TCorp Local Government Services

Economic Commentary - April 2017

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The Month in Review

Economic Commentary

Australian consumer prices rose by 0.5% in 2017Q1 to be 2.1% higher than a year ago. The headline inflation rate, however, was boosted by rising petrol prices over 2016; underlying inflation increased by just 0.4% in Q1 to be 1.8%YoY.

Another measure of underlying inflation – which excludes government-determined prices -- suggested that inflation was just 1% YoY.

Overall, these data were a little softer than the market expected. Moreover, the details point to a clear message for policymakers: core inflationary pressures in Australia remain weaker than the Reserve Bank of Australia (RBA) would prefer.

Of course, policymakers won't place too much emphasis on one particular data point. The relevance of the Q1 inflation data, however, is that they confirm that the inflationary environment remains subdued, while the main drivers of inflation – such as wages growth, commodity prices, the A$ -- suggest that cost pressures aren't likely to intensify any time soon.

'…core inflationary pressures in Australia remain weaker than the RBA would prefer'

Also pointing to an absence of pricing pressure is the weak growth of retail spending. Retail sales fell by 0.1% in February. Consumers have also become more pessimistic in recent months and the unemployment rate has drifted up to 6.9%.

On a more positive note, housing activity remains strong and business surveys pointed to strong conditions over the March quarter and above-average levels of confidence.

The vast majority of economic data releases continue to suggest that global activity remained healthy into April. This said, sentiment-based measures of US activity continue to be much stronger than the 'hard' economic data. And there are some preliminary signs that sentiment itself may be moderating from its recent high levels.

The US economy grew at an annualised pace of 0.7% in the March quarter. This is not only much weaker than the economy's 2% trend pace, but is especially puzzling given that US business surveys have pointed to well above-trend levels of activity.

'…global activity remained healthy into April'

While we suspect that confidence has been boosted by the prospect of large corporate tax cuts and reduced regulation, the GDP report probably understates the underlying pace of growth.

Certainly, labour market data suggest that activity remains firm and there are some signs that wages growth is picking up a little. The employment cost index, for example, rose by a healthy 0.8% in Q1.

Meanwhile, there are some signs that the very strong sentiment readings of recent months have begun to moderate. A bunch of regional Fed manufacturing indexes all dipped in April, although they remain at still-healthy levels. Similarly, China's official manufacturing PMI index fell from 51.8 in March to 51.2 in April. In Europe, however, activity appears to have retained its positive momentum so far.

Market Commentary

Bond yields fell back in April, as investors reassessed how quickly the US political system would be able to deliver the increased spending on infrastructure and major tax cuts. US 10-year bond yields fell by 11bps while Australian 10-year yields declined by 13bps, to 2.58%.

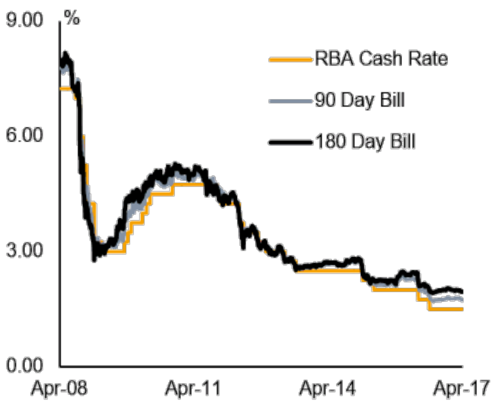
US central bank officials, however, still expect to continue raising rates this year, with strong employment and confidence levels, justifying their strategy. But with the Reserve Bank of Australia likely holding policy steady, the spread between US and Australian yields is likely to narrow further.

