

Investment brief



Global

- **Review:** It was certainly an interesting month watching the economic data flow. There was almost universal disappointment on US activity data, to the point where many raised concerns about a double dip recession. Meanwhile, there was a surprisingly positive run of European activity data, despite the sovereign debt concerns which have plagued that region this year.
- In the US we saw a widespread fall in many leading indicators of growth, including disappointing falls in the manufacturing and services ISM indicators and some regional business confidence indicators for July. GDP in the June quarter rose by an annualised 2.4%, consistent with slowing growth momentum and sluggish final demand growth. Employment growth was weak and retail sales fell for the second consecutive month in June. Consumer confidence dipped to a five month low and housing market indicators were mixed, but remained consistent with pretty depressed levels of activity. The widespread disappointment in many indicators led some to believe that a double-dip economic recession was becoming increasingly likely, although perhaps a less alarmist interpretation was that the recovery is proving to be relatively mild. US Federal Reserve Chairman, Ben Bernanke, described the outlook as “unusually uncertain”.
- In stark contrast, the economic data flow in the major European countries was surprisingly positive, with the weaker euro no doubt helping to fuel economic activity. In Germany, industrial production rose by an impressive 2.6% month-on-month (MoM) in May, the unemployment rate fell to a 20-month low of 7.6% and the Ifo business climate index rose to its highest level in three years. European-wide indicators were also encouraging, with rises in the purchasing managers’ index, consumer confidence, economic sentiment and industrial orders. That said, it was clear that the major EU countries were performing much better than the periphery. UK GDP for the June quarter blew away market expectations, surging by 1.1% quarter on quarter (QoQ).
- Asia remained a strongly growing region, but there was further evidence that tighter policy in China was slowing its economy. GDP rose by 10.3% year on year (YoY) in the June quarter and June macro indicators generally surprised on the downside, with industrial production up ‘only’ 13.7% YoY. Its purchasing managers’ index continued to drift lower, consistent with weaker growth over coming months. Elsewhere, Korea industrial production rose by 21.5% YoY in May, and Singapore GDP blew away expectations with a 19.3% YoY increase in the June quarter. Economic data wasn’t as flash in Japan, with the unemployment rate rising for a fourth straight month and industrial production unexpectedly falling by 1.5% MoM in June.
- With developed world inflation pressures still easing, the Bank of Canada remained the only G7 central bank in a mood to tighten monetary policy, with another 25 basis point (bps) increase in its policy rate to 0.75%. However, with strong growth and rising inflation pressures in the developing world, rate hikes were more widespread with increases in Brazil, India, Korea and Malaysia.
- **Outlook:** We don’t currently subscribe to the double dip recession view, but acknowledge that the economic recovery in the major developed countries is likely to be drawn out and modest, while strong growth should be maintained in emerging markets. Overall, world GDP growth is still expected to exceed 4% this year and in 2012.

New Zealand

- **Review:** The economic dataflow was a little soggy during the month, suggesting that the economic recovery had lost some momentum.
- Business confidence fell for the third consecutive month in July in the National Bank survey, admittedly off a high base, so the message was one of the economic expansion continuing but moderating. The Quarterly Survey of Business Opinion gave the same message.
- Consumer confidence fell for the second consecutive month in July on the Roy Morgan measure. A reduced level of confidence is becoming more consistent with the tepid recovery in retail sales we’ve seen to date this cycle. In the three months to May, the value of retail sales was up 2.6% YoY but up only 0.9% QoQ excluding auto sales.
- The housing market remained soft, with house sales down 24% YoY in June. Building consents rose in June but this followed a big fall in May and the trend series was fairly flat. Expectations for the outlook were tempered by the steady decline in net migration, which peaked around 25,000 per annum a year ago and dropped to a trickle in June (an annualised 4,000 in the June quarter and sub-1000 for June alone).

