

# Pedal to the metal

New Zealand Equities Monthly Commentary

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## Commodity prices imply too much easing?

- Yet again global growth indicators have positively surprised economists and markets. The starkest observation was the 60.8 recorded for the US ISM business confidence survey, yet again stronger than any of the 78 economists that forecast the ISM numbers.
- Against a backdrop of generally stronger data, but continuing geopolitical concerns (Egypt), agricultural and metal commodities were significantly stronger. Jet fuel prices also leapt by over 10% in January. Cotton was the star, up 19% in the month, in part affected by the Queensland floods.
- The NZ equity market rose a miserly 0.9%<sup>1</sup>, while the Australian market was basically flat, up 0.2% in Australian dollars (-1.5% in NZ dollars). Global equity markets rallied, led by European markets. The MSCI index was up 1.7% in US dollars in January led by the energy sector, whereas unsurprisingly global airline stocks were weak.
- In New Zealand contrasting fortunes of retailers provided bookends to performance data, with Michael Hill, Pumpkin Patch and Hallenstein's reporting slower sales, but Kathmandu reporting stronger sales. Bathurst Resources (+26%) was our top performing stock, led by strong coking coal prices.
- The portfolio performed in line with the index, as positive material sector influences were offset by positions in defensive healthcare companies and in the Australian market more generally.

| <b>January 2011</b>  | <b>Month</b> | <b>3 months</b> | <b>6 months</b> |
|----------------------|--------------|-----------------|-----------------|
| Portfolio            | 1.52%        | 3.35%           | 12.76%          |
| Benchmark**          | 1.54%        | 2.61%           | 13.26%          |
| Relative Performance | -0.02%       | 0.74%           | -0.50%          |

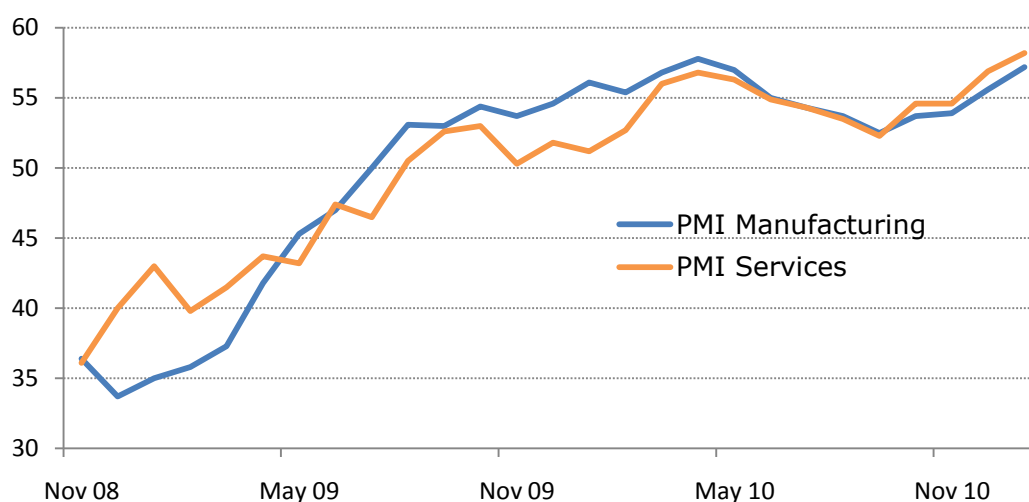
\*\* Benchmark is the Russell / JB Were Tradeable Index including imputation credits. Returns are before fees and taxes. Investor returns may differ.

<sup>1</sup> The NZSE 50 Gross Index rose 0.9% whereas the Russell/JB Were Tradeable Index rose 1.5%

## Strategy – strong growth set to continue but too early to buy consumer stocks

Last month we stated that our strongest conviction view was that Western policy makers are erring on the side of too much stimulus. This has continued to be evident in the economic data for both the US and Europe. Manufacturing and non-manufacturing confidence surveys in the US and Europe have significantly positively surprised.

*Global Business Confidence Continues to Rise*



Source: Bloomberg. JP Morgan data

However, there is very significant concern about employment in Western economies. In the absence of widespread inflation pressures, policy makers are keeping the pedal to the metal<sup>2</sup>. Combined with dramatic climatic events (especially in Queensland), this easy policy is exaggerating the inflation consequences for commodities.

