TCorp Local Government Services

Economic Commentary - July 2014

New South Wales Treasury Corporation

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The Month in Review

Economic and Market Trends

Underlying inflation in the Australian economy was modestly stronger than market expectations in the June quarter, with the trimmed mean CPI reading rising 0.8% q/q (2.9% y/y). While this does not alter the outlook for inflation, financial markets are now only pricing a 40% (previously 70%) chance that the Reserve Bank of Australia (RBA) will cut interest rates over the next 12 months.

Nonetheless, the market is still of the view that further stimulus could be forthcoming, despite the RBA providing no encouragement for the view that they are even contemplating moving interest rates lower. Indeed, in a public speech given at the Anika Foundation Luncheon, the RBA Governor seemed to go out of his way to downplay expectations of a potential rate cut.

But while the RBA remains reluctant to cut rates further, the data remain equivocal as to whether that may be required. Building approvals fell 5% in June, Retail sales fell by 0.5% in May, while the unemployment rate rose to 6% in June. At the same time, housing finance was flat and inflation remains unthreatening.

That said, business confidence has held up at reasonable levels. And while that remains the case, it keeps alive the prospect that non-mining business investment, and hiring activity, will eventually improve. Likewise, a weekly measure of consumer sentiment suggests that confidence has recovered from the weakness brought about by the 2014/16 Budget. For this reason, it appears that the RBA is happy to remain patient and give the economy the benefit of the doubt for the time being.

An escalation of geo-political concerns in Europe has been a major talking point for markets in recent weeks. Despite that, these events haven't had a sustained impact on financial markets yet. While bond yields have edged lower, other assets that tend to benefit during "risk-off events" such as gold and oil have declined over the last month. At the same time, volatility remains low and spreads remain tight. Despite equities being relatively mixed over the month, the last trading day of July saw sharp falls in key global equity markets as a result of the Argentinean Government defaulting on its foreign debt obligations.

Market Movements

Month ending 31 July

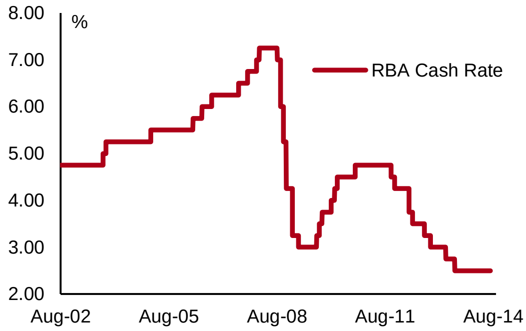
Financial Data	31 Jul	Monthly change	
Cash Rate	2.50%	0.00	–
Corporate Bond Yield*	4.00%	-0.06	▼
Term Deposit**	2.75%	-0.05	▼
ASX200	5633	4.4%	▲
S&P500	1931	-1.5%	▼
AUD/USD	0.930	-0.014	▼
Economic Data* **	**31 Jul**	**Quarterly change**	
Headline CPI	3.00%	0.10%	▲
Trimmed Mean CPI	2.90%	0.30%	▲
GDP Growth	3.50%	0.80%	▲
House Prices	10.90%	0.80%	▲
Unemployment Rate	6.00%	0.00%	–

