

STATE UPDATE: NEW SOUTH WALES

JULY 2016



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KEY POINTS:

Service sectors and construction powering strong NSW economy

CHART 1: STATE GSP GROWTH FORECASTS

Annual growth

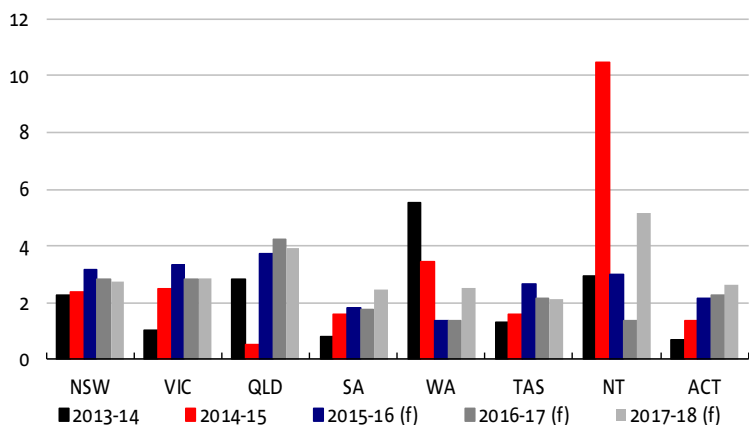
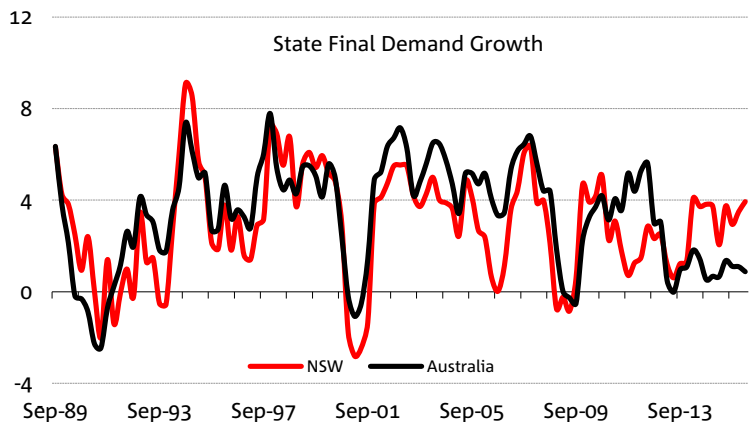


CHART 2: STATE FINAL DEMAND GROWTH

Per cent



- The NSW economy has performed well with the support of a lower AUD and interest rates and solid population growth, as the rebalancing back towards the non-mining sectors continues. **Growth in state final demand has remained well above the national aggregate**, driven by a strong contribution from consumption, a high level of dwelling investment and improved business investment. The external position has also improved a little recently and services export growth remains particularly robust. **Overall, Gross State Product (GSP) growth is expected to pick up to 3.1% in 2015-16, then steady around 2.9% in 2016-17 and 2.7% in 2017-18 (Chart 1).** While infrastructure spending will add to growth in coming years, the challenge for NSW will be maintaining strong SFD growth as momentum from the housing sector and AUD depreciation begins to fade.
- **Construction and the state's service sectors have been major sources of growth in the economy.** These sectors appear to have been most responsive to movement in the AUD and interest rates, and have generally outperformed other sectors across a number of different metrics. **The service sector in NSW has had some of the highest levels of business conditions in the NAB Business Survey, while contributing significantly to the state's employment growth.**
- The residential property market has been instrumental to the state's economic performance, with strong price gains contributing to **both a record high construction pipeline and solid consumption growth** (via wealth effects). Dwelling construction is expected to **continue making a positive contribution to growth through 2017**, but will eventually become a drag as supply begins to outstrip demand.
- Similarly, despite renewed signs of strength in recent months, the **Sydney property market is expected to lose momentum and provide less support to household consumption** going forward. Consequently, we need to see a continuation of solid employment growth and further improvement in household income to drive even our fairly modest expectations for consumption growth – which (like for the broader national economy) will likely require further falls in the household savings rate as well.
- Labour market conditions continue to look good in NSW, although the improvement appears to have lost some momentum. The unemployment rate has fallen around a ½ ppt since mid 2015, but has been steady at around 5¼% for a number of months. The spread between unemployment in Greater Sydney and the rest of NSW has narrowed, although the latter remains higher. Other indicators, including the NAB Business Survey, suggest that decent rates of employment growth are set to continue, while **major infrastructure projects (such as the West Connex and light rail projects) are expected to add significantly to NSW jobs.** However, additional labour supply (from the mining states) is expected to keep falls in the unemployment rate limited. **The unemployment rate is forecast to steady at around 5-5¼%.**
- **Improvements in the business environment has seen spare capacity fall in NSW and could point to an increase in business investment, while public infrastructure spending will provide key support to the local economy over coming years (accounting for around 3% of GSP in the four years to 2019-20).** Indeed, business investment has improved somewhat, but indicators of spending intentions remain mixed.
- Despite a light downgrade to our growth forecast, a diverse industry mix and support from a lower AUD and interest rates will see NSW remaining one of the standouts across the states.

IN FOCUS:

The resurgence of the services sector

The Q1 2016 National Accounts revealed that the non-mining economy is gaining momentum, with services industries leading the way. Given the dominance of the service sector in the NSW economy, the state has been well-positioned to reap the fruits of the recovery/boom of these industries. The lower AUD and subdued growth in labour costs (given that these industries tend to be labour intensive) have helped the recovery, as have the spill over effects from the state's (especially Sydney's) housing boom.

The strength in both personal and professional services is clearly evident in a

CHART 3: BUSINESS CONDITIONS FOR NSW SERVICES

Net balance

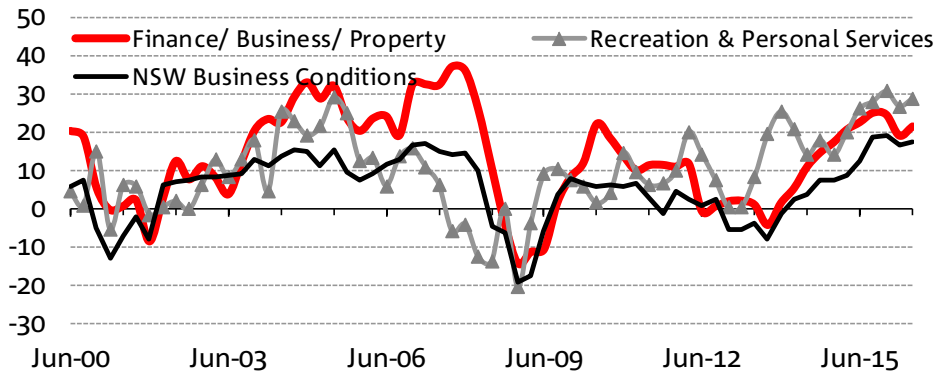
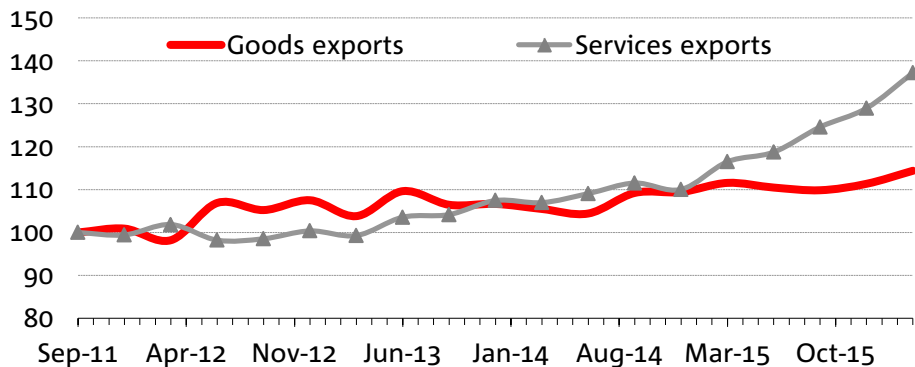


CHART 5: NSW SERVICES EXPORTS

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Source: ABS, NAB Group Economics

number of indicators. Services exports (including tourism) have been stronger, with visitor arrivals trending up and the NAB Business Survey showing that business conditions in finance/ business/ property services and recreation & personal services have outperformed aggregate state conditions. While conditions in these industries have started to ease, they remain at very elevated levels.

