EMBARGOED UNTIL: 11.30AM WEDNESDAY 13 DECEMBER 2017

THE FORWARD VIEW - AUSTRALIA

DECEMBER 2017

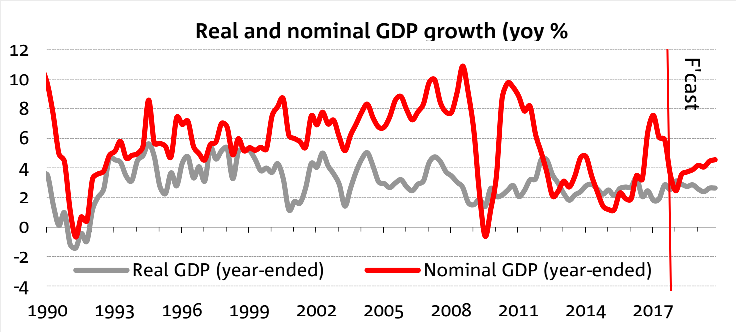
National Australia Bank

The year in review and the year ahead

- **2017 was a year of divergence between the business sector and the household sector. GDP data confirmed healthy (though volatile) growth momentum in the first three quarters**, mainly led by business and government investment. Strong business conditions broadened across industries and states, enabled by strong profitability. Households meanwhile continued to restrain their spending amidst further weakness in wages and household income growth, despite strong employment, while housing construction now appears to have peaked in a trend sense. Net exports didn't contribute as much as expected, partly because LNG has been slower to ramp up, partly due to weather disruptions, and partly due to offset from capital imports.
- **The RBA's focus through 2017 shifted towards addressing concerns about household balance sheets amidst rising housing prices,** concerns which were ultimately addressed through tighter macro-prudential measures. Momentum in house prices is now slowing more clearly, particularly in Sydney and the apartment space. Meanwhile, strong employment outcomes enabled the central bank to maintain its belief that wages/inflation will eventually turn up, although the jury is still out about the strength of any upturn.
- **In many ways, 2018 will be a continuation of 2017.** A moderate improvement in economic growth to 2.9% in annual average terms is forecast (although momentum should slow as the year progresses), driving some further lowering of the unemployment rate to 5.2% by end-2018. Business and government investment will lead (with some offset from capital imports), dwelling construction will pull back a little but remain high and LNG exports will add to growth. Further strength in employment growth will help to narrow the gap between business and households spending, although our forecasts for wages suggest that any improvement in consumer spending will be glacial, particularly if wealth effects have an impact as house prices slow.
- **Underlying inflation is forecast to pick up slowly to 2% by end-18, which together with early evidence of some pickup in wages growth should be enough to see the RBA commence tightening in the second half** - 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.
- **Key developments to watch include:** the transmission from employment to wages amidst forces such as globalisation and digital disruption; momentum in house prices and credit growth and how that impacts on monetary policy and/or macro-prudential policies; the path of the USD, commodity prices and the AUD (forecast to depreciate to USD0.72 by mid-year); domestic energy prices (to remain high and troubling for some sectors); and margin compression in retail.

	2015	2016	2017-F	2018-F	2019-F
Domestic Demand (a)	1.2	1.8	2.6	2.3	2.7
Real GDP (annual average)	**2.5**	**2.6**	**2.3**	**2.9**	**2.6**
Real GDP (year-ended to Dec)	**2.7**	**2.4**	**2.5**	**2.9**	**2.6**
Terms of Trade (a)	-11.5	0.1	11.4	-5.8	-2.0
Employment (a)	2.2	1.6	2.1	1.9	1.4
Unemployment Rate (b)	5.9	5.7	5.4	5.2	5.1
Headline CPI (b)	1.7	1.5	2.1	2.2	2.2
Core CPI (b)	2.0	1.5	1.9	2.0	2.2
RBA Cash Rate (b)	2.00	1.50	1.50	2.00	2.50
$A/US cents (b)	0.73	0.72	0.75	0.73	0.76

(a) annual average growth, (b) end-period, (c) through the year inflation



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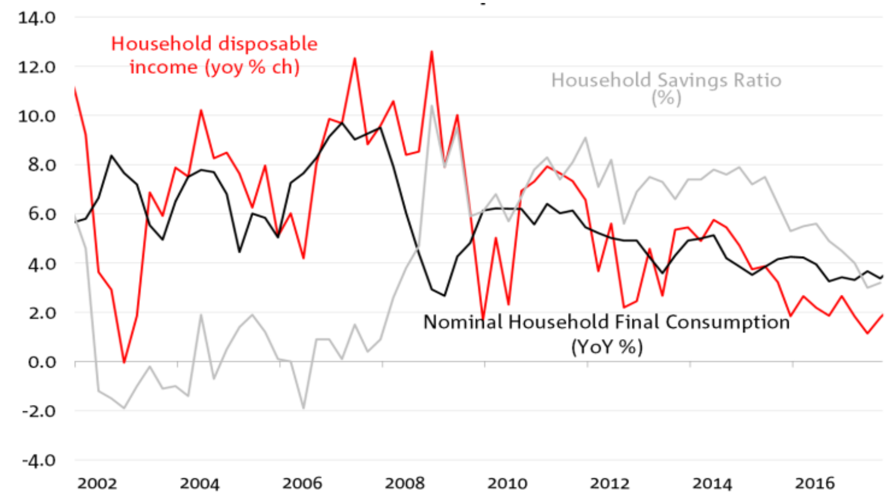
WRAP UP: THE AUSTRALIAN ECONOMY IN 2017 (I)

A year of divergence between business and households

CONSUMER SPENDING AND INCOMES

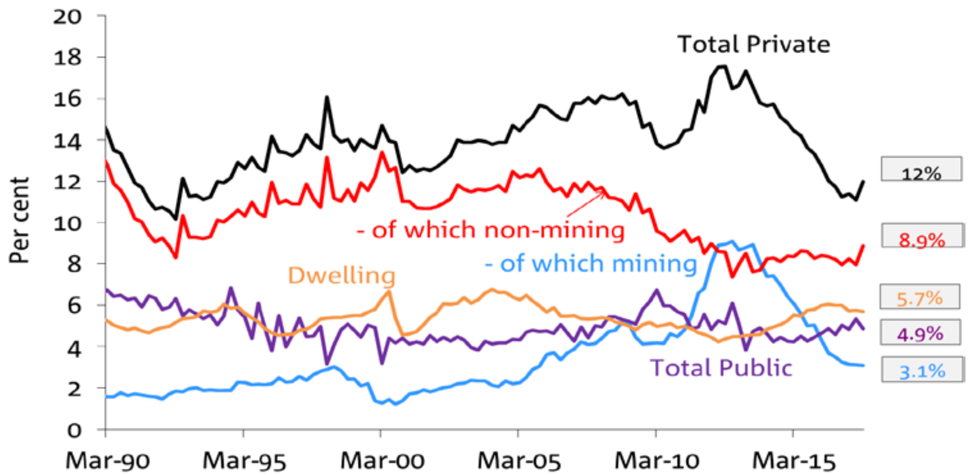
Year-ended % change



Source: ABS, NAB Group Economics

BUSINESS, DWELLING AND GOVERNMENT INVESTMENT

% of GDP



Source: ABS, National Australia Bank

2017 – a year that surprised, and a year that didn't. Economic growth largely transpired as expected, with real GDP growth picking up to 2.8% y/y in the September quarter, only a touch below our forecast of 3.0% y/y made at the end of last year. Within the total:

