EMBARGOED UNTIL 11.30 AM WEDNESDAY 13 JUNE 2018

THE FORWARD VIEW: AUSTRALIA JUNE 2018

Economy off to a strong start early in 2018

OVERVIEW

The economy got off to a bright start in early 2018, with Q1 GDP growth of 1.0% q/q, consistent with our view that growth would regain momentum this year. Indeed, while we had been expecting annual, through the year, GDP growth to hit the 3% mark sometime in 2018, that benchmark has already been achieved (3.1% y/y in Q1). Part of the strength in Q1 related to a build up of stocks, but around half related to stronger exports. That said, over the last six months, the growth rate was around 1.5% (or around 0.75% per quarter).

The details of Q1 GDP were largely in line with our view of the factors likely to drive, and constrain, growth over the rest of the year. Increased infrastructure spending by governments and a ramping up in LNG exports were evident in Q1 and likely to persist over 2018 and into 2019. Underlying business investment growth was only marginal in Q1, but the environment remains conducive to further growth (rising profits and spill overs from public infrastructure programs). At the same time, consumption growth was soft, as consumers remain cautious in the face of higher electricity prices, low wages growth, stalling house price wealth and high debt levels. All up, we expect GDP growth of 2.9% in 2018.

We see many of the same factors still at play in 2019. We had previously expected the ramp-up in LNG exports to peak by end-2018 but now expect the peak to be reached in mid-2019. As a result, GDP growth in 2019 is expected to be similar to that in 2018. In 2020, with LNG not contributing to growth, GDP growth is expected to moderate to 2.7% despite support coming from a strengthening in domestic demand as higher wages growth feeds into stronger consumption. NAB' s Monthly Business Survey continues to report business conditions at very high levels (+17 on a trend basis vis-à-vis a long run average of +5.5). The Business Survey also continues to point to an strong employment growth – of around 20k/month for the next 6 months.

As a result we expect the unemployment rate – which has hovered around 5.5% for the best part of a year – to decline gradually over time. A tighter labour market should eventually lead to a modest improvement in private sector wages growth.

However, given the absence of any recent progress on the wages/unemployment front to-date, we recently removed our call for a RBA rate hike later this year. An environment of above trend growth, declining unemployment and (down the track) higher wages growth is consistent with the RBA eventually withdrawing emergency low monetary policy settings. We have pencilled in a rate hike in mid-2019, but the timing of any move by the RBA remains highly data dependent.

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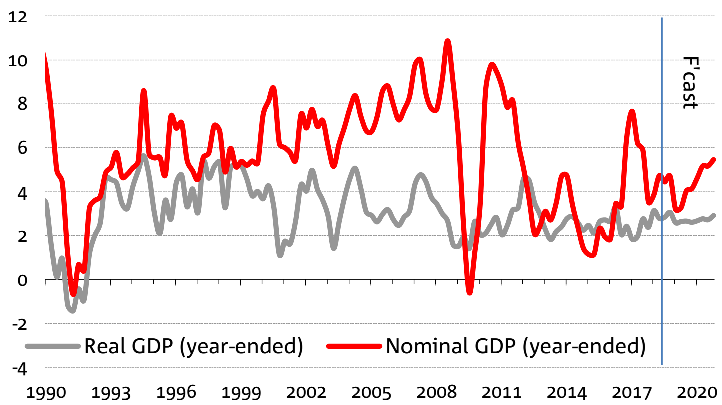
KEY ECONOMIC FORECASTS

	2017	2018-F	2019-F	2020-F
Domestic Demand (a)	3.0	2.8	3.0	3.5
Real GDP (annual average)	**2.2**	**2.9**	**3.0**	**2.7**
Real GDP (year-ended to Dec)	**2.4**	**3.0**	**2.9**	**2.8**
Terms of Trade (a)	11.7	-0.9	-5.1	-0.5
Employment (a)	2.2	2.6	2.1	1.8
Unemployment Rate (b)	5.4	5.3	5.0	5.0
Headline CPI (b)	1.9	2.3	2.2	2.8
Core CPI (b)	1.9	2.0	2.2	2.6
RBA Cash Rate (b)	1.50	1.50	2.00	2.50
$A/US cents (b)	0.78	0.75	0.75	0.73

(a) annual average growth, (b) end-period, (c) through the year inflation

REAL AND NOMINAL GDP GROWTH

y/y % change



Source: ABS, NAB Group Economics

CONSUMERS, LABOUR MARKET AND WAGES

The unemployment rate was up slightly in April to 5.6% (s.a. from 5.5% in March), partly reflecting a small increase in the participation rate. Full-time employment rose by 32,700, although part-time employment was down 10,000.

Meanwhile, the NAB Monthly Business Survey employment index fell 5 points in May to +8, although based on historical patterns this is consistent with a rate of jobs growth around 20k per month. Although capacity utilisation and forward orders edged lower in May. In trend terms, both continue to point to a positive outlook for the non-mining economy.

