

Weekly market & economic update – week beginning 30 January 2012

30 JANUARY 2012

Headline developments of the past week

- > The past week saw share markets and other risk related trades supported by a combination of favourable economic data in the US and Europe as well as good profit results in the US and very dovish comments from the US Federal Reserve (FED), which have boosted expectations for another round of quantitative easing.
- > The key message from the Fed was that it has shifted the likely timing of its first interest rate tightening from mid-2013 to late 2014 at least. This combined with the slight downwards revisions to growth forecasts, expectations that unemployment will decline only gradually and that inflation will remain below target as well as an explicit reference to being prepared to adjust security holdings to boost growth all suggests that the odds of another round of quantitative easing (QE3) are increasing. All of this is seen in a positive light for risk trades such as shares, commodities while at the same time keeping bond yields down.
- > The International Monetary Fund (IMF) downgraded its 2012 world growth forecast from 4% to 3.25% and repeated its warning of a 1930s style crisis if Europe is not brought under control, though this was nothing new. Its growth downgrade, like that from the World Bank a week earlier (which downgraded to 3.4% if weighted on a purchasing power parity basis), is just catching up to private sector forecasts (our expectation is for 2012 world growth of 3%). Our assessment remains that the risks in Europe remain high but thanks to the provision of cheap funding to European banks they have receded from the situation in September and October when both the World Bank and IMF were warning that the global economy was entering a “dangerous phase”.
- > Negotiations aimed at restructuring Greek debt continued with the European Union (EU) insisting private investors accept a lower interest rate before it will consider another bailout for Greece. This is necessary if Greece is to avoid defaulting on a bond payment due on 20 March 2012. Indications are that private investors are willing to concede and accept a sub 4% rate of interest on top of a 68% write down on the net present value of their bond investments. Uncertainties remain as to whether all private investors will be forced into this, what

this will mean for credit default swap payouts and whether the European Central Bank will take a haircut too. Portuguese bond yields have pushed on to record highs (with investors fearing Portugal will go the same way as Greece), but Spanish and Italian bond yields fell sharply over the last week. News that Germany is now open to the idea of boosting the size of Europe’s new bailout fund (the European Stability Mechanism or ESM) by combining its €500 billion with the €250 billion which is remaining in its existing bailout fund (the European Financial Stability Facility or EFSF), helped boost sentiment. Fitch Ratings downgraded sovereign ratings for Italy, Spain, Belgium, Cyprus and Slovenia, but this was just a catch up to the recent Standard and Poor’s downgrades.

- > An obvious risk to watch is the oil price. Geopolitical tensions in the Middle East are on the rise again with the EU banning the purchase of Iranian oil from July and Iran threatening to close the Strait of Hormuz.

Major global economic releases and implications

- > US data was mostly positive. Pending and new home sales fell in December after several months of strong gains. Weekly unemployment claims rose but the trend remains down. Against this, house prices rose in November and durable goods orders rose strongly in December. Leading indicators rose and regional manufacturing conditions indicators continued to improve, as did consumer sentiment. December quarter gross domestic product came in slightly below expectations, but at 2.8% was still a pick-up on the 1.8% pace seen in the September quarter.
- > US earnings results were generally positive with strong results from Apple, Caterpillar, Raytheon and Time Warner. While 70% of recent results have been better than expected, the soft start to the reporting season means that in total only 60% are ahead. This is below that seen over the last 10 quarters. 74% of results have exceeded revenue expectations. The consensus estimate for operating earnings growth over the year to the December quarter last year has increased from 9.4% to 11% over the last two weeks.

- > European economic data over the last week was positive with gains in both manufacturing and services sector conditions indices for the second month in a row. Germany in particular is faring much better than anticipated.
- > In Japan, deflation continued in December, but retail trade was a little bit stronger than expected.
- > Monetary easing continued in Asia over the last week with the Bank of Thailand cutting rates again and the Reserve Bank of India (RBI) joining the easing cycle for the first time by cutting bank cash reserve requirements. With growth and inflation cooling, the RBI will likely start cutting interest rates next month.

New Zealand economic releases and implications

- > The RBNZ issued its regular OCR announcement last Thursday, keeping the interest rate on hold at 2.50%. Essentially the RBNZ noted that it was in no hurry to adjust policy settings with a relatively relaxed outlook on domestic inflation, and wariness of a still uncertain global outlook staying its hand for now.
- > Elsewhere the NZ manufacturing PMI rebounded 5.9 points, coming in at 51.9 in December; this is in contrast to the weaker readings in November and October, but consistent with some of the signs of improved momentum in manufacturing during December elsewhere around the globe.
- > New Zealand also saw trade figures out last week, with exports remaining buoyant, leading to a monthly trade balance of \$338 million, and an annual balance of \$1.11 billion.

Major market moves

- > Share markets generally continued to trend higher on solid economic and profit news, dovish comments from the FED, but worries about the Greek debt impasse acting as a bit of a constraint. US shares were essentially flat, but shares rose in Europe, Asia, Australia and New Zealand.
- > Commodity prices were boosted by better economic news and increased prospects for another round of US quantitative easing. Oil prices benefitted from news of the EU's embargo on Iranian oil from July. The euro and the New Zealand dollar (NZD) both rose as the US dollar weakened.
- > Bonds rallied as investors focused on near zero US interest rates for longer and increasing prospects for QE3 on the back of the Fed's latest statement.

What to watch in the week ahead?

- > In the US, the focus will be on the January ISM manufacturing conditions index (due Wednesday) which is expected to show a further improvement, and payroll employment data (due Friday) which is expected to gain 150,000 jobs with unemployment remaining unchanged at 8.5%. Data for personal spending (due Monday), house prices and consumer confidence (due Tuesday)

and the ISM non-manufacturing conditions index (due Friday) will also be released.

- > In the eurozone, data for business and consumer confidence, unemployment, inflation and retail sales are due for release. The EU leaders' summit on Monday will be watched for progress towards the fiscal compact announced in December and pro-growth measures, but don't expect much of substance in terms of the latter.
- > Chinese Purchasing Managers' Index measuring manufacturing conditions (due Wednesday) are likely to remain around the 50 level. Japanese industrial data (due Tuesday) is expected to show a modest rise.
- > This week NZ has a number of December data points due out that may help inform the housing market outlook; building consents are due on Tuesday as is credit growth, and international travel and migration numbers come out on Friday.

Outlook for markets

- > After strong gains so far this year, shares are a bit overbought and vulnerable to a correction, particularly as we enter the seasonally softer month of February. However, the broader picture for shares is looking more favourable: valuations are attractive particularly against very low bond yields, the risk of a meltdown in Europe has receded, the global recovery looks like it will continue (although at a slower pace than seen in 2010 and 2011), monetary conditions are easing and there is lots of cash on the sidelines.
- > Global bond yields are very low in core countries suggesting low returns unless Europe's debt crisis intensifies.
- > The New Zealand dollar (NZD) is likely to be range bound over the coming months. From a cyclical perspective, strong terms of trade and favourable local economic data are supportive of the NZD. However, the long term valuation measure suggests the NZD is overvalued. As a result, the demanding valuation makes the currency vulnerable to external shocks and any near-term pull backs.
- > Government bonds are a good diversifier and with short term interest rates likely to remain low indefinitely it's hard to see much sustained upwards pressure on bond yields for the foreseeable future. However, yields are extremely low so expect modest medium-term returns.

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