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National Australia Bank

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

With growth having slowed in Q2 2019, there appears limited prospect of a turnaround in Q3 – given the relative weakness in business surveys, market expectations and the deteriorating global trade environment. The US has announced tariffs on European aerospace and a range of other imports, and threatened to extend tensions with China, moving beyond trade restrictions to financial flows. Global trade volumes have contracted, putting additional strain on manufacturers, with uncertainty around trade a major negative for business investment. Emerging market central banks have led an easing monetary policy, though advanced economies have also shifted. We expect the global economy to expand by a sub-trend 3.1% in 2019, with little improvement in 2020 (3.2%) before recovering to the long-term trend of 3.5% in 2021. Critical to the recovery in coming years is the lagged effects of softer monetary policy and cyclical recoveries in India and Latin America, while assuming no further escalation in trade or geopolitical tensions (which both present downside risk).

- The deterioration in the **global trade environment** has continued – with the US announcing new tariffs on a range of imports from the European Union (in retaliation for EU subsidies for its aerospace sector). Meanwhile, tensions between the US & China could extend beyond trade, with reports suggesting the US government is considering restrictions on financial flows with China. These developments highlight the risk of further escalation in tensions that could negatively impact global activity.
- Global **export volumes** fell by 0.5% yoy (on a three-month moving basis) in July, compared with an average increase of around 3.0% in 2018. Weakness in trade extends well beyond the direct US-China dispute. The drop in volumes for Japan and emerging Asia (excluding China) in part reflects the flow-on effects of the dispute (with China sitting in the middle of a manufacturing value chain), along with the decline in global demand more generally. Falling export volumes in the Euro-zone are less connected to the trade dispute, instead reflecting the ongoing uncertainty with Brexit and conditions in key trading markets such as Turkey. The general uncertainty around trade is a negative for global business investment – which could potentially have a larger and more long-lasting impact on economic activity.
- **Central banks** continue to ease monetary policy, led by the EMs. Reserve Bank of India cutting policy rates in October, with official rates cut by 1.35% since the start of the year. China has also reformed its monetary policy settings, trimming rates in September. The US Federal Reserve cut the fed funds rate in September, while the European Central Bank trimmed its deposit rate by 10 basis points and announced it would restart quantitative easing in November. The Fed also announced asset purchases in October, however this is intended address liquidity concerns in short-term repo markets. We see at least one more cut from the Fed, with risks weighted towards more rather than fewer cuts, while policy room for the ECB and Bank of Japan is more limited (given already very low rates).
- More timely indicators of activity – such as **PMI surveys** – suggest that any upturn in global activity is unlikely in Q3. On average, global manufacturing and services readings were weaker in Q3 than Q2, and the recent upturn in manufacturing PMIs reflect the surprisingly strong outcome in China (given weakness in other industrial indicators).
- Growth in the major **advanced economies** slowed to 1.6% yoy in Q2 2019, having trended down from a cyclical peak of 2.6% in Q4 2017. Growth in most of this group declined across 2018 and the first half of 2019 – led by Germany, where growth slowed from 3.4% yoy in Q4 2017 to just 0.4% yoy in Q2 2019. Headwinds to growth are likely to persist – with the boost from US fiscal stimulus in 2018 having faded and Japan hiking its consumption tax on 1 October.
- Growth in **emerging markets** is generally more dependent on international trade than is the case for advanced economies – meaning that these countries have suffered from the slowdown in global trade since late 2018. Weak trading conditions have particularly impacted emerging market manufacturers – with growth in industrial production slowing from around 4.5% yoy (3mma) in early 2018 to just 1.7% yoy (3mma) in July 2019. Weakness has been particularly evident in Latin America and East Asia (outside of China)
- Our forecasts for **global economic growth** remain unchanged this month. We expect the global economy to expand by a sub-trend 3.1% in 2019, with little improvement in 2020 (3.2%) before recovering to the long-term trend of 3.5% in 2021. Critical to the recovery in coming years is the lagged effects of softer monetary policy and cyclical recoveries in India and Latin America.
- These forecasts assume no additional trade tariffs between the US and trading partners or worsening in geopolitical tensions – with potential US tariffs on EU imports and Chinese capital flow restrictions highlighting **downside 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 left our forecasts for growth, inflation and the labour market unchanged. We also continue to expect another 25bp cut in the cash rate to come in December, with the risk of further easing and potential move to unconventional policy in H1 2020 in the absence of a more significant fiscal stimulus or if conditions deteriorate from here. We expect recent trends of a weak consumer and a construction downturn, partially offset by export growth and high levels of public spending, to continue. Business investment remains a key dynamic, with mining investment expected to stabilise and infrastructure spill-overs to support growth in the non-mining sector. That said, weak consumption growth and heightened global uncertainty pose a risk to business investment. Overall, growth is expected to improve slightly from here, but to remain below trend over the next two years, despite low interest rates and some boost from tax cuts. Given our outlook for below-trend growth, we expect the labour market to deteriorate slightly, with unemployment edging higher – further constraining already weak wage growth. As a result, inflation is expected to remain weak, but gradually return to the bottom end of the RBA's target. While, domestic factors have been a large driver of the need for policy support, global developments pose a significant risk should global growth slow further.