Wage growth remains middling, with the ABS wage price index growing by 0.5% q/q in Q1 2018, to be 2.1% higher y/y. This remains well below the long-run average. We still expect that over time, slack in the labour market will lessen and private sector wages will finally begin to see stronger gains.

For now though, the slow pace of wage rises is flowing through to weak consumer sentiment. This was reflected in last week's National Accounts, which showed the economy growing strongly overall in Q1, but households under pressure. Household consumption growth was a surprisingly weak 0.3 % q/q, although it followed strong growth in previous quarters, and the annual growth rate was unchanged at 2.9%, a modest pace by past (pre-GFC) standards.

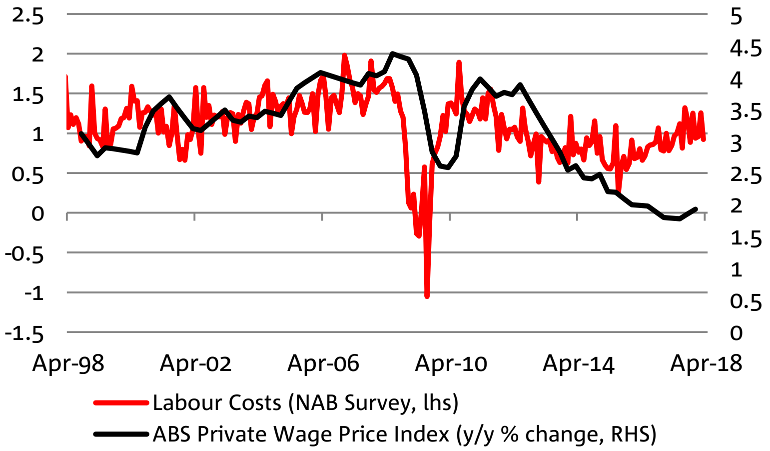
Even with only soft real consumption growth in the quarter, household spending grew at a faster pace than disposable incomes (0.7% q/q compared with nominal consumption growth of 0.9% q/q). As a result, the household savings ratio continued its downward trend and is at its lowest level since 2007 (at 2.1%).

The soft growth in Q1, which was driven by growth in non-discretionary categories, as well as the run-down of the savings rate to finance consumption, reinforces our caution about the outlook for the consumer. This reflects several headwinds including rising energy costs, aforementioned low wages growth, stalling growth in housing wealth (with house prices falling in some markets) and high debt levels.

That said, official retail trade data surprised on the upside in April, up 0.4% (s.a.) after a flat read in March and a gain of 0.6% in February. Weather conditions may have affected these results as may the changed timing of Easter. Thus clothing, footwear and department stores sales were lower but cafes, restaurants and takeaways saw much better results. The Bureau of Meteorology reports that April 2018 was the second hottest April on record. Our NAB Cashless Retail Sales Index for May, which is derived from around 2 million transactions per day across NAB platforms, will be available next week. This will give an advance read on last month's retail sales.

