NSW Economic Outlook

Summary

- NSW is expected to benefit from shifting growth drivers in the economy and is set to outperform growth Australia-wide. Low interest rates, a solid pipeline of infrastructure projects, a rising population and positive wealth effects should all contribute to good growth over the next twelve months.
- Rising house prices and robust construction activity are spilling over into retail spending. While still patchy nationally, aggregate retail spending in NSW has surged in recent months and the outlook for 2015 is positive. Consumer sentiment in NSW is well above the national average.
- Strong home sales during 2014 have delivered the State government solid stamp duty revenue. With an election due in early 2015, State government spending is unlikely to be a drag on economic activity.
- Growth in State final demand for NSW was strong in the June quarter and remained above its long-term average, in annual terms, for the first half of the year. Suggestions are that demand has remained firm in the second half of 2014 and can continue into 2015.
- The 2014-15 NSW State Budget indicated Government spending on infrastructure will be supportive of growth over the next four years. The next State election is scheduled for March 2015.
- Sydney house prices continue to rise at a solid clip. Both domestic and foreign demand are adding to the upwards pressures. Investor demand remains firm, despite some decline in rental yields. An undersupply of housing, a rising population and growth in jobs suggest that prices are unlikely to turn down in the near term.
- The labour market in NSW has fared relatively well, in comparison to Australia-wide. The unemployment rate in the State has been broadly stable over the past year, and in trend terms stood at 5.8% in October.
- We expect NSW gross State product to pick up in 2014-15 to 3.0%, up from 2.1% in 2013-14. If achieved this would be the fastest pace of growth in NSW in 15 years.

Economic Growth

NSW continues to benefit from the shifting growth drivers in the Australian economy and should outperform other States in 2014-15. The stronger growth in NSW over the past year is a welcome change from its previous status as a laggard over the past decade. The mining investment boom over that period and the accompanying higher interest rates weighed more heavily on NSW given its higher house prices, larger than average mortgages and the relative size of the NSW mining industry.

Percentage Shares of the Economy*

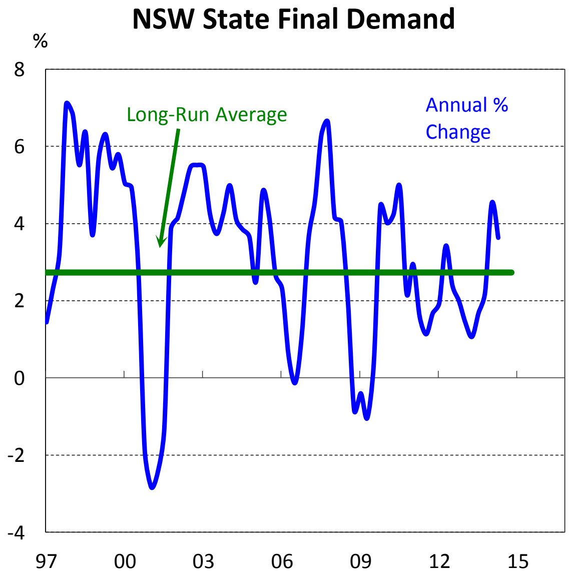
Industries	NSW	Australia
Financial and insurance services	15.1	9.9
Professional, scientific and technical services	8.7	7.5
Manufacturing	8.4	7.5
Health care and social assistance	7.5	7.6
Construction	6.2	9.4
Public administration and safety	6.1	6.3
Education and training	5.6	5.4
Transport, postal and 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	1.1	0.9

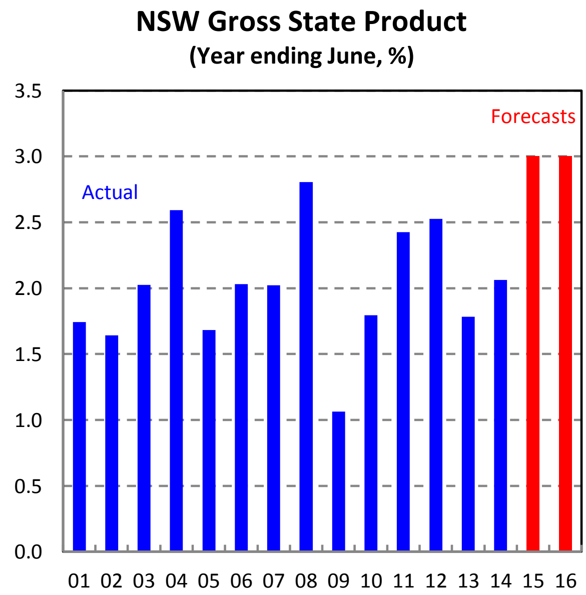
** As % of GSP and GDP less ownership of dwellings*
Source: ABS, St.George

