TCorp Local Government Services

Economic Commentary - August 2014

New South Wales Treasury Corporation

For further details please contact: Brian Redican, Chief Economist.
T: 02 9325 9388 E: brian.redican@tcorp.nsw.gov.au

The Month in Review

Economic and Market Trends

A sharp rise in the Australian unemployment rate in July (to 6.4% from 6.1%) reinforced the trend towards lower bond yields in August. While the labour market data are volatile on a monthly basis, unemployment has trended up since 2011, indicating that there is considerable spare capacity in the labour market. Furthermore, private-sector wages growth slowed to 2.4%yoy in the June quarter – the slowest annual pace since the series began in 1997.

Despite the modest pace of wage increases, inflation was slightly higher than expected in the June quarter, with consumer prices rising by 3% y/y. This, however, mainly reflects the lagged impact of the decline of the A$ in late 2013 – as well as an increase in tobacco excises – rather than wider business margins. With the removal of the carbon tax in July, inflation is likely to fall towards the bottom of the Reserve Bank of Australia's (RBA) 2-3% target band over the year ahead.

The removal of the carbon tax also appears to have boosted business confidence which has improved further in recent months. Consumer sentiment has also improved from its post-Budget weakness. This is important as retail trade data indicated that there was no growth in volumes in Q2. Indeed, with lacklustre consumer spending, softer export growth and muted government spending, GDP growth in the near-term is likely to be soft.

Consistent with the softer outlook for GDP growth and the rise in unemployment, the RBA revised down its growth forecasts in its August Statement on Monetary Policy. With growth now expected to remain below trend over the next 18 months, the RBA doesn't expect unemployment to begin falling until 2016. Nonetheless, the RBA still maintains that current monetary policy settings are appropriate for that outlook, but clearly the risks have tilted downwards in recent months.

The US Federal Reserve's annual Jackson Hole Symposium was front and centre for global financial markets given the increasing importance of this forum in recent years. Former Fed Chairman Ben Bernanke used this forum to signal major policy shifts, such as quantitative easing, and for this reason many were expecting the current Chair Janet Yellen to provide some guidance around the highly anticipated tightening in monetary policy.

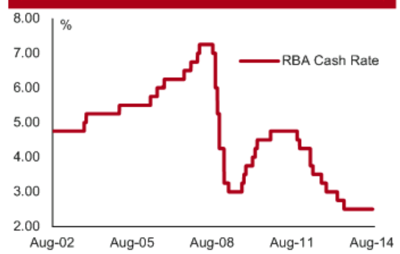
Instead, Yellen's address was very balanced in relation to the central bank's view on employment conditions and the underlying inflation pulse in the economy – the two key determinants of monetary policy for the US economy. Both were seen to be improving, although uncertainty still remains around the sustainability of the improvement, with policy decisions from here still expected to be data-dependant.

European Central Bank (ECB) President Mario Draghi was also invited to speak at the event, although he provided a more definitive outlook for monetary policy, emphasising that the risks of "doing too little" on the policy front outweigh those of "doing too much". That is, the risks of increasing long-term unemployment are less favourable than the risks of excessive inflationary pressures. Indeed, European growth stalled in the June quarter as Germany, which has been a crucial driver of growth over the past several years, contracted by 0.2% in Q2. With such anaemic growth rates, any shock to demand – from trade sanctions to bank stress tests – certainly has the potential to push the economy back into recession.

