EMBARGOED UNTIL: 11.30AM THURSDAY 12 APRIL 2018

THE FORWARD VIEW – GLOBAL

APRIL 2018

National Australia Bank

Summary – first shots fired in the US-China trade war

- Above trend global growth looks set to continue through 2018 but this year should be the peak of this economic cycle.
- 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.

	IMF weights	2012	2013	2014	2015	2016	2017	2018	2019	2020
US	15.5	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.3	1.7
Euro-zone	11.7	-0.8	-0.2	1.4	2.0	1.8	2.5	2.7	2.5	1.9
Japan	4.4	1.5	2.0	0.3	1.4	0.9	1.8	1.4	0.9	0.7
China	17.7	7.7	7.7	7.3	6.9	6.7	6.9	6.5	6.3	6.0
Emerging East Asia	8.0	4.7	4.2	4.1	3.7	3.9	4.4	4.3	4.0	3.7
NZ	0.2	2.6	2.2	3.6	3.5	4.0	2.9	3.0	3.0	2.4
Total	100.0	3.7	3.4	3.5	3.4	3.2	3.6	3.8	3.6	3.3

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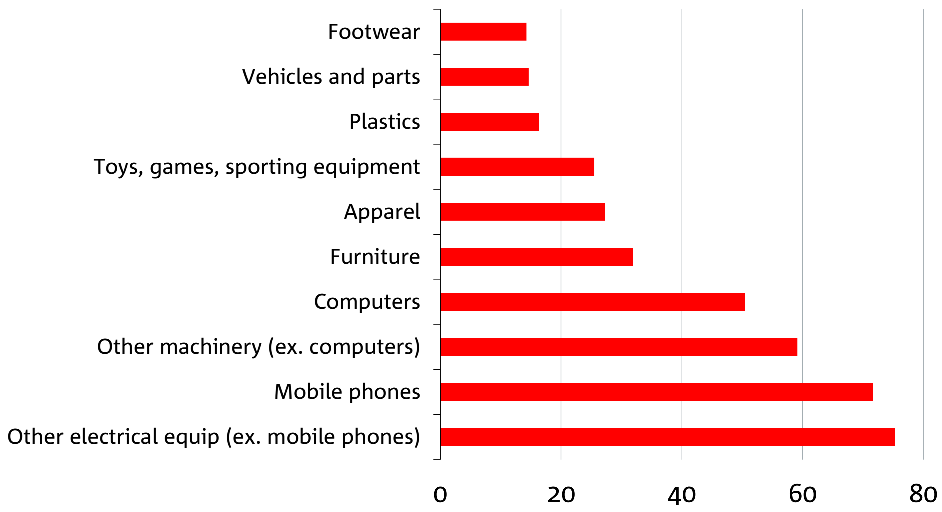
TRADE TENSIONS ON THE RISE

US targets China's tech sector and China is retaliating

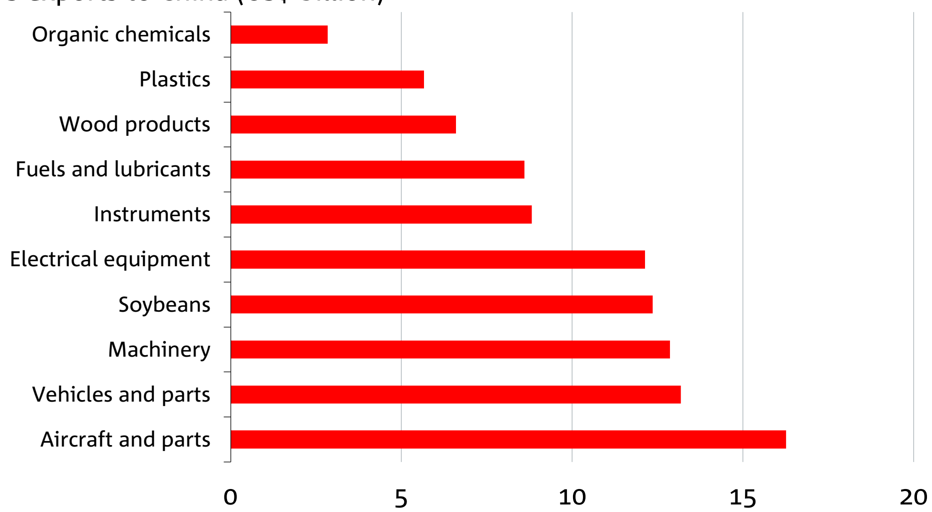
TECHNOLOGY DOMINATES CHINA'S EXPORTS TO THE US

