

# No Double Dip

---

New Zealand Equities Commentary

July 2010 | [andrew@harbourasset.co.nz](mailto:andrew@harbourasset.co.nz) +64 4 460 8302

---

## Most Companies Are Reporting Strong Earnings

- Markets are recovering from a rise in risk aversion. Better than expected US earnings, diminishing concerns over sovereign debt issues and some relative improvement in Chinese data all contributed to improved sentiment. Closer to home, Australia's new Prime Minister cut a revised mining tax deal which greatly reduced the previously announced profit grab.
- Markets also saw a lift in Merger and Acquisition activity with several takeover bids and merger proposals. Investors also tended to focus on more cyclical areas. In addition, telecom stocks continued to be in favour.
- The NZX gross index rose 2.1% in July, significantly under-performing global markets which rebounded by 8.0% in US dollars (although in New Zealand dollars global markets only lifted by 2.8% as the kiwi rose). The Australian market lifted by 4.5% in Australian dollars, and rose 6.1% in New Zealand dollars as the NZ slipped against the Aussie.
- Most economic data confirmed what the market was expecting, a moderation of growth prospects. However, it seems that markets had prepared themselves for a torrent of bad news. If anything Chinese and German data was better than expected, and in the US, whilst consumption related data was poor, production related data was good.
- In New Zealand, business confidence pulled back, housing was soft and migration data was weaker than expected. In contrast exports and the ANZ commodity price data continue to be strong.

## Strategy

At the start of July markets were significantly concerned about the prospects of a double dip. We weren't.

We approached the reporting season with optimism, not because the economic data is going to improve (in fact we expect the leading data to continue to fade), but because markets were too pessimistic about:

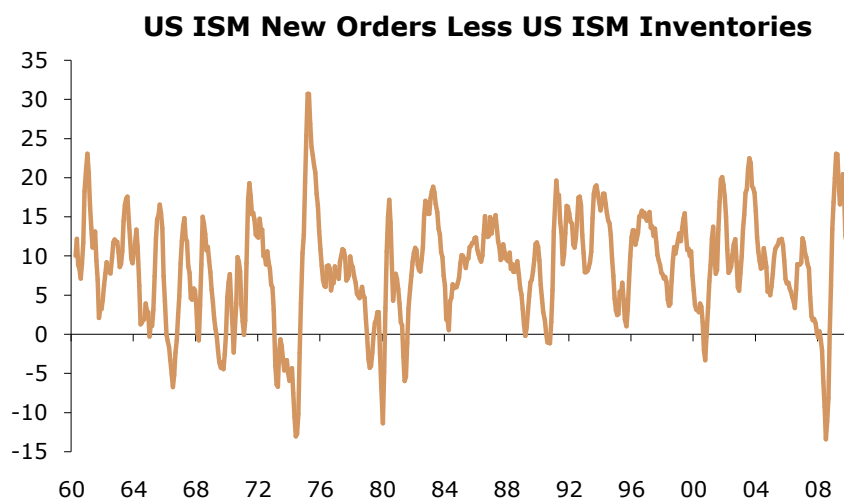
- Corporate earnings
- Cash holdings at both the corporate and institutional level
- China, and the impact that consumption will have on the global economy
- Europe – Germany is still a strong economy

We lifted our exposure to materials and industrials – sectors most negatively impacted in the previous two months by global slowdown fears and the previously proposed mining tax. Inevitably this strategy change has had the impact of lifting Australian exposure, and portfolio beta.

*US reporting season sending good signals .....*

On average, in the US, 77% of the companies that have reported have beaten earnings expectations.<sup>1</sup> Industrials, resources, technology and healthcare stocks have led the market higher. These themes are consistent with our portfolio as we run into the Australasian reporting season. We agree that the US consumer and housing sectors look poor, with only a broad based bottoming out happening, and no real sign of a recovery. In other sectors however, we think that the restocking cycle still has some way to run and there is strong evidence of an upward lift in business investment. This cycle still ought to provide an impetus to local technology, transport and packaging sectors. (As shown on figure 1 below.)

