Economic Commentary

Prepared by Morningstar Research as at 21 May 2013

Outlook for Investment Markets

It has been another good month for equities, globally and domestically, as investors have become more confident about the prospects for the world economy and less concerned about Eurozone debt crises. Conversely, 'safe haven' assets like government bonds and gold have sold off. At home, local equities also gained, as the economy is clearly picking up some momentum. Absent any more Cyprus-style shocks, this pattern should continue into coming months, although more focus will come to bear on the valuation of growth assets, which have arguably moved to the expensive side.

New Zealand Cash & Fixed Interest

Short term rates have once again shown little change, with the 90 day bank bill yield steady at 2.65%, again reflecting the unchanged stance of monetary policy (most recently at the April 24 Official Cash Rate review). Longer term interest rates have also shown little net change over the month. At first it looked as if local 10 year government stock yields would climb, in line with rising overseas bond yields – the local yield, 3.32% a month ago, rose to just shy of 3.50% (May 15) – but in recent days the yield has dropped back again, to 3.35%. The recent drop may reflect the news in the May 16 Budget that new issuance of government bonds will be less than the markets had earlier expected.

After rising to ever higher levels in March and April, the Kiwi dollar finally cracked in May. Over the past month it has dropped from 85 US cents to 81.7 cents, and has dropped 1.5% in overall trade-weighted value. Against the Aussie dollar, however, it has actually gained (from 81.9 Aussie cents to 83.2), as the Aussie dollar has fallen even faster against the US$ than the Kiwi has.

Short term interest rates are headed up: the only question is when. Most forecasters, to date, have been picking the March or June quarter of next year as the time we are most likely to see the first Official Cash Rate (OCR) hike from the Reserve Bank, and the futures market agrees. It also sees little change in 90 day bank bills this year, and then bills moving higher by June by around 0.25%. It is possible that an increase in the OCR could happen before then, however: ideally the Reserve Bank would probably prefer an earlier increase to help deal with frothy housing prices, but has been unable to risk one for fear of sending the Kiwi dollar even higher again. With the Kiwi dollar softening recently, it is possible the Bank now sees scope for an earlier rate hike than markets and the forecasters are currently counting on.

Bond yields are also expected to rise. Although there is still considerable uncertainty amongst forecasters about when, and how fast, overseas bond yields will start moving back to more normal levels, taking local bond yields up with them, most forecasters are expecting sustained rises in local yields. Both the ANZ and the ASB, for example, have the 10 year government stock yield at 4.2% by the end of next year. The Treasury, in its Budget forecasts, is planning on a somewhat larger increase: it expects the yield to be 4.2% by March '14 and to rise to 4.6% by March '15.

Everyone recognises that the Kiwi dollar has been unusually and unsustainably strong: as the Reserve Bank said at its latest OCR review, "The New Zealand dollar remains overvalued and is higher than projected in March", partly because yen weakness had taken the Kiwi into even more rarefied territory, and the Bank has been intervening on the forex markets to help push it back down. That said, few forecasters are picking any big fall in the Kiwi anytime soon: the economy is strengthening, and the Reserve Bank is one of the few developed economy central banks likely to raise interest rates sooner rather than later, and both these factors tend to support the Kiwi. The government's best guess, in the Budget forecasts, was that the big drop in the Kiwi was 2-3 years away: Treasury expected the Kiwi to still be up at the 81 US cents level in March '15, and then to drop over the next couple of years to 72 cents. It's possible that the past few weeks' weakness of the Kiwi has brought this anticipated depreciation forward, and a move back to more exporter-friendly levels is already underway, but the jury is still out.

IMS
INVESTMENT | MANAGEMENT | SOLUTIONS

New Zealand Property

The NZX Property index made a modest 0.4% gain over the past month, continuing the pattern of slow but steady growth all year: the index is up 10.6% year to date.

