TCorp Local Government Services

Economic Commentary – July 2016

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The Month in Review

Economic and Market Trends

In the US the key news was the strong rebound in employment in June after the disappointing outcome in May. Employment increased by 287,000 in June, which was much stronger than the 180,000 new jobs expected. Combined with further strong growth in retail spending and a recovery in industrial production, this suggests that the US economy is entering the second half of 2016 with considerable momentum. That said, the first estimate of Q2 GDP growth (1.2% annualised) fell short of market expectations (2.5% annualised).

Prior to the GDP data, the stronger stream of data also resulted in a slightly more upbeat assessment of the US economy at the Federal Reserve's (Fed) policy meeting in July. The Fed's post-meeting statement highlighted that the labour market had strengthened, and that the near-term risks to economic growth had diminished. While it did not hike rates at the meeting, the Fed's more positive tone puts it back on track for a potential tightening in 2016.

Most of the recent Chinese economic data has underwhelmed, but activity picked up in the month of June with both industrial production and retail spending exceeding market expectations. Overall GDP growth came in at 6.7% y/y in Q2, in line with the growth in Q1. Private business investment is the one sector that remains soft.

The Bank of Japan (BoJ) also attracted a lot of market attention in July. There was intense speculation among market participants that the BoJ, along with the government, would embark on an aggressive and coordinated policy stimulus program to support growth and inflation. But while the BoJ doubled its monthly purchases of some equity products, it did not boost its bond purchases or cut interest rates as most market participants had hoped.

In Australia, the key data release was the CPI for the June quarter. Consumer prices rose by 0.4% in Q2 and by just 1% over the past year. Underlying inflation – which removes some of the volatile price changes – also remained very low, at just 1.5% y/y. The weakness in inflation continues to be broad based. The intensification of competition in the retail sector (especially in food retailing) has slowed retail price growth. Rental price growth has also been subdued, reflecting the increase in housing supply. Meanwhile, the ongoing deceleration in wages growth has weighed on consumer prices more broadly.

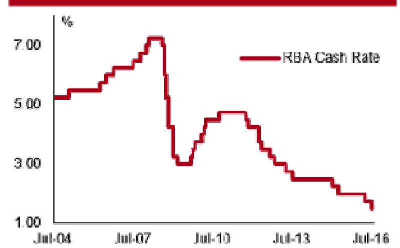
Employment growth has also been lacklustre so far in 2016. The unemployment rate ticked up to 5.8% in June. Business surveys, however, suggest that hiring intentions remained resilient up until June, and business confidence remains at reasonable levels. The Reserve Bank of Australia (RBA) kept policy unchanged in July, as expected. That said, most analysts anticipated that the RBA would cut rates in August following the weak Q2 inflation result.

It was a positive month for financial markets as both equity and bond prices rallied in July. The S&P500 was up 3.6%, buoyed by better-than-expected company earnings results. The ASX200 rallied by a more impressive 6.3%, supported by higher commodity prices (iron ore up 6.7%) and the prospect of a rate cut by the RBA. Global bond yields fell. The Australian 10-year fell 11bps to 1.87%, while the US 10-year fell 2bps to 1.45%. Also in the month, the A$ increased by 1.9% to 76 US cents, which would have increased the likelihood that the RBA would cut the cash rate at their August Board meeting (which it did).

