TCorp Local Government Services

Economic Commentary – February 2015

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

Financial markets remain divided as to when the US Federal Reserve will begin raising interest rates. A very strong employment report for January bolstered support for a rate hike as soon as June. Non-farm payrolls rose by 257,000 in January, but the main surprise was that December jobs growth was revised up to 329,000 and November jobs up to 423,000. If this pace of jobs growth is sustained, the US unemployment should fall below 5% by late 2015.

But while the current strength of the US economy is undeniable, some policymakers are worried that it might not persist. The minutes of the January FOMC meeting and Fed Chair Janet Yellen's testimony to US Congress suggested that there was still a reluctance amongst some committee members to even contemplate raising rates soon. In particular, some members "expressed the concern that financial markets might overreact" if the Fed removed the 'patient' from its communications. At the same time, the impact of a stronger US$ and weak global activity were also cited as reasons for caution. But while markets did push back the timing of the initial rate hike a little, they are still prepared for lift-off in Q3 2015.

In Europe, the newly elected Greek Government agreed to a 4-month extension of its bailout, which delays a possible forced exit from the Eurozone. But while the issue has not been permanently resolved, markets reacted positively to this development. Elsewhere in Europe, the flow of data has been slightly stronger, as the benefits of lower oil prices and a weaker currency have boosted confidence.

In China, the People's Bank of China (PBoC) eased monetary policy. It reduced its Reserve Ratio Requirement for the first time since 2012 and cut its key policy rate by 25bps to 5.35%. While property prices are still declining in China, the pace of those declines is moderating and analysts are expecting prices to stabilise by mid-2015. Obviously, further policy easing would facilitate this.

The Reserve Bank of Australia (RBA) cut its cash rate from 2.50% to 2.25% at its February policy meeting. The RBA is widely expected to cut rates further to at least 2.00%, although opinion is divided as to when this will occur. The RBA has not expressed any urgency to cut rates soon, which suggests that the Bank could wait until its next forecasting round in April before nudging rates lower at its May Board meeting. That said, a spike in the unemployment rate to 6.4% in January, and the bleak private business investment outlook for 2015/16 may have strengthened the argument for another rate cut soon. We also think that the performance of the A$ will affect the RBA's thinking on this issue.

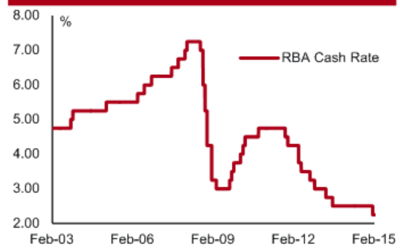
In financial markets, US 10-year bond yields have risen sharply over February, reversing most of the steep decline experienced over January. US yields rose from 1.64% at the start of February to a peak of 2.11% in the middle of the month. A stabilisation of oil prices, strong employment data and encouraging signals out of Europe all contributed to the movement.

Australian yields followed a similar path, but were slightly less volatile. Australian 10-year yields reached a closing low of 2.29% in early February, before returning to 2.57% later in the month. At the short end of the curve, Australian markets have fully priced in at least one further RBA rate cut by mid-year, with a chance that rates could fall to 1.75%.

