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The Bigger Picture – A Global & Australian Economic Perspective

***<u>Global</u>*: The cyclical upturn in the global economy has continued. Business surveys and hard data on industrial output and world trade show growth ramping up, and we expect the pace of global expansion to lift back to around its trend pace by 2018 – the fastest since 2012. Although central banks have done all they are likely to do to stimulate this upturn, they should proceed cautiously with any policy tightening. Meanwhile, fiscal agencies that have previously emphasised the need for austerity now seem unlikely to lift taxes or cut spending. Uncertainty over the political complexion of governments has also risen, along with the chance that incoming administrations could opt for radically different economic policies. It is still unclear what approach the Trump administration will take on a range of important tax and trade issues, the UK Government has to manage the Brexit process and a series of general elections looms in the Eurozone where some high polling populist parties advocate major changes in policy. Our forecast is based on these political risks not de-railing the cyclical upturn in global growth.**

- With the outlook for economic growth looking brighter, reflected in increases in major equity markets, bond yields and commodity prices, central banks in the big advanced economies have gone about as far as they plan to in easing monetary policy. The Fed is already raising rates (and raised by another 25 bps this month), the Bank of England appears unlikely to further expand its announced asset purchase program, the European Central Bank will cut its monthly asset buying from €80 billion to €60 billion from April, and the Bank of Japan has kept the same target rate of asset buying since mid-2016.
- After settling around 3% yoy through the first three quarters of 2016, global growth picked up to 3.2% yoy in December, mainly because of an upturn in growth in the big advanced economies. The acceleration in growth across the big advanced economies has also been evident in the monthly measures of trade and industry. The industrial acceleration has been quite broadly based with an uptrend in big advanced economies like the US and Japan, much faster growth across the arc of East Asian export-driven economies stretching from South Korea to Singapore and signs of a levelling out in activity in big South American economies like Brazil and Argentina which have been hit by deep recessions. Business surveys, the most up to date measure of the pulse of the global economic cycle, confirm that the reflation in economic activity across the big advanced economies has picked up speed further in February.
- Growth looks to be on an upward trend across the big advanced economies. The annualised rate of growth in G7 GDP was around 1¾% in the December quarter, well below September's 2½% annualised pace but much higher than the in the first half of last year. Monthly industrial and trade data as well as the business surveys show the extent of the acceleration in growth through late 2016 and early 2017. Industrial growth picked up from an annualised 1½% in the September quarter to 3½% in December while export growth picked up from 2½% to 5½% between the same two quarters. February business surveys show solid growth across both the manufacturing and services sectors. The upturn in growth looks quite broad based as well with very strong looking US surveys, an upturn in Japanese industry, much better readings from the Euro-zone and a mixed picture for the UK (with buoyant sentiment among manufacturers but less resilience in the service sector).
- The pace of output growth in the emerging market economies did not accelerate through 2016. While GDP growth remained unchanged through the latter half of last year, there was a recovery in both industrial output and export expansion. There has been a particularly sharp turnaround in the Asian emerging market economies with solid year-end export growth following very weak outcomes through the rest of the year. There has also been a big cyclical shift toward growth in Latin America, probably reflecting the commodity price lift. The timing of Chinese New Year complicates interpreting the latest crop of Chinese statistics, which present a mixed picture. Industrial growth was faster, retail sales growth was weaker, fixed investment a little stronger with a switch toward private investment, solid residential investment but house prices levelled off, imports picked up and it was unclear what exports were doing. The Chinese have set their 2017 economic targets with the growth aim being "around 6.5%, or higher if possible" and we expect growth of 6.5% this year.
- We expect the pace of global growth to quicken from 3% in 2016 to 3.3% in 2017 and then rise further to 3.5% in 2018. Rather than either an overly early tightening in economic policy or pressures in the financial system, the most obvious risk to our forecast comes from major political and policy change. We are still awaiting the details on the policies of the Trump administration while the Euro-zone faces a series of elections this year.

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<u>Australia</u>: Real GDP rebounded in Q4 2016 as expected, while sharply higher commodity prices drove a strong bounce in the terms of trade and profits – although labour income remains weak. Leading indicators suggest strong real GDP growth through most of 2017 (we expect growth of around 3%), but we are not as relaxed about the outlook in 2018 as contributions from LNG exports, temporarily higher commodity prices and residential construction fade – while household consumption remains constrained by weak wages growth. Through 2018 we expect growth to be only a touch above 2%. The RBA's increased focused on financial stability considerations suggest they are reluctant to cut rates further, while recent comments from RBA officials raise the possibility that macro-prudential measures will be stepped up. Consequently, we removed our expectation for a 25bp rate cut in late 2017, although there is a risk of more easing down the road given our concerns about the longer-term outlook.

