EMBARGOED UNTIL: 11.30AM THURSDAY 11 OCTOBER 2018

THE FORWARD VIEW – GLOBAL

OCTOBER 2018

National Australia Bank

Summary – solid headline growth masks divergent trends

- Global growth remained solid through to Q2 2018 at around 3.9% yoy – above its long-term trend and its highest level since early 2012. However, beneath the headline result, growth has been diverging across countries. Moreover, business survey, trade and industrial production data, as well as our leading indicator, point to a slowdown in the second half of 2018.
- Divergence can also be seen in financial markets, with equity markets in the US generally moving higher since the middle of the year but falling elsewhere. Similarly, outside of energy prices – which have risen on supply concerns – commodity prices have been soft. However, with growing expectations that the US Fed will continue to increase rates, the resulting rise in US yields has lifted yields in other countries as well.
- Pressure on global growth is coming from a number of sources, including a gradual tightening in monetary policy settings in both advanced and emerging market (EM) economies, acute financial stress in some EM economies and a supply-shock driven 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. Importantly the risk of a tariff measures spreading to other countries has declined.
- 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.

Global Growth Forecasts (% change)

	2017	2018	2019	2020
US	2.2	2.8	2.3	1.6
Euro-zone	2.5	2.0	1.7	1.6
Japan	1.7	1.1	1.2	0.9
UK	1.7	1.3	1.5	1.5
Canada	3.0	2.1	2.0	1.6
China	6.9	6.6	6.3	6.0
India	6.7	7.3	7.1	7.2
Latin America	1.3	1.2	1.8	2.4
Other East Asia	4.4	4.3	3.9	3.8
Australia	2.2	2.9	2.8	2.5
NZ	2.8	2.9	2.8	2.6
Global	3.7	3.7	3.6	3.5

Actual global growth and leading indicator (% yoy)

