Global Economic and Markets Outlook

As at 18 March 2019

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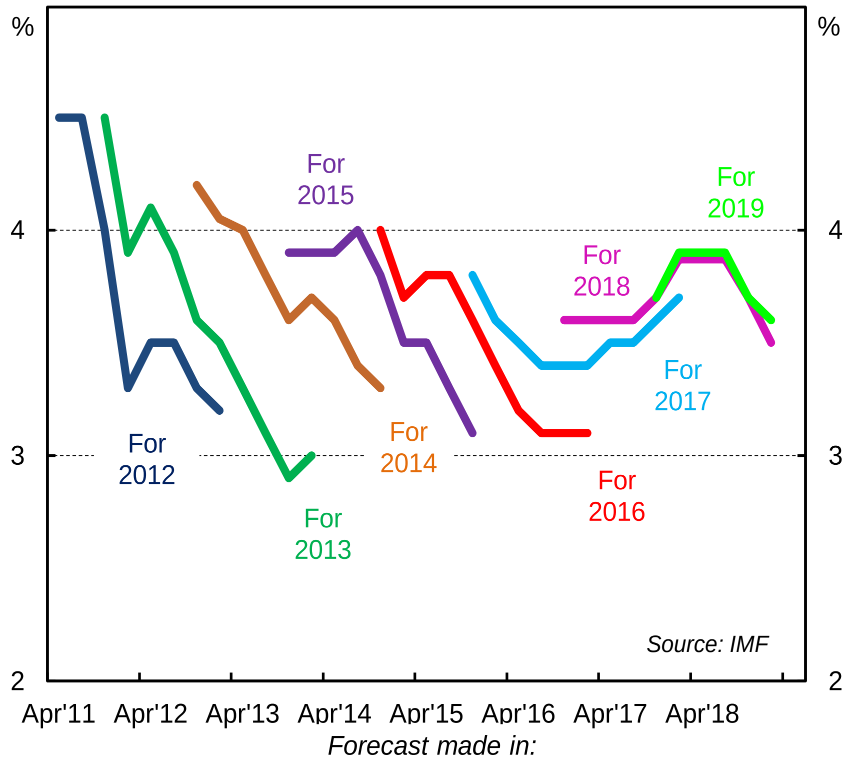
Global

A Less Helpful Global Backdrop

Global growth continues – but acceleration phase is over…

GLOBAL GROWTH FORECAST EVOLUTION
(annual % change)



- **A synchronised global upturn characterised 2016-17.**
- **But growth can't accelerate forever – growth became more uneven in 2018 and desynchronization to continue in 2019-20.**
- **Rising trade tensions and the potential for a US policy "mistake" mean global risks tilting down again.**
- **The IMF nudged down their global growth forecasts in October 2018 (for the first time since 2016) and again in January 2019.**
- **The IMF has global growth running at 3.5% in 2019 and 3.6% in 2020 (around the post-financial crisis average).**

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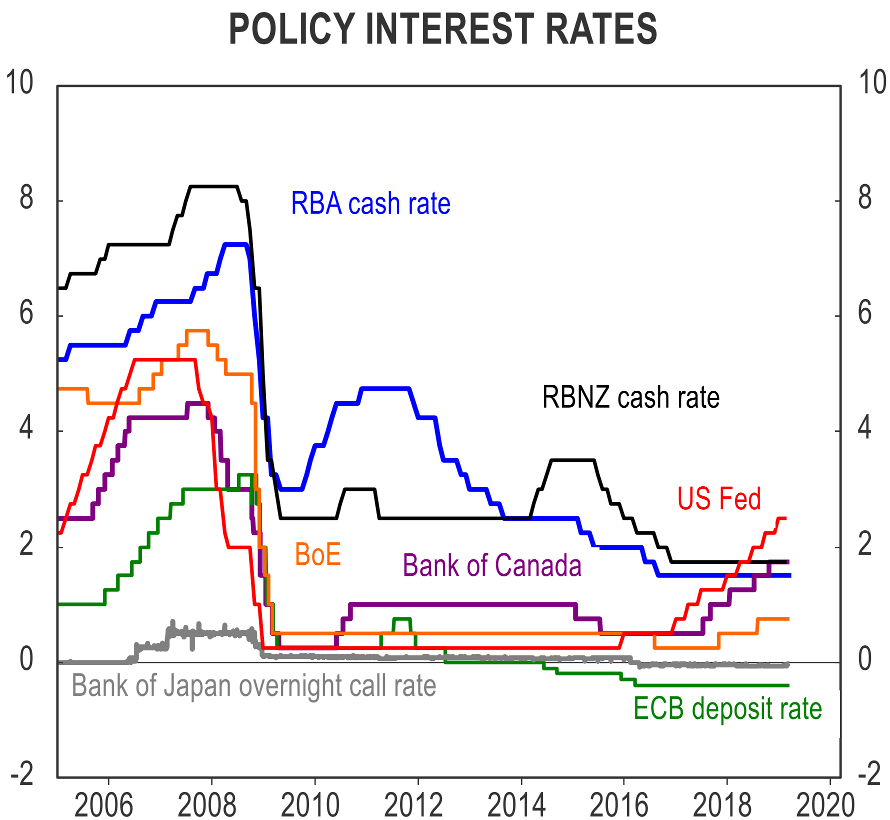
A Less Helpful Global Backdrop; rates to remain on hold



Source: Thomson Reuters Datastream

- **Slower global growth, downside risks from political uncertainty and contained inflation should see a year of little action from central banks.**
- **US Fed appears to have finished its tightening cycle.**
- **Other central banks, including ECB, RBNZ, BoE and RBA expected to be on hold for longer before rates eventually move higher.**
- **Policy interest rates expected to remain low by historical standards.**

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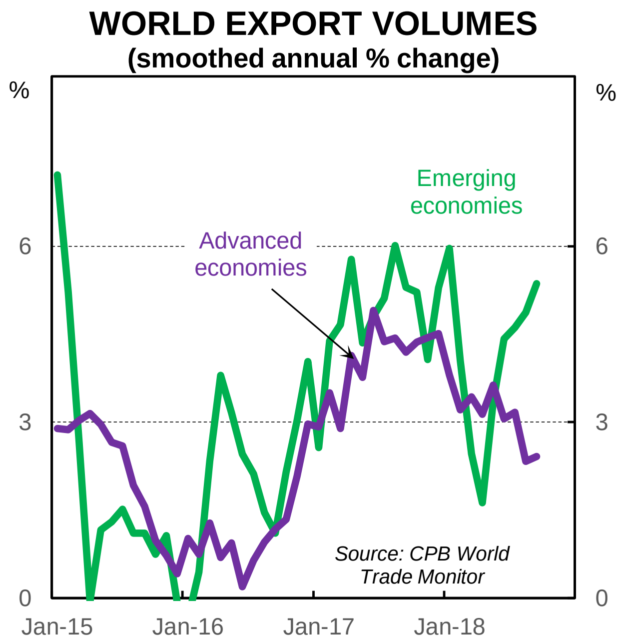
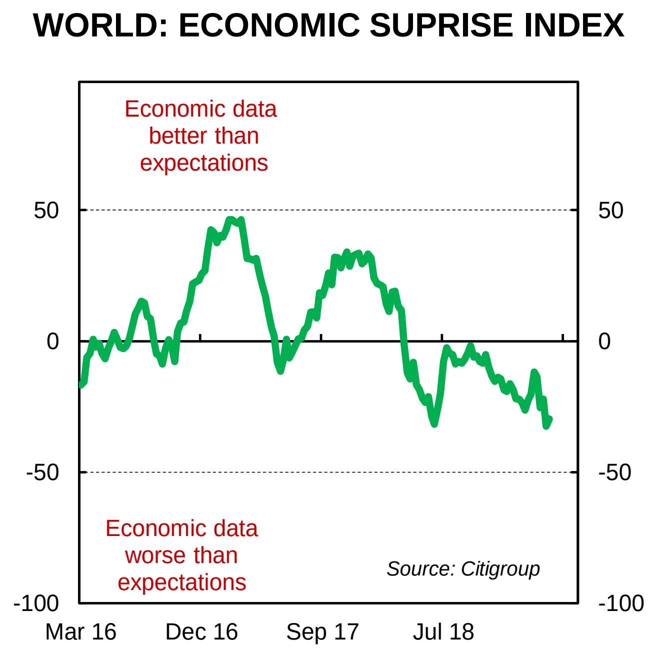
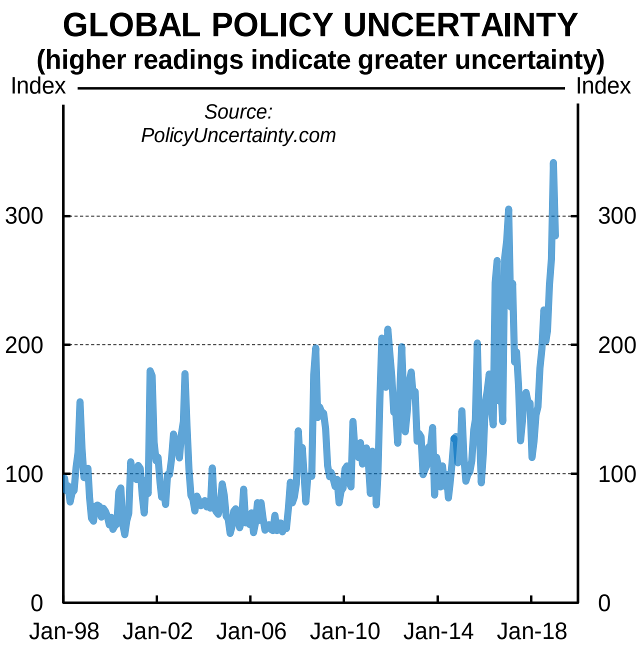
A Less Helpful Global Backdrop

Trade issues are part of the story but policy uncertainty has lifted

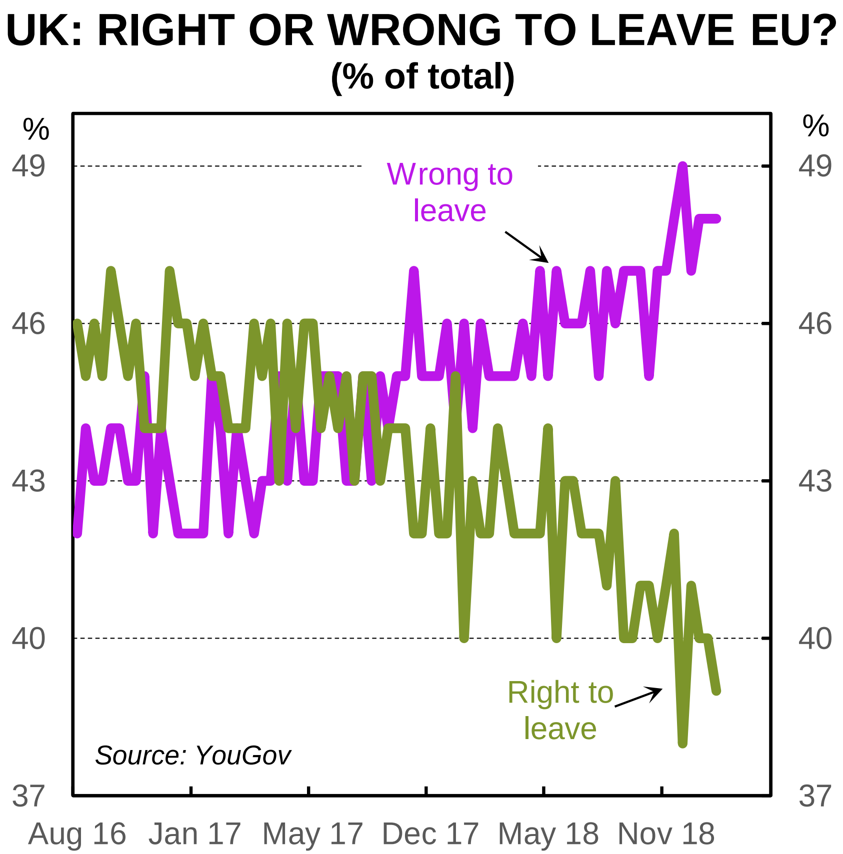






- Divergent trade patterns contribute to the AE and EM divergence.
- But global economic data has disappointed.
- And global policy uncertainty has lifted.

UK: Brexit still dominating



- UK economy has suffered through the Brexit process. This remains unresolved with the deadline of March 29 fast approaching.
- Economic growth has suffered with both business investment and consumption softer on uncertainty. Rate hikes by the Bank of England are now well in the future (2021).
- GBP has been volatile on Brexit news.

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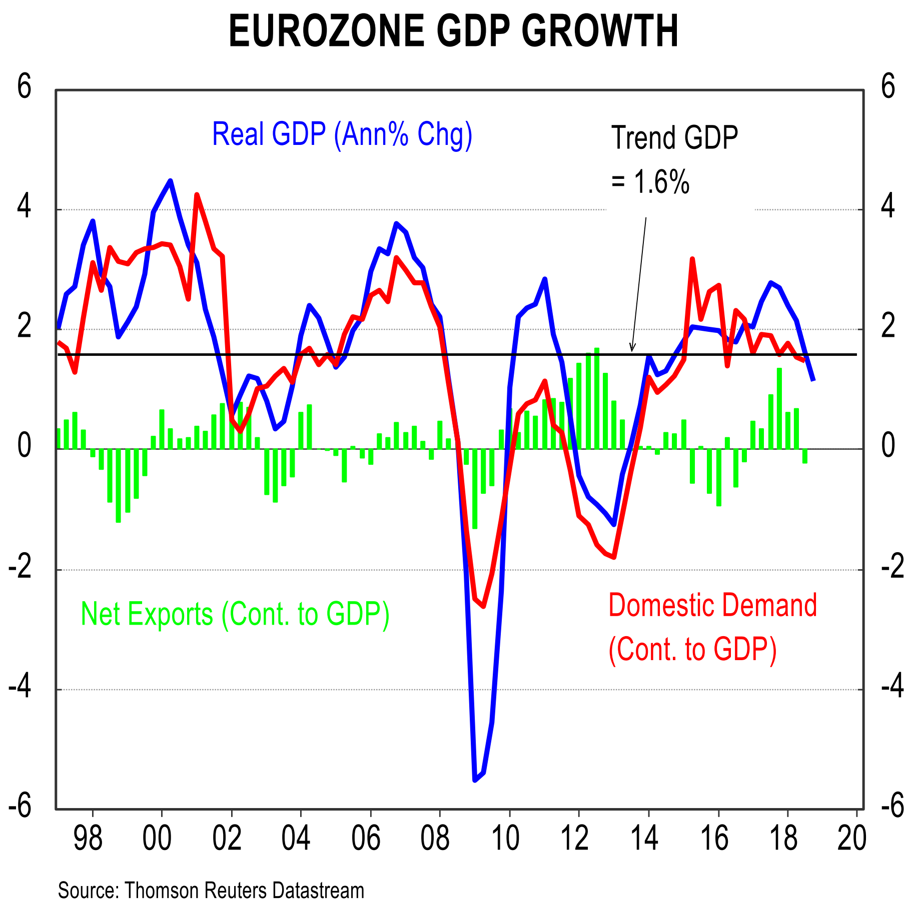
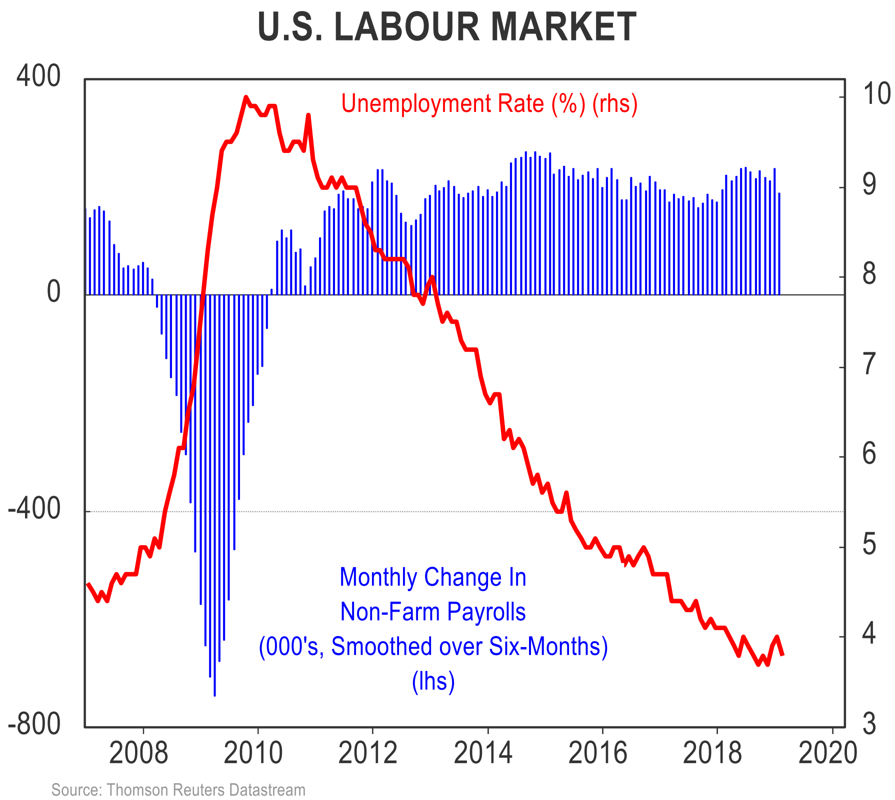
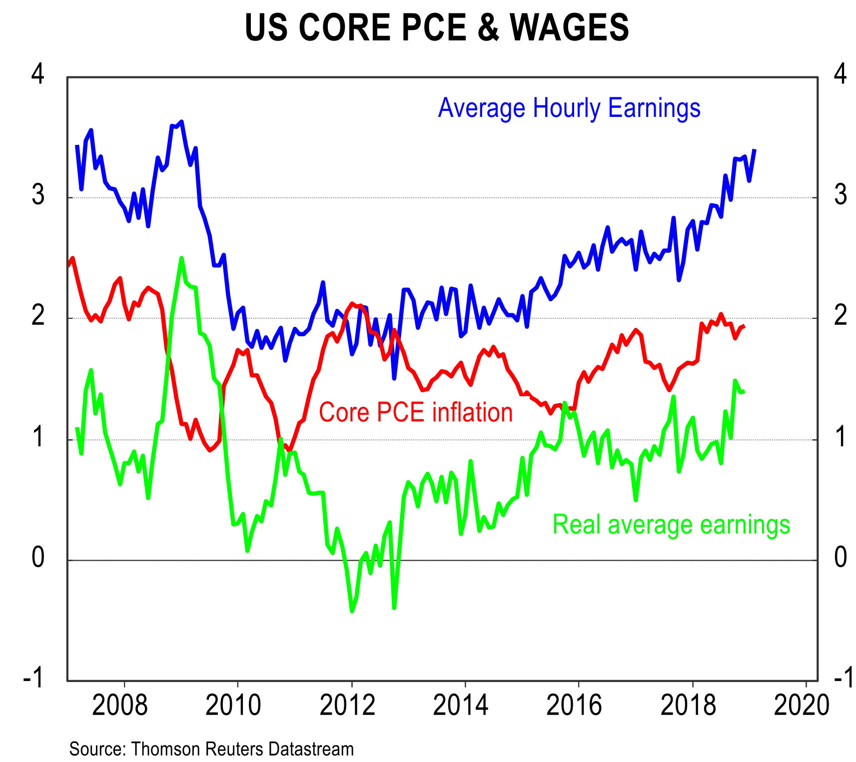
Europe: Better growth, easy monetary policy



- Economic growth in the Eurozone has back to below trend. Italy and Germany have slowed the most. New emissions regulations for cars have hurt the economy.
- European Central Bank have spoken about rising downside risks to growth, we now expect rate hikes to be delayed till late 2020.
- Bright spots for the EU economy include a move to pro-growth fiscal policy in Italy and Germany and improving wages.