Financial/Economic Data

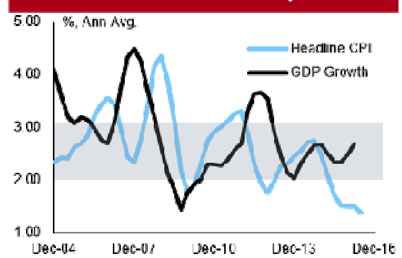
July 2016

RBA Cash Rate



Australia Dollar

Australian Economy

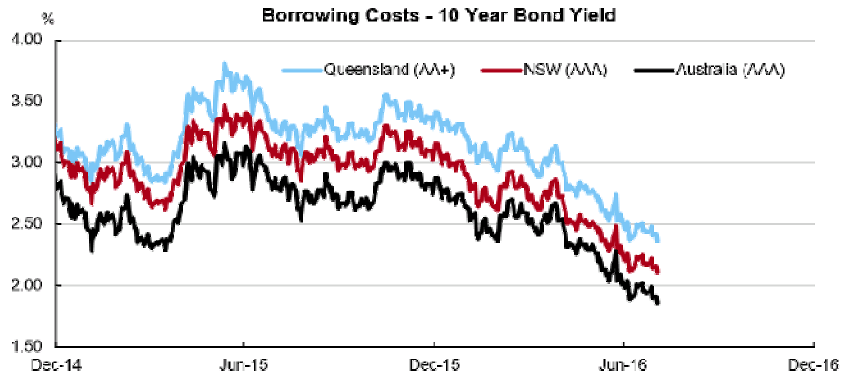


Unemployment Rate

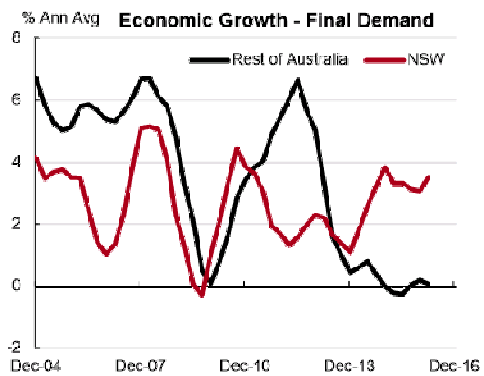
The State of NSW

What would a credit downgrade for Australia mean for NSW?

Earlier in July, credit rating agency Standard and Poor's (S&P) announced that it had placed Australia's AAA credit rating on negative outlook. S&P stated that there is a 1-in-3 chance that it could lower the rating within the next 12 months if it believed that Australia's *"parliament is unlikely to legislate savings or revenue measures sufficient for the general government sector budget deficit to narrow materially"*. The decision resulted in the other Australian AAA-rated entities being placed on negative outlook. The four major banks were also placed on negative outlook, as they receive a ratings uplift from the implicit Commonwealth government support.



The retention of Australia's AAA credit rating has become less certain, but we believe that there is still a significant buffer before Australia's metrics cross the threshold at which a downgrade would be triggered. In other words, it would require a severe recession, or several more years of fiscal neglect, for Australia to lose its AAA rating. We believe that now Australia has been placed on 'negative outlook', it provides the Government with an opportunity to take action to protect the AAA rating.



Market Movements and Economic Data

Financial Data	29 Jul	Monthly change	
Cash Rate	1.75%	0.00	–
Corporate Bond Yield*	2.99%	-0.27	▼
Term Deposit**	2.15%	0.00	–
ASX200	5562	6.3%	▲
S&P500	2174	3.6%	▲
AUD/USD	0.760	1.9%	▲
Economic Data***	**29 Jul**	**Quarterly change**	
Headline CPI	1.0%	-0.3%	▼
Trimmed Mean CPI	1.7%	0.0%	–
GDP Growth	3.1%	0.0%	–
House Prices	6.3%	-1.2%	▼
Unemployment Rate	5.8%	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

However, if Australia were to lose its AAA rating, the key question for NSW is what would happen to its ability to raise funding if it also loses its AAA rating. A simple interpretation is that a lower credit rating would likely result in higher cost of, and access to funding. In this case, however, we believe it is the reason for the downgrade, rather than the downgrade itself, that would matter most for NSW. NSW has the strongest economy and the strongest budget position of any State. The NSW economy continues to grow above trend even at a time when the rest of Australia is experiencing a challenging economic environment. On the fiscal side, net debt as a percent of GSP is virtually zero, while the budget surplus over the next four years is expected to average $2 billion. Put simply, if NSW were to receive an automatic ratings downgrade following the downgrade of the Commonwealth, for investors, the perceived risk of lending the NSW Government would ultimately be unchanged. Therefore, the NSW government would likely continue to have easy access to funding, both domestically and internationally, at a relatively low cost of borrowing.