EMBARGOED UNTIL 11.30 AM WEDNESDAY 11 JULY 2018

THE FORWARD VIEW: AUSTRALIA JULY 2018

Forecasts broadly unchanged but new risks to watch

OVERVIEW

Fundamentally we have not changed our core views on the outlook for the Australian economy - see table and chart. But new risks are emerging and need to be watched.

We still expect GDP to increase by around 2.9% in 2018 with strength from mining exports (LNG), public sector infrastructure investment and a likely flow on to further strength in private investment. On the upside there is now the probability of new investment from the mining sector. Here it is notable that our Monthly Business Survey continues to highlight the mining sector as having both the strongest levels of both business confidence and conditions with capacity utilisation rising back to nearly 90 per cent (the highest read since early 2012).

Against that we continue to be concerned about the outlook for consumption where wages growth remains subdued (with unemployment still well above the NAIRU), electricity prices high , stalling housing wealth – especially if the authorities effectively tighten credit supply - and high debt levels. Even with some moderate uptick in wages we doubt that consumption growth will do much better than 2½% over the forecast horizon. Certainly both our Business Survey and Cashless Retail Sales continue to point to subdued activity and poor confidence in this sector.

There are also new downside risks in the outlook. First is the increasing potential for trade wars to lower global growth and reduce Australian prospects. As we have noted in a recent report, depending on what happens in the current "tit for tat" tariffs environment we could well see the equivalent of a 5% plus increase in average US tariffs (with retaliation) which based on past modelling could lower global growth by around ½ per cent over the next year or so (with possibly higher impacts). Finally there are some emerging signs of softness in the leading indicators on employment growth – albeit our Survey reading would still imply employment growth over the next 6 months of around 20k per month enough to modestly lower unemployment.

At this stage we are inclined to still see the balance of risks as neutral but possibly a touch to the downside. Overall we see upside risks from commodity exports, and infrastructure offset by risks from consumption. For 2019 we expect growth of 2.9% and 2.6% in 2020.

This would still see unemployment edge down to near 5% by mid 2019 and core inflation above the bottom of the RBA 2-3% target range in late 2019 and is consistent with wages growth around 2½% in 2019. At this stage we also still see the RBA starting to increase rates from mid 2019 – but this is very data dependent and it could well be that the timing may be delayed.

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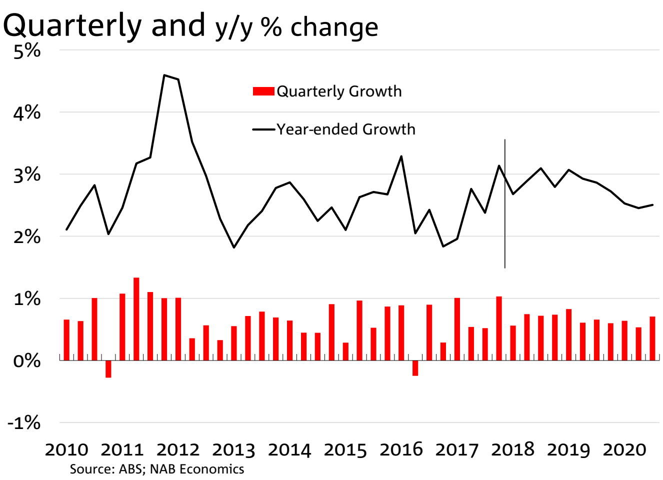
KEY ECONOMIC FORECASTS

	2017	2018-F	2019-F	2020-F
Domestic Demand (a)	3.0	2.8	2.9	3.2
Real GDP (annual average)	**2.2**	**2.9**	**2.9**	**2.6**
Real GDP (year-ended to Dec)	**2.4**	**3.1**	**2.9**	**2.5**
Terms of Trade (a)	11.7	-2.5	-6.7	-1.0
Employment (a)	2.2	2.6	1.9	1.7
Unemployment Rate (b)	5.4	5.3	5.0	5.1
Headline CPI (b)	1.9	2.3	2.2	2.8
Core CPI (b)	1.9	2.0	2.1	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 GDP GROWTH PROFILE



Source: ABS, NAB Group Economics

CONSUMERS, LABOUR MARKET AND WAGES

The unemployment rate fell from 5.6% to 5.4% on a seasonally adjusted basis in May, helped along by a fall in the participation rate with jobs growth only modest (12k). On a trend basis, the unemployment rate was unchanged at 5.5% where it has been since last August.

Meanwhile, the NAB Monthly Business Survey employment index declined for a second month in a row to +5 index points. Despite two consecutive months of falls, the employment index - based on historical patterns - is consistent with jobs growth around 20k per month, slightly above the rate required to keep the unemployment rate constant.

