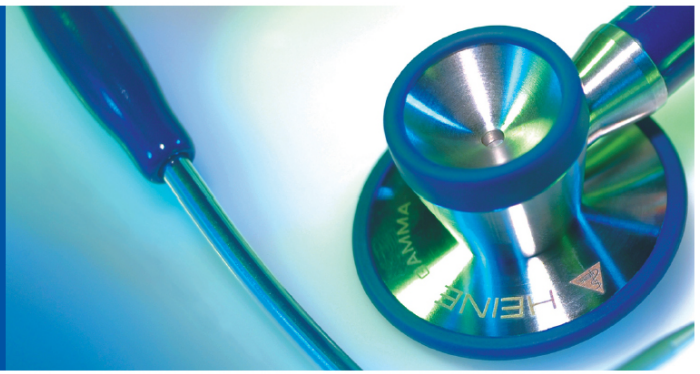




## The Bigger Picture

– A Global & Australian Economic Perspective



***Global: Global growth has returned but is very variable by region. China, India and Non Japan Asia have seen sharp rebounds. The USA is also improving and has the potential to surprise on the upside. Japan also looks better from a low base. Europe, however, is still very disappointing and sovereign risk is real – with significant negative potential.***

- Globally we expect GDP growth of around 3½% in 2010 – after the world economy shrank (for the first time since WW2) by around 1¼% in 2009. Over the longer term we expect growth to approach 4% in 2011. While encouraging, the forecasts mask a very lopsided pattern of global recovery.
- Underpinned by a massive fiscal package and very expansive credit, China grew by around 2½% in Q4 or by around 8.7% in 2009. Industrial production continues at around 18% y/y and the prospect of further strong growth in 2010 seems assured – we expect growth of 9.3%. Recently the Chinese authorities have started to tighten credit in a bid to avoid overheating.
- The strength in Chinese demand has in turn flowed over into export demand across non Japan Asia. After falling steeply in the GFC, Asian production has rebounded. Thus by end 2009 industrial production across Korea, Taiwan, Malaysia, Thailand, Singapore and the Philippines was growing by around 15% (on a year to the latest 3 months basis). While initially this involved a rebuilding of stocks, that phase has long passed. As a result we expect non Japan Asia to grow by around 4.3% in 2010.
- Similarly Indian policy stimulus appears to have been successful in accelerating demand growth and we expect growth of around 7¼% in 2010. Latin American economies are also rebounding, buoyed by increased global trade and strengthening commodity prices.
- After stabilising in Q3 the US economy reported very strong growth in Q4 (up 1.4%). While a good deal of this strength came from restocking and export growth, there were also signs that the falls in housing and business investment may be ending. More fundamentally improved wealth effects from equity markets, less negative housing markets and the lower USD are having an impact. Clearly unemployment is still a significant headwind as is consumer and business de-leveraging. Also, much still depends on public sector stimulus which will need to be unwound. Overall, we expect growth of around 2½% in 2010. Recent strong surveys (e.g. the January manufacturing ISM) suggest there may be some upside to these forecasts.
- Japanese GDP has also surprised on the upside in Q4 – increasing by 1.1%. Again, much of that growth was underpinned by a surge in exports. While the GDP numbers are notoriously volatile and subject to revision, stronger Tanken survey results suggest that the Japanese economy may grow by around 2¼% in 2010 – albeit that growth comes from a very low base.
- Against that, the European data in Q4 can only be described as deeply disappointing. Europe as a whole grew by only 0.1% in Q4 – with France the only large economy actually growing. Similarly after a savage recession, the UK could only manage 0.1% growth in Q4. Prospects for 2011 still look weak. Thus we have revised down our European and UK forecasts to 0.7% and 0.9% respectively.
- For Europe, concerns are being increasingly raised about the ability of governments to fund the extensive fiscal packages that have been put in place. Equally there are concerns – especially in the southern European states – about the ability of governments to put in place the type of fiscal packages necessary to return public finances to a sustainable path. That is especially the case in an environment of still high and rising unemployment. Hence the new emphasis on the possibility of sovereign risk re-emerging – with the potential for very severe and dangerous flow-on effects.
- A key assumption in our forecasts is that some type of package will be put together to ensure that current problems in Europe will not be allowed to escalate into actual defaults. While clearly much could still develop here, we are still reasonably confident of sustained global growth and the prospects of a “W” recession receding.