US imports from China (US$ billion)



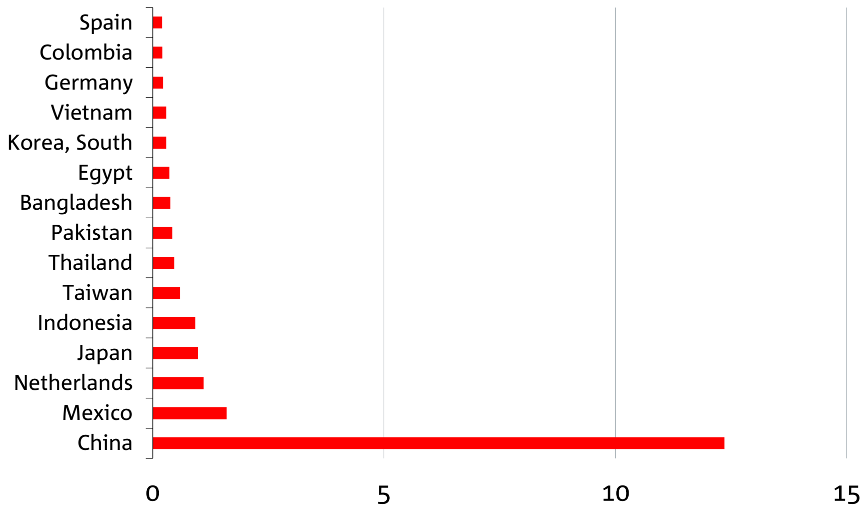
CHINA'S TARIFFS INCLUDE KEY US AGRICULTURAL EXPORT - SOYBEANS

US exports to China (US$ billion)



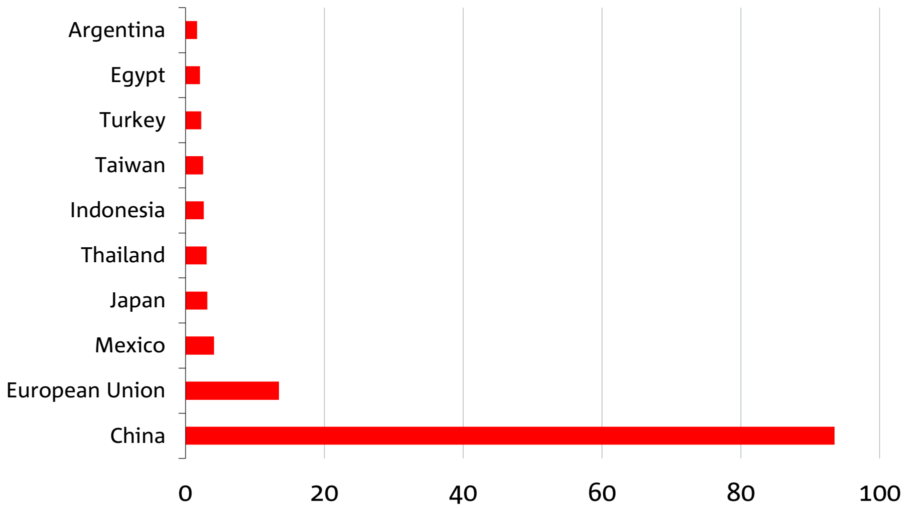
US SOYBEAN FARMERS HIGHLY DEPENDENT ON CHINA...

US soybean exports by country (2017) (US$ billion)



...WITH CHINA FAR AND AWAY THE LARGEST IMPORTER GLOBALLY

Soybean imports by country (2016-17) (Million tonnes)



Sources: US Census Bureau, Bureau of Economic Analysis, US Department of Agriculture, NAB Economics

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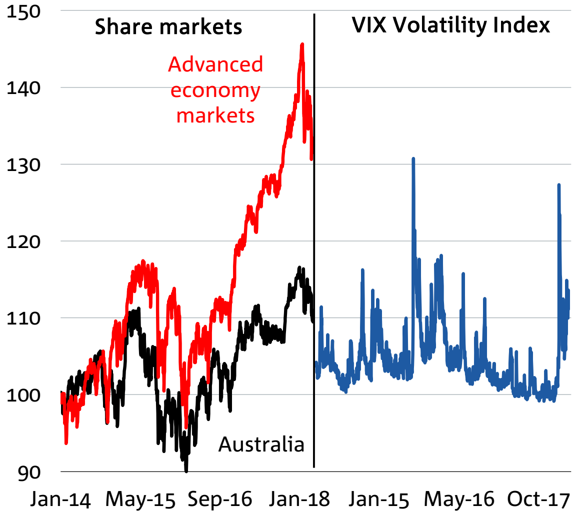
FINANCIAL AND COMMODITY MARKETS

