Monday, 29 June 2015

NSW Economic Outlook

Summary

- There continues to be a generally positive outlook for the NSW economy, which benefits significantly from the low interest rate environment. We expect healthy economic growth in coming years, and for a further pickup in GSP this year and next.
- Housing has been a strongly debated topic given the strong run up in Sydney dwelling prices in recent years. While we consider house prices as being high in comparison to incomes, we do not think that prices are primed for a large fall. A shortage of housing still exists in NSW despite the large run up in residential construction and this will provide support to prices. Demand is being supported by low interest rates and strong population growth.
- The strength in the housing market has flowed onto other areas of the NSW economy, including residential construction and retail spending. Dwelling investment will support economic activity this year. The positive wealth effect from rising house prices is providing support to consumer spending.
- Non-residential construction is also at healthy levels, boosted by a solid pipeline of road and rail infrastructure by the NSW State Government. Better conditions in the retail sector and labour market and a lower Australian dollar also provide promising prospects for the medium-term outlook for investment.
- The NSW labour market continued with a solid run of job growth, with the pace of growth picking up in recent months. The unemployment rate edged down from a recent peak of 6.2% in February to 5.7% in May, the lowest in unemployment rate in almost a year. A solid economic outlook suggests that employment growth should continue at a healthy clip and that the NSW unemployment rate may have peaked earlier this year.

Economic Growth

There continues to be a generally positive outlook for the NSW economy, which benefits significantly from the low interest rate environment. Demand for housing has risen greatly as a result, and Sydney's housing market has become a widely discussed topic. While rising prices have caused some concern about risks to financial stability along with raising broader social concerns, it has helped to support the economy through residential construction and consumer spending. Low interest rates also provide support to the financial services industry, which has a large presence in Sydney, and a gradual pickup in credit growth will help underpin economic activity.

Percentage Shares of the Economy*

Industries	**NSW**	**Australia**
Financial and insurance services	15.1	9.9
Professional, scientific and technical services	8.7	7.5
Manufacturing	8.4	7.5
Health care and social assistance	7.5	7.6
Construction	6.2	9.4
Public administration and safety	6.1	6.3
Education and training	5.6	5.4
Transport, postal and warehousing	5.5	5.6
Retail trade	5.3	5.3
Wholesale trade	4.8	4.6
Information media and telecommunications	4.6	3.3
Administrative and support services	4.2	3.3
Rental, hiring and real estate services	3.9	3.2
Mining	3.2	9.6
Accommodation and food services	3.2	2.7
Electricity, gas, water and waste services	2.9	3.2
Other services	2.3	2.1
Agriculture, forestry and fishing	1.5	2.7
Arts and recreation services	1.2	0.9

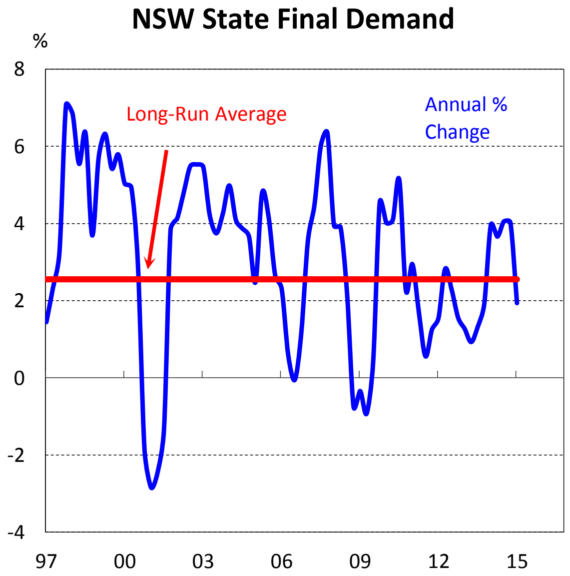
** As % of GSP and GDP less ownership of dwellings 2013-14*
Source: ABS, St.George

