June 2019

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

In our view the global outlook has deteriorated. Financial markets hit a pothole in May following an escalation of the US-China trade dispute and the short-lived US threat to raise tariffs on imports from Mexico. More dovish expectations around central bank policy have helped support markets; we now expect that the US Fed will cut rates (by 50bps) over the second half of 2019. The latest data confirm that major AE growth strengthened in Q1 but this is unlikely to be sustained over the rest of the year. Emerging market economies are more trade exposed than the AEs and therefore the increase in trade tensions are a negative for them. We have again lowered our global growth forecasts – to 3.2% in 2019 (from 3.3%) and to 3.3% in 2020 (from 3.4%) as we expect that last month's trade disputes will negatively affect business sentiment and investment. The forecast revision is also consistent with the message coming from our leading indicator of global activity.

- The recovery in **financial markets** that had been occurring over 2019 hit a sizable pothole in May following the escalation of the US-China trade dispute (tariff increases and a ratcheting up of rhetoric) and the US announcement in late May threatening tariffs on imports from Mexico. This led to a fall in major share markets by as much as 6%. The fall in EM stock markets following the renewed trade tensions was even greater than for the AEs and EM currencies also came under renewed pressure, including a depreciation of the Chinese Yuan against the USD.
- Interest rates futures suggest rate expectations have been marked down for all the major central banks. This is particularly so for the central banks with more policy room to move (US, Canada and the UK). On a net basis EM central banks have also recently been easing policy, adding to the shift in AE central bank policy. In the case of the US Fed, we now expect two fed funds rate cuts in the second half of this year – most likely September and December, but with the risk tilted towards earlier cuts and more than two.
- Growth in the **major advanced economies** (AE) strengthened in Q1, as quarterly GDP growth accelerated in Q1 in the US, Japan, the Euro-zone and the United Kingdom (while Canada's growth was essentially unchanged). However, with an escalation of trade disputes in May, ongoing Brexit uncertainty, and the planned increase in Japan's Value Added Tax later in the year, we expect growth to resume slowing over the rest of 2019. This will primarily be driven by the US (where the boost from last year's fiscal stimulus will also fade), with the other major AEs expected to broadly track sideways at a subdued rate of growth.
- Last month we marked down our US forecast to reflect the impact of increased US tariffs on China and we have done so again this month given **escalating trade tensions**. The US-China dispute is expanding to company specific measures/threats and while the threatened tariffs on Mexican imports has been 'suspended' for now, the hit to business sentiment is likely to persist. As a result, trade uncertainty will remain elevated for a sustained period to come. The impact of trade uncertainty will not be quarantined to the US, but will be a drag on global business sentiment and investment. For Europe this is reinforced by the ongoing Brexit drama and a re-surfacing of Italian political risks.
- As **Emerging market economies** (EMs) are far more trade exposed than advanced economies, the increase in trade tensions between the US and China (along with the possible expansion in US trade measures to other countries) are particularly negative for them. Even before the latest trade measures, EM trade volumes have been weak - decreasing in March. This is particularly the case for Asian EMs, and while several economies in this region have increased exports to the United States (trade diversion due to the tariffs on China's exports), these have typically not been enough to offset lower exports to China and elsewhere. More generally, there is likely to be an ongoing negative impact on business sentiment, which could lead to delayed or cancelled investment. Further, India's economic growth slowed considerably in Q1 2019, although we expect recent cuts in interest rates and a post-election recovery in sentiment will support growth.
- Overall **global GDP growth** eased in Q1 2019 to 3.4% yoy, down from 3.5% yoy in Q4 2018. Business surveys suggest that the slowdown continued into Q2 – with manufacturing PMIs turning negative and services becoming less positive. The downturn in manufacturing is linked to the deterioration in global trade. Given the worsening global trade environment, we have revised our forecasts for global growth down to 3.2% in 2019 and 3.3% in 2020 (from 3.3% and 3.4% respectively). Trade policy is the key risk to the outlook; our forecasts assume that existing tariffs remain but don't include new US tariffs. However, we expect trade disputes to remain in the headlines, leading to elevated uncertainty about trading arrangements. There is a clear risk that the US will implement additional trade barriers (e.g. extending tariffs to all China imports), but the situation is fluid and, as the US-Mexico agreement showed, it is possible trade worries could ease.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: The Q1 national accounts confirmed a third weak quarter of growth. Again, the household sector continued to weigh with further slowing in household consumption growth and another substantial decline in dwelling investment. Net exports and public spending offset some of this weakness, while business made a small contribution. Mining investment continued to decline in the quarter while investment in the non-mining sector rose. Looking forward, we have not materially changed our forecasts for 2020 and 2021, for which we see growth of 2¼% – well below trend and restrained by ongoing weakness in the household sector. In the near-term we have downgraded our forecasts, incorporating the weak outcome for Q1 and a softer expectation for Q2 mostly a result of weakness in consumption. Overall, we see through the year growth falling to 1.3% in Q2 and year-average growth in 2019 of 1.7%. Consequently, we see a weaker labour market, with slowing employment growth and an upturn in the unemployment rate – reaching 5.5% by the end of 2021. As a result, wages growth can be expected to remain weak and inflation is now only expected to return to the bottom of the RBA's target band by end-2021. We still see a rate cut in August but would not be surprised by a move in July. In addition, we now see a second cut in the second half of this year, and while heavily data dependent we have pencilled this in for November. We also think additional fiscal policy action will be required to provide a boost to the economy and some risk that should further stimulus be required, that the RBA will turn to a combination of alternative policy tools in early 2020.

