EMBARGOED UNTIL 11.30 AM AEDT, WEDNESDAY 11 MARCH 2020

THE FORWARD VIEW: AUSTRALIA MARCH 2020

Soft Economy likely to be hard hit by COVID-19. Outlook heavily dependent on severity and how long disruption effects of the virus last.

OVERVIEW

- Basically the Q4 national accounts has done little to our forecasts. The key themes of 2020 remain:
  - Weak consumer spend with wages growth poor
  - Falling investment in dwellings – albeit bushfire rebuild will help stabilise the fall in H2 2020 with the main rebuild in 2021
  - Still very weak business investment
  - Strength in public demand and net exports
- Essentially the economy was soft prior to the COVID-19 impact. NAB internal data suggests that the disruption effects continued through February.
- As a result we have increased the hit from COVID-19 in Q1 – reflecting falling consumer spend, tourist and education hits, supply chain disruption and weaker exports. Previously we had expected Q1 to fall moderately (-0.1%). We now expect to see Q1 GDP down by around -0.3% with a weak Q2 - of around 0.3%. So even if the virus disruption is largely over by mid year we are expecting no growth in H1 2020.
- With a rebound in H2 (at around 0.75% per quarter) that would see 2020 GDP growth of around 1.2%. Previously we had 1.5%. We expect the recovery to be more pronounced in 2021 – albeit from a lower base. Thus we see year average growth of 2.8% in 2021 (was 2.6%).
- That includes stronger consumption and investment growth and bushfire rebuild helping dwelling construction. But relatively flat contributions from net exports and the public sector.
- This profile sees unemployment deteriorate to 5.7% by end 2020 but move back to around 5.5% by end 2021.
- Whether we avoid a technical recession is very much driven by the duration of disruption from COVID-19. Our judgment is the risk has to be that the virus will be a problem for longer and hence there are downside risks.
- We still see the RBA cutting further in April to 0.25% - followed up by the RBA using yield curve guidance and/or buying bonds. The latter is now a central part of our forecasts. Timing will however be virus dependent.
- The Government's upcoming stimulus package will no doubt help. Hopefully it will be aimed at helping SME and household cash flows. That could include investment allowances and delays in GST and BAS payments together with bringing forward infrastructure spend and maintenance. We still have doubts as to whether the size of the package will be sufficient. Prior to the stimulus package we thought it might still be possible to see a budget surplus this year (but would be line ball) but was unlikely to be achieved in 2020/21. The package will be announced tomorrow.

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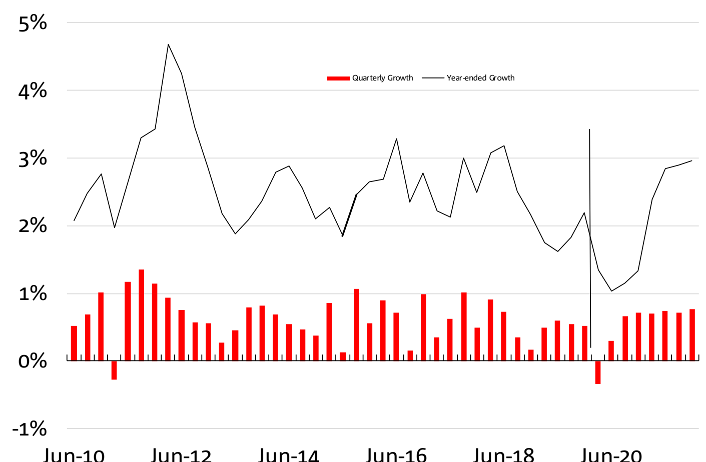
KEY ECONOMIC FORECASTS

	2018	2019	2020-F	2021-F
Domestic Demand (a)	2.9	1.2	1.0	3.1
Real GDP (annual average)	**2.7**	**1.8**	**1.2**	**2.8**
Real GDP (year-ended to Dec)	**2.2**	**2.2**	**1.3**	**3.0**
Terms of Trade (a)	1.8	5.2	-7.2	-1.8
Employment (a)	2.7	2.4	1.0	0.5
Unemployment Rate (b)	5.0	5.1	5.7	5.5
Headline CPI (b)	1.8	1.8	2.0	2.3
Core CPI (b)	1.8	1.4	1.8	2.0
RBA Cash Rate (b)	1.50	0.75	0.25	0.25
$A/US cents (b)	0.71	0.70	0.71	0.74

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

NAB GDP FORECASTS



LABOUR MARKET, WAGES AND THE CONSUMER

The unemployment rate rose to 5.3% in January, unwinding its surprise fall in December, with employment growing by 13.5k (a 46.2k rise in full-time was partially offset by a 32.7k decrease in part-time workers) in the month. The participation rate was unchanged at 66%. Employment growth slowed to 1.9% y/y - still above the rate of growth in the working-age population but lower than rates seen for much of the past 2 years.

