EMBARGOED UNTIL 11.30 AM AEDT, WEDNESDAY 11 DECEMBER 2019

THE FORWARD VIEW: AUSTRALIA DECEMBER 2019

Private Demand still "running on empty". Broadly unchanged forecasts but concerns to the downside. Fiscal policy help unlikely.

OVERVIEW

Post Q3 GDP we have not fundamentally changed our forecasts. Indeed, the Accounts only reinforced previous concerns about the current state of private demand and its prospects going forward. As our November Business survey showed there is still no momentum in the private sector, while our internal data shows Black Friday and Cyber Monday sales produced only marginally higher monthly sales in November 2019 vis a vis November 2018 (and come post the poor October retail sales figures). It appears that tax refunds and rate cuts have been used for balance sheet repair by households rather than consumption. Meanwhile investment in dwellings continues to fall and private sector investment shows worrying weakness – with no improvement in sight. For 2019 our forecasts are unchanged at 1¾%, while 2020 and 2021 are down a touch to 2.0% (was 2.1%) and 2.4% (was 2.5%), respectively.

We have broadly maintained the shape of our growth forecasts. The key dynamics behind our assessment of the economy continue to be headwinds from a weak consumer and a significant downturn in housing construction. We have also slightly lowered business investment. Partially offsetting this is strong public sector spending and growth in exports.

In summary:

- Through the year forecasts of GDP during 2020 are broadly unchanged at 2.1% to December 2020 and 2.5% to December 2021. These are much weaker than the RBA (2¾% and 3% respectively). In our view, the RBA faces the need for another downward revision to their projections. As we head into the MYFEO we are expecting growth of only 1.8% in 2019/20 and 2.3% in 2020/21. That implies a significant hit to the Government's previous economic forecasts.
- Again our forecasts would not be enough to lower unemployment which we still see at around 5.5% by mid to late 2020 and into 2021.
- Inflation forecasts are unchanged with core inflation not back to around 2% (bottom of the band) by end 2021. That reflects weak wage growth and ongoing margin pressures – especially in wholesale and retail.

As noted in our Rate Change Note last week, with the Government unwilling to use policy to meaningfully boost activity we added another 25bp cut to our cash rate track – which together with a cut in February takes the cash rate to 0.25% by mid 2020. At this point, we see an increased risk of a move to 'unconventional' policy in H2 2020 should the labour market deteriorate more significantly than we forecast. That is a real prospect.

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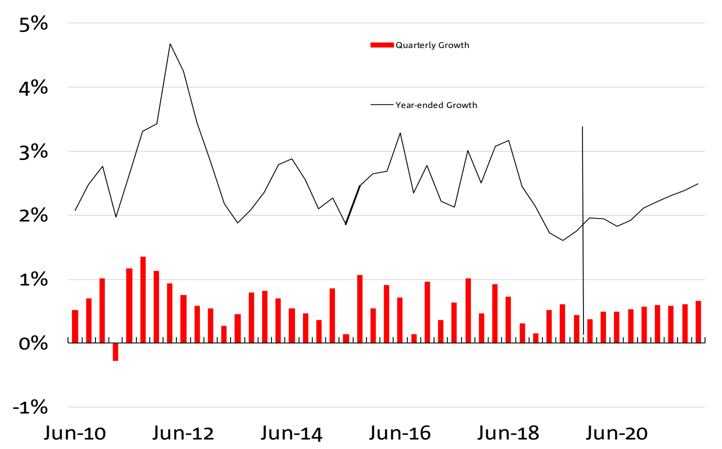
KEY ECONOMIC FORECASTS

	2018	2019-F	2020-F	2021-F
Domestic Demand (a)	2.9	1.0	1.4	2.4
Real GDP (annual average)	**2.7**	**1.8**	**2.0**	**2.4**
Real GDP (year-ended to Dec)	**2.1**	**2.0**	**2.1**	**2.5**
Terms of Trade (a)	1.8	5.4	-6.5	-1.8
Employment (a)	2.7	2.2	0.9	0.8
Unemployment Rate (b)	5.0	5.4	5.6	5.6
Headline CPI (b)	1.8	1.8	1.9	2.4
Core CPI (b)	1.8	1.4	1.7	2.1
RBA Cash Rate (b)	1.50	0.75	0.25	0.25
$A/US cents (b)	0.71	0.69	0.71	0.74

(a) annual average growth, (b) end-period, (c) through the year inflation

NAB GDP FORECASTS



Source: ABS, NAB Group Economics

LABOUR MARKET, WAGES AND THE CONSUMER

The unemployment rate edged up to 5.3% in October – but broadly it continues to hover around ¼ ppt above its trough in February 2019. Alongside a further tick-down in the participation rate, employment fell by 19k in the month, its largest fall since August 2016. The fall was driven by a decline in both the full-time (-11k) and part-time components (-9k). Overall, year-ended growth in employment remains well above that of the working-age population but has slowed from over 2.5% to around 2.0% in recent months. This slowing follows a softening in indicators of labour demand such as job ads and vacancies.