Financial markets continue to watch the US-China trade drama

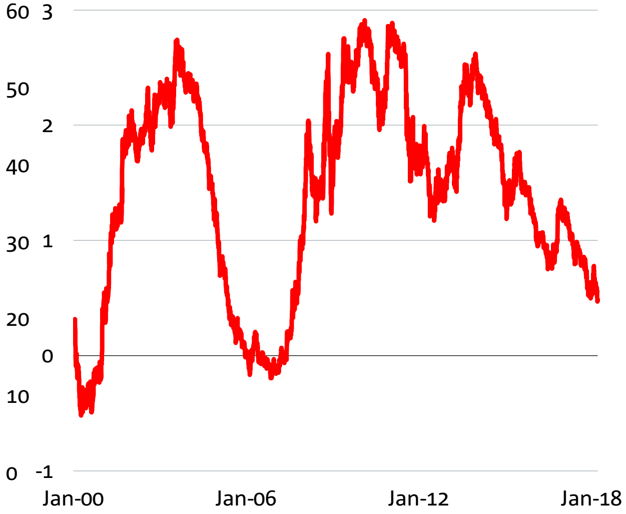
EQUITIES OFF RECENT PEAKS

Share markets and volatility indices



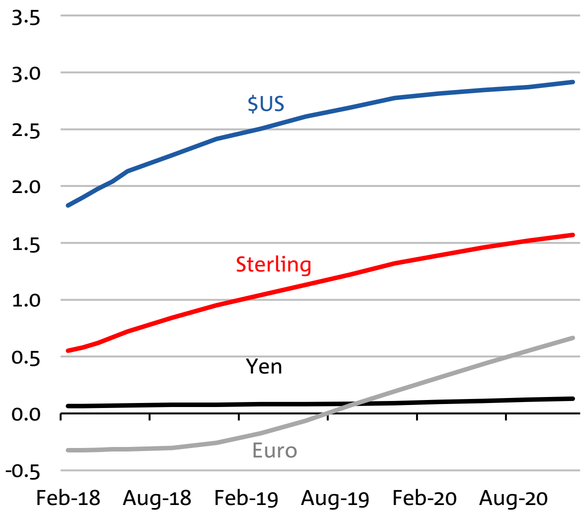
US YIELD CURVE FLATTER

US yield curve (10 year - 2 year) (%)



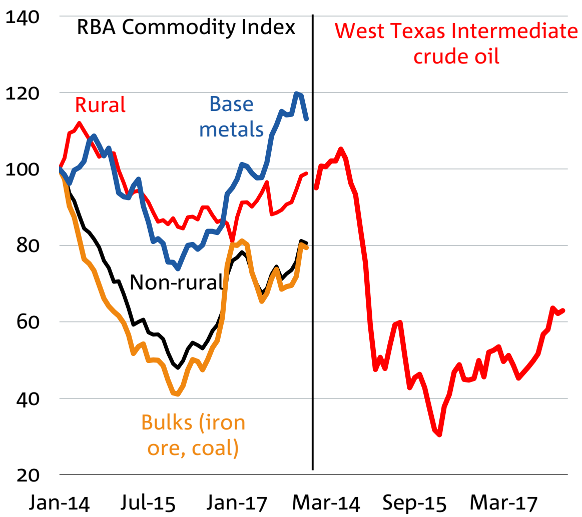
INTEREST RATES TIPPED TO RISE

3 month interest rate futures (%)



COMMODITIES TRENDING UP

Commodity price indices (Jan 2014 = 100)



Sources: Datastream, Bloomberg, NAB Economics

- Financial markets have remained volatile in recent weeks – versus the historical stability across much of 2017 – 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. The closely watched VIX index remains around 20 points (roughly its long term trend level) – compared with an average near 11 points in 2017.

- US yield curves have flattened significantly since recent peaks in December 2016 (during the so-called Trump trade following the US Presidential election). The premium for 10 year Treasuries over 2 year fell below 50 basis points in late March and early April – the lowest level since August 2007. A flattening in yield curves raises concerns among investors as this is often seen as a recession warning. While recession fears seem premature, 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).

- As expected, the US Federal Reserve increased the Fed Funds Rate in March, with further rate rises expected over the next 18 months. Central banks across the advanced world are gradually winding back emergency rates and policy measures and returning to more normal levels. 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 respond to improved economic conditions – given that they are still maintaining stimulatory policies.