Surveyed prices, costs and wages variables continue to suggest weak price pressures in the economy. Labour cost, purchase cost and final products prices growth all edged lower in June. Retail prices tracked sideways in the month, with no growth after increasing at a low rate recently.

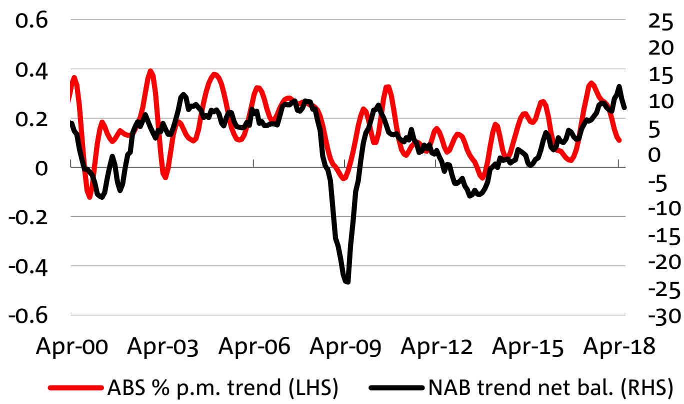
The ABS Wage Price Index was again fairly lacklustre in Q1, up 2.1% y/y (s.a.). The public sector (2.3%) again outpaced the private sector (1.9%).

That said, official retail sales data from the ABS was more resilient than expected in May. Retail turnover rose 0.4% m/m, led by increases in department stores & clothing, footwear & personal accessories. Given April temperatures were well above average, these increases may partly reflect delayed winter clothing purchases. Cafes, restaurants & takeaways was the weakest performing sector for the month.

Our NAB Cashless Retail Sales Index for June, 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.

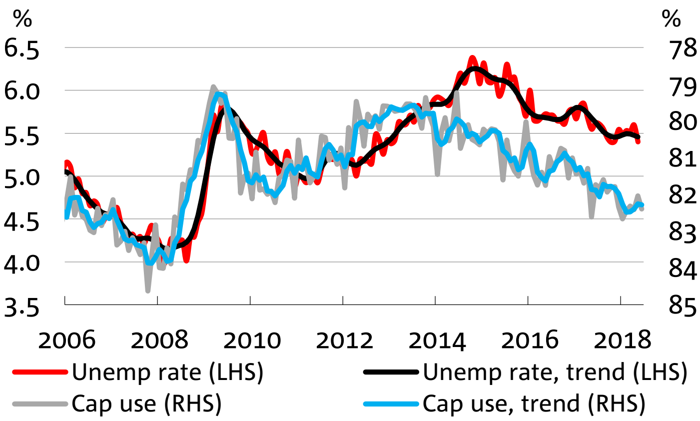
EMPLOYMENT

ABS vs NAB



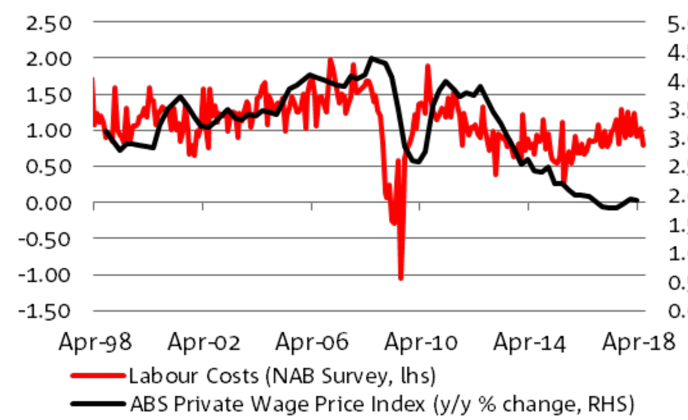
UNEMPLOYMENT AND CAPACITY UTILISATION

ABS (unemployment) and NAB monthly survey



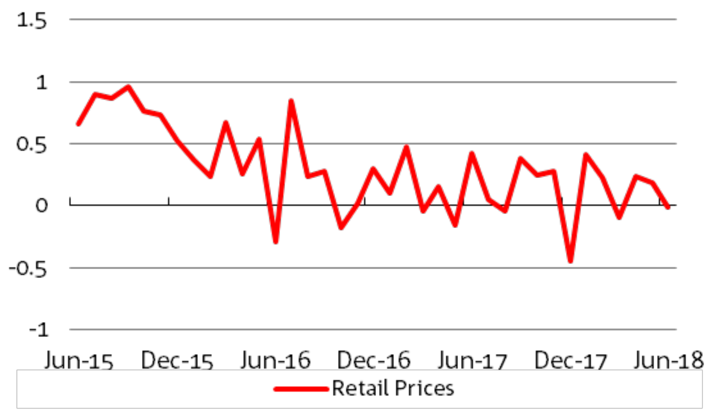
NAB WAGE GROWTH PROXY

y/y % change



NAB BUSINESS SURVEY RETAIL PRICES

% change at quarterly rate



Source: ABS, NAB Group Economics

HOUSING AND CONSTRUCTION

Conditions in the established housing market continued to cool in June with house prices weakening further and auction clearance rates tracking sideways at low levels. The Core Logic 8 Capital City dwelling price index fell 0.3% in June and is 1.6% lower over the year.

