AMP CAPITAL

INVESTMENT BRIEF

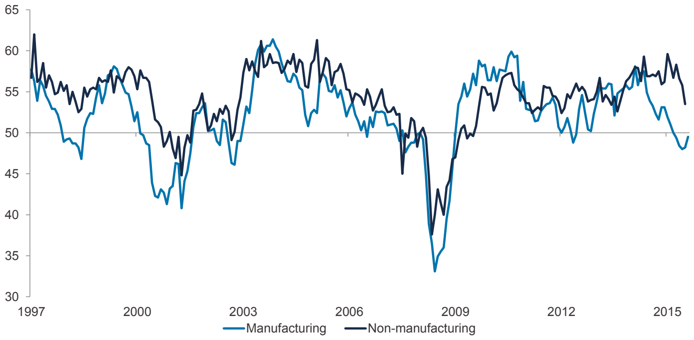
FEBRUARY 2016

Global shares continued to tumble in early February as investor concerns centred on slowing global growth, particularly around the health of the European banking sector. However, volatility dropped and share prices recovered over the second half of February. Global bonds rallied over the month which saw a continuation of January's flight to safety. New Zealand bonds also rallied, with long term bond yields following the lead from offshore markets. The New Zealand share market again showed its resilience in the face of global turmoil, ending up 1%. The New Zealand dollar also continued its recent trend, stronger one month only to fall the next.

1. Can weak manufacturing bring the us economy down?

US Manufacturing and Non-manufacturing PMIs

Index



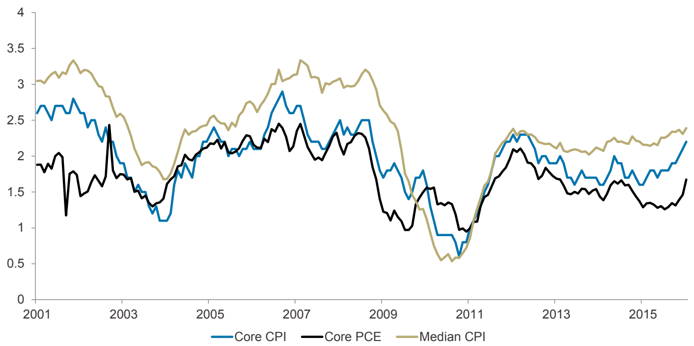
Source: Institute of Supply Management

- It could if the contraction is deep enough and for reasons that also impact on the service sector directly, such as a sharp drop in domestic demand or a significant tightening in monetary conditions.
- We don't think manufacturing weakness is due to factors that are likely to bring the whole economy down. Indeed, the major negative for manufacturing right now – weak oil prices – is good for disposable incomes, which is a positive for the service sector.
- The current softness in the services sector is down to poor weather and sentiment tied to recent equity market weakness, and that will prove short-lived.
- Despite the concern about US growth, recent activity data is reasonable and still broadly consistent with GDP growth of around 2% in 2016.

2. US Inflation is rising - What does the Fed do now?

US inflation

Annual % change



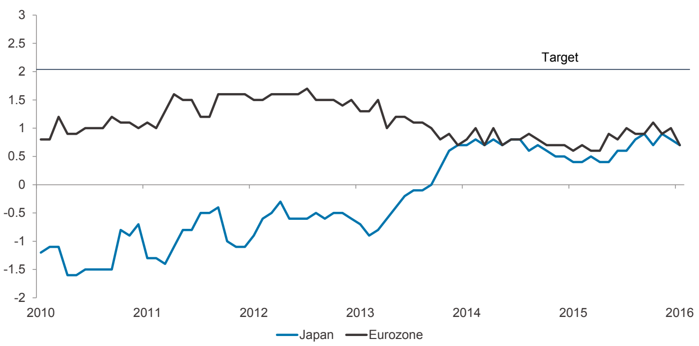
Source: Source: BEA, BLS, Federal Reserve Bank of Cleveland, AMP Capital

- When the US Federal Reserve (the Fed) raised interest rates in December they flagged four further interest rate increases over the course of 2016, but markets are currently pricing none.
- While key inflation measures are now trending sharply higher, market volatility at the start of the year, along with the uncertain impact on the economy of the appreciation in the US dollar, has left the Fed in a difficult position.
- Our expectation of 2.0% GDP growth in 2016 is still ahead of potential, and will see the economy continuing to absorb spare capacity and put continued upward pressure on inflation.
- Until the Fed has greater confidence in that story, they will leave interest rates unchanged, but we expect they will resume interest rate increases in the second half of the year.

