Global & Australian Forecasts

by NAB Group Economics

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National Australia Bank

Key Points:

- Brexit has had less impact on the global economy than many feared. Financial markets are generally either back to pre-referendum levels or even stronger, and the direct economic fall-out looks like being largely restricted to a UK recession and modest spill-over to European trading partners. Having dodged yet another bullet, the global economic upturn continues along at its sub-trend pace with only a few inconclusive signs that things are finally about to get better. We have marked down our US forecasts in the wake of disappointing second quarter data but East Asia is doing slightly better and the outcome is 2016 forecast global growth stays at 2.8%. Inflation generally remains sub-target, central banks have used up much of their policy ammunition (although very unorthodox measures like "helicopter money" remain) and the structural factors that have weighed on global growth remain. China and India are driving more than half of global growth, the former by returning to time-honoured pump priming measures that pile up debt and the latter by printing statistics that many view as erring on the side of optimism in measuring GDP.
- Australian economic growth is expected to remain resilient at 2.9% in 2016 and 2017, despite significant variation across industries and states. However the risks to the outlook going into 2018 are becoming increasingly apparent, as LNG exports flatten off at a high level and the dwelling construction cycle turns down. Against these headwinds, the economy may require additional policy action to support growth, especially if the RBA hopes to see inflation return to within its 2-3% target band. Both global and domestic disinflationary pressures are expected to keep CPI inflation below the target band for an extended period, while structural shifts in the economy and modest economic growth risk upward pressure on the unemployment rate. We now expect the RBA will need to provide further support through two more 25bp cuts in May and August 2017 (to a new low of 1%), which should be enough to stabilise the unemployment rate at just over 5½% and prevent economic growth from dropping below our forecast of 2.6% in 2018. Monetary policy deliberations may then turn to the possible use of non-conventional policy measures if the outlook deteriorates further. Additionally, persistent weakness in CPI inflation could potentially trigger a rate cut even sooner than expected.

Key global and Australian forecasts (*% change*)

Country/region	IMF weight	2015	2016	2017	2018
United States	16	2.6	1.5	2.1	1.9
Euro-zone	12	1.6	1.4	1.3	1.5
Japan	4	0.6	0.5	0.6	0.6
China	17	6.9	6.6	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	3.1	3.1
Australia	2	2.5	2.9	2.9	2.6
Australia (*fiscal years*)		14/15	15/16	16/17	17/18
Private consumption		2.7	3.0	2.6	2.4
Domestic demand		0.8	0.9	1.1	1.6
GDP		2.3	2.9	2.7	3.0
Core CPI (*% through-year*)		2.2	1.5	1.9	1.8
Unemployment rate (*% end of year*)		6.0	5.7	5.7	5.6

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For more information contact:
Alan Oster, Chief Economist: (03) 8634 2927 or 0414 444 652
Tom Taylor, Head of International Economics: (03) 8634 1883
Riki Polygenis, Head of Australian Economics : (03) 8697 9534 or 0475 986 285

Global and Australian overview

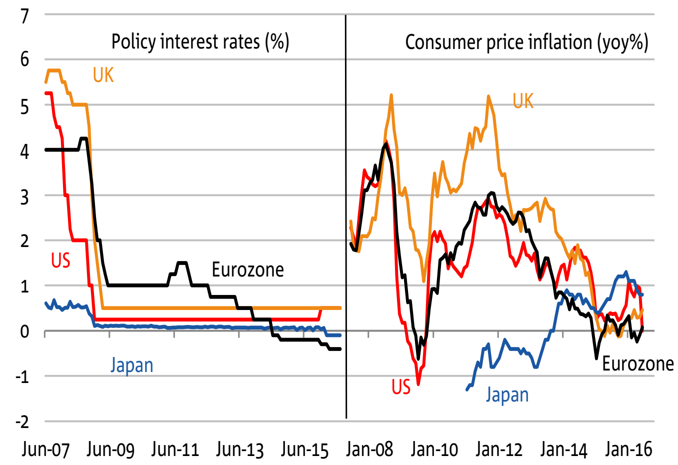
Global overview

- Global growth remains stuck at the sub-trend pace it has been running since 2011. The latest business surveys and monthly data on world trade and industrial output show a few glimmers of hope for faster growth in East Asia but it is too early to be confident that this amounts to more than the normal volatility in the data. Broader measures like GDP are starting to appear for the June quarter and so far they have been a mixed bag. Second quarter US numbers were disappointing, Euro-zone quarterly growth halved but the UK had a surprisingly good June quarter outcome (which predated the impact of the Brexit vote). There was also a modest acceleration in East Asian emerging economies like S. Korea and Taiwan and ongoing solid growth in China.
- Lacklustre growth and sub-target inflation have led central banks in Japan, the UK and the Euro-zone to drive their policy rates to historically low levels while the US Federal Reserve keeps taking longer to lift its policy rate than would be expected on the basis of its labour market. We expect to see a further round of easing by the Banks of Japan and England, following the August package of rate cuts, increased asset buying and measures to encourage bank lending. The European Central Bank will probably also have to eventually fine tune its bond buying programmes and the US Fed is not expected to lift rates again until December and remain very cautious in tightening after that.

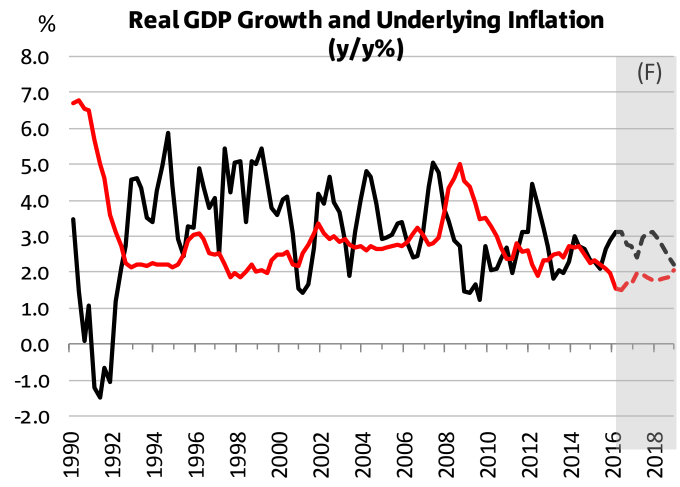
Australian overview

- Our forecasts for Australian economic growth are reasonably robust at 2.9% in both 2016 and 2017. LNG and services exports will add significantly to growth, while domestic demand will be weak amidst sharply lower mining investment. Activity will also remain varied by industry and state, with activity in non-mining sectors (especially services) robust, but mining and related industries struggling as investment unwinds and commodity prices remain low (or retreat again the case of iron ore).
- The economy is then expected to lose some momentum in 2018, which together with the very low inflation outlook, will prompt the RBA to cut the cash rate in both May and August 2017 by 25bps each to a historic low of 1%. Even with this extra stimulus, growth is expected to slow to 2.6% in 2018, and the unemployment rate remain reasonably elevated at 5.6%. Price and wage pressures will remain subdued.
- Our forecasts are also dependent on further depreciation in the AUD, although there are significant risks around our view that the AUD will track down to a low of USD69 cents by mid-2017, not least due to the reliance on either a Fed or a volatility-induced rise in the USD, which cannot be guaranteed. A lower iron ore price (as per our forecasts) would also assist the currency.
- The composition of the new Australian parliament suggests that achieving consensus on microeconomic and tax reform will be challenging, while the threat of a rating downgrade by S&P will see continued emphasis on fiscal consolidation. This will continue to place pressure on monetary policy and any further deterioration in the growth outlook following the cuts in May and August 2017 is likely to prompt consideration of non-conventional monetary policy tools such as asset purchases.