To date, the declines have been led by Sydney and Melbourne which were particularly affected by policy controls around investor credit and a pull-back in foreign demand. The rate of decline in Sydney appears to be slowing – with house prices down close to 6% and apartment prices down 4.5% since their peak in mid-2017. The decrease in Melbourne's prices – which turned down later than Sydney – has accelerated more recently. House prices in Melbourne are now 2.7% off their peak, while apartment prices are 0.4% lower.

The pace of decline in Perth has accelerated again recently after slowing in late 2017. Growth in Brisbane has eased and in Adelaide has been broadly flat in recent months. Prices in Hobart have continued to grow strongly.

Overall we expect national house prices to continue to decline over the next couple of years but we don't expect a particularly sharp fall, rather an orderly correction. A further small tightening lending standards, slower wage growth and slowing investor and foreign demand are likely to continue to weigh.

We have lowered our forecast for house prices a little and we expect a small fall in aggregate house prices across the eight major capital cities in 2018, driven by continued weakness in Sydney and Melbourne and in part, the Brisbane apartment market. This is expected to continue into 2019 with further weakness in the three eastern capitals – though we expect the pace of declines to flatten out through mid-to-late 2019 with prices remaining largely flat in 2020. More details on our updated forecasts will be released tomorrow in the NAB Residential Property Survey.

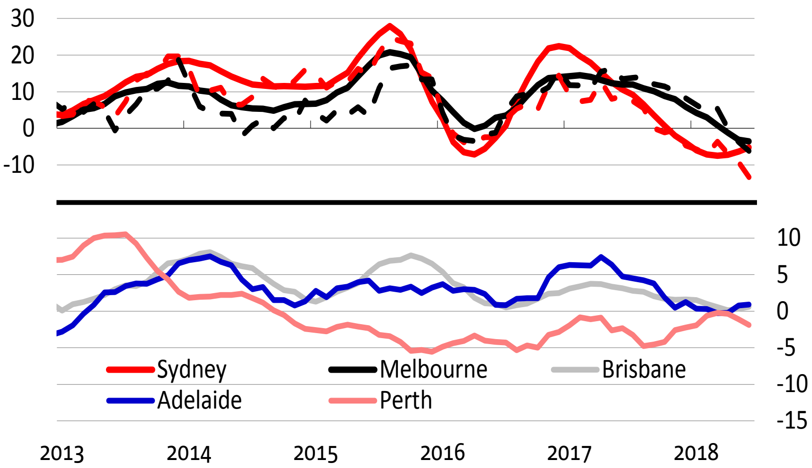
While dwelling investment rose by 0.9% q/q in 2018 Q1 partially reversing the declines seen in the previous two quarters – this was supported by investment in alterations & additions. New and used dwelling investment continued to fall inline with the trend since early 2017.

Building approvals fell 3.2% in May, led by declines in approvals for both high-density and detached housing, while approvals for Melbourne and Sydney were largely flat. Overall, approvals continued to trend lower in May but they remain at a high level suggesting that the pipeline of work will remain elevated for some time.

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 MOMENTUM

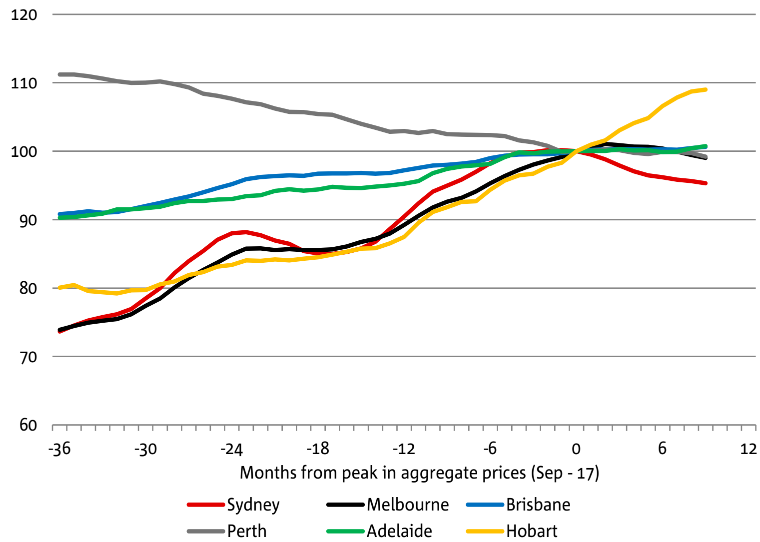
Dwelling price growth (%, 6-month annualised)



