

Relief over Reporting Season

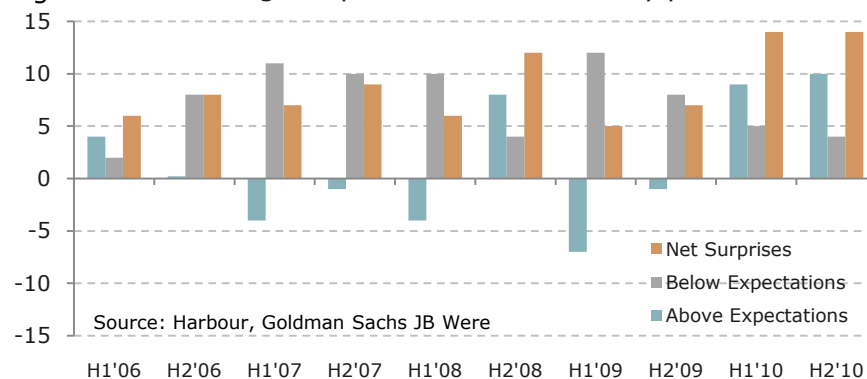
New Zealand Equities Commentary

August 2010 | andrew@harbourasset.co.nz +64 4 460 8302

The NZ reporting season finished on a high note

- The NZ equity market was flat in August returning 0.0%¹. Australian and Global equity markets were down in local terms posting returns of -1.2% and -3.7%, respectively. However, overseas equity market returns were bolstered by a weak NZ dollar; Australian equities returned +1.1% and Global equities 0.0% in NZ dollars.
- The reporting season has been the key feature in August. Companies had to contend with a backdrop of economic uncertainty as markets debated the probability of a double dip. However, as the New Zealand and Australian reporting seasons drew to a close there was a sense of relief that the numbers, on balance, did not disappoint. In New Zealand net surprises were broadly in line with the previous reporting season. Nuplex, Air New Zealand, Mainfreight had the best earnings reports.

Figure 1 Earnings surprises have been mildly positive

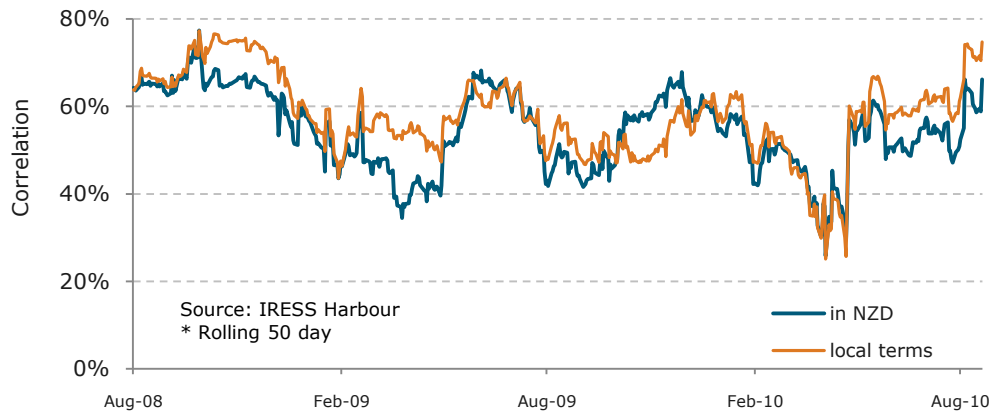


¹ The NZX 50 Gross Index returned 0.0% in the month.

Strategy

In recent months with an increased focus on global economic growth, Australasian markets have sought guidance from overseas. The net result is that both the New Zealand and Australian markets have become rather closely correlated with one another. This is displayed in Figure 2.

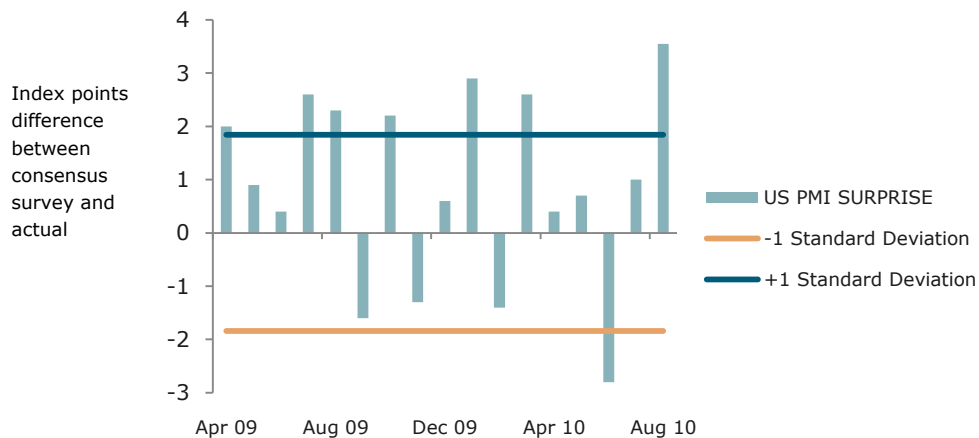
Figure 2 Correlation between NZ and Australian Equities *



The risk of a global 'double dip' – the risk of falling back into recession having only just exited one – was on investors' minds throughout August. Our July report was titled "No Double Dip". However, investment horizons have shortened again – and August saw considerable focus on the next economic number and sentiment proved volatile – the Investors Intelligence Survey (a US based survey of the ratio of bulls to bears) plunged to the lows of the decade. We consider this is often useful as a contrary indicator suggesting much of the negative news is now in the pricing of equity markets.

