October 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Global growth remained solid through to Q2 2018 – tracking above its long-term trend and its highest level since early 2012. However, growth has been diverging across countries and survey and activity data point to a slowdown in the second half of 2018. Pressure on global growth is coming from a number of sources, including a gradual tightening in monetary policy settings, acute financial stress in some emerging market (EM) economies and a rise in oil prices. The US economy continues to benefit from this year's fiscal stimulus but its impact will fade over time. In addition, supply constraints in the US and other advanced economies will also increasingly act to limit growth. Another downside factor is the US/China trade dispute, with the risks around this partially realised over the last month with another round of tariffs going into place. Overall, we expect global growth of 3.7% in 2018 (previously 3.8%), then easing to 3.6% in 2019 (previously 3.7%) and 3.5% in 2020 (its long-term trend rate). These numbers are slightly weaker than recently released IMF global forecasts.

- **Commodity price** trends have diverged in recent months. The Thomson Reuters/Core Commodity CRB Index fell by over 9% between late May and mid-August, but has recovered much of its losses, as oil prices have climbed. However, excl. energy prices, this index has remained weak – down around 10% from late May.
- Trends in **financial markets** have also shown divergence as economic trends in advanced economies vary, and fears around emerging markets have grown. The USD MSCI equity indices for non-US advanced economies and emerging markets have fallen by 15% or more from their late January 2018 peaks, while in contrast the US equity index was broadly unchanged through to early October although there has been a large sell-off so far this week. Due to growing expectations that the US Fed will continue to increase rates, US yields have increased, lifting yields in other countries. The Bank of Canada is considered likely to raise rates again in late October. The European Central Bank and Bank of Japan are further behind in the rate cycle, however the ECB will wind back and end its asset purchases during Q4 2018.
- Overall conditions in the major **advanced economies** remain relatively strong, however trends have started to diverge – away from the synchronised upturn evident across much of 2016 and 2017. The seven largest advanced economies grew by around 2.2% yoy in Q2, marginally above the rate in Q1, but below the recent cyclical peaks across the second half of 2017. The US, boosted by a large fiscal stimulus, has been the standout performer in recent quarters – expanding by 2.9% yoy in Q2 2018 (compared with just 1.3% yoy in the same period in 2016). In contrast, growth in all other major advanced economies has slowed – relative to the peak in Q4 2017 – with only modest upturns in the UK and Japan when compared with Q1.
- Although growth in the big **EM economies** strengthened in Q2, the key driver was a sharp pickup in Indian growth which is unlikely to continue into Q3. The broad EM manufacturing PMI has deteriorated since its peak in December 2017 and services PMIs have fallen sharply in recent months. In China, of particular note is the slowing real retail sales trend, which rose by 6.4% yoy in August (below the growth in real GDP in Q2), highlighting softness in consumption. This may explain why China is looking towards investment, rather than its consumers, to stimulate its economy to address the impacts of US tariffs. China's latest response has been another cut to the required reserve ratio, the fourth cut this year.
- Rising US interest rates, currency pressures, the risk of capital outflows and fears of contagion spreading from economies such as Argentina, Turkey and Brazil have led a range of **EM central banks** to raise policy rates.
- **Global economic growth** has been relative steady over the last four quarters – remaining around 3.9% yoy in the first half of 2018 – a relatively high level by the standard of recent years. However, while the improvement in growth in 2017 was relatively broad based, this is no longer the case, as outside of the US and India growth has clearly decelerated. This appears to have continued into the second half of 2018, reflected in further declines in the Global PMI, while world trade and industrial production data have also seen a slowdown in growth from early 2018 into early Q3. Survey measures of future output expectations have also declined although they remain at a decent level so we don't see growth falling off a cliff.
- Trade tensions and risks around emerging markets are **downside risks** to these forecasts. That said, markets reacted calmly to latest round of US/China tariffs and while we think they will have a small negative impact on the US economy, Chinese authorities should be able to largely offset the impact through policy measures. While the US/China trade dispute may worsen further – the US has threatened tariffs on the remainder of Chinese imports – so far trade tensions are not spreading to other countries. The US, Canada and Mexico have agreed on changes to NAFTA, and the US is pursuing bilateral deals with the Euro-zone and Japan, reducing the risk of US tariffs on auto imports for now. An **upside risk** to our forecasts is that the impact of this year's fiscal stimulus in the US may linger for longer than we are expecting.
- For more detail on the global outlook, please see the [Forward View – Global], released yesterday.

