The Australian Economy:

Update and Outlook

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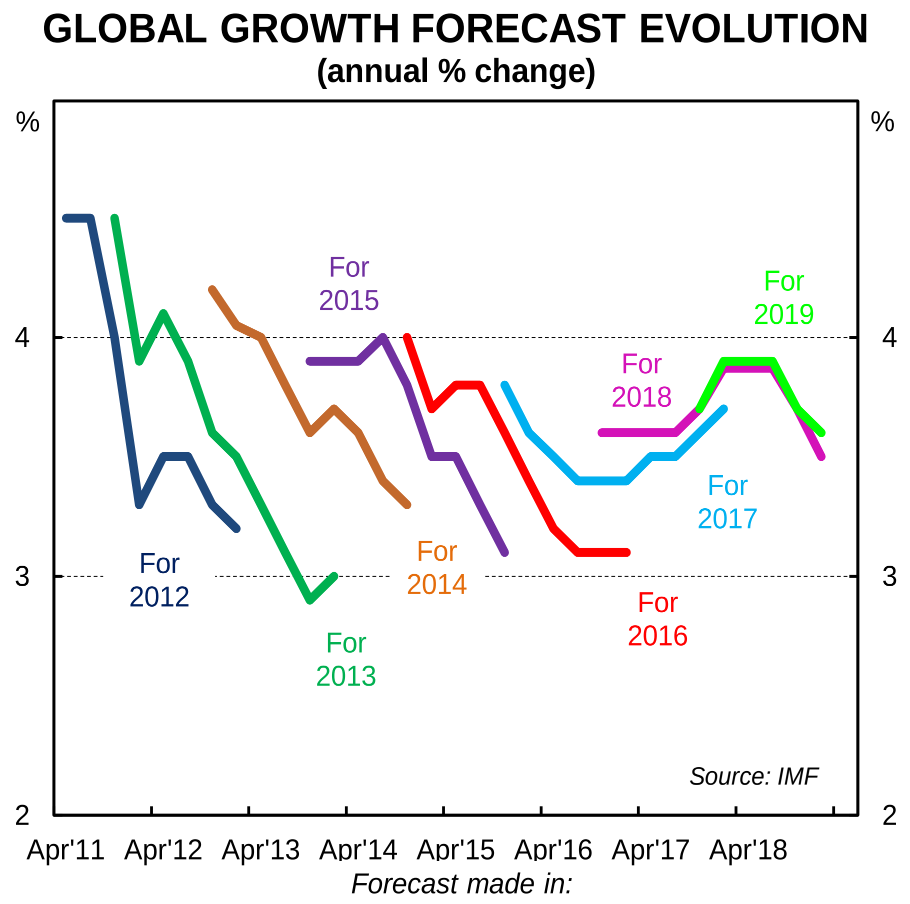
Commonwealth Bank of Australia

Global backdrop



- A synchronised global upturn characterised 2016-17.
- But growth can't accelerate forever – growth more uneven in 2018 and desynchronization to continue in 2019.
- Downside risks to the global outlook include trade war, Brexit, slowing Chinese economy, geopolitical uncertainty and financial market volatility.
- The IMF has global growth running at 3.5%pa in 2019 and 3.6% in 2020 (around the post-financial crisis average).

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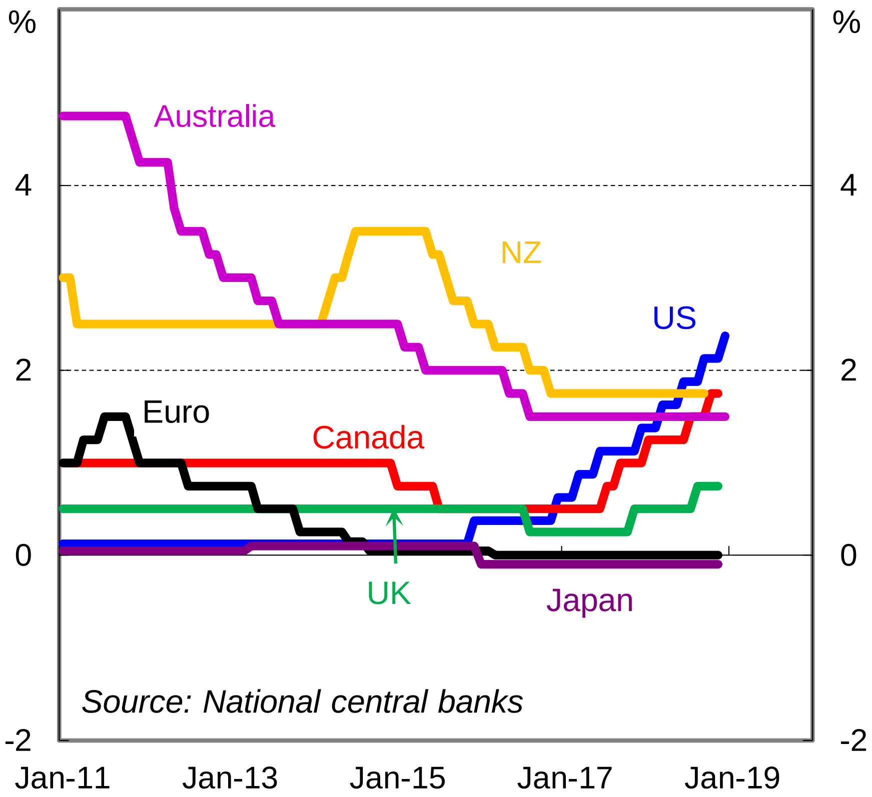
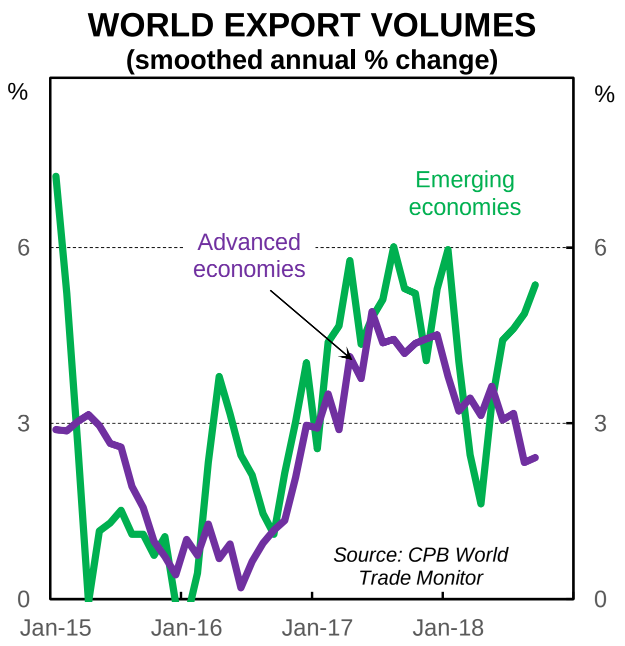
Global backdrop

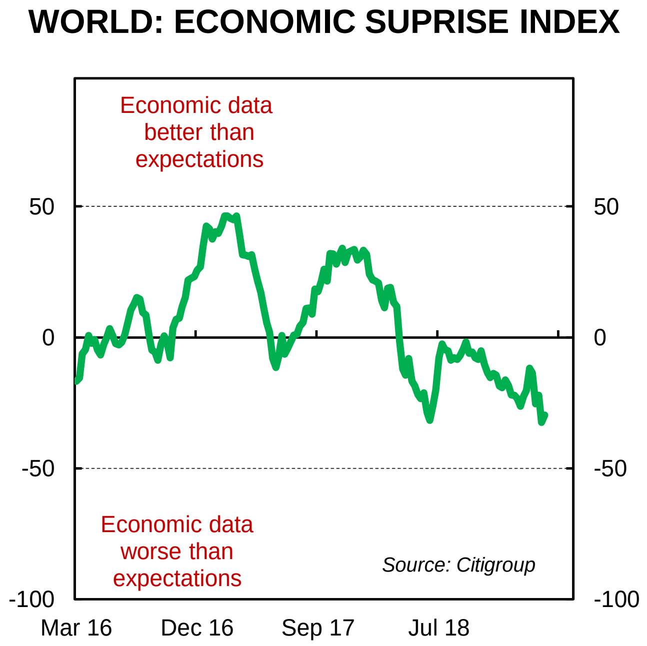
OFFICIAL INTEREST RATES

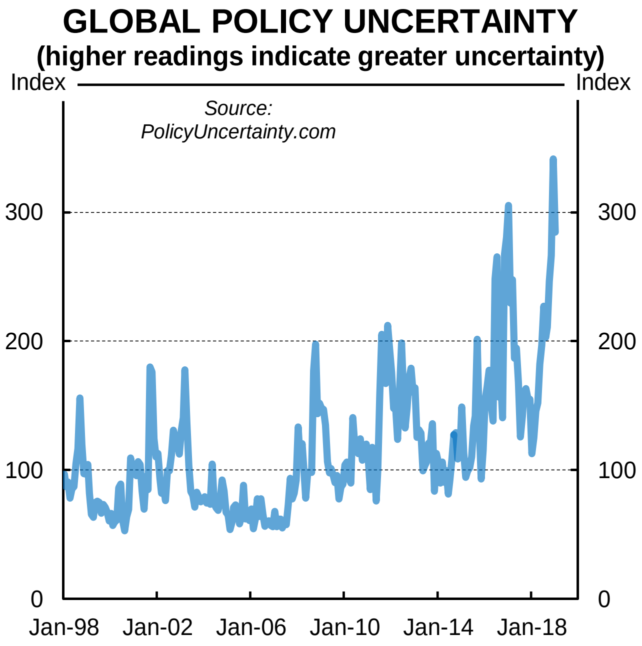


- **Slower global growth, downside risks from political uncertainty and contained inflation should see a year of little action from central banks.**
- **US Fed appears to have finished its tightening cycle.**
- **Other central banks, including ECB, RBNZ, BoE and RBA expected to be on hold for longer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

Global backdrop

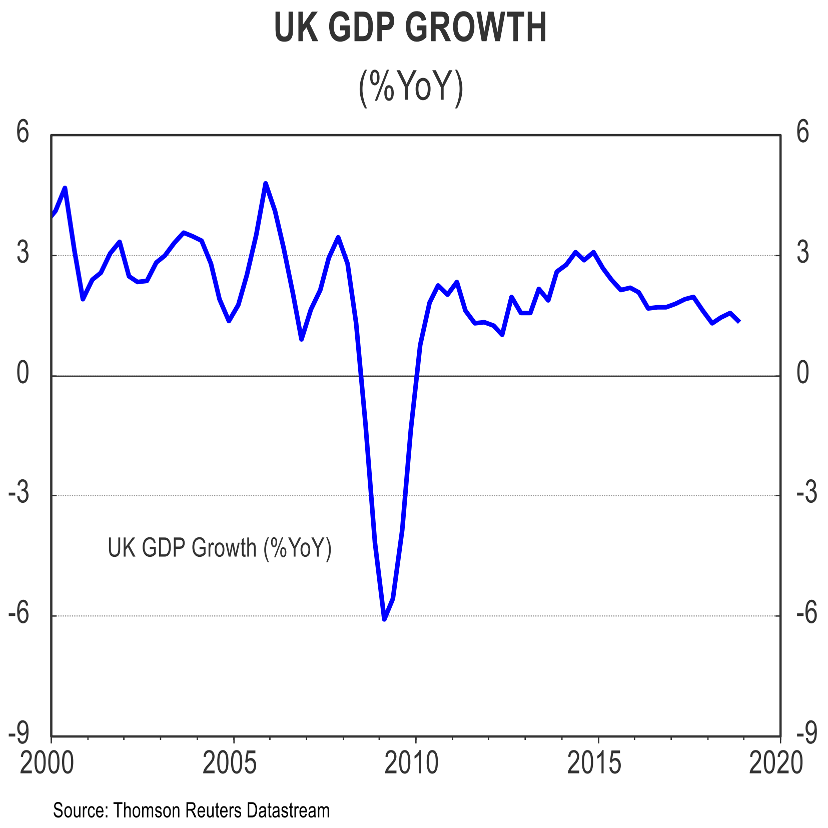


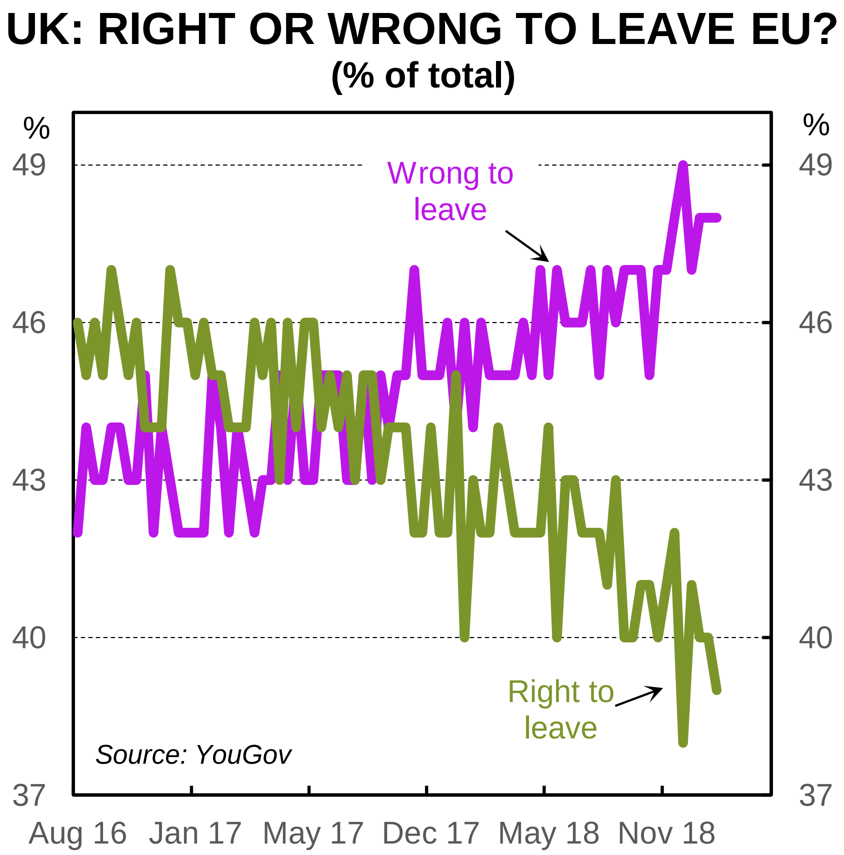




- Divergent trade patterns contribute to the AE and EM divergence.
- But global economic data has disappointed.
- And global policy uncertainty has lifted.

