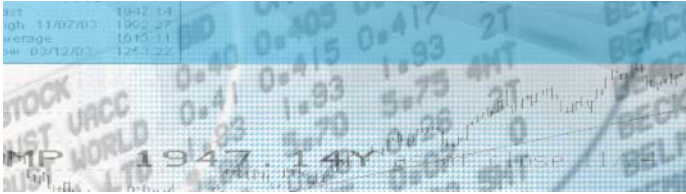


# Weekly market & economic update - Week beginning Monday 2 August 2010



## Headline developments of the past week

- While US earnings results have softened a bit in the last week, they have still been strong with 77% of the US companies to have reported so far exceeding expectations. While cost control has played a big role, 67% of companies have surprised on the upside in terms of revenue growth. In Europe, 60% of companies to report so far have exceeded earnings expectations and 69% have exceeded revenue expectations.
- The Reserve Bank of New Zealand (RBNZ) raised the Official Cash Rate (OCR) by 0.25% to 3.0% in line with market expectations. The accompanying statement was more dovish than many expected however, explicitly noting that the pace and extent of further OCR increases are likely to be more moderate than previously projected. While the Bank recognised that trading partner growth has been stronger than expected, it also pointed to the fragile nature of the global economic recovery, subdued domestic demand, cautious households, weak credit growth, subdued corporate lending and a slowing in net immigration, as all contributing to the somewhat softer growth outlook for the New Zealand economy. This caused a significant rally in New Zealand bonds and a decline in the New Zealand dollar (NZD).

## Major global economic releases and implications

- US GDP growth slowed pretty much as expected to 2.4% annualised in the June quarter, but this was mainly due to higher imports, with domestic demand actually picking up. March quarter growth was revised up as was the savings rate which suggests that US consumers may be in better shape than previously thought. Other data was mixed. Consumer confidence fell further in July, although it seemed to improve slightly as the month wore on, and the Federal Reserve's Beige Book hinted at a slight loss of momentum in the US economy. Against this, house prices continued to rise in May, new home sales rose in June, new mortgage applications rose for the second week in a row, weekly unemployment claims fell and underlying capital goods orders rose further in June after a strong rise in May. The bottom line is that US economic growth has slowed, but still doesn't appear to be headed back into recession.

- The European Central Bank's bank lending survey showed a tightening of lending standards in the second quarter and unemployment remained at 10% in June. However, measures of business and consumer sentiment rose to new recovery highs July.
- Japanese economic data was mixed with a surprise fall in industrial production and rise in unemployment along with continuing price deflation, but with stronger than expected household spending, a rise in small business confidence and a rise in the ratio of jobs to applicants to the highest level in 15 months.
- Benign inflation in Australia has thrown talk of a rate hike in the middle of the Federal election campaign out the window. While the increase in tobacco excise along with higher prices for petrol, health and rents boosted headline inflation to an annual rate of 3.1% over the year to the June quarter, this was offset by general price weakness in many items which pushed underlying inflation down to its lowest level in three years at 2.7%. The lagged impact of the growth downturn in 2008, spare capacity globally, the strong Australian dollar and consumer frugality are combining to keep overall price rises down.

## New Zealand economic releases and implications

- The NBNZ business outlook survey showed business sentiment deteriorated further in July. Firms' own-activity indicator in particular was down 6.1 points to a net 32.4% expecting better activity over the year ahead. This was the second consecutive decline in the measure and suggests that growth momentum is fading. However, it's coming off what was near a 10-15 year high and remains comfortably above the long-run average.
- The number of new dwelling consents rose 3.5% in June to be up 27.7% on a year ago level. This follows a 9.5% decline registered in May. Excluding apartments, it was up 1.7% (up 37.1% year on year).
- The overseas merchandise trade balance was in surplus by \$276 million in June. The balance over the 12 months to June registered a surplus of \$639 million, the strongest result since 2002.

## Major market moves

- Share markets were little changed in the US and Europe with some softer earnings reports and economic data weighing later in the week. Asian shares were up slightly and the Chinese share market had strong gains on expectations for a policy easing in the months ahead. The New Zealand share market was up 1.3%, outperforming its major global counterparts.
- A more cautious assessment of the New Zealand economy by the RBNZ saw the New Zealand dollar come under downward pressure despite a generally falling US dollar and strong commodity prices.

## What to watch in the week ahead?

- In the US, the key ISM business conditions indexes and payroll employment data for July will be the focus.
- In Australia, the Reserve Bank is almost certain to leave interest rates on hold with the benign June quarter inflation reading giving it plenty of time to better assess the outlook for the global and Australian economies.
- In New Zealand, the June quarter labour market reports will be the highlight for this week.

## Outlook for markets

- The very short term outlook for shares is mixed. Strong profit results in the US and Europe has provided a lift. Against this though, double dip concerns are likely to persist for a while and suggest that we may still see more weakness into the seasonally weak months of September and October. However, we remain of the view that a double dip recession globally will be avoided and with shares now very good value, monetary conditions set to remain favourable and China likely to start relaxing its tightening measures in the next few months, shares are likely to stage a strong rally in the December quarter and 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 rising New Zealand - global short term interest rate differential, and more favourable fiscal position relative to the major countries, would point to the NZD remaining richly priced for some time to come. That said, 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.
- Low yields are pointing to poor medium-term returns from government bonds, particularly given worries about excessive public debt and as the latest bout of investor risk aversion abates.