September 2020

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

After massive falls in GDP in Q2 across the advanced economies (AEs), the latest indicators are pointing to a substantial, but incomplete, Q3 rebound. However, momentum appears to have eased through Q3. Similarly, surveys point to a strong rebound in EMs in Q3, but mobility data suggests there is still some way to go, with the ongoing spread of COVID-19 presenting a risk. Due to the large falls in activity in the first half of the year the global economy is projected to contract by 4.0% in 2020 (previously 3.8%) and then to grow by 6.3% (previously 5.9%) in 2021. For many countries the recovery is expected to be protracted. The spread of the virus remains a key risk, with some countries struggling to get it under control and others having experienced a resurgence. Another risk is around how authorities manage the unwinding of the large policy supports that were put in place, with uncertainty around US fiscal policy the most immediate concern.

- **Financial markets** continued their recovery in August. A recovery in equity markets has been evident across both advanced and emerging equity markets, with US equity markets reaching record highs in early September and volatility in equity markets, while still high, significantly below its March peak. However, in recent days there has been a retreat in equities and volatility has picked-up, reversing some of the gains. Yields on 10 year government bonds, following sharp falls for several major AEs, have remained relatively stable since April. How bank lending standards evolve is an issue to watch, with a tightening already evident in the US.
- While advanced economy (AE) **central banks** now have limited policy room, emerging market central banks have continued to ease rates. Central banks cut rates aggressively in response to the first wave of COVID-19 outbreaks, with AE central banks essentially exhausting conventional policy measures. In contrast, emerging market central banks have continued to ease rates. Combined with fiscal programs, central banks have used a range of other measures, including bank funding programs, asset purchases and loan guarantees to support the flow of credit. The US Federal Reserve announced a move to average inflation targeting in late August, reinforcing our view that the fed funds rate target range will remain unchanged over our forecast horizon.
- After massive falls in GDP in Q2 across the **advanced economies** (AEs), the latest indicators are pointing to a substantial Q3 rebound, but with momentum easing within the quarter. The latest monthly activity indicators are generally well above their Q2 averages, leading to an upward revision to our estimates of Q3 GDP for the major AEs. However, July retail sales eased in the Euro-zone and Japan, and the growth rate decelerated in the US and UK. The August composite PMI for the Euro-zone declined and in Japan it only eked out a small gain. Some high frequency indicators – such as Google Mobility – are either improving at a slower rate or have flattened out (particularly in the US) or, as in Korea, have fallen. The loss of momentum likely reflects a waning of pent-up demand, resurgence of the virus in some regions – and reimposition of restrictions or more cautious behaviour – and the reality that a full recovery will take time.
- In **emerging markets** (EMs) growth in China was overwhelmed by steep contractions in other major economies. Overall, EM GDP fell by 7.4% yoy, led by India and Latin America. India's economy contracted sharply in Q2 – down by almost 24% yoy. The spread of COVID-19 remains a major issue in India – where new cases have continued to climb – and Brazil, where new case numbers have stabilised, rather than falling. That said, business surveys show a recovery in activity in most emerging markets in Q3. The aggregate EM manufacturing PMI strengthened in August – up to 52.5 points – compared with 51.4 points in July and the EM services PMI also returned to positive territory in August – up to 51.4 points, from 49.4 points previously. High frequency activity indicators also show a gradual improvement in the second half of August for a range of major EMs.
- The recovery in the **global economy** is evident in global trade and industrial production. In June, industrial production and merchandise trade were up 4.8% and 7.6% on May respectively. National indicators point to a further rebound in trade and IP in July as does the upturn in the global manufacturing PMI which continued through both July and August. The global services PMI has also rebounded strongly. We expect strong growth in the global economy in Q3. Nevertheless, the global economy is projected to contract by 4.0% in 2020 (previously 3.8%) and then to grow by 6.3% (previously 5.9%) in 2021. The 2020 downward revision is despite upward revisions for the major advanced economies (except the UK) and reflects a downside revision to our forecast for India (the world's third largest economy on a PPP basis).
- The spread of the virus remains a key risk. Several countries have found it difficult to get it under control (e.g. Brazil and India) while others have seen a resurgence in cases (including the US – although it is now on a downwards track, and parts of Europe and Asia). Another potential pitfall is how authorities manage the unwinding of the large policy supports were put in place; a sudden withdrawal has the potential to de-rail or slow the recovery. China-US tensions over trade and other issues also remain a concern.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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<u>Australia</u>*: GDP fell by 7% in Q2 – the largest fall in the history of the quarterly national accounts. The fall was driven by a 12% decline in consumption, with spending on household services declining by a massive 18%. Dwelling investment saw a sharp decline, while business investment also fell. By industry, hospitality and recreational services saw the largest falls in activity – though most industries were heavily impacted. Our updated set of forecasts see GDP decline by around 4.7% in 2020, before rising by 1.3% in 2021. We see growth returning to around trend by 2022, but for the level of GDP to only be fully recovered by mid-2023. Unemployment is expected to peak at around 10% in early 2021 – and recover slowly, likely lagging the recovery in activity. Therefore, we see unemployment at around 8.0% by end 2021 and 6.8% by end 2022. Wage growth and inflation are expected to see very soft outcomes and therefore there will be little constraint on easy monetary policy – where we expect rates to stay low for an extended period. Overall, while the economy will begin to recover through 2021, we think that policy makers will need to do more to support the recovery. This will likely come in the form of ongoing support on the fiscal side, with continuation of wage subsidies, higher unemployment benefits as well as the bring-forward of tax cuts. The government is also likely to do what it can to accelerate infrastructure spending and increase investment allowances.