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CONTACT

Alan Oster, Group Chief Economist
+61 3 8634 2927

Gerard Burg, Senior Economist – International, +61 (0)477 723 768

Tony Kelly, Senior Economist
+61 (3)9208 5049

AUTHORS

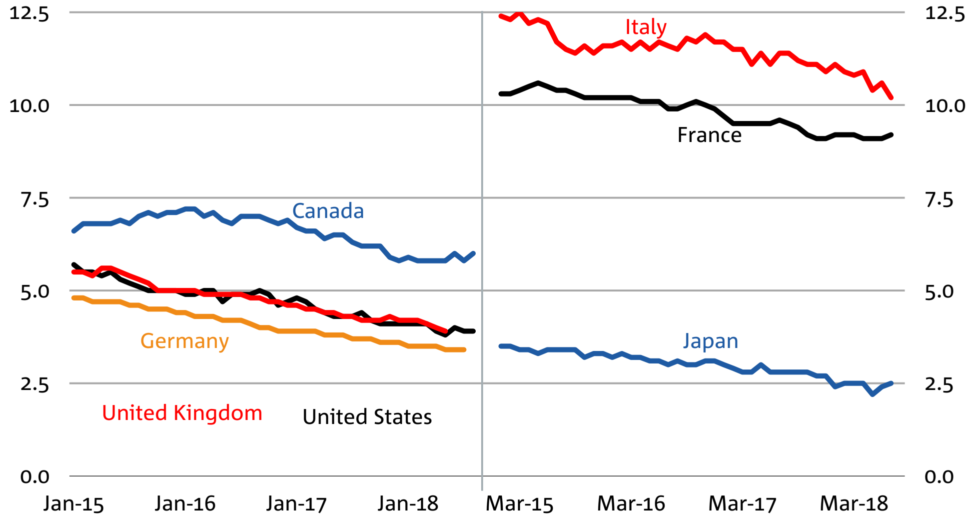
Tony Kelly & Gerard Burg

CONSTRAINTS TO GROWTH BUILDING IN ADVANCED ECONOMIES

Above potential growth set to slow as constraints bite and policy rates rise

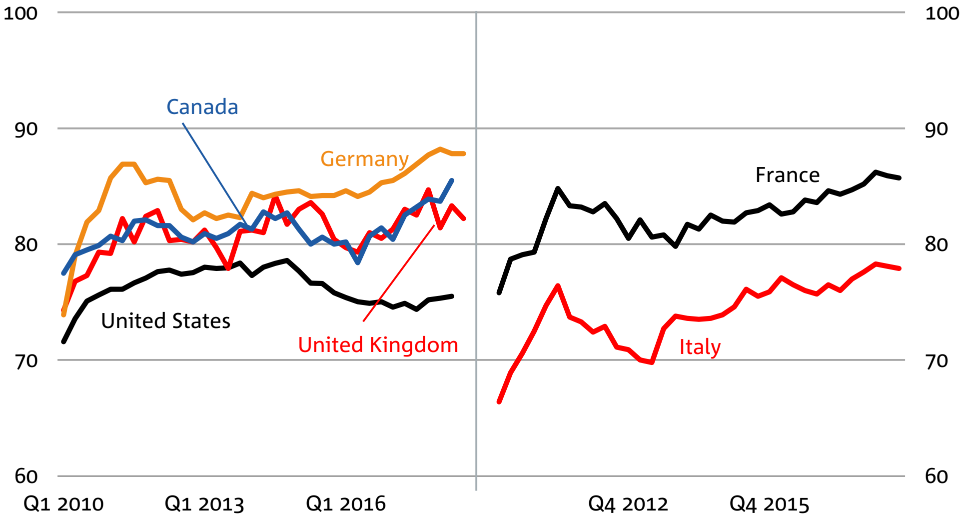
Labour conditions tight in many key economies

Advanced economy harmonised unemployment (%)



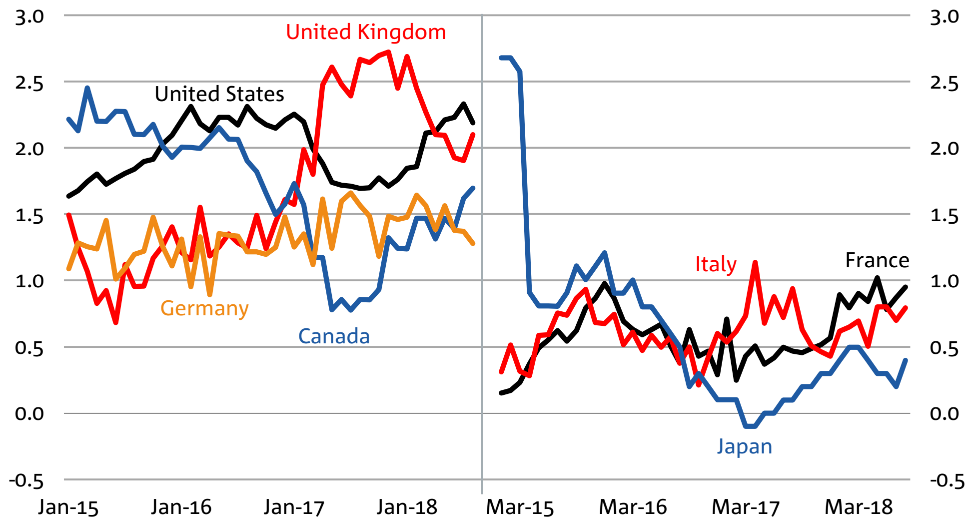
Idle production capacity is diminishing in most markets

Advanced economy capacity utilisation (%)



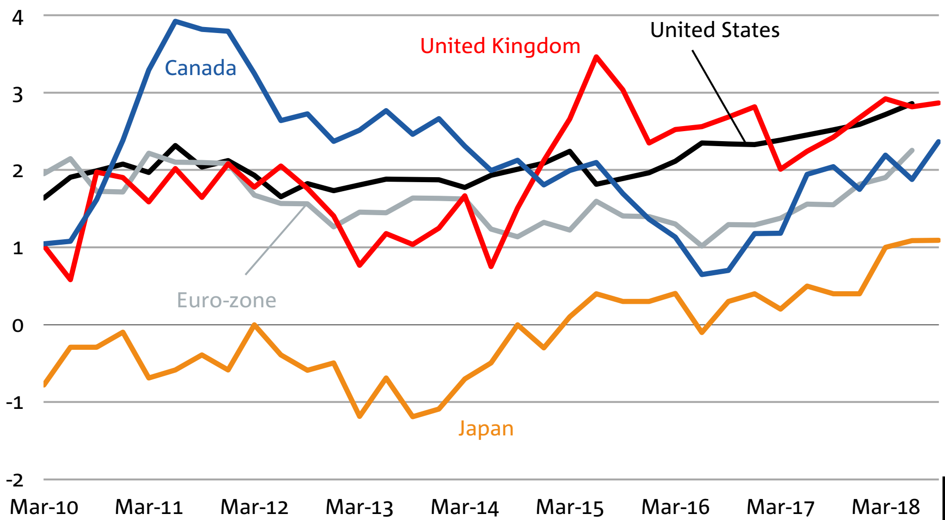
Inflation tracking higher, most notably in US & UK