Central bank policy rates and inflation



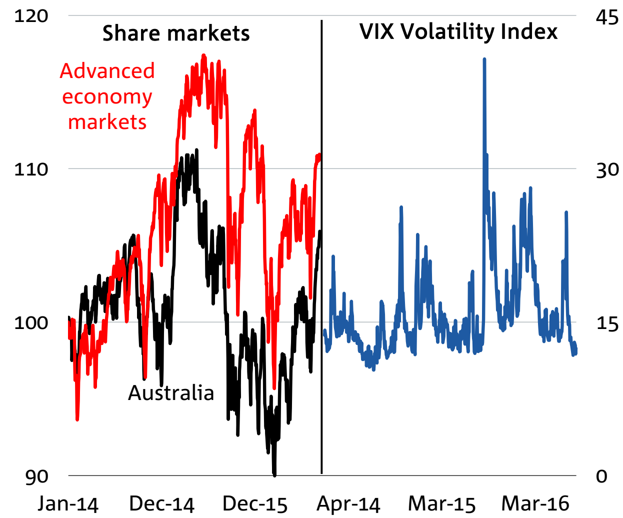
Notes: Where deposit rate is set to negative it is used as 'policy' rate. Inflation is all items except Japan which is ex fresh food and energy



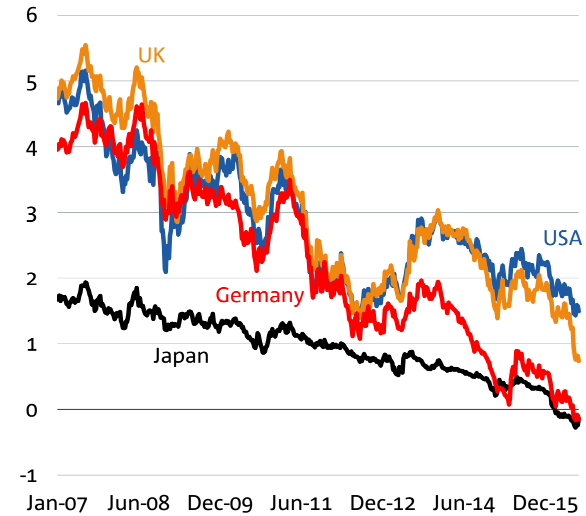
Financial and commodity markets

- Global financial markets have digested the latest shock – the UK's vote in late June to leave the European Union ("Brexit") – quite well. Equity markets fell in the big advanced economies initially in the wake of the Brexit vote, but are back above their pre-referendum level.
- Market volatility spiked as the unexpected poll outcome became clear but it soon subsided and is now not only below pre-referendum levels but is very low by historical standards. Interest rates are also exceptionally low with negative Government long bond rates and either very low or negative central bank policy rates in several key economies. Corporate bond spreads have fallen below pre-Brexit levels in the US and UK.
- Bank lending surveys do not point to much impact of Brexit outside the UK either. According to recent US, Euro-zone and Japanese surveys, neither the demand for bank credit nor measures of banks' lending appetite and terms have taken a hit from the Brexit vote. The picture remains one of continued moderate growth in credit demand with no evidence of credit rationing.
- We cannot be so optimistic for the UK, however, as the latest bank lending survey pre-dates the Brexit vote. Other business surveys show activity weakening quite sharply and a post Brexit vote survey of UK Chief Financial Officers reporting a big jump in uncertainty, a shift away from planned expansion towards defensive strategies and reduced investment. Overall, the shock of Brexit has been quite well confined to the UK so far.
- Central bank policy has tended to disappoint those looking for quick action to either address deflation and/or slow growth risks (in the Euro, Japan and UK) or move the US further along on its much anticipated rate tightening cycle. The Bank of Japan's monetary easing measures disappointed the market, the ECB preferred to wait and see how its last raft of asset buying fared. The Bank of England has now cut rates but will need to move again and the Fed will not raise rates until December.

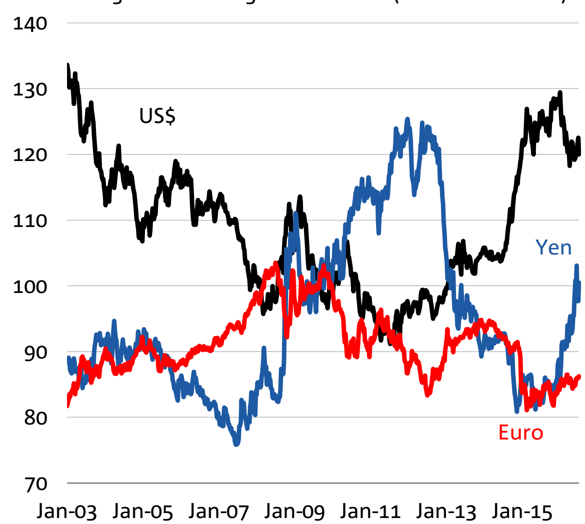
Share markets and volatility indices



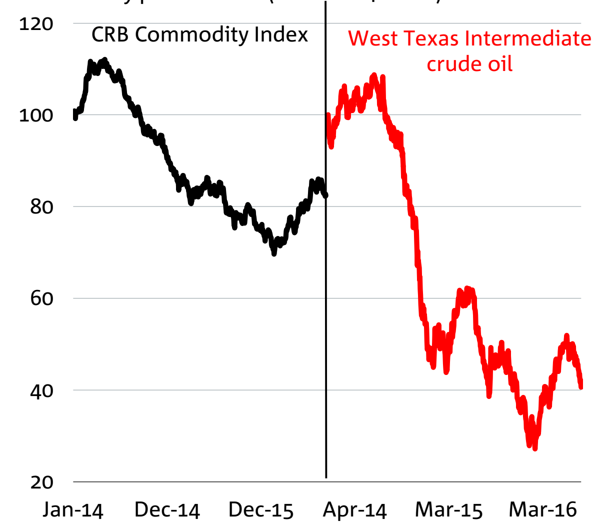
10 yr Government Bond yields (%)



Trade weighted exchange rate indices (1 Jan 2010 = 100)



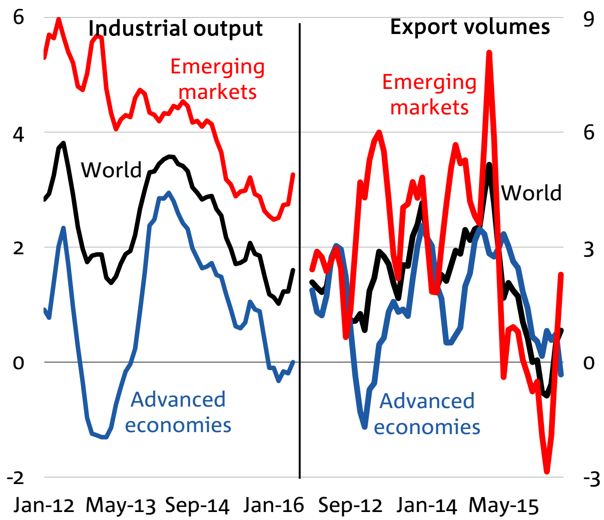
Commodity price indices (1 Jan 2014 = 100)



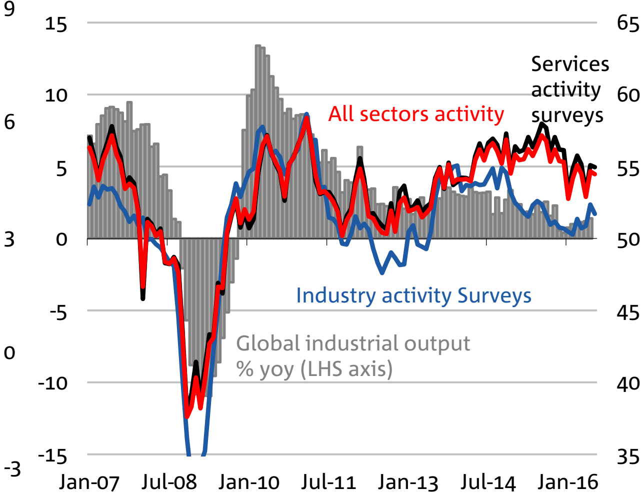
Global Economic Trends

- Global growth remains sub-trend and moderate, but there are a few brighter signs. Although the monthly data bounces around, the pace of growth in the CPB's measure of world industrial output has picked up slightly, following a soft March quarter. Production in the Asian emerging market economies – who buy the bulk of Australia's exports - has been looking less subdued. Export volumes from the emerging markets have also been climbing out of a particularly soft patch whereas exports from advanced economies remain very weak.
- We track industrial growth across a large sample of big economies and some data is available up to June. This data confirms that industrial growth, while still subdued by historical standards, has been gradually rising since the start of the year. Industrial output growth in the 3 months to January was only 0.6% yoy, by June it was up to 1¼% yoy – far from strong and well below its long-run annual average of around 3%, but better than it was.
- The monthly business surveys are also consistent with ongoing moderate growth. Purchasing manager surveys for the big advanced economies show July readings not far off those in June, despite a big post-Brexit hit to UK business sentiment. Activity was better maintained in services than in manufacturing in the big advanced economies and the former is by far the biggest sector in these economies. Turning to the big emerging markets, latest Chinese business reports are consistent with unchanged growth but they point to slightly more optimism for the future. Indian surveys remain little changed and well below what would be expected in such a fast growing economy. Taken overall, the surveys suggest global growth staying around its moderate pace.
- Growth in the big S. Hemisphere commodity exporters has been hard hit by the weak primary product prices that stem from subdued global growth and supply growth. Recent $US weakness has helped lift some commodity markets and their $US export receipts are stabilising.

