# TCorp Local Government Services

Economic Commentary – December 2016

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## The Month in Review

### Economic and Market Trends

After a year of speculation, the US Federal Reserve (Fed) finally raised its key policy rate by 25bps to 0.50%-0.75%. The market had fully priced in a 25bps hike – and so the policy move in itself was not a surprise to investors. The surprise, however, came from the Fed's revised macroeconomic forecasts. The Fed is now expecting to hike its policy rate three times in 2017, as opposed to the two times it was forecasting previously. The prospect of even higher interest rates in 2017 caused some volatility in the remainder of the trading session. The Fed also upgraded its GDP growth forecast for 2017 to 2.1% from 2.0%. Despite the lack of policy details from the President-elect, it seems some Fed officials are now incorporating stronger fiscal spending in their GDP growth forecasts. Economic data released in the US in December continued the robust trend seen in 2016. Non-farm payrolls increased by 156,000 in November, the manufacturing diffusion index increased to its highest level in almost 2 years, while core inflation remained above 2.0%.

The European Central Bank (ECB) also met in December to deliberate on monetary policy. While the ECB did not change its policy rate, it announced an extension of its quantitative easing (QE) programme until the end of 2017. However, given that it now plans to reduce its monthly purchases of bonds from €80 billion to €60 billion, most analysts interpreted the announcement as a tapering of the ECB's QE programme. The ECB also broadened the criteria of which bonds it could buy in its QE programme, allaying fears that it could eventually 'run-out' of bonds to buy. While monetary policy in Europe remains expansionary, the reduction of the ECB's QE suggests it has become less inclined to provide ever-increasing monetary stimulus to the European economy. This new attitude toward monetary stimulus has become more prominent among other major central banks.

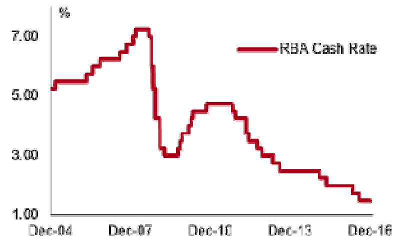
In domestic news, the Australian economy shrank by 0.5% (1.8% y/y) in the September quarter. This was the weakest performance for the economy since 2011 when extensive flooding temporarily affected production. Unlike that occasion, however, there was no single reason why activity was so weak in Q3. In our view, Australia's trend rate of growth has been lacklustre over the last couple of years. Around this tepid trend pace of growth, however, temporary factors can result in a particularly weak result. For this reason, we do not think the weak growth data signal that the Australian economy is suddenly sliding towards recession.

The Fed's upwardly revised policy rate forecasts forced market participants to recalibrate their expectations for interest rates in 2017. The 10-year Australian yield increased 4bps to 2.77%. Equity markets were strong in December, in line with market expectations of stronger global growth in 2017. The ASX200 rallied 4.1%. Currency markets were once more dominated by US$ strength in December. The A$ fell 2.4%.

