Global Economic and Markets Outlook

Commonwealth Bank of Australia

As at 9 November 2018

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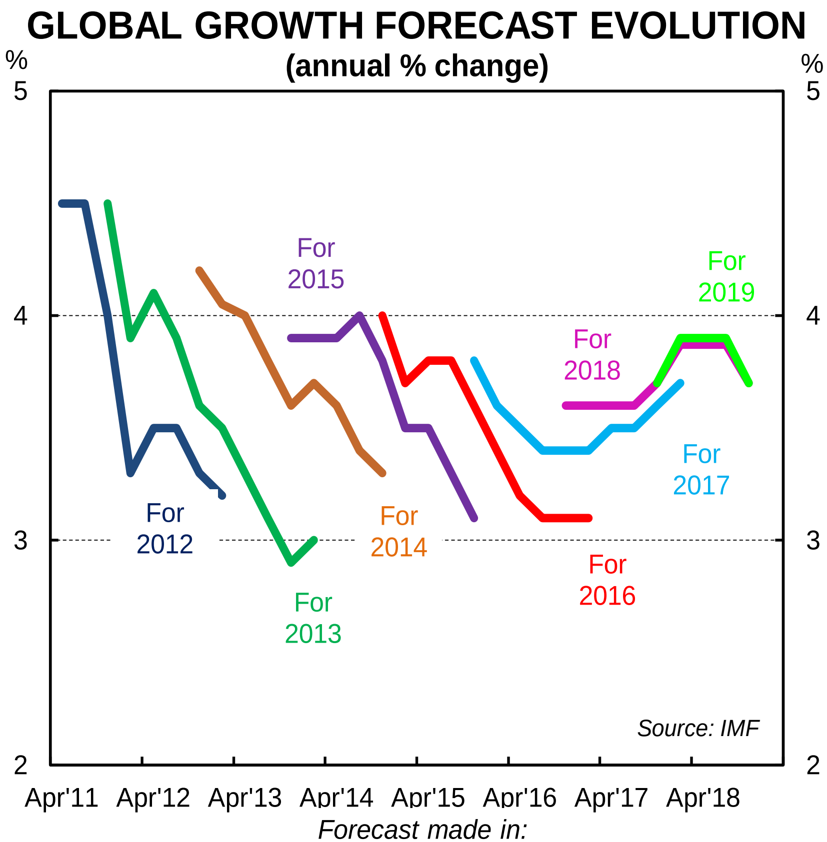
Global

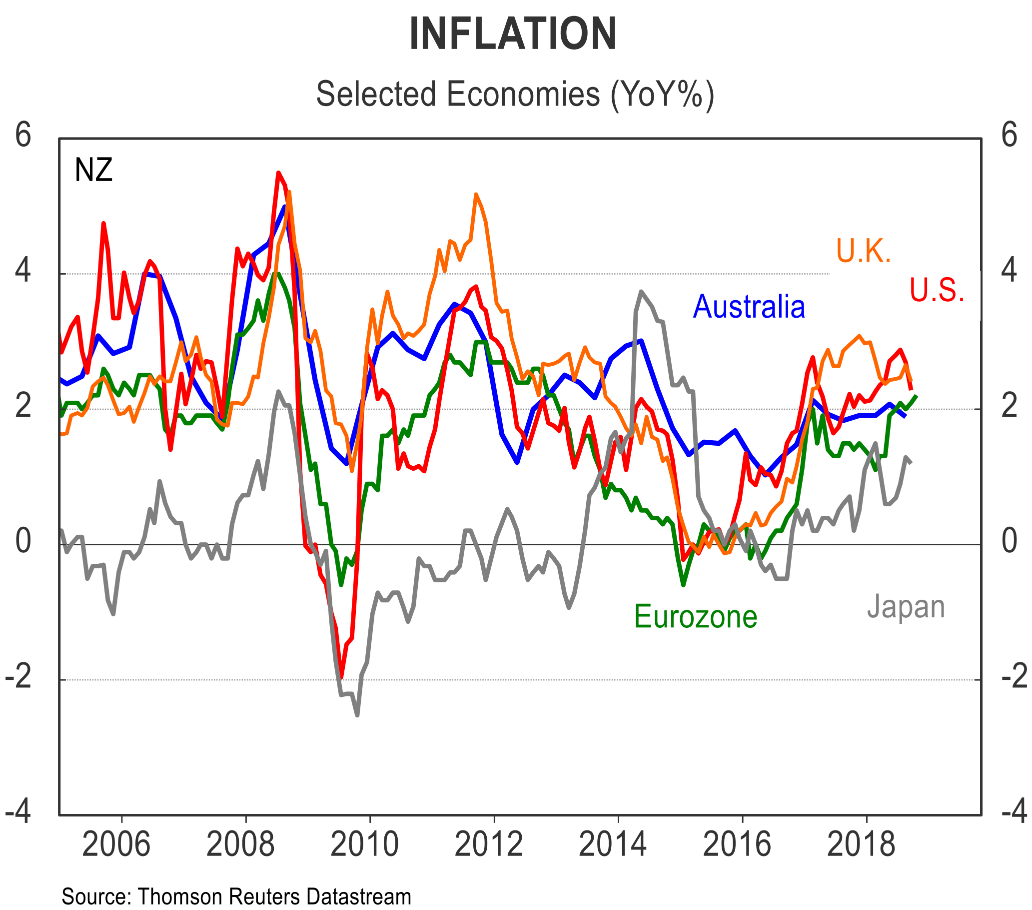
Global Backdrop – Solid (but slower) growth