- Stronger global economic conditions have been reflected in improved demand for commodities and a modest rising trend in commodity prices. That said, despite the recent stronger trend (from around mid-2017 onwards), non-rural commodity prices (as measured by the Reserve Bank of Australia) are around 20% below the levels at the start of 2014, while aggregate commodity prices are 40% below the peaks of 2011.

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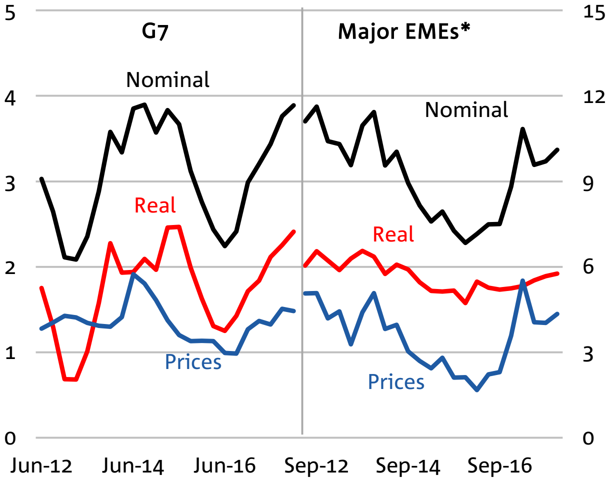
GLOBAL ECONOMIC TRENDS

Trade tensions threatens an otherwise positive economic picture

POSITIVE RECENT ECONOMIC TRENDS

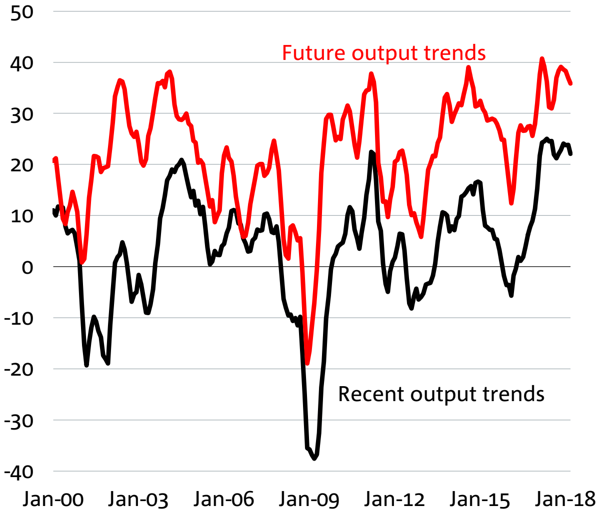
GDP growth - real and price split (% change)



* China, India, Brazil, Indonesia, Russia

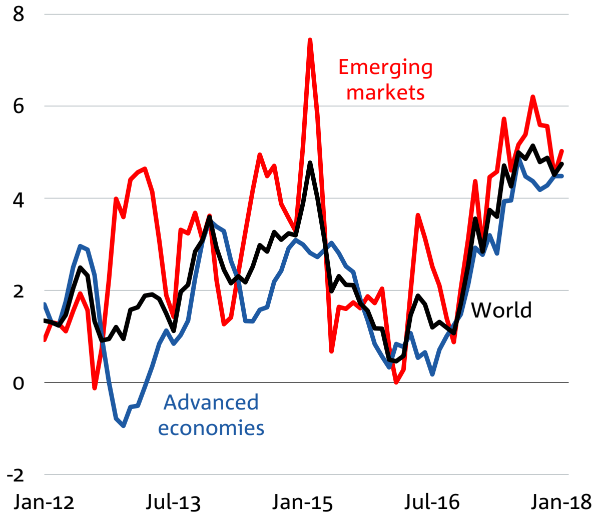
SURVEYS REMAIN STRONG

Business surveys (US, UK, Germany & France) (Index, 3mma)



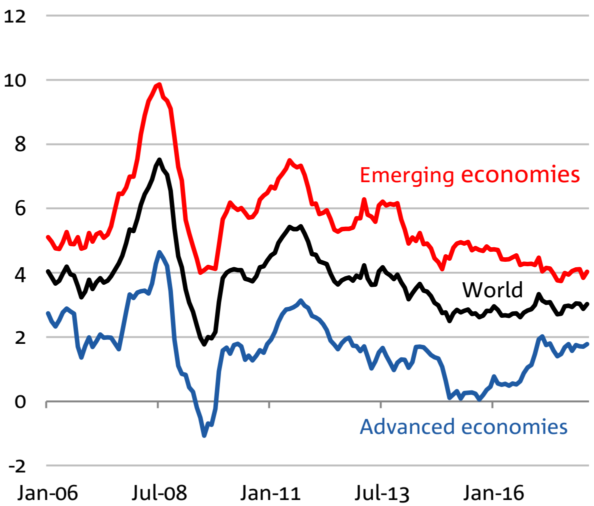
TRADE OFF LATE 2017 PEAKS

Changes in export volumes (% yoy (3mma))



INFLATION TRACKING HIGHER

Consumer price inflation (yoy%)



Sources: Datastream, NAB Economics

- Overall, the global economic picture remains the most encouraging it has for several years – 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.

