

Government Policy Warning

New Zealand Equities Commentary

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Bad policy alert in Australia, and a transition ahead

- In April strong confidence data in the US and related earnings upgrades initially overshadowed the destabilising fiscal and creditworthiness issues in Europe. The sideshow of disrupted European travel characterised the dysfunctional policy vacuum that rocked Europe (and has eventually brought about a US - TARP like package for Europe), whilst the UK Election provided further confusion for investors. Toward the end of April further policy tightening measures in China combined with the looming Greek tragedy combined to pull on the reins on the equity rally. The NZ equity market rose by 0.6% with smaller companies leading the market higher.
- Closer to home these global influences were overshadowed by the expectation, and then the delivery, of the Australian Government's response to the Henry tax review. The Australian the tax landscape is set to be reshaped in a more socialist manner. Markets in our opinion will not like the proposals (and that is all they are) and for a time will place a higher risk premium on Australian equities, especially bank and resource stocks. This may be a buying opportunity, but as yet we have no conviction to reverse our negative bank and resource calls established in April.
- In contrast, we hope May produces a constructive New Zealand budget that will continue a rebalancing of the economy. We also expect further evidence of a stronger New Zealand economy. In our opinion many investment opportunities in New Zealand look promising relative to those in Australia.
- We also continue to consider the risk of a global bond market sell-off as a catalyst for the return of a bear equity market.
- The portfolio has been reshaped in April. We have sold our banks and nearly all our resource positions. These funds have been applied to the healthcare sector, stocks with US exposure and more generally to New Zealand equities where we see lower risk and an improving economy. We continue to significantly hedge back into New Zealand dollars from Australian dollars.



Strategy

Despite the major threat of contagion from peripheral Europe, through bond markets and then equity risk premiums, we continue to recommend that investors overweight both global and New Zealand equities especially relative to bonds.

Equities will benefit in our opinion from:

- Ongoing improving data, especially in the US, but also Japan, the UK and New Zealand. Economic data may deteriorate in Australia and China.
- Further upgrades to earnings from companies with either a US, or New Zealand cyclical bias since they are more than likely to have a positive six months ahead for earnings revisions
- Valuations not being stretched. Bank Credit Analyst and Morgan Stanley in recent publications show that forward looking earnings multiples in the US are on about long term averages.
- Investors still sitting on the sidelines. Cash positions remain high and retail participation is limited. Whether retail investors now have confidence to invest is another thing, but the alternatives to equities are not that attractive.
- Companies appearing well cashed up too. There is likely to be further M&A activity, buybacks, higher dividends and/or increased investment. Most companies used 2009 to reduce debt, balance sheets look generally strong, and cash flows are well up in the first three months of 2010.

On the risk front, more familiar concerns are mounting:

- Monetary and fiscal policies are tightening; a very strong US jobs report serves to remind policy makers that a zero Fed Funds rate is not an equilibrium position. Australia, China and India are well into rate tightening cycles. However, it is hard to see the ECB lifting policy rates anytime this year and perhaps some monetization through quantitative easing may yet be on the European agenda.
- Investors are potentially crowded into cyclical and resource sectors.
There is clearly a short term funding issue in Europe. A combined EUR\$300bn in debt roll-overs for Spain, Portugal and Italy before the end of July may place further strain on European governments and banks. The great private to public debt swap in Europe is now coming home to roost.

Closer to home the two biggest influences on Australasian equity investment strategy are; first the further evidence of a stronger New Zealand economy with a "good" mix of growth and second the major shift in taxation and fiscal policy in Australia. We dwell on the policy shift in Australia first.

