August 2020

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

The global economy continues to recover from the impact of COVID-19 However, there is still a long way back with progress uneven globally. High frequency indicators for the US and India have stalled on the back of a resurgence of the virus, although in this regard the worst may be over for the US. Incoming Q2 GDP data confirm a massive hit to advanced economies (AEs) from the response to COVID-19. The trough in activity across the AEs was centred on April and the subsequent recovery sets the stage for strong growth in Q3, although some countries have imposed some regional restrictions which will slow the recovery. China's economy, the first to be impacted by COVID-19, recovered more strongly than expected in Q2 and GDP is now above its Q4 2019 level. Our global forecast is marginally weaker at -3.8% for 2020 and +5.9% for 2021. How the virus spreads, and how countries respond (including maintaining appropriate fiscal support), is likely to remain a key driver of economies.

- The ongoing recovery in the global economy is being reflected in **financial markets**. Equity markets continue to recover, market volatility and spreads have eased and commodity prices have turned up. Our composite measure of advanced economy equity markets in early August was around 5% below its February peak, a substantial improvement on the 30% fall experienced in March. However, the pace of recovery has moderated in recent months, perhaps in part due the resurgence of the virus in parts of the world. In contrast bond yields remain low reflecting the likely longer term fall out for economies and monetary policy.
- The scope for further monetary easing by AE **central banks** is limited – either because rates are at what is considered to be their lower bound (e.g. the Fed) or due to a reticence to make rates more negative (ECB, BoJ) in an environment where fiscal policy is the more powerful tool. However, the Fed is moving towards flexible average inflation targeting and is likely to complement this with outcome based forward guidance (e.g. a promise to keep rates low until inflation is back at its target level).
- Incoming Q2 GDP data confirm a massive hit to **advanced economies** from the response to COVID-19, including stringent containment measures. GDP fell by 9.5% q/q in the US, 20% in the UK and by 12.1% q/q in the Euro-zone; this was on top of smaller Q1 declines. The falls were centred on March and April, with activity picking up since then, setting the stage for strong growth in Q3. The spread of the virus continues to be a major factor, leading to some restrictions being re-imposed or 're-opening' delayed (e.g. in parts of the US, Spain and UK). We expect that a full recovery will take an extended period of time - many business closures will be permanent, the uncertainty around COVID-19 will engender business and household caution, damaged balance sheets, tighter financial conditions and the time needed to adjust to structural changes accelerated by the virus (e.g. on-line retail, work from home).
- Trends remain mixed across **Emerging Market (EM) economies**. China's economy recovered in Q2, growing by a stronger than expected 3.1% yoy and exceeding the levels recorded in Q4 2019. However, this was an uneven recovery, with strong growth in IT and financial services but relative weakness in consumer sectors. Q2 data available to date for East Asia showed much weaker than anticipated conditions across the region – particularly the Philippines and Indonesia – where COVID-19 cases have surged recently. India's attempts to recover from the impact of COVID-19 countermeasures appear to have stalled – with Google Mobility data showing that movements have plateaued since mid June, limiting the strength of the anticipated recovery in Q3.
- The JP Morgan Global PMI continues to show signs of recovery – with measures of manufacturing and services activity both returning to positive territory in July, the strongest outcome since January. While the **global economy** is likely to grow strongly in Q3, the impact of steep declines in the first half of the year will see the largest contraction in annual economic growth since the early 1950s, and most likely since the Great Depression.
- **Risks** of fresh outbreaks of COVID-19 remain a significant concern and the duration of global emergency fiscal programs implemented presents another uncertainty. If these programs, and other policy supports, are unwound too rapidly, it risks stalling the recovery. Tensions between the United States and China continue to simmer and could reignite their trade war. In addition, the US Presidential election in November presents uncertainty around US economic policy – both on the domestic and international front.
- Our **forecasts** are marginally weaker this month, with a contraction in the global economy of around 3.8% in 2020 now forecast. Upgrades to forecasts for some advanced economies were more than offset by a weaker outlook for India, East Asia and Latin America. We continue to expect the recovery to be spread over 2021 and 2022, with above trend growth in both years
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>: We have downgraded our forecasts on the back of the tightening in virus containment measures in Victoria. Rough estimates suggest the developments in Victoria could subtract around 3% from GDP in Q3, with activity expected to decline by around 15% in the state. In aggregate this sees our forecast decline in GDP reach 3.8% in 2020 (was -1.8%) and for unemployment to rise to around 9.2% by the end of the year. For 2021 we now see growth of 0.8% (was 1.8%) and around trend growth in 2022. Unemployment is expected to peak at over 9.6% and expected to only recovery gradually – staying above 6.5% by end-2022. The RBA's set of staff forecasts see a faster rebound in 2021 than us, but see unemployment peaking at a higher rate. The updated forecasts also saw small downgrades to the wage growth and inflation outlook as a result. Both our and the RBA's forecast imply an extended period of rates at their present level, and in our opinion point to the need for ongoing fiscal support. This will remain key to ensuring that secondary fallout of the economic impact of containment measures is minimised, allowing the economy to recover as quickly as possible. Key risks in addition to the future spread of the virus, will continue to be the degree of scarring in the labour market, the fragility of consumer and business confidence as well as a potential range of structural impacts including the impact on commercial property.

