TCorp Local Government Services

Economic Commentary - December 2017

Brian Redican
Chief Economist
T 02 9325 9388
E brian.redican@tcorp.nsw.gov.au

Gabby Hajj
Senior Economist
T 02 9325 9334
E gabby.hajj@tcorp.nsw.gov.au

The Month in Review

Economic Commentary

The US Federal Reserve (Fed) hiked its policy rate (range) by 25bps to 1.25%-1.50% at its December policy meeting - marking its third rate hike for 2017. In the lead up to the meeting, the Fed aggressively signalled its intention to tighten monetary conditions as economic data in the US continued to improve.

Specifically, the US labour market continued to exhibit robust employment conditions. The latest non-farm payrolls report showed that 228,000 jobs were added to the US economy in November, while unemployment remained extraordinarily low at 4.1%. The Fed's latest forecasts show that three more rate hikes are planned for 2018.

228,000 jobs were added to the US economy

The Reserve Bank of Australia (RBA) left the cash rate unchanged at its December policy meeting. The RBA has been particularly pleased with the progress in the domestic labour market. Employment growth accelerated to 3.2% y/y in November, its fastest pace in almost a decade.

Meanwhile, unemployment has declined steadily from 5.8% to 5.4% over the past 12 months. The Bank also remained positive on the outlook for global growth, particularly in Australia's major trading partners. The RBA expects *"further progress on these fronts over the following year"*.

However, the key uncertainty for the RBA remains to be the outlook for wages growth. Despite stellar employment growth, wages growth has remained at multi-decade lows. The RBA remains particularly unsure about when wages growth will accelerate in line with employment growth. The outlook for consumer spending also rests upon wages growth. Household income growth has slowed to recession-like levels, and has crippled the ability of households to spend on discretionary items. The outlook for consumer spending remains a significant risk for the RBA.

The outlook for consumer spending remains a risk

Market Commentary

The passing of the Tax Reform Bill in both Chambers of the US Congress helped push global bond yields higher. Australian bond yields in particular increased significantly in December. The 2-year Australian yield increased 23bps in the month – more than it had increased in the entire year – to 2.13%. Interest rates in the short-end of the Australian yield curve are now back above those in the US. The 2-year US yield increased by only 10bps to 1.88% in December. In 2017, however, the 2-year US yield increased almost 70bps.

In the long-end of the yield curve, Australian and US bond yields behaved differently. The 10-year Australian yield increased 13bps to 2.63% in December, whereas the 10-year US yield remained unchanged at 2.41%. While the spread between the 10-year US and Australian yield widened in December, it remains relatively narrow at 22bps.

With the US central bank committed to hiking interest rates several more times in 2018, shorter-dated bond yields in the US should continue to contest those in Australia. In Australia, slowing household income growth and a peaking housing market will not provide the RBA with the same scope to raise interest rates.

Equity markets were mixed over December. The S&P500 enjoyed a 1% rally in the month, no doubt supported by the passing of the 'pro-growth' Tax Reform Bill. Over 2017, the S&P500 increased by an impressive 19.4%, making it one of the best performing equity markets in the developed world.

The ASX200 increased by 1.6% in December. The mining stocks (+6.8%) were the primary driver for the increase in the overall index – and were supported by stronger commodity prices in the month. Listed property trusts were weaker (-1.6%) and bank shares were only slightly higher (0.4%). The ASX200 index was up 7% in 2017.

Financial Market and Economic Charts

December 2017

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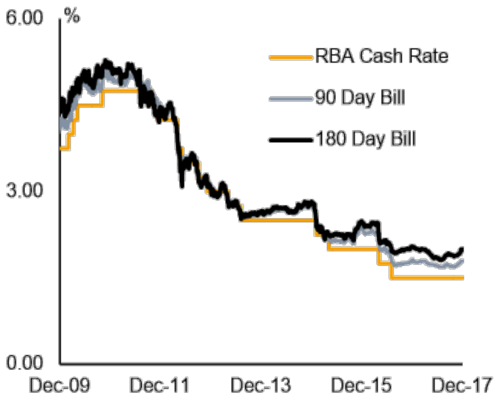
Cash and Bank Bill Rates



