

Awash With Cash

New Zealand Equities Commentary

September 2010 | andrew@harbourasset.co.nz +64 4 460 8302

Positioned for Growth Surprises

- NZ equities rose 5.2% in September¹. Australian and Global equity markets were up in local terms posting returns of 4.6% and 9.3%, respectively. However, volatile currencies led to unhedged Australian equities returning +8.1% and unhedged global equities 4.1% in NZ dollar terms.
- Our Australasian portfolio tilts have favoured pockets of the market which are direct beneficiaries of true sources of economic growth – secular growth in Asia and healthcare. We have avoided those areas exposed to consumers and discretionary spending in developed economies. In that regard we had significantly reduced exposure to the building sector, therefore the positive market response of building stocks to the earthquake in Canterbury impaired portfolio performance as a result of our decision to under-weight this sector.
- The Australasian economies are currently characterised by strong and buoyant externally facing sectors – mining, oil and gas, dairy, meat, lumber and to lesser extent manufacturing. Domestically facing sectors are weaker – consumer, retail, housing and, in the shift towards fiscal austerity, the government sector. The data supporting this thematic is vast including; strong terms of trade, better export sales than retail sales, weaker housing credit growth and home sales, good employment in export related sectors but poor employment in domestically oriented industries.
- Another key pervasive theme is the large and growing cash surplus building up, particularly in corporate balance sheets. Over time we expect to see higher dividends, stronger investment and merger and acquisition activity.

In September the Harbour High Growth Australasian Fund returned 4.6% before tax and fees compared to the benchmark performance of 5.2%.

Performance to Sept 2010	<i>Month</i>	<i>3 months</i>
Portfolio	4.6%	8.0%
Benchmark**	5.2%	7.5%
Relative Performance	(0.6%)	0.5%

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

¹ The NZX 50 Gross Index rose 5.0% whilst the Russell/JB Were Tradeable Index (including imputation credits) returned 5.2%.

Strategy

Globally, share repurchase plans are increasing, the value of dividend payments is rising and the number of merger and acquisition deals has lifted sharply. In New Zealand a recent resource sector capital raising was reported as 4 times oversubscribed.

Copper, gold, and soft commodity prices have risen sharply, and many Asian equity markets have sprung to life.

Global manufacturing confidence indices are still consistent with 4% global GDP growth.

However, this data is significantly at odds with a fall in bond yields in the past quarter², and a sharp decline in interest rate expectations in Australia and New Zealand.

We do however take some comfort with both profit and equity market momentum. The out-performance of stocks in September has also reflected the more immediate easing of anxieties about the potential for a double dip recession. We think anxieties were exaggerated by fears over contagion from European debt concerns, and probably more relevant, concerns over policy tightening in China. Although we expect a further fall in expectations of US growth, European growth may rise somewhat and emerging market growth remains strong.

As a result the portfolio retains a strong bias to resource and industrial stocks and is funding these positions from large under weights in financials and utilities.

In the past month markets have responded positively to the pro-growth stance of the US Fed³, and more recently the Bank of Japan. Central bank concerns about the tail risks of deflation have encouraged the potential for new quantitative easing measures.

Against this background the past two quarters have seen the unusual out-performance of both material stocks (resources) and Telcos (usually seen as defensive). In fact in the September quarter US telco stocks were the best performing sector (up 21%), closely followed by the materials sector (+18%). Financials still lagged – up only 4%.

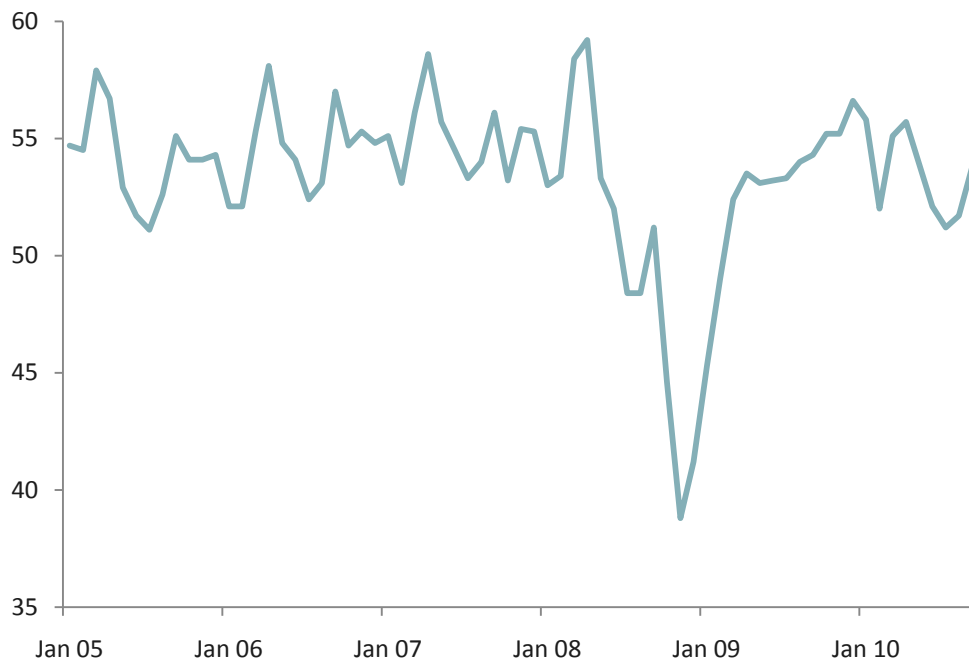
Perhaps we remain too sanguine about the risks of a double dip recession in the US and the risks of deflation; however it seems to us that despite strong returns in September, markets are still a) “sitting” on a lot of cash and b) are not yet reacting to the very high levels of corporate cash which is yet to be “spent”.

