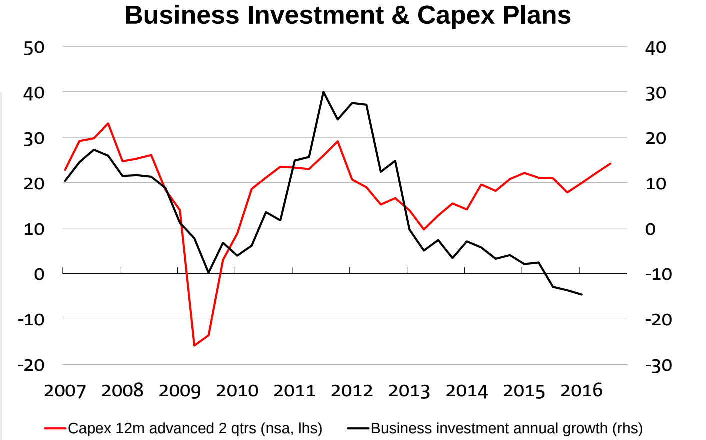


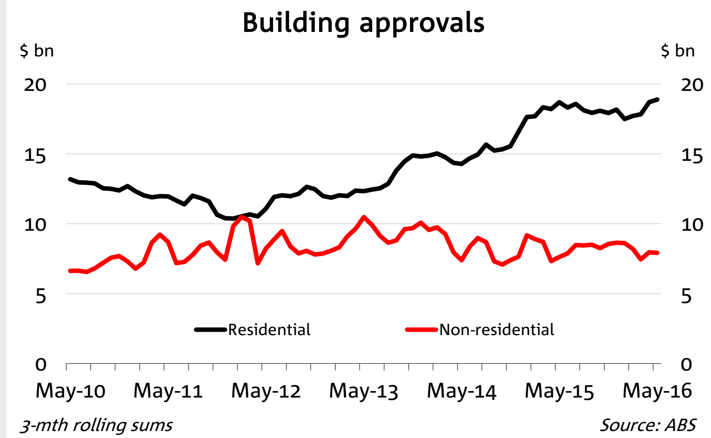
Source: ABS, NAB Group Economics

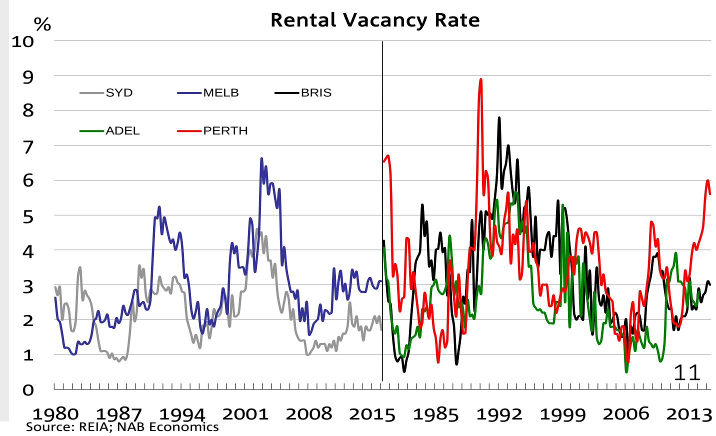


Australian investment

- Non-mining investment remains critical to the sustainability of future growth and has been a major focus for the RBA. The Q1 National Accounts suggested that non-mining investment was relatively tepid, despite solid rates of economic growth for these sectors. More timely information on non-mining investment is relatively limited, but the NAB Business Survey is suggesting reasonable rates of capex growth, regaining momentum in recent months. Levels of capacity utilisation are also reassuring, suggesting that firms may be more encouraged to invest in capital to expand operations – especially given the strength shown in the Survey's index of business profitability. Solid growth in business credit is also encouraging. In contrast, non-residential building approvals suggest building capex has been modest.
- In terms of the longer term outlook, indications are mixed. Weakness is very apparent in the ABS's Private New Capital Expenditure (Capex) Survey, which points to a further contraction in non-mining capex spending for 2016-17 – though much of the weakness is confined to manufacturing, rather than being broad-based. Unsurprisingly, mining capex intentions are especially weak – NAB have recently estimated that the mining investment downturn is only around half way complete.
- That said, the ABS Capex Survey's non mining intentions do not paint the full picture as it excludes around 50% of all non-mining sector investment – and critically excludes fast growing services sectors such as health and education. On the other hand, capex expectations (12 months ahead) improved in the Q1 NAB Business Survey, which is consistent with the falls seen in spare capacity. Commercial property market sentiment in Q1 also remained at above average levels in the NAB Commercial Property Survey, although it did deteriorate relative to the previous quarter.
- In contrast to business investment, the housing construction boom has shown no real signs of slowing down. The pipeline of construction remains substantial and dominated by apartments, while the number of new approvals has also remained elevated (although is no longer growing). The current pipeline is expected to fuel strong rates of dwelling investment well into 2017.
- Vacancy rates have edged higher in some markets, while rental listings have picked up notably in recent months – keeping pressure on rents. As the risk of supply overhang increases and the outlook for returns in this market deteriorate, the rate of new projects approved is expected to slow noticeably. By 2018 the pipeline is expected to be largely eroded and will most likely become a (small) 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 and x% in 2017) – albeit the latter only accounts for around 5% of GDP versus 12% for business investment. In 2018, business investment will increase modestly (+1.8%) while dwelling investment will fall (-3.5%). The effect of Brexit on Australian business investment is uncertain, but is expected to be minimal. Indirect effects through financial market channels (including equity markets and currency markets) are not quantifiable as yet, but do suggest some downside risk. Brexit also creates uncertainty for inbound investment, particularly as the UK remains our second largest source of foreign investment.