US: Wages lifting

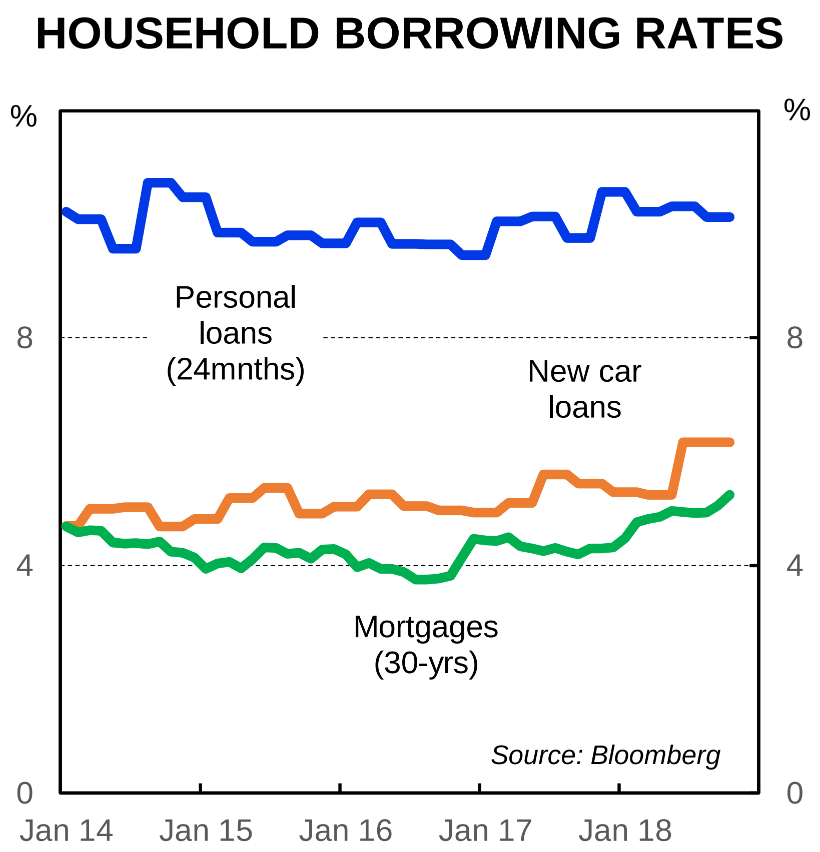


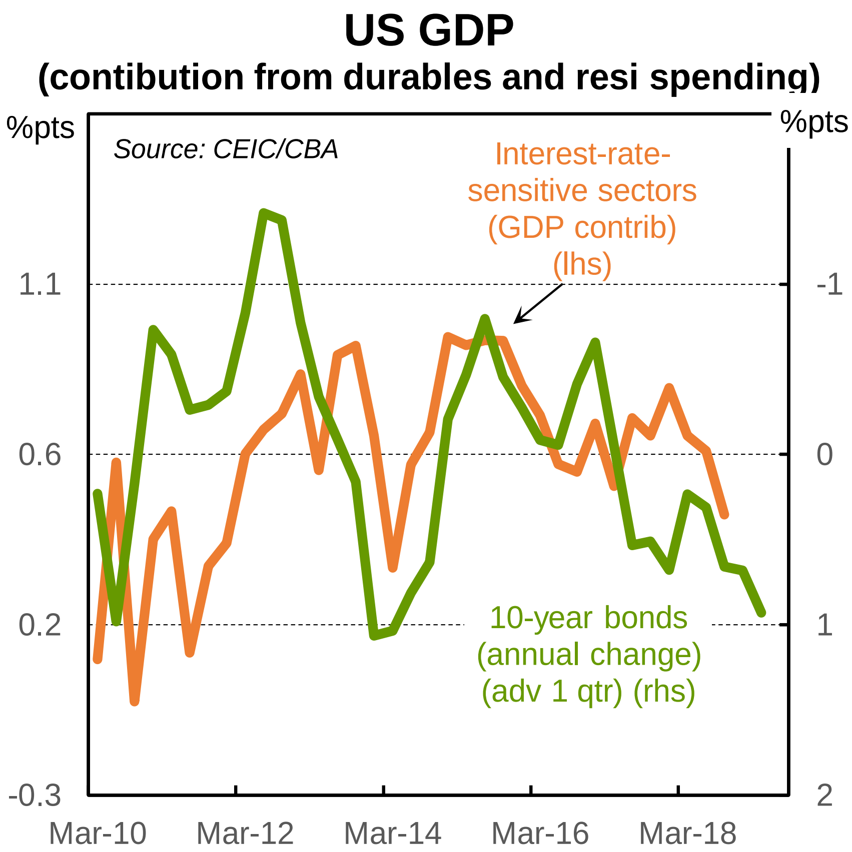


- **US core PCE inflation appears to have peaked despite faster wage growth.**
- **The unemployment rate has ticked up as well.**
- **Some of the interest rate sensitive parts of the US economy have slowed.**

US: Higher rates are biting

Sensitivities

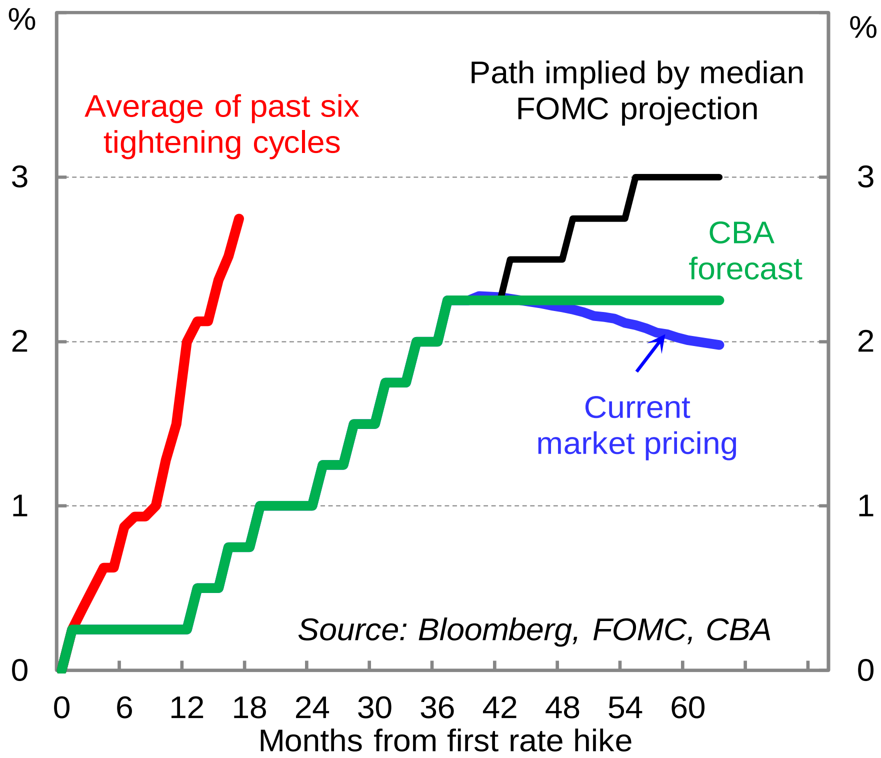




- Interest rates faced by households and businesses have lifted.
- There are downside risks to interest-rate-sensitive parts of the US economy, such as capex, consumer durables and residential investment.

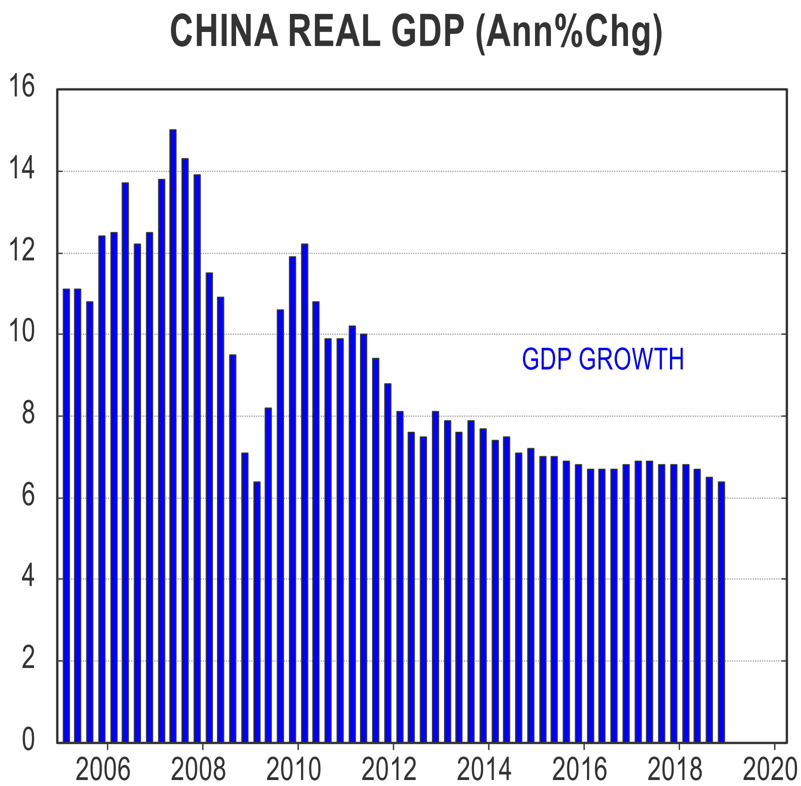
US: Federal Reserve

FED RATE HIKE CYCLES
(cumulative change in the Fed funds rate)

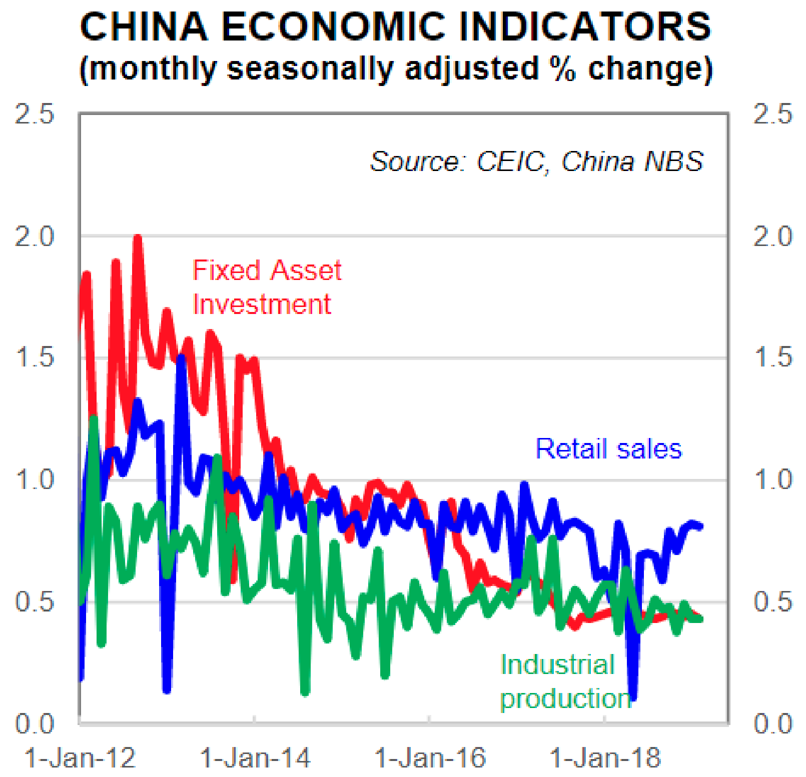


- **Fed hiked rates in December 2018**
- **In January 2019 the FOMC changed its guidance to remove the presumption that the next policy move would be a hike.**
- **Contained inflation, slower global growth and tighter US financial conditions.**
- **Restarting hikes will be a big decision.**
- **CBA view:**
  - We have removed the two rate hikes from our forecast.
  - Expect fed funds peaks at 2.50%.
  - Balance sheet to stop shrinking by end of 2019.

China: Economic slowdown



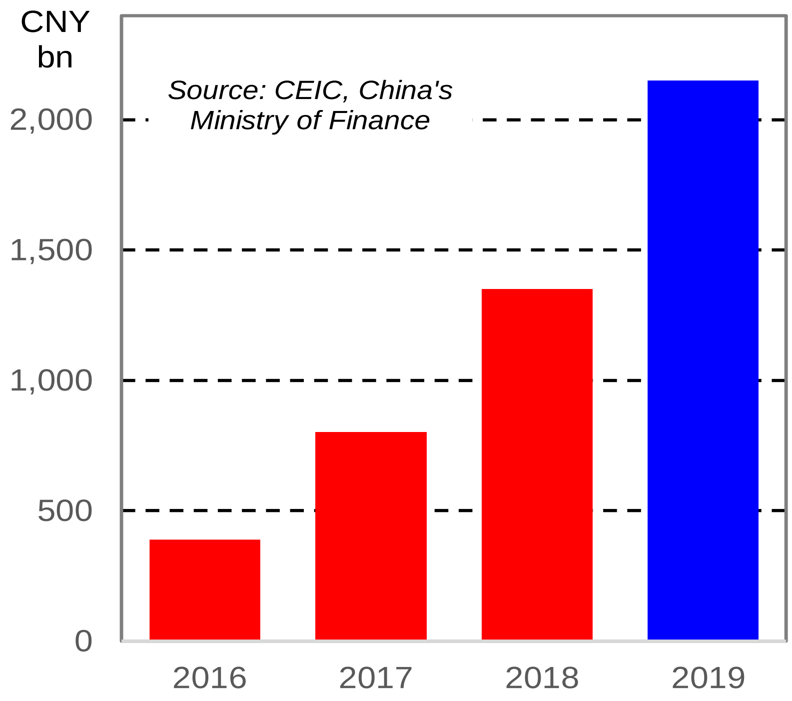
Source: Thomson Reuters Datastream



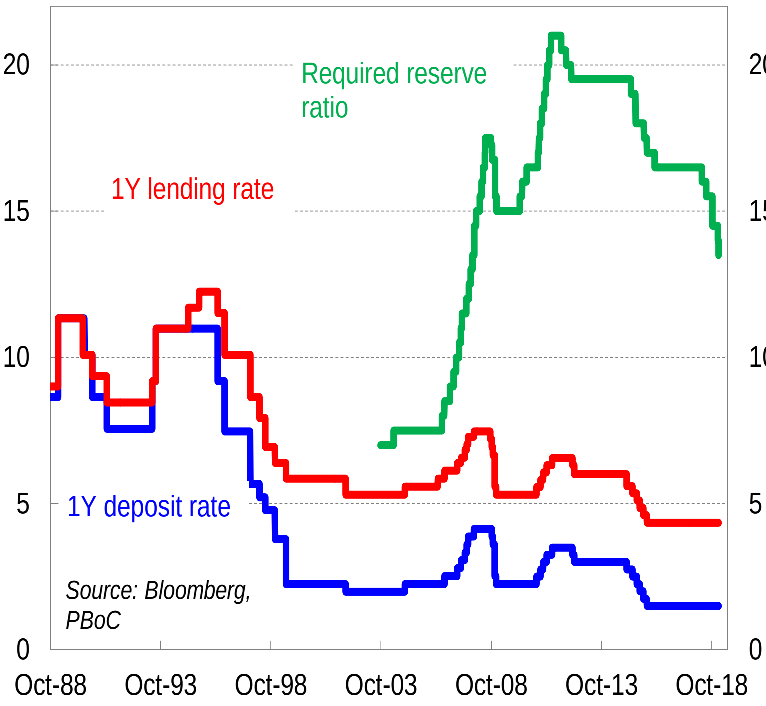
- **Chinese economic growth decelerated to 6.4%/yr in Q4 2018 and is on par with the previous slowest pace set in the 1990s.**
- **Chinese policy makers are increasing fiscal stimulus to address the downside risks to the economy. Fiscal stimulus will push up infrastructure investment and total fixed asset investment later this year.**
- **A gradual economic slowdown is expected, though a bumpy ride is possible.**
- **For 2019 maintaining growth stability is expected.**