The latest round of results from the listed property companies (with the exception of Kiwi Income Property, which had a 15% decline in earnings and is reducing its planned 2014 dividend) have generally shown the benefit of a gradually improving economy and low interest rates, with one common theme being modest revaluation gains on their property portfolios.

The cyclical pickup in business activity that is currently underway provides a good backdrop for the sector, particularly in Auckland: recent research from Colliers International has found falling vacancy rates for prime CBD offices and (particularly) for industrial space, where the Auckland vacancy rate is already at a five-year low of 4%, and Colliers is picking increases in rentals of around 3% over the next 12 months for Auckland industrial, prime office and retail property. The pre-tax dividend yield from the sector, at around the 8% mark, also continues to be attractive. The only question mark is whether property shares have moved to the expensive side, given that they are trading at a historically high premium to Net Tangible Asset backing.

Australian & International Property

The S&P/ASX200 A-REITs index shows a capital gain of 3.4% for the past month, and on an accumulation basis (adding in the pre-tax value of the dividend stream) a slightly larger total return of 3.5%.

International property also had a good month, with the EPRA/NAREIT Global index up 3.4% in US$, and Morningstar's preferred benchmark for the sector, the Global ex Australia index hedged back into A$, was up by 5.3%. As tends to be the way with the property markets, there was pronounced variation from one region to the next.

This month, Europe led the way, with the UK market up 12.6% (in sterling) and Europe ex the UK up 12.2% (in euros). There were some strong rises in the main Eurozone markets, with Italy up 19.9%, France 16.8%, and Germany up 11.2%, presumably on reduced worries about debt crises in the Eurozone – the macroeconomic outlook certainly provided no support for Eurozone property, with GDP falling in the March quarter and only scant growth expected this year and next. The US market was up 6.7% (in US$), while Asia was weaker, down -3.3% (in US$), mainly because of lower property share prices in Japan (-4.4%, in yen): Japanese property shares had previously rocketed on the prospect of an infrastructural spend-up, and were due for some sort of correction.

The Australian economy is currently in a sub-par period of economic growth, and property owners are feeling the impact. Jones Lang LaSalle's March survey of retail property, for example, showed that rents in the March quarter were actually -0.5% lower than a year earlier, with shopping centre landlords having to recognise the reasonably tough trading conditions of their retail tenants. Jones Lang LaSalle's latest survey of the office markets showed the same picture, with March '13 rentals down on a year ago in Sydney (-2.5%), Melbourne (-4.2%), Adelaide (-0.5%) and Perth (-1.6%), while Brisbane rents were unchanged, and the firm expected that in the short-term rents would fall further: "most Australian cities (including Sydney and Melbourne) should see moderate declines".

The sector has delivered for investors year to date – the total return from the sector is 17% – and there is still some attraction from the dividend yield (now a little under 5% at today's higher share prices), particularly as bank deposit rates move down in the wake of the RBA's latest interest rate cut (and possible future ones still in the pipeline). But the current domestic economy is not one where further substantial capital gains look especially likely.

Globally, as the latest (March) survey from the Royal Institution of Chartered Surveyors shows, the outlook is mixed. As the RICS noted, "the uneven economic picture is holding back the occupier market in some parts of the world", notably in the Eurozone and in central and eastern Europe, where, as the survey found, rental expectations are positive in only two countries (Germany, the Czech Republic), and negative everywhere else. The poor prospects for rental growth and capital appreciation were not confined to the peripheral Eurozone economies, with France and Italy showing markedly negative sentiment about the property outlook. Elsewhere, the news is better. The US property market is in good shape, reflecting the ongoing American economic recovery; prospects for

Japanese property have improved dramatically over the past quarter in terms of both expected rents and expected capital appreciation, as a result of the government's massive economic stimulus; and there are a range of other property markets (notably China's) also doing well.

Overall, the outlook for global property is reasonable (though with marked regional variation) and would normally support some modest performance from property equities. From a valuation basis, however, the sector looks pricey. It had been strongly bid up in any event by investors chasing dividend income, and more recently has been inflated by equity gains in Europe that make little fundamental sense, and by the arguably overexuberant rises in Japanese property shares. For now, global property looks unattractively expensive.

