EMBARGOED UNTIL 11.30 AM WEDNESDAY 12 DECEMBER 2018

THE FORWARD VIEW: AUSTRALIA DECEMBER 2018

Growth to slow – with rates now unlikely to change until the second half of 2020. See our special note on this.

OVERVIEW

The key change to our forecasts this month is a delay in our expectation for a first rate rise. For some time we have recognised that a hike in mid-2019 by the RBA was unlikely based on recent data flow which suggests that despite robust growth (largely as we expected), price pressures remain weak (weaker than we expected). The RBA also appears more patient than expected, likely waiting for hard evidence of inflation returning to target on an ongoing basis. We have lowered our price and wage forecasts to be more in line with recent experience as well as slightly lowering our expectations for growth.

In addition we have lowered our forecasts for dwelling prices in 2018 and 2019. We now expect prices to be down around 5% in 2018, around 4% in 2019 and a touch lower again in 2020. We now foresee a peak-to-trough fall around 15% in both Sydney and Melbourne. That is, however, consistent with an orderly – but deeper correction in house prices. The impact of this sees lower investment in dwellings in each of 2019 and 2020 than previously expected. Wealth effects also detract moderately from consumption in the out years.

It is important to note that we still see a reasonably robust outcome for the economy. Areas of strength include public sector demand – both infrastructure spending and NDIS-related public consumption. We also expect non-mining business investment to benefit from additional infrastructure spill-overs. Mining is also a still potential upside factor to the forecasts, with that sector now clearly reporting the strongest conditions and confidence. Exports are expected to continue to grow relatively strongly - as the last of the large LNG projects reach full production capacity – and then level off.

Our key concern remains developments in the household sector with weak consumption growth - which is likely to weigh on broader economic growth (accounting as it does for over half of all economic activity). We still see weak wage growth, high debt levels and now increased anxiety from slower growth in household wealth. As noted above the construction cycle is now likely to be more negative than we previously expected.

On a more positive note, recent data continues to indicate strength in the labour market – with our Business survey pointing to on going growth in employment of around 20k+ per month. As a result unemployment could well fall to around 4¾% by early / mid-2019. Thereafter, with growth slowing to around potential, further falls are not expected.

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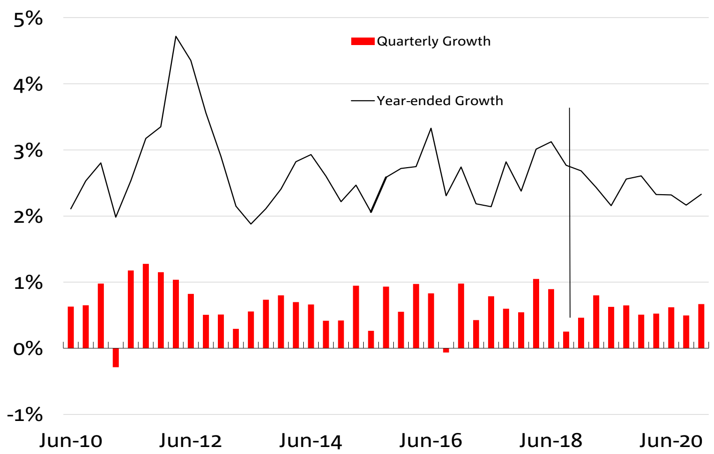
KEY ECONOMIC FORECASTS

	2017	2018-F	2019-F	2020-F
Domestic Demand (a)	2.9	2.9	2.1	2.5
Real GDP (annual average)	**2.4**	**2.9**	**2.4**	**2.3**
Real GDP (year-ended to Dec)	**2.4**	**2.7**	**2.6**	**2.3**
Terms of Trade (a)	11.5	0.1	-4.4	-0.8
Employment (a)	2.3	2.7	2.2	1.6
Unemployment Rate (b)	5.4	4.9	4.7	4.8
Headline CPI (b)	1.9	2.2	2.2	2.5
Core CPI (b)	1.9	1.8	2.1	2.3
RBA Cash Rate (b)	1.50	1.50	1.50	1.75
$A/US cents (b)	0.78	0.71	0.75	0.75

(a) annual average growth, (b) end-period, (c) through the year inflation

REAL GDP GROWTH PROFILE

Quarterly and y/y % change



Source: ABS, NAB Group Economics

CONSUMERS, LABOUR MARKET AND WAGES

Consumption growth slowed in Q3 following stronger than expected outcomes in the first half. Some of the slowing may be due to payback with the true underlying pace of consumer spending being a little higher. While growth slowed in quarterly terms, the year-ended rate of 2.5% is more in line with our expectation for consumption growth over coming years. Retail sales data (around 30% of consumption) suggests a more positive outcome to date in Q4. Nonetheless, we expect the headwinds of slow income growth, high debt levels and weaker growth in household wealth to weigh on consumption over coming years.

While consumption is looking modest, the labour market appears favourable. Employment growth has continued at an above average pace and the unemployment rate has held at around 5.0% on a sustained basis. Forward looking indicators suggest ongoing employment growth, though most likely at a slightly slower pace, but still enough to see the labour market tighten further.