China: More policy support

SPECIAL DEBT ISSUANCE
(by local government)

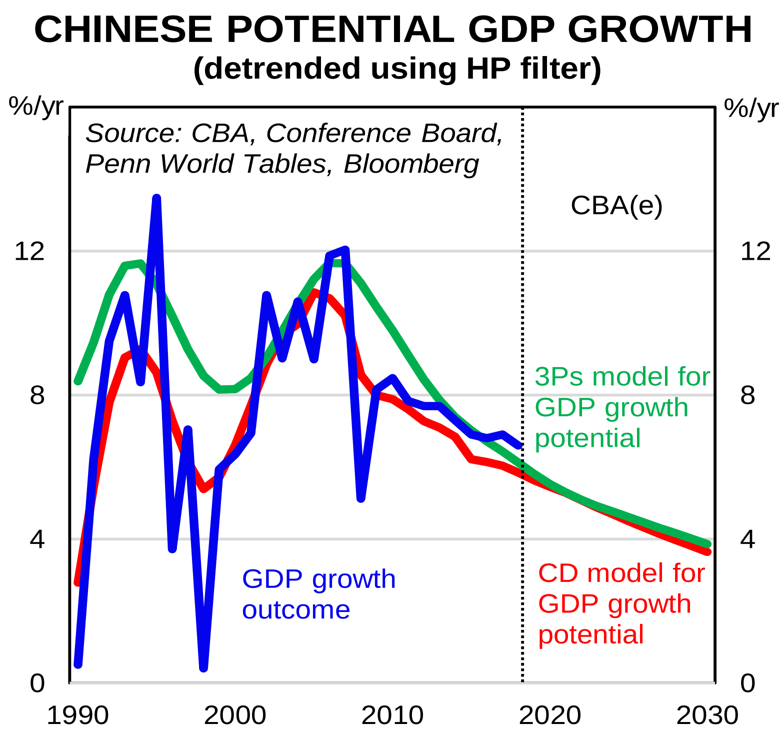


KEY MONETARY POLICY RATES
(% p.a.)



- **Policy makers are in a bind. They want to manage downside economic risks while continuing to transform China from an investment and credit driven economy to consumption and services based growth model.**
- **Modest fiscal stimulus is expected to support purchase of cars and household appliances.**
- **Further RRR cuts also expected and further improvement to the effectiveness of monetary policy.**

China: further slowdown is expected

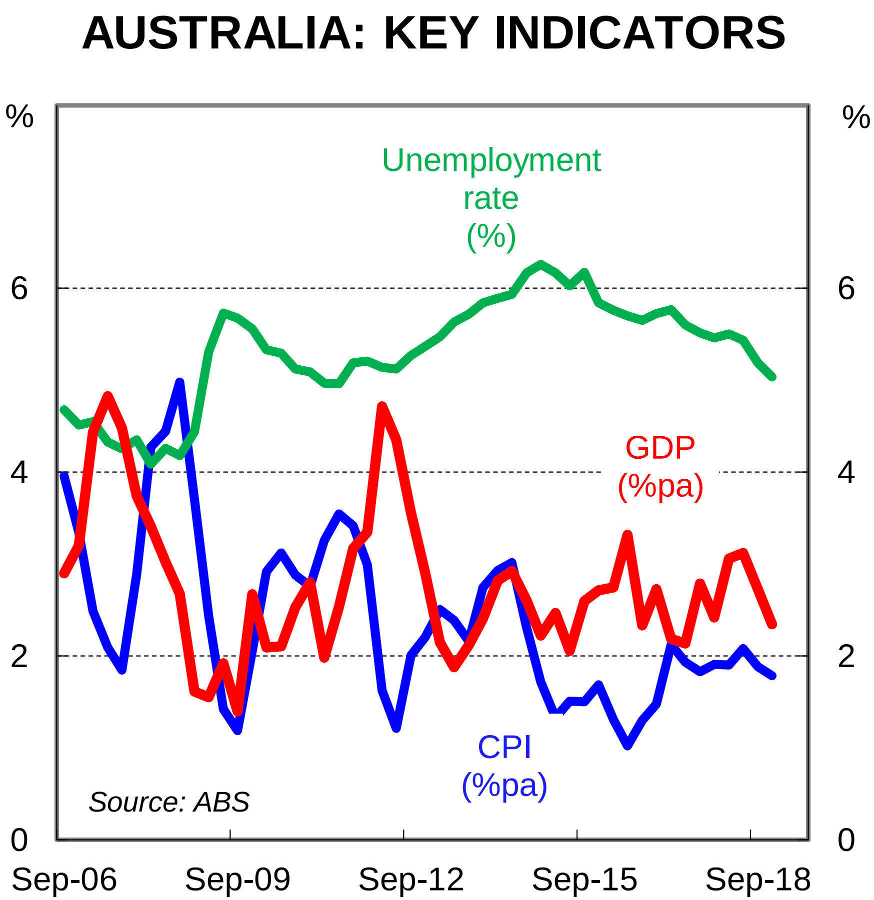


- We estimate that Chinese economic growth potential will decelerate to around 4% by 2030 without reforms to improve productivity.
- We expect growth of 6.1% in 2020 and 5.9% in 2021.
- The population is ageing quickly and growth in productivity is easing.
- The relaxation of the one-child policy in 2016 did little to help population growth. The birth rate dipped to the slowest pace since 1961. Only 15 million babies were born in 2018, 2 million fewer than 2017. There is growing speculation that China may abolish the birth control policy in 2020.

Australia

Australia In Perspective

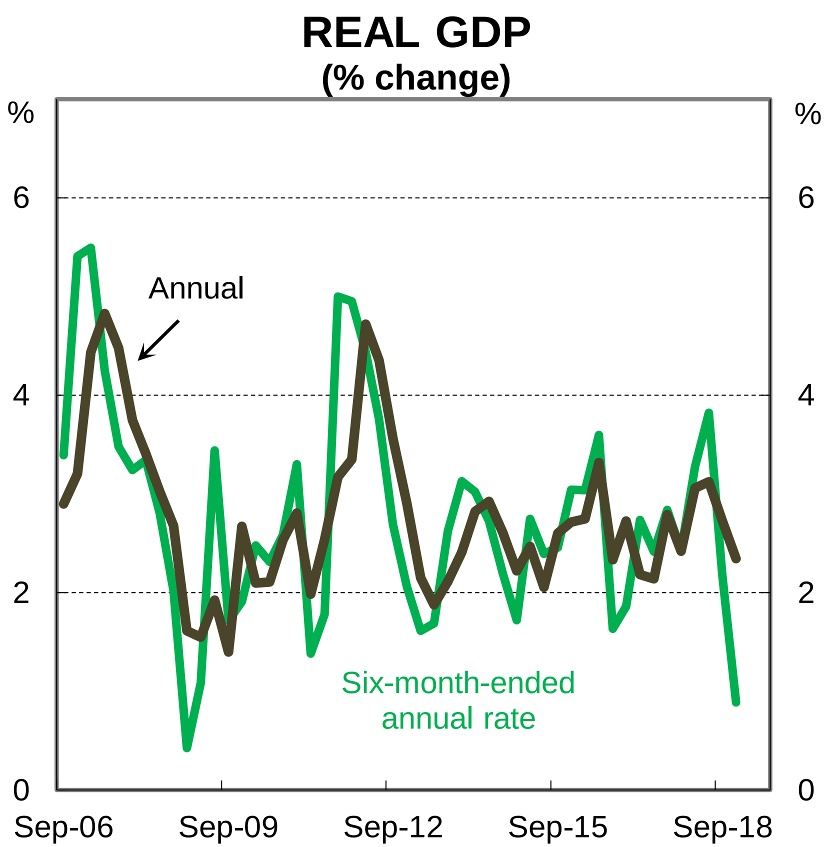
The economy is into its 28th year of expansion



- **The expansion is in its 28th year – the last real recession was in 1990/91.**
- **Unemployment is slowly trending down.**
- **Inflation rates are low.**
- **Public finances and the financial system remain in respectable shape:**
  - the AAA rating remains;
  - the financial system is well capitalised, well regulated and profitable.
- **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.**

The Economy in H2 2018

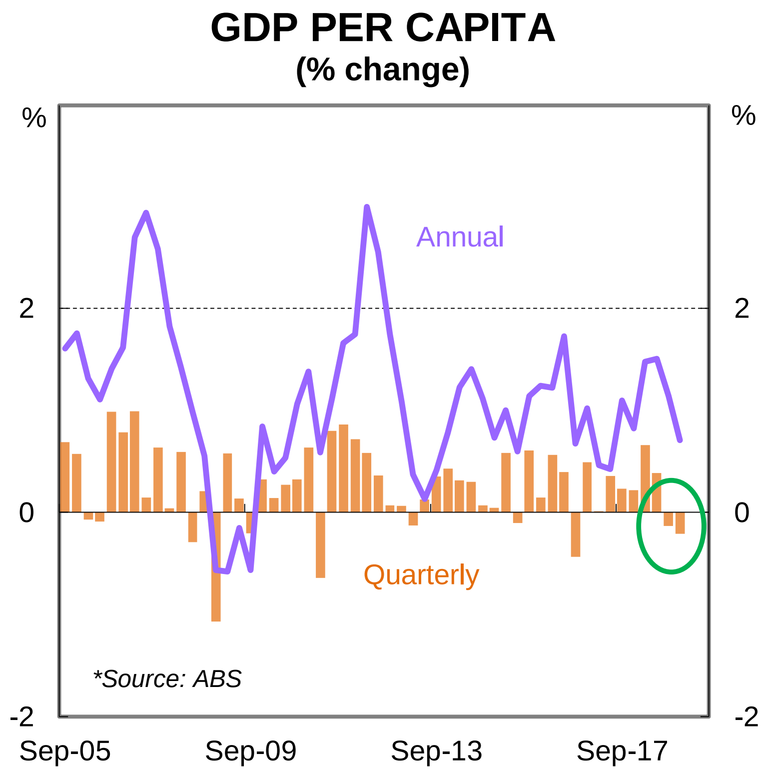
An H2 slowdown

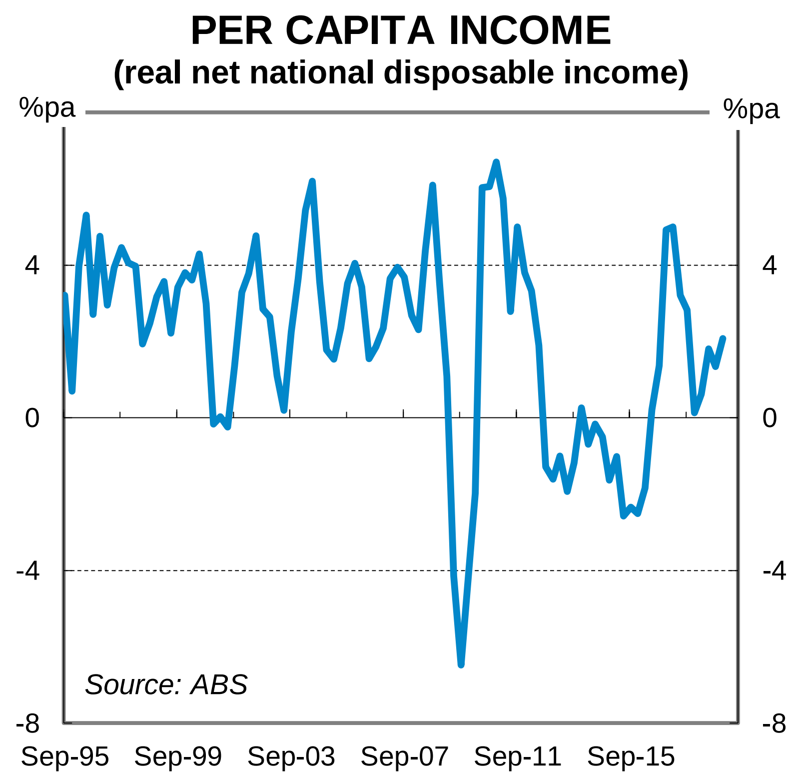


- The economy ended 2018 on a weak note.
- GDP growth slowed from an annualised rate of 3.8% in H1 2018 to 0.9% in H2.
- Growth weakness reflected softer household spending, the downturn in residential construction and ongoing effects of the drought.
- However, forward looking indicators, such as business capex plans look positive. A strong pipeline of public infrastructure work and rising commodity exports volumes will support growth over the year ahead.
- The *nominal* economy is in better shape.

The Economy in H2 2018

A per capita recession?





- **Headlines about a *GDP per capita recession* abound.**
- **GDP per capita is a catchall for living standards. But what matters for living standards is the income generated by that production.**
- **Real Net National Disposable Income per capita is the best measure of living standards. That measure grew by a respectable 2.1% during 2018.**

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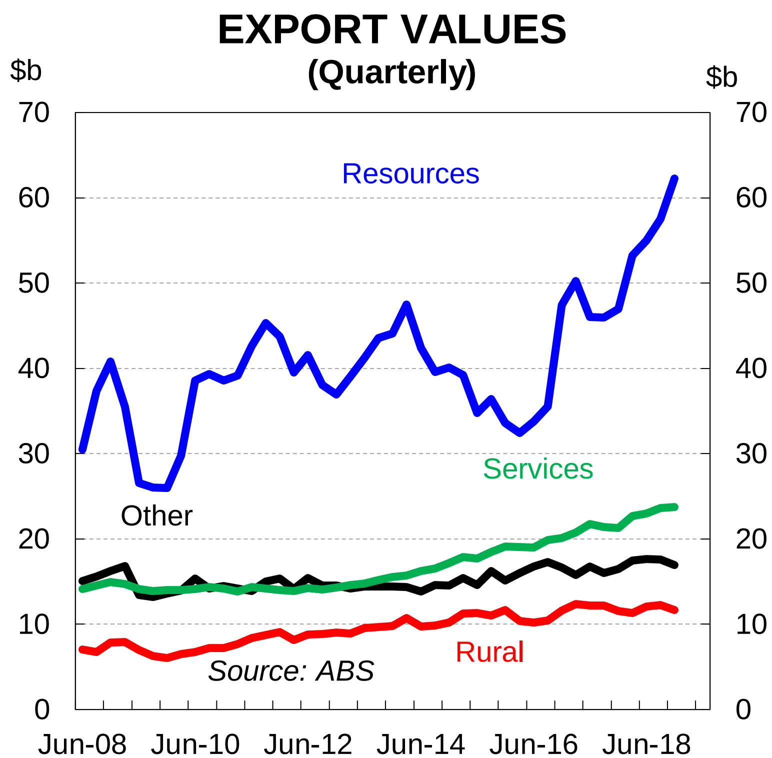
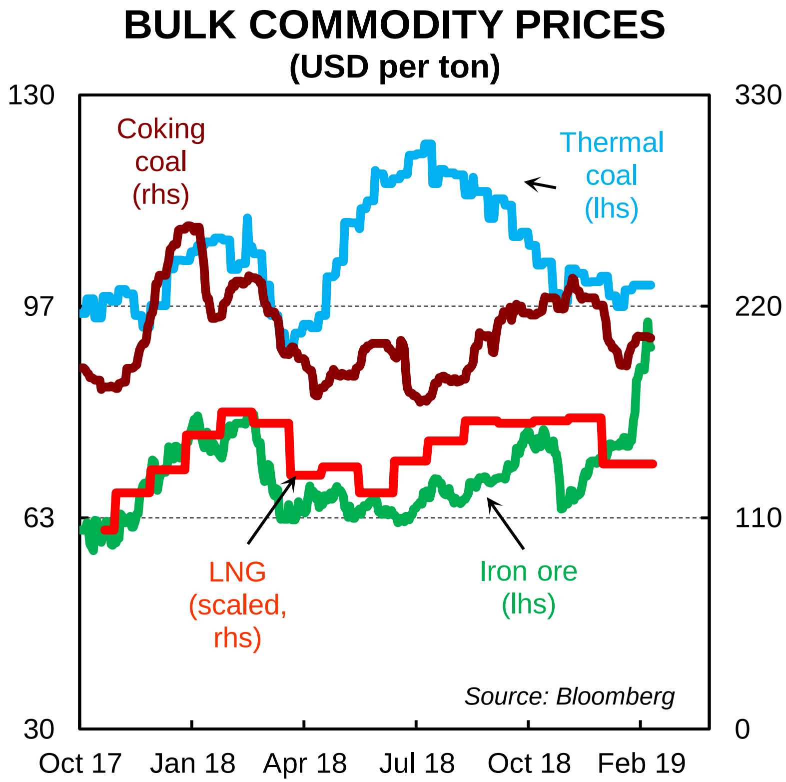
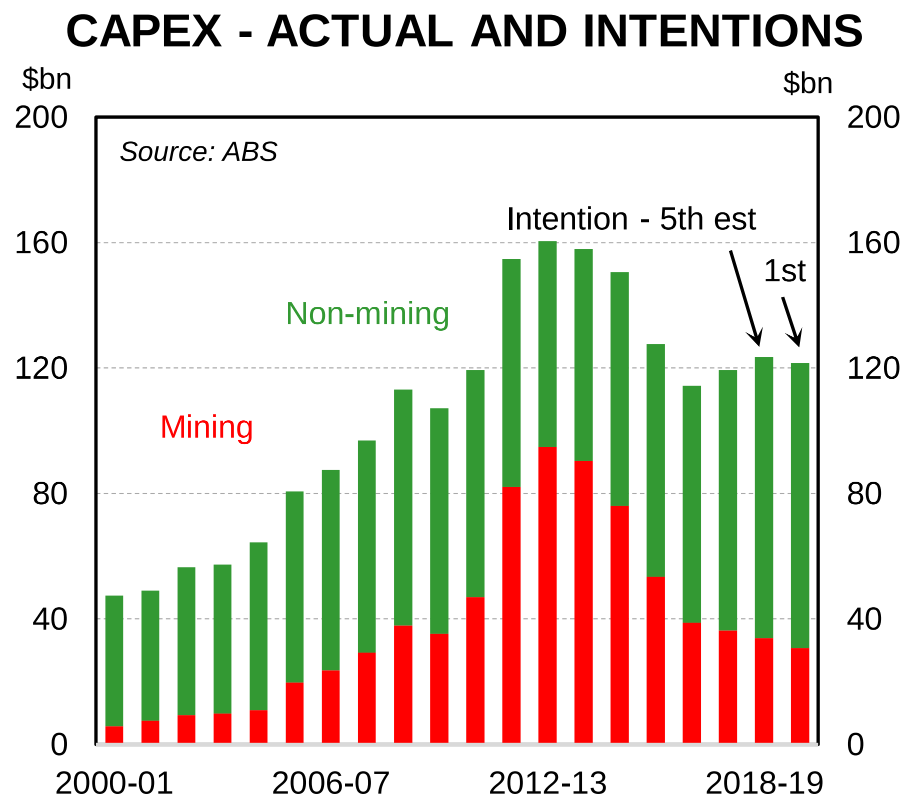
Commodity and Trade Sector