Annual growth in NSW State final demand was above its long-run average in the first half of 2014 and there is little indication of a significant slowdown in the second half. In the year to June, State final demand grew by 3.6% compared to the 10-year average of 2.7%.

NSW is experiencing a lift in retail spending and strong levels of residential construction. These trends are due to modest growth in jobs, but more importantly upon the wealth impact of rising house prices and a firmer sharemarket. Low interest rates, population growth and infrastructure spending are also acting to stimulate demand.

Over the long-term, industries such as tourism, international education, wealth management, gas and agribusiness have been considered as potential areas of strong growth. The recent trade agreement with China will enhance that view. 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

Consumer spending in NSW has grown at a pace previously associated with the resources-dominated State of Western Australia and the Northern Territory. Over the year to September, nominal growth in retail spending in NSW rose 8.6% in trend terms.

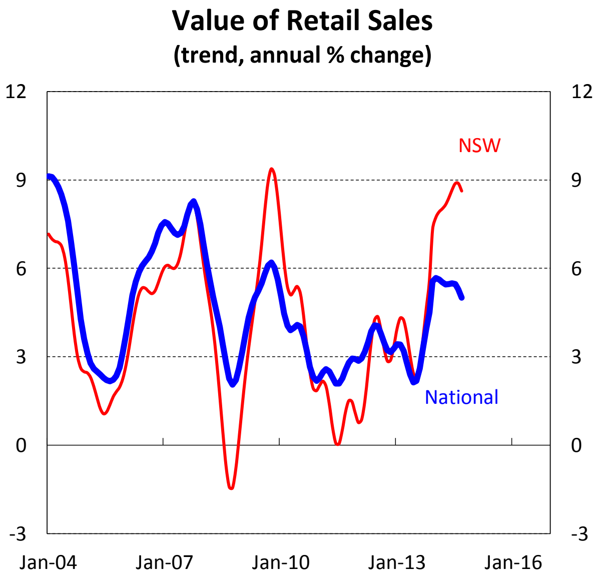
While the growth in retail spending may not be distributed evenly across NSW, it suggests that in many regions, purse strings have been substantially relaxed. Sitting behind the growth in spending are the wealth effects flowing from rising house prices and a rising sharemarket. Ongoing low interest rates have taken some pressure off household budgets while over the year to October the creation of 35,000 jobs in NSW has added to levels of income.

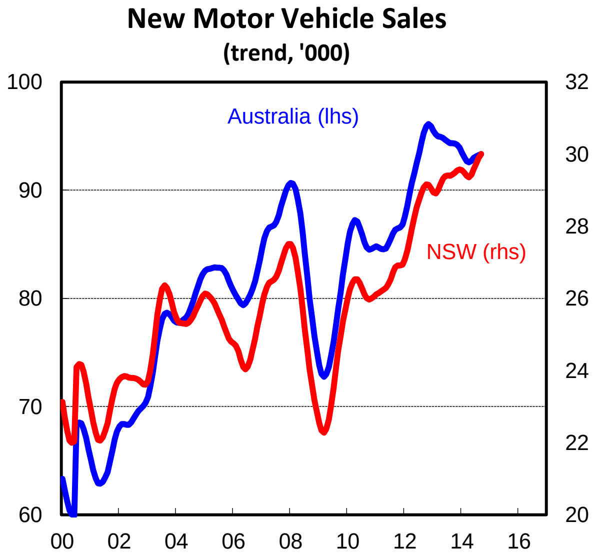
Sales in some sectors have been outstanding. In the year to September, spending on furniture, floor coverings, housewares and textile goods has risen 26.4%. This is likely a reflection of the strong levels of activity in housing construction and home sales. Also associated with housing were the strong results of electrical and electronic goods (16.8%) and hardware, building and garden supplies (17.4%).