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

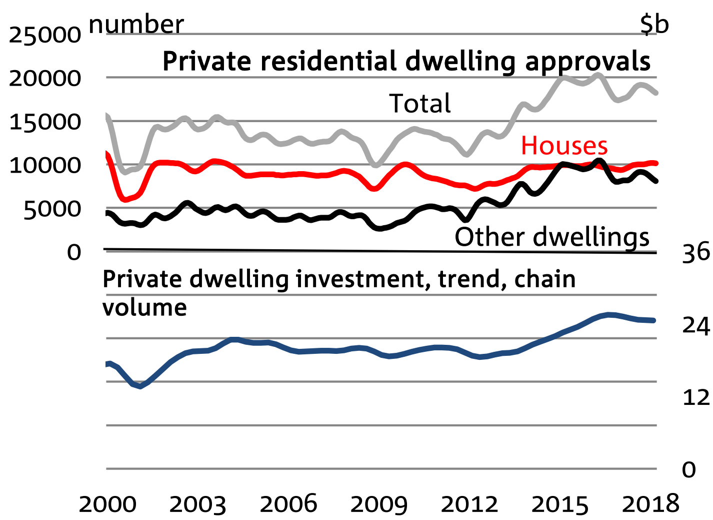
PRICE ADJUSTMENTS TO DATE

Index Sep-17=100



BUILDING APPROVALS & RESIDENTIAL INVEST.

Trend basis



Source: ABS, NAB, Core Logic, APRA.

BUSINESS ACTIVITY AND INVESTMENT

A range of indicators suggest that conditions in the business sector have been quite favourable since late 2017. While a little dated, the national accounts continued to point to a handover from the mining to non-mining sector – and our forecasts imply a continuation of this. We expect underlying business investment to rise by close to 3% in 2018 before accelerating to around 6-7% in 2019 and 2020. The large pipeline of in public infrastructure investment (which is also expected to grow over the forecast horizon at a relatively high rate of around 10%) is likely to have spill overs to the private sector, particularly in machinery & equipment investment, as the sector expands to meet this additional demand.

In addition to this, conditions in the mining sector have improved over the last year or so, and some new investment has been announced. While it is unlikely to be as large as the pipeline of investment seen at the peak of the mining boom, it suggests miners are still willing to lift expenditure when the opportunity presents itself. This is consistent with our view that mining investment is still winding down from its peak, but this effect will begin to wane over the next year.

More generally the outlook for the business sector remains positive. The NAB survey measures of both business conditions and business confidence were steady in June. Conditions remains well above average, even after a pull-back in May and while confidence is around average, forward looking indicators, particularly capacity utilisation, suggest that the outlook for investment and activity remains good. The strength in conditions is relatively broad-based across both states and industries.

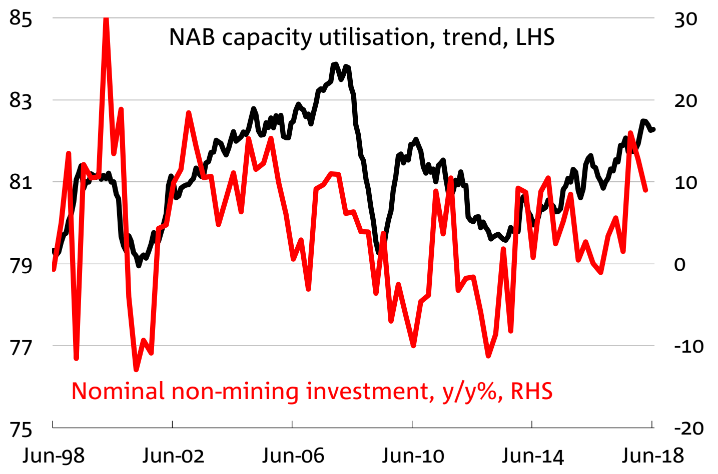
Indeed, the surveyed profitability and cash flow measures remain at a relatively high level. In the context of high capacity utilisation and strong trading conditions, strong cash flow means businesses face few constraints to increasing employment and capex to meet future demand or to increase productivity.