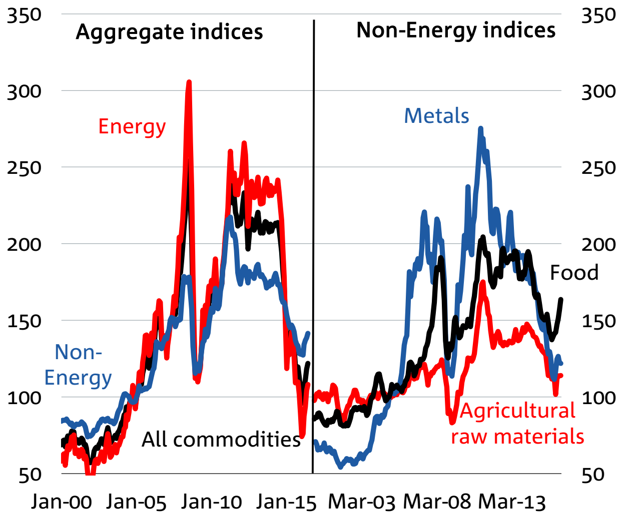
Global changes in trade and output (% yoy (3mma))



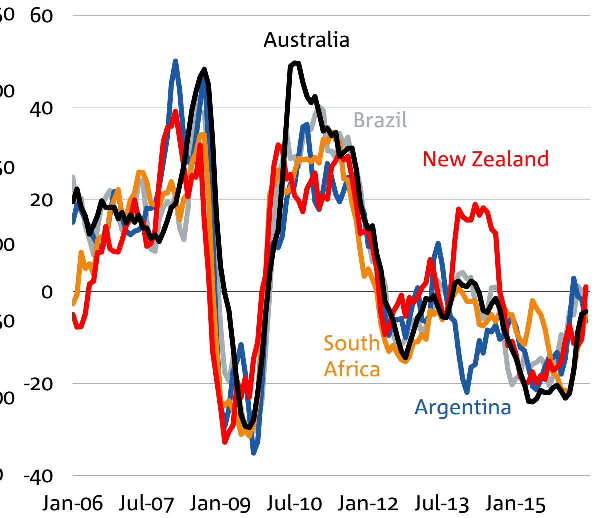
Industrial output & business activity (survey breakeven = 50)



IMF Commodity Price Indices (US$ terms, Jan 2005 = 100)



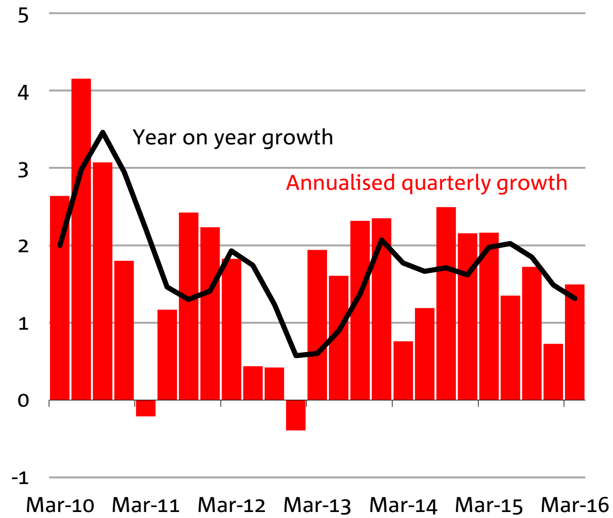
Commodity exporter earnings (US$ terms, % change yoy)



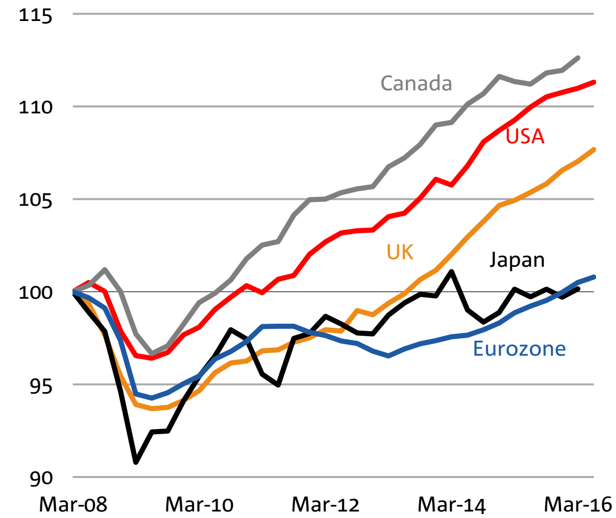
Advanced Economies

- There is not much sign of an acceleration in growth in the big advanced economies through mid- 2016. Industrial output has been fairly flat for some time with quarterly growth of 0.3% last September followed by a decline of 0.2% in December quarter and a very modest recovery of 0.1% in March 2016. CPB industrial output data for the first two months of the June quarter points to another weak quarterly outcome. The picture is similar for advanced economy export volumes with modest growth in the second half of last year followed by a decline in trade flows in March quarter and another soft looking June quarter.
- The monthly business surveys are available up to July and, taken overall, they are not showing much evidence of better conditions either. Business conditions remain consistent with moderate growth but there are growing differences between countries and sectors. The impact of the Brexit vote on the UK is especially evident with a steep fall in survey readings for both the manufacturing and services sectors. Elsewhere activity has held up quite well in the face of the Brexit shock across the rest of the advanced economies, even in the Euro-zone where Brexit would have been expected to have quite an adverse impact on sentiment.
- Broader measures of June quarter economic activity are now starting to be published and some of them have been disappointing. The annualised pace of quarterly US economic growth was only 1.2% in the June quarter, faster than the first quarter's 0.8% but a weak result nevertheless. Much of the rationale for the low number was because US business met sales by running down stocks rather than by producing more – a temporary measure. Final US sales of domestic product actually grew by a much stronger annualised 2.4% in June quarter with the non-farm stock rundown carving around 1 percentage point off GDP. Euro-zone second quarter GDP growth slowed to 0.3%, only half the March quarterly growth rate as French output stagnated.

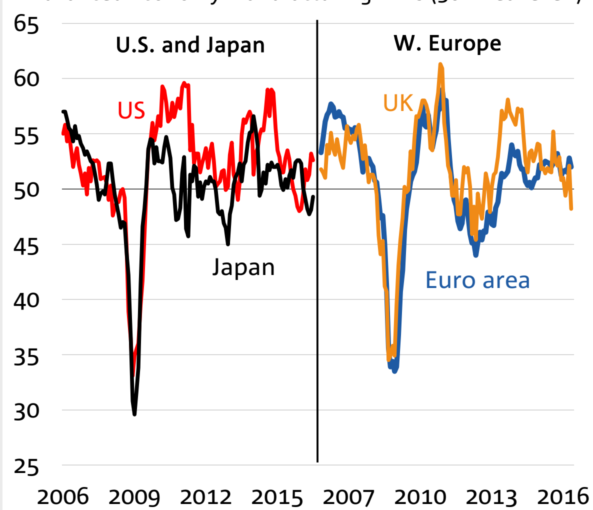
G7 Advanced Economy Growth (%)



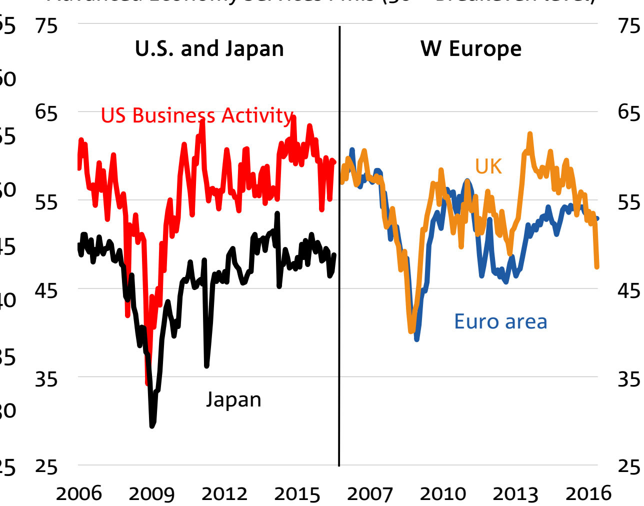
Real GDP - Major Advanced Economies (Mar 08 = 100)



Advanced Economy Manufacturing PMIs (50=Breakeven)

