

## Investment Brief



### Global

- **Review:** Global economic data deteriorated notably during May, indicating the global economy has hit a soft patch. Weaker manufacturing and employment data out of the US in particular is raising concerns over the durability of the US recovery. Supply-chain issues from the recent events in Japan and elevated oil prices appear to be the major contributors to the current slowdown in activity globally.
- US economic data released during the month confirmed that the economic recovery has slowed. The Institute for Supply Management (ISM) business surveys lost momentum in April with the non-manufacturing survey recording a sharp fall to an eight-month low. In nominal terms, US retail sales rose solidly in April. Yet, some of this strength was due to price rises for food and energy, with these increases also visible in inflation readings. The US consumer price index (CPI) inflation rose by 0.5% month-on-month (MoM) in April, with annual inflation reaching 3.2% year-on-year (YoY). America's industrial sector stalled in April, with industrial production flat for month. In particular, US automobile production slumped by 8.9% due to shortages of parts as a result of the devastating earthquake in Japan in March. In positive news, the US labour market recorded healthy employment growth in April, with the largest job gains in 11 months. However despite this, the unemployment rate edged 0.2% higher to 9.0% in April.
- Japan's economy has fallen into recession once again, recording two consecutive quarters of declining activity. Japanese GDP fell by 0.9% quarter-on-quarter (QoQ) in the March quarter. The Bank of Japan conceded that "Japan's economy faces strong downward pressure, mainly on the production side, due to the effects of the earthquake disaster."
- China's economic activity indicators suggested moderating growth momentum, but still elevated inflation. Chinese exports grew strongly over the year to April while import growth was slower, indicating slowing domestic demand. Growth in industrial production and retail sales slowed

more than expected in April, but fixed asset investment was slightly higher than expected. China's annual CPI inflation exceeded market expectations at 5.3% in April, as food prices remained elevated.

- European bond markets continued to be plagued with default concerns during May despite the financial bail out packages for Greece, Ireland and Portugal. Greece, in particular, is under severe pressure due to the perception that the scale of its government debt is too high to be sustainable.
- Despite the lingering sovereign debt issues, Europe recorded a surprisingly strong economic growth result for the March quarter, with GDP expanding by 0.8% QoQ. However, there remains a dramatic divergence in country performance across Europe, with Germany and France continuing to perform strongly while other countries struggle. This divergence was also apparent in business surveys, with Europe's Purchasing Managers Index (PMI) showing a more cautious manufacturing sector while Germany's IFO Business Climate Index remained at 20-year highs. The European Central Bank (ECB) kept its policy interest rates on hold at 1.25% at its May meeting after raising interest rates by 0.25% in April. ECB President Trichet gave no firm signal that another interest rate rise was imminent, but noted the ECB would monitor "very closely all developments with respect to upside risks to price stability."
- **Outlook:** Clearly global growth has lost momentum over recent months. While there is a possibility that the 'soft patch' may be extended rather than temporary, the underlying fundamentals for the global economy is not as troubling as some fear. Given that monetary policy settings are extremely easy and that financial conditions have not materially deteriorated (credit spreads and bank lending standards), the global economy should be able to ride out this run of slower activity over coming months before reviving later this year.

### New Zealand

- **Review:** Key New Zealand economic data released during May surprised on the upside, showing the underlying resilience and improving growth momentum.
- The Budget was generally well received by market and rating agencies. It predicted a return to surplus in 2015/2016 and a smaller bond issuance going forward.
- The monthly NBNZ Business Outlook survey showed business confidence improved notably in May. Headline business confidence rose to a net 38.3% in May from 14.2% in April. Meanwhile, the more reliable own-activity indicator surged to 39.7% in May from 29.5% in April to be back above its long term average. The business confidence data is consistent with the economic growth heading to above-trend rate.

