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THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Hopes of a US-China 'Phase One' trade agreement have lifted financial markets. While it is unclear if existing tariffs will be rolled back, should a deal be agreed it would suggest a lower risk of an extreme tail event and may lift business confidence. Less clear is whether the drag on business investment from the unclear nature of future trading relationships will change. Expectations of further major advanced economy monetary policy easing have been dialled back, but the recent easing that has been put in place is likely to remain for an extended period. Major AE growth appeared broadly steady in Q3 but we expect further slowing through to mid-2020 - with subdued growth in the Eurozone, further slowing in the US and a turn for the worse in Japan (in part due to the increase in its Value Added Tax). Our forecasts for global economic growth are unchanged this month - we expect the global economy to expand by a sub-trend 3.1% and 3.2% in 2019 and 2020 respectively, before returning to the long-term trend of 3.5% in 2021. Recoveries in Indian and Latin American growth are the key contributors to the 2021 upturn.

- Elevated hopes of a US-China 'Phase One' trade agreement have helped to lift **financial markets** over the last month. Share markets have risen, as have bond yields, and market volatility has fallen back. The improved sentiment has been accompanied by a lowering of expectations for future major central bank policy easing.
- **Commodity prices** have declined in recent months. The RBA USD index of non-rural commodity prices fell 12% between July and October, driven by large falls in bulk commodity prices. Easing supply constraints (mainly in iron ore) and weaker Chinese demand is expected to see further price falls.
- Market expectations of future policy easing by the **major central banks** has shifted, with rate cut expectations dampened. However, the recent policy easing that has occurred (or may still occur) will be locked in for a while. At its end October meeting the US Federal Reserve cut rates, bringing the total reduction in the federal funds target range to 75bps since July. The Fed is signalling policy is likely to be on hold for now (in line with our expectation). However, while there is a possibility that the Fed may cut again if growth moderates further, the bar for the recent cuts to be reversed appears much higher. Similarly, both the ECB and Bank of Japan expect their policy rates to remain at 'present or lower levels'.
- Growth in the **major advanced economies** (AEs) appears to have been broadly steady in Q3. However, we don't expect that this represents the end to the slowdown that has been evident since late 2017. Business surveys are still consistent with subdued growth in the Eurozone, further slowing in the US and a turn for the worse in Japan. Support for growth is coming from monetary policy easing; for the major AEs this has largely been limited to the US and, to a lesser extent the Euro-zone but yields have fallen across the board, supporting financial conditions. On current settings, major AE fiscal policy is taking a contractionary turn - US and Euro-zone policy is likely to be neutral in 2020 while Japan's October Value Added Tax increase represents a significant fiscal contraction, although a recently announced stimulus package which could provide some upside to our forecast (but details are not yet available).
- **Emerging market** (EM) PMI surveys have been relatively stable in recent months. A key contributor to the strength in the EM manufacturing reading has been China – where the private sector Caixin Markit PMI survey has strengthened in recent months (contrary to the drop in the official PMI survey). In contrast, manufacturing PMIs for India, Brazil and Indonesia deteriorated. China's economy grew by 6.0% yoy in Q3 2019 – the weakest rate of growth since 1990. Given the larger than expected slowdown in growth in Q3, we have revised our forecasts lower – to 6.1% in 2019 and 5.9% in 2020 (previously 6.25% and 6.0% respectively),
- 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 the easing in monetary policy and cyclical recoveries in India and Latin America.
- While there are hopes of a partial US-China trade deal in the near future, there remains considerable uncertainty around the **US-China trade relationship** going forward. Given the ebb and flow of US-China trade tensions, another deterioration cannot be ruled out – as the US President said this week "If we don't make a deal, we're going to substantially raise those tariffs." Another source of uncertainty has been Brexit; the October agreement between the UK and the EU on the terms of the UK's withdrawal from the EU is subject to parliamentary approval post December's general election but it indicates that there is a lower risk of a damaging 'no-deal' exit.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>*: We have lowered our near-term forecast for growth and now expect 0.3% q/q (1.5%y/y) for the Q3 national accounts (released next month). We have also delayed out expectation for the next reduction in the cash rate to February 2020 (from November). Beyond that, the shape of our forecasts is unchanged. We continue to expect weak private domestic demand with weak growth in household consumption and a significant decline in dwelling investment. Business investment is expected to rise though there are some risks around this, with confidence and conditions low. Offsetting the weakness in the household sector will be a continued rise in exports in the near term and ongoing high levels of public sector investment and spending. Overall, we now see growth of 1.6% this year, before a small improvement - but below trend rates - of 2.1% in 2020 and 2.4% in 2021. With growth remaining below trend, we see a slowing in employment growth and an uptick in the unemployment rate. As a result, wage growth is unlikely to see much of an improvement and overall inflation will only reach the bottom of the target band by end 2021. We see the need for further stimulus, and while we have changed our call to February, think the next rate cut should come in December. There is also a clear role for more fiscal support.

