Third Quarter of 2017

AUSTRALIA UPDATE

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THE GLASS IS HALF-FULL: JOB MARKET IS HEALING, BUT SHAKY HOUSEHOLD FINANCES LIMIT UPSIDE GROWTH POTENTIAL

> The economy is settling into a moderate growth path

The Australian economy is settling into a moderate growth path. Real GDP growth cooled to an annualized 1.1 percent pace in the first quarter of 2017 from 4.5 percent growth in the fourth quarter of 2016. Household and government spending continued to be the primary growth drivers. Moreover, new engineering construction added to economic growth for the first time since 2013 as profitable iron and coal prices halted the extended slump in mining investment (Chart 1). On the downside, some of the first quarter's growth was dampened by tighter lending rules that took steam out of the housing market. Also, a 4 percent appreciation in the trade-weighted Aussie dollar sank exports and lifted imports.

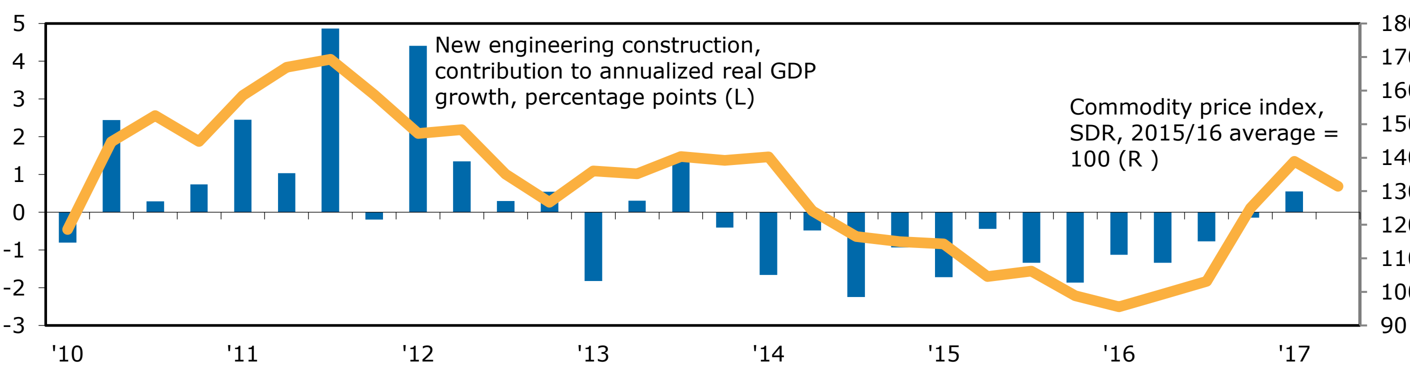
The economy is on track to grow 2.4 percent in 2017, which is about the same rate of growth as in 2016 and 2015. Real GDP growth is then expected to pick up to 2.7 percent in 2018. These are moderate growth rates by historic comparisons. During the mining boom which lasted from 2003 to 2014, the economy grew by an average of 2.9 percent per year. Nevertheless, Australia's new, slower economic growth rates are enviable by OECD standards, especially considering that the Aussie economy is in its 26th year of expansion.

> Job growth is gaining steam with full-time positions doing the heavy lifting

The economy has several advantages working in its favor. First, the job market is improving. Total job growth averaged 30,700 in the first five months of 2017 compared with an average monthly gain of just 8,900 in 2016. The unemployment rate dipped to 5.5 percent in May, its lowest point since 2013. The jobless rate had been stuck between 5.6 and 6.0 percent since late 2015. The composition of job growth is also improving. Between the first quarter of 2014 and the third quarter of 2016, part-time job gains outnumbered full-time positions by nearly two to one. This weighed on wages and consumer confidence. Fortunately, by late 2016, job growth shifted to mostly full-time positions (Chart 2). The number of job advertisements are trending higher, which indicates the pickup in job growth has staying power.

Second, business confidence is improving, a sign that hiring and investment could rise in the coming months. Favorable trading conditions and a steady stream of new orders are keeping

CHART 1: HIGHER COMMODITY PRICES ARE ONLY A TEMPORARY REPRIEVE



Sources: Australian Bureau of Statistics; Reserve Bank of Australia profits at high, even if they have shrunk relative to the boom years. A pickup in activity in services, especially tourism and education, is partially filling the hole left by the mining bust. Capacity utilization is high, which points to stronger pricing power for firms ahead.

