September 2019

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Global economic growth slowed further in Q2 2019. Major advanced economy (AE) GDP growth declined to its slowest pace since mid-2016. We expect the down trend in AE growth to continue through to early 2020 as the US-China trade dispute and other factors weigh on growth. Growth in the five largest emerging markets economies also slowed, including in India, where growth fell to its lowest level since early 2013. In the face of the global slowdown, central banks are moving to support activity; the European Central Bank cut rates this month and the Fed is expected to follow suit. Global growth of 3.1% is forecast for 2019, before edging up to 3.2% in 2020 (previously 3.3%) and returning to its long-term trend (3.5%) in 2021. Key to the upturn is the support from easier monetary policy and cyclical recoveries in Latin America and India, as well as no further escalation in trade disputes or current geo-political risks being realised.

- The **US-China dispute** escalated further on 23 August as both countries announced further tariff increases. **Financial market** reaction was relatively subdued. Since early-to-mid August markets have broadly tracked sideways, and recently have turned up a little. Equities have recorded some gains since early September, in part due to the news of US-China talks in October (and a two week delay to US tariffs scheduled for 1 October) and a reduced chance of a no-deal Brexit next month. Bond yields also stabilised around mid-August, and have risen so far this month, but remain at very low levels.
- In recent months prices most sensitive to the global outlook – base metals – have started falling again. The (equally weighted) Thomson Reuters Core Commodity price index is now around its low for recent years. Fortunately for Australia, bulk **commodity prices** have risen this year, even with recent falls; as a result, the RBA's non-rural commodity price index has held up reasonably well.
- Of the major advanced economy **central banks**, only the US Fed had lowered rates this year until the ECB's announcement this week of a 10bps cut (and a resumption of its bond buying programme (QE)). We also expect the Fed to cut rates by 25bps at its September meeting and by the same amount in Q4. EM central banks have been more aggressive in easing policy. China's monetary stance has also eased, in part by allowing its currency to depreciate against the US dollar, and most recently by a cut in banks required reserve ratio.
- Major a**dvanced economy** (AE) GDP growth slowed to 1.6% yoy in Q2 2019, down from the 2.5% pace of a year ago, and the slowest rate of growth since mid-2016. We expect this slowing to continue through to early 2020 in part due to the US-China trade dispute. Moreover, the impact of last year's fiscal stimulus in the US is largely in the past and Japan's economy will be impacted by a tax increase (VAT) in Q4. The slowdown in AE growth over the last two years has been driven by lower investment, with the pull back in consumption more modest. Export growth has also slowed, particularly over the last year. Recent business surveys continue to point to weak growth outcomes, particularly in the manufacturing sector, with services holding up a little better. Monetary policy easing should help to stabilise growth, but with policy capacity limited in some countries, the expected recovery in growth is relatively modest.
- Economic growth in the five largest **emerging markets** (EMs) slowed further in Q2, down to 5.0% yoy, compared with 6.1% yoy in Q1 2018. India's economic growth continued to slow in the second quarter – down to 5.0% yoy (compared with a relatively weak 5.8% in Q1), its slowest rate of growth since March 2013, with weakness in both private consumption and investment persisting from the previous quarter. EM growth is typically more trade dependent than that of advanced economies, and the trade war between the United States and China is having a range of spill-over effects across the EM Asia region.
- **Global economic** growth continued to slow in Q2 2019, down to an estimated 3.0% yoy (compared with 3.1% yoy in Q1), mainly due to the weaker AE growth. The global manufacturing PMI has signalled a contraction in the sector since May 2019. In contrast, services PMIs – which comprise the bulk of economic activity – have held up comparatively well, but have also trended lower. A weaker outlook for India is the main change to our global forecasts, along with smaller revisions for other regions – reflecting in-coming data and the most recent US-China trade escalation. Global growth is forecast to average 3.1% in 2018, before edging up to 3.2% in 2020 (previously 3.3%). A recovery to the long term trend (3.5%) is expected for 2021. Key to the upturn is the support from easier monetary policy and cyclical recoveries in Latin America and India. The latter is far from assured, as recent turbulence in Argentina demonstrates.
- Our forecasts assume no further tariff measures (beyond what has already been announced). However, such a scenario should not be ruled out, meaning that trade tensions are a **downside risk** to the outlook.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: We have incorporated the latest national accounts data into our growth profile, but have largely left our forecasts for output, prices and the labour market for the next two years unchanged. However, we have revised our forecast profile for the cash rate, incorporating an additional 25bps cut in February 2020, following our prediction of a 25bp cut to 0.75% in November. Further, we see risk of a further cut and a move to unconventional policy should the government continue to hold off providing a more substantial fiscal policy package in the form of infrastructure spending, earlier tax cuts or cash handouts. The national accounts data for Q2 confirmed another soft quarter of growth in the private sector – with the household sector particularly weak, but also weakness in business investment. Growth was supported by a strong boost from exports (LNG) and government consumption in the quarter. Going forward, we broadly expect a similar pattern of growth. We expect the downturn in the dwelling investment cycle to continue, alongside weak household consumption growth. Business investment is expected to rise – including some growth in the mining sector – but there appears to be some downside risk to this forecast with both business confidence and conditions low. Government infrastructure spending as well as general government consumption are expected to be key growth supports. The labour market is expected to deteriorate slightly, which will see wage growth remain weak and contribute to ongoing weak inflation outcomes.