3. Is monetary policy at the limits of its efficacy?

Mind the gap: core inflation

Annual % change



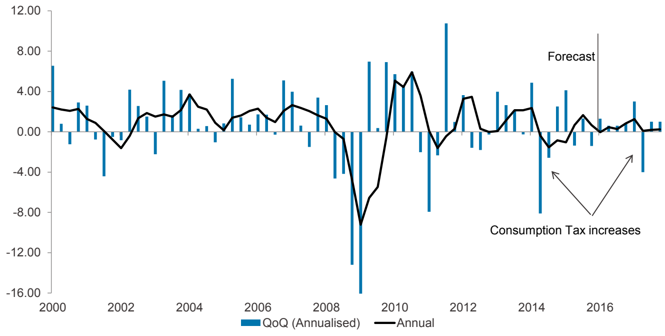
Source: Eurostat, METI, AMP Capital

- Core inflation in both the Eurozone and Japan came in at 0.7% for the year to January, well below mandated levels and heading in the wrong direction.
- In light of persistent inflation undershoots, markets are expecting further easing from both the European Central Bank and the Bank of Japan, among others.
- There are legitimate questions about the efficacy of further monetary policy action, particularly whether there is much more it can do to close persistently large output gaps.
- In persistently missing their inflation targets, central banks are acting for credibility reasons and to keep inflation expectations anchored. The risk is that in continuing to ease central banks may have little impact on the real economy and simply create asset bubbles.

4. What can be done to fix the low growth problem?

Japan GDP growth

Percent change



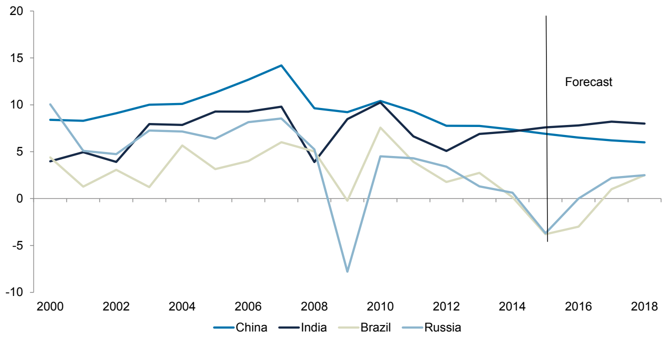
Source: Bloomberg

- We have long warned against too great a reliance on monetary policy alone to solve the problem of deficient demand and uncomfortably low inflation.
- Policy co-ordination is required. The answer lies in an appropriate mix of monetary and fiscal stimulus alongside much needed structural reform. Japanese Prime Minister Shinzo Abe was on the right track with "Abenomics" but progress, especially with respect to the "third arrow" of structural reform, has been woeful.
- The importance of a co-ordinated policy response was repeated at the recent G20 meeting in Shanghai. However, politics is the key constraint on the implementation of such a comprehensive plan for growth for many governments. Structural reform is painful and in many fiscally constrained economies room for pro-growth fiscal expansion can only be created by ending low quality, but in many cases popular, spending.

5. Emerging market Divergence?

Emerging economy GDP growth

Annual average % change



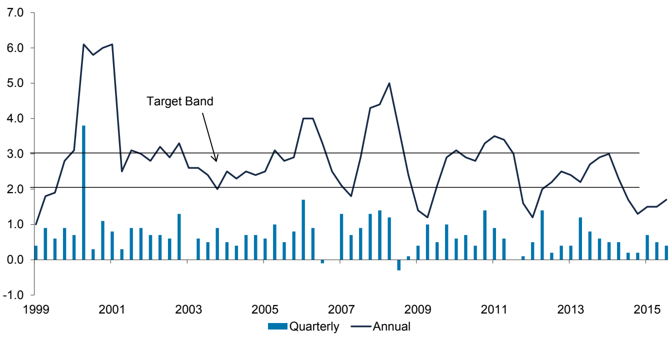
Source: IMF and AMP Capital

- While there are early signs of stabilisation across the emerging economy manufacturing sectors, conditions remain difficult. GDP growth across the key emerging economies looks set to remain highly divergent.
- In general those enjoying the tailwinds of structural reform and lower commodity prices, such as India, Indonesia and Mexico, will perform better than the those who are commodity producers and suffer structural impediments to growth, such as Russia and Brazil.
- China's slowdown is set to continue and we expect further easing in monetary and fiscal policy as the government continues to manage the rebalancing in the economy.
- We expect annual growth of 4.2% across the emerging economies in 2016, slightly higher than the 4.0% recorded in 2015.

6. RBA on hold – for now

Australia CPI

% change



Source: ABS

- The Reserve Bank of Australia (RBA) left interest rates on hold at its March meeting, marking the tenth month in a row the cash rate remained at 2%. In its Statement the RBA made little change, continuing to sound less upbeat on the global economic outlook, acknowledging the volatility in financial markets, continuing to see inflation remaining low, and seeing property price gains in Sydney and Melbourne as having moderated.
- The RBA also indicated it is continuing to wait for more information in order to be able the impact of financial turbulence on the Australian economy and to assess the labour market.
- Our view remains that the RBA will cut interest rates again this year reflecting the risks around the global economy, commodity prices, still subdued growth, a more dovish Fed threatening a higher Australian dollar, and continued low inflation. However, this may not come till May.

