KPMG

Quarterly Economic Outlook

Global and Australian Forecasts

KPMG Economics

—

September 2017

Contents

Executive Summary

Global economy

- Global economic conditions have remained relatively steady over the course of the past quarter while the outlook for the global economy has improved.
- Europe, Japan and the U.S. have seen improved economic activity over the second quarter of 2017. Growth in China has also edged higher over the same period. The British economy which is still saddled with the uncertainty surrounding the outcome of the Brexit talks.
- Natural disasters and geopolitical events have also generated short-term headwinds. Early estimates of the direct costs of Hurricane Harvey (in Southwest Texas) on U.S. economic activity has ranged from USD$30-200 billion.
- Price inflation remains subdued and below central banks' targets in the advanced economies.
- Monetary policy remains accommodative although policy tightening has commenced in some advanced economies and gradual tapering has been signalled in the major advanced economies.
- "Quantitative Tightening" has replaced "Quantitative Easing" as the new buzzword amongst economists and analysts
- On the balance of risks, KPMG Economics maintains its forecast of global growth for 2017 with real GDP at 3.0%, lifting to 3.4% in 2018

Australian economy

- The Australian economy grew by 0.8% q/q (seasonally-adjusted) in the June quarter of 2017 and 2.0% y/y (or 1.8% on a rolling 4-quarter basis).
- Growth was relatively broad-based with domestic final demand and net exports contributing strongly.
- Labour market conditions remained steady with the unemployment rate at 5.6% (seasonally-adjusted) in August 2017
- Headline inflation rose 1.9% y/y in Q2 2017 (0.2% q/q) with underlying inflation at around 1.8% y/y (trimmed mean basis).
- The RBA's official cash rate (OCR) is accommodative at 1.5%.
- KPMG Economics' forecasts for the Australian economy have not substantially changed since the last Quarterly Economic Outlook with real GDP growth expected to grow at around 2.9% for 2017-18.

Australian forecasts

	FY16	FY17	FY18	FY19	FY20	FY21	FY22
GDP (Real)	2.7%	1.8%	2.9%	2.9%	3.1%	3.0%	2.8%
Inflation (1)	1.0%	1.5%	1.6%	2.1%	2.3%	2.5%	2.6%
Unemployment, % (1)	5.7%	5.4%	5.4%	5.2%	5.1%	5.2%	5.3%
A/US (1)	0.746	0.744	0.741	0.740	0.741	0.743	0.745

(1) = Average through the year

Global Outlook

Global economic conditions have remained relatively steady over the course of the past quarter while the outlook for the global economy has improved. Amongst the advanced economies, Europe, Japan and the U.S. have seen improved economic activity over the second quarter of 2017. Growth in China has also edged higher over the same period. Momentum is expected to continue into the second half of 2017 with leading survey-based indicators suggesting an up-tick in global economic sentiment. A recent global survey of CEOs[1], for instance, revealed, that while risks remain, CEOs are optimistic about longer-term global growth trends. This has also been reflected in financial markets by rising equity prices and narrower corporate bond spreads.

Among the major economies, the slight laggard has been the British economy which is still saddled with the uncertainty surrounding the outcome of the Brexit talks. Natural disasters and geopolitical events have also generated short-term headwinds. Early estimates of the direct costs of Hurricane Harvey (in Southwest Texas) on U.S. economic activity has ranged from USD$30-200 billion. This is likely to detract from Q3 2017 U.S. economic growth - mainly due to the shutdown of refineries and business operations. The effects on U.S. GDP thereafter, however, are expected to be limited (or possibly even positive) as the slowdown from these sectors are offset by growth in others sectors such as construction.

Labour markets have continued to tighten across the major economies with the main unemployment rate remaining low by historical standards. Most advanced economies are recording unemployment rates close to their natural rate (or potential) and the output gap has continued to contract. Economists still expect spare capacity in the labour market to narrow further putting upward pressure on wages and prices. It is clear by now, however, that the parameters of the Phillips Curve have changed (the Curve has flattened and moved 'downwards' reflecting a structural change in the labour market). Under-employment remains an issue of labour market spare capacity and high rates are still being observed in many economies.

Chart 1

World GDP Growth

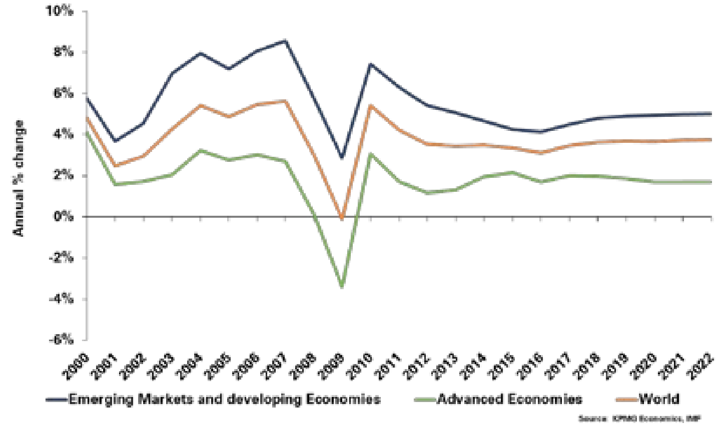
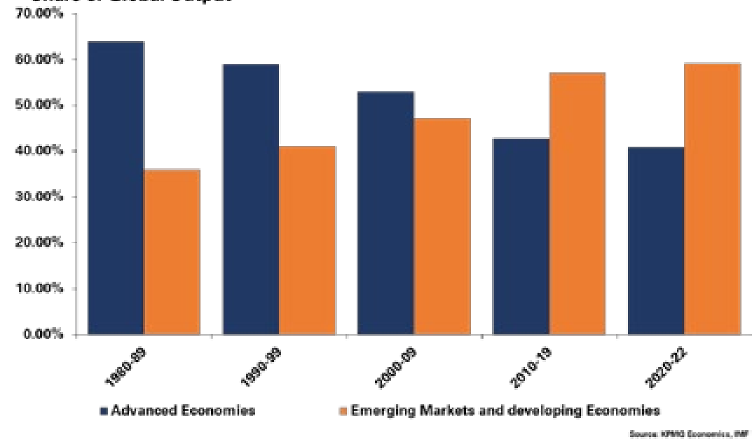


Chart 2

Share of Global Output



[1] KPMG Global CEO Outlook 2017.

[2] At the time writing, a second hurricane – Hurricane Irma has hit the Florida area with the economic costs estimated to be slightly higher than that of Hurricane Harvey.

Global Outlook

Price inflation remains subdued and below central banks' targets in the advanced economies. Headline inflation rates have fallen back in many countries while core inflation rates remain low. Wage growth continues to be modest with real wages trending downwards in emerging and developing economies. This trend is receiving considerable attention by commentators and economists and is a major concern for governments across the globe. The International Labour Organization's (ILO) Global Wage Report 2016/17 revealed that wage growth around the world has decelerated since 2012, falling from 2.5% in 2012 to 1.7% in 2015 – the lowest level in four years. This is visible in most economies, even in those countries with low unemployment rates. Prices of key commodities have remained stable over the course of Q2 2017. According to the RBA's Index of Commodity Prices, preliminary estimates for August indicate a 1.5% (SDR terms) monthly increase following a decrease of 0.8% in July. Global oil prices have jumped slightly since early September 2017 with WTI hovering just under the US$50/bbl mark.

Monetary policy remains accommodative although policy tightening has commenced in some advanced economies and gradual tapering has been signalled in the major advanced economies. 'Quantitative Tightening' has replaced 'Quantitative Easing' as the new buzzword amongst economists and analysts. Minutes from the Fed's latest FOMC meeting in July revealed deliberations on the timing of reducing its securities holdings with the Committee intending to begin implementing balance sheet normalisation "relatively soon". Expectations are that this will commence before the end of 2017. The FFR target range was held at 1.0% to 1.25% with the Fed's 'dot plots' indicating one more 25bps rate hike for 2017. Policymakers and markets also attentively watched the latest Jackson Hole Symposium in August only to be disappointed by the lack of 'forward guidance' on monetary policy. This time round, the main focus at the symposium was on trade and financial regulation.

