

Victorian Economic Outlook

Summary

- The Victorian economy has gained momentum over the past year, and is performing well after being stuck in second gear for some time. The combination of low interest rates and the weaker exchange rate has provided key support for the economy, driving an improvement in economic growth in 2014-15. The Victorian economy is expected to maintain this pace of growth in 2015-16.
- Consumer spending in Victoria is growing at a moderate pace, on par with the 10-year average. Low interest rates, strength in the housing market and an improving labour market are all providing support to consumer spending.
- The upswing in Melbourne's housing market has cooled from its earlier pace. However, the housing market in Melbourne is now the out-performer, with Melbourne dwelling price growth overtaking that of Sydney to become the capital city with the fastest growing dwelling prices.
- In Victoria, business investment is performing better than other States and the outlook is positive. Elevated business conditions in Victoria should provide the groundwork for further activity in business investment. The lower currency should also support exports and assist in boosting competitiveness domestically while strong population growth should help underpin economic activity.
- Job growth in Victoria has been solid in recent months, improving in step with a pickup in economic activity. The State unemployment rate is below 6% and Victoria's unemployment rate could be close to stabilising.

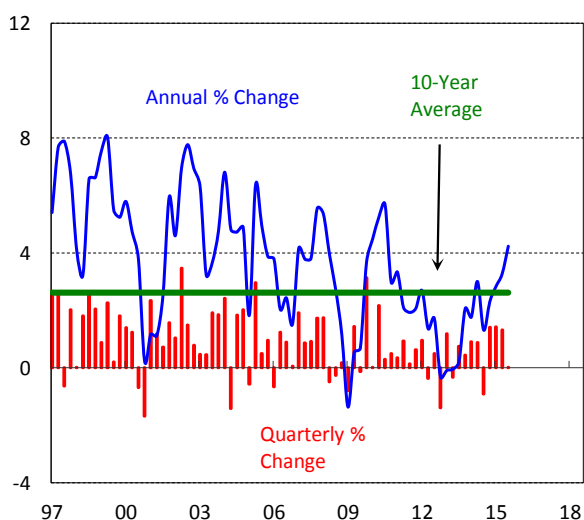
Percentage Shares of the Economy*		
Industries	Victoria	Australia
Financial and insurance services	12.4	10.1
Professional, scientific and technical services	9.0	7.0
Manufacturing	8.9	7.3
Health care and social assistance	8.3	7.6
Construction	7.1	9.1
Education and training	6.5	5.5
Retail trade	6.2	5.2
Wholesale trade	5.6	4.8
Transport, postal and warehousing	5.1	5.4
Public administration and safety	4.7	6.1
Information media and telecommunications	4.3	3.4
Rental, hiring and real estate services	3.5	3.3
Agriculture, forestry and fishing	3.3	2.6
Administrative and support services	3.0	3.1
Electricity, gas, water and waste services	2.9	3.2
Accommodation and food services	2.9	2.8
Mining	2.9	10.2
Other services	2.2	2.2
Arts and recreation services	1.1	0.9

*as % of Industry gross value added 2014-15, excluding ownership of dwellings

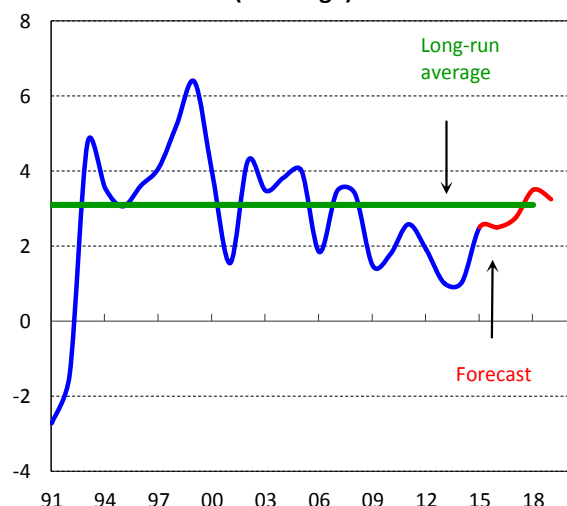
Source: ABS, Bank of Melbourne

Economic Growth

VIC State Final Demand



VIC Gross State Product (% change)



The Victorian economy has gained momentum over the past year, and is performing well after being stuck in second gear for some time. The combination of low interest rates and the weaker exchange rate has provided key support for the economy, driving an improvement in economic growth in 2014-15. While we had been anticipating an improvement for some time, the relative

performance of the Victorian economy has been a little surprising. Gross state product grew 2.5% in 2014-15, slightly stronger than the 2.2% economic growth expected in our last report published in August. It was the fastest pace of growth in four years, and well up on the 1.0% economic growth recorded in 2013-14 and 2012-13. The pace of growth was exceeded only by Western Australia and Northern Territory, and was even a touch stronger than economic growth in NSW (2.4%).

