

July/August 2010

## ECONOMIC COMMENTARY

### Outlook for Investment Markets

The ongoing – if bumpy – recovery in the world economy should prove supportive for global sharemarkets. At home, there are symptoms of a pause in recovery, but New Zealand company profits should benefit from resumed growth over the next year. Interest rates globally remain low, although New Zealand has moved in this area and Australia may soon do so. A key issue will be how governments manage the transition from ultrasupportive fiscal and monetary policies back to more normal settings.

### Australasian Equities

The Kiwi sharemarket has taken its cue from global markets, sharp declines in May and June followed by stabilisation more recently. The NZX50 Index was around 2150 in mid-April, but by the end of June had dipped below 1900, a loss of some 12.0 percent, before recovering to its current 1934. The NZX50 was down 10.10 percent over the quarter.

The Australian sharemarket was much the same. The S&P/ASX200 Accumulation Index was a notch over 5000 in April but slumped to around 4200 by the end of June, a loss of some 16.0 percent, before recovering to around 4458. The index was down 8.70 percent over the past quarter to 23 July, the Industrials down -9.60 percent and the Resources -6.30 percent.

While still growing and expected to keep growing, the New Zealand economy has hit a soft patch. Businesses are reporting a slowdown in exports, employment, investment, activity, and profits. This more hesitant recovery may be attributable to factors such as deteriorating fiscal positions in export destinations, high consumer debt levels, and lower credit availability. These are symptoms of consolidation or a pause in recovery. Forecasters continue to predict growth of about 2.80 percent this year and 3.40 percent next year, though, with associated benefits for company profits. The Australian economy remains extremely healthy by developed world standards. The Federal Treasurer's pre-election Economic Statement predicted the economy to grow by three percent in the year to 30 June 2011 and 3.75 percent in the year to 30 June 2012. Unemployment is expected to be an internationally low 4.75 percent in the June 2012 year, and the budget to be in modest surplus as early as the 2012/13 fiscal year. The labour market has also been much more robust than forecasters had expected, and business and consumer sentiment have both been holding up well. All of this suggests an extremely favourable environment for shares. The key question is the extent to which all this has already been priced in.

### International Equities

World shares have had a bumpy time of it. The MSCI World Index hit a cyclical high of 893 on 15 April, but then dropped back below 800 by mid-May, and a short subsequent rally petered out. World shares have regained some ground in recent weeks, and have just got back over 800 again, but the end result is a fall in world share prices for the quarter of 8.90 percent in foreign currency terms. (This translated into a slightly larger 9.70 percent in \$NZ because of its modest appreciation.) Asia was the most resilient region, down by only 0.80 percent as a whole. Korea turned in a small gain and the declines in Hong Kong, Singapore, and Taiwan were minor. The emerging markets as a whole were also relatively unscathed. Europe did a bit better than the US, the MSCI Europe Index down 6.60 percent compared with the S&P500 Index's 9.40 percent decline. Weakest of all were China and Japan: the Shanghai Composite Index was down 13.80 percent over the three months to 23 July, and Japan's Topix was down 14.0 percent.

Softer than expected US economic data has been the major reason for recent world sharemarket weakness. The University of Michigan's index indicated a sharp fall in consumer confidence in

July. The labour market, while recovering, is creating too few new jobs to make any real dent in the unemployment rate. This kind of cyclical choppiness is however the sort of thing that happens even in periods of recovery, and will not permanently disrupt the recovery of the US or global economies. Growth prospects have been rotating, some regions dropping back but others showing better numbers. Until recently, for example, forecasters had been looking to the US as leading the recovery, the Eurozone lagging behind. In recent months, however, the Eurozone has perked up. Consumer sentiment, industrial orders, and purchasing intentions have all been stronger than expected. Looking at the global picture, the areas that are expanding are making up for the areas that are lagging. London forecaster Consensus Economics estimates that the consensus forecast is for global economic growth of 3.50 percent this year and 3.30 percent next. All the indicators are that the world economy will continue to pull itself forward, although the recovery may be long and painful.

