

# Quarterly Economic Report

Wednesday, 30 January 2019



## The Year Ahead – A Profusion of Risks

- The year 2019 has started with a profusion of risks to the global economic outlook. These risks primarily come from a recent US government shutdown, disappointment on Chinese growth, ongoing trade tensions and the road to nowhere with the Brexit negotiations. Domestic risks from housing remain.
- A US government shutdown and share market volatility is causing the US Federal Reserve to be cautious. We do not expect the first US rate hike for 2019 to come until June. Another tightening should follow in September.
- Trade tensions are likely to stay a theme throughout this year. The Chinese government will likely fight US demands for deep structural changes in the Chinese economy.
- The Australian housing downturn will continue over 2019. It represents the biggest domestic economic risk via wealth effects to the consumer. However, the RBA is forecasting only minimal wealth effects.
- The labour market remains solid in Australia, which is encouraging and should limit some of the negative impacts to the consumer from the weakness in housing. We expect downward pressure on the unemployment rate to be sustained over the year ahead.
- We estimate the Australian economy grew by 3.0% last year, above the trend rate. We are expecting the economy to grow by an average of 2.4% this year (or 2.6% through the year), just below the trend rate. We are forecasting a slightly faster average pace for 2020.
- We continue to expect the Reserve Bank to hold the cash rate steady at 1.50% this year.
- In early December last year, financial markets started to consider the possibility that the next move from the RBA would be a cut. A weak GDP report was the trigger. We still see the next move from the RBA as a rate hike but it will take some time to occur.
- The RBA is primarily guided by the inflation outlook in its cash-rate decisions. Core inflation has now undershot the RBA's long-term target band of 2-3% for twelve straight quarters, the longest stretch since the CPI series began. We do not expect inflation will reach the middle of the RBA's target band before 2020.
- We expect Australian bond yields to grind higher over 2019 and US long-end yields to peak near the end of this year, as Fed tightening weighs on US economic activity.
- The downside risks to the global economic outlook and softer outlook for commodity prices suggest the Australian dollar will end this year lower. However, our expectation the Federal Reserve might end its rate-hike cycle later this year suggests the downside in the AUD/USD is limited. We forecast the AUD at 69 US cents and 72 US cents at 2019 and 2020, respectively.

## The Year Ahead

The year 2019 has started with a profusion of risks to the global economic outlook, which had been mounting as 2018 neared an end. These risks primarily come from a recent US government shutdown, disappointment on Chinese growth, ongoing trade tensions and the road to nowhere with the Brexit negotiations. Domestic risks from housing remain.

### United States

The US government shutdown has ended after 38 days, but the political issues that led to this shutdown have not been resolved. A resumption of the shutdown cannot be ruled out and has already negatively impacted economic activity.

The US Federal Reserve has recently adopted a more cautious stance and signalled a pause in its rate tightening cycle. Moreover, volatility in share markets has also likely rattled the US Federal Reserve. We do not expect the first US rate hike for 2019 to come until June. Another tightening should follow in September. While economic growth is expected to moderate, the rate of growth is to stay above potential. The strength of the labour market suggests there is still a case for the Federal Reserve to hike rates further.

This hike in September would take the federal funds target range to 2.75-3.00%, which we see as the peak in this cycle. The stimulus to the economy from the fiscal package would have faded further by later this year, coinciding with the peak in the federal funds rate. The Federal Reserve's policy decision is due tonight (i.e. Thursday 6am AEST); we should continue to see a patient tone adopted in its communications.

### China

Chinese growth for 2018 of 6.6% matched consensus expectations, but markets were still disappointed. Consensus is factoring in much slower growth in China this year of 6.2%, as the Chinese government continues to try and restructure the economy for long-term growth. There have been news reports that Chinese authorities will lower their target to 6-6.5% for this year.

The US-China trade tensions remains ongoing. Cabinet-level delegations from the US and China have resumed trade negotiations this week, but early indications are that the two sides remain sharply divided. Last week, US Commerce Secretary Wilbur Ross said the two sides remain "miles and miles" apart. The Chinese government will likely fight US demands for deep structural changes in the Chinese economy, which include eliminating subsidies to favoured industries. Therefore, trade tensions are likely to stay a theme throughout this year.

