February 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

***Global**: Recent shifts in financial market pricing reflect the move toward solid global growth, positive data surprises, upward revisions to forecasts and the balance of risks shifting from deflation and slow growth to higher growth and inflation. Low interest rates and very low jobless rates have been a rare combination in the last 40 years – normally rates would be higher in the current environment with the lowest jobless rates in the big advanced economies since the 1970s. The outlook is for ongoing global growth driving modest rises in wage and price inflation as well as higher interest rates.*

- The calm in financial markets for much of 2017 and into early 2018 recently came to an abrupt end with a surge in market volatility and big falls in share prices. We think this volatility in global financial markets reflects investors concluding that a solid global economic upturn has shifted the direction of risk away from price deflation and low growth and towards positive surprises in the economic data and the emergence of higher inflation. Unemployment in the big advanced economies has fallen to levels last seen in the 1970s but key interest rates are around historic lows. This combination of tightening constraints on supply and very low rates is only possible because up till now inflation has been subdued and wages surprisingly unresponsive to tighter job markets. Markets may turn out to have over-reacted to one month's US wage number, the immediate trigger for the recent turbulence, but it is symptomatic of sensitised investors watching for signs of higher inflation and they are not going to stop looking. Consequently we can expect further volatility as the data arrives.
- Central banks so far do not seem particularly concerned. As the global economy heals and inflation heads back to target, central banks would be expected to adjust their "emergency" policy to gradually deliver interest rates that are suited (i.e. higher) for more "normal" economic conditions.
- Global economic growth is running above its long-run trend with ongoing solid growth in the big emerging markets coinciding with a lift in the rate of demand expansion in the big advanced economies. Increases in output and spending now outstrip growth in supply capacity across advanced economies that represent a third of the global economy. At the same time, emerging market economy growth is robust. China and India (25% of the global economy) look set to exceed 6% growth this year and economic expansion has resumed in Russia and Brazil (representing 6% of the global economy) as they move out of recession.
- The most recent indicators of economic activity show the upturn continuing through the closing months of 2017 and into this year. The momentum of expansion in both industrial output and world trade was being maintained until the end of last year and the business surveys for early 2018 report multi-year highs for recent activity and confidence. Manufacturing surveys are the best for around 7 years and economy-wide measures are the best for 3½ years. Forward-looking survey questions show many firms expect these good conditions to continue.
- The pace of economic growth in the big advanced economies has become more synchronised and accelerated to around 2¼% yoy in the latter half of last year. Annual economic growth of 2 to 3% in the big advanced economies is a pretty good outcome as their average growth since 2000 is only 1.6%. Furthermore, estimates of the rate of sustainable growth in the supply potential of these economies are generally both low and well under recent increases in output - so the pace of expansion can only be maintained by drawing on dwindling margins of spare productive capacity left standing idle in earlier years of weak outcomes. Pursuing avenues to lift potential growth is increasingly important because the latest surveys do not show any sign that demand growth is about to slow and a squeeze on productive resources in some big advanced economies could emerge sooner than previously thought - the US jobless rate is around 4%, Japan's is under 3% and across the G7 advanced economies it is around 5%, low by the standards of the last 30 years.
- China's economy grew by 6.9% in 2017, the first acceleration in growth since 2010 and well ahead of the government's growth target. At the same time, China's gradual transition away from heavy industrial led growth towards consumption is continuing. More broadly, emerging market industrial production has continued to grow robustly – having accelerated to around 4% yoy in early 2017 (from recent lows of 2¾% in late 2015 and early 2016) and remaining around these levels across most of the year. Stronger export volumes have contributed to the improved industrial conditions in emerging markets, generated by the general upturn in the global economy.
- We think the global upturn will continue with above-trend growth through 2018 and 2019. Our expectation is that central banks will gradually lift their policy rates and bond markets will increase yields as wage and price inflation increases – but although these rate rises will curb the rate of economic growth in the short run, they should ensure a more sustainable upturn over the long haul as demand growth is not allowed to overheat. The bottom line is that the latest bout of financial market turbulence has not changed the outlook which is still a positive one of sustained economic growth.
- For more detail on the global outlook, please see the [Forward View – Global], released yesterday.

Alan Oster (Group Chief Economist), Ph: +(61 3) 8634 2927 or M: 0414 444 652
Alt: Tom Taylor (Head of International Economics), Riki Polygenis (Head of Australian Economics)

<u>Australia</u>: We are gradually becoming more confident that infrastructure spending and non-mining business investment should help the Australian economy navigate the challenges of peaking LNG exports and dwelling construction. We are forecasting economic growth of 2.9% in 2018 and 2.8% in 2019 in annual average terms, suggesting an economy which manages to grow slightly above potential. Tepid consumer spending amidst low and only gradually rising wages growth however tempers the outlook, and is a key uncertainty for monetary policy. If unemployment continues to drift lower and wages gradually higher as anticipated, we believe the RBA will have enough confidence that inflation will eventually pick up towards the bottom of the band. Acting in anticipation of this would be appropriate and we forecast two 25bp rate hikes in August and November, although we acknowledge the risks are that these hikes could be delayed.

