

Investment brief



Global

- **Review:** After a solid start to the year, economic growth indicators showed an increasing propensity to disappoint expectations over the month, possibly reflecting an overshooting of previous upgrades to forecasts. This trend was most notable in the US. Furthermore, it was clear that growth momentum was fading, admittedly from a high base, in many countries, including China. Fiscal austerity was a key focus for governments in Europe to alleviate market fears about public debt spiralling out of control.
- In the US the removal of the home-buyers tax credit in April had a significant impact on activity data in the housing market. Existing and new home sales, housing starts, permits and builder's confidence indicators all pulled back over the past month, some significantly so. Further questions were raised about the sustainability of economic recovery, with employment data surprising on the weak side and consumer confidence falling during the month. Headline retail sales and durable goods orders both fell during the last month, but core levels for both series were in line with expectations. The all-important manufacturing ISM indicator fell slightly, but was consistent with solid growth in manufacturing. Indeed, industrial production continued its rising trend, up 7.6% year-on-year (YoY) in May. Inflation pressures remained very weak, with the core CPI rising by 0.9% YoY, equalling the lowest rate since the 1960s.
- The larger European nations joined in the fiscal austerity trend recently adopted by the smaller peripheral countries. Proposals in Germany and France were put forward to cut budget deficits, highlighting that tighter fiscal policy would be a headwind for growth in the region. The new government in the UK announced an emergency Budget designed to tighten fiscal policy by over 6% of GDP over five years. The debt concerns in Europe were beginning to have some impact on timely confidence indicators, but economic momentum in the region's largest economy, Germany, remained good. Germany's Ifo index rose to a two-year high and factory orders were strong, helping to drive a very strong 9.3% YoY increase in EU industrial production in April. Retail sales across the region remained

weak, with real sales down 1.5% month-on-month in April. The unemployment rate in the region continued to rise, reaching 10.1% in April.

- In Asia, it was clear that tightening measures introduced in China were working, with the PMI tracking lower, suggesting that growth momentum was coming off its recent highs. Industrial production slowed to 16.5% YoY in May. By contrast, exports surged by 48.5% YoY in May, the largest gain in exports in six years and import growth was similarly strong. China's CPI inflation reached a 19-month high of 3.1% YoY and there were also reports of strong wage increases for some manufacturers, adding to the concerns about inflation. A key policy announcement was that China's central bank would proceed further with reform of the renminbi exchange rate and increase its flexibility.
- G3 central banks remained in no mood to tighten monetary policy in the current environment, although the Bank of Canada became the first G7 central bank to tighten monetary policy this cycle, raising its policy rate by 25 basis points (bps) to 0.5%.
- **Outlook:** Global growth momentum is slowing after a strong initial burst out of recession, but world GDP growth is still expected to comfortably exceed 4% this year. Europe is likely to remain a weak link and contagion risks to other areas remain a genuine threat to the global recovery. Growth momentum in the developing world is also slowing, but will remain well above developed world growth for many years to come.

New Zealand

- **Review:** New Zealand's economic recovery continued, but surveys suggested higher levels of confidence and activity than currently suggested by the hard evidence.
- GDP rose for the fourth consecutive quarter, up 0.6% in the March quarter (up 1.9% YoY), confirming that New Zealand's economic recovery remains on track, despite the growth pulse being weaker compared to other post-recession recoveries.
- The domestic economic growth pulse remained tepid, with retail sales ex-auto growth running at 1-1.5% and total sales up around 2.5-3%. The housing market was in a holding pattern, with the volume of house sales running at historically low levels, suggesting that the recent revival in dwelling consents might not be sustained.
- That said, business and consumer confidence remained elevated. Westpac's consumer confidence index rose over the June quarter to maintain its above-average level. Confidence slipped off recent highs in the National Bank's business outlook

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survey, but the own-activity indicator was still at levels consistent with GDP growth of almost 5%.