Advanced economy core inflation (% yoy)



Wages starting to rise, fuelling inflation pressures

Advanced economy wages (% yoy)



 Sources: OECD, Datastream, NAB Economics

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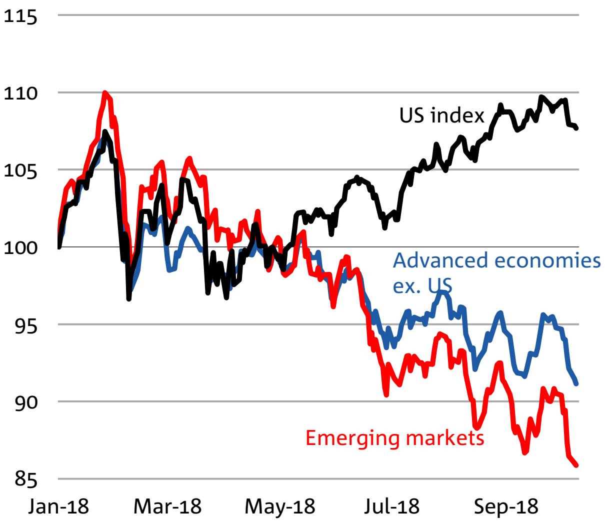
FINANCIAL AND COMMODITY MARKETS

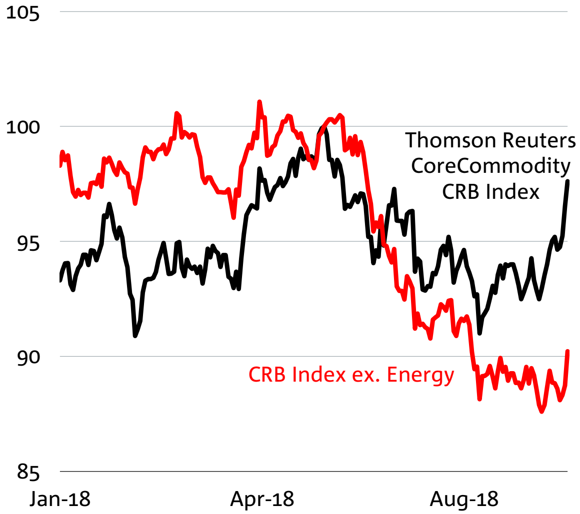
Market trends are diverging, as policy rates have started to rise

DIVERGING TRENDS IN EQUITY AND COMMODITY MARKETS

MSCI Equity Indices (1 Jan 18=100)

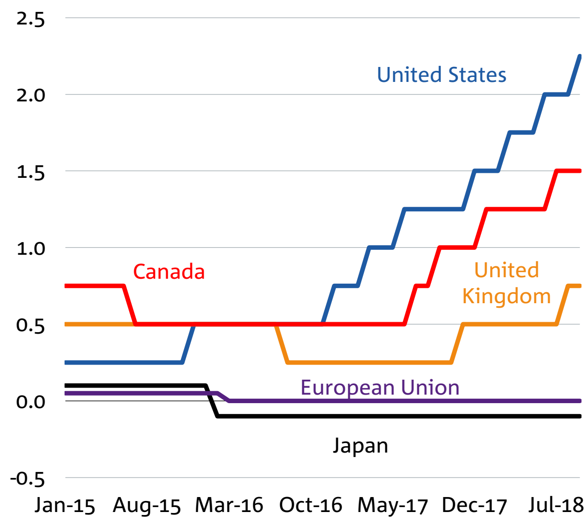


Commodity indices (23 May 18 =100)



