quarterly strategic outlook
June 2010

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executive summary

The global economic recovery remains on track. This is despite rising concern over sovereign debt levels, particularly in Europe. Deleveraging by households and governments was always going to be a feature of the recovery that would keep economic growth relatively subdued, especially in developed markets.

A front-loading of fiscal austerity measures is expected to constrain near-term growth in some countries. But, as a result, medium-term growth prospects look brighter. While fiscal austerity will have its greatest impact in Europe, the weakness in the Euro will help export growth in the medium-term.

In the meantime, the recovery in the United States is looking increasingly entrenched and the new challenge for emerging markets is to contain economic imbalances in the face of strong economic growth and strong capital inflows. It is this strong growth in emerging markets that is the key contributor to our expectation of global growth of over 4% per annum between 2010 and 2015.

Robust growth and better-than-expected earnings count for nothing when fear is in the ascendancy. We know that fear can be self-fulfilling, if everyone starts thinking a slowdown is around the corner and act accordingly, the slowdown will surely arrive. But an investment strategy based on guessing the expected level of fear (or greed) is a road to ruin.

In times like this it is important to take a dispassionate assessment of the risks and not get lost in the moment. We trust politicians are doing the same, and don't repeat the fiscal mistakes made during the Great Depression and turn a promising recovery into a double-dip recession. Our assessment of the situation is that European peripheral risk is manageable and markets will eventually move higher on the back of above-trend global growth and a margin-led sustained recovery in profits. Consequently, we remain overweight growth assets with emerging markets still our preferred asset class.

our views in summary

Asset class	Near-term view	Medium-term view	Current Position
Global equities	Markets look evenly poised, with fiscal and banking sector worries in a tug-of-war with the ongoing recovery in growth & earnings.	Positive on current valuations but subdued growth in developed economies points to single digit returns. Emerging markets is our preferred overweight.	Overweight
Australasian equities	Should largely track developed equities. Australia expected to do better than NZ.	Positive on current valuations. Australia's higher growth potential translates into higher earnings potential.	Overweight (over AUS/ under NZ)
Emerging equities	Expect emerging markets returns to be an amplification of global equities in the near-term due to their higher beta.	Should do very well on the back of relatively high GDP and earnings growth, plus lower leverage.	Overweight
Property & infrastructure	Direction of risk appetite is key, but questions are being asked on listed property valuations.	Listed property looks fully valued. Expect returns to be below other growth assets.	Underweight
International bonds	Government bonds look expensive but the flight-to-safety trade will see bonds do the opposite of equities in the near-term.	Expect modest returns over the medium-term with credit spreads close to fair-value and low government bond yields. Massive sovereign issuance also means there is upside risk to yields over the medium-term.	Underweight
Domestic bonds	Government bonds offer some equity downside protection but yields will largely take direction from offshore.	Low long-term government bond and swap yields points to modest returns but NZ deficits and debt ratios look much healthier than most other countries.	Neutral
Cash	Returns from cash will remain below average in the near-term but the asset class is less sensitive to rising interest rates.	Rates will need to normalise over the medium-term and while cash offers a little lower expected return than other income assets it comes with much less risk.	Overweight
Currency	Expect the NZD to largely track risk appetite over the near-term.	Despite the recent (MSCI-weighted) decline, the NZD still looks overvalued, particularly against the USD and GBP.	Below benchmark hedge (MSCI basket)

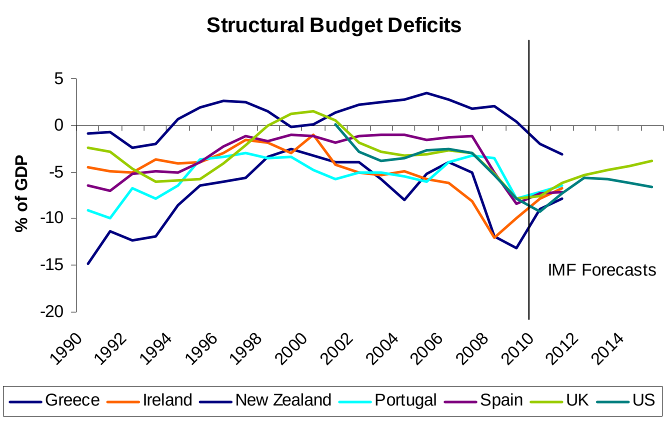
sovereign debt: the crisis de jour

Concern about levels of sovereign debt in some developed countries, particularly in Europe, is the latest manifestation of the Global Financial Crisis. For us, not a lot has changed. Regular readers of *Quarterly Strategic Outlook* will recall our view that:

- private sector debt crises are often followed by public sector debt crises and this time would be one of them;
- that governments would be forced to make hard political decisions to rein in large public deficits and stabilise levels of public debt;
- that the important thing for Governments to do was (and still is) to develop, articulate and then implement credible plans for fiscal consolidation and a return to sustainable fiscal positions;
- that those necessary austerity measures would result in lower standards of living in some countries; and
- that getting both household and public debt under control in some developed countries would prove a major constraint on economic growth for many years to come.

The recent focus of financial markets on sovereign debt is a timely reminder that the global economy, while continuing to recover, still faces significant headwinds. What was initially a private sector debt crisis only became a public sector debt crisis as the public sector bailed out the private sector. That left the public sector, and ultimately the taxpayer, to foot the bill.

Given the structural nature of the recession, it has also become obvious that large budget deficits in many developed countries are also structural in nature. That means that governments running large budget deficits cannot just sit back and wait for economic growth to recover and solve the problem.



Source: IMF and AXA Global Investors

Governments need to cut spending, raise revenue, or some combination of the two in order to rein in large deficits and stabilise, and ultimately lower, high levels of public debt.

Recent concern has centred on Greece and other peripheral European countries. Dithering at the political level to address firstly solvency concerns in Greece and then in broader Europe meant that financial markets were starting to dictate the course of events. Left unchecked, the market would dictate faster and therefore more growth detracting fiscal austerity measures.

That led to the important announcement of the European financial stability mechanism, including a €750b "wall of money" to stand behind European sovereign debt. While this was never going to solve the problem, indeed we still think a restructuring of Greek public debt is more likely than not, it has allowed the politicians to wrest the initiative back from financial markets.

This has prompted a number of governments to firm up their fiscal consolidation plans. Extensive austerity measures have now been announced in Ireland, Greece, Portugal, Spain and Italy. The UK is expected to bring down a suitably austere Budget later this month. This is very welcome.

There is, however, an important word to remember and that is "balance". The global economic recovery is still fragile. It is important that governments get the balance right between fiscal consolidation and supporting economic growth. Fiscal consolidation can play out over a long period of time – so long as the plan is credible.

It is also important to watch what spending gets cut. For example, a winding back of infrastructure spending is tantamount to reducing investment in future economic growth. Governments need to focus their spending cuts in areas of low quality spending.

Consolidation plans should also address longer-term structural fiscal issues such as the ageing population, pension entitlements and rising costs of healthcare. Indeed many countries have incorporated pension reform into their consolidation plans.

Failure to develop, articulate and then implement credible plans for fiscal consolidation will result in financial markets again dictating the course of events. This applies to every country running large structural deficits including the United States and the United Kingdom. That will ultimately mean pressure to consolidate fiscal positions more quickly, which would be damaging to the nascent global economic recovery.

growth outlook: not much has changed.

A front-loading of fiscal austerity is the new risk to the near-term global economic growth outlook. However heightened fiscal concerns could, somewhat perversely, bring benefits to the longer-term growth outlook.

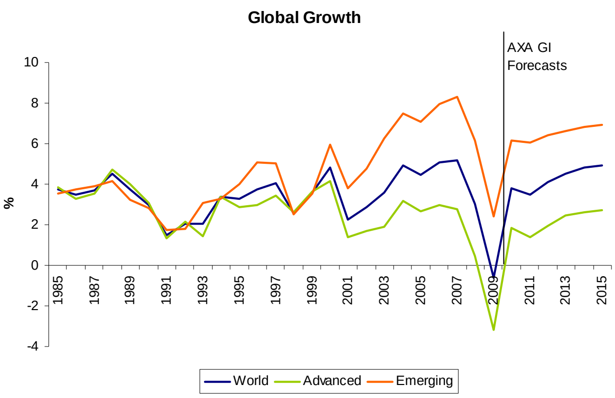
For about 12-months now, we've been writing that after the "Great Recession" would come the "Great Unwinding" – the unwinding of the stimulus that has been put in place over the last 2 years. The fiscal part of the stimulus exit strategies meant that growth in developed markets would remain subdued for many years as unsustainably high budget balances were unwound and public debt levels were stabilised and then brought down.