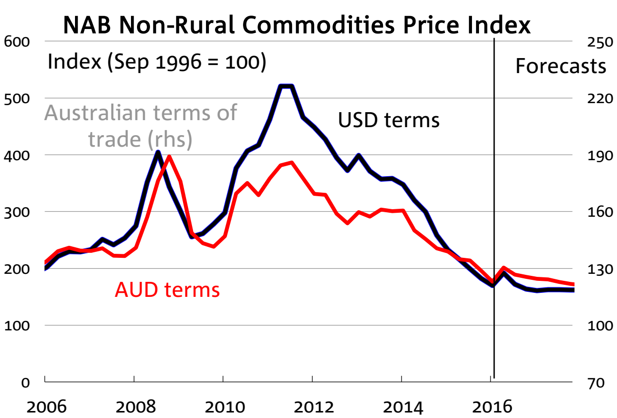


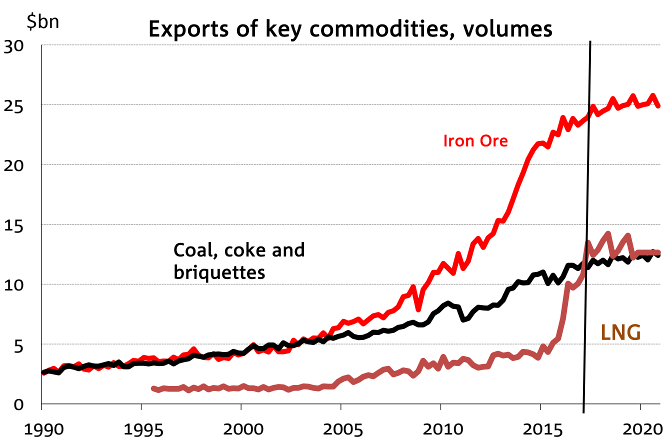


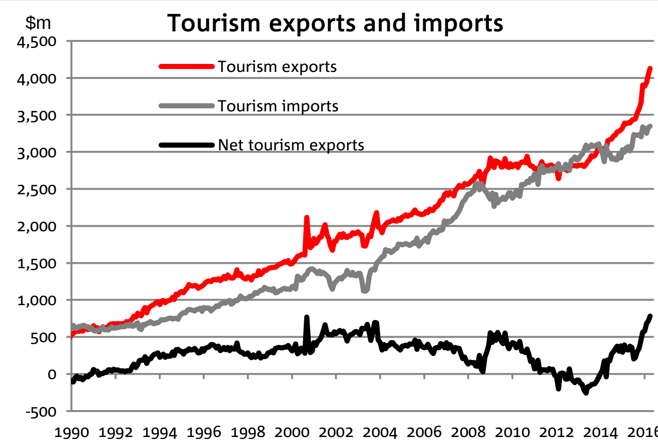


Australian commodities, net exports and terms of trade

- Export volumes are forecast to grow solidly over the next year owing to strong LNG and services exports, while import growth will remain moderate. Overall, net exports are expected to contribute 2.6 and 1.5 ppt to GDP growth in 2016 and 2017. In 2018. the contribution from net exports will reduce to 0.3 ppt, as LNG exports flatten off at a high level and support from the lower AUD start to wane. With commodity prices to broadly stabilise, Australia's trade deficit will decline to under $30bn and $20bn in 2016 and 2017, with the current account deficit narrowing to under 4% of GDP by end-17. The Brexit decision is unlikely to have a material impact on Australia's net exports in the near term, as the UK represents only about 3.2% of our total two way trade.
- Global commodity prices have stabilised somewhat since the beginning of the year. Gold prices especially have risen due to Brexit, however further modest price declines are expected for Australia's key exports (ie., coal and iron ore). **The NAB non-rural commodity index** is forecast to rise 8.7% in the June quarter, supported by a temporarily higher iron ore prices, before trending down again. Overall, the index is expected to fall by 6.3% in 2016 and another 2.5% and 0.4% in 2017 and 2018 in USD terms. The expected depreciation of the AUD in the near term will cushion some of the fall, with the index in AUD terms to fall by a smaller 3.0% in 2016, before AUD re-appreciation accentuates the declines in 2017 and 2018 to 2.5% and 7.1% respectively.
