

Too much stimulus?

New Zealand Equities Monthly Commentary

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Who said we would have a double dip ...

- Equity markets had a positive seasonal bias in December, assisted by economic data, by corporate activity and by positive sentiment to European debt issues, Chinese inflation risks, and the potential impact of both QE2 and Obama's tax cut extension.
- The NZX gross index rose a miserly 1.4¹%, while the Australian market was up 3.5% in Australian dollars (5.4% in NZ dollars). Global equity markets rallied strongly. The MSCI index was up 6.6% in US dollars in December.
- A feature of the month was the strength in commodity prices, especially "soft" commodities – or food related primary product prices that generally lifted by 20% in the month. For the 2011 year, corn and wheat prices were up by around 50%, while the protein commodities (soy, cattle, milk powder etc) rose by about 25-35%.
- New Zealand economic data is still weak, impacted by the Canterbury earthquake and aftershocks, and household deleveraging. We do expect New Zealand growth to pick up, led by robust trading partner growth, by strong commodity prices, by loose monetary policy, and by earthquake rebuilding investment and spending associated with the Rugby World Cup.
- The portfolio performed strongly in December, led by our overweight materials, energy and industrial sector positions and our underweight stance in banks, consumer and utility companies.

December 2010	Month	3 months	6 months
Portfolio	3.13%	5.66%	14.16%
Benchmark**	1.60%	5.37%	13.30%
Relative Performance	1.53%	0.29%	0.86%

** Benchmark is the Russell / JB Were Tradeable Index including imputation credits
Returns are before fees and taxes. Investor returns may differ

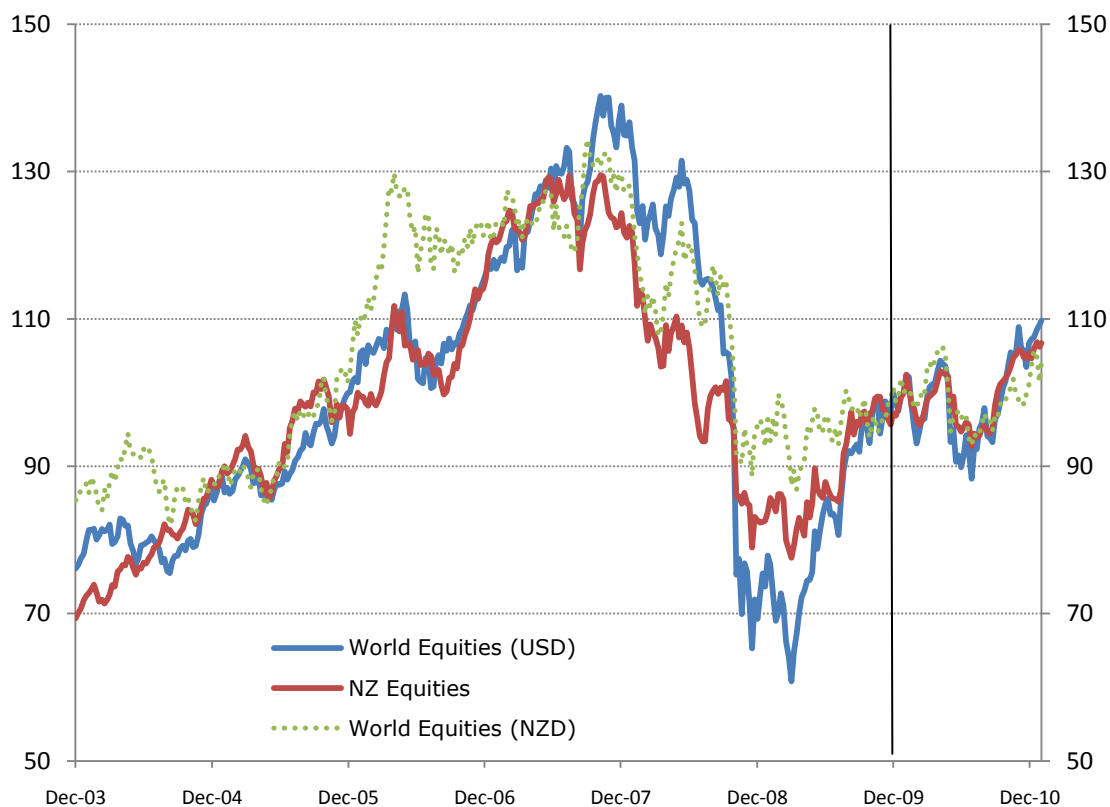
¹ The NZSE 50 Gross Index rose 1.4% whereas the Russell/JB Were Tradeable Index rose 1.6%

