June 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

***Global** growth was marginally softer in Q1, reflecting a modest slowdown in the advanced economies. This was particularly evident in the Euro-zone and Japan, suggesting some divergence in growth across countries after having previously exhibited a degree of synchronisation in growth for much of 2016 & 2017. Growth in the big emerging markets was slightly stronger led by a rebound in India, but again trends diverged between economies. It appears that the current global upswing has peaked (or is near that point). That said, our forecasts still imply above trend growth in both 2018 and 2019 before easing back to the long-term average of 3.5% in 2020.*

- **Commodity prices** have tracked higher – led by a surge in oil prices between early April and mid-May. Supply side factors have driven most of this increase – following an agreement between OPEC and Russia to restrict output and collapsing supply from Venezuela, along with concerns around Iranian output following the US withdrawal from the nuclear deal. Higher prices should entice US shale producers back into the market – suggesting there is limited upside to prices in coming months, with benchmark Brent prices peaking at around US$80 a barrel in mid-May, before pulling back to the mid $70s in June. Increases in other commodity prices have been more modest.
- **Financial markets** have been affected by political uncertainty in Italy and Spain which led to a spike in CDS spreads – highlighting investor concerns.
- As anticipated, the **US Federal Reserve** raised the fed funds rates this week. We now expect two further fed fund rate increases in the second half of 2018 (previously one), followed by three increases in 2019, leading the fed funds rates to peak at 3.25% for this cycle (previously 3.0%). The Bank of Canada is also expected to lift rates at its next meeting in July (64% probability). Softer data has reduced the likelihood of another increase from the Bank of England, while the European Central Bank and Bank of Japan are likely to be slower to raise rates – given that they have considerable policy stimulus to unwind prior to any hikes.
- **Global economic activity** was marginally softer in the first quarter of 2018. Weaker growth in advanced economies more than offset the modest improvement in emerging market growth. That said, global growth remains above its long-term trend – which has averaged around 3.5% since the start of the 1970s. International trade outcomes were less encouraging in March, with a marked slowdown in the growth of export volumes, most notably from emerging Asian economies. The global trade environment remains uncertain – particularly the relationship between the United States and China – with trade tensions ebbing and flowing since early March.
- Economic growth in the big **advanced economies** was slightly weaker in early 2018. Growth in Japan, the United Kingdom and Italy has slowed in recent quarters, possibly reflecting some temporary factors (weather and political uncertainty). In contrast, in the United States early indicators of growth point to strong conditions in the second quarter. Labour markets are increasingly tight; the average rate of unemployment across major advanced economies it at the lowest levels since the late 1970s. Business surveys continue to point to robust conditions in advanced economies, although these measures are generally weaker than peaks at the start of the year.
- Economic growth in the big **emerging market economies** edged higher in Q1 2018 but the underlying trends were mixed. India drove much of the improvement. Growth remained relatively stable in China and Indonesia, but the trends for Brazil and Russia were less encouraging. Industrial production has plateaued since the start of the year and while emerging market export volumes have remained comparatively strong, growth appears to have slowed in March. Smaller capital dependent emerging markets are facing some significant challenges. Several central banks have responded to the pressure of capital outflows (driven by an increasing focus on risk in these economies along with higher rates in the United States) with Indonesia and Argentina (which has received an IMF bailout) lifting rates.
- It appears that the current **global economic cycle** has either peaked or is near this point. Our leading indicator also suggests that growth is set to slow across the remainder of the year. However, while the cycle may have peaked, we expect global growth to remain above trend this year and the next (at around 3.75%), before moving back to its long term trend (3.5%) in 2020. This move back towards trend is likely to be most evident in the big advanced economies. Low rates of unemployment and diminishing idle capacity will begin to constrain growth and increase inflationary pressures, leading central banks to tighten policy settings.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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***Australia**: National Accounts data for Q1 2018 showed the economy picked up some momentum following the weaker-than-expected outcome in Q4 2017. Growth was supported by both the household and government sectors, as well as a bounce back in net exports. Underlying business investment contributed little – though looking at the sub-components paints a slightly more positive picture. Investment in machinery & equipment (largely the non-mining sector) continued to support business investment; while the drag from mining appears to be fading. Household consumption growth was relatively weak – likely reflecting the headwinds faced by consumers which we expect to persist in 2018. Overall, the rise in economic momentum will likely lead to continued growth in employment but wages growth and inflation look to have remained subdued. We expect employment growth to remain solid over 2018 and into 2019, resulting in a decline in the unemployment rate to around 5.0%. This tightening should in-time see a rise in the pace of wages growth and inflation. We expect to have seen enough of a tightening in the labour market and enough evidence of a meaningful pick-up in wages by around mid-next year for the RBA to begin to lift rates from the current low settings.*