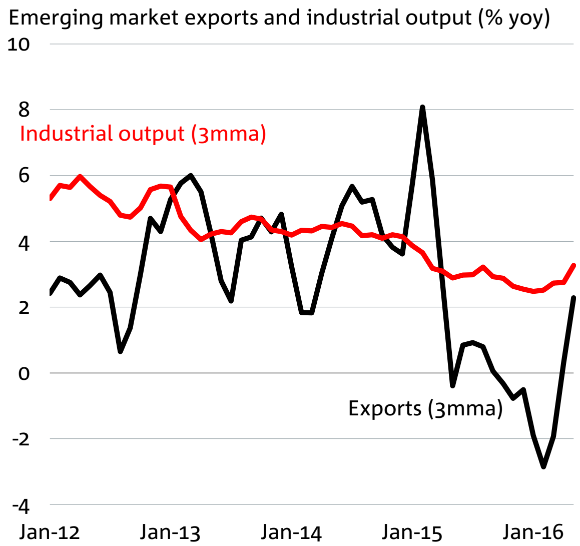


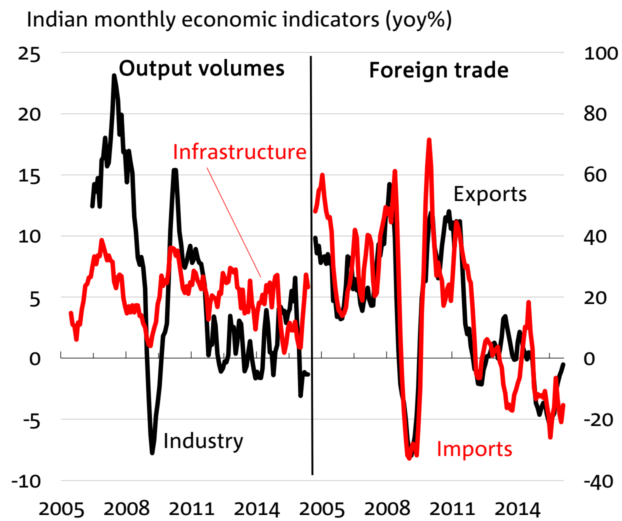
Advanced Economy Services PMIs (50 = Breakeven level)

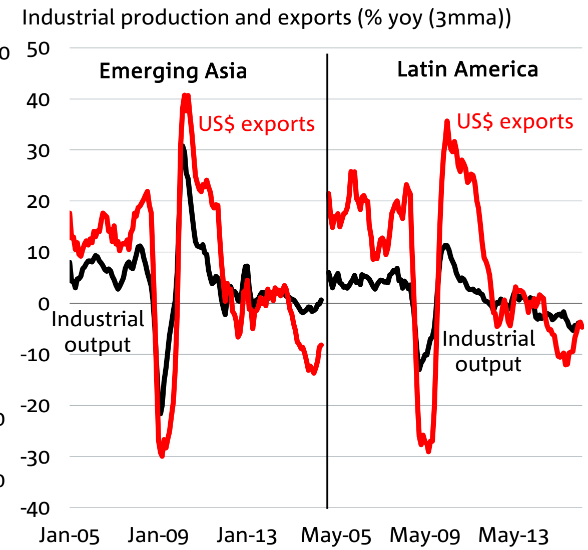


Emerging Market Economies

- The emerging market economies now drive most of the expansion in the world economy. The biggest players like China, India and Brazil play the most prominent roles and their fortunes have been mixed– the first two are growing rapidly, the latter has been in recession.
- After a long period of softness, emerging economy industrial growth finally looked a little better in the June quarter. The CPB calculates the most comprehensive measure of industrial output and it shows quarterly growth slowing from 0.8% to 0.3% between December 2015 and March 2016 but a very solid result for the month of May could give a better outcome for June quarter. This recent upturn is concentrated in Asia and is evident in the manufacturing sectors of economies like S Korea, Taiwan and Thailand as well as recent more solid Chinese industrial growth.
- While the industrial sector looks less sluggish, trade volumes remain soft – which is odd as so much East Asian manufacturing is export driven and relies on imported inputs. East Asian export volumes did start to grow again in March quarter but have fallen back through the first two months of the June quarter. East Asian import volumes show the opposite pattern – they fell heavily at the start of the year but have suddenly picked up in May, driving a sharp upturn in import demand across the entire emerging economy group.
- While some of these recent trends are welcome, it is too early to say that the corner has been turned and that a solid and sustained upturn in emerging economy growth is at hand. June quarter Chinese GDP showed solid growth continuing but there are question marks over the extent to which it is sustainable over the long haul. These questions relate to the way in which Chinese growth again relies on firing up the traditional credit-housing-industry drivers that have already generated such high debt ratios.



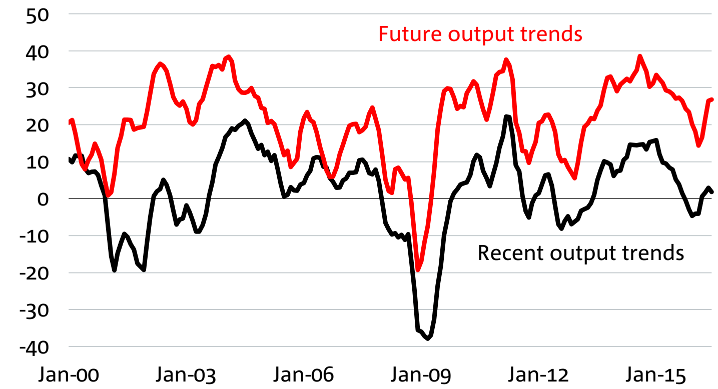




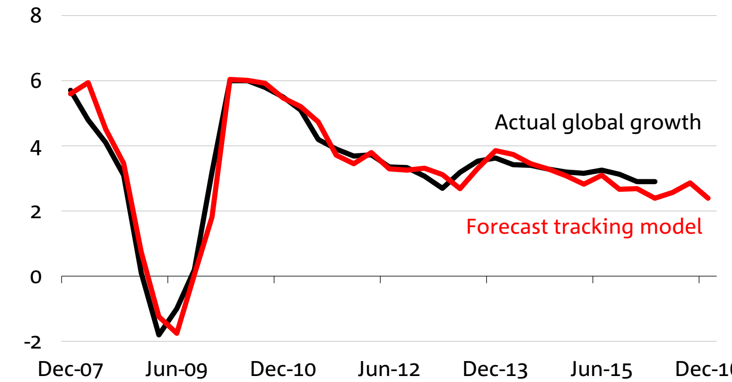
Global forecasts and policies

- Our view of the world economy has not changed. There have been downward revisions to US data as well weaker than expected second quarter US economic numbers, reflecting the way that US firms met demand by running down stocks. We expect this to be only a temporary disappointment with growth running around 2% through the next couple of years. Nevertheless, the low second quarter reading still contributes to a cut in our 2016 US growth forecast from 1.8% to 1.5%. We have also cut our Euro-zone numbers for 2017 as the predicted UK recession hits demand for their exports and rising populist sentiment delays investment plans. East Asian emerging market growth is looking a little stronger.
- This has been a long period of sub-trend growth for the global economy with repeated expectations in the IMF and OECD that the pace of expansion was finally about to lift off. However, optimistic expectations of a "hockey stick" recovery profile for global growth have been dashed by the structural weaknesses that are now built into the global economy, the lack of room for economic policy manoeuvre due to high public debt burdens and historically low interest rates and a series of shocks that have hit confidence (Greece, Chinese currency and share markets, Brexit, Euro-zone break-up).
- Some of the latest data finally shows a few glimmers of better conditions and expectations in some advanced economy business surveys have lifted a little. Nevertheless, our tracking indicator still does not show the long hoped for "hockey stick" output profile. We do expect global growth to accelerate from 2.8% this year to around 3% through 2017 and 2018 but this reflects a shift towards trend in N. America and an end to recession in Latin America rather than the start of a new self-generating global cyclical upturn.

