

Investment Comment – August 2010

1 Introduction

The purpose of this note is to provide a brief commentary on the investment markets for the month of August 2010. We look at index results, comment on local and global markets and raise issues that may be concerning investors.

2 Index results for the month of August

Australasian shares	The NZSX 50 was up 0.1% while the ASX 200 was down 2.0%
Global Shares	In unhedged terms, the MSCI World Index fell 0.5%, while in local currency terms it fell 3.3%.
Yields	Yields on NZ 5 year Government Bonds fell from 4.6% to 4.4% and US 5 year Treasury yields fell from 1.6% to 1.4%
Global Bonds	The Barclays Global Aggregate Index was up 1.7% at 30 August.
Currency	The NZ dollar finished down 2.8% at 70.4 US cents.

3 Markets

Share markets were down in August, with the MSCI World Index falling 3.3% in local currency terms. Faring the worst were Ireland, Greece and Japan. The USA was also down quite severely (-4.7%). Other than NZ, only four developed markets posted positive returns (Israel, Canada, Hong Kong and Portugal).

Bond markets rallied strongly, with yields on US 5 year Treasuries falling to 1.4% at the end of the month. This is not far off their lowest level (of 1.3% in December 2008) in almost 50 years of record keeping. UK yields, at 1.8% are below their December 2008 levels.

Included in an Appendix this month are several charts that give a snapshot of markets at the end of August.

4 Economies

In August, the US Federal Reserve made commitment to continuing quantitative easing by announcing it would invest the proceeds from maturing Mortgage Backed Securities into Treasuries. This move was largely symbolic, as the amounts will be relatively small compared to the Fed's balance sheet. However, the decision was not unanimous and this shook markets. The fear is that the Fed does not have the power to revive the economy. Indeed at the annual Jackson Hole meeting of central bankers, Ben Bernanke remarked that "*central bankers alone cannot solve the world's economic problems.*"

The US housing market remains weak. The National Association of Home Builders index slumped to the worst level since March 2009 and pending home sales fell 3% compared to an expectation of a 4% gain. However, housing starts were up 546,000 (although worse than expected) and the Case-Shiller house price index was up 4.2% in the year to June (better than expected).

Sovereign debt continues to rally as investors seek safe havens. Switzerland is a good case study. Swiss government yields have fallen to record lows as investors flock to the market for its "risk-free" properties. Currently yields on 10 year Swiss bonds are 1.15% and had fallen as low as 1.02% in late August. No country in the developed world (apart from Japan) has ever seen 10 year government bond yields drop below 1%. A secondary effect has seen the Swiss franc appreciate with the demand for the currency.

Other safe havens are rallying too. Gold was up a further 5.7% in the month (and is now over US\$1200 / ounce).

5 New Zealand

The June quarter Household Labour Force Survey showed the unemployment rate bounce to 6.8% from 6.0% in March. The rate peaked at 7.1% in December 2009, so the latest reported level is more in line with the gradual recovery being touted by economists.

It now seems the Reserve Bank may pause in its tightening cycle. In January, the market was predicting a 4.25% OCR by this stage of the year. However, softening economic data releases have tempered expectations. Rates are now only expected to reach 3.5% by late 2011.

As noted in our previous commentary, Governor Bollard was more dovish than expected in his statement of 29 July, suggesting *“The pace and extent of further OCR increases is likely to be more moderate than was projected in the June Statement.”* Additionally in his speech on 19 August, *“Keeping Inflation Anchored During Economic Recovery”*, Governor Bollard did not take the opportunity to try to “talk up” interest rate expectations. There is now just a 30% chance that rates will be lifted on 16 September, according to the market.

6 Outlook

Financial markets are uneasy at signs the recovery in the West is stalling. As such they are tracking downwards on a negative view for growth.

We expect that New Zealand, courtesy of its proximity to Asia, will remain resilient in the current environment, particularly if interest rates are maintained at stimulatory levels for longer than was previously expected.

