

Waves of pessimism and optimism, and still no road map

Australasian Equities Monthly Commentary

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Markets are swinging from focusing on significant downgrades to European growth expectations and the prospect of financial contagion from European debt stress to hope that a road map for Europe will be 'published' in coming months.

The broad picture hasn't changed. Europe and the US have too much debt, and China is managing a transition towards urbanisation and raising domestic consumption.

The stakes are high as, despite the talk, Euro problems remain unsolved with a very real risk of civil unrest, and the prospect of a prolonged recession remains a real consideration. In addition, there are signs that Chinese property sales are lagging construction and that country's inflation battle has yet to be won.

In New Zealand, delays to Christchurch rebuild may be postponing recovery. We need hard data pointing to an employment recovery. The recent stronger building consent numbers are a good start.

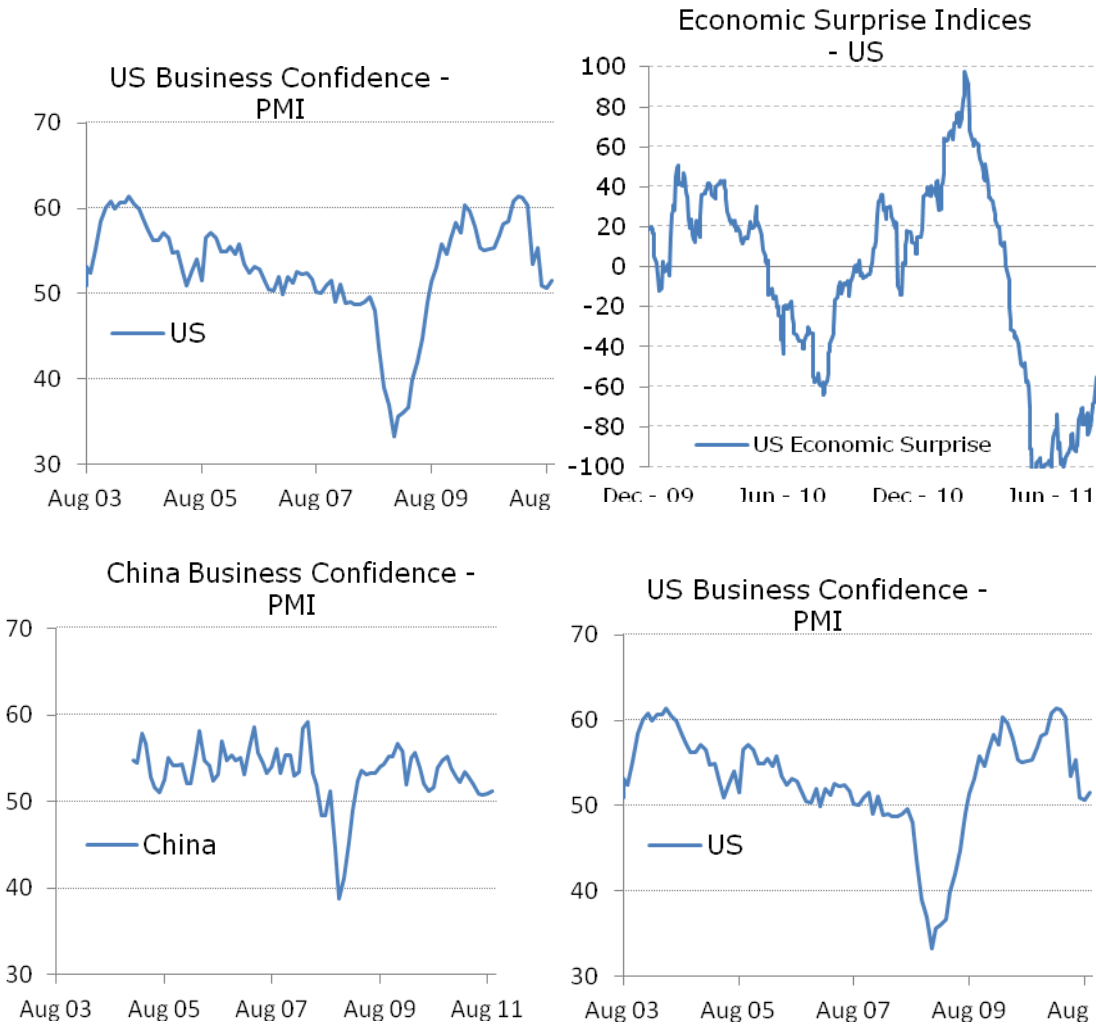
Meanwhile, Australia's battle with a hot resources sector and a weak domestic sector carries both economic and political risks – and probably further earnings downgrades for retail, media and other domestic sectors.