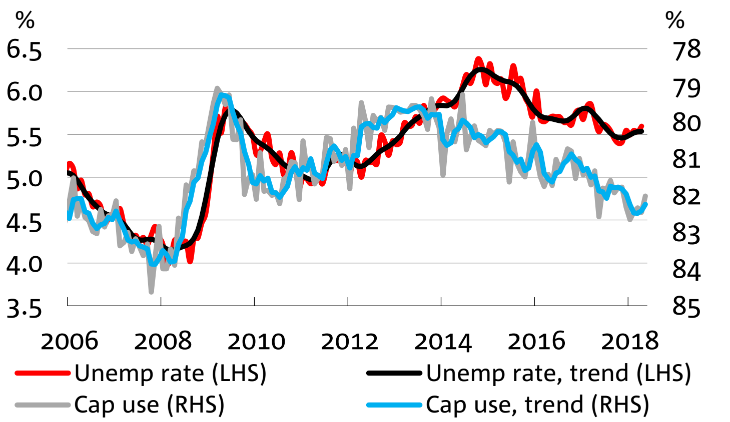
NAB WAGE GROWTH PROXY

y/y % change



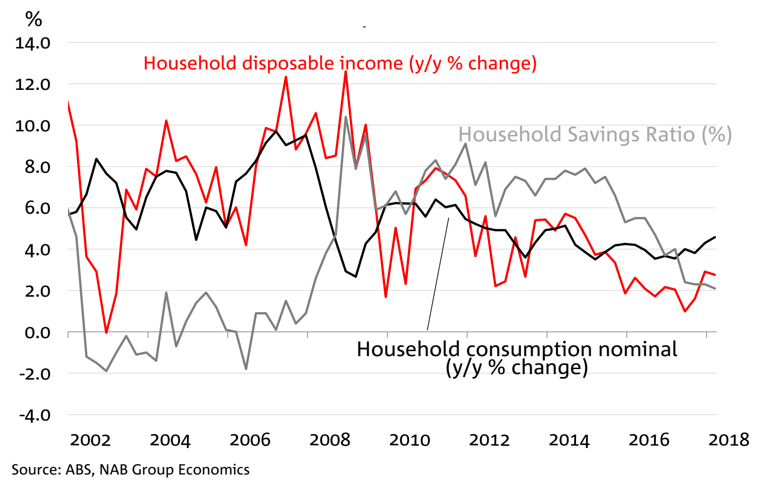
UNEMPLOYMENT AND CAPACITY UTILISATION

ABS (unemployment) and NAB monthly survey



H'HOLD CONSUMPTION AND INCOME GROWTH

y/y % change



Source: ABS, NAB Group Economics

HOUSING AND CONSTRUCTION

Housing market conditions continue to show weakness, particularly in Sydney and Melbourne. Dwelling prices (hedonic price measure) in the capital cities are mostly either falling or flat. In April & May, the Core Logic 8 Capital City dwelling price index was lower than the same time last year, the first annual declines since 2012. Auction clearance rates have also been moving down.

Sydney dwelling prices started falling last year, with Melbourne following this year. There are signs that the rate of decline in Sydney is moderating while at the same time it has picked up in Melbourne and in recent months has fallen a bit more quickly than in Sydney. Prices in Adelaide and Brisbane have been broadly flat in recent months while Perth and Darwin appear to be stabilising. Hobart is the exception, with prices growing at a double digit rate.

The Melbourne and Sydney housing markets have been particularly affected by policy changes to investor credit provision while there has also been a reduction in foreign demand. The value of investor finance approvals took another downwards dip in March, and in April was 15% below the same time last year.

In late April APRA announced that from July the investor loan growth limit of 10% would no longer apply to banks – however that limit has not been binding for some time and investor credit is only up 2.3% in the year to April. Against that, the Royal Commission into Banking has seen fears that the ultimate outcome may see banks further tightening both housing and business credit criteria (albeit in 2019 rather than in the near term; indeed recently competition in the housing lending market has seen increased discounting).

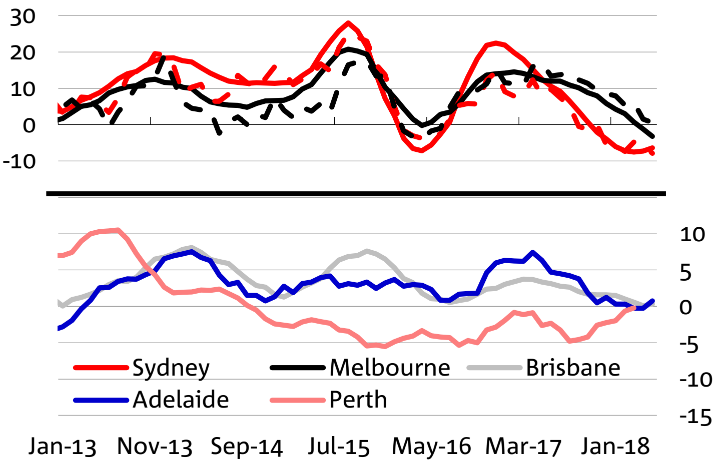
Overall we expect a small fall in aggregate house prices across the eight major capital cities in 2018, largely due to continuing weakness in the Sydney market and a softening Melbourne market. For 2019, house prices are expected to show only a very small increase (with a further modest decline in Sydney prices). Expectations for apartment prices are a bit softer again reflecting large stock additions and a soft outlook for foreign demand.

Dwelling investment rose by 0.9% q/q in 2018 Q1, partially reversing the declines seen in the previous two quarters. However, this was due to alterations & additions, with new and used dwelling investment falling consistent with the trend decline since early 2017. This itself followed a decline in building approvals data. However, building approvals have settled at a new, albeit still relatively high level so far this year.

As a result, and with strong population growth providing support even as the large stock of apartments come onto the market over the next few years, we are not expecting a major correction in building activity. We are forecasting only small declines in dwelling investment in 2018 and 2019 before stabilising in 2020.

HOUSE PRICE GROWTH

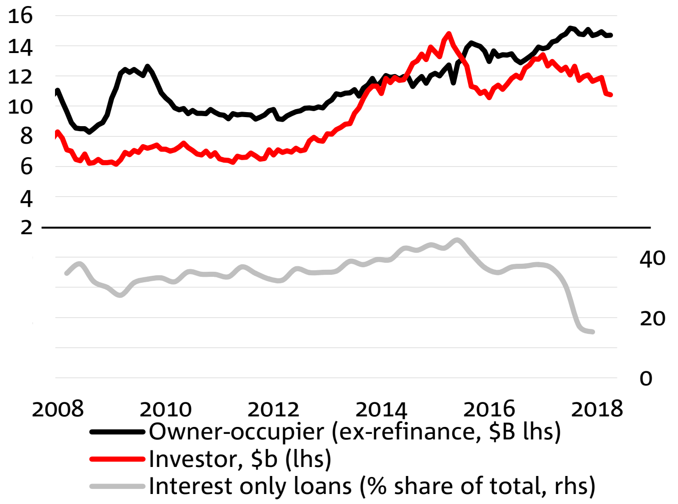
Dwelling price growth (%, 6-month annualised)



* Solid lines are hedonic prices. Dotted lines represent simple median prices.