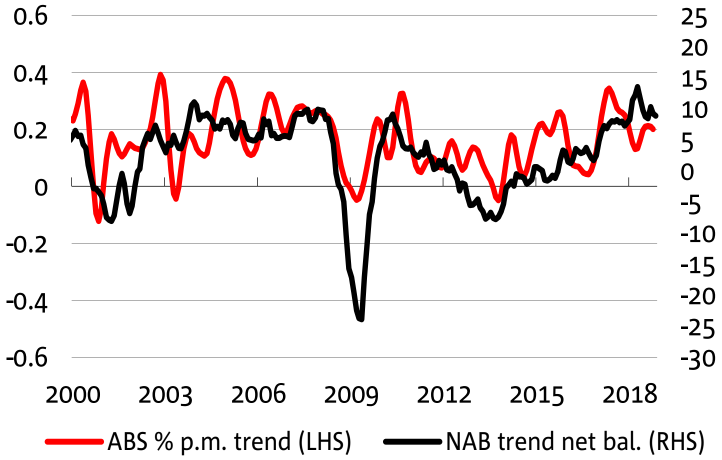
The NAB Monthly Business Survey employment index rebounded in November, and continues to imply employment growth of over 20k per month. This should be enough for the labour market to hold on to recent gains, and see further gradual declines in the unemployment rate over the next year or so.

With the unemployment rate expected to decline further, the extent to which this will generate faster wage growth is uncertain at present. Previous estimates suggest a level of full employment around 5.0%, though it is likely that unemployment could fall further before a substantial lift in wage growth occurs.

For now, wage and inflation pressure remains weak with price and labour cost variables from the NAB business survey remaining subdued.

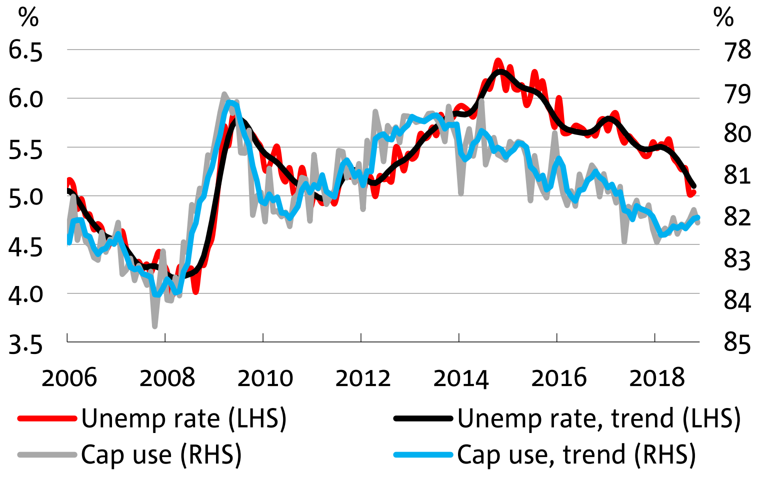
EMPLOYMENT

ABS vs NAB



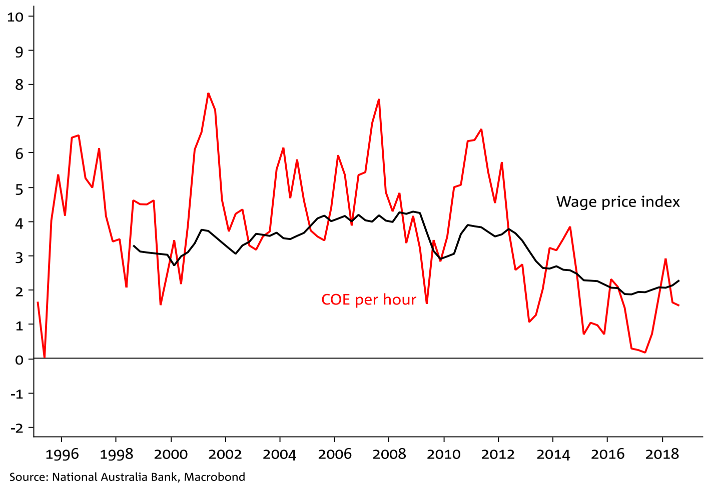
UNEMPLOYMENT AND CAPACITY UTILISATION

ABS (unemployment) and NAB monthly survey



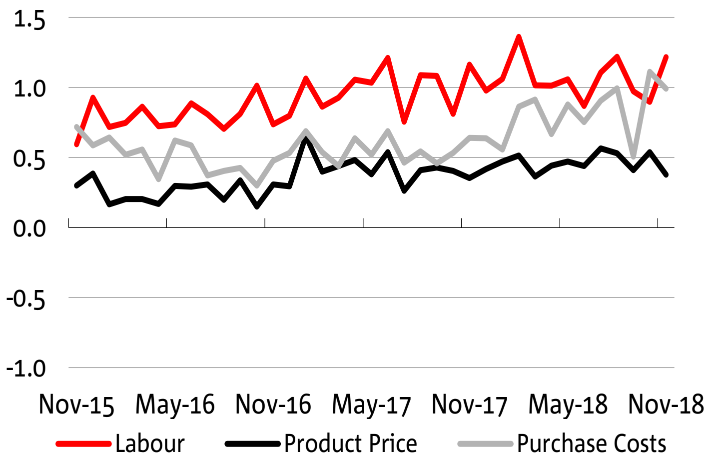
WAGE AND INCOME GROWTH

Y/Y%



NAB BUSINESS SURVEY PRICE PRESSURES

% change at quarterly rate



Sources: ABS, NAB Group Economics

HOUSING AND CONSTRUCTION

The ongoing cooling in the housing market is now evident across both monthly housing activity and prices data. Despite the cooling, the national accounts measure of dwelling investment rose in Q3 – though this was entirely driven by a pick-up in alterations & additions. In the established market, the auction clearance rate has remained at low levels with volumes also having fallen.

