ANZ RESEARCH

AUSTRALIAN ECONOMICS

AUSTRALIAN ECONOMIC UPDATE

28 NOVEMBER 2014

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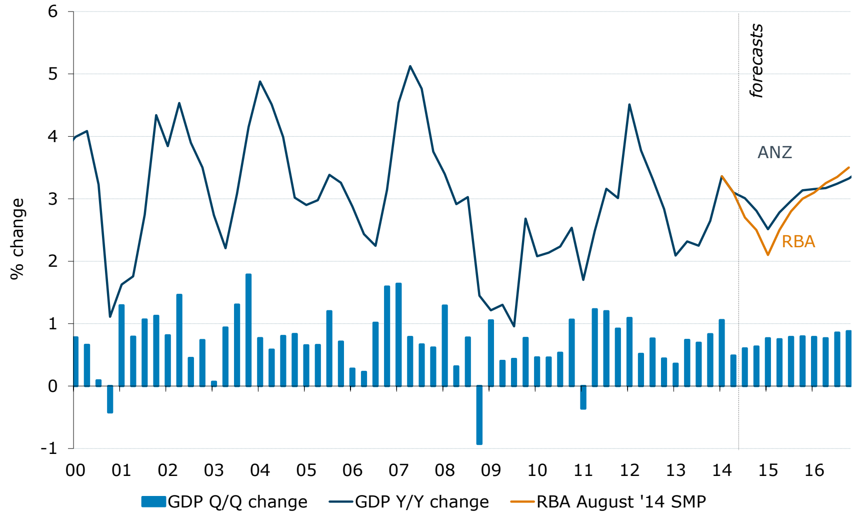
FORECAST DOWNGRADE: SLOWER GROWTH, LATER RATE HIKES

KEY POINTS

- We have revised down our growth profile for Australia, and **now expect slightly softer growth in 2015 and 2016 of 2.9% and 3.2% respectively**. This new forecast incorporates recent sharp downward revisions to our iron ore price forecast, and has seen us take around 1ppt off our nominal GDP forecast and around ¼ppt off real GDP growth.
- **Lower commodity prices will weigh on profits and wages**, while also reducing both company taxes at the federal government level and royalties at the state level. They will in turn constrain consumer spending and business investment, and lead to an extended period of weaker than usual growth in public demand. Importantly, these revisions represent a delay in the return to trend growth rather than a change in the trajectory of the Australian economy.
- With lower growth and little inflationary pressure, the RBA has scope to keep monetary policy accommodative for longer. Accordingly, we have revised our cash rate forecasts. **We still expect a new tightening phase to commence next year, but have pushed back the timing of the first rate hike from May to November. We expect 100bps of rate hikes over the following year to take the cash rate to 3.5% by the middle of 2016.**
- The lower growth profile and slower expected policy normalisation from the RBA have led us to **revise our rates market forecasts lower**. We expect the slower and longer path to rate hikes to flatten the mid curve a little more than previously forecast, though the theme of a flatter curve remains central to our view. We also expect the Aus/US 10yr spread to narrow a fraction more than previously forecast as the Federal Reserve is likely to normalise policy ahead of the RBA.
- Taking into account the impact of these interest rate revisions, ANZ Research estimates that fair value for the AUD is about USD0.79. Despite this, **we maintain our USD0.82 forecast for end-2015** and believe that either a rate hike from the US Federal Reserve, or a further step down in key commodity prices would be a more compelling trigger to further downgrade our forecasts.