The Victorian economy has had its fair share of headwinds in recent years, but there is now cause for optimism. We have written previously about our expectations for stronger growth boosted by the weaker Australian dollar and low interest rates. There is now evidence that this improvement is occurring, particularly in spending, investment and employment indicators.

State final demand took a breather in the September quarter, remaining unchanged after three consecutive quarters of very strong growth. For the year to the September quarter, State final demand rose 4.2%, the strongest annual growth rate since September 2010.

Although the outlook for Victoria has improved, there remain some headwinds that face the economy. Victoria's economy has benefited from high levels of residential building activity, but these will have to slow at some point. The end of car manufacturing will also impact activity and jobs in the State. Running counter to these headwinds is strong population growth in Victoria, the low Australian dollar and low interest rates, which are lending strong support to economic activity and will continue to do so throughout 2016.

Gross State product is expected to continue at an annual pace of 2.5% in 2015-16, which is equal to the growth seen in 2014-15. While the pace of economic growth has improved from 2013-14, it remains below the long-run average pace of growth. (Please see page 8 for more detailed forecasts).

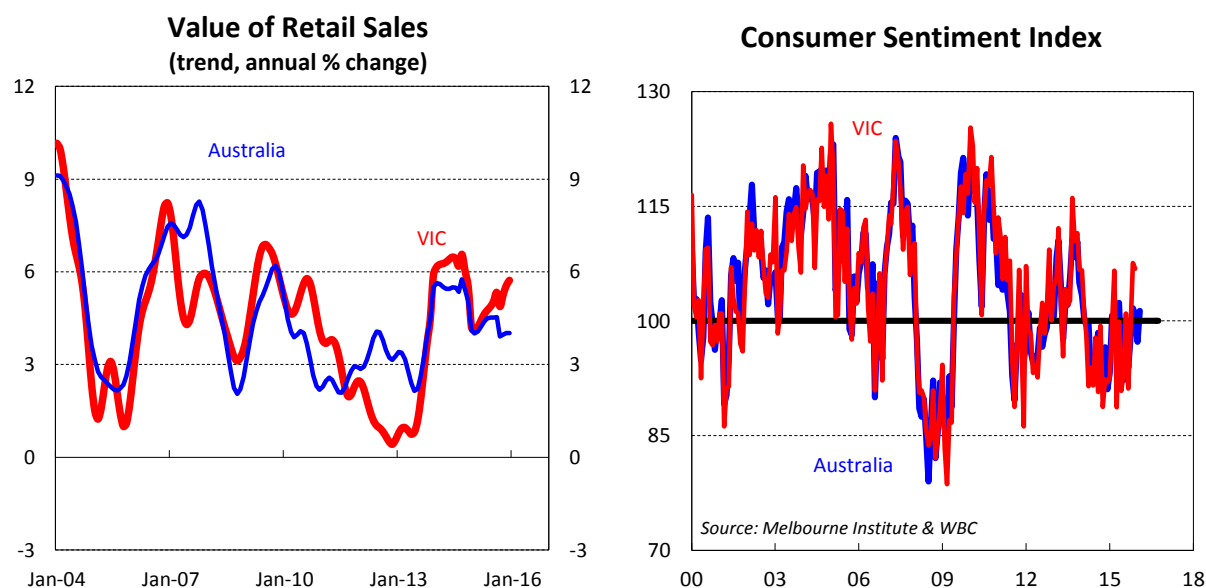
Consumer Spending

Consumer spending in Victoria grew at a moderate pace of 2.6% in the year to the September quarter. This was equal to the 10-year average, although activity is tracking below the heady pace of growth prior to the GFC. Low interest rates, strength in the housing market and an improving labour market are all providing support to consumer spending and could result in a slight pickup. However, slower growth in incomes and an unwillingness to draw down on savings suggests that consumer spending will continue to grow at a moderate pace over the medium-term.

