

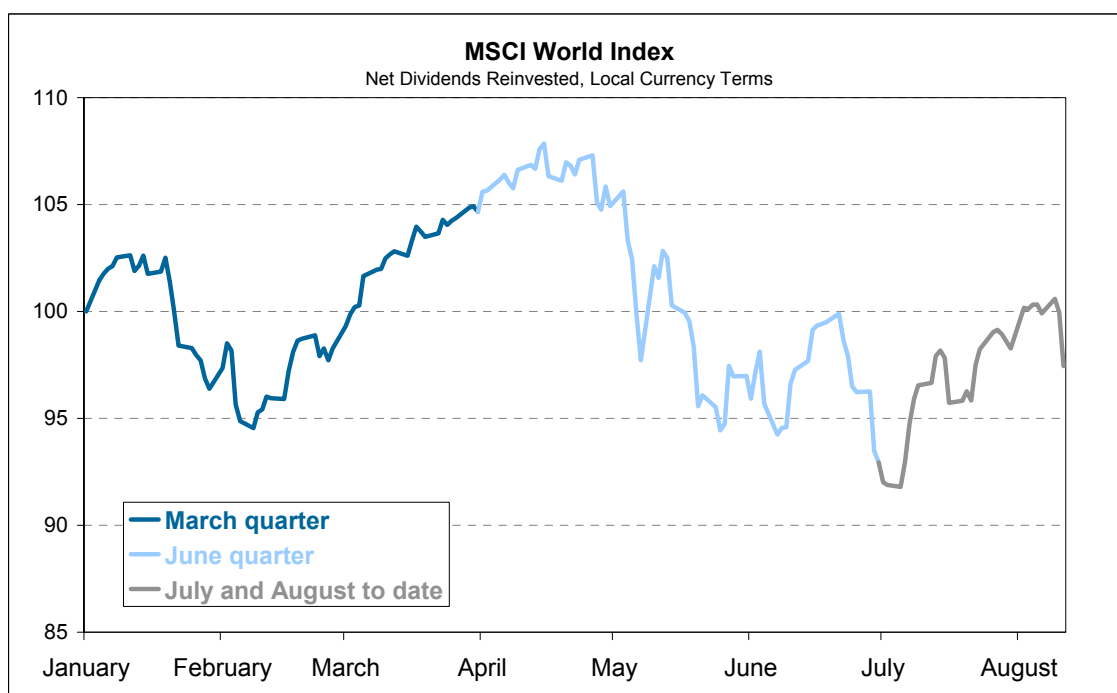
Investment Comment – 12 August 2010

1 Markets

Share markets were up over the month of July as sentiment brightened around the globe. Southern European countries continued to be the most volatile with Greece up 23% in the month and Spain up 15% as the results from the bank stress tests went some way to calming market nerves. Of the 91 banks tested, 7 failed the 6% Tier 1 Capital Ratio threshold (5 in Spain, 1 in Greece and 1 in Germany).

In fact, all developed markets tracked by the MSCI (save for Israel) posted positive movements for the month. The top 5 markets were all from continental Europe, followed by the United Kingdom and then the USA. The weakest gains were from Ireland, Japan, Switzerland and New Zealand. Australia saw a reasonable result near the middle of the group.

The chart below demonstrates the turnaround seen in early July after the big falls in the June quarter for the MSCI World Index. However, in the second week of August the market fell back somewhat.



2 Economies

Data releases were mixed over the month of July but there were no significant negative shocks to set markets back. US payroll figures for June revealed employment dropped 125,000 in the month but this figure included a drop in temporary census workers. Allowing for this, private sector employment increased 83,000, although this was still short of the 110,000 increase commentators were expecting. In August, the amount of people claiming the unemployment benefit disappointed by rising slightly to 484,000. This is the highest since February and capped a week of falling share prices.

US housing activity has yet to pick up in the post-tax credit economy. The National Association of Home Builders index reached a 15 month low in June, while existing home sales fell over 5% to a seasonally adjusted 5.4 million in June. Pending home sales lacked any sign of buoyancy as well, sliding a further 3% in June after a 30% slump in May. However new home sales for June were up slightly (and better than expected) at 330,000.

On August 10th, the US Federal Reserve announced it would counteract the passive shrinking of its balance sheet as its pool of Mortgage Backed Securities (MBS) matured. The proceeds of MBS will now be rolled back into US Treasuries, effectively signalling the Fed is committed to

maintaining its stance of Quantitative Easing – or support for the financial system. However, the market fell slightly as the announcement coincided with weaker news out of China.

In the UK the recovery is unstable at best with job vacancies still increasing, albeit slightly. However, there were glimmers of hope with the unemployment rate falling slightly to 7.8% in the June quarter and, less formally, train passenger numbers (which are seen as a measure of consumers' propensity to spend) rebounding to 2008 levels.

The new government has seen some disgruntled reactions to the cuts introduced in its June budget. In particular the EEF (a manufacturing employers organisation) warned that although the manufacturing sector had recently performed better than expected and would grow 3.8% for the year (compared to 1.1% for the overall economy), the public spending cuts would negatively affect companies reliant on big government projects.

The divide between east and west in monetary policy is apparent with India tightening in July and in doing so joining China, Brazil and other developing nations that are looking to slow their economies to stable levels. In this latest instance, the Indian central bank raised its main lending rate 0.25% to 5.5% but this is still well below inflation. The Wholesale Price Index (WPI) inflation rose to 10.2% in May.

3 New Zealand

The Reserve Bank raised interest rates on 29 July, moving the official cash rate for the second time this cycle by 0.25% to 3%. However, Governor Bollard was more dovish than expected in [his statement](#), saying

[S]ome further removal of monetary policy stimulus is appropriate at this stage. Even after today's move, the level of the OCR is still very supportive of economic activity. The pace and extent of further OCR increases is likely to be more moderate than was projected in the June Statement. Our policy assessment will be continually reviewed in light of economic and financial market developments.

On August 5th, the June quarter employment report showed the unemployment rate rise sharply to 6.8% from 6.0% last quarter. However, last quarter's release is now being viewed as a statistical anomaly. If ignored, the trend is from 7.1% unemployment in the December quarter to 6.8% currently. This is more in line with the weaker recovery that commentators were expecting after the recession.

The most recent major release, the Performance of Manufacturing Index (PMI), was worse than expected. The index dropped to 49.9, the first reading of below 50 (and therefore signalling a contraction) in 12 months. While this was a disappointment, it is perhaps to be expected given the patchy nature of the recovery.

The Reserve Bank is now less likely to raise rates at each of the three meetings before year end, with some picking a 50% chance that the Bank will pause at its next meeting in September.

4 Outlook

The outlook remains uncertain for the global economy; however New Zealand appears in a better position than most developed countries given our proximity to faster growing developing countries. Data has yet to paint a clear picture of recovery and we are likely to see markets continue to oscillate until there is firm improvement in underlying economies.

It is likely we are in for a period of low or patchy growth in the medium-term as the western world works towards paying off the large debts it has accumulated.