October 2016

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global</u>*: *Global growth remains sluggish and sub-trend. Despite signs of stabilisation in areas of the world where economic activity has been weak, there is little evidence of new growth engines that could pull economic growth out of the doldrums. Consequently, we do not expect much improvement in global growth, which should remain below trend. Weak growth and below target inflation allows central banks to keep rates historically low and the focus in fiscal policy is shifting away from austerity to wind back big public debts and towards how public sector investment can be increased. While global growth has been disappointingly sluggish it has at least proved resilient, continuing through numerous shocks – Brexit, 2015's Chinese currency and share market volatility, and the early 2016 growth scare to name just three.

- Global economic growth remains soft with a sub-trend pace of expansion set to continue and few signs of an upturn. The pace of economic growth remained stuck at around 3¼% yoy between late 2015 and mid-2016. Advanced economy growth was running at less than 1½% yoy while emerging market economies have been growing by 4½% yoy. As the advanced and emerging market economies each account for around half of the world economy, their combined outcome is a global growth rate of about 3%.
- The CPB measure of global industrial output has been published to July and growth was still running between the 1% and 1½% yoy seen since late 2015. An upturn in emerging market economy industrial output has been offset by renewed weakness in the manufacturing sectors of the big advanced economies. We calculate a measure of industrial growth for a smaller array of countries that is available to August and it shows growth stuck around 1% yoy with falling output across many of the advanced economies. Finally, business survey readings are now available for September in the big advanced economies and they showed a modest uptick in activity from August's weak outcome but business sentiment has only got back to its July level which was not strong.
- While industrial output has been growing, albeit slowly, world trade continues to fare surprisingly poorly. Normally trade grows much faster than output, lifting the globalisation of economic activity. However, in recent years global trade growth has only been under 3%, less than the annual growth in GDP. The latest CPB measures of world trade shows flat trade in the first three months of 2016 and a fall of 0.8% in the June quarter and the weakness looks to have continued into the second half of the year. Lower commodity prices added an extra headwind to key Southern Hemisphere primary exporters but prices have been rising recently, reinjecting income back into those economies.
- While manufacturing growth has been sluggish, services drive most economic activity and growth here has been stronger. The US service sector, in particular, has kept growing strongly.
- All central banks have been wary of lifting rates to more "normal" levels, but there are important differences in the health of their economies. Among the big economies, the US economy has gone furthest toward achieving success in getting sustained economic growth and the unemployment rate down. While inflation is still well below the Fed's 2% target, it is expected to hit it over the medium term. Several Fed Governors want an immediate hike in interest rates, 3 voted for a rise at the September rate setting meeting and other non-voting officials want a small rate rise now to pre-empt problems down the track. We expect the Fed to lift rates by 25 bps in December, followed up by 2 more rises next year but for rates to stay very low by historical standards considering the reasonable state of the economy.
- Other advanced economy central banks seem nowhere near as ready as the Fed to consider lifting rates. In the wake of the UK's Brexit vote, the Bank of England eased policy and at its September meeting the central bank said that another small interest rate cut looked likely if the UK economy behaved as expected. In the event, the UK has fared better than initially feared and the markets seem unconvinced that another rate cut is coming but we still consider one likely. Both the European Central Bank and the Bank of Japan have big asset buying programmes. Recent media reports that the former could wind back its buying look premature and the latter has recently re-emphasised its plans to keep its policy aimed at getting inflation up to its target.
- We have slightly lifted our forecasts for the UK and Emerging East Asia but the broad picture remains unchanged – sub-trend global growth of 3 to 3¼% should continue. Neither the recent business survey readings, nor our leading indicator of global growth, nor recent information on global industrial output or trade point to a lift in the pulse of global economic growth. 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 ceiling on the growth in commodity demand at a time when supplies are still plentiful, limiting the upside for commodity prices.

