November 2018

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

While global growth remains above average, GDP data for Q3 point to a slowdown in the second half of 2018. Business surveys also indicate a slowdown is underway, particularly in manufacturing. The divergence in growth rates between the major economies that emerged in the first half of 2018 has carried over into Q3 - the US economy posted another strong result, while Euro-zone growth slowed noticeably and Japan's economy went backwards (partly reflecting temporary factors). Growth in the major emerging market economies also likely slowed in the quarter. Financial market volatility has also lifted with large falls in equity markets. We expect above average global growth in 2018 at 3.7%, slowing to 3.6% in 2019 and 3.5% in 2020 (the long-term historical average). This expected slowdown is driven by advanced economies as US fiscal stimulus fades, monetary policy tightens and supply constraints bite. The US-China trade dispute is a potential headwind to growth; especially if there is further escalation.

- **Commodity prices** have fallen since early October, largely driven by falling oil prices, as exemptions to US sanctions on Iran have eased supply concerns.
- **Financial markets** have come under pressure. In particular, global equity markets fell considerably across much of October – continuing a downward trend that has been evident for some time in both emerging markets and advanced economies excluding the United States. However, US markets also corrected in October – almost erasing the gains recorded in 2018. Market volatility measures such as the VIX also increased.
- The divergence in growth rates between the major **advanced economies** that emerged in the first half of 2018 has carried over into Q3. The US economy posted another strong result and, while there was some improvement in the UK, Euro-zone growth slowed noticeably and Japan's economy went backwards. Some temporary factors contributed to the weakness - typhoons and a major earthquake in Japan and German auto sector production delays. However, in the Euro-zone, Italy's economy also weakened, and this may persist as the tighter financial conditions caused by the Italian government's budget dispute with the European Commission continues. While we expect advanced economy growth to stay above trend for now, it will likely slow over-time. US fiscal stimulus is set to fade, monetary policy is gradually being tightened and, with low unemployment rates across many countries, supply constraints will increasingly bite.
- Economic growth in the major **emerging markets** likely slowed in Q3 – driven by weaker growth in China and a probable slowing in India's growth. China's economic growth slowed to 6.5% yoy in Q3 its slowest rate since Q1 2009, with the deleveraging program the major driver of this trend. That said, trade could have a growing impact over coming quarters as the full effects of recent tariff increases emerge. After deteriorating for much of this year, EM financial markets have recently shown some signs of stabilising, but are likely to keep coming under pressure from US monetary policy tightening (which has been a factor behind EM central banks increasing rates, on average, this year).
- **Global economic growth** has been steady over the four quarters to June 2018 – at around 3.9% yoy – but available GDP data for Q3 point to a slowdown in the second half of the year, and an increasing divergence between the performance of different regions and countries. Monthly world trade and industrial production data (to August) also point to a slowdown, with growth rates off recent peaks. The trade data have improved a little in recent months, but this may be due to attempts to get ahead of US/China tariff increases. Business surveys also point to a slowdown in world manufacturing. However, while the surveys also suggest there has been a slowdown in the much larger services sector, albeit modestly and there are some tentative signs that those trends may be readings stabilising. This is also the message from our global leading indicator which is pointing to growth slowing before stabilising in early 2019.
- **Upside risks** to the outlook include a stronger than expected bounce-back from the temporary factors weighing on Euro-zone and Japan growth and current US strength may persist for longer than expected. The recent fall in oil prices is also a welcome development if sustained. On the **downside**, there is a risk of further escalation of the US-China trade dispute, which could be expected to cause a deterioration in business sentiment. Moreover, the ability of Chinese policy measures to offset the negative impact of recent US-China tariffs is unclear and uncertainty with China's economic policy is at high levels. As central banks tighten policy, another risk is that they go too far; especially the Fed as its policy actions can affect financial conditions in other countries, particularly EMs.