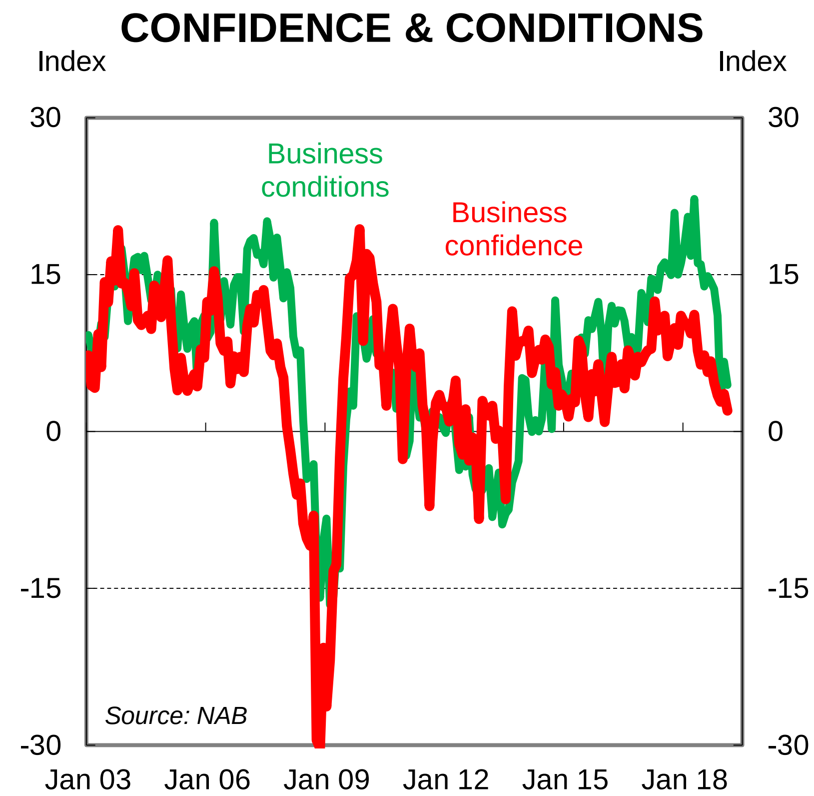




- **Resource export volumes continue to rise on the back of a surge of production. LNG coming on stream through 2018. Will take over from metallurgical coal as the second largest export .**
- **Services are also rising sharply, driven by Tourism and Education.**
- **Net exports should provide a positive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

Private Capex





- Private non-mining investment lifted significantly over 2017/18. More to come.
- Business conditions and confidence have retreated.

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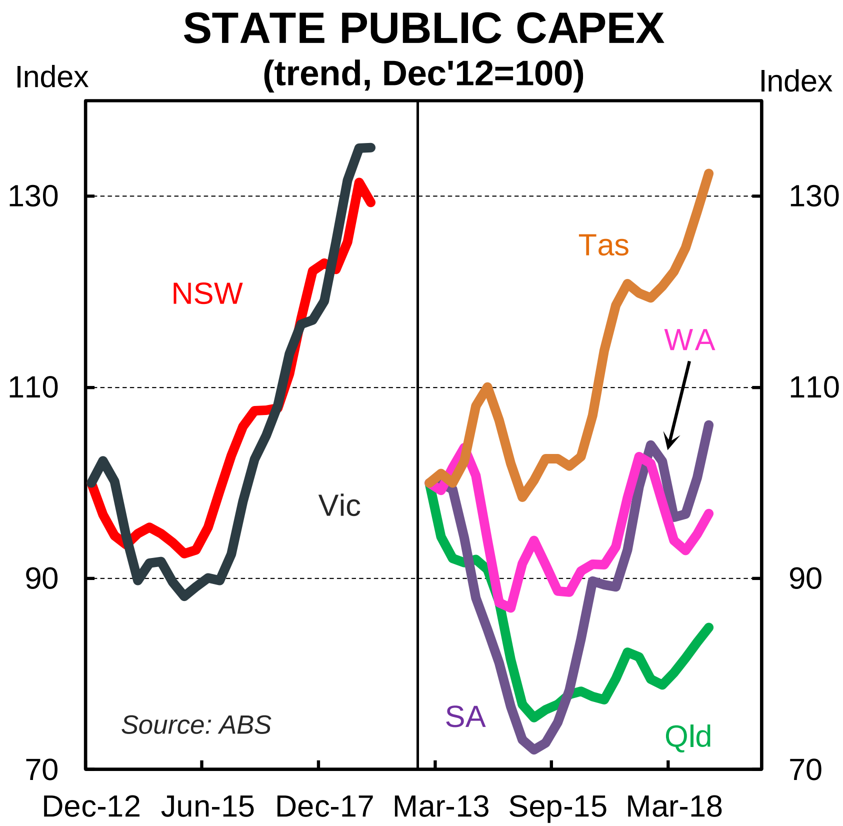
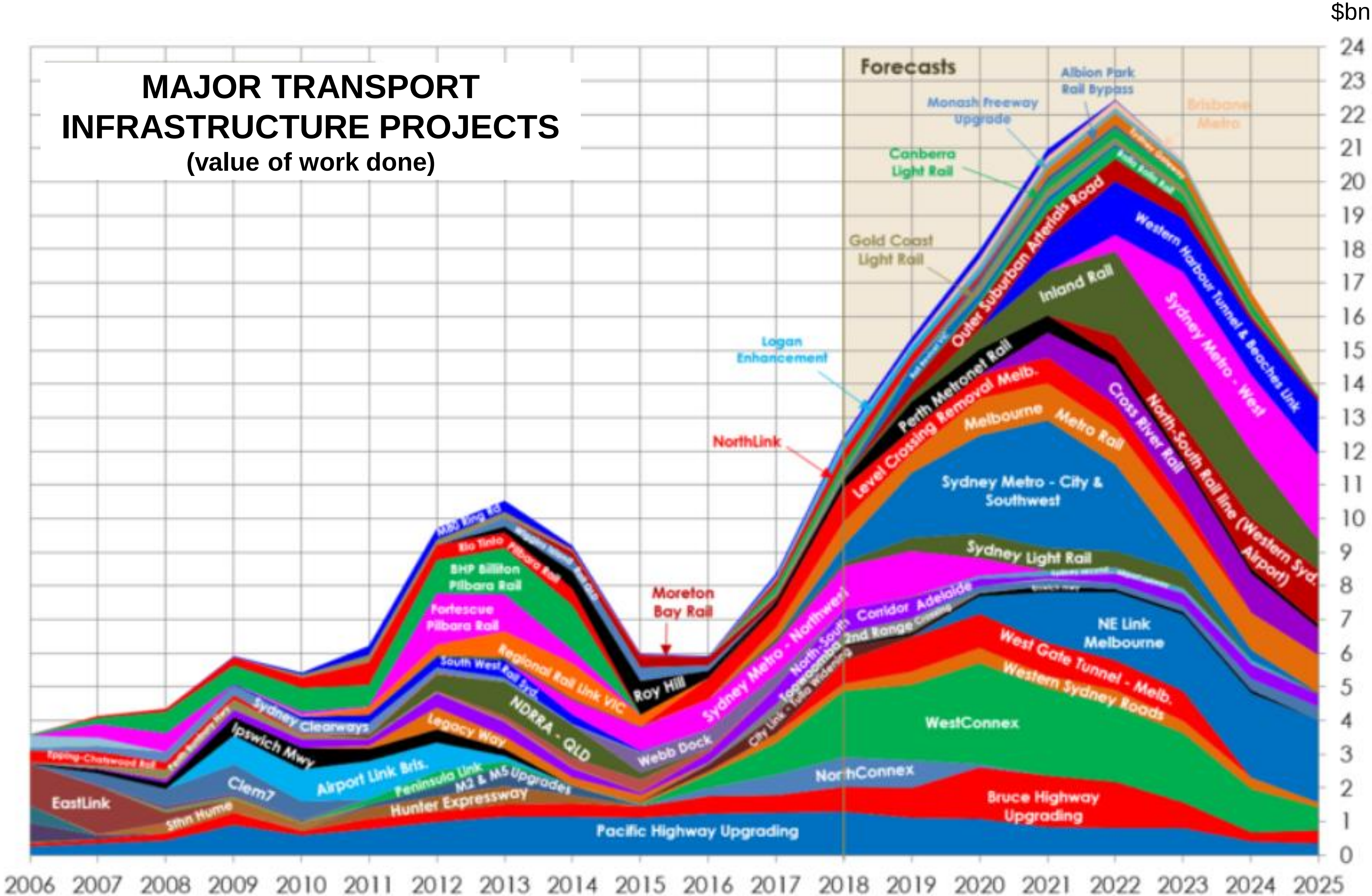
Public Investment



- 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.

Public Investment



Source: Macromonitor,

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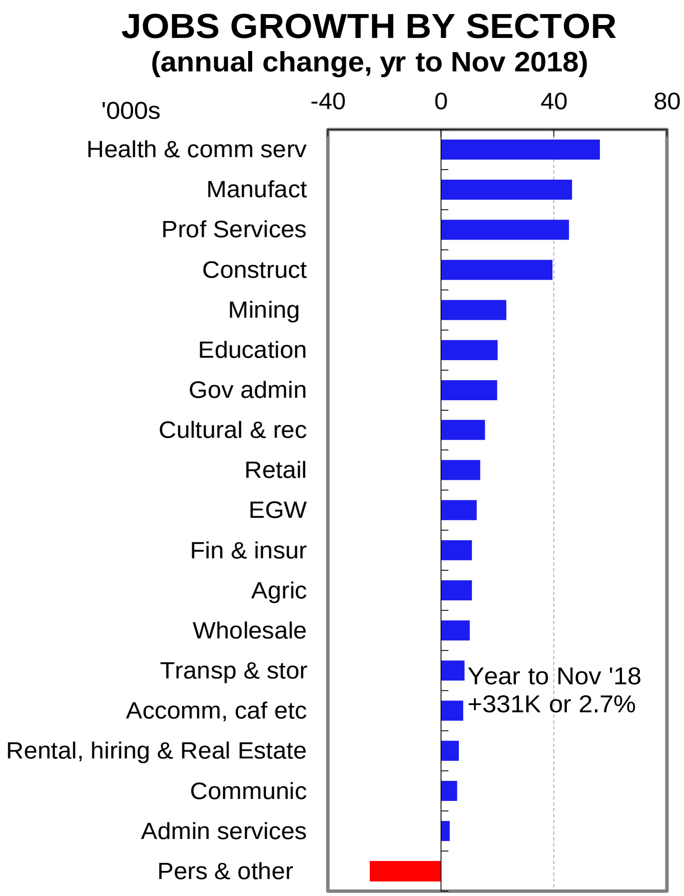
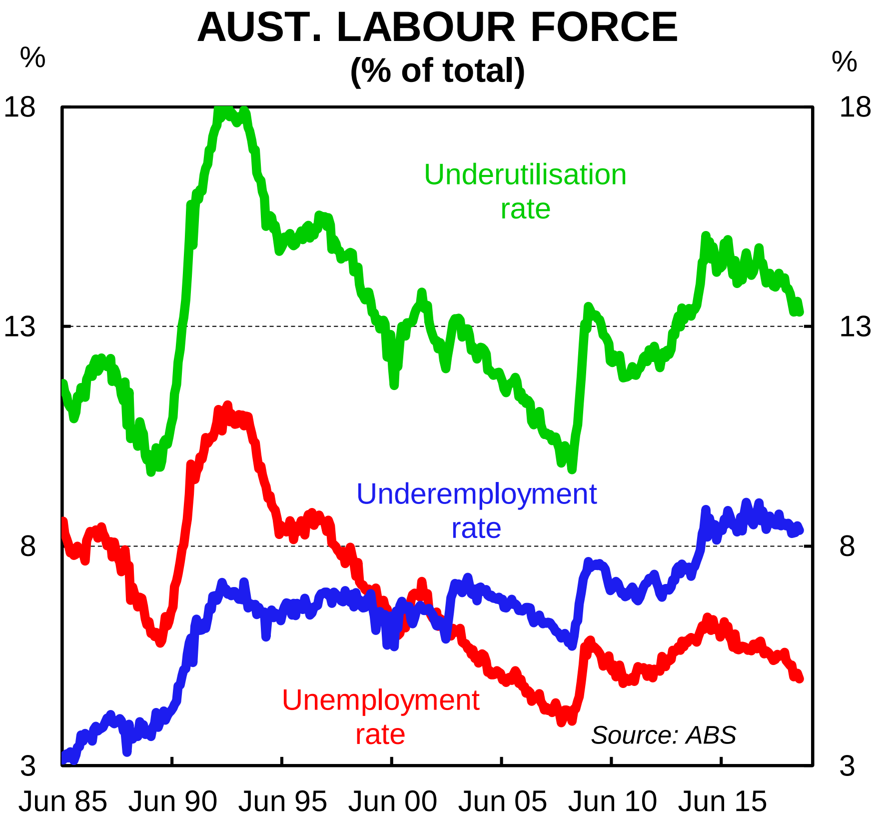
Low Wages Growth Helping Employment