Global growth continues – but acceleration phase is over…



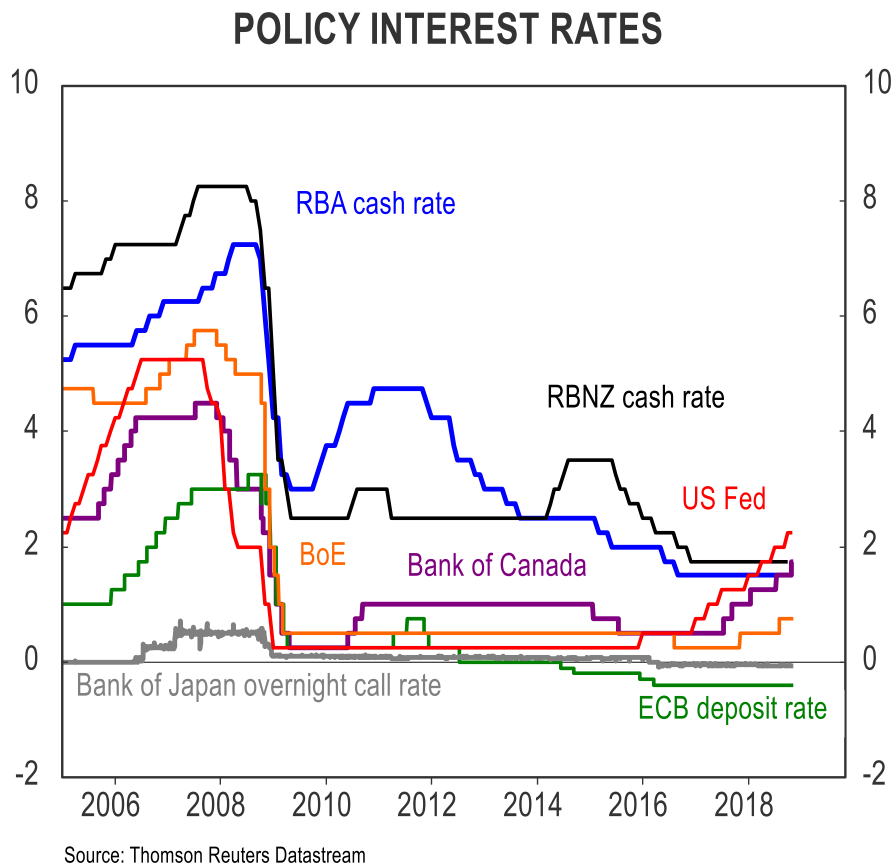
- A synchronised global upturn characterised 2017 and H1 2018.
- But growth can't accelerate forever.
- Rising trade tensions mean global risks have starting to tilt down again.
- The IMF have nudged down their global growth forecasts for the first time since 2016.
- The IMF has global growth running at 3.7%/yr over 2018-20 (or just above the post-financial crisis average).
- Higher US interest rates, higher oil prices and tighter financial conditions were the other main reasons for the downgrade.

Global Backdrop - Inflation Moving Up



- **Headline inflation rates in the advanced economies (excluding Japan) are around the central bank targets.**
- **This has added to financial market volatility as central bank policy expectations have been reassessed.**
- **Underlying inflation rates remain relatively subdued – so interest rates can rise only gradually.**

Global Backdrop - Official Rates Rising



- Solid economic growth and an upward trend in inflation is one where ultra-easy monetary policy settings are no longer required.
- Nevertheless, policy makers are moving cautiously, outside the US.
- Policy interest rates expected to remain low by historical standards.
- US Fed expected to continue to lift rates in 2018 and 2019.
- BoE and BoC already lifted rates this year. A little more to come.
- ECB, RBNZ and RBA expected to be on hold for longer before rates eventually move higher.
- BoJ will be the exception and hold rates at historic lows.

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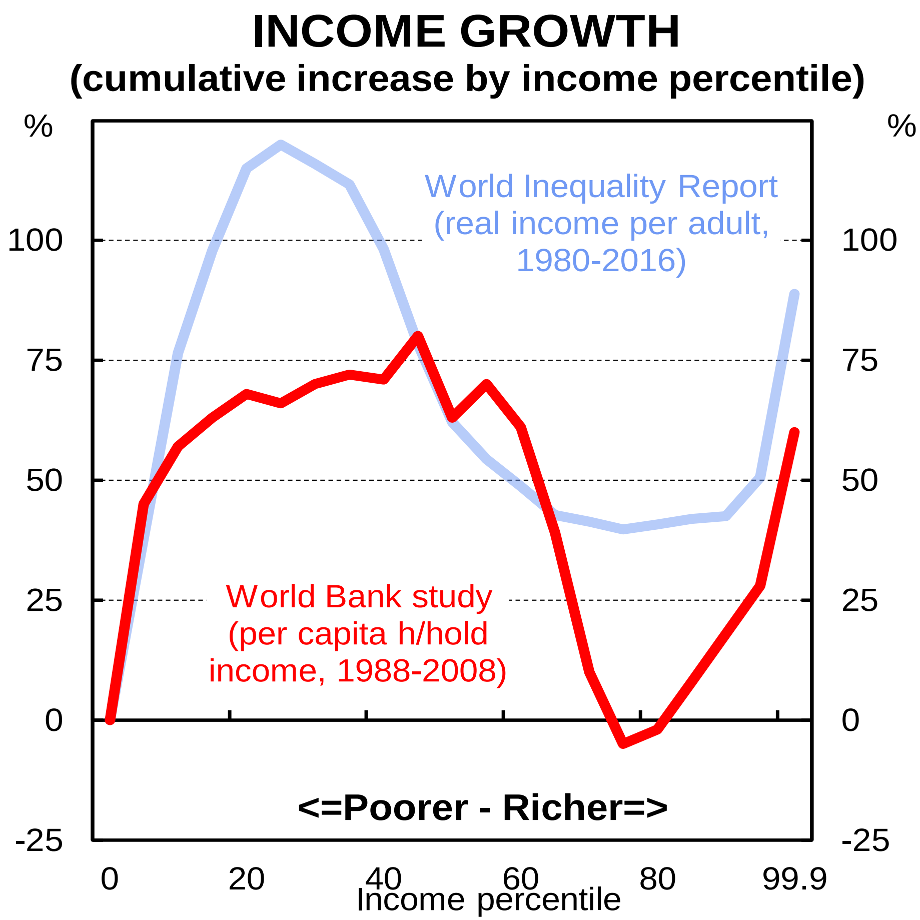
Global Risks & Opportunities – Income inequality