Labour market statistics show a similar pattern, with the number employed in service sectors (outside distribution industries) increasing sharply over the past year.

CHART 4: NSW SERVICES VS NON-SERVICES EMPLOYMENT

Thousands, annual

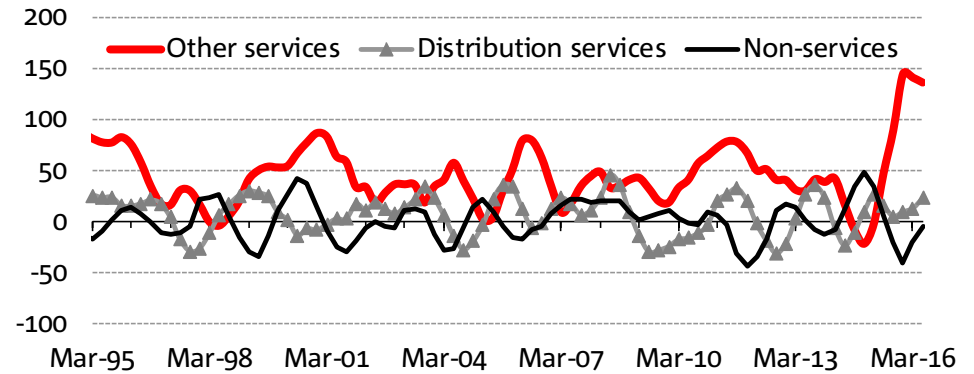
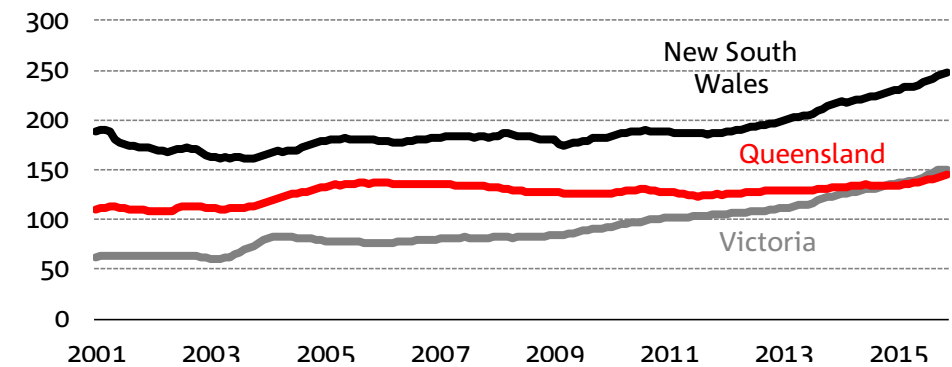


CHART 6: NSW VISITOR ARRIVALS

Thousands



CONSUMER SPENDING:

Stronger labour market having a positive effect on consumers

Household final consumption has continued to make a solid contribution to state final demand, growing by a solid 3.9% over the year to Q1 2016. The renewed pick up in consumption growth has coincided with an acceleration in compensation of employees, driven by both an acceleration in average compensation and ongoing growth (annualised) in employment.

The impact of wealth effects from property prices has become less clear. House prices have accelerated again in Sydney, after moderating notably from late 2015, while consumption has been more subdued. Meanwhile, the consumption of goods often associated with a heated housing market (such as furnishings) has slowed.

CHART 7: NOMINAL COMPENSATION OF EMPLOYEES AND HOUSEHOLD CONSUMPTION GROWTH

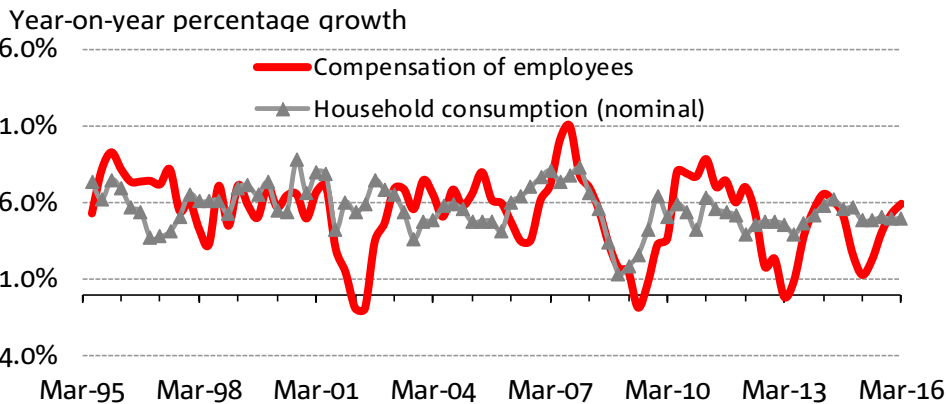
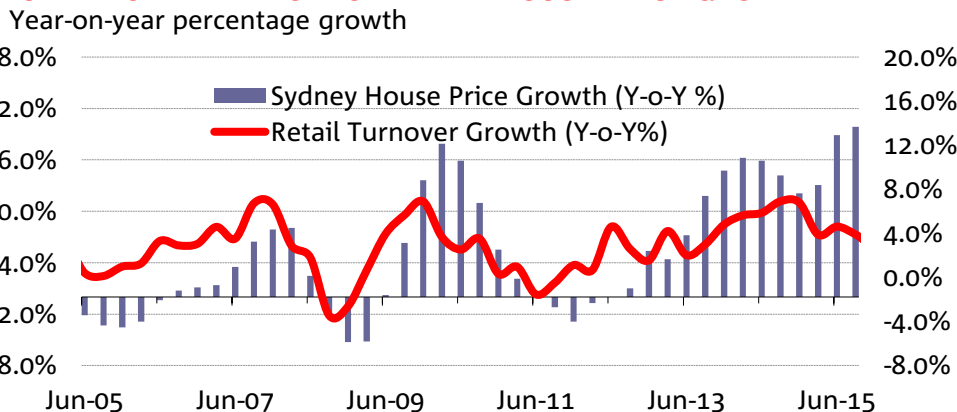


CHART 9: RETAIL TURNOVER AND HOUSE PRICE GROWTH

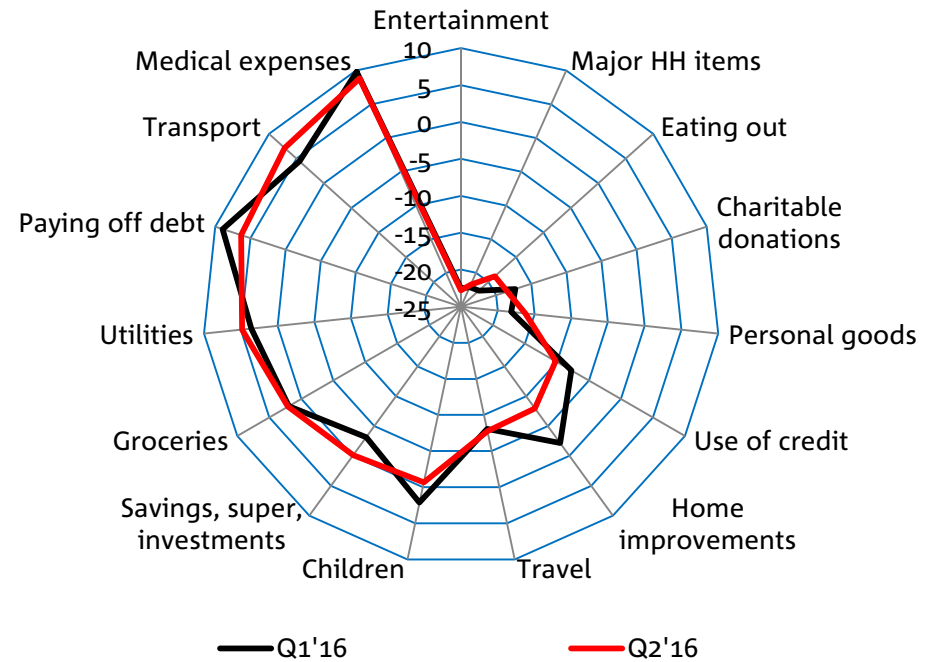


The housing market is still expected to cool going forward, meaning consumption growth will be increasingly reliant on additional income/employment growth. That said, the labour market is expected to improve, but only gradually.