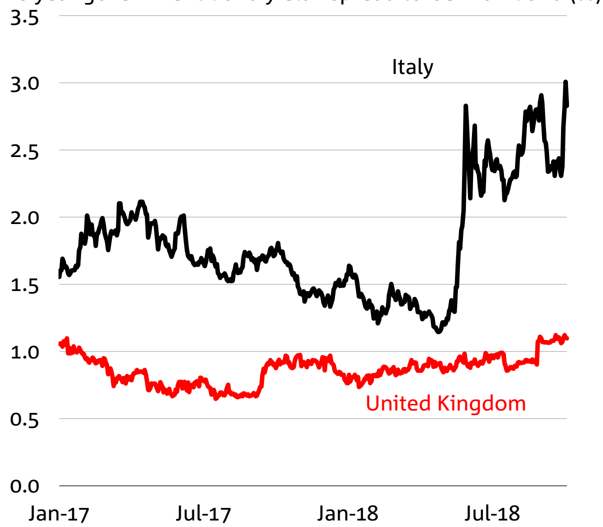
US LEADING AE POLICY RATE RISES

Advanced economy central bank policy rates (%)



WIDENING EUROPEAN BOND SPREADS

10 year government bond yield - spread to German bond (%)



- Trends in financial markets have diverged in recent in months 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% and 22% respectively between their late January 2018 peaks and 9 October, well in excess of US dollar appreciation over this period. In contrast, the US equity index was broadly unchanged over the same period (having corrected then recovered since April), although as we write there has been a large sell-off in US equity markets overnight.
- Similarly, commodity price trends have diverged in recent months. The aggregate 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. Excluding energy commodities, this index has remained weak – down around 10% from late May – with base metals falling in response to the escalating US-China trade dispute.
- Constraints to advanced economy growth are building – as noted above – with inflation increasing as spare labour and productive capacity is eroded. Central banks in several key markets – led by the United States – have raised rates, with the US Federal Reserve hiking as expected in September. The Bank of Canada is considered likely to raise rates again at its meeting 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 asset purchases during Q4 2018.
- Policy rate increases – particularly in the United States – have increased pressure on emerging market central banks. EM economies are facing increased scrutiny, as their currencies come under additional pressure (with the MSCI EM Currency Index down 7.4% from its April peak at the time of writing – a little higher than the trough in early September). In particular, Argentina and Turkey have come under pressure – forcing their central banks to drastically increase rates.
- In Europe, fears persist around the outlook for both the United Kingdom and Italy. The outcome of negotiations around Brexit is highly uncertain, and the likelihood that the UK could leave the European Union without a trade and diplomatic deal in place has increased. In Italy, the populist coalition government has produced a draft budget that may breach EU fiscal requirements. Italy has the second highest debt to GDP ratio of any EU economy (after Greece), and widening bond spreads highlight market concerns.

Sources: Datastream, Bloomberg, NBER, NAB Economics

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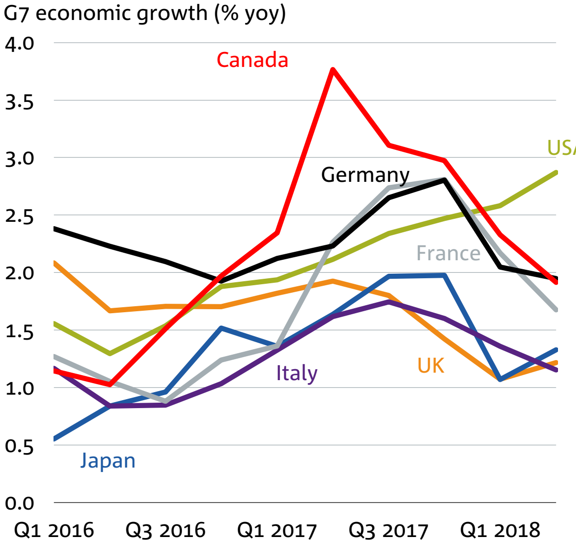
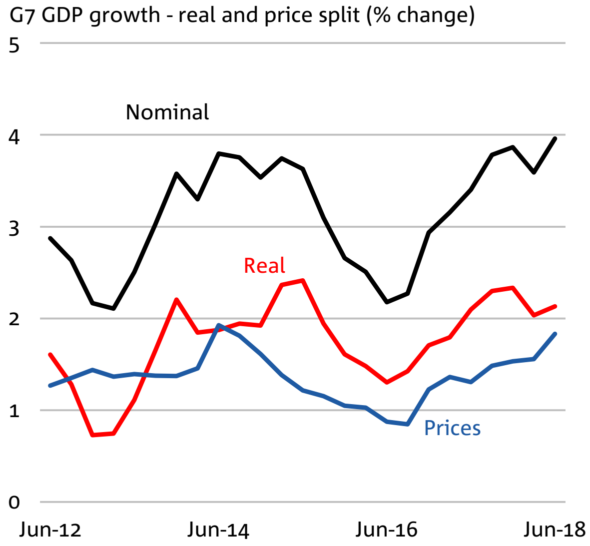
ADVANCED ECONOMIES