The Core Logic 8 Capital City dwelling price index fell 0.9% in November driven by further declines in Sydney (-1.4% m/m) and Melbourne (-1.0% m/m). Since their peak, prices have now declined by 9.5% in Sydney and 5.8% in Melbourne. Perth has weakened again recently (-4.2% y/y) after appearing to have stabilised in early 2018. Elsewhere, Brisbane and Adelaide have recorded flatter outcomes, while Hobart is up almost 10% over the year.

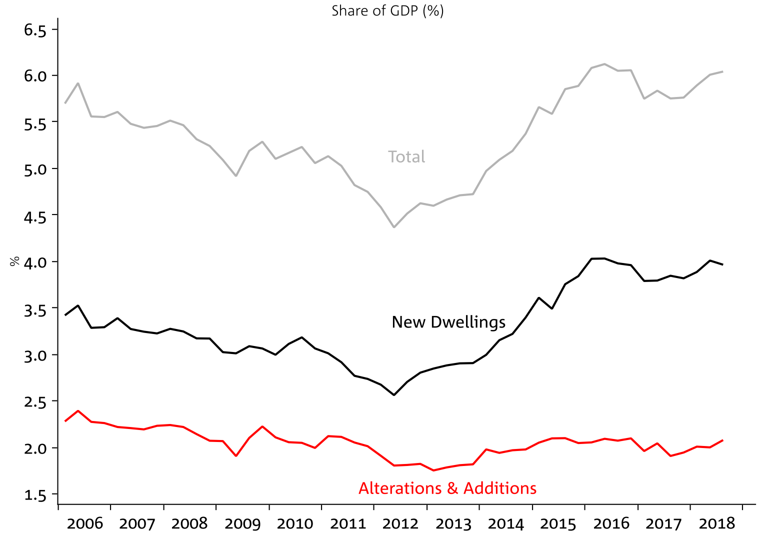
Housing credit growth continued to ease in October – slowing to 5.1% y/y. Investor credit has slowed substantially through 2018, reaching 1.3% in October, and while outstanding credit to owner-occupiers has also slowed, it has tracked at 7.1% over the year. Loan approvals (new credit) rebounded slightly in October led by a rise in new loans to owner occupiers.

On the activity side, residential building approvals continued to trend down in October – though approvals for new houses ticked up in the month. This increase was offset by a fall in the volatile apartments series which is now around 20% lower than a year ago. While approvals are clearly trending down, they are doing so from a relatively high level.

Based on recent momentum we now expect house prices to fall further than previously forecast over the next two years. But we expect the decline to be orderly, with prices still remaining well up on 4 years ago. We now expect peak-to-trough declines of around 15% in both Sydney and Melbourne. We expect more moderate outcomes in the other capitals. Alongside the decline in house prices and weaker building approvals, we expect dwelling investment to decline somewhat over the next two years.

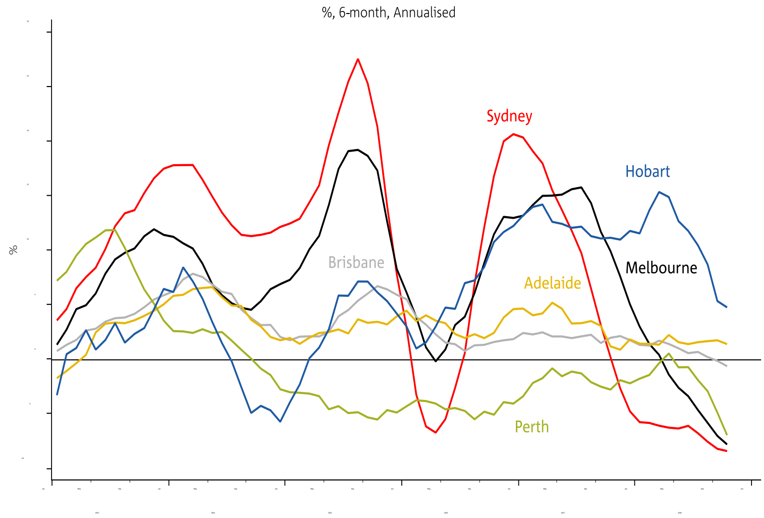
The decline in house prices to date represents a significant correction compared with recent housing cycles. It is unusual for prices to decline while the unemployment rate is falling and interest rates are low and relatively stable. We believe that these declines have been driven by a number of factors including tighter credit, investor price expectations (which also see lower demand for credit) and weaker foreign demand. It is also likely that with house prices having significantly outpaced the growth in household incomes overs recent years, there is some adjustment occurring to restore this balance.