- **A strong vein of global disillusionment is influencing economic trajectories and political outcomes - driving financial markets.**
- **There is a need for the benefits of economic reform to carry everyone forward. The "elephant curve" suggests some are missing out:**
  - developed by the World Bank, and an updated by the World Inequality Report;
  - Ranks the world's population from poorest to richest;
  - Shows income growth from 1988-2008 and also 1980-2016.
- **A significant group in the 70-90th percentile (advanced economy middle income earners) went nowhere.**
- **One result has been the rise of populist politics.**

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Global Risks & Opportunities – China evolution

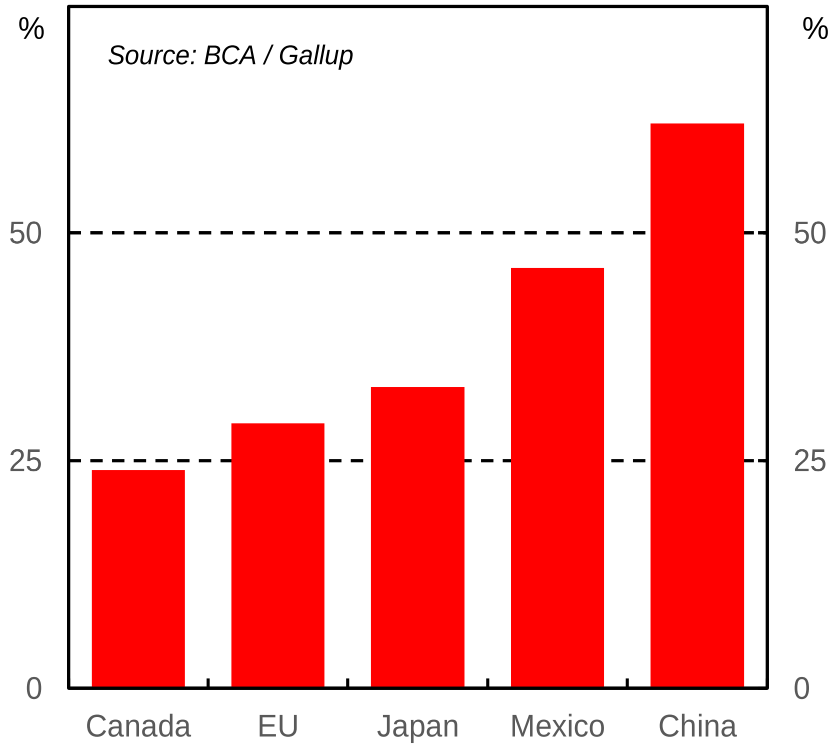
Belt & Road – a new "China"?

- **China's 'Belt and Road' initiative could be an upside source of growth for the global economy.**
- **But another China-type commodity supercycle seems unlikely.**

Global Risks & Opportunities – Trade ‘war’

A political solution?

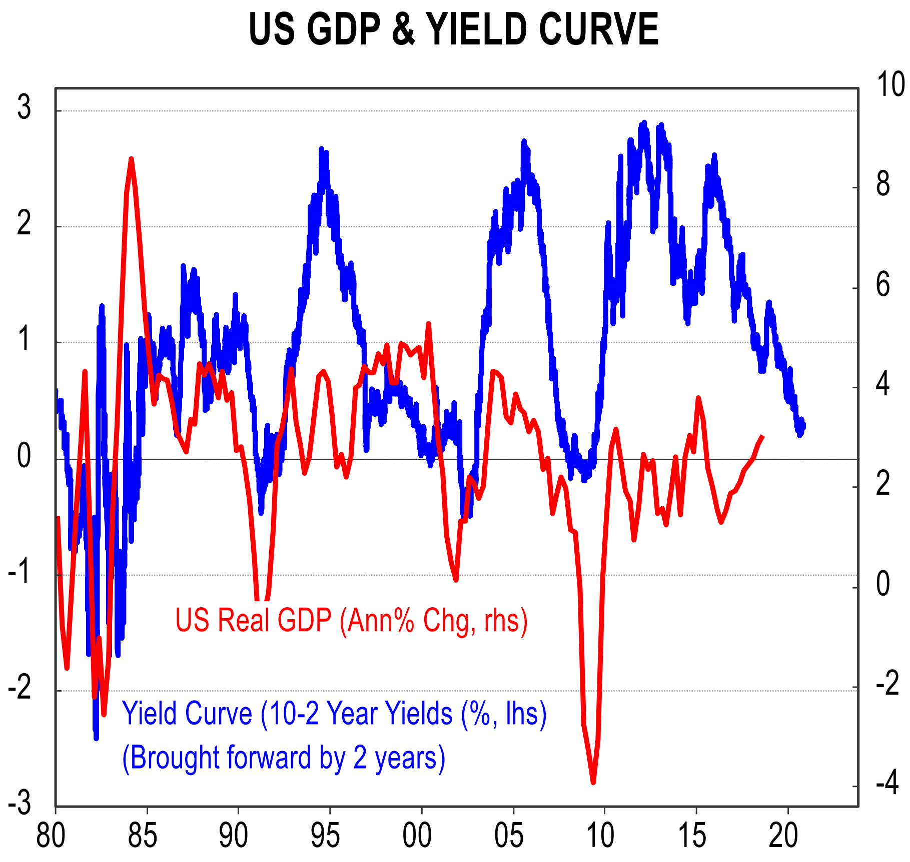
TRADING RELATIONSHIP PERCEPTIONS
(% of Americans seeing relationship as unfair)



- The political dynamics behind the trade ‘war’ and the relatively small changes in the USMCA (NAFTA 2.0) offered hope that a compromise can be reached with China as well.
- But US perceptions about the trading relationship with China are much more negative than other countries the US has negotiated with.
- Risk is that the US-China dispute is harder to resolve.
- The direct impact of curtailing US and Chinese exports looks small relative to economic size.
- The bigger hit is to those involved in global value chains with China and the US.