Higher commodity prices for staple foods is exacerbating geopolitical tensions in poor countries (Egypt), and may yet see further policy measures in the emerging markets such as China<sup>3</sup> and India where rising inflation is principally a reflection of food price inflation and previous monetary expansion in the wake of the GFC.

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<sup>2</sup> "With output growth likely to be moderate for awhile and with employers reportedly still reluctant to add to their payrolls, it will be several years before the unemployment rate has returned to a more normal level," Bernanke said today in a speech at the National Press Club in Washington. "Until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established." Bloomberg 4 February 2011

<sup>3</sup> For example China's central government allocated 1.5 billion yuan to support vegetable supplies for key northern cities. Bloomberg February 2011.

## Global Food Prices Have Skyrocketed

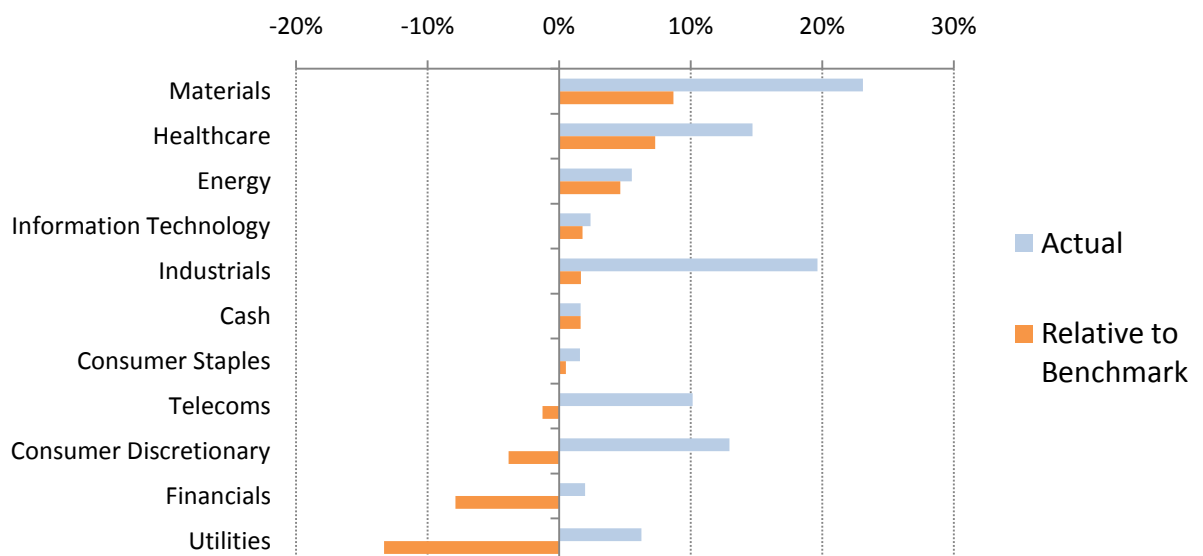


Source: Bloomberg, CRB Index Food

Our broad sector weightings remain in place; however we have continued to elevate energy with further purchases of companies like Santos. In addition by the end of the month we had again added to BHP-Billiton reflecting the prospect of further earnings momentum.

The floods in Queensland have had two direct consequences. First consumer demand is likely to be suppressed, and second rebuilding activity is going to be stronger in the near term than we had expected. Our investment reaction has been to reduce exposure to airlines (they are also likely to be affected by higher fuel costs) and increase exposure to the building sector, we have now shifted back to overweight Fletcher Building.

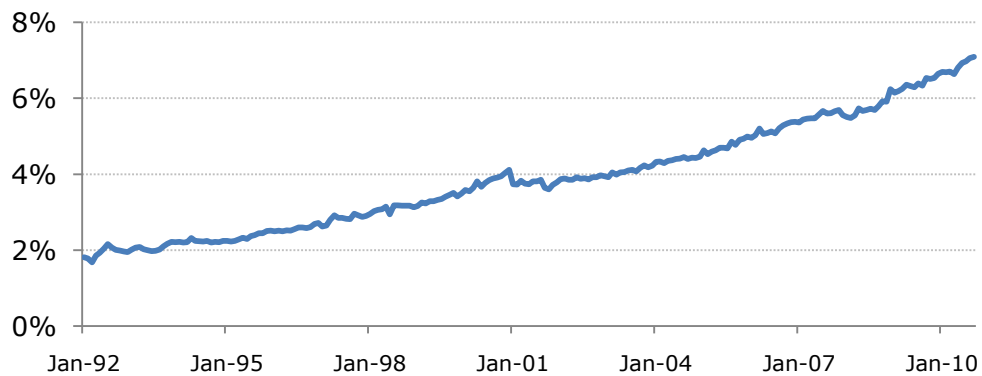
*The Portfolio Remains Heavily Tilted to Resources, Healthcare and Energy*



Source: Harbour. Sector weights are from a representative portfolio, 31 Jan 2011. Note positions may change.

