Quarterly Economic Report

Monday, 18 January 2016

Executive Summary

The Australian Economic Outlook

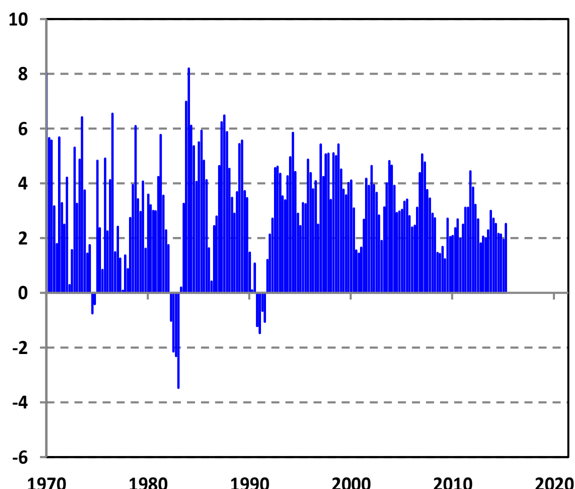
- The Australian economy is set to grow modestly in 2016 and reach 25 consecutive years without a recession. Low interest rates and a lower AUD should help counteract weaker capital spending in the mining sector.
- Labour market indicators remain firm, business sentiment is mildly positive, demand for credit is edging higher and export volumes are set to increase. The major risk to the Australian economy is weaker than expected growth in China and the United States.

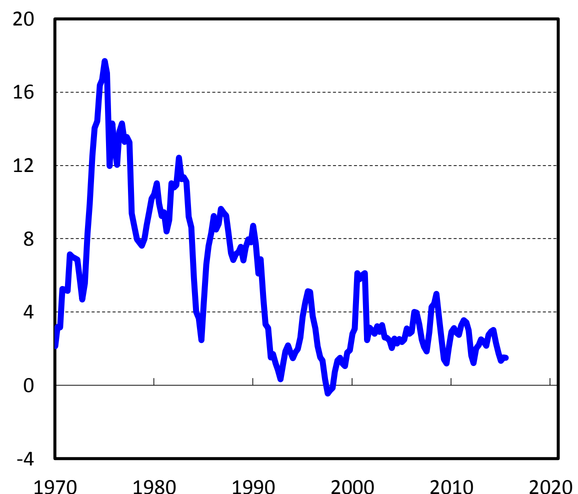
The Outlook for Interest Rates

- We expect the RBA to leave its cash rate on hold throughout 2016. Further rate cuts appear unwarranted this year, while a rate hike can wait until 2017. The downside risk to our view is if the global economy slips into a new economic crisis.
- Australian bond and swap yields are expected to edge higher in 2016 as the US gradually lifts its Fed funds rate. Ongoing low inflation, modest global growth and quantitative easing in Europe and China should limit the increases in yields.

The Outlook for the Australian Dollar

- Renewed concerns regarding the outlook for China and falls in commodity prices have driven the Australian dollar to a seven-year low since the turn of the year. The key risk remains the uncertain outlook for commodity prices.
- We expect the AUD to mostly trade near 70 US cents over the first half of 2016, notwithstanding some volatility while financial markets remain on edge. Our end of 2016 forecast is 74 US cents, reflecting growing signs of a pickup in growth towards the later part of the year.





The Outlook for the Australian Economy

As the Australian economy moves into 2016, the trends seen during 2015 seem set to continue. These include firmer export volumes but reduced capital expenditure in the resources sector; solid activity in the residential construction sector and further spending on infrastructure projects.

Low inflation, modest wage growth and slowly expanding household consumption should see further growth in jobs and a slightly lower unemployment rate by the end of the year.

Why our relative optimism? Why not a recession? What are the risks?

Relative optimism.

Ongoing low interest rates should provide a foundation for activity by keeping costs down for borrowers and providing incentives for expansion. The equity built up by homeowners over the past few years could also be a source of increased spending in the year ahead.