- That said, trends in international trade have been less encouraging. Global trade volumes have trended slightly lower in recent months – with growth down to 4¾% in January (on a three month moving average basis), compared with a recent peak near 5¼% in September 2017. Weaker exports from emerging markets have been the key driver.

- 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. This could have political implications ahead of US congressional mid-term elections – given that rural voters overwhelmingly favoured President Trump in 2016.

- Inflation has slowly tracked higher, with advanced economy consumer prices increasing by 1.8% yoy in February (near the bottom end of most central bank ranges). US inflation has pushed above the 2% mark, while even Japan's has reached 1.5%.

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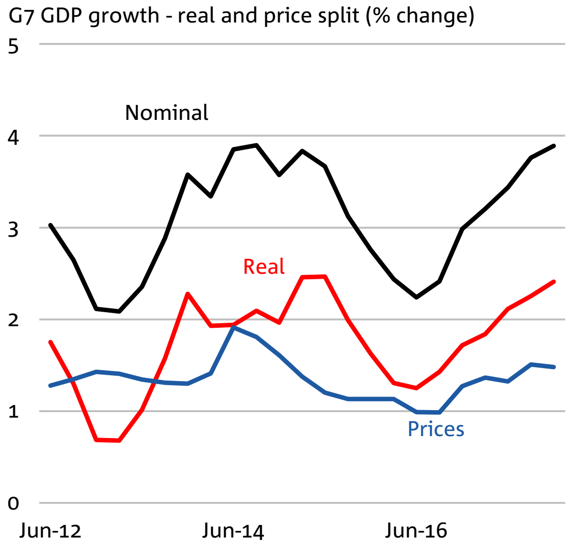
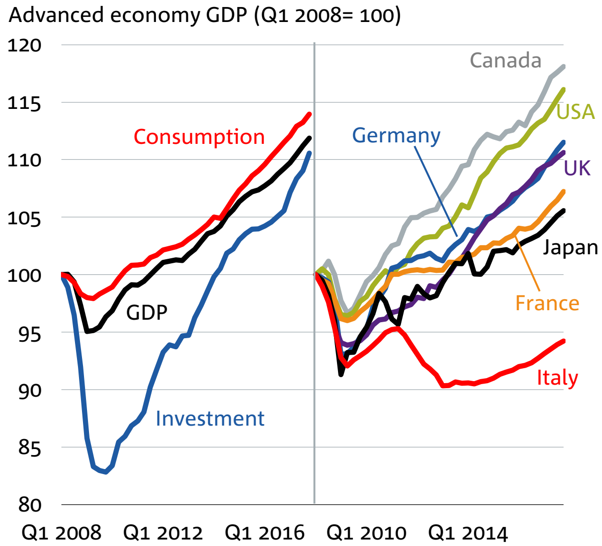
ADVANCED ECONOMIES

Cyclical upturn continues but could peak growth be near?

