

On the upgrade cycle

New Zealand Equities Commentary

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Growth outlook remains strong

- NZ equities rose 4.7% in Octoberⁱ. October saw equity markets push on from the gains made in September with the majority of global equity markets finishing the month higher. The start of domestic AGMs, combined with a strong US reporting season, provided the main news flow for investors. The prospect of the US Federal Reserve recommencing a second round of quantitative easing (QE2) and its implications for various asset classes was also a focus. The Australian market (ASX200) finished the month up +1.7% in Australian dollars.
- Stronger commodity prices remained a feature during October, while China surprised investors with a 25bp rate hike before reporting strong macro data (GDP +9.6%; and a strong PMI).
- M&A activity continued to feature globally. In Australia, the Singapore Stock Exchange bid for ASX and Perpetual announced that KKR had made an approach.
- We believe investors are still cautious, unsure of the implications of US Fed policy, of tightening measures in China, and of exchange rate volatility. Meanwhile, earnings growth looks solid. This means that our Australasian portfolio tilts still favour pockets of the market which are direct beneficiaries of true sources of economic growth – secular growth in Asia and healthcare. We continue to have low exposure to consumers and discretionary spending in developed economies, although we have lifted our exposure to the media and airline sectors.
- In October the Harbour High Growth Australasian Fund returned 3.8% before tax and fees compared to the benchmark performance of 4.3%.

<i>Performance to Oct 2010</i>	<i>Month</i>	<i>3 months</i>
Portfolio	3.8%	9.1%
Benchmark**	4.3%	10.4%
Relative Performance	(0.5%)	(1.3)%

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

Strategy

The past month continued to develop a macro- environment that is consistent with our sector preferences. For instance, US data has been stronger, Chinese growth robust and, commodity prices strong.

Why, given our growth bias, has the portfolio only performed broadly in-line with the index in recent months?

In part investors are also attracted to yield stocks at the moment. As a result, high dividend yield stocks like Vector and some property stocks continue to do well, despite not having exposure to strong earnings upgrades. This two speed market is also “leaving behind” higher quality export stocks that have experienced some earnings downgrades directly in response to strong Australian and New Zealand dollars.

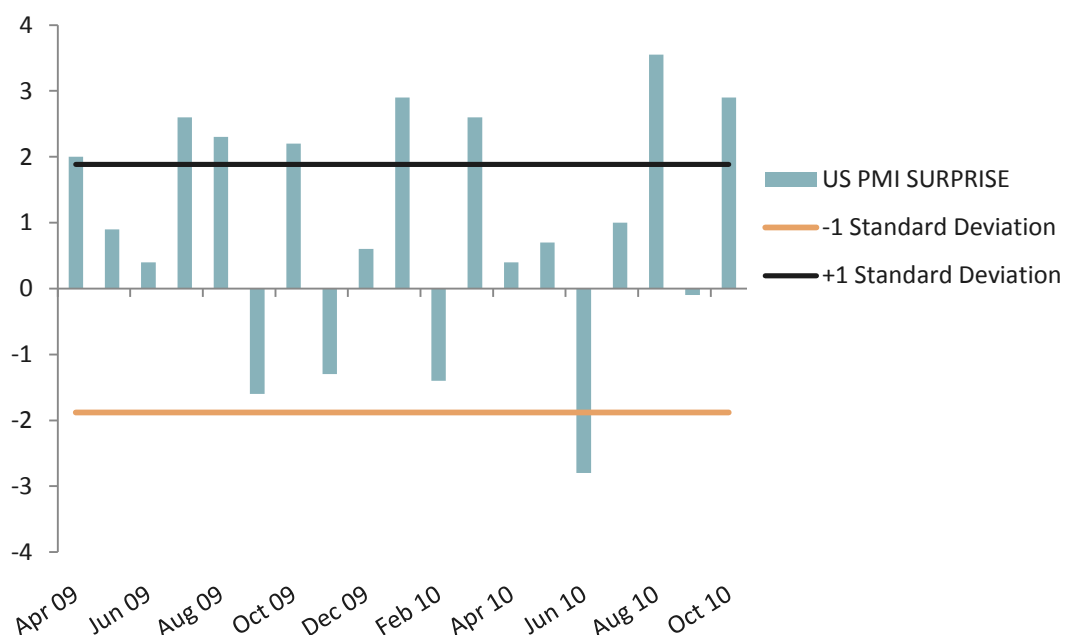
We think that investors chasing yield alone risk exposing their portfolios to a growth shock. Instead our portfolio has tilts to pockets of the market which are direct beneficiaries of true sources of economic growth – secular growth in Asia and healthcare. We continue to have low exposure to consumers and discretionary spending in developed economies.