Australasian Equities

New Zealand shares scored a relatively modest 2.7% gain over the past month, although that needs to be put in the context of the local market progressing steadily earlier in the year when world markets were in flux. The highlight of the period was the successful $1.7 billion float of 49% of Mighty River Power, which attracted a wide shareholder base. Although it initially went to a modest premium over the IPO price, it is currently back to just above the $2.50 float price. The government indicated in the Budget that the next entity to be listed will be another energy generator, Meridian, although this will be somewhat more difficult for the market to digest: 49% of Meridian would be in the neighbourhood of $3.0-3.5 billion.

After a weak March, and a flat period in the first half of April, Australian shares have done better in later April and May, and although they have not quite matched the strong rises of overseas markets, the S&P/ASX200 index has banked a respectable 3.5% gain in A$ terms for the past month. New Zealand based investors have benefitted rather less, however, due to the 1.9% appreciation of the Kiwi dollar against the Aussie.

Most sectors, other than consumer staples (-0.4%), shared in the gains, with the IT sector up 7.6%, consumer discretionary up 4.3% and the financials up 3.7%. The resources sector was also up, by 3.1% (going by the S&P/ASX300 Metals and Mining index), but has yet to make up the ground lost earlier in the year when there had been greater concerns about the outlook for global economic activity (and Chinese growth in particular). At current levels the mining shares are still 14.9% below their opening level at the start of this year.

The latest New Zealand indicators all point in the same direction – a strengthening economy, with the impact of the Canterbury rebuild increasingly evident, and a generally good environment for corporate profits.

Data for the March quarter showed that employment grew by 12,000, unemployment fell sharply (from 6.8% to 6.2%), hours worked rose by a substantial 3.2%, and 'real' retail sales (the volume of things bought) grew by 0.5% in the quarter and by 3.5% over the past year. The retail sales numbers reflect the fact that households are clearly feeling more comfortable: the latest (May) ANZ Roy Morgan index of consumer confidence showed households the happiest in three years. Combining strong consumer confidence with the positive readings from their business survey, the ANZ now reckons the economy will be growing at a 3.5% pace by the middle of this year (up from the 2.7% they expected two months ago). Other surveys, such as the latest (April) BNZ/Business NZ Performance of Manufacturing Index, show the same picture, with new orders (a good forward-looking indictor of activity down the track) particularly strong.

Businesses, unsurprisingly, are expecting good levels of future profits (as shown in the ANZ's survey, for example), and Treasury's forecasts, included in the latest Budget material, are that business profits will rise by a strong 13.9% in the year to next March, after a distinctly modest 1.5% gain in the March year just finished.

It is not surprising in these circumstances to see local equities making steady gains: the share market has clearly priced in this positive outlook for corporate profits. The only question, as it is for many share markets after their recent advances, is whether share valuations are moving to the expensive side. While Treasury's estimates show that we are currently in a 'sweet spot' for business profits, expected profit growth slows down in the years to March '15 (+2.5%) and March '16 (+4.2%). Shares may need something else – perhaps a lower exchange rate – to help them make significant gains beyond current levels.

In Australia, the big issue for the equity market remains the transition from the slowing resources boom to faster growth in the rest of the economy, and whether the equity market is being realistic about the transition.

Recent data – and implicitly the Reserve Bank's recent interest rate cut – suggest that the transition is still proving difficult. The Reserve Bank put it fairly mildly – "Growth in Australia was close to trend in 2012 overall, but was a bit below trend in the second half of the year, and this appears to have continued into 2013" – whereas going from the most recent business and consumer surveys, business conditions are actually quite weak by historical standards. The latest (April) Australia Industry Group indices of performance in manufacturing, services, and construction, for example, show that all three sectors were actually going backwards in terms of economic activity, and were in worse shape than in March, and NAB's April business survey was described by the bank as showing "very difficult" operating conditions, with "no sign of upward momentum". Consumer confidence (on the latest Westpac Melbourne Institute reading) has also weakened.