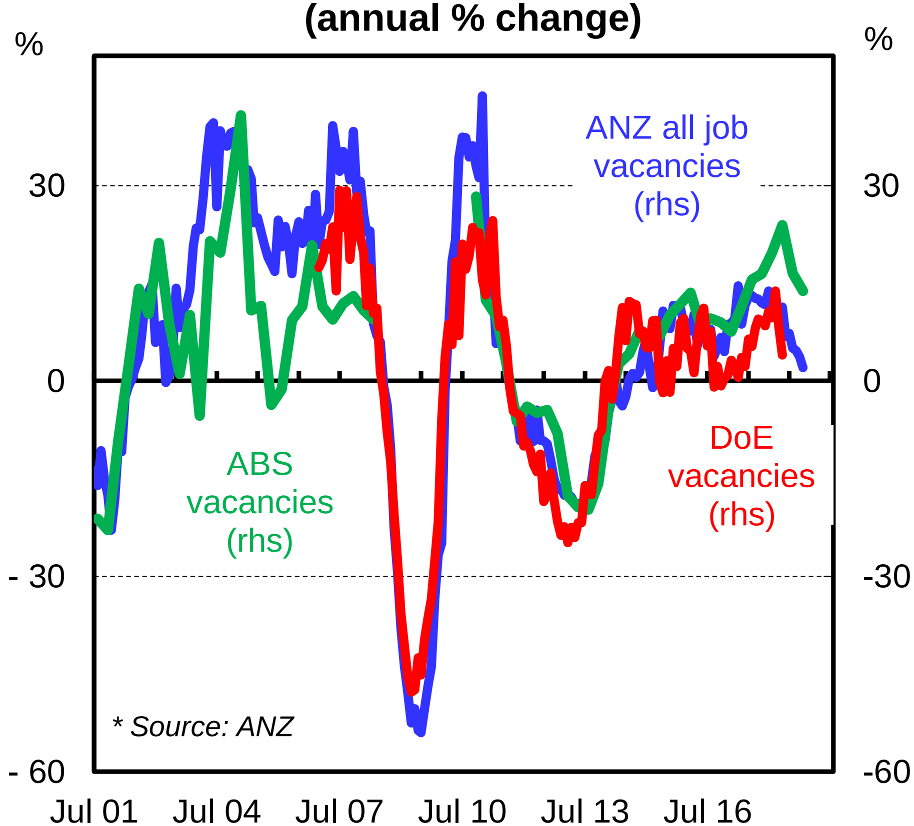




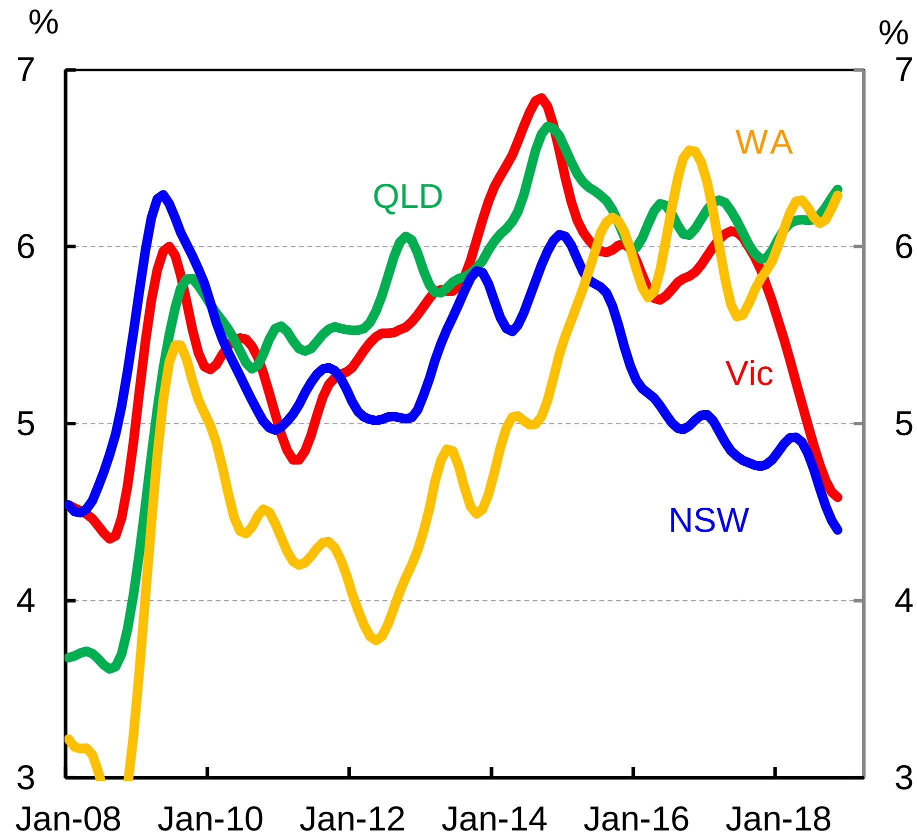
- **The annual pace of employment growth has deaccelerated in 2018,and was last recorded at 2.2 %/yr, still above the rate of population growth.**
- **The unemployment rate has fallen to 5.0%, at the RBA's estimate of full employment.**
- **Higher underemployment rate the issue although more recent data has shown a fall.**

Labour market

JOB VACANCIES
(annual % change)

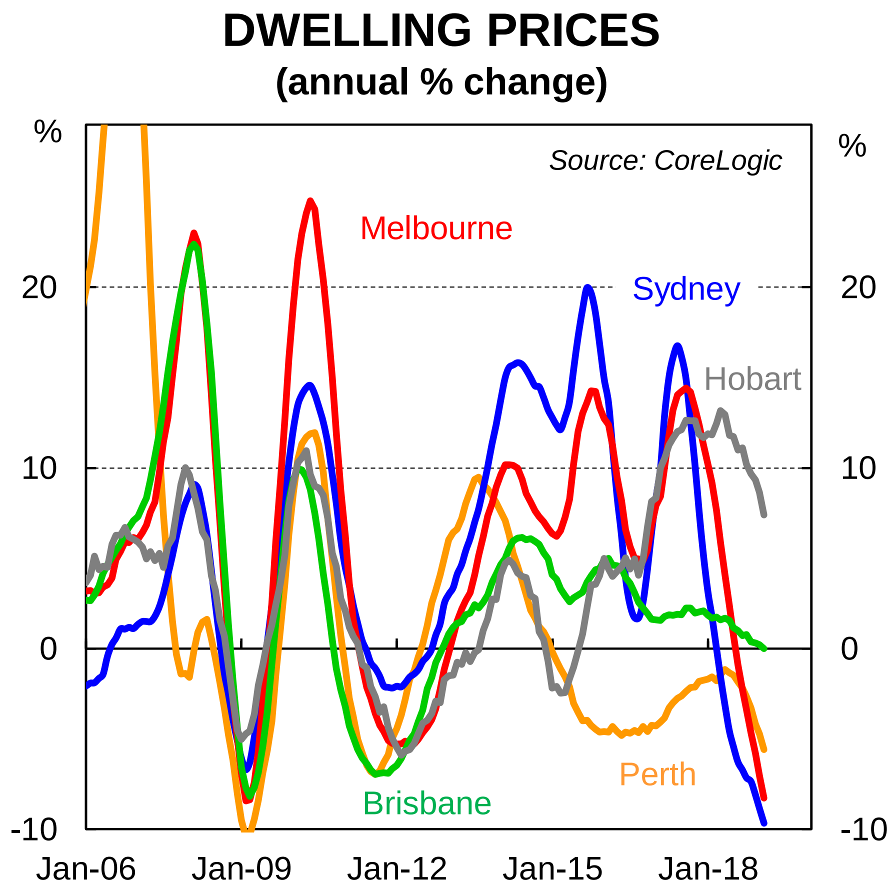


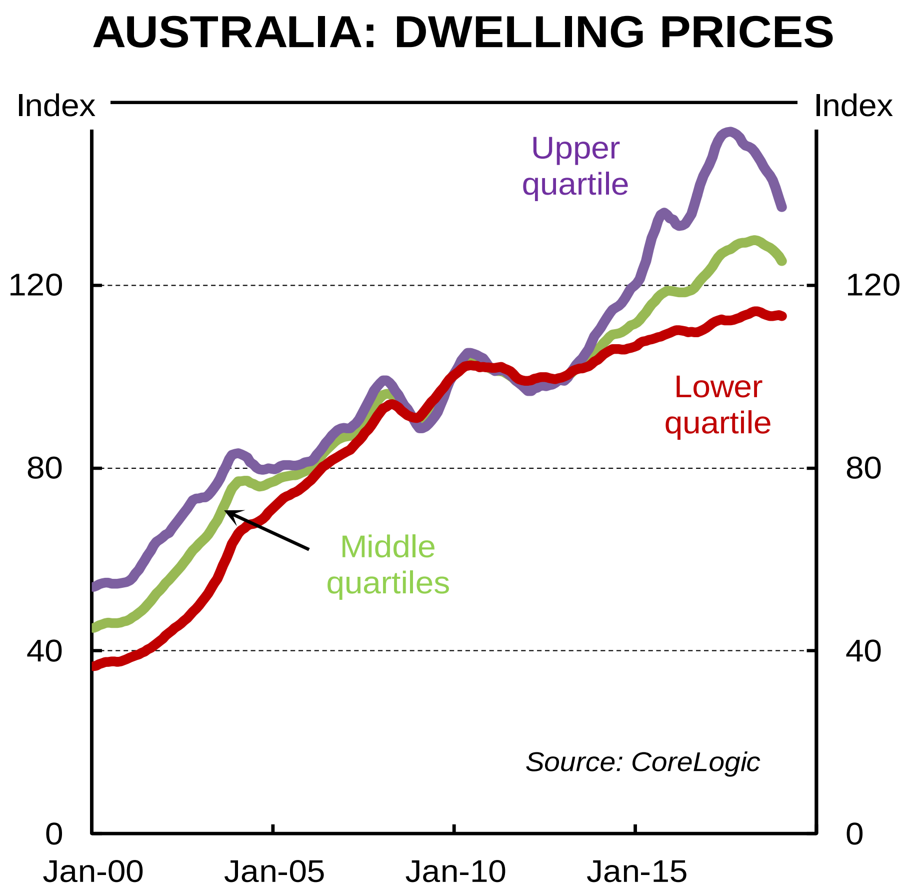
UNEMPLOYMENT RATES



- **NSW and Victoria leading the charge with unemployment rates below the natural rate.**
- **Leading indicators still pointing towards solid growth but have softened.**

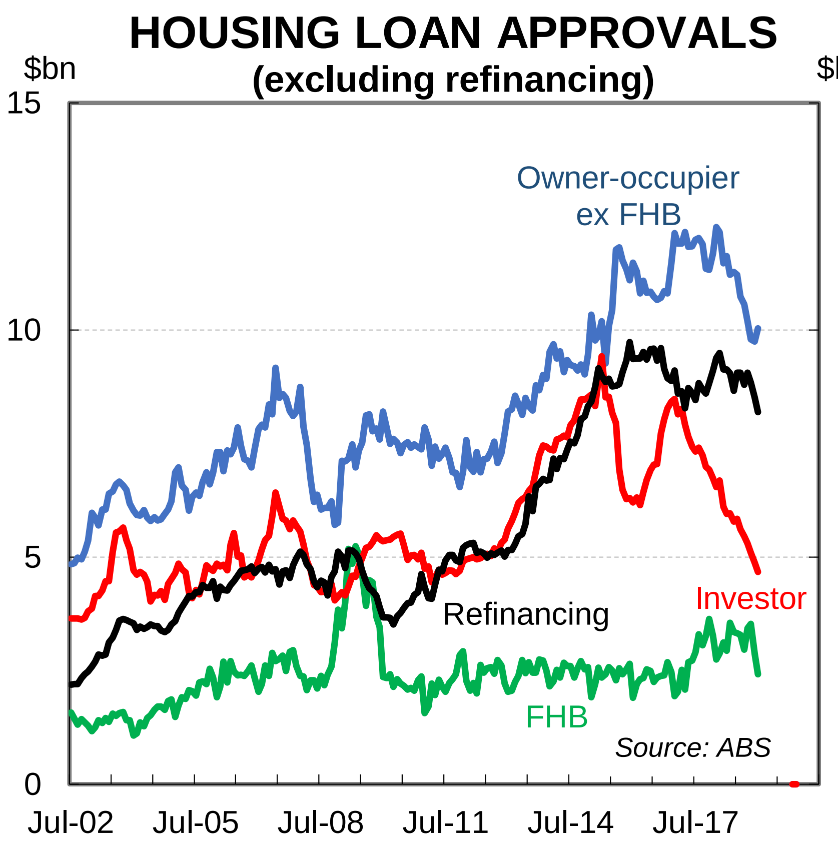
Dwelling prices

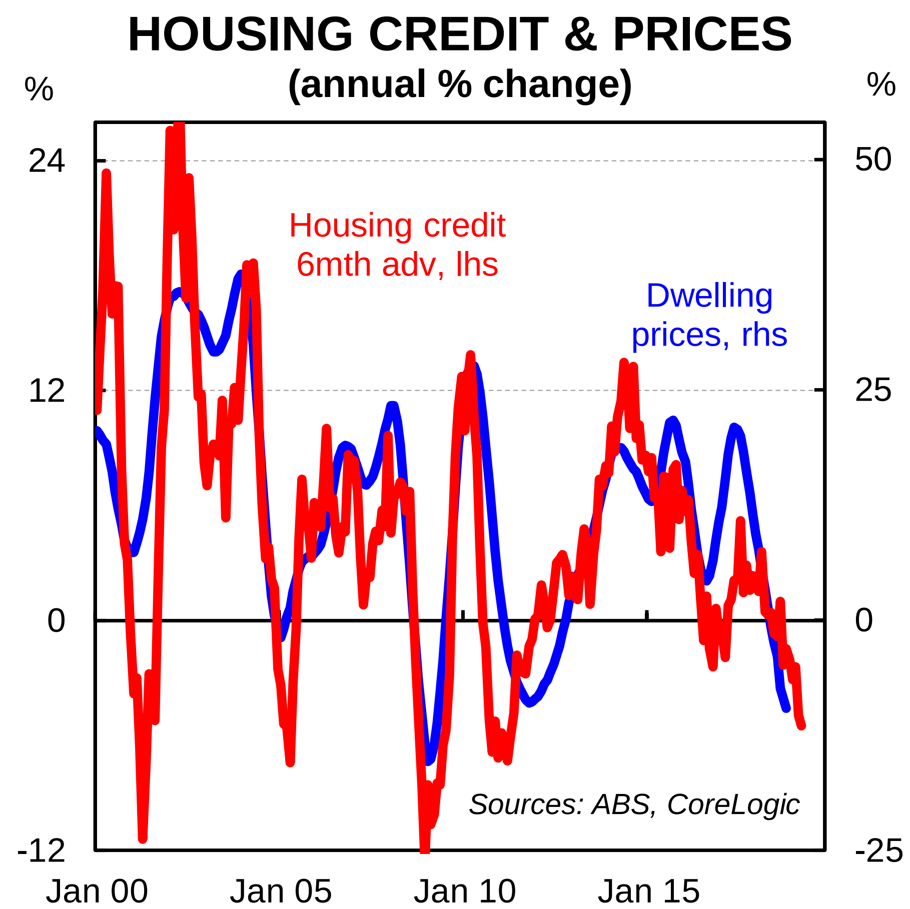




- **Dwelling prices are falling nationally.**
- **Prices are down through the year in Sydney, Melbourne and Perth.**

Housing market – supply and demand for credit





- **The flow of credit is falling.**
- **The flow of credit tends to lead prices by six months.**

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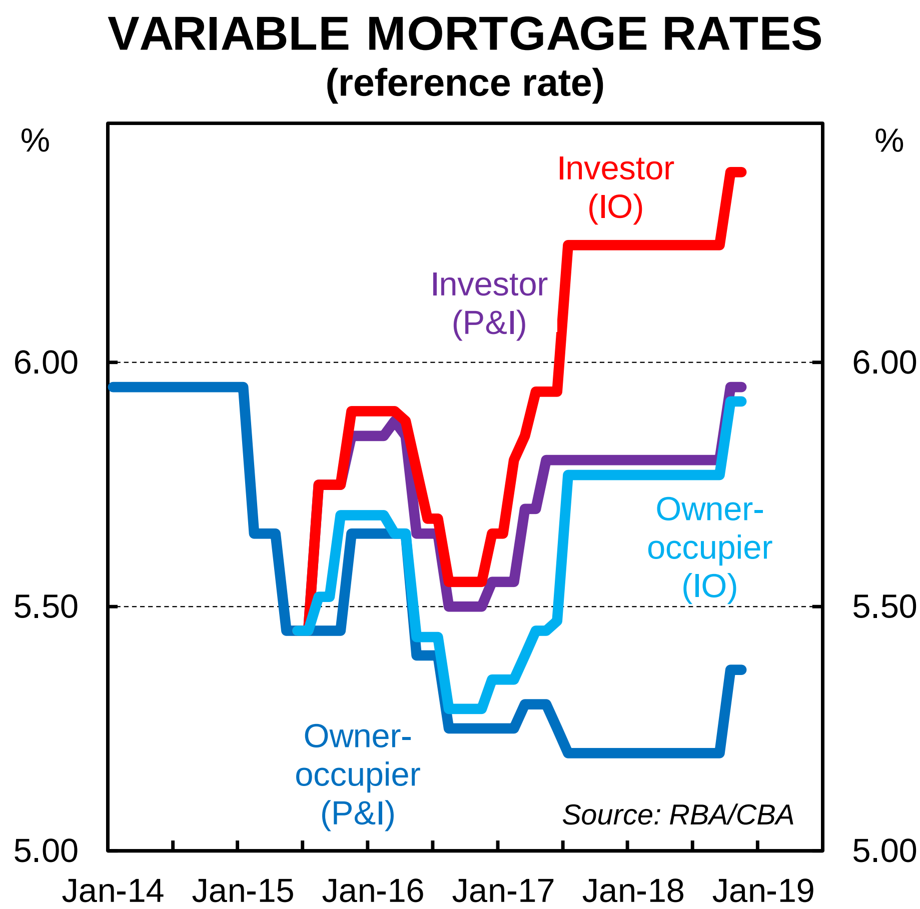
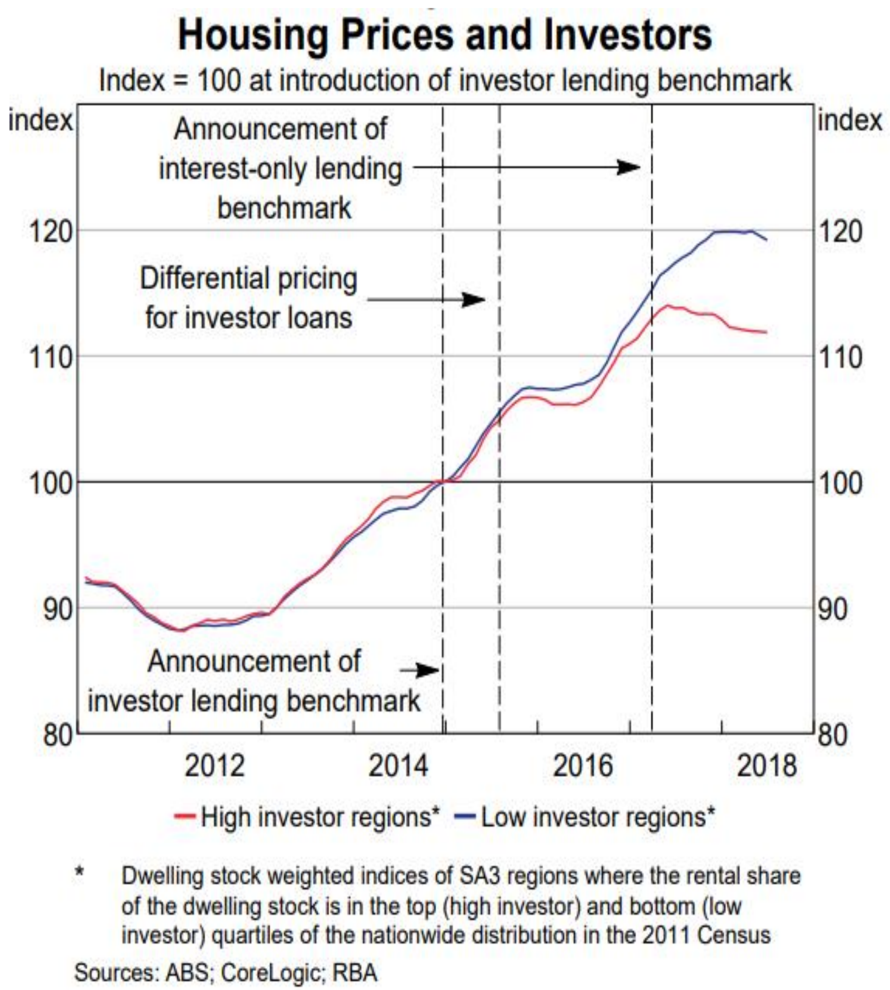
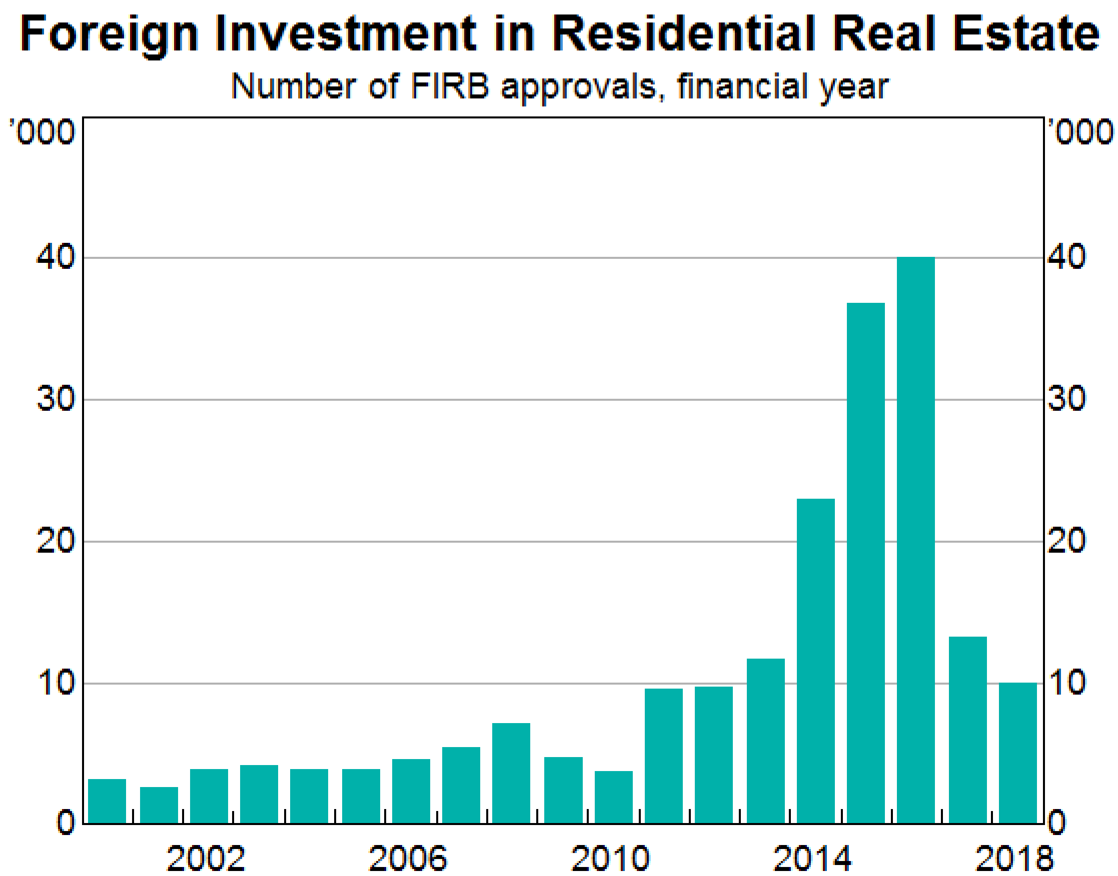
Housing market - regulation