Business surveys (US, UK, Germany & France) (Index)



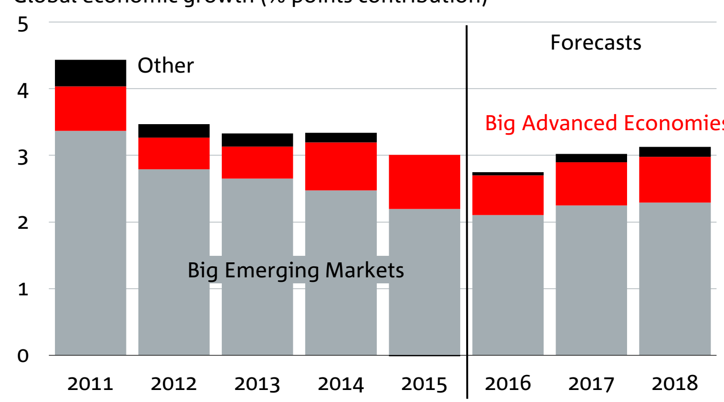
Actual and Forecast model for global growth (yoy%)



Global growth forecasts % change year on year

	2011	2012	2013	2014	2015	*NAB Forecasts* 2016	2017	2018
US	1.6	2.2	1.7	2.4	2.6	1.5	2.1	1.9
Euro-zone	1.6	-0.8	-0.3	0.9	1.6	1.4	1.1	1.5
Japan	-0.4	1.7	1.4	-0.1	0.6	0.5	0.6	0.6
UK	1.5	1.3	1.9	3.1	2.2	1.6	0.6	1.6
Canada	3.1	1.7	2.2	2.5	1.1	1.4	1.9	2.0
China	9.5	7.7	7.7	7.3	6.9	6.6	6.5	6.3
India	7.9	5.9	6.4	7.0	7.2	7.7	7.7	7.5
Latin America	4.5	2.3	2.5	0.4	-0.6	-0.9	0.9	1.7
Emerging East Asia	4.4	4.6	4.2	4.1	3.5	3.6	3.6	3.5
New Zealand	1.8	2.4	2.4	3.7	2.5	2.9	2.9	1.9
World	*4.4*	*3.5*	*3.3*	*3.3*	*3.0*	*2.8*	*3.0*	*3.1*
memo								
Advanced Economies	1.7	1.2	1.2	1.8	2.0	1.5	1.6	1.7
Big Emerging Economies	7.0	5.4	5.5	4.9	4.4	4.1	4.7	4.8
Major trading partners	4.7	4.3	4.2	4.1	3.8	3.6	3.7	3.6

Global economic growth (% points contribution)



Australian outlook

- Real GDP growth in Australia is forecast to remain at around 3% in 2016 and 2017, above our estimates of long-run potential growth rate of around 2½%. This will largely owe to surging LNG exports and strong growth in net services exports. Domestic demand growth will remain very weak at around 1% despite strong dwelling construction. This largely reflects sharply lower mining investment, although the outlook for non-mining investment growth is disappointingly modest. Household consumption growth is expected to remain at around 2½ to 2¾% p.a, somewhat below its historical average, amidst soft growth in household incomes (owing to subdued wages growth).
- Looking into 2018 however, the real GDP outlook deteriorates, as LNG exports flatten off, the dwelling construction cycle turns down and the lagged benefit from the sharp currency depreciation since 2013 starts to wane. Even incorporating our latest forecast for two further rate cuts in May and August 2017, real GDP loses some momentum, easing to an average 2.6% in 2018, and the unemployment rate hovers at around 5¾%, a rate which indicates ongoing spare capacity in the labour market.
- Within these aggregates, the Australian economy will continue to experience varying conditions across industries and geographies. New South Wales and Victoria will remain in the lead in coming years in terms of state final demand, and real gross state product growth will be neck and neck. For our full forecasts by state, please see the recent States Handbook. Services activity (including but not limited to tourism and education exports) is clearly outperforming, while both states will continue to benefit from relatively strong population growth, high levels of housing construction, infrastructure expenditure and a modest pick up in wages. The challenge for both NSW and Victoria (like the national economy however) will be to sustain momentum as the impetus from the lower AUD and housing construction starts to tail off.
- The combination of low commodity prices and lower mining investment is having a more pronounced impact on WA, the NT and parts of Queensland to differing degrees. The labour market adjustment in particular, and negative impact on labour incomes, will become more marked over coming years as another 50K jobs are lost, with flow on effects to consumer spending, business investment and government revenue in affected states. In terms of timing, the drag will come earlier in Queensland, where all three major LNG projects have started shipping or are due for completion in 2016.
- Strength in tourism spending (both domestic and international) and education exports are likely to remain bright spots for most states and territories, including Queensland, Tasmania, SA and the larger states of NSW and Victoria.

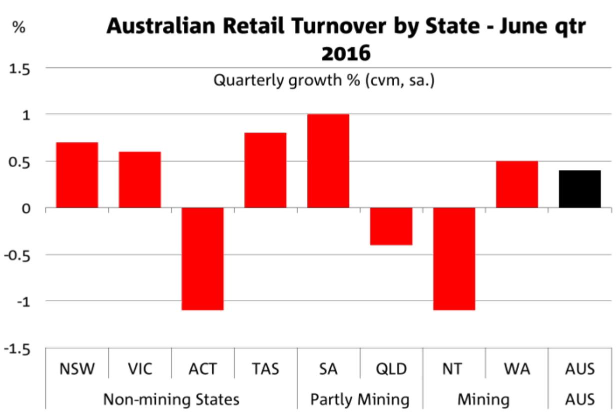
Australian economic and financial forecasts (a)

	Fiscal Year			Calendar Year			
	2015-16 F	2016-17 F	2017-18 F	2015	2016-F	2017-F	2018-F
Private Consumption	3.0	2.6	2.4	2.8	2.9	2.4	2.4
Dwelling Investment	8.7	2.8	-1.8	9.8	5.5	0.4	-3.3
Underlying Business Investment	-13.9	-10.6	-3.4	-10.5	-13.2	-7.9	1.3
Underlying Public Final Demand	2.8	2.6	2.6	2.1	2.5	2.6	2.6
Domestic Demand	**0.9**	**1.1**	**1.6**	**1.1**	**0.9**	**1.2**	**1.9**
Stocks (b)	0.0	0.0	0.0	0.0	0.1	-0.1	0.0
GNE	**0.9**	**1.1**	**1.6**	**1.1**	**1.0**	**1.2**	**2.0**
Exports	7.6	9.5	8.1	5.9	9.4	9.4	5.4
Imports	-0.2	1.3	2.6	1.5	-0.2	1.9	3.3
GDP	**2.9**	**2.7**	**3.0**	**2.5**	**2.9**	**2.9**	**2.6**
– Non-Farm GDP	3.0	2.7	3.0	2.5	2.9	2.9	2.6
– Farm GDP	-0.6	2.5	2.0	0.0	2.5	1.6	2.0
Nominal GDP	2.4	3.3	4.2	1.8	2.7	4.0	3.9
Federal Budget Deficit: ($b)	-37	-34	-23	NA	NA	NA	NA
Current Account Deficit ($b)	83	76	74	78	79	74	80
(-%) of GDP	5.0	4.5	4.2	4.8	4.7	4.2	4.4
Employment	2.2	1.7	1.8	2.0	1.8	1.9	1.7
Terms of Trade	-10.1	-4.8	-3.6	-11.5	-6.7	-4.6	-3.1
Average Earnings (Nat. Accts. Basis)	0.9	1.6	2.2	0.6	1.2	2.1	1.9
End of Period							
Total CPI	1.0	2.9	2.5	1.7	1.7	2.6	2.6
Core CPI	1.5	1.9	1.8	2.0	1.7	1.8	2.0
Unemployment Rate	5.7	5.7	5.6	5.9	5.8	5.6	5.6
RBA Cash Rate	1.75	1.25	1.00	2.00	1.50	1.00	1.00
10 Year Govt. Bonds	1.98	2.00	2.05	2.88	1.95	2.05	2.05
$A/US cents :	0.74	0.69	0.72	0.73	0.70	0.70	0.75
$A - Trade Weighted Index	62.5	60.0	60.9	62.7	61.0	60.0	62.4

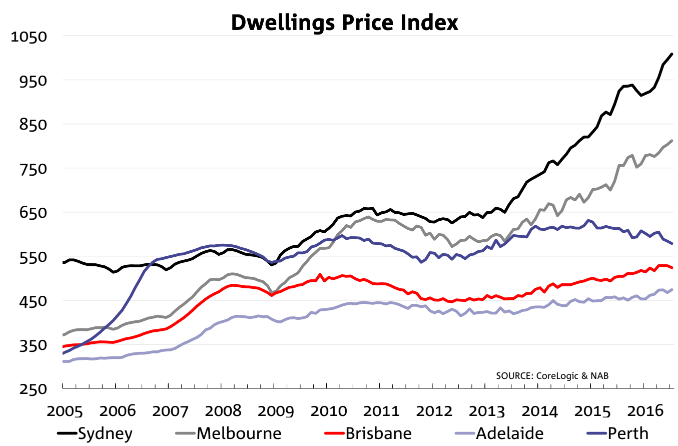
(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.
(b) Contribution to GDP growth

