The skew in global growth means Australia’s major trading partners should outperform again.

PAGE 03

Risks have intensified around the combination of Australia’s high household debt and weak income growth, as well as around the global backdrop.

PAGE 03 & 08

The growth-wages-inflation nexus has been missing in action in recent years but could resurface later in 2019, although the RBA is likely to remain on the sidelines through 2020.

PAGE 04
This report is an abridged version of “Australia in 2019: Risks & Issues” written by Commonwealth Bank Chief Economist, Michael Blythe, and published on 15 January 2019.

Michael Blythe is the Chief Economist and a Managing Director at the Commonwealth Bank. Michael has extensive experience in his field, having worked more than 30 years in economic policy and financial market-related areas. Michael joined the Commonwealth Bank in 1995.
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Chart data throughout this document dated as of 28 February 2019
Overview

Downside risks have lifted

- 2018 was expected to be a year of transition to above-trend growth for the Australian economy.
- Another year of below-trend growth is likely in 2019 as downside risks have lifted.
- Favourable labour market trends should continue in 2019.

The positive views on the outlook for the global and Australian economies at the start of 2018 slowly disappeared as the year progressed.

Some of the risks that worried policy makers and financial markets for some time moved closer to reality. Nevertheless, some economic outcomes were respectable. Trade and capex continued to grow and economies ran around potential. Labour markets improved further while commodity prices again defied the consensus.

The global backdrop will be more uneven in 2019. But the skew in global growth means Australia's major trading partners should outperform the rest of the world again and the downside to commodity prices looks limited. Favourable labour market trends should continue. A tightening labour market gives some confidence that the modest lift in wages growth in 2018 will continue in 2019. It also provides some confidence that inflation will slowly edge back into the Reserve Bank of Australia's (RBA) 2-3% target band. Nevertheless, 2019 is likely to be another year where the monetary authorities remain on the sidelines.
The risks and issues facing Australia remain many and varied. Some have receded, some have intensified and some new risks have emerged:

- Desynchronised growth is the central global theme for 2019. Within that uneven pattern, policy moves mean growth should favour industrial production and Asia. (pp10-11)
- The main global risks are sourced from the US-China trade war, a (Federal Reserve) policy “misstep” and a slowing US economy, high levels of USD corporate debt in Asia and geopolitical tensions, particularly Brexit, Italy and populism. (pp12-17)
- How commodity prices behave in a desynchronised world is critical for the transmission to Australia. Chinese policy stimulus should help stabilise demand. Cautious producers should cap supply. India, the Belt & Road Initiative (BRI) and US infrastructure spending could help. (pp18-19)
- Household debt and the housing market that lies behind it are the main sources of domestic risk. The regulators have reduced the financial stability risks associated with debt and housing. But they have created a new risk to the consumer from higher mortgage payments, falling house prices, a negative wealth shock and a potential credit squeeze. (pp20-23)
- A modest lift in wages growth, a potential shift towards some fiscal stimulus, demographic support to housing construction, a lift in non-mining capex and a bottom in mining capex have allowed some domestic risks to recede. But the Australian Federal election could muddy the waters. (pp24-27, 30)
- The payoff from rising resource exports, the infrastructure boom and rising Asian incomes will continue. (pp28-29)
- The growth-wages-inflation nexus has been absent in recent years but could resurface in 2019. Inflation rates may lift a little but the RBA is likely to remain on the sidelines. (pp30-33)
“How commodity prices behave in a desynchronised world is critical for the transmission to Australia.”

Michael Blythe, Chief Economist
Commonwealth Bank of Australia
Overview

Australia’s economy grew below potential in 2018

The positive view on the outlook for the global and Australian economies in early 2018 slowly disappeared during the year.

Major forecasting institutions like the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) revised global growth forecasts down for the first time since 2016.

In Australia rising employment and a low unemployment rate are key to minimising some of the domestic economic risks.

Growth around potential will help keep unemployment low. Rising employment and a low unemployment rate are key to minimising some of the domestic economic risks.

Background economic and policy parameters are favourable for Australia’s growth prospects at the start of 2019:

- Monetary conditions as measured by the CommBank Monetary Conditions Index remain very accommodative (Graph 1).
- Competitiveness and labour cost settings are helpful (Graph 2).
- Australian policymakers have the ability to deliver monetary and fiscal stimulus if required.
- The floating AUD remains an effective buffer against external economic shocks (Graph 3).

Graph 1: Real MCI (Jan’88=100)

Graph 2: Competitiveness and labour cost

Graph 3: The AUD Trade-Weighted Index

Source: CommBank

Source: RBA/ABS

Source: Bloomberg
“Background economic and policy parameters are favourable for Australia’s growth prospects at the start of 2019”
Overview

The Australian economy to grow below potential again in 2019

Several enduring themes have underpinned CommBank’s Australian economic forecasts for some years now. Many of these will transition through to 2019.

The risks that relate to a sharp downturn in residential construction activity and business reluctance to lift capex have receded. Strong population growth limits the downside to residential construction and business capex is finally lifting. Additionally, there are tentative signs of an improvement in wages growth.