The European Central Bank (ECB) is once again walking a tightrope. Moderate improvements in economic conditions in the Euro Area (EA19) have been countered by an appreciation of the Euro (7.0% on trade-weighted basis since June). This will put downward pressure on inflation and weigh heavily on the ECB's monetary policy stance going forward. The ECB held its benchmark interest rate at 0.0% with the rate of asset purchases targeted at €60 billion per month.

Chart 3
Unemployment Rate

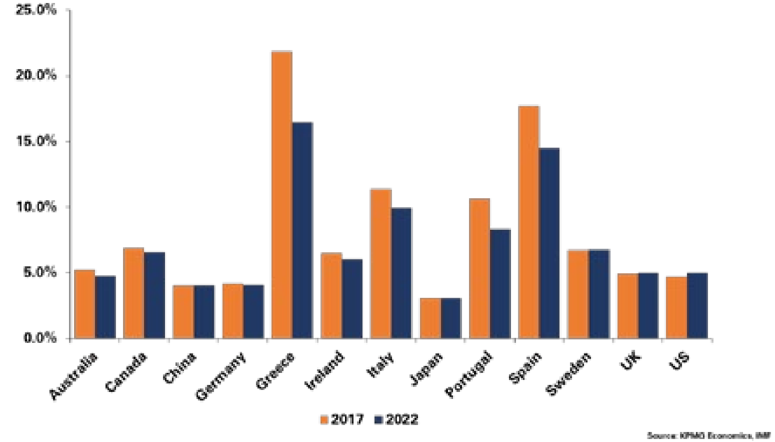
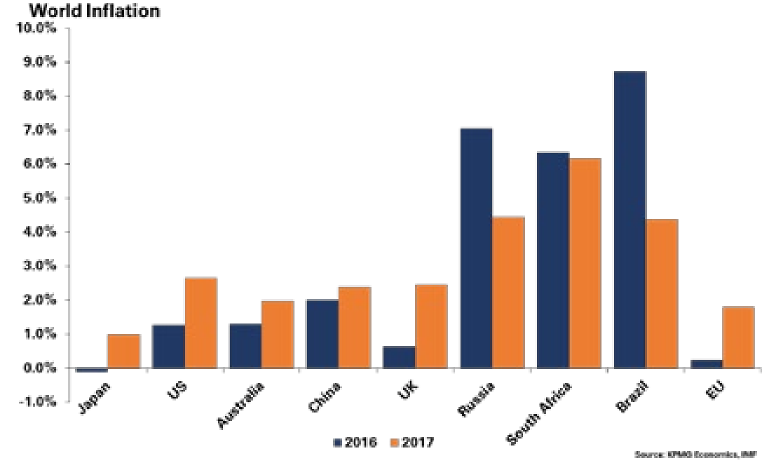


Chart 4
World Inflation



Global Outlook

The Bank of England (BoE) and the Bank of Japan (BoJ) have kept policy parameters unchanged (0.25% and -0.10% respectively). Of note, is that the Bank of Canada lifted its key benchmark overnight rate twice (25bps each in July and September) to 1.0% on the grounds of stronger-than-expected economic data.

August 2017 marked the 10-year anniversary of the GFC with financial stability and financial conditions now a closely-monitored indicator of real economic activity.[3] On average, financial conditions have been little changed since Q2 2017 and continue to be favourable. The level of longer-term interest rates along with yields on bonds and term premiums have remained low. Among the major currencies, the Euro has gained the most, increasing by around 7% on a trade-weighted basis since Q2 2017, while the USD (on trade-weighted basis) has declined the most with uncertainty and policy gridlock in Congress. Equity markets continue to show strength.

A key benchmark rate, the London Inter-bank Offered Rate (LIBOR) – which underpins the rates set for financial products such as mortgages and loans – is to be phased out by 2021. LIBOR has been hit by scandals relating to its manipulation and Britain's Financial Conduct Authority is seeking to transition to other reference rates that more closely align with actual loan transactions. Whether or not a suitable replacement rate can be found or if the transition is a smooth one remains to be seen.

Geopolitical tensions have increased recently after North Korea launched a ballistic missile over Japan and threatened to fire intercontinental ballistic missiles into the U.S. territory of Guam. As a result, the United Nations Security Council unanimously passed new sanctions on North Korea which would cap the nation's oil imports, ban textile exports and end additional overseas labourer contracts. Measures of volatility such as the VIX Index and the VSTOXX Index increased in the immediate aftermath but have since returned to more normal levels. The economic impact from the fallout between Qatar and neighbouring countries - Saudi Arabia, the UAE, Bahrain and Egypt – has not fully transmitted to global markets but, depending on the duration of this dispute, could affect global LNG supply and prices.

On the balance of risks, KPMG Economics maintains its forecast of global growth for 2017 with real GDP at 3.0%, lifting to 3.4% in 2018.

Chart 5
Official Interest Rates

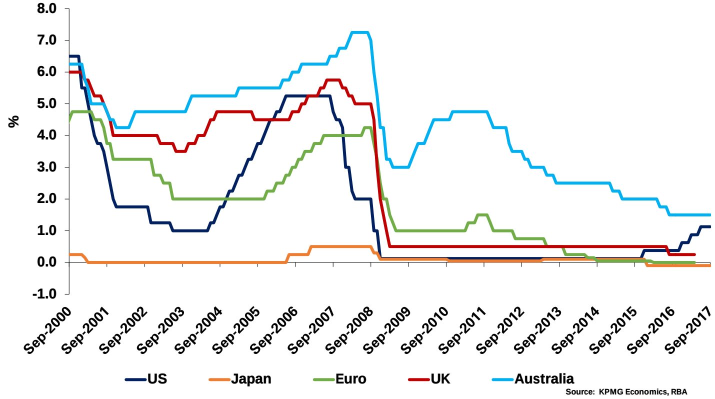


Chart 6
Global Economic Policy Uncertainty Index

[3] KPMG Economics released a research note on the GFC 10-years on in the same month: https://assets.kpmg.com/content/dam/kpmg/au/pdf/2017/global-financial-crisis-10-years-on.pdf

Global Outlook

The U.S. economy grew at an annualised rate of 3.0% (seasonally-adjusted) in Q2 2017. This was led by increases in personal consumption expenditure and non-residential fixed investment. Partially offsetting these gains were decreases in government spending. The unemployment rate in August was little changed at 4.4% while the latest print on inflation at 1.7% was still below the Fed's target rate. Notably, the IMF has recently revised downwards its growth forecast of the U.S. from 2.3% to 2.1% in 2017 and from 2.5% to 2.1% in 2018. Headwinds remain for the remainder of 2017, including any negative effects that the recent departure of senior White House staff and the dismantling of the Business Councils will have on the Trump administration, policy and markets. President Trump has signed a deal extending the debt ceiling deadline to 8 December 2017 (a three-month extension).

U.K. Q2 2017 GDP grew by 0.3% (seasonally-adjusted) q/q (up from 0.2% q/q in Q1 2017) with the services sector leading the way. Unemployment has continued its downward trend edging to 4.4% in Q2 2017 but wage growth remains low. Inflation, however, was 2.9% y/y in August up from 2.6% y/y in June 2017. This poses a concern for the BoE that must weigh the balance of weak growth with above-target inflation in its policy decisions. The BoE must write to the U.K. government if inflation is above 3% explaining why inflation is a full percentage point above target. On the positive side, the weaker pound has provided a boost for exports but whether the lower pound can be sustained is yet to be determined. The IMF has revised down their forecasts for the U.K. economy by 0.3% to 1.7% in 2017 against the backdrop of uncertainty surrounding Brexit outcomes.

