Quarterly Economic Report

Thursday, 6 October 2016

Executive Summary

The Australian and Global Economic Outlook

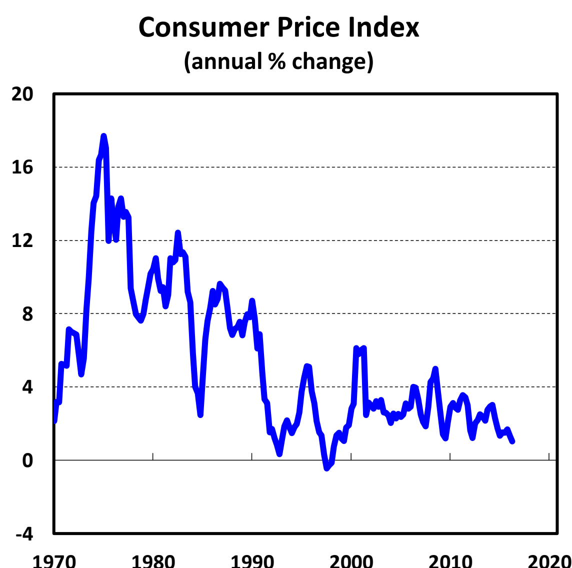
- The Australian economy has not seen a recession in 25 years due to a mix of good fortune and good policy. We expect growth to continue driven by exports, household consumption, infrastructure construction and population growth.
- The global economy faces challenges as both economic growth and trade ease their pace of growth. The US and Chinese economies are expanding at a reasonable pace but Europe continues to struggle.

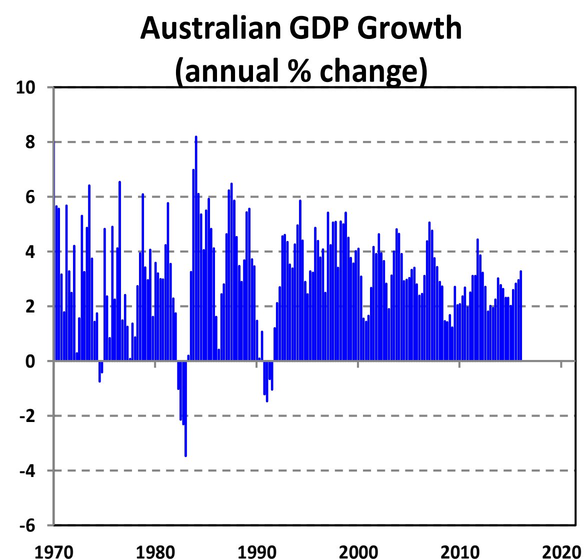
The Outlook for Interest Rates

- Australia's official cash rate at 1.50% is at its lowest on record. We expect the RBA to reduce its cash rate to 1.00% by mid-2017 as inflation remains stubbornly low.
- The net impact of US, European and Japanese central bank policy is expected to be an increase in Australian swap and bond yields over the course of 2017. Rate hikes by the US and slightly less accommodative policies in Europe and Japan are expected to see longer term rates rise.

The Outlook for the Australian Dollar

- The Australian dollar has continued to show resilience over the past year. After some volatility earlier in the year, the AUD has traded within a narrow band over the past three months. Stronger-than-expected commodity prices are the major factor keeping the AUD elevated.
- While the AUD has traded a little higher than what we had anticipated, it remains close to the mid-70 cent range where we had expected it stay for the remainder of this year. We have maintained our forecast of US$0.74 for the end of 2016 and expect US$0.76 for end 2017.





The Outlook for the Global and Australian Economies

Global Economic Outlook

The Brexit vote has come and gone. The US presidential election is before us. The Chinese yuan has become a 'reserve currency' and the Italians face a vote on constitutional change. OPEC is attempting to curb the supply of oil, a major German bank faces large fines in the US and we see negative interest rates across a range of jurisdictions. There is always something to keep the global economy and markets on edge.

