November 2017

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

<u>Global</u>: The global economic upturn continues, with growth next year set to just beat its long-term trend. Inflation remains subdued and financial markets calm, with little need for aggressive central bank moves on policy. Market volatility and economic policy uncertainty are both fading as the probability of severe "tail risk" events are marked lower.

- Reflecting the ongoing growth in the global economy, as well as still loose monetary policy settings, major advanced economy stock markets continue to move higher. Moreover, despite geo-political risks flaring up from time-to-time – for example, North Korea/US and Catalonia separatist tensions in Spain – markets have not been particularly volatile.
- There has recently been some easing in long-term bond yields. That said they still generally remain above their mid-year level, prior to the shift in advanced economy central bank rhetoric away from further easing to when to tighten. In November, the Bank of England (BoE) became the third major central bank to lift rates this year, following earlier moves by the US Fed and the Bank of Canada. At this stage all the BoE has done is unwind its emergency post Brexit rate cut, and it is only signalling future 'gradual' and 'limited' rate rises. The ECB recently announced changes to its asset purchase program, but is saying that rates won't start to rise until well past the end of asset purchases. Similarly, the BoJ also continues to purchase large amounts of assets, but at a slower pace. In contrast, from October 2017 the Fed started unwinding the stock of assets accumulated under its previous asset purchase programmes, although only at a slow pace to start with.
- A broad-based economic upturn continues across the global economy driven mainly by the advanced economies. That said, the pace of expansion in the big emerging markets continues to be robust. Inflation has remained moderate through this acceleration in global growth. While headline CPI in the advanced economies has risen from practically zero in 2015 to much nearer the 2% inflation target adopted by several key central banks, much of that increase reflects higher prices for energy and food. Excluding the volatile commodity items "core" CPI inflation has been stuck in a 1¼% to 1½% range since early 2013. In contrast, headline inflation in the emerging market economies has been trending down through the last 7 years to reach around 4% yoy in August 2017. Again, higher commodity prices have lifted the headline rate with core inflation running around 3½% yoy.
- Solid growth has continued in the big advanced economies. By mid-2017 the pace of expansion was running above its long-run potential in the two biggest economic blocks – the US and Euro-zone, which in combination account for two-thirds of advanced economy output. The UK has out-performed the gloomy economic predictions made after last year's Brexit poll with annualised GDP growth increasing from 1.2% to 1.6% between the second and third quarters. The outcome of this above trend growth is falling rates of unemployment, with the Euro-zone jobless rate down from its 12% peak in the currency block's debt crisis to under 9%. The US labour market is also tightening as economic growth outstrips its long-run potential. The jobless rate fell to 4.1% in October, down from last October's 4.8% rate and far short of the 10% jobless peak rate of late 2009. The latest data confirms that the upturn in the big advanced economies is continuing. The latest set of monthly business surveys (for October month) show manufacturing conditions improving strongly in the big advanced economies while service sector growth continues at a solid pace.
- There has been little acceleration in the growth of industrial production in emerging market economies over recent months, and while export volumes are relatively strong, they too have been stagnant of late. However, this flat growth profile masks mixed industrial production trends in major emerging markets. The main improvement has been in Brazil as the economy has recovered from a deep recession. In contrast, there has been a noticeable slowdown in industrial growth in India and South Africa since the middle of 2016, while Indonesian growth has stabilised. In China, industrial production growth has trended around 6¼% yoy since early 2015. China's economic growth slowed marginally in Q3 (at 6.8% yoy) and industrial activity is likely to slow in Q4 – with Chinese authorities ordering the shutdown of a sizeable share of steel production capacity to address pollution concerns during the northern winter. China's latest indicators point to a modest slowing trend following the recent leadership change, which could flow through into weaker demand for imports from other emerging markets. Industrial production in East Asia has picked up in recent months particularly in the more export orientated economies with a heavy reliance on the electronics sector.
- The global economic upturn remains on track with global growth expected to return to its 3½% long run trend this year before accelerating to modestly above trend in 2018, which should be the best year for the global economy since 2012.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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Australia**: Overall, we are quietly confident that improving prospects for infrastructure construction and non-mining business investment will help sustain economic growth at a steady (but moderate) rate, despite some obstacles ahead. Real GDP growth is forecast to strengthen in coming quarters to 3.2% y/y by Mar-18, ease to 2.4% by Dec-18 before picking up slightly to 2.6% by end-19. Our inflation forecasts have been revised down slightly to reflect new weights from the ABS, with core inflation expected to hit the bottom of the RBA target band by end-18. The RBA remains comfortably on hold, with few hints of a move in either direction. We still expect two 25bp hikes in H2 2018, subject to more progress being made on reducing unemployment and/or underemployment, and wages growth showing some (at least tentative) signs of picking up.***

