Month ended 30 May 2010

AMP capital INVESTORS

Investment brief

Global

- **Review:** Global economic data, which remained generally positive in May, were overshadowed by the turmoil in Europe, where investors lost confidence in the ability of policy-makers to resolve the debt issues that are plaguing the region. The main concerns investors had were the risk of a major sovereign debt crisis, the implications of the necessary tighter fiscal policy on growth and the renewed tension in bank funding markets.
- The heat came on policy markers to deliver credible measures that would stem the risk of contagion around Europe. Early in the month there were fears that the significant aid package to Greece wouldn't be enough to prevent the debt crisis spreading to other euro-zone countries. Share markets went into free-fall, after being disappointed by the lack of any decisive action by the European Central Bank (ECB). But within days of that, the European Union (EU) Commission announced that it would set up a €750 billion facility of loans, loan guarantees and funding from the International Monetary Fund to help needy countries finance their budget deficits. Furthermore, the ECB announced that it would begin sterilised purchases of government and private debt in dysfunctional markets, while the US Federal Reserve re-activated emergency US dollar (USD) swap lines with the ECB and other major central banks to ease pressure on short term money markets. Countries like Italy, Greece, Spain and Portugal adopted further austerity measures to reduce budget deficits, while the EU proposed an upfront levy on banks to insure against future financial failures. Germany proposed a ban on short selling of sovereign credit default swaps and naked short selling of shares in large banks and insurers, but the market reacted negatively to this as it was a unilateral decision – without consultation with other countries – and many argued that it didn't get to the root cause of the current problems.
- Despite the significant problems in Europe, the dataflow remained generally positive in the largest countries, with the PMIs and Germany's Ifo index remaining close to recent highs and strong industrial production data. It was too early to expect any fall in some leading indicators on the back of the debt turmoil, but some sentiment indicators did peel off from recent highs. In the UK, the election result was the country's first hung Parliament in 36 years, with a minority government eventually formed, led by the Conservatives.
- In the US, the dataflow was also positive, with the manufacturing ISM indicator rising to 60.4, the non-manufacturing ISM indicator steady at a four year high and further positive momentum in employment, retail sales, industrial production, housing activity and durable goods orders. On the negative side, jobless claims figures were on the soft side, while the Conference Board's leading indicator fell for the first time in 14 months in April. Inflation remained depressed, with the core CPI rising by just 0.9% year-on-year (YoY), the lowest figure since the 1960s.
- Japan's leading index showed its largest monthly gain since 1980 while GDP for the March quarter rose by 1.2% quarter-on-quarter (QoQ) and 4.2% YoY, making Japan the strongest growing major developed economy over the past year. China economic activity data remained strong, although there were reports of a sharp slowdown in the housing market in the key cities, suggesting that the Government's policy moves to weaken heightened speculation in the housing market have worked.
- **Outlook:** Global GDP growth is still expected to comfortably exceed 4% over 2010 and 2011, but the intensifying risks in Europe threaten to spoil that positive trend. Contagion risks remain only a threat at this stage, but clearly Europe will be a weak spot, while the developing world remains a beacon of strength.

New Zealand

- **Review:** The picture painted by the dataflow remained one of an economic recovery gradually broadening and deepening, with an improving retail sales trend, a decent bounce in dwelling consents, higher than average levels of business and consumer confidence and an improving trade balance.
- The combination of surprisingly strong employment growth in the March quarter of 1.0% QoQ and surprisingly weak labour force participation drove a massive fall in the unemployment rate from 7.1% to 6.0%. One shouldn't jump to conclusions on a single figure but it does raise some doubt about how much excess capacity there is in the local economy.
- Fonterra's first estimate of the projected payout for the financial year 2010/11 season is $6.90-$7.10 per kilogram of milk solids, which will pump in more than $600 million to the local dairy industry, or closer to $1 billion as the impact of the drought wanes.