Figure 1: US Inventory Cycle and New Orders

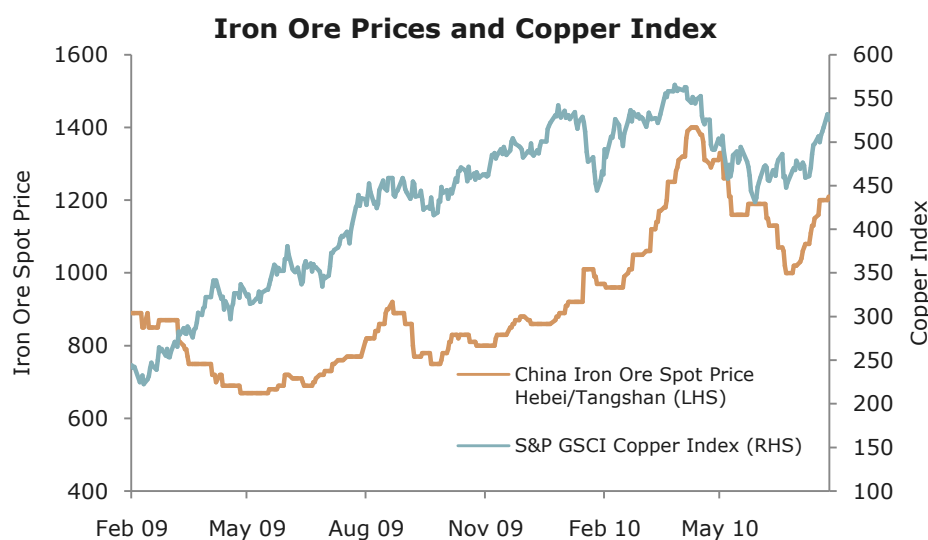


Source: Macquarie Bank

<sup>1</sup> Source Strategas 30 July 2010.

Iron ore and copper prices signal that the Chinese slowdown has paused.....data in May and June unequivocally pointed to a slowdown in Chinese production. The more timely PMI data also pointed to a pull back, and the latest data, whilst still lower, is still consistent with growth closer to 8% than 6%. Chinese authorities are subtly changing their policy stance, pulling back from “restraint” language. Spot Chinese iron ore and US copper prices were up 13% and 12% respectively in July.

Figure 2: China Iron Ore Price and US Copper Price



Source: Bloomberg

Evidence of a willingness to invest in productive output is rising. In New Zealand this is most obvious in the agricultural sector with several corporate deals announced in July. In Australia deal flow continued in the resource sector and also flowed through to agriculture proposed merger activity. A sharp pull back in global interest in Australia – which was exacerbated by the Henry tax review and the Rudd budget - appears to be defrosting. The removal of policy uncertainty post the election could prove a catalyst for renewed investor interest. Good profit results and mining sector upgrades may be other factors.

At the same time there is growing evidence of a pull back in the housing and consumer markets in both Australia and New Zealand. This has resulted in downgrades of earnings (albeit small to-date) in the Australasian home builders. We retain a large underweight in consumer stocks and have reduced Fletcher Building leading into the reporting season as we expect further small earnings downgrades for 2011. Consistent with this theme we have also seen further earnings downgrades across the banking sector, and lending growth remains subdued.

## DISCLAIMER

*The New Zealand Equities Commentary is given in good faith and has been prepared from published information and other sources believed to be reliable, accurate and complete at the time of preparation but its accuracy and completeness is not guaranteed. Information and any analysis, opinions or views contained herein reflect a judgement at the date of preparation and are subject to change without notice. The information and any analysis, opinions or views made or referred to do not constitute specific advice (whether of an investment, legal, tax, accounting or other nature) or a recommendation to any person and may not be suitable for all investors. The price, value and income derived from investments may fluctuate in that values can go down as well as up and investors may get back less than originally invested. Past performance is not indicative of future results, and no representation or warranty, express or implied, is made regarding future performance. Where an investment is denominated in a foreign currency, changes in rates of exchange may have an adverse effect on the value, price or income of the investment. Reference to taxation or the impact of taxation does not constitute tax advice. The rules on and bases of taxation can change. The value of any tax reliefs will depend on your circumstances. You should consult your tax adviser in order to understand the impact of investment decisions on your tax position. To the maximum extent permitted by law, no liability or responsibility is accepted for any loss or damage, direct or consequential, arising from or in connection with this document or its contents. Actual performance of investments managed by Harbour Asset Management Limited will be affected by management charges.*