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THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Global growth continued slowing into Q4 last year – with China and the Euro-zone leading the way lower, while growth in the United States is expected to have come off its 2018 highs. Early indicators point to a further softening in the global economy into early 2019. Given the softer economic conditions, expectations around major central bank monetary policy has become more dovish, helping to reverse some of the deterioration in financial conditions that occurred in late 2018. Our forecasts for global growth have been revised marginally lower in 2019 – down to the long term trend rate of 3.5% (from 3.6% previously). Slower growth in the US, the Euro-zone and China are the key drivers of this trend. We expect growth to stabilise at this level in 2020, partly as a result of a dovish shift in policy.

- The impact of the slowdown evident in the global economy, as well as ongoing uncertainty around the US-China trade relationship and Brexit, continues to reverberate around **financial markets**. Our composite measure of advanced economy stock markets as the end of January was still around 8% below its end-September 2018 level. The stress in financial markets that emerged late last year was not limited to equities; credit spreads and measures of financial market volatility also rose. **Commodity markets** have generally been less impacted apart from oil prices which also fell in late 2018, although partly due to supply factors.
- Overall measures of financial conditions deteriorated in late 2018/early 2019, although they have stabilised recently and have partially recovered. This was in part due to a lowering in expectations of **central bank** tightening, which has contributed to a large decline in government bond yields. The Fed, which as recently as its December meeting was still flagging gradual rate rises, removed its bias towards raising rates in January, instead indicating that it would be patient. We don't expect any rate hikes by the Fed this year, and markets have gone even further with pricing suggesting the next move is most likely a cut. This will be a relief to Emerging Market economies, which came under pressure earlier in 2018, in part due to the pressure on capital flows from rising US rates.
- There was a broad based slowdown in economic growth across the **major advanced economies** last year, with the US being the major exception as growth accelerated. Over 2019 we expect US growth to slow due to a fading fiscal policy boost and the deterioration in financial conditions in late 2018. Euro-zone GDP growth has slowed to its lowest level since 2013 (and the Italian economy has fallen into recession) due to a combination of factors. As some of the more temporary headwinds fade, Euro-zone growth is expected to recover somewhat – particularly given still easy monetary policy settings and an expected fiscal boost. The recovery in Japanese GDP in Q4 disappointed after the natural disaster affected Q3, and growth over 2019 and 2020 will be held back by the impact on Japan's trade flows from the slowdown in global growth and the planned October 2019 VAT increase.
- In **emerging market economies** there are highly divergent trends between the more trade-exposed manufacturing space and the more domestic-oriented services sector. Emerging market manufacturing has deteriorated since its peak at the end of 2017 and turned negative in January 2019. The US-China trade dispute has contributed to weaker manufacturing survey results in China, but more general weakness in trade activity has impacted conditions in both Indonesia and South Africa. In contrast, services PMIs have remained relatively strong. **China's** economy slowed in Q4 2018 to 6.4% yoy, its equal weakest rate since 1990. This was largely related to the deleveraging program that limited new credit issuance during the year. So far, stimulus has been limited when compared with earlier episodes, and further slowing is anticipated this year. Emerging market financial conditions have improved in recent months, with sovereign credit default swap spreads easing and EM equity prices rising as have EM currencies overall.
- The data available for Q4 **global economic growth** has generally been weaker suggesting a continuation of the modest slowing trend that has been evident across the year. Early indicators point to a softer start to 2019, with manufacturing surveys weaker across both advanced and emerging markets and services while advanced economies led the softer services results. Our leading indicator also points to a further weakening in economic growth across the first half of 2019. Our forecasts for global growth have been revised lower in 2019 – down to the long term trend rate of 3.5% – but remain unchanged for 2020, also at 3.5%. Upside risks to the forecasts include the possibility that the impact of the US fiscal stimulus may be more persistent than expected, while lower oil prices are a positive for energy importing nations. In contrast, the upturn in financial market volatility, and the continuing uncertain trade environment could further impact confidence and investment.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: While we have fine-tuned some of our near term growth forecasts – to include weaker than expected private consumption and net exports in Q4 2018 – we have fundamentally not changed our GDP forecasts. We expect growth over the next two years to be supported by government spending (infrastructure and NDIS), growing commodity exports and private business investment. Against that, we expect consumption growth to weaken and dwelling investment to fall. Indeed both our Business survey and internal NAB data point to continued consumer weakness in the early part of 2019. Overall our key forecasts remain unchanged with GDP growth of 2.4% in 2019 and 2.2% in 2020 – with a more marked slowdown in the through the year numbers (2.7% and 2.2% respectively). Our outlook for the labour market and inflation are broadly unchanged. The most significant change to our forecasts this month is the outlook for interest rates. We no longer expect the RBA to increase rates in H2 2019, and expect rates to remain on hold with growth slowing but the labour market still tightening and inflation and wage growth beginning to lift. However at face value, our forecasts imply a cut is necessary in order for the RBA to provide some additional support to the economy that would see better outcomes on the growth and labour market and a faster return to the inflation target with the risk of overshooting very low and financial stability concerns having faded. Further, it appears that over the past few months, risks to our forecasts have either materialised or shifted to the downside. Should labour market conditions deteriorate in these circumstances, the RBA will likely act sooner - rather than later - to lower the cash rate.

