January 2016

The Bigger Picture – A Global & Australian Economic Perspective

***Global**: We have lowered our 2016 global forecasts to 3.0% (from a revised down 2.9% in 2015) in the face of a continuing sharp recession in Brazil, lower commodity prices, global equity market uncertainty and rising spreads – weakness in late 2015 in the USA has also not helped. Global growth continues to disappoint and remains sub-trend as the slowdown continues across many emerging market economies. The latest bout of financial market volatility and sliding commodity prices further illustrate the risks, which have become more weighted to the downside. Nor do we see much sign of a pick up in 2017 (3.3% forecast). These numbers remain significantly lower than recent IMF revised (down) global forecasts.*

- 2016 got off to a bad start in global equity and commodity markets. Although the biggest falls since end 2015 have been in oil and Chinese equities (down by over 20% and 16% respectively), the price decline has been broad-based, while volatility has also increased in the market. Equity market fluctuations are similar to what was seen in some markets mid last year in response to the implosion of the Chinese share market bubble and questions over China's handling of its currency. Last year's spike in volatility was much bigger, but the fall in major advanced economy equity markets just as big. This could turn out to be just another transitory period of "risk off/head for the exit" financial market turbulence associated with the unsettling effect of the US fed starting rate tightening, low primary produce prices affecting commodity producers and uncertainty over Chinese policy. So far the disruption has mainly affected certain weak sovereign credits and energy producers and the Fed could postpone its rate rises. Oil price changes generally redistribute income but big falls in asset prices erode wealth and confidence. Consequently, unless markets stabilise soon there could well be adverse effects for an already lacklustre global economy.
- The latest episode of financial market instability has occurred against a backdrop of continued sluggish growth - but not recession. Monthly measures of economic activity, which generally reflect activity in goods rather than in the stronger services sector, show soft growth for global industrial output and world trade. Business survey results up to December are also consistent with continued, albeit very modest, rates of expansion in global industrial output. Service industry activity is faring better, which explains why GDP growth is a higher – although still sub-trend. This (in addition to falling commodity prices) helps explain why price pressures are remaining so low with sub-target CPI inflation in many countries, falling producer prices and a general absence of wage pressures across the advanced economies. This outlook for continued excess capacity should mean a prolonged period of low inflation, allowing central banks to keep rates low by historical standards and ease further if needed.
- Moderate economic growth has continued across the 7 big advanced economies. While considerable progress has been made since the depths of the Global financial crisis (GFC) and the Euro-zone financial crisis, considerable variation remains in the strength of economic conditions between the big economies. The US and Canadian economies have experienced the strongest upturns but US growth slowed in the latter half of last year and Canada has been hit by weaker commodity prices.
- By contrast, the Euro-zone, where economic activity was depressed by the long-running Euro crisis, is looking stronger with the business surveys showing sustained expansion. The December purchasing manager surveys provide the most up to date reading of business activity and they show the stronger $US and weaker energy prices taking a toll on US manufacturing while services activity growth remains solid. Euro-zone surveys show faster growth, with manufacturing benefiting from previous Euro depreciation and services growing strongly to produce the best growth results for 4½ years. The UK surveys are also positive, showing ongoing growth, but Japanese results remain weak. Taken overall, the latest results are consistent with moderate growth, not recession.
- Emerging economies have now become the biggest contributor to the disappointing sub-trend global picture. Falling commodity prices are adding to the situation, lowering export incomes, while several key commodity producers have also been hit by the reversal of capital movements as US rates rise and investors seek safe havens. Brazil and Russia have experienced very deep recessions and Chinese quarterly growth has continued slowing. Additionally, more timely business surveys and monthly measures of trade continue to show a slowing trend. The softening across the Emerging market economies is also broad-based. With the exception of India, still experiencing very rapid growth, the picture is generally one of either slowdown (China), sluggish growth (much of East Asia, South Africa) or outright recession. Few regions have been spared with both industrial output and $US export earnings slipping below year earlier levels across Latin America and much of East Asia (ex China).
- We have lowered our 2016 global forecasts to 3.0% (from a revised down 2.9% in 2015) in the face of a continuing sharp recession in Brazil, lower commodity prices, global equity market uncertainty and rising spreads. Nor do we see much sign of a pick-up in 2017 (3.3% forecast).

