TCorp Local Government Services

Economic Commentary - October 2014

New South Wales Treasury Corporation

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The Month in Review

Economic and Market Trends

October marked the return of significant market volatility as investors became alarmed by weaker European growth and the impending end of the US Federal Reserve's asset purchase program. This volatility reached a crescendo on 15 October when 10-year US bonds – the most liquid market in the world – traded in a 37 basis point range during the day, and a measure of equity market volatility (VIX) spiked to 26, nearly double its average level over 2014.

This surge in volatility was all the more surprising as the economic data flow remained reasonable. The US unemployment rate fell to 5.9% in September as 236,000 new jobs were created. Jobless claims remain extremely low, suggesting the unemployment rate should continue to track lower over the next 6 months.

Moreover, the US corporate earnings reporting season suggests that US companies remain very profitable. With 88% of firms in the S&P500 having reported, 75% of companies have delivered earnings growth above expectations, with the overall earnings growth at 9.2% - nearly double equity analyst expectations.

The second key development was the sharp fall in oil prices. As this flows through to lower petrol prices, it will temporarily suppress inflation and support consumer spending as households are left with more spare change in their pockets at the end of the week.

While the volatility in markets led some members of the US central bank's policymaking committee (the FOMC) raise the prospect of continuing its asset purchase program, in the end, the strong economic data won out. And at its October policy meeting, the FOMC finally ended the program. The FOMC also conceded that the labour market had improved substantially and indicated that the timing of future rate hikes was entirely dependent on how the data evolves over 2015.

The third major development in October was the decision of the Bank of Japan (BoJ) to ramp up its asset purchase program. This not only entails buying additional Japanese Government bonds, but also Real Estate Investment Trusts, Exchange Traded Funds and equities. Since the BoJ's decision was announced, the Japanese equity market rallied 7.2%.

Australian economic data remained patchy, with retail sales growth stronger in September but building approvals weaker. Lower oil prices should, however, provide a boost to domestic spending as they will elsewhere in the world. The main local economic news over the last month were the Q3 inflation data. They revealed that inflation is falling towards the lower end of the RBA's inflation target, and will make the RBA more comfortable with easing policy should they become alarmed with the ebbing growth momentum.

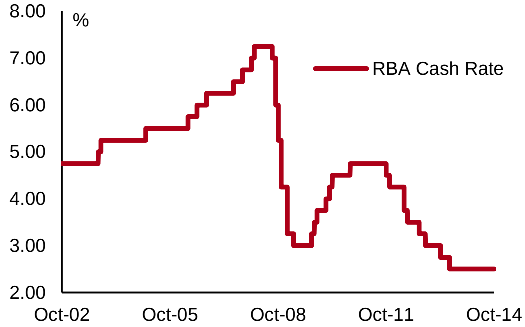
In Australia, the market incorporated some chance that the RBA could ease policy over the next 12 months. The long-end of the Australian yield curve fell more sharply. In equity markets, the ASX 200 rose by a healthy 3% over the month, but is 6% higher than its low point in early October. That said, equity valuations were still 3% lower than their recent high point reached in early September

But while volatility hit the equity bourses and fixed income markets in October, the A$ was fairly steady against most of the major currencies, but did strengthen against the Yen. After falling by 7% over September and reaching a low of US 86.75 cents in early October, the A$ was sitting around US 88 cents by the end of the month.