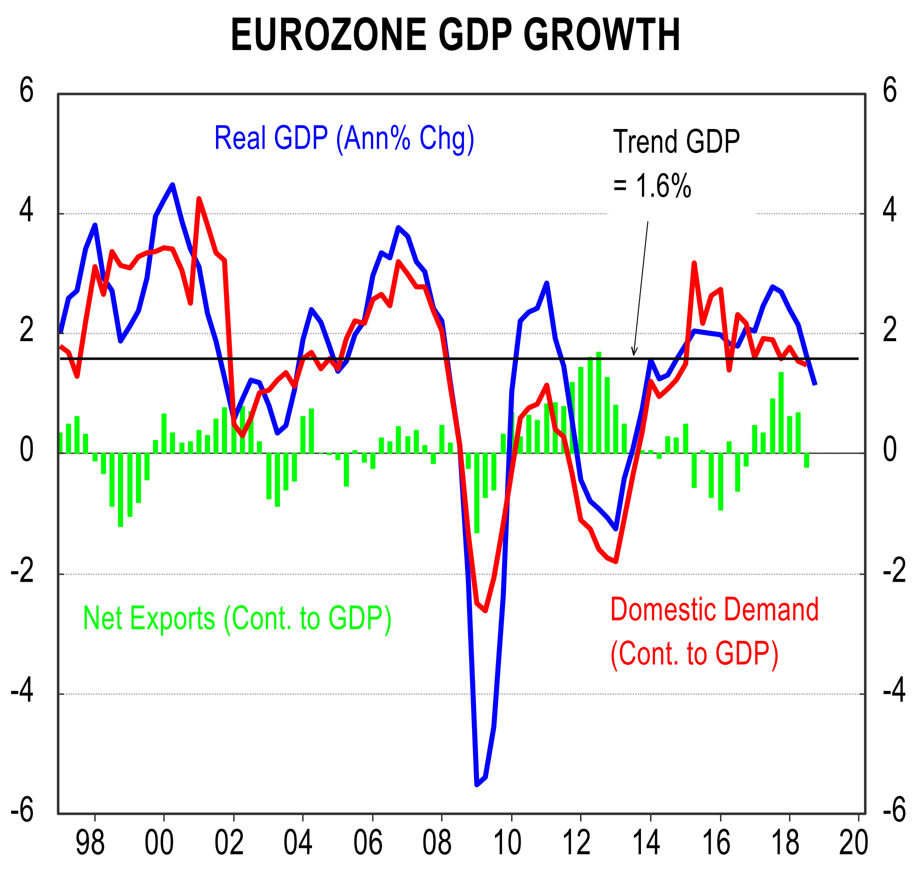
UK: Brexit still dominating





- **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.**

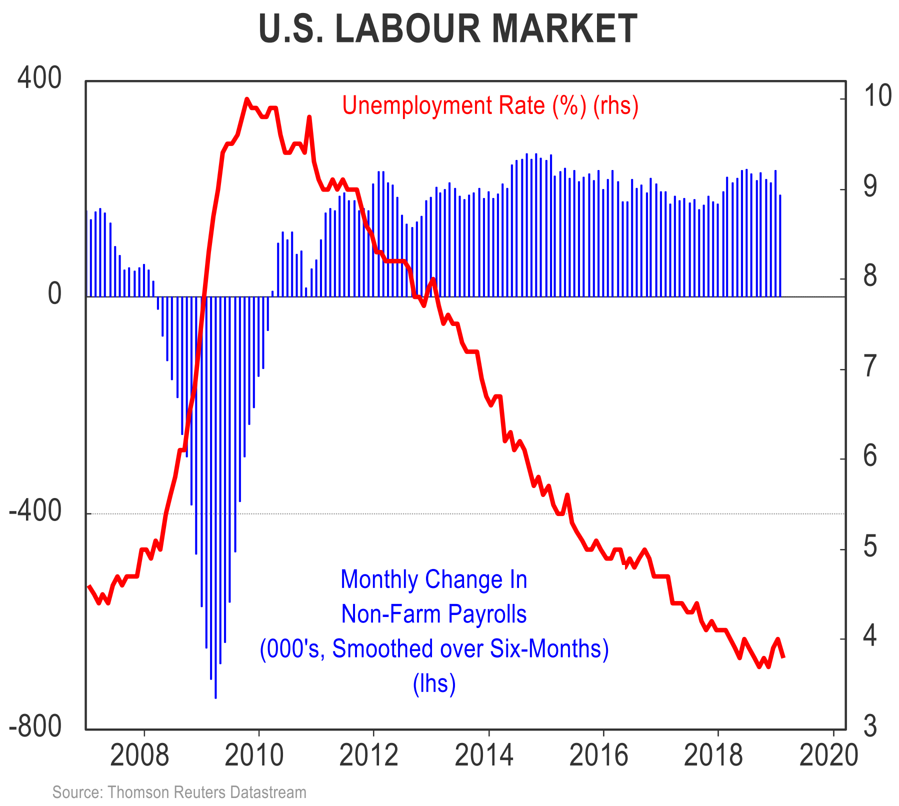
Europe: growth has slowed

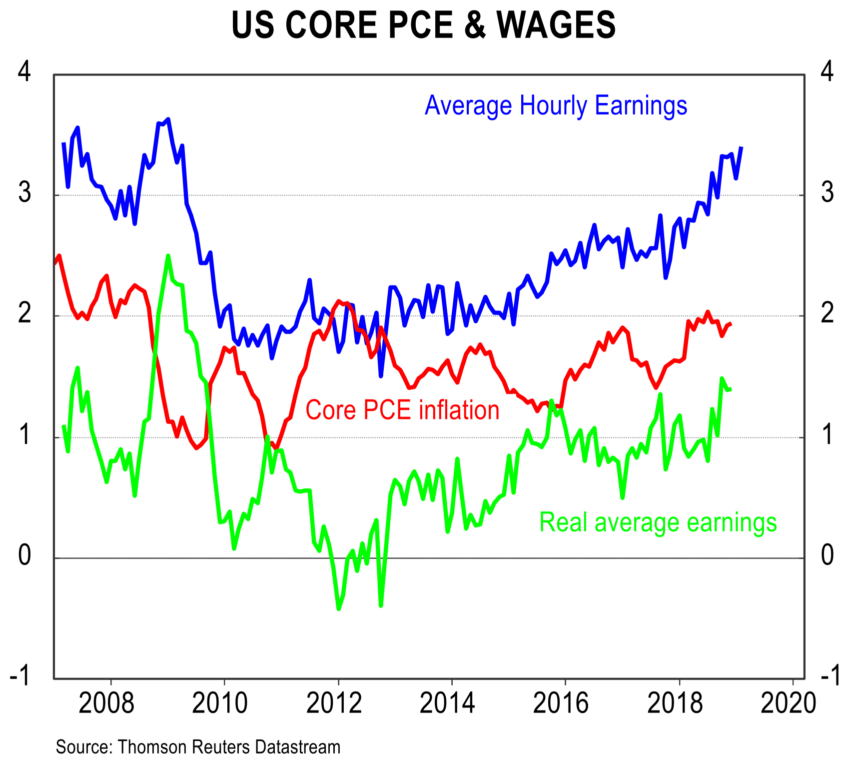


Source: Thomson Reuters Datastream

- **Economic growth in the Eurozone has back to below trend. Slow down has been broad based. New emissions regulations for cars have hurt the German 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.

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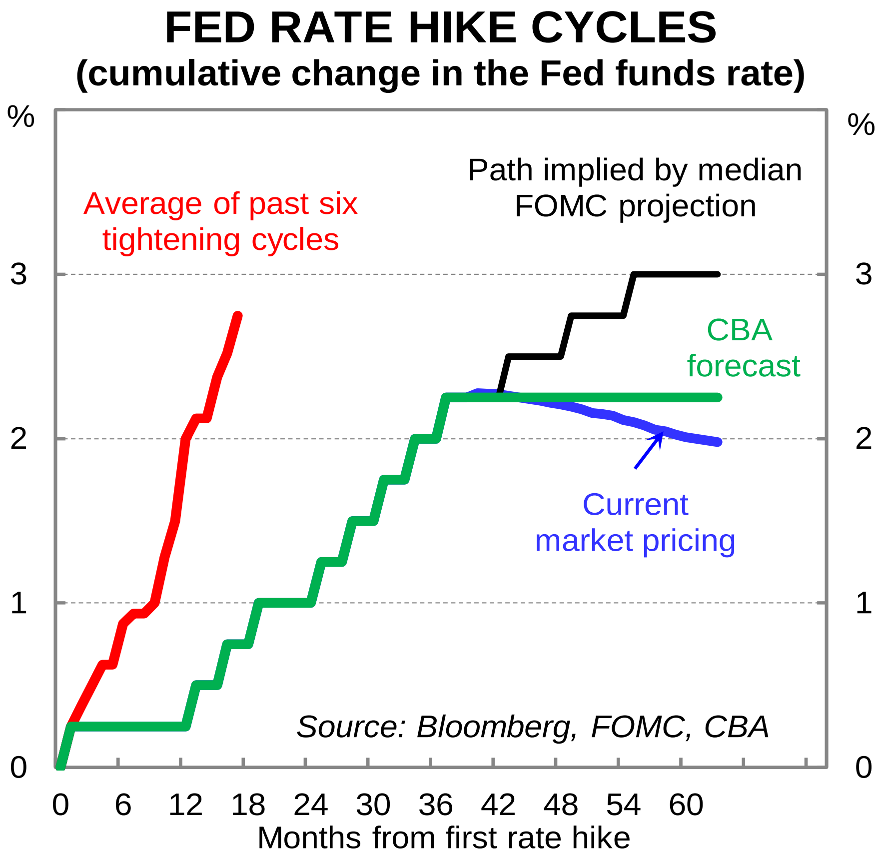
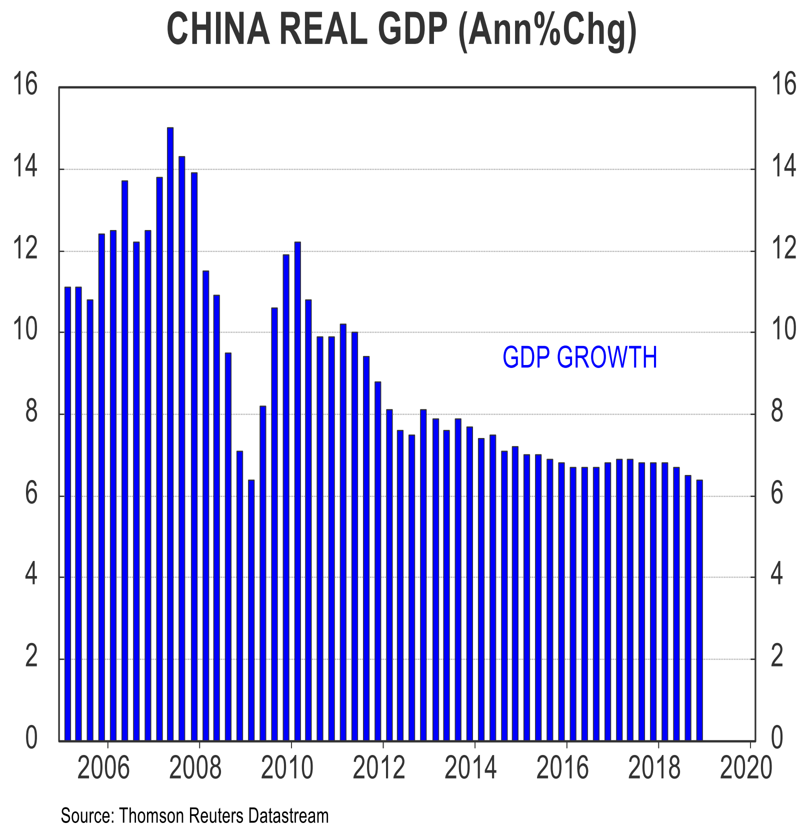
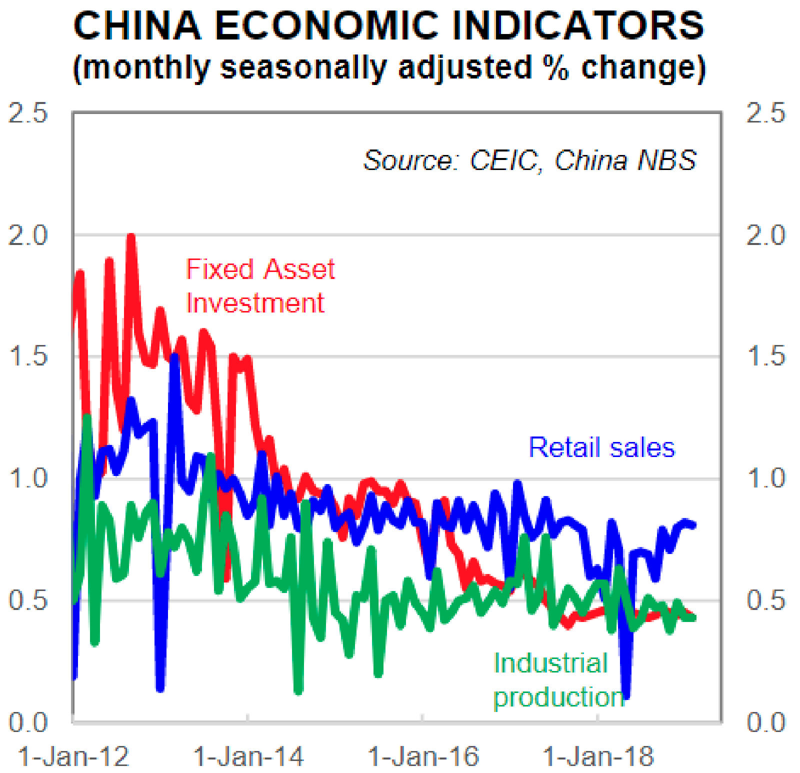
US: Federal Reserve



- **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 in September.

China: growth is slowing





- **China's economy is slowing due to measures to address the shadow banking system and anti-pollution measures.**
- **Policy makers have adopted a supportive stance and fiscal stimulus is expected to support domestic demand.**
- **Growth is running at 6.4%pa. We expect a gradual slowdown to 6.3%pa in 2019.**

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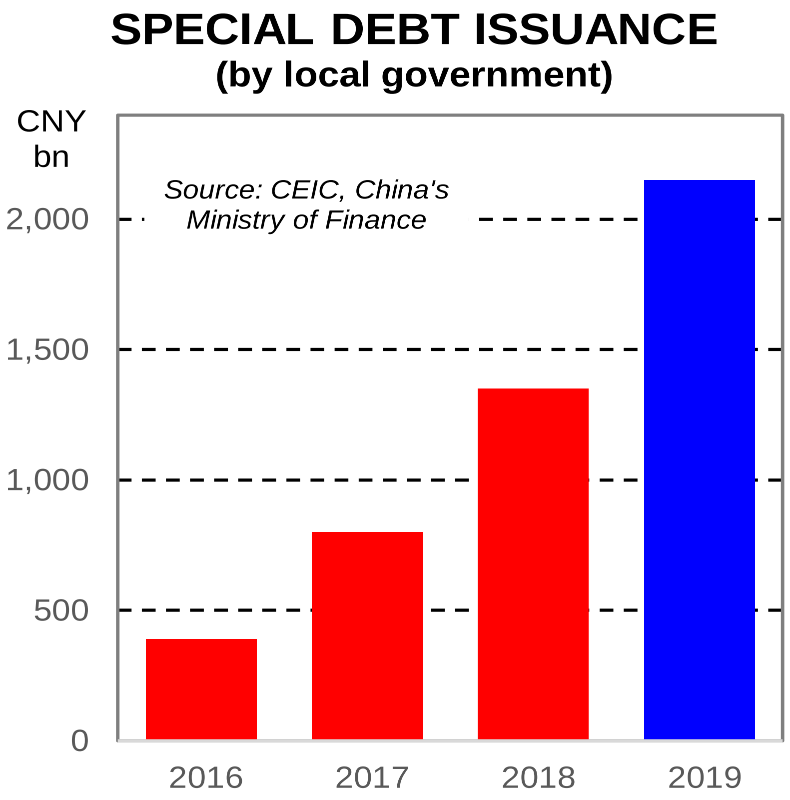
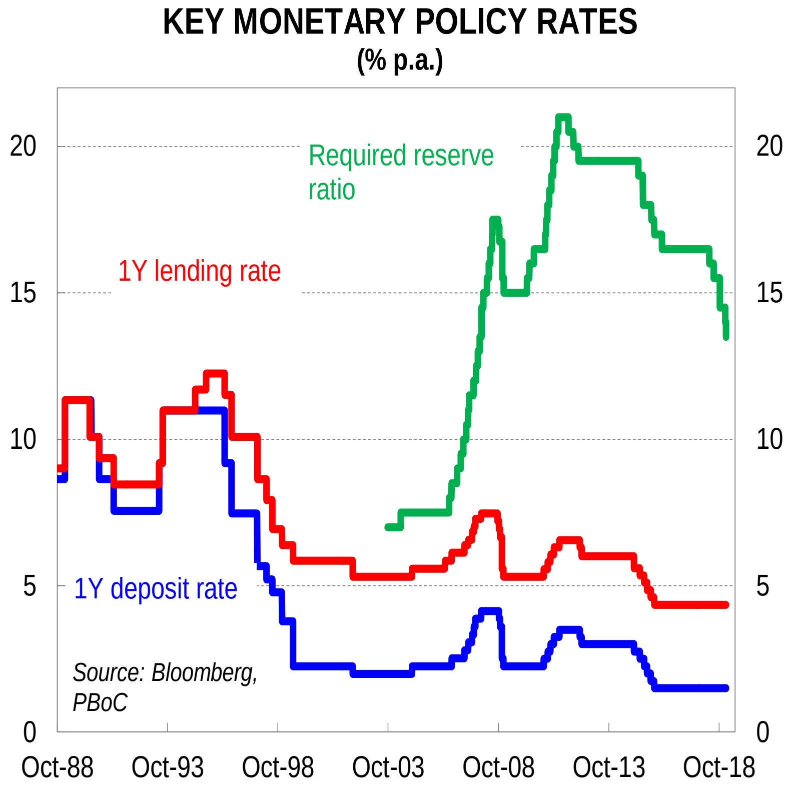
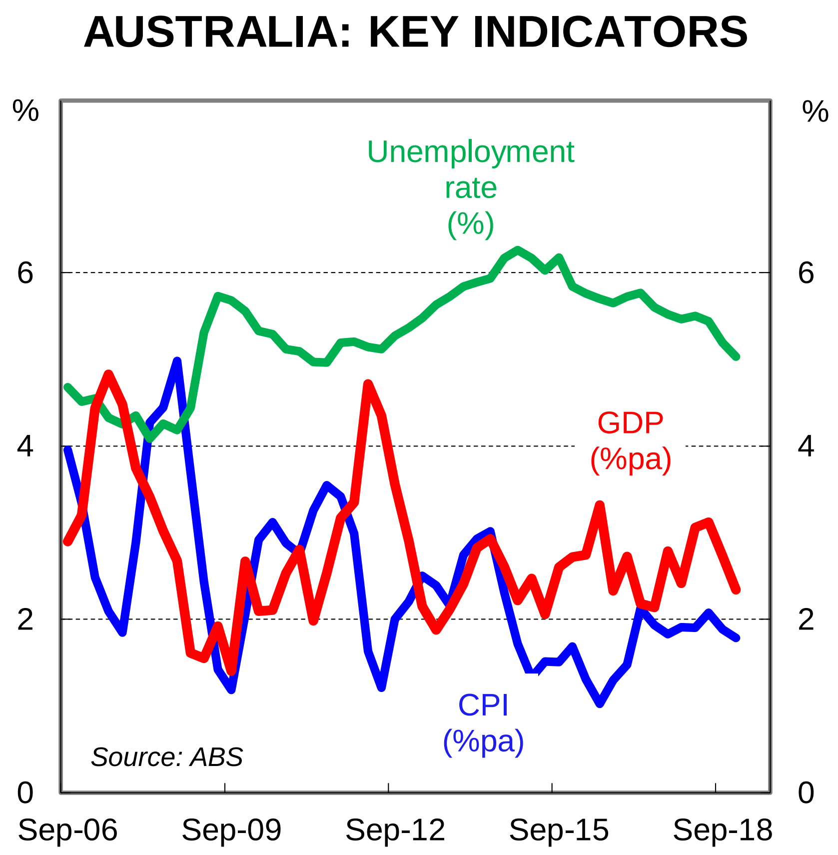
China: more policy support





- **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.**

Australia In 2018



- The expansion is in its 28th year – the last real recession was in 1990/91.
- The economy grew at a trend-like 2¾%.
- The economy was strong enough to drive solid jobs growth and the unemployment rate at year end was at the 5% level equated with "full employment".
- There was a hint of a turn in the wages story but inflation rates remained low.
- Commodity prices held up and incomes rose. The distribution of this income remained skewed towards profits and taxes. Households missed out again.
- A shrinking budget deficit and widening trade surplus saw Australia's AAA rating affirmed.