*A 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

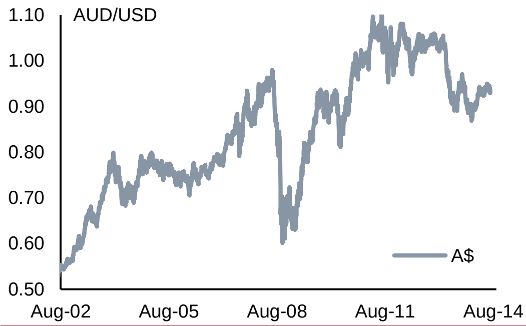
Financial/Economic Data

July 2014

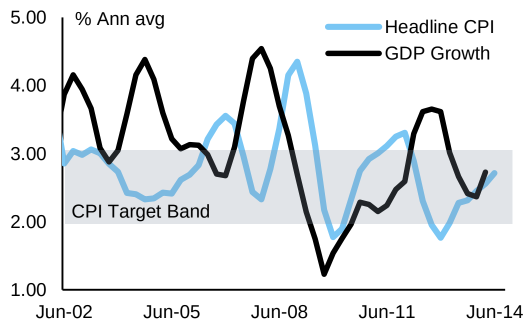
RBA Cash Rate



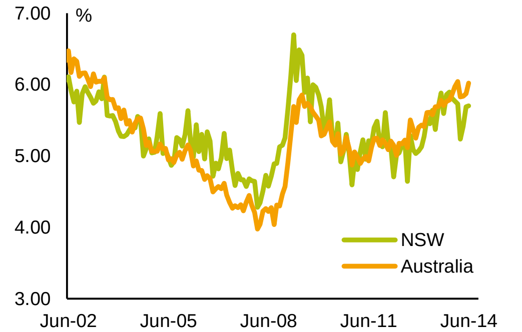
Australia Dollar



Australian Economy



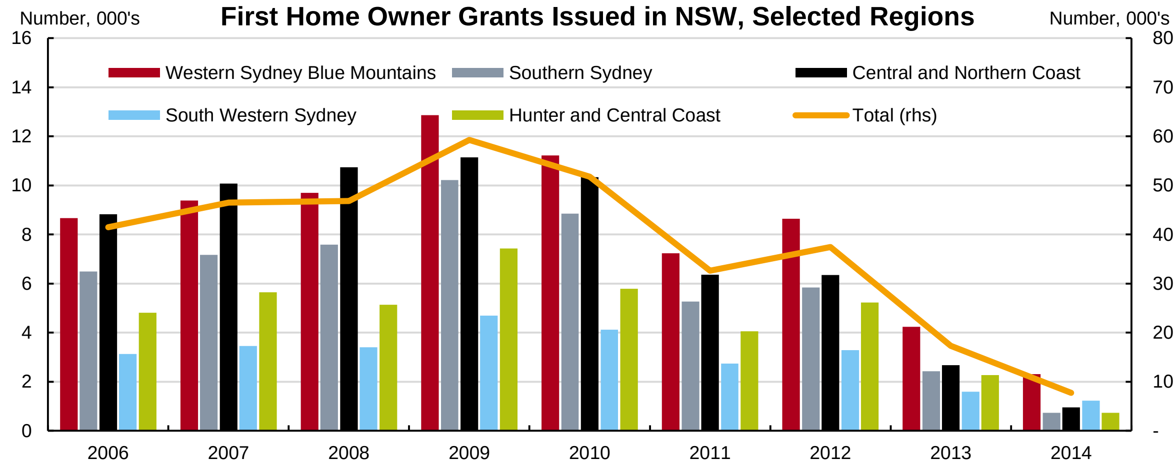
Unemployment Rate



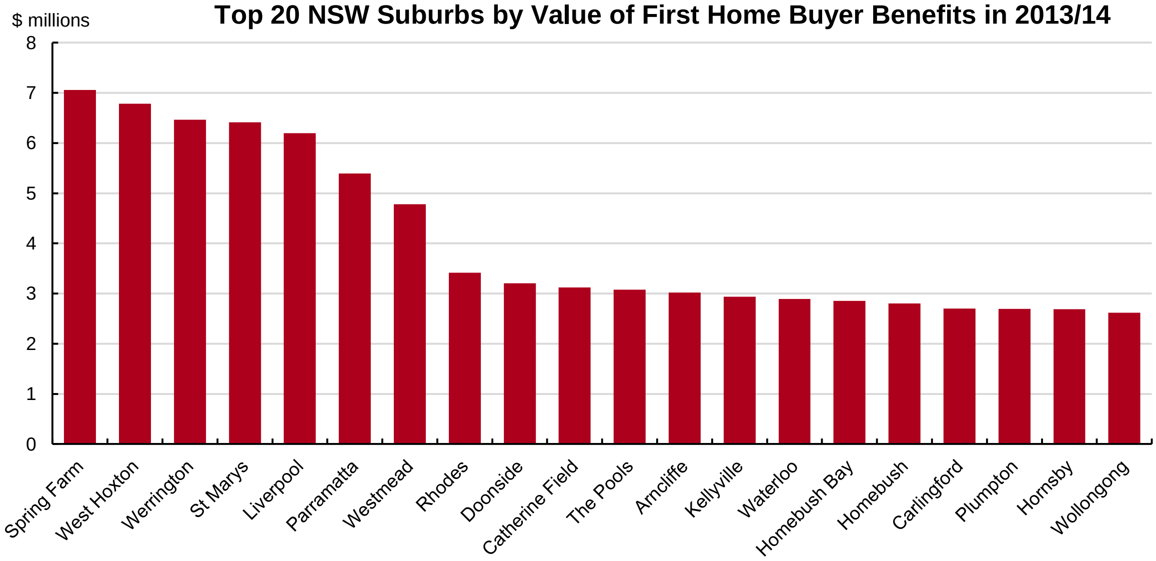
The State of NSW

Where is the housing recovery taking place?

A key challenge for Australian economic policymakers has been to revive household spending now that mining investment is declining sharply. And there has been a strong improvement in housing building approvals over the last year, as well as rising house prices. This recovery has been most obvious in New South Wales, where construction is likely to rise by around 20% over the next couple of years.



The main reason for the improvement in housing activity is the low level of mortgage interest rates. Another reason why housing construction is improving, however, may be the shift in the way in which first-home owner grants are paid, as they now provide an incentive for potential first-home buyers to purchase a newly constructed home or to build their own. Thus, while there are fewer first-buyer grants being issued, they are now directly boosting the supply of housing rather than simply adding to the demand for the existing housing stock. This is a better outcome for both home buyers and the economy.



In terms of where first-home buyers are heading, the chart above highlights that the top 2 performing suburbs (as measured by benefits paid to first home buyers) are South-western Sydney, while third and fourth place were in the Western Sydney and Blue Mountains regions. The data also show, however, the effects of urban infill policies, with areas like Parramatta, Rhodes, Waterloo and Arncliffe reflecting the shift towards apartment living near major transport hubs. With housing affordability a key driver of first-home buyer activity, popularity among these more affordable regions is likely to continue.