- New Zealand's terms of trade rose by 5.8% quarter on quarter in the March quarter, suggesting that nominal GDP was tracking much better than the real GDP figures suggested. Improved pricing and stronger export volumes helped drive New Zealand's current account deficit down to 2.4% of GDP in the March quarter, the best result in more than two decades.
- As widely expected, the Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 25 bps to 2.75%, the first rate hike this cycle. While the projections continued to show a gradually rising path for the 90-day rate (a similar end point to the previous Statement of just over 6%) the commentary on the policy outlook was fairly bland. The key comment was "...the further removal of stimulus will be reviewed in light of economic and financial market developments".
- **Outlook:** New Zealand's economy is likely to experience a broad based economic recovery in line with the global economy through 2010, with the strong terms of trade helping to boost incomes. We expect GDP growth to average 3.5% over 2010 and 2011.

International shares

- **Review:** Global shares fell during June as risk appetite fell away. There were concerns about the debt turmoil in Europe spreading around the world, leading to tighter fiscal policy and a lower growth outlook, with some commentators believing that the chances of a double-dip global recession were high. The softer trend for economic data in the US and China added fuel to the fire. Earnings expectations were ramped up earlier this year, but with the risks to the macro outlook rising, it seemed that a period of downgrading earnings forecasts was ahead.
- The MSCI World Index in local currency terms fell by 4.1% in June, capping off a very poor quarter overall for share markets, down 11.0% for the quarter. Underperforming regions during the month were the US and UK, while emerging markets, Australia and Europe outperformed. In the environment of reduced risk appetite, defensive sectors outperformed cyclical sectors.
- **Outlook:** While falling share prices and bond yields suggest improved valuations, even accounting for a weaker macro outlook, negative sentiment and reduced economic momentum (after a strong bounce post recession) cloud the near-term outlook for share markets and we are maintaining a cautious stance.

New Zealand shares

- **Review:** The New Zealand market was negatively impacted by the global environment but managed a more moderate fall of "only" 2.9% for the month for the NZX 50 Index and 3.0% for the NZX Portfolio Index. For the quarter, the NZX 50 Index fell by a significant 9.1%.
- Not surprisingly, in the environment of falling risk appetite, defensive sectors outperformed during the month, particularly property, utilities and stocks like Auckland International Airport and Telecom NZ. That said, somewhat surprisingly, three retailers – Kathmandu, Hallenstein Glassons and Restaurant Brands – headed the leaderboard.

- Underperforming stocks were NZX, which lost a contract to ASX on electricity derivatives trading, Pyne Gould Corporation on renewed concern about the non-banking finance sector after South Canterbury Finance's credit rating downgrade and investigations into its founder Alan Hubbard, and New Zealand Oil and Gas after further disappointing news on its drilling programme.
- In major corporate news, the Guinness Peat Group announced a corporate restructuring with a demerger of its Australian assets, but this was not favourably received by investors.
- **Outlook:** The fall in share prices and bond yields has improved the valuation of New Zealand shares. However, there are no obvious near-term catalysts to improve sentiment in the market and investors will have to be a little patient to realise better returns.

New Zealand listed property

- **Review:** New Zealand listed property went against the general trend for growth assets over the month, with the NZX Property Index up 1.2% and the sector down "only" 4.4% for the quarter. The move towards more defensive positioning helped relative performance against New Zealand shares.
- Kiwi Income Property Trust announced that the net effect of the tax changes in the Budget will be an increase in its effective tax rate and a circa 5% decrease in income available for distribution in the first full year of implementation (Financial Year 2012). It also announced that it intended to conduct an on-market buy-back of up to 20 million units over the next year. National Property Trust announced that it was moving to a corporate structure and the current management rights will be sold for \$2.5 million.
- **Outlook:** While valuations appear to be stabilising, the outcome of a review around the depreciation treatment of fixtures and fittings has the potential to further reduce distributable earnings for property vehicles.