Not all the upside in retail in NSW is directly related to housing. Spending on takeaway food services has risen 16.9% over the year and sales of footwear & other personal accessories have risen 15.0% in the past twelve months.

The overall strength of retail spending in NSW is exemplified by the real quarterly volume of sales i.e. sales adjusted for inflation. While nominal sales rose 8.6% in trend terms, the volume of sales rose a very healthy 6.4% (the fastest rate in 3½ years).

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 29,681 during 2014 so far, an increase of 12.8% over three years. Over the past twelve months growth has been modest but the new and higher level of sales has been maintained.





In NSW, consumer sentiment has rebounded from its post–budget lows. As of November, the Westpac-Melbourne Institute of consumer sentiment index for NSW stood at 102.5 compared to 96.6 for Australia. Sentiment was even stronger in Sydney where the index stands at 107.5. Results above 100 indicate that there are more optimists than pessimists. As noted earlier, job creation, low interest rates, infrastructure spending, rising house prices and extensive home building activity is lifting the spirits and the spending power of those living in NSW.

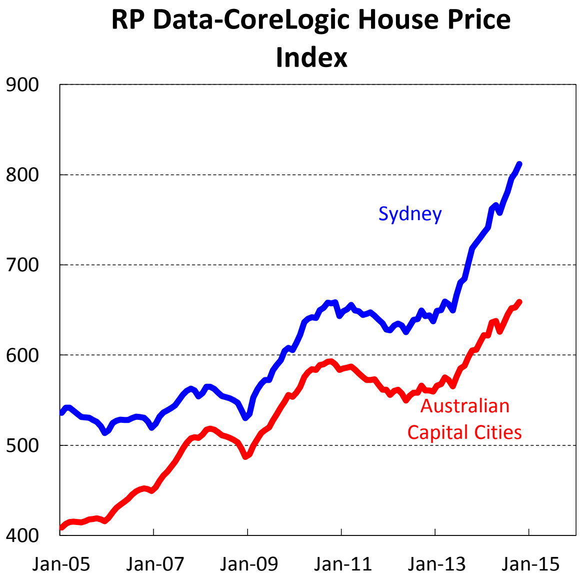
Looking ahead, it seems likely that interest rates will remain low, the population will continue to grow via migration and construction levels will remain firm. These should support growth in consumer spending over at least the next twelve months.

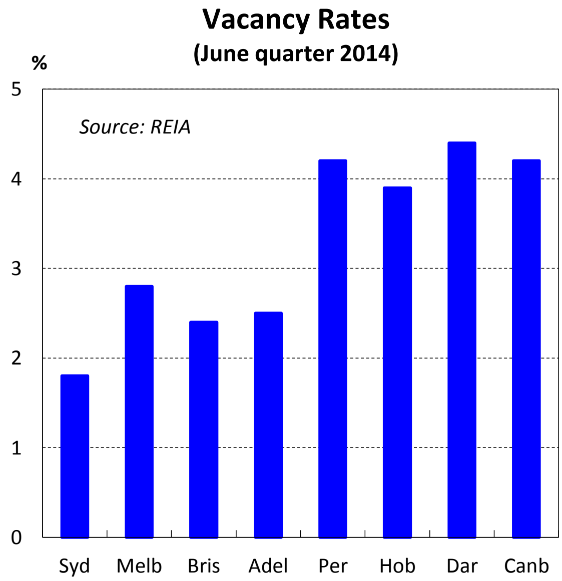
Housing

The residential housing market has improved further 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-Rismark, Sydney dwelling prices were up 13.1% in the year to October. While firm, this is less than the recent peak of 16.7% growth in house prices seen in the year to April.

According to BIS Shrapnel, the undersupply of housing in NSW in 2013 was 46,500. In 2014 this was estimated to have risen to 53,900 and for 2015 they estimate an undersupply of homes of 55,700. Sitting behind these estimates are rapid population growth (particularly in the area of overseas migration) and a paucity of home building in the period 2006-2011. While home construction has accelerated in the past three years, it remains behind the needs of the population. Hence, the shortage and hence the upward pressures on the existing stock.