Other drivers of activity in 2016 should include population growth (albeit a touch slower than in 2014), the 'slow burn' of technological improvements, ongoing growth in our major trading partners, government spending on infrastructure projects and possibly new trade opportunities flowing from trade agreements. An election year Budget may lift business and consumer confidence.

Business surveys point to the positive effects of the lower AUD on exports and on import competition. During 2015, the AUD fell 10.9% against the USD and 5.7% on a trade weighted basis. We expect the AUD to remain near its current 'low' levels for much of 2016 (see page 9 for further details). The currency has become an economic 'safety valve' since floating in 1983 and should continue to boost economic activity during 2016.

Labour market indicators at the end of 2015 were positive. ANZ job ads were up 10.0% on a year earlier, the ABS measure of job vacancies was up 11.8% on a year earlier and the Australian Industry Group's index of manufacturing employment was at its highest since December 2014.

The jobs created in 2015 and the modest decline in the unemployment rate has helped lift consumer sentiment. Mildly positive consumer sentiment, modest wage growth and additional spending by overseas tourists, are expected to underpin retail spending in 2016. Growth in private consumption is unlikely to be spectacular but a step up from that seen during 2015.

Business surveys are painting a mixed picture for 2016 with continued pain in resources related industries and slowly improving conditions in other sectors. Apart from the mining sector, capacity utilization is on a slowly rising trend and suggests some pickup in capital spending over time.

It may be the case that the worst of the decline in resource related construction is behind us. If this is the case then changes in private capital expenditure could actually add to the growth numbers sometime during 2016.

Inflation is expected to remain well contained. Modest wages growth, strong competition and the flow on effects of weaker fuel costs should see the headline inflation rate at around 2.5% by the end of the year, up marginally from an expected 1.6% at the end of 2015.

Australia's population growth has slowed from the heady days of the resources boom. Nonetheless, immigration and natural population growth should lift Australia's population growth by around

300,000 in 2016. According to the RBA, the slower population growth of the past few years has reduced the potential or trend growth rate of the economy to a touch under 3.0%

For calendar 2016 we expect the economy to grow 2.8%. This compares with 2.6% growth in 2015 and expected growth of 2.3% in 2015.

Why not a recession?

A recession is never out of the question, even after almost 25 years of continuous economic growth. The status quo cannot be taken for granted and we acknowledge the risks facing the economy and our forecasts. The risks that could, but most likely will not, lead to recession in 2016 are outlined below.

The Risks.

The major risk to continued growth in Australian is the global economic environment and its potential impact on domestic business and consumer confidence. The early weeks of 2016 have demonstrated how rapidly Australian markets react to offshore events.

The economic landscape in Australia would change for the worse if economic activity in the United States and China were significantly lower than current expectations. So how are they really traveling?

