September 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Global growth reached its highest rate since September 2011 in Q2 2018, but has likely peaked as our global leading indicator points to a slowing in the second half of 2018. Moreover, underneath this solid headline reading, growth has become less synchronised across countries, and this will be exacerbated in the second half of the year due to a major deterioration in financial conditions in certain EM economies. Contagion across the range of EM economies has so far been limited, but remains a concern against a backdrop of ongoing trade tensions. Reinforcing the expected slowing in growth is the gradual tightening in monetary policy underway across both advanced and EM economies, the fading over time of this year's US fiscal stimulus and growing supply constraints. Overall, we expect global growth to peak this year at 3.8%, before easing over 2019 (3.7%) and 2020 (3.5%). US/China trade tensions represent the major risk to the global outlook.

- There have been some downward moves in **commodity prices** in recent months. While this might in part reflect US dollar strength, the larger falls have been in base metals such as copper, which can be more sensitive to the economic outlook and risk sentiment.
- With advanced economy growth above trend and unemployment rates moving close to, or below, estimates of full employment, the major **advanced economy central banks** are looking to tighten policy. However, this is happening only gradually as inflation pressures are muted, although core inflation in the US is now at the Fed's 2% long-term target.
- There has been a major deterioration in **financial conditions in certain EM economies**, such as Argentina and Turkey. Contagion across the range of EM economies is so far limited but remains a concern against a backdrop of ongoing trade tensions. US Federal Reserve rate increases often put pressure on EM central banks to also lift rates, as they seek to avoid capital outflows and consequently pressure on their currency, and this is again the case. While, outside of Turkey and Argentina, the increase in EM rates so far this year is relatively modest, it still represents a tightening in policy which may be expected to weigh somewhat on growth.
- The latest data confirm that major **advanced economy growth** rebounded strongly in Q2 after a soft patch in Q1. This was led by the US, but Japan, the UK and Canada all experienced stronger growth, with only Euro-zone missing out with growth unchanged from Q1. However, outside of the US, the annual growth rate has declined in these economies. Across the advanced economies, monetary policy is still relatively loose and so supportive of above trend growth, while fiscal policy has also turned more supportive, particularly in the US. While growth should remain above trend, the pace is likely to ease - monetary policy will become less stimulative over time and this year's US fiscal stimulus impact will fade. Unemployment rates continue to trend down suggesting that supply will be an increasing constraint.
- Despite the growing uncertainty around international trade, economic growth in the big **emerging markets** edged higher in Q2 2018 – to 6.1% yoy (from 6.0% in Q1). Growth has accelerated since the end of 2015 (when it dipped below 5%), however trends have remained mixed across the group. The main contributor to the upturn was India, where growth accelerated to 8.2% yoy (from 7.7% in Q1). In contrast, both Chinese and Brazilian growth eased.
- The uptick in growth in emerging markets, combined with the modest turn-around in advanced economies, has driven global economic growth to its highest rate since September 2011 (at around 4.0% yoy). That said, we maintain our view that **global growth** is near its peak for the current cycle, with growth set to slow in coming years. This will be largely driven by slowing trends in advanced economies, as US fiscal stimulus fades and monetary policy gradually tightens in the face of intensifying capacity constraints. In contrast, emerging market growth is expected to remain relatively stable – with India and non-China East Asia remaining strong, while a modest slowing in China is offset by a recovery in Latin America.