Within household spending, annual growth was strongest for discretionary items and services, including the purchase of vehicles (8.9%), furnishings & household equipment (7.0%), clothing & footwear (6.7%), health (6.3%) and insurance & other financial services (5.5%).

Retail spending data points to a further pickup in consumer spending in Victoria in recent months. Growth stood at 5.8% in the year to December, which is well above the long-term average of 4.3%.

New motor vehicle sales have been strong in Victoria, with a record number of new vehicles sold in Victoria in 2015.



With interest rates expected to remain near record lows for some time and further moderate improvement in the labour market expected, consumer spending in Victoria is likely to be well-supported. An elevated level of consumer confidence over the past four months provides an encouraging sign that household spending will continue to grow at a moderate pace.

According to the Westpac-Melbourne Institute survey, consumer sentiment for Victoria was at 104.2 in February, the fourth consecutive reading above 100 (which is the point where optimists outweigh pessimists).

Soft income growth, however, remains a risk to the outlook, and could limit the capacity for households to increase spending. Nonetheless, the current high level of household savings suggests that there is room for consumers to maintain a pace of spending stronger than growth in incomes. This would require a sustained lift in confidence and ongoing improvement in the labour market.

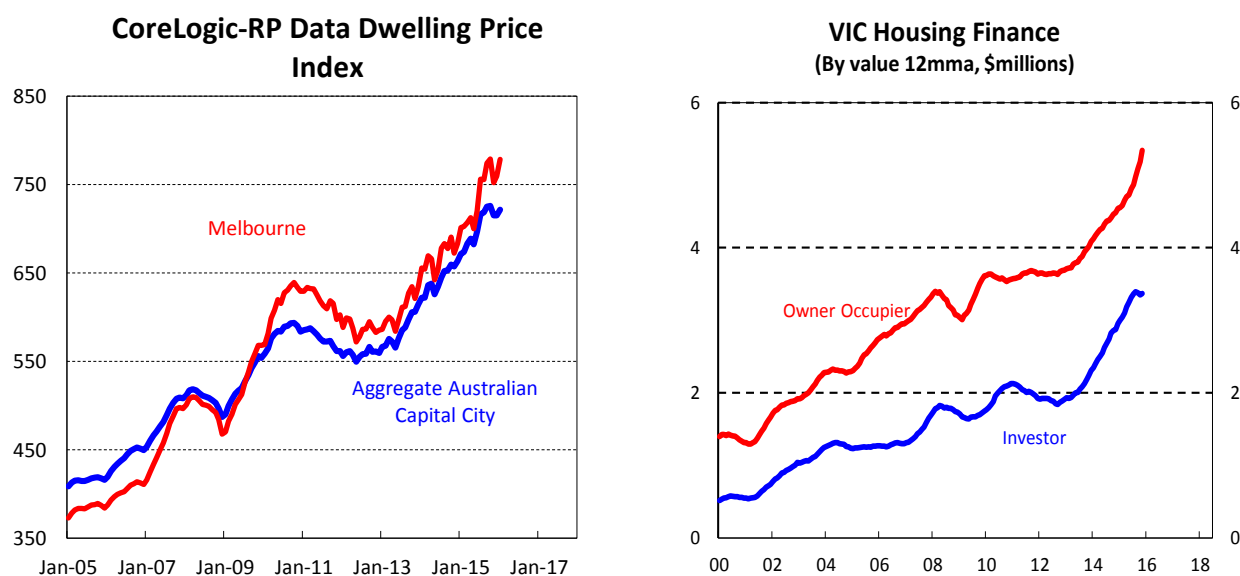
Housing

The upswing in Melbourne's housing market has cooled from its earlier pace. However, the housing market in Melbourne is the out-performer, with Melbourne dwelling price growth overtaking Sydney to become the capital city reporting the strongest dwelling price growth. In the year to January, dwelling prices in Melbourne rose 11.0%, which was just ahead of Sydney at 10.5% and well above the Australian capital city average of 7.4%.

Owner occupier demand for housing has remained solid, supported by low interest rates. Lending to owner occupiers in Victoria rose 13.8% in the year to December. Growth in owner occupier housing finance in Victoria is the second strongest of all the States, behind NSW (18.4%). The number of new owner occupier loans in Victoria has been above its long-run average for 32 consecutive months.

