

Client Update



Market Update – August 2010

Global Shares

Global shares gave up some of July's gains as the MSCI Gross fell 3% in local currency terms during August. In response to emerging signs that the pace of global recovery is slowing, the US Federal Reserve announced it would consider steps to provide further economic support, but only if the outlook weakens "appreciably". This came as a disappointment to some market participants who had been hoping for further intervention from the Fed in the short term, but illustrates a degree of prudence following the very significant level of stimulus that has already taken place.

NZ and Australian Shares

NZ shares ended flat for the month as business confidence remained subdued, adding further to indications that the economic recovery is likely to be gradual. Telecom added 3%, further building on its recovery from recent lows although the company's shares remain well down over the past year. However, GPG shares fell a further 4% as it appears that it is back to the drawing board on the company's plans for a return of value to shareholders.

While Australian shares fell 1% in local currency terms amid the election gridlock, a 2% fall in the NZD against the AUD turned this into a positive result for NZ investors. Resource giant BHP fell 6% after moving to expand into the global fertiliser business through a hostile takeover bid for Canadian resource company Potash Corp. Among the major banks, returns were mixed reflecting trends in the latest earnings results, with slowing underlying growth affecting NAB and Westpac (down 6% and 8% respectively) while ANZ was flat with solid results in both new lending and expanding profit margins.

Interest Rates

The Reserve Bank is expected to maintain the Official Cash Rate (OCR) at 3.0% in September and the market is now expecting it to remain at this level until the end of the year. The change in expectations has resulted from the combination of weaker than expected data releases domestically and continued volatility in global interest rates. NZ bond yields followed global trends over the month, continuing to fall but to a lesser extent than overseas.

Summary of Market Movements as at 31 August 2010

Share Markets	31/08	31/07	1 Month Return	3 Month Return	6 Month Return	12 Month Return
NZX50	3,036	3,035	0.0%	-0.8%	-3.8%	-2.0%
ASX 200 (local)	31,609	31,977	-1.2%	0.6%	-3.0%	2.2%
MSCI (local)	1,878	1,945	-3.4%	-2.2%	-3.3%	2.3%
MSCI (NZD)	3,748	3,746	0.1%	-2.5%	-3.2%	-0.4%
Fixed Interest Markets	31/08	31/07	1 Month Change %	3 Month Change %	6 Month Change %	12 Month Change %
NZ 10-Yr	5.13	5.33	-0.20	-0.43	-0.63	-0.54
US 10-Yr	2.47	2.91	-0.44	-0.82	-1.14	-0.93
NZ OCR	3.00	3.00	0.00	0.50	0.50	0.50
Currencies	31/08	31/07	1 Month Return	3 Month Return	6 Month Return	12 Month Return
NZD vs USD	0.6967	0.7243	-4.0%	2.7%	-0.3%	1.7%
NZD vs AUD	0.7831	0.8014	-2.3%	-2.6%	0.2%	-3.8%
NZD vs MSCI			-3.5%	0.3%	-0.2%	2.7%
Commodities	31/08	31/07	1 Month Return	3 Month Return	6 Month Return	12 Month Return
CRB Index	264.2	274.4	-3.7%	3.7%	-3.9%	4.1%
Oil	71.9	79.0	-8.9%	-2.8%	-9.7%	2.8%
Gold	1,249.0	1,181.7	5.7%	3.0%	11.6%	31.2%

Summary of Market Indices as at 31 August 2010



China, Emerging Economies and the Global Economic Recovery

Over the past several months, signs have emerged that the rate of economic growth in China has slowed from earlier levels. As the world's second largest economy and the greatest contributor to global growth, China's demand for new infrastructure makes it the world's most significant importer of commodities and a pillar of support for the Australian economy. By extension as Australia's "lucky neighbours" this flows through to the NZ economy as well. However, while Chinese economic growth is slowing, this is more a moderation from a 10% annual GDP growth rate to a more "reasonable" level of around 8% growth projected for 2011.

