August 2019

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

The latest escalation in the US-China trade war has reverberated through financial markets. The policy response will be important - we now expect two further 25bp cuts in the fed funds rate this year. China is also likely to use policy measures to offset any tariff impact, including allowing further depreciation of its currency. The pick-up in Advanced Economy (AE) growth in Q1 was not sustained in Q2, and we expect AE growth to slow further in H2 2019 before stabilising in 2020. Trade exposed Emerging Markets are struggling, with exports from East Asia falling significantly. We have lowered our 2019 global growth forecast to 3.1% (from 3.2%) but our forecasts for 2020 (3.3%) and 2021 (3.5%) are unchanged. Trade policy remains a key risk and there are also other geo-political risks.

- The US decision on 1 August to further escalate the trade war with China reverberated through **financial markets**. The announcement was for a 10% tariff on remaining China imports starting 1 September, but on 13 August it was announced that the new tariff would be delayed for a range of products until 15 December. Stock markets and bond yields declined sharply following the 1 August decision. Financial market volatility also increased albeit not to a particularly worrying level. Similarly, credit spreads widened but are not noticeably elevated. **Commodity** prices have also moved down sharply since the end of July, with particularly large falls in oil and iron ore prices. Markets have also come under pressure from concerns over political developments (Argentina, Hong Kong) and weak China and German economic data.
- Markets continue to expect an easing in **monetary policy** going forward. The US Federal Reserve cut the fed funds rate by 25bp at its July meeting. We had been expecting the Fed to cut rates by a further 25bp in September before staying on hold, but with trade headwinds intensifying we now expect another 25bp rate cut later in the year. The ECB at its last meeting indicated that not only will rates be unchanged through to H1 2020 but that they might be lowered, suggesting that it will soon ease policy. A range of EM central banks have also eased policy in recent months, including the Bank of India which has cut its policy rate by 110bps this year. In China, we expect the authorities to set policy to limit the fall-out from the US-China trade dispute, including allowing controlled appreciation in the USD/CNY.
- Q2 GDP estimates are now available for most major **advanced economies** (AEs) and indicate that the Q1 pick-up in growth was not sustained. We expect AE growth to slow further in H2 2019 before stabilising in 2020 partly due to monetary policy support kicking in and as the impact from Japan's VAT increase fades. The latest US business surveys point to an economy further slowing into H2 2019 and they are yet to reflect any impacts from the latest US-China trade escalation. The Euro-zone remains a source of concern; with the manufacturing PMI declining even further into contractionary territory in July. That said, the Euro-zone services sector PMI has held up better, so a continuation of recent modest growth looks likely. Q2 growth in Japan was notably higher than expected at 0.4% q/q but the October increase in the Value Added Tax will weigh on activity (even if the rush to avoid it provides a boost to activity in Q3) as will the latest US-China trade escalation.
- The escalation in US tariffs is a negative for the manufacturing sector in **emerging markets (EM),** particularly emerging East Asian economies. Chinese industrial production, fixed asset investment and retail sales growth weakened in July. This follows a surprise pickup in June and the trend across these two months points to a continued gradual slowdown. For now, our growth forecasts remain unchanged on the assumption of an offsetting domestic policy response, but there is clearly downside risk. PMI surveys to July showed EM manufacturing was at essentially neutral levels, having deteriorated from robust conditions in late 2017-early 2018. In contrast, EM services have held up comparatively well (albeit weaker than recent peaks).
- We have lowered our forecast for **global growth** in 2019 to 3.1% (from 3.2%) mainly reflecting revisions to US data, continuing weakness in India as well as the growing trade headwinds. We expect growth to pick up modestly to a still below-trend 3.3% in 2020 and further recover in 2021 (3.5%). Our expectation that global growth will start to recover in 2020 is based on two main assumptions. Firstly, that central banks will deliver further monetary easing which provides meaningful support to growth. Secondly, that there will be a recovery in growth in India and Latin America (where domestic factors have also affected growth).
- Trade disputes remain a key **risk**. Our forecasts are based on no change to announced trade barriers. With the US also considering auto tariffs and voicing displeasure over 'currency manipulators', trade risks are slanted towards further escalation. Political risks are also evident including developments in Hong Kong, Argentina, Italy, a recent dispute between Japan and Korea which is spilling over into trade. Brexit uncertainty also remains high.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: We have fine-tuned our forecasts for growth in Q2 (now see 0.4 to 0.5% q/q) but largely expect a similar pattern of growth further out to previous forecasts. We see growth of 1.6% this year, before a small improvement to around 2¼% on a year-average basis in each of the out years. The unemployment rate is expected to lift slightly (reaching 5.5%), with employment growth slowing on the back of sub-trend growth. The key dynamic behind this slower growth is a weaker household sector with modest consumption growth (weak wage growth being a key headwind) and ongoing falls in dwelling investment. The public sector and net exports are likely to show some strength, offsetting some of this weakness. We also anticipate a solid performance from the business sector, with private investment likely to rise in aggregate on the back of growth in the non-mining sector, while mining should at least stabilise. However, a weak starting point, with low inflation and sizable spare capacity in the labour market are likely to see the RBA cut the cash rate further (indeed, their own forecasts embody a further 50bps of cuts). We see a November cut as probable but think there is significant risk of further cuts, and would not rule out unconventional policy should the economy not receive substantial support from other policy arms or global headwinds worsen.