DWELLING INVESTMENT



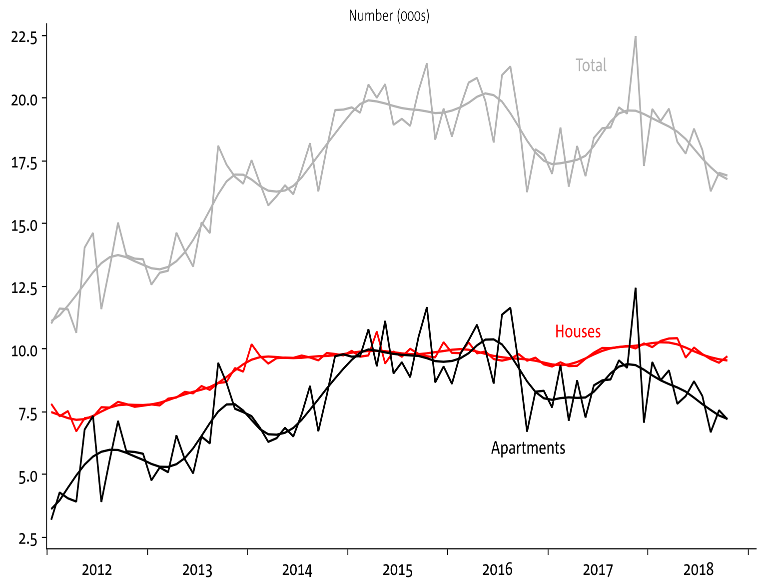
Source: National Australia Bank, Macrobond

DWELLING PRICES



Source: CoreLogic, National Australia Bank, Macrobond

RESIDENTIAL BUILDING APPROVALS



Source: National Australia Bank, Macrobond

BUSINESS AND TRADE

In addition to an update for the monthly business survey, the key quarterly updates for business investment in the national accounts and ABS Capex survey were released over the past month. Overall, these data suggest business investment has been a little weaker than expected, with mining still falling and lower than expected growth in the non-mining sector. Nonetheless, there are signs that non-mining business investment will pick up and the fall in mining investment will level out.

We expect business investment to support growth over the next two years. Non-mining business investment is expected to grow relatively strongly while buoyed by favourable business conditions and high capacity utilisation. There will likely also be further spill overs from the large pipeline of public infrastructure investment under way. We also expect that the drag from mining investment will fade as the last of the large LNG projects enters the production phase. In addition, there may be further upside, with a number of new projects recently announced. It is also likely that mining investment will settle at a new higher level with the required amount of sustaining capex now larger given the expansion in the sector over recent years.

The NAB Business Survey suggests that the business sector has lost some momentum through the middle of 2018. Despite the weaker trend, business conditions remain well above average. The Capex measure - while volatile of late – suggests ongoing investment growth and capacity utilisation remains high after trending up in recent years. An update on forward looking expectations for activity and capex will be available next month with the Q4 business survey.

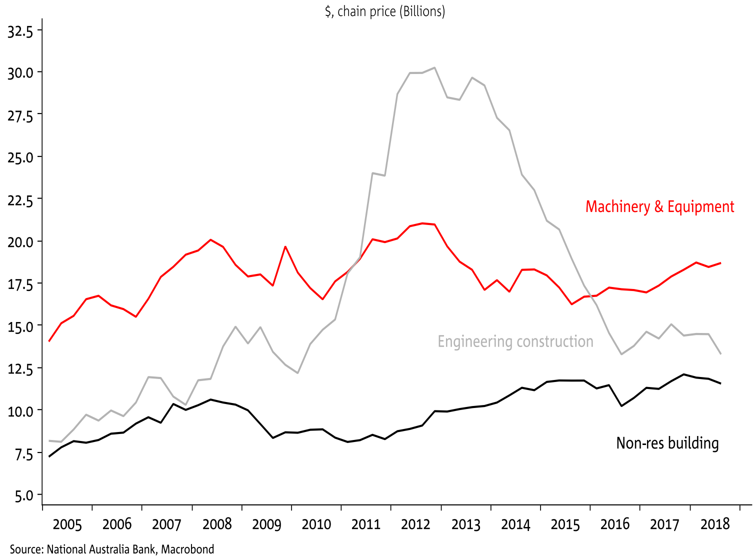
Forward looking indicators appear a little weaker with confidence falling to below average - suggesting that businesses outlook may be less positive than previously. The survey measure of forward orders, which we believe best lines up with official data, has also eased and is now below long-run averages for the first time since late 2016.

The ABS Capex survey expectations for investment suggest a more positive outcome for investment in the next financial year. Expectations for non-mining investment were revised up and now imply growth of around 4% in the year. Mining is expected to decline a little further.

