TCorp Local Government Services

Economic Commentary - February 2017

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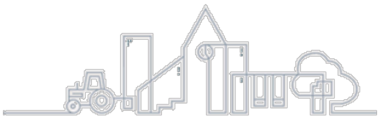


The Month in Review

Economic Commentary

The Reserve Bank of Australia (RBA) retained its upbeat outlook for the Australian economy when it released its updated forecasts in early February, predicting that the economy's growth rate will jump from its 2.4% pace to above 3% in the year ahead.

Perhaps more surprising were the comments of RBA Governor Phil Lowe, who indicated that he was relaxed about the A$'s strong rise over 2017. Even though the A$ had risen by 6% in recent months, Dr Lowe said that it was hard to argue that the A$ was fundamentally overvalued.

Despite the RBA's optimism, the Australian economic data flow remains quite mixed. One of the bright spots has been business confidence, which increased to +10 in January, its highest level since February 2014. And there is also more evidence that the strong improvement in commodity prices over 2016 is now being reflected in stronger profits for the resources sector.

'One of the bright spots has been business confidence'

While firms have become more optimistic, this doesn't appear to be affecting their behaviour, at least not yet. The Statistician's survey of planned business investment pointed to lacklustre spending intentions for 2018-19 as well as 2017-18.

In addition, retail sales were reported to have dipped by 0.1% in December while private-sector wages growth fell to 1.8% over 2016, which is the slowest pace recorded in the history of this measure.

The synchronised acceleration of global manufacturing activity remained in place in February, with surveys of business activity remaining at very healthy levels. Interestingly, some of the leading indicators embedded within these surveys – such as new orders – continue to push higher. This suggests that the improvement evident over the last 6 months, has further to run.

In the US, employment again beat expectations, with total jobs rising by 227,000 in January compared with an anticipated gain of 180,000. Alongside a very low level of new jobless claims, this suggests that the US labour market continues to tighten. This said, wages growth remains surprisingly subdued and average hourly earnings growth fell to 2.5% in January, down from 2.9% in the previous month.

'The US labour market continues to tighten'

While some US Federal Reserve (Fed) policymakers have said that an increase in wages growth is not a necessary pre-condition for them to continue to hike interest rates, this certainly will remove some of the urgency to raise rates quickly. Consistent with this, markets remain undecided whether the Fed will raise interest rates again as soon as March.

European manufacturing has been healthy in recent months, and headline inflation has increased to 1.8%, which is close to the European Central Bank's aim to keep inflation close to, but below, 2%. China's growth remained steady in January, reflecting the looser policy settings introduced in 2016. Recent reports suggest that authorities have begun tightening policy again, as the previous fears about a rapid slowdown of growth have abated.

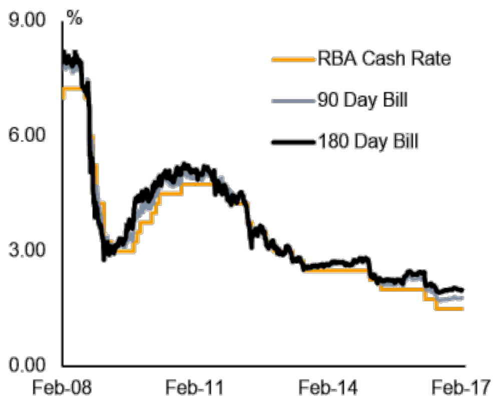
Market Commentary

Global bond markets tended to rally over February, although there were large differences in performance between markets. Despite strong US growth, US 10-year bond yields fell by 6bps to 2.39%. German bonds were strongly bid as political fears over the elections this year remain. The Australian bond market underperformed in February. The 10-year yield increased by 1bp. While lower bond yields are often associated with a degree of caution amongst investors, the strong performance of equity markets over February suggest that many investors are in fact quite positive. The MSCI World Index (ex Australia) rose by 2.7% over the month, while Australian stocks recorded a more modest 1.6% gain. Higher commodity prices continue to support the resources sector.

