

## Outlook for Investment Markets

Growth assets prospered in the three months to early November, but weakened more recently. The rise was based on increasingly solid evidence of ongoing global economic growth, while the relapse came about because of second thoughts about risks to the recovery. The most likely outcome is for continuing recovery, overlaid with recurrent episodes of investor uncertainty. Fixed interest markets, after dropping to ever lower yields, appear to have reversed course en route towards more sensible levels.

## Australasian Equities

The New Zealand and Australian sharemarkets have both followed global trends recently, the NZX50 and S&P/ASX200 Accumulation Indices rising in September and October and peaking in early November before succumbing to weakness. Both indices were as a result down slightly for the past month (New Zealand only marginally, Australia down 1.10 percent), but both showed gains for the past quarter (7.90 percent for New Zealand shares, the Australian market 2.70 percent in \$A terms, and much the same in \$NZ terms). The major corporate event was the successful float of 66.0 percent of Queensland government-owned rail operator QR National, which listed at a small premium.

The outlook for the New Zealand economy is good, although not earth-shattering. Respondents in the Reserve Bank of New Zealand's most recent quarterly survey of business expectations anticipated GDP growth of 2.50 percent in a year's time, and 2.70 percent in two years, a modest pickup from the 1.90 percent growth actually recorded in the June 2010 year. They also expected unemployment to drop to six percent in a year's time and 5.60 percent in two years' time, down from today's 6.40 percent.

The outlook for the Australian economy is stronger. The government's Mid-Year Economic and Fiscal Outlook forecast is for growth of 3.25 percent in the current 2010/11 financial year, rising to 3.75 percent the following year, and leading to a steadily falling unemployment rate. (Unemployment is forecast to be 4.75 percent by June 2011 and 4.50 percent by June 2012.) The government's books are also in much better shape than many other developed economies, the economy expected to be in surplus as early as 2012/13. Other public and private sector forecasters have similar upbeat views. The Reserve Bank, for example, is expecting growth of 3.50 percent this year and 3.75 percent in 2011/12, high world commodity prices, very strong investment in the resources sector, and ongoing population growth the important factors behind this.

As always, there are some risks and uncertainties in both countries: monetary conditions in Australia have tightened due to the combination of a much stronger \$A and higher interest rates, the combined effect showing up in surveys of business and consumer confidence, which have eased back. The same is true in New Zealand, where despite high export prices, there is "continued household caution... and many firms have become less optimistic about their future prospects" (in the RBNZ's words). That said, the big picture on both sides of the Tasman remains encouraging, although more so in Australia: profit expectations in the latest Dun & Bradstreet survey were at a seven-year high, for instance. (Profit expectations in New Zealand, while picking up in the latest National Bank surveys, are not as gung-ho.) Strong profits make for good sharemarket performance, although the immediate cyclical outlook favours Australian companies.

## International Equities

The MSCI World Index of international shares was up 2.40 percent over the past month, although this does not reveal much of the underlying changes in sentiment. World shares rose strongly in September, October, and into early November (peaking on 5 November), but have been weaker more recently.

## International Equities (contd...)

World shares were up 9.40 percent over the past quarter, although some of that gain was clawed back by the overall strength of the \$NZ. Most major markets followed this overall pattern of two good months followed by patchiness, although there were some exceptions – the German market was strong throughout (the DAX was up 5.40 percent for the month, and 12.60 percent for the quarter), reflecting its relatively strong economy by Eurozone standards. The Japanese market, which had been very weak (sub-9000 on the Nikkei Index in late August), has also kept performing in recent weeks, cracking 10,000 on 18 November. The emerging markets also had a good month (up five percent) and quarter (+9.20 percent).

The initial strength but subsequent weakness of world shares reflects two factors. The strength came from evidence that the US economy is gradually recovering. The official statistics showed that GDP grew at a two percent annual rate in the September quarter, current consensus forecasts expect that it will grow at about a 2.50 percent annual rate through to the end of 2011, and recent surveys showing strong levels of new orders are also encouraging. Most importantly, latest US jobs numbers sprang a pleasant surprise, with 161,000 new jobs in October, 159,000 of them in the private sector, which has now generated 1.1 million jobs for the year to date.