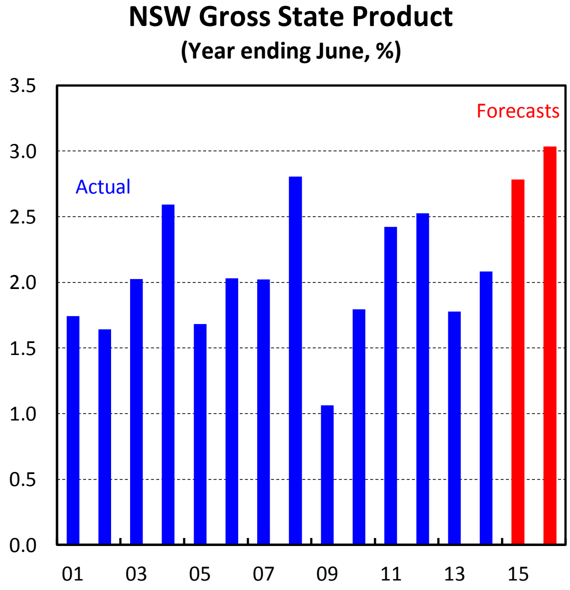
In 2013-14, the NSW economy grew by 2.1%, just above the 10-year average of 2.0%, and appears on track for a further pickup in growth in coming years.

State final demand grew at a modest pace of 0.5% in the March quarter for annual growth of 1.9%. While the annual rate was below par, it partly reflects volatility in the data, and will likely pickup in coming quarters.

NSW is experiencing a lift in retail spending, strong levels of residential construction and there is an elevated level of investment projects in the pipeline. Low interest rates and rising house prices are supporting growth in the State.

The ongoing transition in growth drivers in the Australian economy from one led by mining investment to other sectors suggest NSW will benefit greatly. Tourism, international education, wealth management, gas and agribusiness have been considered as potential areas of strong growth. Many of these sectors have a strong presence in the NSW economy and NSW has the potential to take advantage of these key growth areas.





Consumer Spending

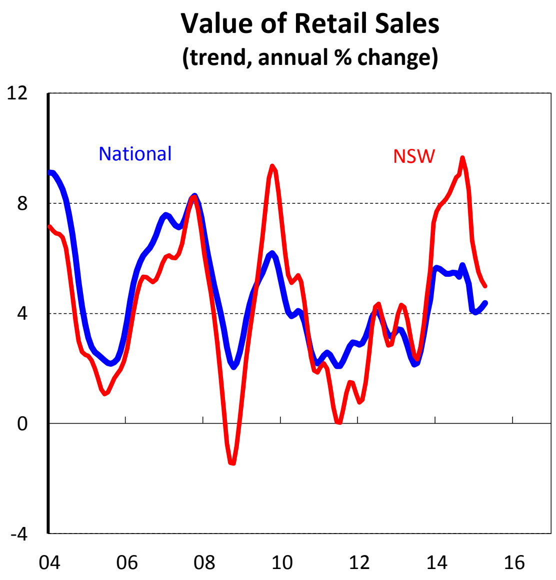
The pace of growth in retail sales in NSW has slowed from the 9%-plus growth experienced in the second half of last year. However, with growth of 5.0% in the year to April in trend terms, growth in NSW retail sales is above its long-term average and compares favourably to most other States and territories.

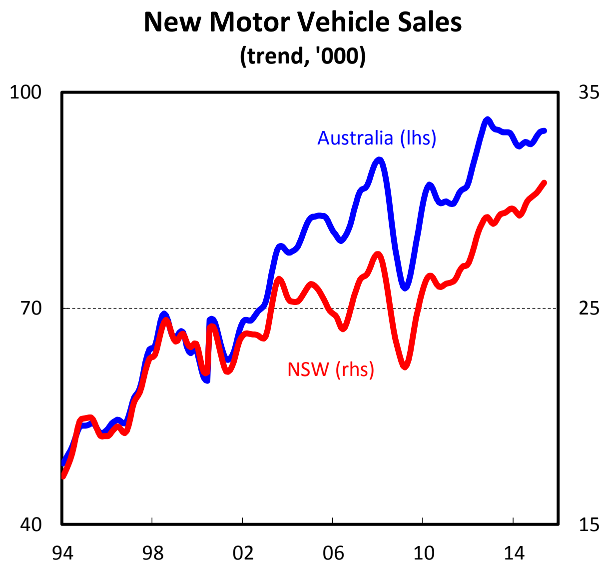
A positive wealth effect from rising house prices and a rising sharemarket over the past year has been supportive for consumer spending, particularly in NSW where house price gains have outpaced other States and territories. Ongoing low interest rates have taken some pressure off household budgets and a more positive response to this year's Federal Budget (compared to last year) has supported consumer sentiment.

Sales in some sectors have been very strong. In the year to April, spending on electrical and electronic goods rose 15.4% and spending on furniture, floor coverings, housewares and textile goods retailing rose 9.5%, likely reflecting the impact of the stronger housing market. Some sectors not directly impacted by the housing market also showed solid growth including spending on footwear and other personal accessory retailing (11.9%) and takeaway food services retailing (11.7%). These sectors may have benefited from low interest rates.