Financial Market and Economic Charts

February 2017

Cash and Bank Bill Rates



We expect the RBA will leave the cash rate at 1.50% in 2017

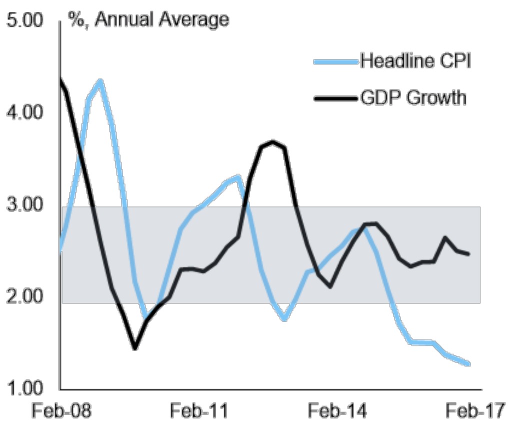
Australian Dollar

The A$ appreciated 5% against the US$ in January

Unemployment rate

Unemployment in NSW is around 0.8% lower than the rest of Australia

Australian Economy



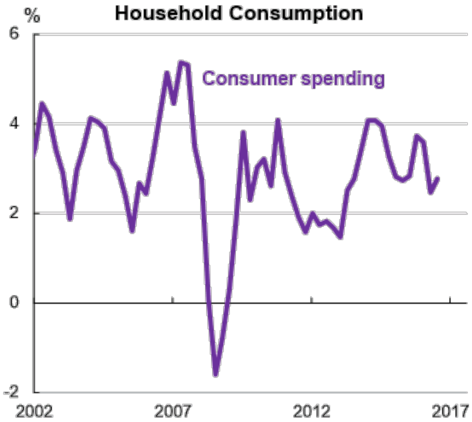
Inflation has been below the RBA's target band (2-3%) for 8 consecutive quarters

The State of New South Wales

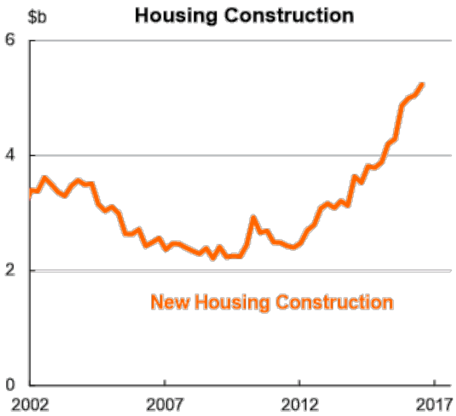
What's driving growth?

The NSW economy continues to perform very well with activity growing by 0.8% in the December quarter and by more than 4% over 2016. For the rest of Australia, the same measure of activity increased by just 1.1%.

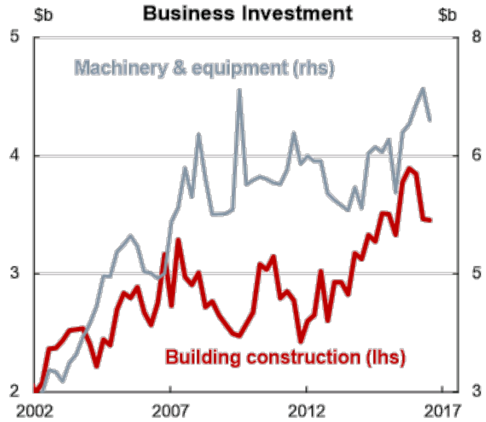
Not only is growth strong in NSW, but it is also broadly based. Consumer spending has been growing at around 3% in recent years, which is close to its long-term average (see chart below). In contrast, consumption growth in the rest of Australia has weakened notably since the GFC.



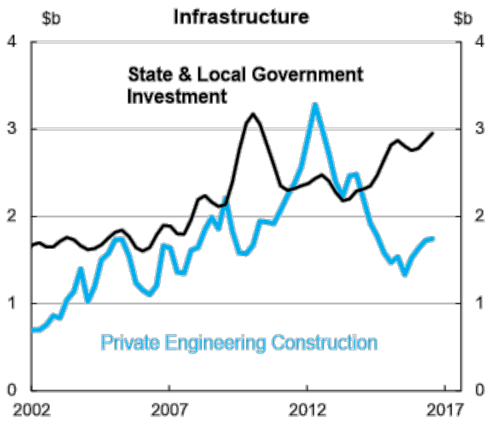
One reason why NSW households have been spending more freely, is the surge of housing construction (see chart below). Indeed, the amount of construction activity at the end of 2016 was more than double its level of 5 years ago. And while we think we are nearing the peak of activity, the level of construction is likely to remain through 2017.