- We have changed our view on the **cash rate**, to include an extra cut in late 2019 – while heavily data dependent we have tentatively placed the cut in November. We also think that lower interest rates will be supported by fiscal stimulus later this year. We would not rule out the possibility of alternative monetary action in early 2020, in addition to further rate cuts, if the economy remains very subdued. We still see RBA growth forecasts as optimistic, a large degree of spare capacity in the labour market – and the potential this increases with a deteriorating unemployment rate.
- **Consumption** growth slowed further in Q1. Household spending rose by 0.3% in the quarter to be a modest 1.8% higher over the year. Spending on essential items drove this outcome with spending on discretionary items weakening. Also, services spending again outpaced that of spending on goods. We expect consumption growth to remain weak over the next two years with high debt levels, weak income growth and slower growth in household wealth weighing. Indeed, consumption looks to have remained weak in the June quarter with monthly retail sales growth remaining soft.
- The national accounts showed **business investment** rose by 0.6% in the quarter but is 1.8% lower over the year. Mining investment fell by 1.8%, while investment in the non-mining sector rose 2.0%. By asset, investment in non-residential buildings rose relatively sharply while engineering construction fell 1.5% (consistent with a decline in mining investment) and machinery & equipment spending was slightly lower. The NAB business survey suggests that there are some ongoing risks around our outlook for business investment. Business conditions declined further in May and are now well below average – and only just positive. The decline in conditions over the past year has been broad-based across states and industries, suggesting a wide-spread loss of momentum across the business sector. While confidence rose sharply on the back of the election outcome and firming rate cut expectations, we expect this to be short lived with other forward-looking indicators such as forward orders – now well below average – and capacity utilisation which is a touch below average suggesting that the spike in confidence is likely to be short-lived.
- The rate of decline in **house prices** has slowed in recent months but the housing market is continuing to cool. Prices have fallen further, approvals for both new building as well as financing have fallen, and dwelling investment recorded another substantial fall in Q1. Alongside this, housing credit growth has continued to slow. We expect dwelling investment to fall a further 10-15% of the next two years and a further small decline in house prices through his year before stabilising next year.
- The **labour market** remains healthy but is expected to deteriorate somewhat over the next two years. In May, the unemployment rate was unchanged at 5.2%, despite another solid outcome for employment with the participation rate again ticking up in the month. Employment growth was likely supported by a boost from temporary election employment in the month (also consistent with the tick-up in participation). Indeed, the bulk of employment growth in May was on a part-time basis (+39.8k), while full-time employment rose 2.4k. Going forward we think the slowing in economic activity will lead to slowing in employment demand. This slowing will see employment growth slow to around 1½-1¾% which will likely see the unemployment rate rise to around 5½% over the next two years.
- **Net exports** made a 0.2ppt contribution to growth in Q1. Early in Q2 the trade balance has remained wide, with the high price of iron ore boosting values. Going forward we expect exports to contribute further as the last of the LNG mega-projects ramps up to full production before levelling off as production plateaus.
- Our outlook for **commodity prices** is broadly unchanged; iron ore prices have held up on global supply constraints while coking coal also remains elevated. Thermal coal has trended lower since mid-2018 and more recently oil prices have declined sharply. Base metals have also weakened over recent months.
- The **AUD/USD** has traded below US70c on the back of ongoing trade ructions and expectations of rate cuts by the RBA. We have lowered our forecast for the Aussie over the next few years but expect it to drift up to the mid 70c mark through next year before tracking higher in the out year.
- For more detail on the Australian outlook, please see the <u>Forward View – Australia</u>, released on Wednesday.

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