September 2016

The Bigger Picture – A Global & Australian Economic Perspective

***Global**: Despite signs of stabilisation in areas of the world where economic activity has been weak, there is little evidence of new growth engines appearing that could pull economic growth out of the doldrums. Consequently, we do not expect much improvement in global growth from the sub-trend 2¾% recorded since late 2015. Sub-trend growth and below target inflation means that central banks are under little pressure to lift their policy interest rates off historically low levels. The Fed should continue its ultra-cautious tightening with a rate hike in December but in the UK, Japan and Euro-zone the odds are skewed more to monetary loosening than interest rate increases. While global growth has been disappointingly sluggish, output expansion has continued through numerous shocks – Brexit, 2015's Chinese currency and share market volatility and the early 2016 growth concerns to name just three.*

- Global financial markets recovered well from the shock of Brexit and are coping with the prospect of higher US interest rates in the next few months. While they remain below their 2014 highs, share markets in the advanced economies have been trending upwards since the soft patch at the start of the year. Nevertheless, there are big differences between the main economies with US markets faring well, W Europe looking much weaker and Japanese share prices recovering much of their earlier losses. Market volatility is exceptionally low, back around the levels seen prior to the 2007/8 financial crisis. Bond markets continue to set records – 10 year government bonds in Japan and Germany have negative yields, UK bond yields are at record lows and even some private sector bond yields have turned negative. With the exception of the US Fed – who we expect to lift rates in December and follow up with two more hikes next year – central banks seem in no hurry to increase their policy rates. Indeed, the Bank of England adopted a raft of monetary easing measures in August after the Brexit vote and more easing could still be to come, the European Central Bank is still assessing if its March package of rate cuts and stepped-up asset buying will finally get growth and inflation higher and the Bank of Japan looks more likely to continue easing its already ultra-easy monetary policy than lift rates or cut its asset buying.
- Global growth remains sub-trend with no sign of an upturn yet. Global growth settled around 2¾% yoy at the end of 2015 and has remained at that rate through the first half of 2016. Emerging economy growth has stabilised at around 5¼% yoy but expansion in the big advanced economies has disappointed, slowing from almost 2% yoy in mid-2015 to only 1.2% yoy in mid-2016.
- Monthly data is sending mixed signals on global economic conditions. Global industrial output rose by 0.4% in the second quarter, faster than the 0.2% in the first quarter. The annual rate of growth has risen from around 1% yoy at the turn of the year to around 1¾% in June, driven by an acceleration in the emerging market economies and less negative trends in the advanced economies. World trade remains weak with export volumes down by 0.7% in the June quarter, about the same as in March.
- Industrial output trends are available for some key economies to July. Aggregating this data confirms that there has been a modest acceleration in the pace of output growth to what is still a pretty lacklustre pace by historical standards – factory output was growing by 1.3% yoy in the 3 months ended July, well below its long-run trend. Business survey data is available to August and it shows the pace of industrial growth in the big advanced economies, which had picked up modestly through the first half of the year, has subsided to quite modest levels.
- The pace of growth in services has been running well ahead of that in manufacturing – and services are by far the bigger sector. This picture has recently been clouded by a surprisingly weak survey reading for US services in August. Taken overall it is too early to say that the data points to an acceleration in growth, with data surprises offsetting what had looked like more positive trends.
- Commodity producer export revenues are looking less weak and recent GDP outcomes in Australia, New Zealand and South Africa show solid economic growth.
- Our forecasts for global growth have not changed and we still expect to see sub-trend growth persist through the rest of the year and into 2017 and 2018. Neither the business surveys nor our tracking indicator point to any imminent change in growth momentum. However, August business survey readings pose some challenges to our numbers – the US services survey was weaker than we expected while the UK did better than post Brexit concerns suggested was likely. Given the growth environment, global interest rates will remain very low by historical standards, even if the US Fed does lift its policy rates. Sub-trend global growth also puts a low ceiling on the growth in commodity demand at a time when supplies are still plentiful. There have been some sizeable price increases for commodities like dairy, iron ore and coal but securing a broad-based sustained upturn probably needs the global economy to be growing faster than the 3% or so we are expecting though the next couple of years.