The Q2 2016 NAB Consumer Anxiety Survey showed an increase in consumer anxiety, reflecting a deterioration in people's views on job security and health. Consistent with higher anxiety, households suggested greater reluctance to spend on certain discretionary items such as home improvements, and were more reluctant to take on debt.

CHART 8: NAB CONSUMER ANXIETY SURVEY - CONSUMER SPENDING PREFERENCES

Changes in Consumer Spending Preferences (net balance)



BUSINESS CONDITIONS:

Strong and broadening. Fundamentals for investment continue to improve

The NAB Monthly Business Survey is showing that NSW has remained a clear outperformer in terms of business conditions and may have even regained some of the lost momentum from late 2015/ early 2016. According to the Survey, capacity utilisation for businesses in NSW is close to previous peaks, and is well above the national average (Chart 10).

Diminishing spare capacity appears to have had a modest impact on business investment in NSW (rising 2.3% y/y in Q1 2016, compared to 0.2% y/y at the same time last year). The impact on the local labour market has been more noticeable,

CHART 10: NAB BUSINESS SURVEY – CAPACITY UTILISATION

Per cent of full capacity

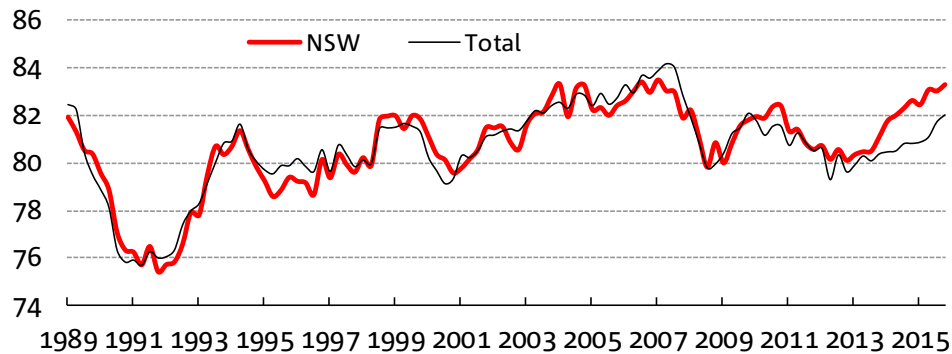
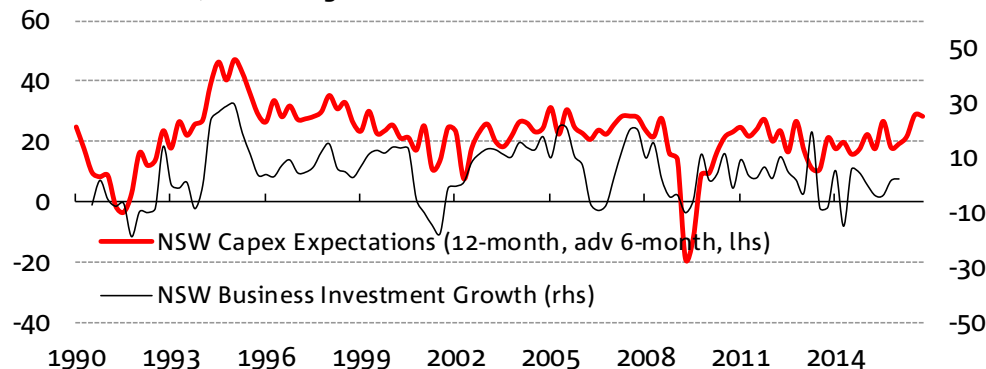


CHART 12: NAB SURVEY CAPEX EXPECTATIONS & PRIVATE BUSINESS INVESTMENT GROWTH

Net balance; Per cent growth



with big increases in services employment (see pages 3 & 7).

The fundamentals for investment have improved, but there remain a number of challenges to the investment outlook. Conditions in capital intensive industries have taken longer to improve, while confidence and measures of investment intentions are mixed. Expectations from the NAB Survey look solid (Chart 12), while ABS capex expectations are muted (slide 6).

Services sectors have led improvements in business conditions in the NAB Survey, but this appears to be broadening. Confidence is mixed (Chart 13).

CHART 11: SPREAD IN NAB BUSINESS CONDITIONS

Net balance

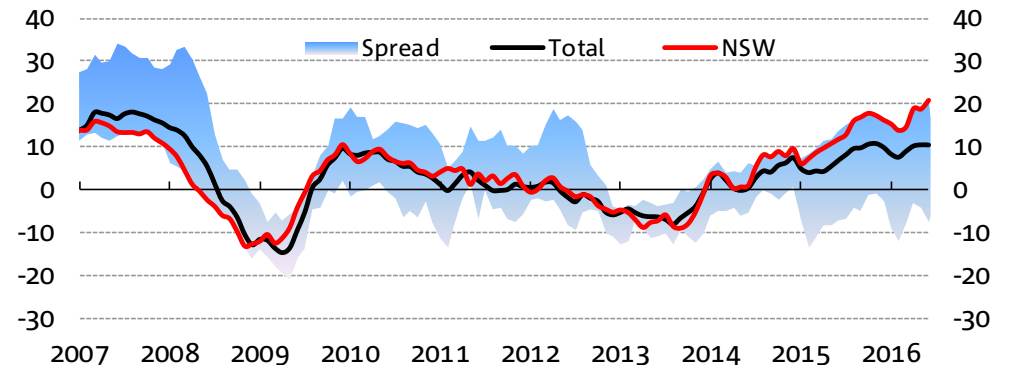
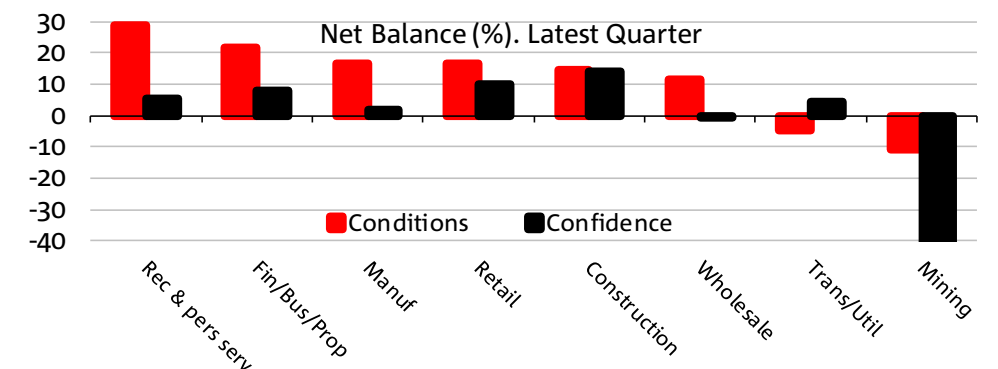


CHART 13: NSW BUSINESS CONDITIONS & CONFIDENCE BY INDUSTRY

Net balance, Q2 2016



INVESTMENT:

Spending up a little, but intentions remain mixed despite good fundamentals

Private business investment has picked up in the last two quarters, although this followed a very weak outcome in Q3 2015. Equipment investment has risen steadily, while non-dwelling construction has been more mixed. Non-residential approvals have been mixed, with most sectors (besides 'other') looking subdued (Chart 14).

