TCorp Local Government Services

Economic Commentary – October 2016

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The Month in Review

Economic and Market Trends

In October, long-dated bond yields rose substantially. This shift has been driven by three developments. First, markets are becoming resigned to the Fed raising rates in December. Second, investors are also questioning whether central banks in Japan and Europe have reached the limit of their unconventional policy measures. Third, there are some early signs that inflation is beginning to pick up.

In the US, some positive economic data will keep the US central bank on track for a December interest rate hike. The US economy grew at a 2.9% annualised pace in the September quarter, which is the strongest pace since 2014. At the same time, the Employment Cost Index increased by 0.6% in Q3 which suggests that wages growth is picking up. The main disappointment for the US in October was the weakness in consumer sentiment which appears to have been harmed by uncertainty ahead of the upcoming election.

Following the European Central Bank's (ECB) October policy meeting, ECB President Mario Draghi said that extending its quantitative easing programme (QE) beyond March 2017 was not discussed. This disappointed some investors who were looking for some reassurance that the ECB remained committed to QE following a news article which reported that some ECB officials were considering how the ECB might go about tapering its bond purchases. While this added to upward pressure on long bond yields, Draghi did indicate that a *"sudden stop [in QE] is not in anybody's mind. It's not something that people naturally contemplate"*.

In China, producer prices are rising for the first time in 4 years. The combination of higher commodity prices and the weaker Chinese currency has enabled Chinese firms to raise their local-currency denominated selling prices while keeping their export price unchanged. This development will be a positive for the profitability of the Chinese corporate sector in the near term. The key question for investors, however, is whether the Chinese authorities will continue to allow the Chinese Renminbi to depreciate, which would run counter to their public statements. In addition, if the currency were to weaken much further it would exert pressure on those firms with US$-denominated borrowings, which are already facing higher funding costs in the wake of the US money-market reforms.

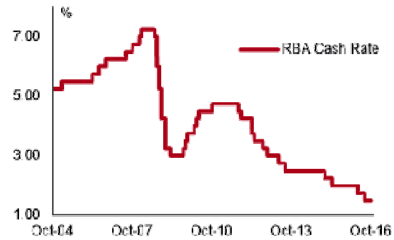
In Australia, consumer prices rose by 0.7% in the September quarter and by 1.3% over the past year, while underlying inflation was just 0.4% in Q3 and 1.7% over the past year. While this is still well below the bottom end of the Reserve Bank of Australia's (RBA) 2-3% inflation target, it was in line with expectations and markets became more confident that the RBA would keep policy on hold. That said, there are few signs that inflationary pressures are re-emerging, and so it could be too early for the RBA to declare victory.

Long-dated bond yields were the big movers over October. The US 30-year yield rose by 26bps, while 10-year yields increased by 23bps. Australian bond yields were particularly hard hit, with the 10-year CGS yield increasing by 44bps to 2.35%. This sell-off reflected a stronger inflation outlook. 10-year Break-even inflation rates in Australia increased 24 bps to 1.79%. The hefty increase in bond yields was also associated with weaker equity markets, at least in the US and Australia. The S&P500 fell by 1.9%, while the Australian market declined by 2.2%. Stock markets in parts of Europe and Asia fared better, with the German market rising by 1.5% and the Nikkei jumping by 5.9%. The A$ fell by 0.7% against its US counterpart over October, but was stronger against the Euro and Yen.

Financial/Economic Data

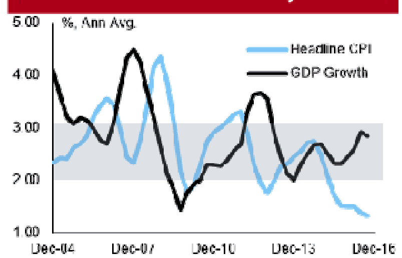
October 2016

RBA Cash Rate



Australia Dollar

Australian Economy

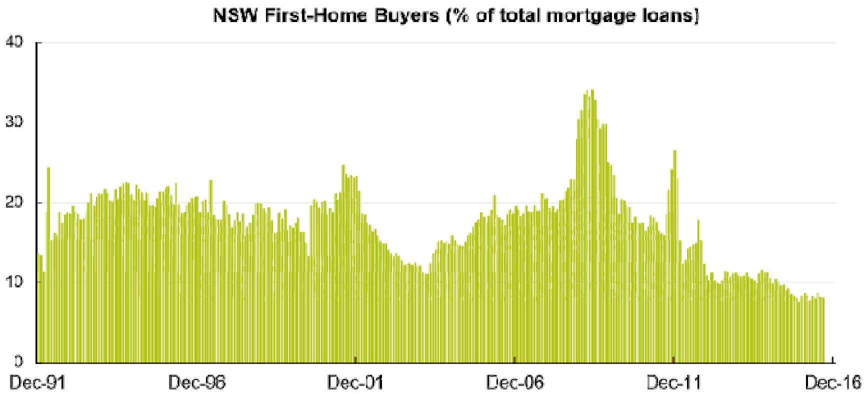


Unemployment Rate

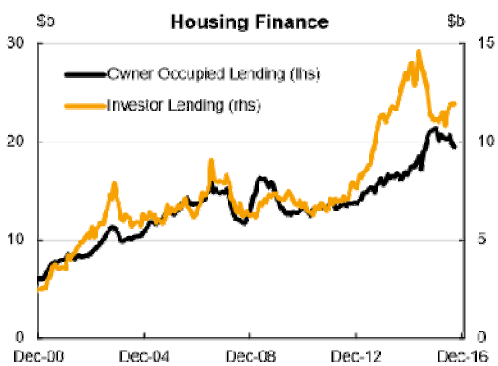
The State of NSW

First-home buyer activity is not as bad as the data suggests

According to the Statistician, the percentage of first-home buyers (FHB) applying for mortgage loans has fallen from around 35% of all loans to less than 10% in around 6 years. Over time, the percentage of FHB mortgage applications has averaged around 20% of the total. It is true that the rapid increase in house prices in NSW has reduced housing affordability, and therefore the ability for FHBs to enter the market, but the data may be overstating the impact to the overall FHB cohort for three reasons. First, the data only captures those who apply for loans through a financial institution, and not those who can gain finance elsewhere – like borrowing from family.



Second, anecdotal information suggests that some FHBs are breaking into the property market by buying an investment property, rather than becoming owner occupiers. Moreover, investor loan data are not broken into FHBs and non-FHBs. If that person then used the capital gain from their investment property to use as a deposit for an owner-occupied home, they would no longer be considered a FHB and so would not be recorded anywhere.



Market Movements and Economic Data

Financial Data	31 Oct	Monthly change	
Cash Rate	1.50%	0.00	–
Corporate Bond Yield*	3.18%	0.27	▲
Term Deposit**	2.05%	-0.10	▼
ASX200	5318	2.2%	▼
S&P500	2126	-1.9%	▼
AUD/USD	0.761	-0.7%	▼
Economic Data* **	**31 Oct**	**Quarterly change**	
Headline CPI	1.3%	0.3%	▲
Trimmed Mean CPI	1.7%	0.0%	–
GDP Growth	3.3%	0.3%	▲
House Prices	7.6%	0.6%	▲
Unemployment Rate	5.6%	-0.2%	▼

*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

Last, the Statistician has had trouble measuring FHB activity because *"some lenders were reporting only loans extended to first home buyers who had also received a First Home Owner Grant, instead of all first home buyers."* While the Statistician has tried to correct these data, it is possible that lingering issues remain. Overall, we believe that FHB activity is trending closer to the long term average than the data would suggest.