Strategy – US economy provides positive surprises

Our strongest conviction view remains that Western policy makers are erring on the side of too much stimulus. Even in China where rising inflation is resulting in a gradual tightening of policy, we expect that policy makers are still more concerned with full employment. As a result we expect further upside surprises to growth and eventually corporate earnings. Loose monetary policies probably also mean further upside risks to commodity prices, especially where supply constraints are evident. We are least optimistic about domestic Australian growth opportunities and favour globally oriented companies.

Equity markets and most non household/housing activity indicators are back to pre-Lehmans (GFC) levels. Equity markets in aggregate have generally been reasonably highly correlated in 2010.

New Zealand and Global Equity markets continue to be highly correlated

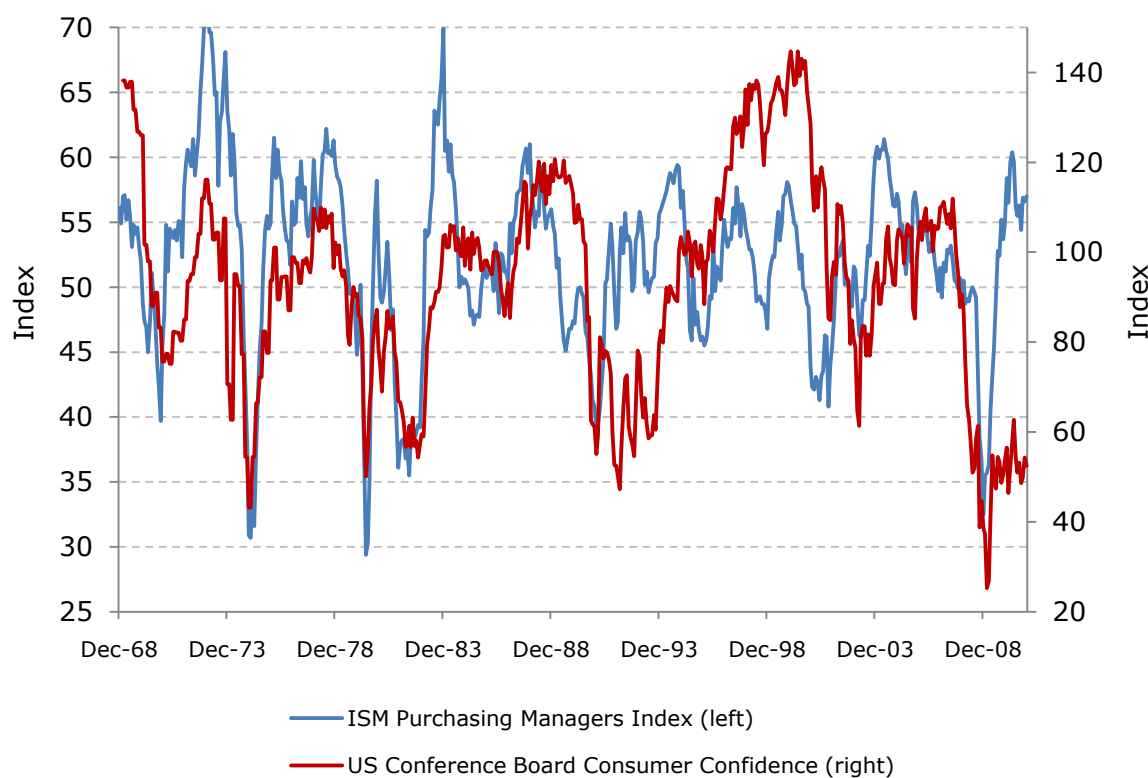


Source: Bloomberg

We continue to think that global growth will be strong in 2011, probably closer to 5% than 4%. Recent data has tended to support this view. The

