TCorp Local Government Services

Economic Commentary – August 2015

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The Month in Review

Economic and Market Trends

China remained in the headlines in August given disappointing economic data and the decision of China's policymakers to depreciate its currency. While the currency move was modest – less than 5% – the unexpected shift in policy did alarm investors who worried whether it might signal that growth had fallen more sharply than expected. Meanwhile, the annual growth in industrial production slowed substantially to 6% in July from 6.8% previously, while retail sales decelerated to 11.2% from 11.4%. The People's Bank of China (PBoC) reassured markets that it did not plan to weaken the Yuan substantially further in an attempt to soothe the nerves of investors.

But the shock to global financial markets came towards the end of August when the Shanghai Composite fell 22% in a single week. Investors became uncertain in the PBoC's ability to stabilise growth in the region and the subsequent policy responses from other central banks in the emerging world. Ironically, it was only a few months ago when China's policymakers had tried to dampen the strength in its share market by restricting the leverage retail equity investors had access to. In any case, most analysts believe it was the rapid decline in the Chinese equity market that initiated the extreme risk-off behaviour in global financial markets more broadly.

In the US, most indicators of the economy continued to point to a solid steady expansion. This is evident in the housing market, employment, industrial production and retail spending. To be sure, wages growth remains soft. But underlying inflation is beginning to edge back up towards the US Federal Reserve's (Fed) 2% inflation goal partly due to a tighter rental market. While the vast majority of economists expect the Fed to hike rates in September, markets are now pricing in less than a 50% chance of that occurring. That said, numerous Fed officials still believe that it is possible for the key policy rate to rise in September.

The European economy grew by 0.3% in the June quarter and by 1.2% over the past year. While still modest, this was the strongest pace of growth in 2 years, and suggests that the European Central Bank's aggressive stimulus – and the lower EUR – have stabilised the economy. In contrast, the Japanese economy shrank in the June quarter, although policymakers are confident that activity will spring back strongly in the September quarter.

In Australia, the wage cost index suggested that overall wages have grown by 2.3% over the past year – the slowest pace since these data were first collected in 1997. Similarly, enterprise bargaining agreements – which cover around 40% of the workplace – pointed to wage gains of 3% annualised growth. This is slowest pace recorded since the early 1990s recession.

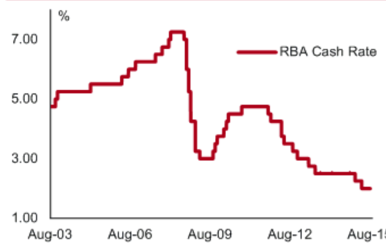
Subdued wages growth may be one factor contributing to weak consumer sentiment. Sentiment has failed to improve noticeably despite record low interest rates and lower petrol prices. It might also explain why business confidence has been improving over 2015, as it has enabled firms to maintain margins despite weak demand.

But perhaps the strongest implication of the ongoing moderation of wages growth in Australia is that inflation will be subdued for an extended period. This is because the average duration of an enterprise bargaining agreement is 2½ years. In other words, the low wage outcomes being agreed to today will continue to keep wages growth subdued during 2016 and 2017.

