TCorp Local Government Services

Economic Commentary – November 2015

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

In November global growth stabilised. In the US, the data continue to show that the economic recovery remains on track. The strong job creation in October (+271,000) allayed the US Federal Reserve's (Fed) concerns that employment growth was slowing. Unemployment fell by 0.1% to a seven-year low of 5.0%.

Manufacturing activity in the US slowed further in October. The official Purchasing Managers Index (PMI) fell 0.1 to 50.1. A PMI above 50 suggests that the sector is expanding. The slowing in manufacturing has gone hand-in-hand with the appreciation of the USD. The USD trade weighted index has risen 25% since 2014. At the same time, the acceleration in the US services sector has provided an offset to the slowing in manufacturing. The Services PMI rose to 59.1 in October – the second highest level in ten years.

The Fed's October policy meeting minutes revealed that the current pace of economic activity in the US would be consistent with a decision to raise interest rates in December. Fed members also agreed that the pace of the subsequent rate hikes should be gradual.

In Europe, the outlook for growth improved. As indicated by the Composite PMI, manufacturing and services activity accelerated further in November to a four-year high of 54.4. The level of the PMI is consistent with GDP growth at around 2% year-on-year (y/y), an impressive result given the slowdown in the emerging market economies (EME), the ongoing refugee crisis and the recent terrorist attacks. The improvement has been evenly spread across Europe.

Despite the stronger data, the European Central Bank (ECB) is still concerned with the medium-term headwinds for the economy, such as the deteriorating outlook for the EME and softer domestic inflation. Headline CPI in Europe was 0.1% y/y in October, while core CPI was 1.1% y/y, well short of the ECB's target of just under 2%. In a speech at a banking conference in Germany, ECB President Mario Draghi reassured markets that the central bank will *"do what they must to raise inflation as quickly as possible"*.

The Australian economy continues to track at a slightly sub-trend pace. Housing construction appears to be strong, although sentiment around the property market has eased further. Auction clearance rates continued to decline, falling below 60% in Sydney throughout November. Indices tracking daily house price movements suggest that house prices are falling in most jurisdictions.

Private business investment took a turn for the worse in falling 9.2% in Q3. Both the mining and non-mining sectors registered stark declines in capital spending. This puts into question the ability of the non-mining sector to offset weakness in the resources sector. Australian businesses are still planning to spend $120 billion in FY16.

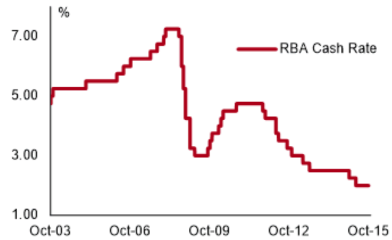
The Reserve Bank of Australia (RBA) left the cash rate unchanged at its November Board meeting. Markets were toying with the idea that the RBA would lower rates in response to the tightening of mortgage rates by the major banks, and the surprisingly weak Q3 CPI print.

Bond yields in the US moved higher following the Fed's October policy meeting where members confirmed their commitment to raise the central bank's key policy rate. The Australian 10-year bond yield followed US bond yields, rising from 2.61% to 2.95% in early November, only to fall 9bps to 2.86%. As for short-term interest rates, the futures market is pricing a 60% chance that the RBA will cut its cash rate by 25bps by June 2016.