US is delivering stronger economic data with both the manufacturing and service sector PMI's well ahead of the consensus. Many economists are revising up forecasts of growth. In China, economic data is also strong, however inflation concerns are more apparent and the authorities tightened policy on Christmas day after tightening twice in November. We are of the view that China is not set to significantly constrain growth – however we note this is a risk for 2011 especially after the sharp rise in food price inflation in December.

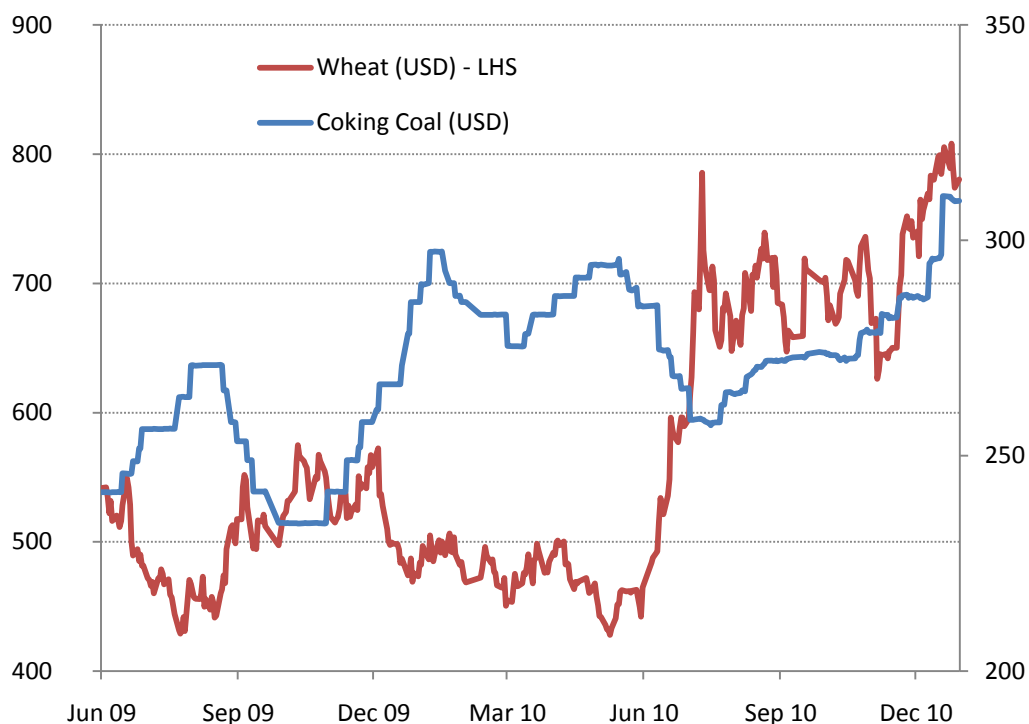
US businesses are still optimistic, consumers are still pessimistic



Source: Bloomberg

In Australia a key issue for investors at a sector level is coming to grips with the Queensland floods and the sharp tightening in global supply of seaborne coking coal and to a lesser extent wheat. The devastation in parts of Queensland may also serve to soften Australian GDP and lower the resolve of the RBA to raise interest rates further. Our view is that this supply constraint continues to highlight the value of continuing a portfolio tilt toward material and resource companies.

Commodity prices have risen sharply, especially where supply is disrupted



Source: Bloomberg

The Portfolio – growth oriented

Our largest overweight – Oil Search – performed strongly in December (at one stage up 5%), led higher by a strong oil price. (Oil was up 9% in the month). We took this opportunity to reduce the overweight and partly diversify the portfolio's energy exposure. In December the energy sector in Australia also had to digest the implications of the NSW retail electricity privatization – with Origin being one of the beneficiaries. In addition, Santos announced a gas off-take deal with Korea Gas which will see their LNG development commence. The portfolio has new positions in both Santos and Origin as we expect both these developments will result in earnings upgrades and valuation support.