Normally at this stage of the cycle we would consider taking a stronger interest in retail stocks in anticipation of improving employment growth and household incomes. Generally speaking, retail stocks look cheap and have significantly under-performed the market. However, two features are holding back our desire to increase consumer exposures. First, the deleveraging cycle is still very evident in both the macro-economic data and in retail companies' commentary regarding Christmas and New Year trading. Secondly, the ongoing trend toward the internet shopping is lowering margins and reducing foot-traffic.

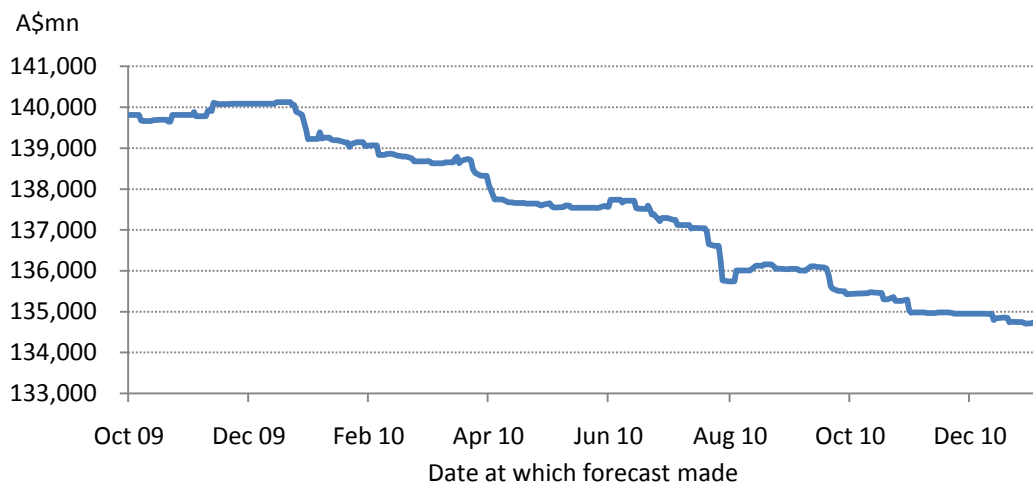
*Electronic Shopping as a % of Retail Sales : US data*



Source: Bloomberg

In addition Australia has been buffeted again by extreme weather that has affected retail spending. The policy response to the Queensland floods, the imposition of a high income earners levy, serves further to dampen the outlook for a recovery in consumer spending. In the past year retail sales forecasts of analysts for the largest Australian retailers have fallen sharply.

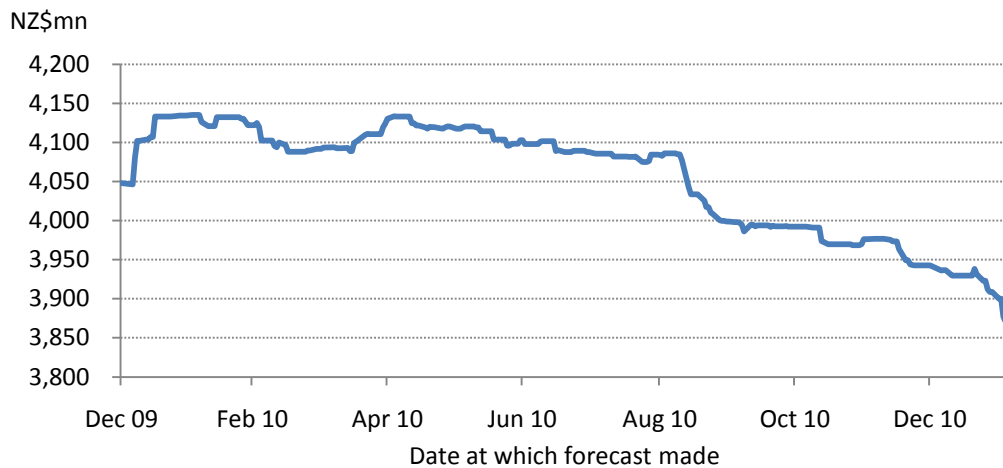
*Retail Sales forecasts for the largest listed Australian retailers*



