
Policy is moving further towards reflation

Australasian Equities Monthly Commentary

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- New Zealand equities returned -1.0% in 2011, and despite the fall NZ was one of the top performing equity markets. Global equities fell 5.0% in US dollars, with a small positive return in the US market disguising very negative returns for Europe and Emerging markets, and the Australian market returned -14.5%, weighed down by the global slowdown and continued consumer deleveraging.
- 2011 will be remembered for the tragic further development of seismic activity in Christchurch and for the ongoing battle with deleveraging around the world, with a particular focus on Europe.
- In December the New Zealand equity market (+0.1%) was broadly in-line with global markets (0.0% in US dollars), while the Australian market continued to underperform. The further large sequence of Christchurch earthquakes on the 23rd of the month rattled the New Zealand equity market in light trading.
- Corporate activity focussed on the successful IPO of TradeMe, and on further downgrades to retail company earnings with severe cuts to profit outlooks for Billabong, and market darlings, Kathmandu and JB HiFi.
- Globally, US economic data continued to positively surprise – especially consumer and employment data, while the European Summit led to some progress on fiscal integration and the ECB lowered interest rates and significantly expanded its balance sheet through the new Long Term Refinancing Operations. Concerns regarding Chinese growth continued to drag on markets, and commodities generally were weak despite evidence of strong imports and a significant fall in inflation. The exception was oil prices which rose in the month associated with geopolitical tensions. The US dollar continued to strengthen, reflecting both positive US economic surprises and investor concerns regarding European developments.
- We still think that equity markets seem overly bearish as to outcomes for US growth. We expect New Zealand growth expectations may stabilise (and even improve) providing scope for better performance of equities. Europe remains on the dark horizon, whilst Chinese and Australian growth risks are more evenly balanced.

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Our wish list for 2012:

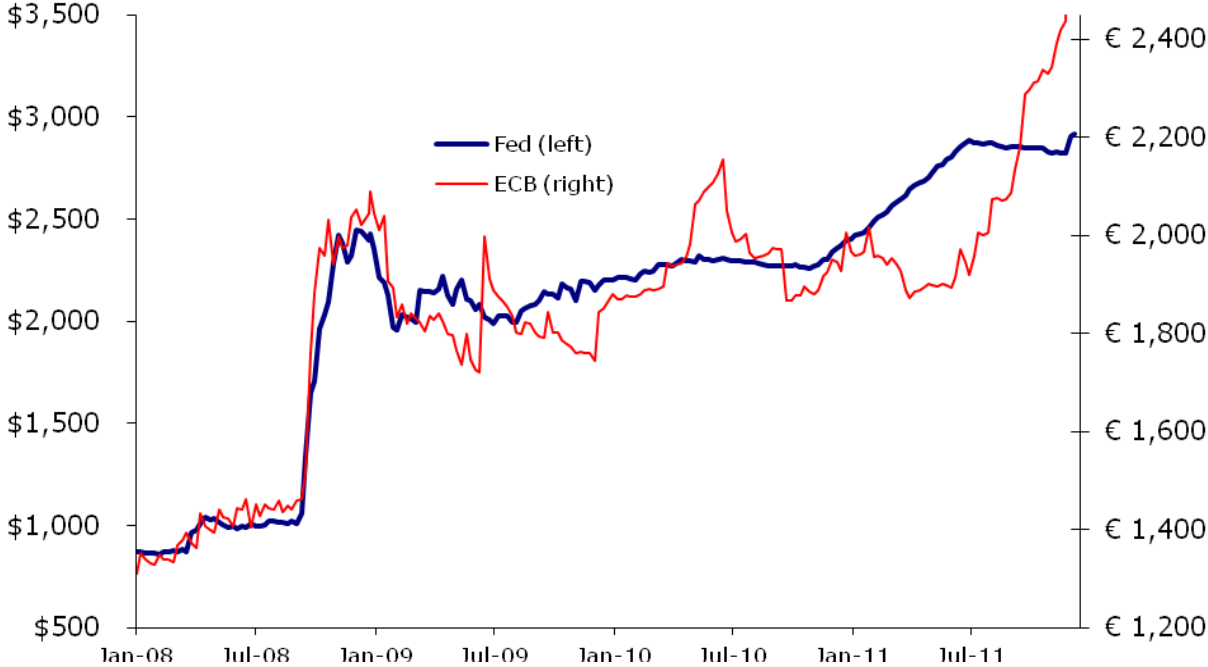
- **A soft landing in China.** Concerns over the property market are weighing on China, and resource stocks. And yet real estate floor area under construction is up 28% yoy to November, iron ore imports are up 12% yoy, and electricity production is rolling along at 8.5% yoy. Meanwhile inflation has dropped to 4.2%, and that provides scope for monetary easing in 2012. There are tentative signs that policy is easing with a lowering of reserve requirements and stronger lending data for December.
- **Continued US consumption and employment growth.** There are very good signs of stronger jobs growth and retail activity in the world's largest economy. US data has been positively surprising markets for the best part of 2 months and looks set to record strong GDP for the current quarter. However, fiscal tightening is ahead, and a European slowdown will bite.
- **Less volatility in equities and commodities.** The risk-on or risk-off trade has dominated the past 6 months. As we move into 2012, stronger profit momentum and low interest rates should encourage a steadier market background. A risk for markets is increased currency volatility.
- **Significant further monetary easing in Europe to offset fiscal austerity and get the interbank market working again.** (See below)
- **No more Christchurch Earthquakes.** Well you just have to feel for the people of Christchurch, again set back by Mother Nature. We tend to think that this latest setback will accelerate momentum in building activity **outside of Christchurch** as migration of both people and money continues from the CBD and red zones to new growth areas.
- **A recovery in profit flows through to investment in New Zealand and jobs growth.** A stronger profit outlook and good farming incomes should get investment up and going in 2012, and we would expect a stronger employment environment.
- **Australia negotiates the twin speed without having a housing collapse.** Recent rate cuts reduce the prospect of a further housing market deceleration; however confidence is fragile in both the Australian retail and housing sectors.
- **Inflation stays in check as central banks engage further monetary easing.**