The overall strength of retail spending in NSW is exemplified by the real quarterly volume of sales i.e. sales adjusted for inflation. Retail sales volumes rose 3.9% in the year to the March quarter in NSW, the strongest performance of any of the States and territories and above the long run average of 2.8%.

Sales of motor vehicles are a significant portion of consumer spending. NSW has seen strong growth in vehicles sales since 2011 with the monthly average of sales rising from 26,301 in 2011 to 30397 during 2015 so far, hitting a record high in March 2015. Over the twelve months to April, NSW motor vehicle sales have increased 3.6%, compared to 2.8% nationally.





Consumers have been relatively upbeat in NSW according to the Westpac-Melbourne Institute survey of consumer sentiment. The index for NSSW has held above 100 for six consecutive months signaling consumers are more optimistic than pessimistic. After the Federal Budget, the index lifted to 111.1 in May, a 13-month high but fell in June to 103.6. The buoyant housing market, improvement in the labour market and the low interest rate environment are helping to boost the mood of NSW residents.

Looking ahead, it seems likely that interest rates will remain low, the population will continue to grow via migration and construction levels will remain firm. These should support growth in consumer spending over the next twelve months.

Housing

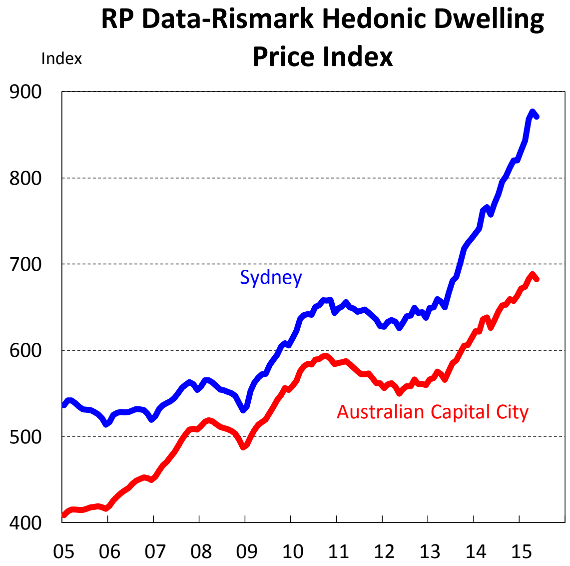
The residential housing market in NSW has remained robust this year, driven by low interest rates and a rising population. Sydney has the highest house prices and largest mortgages of all capital cities. As such, the NSW housing market has been the greatest beneficiary of historically low interest rates.

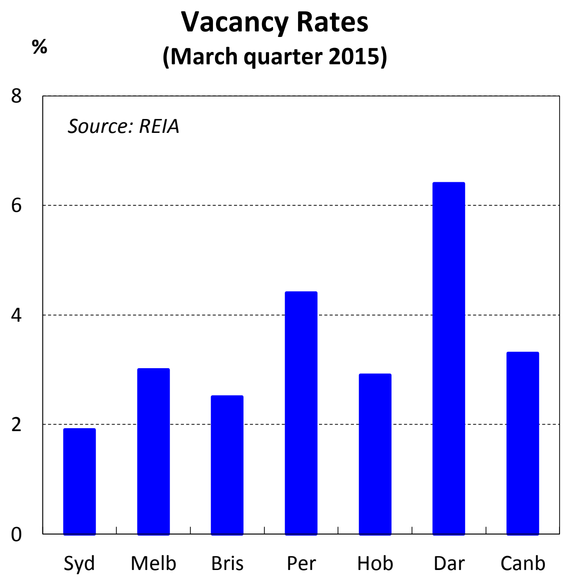
According to RP Data Corelogic, Sydney dwelling prices were up 15.0% in the year to May. Although this is down from a cyclical peak of 16.7% in the year to April 2014, it remains solid and lifted from an increase of 14.5% in the year to April. After a strong run of 11 consecutive monthly gains in Sydney dwelling prices, they slipped 0.7% in May, which followed an average monthly increase of 1.7% in the first four months of 2015.

The debate surrounding a housing bubble has heated up, particularly given some recent concerns raised by key policy makers including RBA Governor, Glenn Stevens. We consider house prices as being high in comparison to incomes. However, it has not been accompanied by a significant increase in leverage. After taking into account balances in offset accounts and redraw facilities, household gearing levels have actually declined.