- The read on business conditions was extremely strong in the October NAB Monthly Business Survey, with manufacturing posting a strong result despite the recent closure of auto manufacturing plants. The conditions index jumped to a record high, and while confidence is not quite as buoyant, it is holding above long-run average levels. Despite record business conditions, **capacity utilisation** eased slightly, but **capital expenditure** has rebounded to solid levels – perhaps signalling some shift away from a focus on balance sheet repair.
- The latest ABS figures show **employment** grew by 3.7k in October in seasonally adjusted terms. While the gain was smaller than the market expected, it came after a period of strong jobs growth and marked the 13th month of consecutive increase. The participation rate declined by 0.1ppt to 65.1%, seeing the unemployment rate decline further to 5.4%. Employment grew the strongest in Queensland this month, after declining last month, while other states showed some weakness. Victoria lost 14.5k jobs, possibly related to the car manufacturing closure, which also saw a decline in its participation rate. Forward indicators continue to suggest the labour market will tighten further. The NAB Business Survey is consistent with employment growth of around 20k a month – similar to the current trend growth rate – and is importantly above the +14.4k breakeven level needed to keep the unemployment rate unchanged.
- Retail trade volumes rose just 0.1% q/q in Q3 following a 1.5% bounce in Q2, while the value of sales fell 0.3% in the quarter suggesting further deflation in the sector. In the month of September, the value of retail sales was flat, following a 0.5% m/m fall in August. This was below the 0.6% rebound signalled by NAB's Cashless Retail Sales Index. While a changed seasonal pattern due to the release of the new iPhone in November this year compared to a September release in previous years may have played a role, falls were also evident in other areas of household goods, clothing & footwear and recreational goods. Further, NAB's Online Retail Index fell 0.6% m/m. Business conditions in retail rose modestly out of negative territory to +0, but were well below the above-average conditions in all other industry groups. We are now forecasting **household consumption** growth of just 0.4% q/q in Q3, and for modest annual growth of 2 to 2½% in 2018 and 2019.
- In addition to strong results in the NAB Business Survey, the value of non-residential building approvals rebounded sharply in September, extending the overall positive trend seen this year; up 22.4% m/m in September (seasonally adjusted) and 15.3% higher y/y in trend terms. Meanwhile, monthly data on the value of capital goods imports picked up in Q3 (rising more than 7% in Q3, to be almost 20% higher over the year) – suggesting high levels of machinery and equipment investment, although capital imports may be seeing some volatility from the import of large LNG platforms. Overall, trends in the data support our expectation for a further acceleration in non-mining **business investment** ahead. However, despite the positive reads, official data showed a deceleration in business credit growth to just 0.1% m/m in September, while annual growth eased to 4.3% y/y, which is quite soft by historical standards and down from last year's peak (7.3%).
- There were more broad-based signs in the last month that the **housing market** is quickly cooling, although Sydney is where much of the pull-back has taken place, while Melbourne has largely bucked the trend. Annual national dwelling price growth has slowed to 7% y/y in October, having peaked at 11.4% earlier this year. Auction clearance rates in Melbourne have dipped recently, while they are at multi-year lows in Sydney (for this time of year). Housing finance approvals (owner-occupier) fell in September, but are still up a solid 11.8% over the year, and investor finance approvals also fell in the month (down 6.2% m/m) to be lower than the same time last year. Our outlook for prices is unchanged, with the market expected to cool further. On the supply side, Private residential building approvals rose again in September, and while they are still down from their peaks, they have been broadly flat over the year (better than expected). Much of the recent lift has come from NSW, particularly in medium density, but we do expect the downward trend in national approvals to resume in time.
- The **trade** surplus widened further in September, to be a better-than-expected $1.7 billion. Further improvements in the trade surplus might be harder to achieve in Q4, given recent declines in iron ore prices and scheduled maintenance at the Curtis Island LNG project. Net exports are expected to have added 0.3 ppts to GDP growth in Q3, as LNG exports continue to ramp up and the temporary impacts of weather disruptions in Q2 have dissipated. The NAB non-rural commodity price index was 3% higher q/q in Q3, mostly driven by the temporary surge in iron ore prices in July but also helped by higher oil and base metals prices. Forecast weakness in iron ore prices will drive the commodity price index lower in Q4 2017 and in 2018.
- We hold to the view that **AUD/USD** can close out the year nearer 0.75, which will likely require at least a modest extension of the Sep-Oct USD rally, something we continue to expect. It's no co-incidence that AUD/USD move lower has stalled alongside the cessation of the USD uptrend. Yield differentials remain quite pivotal to our view of how AUD/USD plays out in coming months, as well as an expectation that key bulk commodity prices will edge down. Assuming the Fed moves in December, then one additional tightening in H1 2018 would see the fed funds rate above the RBA cash rate.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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