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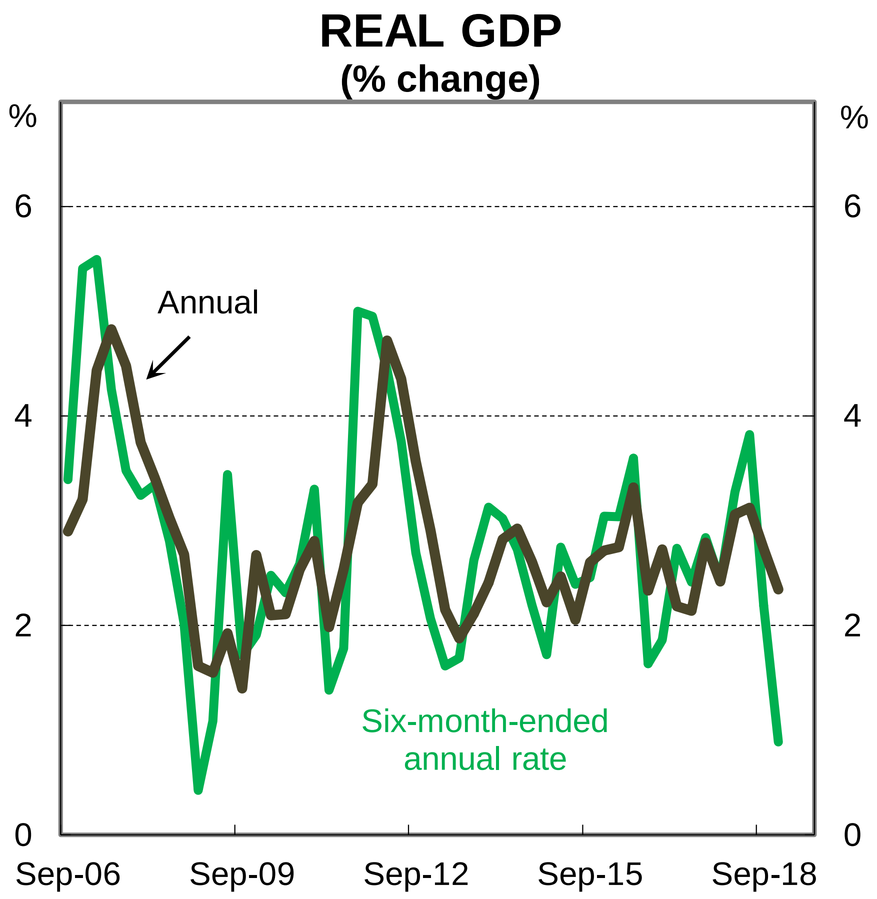
Australian GDP growth



- **Both Q3 and Q4 2018 GDP growth were soft.**
- **The slow down was driven by weak growth in consumer spending, the downturn in resi construction and the ongoing effects of the drought.**

A strange "recession"

Key Data: H1 vs H2 2018

(%change, annualised rate)

Source: ABS	**H1 2018**	**H2 2018**
Real GDP	3.8	0.9
Employment	2.1	2.5
Personal income tax	10.0	9.3
Unemployment rate (%)	5.5	5.1
GDP per capita	2.1	-0.7
Real net national disposable income per capita	2.9	1.3
Terms-of-trade	4.0	8.2
Average earnings	1.4	2.1
Domestic final demand deflator	1.6	2.4

- **The slowdown in GDP growth in H2 sits at odds with a range of other economic data.**
- **RBA Governor Lowe in a recent speech focussed on the "growing tension between strong labour market data and softer GDP data".**
- **The preference should be for the labour market data:**
  - Growth in employment-related taxes such as PAYG and payroll tax are running at the high end of the range of the past five years.

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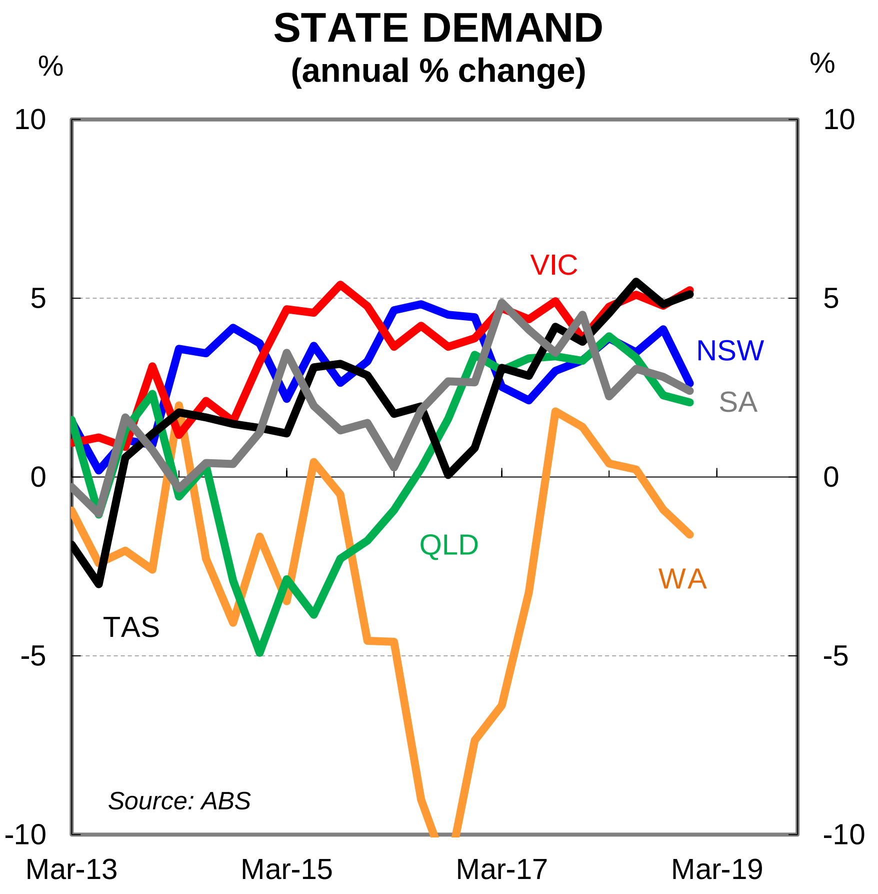
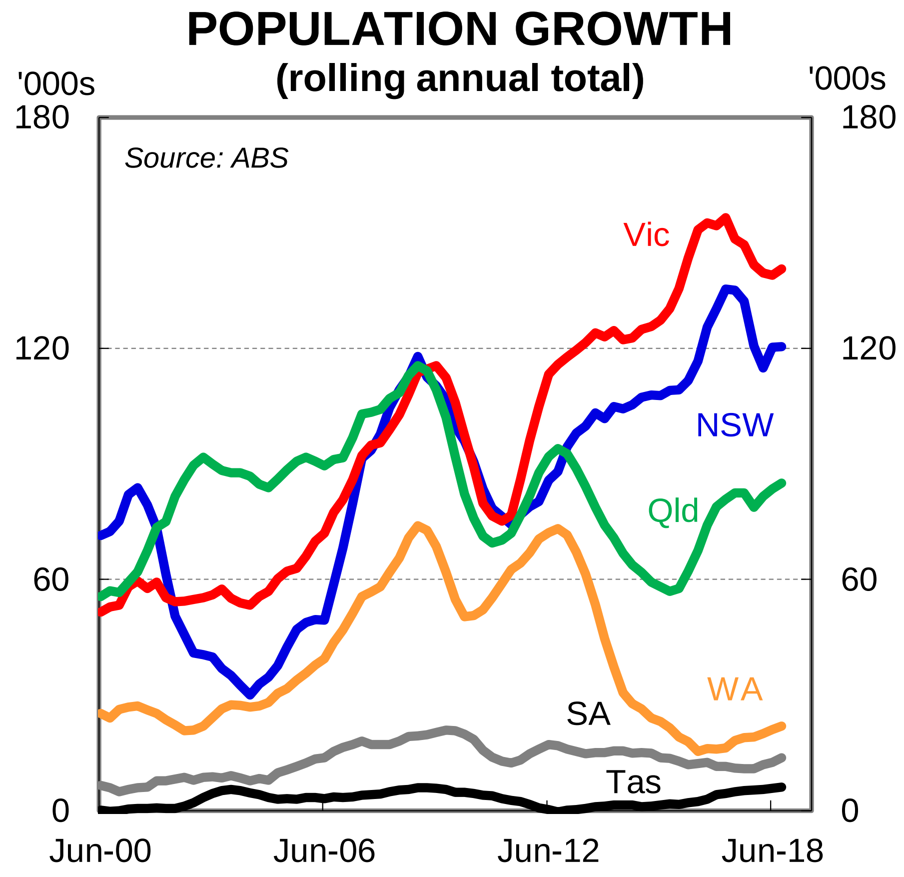
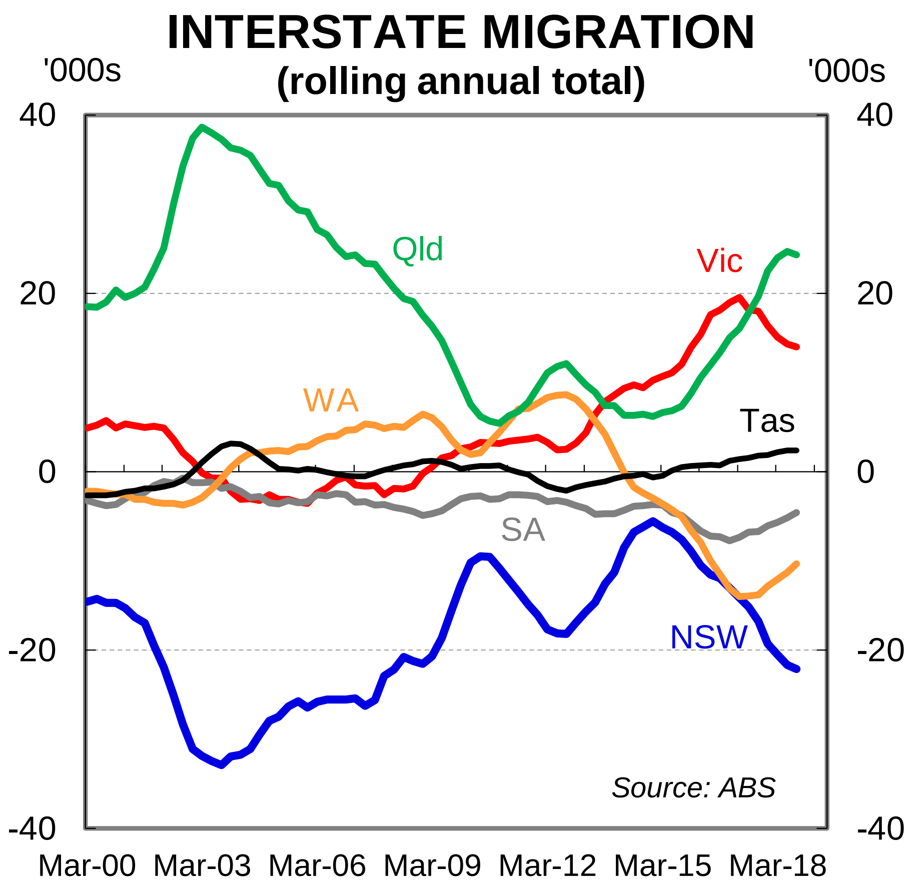
State trends



- Victoria and Tasmania are the strongest performers.
- Strong population growth a key driver.
- NSW has slowed on soft consumer spending and a fall in resi construction.
- WA still weak.

Population growth

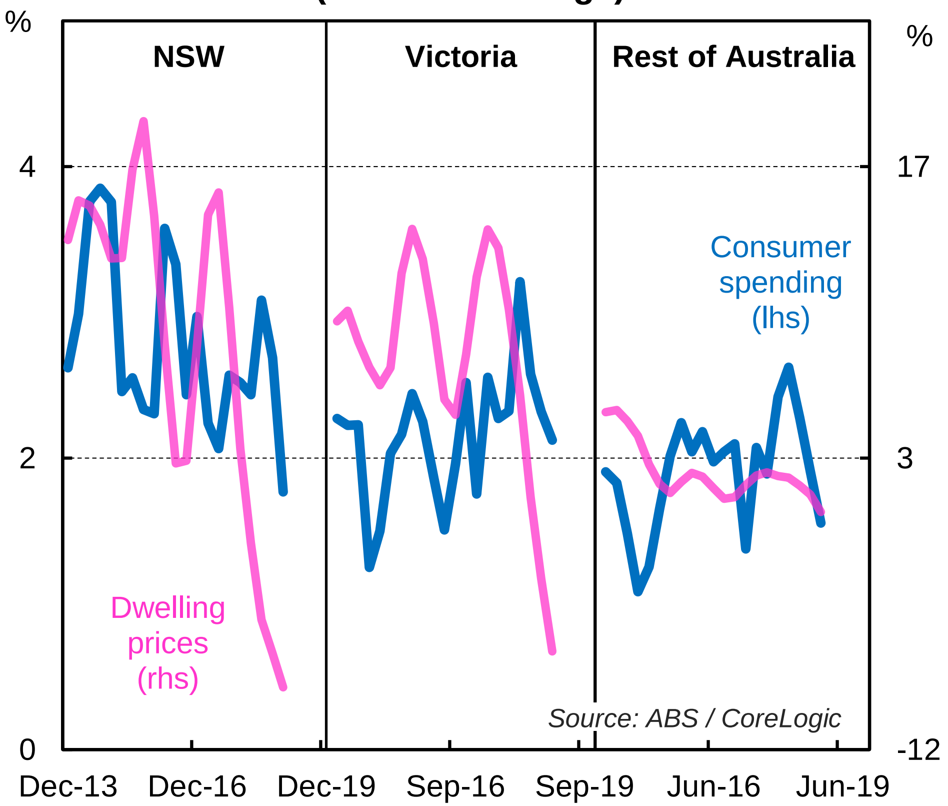




- **Population growth is strongest in Victoria.**
- **Population growth lifting in QLD driven by both overseas migration and net interstate migration.**

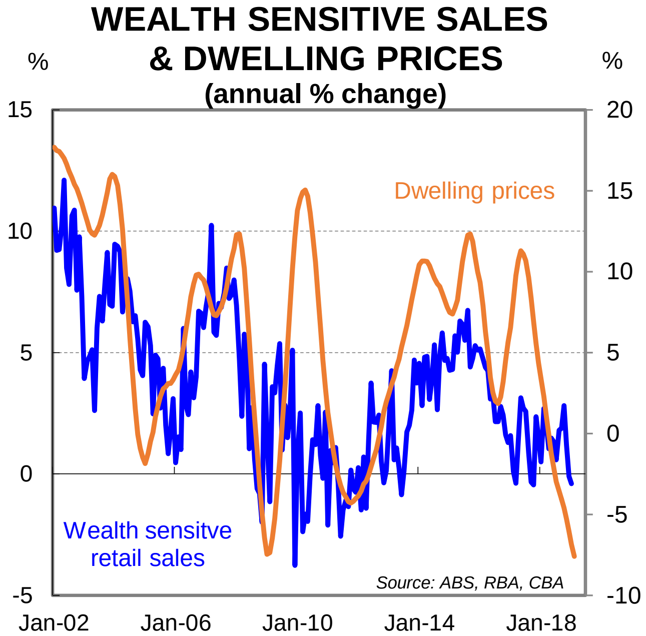
State trends

CONSUMER SPENDING & HOUSE PRICES
(annual % change)

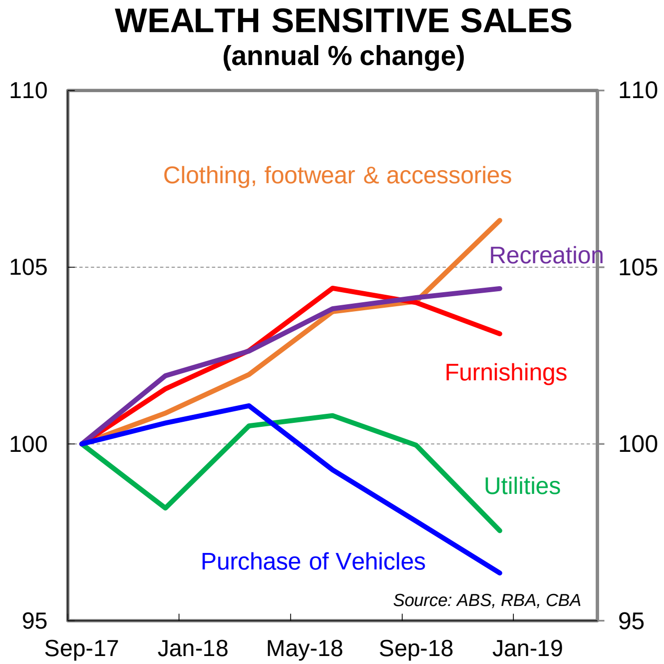


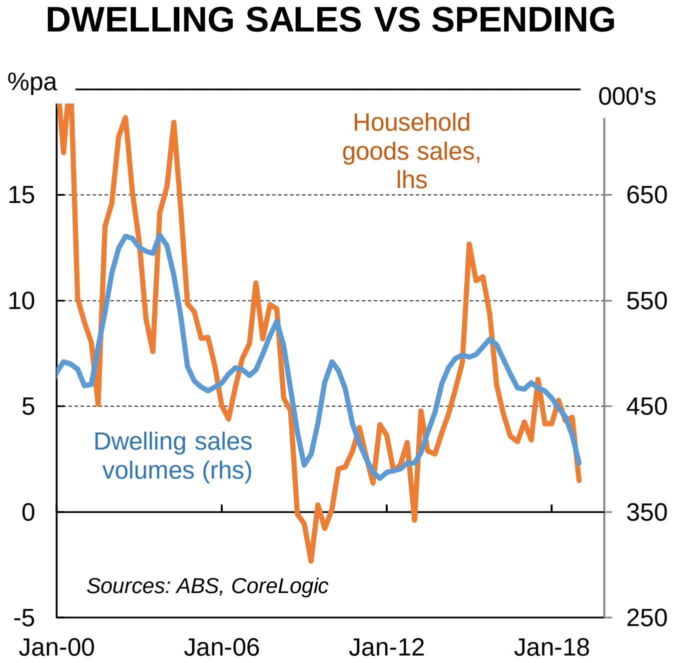
- Consumer spending is slowing across the board.
- Part of this due to the dwelling price falls with NSW showing the clearest sign of slowing.
- Victoria is seeing less signs of a slowdown, helped both by stronger population growth and a later start to the falls in dwelling prices.
- Slow income growth remains a large part of the story with states including Queensland also seeing weaker consumption despite dwelling prices remaining in positive territory.

