

## Weekly market & economic update – week beginning 20 February 2012

20 FEBRUARY 2012

### Headline developments of the past week

- > The ongoing confusion as to whether an agreement has been reached or not regarding Greece's latest bailout negotiations raged last week, resulting in a volatile ride for risk assets like shares. Greece looks to have fulfilled the conditions required to receive another bailout, but European leaders' reluctance to grant the bailout ahead of elections in April is causing the process to be dragged out. Our assessment is that a deal is close by, as both sides have too much to lose, though the risks remain high. There is a good chance that Eurozone finance ministers agree to a deal at their 20 February 2012 meeting.
- > In a broader sense there was mostly good news regarding the European debt issue over the last week. Moody's played catch up in downgrading various European countries. Against this, the European Central Bank (ECB) appears to be moving closer to forgoing profits on its Greek bond holdings in order to help ensure Greece's debt falls to 120% of gross domestic product by 2020, Spain is now a third of the way through its planned bond issuance for this year, China gave assurance that it would help support Europe in its debt struggles and German officials signalled a willingness to provide more assistance to Portugal. Most importantly bond yields in Spain, Italy, France and Portugal were little affected by the ongoing Greece debt debate of last week, suggesting investors are becoming less concerned about contagion.
- > Meanwhile, global deflation remains an ongoing theme with the Bank of Japan announcing extra quantitative easing, a short term inflation target of 1% and a medium term target of 2%. This is a very significant decision. If Japan is serious about meeting its inflation targets, it means more monetary easing in order to break the psychology of deflation. It could mean a fundamental downturn in the yen and the relative upswing in the performance of Japanese shares. Such a move adds to quantitative easing by the US, UK and ECB and is ultimately a positive move for financial assets generally.

### Major global economic releases and implications

- > US data releases last week were mostly upbeat. January retail sales and industrial production were a little softer than expected, but there was a slight rise in small business optimism and solid gains in manufacturing conditions in the New York and Philadelphia regions. There was a further fall in unemployment claims and another rise in an index of leading indicators. There was another fall in mortgage delinquency rates, further gains in housing starts and permits as well as a further recovery in home builders' conditions. The latter is very positive and adds to evidence the US housing sector is recovering. General Motors posted a record annual profit, adding to the renewal of US manufacturing underway. As Lee Iacocca reportedly said "as goes General Motors, so goes the nation" – perhaps. Congress has extended payroll tax relief and expanded unemployment benefits for the remainder of this year.
- > The eurozone contracted -0.3% in the December 2011 quarter, likely signalling the start of a recession. Fortunately, the decline was less than feared and recent indicators suggest it will be a mild recession.
- > Japan's economy also contracted in the December quarter. Gains in industrial production, a tertiary activity index and a likely rebound in public demand point to a return to positive growth in the current quarter.
- > Growth in Malaysia remained strong in the December 2011 quarter, boosted by robust domestic demand. Slowing exports are likely to see growth slow to a still reasonable 4% this year, ahead of renewed strength next year.

### New Zealand economic releases and implications

- > December quarter retail sales grew 2.2% compared to the previous quarter; or a record 2.9% excluding the more volatile motor vehicles and related components. Much of the strength can be attributed to the Rugby World Cup.

- > Aside from the positive December retail sales number, the higher frequency partial data in January were somewhat less encouraging, with job ads down slightly, the NZ manufacturing PMI down 1.4 to 50.5, and the ANZ Consumer Confidence index down 2.8 to 113.3

## Major market moves

- > Global share markets rose over the last week thanks to strong US data and optimism Greece won't default next month. The stand out was the US share market which was flirting with last year's highs. By contrast, Australian shares fell and are struggling on the back of much tougher monetary conditions, as rate cut expectations have been dampened, mortgage rates have risen and the Australian dollar remains strong.
- > The New Zealand share market dipped down slightly during the week, amid the December quarter earnings results season.
- > The New Zealand dollar (NZD) had another volatile week, but failed to break out of the 83 cents range against the US dollar.

## What to watch in the week ahead?

- > In the US, expect modest further gains in existing home sales data (due Wednesday) and new home sales (due Friday) and flat December house prices (due Thursday). Data for consumer sentiment will be released on Friday.

- > In Europe, the focus will stay on Greece with finance ministers to consider the bailout package on Monday. Purchasing managers index business conditions indicators (due Tuesday) and the German IFO index (due Thursday) will be watched closely.
- > The week ahead will bring some insight into New Zealand's inflation situation, with the RBNZ survey of inflation expectations and the Producer Price Index data for the December quarter.

## Outlook for markets

- > Shares remain vulnerable to a short-term pullback after strong gains so far this year, and this may now be occurring on the back of Greek worries. However, the broader trend is likely to remain up. Valuations are attractive particularly against very low bond yields, the risk of a Eurozone meltdown has receded, momentum in global economic indicators has turned positive, global monetary conditions are easing and there is lots of cash on the sidelines. Our medium term view on Australasian equities remains supportive; particularly on Australian equities where relative valuation metrics and economic prospects add to the medium term (3-5 year) case.
- > Like shares, the NZD continues to be pushed around by the day to day shifts in global risk sentiment. As such, the NZD is likely to see continued volatility, with a medium to long term gravitation towards fair value. In the short term the NZD will likely be strongly influenced by the key global macro events such as the Eurozone debt crisis, the prospects of further quantitative easing, and any further developments in regards to the interest rate outlook in New Zealand.