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- After a very strong run, the upside in New Zealand's commodity prices might be drawing to a close, with dairy prices in Fonterra's online auction down 13.7% MoM in July, although still up a strong 61% YoY.
- The CPI rose by 0.3% QoQ and 1.8% YoY, confirming that inflation pressures remain well contained for the time being.
- The Reserve Bank of New Zealand (RBNZ) raised the official cash rate (OCR) for the second consecutive month, up 25 bps to 3.0% but issued an easier statement than expected, indicating that future growth prospects had deteriorated and that the pace and extent of further OCR increases was likely to be more moderate than was projected in June.
- **Outlook:** As for the developed world, the economic recovery in New Zealand is likely to be modest by historical standards but the economic expansion is likely to continue through into next year. New Zealand's terms of trade may have peaked but the lagged impact of their strength will feed into domestic incomes for some time yet.

International shares

- **Review:** Following a poor June quarter, share markets around the world showed a strong bounce back in July. A strong earnings reporting season in the US, with a large majority reporting stronger than expected results, helped underpin share markets, despite the weaker flow of economic data. The better than expected flow of economic data in Europe, increased visibility on sovereign debt exposure following stress tests for the major banks, and an easing of bank funding pressures in the region supported share markets in Europe.
- The MSCI World Index surged by 5.8% for the month. Of the major regions, Europe and the UK performed well, while Japan performed poorly. The US market was strong in local currency terms (up by 7.0%), but the significant fall in the US dollar (USD) detracted from its unhedged return. As a sign that the risk bet was back on, Greece and Spain headed the leaderboard, with rises of 23% and 15% respectively.
- There was a strong performance across most sectors of the market with the defensive sectors of Health Care and Consumer Staples notable underperformers. The Financial sector was the best performing, given good bank results in Europe and an easing of funding pressures in that region. In the US, the Financial Reform Bill was passed which is intended to address some of the sector's failings during the financial crisis.
- **Outlook:** Volatility in share markets has kicked up a gear over recent months and the near-term outlook is cloudy. Longer term we see much better value in share markets than bond markets, but we're looking at a pretty rocky road ahead over the near term as sentiment zigs and zags.

New Zealand shares

- **Review:** New Zealand was one of the worst performing markets in the developed world as it typically is when the risk bet is on. The softer run of local economic data and stronger currency did the market no favours. The NZX 50 Index rose by 'only' 2.1% while the NZX Portfolio Index rose by 2.5%.
- NZ Farming Systems Uruguay was at the top of the leaderboard, after receiving a full takeover bid by a Singapore company. Rakon bought the assets of a small competitor in

France and was expected to report record sales on the back of the boom in GPS-enabled smartphones and tablet PCs. In other major corporate news, Telecom NZ announced the sale of some of its Australian assets for A\$140 million.

- Pumpkin Patch was at the bottom of the leaderboard, following reports that Australian retailers were struggling. Other notable underperformers were Vector, Fisher & Paykel Healthcare and Fletcher Building.
- **Outlook:** Our valuation metrics show New Zealand shares to be very good value against bonds but not so good against global shares. There are no obvious near-term catalysts to improve sentiment in the market and investors will have to be a little patient to realise better returns.

New Zealand listed property

- **Review:** The NZX listed property sector slightly underperformed the broader market, with the index up 1.6% for the month. Of the majors, Kiwi Income Property Trust was the best performing, returning 5.6%, supported by its share buy-back programme, although few shares were purchased on market. Goodman Property Trust rose by 1.1%, ING Property Trust and Property for Industry (PFI) were flat, while AMP NZ Office Trust fell by 1.4%.
- There was little corporate news during the month. There was some further disclosure about the impact of the Budget announcements. PFI's financial statements for the first half of 2010 are expected to show an increase of circa \$36 million in deferred tax liability relating to the depreciation of building structure and distributable profit for PFI is expected to be reduced by 4-5% for the 2011 financial year. This estimate is in line with previous announcements from other listed property companies and trusts. National Property Trust unit holders approved the manager's proposal to convert the trust to a company and internalise management.
- **Outlook:** The sector provides an attractive gross dividend yield but it is hard to see a positive catalyst in the face of modestly declining asset values and dividend levels. In addition, we still await the outcome of a review around the depreciation treatment of fixtures and fittings, which has the potential to further reduce distributable earnings for property vehicles.