International bonds

- **Review:** The debt concerns in Europe and weaker data flow had the effect of pushing out expectations of when the G3 central banks would begin to tighten policy from late 2010 into 2011. The impact of this trend combined with the reduction in risk appetite meant there was strong support for the bond market, pushing down yields to new lows in some cases.
- The two-year US Treasury yield fell to a record low during the month and ended at 0.60%, down 16 bps. The US 10-year rate fell to its lowest level since April 2009, breaching the 3% mark and ending the month at 2.93%, down 35 bps for the month and a considerable 89 bps for the quarter. For the month, 10-year rates were lower across Germany (down 8 bps to 2.58%), the UK (down 23 bps to 3.36%) and Japan (down 17 bps to 1.09%). Debt concerns intensified in the European "PIIGS" countries, with considerably higher rates in Greece and Portugal (up 275 bps and 99 bps respectively) and to a lesser extent Ireland (up 67 bps) and Spain (up 34 bps).
- As risk appetite waned, credit spreads widened. The yield on the US BAA index rose slightly during the month.
- **Outlook:** When risk appetite returns, we'd expect to see long term rates rise back towards where they were earlier in the year. That said, the latest risk event has delayed by several

months the time for higher policy rates in the major countries and deflationary risks have increased, and these factors are supportive for bond rates.

New Zealand bonds and cash

- **Review:** The RBNZ's first tightening this cycle and the message that rates would rise further over coming quarters was well anticipated by the market. The 90-day bank bill rate rose by 18 bps. That said, longer maturities were heavily influenced by the strong global trend towards lower rates and even New Zealand's two-year swap yield ended the month 29 bps lower at 4.09%.
- At the longer end, rate reductions were considerable, with five-year and 10-year swap rates down by 46 bps and 38 bps respectively and five-year and 11-year government stock rates down by 23 bps and 22 bps respectively, with the latter falling to 5.34%. Ten-year swap spreads traded negative as the risk bet was taken off and liquidity issues drove this untypical phenomenon.
- **Outlook:** A series of interest rates hikes is expected over coming quarters, putting upward pressure on the short end of the curve. While current sentiment is driving long bond rates lower, we would expect a reversal of fortunes as risk appetite recovers.

New Zealand dollar

- **Review:** Despite the reduction in risk appetite, the New Zealand dollar (NZD) held up well during the month, perhaps because commodity prices held up well (excluding industrial metals) and the tightening by the RBNZ. Of the majors, sterling and the yen were the strongest, the former reflecting the new government adopting sensible policies to reduce its fiscal deficit, and the latter reflecting the reduction in risk appetite. China's move to allow more flexibility in its exchange rate did not seem to have a significant impact on the market.
- The NZD rose in the first half of the month and fell in the second half, so the monthly changes weren't particularly strong. For the month the NZD rose by around 2% against the USD, euro and Australian dollar and fell by around 1% against sterling and the yen. On an MSCI weighted basis the NZD rose by 1.5%.
- Over the quarter it was a different story, with the NZD up strongly against the Euro and Australian dollar (7% and 5% respectively), and down against the USD (-3%), Yen (-8%) and Sterling (-2%). These significant moves were cancelled out somewhat, with the NZD on an MSCI weighted basis down by 1%.
- **Outlook:** The NZD is highly correlated with global shares at the moment, moving up or down in line with risk appetite. That makes us cautious about the NZD in the near term, despite rising interest rate differentials in New Zealand's favour being a supporting factor.

Summary

Key financial markets summary

| | As at 30 June 2010 | Change over the month (%) | Change over the year (%) |
|-------------------------------|--------------------|---------------------------|--------------------------|
| MSCI - US | 3559.65 | -5.3 | 14.3 |
| MSCI - UK | 7701.08 | -5.0 | 19.5 |
| MSCI - Germany | 1807.38 | 0.0 | 23.4 |
| MSCI - Japan | 958.26 | -4.7 | -7.5 |
| NZX 50 | 2972.09 | -2.9 | 6.3 |
| MSCI - World (local currency) | 2537.32 | -4.1 | 12.1 |
| MSCI - World (NZD) | 5022.75 | -5.4 | 4.4 |
| NZ Official Cash Rate | 2.75 | 25 bps | 25 bps |
| NZ 90 - day bank bill yield | 3.14 | 18 bps | 30 bps |
| NZ 10 - year bond yield | 5.34 | -22 bps | -112 bps |
| US 10 - year bond yield | 2.93 | -35 bps | -60 bps |
| NZD - USD | 0.6876 | 2.1 | 6.2 |
| NZD (TWI) | 66.4 | 1.4 | 8.6 |
| NZD (MSCI weighted) | 72.6 | 1.5 | 9.5 |

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