Financial/Economic Data

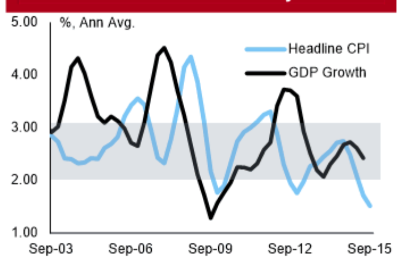
November 2015

RBA Cash Rate



Australia Dollar

Australian Economy

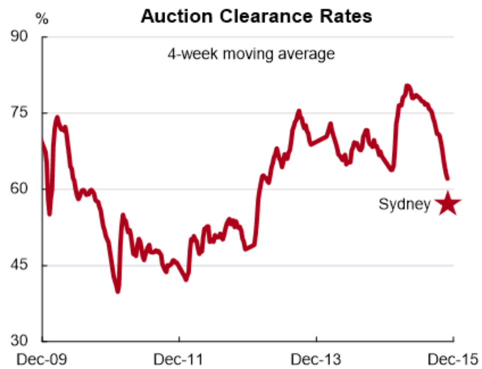


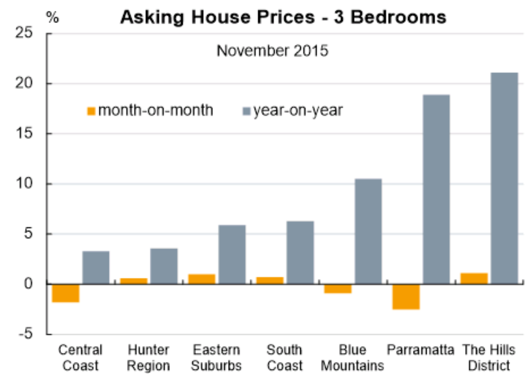
Unemployment Rate

The State of NSW

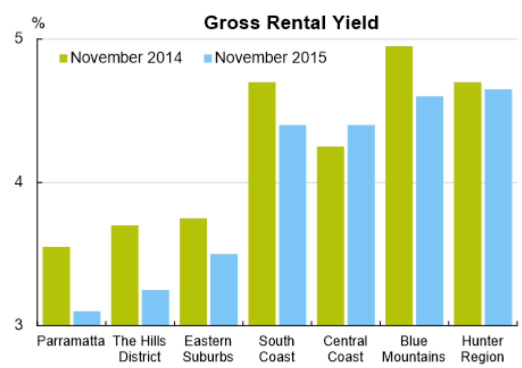
The Property Market

We return to a hot topic – the NSW property market. There seems to have been a shift in sentiment around the property market in recent times, particularly in Sydney. NSW still remains the outperformer in the nation in terms of house price growth, but attitudes are changing. We think the reason behind the change in sentiment is three-fold. First, the banking regulator has been successful in slowing investor lending by increasing the amount of capital banks will need to hold when lending to property investors. We have already seen investor loans slow to 9.7% y/y in October, below the 10% y/y *guideline* the banking regulator has set. Second, mortgage rates for both investors and owner occupiers have increased. Third, more timely measures of house prices fell in November, with house prices in Sydney down 1.5% m/m in November.





Auction clearance rates in Australia have fallen from their 2015 highs (chart top-left). Successful auctions in Sydney have been especially weak, falling below 60% throughout November. Putting it all together, it seems that the momentum in the housing market has been one way, but many economists are not expecting house prices to continue falling. Based on historical data, auction clearance rates would have to fall below 50% for house prices to fall in annual terms. The current level of successful auctions in Sydney is still consistent with low, single-digit house price growth. While overall house price growth in NSW has been strong, the property market within NSW has been mixed.



Market Movements and Economic Data

Financial Data	30 Nov	Monthly change	
Cash Rate	2.00%	0.00	–
Corporate Bond Yield*	3.99%	0.19	▲
Term Deposit**	2.20%	0.00	–
ASX200	5167	-1.4%	▼
S&P500	2080	0.1%	▲
AUD/USD	0.723	1.2%	▲
Economic Data* **	**30 Nov**	**Quarterly change**	
Headline CPI	1.5%	0.0%	–
Trimmed Mean CPI	2.1%	-0.1%	▼
GDP Growth	2.5%	0.4%	▲
House Prices	10.5%	3.0%	▲
Unemployment Rate	5.9%	-0.4%	▼

*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

House prices in the fastest growing suburbs, such as Parramatta and the Hills District, have outperformed (chart top-right). At the same time, the outperforming suburbs over the year have seen a more pronounced slowdown in house prices in recent weeks. In contrast, the regions where house prices have accelerated the most, rents have not followed (chart bottom-left). This mechanical relationship is a key reason for lower rental yields more broadly. But in an environment where interest rates are at exceptionally low levels – and will likely remain so – investors may still feel compelled to dabble in the property market despite lower gross rental yields and higher borrowing costs.