

Investment Brief



Global

- Review:** Financial market conditions remained fragile during September as the European debt crisis escalated. The International Monetary Fund (IMF) in its World Economic Outlook warned that the global economy has entered a “dangerous new phase”.
- American economic data continued to reveal weak growth. The Institute for Supply Management (ISM) manufacturing survey fell by 0.3 points in August to 50.6. The US service sector displayed some resilience with the ISM composite survey rising by 0.6 points to 53.3. Durable goods were flat in August after a 4% surge in July suggesting that US business investment is still in recovery. America’s labour market also stagnated in August with no gain in jobs and the unemployment rate holding steady at 9.1%. US retail sales disappointed, coming in flat in August, and consumers remained pessimistic as evidenced by September’s weak Conference Board sentiment survey. Importantly, US growth continues at a sedate pace. This was shown by America’s real gross domestic product (GDP) for the June quarter, which was marginally revised upwards to 0.3% quarter on quarter (QoQ), and the Chicago Federal Reserve’s National Activity Index. President Obama challenged Congress to pass a US \$447 billion stimulus package to give “a jolt to an economy that has stalled”. This package would equate to a 3% stimulus to US real GDP.
- At its September meeting, the US Federal Reserve (Fed) recognised that “there are significant downside risks to the economic outlook, including strains in global financial markets”. Accordingly, the central bank launched a modern day ‘Operation Twist’. This involves selling short dated Treasury bonds from its balance sheet and buying longer dated securities with the hope that the result will be lower long term borrowing rates.
- Germany’s parliament voted in favour of expanding the European Financial Stability Facility (EFSF). This was in support of the 21 July European Union summit proposal for an expanded €440 billion EFSF Fund. While this is a constructive development, the immediate reality is that Europe is likely to fall into a recession over the next two quarters, given the budget austerity measures and damage to confidence with recent financial market turmoil. The European Commission surveys for September indicate that both industrial and consumer sentiment are edging towards recession levels. September purchasing managers index (PMI) business surveys in the region were also consistent with contraction. In addition, Germany’s IFO Business Climate Index fell to a 15 month low, showing that Europe’s largest economy is seeing fading growth momentum. The European Central Bank (ECB) kept policy interest rates on hold at 1.50% at its September meeting, although President Trichet noted that the central bank staff had “revised downwards” their economic growth forecasts.
- Japanese GDP contracted by 0.5% (revised from 0.3%) in the June quarter and Japan posted a return to a trade deficit as the export sector continued to struggle. More encouraging however was the nation’s small business survey, which rose further in September. This suggests that Japan is now gradually emerging from a recession that was compounded by the tragic earthquake and tsunami in March.
- The Chinese economy cooled to a more sustainable pace in August with manufacturing PMI improving only slightly to 50.9 from 50.7 in July. China’s annual consumer price index inflation also fell to 6.2% in August from 6.5%, suggesting that inflation has peaked. On the activity front, fixed asset investment growth, industrial production growth and retail sales growth all moderated further, but remained at relatively robust levels.
- Outlook:** The downside risk for the global economy remains significant and is led by Europe on the back of ongoing pressure for fiscal consolidation in the region. Meanwhile, the data so far suggests the US economy may be muddling along with slow growth rather than sliding back into recession. In response to the subdued global economic outlook, monetary policy will remain accommodative in many economies for some time to come to offset the global trend toward fiscal consolidation. In addition, the fall-back in global oil and food prices should help relieve household budgets. While growth in the emerging world is slowing from excessively strong levels, there is no evidence of a sharp decline indicative of recession, so overall it should remain reasonably strong. Emerging countries now account for more than 50% of world economic activity. Japan also appears to be continuing to recover from its recession earlier this year. On balance, while the risk of a return to global recession is not insignificant, we remain of the view that the global economy should be able to continue to grow, although only at a moderate pace.

