

May Risk Aversion

New Zealand Equities Commentary

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The ideo of May, exacerbated by policy...

- Equity markets tumbled in May, bearing the brunt of a sharp rise in risk premiums. Sovereign debt risk, moderating growth expectations in China, persistent policy intervention and geopolitical concerns inspired investors to become risk averse. Aside from the May US employment report, actual economic data proved to be better than expected.
- In New Zealand, the Budget, economic confidence and employment data all provided a positive backdrop for growth. Corporate news flow was more mixed. The New Zealand equity market ended down 6.8%, only marginally out-performing global markets, which fell 7.5% in local currency terms.
- Thematically, while defensive names tended to out-perform, there was no conviction to this theme as larger defensive and growth companies also seemed impacted by investor sentiment.
- Across the Tasman, banks were the worst performing sector by some margin. This followed earnings downgrades across the sector and a poor global backdrop on the regulatory front. The Australian equity market response to both the Henry tax review (and the Resource Super Profits Tax) and an evident downturn in business confidence was highlighted by the more cyclical companies under-performing. Another rate hike by the RBA was over shadowed by global events, and both the Australian and New Zealand dollars took the elevator shaft down during the month as risk appetite plunged.

We are reviewing several key themes: the Australian housing market, the China slow down and the probability that NZ companies have a better back drop for earnings. These themes currently lend our portfolio stance to maintain a higher New Zealand equity weight, limit exposure to Australian themes and continue to transition the portfolio to quality (and potentially more defensive) names.

<i>Performance %</i>	<i>Month</i>	<i>Quarter</i>
Portfolio	(6.47%)	
Benchmark**	(6.29%)	
Relative Performance	(0.18%)	

** Benchmark is the Russell JB Were Index including imputation credits

Returns are before fees and taxes. Investor returns may differ



Perspectives on the Road – China and global risks

So why are markets so risk averse, if the world's second largest economy grows at 8% (acknowledging that is a major slow down from 10%), and US business confidence still points towards 4% growth in the US?

Travelling through Hong Kong, Beijing and Shanghai, it is difficult to contemplate the latest bout of pessimism about forward prospects. Relative to 18 months ago when we made a similar trip, the evidence of a society in transformation is just so great. The cyclical changes are also very evident. Gone in Hong Kong are the 50% off sales, empty bars and restaurants – Hong Kong is doing very nicely at the moment. Gone in Beijing are the thousands of bicycles, modestly dressed people and hundreds of cranes and building sites. Beijing felt like a capital city in its prime, and in Shanghai the Bund was awash with people – far more colourful, happy and with lots of shopping bags from a day out at the Expo or Nanjing Road. Most interestingly, from the hotel room you can count the number of cranes on one hand.

There is evidence of inflation, there is significant evidence of over build in the CBDs, and everyone is talking about the coming pull back in property prices. And again everyone is talking about lifting consumption. Shops were full, with very little apparent discounting. The papers were full of the FoxCon (makers of the iPhone and iPad) 100% pay rise for 800,000 staff, and Honda's 24% pay rise. Economists and strategists were clearly "Bearish" on property, infrastructure and the near term demand for resources. Many were falling over themselves to lower GDP estimates, pointing out that even if consumption growth hits 10% or even an unlikely 15%, it is difficult to get GDP growth much above 8% with exports, property and infrastructure growth in retreat. The big targets talked about are reducing water and energy intensity.

There are major risks in transforming a society and economy from export, property and infrastructure focused to consumption focused. It is easy for economists to point to the oversupply in the CBD, the possible fall in property prices, and recent destocking of resources. It is much harder to forecast or speculate as to the outlook for consumption growth. However, there is no doubt in our mind that consumers in China have got the message. From Hong Kong to Beijing, both private sector and government sector are in buying mode. This is being supported by large wage rounds and directives (it seems) to buy both local and foreign goods.

However, the micro labour dislocations are significant and the macro inflation risks are evident. On the micro front persistent anecdotes emerged that it is increasingly hard to get "migrant workers" because they went home for the spring break and didn't come back because they have better work opportunity inland. To attract workers, factories in the large coastal cities are hiking wages and the impact is evident in full pricing for goods, full shopping malls, "bling and fashion", new cars and mostly full restaurants and bars. For three days this week all flights (and that is four an hour) and all seats on the bullet train (four a day), and sleeper seats on the slow train from Beijing to Shanghai were booked



out. Several New Zealanders on the way to the Expo are doing the 14 hour bus ride! It is not a question of price.

The transformation of Chinese society towards consumption also carries global risks. If China's current account surplus falls, who is going to buy the rising debt of the US and Europe? And which countries and global companies are positioned to benefit from this transformation? And the trickier question if you are particularly bearish, will this transformation end like the 1980s Japanese transformation to a consumer society with a period of above trend consumer lead growth, followed by inflation and the necessary clampdown!. I am not in that latter camp as it requires a level of indebtedness that is not currently evident in Chinese households.