- With most official **business indicators** now dated, the NAB Monthly and Quarterly Business Surveys have been the key news around the business sector. While conditions in the monthly survey have showed some seasonal volatility, the surveys point to a loss in momentum in the business sector with a relatively sharp decline over the past 6 months. Given the high starting point, conditions, confidence - and forward orders – are still around long run average – i.e. reasonable – levels. The declines in conditions have been broad-based across industries and states, with retail having shown a significant deterioration. A big issue going forward is whether the current strength in the labour market is a reflection of previous strength in activity in mid 2018 – ie lags. It was however notable that the latest reads for conditions did not improve in NSW and Victoria and remains very depressed in retail.
- The falls in **house prices** appear to have sharpened over recent months and the impact on housing related activity is becoming more evident. Sydney has now declined 12% from the peak in mid-2017 while Melbourne has fallen by 8% from its respective peak in November 2017. Price declines in Perth have also accelerated after prices had shown some signs of stabilising earlier in 2018. Prices in Brisbane and Adelaide have been flatter. While dwelling investment held up in Q3 (supported by alts & ads), we expect a relatively sharp decline – of around 20% in the next two years. Indeed, building approvals have declined sharply over the past year, with a particularly sharp fall in approvals for apartments; house approvals have also declined but less sharply. While there is a large outstanding pipeline of work due to the prior run-up in approvals, this decline in approvals could be expected to feed through to investment over the next year.
- **Labour market** conditions remain strong with the unemployment rate ending 2018 at 5.0% - around 0.5ppt lower than the beginning of the year. Employment grew strongly in 2018, rising by 270k, 60% of which was on a full-time basis. Forward looking indicators point to ongoing employment growth, though a recent softening suggests the pace may slow somewhat. The NAB Monthly Business survey continues to point to employment growth of 19k+ per month, which would be enough to see the unemployment rate decline further, albeit at a very gradual rate. We expect unemployment will edge lower in the first half of 2019 but then flatten out over the remainder of the forecast period (end 2020).
- With **wage growth** having remained relatively low despite recent gains in the labour market, it appears the true level of full employment may be a little lower than previous estimates. Nonetheless, with the improvement to date, and increased reports of difficulty in finding suitable labour, we expect wage growth to rise gradually from here, reaching around 2.5% in late 2020.
- The monthly outcomes for the **trade** surplus, taken together with quarterly trade prices, suggest that in real terms exports were relatively weak, while imports increased moderately. That is, a good deal of the Q4 trade surplus reflected price effects. Indeed, it appears net exports will subtract around 0.3ppt from growth in the December quarter. We expect exports to continue to rise over 2019, with the ramp-up of LNG production.
- Prices for **iron ore** have risen to around $90 per tonne on the back of a lower supply outlook with the iron ore closures in Brazil. Consequently we have revised up our forecasts for 2019 and 2020 to around $82/tonne. **Coal prices** have generally held at high levels and we have revised up our forecasts for both thermal and coking coal. **Oil prices** eased considerably late last year, but have come back a little in the new year. Brent has generally traded in the low-US$60s range over the last month, while WTI has been in the low-mid US$50s over the period. 2019 has seen a fairly tough start for agriculture amid the hottest January (nationally) on record and a lack of rain across much of the country.
- The **AUD/USD** has traded down to below 0.71 cents at present from around 0.74 cents at the start of December. The move lower has come against the backdrop of a generally firmer US dollar and latterly, the shift in RBA rhetoric that has heightened expectations the next move in the RBA's Cash Rate could be a cut.
- For more detail on the Australian outlook, please see the <u>Forward View – Australia</u>, released on Wednesday.

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