NAB CHANGE IN CASH RATE CALL FEBRUARY 2019

NO INCREASE FOR THE FORESEEABLE FUTURE – INCREASED RISK OF CUT

NAB Group Economics

- **We have removed our expectation for a rate rise in late-2020 and now expect the cash rate to remain on hold over the forecast horizon. While our central case is for the cash rate to remain on hold, based on the balance of risks, the next move could well be down - potentially as soon as H2 2019.**
- **While labour market conditions have been positive, inflation remains meek – with little global and domestic inflationary pressure at present. Growth was solid through the first half of 2018 but has slowed in H2 2018, with a weak GDP print in Q3, and high frequency indicators pointing towards a similar outcome in Q4. Further, our internal data points to a soft start in 2019 with retail sales still weak and business conditions trending lower, though not as dramatically as suggested by the December NAB survey.**
- **We have not materially changed our forecasts for growth and still see the outcomes as broadly around trend (Note: NAB's view of trend is 2¼ to 2½%, lower than the RBA's). We see a final outcome of 2.9% y/y for 2018 GDP growth (Q4 GDP of 0.4% q/q) with growth slowing to 2.4% y/y in 2019. Wage growth is expected to pick up gradually but remain low with only modest further gains on the unemployment rate from here.**
- **We expect house prices to continue to decline in Sydney and Melbourne but to do so in an orderly fashion. We see the risk to households driven by a number of other headwinds, namely weak income growth, and at this point see little evidence of large negative wealth effects. We have, however, factored in a relatively sharp decline in residential building activity related to the cooling in the housing market.**
- **With inflation remaining weak and growth weaker than the RBA expected, the risk is that the Bank will act to bolster the economy should the labour market show any signs of deterioration or consumer spending weaken further.**

Late last year we delayed our expectation for the first cash rate increase to late 2020. At the time our view was that projections pointed to the next move being up, rather than down. Ongoing above trend growth and further tightening in the labour market were expected to see momentum in wage growth build. Inflation had remained low – largely based on one-off factors - but could be expected to increase based on stronger growth in domestic labour costs. This process was expected to be gradual, and the RBA was seen to be more patient than previously expected – even with conditions in the labour market quite healthy and likely to be supported by ongoing above trend growth.

The risks around this outlook have shifted to the downside. The weakness in consumption we have been concerned about appears to have materialised, with the December quarter looking as weak as Q3. Official retail sales point to a weak outcome on the goods side, while our own data suggests services are also likely to have weakened. Further, the NAB monthly business survey points to a significant loss of momentum in the second half of 2018 across almost all industries, though not quite as significantly as suggested by the December survey. Retail sector profitability has been particularly impacted. Global risks have also risen, with slower growth expected in advanced economies, while uncertainty over the US-China trade war has continued.

Overall NAB's outlook for growth and inflation is broadly similar to late last year and at face value suggests a rate cut, with growth falling to below trend in the back end of 2020 and core inflation returning to the bottom of the target band after an extended period below. However, our outlook for the labour market is still positive. Despite growth slowing, we expect enough ongoing employment growth to see the unemployment rate edge down a little further before levelling out. While it appears the level of full employment is now slightly lower than 5%, an outcome around this level would historically be a good outcome and the lowest level since the lead up to the GFC.

Growth will be supported by ongoing strength in government spending – including the NDIS rollout, infrastructure investment and defence spending. Also private business investment is likely to improve while resource exports will ramp up as the last of the LNG-mega projects come on stream. Further the drag from falling mining investment is likely to wane and actually reverse as some new projects begin in coming years. Finally the upcoming election budget will no doubt see some additional spending announcements.