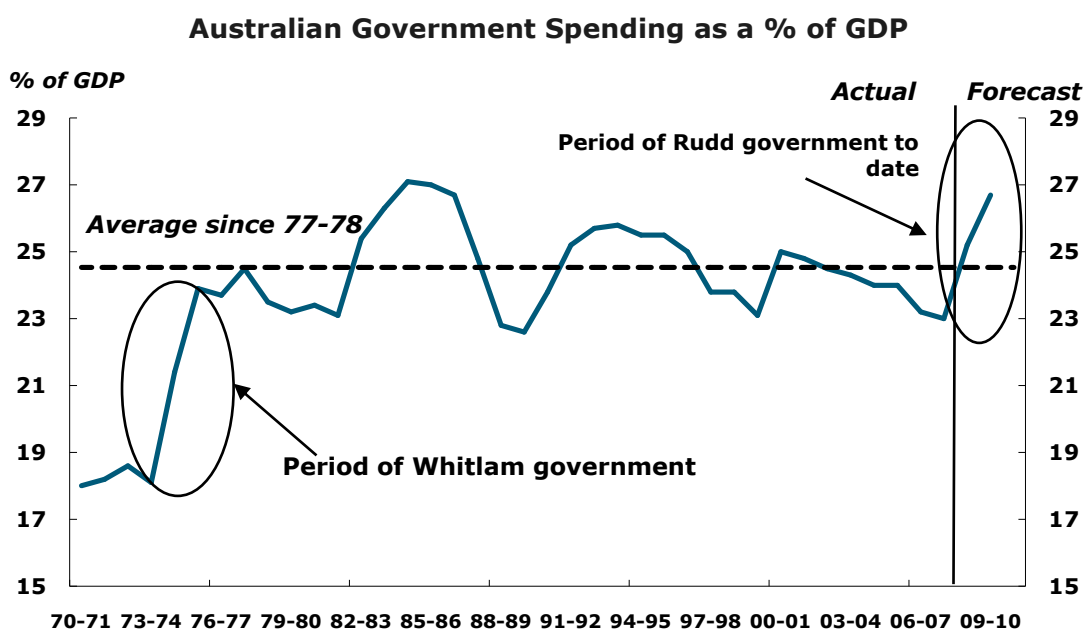
What are you waiting for "Robin" Rudd? Banks are next?

Perhaps we are overly influenced by listening for three days to Chief Executives of Resource companies at the major annual investment conference in Sydney. Or was it the talk around



the coffee machines as one global investment analyst after another shook their heads in dismay. We are not talking about the Greek fallout, or the “trading error” that wiped \$1 trillion in seconds, we are talking about the ill conceived super profits tax.

It is ironic that a developed country with the strongest fiscal position and economic outlook (Norway aside) has stepped into a very market unfriendly policy world. Global investors are overweight Australian banks and resource companies. The proposed implementation of the Henry tax review in the opinion of several analysts may turn Australia from a 2 speed economy to a low speed economy. The significant socialist lurch in fiscal policy to forcing Australians to over save for their retirement and discouraging global investment in the one sector which drives domestic growth seems destined to lift the risk premium on Australian investments. In the days following the announcement it was clear that global investors became concerned. The Rudd Government in two years has lifted spending from 23% of GDP to 27% of GDP (some \$42bn of spending). They now intend to fund this structural increase by taxing the one sector of the economy that has delivered 19 years of unbroken economic growth.



Source: Macquarie Bank

This is at the point when global companies are about to consider major capital projects in Australia. How will BHP shareholders now react when according to Southern Cross Equities, BHP’s effective tax rate has moved up from 43% to 57% on Australian investments, compared to an effective US tax rate of 40%, and Brazilian and African tax rates that are much lower again? BHP is 40% owned by foreigners, RIO is 70% owned by global investors.

Rio Tinto have announced placing on hold parts of the Pilbara Iron Ore project, whilst at the same time going ahead with a major Canadian iron ore project. The estimated Net Present Value impact for Australian resource companies varies significantly depending on the proportion of revenue from overseas. For most companies, broking analysts have estimated a 15-25% reduction in discounted cash flows. In contrast a handful of Australian listed resource



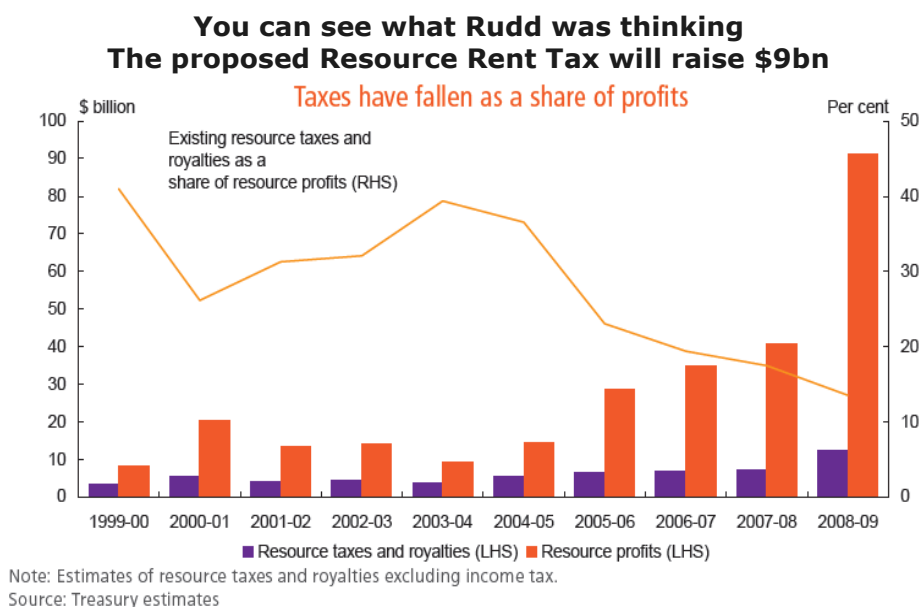
companies have most or all their assets overseas, for example Oil Search and the ironically named Pan-Australian Resources.

