March 2020

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

We have significantly lowered our global growth forecasts due to the slower than expected recovery in activity in China and the increasing spread of the Coronavirus to other countries and associated containment measures. We now expect global growth to be only 2.4% in 2020 (from 3.0% last month and 3.2% pre-virus). Financial markets have gone into a tailspin with large falls in equities, bond yields and commodity prices. Central banks are easing policy and fiscal measures are being put in place. Growth is only likely to show recovery when panic around the spread of the Coronavirus starts to ease and containment measures (by government or self-imposed by households/businesses) start to recede. We now expect a large fall in China GDP in Q1, recessions in the Euro-zone and Japan and much lower growth elsewhere in H1, with risks skewed to the downside.

Since our forecasts were prepared earlier this week some of these risks have been realised – including new containment measures in the US (e.g. a European travel ban) and all non-essential shops being closed in Italy – so further forecast downgrades are likely. With a pandemic underway governments are prioritising containing the virus over economic activity. The sooner the virus spread is controlled the sooner economic activity can rebound but the risk is that the stress on businesses and markets sets in train a longer downturn.

- The growing spread of the Coronavirus spooked **financial markets** in late February. Global equity markets have fallen sharply – with US markets down around 27% peak to trough (including a 10% fall overnight), from their high point on 19 February, market volatility is high and credit spreads have increased. Bond yields have fallen across most major markets – yields on ten-year US treasuries fell to an all-time low. **Commodity prices** have also fallen on expectations that slower global economic growth would further weaken demand for raw materials. Energy markets have seen the largest falls due to OPEC+ failing to agree to production cuts.
- **Central banks** are easing policy and supporting market liquidity. In early March, the US Fed cut the fed funds rate by 50bps and overnight stepped in to alleviate market stress by redistributing its $60b a month of T-bill purchases across the curve and by announcing further term repo operations. Our current forecast is for the Fed to cut rates by 75 basis point this month and 25 bps more in April but clearly there is chance that they will do this in a single meeting (i.e. 100bs at next week's meeting or before). The Bank of England also cut Bank Rate by 50bps. The ECB surprised by leaving its deposit rate unchanged but announced further asset purchases and lending support measures. We expect the Bank of Japan this month will undertake similar measures but also expect a small (10 basis points) in the deposit rate.
- We now expect a decline in the major **advanced economies** (AEs) economies in the first half of the year, including recessions in Japan and the Euro-zone. This reflects the likelihood of growing supply disruptions, the impact of containment measures and community reaction (staying at home). Italy has also seen a major outbreak and case numbers are growing in the rest of Europe, as well as in the US. In Italy, quarantine restrictions have been imposed on the entire country (although travel for work appears permitted). The economic impact of such extraordinary measures is hard to quantify but is likely to be significant. The risk is that such measures continue to ramp up in the rest of Europe and to North America.
- PMI surveys in **Emerging Economies** (EMs) showed a sharp drop off in February, although this was driven largely by China (where both the manufacturing and services PMIs were at all-time lows). Given this, and the only slow recovery indicated by tracking indicators, we have further reduced our forecasts for China and now expect a 1.5% qoq contraction in Q1 growth. This will have flow on effects to its neighbours in East Asia and there has been a rapid increase in Coronavirus cases outside China (particularly South Korea).
- We now expect **global growth** to be only 2.4% in 2020. Risks and uncertainties around the forecasts are high and are skewed to the downside. Central to the forecast is an expectation that containment efforts will be somewhat successful and that this is evident sometime in Q2. Whether this is the case, and how quickly any rebound commences, is highly uncertain. Countries experiencing an increase in the number of infections are putting in place a range of containment measures with the list of measures growing daily. Consumer and business behaviour (not going out to cinemas, cutting back on travel) is another factor. What new containment measures will be implemented from here, and how consumers/businesses react, is hard to predict.
- The longer the virus impacts economies, the greater the **risk of second round impacts** – company failures (e.g. in the US with corporates highly geared or in hard hit sectors such as travel, energy), layoffs (or unpaid leave) leading to financial stress, and capital flight from vulnerable EMs – triggering a deeper and longer downturn. Policy – both fiscal and monetary policy – is being deployed. It may not be able to resolve the underlying cause, but it can mitigate the economic impact and reduce the risk of a deeper downturn.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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Australia: The national accounts showed growth of 0.5% q/q (2.2% y/y) confirming a below-trend pace of growth prior to any virus impact. The accounts showed a similar pattern of growth to previous quarters, with falling dwelling and business investment detracting from domestic demand, while consumption growth remains soft. Again, the public sector and exports added to growth, but by less than recent quarters. While the release largely confirmed growth remained soft in the back end of 2019, all focus is now on the impact on growth from the spread of the corona virus. We have pencilled in a negative quarter of growth for Q1 – on the back of softer exports (tourism and education) as well as a hit to consumption. For Q2 we believe the Government's announcement of an $18bn fiscal support package has centred the risks around our expectations of a small rise in GDP. Overall, we see little growth in H1 2020 and year-average growth of 1.2% in 2020. We see an improvement in growth to 2.8% in 2021, however this will not occur fast enough to prevent a deterioration in the unemployment rate – which is expected to reach 5.7% by end-2020. Consequently, we see further easing in monetary policy (including a move to yield curve control) and the potential for more support from fiscal policy in the may budget.