Office approvals have been soft despite a steady decline in office vacancy rates, which are now at their lowest level for the post-GFC period. Sentiment in the market has also been elevated according to the NAB Commercial Property Survey.

In contrast to the NAB survey measures which are more upbeat (page 5), official measures of capex intentions continue to suggest a subdued outlook, particularly for

CHART 14: NON-RESIDENTIAL BUILDING APPROVALS

Million dollars

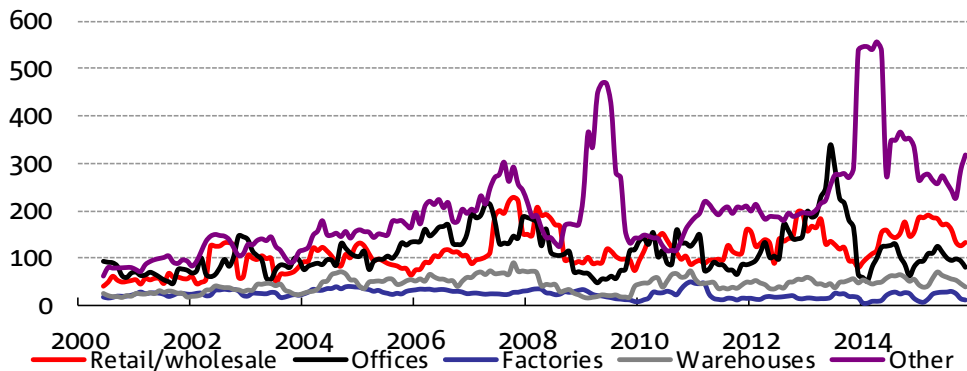
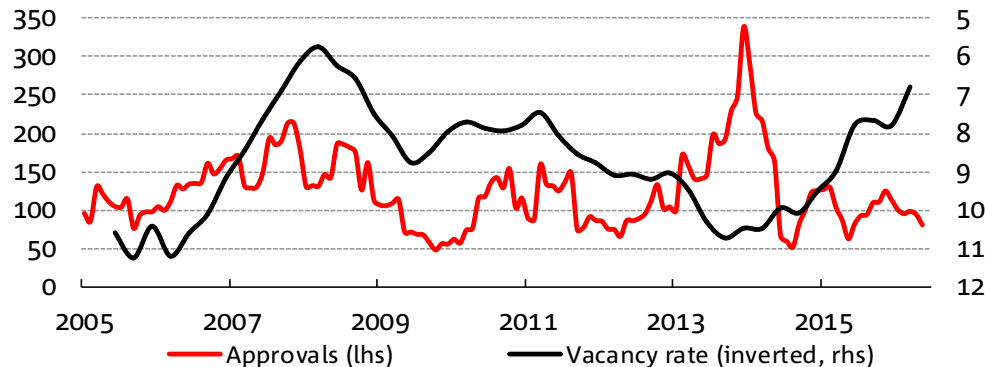


CHART 16: NSW OFFICE MARKET CONDITIONS

Million dollars; Per cent of capacity



buildings & structures, consistent with the slower improvement in business conditions for more capital intensive sectors.

Expected capital expenditure (capex) by businesses (according to the ABS survey) suggests that spending on buildings and structures in NSW could fall further in the next 12 months, while planned spending on machinery and equipment is expected to improve moderately (Chart 15).

However, construction activity is likely to be supported going forward by very large pipeline of public infrastructure projects (more than \$70b spent by 2020), most of which includes a private partnership component.

CHART 15: NSW CAPITAL EXPENDITURE & EXPECTATIONS

Actual & expected based on previous realisation ratio (\$billion)

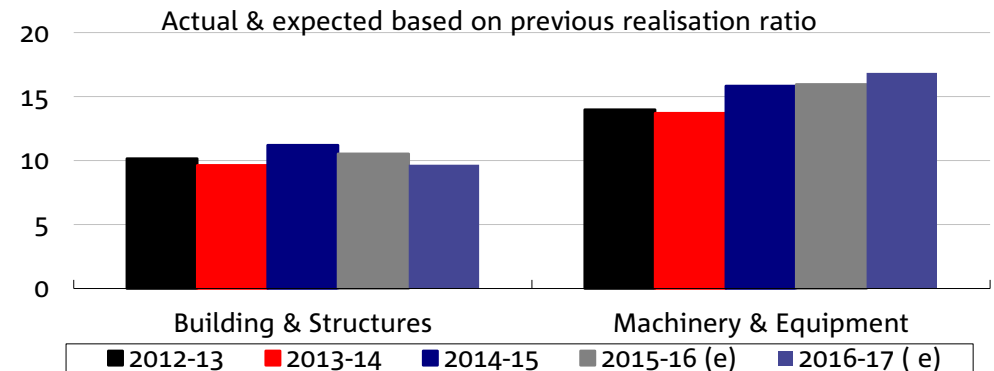
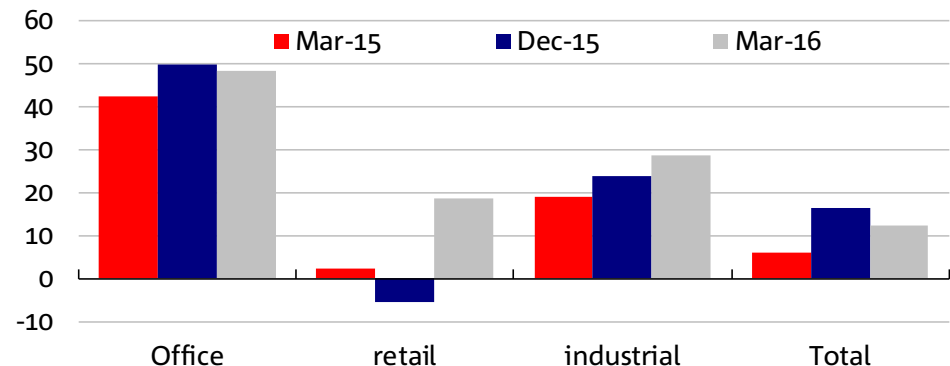


CHART 17: NAB COMMERCIAL PROPERTY INDEX - NSW

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LABOUR MARKET:

Recovery still dominated by the service sectors

The improvement in the NSW labour market has been relatively broad based, with unemployment rates in regional NSW closing most of the gap that had emerged with Greater Sydney (Chart 18).

Jobs growth in NSW has moderated a little, but remains impressive, rising by around 117k over the year to June 2016. The participation rate has picked up sharply at the same time, which has kept the unemployment rate steady at around 5.4% since late 2015, although this is still well down on the 6.2% peak at the start of last year.

In the near-term, high capacity utilisation rates and positive employment conditions in the NAB Business Survey point to ongoing strength in the NSW labour market (Chart 20).

Over 2015, most of the jobs created were in business and personal services. Surprisingly, robust residential construction has not translated into additional jobs in the past year, although there was a notable jump in Q2 2016 (up 43k). Job losses have been largest in manufacturing (despite AUD assistance) (Chart 19).