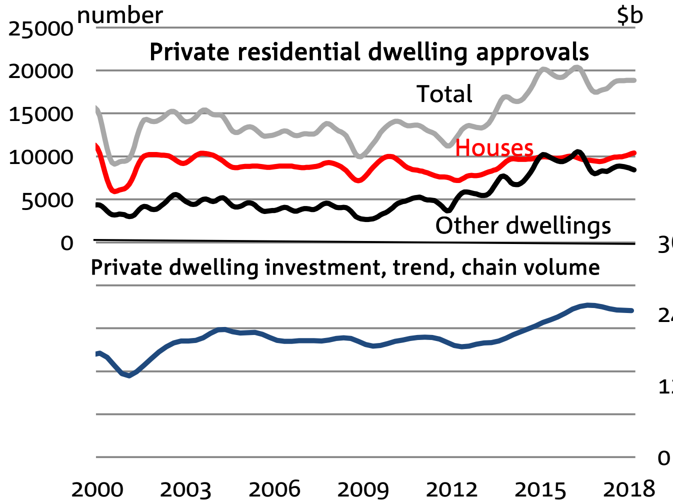
INVESTORS UNDER PRESSURE

Housing Finance approvals, $ b (lhs), % share (rhs)



BUILDING APPROVALS & RESIDENTIAL INVEST.

Trend basis



Source: ABS, NAB, Core Logic, APRA.

BUSINESS ACTIVITY AND INVESTMENT

Investment data continues to paint a picture of a handover to the non-mining sector, albeit with some volatility, while at the same time the mining drag is fading. Q1 2018, underlying business investment (which excludes transfers) recorded soft growth of 0.1% q/q. However, investment in machinery & equipment (largely the non-mining sector) rose 1.0% to be around 9% higher over the year. Engineering construction (often affected by lumpy LNG investment) also rose slightly in the quarter, suggesting a waning impact from the pull-back in mining investment as the bulk of large LNG projects enter the production phase. Buildings & structures investment weighed on investment growth in the quarter but remains higher over the year.

Looking at more timely indicators of capex, the NAB business survey measure of actual capital expenditure declined in May. Although it is at its lowest level since last October on a trend basis, it is still above average. The value of non-residential approvals, while still at a solid level, has also come off its recent peak. The recent downturn has been lead by a decline in office approvals, despite very low office vacancy rates in the major Sydney and Melbourne markets.

The outlook for private business investment remains broadly positive, although measures of investment intentions are somewhat mixed. The ABS' capex intentions survey suggests that while the drag from the mining sector may be waning it will linger for a while yet. Moreover, the ABS survey is not signalling much (if any) acceleration in 2018-19 in non-mining investment after solid gains in 2017-18. However, NAB's Quarterly Business Survey 12 month capex measure is more positive, and points to investment growth strengthening.

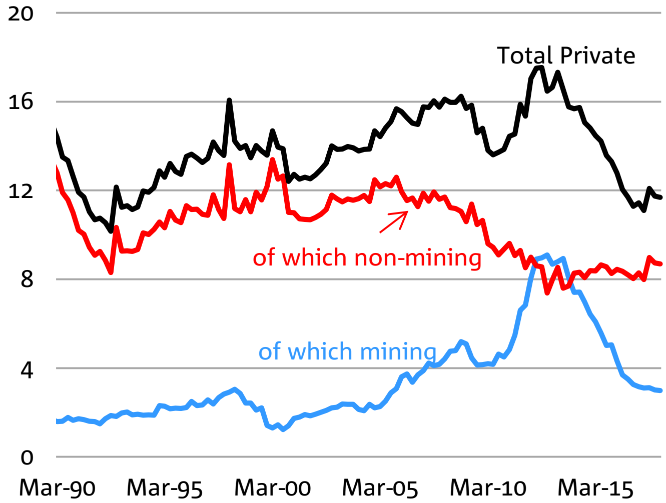
With trend business conditions still strong in May, rising capacity utilisation measure over the last few years and strength in the Survey measures of corporate profits an environment conducive to business investment growth seems well established.

Adjusting for asset transfers, public investment grew solidly in 2018 Q1, and was up more than 7% over the year. The Commonwealth's 2018-19 Budget included a raft of new infrastructure proposals which should support the already elevated pipeline going forward. The Victorian government's recent Budget projects infrastructure investment, which in 2017-18 was already more than double the 10 year average to 2014-15, will increase even further in 2018-19. Given the involvement of the private sector in public infrastructure projects, this should be a positive to private business investment as well.

Overall, we expect underlying business investment to grow by around 3% this year, before strengthening to around 7% annually in both 2019 and 2020. Growth in underlying public investment is likely to be even higher (at around 10% in each of the next two years).