The participation rate remains near its record high but appears to have stabilised. The rise in the participation rate has driven the employment to population to record highs - even though the unemployment rate remains higher than in the lead up to the GFC. This large supply response has seen downward pressure on wage growth which continues to track at low rates. The WPI for Q4 slowed to 0.5% q/q and 2.2% y/y. This is well below the 3.5% rates more likely to be consistent with overall inflation of 2.5% and will also see ongoing softness in overall household income growth.

The real impact of softer wage growth (and income growth) continues to be sluggish household consumption growth. The Q4 national accounts confirmed that household consumption continues to track at its slowest rate since the GFC. In addition to weak wage growth confidence is low and budgets are stretched at a time when household debt is elevated.

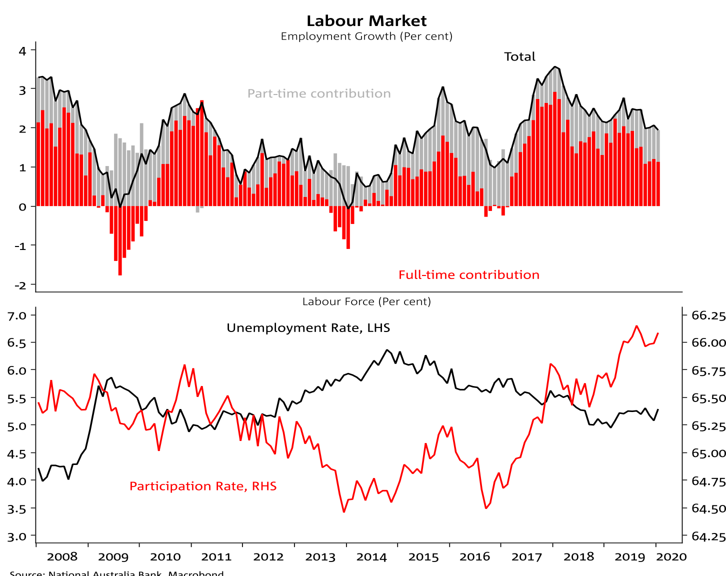
This has been particularly evident in the slowing in discretionary spending growth over recent years. Essentials spending has held up better, but has also slowed. This outcome is also inline with the slowing in spending on goods (which are more tilted towards discretionary items) compared with growth in services spending which has also held up.

While the national accounts showed some improvement in spending on household goods and other discretionary items in the q4, the impact of the tax cuts appears to had little material impact on household spending. Rising household wealth as a result of increasing house prices is likely to have been a support. However, recent declines in equity markets (and hence financial assets) are likely to weigh on households going forward – though these assets typically comprise a smaller share of household wealth than property.

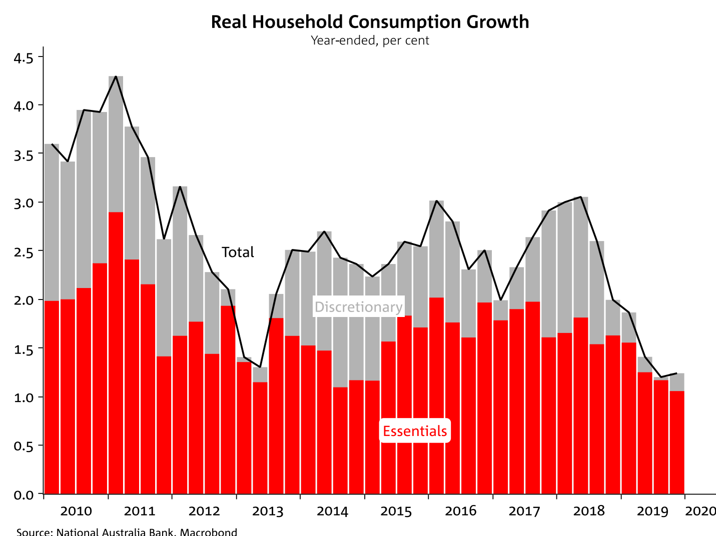
Indeed, retail sales for January suggest that consumption has remained weak, printing a 0.3% fall following a revised fall of -0.7% in the month of December. In the short-term there may be some positive support from households brining forward expenditure on coronavirus concerns, while other discretionary spending may have been negatively impacted.

An early read on how retail sales are tracking in February will be released in NAB's Cashless Retail Sales release next week.

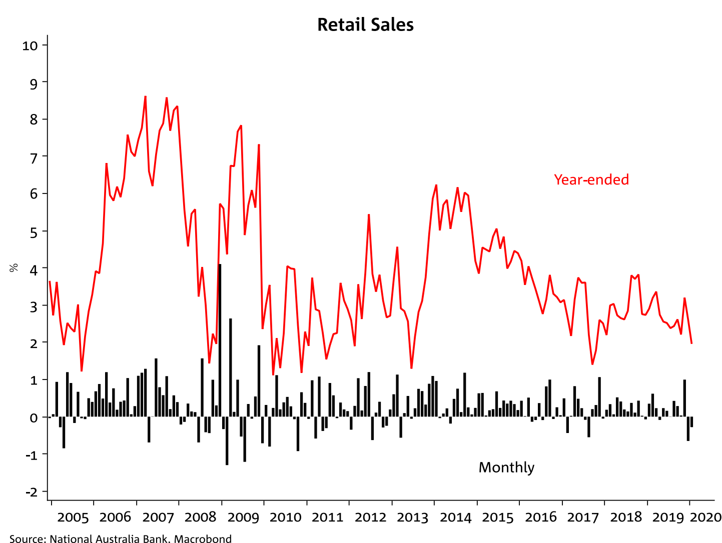
EMPLOYMENT GROWTH HAS SLOWED...



