

Investment Brief

continued to increase in July to 6.5% MoM. The increase is attributed to a rise in food price inflation, which appears to have peaked. While China's manufacturing PMI for July showed a mild decline (-0.2 points to 50.7), hard economic data remained strong. July data releases showed industrial production up 14% YoY, fixed asset investments up 25.4% YoY, retail sales up 17.2% YoY and exports up 20.4% YoY.

Global

- **Review:** August was characterised by a marked increase in pessimism and risk aversion globally due to a combination of renewed sovereign debt issues in Europe, the US losing its AAA credit rating from S&P and weak economic data.
- Economic indicators showed a slowing in the US economic recovery with second quarter gross domestic product (GDP) revised down to 0.2% quarter on quarter (QoQ), compared to original estimates of 0.3% QoQ. US retail sales for July rose 0.5% month on month (MoM), although surveys showed consumer sentiment was at its lowest reading since 1980. This pessimism is being attributed to ongoing debate and slow resolution regarding raising the US debt ceiling in July. Speculation about another US Federal Government quantitative easing program was rife, with the US Federal Reserve (Fed) signalling that further monetary stimulus measures will be considered.
- European data releases were generally poor during August. Europe's real GDP expanded by only 0.2% QoQ in the June quarter, which brings the annual growth rate to 1.7% year on year (YoY). The manufacturing purchasing managers index (PMI) fell (-0.7 points) to 49.0 (which is now below the '50' level indicating a contraction). Industrial production fell by -0.7% MoM in July. In Germany, the IFO business climate index fell (-4.2 points) to 108.7 (a 14 month low) which suggests the German economy is slowing from 3% growth in the first half of 2011, to below 2%.
- As was expected after the earthquake and tsunami in March 2011, Japanese GDP contracted by 0.3% QoQ in the second quarter. Japan's exports fell (-4.9% QoQ) and new housing construction fell (-1.8% QoQ), while government spending (+0.5% QoQ) and public investment (+3.0 QoQ) both rose.
- Amid inflation worries in China, monetary policy remained tight with monetary supply and lending slowing, indicating monetary policy might ease in 2012. Chinese inflation

- **Outlook:** The global economic outlook continues to deteriorate led by the US and Europe. The soft patch in US economic data seems to be worsening and the risks of a return to recession are increasing given a number of major issues facing the global economy. However, monetary policy will remain accommodative in many economies for some time to come to offset the global trend toward fiscal consolidation. In addition, the fall back in global oil and food prices should help relieve household budgets. While growth in the emerging world is slowing from excessively strong levels, there is no evidence of a sharp decline indicative of recession, so overall it should remain reasonably strong. Emerging countries now account for more than 50% of world economic activity. Japan also appears to have recovered from its recession earlier this year. On balance, while the risk of a return to global recession is not insignificant, we remain of the view that the global economy should be able to continue to grow, although only at a moderate pace.

New Zealand

- **Review:** New Zealand data during August added to evidence that the economy is on a solid footing and set to pick up over the remainder of the year.
- Employment remained flat in the June quarter after a 1.3% rise in the March quarter. While full-time employment rose by 0.2% over the quarter, it was offset by a small decline in part-time employment (-0.1%). The unemployment rate remained steady at 6.5% in the June quarter. Coming after the strong March quarter results, this is a reasonably positive outcome, especially in light of the drag from the Canterbury region following the earthquake in February.
- Hours worked increased by 1.6% over the quarter, suggesting labour demand is strengthening.
- Retail sales grew by 0.9% in volume terms in the June quarter, rising 1.1% from a year ago. This exceeded the consensus forecast of a 0.6% QoQ growth and follows a 1.1% lift recorded in the March quarter. Core sales (ex autos) jumped 1% over the June quarter. Meanwhile, consumer confidence rebounded in August, but remains below its historical average.