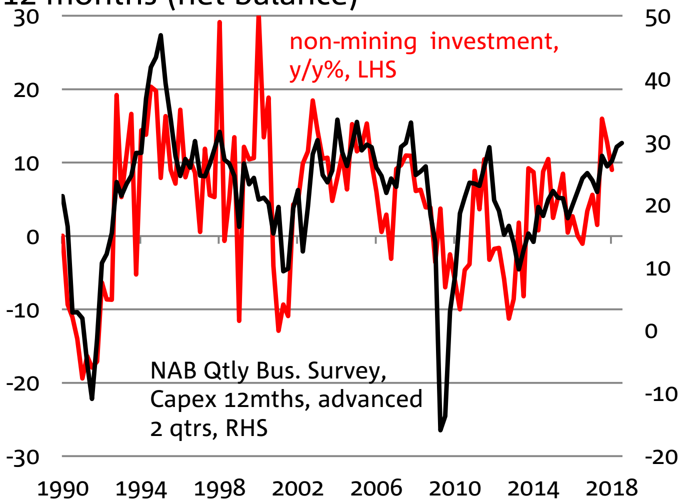
PRIVATE INVESTMENT TRANSITION

(% of GDP)



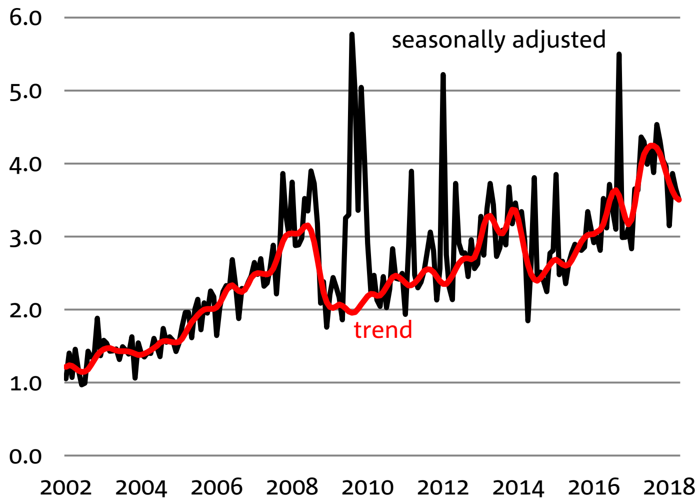
NAB SURVEY INVESTMENT INDICATOR

Non-mining investment (y/y%) & survey capex next 12 months (net balance)



NON-RESIDENTIAL APPROVALS

Value of non-residential building approved, Aust.



Source: ABS, NAB.

COMMODITIES AND TRADE

Bulk commodity markets have been relatively stable in recent months, with iron ore prices trading in the mid-to-high US$60s range while hard coking coal prices have remained around the mid-US$180s range since early May. We expect weaker conditions in China's steel sector to result in softer prices for these key commodities over the year ahead.

Oil prices have seen substantial gains, reflecting the ongoing impact of the OPEC-Russia deal, collapsing Venezuelan production and the US ending the Iran deal. On the other hand, Saudi Arabian officials have signalled that production restrictions may be loosened and US shale drillers should be enticed back into the market at these levels. Still, Australian fuel prices are at their highest level in four years.

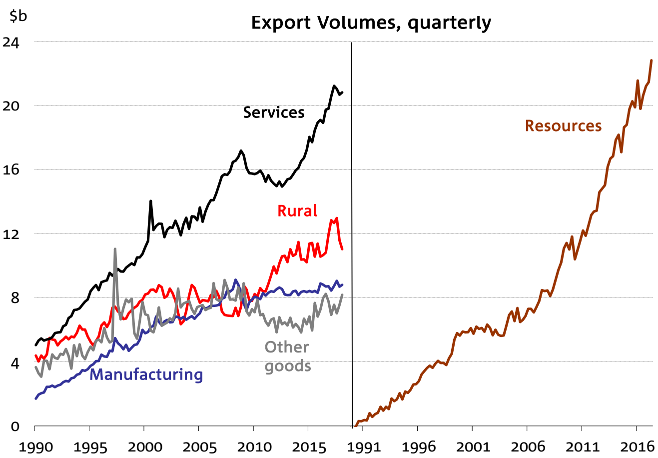
Rural commodities have likewise been mixed, partly reflecting very dry seasonal conditions.

The NAB Rural Commodities Index gained 3.1% month on month in May amid an 11.4% surge in wheat prices but a 5.6% drop in cattle. Elsewhere, horticultural, dairy, wool and cotton prices were higher and lamb has proven resilient in the face of the dry. Wool has been an especially strong performer, EMI having topped 2,000/kg.