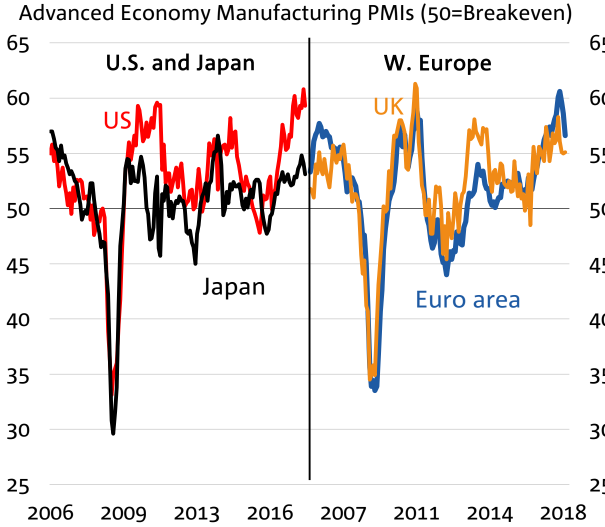
ABOVE-TREND OUTPUT EXPANSION



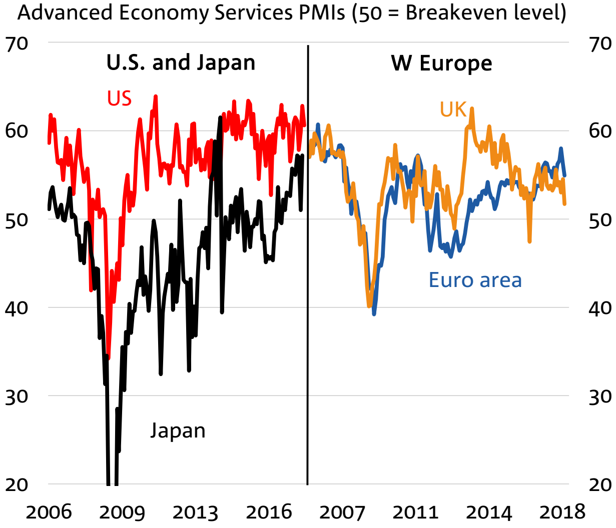
VARIATION BETWEEN SECTORS/NATIONS



SOME INDUSTRY SURVEYS SLOWING



SERVICE SECTOR SOLID GROWTH



Sources: Datastream, NAB Economics

- 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. This modest lift in inflation plus the sizeable acceleration in output volume growth means that the dollar value of G7 output is expanding by around 4% yoy, allowing inflation to hit the 2% rate targeted by central banks and still leave room for reasonable output growth.

- The business surveys for the opening months of 2018 point to continued solid expansion, although there is evidence of a recent slowing in growth in the manufacturing and services sectors in Western Europe.

- While there has been a solid upturn in the big advanced economies taken as a group, there have been big differences between sectors. Consumer spending has been growing fairly steadily since the post-GFC trough. The profile of G7 business investment has been much less steady. Capital spending generally falls in a downturn like the GFC but its subsequent path has been more unusual - the six years it took to regain its pre-crisis level, followed by a period of sluggish investment through 2014 and 2015 before a sharp acceleration since the start of 2016.

- The recent ramping up in investment reflects the erosion of once ample margins of spare capacity and the boost to business confidence stemming from the reduced likelihood of severe setbacks like deflation, the break-up of the Euro-zone or a hard landing for the Chinese economy.

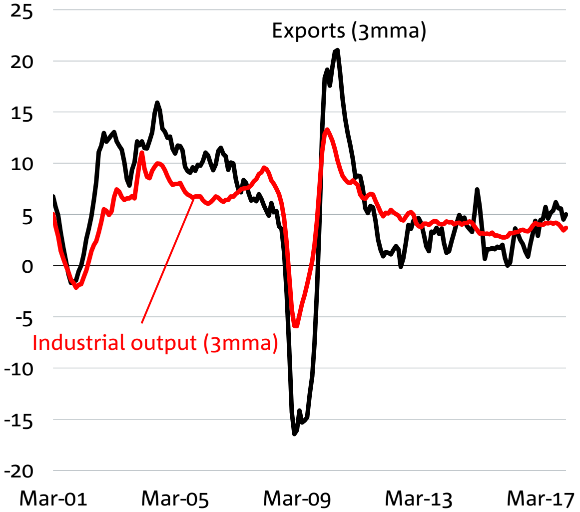
- There are also big differences in the output records of different economies. The strongest growth performers have been in North America and the weakest in the Euro-zone and Japan. Italy looks a clear outlier because of its particularly poor growth record. Japanese growth has lifted in the last couple of years with output now growing well above its long term potential rate and the economy's pool of spare resources rapidly drying up.

EMERGING MARKET ECONOMIES (EMES)

East Asia collateral damage in trade war but Latin America could benefit

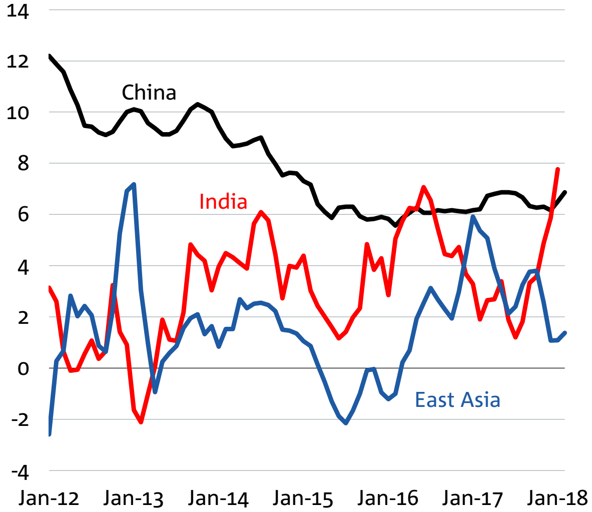
OUTPUT & TRADE OFF LATE 17 PEAKS

Emerging market exports and industrial output (% yoy)



