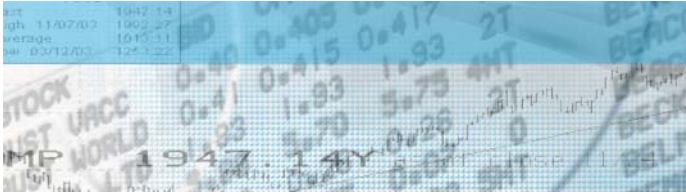


Weekly market & economic update - Week beginning Monday 16 August 2010



Headline developments of the past week

- The past week has been tough for shares, commodities and the New Zealand dollar (NZD) as investors succumbed to a new bout of worries about a double dip back into global recession. The worry was in response to weak economic data and disappointment that the US Federal Reserve (Fed) downgraded its assessment of the US economic outlook but didn't embark on a new round of quantitative monetary easing.

Major global economic releases and implications

- US economic data was generally poor with a blowout in the trade deficit in June, coming on the back of weak data for construction and inventories and pointing to a downwards revision to June quarter GDP growth from 2.4% annualised to just 1.25%. Small business confidence also fell, retail sales were weaker than expected and unemployment claims rose. On a positive note, mortgage applications rose for the fourth week in a row and consumer sentiment rose slightly. Core inflation remained benign in July at just 0.9% year-on-year (YoY) leaving plenty of scope for further Fed easing.
- The euro zone economy rose strongly in the June quarter, with Germany being the main driver on the back of the surge in global demand over the last year. However, fiscal tightening and slower global growth will likely lead to a slowdown in growth in the year ahead.
- The Bank of Japan left interest rates on hold, but with no measures to stop the rise in the yen. Economic data was soft with falls in bank lending and consumer confidence and soft machinery orders.
- July economic data confirmed that China's economy is slowing, but there is no sign of the hard landing feared by many but neither is there any sign yet of policy easing. So far the Chinese slowdown is gradual and consistent with a soft landing in the economy, i.e. growth settling down to around 9% per annum. We remain of the view that Chinese tightening measures will start to be eased in the next few months. However, with no sign of any easing yet, investors are understandably nervous.

New Zealand economic releases and implications

- New Zealand economic data was mixed. The Performance of Manufacturing Index fell to 49.9 in July from 55.9 recorded in June. This was the first time that the index fell below 50 (the expansionary threshold) since August last year. The REINZ monthly report showed that housing market activity remained weak in July, with a 1.2% decline in the housing price index over the month of July and house sales down 26.7% from a year ago.
- Retail sales surprised on the upside, in contrast with the volume of total sales rising 1.3% over the three months to June (+2.8% YoY). While this was much stronger than the 0.3% quarter-on-quarter (QoQ) gain expected by the market, the strength was driven largely by aggressive discounting as reflected in the 0.8% QoQ fall registered by the retail trade deflator. As such, the underlying state of the consumer sector probably remains much weaker than what the headline sales growth figure suggests. Looking ahead, while the consumer confidence readings of late point to stronger retail sales activity in the current quarter, the potential pull-forward of consumer spending ahead of the 1 October GST increase is likely to make it difficult to interpret the underlying strength in spending.
- The food price index rose 1.6% in July, but fell 1% from a year ago. The increase for the month was driven largely by an 11.5% lift in vegetable prices.

Major market moves

- Despite a solid start to the week, shares ended it down sharply on the back of renewed worries about a double dip in the US, a hard landing in China and the Fed's less than inspiring move towards more quantitative easing.
- The return of investor risk aversion saw commodity prices, with the exception of gold, and the NZD fall but government bonds benefited from the flight to safety and fears about the economic outlook.

What to watch in the week ahead?

- In the US, producer price inflation in July is likely to have remained benign and housing data will be watched closely for signs of stabilisation after the slump following the ending of the first time home buyer tax credit in April.

- In New Zealand, the producer price index is likely to record a further solid gain on the back of increases in commodity export prices, while a weak housing market and the recent monetary policy tightening by the Reserve Bank of New Zealand are likely to have weighed on the consumer confidence reading for August. Net inward migration is expected to have weakened further in July.

Outlook for markets

- With the good news from the US profit reporting season behind us, worries about a double dip back into global recession now escalating again and policy makers in the US and China unlikely to respond immediately - shares are now at high risk of having another leg down, particularly as we head into the traditionally weak months of September and October. However, beyond the likelihood of another round of near term share market weakness, we remain of the view that a double dip recession globally will be avoided. With shares good value, monetary conditions set to remain favourable and China likely to start relaxing its tightening measures sometime in the in the next few months, shares are likely to stage a decent rally in the December quarter and then 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 all point to the NZD remaining richly priced for some time to come. However, 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.
- Double dip and deflation worries will keep bond yields low in the short term, but medium term returns are likely to be poor reflecting low yields and excessive public debt levels in many developed countries.