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- The National Bank Business Outlook Survey for August showed a moderation in business sentiment from the lofty levels recorded in July, reflecting the deteriorating global financial market conditions. However, the own-activity indicator (which has been a better leading indicator for GDP growth) barely budged, with a net 43% of respondents expecting better times for their own businesses over the year ahead, compared to 43.7% in July. The own-activity indicator continues to signal an annual growth rate of around 5% over the coming year.
- The ANZ Commodity Price Index fell by 0.1% in July after a 1.2% decline in June. The Index is still up 22.3% from a year ago.
- The REINZ's monthly residential market report showed that New Zealand house prices fell 0.6% in July after a 1.3% increase in June. House prices were 0.5% higher a year ago. House sales were up 11.4% YoY. Overall, the underlying trend for the data suggests that the New Zealand housing market continues to stabilise.
- The number of dwelling consents issued increased by a solid 13% in July. Excluding the volatile apartment category, the number of consents was up 6.3% in July. The data adds to evidence that residential construction activity is bottoming out.
- There was a net outflow of 220 permanent/long term migrants in July, recording a fifth consecutive monthly net outflow. For the year to July, there was a net inflow of 2,900 migrants in total, the lowest since October 2001. The number of short term visitor arrivals to New Zealand increased 2% in July following a 4.4% decline in June.
- The Reserve Bank of New Zealand (RBNZ) Survey of Expectations for the September quarter showed a slight moderation in inflation expectations. The one-year-ahead inflation expectation fell from 3.1% to 2.9%, while the two-year-ahead expectation eased slightly from 3% to 2.9%. While a fall in inflation expectations is encouraging, inflation expectations remain uncomfortably close to 3% (the upper bound of the RBNZ's inflation target range).
- **Outlook:** New Zealand's growth momentum should pick up over the second half of this year. Reconstruction in Canterbury is expected to boost the level of economic activity significantly over the coming years and the backdrop of strong export commodity prices and the favourable terms of trade will continue to be supportive of growth. Downside risks to this optimism are weakening global economic activity and the cautious household sector on the back of elevated household debt. Fiscal consolidation also will weigh on activity over the coming years.

International shares

- **Review:** Global share markets experienced extreme volatility during August in response to the risk of a US recession and continuing sovereign debt issues in Europe. The sell off was initially triggered by the US losing its AAA rating from S&P, but continued as investor focus turned to deteriorating global growth prospects.
- The leading measure of global share market performance, the MSCI World Index, fell sharply by 6.7% in local currencies (or -4.8% in unhedged New Zealand dollar terms). This was the fourth consecutive monthly decline in the global share market. US shares fell 5.5% over the month after a 1.9% decline in July. Re-escalation in the European sovereign crisis and signs of

stress in European bank funding markets saw European shares significantly underperform the global market during August. German shares ended the month down 18.7% while shares in Italy and France were down 14.9% and 10.9% respectively. The UK share market fell 6.5%. Asian markets also generally underperformed with Japanese shares down 9% and emerging Asia down 9.5%.

- **Outlook:** Share market valuations are attractive for long term investors and shares are likely to benefit from impending monetary easing. However, the risk of further falls is high as the risk of recession in advanced countries is significant and the probability of a further blow up in Europe is considerable. September is also normally a poor month for shares.

New Zealand shares

- **Review:** The New Zealand equity market outperformed its global counterparts during August in its 'low-beta' capacity in the environment of falling markets and soaring risk aversion. Relatively strong economic fundamentals and a solid earnings season also supported the New Zealand market.
- The NZX50 Index fell 2.1% over the month while the NZX Portfolio Index recorded a 2.6% decline for the month.
- **Outlook:** Our valuation metrics continue to show New Zealand equities to be good value against bonds but not so good against global equities. New Zealand equities are likely to lag any positive trend in global shares given their low beta nature, but equally they would perform relatively better should global shares suffer a bout of weakness along the way.

New Zealand listed property

- **Review:** The listed property sector had another flat month, falling 0.2%, although still outperforming the NZX50 which dropped by 1.5% in August. The best performers during August were AMP NZ Office Limited (ANO) and Kiwi Income Property Trust (KIP), delivering 2.4% and 1.5% returns respectively, closely followed by Goodman Property Trust (GMT) up 1.0%. Weakest were National Property Trust (NPT) down 5.8% and Vital Healthcare Property Trust (VHP) down 4.3%. The listed property sector has returned 9.9% for the year so far, significantly better than the NZX50, up only 1.2% for the same period.
- Argosy Property Trust's (ARG) \$20 million management internalisation proposal has now been approved by unit holders at the August AGM. ARG have advised the next step is corporatisation, a proposal for which will be presented to unit holders for approval at 2012's meeting. Negotiations around VHP's internalisation proposal are still ongoing.
- A large number of transactions have taken place during August, with KIP (\$8 million), Kermadec Property Fund (KPF) (\$4 million), Property For Industry (PFI) (\$7.4 million) and DNZ Property Fund (DNZ)(\$32 million) all achieving asset sales.
- **Outlook:** There have been positive signs for the general New Zealand property market in the last quarter, with an increase in investment activity and the number of transactions picking up. Yield continues to be the main focus for investors while interest rates remain low. The dividend yields on offer from listed property vehicles continue to be attractive to investors despite the effects of tax changes.