- The **RBA tweaked its current package of monetary policy settings** in September. The cash rate and 3-year AGS targets were left unchanged at 0.25%. However, the Bank expanded and extended the term funding facility (TFF). The expansion of the TFF means ADIs will be able to borrow up to an additional 2% of outstanding credit at 0.25% for three years, until June 2021. We expect the RBA will keep these settings in place for an extended period but acknowledge the risk that should the bank be disappointed by its forecast it may do more – most likely in the form of extending the yield curve target along the curve alongside any required bond purchases to do so.
- The **unemployment rate** edged up to 7.5% in July, taking the total increase since February to 2.4ppts. While the monthly increase was less than expected, overall the labour force data continue to show that labour market conditions have deteriorated sharply this year, notwithstanding a partial recovery in recent months. Employment rose by a solid 115k – meaning the labour market has recovered around 40% of the jobs lost since February. We expect unemployment to drift higher from here, peaking at around 10% in early 2021 before gradually recovering to around 6.8% by the end of 2022.
- **Retail sales** rose by 3.2% in July – and are now 10.6% above pre-COVID levels. All sub-categories have now recovered, except cafes, takeaways & restaurants. The Q2 national accounts confirmed the very large hit to household consumption more broadly, where spending fell 12.1% driven by a very large fall in services. Transport services, hotels, cafes & restaurants as well as health services saw very sharp declines. Spending on goods also saw a sizable fall. While goods spending has been strong recently, we expect it to moderate from here. The NAB Cashless Retail Sales index points to a 2.4% decline in August – with official data out next week.
- The **NAB monthly business survey** for August showed a deterioration in conditions that almost entirely reversed last month's gains. While the impact of the stage 4 lockdowns in Melbourne were evident in the Victorian numbers, there were even larger declines in conditions in Tasmania, Queensland and South Australia. Confidence rose after deteriorating sharply last month but is still deeply negative. It remains negative in all industries, despite improvements outside of mining and recreational & personal services in the month. The two largest states, NSW and VIC continue to see the weakest confidence overall.
- **House prices** outside of Melbourne have generally held up better than expected through 2020 but in aggregate have continued to decline. August saw a 4th consecutive decline in the CoreLogic 8-Capital City House Price Index which fell by 0.5% to be 2.1% lower over the last three months. In the month the declines were led by a 1.2% fall in Melbourne and a 0.5% fall in Sydney. Brisbane, Adelaide, Perth and Hobart were broadly flat in the month. Since the peak in April, prices have fallen by 4.3% in Melbourne and 2.6% in Sydney. Perth is down by 2.2%, while the other capitals have either seen smaller declines or small increases.
- **Net exports** contributed 1.0ppts to quarterly GDP growth. As in Q1, there were large falls in both exports and imports, particularly for services due to international travel restrictions. Preliminary trade data for July show the trade balance narrowed sharply to $4bn in the month. Commodity exports fell sharply in the month, while imports saw a large rebound after weakness in previous months.
- A revised set of **commodity price** forecasts will be released next month. Iron ore prices continued to rally in the month and are now around US$130 per tonne – the highest level since 2014. In contrast, coal prices have remained soft due to weaker demand in energy markets and a ready supply of LNG in Asia. While oil prices have partially recovered from recent COVID-19 related weakness, benchmark Brent crude prices remain under pressure due to continued weak demand, lower prices from Saudi Arabia offered to Asian buyers and a slowdown in imports from China.
- Our forecasts for the **exchange rate** are unchanged. 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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