

# Christmas Future?

New Zealand Equities Monthly Commentary

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## A month marked by the Pike River disaster

- Markets lost ground in November. The NZX gross index fell 1.1%, the same as the Australian market in Australian dollars. Global markets initially rallied strongly as Ben Bernanke provided markets with the details of round two of quantitative easing. However, as Ireland sought a bailout and China tightened reserve requirements, markets became slightly more risk averse. Global equities ended the month down 1.7% in US dollars.
- The market performance came after two months of strong equity returns, so some pause may have been warranted. Generally speaking global cyclical stocks did better than more defensive sectors, reflecting stronger economic data (especially US payrolls and business confidence). Bond yields rose on the stronger data.
- A key surprise in the month was the Reserve Bank of Australia raising rates by 0.25% to 4.75%. Economic data for Australia was mixed, with comments at AGMs also generally more subdued than expectations. Corporate activity continued with the AMP-AXA merger looking likely, and Shell selling a large stake in Woodside Petroleum.
- In New Zealand, markets were over-shadowed by the tragic Pike River Mine disaster that focussed the country on the West Coast with hope turning to a tragic ending. Unsurprisingly, New Zealand Oil and Gas was the worst performer in the month falling 28% as investors effectively valued Pike River at close to zero.<sup>1</sup> Telecom was the top performing stock in November rising 8% as investors weighed the potential risks/returns associated with the Ultra-Fast Broadband rollout.
- The portfolio underperformed for the month as a rights issue for Wellington Drive on the last day of the month impacted negatively on the portfolio.<sup>2</sup>

<b>November 2010</b>	<b>Month</b>	<b>3 months</b>	<b>6 months</b>
Portfolio	(1.28%)	7.13%	7.60%
Benchmark**	(0.53%)	9.10%	9.12%
Relative Performance	(0.75%)	(1.97%)	(1.52%)

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

<sup>1</sup> Pike River Coal has remained in trading halt at 0.88.

<sup>2</sup> The portfolio impact was almost -0.3% from this announcement.

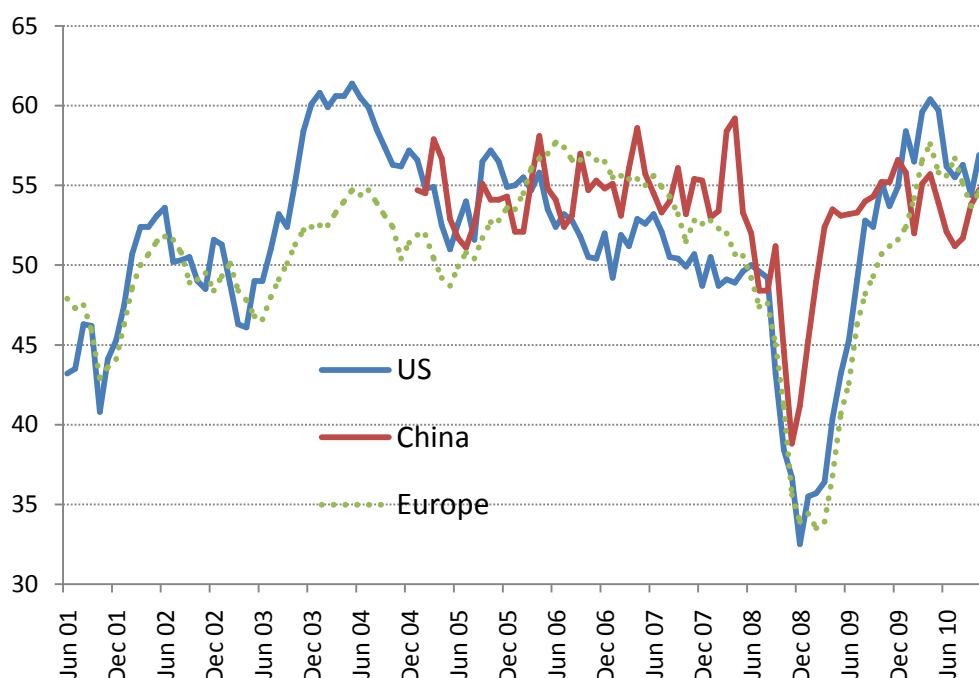
## Strategy – Growth levers still engaged

Stronger than expected macro-economic data continues to result in cyclical sectors generally out-performing defensive sectors. However, the degree of resource out-performance has recently been tempered by geopolitical concerns in Ireland and the Korean peninsula.

Closer to home, market sentiment was also dampened by the Reserve Bank of Australia's interest rate rise. Sentiment in New Zealand was impacted by the Standard and Poors move to a negative credit watch, and the Pike River mine disaster.

We continue to think that global growth will be strong in 2011. Recent data has tended to support this view. The US is delivering stronger economic data. 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 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.