Financial Market and Economic Charts

April 2017

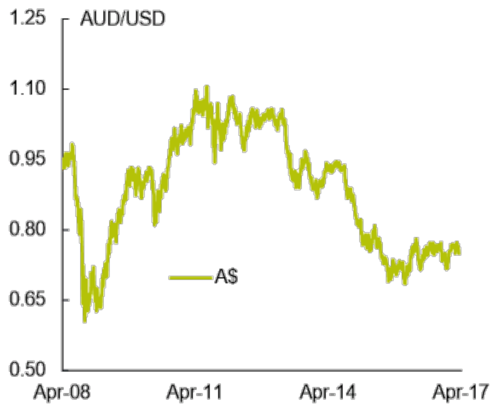
TCorp

Cash and Bank Bill Rates



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

Australian Dollar

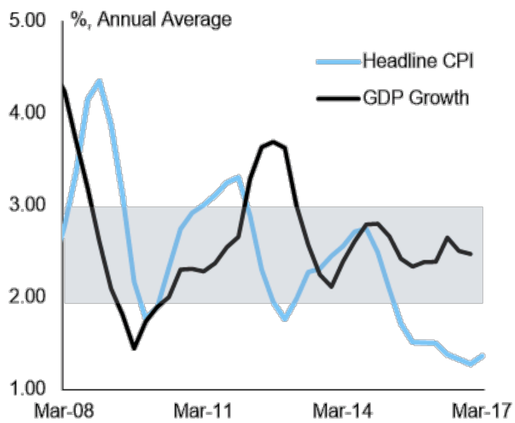


The A$ has been range-bound so far in 2017

Unemployment rate

NSW's labour market remains substantially stronger than the rest of Australia

Australian Economy



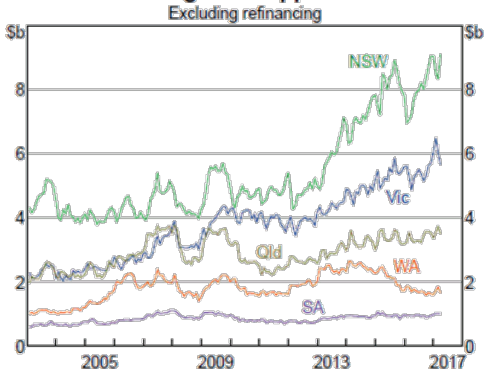
Inflationary pressures remain extremely subdued

The State of New South Wales

Changing housing markets

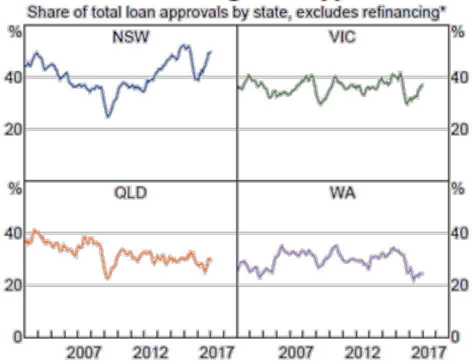
The Reserve Bank of Australia's (RBA) semi-annual Financial Stability Review provided some interesting perspectives on State housing markets. It also provided some context for the regulators' decisions to impose limits on investor lending and interest-only loans.

Housing Loan Approvals
Excluding refinancing



The chart above shows that in recent years, NSW and Victoria have been the main beneficiaries of increased lending. Housing finance in Queensland has edged higher, lending in South Australia has been fairly flat, while lending has weakened in WA.

Investor Housing Loan Approvals
Share of total loan approvals by state, excludes refinancing*



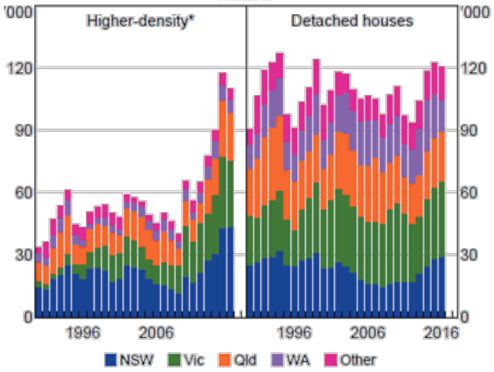
While the RBA is worried about the overall pace of lending growth, it also has concerns over the type of lending. In particular, it views the rapid growth of investor loans – and interest-only loans – as a potential problem. This explains why it imposed a 10% speed limit on investor lending growth, while interest-only loans are now limited to 30% of new mortgage approvals.

The restrictions on investor borrowing may have a disproportionately large impact on the NSW market, where around 50% of loans are made to investors.

That said, the restrictions relate to the banks' overall loan books, so banks could 'make room' for more lending in NSW by cutting back lending elsewhere.