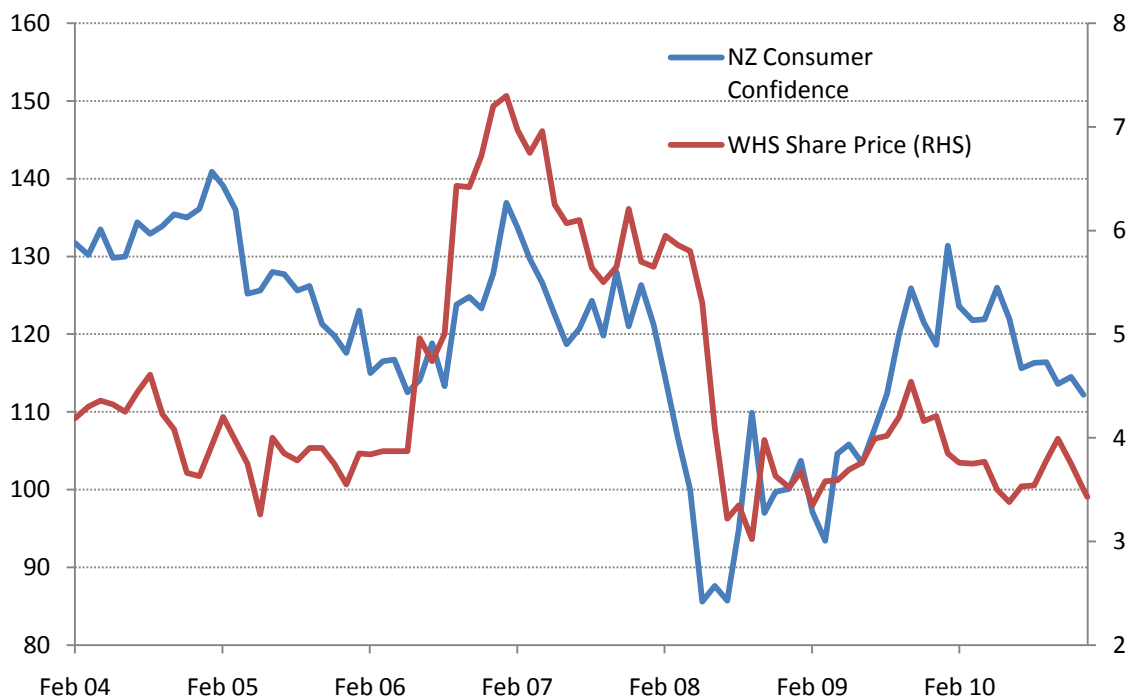
Other strong portfolio performances in the materials sector included BHP Billiton (+6% in December), global packaging giant Amcor (+5%) and small West Coast based coking coal company, Bathurst (+39%).

Upgrades to earnings are hard to come by at the moment, which is why we rate highly global blood plasma manufacturer CSL – especially given the currency headwinds the company has been facing. CSL's share price rose 4% in December as one of its competitors (Octopharma) continued to

suffer with a product recall. We also invested in Resmed in the month, increasing our exposure to the global OSA market, where both Resmed and F&P Healthcare have been gaining market share.

Closer to home, December was marked by poor consumer stock performances, especially by The Warehouse, Briscoes and Hallenstein Glasson. All these stocks would have been negatively impacted by the Boxing Day earthquake in Christchurch that closed several malls, and also by ongoing consumer deleveraging. We remain significantly underweight retail stocks.