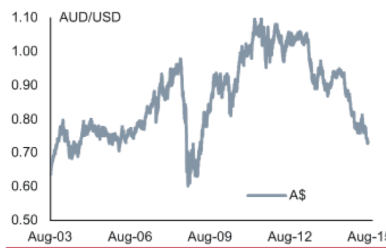
Financial/Economic Data

August 2015

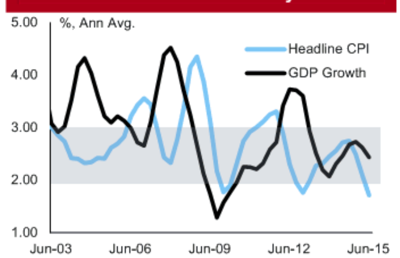
RBA Cash Rate



Australia Dollar



Australian Economy

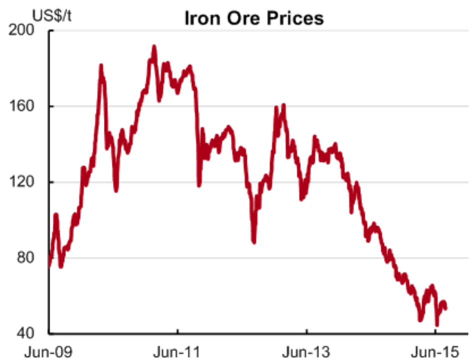


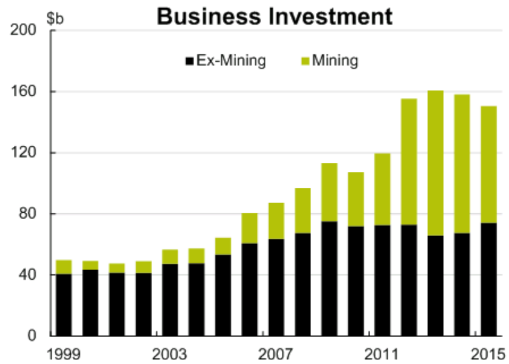
Unemployment Rate

The State of NSW

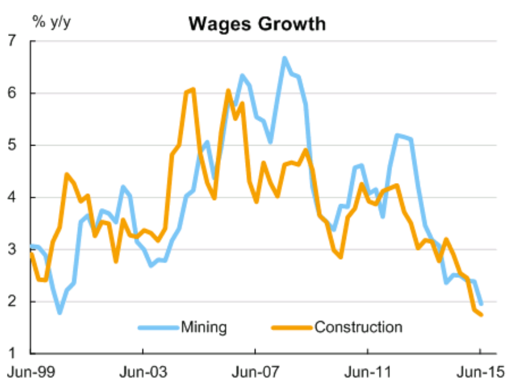
Labour for construction

The commodity boom that started in 2009 was incredibly beneficial for Australia. Both domestic and foreign mining companies unleashed a frenzy of capital expenditure in response to the rapid increase in commodity prices as the growth in China's demand outpaced that of supply. At the peak of the commodity boom, mining investment in Australia totalled just under $100 billion in 2012-13. To put that into perspective, the value of mining investment in 2012-13 was double that of total business investment only ten years earlier. As commodity prices hit new highs, mining companies became fixated on completing their mining projects as quickly as possible. This saw multiple projects occurring at the same time, resulting in an almost untenable rise in demand for mining-related labour, capital and services. Ultimately, the costs of completing these mining projects increased rapidly.





But now as the mining investment boom unwinds, the reverse has started to occur. Specifically, the contraction in mining-related employment has freed up labour for other sectors. The subsequent increase in labour market slack has slowed wages growth in those industries. And coupled with the general malaise in labour costs overall, this has slowed wages growth in construction and mining sectors to 15-year lows (chart bottom left).



Market Movements and Economic Data

Financial Data	31 Aug	Monthly change
Cash Rate	2.00%	0.00 –
Corporate Bond Yield*	3.63%	-0.04 ▼
Term Deposit**	2.20%	0.00 –
ASX200	5207	-8.6% ▼
S&P500	1972	-6.3% ▼
AUD/USD	0.711	-0.020 ▼
Economic Data* **	**31 Aug**	**Quarterly change**
Headline CPI	1.5%	0.2% ▲
Trimmed Mean CPI	2.2%	-0.1% ▼
GDP Growth	2.0%	-0.5% ▼
House Prices	7.5%	0.0% –
Unemployment Rate	6.3%	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

Many analysts agree that slower wages growth will weigh on aggregate household incomes. But at the same time, the Reserve Bank of Australia believes that weaker labour cost growth has resulted in stronger than expected employment growth over the past year. Meanwhile, the decline in employment at the mines should free-up labour for the construction industry more broadly. And with the pipeline of building activity at an all-time high, this will allow the proliferation of residential construction without the typical acceleration in costs.