And whilst markets may have started to react to improving Chinese data, we think that global data will continue to support demand for resource and materials companies. We note that many resource companies are now sitting on net cash positions in their balance sheets and we would anticipate a combination of increased M&A activity, higher dividends and increased investment.

² US 10 yr bond yields fell almost 50 basis points in the September quarter

³ The Fed changed their policy statement to “is prepared to provide additional accommodation if needed to support the economic recovery” on 21 September.

Figure 2 **Chinese PMI, Stronger again**



Source: Bloomberg

What could derail our positive view of equities?

- Clearly markets are becoming focussed on protectionism. Poor polling data for the US Democrats may put pressure on US politicians to seek policies that strengthen domestic employment.
- Competitive devaluations are also a concern especially if the US, the UK and Japan embark on further quantitative easing. Already the Australian and New Zealand dollars, the Brazilian Real and the Chinese Yuan are under significant upward pressure.
- A further down-turn in US house prices may also be a risk. Recent data in the US housing sector has been weaker than expected, and consumer confidence has also pulled back. We suspect that US growth revisions will be negative in the next few months as the consensus for 2.4% growth in 2011 is certainly higher than that implied by some partial data. However, a pull back to a 2% or a 1.5% growth rate would not of itself derail our positive equity view.
- Perhaps the greatest risk is that the global economy is actually much stronger than policy makers think, and that the next bout of quantitative easing feeds an already growing global credit cycle (and creates a bubble of sorts in commodity prices) that leads to much higher inflation than markets are pricing today.

Turning to local events, in the past month we visited a lot of companies in New Zealand and Australia. Our general view is that the Australian and New Zealand economies are gaining momentum principally through net exports. The consumer in both countries is lowering debt; as a result consumer confidence remains subdued. Having said that, there are differences; the Australian labour market is stronger than New Zealand – in Australia wages are growing and employment is rising by about 30k a month. Despite this we were somewhat surprised by the Reserve Bank of Australia's decision to pause for longer, and the fact that they highlighted global uncertainty in financial conditions as a reason for pausing, despite accumulating evidence in China (and commodity prices) that growth has firmed.

In New Zealand, the month was overshadowed by the Canterbury earthquake. Our investment strategist was in Christchurch that morning and over the following days experienced first-hand the damage and the anxiety of after-shocks. It is hard to gauge the timing of rebuilding and the impact on growth. New Zealand appears fortunate in that global reinsurers and the likely liquidation of the Earthquake and War Damages Commission's global equity portfolio will foot most of the "bill". This may place some upward pressure on the exchange rate.

However, the lags in settling claims, in determining land protocols and rebuilding are uncertain and likely to be lengthy. Therefore the implications for growth are also uncertain. Analysts have broadly estimated that spread out over the next 3 years Fletcher Building might see between \$50mn - \$100mn of additional EBIT, but even these estimates assume a status quo with Government projects elsewhere in the country. This may add around \$0.15 a share to analyst valuations for Fletcher Building; as a result we were somewhat surprised with the reaction of the market⁴.

In other corporate news, GPG announced the appointment of 4 new independent directors and a strategic review. Fisher and Paykel Appliances announced a new compressor motor and an agreement with Embraco and both Wellington Drive and new resources company, Bathurst, had capital raisings.

Our investment strategy remains focussed on over-weights in the materials, healthcare and industrial sectors. Our only consumer discretionary positions are in the media sector – which we tend to view are more aligned with the business investment cycle. In the month we added Seek to the portfolio reflecting ongoing strength in the Australian labour market and also the better performances from emerging markets such as Brazil and China where Seek has a large and rapidly growing business.

⁴ Fletcher Building shares rose \$1.00 in the fortnight after the quake, but have since halved that gain.

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