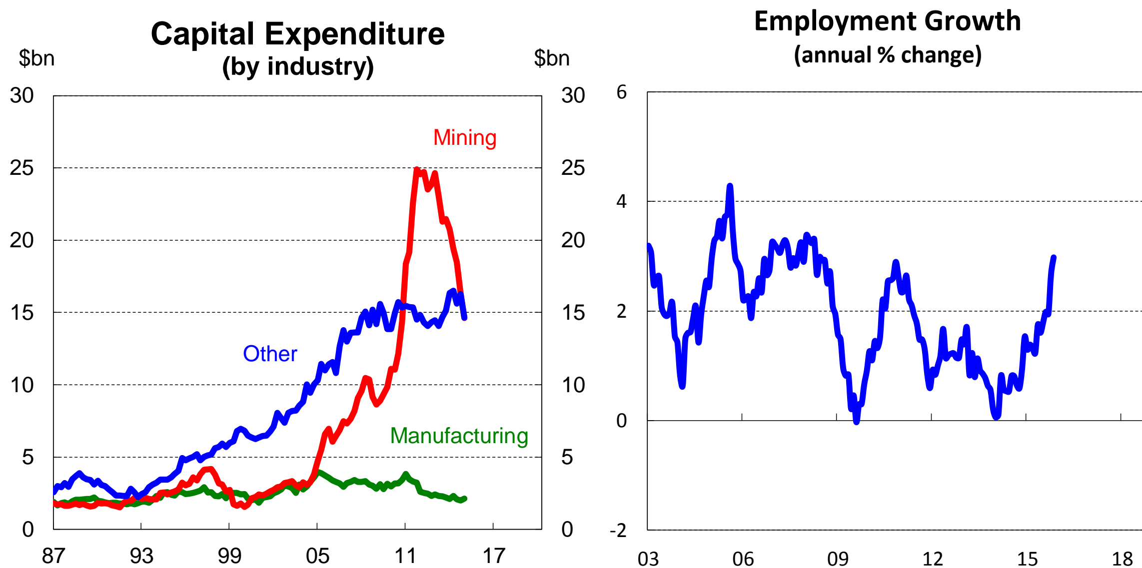
The US Federal Reserve (the Fed) lifted its Fed funds rate in December 2015. This was undertaken in the belief that the US economy could maintain its growth momentum in 2016. If current momentum were to falter, the Fed would likely delay raising rates in order to sustain growth. Working against US growth at present are its firming currency and unsettling conditions in its energy sector. We expect modest growth in the US with risks to growth managed by the Fed.

The outlook for China in 2016 is a little more uncertain. While we acknowledge the vast structural changes seen in China over the past decade and expect these to continue, we also note that China is entering new phases in its development. The transition away from heavy industry and towards a more consumer and services oriented economy may not go smoothly. In addition, the management of China's transition towards more market based policies also comes with risks, as seen by the reactions to recent moves in the yuan.

China is now a very large economy and the growth rates of past years are unlikely to be sustained. However, a growth rate of around 6% would still represent a very large increase in demand and be sufficient to lift or at least maintain the living standards of its vast but ageing population.

The debt servicing capacity of emerging nations is a further risk facing the global economy. While band-aids have been applied to Europe's debt problems, the rise of US denominated debt in emerging markets could become a matter for concern. A stronger US dollar and an uptick in US interest rates could lead to debt servicing problems during 2016.

Domestically generated risks could include a Budget in May that damages business and consumer confidence, a Tax White Paper with recommendations that are deemed highly inequitable, or the announcement of an early Federal election. Any of these could dent consumer spending and torpedo our forecasts as could a sharp decline in non-mining capital expenditure.



The Outlook for the Interest Rates

Our view is that the RBA will hold its cash rate steady at 2.00% throughout 2016. After that, the next move is up. There are downside risks to this outlook and these will be explained below.

We expect swap and bond yields in Australia to edge higher over the coming year as the US Federal Reserve gradually lifts its Fed funds rate in the face of increasing inflation risks. The ongoing quantitative easing programs in Europe and Japan should prevent longer term yields from rising excessively.

Why the RBA stays on hold in 2016

The Australian economy is growing, core inflation sits at 2.2% and the labour market has seen solid jobs growth over the past 12 months. Business sentiment is positive, consumer sentiment is close to neutral and export volumes are rising. The past year has seen record sales of new motor vehicles, record levels of residential home construction and a solid expansion of retail spending. Credit growth is picking up, infrastructure projects are underway and the population continues to grow. These are not the conditions that warrant a lower cash rate nor, at this stage, a rate hike.

Australian interest rates are at historically low levels and the currency has fallen almost 20% on a trade weighted basis and almost 30% against the US dollar over the past three years. These are tail winds that should see Australia reach 25 consecutive years of economic growth by the end of 2016.

There are serious issues facing the mining sector and the sharp decline in private capital expenditure is a drag on current economic activity, although this could reduce over time. In our view, cutting the RBA's cash rate by 25 or 50 basis points would do little for the mining sector nor would it alter the near term outlook for private capital expenditure. Commodity prices, which are at the heart of the mining sectors woes, are determined by global demand and supply while private capital expenditure is driven by business confidence and capacity constraints.

