TCorp Local Government Services

Economic Commentary - November 2014

New South Wales Treasury Corporation

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The Month in Review

Economic and Market Trends

The most significant factor bearing on the Australian economic outlook has been the relentless decline in iron ore prices, which declined from US$80 per tonne in October, to below US$70 per tonne in November. Since the start of 2014, the iron ore price has declined by nearly 50%. At these levels, some of the smaller iron ore producers are not profitable, and may be forced to mothball production if prices don't soon recover.

Expansion projects in the resources sector will also be deferred, which will place further pressure on mining-services firms. The reduction in mining company profitability will also reduce Federal Government tax revenue and result in a larger budget deficit than previously expected.

In other domestic news, retail sales and business conditions reportedly improved over September and October, but business confidence deteriorated and building approvals also moderated. At the same time, the outlook for business investment remains subdued with mining investment declining steadily, but only modest gains in spending by firms in the non-mining sectors. GDP growth in Q3 also disappointed as activity rose a meagre 0.3% q/q (see next page).

Turning to Australia's major trading partners, China's policymakers announced cuts to lending and deposit interest rates in a move that surprised markets in November. This demonstrates the determination of policymakers to ensure that growth doesn't slip too far.

Expectations that the European Central Bank (ECB) will also engage in sovereign bond purchases also received a boost as ECB President Mario Draghi said the ECB would "do what we must" to ensure that inflation soon approaches the ECB's target of 'close to 2%". In October, inflation in Germany fell to 0.5% y/y, while in Spain consumer prices fell by 0.4% y/y. To put this into perspective, Australian inflation is currently running at 2.3% y/y.

The outlook for global inflation has been further dampened by a precipitous fall in oil prices in recent months. Crude oil prices fell from $82 per barrel in October, to $68 per barrel in late November. Some analysts had thought that OPEC would announce production cuts in an effort to support oil prices, but instead OPEC vowed to maintain existing production levels.

In contrast to the fevered action elsewhere, the US was an oasis of calm over the last month. The US economy grew at a 3.9% annualised pace in Q3, and recent data on the labour market and manufacturing sector suggest that growth has continued at a reasonable pace into the end of the year. This is significant as some analysts were concerned that the stronger US$ and weaker global activity may have undermined US growth. At this stage, however, there is no evidence that this has occurred.

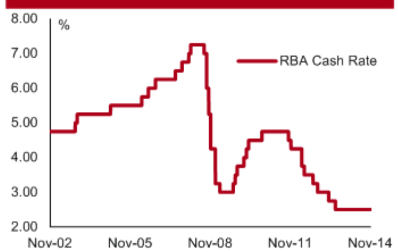
The combination of weak global activity, sharp falls in oil prices and more aggressive policy easing has placed further downward pressure on global yields, while credit spreads also compressed.

The performance of global equity markets had diverged significantly over November with an unusually large underperformance by the Australian market. Global equity markets have been supported by policy easing, which has lifted stocks in China, Japan, Europe and the US. In contrast, the decline in commodity prices has tended to weigh on resource and energy stocks, and this has dragged the Australian stock market lower