- **A drop in investor activity in response to regulatory changes kicked off the dwelling price downturn.**
- **Owner-occupiers are pulling back now too.**

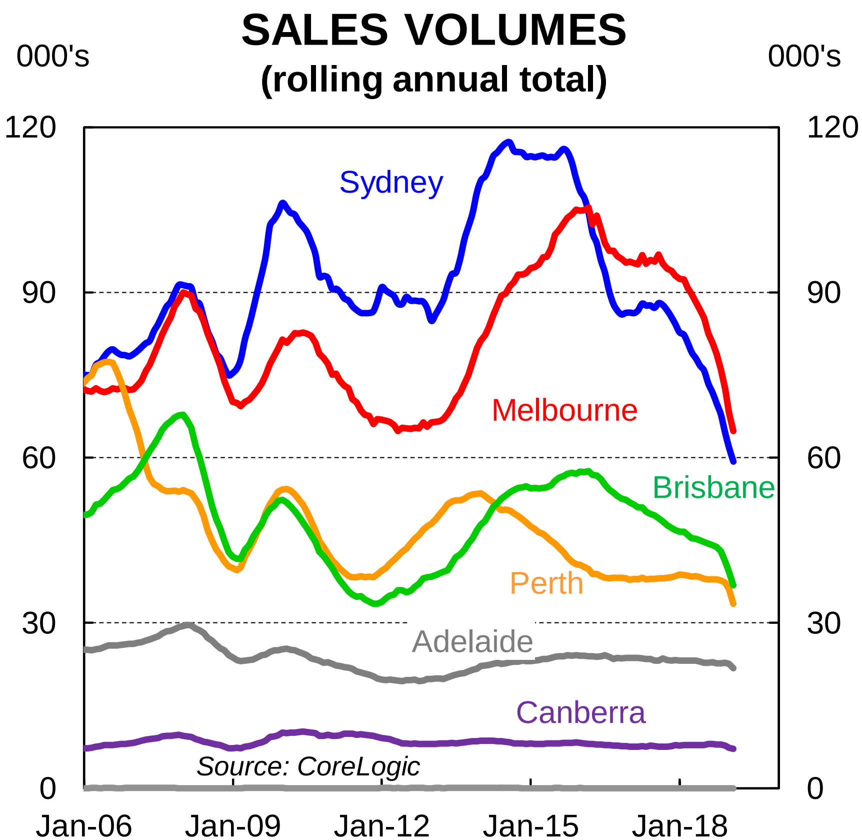
Housing market – foreign angle

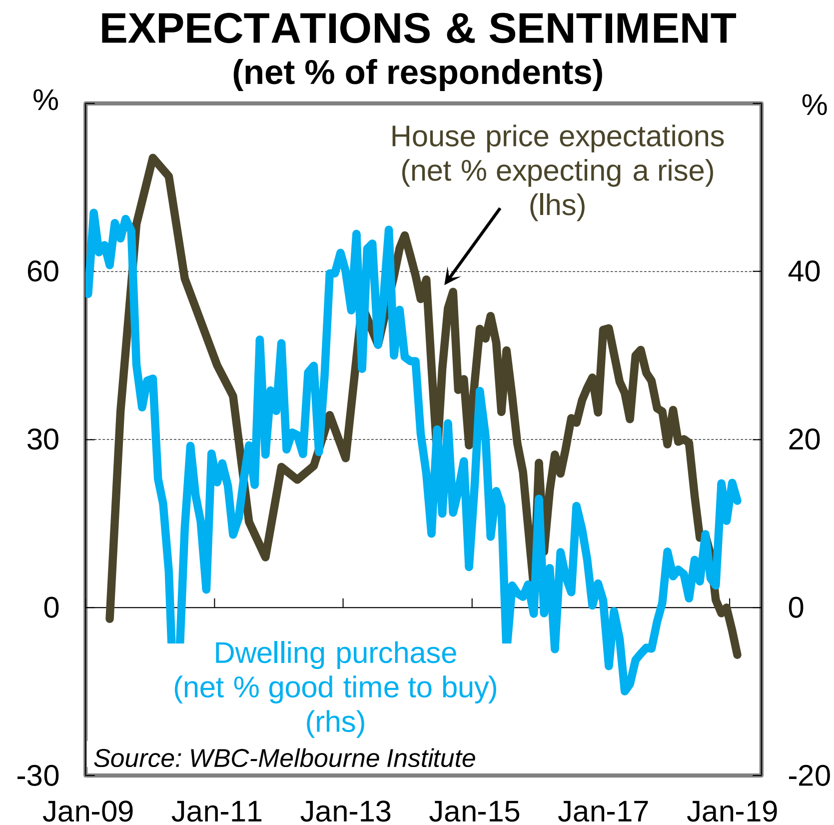


Source: FIRB

- Foreign buyers have fallen. State government taxation and changes to Chinese capital flows have driven the slowdown.

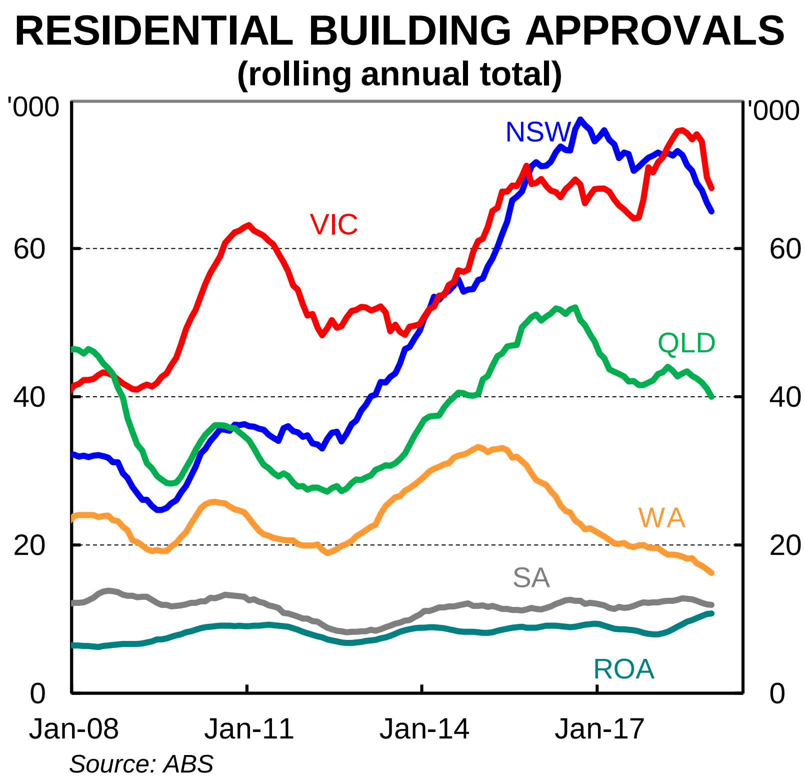
Sales Volumes are lower and sentiment indicators are easing

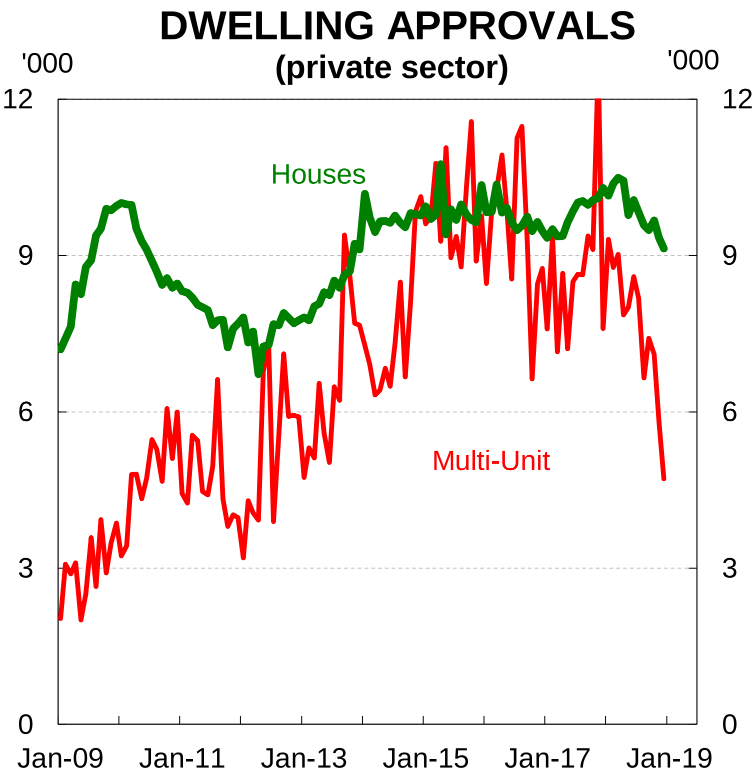




- **Sales volumes have fallen in most capital cities.**
- **Both buyers and sellers are stepping back from the market.**
- **The time to buy a dwelling index has risen but at the same time, pessimists are outweighing optimists when it comes to the outlook for house prices.**

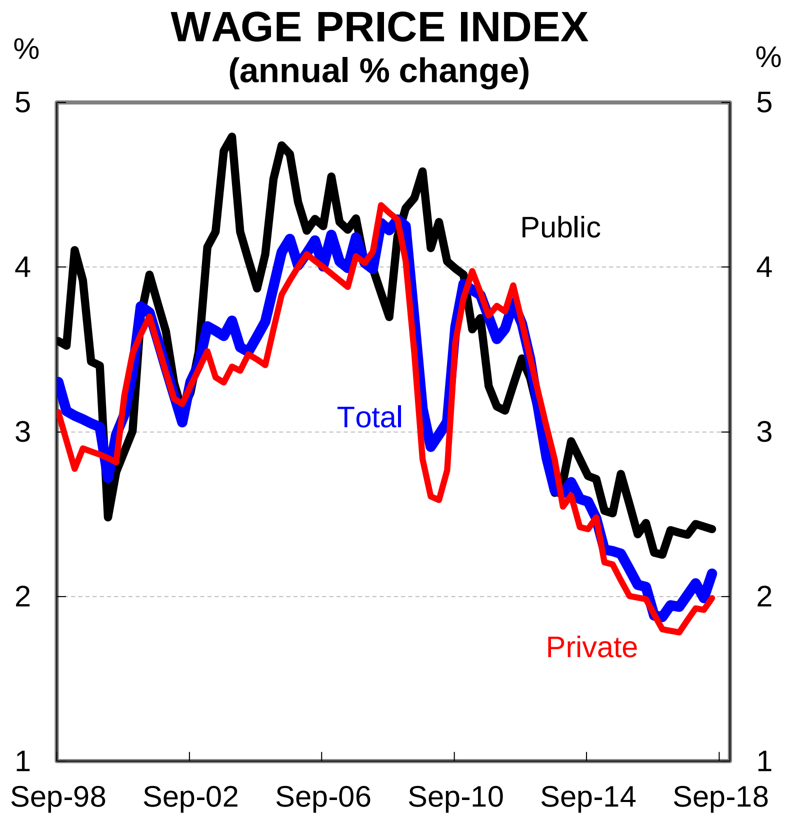
Residential Construction

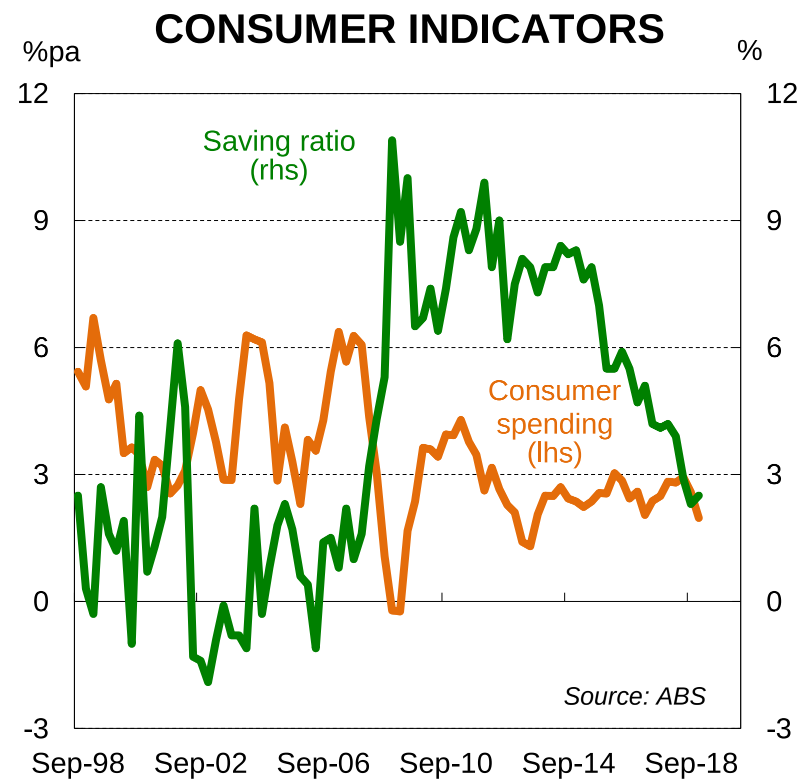




- **Multi-year residential construction boom has peaked and returning quickly to normal.**
- **Approvals are trending lower but still a significant pipeline of work remain to be complete but dwelling construction will contract from GDP growth over the next two years.**