Net exports added 0.3ppts to GDP growth in Q1, following a large 0.7ppts detraction in 2017 Q4. The turnaround in exports was driven by resource exports (particularly LNG and to a lesser extent coal) and came despite another decline in rural export volumes after a mixed cropping season. Australia's LNG production is continuing to ramp up. We now expect these gains to be largely complete by mid-2019 (previously end-2018) due to a late ramp-up in Ichthys. With seasonal conditions very dry, there is a further risk to Australian grain production this season.

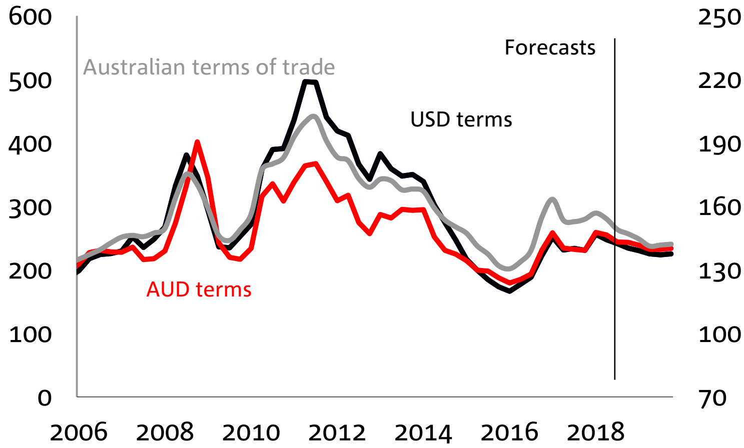
QUARTERLY EXPORT VOLUMES

$b



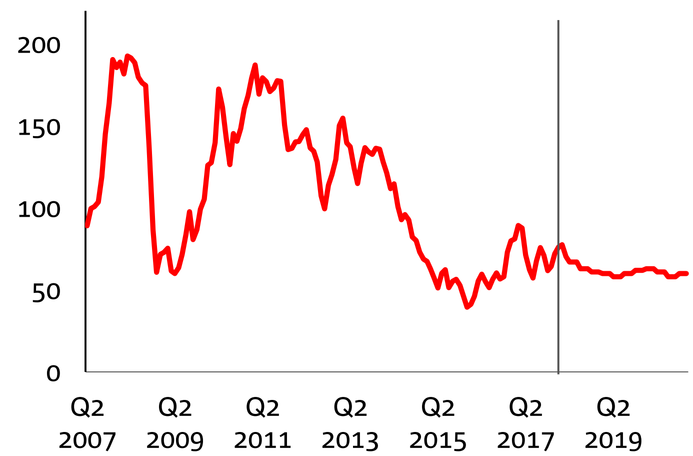
NAB NON-RURAL COMMODITIES PRICE INDEX

Sept 1996 = 100



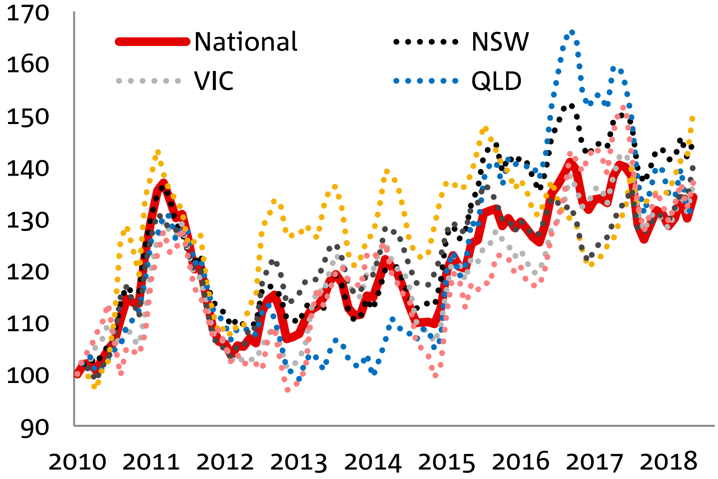
IRON ORE SPOT PRICE FORECASTS

US$/t (incl. cost of freight)



NAB RURAL COMMODITIES INDEX

Jan 2010 = 100



Source: ABARES, Meat and Livestock Australia, Australian Pork, Ausmarket, ABS, Bloomberg, Thomson Reuters, BREE and Profarmer

MONETARY POLICY, INFLATION AND FX

While core inflation all but reached the bottom of the RBA's inflation target band in early 2018, it looks likely to remain subdued for a while to come. This is due to still low wages growth, which is only expected to strengthen gradually, intense supermarket competition, and significant on-line competition squeezing margins. Our models suggest that core inflation will stay at around the bottom of the RBA's target through to early-mid 2019. The RBA sees core inflation being stuck at this level for longer, not moving higher until 2020. While headline inflation will be higher for a while, due to rising energy, inflation is not a near term concern.

We are not expecting the AUD/USD to change significantly over the next couple of years as a number of largely offsetting forces are in play. While Italian political uncertainty, and the recent strength of the US economy compared to softer data in other major economies has helped lift the USD, we expect that the underlying trend is likely to be one of broad USD weakness. This is in part due to concerns over the US' fiscal and current account deficits. At the same time we expect commodity prices to gradually decline, and US/Australia interest rate differentials to widen, factors which will work the other way for the AUD.

