

Weekly market & economic update – week beginning 2 January 2012

2 JANUARY 2012

Headline developments of the past week

- > Europe's debt debacle has continued into 2012 with mixed responses in Global share markets this week. For the years opening, European shares have ranged between the 'robust' (German shares up 3.4%) and the 'also rans' (Spain down -2.8 %). Given that Europe's banking and sovereign debt crisis is yet to be resolved and the politicians are planning another round of summit meetings, European shares seem set for a difficult 2012.
- > The weaker European nations are struggling with the task of trimming their large budget deficits. Spain had originally targeted a budget deficit of approximately -6 % Nominal gross domestic product (GDP) in 2011 but this appears likely to be closer to -8% GDP. Spain's new conservative government, after the November 2011 election, has announced additional tax hikes of €6 billion and €8.9 billion in spending cuts to reduce the budget deficit by 1% of GDP.
- > By contrast, US shares have had a more promising opening week for 2012. The benchmark US share index in the S&P 500 has risen by 1.9%.

Major global economic releases and implications

- > European business surveys continue to indicate a recession. The purchasing managers index (PMI) survey for December did rise marginally by +0.5 to 46.9 but suggests that European industrial production is still contracting.
- > America's Institute for Supply Management (ISM) business surveys suggests moderate US growth in the final quarter of this year. December's ISM survey for manufacturing rebounded by 1.2 points to 53.9, the highest reading in six months. The ISM non-manufacturing survey improved by 0.6 points to 52.6 in December and is indicative of modest US growth. Essentially these ISM surveys suggest that the US economy ended 2011 with activity expanding at a pace of +2 % real GDP.
- > America's labour market recorded solid jobs growth in December of 200,000 compared to November's result of 120,000. Private sector hiring was 212,000 in

December. America's unemployment rate fell by 0.1% to 8.5% in December, the lowest level in three years.

- > The US Federal Reserve's (Fed) meeting minutes for December provided some interesting comments. The Fed noted that there were a number of factors restraining US economic growth such as "*fiscal and banking issues in the Euro area*" as well as "*fiscal tightening in the United States, high levels of uncertainty among households and businesses, the weak housing market and household deleveraging*".
- > Yet US consumer confidence rose to the highest level in more than five months. The Bloomberg Consumer Comfort Index climbed to -44.8 in the period ended 31 December 2011, the best reading since mid-July 2011. There appears to be some improvement in the US labour market. Applications for jobless benefits decreased by 15,000 to 372,000 according to Labor Department figures.

New Zealand economic releases and implications

- > The New Zealand economy grew faster than expected in the September quarter. New Zealand GDP was up +0.8% in Q3 2011 (consensus 0.6%, previous 0.1%), and 1.9% on a year on year basis (1.1% in Q2). Looking at the components, private consumption was the main driver of growth in the quarter, while investment was subdued and net exports were a drag on growth. On an industry basis, manufacturing was strong, as was the retail & hospitality sector (thanks to the Rugby World Cup). Full year GDP growth for 2011 is likely to come in around 2%, and may rise to 2.8% this year on the back of strong terms of trade, stimulatory monetary policy, and the Canterbury rebuild.
- > New Zealand's current account deficit widened to a seasonally adjusted \$2.7 billion in the September quarter on the back of a lower trade balance and worse investment income balance; placing the annual current account deficit at 4.3% of GDP, the largest since Q2 2009. Meanwhile, the net International Liability Position widened to 73% of GDP (from 69%). The current account deficit is likely to come in at similar levels in Q4 2011, but may widen further during 2012.

Major market moves

- > Europe's currency continues to edge lower as markets question the integrity of the European monetary system. The euro has fallen by 1.3% against the US dollar over the week. Indeed the euro is now at a record low against the New Zealand dollar since the introduction of the euro in 1999.
- > Oil prices remain bad given concerns over Iran's intentions in the Strait of Hormuz and potential threat to global energy supply. Brent Crude has risen by 4.7% over the past week to US\$112.5 per barrel.

What to watch in the week ahead?

- > US retail sales for December are to be released next Thursday and are an important measure of consumer spending. The US Federal Reserve releases their anecdotal survey of the American economy (known as the 'beige book') which typically gives some insights on current regional performances.
- > The European Central Bank (ECB) and the Bank of England have monetary policy meetings next Thursday. While no interest rate changes are expected, there will be particular interest in the ECB President's comments on the European banking and sovereign debt crisis and the response of the central bank.
- > China is set to release critical economic activity data next week, including real GDP for the December quarter, industrial production and retail sales for December as well as December CPI inflation. The key interest is whether China's economy continues to slow given tighter monetary policy in 2010-2011 and recent weaker global demand for its exports, particularly in Europe. A further moderation of inflation pressures in December would be welcome as this could give China scope to cut interest rates sooner.

Outlook for markets

- > Global shares are very cheap compared to corporate profits as well as relative to government bond yields. Yet Global shares have to battle the current prevailing headwinds of Europe's banking and debt crisis, doubts on the durability of the US recovery as well as concerns that Asia's growth is slowing sharply. While global shares are likely to tread water in the short term given the prevailing pessimism, 2012 should ultimately prove a better year than 2011. Global share have factored in a significant amount of stress as indicated by forward price to earnings multiples which are now 10.2 times for global shares compared to 12.4 times a year ago.
- > The New Zealand dollar (NZD) is likely to be range bound over the coming months. From a cyclical perspective, strong terms of trade and favourable local economic data are supportive of the NZD. However, the long term valuation measure suggests the NZD is overvalued. As a result, the demanding valuation makes the currency vulnerable to external shocks and any near-term pull backs.
- > Government bonds are a good diversifier and with short term interest rates likely to remain low indefinitely it's hard to see much sustained upwards pressure on bond yields for the foreseeable future. However, yields are extremely low so expect modest medium-term returns.