TCorp Local Government Services

Economic Commentary – January 2015

New South Wales Treasury Corporation

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The Month in Review

Economic and Market Trends

The key developments in January were the ongoing decline in oil prices and the European Central Bank's (ECB) announcement that it would begin purchasing sovereign bonds.

Confidence that the ECB would commence quantitative easing (QE) had risen steadily through December and early January, but the ECB still managed to exceed expectations with its announcement. The key reasons for this were that the size of the ECB's monthly purchases – at 60 billion Euro per month – was higher than expected while the ECB also committed itself to continuing its purchases until the path of inflation was consistent with the ECB's inflation target of close to 2%. This means that European QE is potentially open ended, similar to QE3 in the US.

Oil prices continued to fall in January. Prices declined from US$68 per barrel in November to as low as US$44 per barrel in January. Analysts have debated whether this has been driven by reduced global demand or rising global supply (from the US). We think that both factors have contributed but that the benefits to consumers of lower petrol prices will outweigh the costs to oil producers.

Meanwhile, the US economy remains strong with consumer confidence rising to its highest level since 2005 in January, and employment growth over 2014 the strongest since 1999. In China, the economy expanded by 7.3% over 2014 which, although close to the Government's target of 7.5%, was the weakest growth since 1999. There are some signs that activity has stabilised, however, with December data in China generally exceeding expectations.

In Australia the domestic data remain okay. Retail sales appear to have been reasonable over the Christmas period and building approvals remain healthy. There has also been a notable improvement in the inflation outlook, due to lower oil prices as well as softer wages growth. This was confirmed with the Q4 CPI release, which showed headline inflation rising by 0.2% q/q (1.7% y/y). There was, however, an element of surprise for markets from the CPI report. The underlying measure of inflation came in at 0.7% q/q (2.3% y/y), versus market expectations of 0.5% q/q.

It is no secret that lower oil prices have weighed on headline inflation. But unless oil prices keep on falling, the impact on headline inflation will be temporary. This is why central banks rely more heavily on the underlying measures. And it is for this reason that most economists initially thought the inflation data might encourage the RBA to keep interest rates unchanged in February. That said, inflation is likely to slow over 2015 and this leaves the door ajar for further rate cuts.

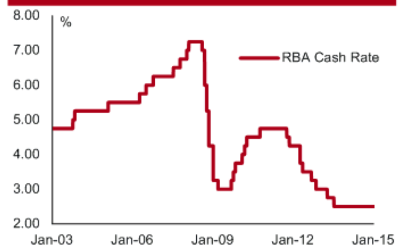
Volatility in foreign exchange markets has jumped in recent months, with expectations of ECB QE the main driver. The Euro fell to 113.55 in late January, down 6% in the month and 17% below its level in mid-2014. The A$ also dipped to US 77 cents in January, reaching its lowest level since 2009, but was up against the Euro.

Equity markets have been driven by both the decline in oil prices as well as hopes for European QE. Energy stocks were understandably hit hard by the decline in oil prices. Most European bourses rose by more than 7% over January. US stocks were down by more than 3%. The Australian equity market initially followed its US counterpart but moved back into positive territory (+3%) late in the month.