Additionally, a shortage of housing in NSW is continuing to support house prices. The recent surge in residential construction will only mildly dent the shortfall. To put this into perspective, in the year to the December quarter 2014, there were 49.3k new homes built in NSW. This is only slightly greater than the needs of NSW's new population. The shortage has built up over time given rapid population growth (particularly in the area of overseas migration) and weak home building in the period 2006-2011. While home construction has accelerated in the past three years, it has only just caught up with the needs of the growing population. Hence, the shortage and hence the upward pressures on prices.

These factors would suggest that house prices in Sydney are not primed for a large fall in the near-term.





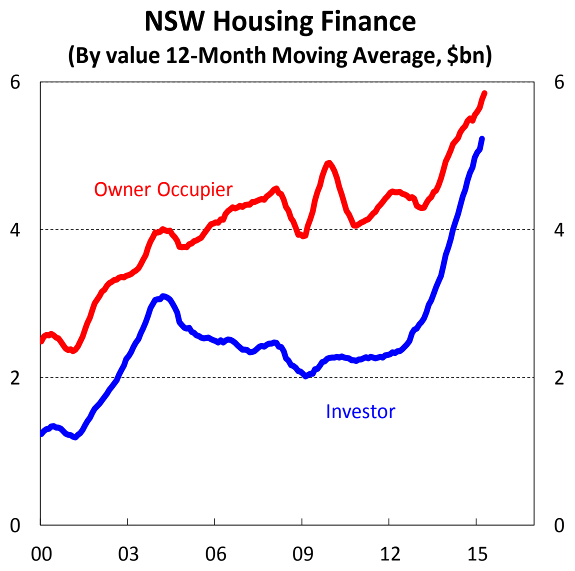
The shortage of housing has contributed to low rental vacancy rates in Sydney. Vacancy rates have risen over the past year, but rental markets remain tight. The Sydney vacancy rate stood at 1.9% in the March quarter 2015, and continued to be the lowest vacancy rate of all the capital cities. Vacancy rates below 3% are indicative of tight rental markets and strong demand for rental accommodation and below 2% is considered very tight. Sydney median weekly rents for 3-bedroom houses in the year to the March quarter 2014 were unchanged at $450, while rents for 2-bedroom 'other dwellings' rose 4.0% to $520.

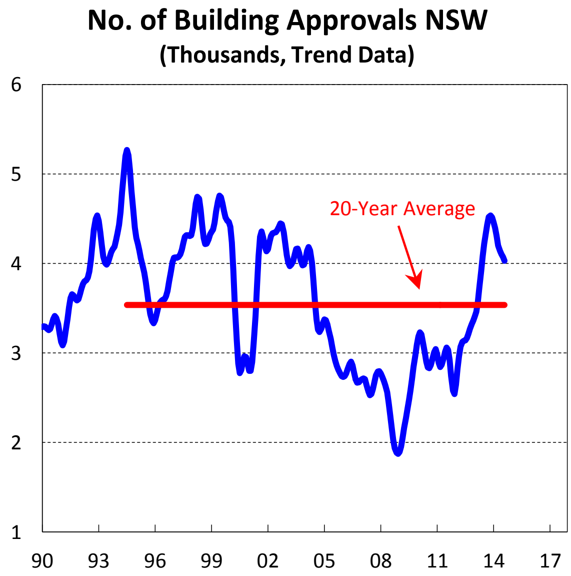
Investor demand for housing in NSW has picked up strongly in the past three years suggesting that investors have been encouraged by attractive rental yields, a low interest rate environment and rising house prices, although yields have fallen recently. Tight rental markets continue to suggest strong demand for rental accommodation. The Australian Prudential Regulation Authority (APRA) placed additional restrictions on growth in lending to investors in December last year, which may be acting to curb investor demand.

Owner-occupier demand for housing remains strong and in trend terms, finance for housing is currently at record levels. Over the past twelve months 52.5% of finance for housing has been for owner-occupier purposes, while finance for investor housing makes up the other 47.5%. A year earlier investor housing made up 43.7% and two years earlier it stood at an average 39.4%.

Rising prices and changes to State policy have held back the reported number of first-home buyers in NSW. First-home buyers in NSW as a percentage of all dwellings financed were 11.1% in April 2015, which is not far above the record low of 9.3% in July 1991. While affordability remains an issue for first home buyers, it is likely some first-home buyers have become housing investors and do not appear in 'first-home buyer' statistics, 'muddying' the statistics.

Strong growth in house prices in Sydney in recent years have been negative for first-home buyers and present an affordability issue for non-home owners. For home owners, however, rising house prices cause a positive wealth effect, which boosts consumer confidence and spending.





