August 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Global growth appears to have remained above average through the first half of 2018, but with our leading indicator pointing to a moderation in coming quarters, we think that this will represent the peak for this cycle. As a result we expect global growth to reach 3.8% in 2018 and then to ease over 2019 (3.7%) and 2020 (3.5%). After hitting a soft patch in Q1, major advanced economy growth rebounded in Q2. Industrial indicators in emerging market (EM) economies are mixed and risk concerns are elevated as some EM financial markets have come under strong pressure, most notably Turkey recently, with some contagion to other EMs. A gradual tightening in advanced economy monetary policy settings is underway.

- Overall commodity prices – as measured by the Thomson Reuters/Core Commodity CRB Index – after falling by around 8% between end May and mid-June, briefly stabilised before coming under further pressure as EM concerns re-emerged.
- A gradual tightening in **advanced economy monetary policy** settings is underway. This month, the Bank of England (BoE) raised its Bank Rate; this followed last month's hike by the Bank of Canada and the Fed's rate hike in June. However, the key word is 'gradual' – Fed and BoE rate tightening in particular is happening at a slow pace by past standards, and in the case of the ECB any tightening is still in the future. The Bank of Japan recently tweaked its policy with the result that 10 year yields will be allowed to move a bit higher, but a major change in policy settings any time soon is unlikely.
- After hitting a soft patch in Q1, **major advanced economy growth** has rebounded in Q2. This was most evident for the US, but was also true for Japan and the UK. Canada is also widely expected to show stronger growth in Q2. Monetary policy across the advanced economies remains a factor supporting growth, notwithstanding some gradual tightening to-date. Fiscal policy has also turned supportive, particularly in the US. Supply constraints are likely to increasingly restrain growth, as highlighted by the already low unemployment rates in many advanced economies. The major downside risk is from trade tensions and the possibility that businesses faced with an uncertain environment might defer investment.
- **Emerging Market (EM) economies** have come under pressure – reflected in falling currencies and stock prices – following the rise in the US dollar from early April, as well as due to local factors. While a few countries – such as Argentina and Turkey – have been hit particularly hard, there has been some broader contagion, leading some EM central banks to raise rates. Trends in EM activity indicators remain mixed - with output growth in China remaining relatively stable, while growth in India and Brazil has slowed since the early part of the year. China's economic growth was marginally softer in Q2, down to 6.7% yoy (following three straight quarters of growth at 6.8%); this robust result was despite a deleveraging program. The pace of deleveraging may slow in H2, as a policy response to support growth.
- While the recent partial indicators for EM economies have been somewhat mixed, the rebound in major advanced economy growth in Q2 2018 suggests that overall the **global economy** continued to grow at an above trend rate through to mid-2018. We continue to think that the current global economic cycle peaked this year. Our leading indicator suggests that growth is set to slow across the remainder of this year. A slowing in global economic growth in coming years will be most evident in advanced economies, due to gradual monetary policy tightening, US fiscal stimulus fading and capacity constraints. The ongoing transition of China's economy, and associated trend growth slowdown, will also be a factor although still robust growth in India will provide an offset. Overall, we expect global growth of 3.8% this year, but for growth to ease to 3.7% in 2019 and 3.5% in 2020.
- **Trade actions remain a major risk** for the global economy. While US/EU talks have calmed some trade fears, 25% tariffs on a further $16b of China exports to the US will be imposed on 23 August, and the mooted tariff on a further $200b of imports was increased from 10% to 25%. China has indicated it will retaliate which could trigger US tariffs on another $200b of imports from China. If all the threatened US/China tariffs were to go ahead then past studies suggest they could lower US GDP by 0.5-0.9ppts and world GDP by 0.2-0.4ppts. While this might be spread out over a few years it would represent a strong headwind to US and global growth (particularly in East Asia).
- While trade remains the key risk, recent developments in Turkey are a reminder that **navigating gradual monetary policy normalisation** in advanced economies, given structural and policy weaknesses in some EM countries, is not going to be all smooth sailing.
- For more detail on the global outlook, please see the [Forward View – Global](), released yesterday.