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<u>Australia</u>: We have left our Australian forecasts unchanged but have lowered our near term outlook for the exchange rate. Following strong in the first half of 2018, we see growth slowing but supported by public sector demand (both NDIS and infrastructure related), a strong non-mining business sector and in the near term LNG-led export growth. In addition, both conditions and confidence point to more positive outcomes in the mining sector, with some new investment likely and higher levels of sustaining capex. At the minimum the effect of the unwinding of the mining investment boom should wane as the last of the LNG projects enters the production phase. Growth is expected to reach over 3% in 2018 before slowing in 2019 and 2020 with exports levelling out and consumption growth remaining modest. The housing cycle will detract slightly more than previously anticipated but we do not expect a sharp contraction in the sector. Despite recent strong growth in the economy, price pressures have remained relatively weak with core inflation only just at the bottom of the RBA's target band. There have been some tentative signs of building price pressures and we expect this to continue, with first a gradual rise in wages growth as the labour market tightens and then as inflation more broadly begins to rise. However, with this process only being gradual we do not see any action from the RBA until mid-to-late 2019 but this view remains highly data dependent, with the RBA seeking further confirmation of building price pressures before beginning a gradual process of rates normalisation.

- The outlook for the **business sector remains positive.** Business conditions from the NAB Survey appear to have stabilised at a high level after sharp declines in the middle of the year. Profitability, trading conditions and employment all remain well above average, while actual capex in trend terms remains at a high level as is capacity utilisation. Somewhat offsetting this strength is the weakness in forward orders, which have been volatile of late and fell back to average in the month. The mining sector continues to see particularly positive outcomes with both confidence and conditions highest of all industries. The retail sector continues to lag, being the only industry to record worsening conditions. 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** fell 0.6% in September to be down 3.7% over the year. To date, Sydney and Melbourne have led the declines (down 6.2% and 4.4% respectively from their peaks), though Perth appears to have weakened again recently. We expect prices to continue to decline over the next year or so before levelling out – and have downgraded our outlook with slightly deeper prices falls of closer to 10% in Sydney and 8% in Melbourne. That said, we expect the correction to continue in an orderly fashion, with prices remaining well up on even three years ago. With the cooling in the housing market to continue we expect some weakness in dwelling investment going forward, as the housing market continues to cool. Indeed, building approvals have recorded two consecutive declines and housing credit growth has slowed this year.
- Our outlook for **consumption remains weak.** Slow wage growth, falling house prices, and a high debt burden are expected to weigh on the consumer over the next few years. We expect consumption to print at 2.8% in 2018 before slowing to 2.5% in each of 2019 and 2020. Recent data suggest consumption was relatively weak into Q3, with the ABS measure of retail sales rising by 0.3% in August after a flat outcome in July. Our Cashless Retail Sales Index suggests sales were again weaker, recording two flat outcomes in the first part of the quarter. An update on the NAB Cashless retail sales index will be released next week, which will provide an early indication of momentum September.
- The **labour market** dynamic remains and important factor for both the outlook for monetary policy and risks around the consumer. With domestic inflation held back by weak unit labour costs growth and slower wage growth constraining the consumer. Employment has grown at a trend rate of just under 30k in recent months, seeing the unemployment rate decline to 5.3%, its lowest level for a number of years. Looking forward, the outlook for the labour market remains positive. The NAB survey employment index continues to imply employment growth of over 20k per month for the next 6 months - which points to further declines in the unemployment rate. Despite some early signs of a tightening labour marker, surveyed wage and price measures eased in September, suggesting that overall price pressures remain weak.
- The **trade surplus** widened slightly in August, with export growth led by LNG and soft commodities outpacing the growth in imports (led by volatile fuels and aircraft in the month). We expect exports to grow relatively strongly over the next year, with the remaining LNG projects entering the production phase, before levelling off at a high level.
- Prices for **iron ore** have remained range bound in the high US$60s while, **coking coal** prices have moved higher over the past month. Oil has also traded higher over the past month. The **NAB Rural Commodities Index** was up 6.5% in September, with grain prices sharply higher.
- 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.
- For more detail on the Australian outlook, please see the <u>Forward View – Australia</u>, released on Wednesday.

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