Global Risks & Opportunities – A flatter yield curve

A flattening yield curve could signal a US recession



Source: Thomson Reuters Datastream

- The US 10yr-2yr yield curve has been flattening over the past two years and longer-term since late 2013.
- History shows the yield curve has been a reasonable predictor of past US recessions.
- There could be a difference this time due to the term premium component remaining at very low levels.
- This could reduce the information content from the flatness of the yield curve.
- But the flattening yield curve could be sending a warning signal of US recession around 2020-2021.

Global Risks & Opportunities – US Budget deficit

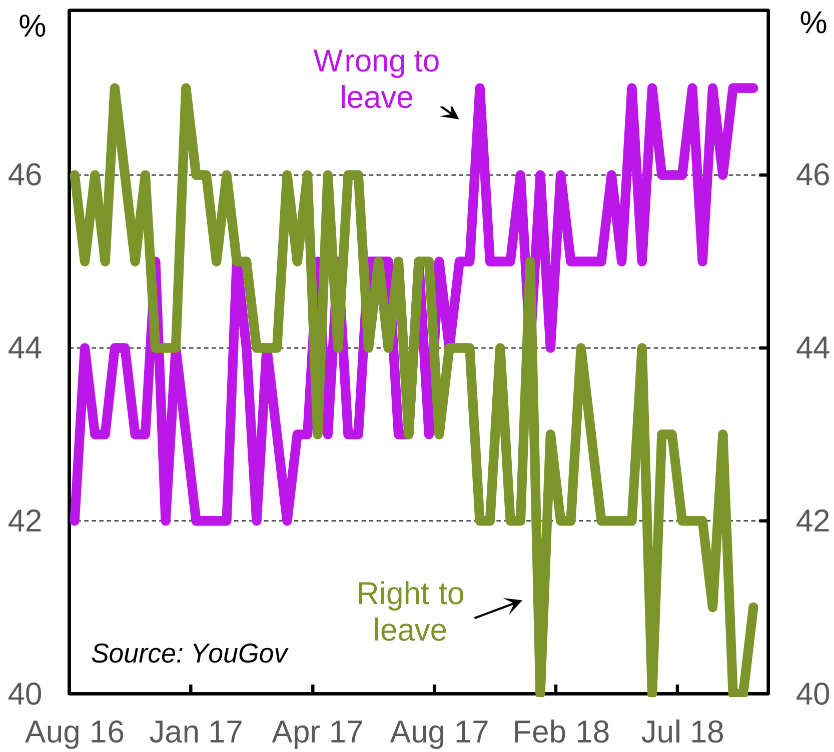
Rising US Budget Deficit

- Significant US fiscal policy stimulus has boosted the US economy.
- The tax cuts are worth about 0.6% of GDP in 2018 and 1.0% in 2019.
- There are some spending increases as well.
- But, the US Budget deficit is rising even in the context of a strong economy.
- This will add upward pressure to US bond yields.
- Concerns remain around the size of the Budget deficit, especially once the US economy slows.
- Could hit 5% of GDP or even higher!
- Who will pay for this?

Global Risks & Opportunities – Brexit

Brexit

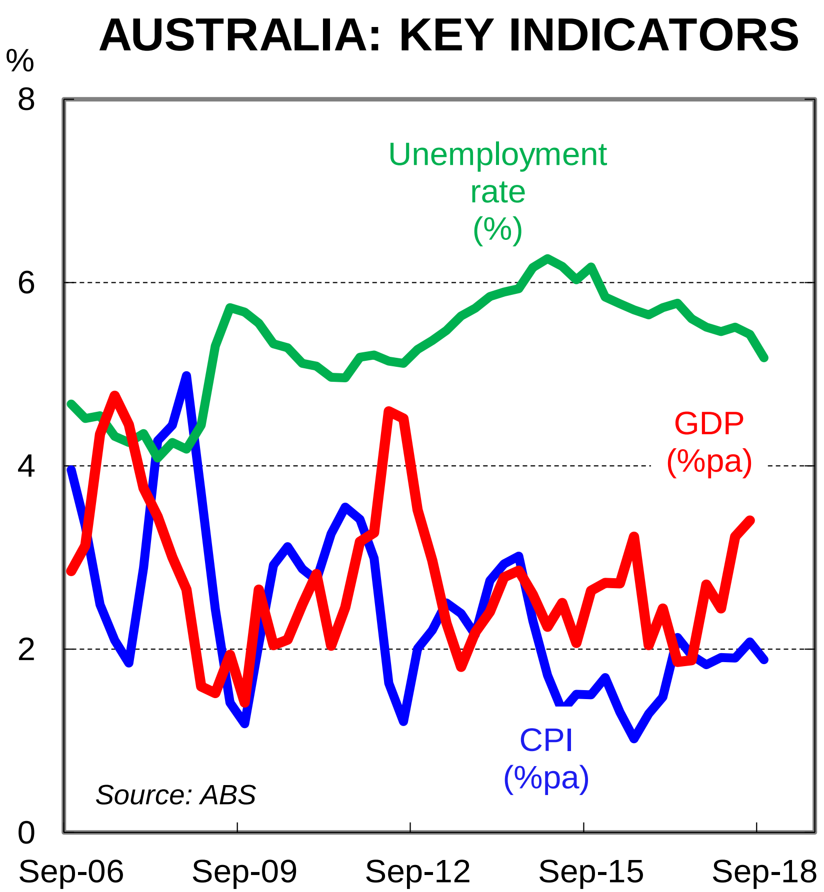
UK: RIGHT OR WRONG TO LEAVE EU?
(% of total)



- **A degree of "Bremorse" has set in.**
- **Chances of a hard exit have lifted.**
- **The longer negotiations take the more the downside becomes apparent and the greater the chance of "Bremain".**

Australia

Australia In Perspective



- **The economic expansion is in its 28th year – the last recession was in 1990/91.**
- **Unemployment is (slowly) trending down.**
- **Inflation rates are low near 2%/yr.**
- **Public finances and the financial system remain in respectable shape:**
  - the AAA credit rating remains;
  - the financial system is well capitalised and managing the risks.
- **Policy makers retain some firepower:**
  - policy interest rates are well above zero;
  - the OECD estimates that Australia has considerable "fiscal space".
- **The generational benefits of the resources boom and the Asian emergence continue.**