- Household consumption underwhelmed as we had foreshadowed, with growth of 2.2% y/y in real terms (we had forecast 2.3% y/y) and 3.4% in nominal terms. This was despite stronger than expected employment, with 316K jobs added in the ten months to October (266K of them full-time), and the unemployment rate easing to 5.4% (c/f our forecast of 5.7%). A key reason for slow consumer spending growth was that job gains did not translate through to wages and household incomes. Yearly growth in the wage price index was 2% in Q3, only a touch higher than at the end of 2016. (page 8) Meanwhile average earnings were exceedingly weak (just 0.6% y/y in Q3) - a measure which includes compositional shifts to lower paying industries and reductions in penalty rates/overtime etc) - as well as household disposable income growth (1.8% y/y in nominal terms, equivalent to the rate of inflation). As expected, high levels of household debt, feelings of job insecurity and concerns about the rising cost of energy likely also played a part in constraining spending. That said, the household savings ratio fell through the year despite a tick higher in Q3 to 3.2% - it is unclear to what extent this has been voluntary, or involuntary to fund essentials.
- Growth in business investment has been stronger and come a little earlier than expected (up 7.8% y/y in underlying terms in Q3) despite mining investment declining as large projects ended. Instead, non-mining investment has increased much more strongly than forward-looking indicators such as the capex survey suggested, and while business conditions softened in late 2016 (prompting us to be cautious about investment), conditions subsequently rose strongly and broadened across industries (with the exception of retail). This was enabled by strength in corporate profitability, both in mining (thanks to surprise surges in coal and iron ore prices earlier in the year), but also non-mining.
- State governments in particular acted more urgently to accelerate infrastructure spending plans, which has driven public investment up 13% over the year to September (in underlying terms).
- Meanwhile, dwelling construction looks to have peaked a little earlier (late 2016 versus our expectation of late-17 or early-18, although we had flagged the possibility of an earlier peak). This could be a positive signal as it suggests a more elongated cycle with reduced possibility of sharp decline, and we note that dwelling approvals have picked up again.*(cont)*

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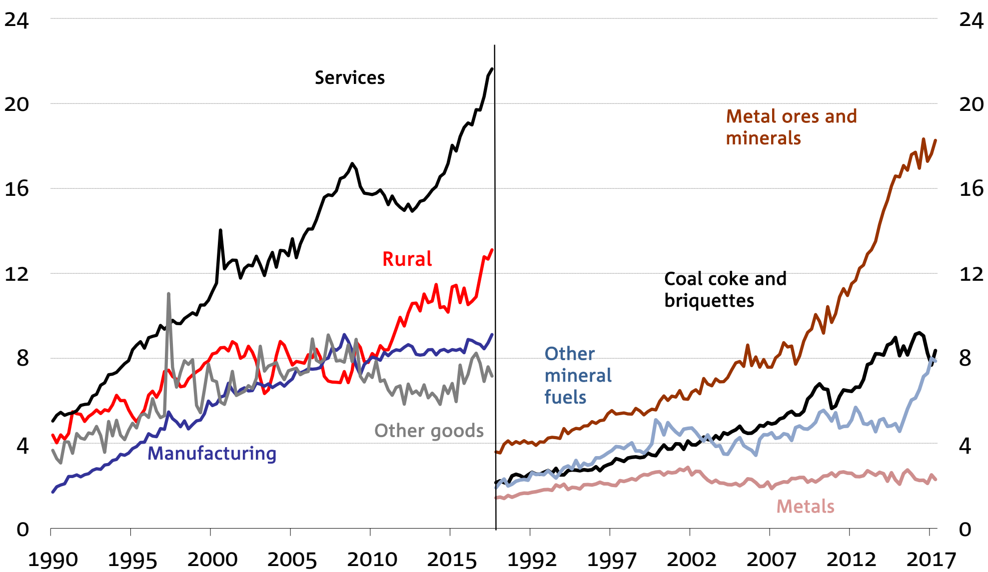
WRAP UP: THE AUSTRALIAN ECONOMY IN 2017 (II)

A year of divergence between business and households

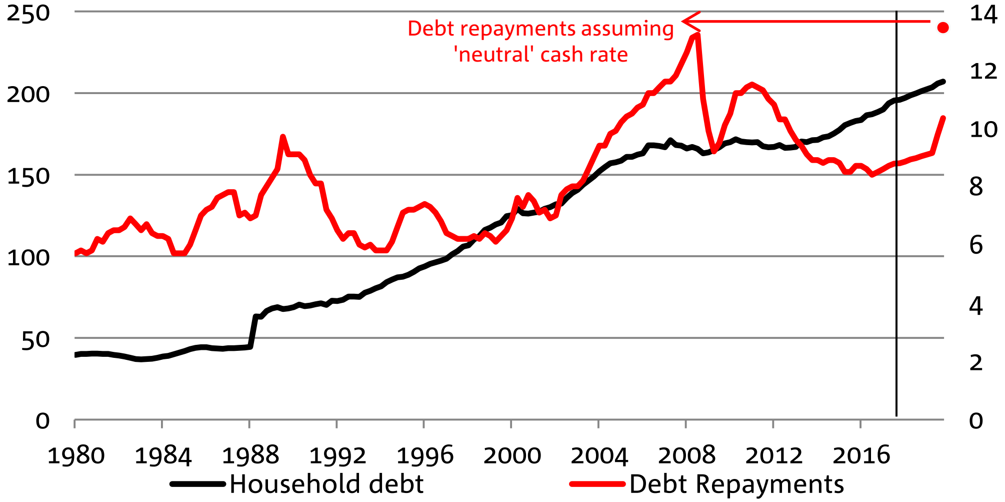
EXPORT VOLUMES

Quarterly, $bn



HOUSEHOLD DEBT AND SERVICING COSTS

% of disposable income



(cont from page 2) Part of the decline in dwelling construction has also been driven by weakness in renovations. While we had never expected a sizeable correction in housing prices, prices gains continued to defy expectations for much of the year, only in recent months showing clear signs of loss of momentum (especially in Sydney, see page 7).

- Net exports failed to add to growth as expected, with a subtraction of 0.4ppt over the year to September. Some gains from private and public investment were offset by higher capital imports (see page 9), even looking through the import of large LNG floating platforms. This, together with appreciation of the AUD, delays in LNG exports and weather disruptions hitting iron ore and coal exports weighed on (still respectable) exports growth. That said, services exports (tourism and education) surged and surprising strength in commodity prices (particularly iron ore and coal earlier in the year) helped the trade balance remain in positive territory, and the current account deficit shrink.

Underlying inflation remained below the bottom of the RBA's 2-3% target band at 1.8% y/y in September, a little lower than our forecast of 2.0% y/y (see page 5). Strong retail competition, margin compression, weak wages growth and a stronger than anticipated AUD all played a part.

A less hawkish US Fed and softer USD, as well as upside commodity price surprises, were key reasons for the AUD appreciating rather than depreciating this year, peaking at just over USD0.81 in September but easing back to USD0.75 at the time of writing as rate differentials finally moved against the currency late in the year.

The RBA's focus changed through 2017 towards concerns about house price growth and household balance sheets. Stronger employment also allowed the central bank to shift its attention, despite wages and inflation failing to pick up. Equally, while the central bank became increasingly nervous about stoking an already hot property market, it refrained from hiking rates given the still fragile nature of the economic recovery and concerns about unduly crunching household spending – macro-prudential measures were instead used to slow housing credit. We removed our expected rate cut early in the year (and in September brought forward the expected timing of the first rate hikes to Aug & Nov-2018).

All in all, 2017 was a year in which outcomes for businesses and consumers diverged, in which the property market eventually slowed but later than expected, and a year in which the RBA remained on the sidelines.
What will 2018 bring? (See overleaf for our predictions)

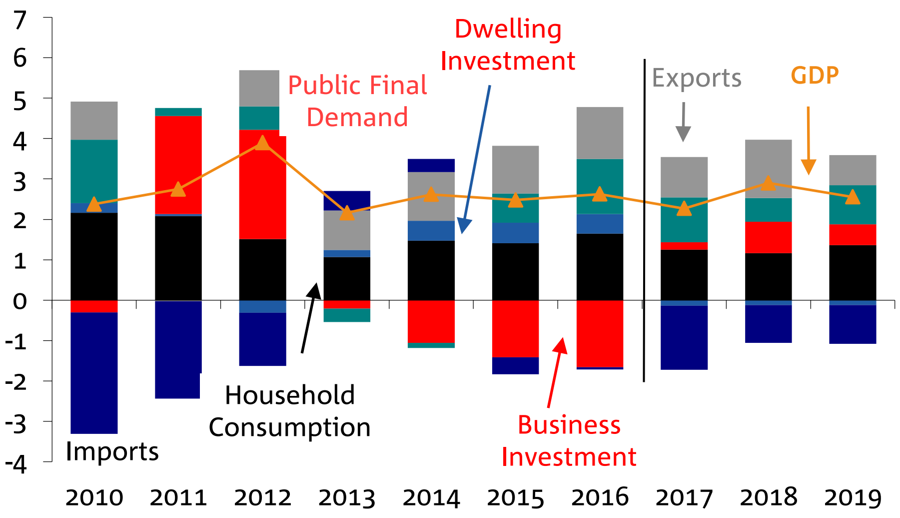
 Sources: ABS, NAB

LOOKING FORWARD: THE AUSTRALIAN ECONOMY IN 2018 (I)