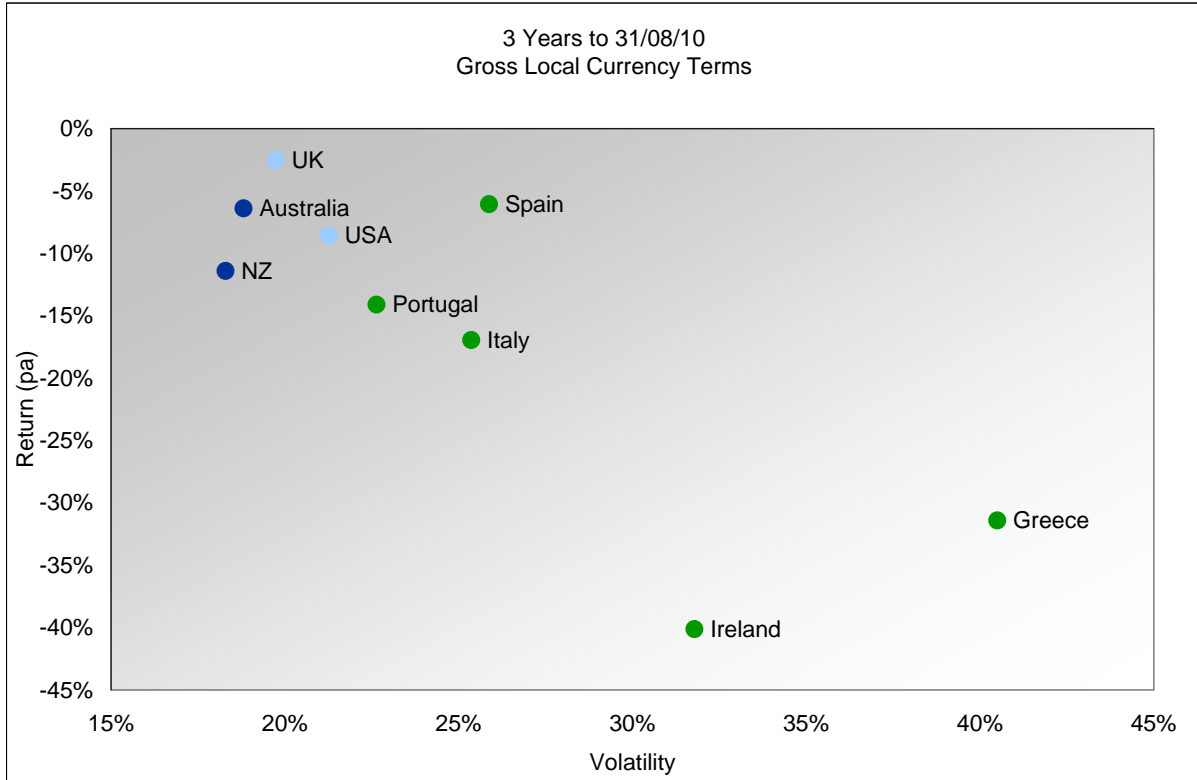
7 Issues

With global shares up 40% from early 2009 and bond yields at historical lows, investors may be wondering how their current strategy will perform over the coming months. Are equities fairly priced relative to fundamentals? Will we continue to see a rally in the fixed interest market?