We expect the RBA will leave the cash rate at 1.50% in 2018

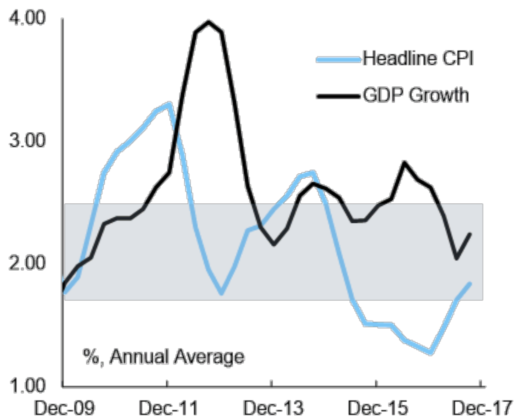
Australian Dollar

The A$ increased almost 10% in 2017

Unemployment rate

NSW's labour market is the strongest in the country

Australian Economy



Inflationary pressures remain subdued

The State of New South Wales

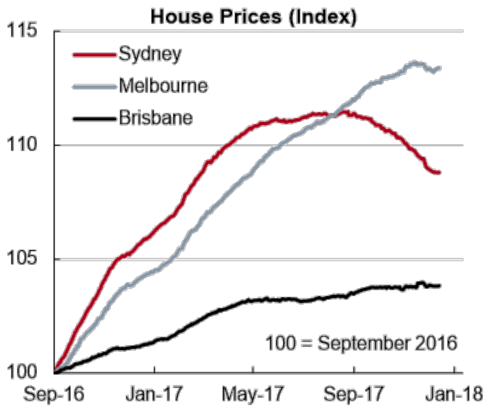
Where is the housing market headed?

There has been a lot of chatter around whether the Australian housing market has peaked. Specifically, should we expect to see house prices and residential building activity decline this year? Various measures of house prices and recent anecdotes suggest that house prices have already seen moderate declines. For example, the Australia Financial Review recently reported that *"1 in 4 Melbourne city properties resold at a loss"*, while the proportion of properties resold at a loss in Brisbane is at the highest level since 2015.

These claims would no doubt be chilling soundbites for some home owners, particularly investors. However, it is not uncommon for certain areas – even neighbouring suburbs – to exhibit very different price action. For example, Melbourne's CBD has experienced an astronomical increase in supply of high-density housing – targeted at foreign investors and students studying abroad. Given the concentration of small high-density housing in the CBD, the probability of house price declines in the area would be naturally higher than in other more suburban suburbs.

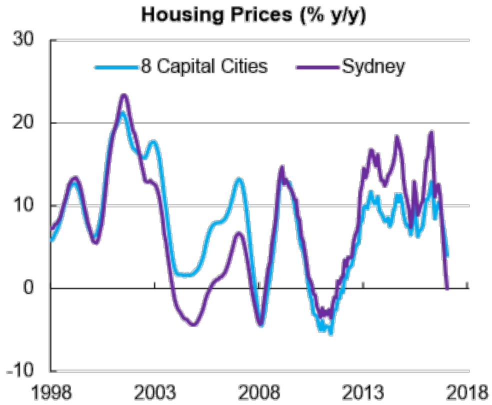
A high proportion of homes built in Sydney have also been high-density. Fortunately, however, construction activity has been much more geographically dispersed. Housing construction in regional NSW has also increased at double-digit growth rates. The broad-based nature of Sydney's housing construction boom lowers the probability of sharp price declines in certain areas.

That said, recent aggregate house price data suggests that house prices in Sydney have started to moderate. And in contrast to some anecdotes, overall house prices in Melbourne are outperforming the other capital cities. House prices in Brisbane – another city which has had plenty of high-density housing construction – have been stable.



Again, looking at this chart in isolation may be worrying to home owners in Sydney. If compared to the house prices gains in Sydney over the past couple of years, however, the recent decline begins to look like a rounding error.

So what is our view? The recent house price action observed in Sydney is consistent with our expectation that house price growth will moderate in 2018 and 2019. Our view is predicated on the simple observation that house prices in Australia are very cyclical. That is, after a period of strong growth, house prices tend to revert. There are several reasons why house prices are cyclical.



