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THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

The Omicron variant of COVID-19 has spread rapidly; while activity restrictions have been less onerous than in earlier waves, the sheer number of cases is disrupting economic activity as infected workers are forced to isolate. With inflationary pressures persisting, central bank policy rates are set to rise more rapidly than previously anticipated. Growth prospects for early 2022 appear relatively weak for both advanced economies and emerging markets, largely related to the current COVID-19 wave, with services being particularly impacted. Receding case numbers should allow for a bump in growth from Q2. COVID-19 remains the primary risk to the global outlook, including the potential for further waves, and it remains uncertain how long global supply chain bottlenecks will persist. Political tensions also pose a risk, most notably border tensions between Ukraine and Russia. Overall, our forecast for global growth in 2022 is softer – down to 4.2% (from 4.4% previously).

- **Financial markets** were impacted in January by growing expectations of monetary policy tightening, the Omicron wave and Russia-Ukraine tensions. The US MSCI equity index was down around 10% in late January. Other advanced economy equities fell by almost 5% and emerging markets by over 3%. In contrast, there has been an increase in a broad range of government bond yields since mid-December. 10-year US Treasuries reached their pre-pandemic levels in early February, while others (such as the 10 year bonds for the UK, Eurozone and Canada) have moved above them.
- The Bank of England has already started lifting rates and other advanced economy **central banks** are expected to follow. We expect the US Federal Reserve to lift rates four times over 2022 (each by 25bps), starting in March, although there is a risk that they will do more (market pricing has six hikes post the US CPI). The Fed is also expected to start quantitative tightening (reducing the size of its balance sheet) this year; we now expect this to kick-off in Q3 (previously Q4).
- **Inflationary pressures** are persisting. Producer prices rose by 15.8% yoy in December (marginally below the November peak) with commodity prices trending higher. In early February, the Refinitiv CoreCommodity CRB Index rose to its highest level since late 2014. Energy commodities have increased comparatively strongly since a brief dip in early December and thermal and coking coal prices have also risen strongly. Global consumer prices rose by around 5.4% yoy in December, the strongest rate of increase since October 2008 (and among the advanced economies the strongest since the mid-1990s).
- **Major advanced economy** (AE) growth appears to have been robust in Q4 2021. Euro-zone growth slowed in Q4 but this was offset by much stronger growth in the US and, we expect, Japan as it exited emergency settings. However, Q1 2022 growth is likely to be much weaker due to the latest COVID wave. Outside of Japan the wave is already receding across the major AEs which should see a recovery in coming months and a bump in Q2GDP. Overall, we have lowered our major AE growth forecasts for 2022, partially offset by higher 2023 growth. This reflects the current COVID wave (a drag on 2022 but a boost for 2023), the impact of high inflation on households, tight labour markets (a supply side constraint), and the bring forward of monetary tightening.
- **Emerging market** (EM) purchasing manager indices softened in January both for manufacturing and services. China's manufacturing PMI turning negative in January, and there were weaker readings in India and Brazil with disruptions due to fresh waves of COVID-19 across these countries. Similarly, the fall in the EM services PMI was driven by China and India. China's economic growth slowed to 4.0% yoy in Q4 (from 4.9% yoy in Q3), reflecting weaker growth in construction-linked industrial production and retail sales. Tightening monetary policy in AEs poses risks, and some EM central banks may be forced to raise rates to prevent capital flight. Others have already raised rates, largely to address inflation concerns.
- The JP Morgan global composite PMI softened in January, driven by a deceleration in the services sector which, while remaining in positive territory, fell to an 18-month low. The Omicron variant has spread incredibly rapidly and, while a smaller proportion of infections require hospitalisation, the sheer number of cases is straining healthcare systems. For China, comparatively weaker vaccine protection against the Omicron strain means that hard lockdowns in response to Chinese COVID-19 outbreaks remain likely – with flow on effects for global supply chains. Reflecting the weak momentum in key parts of China's economy entering 2022, along with lower growth potential from exports, we have cut our 2022 forecast to 5.1% (previously 5.8%). The weaker outlook for China is a major driver of a softer forecast for **global economic growth** in 2022 – down to 4.2% (from 4.4% previously). In addition, we have lowered our expectations for growth in the US, Japan and United Kingdom, while our forecast for India is somewhat stronger.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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For Australia, we have revised up the expected rebound in Q4 GDP on the back of stronger than expected partials, but have pulled down Q1 2022 as the spread of omicron weighs on the economy through both consumer caution as well as disruption to business. That said, we continue to expect well above trend growth of 3.7% in GDP this year, before slowing to around trend in 2023. In the near-term, growth will be supported by a recovery in household spending, as well as both business and dwelling investment. Government spending will also likely continue to support growth this year. We expect the unemployment rate to decline further, from an already low 4.2%, which will eventually feed through to higher wage growth. Inflation is expected to remain high in the near-term as the impact of COVID on supply chains continues to play out, and firms continue to pass through the build-up in cost pressures. However, we expect this to begin to normalise later in the year. This will see inflationary pressure ease somewhat through 2023, but will be offset by faster wage growth – with inflation in underlying terms tracking around the top half of the target band by H2 2023. With a faster than expected recovery in the economy, we recently brought forward our rate call, with the RBA to begin normalising policy in late 2022. Overall, uncertainty remains elevated, with risks related to ongoing virus impacts, the pace of the recovery in migration, the true level of full employment, and how quickly supply chain issues resolve.