- The RBA left the **cash rate** unchanged at 1.0% in September against a backdrop of another weak result for private domestic demand growth. We have changed our rate call this month – and now expect an additional 25bp easing in February 2020, following our previously forecast reduction to 0.75% in November. Further, should the government fail to provide a more meaningful fiscal stimulus, we acknowledge the risk of a further easing around mid-next year to 0.25%, in conjunction with a move to unconventional policy.
- **Consumption** growth remains weak – despite a marginally better than expected outcome in Q2. Growth was supported by spending on hotels, cafes & restaurants, recreation and culture and financial & insurance services. In annual terms, growth has slowed to 1.4% with the bulk of the increase in spending occurring in 'essentials' and in services categories, rather than discretionary segments. This reflects the ongoing cautiousness in the household sector with low wage growth, high debt levels and stretched budgets continuing to weigh. Further, it appears that the support to households from tax rebates has had little impact, or has not been large enough to offset growing weakness in the sector. Nominal retail sales declined in July, while internal NAB data suggest there has been little boost beyond that. Going forward we expect an improvement in household consumption growth, though expect it to rise to only a modest pace.
- The **business sector** continues to weaken, with both business confidence and conditions edging lower in the month – and continuing their recent trend of below average outcomes. The decline in business conditions has been broad-based across industries over the past year and has been particularly sharp in retail. Mining remains most favourable, while the services sectors have generally held up better. Construction, manufacturing and the other goods-related industries have also turned negative. Business confidence and forward orders are both below average and suggest that there is unlikely to be a turnaround in business conditions in the near-term. Q2 national accounts data showed that the non-mining sector remained weak, while mining may have now troughed. While we expect that the large public infrastructure pipeline will see spill-overs to the private sector, the weakening in conditions and activity more generally puts our relatively positive outlook for the business sector at risk.
- Prices in the established **housing market** look to have stabilised, with prices on the east coast continuing to rise in August. This is the third consecutive monthly increase since May, following the previous 18 months of declines. Despite the stabilisation in prices, building approvals have continued to weaken, suggesting the outlook for the activity side of the housing market will remain weak. Indeed, the national accounts and building activity releases confirmed that dwelling investment in Q2 recorded another sharp fall which we think is likely to continue over the next few quarters.
- The **labour market** remains healthy with the unemployment rate relatively low compared to history, and ongoing employment growth at rates well above that of the working-age population. Nonetheless, the unemployment rate has hovered around 0.25ppt higher than its recent low in early February for the past 4 months, and remains well above recent estimates of full-employment (around 4.5%). With growth slowing – particularly in the private sector – we expect employment growth to slow and the unemployment rate to drift higher over the next 2 years. Consequently, wage growth is expected to remain weak.
- **Net exports** were a key support to growth in Q2, with a large boost from rising LNG exports. We expect further support from LNG in the near-term as the last of the mega-LNG projects ramps up to full capacity. After this, exports are expected to level off and provide little contribution to growth with only marginal contributions to production capacity from investment over the next few years.
- **Commodity prices** were generally weaker in the month. Iron ore prices continued to fall on the back of further recovery in Brazilian export volumes. Coal prices (both thermal and coking) also continued to ease in August.
- The **AUD/USD** has strengthened over the month after falling to decade lows in July on the back of heightened trade tensions. It is likely that recent momentum could see the Aussie reach US69c in the short term. We expect the pair to fall to US65c by year's end, before drifting back to around US75c over the next two years.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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