*NZ Consumer Confidence (Roy Morgan) and The Warehouse ...
Still having issues with super categories of music and apparel*

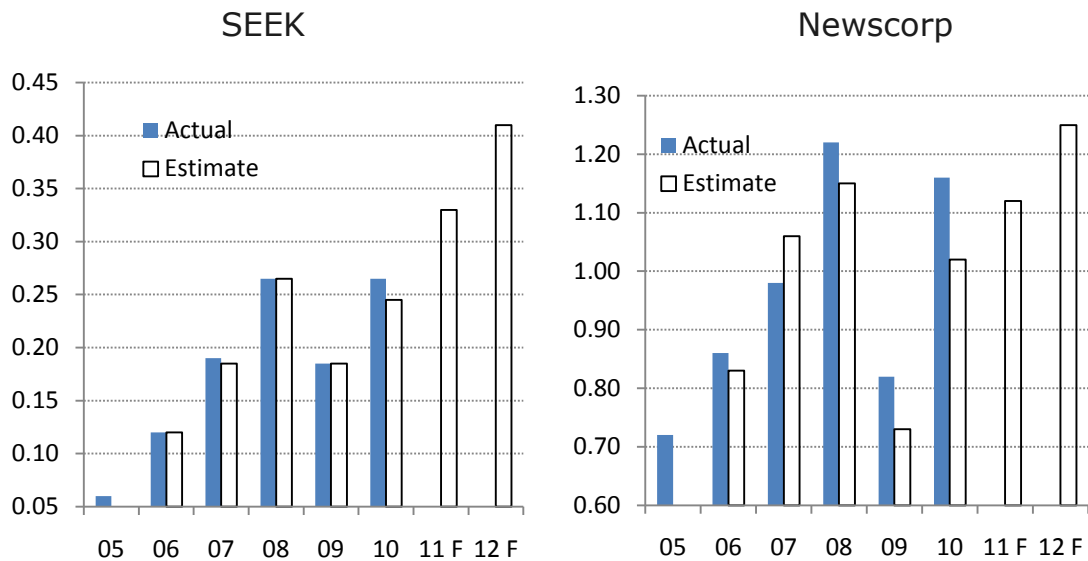


Source : Bloomberg

Our key exposure to the discretionary spending this cycle is through the media and employment sectors. The portfolio retains investments in NewsCorp, Seek and Sky Network TV. One reason we like these stocks is the recent pattern of exceeding expectations on earnings – and the fact that earnings expectations show good secular and cyclical growth.