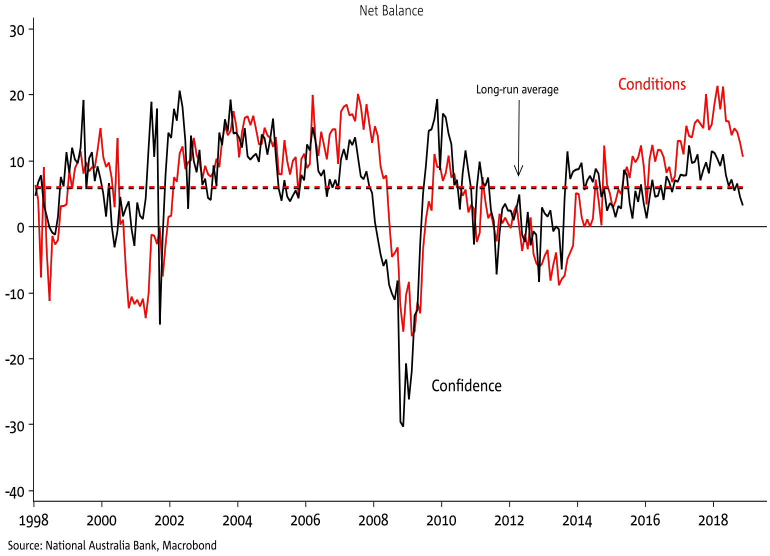
Trade provided some support for growth in Q3, with net exports contributing a solid 0.3% q/q. Mining related exports have continued to rise – though the quarter also saw imports soften which contributed to this outcome.

Overall, trade continues to play out as expected with ongoing strong demand for our key bulk commodity exports to Asia continuing and commodity prices holding their ground. We expect this strong demand to continue and LNG exports to rise over the next year or so as the last of the LNG projects reach full production capacity. One this has occurred, we expect exports to level out for a period.

BUSINESS INVESTMENT

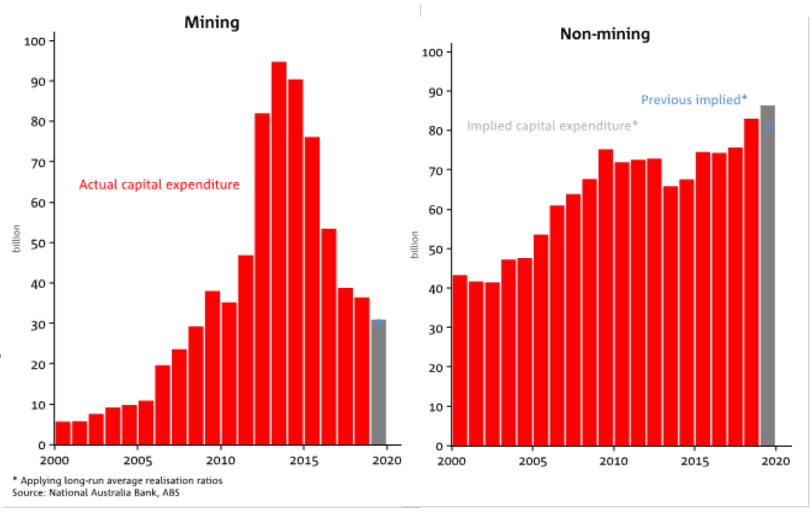


NAB SURVEY CONDITIONS AND CONFIDENCE



CAPEX EXPECTATIONS

Annual ($b)



COMMODITIES

Iron ore spot prices corrected sharply in late November, as Chinese steel capacity closures (as a means to address pollution during the northern winter) started to impact demand. Prices dropped back into the range from US$60 to US$70 a tonne that was evident between March and September. In contrast, prices for both thermal and metallurgical coal have remained elevated – with supply side constraints impacting these markets.

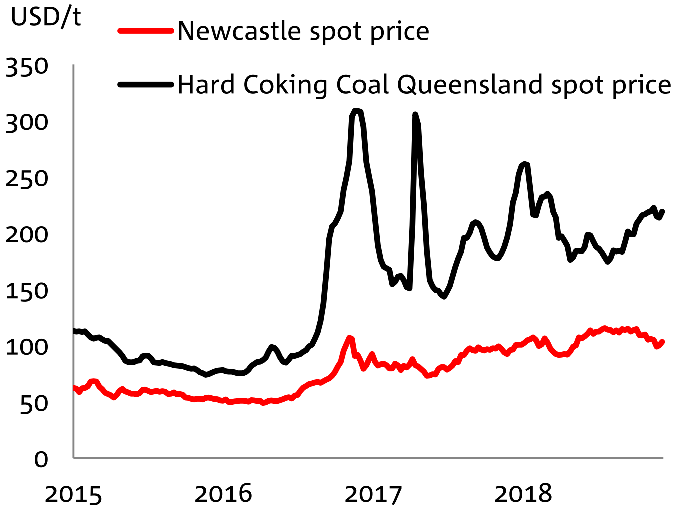
Australian fuel prices have now dropped substantially, falling from above 160c/l (national average, weekly) in early November, to mid-130s in early December. This decline reflects a sharp drop in the price of crude over the past two months. Brent peaked above USD86 in early October, before falling to the high USD50s to low USD60s range recently.

This sharp change in sentiment has been driven by supply outpacing expected demand, combined with a range of geopolitical issues – notably US pressure on Saudi output and ongoing US-China trade dramas. Last week, OPEC agreed to larger than expected supply cuts in the order of 1.2m bbl/d. Whether this will stabilise the market remains to be seen, although we see crude prices generally moderately higher in the new year.