Investment enquiries

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- The centre-piece of the Government's 2010 Budget was a rejig of the tax system and this was favourably received by many. Income tax rates were reduced across the board and the corporate tax rate and PIE rates were cut, funded by a rise in GST, removal of the depreciation shield on residential and commercial property and a tightening up of other tax rules. It was a step in the right direction to help improve long run growth prospects, with better incentives to work and save and a reduced incentive to consume.
- **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:** Risk appetite collapsed during the month on fears that the sovereign debt crisis that began earlier this year in Greece would spread to other European countries. While governments were active in trying to regain the confidence of markets through the announcement of new policy initiatives, the market was sceptical that the problem of too much debt could be solved by issuing more debt.
- In an unusual event, and still not entirely explainable, the Dow Jones index fell by over 1000 points intra-day early in the month, before recovering, with automated programme trading seen to be the cause. This risk event did nothing to restore confidence in the market.
- The MSCI World Index ended the month down 7.5%. While the fall was significant, it simply eroded the gains seen over the previous few months. In local currency terms, the best performing regions were the euro area and UK, while the US and Japan underperformed. While this seems odd, given that Europe was the epicentre of this new risk event, the movement of currencies explains the pattern. With the euro and sterling hit hard and the USD and the yen well supported, in common currency terms, the pattern of performance was reversed. Along with the global headwinds, Australia was hit by the surprise announcement of a proposed Resource Super Profits Tax as part of the long-awaited Henry Tax Review. The S&P/ASX 200 index fell by 7.9%, with the plunge in the Australian dollar adding to the pain for global investors.
- Defensive sectors such as telecommunications services, consumer staples and utilities performed best as the market plunged, while the IT, financials and energy sectors were the worst performing.
- **Outlook:** Recent events in Europe have brought forward the sovereign debt issues we previously saw developing over coming years and represent a significant risk to the global economic recovery and muddy the outlook for global shares. Valuations have improved, which is a positive factor for expected returns, but volatility has also increased, suggesting a rockier trend in global shares.

New Zealand shares

- **Review:** New Zealand shares were dragged down broadly in line with global shares, which wasn't actually a very good result considering the plunge in the New Zealand dollar (NZD). So in common currency terms, New Zealand significantly underperformed, along with Australia.
- The NZX50 index fell by a significant 6.8%, while the NZX Portfolio Index dropped by 7.3%. There was plenty of corporate news to digest on the back of the minor reporting season. Results were mixed. Solid results were reported by Ryman Healthcare, Mainfreight, Fisher & Paykel Healthcare and Tower. Falls in profit were announced by Telecom NZ, Fisher & Paykel Appliances, Rakon and Sanford.
- At the top of the leaderboard were beneficiaries of the weaker NZD, such as PGG Wrightson (PGW), NZ Farming Systems Uruguay and Sanford. PGW was further supported by the higher dairy payout projected by Fonterra and a further sell-down by a major investor, reducing the overhang in the stock.
- Telecom NZ announced that it was considering splitting it's network and retail assets into separate companies so it can participate in the nation's high-speed broadband network.
- **Outlook:** The fall in share prices and bond yields has improved the valuation of New Zealand shares. However, this asset class is likely to lag any recovery in global share markets.

New Zealand listed property

- **Review:** The listed property sector index was down 6.7% for May, marginally outperforming the NZX50 which was down 6.8%. Only National Property had positive returns for the month at 2.1%, with the worst performer being Kiwi Income Property (KIP) dropping 9.9%.
- The tax reforms in the budget will have an impact on distributable earnings and therefore valuation. The major changes are the removal of depreciation on building structures which is partially offset by the lowering of the corporate and PIE tax rates to 28%. Property vehicles will also be impacted to a lesser degree by the removal of 20% accelerated depreciation on Property Plant and Equipment and the increased GST level to 15%.
- AMP NZ Office Trust (ANZO) announced the depreciation changes would reduce distributable profit by 7-9%, before the benefit of the 28% PIE tax rate. Property For Industry (PFI) stated that distributable earnings would be reduced by 4-5%. A large portion of the difference is due to ANZO being an investor in Office property's, meaning the building makes up a larger portion of the earnings than with industrial assets such as PFI's.
- Goodman Property Trust (GMT) and KIP confirmed valuations for the year to March at -3.3% and -3.9%. ANZO released its unaudited full year valuation to June 2010 at -7.6%.
- **Outlook:** The outcome of a review around Fixtures and Fittings coming out of the budget has the potential to add to the lower distributable earnings for property vehicles. Valuations appear to be stabilising and are more likely to do so once the impacts of the budget have worked there way through over the next year.