Against that, private sector consumption will continue to weigh on growth, with consumers still facing a number of headwinds. In particular we see ongoing slow wage growth, falling savings rate, high debt levels

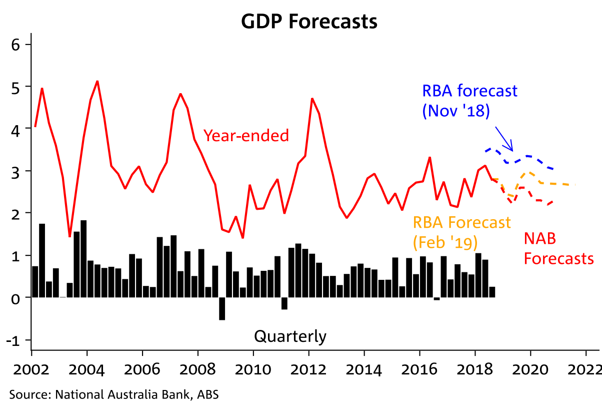
Contacts: Alan Oster – Chief Economist
© National Australia Bank Limited ABN 12 004 044 937 AFSL and Australian Credit Licence 230686

and falling house prices as ongoing headwinds. While there is very limited evidence, as yet, of a significant negative wealth effect of house prices, lower prices clearly will not help. Beyond the turnover-related slowdown in retailing of household goods already in evidence, we also expect a pronounced downturn in the residential construction cycle. We expect dwelling investment to fall by almost 20% over the next two years , a much larger peak-to-trough decline than the RBA's outlook.

As always, any action from the RBA will be highly data dependent. While there are signs of a slow pick-up in inflation and the outlook for the labour market remains positive – arguments against cutting the cash rate further, there is growing weight to the argument that a reduction in the cash rate would allow for even better outcomes on both inflation and growth and see a faster return of inflation to target. Financial stability constraints – specifically the concern that households are simply running up debt too quickly - no longer seem to require a significant weight in decision making, with dwelling prices declining relatively sharply (though from a high level) and credit growth slowing.

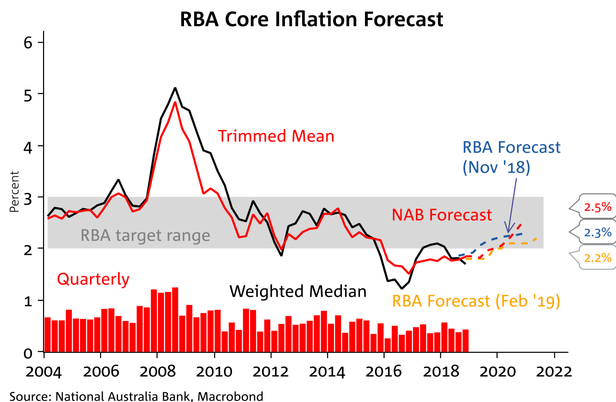
In short, our forecasts raise the question as to why the RBA would not move to give the economy some further support. Certainly any sign of deteriorating labour market conditions or further weakness in consumer spending would likely be enough to see the RBA firm up its assessment that the economy may need further support.

Chart 1: NAB forecasts slower growth



Source: National Australia Bank, ABS

Chart 2: NAB expects a greater lift in inflation



Source: National Australia Bank, Macrobond

AUTHORS

Alan Oster, Group Chief Economist
Ivan Colhoun, Global Head of Research
Gareth Spence, Senior Economist

Group Economics

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Jacqui Brand
Executive Assistant
+(61 3) 8634 2181

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

John Sharma
Economist
+(61 3) 8634 4514

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0) 436 606 175

Phin Ziebell
Economist – Australia
+(61 0) 475 940 662

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
+(61 3) 9208 2929

International Economics

Tony Kelly
Senior Economist
+(61 3) 9208 5049

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

Global Markets Research

Ivan Colhoun
Global Head of Research
+(61 2) 9237 1836

Important Notice

This document has been prepared by National Australia Bank Limited ABN 12 004 044 937 AFSL 230686 ("NAB"). Any advice contained in this document has been prepared without taking into account your objectives, financial situation or needs. Before acting on any advice in this document, NAB recommends that you consider whether the advice is appropriate for your circumstances.
NAB recommends that you obtain and consider the relevant Product Disclosure Statement or other disclosure document, before making any decision about a product including whether to acquire or to continue to hold it.

Please click here to view our disclaimer and terms of use.