- The ramp-up in exports from several large scale LNG projects will contribute the most to total export growth, adding 4.7 and 3.2 ppt in 2016 and 2017 respectively. Iron ore and coal export volumes are expected to hold up due to Australian producers' cost competitiveness, however lower prices imply the associated income and government revenue receipts will not grow as quickly as previously anticipated.
- **Services exports** have accelerated, driven by a lower AUD and rising income levels in Asia. International tourism and education have been significant contributors to growth, with both international short-term visitors and student enrolment rising. The lower pound, however, could see visitor numbers from the UK ease somewhat following the Brexit decision. **Growth in imports is expected to be subdued,** before rising again in 2017**.** While stronger household consumption and dwelling investment are supporting consumption goods and intermediate goods imports, the weak business investment outlook means capital goods imports will remain weak for the time being. Services imports are limited by the lower AUD and soft income growth.
- Winter rainfall is shaping up well across much of Australia, boosting our outlook for agricultural exports. The Bureau of Meteorology's latest 3-month outlook points to above average rainfall continuing into early spring. Although conditions in the Pacific remain neutral, the BOM remains on La Nina watch, assessing the likelihood of La Nina at around 50%. We now expect the wheat crop to be in excess of 26 million tonnes, with Western Australia in particular looking strong. Rain induced demand has pushed the Eastern Young Cattle Indicator to dizzying heights – smashing records to reach 660.50 c/kg at the time of writing. However, low farmgate milk prices are set to continue into 2016-17. Murray Goulburn's headline opening price for the 2016-17 season is $4.80/kg milk solids, although with Milk Supply Support Package repayments the price could be as low as $4.31/kg milk solids for some producers.







