July 2019

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

After modest improvement in Q1, indicators in major advanced economies (AEs) point to a renewed easing in growth for the rest of 2019, driven largely by the US economy. Emerging market (EM) economic growth also continues to come under pressure. With global growth slowing, the policy outlook has turned more dovish and a reduction in central bank policy rates is likely both across AEs – led by the Fed – but also EM economies, where there has already been some policy easing so far this year. While the resumption of trade talks between the US and China is welcome, with the eventual outcome unclear, uncertainty around trade policy remains elevated and it is likely to be a drag on business investment. Moreover, possible future US trade policy action is not limited to China and there are a range of other risks to the global outlook. We have left our forecasts unchanged this month, and expect global growth of 3.2% in 2019 and 3.3% in 2020. These rates of growth are below par, but not in recession territory.

- Weaker economic growth and the deterioration in manufacturing conditions in recent quarters have impacted global **commodity markets** although conditions are mixed across different sectors. Base metals have continued to soften – largely reflecting the deteriorating conditions in China's manufacturing sector – while iron ore prices have continued to rise because of supply constraints in both Brazil and Australia.
- Following on from the tariff-induced uncertainty in May, equity **markets** have generally trended higher since early June. While this resulted in the US MSCI index reaching record highs in early July, other advanced economies and emerging market equities remain below the recent cycle peak (in January 2018). Financial market volatility declined during the month.
- Markets continue to expect an easing in **monetary policy** going forward. We anticipate two 25bp cuts to the Fed Funds Rate – in July and September. While the European Central Bank has limited ammunition, given rates remain at emergency low levels, we expect a further cut to ECB deposit rates, with the potential for a resumption in asset purchases should additional support be required. Similarly, emerging market monetary conditions have also loosened, led by three 25 bps cuts in Indian policy rates, while China may also seek to ease monetary policy to counter the negative impacts of the US-China trade tensions. That said, the PBoC governor has reiterated the importance of addressing systematic risk – highlighting the competing short and medium-term goals of the country's authorities.
- After modest improvement in Q1, partial indicators in **major advanced economies** (AEs) point to renewed easing in growth in Q2. Growth is expected to slow further in the second half of 2019 as the robust growth seen in the US economy seen over the last year unwinds. US growth will be affected by a fading impact from the 2018 fiscal stimulus, lagged impacts from the tightening in financial conditions last year and trade uncertainty which is depressing business sentiment and investment. The expected slowdown in the US will be enough to drag total major AE growth down as growth for the other major AEs is, in aggregate, expected to broadly track sideways at a modest rate. Despite the slowdown in AE economies, labour markets have held up surprisingly well, although the pace at which unemployment rates are declining has generally slowed.
- **Emerging market** (EM) growth continues to come under pressure. Reassuringly, there has been some improvement in financial conditions this year and net capital flows (ex-China) have generally been positive as well. In China, May data showed some further signs of weakness, with IP and fixed asset investment growth slowing. A key assumption underpinning our China growth forecasts of 6.25% this year and 6% in 2020 is that policy action will broadly offset the impact of the US-China trade dispute. The direction of the Indian economy remains a concern; the composite PMI fell to its lowest level in over a year in June, disappointing hopes of a post-election bounce, and indicating downside risk to our (below consensus) forecasts for Indian GDP growth.
- After having marked down our global growth forecasts over the last two months due to an escalation in trade disputes, we have left our **global growth** forecasts unchanged this month at 3.2% in 2019 and 3.3% in 2020. These rates of growth are below par, but not in recession territory, consistent with the message from business survey outlook indicators. Monetary policy is increasingly becoming supportive which should help stabilise activity despite continued trade headwinds and other factors weighing on activity.
- Trade policy remains a key **risk**. The forecasts assume no further escalation in trade disputes (or improvement). The US-China talks could drag on, breakdown or resolve the dispute – suggesting risks are two sided. Possible US trade action is not limited to China – the US may introduce auto tariffs or target 'currency manipulators' at some point. There are also geopolitical (e.g. Brexit or oil supply disruptions), and US fiscal policy (where action is required to avoid fiscal cuts later this year) risks.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: We have not changed our forecasts for activity, the labour market and inflation this month. Overall, we expect growth to continue at a below trend pace over the next few years. We see growth of 1.7% this year, before a small improvement to 2.3% on a year-average basis in each of the out years. We continue to see the same factors driving the growth outcomes. The household sector is expected to remain weak with modest consumption growth and ongoing falls in dwelling investment. Offsetting this will be ongoing strength in public spending as well as near-term pickup in exports. Business investment is also expected to make a solid contribution. With overall growth below trend, we see a small deterioration in the labour market with employment growth slowing and the unemployment rate rising gradually - seeing a further build-up of spare capacity. As a result, our outlook for inflation remains meek, with core inflation only reaching the bottom of the RBA's target band by end-2021. Consequently, we see a further rate cut in 2019 and think that more work from fiscal policy will be required. We would also not discount the risk of further monetary easing in 2020. The recent run of high frequency data suggests that growth is likely to have remained weak in Q2 with soft retail sales growth pointing to continued weak consumption growth, and continued below average business conditions in the NAB business survey pointing to weakness elsewhere in the economy.