CONSUMPTION GROWTH REMAINS WEAK...



RETAIL SALES STILL WEAK IN Q1...



HOUSING AND CONSTRUCTION

Housing market dynamics – both the established market and new construction – remain a significant impact on the economy. House prices have risen strongly in Sydney and Melbourne since reaching a trough in May last year, while construction has continued to fall at a fairly rapid pace.

The national accounts showed a 3.4% q/q decline in dwelling construction in Q4. Both the construction of new dwellings (-4.1% q/q) as well as alterations & additions (-2.2%) were lower. The declines were driven by decreases in NSW and Qld, with Vic lifting slightly. Overall, dwelling construction is down around 9.7% over the year and is 13% lower than the peak in 2017. We expect dwelling investment to remain weak before levelling off in Q4 2020.

Dwelling approvals remain low, but appear to have broadly stabilised (or even trended slightly higher) in the past 6 months. Nonetheless, high rates of work done will likely see the existing pipeline rapidly eroded. More information on commencements and work yet-to-be done will be received in the construction activity release for Q4 (out in Mid-April).

In the established marked house prices have continued to rise. The CoreLogic 8-Capital City dwelling price index saw a rise of 1.2% in February, driven by an increase in Sydney (1.7%) and Melbourne (1.2%), though each of the other capitals also saw an increase (except Darwin).

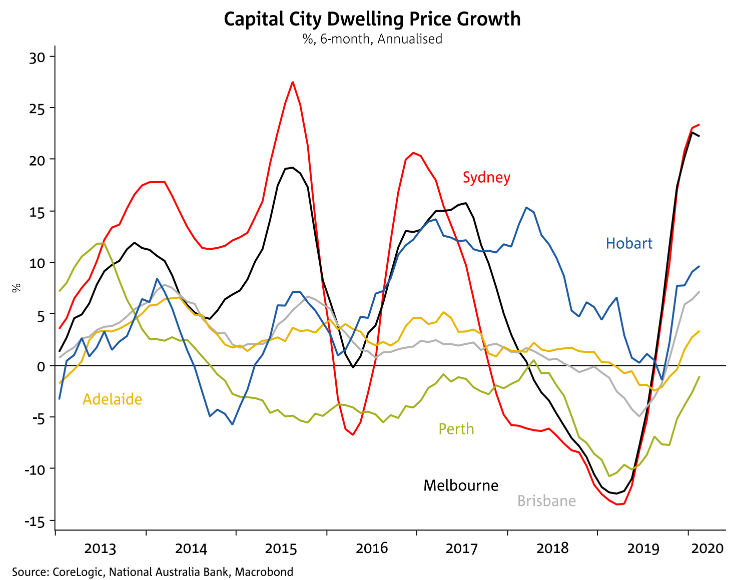
Dwelling prices have recovered sharply since May 2019, with increases in Sydney and Melbourne of close to 11% over the past year. The other capitals are also up over the past year, with the exception of Perth (which appears to have improved more recently) and Darwin – with strong state specific factors at play in these cities.

The easing in macroprudential controls, lower interest rates and improving sentiment are likely to have contributed to this turnaround. Going forward, healthy population growth will continue to be a support, while the rapid adjustment in construction will see supply also adjust relatively quickly.

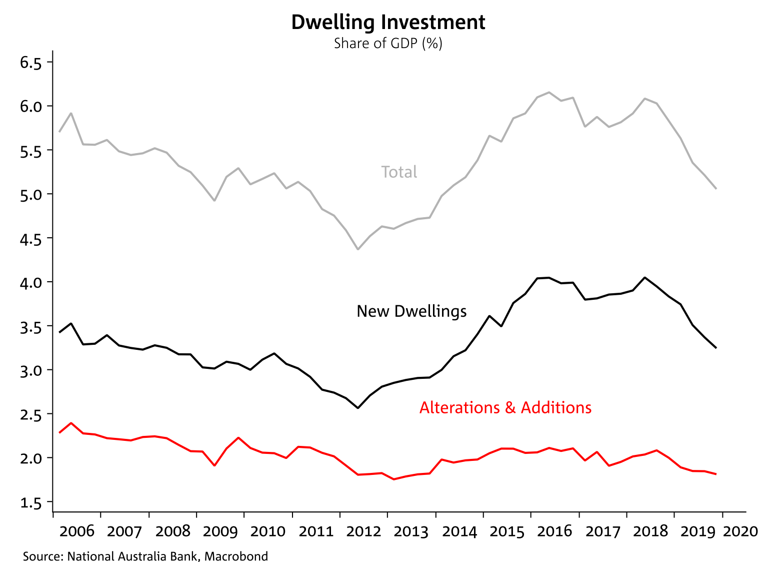
While turnover in the established market has improved, credit growth has remained soft. Approvals for housing finance have seen some improvement but higher principal repayments as a result of the decline in interest rates has seen overall housing credit expand by 3.1% y/y. Owner-occupier credit growth has risen 5.1% over the past year, while investor credit is weak, having fallen 0.3%. However, January saw the first monthly rise in investor credit since February 2019.