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<u>Australia</u>: Our outlook for the economy is unchanged from last month, though we believe the balance of risks may be shifting to the downside. Growth is expected to rise to just under 3.0% in 2018 and 2019 before slowing a little in 2020. Rising commodity exports, public infrastructure investment and a recovery in non-mining business investment are expected to drive growth. Our outlook for the consumer remains weak, given the headwinds faced by the household sector. The unemployment rate (and spare capacity) is expected to decline gradually, which should see a gradual increase in the pace of wage growth and eventually be passed through to inflation more generally. For now we have left our outlook for rates unchanged, but should the building risks in business sector materialise or wages/inflation growth pickup more slowly than expected, any increase in interest rates could well be delayed. Indeed, recent wage and CPI data suggest inflation pressures remain relatively meek, as do the RBA forecasts updated in the August SMP.

- **Business conditions** from the NAB Monthly Business Survey declined further in July – and have now come off their high levels earlier in the year – but remain well above average. Forward orders also declined, and like business conditions has eased significantly over recent months to be at around average levels. Business confidence edged slightly higher in the month but remains around average. Capacity utilisation edged slightly lower in the month but remains above average after trending higher in recent years. The trend in business conditions and in particular forward orders (due to its forward looking nature) is of concern, and should these trends continue, there may be a pull-back in activity in the business sector. For now though, conditions remain well above average, suggesting that activity in the sector has remained robust through mid-2018.
- National **dwelling prices** fell further in July, led by declines in Melbourne and Sydney – while conditions in Perth have weakened again recently. The other capital cities have held up relatively well, as have regional house prices. Over the year prices have declined by 2.4%, with Sydney around 6% lower than its peak and Melbourne down 3%. Housing credit grew by 0.3% in the month with the growth in owner-occupier housing credit continuing to outpace that of credit extended to investors (which recorded its first monthly decline since 2009). Finance approvals (new lending) fell for both owner-occupiers and investors in the month. On the construction side, building approvals rebounded in the month, with new approvals for both houses and apartments rising. Looking through recent volatility, building approvals have trended down recently, but remain at high levels.
- **Consumption** indicators continue to paint a mixed picture of the household sector. The ABS measure of retail sales rose by 0.4% in June, stronger than implied by the NAB Cashless Retail Sales measure. Over the quarter, the volume of retail sales – which rose 1.2% - implies a relatively strong outcome for consumption in Q2. An update on the NAB Cashless retail sales index will be released next week, which will provide an early indication of momentum in Q3. CPI data released for Q2 showed that general price pressures have remained weak with headline inflation rising by 2.1% over the year, and underlying measures continuing to track just below the RBA's target band at 1.9%.
- The **unemployment rate** has edged lower over the last two months, printing at 5.3% in July. The volatile employment figures showed a small fall in **employment** in July (-3.9k) following the surprisingly strong outcome in June (+58k). The NAB Survey employment index rebounded to +10 in July after declining in June – and while it is a little lower than earlier in the year, implies ongoing growth of 23k per month – enough to see the unemployment rate fall further through the second half of 2018. Wages data for Q2 suggest a very marginal increase in wage growth (0.6% q/q from 0.5%), but overall suggests wage pressure has remained largely unchanged with year-ended growth continuing at around 2.1%. Looking forward, we expect the unemployment rate to continue to decline, reaching 5.0% by mid-2019 which should see some further gradual build up in the pace of wages growth.
- The **trade** surplus widened in June driven by increases in bulk commodity exports. Monthly trade data over the June quarter (in combination with trade prices) suggest that **net exports** will make little, if any contribution to growth Q2. We expect the ramp-up in LNG production from the remaining mega-projects to see further growth in exports over the next year or so, before levelling off.
- Commodity prices have been mixed in Q3 to date, following a 3.0% decline in NAB's USD non-rural **commodity price** index in Q2. Iron ore prices have risen slightly, while coal prices have continued to trend lower. The NAB Rural Commodities Index was up 1.3% in July, led largely by higher grain and lamb prices. Drought conditions continue unabated in New South Wales and parts of Queensland, with the Bureau of Meteorology reporting that July 2018 was the driest month nationally since 2002. That said WA looks to be in good shape and the drought effects on the Australian economy are not yet likely to be large.
- Our USD/AUD model continues to suggest a fundamental value estimate in the mid-70c range. The exchange rate has held just below US74c for much the last month before trading lower on the ructions in emerging markets in mid-August. We expect the Aussie to trend gradually lower over the next few years, with widening interest rate differentials and lower commodity prices.
- For more detail on the Australian outlook, please see the <u>Forward View – Australia</u>, released on Wednesday.

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