Putting aside whether the policy shift is good or bad, as investors we need to decide what is in the price? Surely if China continues to grow at 8-10%, and if the large resource companies have strong balance sheets, then the sector will experience strong growth and further M&A activity?

The unfortunate thing for investors is that appropriately China is working to slow parts of its economy. The Chinese property sector in particular has seen a rapid retrenchment in project funding. Our belief is that China still has excellent medium and longer term prospects. As a global investment theme the urbanization of China (and other strong balance sheet emerging economies) is the right investment strategy.

BUT, the latest soundings are less sanguine. The Chinese PMI has pulled back, spot iron ore prices have slipped and even oil has weakened significantly. As we see it the resources trade is crowded. Nearly all the strategists we follow have until very recently had resources as an overweight sector. A very recent Deutschebank strategists trip to the US and Europe (over 50 investors) had a prevailing theme of overweight Australian resource stocks. In April we sold most of our resource exposure with Oil Search and Pan-Australian Resources our only positions of significance.

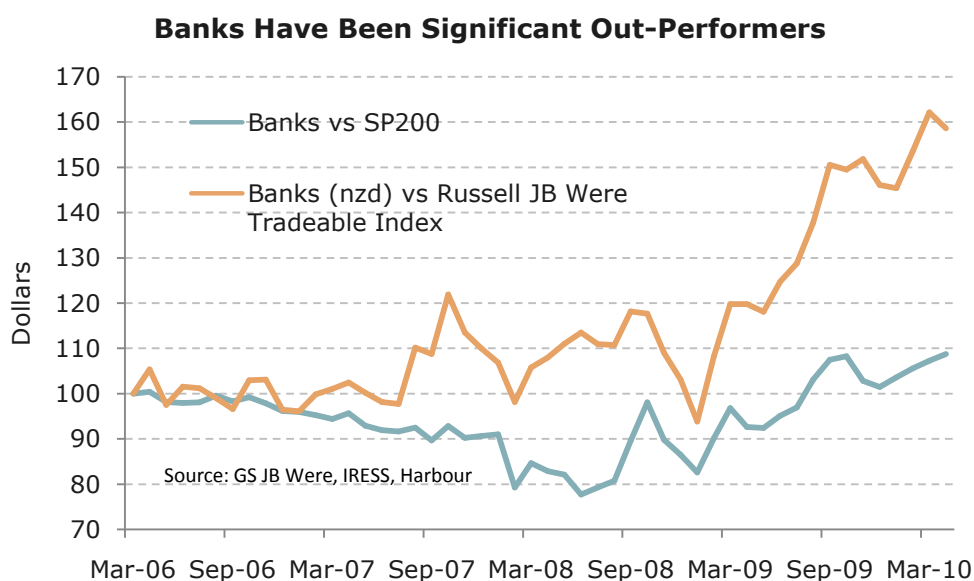
As a result we ask ourselves is this a good buying opportunity. World growth is good and getting better? We think that for a time there may be better ways to find companies with positive earnings momentum. Companies like NewsCorp, Amcor and Ansell probably provide better exposure to the US economy than the resources trade. This risk to our standoff strategy is that global liquidity and economic growth really take off and commodity prices drift (or even charge) higher, much like the 1970s.



A few canny analysts are pointing out that the Australian bank sector is next in line for regulatory tinkering. The Rudd Government has been clear from day one, Telstra was fair game and the utility sector continues to have a strong regulatory oversight. The ACCCs decision on the NAB-AXA takeover seemed to have significant political overtones. Southern Cross Equities expect the Rudd Government to follow many of the G20 recommendations. This means that tougher bank regulation is coming and, as several commentators have pointed out, what would be the biggest vote winner in Australia (as the polls tighten) – taxing banks!