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New Zealand

- **Review:** New Zealand data during September continued to indicate that the economy is on a solid footing and set to pick up towards the end of the year and into 2012.
- June quarter GDP growth came in at 0.1%, falling short of market expectations at around 0.5%. This was a marked slowdown from the revised 0.9% growth recorded in the March quarter. However, a growth rate of around 1% in total for the first half of this year is still a solid outcome, given Christchurch's devastating February earthquake. The NBNZ survey of business confidence continued to moderate in September, but remained at historically high levels.
- Building consents were up for a second consecutive month in August, rising 12.5%. This supports our view that we have passed the weak point in the residential construction cycle. House sales were up 21% year on year (YoY) in August to reach the highest since December 2009. House prices rose 0.5% over the month.
- The terms of trade have risen a further 2.3% in the June quarter, rising to a fresh 37 year high. While the ANZ world commodity price index recorded its third consecutive monthly decline (-1.2% month on month (MoM)) in August, the index is still more than 20% higher than a year ago, remaining near its record high. This is in line with the recent trend in agricultural commodity prices which have held up relatively well during the latest market turbulence.
- The BNZ-BusinessNZ Performance of Manufacturing Index fell slightly by 0.3 points to 52.9 in August. New orders improved, but the employment index fell to its lowest since December 2009. The BNZ-BusinessNZ Performance of Services Index fell slightly but remained above the expansionary threshold of 50 recording 53.9 in August.
- Consumer confidence was down 0.7 points to 112.6 in September. While households were more confident about the five year ahead outlook, they were less confident about the near term outlook.
- The current account balance for the June quarter was in deficit of \$921 million taking the deficit for the 12 months to June to \$7.5 billion. This equates to 3.7% of GDP, compared with an annual deficit recorded for the March year at 3.6% of GDP.
- The number of short term arrivals rose by 8% in August to be up 5% from a year ago, helped by Rugby World Cup visitors from Australia and the UK. There was a net inflow of 210 migrants in August, the first such net inflow since February.
- The big news towards the end of the month was the downgrade of New Zealand's sovereign credit rating by both Fitch and Standard & Poor's. The downgrade largely reflects recent deterioration in the global growth outlook and the tightening in global credit markets.
- **Outlook:** New Zealand's growth momentum should continue to pick up over the coming 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 weakening global economic activity and a cautious household sector on the back of elevated household debt. Fiscal consolidation also will weigh on activity over the coming years.

International shares

- **Review:** Global share markets continued to experience significant volatility during September as a result of European debt worries and global growth concerns. The announcement of a jobs stimulus plan by President Obama provided only temporary relief at the beginning of the month before fears of an imminent default by Greece, triggering a European banking crisis, resurfaced. Share markets then rebounded as French and German leaders reaffirmed their commitment to supporting Greece and the ECB announced it would provide three months of US dollar funding to eurozone banks in co-ordination with other central banks.
- The leading measure of global share market performance, the MSCI World Index, fell by another 6% in local currencies (but rose 2.1% in unhedged New Zealand dollar terms due to the lower New Zealand dollar). This was the fifth consecutive monthly decline in the global share market, which is now down 17% from the April close. US shares fell 7.2% over the month after a 5.5% decline in August. German shares ended the month down 5.4% while shares in France and Italy were down 8.2% and 4.4% respectively. The UK share market fell 4.7%. In Asia, while Japan outperformed its global peers by falling just 0.8%, emerging Asia underperformed by falling 8.4% over the month.
- **Outlook:** With Europe yet to get on top of its sovereign debt crisis, it's still too early to say that shares have bottomed. However, there are some signs that shares might have seen the bottom or are not far from it. Europe appears to get the message that it needs to do more, central banks are starting to ease, the US economy appears to be avoiding recession and while October is often a very volatile month it also often sees markets bottom before heading higher into year end. Share market valuations are attractive for long term investors and shares are likely to benefit from global monetary easing.

New Zealand shares

- **Review:** The New Zealand equity market significantly outperformed its global counterparts during September, acting in its 'low-beta' capacity in the environment of falling markets and elevated risk aversion. Relatively strong economic fundamentals and the defensive sectoral composition (of the market) supported the New Zealand market.
- The NZX50 Index rose 0.6% over the month while the NZX Portfolio Index recorded a 0.7% decline for the month.
- **Outlook:** Our valuation metrics continue to show New Zealand equities to be good value against bonds but not so good against global equities. New Zealand equities 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 listed property sector had a more positive month in September, up 1.9% after two months of slightly negative returns. It outperformed the NZX 50 which gained 1.2%.
- The September quarter saw the listed property sector return 1.7% compared with the NZX 50 which was down -2.4%. Over the last 12 months the listed property sector has returned 15.6%, significantly outperforming the NZX 50 (6.9%). The top

performers during September were Vital Healthcare Property and Kiwi Income Property up 4.6% and 4.4% respectively, while Property For Industry had a loss (-2.5%).

- Goodman Property confirmed a new \$12.8 million development at their Highbrook Business Park. This will involve 7,500sqm of purpose built accommodation for Panasonic New Zealand. The facility should be completed early 2013 and will be leased to Panasonic initially for 10 years with further rights of renewal.
- AMP Capital recently announced it has sold the management rights for Property For Industry to DPF Management Ltd. The transaction is due to settle 20 January 2012.
- **Outlook:** The property market appears to be recovering and, as a result, the listed property sector has performed well so far in 2011. Dividend yields on offer from listed property vehicles (LPVs) continue to attract investors while interest rates remain low. While there are ongoing global risks and uncertainties which may impact recovery, the LPVs have kept their balance sheets stable and have the benefit of high occupancy levels and generally strong weighted average lease terms (WALT).