However, the risks around the global backdrop and Australia’s high household debt/weak income growth nexus have intensified. Globally the theme has shifted to a more desynchronised growth outcome (see page 10). Domestically the measures taken to improve financial stability have worked. But the risk has essentially been transferred to the macro-economy via consumer activity (p20).

Growth positives that will go a long way to countervailing the negatives include:

- A skew in global growth that favours Australia’s major trading partners and commodities (p10).
- Removal of the final commodity-related headwind as mining capex bottoms out (p26).
- Favourable demographics and solid labour market outcomes (pp26, 20).

From a market perspective our calls have the RBA remaining on the sidelines in 2019 versus market pricing that now has a significant chance of a rate-cut by year-end.
“Not only is the global economic growth in the right regions for Australia, it is also skewed towards industrial production which favours Australia’s commodity exports.”

Michael Blythe, Chief Economist
Commonwealth Bank of Australia
Global themes: An Australian perspective
Global themes: An Australian perspective

Global growth is evolving in a way that lessens the risks to Australia

Desynchronised global growth will be the central theme for 2019. However, it appears to be evolving in a way that lessens the risks to Australia:

- PMI surveys show the Emerging Market (EM) economies, arguably more important for Australia, retained a positive growth momentum at the end of 2018. Australia’s major trading partners should outperform the global economy in 2019 (Graph 4).

Graph 4: Global PMI Momentum (annual change in composite PMI)

Other global themes include:
- Fiscal policy will shift from providing stimulus to becoming more neutral. China is a significant exception.
- Global inflation should remain well contained in 2019 although some fundamentals have shifted in a way that favours a lift in inflation rates.
- Growth in global trade has slowed and risks here continue to build.
- Labour markets continue to improve which is supportive of consumer spending.
- The global capex cycle has further to run, especially in EM economies.
Global risks in 2019
Global risks in 2019

Emerging economies, mainly in Asia, at most risk in trade war

There are many risks to global growth. Trade issues and fears of a policy mistake figure prominently in Oxford Economics’ Global Risk Survey (Graph 6).

Graph 6: Top Downside Risk next 10 years (% of respondents)

There are many risks to global growth. Trade issues and fears of a policy mistake figure prominently in Oxford Economics’ Global Risk Survey (Graph 6).

Graph 6: Top Downside Risk next 10 years (% of respondents)

The trade war

The trade war moved from risk to reality in 2018. Data already shows a divergence between (slowing) exports from the advanced economies and (ongoing) export growth in the EM economies, a major factor explaining 2018’s global growth desynchronisation (Graph 7).

Graph 7: World Export Volumes (smoothed annual % change)

Like any brawl, it is often the little guys that are hurt when the big players (China and the US) slug it out. The integrated nature of global trade means the countries most actively participating in global value chains are the most exposed, particularly those with a large share of exports going to the US and China. The EM economies, mainly in Asia, are most at risk (Graph 8).

Graph 8: Trade and Global Supply Chains

The IMF has conducted some scenario analysis on the impact of trade restrictions on global GDP. Tariffs on their own have a relatively small effect – a loss of about 0.1% relative to baseline. But global GDP is cut by 0.4% in Year 1 and 0.5% in Year 2 when trade tensions weaken confidence.
Nobody wins in a trade war. Analysis by the Australian Productivity Commission shows that, in a worst case scenario, where all countries raise tariffs by 15%, global recession would follow (Graph 9).

Australia however fares better than most other countries and regions. This is partly due to its relatively low participation in global value chains.

Most of what Australia sells to China remains in China (77%). Very little of it goes into the production process (23%) to emerge as an export from China to the US (20% of the 23%). Only 1.4% of Australia’s trade (0.08% of Australia’s GDP) is exposed in a US-China trade war.

**Graph 9: Impact of a 15% Tariff Rise**

<table>
<thead>
<tr>
<th>Country</th>
<th>% Deviation in Global Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUS</td>
<td>-3</td>
</tr>
<tr>
<td>CHN</td>
<td>-6</td>
</tr>
<tr>
<td>US</td>
<td>-3</td>
</tr>
<tr>
<td>MEX</td>
<td>0</td>
</tr>
<tr>
<td>CAN</td>
<td>-3</td>
</tr>
<tr>
<td>JAP</td>
<td>-3</td>
</tr>
<tr>
<td>KOR</td>
<td>-3</td>
</tr>
<tr>
<td>ASEAN</td>
<td>-3</td>
</tr>
<tr>
<td>EU</td>
<td>0</td>
</tr>
<tr>
<td>REST</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Australian Productivity Commission

Emerging market economies, mainly in Asia, are most at risk in the trade war.

Only 1.4% of Australia's trade is exposed in a US-China trade war.
Global risks in 2019

Why bond yields could rise

IMF modelling shows the US Tax Cuts & Jobs Act is pushing US output further above potential and the unemployment rate further below the full employment level, meaning the Federal Reserve (Fed) has to lift interest rates further than otherwise – 100bp according to the model. It has rates peaking in 2020 just as the fiscal stimulus fades. This policy combination is behind the policy ‘mistake’ fears that are driving current US growth concerns and market volatility.