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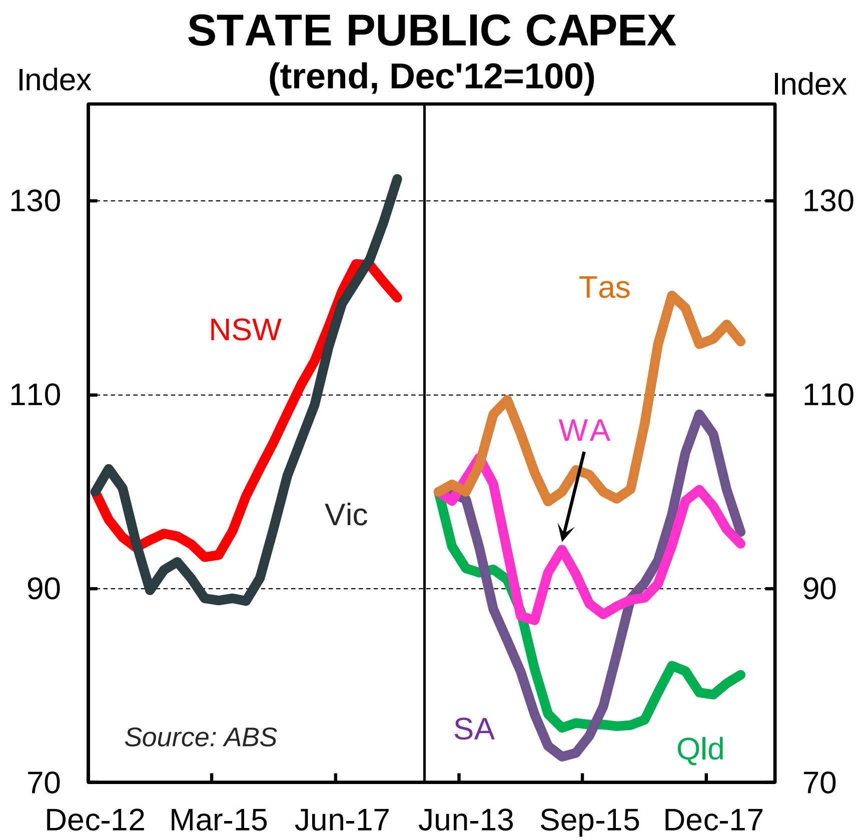
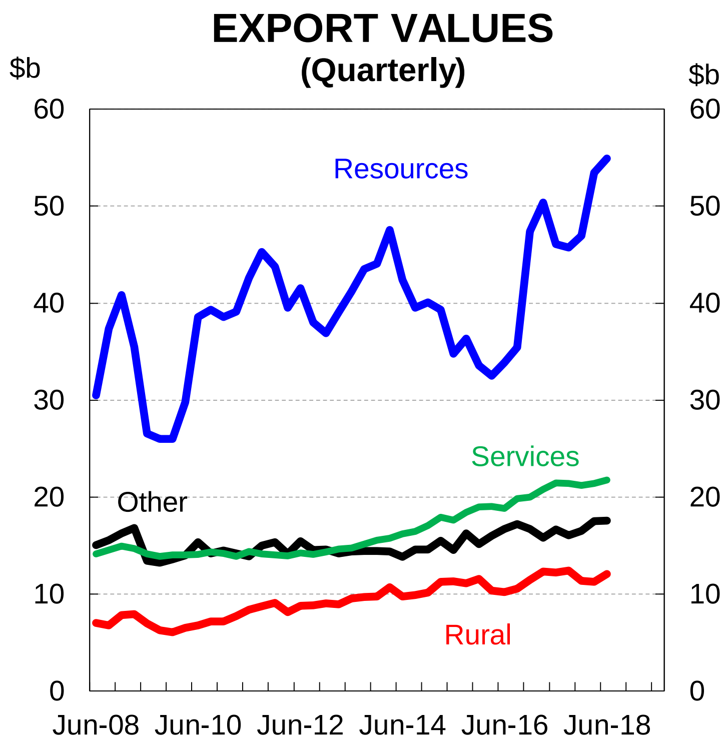
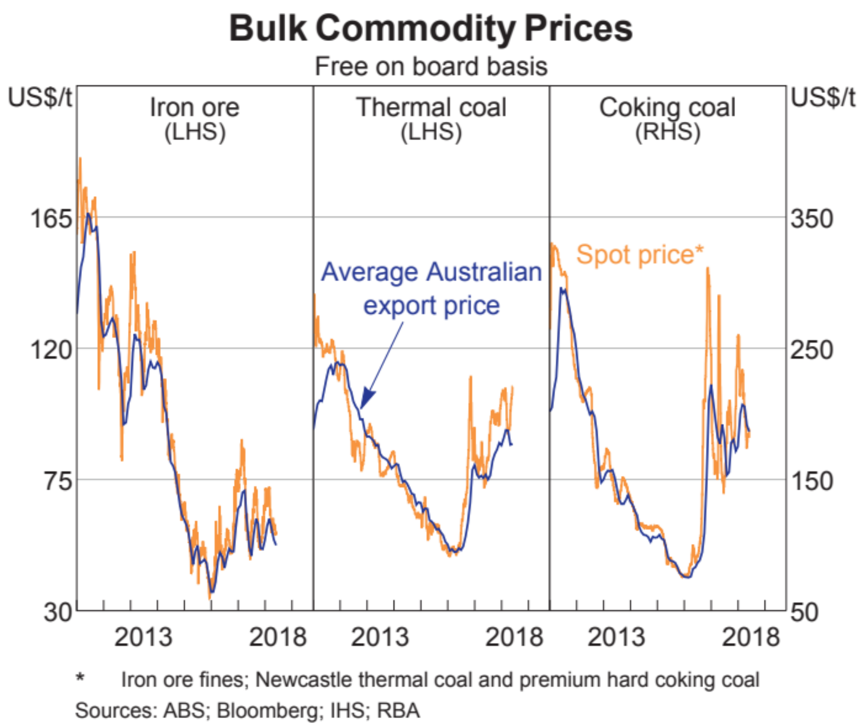
Infrastructure spending supporting growth



- The States are responsible for most infrastructure spending.
- After a long period of disappointing outcomes, spending is now growing strongly.
- Ramping up infrastructure spending is also now a major Commonwealth fiscal theme.
- Moving beyond transport infrastructure to include social infrastructure projects.
- Asset recycling programs can prolong the cycle.