- The **RBA left the cash rate unchanged at 0.75% in November** but released a set of updated forecasts suggesting inflation will barely return to the bottom of the target band by end 2021. Both the post meeting statement and the statement on monetary policy signal that the RBA is now in a holding pattern while it assesses the impact of the past three rate cuts. As a result, we have pushed out our expectation of the next cut to February 2020. To be clear we think the economy needs further support with the impact of recent tax cuts having been muted. With a material fiscal stimulus now looking unlikely, this presents further risk that the RBA will be forced to ease further (including both rate cuts and unconventional policy) through the first half of 2020.
- The **labour market** remains healthy despite the recent slowing in growth. The unemployment rate edged higher in October, printing at 5.3% - around ¼ppt higher than its recent trough in early 2019. The unemployment rate also remains round one percent higher than recent estimates of full employment. In the month employment fell by 19k, with decreases in both part-time and full-time employment. The participation rate edged lower but remains high after reaching record highs in mid-2019. We expect the recent strong growth in employment to slow from here and for the unemployment rate to drift higher – reaching 5.5% over the next two years. Consequently, wage growth is likely to remain weak following its Q3 print of 0.5%q/q (2.2% y/y).
- A weak outlook for **consumption** continues to weigh on our outlook for the economy overall. The weakness in household income growth (with little growth in wages) and high debt levels and stretched budgets are the key dynamics in consumer restraint. This is in line with the weak outcomes for growth in discretionary spend (and spend on goods) over the past year. Spending on essentials has grown at a higher rate but it too has slowed. Retail sales increased by 0.2% in the month of September (in nominal terms) but overall fell in volumes terms for the September quarter as a whole. Over the year, real retail sales fell by 0.2% - the weakest result since the early 1990s. Internal modelling suggests that services spending has also remained weak in Q3, pointing to a weak outcome for household consumption overall.
- Activity in the **business sector looks to have remained weak**. The NAB Monthly Business survey broadly continued to track sideways in the month, suggesting ongoing weakness in the private sector. While confidence rose in October and conditions edged higher, both remain below average after deteriorating through 2018 and early 2019. The improvement in conditions was driven by an uptick in the profitability and trading sub-components, while the employment index was flat. Conditions in the services sectors are now most favourable, while goods-related sectors including retail and wholesale are weakest. By state, NSW, WA and SA see the most favourable conditions, while Vic (after deteriorating this year) and QLD are weakest. The capex survey and national accounts released over the next month will provide an update on how business investment is tracking.
- Sydney and Melbourne continue to the lead the recovery in **house prices**, unwinding a significant proportion of their prior decline since bottoming in May. Outcomes for the other capitals have been more mixed and Perth has continued to weaken. From here we see prices increasing by around 7.5% in the two largest markets in 2020 before levelling off. While conditions in the established market have improved, we expect new construction activity to weaken further, forecasting a significant decline in dwelling investment over the next 18 months, taking the peak to trough decline to over 20%.
- **Net exports** continue to be a near-term support to growth in our forecasts. We expect the final ramp up of LNG production to support growth in exports in the near term before levelling off. With only incremental expansions in the rest of the mining sector expected, we see the support from exports fading over the next two years. For Q3, however, monthly trade data in combination with trade prices suggest net exports will add 0.1-0.2 ppt to growth.
- **Commodity prices** were generally lower in the month with prices for iron ore and coal declining, though oil tracked sideways. Going forward we expect this general trend to continue with global growth slowing and a slowdown in the Chinese construction sector. LNG volumes are expected to peak in the September quarter.
- The **AUD/USD** is important to the outlook for monetary policy. An appreciation would see further unwelcome pressure on growth and the interaction with global monetary policy remains important. We have slightly revised up our outlook for the dollar over the past month, now seeing US69c by the end of 2019 before drifting higher over 2020 and 2021.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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