Going forward, we expect the housing market to continue to recover. House prices will continue to rise, though likely at a more modest pace, while the falls in new construction should abate and eventually rise – albeit more gradually than the previous upturn. Interest rates are low and will continue to support the housing market, though any deterioration in the labour market on the back of slowing growth could see a more muted recovery in housing.

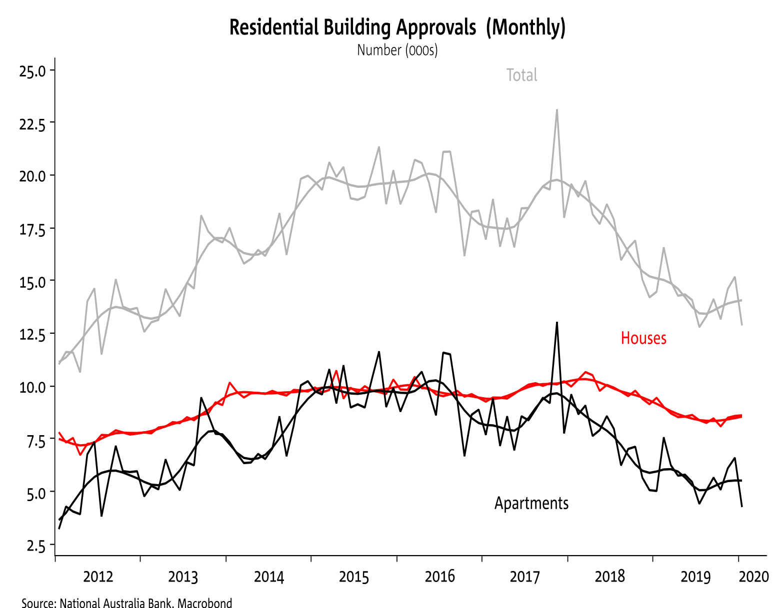
PRICES ARE RECOVERING STRONGLY...



DWELLING INVESTMENT TO FALL FURTHER...



APPROVALS SUGGEST MORE WEAKNESS...



BUSINESS AND TRADE

With the household sector to remain weak – on the back of modest consumption growth and falling dwelling investment (at least in the near term), the outlook for both business investment and trade are important swing variables. We expect the business sector to remain weak in the near-term and our optimism on exports has been tempered by the coronavirus impact in the near term.

Business investment fell in Q4 – led by a decline in the non-mining sector. Mining investment edged higher in the quarter (and recorded its first annual rise in a number of years). By asset, there was a fall in non-dwelling construction (both engineering and buildings) which was partially offset by an increase in spending on equipment.

While there are often large differences between expectations reported in the ABS Capex survey and the final outcomes reported in the national accounts, the first expectations for 2020/21 suggest that non-mining investment is expected to remain weak. Adjusting for the usual bias in reported expectations the survey implies a 6.5% increase in nominal investment, driven by a 21% rise in the mining sector. Of some concern are the weak expectations for the non-mining sector where weakness has already seen overall investment fall to its lowest share of GDP since the 1990s recession.

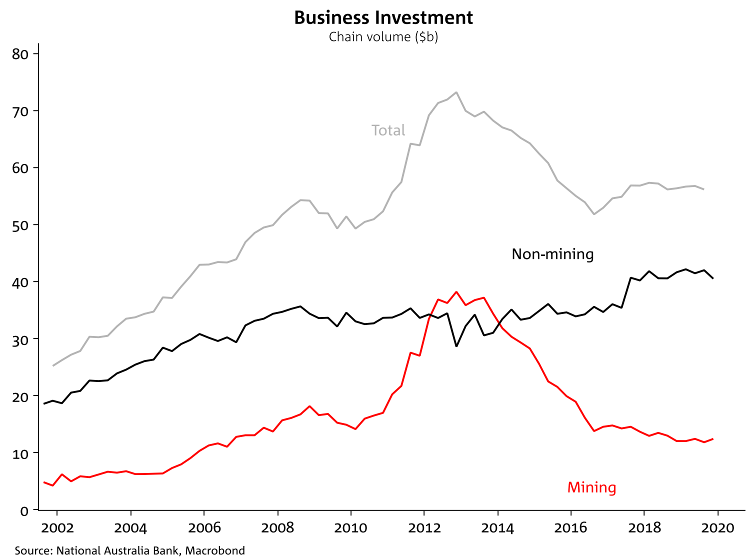
More broadly, the NAB monthly business survey points to ongoing weakness in the sector. Both business conditions and confidence declined in the month – albeit by less than we had expected. Nonetheless, confidence is now significantly negative, suggesting that conditions, which declined to a neutral position in the month, are unlikely to turn around in the near-term.

