March 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

***Global**: The global economic environment remains the most encouraging it has been for many years. Growth has broadened out across the advanced world, and some key emerging market economies have recovered from deep recessions. Financial market volatility has eased since the US equity market correction in late January but there are still a range of geo-political and market events that could emerge to again increase the level of uncertainty, with the risk of a trade war intensifying as President Trump has imposed tariffs on US steel and aluminium imports. If these risks remain in check, we expect that the current above trend growth can continue this year and next, as long as advanced economy central banks remain relatively cautious in tightening policy and governments place a low priority on budget repair.*

- **Financial market** volatility has eased since the US equity market correction in late January but a range of geo-political and market events could trigger another bout of uncertainty. The closely watched VIX index spiked in early February as the sell-off in US markets gathered pace and has subsequently settled close to its long term trend level. Recent market concerns have focused on the announcement in early March of a 25% tariff on US steel imports and 10% on aluminium imports, followed by the resignation of President Trump's pro-trade economic advisor Gary Cohn. Trump's campaign was highly protectionist and the tariffs have raised fears around a potential trade war (which would have significant negative economic effects).
- **Central banks** are gradually attempting to remove long-running emergency rates and policy measures, and return to more normal levels. US monetary policy could also tighten more rapidly than previously thought – with markets anticipating a more hawkish approach from the US Federal Reserve.
- **Above trend global economic growth** has continued, with the sustained, synchronised upturn in advanced economies (which account for just under a third of global output) supported by continued expansion in the big emerging markets. Business survey readings in advanced economies remain strong – with manufacturing readings in February just off the seven year highs recorded at the end of 2017, while forward looking indicators suggest that businesses expect positive conditions to continue. That said, there are some near term trends that are somewhat less encouraging – with growth in emerging market industrial production and global trade volumes both slowing since recent cycle peaks in September 2017.
- From recent lows in mid-2016 (near 1¼%), growth in the big **advanced economies** accelerated – moving up to 2.3% yoy in Q4 2017. Particularly encouraging has been the synchronised nature of this upturn, with many previously weaker regions – such as Japan and the Eurozone – recording stronger growth in recent times. The strongest performers in Q4 were Germany and Canada – with growth close to 3% yoy – followed by France and the United States (both around 2.5%). The main exception has been the UK, where uncertainty around the post-Brexit environment is impacting the economy. Growth in many of these economies is running ahead of their potential – possible only in the short term as they erode the excess labour and production capacity that was built up in the post-GFC period. This can be seen in labour markets in the big advanced economies – with weighted unemployment across the G7 at its lowest levels on record (stretching back to the late 1970s).
- Overall trends for the big **emerging market economies** have improved in recent quarters – with economic growth pushing up to 5¾% in Q4 2017, up a full percentage point from the recent lows at the end of 2015. That said, trends differ considerably across countries. Indian growth picked up in Q4 with the negative impacts of tax changes and demonetisation washing out of the system and Brazil's economic recovery has continued. In contrast, Russian growth appears to have slowed in Q4, albeit only preliminary estimates were available at the time of writing. China's period of economic stability has continued – with growth remaining at 6.8% yoy in Q4. Economic targets unveiled at the National People's Congress in early March point to more of the same with the growth target unchanged at 6.5%. The only significant shift is a smaller fiscal deficit target, at 2.6% of GDP (from 3.0% last year), which may point to softer (near target) growth in 2018.
- We expect that **the current above trend growth can continue this year and nex**t, on the proviso that advanced central banks remain relatively cautious in their moves to tighten policy and governments place a low priority on budget repair and debt management, along with key risks remaining in check. Beyond this point, supply constraints are likely to impact – with unemployment already historically low in major advanced economies and spare production capacity severely eroded – bringing advanced economy growth back towards potential and inflation tracking higher. Similarly, we anticipate further softening in China's growth profile.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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***Australia**: Full-year economic growth in 2017 came in at a relatively subdued 2.3%. The good news story through 2017 was the long-awaited uplift in non-mining business investment, as well as a strong contribution from government infrastructure investment, although consumer spending disappointed and dwelling investment peaked. We see the economy gathering some speed through 2018, as business and government investment, as well as LNG exports contribute to growth. As a result, we see annual average growth of 2.8% in 2018, followed by 2.6% in 2019 and 2.8% in 2020. With growth running slightly above potential, spare capacity should gradually be eliminated, resulting in the unemployment rate tracking down and wages and inflation pressures gradually picking up. The RBA will not hike rates until there is comprehensive evidence that wages growth/inflation is moving in the right direction. At this stage, we have the first hike pencilled in for November 2018, with some risk that it occurs later.*