Household sector



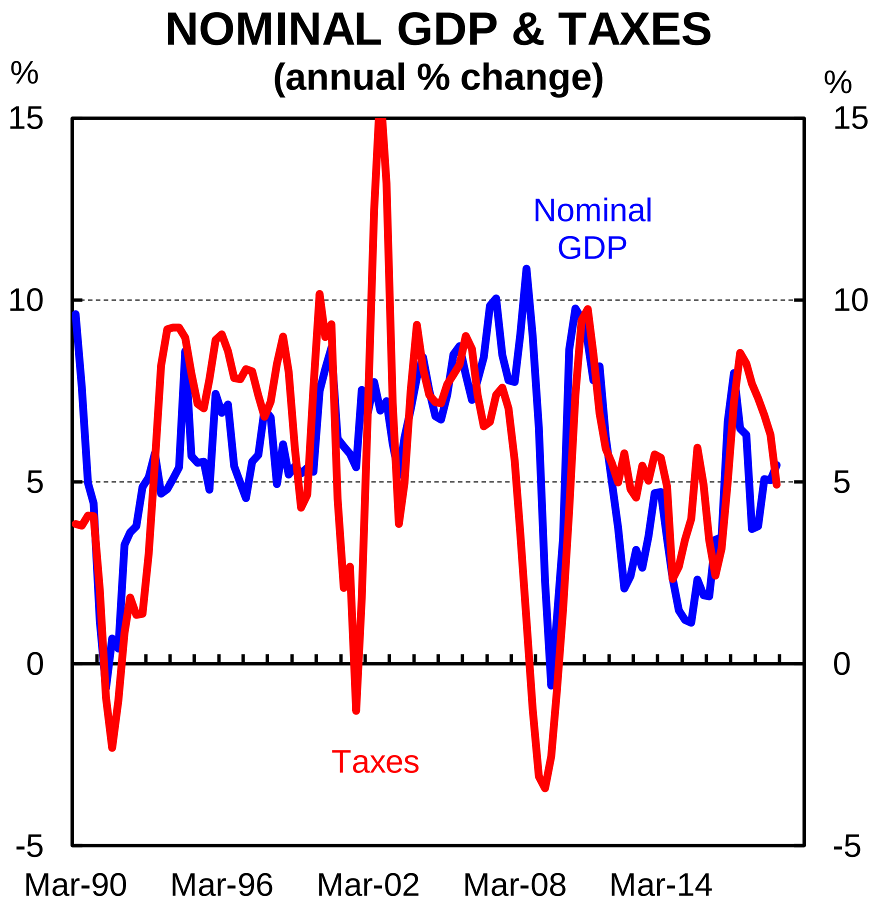
Wealth sensitive Dept stores, Clothing, household goods, newspapers, books and other recreation



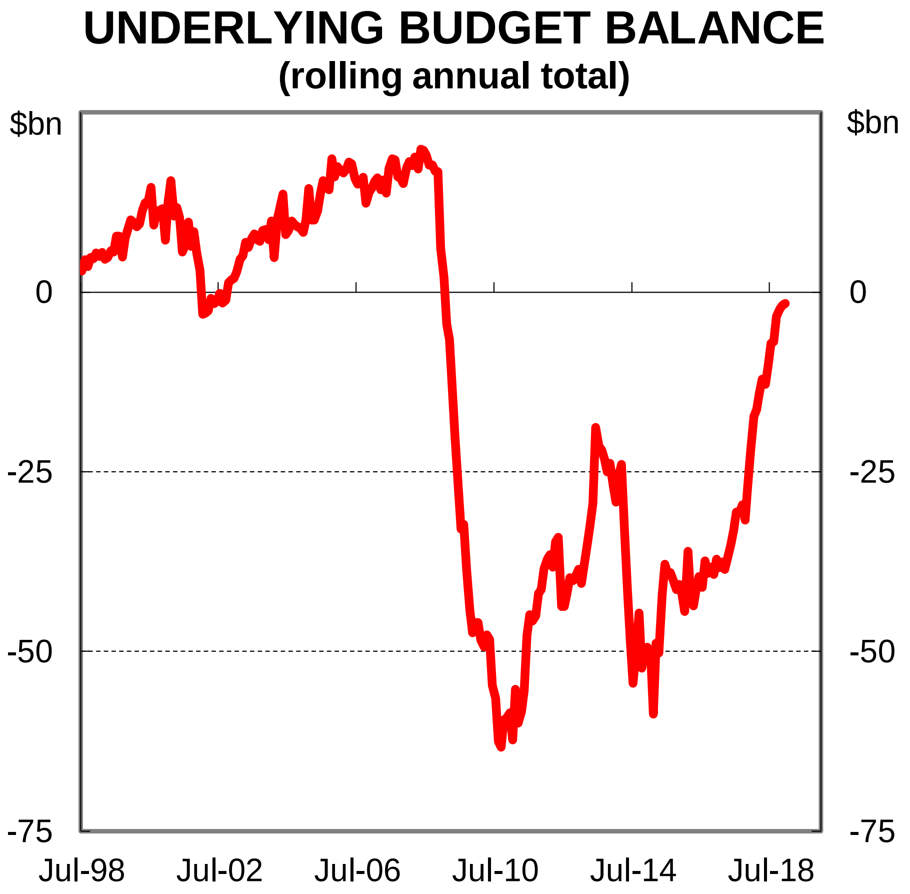


- Some evidence of “wealth” effects.
- Motor vehicles and utilities impacted the most.
- Lower dwelling sales volumes impact on spending.

The budget

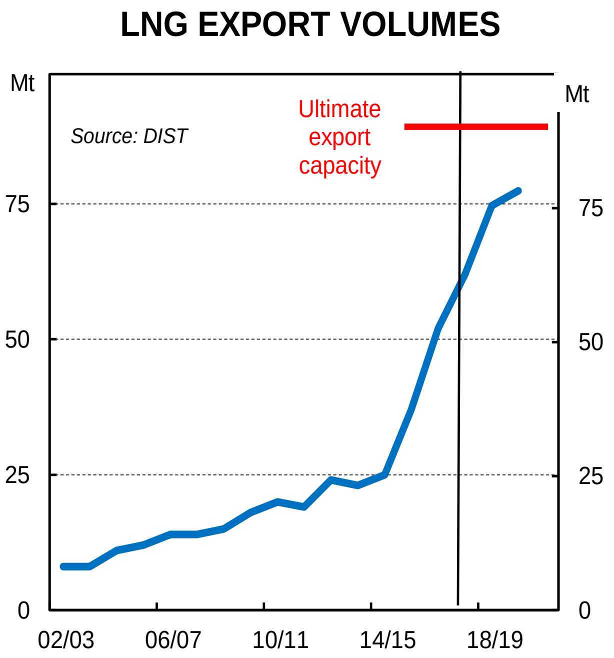


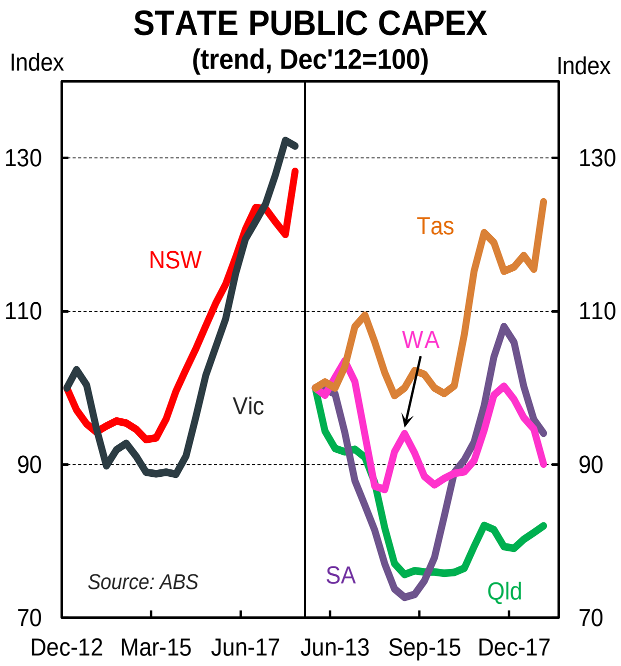
NOMINAL GDP & TAXES
(annual % change)
%
%
15
10
5
0
-5
15
10
5
0
-5
Nominal
GDP
Taxes
Mar-90
Mar-96
Mar-02
Mar-08
Mar-14

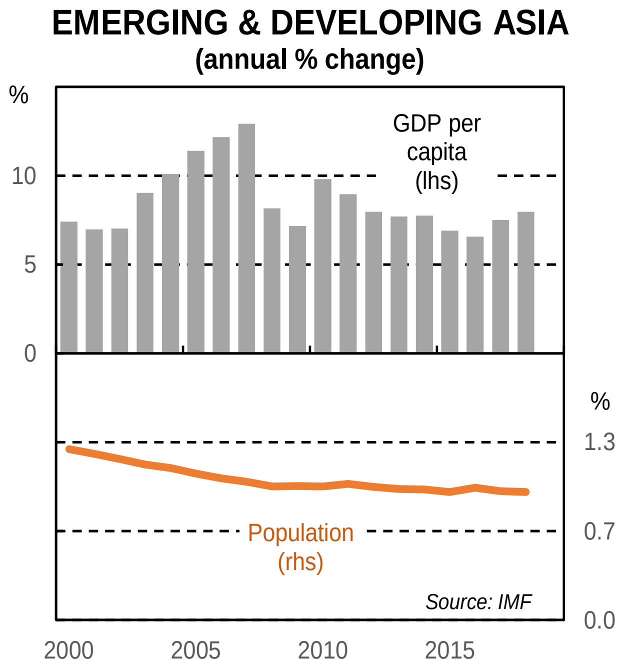


UNDERLYING BUDGET BALANCE
(rolling annual total)
$bn
$bn
0
-25
-50
-75
0
-25
-50
-75
Jul-98
Jul-02
Jul-06
Jul-10
Jul-14
Jul-18

Growth drivers for 2019

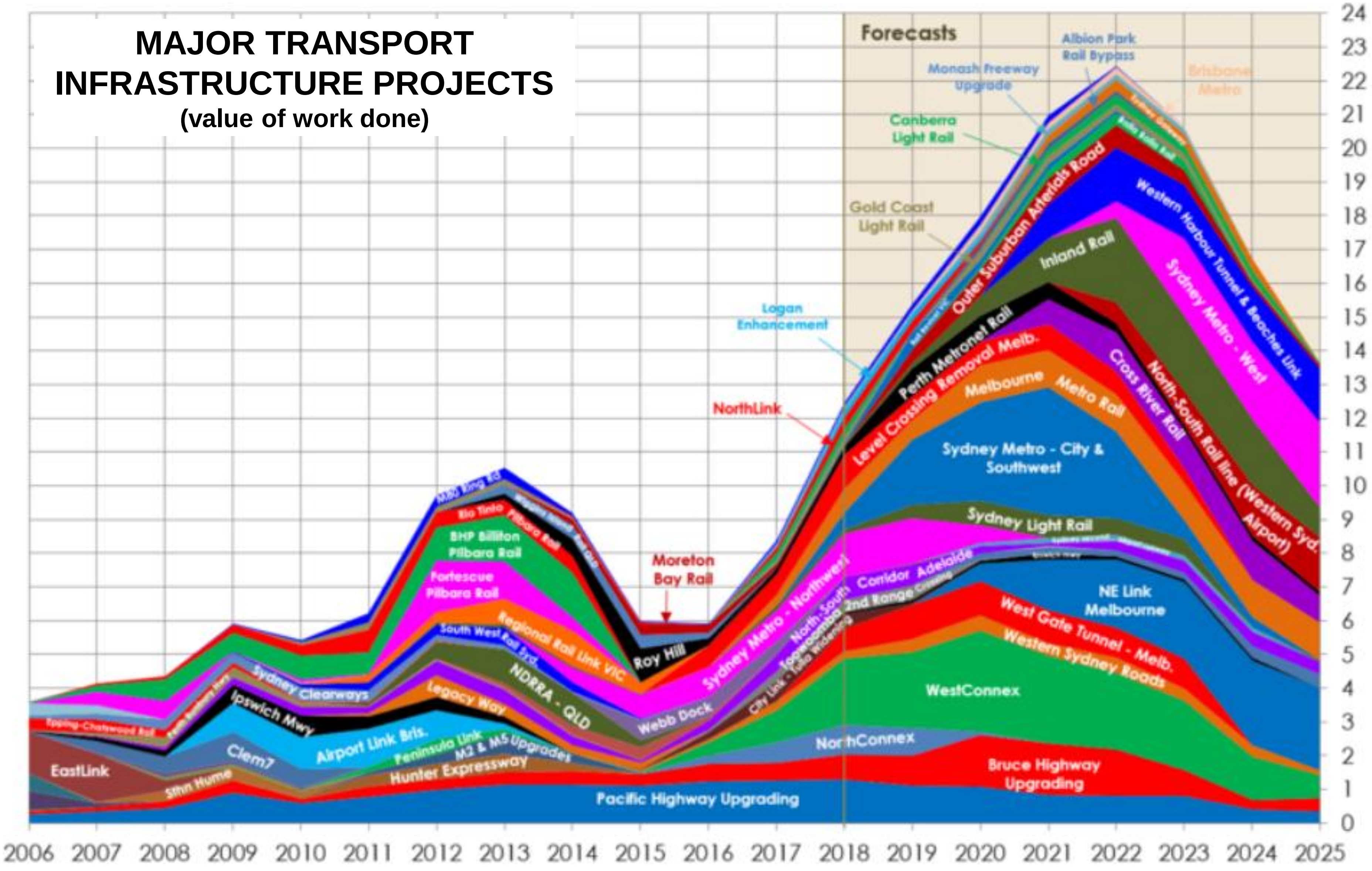




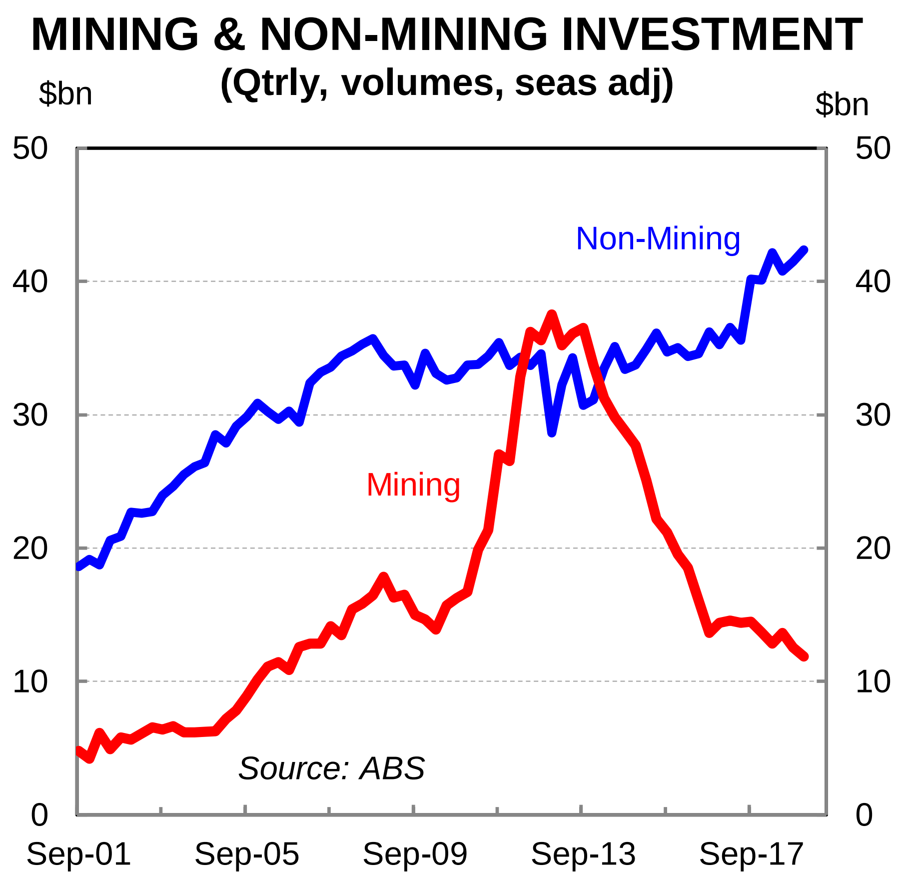


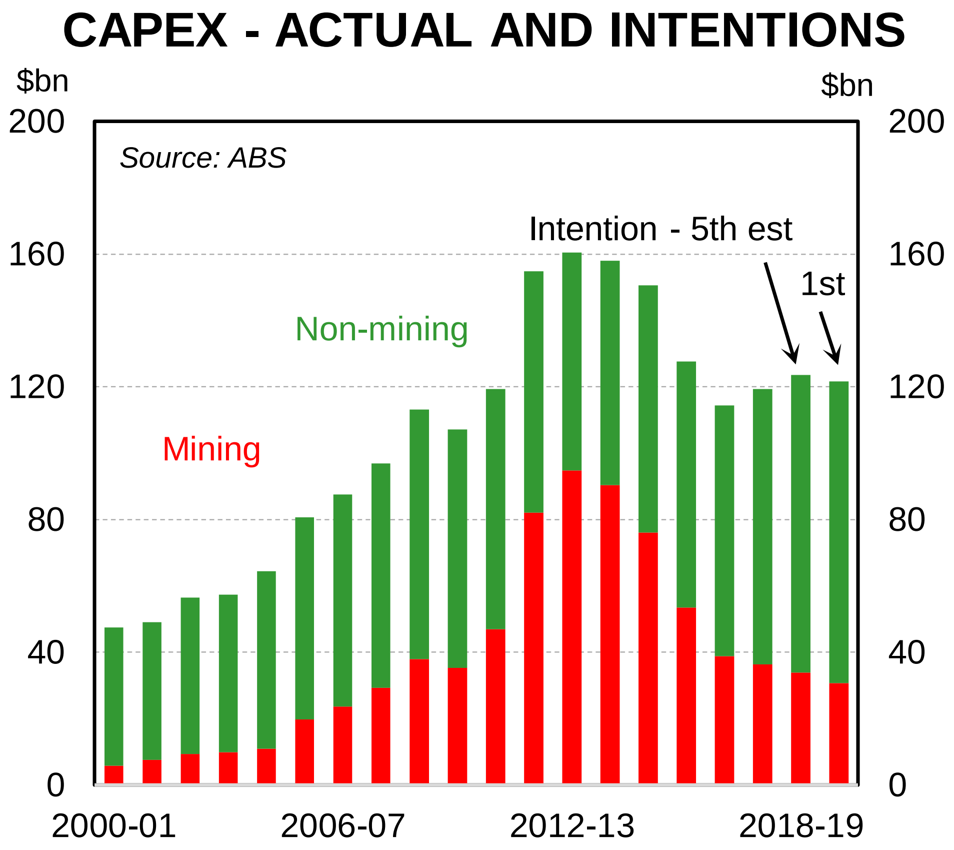
- **Commodity exports, public infrastructure spending and the flow on effects from the Asian income expansion will lift growth in the years ahead.**