- **Business conditions** strengthened in the January NAB Monthly Business Survey and, on a trend basis, remain at elevated levels providing further confirmation of robust business activity. Business confidence also improved, and has trended upwards in the past two months, although this pre-dated the recent global financial market turbulence. Capacity utilisation rates in the survey are on an upwards trend and while capital expenditure declined, looking through the monthly volatility, the broad pattern of a pick-up in the level starting in 2017 is unchanged.
- Another healthy rise in **employment** in December completed a year of strong labour market improvement in 2017.Over 2017, employment grew by a robust 403k, 302k of which full time employment. Employment grew by another 16k in January – the 16th consecutive month of increases. In trend terms employment growth is currently around 23k with unemployment unchanged at 5.5%. The female participation rate has hit record levels. Rising participation has offset rising employment growth. Trend employment growth is now positive in all states. The NAB employment index implies employment growth of a little less than 300K at present, and a slowdown to around 240K per annum over the next 6 months, or a monthly pace of around 20K per month. Provided the participation rate doesn't continue to rise this should still be sufficient to see the unemployment rate inch downwards. We expect the unemployment rate to gradually drift lower to around 5.1% by the end of the year.
- Available data for Q4 2017 so far suggests a better quarter for **consumer spending**. Retail sales were up 0.7% q/q in real terms, compared with 0.1% q/q in Q3 2017. The rise in volumes was driven by household goods which benefitted from strong promotions and the release of the new iPhone in November. That said, the seasonal pattern of retail spending is changing - the value of retail sales turnover was up strongly in seasonally adjusted terms in the month of November (1.3% m/m, thanks to Black Friday sales being introduced in Australia) and the release of the iPhone, but then was down by 0.5% in December. This see-saw pattern was also evident in NAB's Cashless Retail Index and NAB's Online Retail Sales Index. With household income growth constrained by low wages growth, cost of living concerns still weighing on consumers, coupled with the likelihood that a softer housing market will be blunting any wealth effect into consumer spending this year, we remain comfortable with our forecasts for moderate household consumption growth of 2.4% in 2018 and 2.5% in 2019.
- The value of private & public non-residential building approvals in December was up over 30% y/y in trend terms. The upwards trend in approvals has been evident in such sectors as offices, warehouses, educational and aged care construction, while retail and accommodation approvals have been more stable. Other partial indicators on investment are mixed - while capital goods imports were down in Q4, commercial vehicles sales in December 2017 were up by 20.6% y/y for light vehicles and by 13.7% for heavy vehicles, and the RLB non-residential crane index rebounded in Q4. Underlying **business investment** has accelerated over the 2017, reaching 7.9% y/ in 2017 Q3. In year average terms, we are forecasting growth of around 4-5% in 2018 and 2019. Underlying **public investment** is expected to be even stronger with growth forecast to be around 9% in both 2018 and 2019.
- The softer **housing mar**ket conditions witnessed towards the end of last year continued into early 2018. Annual national dwelling price growth slowed to 3.2% y/y in January, having peaked at 11.4% in early 2017. The biggest shift in momentum has occurred in Sydney, with 6-month annualised growth becoming more negative. For 2018, our assessment of the market direction remains largely unchanged although the degree of moderation has accelerated mainly driven by downward revisions to Sydney house prices (see NAB's Residential Property Survey). The number of housing finance approvals (owner-occupier, ex refinancing) fell 3.4% in December, and at the same time the value of investor finance approvals was down 2.6% m/m. Private residential building approvals dropped by a sharp 20% in December, driven by a big fall in medium-density approvals, although they are still up nearly 4% y/y in trend terms. Following a fall of 2.3% in 2017, dwelling investment is expected to decline by a further 2.2% in 2018 and 3.1% in 2019.
- **Net exports** likely detracted nearly 1 ppt from Q4 GDP growth, a weaker than expected result. We are forecasting a bounce-back in Q1, with a small positive contribution expected. Positive net exports are also expected for the rest of 2018, driven by the ramping-up of LNG exports, before tapering off in 2019.
- For the **AUD** we anticipate a drop to at least the 75 cents area by end-18. We see good reasons for iron ore and coal prices to come off this year, and our expectation for a somewhat softer overall terms of trade is one key factor behind our forecast for AUD cross-rate underperformance.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 2) 9237 8017

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Behavioural & Industry Economics

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(61 3) 9208 2929

International Economics

Tom Taylor
Head of Economics, International
+(61 3) 8634 1883

Tony Kelly
Senior Economist – International
+(61 3) 9208 5049

Gerard Burg
Senior Economist – Asia
+(61 3) 8634 2788

John Sharma
Economist – Sovereign Risk
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

Important Notice

This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances.

NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click **here** to view our disclaimer and terms of use.