These latest talks are aimed at staving off the Trump administration's plans to raise tariffs on US\$200 billion of Chinese goods to 25%, up from the 10% levies imposed last year. The levies were originally set to go into force January 1, but President Xi and President Trump agreed to a 90-day truce on 1 December 2018. If the two sides don't cut a deal or agree to extend the truce -- the tariff increase will come into effect on March 2.

### Europe

Brexit negotiations remain uncertain and European economic data continues to suggest that European growth is faltering. Last week, the European Central Bank President highlighted that downside risks have emerged for the eurozone outlook. One of the eurozone's biggest economies, Italy, might have entered recession near the end of 2018.

Turning to the UK, it has eight weeks until it is scheduled to leave the European Union. As it stands, there is still no deal. An overhaul of the back-up plan for the Irish border remains one of

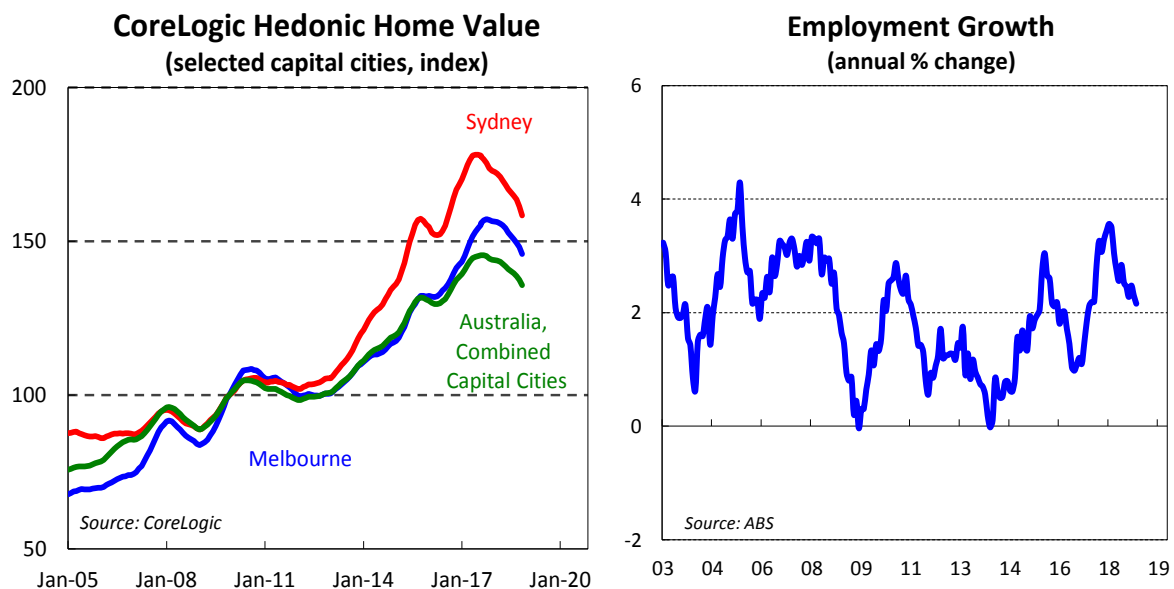
the most contentious parts of the exit package.

## Global Growth

It leaves global economic growth on a less certain footing at the start of 2019 compared with a year ago; one that is characterised by more downside risks. The pace of growth in the global economy remains solid, but the outlook is less favourable than one year ago. Indeed, the International Monetary Fund (IMF) has downgraded its world growth forecasts for this year and next to 3.5% and 3.6%, respectively.

## Australian Economic Growth

On the domestic front, 2018 witnessed the unfolding of a housing downturn. This downturn will continue over 2019 and represents the biggest domestic economic risk. The Reserve Bank (RBA) expects a minimal wealth effect from the slowing in house prices, but this is a point of difference for us. We expect the downturn in house prices and activity to constrain consumer spending. We forecast consumer spending to grow by only a modest pace of 2.4% this year, limiting the overall growth of Australian economic activity.



Housing will remain a key focus this year, as prices continue to fall. Investor activity should continue to lead the declines, despite the Australian Prudential Regulation Authority (APRA) announcing an easing of macro-prudential restrictions before Christmas (the 30% limit on interest-only lending was removed).

Nationally, capital city dwelling prices have been in decline on an annual basis for eight consecutive months. The fall in dwelling prices has been led by Sydney and Melbourne. Australia-wide capital city dwelling prices fell 6.1% last year, the largest annual decline since March 2009. And Sydney and Melbourne dwelling prices are down 11.1% and 7.2% from their peaks.

