

# AUSTRALIAN MARKETS WEEKLY



## Consumer sentiment, low interest rates and tax cuts

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### Analysis – Consumer sentiment, low interest rates and tax cuts

- Consumer sentiment has fallen 8% since the Reserve Bank started cutting rates, kindling debate over whether lower interest rates are sapping confidence. We downplay this interpretation given history shows it is common for confidence to decline in the early stages of an easing cycle.
- More surprising is that recent income tax cuts have failed to lift confidence, raising the possibility that the underlying trend in income has deteriorated. Our modelling shows that confidence can help a little in estimating spending, but income is more important. Unless income picks up, spending is likely to remain subdued, which would hold down overall economic growth.

### The week ahead – RBA Governor speaks and AU CPI; US GDP, payrolls & FOMC rate cut

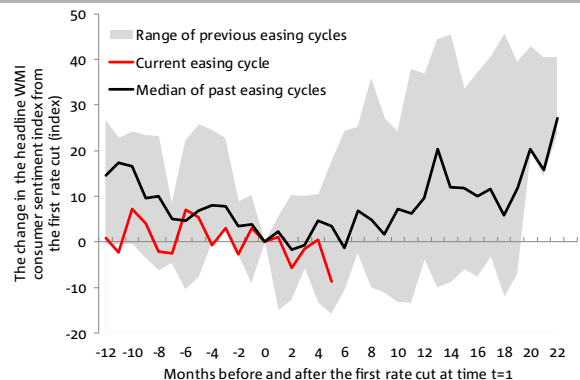
- In Australia, RBA Governor Lowe is speaking on “Some echoes of Melville” on Tuesday night, where Melville was a formative force for central banking in Australia. We think he could expand on recent remarks that increased risk aversion has made it more difficult for monetary policy to stimulate the economy. The Q3 CPI on Wednesday should show core inflation steady at 0.4% q/q/ 1.6% y/y, broadly in line with the Reserve Bank’s forecast. Building approvals should fall a further 3.5%, posing more headwinds for residential construction. In NZ, the market is focused on Thursday’s ANZ business survey.
- Markets will take stock of the US economy with Wednesday’s first estimate of Q3 GDP ahead of Friday’s October readings on payrolls and the manufacturing ISM. The consensus looks for annualised growth in GDP of 1.6% after a 2.0% increase in Q2. The FOMC is expected to announce its third consecutive rate cut on Wednesday amid continuing trade concerns and signs of a slower economy. Payrolls growth is expected to soften from 136K to 93K. The manufacturing ISM to marginally improve to 49 in October after September’s 47.8 reading. Chinese PMIs are due later in the week. The BoJ should remain on hold, while the Brexit saga continues in Europe.

### Key markets over the past week

	Last	% chg week		Last	bp/% chg week
AUD	0.6814	-0.8	RBA cash	0.75	0
AUD/CNY	4.81	-0.9	3y swap	0.80	-6
AUD/JPY	74.1	-0.6	ASX 200	6,741	1.3
AUD/EUR	0.615	-0.2	Iron ore	85	2.8
AUD/NZD	1.074	0.2	WTI oil	56.5	5.6

Source: Bloomberg

### Chart of the week: Confidence during easing cycles



## Consumer sentiment, low interest rates and tax cuts

*"I fear that rate cuts from the Reserve Bank are probably now reducing confidence rather than adding to it"*

Future Fund Chair and former treasurer Peter Costello<sup>1</sup>

- **Consumer sentiment has fallen 8% since the Reserve Bank started cutting rates, kindling debate over whether lower interest rates are sapping confidence. We downplay this interpretation given history shows it is common for confidence to decline in the early stages of an easing cycle.**
- **More surprising is that recent income tax cuts have failed to lift confidence, raising the possibility that the underlying trend in income has deteriorated. Our modelling shows that confidence can help a little in estimating spending, but income is more important. Unless income picks up, spending is likely to remain subdued, which would hold down overall economic growth.**

### Consumer sentiment has dropped to a four-year low

Consumer sentiment has slumped over recent months, with the widely-followed Westpac-Melbourne Institute (WMI) summary series falling by 8% since the Reserve Bank started cutting interest rates in June. The decline in sentiment to its lowest level since 2015 has kindled some debate over whether lower interest rates have proved counterproductive by contributing to lower confidence.