That volatility in itself could raise term premiums as investors seek compensation for higher risk. Higher Treasury term premiums would be a negative for US growth prospects, particularly if they cause further strength in the USD. Moreover, IMF spillover modelling suggests a 100bp rise in the global term premium would cut US and UK GDP by 0.6ppt relative to baseline and the rest of the world by 0.2ppt.

Other factors affecting bond yields include central banks turning from net buyers to net sellers:

- BCA Research estimates that private investors must absorb an additional US$1.2 trillion of government bonds in 2019 given the European Central Bank (ECB) has stopped buying European bonds and the Fed is running down its balance sheet (Graph 10).
- With China’s current account surplus disappearing in 2018, one of the big natural buyers of bonds will be less active because it has less funds to recycle.

Another issue is that around US$1.2 trillion of EM corporate debt denominated in USD must be refinanced between 2019 and 2023. The initial stages would be occurring at a time of higher US interest rates and a stronger USD (Graph 11).

Indebtedness is a global phenomenon. The entire economy is exposed to higher debt servicing costs as interest rates rise. Fiscal policy is also constrained, limiting much needed investment in infrastructure and leaving many economies exposed to the pressures from ageing populations.

More broadly, growth in global population and productivity is at the low end of the range of the past 28 years while labour force participation rates are trending lower. Therefore, downside risks to potential growth rates over the medium term persist (Graph 12).

Graph 11: Emerging Market Debt

Source: IIF

Graph 12: Global 3P’s (annual % change)

Source: World Bank / Conference Board / CommBank
Global risks in 2019

Geopolitical tensions abound as populism rises

As well as Brexit, the main geopolitical concerns to emerge from Oxford Economics’ Global Risk Survey were:

**Italy**: Given its weak economy and fiscal policy that is pushing the limits, Italy faces significant political and policy uncertainty in 2019. While it is a source of risk for financial markets, experience has been that support for Europe and European institutions increases in economies under pressure (Graph 13).

**Graph 13: Support for the Euro (% in favour)**

![Graph showing support for the Euro](source)

**Source**: Eurobarometer

**Populism**: On some measures, support for populist leaders/parties is at its highest since the late 1930s (Graph 14).

**Graph 14: Populism (% vote across key economies)**

![Graph showing populism](source)

**Source**: Deutsche Bank

Populists are often elected to fix an economic problem and tend to pursue expansionary policies. Professor Schularick from The University of Bonn studied 27 episodes of populism over the last 100 years. He found that stocks, and to a lesser extent bonds, tend to benefit and that exchange rates often go up.
Populists are often elected to fix an economic problem and tend to pursue expansionary policies.
Lower oil prices

The dramatic drop in oil prices towards the end of 2018 has prices below the breakeven for most Organisation of the Petroleum Exporting Countries (OPEC) and most other producers (excluding US shale oil producers) (Graph 15). Therefore, supply cuts should eventually provide some support.

Lower oil prices are a negative for the growth prospects of oil producers and probably less of a stimulus for oil importers. They are also negative for US oil-related capex and employment.

Lower oil prices will weigh on headline inflation and inflation expectations. These impacts will have some influence on monetary policy deliberations.

Graph 15: Fiscal Breakeven Oil Prices (for 2019)

Source: IIF
“US shale oil producers are now the global swing producer. Their breakeven is around US$50, so oil price downside in 2019 looks limited.”

Michael Blythe, Chief Economist
Commonwealth Bank of Australia
Outlook for commodity prices
Outlook for commodity prices

The supply/demand mix should limit downside to commodity prices

Commodity prices more broadly defied expectations again in 2018. The failure of supply to respond to higher margins helped offset the slowdown in demand (Graph 16).

With the supply side of the backdrop likely remaining benign, the direction of commodity prices in 2019 will be set by demand. From Australia’s perspective China is key to commodity demand.

CommBank’s China Tracker indicates only a weak growth momentum at year-end (Graph 18), making a more aggressive policy response more likely. In late 2018 the Central Economic Working Conference said its policy would focus on the need to “stabilise aggregate demand” through “countercyclical policy adjustments” with fiscal policy to become “more forceful and effective”.

Accordingly, local government debt issuance has already surged and tax cuts are coming. Monetary policy has also responded and we expect further cuts to the Required Reserve Ratio.

The interest rate cuts and disappearance of the current account surplus have weakened the RMB, further easing Chinese monetary conditions.

Amid the trade war, stimulatory efforts will focus on China’s domestic economy to which, as noted earlier, Australia is most exposed.

China’s policy objectives are not just about economic growth but are now also about the quality of growth. This should offer opportunities for Australian commodity producers.
The supply/demand mix should limit downside to commodity prices

Other supportive factors include:

- The BRI with its large amount of commodity-friendly infrastructure spending.
- India has the same population and urbanisation trends and infrastructure needs as China.
- Improved prospects for a US infrastructure bill which would help infrastructure demand at the margin.
In conclusion, the supply / demand mix should limit downside to commodity prices in 2019 and have limited impact on Australia’s growth trajectory.
Risk and Australia
Risk and Australia

The risks around household debt and housing have intensified

Some domestic risks have intensified, others have receded and new ones have emerged. The balance of these risks will largely determine how the Australian economy performs in 2019.