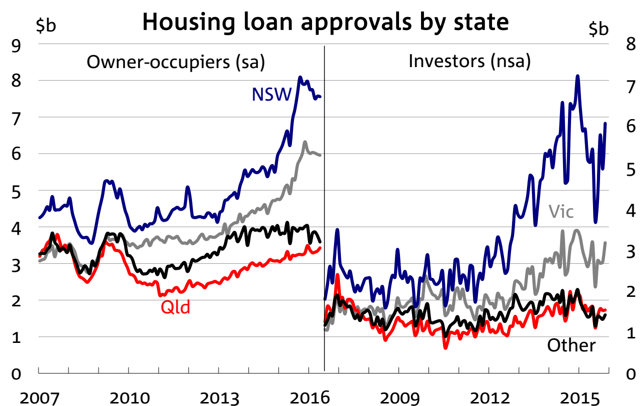
Australian consumer demand and housing market

- Overall, household spending has been holding up relatively well, despite the recent slowdown in employment growth and low wages growth. That said, higher frequency data such as retail sales, our monthly NAB Online Retail Index and NAB Business Survey have lost some momentum in recent months. Retail sales growth in June was modest at 0.1% m/m and 0.4% q/q, a continuation of the soft patch that started since late 2015. By state, retail turnover in real terms in Q2 was, somewhat surprisingly, led by SA (1.0% q/q), followed by Tasmania (0.8% q/q) and NSW (0.7% q/q), while Queensland (- 0.4% q/q) was the weakest of all mainland states. According to our monthly NAB Business Survey, business conditions for the retail sector continued to ease in July in trend terms, to be well below its recent peak in late 2015. Meanwhile, NAB's monthly Online Retail Sales Index for June recorded a 0.8% m/m (13.5% y/y) rise in online spending. While still strong, growth in the index has flattened from the year-on-year growth seen back in 2011 when the index was first established.
- While soft wages growth will remain a constraint, we continue to expect reasonably resilient household consumption growth in the coming quarters. A further cut to the cash rate by the RBA to a new record low of 1.5% (albeit only partially passed on by banks) and renewed strength in house price growth, especially in Sydney and Melbourne, should be positive for consumer spending. We currently forecast household consumption growth to average around 2.9% for 2016, before moderating to 2.5% and 2.4% in 2017 and 2018 respectively.
- Dwelling prices (hedonic) powered ahead in July, led by Sydney and Melbourne, while Hobart and Adelaide also had solid gains. Elsewhere, Brisbane prices lost more momentum, while Perth prices are still sliding. Strong price growth has returned to Sydney and Melbourne despite anticipated increases in housing supply (especially for apartments), which has contributed to subdued rental growth. Concerns over foreign demand and potential settlement risks given tighter lending restrictions on foreign buyers has failed to dampen the market, which might suggest that the recent RBA rate cut(s) is working to provide support. Additionally, the drop in investor credit growth below the 10% speed limit imposed on banks has provided scope for greater investor lending – a trend that has become apparent in loan approvals, especially in NSW. Finally, hedonic (quality-adjusted) price measures (6% over the year to July nationally) are still outperforming median measures (1.8% on the same basis), suggesting a deterioration in the quality of dwellings entering the market (along with some apparent methodology changes). As much of the coming new supply will be apartments with comparatively smaller footprint, this trend may continue.
- Prices are continuing to surprise on the upside, suggesting further upside risk to our 2016 forecast despite recent upward revisions – although outcomes vary by city, with mining related regions weak. This is accentuated by the RBA's announced cash rate cut this month – although banks have not fully passed it through. However, market headwinds, including low rental yields, prudential constraints and large additions to housing supply, are still expected to take hold in the coming 6-12 months. 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.



Source: ABS, NAB

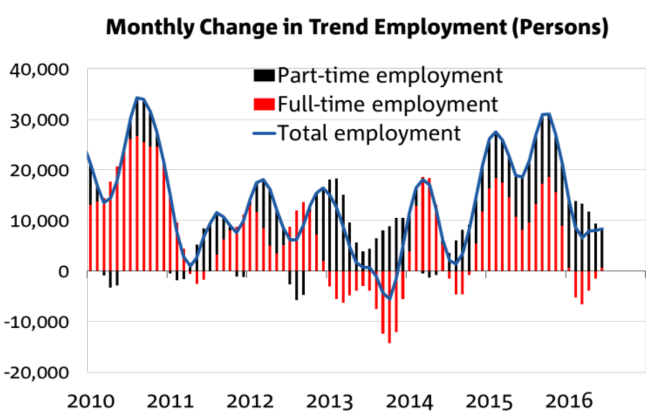


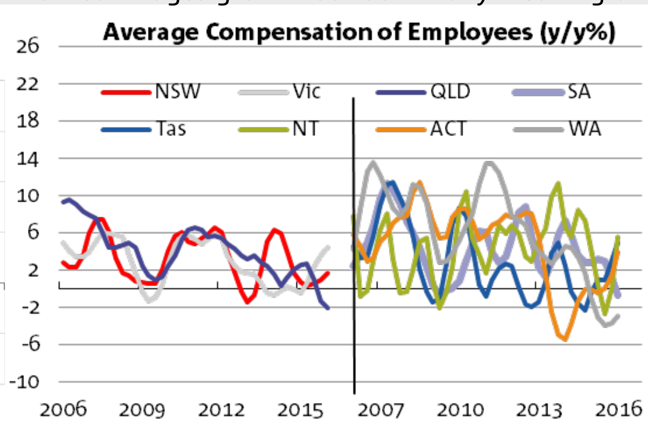


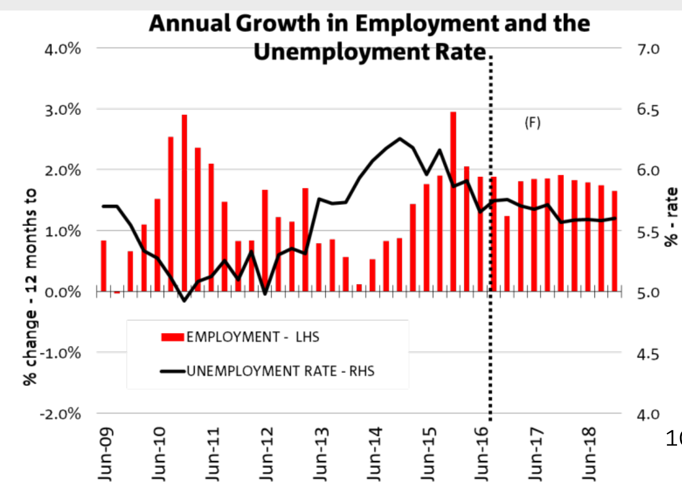
*Owner-occupied includes refinancing
Source: ABS, NAB Economics

Australian labour market

- In June, the general optics of the labour market were little changed. Employment in seasonally adjusted terms grew moderately by 7.9k in the month despite quite a notable detraction from sample rotation effects, while the participation rate rose marginally by 0.1ppt to 64.9%. A rise in the participation rate, combined with an employment increase significantly below the "replacement rate" (a rate that is commensurate with the growth in labour force) saw the unemployment edge up modestly to 5.8%. Having said that, average hours worked continued to trend lower in the month, pointing to a build-up of spare capacity. This is partly driven by the contraction in full-time employment in the early months of 2016. While full-time jobs showed a rebound (+40k) in June, more data points are needed to see if the recovery can be sustained.
- Labour market conditions by state continued to be mixed, with further evidence suggesting mining states are lagging further behind. Victoria overtook NSW in the month to have the highest year-ended employment growth across all states in June, after gaining momentum gradually over the first half of 2016. However, year-ended employment growth in NSW remains resilient at elevated levels (albeit showing a moderation since late 2015) and continues to trend upwards in ACT and NT, but remains quite soft or trending downwards in SA, Tasmania, Queensland and WA. Generally weaker employment growth over the first half of 2016 have resulted in the unemployment rate either stabilising or ticking up slightly in most states. In the meantime, Queensland has shown a notable rise in its unemployment rate lately.
- Forward indicators generally are quite positive overall. The employment index from the June NAB monthly business survey stayed unchanged at +4 in July, which is consistent with employment gains (of 18k per month) in the next six months, however softer actual employment growth suggests downside risks to this projection.
- With wage and price pressures expected to be weak throughout the forecast horizon, we now expect the RBA to cut the cash rate by 25bps in May-17, and another 25bps in Aug-17.This is likely to stimulate employment growth and see unemployment rate ease in the near-term. In light of our rate call change, we now expect the unemployment rate to rise modestly to 5.8% by end-16, before inching lower to 5.6% by end-17 and holding steady till end-18.
- So far there are few signs of an acceleration in wages growth, partly reflecting a degree of spare capacity in the labour market, as well as weaker inflation expectations in general. Again, state-based analysis reveals divergent trends, with the income measure of average compensation of employees showing that income growth is positive and gaining traction in NSW, Victoria, Tasmania, NT and ACT, but wages are contracting in WA, Queensland and SA. By industry, SEEK data is showing signs of wage pressure building in sectors such as construction, hospitality and tourism, government and defence and sales, but it is insufficient at this stage to augment the weak wages growth outlook in any meaningful way..