During the past three months, OECD growth forecasts for the global economy have been pared back and the IMF appears poised to do the same. The World Trade Organisation (WTO) has recently revised down its outlook for global trade and the bankruptcy of a major Korean shipping line has unsettled some exporters and importers. The outlook for global growth is softer than three months ago but it is not dire.

The OECD expects global growth to be 2.9% in 2016 and 3.2% in 2017. This is 0.1 percentage points lower, for both 2016 and 2017, than had been forecast in June. According to the WTO, for the first time in 15 years, growth in world trade, at 1.7% for 2016, is set to be lower than growth in the global economy.

While disappointing, the outlook is not all doom and gloom. The US economy continues to expand and create jobs. It is almost at the point where the Federal Reserve feels it can once again lift the Fed funds rate. China too continues to expand and in July the IMF lifted its 2016 growth forecast for China from 6.5% to 6.6%. Like Australia, China is undergoing transition pains as it seeks to lift domestic demand and the process is not always smooth.

Europe's economy faces hurdles. The UK expects to formerly trigger the exit process by the end of March 2017 and be out of the European Union by 2019. The OECD has reduced its forecasts for economic growth in Europe to 1.5% in 2016 and 1.4% in 2015. Following the Brexit vote, the OECD expects UK economic growth of just 1.0% in 2017. However, we believe the weaker UK pound will assist the UK economy as might some compromise in negotiations over the next two years.

Domestic Economic Outlook

The Australian economy has avoided recession for the past 25 years due to a mix of good policy and good fortune. A floating currency, expansive fiscal policy and solid growth in the Chinese economy all played their part. The outlook for the next few years is one of ongoing growth based on exports, growth in the services sector and ongoing infrastructure construction.

In the year to the June quarter 2016, GDP grew 3.3%. We expect growth of 3.1% for the year to December 2016 and 2.7% for the year to June 2017. However we cannot take growth for granted. A slowdown in housing construction could hurt Australia's growth prospects as would a significant downturn in Chinese economic activity. With global interest rates at exceedingly low levels, and in some cases negative, an unexpected upward correction in rates could lead to sharp downturn in equity prices. This, in turn, could hamper economic growth in Australia and globally. While this is not our base case, the risk exists.

A current drag on activity is the downturn in business investment which fell 14.7% in the year to June 2016. This reflects the completion of major resource projects and the lack of new projects to take their place. The good news is that once this slump passes through the system, business investment can again add to GDP growth. We expect this to occur during 2018. In the meantime,

growth in exports, investment in dwellings and private consumption are expected to generate growth.

Our forecasts suggest growth in domestic demand i.e. GDP excluding net exports, will remain muted at 1.7% in the year to December 2016 and 1.9% in the year to June 2017. With this in mind, we also expect headline inflation to remain subdued at 1.1% in the year to December and 1.9% in the year to June 2017.