***<u>Australia</u>*: Real GDP forecasts for Australia are largely unchanged at 3.0% in 2016 and easing to 2.8% in 2017 and 2.6% in 2018. The unexpectedly high settlement for Q4 coking coal prices will provide a boost to Australia's terms of trade, nominal GDP and government revenues, but is unlikely to be sustained. Business survey data is showing weakness in retail conditions, which implies some risks to our already moderate forecasts for real household consumption growth of 2¼-2½% in 2017 and 2018. The labour market outlook is key, but while we expect the unemployment rate to remain in its current range between 5½% and 5¾%, the recent softening in trend employment growth bears close watching. House prices in Sydney and Melbourne have re-accelerated, which should prevent any further RBA cuts this year barring an exceptionally low Q3 CPI outcome in late October. Further cuts in 2017 remain likely.**

- Results from the NAB Monthly Business Survey suggest a multi-speed economy, but one where most key non-mining sectors are performing well in the near-term. However, weakening retail conditions are a significant risk to our outlook, especially considering that consumption accounts for more than 50% of Australian GDP. Confidence of firms in aggregate remain at reasonable levels (albeit varied by industry), despite the numerous uncertainties still lingering in the background – particularly those emanating from overseas. However, there is no hint that the RBA's interest rate cut in early August had any further material impact on confidence in September after seemingly providing some support in August, although the counterfactual is impossible to measure.
- In August, employment fell by 3.9k jobs, but a significant fall in the participation rate saw the official unemployment rate ease by 0.1% to 5.6%. That said, trend employment growth was slightly more encouraging at +9.9k in the month. Part-time jobs are driving the growth trend, although full-time jobs appear to have stopped falling. By state and territory, the divide between mining and non-mining states has been less pronounced lately, although Victoria has seen a rebound in employment growth in recent months. The employment index from the NAB monthly business survey fell notably in August, which suggests more subdued employment growth in the near-term – hinting at annualised jobs growth of around 188k (around 16k per month) in coming months, which is only sufficient to steady the unemployment rate. Recent data suggests wages momentum remains soft.
- Soft wages growth and slowing employment growth has kept consumer spending subdued. While the ABS retail trade data for August showed a stronger-than-expected 0.4% growth in retail turnover, retail sales growth was modest at 0.1% in trend terms. Other high frequency data such as our own NAB Online Retail Index and NAB Business Survey also paint a lacklustre picture of consumer spending in general. While persistently soft wages growth and easing employment growth are expected to act as constraints, we continue to expect moderate (albeit easing) household consumption growth in coming quarters. A sustained low interest environment, as well as the resilience in house price growth in major capital cities, should provide some positive impetus to consumption overall.
- Timely indicators of the housing market point to renewed momentum following the RBA interest rate cut in August – this has been mostly apparent in Sydney and Melbourne property prices. Auction clearance rates are also suggesting a tight market, although this in large part is a reflection of a lower number of properties going up for sale – also reflected in falling sales volumes in most markets. Lending finance and credit numbers are pointing to greater investor activity as well. These trends are, however, hard to reconcile with concerns over excessive apartment construction, uncertain foreign (and domestic) investor demand and stretched household balance sheets. Consequently, there are material upside risks to our 2016 and 2017 price forecasts – especially in Sydney and Melbourne.
- 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.
- The biggest forecast change relates to the settlement of a surprisingly high coking coal contract price for Q4 at $200/tonne. This will add around 8% to the terms of trade in coming quarters, which if sustained would add 3.5bn to government revenue in the first year and another 9.1bn in the second year if sustained according to the Federal Treasury's sensitivity analysis. The actual boost however is likely to be smaller, as we believe the recent surge reflects short-term supply constraints, including policy changes by China to curb its domestic coal production which will not continue given the detrimental impact of high coal prices on the steel industry.
- These forecasts are predicated on two further 25bp cuts to the cash rate in mid-2017to 1%. These will be in response to ongoing low inflation and a desire to prevent the unemployment rate from rising into 2018 as economic activity slows as support from LNG exports and dwelling construction taper off. As for the AUD, our forecasts remain for it to slowly depreciate against the USD to 70 cents by end-2017 and a low of 68 cents in mid-2018.

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