Our view is that by maintaining the cash rate at 2.00%, the RBA leaves itself sufficient 'firepower' should a global economic shock emerge. It also provides stability in a period of fragile financial

markets. As suggested earlier, our base case for the Australian and the global economy is for continued modest growth. Hence our forecast of no change to the RBA's cash rate this year.

Downside risks to the outlook

As noted earlier, the major risk to economic growth in Australia and thus the major risk to our RBA cash rate forecast is the global economic environment. If real economic conditions in the US economy, the Chinese economy and wider global economy were to deteriorate significantly, then a rate cut, or two, might be warranted. But that is not our base forecast for the global economy.

The market, by currently 'pricing in' an RBA rate cut of 25 basis points by December 2016, has built in more pessimism than we believe is warranted. In the latter half of 2015, the market was pricing in two rate cuts, with one to occur in 2015. That did not happen. Domestic economic conditions held up, as did the global economy. We expect the same in 2016 despite the current volatility in financial markets.

Swap and bond yield forecasts – Domestic and Global

We expect swap and bond yields to edge higher over the course of 2016. The US Federal Reserve (the Fed) lifted its Fed funds rate in mid-December 2015 and expects to gradually lift it further over 2016. This could see some upward pressure on swap and bond yields. At the same time, the central banks of Europe and Japan are engaged in 'quantitative easing' in an attempt to keep bond yields down and stimulate their economies.

The net impact of US, European and Japanese central bank policy should be a muted rise in swap and bond yields, as opposed to the potentially more significant increase that might otherwise have occurred without the European and Japanese actions. That said, increases in the US Fed funds rate are likely to be small and gradual.

By December 2015, the Fed came to the conclusion that its 'zero' interest rate policy was no longer appropriate; it was running the risk of igniting inflationary expectations via an acceleration in US wages growth. While wages growth and inflation remain low, they could pick up during 2016 given the firmer US labour market. A lift in inflation expectations could see upward pressure on swap and bond yields.

We expect US ten-year bond yields to rise from 2.03% at the time of writing to 2.50% by June 2016 and to 2.70% by December 2016. This would then translate into upward pressure on Australian ten year bond yields which we see increasing through 2016.

Risks to the swap and bond yield forecasts

Slower domestic and global economic growth combined with lower than expected inflation could see swap and bond yields not achieve our forecast levels. Core inflation in the US, Europe and Japan is currently below 2.0%. Wage growth is modest and business capacity utilization is not at its limits in each of these jurisdictions.