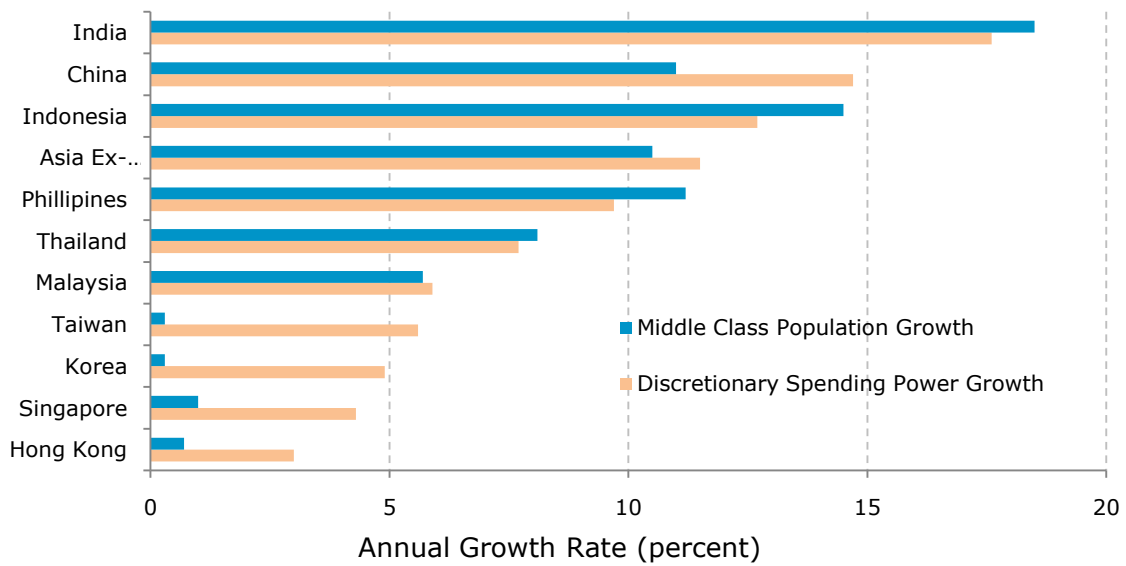
*Figure 1: Global Business Confidence is at strong levels*



Source: Bloomberg. PMIs

As we look to 2011, we consider medium term themes and sector influences. The core view is that consumption in developing countries is a key source of global growth.

*Figure 2: The Growth Rate of the Middle Class and its Spending*



Source: Harbour Asset Management, CLSA, See Disclaimer

The cyclical recovery in developed countries will be held back by the availability of credit and consumer appetite for debt. In the US and Europe yield curves are likely to stay steeply sloped. We think equities as an asset class are attractively priced, especially relative to cash and bonds. There is an increasing risk that these views are closer to those of the consensus and we are considering the “next” major risk. One risk is that inflation in developing countries spreads globally. Another risk is that growth in New Zealand is stronger than expected.

In New Zealand markets may be specifically influenced by cash flows stemming from Earthquake reconstruction and the Rugby World Cup. Recent abnormal dry weather conditions may dampen key agricultural production.

As global corporate cash levels remain high, we think Merger and Acquisition activity will rise, but picking stocks on this basis is difficult. We think a clearer outcome from high cash levels is that the investment cycle improves. Plant and machinery orders continue to rise, and there are tentative signs of stronger advertising and employment data. Regulatory reviews, specifically relating to Telecom, and in Australia the banking sector, may have also have large impacts on equity prices.

## Portfolio Considerations

As we look forward to 2011 we still expect positive earnings momentum for resource, energy and many industrial stocks. Stocks in these sectors are also generally in our opinion valued attractively relative to the market, reflecting a widespread concern over global growth prospects. However, for some commodities, price movements may have moved ahead of the economic cycle and structural influences. As a result we have recently concentrated the portfolio in larger stocks, for example, BHP-Billiton and Oil Search, while at the same time reducing and selling specific iron ore and copper exposures.

Our strong view on the investment, advertising and employment cycle has also led to overweight positions in the transport and media sectors in stocks like Newscorp, Mainfreight, Sky Network TV, Seek, and more recently investment in Air New Zealand and Qantas.

We are balancing these pro-cyclical positions with investments in healthcare stocks such as Ryman Healthcare, Fisher & Paykel Healthcare, CSL Limited and Ansell. The last three of these stocks all face an uphill battle with the weak US dollar, however all these stocks have strong underlying profit growth and their valuations do not look demanding.

A key issue for portfolio construction has been our zero weighting to financials, particularly banks. We retain today no weighting in the major banks as we think there is still downside risk to analyst forecasts of credit growth and the regulatory overhang is uncertain. However, financials have underperformed significantly and we are monitoring closely this position. In November we moved to reduce partly the very large sector underweight by buying AMP Limited after the merger announcement. We think the negative market reaction to the announced AXA-AMP merger is rather technical and does not reflect the expected earnings lift.

The developing world recovery is predictable and portfolio exposures are generally based on underappreciated earnings growth.

However, the developed world recovery is more fragile and patchy. As a result our exposures in New Zealand and Australia largely reflect the potential for earnings upgrades and our analyst conviction in specific investment opportunities. We continue to maintain a diversified portfolio which balances the world's strong demand for resources with the potential for a recovery in late cycle sectors.

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