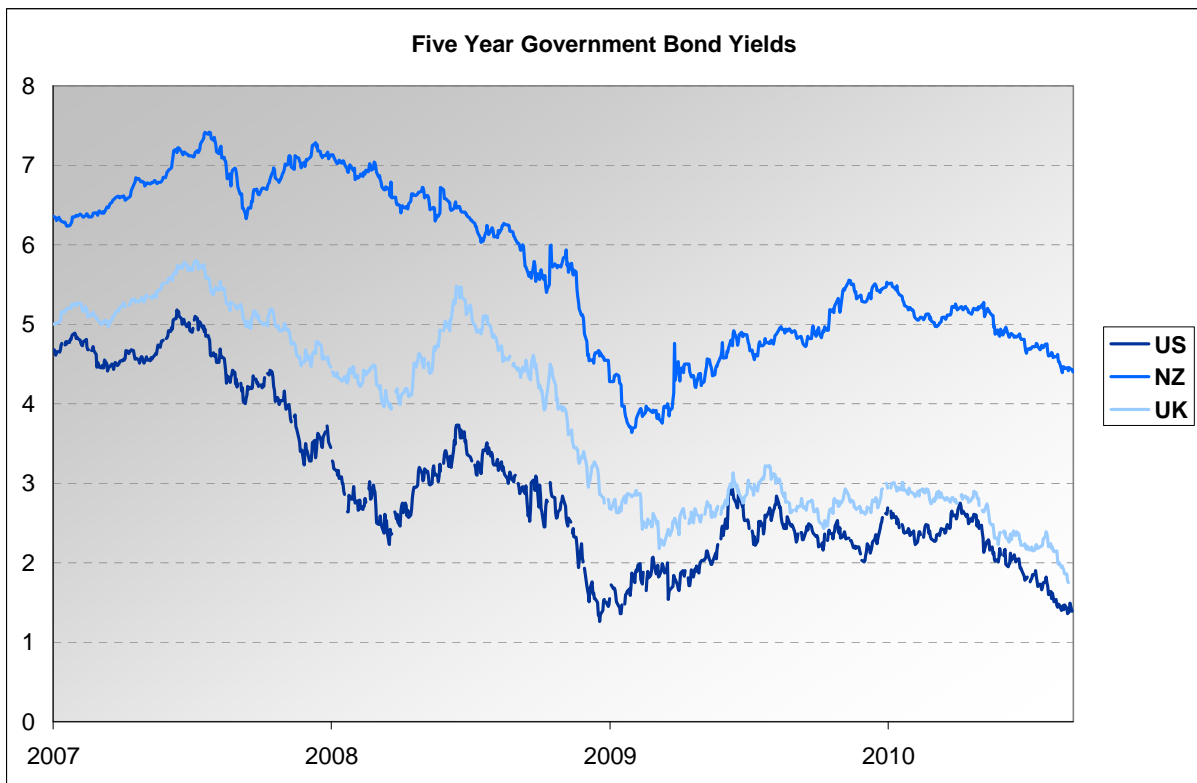
Additionally, the NZ dollar continues to be strong against the US dollar and the Euro. One might expect it to fall on a purchasing power argument. However if we are in a sustained boom for commodities, could it track higher?

We believe that the best way forward is for investors to fully appreciate the risks (whether quantifiable or not) in their portfolio and be prepared to accept the range of positive and negative outcomes. An objective basis for measurement of performance will help in this regard. Investors can then seek to maximise their returns for their accepted level of risk.

