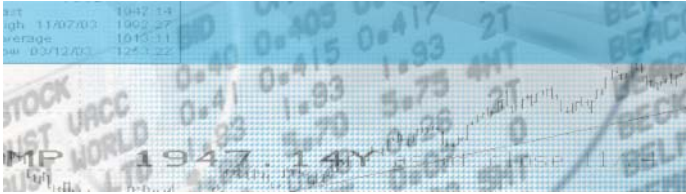


Weekly market & economic update - Week beginning Monday 26 July 2010



Headline developments of the past week

- All but seven of the 91 European banks subject to stress tests passed with a total capital shortfall of 3.5 billion euros, which was a far better outcome than the market expected. The small capital shortfall may reflect the 220 billion euros in capital raised by European banks over the last 18 months, but some have argued that the stress tests were not stressful enough. However, in terms of the latter, it is worth noting that similar concerns were raised about US bank stress tests a year ago.

Major global economic releases and implications

- US economic data were soft, but not as bad as expected. Home sales, housing starts and a home builders' conditions index all fell, but permits to build new houses rose after two months of sharp falls. Weekly mortgage applications and house prices also rose in May. An index of leading indicators fell in June and unemployment claims jumped leaving them in the sideways range they have been in for much of this year. The soft tone to US economic data is clearly registering at the Federal Reserve (Fed) with Chairman Ben Bernanke calling the US economic outlook "unusually uncertain" and indicating that the Fed stands ready to ease further if needed.
- While US economic data have been soft of late, US earnings reports have been very good. In fact, 85% of the companies to have reported so far have exceeded expectations. This is good news for business investment and employment going forward.
- Europe appears to be weathering its sovereign debt crisis remarkably well, with business conditions indicators actually rising in July on the back of strength in Germany and France, industrial orders surging higher in May (no doubt helped by the fall in the euro) and consumer confidence actually improving in July. UK retail sales also came in stronger than expected in June and June quarter UK GDP growth was nearly double expectations at +1.1% quarter on quarter.

New Zealand economic releases and implications

- Net migration continued to trend lower, with the monthly figure for June barely positive at +70 (yes, 70 people, not thousand!). For the year ending June, net migration was just over 16,000, but this will fall rapidly if the recent downturn is sustained and it reduces one

key driver of demand for housing. Short-term visitor arrivals were up 7.9% year on year but there is clear evidence that upward momentum in tourism growth is beginning to wane. Consumer confidence fell in July according to the ANZ-Roy Morgan Consumer Confidence measure. The index fell six points to 115.6, the lowest level since the start of the year. This goes some way to closing the gap between the surprisingly high level of confidence and the somewhat tepid recovery in retail sales growth.

Major market moves

- Shares had a solid week - rebounding from the falls late in the previous week on the back of strong earnings results, takeover speculation and better than expected economic data in Europe.
- The Chinese mainland share market rose 6.1% on optimism that the Chinese authorities will relax some of their tightening measures in the next few months and on indications that measures to boost consumption will be enhanced.
- The improvement in investor confidence also flowed through to commodity prices and the New Zealand (NZD) dollar, with the NZD pushing back towards US\$0.73.

What to watch in the week ahead?

- In New Zealand, on Thursday the Reserve Bank of New Zealand (RBNZ) is expected to raise the Official Cash Rate (OCR) for the second time this cycle, with a 25 basis point increase to 3% widely anticipated. The market will be focused on the tone of the accompanying statement. As we are still very early in the tightening cycle, it is likely to signal further rate hikes ahead, conditional on the flow of data over coming months. In the National Bank's Business Outlook Survey on Wednesday, we are likely to see another fall in confidence in July, which the less comprehensive BNZ confidence survey has already signalled. Overseas Merchandise Trade data on Thursday is expected to show another modest monthly trade surplus, given exports values should still be benefiting from high commodity prices and strong Chinese demand. We will be watching for any signs of a pick up in plant and machinery imports as a sign of potential future business investment. Credit data released later that afternoon are expected to remain

very weak, with households more focused on debt reduction than increased spending. Finally, building consents issued for June will be released on Friday. Following the large 9.5% month on month drop in May, there is the possibility of a statistical bounce, even though house sales data, a leading indicator, suggest some lingering underlying weakness in the housing market.

- In Australia, the big focus will be the June quarter inflation figures due for release on Wednesday, given that a worse than expected result could trigger a rate hike right in the middle of the election campaign. Our expectation is that headline inflation will rise 0.9% quarter on quarter or 3.3% year on year, but because this will be boosted by an increase in tobacco excise, it will be necessary to focus on the underlying rate of inflation - which we expect to rise 0.7% in the quarter or 2.9% over the year. If this is the case it would be broadly in line with Reserve Bank of Australia expectations and shouldn't be enough to justify an imminent rate hike. Of course if underlying inflation is 3% or above, then the pressure to raise interest rates again next month will intensify. Private sector credit data will also be released.
- In the US, data for new home sales are likely to show some stabilisation after recent falls, consumer confidence is likely to remain soft and durable goods orders are likely to rise after a fall in May. US June quarter GDP data is expected to show growth running at around 2.5% annualised, consistent with a continuing but sub-par recovery compared to past recovery cycles. The US profit reporting season will continue with another 155 S&P 500 companies due to report. Japanese unemployment and inflation data will also be released.

Outlook for markets

- Strong profit results in the US are currently providing a lift for shares, but we expect the upcoming New Zealand profit reporting season to be a more subdued affair, with anecdotes pointing to a tough operating environment for most companies. Double dip concerns are likely to persist for a while and suggest that we may still see more volatility and weakness into the seasonally weak months of September and October. However, we remain of the view that a double-dip recession globally will be avoided. With shares offering very good value, monetary conditions likely to remain favourable and China likely to start relaxing its tightening measures in the next few months, shares could well have a reasonable rally in the December quarter and through 2011.

- From a long term perspective, the NZD is overvalued, but such conditions can be sustained over many years. New Zealand's strong terms of trade, the rising New Zealand / global short term interest rate differential, and more favourable fiscal position relative to the major countries, would point to the NZD remaining richly priced for some time to come. That said, the NZD appears to be highly correlated with global shares at the moment, moving up or down in line with risk appetite, rather than economic fundamentals and that makes its movements difficult to pick over the short term.
- Low yields are pointing to low medium term returns from government bonds. Yields should increase towards levels seen earlier in the year as the current high level of investor risk aversion abates.