Source: Bloomberg. Sales expectations for 2012 for WOW, WES, DJS, MTS, MYR

In New Zealand, sales expectations has been sharper since Christmas, which largely reflects the fact that local analysts seem to wait for companies to provide guidance. In part the more recent lower guidance for stocks like Michael Hill, Pumpkin Patch and Hallenstein Glassons reflects the impact of the Queensland floods.

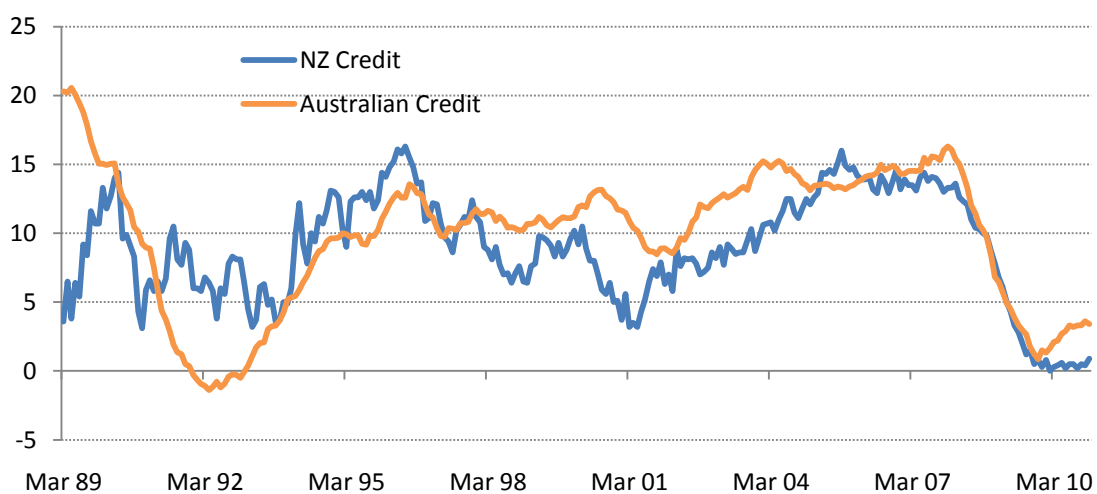
*Retail Sales forecasts for New Zealand listed retailers*



Source: Bloomberg. Sales expectations for 2012 for WHS, BGR, PPL, MHI, RBD, KMD

A key issue for judging the timing of increasing exposure to consumer stocks is the pattern of **consumer deleveraging**. In Australia the household saving rate has recovered to 10% from a consistent negative or low single digit level in the 1997-2008 period. However, credit growth remains weak in Australia, and in New Zealand credit growth is non-existent.

*Credit Growth in Australia and New Zealand is Weak*



Source: Bloomberg

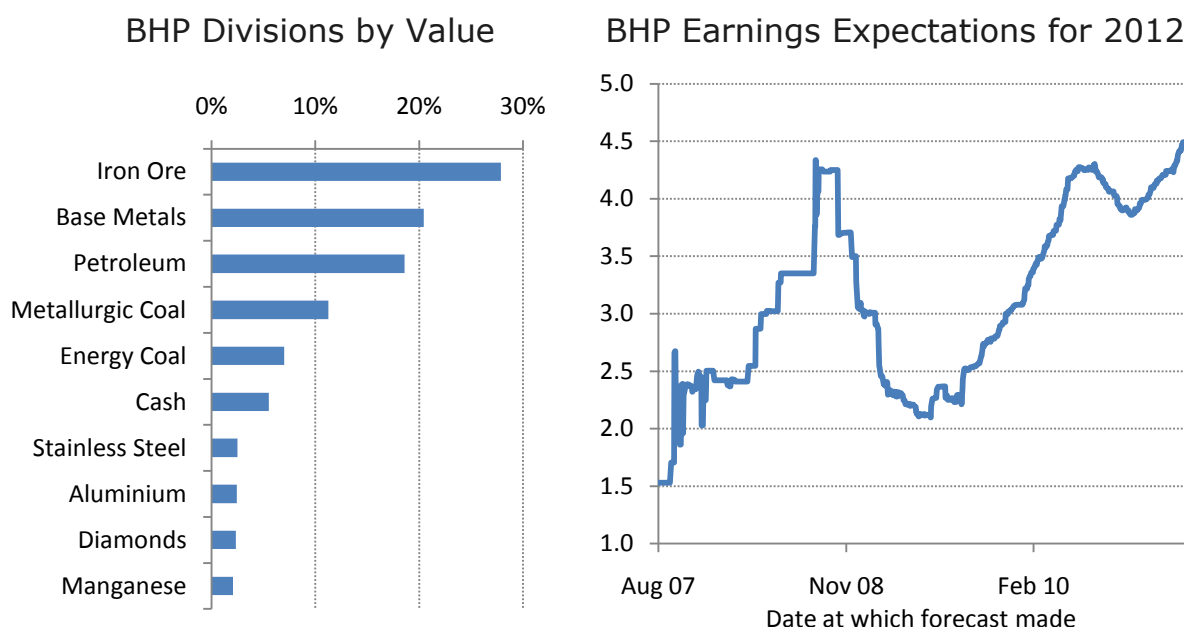
This lack of credit growth is a key reason why banks also lack any earnings momentum at the moment.