- The **RBA cut the cash rate by 25bps in October** to a new record low of 0.75%. This followed cuts in June and July, and was largely factored into the RBA's own forecasts released in August (albeit with uncertain timing). The post-meeting statement suggested that the Board "is prepared" to ease rates further to support the economy if required – a more dovish easing bias than was expected. We expect a further cut in December taking the cash rate to 0.5% and acknowledge the risk that more may be required in H1 2020 should a more material fiscal stimulus fail to materialise or conditions deteriorate further.
- The **labour market** remains healthy despite the recent slowing in growth. Employment has continued to grow at a solid clip, while the participation rate has risen to very high levels. Unemployment has edged higher on the back of this increase in participation, but remains low compared with history. Unemployment remains lowest in NSW and Vic where rates lie below 5%. In aggregate, the national unemployment rate sits almost 1ppt above recent estimates of full employment – pointing to ongoing weakness in wage growth. This will see a persistence in weak household income growth. Going forward, we expect the labour market to deteriorate slightly with growth having slowed (and remaining below trend) and for the unemployment rate to tick-up.
- **Consumption** growth appears to have remained weak in Q3. Retail sales rose by 0.4% in August following a flat outcome in July, to be 2.5% higher over the year. In monthly terms, the improvement is a welcome development but suggests that the boost from recent tax rebates may have not been enough to significantly boost household consumption. The NAB Cashless retail sales index to be released next week will provide and early indication of how sales have tracked in the final month of the quarter – ahead of the official quarterly volumes release. Household spending will remain a key focus with concerns around overall growth, and our view is slow income growth, high debt levels and stretched budgets will continue to be constraining factors on household spending.
- Activity in the **business sector looks to have remained weak**. The NAB Monthly Business survey for September suggests that both business confidence and conditions remained below average and this continues to point to weak growth in the sector. Capex has declined further and is now close to its long-run average, despite capacity utilisation and employment remaining above average. Forward orders remain negative suggesting that weak conditions are likely to persist in the near term. Acknowledging the risk, we expect business investment to rise over the next few years, with mining investment stabilising and spill-overs from infrastructure investment to support the non-mining sector.
- **House prices have continued to rise** since reaching a trough in May, driven by strong increases in Sydney and Melbourne. The relatively sharp correction in prices occurred in an orderly fashion and came after a significant increase in prices in prior years. Outside of Sydney and Melbourne (and capital cities) prices have been more mixed. In general, low interest rates and some easing in macroprudential policy will act as a support to prices, as will an adjustment in supply growth, with new construction declining. Alongside, this supply adjustment, population growth remains relatively strong. We expect dwelling investment to continue to decline, with approvals continuing to trend lower and credit growth also slowing.
- **Net exports** have been a key support to growth over the past year, with the last of the mega-LNG projects ramping up to full capacity. In the near-term we expect this trend to continue as the last of the projects reaches full production – after which we expect a plateau in exports. Trade data for August suggest that the trade surplus narrowed on the back of lower iron ore prices, but remains near record levels following the increase in exports over the past decade.
- **Commodity prices** were mixed in the month. Prices for coking coal eased, while prices for thermal coal have stabilised. Iron ore prices have also stabilised (and remain high) around US$90 a tonne. We expect commodity prices to ease over the next few years on the back of a slowing in Chinese demand and weaker global growth.
- The **AUD/USD** has settled around the US67.5c. The past month has seen moves both above and below this level, and notably, the pair came under pressure with the release of a bearish post-meeting statement by the RBA alongside a renewed focus on QE. Our forecasts remain unchanged with the pair expected to fall to US65c by year's end, before drifting back to around US75c over the next two years. The exchange rate will remain an important component of monetary transmission in the face of a renewed global easing.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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