Dwelling price gains in Sydney in the year ahead seem likely to be more moderate than those seen over the past twelve months. While demand remains strong, investors are seeing yields decline as prices rise and the short-term outlook for capital gain appears less certain than a year or two earlier.

Above average levels of building approvals will ensure healthy levels of home construction in NSW this year, which will help boost economic activity and ease the undersupply of housing in the State.

Business Investment and Infrastructure Spending

The pace of growth in business investment in NSW has recently slowed to 1.2% in the year to the March quarter, down from 9.5% in the previous quarter. Private capital expenditure has similarly weakened after hitting a three-year high in the December quarter 2014, although remained 4.1% higher than a year ago.

A weak recovery in non-mining investment across Australia poses some concern for business spending in NSW. However, there is a healthy number of projects that will keep activity at an elevated level.

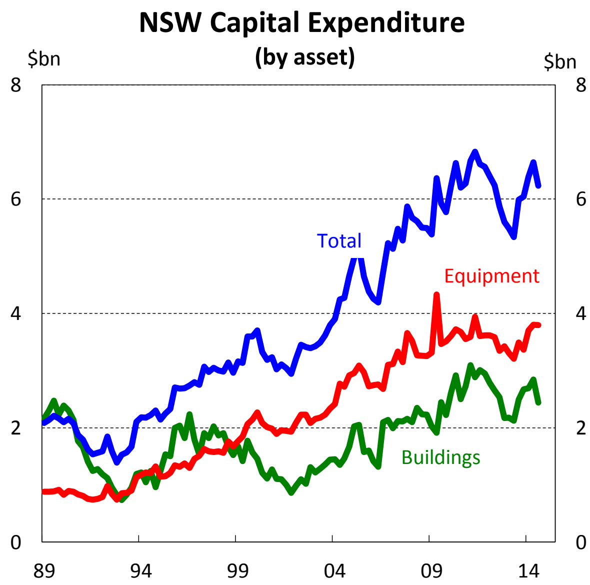
Within commercial construction, the most notable project continues to be Barangaroo, worth $6bn, which will underpin activity over the next few years. Other large projects include the Darling Harbour Live project, which includes the new Sydney Convention and Entertainment Centre worth $900mn and a new hotel worth $250mn.

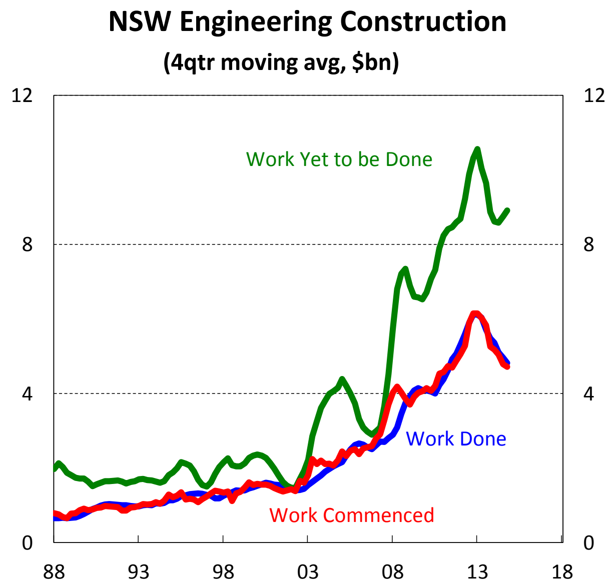
Much of the big money is within infrastructure spending or engineering construction. Transport projects leading the work underway including the $8.3bn North West Rail link. The WestConnex road project is the largest project in the pipeline, linking Sydney's M4 and M5 motorways through to the Sydney CBD and Sydney Airport. It is estimated to be worth around $11.5 billion. Work on Stage 1, which includes the M4 widening, has commenced, and will take around 10 years to deliver in 3 stages.

In the recently announced NSW State Budget 2015-16, the State government has allocated $68.6 billion in funding for infrastructure spending over the next four years. This will be spent on previously announced road and rail projects. Another $5bn has been allocated for hospital upgrades, redevelopments and expansions across the State.

Within the mining sector, falling commodity prices are taking their toll on the investment outlook. The pipeline of projects has continued to dwindle, according to official estimates. There were six mining projects at the committed stage of development as of April 2015 worth $2.5bn. This was down from seven projects worth $2.8bn in October 2014. These are projects which have received final investment approval or are currently under construction. The large fall in thermal coal prices and the risk that prices will remain muted suggests a weak outlook for future resources and energy projects within NSW.