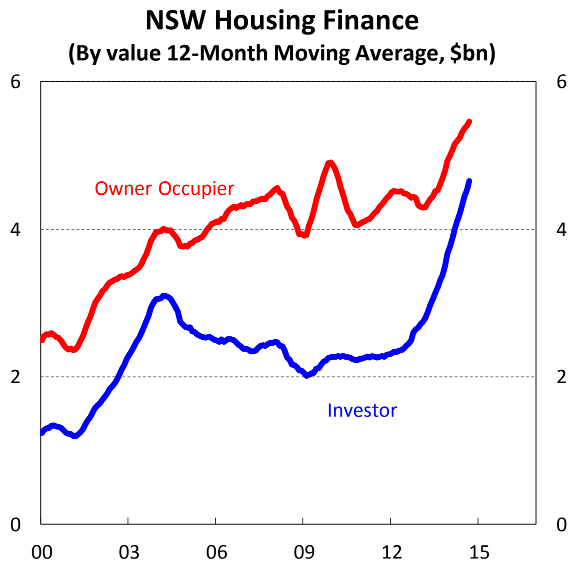


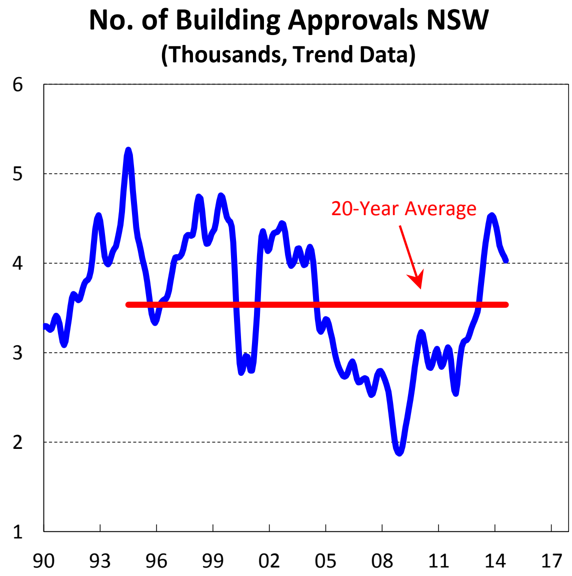
The shortage of housing has contributed to low rental vacancy rates in Sydney. These stood at 1.8% in the June quarter, the lowest vacancy rate of all the capital cities. A year earlier the vacancy rate stood at 2.1%. Vacancy rates below 3% are indicative of tight rental markets and strong demand for rental accommodation and below 2% is considered very tight. Sydney median weekly rents for 3-bedroom houses in the year to the June quarter 2014 rose by 7.1% to $450, while rents for 2 bedroom 'other dwellings' rose 5.3% to $495.

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.

Owner-occupier demand for housing remains strong and in trend terms, finance for housing is currently at record levels. Over the past twelve months 54.0% of finance for housing has been for owner-occupier purposes, while finance for investor housing makes up the other 46.0%. A year earlier investor housing made up 41.7% and two years earlier it stood at 36.0%.

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 just 8.5% in September 2014. This was a touch off its low of 6.8% in September 2013, however, the suggestion has been made that many first-home buyers have become housing investors and this has 'muddied' the statistics.





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. We also face the prospect in late 2014 of the RBA and APRA making at least a preliminary announcement regarding the introducing as yet unspecified restrictions on finance for housing late.

Above average levels of building approvals will ensure healthy levels of home construction in NSW in the first half of 2015 but it is certain how this will impact upon prices.

Business Investment and Infrastructure Spending

Business investment has been uneven in NSW, declining 1.2% in the year to the June quarter, following annual growth of 8.1% in the March quarter. Capital expenditure in NSW, however, appears to have recovered from recent lows recorded in December last year, and grew at an annual pace of 5.8%. The mixed outcome reflects the transition occurring in the Australian economy as well as in NSW. Mining investment is weakening and providing a drag on the NSW economy. Meanwhile, non-mining investment has been recovering, but at a gradual pace.

