

Market Summary – June 2010

Economic Summary

The global economic recovery remains on track. Economic data over 2010 has supported the story of a subdued recovery in the major developed economies, including the United States, the United Kingdom and Europe. Growth is strongest in the key emerging economies of China, India and Brazil. This strong growth in China and India is having a positive impact on growth across the broader Asian region.

It is still the case, however, that inventory rebuilding and stimulus measures have been leading the broader economic recovery. The impact of both of these factors will wane in the months ahead and as that occurs, we will get a true picture of the underlying strength of the global recovery.

It was this factor coupled with ongoing weakness in some of the key historical growth drivers such as consumption, that have contributed to growing concern about the sustainability of the recovery in the major developed economies such as the United States. But then consumption was always going to be a lagging indicator in the US this time around. The US needs to rebalance its economy towards exports, and the early signs in that regard are quite promising.

Concerns about sovereign debt, particularly in peripheral Europe, came to the fore over the quarter. These concerns led to the establishment of a joint European Union and International Monetary Fund initiative to stabilise debt markets in Europe. This has enabled governments across Europe to seize back the initiative from debt markets and firm up their plans for fiscal consolidation. This has contributed to expectations of weaker economic growth in the months ahead.

While we acknowledge there are still valid concerns about the sustainability of the global economic recovery, the worrying signs need to be balanced with the positive, albeit early, signs of the necessary rebalancing in growth in some countries.

Building a sustainable economic recovery was always going to be hard work. Indeed the next six months will be the most challenging of the recovery so far.

Fixed Interest and Short-Term Cash Securities

There have been two opposing forces impacting on global fixed interest securities in recent times: concerns about the sustainability of rising sovereign debt and the sustainability of the economic recovery.

Concerns over the possibility of a sovereign default saw a flight to quality, pushing Government bond prices higher in the United States over the period. Concerns about the pace of the recovery and the implications for monetary policy also had a positive influence on prices. These factors had a similar impact on domestic bonds.

For some time now we have been of the view that the sheer weight of debt to be issued by many developed economies over the next few years will lead to a rise in bond yields as investors seek greater reward compensation for higher risk as debt levels rise. We remain of that view over the medium-term.

International Equities

Global equities have moved lower over the year as fears grew about the sustainability of the economic recovery and the concerns over European sovereign debt. Greece has been at the centre of the drama, but concern has spread to other European countries, necessitating the implementation of the EU and IMF rescue package. While it is clear that economic growth will move lower in the months ahead as the temporary factors that have driven the recovery this far wane, we believe that fears of a return to global recession are overdone.

Global equity valuations do not look expensive, especially compared to bond yields. Among global equities, we think emerging markets remain the most attractive.

Australasian Equities

Australasian equities are also lower this year, reflecting wider global growth and sovereign debt concerns. In Australia, a proposed new resource profit tax and worries of a slowdown in the rate of Economic growth in China also weighed on shares. The resource tax was amended subsequent to the end of the period, following a change in leadership in the Australian Government. Looking forward, we continue to expect Australian equities to outperform New Zealand.

Listed Property and Infrastructure

Along with growth assets generally, listed property markets were also down over the period. New Zealand listed property is down further than global property, reflecting tax changes announced in the May Budget. We expect New Zealand listed property returns will lag other growth asset classes given rising vacancies, falling rents and dividend cuts.

Currency

The New Zealand dollar (NZD) has declined against the United States dollar and Japanese Yen over the year. It has risen against the British Pound, Australian dollar and made large gains against the Euro. More recently some of the gains made against the Pound have reversed.

The NZD position against the major currencies we monitor continues to reflect relative economic fundamentals. It remains overvalued against the US dollar and the British pound, reflecting the fact that New Zealand is generally better economic health than both of those countries. We are undervalued against the Australian dollar given that Australia is in better shape than we are.

Outlook

The global economic recovery remains on track, but the recoveries in some of the key developed markets will face their toughest test over the next few months as their true underlying strength becomes obvious. It won't all be good news every day, but in general we expect to see data confirming a modest but, over time, an increasingly sustainable economic recovery.

In this environment, we expect equity markets will eventually move higher on the back of above-trend global growth and a margin-led sustained recovery in profits.