Growth stronger near term, but lose some momentum as the year progresses

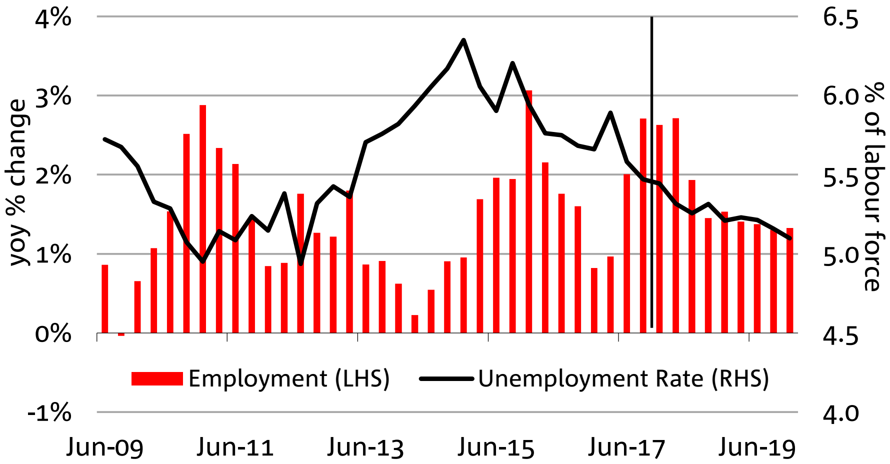
SOMEWHAT STRONGER GROWTH MOMENTUM IN 2018

Annual average % change



UNEMPLOYMENT RATE TO INCH DOWN

Employment growth and unemployment rate



Sources: ABS, NAB

In many ways, 2018 will be a continuation of 2017. We are expecting a moderate improvement in growth to 2.9% in annual average terms, up from 2.3% in 2017 (although momentum will slow as the year progresses) with the unemployment rate easing a touch to 5.2% by end-2018. Business and government investment are expected to lead domestic demand growth (with some offset from capital imports), dwelling construction is forecast to pull back a little but remain high and LNG exports should add to growth. While employment growth remains solid (though a little more moderate than in 2017), consumer spending meanwhile struggles to lift much given an expected very slow and gradual improvement in wages and therefore household income growth, and a more muted wealth effect as house price growth slows.

Underlying inflation is forecast to pick up slowly to 2% by end-18, which together with early evidence of a pickup in wages growth should be enough to see the RBA commence tightening in the second half - 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.

Risks to our forecasts and developments to watch include:

- **Wages growth** - Australia's experience is likely to follow other economies – that is, slow transmission from strong labour market conditions into wages. It is likely, though not certain, that globalisation, automation and technological developments are playing a role and that these forces will remain. Our research also suggests that growth in labour productivity is a pre-requisite for a stronger pick up. That said, if unemployment drops more quickly than expected, we may be pleasantly surprised.
- **House prices and credit –** The RBA's concerns about household balance sheets may not dissipate entirely, with household debt still expected to grow more quickly than household income. Further macro-prudential measures may be on the cards, but are not factored in. Housing prices will be critical here, with hikes less assured in the unlikely event that housing prices experience a severe correction. On the flipside, a house price reacceleration may bring forward hikes and/or macro-prudential measures.
- **Margin compression in retail/sluggish consumer demand –** the competitive environment in Australian retail is heating up at a time when the consumer demand outlook is uncertain. The headwinds already weighing on consumer discretionary spending – most notably low wage growth and high debt – are unlikely to be resolved soon, suggesting retailers will continue to feel the pinch from margin compression. Retailers are already lagging well behind other industries in the NAB Business Survey and that gap is expected to remain, at least to some degree, in 2018. How retailers respond in this challenging environment will be watched closely.
- **China's growth path** - while global geopolitical risks abound, a hard-landing in China remains the single largest downside risk for Australia, despite (*cont*)

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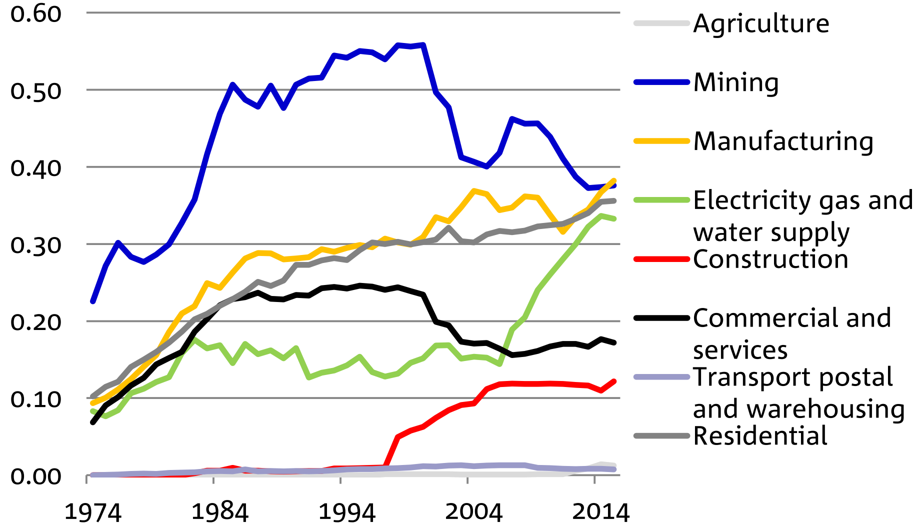
LOOKING FORWARD: THE AUSTRALIAN ECONOMY IN 2018 (II)

Growth stronger near term, but lose some momentum as the year progresses

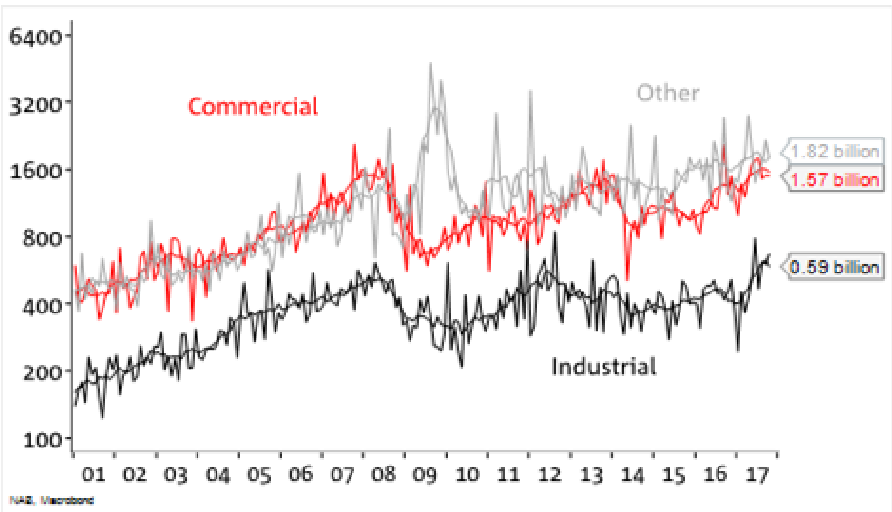
LNG INTENSITY BY INDUSTRY

Natural gas as share of total energy use (in PJ)



NON-RESIDENTIAL BUILDING APPROVALS

$ billions



Sources: ABS, NAB

(cont from page 4) our expectation for a gradual slowdown. An industrial/construction centred slowing would be most challenging for Australia given pressure on commodity demand and prices, although AUD depreciation would be a counterbalancing force.