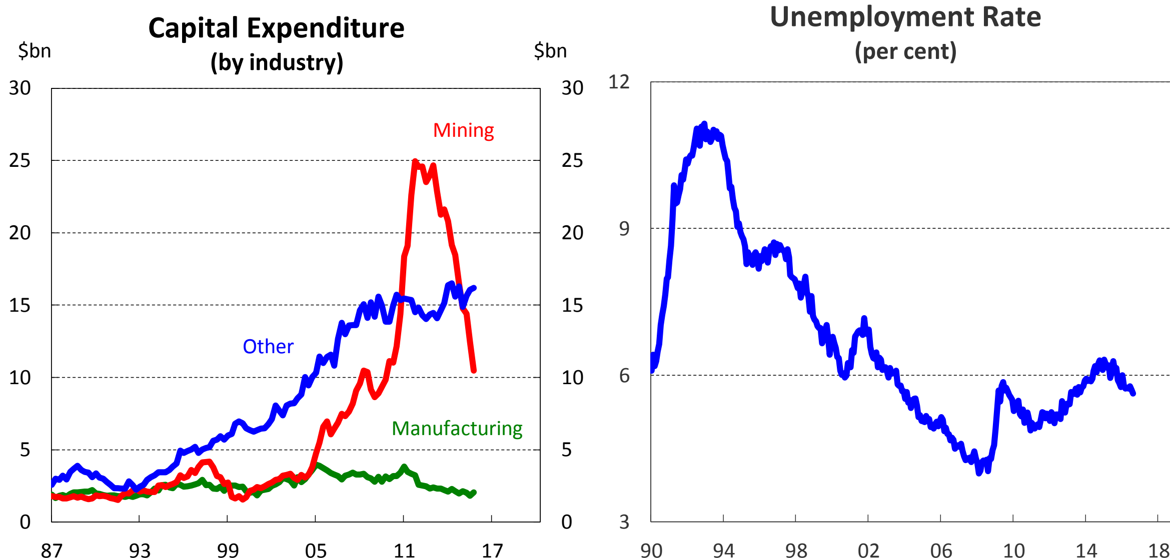
With GDP growth close to 3.0%, it is difficult to forecast unemployment falling dramatically unless there are changes to underlying factors such as population growth or the participation rate. As of August 2016, the unemployment rate stood at 5.6% and seems likely to hover around that rate for the next twelve months.

Helping to keep the unemployment rate below 6% has been a slowing in the pace of migration. In the year to March 2016, Australia attracted 171.1k migrants. This was well down on the 315.7k increase in the year to December 2008 and the 237.4k in the year to December 2012. A contraction in the mining construction sectors of Western Australia, Queensland and the Northern Territory has seen migration flows subside and then level out.

Other Risks to Domestic Growth

There are risks to every forecast. In the case of the Australian economy, the major uncertainties and risks surround the level of business investment, the pace of export growth and renewed weakness in commodity prices.

The RBA has rightly pointed out that an increase in the AUD has the potential to complicate Australia's growth path. The AUD has risen from US 72 cents in May to US 76 cents at the time of writing. The Trade Weighted index of the AUD has seen a similar move over that time frame. Our forecasts for the AUD and a range of economic indicators can be found below at page 10.



The Outlook for the Interest Rates

Interest Rates – Have We Seen the Lows?

The Reserve Bank of Australia (RBA) cut its official interest rates by 25 basis points to a fresh record low of 1.50% in August. This followed an interest rate cut in May. Lower than expected domestic inflation has allowed the RBA to cut interest rates to historical lows.

Will The RBA Cut Interest Rates Again?

Australia's GDP growth is strong; however, softer growth in domestic demand indicates that growth in the domestic economy is less robust. Employment is growing at a slower pace than a year ago, despite two interest rate cuts this year.

Inflation is at historical lows and this has been a key factor in recent RBA interest rates decisions. Low inflation is being driven by domestic and international factors and is expected to remain an ongoing issue in the medium term. Core CPI inflation is not expected to return to the RBA's 2-3 percent per annum inflation target band until the second half of 2017 at the earliest.

Recent commentary from the RBA does not suggest it is poised to lower interest rates soon, although it has left the door open further rate cuts. We think further rate cuts are likely, if domestic economic growth remains lacklustre and inflation is still low. Later this month the CPI inflation results for Q3 will be released. If these remains low, as we expect, we favour November as the possible timing for another rate cut. We expect official interest rates to fall to as low as 1.00% by mid-2017.

Financial markets are pricing in only around 20% probability of a rate cut by December this year and around 50% probability by mid-2017.

Australian Bond Yields

Australian bond yields rebounded in September, after hitting record lows in early August. The Australian 10-year government bond yield hit a low of 1.82% on 2nd August, and the three-year bond yield fell to a record low of 1.37% on the same day. Despite rising last month, Australian government bond yields remain at historically low levels.