Clearly it is hard sledding for corporate profits at the moment: NAB's survey measure of profitability is weak, and Treasury's comment in the Budget was that "subdued profits in the non-resources sectors reflects competitive pressures from the sustained high Australian dollar, with firms absorbing costs by squeezing profit margins at the same time as they
pass on lower import prices to consumers".

It may be that the recent fall in the A$ (if maintained) will ease some of the current pressures on profits, and it is also worth noting that, despite the current soft patch, Australia's forecast GDP growth in 2013 (+2.7%) and 2014 (+3.0%, both going by the Economist's poll of international forecasters) is quite good by international standards. Even so, the current strength of Australian equities seems to be somewhat at odds with immediate prospects for local corporate profits.

International Fixed Interest

The past month has been one where equities have been strongly in favour globally. Whether this reflects greater confidence about the global economic outlook, or whether investors have had enough of extremely low yields from bonds, either way it has not spelt good news for international fixed interest: yields have, broadly, risen, particularly in May, and prices have fallen.

In the US, the benchmark 10 year Treasury yield is up 0.25% to 1.95%, in Japan its equivalent is up 0.20% to 0.80% (somewhat surprisingly, given the massive monetary expansion intended to keep rates down), and in the UK the 10 year gilt is up 0.15% to 1.90%. German, French and Swiss government bond yields were effectively unchanged.

There was better news for bondholders in the weaker Eurozone countries. There were sharp falls in 10 year government bond yields in Greece (down 3.20% to 8.20%) and Portugal (down 0.90% to 5.30%), and more modest declines in Ireland, Italy and Spain. Investors in fixed interest also benefitted from the capital gains generated by lower corporate credit spreads. Markit's iTRAXX Europe index, for example, which tracks the annual cost of insuring a wide portfolio of European bonds against default, dropped a little further over the month to 95 basis points, compared to 100 basis points a month ago, and 120 basis points three months ago.

The rise in government bond yields in the major economies in May has been the major influence on the outcome for the asset class. On the Barclays Capital data, month to date global Treasuries are down -3.5%, and year to date -5.4%, and this has taken the broader fixed interest market into the red with it, with the Global Aggregate down -2.7% for the month and -3.4% year to date. Global corporate bonds have fared a bit better (-1.7% for the month, -0.5% for the year) thanks to lower credit spreads, while the more speculative 'high yield' end of the asset class is still in the black, with global high yield only slightly down in May and still 3.9% up this year.

Short-term interest rates are likely to remain at zero or near zero levels in much of the developed world at least until well into 2014, and possibly beyond. Indeed, the latest development has been that the European Central Bank has cut its already low main lending rate from 0.75% to an even lower 0.5%, and reaffirmed that it stands ready to provide unlimited liquidity support for Europe's banks at least until the middle of next year. Forecasters are expecting no move away from extremely low short term rates until late 2014, at the earliest, and even then are expecting various cautious moves by the main central banks back to more normal conditions. The Wall Street Journal''s panel of forecasters, for example, is expecting the Fed funds rate to be only 0.36% by the end of next year, and to rise only modestly, to 1.30%, by the end of 2015, and most other central banks are likely to be equally slow to take interest rates higher.

The outlook for longer term rates is more unclear. Most of the major central banks are following policies of "quantitative easing" (QE), meaning purchases of government bonds (and of other securities), bidding up their price and lowering their yields. Some economies are even thinking of stepping up the pace of their bond buying: there has been considerable speculation that the Bank of England, for example, might buy even more bonds than the £375 billion it currently plans. This is part of their effort to keep the whole spectrum of interest rates lower than otherwise, to support faster economic activity and to provide liquidity to banks and the financial markets.