Forward indicators were generally softer, with forward orders declining to a well below-average position and capacity utilisation edging lower (but still around average). In addition to the downtrend in confidence, activity appears to have weighed on investment plans with reported capex also having fallen over the past 18 months or so. The employment index has held up better, but has also eased alongside trading and profitability – now implying job increases of around 16k per month over the next 6 months. This is well down on the rates seen in late 2018 and early 2019.

Net exports again offset softness in the domestic economy, contributing 0.1ppt in Q4. Going forward we think there is a risk to exports (particularly for services) with the spread of the coronavirus. Should global growth also slow materially there could well be ongoing impacts on exports in addition to the expected plateau in resource exports on the back of little investment in recent years. However, imports could also fall with Australians pulling back on foreign tourism and supply chain disruptions for products out of China.

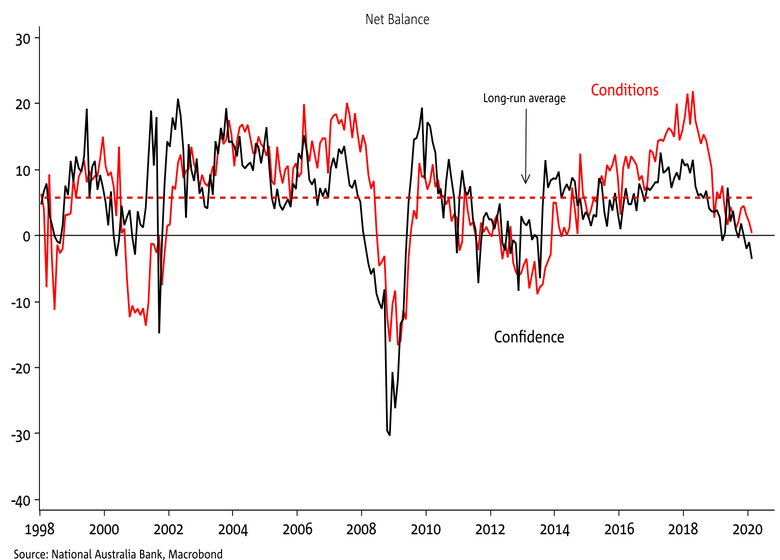
The trade balance narrowed slightly in January, with falls in both the value of exports and imports.

NON-MINING INVESTMENT IS WEAK..



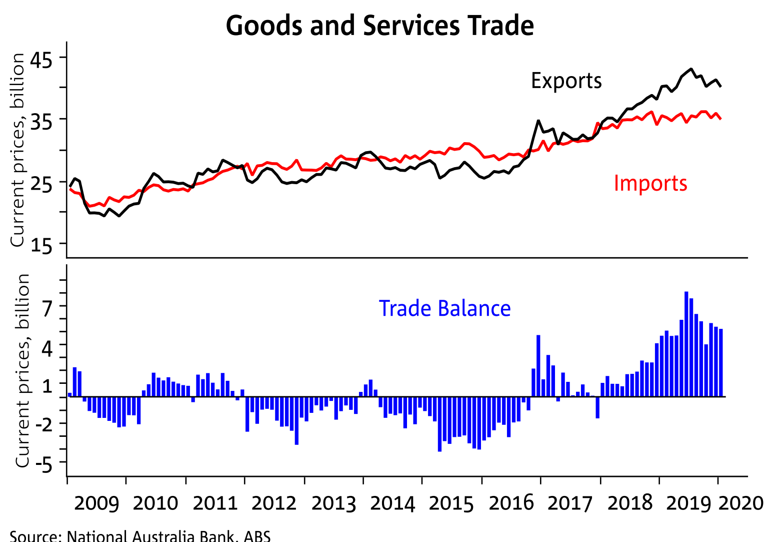
Source: National Australia Bank, Macrobond

CONFIDENCE AND CONDITIONS EASE...



Source: National Australia Bank, Macrobond

EXPORTS AT RISK...



Source: National Australia Bank, ABS

COMMODITIES

Iron ore markets have exhibited considerable volatility in recent weeks – with spot prices rising from just over US$80 a tonne in early February to over US$90 a tonne in the second half of the month before a modest subsequent retreat. That said, prices remain well below the recent peaks in 2019. Supply disruptions – including Tropical Cyclone Damien in Western Australia and heavy rains and regulatory constraints in Brazil – provided some short term upward pressure. The easing of these factors, along with prolonged demand weakness due to the Covid-19 impact globally, should add some downside pressure to iron ore prices. We forecast iron ore to average US$75 a tonne in 2020 and US$70 a tonne in 2021.

