TCorp Local Government Services

Economic Commentary – October 2015

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The Month in Review

Economic and Market Trends

Global growth momentum appears to have stabilised after a modest deterioration in recent months. In China, the economy grew by 6.9% y/y to September, which was marginally stronger than analysts expected and only just lower than the government's growth target.

In the US, consumer sentiment continues to move in line with the equity market, improving in October, after declining in August and September. But while the dip in confidence was reflected in weaker retail spending in Q3, the US housing market has strengthened further. Housing starts rose by 6.5% in September, which was much stronger than market expectations, while an index of homebuilder sentiment rose to its highest level since 2005.

The strength of housing is important as it will give the US Federal Reserve (Fed) confidence that the US economic recovery remains on track despite some softer employment and manufacturing outcomes. While most members of the Fed's policy setting committee still favour raising interest rates later this year, the opponents of tightening have become more vocal over the last month.

Most indicators of the Australian economy continue to suggest that growth is at a slightly sub-trend pace. What has changed over the last month, however, is the perception of the housing market. Banks have progressively tightened lending policies over 2015 in response to pressure from the banking regulator. This appears to have affected sentiment, with auction clearance rates in Sydney, for example, falling from almost 90% in early 2015, to 65% in October.

To be clear, a 65% clearance rate for Sydney is still strong. And housing finance data up until August only point to a very modest slowing of growth, while house price data continue to point to strong demand in Sydney and Melbourne, alongside subdued activity in the rest of Australia. That said, it does appear that momentum has waned. And the decision by the four major Australian banks to raise mortgage rates by 15-20bps resulted in much speculation as to whether the Reserve Bank of Australia (RBA) will cut rates in 2015.

While the weaker A$ is supporting growth, it remains the case that the housing sector is currently the main driver of growth in the economy. If that support disappeared, then it is highly likely that overall GDP growth would fall sharply in 2016.

The CPI print for the September quarter was also weaker than expected. Headline inflation increased by 0.5% q/q to 1.5% y/y – the fourth consecutive quarter where headline inflation has been below the RBA's target of 2-3%. Underlying inflation – which is the RBA's preferred measure of inflation - rose by a more modest 0.3% q/q and 2.1% y/y. The deceleration in energy, clothing and communications price growth weighed on the overall CPI in Q3.

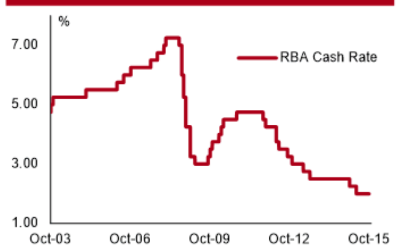
While the RBA seems relaxed about how the Australian economy is evolving, it would not welcome a tightening of overall financial conditions. For that reason, it seems likely that given the actions of the major banks, coupled with slowing inflation, the RBA would seek to offset that by reducing its cash rate in the coming months.

After the sell-off in equity markets in September, risk assets made somewhat of a comeback in October. The S&P500 was up over 8% in the month, with the ASX200 rising a noteworthy 4%. Global bond yields moved slightly higher after the Fed's insistence that rates could rise this year. Australian bond yields, however, were slightly lower thanks to the prospect of an easing of policy by the RBA.