We expect a continued moderate, but persistent, decline in house prices this year and next, concentrated in Sydney and Melbourne.

The labour market remains solid in Australia, which is encouraging and should limit some of the negative impacts to the consumer from the weakness in housing. The unemployment rate fell to 5.0% in December. Moreover, 269k net new jobs were added to the economy. It is less than the 414k jobs added in 2017, but still a solid performance. We expect downward pressure on the unemployment rate to be sustained over the year ahead.

But consumers will still be challenged by soft wages growth and high levels of household debt.

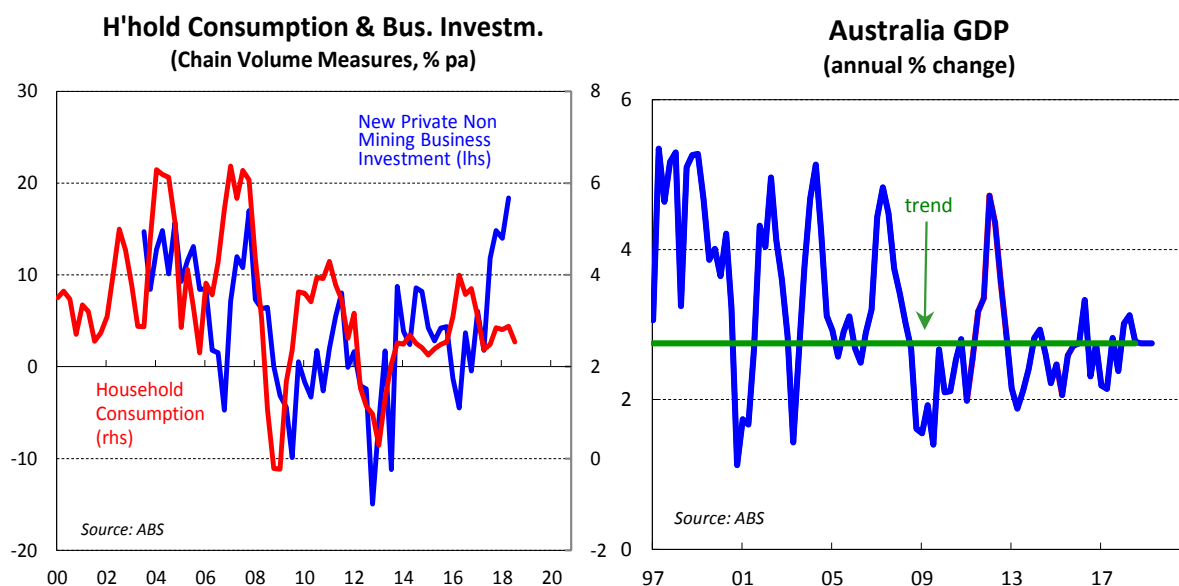
Consumers and business might also be challenged in 2019 by an upcoming Federal election and a State election in NSW in March. Both elections could result in a change of government. Elections typically are associated with uncertainty and consumers and businesses dislike uncertainty.

However, the Federal Budget has been brought forward one month to April. The Federal budget bottom line is improved and there is speculation tax cuts could be announced.

We estimate the Australian economy grew by 3.0% last year, above the trend rate. We are expecting the economy to grow by an average of 2.4% this year (or 2.6% year-on-year), just below the trend rate. We are forecasting a slightly faster pace for 2020 of 2.6% (also 2.6% year-on-year).

Australian economic activity will be underpinned by firm population growth, ongoing infrastructure spending, growth in business spending and exports (especially LNG). Consumer spending will add to growth, but only modestly. Dwelling investment will detract from growth.

The recovery in business investment showed encouraging signs in the second half of last year, however, the latest business survey from NAB show some reason for cautious optimism with both business conditions and business confidence continuing to wane. This recovery in business investment warrants close monitoring.



### Reserve Bank Outlook

We remain of the view that the Reserve Bank will keep to the sidelines and not change the cash rate this year or next year. The cash rate is currently at 1.50% and was last moved in August 2016. Furthermore, we still see the next move from the RBA as a hike but not for some time.

In early December last year, financial markets started to consider the possibility that the next move from the RBA would be a cut not a hike. This possibility was considered in the wake of a weaker-than-expected GDP result for the September quarter. GDP grew by only 0.3% in Q3 compared with consensus expectations and RBA implied expectations of a much stronger result. Moreover, back revisions suggested that the economy was not as strong as previously reported.