CHART 18: UNEMPLOYMENT RATE BY REGION

Per cent, nsa

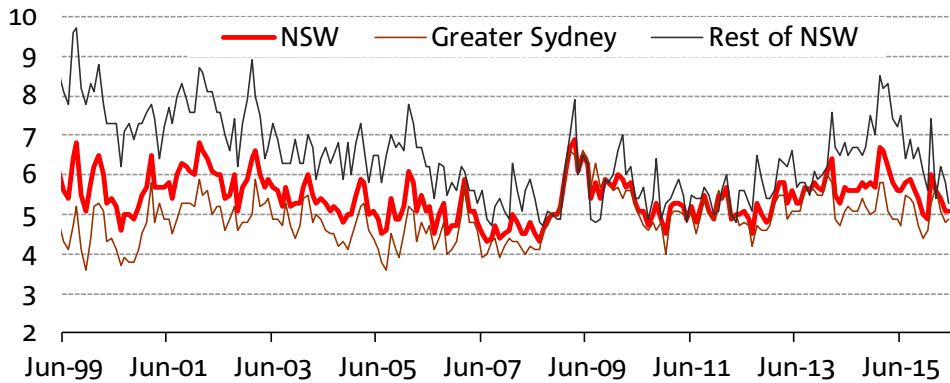


CHART 19: CHANGE IN EMPLOYMENT BY INDUSTRY, NSW

Last 12 months, thousands

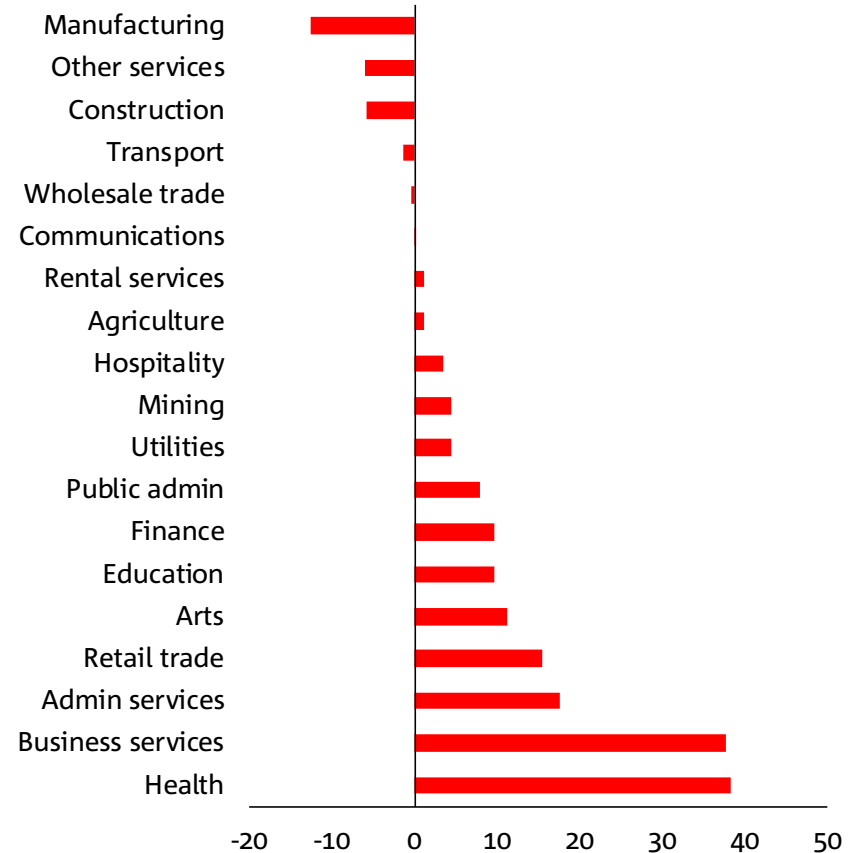
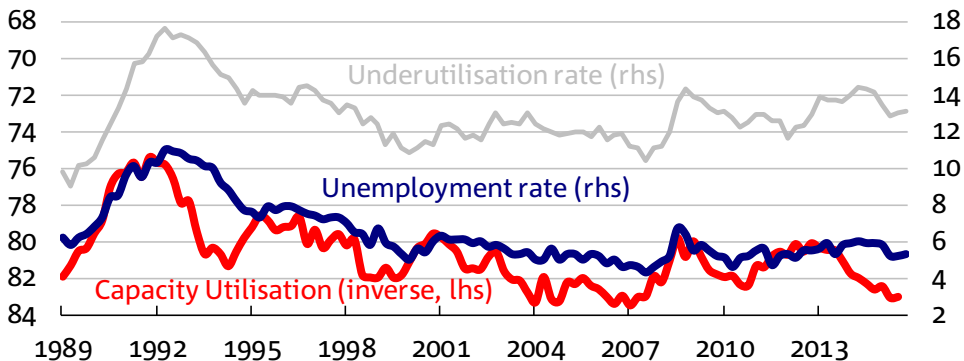


CHART 20: UNEMPLOYMENT RATE & NAB CAPACITY UTILISATION RATE

Per cent; dollar billions



DEMOGRAPHICS:

Trends turning more positive as mining investment boom winds down

NSW population growth is down from previous peaks, but is holding up at elevated levels, driven by both overseas migration and shrinking interstate outflows – reflecting the relatively more favourable labour market, especially compared to the mining states (Chart 21).

After lagging behind for more than a decade, NSW population growth is now consistent with national average levels (Chart 23).

CHART 21: NSW POPULATION GROWTH

Thousands, over the year

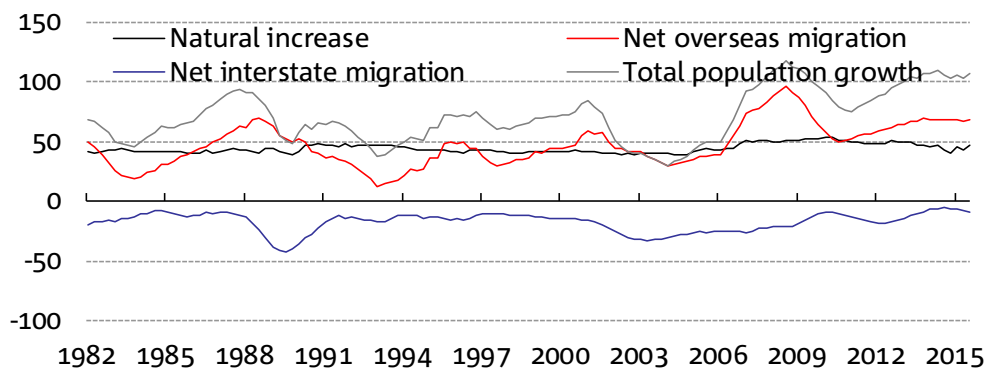
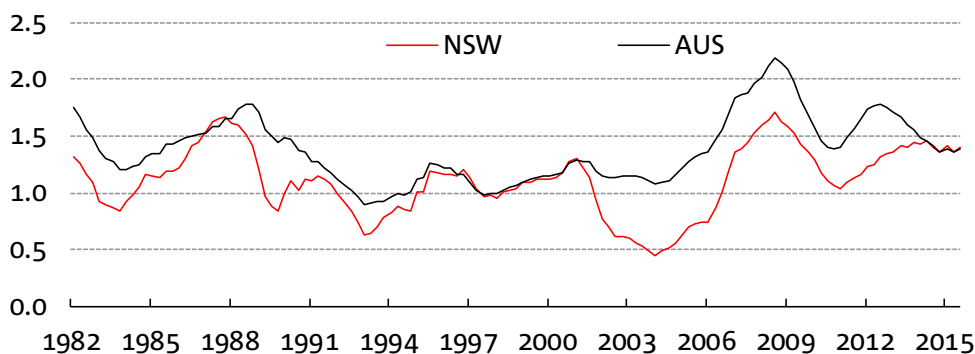