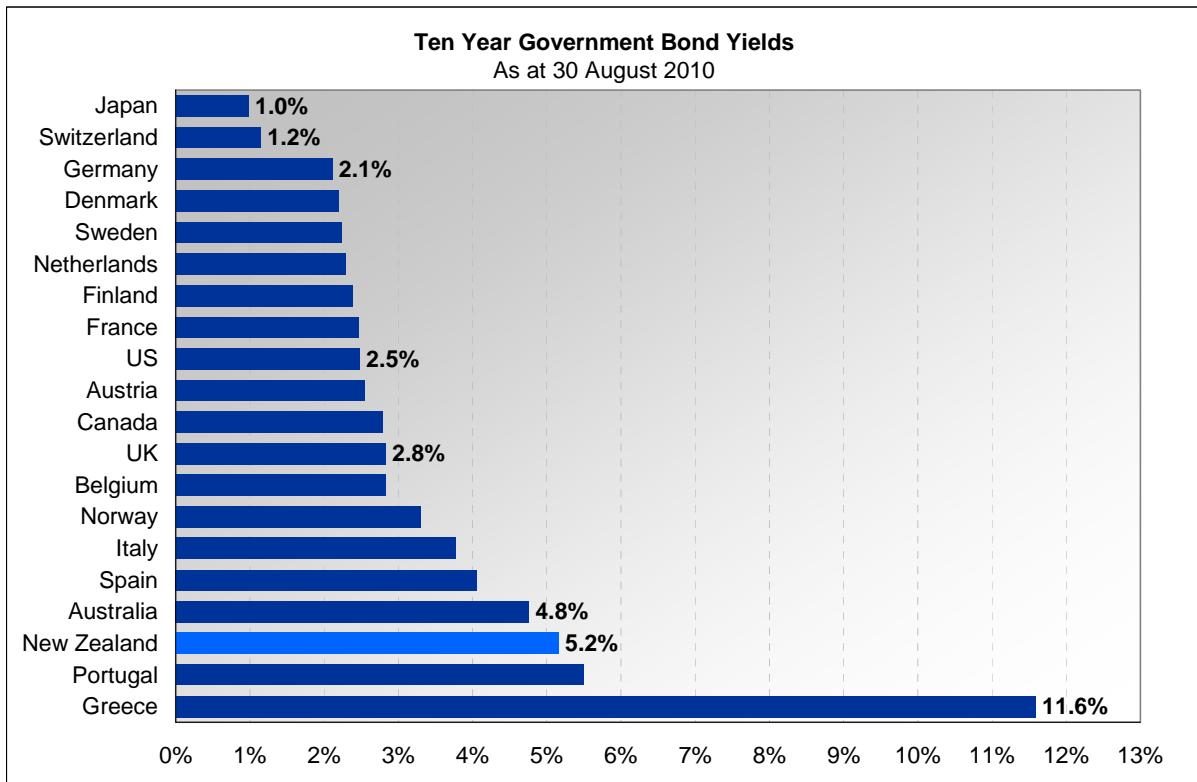
Appendix



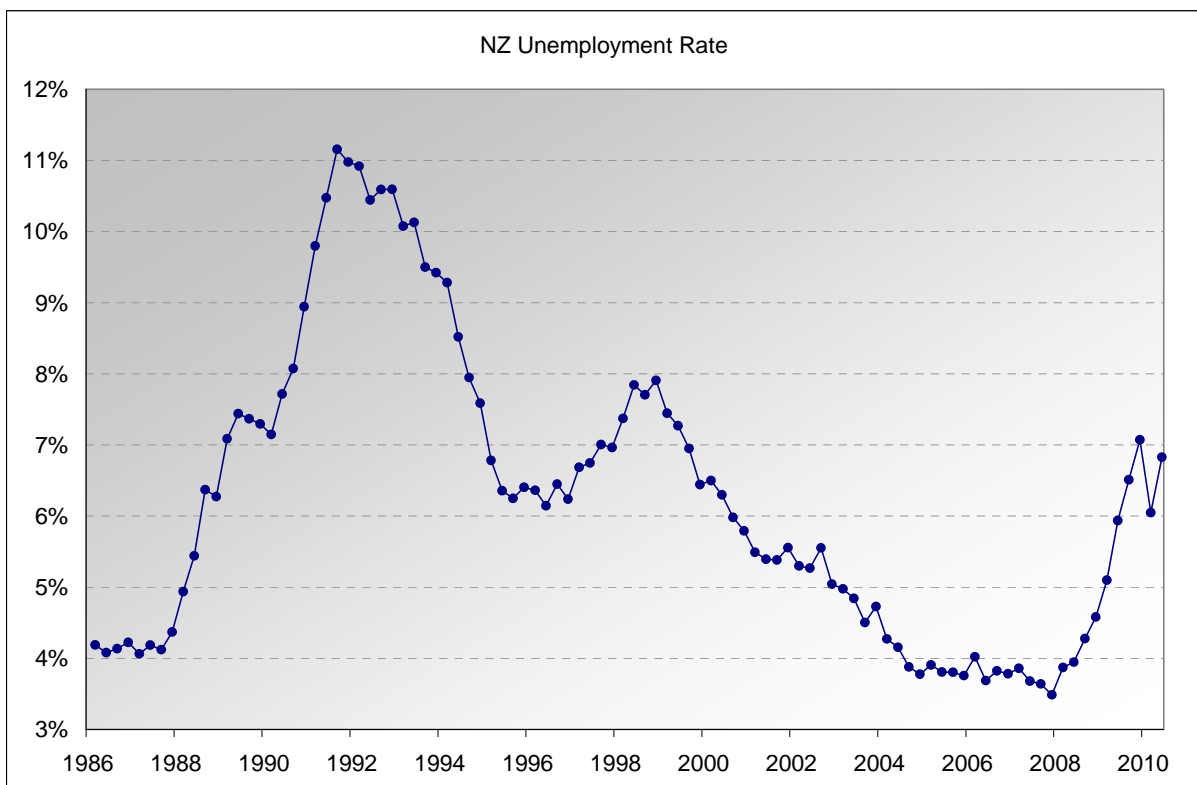
The chart above shows the risk/return results for NZ and Australia compared to the USA, UK and the “PIIGS”. The 3 year period roughly coincides to the start of the bear market in 2007.



The chart above shows the movement in sovereign debt yields since 1 January 2007. The recent fall is significant and has brought yields close to their late 2008/early 2009 levels.



The chart above shows the yields on sovereign debt as at 30 August. Lower yields can be indicative of low inflation expectations (eg Japan) and/or high demand for government debt (eg Switzerland).



The chart above highlights the volatility in the unemployment rate over the past 12 months. If the March 2010 data point is ignored, the slight decline from 7.1% in December 2009 to 6.8% in June 2010 is more in line with what has been seen in the past.