- **Trade tensions** are a major risk for the global economy; in particular, the future of NAFTA and the prospect of escalating US/China tariffs. Although the US has reached agreement with Mexico on changes to NAFTA and is currently in discussions with Canada, there is no certainty an agreement will be reached. Meanwhile, the US is expected to announce tariffs on up to $200b of imports from China, though the extent and timing of action is uncertain. If China retaliates (as it has indicated it will do), President Trump has threatened further tariffs that would essentially encompass all of China's exports to the US. Threatened US tariff measures on Chinese imports (and retaliatory Chinese action) represent a substantial downside risk to the outlook although a range of factors, including the fiscal and monetary policy response, would shape the overall impact.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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***<u>Australia</u>*: The release of the Q2 national accounts confirmed that the economy has grown at a strong pace over the last year, with notable growth in government infrastructure spending, and a surprisingly resilient household sector. Exports have also risen as expected. Growth in the business sector has been a little more mixed, with weakness in the non-mining sector evident in Q2; investment in the mining sector rose in Q2. While the economy has grown more strongly than expected over the first half, the outlook is broadly unchanged from previous months. In addition, downside risks have abated somewhat, with business conditions rebounding in August (though confidence weakened). Growth is expected to continue at above trend rates (at 3.3% in 2018 before slowing in 2019 and 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 weaker, given the headwinds faced by the household sector. The cooling in the housing market is also likely to see some weakness in dwelling investment over the next few years. While growth has been strong, inflationary pressure has remained weak, suggesting there is some time to go for the rise in output growth (and improving labour market) to feed through to inflation pressures more broadly – though recent data prints have showed some signs of a pick-up. For now we have left our outlook for rates unchanged, but the risk remains that this could well be delayed.*

- Outcomes in the **business sector** have been mixed recently, but the outlook remains positive. Both the national accounts and ABS Capex Survey suggested **weakness in the non-mining sector in Q2**, and looking forward, the capex intentions for 2018/19 imply some further weakness (though only cover a subset of industries). The **NAB Monthly Business Survey saw a broad-based improvement in the month**, with a rebound in conditions and forward orders, as well as a lift in actual capex; confidence did ease however. Overall, the survey continues to suggest conditions in the business sector have remained positive into the second half of 2018 – and our outlook for a lift in business investment over the next two years stands. Capacity utilisation remains high, profitability remains strong and the large pipeline of public infrastructure investment is likely to provide some additional spill-overs to the non-mining sector. Further the drag from falling mining investment is likely to wane as the last of the large LNG projects enters production.
- **Dwelling prices** continued their correction August, falling a further 0.4%. The declines were led by Melbourne and Perth, while Sydney continued to ease at a more moderate monthly pace. The other capitals and regional areas have continued to hold up better, though did not experience the rapid run up in prices that occurred in the two largest cities. While now dated, **dwelling investment** in the national accounts rose in Q2 with a solid increase in investment in new dwellings, offset by a decrease in alterations & additions. We expect some weakness in dwelling investment going forward, as the housing market continues to cool, though it is likely to be volatile as it passes the peak, and will likely remain at a high level with a relatively large pipeline of work in train.
- **Consumption** indicators continue to paint a mixed picture of the household sector. Consumption recorded a reasonable outcome (0.7% q/q) in the Q2 national accounts, but continued to outpace growth in household income, which saw the savings ratio fall to 1%. We expect consumption growth to slow slightly, with the household sector continuing to face headwinds from weak wage growth, a high debt burden and slower growth in household wealth. More recently, the ABS measure of **retail sales** was flat in July after a run of stronger-than-expected results, but in line with the NAB Cashless Retail Sales measure which implied a small fall in the month. An update on the NAB Cashless retail sales index will be released next week, which will provide an early indication of momentum August.
- The **labour market** continued to show strength in August with employment increasing by 44k and a rise in the participation rate. This saw the **unemployment rate remain unchanged at 5.3%** in the month and it appears that the decline over recent months has been sustained. Looking forward, the outlook for the labour market remains positive. The **NAB survey employment index** held at well above average levels in August **– implying employment growth of over 20k per month for the next 6 months** - which points to further declines in the unemployment rate, with growth in employment continuing to outpace that of the working-age population. Surveyed wage costs also rose in August, and while this is not a pure wage measure, it provides some further evidence that wages pressures are gradually beginning to build.
- **Net exports** made a small contribution to growth in Q2. While export growth slowed, it remained robust and broad-based with all sub categories contributing. Resource exports are sharply higher over the year. More recently, the **trade surplus** narrowed in July with a slight pull-back in iron ore exports (which recorded a strong outcome in the previous month) while imports of intermediate goods rose.
- Prices for **iron ore** have remained range bound in the high US$60s while, **coking coal** prices have moved higher over the past month. The **NAB Rural Commodities Index** was up 0.8% in August, with grain, lamb and wool prices on the rise, but cattle and dairy lower. Continued drought conditions in the east is likely to see elevated grain prices but lower cattle prices.
- Our **USD/AUD** model continues to suggest a fundamental value estimate in the mid-70c range. Though continued strains in emerging markets as well as ongoing China-US trade tensions have seen the Aussie trade closer to US70c in recent weeks. 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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