- **Energy prices -** with gas producers now able to send gas offshore, Australia is subject to prevailing prices in East Asia, most of which are oil-linked and well above historic Australian norms. If export prices move higher, following oil, domestic prices could again exceed AUD8/GJ. Higher gas prices (and tighter supply) are likely to have a material impact on the National Electricity Market (NEM) going forward. Dependence on high cost gas generation may put upward pressure on wholesale electricity prices in the summer. If this continues for an extended period, retail prices will rise further.
- **Renewed focus on non-residential construction** – while the dwelling construction cycle appears to have hit a peak, attention is now turning to non-residential construction, which has been more clearly on the rise on the back of more favourable business conditions and higher infrastructure spending. NAB's Commercial Property Survey is also pointing to strong confidence in the office and hotel markets in particular. The strength in infrastructure spending has been evident in the pipeline of engineering projects under construction, while we have also seen encouraging signs elsewhere, like in offices where some markets have seen tight supply and strong capital gains. Non-residential building approvals have clearly trended higher and are expected to sustain the improving trend in non-mining business investment growth into 2018 and beyond.
- **The USD and the AUD** – we have slightly revised our forecasts for AUD/USD to 0.72 by mid-18 as the confluence of narrower rate differentials, softer commodities and risk sentiment are likely to weaken the AUD to the USD0.70-75 range. Technical analysis points to some greater downside risk near term. This would see some upside risk to our economic growth and inflation forecasts, with exporting industries such as agri and services (tourism/education) and import competing industries to benefit the most. That said, the forecast remains highly dependent on the USD path – for now, we are holding to our call for three US rate hikes in 2018 (as per the Fed's "dot plot" projections), particularly given the likelihood of fiscal stimulus as Trump's tax bill inches closer to passing Congress.
- **Global central banks winding back liquidity –** The Fed has started to reduce its balance sheet, and there is an expectation that the ECB will ends its asset purchase program later next year, which may put some upward pressure on global yields and potentially have implications for currencies and other asset markets such as equities. However, any impact from these changes is probably already, at least partially, priced in and major central bank balance sheets will continue to be very large for years to come.

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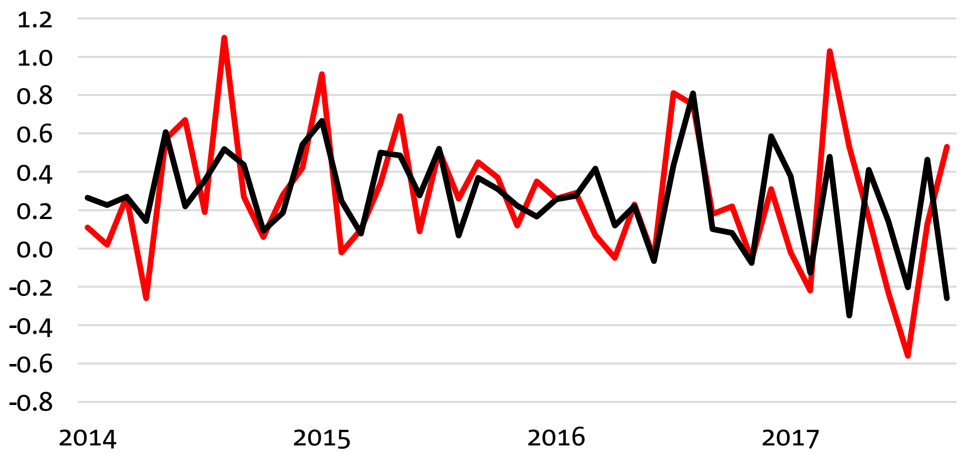
CONSUMER DEMAND AND INFLATION

Household consumption unable to accelerate amidst low income growth

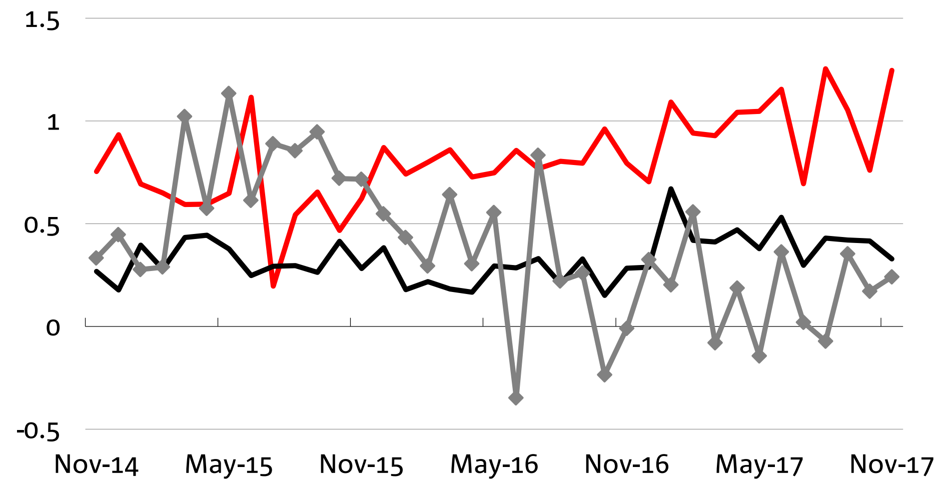
RETAIL SALES MEASURES (NAB VS ABS MAPPED)

Monthly % change



NAB SURVEY RETAIL PRICE GROWTH RECOVERED SOMEWHAT IN NOV

% change at a quarterly rate



Sources: ABS; NAB Economics

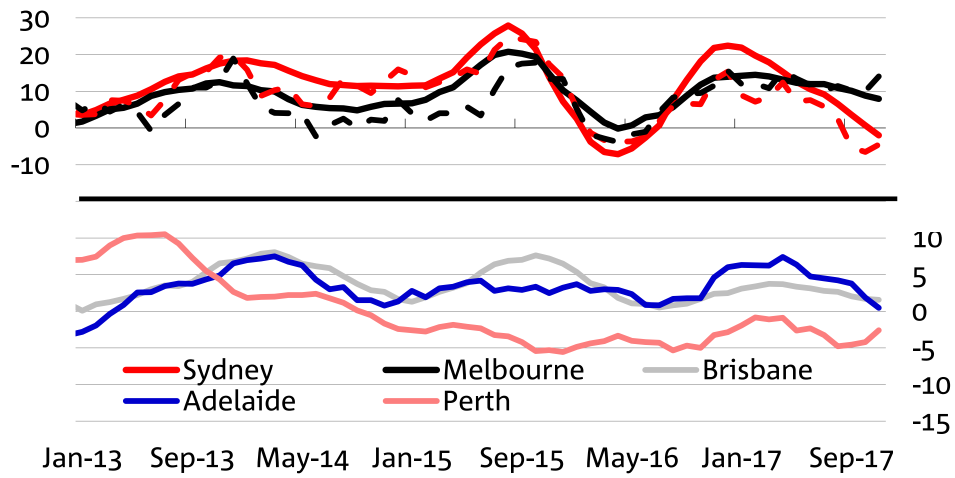
- Household consumption growth was muted in Q3 at 0.1% q/q, well down from 0.8% in Q2 to be 2.2% higher over the year in real terms (3.4% yoy nominal). Consumption grew at a slower pace than disposable incomes (income at 0.5% q/q, compared to 0.2% q/q for nominal household consumption), causing the household savings ratio to rise for the first time in over a year, to 3.2% from 3% in Q2. Over the past year, there has been strong growth in insurance & financial services (+4.8% y/y), food (+4.3% yoy), communications (+4% y/y) and transport services (+3.2%). There are only very limited signs of strength in spending on discretionary items, with categories such as hotels, cafes & restaurants declining over the year (-1.7%). Health and communications spending also fell in the quarter, which are quite rare occurrences and could well bounce back next quarter.
- 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). The weakest industry is household goods, which is likely related to the slowing housing cycle. Food and cafes & restaurants remain the strongest. Meanwhile, NAB's Online Retail Sales Index rose 1.5% in October, suggesting substitution between traditional and online retailers. (The growing share of online sales is not captured as fully in the official data, and the rise of online also appears to be changing seasonality, implying we interpret monthly movements cautiously).
- 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.
- As mentioned last month, we have revised our inflation forecasts a little lower, as new CPI weights from Q4 show the weights for items with falling prices generally having increased in the consumption basket and vice versa. Other than that, our assessment of the inflation outlook hasn't changed fundamentally. We expect headline inflation in Q4 to be boosted somewhat by higher utilities and fuel prices. For underlying inflation, it will be supported by the gradual tightening of the labour market, which is expected to slowly translate into higher wages growth. On the other hand, low rent inflation due to increasing housing supply and increasing competitive pressure in the retail industry will keep underlying inflation subdued. The latest NAB Monthly Business Survey showed labour cost and retail price growth increased in November, while product price growth eased slightly. Overall underlying inflation is forecast to pick up to 2.0% by end-18, and 2.2% by end-19 y/y. This is a touch higher than the RBA's forecast of underlying inflation rising to 2% by June 2019.