CHART 23: NSW POPULATION GROWTH

Year-ended growth

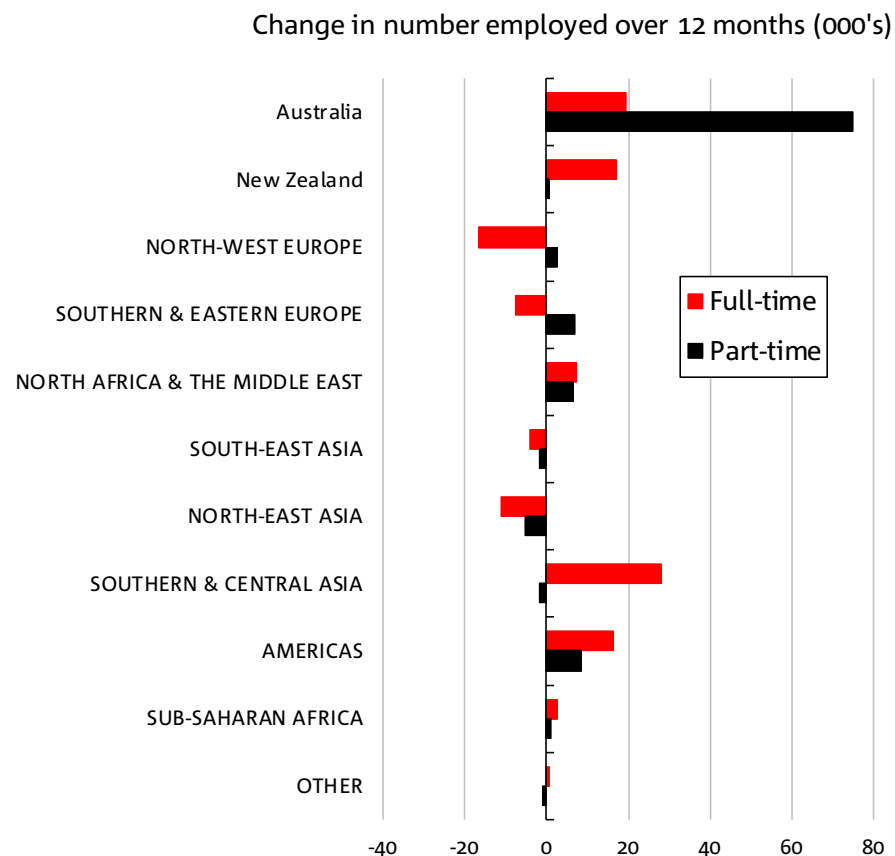


Sources: ABS; NAB Economics

Population trends are consistent with observations from the labour market. While employment growth in NSW has improved notably, it appears that domestic workers have largely satisfied the growing demand via part-time workers (Chart 22).

CHART 22: NSW EMPLOYMENT BY COUNTRY OF BIRTH

Thousands, over the year to May 2016



RESIDENTIAL PROPERTY:

Market's 'second wind' to be temporary, as dwelling construction rates soar

Fundamentals appeared to catch up with the housing market in late 2015, with residential property prices showing signs of moderation. However despite expectations, the moderation was short lived and price growth has accelerated again in recent months (Chart 24). Price growth has varied across property types and regions, although all have generally performed reasonably well. Price growth by sub-region in Sydney suggests houses have outperformed units, especially in certain regions, although both have generally seen good growth (Chart 26).

Additions to the housing supply are expected to be large, reflecting an extremely high pipeline of construction projects. Approvals also remain elevated, adding

to the pipeline, although the pace of growth has slowed. While this will support construction activity in NSW, it heightens the risk of excess market supply further down the road, especially for apartments (Chart 27). Rising supply, along with worsening affordability, less foreign demand and prudential constraints are all expected to limit future price gains.

Consistent with this, the NAB Property Survey suggest residential prices growth will be relatively modest in the near and medium-term (Chart 25). NAB's forecast for price growth is similar, predicting flat to very modest positive growth in the near-term. While the risks are likely skewed more to the downside, recent resilience has been surprising.

CHART 24: NSW RESIDENTIAL PROPERTY PRICE GROWTH

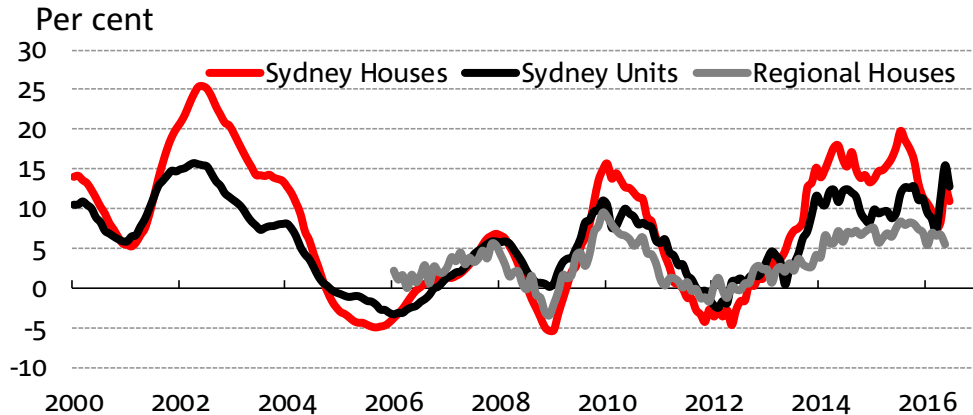
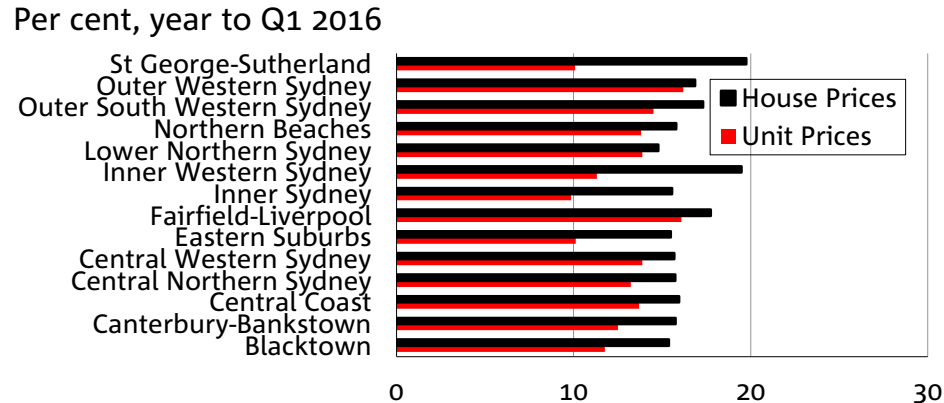