### **New Zealand Property**

The New Zealand listed property sector followed the local and international sharemarkets down in May and June, but regained its footing in July, to record a 6.10 percent capital loss for the quarter. Adding back the income yield reduced the overall loss to 4.10 percent. In corporate activity, there are plans to convert **National Property Trust** NAP into a company and replace its existing manager, while there will be a new listing in August, DNZ planning to raise NZ\$35.0 – NZ\$45.0 million in an initial public offering, the bulk of which will be used to retire the investment contract of the current manager.

Previous weakness was attributable in part to investor hesitance in the face of forthcoming tax changes expected to reduce the attractiveness of property investment. In the event the sector continues to attract little investor attention. This may be partly because some of the tax details remain to be worked out, in particular to what extent depreciation will not be available as an expense against tax. For whatever reason, the sector is not attracting much investor interest at the moment, and there does not seem to be any major catalyst on the horizon to prompt change.

### **Cash and Fixed Interest**

New Zealand – New Zealand 90-day bank bill yields rose sharply over the past quarter, up 0.60 percent to just under 3.30 percent. This reflected the first of the Reserve Bank of New Zealand's interest rate increases (0.25 percent on 10 June) and the prospect of more to come. Ten-year government bond yields have followed the global trend, and fallen 0.60 percent to 5.40 percent. Swap rates fell by similar amounts. The New Zealand dollar has ranged from as high as 73 US cents in April to as low as 66 cents in June before rising again more recently. The \$NZ was up 1.90 percent over the three months to 23 July, and also up 2.20 percent in overall trade-weighted value.

The Reserve Bank said in its 10 June Monetary Policy Statement that it had decided "to begin removing some of the monetary policy stimulus that is currently in place", and that "The further removal of stimulus will be reviewed in light of economic and financial market developments". The financial markets have taken this to mean further increases in interest rates in coming months. The Bank opted for a further 0.25 percent increase on 29 July, commenting that "while the outlook for economic growth has softened somewhat, it is still appropriate to continue to reduce the extraordinary level of support implemented during the 2008/09 recession, and reiterating its view that monetary policy "is still very supportive of economic activity". The returns from cash will be improving over the next year, but in the meantime they are still well adrift of what is available from government debt, and from corporate bonds, where yields on longer dated good-quality (AA- or A-rated) names are in the six to 6.50 percent range.

The New Zealand dollar does not appear obviously over- or undervalued trading in the high 60s/low 70s against the \$US. The \$NZ may appreciate given favourable commodity prices and higher expected interest rates.

International – Sharp falls in government bond yields was the key recent development in global bond markets. The yield on 10-year US Treasuries was just shy of four percent in early April, but dropped to below three percent in late June and reached a low of 2.88 percent on 21 July. Other government bond yields also fell – even the already very low Japanese 10-year bond yield

dropped a bit further from 1.30 to 1.05 percent. All this translated into a rise in bond prices of 2.30 percent on the JP Morgan Global Government Bond Index. US investment grade corporate bond prices rose almost two percent over the past quarter, but low-grade corporate bonds dropped in value in both the US (1.30 percent) and Europe (1.20 percent).

Short-term interest rates will not be going up meaningfully in Europe or the US any time soon. Monetary authorities remain very watchful of developments in the world economy, and continue to peg monetary policy settings at "extremely supportive". These low official rates will to some degree anchor longer-term interest rates at historically low levels. If the world economy does muddle through and economies recover, there is an increased risk of capital loss on bonds on such low yields. But global bonds do also continue to provide a degree of portfolio insurance in the event of a sudden deterioration in world sharemarkets as a result of setbacks to the global economy.

*Performance periods refer to the month and three months to 23 July 2010.*

*The content within this commentary has been extracted from Morningstar Research Pty Ltd July/August Economic Update*