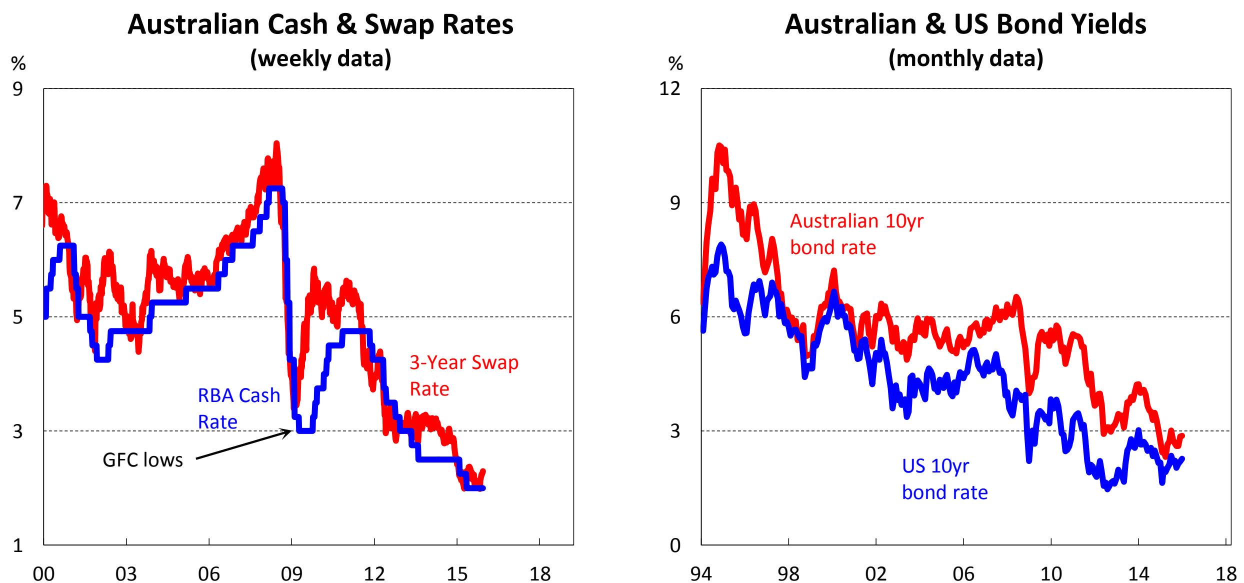
Debt servicing problems in emerging markets, tensions between Russia and the remainder of Europe, wider conflict in the Middle East, debt restructuring issues in Greece and fallout from low oil and other commodity prices all have the capacity to disrupt global sentiment and our forecasts.

The basic premise of our bond yield forecast is that global economic growth will pick-up during 2016 despite a shaky start on financial markets and weaker commodity prices. This modestly firmer

growth should absorb some excess capacity. This will, in turn, place some upward pressure on wages and inflation. Bond yields should then drift a touch higher than they are today.

We expect the yields on 10 year Australian government bond yields to rise from 2.68%, at the time of writing, to 2.95% by June 2016 and 3.40% by December 2016. Likewise, yields of 3 year government bonds are expected to rise from 1.89% at the time of writing to 2.40% by June 2016 and to 3.00 by December 2016.

Our full interest rate forecasts can be found on page 9.