The portfolio has been tilted towards growth despite this broadly pessimistic backdrop. Global non-financial corporations have very strong cash-flows / profits and their balance sheets are in good shape. Indeed, in the month a raft of corporate takeover activity was announced.

Figure 3 US Business Confidence: Economic Surprise relative to survey



Source: Bloomberg, Harbour

Moreover, it hasn't taken much to get markets to lift. Towards the end of August this reignited takeover activity, and then improved business confidence, lifted markets. In fact US business confidence provided the biggest shock to markets for almost a decade with the US PMI coming out higher (at 56.3 when the survey median was 51.7) than any of 78 surveyed economists.

In the US workers are working longer hours, and remuneration has lifted. The next step is a probable improvement in payrolls (employment).

With the global consumer remaining cautious and saving and paying down debt where possible, businesses are rightfully spending carefully – removing obsolescent capacity, and investing in productivity improvements. This capital spending is providing the impetus for growth at present.

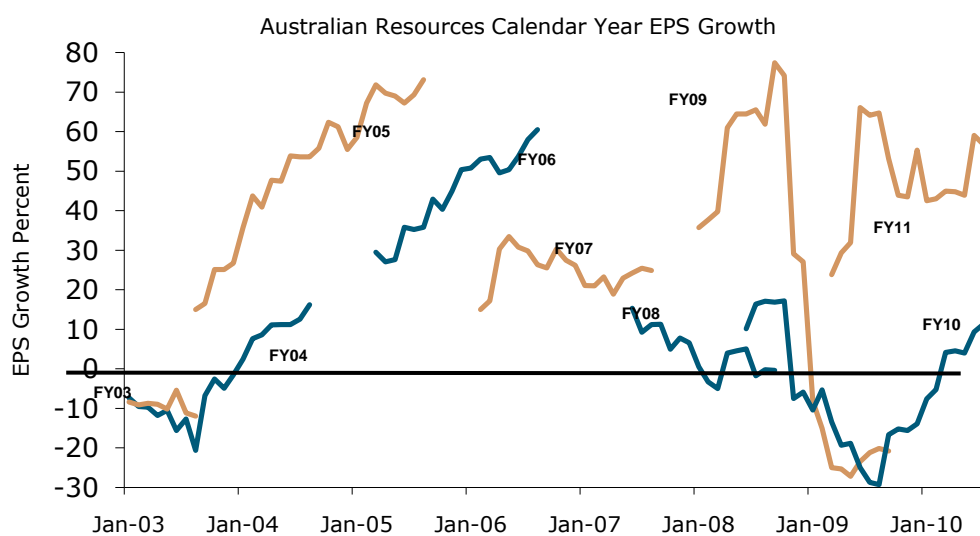
Financial corporations are in much better shape too. Their liquid asset ratios, solvency and capital adequacy measures are strong. In addition, surveys now show that many banks are now willing to lend despite the fact that consumers are still unwilling to borrow. This is a far cry from a couple of years ago when the interbank market was dysfunctional – banks could not even lend to one another let alone to businesses or consumers. However, the lesson learnt by consumers has been a powerful one - household debt needs to be reduced and global demographics in the Western world are further constraining credit growth.

We remain zero weighted in the financial sector. In addition to an outlook of low credit growth, banks have generally reported further interest margin deterioration.

In sharp contrast our largest positions are in the materials sectors. We strongly believe that emerging market growth has yet to be fully factored into earnings.

Already we have seen further evidence of upgrades to resource earnings, with Rio Tinto and OZ Minerals two good examples from the last earnings round.

Figure 4 Resource Sector Earnings Upgrades



Source: Macquarie Bank, Harbour

Finally, our sector positioning remains focused on the expectation that emerging market growth, and specifically that of the Asian region continues to drive global growth, whilst growth in the US and Europe gradually emerge at a subpar level (but above expectations).

As a result we are investing in companies that rate highly in our process in the materials, industrials, technology, and energy sectors. Our diversification strategy reflects significant over-weights in secular healthcare companies.

Alongside this strategy we continue with a higher weight in Telecom reflecting the expectation that the market has factored in outcomes for UFB that are worse than may emerge.

Our major funding sectors are financials and utilities.

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