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

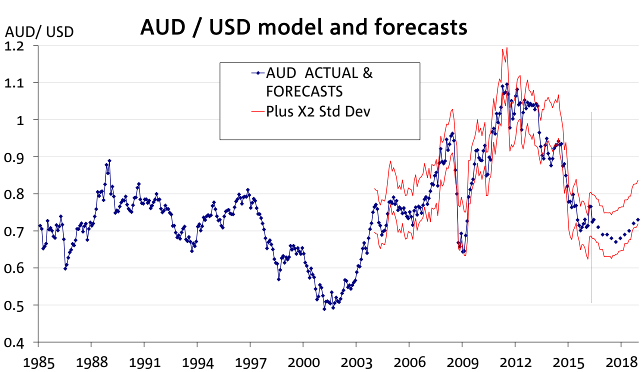
Australian financial markets

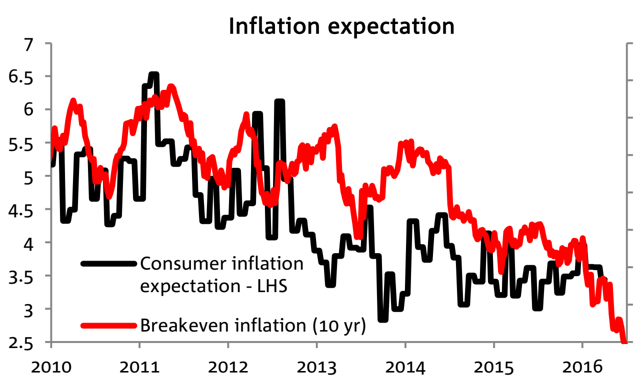
Exchange rate

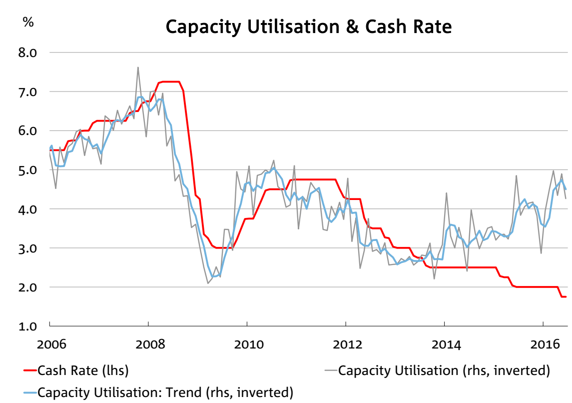
- After some volatility in the lead up and the aftermath of the Brexit vote, the AUD has settled much where it was a month ago at just over 74 US cents. Our AUD forecasts have been re-examined post the UK referendum result (and now uncertain domestic political landscape) but revisions are small. Re-evaluating our AUD forecasts in the wake of the UK EU referendum outcome hasn't resulted in any significant revisions. Similarly, the less certain domestic political landscape is, if history is any guide, unlikely to have more than modest and/or temporary negative impact on AUD. The new numbers now reflect less conviction that new cycle lows will be seen in 2016 or 2017, but we still expect a move sub-0.70 at some point next year. We now have AUD/USD holding at or above 0.70 through year-end (0.69 previously), aided by the view that we won't now see more than one Fed tightening this year (previously we forecast two). In 2017, AUD is still seen revisiting, but now not necessarily breaking below its 2015/early 2016 lows.

Interest rates and inflation

- We still consider that the RBA will keep the cash rate unchanged at 1.75% - monetary policy is already highly accommodative, and further easing is unlikely to stimulate the key underperforming sectors, although may place some downward pressure on the currency and upward pressure on inflation at the margin. That said, we acknowledge that a cut as early as August is still on cards, particularly given the RBA's wording following its latest decision that *"further information should allow the Board to refine its assessment of the outlook for growth and inflation and to make any adjustment to the stance of policy that may be appropriate".* This suggests that the August RBA meeting is a 'live' meeting, with a cut possible if Q2 inflation again prints on the low side (released 27 July). The RBA is also looking for further verification that non-mining business activity remains solid. On the latter point, the RBA would welcome the resilience of Nab's business confidence and conditions readings and improved leading indicators.
- The lower-than-expected March quarter CPI outcome was likely to be driven by both temporary and more long-term factors. There are a few factors contributing to below-average inflation that are likely to persist. For non-tradables inflation, wage price inflation is likely to remain subdued with spare capacity in the labour market remaining, despite our forecast of a lower unemployment rate. Higher rental vacancy rates in the housing market are also keeping residential rent inflation contained. For tradables inflation, exchange rate pass-through has largely been absorbed by retailers facing increasing competition, through cost savings elsewhere and low labour cost growth. As a result, inflation is likely to remain low with the RBA also noting in its latest minutes that both short and long-term measures of inflation expectations remain below average (middle chart below). The latest NAB Business Survey shows negative retail prices growth in June and worsening retail industry conditions, which could suggest retailers are facing tough competition and not passing on price rises.







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