What this boils down too, is that for the time being, the still crowded resources (or commodities) trade probably has significant headwinds. We think that the ongoing contango (the forward price being higher than the spot price) of many commodities will limit new portfolio money entering commodities. In our opinion, like private equity, some funds have over-done their allocation to index like commodity exposure as the diversification benefits have not proven themselves in the current cycle.

The time will come again for resource company exposure – especially when resource tax initiatives around the world settle down. If anything in 3-5 years the supply conditions may deteriorate, placing a high marginal cost floor for many commodity prices.

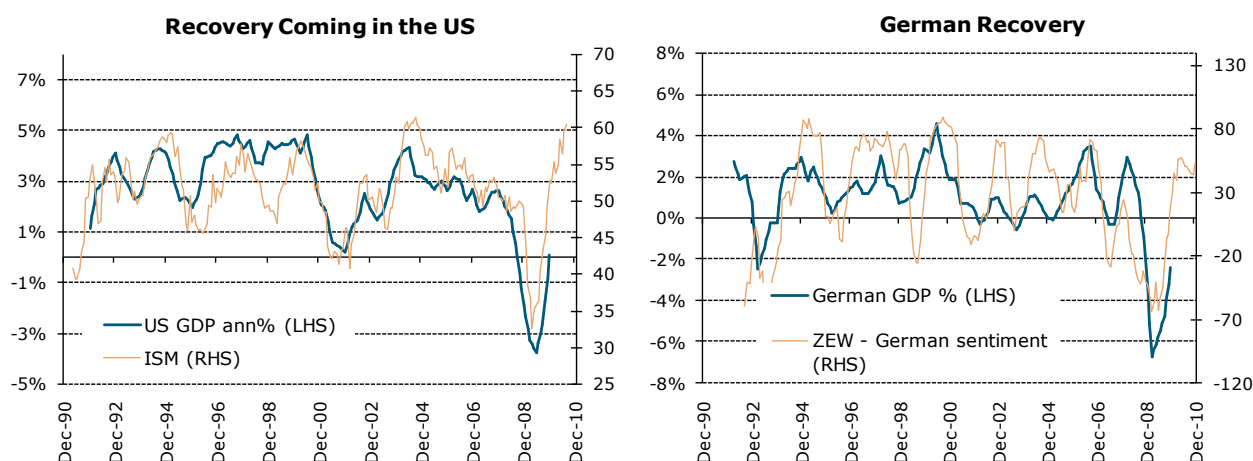
Through this key global transformation markets have other non-trivial concerns regarding:

- The potential for yet further debt restructuring in Greece, Hungary and for the Spanish banks, and the related question of whether the German public will back their politicians in acting as the lender of last resort.
- Poor policy prospects for the global banking sector, highlighted by Germany's short selling ban and US financial regulation.
- A new political leadership in Japan.
- The impact on US growth of the gulf oil spill, and this follows the impact on Europe of the Icelandic volcano.
- Other small but potentially large tail risks associated with geopolitical concerns in Thailand, North Korea and Israel.

Many of these concerns have manifested themselves in LIBOR for both the US dollar and the Euro, and credit default swaps at a country level remaining elevated. However, the economic consequences of say 0.5% higher funding costs have probably been limited in some economies that have instead delayed or reduced rises in interest rates (for example the market now expects Australia to hold off on further rate rises). As a consequence most economic indicators today (including the recent global round of leading business confidence indicators) are largely unchanged relative to a month or two ago. For the US,



China and Germany, they all point to expansion at a solid pace. New Zealand's business confidence indicators point to the highest prospective growth in a decade.



Source: Goldman Sachs JB Were

The only major indicator that has recently failed to inspire, and has really created the latest 5% down leg in equity markets, was the US jobs report, which only showed 41,000 private sector jobs added in May, well down on expectations. Those higher employment growth expectations reflected the fact that US corporates are sitting on over \$600bn of undistributed tax paid profits, up from \$220bn a year ago and almost double the trend of the last 5 years. Corporates in surveys show they are ready to re-hire, ready to invest and likely to engage in M&A activity. In the recession, the US laid off 8.4mn workers. Even if only half these workers are rehired in the next 2 years (and the long term correlation with GDP suggests more than that will be hired), we should expect about 175,000 workers hired each month for the next two years. Unless business confidence falls, or expectations of corporate profits collapse we should see this happen.

Some have suggested that the oil spill is in part to blame for the poor jobs data, as in four states tourism, fishing and oil related employment is likely to have been set back badly. Evidence of this is hard to come by; anecdotally we met with three US people from the Gulf States while travelling, and there is some real concern that this disaster will have a significant knock to households throughout the summer. However the big test is more in the winter when people travel south for breaks in the sun. No one will want to do this if the beaches are covered in tar. From a sentiment perspective if BP can cap the well shortly, and make restitution payments (already cheques for US\$100mn have been cut), then the prospects probably look brighter than the anecdotes imply.

