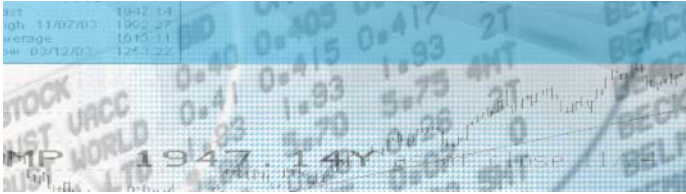


Weekly market & economic update - Week beginning Monday 9 August 2010



Headline developments of the past week

- The past month has seen share markets and other growth assets climb a wall of worry. However, while economic indicators suggest global growth has slowed, there is no sign of the double dip recession so feared a month ago. In fact Europe, which was the initial source of this year's instability, has been surprising on the upside.
- Global earnings reports have remained strong, with 76% of US companies and 62% of European companies to have reported for the June quarter having come in better than expected. While the earnings results are backward looking, they do tell us that the corporate sector globally is in good shape with good balance sheets and strong cash flows. This should augur well for business investment, employment, dividends, share buybacks and merger and acquisition activity - providing an offset to poor households and/or public sector balance sheets.

Major global economic releases and implications

- US economic data was mixed. On the negative side, pending home sales fell further in July, initial jobless claims rose and weekly retail sales data came in weaker than expected. July payroll employment was weaker than expected, with just a 71,000 rise in private payrolls, but it is worth noting that hours worked continue to increase and this is providing a solid boost to the income of existing workers. On the positive side, while the ISM manufacturing conditions index survey slipped in July, it fell by far less than expected and remains at levels consistent with solid growth. The ISM non-manufacturing conditions index actually rose in July, weekly mortgage applications rose for the third week in a row suggesting that the housing sector may have stabilised following its post tax credit slump and various labour market indicators point to continuing private sector jobs growth. The basic picture is that while momentum in the US economy has slowed down it doesn't appear to be collapsing back into recession.
- Final European business conditions indicators for July showed an improvement on June, particularly for the manufacturing sector with the earlier weakness in the euro playing a role. German factory orders are also continuing to rise solidly.

- Chinese business conditions surveys painted a mixed picture of the Chinese economy in July, with manufacturing softening but non-manufacturing improving. The key message is that growth in China is slowing but not collapsing.
- In Australia, there were no surprises from the Reserve Bank (RBA) which left interest rates on hold. However, while current interest rates may be appropriate for now, with the RBA still forecasting growth to rise above trend over the next two years and inflation expected to bottom in the top half of the RBA's target range before starting to rise again, it is clear that the Bank retains a tightening bias and so we continue to expect occasional and gradual rate hikes to resume by year end.

New Zealand economic releases and implications

- The Household Labour Force Survey (HLFS) surprised yet again, with a bigger-than-expected jump in the unemployment rate, registering 6.8% for the June quarter versus 6.0% recorded in the previous quarter. Against the steady labour force participation rate, employment fell by 0.3% over the quarter. While the unexpected sharp fall in the unemployment rate over the March quarter meant that a payback of sort was to be expected in the June quarter, the outcome was decidedly weak. The market was expecting a jobless rate of around 6.2% while the Reserve Bank of New Zealand's (RBNZ) June Monetary Policy Statement was forecasting a 0.5% gain in employment with the unemployment rate remaining unchanged at 6%. The extreme volatility in the HLFS data makes interpretation difficult. However, the data, together with recent weakness seen in prices for New Zealand's dairy exports, are likely to add to the case for the RBNZ to pause interest-rate increases later this year.
- The private sector ordinary time labour cost index was up 0.4% in the June quarter. From a year ago it was up 1.4%. Labour costs in the public sector rose 0.2% over the same period, the smallest increase in 11 years. While the data suggests wage pressures remain subdued in New Zealand, wage inflation has likely passed its low point with forward-looking employment indicators looking more positive and as the economic recovery continues.

- The ANZ commodity price index fell 0.8% in July extending a 1.6% decline recorded in June. The decline was mainly driven by a 5.7% fall in dairy prices.

Major market moves

- Share markets rose as economic data came in better than feared and profit results remained favourable.
- While commodity prices pushed higher over the week, the New Zealand dollar (NZD) was in a consolidation mode, remaining largely unchanged for the week. On one hand, a sliding US dollar provided a floor for the NZD, while on the other hand the poor labour market data and the weaker dairy prices weighed on the currency.

What to watch in the week ahead?

- In the US, the Federal Reserve is expected to leave interest rates unchanged but the big issue is whether it will step up quantitative easing in the face of the “unusual uncertainty” regarding the economic outlook.
- Chinese economic data for July will be watched closely with industrial production and fixed asset investment likely to show a further modest slowing in momentum, retail sales growth likely to remain strong and inflation likely to rise to around 3.4% from 2.9% on the back of the flood driven rise in food prices.
- In New Zealand, the data for retail sales is likely to show a modest lift in sales volume over the June quarter, the manufacturing PMI will be watched for any signs of loss in growth momentum and the REINZ report is likely to show housing market activity remained subdued in July.

Outlook for markets

- The short term outlook for shares is mixed. Strong profit results in the US and Europe have provided a lift. Against this, double dip concerns are likely to persist for a while and suggest that we may have another bout of weakness into the seasonally weak months of September and October. However, we remain of the view that a double dip recession globally will be avoided. With shares very good value, monetary conditions set to remain favourable and China likely to start relaxing its tightening measures in the next few months, shares are likely to stage a strong rally in the December quarter and through 2011.

- From a long term perspective, the NZD is over-valued, but such conditions can be sustained over many years. New Zealand’s strong terms of trade, the favourable New Zealand-global short term interest rate differential, and healthier fiscal position relative to the major countries, would point to the NZD remaining richly priced for some time to come. That said, the NZD appears to be highly correlated with global shares at the moment, moving up or down in line with risk appetite rather than economic fundamentals, and that makes its movements difficult to pick over the short term. At the margin, waning growth momentum and the recent weakness in New Zealand’s export commodity prices are likely to act as headwinds for the NZD in the near term.
- Low yields are pointing to poor medium term returns from government bonds, particularly given worries about excessive public debt.