However, while conditions remain favourable in the business sector there are some signs that some downside risks may be emerging. Forward orders declined for a second month in a row (to +2) and has eased noticeably in recent months. The employment index has also weakened recently falling to +5 from +12 two months ago. These measures may be signalling a small loss of momentum in the sector, though at this point we think this may be a downside risk rather than central scenario. Forward orders still remain above average and the employment index implies growth in employment of 20k per month.

The volatile measure of non-residential building approvals was broadly flat in the May, though it has trended down recently. Despite this easing, the value of approvals remains at a relatively high level, suggesting continued growth in the non-mining sector.

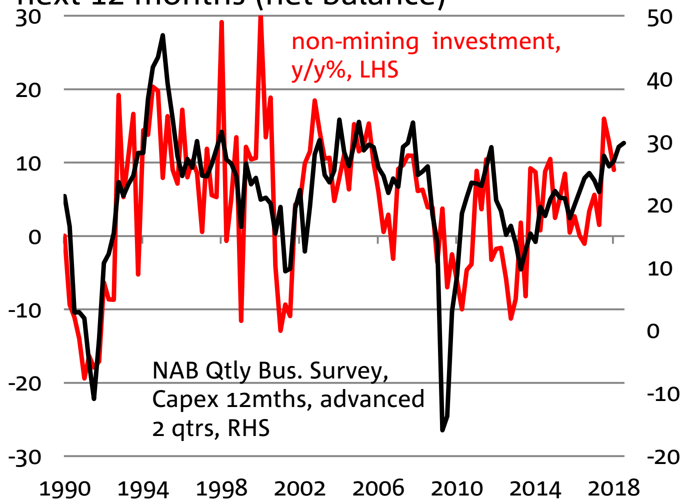
NAB SURVEY CAPACITY UTILISATION

Non-mining investment (y/y%) & survey capacity utilisation (%)



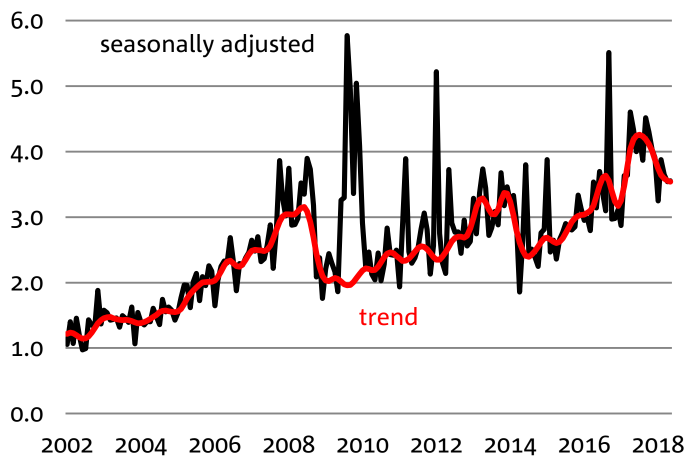
NAB SURVEY INVESTMENT INDICATOR

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



NON-RESIDENTIAL APPROVALS

Value of non-residential building approved ($b)



Sources: ABS, NAB.

COMMODITIES AND TRADE

NAB's USD non-rural commodity price index declined by over 3% q/q in Q2 2018. This only partially reversed the large gain made in the previous quarter and, as a result, it is still 7.5% higher than a year ago. The fall in Q2 mainly reflected a decline in iron ore and metallurgical coal prices, although LNG export prices – linked to the price of oil – rose.

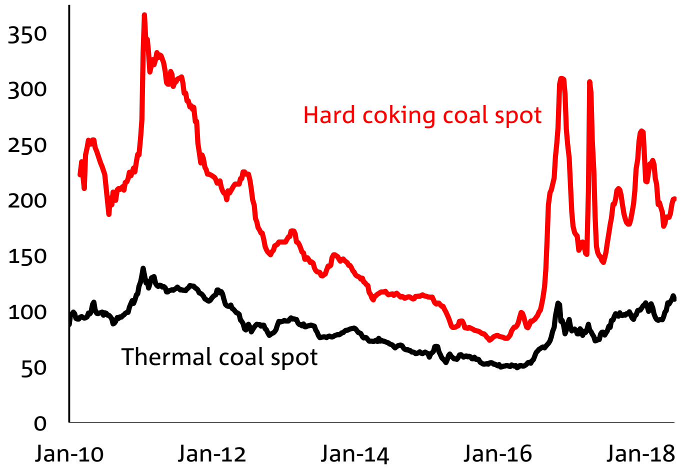
We expect economic fundamentals will lead to further declines in overall USD commodity prices through to end-2019. While the global economy continues to grow at an above average rate, the acceleration seen in 2017 is no longer occurring and global growth appears to have peaked. China remains a key player in the global commodity markets, and its economy is expected to slow gradually in coming years, in part driven by a slowdown in the commodity intensive construction industry.