MARKET COMMENTARY

GLOBAL SHARES

The first half of February saw volatility remain elevated and global shares continue to tumble as investors' concerns centred on slowing global growth, with particular concern around the health of the European banking sector. Investors became increasingly worried that the current environment will make it harder for banks to service their debt obligations. Investor sentiment shifted mid-month to a more positive tone as Mario Draghi, the European Central Bank (ECB) President, reassured the market that the ECB is watching the financial turmoil on banks closely and "will not hesitate to act". An agreement between Russia and various OPEC oil producers to cap oil production at current levels also helped ease investor concerns. Volatility dropped and share prices recovered over the second half of February, ultimately ending down 1% over the month. The US market finished down slightly over February, with the S&P 500 falling 0.1%. European markets however were weak, ending down 3.1%. Emerging markets finished in positive territory, outperforming their developed market counterparts.

NEW ZEALAND SHARES

The New Zealand share market again showed its resilience in the face of global turmoil, ending up 1.0% over February. The reporting season was the main focus over the month with company results largely coming in-line or slightly ahead of expectations. But it was corporate activity which saw Nuplex and Diligent lead the market forward as both companies announced takeover bids which saw their share prices spike. Nuplex ended the month up 21.4%, while Diligent shares finished 19.4% higher.

NEW ZEALAND LISTED PROPERTY

A -0.1% return from the New Zealand listed property sector saw it outperform the broad global market, but lag the broader domestic equity market. Half the names in the property index ended with a positive return, with thinly traded CDL Investments leading the way forward, rallying 4.9% over the month. During the month CDL Investments released its 2015 full year result which featured a 19% increase in profit after tax. The result was the sixth successive year of profit growth and a record profit for the company.

GLOBAL BONDS

Global bonds rallied over February which saw a continuation from January's flight to safety. Yields tumbled as investors sought the perceived safety of bonds as equity markets around the world sold off. Concerns over the stability of European banks and mixed data out of the US added to the already uncertain economic environment. Meanwhile, credit rating agency Moody's cut Brazil's sovereign credit rating to Ba2, meaning that all major agencies now rate Brazil below investment grade. The Barclays Global Aggregate Index returned 1.12% over February. Yields on the US 10-year Treasury closed the month at 1.73%, down 19 basis points over the month.

NEW ZEALAND BONDS AND CASH

New Zealand bonds also rallied over the month, with long term bond yields following the lead from offshore markets. The Global Dairy Trade auction added to concerns as its price declined twice in February which assisted in pushing short term bond yields lower. The price of whole milk powder is now 33% below its recent October highs. The 90 Day Bank Bill yield ended February 15 basis points lower at 2.56%, while the 10-year NZ Government bond yield ended down 25 basis points at 2.97%.

COMMODITIES

After an initial decline at the start of February the Bloomberg Commodities Index recovered somewhat, eventually ending down 1.7%. Crude oil was the catalyst for the initial fall as Iran raised production following the removal of international sanctions, Iraqi volumes reached a record and Saudi Arabia ramped up output. However, the price of oil recovered slightly mid-month as Saudi Arabia and Russia reached a preliminary agreement to freeze oil output at current levels. Gold was the big winner over February as market uncertainty saw investors sell out of equities and into the precious metal safe haven.

GLOBAL LISTED PROPERTY & INFRASTRUCTURE

Both the Global listed property and global listed infrastructure asset classes held up better than the broader global equity market over February, returning 0.1% and 0.6% respectively. These two interest rate sensitive asset classes received a boost as bond yields declined.

NEW ZEALAND DOLLAR

The New Zealand dollar (NZD) continued its recent trend, stronger one month only to fall the next. The NZD ended 1.2% higher on a trade weighted basis, and 1.6% higher against the US dollar. The NZD ended February 4.0% higher against the British pound, hitting a nine-month high amid concern about a potential British exit from the European Union.

	AS AT 29 FEBRUARY 2016	CHANGE OVER THE MONTH (%)	CHANGE OVER THE YEAR (%)
MSCI - US	7512.50	-0.2	-6.9
MSCI - UK	11621.92	+0.9	-9.2
MSCI - Germany	2972.99	-3.0	-16.2
MSCI - Japan	1623.27	-9.3	-14.7
NZX 50	6230.87	+1.0	+6.0
MSCI - World (local curr.)	4557.42	-1.5	-9.2
MSCI - World (NZD)	9014.87	-2.3	+2.7
NZ Official Cash Rate	2.50	0 bps	-100 bps
NZ 90-day bank bill yield	2.56	-14 bps	-107 bps
NZ 10-year bond yield	2.99	-25 bps	-31 bps
US 10-year bond yield	1.73	-19 bps	-26 bps
NZD-USD	0.659	+1.6	-12.9
NZD (TWI)	72.0	+1.1	-7.9
NZD (MSCI weighted)	73.3	+0.8	-11.6