Concerns about household debt and an over-valued housing market have persisted for almost two decades. It is worth revisiting some facts around household debt and dwelling prices.

- Towards year-end household debt equated to 127% of GDP or 189% of disposable income, near record highs and very high on any global comparison (Graph 18).
- Household assets have expanded with rising house prices. Debt:asset ratios are well below the 2009 peak (Graph 19).
- Despite the debt, consumer spending grew by around 2.5% in 2018, matching the average of the past five years and accounting for half of 2018’s GDP growth.
- The price:income ratio, the standard housing valuation metric, is slightly under 5. That is close to an Australian record but in the middle on any global comparison.
- Dwelling prices are 6.7% below their 2017 peak. Falls are mostly in Sydney and Melbourne and skewed towards the higher price brackets. The universal price falls associated with a slump are not in evidence.
- The 6.7% fall in prices (to date) follows a 47.9% rise over the previous five years (Graph 20).
The reality is that households have been building up protection against shocks:

- In late 2018, on CommBank data, 78% of home loan borrowers were ahead of their repayment schedules. The average borrower, when offset balances are included, effectively had 32 payments worth of protection.
- There is a skew whereby 35% of borrowers with protection have buffers of less than one month. The majority are investors who want to keep interest payments high for tax purposes or borrowers with loans like fixed-rate that structurally restrict payments in advance.

Rising unemployment and/or interest rates are the traditional triggers to turn household debt into a serious problem for the economy and financial system. However:

- The unemployment rate has fallen and will continue to fall amid output growth around potential, falling real labour costs, elevated job vacancies and positive hiring plans (Graph 21).
- The RBA has shifted to a neutral policy bias which means any rates move in 2019 is unlikely. And there is a good chance of this neutral stance persisting through 2020 as well.

Most household debt is housing-related. The housing market itself is a potential trigger.

The risks around household debt and housing have intensified

Graph 21: Employment & Vacancies (annual % change)

Source: ABS
Risk and Australia

Steps to improve financial stability
shift risk to macro-economy

From financial stability risk...
Unusually high shares of housing lending to investors and of interest-only (IO) home loans raised fears about financial stability. The regulators’ actions, starting in late 2014, to lower the volume of these types of loans were very successful (Graph 22). Other risks are emerging however.

Graph 22: Housing Credit Shares (% of total)

(ii) ...to house price risk
The largest house price falls have been in markets dominated by investors.
Other factors are weighing on sentiment (Graph 23) but it is reasonable to assume dwelling prices will trough in 2019:
- Some first-home buyers can now enter the market.
- Robust population growth continues in Sydney and Melbourne.
- Falling rates on new home loans amid competition for high-quality borrowers.
- New supply is slowing.

Graph 23: House Price Expectations (% expecting price rises over the next year)

Source: Digital Finance Analytics

(i)...to consumer risk
The RBA estimates that at the end of the five-year IO period when borrowers move to principal and interest, repayments are 30-40% higher. Amid subdued income growth, any increase in mortgage payments reduces household spending power.
(iii)...to credit crunch

Any restriction in the supply of credit would be negative for the outlook of the housing market and the economy. Credit growth to owner-occupiers hasn’t slowed however (Graph 24). Nor is there any evidence of credit slowing to the business sector.

Graph 24: Credit & Regulation (% change)

There is a risk though that consumers are less likely to run down savings further amid falling house prices.

(iv)...to wealth shock

Housing is the main component of household wealth. Historically households have spent about 4¢ for every $1 of additional wealth. That impact wasn’t evident this time even though the value of housing stock increased by $2.2 trillion over the last six years (Graph 25).

(v)...to policy constraint

High levels of debt make households more sensitive to interest rate changes because the impact on their cashflow is larger. The last peak in the household debt service ratio was 10.4% in mid-2008. Today it would only take a cash rate of 4% to get to a similar ratio (Graph 26).

Graph 25: Household Wealth & Spending (annual % change)

Source: ABS

Graph 26: Household Debt Service (% of income)

Source: ABS/CommBank
Risk and Australia

Risk receding as wages growth turns up

A number of risks that were quite threatening at the start of 2018 look less so a year on:

(i) Wages growth turning up?

All else equal, the unusually weak income growth (principally due to subdued wages growth) over the past five years probably accentuated the rise in the debt:income ratio (Graph 27).

The modest turn up in wages growth in recent quarters is encouraging but we remain cautious on signing off on an ongoing wages recovery just yet. Labour market slack is larger than the headline unemployment rate suggests. The old correlation between the unemployment rate and wages growth has disappeared. The new correlation is with underemployment (Graph 28).

A significant and sustained lift in wages growth is unlikely until there is a significant and sustained fall in underemployment – currently 8.4%. It is therefore critical to get the economic and policy backdrop right.

