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THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

***Global**: Overall, the global economic picture remains the most encouraging it has for several years – supported by synchronised growth among the big advanced economies and broadly stable growth across the big emerging markets. Above trend global growth looks set to continue through 2018 but this year should be the peak of this economic cycle and growth should slow to below-trend levels by 2020 but our base case is for a soft landing for the global economy. The obvious risk to this outlook comes from trade tensions between China and the US, which could erode business confidence, disrupt supply networks and distract political and business leaders from pursuing the reforms needed to boost future growth potential.*

- **Financial markets** have remained volatile in recent weeks reflecting the impact of stronger inflation and interest rate expectations (particularly in the United States) along with the uncertain prospects for the global trade environment, as the US and China have started to escalate tariff measures against each other. US yield curves have flattened significantly since recent peaks in December 2016 (during the so-called Trump trade following the US Presidential election). The flatter curve highlights the disparity between strong near term growth prospects and longer term uncertainty (given trade war risks and above potential growth, which could soon fall back towards trend).
- **Central banks** across the advanced world are gradually winding back emergency rates and policy measures. As expected, the US Federal Reserve increased the Fed Funds Rate in March, with further rate rises expected over the next 18 months. Markets are currently pricing a May increase by the Bank of England as a 50-50 chance, while the European Central Bank, and particularly the Bank of Japan, are likely to be slower to start the move back to more normal policy settings.
- **Global economic activity** is being supported by synchronised growth among the big advanced economies (which together account for a third of global output) and broadly stable growth across the big emerging markets (albeit trends differ somewhat among this group). Business survey readings in the advanced economies have dipped slightly – away from seven year highs recorded in late 2017 – but they remain strong. This extends to forward looking indicators, which continue to anticipate strong production in coming months, although global trade volumes have trended slightly lower in recent months.
- **Trade tensions** have escalated as the US Trade Representative completed a Section 301 investigation that accused China of intellectual property breaches – particularly the forced transfer of US technological IP to Chinese firms. Tariffs have been announced that will target between US$50-60 billion of Chinese imports – particularly high tech products. China has already retaliated with two rounds of tariff announcements that largely hit US agricultural exports. The second announcement in early April included a 25% tariff on soybeans – the largest single US agricultural export to China. Trump is also threating another round of tariffs on around $100bn of Chinese imports.
- The rate of output growth in the big **advanced economies** ramped up in the first half of 2017 and an above-trend pace of expansion has been maintained since then. Output volumes grew at an annualised rate of around 2½% through the June, September and December quarters of last year. Inflation in the big advanced economies remains muted and below target but it has risen from 1% in 2016 to around 1½% in late 2017.
- Industrial production and export data provide the most up to date indicators of conditions in **emerging market economies**. Overall, industrial production growth was marginally stronger in January but growth remains below the trend recorded across most of last year. Since late 2017, there has been a slowing trend in output growth in Latin America, Eastern Europe and Africa/Middle East regions. In contrast, Asian output has remained relatively stable – on the back of stability in China and strengthening in India. However, industrial production in other East Asian markets has slowed considerably (led by Korea and Singapore).
- 2018 should see the peak of the **global economic growth cycle**. Our leading indicator is signalling a modest dip in growth late this year and our forecasts show growth easing to an around trend rate of 3.6% next year before a further slowing to a below-trend pace of 3.3% by 2020. The predicted slowdown in growth is most marked in the big advanced economies, where output has recently been expanding at a rate above their long run growth potential. This has been made possible by the use of formerly idle productive resources but now G7 jobless rates have fallen to lows not seen since the 1970s and margins of idle capacity have also dried up. Growth is also predicted to slow in the main emerging market economies, with Chinese growth slowing from almost 7% in 2017 to 6% by 2020 and Indian growth proving unable to consolidate above 7%.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: After a somewhat disappointing 2017 we continue to expect growth to gain more momentum during 2018 – with GDP increasing by around 3% through the year or 2.8% in year average terms. This reflects increased government infrastructure spending, some continued improvement in non-mining business investment and the impact of increasing LNG exports, despite seeing little pick up in the speed of consumption growth this year. With indicators pointing to continuing strong jobs growth unemployment is expected to fall to around 5% by the end of 2018, which should place some upwards pressure on wages. This environment – together with above trend global growth – is consistent with the RBA gradually withdrawing emergency low monetary policy settings from late 2018. However nothing will happen until wages growth accelerates and the RBA will be very cautious and data driven.