Financial/Economic Data

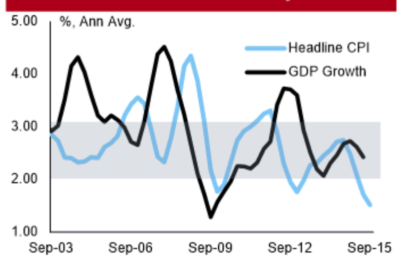
October 2015

RBA Cash Rate



Australia Dollar

Australian Economy

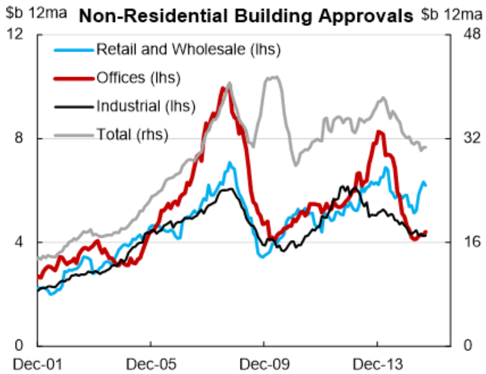


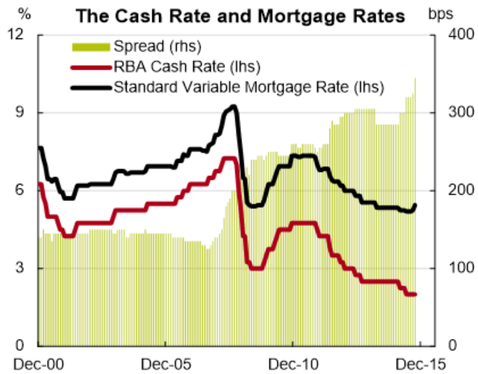
Unemployment Rate

The State of NSW

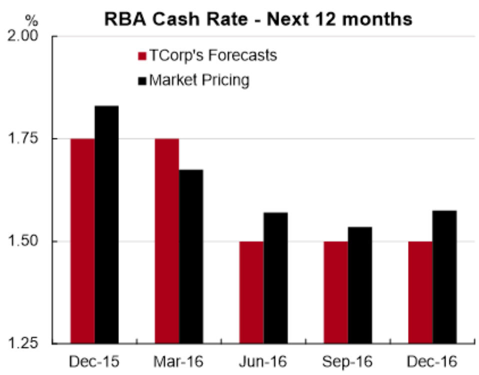
TCorp's revised RBA Cash Rate forecasts and what it means for NSW

The Australian economy is undergoing a major transition. As mining investment winds down, the non-mining sectors of the economy have accelerated in response to lower interest rates and a weaker currency – especially in NSW. But while the non-mining economy is strengthening, it is not doing so at a strong enough pace. At the same time, the outlook for global growth has deteriorated. International trade has slowed. Inflationary outcomes have continued to underwhelm, and policymakers globally have imparted further monetary stimulus. As a result, the outlook for Australia faces several headwinds, although we still expect the domestic economy to expand at a quicker pace than most of the developed world.





Another key development in October, was the decision of the four major Australian banks to raise mortgage rates for owner-occupiers and investors. Because the rise was independent of any changes to the RBA's cash rate, this has resulted in an unwanted tightening of financial conditions. In addition, this has occurred at a time when there are some preliminary signs of a slowdown in the housing market. The RBA has been concerned with the pace of house price growth in Sydney and Melbourne, and the growth in credit to investors. So we believe the RBA would be happy with some moderation in this sector. That said, housing construction is the major driver of growth in the economy at present and if building activity turned down, then overall growth would be unacceptably weak in 2016.



Market Movements and Economic Data

Financial Data	30 Oct	Monthly change
Cash Rate	2.00%	0.00 –
Corporate Bond	3.80%	0.13 ▲
Term Deposit**	2.20%	0.00 –
ASX200	5239	4.3% ▲
S&P500	2079	8.3% ▲
AUD/USD	0.714	0.012 ▲
Economic Data* **	**30 Oct**	**Quarterly change**
Headline CPI	1.5%	0.2% ▲
Trimmed Mean CPI	2.1%	-0.2% ▼
GDP Growth	2.0%	-0.5% ▼
House Prices	10.5%	3.0% ▲
Unemployment	6.2%	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

While the increase in mortgage rates, so far, has been modest, if the RBA does not respond to the banks' move, it threatens to undermine confidence in the housing sector. This could affect consumer spending as well as building activity, which have been important drivers of overall growth in NSW over the past two years. For that reason, we expect the RBA will cut rates by 25bps to 1.75%, most likely at its December Board meeting, in order to restore the level of financial conditions to where they were in mid-2015. The prospect of further repricing action by the banks in 2016, coupled with weak non-mining investment, increases the risk that the RBA will be forced to cut the cash rate by another 25bps to 1.50% by mid-2016.