TCorp Local Government Services

Economic Commentary – May 2016

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The Month in Review

Economic and Market Trends

While opinion polls suggest that Britain will vote to remain in the European Union (EU), the issue had become serious enough for the Governor of the Bank of England, Mark Carney, to state that it could undermine UK growth in mid-2016 due to the uncertainty created. Governor Carney also said that if Britain did elect to leave the EU, that it could trigger a collapse in the British pound, a jump in inflation and a 'technical recession' (6 consecutive months of falling activity).

Other policymakers, including those at the US Federal Reserve (Fed), had also cited the risk of 'Brexit' as a reason to be cautious in coming months. That said, the overall tone of commentary from Fed officials over the past month is that the US economy remains strong, that there is a good case for higher rates in the US in the next few months, and that markets remain far too complacent about that possibility. So while recent US economic data has pointed to only moderate growth in the economy, it is still sufficiently strong in the view of the Fed to justify some further tightening of policy.

The problem for US policymakers at present, however, is that investors don't believe the US economy is ready for higher policy rates. Moreover, the economic data in the US were slightly more negative. The US manufacturing sector showed a slowing in activity in April. The ISM manufacturing index fell to 50.8 in April from 51.8 in the previous month (although a reading above 50 denotes rising activity). At the same time, employment grew by 160,000 in April, around 48,000 below the 5-year average. Inflation in the US, however, remained higher than the last several years. Overall, core consumer prices rose by 2.1% over the year to April.

In response to the surprisingly weak inflation reading, the Reserve Bank of Australia (RBA) reduced the cash rate from 2% to 1.75% at its policy meeting in early May. While that decision caught some analysts by surprise, even more unexpected was how aggressively the RBA revised down its inflation forecasts in its quarterly Statement of Monetary Policy. Whereas previously the RBA thought inflation would remain comfortable between 2-3% over the next 2 years, the latest forecasts suggest that inflation will remain below 2% until 2019.

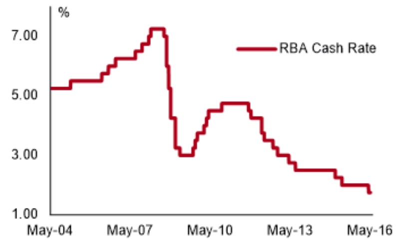
The aggressive downgrades in the RBA's inflation forecasts, in turn, prompted analysts to completely reassess the outlook for interest rates. Some analysts – even those who were previously expecting the RBA to hike interest rates in 2017 – are now calling for the cash rate to fall to 1% over the next year. It should be noted that while the RBA has changed its tune on inflation, it is still comfortable with Australia's economic growth momentum. And while the March quarter inflation data were very soft, there is always a risk that it exaggerated how weak inflation really was. If the activity data begin to weaken, however, then these more extreme rate cutting scenarios would become more likely.

Movements in Australian bond yields over May were dominated by the RBA's decision to lower the cash rate. The 10-year yield fell as much as 37bps in the opening weeks of May to an all-time low of 2.20%, but finished the month at 2.30%. The A$ also reacted dramatically, falling almost 5% over the month to the 72 US cent level. Commodity prices were not far behind. News that iron ore stock piles in China had exceeded 100 million tonnes for the first time since early 2015 saw the iron price fall 25% to around US$50 a tonne. The ASX200 rallied by a respectable 2.4% in May, and is still one of the better performing equity markets this year.