Economic trends are diverging as constraints start to mount

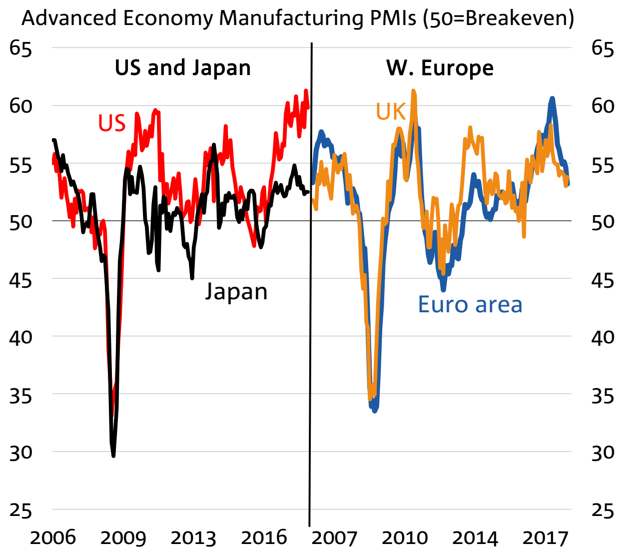
US DRIVING AE STRENGTH



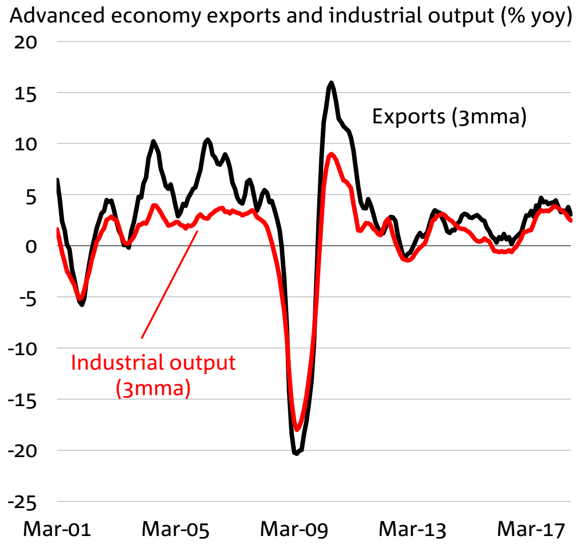
INFLATION PRESSURE RISING



MFG MEASURES FALLING OUTSIDE US



TRADE VOLUMES RETREATING



Sources: Datastream, NAB Economics

- 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. In year-on-year terms, the seven largest advanced economies grew by around 2.2% in Q2, marginally above the rate in Q1, but below the recent cyclical peaks across the second half of 2017.
- The United States, 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.
- As noted above, constraints in the advanced economies are growing – as stocks of idle labour and productive capacity have been eroded. Inflation has been rising and central banks (with the main exceptions of the European Central Bank and Bank of Japan) are gradually tightening monetary policy. Interest rates remain historically low across the major advanced economies – and so supportive of above trend growth – but this tailwind is set to reduce in coming years.
- A key uncertainty to the outlook for advanced economies is the impact of current trade tensions. Business surveys point to some weakening in advanced economy manufacturing – albeit this weakness sits outside the United States. It is worth noting that PMI surveys of the services sector remain strong in advanced economies – particularly in the United States (which in September recorded its highest reading since January 2004).
- It is still too early to see a clear impact from trade tensions on export volumes – as aggregate data for advanced economies is only available to July (the initial month of US-China tariff measures). That said, there is evidence of a slowing in volume growth – with increases of just 3.1% yoy (on a three month moving average basis), compared with a trend of around 4% yoy between Q2 2017 and Q1 2018. Growth in industrial output has also slowed over the same period.
- Uncertainty around the global trading environment remains a downside risk. The current dispute could impact business confidence, disrupt supply chains or delay business investment – factors that could slow economic activity.