Prospects for new business investment in the near term are expected to lie outside of the mining sector within NSW. Encouragingly, confidence among businesses in the State has improved following a more palatable Federal Budget in comparison to last year. A further sustained lift in confidence, better conditions within the retail sector and other flow on effects from Sydney's buoyant housing market should support the medium-term outlook for investment.





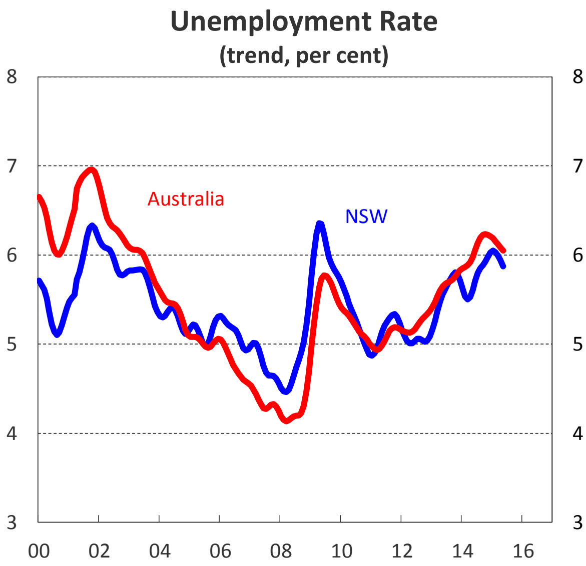
Labour Market

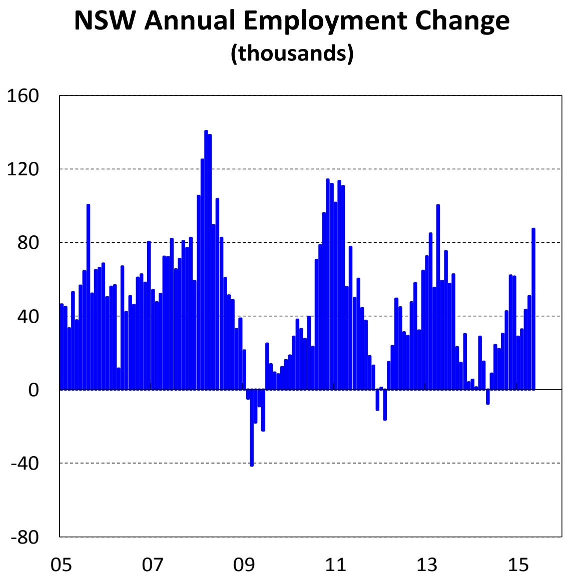
The NSW labour market continued with a solid run of job growth, with the pace of growth picking up in recent months. In the year to May, the NSW economy added 87.6k jobs, the largest annual gain in two years.

Solid job gains have resulted in the unemployment rate edging down from a recent peak of 6.2% in February to 5.7% in May, the lowest in unemployment rate in almost a year. It sits below the nationwide unemployment rate of 6.0%.

Recent job gains have been concentrated in healthcare and social assistance (66.7k), professional, scientific & technical services (42.3k), retail trade (16.4k) and accommodation & food services (15.7k). These are services largely tied to consumer spending, which are benefiting from low interest rates.

Strengthening activity within housing construction and a more promising outlook for business investment suggests that employment growth should continue at a healthy clip and that the NSW unemployment rate may have peaked earlier this year.





St.George Banking Group Forecasts

The NSW economy is set for healthy economic growth in coming years. Low interest rates and strong population growth are expected to support dwelling investment. Further private and public spending on road and rail infrastructure will ensure solid levels of non-residential construction which in turn will lift employment and retail spending. The housing upswing has also boosted the State government's coffers, therefore fiscal spending will likely have a more positive impact on growth in comparison to other parts of the country. We expect NSW gross State product (GSP) to gradually pick up modestly to 2.8% in 2014-15 and 3.0% in 2015-16.

Economic Indicators, % Change (year average)				
	2013-14	**2014-15 (f)**	**2015-16 (f)**	**2016-17 (f)**
Gross State Product	2.10	2.80	3.00	2.70
State final demand	2.90	3.00	3.10	3.10
Employment	0.60	1.30	2.00	1.70
Unemployment rate (year average)	5.70	5.90	5.70	5.60
Sydney CPI	2.60	1.80	2.20	2.50
Wage Price Index	2.50	2.40	2.10	2.70

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