THE HOUSING MARKET

Housing market clearly cooling, but construction indicators surprisingly resilient.

MOST MARKETS ARE LOSING PRICE MOMENTUM

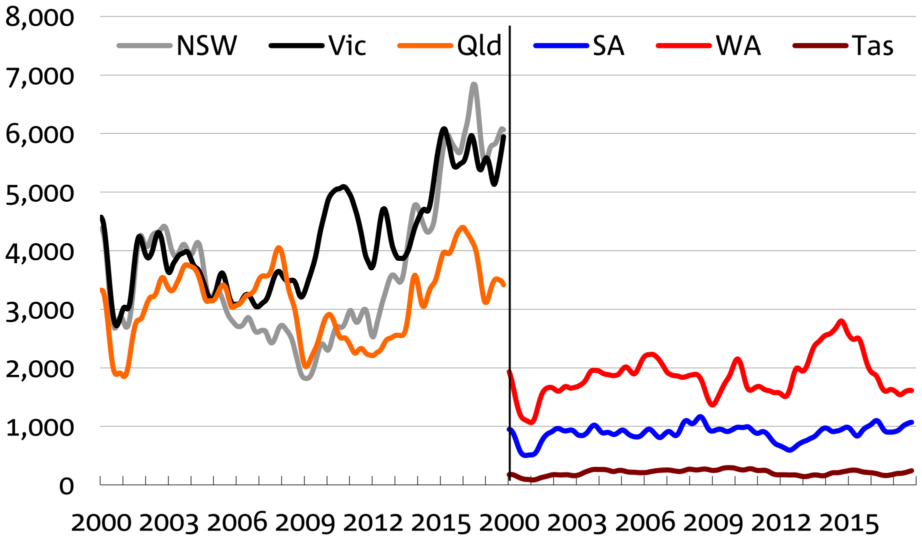
Dwelling price growth (%, 6-month annualised)



* Solid lines are hedonic prices. Dotted lines represent simple median prices.

RESIDENTIAL BUILDING APPROVALS BY STATE (TREND)

Private dwelling units approved



Sources: ABS; CoreLogic

- The housing market continued to cool in November, ahead of the usual pre-Christmas slow period. Auction clearance rates have eased, but that has been largely driven by Sydney where the rate has dipped below 60% on average over recent weeks (having been closer to 80% early in the year) – implying a buyers' market. Melbourne clearance rates have eased, but not to the same extent, while auction volumes have held up.
- These trends are clearly reflected in prices. Annual national dwelling price growth slowed to 5½% y/y in November, having peaked at 11.4% earlier this year. Momentum has turned negative in Sydney (chart), although annual growth is still modestly positive (5%) – interestingly, unit prices have been doing better than house prices in recent months, which might be an indication that affordability is a major factor. Momentum is also easing in Brisbane and Adelaide, and while the trend has improved in Perth, prices are still down over the year. Prices in Melbourne meanwhile are holding up reasonably well, with growth only coming off slightly (rising 10.1% over they year to November).
- The number of housing finance approvals (owner-occupier, ex refinancing) fell in October, but is still up 9% over the year. Meanwhile, investor finance approvals rose (up 1.6% m/m), but are still down more than 6% on last year.
- Our outlook for prices is unchanged, but slightly weaker than expected prices in Sydney in recent months suggests some downside risk – our forecasts will be updated in the release of NAB's Residential Property Survey later this month. Our national house price forecasts for 2017 are currently 4.7%, 3.4% in 2018 and 2.5% in 2019. Unit prices are forecast to rise 4.7% in 2017, 0.5% in 2018 and a slight decline (-0.3%) in 2019.
- Dwelling investment was down again in the quarter, falling 1%, continuing the trend that has seen investment fall 2.3% over the year. While weak results in previous quarters were partly put down to disruptive weather, the fall in Q3 could suggest that the housing construction cycle has peaked even sooner than what most were expecting. That said, new house building rose this quarter and it was a decline in alterations & additions/renovations (-4.8% q/q), that drove the fall in the quarter.
- Private residential building approvals increased 0.3% in October, and despite being down from their peaks, are now up over the year (4.2% in trend terms). The trend for both detached houses and units has ticked up recently, with the lift from NSW and Victoria. We still expect approvals to trend down from here, but a continuation of solid population growth could help sustain these levels.
- Ongoing weakness has prompted us to revise our dwelling investment outlook slightly lower. It is now expected to be down in 2017, before falling another 2.2% in 2018 (previously +0.7%) and 2019 (previously -1.3%), albeit with limited impact on economic growth given its small share of GDP.

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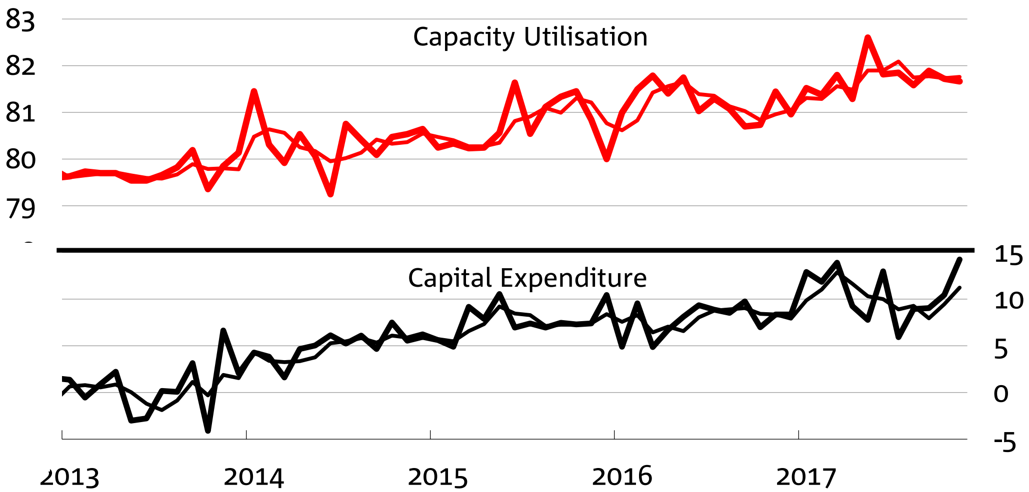
BUSINESS ACTIVITY, INVESTMENT AND CONSTRUCTION