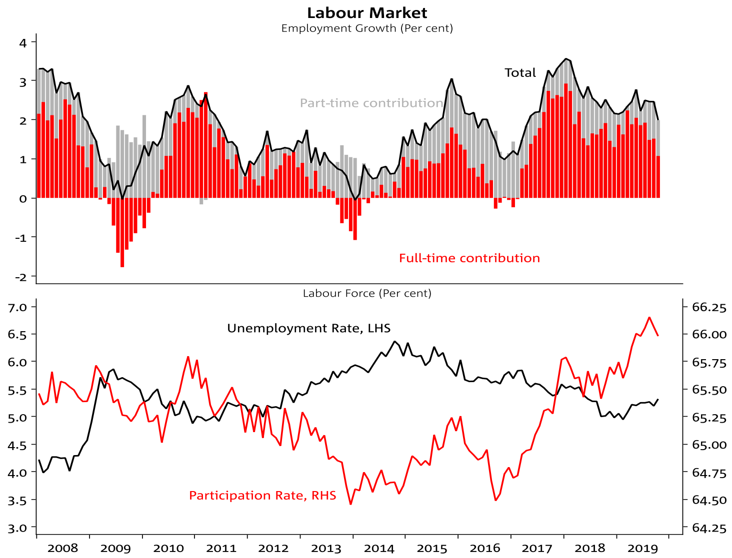
For now, despite this extended period of strong employment growth, it appears that there is significant spare capacity remaining in the labour market with unemployment around 1ppt higher than recent estimates of full employment. Indeed, wage data for the September quarter shows momentum has stalled with quarterly growth slowing to 0.5% and y/y growth printing at just 2.3%.

Going forward, we expect employment growth to slow further (falling to just 1% y/y) with private sector growth remaining weak. At this pace, we think the unemployment rate will edge higher and that wages growth with remain muted as spare capacity in the labour market grows.

A key implication of weaker wage growth is ongoing restraint in household consumption, with households already constrained by high debt levels seeing little growth in income. Consumption growth slowed to 1.2% y/y in Q3 – its weakest pace since the GFC. In the quarter the 0.1% outcome was driven by a rise in health, recreation & culture and spending on financial services. This was offset by weakness in other, more discretionary items. This pattern has been broadly reflected over the year, with spending growth on all but stalling and growth in spending on essentials also slowing significantly. This is in line with a constrained household forced to spend only on those items it requires. Households appear to have saved the bulk of tax refunds.

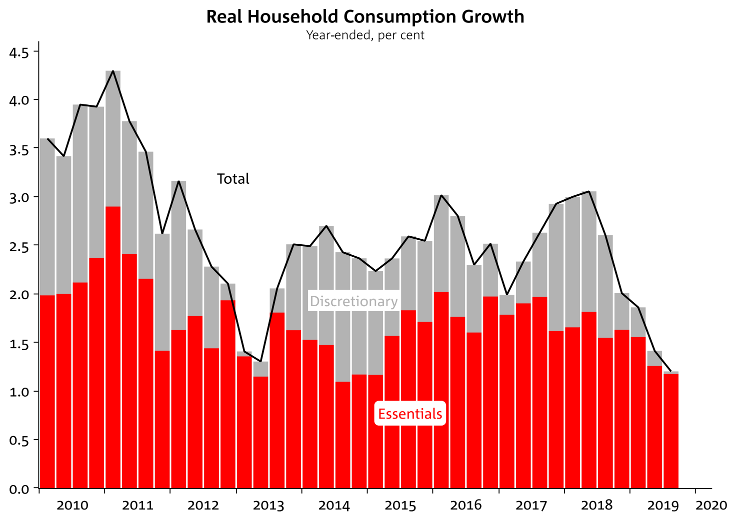
We expect consumption growth to remain modest (and continue to weigh on overall growth) over the next two years. Indeed, retail sales for the first month of Q4 recorded a flat outcome – meaning that goods consumption will again be weak in Q4. The NAB Cashless Retail Sales index for November will provide an early read on how sales have progressed into the middle of the quarter.

HEALTHY LABOUR MARKET...



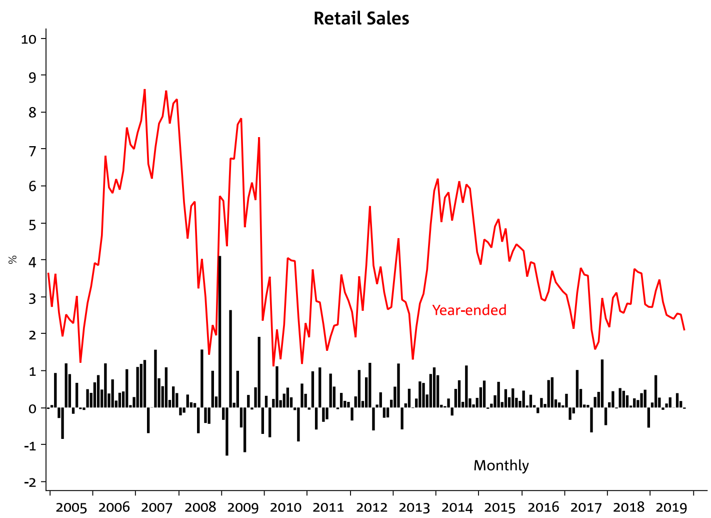
Source: National Australia Bank, Macrobond

WEAK CONSUMPTION GROWTH...