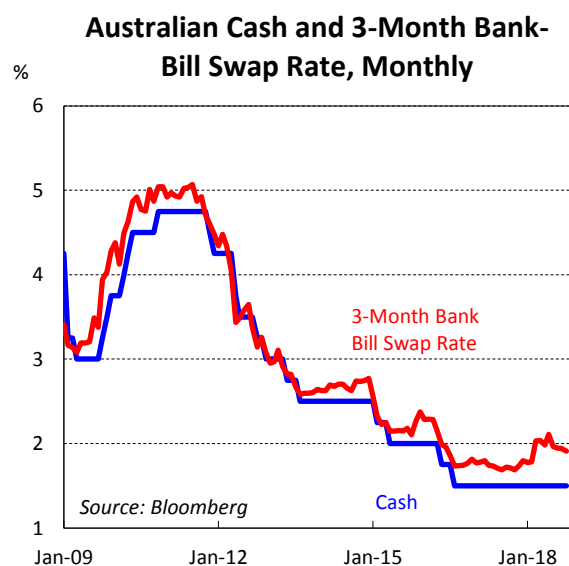
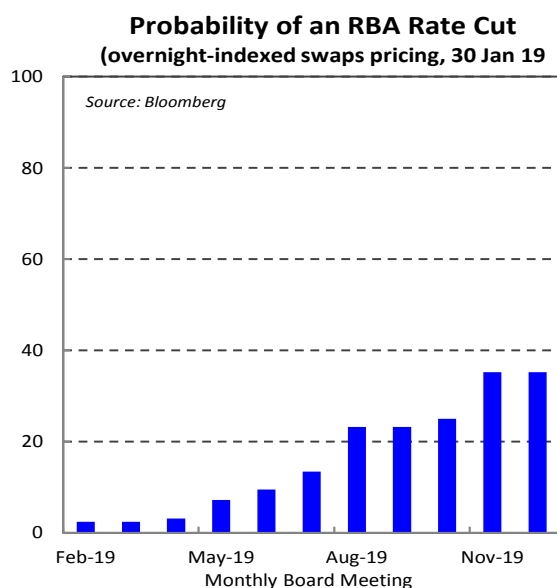
The first RBA meeting of the year takes place next Tuesday, 5 February. We will be combing the accompanying statement carefully for any change in stance from the RBA. The central bank's commentary has been "the next move in the cash rate was more likely to be an increase than a decrease" throughout much of 2018.

The quarterly Statement on Monetary Policy (SoMP) follows the RBA meeting on February 8. This statement contains growth forecasts from the RBA. With the Q3 growth figures disrupting the RBA's growth projections, we expect 2018 growth to be revised lower. The softer 2018 starting point for growth means 2019 and 2020 growth projections could also be cut. We would need to see the RBA cut the growth forecasts significantly (to 2.5% or lower for this year) for a rate cut to be a more serious proposition. Having said that, the risk of a rate cut as the next move is greater than what it was a year ago.

Financial-market pricing shows that markets are attaching a 45% probability of a rate cut by year's end. Surveys reveal that economists expect the RBA to stay on hold this year. In a survey by Reuters on 12 December 2018, 28 out of 40 economists polled expected the RBA to leave the cash rate unchanged. Nine economists expect a rate hike later this year and just two expect rate cuts this year.

### Australian Inflation Outlook

The RBA is of course primarily guided by the inflation outlook in its cash-rate decisions. The RBA aims to keep inflation in a 2-3% per annum target band over time. Core inflation has now undershot the RBA's long-term target band for twelve straight quarters, the longest stretch since the series began. Without a significant pick up in wages growth it is difficult to foresee broader inflation rising convincingly. We do not expect inflation will reach the middle of the RBA's target band before 2020.



### Bond and Swap Rates Outlook

Short-term money market rates remain elevated. The 90-day bank-bill swap rate has lifted 15 basis points to 2.07% in the past three months. This is a 57 basis point differential to the RBA's cash rate of 1.50%. The elevation of the short-term rates poses higher borrowing costs to financial institutions. These higher borrowing costs have contributed to out-of-cycle rate increases on mortgage variable rates by some financial institutions in Australia, contributing to a tightening of financial conditions.

Longer-term swap and bond yields will continue to be driven by trends in US bond yields for much of this year. At the Australian long end, we expect Australian 10-year yields to grind higher over this year, from around 2.23% now to 2.60% at the end of this year.