Financial/Economic Data

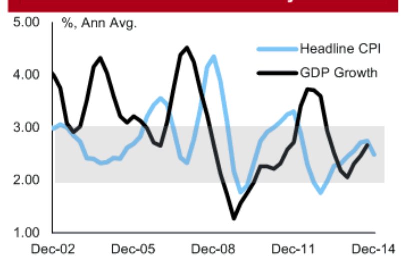
January 2015

RBA Cash Rate

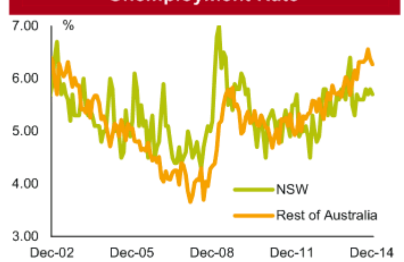


Australia Dollar

Australian Economy



Unemployment Rate



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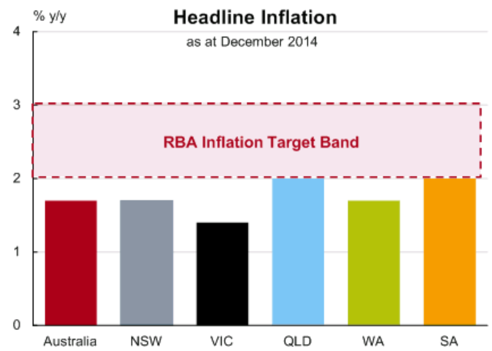
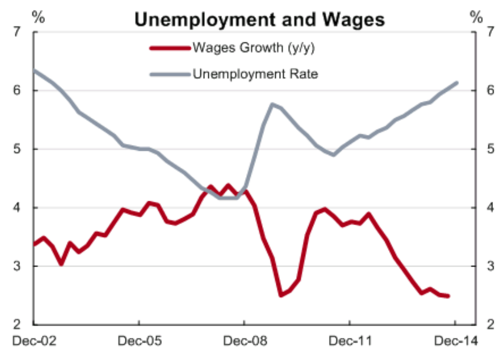
The State of NSW

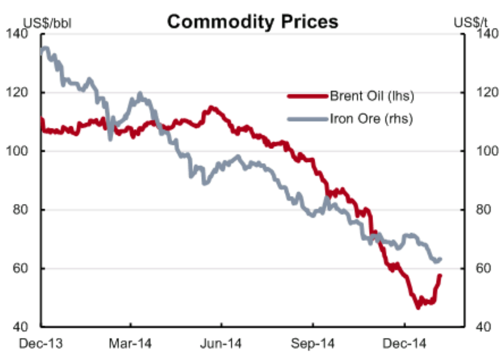
Inflationary pressures recede

Inflationary outcomes are important. If inflation is high and volatile, businesses and households find it much more difficult to make decisions. If inflation is rising faster than wages, people lose their purchasing power. And if inflation is accelerating beyond what policymakers deem acceptable, they are more likely to raise interest rates and slow economic activity. These days, however, it seems too little inflation is the key concern for global policymakers. There are, in fact, some economies - such as the euro area - which are experiencing falling consumer prices. While not as extreme, the Australian economy has also found itself in a benign inflationary environment. The Reserve Bank of Australia (RBA) targets an inflation rate between 2 and 3%. Currently, inflation in most of the States are below this target band.





One of the key drivers behind the disinflationary environment has been the gradual rise in unemployment. While unemployment in NSW is below the rest of Australia (5.7% vs 6.3%), national unemployment has been trending higher for almost 5 years. Wages growth has a very close relationship with unemployment. Wages growth is currently tracking at its slowest pace in almost 20 years. The rapid decline in oil prices has been another prominent force driving weaker inflation. With petrol prices in Australia falling around 35% since the middle of 2014, it is understandable why the measure of headline inflation has fallen to 1.72% y/y. In fact, the peak impact of lower petrol prices should occur in 1Q15, with the RBA expecting inflation to slow to 1.25% y/y. However, the lower oil price actually has positive implications for growth. On average, Australian households spend 3% of their disposable incomes on automotive fuel. The savings at the pump should result in a boost to household disposable incomes. This could then lead to a pick-up in discretionary spending. The NSW economy will be an obvious beneficiary from this given its heavy reliance on the services sector.



Market Movements and Economic Data

Financial Data	30 Jan	Monthly change	
Cash Rate	2.50%	0.00	–
Corporate Bond Yield*	3.35%	-0.22	▼
Term Deposit**	2.80%	-0.05	▼
ASX200	5588	3.3%	▲
S&P500	1995	-3.1%	▼
AUD/USD	0.776	-0.041	▼
Economic Data***	**30 Jan**	**Quarterly change**	
Headline CPI	1.70%	-0.60%	▼
Trimmed Mean CPI	2.20%	-0.20%	▼
GDP Growth	2.70%	0.00%	–
House Prices	9.20%	-1.10%	▼
Unemployment Rate	6.10%	-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

A lower inflationary pulse will also provide the RBA with the scope to ease monetary policy and further stimulate residential construction and household expenditure. Again, the NSW economy is highly leveraged to these sectors for growth. Normally, low inflation is a signal of weaker growth. But while the Australian economy continues to rebalance away from the resources sector, lower petrol prices and lower interest rates will certainly do their part in supporting growth in the year ahead.