While investors continue to be an important force in the Melbourne housing market, growth in this sector has moderated. Investor home loans made up 32.4% of all home loans by value in November, down from above 43% in May last year. Measures by APRA to temper growth in

investor housing demand have impacted the market. Interest rates remain close to record lows, however, helping to drive demand.



- Rental Markets

Rental markets have been near balanced over the past two years, which is somewhat surprising given the high level of building activity in Melbourne. In the September quarter, vacancy rates stood at 2.9%. Vacancy rates at 3.0% generally signal a balanced rental market.

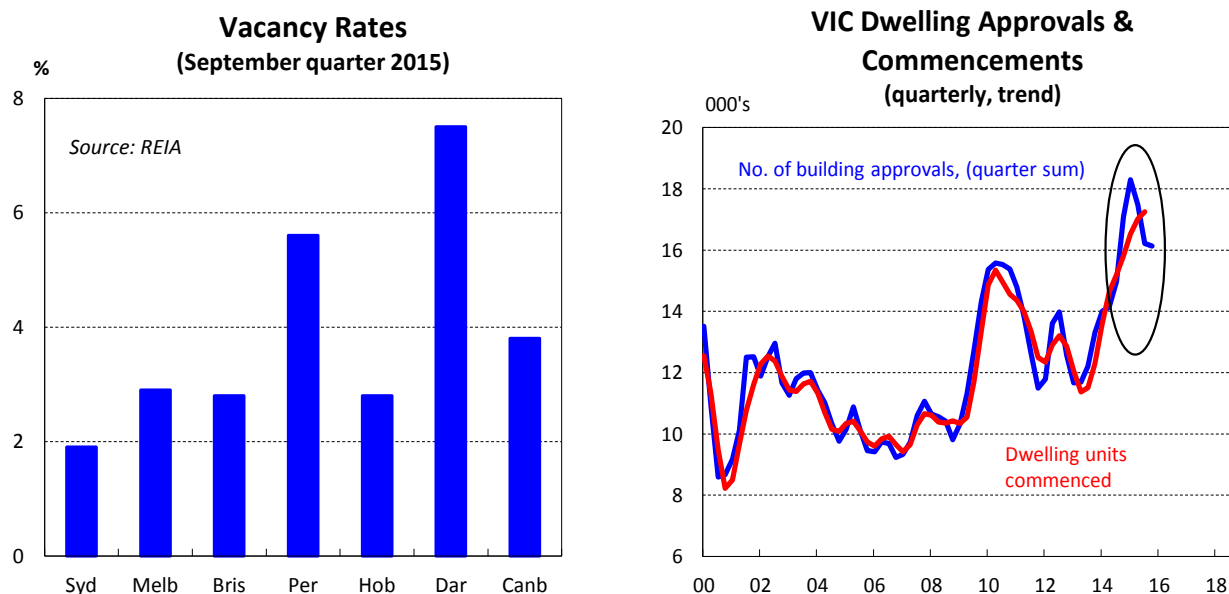
Moreover, rents have continued to increase modestly. In the September quarter, rents for three-bedroom houses rose at an annual rate of 2.9% and rents for two-bedroom units lifted 4.3% in the year.

The lift in rents and a balanced rental market point to little sign of oversupply. Strong population growth continues to support demand for housing. There is also the possibility that a greater number of apartments have been left vacant by investors. Nonetheless, the influx of new apartments still coming on-line continues to suggest that vacancy rates remain at risk of edging higher and limiting growth in rents.

Running counter to this is robust population growth in Victoria, at 1.7% in the year to June 2015, when almost 100,000 people moved to the State. This population growth is the fastest of all the States and above the national average of 1.4% over the same period.

- Dwelling Investment

Residential building has been relatively elevated in Victoria for many years, and Victoria is continuing to build more homes than any other State. In recent years, building activity has been supported by solid gains in dwelling prices, population growth and driven further growth in residential construction. Dwelling investment in Victoria grew at an annual rate of 16.2% in the year to the September quarter, the strongest rate in more than 13 years.



- Outlook

The strong growth in residential investment in Victoria in recent years is not sustainable. Indeed, recent building approvals data suggests a peak in building approvals was reached early last year, although approvals remain at elevated levels. The buoyant growth in Victoria's population is a major support for Victorian housing. Our expectation that interest rates will remain low this year should support house prices, and dwelling investment is expected to remain elevated.

At some point, house prices will moderate, particularly given the steady lift in supply over the past few years. Dwelling price growth has moderated in recent months and as more supply comes online this trend will accelerate.