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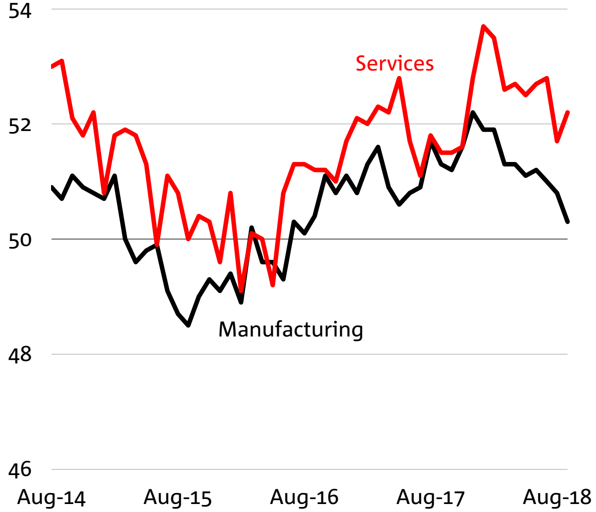
EMERGING MARKET ECONOMIES (EMES)

Concerns mounting despite strong recent growth trends

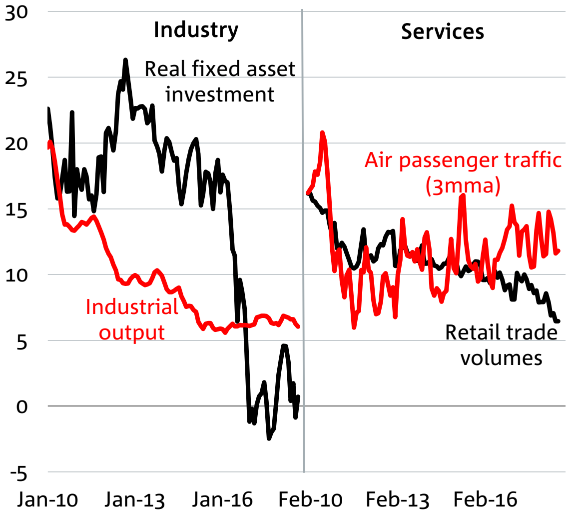
PMI SURVEYS DETERIORATING

Emerging market PMI (Breakeven = 50)



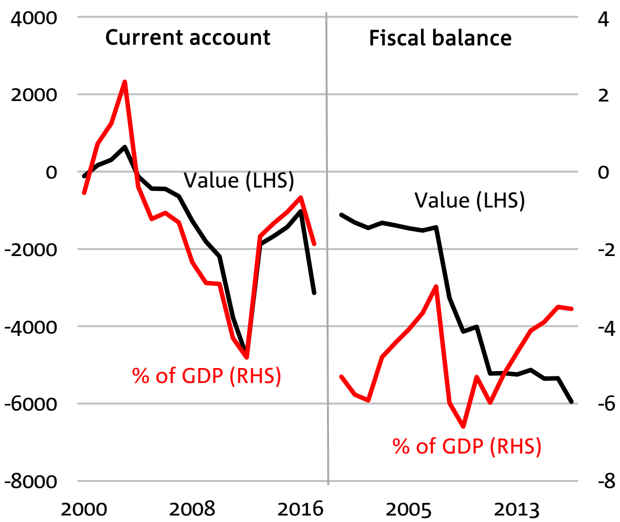
SOFTER CHINESE INDICATORS

Chinese monthly economic indicators (% yoy)



