

Changing Emphasis

New Zealand Equities Monthly Commentary

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Is there an Elephant in the Room?

- Equity markets are strong. The NZX50 Gross Index (including imputation credits) returned 2.4% in March, and finished the quarter on a near 3 year high. By 5th April the NZ market had been up 15 days in a row. Global equities were also up, despite the Japanese disaster and geo-political issues. Concerns over a small slowing in the Chinese economy and the exit from super easy monetary and fiscal policies were ignored by markets as economic data, especially in the US, continued to positively surprise.
- Without taking away the tragic consequences of Japan, Northern Africa/Middle East hostilities, and renewed European debt and austerity concerns, the world economy seems robust on the growth front.
- But we think markets are at a point of change. For over 2 years we have been thinking that global growth would positively surprise. Therefore the portfolio has been concentrated in global exposures, especially resources.
- Our view now is that several lagging sectors are becoming more attractive. We have purchased financial sector positions, lifted healthcare exposures, and we are also maintaining high energy sector weights.
- We are increasingly wary that the growth trade is priced into markets, whereas the perceived threat of inflation may not be anticipated. This means that we are increasingly emphasising longer term secular equity opportunities.
- The portfolio out-performed in March by 0.6% rising by 2.9%. For the March quarter we returned 5.9%. The best performing stocks in March were Santos, Bathurst Resources, Mainfreight, Rakon, Oil Search and Amcor.

To March 2011	Month	3 months	6 months
Portfolio	2.9%	5.9%	11.9%
Benchmark**	2.2%	3.9%	9.5%
Relative Performance	0.6%	2.0%	2.4%

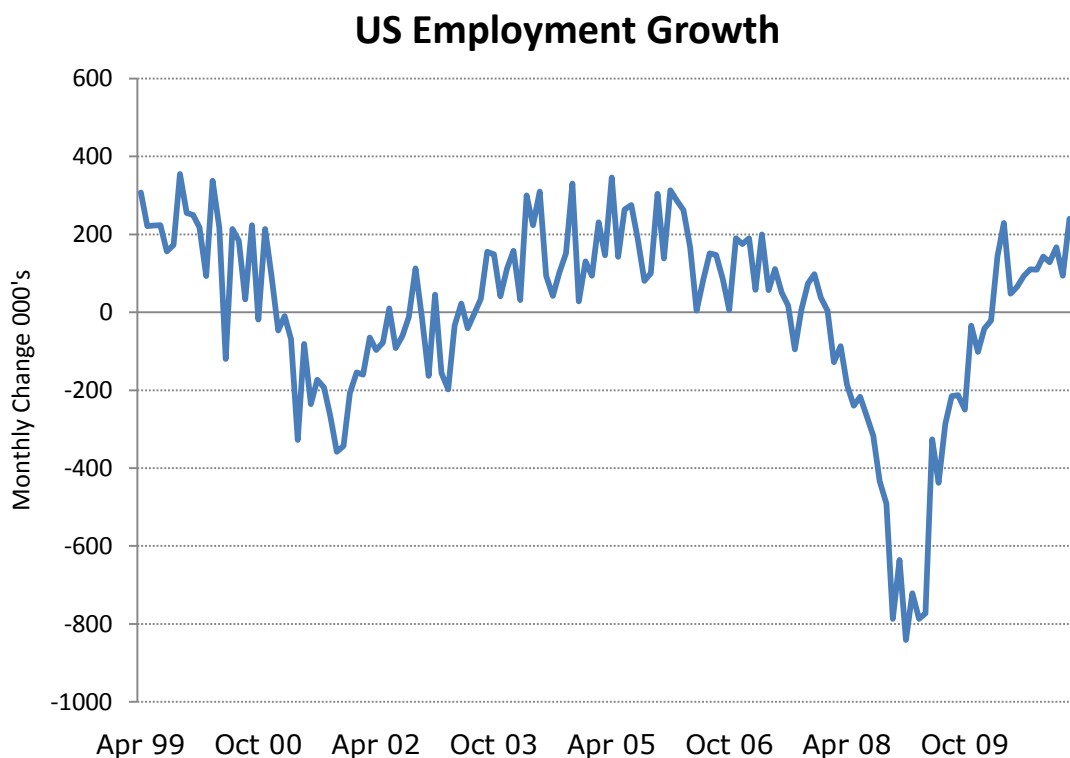
** Benchmark is the Russell / JB Were Tradeable Index including imputation credits. Returns are before fees and taxes. Investor returns may differ. Numbers may not add due to rounding.

