

Investment Brief



Global

- Review:** The US debt ceiling negotiations dragged on and the sovereign stress in Europe intensified. The lack of signs of recovery in global economic activity after the slowdown witnessed over the June quarter lowered growth prospects further during July. This in turn raised concerns that a stalling economy will undermine the fiscal austerity effort in Europe.
- The global financial markets' primary focus during the month was whether the US Congress could agree to raise the national debt ceiling limit from US\$14.3 trillion by 2 August. Negotiations between Republicans and Democrats became acrimonious over spending cuts versus tax increases, resulting in weeks of uncertainty. An eleventh hour compromise was announced on 31 July. The agreement increased the debt ceiling in return for budget savings of US\$917 billion over ten years, with a further US\$1.5 trillion in savings to be identified by a bi-partisan congressional committee by late November.
- Meanwhile, US economic data released during July was weak. Labour market data for June showed that only +18,000 new jobs were created with May's result revised downward to only +25,000 new jobs from the earlier estimate of +54,000. America's unemployment rate rose by 0.1% to 9.2% in June, the highest rate in the past six months. US retail sales were also subdued, registering only +0.1% month on month (MoM) growth in June, with the University of Michigan Consumer Sentiment Survey showing that consumers are losing confidence. Finally, the June quarter gross domestic product (GDP) data showed a sharp slowdown in US economic growth at just +1.6% over the year to June.
- More encouraging is that Japan's economy continues to recover from the tragic earthquake and tsunami in March. Japanese industrial production has revived after March's sharp fall of -15.5% MoM, with April recording +1.6% MoM growth and May a further +6.2% MoM growth. This recovery continued in June with a +3.9% MoM rise. Meanwhile, China's economy continued to expand at a solid pace, with real GDP growing by +9.5% year on year (YoY) in the June quarter. Other Chinese economic indicators showed strong growth in industrial production (+15.1% YoY), retail sales (+17.7% YoY) and fixed asset investment (+25.6% YoY). However, inflation remains a concern, with consumer price index (CPI) data surging to +6.4% YoY in June. The People's Bank of China raised its key one year lending rate by 0.25% to 6.56% in the third interest rate rise so far this year.
- Economic news from Europe was dominated by sovereign debt woes. Portugal was the latest country to have its sovereign debt rating downgraded to 'junk' status or 'Ba2' by Moody's, while Spanish and Italian bond yields spiked higher as fears of contagion spread. Disagreement within the European Union (EU) about how to respond to the deteriorating crisis created further uncertainty, along with news that European bank stress tests found that eight banks failed, with another 16 banks needing to boost capital. European leaders announced a new bailout for Greece and enhanced support for other problem countries later in July. The key elements of the package include: €109 billion in new financing for Greece; a €37 billion contribution from private sector investors; an extension of loans from the current 7.5 years to at least 15 years; a cut in the interest rate for Greece, Ireland and Portugal to 3.5%; and allowing the European Financial Stability Facility (EFSF) to buy bonds in secondary markets.
- Outlook:** The global economic outlook continues to deteriorate, led by the US and Europe. The soft patch in US economic data seems to be intensifying and the risks of a return to recession are admittedly increasing given a number of major issues facing the global economy. However, 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 have recovered 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:** In New Zealand, in light of the recent run of positive economic news, the Reserve Bank of New Zealand (RBNZ) released a relatively hawkish statement with its July Official Cash Rate (OCR) decision. While the RBNZ kept the rate unchanged at 2.5%, it made it pretty clear that the 0.5% 'insurance cut' won't remain in place much longer.
- The delayed March quarter GDP numbers came in far stronger than expected despite the earthquake. The real GDP expanded by 0.8% over the March quarter, following a 0.5% growth recorded in the December quarter of 2010. This was the strongest quarterly growth recorded since the December quarter of 2009 and was more than double the market expectations. This is a remarkably solid result considering the scale of the disaster that the nation has seen with the Christchurch earthquake in February. The data suggests the economic impact of the earthquake was not as large as many estimated and that the underlying economy was in better shape than previously perceived.
- The CPI rose 1% in the June quarter taking the annual inflation rate to 5.3% - the highest annual inflation rate since June 1990. This was higher than the consensus forecast of 0.8% QoQ and 5.1% YoY. Excluding the impact of the GST hike from October last year, the headline inflation would have been around 3.3% for the year to June, which is still some way above the RBNZ's target band of 1-3%. With the rise in headline inflation largely driven by higher food and energy prices, the various core measures of inflation ranged from 0.5% to 0.9%.
- The NBNZ business outlook survey showed further improvement in business sentiment in July, with the headline business confidence rising to a 47.6 from 46.5 in June. The own-activity indicator rose even more solidly recording 43.7 in July, up from 38.7 in June. The own-activity indicator is now at its highest since May 2010 and signals an annual growth rate of nearly 5% heading into 2012. The strong rebound in business confidence since the trough in March suggests the accommodative monetary policy at present is getting significant traction with the majority of households now having floating-rate mortgages.
- The monthly residential market report by REINZ showed continued signs of recovery in New Zealand's housing market activity with solid gains in house prices and house sales. House prices were 1.3% higher in June compared to a month ago while house sales were up 14.2% YoY.
- Consumer confidence slipped in July to stand at 109.4, below historical averages. The significant aftershocks that hit Christchurch in June may have weighed on confidence.
- Despite growing optimism in the construction sector associated with the eventual post-quake rebuild in Christchurch, dwelling consents remained very weak in June. Dwelling consents fell 1.4% in June to be down 26% from a year earlier. Excluding apartments, consents were down 4.5% MoM and down 28% YoY.
- The ANZ commodity price index fell 1.2% in June, its first monthly decline in 10 months. The index however is still up 20.6% from a year ago and remains at a historically elevated level.