The US Federal Reserve

The US Federal Reserve (Fed) raised interest rates in December last year and an eagerly awaited follow-up rate hike has failed to materialise so far this year. The Fed has indicated that a rate hike this year is likely, with December as the expected timing. The decision to raise interest rates is heavily dependent on US economic data. Commentary indicates members of the Fed's FOMC are increasingly divided on their reading of the economy and their expectations on the number of rate hikes going forward.

At its September meeting, the Fed's "dot plot" predictions for interest rate hikes showed FOMC members had toned down their rate hike expectations. Pricing by financial markets, however, has held its ground since June. The Fed's predictions for rate hikes and those of financial markets are now the closest they have been in some time, although market expectations for rate hikes still trail those of the Fed.

When is a rate hike likely?

We had expected two rate hikes from the Fed this year, we now expect just the one, in December. However, even with interest rates still at very low levels and concerns from some the Fed is 'behind the curve'; a rate hike this year is not a certainty. Both upcoming economic data and political uncertainty have the potential to derail a rate hike this year. Following a likely interest rate increase in December this year, we expect the Fed to hike interest rates twice in 2017.

Global Bond Yields

Global bond yields hit record lows in the past quarter, but have since risen. Growing uncertainty about the efficacy of monetary policy at low and especially negative interest rates has weighed on bond prices (and pushed bond yields higher).

Following its September, meeting the Bank of Japan announced it would target a yield on 10-year bonds, in addition to its official short-term interest rate target. This led to speculation the Bank of Japan may be looking for other monetary tools as it slowly back tracks on negative yields (at least at the long end of the yield curve). It also led to speculation the Bank of Japan could be running out of options for monetary policy tools.

It is possible the European Central Bank and the Bank of Japan are approaching (or have reached) a peak in the pace of their bond purchases. Knowledge that central banks were buying increasing amounts of government bonds has been a key bond rally driver. Private buyers have been incentivised to buy low (or negative) yielding government bonds on the expectation that central bank demand would continue to rise. There is now more of a question mark over this logic, which has supported bond yields this quarter.

Despite the rise in bond yields over the quarter and an apparent subtle shift in sentiment, global monetary policy remains ultra-stimulatory. This continues to put a floor under demand for bonds globally, limiting the uptick in yields.

Forecasts

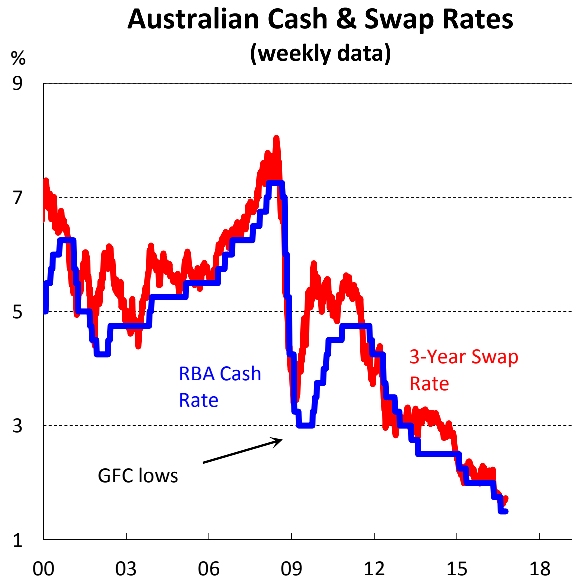
The large amount of monetary stimulus globally has caused the global sovereign bond market to move 'as one'. Therefore the outlook for Australian bond yields is arguably more dependent on the outlook for global monetary policy than it is on that of Australia.