Growth in China has been strong at 1.7% (seasonally-adjusted) q/q (and 6.9% y/y) in Q2 2017 coming in above expectations with fiscal stimulus a key driver. This was the strongest growth rate posted since mid-2015. Industrial production and retail sales were the other key contributors to economic growth. The build-up of leverage still poses a significant risk to the Chinese economy although the PBOC have tightened monetary conditions slightly allowing interbank rates to rise to contain leverage. The 19th Party Congress of the Chinese Communist Party (CCP) (scheduled for October or November 2017) is likely to see the appointment of new senior leadership along with President Xi Jinping expected to commence his second five-year term as CCP General Secretary. Whilst there will be a transition of party leadership, not much is expected to change materially in terms of current policies. The Chinese authorities have taken a strong stance on crypto currencies with the recent ban on Initial Coin Offerings.

Chart 7
Output Gap by Country

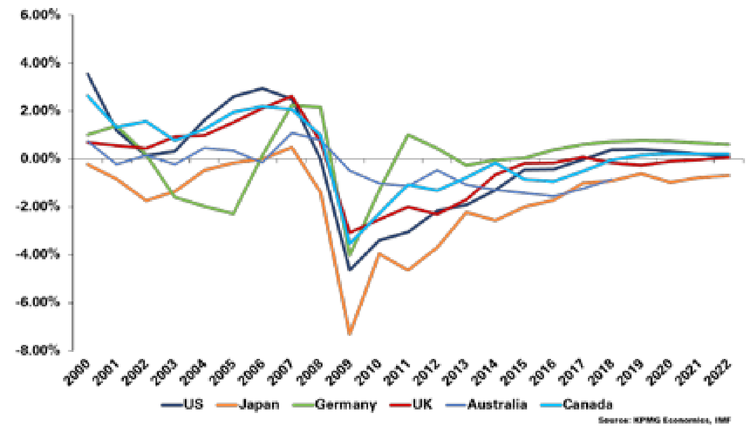
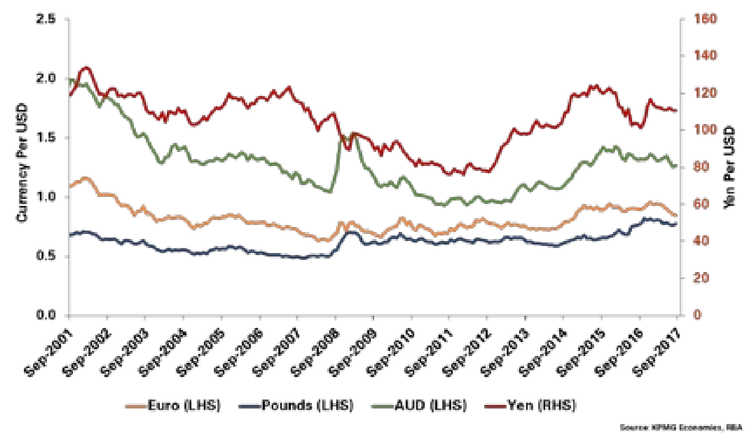


Chart 8
Exchange Rates (USD)



Global Outlook

In Europe, GDP in the Euro Area (EA 19) and European Union (EU 28) rose by 0.6% q/q (seasonally-adjusted) in Q2 2017. Year-on-year, Euro Area growth was 2.2% while EU 28 growth was 2.3%. Growth in the Euro Area has also been more broad-based. The unemployment rate in the EU was unchanged at 7.7% (seasonally-adjusted) in July down from its peak of 11% in 2013 while the unemployment rate in the EA was 9.1% (seasonally-adjusted). Forward-looking economic indicators point toward improving sentiment with PMIs reaching their highest level over the past few years. The European economy seems to be gaining momentum and looks to be on the path to recovery although risks remain in the shorter-term particularly with regard to the banking sector in Italy.

German GDP growth expanded by 0.6% (seasonally-adjusted) q/q in Q2 2017 and 2.1% (seasonally-adjusted) y/y. This was the 12th straight quarter of expansion with positive contributions from household consumption and fixed investment. The unemployment rate was down to 3.7% in July from 3.9% in the previous month. Inflation rose to 1.8% y/y in August 2017, the highest inflation rate since April 2017. Results of the Bundestag elections held on 24 September 2017 revealed a fourth consecutive victory for Chancellor Angela Merkel and her Christian Democrat-led bloc but no outright majority. The main political parties – the Christian Democrats and Social Democrats - received historic-low votes as voters turned to the anti-immigration Alternative for Germany (AfD) party in a rebuke to current immigration policy. The next step for Chancellor Merkel is to forge a coalition to govern – a process likely to take months.

As President Macron prepares to tackle the challenges of labour market reform, the French economy grew by 0.5% (seasonally-adjusted) q/q in Q2 2017 (and 1.7% y/y) – falling in line with estimates. This was the fourth consecutive quarter of economic expansion primarily driven by household consumption and government spending. Unemployment remains elevated at 9.5% in Q2 2017 but still the lowest since 2012. The proposed labour market reforms, which will give firms more flexibility to set pay and working conditions, is intended as a first step at lowering chronic unemployment and making the French economy more attractive for corporations and investors.

Chart 9
Share Price Index

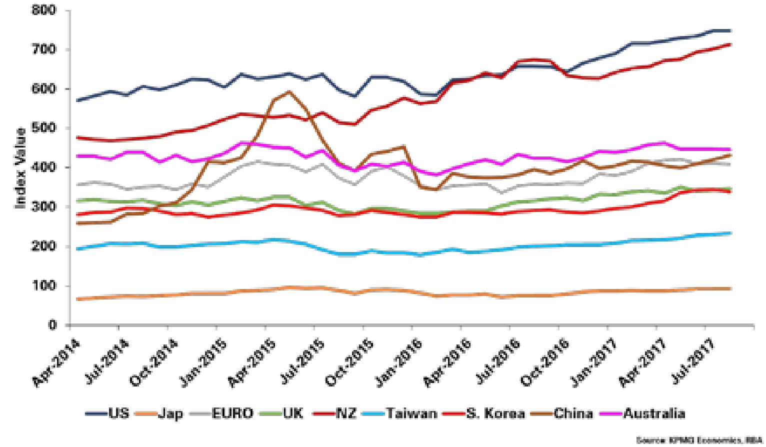
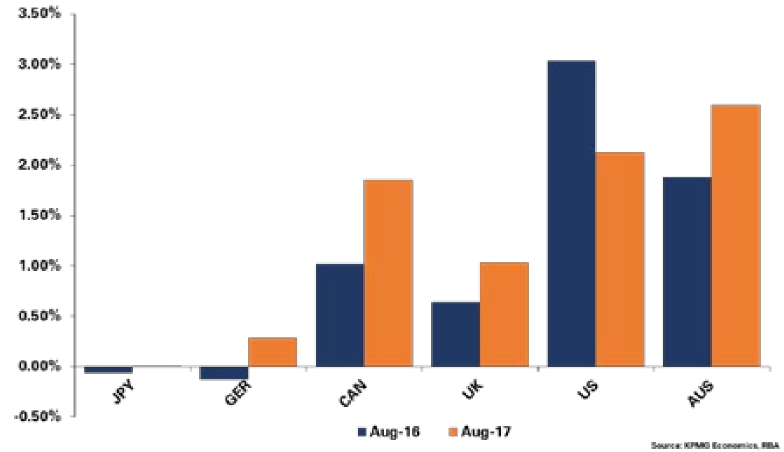


Chart 10
10 Year Government Bond Yields



Global Outlook

Japan's economy grew for a sixth consecutive quarter with GDP coming in at 0.6% (seasonally-adjusted) q/q (2.5% y/y) in Q2 2017. This was led by private consumption and business investment. The unemployment rate remains at record low levels of 2.8% in July 2017 but upward pressure on wages or prices is yet to eventuate. Inflation remains stubbornly low at 0.4% y/y in July 2017 - core inflation is at 0.2% y/y. Interestingly, at the Jackson Hole Symposium, BoJ Governor Kuroda suggested that growth of 4.0% cannot be sustained and that "around 2.0% growth is likely". Prime Minister Shinzo Abe has announced that he will dissolve the lower house of parliament on 28 September 2017 and call a snap election likely to be held on 22 October 2017.