The Government’s improved fiscal position provides scope to “top up” the personal income tax cuts in the May 2018 budget. Alternatively, the Government could bring them forward so that they build more quickly over the years in the same way that it is bringing forward the tax cuts for small business (Graph 29).

But there’s more to household activity than base financial indicators. Health, work/life balance and education are important in determining the quality of life.

CommBank’s Household Satisfaction Index slowly improved up until early 2017 and has since tracked sideways (Graph 30). The granular data indicates that policies targeting improvements in civic engagement, environment and education would help.

Graph 27: Wages & Debt

Graph 28: Wages & Underemployment

Graph 29: Tax Cuts (% of GDP)

Graph 30: CommBank Household Satisfaction Indicator (0=completely dissatisfied, 1=completely satisfied)
Risk and Australia

Risks receding from construction, business capex and drought

(ii) Residential construction subsiding?
The downturn in residential construction activity looks likely to be milder than in previous cycles, supported by:

• Strong population growth (Graph 31).
• The skew towards medium-density buildings that prolongs the peak.
• Additionally, if falling dwelling prices aren’t a disincentive, renovation activity may pick up. It currently represents only 34% of all activity, below the long-run average of 40%.

Graph 31: Dwelling Supply (new construction as % of population growth)

Source: ABS

Construction activity outside of Victoria and New South Wales has already returned to more normal levels, limiting the need for a more savage pull back. Thus, we expect a modest pull back in this cycle.

(iii) The end of the mining capex drag?
After peaking at 9.3% of GDP in 2012, mining capex is levelling out at around 2.5% of GDP (Graph 32). It is no longer a drag on spending and jobs. Surprisingly, new mining projects are emerging.

Graph 32: Mining Capex (% of GDP)

Source: ABS

(iv)...and a sustained lift in non-mining capex
The long-awaited recovery in non-mining capex has finally arrived (Graph 33) in a delayed response to positive fundamental drivers and reflecting some positive industry dynamics.

These relate to:

• The National Disability Insurance Scheme.
• Renewable energy.
• IT revolution.
• Infrastructure boom.
• Tourism and education booms.

Graph 33: Non-Mining Capex (rolling annual)

Source: ABS
Signs of caution remain:

- A preference to return earnings to shareholders.
- The Australian Institute of Company Directors’ Director Sentiment Index reported that 69% of company directors see a risk-averse decision-making culture amid excessive focus on compliance over performance, pressure from shareholders for short-term returns and inaction around government policy on energy, taxation, infrastructure and climate change.
- Record level of business bank deposits.
- Subdued growth in new ABN registrations.

(v) The drought bottoms?

Following 2017/18’s 33% drop in winter crop production, the Australian Bureau of Agricultural and Resource Economics predicts a further 23% drop in 2018/19 (Graph 34).

This will knock 0.1ppt off GDP growth. The more important impact this year may be on rural exports and food prices.

Graph 34: Australian Crop Production (winter crop)

Source: ABARES
Some of the growth is already locked in

In recent years we have discussed why a significant part of Australia’s growth is guaranteed.

**In the resource export payoff**, liquefied natural gas (LNG) stands out because:

- Australia should decisively become the largest global exporter of LNG in 2019 (Graph 35).
- LNG will be Australia’s second largest export.
- Australia’s exposure to the commodity price cycle and the major LNG markets (Japan, China, South Korea) will increase.
- The linkage of LNG contracts to oil prices means oil price gyrations become important in driving the terms of trade and AUD.

An indicative timeline of spending on transport projects begun suggests the peak effect won’t be felt until 2022. Additionally, the improved fiscal position provides scope for additional spending, noting analysis prepared for the G-20 puts the infrastructure spending gap at 10% of GDP by 2040 (Graph 36).

**The payoff from rising Asia incomes** comes through many channels, but particularly from the boom in tourism and education (Graph 37).

---

**Graph 35: LNG Export Volumes**

```
<table>
<thead>
<tr>
<th>Year</th>
<th>LNG Export Volumes (Mt)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>0</td>
</tr>
<tr>
<td>2007</td>
<td>25</td>
</tr>
<tr>
<td>2011</td>
<td>50</td>
</tr>
<tr>
<td>2015</td>
<td>75</td>
</tr>
<tr>
<td>2019</td>
<td>Ultimate export capacity</td>
</tr>
</tbody>
</table>
```

Source: DISG

**Graph 36: Infrastructure Spending (% of GDP)**

```
<table>
<thead>
<tr>
<th>Year</th>
<th>Current trends</th>
<th>Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>2.5</td>
<td>3.0</td>
</tr>
<tr>
<td>2013</td>
<td>3.0</td>
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</tr>
<tr>
<td>2019</td>
<td>3.5</td>
<td>4.0</td>
</tr>
<tr>
<td>2025</td>
<td>4.0</td>
<td>4.5</td>
</tr>
</tbody>
</table>
```

Cumulative gap is 10% of GDP by 2040

Source: Global Infrastructure Hub

**The payoff from the infrastructure boom** that became a significant growth driver in 2016 comes from the necessary refurbishment and expansion of the infrastructure capital stock, particularly transport. It is guaranteed because many are multi-year projects that are underway and will be completed.