Another area where NSW stands out is the strength of business investment. Weak business investment has been a global phenomenon in recent years as firms have tended to focus on cutting costs rather than expanding capacity. NSW is a notable exception with both business spending on buildings (e.g. hotels, shopping centres and office towers) and machinery (computers and motor vehicles) trending higher in recent years.



Not every sector has been strong, however, with private-sector engineering construction (e.g. mining activity) falling sharply since 2012. Importantly, however, this has been offset by increased government spending, as the NSW Government's ambitious infrastructure plans steadily take shape (see chart below).



It appears, however, that private engineering construction has now troughed, which will be important if the boost to growth from housing begins to recede. But as long as consumers keep spending, then firms will keep investing and NSW growth should remain solid.

Financial Markets Data

February 2017

Interest Rates	Close (%)	1 Month (bps)		CYTD (bps)	
RBA Cash Rate	1.50	0	–	0	–
Term Deposit (average 90-day rate for $10,000)	2.05	0	–	0	–
90-day BBSW	1.78	1	▲	-3	▼
5-year A-Rated Corporate Bond Yield	3.50	-14	▼	-28	▼
3-year Australian Bond Yield	1.95	5	▲	-1	▼
10-year Australian Bond Yield	2.72	1	▲	-4	▼
10-year Australian Break-Even Inflation	1.91	0	▲	-2	▼
10-year Australian Real Yield	0.81	1	▲	-3	▼
Fed Funds Rate (lower bound)	0.50	0	–	0	–
2-year US Treasury Yield	1.26	6	▲	7	▲
10-year US Treasury Yield	2.39	-6	▼	-5	▼
10-year German Bund Yield	0.21	-23	▼	0	–

NSW TCorp Bonds	Close (%)	1 Month (bps)		CYTD (bps)	
4.00% 20 February 2017	1.74	-1	▼	0	–
6.00% 1 February 2018	1.72	-9	▼	-12	▼
3.50% 20 March 2019	1.95	3	▲	-6	▼
6.00% 1 May 2020	2.13	2	▲	-8	▼
4.00% 8 April 2021	2.28	3	▲	-7	▼
6.00% 1 March 2022	2.39	2	▲	-7	▼
4.00% 20 April 2023	2.56	-1	▼	-7	▼
5.00% 20 August 2024	2.71	1	▲	-4	▼
4.00% 20 May 2026	2.92	1	▲	-2	▼
3.00% 20 March 2028	3.15	1	▲	-2	▼
3.00% 20 February 2030	3.36	2	▲	-2	▼
3.75% 20 August 2020 CIB	0.60	10	▲	-3	▼
2.75% 20 November 2025 CIB	0.99	3	▲	-3	▼
2.50% 20 November 2035 CIB	1.56	6	▲	5	▲
10-year NSW TCorp Bond Yield	3.02	2	▲	-2	▼
10-year TCV (Victoria) Spread	-0.02	0	–	-1	▼
10-year QTC (Queensland) Spread	0.17	0	–	-1	▼

Equities	Close	1 Month		CYTD	
S&P/ASX 200 (Australia)	5,712	1.6%	▲	0.8%	▲
S&P 500 (US)	2,364	3.7%	▲	5.6%	▲
FTSE 100 (UK)	7,263	2.3%	▲	1.7%	▲
DJ Stoxx 600 (Europe)	370	2.8%	▲	2.4%	▲
Nikkei 225 (Japan)	19,119	0.4%	▲	0.0%	▲
Shanghai Composite (China)	3,242	2.6%	▲	4.4%	▲

Currencies	Close	1 Month		CYTD	
AUD/USD	0.77	0.9%	▲	6.2%	▲
EUR/USD	1.06	-2.1%	▼	0.6%	▲
USD/JPY	112.77	0.0%	▼	-3.6%	▼
GBP/USD	1.24	-1.6%	▼	0.3%	▲
US$ Index	101.12	1.6%	▲	-1.1%	▼

Commodities	Close	1 Month		CYTD	
Brent Oil (US$/bbl)	55.59	-0.2%	▼	-2.2%	▼
Iron Ore (US$/t)	91.27	9.5%	▲	15.7%	▲
Newcastle Coking Coal (US$/t)	148.20	-6.4%	▼	-19.4%	▼
Gold (US$/oz)	1,248.33	3.1%	▲	8.3%	▲