In the aftermath of two recent policy measures – demonetisation late last year and the GST rollout in July 2017 – India's economy grew by 1.5% q/q (5.7% y/y) in the April-June Quarter 2017 (technically, the Central Statistics Office records this April-June quarter as the first quarter of 2017-18). The economy expanded at a slower pace than the previous quarter's 6.1% y/y and a far cry from the 7.9% y/y recorded in the first quarter of 2016-17. Some of the slowdown in activity has been attributed to stalled production as businesses prepare for the switchover to the GST regime. Recovery is expected but also conditional on how efficiently businesses adapt to the GST. The inflation rate in India increased 3.36% y/y in August 2017, up from 2.36% y/y in July 2017.

New Zealand's General Election was held on 23 September 2017 with no clear mandate delivered to any party. Leader of the Labour Party, Jacinda Ardern, campaigned on a platform that included new taxes, increased welfare spending and immigration cuts. By contrast, Prime Minister Bill English and his National Party promised tax cuts, investment in infrastructure, and a 'safe pair of hands'. The National Party, which has led a government since 2008 won 58 seats in the 120-seat parliament while the Labour Party secured 45 seats. To form government, both major parties will need the support of New Zealand First party leader Winston Peters. The New Zealand economy expanded 0.5% q/q (seasonally-adjusted) in Q1 2017, up from 0.4% q/q (seasonally-adjusted) in the previous quarter. The RBNZ maintained the Official Cash Rate at 1.75% in August 2017.

Chart 11
Index of Selected Commodites And Exchange Rate

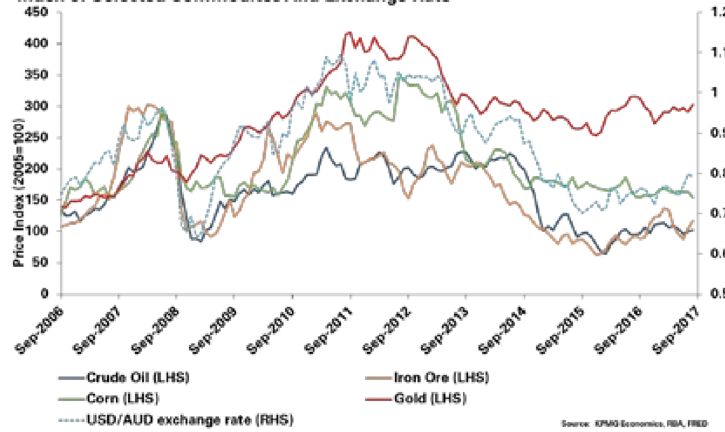


Chart 12
World Export Growth

Global Outlook

Growth in Real GDP

Year End December	2016	2017	2018	2019	2020	2021	2022
OECD	1.7%	1.8%	1.8%	1.9%	1.9%	1.8%	1.8%
Americas							
Brazil	-3.5%	-1.3%	0.7%	1.8%	2.2%	2.3%	2.5%
Canada	1.4%	1.7%	2.1%	1.8%	1.5%	1.3%	1.3%
Latin America	2.0%	2.2%	2.6%	3.1%	3.1%	2.9%	2.7%
Mexico	2.0%	2.2%	2.3%	2.5%	2.7%	3.0%	3.2%
USA	1.7%	2.1%	2.1%	2.2%	2.3%	2.3%	2.2%
Europe							
EMU	1.7%	1.5%	1.4%	1.3%	1.2%	1.2%	1.2%
France	1.1%	1.1%	1.1%	1.2%	1.2%	1.2%	1.2%
Germany	1.8%	1.7%	1.2%	0.8%	0.7%	0.6%	0.7%
Greece	-0.1%	0.1%	2.4%	2.2%	2.4%	2.6%	2.7%
Ireland	4.3%	3.4%	2.2%	1.9%	1.6%	1.4%	1.4%
Italy	0.9%	1.0%	1.2%	1.4%	1.5%	1.5%	1.4%
Russian Federation	-0.5%	0.2%	1.0%	2.0%	1.6%	1.5%	1.6%
UK	2.0%	1.1%	1.5%	1.6%	1.8%	1.9%	1.9%
Africa	1.9%	2.4%	3.1%	3.5%	3.6%	3.7%	4.0%
South Africa	0.7%	2.2%	1.3%	1.6%	2.3%	3.0%	3.5%
Middle East	2.4%	2.9%	3.2%	2.9%	3.0%	3.1%	3.1%
Asia							
China	6.7%	5.9%	5.8%	5.5%	5.4%	5.4%	5.5%
East Asia	4.0%	4.3%	4.4%	4.5%	4.5%	4.4%	4.4%
Hong Kong	1.6%	2.3%	1.8%	1.7%	1.7%	1.7%	1.8%
Indonesia	5.1%	4.8%	5.3%	5.4%	5.2%	4.9%	4.6%
India	7.2%	6.0%	7.8%	6.5%	6.3%	6.2%	6.2%
Japan	1.0%	0.7%	0.7%	0.5%	0.4%	0.2%	0.1%
Singapore	1.7%	1.3%	4.0%	3.0%	2.9%	3.0%	3.2%
South Korea	2.8%	1.9%	2.8%	3.2%	3.5%	3.6%	3.8%
Taiwan	1.1%	1.5%	1.8%	1.9%	2.2%	2.5%	2.9%
Vietnam	7.6%	2.5%	5.5%	5.2%	4.7%	4.2%	3.8%
Oceania							
New Zealand	4.1%	2.7%	3.2%	3.3%	2.8%	2.6%	2.6%
World	**3.0%**	**3.0%**	**3.4%**	**3.3%**	**3.3%**	**3.3%**	**3.4%**