Australia's LNG production ramp-up is nearing completion, and while prices look strong, we see them retreating a little in the new year.

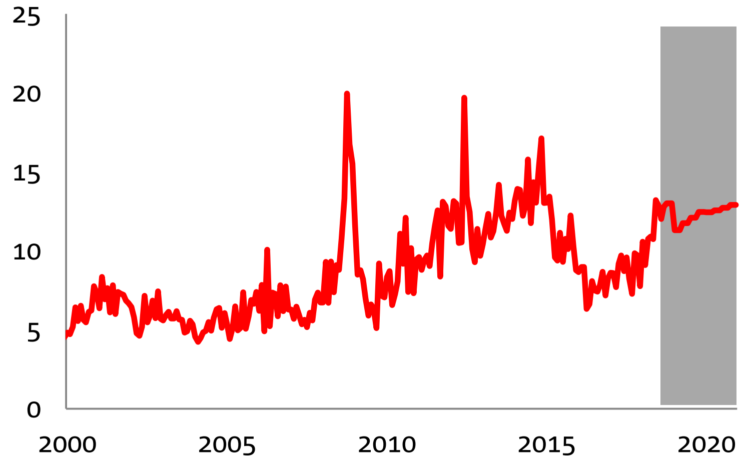
The NAB Rural Commodities Index fell 2.0% in November, reversing a 2.0% gain in October. The index tracks 28 commodities weighted by the relative size of each commodity in the Australian agricultural sector. Grains were generally lower (albeit from a very high peak), as were wool and lamb. Dairy export prices also trended lower (down 5.5%). Meanwhile, pork looks to have turned a corner (up 6.5%) and cattle remains remarkably resilient given the current seasonal challenges.

COAL SPOT PRICES



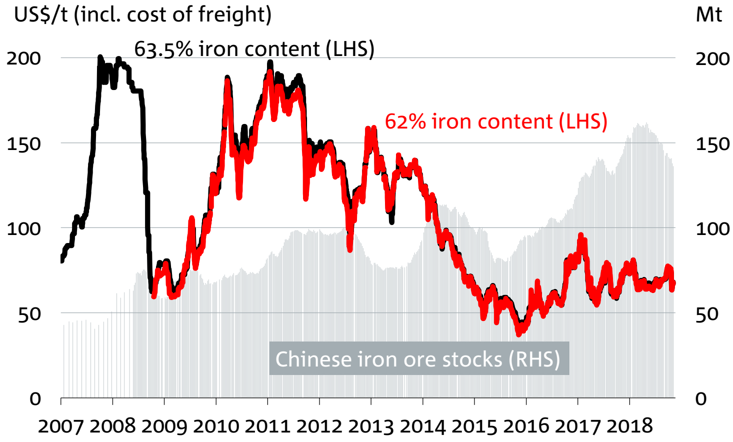
AUSTRALIAN LNG EXPORT PRICES

Monthly actuals and quarterly forecasts, AUD/GJ



IRON ORE SPOT PRICE

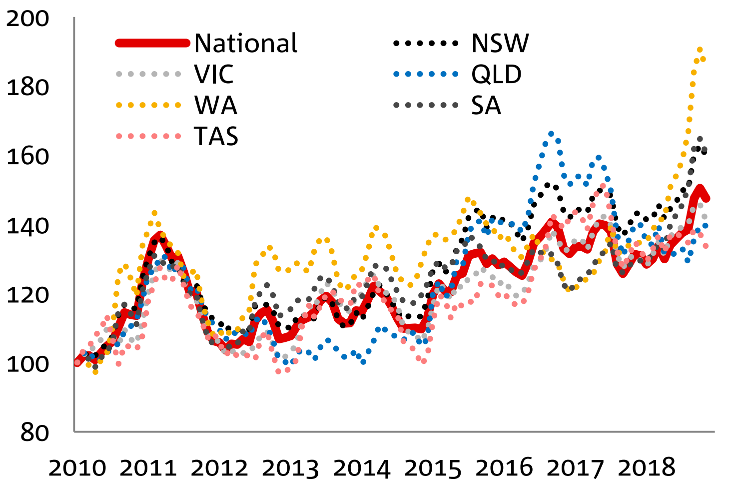
US$/t (incl. cost of freight)



Source: Bloomberg, Thomson Datastream, NAB Economics

NAB RURAL COMMODITIES INDEX

Jan 2010 = 100



Source: ABARES, Meat and Livestock Australia, Australian Pork, Ausmarket, ABS, Bloomberg, Thomson Reuters, BREE and Profarmer

MONETARY POLICY, INFLATION AND FX

There was no move on monetary policy in December – as was widely expected. The recent run of activity data has confirmed the economy has maintained a healthy momentum (though has slowed slightly from the strong pace in early 2018). Above trend growth has seen employment continue grow and the unemployment rate decline further, with the decline in the unemployment through mid-to-late 2018 now appearing to have been sustained. Recent inflation data has confirmed that despite the strength on the activity side, price pressure remains weak with core measures tracking at around 1¾% - somewhat below the RBA's target band. The RBA's outlook continues to point to the next move in rates being up, but for now the RBA appears content to see stability in rates. Low rates are providing support to the economy and previous concerns around the build up of risk in the household sector appear to be contained – following earlier macro-prudential action – and the ongoing cooling in the housing market. The build-up of inflationary pressures is expected to remain gradual, with some remaining spare capacity in the economy and a relatively low starting point for inflation.