- **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 a weaker global economic activity and a cautious household sector on the back of elevated household debt. Fiscal consolidation will also weigh on activity over the coming years.

International shares

- **Review:** Market volatility remained elevated in July as the US debt ceiling negotiations dragged on and investors remained nervous about sovereign stress in Europe. Despite a reasonable start to the Q2 earnings season and the agreement between the EU leaders on the latest Greece bailout package, global equities lost ground for the third consecutive month.
- The leading measure of global share market performance, the MSCI World Index, fell further by 2.7% in local currencies (or -7.2% in unhedged New Zealand dollar (NZD) terms). US shares fell another 1.9% over the month of July after a 1.7% decline in June. Shares in Europe were weak across the board with Germany down 3.0%, Italy down 8.4%, France down 7.2% and the UK down by 2.1%. Asian shares held up somewhat better. Japanese shares returned -1% while shares in emerging Asia ended the month more or less flat. Chinese shares fell 2.4% during the month.
- **Outlook:** Beyond the doubtful short term outlook, we remain of the view that the fundamentals for shares are reasonable. Shares are cheap again, temporary factors weighing on global growth are abating (higher oil prices, Japanese supply chain disruptions) and monetary conditions globally remain very easy. This all points to reasonable returns from shares on a six to 12 month horizon.

New Zealand shares

- **Review:** In line with the global trend, the New Zealand share market fell further in July. In spite of the improving domestic economic outlook, the weakness in the market was driven by the deteriorating global economic backdrop and concerns about US fiscal reform. Corporate news was relatively quiet while the strong NZD added to investor concerns.
- The NZX50 Index fell 1.5% over the month while the NZX Portfolio Index recorded a 2.1% 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:** After the strong performance over the last quarter, the New Zealand Listed Property Sector saw a slight decline of -0.2% in July, however still outperformed the NZX50 which experienced a drop of -1.5%. The best performances in July came from Goodman Property Trust (GMT) and Kermadec Property Fund (KPF) which posted returns of 4.2% and 3.3% respectively. The lowest performances for the month were

Kiwi Income Property Trust (KIP) at -2.9% and Vital Healthcare Properties (VHP) at -1.7%. In the last year, the listed property sector has returned 21%, outperforming the NZX50 which has returned 13%.

- A significant transaction in July was the sale of the remainder of AMP NZ Office Limited's (ANO) property on Chews Lane, Wellington, which sold for \$50 million and at a passing yield of 8.2%. The Auckland property market over the last quarter has seen a number of notable sales over \$20 million.
- Outlook: There have been positive signs for the general New Zealand property market in the last quarter and the year to date. Improved banking conditions and an increase in leasing activity, in the Auckland property market in particular, continue to indicate a modest recovery in 2011. Yield continues to be the main focus for investors while interest rates remain low, although they are predicted to rise before the end of the year. Dividend yields from listed property vehicles (LPVs) remain attractive to investors despite the effects of tax changes. Stabilising of revaluations may see some of the more heavily discounted LPVs reduce the level of discount to NTA in 2011.