Whilst the highlight globally in the month of December has been the **improvement in US economic data – the continued sharp expansion of the European Central Bank's balance sheet has also been an important step to avoid a European banking sector meltdown**. Whereas a month ago markets were focussed on the potential for a Lehman like moment in Europe, going forward the introduction of Long Term Refinancing Operations (LTROs) may infer a significant new impetus to easing monetary policy.

However Europe is still very slowly moving toward a 'grand plan'. We are up to the 15th Summit! The 'fiscal pact' is just words at the moment but shows a new path forward to kick the can along. In addition, peripheral economies are implementing 'forced deleveraging and fiscal austerity'. Without significant monetary easing, these austerity measures are not credible – that is why markets are looking carefully at bond auctions, and at the ECB's weekly balance sheet. So far so good, in that Italy has had auctioned bonds at rates lower than last month, and Spanish yields have fallen. The continued extension of US dollar swap lines reduces the probability of a liquidity crunch a la 2008. However, it is more important that the new LTROs allow banks to recapitalise and buy sovereign bonds. In the last week E490bn of loans were provided to banks in return for debt collateral (most of which is sovereign debt from peripheral economies). The LTROs may possibly be viewed as an a backdoor way of Quantitative Easing if only banks bought say Italian and Spanish bonds with the funds they have borrowed from the ECB. To-date there is apparently little sign that this is actually happening.

Moreover, the real concern in the months ahead is the mountain of European sovereign and bank debt that needs to be rolled over. The actual outcomes for Europe are still so uncertain, which is why there is such a wide range in views on growth in Europe for 2012.