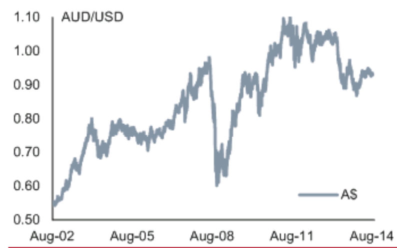
Financial/Economic Data

August 2014

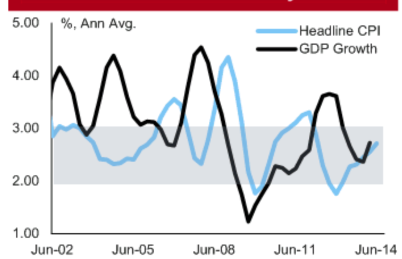
RBA Cash Rate



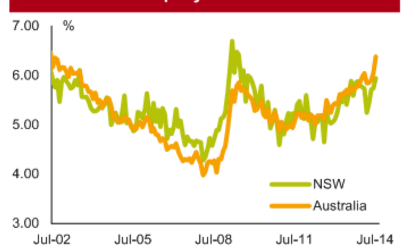
Australia Dollar



Australian Economy



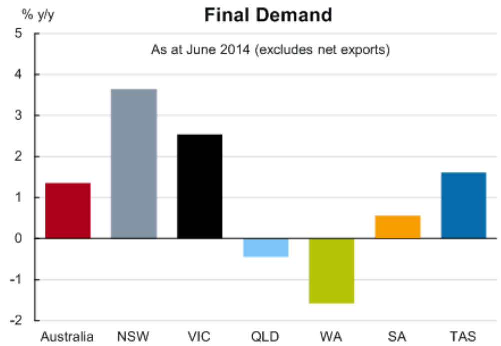
Unemployment Rate

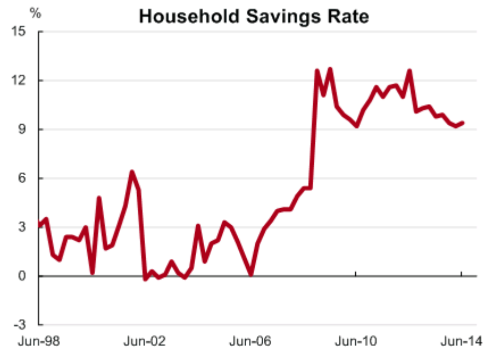


The State of NSW

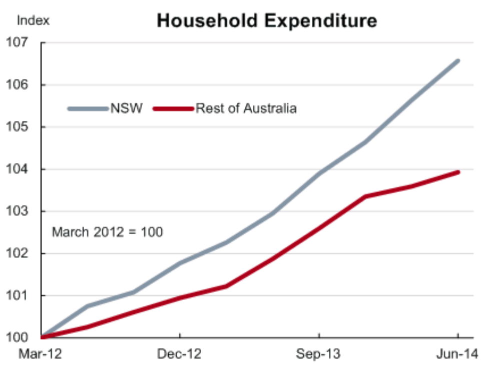
After a small hiccup in activity, NSW is still ahead

The latest round of Australian GDP growth data showed yet another robust period of activity over the June quarter despite the significant declines in net exports and business investment. The Australian economy grew 0.5% q/q to finish 3.1% larger than this time last year, which is in line with trend growth in the economy. Overall, it appears that some more progress is being made in the transitioning of activity away from the resource sector. Household expenditure and residential construction continued to expand, underpinning the lift in domestic demand in the non-mining sectors, which policymakers are hoping will drive growth over the coming years. The data also showed that household savings remained relatively high at 9.4% of disposable income, business profits fell on the back of falling bulk commodity prices, and that manufacturers, wholesalers and miners alike saw a strong rise in inventories (which should weigh on growth in Q3).





As for the NSW economy, activity continued to outpace that of its peers, with state final demand growing 3.6% over the year (the next best being Victoria at 2.5% y/y). NSW remains the standout beneficiary of the ongoing (albeit gradual) shift in activity towards the services sectors. Most notable was the rapid gain in the construction of new homes, rising 9% in the June quarter to be 16% higher than a year ago. Along with the increase in the housing supply, consumers increased their spending on discretionary goods and services by 3.5% over the year - well above national pace of 2.5% y/y.



Market Movements and Economic Data

Financial Data	29 Aug	Monthly change	
Cash Rate	2.50%	0.00	–
Corporate Bond Yield*	4.00%	-0.06	▼
Term Deposit**	2.75%	-0.05	▼
ASX200	342	1.8%	▲
S&P500	2003	3.8%	▲
AUD/USD	0.934	0.004	▲
Economic Data***	**30 Jun**	**Quarterly change**	
Headline CPI	3.00%	0.10%	▲
Trimmed Mean CPI	2.90%	0.30%	▲
GDP Growth	3.10%	-0.30%	▼
House Prices	10.10%	-1.10%	▼
Unemployment Rate	6.40%	0.60%	▲

*A 5-year rate, source: RBA **Average 90-day rate of the five largest banks for $10,000, source: RBA ***National data, y/y, source: ABS, RBA

While it is too soon for policymakers to be sounding the victory horn, we believe the Australian economy has laid the necessary groundwork to achieve a much needed rebalancing of activity. Further gains in residential construction and house prices will help stimulate confidence and spending – both of which are occurring at a healthy pace in NSW. There are, however, lingering headwinds which could impede on further gains in production from here, such as the persistently strong A$, the reluctance of non-mining businesses to invest on newer and more efficient capital, rising unemployment, and the pressure on both State and Commonwealth governments to pull back spending.