Infrastructure



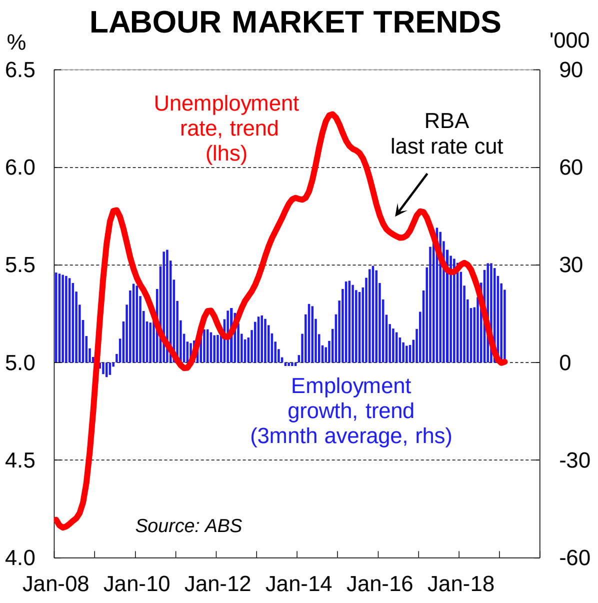
Business investment

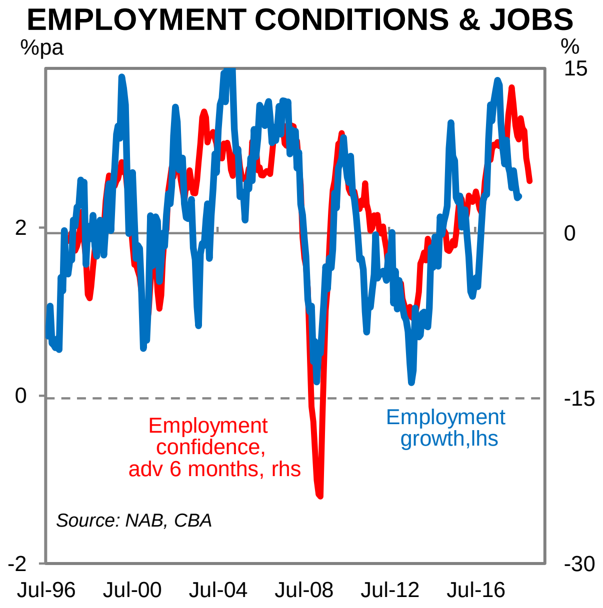


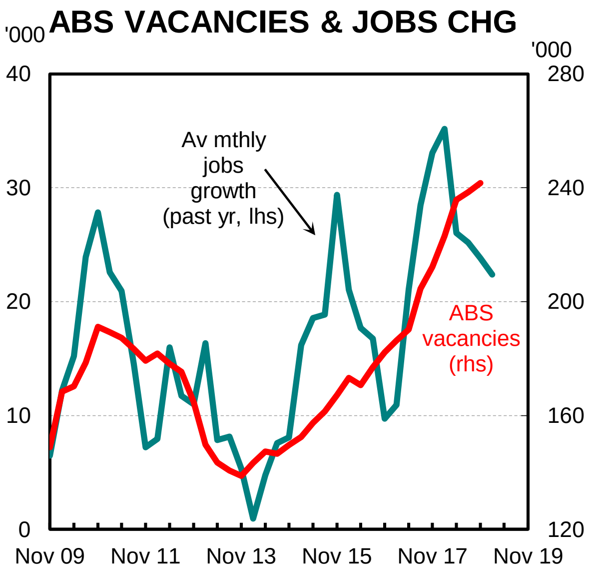


- **Non-mining capex has picked up.**
- **The ABS capex shows non-mining firms expect to lift capex spending by around 8% in 2018/19. And a little further in 2019/20.**
- **Mining capex to lift from 2019/20.**

Labour market

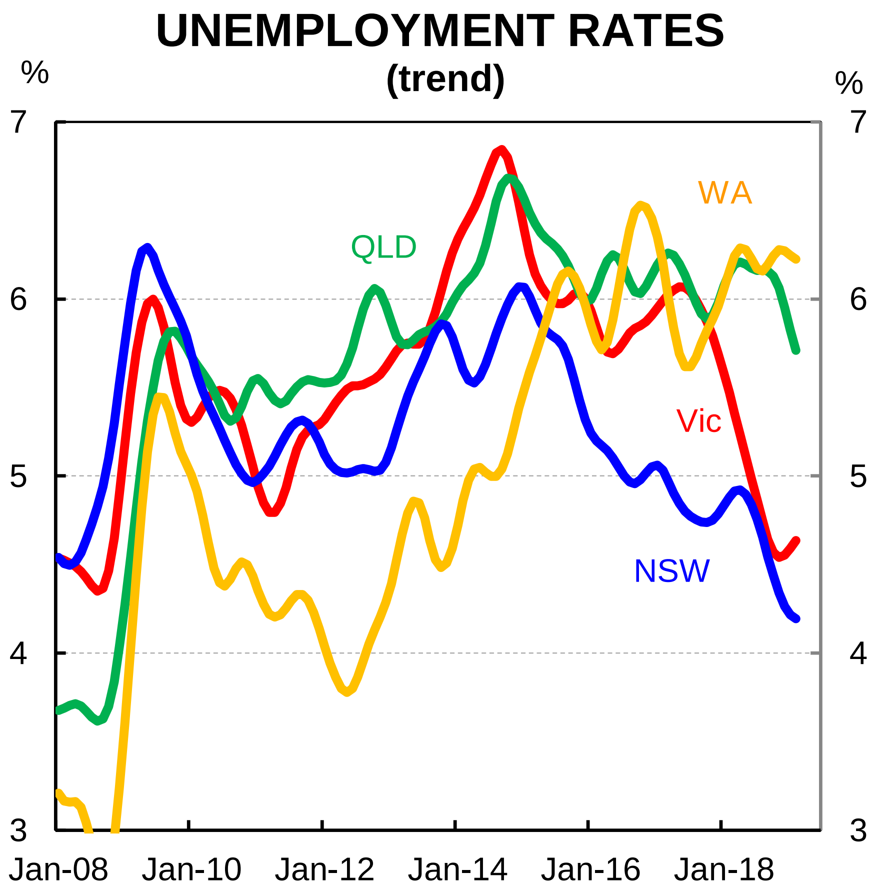


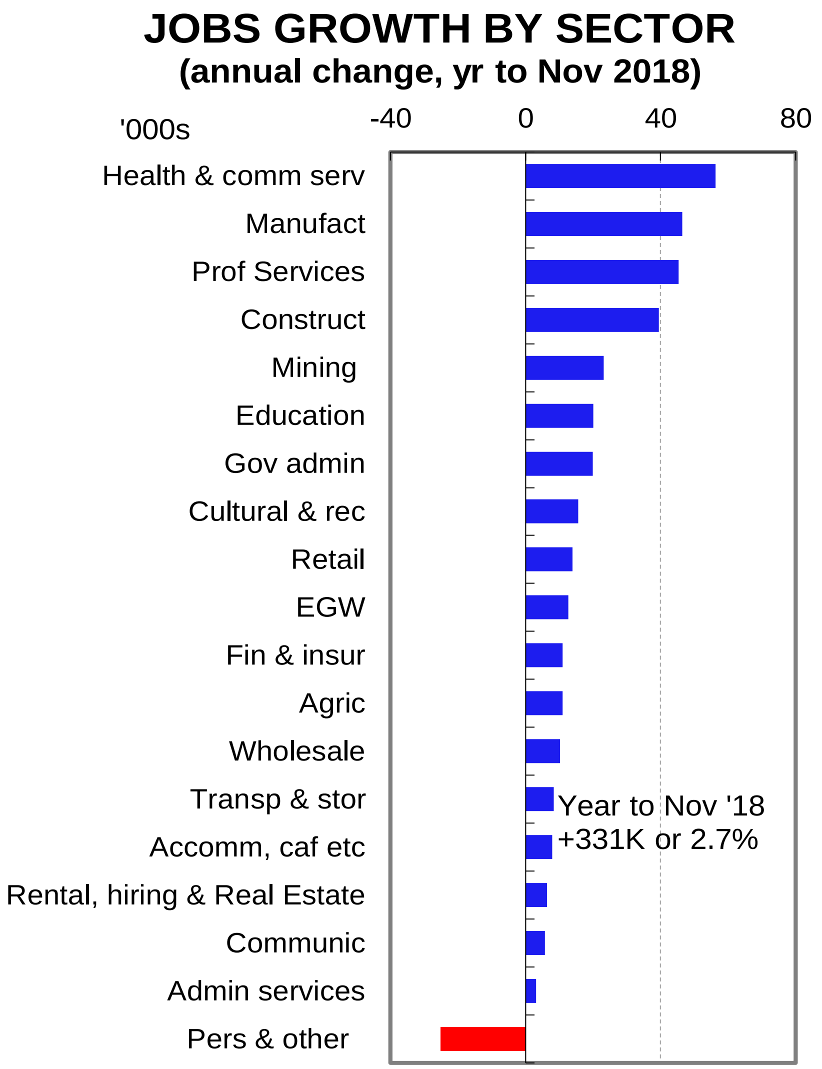




- **Jobs growth has been solid.**
- **Leading indicators have pulled back but still point to decent jobs growth ahead.**

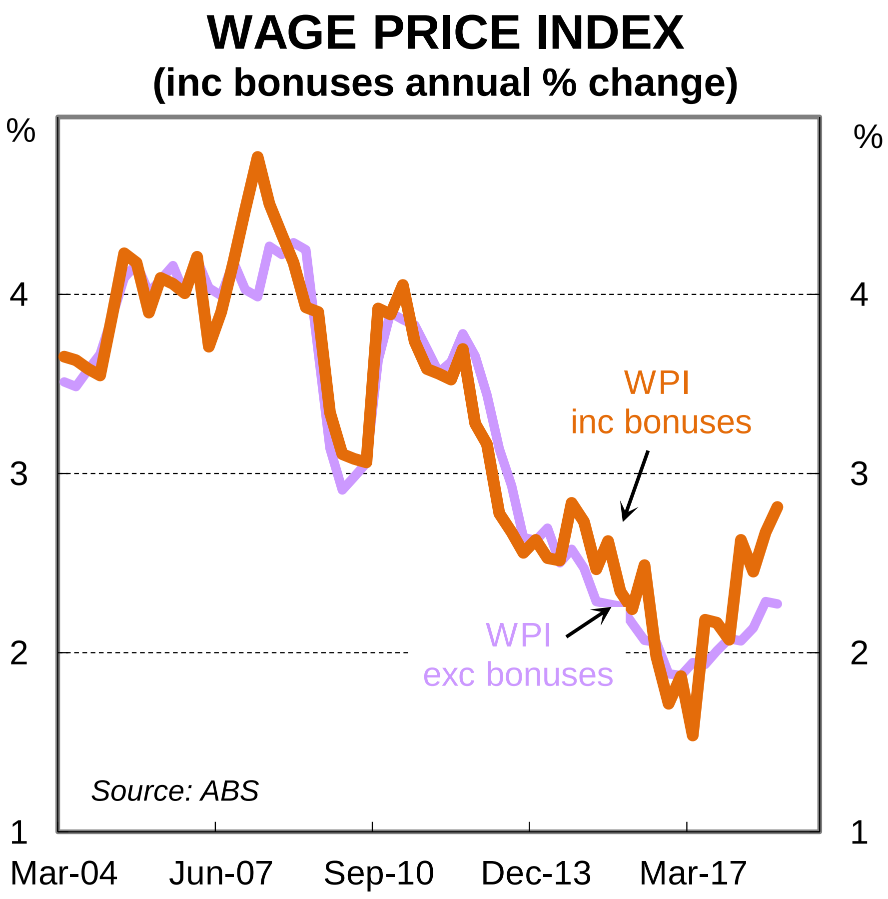
Labour market

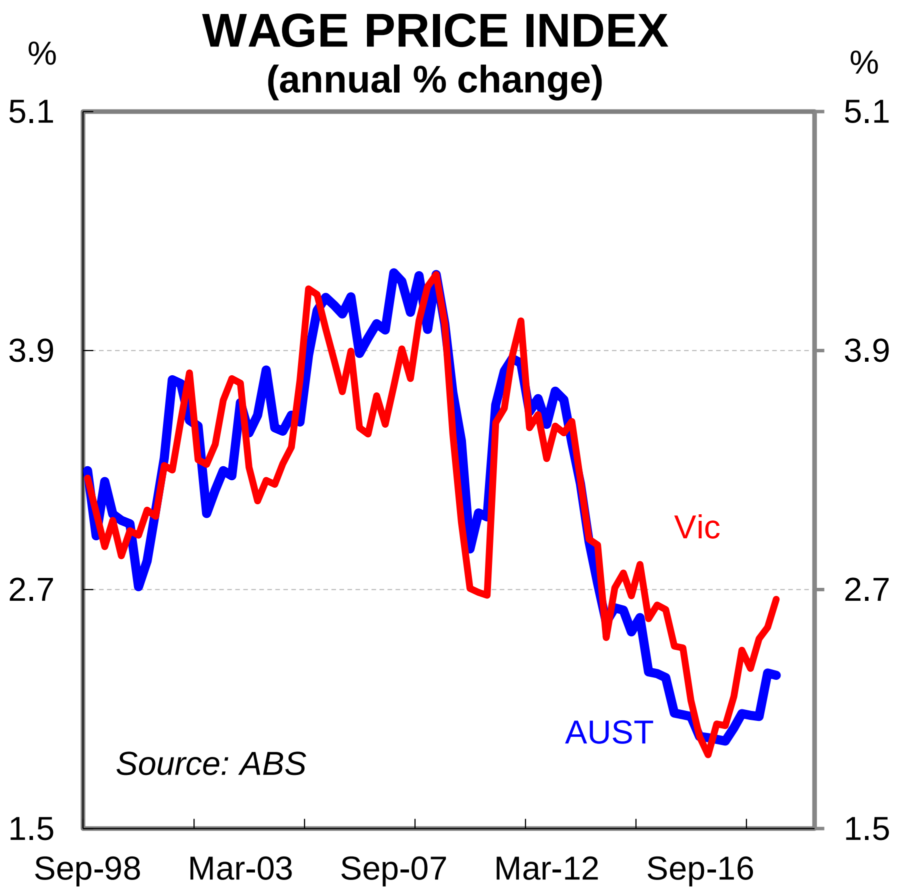




- NSW and Victoria have the strongest jobs markets.

Wages growth





- **RBA business liaison is pointing to stronger wage pressures.**
- **Bonuses have lifted.**
- **Vic has the strongest jobs growth.**

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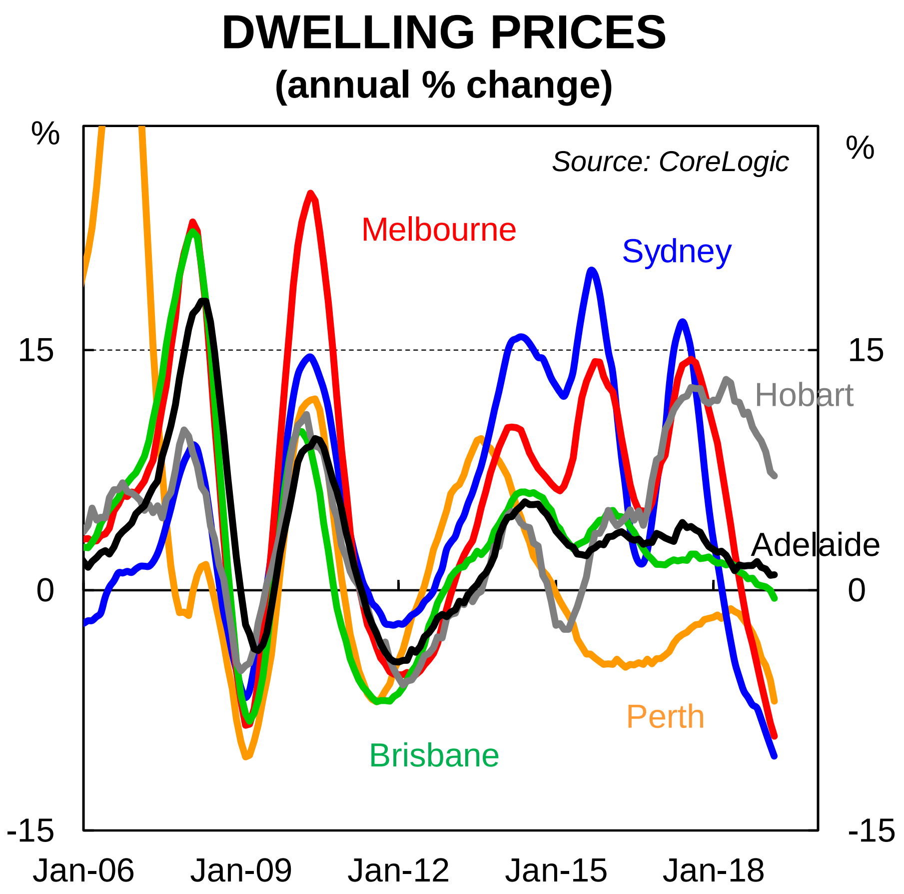
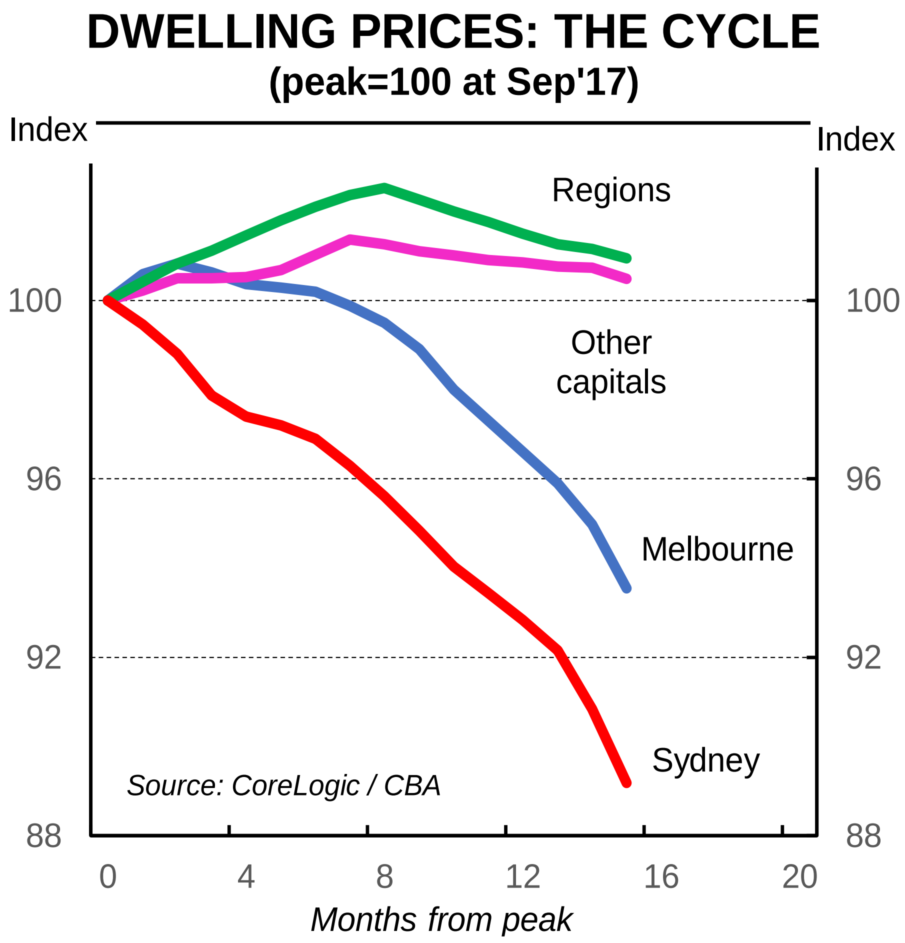
Dwelling prices