As a result we expect the AUD to be around the mid-70c mark over the rest of 2018 and into 2019. While bouts of market risk-on/off will undoubtedly lead to some volatility our forecast does not include a major escalation of the current US/China trade disputes – which would see a significantly lower AUD.

The RBA has indicated that it expects the next move in the Cash Rate to be up, but it is clearly on the sidelines for a considerable time yet. In particular, it wants to see signs of an improvement in wages growth and less risk about consumption outlook (given low wages growth, high energy prices, flat to falling house prices and consumer caution in the face of high debt levels).

Consequently, with no signs yet of wage growth moving up from its current subdued level and the unemployment rate unchanged for the best part of a year, we recently changed our call on when the RBA will next move on rates. We now think that the RBA will be on hold for the rest of this year (previously we had a November rate hike pencilled in).

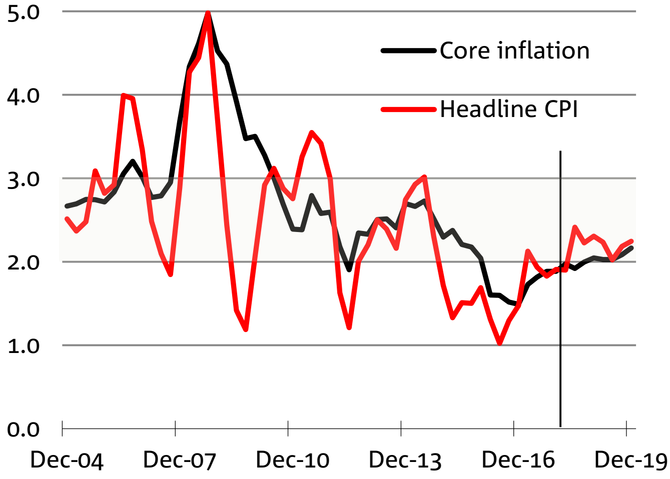
We are projecting that by mid-2019 Wage Price Index growth will have shown gradual improvement to be around the 2½% y/y mark, while at the same time the unemployment rate will be close to its full-employment level and GDP growth above trend. In these circumstances we expect the RBA would have sufficient confidence that inflation will move back towards target and so start to gradually lift the cash rate off its current very low level in mid 2019 (May).

Once the tightening cycle starts, further rate increases are likely to be very gradual and highly data dependent. We have the second move up in late 2019.

While the global environment will see other central banks tightening policy – particularly the US Federal Reserve where we could 5 more rate rises by late 2019 – the RBA will be very focussed on the local economy. They would not be concerned if current settings see some downside to the AUD from interest rate differentials.

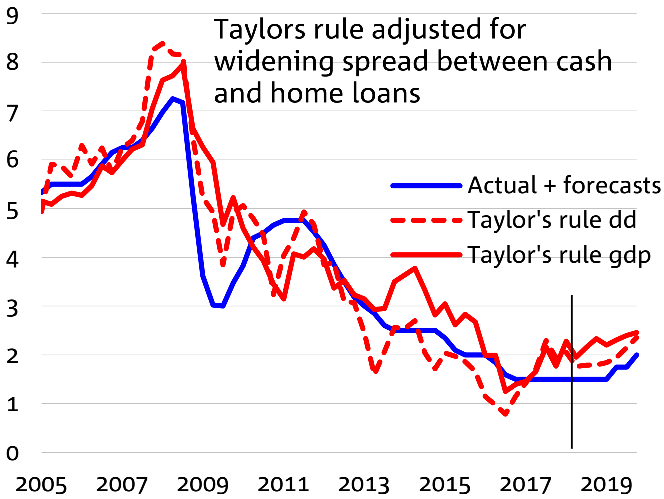
HEADLINE AND CORE INFLATION

y/y % change



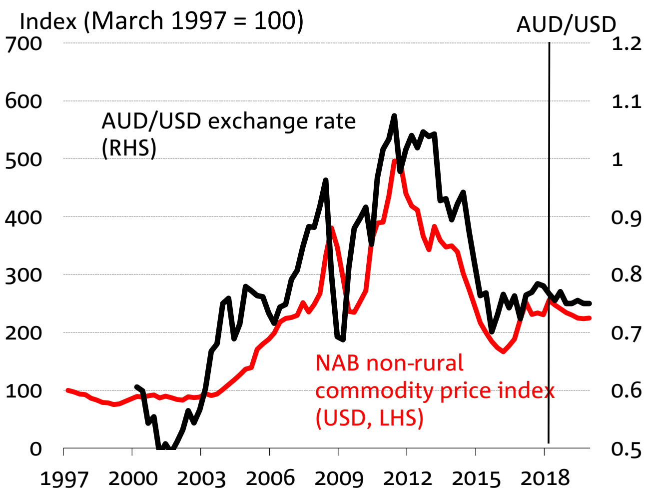
TAYLORS RULE AND RATE FORECASTS

y/y % change



AUD AND COMMODITY PRICES

NAB Non-rural commodity price index & AUD/USD



Sources: Econdata DX, RBA, ABS, NAB Economics

APPENDIX A: FORECAST TABLES

DETAILED ECONOMIC FORECASTS (ANNUAL AVERAGE)