Source: National Australia Bank, Macrobond

RETAIL SALES GROWTH IS WEAK...



Source: National Australia Bank, Macrobond

HOUSING AND CONSTRUCTION

House prices in Sydney and Melbourne have risen strongly since reaching a trough in May, while auction clearance rates have also recovered. While prices in the established market have recovered following the relatively large declines observed over the previous two years, the activity side of market remains soft with construction pulling back and approvals for new dwellings continuing to trend down.

Lower interest rates and a reduction in serviceability floors are likely to have contributed in part to the rebound in house prices on the eastern seaboard. Also population growth remains strong and the unemployment rate is also relatively low in each of these states. The adjustment underway on the supply side (weaker construction), would also serve to support prices.

In November the CoreLogic 8-Capital City dwelling price index rose by 2.0% m/m. Price rises were led by Sydney (2.7%) and Melbourne (2.2%), while the other capitals also saw increases (excluding Darwin). This outcome includes the first monthly increase in Perth prices for sometime, where conditions in the established housing market have remained weak.

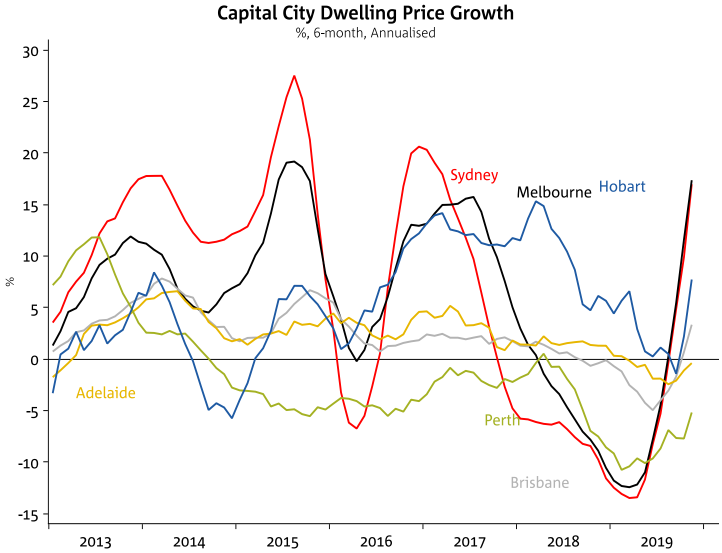
Prices are now 8% below their peak in Sydney and 4% lower than their highs in Melbourne. This compares with peak to trough declines over 15% and 11% respectively in these cities. Perth is 21% lower than its previous peak in 2014. Brisbane and Adelaide have seen more mixed outcomes.

As noted above, actual new construction in the residential market continues to soften. Dwelling investment recorded a fall of 1.7% in the Q3 national accounts (a 2.5% fall in new dwelling construction was partially offset by a small rise in investment in alterations & additions). This takes the total decline over the year for dwelling investment to 9.7%. We continue to expect a similar sized decline over 2020 before activity flattens out in 2021.

Related to the slowing in the activity side of the market, housing credit growth has continued to slow. Over the year, investor credit has fallen 0.2% and though credit to owner-occupiers has held up better, it has also slowed and is now 4.8% y/y. Overall, housing credit has slowed to 3.8% y/y. The accelerated repayment due to lower rates has also been a drag on credit.

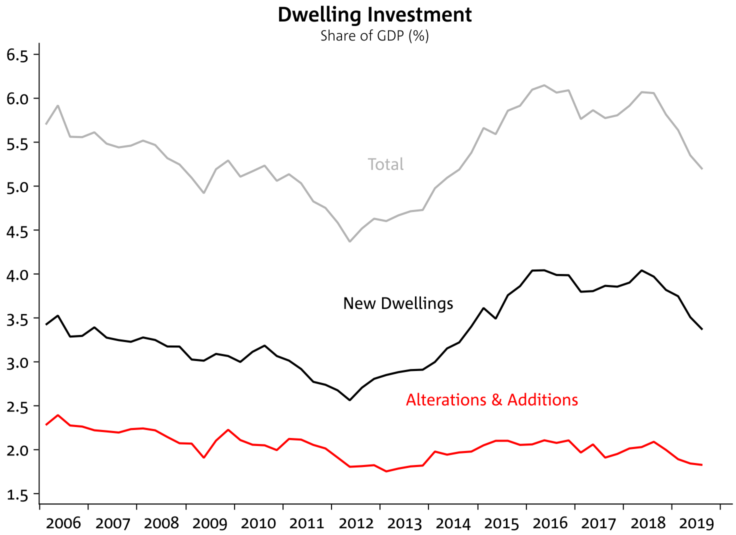
We expect the recovery in prices to continue with Sydney and Melbourne prices increasing by around 7.5% over 2020. The other cities are likely to see flatter outcomes. Overall we expect prices nationwide to increase by around 5.0% over the year. While we expect prices to continue to rise, we expect dwelling construction to continue to decline relatively sharply. We expect dwelling investment to decline by a further 9% in 2020 before levelling off in 2021. While the pipeline of work remains elevated the high rate of work done will see this rapidly eroded with approvals (new work) continuing to trend lower.

