TCorp Local Government Services

Economic Commentary - December 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

Coming into December, markets were expecting the US Federal Reserve (Fed) to lay the groundwork for higher interest rates in 2015 at its December policy meeting. The ongoing strength in non-farm payrolls (November added 321,000 jobs) and the fastest pace of GDP growth seen in 8 years added to the market's confidence that the Fed was getting closer to tightening policy after keeping its policy rate at zero for more than 6 years. However, in the post meeting statement, the US central bank still appeared reluctant to raise rates in the near-term, informing markets that *"it can be patient in beginning to normalize the stance of monetary policy".*

Softer inflationary outcomes have provided the Fed with more wriggle room to keep monetary policy expansionary. Likewise, the absence of a pickup in wages growth and the persistent declines in oil prices suggest inflation will not be a problem for the Fed in the foreseeable future. However, if these factors were to dissipate, the Fed will likely respond by raising rates sooner.

Turning to Europe, it appears policymakers were working in the other direction. In a statement following the December policy meeting, European Central Bank (ECB) President Mario Draghi explicitly committed to "reassess the monetary stimulus achieved" in early 2015 to see whether further policy action was warranted. Draghi also stipulated that unanimous support among ECB members is not necessarily required to enact further monetary stimulus.

Lower inflationary expectations in the US and the euro area will ensure global interest rates (even in Australia) are lower for longer.

In domestic news, the Commonwealth Government released its 2014/15 Mid-Year Economic and Fiscal Outlook (MYEFO). The Budget position for the current financial year was downgraded, with the deficit now expected to be $40.4b rather than the $29.8b forecast in May 2014. Lower commodity price forecasts and weaker wages growth have combined to reduce revenue growth resulting in Budget deficits about $10b higher per year over the forecast horizon.

In response to some of the market fears surrounding the rapid rise in speculative activity in the property market, the Australian Prudential and Regulatory Authority (APRA) announced a version of macroprudential policy without the 'big-bang' Loan-to-Value restrictions or increased capital requirements. Instead, APRA produced 16 recommendations that Authorised Deposit-taking Institutions (ADIs) should adopt. These included capping the annual growth in mortgage lending to investors at 10% while also reducing riskier lending more generally. APRA also appear primed to enforce harsher rules and penalties if ADIs do not comply with its recommendations.

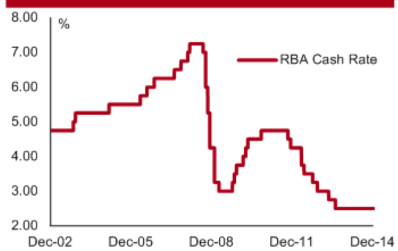
At face value, financial markets seemed to normalise in December. Global shares were mostly up, with the US (+1.1%) and Australian (+3.0%) bourses finishing higher in the month. China's market was the clear outperformer, rising 18.1% in December (up 50% over the year).

In the global bond market, however, while US yields steadied after the sharp declines in November (10-year yields increased 4bps to 2.20%), the Australia equivalent fell 30bps to 2.74%. Weaker domestic inflationary expectations from lower oil prices and the increasingly popular view that the RBA will cut interest rates helped push yields lower. As for the currency, the A$ fell another 4.4%, in line with the 3.7% decline in iron ore prices.

Financial/Economic Data

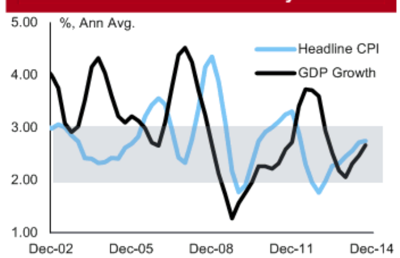
December 2014

RBA Cash Rate



Australia Dollar

Australian Economy



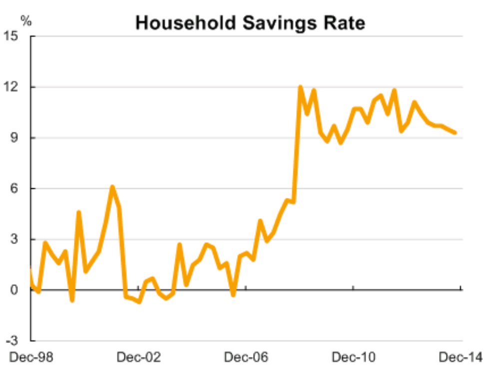
Unemployment Rate

The State of NSW

What is in store for the Australian and NSW economies in 2015

With mining investment falling, it is becoming increasingly unlikely that Australia will see a strong acceleration in economic growth in 2015. Of course, there will be pockets of the Australian economy that will be able to weather the 'mining storm' better than others, particularly NSW where mining activity has a minimal role in the economy. Instead, we know the NSW economy is more attuned to dwelling investment and consumer spending. So far, lower interest rates have greatly benefitted the NSW economy and should continue to do so in the New Year. There are, however, a few developments in these sectors worth mentioning. First, some economists believe housing indicators are showing tentative signs of a peak in activity. Indeed, annual growth in building approvals for stand-alone houses in Australia has decelerated from 25% to 4% over 2014.

But in our view, rather than this posing a problem in the near term, the sufficient backlog of residential construction work should continue to support growth (especially in NSW) in 2015. The peak in approvals, however, means there is a risk that housing ceases to boost growth in 2016. Second, many commentators have highlighted that sluggish wages growth and higher taxes will weigh on household disposable incomes. While we agree, lower petrol prices should support retail spending over the next year. In addition, the low A$ should also switch spending away from imports towards domestic retail (as more people holiday in Australia). And with a high national savings rate, households still have the scope to run-down savings to increase spending. In any case, retail sales in NSW (9%) has accelerated at more than 2 times the annual pace of the remainder of Australia (4%).



Market Movements and Economic Data

Financial Data	31 Dec	Monthly change	
Cash Rate	2.50%	0.00	–
Corporate Bond Yield*	3.57%	-0.37	▼
Term Deposit**	2.85%	0.00	–
ASX200	5411	1.8%	▲
S&P500	2059	-0.4%	▼
AUD/USD	0.818	-0.033	▼
Economic Data* **	**31 Dec**	**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	6.30%	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

Overall, the NSW economy is still well positioned for growth in 2015. The challenges will be greater for the remainder of Australia. More than half of overall GDP growth is currently coming from exports, and resource exports in particular. Unfortunately, mining production is very capital intensive and so doesn't require much additional labour to support it, increasing the risks for higher unemployment, particularly for those States who are heavily reliant on resource-related activity. With this in mind, we believe the Reserve Bank of Australia will look to lower interest rates in 2015 to provide further stimulus to the Australian economy.

The information contained in this Report is subject to change without notice. TCorp does not guarantee the accuracy, timeliness, reliability or completeness of the information and will not be liable for any errors, omissions or actions taken in reliance on the information in this Report. You should avoid placing any undue reliance on the forward looking information. Any forward looking information is predictive in nature and may be affected by inaccurate assumptions or by known or unknown risks or uncertainties. The expected results may differ from the results ultimately achieved. Past performance is not a guarantee or indication of future results. This Report is for the recipient only and should not be circulated without TCorp's consent.