WEEKLY ECONOMIC COMMENTARY

Week beginning 25th May 2015

ECONOMIC DATA ROUNDUP

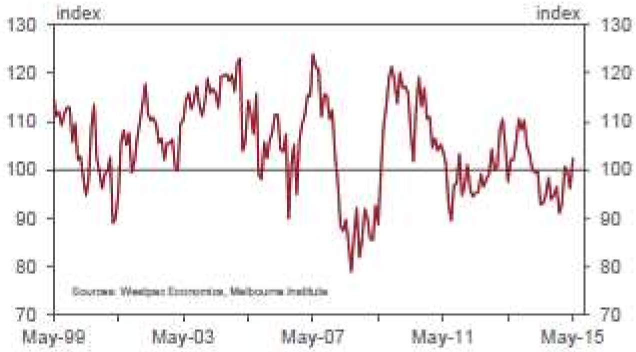
DATA RELEASED LAST WEEK

Economic Data	Period	Actual	Previous
New Motor Vehicle Sales	April	-1.5%	+0.5%
Westpac/MI Consumer Sentiment	May	+6.4%	-3.2%
DEER Internet Vacancies	April	+0.1%	+1.9%

New motor vehicle sales were down 1.5% in April, to be up 2.8% over the year. By category, passenger vehicle sales dropped 8.3% and sales of other types of vehicles fell 0.6%. In contrast, sports utility vehicles rose 7.4% in April. By region, the ACT had the largest percentage decrease (-6.1%) followed by Queensland (-4.8%) and Western Australia (-2.8%), while the Northern Territory saw the largest increase in sales (+3.2%).

The **Westpac-Melbourne Institute Consumer Sentiment index** was up 6.4% in May, its highest level in over a year and now sits at a level of 102.4 (above 100 indicates there are more optimists about the economy than pessimists). In May, the Index was 10.1% above a year ago. Westpac chief economist Bill Evans said that while the latest RBA rate cut was a positive, the Federal Budget was a larger factor for the surge in confidence. "For example, the confidence of those respondents who hold a mortgage increased by a solid 4.8% although that rise was somewhat less than the overall lift for all respondents of 6.4%" he said. Four of the five sub-components increased in May. The largest increase was in the “economic conditions next 5 years” (+20.2%), followed by a 9.2% lift in the “economic conditions next 12 months” component. “Family finances versus a year ago” rose by 5.8% and “family finances next 12 months” posted a more modest increase of 2.2%. The only component that went backwards in May was “good or bad time to buy major household items” component (-1.0%). The boost to confidence was apparent in all major states except Western Australia where confidence actually fell by a concerning 7.7%.

Consumer Sentiment



The Department of Employment **Internet Vacancy Index** fell 0.1% in April to be 9.3% higher than a year ago, suggesting that demand for labour has improved modestly. However, vacancies remain 148,900 (or 48.6%) below the peak recorded in March 2008 indicating that labour market conditions are likely to remain relatively subdued, at least in the near term.

The minutes of the Reserve Bank May Board meeting were released last week and provided little new information on the economy. On the rate cut, it appears that the decision was prompted by a soft outlook for capital spending, coupled with weak inflationary pressure, outweighing recent signs of a pick-up in economic data. On the issue of (Sydney) housing, while members discussed “the potential risk that low interest rates could foster imbalances in the housing market”, the Board’s conclusion was that these risks “could be less than in the past”, the minutes reiterating that the “Bank would continue to work with other regulators to assess and contain the risks arising from the housing market”.

Data over the next week

Economic Data	Date	Period	Forecast	Previous
Construction work done	27 May	March Quarter	-1.5%	-0.2%
CAPEX	28 May	March Quarter	-1.8%	-2.2%
Private Sector Credit	29 May	April	+0.5%	+0.5%

ECONOMIC COMMENTARY

LAST WEEK

In a relatively quiet week for data releases, the Westpac Consumer Sentiment Index moved into positive territory (above the 100 level) for the first time since January 2014, rising by 6.4% thanks to the RBA's latest rate cut and the Federal Budget (a complete turnaround from 12 months ago when there was a negative reaction to the poorly received Budget).