Chart 1: Consumer sentiment is at a four year-low



Source: Westpac and Melbourne Institute, National Australia Bank

Sentiment is measured as the average of five questions about current and expected conditions, with the fall in sentiment driven by increased pessimism about the outlook.

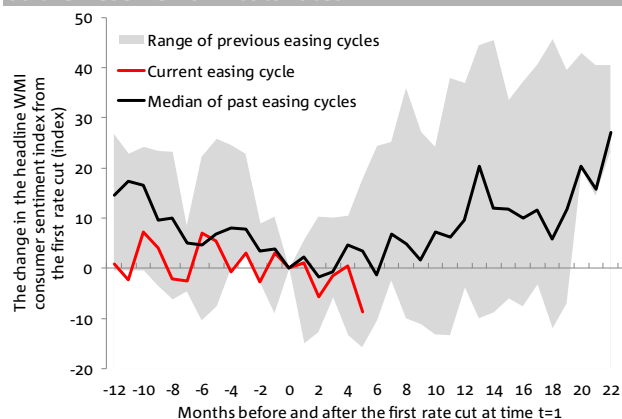
- **Current conditions have fallen 3% from May.** The index of family finances versus a year ago is down 5% and the time to buy a major household item series is 1% lower.
- **Expected conditions have dropped 12%.** Family finances over the coming year have dropped 10%. The indexes of economic conditions over the coming

year and five years have fallen by 10% and 16%, respectively.

### History shows it is not unusual for sentiment to deteriorate as the Reserve Bank cuts rates

Contrary to the current concern that low interest rates may be sapping confidence, the decline in sentiment to date is actually similar to the weakness seen in past easing cycles, where it is common for surveyed confidence to fall as the Reserve Bank cuts rates. This suggests to us that the weakness in sentiment should not automatically be assumed to reflect the impact of lower interest rates, but rather broader economic trends.

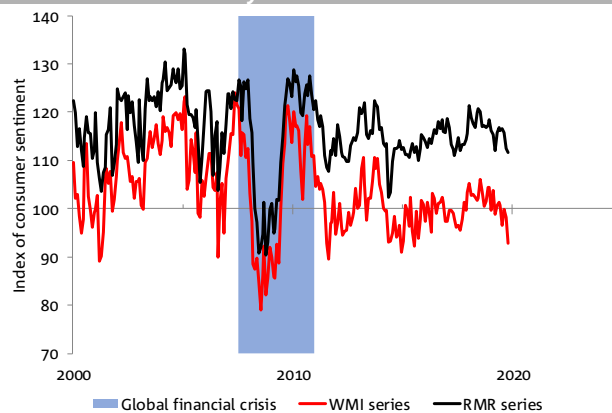
Chart 2: History shows consumer confidence can weaken as the Reserve Bank cuts rates



Note: The previous easing cycles were: (1) 1982-83; (2) 1986-87; (3) 1990-93; (4) 1996-97; (5) 2001; (6) 2008-09; and (7) 2011-16. The range of previous easing cycles covers the 10<sup>th</sup> to the 90<sup>th</sup> percentiles of the distribution. Time t=0 marks the peak in interest rates with the first rate cut at time t=1. Source: Dungey and Hayward. Reserve Bank of Australia, National Australia Bank

This caution is reinforced by our concern that some of the weakness in confidence could reflect volatility in the survey data. For example, the alternative Roy Morgan Research (RMR) measure of consumer sentiment – which is constructed the same way as the WMI series with a similar sample size, but is undertaken by face-to-face interviews rather than by phone – has also fallen over recent months, but by a smaller amount of 4%.

Chart 3: The Roy Morgan Research measure of sentiment has fallen by less than the WMI series



Source: Roy Morgan Research, National Australia Bank

<sup>1</sup> See Clancy Yeates, *'That's our risk at the moment': Peter Costello warns about 'over-regulating' banks*, The Age, 22 October 2019.