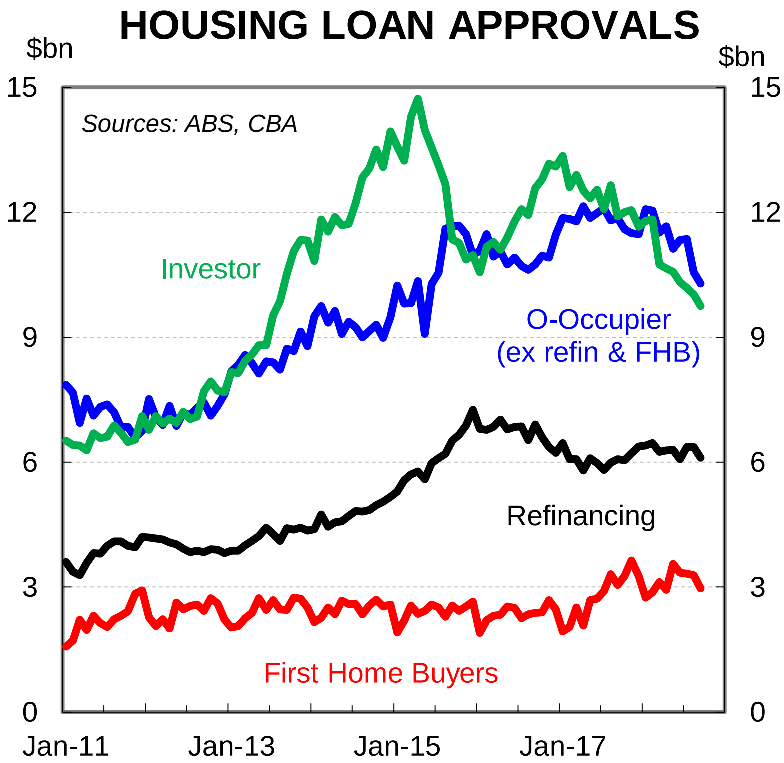
Export sector performing strongly

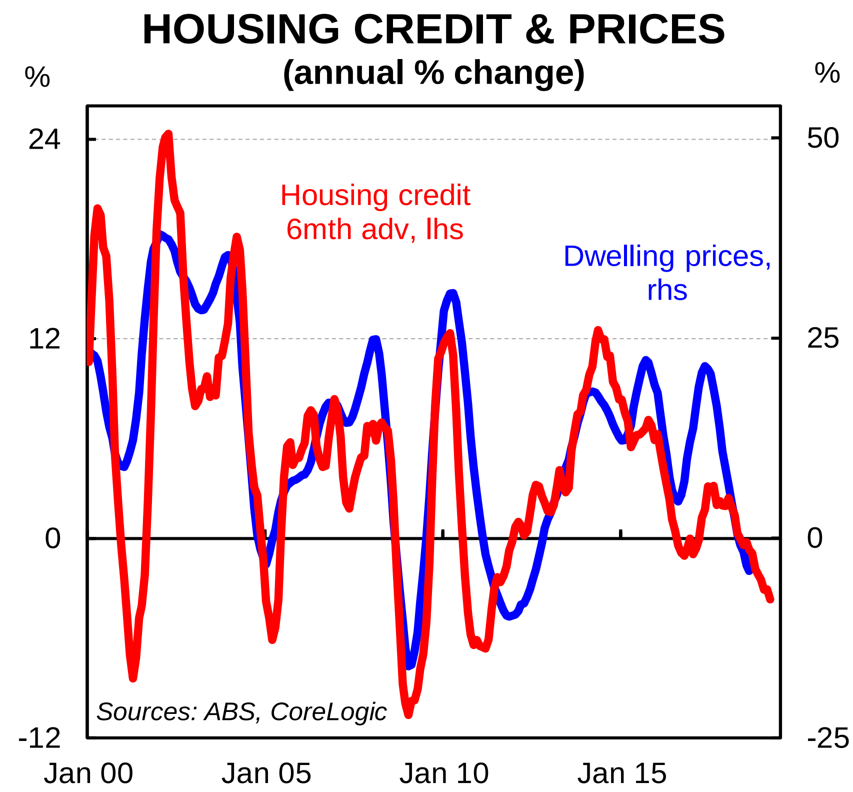




- **Resource export volumes continue to rise on the back of a surge of production. LNG coming on stream through 2018. Will take over from metallurgical coal as the second largest export (behind iron ore).**
- **Services exports are also rising sharply, driven by Tourism and Education.**
- **Net exports should provide a positive contribution to growth in the years ahead.**