Deputy RBA Governor Phil Lowe commented last week that the RBA still had scope to cut rates - albeit self-evident when rates are 2% and much of the rest of the world is at zero. The RBA's minutes were released, which spent some time carefully explaining their lack of forward guidance in statements where monetary policy was changed. The RBA noted that it had not provided markets with forward looking policy guidance at the time (of the rate cut) but still added that this would not limit its ability to adjust policy again at future meetings. The RBA added a comment that "Members agreed that...the statement communicating the decision would not contain any guidance on the future path of monetary policy". The minutes then went on to note that there was still scope to ease policy.

There was a subdued reaction to the minutes of the last US Federal Reserve Board meeting released last week where they signalled that a US rate hike in June was unlikely, however this did little to dispel the notion that a US rate hike was coming later this year. Anxiety heightened last week over Greece's inability to make its debt repayments to the IMF on 5 June, with signs of possible disagreement between the IMF and European Commission emerging. In response to Greece's financial state, deposit outflows are continuing, with estimates that EUR40bn has left the Greek banking system since December, equivalent to about 20% of their total deposits.

By the close of trading on Friday, the 90-day bank bill was trading at 2.13% compared to 2.14% a week earlier. In the long term maturities, 3 and 10 year bond yields closed at 2.05% and 2.92% respectively, from 2.06% and 2.90% a week earlier.

CURRENCY

A weaker US dollar early last week saw the Australian dollar open the week higher at USD0.8062. It was mostly downhill from there as the fortunes of the US dollar improved, the Australian dollar drifting lower for most of the week. Commodity prices took a tumble last week (especially iron ore) which also weighed on the Australian dollar.

The main driver for the currency's direction is the US dollar and market expectations of the timing for the first US rate hike by the US Fed. Any delays in a move by the US Fed sees the US dollar weaken against all the cross rates and pushes the Australian dollar towards USD0.80.

By the close on Friday the Australian dollar was trading at USD0.7924 compared to USD0.8035 a week earlier.

EQUITIES

Our share market traded near a three-month low last week, weighed down by a fall in the price of iron ore and oil. The sell off was limited by some strong moves in offshore markets, with Wall Street rallying to a new high last week as analysts suggested the US Fed will delay any planned rate hikes. Across the Atlantic, the European Central Bank suggested it may speed up its quantitative easing (bond buying) program which gave European share markets a boost. Even Japan's Nikkei rallied to a three-week high thanks to Wall Street and a surge in companies announcing higher shareholder returns.

By the close on Friday the S&P/ASX200 Index was trading at 5,664.7 compared to 5,735.5 a week earlier.

THIS WEEK

The focus for economists in the week ahead will be the release of the March quarter partial indicators that feed into GDP data to be released next week. Subject to no surprises in these indicators, the preliminary estimate for March quarter GDP is +0.5%, to have annual economic growth at only 1.8%

INTEREST RATE VIEW

The May RBA rate cut Board minutes and communications by senior policymakers last week suggest that any recommencement of monetary policy easing is probably not until later this year at the earliest.

An easing bias remains as economists forecast that the current boost in confidence, an effect of the Federal Budget and RBA rate cut, will only be temporary. As such, futures market pricing is currently still indicating a terminal rate close to 1.85%, from as early as November 2015.

Economic Data	12 months ago	6 months ago	3 months ago	1 month ago	Now
Official Cash Rate	2.50	2.50	2.25	2.25	2.00
90 day Bank Bill	2.69	2.73	2.33	2.26	2.13
180 day Bank Bill	2.72	2.82	2.36	2.30	2.25
1 year swap	2.69	2.69	2.14	2.14	2.10
3 year swap	2.99	2.78	2.17	2.23	2.27
5 year swap	3.44	3.11	2.42	2.51	2.67
10 year swap	4.13	3.63	2.81	2.87	3.21
AUD/USD	0.9242	0.8598	0.7889	0.7808	0.7924
S&P/ASX200 Index	5,492.8	5,334.8	5,944.9	5,933.3	5,664.7

CHARTS OF THE WEEK

Sydney's Sizzling House Prices Losing Power to Prevent RBA Cuts

Source: Bloomberg, by Garfield Reynolds and Benjamin Purvis

Sydney's sizzling property boom may not keep the central bank from cutting borrowing costs again.