However, we have lifted exposure to the media and advertising sector with a new position in West Australian News, and further investment in Seek.com, reflecting gradual strengthening in the underlying Australian economy.

Global Developments

The US ISM (PMI) index jumped from 54.4 in September to 56.9 in October, its strongest level since April 2010. The index was higher than any of the predictions of 72 economists and represented the seventh statistically significant positive surprise in this recovery.

Figure 1 US PMI – Continued Positive Surprises



It is worth noting that a surge in the US new orders sub-index, from 51.1 to 58.9, drove the increase with export orders jumping from 54.5 to 60.5 and production jumping from 56.5 to 62.7.

This is a stronger result than the market expected, beating the consensus forecast for a headline result of 54.0. The number suggests a quickening pace of manufacturing growth from strong rest-of-world demand in the final months of 2010. In fact, the US ISM follows an unexpected rise in the UK manufacturing PMI on its latest reading, and an unseasonably strong result for the China manufacturing PMI. These data points highlight the reflationary effects of very low global interest rates and a weaker US\$.

On top of this strong US ISM, the US reporting season (80% complete) again exceeded expectations, with aggregate earnings 5.6% above expectations.ⁱⁱ

The market had been concerned that a tightening of policy in China would impact on global growth. Instead, we think that China's moves promote a more durable recovery with a further pre-emptive strike at inflation. In fact one of our key concerns both from an economic and social perspective is the latest Chinese PMI inflation component that surged by nearly 20 points over the last three months (from 50.4 in July to 69.9 in October). In October, the sharpest increases in the purchase prices are seen in sectors such as cement, timber, metals, and apparel.

In addition, the spot price of cotton in China rose 18% in October. This list of sectors matches very nicely with the list of sectors that are reporting the biggest increases in the new orders sub-index. It is possible that the main driver for the Chinese new orders increase (and therefore production increase) is related to price increases. When prices rise, they boost expectations for inflation, and thus both traders and end-users will tend to buy more aggressively.

Watch this space carefully. Deutschebank warn that "news from the Guangdong Trade Fair also suggest that the volume growth of export orders is weak, though many exporters are raising selling prices due to the cost pressure."ⁱⁱⁱ This in our view is further evidence of the seismic shift in the lowering of living standards in the developed world. A repeat of the 1970s, except this time the winners are the emerging markets and those with a broader range of resources.

Outlook

The global cycle is moving on, supported by Western Central Banks and by emerging market demand. We continue to believe that global growth will be good in 2011, and that we will see more demand for raw materials, including the agricultural goods. Further quantitative easing in our view may promote sectors where supply constraints are evident. We see soft commodity demand as part of the new story and we are seeking exposure where relevant. (For instance we invested in Delegats in the month.)

Abundant liquidity at a time when investors are shunning property as a store of wealth is an unusual cycle. It is also unusual that credit growth in the Western world, (Australia and New Zealand included), remains so low.

As global markets remain pre-occupied with QE2, we think that equity markets grind out further gains as earnings positively surprise, merger and acquisition activity lifts and companies slowly spend more on advertising, plant and equipment investment and eventually employment.

Across Australasia resource stocks probably do more “heavy lifting”, although the sector does look over-bought. We think, despite the best efforts of Central Banks either bond yields rise or the US dollar slips more. The new pattern for New Zealand is that we think that soft commodities begin to lift –sugar, cotton and wool prices have lifted strongly. (Cotton prices reached the highest levels since the U.S. Civil War in the 1860s, and sugar prices neared previous record highs). Perhaps with grain prices rising, we will see another lift in milk powder prices.

We are about 14% overweight resource exposures – down from a peak of 17% overweight as we have taken profit on copper and some other non-bulk exposures. Some of the resulting cash has been invested in the media sector, while more controversially we have also initiated an investment in Qantas, reflecting our view of potential earnings upgrades and our expectation that the stronger AUD will be positive for QANTAS’s earnings.

In addition in the month we added to our hedge from AUD to NZD reflecting a likely longer term view that we are nearing a broad bottom for the cross rate based on relative terms of trade and relative growth trends.

PS At the time of writing the US Federal Reserve as confirmed US \$600bn of Treasuries until the mid 2011 together with maturing Treasuries, implying a \$850-\$900bn repurchase programme. This appears more aggressive than consensus estimates.

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ⁱ The NZX 50 Gross Index rose 4.0% whilst the Russell/JB Were Tradeable Index (including imputation credits) returned 4.3%.

ⁱⁱ Source : Macquarie Bank

ⁱⁱⁱ Deutschebank 2 November Sales note from Jun Ma