**Graph 37: Australia Service Exports to China (values, annual)**

```
<table>
<thead>
<tr>
<th>Year</th>
<th>Business &amp; Financial*</th>
<th>Education</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2</td>
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</tr>
<tr>
<td>2017</td>
<td>$8</td>
<td>$8</td>
<td>$6</td>
</tr>
</tbody>
</table>
```

*Includes: business travel; insurance and pension; financial; use of intellectual property; telecommunications, computer and information services; other business services

Source: ABS/RBA
It is guaranteed because rising Asia incomes is a demographic structural shift that has further to run.

It is also worth noting that Asian demand is driving a recovery in food-related manufacturing (Graph 38).

The Asian income story is impacting sectors like agriculture, education and tourism. But there are other trends to watch, such as Asian demand driving a recovery in food-related manufacturing.

Furthermore, the BRI’s productivity-enhancing infrastructure spending has the potential to accelerate income growth in BRI economies. This would widen the Asian income story and the benefits flowing from it.
The political dynamic and fiscal stimulus

The 2019 Budget was brought forward to 2 April 2019 and a Federal election seems likely on 11 May or 18 May 2019. A rapidly improving budget backdrop (Graph 39) and unfavourable opinion polls for the Coalition government have increased the likelihood of fiscal settings moving in an expansionary direction in 2019.

Regardless of who wins the election, the mainly positive economic fundamentals will still be in place. Possible areas of policy shift with a new government include:

- Changed income tax cuts.
- Changed tax arrangements for housing.
- Changes to dividend imputation.
- More spending on education and health.
- Some limits on immigration.
- Energy policy favouring renewables.
- Some unwinding of IR changes.

Graph 39: Potential Election War Chest

Source: CommBank

Is the growth-wages-inflation nexus broken?

The economy ran at or above potential in 2018 and the unemployment rate edged down to the “full employment” level of 5%, with wages growth showing some early signs of turning up. Yet inflation outcomes remained dead in the water – as at Q4 2018 the inflation rate had been below the RBA’s 2-3% target for 15 of the past 17 quarters.

But when the CPI is decomposed by degree of flexibility – into the subset of prices that change quite often (flexible prices) and those that change less frequently (sticky prices) – then it is clear that flexible prices are responding to the underlying economic momentum.

Flexible CPI trended up in 2018, consistent with measures of economic slack like unemployment and NAIRU (Graph 40).

Graph 40: Flexible CPI & Economic Slack

Source: CommBank/ABS
The sticky Consumer Price Index (CPI) suggests that inflation expectations will be hard to shift, making it harder to get wages/inflation moving in the desired direction (Graph 41).

**Graph 41: Sticky CPI & Inflation Expectations**

With flexible CPI trending up, it is clear that flexible prices are responding to the underlying economic momentum.
Commonwealth Bank Purchasing Managers’ Index™
Since 2017 Commonwealth Bank has been partnering with IHS Markit to publish Purchasing Managers’ Index (PMI) surveys for Australia, covering the manufacturing and service sector.

The PMI series produced by IHS Markit is one of the most closely-watched signals of business activity. Central banks, financial markets and business decisionmakers around the world value the surveys as timely and often unique indicators of economic trends. The indexes are based on monthly surveys of more than 28,000 companies in more than 40 countries, representing 87% of global GDP. The launch in October 2018 by Commonwealth Bank and IHS Markit of a Flash PMI series for Australia means monthly updates are now available even earlier – around one week prior to the end of each month.

PMI surveys have become highly-valued economic indicators in all major economies of the world, providing a timely alternative data set to official economic statistics.

Key features of the PMI surveys include:

**Timeliness**: the PMI is available well ahead of comparable official data such as GDP, employment and inflation: data are released right at the start of each month referring to the month just past.

**Wide coverage**: the PMI surveys were the first data to cover the increasingly important services sector, filling a void in analysts’ knowledge of major economies.

**Internationally comparable**: an identical methodology is used to produce and calculate the PMI in over 40 countries, generating a unique data set that can be easily used for international comparisons and regional aggregation, including unique global sector data.

**Accuracy**: the surveys have an unparalleled track record of providing early signals for policymakers, businesses and investors on changing economic trends. The PMI data were the first to indicate the severity of the impact of the global financial crisis on the real economy and have since become the most closely-watched, market-moving economic indicators in the world.
IHS Markit began producing PMI data in 1992, gradually extending coverage to some 40 countries. Australian PMI data were added in 2016, sponsored by Commonwealth Bank.

Over 28,000 companies now contribute to the monthly surveys, including over 850 in Australia, providing factual information on metrics such as output, order books, employment and prices.

PMI Coverage

Countries covered: 40
Companies surveyed monthly: 28k
Global GDP: 87%

Current coverage Source: IHS Markit
Commonwealth Bank Purchasing Managers’ Index™

Global slowdown gathers pace at start of 2019

IHS Markit worldwide PMI™ surveys

The global economy started 2019 with the weakest expansion since September 2016. The JPMorgan Global PMI, compiled by IHS Markit and incorporating the CommBank PMI surveys for Australia, hit a 28-month low of 52.1, down from 52.7 in December, extending a slowdown that had been evident throughout 2018 into the New Year (Graph 42).

