May 2020

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

We have revised down our forecasts for global GDP and now expect -3.8% in 2020 (was -2.8%) and +6.5% in 2021 (was 6.6%), reflecting some further escalation of containment measures and only a gradual easing of restrictions in other economies, coupled with ongoing household and business caution. The forecast changes don't alter the overall picture – there has been a huge fall in activity across most of the world; in China it was centred in February but in many other economies it occurred over March/April. The unemployment rate in the US has gone from a 50 year low in February to the highest on record two months later (data began 1948). With high frequency indicators now starting to show some improvement, global activity likely bottomed in April although a full recovery is likely to be drawn out many countries. In addition, there are a range of risks that may slow or reverse any recovery, including the potential for further major outbreaks of COVID-19, financial market stress, or a flare-up in geo-political tensions.

- **Financial markets** remain under stress, given the dislocation caused by a wide range of COVID-19 countermeasures, although conditions differ considerably across individual markets and regions. Equity markets fell sharply between mid-February and mid-March, but trended higher across April (but remain well down on their February level). US equities rose more strongly than other markets – likely due to perceptions of the US being a safe haven. Government bond yields have generally trended lower in recent months – as expectations around economic growth, inflation and interest rates have eased, and spreads between 10-year US treasuries and major emerging market bonds have widened. **Central banks** have responded by cutting rates and moving to support financial markets to ensure market functioning and on-going credit provision.
- **Commodity prices** have fallen sharply since early March due to constrained demand while supplies have generally remained ample. In particular, oil prices have plunged, with OPEC+ production cuts insufficient to counter the perilous decline in demand as transport activity has been curtailed. US oil prices briefly turned negative in April, on fears that storage capacity was almost exhausted.
- US, Eurozone and UK GDP fell in Q1, and we expect similar results for the other major **advanced economies** (AEs). US Q1 GDP fell by 1.2% qoq in Q1, its fall largest since the end of 2008. The Euro-zone declined 3.8% qoq, including a 4.7% qoq fall in Italy and a 5.8% qoq drop in France. In the UK GDP declined 2.0% q/q. Q2 will be worse by a considerable order of magnitude. While available indicators point to the trough having been reached in April, it will be a long-time before activity is fully recovered. While we expect a bounce in Q3 as restrictions are eased, the level of activity will remain well below where it was at the start of the year. Indeed, under our forecasts the level of AE GDP at the end of 2021 is still below its end-2019 level. Moreover, there is the risk of further outbreaks of the virus as economies re-open, and the possibility of restrictions being reimposed.
- Conditions in **emerging market** (EM) economies have deteriorated, as COVID-19 countermeasures have impacted domestic output and demand, while the global downturn has restricted trade. Preliminary indicators of Chinese conditions in April suggest that consumers remain cautious. Conditions in other key emerging market economies deteriorated rapidly in April. Manufacturing PMIs for India and Indonesia fell particularly sharply, with both below 30 points, while India's services PMI fell to just 5.4 points – highlighting the severity of its lockdown on economic activity. EMs remain vulnerable to capital outflows.
- The impact of the COVID-19 countermeasures are likely to see the biggest fall in the **global economy** at least since the 1950s, and most likely since the Great Depression. We expect global GDP to fall by 3.8% in 2020. While growth is expected to rebound in 2021 to 6.5%, there are considerable risks around this outlook. Available Q1 GDP reports are pointing to broad-based falls in activity and the JP Morgan World PMI plunged further in April. The trough in activity is likely to be in Q2, as many countries have started to ease restrictions, although only gradually. Societal behaviour is also likely to remain cautious as governments continue to recommend social distancing. Moreover, there is a risk of fresh outbreaks of the virus which may see some restrictions reimposed.
- While an easing in containment measures – if sustained – will likely lead to a bounce in activity, a full recovery from the downturn is likely to take an extended period for many countries. Many businesses that were marginal at the time of the downturn will likely close permanently. The damage to household and business balance sheets will likely hold back future activity and the significant deterioration in public finances across most countries will also need to be worked through. It is possible that EM capital outflows will end up de-stabilising some economies. Structural change within economies is also likely to be acute. There have been also widespread supply disruptions and while these will fade over time, supply chains were already a major issue due to the US-China trade dispute. The risk of this dispute re-escalating has risen due to US-China tensions over COVID-19.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: Overall our forecasts are mostly unchanged from last month – but we have tweaked them slightly based on the release of Q1 retail volumes and the CPI. We expect a small fall in Q1, a large fall in Q2 and a small rebound in Q3 for GDP. Overall, we expect GDP to fall by 8.5% in H1 2020. This would be a downturn in activity of unprecedented speed and magnitude, and consequently sees a rapid rise in unemployment to near double digit levels by year end. While we see a rebound in growth next year, the level of activity will not be fully recovered until early – mid 2022. This results in a partial but not complete recovery in unemployment to around 7% by end-2021 - a still high level by recent standards. By component, we expect large falls in consumption, business investment and dwelling investment this year. Our forecasts are predicated on ongoing containment of the COVID-19 in Australia but a slower recovery in the global economy. Should there be a secondary spread of the virus and containment measures reinstated this pattern will see a necessary revision. A significant risk going forward is the ongoing fallout from damaged consumer and business confidence. Consequently, we see ongoing support from policy makers with interest rates remaining low for an extended period and likely further fiscal policy action as existing measures are wound back or expire.