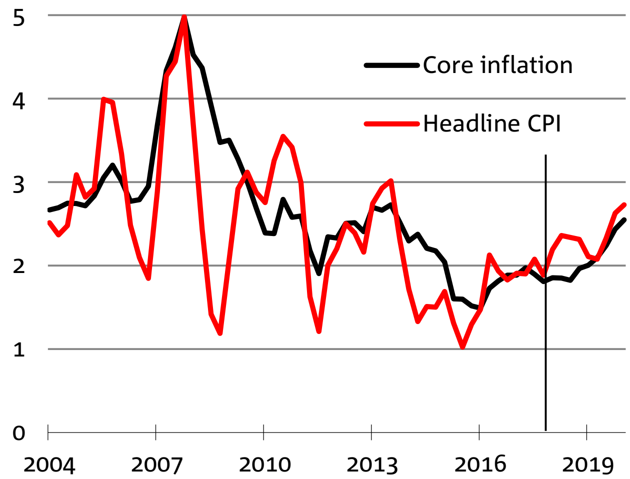
With the recent run of quarterly prices and activity data we have reassessed our view on the likely path of monetary policy. We still expect the next move in the cash rate to be up, but expect the first move to occur in the second half of 2020. While our outlook for the activity side has largely played out as expected, inflationary pressure remains weak – and well below what is needed for the RBA to be confident of achieving inflation of 2-3% on average over the cycle. We think this has occurred because of a higher degree of spare capacity remaining in the labour market and hence smaller than expected increases in wage growth. While there are signs that the labour market continues to tighten, wage pressure to date, remains below that required to hit the centre of the RBA inflation target. We think it is unlikely to do so until 2020. In that environment – especially where house prices continue to move down - the RBA will take some convincing that inflation will return to the target range on a sustainable basis.

We have revised down our growth outlook slightly with a larger impact of the downturn in the housing market both through activity and spill overs to the consumer. We have also lowered our expectation for wages growth and inflation, which we now see rising more gradually. However, the RBA appears to be more patient than previously anticipated – though still forward looking. Consequently we do not see any move by the RBA, based on the current trajectory for inflation, until H2 2020.

The AUD/USD is roughly unchanged from a month ago. After rallying at the beginning of the November, AUD/USD mostly range-traded between 72 and 73 cents during the rest of the month. Speculation over the US-China trade relationship, softer oil prices, Fed rhetoric turning dovish and a more cautious RBA were the main sources of volatility for the currency during the month. Looking forward we expect the currency to trade nearer to US75c with our fair-value models pointing to this level over the next couple of years after trading close to US71c in the near term.

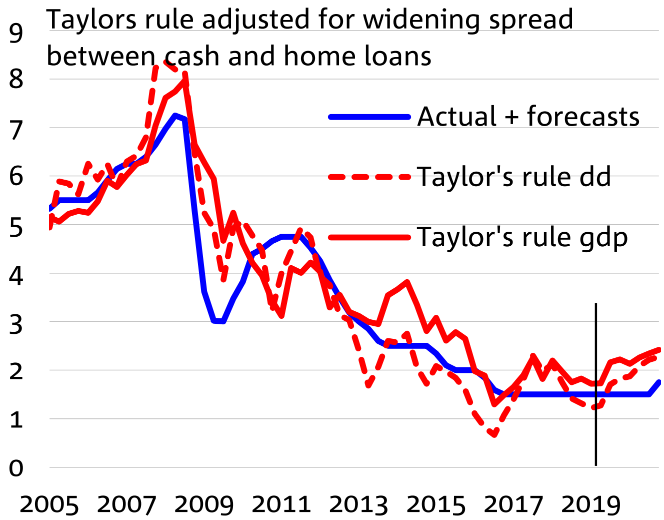
HEADLINE AND CORE INFLATION

y/y % change

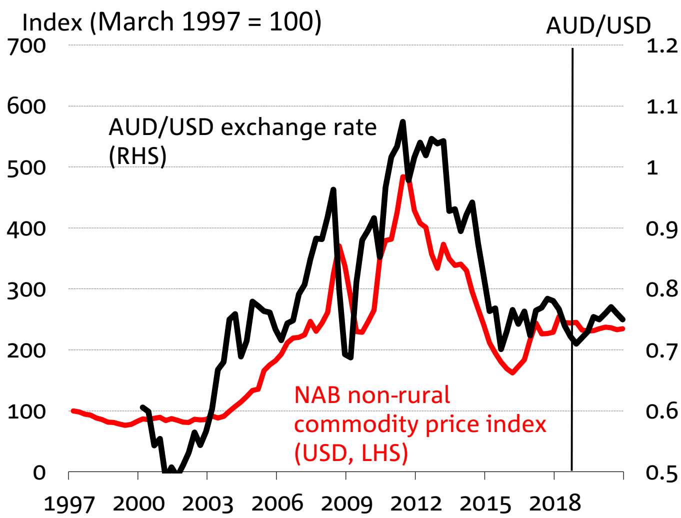


TAYLOR RULE AND RATE FORECASTS

%



AUD AND COMMODITY PRICES



Sources: Econdata DX, RBA, ABS, NAB Economics

APPENDIX A: FORECAST TABLES

DETAILED ECONOMIC FORECASTS (ANNUAL AVERAGE)