For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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***Australia:** We have not changed our assessment of the underlying trends in the Australian economy. Following the strong growth of early 2018 we expect economic growth to slow a little over the next two years. However, we think the strength in the economy will still be enough to see the labour market hold onto recent gains, and for the unemployment rate to decline further from the 5.0% reached in September/October – a 6-year low. Recent data have largely confirmed that spare capacity is falling and that wage growth is beginning to moderately lift. As has been the case for some time, we expect the inflationary impacts of this erosion in spare capacity to emerge only gradually. Indeed, the Q3 CPI confirms we are starting from a below target position at around 1¾% on the core measures. With these trends heading in the right direction, we have left our call on the first move in interest rates unchanged but remain firmly of the view that this is highly data dependent. Even with robust growth, the labour market tightening and evidence of a modest pickup in wage growth, the RBA will want to see firm evidence of higher wages growth feeding through to inflation before adjusting rates.*

- Key data on the **business sector** are now a little dated, but the ABS Capex survey, business profits and national accounts releases later this month will provide an update on the trends for business investment and activity. The more timely **NAB Monthly Business survey** suggests that the sector may have lost some momentum through the middle of 2018 with business conditions having declined some way from their highs earlier in the year. Nonetheless, business conditions remain well above average, suggesting that despite the slowing, growth likely remains favourable in the sector. Capacity utilisation has remained relatively high and capex has stabilised at an above average level. Against that, confidence has weakened to below average levels and forward orders – our best read of domestic demand – only just remains above average.
- The recent run of housing data has confirmed that conditions in the **housing** sector have continued to cool. The Core Logic capital city hedonic house price index fell 0.6% in October to be down 5.0% over the year. Sydney and Melbourne declined by 0.7% and 1% respectively to be down 8.4% and 6.3%, respectively over the year. Prices in Perth are also down 2.9% over the year, having weakened again in 2018 after a period of stabilisation. The other capitals have held up – with Adelaide and Brisbane up marginally over the year; Hobart remains the outlier, up 9.7% over the year. On the activity side, building approvals are now clearly trending down but remain elevated. This signals some downturn in the construction cycle, but with the pipeline of work yet-to-be done still high, we expect only a small decline in dwelling investment over the next 2 years.
- Our outlook for **consumption** remains weak with historically weak wage growth, high levels of indebtedness and to a lesser extent some anxiety over slower growth in household wealth. While consumption was stronger than expected in H1 2018, retail sales volumes grew by only 0.2% in the September quarter. While the national accounts measure captures a broader spectrum of household spending, this suggests some downside to the likely print. An update on the **NAB Cashless retail sales index** will be released next week, which will provide an early indication of momentum in the 4th quarter.
- The **labour market** continues to show a healthy dynamic. Employment has continued to grow at a trend rate of 25-30k per month over recent months and is in line with mapping from the NAB business survey and our other big data indicators. The unemployment rate declined to 5.0% in September and held its ground in October, suggesting that the recent step down is genuine. The labour market appears tightest in NSW and Vic where trend unemployment rates are close to the 4.5% mark. Wage data (surveyed a little earlier than the most recent falls in the unemployment rate) suggest that the pace of wage growth has begun to lift, though as expected has been gradual. Over the year to September, the WPI rose by 2.3% (private sector: 2.1% and public sector: 2.5%). We expect these trends to continue, with our forward looking indicators (and our forecasts) pointing to further growth in employment and falls in the unemployment rate. As spare capacity in the labour market is reduced, wages growth should lift and eventually feed through to faster inflation – though this dynamic remains the swing variable for the path of monetary policy.
- The **trade surplus** widened in September (and was upwardly revised for August), with ongoing LNG export growth. Monthly trade data for the three months to September, taken together with the quarterly trade prices release, suggest that net exports will contribute 0.2% to growth in Q4. We expect exports to continue to rise over the next year or so, as the last of the large LNG projects reach production capacity before levelling off.
- Prices for **iron ore** have moved above their 6-month range to around $75 per tonne – strengthening demand from China ahead of winter shut downs has boosted the price while going forward, any Chinese infrastructure stimulus on the back of US-China trade tensions should provide further support. **Coal prices** have generally held at high levels. **Oil prices** have fallen on easing supply concerns. The **NAB Rural Commodities Index** rose 1.8% in October, following a 6.5% jump in September.
- Our **USD/AUD** model continues to suggest a fundamental value estimate around US74c. We expect the pair to trade nearer to the US71c mark for the rest of 2018 with some ongoing uncertainty over global trade policy and some further EM strain seeing bouts of risk-off sentiment.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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