Strategy – when do markets start to worry?

It seems impossible to believe that equity markets rose in March, especially in the wake of:

- the tragic Christchurch earthquake,
- the Japanese disaster,
- broiling Middle East/Africa concerns,
- a renewed European sovereign crisis, and
- markets considering a broad range of views on the exit from extraordinarily easy monetary and fiscal policies, the potential of commodity lead inflation and a slowing of growth in China.

However the growth and risk “trade” has dominated markets with the latest US business confidence indicator (the March Purchasing Managers Index) again showing a very high reading, at 61.2. Meanwhile jobs growth in the US is also returning, and more rapidly than many commentators had thought possible given the very weak US housing sector.

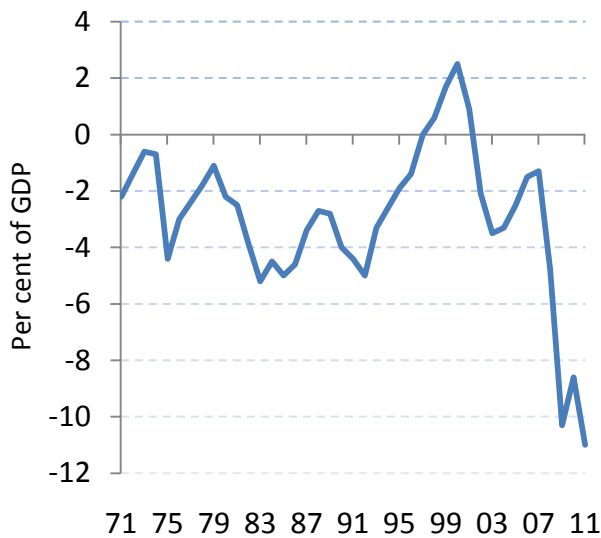


Source: Bloomberg

As a result policy makers are now publically discussing the exit¹ from very easy policies. The very policies that have helped prime the global economy and resources will at some stage need to be reversed.²

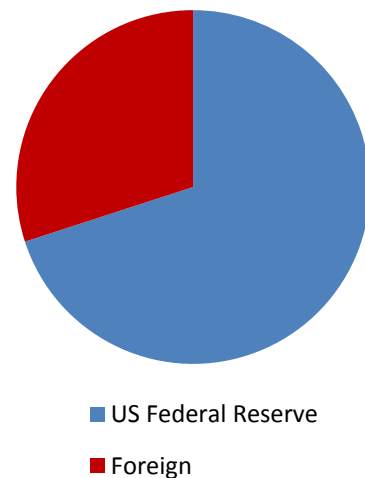
The move to less extra-ordinary polices will be difficult to negotiate, and as Federal Reserve Chairman, Ben Bernanke recently said, "we are in uncharted waters". For instance the US fiscal deficit is about \$1.5trillion (or over 10% of GDP). This is not sustainable, and the US Congress and Senate will be debating how to close this gap in the next few months. In addition three US Federal Reserve Bank governors have now publicly aired their view that quantitative easing should be slowed before the 30th June deadline. Although it seems a similar number have been pressing for a third round of quantitative easing, so the middle line of a 30th June end to the Fed buying bonds still seems likely. At some stage a normalization of policy by the Fed could be seen by markets as an issue for funding the US fiscal deficit.