International bonds

- **Review:** Global sovereign bond markets continued to rally in September pushing yields for many regions to new lows. The combination of lower global growth prospects, expectations for further monetary stimulus and safe haven flows has served to depress real yields for major economies.
- The US ten-year bond yield fell further by 31 basis points (bps) to close the month at 1.92%. In Europe, the ten-year yields for Germany and the UK were down 33 bps and 17 bps respectively. Australia's ten-year bond yield also fell and was down 15 bps to 4.22%. Japan's ten-year bond yield was flat remaining at 1.03%.
- **Outlook:** Softer economic data has helped sovereign bonds in key countries perform strongly this year as yields have fallen dramatically. They could still rally further in the short term and are a good diversifier. However, yields are very low so expect modest medium term returns.

New Zealand bonds and cash

- **Review:** While New Zealand economic data remained relatively positive, significant falls in global equity markets and heightened risk aversion saw markets continue to revise down expectations for rate hikes from the Reserve Bank of New Zealand in the coming year. As markets lowered their expectations to only one rate hike over the next 12 months (from two previously), bond yields and swap rates nudged lower during the month.
- As expected, the Reserve Bank of New Zealand (RBNZ) left the Official Cash Rate (OCR) unchanged at 2.5%. The Bank expressed its concerns about the increased downside risks for the global economy.
- The four-year government bond yield fell 24 bps to end the month at 3.36% while the ten-year rate ended the month down 10 bps at 4.42%. The five-year swap rate fell 38 bps while ten-year swap rate ended the month down 32 bps. The 90-day bank bill fell by 9 bps to end the month at 2.87%.

- **Outlook:** Recent concerns of a double dip in the US and weaker data elsewhere have effectively pushed out the timing of the expected rate hike. However, the ongoing improvement in domestic economic activity and relatively elevated inflation expectations mean the RBNZ cannot indefinitely keep rates at the record low level of 2.5%. Following the RBNZ announcement in September, we have shifted our expected first rate hike from December 2011 out to March 2012, but still expect that first increase to be 0.5%. We are keeping to our expected OCR peak of 4.5%, even though the Bank's interest rate forecasts imply a peak of 4%. Meanwhile, the long term bond yields are likely to remain under downward pressure in the near term given the fragile financial market conditions and weak global economic data.

New Zealand dollar

- **Review:** The New Zealand dollar (NZD) fell heavily during September against most major currencies as risk aversion surged and global growth concerns prevailed. The news of the downgrade of New Zealand's sovereign credit rating by both Fitch and Standard & Poor's also weighed on the NZD towards the end of the month.
- The NZD plunged by 10.5% against the USD to reach its lowest level since April this year. It also fell sharply against the yen, down by 9.8% for the month. The NZD was down 6.4% vs the sterling and down 3.9% against the euro. The decline was less steep against the Australian dollar (AUD) falling by a more modest 1.4%, as the AUD was also affected by the global ructions and a fall in commodity prices. On a MSCI weighted basis, the NZD fell more than 8%, while it was down by 6.4% 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, strong export commodity prices and improving local economic data should be supportive of the NZD. However, the long term valuation measure suggests the NZD is overvalued. The demanding valuation makes the currency vulnerable to external shocks and any near term pull-backs.

Summary

Key financial markets summary

	As at 30 September 2011	Change over the month (%)	Change over the year (%)
MSCI - US	4023.15	-7.2	+1.3
MSCI - UK	8394.27	-4.7	-4.2
MSCI - Germany	1673.78	-5.4	-11.5
MSCI - Japan	884.51	-0.8	-7.7
NZX-50	3343.35	+0.6	+5.2
MSCI - World (local curr.)	2650.21	-6.0	-4.5
MSCI - World (NZD)	4948.68	+2.1	-7.5
NZ Official Cash Rate	2.50	0 bps	-50 bps
NZ 90-day bank bill yield	2.87	-9 bps	-30 bps
NZ 10-year bond yield	4.42	-10 bps	-59 bps
US 10-year bond yield	1.92	-31 bps	-59 bps
NZD-USD	0.7644	-10.5	+3.9
NZD (TWI)	68.3	-6.4	+3.2
NZD (MSCI weighted)	77.2	-8.2	+3.6

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