Financial/Economic Data

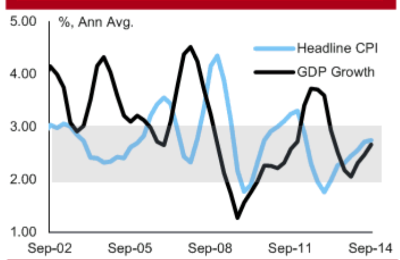
November 2014

RBA Cash Rate



Australia Dollar

Australian Economy

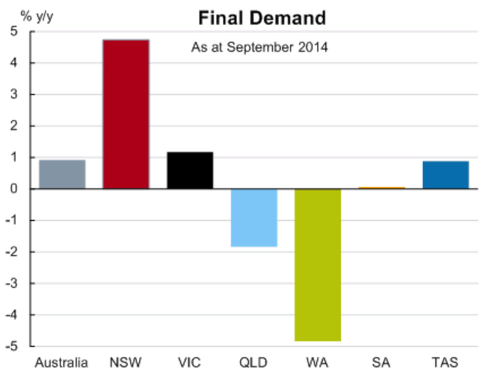


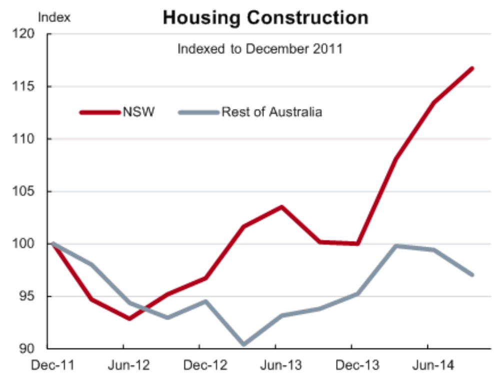
Unemployment Rate

The State of NSW

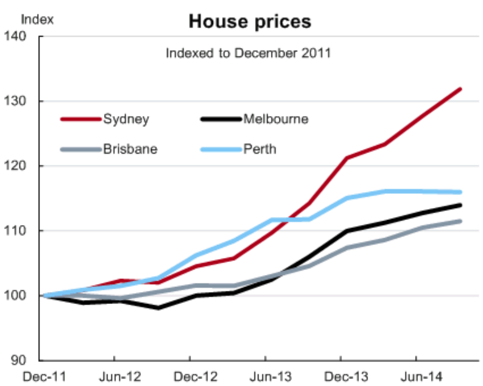
NSW accelerates as the rest of Australia slows

The latest round of domestic economic data showed a marked slowing of growth in the September quarter. The Australian Statistician measured GDP growth in Q3 to be 0.3% q/q and 2.7% over the year. To put this in perspective, Australia's trend growth is said to be around 3%. Production was much weaker than what economists were forecasting, fuelling expectations that the RBA may have to cut interest rates early next year. The downside surprise came from a large decline in mining-related activity. As surprising as the weak GDP reading may have been for markets, it is consistent with the theme of rapidly declining mining investment – something the RBA has highlighted frequently in its past communications. But despite the marked slowdown in overall growth, the NSW economy continued to buck the trend. Final state demand in NSW accelerated to 4.7% over the year – four times the pace of growth seen in Victoria.





The key behind NSW's success has been the impressive momentum in its housing sector. NSW homeowners have enjoyed a 15% rise in house prices over the year to September, much faster than the other States. The response from home builders and property developers to higher house prices has been just as pronounced. Residential construction activity in NSW is almost 20% higher than it was 3 years ago, whereas the remainder of Australia has seen residential construction fall over this period. This activity is especially important for NSW because it is labour intensive, allowing for stronger employment multipliers.



Market Movements and Economic Data

Financial Data	28 Nov	Monthly change	
Cash Rate	2.50%	0.00	–
Corporate Bond Yield*	3.94%	-0.11	▼
Term Deposit**	2.85%	0.00	–
ASX200	347	3.1%	▲
S&P500	2068	2.5%	▲
AUD/USD	0.851	-0.029	▼
Economic Data* **	**28 Nov**	**Quarterly change**	
Headline CPI	2.30%	-0.70%	▼
Trimmed Mean CPI	2.50%	-0.30%	▼
GDP Growth	2.70%	0.00%	–
House Prices	9.20%	-1.10%	▼
Unemployment Rate	6.20%	0.10%	▲

*A-rated 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

We have been very comfortable with the performance of NSW this year, particularly relative to the rest of Australia. There are, however, challenges the Australian economy as a whole will continue to face. Australian businesses remain reluctant to invest at a time of subdued consumer spending. The currency remains high relative to fundamentals. Bulk commodity prices have fallen roughly 50% since the start of the year. There are tentative signs that the housing market has peaked. Real wage growth has been stagnant. Unemployment is rising and growth is expected to be below trend (3% y/y) over the next 2 years. These factors have prompted economists to envisage the possibility of interest rate cuts in early 2015. As for financial markets, current pricing suggests that interest rate cuts are all but certain.