

SPS Opening Commentary – March 2010

Economic Summary

Last year we were constrained to making broad generalisations about how we thought the recovery needed to play out. We thought that developed markets had consumed too much and needed to “under-consume” for a while; that developed markets needed to de-leverage; that growth needed to rebalance and be productive sector lead; and that some belt-tightening would be required as the pathway back to fiscal sustainability would be somewhat fraught.

We are now able to assess the extent to which all of these factors that we thought were important to a long-term sustainable recovery are playing out. The early signs are, in our view, quite promising. Amongst developed economies, the United States, Japan, Germany and France are slowly recovering. The United Kingdom and Spain are further behind in the process. It is these countries where households are more highly leveraged. Italy is also proving a growth-laggard, reflecting the fact that authorities there provided less fiscal stimulus during the recession.

The key emerging markets of China and India are growing strongly again with China in particular providing strong growth impetus in broader Asia.

It is still the case, however, that inventory rebuilding and government stimulus measures are providing much of the growth impetus in developed markets. It was this concern coupled with ongoing weakness in some of the key historical growth drivers such as consumption that led to renewed fears at the start of the year about the sustainability of the recovery in the major developed economies such as the United States.

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 signs that we are seeing the early indications of the necessary rebalancing in growth in some countries.

Building a sustainable economic recovery was always going to be hard work. The early signs are positive, but there are still significant challenges to traverse. Authorities in India and China have already started putting the growth-brakes on to prevent bubbles and governments all around the world are starting to rein in big fiscal deficits.

Fixed Interest and Short-Term Cash Securities

The risk of a government defaulting on its debt moved to the fore over this year as concerns over Greece's fiscal accounts shook investors into taking a harder look at other countries' finances. We have been concerned for some time that elevated budget deficits present upside risk to bond yields, particularly US and UK yields.

Global government bond yields moved lower this year, partly due to a flight-to-quality earlier in the period and partly due to the US Fed's reiteration to keep interest rates 'exceptionally low' for an extended period. Domestic bonds followed global yields lower over the quarter, assisted by weak NZ unemployment and housing data.

However, yields ended the quarter on the upward grind that began six months ago as focus turned to the building economic recovery and the expectation that central banks that have not

already done so, would soon be raising interest rates. We expect the significant amount of public debt that has to be issued will continue to push yields higher.

International Equities

Global equities posted solid gains this quarter, having recovered from an 8% decline between mid-January and early February. This follows a strong six months and exceptionally strong year of returns.

The start of 2010 saw renewed risk aversion on the back of concerns about the strength and sustainability of the global economic recovery and the possibility of a crisis in sovereign credit. While the latter is clearly a concern, equity markets reacted positively later in the quarter to stronger economic data and earnings reports.

The latest earnings season in the US has been particularly pleasing, with both sales and margins rising for the first time in a long time. Sales are rising now that the economy is growing again, while margins are increasing not only because fixed costs provide operating leverage, but also because high unemployment is keeping a lid on variable employment costs.

We believe the earnings outlook remains positive and that continued low interest rates will contribute to investor demand for riskier assets. It will not be plain sailing of course. Renewed weakness in the US housing market may result in further write-downs in the banking sector.

Australasian Equities

Australasian equities posted similar gains of roughly 1.5% and 5% over the past quarter and six months. Over the past year however, Australian equities have been almost 10% stronger in local currency terms.

The latest earnings season in Australia and New Zealand has just drawn to a close and it mirrored what's going on in the respective economies. This should come as little surprise with employment, housing and business investment all looking much healthier across the ditch.

Australian company earnings would have looked even better if resource sector profits weren't held back by low contracted commodity prices. As those contracts roll material sector earnings will catch up with the rise in spot metal prices.

We continue to hold a greater than normal weight to Australia over New Zealand within the portfolio. Australia will continue to benefit from higher commodity prices. Commodity prices in general, and metal prices in particular, will likely rise further from here as the global economy is expected to grow above 4% over the next few years. We expect New Zealand's economic performance to lag behind that of Australia.

Listed Property and Infrastructure

Most listed property markets remained under pressure during the quarter but the US was again the notable exception. Here recent data shows commercial property prices rose for the second month in a row, following 13 months of declines.

We are pleased that the period of large price declines might be over for US commercial property following a 44% fall from the peak. But valuations don't look too comforting. Recent share price gains and equity dilution have moved US dividend yields 2% below the 15-year average. New Zealand listed property looks better value with a dividend yield closer to 8% but possible tax changes and rising vacancy rates represent real headwinds for the sector in the near term.

Currency

The New Zealand dollar (NZD) declined against the US dollar, Japanese yen and Australian dollar over the quarter but rose against the British pound and euro.

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 in 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

Economic conditions are expected to continue to improve. It won't all be good news every day, but in general we expect to see data confirming a modest and increasingly sustainable economic recovery.

The focus for the year ahead will be the unwinding of the unprecedented policy stimulus that was put in place during the darkest days of the Global Financial Crisis. The timing and sequencing of these moves will be critical to the ongoing improvement in economic conditions.

The outlook for global developed equities remains positive. The global economy is forecast to grow 4.3% p.a. over the next 5 years compared to an average 3.5% since 1970. Company earnings and sales are both rising again. Profit margins remain above average and are likely to stay there due to high levels of unemployment and a globalised labour force. And finally, valuations remain reasonable.

We expect bond yields to continue rising from here. This reflects the continuing improvement in general economic health, expectations of monetary policy tightening in most major economies in the year ahead, and high levels of debt issuance.