### Investment enquiries

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- The quarterly labour market data surprised on the upside, with total employment rising by 1.4% over the March quarter. This takes annual employment growth to 1.8%. With the quality of the data having been impacted by the Canterbury earthquake, the employment data excluding Canterbury revealed an even stronger outcome with employment outside Canterbury rising 1.8% over the quarter. The unemployment rate fell from a revised 6.7% in the December quarter to 6.6% in the March quarter.
- The Labour Cost Index showed private sector salary and ordinary time wages were up 0.4% over the March quarter, rising 2% over the 12 months to March. Wage inflation is essentially benign to date being roughly in line with the long run average of 2.1% YoY and it should present no additional concern for the central bank's inflation outlook.
- The ANZ commodity price index was up another 1.6% in April, an eighth consecutive monthly gain which takes it to a new record high.
- Total electronic card transactions were up 1.7% in April after a 0.5% increase in March. Total spending in the retail industries was up 1.5% to be up 9.5% on a year ago.
- The number of house sales was down 4.2% YoY in April. On a monthly basis however, sales were up around 0.2% MoM in April after a 4.6% MoM lift in March. House prices rose 1.1% MoM in April to be down 0.4% on a year ago. House prices are now 4% below their November 2007 peak.
- The BNZ-Business NZ Performance of Manufacturing Index improved recording 51.5 in April, up from 50.2 in March.
- The ANZ-Roy Morgan Consumer Confidence Survey rose slightly, the first increase in consumer confidence recorded since the Canterbury earthquake of February.
- The Reserve Bank of New Zealand (RBNZ) survey of expectations showed a rise in the two-year ahead inflation expectation to 3.0% in the June quarter from 2.6% in the March quarter. The inflation expectation is now at its highest since September quarter of 2008, the quarter that saw the headline CPI inflation peak at 5.1%.
- Overseas merchandise trade balance recorded a record monthly surplus of \$1.1 billion in April, the largest surplus as a percentage of exports since May 1993.
- **Outlook:** New Zealand's growth momentum should pick up notably over the second half of this year. Reconstruction in Canterbury is expected to boost the level of economic activity significantly over the coming years and the backdrop of strong export commodity prices and the favourable terms of trade will continue to be supportive of growth. Downside risks to this optimism are softening world economy and cautious household sector on the back of elevated household debt. Fiscal consolidation also will weigh on activity over the coming years.

## International shares

- **Review:** Disappointing economic data, renewed concerns about the European debt crisis and worries about continued policy tightening in emerging economies saw a rise in risk aversion during the month. Deterioration in risk appetite in turn led to declines in global shares.
- The leading measure of global share market performance, the MSCI World Index, returned -1.2% in local currencies (or

-3.8% in unhedged New Zealand dollar terms). US shares fell 1.1% in local currency terms. European equities were mixed but generally underperformed, with Germany down 2.8%, Greece down 8.5% and Italy down 3.9% for the month. France was down by just 0.1% while UK shares declined by 0.9%. In Asia, the Japanese share market fell further by 1.5%, the third consecutive monthly decline. Shares in the emerging Asia markets performed broadly in line with the developed markets, recording a decline of 1% for the month. Concerns around policy tightening and fears of a hard landing in China saw Chinese shares underperform considerably as they fell 6% over the month.

- **Outlook:** While volatility will likely remain high in the global share market for some time yet, our broad assessment remains that shares will continue to climb the 'wall of worry' this year helped by still cheap valuations, solid corporate earnings and easy global monetary conditions.

## New Zealand shares

- **Review:** In the environment of falling global equities, the New Zealand share market proved more defensive and outperformed its global counterparts. Improving local economic data was also supportive of the New Zealand market.
- The NZX50 Index managed a modest gain, ending the month up 0.8%, while the NZX Portfolio Index recorded a 0.3% decline for the month. Profit results were generally mixed with Mainfreight and Fisher & Paykel Appliances surprising and Rakon disappointing. The re-rating of Telecom on the awarding of 70% of the UFB (Ultra Fast Broadband) build was a key contributor to the performance of the NZX50 Index.
- **Outlook:** Our valuation metrics continue to show New Zealand shares to be good value against bonds but not so good against global equities. New Zealand shares are likely to lag any positive trend in global shares given their low beta nature, but equally they would perform relatively better should global shares suffer a bout of weakness along the way.

## New Zealand listed property

- **Review:** The New Zealand listed property sector had a positive month in May, posting a 4% return, outperforming the NZX50 which was up 0.9%. Top performers were Vital Healthcare Property Trust and Argosy Property Trust (ARG), up 6.3% and 5.0% respectively, with Kiwi Income Property not far behind, up 4.8%. The DNZ Property Fund (DNZ) had the weakest performance being the only listed property vehicle to have a flat month.
- DNZ continues to seek to engage with the directors of ARG with regards to their proposed merger, ARG have indicated that their short term priority is the completion of its internalisation before looking at strategic initiatives.
- **Outlook:** Increasing levels in tenant enquiry and activity, together with improved banking conditions, indicate a modest recovery in 2011. Yield continues to be the main focus for investors while interest rates remain low. Dividends in the 2012 financial year may reduce due to tax changes however the dividend yields remain attractive. Stabilising of revaluations may see some of the more heavily discounted listed property vehicles reduce the level of discount to NTA.