- As expected the **RBA left rates unchanged** at 0.25% in May and maintained its yield curve target of 0.25% at the 3-year horizon. The rate of bond purchases along the curve have slowed as functioning of markets has improved. However, the Bank broadened its scope of eligible repurchase agreement collateral to include investment grade corporate bonds. We expect these policy settings to be maintained for an extended period. The cash rate will remain unchanged until the yield curve target is removed. The Bank has stated that these settings will remain in place until progress has been made on achieving full employment and inflation returning to the target band – which on our forecasts does not occur for an extended period. The RBA's latest set of forecasts released in the May SMP are broadly in line with our growth forecasts but slightly more optimistic on the labour market front.
- The **unemployment rate** rose by 1 percentage point in April to 6.2% - much lower than expected. However, labour force participation rate fell significantly, offsetting the largest fall in employment on record. An 8% decline in hours worked reflects the sheer magnitude of the downturn in economic activity. The large move in the participation rate presents a downside risk to both NAB and RBA unemployment rate forecasts of 11.7% and 10% respectively. However, it is still likely that the unemployment rate will move up to near double digit levels by year end and only gradually recovery to remain above 7% by the end of 2021 – presenting ongoing risks to consumption growth and the housing market.
- We expect **consumption** to rise by 0.5% in Q1 on the back of household hoarding which appears to have offset weakness elsewhere. However, we expect a significant fall of around 9% in Q2, reflecting the direct impact of containment measures as well weak confidence. Indeed, the NAB Cashless Retail Sales Index suggests that retail sales fell by 5.3% in April following a large 8.5% rise in March. We expect consumption to rebound in Q3 with an unwind of containment measures, but then for ongoing weak growth in consumption with confidence remaining low, debt burdens still high and weak income growth overall with unemployment staying elevated and slower employment growth. Both factors will also see slower wage growth.
- The **NAB monthly business survey** saw conditions decline further in April with a fall across most non-mining industries. Conditions are weakest in recreational and personal services but are negative across all industries. Business confidence saw a bounce in the month but remains around twice as week as the lowest level seen in the 1990s recession. Forward orders softened further which, alongside confidence, suggests that activity may well fall further. The decline in activity to date has seen a sharp fall in capacity utilisation to its lowest level ever – suggesting a significant contraction in economic activity. Capex has declined sharply as well – and will unlikely recover until conditions normalise. We forecast a significant fall in business investment this year with confidence and conditions remaining weak.
- The **Housing market** is also likely to weaken going forward. House price growth has slowed in recent months following the rapid growth seen in the second half of 2019. However, to date house prices have held up relatively well despite the looming impacts on the property market of the coronavirus related deterioration in the labour market and activity more broadly. We expect house prices to decline by 10-15 over the next year or so and a substantial fall in dwelling investment to occur.
- **Trade** will likely be an important swing variable as 2020 plays out. Data for March saw the trade surplus widen to a record $10.6b. A rebound in iron exports and a sharp increase in gold more than offset a 14% decline in tourism exports. Imports fell 4% in the month. Overall, we estimate that the external sector will make a modest contribution to growth in the Q1 national accounts.
- **Commodity markets** continue to feel the impact of the COVID-19 downturn. Coal prices softened in the last month, while iron ore has remained range bound in the second half of April. The oil market has stabilised but prices remain low. Our forecasts for thermal coal are unchanged while we have trimmed forecasts for coking coal; Price expectations for iron ore have been revised up, while LNG prices have been lowered.
- We expect the **exchange rate** to end the year at US68c before drifting slightly higher over 2021, reaching US72c by end-2021. Risks around this view include developments in commodity prices, periods of heightened risk aversion with ongoing economic fallout of coronavirus containment efforts and importantly the relative pace of recovery and the speed at which interest rates are normalised by international central banks.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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