As long as these QE programmes are fully operative, bond yields will stay generally low. The big question is whether the past month's rise in US bond yields could be an early recognition that America's QE programme is getting towards its endgame.

The WSJ forecasters currently expect the Fed to start tapering back its current US$85 billion a month QE programme in the second half of this year or, at the latest, the first quarter of next year, and to have wound it up completely by sometime in 2014, and they expect the 10 year Treasury yield to rise modestly as a result, to 2.2% by the end of this year and to 2.9% by the end of 2014.

They are likely right, but on the other hand we have seen one of these rises in US bond yields not so long ago, and it proved premature. The 10 year yield rose from around 1.60% last December to over 2.0% this March, but then dropped all the way back to 1.60% again by early May.

Whether it's happening now, or will actually hold off until sometime in 2014, is, in short, still up in the air. Either way, though, bond yields are hugely below where you would expect them to be – partly because of QE, partly because of investors' earlier fears about the economic and financial outlook (which led them to buy 'safe have' assets like bonds), and partly because zero returns from cash have sent investors into every nook and cranny of the fixed interest world in search of the last remaining scrappets of yield. The return on global corporate bonds, for example, is currently only 2.50%. The timing of a move upwards (and the associated capital losses) may still be uncertain, but investors need to be aware that it is certainly lurking down the track.

International Equities

International equities had a strong month. After vacillating earlier – world shares went up in early March, traded sideways in later March, and were choppy in the first half of April with a lot of volatility – it's been plain sailing since, with substantial gains. The MSCI World index is up 7.7% in overseas currency terms for the past month. And after a long period where overseas gains were not passing through into local investors' hands because of the strong local dollar, that too turned in investors' favour, with the overseas gain being added to by a 1.50% decline in the overall value of the Kiwi dollar.

The gains have been widespread. In the US, the S&P500 has been climbing from one all-time high to the next, and is up 7.40% for the month. Japan's share market continues to benefit from the expansionary policies of the Abe government, and is up by 13.10%. And even in Europe, where the economic data have been quite poor, equities have risen substantially in Germany (+11.90%), France (+11.10%) and the UK (+7.70%). Across Europe as a whole shares are up 8.70% (going by the FTSEurofirst 300 index).

Emerging markets also contributed, though not quite as strongly, with a 5.20% rise in the MSCI Emerging Markets index, with the gains spread across Asia (+5.70%), Eastern Europe (+5.10%) and Latin America (+2.50%). It helped that the Chinese market turned around: after falling steadily from mid-February to early May on concerns about slower economic growth, Chinese shares finally picked up again, with the Shanghai Composite up 4.10%.

The recent surge in global equity prices has a number of components behind it. One is investors turning away in increasing numbers from unacceptably low returns in the cash and fixed interest markets. While real, this can be somewhat problematic, as equity markets inflated by the weight of money, rather than by genuine improvements in underlying corporate profits, are apt to deflate just as easily.

But improved expectations about global business activity also seem to be playing an important role.

The improved mood can be seen in a variety of ways. The VIX index, which measures the volatility investors expect to encounter in the US share market, is down to ‘no worries' levels (12.45 currently, down from an already relaxed level of 16.5 a month ago). And the gold price, which had shot up during the worst of the Eurozone's debt issues and which is a reasonable indicator of investors' insecurities, has continued to fall. It started the year around the US$1,700/oz level, gradually drifted down to around the US$1,550 mark a month ago, and has fallen sharply over the past month to its current US$1,365.

This growing optimism has been based on a variety of factors – ongoing recovery in the US, reflation in Japan, reduced concerns over China's prospects, a prolonged period of monetary support from the major central banks (as noted earlier), and some progress in dealing with the Eurozone's most indebted economies.