***Australia*: The Australian economy grew at a year-ended rate of 3.3% in Q2, the fastest pace since mid-2012, thanks to a surge in government spending. Going forward, real GDP growth is expected to ease, most clearly in 2018 after the dwelling cycle has turned and resource exports no longer contribute to growth. Our forecasts are for real GDP growth of 3.0% on average in 2016, followed by 2.8% in 2017 and 2.6% in 2018. The unemployment rate is expected to hold steady through the forecast horizon at around 5.6-5.7%, a rate which indicates ongoing spare capacity in the labour market. There is some downside risk to our near-term forecasts given the recent loss of momentum in indicators of household spending in particular, but also business conditions. These bear close watching. The RBA will hold steady in the near-term, but two cuts are likely to follow in mid-2017 as low inflation persists.**

- Results from the NAB Monthly Business Survey remain relatively upbeat, although business conditions appear to have lost momentum and industries such as retail have been somewhat disappointing of late. Nevertheless, business sentiment has proven to be extremely resilient to negative influences over recent months, which has flowed through to more stable (and above average) levels of labour demand reported in the Survey. Capacity utilisation rates are currently around average levels, suggesting excess capacity is not a material constraint on investment, while the recent interest rate cut by the RBA may encourage additional spending by firms. Indeed, the NAB Survey's capital expenditure index has remained solid, looking more upbeat than other capex indicators.
- In August, the unemployment rate eased slightly to 5.6%, despite a fall in employment for the month. Employment growth has been solid over the past year, but this outcome masks some of the weakness in the underlying components, especially the widening divergence between full-time and part-time jobs growth (32k vs 149k jobs created in 12 months). By state, employment growth continues to be mainly driven by strength in NSW and Victoria, while job losses in Queensland persist. The employment index from the NAB monthly business survey has been relatively resilient and implies employment gains of 18k per month in the next six months, slightly above the 15k per month required to keep the unemployment rate unchanged. Nevertheless, we expect the unemployment rate to hold steady.
- The Q2 National Accounts revealed subdued growth in household consumption expenditure, with slowing retail spending a drag. Higher frequency data such as retail sales, our own NAB Online Retail Index and NAB Business Survey continued to soften in the latest month. Meanwhile, the NAB Consumer Behaviour Survey for Q3 shows that consumer spending patterns remain conservative despite falling levels of anxiety. While soft wages growth and more gradual employment growth going forward could act as constraints, we expect moderate (albeit easing) household consumption growth in coming quarters. Low interest rates and renewed strength in house price growth, especially in Sydney and Melbourne, should provide some positive impetus to consumption.
- Indicators of momentum in the housing market have been mixed of late, but despite this, (hedonic) prices in Sydney and Melbourne appear to be taking off again, and are at risk of being further spurred on by the RBA's August rate cut – supported by strength in other market indicators, such as clearance rates. These trends remain a surprise in the context of growing concerns over new housing supply, uncertain foreign (and domestic) investor demand and stretched household balance sheets. Consequently, we see substantial upside risk to our forecasts for much more subdued price growth going forward – although outcomes vary by city, with mining related regions weak.
- Business investment fell 5.7% in the Q2 National Accounts, with the decline primarily driven by a large drop in non-dwelling construction – the mining sector being the main driver. Nonetheless, lower interest rates, less spare capacity and resilient business confidence should all lend support to non-mining business investment going forward. Encouragingly, the NAB Survey is showing good rates of non-mining capex activity and future capex plans. The ABS measure of capex plans has not been as upbeat as the NAB Survey, although there was an improvement in the Q2 result for non-mining investment intentions in 2016-17. We remain optimistic that non-mining investment will improve, albeit gradually. On dwelling investment, the pipeline in apartment construction remains substantial, and will fuel strong rates of dwelling investment well into 2017, but will drag on activity into 2018.
- Net exports made a mild subtraction from GDP growth in Q2, but are expected to add to GDP growth again in Q3, as resource exports ramp up, driven largely by new LNG exports. Note that the bulky nature of LNG projects and their uncertain timing may cause fluctuations in quarterly exports growth. Additionally, higher iron ore prices have prompted us to revise up the spot price forecasts for the near term, but these are expected to be temporary, with declines towards $40 expected in 2017.
- We expect that the RBA will be forced to ease monetary policy again through 2017, mainly in response to the expectation that underlying inflation will run below target for more than two years, but also the need to prevent a rise in unemployment as the economy loses some momentum in 2018. As for the AUD, NAB expects it to hold up through the remainder of 2016, before easing to USD70c by end-2017 as the USD strengthens following an expected Fed rate hike in December, rate cuts from the RBA in mid-2017 and another leg down in key commodity prices such as iron ore through 2017. The currency is then expected to broadly stabilise through 2018, with our new forecast at USD69c by end-2018.

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