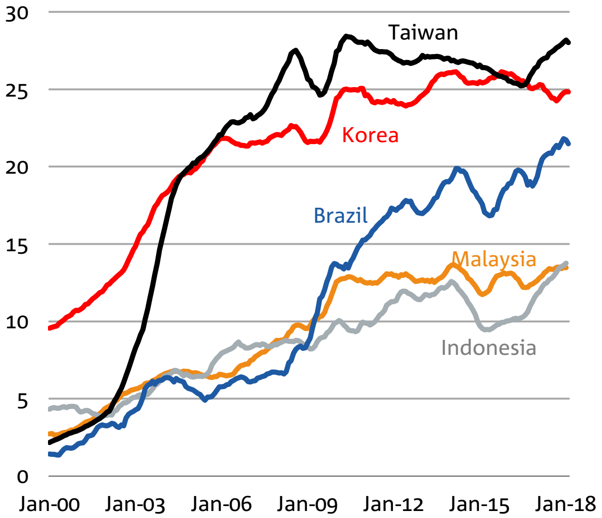
E. ASIA OUTPUT GROWTH WEAKER

Industrial production (% yoy (3mma))



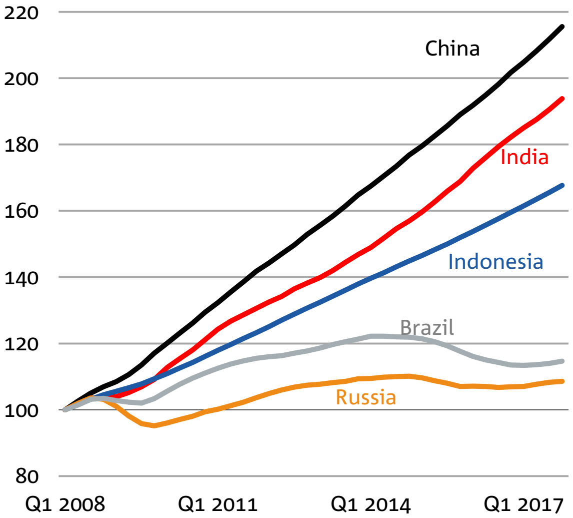
CHINA A KEY EXPORT MARKET

China share of total exports (%)



EME ECONOMIES STILL DIVERGENT

Emerging market GDP index (12mma) (Q1 2008=100)



Sources: Datastream, Bloomberg, CEIC, NAB Economics

- 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, at 3¾% yoy, compared with 3½% at the end of 2017. That said, growth still remains below the trend (above 4% yoy) recorded across most of last year.
- Since the latter part of the year, 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).
- Export volumes have also slowed somewhat in recent months – with volumes increasing by 5.0% yoy in January 2018 (compared with a recent peak of 6¼% in September 2017. Weaker volumes from emerging Asian economies was the key contributor to the softer trend.
- This region could further be impacted by the tariffs announced by the Trump administration against China. Since the turn of the century, China's rapid industrialisation has made the country a critical export market for a range of countries – initially for lower value commodity producers, but more recently higher value technology components as well (including Taiwan, Korea and Japan). The value chains of manufactured goods have become increasingly complicated and interconnected – meaning that weaker demand for Chinese products in the United States would flow through to East Asian trade partners.
- Despite the recent recoveries in Brazil and Russia (following deep recessions), their output remains below their previous cyclical peaks, in early and late 2014 respectively. This is in stark contrast to the much stronger performance of China, India and Indonesia.

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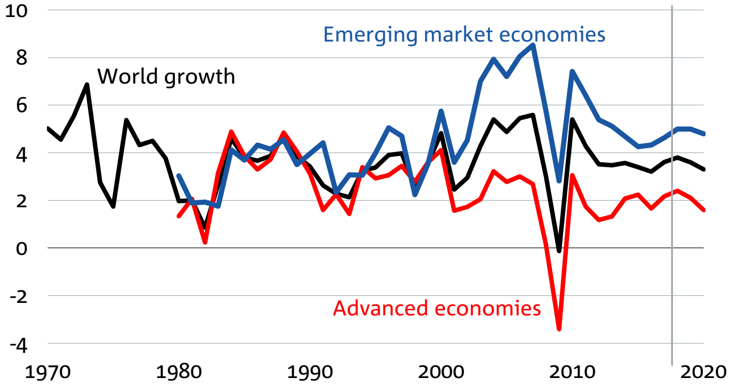
GLOBAL FORECASTS, POLICIES AND RISKS