International bonds

- **Review:** Concern about sovereign risk in Europe eased during the month, with countries and banks in the region finding the going a little easier in terms of issuing new debt. The publication of the stress tests for major European banks helped, providing increased disclosure on various exposures. With higher risk appetite, there was a shift away from the safe haven of German bonds into the periphery. The better economic dataflow, particularly for Germany, also helped push rates up for that country. Therefore, Germany's 10-year bond rate rose by 9 bps to 2.67%, while rates across Italy, Spain, Portugal and Greece fell.
- In the US, bonds were well supported considering the strong recovery in share markets. The consensus continued to shift out rate hike expectations far out into the future and the weaker flow of economic data helped. The US 10-year rate ended the month down 3 bps to 2.91%. In other major countries, the UK 10-year rate fell by 3 bps to 3.33%, while Japan's rate fell by 2 bps to 1.07%.

- **Outlook:** With no real threat of higher policy rates in the US, Japan and continental Europe and with inflation indicators still easing, the bond market could well be supported over the short term. However, current rates are well below historical norms, and investors should have a more cautious medium to long term view of the bond market.

New Zealand bonds and cash

- **Review:** The RBNZ's 25 bps increase in the OCR was well anticipated by the market, but the softer outlook statement was not, leading to lower interest rates across most of the curve as the market priced out the extent of future rate hikes. The 90-day bank bill rate rose by 14 bps to 3.27% but the two year swap rate fell by 11 bps to 3.97%, with all of the fall coming after the Bank's Statement.
- The five year government stock rate fell by 4 bps to 4.61% while the long bond rate (close to 11 years) fell by 1 bps to 5.33%. Swap spreads narrowed, with the five year swap rate down 13 bps to 4.64% and the 10-year rate down 13 bps to 5.24%.
- **Outlook:** The softer than expected statement by the RBNZ raises an element of doubt about the precise OCR track over coming quarters and the possibility of a data-dependent pause now comes into play. That said, the tightening cycle has still only just begun and, looking at a wider picture, the OCR has a long way to go before even reaching a neutral level of circa 4.5%. Longer term bond rates will be driven more by international trends, with some support over the short term, but lingering doubts about the sustainability of rates at current low levels.

New Zealand dollar

- **Review:** The USD was the weakest currency by far of the majors, given the weaker economic data flow compared to Europe and Japan. The rollercoaster ride for the euro continued, with a strong recovery following some serious damage to that currency earlier in the year. The New Zealand dollar (NZD) had a middling sort of performance overall.
- The NZD rose by a considerable 5% against the USD and reached a six-month high at one point. The NZD was also fairly robust against the yen with a 3% appreciation. Other movements were more modest. The NZD rose by less than 1% against sterling, and fell by about 1% against the euro and under 2% against the Australian dollar.
- On an MSCI-weighted basis, the NZD rose by just under 3% and a little over 1% on a trade-weighted basis.
- **Outlook:** The NZD is highly correlated with global shares at the moment, moving up or down in line with risk appetite and this makes it difficult to predict. The currency is due for a breather, following its appreciation despite some weaker economic fundamentals such as lower dairy prices, a weaker economic data flow and the softer statement by the RBNZ.

Summary

Key financial markets summary

	As at 31 July 2010	Change over the month (%)	Change over the year (%)
MSCI - US	3808.44	7.0	13.7
MSCI - UK	8249.70	7.1	18.0
MSCI - Germany	1860.67	2.9	14.9
MSCI - Japan	971.88	1.4	-8.8
NZX 50	3034.62	2.1	0.6
MSCI - World (local currency)	2683.56	5.8	10.4
MSCI - World (NZD)	5156.10	2.7	0.3
NZ Official Cash Rate	3.00	25 bps	50 bps
NZ 90 - day bank bill yield	3.27	14 bps	48 bps
NZ 10 - year bond yield	5.33	-1 bps	-91 bps
US 10 - year bond yield	2.91	-3 bps	-57 bps
NZD - USD	0.7243	5.3	10.0
NZD (TWI)	67.3	1.4	9.6
NZD (MSCI weighted)	74.7	2.9	11.5

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