US Fiscal Balance



US Treasury Market

Purchases Since QE Started

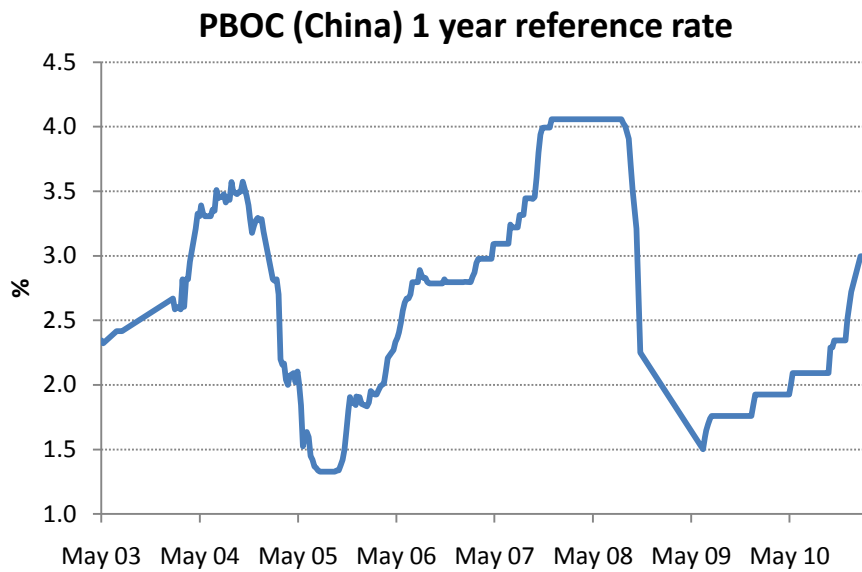


Source: Bloomberg

¹ As my colleagues have pointed out an Exit is actually a poor term, a better phrase would be a move toward a more neutral stance in policy. The problem is on nearly all fronts policy is off the charts on the easy side!

² Christian Hawkesby discussed the Fed exit from QE in his note: *The Impact of Quantitative Easing on the Bond Market*, 6 April 2011. This will be available on our website or can be provided directly to clients.

At the same time Chinese policy is gradually tightening to control currently mild inflation risks, increasing interest rates again this week.



Source: Bloomberg

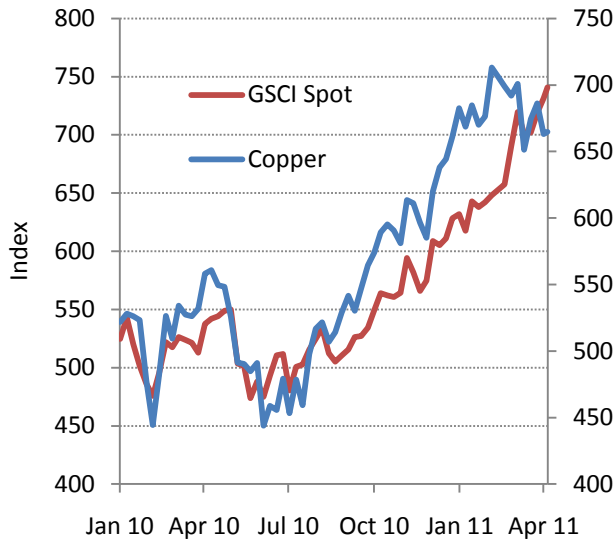
However, a slowing in Chinese growth seems to be less of a risk for markets with broad indicators of business confidence stabilising in positive territory.



Source: Bloomberg

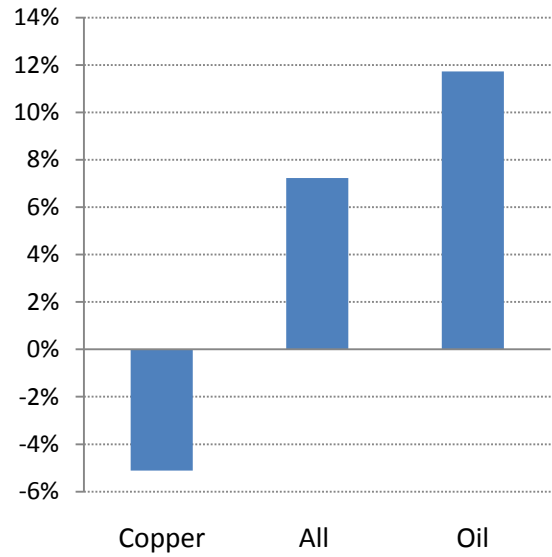
The tragic overlay of the Japanese disaster combined with a perception of slowing Chinese demand has combined to change price momentum in many commodities, with downward pressure on some metals but upward pressure on energy. Overall, commodity prices have still trended higher.