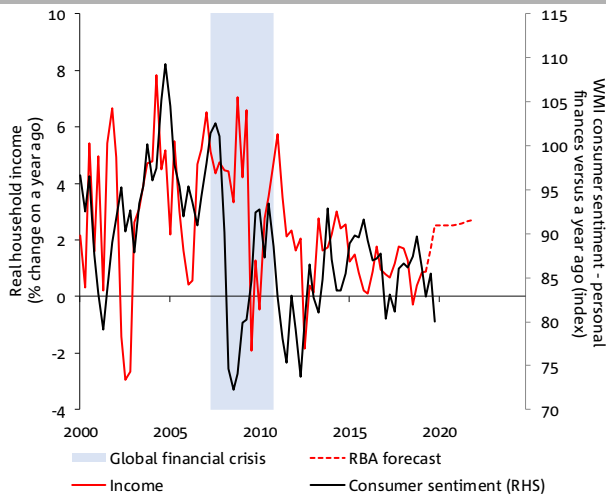
**It is more surprising that personal income tax cuts have failed to lift confidence**

In our view, the more interesting issue posed by the weakness in sentiment is that the government’s personal income tax cuts are hard to see in the numbers, even though they took effect from 1 July.

The tax cuts sum to \$7b for 2018-19 as a whole, equating to 0.3% of GDP. The Reserve Bank forecasts the cuts, in combination with lower interest rates, will lift annual growth in household income from 0.8% in Q2 to 2.5% by Q4, broadly holding at that rate until the end of 2021. In contrast, the WMI assessment of personal finances versus a year ago is currently at its lowest level since 2017 and not far from the lows reached in the early 2010s.

Actual income growth and consumer sentiment have often diverged in history, but the current gap raises the possibility that the underlying trend in income has deteriorated, offsetting the boost from tax cuts.

**Chart 4: Sentiment hasn’t responded to recent income tax cuts**



Note: Consumer sentiment is reported as a quarterly average. The Q4 2019 estimate is October 2019. The Reserve Bank forecasts for annual growth in household income are from the August Statement on Monetary Policy. The forecasts for Q3 2019, Q1 2020, Q3 2020, Q1 2021 and Q3 2021 are interpolated. Source: Australian Bureau of Statistics, Westpac and Melbourne Institute, National Australia Bank

**Consumer sentiment helps at the margin in estimating consumer spending**

To judge the potential impact of lower confidence on spending, we estimated a simple model that specified real consumption as a function of:

- The wages bill adjusted for inflation.
- Other household income adjusted for inflation.
- Net household wealth adjusted for inflation.
- The change in the unemployment rate.

The model was estimated over the period from 2000 to 2019 and explains about 33% of the quarterly growth in spending. By way of comparison, the Reserve Bank’s long-run model of spending, which also includes the real

cash rate, had a similar fit of 28% when estimated over a much longer period of 1989 to 2018.<sup>2</sup>

**Table 1: A simple model explains one-third of the variation in consumer spending**

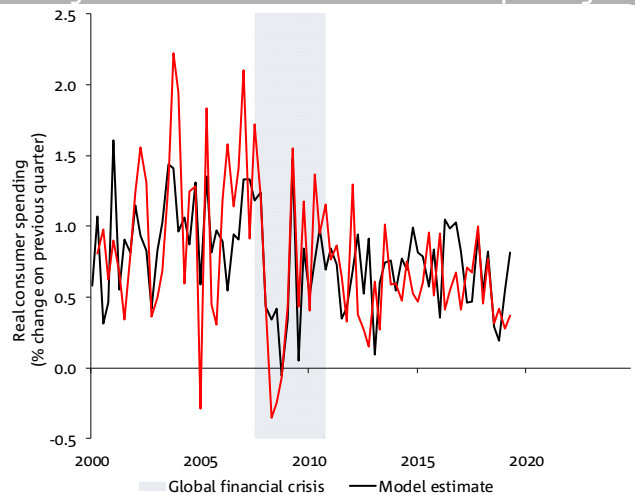
(estimated from Q1 2000 to Q2 2019)	Coefficient	P-value
Constant	0.00	0.00
Real wages bill (-2)	0.21	0.00
Real other household income (-2)	0.04	0.00
Real net household wealth	0.15	0.00
Change in the unemployment rate (-1)	-0.72	0.02
R-bar-squared	0.33	

Note: Estimated in log differences, except for the change in the unemployment rate, which was divided by 100. HAC standard errors were used.

Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

Consumer spending is notoriously difficult to estimate, but this simple model does an acceptable job in picking the trend in spending over time, although it has overestimated recent growth. This overestimation mainly reflects the short-term impact of the house price-driven turnaround in wealth, which can be difficult to pin down, particularly when our simple specification does not allow for any long-run relationship between wealth and spending.