However, while the world is focused on the negatives, we see several potential circuit breakers and positive events in the next quarter:

- New Zealand economic data continues to improve as leading indicators of growth spread into actual employment
- Australia may cut interest rates as inflation pressures ease
- US employment growth stabilises at above 100,000 a month, supporting consumption
- Markets start to focus on more positive economic data in the US and China and leading business confidence indicators consolidate at levels above 50
- A broad based Euro deal is reached which sees bank recapitalisation, economic pain for the peripherals and a lessening of panic valuations in credit and equity markets
- China stops tightening monetary policy as inflation pressures ease

As we look into the final quarter, it is obvious that how things evolve in Europe will continue to shape markets. Our recently published note, 'Europe on the Brink', canvases the issues and contends that we should expect bouts of optimism and pessimism, and yet further downgrades to the meagre growth expectations in Europe.

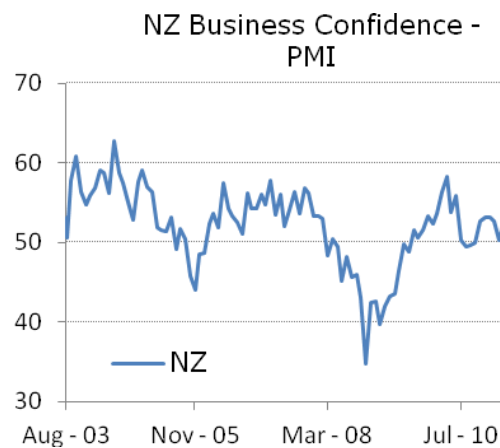
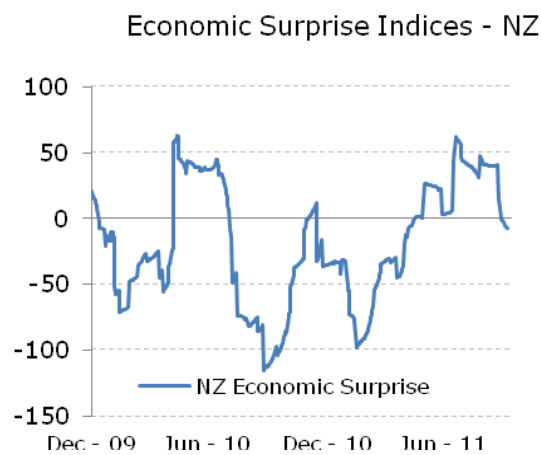
Secondly, we will be watching the hard economic data, especially relative to expectations. In the last month investors have generally distanced themselves from economic data and company announcements and as a result in our opinion investment opportunities may present themselves. In particular, at a macro level, both US and Chinese manufacturing surveys have been stronger than expected, and **yet according to Bloomberg 43% of investors expect a global recession in the next year**. This seems too pessimistic to our assessment of the data.



Source: Bloomberg

In New Zealand, the data is also very important as we begin to see some evidence of the impact of low interest rates and the Christchurch rebuild on building consents. Residential building consents were up 12.5% in August and we expect further momentum in coming months.

However, anecdotes stemming from the Rugby World Cup period suggest that retail demand has been patchy. Recent earnings downgrades from Fletcher Building, Cavalier and Methven – whilst Australian centric – back the view that New Zealand growth expectations may be pulling back.