- **Business conditions** declined in the March NAB Monthly Business Survey although they remain at a high level by historical standards. Business Survey leading indicators – forward orders and capacity utilisation - on a trend basis remained at their highest level since mid-2008 and early 2010 respectively.
- The **unemployment rate** was up slightly in February to 5.6% (s.a.), despite strong **employment** growth. February saw the 17th straight month of employment growth, but over the past year there has been strong growth in the working age population (up 329,000 over the past year) as well as a higher participation rate which have kept the unemployment rate up. Despite declining in March (down 7 to 9 index points), the NAB Monthly Business Survey employment index is still consistent with a solid level of jobs growth - approximately 21k per month over the next 6 months. As a result we continue to see unemployment falling to around 5 per cent by end 2018. That of course depends on the participation rate not continuing its “puzzling rise”. A tighter labour market should see a modest improvement in the still sluggish, pace of private sector wages growth.
- Reflecting lacklustre wage growth, consumer demand signals have been mixed. The NAB Cashless Retail Sales Index saw growth of 9.4% yoy in February, up from 8.8% in January and the fastest rate since mid-2016. Our forecast was for the official ABS measure of retail sales to increase 0.7% m/m in February, which proved to be close to the mark with ABS retail sales printing at 0.6% m/m. While retail has been reasonable in recent months, consumers remain cautious in the face of higher electricity prices, low wages growth, stalling house price wealth and high debt levels. It looks likely that consumption growth will be significantly slower in Q1 2018 as one off effects in Q4 2017 fade.
- Actual indicators of private **business investment** have been mixed recently. The NAB business survey measure of actual capital expenditure declined in March, but on a trend basis it remains elevated. Similarly, the value of non-residential approvals has also come off its recent peak, but it remains at a high level. Solid company profitability should provide a supportive backdrop to business investment. After diverging post-GFC, the relationship between non-mining investment and profits has reasserted itself, with non-mining investment increasing. With a large public sector investment pipeline already in place, underlying public investment growth should also be robust in coming years and as many projects are delivered in partnership with the private sector, this will also support private business sector investment. As a result, with the drag from mining investment likely to fade further over time, we expect underlying business investment to grow by around 5-6% annually in the out years, with growth in underlying **public investment** even stronger.
- **Housing** market conditions continue to soften with most capital city housing markets seeing price falls or slower growth, and transaction numbers remain lower than year ago levels. We have slightly lowered our house price forecasts for 2018 and now expect a small fall in house prices (now -0.8% was +0.7%), largely due to continuing weakness in the Sydney market and a softer Melbourne market. For 2019, the house price forecasts remain broadly unchanged at +0.8% with only Sydney expected to fall (albeit modestly). Apartment forecasts are broadly unchanged (-0.8% in 2018 & -1.8% in 2019) reflecting large stock additions and a soft outlook for foreign demand. On the supply side, **dwelling investment** has been trending down since Q3 2016 but while residential building approvals remain off their peaks, there is little sign at this stage of further downwards momentum, and they remain relatively high by historical standards. Strong population growth means that even as a large stock of apartments come onto the market in coming years, we are unlikely to see a major correction. Nevertheless, we still see further small declines in dwelling investment in 2018 and 2019 before stabilising in 2020.
- In February, the **trade** surplus declined on a seasonally adjusted basis, down 13% to an $825m surplus for the month. Rural goods exports rose 17% after a very weak January print, offsetting falls in non-rural goods and non-monetary gold exports. While there was little change in total imports, consumption imports were stronger in February. Net exports detracted 0.5 ppts from GDP growth in Q4 2017, so these surpluses in January and February may point to a small upside in Q1.
- We do not see much change in the **currency**. Our USD/AUD model currently has a fundamental value estimate of 77c +/- 5c. We have maintained our forecast that the AUD may move down to around 75c by late 2018 as the interest rate differential moves in the USD favour and commodity prices come off by around 5% during the year. For 2019 we see the AUD as hovering in the mid-70s. This forecast does not include an outbreak of a real trade war between the USA and China – which would see a significantly lower AUD.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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