December 2017

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

***Global**: The global economic backdrop is now the best is has been for a number of years as the upturn continues and GDP growth rises to around trend. There are now welcome signs of a broadening in the expansion to include more investment spending and growth in old world sectors such as manufacturing. Market volatility and economic policy uncertainty are both lower as the probability of severe "tail risk" events are marked lower. Labour markets are tightening around big advanced economies but there is still little sign of a pick-up in wage inflation.*

- Markets remain calm, with indicators of market stress and volatility such as credit spreads and the VIX index all remaining low. As a result, while several major central banks have raised rates this year – the US Fed, the Bank of England and the Bank of Canada - broader measures of financial conditions have either remained benign or eased further.
- While there has been a shift in advanced economy central bank rhetoric away from further easing measures to when to tighten policy, there are still large differences between major central banks. Over 2018 the US Fed should continue to lead the way. The Fed raised rates three times in 2017 and started to unwind its large balance sheet. We expect another three rate hikes next year as well, conditional on a pick-up in inflation. Market pricing is more cautious for 2018, but even so it still has the Fed tightening policy more rapidly than any other major central bank. The Bank of England (BoE) is only signalling future 'gradual' and 'limited' rate rises. The ECB has scaled back the size of its monthly asset purchases, and the programme will probably end by late next year. Markets are also debating when it might start to raise rates although this is not likely to happen until the end of 2018 at the earliest. The Bank of Japan continues to target a near zero 10 year government bond yield, and is undertaking asset purchases (although at a slower pace than before) with no change in policy in sight.
- The world economic upturn continues to gather momentum. Global output growth has accelerated from around 3% yoy in mid-2016 to 3¾% yoy in September. Consequently, global growth is now running (in through the year terms) above its 3½% long-term trend for the first time since mid-2005. Inflows of new orders are generally a good leading indicator of output and these have been rising solidly across a range of advanced and emerging market economies. Global industrial production continues to grow solidly, while world trade has also been picking up in 2017.
- One of the best aspects of the global economy through this year has been the way the upturn has become more securely established – broadening out geographically to include formerly soft economies and deepening with an acceleration in the pace of growth in fixed investment in the big advanced economies. As the upturn in demand gradually erodes surplus capacity across the G7 advanced economies, it is increasingly important that investment grows solidly to facilitate a long and sustainable period of economic growth – and that is now starting to happen with a ramping up in capital spending through the last year. While advanced economy growth has accelerated from 1¼% yoy in mid-2016 to 2¼% yoy in September 2017, it is the emerging market economies that still provide the bulk of increased global output (albeit their growth rates remain relatively stable).
- The upturn in the advanced economies is broadening out. The US and Canadian economies have been the standout growth performers through the recovery from the GFC while Japan and the Euro-zone had been the worst-performing major economies. Euro-zone growth has ramped up to an annualised rate of around 2½% yoy in Q3 2017, well above the 1¾% pace averaged over the previous year. There is, however, still great divergence within the Euro-zone. The Japanese economy has also seen a marked lift through 2017 with second and third quarter growth averaging almost 2¾% at an annualised pace. Recent output expansion in both the Euro-zone and Japan outstrips estimates of the growth in their long-run productive potential, an outcome only made possible by eroding margins of spare capacity.
- Economic growth in the 5 biggest emerging market economies increased from around 5¼% yoy in March quarter to 5½% in June and rose again slightly in September - the fastest rate of growth for this group for three years. Most of the improvement since the cyclical low in late 2015 has been driven by Russia and Brazil – as their economies have recovered from deep recessions. In contrast, Indian growth has been disrupted by shifts in domestic economic policy while China and Indonesia have tracked sideways. Broad measures of industrial production and export volumes across the wider emerging market economies show divergent trends. Growth in industrial production accelerated in late 2016, but has largely remained stable across 2017. Growth in export volumes accelerated across 2017 with the most notable upturn occurring in Q3.
- This is the best global backdrop for Australia we have seen for a number years. Economic growth has ramped up to an above trend level, business confidence is high and measures of financial market volatility, risk spreads and policy uncertainty are well down from earlier highs. We expect the global upturn to continue into 2018 and the risks look more skewed to the upside.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

Australia*: National Accounts data for Q3 2017 again highlighted the divergence between the business and household sectors in Australia. Economic growth should see a moderate improvement next year, to 2.9% in annual average terms (although momentum should slow as the year progresses), driving some further lowering of the unemployment rate to 5.2% by end-2018. Further employment gains will help to narrow the gap between business and households spending, although our forecasts for wages suggest only a glacial improvement in consumer spending, particularly if the softer housing market has an impact on wealth effects. Underlying inflation is forecast to pick up only slowly, which together with early evidence of higher wages growth should be enough to see the RBA commence tightening in H2 - we have 25bp hikes in August and November pencilled in. This would take the cash rate up to 2%, a level which is still considered stimulatory.