Offsetting this good news, however, have been a clutch of more awkward issues: the Fed's 'QE2' decision, so-called 'currency wars', Eurozone debt difficulties, and Chinese inflation. QE2 was good news in one sense, by providing liquidity to the banking system and aiming to keep long-term interest rates low, but bad news in the sense that the Fed read the US economy as weak enough to need further monetary support. The currency wars were outright bad news – governments at outright economic cross-purposes are not helpful for the global economy.

Ireland's debt difficulties, although assisted by the announcement of a joint bailout by the European Union and the International Monetary Fund, have not prevented worries about further financial turmoil in other peripheral Eurozone countries. And news that Chinese inflation had hit 4.40 percent in October resurrected worries that tighter monetary policies could imperil what has been one of the bigger props to the world economy, China's very rapid growth (9.60 percent in the year to September). The Chinese sharemarket did not enthuse: the Shanghai Composite Index has dropped 11.0 percent since its recent high point on 8 November.

All of this sends mixed signals about the outlook for world shares. The central scenario must still be one of continuing economic recovery. Consensus forecasts for virtually every economy of note show growth in 2011 (with the exceptions of Greece, Ireland, Portugal, and the oddball Venezuela), and latest OECD forecasts are for growth to carry on in the developed economies in 2012. Normally this sustained cyclical recovery would be good for shares, but as this month has shown, the longer term outlook has the potential to be thrown off course from time to time along the way.

## New Zealand Property

Not a lot happened over the past month, the NZX Property Index drifting down slightly from mid-October to show a capital loss of -0.90 percent. The picture looked rather better over the past quarter, when rising prices in September and the first half of October meant that the sector showed a 7.80 percent gain. The main item of corporate news was AMP Office's conversion to a company structure and move to lower management fees.

The profit reporting season for the September quarter showed generally good operating performance for the sector.

## **New Zealand Property (contd...)**

The run-up in prices in the past quarter has reduced the valuation attractions of the Kiwi listed property sector. The discount to net assets is now around the 10.0 percent mark (although with large individual variations, from a small premium for Property For Industry through to 25.0 percent discounts for National Property and DNZ), and gross yields have narrowed to 11.50 – 12.0 percent (again with considerable variation). The yields still remain more than competitive with government and corporate debt, however, and even allowing for some niggles in the sector – oversupply in some CBD office markets, a moderate rather than strong economic cycle, and a likely modest reduction in payout rates in the future – the yield pickup should continue to be a drawcard for income-oriented investors.

## **Australian & International Property**

The Australian real estate investment trust sector had a good run in late August and early September, but has since gone gently downhill again. The S&P/ASX200 AREIT Accumulation Index was consequently down 2.40 percent for the past month (and quarter). In corporate news, Westfield announced that it is planning a spinoff of 50.0 percent of its Australian and New Zealand shopping centres into a new listed Westfield Retail Trust.

Global listed property has behaved very similarly to both Australian and international equities, rising in September, October, and early November before losing ground in recent weeks. The EPRA/NAREIT Global Property Index (ex-Australia) hedged into \$A was down 2.90 percent for the past month, although earlier strength means that the index was up 10.80 percent over the past quarter. The United States, United Kingdom, and Asia as a whole followed the overall pattern, while Japan did rather better (up marginally for the past month and up 12.30 percent for the quarter, in yen terms), and Europe did rather worse (down four percent for the month, up 8.10 percent for the quarter, in euros).