Australian economic and financial forecasts (a)

	Fiscal Year				Calendar Year				
	2016-17	2017-18 F	2018-19 F	2019-20 F	2016	2017	2018-F	2019-F	2020-F
Private Consumption	2.6	2.8	2.3	2.7	2.9	2.7	2.5	2.5	2.9
Dwelling Investment	3.1	-2.8	-2.1	-1.2	8.7	-2.2	-1.4	-2.6	0.4
Underlying Business Investment	-6.6	5.7	4.5	6.8	-11.9	2.8	3.3	6.6	6.5
Underlying Public Final Demand	5.0	5.0	4.2	4.6	5.2	4.5	4.8	4.3	4.5
Domestic Demand	**2.3**	**3.2**	**2.7**	**3.3**	**1.9**	**3.0**	**2.8**	**3.0**	**3.5**
Stocks (b)	0.1	-0.1	0.0	0.0	0.1	-0.1	0.1	-0.1	0.0
GNE	**2.4**	**3.1**	**2.6**	**3.3**	**2.0**	**2.9**	**2.8**	**2.9**	**3.5**
Exports	5.4	3.2	5.3	3.4	6.8	3.5	4.4	4.8	2.4
Imports	4.8	6.4	3.6	5.4	0.2	7.8	4.2	4.4	5.8
GDP	**2.1**	**2.7**	**2.9**	**2.8**	**2.6**	**2.2**	**2.9**	**3.0**	**2.7**
Nominal GDP	5.9	4.5	4.0	4.6	3.8	5.8	4.4	4.0	5.0
Current Account Deficit ($b)	39	48	61	81	53	44	50	71	91
(-%) of GDP	2.2	2.6	3.2	4.1	3.1	2.5	2.7	3.7	4.4
Employment	1.3	3.1	2.1	2.1	1.6	2.2	2.6	2.1	1.8
Terms of Trade	14.5	2.0	-4.1	-2.1	0.2	11.7	-0.9	-5.1	-0.5
Average Earnings (Nat. Accts. Basis)	0.3	1.4	2.1	2.6	0.9	0.6	1.8	2.4	2.7
End of Period									
Total CPI	1.9	2.4	2.0	2.6	1.5	1.9	2.3	2.2	2.8
Core CPI	1.8	1.9	2.0	2.4	1.5	1.9	2.0	2.2	2.6
Unemployment Rate	5.6	5.5	5.1	5.0	5.7	5.4	5.3	5.0	5.0
RBA Cash Rate	1.50	1.50	1.75	2.25	1.50	1.50	1.50	2.00	2.50
10 Year Govt. Bonds	2.60	2.80	3.30	3.65	2.77	2.63	3.00	3.50	3.80
$A/US cents :	0.77	0.75	0.76	0.74	0.72	0.78	0.75	0.75	0.73
$A - Trade Weighted Index	65.5	64.3	62.5	60.8	63.9	64.9	62.6	61.8	59.9

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

COMMODITY PRICE FORECASTS

		Spot	Actual	Forecasts										
	Unit	7/06/2018	Mar-18	*Jun-18*	*Sep-18*	*Dec-18*	*Mar-19*	*Jun-19*	*Sep-19*	*Dec-19*	*Mar-20*	*Jun-20*	*Sep-20*	*Dec-20*
WTI oil	US$/bbl	66	65	68	67	64	64	63	62	61	62	63	64	64
Brent oil	US$/bbl	77	69	75	73	70	70	69	68	67	68	69	70	70
Tapis oil	US$/bbl	77	70	76	74	71	71	70	69	68	69	70	71	71
Gold	US$/ounce	1298	1330	1310	1320	1350	1360	1370	1380	1390	1400	1400	1410	1420
Iron ore (spot)	US$/tonne	n.a.	75	67	63	61	60	58	60	62	63	61	58	60
Hard coking coal*	US$/tonne	n.a.	230	186	170	155	150	155	145	140	130	125	120	125
Semi-soft coal*	US$/tonne	n.a.	167	134	122	112	108	112	105	101	94	90	87	90
Thermal coal*	US$/tonne	94	85	95	95	95	95	75	75	75	75	65	65	65
Aus LNG**	AU$/GJ	n.a.	9.93	11.30	11.95	11.97	11.53	11.45	11.38	11.23	11.09	11.39	11.54	11.85

* Data reflect NAB estimates of US$/ tonne FOB quarterly contract prices (thermal coal is JFY contract). Actual data represent most recent final quarterly contract price.

Source: Thomson Reuters Datastream, ABS, Econdata DX, RBA, NAB Economics

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