Australian economic and financial forecasts (a)

	Fiscal Year				Calendar Year				
	2016-17	**2017-18 F**	**2018-19 F**	**2019-20 F**	**2016**	**2017**	**2018-F**	**2019-F**	**2020-F**
Private Consumption	2.4	2.8	2.2	2.5	2.7	2.4	2.5	2.3	2.5
Dwelling Investment	2.5	0.1	0.3	-10.2	7.9	-2.4	4.7	-7.7	-8.6
Underlying Business Investment	-6.3	6.7	0.0	5.6	-11.8	3.5	1.9	3.2	5.1
Underlying Public Final Demand	5.3	4.4	4.2	4.4	5.7	4.5	4.3	4.1	4.5
Domestic Demand	**2.2**	**3.3**	**2.2**	**2.4**	**1.8**	**2.9**	**2.9**	**2.1**	**2.5**
Stocks (b)	0.0	0.0	-0.1	0.0	0.1	-0.1	0.1	-0.1	0.0
GNE	**2.2**	**3.3**	**2.0**	**2.4**	**1.9**	**2.7**	**3.0**	**2.0**	**2.5**
Exports	5.5	4.0	4.4	3.7	6.8	3.5	5.4	4.0	2.8
Imports	4.7	7.0	0.8	3.4	0.1	7.7	3.7	1.6	3.7
GDP	**2.3**	**2.8**	**2.5**	**2.5**	**2.8**	**2.4**	**2.9**	**2.4**	**2.3**
Nominal GDP	6.2	4.7	4.2	4.0	3.9	6.1	4.7	3.7	4.4
Current Account Deficit ($b)	38	51	54	67	56	47	48	62	71
(-%) of GDP	2.2	2.8	2.8	3.3	3.3	2.6	2.5	3.1	3.5
Employment	1.4	3.0	2.5	1.8	1.6	2.3	2.7	2.2	1.6
Terms of Trade	14.3	1.6	-1.7	-2.9	0.0	11.5	0.1	-4.4	-0.8
Average Earnings (Nat. Accts. Basis)	0.5	1.4	1.5	2.6	0.9	0.8	1.5	2.2	2.7
End of Period									
Total CPI	1.9	2.1	2.4	2.3	1.5	1.9	2.2	2.2	2.5
Core CPI	1.9	1.8	1.9	2.2	1.4	1.9	1.8	2.1	2.3
Unemployment Rate	5.6	5.6	4.7	4.7	5.7	5.4	4.9	4.7	4.8
RBA Cash Rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
10 Year Govt. Bonds	2.60	2.63	2.75	2.60	2.77	2.63	2.55	2.70	2.70
$A/US cents :	0.77	0.74	0.73	0.77	0.72	0.78	0.71	0.75	0.75
$A - Trade Weighted Index	65.5	62.6	64.5	65.5	63.9	64.9	61.5	65.2	62.4

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

COMMODITY PRICE FORECASTS

		Spot	Actual	Forecasts								
	Unit	7/12/2018	Sep-18	*Dec-18*	*Mar-19*	*Jun-19*	*Sep-19*	*Dec-19*	*Mar-20*	*Jun-20*	*Sep-20*	*Dec-20*
WTI oil	US$/bbl	53	71	58	63	69	71	72	74	74	74	74
Brent oil	US$/bbl	63	75	66	70	75	77	78	80	80	80	80
Tapis oil	US$/bbl	64	77	67	71	76	78	79	81	81	81	81
Gold	US$/ounce	1246	1210	1250	1280	1300	1300	1320	1340	1360	1380	1410
Iron ore (spot)	US$/tonne	n.a.	67	68	63	60	61	62	63	61	58	60
Hard coking coal*	US$/tonne	n.a.	187	195	180	175	160	165	160	156	153	150
Thermal coal (spot)	US$/tonne	103	114	110	105	103	101	100	103	100	98	100
Aluminium	US$/tonne	1951	2055	1975	1950	1940	1960	1970	1975	1960	1955	1950
Copper	US$/tonne	6149	6119	6200	6275	6375	6450	6300	6225	6150	6125	6100
Lead	US$/tonne	1983	2096	1975	2000	1950	1900	1850	1825	1800	1750	1725
Nickel	US$/tonne	10846	13262	11500	12000	12250	12500	12750	12600	12500	12400	12500
Zinc	US$/tonne	2681	2537	2650	2550	2500	2480	2470	2450	2475	2450	2425
Aus LNG**	AU$/GJ	n.a.	12.8	13.0	11.3	11.7	12.1	12.5	12.4	12.6	12.7	12.9

S * Data reflect NAB estimates of US$/ tonne FOB quarterly contract prices. Actual data represent most recent final quarterly contract price.

** Implied Australian LNG export prices

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