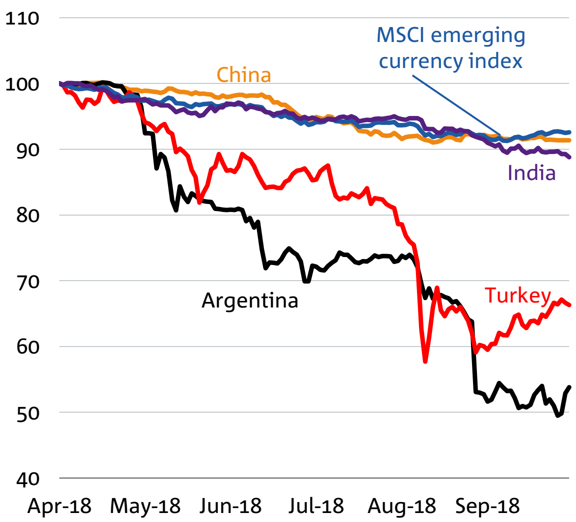
INDIA'S TWIN DEFICITS

Indian Rupees (billion) % of GDP



EM CURRENCIES UNDER PRESSURE

Emerging market currency indices (to US$) (3 April 18 = 100)



- Concerns around conditions in emerging markets have grown in recent months, as trade tensions have risen. Although growth in the big emerging markets 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 – down to 50.3 points in September. Similarly, services PMIs have fallen sharply in recent months as well (although there was a modest uptick in September).
- China has been the main driver of these weaker survey results – in line with a softer indicators across a range of sectors. 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 – increasing the capacity of its banks to lend to firms. This was the fourth cut this year, however earlier cuts were more targeted (aimed at repaying debts to the central bank and boosting lending to SME firms impacted by deleveraging), whereas this appears to be direct monetary stimulus.
- India's growth in Q2 was boosted by base effects – with conditions in the same period in 2017 comparatively weak. Growth is expected to ease a little in the next few quarters (as those base effects fade), however there are some growing concerns related to vulnerabilities, such as the sizeable current account and fiscal deficits and exposure to higher oil prices. These factors have not been helped by the Indian Rupee, which has fallen by almost 15% since the start of January.
- We are yet to see a clear impact of US tariffs in emerging market trade data – although this data is only available up to July (when the first round of tariffs were introduced). In three month moving average terms, EM export volumes accelerated slightly in July – up by 4.1% yoy (compared with 3.5% yoy in June), however this remains well below the trend rate recorded between Q1 2017 and Q1 2018 (5.0% yoy).
- 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. This is likely to constrain growth going forward.

Sources: Datastream, CPB, IIF, NAB Economics

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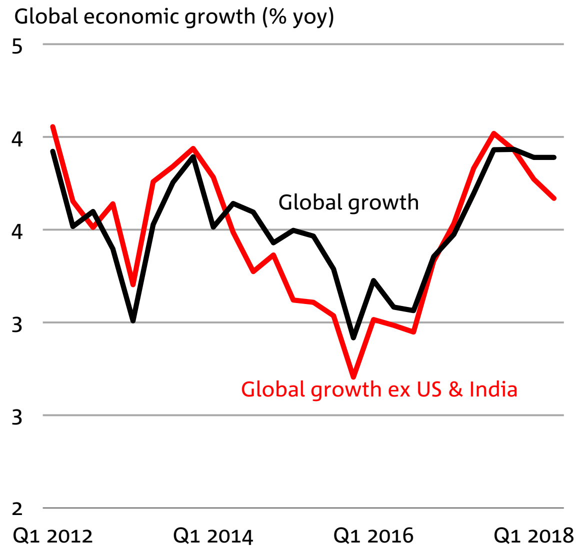
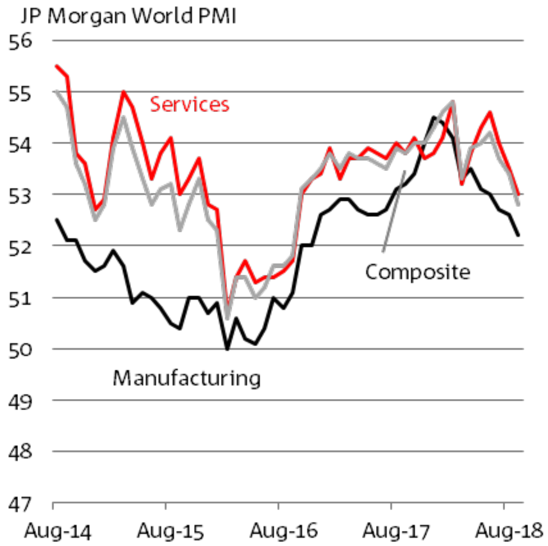
GLOBAL FORECASTS, POLICIES AND RISKS