Newscorp and Seek – Exceeding Expectations in 2010 with Strong Growth

Actual and Consensus Estimates of Earnings per Share

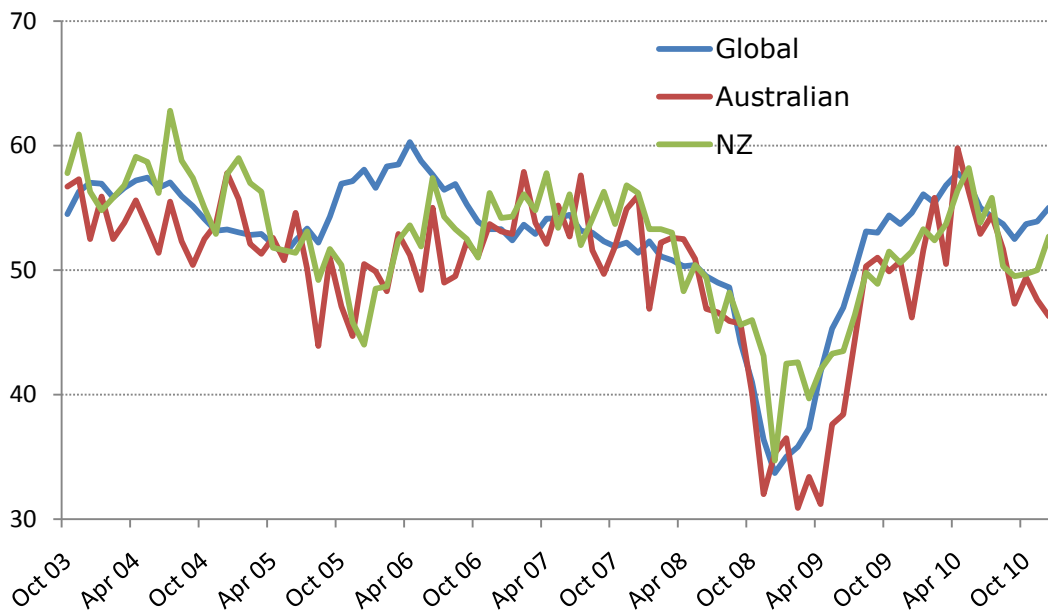


Source: Bloomberg. Bloomberg consensus estimates

Many commentators note that Australian GDP growth has exceeded New Zealand growth significantly over the past two years, and is expected to do so over the foreseeable future. As a result, some investors anticipate strong growth in earnings for Australian companies. While this may be so, we note that the Australian equity market has significantly outperformed the New Zealand market over the past few years, and that in more recent times Australian market performance has been more concentrated in the resource and materials sectors.

Moreover the tightening of policy in Australia – both via interest rates and the high exchange rate – has significantly dented business confidence. On a global scale Australian business confidence is weak and this may serve to dampen earnings expectations.

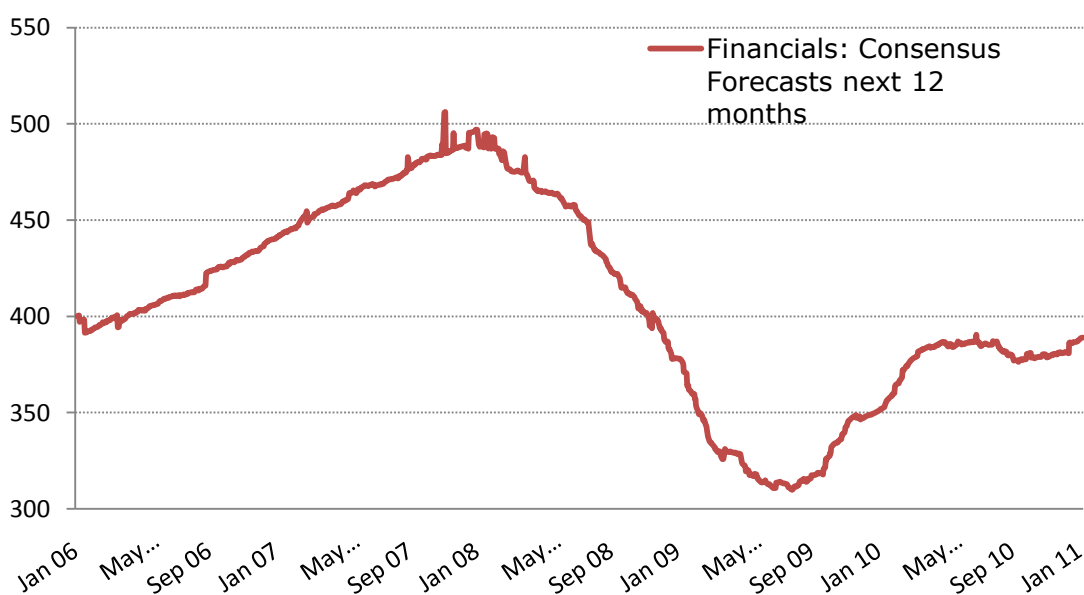
Business confidence has picked up globally and in NZ, but Australian confidence has fallen



Source : Bloomberg

The Australian floods are estimated to take a further 0.3% off GDP in the next few quarters. One area for concern is the lack of earnings momentum for Australian financials. Financials make up almost 38% of the Australian index, and earnings continue to disappoint. Exposure to weaker business confidence and the Queensland floods may further constrain earnings growth for Australian banks. We retain a zero weight in the banks.