PRICES ARE STABILISING...



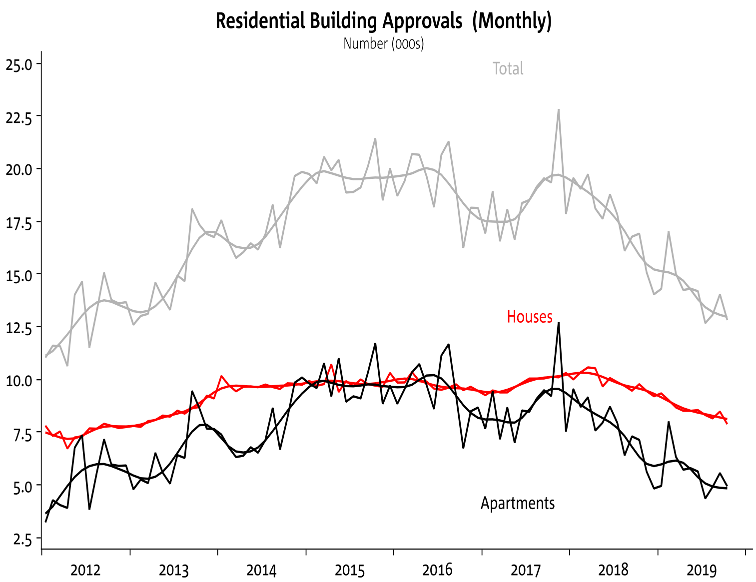
Source: CoreLogic, National Australia Bank, Macrobond

DWELLING INVESTMENT TO FALL FURTHER...



Source: National Australia Bank, Macrobond

APPROVALS SUGGEST MORE WEAKNESS...



Source: National Australia Bank, Macrobond

BUSINESS AND TRADE

With consumption growth expected to be weak, business investment will be an important swing factor for growth. However, at present investment growth appears to be relatively weak despite the low rate environment and expected spill-overs from strength in public infrastructure spending. At least in part, the weakness in investment can be explained by the fact firms continue to use sticky hurdle rates (which are relatively high for a low inflation environment) despite a lower cost of capital. Investment in the mining sector is also likely to remain volatile as it troughs – but we think it is unlikely that there will be a material increase in new projects in the sector over coming years.

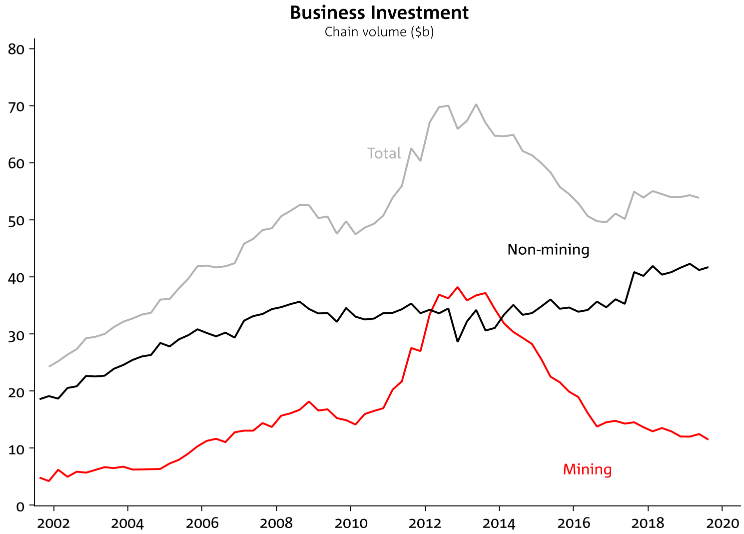
Overall, national accounts data for Q3 showed business investment remained weak. Investment fell by 2.0% in Q3 on the back of a sharp fall in engineering investment (mining related) and a fall in spending on machinery & equipment (typically related to the non-mining sector). Non-residential building saw a rise in the quarter driven by construction of offices and other industrial buildings. New business investment is now 1.7% lower than a year ago.

The NAB Monthly Business survey which provides a more timely read of activity in the business sector suggests that conditions have remained weak but have stabilised after a period of significant declines from mid-2018 through to mid-2019. In the November, conditions were unchanged at +4 index points, while confidence unwound last months increase and now lie at 0 index points. Other forward indicators also pulled back with forward orders reversing last month's increase to again be negative and below average, while capacity utilisation fell back to around average.

The survey continues to suggest a gap in the performance between services industries, which currently see the best conditions and the goods industries, which are weakest. Manufacturing and construction have stabilised around he middle of the pack, while mining has eased back in recent months. By state, the best conditions are seen in NSW and Tas, while Vic and Qld are weakest.