Solid results once again for the business sector. Signs of more capex to come

NAB MONTHLY SURVEY INVESTMENT INDICATORS*

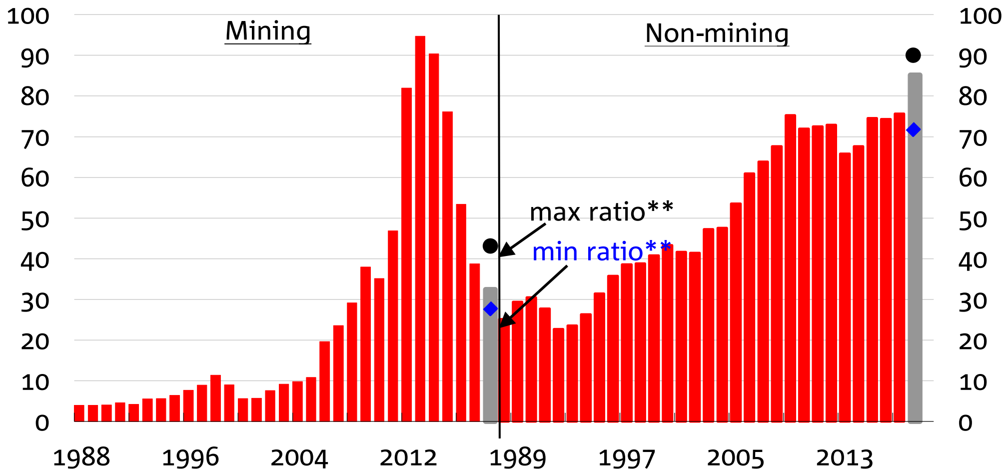
% of capacity; Net balance



* Light lines represent the 3mma

NON-MINING INVESTMENT INTENTIONS ON THE RISE

Capital Expenditure Expectations, $ billions*



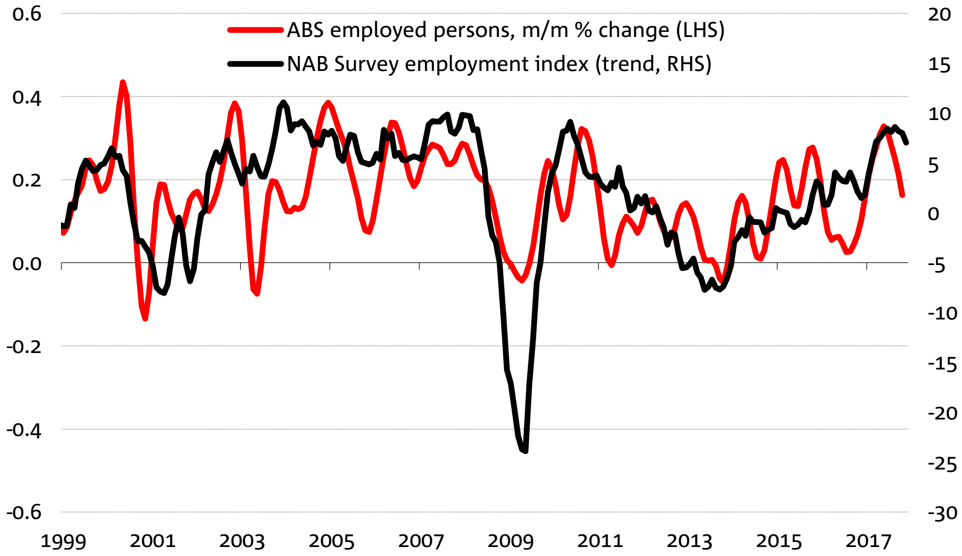
* Grey bars are the latest expectations adjusted by the previous year's realisation ratio measure
** The max and min estimates based on historical max-min realisation ratios
Source: NAB, ABS

- 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. In terms of the read on business investment, capacity utilisation rates were steady (at solid levels), but capital expenditure solidified, consistent with better reads on investment expectations from the ABS (see below).
- Similarly, despite a decline in the value of non-residential building approvals in October, the trend remains quite positive; up 20% y/y in trend terms (private & public). Office approvals have been particularly strong, albeit lumpy, while trends are generally encouraging in other sectors such as warehouses. Education and retail have seen support from some major projects this year.
- 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. Private engineering construction saw solid growth of 6.3% q/q, which is likely supported by both infrastructure projects and some residual mining investment. Non-residential building construction rose by only 0.1% q/q, but is up a solid 11% y/y – good trends in non-residential building approvals suggest further growth over coming quarters. Meanwhile, machinery and equipment investment rose by 1.1%, which is a solid result, but softer than Q2.
- Underlying public investment was up a solid 7.4% q/q, which is consistent with a ramp-up of infrastructure programs – spending was weaker in underlying terms due to the impact of second hand asset transfers (namely the completion of the Royal Adelaide Hospital).
- Reads on the longer-term outlook for business investment stepped up recently with the ABS Private Capex survey pointing to much stronger non-mining investment in FY18 (chart) – coming more into line with solid 12-month ahead expectations in the NAB Quarterly Business Survey. The confirmed pipeline of infrastructure projects is also large, which will keep public investment elevated.
- Underlying business investment (around 12% of GDP) is forecast to be higher in 2017 (2.8%), accelerating to 4.8% in both 2018 and 2019.

LABOUR MARKET AND WAGES

Unemployment rate to continue to drift lower before wages growth picks up

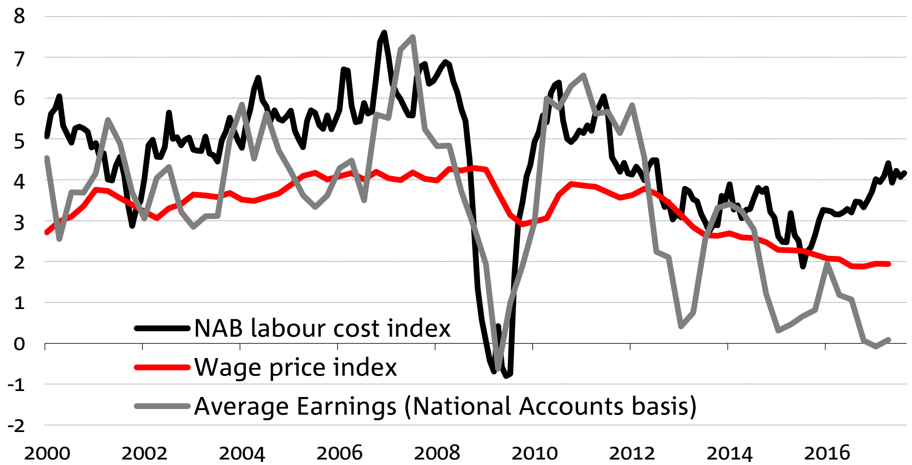
NAB SURVEY POINTS TO IMPROVING EMPLOYMENT CONDITIONS



Source: ABS

WAGES SUBDUED, ALTHOUGH NAB WAGE BILL MEASURE CREEPING UP

y/y % change



Source: ABS, NAB Economics

- The labour market continued to improve strongly, with the latest ABS figures showing 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, and a rise of 15K is forecast for November (Mkt: +19K). The participation rate declined by 0.1 ppt to 65.1% in October, driving the unemployment rate down further to 5.4%. It was the first time the participation rate fell this year, as the overall stronger labour demand has been met with increased labour market participation, especially among older workers and women. We forecast the unemployment rate to continue to drift lower as the labour market improves further, to around 5.2% by the end of 2018. How rapidly the unemployment rate might decline is dependent on the participation rate.
- Employment grew the strongest in Queensland in October, 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. Over the year, Victoria still recorded strong employment growth. In trend terms, all states and territories recorded positive employment growth except for Tasmania and the Northern Territory.
- 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 jobs growth– and is importantly above the +14.4k breakeven level needed to keep the unemployment rate steady.
- Wages growth rose 0.5% q/q and 2.0% y/y in Q3, below market expectations and failed to show a noticeable lift as a result of the increase in the minimum wage. While it seemed the minimum wage increase did drive wages growth in one-third of the industries, the other two thirds did not show much flow-on effect. Wages growth in WA also lagged behind, but it is hoped as the drag from the mining downturn has largely passed, wages growth might start improving. The Q3 National Accounts also showed weak labour earnings growth, with average labour earnings increasing by only 0.3% in the quarter and 0.6% over the year. The NAB survey showed labour costs growth rebounded somewhat in November, to 1.2% (a quarterly rate, previously 0.8%). Labour cost inflation has been subdued but trending higher. Wage pressures are strongest in mining, but softest in construction..
- While still elevated at 8.6%, the latest measure of the underemployment rate had declined from recent highs and is expected to decline further as labour market spare capacity is gradually eliminated. Overall we expect to see some lift in wages growth as a result of the strong labour market improvement.