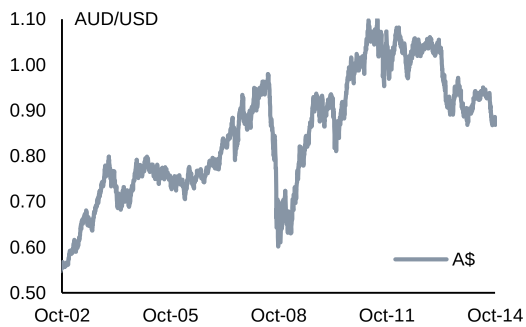
Financial/Economic Data

October 2014

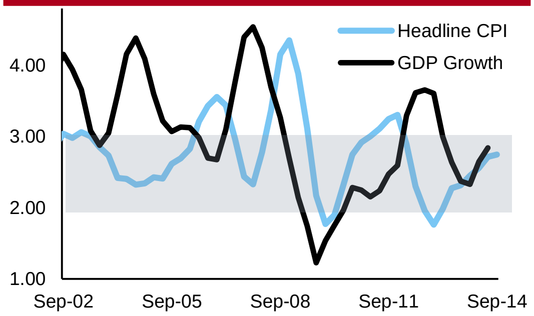
RBA Cash Rate



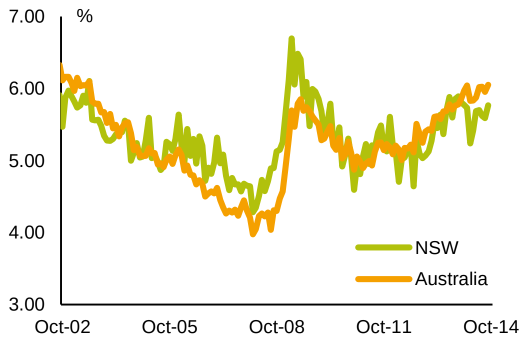
Australia Dollar



Australian Economy



Unemployment Rate

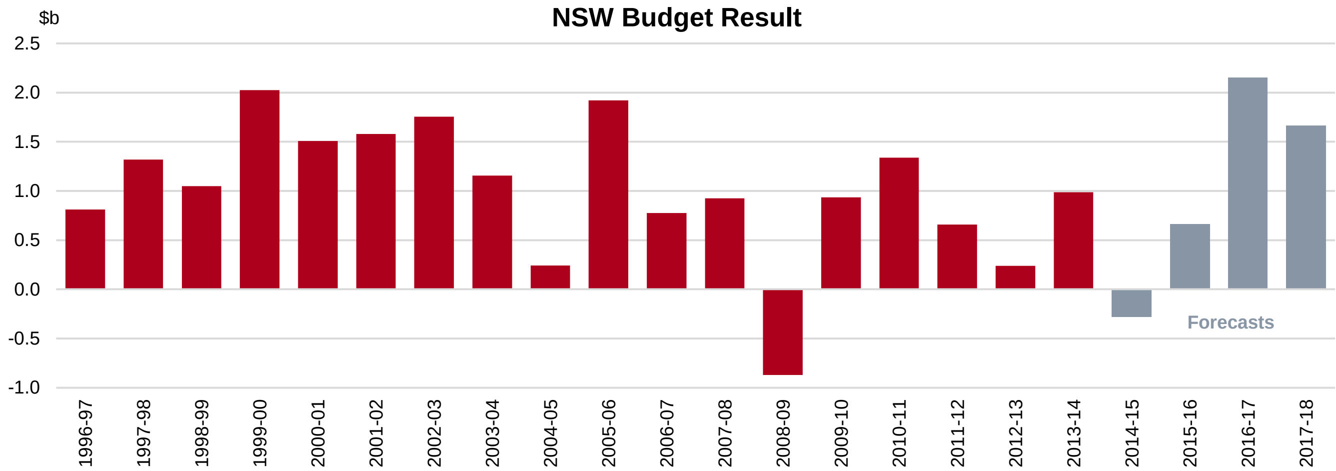


The State of NSW

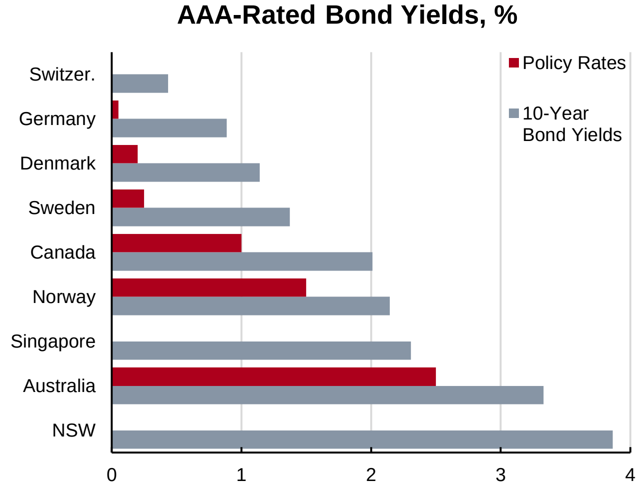
NSW keeps its AAA credit rating

Since the onset of the GFC, the number of AAA rated countries and corporates has collapsed. NSW's AAA credit rating (the highest possible rating) was confirmed in a recent review by the global credit rating agency Standard and Poor's (S&P). A credit rating of AAA is important for two key reasons. First, the entity with a AAA rating is able to raise debt with favourable conditions, such as lower borrowing costs. And second, a stronger credit rating attracts foreign capital given the very low risk of default from an investor's viewpoint.

According to S&P, for an entity to achieve a AAA rating, it needs to show very strong financial management and a high and stable revenue stream. S&P praised the NSW government for *"cutting spending in recent budgets to better align spending growth with slower revenue growth".* S&P also looked favourably on the NSW Government's ability to use its balance sheet to finance crucial infrastructure projects, rather than increasing debt levels. The NSW Government's long-term lease of the Port of Newcastle is a recent example of NSW's ability to privatise existing assets to raise funds for capital expenditure.



Elsewhere in the report, S&P also revised up its outlook for the NSW economy. S&P is aware of the challenges the Australian economy is facing given the impending declines in mining-related investment. But it also acknowledge that non-mining activity has been accelerating in response to lower interest rates set by the Reserve Bank of Australia. And given the State economy's orientation towards the services sector, much of the improvement has occurred in NSW. We have been positive on the underlying momentum of activity in NSW, and recent data still suggest that the State is growing more quickly than the rest of Australia. Importantly, a strengthening economy bodes well for revenue growth – an important aspect of S&P's credit rating assessment.



Market Movements and Economic Data

Financial Data	31 Oct	Monthly change	
Cash Rate	2.50%	0.00	–
Corporate Bond Yield*	4.05%	-0.07	▼
Term Deposit**	2.85%	0.00	–
ASX200	343	0.3%	▲
S&P500	1972	-1.6%	▼
AUD/USD	0.875	-0.059	▼
Economic Data***	**31 Oct**	**Quarterly change**	
Headline CPI	3.00%	0.10%	▲
Trimmed Mean CPI	2.90%	0.30%	▲
GDP Growth	3.10%	-0.30%	▼
House Prices	10.10%	-1.10%	▼
Unemployment Rate	6.10%	0.20%	▲

*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

What does this mean for NSW overall? The NSW Government will continue to be able to access cheaper funding than its peers, while global demand for NSW's debt will remain strong. Low financing costs will allow NSW to manage its costs more effectively, while stronger economic momentum will ensure a healthy revenue stream. Ultimately, a AAA credit rating will make it easier for the NSW Government to borrow and invest in the State economy, which will help in achieving sustainable growth.