TCorp Local Government Services

Economic Commentary – July 2015

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The Month in Review

Economic and Market Trends

Financial market headlines in July were dominated by the ongoing Greek Crisis and the sharp fall in the Chinese stock market. Despite that, US Federal Reserve Chair Janet Yellen indicated that the US central bank remains on track to raise interest rates before year end. This reflects the continuation of mostly solid economic data as well as the expectation that neither Greece's troubles nor China's travails will derail the US recovery.

The US labour market continues to be a bright spot, with another 223,000 jobs created in June. Meanwhile, jobless claims remain at very low levels, suggesting that this strength will persist over the remainder of the year. At the same time, building permits rose by 7.4% in May and are now at their highest level since 2007. And the ISM index of manufacturing activity improved to 53.5 in June (note that a level of 50 denotes steady activity) which suggests that manufacturing has stabilised despite the impact of a stronger USD.

Greece's outlook deteriorated when the Syriza-led government failed to come to an agreement with its creditors on what reforms it should pursue in order to continue receiving funding. Instead, the Greek government called a referendum on whether they should accept the creditor's demands. But despite a strong "no" vote, the Greek government then back-flipped and agreed to a more austere reform package than they had previously rejected.

While this episode could prove disastrous for the Greek economy, most analysts think that the implications for European growth - or financial markets generally - will be minimal. This is because of the small size of the Greek economy and the way in which European policymakers have quarantined the links between Greece's debt and financial markets over the last 3 years.

Elsewhere, the Chinese economy showed further signs of stabilising, with retail trade, industrial production and fixed-asset investment all coming in stronger than expected in June. GDP growth in China was 7.0% over the year to June – in line with the target set by policymakers. That said, financial markets were more focussed on the sharp fall in China's stock market, and the government's aggressive actions to try and stabilise it.

Australian firms became substantially more confident over recent months. Business confidence has risen from an index reading of 3.5 in April to 9.8 in June – the highest level since 2013 (note that a reading of zero denotes neutral sentiment). This recent pick-up follows the delivery of the May Budget, which included tax relief for small businesses.

But while firms have become more upbeat, consumers have become more pessimistic. Indeed, consumer sentiment has fallen by 10% over the last two months, and is around 8% lower than its long-term average. Not only is it rare for consumer and business sentiment to diverge, but the size of the current disparity is also highly unusual.

There have been several explanations that attempt to explain this divergence. Some analysts think that households have been more affected by the dire headlines surrounding Greece. Other analysts argue that weak wages growth is undermining consumer morale. In our view, however, the weaker A$ may be playing a key role. This is because it makes firms more competitive and so is consistent with stronger business confidence, whereas consumers may focus on the way a lower A$ will increase the cost of imports and overseas travel.

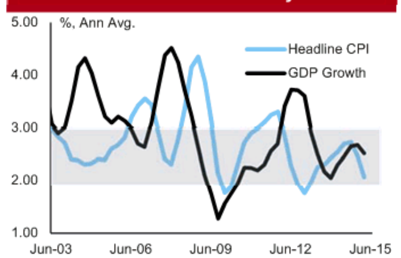
Financial/Economic Data

July 2015

RBA Cash Rate

Australia Dollar

Australian Economy

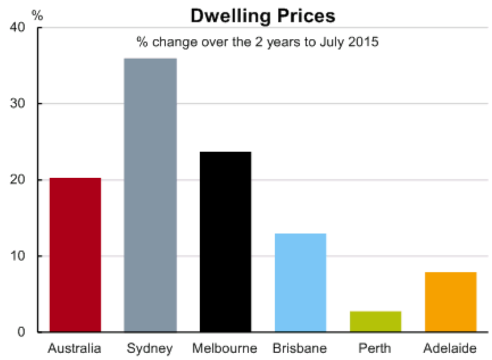


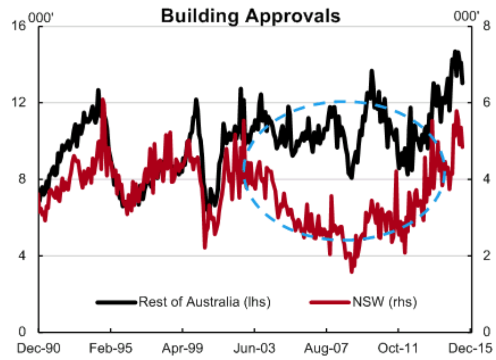
Unemployment Rate

The State of NSW

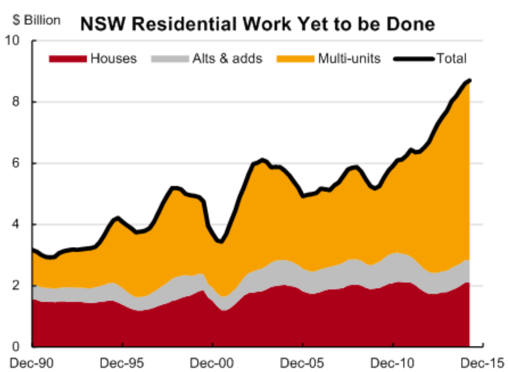
Housing in NSW

It is not often we see house prices in Sydney rise 36% (RP Data) in a period of just two years. Record low interest rates obviously stimulate the property market - especially in those cities which are inherently more sensitive to movements in interest rates. Indeed, the varying economic health of the major Australian cities has resulted in a divergence in house price performance. Over the past year, Sydney house prices have shot out ahead of the pack, rising a mammoth 18.4% y/y in July. On the other side of the spectrum, house prices in Perth have already started to fall (-0.3% y/y). That said, house prices in Sydney lagged during the mining boom, and so there is some degree of catch up. It is also worth noting that much of the house price gains in Sydney have been concentrated in the metropolitan areas.





But the outperformance in Sydney house prices has not only been attributable to the stronger economic backdrop. The other part of the story has been the lacklustre expansion of housing supply in NSW – particularly given stronger population growth. In the 1990's, the increase in the NSW housing supply was proportional to the increase in the rest of Australia. In the 2000's, housing construction in NSW began to lag the rest of Australia, as more households shifted to the States where housing was more affordable. The top right chart highlights the extent to which building activity in NSW lagged the other States. In the late 2000's, the divergence was further exacerbated by the burgeoning performance of the mining States – WA and Queensland – which saw rapid jobs growth and a commensurate increase in migration flows.



Market Movements and Economic Data

Financial Data	31 Jul	Monthly change	
Cash Rate	2.00%	0.00	–
Corporate Bond Yield*	3.67%	-0.07	▼
Term Deposit**	2.20%	0.00	–
ASX200	5699	4.4%	▲
S&P500	2104	2.0%	▲
AUD/USD	0.731	-0.040	▼
Economic Data* **	**31 Jul**	**Quarterly change**	
Headline CPI	1.5%	0.2%	▲
Trimmed Mean CPI	2.2%	-0.1%	▼
GDP Growth	2.3%	-0.1%	▼
House Prices	7.5%	0.0%	–
Unemployment Rate	6.0%	-0.1%	▼

*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

Fortunately, the notable acceleration in building approvals in NSW over the past four years has resulted in a substantial pipeline of residential construction work. As the bottom left chart shows, the quantity of work yet-to-be-done is more than double what it was at the end of the 1990's, and 50% higher than what it was five years ago. Meanwhile, there has already been a considerable surge in housing completions in NSW. Over the past 12 months, almost 45,000 new dwellings were built in NSW alone. That is 30% higher than the number of dwellings built in 2013, and 36% higher than the 10-year annual average. Importantly, the increase in housing supply in NSW over the next 24 months should dial down house price growth in Sydney.