That said, we see some upside to LNG export prices over the rest of this year. Reflecting supply-side issues, we expect Brent oil prices to remain in the mid-to-high US$70s range in coming months. This will flow through to higher Australian gas export contracts as they are tied to the price of oil. However, the prospects of an increase in OPEC-Russia and US shale production should in-time lead to some moderation in energy prices.

The NAB Rural Commodities Index gained 1.4% month on month in June, following a 3.1% gain in May. On a year on year basis, the index was down 2.9% in June. The monthly gain reflects strong lamb, wool and cotton prices. The last couple of weeks have seen some helpful rains across Australia, but overall the season remains very tough in many parts of the country. As a result, local seasonal conditions continue to have a more than usual impact on prices. The Bureau of Meteorology's forecast of a 50% chance of El Nino developing warrants close watching.

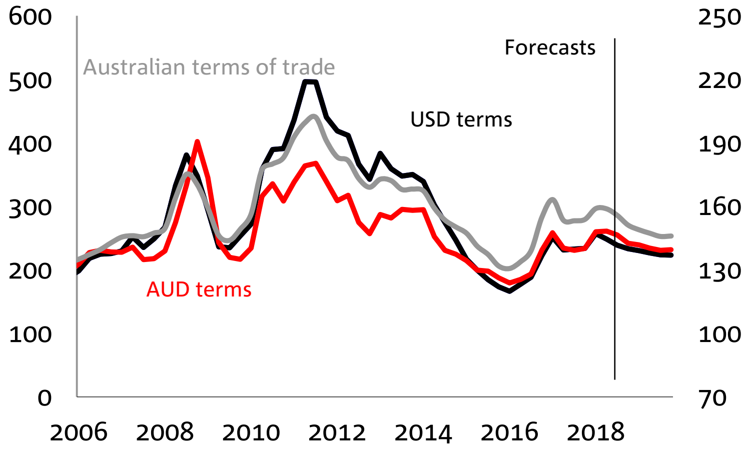
COAL SPOT PRICES

USD/t



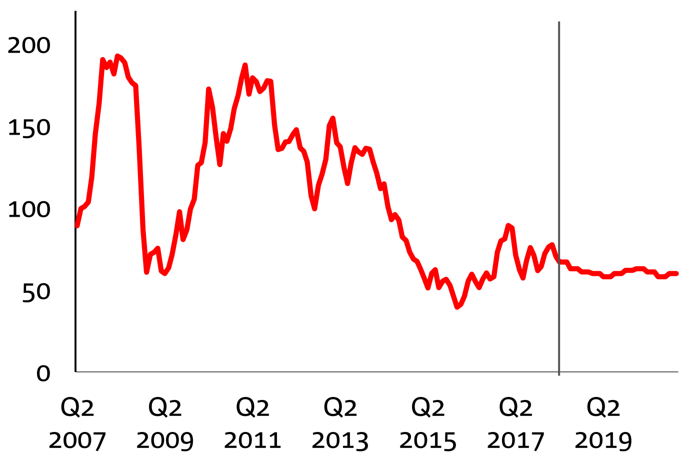
NAB NON-RURAL COMMODITIES PRICE INDEX

Sep 1996 = 100



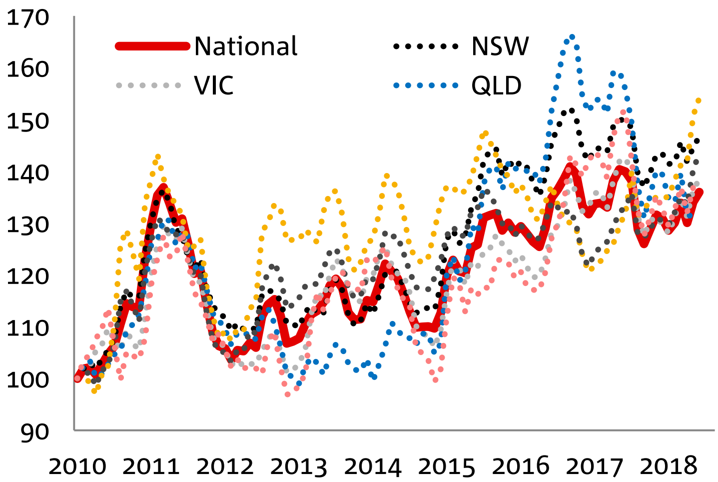
IRON ORE SPOT PRICE FORECASTS

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

CPI data for the June quarter will be released later this month – though we expect this is unlikely to change our (and the RBA's) assessment of the inflationary pressures in the economy. Underlying inflation has now tracked at or a little below the inflation target band for some time. The weakness in domestic inflationary pressures has largely been a result of historically weak wage growth over recent years. We expect slow wage growth to persist for some time as despite reasonable employment growth, the labour market will only gradually tighten. Strong competition in the supermarket sector and competition with online sales has seen some compression of margins for retailers. Our models suggest that core inflation will stay at around the bottom of the RBA's target through to early-mid 2019 before picking up gradually. In the near term, headline inflation is likely to see a small transitory spike as a result of higher energy costs.