**Chart 5: The simple model does a reasonable job, although it has overstated recent consumer spending**



Source: Australian Bureau of Statistics, Reserve Bank of Australia, National Australia Bank

Extending this model, we added the WMI measure of consumer sentiment. This had a slightly better fit, explaining 37% of the variation in the growth in spending. Interestingly, consumer sentiment knocked out the change in the unemployment rate, which points to sentiment partly reflecting the state of the labour market.

<sup>2</sup> See Alexander Ballantyne, Tom Cusbert, Richard Evans, Rochelle Guttmann, Jonathan Hambur, Adam Hamilton, Elizabeth Kendall, Rachael McCrick, Gabriela Nodari and

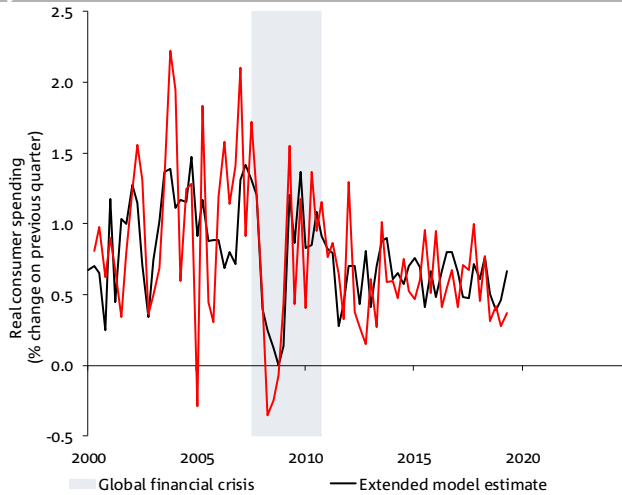
Daniel Rees, *Online appendix – MARTIN has its place: A macroeconomic model of the Australian economy*, August 2019.

**Table 2: Consumer sentiment helps a little in estimating consumer spending**

(estimated from Q1 2000 to Q2 2019)	Coefficient	P-value
Constant	-0.02	0.01
Real wages bill (-2)	0.14	0.03
Real other household income (-2)	0.03	0.00
Real net household wealth	0.08	0.00
WMI index of consumer sentiment	0.02	0.00
R-bar-squared	0.37	

Note: Estimated in log differences, except for the WMI measure of consumer sentiment which was divided by 100. HAC standard errors were used.  
 Source: Australian Bureau of Statistics, Reserve Bank of Australia, Westpac and Melbourne Institute, National Australia Bank

**Chart 6: The extended model overstates recent spending by a lesser extent**



Source: Australian Bureau of Statistics, Reserve Bank of Australia, Westpac and Melbourne Institute, Reserve Bank of Australia, National Australia Bank

**Income growth matters more than sentiment**

Weighing up the decline in sentiment to date, the extended model suggests that the 8% drop in confidence should take about 0.2pp off annual growth in consumer spending, where consumption is up only 1.4% over the past year.

In comparison, household income is more important. With the income tax cuts possibly being offset by weakness elsewhere in disposable income, this suggests that the risk is that spending remains weak, which will hold down growth in the overall economy given the consumer accounts for more than half of national output.