Global growth still solid but is slowing

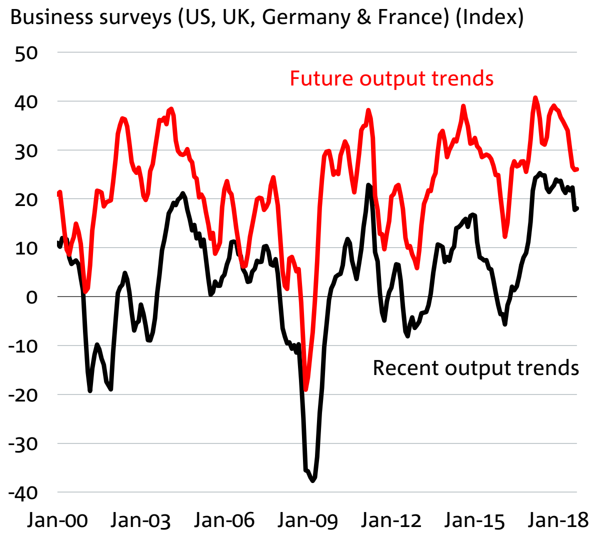
GROWTH MORE NARROWLY BASED



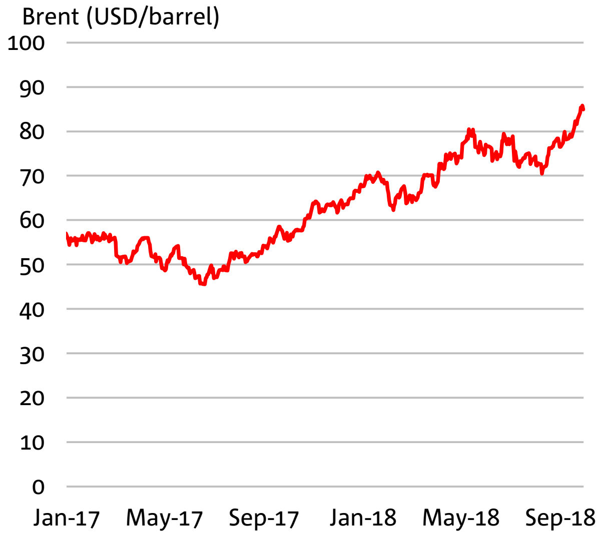
BUSINESS SURVEYS DOWN



FUTURE OUTPUT DOWN BUT SOLID



OIL PRICE RISE A HEADWIND



- 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, with headline global growth in 2018 being supported by the acceleration in the US and India. Outside of these two countries, growth has clearly decelerated.
- This appears to have continued into the second half of 2018, reflected in further declines in the Global PMI. 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, and similarly our leading indicator (page 1) sees growth declining in Q3 but then stabilising in Q4.
- Moreover, while the US is set for another strong result in Q3, Indian growth is likely to come off as the rebound from last year's national GST fades. The tightening in monetary policy settings across advanced and EM economies (albeit only gradually for the most part), acute financial stress in some EM economies, the impact of the latest round of US/China tariffs and rising oil prices are all headwinds to growth. Over time, the stimulus from US fiscal policy will also fade and supply constraints will increasingly bite.
- Reflecting these pressures and the recent data flow, we have eased our global growth forecasts. We now expect global growth of 3.7% in 2018 (previously 3.8%), 3.6% in 2019 (previously 3.7%) and 3.5% in 2020 (its long-term historical average).
- Trade tensions and risks around emerging markets are downside risks to these forecasts. That said, markets reacted calmly to the 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.

Sources: Datastream, NAB Economics

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Australian Economics and Commodities

Gareth Spence
Senior Economist – Australia
+(61 4) 36 606 175

Phin Ziebell
Economist – Agribusiness
+(61 4) 75 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

International Economics

Tony Kelly
Senior Economist
+(61 3) 9208 5049

Gerard Burg
Senior Economist – International
+(61 3) 8634 2788

John Sharma
Economist
+(61 3) 8634 4514

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836