The Outlook for the Australian Dollar

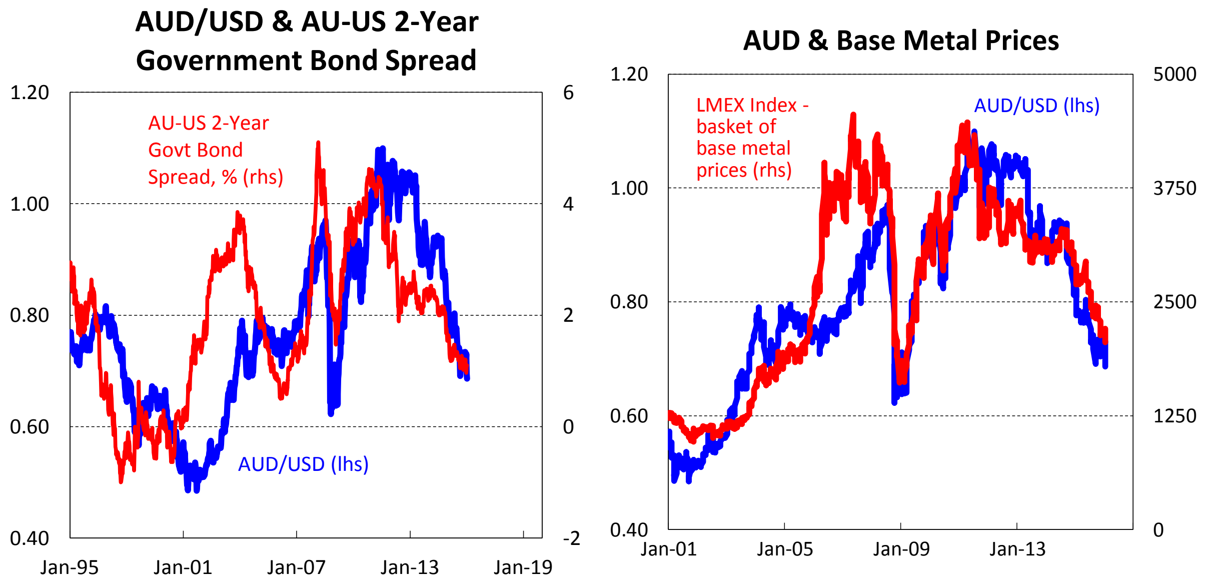
A Recap

The Australian dollar has had a volatile few months, mostly trading within a US$0.69-0.74 range since September. After touching a low of US$0.6896 on 7 September, the Australian dollar ended 2015 at US$0.7286, in line with our long-held forecast of 73 US cents.

Our forecast was based on the notion that markets had taken an overly pessimistic view on the outlook for China, the domestic economy and domestic interest rates, as stated in our AUD outlook published on 14 September. Since then, the run of domestic economic data has been relatively upbeat, and market pricing for further reductions to the RBA cash rate has pared back. Evidence of the Australian economy's resilience, along with a rebound in risk appetite has provided support for the Australian dollar, and outweighed downward pressures from weak commodity prices.

Nonetheless, we also stated in September that we did not expect any sustained rally in the Australian dollar. Lower commodity prices, and ongoing uncertainty regarding the global economy and developments in China, could continue to weigh on the Australian dollar. More recently, the Australian dollar slid sharply over the first couple of weeks of this year, and hit a seven-year low of

US$0.6831 on 18 January as risk aversion once again escalated amid Chinese concerns and renewed falls in commodity prices.



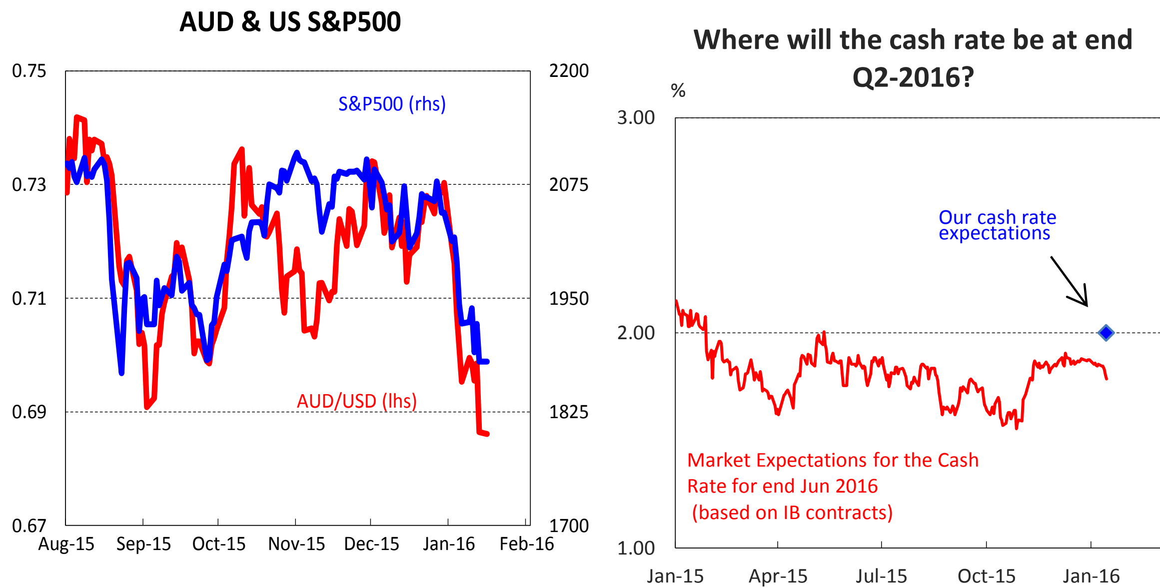
Where to Next for the AUD?

The balance of risks suggests to us that the AUD will mostly trade near 70 US cents over the first half of the year unless developments diverge significantly from our expectations.