**Kieran Davies**

## CALENDAR OF ECONOMIC RELEASES

Country	Economic Indicator	Period	Forecast	Consensus	Actual	Previous	GMT	AEST
<b>Monday 28 October 2019</b>								
NZ	<b>Public holiday - Labour day</b>							
US	Wholesale Inventories MoM	Sep P		--		0.2	12.30	23.30
<b>Tuesday 29 October 2019</b>								
JN	Tokyo CPI YoY	Oct		0.6		0.4	23.30	10.30
AU	<b>RBA Governor Lowe speaks in Canberra</b>						<b>6.45</b>	<b>17.45</b>
US	Conf. Board Consumer Confidence	Oct		127.8		125.1	14.00	1.00
<b>Wednesday 30 October 2019</b>								
AU	CPI QoQ / YoY	3Q	0.4 / 1.6	0.5 / 1.7		0.6 / 1.6	0.30	11.30
AU	CPI Trimmed Mean QoQ / YoY	3Q	0.4 / 1.6	0.4 / 1.6		0.4 / 1.6	0.30	11.30
GE	Unemployment Claims Rate SA	Oct		5		5	8.55	19.55
US	ADP Employment Change	Oct		132		135	12.15	23.15
US	GDP Annualized QoQ	3Q A		1.6		2	12.30	23.30
US	Core PCE QoQ	3Q A		--		1.9	12.30	23.30
GE	CPI MoM	Oct P		0.1		0	13.00	0.00
GE	CPI YoY	Oct P		1.1		1.2	13.00	0.00
CA	Bank of Canada Rate Decision	Oct 30	1.75	1.75		1.75	14.00	1.00
US	FOMC Rate Decision	Oct 30	1.75 / 2	1.75 / 2		1.75 / 2	18.00	5.00
US	Interest Rate on Excess Reserves	Oct 31		1.55		1.8	18.00	5.00
<b>Thursday 31 October 2019</b>								
NZ	Building Permits MoM	Sep		--		0.8	21.45	8.45
JN	Industrial Production YoY	Sep P		-0.1		-4.7	23.50	10.50
NZ	ANZ Business Confidence	Oct		--		-53.5	0.00	11.00
AU	Private Sector Credit MoM	Sep	0.2	0.3		0.2	0.30	11.30
AU	Private Sector Credit YoY	Sep		2.7		2.9	0.30	11.30
AU	Building Approvals MoM	Sep	-3.5	0		-1.1	0.30	11.30
AU	Building Approvals YoY	Sep		-25.7		-21.5	0.30	11.30
AU	Export Price Index QoQ	3Q		-0.5		3.8	0.30	11.30
CH	Manufacturing PMI	Oct		49.8		49.8	1.00	12.00
CH	Non-manufacturing PMI	Oct		53.8		53.7	1.00	12.00
JN	BOJ Policy Balance Rate	Oct 31	-0.1	-0.1		-0.1		around 2pm
EC	CPI Core YoY	Oct P		1		1	10.00	21.00
EC	CPI MoM	Oct P		0.1		0.2	10.00	21.00
EC	CPI Estimate YoY	Oct		0.7		0.9	10.00	21.00
EC	GDP SA QoQ / YoY	3Q A		0.1 / 1		0.2 / 1.2	10.00	21.00
EC	Unemployment Rate	Sep		7.4		7.4	10.00	21.00
CA	GDP MoM	Aug		0.3		0	12.30	23.30
CA	GDP YoY	Aug		--		1.3	12.30	23.30
US	PCE Core Deflator YoY	Sep		1.7		1.8	12.30	23.30

Friday 01 November 2019						
NZ	ANZ Consumer Confidence Index	Oct	--	113.9	21.00	8.00
AU	AiG Perf of Mfg Index	Oct	--	54.7	21.30	8.30
AU	CoreLogic House Px MoM	Oct	--	1.1	23.00	10.00
JN	Jobless Rate	Sep	2.2	2.2	23.30	10.30
JN	Jibun Bank Japan PMI Mfg	Oct F	--	48.5	0.30	11.30
AU	PPI YoY	3Q	--	2	0.30	11.30
CH	Caixin China PMI Mfg	Oct	51	51.4	1.45	12.45
AU	Commodity Index SDR YoY	Oct	--	1.8	5.30	16.30
US	Change in Nonfarm Payrolls	Oct	95	136	12.30	23.30
US	Unemployment Rate	Oct	3.6	3.5	12.30	23.30
US	Average Hourly Earnings MoM	Oct	0.3	0	12.30	23.30
US	Average Hourly Earnings YoY	Oct	3	2.9	12.30	23.30
CA	Markit Canada Manufacturing PMI	Oct	--	51	13.30	0.30
US	Markit US Manufacturing PMI	Oct P	50.9	51.5	13.45	0.45
US	ISM Manufacturing	Oct	49	47.8	14.00	1.00
US	Construction Spending MoM	Sep	0.2	0.1	14.00	1.00
US	Fed's Clarida speaks in New York				17.00	4.00
US	Fed's Quarles discusses the price system				17.00	4.00
US	Fed's Williams speaks in moderated Q&A at Rutgers				18.30	5.30
Upcoming Central Bank Interest Rate Announcements						
Canada, BoC		Oct 30	1.75	1.75		1.75
US, Federal Reserve		Oct 30	1.75/2	1.75/2		1.75/2
Japan, BoJ		Oct 31	-0.10	-0.10		-0.10
Australia, RBA		Nov 5	0.75	0.75		0.75
UK, BOE		Nov 7	0.75	0.75		0.75
New Zealand, RBNZ		Nov 13	1.00	1.00		1.00
Europe, ECB		Dec 12	-0.50	-0.50		-0.50