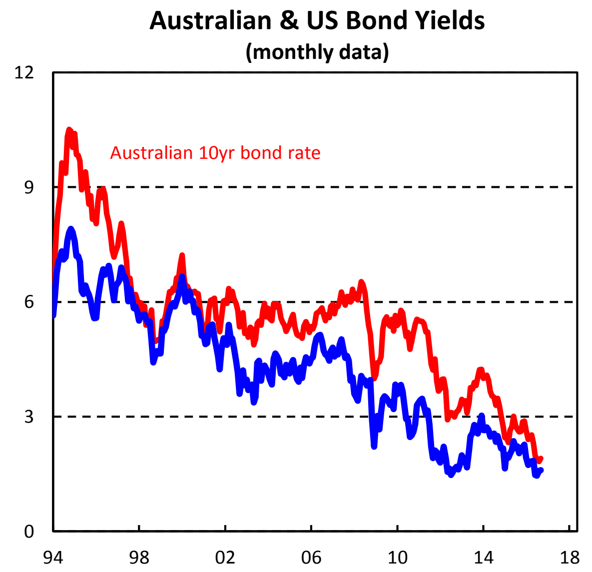
We expect the US to raise interest rates over the coming year. Although the pace is expected to be gradual, it will likely be more aggressive than the market is currently pricing. This is expected to lead to an increase in US bond yields, which will boost Australian long term bond yields. Meanwhile the yields on Australian 3-year bond yields are expected to edge lower this year as the RBA cuts interest rates further.

US 10-year bond yields are expected to rise to 1.80% by year-end, and to 2.60% by the end of 2017. Our forecast is for yields on the US 2-year government bond yield to rise to 0.95% by year-end and to 1.50% by the December quarter 2017.

The yields on Australian 10-year government bonds are expected to rise from 2.14% at the time of writing, to 2.25% by year-end and 2.60% by December 2017. We expect yields on Australian 3-year Government bond to fall to 1.50% by year-end (as the RBA cuts interest rates), before rising to 1.90% by the end of 2017.

Our full interest rate forecasts can be found on page 10.





The Outlook for the Australian Dollar

Steady As She Goes

The Australian dollar has shown resilience over the past year. After some volatility in early 2016, the AUD has traded within a narrow band of between US$0.7462 and US$0.7703 over the past three months. It is currently trading at close to 76 US cents.

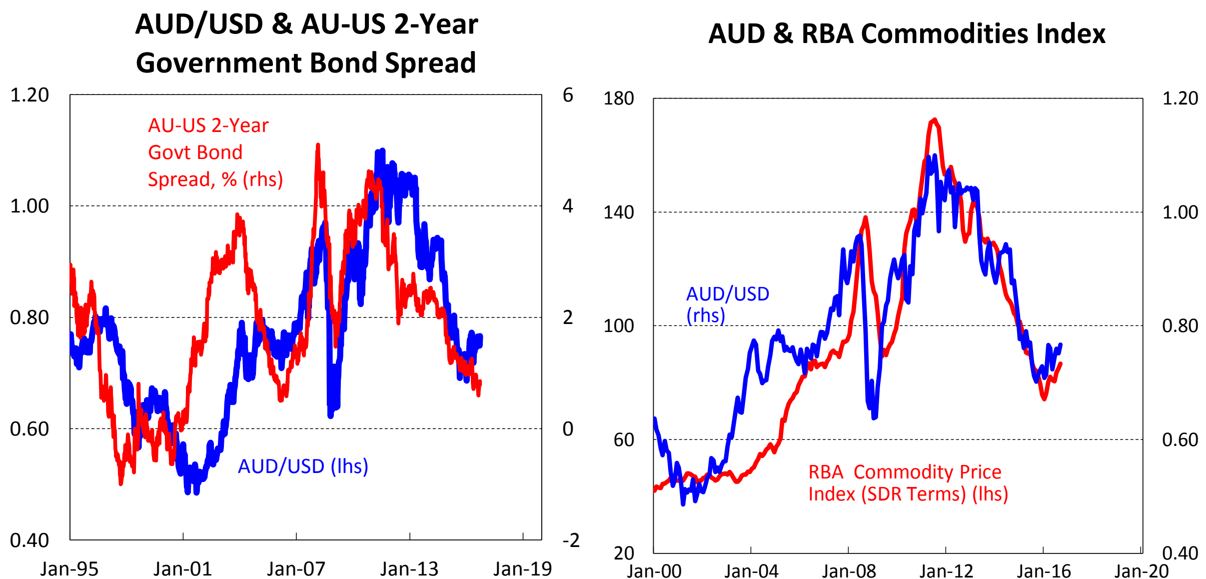
Stronger-than-expected commodity prices are the major factor keeping the AUD elevated. In particular, coking coal prices have surged nearly 150% since the beginning of June to over $200 a tonne. Iron ore prices have also been elevated, but are off their highs hit in April of this year.