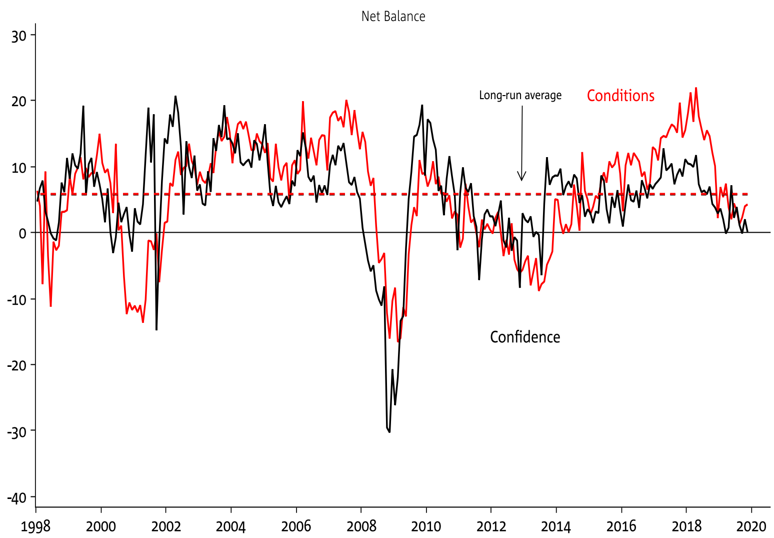
Net exports contributed 0.2% to GDP growth in Q3, for an annual contribution to growth of over 1.0%. These increases have been driven by the ramp up of LNG production as the last of the mega-projects inters production. Data for the first month of Q4 suggest some pull-back in exports with iron ore softening. Going forward we expect exports to make a contribution in the near term to growth but that this will level off with little further expansion in the mining sector underway. Growth in exports will likely come from services such as tourism and education going forward, but this will depend on the exchange rate and world income growth.

NON-MINING INVESTMENT IS WEAK..



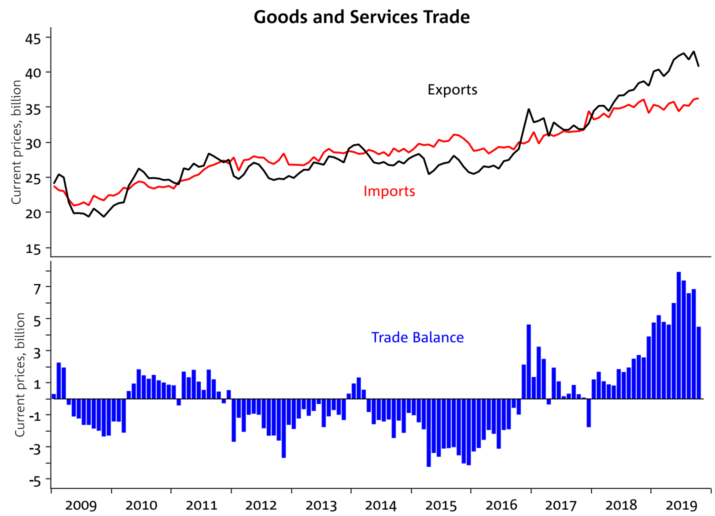
Source: National Australia Bank, Macrobond

CONFIDENCE AND CONDITIONS WEAK...



Source: National Australia Bank, Macrobond

EXPORTS CONTINUE TO RISE...



Source: National Australia Bank, ABS

COMMODITIES

Spot prices for iron ore fell in the first half of November – briefly dipping below US$80 a tonne – before strengthening in the second half, with prices back above US$90 a tonne at the time of writing. The price increase has been attributed to rising steel prices and expectations of infrastructure supported growth in China in 2020. That said, weaker iron ore demand (due to Chinese steel capacity closures over the northern winter) should begin to weigh on prices going forward. Our forecasts for iron ore are unchanged, with the landed spot price in China to average US$93 a tonne in 2019 before easing to US$74 a tonne in 2020.

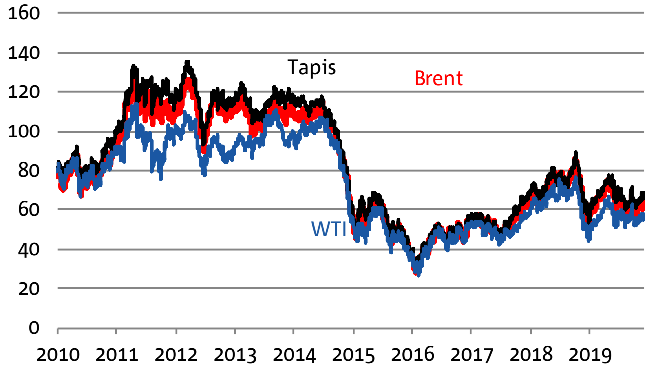
Spot prices for thermal coal have remained relatively stable since early October – with prices ranging between US$66 and US$68 a tonne. Similarly, prices for hard coking coal were fairly flat across November – in the low-to-mid US$130s range – but have risen back to around US$140 a tonne in early December. Weak demand – due to steel capacity closures over the northern winter – should limit upside pressure in the near term. Our forecasts for 2020 remain unchanged – with hard coking coal averaging US$150 a tonne and thermal coal averaging US$70 a tonne – however with current spot prices below these levels, there is an obvious downside risk to this outlook.