Commodity Indices



Commodity Price Moves

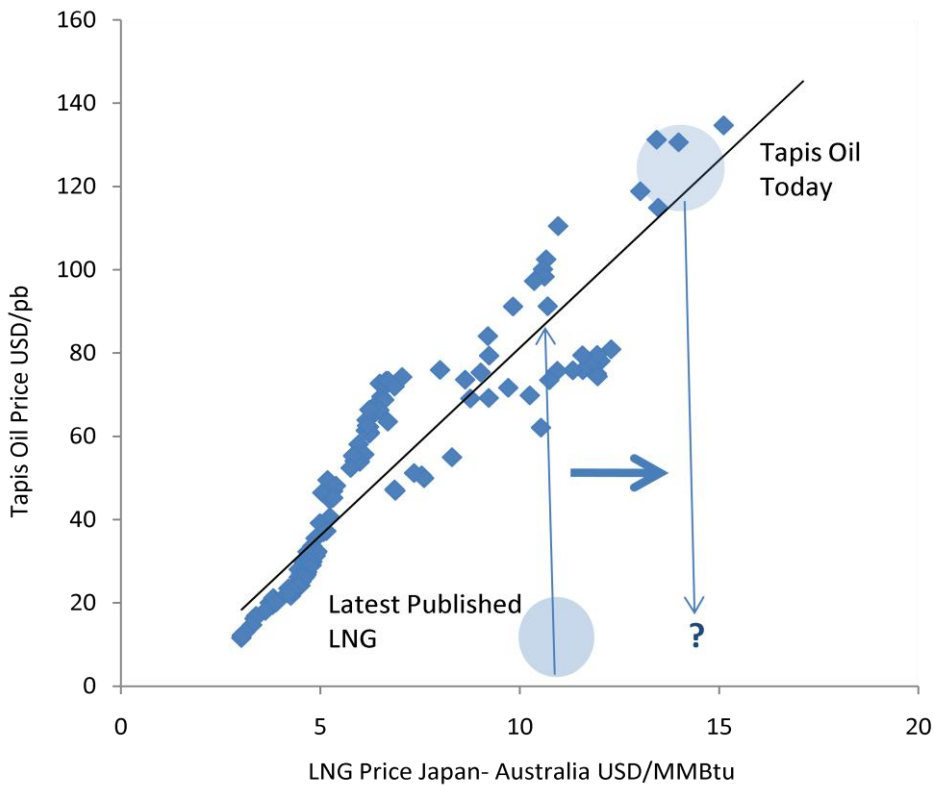
since February 2011*



Source: Bloomberg. *Moves to 6 April 2011

In contrast, geo-political influences in North Africa/Middle East and perceptions of likely Japanese replacement energy demand, has increased oil and as a consequence liquid natural gas (LNG) prices.

LNG Prices Have Upward Pressure



Source: Bloomberg, Harbour

In terms of portfolio consequences our key rotation in March has been to continue to reduce and then sell most of our mining resource exposures and increase energy exposures, especially to LNG.

In New Zealand, business surveys have expectedly reported a significant pull back in confidence, but by no more than was widely expected. For example the domestic trading activity fell from a -1% to a -5% in the Quarterly Survey of Business Opinion, and this appeared less of a decline than expected in the wake of the Christchurch earthquake. The smaller than expected drop in sentiment may reflect the emergency 2.5% cash rate, which the Reserve Bank preemptively introduced in the month.

Specific Canterbury region indicators predictably remain weak, with the trading activity indicator falling to -33% from an already low -28%. However, many surveys may be under-estimating actual weakness as more than 40% of firms in Canterbury did not respond to the NZIER Survey.