Increased production, steel furnace closures will pull down coal and iron prices

Nevertheless, a number of weaknesses will prevent a stronger economic rebound in 2017 and 2018. First, commodity prices will likely moderate in the coming months, though they will remain at profitable levels. Prices for coal, iron ore and gold made spectacular comebacks in 2016 as China's infrastructure investment picked up and later in the year markets anticipated a large U.S. fiscal stimulus to jumpstart U.S. growth in 2017 and 2018. Spot prices of coking coal for export surged by more than 150 percent from late 2015 to late 2016 and thermal coal prices nearly doubled. From late 2015 to early 2017, iron ore prices jumped nearly 90 percent and gold prices rose about 18 percent. In the months ahead, prices for thermal and coking coal will be pressured as Chinese and Indian production increases global supplies. Also, closures of Chinese steel furnaces and diminished prospects for large-scale infrastructure spending in the U.S. mean iron ore will likely be oversupplied.

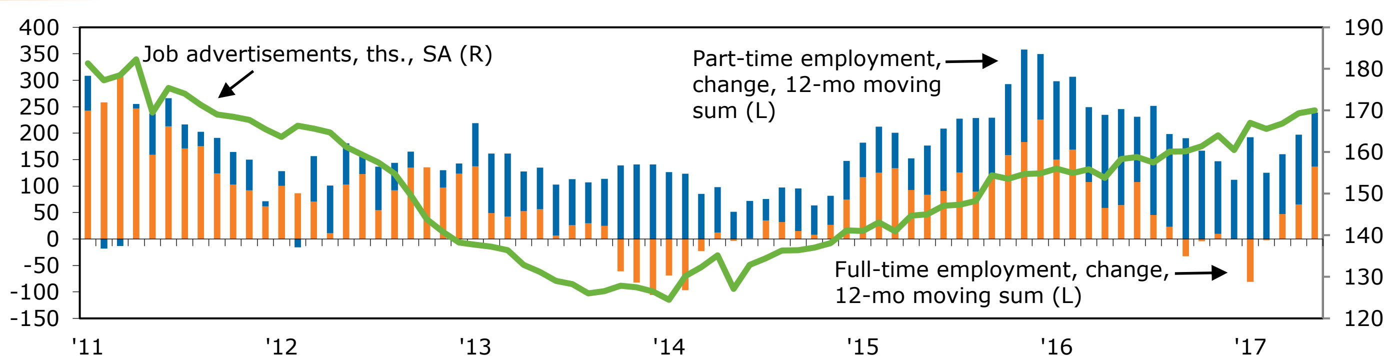
A second soft spot in the economy is that the foundations for household spending are weak. Wage growth will remain tepid in the next 12-18 months, even as job growth improves. Technological changes and weaker worker bargaining power are dampening income growth in many OECD countries and Australia is unlikely to be an exception. In addition, consumer confidence is still shaky and households have been supporting their spending by reducing saving. Considering that housing is unaffordable in many major cities and households carry debt worth more than 120 percent of GDP, there is limited scope for increased spending via increased debt. Hence, consumers will likely focus their purchases on essentials.

The Aussie dollar will weaken as the U.S. Fed raises rates and commodity prices moderate

The Reserve Bank of Australia will likely hold the target cash rate at its historic low of 1.50 percent until the second half of 2018. Central bankers are increasingly confident of economic growth prospects but are worried that the significant level of household debt and underemployment could weigh on wages, consumption and inflation. Consumer price inflation is currently running a little below the RBA's 2-3 percent target range and will likely return to target in 2018. However, inflation has been stubbornly low in many advanced economies and could undershoot expectations in Australia as well.

PNC Economics expects the Australian dollar to weaken slightly to 0.74 USD in the third quarter from 0.75 USD at the end of June. The Aussie dollar is forecast to remain at 0.75 USD through the end of 2018. The U.S. Federal Reserve is expected to begin shrinking its balance sheet later this year. It will likely hike its policy rate one more time in late 2017 and three more times in 2018. At the same time, commodity prices will pull back from their recent levels. These two forces will prevent the Aussie dollar from appreciating, despite the economy's relatively healthy growth rate.

CHART 2: JOB GROWTH IS IMPROVING AND THE BALANCE HAS SHIFTED TOWARD FULL-TIME EMPLOYMENT



Source: Australian Bureau of Statistics

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