In the US, the news has been reasonably good, in particular the April jobs report, which beat forecasters' predictions with 165,000 new jobs in the month, a drop in the unemployment rate (from 7.60% to 7.50%), and revisions to the previous numbers for February and March, which showed that there were 114,000 more jobs created in those two months than originally thought. The overall economy continues to grow at a decent rate, with 2.50% annualised growth in the March quarter. And while no-one should underestimate the American politicians' capacity to create problems for the US economy with their fiscal bickering - the latest nuisance being automatic “sequester” cutbacks to government spending - forecasters nonetheless expect ongoing economic growth. The Wall Street Journal''s panel of US forecasters is currently picking a gradual pickup in growth, from 2.40% this year, to 2.80% in 2014 and 3.0% in 2015.

In Japan, the economy appears to be responding to the very vigorous expansionary policies of the new government – what has come to be called ‘Abenomics' – with a faster than expected 0.90% increase in GDP during the March quarter. Within that total, consumer spending was also up 0.90%, which was an especially positive development, since families leaving their wallets and handbags shut have been one of the main reasons for Japan's sluggish performance till now. And there is likely to be further good news as the year develops: although net exports made a small contribution to Japan's growth figures, the sharp depreciation of the yen is too recent to have made much of a difference to Japan's exporters, but they will progressively perform better as the year goes on. In China, the risk of a sharp slowdown looks low. Officials had been concerned about inflation in general and house price inflation in particular, but the latest data showed little cause for alarm. The latest annual inflation rate was 2.40% in April – not a figure to be worried about, and even though it was slightly higher than March's 2.10%, the increase reflected volatile food prices rather than any generalised rise in inflation pressures. China looks well set to continue to grow at close to an 8.0% rate this year.

The major blot on the economic landscape remains the Eurozone. Although the risks of a break-up of the Euro or a disorderly bankruptcy of one of the more indebted Eurozone countries are now low, and have been recognised in the much lower interest rates that the ‘PIIGS' are now paying on their debt, the economic performance of the Eurozone is still very poor. Output contracted in the Eurozone as a whole by -0.20% in the March quarter (a little worse than the -0.10% expected), while the largest and strongest of the Eurozone economies, Germany, only managed a marginal 0.10% increase in output (0.3% expected). And the outlook remains distinctly precarious: the European Commission's forecast is for +0.40% growth this year, and for only +1.20% next year. These low numbers are vulnerable to any shocks that might come out of left field.

Europe aside, however, the world economy as a whole is clearly showing concrete signs of continuing to mend from the GFC. As investors have become more confident about this outlook, equity markets have been a major beneficiary. The major issue is whether equity markets have run too far, too fast.. The p/e ratio for the S&P500, for example, keeps creeping up, from 12.7 times earnings at the start of this year to 14.5 times earnings now – not yet the very pricey valuation one sees at the peak of a stock market rally, but becoming less of a bargain day by day. The same sorts of questions could be asked about the outsize jump in Japanese share prices – certainly partly explicable by a dramatic change in domestic economic policy, but also arguably overdone. Japanese shares are up by nearly 75.0% since they started on their current run, in November last year. The same is particularly true of European shares. Some ebullience in Japanese equities might be expected, given the prospects for faster growth, but little explains some of the European markets. France, for example, is in recession, has shown little sign of addressing its structural issues, and yet the French share market says French companies are worth 16.3% more than six months ago.

Overall, the outlook for global business activity have been improving, and higher share prices have reflected the turn for the better. There may well be further gains ahead, but current valuations will need to be justified by companies actually delivering the results investors expect.

Morningstar's views and research do not necessarily reflect the views of Selwyn Parker, IMS, or PIA however, they do form part of our holistic external and internal research process.

To discuss how this economic update may impact on your current and future investment strategy please contact **Selwyn Parker** of **Investment Management Solutions Ltd (IMS) below.**

Ph: 07 576 7286, or 027 658 3263
Email: selwyn@imsnz.co.nz
Fax: 07 576 7236
www.imsnz.co.nz

A copy of the IMS disclosure document is available from our web site or free of charge on request.

"**Helping** our **clients** make **smart** choices with their **money**"