- In February, the NAB Monthly Business Survey moderated from the surprising strength seen in January, but remained consistent with a relatively robust view of business activity and investment behaviour in the near-term. Business conditions dropped back below December levels, but are still well above historical average. Business confidence also gave back some ground, but is still above both December and historical average levels. Meanwhile, capacity utilisation rates stayed at solid levels, while the Survey's indicator of capital expenditure remained strong despite easing in the month.
- The number of employed persons was down 6.4k in February (below consensus, +16.5k), while an unchanged participation rate saw the unemployment rate rise to 5.9% (from 5.7%). Full time employment reversed some of last month's losses, up 27.1k, while part time employment fell for the first time since October last year, by 33.5k. The series tend to be volatile from month to month and caution should be exercised when interpreting the data. By state, Victoria continued to report strong employment gains, while the largest losses happened in Queensland and to a lesser extent Western Australia. However, in trend terms, employment growth in the two mining impacted states has been improving. Meanwhile, the NSW labour market continues to look weak. Leading indicators from the NAB Business Survey and job vacancies data are showing more encouraging signs, although we expect the unemployment rate to remain broadly unchanged near 5¾%.
- Latest national accounts data showed household consumption growth improving in Q4 2016 (up 0.9% q/q) following middling growth in Q3. The increase came largely from a notable drop in the household savings rate to 5.2% (from 6.3%), as labour income growth remains low. Meanwhile, seasonally adjusted retail turnover grew 0.4% in January 2017 after dropping 0.1% in December 2016. NAB's Online Retail Sales Index contracted -0.5% (m/m) in January, much slower than the revised previous month (0.5% m/m), while the NAB Monthly Business Survey shows the retail sector continuing to struggle. The outlook for household consumption is muted, as subdued wages growth, slower wealth accumulation and elevated levels of household debt are likely to weigh on consumption growth.
- Underlying private business investment rose by a better than expected 1.9% q/q, which is the first quarter of positive growth since 2013. In terms of the more timely indicators, the value of non-residential building approvals has not been especially encouraging, exhibiting a downward trend since a spike around mid-2016 and falling around 14% in January (trend down nearly 7%). In contrast, the volume of capital goods imports increased solidly in Q4, while values were up 13.6% y/y in January. Regarding the longer-term outlook, leads tend to be mixed with investment expectations from the NAB Quarterly Business Survey holding up, while the ABS Private Capital Expenditure Survey tends to suggest a loss of momentum in the non-mining investment recovery for 2017-18.
- Dwelling investment increased 1.2% in Q4, although that only partly unwound the Q3 decline – a subdued result given the anticipated rebound from temporary weather-related disruptions and the record level of construction projects in the pipeline. There are, however, signs that the contribution of dwelling investment to economic growth may soon peak. New medium-density approvals have come off sharply from their highs, although they are still at elevated levels (especially in Victoria). Meanwhile, housing markets in Sydney and Melbourne continue to defy belief in 2017, with property prices showing no signs of slowing despite tightening credit conditions and concerns about affordability.
- Net exports added 0.2 ppts to GDP growth in Q4 2016. Going forward, net exports are expected to contribute significantly to overall economic growth on the back of higher LNG exports, before flattening off in 2018. High commodity prices have also boosted Australia's terms of trade, up 14% in Q4 2016 from a year ago and expected to peak in Q1 2017.
- The RBA is becoming increasingly focused on financial stability considerations, particularly household balance sheets in the context of a re-acceleration in house price growth in Sydney and Melbourne amidst elevated levels of household debt. Recent comments from RBA officials raise the possibility that macro-prudential measures may be stepped up and we now consider a further rate cut as unlikely in this environment. We have removed our expectation of a 25bp rate cut in late 2017, although continue to flag the risk of further monetary policy easing at some point given our concerns about economic growth and the labour market in 2018. As a result of our RBA view change, we are revising up our 2018 AUD/USD forecast slightly while maintaining our 0.70 end-2017 projection. A weaker AUD is still likely on a combination of further US interest rate-driven US dollar strength, lower commodity prices and potentially some deterioration in risk sentiment from current elevated levels.

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