- Alongside an updated set of staff forecasts in the August SMP, the **RBA left policy settings unchanged** early in the month. The cash rate and 3-year AGS targets remain at 0.25% with the RBA standing ready to undertake secondary market purchases of bonds along the curve to achieve these targets. Indeed, the RBA announced the intention to undertake bond purchases the day after the board meeting as while the yield curve had broadly tracked the target, it had drifted a little higher in recent weeks. The RBA released an updated set of economic scenarios, with the central case largely unchanged for output, but slightly worse for unemployment and consequently a weaker outlook for wage growth and inflation.
- The **unemployment rate** edged higher in July – rising 0.1ppt to 7.5%. A solid 115k rise in employment was met by a lift in participation as more workers re-entered the labour force. Hours worked rose 1.3% but remain 5.5% below pre-COVID levels. Likewise, despite solid gains in the past two months employment remains around 530k lower than February. Broader measures of labour market underutilisation also showed an improvement but remain severely elevated reflecting the large deterioration in the labour market in April. Going forward we expect the participation rate will continue to recover alongside the pickup in employment – and this will see the unemployment rate rise further, reaching 9.2% by the end of the year and peaking at over 9.5% in 2021. The recovery in the labour market will lag that of output, and will see unemployment still at 6.6% by the end of 2022.
- **Retail sales** continue to track at around 7% above pre-COVID levels. The massive 18% decline recorded in April appears to have been more than offset by the recovery in subsequent months. This is in line with our internal transactions data which showed that consumer spending fell by around 15% and is now back above the levels seen in late February. The NAB Cashless Retail Sales index points to a 0.7% fall in retail sales in July following a 2.7% rise in June. Overall, we expect a large, 7% fall in consumption for Q2 following the 1.1% fall in Q1.
- The **NAB monthly business survey** for July saw a continued recovery in conditions, prior to the escalation in containment measures in Victoria. While conditions have rebounded relatively quickly and are now around pre-COVID levels, this comes off a low base. Capacity utilisation has shown some improvement but remains around 4ppt below its level in late 2019. Confidence declined sharply in the month to -14 index points – reflecting the fragility of the outlook for businesses with the spread of the virus becoming a concern late in the month.
- **House prices** have continued to soften though the pace of decline to date has been orderly. In July house prices across the capitals recorded a 3rd consecutive decline with the 8-Capital City Dwelling Price index falling by 0.8%. The decline in city prices were led by a 1.2% fall in Melbourne and a 0.9% fall in Sydney. Perth (-0.6%), Brisbane (-0.4%) and Hobart (-0.2%) also saw declines. Prices were 0.1% higher in Adelaide. Over the past three months, Melbourne has now seen a 3.2% decline while Sydney and Perth have also seen declines of over 2%. Despite the recent softening, prices remain well up on a year ago in each of the major capitals reflecting the strength of the run up in the second half of 2019.
- The **trade balance** has hovered around $8bn over the past three months with the decline in exports roughly offset by a decline in imports. We estimate that net exports will contribute a solid 1.3ppt to growth in Q2 but this will likely be swamped by the falls expected in other GDP components.
- Our forecasts for **commodity prices** are broadly unchanged. However, the recent rally in iron ore prices to around US$120 per tonne presents an upside risk to our forecasts for the commodity. Coal prices continue to be suppressed by weak demand and excess supply of alternate fuels. We forecast coking coal to average US$126 a tonne this year, before rising to US$133 per tonne next year. Thermal coal is forecast to average US$60 this year and a little higher at US$62 per tonne next year.
- We have revised up our forecasts for the **exchange rate** slightly. We expect the Aussie to trade around US74c by end-2020, before rising to around US78c at end-2021 and US80c by end-2022.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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