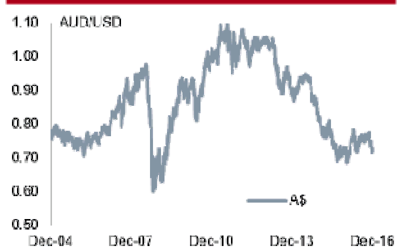
### Financial/Economic Data

December 2016

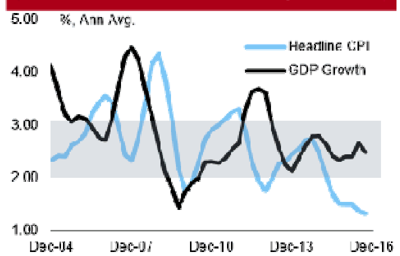
#### RBA Cash Rate




#### Australia Dollar




#### Australian Economy



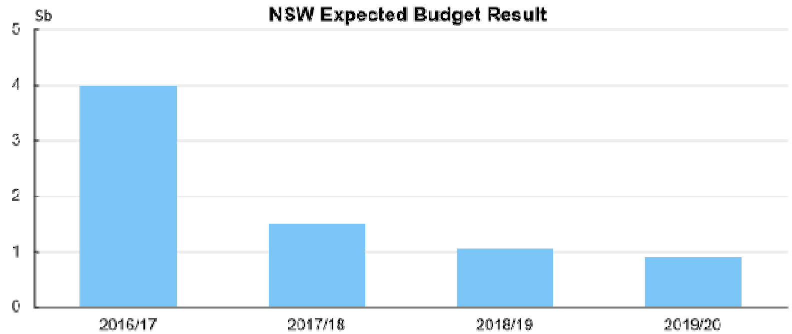

#### Unemployment Rate

TCorp

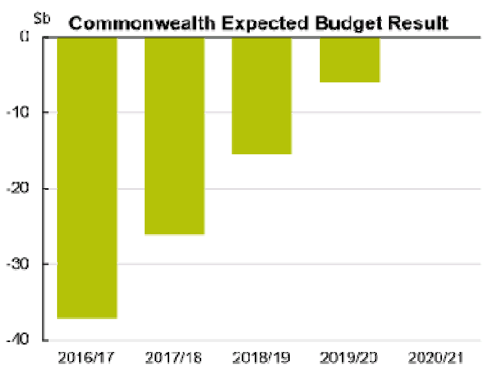
# The State of NSW

## Is NSW still at risk of losing its AAA rating?

The NSW Treasurer's 2016/17 mid-year Budget update released last month was rock solid. The NSW government is now forecasting a $4 billion surplus this financial year. Budget surpluses are also projected over the next four years, while net debt is expected to be just 1.3% of GSP by June 2017. Needless to say, the NSW's strong fiscal management has secured its AAA credit rating. So is NSW still at risk at losing its AAA rating? The answer, unfortunately, is yes. Because NSW government revenues rely on transfers from the Commonwealth Government, the fiscal health of both are important in the determining NSW's credit rating. This dependency is where the downgrade risk lies.




The Commonwealth Government also released its 2016/17 mid-year Budget update (MYEFO) in December. But while the deteriorating fiscal budget outlook did not trigger a sovereign rating downgrade, the details in the MYEFO suggest that a downgrade is still likely. The Budget deficit for 2016/17 is now expected to be slightly lower ($36.5 billion) thanks to unexpectedly (and unsustainably) higher bulk commodity prices. However, the MYEFO revealed $10 billion worth of deficit slippage in the outer years to 2021. Even though the Commonwealth is still forecasting a budget surplus by 2021, the slowdown in nominal GDP growth, the subdued wages growth, and the political gridlock will make achieving such target unlikely. But for the rating agencies, achieving a budget surplus by 2021 is critical for retaining their AAA status for Australia.




**Market Movements and Economic Data**

| Financial Data | 30 Dec | Monthly change | |
|---|---|---|---|
| Cash Rate | 1.50% | 0.00 | – |
| Corporate Bond Yield* | 3.64% | 0.06 | ▲ |
| Term Deposit** | 2.05% | 0.00 | – |
| ASX200 | 5666 | 4.1% | ▲ |
| S&P500 | 2239 | 1.8% | ▲ |
| AUD/USD | 0.721 | -2.4% | ▼ |
| **Economic Data*** ** | **30 Dec** | **Quarterly change** | |
| Headline CPI | 1.3% | 0.3% | ▲ |
| Trimmed Mean CPI | 1.7% | 0.0% | – |
| GDP Growth | 1.8% | -1.3% | ▼ |
| House Prices | 10.8% | 3.7% | ▲ |
| Unemployment Rate | 5.7% | 0.1% | ▲ |

*A-rated 5-year rate, source: RBA **Average 30-day rate of the five largest banks for $10,000, source: RBA ***National data, y/y, source: ABS, RBA

A downgrade of the Commonwealth would result in a downgrade for NSW (and the four major Australian banks). Some fear that a lower credit rating would translate to less access to funding, and at higher costs. In this case, however, we believe it is the reason for the downgrade, rather than the downgrade itself, that would matter most for NSW's funding. NSW has the strongest economy and the strongest budget position of any State. Therefore, in the event of a downgrade, the NSW government would likely continue to have easy access to funding at relatively low costs.