- **Real GDP** figures showed a pick-up in growth to 1.0% in Q1 (from 0.5% in Q4) lifting growth to 3.1% over the year. As expected growth was largely supported by rising LNG exports, and continued strength in government (infrastructure-related) and non-mining business investment (largely concentrated in machinery & equipment). Household consumption growth remained weak at 0.3% in the quarter, suggesting the headwinds faced by households continue to weigh on expenditure - indeed, the composition of consumption growth in Q1 reflected households more concerned with expenditure on 'essentials' as compared to discretionary items. Dwelling investment edged up slightly in the quarter (following two quarters of falls) but was driven entirely by alterations & additions – suggesting that the peak in the construction cycle is now past us.
- **Business conditions** eased in the May NAB Monthly Business Survey after reaching historical highs in April. Despite the decline, conditions remain at well above average levels. Business Survey leading indicators – forward orders and capacity utilisation - on a trend basis continue to suggest robust outcomes in the business sector in 2018.
- While total **business investment** recorded a weak outcome in the National Accounts for Q1, more recent indicators continue to suggest a reasonable pace of investment growth, notwithstanding some small pull-back across these measures. The NAB Business survey of actual capex eased in May but remains above average, as did non-residential building approvals. Forward looking indicators are a little mixed with NAB's Quarterly Business Survey measure of 12-month capex pointing to a strengthening in investment, while the ABS capex survey suggests little acceleration in the non-mining sector; though it does suggest the drag from mining is fading. Overall, conditions in the sector remain conducive to further investment growth with Survey measures of profitability and capacity utilisation remaining above average.
- The **unemployment rate** ticked down in May to 5.4% (s.a.) and has now hovered around 5.5% for the best part of a year despite strong **employment** growth. Employment rose by 12k in the month – continuing at a slower pace this year, but is still a solid 2.5% higher over the year. The NAB Monthly Business Survey employment index declined in May, but is still consistent with a solid level of jobs growth of around 20k per month over the next 6 months. We expect the continued growth in employment combined with a flattening participation rate to lead to a decline in the unemployment rate over the remainder of 2018. This should see wages growth lift from relatively low levels of just above 2.0% over time but we do not expect to see a meaningful rise in the June quarter WPI released next month.
- Indicators of **household consumption** have been mixed in recent months. While the NAB Cashless Retail Sales index fell modestly in April, the ABS retail sales measure surprised on the upside (0.4% mom). The NAB Cashless Retail Sales index for May (released next week) will provide an early indication on how retail sales have tracked since April's more positive print on retail sales. Nonetheless, we continue to expect a cautious consumer for the rest of 2018 as the headwinds faced by households (weak wage growth, declining housing wealth and high debt levels) persist.
- **Housing** market conditions continue to show weakness. The CoreLogic Capital City dwelling price index showed its first annual declines since 2012 in April and May – with weakness concentrated in Sydney and Melbourne, though dwelling prices across capital cities are also either flat or falling. Auction clearance rates have also fallen to relatively low levels in recent months. We continue to expect a small fall in aggregate house prices nationally in 2018 (led by a decline in Sydney) with only a modest pick-up in 2019.
- **Net exports** contributed 0.3ppts to GDP growth in Q1 2018 after recording a weak outcome in Q4. The bounce-back was driven by a rise in LNG exports and to a lesser extent an increase in coal exports. We expect LNG exports to continue to support growth in 2018 and into 2019 as the bulk of the LNG projects enter the production phase.
- Our **USD/AUD** model continues to suggest a fundamental value estimate in the mid-70c range. We expect to the Aussie to be around 75c at the end of 2018 before declining slightly in line with an easing in commodity prices and a widening in interest rate differentials over 2019.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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