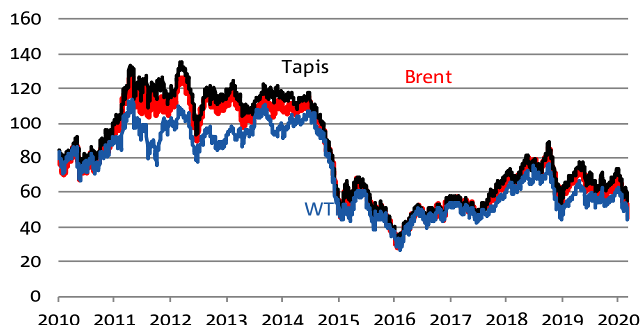
Spot prices for metallurgical coal rose in early 2020 – in line with the strength in iron ore markets – up above US$150 a tonne in mid January. However, prices have dropped back below this level at the time of writing – reflecting steel sector demand fears related to the Coronavirus outbreak. In contrast, price movements in thermal coal markets have (to date) been more moderate – with prices just below US$70 a tonne. Coal prices are expected to fall in 2020 – hard coking coal is forecast to average US$146 a tonne (down around 18% from 2019), while thermal coal is forecast to average US$67.50 a tonne (a decrease of almost 14%).

Oil prices plunged following Russia and Saudi Arabia failing to agree to production cuts. Benchmark Brent crude fell to US$36/bbl, the lowest level since Feb 2016. Following Russia's refusal to acquiesce to additional cuts demanded by Saudi Arabia, the Saudis decided to boost production, as well as to offer price discounts to gain market share – at the expense of Russia and US shale oil producers. This rise in production, combined with substantially weaker demand as a result of the Covid-19 outbreak drove the plunge in prices. In response, we have substantially downgraded our oil price forecasts, particularly for the first half, with Q1 2020 now forecast at US$42/bbl (previously US$55/bbl).

The LNG market has been affected by rising supply and a slump in demand – particularly from China due to the Covid-19 virus. While there are some tentative signs of the virus' growth stabilising in China, it continues to spread across the world, leading to fears of a pandemic. In this environment, buyers – particularly from Asia – are seeking more competitive terms for their gas purchases, and increasingly resorting to purchasing gas on the lower cost spot market. Force majeure clauses have so far not been widely invoked, except for China's CNOOC purchase of a delivery from France's Total. We have further lowered our export price and volume forecasts, particularly for Q1 2020.

GLOBAL OIL PRICES

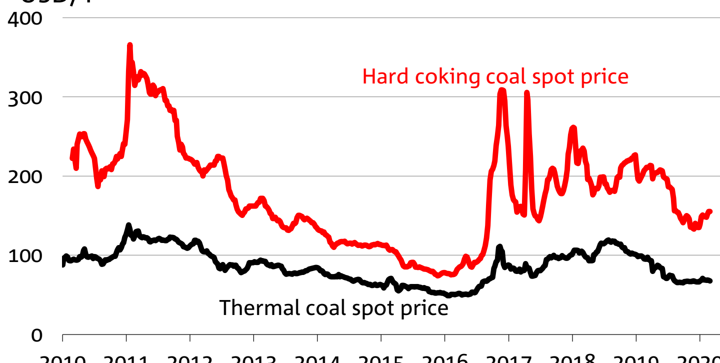
USD/bbl, daily



Source: Refinitiv, NAB Economics

COAL SPOT PRICES

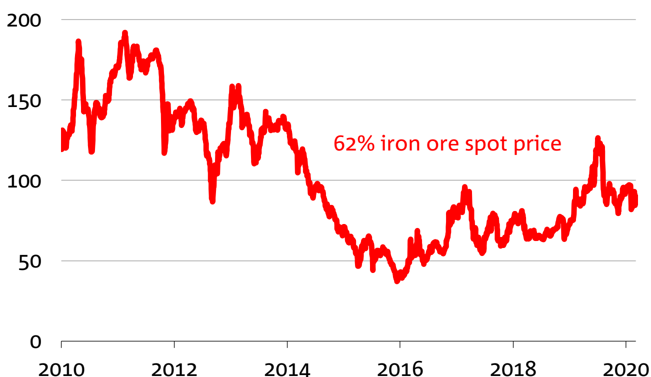
USD/T



Sources: Bloomberg, NAB Economics

IRON ORE SPOT PRICE

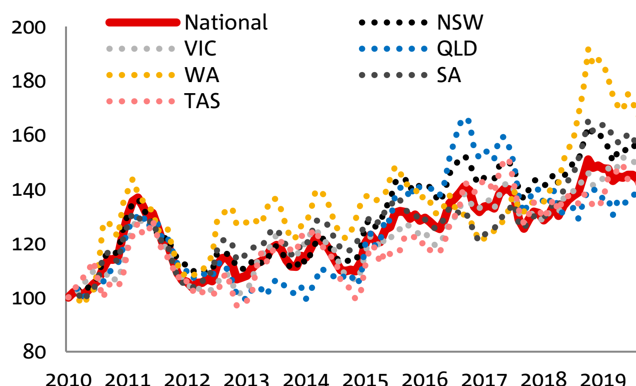
US$/t (incl. cost of freight)



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

The RBA cut rates by 25bp to 0.5% in March – largely on the back of the escalating economic fallout from the spread of the coronavirus. We expect the RBA will cut rates again in April to a new record low of 0.25% - and the effective zero bound. With the impact of the coronavirus looking to require a larger response. we now expect the RBA will move to implement QE in the form of yield curve control. Essentially, the RBA will announce a target for yields and then intervene through the purchase of bonds should rates not adjust to this expectation.