Business Investment

According to the ABS capital expenditure survey, non-mining investment Australia-wide is set to decline in 2015-16. While the outlook nationally for business investment remains subdued, in Victoria the outlook is more encouraging.

The need for the Australian economy to transition from mining investment to other parts of the economy is well-known. In Victoria, business investment is performing better than other States, including States with a small presence in mining. In the September quarter, business investment grew at an annual pace of 10.5%, the strongest in nearly two years.

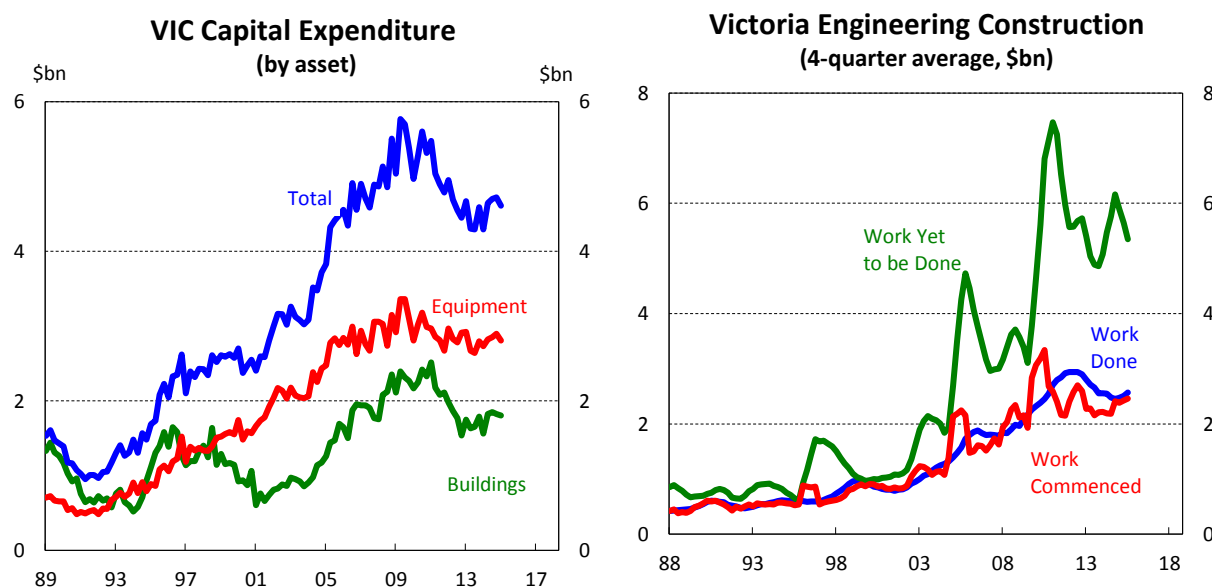
The signs are also positive for the outlook. According to the NAB survey, conditions among businesses in Victoria jumped to a reading of 20.8 in Q4 from a reading of 12.5 in Q3. This was the highest reading since Q4 2007. It is also well above the average reading of 0.1. Capacity utilisation for Victoria rose to 82.6% in Q4 2015, above the long-term average of 80.9%. Elevated business conditions in Victoria should provide the groundwork for further activity in business investment. The lower currency should also support exports and assist in boosting competitiveness domestically while strong population growth should help underpin economic activity.

The lower Australian dollar has had a positive impact on Victorian businesses in many industries, including the tourism industry. Overseas visitors to Victoria rose 10.9% in 2015. The number of overseas visitors to Victoria overtook those going to Queensland in 2015, putting Victoria in second place behind NSW.

Nationally, business surveys point to an improvement in business conditions and confidence in the services sector. The services sector is benefiting from low interest rates and the depreciation of the currency over the past year. Growth in the services sector is reflected in the pickup in employment growth in recent months, with the services sector more labour intensive, rather than capital intensive.

The near-term pipeline for both engineering and commercial construction appears promising. Within engineering construction, work has started on the \$1.3bn project to widen the CityLink and Tullamarine Freeways and the \$5.5bn Western Distributor road project has been approved. The State government is also planning \$11bn towards underground rail tunnels and new stations across Melbourne CBD.

Within commercial construction, a healthy level of office projects is in the pipeline or under way including the 80 Collins Street Office Tower, development at Collins Square and the Wesley Church Site Office Development.