Oil prices briefly perked up after OPEC+ (OPEC & other major producers such as Russia) agreed to cut oil supplies by a further 500,000 barrels per day (bpd) in early 2020 – although weak Chinese merchandise export numbers limited these gains. These cuts are in addition to the 1.2 million bpd reductions agreed upon earlier. We have maintained our end of year forecasts for the benchmark Brent indicator at US$65/bbl for 2019. Further out, we have trimmed our forecasts – with our December 2021 forecasts down to US$70/bbl, previously (US$72/bbl).

Production and exports of LNG continue to remain strong in Australia, with Australia likely to have surpassed Qatar as the world's largest LNG exporter, according to EIA estimates. Increasing production and lower prices (relative to a year ago), suggest that the Australian Domestic Gas Supply Mechanism trigger will likely not be initiated this summer. However, Consultancy Wood McKenzie note that Victoria could face a shortfall as early as 2023, partly due to bans on onshore drilling. Further, export prices will be constrained to around AUD 11-12/GJ due to softer demand and more aggressive negotiation tactics from Asian buyers such as Korea Gas Corporation.

GLOBAL OIL PRICES

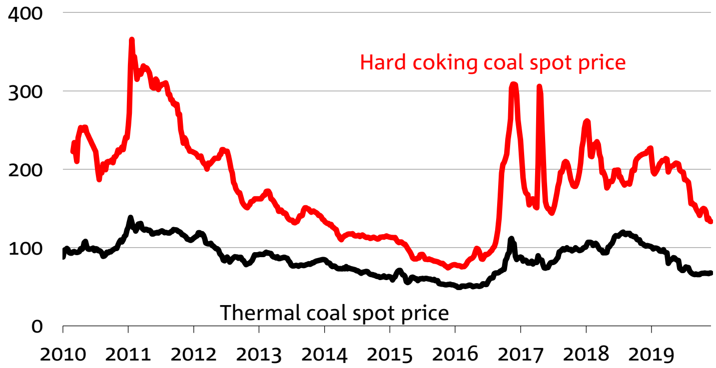
USD/bbl, daily



Source: Refinitiv, NAB Economics

COAL SPOT PRICES

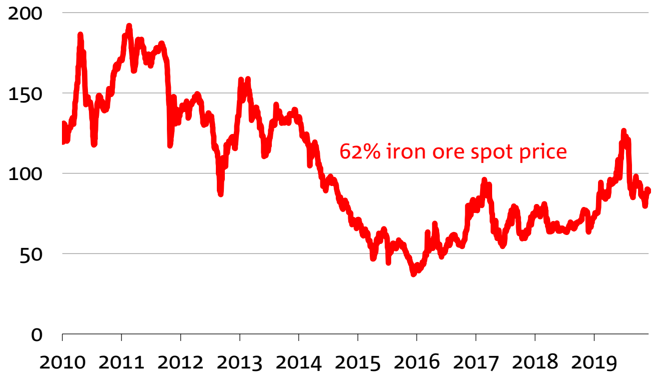
USD/T



Sources: Bloomberg, NAB Economics

IRON ORE SPOT PRICE

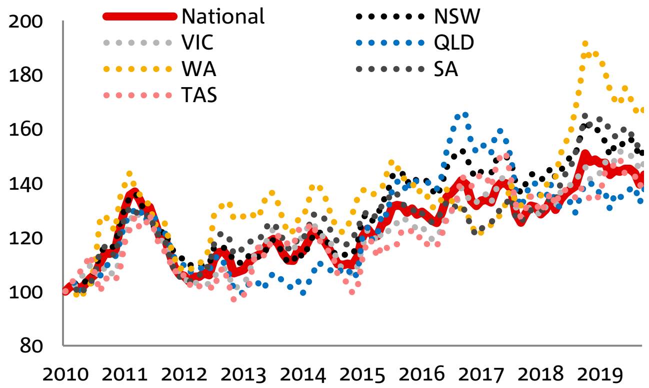
US$/t (incl. cost of freight)



Sources: Refinitiv, NAB Economics

NAB RURAL COMMODITIES INDEX

Jan 2010 = 100



Source: ABARES, Meat and Livestock Australia, Australian Pork, Ausmarket, ABS, Bloomberg, Thomson Reuters, BREE and Profarmer

MONETARY POLICY, INFLATION AND FX

As noted above the RBA has a more positive view on the outlook for the economy. Indeed the first paragraph of the recent Statement on Monetary Policy (SOMP) reads "The Australian economy is gradually coming out of a soft patch. GDP growth has been recovering since its low point last year; it picked up a little in the first half of 2019 and moderate growth is expected over the remainder of the year. Growth is expected to reach 2¾ per cent over 2020 and around 3 per cent by the end of 2021". In our view recent data – including Q3 National accounts – seriously draws that assessment into doubt.

Of course holding rates at their current level in December "allows time to assess the effects of the recent easing of monetary policy as well as global developments". Beyond that the Bank has signalled a willingness to further "support sustainable growth in the economy, full employment and the achievement of the medium-term inflation target over time".