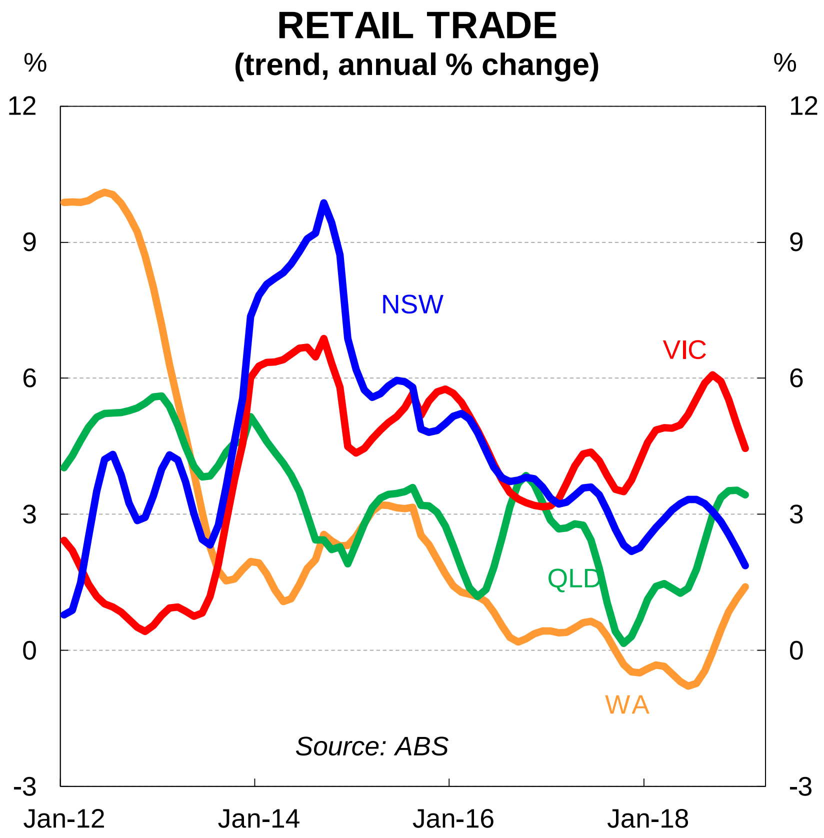
Wages and spending

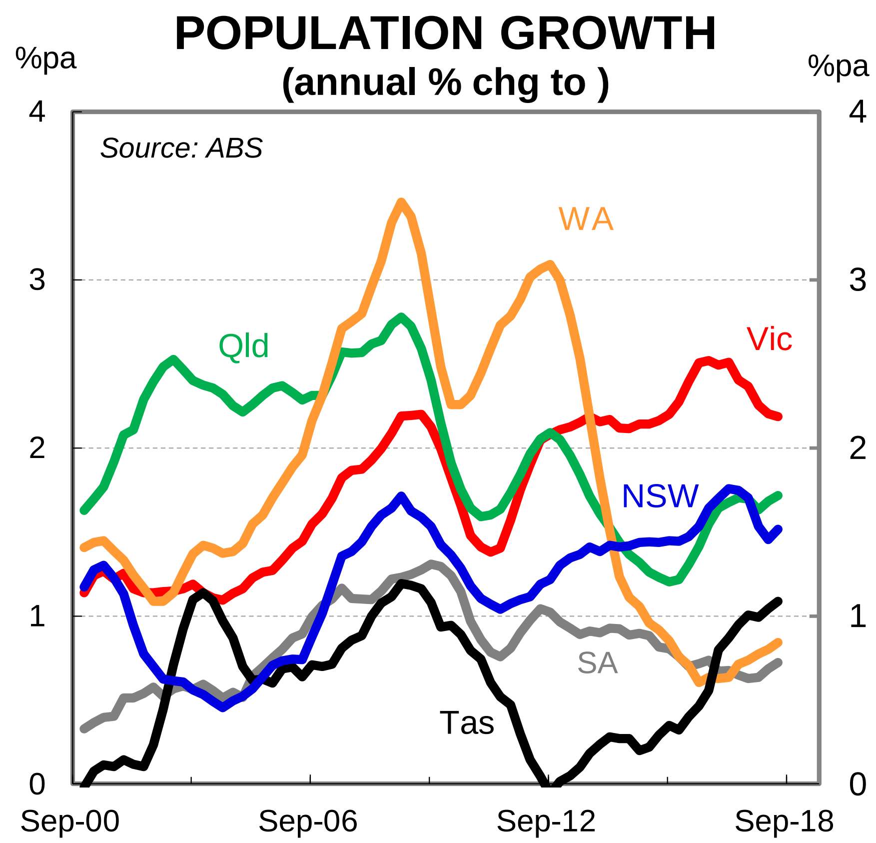




- **Annual wages growth at 2.1%/yr, just off record low of 1.9% but slowly trending higher. Faster growth if include bonuses (2.5%).**
- **The household savings rate has also fallen as households try to maintain consumption with little income growth, household deposit growth is also slowing.**

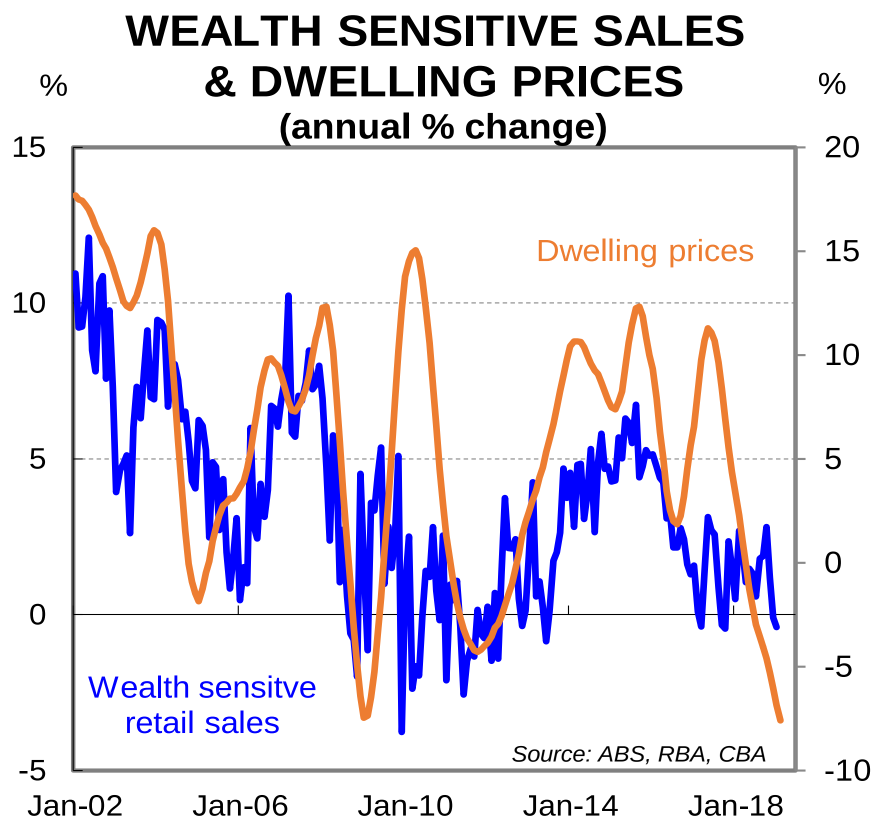
Population growth and spending



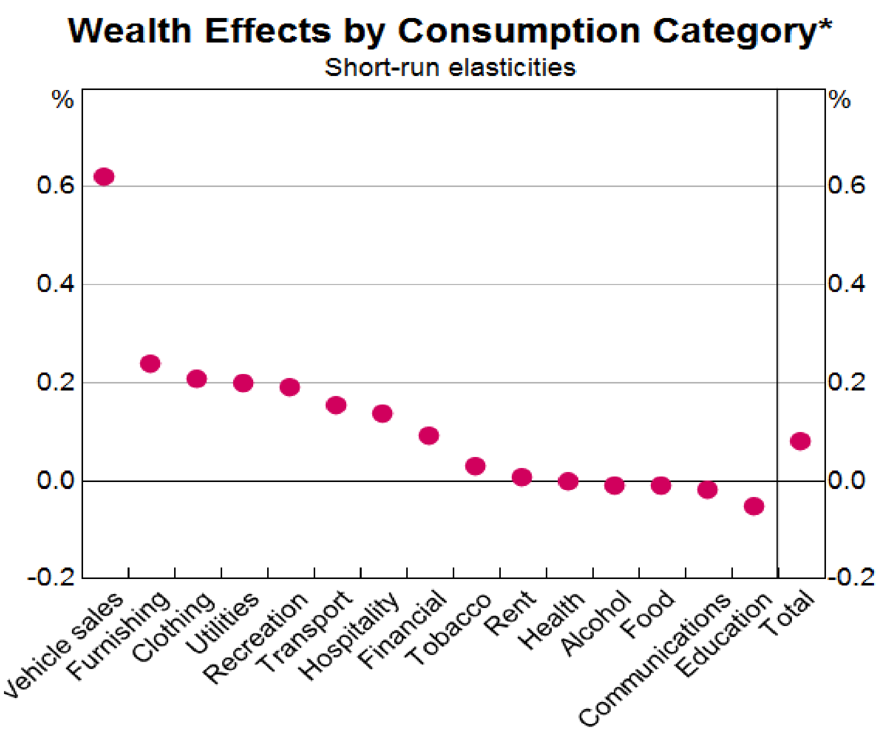


- **Australia's population is growing around 1.6%pa.**
- **States with faster population growth have seen stronger levels of consumer spending**

Housing sales volume and impact on consumption



Wealth sensitive Dept stores, Clothing, household goods, newspapers, books and other recreation

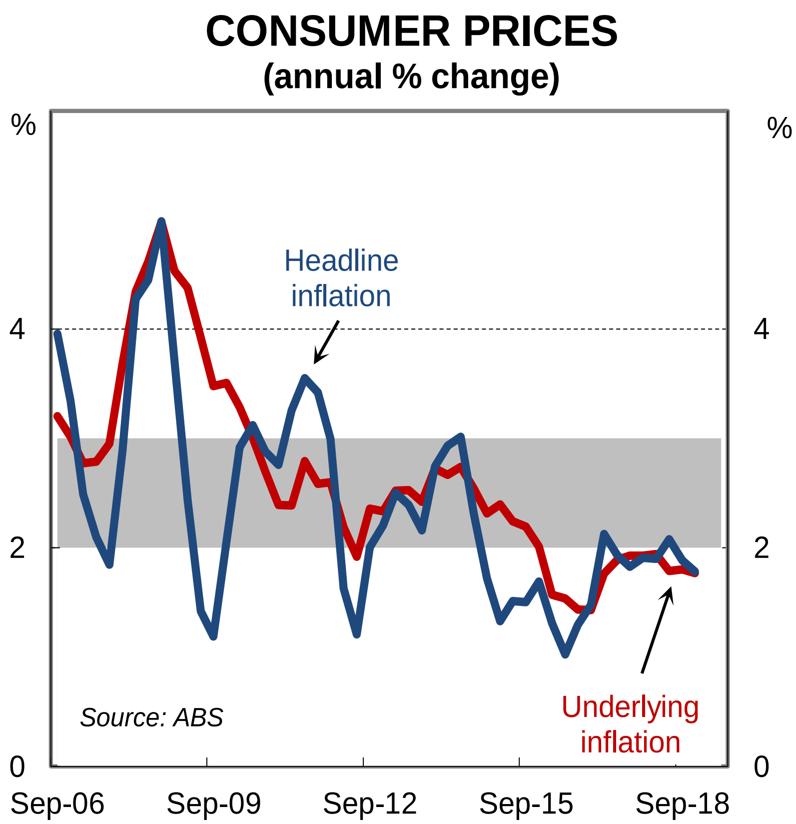


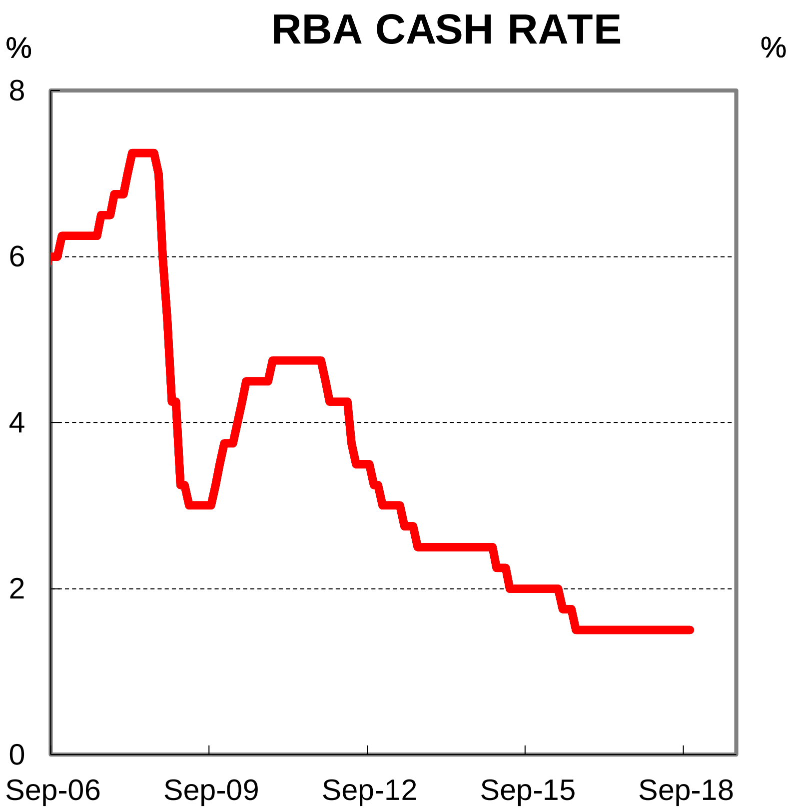
* Effect of a 1 per cent increase in per capita housing wealth over six months

Sources: ABS; Corelogic; RBA

- **The wealth effect and lower consumer sentiment are two channels the deteriorating housing market can impact.**
- **Lower sales volumes though have a high correlation with household goods sales.**
- **The RBA estimates that the biggest impact of lower house prices is on car sales.**

Inflation and Monetary policy

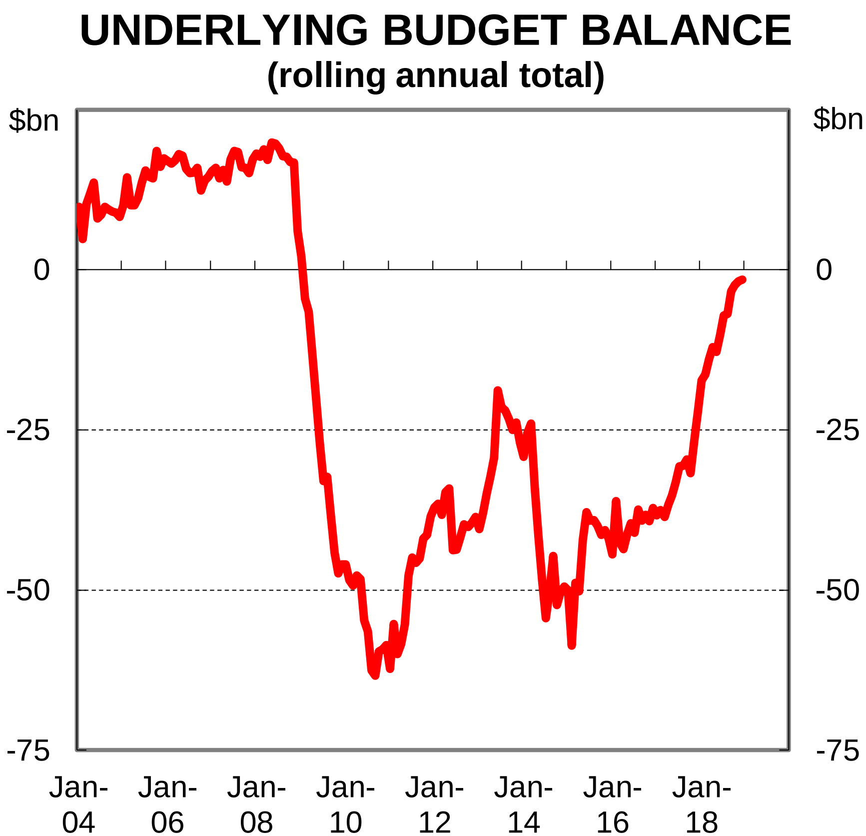




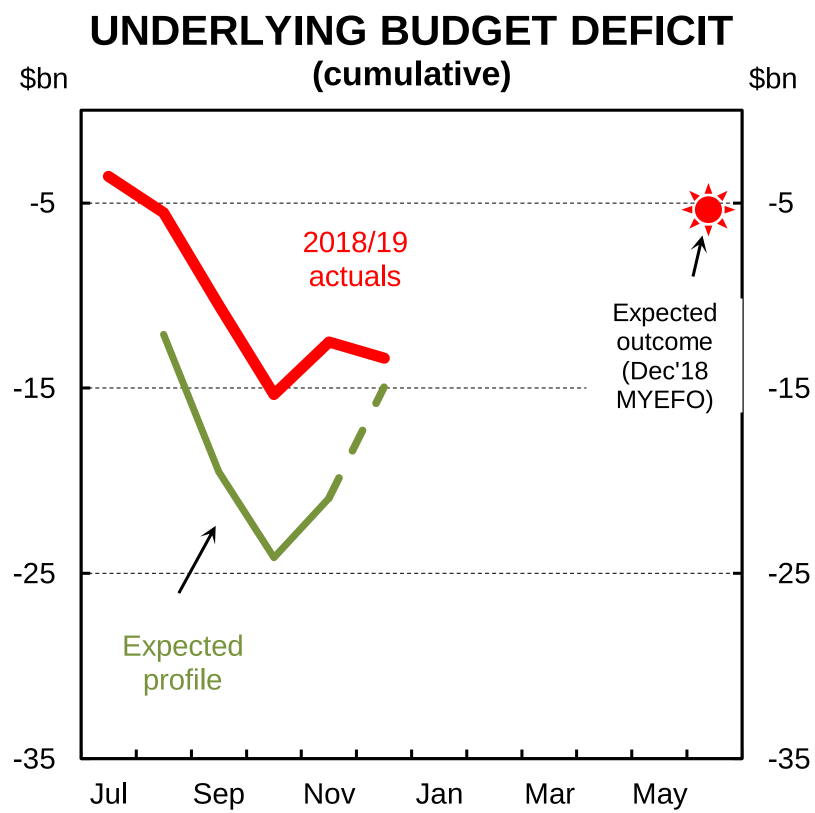
- ***Headline* inflation printed at 1.8%/yr in Q4 18.**
- **The inflation rate has been *below* the RBA's target for 15 of the past 17 quarters.**
- ***Underlying* inflation is also stuck below the 2%pa lower target band.**
- **RBA on hold for the foreseeable future (at least till late 2020).**