The 31% surge in the city's home prices over the past two years helped fuel speculation that the Reserve Bank of Australia is reluctant to reduce interest rates again after lowering them to an unprecedented 2% this month.

Banks are scaling back discounts offered on mortgages to landlords amid a regulatory crackdown aimed at cooling the housing market. ANZ Bank said last Thursday it will only offer advertised rates on mortgages to investors, while NAB said it was reducing discounts. The Australian Prudential Regulation Authority warned lenders this month it was "watching carefully," after urging them in December to limit mortgage growth to investors to 10% annually.

Still, property gains over the past decade lagged behind wage growth, government data show, undercutting concern the market has become overheated. The drop in the Australian dollar also means foreign buyers are set to remain as a source of demand.

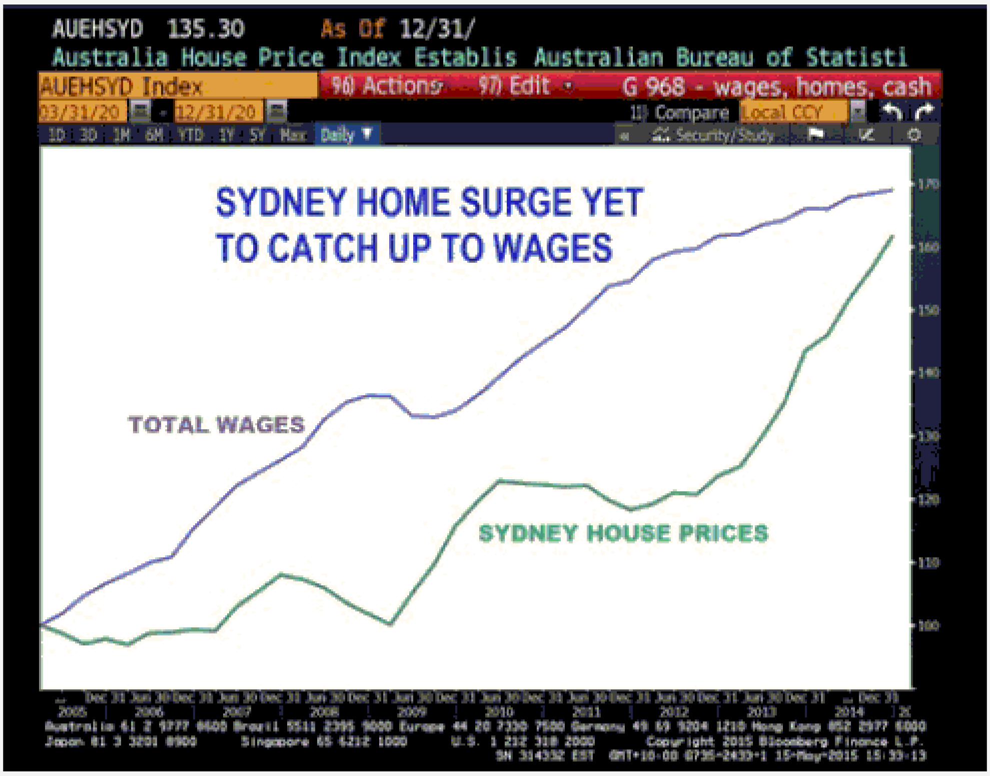
Pacific Investment Management Co. says central bank comments about the strength in the property market don't signal the RBA will sit on its hands as the rest of the economy suffers. Unemployment near a decade high and business investment evaporating argue that additional stimulus may be needed.

"The RBA won't rule out further easing should the aggregate real economy be at risk of stalling," said Robert Mead, Sydney-based head of portfolio management in Australia for Pimco. "They are aware of the trade-off of encouraging debt-fuelled consumption as we navigate a period of slowing income growth, given the existing high levels of leverage in the household sector, hence their incremental approach toward policy changes."