Australian Financials: An index of Earnings expectations in the next 12 months

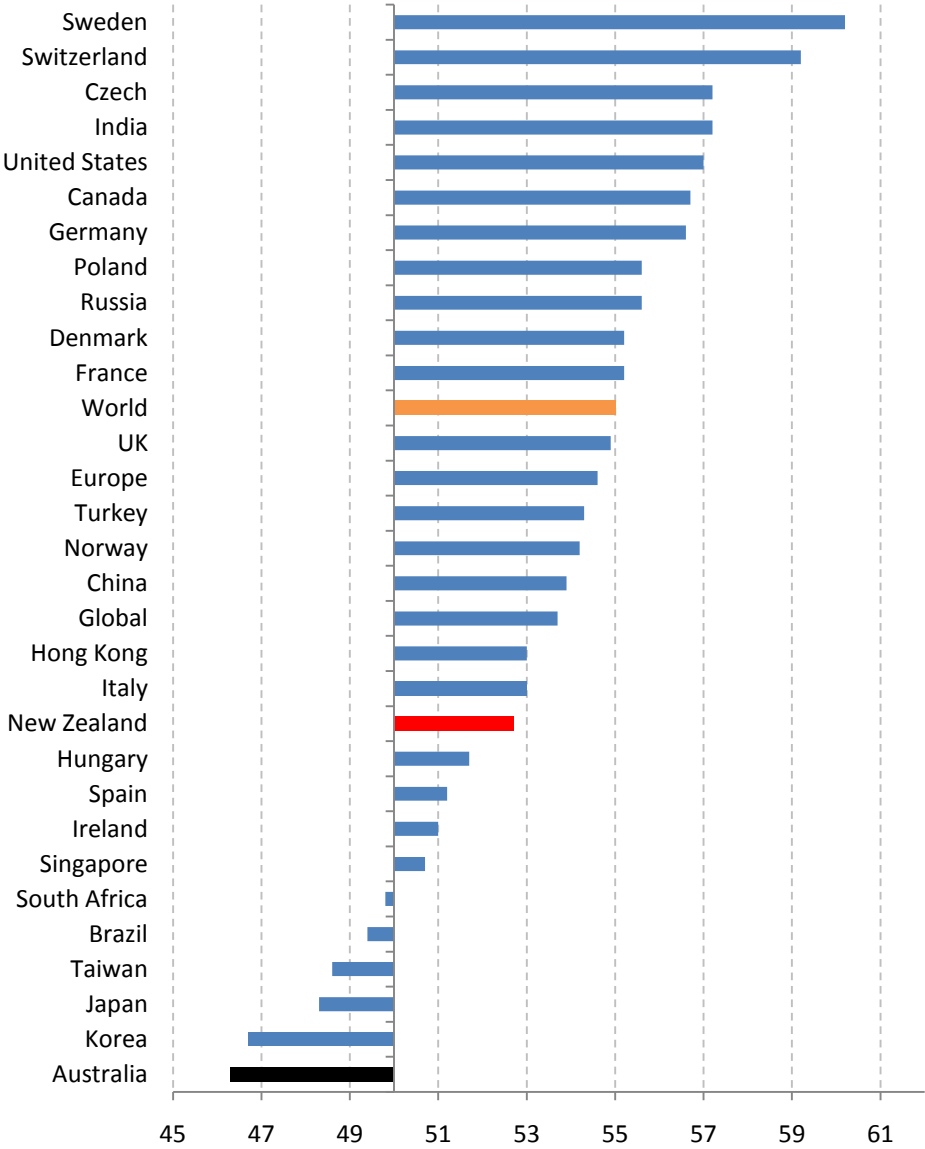


Source : Bloomberg

Weak Australian growth prospects contrast with a gradually improving backdrop for New Zealand growth. The NZIER Quarterly Survey of Business Opinion improved moderately in the December quarter, reinforcing the more timely PMI and National Bank business indicators. Nevertheless, positive earnings momentum is hard to find. Some globally facing stocks like Mainfreight, Delegats, Cavotech and Skellerup have had earnings upgrades. And where possible in we continue to emphasise global exposure over and above specific domestic positions which is hardly a surprise given that global business confidence is stronger than that in New Zealand.

Business Confidence from around the world

Australia at the bottom



Source: Bloomberg

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