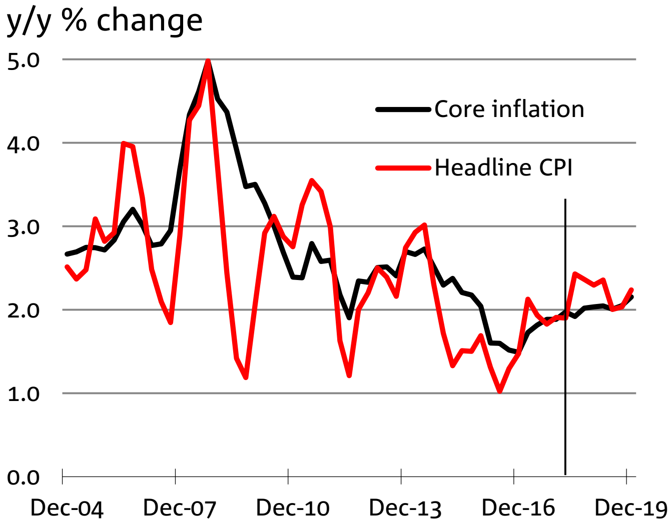
The exchange rate has depreciated a little recently from the mid to high US70c range seen over most for 2018 to date. We are expecting the AUD/USD to hover around the US75c mark for the next couple of years, notwithstanding some volatility due to uncertainty over trade policy and political uncertainty in Europe. Overall, we expect a period of broad USD weakness over concerns about the US's current account and fiscal deficits. However, a widening interest rate differential and a downward trend in commodity prices are likely to see some downward pressure on the AUD.

RBA staff forecasts are for a gradual tightening in the labour market and a relatively slow pickup in wage growth and inflation over 2018 and 2019, despite relatively robust output growth. Governor Lowe has indicated that the ideal outcome would be for a gradual lift in both wages and productivity – emphasising a longer term perspective of sustainable wage growth and inflation of 2-3%. The RBA also remains cautious on the outlook for consumption, as in addition to weaker wage growth, high debt levels, slower growth in household wealth and rising utilities prices have also weighed on consumer spending.

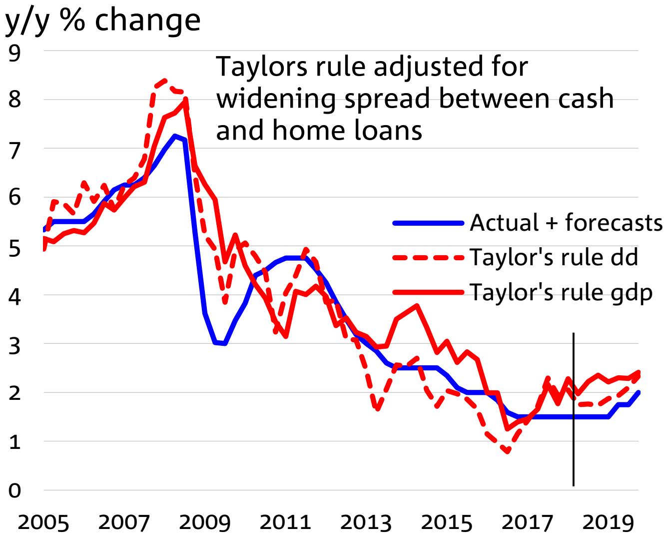
While the advanced economies are likely to tighten policy over the next year as capacity constraints begin to bind and global inflation rises, we think the RBA will patiently sit on the sidelines until there is sufficient evidence of a genuine reduction in spare capacity and evidence of higher wage growth feeding into the inflation outlook. We expect wages growth to gradually rise from here, reaching 2½% in mid-2019.

While our outlook for monetary policy is highly data dependent, we think at this stage the RBA will have seen enough of a pick-up in wages growth and gained enough confidence in its inflation forecasts to increase rates for the first time in mid-2019 and a second possible increase later that year contingent on the data flow and impacts from the initial tightening. At this point, any further depreciation of the exchange rate is unlikely to significantly weigh into policy discussions as any inflation spike will be viewed as transitory and unlikely to impact significantly on inflation expectations more generally, given the weakness in domestic labour costs. Indeed, a lower exchange rate may support growth going forward.