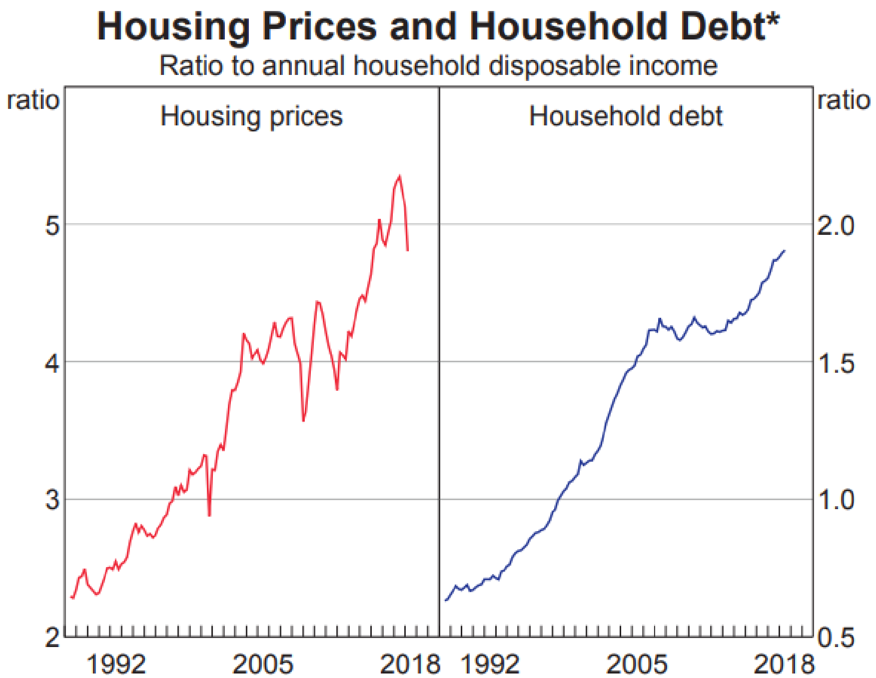
Housing market showing the strains





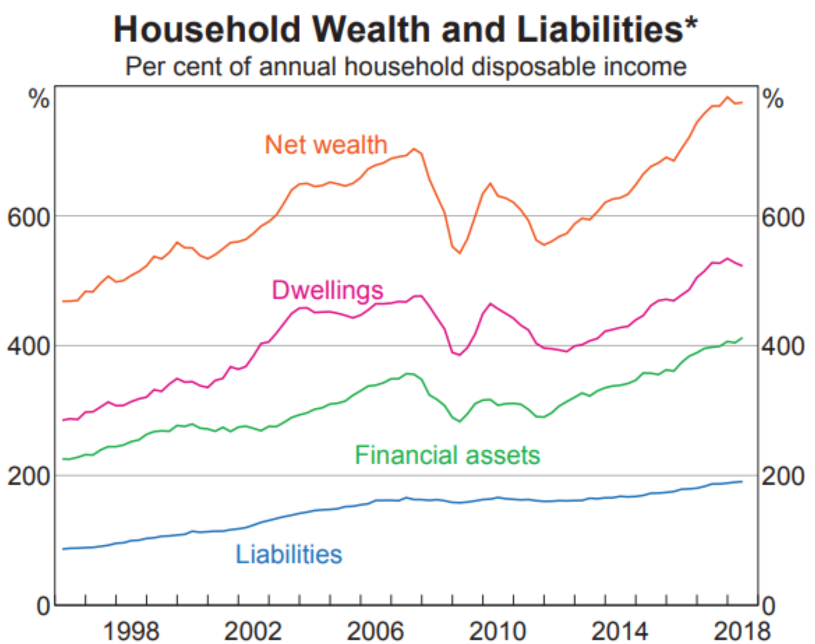
- The flow of credit to the housing market has slowed.
- This has fed through to decline in house prices, especially at the upper end of the market in Sydney and Melbourne.
- Population growth means we still need more houses/apartment built.

Household debt is high as wealth effect moderates



* Household disposable income is after tax, before the deduction of interest payments, and includes income of unincorporated enterprises