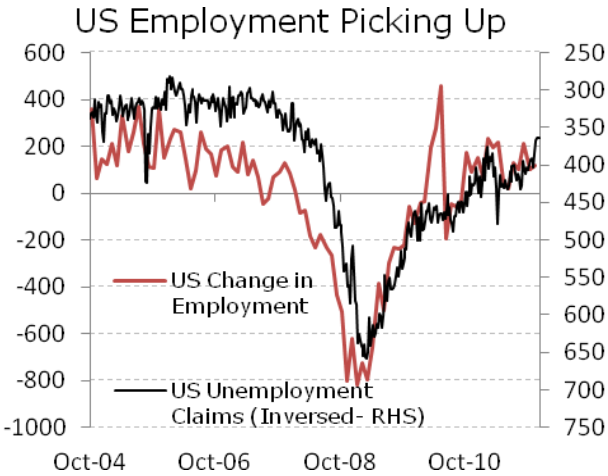
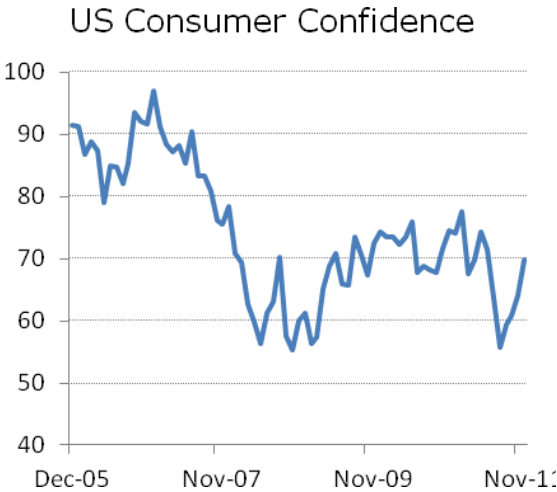
Fed Balance Sheet vs. ECB Balance Sheet (BN)



Source: Strategas and Bloomberg

At the same time as we begin 2012, US data is picking up. Last month we showed the very strong reading for the US economic surprise index – this has strengthened further.

One of the reasons is the surprising lift in employment and consumer confidence. Spending has also risen.

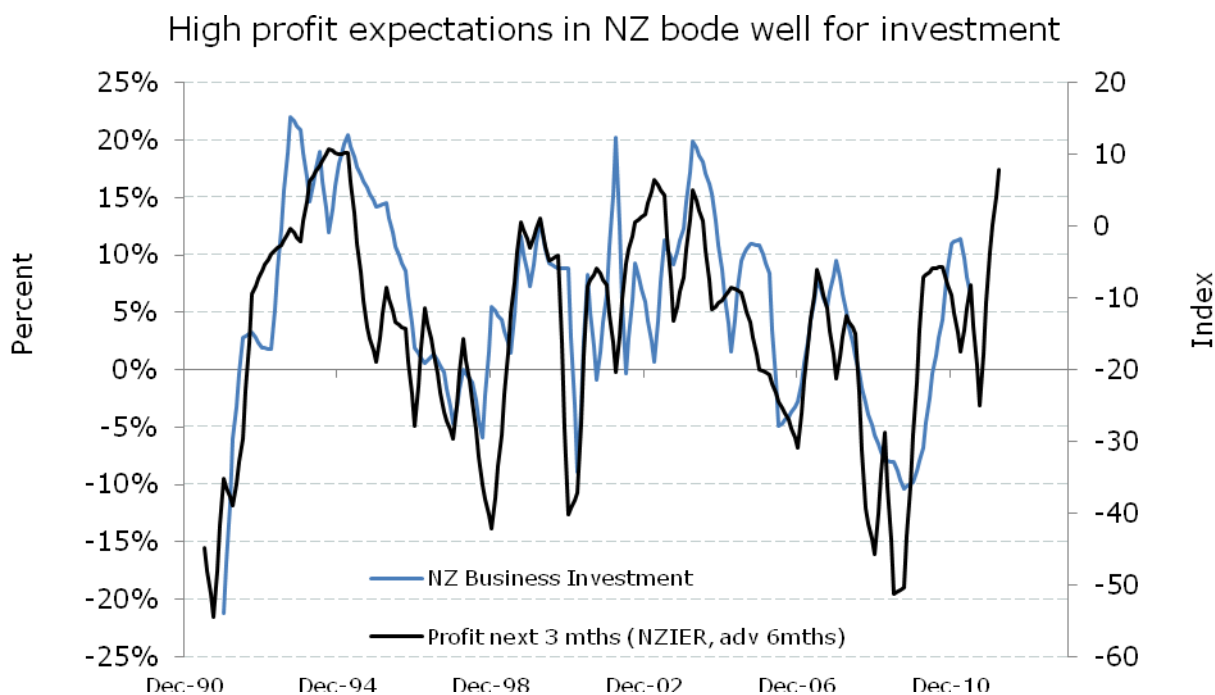


Source: Bloomberg

In New Zealand, some economic data has been slightly softer in December with consumer and business confidence drifting lower. However, house sales lifted 17% yoy and GDP was 1.9% for the 3rd quarter, positively influenced by the Rugby World Cup.