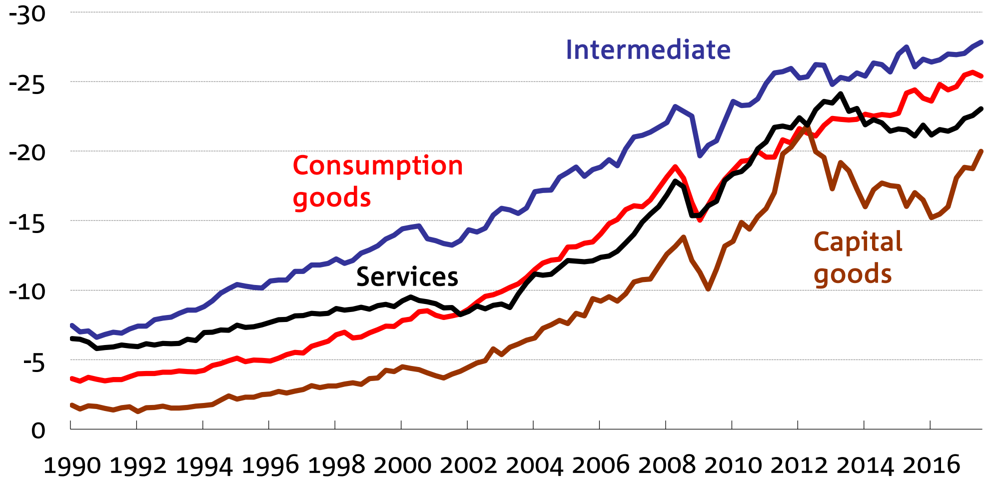
National Australia Bank

NET EXPORTS, COMMODITIES AND THE TERMS OF TRADE

Ramping up of LNG exports to drive net exports contribution in 2018

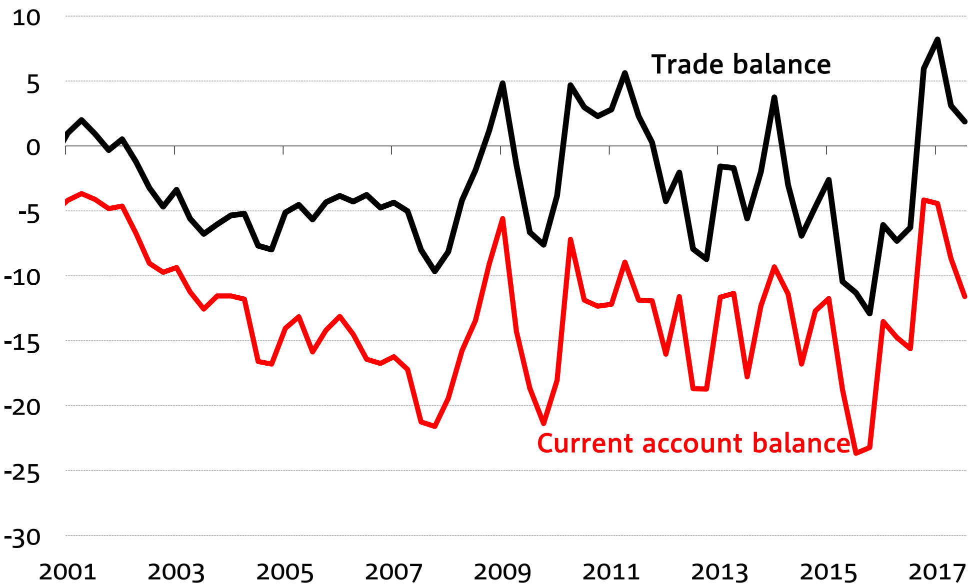
CAPITAL GOODS IMPORTS ROSE STRONGLY IN Q3

Import volumes, quarterly, $billion



TRADE BALANCE NARROWED IN OCTOBER

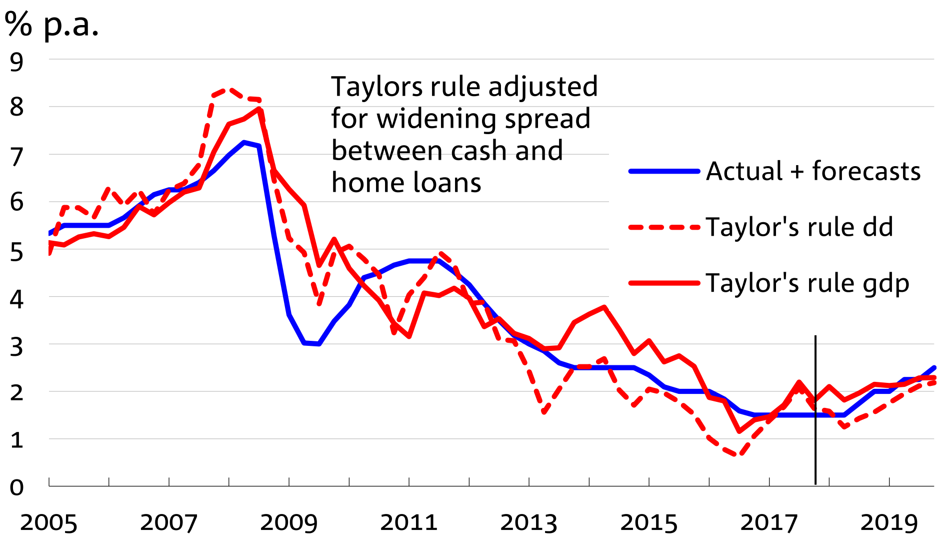
Current account & trade balance, $billion



- Net exports were largely unchanged in Q3, making zero contribution to GDP growth. The contribution was lower than expected, as the decline in volatile non-monetary gold exports coincided with a large rise in capital goods imports. The trade balance undershot in October, to a small surplus of $105m, driven by a large decline in both iron ore shipments and some earlier softness in prices. Iron ore export volumes are likely to recover somewhat in November, but overall net exports might struggle to contribute to growth in Q4.
- The ramping up of LNG exports is expected to continue driving exports, alone adding approximately 0.3, 0.4 and 0.1 ppts to GDP growth in 2017, 2018 and 2019 respectively. When the Prelude FLNG and Ichthys floating LNG platforms are completed late this year and next year respectively, Australia will have a nameplate export capacity of around 85 million tonnes, the largest in the world. However due to the low oil prices and some well production issues, we expect some terminals will run well below nameplate capacity. As a result, our forecast is somewhat below the Department of Industry's. While there could be some incremental gains in iron ore and coal volumes, they are not expected to be substantial. Recently elevated metal prices have also seen increased expansion efforts, including BHP's plan to expand the Olympic Dam mine, which should see copper exports rise as well in the next few years. With the AUD forecast to depreciate (see page 10), services exports especially tourism exports are expected to strengthen. For imports, consumption and intermediate imports are expected to improve as household consumption growth picks up while capital imports will slow.
- The NAB non-rural commodity price index was 3% higher q/q in Q3 (in USD terms), mostly driven by the temporary surge in iron ore prices in July but also helped by higher oil and base metals prices. We forecast the index to fall by 7% q/q in Q4 in USD terms, to end the year unchanged from Q4 2016 levels, driven by forecast weakness in iron ore prices. Further weakness in 2018 will likely see the index 5.4% lower by Q4 2018 compared to a year ago. In AUD terms, similar falls are expected, with a 2.9% q/q decline expected in Q4 and more declines in 2018.
- The outlook for agriculture in 2018 is reasonably upbeat, although the forecast for summer rainfall has been complicated by the declaration of a short and weak La Nina event. Major rainfall events across south-eastern Australia have raised the prospect of crop quality downgrades, although a big effort was made to harvest as much as possible before the weather hit, lessening the damage. Ultimately, we see grain production well below last year's (record) crop. Lamb and wool continues to perform, while cattle prices seems to have settled at a higher level.