First, policymakers are inclined to slow housing activity if debt rises too quickly. Currently, household debt in Australia is at record levels. The latest data suggest that debt to income in Australia is fast approaching 200%. Australia's banking regulator has responded by tightening lending standards on several occasions to slow credit growth and investor activity.

Second, the very fact that debt is high means that the capacity for households to take on more debt has been heavily reduced. So if the RBA was to cut interest rates again, households would not necessarily have the appetite to take out a new mortgage.

And third, foreign housing demand has eased as the foreign investor surcharge has increased over the past 12 months in most states. Meanwhile banks have also scaled back lending to foreign investors.

To be clear, we are not expecting a collapse in house prices. Strong population growth and the structural undersupply of housing in NSW will ensure steady demand, and provide a floor for prices. We expect house price growth to be flat over the next two years.

Financial Markets Data

December 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)	1.95	0	–	-10	▼
90-day BBSW	1.80	5	▲	-1	▼
5-year A-Rated Corporate Bond Yield	3.18	19	▲	-46	▼
3-year Australian Bond Yield	2.13	23	▲	14	▲
10-year Australian Bond Yield	2.63	13	▲	-15	▼
10-year Australian Break-Even Inflation	1.89	2	▲	-3	▼
10-year Australian Real Yield	0.74	11	▲	-11	▼
Fed Funds Rate (lower bound)	1.25	25	▲	75	▲
2-year US Treasury Yield	1.88	10	▲	67	▲
10-year US Treasury Yield	2.41	0	▼	-7	▼
10-year German Bund Yield	0.43	6	▲	25	▲

NSW TCorp Bonds	Close (%)	1 Month (bps)		CYTD (bps)	
6.00% 1 February 2018	1.85	13	▲	-2	▼
3.50% 20 March 2019	1.90	11	▲	-15	▼
6.00% 1 May 2020	2.10	15	▲	-14	▼
4.00% 8 April 2021	2.28	19	▲	-10	▼
6.00% 1 March 2022	2.37	18	▲	-13	▼
4.00% 20 April 2023	2.51	16	▲	-13	▼
5.00% 20 August 2024	2.65	15	▲	-13	▼
4.00% 20 May 2026	2.82	13	▲	-14	▼
3.00% 20 March 2028	3.01	9	▲	-17	▼
3.00% 20 February 2030	3.21	9	▲	-18	▼
3.75% 20 August 2020 CIB	0.62	16	▲	-3	▼
2.75% 20 November 2025 CIB	0.92	11	▲	-11	▼
2.50% 20 November 2035 CIB	1.31	10	▲	-20	▼
10-year NSW TCorp Bond Yield	2.99	10	▲	-14	▼
10-year TCV (Victoria) Spread	0.00	0	–	1	▲
10-year QTC (Queensland) Spread	0.12	0	–	-6	▼

Equities	Close	1 Month		CYTD	
S&P/ASX 200 (Australia)	6,065	1.6%	▲	6.4%	▲
S&P 500 (US)	2,674	1.0%	▲	18.9%	▲
FTSE 100 (UK)	7,688	4.9%	▲	8.0%	▲
DJ Stoxx 600 (Europe)	389	0.6%	▲	8.0%	▲
Nikkei 225 (Japan)	22,765	0.2%	▲	18.9%	▲
Shanghai Composite (China)	3,307	-0.3%	▼	6.8%	▲

Currencies	Close	1 Month		CYTD	
AUD/USD	0.781	3.2%	▲	8.2%	▲
EUR/USD	1.201	0.8%	▲	14.4%	▲
USD/JPY	112.69	0.1%	▲	-3.3%	▼
GBP/USD	1.35	-0.1%	▼	10.2%	▲
US$ Index	92.12	-1.0%	▼	-10.3%	▼

Commodities	Close	1 Month		CYTD	
Brent Oil (US$/bbl)	66.87	5.2%	▲	19.1%	▲
Iron Ore (US$/t)	71.28	12.5%	▲	-10.6%	▼
Newcastle Coking Coal (US$/t)	178.20	6.5%	▲	-10.1%	▼
Gold (US$/oz)	1,303.05	2.2%	▲	12.5%	▲

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