Long-end yields in both Australia and the US have dropped since early November 2018, as global

share markets exhibited greater volatility due to concerns over the growth outlook. In the US, we expect long-term yields to grind higher before peaking around September, coinciding with the peak in the US Federal funds target rate. The risk of a worsening in the global trade war and ongoing volatility in equity markets hangs over financial markets. If these concerns linger or grow considerably, the rise in bond yields both here and in the US will be curbed.

As the end of this year nears, markets are likely to look ahead to when the US Federal Reserve will start to cut. Meanwhile, the RBA is likely to remain on hold and markets should come around to this view. We, therefore, see the Australian-US 10-year bond spread narrowing by year's end.

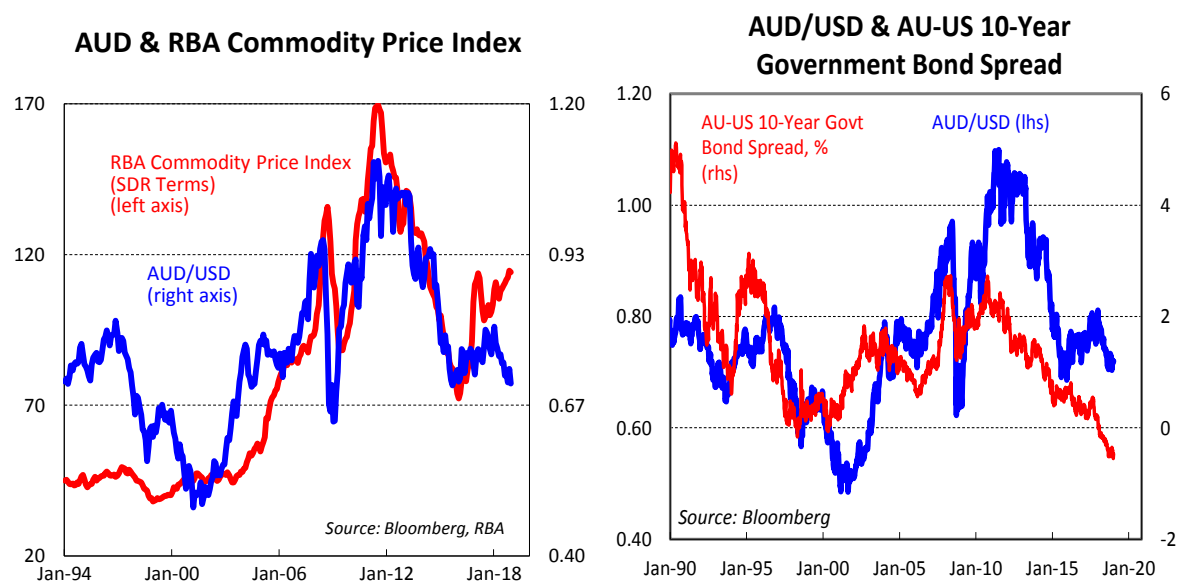
Australian 3-year swap yields will also move higher over this year, from near 1.90% to 2.20% at the end of this year. Some speculation from financial markets that the next move in the RBA could be a cut could cap the rise in these yields. However, our view is the next move from the RBA will eventually be a hike, suggesting any cap in swap yields from market speculation of a rate cut will be temporary.

### Australian Dollar Outlook

Trade tensions along with signs that the global economy is losing momentum have been dominant themes over the past few months within financial markets. These concerns have weighed on financial market sentiment and have continued to keep a lid on the Australian dollar.

The AUD/USD dipped to a low of 0.6741 on January 3, although the AUD quickly rebounded back to above 0.7000 immediately the following day, suggesting the “flash crash” was based on technical factors rather than underlying fundamentals. Thin trading in the holiday period exacerbated the sell off.

Nonetheless, over the course of 2018, the Australian dollar has been in trend decline, mostly reflecting the ongoing trade conflict between the US and China. More recently, indicators on economic activity globally have been signalling a softening of momentum, suggesting that the lingering uncertainty regarding trade developments are now taking a greater toll on confidence and having a negative impact on activity. It is reflected in the recent downgrade to global growth forecasts from the IMF.



The story of slower global growth has negative implications for the Australian dollar. There also continue to be downside risks to the global economy, which could weigh further on the Australian

dollar. Nonetheless, we are not expecting a significantly sharp slowdown in global growth.