Labour Market

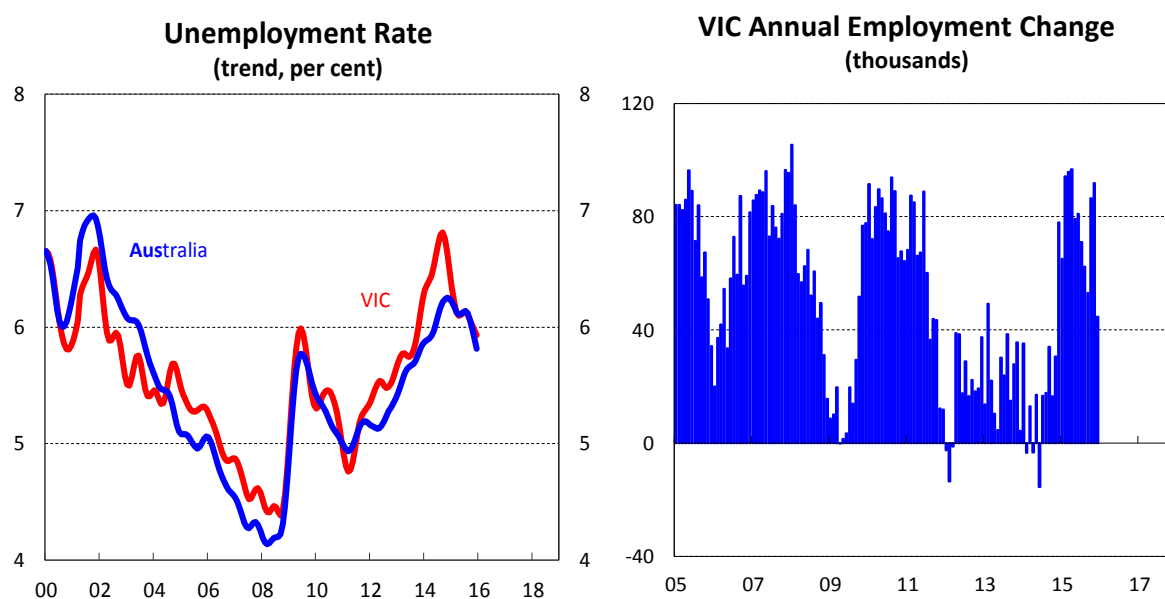
Job growth in Victoria has been solid in recent months, improving in step with a pickup in economic activity. In the year to December, Victoria's labour market added 44.7k jobs or grew by 1.5%. This was down from an annual gain of 91.9k in the year to November, and trails growth in NSW and Queensland, but remains a reasonable pace of growth.

Victoria's unemployment rate fell to 5.9% in December, from 6.4% a year earlier, but is back above the national unemployment rate of 5.8%.

By industry, some of the largest job gains for Victoria in the year to November were in the services sector, including healthcare & social assistance (33.3k), administrative & support

services (21.0k), professional, scientific & technical (18.5k), financial & insurance services (11.4k). The strength in construction resulted in 32.0k new construction jobs in the year to November, while the agriculture, forestry & fishing industry created 17.9k new jobs. The largest job losses were in manufacturing (-23.3k) reflecting the impact on the industry of the stronger Australian dollar in previous years, including the well-publicised challenges within the car manufacturing industry.

There remain downside risks to the employment outlook. The cessation of local motor vehicle production is one of these risks, and will affect Victoria more than other States as the majority of workers employed in the industry are located in Victoria. However, a slowly improving economy suggests that further moderate job gains are in prospect and that Victoria's unemployment rate could be close to stabilising.



St.George Banking Group Forecasts

Economic Indicators, % Change				
	2015-16 (f)	2016-17 (f)	2017-18 (f)	2018-19 (f)
Gross state product (GSP)	2.50	2.75	3.00	3.00
State final demand	2.50	2.00	2.50	2.50
Employment	1.80	1.70	1.60	1.60
Unemployment rate	6.00	5.80	5.70	5.60
Melbourne CPI	2.00	2.25	2.50	2.50
Wage Price Index	2.50	2.80	3.00	3.50

Source: St.George Banking Group

We expect that the pace of growth in Victoria will hold at 2.50% in 2015-16, before lifting to 2.75% in 2016-17. The lower Australian dollar, low interest rates and robust population growth should continue to provide support to the broader Victorian economy over the next few years.

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