***Australia: After a remarkable 2009, Australian growth strengthened in late 2009 – with the labour market now substantially stronger. While it looks like 2010 started on a weaker note, confidence is still high and we expect growth of 3% - with unemployment falling to 4¾% by year end. RBA has around 100 points to do over 2010.***

- Recent business surveys point to a very strong end to 2009. Indeed based on past relationships the survey suggests that demand was probably running around 4% at an annualised rate in H2 2009. For Q4 we are currently expecting GDP growth of around 0.9% - we also suspect that the relatively low Q3 estimate of 0.2% may be understating the true momentum of the economy.
- That is certainly also in keeping with a very strong labour market. According to the official estimates employment has accelerated from no annual growth in Q3 to around 1% growth in Q4. Unemployment has fallen from 5.8% to 5.3% in January 2010. The survey also shows very strong employment growth in late 2009/ early 2010 – with a substantial increase in hours worked in late 2009.
- Businesses have also increased their level of capacity utilisation as greater confidence in the sustainability of recovery builds and are no longer de-stocking. That said, business investment intentions remain relatively low and business continues to de-leverage (especially corporates). As a result demand for business credit continues to fall – with business reporting “no need for credit” rising to a record high of 47% in the January business survey.
- Given the strength of activity in late 2009 it is perhaps not surprising that overall business confidence in the January survey remains at high levels (+15 points). That said it appears that January trading and profits were well off the levels reported in late 2009 – with the Survey’s measure of activity falling by 7 points to +3 index points. That decline would have been more were it not for a still strong labour market. Similarly there was a marked fall in new orders. Broadly it appears that business may have been surprised by the January outcomes. While they remain optimistic future trends will need to be carefully watched.
- Overall, the combination of a strong labour market (both on an hours worked and heads basis) and improved wealth from equity and housing markets will continue to underwrite robust consumer spending (around 3¾% in 2010) notwithstanding continuing de-leveraging.
- On property markets, while the end of the FHOB and higher rates will detract, those factors are more than offset by lower unemployment and a continuing undersupply of housing. As a result we now see house prices up 5-10% in 2010 compared to previous expectations of falls.
- Overall we see no reason to change our credit forecasts for 2010 – which have business credit falling by 5%, housing credit growth of 8% which, with moderate consumer credit, leads to total credit growth of 2¾%.
- Even with little expected growth in business investment, strong consumption growth and still robust public sector spending (around 5½%) will see GDP growth of around 3% in 2010 (and somewhat stronger on a December 2009 / December 2010 basis). For 2011 we see growth strengthening further to around 3¾% (marginally stronger than RBA estimates in last weeks SMP).
- Applying those growth rates to the labour market, would see unemployment falling to 4¾% by end 2010 and around 4¼% by late 2011. We also see core inflation slowing to around 2.3% by late 2010 as the currency strengthens and spare capacity persists. On the currency we still see the AUD nearing parity in mid 2010 as Australian growth outperforms while rates and commodity prices move higher.
- Clearly those forecasts are not consistent with very low interest rates. We still see the need for the RBA to increase rates by around 100 points to 4¾% by end 2010. While the RBA has signalled they are reassessing the impact of the 3 rises already delivered, the timing of the expected rises is very much data driven. That is every meeting is potentially live in 2010. At this stage we expect 25 point rises in May, June, August and November. But the possibility of a rate rise in March is still near 50% given recent strong data. We then expect the RBA to take rates to around 5½% by late 2011 which would be on the tight side of neutral – but consistent with the strong activity forecast by ourselves and the RBA for 2011.

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