Investment Brief

31 DECEMBER 2011

Global

The European debt crisis continued to dominate headlines in December. On 30 November, key central banks around the world announced a coordinated 'liquidity swap' arrangement with a lower interest rate to "ease strains on financial markets". The US, Canadian, British, European, Japan and Swiss central banks agreed to provide multi-currency swaps at cost of overnight indexed swap +0.5% margin (previously the margin was +1%).

While these measures do not address the fundamental issues affecting markets, they at least enable European banks to fund their assets at cheaper levels than would otherwise have been the case.

American economic data was resilient in the face of global turmoil. The Institute for Supply Management manufacturing survey improved rising by 1.9 points to 52.7, suggesting that the US economy is growing at a sedate pace. The labour market recorded a modest gain of 120,000 jobs in November and the unemployment rate surprised by falling to 8.6%. US house prices drifted lower with the Standard & Poor's Case Shiller Major 10 cities Index recording a 1.1% decline in October. More encouraging was the Conference Board's confidence survey which rose almost 10 points to 64.5 in December, suggesting that American consumers appear to be shrugging off recent pessimism. US nominal retail sales proved mildly disappointing in November recording a marginal monthly rise of 0.2%. The US Federal Reserve maintained the federal funds rate target range between 0% to 0.25% at its December meeting, reaffirming previous guidance that interest rates should remain "exceptionally low" until mid-2013. The central bank indicated that it will continue extending the maturity of bonds on its balance sheet, but failed to announce any further quantitative easing measures. After much wrangling the US Congress agreed to extend a payroll tax cut and increased unemployment benefits beyond their 31 December expiry which should avoid a sharp fiscal contraction in 2012.

In the eurozone, the regions leaders met on 9 December to address the sovereign debt crisis and generally agreed on a number of key proposals: A 'fiscal compact' of limiting government budget deficits to -0.5% of nominal gross domestic product (GDP), and the European Financial Stability Facility will be "rapidly deployed and the European Stability Mechanism brought forward one year to start in July 2012. There is also a proposal to provide the International Monetary Fund with €200 billion of loans to "deal with the crisis". On 15 December European Central Bank (ECB) President Draghi gave a speech in which he conceded that Europe's banking and debt crisis "has not ended yet" and stated that Europe will need to "swiftly implement all those decisions" of the December summit. Yet the ECB President viewed the summit as a "breakthrough for clear fiscal rules in our monetary union". Later in the month, the ECB announced that 523 European banks will take a total of €489 billion in cheap three-year loans under its long term refinancing operations. Such action should substantially reduce the risk of a bank collapse triggering another event similar to the global financial crisis. The ECB decided to lower its key policy interest rate at its December meeting by a further 0.25% to 1.0%.

In Japan, September quarter GDP rose 1.4% quarter-on-quarter (QoQ), revised slightly down from the previous estimate. Economic data releases were mixed. Vehicle sales improved rising 24.1% year-on-year (YoY) in November, bank lending picked up at +0.2% YoY in November and the tertiary activity index beat market expectations increasing 0.6% month-on-month (MoM) in October. Yet Japan's exports fell again in November, providing another reminder of the global slowdown and the impact on Asia, and machine orders were down 6.9% MoM in October. During the month, the Bank of Japan downgraded its assessment of the economic outlook.

In China, the official purchasing manager's index rose to 50.3 in December after dipping below 50 in November. Overall, this report is consistent with an economy slowing to around 8% growth in the first half of 2012. Elsewhere, Chinese economic data was positive. Retail sales improved 17.3% YoY in November, industrial production was up 12.4% in the month and fixed asset inventories rose 24.5% YoY year-to-date.

New Zealand economy

During December we saw three key developments in New Zealand. First was the Reserve Bank of New Zealand (RBNZ) monetary policy statement. The RBNZ was moderately positive on the domestic economy, but stressed the "high degree of uncertainty around the global outlook", with the possible downside risk scenarios effectively taking rate hikes off the table in the immediate term. The second key economic development was September quarter GDP results, with quarterly economic growth of 0.8% being higher than expected. The main source of growth was private consumption, while investment was subdued and net exports were a drag on growth. On an industry basis, manufacturing was strong, as was the retail and hospitality sector (thanks to the Rugby World Cup). Finally, the third notable development was the current account data, which showed a widening of the current account deficit in the September quarter to an annual 4.3% of GDP on the back of a lower trade balance and worse investment income balance.

Global shares

Global share markets continued to experience significant volatility over December, although within the same range since early August. Shares surged at the beginning of the month on central bank action and hopes that a fiscal union in Europe would occur. Markets then fell back on worries leading up to the European leaders' summit. Late in the month share markets rebounded helped by better news out of Europe and the US. The leading measure of global share market performance, the MSCI World Accumulation Index, returned 0.7% in local currencies.

The US S&P 500 Accumulation Index returned 1.0% in local currency terms. In the European region, the Eurostoxx Accumulation Index returned -0.3% while the UK FTSE 100 Accumulation Index returned 1.3%, both in local currency terms. Shares in Asia remained weak, with Japan's Topix Accumulation Index returning 0.1% and China's S&P/CITIC 300 Total Return Index returning -6.9%.