It's not surprising that the domestic listed property sector has weakened, as its core problem has worsened in recent weeks. The yield from the sector (around 5.50 percent for Westfield, and 6.0 – 6.50 percent for many of the other big names) was already uncompetitive with the returns from fixed interest, and this issue has become worse as fixed interest yields have started to rise. If bond yields have further to go, as seems likely, the sector will continue to struggle to find takers. A cyclical upswing in global growth ought to be beneficial for global property, but this simple picture is complicated by three issues. One is that in a very low interest rate world, property share prices have been driven up by yield-chasing investors, and this risks being unwound as interest rates rise. Another is the overhang of distressed property in the hands of banks, which is sizeable for some sectors. And the third is what is arguably a speculative bubble developing in countries where growth has been high but interest rates have been low. It's not surprising that the Reserve Bank of Australia included analysis of rocketing house prices in East Asia in its latest Monetary Policy Statement. For now, the global property sector has more than its fair share of risks.

## **New Zealand Cash & Fixed Interest**

New Zealand short-term interest rates were unchanged over the past month, 90-day bank bills just below 3.20 percent. Ten-year Government yields have risen in line with overseas trends, from 5.10 to 5.65 percent, and other long-term rates are also higher, the five-year swap rate up from 4.35 to 4.85 percent. The Kiwi dollar strengthened over the past month, the trade-weighted index rising by 3.90 percent as the \$NZ gained against both the \$US (from 74.4 to 77.8 cents) and \$A (from 76.8 to 78.9 cents), although at time of writing the \$NZ was under some selling pressure again in the wake of a Standard & Poor's warning about New Zealand's credit rating. One important development was a firming \$US, which after a long period of decline bottomed out (on a trade-weighted basis) in early November, and has been rising gradually since.

## **New Zealand Cash & Fixed Interest (contd...)**

Steady short-term interest rates reflect the Reserve Bank of New Zealand's caution about moving rates any time soon. In the Official Cash Rate review on 28 October, the Bank mentioned weaker-than-expected local economic data, and although the Bank still believes that it will need to raise interest rates "at some stage", financial markets have now pushed out the expected date for that first rise to March/June next year. When rises do come, they are expected to be relatively modest, the futures market now pricing in a one percent increase by the end of 2011. Globally, longer-term interest rates look to be on the rise, and local longer-term rates are likely to follow suit. The \$NZ appears overvalued from an exporters' competitiveness point of view, and might therefore be expected to move lower. But both the \$NZ and \$A remain favoured on relative interest rate grounds, and if investors are feeling confident enough to exploit the interest rate differentials, the Kiwi may yet find further support.

## **International Fixed Interest**

Global bond markets have seen an important change: government bond yields have reversed course. In the US, the yield on the 10-year Treasury note had dropped steadily from four percent in April to a cyclical low point of 2.385 percent on 7 October. Since then, however, the yield has risen significantly, almost reaching three percent on 15 November before dropping back a bit. Most other major government bond markets have followed suit with similar increases: UK 10-year bond yields were up over the past month from three percent to 3.40 percent, and German yields from 2.40 to 2.70 percent. Even the ultra-low Japanese yields have risen from 0.90 to 1.10 percent. These rises in government bond yields have taken corporate bond yields up as well, generating modest capital losses.

The recent rise in bond yields was in one sense a surprise: the Federal Reserve's 'Quantitative Easing 2' should have supported prices and kept long bond yields low. But from other perspectives the rise makes sense. Yields have remained low because of 'safe haven' demand from investors in uncertain times, and stimulatory monetary policies in several economies. But yields looked out of line with where they ought to be as the world economy continues to recover, and with where they ought to be to attract enough buyers to fund the giant fiscal deficits of the US and the UK. Even now, after this increase, the yield on global Treasuries is a skimpy two percent, the yield on global corporates 3.60 percent, and the yield on the benchmark Lehman Aggregate Index is still only 2.50 percent. Forecasters had been picking long-term yields to rise – the Wall Street Journal's poll had expected a 10-year US yield of three percent by mid-2011 – but it looks as if the rise is underway earlier, and stronger, than expected.

*Performance periods refer to the month and three months to 24 November 2010.*