Worries regarding China continue to pose downside risks for the Australian dollar, as the Chinese economy slows and continues to undergo its transition towards more market-driven financial markets. These concerns could result in further market ructions over the coming year. However, we maintain that risks to the real economy have not taken a significant turn for the worse. This would suggest that the events over the past few weeks should have limited implications for our forecasts over the coming year. Nonetheless, the AUD will likely remain volatile while these worries linger.

The commodity price outlook is also a significant risk for the currency outlook. Further falls in commodity prices remain a distinct possibility, and commodity prices tend to be a key determinant of the AUD over the longer-term. However, substantial falls from current levels in the prices of commodities such as oil and iron ore, would be unlikely sustainable over the long-term. Further, commodity prices are also not the only driver for the Australian dollar. The growth outlook for Australia and interest rates also plays a part.

On this front, the domestic economy is performing relatively well given the income squeeze from falling commodity prices. This is in part due to solid growth in export volumes, but also because there are signs of recovery in non-mining sectors of the economy which are not as affected by movements in commodity prices. These are sectors which have supported strong growth in jobs and will support the case for the RBA to leave rates on hold. Our view for a steady cash rate for all of 2016 should limit further falls in the AUD, although some chance of a rate cut is likely to remain embedded into market pricing while inflation remains low, growth remains below trend and global growth concerns persist.



Currently, markets are close to fully pricing in a rate cut from the RBA by June this year, although this is less than the two rate cuts priced in some months ago. This suggests that the AUD could lift if the RBA leaves official interest rates unchanged, particularly towards the end of the year when we expect to see further signs of growth picking up towards trend. Hence, we expect the AUD to begin appreciating towards the second half of 2016, with an end of year target of 74 US cents.

Risks and Uncertainties

We see the risks to our AUD forecasts as being mostly balanced. The key risk remains the uncertain outlook for commodity prices. The AUD has also been moving closely with equity markets and risk appetite, which have been volatile of late (see chart above left).

Another factor that could influence the currency is the outlook for the Federal Reserve. The US central bank finally kicked off its tightening cycle in December last year. As we expected, this resulted in limited market reaction given the move was widely telegraphed. We expect a further three 25 basis point increases this year, which should give the US dollar support (downward pressure on the AUD). However, the risk is that the Fed will lift rates at a slower pace given the weak inflation outlook. This would limit any further appreciation of the US dollar.

The domestic economy may not pick up as soon as expected, and delay the expected AUD appreciation towards the end of the year. However, once there are stronger signs of recovery in the domestic economy, and markets begin to get a sense that an RBA rate hike is on the horizon, the AUD could lift quickly over a short period of time.

Summary

We expect that the AUD will trade close to US 70 cents over the first half of this year. In the near-term, weakness in commodity prices and fragile market sentiment are likely to continue to provide some downside risk, and could keep the currency volatile. Nonetheless, we do not expect the Australian dollar to sustain falls substantially below 70 cents unless RBA rate cuts become a strong possibility or the global outlook takes a significant turn for the worse. We expect the currency to begin appreciating in the second half of the year, as the recovery in the domestic economy takes hold. Our end of 2016 forecast for the AUD is $0.74.

Our detailed currency forecasts can be found on page 9.

Major Upcoming Data and Events

Australian Data / Events Underlined

January	29th Aust PPI Q4	4th US Factory Orders Dec
20th WBC-MI Consumer Confidence Jan	29th US GDP Q4	5th Aust Retail Sales Dec
20th US CPI Dec	**February**	5th Aust Retail Sales Volumes Q4
20th US Housing Starts Dec	1st China Caixin Manufacturing PMI Jan	5th RBA Statement on Monetary Policy
22nd US Markit Manufacturing PMI Jan	1st US Personal Income Dec	5th US Nonfarm Payrolls Jan
22nd US existing Home Sales Dec	1st US PCE Deflator Dec	5th US Trade Balance Dec
26th US CB Consumer Confidence Jan	1st US ISM Manufacturing Jan	10th WBC-MI Consumer Confidence Feb
27th US Federal Reserve Rate Decision	2nd Aust RBA Cash Rate Target	12th Aust Housing Finance Dec
27th US New Home Sales Dec	3rd Aust Trade Balance Dec	12th US Retail Sales Jan
28th Aust Trade Prices Q4	3rd Aust Building Approvals Dec	12th US UoM Consumer Sentiment Feb
28th US Durable Goods Orders Dec	3rd China Caixin Services PMI Jan	17th US Housing Starts Jan

