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Global fear, and more politics

New Zealand Equities Commentary

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Data point to softer earnings....

- Markets lost ground in June. The NZX50 gross index fell -2.8% bringing a decline of -7.5% for the first half of calendar 2010. With no major earnings announcements, markets looked to the economic data – and there was no consistent lead. However, as the month progressed economic outcomes globally, and in New Zealand, fell short of expectations. Late month jitters about a surprise drop in US consumer confidence, softening Chinese data, worries over US financial regulations, and the forthcoming repayment of Eur442bn on emergency loans, all played on investors' minds.
- Across the Tasman, the surprise change of leadership lifted hopes for a compromise on the proposed Resource Super Profits Tax. Julia Gillard's approach appears to have a stronger consensus line and the partial back flip led to miners outperforming the market in June despite weak data.
- Otherwise more defensive sectors led the relative performance stakes. This in part reflected the deal struck between Telstra (+8.9% in New Zealand dollars) and the Australian government, that gave some further hope that Telecom may be included in a compromise deal in New Zealand. Utilities performed relatively strongly, with Infratil and Auckland International Airport lifting as typically defensive names. Unusually, the smaller consumer stocks also rallied strongly at the end of the quarter, however we think this reflected portfolio positioning rather than any earnings trend.

  On the economic front, the Reserve Bank of New Zealand lifted the OCR by 0.25% to 2.75%. Although this was expected, the slip in expectations of further rate rises in Australia, together with the actual rate rise in New Zealand, probably helped lift the New Zealand dollar.

Strategy

We were wrong in early June to think that markets could form a base. The economic data has not supported markets, and political concerns on a number of fronts allow investors to sit on the sidelines.

Initially in June it appeared to us as if markets could move higher:

- China allowed a more flexible yuan
- Housing price data in the US was better than expected
- Closer to home the Australian government first struck a compromise deal with Telstra and then rumours circulated that the RSPT was going to be watered down

However, markets remain risk averse with investors not only sitting on the sidelines, but some more "media focused" fund managers have been quoted as changing their views.

For instance only on 29 June Barton Biggs said that "*I'm definitely not a seller. ….I'd be inclined to be a buyer."* And after the US consumer confidence data and other weaker than expected indicators he switched positions stating only 5 days later that... *"I sold stocks pretty aggressively in the U.S., and we had a lot in tech ...I've taken basically all of it out".*[1] Several papers have also had bearish headlines such as "Double-dip fears"[2], and "Pulling back spending, amid echoes of the 1930s"[3].

A key factor behind investor concerns is the staged withdrawal of government policy stimulus globally at a time when private sector credit growth cannot provide an offsetting growth source.

Governments (New Zealand aside) are also focused on higher taxes and financial sector regulation that imposes a negative bias to earnings. To top it off, the small proportion of companies that have provided earnings guidance across Australasia have generally resulted in large analyst downgrades – e.g. Virgin Blue, Downer EDI, Sonic Healthcare, Macquarie Bank and Brambles.

From an Australasian portfolio perspective it doesn't help when Australia has led in tightening both monetary and fiscal policy, together with placing investors on edge with uncertain policy direction in the largest sector – resources. The proposed trimmed Minerals Resource Rent Tax (MMRT) cuts a deal that provides a more politically balanced approach for investment in resources and broader tax cuts for "all Australians". We (and the market) partly expected some back flip and we increased weights in the resource sector in June.

In contrast we remain concerned with bank, consumer cyclical, and increasingly, industrial earnings trends.

As a result the portfolio retains an unusually low weight in "Australian" exposures – with stocks such as Oil Search, Rio Tinto, CSL, Amcor and Newscorp representing our largest non-New Zealand positions.

In the broader portfolio we increased weightings in Telecom New Zealand further up toward a benchmark weight (as discussed last month), and also took part in a discounted placement of Ryman Healthcare stock.

A focus for New Zealand investors in June was the announcement by GPG of a proposed demerger as a first step towards a broader restructuring. Taken at face value this sounds like the right step for GPG and shareholders, however, digging deeper into the proposal, in our view, it appears unlikely to provide the value release expected. The ensuing Board level fracas, with the removal of Tony Gibbs from the Board, serves to highlight deep divisions in the company.

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[1] Source: Bloomberg 2nd July 2010.
[2] AFR 1st July 2010.
[3] New York Times, 30th June 2010.

Finally, we are watching the Australian housing market closely. Signs of a softening in house price growth are developing. Figures from RP Data show that more affordable dwelling prices only rose by 1.9% in the three months ended May 2010. They noted that the more price-sensitive sectors of the Australian housing market, where interest rates have the biggest effect, are behind a pull back. It is too early to express heightened concern for the housing market, however given the importance of the residential sector in the context of financial stability across Australasia it is worth maintaining a stronger focus.

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