So backing out all these concerns, it is obvious that most strategists we follow are right in implying that the fall in the market reflects a rise in risk premiums, reflecting both noise and real tail risks.

When we examine the outlook for major sectors what we see is that globally housing is still in an "L" shaped recovery (and in China actually we are still moving down the vertical



part of the L). There is also evidence in Australia that higher interest rates are having an impact, and although (in a separate report) we find a low likelihood of a significant pull back in the Australian housing sector, near term weakness seems a likely trend.

In contrast, global manufacturing activity is still V shaped, with technology, transport and media the key sectors experiencing significant lifts in activity.

The consumer sector lies somewhat between these extremes, with Western middle class consumers likely to bear the medium term brunt of the fiscal consolidation ahead. In contrast consumption in China is manifestly lifting with the implication that global consumption is likely to do a bit better than just muddling along. The proviso here is that inflation remains well behaved.

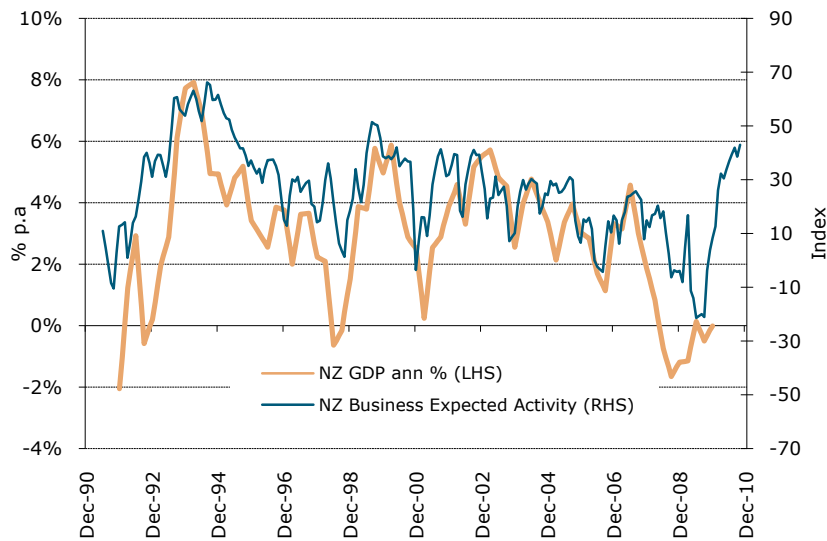
New Zealand – Seen From Afar

The New Zealand economy and recent budget are getting increasingly good coverage overseas, albeit from a minimalist base. In a world concerned by poor policy decisions, high indebtedness, banking system stability, geopolitical risks and slowing growth prospects, New Zealand from an economic perspective looks comparatively good. As we have pointed out since March, the relative indicators on momentum look particularly good. Whilst relative valuations are neutral, we think increasingly some companies will report better than expected earnings.

Better still the growth we are seeing appears to have a more “desirable” balance, away from consumption and housing, and focused instead on investment, stock rebuilding and exports. This feature alone has had favourable commentary from overseas observers. Labour market conditions also appear to have improved, and the National Bank business opinion survey of firms’ own assessment of the outlook has moved to the highest level since May 1999. This level is consistent with 5% GDP growth in the year ahead, contrasting heavily with the consensus nearer 3%.



Big push in NZ GDP ahead



Source: National Bank, Statistics NZ, Harbour

We think that the themes in the portfolio are still appropriate. In most sectors we prefer New Zealand names to those in Australia. Across the portfolio we are increasingly attracted to non-cyclical, secular growth opportunities. The exceptions are the transport and media sectors where growth tends to occur late in the cycle. We continue to “fund” these overweight positions through low or zero exposure to the financial and property sectors.

From our perspective, portfolio emphasis on stocks like Fisher & Paykel Healthcare, CSL and Ansell, provides significant longer term secular earnings growth. We balance these healthcare positions through investments in Amcor, APN New and Media, NewsCorp, Auckland International Airport and Mainfreight which may all see a stronger near term correlation of earnings with GDP.

Most recently, and somewhat controversially, we have also started to buy Telecom shares. We think that whilst there is a lot of news yet to emerge regarding the nature of Ultra-Fast Broadband, that regulatory uncertainty may have peaked. The acknowledgement that structural separation of Telecom into retail and wholesale businesses may provide a way forward has provoked a fall in the price of Telecom toward levels closer to “a worst case” scenario. We are not saying that Telecom is out of the woods, however participating in an economical way in UFB could provide upside relative to current expectations.



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