Forecasts

			2016				2017	
End Period:	**Q3**	**Q4**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Interest Rates:								
RBA Cash Rate, %	2.00	2.00	2.00	2.00	2.00	2.00	2.25	2.50
90 Day BBSW, %	2.16	2.33	2.30	2.30	2.40	2.50	2.80	3.00
3 Year Bond, %	1.83	2.02	2.35	2.40	2.70	3.00	3.30	3.50
10 Year Bond, %	2.61	2.88	2.90	2.95	3.20	3.40	3.70	3.80
USD Exchange Rates:								
AUD-USD	0.7018	0.7286	0.7000	0.7000	0.7200	0.7400	0.7500	0.7600
USD-JPY	119.88	120.22	122.00	122.00	120.00	119.00	118.00	118.00
EUR-USD	1.1177	1.0862	1.0800	1.0800	1.0900	1.1000	1.1100	1.1100
GBP-USD	1.5128	1.4736	1.4800	1.5000	1.5200	1.5400	1.5500	1.5600
USD-CHF	0.9733	1.0021	0.9900	0.9900	0.9800	0.9800	0.9800	0.9800
USD-CAD	1.3313	1.3839	1.4000	1.4000	1.3500	1.3300	1.3300	1.3100
NZD-USD	0.6399	0.6831	0.6600	0.6600	0.6700	0.6800	0.6900	0.7000
USD-CNY	6.3560	6.4937	6.5500	6.5500	6.6000	6.6000	6.6000	6.6000
USD-SGD	1.4223	1.4185	1.4200	1.4200	1.4400	1.4200	1.4000	1.3800
AUD Exchange Rates:								
AUD-USD	0.7018	0.7286	0.7000	0.7000	0.7200	0.7400	0.7500	0.7600
AUD-EUR	0.6280	0.6710	0.6480	0.6480	0.6610	0.6730	0.6760	0.6850
AUD-JPY	84.10	87.60	85.40	85.40	86.40	88.10	88.50	89.70
AUD-GBP	0.4640	0.4940	0.4730	0.4670	0.4740	0.4810	0.4840	0.4870
AUD-CHF	0.6830	0.7300	0.6930	0.6930	0.7060	0.7250	0.7350	0.7450
AUD-CAD	0.9340	1.0080	0.9800	0.9800	0.9720	0.9840	0.9980	0.9960
AUD-NZD	1.0970	1.0670	1.0610	1.0610	1.0750	1.0880	1.0870	1.0860
AUD-SGD	0.9982	1.0335	0.9940	0.9940	1.0368	1.0508	1.0500	1.0488

* Note that the AUD cross exchange rates have been rounded.

	2014-15 (f)	**2015-16 (f)**	**2016-17 (f)**	**2014**	**2015 (f)**	**2016 (f)**
GDP, %	2.2	2.6	3.1	2.6	2.3	2.8
CPI (Headline), %	1.7	1.8	2.4	2.5	1.5	2.2
CPI (Underlying), %	2.4	2.0	2.3	2.5	2.2	2.2

Contact Listing

Chief Economist	Senior Economist	Senior Economist
Hans Kunnen	Josephine Horton	Janu Chan
kunnenh@stgeorge.com.au	hortonj@stgeorge.com.au	chanj@stgeorge.com.au
(02) 8254 8322	(02) 8253 6696	(02) 8253 0898

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