FIGURE 1. GDP OUTLOOK

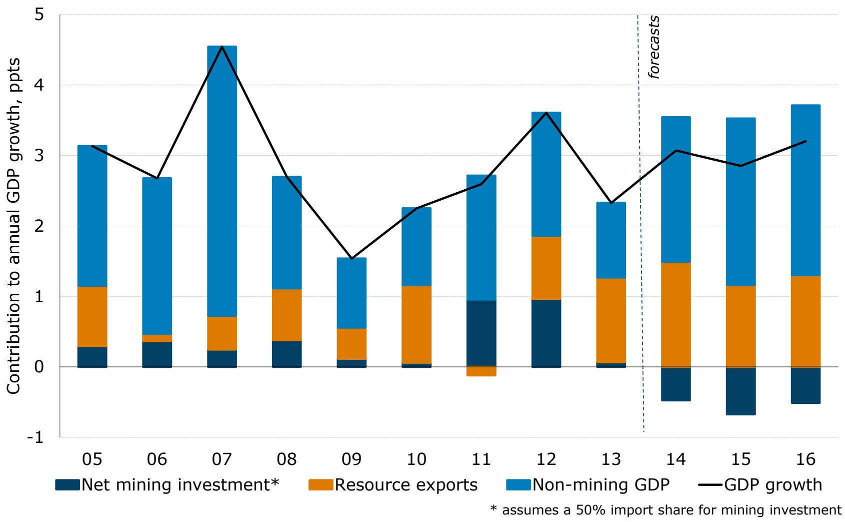


Source: ABS, RBA, ANZ Research

DETAILS

- Lower iron ore prices have seen us revise our terms of trade forecasts down significantly. ANZ's Commodity Research team has recently revised its iron ore forecasts down from an average of USD101 to USD78 in 2015 and from USD95 to USD85 in 2016. This has been the primary driver of a cut to our terms of trade forecast in 2015 from -2.7% to -7.4% — a cut which has shaved more than 1ppt off nominal GDP growth, which we now expect to be only 3.1% in 2015, picking up to 5.5% in 2015.
- The fall in the terms of trade will place further downward pressure on already soft wages growth. We now expect the wage price index to grow only 2.6% in 2015 and 2.9% in 2016. Growth in overall earnings, however, will be significantly lower given compositional changes in the labour force, with high paying mining jobs being replaced by lower paid jobs in the services sector.
- This weakness in household incomes will in turn weigh on household spending. Consumer spending has been a key disappointment of the recovery despite strong gains in house prices. While we continue to expect further gains in house prices, albeit at a slower rate in Sydney and Melbourne, ongoing heightened consumer caution and low wages growth is likely to see only a very gradual recovery in consumer spending. We look for growth of 2.4% in 2015 and 2.9% in 2016. This would still see a persistent gradual decline in the savings rate to around 7.5% by the end of 2016.
- We have also pushed out the timing of the recovery in non-mining business investment slightly. While we continue to expect the recovery to come through given all the fundamentals are in place for a substantial recovery, many businesses are reporting that they are reluctant to lift spending before the pick-up in demand becomes more sustained so we now think the upswing will come a little later than we had previously thought. We now expect non-mining investment to grow around 6% in 2015 (down from our previous forecast of +8%), picking up steam to grow at around 12% in 2016.
- While we continue to look for a very sharp decline in mining investment over the next couple of years, strongly increasing resources exports will provide an offset. We expect net exports to contribute around 1.5ppt to growth in 2015, and 1ppt in 2016.

FIGURE 2. NON-MINING ACTIVITY IS THE KEY TO THE RECOVERY

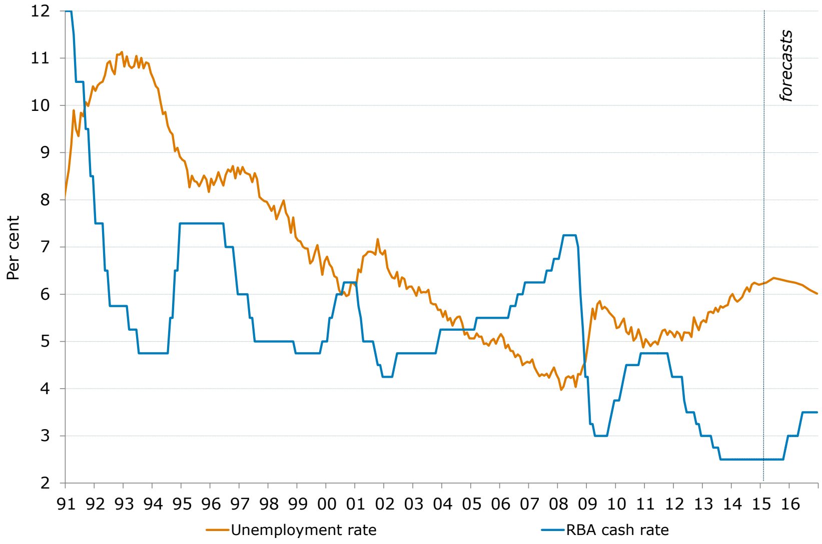


Source: ABS, ANZ Research

- Reflecting the weaker commodity price outlook, we have recently revised down our estimates for the AUD and now expect the exchange rate to continue to drift lower, ending 2015 at USD0.82 and 2016 at USD0.80.

- While gauging the starting point for unemployment remains difficult at present given the unreliability of the official data, below-trend growth is likely to see the unemployment rate tick up marginally and then stabilise at around 6¼% through 2015, before declining very gradually through 2016.