CHART 26: SYDNEY - MEDIAN PROPERTY PRICE GROWTH



Source: ABS; CoreLogic; NAB Economics

CHART 25: NAB PROPERTY SURVEY – PRICE EXPECTATIONS

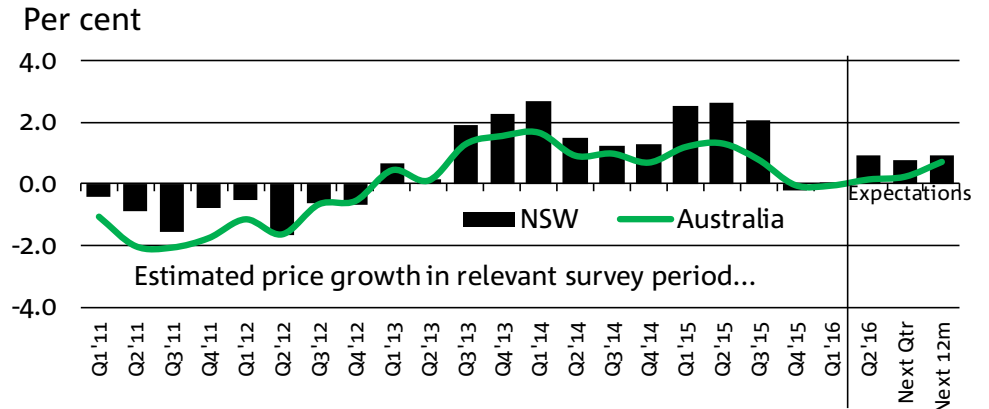
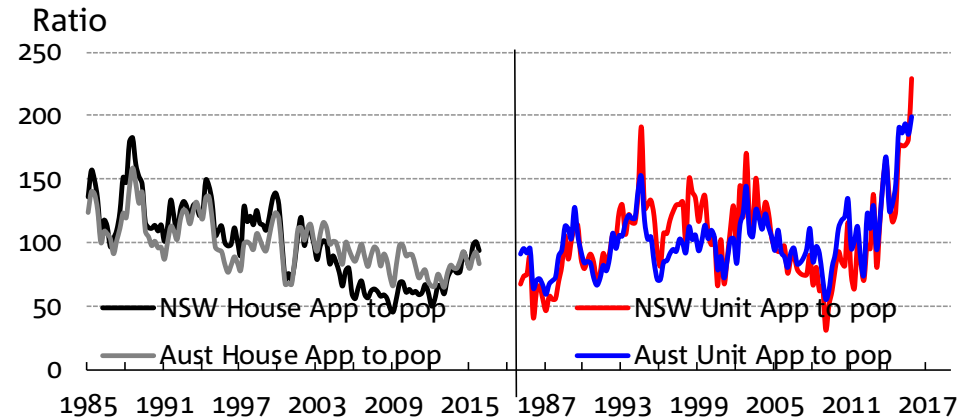


CHART 27: NSW RESIDENTIAL APPROVALS TO POPULATION



FISCAL OUTLOOK:

Near-term position improved. Extensive infrastructure investment pipeline

Good economic performance and a booming residential market will help the state government achieve solid fiscal results in the near-term, although weaker growth in Commonwealth GST payments and an anticipated moderation in the housing market are expected to see revenue growth slow over the forward estimates. The operating surplus for 2016-17 has been revised up by more than \$1b (to 0.7% of GSP), but the expected surplus for the following 2 years has been revised down by a cumulative \$1.7b (Chart 28).

In net terms, the upward revision to the 2016-17 surplus has been driven mainly by revenue revisions – namely to parameter expectations. Revenue growth is expected to be relatively muted in following years, in large part due to slower growth in

CHART 28: NSW NET OPERATING BALANCE & TRANSFER DUTY

Per cent of GSP

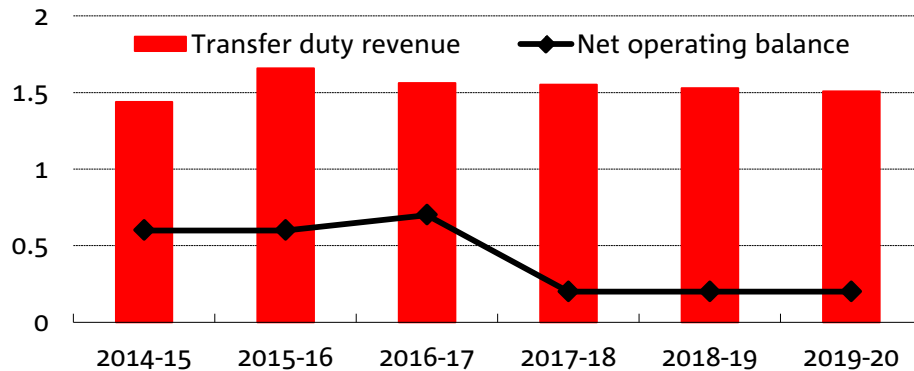
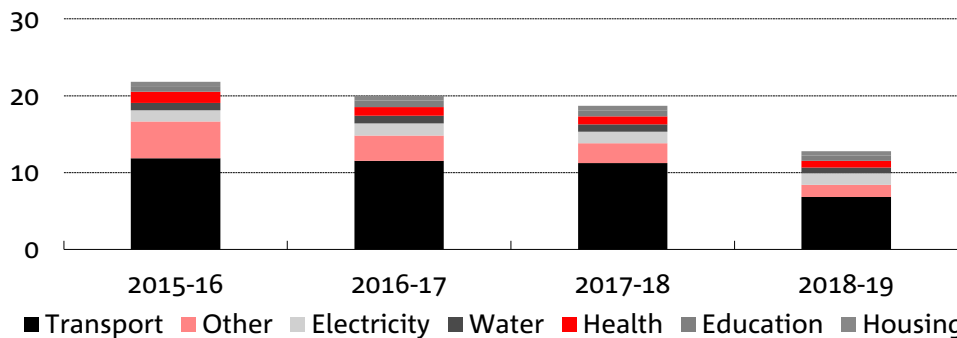


CHART 30: NSW STATE CAPITAL SPENDING BY FUNCTION

Billion dollars, as at 16-17 Budget



Source: NSW State Budget; NAB Economics

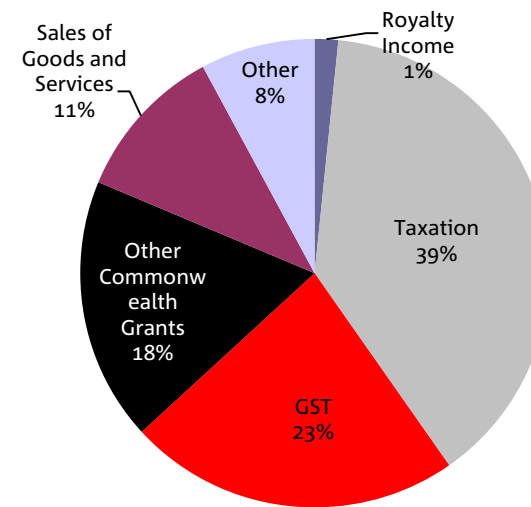
Commonwealth grants. Transfer duties are expected to broadly keep pace with GSP growth, although a greater than expected moderation in residential property markets pose a significant risk.

State government expenses have been revised since the mid-year review, adding more than \$3 billion over 3 years. The revision mainly reflects the impact of new policy decisions (amounting to \$6b), while parameter and technical adjustments also contributed (adding \$1.1b over three years).

At the time of the 2016-17 Budget, the Government (consolidated) was committed to spending \$73.3b on infrastructure in the four years to 2019-20 – which accounts for around 3% of GSP for that period. Much of the spending is in transport infrastructure, although there is also major hospital redevelopments, the construction of new schools and significant funding for new correctional centres. Large amounts of infrastructure spending will help create jobs and are aimed at boosting long-term productivity in the economy. According to the Budget, the WestConnex and light rail projects alone will create around 20k jobs in NSW.

CHART 29: NSW COMPOSITION OF STATE REVENUES

Per cent



SEMI GOVERNMENT AND CREDIT OUTLOOK:

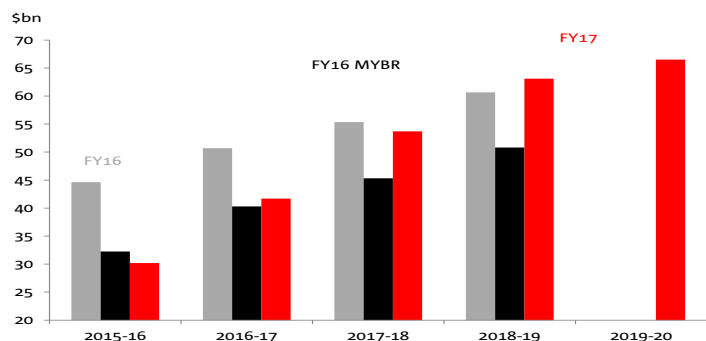
Asset sales/leases reducing the debt burden

At the total state level, net debt is forecast to rise from \$30bn to \$66bn over the forecast horizon. However we note that previous forecasts for rising debt haven't eventuated, largely because of asset sales/long-term leases. Leases of Ausgrid and Endeavour are likely to significantly reduce debt in the coming years.