- The RBA left the cash rate unchanged at 1.0% in August, following back-to-back cuts in June and July. Despite the pause, the RBA has maintained an easing bias, noting that it stands ready to reduce the cash rate further should the economy weaken. The RBA's forecasts for growth and inflation were recently downgraded, while the improvement in the unemployment rate was delayed. Overall, the forecasts paint a picture of growth around trend, and inflation returning to the target band – though only gradually. Notably, these forecasts are predicated on a further 50bp easing in the cash rate. We expect another RBA cut by 25bp in November, but acknowledge the risk of further cuts and that there may be more action on the fiscal side as well as a move to unconventional policy measures.
- We expect **consumption** growth to remain weak, both in Q2 and over the next two years. Nominal retail sales rebounded somewhat in June, rising by 0.4% in the month following very weak readings in the first two months of the quarter. Overall, for the quarter, the volume of retail sales grew by 0.2% (after falling 0.1% in Q1) which saw growth over the year fall to its lowest rate since the 1990s recession. On the services side we see growth slowing in Q2, suggesting that overall consumption will print at 0.3-0.4%. Going forward we see a small improvement with consumption growth to average a modest 2¼% annually over the next two years. We expect that the effects of weak income growth will persist with wage growth remaining low, and for concerns over high debt levels and stretched household budgets to persist.
- The **business sector** appears to have lost significant momentum over the past year – with conditions deteriorating across all states and most industries since early 2018. Forward looking indicators suggest that conditions are unlikely to improve significantly in the near term, while capex has also declined to around average over the past year, implying that the fall in conditions has fed through to future business decisions. ABS measures of investment and intentions released later in the month and in the national accounts will provide an important update on both actual and expected investment spending economy-wide. We remain optimistic that business investment will grow relatively strongly over the next few years, supported in part by spill-overs from the large pipeline of public infrastructure work.
- Prices in the established **housing market** appear to have stabilised, recording the second consecutive rise after consistent declines since late 2017. Auction clearance rates have also increased, but volumes remain low. While this is a positive sign, it is likely that investment in the housing market (newly built structures) will continue to weaken with approvals continuing to ease and dwelling investment expected to decline further. While the pipeline of work remains elevated it is likely to decline relatively quickly.
- The **labour market** remains healthy but is expected to weaken slightly over the next year. The unemployment rate was unchanged in July at 5.2%. Employment rose by 41.1k – and at 2.6% over the year has been well above population growth. We expect employment growth to slow and the unemployment rate to drift up to around 5½% over the next year on the back of slowing employment growth, implying greater spare capacity in the labour market and contained wage growth. Wage data for Q2 saw another weak outcome for wage growth with wages lifting 0.5% in the quarter to be 2.3% higher over the year.
- **Net exports** look to make another solid contribution to growth in Q2 following the 0.2ppt contribution to growth in Q1. Based on monthly trade data and the trade prices release, we estimate a contribution of 0.3-0.4%. The trade surplus has widened significantly on the back of higher iron ore exports and prices.
- **Commodity prices** were generally weaker in the month. Iron ore prices fell sharply (though from a high level) with ongoing recovery in Brazilian supply. Prices for both thermal and coking coal continued to ease, while oil prices fell to their lowest level since January. We expect prices across each of these commodities to decline further in 2020.
- The **AUD/USD** has weakened over the month, trading as low as US67.5c on the back of an escalation in trade tensions and expectations of further rate cuts. We have lowered our forecast for the Aussie over the next year, with the currency expected to fall as low as 65c by end-2019 before lifting to US70c by end-2020.
- For more detail on the Australian outlook, please see the <u>Forward View – Australia</u>, released on Wednesday.

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