- The **RBA** cut rates by 0.25% in March to a new record low of 0.5%. We expect the RBA to cut rates again in April, taking the cash rate to 0.25% - the zero bound in Australia. Given the weak starting point for the economy, the global impact of the coronavirus is likely to require a larger response. Therefore, we now expect the RBA to engage in 'unconventional policy' by June. This will most likely come in the form of yield curve control. Essentially this is a form of quantitative easing where the central bank first announces a 'target' for the yield curve – leveraging the announcement effect. If the announcement alone is not enough hit the target, the RBA will then directly purchase bonds in the secondary market driving down yields. The duration and magnitude of this policy action will depend on economic and financial conditions going forward.
- The **unemployment rate** edged up to 5.3% in January following the surprise decline in December. Employment rose 13.5k (46.2k increase in FT, partially offset by a 32k decline in PT). The participation rate was unchanged at 66%, close to its record high. With unemployment around ¾ppt above the NAIRU it is likely wage pressures will remain weak. WPI for Q4 showed ongoing weak wage growth of 0.5% q/q and 2.2% y/y. Indicators of labour demand have moderated recently suggesting that employment growth will slow from the rates seen early last year. Indeed, the NAB survey employment index, has moderated (to around average) and implies employment growth going forward of around 16k per month.
- The national accounts showed **consumption** continues to grow at its slowest pace since the GFC. In the quarter, consumption rose 0.5% - led by a rise in discretionary spending. However, over the year consumption growth was flat at 1.2%. with the bulk of growth coming from spending on essentials. We expect the dynamics of weak household income growth, high debt levels and stretched budgets to continue to weigh on consumption growth going forward. While rapidly rising house prices over the second half over 2019 may have provided some support via a 'wealth effect' the recent declines in share prices are likely to weigh going forward. Consumption looks to have remained weak in Q1, with nominal retail sales declining by 0.3% in January, following a downwardly revised 0.7% fall in December. An update of the NAB Cashless Retail Sales Index released next week will give an early indication of how sales have tracked in the middle of the quarter.
- **Business investment** fell in Q4 driven by weakness in the non-mining sector. Mining investment ticked up in the quarter. By asset, non-dwelling construction fell with both building and engineering construction lower. The ABS capex survey showed a rise in investment expectation in 2019/20 on the back of higher mining investment while the first estimate (while highly uncertain) for 2020/21 implies and increase of around 6.5% in nominal terms. Mining investment is expected to rise by around 21% suggesting the non-mining sector is likely to remain weak. Indeed, the NAB Monthly Business survey reports a decline in capex alongside the decline in business confidence and conditions over the past 18 months or so. In February, both conditions and confidence declined, while forward indicators were also softer.
- **Housing market** dynamics continue to have pervasive impacts on the economy. The decline in new construction continued in Q4 with dwelling investment down 3.2%. Dwelling investment has fallen by 9.7% over the past year (and around 13% since 2017). We expect that new construction will continue to decline in the near-term, with approvals still low and a high rate of work done, seeing the pipeline of construction rapidly eroded. Dwelling prices have continued to increase. **Dwelling prices** continue to rise, led by Sydney and Melbourne which are now up by around 11% over the past year. The other capitals have also increased over the past year except for Perth and Darwin.
- **Net exports** made a small contribution to growth in Q4 but ongoing impacts from the coronavirus may impact both imports and exports going forward. Beyond that, we still expect resource exports to level off with little new production capacity coming online. The trade surplus narrowed slightly in January but remains elevated.
- **Commodity prices** have seen significant volatility in recent weeks as news of the impact of the coronavirus spread worsens. Oil prices have also fallen significantly on the fallout between Russia and Saudi Arabia. From here we expect a general softening in commodity prices through the rest of 2020.
- The AUD has depreciated by around 6% since the beginning of 2020 – and recently seen impacts from the coronavirus. We have slightly lowered our currency forecast to around 0.70c by end 2020 and 0.73c by end 2021.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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