It has been our view for some time that the underlying weakness in the economy, even before the impact of the coronavirus (and to a lesser extent bushfires) would justify further policy support. Therefore our view has shifted from the risk of QE in the second half of the year to implementation by mid-year but even earlier could not be ruled out based on the aggressiveness of foreign central bank action.

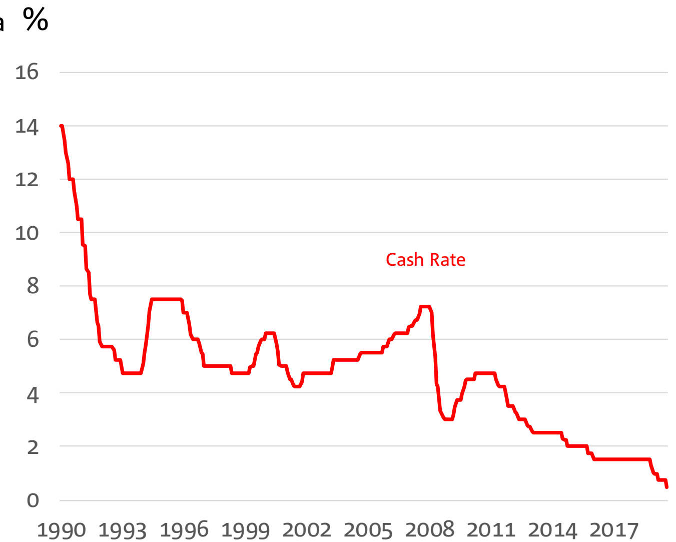
The goal of the RBA's approach will be to lower the risk free rate and therefore lower interest rates paid by consumers and business. The magnitude of any RBA action will depend on both economic and financial market conditions going forward. The shape of the yield curve and movement in credit spreads will be important. A larger than expected deterioration in economic conditions, particularly in the labour market, would also see a larger response by the RBA. An important channel will continue to be the exchange rate – and any dramatic action by other central banks could see upward pressure on the dollar.

With heightened uncertainty, the RBA will also act if needed to ensure sufficient liquidity in the cash market as well as foreign exchange markets. This is the normal part of business for the RBA and will be important to ensure passthrough from the short-end of the market to end-user rates in the economy.

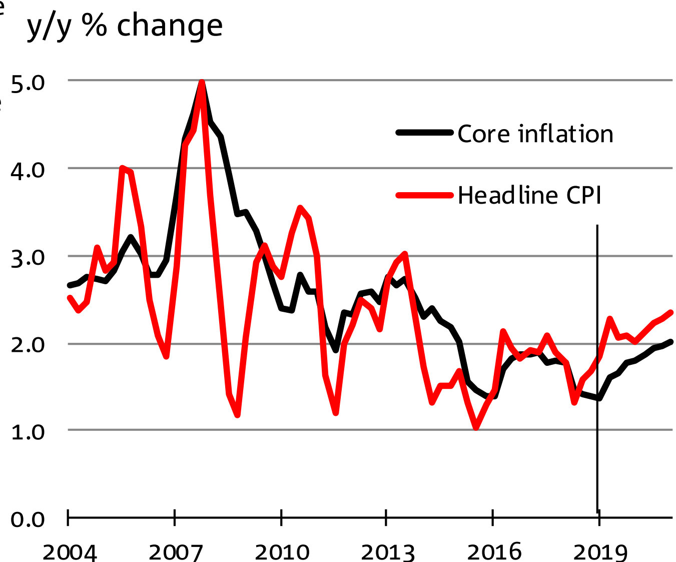
There are few constraints on easier policy. Inflation is likely to remain soft over the next two years, with wage growth still weak (and a deterioration in the labour market expected) and the impact of weaker oil prices in the near-term. Some of the weakness in inflation is likely to be offset by recent depreciation of the Aussie – around 5% since the beginning of 2020.

The exchange rate is however still an important channel of monetary policy and a mechanism by which global developments will impact the domestic market. Recent weakening of the AUD due to fears of what the Coronavirus might do to China is clearly a help in Australia's adjustment to recent shocks. That said, the virus is also likely to cause a significant easing in US rates. We now see another 75bp in next weeks FOMC meeting and another 25bp in the April meeting bringing the Fed Funds rate down to 0.25 per cent – the same as in Australia. While much will depend on how the virus effects both economies and how long it lasts, at this stage we see the USD gradually weakening bringing the AUS back to where our models suggests at around 70c by end 2020 and a touch above that by end 2021 as the Australian economy accelerates faster (around 2.8%). Our formal forecast for the AUD/USD by end 2021 is US73c.