As banks have continued to out-perform, (up until the end of April 2010, and despite a major resource rally, the major four banks have out-performed the broad market by 1.2% annualised over the past 5 years and a whopping 22% in the past year) investors have continued to lift their weights. In contrast in April we sold our bank positions. Our rationale does not so much rely on further poor policy, instead we think:

- that credit growth in the coming cycle will be more limited,
- that funding costs are rising, that banks have now fully disclosed the improvement in the bad debt cycle and analysts forecasts have factored this in,
- and finally banks globally are in the firing line again – exposure to Greece, regulation, and in the extreme further criminal charges which again may serve to increase the cost of business.



The Rudd response to the Henry review gave an estimated further \$18bn of net inflows into the superannuation industry at a time when the market had seemed more concerned with other regulatory reviews (e.g. Cooper/Ripoll). Potentially, sentiment will turn more positive for the wealth managers, at least on a relative basis. Most analysts have upgraded their earnings forecasts and valuations for stocks like AMP. Despite the probability of a capital raising to buy AXA we remain overweight AMP.



Increase US and New Zealand exposures

In our opinion the key strategy for the coming months is to increase US and New Zealand exposures. To a certain extent this may tend to reduce the cyclical exposure in the portfolio and lift quality as healthcare names tend to come forward.

The US data remains very strong. We had thought that the US economy might register growth of 4% (well above consensus, for example Goldman Sachs still forecasts only 2.8% GDP). We now think that the data points to growth above 5%. And with no inflation, despite the very strong April employment report, unemployment is so high; the policy stimulus looks set to continue. Earnings revisions in the US remain strongly positive.

We continue to favour portfolio holdings in companies like Newscorp, Amcor, and healthcare companies like Resmed, CSL and Ansell. For New Zealand listed companies gaining exposure to the US is possible in Fisher & Paykel Appliances, Pumpkin Patch, Michael Hill and Fletcher Building. However, these companies also have large exposures to Australia. The largest position in the portfolio remains Fisher & Paykel Healthcare (55% of earnings from the US).

We agree that once US monetary policy starts to tighten and the reins are drawn on fiscal policy, that the US will have a much lower growth profile. However, when you gaze across Europe, and look at the more restrictive Chinese policy stance, the US seems to provide strong relative attraction.

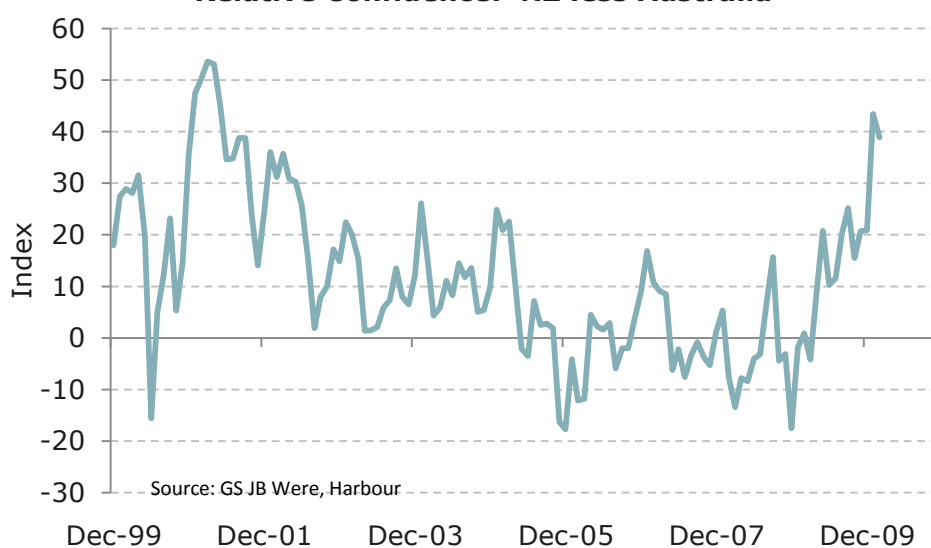
Rebalancing the New Zealand economy

Since about mid March we have been talking to investors about the likely relative improvement in the attractiveness of New Zealand investments over Australian positions. We monitor a large range of economic and company indicators, and increasingly both the bottom-up and top down factors are showing three clear trends:

- New Zealand business confidence is looking up relative to Australia (graph on next page)
- The New Zealand economy is rebalancing (ironically ahead of the Budget) toward both exports and investment.



NZ Businesses Are More Confident Relative Confidence: NZ less Australia



As the New Zealand recovery builds momentum, a key departure in this recovery is that growth is being led by exports and investment. Most economists will tell us that a recovery built on external growth and investment is "self-sustaining" or more durable. What is clear is that policy makers like this trend, and the May Budget is likely to reinforce this rebalancing through a rise in GST, through discouraging over investment in housing and potentially through encouraging companies to invest productively in both capital and labour.