New Zealand shares

The New Zealand share market was broadly flat over the month of December – modestly underperforming global markets. Mixed economic releases and associated pressures on earnings of more cyclical companies, ongoing global volatility and further seismic shocks in Canterbury pressured equity market sentiment.

The NZX50 index returned 0.2% over the month and the NZX Portfolio Index fell 0.7%. Firm evidence of an Auckland-led domestic recovery and strong support for the agricultural sector from still high commodity prices (though off peak levels) combined with impetus from the earthquake recovery (although deferred due to ongoing quakes) and leaky homes continue to support the case for New Zealand economic growth. The New Zealand equity market valuation is modestly attractive in our view.

New Zealand listed property

The listed property sector posted a negative return of -1.2% in December, while the NZX50 experienced a flat month returning 0.2%. Kermadec Property (KPF) and Goodman Property (GMT) were the best performers during December, up 6.5% and 1.0% respectively. Vital Healthcare Property (VHP) had a poor month with the lowest return of -5.2%. Overall, 2011 was a positive year for the listed property sector with a return of 11.8% for the last 12 months, significantly outperforming the NZX50 which returned only 0.4%.

December was a fairly quiet month in the sector with the main news being VHP's acquisition of Mayo Private Hospital in New South Wales for A$13 million. The purchase of this property together with another recent lease extension has helped increase VHP's weighted average lease term (WALT) from 11 years to 11.5 years.

KPF also announced the sale of a Palmerston North property for $2.75 million, marginally less than its book value of $2.85 million. This property had been lying vacant therefore the sale has helped boost KPF's occupancy levels from 91% to 94%.

The property market appears to have stabilised, allowing the listed property sector to perform well during 2011. Dividend yields on offer from listed property vehicles (LPVs) continue to appeal to 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 WALTs.

Global bonds

Global bond markets were volatile in December, falling back at the beginning of the month on news that central banks worldwide had implemented measures to boost liquidity before moving higher again on concerns about Europe's ability to employ tighter fiscal controls. The US ten-year bond yield fell by 19 basis points (bps) to 1.88%, and Japan's ten-year bond yield fell by 8 bps to 0.99%. In Europe, the UK ten-year bond yield fell by 33 bps to close the month at 1.98% while Germany's ten-year bond yield fell by 45 bps to 1.83%.

New Zealand bonds and cash

New Zealand bond yields fell in December, continuing the rally which began in mid-October. Ongoing and increasing concerns that the Euro region politicians are failing to produce a solution to the debt crisis are the principal reason for falling yields. 10-year government bond yields were 0.20% lower, closing at 3.81%, while 10-year swap rates were 0.27% lower closing at 4.03%. Shorter term rates did not fall as much given the global nature of the rally with the 2-year swap rate 0.09% lower at 2.71%

2012 is a significant year for refinancing debt for both the banking sector and European sovereigns. With this backdrop we expect to see credit spreads widen, amplified by any shocks such as credit rating downgrades. New Zealand bank debt spreads have been reasonably well protected due to the lack of new issuance (price discovery) and the tightly held bonds in the secondary market. This is unlikely to last and we expect to get great entry levels during 2012.

Should there be a significant widening in bank funding costs it is likely that mortgage rates will begin to edge higher as banks pass on this additional cost. If there is no pick-up in economic activity, then there is a possibility that the RBNZ may need to consider lowering the OCR to maintain market rates at their current level. This is not our central scenario, but rather we expect rates to remain low for an extended period of time

New Zealand Dollar

December was a mixed month for the New Zealand dollar (NZD) with the currency rising against the euro (3.4%), pound (0.6%) and Australian dollar (0.3%) and falling against the US dollar (-0.4%) and yen (-1.3%). Euro weakness was the main theme of the month with the single currency declining against all the majors following an interest rate cut and the introduction of a 3-year unlimited bank loan facility by the ECB. On a MSCI-weighted basis, the NZD rose by 1.0%.

Looking ahead, the NZD will likely be pulled and pushed by a mixture short and longer term influences. Over the medium term, the fundamentals such as fair value will likely pull the NZD down versus currencies which it's overvalued against, like the US dollar and British pound. Meanwhile in the shorter term the NZD will be at the mercy of the 'risk-on, risk-off' mentality that has gripped the markets in recent times, with risky assets like the NZD weakening in times of global uncertainty.

Summary

Key financial markets summary

	As at 31 December 2011	Change over the month (%)	Change over the year (%)
MSCI - US	4495.07	+0.9	+2.0
MSCI - UK	9180.85	+1.3	-1.8
MSCI - Germany	1798.15	-3.1	-14.7
MSCI - Japan	848.93	-0.1	-18.6
NZX-50	3274.71	+0.1	-1.0
MSCI - World (local curr.)	2860.03	+0.6	-5.0
MSCI - World (NZD)	5223.49	-0.4	-4.9
NZ Official Cash Rate	2.50	0 bps	-50 bps
NZ 90-day bank bill yield	2.74	0 bps	-46 bps
NZ 10-year bond yield	3.81	-21 bps	-206 bps
US 10-year bond yield	1.88	-19 bps	-142 bps
NZD-USD	0.7801	+0.3	-0.1
NZD (TWI)	69.5	+1.3	+0.1
NZD (MSCI weighted)	79.2	+1.2	+0.1

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