- The RBA cut the **cash rate** by 25bps for a second consecutive month in July, taking the cash rate to a new record low of 1.0%. Based on slower growth, building spare capacity and little constraint from inflation we see the RBA cutting by a further 25bps later this year. Though likely data dependent we have pencilled in November for a further easing to a new low of 0.75%. In addition to the action in monetary policy, the Federal Government's tax package was legislated in early July, locking in around 7½bn of tax cuts in 2019/20. Internal modelling suggests these cuts will provide some support, but are only likely to provide a small boost to activity. For now, the effect of a cumulative three interest rate cuts in our central scenario is likely to provide a bigger boost to the economy but is likely to have a larger impact in 2020 – an unsurprising result given the long and variable lags of monetary policy.
- **Consumption** growth looks to have remained weak Q2. Nominal retail sales increased by a modest 0.1% in May, following a similar sized fall in April. Weak retail sales figures point to another quarter of weak goods consumption in the national accounts, suggesting another overall outcome of around 0.3-0.4% for household spending. We see consumption growth of around 2-2¼% y/y over the next few years with the current household headwinds continuing to persist. Weak wage growth is likely to remain a driver of slow household income growth and, in the face of an already low savings rate and high debt levels, is likely to see household restraint continue.
- The **business sector** appears to have lost significant momentum over the past year. The NAB monthly business survey showed business conditions remained well below average in June despite a small pickup in the month. Over the past year, the weakening in conditions has been broad-based across states and industries. Business confidence unwound its spike in May following the post-election boost to confidence and increased certainty about a new rate cutting cycle. In addition to below average confidence, weak forward orders suggest that conditions are unlikely to turn around in the near term. On a more positive note, capacity utilisation rose sharply in the month, and the employment sub-index rose to around twice its long-run average. While both positive signs, they warrant close watching over coming months to see if these increases are sustained.
- Conditions in the **housing market** appear to be stabilising with auction clearance rates lifting and the decline in house prices slowing over recent months. In June, prices in Sydney and Melbourne recorded their first increases since each city's respective peak in mid-to-late 2017. Outside of the two largest cities, prices appear to have weakened a little. On the activity side, building approvals are around 20% lower over the year, suggesting that there will be a further pull-back in construction activity. Alongside this, housing credit growth has slowed to 3.7% y/y with investor lending broadly flat over the past 5 months. Lending to owner-occupiers has also slowed, but growth remains higher at 5.3% y/y.
- The **labour market** remains healthy, with ongoing strong employment growth. Despite this, a rise in the participation rate in recent months has seen the unemployment rate remain at 5.2% - well above the RBA's current estimate of full employment. The underutilisation rate has also risen slightly in recent months.
- **Net exports** look to make another solid contribution to growth in Q2 following the 0.2ppt contribution to growth in Q1. Monthly trade data show an increasingly wide trade surplus on the back of rising iron ore exports (prices have risen strongly on global supply shortages). In May, there were also modest increases in coal, and to a lesser extent LNG, which saw overall exports outpace the 1.5% rise in imports in the month.
- **Commodity prices** were mixed in the month; iron ore prices have risen relatively sharply on the back of global and domestic supply concerns, while both thermal and coking coal prices have declined. Oil prices continue to be supported by production cuts, but have also faced downward pressure from global growth concerns.
- The **AUD/USD** has continued to trade near the US70c mark over the past month. We expect the Aussie to drift up over the next few years, finishing 2019 around US73c before edging slightly higher in the out year. While the RBA has moved to a new easing cycle, we expect the US economy to slow and commodity prices to remain elevated. In the short-term, volatility is likely to be driven by ongoing trade ructions and global growth concerns.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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