From an equity investment perspective this means continuing to downplay domestic growth opportunities. This significantly limits investment choice, so exporters and global companies Rakon, F&P Healthcare, Cavotec, Wellington Drive, and F&P Appliances, together with late cyclical, Auckland International Airport, Air New Zealand, Mainfreight and APN (Queensland and New Zealand media) all feature as portfolio positions. We continue to fund these positions with under or zero weights in Contact, Sky City Entertainment, the Warehouse and the listed property sector. We admit that significantly under weighting Telecom is becoming a lower conviction call, and we have recently tactically reduced our previously extreme underweight ahead of the Q3 profit result (which due to lower costs was better than expected), the forthcoming industry day and further Government UFB announcements.

The next transition: Policy tightening in New Zealand?

A risk for increasing our New Zealand equity weightings could be an aggressive Reserve Bank tightening. We think this is unlikely, and that instead the RBNZ remain on track to lift the Cash Rate to 4% by the end of this year and about 5% in the course of 2011.

As we move through the balance of 2010 a gradual policy tightening could see outperformance from cyclicals diminish. Typically higher quality stocks and sometimes defensive stocks outperform. Although we may be ahead of time, we have sold the resource and bank positions and applied them to both increasing US exposure and lifting quality. Our recent move to a large overweight in Infratil is an example of a more defensive tilt.

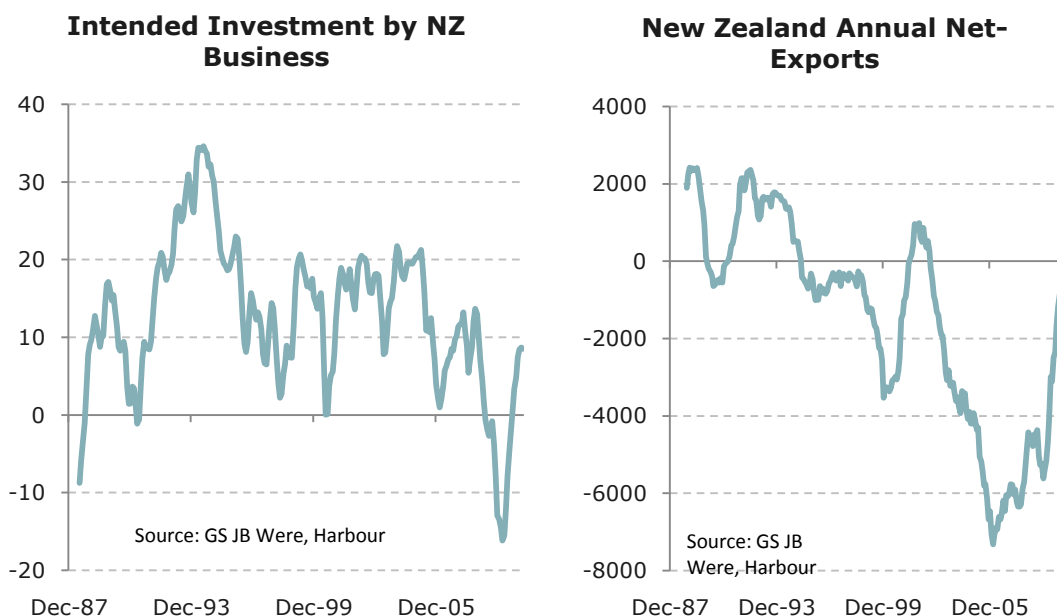


Summary

The Rudd Government has hastened our strategic reduction of weights in the resource sector, bolstering the impact of fears over China tightening. We think that Australian equity risk premiums will rise, and that global investors will look ahead and be more cautious with their Australian equity positions. The bank sector looks ripe for under performance in our opinion.

At the same time the US economy continues to positively surprise, and whilst the structural issues are significant, the cycle of upgrades may support companies with US exposures. Globally, European economic risks, bond market concerns and broader geopolitical issues may continue to limit a recovery in equity prices over the Northern Hemisphere summer.

Finally, the economic cycle in New Zealand is looking favourable, both in terms of the recovery and the shape of the recovery. The forthcoming Budget is expected to reinforce the rebalancing theme. As the recovery takes shape an important transition lies ahead for investors. Emphasizing quality, exporters and particularly the healthcare and technology sectors could be a successful strategy.



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