- **The labour market surged at the end of 2021, with the monthly unemployment rate falling to decade-lows.** Employment rose a record 366k in November and a further 65k in December, more than recovering the jobs lost during the Delta-outbreak lockdowns. With the unemployment rate at 4.2% and the underemployment rate at a 13-year low, the labour market is now significantly tighter than in the period leading up to the pandemic. Looking forward, job ads indicate labour demand remains strong, pointing to further strength in employment in the near-term. Ongoing tightening in the labour market should see a gradual pick-up in wage growth over the next year or so, reaching around 3% y/y in the second half of 2022.
- **Household consumption is expected to almost recover the Delta-related fall in Q4**. Quarterly retail trade volumes rebounded entirely from their largest fall on record in Q3, rising 8.2% q/q. The result was driven by catch-up spending after lockdowns with large gains in clothing, footwear & accessories, restaurants & takeaway food, household goods, and department stores. Services consumption should also have seen a rebound in the quarter. Going forward, a key uncertainty will be how quickly the balance between goods and services spending is restored, important in a sectoral sense as well as for inflation. However, household spending will likely be well supported in the near-term, with a significant runup in savings during the pandemic.
- **House price growth is still solid but slowing, and we expect prices to start falling from late 2022.** House price growth has already eased across most capitals but accelerated in Brisbane and Adelaide. We see the waning impact of lower interest rates and affordability constraints beginning to weigh on prices at the end of 2022, before a 10% decline in prices in 2023. On the construction side, we see residential investment rising through to mid-2022 – including a post-lockdown rebound in Q4 – with a pull-back in activity accelerating through 2023 as the pipeline of work is eroded and the impact of higher rates begins to flow through.
- **The business sector continues to see ongoing disruptions from the spread of Omicron, though conditions have held up relatively well in the latest outbreak.** Business conditions have softened over the past two months but remain in positive territory – despite a broad-based deterioration across states and industries in January. Business confidence rebounded in January after a sharp fall in December, while forward orders and capacity utilisation have held up. This provides some optimism that despite ongoing disruptions, the outlook for business investment remains healthy.
- **As expected, the first RBA meeting of the year marked the end of the QE program and opened to the door to the possibility of a late 2022 rate hike.** On the cash rate, the RBA has acknowledged the possibility of rate rises in 2022 after significantly upgrading its forecasts for the labour market and inflation, which is now projected to move beyond the top of the target band in "coming quarters" before easing back to target in 2023. For now, the RBA continues to look through transitory drivers of higher inflationary outcomes but has increased the flexibility in its communication while it waits for "further" evidence of inflation sustainably in the band.
- **Net exports are expected to subtract around 1ppt from Q4 GDP based on monthly trade data and quarterly prices.** The trade surplus narrowed further in December, with the growth in imports outpacing that of exports. The increase in imports was broad-based but led by gains in consumption imports, indicating that goods demand remained strong at the end of 2022.
- **The AUD/USD has continued to hover in the low US70c range over the past month.** Our forecasts remain unchanged, and we still expect a small appreciation over the next 2 years. Overall, we see the AUD/USD around 77c by end 2022 and staying around that level until the end of 2023.
- **The outlook remains highly uncertain**. The evolution of the virus and any impact on activity continues to be a key risk. In addition, the true level of "full-employment" and how quickly wage growth responds to a tight labour market remains unknown. The persistence (and potential further pass-through) and any resolution in supply chain bottlenecks also remains uncertain, as does the RBA's tolerance for inflation tracking above the target band for a period of time. These factors will all be important for the evolution of policy settings through 2022.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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