Manufacturing led the slowdown, with factory output growth easing to a 31-month low and slipping closer to stagnation amid an increased rate of decline in worldwide export volumes. However, the service sector likewise reported a weaker rate of expansion, showing the smallest gain since September 2016 as the slowdown broadened out and business uncertainty spiked higher (Graph 43).

Other indicators showed new order inflows at their lowest since July 2016 and a second successive marginal decline in backlogs of work. Job creation hit a 21-month low as hiring slowed in response to the weakened order book trend. Optimism towards the year ahead meanwhile regained some ground from December’s two-and-a-half year low, but remained subdued by recent standards.

Growth slowed in all major developed and emerging economies in January with the exceptions of the US and India. Developed world growth consequently slipped to a 28-month low while the emerging markets saw growth falter to one of the weakest seen over the past year and a half (Graph 44).
Commonwealth Bank Purchasing Managers’ Index™

US shows resilience to developed world slowdown

Developed world PMI comparisons

The US continued to lead the developed world expansion, the gap widening with other major economies as faster manufacturing growth accompanied a steady improvement in the service sector, both primarily reflecting solid US domestic demand (Graph 46).

In contrast, the UK reported a near-stalling of growth as Brexit worries intensified, the composite PMI dropping to its lowest since 2012 with the sole exception of July 2016, when business faltered in the immediate aftermath of the 2016 EU referendum.

Eurozone businesses also reported only modest growth, with the composite PMI down to its lowest since July 2013. The surveys hint at downturns in both Italy and France as well as much weakened growth in Germany, often linked to rising political uncertainty.

Growth meanwhile also faltered in Japan, sliding to the lowest since the current upturn began in late-2016 as manufacturing moved into contraction for the first time for over two years.

Growth in Australia also disappointed at the start of the year, with the CommBank Composite PMI registering the weakest expansion of business activity recorded since survey data were first collected in 2016.
China acts as key emerging market drag

Emerging market PMI comparisons

Emerging market growth slowed to one of the weakest seen over the past year and a half in January, mainly due to a slowdown in China (Graph 47).

The Caixin PMI composite output index, compiled by IHS Markit, dropped from 52.2 in December to 50.9 in January, its second-lowest since mid-2016 (Graph 48). A weakened manufacturing performance led the slowdown, while service sector growth proved far more resilient.

Encouragingly, the survey recorded a slight upturn in China’s exports for the first time in ten months and expectations of future growth also ticked higher, in part reflecting rising hopes of a swift resolution to the Sino-US trade spat.

Only marginal slowdowns were meanwhile seen in Brazil and Russia, with both enjoying relatively solid growth by recent standards. India was consequently the only major emerging market not to see growth weaken compared with December, sustaining one of its best growth spells seen for several years.
Commonwealth Bank Purchasing Managers’ Index™

Manufacturing slowdown broadens out

Worldwide PMI comparisons

Despite seeing slower growth at the start of the year, Australia fared well in the manufacturing growth rankings in January, rising to fourth place compared to eighth place over 2018 as a whole (Graph 49).

Of the 30 countries for which IHS Markit produces PMI data, the number reporting a deterioration of business conditions rose from 10 in December to 11 in January, up markedly from just two in January of last year.

The worst performance was again seen in Turkey, but the list of countries in manufacturing downturns now includes China, Germany and Italy.

However, Taiwan, Malaysia, South Korea and Indonesia all also reported sub-50 PMI readings. This widening downturn in Asia was led by China, which recorded the steepest downturn for almost three years. The pan-Asia Manufacturing PMI consequently slipped into decline for the first time since June 2016.

The eurozone only narrowly managed to avoid contraction and growth in the UK slowed to the second-weakest for two-and-a-half years. Overall growth in the European Union was consequently the joint-lowest since the current upturn began in July 2013.

While manufacturing trends deteriorated in Asia and Europe, it was a different story in North America, where growth accelerated (Graph 50). Faster manufacturing growth pushed the US up into second place in the global rankings compared to eighth place in December.

If the US were excluded, the global manufacturing economy would have stagnated in January, the first such lack of growth seen since May 2016.

Canada also moved up the table, rising from ninth place in December to sixth place despite seeing growth wane to a two-year low. Mexico also returned to growth after two months of decline.
Global business investment indicators fall sharply

**Detailed sector PMI analysis**

Global PMI data showed nine of the 26 sectors covered by the surveys to have been in contraction at the start of 2019 (Graph 51). By comparison, none were in decline this time last year. More cyclical sectors tended to fare worse, especially manufacturing and capex-related sectors. Metals, mining, basic resources and timber industries saw the steepest downturns, boding ill for some of Australia’s largest export industries, but other notable sectors in contraction included autos and machinery and equipment.