International bonds

- **Review:** The turmoil in Europe had significant flow on effects for fixed income markets. Normally sedate money markets were kicked into life and we saw some spreads increase at the very short end of the curve, which is fairly rare in a stable policy rate environment. A sharp rise in the USD Libor-OIS spread, for example, reflected concerns about a looming funding crisis, particularly for European banks, which have sizeable USD funding needs.

- Needless to say, in the falling risk appetite environment, government bonds were well supported in the major countries. The US 10-year US Treasury yield fell by 37 basis points (bps) to 3.28%, and reached as low as 3.06% during May, levels not seen since the first half of last year. Germany's 10-year rate fell by 36 bps to 2.66%, while the UK rate fell by 27 bps to 3.58%. In Europe's periphery, rates were all over the place, with a big fall in Greek and Portugal rates, but upward pressure on rates in Italy and Spain. The 10-year rate fell by 2 bps in Japan to 1.27%. Corporate spreads widened, as risk appetite waned, but this didn't necessarily mean higher absolute rates. In the US, the Moodys BAA investment grade composite showed a relatively steady rate for the month.
- **Outlook:** As risk appetite returns, we'd expect to see long term rates rise back to where they were earlier in the year. That said, the latest risk event has delayed the time for higher policy rates by several months in the major countries and this is supportive for bond rates, at the margin.

New Zealand bonds and cash

- **Review:** There was upward pressure on rates at the short end of the curve, as the time for the beginning of the tightening cycle in New Zealand drew closer. The very strong employment figures increased confidence that rate hikes were inevitable in New Zealand. The 90-day bank bill rate rose by 23 bps to 2.96%.
- Government bonds were well supported, in line with global trends, as investors de-risked portfolios. New Zealand's long bond rate fell by 35 bps to 5.56%. Swap spreads widened significantly, with the New Zealand 10-year swap rate falling by "only" 7 bps to 5.75%.
- **Outlook:** Most expect the tightening cycle to get underway in June and that should put upward pressure on short-dated yields. A recovery in risk appetite would drive higher long term rates as well.

New Zealand dollar

- **Review:** The collapse in risk appetite generated some extreme movements in cross rates, with the yen and USD the strongest global currencies over the month and the NZD and Australian dollar (AUD) being hit hard at the other extreme, not helped by falling commodity prices. The Euro and Sterling were weak against the other majors, with Europe the epicentre of the risk event and investors concerned that ultimately a much weaker euro was required to help support the region.
- The New Zealand dollar fell by a significant 10.7% against the yen and 7.8% against the USD. Changes against the European cross rates were more modest, with a 2.9% fall against sterling and relatively flat against the euro. The NZD rose by 2.3% against the AUD. On a trade-weighted basis the NZD fell by 4.2%, while on an MSCI-weighted basis the NZD fell by 5.6%.
- **Outlook:** If concern about Europe contagion wanes, then we'd expect the NZD to recover much of the lost ground over the past month. The beginning of the tightening cycle in NZ is also a supporting factor for the NZD.

Summary

Key financial markets summary

	As at 30 May 2010	Change over the month (%)	Change over the year (%)
MSCI - US	3759.57	-8.1	21.0
MSCI - UK	8110.60	-6.1	21.7
MSCI - Germany	1807.84	-2.9	20.3
MSCI - Japan	1005.98	-11.0	-0.1
NZX 50	3061.22	-6.8	10.7
MSCI - World (local currency)	2646.64	-7.5	16.9
MSCI - World (NZD)	5307.50	-1.8	8.6
NZ Official Cash Rate	2.50	0 bps	0 bps
NZ 90 - day bank bill yield	2.96	23 bps	21 bps
NZ 10 - year bond yield	5.56	-35 bps	-25 bps
US 10 - year bond yield	3.28	-17 bps	-17 bps
NZD - USD	0.6736	-7.8	5.2
NZD (TWI)	65.2	-4.2	8.1
NZD (MSCI weighted)	71.5	-5.6	9.2