**GMT: Greenwich Mean Time; AEDT: Australian Eastern Daylight Time**

# FORECASTS

Economic Forecasts																					
	Annual % change				Quarterly % change																
	2018	2019	2020	2021	2018				2019				2020				2021				
Australia Forecasts	2018	2019	2020	2021	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Household Consumption	2.6	1.4	1.7	2.3	0.5	0.8	0.3	0.4	0.3	0.4	0.3	0.3	0.4	0.5	0.6	0.5	0.6	0.6	0.6	0.6	0.6
Underlying Business Investment	1.2	-2.1	0.2	1.9	0.7	-0.8	-2.1	0.1	-0.2	-0.6	-0.3	-0.5	0.1	0.1	1.1	0.5	0.4	0.4	0.2	0.4	0.4
Residential Construction	4.8	-8.6	-8.1	-0.9	3.3	2.8	0.1	-2.8	-2.2	-4.4	-2.7	-2.4	-2.1	-1.3	-1.7	-0.5	0.1	0.2	0.5	0.8	0.8
Underlying Public Spending	4.3	4.2	3.8	3.6	1.4	-0.1	2.1	0.8	1.1	1.4	0.4	0.8	1.1	1.1	0.9	0.9	0.8	0.8	0.8	0.9	0.9
Net Exports (a)	0.8	1.6	-0.1	-0.2	0.6	0.0	0.4	-0.2	0.4	0.6	0.3	0.3	0.0	0.0	-0.1	0.0	0.0	0.0	-0.1	0.0	0.0
Inventories (a)	0.1	-0.4	0.1	0.1	0.0	0.2	-0.3	0.2	-0.1	-0.5	0.0	0.1	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic Demand (q/q %)	-	-	-	-	0.9	0.5	0.4	0.2	0.1	0.3	0.2	0.2	0.5	0.5	0.6	0.6	0.7	0.7	0.7	0.7	0.7
Dom Demand (y/y %)	2.8	0.9	1.7	2.6	3.5	3.3	2.5	2.0	1.2	1.0	0.8	0.8	1.2	1.4	1.9	2.2	2.5	2.6	2.7	2.8	2.8
Real GDP (q/q %)	-	-	-	-	1.0	0.7	0.3	0.1	0.5	0.5	0.5	0.5	0.6	0.5	0.7	0.6	0.6	0.6	0.6	0.7	0.7
Real GDP (y/y %)	2.7	1.7	2.2	2.5	3.1	3.1	2.6	2.2	1.7	1.4	1.6	2.0	2.1	2.1	2.3	2.4	2.4	2.6	2.5	2.6	2.6
CPI headline (q/q %)	-	-	-	-	0.4	0.4	0.4	0.5	0.0	0.6	0.4	0.6	0.4	0.4	0.5	0.7	0.5	0.5	0.6	0.7	0.7
CPI headline (y/y %)	1.9	1.5	1.8	2.2	1.9	2.1	1.9	1.8	1.3	1.6	1.6	1.6	2.0	1.7	1.8	1.9	2.0	2.1	2.3	2.3	2.3
CPI underlying (q/q %)	-	-	-	-	0.5	0.5	0.4	0.4	0.2	0.4	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
CPI underlying (y/y %)	1.9	1.4	1.5	1.9	1.9	1.9	1.8	1.8	1.5	1.4	1.4	1.3	1.5	1.5	1.5	1.6	1.7	1.9	2.0	2.0	2.0
Private wages (q/q %)	-	-	-	-	0.5	0.6	0.5	0.6	0.5	0.5	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Private wages (y/y %)	2.1	2.3	2.5	2.8	1.9	2.1	2.1	2.3	2.4	2.3	2.3	2.3	2.4	2.5	2.6	2.6	2.7	2.7	2.8	2.8	2.8
Unemployment Rate (%)	5.3	5.2	5.4	5.5	5.5	5.6	5.1	5.0	5.0	5.2	5.2	5.3	5.3	5.4	5.5	5.5	5.5	5.4	5.4	5.5	5.4
Terms of trade	2.0	3.2	-7.9	1.8	3.3	-1.3	1.1	3.0	3.1	1.5	-4.4	-4.7	-2.6	-0.6	0.9	-0.2	1.2	0.6	-0.1	-0.1	-0.1
Current Account (% GDP)	-2.1	0.3	-1.0	-0.8	-2.2	-2.7	-2.2	-1.4	-0.2	1.2	0.5	-0.3	-0.9	-1.1	-1.0	-1.0	-0.8	-0.7	-0.8	-0.9	-0.9