We think that the NZ housing market has now bottomed. Anecdotal evidence continues to point to stronger section sales in Canterbury while the Auckland housing market is lifting.

The December consensus forecasts of economic growth for the New Zealand economy remained relatively stable at 3.0% for 2012. Consistent with this growth outlook, companies remain positive about their profit expectations. This ought to bode well for both investment and employment in 2012.



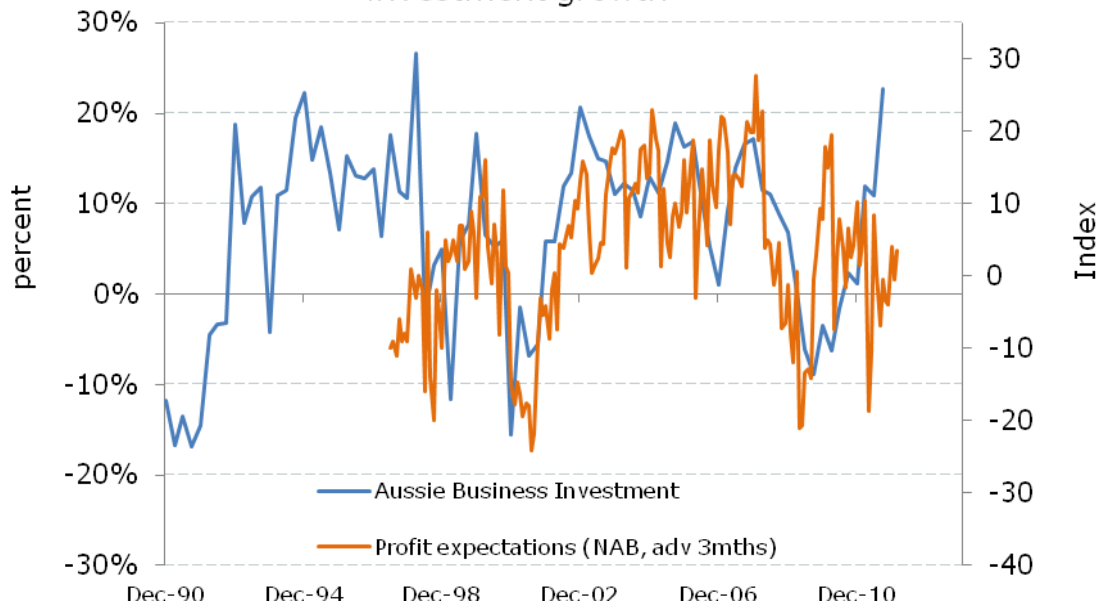
Source: Harbour, Bloomberg

As a result, we are beginning to build a more cyclical bias to the portfolio in New Zealand reducing exposure to the more defensive stocks that have performed strongly. We participated in the TradeMe IPO. TradeMe is expected to record stronger profits next year associated with a lift in property and general merchandise sales. Freightways, Mainfreight and Fletcher Building are also well positioned to have stronger revenues as the economy lifts.

We have also changed the portfolio positioning in the Telco sector where the split of Telecom has provided in our opinion an opportunity to invest in Chorus at an attractive valuation.

Looking across the Tasman, it is clear that the economy has slowed significantly. A further cut in rates by the RBA may assist confidence in 2012. Meanwhile investment associated with the oil, gas and mining sectors continues to prop up aggregate growth. However, unlike New Zealand, overall profit expectations remain subdued. A key issue for 2012 is the potential to begin to lift the cyclical exposure to domestic Australian names as an easing of monetary policy may assist growth expectations. At this stage it is wait and see, and we have sold exposure to the main trading banks and our positioning is mainly focussed on the LNG sector, on healthcare names and in selected growth stocks like Seek, Incitec Pivot and TransPacific Industries.

Profit expectations in Aussie lag behind massive investment growth



Source: Harbour, Bloomberg

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