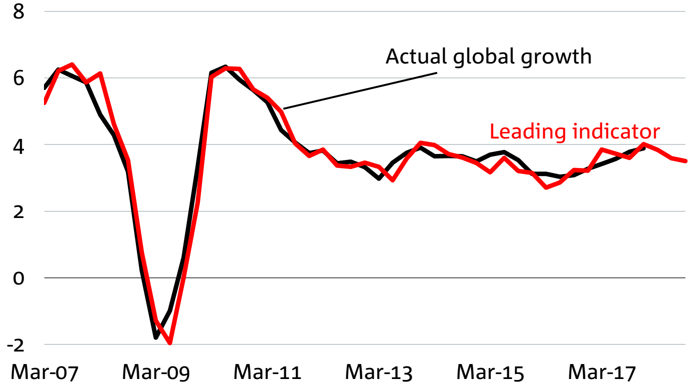
Cyclical peak in 2018, global growth back below trend by 2020

GLOBAL CYCLE MUTED BY HISTORICAL STANDARDS

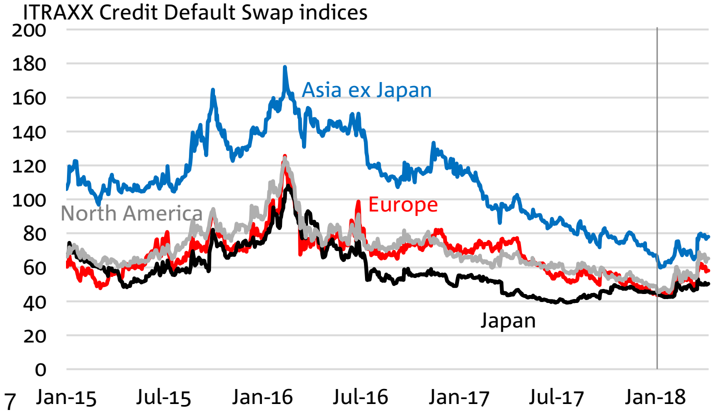
Annual economic growth (%)



Actual global growth and leading indicator (% yoy)



ITRAXX Credit Default Swap indices



- Global economic growth has accelerated from around 3% yoy in the first half of 2016 to almost 4% yoy in the second half of last year, above the 3½% annual growth rate averaged over the last 40 years. Our leading indicator is signalling a modest dip in growth late this year and our forecasts show global 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. 2018 should see the peak of the economic growth cycle, but its amplitude remains muted compared to many of the output fluctuations seen through the last 40 years.
- 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. While inflationary pressures remain low, central banks in the US, Canada and the UK will be lifting their policy interest rates while central banks in Europe and Japan will either wind back or stabilise their asset buying. This will lower the policy stimulus to growth.
- 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%. As those two countries account for almost half of total output in the emerging market economies, that puts a considerable brake on the expansion of that grouping. The slowdown in advanced economy growth should also lead to an easing in the pace of expansion in global trade, curbing growth in trade dependant emerging market economies across East Asia and Latin America through 2020.

GLOBAL GROWTH FORECASTS (% change)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
US	2.2	1.7	2.6	2.9	1.5	2.3	2.7	2.3	1.7
Euro-zone	-0.8	-0.2	1.4	2.0	1.8	2.5	2.7	2.5	1.9
Japan	1.5	2.0	0.3	1.4	0.9	1.8	1.4	0.9	0.7
UK	1.5	2.1	3.1	2.3	1.9	1.8	1.8	1.7	1.5
Canada	1.7	2.5	2.6	0.9	1.5	3.0	2.0	1.8	1.5
China	7.7	7.7	7.3	6.9	6.7	6.9	6.5	6.3	6.0
India	7.3	6.1	7.0	7.6	7.9	6.4	6.8	7.2	6.9
Latin America	2.7	2.5	0.9	0.1	-0.9	1.2	2.6	2.8	2.7
Emerging East Asia	4.7	4.2	4.1	3.7	3.9	4.4	4.3	4.0	3.7
NZ	2.6	2.2	3.6	3.5	4.0	2.9	3.0	3.0	2.4
Total	3.7	3.4	3.5	3.4	3.2	3.6	3.8	3.6	3.3

Sources: Datastream, Bloomberg , NAB Economics

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