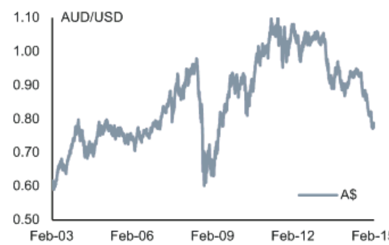
Financial/Economic Data

February 2015

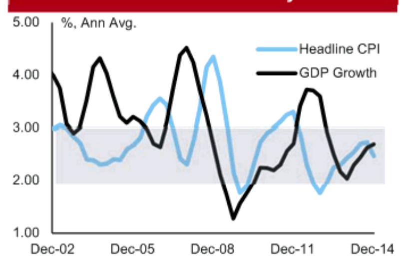
RBA Cash Rate



Australia Dollar



Australian Economy

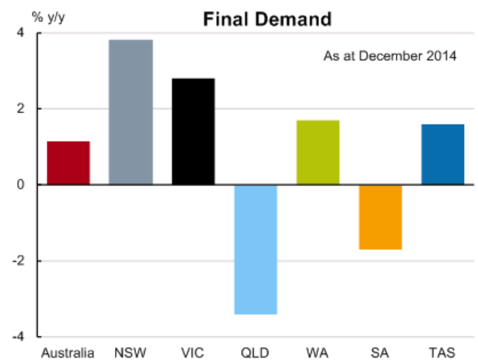


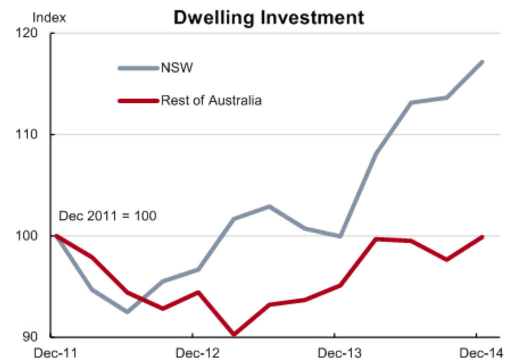
Unemployment Rate

The State of NSW

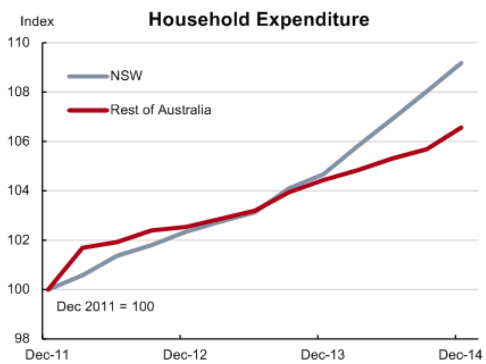
NSW is still in front

Within the developed world, there are some economies that are still struggling to grow. Europe, for example, recently reported that its economy grew by less than 1% in 2014. This, of course, is a better outcome than an economy that is shrinking. In contrast, the Australian economy grew by 2½% over the same period. This makes it confusing to understand what all the fuss is about with relation to the risks facing the Australian economy. But if we look at the data more closely, growth over the past 6 months has decelerated to an annualised pace of 1¾%. Meanwhile, the outlook is still haunted by the impending decline in mining-related activity and the relatively high A$.





The New South Wales economy remains at the forefront of Australian growth. The NSW economy (outside of international trade) expanded by 3.8% in 2014, taking the lead against the other Australian States and Territories. Encouragingly, household expenditure and residential investment have supported growth in the NSW economy. The protracted period of low interest rates have been crucial for these sectors, while the fall in petrol prices in the last part of 2014 would have given households the confidence to spend more on discretionary goods and services. In fact, there were notable gains in spending in the alcoholic beverages and recreational/culture components. Meanwhile, dwelling construction, particularly in the NSW economy, has continued to play its part in driving overall growth. After all, the RBA has lowered its cash rate to an all-time low of 2¼%.



Market Movements and Economic Data

Financial Data	27 Feb	Monthly change	
Cash Rate	2.25%	-0.25	▼
Corporate Bond Yield*	3.20%	-0.15	▼
Term Deposit**	2.40%	-0.35	▼
ASX200	5929	6.1%	▲
S&P500	2105	5.5%	▲
AUD/USD	0.781	0.005	▲
Economic Data* **	**27 Feb**	**Quarterly change**	
Headline CPI	1.70%	-0.60%	▼
Trimmed Mean CPI	2.20%	-0.20%	▼
GDP Growth	2.50%	-0.20%	▼
House Prices	7.00%	-2.40%	▼
Unemployment Rate	6.40%	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

The NSW economy is still well placed to benefit from the accommodative setting of monetary policy. But as we have advised in the past, there are still issues tainting the outlook on a national level. Australian businesses outside of the resources sector remain reluctant to invest, the currency remains high relative to fundamentals, the terms of trade (linked with national income) fell another 11% in 2014, and real wage growth has been stagnant. Fortunately, the RBA has further scope to cut its key policy rate, whereas other central banks in the developed world have reached the 'zero bound'.