- **Business condition**s moved to a record high in the February NAB Monthly Business Survey, and although business confidence eased it remained above average. Moreover, forward orders jumped, confirming the upwards trend of recent years, and signalling an improved outlook for the non-mining economy. There was a small decline in capacity utilisation, but the upwards trend remains in place and actual capex, which had eased in the prior two months, moved to its highest level since 2004 in trend terms.
- **Employment** growth surprised significantly to the upside through 2017, with more than 400K jobs created, approximately 300K of which were full-time. The NAB Business Survey suggests further strength in employment growth of 27K per month in the near term, which, while somewhat softer than the current trend in official employment growth, continues to suggest labour market strength through 2018. The gains in employment have been broad based across states - trend employment growth was driven by the three largest states, with the recent pickup in QLD employment particularly welcome. WA also recorded slight positive growth and the other regions have been reporting positive employment growth as well, especially the ACT. We are forecasting the **unemployment rate** to head down to around 5% by end-18 and then hold broadly steady thereafter. This should be enough to put some gradual upward pressure on wages growth.
- As expected, **consumer spending** rebounded in Q4 with growth of 1.0% q/q. This took household consumption growth over the year to 2.9% y/y which is still modest by historical standards. Early indicators for 2018 are mixed. The NAB Cashless Retail Sales Index for January showed an improvement following a weak December, while the official ABS data increased only 0.1% m/m. Moreover, retail business conditions in the NAB Business survey have shown recent improvement, and this continued into February; although on the flipside personal & recreational services have been trending down recently. Caution is required in interpreting recent consumption growth data as the seasonal pattern of retail spending is changing, adding volatility. Cost of living pressures – particularly the rise in utility bills - are still weighing on households, and with wages growth still subdued and a less supportive wealth effect as housing prices cool, we still only expect moderate household consumption growth of 2.5% in both 2018 and 2019, followed by some strengthening to 2.7% in 2020.
- There was a pause in the upwards trend in underlying private **business investment** in Q4 as it fell 1% q/q although it was still up 5.8% over the year. The Q4 decline followed a large rise in Q3 (3.2% q/q) and it was likely affected by the lumpy profile of LNG investment projects. Mining investment, after holding steady in Q3, resumed its downwards trend in Q4. Investment intentions point to more falls ahead but smaller than those seen in previous years suggesting that the mining investment drag will continue to ease. In contrast, the capex intentions survey points to increasing non-mining business investment. Consistent with this, the value of non-residential buildings approvals remains at high levels, and in January 2018 they were 14% higher than a year ago in trend terms. We expect the Q4 weakness in underlying business investment to be short lived and for it to grow by around 5-6% p.a. out to 2020 (in year average terms). Underlying **public investment** is expected to be even stronger, with growth of 7% in 2018 and 10% in 2019 forecast.
- Softer **housing** market conditions continued into the first two months of 2018. In annual terms, national hedonic dwelling price growth slowed to 1.9% in February, the weakest rate since December 2012. In particular, over the last six months, Sydney dwelling prices have fallen approximately 7% (annualised rate). House prices are forecast to increase by only 0.7% in 2018 with growth remaining subdued in 2019, while the apartment market is expected to be a little weaker. On the supply side, **dwelling investment** was down again in Q4, falling 1.3%. We expect further modest declines in coming years, with building approvals sitting around 7.5% below their late 2016 peak, although they have been broadly flat in recent months. Following a fall of 2.4% in 2017, dwelling investment is expected to decline by 3.3% in 2018 and 2.0% in 2019 before stabilising in 2020.
- Net exports detracted 0.5 ppts from GDP growth in Q4, with rural goods and services exports lower, and coal exports affected by temporary supply disruptions. At the same time, there was a rise in imports consistent with stronger consumer spending in the quarter. However, in January export growth was led by non-monetary gold and LNG – the latter a sign of a ramp-up in LNG production.
- The **AUD/USD** fell sharply in early February in conjunction with the extreme, albeit temporarily, deterioration in risk sentiment. A subsequent bounce mid-month was short-lived aided by a further adverse move in interest rate differentials. We expect the AUD to head down to USD 0.75 by end-18 and to hold there through 2019.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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