Annual Inflation

Year End December	2016	2017	2018	2019	2020	2021	2022
OECD	1.4%	2.0%	1.9%	1.8%	1.8%	1.9%	1.9%
Americas							
Brazil	7.1%	5.6%	5.6%	5.7%	4.9%	4.2%	4.2%
Canada	1.0%	1.7%	1.2%	1.3%	1.4%	1.6%	1.7%
Latin America	5.3%	2.7%	0.9%	2.5%	3.5%	3.9%	4.1%
Mexico	3.2%	5.9%	3.5%	2.0%	1.8%	2.2%	2.7%
USA	1.5%	1.5%	1.7%	1.7%	1.8%	1.9%	2.0%
Europe							
EMU	0.8%	1.2%	1.3%	1.3%	1.3%	1.3%	1.3%
France	0.3%	1.0%	1.1%	1.2%	1.2%	1.2%	1.2%
Germany	1.2%	1.0%	1.3%	1.3%	1.3%	1.3%	1.3%
Greece	0.3%	-0.7%	0.5%	0.9%	1.1%	1.3%	1.3%
Ireland	0.9%	1.0%	1.1%	1.2%	1.2%	1.2%	1.2%
Italy	0.4%	2.1%	1.7%	1.6%	1.5%	1.4%	1.4%
Russian Federation	5.5%	4.5%	5.2%	5.0%	4.9%	4.7%	4.5%
UK	0.7%	2.4%	2.7%	2.5%	2.1%	1.8%	1.8%
Africa	13.9%	5.2%	5.5%	5.3%	4.9%	4.5%	4.2%
South Africa	6.2%	6.5%	5.0%	2.5%	1.4%	1.4%	2.0%
Middle East	7.1%	6.5%	4.4%	3.7%	3.3%	2.9%	2.4%
Asia							
China	2.2%	2.2%	1.7%	2.0%	2.1%	2.4%	2.8%
East Asia	2.3%	1.8%	2.7%	2.7%	2.7%	2.7%	2.8%
Hong Kong	2.3%	1.9%	1.6%	1.7%	1.8%	2.0%	2.3%
Indonesia	3.8%	4.7%	4.6%	4.5%	4.3%	4.2%	4.1%
India	4.0%	1.4%	4.9%	4.9%	4.4%	4.1%	3.9%
Japan	-0.6%	0.8%	0.8%	0.9%	0.8%	0.8%	0.8%
Singapore	0.3%	-0.1%	1.8%	2.0%	2.3%	2.7%	2.9%
South Korea	1.3%	1.5%	1.7%	1.8%	1.9%	1.9%	1.9%
Taiwan	0.8%	0.5%	1.1%	0.8%	0.8%	0.9%	1.0%
Vietnam	3.9%	3.4%	5.2%	5.5%	5.6%	5.5%	5.6%
Oceania							
New Zealand	0.0%	1.6%	2.1%	2.1%	2.0%	2.1%	2.3%

Australian Outlook

Australian Outlook

The Australian economy grew by 0.8% q/q (seasonally-adjusted) in the June quarter of 2017 rebounding from the weak 0.3% q/q growth in Q1 2017. On an annual basis, the Australian economy grew at 2.0% y/y (or 1.8% on a rolling 4-quarter basis) increasing from 1.6% y/y in Q1 2017. Growth was relatively broad-based with domestic final demand and net exports contributing strongly.

Household consumption added 0.4 percentage points to growth in Q2 2017 while government expenditure contributed 0.8 percentage points. The export sector was strong with net exports adding a further 0.3 percentage points to growth – a significant change from the -0.9% detraction in Q1 2017. Business investment remained a drag on economic expansion subtracting 0.8% from growth, in contrast to its positive contribution in Q1 2017.

Labour market conditions remained steady with the unemployment rate at 5.6% (seasonally-adjusted) in August 2017 – unchanged from July 2017. The Australian economy added a healthy 54,200 (seasonally-adjusted) jobs in August 2017 bringing the total number of employed people to 12.27 million. This was the largest increase since October 2015. Spare capacity in the labour market still exists and the associated unemployment gap remains. Labour costs stay subdued with Australia's seasonally-adjusted Wage Price Index growing by 0.5% q/q (1.9% y/y) in Q2 2017. RBA Governor Philip Lowe summed up the predicament during testimony to lawmakers recently, noting that wage growth in Australia has slowed more than productivity growth and that "the consequence of that is that the share of national income that is going to capital is at a five-decade high and the share going to labour is at a five-decade low."

Headline inflation rose 1.9% y/y in Q2 2017 (0.2% q/q) with underlying inflation at around 1.8% y/y (trimmed mean basis). Inflation remains contained and under the RBA's medium-term target of 2.5%. The RBA's official cash rate (OCR) is accommodative at 1.5%. Risks to the outlook remain, particularly in the form of a stronger Australian dollar for export-oriented businesses.

Looking ahead, KPMG Economics' forecasts for the Australian economy have not substantially changed since the last Quarterly Economic Outlook with real GDP growth expected to grow at around 2.9% for 2017-18.

Chart 13
GDP Growth by Component

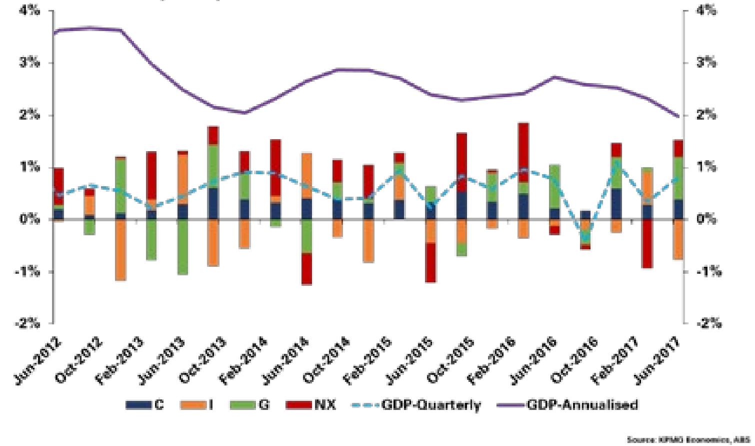
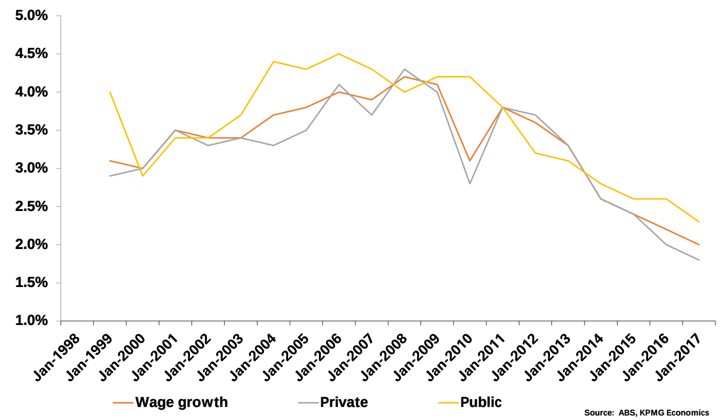


Chart 14
Private and Public Wage Growth



Government

Government expenditure grew by 1.2% q/q (seasonally-adjusted) in Q2 2017, up from 1.0% q/q (seasonally-adjusted) in Q1 2017. This was driven by expenditure on Defence (2.8% q/q) while non-Defence expenditure rose 0.5% q/q. National government expenditure increased 0.9% q/q in Q2 2017 (up from 0.5% q/q in Q1 2017) and State government spending grew by 1.4% q/q (down from 1.5% q/q in Q1 2017).

The underlying cash balance is currently in deficit (around -2.0% of GDP) but expected to improve over the forward estimates to a projected surplus of $7.4 billion (0.4% of GDP) in 2020-21. The net operating balance is expected to improve from -$19.8 billion (-1.1% of GDP) in 2017-18 to $17.5 billion (0.8% of GDP) in 2020-21.

The Federal Government's debt position remains low by global standards but is high from a historical perspective. As at June 2017, the total face value of Commonwealth Government Securities (CGS) on issue stood at $501 billion, up from $420 billion the year before. At the onset of the GFC in 2008, the total face value of Australian CGS on issue was $55 billion. As a proportion of GDP, CGS on issue was 4.7% in 2008, growing to 28.6% by June 2017. According to the Australian Office of Financial Management (AOFM), Gross Treasury Bond issuance in 2017-18 is expected to be around $80 billion. After accounting for maturities ($31 billion) and buybacks ($15 billion), net issuance will be around $34 billion.

In the 2017-18 Budget Papers, net government debt is projected to be 19.5% of GDP in 2017-18 and peak at 19.8% of GDP in the next financial year. Net government debt is then projected to decline as a share of GDP to 8.5% by 2027-28.