<u>Australia</u>: The outlook for the Australian economy is essentially unchanged despite global risks and we continue to anticipate further recovery across the non-mining economy. The AUD (now expected to depreciate to USD66c by mid-2016) will continue to act as a pressure valve, the tilt towards services activity will support employment, and lower petrol prices will support the cash flow position of most households and businesses. Resource export volumes will remain strong, although the associated income and government revenue will of course be challenged by low commodity prices. For the RBA, unless financial market volatility translates into substantive negative real economic outcomes offshore, the central bank is likely to remain on the sidelines and observe developments.

- In light of recent financial market turmoil, the NAB Monthly Business Survey provides a timely indication of how market movements have so far affected business sentiment. While business confidence took a step back this month, the index remained encouragingly resilient (and positive). Additionally, the survey continues to show business conditions at quite elevated levels, despite easing a little in the month, suggesting there are no real signs (beyond normal monthly volatility) that there is a fundamental weakening in the non-mining recovery – although downside risks have risen.
- In November and December, trend employment data continued to point to a robust pace of job creation of around 30k each month, well above the 14 to 15k needed to keep the unemployment rate constant (although there was some statistical uncertainty). The trend unemployment rate has therefore fallen at a quicker rate than expected to 5.8% in December, driven primarily by the eastern states. However, forward-looking indicators look mixed overall. The SEEK job ads series continue to show strong divergence between mining and non-mining states, while the NAB Business Survey employment index fell for the third consecutive month in December to the neutral point – somewhat at odds with the official ABS data, but still consistent with our forecast for further improvements in unemployment rate going forward; 5.6% by end-16 and 5.5% by end-17.
- There are signs that the strength in household goods expenditure is losing steam, possibly reflecting the recent cooling of the housing market spearheaded by Sydney. That said, the more recent data on retail spending continues to be relatively resilient, underpinned by improving trading conditions, while a lower AUD has encouraged tourism spending. ABS retail turnover growth for November (0.4%) was slightly below October (0.6%) to be 4.1% y/y, around the trend seen since late 2014. Meanwhile, NAB's Online Retail Sales Index for November showed a 0.7% m/m rise in online spending. Despite soft wages growth, we expect a modest pick-up in consumer spending growth through to 2016, driven by a gradual reduction in households' saving ratio and strong employment growth.
- The Sydney housing market has clearly cooled, having recorded two consecutive months of price declines, while momentum in the Melbourne market has also slowed -but not as much as Sydney. Other capital cities experienced mixed outcomes in December. Recent property market outcomes are consistent with our view that prices growth will increasingly come under pressure as credit restrictions on investor lending bite, in combination with subdued incomes and slowing population growth/rising supply. We have maintained our previous forecast for much slower house price growth in 2016 (2%), although risks to the downside have escalated even more, especially in the apartment market.
- Signs of stronger non-mining investment remain hard to find in the official data (especially the expectations data), while inevitable declines in mining capex continue – and could well become more pronounced given further falls in commodity prices. Despite significant signs of improvement in the business landscape, the NAB Business Survey reports that firms are still apparently gun-shy on investment. A fall in capacity utilisation in the December Monthly business survey has probably not helped, nor would recent financial market uncertainties. That said, we remain hopeful that AUD depreciation will eventually assist investment in trade exposed industries. Dwelling investment has been a little softer than expected in recent quarters, yet record high numbers of dwellings in the construction pipeline suggest the positive contribution to growth is likely to continue – although the cooling housing market will likely stem the flow of new projects.
- Heightened market volatility since the start of 2016 has seen global commodity prices decline further. With LNG contract prices tied to oil prices, the fall in oil prices will significantly impact the profitability of Australia's LNG projects. While contracts in place indicate strong export volumes, downside risks remain. Meanwhile coal prices have drifted lower, while iron ore prices have been stable in recent months as lower oil prices and efficiency gains have lowered production costs.
- Overall, real GDP is forecast to pick up gradually to 2.7% in 2016 and 3.0% in 2017 (on the back of higher LNG exports) before moving back to around 2½% in 2018. The unemployment rate track has been revised lower given the lower starting point, and is now expected to ease to 5.6% by end-16 and 5.5% by end-17. For the RBA, unless financial market volatility translates into substantive negative real economic outcomes, the central bank is likely to remain on the sidelines watching developments.

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