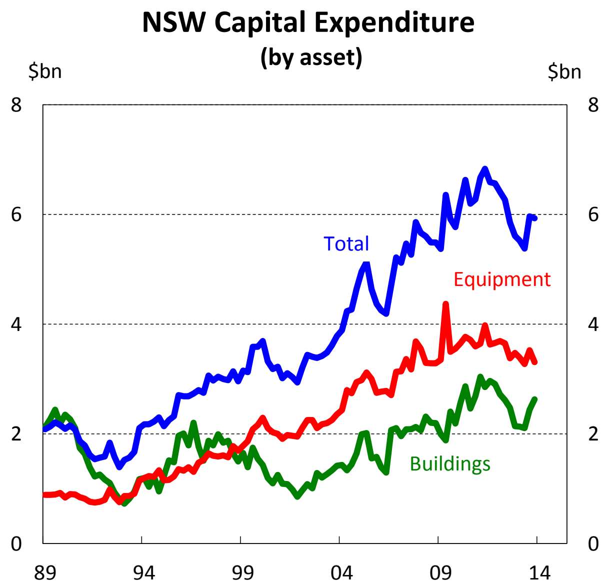
Some of the recent recovery in non-mining business investment has been driven by commercial construction. The $6bn Barangaroo development is leading construction in this sector and will continue to support activity for the next few years. There is also the Darling Harbour Live project estimated to be worth $1bn.

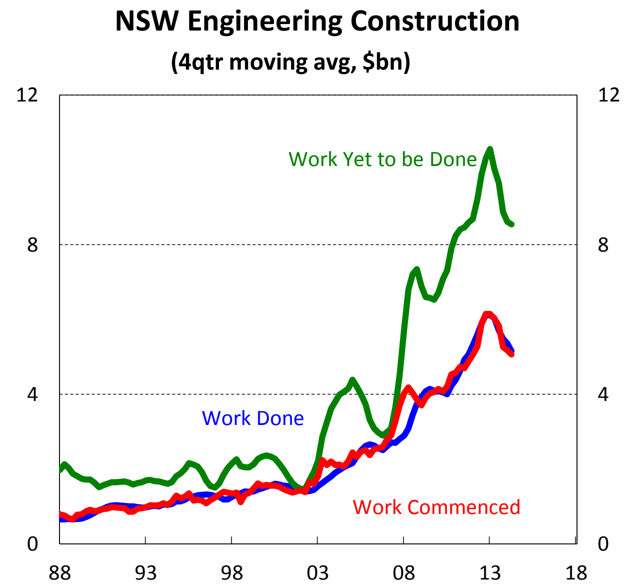
Infrastructure spending (engineering construction) is also set to remain at elevated levels, reflecting the pipeline of road and rail infrastructure. This is despite some softening in engineering activity in recent quarters. There are currently a number of projects underway including the$8.3bn North West Rail Link and the $2.0bn South West Rail link. The biggest project in the pipeline is the WestConnex to link Sydney’s M4 and M5 motorways through to the Sydney CBD and Sydney Airport, estimated to be worth around $11.5 billion. Construction on the first stage of the project is due to commence in 2015 with the final third stage due to finish in 2023. The $3bn NorthConnex road project, joining the M2 to the M1, may begin construction in 2015 and due is for completion in 2019.

Within the mining sector, the pipeline of projects is diminishing, reflecting the impact of lower commodity prices. As of April, the Bureau of Resources and Energy Economics (BREE) estimated that a total of ten projects worth $3.0bn were at the committed stage in NSW. This was down from 15 projects worth $6.4bn at the committed stage in October 2013. These are projects which have received final investment approval or are currently under construction. The majority of projects are within the coal industry including coal mine projects or infrastructure to support coal transportation. The relatively large fall in the price of thermal coal suggests that potential coal projects are less likely to receive the go ahead in the near term.

Development within NSW's coal seam gas industry could also affect the outlook for business investment. The Narrabri Gas project in northwest NSW and the Gloucester gas project are still in the early stages of development, but face hurdles regarding environmental concerns.

Outside of mining, the outlook for business investment in NSW continues to hinge on businesses having sufficient confidence to expand and invest. The hope is that the resurgence in housing construction and a lift in consumer spending will feed into stronger investment activity over the next few years.