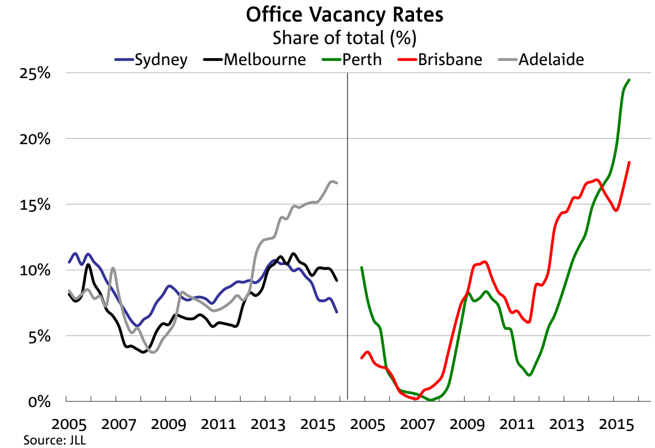


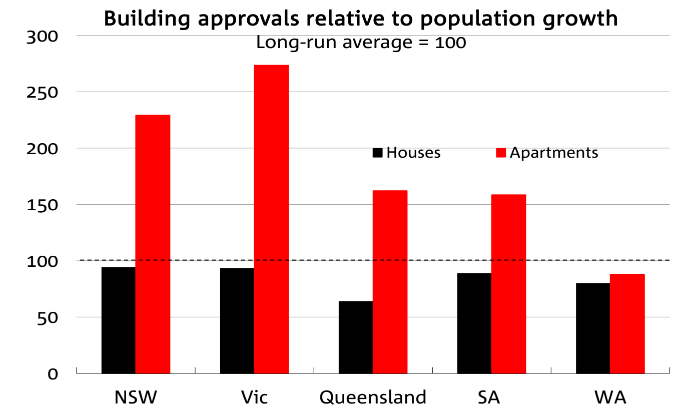


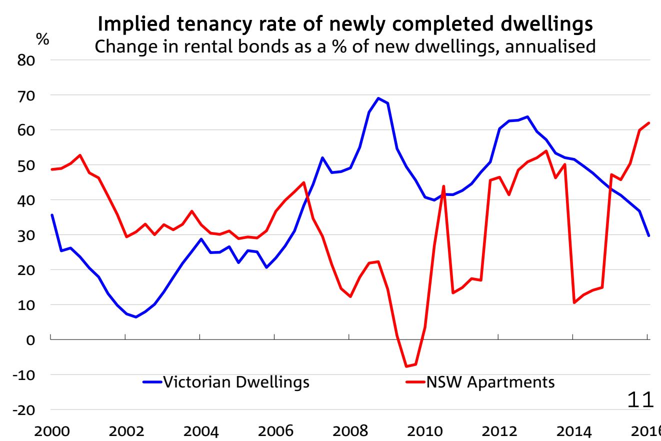
Source: ABS, NAB Group Economics

Australian investment

- The NAB Business Survey shows that firms remain resilient against negative external events, including Brexit and an uncertain political environment, which had threatened to derail business sentiment; the NAB business confidence index remained defiantly positive in July. With capacity utilisation rates trending higher since 2013, optimistic firms are more likely to consider investing in expanding their productive capacity, particularly given the additional support from recent interest rate cuts by the RBA. Indeed, the NAB Survey is showing reasonably solid rates of non-mining capex activity and future capex plans. Also consistent with the record low cash rate, growth in business credit has steadily improved in the last two years, although it appears to have lost momentum in the past two months.
- Other indicators suggest a more mixed outlook for business investment. The value of non-residential building approvals has not been as responsive to interest rate cuts as residential construction, although the trend has started to improve modestly. The sluggish response is unsurprising given the extent of the hangover still being felt across commercial property markets post the commodity prices and mining investment booms. Naturally, this is most evident in mining cities such as Perth, where around a quarter of the available office space is currently vacant. In contrast, office vacancy rates in Sydney and Melbourne, where the non-mining recovery has been most evident, are much lower – contributing to solid growth in office capital values. 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 terms of the longer term outlook, weakness was very apparent in the ABS's Q1 Private New Capital Expenditure (Capex) Survey, which pointed to a further contraction in non-mining capex spending for 2016-17. However, limited coverage in the ABS Survey of important growth industries might imply a degree of downward bias. Unsurprisingly, mining capex intentions are especially weak – NAB estimate that the mining investment downturn is only around half way complete.
- The housing construction boom has continued at full steam and could potentially see additional support from recent RBA interest rate cuts and renewed strength in property prices and investor credit. The pipeline of construction remains substantial and dominated by apartments, while the number of new approvals has stayed elevated, albeit no longer rising. However, risks are rising as new supply hits the market and tighter financing constraints run the risk of disrupting settlement for developers (particularly with foreign buyers). Supply overhang is expected to become more of a concern over the next 12-18 months, but vacancy rates to date in NSW and Victoria are not overly concerning – although data on active rental bonds in Victoria suggests the number of new dwelling remaining empty might be rising more than vacancy rates suggest (see Chart).
- Dwelling investment (around 5% of GDP) is expected to remain solid, rising 5.5% in 2016 and 0.4% in 2017, until the current pipeline becomes depleted and markets face oversupply around 2018. Dwelling investment will then likely become a (small) drag on economic activity. Business investment (around 12% of GDP) is forecast to decline by around 13% in 2016 and 8% 2017. In 2018, business investment will increase modestly (+1.3%).

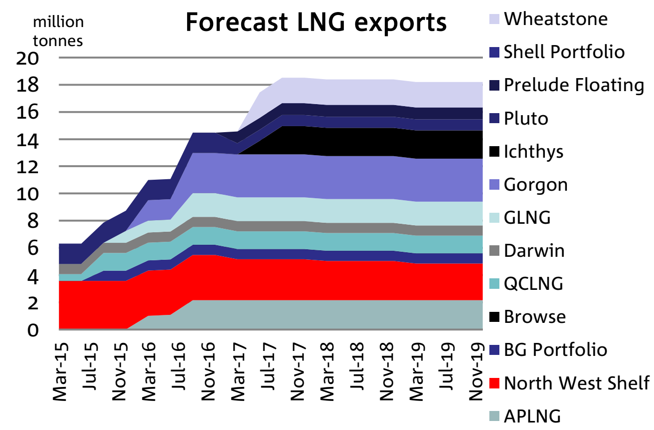


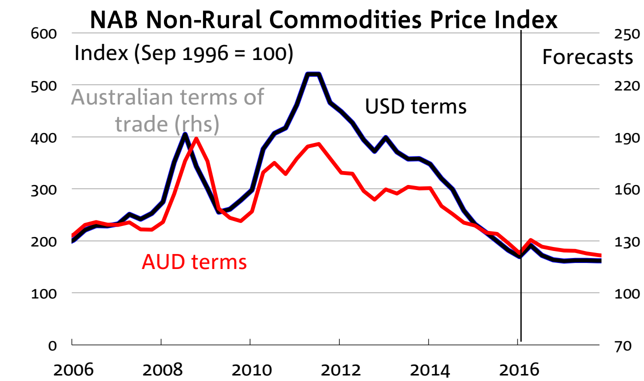




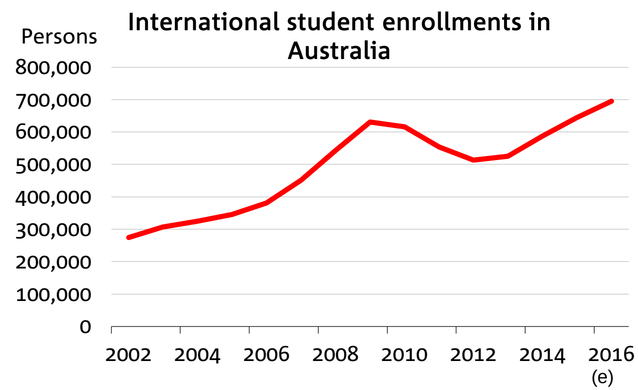
Australian commodities, net exports and terms of trade