International bonds

- **Review:** International bond markets rallied further during July on the back of safe haven demand. While yields for Greece, Portugal and Ireland fell following the EU announcement of the second Greek bailout and the enhanced EFSF, the yields for Italy and Spain rose sharply indicating European sovereign debt problems have not been resolved.
- The US ten year bond yield ended the month down 36 basis points (bps) at 2.80% while Japan's ten year bond yield was down 6 bps to close at 1.08%. In Europe, the ten year bond yields for Germany and the UK fell sharply by 49 bps and 52 bps respectively. The Australian ten year bond yield was also down heavily by 40 bps to end the month at 4.80% as the weakness in the local economic data and the deteriorating global economic backdrop raised expectations for a rate cut in Australia. Reflecting the rising contagion risk of a European sovereign debt crisis, the ten year yield for Italy surged 99 bps while the Spanish ten year yield rose 64 bps.
- **Outlook:** Softer economic data has helped sovereign bonds in key countries perform strongly over the last few months as yields have fallen dramatically. Considering the prospect that the global recovery regains momentum over the next six to 12 months, and bond yields are already at such low levels, global bonds offer poor return prospects over the medium term.

New Zealand bonds and cash

- **Review:** Reflecting the improving domestic economic data and rising inflation expectations, New Zealand's cash and money market rates surged higher to price in the removal of the 50 bps emergency cut as early as September. Swap rates also moved significantly higher. However, demand for New Zealand government bonds continued in July with the fragile risk appetite in financial markets further supporting the sentiment for bonds. The yield curve flattened as short term rates adjusted to reflect looming rate hikes while longer term rates tended to be anchored by global concerns.

- The latest inflation readings point to less spare capacity in the economy than previously thought. This, along with improving growth momentum and rising inflation expectations, adds to the case for an earlier move away from the current 'emergency' monetary policy settings.
- The four year government bond yield ended the month 5 bps higher at 4.03%, while the ten year rate ended the month down 14 bps at 4.93%. The five year swap rate rose 14 bps while the ten year swap rate ended the month down 1 bp. The 90 day bank bill surged by 26 bps to end the month at 2.92%.
- **Outlook:** We expect a rate hike in September. Beyond September, the RBNZ is likely to pause and assess the global economic backdrop and the impact of the strong NZD on New Zealand economic activity and inflation. This means that New Zealand bond yields should move higher in anticipation of the eventual resumption in the tightening cycle. However, the long term bond yields are likely to remain under downward pressure in the near term given the elevated level of risk aversion in the global financial market at present.

New Zealand dollar

- **Review:** The combination of the US debt ceiling debacle and poor data weighed on the US dollar (USD) during the month. This saw the NZD rally strongly against the USD reaching a new post-float high of around \$0.88. More broadly, the NZD gained solidly against most major currencies during the month, benefitting from the improving domestic economic outlook and the widening NZ/global interest rate differential.
- The NZD rose sharply against the USD and the euro, up by 5.8% and 6.7% respectively. The NZD was also stronger against the other major currencies: up 3.5% against the Sterling, 3.1% against the Australian Dollar and 1.1% against the yen. On an MSCI weighted basis, the NZD was up 5.2% while it was up 4.7% 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 very overvalued. The demanding valuation makes the currency vulnerable to external shocks and any near term pull-backs.

Summary

Key financial markets summary

	As at 31 July 2011	Change over the month (%)	Change over the year (%)
MSCI - US	4588.74	-1.9	+20.5
MSCI - UK	9421.20	-2.1	+14.2
MSCI - Germany	2176.65	-3.0	+17.0
MSCI - Japan	979.60	-1.0	+0.8
NZX-50	3395.63	-1.5	+11.9
MSCI - World (local curr.)	3023.26	-2.7	+12.7
MSCI - World (NZD)	5093.00	-7.2	-1.2
NZ Official Cash Rate	2.50	0 bps	-50 bps
NZ 90-day bank bill yield	2.92	+26 bps	-35 bps
NZ 10-year bond yield	4.93	-14 bps	-40 bps
US 10-year bond yield	2.80	-36 bps	-11 bps
NZD-USD	0.8738	+5.8	+20.6
NZD (TWI)	74.4	+4.7	+10.4
NZD (MSCI weighted)	86.0	+5.2	+15.2

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