In part, the moderation reflects efforts by the Chinese government to curb speculation in the property market, with new bank lending deliberately curtailed when credit growth reached unsustainable levels. These measures have been reflected in a marked decline in property sales over the past 6 months. While significant, this is not reflective of the long-term outlook for housing - considerable expansion in the amount of housing stock is required to accommodate the move of around 10 million people from rural areas to the cities each year for the next five years. Importantly, household borrowing levels are also significantly lower in China than in the developed world, with the traditionally cash-based economy reflected in over 80% of urban dwellings being owned outright. This adds an element of underlying stability when compared to the much more highly geared levels and resulting foreclosures that contributed to the housing market difficulties in the United States.

A side effect of the moderation in growth has been a decrease in inflation pressures, with around 2% inflation expected for next year. As a result, the authorities now have considerably more flexibility in using their substantial fiscal resources to provide support to the economy should growth start to slow too rapidly. As a result, the slower rate of economic growth is unlikely to result in a "hard landing" but rather, a more sustainable growth path going forward.

Stronger fiscal positions in emerging economies

China is not alone among "emerging" economies in terms of its relatively stronger fiscal position. Generally speaking, the governments in emerging economies have lower borrowing levels and budget deficits than those in the developed world. As a result, these developing economies are less subject to the economic headwinds generated by the fading effects of past stimulus packages, and are more able to provide continuing support to their economies as required.

However, this does not mean that the investment markets of the developed world should be written off. Globalisation and the increased linkages that now prevail throughout the world economy mean that the relationship between the "east" and "west" is growing more complex than in the past, when simplistically western consumers purchased products made cheaply in developing economies. Improving income levels in Asia have led to a rapid expansion in the number of middle class consumers, which is expected to continue into the future. This is leading to growing demand for luxury goods and services produced in the west.

Another consequence of higher incomes in lower-cost countries is a decrease in the attractiveness for multinationals of producing goods in these countries. Some US multinationals are now contemplating moving some production back home as the operational cost savings are no longer sufficient to offset the logistical issues of producing so far away from their key customer base. For this reason, local company Fisher & Paykel Appliances has also established manufacturing facilities in the United States as well as in low-cost countries such as Thailand and Mexico. Furthermore, as US companies have capitalised on global economic growth their dependency on the US economy has reduced, with half of US corporate earnings now generated offshore.

Emerging markets in your portfolio

The stronger fiscal position and growth outlook within emerging economies justifies investor attention, although with some degree of caution. Returns on emerging market shares are considerably more volatile than world shares in general. As such, their role in investor portfolios needs to be carefully managed with respect to the cycles that drive investment markets. For the past four years your global share portfolio has included a 5% allocation to an index fund which tracks the top 25 Chinese companies. This fund was selected with the aim of effectively capturing growth in the Chinese economy, as China was judged to possess the most robust overall economic characteristics of the major emerging economies in terms of matching strong GDP growth with relatively low inflation and a greater degree of resilience to external shocks. While this continues to be the case, we are cautiously and gradually substituting half of this Chinese allocation with a broader allocation to emerging markets, to capture the benefit of a cyclical recovery in emerging market shares as global markets recover over time.

Summary of Recent Key Portfolio Monitoring Decisions

NZ Fixed Interest Portfolio

- To maintain the portfolio's neutral duration position relative to the benchmark NZ Government Stock index, the maturity profile has been lengthened slightly to 4 years. This was done by adding a 12% allocation to the 2021 NZ government bond, along with a small increase of 3.5% to the 2011 bond, funded by reducing the holdings in 2015 and 2017 government stock by 5.5% and 10% respectively.

Corporate Bond Portfolio

- A 2.5% weighting to Greenstone Energy Finance Ltd bonds has been included in the portfolio during August. The bonds mature in October 2016, and have a fixed coupon of 7.35%. Greenstone was established following the purchase of Shell during April 2010, by NZ Superannuation Fund and Infratil. As there was sufficient cash in the portfolio to enable this allocation, the targets of several positions that have fallen below the target weights and are unable to be obtained have been reduced to allow for the Greenstone allocation.

NZ Share Portfolio

- Following a disappointing plan promoted as a "return of value" to shareholders, and the resignation of Tony Gibbs as a director, GPG's allocation within the portfolio has been reduced from 3.0% to 2.5%. The sale proceeds were applied to increase Telecom's weight to 6.5%, although this remains well below the company's 11% weight within the NZX 50 index.