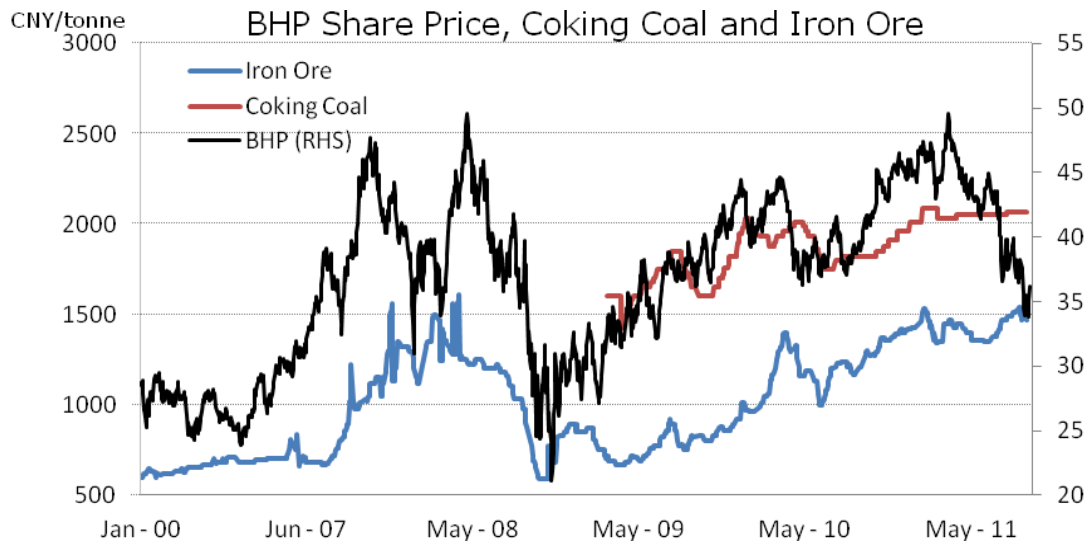
Source: Bloomberg

Another key influence on returns will be the path of commodity prices, and correlated investments like the Australian and Kiwi dollars. Australian resource and energy companies will be highly influenced by both global growth prospects and, specifically, Chinese economic data. There are plenty of very bearish commentators about China's prospects at the moment and the consensus for GDP forecasts for China for 2012 and 2013 has edged down towards 8%.

Investors seem principally concerned with the Chinese property sector and tight monetary policy settings. While residential property investment is up 36% this year, housing starts are up 23% - signalling continued expansion into 2012. At the same time, Chinese house sales may be falling behind - only up 17%, and a stock of unsold housing may be developing. This is certainly worth monitoring closely.

Yet Chinese growth is not all centred on property investment. Chinese consumers are still spending. Real incomes were up 7% in the first half of 2011. This has supported a 17% increase in retail sales. Rural net income has also been strong, up nearly 14% in the same time period, supporting growth in the, so called, tier 3 cities.

This growth in China has come at time when monetary policy has tightened to stem inflation pressures. Recent government announcements appear to be preparing the way for a cessation of interest rate hikes.



Source: Bloomberg

What does this mean for Chinese commodity demand? In our view, volume growth will remain strong. Recent comments from BHP, Rio Tinto and smaller Australian producers show steady demand for iron ore and coking coal. As an aside, we recently met with senior managers of a large Chinese steel company, and clearly their demand at the moment for high quality coking coal and iron ore has not diminished. This seems borne out in imports and prices with both iron ore and coking coal remaining at elevated levels.



Source: Bloomberg

However, resource company share prices appear more correlated with bouts of pessimism and optimism with respect to European developments.

Finally, it is clear that to be underweight domestic Australian companies is consistent with the consensus view. For most of the last 6 months, we have not owned an Australian bank, retailer or media company, and whilst these have been good 'calls' it is possibly time to take a fresh look. Part of Australia's problem has been a tight monetary policy. The recent fall in the Australian dollar and talk of an interest rate cut are positive developments at a time when the market is very short cyclical exposures.

In our portfolio, we have tentatively begun to buy small positions in the bank sector. While there is a lot of pessimism with respect to the outlook, we intend to maintain a diversified Australasian portfolio with a bias towards getting back into the Australian market for new opportunities.

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