Monetary and fiscal stimulus in China has driven a resurgence in Chinese demand creating key support for commodity prices and the Australian dollar.

Higher commodity prices have been the overriding factor in determining the value of the Australian dollar. The currency is well up from its January lows, when it hit US$0.6864, and comes despite the fact that the RBA has lowered official interest rates by a total of 50 basis points over May and August. It does not appear that lower official interest rates have had much of an impact in keeping the AUD under downward pressure, although lower interest rates may have had the impact of keeping the AUD lower than it otherwise would have been.

Another factor supporting the AUD (or keeping downward pressure on the USD) has been the scaling back of expectations of Federal Reserve rate hikes. So far this year the Fed has not lifted its Fed funds rate and this follows Federal Reserve forecasts of up to four rate hikes in 2016.

While the AUD has traded a little higher than what we had anticipated, it remains close to the mid-70 cent range where we had expected it to stay for the remainder of this year.



Where to Next for the AUD?

Over the near-term, we expect the AUD to trade near its current range and we have maintained our year end forecast of 74 US cents. We expect it will trade close to within the US 70 cent range over the coming year.

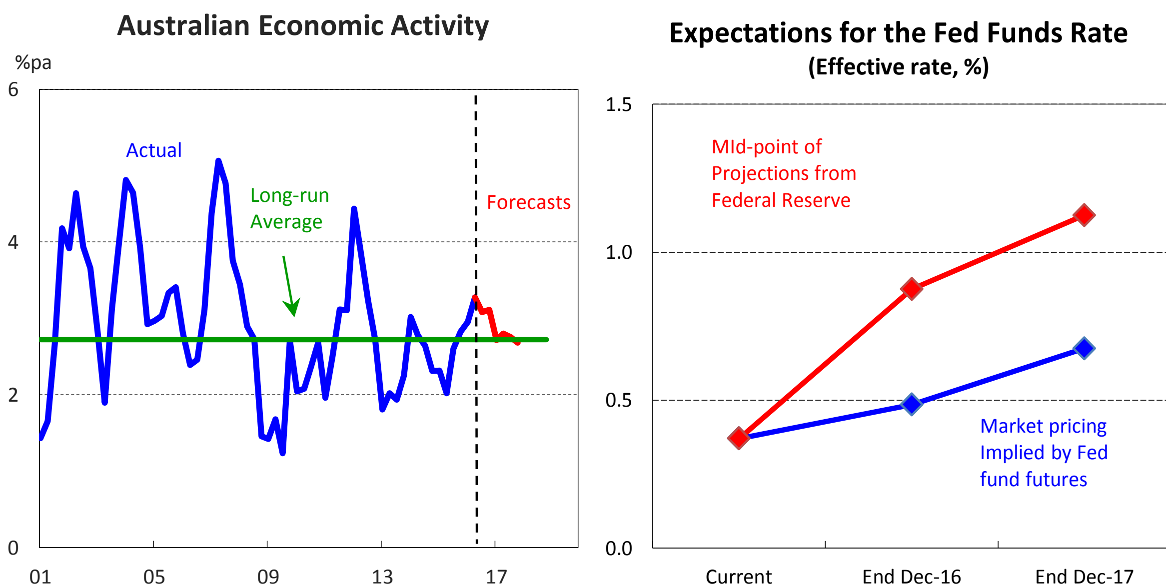
There is little on the horizon which suggests currencies will move strongly in any particular direction, with risks close to balanced.