The swaps market is pricing in about a 46% chance that the central bank will lower its cash target by at least a quarter point within the next six months, according to data compiled by Bloomberg.

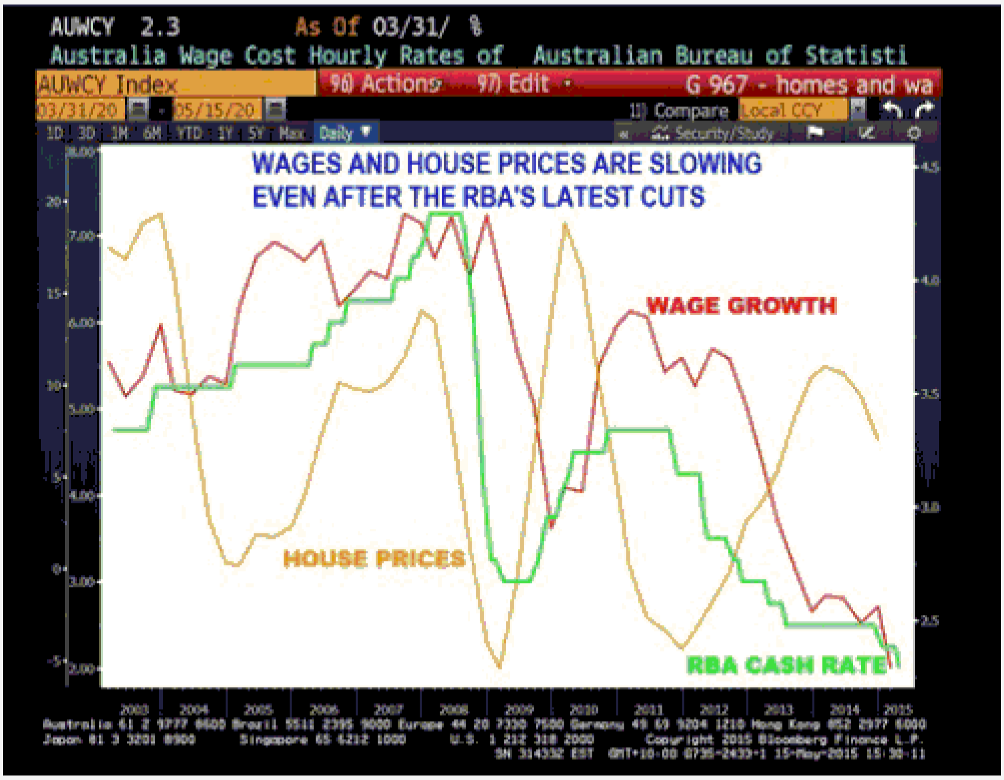
The following charts show how the surge in Sydney house prices seems less excessive when considering longer-term shifts in workers' pay, the increased spending power of Chinese purchasers and how the national property market has slowed even with the RBA cutting rates.

CHART 1: Housing prices in Sydney are making up for an earlier period of stagnation and have yet to catch up with national wage growth. While workers' pay climbed 73% over the past 10 years, home prices in the nation's most populous city rose 58%.



CHARTS OF THE WEEK

CHART 2: Looking at the national housing market, home price growth may have peaked even as the RBA cuts borrowing costs. The last two times the property market cooled, it was reacting to central bank interest-rate increases.



* CHART 3: While surging home prices in Australia's biggest cities prompt concern from regulators, the Aussie dollar's slide helps make them affordable for buyers from China, the biggest source of foreign demand. Sydney prices rose less than 6 percent over the past two calendar years in Chinese yuan terms, while Melbourne prices declined 9 percent. Credit Suisse Group AG has predicted Chinese demand for Australian housing will double over the next six years.

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Postal Address:
PO Box 3660,
Rundle Mall, SA 5000

Telephone: 1300 660 115
Facsimile: 08 8121 0106
service@ruralbank.com.au
www.ruralbank.com.au