The skew in the New Zealand economy is highlighted in the following data³:

- building intentions soared in Canterbury (net +38% from -6%) while
- employment intentions plummeted (a net -15% from +10%)

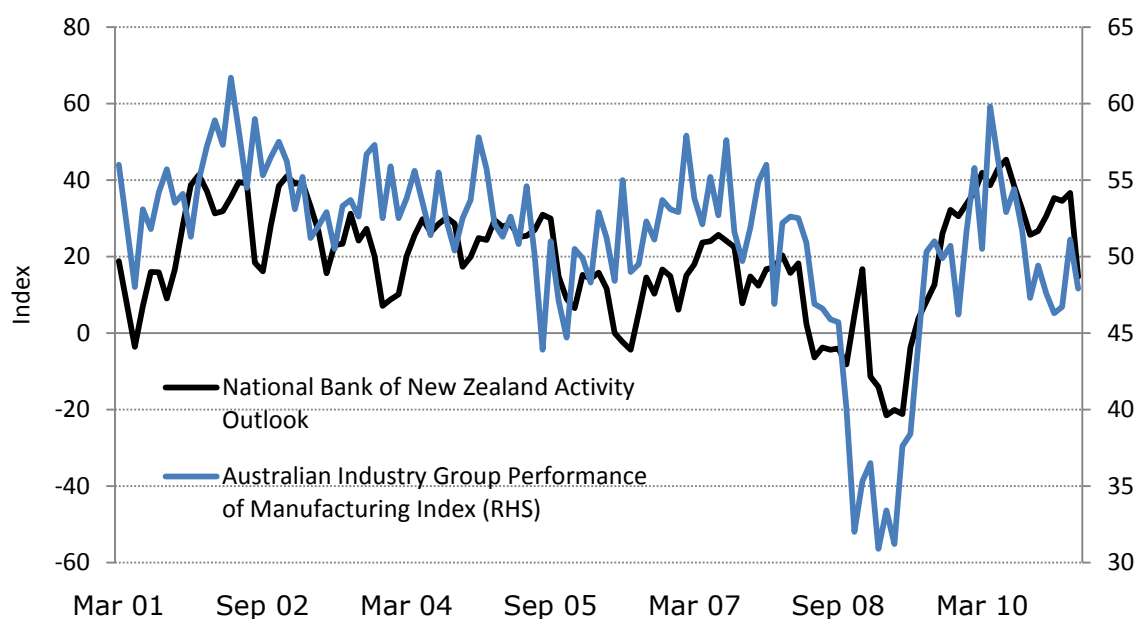
This positive building sector outlook is also complemented by a growing NZ trade surplus which we think will be maintained as a strong terms-of-trade and weak consumer environment persists.

In Australia, a similar pattern is evident, although overall business confidence is weaker than in New Zealand. Australian businesses are struggling with a high real exchange rate (see last month's report) and pricing pressures across a range of industries. This perspective seems at odds with the view that the commodities boom will "lift all boats".

It is interesting that in Australia only the energy, packaging (which is dominated by the global company Amcor) and the banking sectors experienced earnings upgrades in the past month. We are overweight all these sectors, although our banking exposure is focused on the consumer, wealth management and cost focused banks – CBA and Westpac.

³ See UBS research 5 April 2011 Robin Clements *Business confidence slumps after earthquake*.

Australian and New Zealand Business Confidence



Source: Bloomberg

Against that background it is not surprising that more enduring investment themes, built from bottom-up research are now being emphasized in the portfolio. For instance healthcare is now the largest sector overweight, displacing both materials and energy.

Within the materials sector, building and packaging are now key positions, as we remain a little more cautious on how the market may read a slight slowing in the Chinese economy.

Looking out over the next few months, markets are not without risks. Sometimes, markets do continue to rise in higher risk environments (climbing a wall of worry). More often than not, it is the stocks that have strong secular growth characteristics that markets value more highly. Although it is not our central scenario, we are becoming significantly more vigilant of inflation risks, and for some stocks we could see margins eroded by input price pressures, and potentially valuations could be affected by higher interest rates.

We look forward to reporting further portfolio matters following the current earnings announcement period.

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