Source: NAB Group Economics; (a) Contributions to GDP growth

Exchange Rate Forecasts						
	28-Oct	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
<b>Majors</b>						
AUD/USD	0.681	0.65	0.66	0.67	0.69	0.70
NZD/USD	0.63	0.62	0.62	0.63	0.65	0.65
USD/JPY	108.8	104	104	105	106	106
EUR/USD	1.11	1.12	1.11	1.13	1.14	1.15
GBP/USD	1.28	1.20	1.18	1.20	1.22	1.24
USD/CNY	7.06	7.40	7.40	7.30	7.20	7.10
USD/CAD	1.31	1.36	1.38	1.38	1.36	1.35
USD/CHF	1.00	0.97	0.95	0.96	0.96	0.96

Australian Cross Rates						
	28-Oct	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/NZD	1.07	1.05	1.06	1.06	1.06	1.08
AUD/JPY	74.1	68	69	70	73	74
AUD/EUR	0.61	0.58	0.59	0.59	0.61	0.61
AUD/GBP	0.53	0.54	0.56	0.56	0.57	0.56
AUD/CNY	4.81	4.81	4.88	4.89	4.97	4.97
AUD/CAD	0.89	0.88	0.91	0.92	0.94	0.95
AUD/CHF	0.68	0.63	0.63	0.64	0.66	0.67

Interest Rate Forecasts						
	28-Oct	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
<b>Australian Rates</b>						
RBA cash rate	0.75	0.50	0.50	0.50	0.50	0.50
3 month bill rate	0.89	0.60	0.60	0.60	0.60	0.60
3 Year Swap Rate	0.80	0.70	0.70	0.85	0.95	1.00
10 Year Swap Rate	1.28	1.05	1.05	1.20	1.35	1.45
<b>Offshore Policy Rates</b>						
US Fed funds	2.00	1.75	1.75	1.75	1.75	1.75
ECB deposit rate	-0.50	-0.60	-0.70	-0.70	-0.70	-0.70
BoE repo rate	0.75	0.75	0.75	0.75	0.75	1.00
BoJ excess reserves rate	-0.10	-0.20	-0.20	-0.30	-0.30	-0.30
RBNZ OCR	1.00	0.75	0.50	0.50	0.50	0.50
China 1yr lending rate	4.35	4.10	4.10	4.10	4.10	4.10
China Reserve Ratio	13.0	12.50	12.00	12.00	12.00	12.00
<b>10-year Bond Yields</b>						
Australia	1.11	0.90	0.90	1.00	1.10	1.20
United States	1.81	1.50	1.50	1.60	1.70	1.80
New Zealand	1.20	0.95	0.95	1.05	1.10	1.30

Sources: NAB Global Markets Research; Bloomberg; ABS

Global GDP				
	2018	2019	2020	2021
Australia	2.7	1.7	2.2	2.5
United States	2.9	2.2	1.6	1.8
Eurozone	1.9	1.1	1.1	1.4
United Kingdom	1.4	1.2	1.2	1.5
Japan	0.8	1.0	0.2	0.9
China	6.6	6.3	6.0	5.8
India	6.8	5.7	6.8	7.1
New Zealand	2.9	2.1	2.4	2.0
World	3.6	3.1	3.2	3.5

Commodity prices (\$US)					
	28-Oct	Dec-19	Mar-20	Jun-20	Sep-20
Brent oil	61.9	70	70	75	75
Gold	1504	1450	1483	1518	1547
Iron ore	na	76	72	68	71
Hard coking coal*	149	170	165	160	155
Thermal coal	70	90	93	90	88
Copper	5907	6300	6225	6150	6125
Aus LNG**	10	12	12	12	12

\* FOB quarterly contract prices (thermal coal is JFY contract)

\*\* Implied Australian LNG export prices

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