## The Portfolio – growth oriented

One of our largest portfolio over-weights is BHP–Billiton (BHP); earnings expectations for BHP continue to rise. With interests in over 100 operations and over 20 countries, BHP is truly diversified.

In the past month BHP has seen 14 analysts revise up their earnings; the consensus now expects BHP to earn more than \$4.50 per share in 2012, which is more than double the expectation of only 18 months ago.

Whilst PE multiples can over simplify valuations, BHP has traded on an average multiple of 11x next year's earnings for most of the past decade. Further upgrades to the \$4.50 earnings expectations may imply upside to BHP's current share price of around \$46. The key opportunities and risks for BHP are associated with iron ore, copper, oil and coal prices, together with the outlook for the Australian dollar.

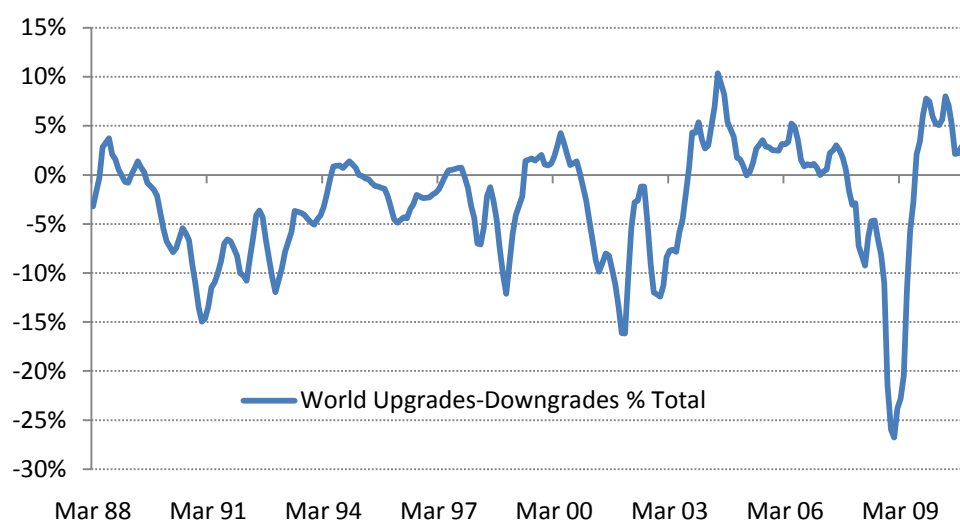


Source: CLSA, Bloomberg Estimates

The earnings of the next nine largest portfolio overweights are all largely driven by the global economy, for instance global packaging company Amcor, New Zealand listed global chemical company Nuplex, energy companies: Oil Search and Santos, and transport companies Mainfreight and Asciano. Not all our exposures are industrials, for instance as we highlighted last month, Seek and NewsCorp are also significantly exposed to the global economy.

This strong portfolio tilt continues to reflect the potential we see for upgrades to earnings in globally facing companies relative to those facing either the New Zealand or Australian domestic economies.

### *Global Earnings Upgrades are Still Positive*



Source: UBS. World upgrades less downgrades as a % of total

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

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