Chart 15
Budget aggregates

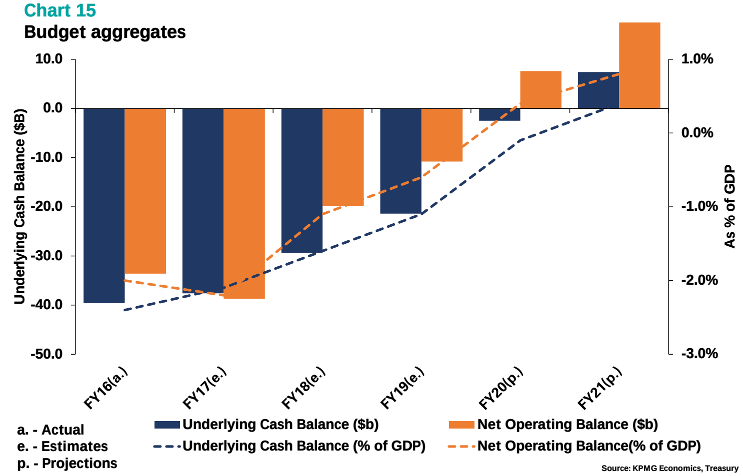
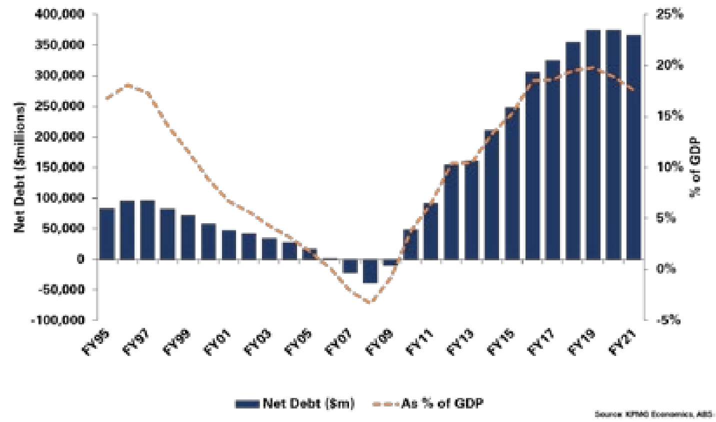


Chart 16
Australian Government Net Debt



Production

The Finance and Insurance Services industry continues to be the largest industry, accounting for 9.7% of the economy's Gross Value Added. Construction (8.1%), Health Care and Social Assistance (7.4%) and Mining (7.4%) make up the top four largest industries within the Australian economy, accounting for just under 33% of GVA. The Mining industry remains in the top four but continues to trend downwards.

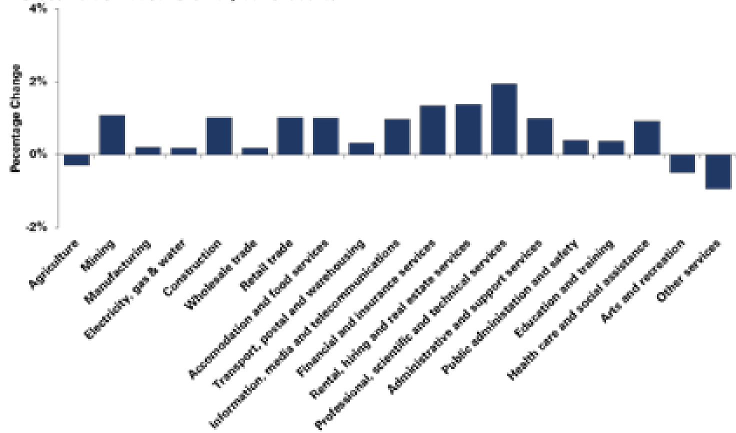
GVA growth in Q2 2017 was relatively broad-based with 17 of the 20 industries recording positive growth for the quarter. Strongest growth was observed in Processional, Scientific and Technical Services (1.9% q/q), Rental Hiring and Real Estate Services (1.4% q/q), and Financial and Insurance Services (1.4% q/q). Arts and Recreation Services (-0.5% q/q), Other Services (-0.9% q/q), and Agriculture (-0.3% q/q) all experienced contractions in GVA over Q2 2017.

ABARES latest Australian Crop Report (September 2017) forecasts a rise in the area planted with summer crops by 3.0%, reaching 1.4 million hectares in 2017-18. Total summer crop production is projected to rise by 21% to around 4.6 million tonnes while total winter crop production is projected to decrease by 39% in 2017-18 to 36.3 million tonnes. The 2017-18 production forecast is a downward revision of 9.0% from ABARES forecast published in the June 2017 edition of the Australian Crop Report. For the major crops, wheat production is forecast to decrease by 38% to 21.6 million tonnes, barley production is forecast to decrease by 40% to 8.0 million tonnes and canola production is forecast to decrease by 33% to 2.8 million tonnes.

The Department of Industry, Innovation and Science (DIIS) anticipates that Australia's metallurgical coal production will increase by 3.4% to 196 million tonnes (Mt) in 2016-17 and remain at around similar levels (198 Mt) in 2017-18. Coal production is expected to increase at an average annual rate of 1.4% till 2021-22. Iron ore export volumes are also projected to grow by 8.2% to 850 Mt in 2016-17 and 890 Mt in 2017-18, supported by productivity improvements and capacity expansions.

Chart 17

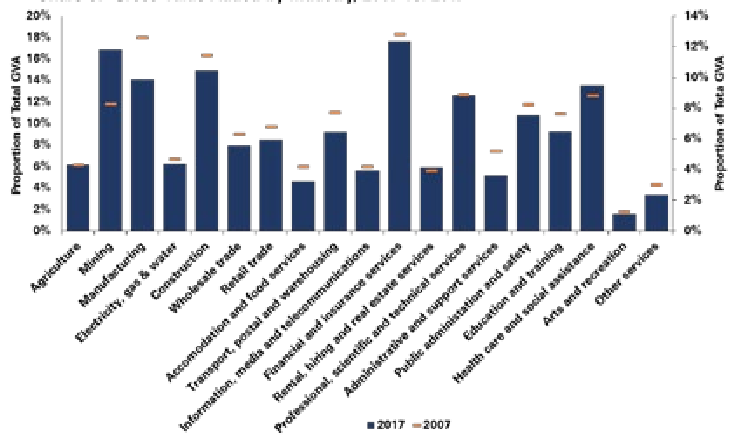
Gross Value Added Growth, June Quarter



Source: KPMG Economics, ABS

Chart 18

Share of Gross Value Added by Industry, 2007 vs. 2017



Source: KPMG Economics, ABS

Consumption

Household final consumption expenditure grew 0.8% q/q (seasonally-adjusted) in Q2 2017, and 2.6% on a rolling 12-month basis. This was led by Furnishings and household equipment (2.0%), Transport services (1.8%), Communications (1.5%), and Insurance and other financial services (1.3%). Purchases of vehicles fell 1.1% over the quarter, the only category of expenditure to record negative growth. Household consumption contributed 0.4% to Australian GDP growth in Q2 2017 – half of total quarterly GDP growth.

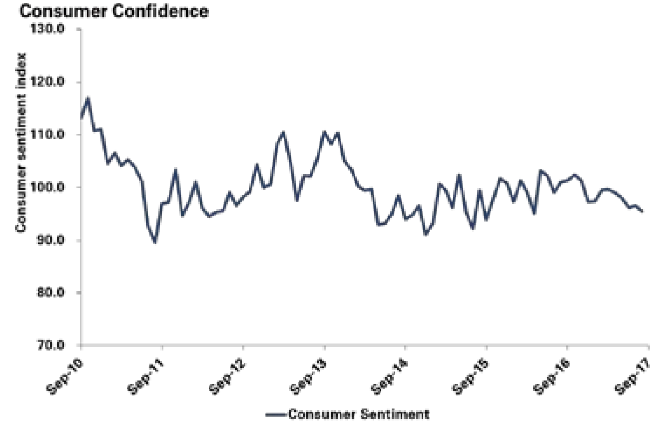
Retail trade growth has been on a downward trend since 2015 but registered growth of 1.5% (seasonally-adjusted) q/q in Q2 2017. Month-on-month, seasonally-adjusted July 2017 figures reveal no growth following 0.2% growth in June 2017. 'Department stores' saw the largest increase, growing by 3.1% q/q in Q2 2017 on the back of flat and negative growth in previous quarters. This was followed by clothing, footwear and personal accessory retailing (2.8% q/q), and household goods retailing (2.5% q/q). All categories recorded positive growth in the June quarter of 2017.