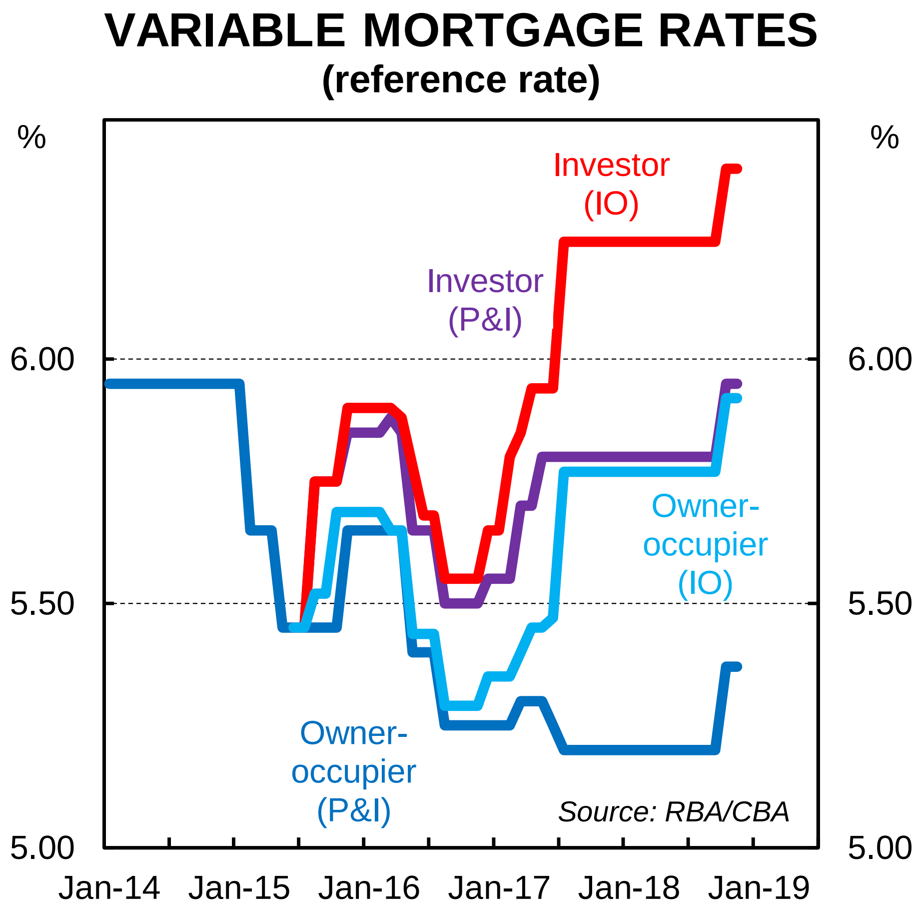


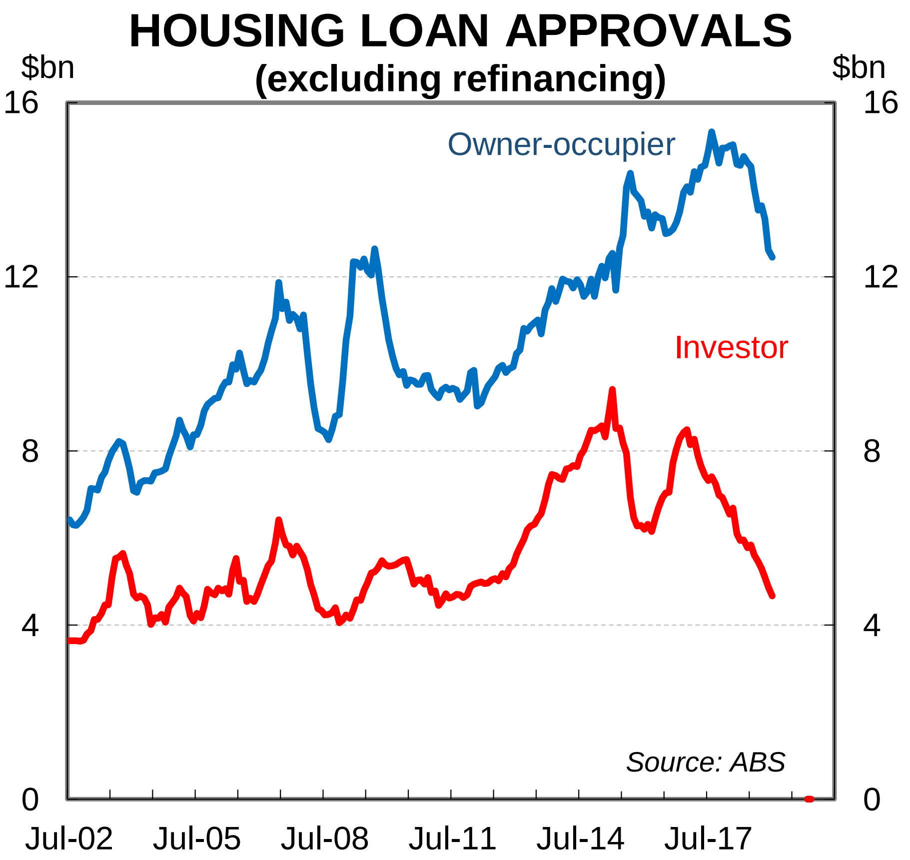
- **Dwelling prices are down through the year in Sydney, Melbourne and Perth.**

CBA Dwelling Price Forecasts

	Sydney	Melbourne	Brisbane	Adelaide	Perth	Hobart	Darwin	Canberra	8 Capital cities
% ann chg to Dec 2018 (a)	-8.9	-7.0	0.2	1.3	-4.7	8.7	-1.5	3.3	-6.1
% ann chg to Dec 2019 (f)	-4.7	-5.9	-1.5	0.5	-3.0	3.0	-1.0	1.5	-5.7
% chg peak to Dec 2019 (f)	-15.3 (July ’17)	-12.7 (Nov ’17)	-2.2 (Apr-18)	-	-19.0 (June ’14)	-	-26.5 (May ’14)	-	-12.0 (Sep ’17)

Housing market





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

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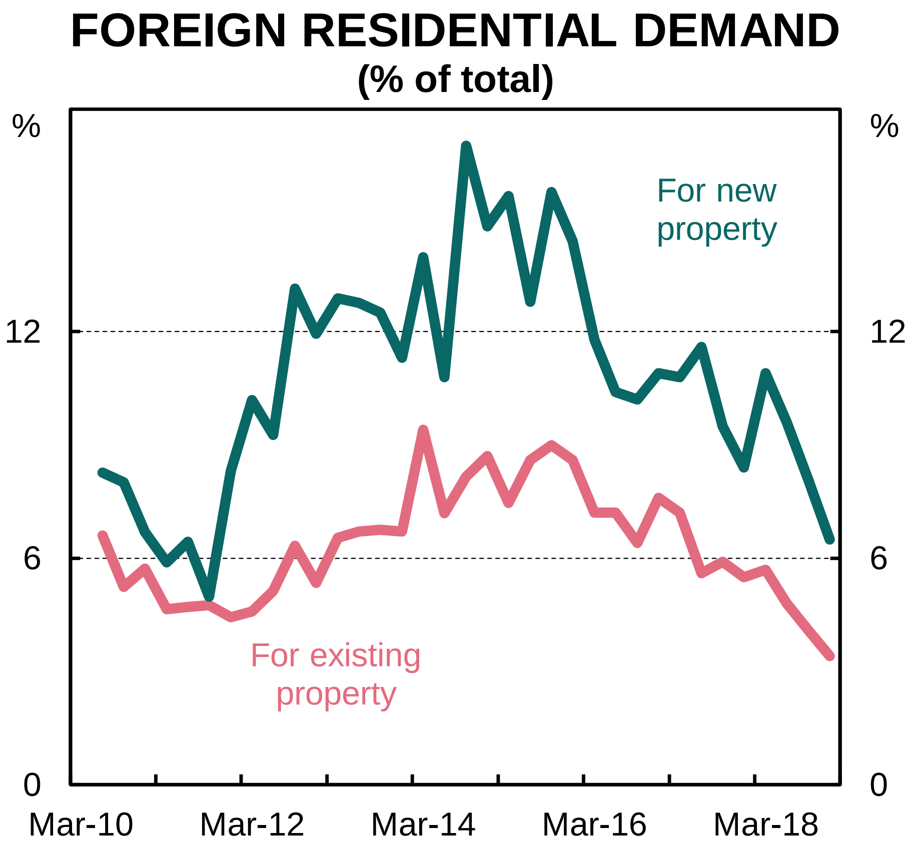
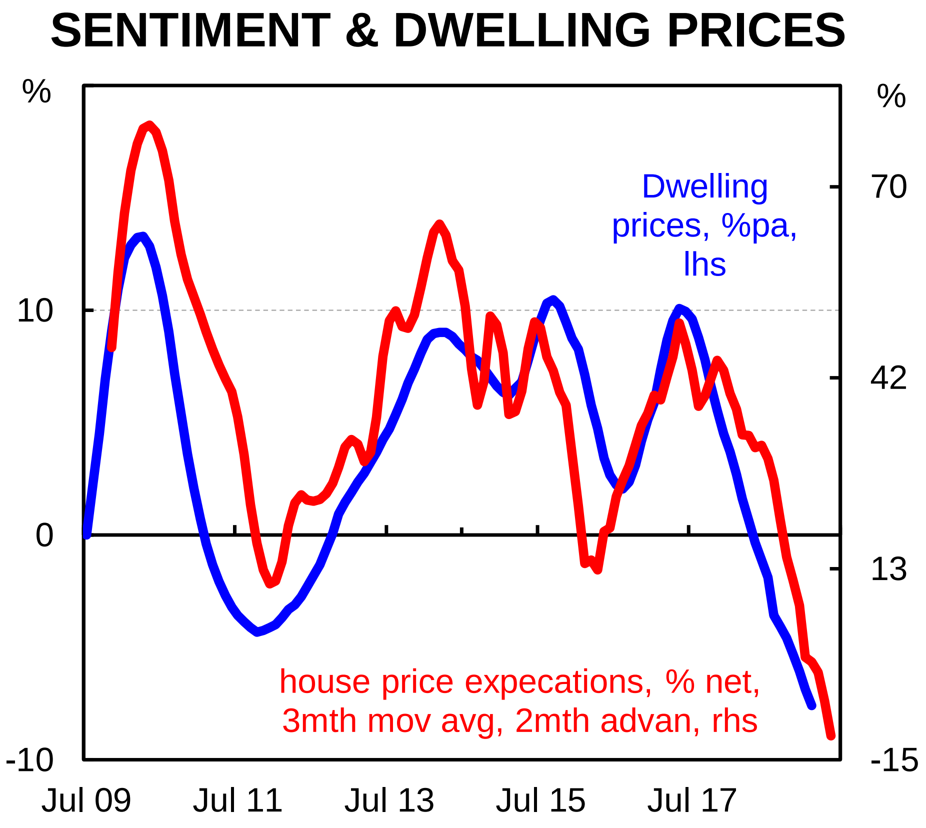
Housing market



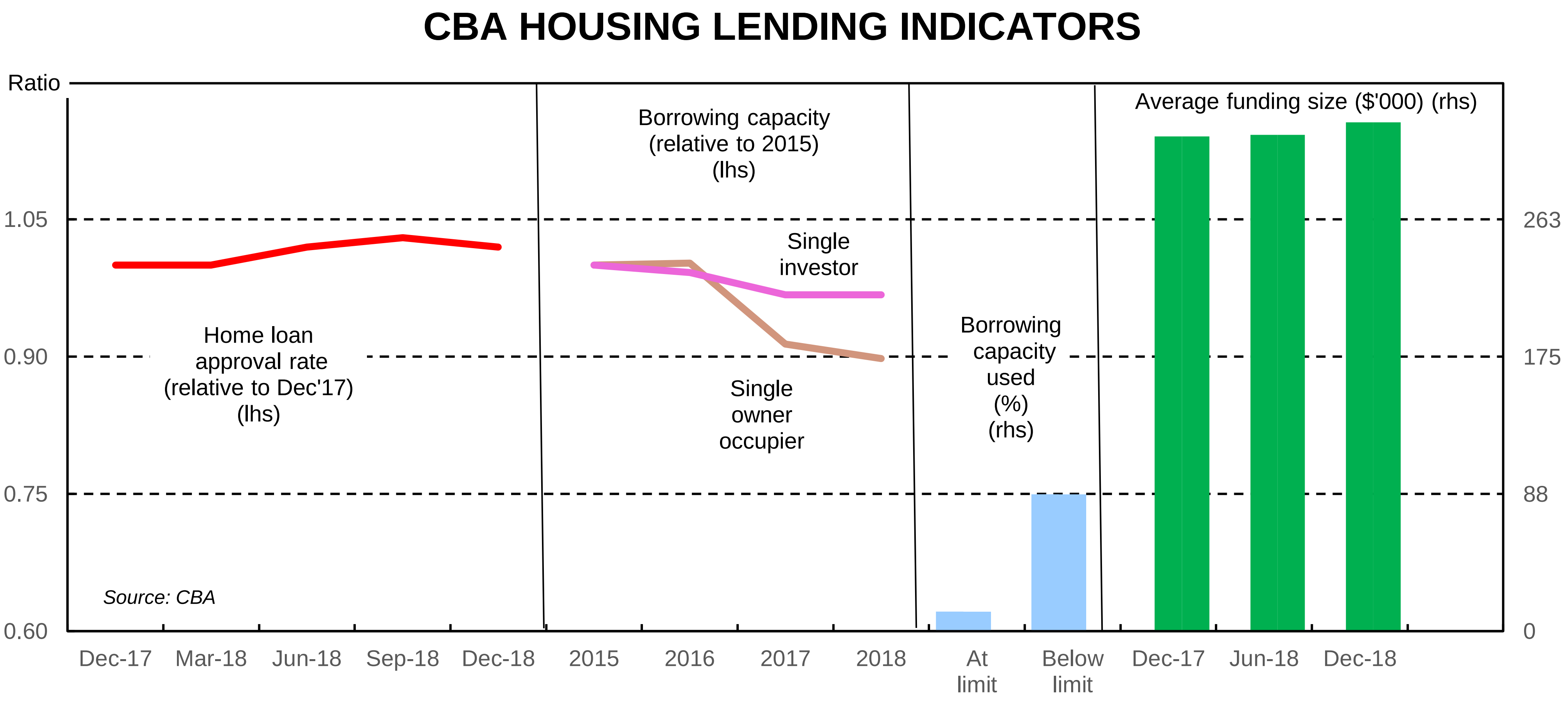
Source: NAB Residential Property Survey



Sources: CoreLogic, WBC

- **Foreign interest has declined.**
- **Expectations are for further price falls.**

Housing market



- **CBA lending metrics do not support the credit squeeze hypothesis:**
  - loan approval rates have not fallen;
  - borrowing capacity is lower but few borrow to the hilt
  - average funding size has increased.