Sources: ABS; APM; APRA; CoreLogic; RBA

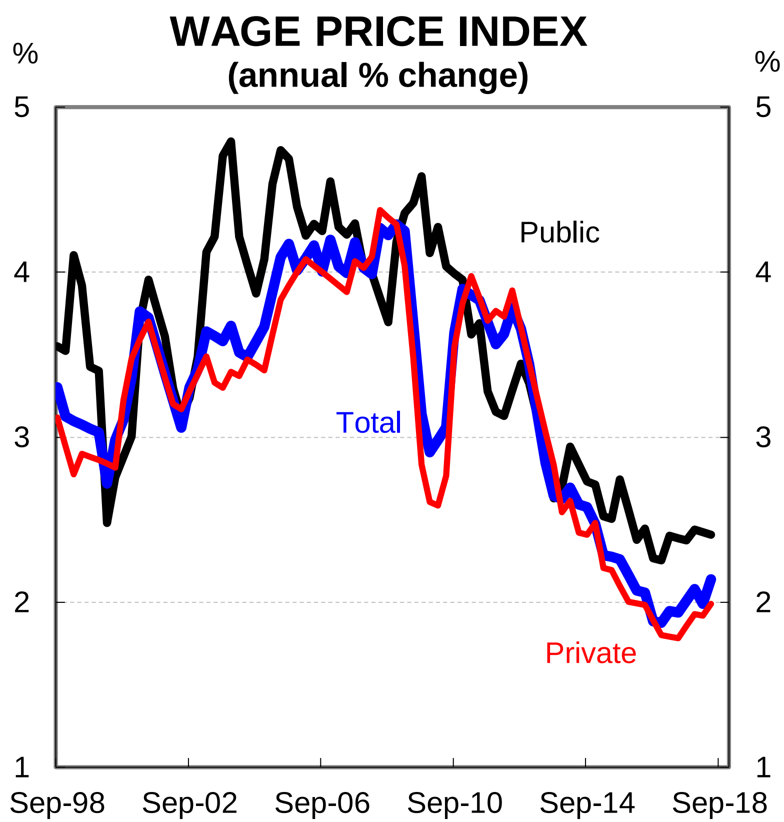


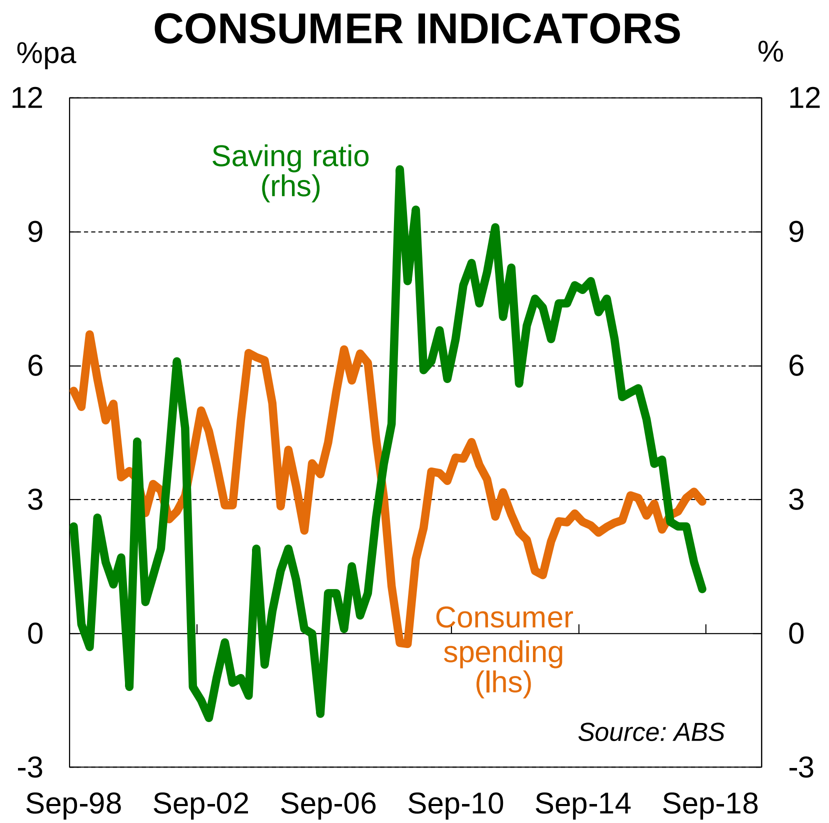
* Household disposable income is after tax, before the deduction of interest payments, and includes income of unincorporated enterprises

Sources: ABS; RBA

- **Australian household debt is high by historical standards and very high by global standards.**
- **This could limit the households ability to spend.**
- **Household wealth remains high – but is no longer rising.**

Wages and spending

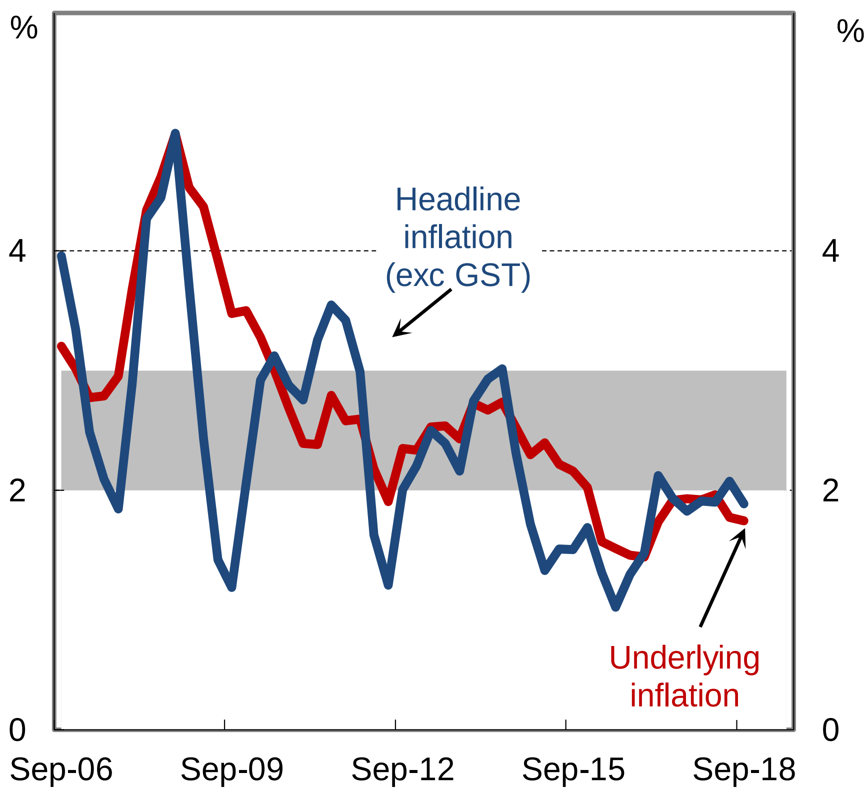




- **Annual wages growth at 2.1%/yr, just off record low of 1.9% but slowly trending higher.**
- **The household savings rate has also fallen as households try to maintain consumption with little income growth.**
- **An increase in real wages growth will be critical for the consumer sector.**

Inflation and Monetary policy

CONSUMER PRICES
(annual % change)



- ***Headline*** **inflation printed at 1.9%/yr in Q3 18.**
- **This puts the inflation rate just below the RBA's 2%-3% target.**
- ***Underlying*** **inflation is also seemingly stuck below the 2%/yr lower target band.**
- **Governor Lowe notes "it is likely that the next move in interest rates will be up" but any change "is some time away".**
- **CBA House view:**
  - First rate rise pencilled in for November 2019;
  - Expect any tightening cycle will be cautious, drawn out and peaking at just 2.5%

Summary

Global

- Backdrop to remain favourable although risks from trade tensions are rising.
- Watch; Brexit, US divided Congress and US-China trade and China economy.

Australia

- Economic growth to be reasonable – around 3% over 2018/19.
- Unemployment rate to grind a little lower at approx. 4.75%-5%.
- Income and wages growth to be constrained due to spare capacity in the labour market.
- Interest rates to stay low – cash rate on hold at 1.5% till Q4 2019 at the earliest.
- Dwelling prices to continue to correct lower in Sydney and Melbourne, but a hard landing is unlikely.
- AUD to drift lower in near-term on stronger USD and interest rate differentials, but better supported medium-term on lower Current Account deficit.
- Equity markets supported by good economic growth globally and locally, but risks are building.

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The Bank is a swap dealer provisionally registered with the US Commodity Futures Trading Commission and is a member of the National Futures Association in such capacity (NFA ID 0249150). In the United States, swaps, and products and strategies involving swaps are not suitable for investment by counterparties that are not "eligible contract participants"(as defined in the US Commodity Exchange Act ("CEA")) and the regulations adopted thereunder; or (ii) entities that have any investors who are not "eligible contract participants." Each hedge fund or other investment vehicle that purchases the products must be operated by a registered commodity pool operator as defined under the CEA and the regulations adopted thereunder or a person who has qualified as being exempt from such registration requirement.