Clearly we are much more wary on the near term and longer run growth outlook. That also applies to our unemployment expectations – which also feeds into weak wages growth. Like the RBA, however, we see few signs that inflation will do any better than reaching the bottom of the target (i.e. 2%) before December 2021 – indeed they forecast 1.9%. Our forecasts are based on relatively weak wages growth (not helped by rising unemployment), low productivity growth and strong downward margin pressure in the retail sector.

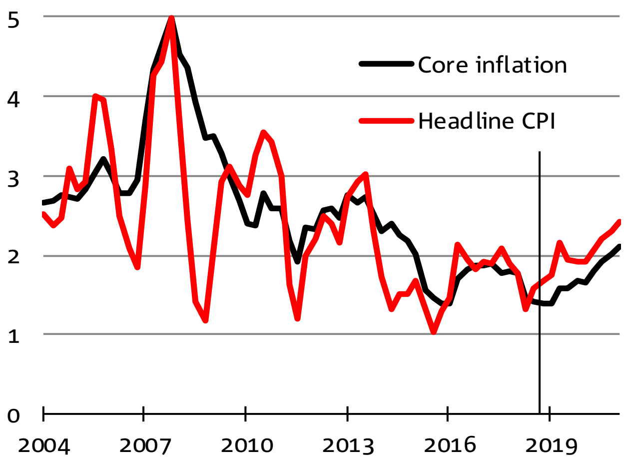
As noted previously, with the Government unwilling to use policy to meaningfully boost activity we added another 25bp cut to our cash rate track – which together with a cut in February takes the cash rate to 0.25% by mid 2020. At this point, we see an increased risk of a move to 'unconventional' policy in H2 2020 should the labour market deteriorate more significantly than we forecast. That is a real prospect.

On the question of how the transmission mechanism of monetary policy has changed in a low rate environment our judgment is that it has probably weakened – especially in household cashflow terms (as households opt not to pay less on mortgages and those dependent on interest income are forced to reduce spending). Also interest rates so far have not really been effective in increasing business willingness to invest. That may be partly explained by lags, but the use of high and relatively sticky hurdle rates (around 14% according to results from our quarterly Business survey) also constrains business investment. Finally the Government's decision to delay new investment allowances till the May Budget has also not helped.

The exchange rate is however still an important channel of monetary policy and a mechanism by which global developments will impact the domestic market. The exchange rate recently - post the increased confidence of a US-China trade deal and less action priced for the Fed - is trading around 0.685c with the TWI around 59.5. The latter is interesting in that it remains around the same level as when the RBA started cutting in June 2019. Clearly as other central banks also cut, the currency has remained broadly unchanged rather than depreciating. We have not changed our currency forecast of 0.69c by end 2019 and around 0.70c by end 2020 and 0.74c by end 2021. Clearly a rising currency would be unhelpful.

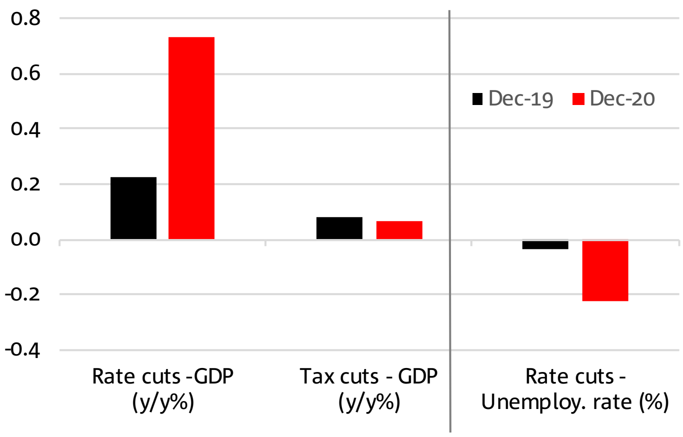
HEADLINE AND CORE INFLATION...

y/y % change



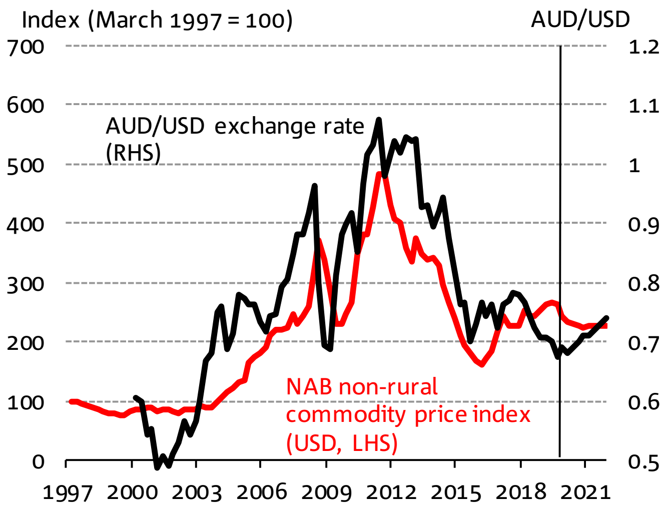
IMPACT OF FISCAL STIMULUS AND RATE CUTS ON ACTIVITY FORECASTS...