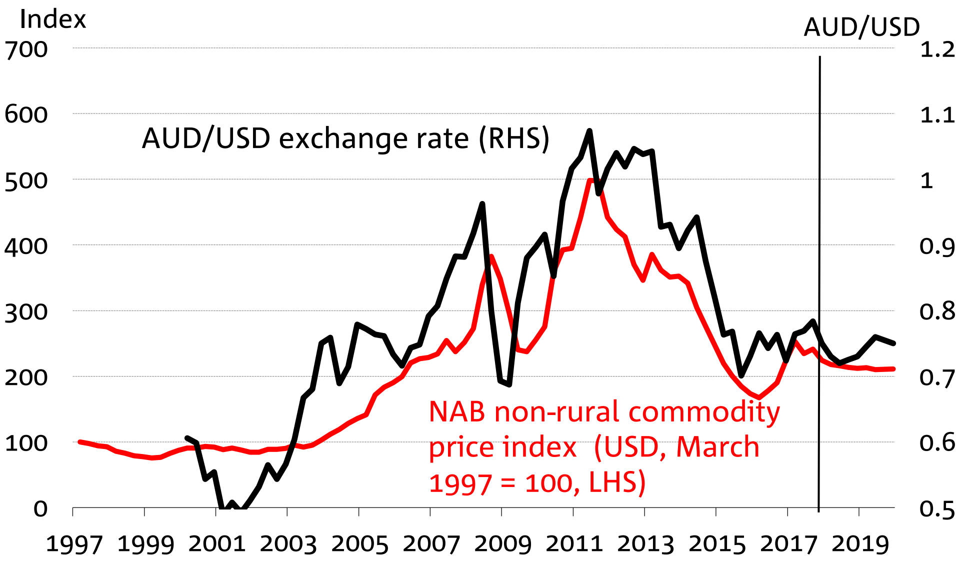
MONETARY POLICY AND THE EXCHANGE RATE *RBA to start hiking in H2. Stronger USD and gradual commodity price decline to weigh on AUD.*

AUSTRALIAN CASH RATE AND TAYLOR RULE



AUSSIE DOLLAR VERSUS COMMODITY PRICE OUTLOOK

NAB Non-rural commodity prce index and AUD/USD



Source: RBA, Bloomberg, NAB Economics

- The RBA left the cash rate on hold in December, affirming that current settings remain appropriate. The latest *Statement on Monetary Policy* revealed a central bank that is more positive, with the outlook for non-mining investment further improving and the labour market strong. However, the RBA remains concerned about risks to household consumption against a backdrop of weak income growth and high debt levels.
- The RBA welcomes the stronger trends in investment from non-mining and government sources, as well as positive looking forward-indicators. Improved outcomes for employment and capital spending are driving a more confident growth outlook, although spare labour market capacity will need to shrink further for wages growth to lift. Encouragingly, firms are reporting greater difficulty sourcing suitable labour, which is normally a pre-cursor to reduced spare capacity and strengthening wages. The RBA appears to be watching this measure from our NAB Quarterly Business Survey closely, as well as reports from its liaison program.
- The RBA will be reluctant to raise rates until there are reliable signs that wages growth and inflation are moving in the right direction, especially as the cooling housing market has simultaneously lessened the urgency for RBA rate hikes. However, we expect that stronger labour market conditions will see wage growth lift over time. Additionally, the RBA's concerns around household balance sheets are unlikely to dissipate, especially as levels of household debt continue to rise faster than incomes (see chart on page 3). On balance, for now, we retain our view that the RBA will begin gradually lifting interest rates in H2 2018 as the unemployment rate falls further.
- 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. The RBA has consistently warned that an appreciating exchange rate would result in a slower pick-up in economic activity and inflation, thus making it ideal for AUD/USD to be below 0.75 and above 0.70. Additionally, RBA Governor Lowe has expressed that rising US interest rates are likely to be associated with some further weakening of the currency. At this stage, we have revised our point forecasts to 0.72 (from 0.73) by mid-2018 and 0.73 for end-2018 (see further discussion on page 5).

DETAILED ECONOMIC FORECASTS

Australian economic and financial forecasts (a)

	Fiscal Year				Calendar Year				
	2015-16	2016-17	2017-18 F	2018-19 F	2015	2016	2017-F	2018-F	2019-F
Private Consumption	2.8	2.4	1.9	2.2	2.4	2.8	2.1	2.0	2.4
Dwelling Investment	10.5	2.6	-2.7	-2.4	9.6	8.6	-2.3	-2.2	-2.2
Underlying Business Investment	-12.6	-6.7	6.9	3.7	-10.4	-12.0	2.8	4.8	4.8
Underlying Public Final Demand	4.5	4.9	4.3	3.5	3.4	5.2	4.4	3.6	4.1
Domestic Demand	**1.4**	**2.1**	**2.7**	**2.3**	**1.2**	**1.8**	**2.6**	**2.3**	**2.7**
Stocks (b)	0.0	0.2	-0.1	0.0	0.1	0.1	-0.1	0.0	0.0
GNE	**1.4**	**2.3**	**2.6**	**2.4**	**1.2**	**1.9**	**2.6**	**2.4**	**2.7**
Exports	6.9	5.4	7.1	5.0	6.5	6.8	5.1	7.1	3.6
Imports	-0.1	4.8	6.0	3.6	1.9	0.2	7.4	4.1	4.2
GDP	**2.8**	**2.0**	**2.8**	**2.6**	**2.5**	**2.6**	**2.3**	**2.9**	**2.6**
Nominal GDP	2.4	5.8	3.8	4.0	1.6	3.8	5.7	3.4	4.3
Federal Budget Deficit: ($b)	-37	-34	-23	-22	NA	NA	NA	NA	NA
Current Account Deficit ($b)	75	32	41	52	77	48	34	47	59
(-%) of GDP	4.5	1.8	2.3	2.8	4.7	2.9	1.9	2.5	3.0
Employment	2.2	1.3	2.5	1.4	2.2	1.6	2.1	1.9	1.4
Terms of Trade	-9.9	14.5	-1.7	-3.6	-11.5	0.1	11.4	-5.8	-2.0
Average Earnings (Nat. Accts. Basis)	1.1	0.3	1.6	2.1	0.9	0.9	0.7	2.0	2.3
End of Period									
Total CPI	1.0	1.9	2.4	2.3	1.7	1.5	2.1	2.2	2.2
Core CPI	1.5	1.9	1.7	2.1	2.0	1.5	1.9	2.0	2.2
Unemployment Rate	5.7	5.6	5.3	5.2	5.9	5.7	5.4	5.2	5.1
RBA Cash Rate	1.75	1.50	1.50	2.25	2.00	1.50	1.50	2.00	2.50
10 Year Govt. Bonds	1.98	2.60	3.05	3.40	2.88	2.77	2.75	3.40	3.50
$A/US cents :	0.74	0.77	0.72	0.76	0.73	0.72	0.75	0.73	0.75
$A - Trade Weighted Index	62.5	65.5	59.8	62.9	62.7	63.9	63.0	60.3	62.1

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

COMMODITY PRICE FORECASTS

		Spot	Actual				*Forecasts*				
	Unit	11/12/2017	Sep-17	*Dec-17*	*Mar-18*	*Jun-18*	*Sep-18*	*Dec-18*	*Mar-19*	*Jun-19*	*Sep-19*
WTI oil	US$/bbl	58	50	54	57	58	59	59	60	60	60
Brent oil	US$/bbl	65	53	60	63	64	65	65	66	66	66
Tapis oil	US$/bbl	69	54	61	64	65	66	66	67	67	67
Gold	US$/ounce	1248	1280	1260	1270	1280	1290	1300	1310	1320	1330
Iron ore (spot)	US$/tonne	n.a.	72	62	60	62	61	60	60	60	60
Hard coking coal*	US$/tonne	n.a.	189	160	140	120	105	100	101	99	100
Semi-soft coal*	US$/tonne	n.a.	135	115	101	87	76	72	73	71	72
Thermal coal*	US$/tonne	97	85	85	85	80	80	80	80	65	65
Aluminium	US$/tonne	2001	2010	2110	2090	2070	2070	2070	2070	2070	2070
Copper	US$/tonne	6635	6350	6800	6730	6660	6660	6660	6660	6660	6660
Lead	US$/tonne	2494	2330	2470	2450	2420	2400	2370	2370	2370	2370
Nickel	US$/tonne	11177	10540	11590	11480	11480	11540	11590	11590	11590	11590
Zinc	US$/tonne	3130	2960	3260	3280	3290	3310	3320	3320	3320	3320
Aus LNG**	AU$/GJ	n.a.	8.50	8.00	7.45	7.67	7.92	8.17	8.30	8.43	8.56

* Data reflect NAB estimates of US$/ tonne FOB quarterly contract prices (thermal coal is JFY contract). Actual data represent most recent final quarterly contract price. ** Implied Australian LNG export prices

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