The Fiscal Position Will Help

A sizeable war chest – money in the bank



Source: Department Of Finance



- **The Budget deficit is shrinking at the fastest pace in at least 25 years.**
- **Budget surplus is in sight.**
- **Shrinking budget and current account deficits have shored up the AAA rating.**

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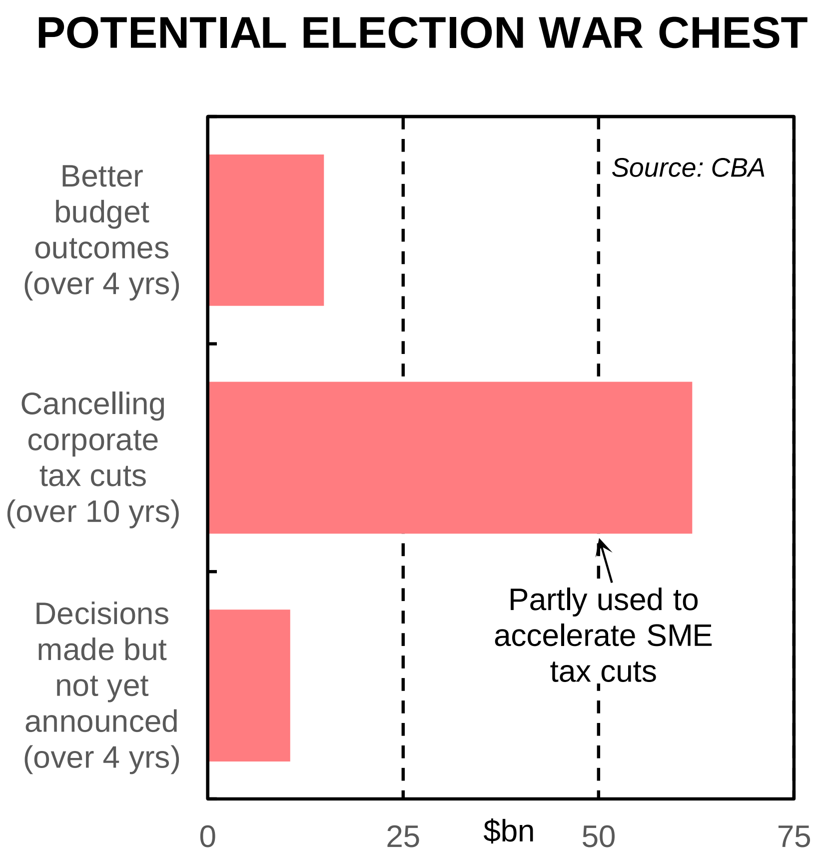
The Political Dynamic

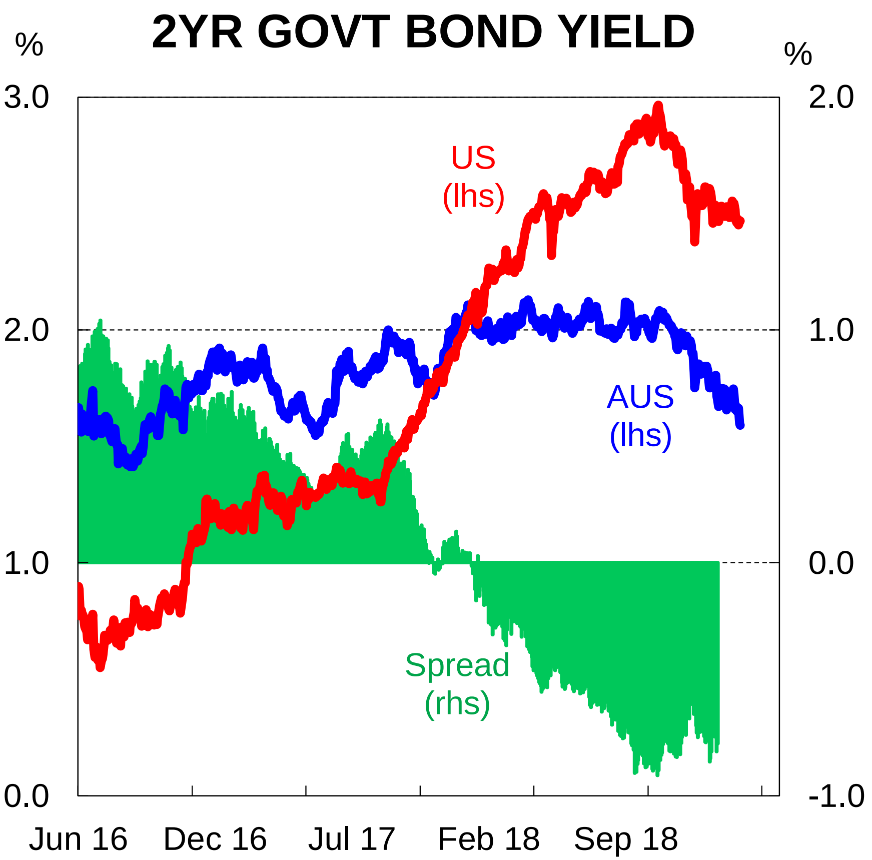
A sizeable war chest

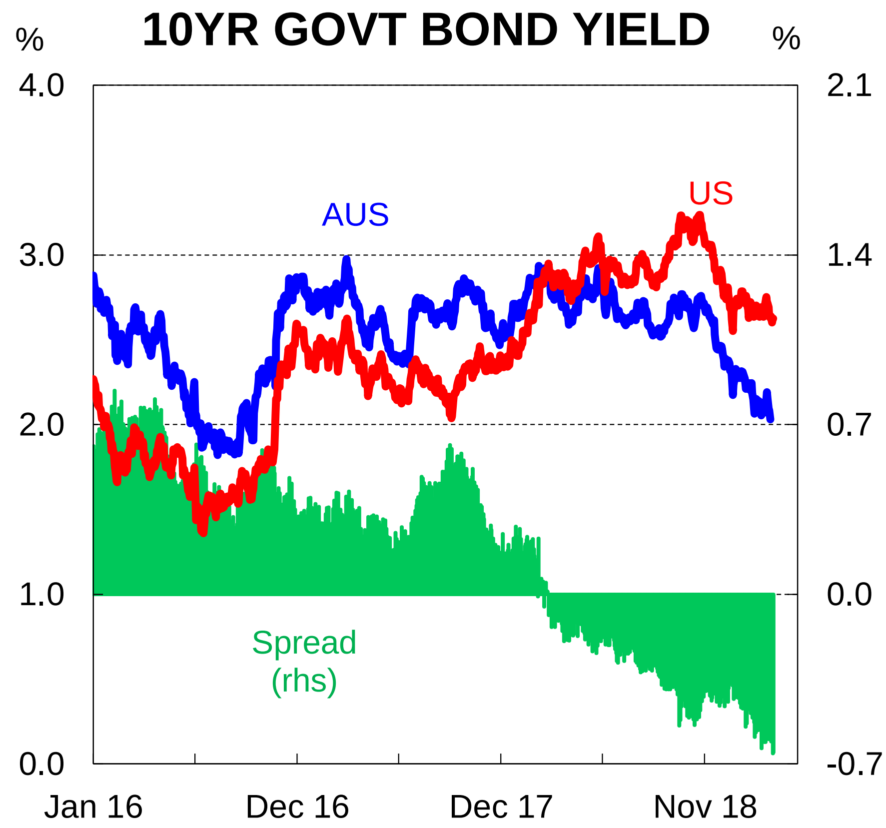


- **The budget deficit for the first five months of 2018/19 is $8½bn *lower* than expected.**
- **The MYEFO predicted a net improvement of $15bn in budget finances (over 4 years).**
- **The MYEFO also revealed that $9.2bn had been set aside in the Treasury portfolio over four years under the banner of "decisions taken but not yet announced".**
- **The abandoning of tax cuts for big companies has freed up $72bn over the next ten years for use elsewhere.**
- **Some $10bn was used to bring forward tax cuts for SME's.**

Global Markets

Bonds

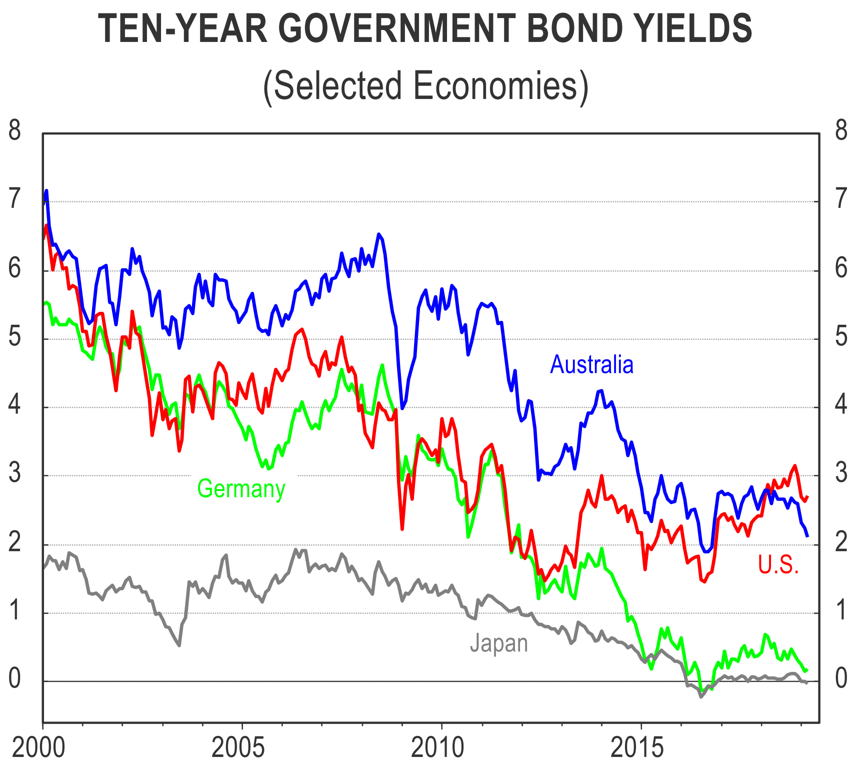




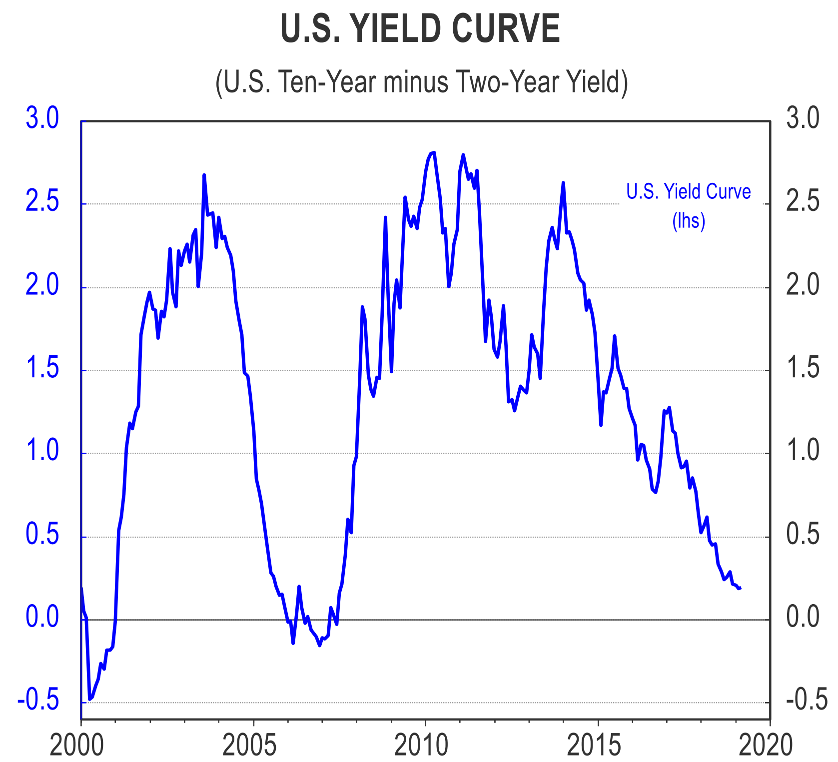
CommonwealthBank of Australia

CommonwealthBank of Australia

Bond Yields



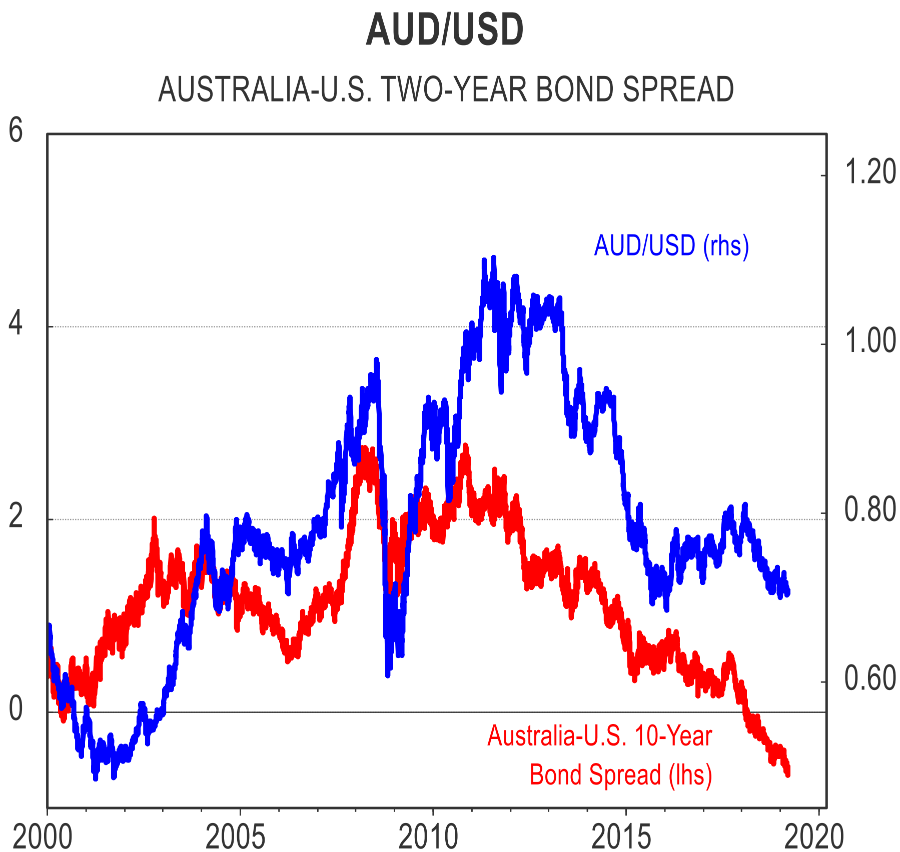
Source: Thomson Reuters Datastream



Source: Thomson Reuters Datastream

- **Bond yields have reacted to trade tensions, global growth downside risks, contained inflation and a more "patient" Fed. Markets are also pricing in chance of rate cuts in the US.**
- **US bond yields higher than Australian bond yields.**

Australian Dollar



Source: Thomson Reuters Datastream

- **Despite a more patient Fed it is unlikely the US dollar will depreciate much in 2019.**
- **AUD weakened over 2018 but commodity prices (particularly rising iron ore prices) have helped support.**
- **A more neutral outlook for the AUD has also lowered our forecasts for the AUD over 2019.**
- **We expect the AUD to finish 2019 at $US0.72 and $0.75 in 2020.**

Our View

- **Global growth uneven but a trend type outcome likely in 2019 – risks to the downside**
  - growth more desynchronised, momentum loss in developed economies more than EM;
  - US policy (esp trade), Brexit, geopolitics sources of growth risk and market volatility;
  - global central banks reluctant to raise rates further – or start lifting them at all;
  - EM Asia to outperform other EM's but trade frictions a rising risk;
  - expansionary policy settings to support China but *structural* slowdown continues;
  - commodity prices expected to track sideways in 2019.
- **Australian growth heading for trend or better**
  - the drag from falling mining capex is complete;
  - resource exports, infrastructure spending and rising Asian incomes helping growth;
  - residential construction downturn may be limited and business capex lift should continue;
  - high household debt and falling house prices a significant risk for consumer activity.
- **Economic policy and markets**
  - RBA has moved to a neutral bias – cash rate at 1½% for an extended period;
  - We expect bond yields to lift.
  - We expect AUD to hold in low '70's before edging higher to USD0.72 at end 2019.

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