- Strong export growth driven by LNG will see net exports contribute positively to overall economic growth in the next few years, adding 2.5 and 1.6 ppt to overall GDP growth in 2016 and 2017, before declining to a 0.3 ppt contribution in 2018 as LNG export levels flatten off. Net exports however are likely to subtract slightly from growth in the June quarter, with import volumes outpacing export volumes, although this follows a very large contribution to growth from net exports in Q1. Imports are forecast to decline in 2016, before stabilising and rising in 2017 and 2018 as the effect of the drag from mining-related imports and the depreciating AUD wears off and domestic demand recovers sufficiently to support import growth.
- During the past month, APLNG commenced its first shipment of LNG to Kansai Electric in Japan on 29 June, which should boost export figures from July onwards. Meanwhile, production at Gorgon in Western Australia is gradually returning, after a temporary shutdown in April, with exports expected to resume shortly. However, prices remain depressed and there is increasing concern that producers may rein in output, posing downside risks to our exports forecasts.
- The lower AUD and rising wealth in Asia continue to support short term visitor arrivals. In addition, international student enrolments have been steadily on the rise, with further growth expected, as Australia's proximity to Asia and perceived status as a safe country continue to attract students. Combined, tourism and education exports will contribute positively to total exports, although the pace of growth may slow somewhat as the AUD stabilises into mid-2017.
- The US election campaigns currently under way have highlighted the nation's increasing opposition to global trade. While it is unclear whether some of the suggested actions will carry through (ie., withdrawal from the Trans-Pacific Partnership, labelling China as a currency manipulator), these developments should be viewed with a degree of concern. China and the US are both major trading partners of Australia and any US-China trade disputes could have negative implications for Australian trade flows.
- Commodity prices have risen over the month to be well above the low levels reached around the turn of the year. The NAB non-rural commodity index is forecast to rise 8.7% in Q2, 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. The Index in AUD terms will fall by a smaller 3.0% in 2016, before AUD re-appreciation accentuates the declines in 2017 and 2018 to be 2.5% and 7.1% respectively.
- Overall, the outlook for Australian agriculture remains generally very robust, with a mostly very favourable season and good prices for many (but not all) commodities. Winter has been kind to most producers so far, particularly those in broad-acre cropping and livestock industries. This month, we upgrade our Australian 2016-17 wheat production forecast to 27.2 million tonnes. The outlook for spring rainfall is generally favourable, presenting further upside overall.





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



Note: The figure for 2016 has been estimated based on the historical seasonal patterns of international student enrolments

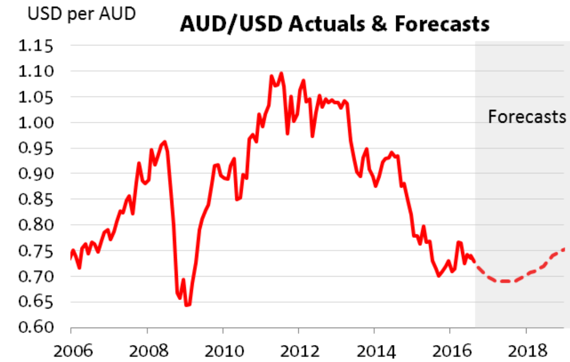
Australian financial markets

Exchange rate

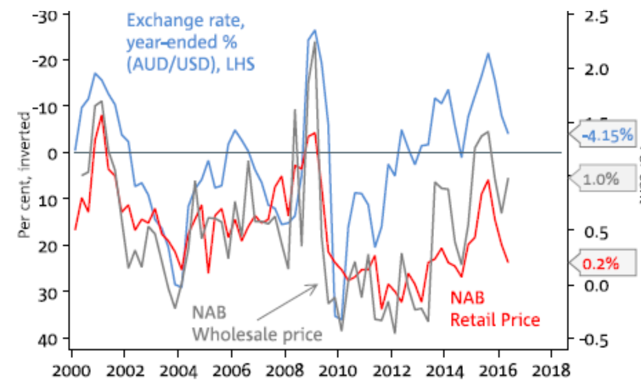
- Our new forecast trajectory for the RBA Cash Rate doesn't have immediate implications for our AUD FX forecasts and which currently have the AUD/USD falling to just beneath 70 cents in H2 2017 before gradually recovering later in 2018 and beyond. In our most recent Global FX Strategist published on 3rd August, we flagged upside risk to our forecasts for AUD falling back below 70 cents, given reduced confidence in a sizeable US dollar recovery later this year and 2017. Our forecast for more aggressive easing by the RBA next year than currently discounted in market pricing provides something of a counter to these upside AUD risks. This leaves us comfortable maintaining our existing forecasts, but we are reviewing our AUD forecasts for 2018 and beyond and where the risk is that the appreciation in the current forecast trajectory will not now materialise.

Interest rates and inflation

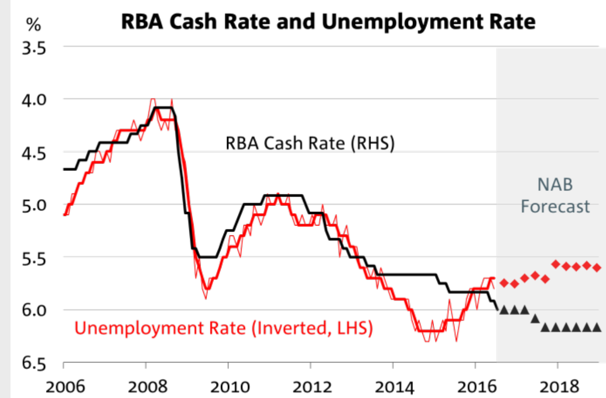
- The RBA cut the cash rate by 25bps to 1.5% in August (against our expectations) following a similarly-sized 25bp cut in May. Major banks have since passed on some, but not all of the easing through to lending rates. The RBA Board concluded that "prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by easing monetary policy at this meeting". This suggests the Board believes that monetary policy continues to be effective in Australia (although it is unclear whether the RBA expected banks to pass on the cut in full or not), that house price risks have diminished (there was a large paragraph to this end despite what we consider to be very strong house price growth recently), and most importantly, that the Bank preferred to take out some extra insurance on the inflation target front.
- With inflation forecasts still very low and the RBA showing its hand as a committed inflation targeter, it is seemingly less worried about using up some of its valuable remaining monetary policy ammunition than we thought, we now expect two cuts of 25bps in May and August 2017 – although persistent weakness in CPI inflation could trigger a rate cut sooner. By that time, the RBA will be looking towards 2018, for which our forecasts also suggest some loss of momentum in economic activity (although the RBA's forecasts are more optimistic for now).
- The Q2 CPI remained subdued, although higher than the Q1 result, with core inflation at 0.5% q/q and headline inflation at 0.4% q/q. Tradables inflation was higher at 0.6% q/q, showing some tentative evidence of exchange rate pass through. The NAB wholesale price index has picked up while retail price remains subdued (middle Chart). It is expected that retailers will eventually pass through at least some of the wholesale prices increases to consumers but the extent and timing of which is unclear in a period of heightened retail competition. Non-tradable inflation remained subdued at 0.4% q/q, a pace that has been maintained since June 2015. Growth in rents is expected to remain low for the next 12 to 18 months as substantial new housing supply is completed. Wage growth will also remain subdued.
- The outlook for inflation remains very subdued. Underlying inflation is expected to remain below the bottom of the target band until mid-2018. Most of the factors currently suppressing inflation are likely to persist, including low wages growth, strong retail competition both domestically and offshore, low commodity prices globally and slow growth in rents as dwelling supply picks up. The RBA outlook for CPI is similar, expecting inflation of 1½ - 2½% out to 2018 (below the 2% target for much of this period).



Source: Bloomberg, NAB Group Economics



Source: National Australia Bank, Bloomberg



Source: ABS, NAB

Group Economics
Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 2) 9237 8017

Vyanne Lai
Economist – Australia
+(61 3) 8634 0198

Amy Li
Economist – Australia
+(61 3) 8634 1563

Phin Ziebell
Economist – Agribusiness
+(61 4) 75 940 662

Industry Analysis
Dean Pearson
Head of Industry Analysis
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Industry Analysis
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Industry Analysis
+(61 3) 8634 3837

Steven Wu
Senior Analyst – Industry Analysis
+(61 3) 9208 2929

International Economics
Tom Taylor
Head of Economics, International
+61 3 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research
Peter Jolly
Global Head of Research
+61 2 9237 1406

Australia
Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand
Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Markets Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Jason Wong
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

Asia
Christy Tan
Head of Markets Strategy/Research, Asia,
+ 852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055

UK/Europe
Nick Parsons
Head of Research, UK/Europe,
and Global Co-Head of FX Strategy
+ 44 207 710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532