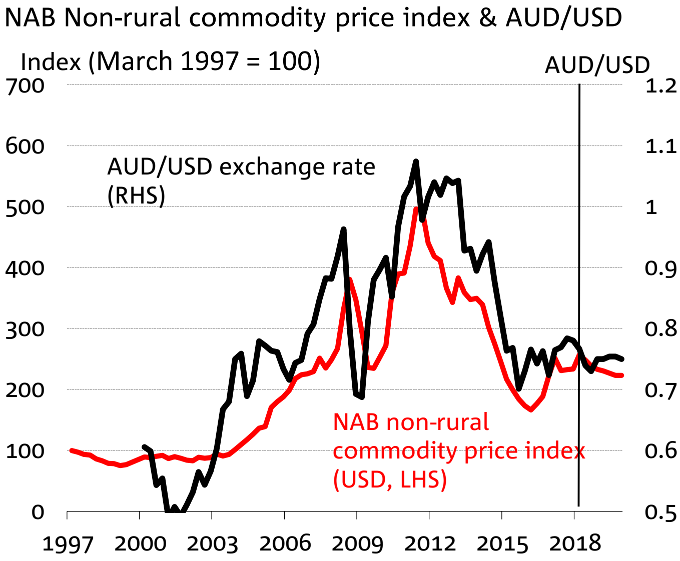
HEADLINE AND CORE INFLATION



TAYLORS RULE AND RATE FORECASTS



AUD AND COMMODITY PRICES



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	2.4	2.5	2.9	2.7	2.5	2.5	2.5
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	5.6	3.7	6.4	-11.9	2.8	2.8	5.8	6.2
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**	**2.6**	**3.1**	**1.9**	**3.0**	**2.8**	**2.9**	**3.2**
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**	**3.1**	**2.0**	**2.9**	**2.8**	**2.8**	**3.2**
Exports	5.4	3.4	6.1	3.5	6.8	3.5	5.2	5.1	2.4
Imports	4.8	6.6	4.0	5.2	0.2	7.8	4.6	4.6	5.4
GDP	**2.1**	**2.7**	**3.0**	**2.8**	**2.6**	**2.2**	**2.9**	**2.9**	**2.6**
Nominal GDP	5.9	4.3	3.6	4.3	3.8	5.8	4.1	3.6	4.8
Current Account Deficit ($b)	39	50	71	95	53	44	55	84	105
(-%) of GDP	2.2	2.7	3.7	4.8	3.1	2.5	3.0	4.3	5.2
Employment	1.3	3.1	1.9	1.9	1.6	2.2	2.6	1.9	1.7
Terms of Trade	14.5	1.4	-6.0	-3.3	0.2	11.7	-2.5	-6.7	-1.0
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	2.1	2.6
Unemployment Rate	5.6	5.5	5.1	5.0	5.7	5.4	5.3	5.0	5.1
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	2.75	3.30	3.65	2.77	2.63	3.00	3.50	3.80
$A/US cents :	0.77	0.74	0.75	0.74	0.72	0.78	0.75	0.75	0.73
$A - Trade Weighted Index	65.5	62.6	61.3	59.1	63.9	64.9	62.7	60.2	58.2

(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	9/07/2018	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$/bbl	74	68	70	68	66	64	62	61	62	63	64	64
Brent oil	US$/bbl	78	75	76	74	72	70	68	67	68	69	70	70
Tapis oil	US$/bbl	79	76	77	75	73	71	69	68	69	70	71	71
Gold	US$/ounce	1262	1310	1270	1310	1340	1360	1370	1380	1400	1400	1410	1420
Iron ore (spot)	US$/tonne	n.a.	67	63	61	60	58	60	62	63	61	58	60
Hard coking coal*	US$/tonne	n.a.	190	170	155	150	155	145	140	130	125	120	125
Thermal coal (spot)	US$/tonne	114	102	98	90	93	85	80	75	77	73	70	68
Aluminium	US$/tonne	2146	2261	2142	2125	2080	2055	2025	2000	1985	1962	1958	1955
Copper	US$/tonne	6383	6877	6642	6725	6825	6875	6950	7050	6900	6825	6725	6650
Lead	US$/tonne	2332	2383	2405	2395	2380	2340	2300	2300	2280	2260	2240	2220
Nickel	US$/tonne	14118	14456	15045	14235	14000	13750	13525	13025	13250	13500	13250	13000
Zinc	US$/tonne	2716	3112	2900	3000	3145	2895	2700	2600	2550	2500	2485	2465
Aus LNG**	AU$/GJ	n.a.	11.5	12.8	12.6	12.3	11.9	11.6	11.4	11.3	11.6	11.7	12.0

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

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