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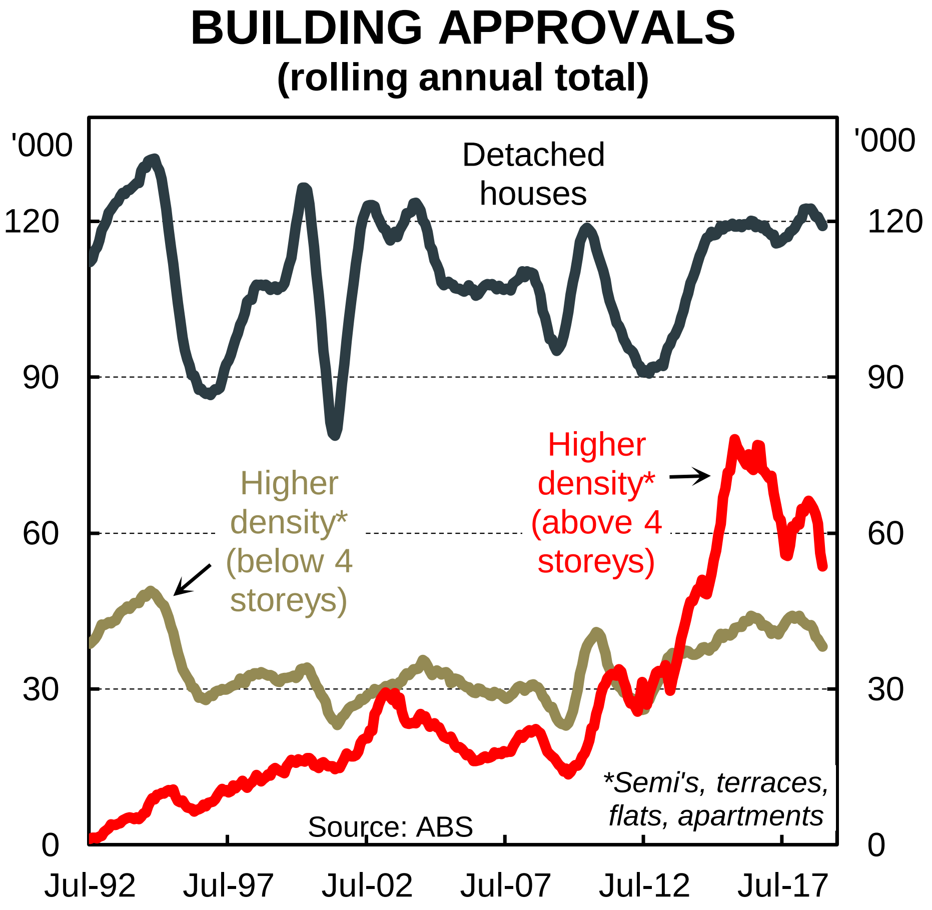
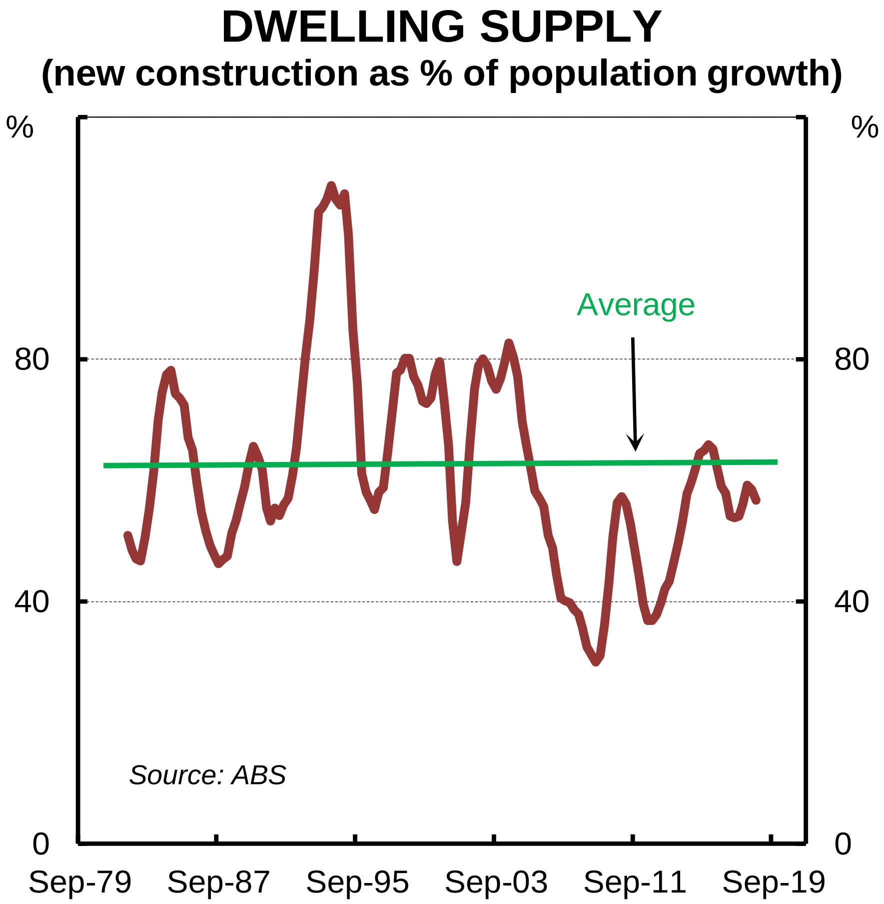
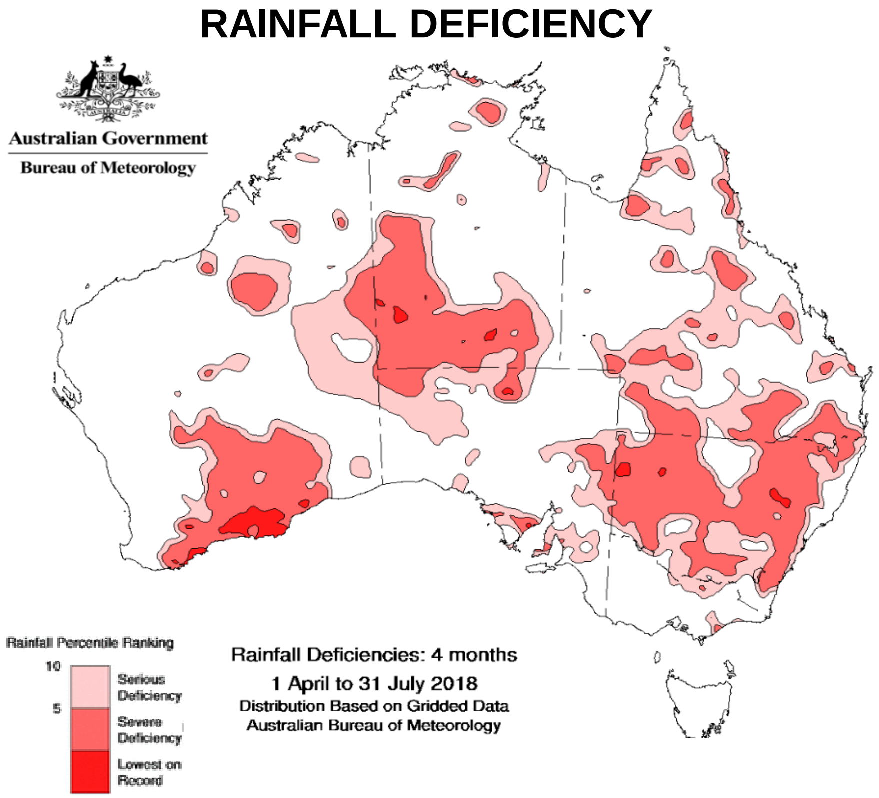
Residential construction





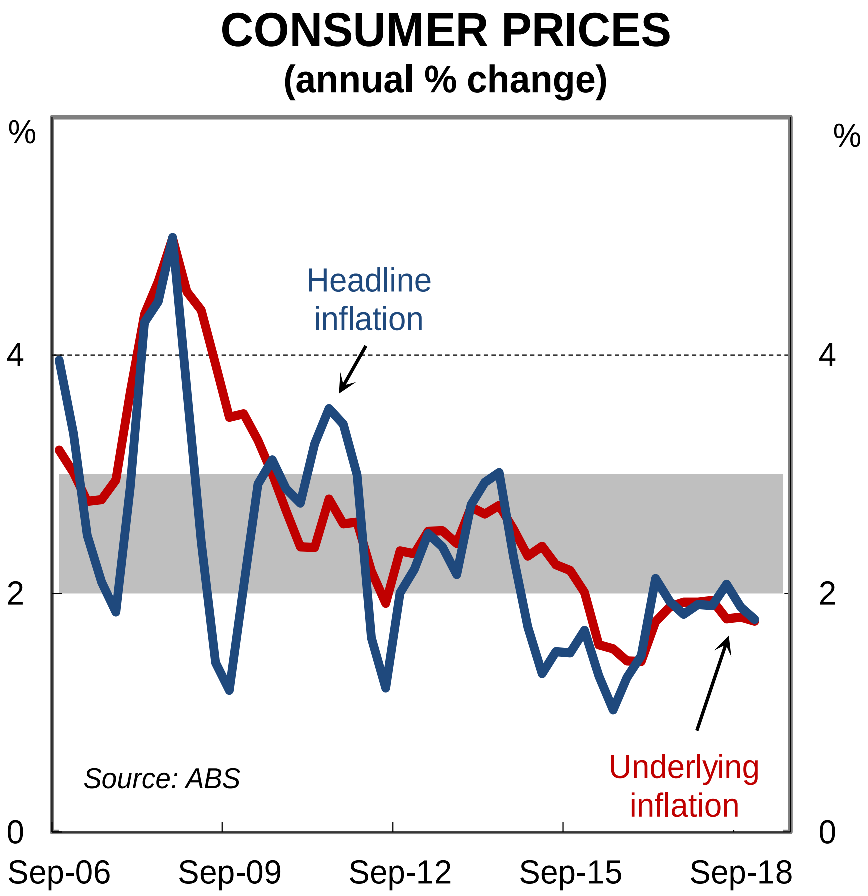
- Residential construction activity has peaked.
- Risk of oversupply is low.
- An over tightening of lending standards for developers could mean a sharper downturn.

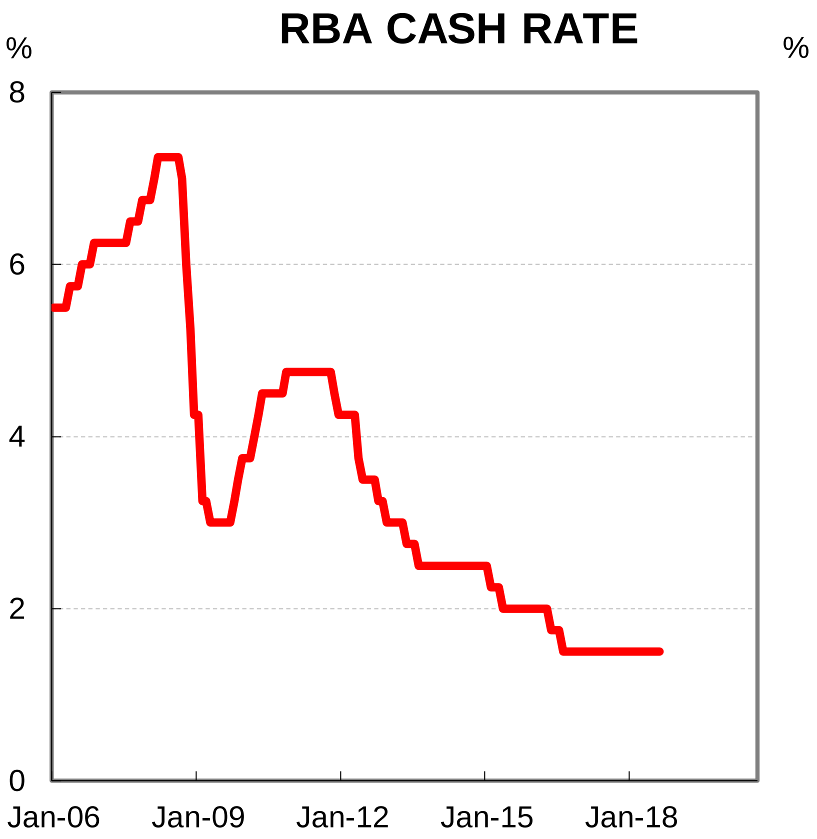
Drought



- **The East Coast Drought is now having its maximum negative impact on the economy.**
- **Any recovery remains some way off. But the detraction from GDP growth should ease.**
- **Agriculture is about 2% of GDP. But the very large swings in crop production during droughts can produce a large GDP impact. A partial offset comes from higher livestock slaughtering.**
- **In the past droughts have cut growth by up to ½ - ¾%.**
- **The current drought has reduced farm output by around 6% and total GDP by 0.15%.**

Inflation & monetary policy





- **Inflation remains low.**
- **The RBA have said that developments in the labour market will be the key to the direction on the next cash rate move.**

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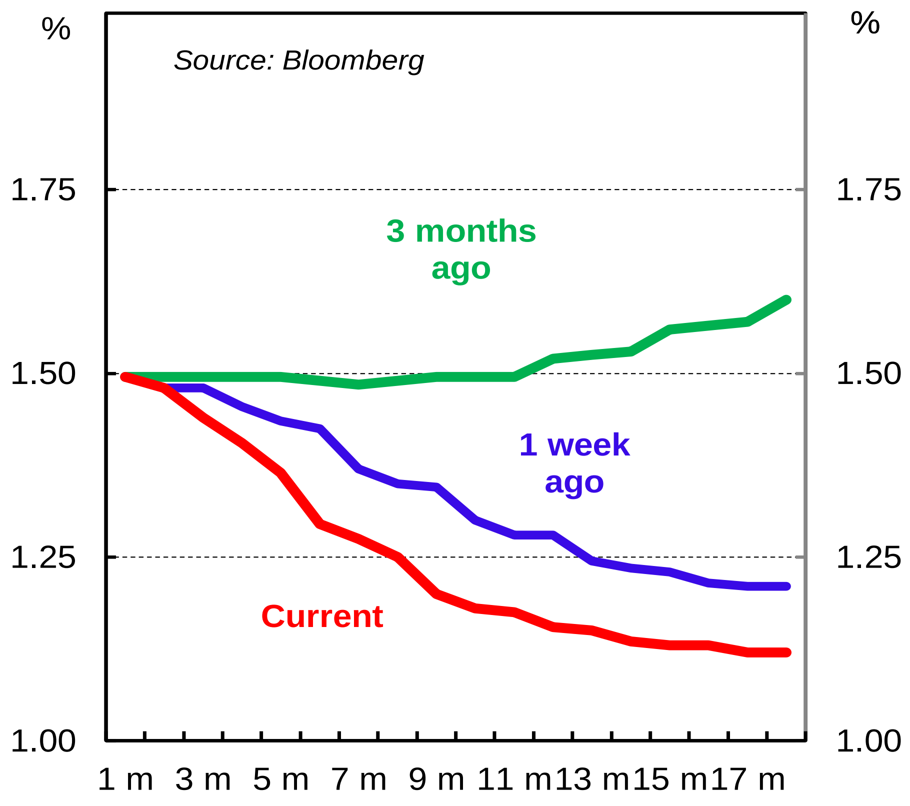
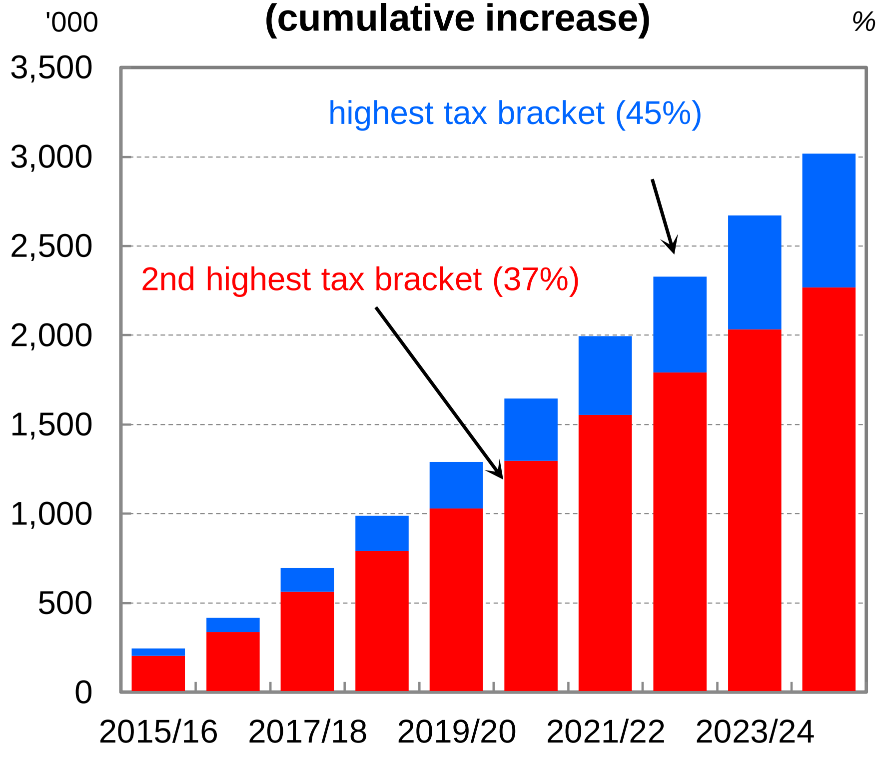
Monetary or fiscal policy?

OIS CASH RATE PRICING

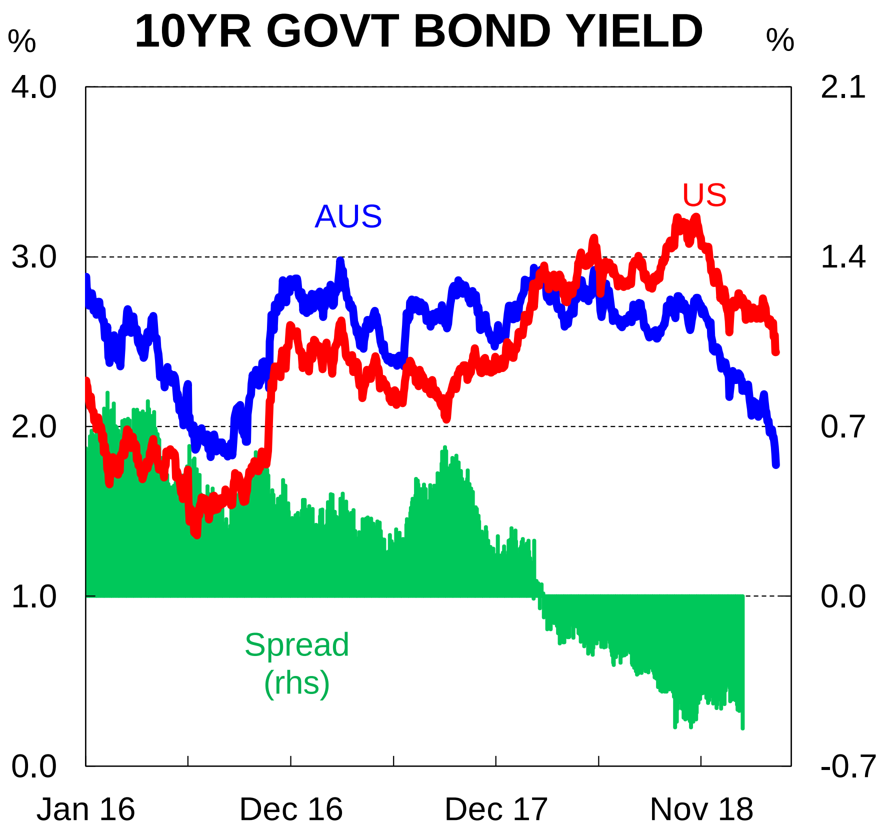


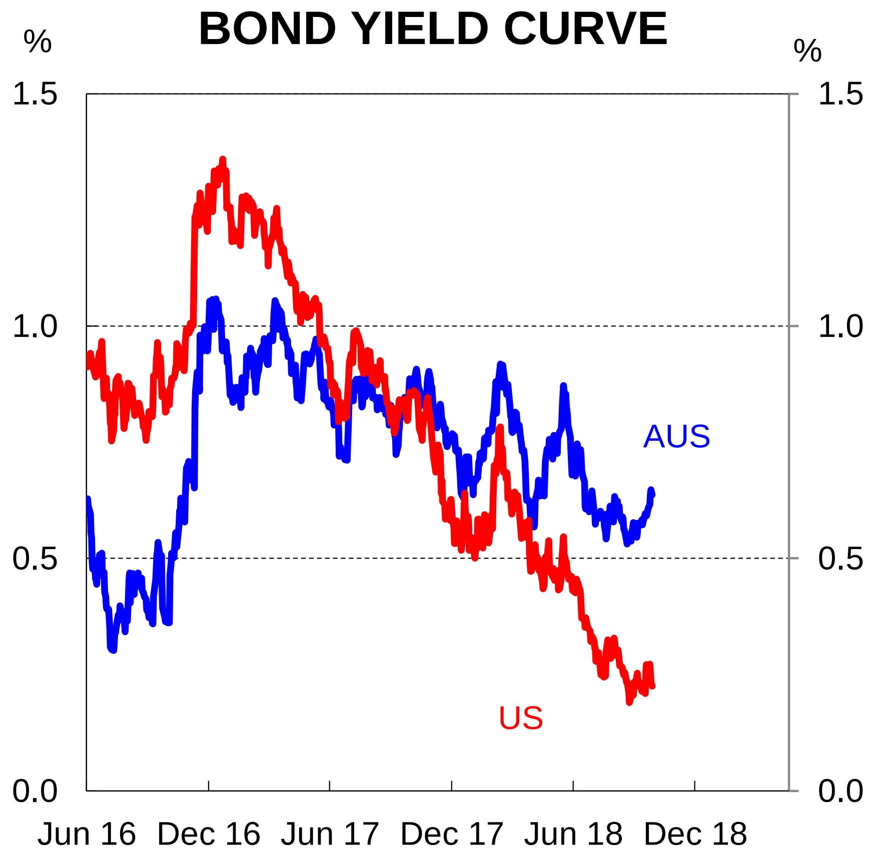
TAXPAYERS IN TOP TWO BRACKETS
(cumulative increase)