First and foremost, the outlook for Federal Reserve monetary policy will be the key determinant for currency markets. Financial markets continue to place a relatively low probability of Fed rate hikes over the coming year – only a "below 50%" chance of a 25 basis point rate hike by December and a 75% chance of a hike by 2017. We expect a larger 50 basis points of hikes by the Fed next year, in line with the median estimate of Fed projections. While this is more than what markets seem to be suggesting, the pace of expected rate tightening is extremely conservative. Consequently, we do not expect a significant appreciation in the US dollar, and that it will track broadly sideways over the next year.

The outlook for a broadly steady US dollar suggests that commodity prices are not expected to undergo large swings, given the US dollar is a key influence on commodity prices. Recent stimulus measures have boosted economic growth in China and helped to underpin demand for commodities, keeping prices stronger than expected. There is however, the question of how sustainable the recent pickup in commodity prices will be, as there continues to be issues of overcapacity in the Chinese steel sector. That would suggest that a sustained rally in commodity prices is unlikely.

The RBA outlook is the other factor which will influence the Australian dollar. Our expectations are for the RBA to cut official interest rates by a total 50 basis points before mid-next year, which is more than markets are currently anticipating. Interest rate futures are pricing in a 'near 70%' chance of a 25 basis point rate cut by mid-2017. Nonetheless, rate cuts from the RBA have taken a backseat in determining the Australian dollar outlook. Despite two rate cuts from the RBA this year, the Australian dollar is relatively unchanged from its value in April. This might reflect the fact that the Australian economy is growing at a relatively healthy pace. In the year to the June quarter, the economy grew at an above trend pace of 3.3%, and we expect economic growth to remain close to trend over the next year.

The Australian dollar's resilience in the face of RBA rate cuts may also, in part, reflect the very easy monetary policy stances of other central banks around the world. These include the Bank of Japan and the European Central Bank, although there are becoming increasingly limited options for monetary policy that these central banks are able to provide.



Risks and Uncertainties

In the near-term, the US presidential election could pose some downside risks to the Australian dollar. A growing prospect of a Trump presidency would more than likely weigh on financial market sentiment and bring down the Australian dollar, but this would only have an impact over the short-term.

An uncertain outlook for China is the other major risk on the horizon. Chinese growth has received a near-term boost thanks to stimulus measures from authorities. However, this might give way to softer growth as the effects from these measures fade and as growth continues to rebalance towards a more sustainable growth path.

Risks run in both directions in terms of the interest rate outlook. There is the possibility that the US Federal Reserve would further delay raising official interest rates. Conversely, a faster pickup in US wage pressures and inflation could see the Fed raise rates faster than expected. The RBA may also delay reducing official interest rates which could help boost the AUD higher than expected, although RBA monetary policy appears to have had less of an impact on the currency of late.

Summary

We expect that the Australian dollar will trade not far from current levels over the next year. While the RBA is expected to lower official interest rates further, we anticipate that commodity prices and the Fed will be more important for the outlook for the Australian dollar.

Sluggish global demand and still ample capacity suggests that commodity prices are unlikely to rally substantially, but we doubt that commodity prices will fall back to their January lows. Expected rate cuts by the Fed and interest rate cuts by the RBA are expected to only place mild downward pressure on the AUD.

We have maintained our forecast of US$0.74 for the end of 2016 and expect US$0.76 for end 2017.

Our detailed currency forecasts can be found on page 10.

