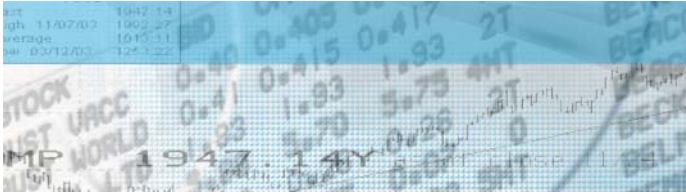


# Weekly market & economic update - Week beginning Monday 30 August 2010



## Headline developments of the past week

- US Federal Reserve Chairman Ben Bernanke indicated that the Fed stands ready to provide further monetary stimulus if the economic outlook deteriorates significantly further. However, there is nothing new in this and his insistence that the preconditions still appear to be in place for a pick up in growth in 2011 and that the Fed has not yet agreed on criteria or triggers for more action suggests that the Fed is nowhere near ready to undertake more quantitative easing just yet. US shares rose solidly on Bernanke's comment that the Fed will act if necessary, but given his failure to provide anything new this may be nothing more than a bounce from oversold levels.

## Major global economic releases and implications

- US economic data seems to be going from bad to worse. June quarter GDP growth was revised down to 1.6% annualised which some would say is stall speed from a previously reported 2.4% pace. Consumer sentiment slipped, both new and existing home sales fell sharply pointing to renewed falls in US house prices, underlying capital goods orders fell sharply in July, weekly retail sales fell and regional manufacturing surveys continue to point to a softening in business conditions. Our base case is still one of very weak growth in the US because corporate strength and a likely further bout of Fed quantitative easing should help the US avoid a return to recession for now, but with the recent run of poor data out of the US we think that the risk of double dip has increased from around 30% to around 35-40%. In any case the US faces a tough six months ahead.
- European economic data was mixed. While industrial new orders rose 2.5% in June, European business conditions indicators for August fell slightly. They are still at high levels but it is quite likely that Europe is simply lagging the strength in the global economic cycle seen six months ago.
- Japanese economic data for July showed a slight fall in unemployment but weaker than expected household spending and continuing price deflation. Reflecting the deteriorating economic outlook, the Japanese Government is preparing further economic stimulus and has indicated it will put pressure on the Bank of

Japan to reduce the value of the Yen, although it's worth noting we have heard that one before!

## New Zealand economic releases and implications

- The RBNZ Survey of Expectations for the September quarter showed that the average one-year-ahead inflation expectation nudged up to 3.9% from 2.9% in the March quarter. In contrast, the two-year-ahead inflation expectations moderated from 2.8% to 2.6%. This provides some encouraging news given the RBNZ's continued emphasis on longer-term inflation expectations and the expectations that the impending period of high headline inflation due to the 1 October GST hike will prove only a temporary effect.

## Major market moves

- Despite a rally in US and European markets on Ben Bernanke's comments late in the week, global share markets fell over the week as a whole on the back of weak economic data and worries about a return to recession in the US.
- Despite growth fears, commodity prices rose, providing support for the NZ dollar.

## What to watch in the week ahead?

- In the US, the August ISM manufacturing conditions index is expected to fall to around 52 from 55.5 in July and private payrolls are likely to remain sluggish with a gain of just 40,000 in August, neither of which will do anything to allay worries about a return to recession in the US.
- In China, the news may be a little better with the Chinese manufacturing PMI likely to stabilise or rise a little for August, after falling in previous months.
- In Australia, along with the election outcome, the focus is likely to be on June quarter GDP data which is expected to show growth of 0.8% in the quarter or 2.7% over the year reflecting solid contributions from consumer spending, dwelling construction and net exports.
- In New Zealand, the key data this week is August business confidence, which is likely to show a continued softening trend. Meanwhile dwelling consents data have remained lacklustre and the ANZ world commodity price index may record its third monthly decline in NZ's export commodity prices.

## Outlook for markets

- With worries about a dip back into global recession now escalating and policy makers in the US and China unlikely to respond immediately, shares are at high risk of having another leg down, particularly as we head into the normally weak months of September and October. However, beyond the likelihood of another round of near term share market weakness we remain of the view that a double-dip recession globally will be avoided and with shares offering very good value, the US Federal Reserve likely to embark on another round of quantitative easing and China likely to start relaxing its tightening measures sometime in the next few months, shares are likely to stage a decent rally in the December quarter and then through 2011. It's likely to remain a volatile and constrained ride though.
- The NZ dollar is liable to remain volatile in the short term, particularly with double dip fears persisting and the expectations for the next interest rate hike in New Zealand being pushed out.
- Double dip and deflation worries will keep bond yields low in the short term, but medium term returns are likely to be poor reflecting low yields and excessive public debt levels in many developed countries.