International bonds

- **Review:** Most sovereign bond markets rallied strongly during August pushing yields for many regions to new lows. The combination of lower global growth prospects, expectations for further monetary stimulus and safe haven flows has served to depress real yields for major economies.
- In early August, the European Central Bank announced it would buy bonds in secondary markets in a bid to stabilise the bond yields of vulnerable European countries. This saw Italian and Spanish bond yields rally, as well as modest improvements in Ireland and Portugal's bond yields.
- Over the month the US ten-year bond yield plunged by 57 basis points (bps) to end the month at 2.22%. The ten-year yields in the UK and Germany were down 26 bps and 32 bps respectively. Australia's ten-year bond yield also fell sharply, down 43 bps to 4.37%. Japan's ten-year bond yield fell further by 5 bps to close at 1.03%.
- **Outlook:** Softer economic data has helped sovereign bonds in key countries perform strongly over the last few months as yields have fallen dramatically. They could still rally further in the short term and are a good diversifier. However, yields are very low so expect modest medium term returns.

New Zealand bonds and cash

- **Review:** While New Zealand economic data remained relatively robust, the global market turbulence saw markets revise down expectations for rate hikes from the RBNZ in the coming year - from around 100 bps to only around 50 bps. This, along with global recession concerns and a surge in risk aversion, drove swap and bond rates sharply lower. Government bond yields fell more than swap rates taking swap spreads a little wider. The yield curve flattened further as global growth concerns weighed on longer term rates.
- The four-year government bond yield fell 43 bps to end the month at 3.59% while the ten-year rate ended the month down 41 bps at 4.52%. The five-year swap rate fell 35 bps while the ten-year swap rate ended the month down 32 bps. The 90-day bank bill rose by 4 bps to end the month at 2.96%.
- **Outlook:** Recent concerns about a double dip in the US and weaker data elsewhere is calling into question the RBNZ removing the 50 bps emergency rate cut in September. However, the ongoing improvement in domestic economic activity and elevated inflation expectations mean the RBNZ cannot indefinitely keep rates at the record low level of 2.5%. While the Official Cash Rate (OCR) is expected to be raised before year end, long term bond yields are likely to remain under downward pressure in the near term given the elevated level of risk aversion in the global financial market at present.

New Zealand dollar

- **Review:** The New Zealand dollar (NZD) came under pressure falling against most major currencies on global growth concerns and a sharp decline in risk appetite during the month.
- Along with the NZD, other "growth sensitive" currencies such as the Canadian dollar and the Australian dollar were also affected by the fall in risk appetite. Notably, the Swiss franc, the currency that is normally considered a safe haven, was among the worst performing currencies during the month as the Swiss National Bank intervened in an attempt to stem the appreciation of the "massively overvalued" currency.
- The NZD fell 2.3% against the US dollar and 2.5% against the euro. It also fell against the yen and the British pound sterling, down 3.2% and 1.5% respectively. The NZD was more or less flat against the Australian dollar for the month. On a MSCI-weighted basis, the NZD was down 2.2% and down 1.9% on a trade weighted basis.
- **Outlook:** The NZD is likely to be broadly range bound over the coming year or so. In the near term, strong commodity prices and improving local economic data should be supportive of the NZD. However, the long-term valuation measure suggests the NZD is very overvalued. The demanding valuation makes the currency vulnerable to external shocks and any near term pull-backs.

Summary

Key financial markets summary

	As at 31 August 2011	Change over the month (%)	Change over the year (%)
MSCI - US	4334.93	-5.5	+19.1
MSCI - UK	8804.44	-6.5	+6.8
MSCI - Germany	1768.80	-18.7	-1.4
MSCI - Japan	891.61	-9.0	-3.1
NZX-50	3323.07	-2.1	+9.5
MSCI - World (local curr.)	2819.99	-6.7	+8.7
MSCI - World (NZD)	4846.09	-4.8	-5.6
NZ Official Cash Rate	2.50	0 bps	-50 bps
NZ 90-day bank bill yield	2.96	+4 bps	-29 bps
NZ 10-year bond yield	4.52	-41 bps	-61 bps
US 10-year bond yield	2.22	-57 bps	-24 bps
NZD-USD	0.8540	-2.3	+21.9
NZD (TWI)	73.0	-1.9	+11.3
NZD (MSCI weighted)	84.1	-2.2	+15.9

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