July 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

The global economy remains in reasonable shape right now despite some pressures on Emerging Market economies. Advanced economy growth looks like it picked up in Q2 and business survey readings are still at solid levels. In contrast, growth in China and some other EME countries looks to have slowed. Our forecasts for global growth have not fundamentally changed, and while we expect it to remain above its long-run average for now, we think growth of 3.8% for this year will be the peak, with our leading indicator of global growth pointing to a moderation in growth in coming quarters. The major immediate risk to this view comes from rising trade tensions, and the possibility that a tit-for-tat cycle of retaliatory measures escalates out of control.

- While oil prices are at their highest level since late 2014 there has been some easing in overall **commodity prices** recently. The aggregate Thomson Reuters/CoreCommodity CRB Index has declined 5% since the end of May.
- The easing in overall commodity prices is another factor contributing to **volatility in financial markets**. The increase in Euro political uncertainty post the Italian elections, rising trade tensions, changing perceptions about central bank actions and softer economic data to start the year have all contributed to a rise in volatility and risk measures, although by historical standards they are still relatively low. These factors, as well as stronger US economic data in Q2 2018, have contributed to a rise in the US dollar since early April, adding to pressure on some emerging market (EM) economies, leading to capital outflows.
- For the **major central banks**, policy is generally moving towards becoming tighter, with the exception of the Bank of Japan. The US Federal Reserve remains on track to deliver further rate rises, the Bank of Canada raised its policy rate mid- week, and markets view a rate hike by the Bank of England later this year as very likely. The ECB has indicated that it will taper its QE program in Q4 and while also indicating that key interest rates will remain on hold at least through to Summer 2019 the direction of policy (tighter) remains in place.
- The imposition on 6 July of a 25% tariff by the US on around $34b of imports from China, immediately followed by matching retaliatory measures from China, highlights the **rising trade war risk**. While measures implemented to date are too small to knock the global economy off track, the concern is that we are at the start of a cycle where retaliation leads to further retaliation and other countries start raising their tariffs as well in order to protect their domestic industries from the fall out.
- While economic growth in the **major advanced economies** clearly slowed in Q1 2018, partial indicators point to stronger growth in Q2. Moreover, business surveys are consistent with solid growth going forward, even if below the highs of last year. Monetary policy across the advanced economies remains a factor supporting growth, notwithstanding some gradual tightening. The major downside risk is from trade tensions and the possibility that businesses might defer investment activity until the uncertainty clears up.
- **Emerging market** Industrial production appears to have plateaued somewhat this year, and growth in export volumes has slowed considerably in recent months. The key driver of this slowdown has been East Asia – the region that will be most impacted both directly and indirectly by US tariffs against China. More generally, recent data point to some slowing in China, in line with our expectations. In response to capital outflow pressures, a number of **EM central banks** have lifted their policy rates this year. A key exception is China where authorities moved to ease some of the policy tightening that had been put in place to bring credit growth under control. Chinese Q2 GDP is out next week (we expect 6.5% y/y) and will be closely watched
- The **global economy** has been growing at an above average pace and there remain a number of positive indicators that suggest solid growth is likely to continue in the near term. These include forward order measures in major economies – which remain elevated – and robust services sector PMI measures (which accounts for the largest share of economic activity in major economies). That said, it is likely that the current global economic cycle has either peaked or is near its peak. Our leading indicator suggests that growth is set to slow across the remainder of this year. Similarly, forward looking measures in advanced economy business surveys have started to soften, but remain historically strong. Slowing in economic growth in coming years will be most evident in advanced economies – where monetary policy is becoming tighter and which are hitting capacity constraints in labour markets and idle production capacity is diminishing. This is the key driver of our weaker outlook for the global economy – easing to 3.7% growth in 2019 and 3.5% in 2020.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: Our forecasts for the economy are broadly unchanged from last month – we expect growth of 2.9% in 2018 and 2019 before slowing to 2.6% in 2020. In the near-term, growth will be driven by increasing LNG exports, strong growth in public sector investment and a pickup in private business investment growth which will continue the handover from the mining sector. Against this, we expect mining investment to continue to fall – though at a declining rate. We expect dwelling investment to also weigh on growth, and the outlook for the consumer to remain weak. While our forecasts remain unchanged, we believe a number of new risks have emerged. On the upside – as evident in the NAB Monthly Business Survey – conditions remain favourable in the mining sector and it appears there may be some new investment. Against this the outlook for the consumer remains highly uncertain. A slowing in employment growth recently may result in a slower pickup in wage growth and ultimately consumer confidence. Also forward orders have come off significantly in recent months. We continue to expect the first rate increase by the RBA to occur around mid-2019 though this remains highly data dependent. Overall the risks are building that the RBA may be on hold for longer.