- **Real GDP** figures for Q3 showed a slight moderation in the quarterly growth rate to 0.6% (from 0.9% in Q1), although annual growth accelerated to 2.8% y/y. The moderate growth momentum in Q3 was mainly led by business and government investment. Households are restraining their spending amidst further weakness in wages and household income growth, despite strong employment. Dwelling investment declined, which may suggest we are at the peak of the construction cycle (although the pipeline remains large).
- Last month's spike in **business conditions** was completely unwound in the November NAB Monthly Business Survey, although the index remains at very elevated levels. Business confidence has been less volatile, but appears to be showing a modest downward trend. Capacity utilisation rates were steady (at solid levels), but capital expenditure solidified, consistent with better reads on investment expectations from the ABS (see below).
- **Employment** grew again in November, up by a stronger-than-expected 62k (the 14th month of consecutive employment gains). This follows a soft read last month. The strong employment growth underlined rising labour force participation, with the participation rate rising to 65.5%. Overall the unemployment rate remained steady at 5.4% and the underemployment rate also fell to 8.3%, down 0.2 ppts, the third quarterly decline. The jobs gains were broad based across the states. Victoria recorded the biggest increase in employment after falling in October. NSW also reported strong jobs growth while NT also posted positive trend employment growth. Overall the strong ABS jobs growth numbers confirmed the positive signals from leading indicators including the NAB survey. The NAB employment conditions index remained solid in November. At +7 points, it is consistent with an annual job creation rate of around 240k (20k per month), enough to see the unemployment continuing to trend lower. NAB expects the unemployment rate to gradually drift towards 5% over the next 2 years.
- **Household consumption** growth was muted in Q3 at 0.1% q/q, well down from 0.8% in Q2 to be 2.2% higher over the year in real terms (3.4% yoy nominal). Consumption grew at a slower pace than disposable incomes, causing the household savings ratio to rise for the first time in over a year, to 3.2% from 3% in Q2. There are only very limited signs of strength in spending on discretionary items. In October, the value of retail sales increased 0.5% m/m and 1.8% y/y following four consecutive weak outcomes. This was above the 0.1% increase predicted by NAB's Cashless Retail Sales Index, although the ABS measure declined in trend terms (0.1% m/m). Meanwhile, NAB's Online Retail Sales Index rose 1.5% in October, suggesting substitution between traditional and online retailers. Household consumption is forecast to grow by a modest 2.0% in 2018, before a small improvement to 2.4% in 2019 (real), unless we see a stronger pickup in wages and household income growth.
- Underlying **private business investment** has been heading steadily higher – rising by 2% q/q, which was the fourth consecutive quarter of growth (up 7.5% over the year). Separately released data from the ABS shows that mining has become much less of a drag on investment, holding steady in Q2, while NAB estimates suggest that non-mining investment growth was again solid in the quarter. More timely indicators such as the NAB Business Survey and non-residential building approvals have been encouraging. Consistent with that, leads on the longer-term outlook for business investment have been much more encouraging, with the ABS Private Capex survey pointing to much stronger non-mining investment in FY18.
- **Government spending** was softer in Q3, but that followed strong growth in the previous quarter and reflected the impact of second hand asset transfers to the private sector – the completion of the Royal Adelaide Hospital. After accounting for second hand asset transfers, underlying public investment actually rose by a solid 7.4%.
- The **housing market** continued to cool in November, ahead of the usual pre-Christmas slow period. Auction clearance rates have eased, particularly in Sydney. These trends are clearly reflected in prices, with annual national dwelling price growth slowing to 5½% y/y in November, having peaked at 11.4% earlier this year. Our outlook for prices is unchanged, with the market expected to cool further. Dwelling investment fell in Q2, and is 2.3% lower over the year. While much of the fall reflects less renovation activity, it does suggest that dwelling construction has already peaked – pointing to a more elongated cycle as dwelling construction holds steady at a high level for some time. That said, residential building approvals have been holding up better than expected.
- **Net exports** were largely unchanged in Q3, making zero contribution to GDP growth. This was lower than expected, as a drop in volatile non-monetary gold exports coincided with a large rise in capital goods imports. The trade balance undershot in October and net exports might again struggle to contribute to growth in Q4.
- Rates differentials, softer commodities and reduced risk sentiment could all weaken **the AUD**, which we now see headed into a lower 0.70-0.75 range. At this stage, we have revised our point forecasts to 0.72 (from 0.73) by mid-2018 and 0.73 for end-2018.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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