Downside risks to the Australian economy are also likely to weigh on the AUD. Falling house prices suggests that household consumption may not maintain its current pace of growth as the reduced wealth of households means that they could hold back spending. Along with the softer global environment, it points to a weaker outlook for the Australian economy.

To the extent that some of these risks are factored into the Australian dollar's value, however, suggests a limit to how far the AUD will depreciate. The outlook for just modestly lower commodity prices over 2019 also points to an AUD not too far from its current value.

Moreover, another changing development is a shift in language by the US Federal Reserve, which has acted to bring down the USD and somewhat mitigated weakness in the AUD. Over the past few years, the Federal Reserve has been on a course to gradually normalise interest rate policy. But over recent months, commentary from Federal Reserve officials has become noticeably more cautious in proceeding with further rate hikes. This shift has resulted in the US dollar index weakening over late December and early January, before rebounding in mid January. Market pricing has reduced the chances of another Federal Reserve rate hike by the end of 2019 and are now implying just a small chance.

However, the expectation that the US economy will continue to grow above the potential rate of growth suggests that tightness in the US labour market is going to continue and still support the case for further rate hikes by the Federal Reserve. This would suggest the US dollar index could push higher.

On balance, the slowdown in global growth and associated downside risks to the global economy, suggest a modest depreciation in the AUD. However, given we are not anticipating a sharp slowdown in the global economy we do not expect the currency to veer substantially from current levels over the medium term. We are expecting 69 US cents and 72 US cents for 2019 and 2020, respectively.

## Forecasts

End Period:	2018		2019				2020	
	Q3	Q4	Q1 (f)	Q2 (f)	Q3 (f)	Q4 (f)	Q1 (f)	Q2 (f)
<b>Interest Rates:</b>								
RBA Cash Rate, %	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day BBSW, %	1.95	2.09	2.05	2.05	2.00	2.00	1.95	1.95
3 Year Swap, %	2.12	1.91	2.10	2.15	2.15	2.20	2.20	2.25
10 Year Bond, %	2.67	2.32	2.35	2.40	2.60	2.60	2.50	2.50
<b>USD Exchange Rates:</b>								
AUD-USD	0.7224	0.7049	0.7100	0.7000	0.6800	0.6900	0.7000	0.7100
USD-JPY	113.70	109.69	110.00	111.00	113.00	112.00	111.00	110.00
EUR-USD	1.1604	1.1467	1.1300	1.1100	1.1000	1.1000	1.1100	1.1400
GBP-USD	1.3031	1.2754	1.2700	1.2800	1.3000	1.3200	1.3300	1.3400
USD-CHF	0.9817	0.9821	0.9900	0.9900	0.9900	0.9900	0.9900	0.9900
USD-CAD	1.2908	1.3637	1.3300	1.3400	1.3300	1.3200	1.3100	1.3000
NZD-USD	0.6619	0.6719	0.6600	0.6400	0.6200	0.6300	0.6400	0.6500
USD-CNY	6.8688	6.8785	6.8500	6.9000	6.9000	6.8500	6.7000	6.6000
USD-SGD	1.3670	1.3629	1.3700	1.3700	1.3700	1.3600	1.3500	1.3400
<b>AUD Exchange Rates:</b>								
AUD-USD	0.7224	0.7049	0.7100	0.7000	0.6800	0.6900	0.7000	0.7100
AUD-EUR	0.6230	0.6150	0.6280	0.6310	0.6180	0.6270	0.6310	0.6230
AUD-JPY	82.10	77.30	78.10	77.70	76.80	77.30	77.70	78.10
AUD-GBP	0.5540	0.5530	0.5590	0.5470	0.5230	0.5230	0.5260	0.5300
AUD-CHF	0.7090	0.6920	0.7030	0.6930	0.6730	0.6830	0.6930	0.7030
AUD-CAD	0.9320	0.9610	0.9440	0.9380	0.9040	0.9110	0.9170	0.9230
AUD-NZD	1.0910	1.0490	1.0760	1.0940	1.0970	1.0950	1.0940	1.0920
AUD-SGD	0.9875	0.9607	0.9727	0.9590	0.9316	0.9384	0.9450	0.9514

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

	2018 (f)	2019 (f)	2020 (f)
GDP, %	3.0	2.4	2.6
CPI (Headline), %	1.9	1.8	1.7
CPI (Underlying), %	1.8	2.0	2.1



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