Tricky Turning Point

New Zealand Equities Monthly Commentary

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Earnings guidance impacted by currency

- Currency and commodity fluctuations continued in April, with a further depreciation of the US dollar a dominant influence on returns.
- Despite growing concerns around the Chinese economy and the exit from super easy US monetary and fiscal policies, equity markets continued to rise in April. The MSCI world index lifted by 4.0% in US dollars, the NZ equity market was up by 2.3%, while Australian equities continued to disappoint, up by only 0.3% in Australian dollars.
- Global leading indicators continued to pull back in April, although on average global business confidence is still predicting a solid economic expansion. For example, although the US indicator fell to 60.4 from 61.2, the measure has exceeded 60 for four consecutive months, the best performance since 2004.
- We said last month that markets are at a point of change. Growth is no longer positively surprising, while inflation concerns stemming from commodity price inflation are increasingly an important investment influence.
- In NZ, we think that tentative signs of stronger house sales and a recovery in business confidence promise a better second half. This may potentially improve the prospect for more domestically oriented companies. In contrast the very strong Australian dollar has created a wave of corporate earnings downgrades in Australia. Some resource businesses are also seeing downgrades in Australian dollars. Earnings upgrades are largely confined to specific stock situation.
- The portfolio returned 1.2%, under-performing in April by 1.4% as the Russell & JBWere Index rose by 2.6%. The key negative influences were stocks hit by the strong Australian dollar, namely CSL, Bathurst Amcor, Santos and Newscorp.

To April 2011	***Month***	***3 months***	***6 months***
Portfolio	1.2%	5.6%	9.1%
Benchmark*	2.6%	5.0%	7.2%
Relative Performance	(1.4%)	+0.5%	+1.3%

* Benchmark is the Russell JBWere Index including imputation credits. Returns are before fees and taxes. Investor returns may differ. Numbers may not add due to rounding.

Strategy – greater focus on earnings certainty with a New Zealand emphasis

Our strategy development reflects:

- A world still in expansion but with gathering risks
- A better outlook for New Zealand growth momentum, near term, relative to Australia
- Risks around a near term pull-back in the global commodity boom
- Increasing some NZ consumer exposure given under-performance and the rebuilding of savings
- A preference for LNG exposure over bulk commodities
- Increased growth and quality positions relative to cyclical recovery opportunities at a stock level

At turning points in growth momentum, sector returns are harder to predict. At the moment sector and stock returns are also being influenced by the extra-ordinary appreciation of the Australian dollar, weakness in the US dollar and volatility in commodity prices.

Take for example the largest stock in the Australasian market – BHP Billiton. To our thinking, there is no doubt that BHP stands to earn well in excess of its cost of capital in the next decade. New projects and expansions are likely to earn more than BHP's cost of capital. At the same time, with such a strong balance sheet, BHP is buying back shares to increase earnings per share. However, in US dollars, iron ore and copper prices have softened slightly. Whilst oil prices have risen in US dollars in the last three months, in Australian dollars they are flat to down. Even the gold price has barely moved in Australian dollars. Seen from an Australian dollar perspective, BHP's forecast 2012 earnings expectations have fallen slightly in recent months. And as a result market sentiment has pulled back BHP's share price in the past month. BHP is also seen as a bell-weather of the Chinese growth story and this may pose further sentiment risks in the near term. However, we think that near term weakness may provide an opportunity to again examine the potential for investing in one of the better secular stories; namely the continued increase in resource consumption per capita in the China and India. Our favoured exposures currently are metallurgic coal and LNG.

A similar, but less Chinese growth-oriented, story plays out with other strong Australian franchises spanning a number of industries. For example:

- CSL – the global healthcare company - expanded earnings by over 15% last year in US dollars, and like BHP, has a strong industry position,

however, the headwind of a very strong Australian dollar is impacting on earnings reported in Australian dollars.
- Amcor – the global packaging giant – has strong earnings growth coming through from consolidation and improving US and European growth
- Macquarie Bank – now earns more than 65% of its revenue from outside Australia and should benefit from increasing M&A, privatizations and a general rise in corporate activity
- Computershare – one of a handful of global registry businesses and is well positioned. Like Macquarie ought to benefit from increasing corporate activity and is using the high A$ to buy global businesses.

New Zealand also has it’s fair share of smaller, but equally key global franchises:

- Fisher & Paykel Healthcare has a greater than 50% of the global hospital heated humidified respiratory market. With new facilities in Mexico and continued global growth in the obstructive sleep apnea market, F&P Healthcare has in our opinion more than five years of double digit growth in earnings ahead.
- Rakon is a global leader in timing devices for GPS and other Telco applications. With production facilities now in the UK, France, India and China, Rakon is no longer just a New Zealand based company exporting to the world. The global trend in hand held mobile devices, tablets, and the role out of ultra fast broadband, increase the market size significantly for Rakon.
- Mainfreight has recently expanded its footprint into Europe and earnings growth will now increasingly come from the Northern Hemisphere.

In constructing the portfolio we are mindful of our direct and indirect correlated (China/resource) exposures. That is partly why we reduced and then sold our large Australian resource exposures in the first quarter of this year and lifted our exposure to some of the (other) global exposures above. We did not think that the portfolio should be so significantly exposed to one global theme when were experiencing a pull back in Chinese growth.

In balancing this switch in the portfolio we have lifted positions in financials – specifically focusing on wealth management (AMP and CBA) – together with establishing positions in smaller New Zealand companies like New Zealand Exchange, Hallenstein Glassons and Freightways. These later portfolio moves reflect that we are seeing better earnings growth momentum in specific stocks across a range of sectors rather than 2010’s theme which was dominated by concentrated global materials positions.

So where are the positive growth signals in New Zealand?

Business confidence has recovered from the Christchurch earthquake. The cut in interest rates to 2.5%, the reiteration by the RBNZ to keep interest rates low, despite signs of recovery in consumer spending, has injected some confidence into the housing market. For instance, in Auckland house sales have lifted meaningfully in the latest month.

This in part may be due to internal "earthquake" affected migration, but also lower interest rates may be installing confidence in the housing sector.

Specific March data showed retail spending improved by 1.3% in the month, and Auckland house sales lifted by 11% in the month, setting a record average price.
The rural sector has also benefitted from strong commodity prices. And whilst credit indicators suggest debt repayment is a priority, regional spending trends are reported to be firming.

Adding to this in the next quarter is the RWC which will buoy spending patterns. Beyond that, a sharper lift in earthquake reconstruction at both a civil and residential level will begin to lift employment.

Whilst volatile from quarter-to-quarter, employment is looking considerably better. 34,000 more were employed in March than the previous quarter and unemployment fell from 6.8% to 6.6%.

Corporate activity is also picking up. Specific deals relating to investment in New Zealand include; Contact Energy raising funds for the Te Mihi geothermal plant, Ryman Healthcare's commencing their 450 bed Tauranga village, Kiwi Property refurbishing their Hamilton shopping centre, Goodman Property Trust announcing a new retail/commercial town centre at Highbrook. In addition the rural broadband initiative contract was announced.

Just adding these listed company investments brings over $1.2bn of new investment announced in April. For those of you that have travelled to Christchurch recently, you will know the speed with which the Northwest corridor is also seeing development.

With this background, growth may positively surprise in New Zealand relative to overseas, where some uncertainty over the path of Chinese monetary policy and some commodity price led chilling of growth elsewhere may pose limitations to faster growth.

We look forward to reporting further portfolio matters after the New Zealand budget later in May.