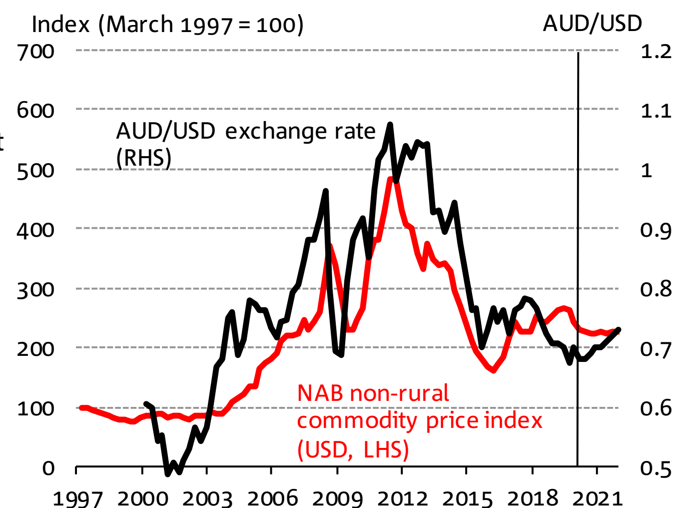
CASH RATE TO STAY LOW…



HEADLINE AND CORE INFLATION…



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	2020-F	2021-F
Private Consumption	2.9	2.0	0.9	1.4	2.5	2.7	1.4	0.7	2.1
Dwelling Investment	0.5	0.0	-9.2	-1.9	-2.2	4.7	-7.1	-7.4	4.4
Underlying Business Investment	6.9	-1.9	-4.3	0.3	3.8	1.3	-2.0	-4.6	4.2
Underlying Public Final Demand	5.0	4.3	4.8	3.8	5.0	4.5	4.9	4.0	3.8
Domestic Demand	**3.5**	**1.7**	**1.0**	**2.1**	**3.0**	**2.9**	**1.2**	**1.0**	**3.1**
Stocks (b)	0.0	-0.2	0.0	0.1	-0.1	0.1	-0.2	0.0	0.1
GNE	**3.6**	**1.5**	**0.9**	**2.1**	**2.9**	**2.9**	**1.0**	**1.0**	**3.2**
Exports	4.1	3.9	1.9	1.0	3.4	5.1	3.2	0.5	1.8
Imports	7.2	0.2	-1.4	2.0	7.8	4.0	-1.2	-0.5	3.9
GDP	**2.9**	**2.0**	**1.6**	**1.9**	**2.5**	**2.7**	**1.8**	**1.2**	**2.8**
Nominal GDP	4.9	5.3	3.2	2.7	6.2	5.0	5.1	1.5	4.4
Current Account Deficit ($b)	51	14	-3	26	46	39	-10	14	32
(-%) of GDP	2.8	0.7	-0.2	1.2	2.6	2.1	-0.5	0.7	1.5
Employment	3.0	2.4	2.0	0.2	2.3	2.7	2.4	1.0	0.5
Terms of Trade	1.8	5.6	-2.0	-5.2	11.7	1.8	5.2	-7.2	-1.8
Average Earnings (Nat. Accts. Basis)	1.4	1.8	2.9	2.6	0.9	1.5	2.5	2.7	2.8
End of Period									
Total CPI	2.1	1.6	2.1	2.2	1.9	1.8	1.8	2.0	2.3
Core CPI	1.8	1.4	1.7	1.9	1.9	1.8	1.4	1.8	2.0
Unemployment Rate	5.6	5.1	5.2	5.6	5.4	5.0	5.1	5.7	5.5
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	0.60	0.90	2.63	2.32	1.37	0.70	1.20
$A/US cents :	0.74	0.70	0.68	0.71	0.78	0.71	0.70	0.70	0.73
$A - Trade Weighted Index	62.6	60.1	58.7	60.2	64.9	60.7	60.3	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	9/03/2020	Dec-19	*Mar-20*	*Jun-20*	*Sep-20*	*Dec-20*	*Mar-21*	*Jun-21*	*Sep-21*	*Dec-21*
WTI oil	US$/bbl	46	55	37	40	50	53	57	57	58	60
Brent oil	US$/bbl	37	61	42	45	55	58	62	62	63	65
Tapis oil	US$/bbl	58	63	57	60	62	64	64	64	65	67
Gold	US$/ounce	1666	1480	1600	1590	1600	1610	1610	1620	1630	1630
Iron ore (spot)	US$/tonne	88	89	85	76	72	68	71	69	71	69
Hard coking coal*	US$/tonne	n.a.	140	135	152	150	148	151	147	145	140
Thermal coal (spot)	US$/tonne	68	67	68	68	65	70	70	66	63	61
Aluminium	US$/tonne	1668	1758	1700	1750	1765	1775	1800	1825	1850	1875
Copper	US$/tonne	5522	5900	5650	5725	5750	5850	5900	5950	6000	6020
Lead	US$/tonne	1830	2039	1850	1800	1750	1725	1700	1725	1700	1675
Nickel	US$/tonne	12603	15395	12750	12500	12250	12100	12300	12500	12750	13000
Zinc	US$/tonne	1962	2384	2200	2400	2425	2450	2300	2200	2150	2150
Aus LNG**	AU$/GJ	n.a.	12.0	9.7	10.0	10.4	10.6	11.0	10.9	11.0	11.1

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

** Implied Australian LNG export prices

Source: Thomson Reuters Datastream, ABS, Econdata DX, RBA, NAB Economics

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