Major Upcoming Data and Events

Australian Data / Events Underlined

October	19th China GDP Q3	**November**
11th NAB Business Survey Sept	20th ECB Monetary Policy Meeting	1st China Manufacturing PMI Oct
12th US Minutes of FOMC meeting Sept	20th Aust Labour Force Sept	1st China Caixin Manufacturing PMI Oct
12th WBC-MI Consumer Confidence Oct	20th US Existing Home Sales Sept	1st Aust RBA Cash Rate Target
14th China CPI Sept	21st China Property Prices Sept	2nd Aust Building Approvals Sep
14th US Retail Sales Sept	24th US Markit Manufacturing PMI Oct	2nd US FOMC Rate Decision
17th US Industrial Production Sept	25th US CoreLogic/CS House Prices Aug	4th RBA Statement on Monetary Policy
18th RBA Board Meeting Minutes Oct	26th Aust CPI Q3	4th Aust Retail Sales Sep
18th US CPI Sept	26th US New Home Sales Sept	8th US Presidential Election
19th China Industrial Production Sept	27th China Industrial Profits Sept	16th Aust Wage Prices Q3
19th China Retail Sales Sept	31st Aust Private Sector Credit Sep	17th Aust Labour Force Oct
19th US Housing Starts Sept		**December**
		15th US FOMC Rate Decision

Forecasts

	2016				2017			
End Period:	**Q1**	**Q2**	**Q3**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Interest Rates:								
RBA Cash Rate, %	2.00	1.75	1.50	1.25	1.25	1.00	1.00	1.00
90 Day BBSW, %	2.27	1.94	1.74	1.50	1.50	1.25	1.25	1.25
3 Year Bond, %	1.90	1.55	1.59	1.55	1.60	1.60	1.80	1.90
10 Year Bond, %	2.49	1.98	2.14	2.25	2.25	2.40	2.40	2.60
USD Exchange Rates:								
AUD-USD	0.7657	0.7451	0.7664	0.7400	0.7300	0.7200	0.7400	0.7600
USD-JPY	112.57	103.20	101.35	100.00	100.00	100.00	103.00	105.00
EUR-USD	1.1380	1.1106	1.1235	1.1200	1.1300	1.1300	1.1300	1.1300
GBP-USD	1.4360	1.3311	1.2972	1.3000	1.3300	1.3500	1.4000	1.4500
USD-CHF	0.9618	0.9760	0.9714	0.9800	0.9700	0.9700	0.9700	0.9700
USD-CAD	1.3004	1.2924	1.3127	1.3000	1.3000	1.3200	1.3400	1.3500
NZD-USD	0.6909	0.7134	0.7286	0.7000	0.7000	0.6900	0.7000	0.7100
USD-CNY	6.4536	6.6480	6.6718	6.6000	6.6000	6.6000	6.5500	6.5000
USD-SGD	1.3484	1.3472	1.3631	1.3500	1.3500	1.3400	1.3200	1.3000
AUD Exchange Rates:								
AUD-USD	0.7657	0.7451	0.7664	0.7400	0.7300	0.7200	0.7400	0.7600
AUD-EUR	0.6730	0.6710	0.6820	0.6610	0.6460	0.6370	0.6550	0.6730
AUD-JPY	86.20	76.90	77.70	74.00	73.00	72.00	76.20	79.80
AUD-GBP	0.5330	0.5600	0.5910	0.5690	0.5490	0.5330	0.5290	0.5240
AUD-CHF	0.7360	0.7270	0.7440	0.7250	0.7080	0.6980	0.7180	0.7370
AUD-CAD	0.9960	0.9630	1.0060	0.9620	0.9490	0.9500	0.9920	1.0260
AUD-NZD	1.1080	1.0440	1.0520	1.0570	1.0430	1.0430	1.0570	1.0700
AUD-SGD	1.0325	1.0038	1.0447	0.9990	0.9855	0.9648	0.9768	0.9880

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

	2014-15	2015-16 (f)	2016-17 (f)	2015	2016 (f)	2017 (f)
GDP, %	2.3	2.9	2.9	2.4	3.1	2.7
CPI (Headline), %	1.7	1.4	1.5	1.5	1.1	2.0
CPI (Underlying), %	2.3	1.8	1.6	2.2	1.5	1.8

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