Financial/Economic Data

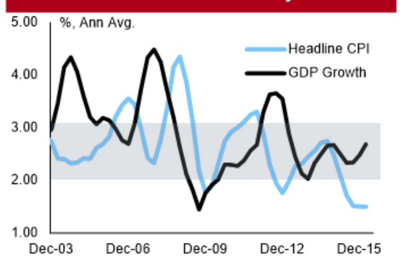
May 2016

RBA Cash Rate



Australia Dollar

Australian Economy

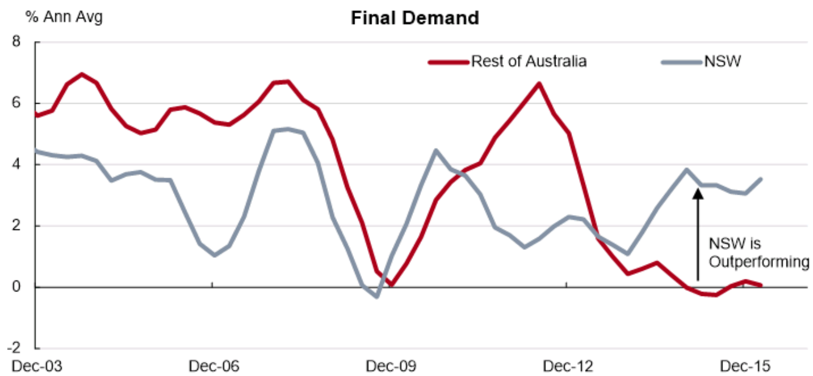


Unemployment Rate

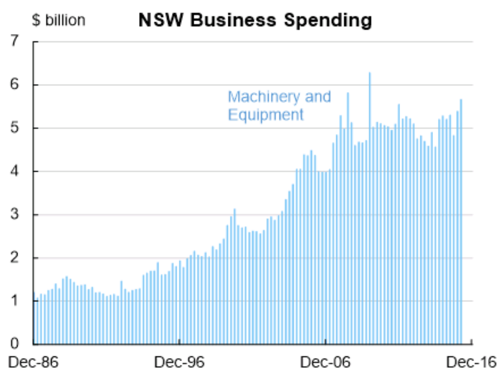
The State of NSW

State Final Demand in NSW is still the strongest

The Australian economy grew by 1.1% in the first quarter of 2016, taking the annual growth rate to a strong 3.1%. Growth in the March quarter was, however, overwhelmingly due to strong exports, which contributed 1ppt to growth in the quarter – so over 90% of total growth. This implies that spending in the overall domestic economy was essentially flat in Q1.



However, this anaemic performance of domestic spending was not apparent in NSW. In fact, NSW State Final Demand grew by 1% in Q1, which compares to the next strongest State of Tasmania which recorded growth of just 0.1% for the quarter. In the March quarter, consumer spending, housing and business spending on machinery and equipment drove the strong growth in the NSW economy. And as we would expect, all of these sectors are still benefitting from the low setting of interest rates and the weaker A$. Over the last year, NSW State Final Demand has grown by an impressive 3.9%, whereas for Australia as a whole Final Demand has increased by 0.9%.



Market Movements and Economic Data

Financial Data	31 May	Monthly change
Cash Rate	1.75%	-0.25 ▼
Corporate Bond Yield*	3.49%	-0.15 ▼
Term Deposit**	2.15%	-0.05 ▼
ASX200	5379	2.4% ▲
S&P500	2097	1.5% ▲
AUD/USD	0.723	-4.9% ▼
Economic Data***	**31 May**	**Quarterly change**
Headline CPI	1.3%	-0.4% ▼
Trimmed Mean CPI	1.7%	-0.4% ▼
GDP Growth	3.1%	0.2% ▲
House Prices	10.0%	2.3% ▲
Unemployment Rate	5.7%	-0.3% ▼

*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

While the recent performance of the NSW economy stands out from the rest of Australia, the pick-up in business spending on machinery and equipment (which is up by 8.9% y/y) is particularly encouraging. This is because it suggests that business confidence is translating into action, which implies that healthy growth and activity can be sustained even as the level of housing construction begins to plateau over the next couple of years. The pick-up in non-mining investment has been at the forefront of the RBA's campaign to encourage businesses to take entrepreneurial risks, especially at a time when the cost of borrowing is exceptionally low. It seems this message has resonated with businesses in NSW the most.