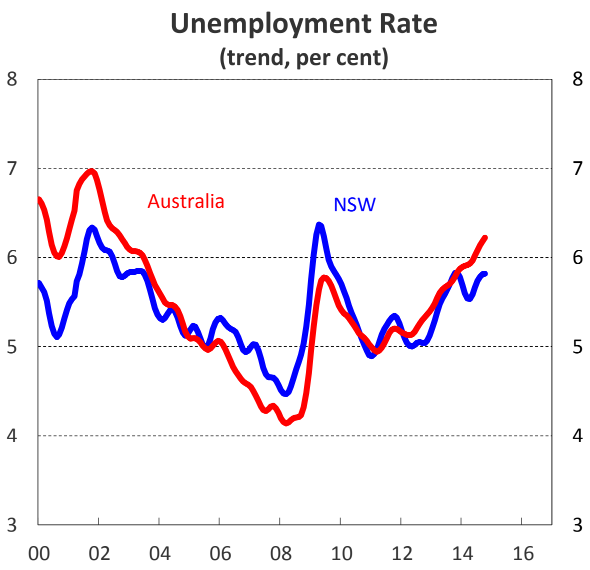
Labour Market

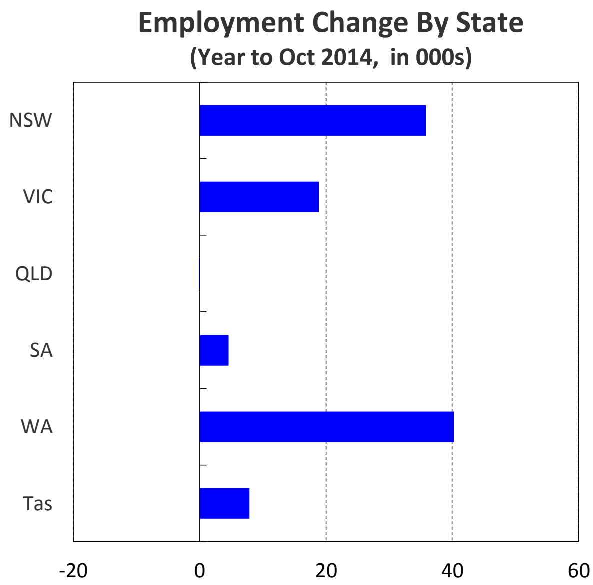
The labour market in NSW has fared relatively well, in comparison to Australia-wide. The unemployment rate in the State has been broadly stable over the past year, and in trend terms stood at 5.8% in October. In contrast, the nationwide unemployment rate in trend terms has crept up to above 6.2%.

A moderate pace of job gains has helped keep the NSW unemployment rate in check. In the year to October, the NSW economy added 35.8k jobs. Western Australia was the only other State to create more jobs over that period.

The high levels of activity within residential housing construction and the retail sector is supporting job growth in these sectors. The construction industry added 29.0k jobs in the year to August, more than half of the net jobs created in NSW. Retail also added a large proportion of jobs in NSW at 26.4k. Those industries to report the most jobs lost were in arts & recreation services (-25.5k), public administration & safety (-24.0k) and healthcare & social assistance (-15.9k).

Strengthening activity within housing construction and a more promising outlook for business investment suggests that employment growth should continue to pick up over the coming year and that the NSW unemployment rate could be possibly near a peak.





St.George Banking Group Forecasts

Low interest rates, population growth and offshore demand are expected to support dwelling investment. The modestly weaker AUD should assist exports and constrain imports. Further private and public spending on road and rail infrastructure will ensure solid levels on non-residential construction which in turn will lift employment and retail spending. An improvement in State government finances due to strong stamp receipts suggests that State government spending will not be a significant drag on growth in 2014-15. We expect NSW gross State product (GSP) to pick up modestly in 2014-15 to 3.0%, up from an estimate 2.8% in 2013-14.

In its last budget papers, the NSW Government was expecting slightly stronger GSP growth of 3.0% in 2013-14 and similar growth in 2014-15.

St George Banking Group Forecasts:

Economic Indicators, % Change (year average)	2013-14	2014-15 (f)	2015-16 (f)	2016-17 (f)
Gross State Product	2.10	3.00	3.00	3.00
State final demand	3.00	3.20	3.30	3.30
Employment	0.50	1.30	1.60	1.70
Unemployment rate (year average)	5.70	5.80	5.80	5.70
Sydney CPI	2.50	2.50	2.70	2.80
Wage Price Index	2.60	2.70	3.20	3.50

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