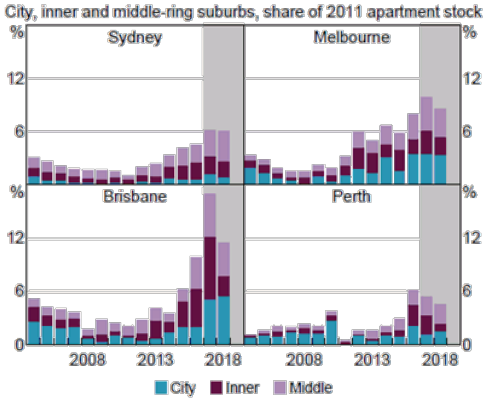
Regulators must also think about the impact of these restrictions on construction. The chart below highlights the massive shift towards high-rise apartment construction in the current cycle. Historically, NSW accounted for about half of high-density apartment approvals, but in the current cycle, that proportion has fallen to around 30%.

Dwelling Approvals
Number



This alludes to the fact that some cities – such as Brisbane and Melbourne – have a very large amount of stock that is poised to come onto the market. In our view, this suggests that it is these markets that are most at risk of the regulators' lending restrictions. The Sydney market still appears on track for a soft landing.

Estimated Apartment Completions
City, inner and middle-ring suburbs, share of 2011 apartment stock



Financial Markets Data

April 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)	2.00	0	–	0	–
90-day BBSW	1.75	-5	▼	-7	▼
5-year A-Rated Corporate Bond Yield	3.30	-8	▼	-34	▼
3-year Australian Bond Yield	1.80	-11	▼	-16	▼
10-year Australian Bond Yield	2.58	-13	▼	-19	▼
10-year Australian Break-Even Inflation	1.91	2	▲	-2	▼
10-year Australian Real Yield	0.66	-15	▼	-17	▼
Fed Funds Rate (lower bound)	0.75	0	–	25	▲
2-year US Treasury Yield	1.26	1	▲	7	▲
10-year US Treasury Yield	2.28	-11	▼	-16	▼
10-year German Bund Yield	0.32	-1	▼	11	▲

NSW TCorp Bonds	Close (%)	1 Month (bps)		CYTD (bps)	
6.00% 1 February 2018	1.71	-1	▼	-13	▼
3.50% 20 March 2019	1.82	-10	▼	-19	▼
6.00% 1 May 2020	1.98	-10	▼	-22	▼
4.00% 8 April 2021	2.13	-12	▼	-23	▼
6.00% 1 March 2022	2.24	-13	▼	-21	▼
4.00% 20 April 2023	2.42	-12	▼	-21	▼
5.00% 20 August 2024	2.57	-11	▼	-19	▼
4.00% 20 May 2026	2.78	-11	▼	-16	▼
3.00% 20 March 2028	3.03	-9	▼	-14	▼
3.00% 20 February 2030	3.24	-9	▼	-14	▼
3.75% 20 August 2020 CIB	0.42	-14	▼	-21	▼
2.75% 20 November 2025 CIB	0.81	-14	▼	-21	▼
2.50% 20 November 2035 CIB	1.32	-12	▼	-19	▼
10-year NSW TCorp Bond Yield	2.92	-9	▼	-11	▼
10-year TCV (Victoria) Spread	-0.03	0	–	-2	▼
10-year QTC (Queensland) Spread	0.18	0	–	0	▲
6.00% 1 February 2018	1.71	-1	▼	-13	▼

Equities	Close	1 Month		CYTD	
S&P/ASX 200 (Australia)	5,924	1.0%	▲	4.6%	▲
S&P 500 (US)	2,384	0.9%	▲	6.5%	▲
FTSE 100 (UK)	7,204	-1.6%	▼	0.9%	▲
DJ Stoxx 600 (Europe)	387	1.6%	▲	7.1%	▲
Nikkei 225 (Japan)	19,197	1.5%	▲	0.4%	▲
Shanghai Composite (China)	3,155	-2.1%	▼	1.6%	▲

Currencies	Close	1 Month		CYTD	
AUD/USD	0.75	-1.8%	▼	3.9%	▲
EUR/USD	1.09	2.3%	▲	3.6%	▲
USD/JPY	111.49	0.1%	▲	-4.7%	▼
GBP/USD	1.30	3.2%	▲	5.0%	▲
US$ Index	99.05	-1.3%	▼	-3.1%	▼

Commodities	Close	1 Month		CYTD	
Brent Oil (US$/bbl)	51.73	-2.1%	▼	-9.0%	▼
Iron Ore (US$/t)	68.80	-14.4%	▼	-12.8%	▼
Newcastle Coking Coal (US$/t)	225.10	51.8%	▲	22.5%	▲
Gold (US$/oz)	1,268.29	1.5%	▲	10.1%	▲