Household borrowing has continued to rise. The Australian household debt-to-income ratio has been rising over the past decade reaching record levels (debt-to-income of 190.4 in March 2017). Recently, the ABS, based on their Household Income, Wealth and Expenditure Survey, found that the average amount of debt (inflation-adjusted) has almost doubled in the past 12 years — from $94,100 in 2003-04 to $168,600 in 2015-16.

Consumer sentiment, as measured by the Westpac-Melbourne Institute Index of Consumer Sentiment, jumped 2.5% in September to 97.9 from 95.5 in August. The Index has been below the 100 mark since November 2016, reflecting slightly more pessimists than optimists within the 1,200 survey respondents. On the positive side, expectations for the economic outlook over the next 12-months rose 2.7% while measures of the economic outlook for the next five years increased by 5.1%. The measure of family finances compared to a year ago also rose 6.1%. The main drag on the Index in August was consumers' outlook for family finances which declined 2.1%.

Chart 19
Retail Sales, Australia

Chart 20
Consumer Confidence



Investment

Private investment in Australia has been relatively weak in recent quarters but Q2 2017 saw an increase of 0.8% q/q (seasonally-adjusted) in private capital expenditure. This was the second consecutive quarter of positive growth in private investment. Expenditure on buildings and structures fell 0.6% q/q (seasonally-adjusted) while expenditure on plant and machinery rose 2.7% q/q (seasonally-adjusted) in Q2 2017. Gross Fixed Capital Formation in Australia also increased 1.5% (seasonally-adjusted) in Q2 2017. Year-on-year, gross fixed capital formation was down 1.8% on a seasonally-adjusted basis for June 2017.

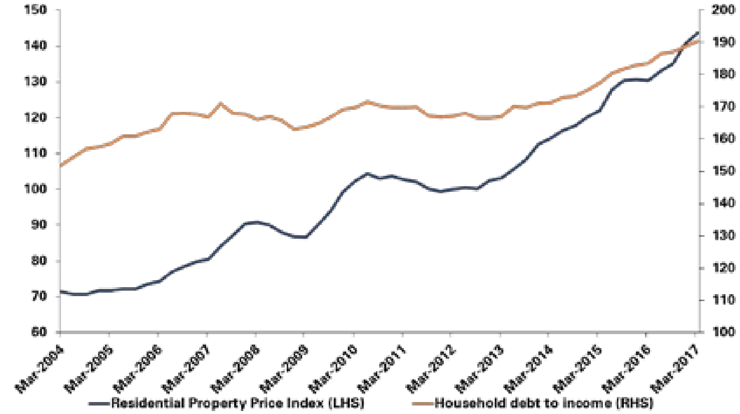
The number of dwelling approvals decreased by 1.7% m/m (seasonally-adjusted) in July 2017, driven by declines in ‘private dwellings excluding houses’. Dwelling approvals declined the most in Western Australia (11%) and Tasmania (11%). Only New South Wales (1.5%) and South Australia (0.3%) registered positive growth rates in dwelling approvals.

The HIA New Home Sales indicator declined 3.7% m/m in July 2017 following a 6.9% fall in June 2017 reflecting a drop in sales volumes over the past months. This is the lowest level the indicator has been at since 2013 and possibly reflects some of the tightening measures put in place by APRA and the RBA.

In terms of leading investment indicators, the NAB Business Confidence Index fell sharply to 5 in August 2017 from 12 in July 2017 – the lowest level since October 2016. This decline was attributed to a deterioration in confidence in relation to customer demand and government policy. A decline in small business sentiment was also observed in Q2 2017. Services and Manufacturing PMIs, however, were in the expansionary range (above 50) although the Australian Performance of Services Index fell from 56.4 in July 2017 to 53 in August 2017). The AIG/Housing Industry Association Performance of Manufacturing Index showed a strong increase to 59.8 in August of 2017 from 56 in July 2017 – the eleventh straight month of expansion and highest since May 2002.

Chart 21

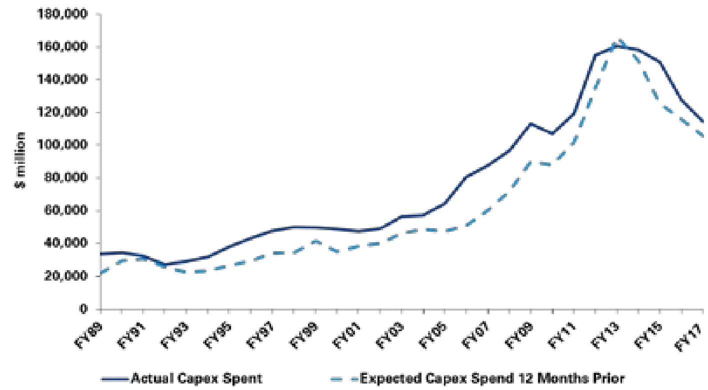
House Prices and Household Debt



Source: KPMG Economics, ABS, RBA.

Chart 22

Actual and Expected Private New Capital Expenditure



Source: ABS, KPMG Economics

Labour Market

Most indicators of the Australian labour market have remained steady with the exception of the recent August 2017 job numbers where the economy added a strong 54,200 (seasonally-adjusted) jobs. This was the largest increase since October 2015 and exceeded market expectations. At the end of August 2017, the domestic labour force comprised around 8.39 million full-time employed persons (approximately 68% of the total employed labour force) and 3.88 million part-time employed persons (approximately 32% of the total employed labour force) bringing the size of the Australian labour force to 12.27 million employed people.

The unemployment rate remained at 5.6% (seasonally adjusted) where it has stood since June 2017. The quarterly underemployment rate (seasonally-adjusted) decreased by 0.2% to 8.6% - down from 8.8% in Q2 2017. The underutilisation rate also decreased by 0.2% to 14.1% over the quarter. Monthly hours worked in all jobs increased by 0.4% to 1,705.4 million hours.

The labour force participation rate increased by 0.2 percentage points to 65.3% in the month of August 2017. Since the start of the year, the labour force participation rate has been edging up, a positive signal in the labour market as discouraged workers return and first-time participants enter the labour force. The labour force participation rate is currently at its highest point since September 2012.

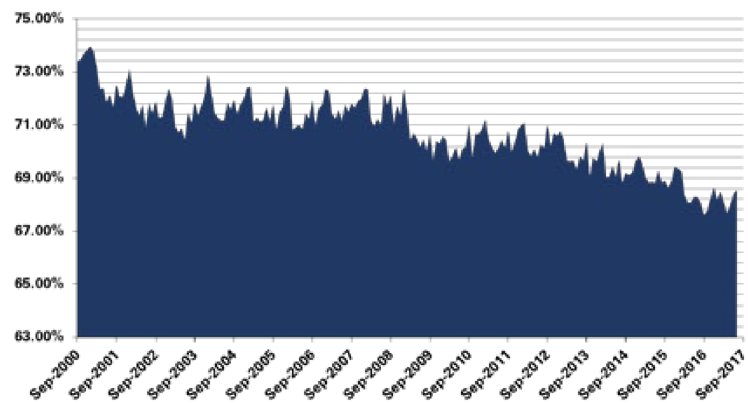
Forward-looking indicators signal moderate growth in the labour market for the remainder of 2017. The ANZ Job Advertisements Series showed a strong 2.0% m/m increase in the number of job advertisements in August 2017, and a 13.3% increase year-on-year. This suggests encouraging and improving labour market conditions in Australia, closing the gap on spare capacity in the labour market. For a sustainable and healthy labour market, however, these improvements need to coincide with wage growth which has been subdued.