The budget is not seen to place any pressure on NSW's AAA credit rating although we note it will be lowered if the Commonwealth's rating is changed.

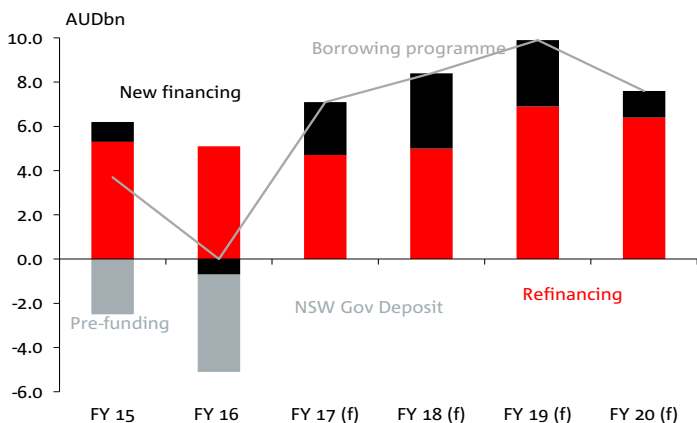
NSWTC funding program of 2016-17 is \$7.1bn, comprising \$2.4bn of new client loans and \$4.7bn of maturities. Issuance may be lower following the completion of the long-term leasing of Ausgrid and Endeavour.

NSW NON-FINANCIAL PUBLIC SECTOR NET DEBT



Source: NSW Budget papers

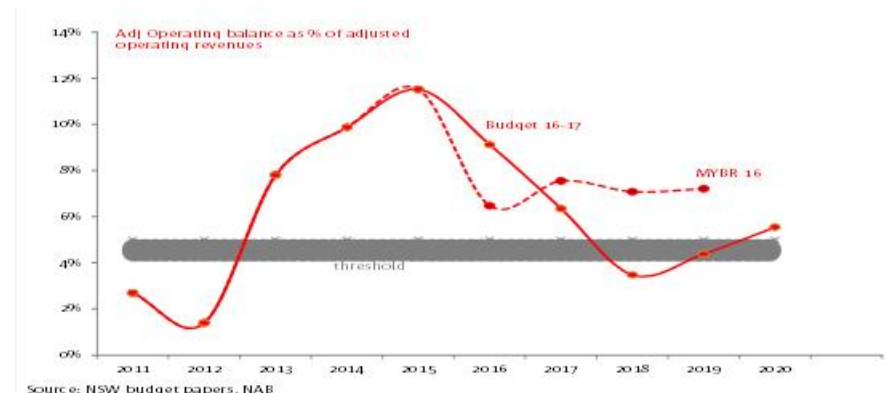
NSWTC BORROWING PROGRAMME



Source: NSWTC

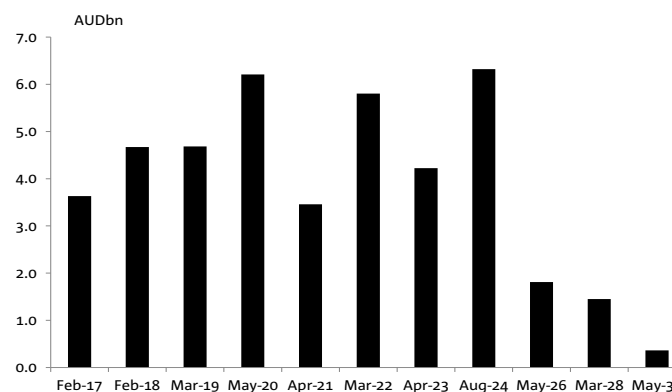
State Update: NSW

S&P CREDIT METRIC: OPERATING BALANCE AS % OF REVENUE



Source: NSW budget papers, NAB

NSWTC TERM BONDS OUTSTANDING AS AT END JUNE 2016



Source: NSWTC

ECONOMIC STRUCTURE AND TRADE:

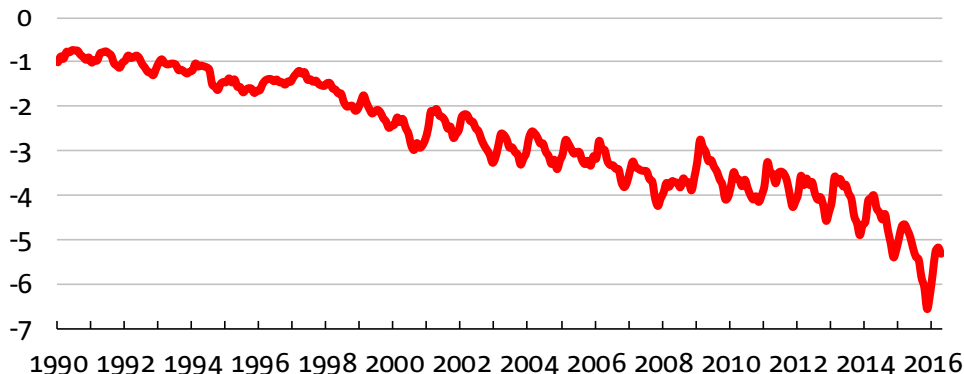
Net exports improved modestly as AUD depreciation helps some traded sectors

The NSW trade position has shown a modest improvement, reflecting smaller deficits in both goods (Chart 35) and services trade. Although growth in goods exports has been slower than services, goods imports have also fallen recently – not an encouraging indicator for domestic demand.

Some trade sectors are seeing clear benefits of AUD depreciation, especially in services such as tourism. Short-term visitor arrivals to NSW have been steadily increasing, which is helping soak up capacity in the hospitality sector (Chart 36).

CHART 35: NSW NET TRADE

Billion dollars, 3mma



TOP EXPORT DESTINATIONS, NSW

Billion dollars, 12-month average

Value of exports (\$m)		Value of imports (\$m)			
1	Japan	8852	1	China	28764
2	China	5714	2	EU	22128
3	ASEAN	3328	3	ASEAN	14019
4	Korea	3126	4	US	12457
5	US	2755	5	Japan	6378
6	New Zealand	2105	6	Germany	5723
7	Taiwan	1915	7	Korea	5072
8	EU	1855	8	UK	3332
9	India	1172	9	Singapore	3060
10	HK	945	10	New Zealand	2737
11	UK	675	11	Taiwan	1960
12	Singapore	457	12	HK	538
13	Germany	136			

Source: ABS, NAB Economics

CHART 36: HOTEL OCCUPANCY RATES

Per cent of revenue

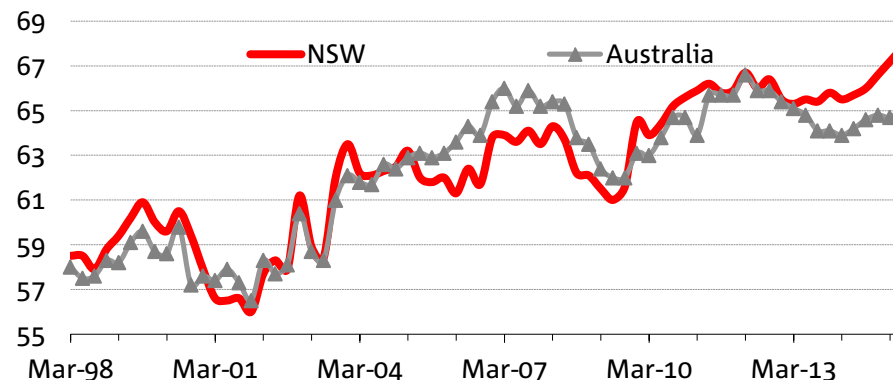


CHART 34: COMPOSITION OF EMPLOYMENT & GVA

Per cent