Auto makers reported the largest drop in output since August 2015, with production now having fallen for a fourth successive month. Worse may be to come, as new orders sank at the steepest rate for six years to suggest little sign of the downturn in demand ending any time soon (Graph 52).

However, perhaps one of the most important indicators came from machinery & equipment makers, who reported the largest drop in global demand recorded since comparable data were first available in 2009, hinting at reduced global business investment.
Australia PMI hits new low at start of 2019

CommBank survey data
The CommBank surveys painted a disappointing picture at the start of 2019. The survey’s headline index – the composite output index, which covers both manufacturing and services – fell to the lowest seen since data were first collected in May 2016 (Graph 53). The index nevertheless remained above the critical no-change level of 50.0, but clearly indicates that the rate of growth of the Australian economy has moderated markedly since this time last year.

Manufacturing remained more resilient than the service sector, with factory output growth remaining relatively robust in January, albeit losing some momentum. In contrast, service sector growth sank to a survey low.

The subdued pace of growth seen in January also takes the CommBank PMI for Australia below the global average (Graph 54).
Divergent business trends seen within manufacturing & services

CommBank survey data: output by sector

Within the manufacturing economy of Australia, intermediate goods producers (suppliers of components to other manufacturers) have enjoyed the strongest growth in recent months, rebounding from a mid-year contraction (Graph 55).

Producers of investment goods such as plant and machinery, have shown some signs of perking up, albeit from a low base late last year, which reflected weakened global investment spending. The recent upturn mainly reflects strong domestic investment spending. Consumer goods producers have meanwhile seen growth weaken compared to the strong gains seen last year.

Graph 55: Manufacturing sector output
PMI Output/Business Activity Index (3 month ave)

In the service sector, transport, IT and communications companies have reported the fastest growth of business activity in recent months, with business picking up markedly compared to the middle of last years, Consumer services providers also reported strong growth (Graph 56).

In contrast, a downturn has been recorded in the financial, real estate and business services sector, in part reflecting recent volatile financial market trends.

Graph 56: Services sector output
PMI Output/Business Activity Index (3 month ave)

Demand for goods and services showed signs of waning at the start of 2019 (Graph 57). Australian companies reported that new orders grew in January at the slowest rate recorded by the survey to date, the rate of increase running markedly lower than this time last year. Manufacturers enjoyed greater resilience, reporting faster order book growth than service providers for the sixth straight month, buoyed in part by rising export orders.

Graph 57: New orders
PMI New Orders Index

Source: CommBank
Backlogs of uncompleted work continued to rise at a steep rate in January, accumulating in both manufacturing and services in a sign of elevated capacity utilization, linked in some cases of skill shortages. However, the recent slowing in inflows of new work suggest the rise in backlogs could prove short-lived, especially in the service sector, which would in turn put downward pressure on jobs growth in coming months.

Employment growth eased in January to one of the slowest seen in the history of the survey, reflecting increased caution with respect to hiring amid weakened order book growth. However, some companies also reported hiring to have been constrained by skill shortages. The slowdown in jobs growth was led by the service sector, contrasting with a slight uptick in factory hiring.
Commonwealth Bank Purchasing Managers’ Index™

Price pressures cool to lowest in CommBank survey history

CommBank survey data: inflation indicators

Graph 60: Costs

While manufacturers have reported a steep easing in upward cost pressures since the middle of last year, much of the easing reflects lower oil prices. There is some evidence to suggest that underlying price pressures remain an area of concern. Specifically, factories continued to report lengthening delivery times from their suppliers at the start of 2019, with the incidence of delays rising. Such delays commonly point to a sellers’ market for goods, with pricing power being buoyed as demand rises faster than supply. Such pressure could therefore provide support to raw material prices in coming months.

Graph 62: Supply chains & prices

Cost pressures cooled markedly at the start of 2019, primarily attributable to lower global oil and associated energy costs. The overall rise in cost was the weakest recorded since data were first collected in May 2016.

Graph 61: Selling prices

Average selling prices for goods and services continued to rise at the start of 2019, but the rate of increase was among the lowest seen over the past one-and-a-half years. The slower rate of price inflation was commonly associated with the recent easing in upward input cost pressures. The survey data therefore suggest that lower prices should feed through to a reduction in consumer price inflation in coming months.
Commonwealth Bank Purchasing Managers’ Index™

Global Metal PMIs hit six-year lows

Detailed sector PMI analysis

One of the advantages of the PMI surveys is that data can be easily aggregated on geographical boundaries as well as by sector across countries. However, an additional way of looking at the data is according to groups of companies that use specific inputs, as this gives an up to date picture of upstream business conditions for supplier and producers of those inputs.

Such use is illustrated by the Global Metals PMI, which tracks business conditions at companies across more than 30 countries which use metals including copper, aluminium and steel as key inputs.

As to be expected, the Global Aluminium, Copper and Steel PMIs are closely correlated with each other, and with the general manufacturing cycle. The indicators showed growth surging for all three metals groups in early 2018, since when a steady slowdown has been apparent, culminating in a deterioration of business conditions in all three cases for a second successive month in January. In all three cases, business conditions are deteriorating at the steepest rates since late-2012.
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