- **Business confidence and conditions** were broadly steady in the NAB Business Survey for June after easing back in the previous month. That said current business conditions remain well above average levels. Confidence is around average levels but is a little lower than expected given other forward indicators in the survey. Business Survey leading indicators – forward orders and capacity utilisation - on a trend basis continue to suggest robust outcomes in the business sector in 2018.
- Following the release of the Q1 national accounts there has been little official data released on **business investment**. Over the past year or so, these data have suggested that the handover from the mining sector to the non-mining sector is well underway. Our forecasts are for this to continue and for the decline in mining investment to gradually tail off over 2019. The NAB survey measure of actual capex has eased slightly in recent months but remains above average. Forward looking indicators remain mixed. The most recent ABS capex survey suggested little pickup in in the pace of non-mining investment growth next year and non-residential building approvals were broadly flat in May after trending down in recent months – though they remain at a high level. In contrast NAB's Quarterly Business Survey measure of 12-month capex is pointing to a strengthening in investment. Overall, conditions in the sector remain conducive to further investment growth with survey measures of profitability and capacity utilisation remaining above average.
- Labour force data for June are yet to be released following the decline in the **unemployment rate** to 5.4% in May. This will be an important read with regards to the persistence of the decline in May and will provide further indication on whether **employment growth** has continued its slowing trend this year. Indeed, the NAB Survey employment index fell to +5 (from +9) in June, continuing its decline over recent months. However, it remains above average and implies employment growth of 20k per month over the rest of 2018. 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.
- Indicators of **household consumption** have been mixed in recent months. Retail sales surprised on the upside in May (0.4%) – stronger than implied by our mapping from the NAB Cashless Retail Sales index. The NAB Cashless Retail Sales index for June (released next week) will provide an early indication on how retail sales have tracked since May. We continue to expect a cautious consumer for some time as the headwinds faced by households (weak wage growth, declining housing wealth and high debt levels) persist resulting in consumption growth of not much more than 2.5% over the next couple of years.
- Recent data suggests that the **housing market** continues to cool**.** The CoreLogic Capital City dwelling price index declined 0.3% in June to be 1.6% lower over the year. The weakness in prices continues to be driven by the Sydney and Melbourne markets – which were most impacted by previous prudential measures around investor loans – and also experienced the largest run-up in recent years. We released the quarterly <u>NAB Property Market Survey</u> yesterday which also showed a significant deterioration in sentiment in Q2. We have revised down our forecasts for nationwide dwelling prices in 2018 (-1.7% from -0.8%) and 2019 (-0.4% from 0.4%). We expect continued weakness in Sydney and Melbourne for the next 18 months as well as some deterioration in the Brisbane apartment market. Investor credit growth was flat in May and continued to slow in year-ended terms, credit for owner-occupiers was up 0.6%. Loan approvals followed a similar pattern with the value of investor approvals falling 0.1% and the value of lending to owner-occupiers up 0.8%.
- The **trade** surplus widened in May driven by increases in non-rural exports. We expect that **net exports** will continue to support growth over 2018 and 2019 before flattening out as LNG production reaches capacity.
- NAB's USD non-rural **commodity price** index declined by over 3% q/q in Q2 reflecting falls in iron ore and metallurgical coal, but remains 7.5% higher over the year. We expect commodity prices to ease from here with a small pull-back in global growth and a gradual decline in construction related growth in China in coming years.
- Our **USD/AUD** model continues to suggest a fundamental value estimate in the mid-70c range. We expect 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 <u>Forward View – Australia</u>, released on Wednesday.

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