## International bonds

- **Review:** International bond markets rallied further during May in response to weak economic data in the US and the deteriorating outlook for Greek sovereign debt. Reflecting the rising default risk, the yield on Greek 10-year sovereign bonds rose to around 16%.
- The US 10-year bond yield fell by 23 basis points (bps) to 3.06%, and Japan's 10-year bond yield fell by 4 bps to close at 1.17%. In Europe, the UK 10-year bond yield fell by 14 bps to close the month at 3.29% while Germany's 10-year bond yield fell by 22 bps to 3.02%. Australia's 10-year bond yield also fell 22 bps to 5.21.
- **Outlook:** Global sovereign bonds may provide good portfolio diversification in the near term with yields likely to fall further if global growth expectations continue to weaken on the back of a soft patch in economic data releases. However, considering the prospect that the global recovery regains momentum later this year and with bond yields already at such low levels, global bonds offer poor returns from a long term perspective.

## New Zealand bonds and cash

- **Review:** Despite improving local economic data, New Zealand government bond yields moved significantly lower during the month in line with the global trend. Demand for New Zealand government bonds continued in May with the Budget providing further impetus. Cash and money market rates remained low due to no near term prospect of a rate hike from the RBNZ. The downward pressure for yields was greater for long term bonds, resulting in a flatter yield curve.
- The five-year government bond yield ended the month 18 bps lower at 4.11% while the 10-year rate ended the month down 33 bps at 5.11%. Meanwhile, the five-year and 10-year swap rates were down by less, down 9 bps and 15 bps respectively. Relative moves in government bonds and swaps saw swap spreads turn positive.
- **Outlook:** With no prospect of a rate hike in the near term, New Zealand rates are likely to remain relatively well anchored. However, as the economy recovers from the current weakness over the second half of this year, yields should start to move higher fairly rapidly in anticipation of the eventual resumption in the tightening cycle.

## New Zealand dollar

- **Review:** A surge in risk aversion saw the US dollar generally strengthen against most major currencies during the month. However, the recent run of positive New Zealand economic news saw the New Zealand (NZD) dollar rally sharply during the month, which rose to its new post-float high of \$0.8264 against the US dollar.

- The NZD rose solidly against all major currencies. It was up 1.9% against the US dollar while it was up 2.0% against the Yen. It rose 5.1% against the Euro while it rose 3.2% against the Sterling. The NZD rallied 4.6% against the Australian dollar as the Australian dollar lost ground on lower commodity prices and softer-than-expected economic data. On a MSCI-weighted basis, the NZD was up 2.9% while it gained 3.5% on a trade-weighted basis.
- **Outlook:** The NZD is likely to be broadly range-bound over the coming year or so. In the near term, the strong commodity prices and improving local economic data should be supportive of the NZD. However, the long term valuation measure suggests the NZD is becoming increasingly overvalued. As such, the demanding valuation is likely to be a headwind for the NZD beyond the near term strength. Softening global growth momentum is also negative for growth-sensitive currencies such as the NZD.

## Summary

### Key financial markets summary

	As at 31 May 2011	Change over the month (%)	Change over the year (%)
MSCI - US	4760.61	-1.1	+26.6
MSCI - UK	9667.73	-0.9	+19.2
MSCI - Germany	2219.63	-2.8	+22.8
MSCI - Japan	981.29	-1.5	-2.5
NZX-50	3547.64	+0.8	+15.9
MSCI - World (local currency)	3155.94	-1.2	+19.2
MSCI - World (NZD)	5594.76	-3.8	+5.4
NZ Official Cash Rate	2.50	0 bps	0 bps
NZ 90-day bank bill yield	2.69	+2 bps	-27 bps
NZ 10-year bond yield	5.11	-33 bps	-45 bps
US 10-year bond yield	3.06	-23 bps	-22 bps
NZD-USD	0.8226	+1.9	+22.1
NZD (TWI)	71.0	+3.5	+8.3
NZD (MSCI weighted)	81.5	+2.9	+13.9

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