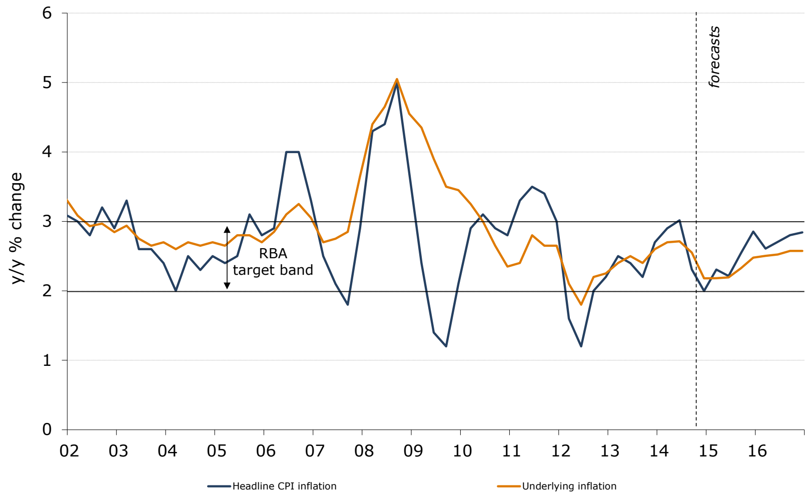
FIGURE 3. UNEMPLOYMENT IS SET TO REMAIN ELEVATED



Source: ABS, RBA, ANZ Research

- Inflation remains completely off the radar given excess capacity, global disinflationary pressures and weak commodity prices. While our inflation forecasts remain near the middle of the target band (excluding the carbon tax) due to currency pass-through, lower wages growth will weigh on non-tradables components (at least for those CPI items not administered by the government). Meanwhile, demand-pull forces will remain subdued given below-trend consumer spending growth.

FIGURE 4. THE INFLATION OUTLOOK REMAINS BENIGN

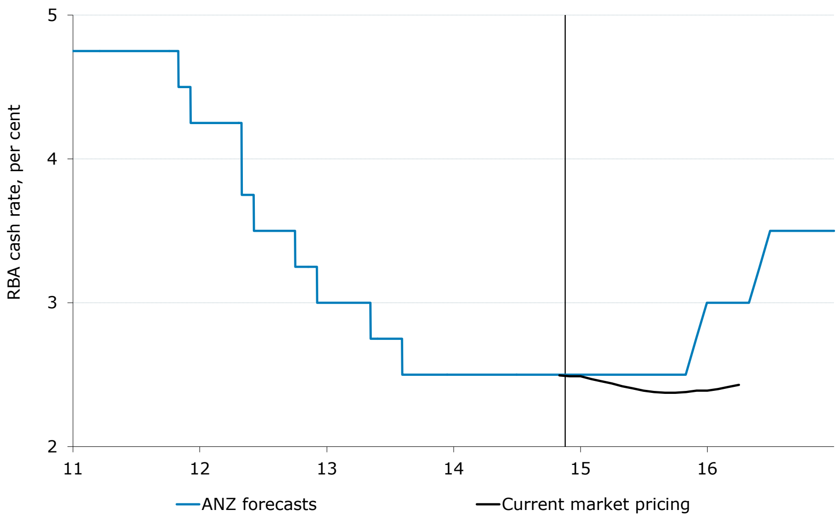


Source: ABS, RBA, ANZ Research

MONETARY POLICY TO REMAIN ACCOMMODATIVE

- The benign inflation outlook points to ongoing accommodative monetary policy. Global inflationary pressures remain very weak, there is significant spare capacity in the labour market, and the AUD is not providing the stimulus to growth that it would normally.
- While we believe that the risks around a near-term easing in monetary policy have risen modestly, we continue to expect that the next move in rates will be up. We think the timing of the start of US monetary policy normalisation will be important given the potential impact on the exchange rate, we now expect that the RBA will not begin lifting the cash rate until November 2015. Following that, we expect only a very gradual tightening cycle with the cash rate peaking at 3.5% in mid-2016.
- In the meantime APRA could possibly introduce some sort of soft macroprudential controls in an attempt to take the heat out of the investor segment of the housing market.

FIGURE 5. MARKETS CONTINUE TO PRICE THE CHANCE OF A NEAR TERM RATE CUT



Source: Bloomberg, ANZ Research

RISKS AROUND THE OUTLOOK

Our view is predicated on a sustained recovery in the US economy, with the Fed beginning to raise rates in March 2015. Moreover, we continue to expect solid, but slowing growth in China.

- A hard landing in China would clearly impact the outlook. The key channel through which this would be felt is through further falls in the terms of trade. This would weigh further on incomes and demand and dampen the recovery.
- On the upside, a faster cyclical recovery is also a possibility. While the upswing in consumer spending and non-mining business investment has so far been somewhat disappointing, there is some chance that confidence picks up and spending by both businesses and households recovers more quickly than we currently anticipate.

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