Source: Australian Government

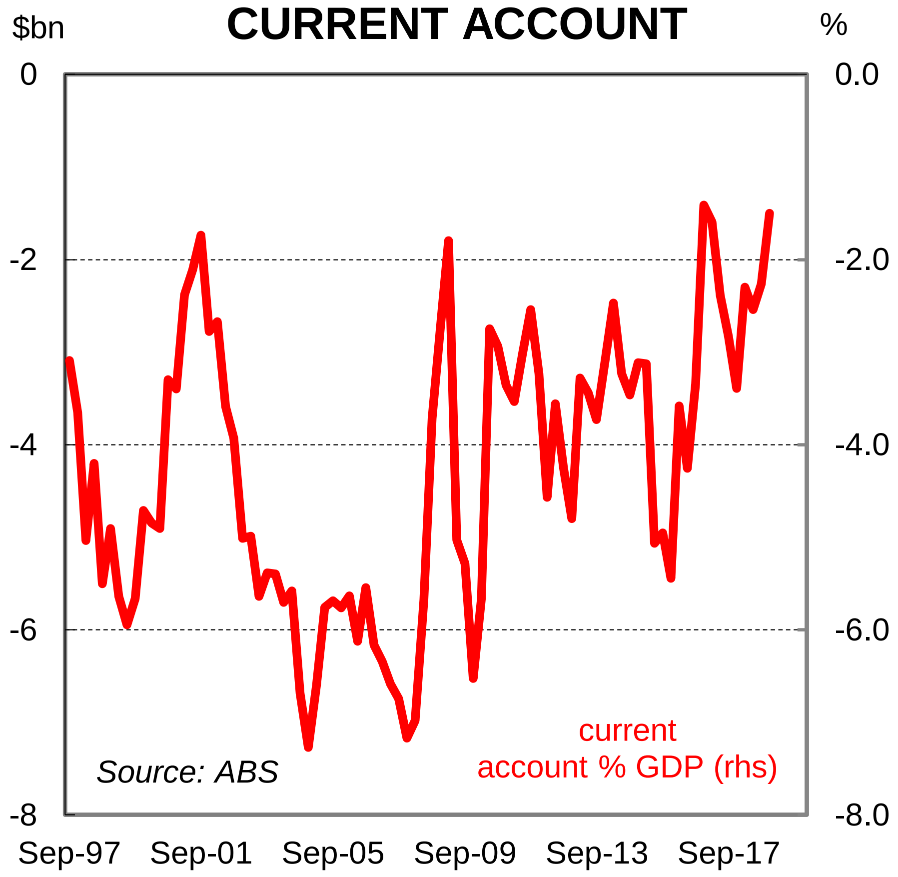
Bond yields

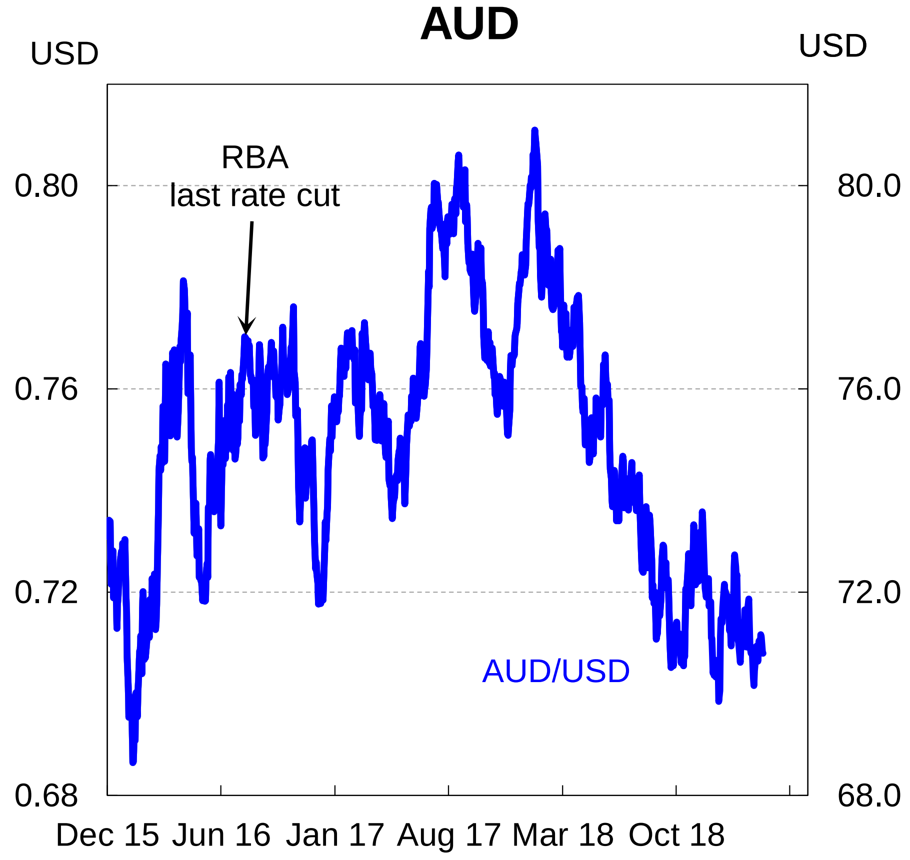




- **Bond yields have reacted to trade tensions, global growth downside risks, contained inflation and a more "patient" Fed. Markets are also pricing in chance of rate cuts in the US.**
- **US bond yields higher than Australian bond yields.**
- **We expect Australian bond yields to drift a little higher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

Australian dollar





- Australia dollar moved lower over 2018 because of a stronger US dollar.
- We think that the Fed have finished their tightening cycle and the RBA will stay on hold for quite some time.
- We think the AUD/USD will drift broadly sideways over 2019 and appreciate modestly in 2020.

What we expect over the next year

- **Global backdrop looks reasonable but risk of trade war remains.**
- **Commodity prices to hold up at decent levels.**
- **Australian economy to grow a little below trend this year (2.4%).**
- **Unemployment rate to stay close to 5.0%.**
- **Income and wages growth to be constrained due to spare capacity in the labour market but to edge a little higher.**
- **High household debt and falling house prices a significant risk for consumer activity.**
- **Interest rates to stay low – cash rate on hold at 1.5% for quite some time.**
- **Dwelling prices to continue to correct lower, but a hard landing unlikely.**

CBA Australian Forecasts

	2015/16 (a)	2016/17 (a)	2017/18 (a)	2018/19 (f)	2019/20 (f)	2020/21 (f)	2015 (a)	2016 (a)	2017 (a)	2018 (a)	2019 (f)	2020 (f)
Economic Activity												
Private final demand	**0.6**	**0.9**	**3.4**	**1.3**	**2.1**	**2.9**	**0.7**	**0.5**	**2.2**	**2.7**	**1.3**	**2.6**
Of which: Household spending	2.8	2.4	2.8	2.0	2.3	3.0	2.4	2.7	2.4	2.6	1.9	2.7
Dwelling investment	9.5	2.5	0.2	0.7	-3.7	-4.8	9.0	7.9	-2.4	4.4	-3.6	-3.9
Business investment	-11.7	-7.1	9.2	0.3	4.6	6.1	-9.6	-11.8	3.1	4.3	2.4	5.3
Public final demand	**4.6**	**6.5**	**3.3**	**5.5**	**3.2**	**2.3**	**3.2**	**6.4**	**5.0**	**4.0**	**4.5**	**2.7**
Domestic final demand	**1.4**	**2.2**	**3.4**	**2.3**	**2.3**	**2.8**	**1.2**	**1.8**	**2.9**	**3.0**	**2.1**	**2.6**
Inventories (contrib to GDP)	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.1	-0.1	0.1	0.0	0.0
GNE	**1.4**	**2.2**	**3.4**	**2.3**	**2.4**	**2.7**	**1.3**	**1.9**	**2.7**	**3.2**	**2.1**	**2.6**
Exports	6.8	5.5	4.1	3.3	5.5	3.9	6.5	6.8	3.4	5.0	3.7	5.1
Imports	-0.1	4.7	7.1	1.2	4.4	5.1	2.0	0.1	7.7	4.1	2.1	5.1
Net exports (contrib to GDP)	*1.4*	*0.2*	*-0.6*	*0.5*	*0.3*	*-0.2*	*0.9*	*1.3*	*-0.8*	*0.2*	*0.4*	*0.0*
GDP	**2.8**	**2.3**	**2.8**	**2.3**	**2.8**	**2.5**	**2.5**	**2.8**	**2.4**	**2.8**	**2.4**	**2.7**
Prices & Incomes												
CPI	**1.4**	**1.7**	**1.9**	**1.7**	**2.3**	**2.5**	**1.5**	**1.3**	**1.9**	**1.9**	**1.7**	**2.6**
Underlying CPI	1.8	1.6	1.9	1.7	2.2	2.7	2.2	1.5	1.9	1.8	1.8	2.6
WPI	**2.1**	**1.9**	**2.1**	**2.4**	**2.9**	**3.0**	**2.2**	**2.0**	**2.0**	**2.2**	**2.6**	**3.0**
Nominal GDP	2.4	6.2	4.7	4.9	5.2	4.8	1.6	3.9	6.1	4.9	4.9	4.9
Real h/hold disposable income	0.6	1.2	1.6	0.7	2.5	3.1	1.1	1.0	1.3	1.1	1.6	2.9
Labour Market												
Employment	2.3	1.5	3.0	2.3	2.0	1.8	2.0	1.8	2.3	2.7	2.1	1.9
Unemployment rate	5.9	5.7	5.5	5.0	4.7	4.6	6.1	5.7	5.6	5.3	4.8	4.6
External Accounts												
Current Account: $bn	**-75.7**	**-38.3**	**-51.0**	**-34.3**	**-27.4**	**-29.3**	**-76.3**	**-53.3**	**-46.2**	**-40.7**	**-30.1**	**-27.6**
% of GDP	*-4.6*	*-2.2*	*-2.8*	*-1.8*	*-1.3*	*-1.4*	*-4.6*	*-3.1*	*-2.6*	*-2.1*	*-1.5*	*-1.3*

CBA Global Economic Forecasts

CBA Global Growth Forecasts

	2017 *(a)*	2018 *(f)*	2019 *(f)*	2020 *(f)*
World	3.4	3.6	3.6	3.3
United States	2.2	2.9	2.6	1.8
Japan	1.7	0.9	0.8	0.0
Eurozone	2.5	1.9	1.8	1.7
United Kingdom	1.7	1.3	1.6	1.6
Canada	3.0	2.1	2.0	1.8
China	6.8	6.5	6.3	6.1
India	6.1	7.5	7.7	6.9
New Zealand	2.8	2.7	2.8	3.2

- **CBA forecasts have global growth at trend in 2019, slowing in 2020.**
- **Above-potential growth in advanced economies to continue for now before returning to potential as output gaps close and interest rates normalise.**
- **Policy stimulus to assist China growth outlook.**
- **EM Asia to outperform other EM's but trade frictions a rising risk.**
- **Oil exporters under pressure from low oil prices. Other EM's with high debt and weak external metrics at risk.**
- **Global inflation indicators sending mixed signals.**
- **US policy settings (esp trade), geo-politics, Chinese debt are risks.**
- **A reasonably supportive backdrop for commodities and Australia.**

CBA central bank calls

Central Bank Calls

	Current Stance	Expected Stance
The Fed	• Policy rate: 2¼-2½% • Balance sheet normalization program began in Oct'17 with Fed holding USD4½trn	• Fed funds rate has peaked • Risk in 2019 is further lift in H2 • Balance sheet unwind could be finished by end 2019
ECB	• Policy rate: 0% • Deposit rate: -0.4% • Asset purchases end Dec'18	• ECB ceased asset purchases at end'18 • A lift in deposit and refi rates from Dec 2020
BoE	• Policy rate: ¾% • Gilts QE target £435bn	• Brexit uncertainties mean any future move unlikely before mid '19
BoJ	• Policy rate: -0.1%; 0% 10-yr JGBs • Quantitative & Qualitative Easing with yield curve control – JGB purchases target: ¥80trn pa	• On hold • JGB purchases slowing
BoC	• Policy rate: 1¾%	• BoC on hold until Q4 2019, further move in Q2 2020 to terminal rate of 2¼%
RBA	• Policy rate: 1½%	• On hold – rate rise unlikely before end 2020
RBNZ	• Policy rate: 1¾%	• On hold – rate rise unlikely before Q1 2021

CBA FI Views

Australia	04-Mar	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Official cash rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
3M BBSW Rate	1.87	2.00	2.00	2.00	2.00	2.00	2.00	2.08	2.20
2-yr bond yield	1.77	1.75	1.75	1.85	1.90	1.90	2.00	2.05	2.15
3-yr bond yield	1.71	1.70	1.70	1.80	1.90	1.90	2.00	2.10	2.30
5-yr bond yield	1.82	1.90	1.90	1.90	1.90	1.90	2.00	2.10	2.40
10-yr bond yield	2.21	2.25	2.30	2.40	2.40	2.40	2.50	2.50	2.60
30-yr bond yield	2.77	3.15	3.15	3.20	3.25	3.25	3.25	3.25	3.25
3-10yr yield curve	50	55	60	60	50	50	50	40	30
US	**04-Mar**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**	**Jun-20**	**Sep-20**	**Dec-20**
Cash	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
2-yr bond yield	2.55	2.60	2.60	2.70	2.80	2.80	2.80	2.80	2.80
5-yr bond yield	2.56	2.65	2.75	2.75	2.80	2.70	2.70	2.70	2.70
10-yr bond yield	2.75	2.80	2.80	2.75	2.75	2.70	2.70	2.70	2.70
30-yr bond yield	3.12	3.10	3.20	3.10	3.00	3.00	2.90	2.80	2.80
AUS-US 10-yr sprd	-54	-55	-50	-35	-35	-30	-20	-20	-10
New Zealand	**04-Mar**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**	**Jun-20**	**Sep-20**	**Dec-20**
Official cash rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
2-yr bond yield	1.69	1.70	1.70	1.75	1.80	1.80	1.80	1.90	2.00
5-yr bond yield	1.85	1.80	1.80	1.90	1.95	2.00	2.05	2.10	2.25
10-yr bond yield	2.21	2.15	2.25	2.35	2.45	2.50	2.55	2.60	2.65
NZ-AUS 10Y sprd	0	-10	-5	-5	5	10	5	10	5
NZ-US 10-yr sprd	-54	-65	-55	-40	-30	-20	-15	-10	-5

AUD Swap Rates	04-Mar	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
1M BBSW	1.84	1.95	1.95	1.95	1.95	1.95	1.95	2.05	2.15
3M BBSW	1.87	2.00	2.00	2.00	2.00	2.00	2.00	2.08	2.20
6M BBSW	1.99	2.10	2.10	2.10	2.10	2.10	2.15	2.20	2.30
2-year	1.80	1.90	1.95	2.10	2.15	2.10	2.20	2.20	2.30
3-year	1.82	1.85	1.90	2.05	2.15	2.10	2.20	2.25	2.45
5-year	2.10	2.25	2.25	2.25	2.20	2.20	2.30	2.40	2.45
10-year	2.45	2.55	2.65	2.80	2.75	2.75	2.80	2.80	2.85

CBA FX Views

	End Period			
	Mar-19	Jun-19	Sep-19	Dec-19
Majors				
EUR/USD	1.1300	1.1400	1.1500	1.1700
USD/JPY	111.00	112.00	112.00	111.00
GBP/USD	1.2400	1.2600	1.2700	1.2800
AUD/USD	0.7100	0.7100	0.7200	0.7200
NZD/USD	0.6800	0.6800	0.6900	0.6900
USD/CAD	1.3100	1.3000	1.3000	1.2900
USD/CHF	1.0000	1.0100	1.0000	0.9900
USD/CNY	6.8000	6.8500	6.9000	7.0000

	End Period			
	Mar-19	Jun-19	Sep-19	Dec-19
European Cross Rates				
EUR/JPY	125.43	127.68	128.80	129.87
EUR/GBP	0.9113	0.9048	0.9055	0.9141
EUR/CHF	1.1300	1.1514	1.1500	1.1583
EUR/AUD	1.5915	1.6056	1.5972	1.6250
EUR/NZD	1.6618	1.6765	1.6667	1.6957
GBP/JPY	137.64	141.12	142.24	142.08
GBP/CHF	1.2400	1.2726	1.2700	1.2672
GBP/AUD	1.7465	1.7746	1.7639	1.7778
GBP/NZD	1.8235	1.8529	1.8406	1.8551

AUD cross rates				
AUD/EUR	0.6283	0.6228	0.6261	0.6154
AUD/GBP	0.5726	0.5635	0.5669	0.5625
AUD/JPY	78.81	79.52	80.64	79.92
AUD/NZD	1.0441	1.0441	1.0435	1.0435
AUD/CAD	0.9301	0.9230	0.9360	0.9288
AUD/CHF	0.7100	0.7171	0.7200	0.7128
AUD/CNY	4.8280	4.8635	4.9680	5.0400

NZD cross rates				
NZD/EUR	0.6018	0.5965	0.6000	0.5897
NZD/GBP	0.5484	0.5397	0.5433	0.5391
NZD/JPY	75.48	76.16	77.28	76.59
NZD/AUD	0.9577	0.9577	0.9583	0.9583
NZD/CAD	0.8908	0.8840	0.8970	0.8901
NZD/CHF	0.6800	0.6868	0.6900	0.6831
NZD/CNY	4.6240	4.6580	4.7610	4.8300

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ADDITIONAL INFORMATION FOR PROFESSIONAL INVESTORS OUTSIDE OF AUSTRALIA (CONT.)

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