Impact of policy stimulus (deviation from baseline)*



*Rate cuts: 25bp cut in each of Q2, Q3, Q4 2019; annual tax cut of $7.2b starting Q3 2019. NAB estimates utilsing AUS-M model

AUD AND COMMODITY PRICES...



Sources: Econdata DX, RBA, ABS, NAB Economics

APPENDIX A: FORECAST TABLES

DETAILED ECONOMIC FORECASTS (ANNUAL AVERAGE)

Australian economic and financial forecasts (a)

	Fiscal Year				Calendar Year				
	2017-18	2018-19 F	2019-20 F	2020-21 F	2017	2018	2019-F	2020-F	2021-F
Private Consumption	2.9	2.0	1.1	1.8	2.5	2.7	1.4	1.4	2.0
Dwelling Investment	0.5	0.0	-9.1	-4.5	-2.2	4.7	-7.1	-7.8	-0.7
Underlying Business Investment	6.9	-1.9	-4.4	1.4	3.8	1.3	-3.0	-2.4	3.2
Underlying Public Final Demand	5.0	4.1	5.2	3.9	5.0	4.4	4.8	4.6	3.6
Domestic Demand	**3.5**	**1.7**	**0.9**	**2.0**	**3.0**	**2.9**	**1.0**	**1.4**	**2.4**
Stocks (b)	0.0	-0.2	-0.1	0.1	-0.1	0.1	-0.3	0.1	0.0
GNE	**3.6**	**1.5**	**0.8**	**2.1**	**2.9**	**3.0**	**0.7**	**1.4**	**2.4**
Exports	4.1	3.9	3.4	1.9	3.4	5.1	3.5	2.5	2.0
Imports	7.2	0.2	-1.4	1.7	7.8	4.1	-1.5	0.1	2.5
GDP	**2.9**	**2.0**	**1.9**	**2.1**	**2.5**	**2.7**	**1.8**	**2.0**	**2.4**
Nominal GDP	4.9	5.3	3.6	2.9	6.2	5.0	5.0	2.4	4.0
Current Account Deficit ($b)	51	14	-14	9	46	39	-14	1	11
(-%) of GDP	2.8	0.7	-0.7	0.4	2.6	2.1	-0.7	0.1	0.5
Employment	3.0	2.4	1.6	0.6	2.3	2.7	2.2	0.9	0.8
Terms of Trade	1.8	5.6	-1.2	-5.0	11.7	1.8	5.4	-6.5	-1.8
Average Earnings (Nat. Accts. Basis)	1.4	1.8	2.9	2.7	0.9	1.5	2.5	2.7	2.8
End of Period									
Total CPI	2.1	1.6	1.9	2.2	1.9	1.8	1.8	1.9	2.4
Core CPI	1.8	1.4	1.6	1.9	1.9	1.8	1.4	1.7	2.1
Unemployment Rate	5.6	5.2	5.4	5.5	5.4	5.0	5.4	5.6	5.6
RBA Cash Rate	1.50	1.25	0.25	0.25	1.50	1.50	0.75	0.25	0.25
10 Year Govt. Bonds	2.63	1.32	0.80	1.00	2.63	2.32	1.00	0.80	1.20
$A/US cents :	0.74	0.70	0.69	0.72	0.78	0.71	0.69	0.71	0.74
$A - Trade Weighted Index	62.6	60.1	58.7	60.2	64.9	60.7	59.0	59.9	61.1

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

COMMODITY PRICE FORECASTS

		Spot	Actual	Forecasts								
	Unit	6/12/2019	Sep-19	*Dec-19*	*Mar-20*	*Jun-20*	*Sep-20*	*Dec-20*	*Mar-21*	*Jun-21*	*Sep-21*	*Dec-21*
WTI oil	US$/bbl	59	58	60	60	61	62	63	63	64	64	65
Brent oil	US$/bbl	64	64	65	65	66	67	68	68	69	69	70
Tapis oil	US$/bbl	70	67	67	67	68	69	70	70	71	71	72
Gold	US$/ounce	1460	1480	1480	1490	1510	1520	1540	1550	1570	1580	1600
Iron ore (spot)	US$/tonne	90	102	88	79	76	72	68	71	69	71	69
Hard coking coal*	US$/tonne	n.a.	163	150	145	150	152	150	153	151	150	150
Thermal coal (spot)	US$/tonne	67	69	72	72	70	68	70	72	68	65	65
Aluminium	US$/tonne	1772	1764	1750	1740	1750	1765	1775	1800	1825	1850	1875
Copper	US$/tonne	5962	5814	5750	5700	5725	5750	5850	5900	5950	6000	6020
Lead	US$/tonne	1875	2011	2050	1900	1800	1750	1725	1700	1725	1700	1675
Nickel	US$/tonne	13423	14891	15250	12750	12500	12250	12100	12300	12500	12750	13000
Zinc	US$/tonne	2243	2355	2450	2400	2400	2425	2450	2300	2200	2150	2150
Aus LNG**	AU$/GJ	n.a.	12.5	11.0	11.2	11.0	11.0	11.0	11.2	11.0	11.0	10.7

* Data reflect NAB estimates of US$/tonne FOB quarterly contract prices, based on quarterly average spot prices.

** Implied Australian LNG export prices

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