KPMG maintains its forecast for the unemployment rate at 5.4% for 2018.

Chart 23
Unemployment and Participation Rates

Source: KPMG Economics, ABS

Chart 24
Proportion of full-time to total Employment



Source: KPMG Economics, ABS

Net Exports

The Australian economy posted a current account deficit of $9.56 billion in Q2 2017, equivalent to 2.7% of GDP. This was the largest deficit in three quarters as the trade surplus dipped to $0.46 billion m/m (seasonally-adjusted) in July 2017 from a revised figure of $0.89 billion m/m (seasonally-adjusted) in June 2017.

Exports of goods and services declined 2.0% to $31.07 billion. Export of goods contributed $24.76 billion while export of services contributed $6.31 billion to the trade balance. Imports of goods and services fell 1.0% to $30.61 billion, with imports of goods contributing $24.18 billion and import of services contributing $6.43 billion. Short-term visitor arrivals increased to 605,100 in June 2017 from 579,000 in May 2017. The longer-term trend of positive growth rates in visitor arrivals is indicative of a healthy tourism sector.

Australian exports are still expected to remain strong over the year supported by healthy demand for commodities, although the recent strength in the Australian dollar against the USD might provide headwinds. According to the RBA's Index of Commodity Prices, preliminary estimates for August 2017 indicate a 1.5% (SDR terms) monthly increase following a decrease of 0.8% in July 2017. The increase was led by iron ore prices which offset the drop in coking coal and beef prices. In Australian dollar terms, the index increased by 1.0% in August 2017. Year-on-year, the index has increased by 20.1% in SDR terms and 16.6% in Australian dollar terms, driven primarily by higher coal and iron ore prices. Australia's Terms of Trade (ToT) decreased to 103.6 index points in Q2 2017 from 109.7 in Q1 2017. KPMG maintains its forecast for the ToT at around 96.0 for 2018.

The Australian dollar has appreciated against the U.S. dollar since Q2 2017, and is currently trading at around USD 0.80c. This has come on the back of a generally weaker U.S. dollar. On a trade-weighted basis, the Australian dollar is also marginally higher at around 67 in September 2017 compared with 65 in June. KPMG's forecasts have the AUD/USD exchange rate settling around the USD 0.75c level for the immediate future.

Chart 25

Rolling Annual: Exports by Type

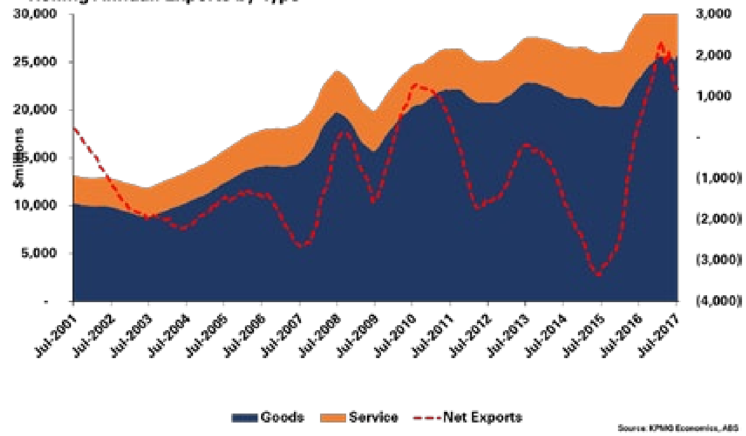
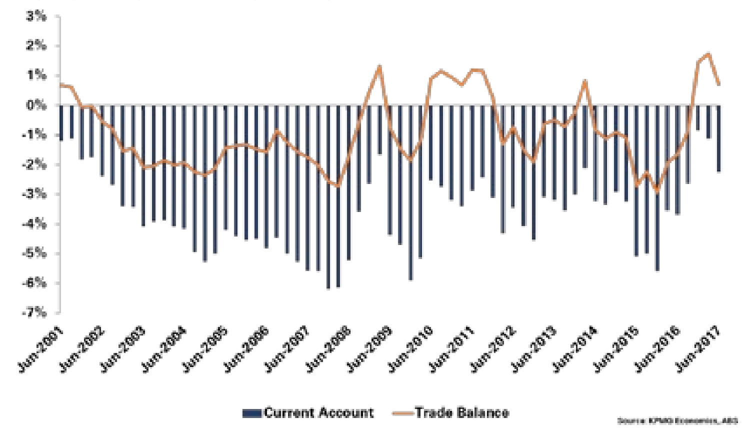


Chart 26

Current Account and Trade Balance



Forecast Assumptions

Changes in key assumptions impacting KPMG's Economics forecasts since November 2016 include:

Global

- A rise in 10-year bond yields in most jurisdictions through 2017;
- A tightening in the spread between sovereign bonds and corporate bonds, suggesting the margin for corporate borrowing compresses;
- Oil prices stablising to trade in a tight range of US$54/bbl to $58/bbl until the end of 2018;
- Equity prices to retreat from recent high's once the 'sugar hit' from the commencement of the Trump Administration in the US wear's off.

Australia

- Residential construction activity to soften in 2017 and 2018 due to a moderation in non-housing construction;
- Non-mining business investment to continue to steadily rise, although the decline in mining investment will continue to swamp aggregate investment such that negative growth remains in FY17;
- Household consumption activity to be limited by high debt levels, anemic wages growth and moderate employment growth;
- Limited fiscal reforms in Australia, thereby keeping the effective corporate tax rate and effective personal income tax rate the same as in FY16, with government spending also to be maintained at levels forecast in the recent MYEFO statement.

Australian Outlook

	FY16	FY17	FY18	FY19	FY20	FY21	FY22
GDP (Real)	2.7%	1.8%	2.9%	2.9%	3.1%	3.0%	2.8%
Private Consumption	2.9%	2.4%	2.7%	2.8%	2.9%	3.0%	2.9%
Investment							
Housing	8.5%	2.1%	-2.2%	4.0%	4.2%	1.9%	1.4%
Business	-11.0%	-4.5%	5.8%	2.4%	2.5%	3.1%	2.5%
Government							
Consumption	3.7%	2.8%	2.1%	2.0%	2.0%	2.1%	2.2%
Investment	2.7%	-0.9%	-4.6%	-1.9%	-1.4%	0.8%	1.4%
Total domestic demand	1.3%	1.3%	2.3%	2.5%	2.6%	2.7%	2.5%
Export volumes	6.7%	5.9%	5.9%	5.1%	5.0%	5.0%	5.1%
Import volumes	-0.3%	3.7%	3.2%	3.5%	3.6%	4.0%	3.9%
Inflation (1)	1.0%	1.5%	1.6%	2.1%	2.3%	2.5%	2.6%
Real Personal Disposable Income	1.6%	2.3%	2.8%	2.8%	3.0%	3.0%	2.8%
Unemployment, % (1)	5.7%	5.4%	5.4%	5.2%	5.1%	5.2%	5.3%
Government Balance as % of GDP	-2.3%	-2.3%	-1.4%	-0.9%	-0.8%	-0.9%	-1.0%
Govt. debt as % of GDP	44.2%	45.7%	45.8%	45.0%	43.6%	42.2%	40.9%
Current account as % of GDP	-4.4%	-2.1%	-1.4%	-1.2%	-1.1%	-0.9%	-0.7%
A/US (1)	0.746	0.744	0.741	0.740	0.741	0.743	0.745
Terms of Trade (1)	96.7	97.0	96.2	95.3	95.0	94.6	94.0

(1) = Value at end of the year

KPMG Economics

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