Recent focus on unsustainable fiscal positions in some countries has resulted in a firming up of fiscal austerity plans in some of them. To placate financial markets, these measures could end up being more extreme than would have been necessary had governments simply articulated credible plans earlier in the process.

This has led us to firm up our earlier expectation that global growth in 2011 may be somewhat softer than 2010 as fiscal austerity is implemented in some countries before the necessary transition from public demand to private demand has occurred. This is especially the case in Europe.

But at the same time we scale back recovery in Europe, we believe the recovery in the United States, while weak, is becoming increasingly entrenched. The labour market is now the key to a more sustainable recovery. (The United States is covered in the next section.)

That leaves our near term developed market growth forecasts weaker than those released by the International Monetary Fund in April. Our near term emerging market forecasts are also weaker on the back of lower export growth to developed markets, but emerging markets will still significantly out-perform developed markets in the growth stakes.



Source: IMF, AXA Global Investors

Note that the downward blip in growth in 2011 is not the dreaded global double-dip, although we cannot rule that out for some countries. It is better described as a "post-dip-blip".

Further out, however, our growth forecasts are somewhat stronger than the IMF's. Not all recent developments have been negative for economic growth. In Europe and the United Kingdom for example, a weak exchange rate will be positive for exports and therefore economic growth. It is also positive for the necessary rebalancing in their respective economies from their non-tradeable to tradeable sectors.

Also, greater near-term fiscal austerity essentially means a front loading of measures to rein in large budget deficits. That means the fiscal austerity drag on growth will be over more quickly.

In short, we find ourselves with broadly the same economic story, albeit with a few tweaks. A subdued economic recovery is playing out in developed markets. This recovery will be constrained by the need to get house hold and government debt back to sustainable levels. This process may take some years. In the meantime, emerging markets are not constrained by the same debt overhang and will continue to be the strongest performing economies.

As always, there are risks. In particular, for many developed countries, there is no fiscal headroom left. That means that if growth takes a turn for the worse, there is no further room to move on fiscal policy to support economic growth.

It is also the case that there is still considerable work to do to wean many countries off public demand and complete the transition to private demand. In these countries, jobs growth remains key.

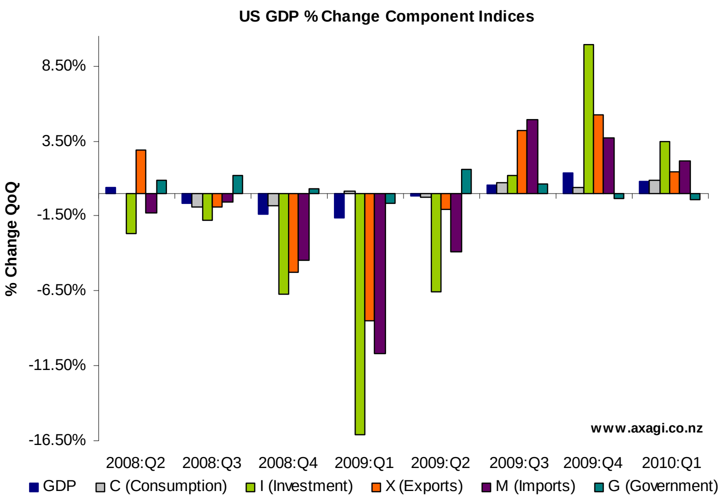
Finally, there is still a need for considerable global co-operation. In that respect the upcoming G20 meeting in Toronto will be critical in forging a pathway to increased global co-operation.

US recovery: increasingly entrenched but subdued

The economic recovery in the United States looks increasingly entrenched, albeit still subdued compared to typical recoveries. GDP expanded at a 3.0% annualised rate in the first quarter of 2010, weaker than the 5.6% recorded in the fourth quarter of 2009.

That growth, while weaker, was more broadly balanced across the economy. In particular, consumption chimed in with a contribution and, most pleasing of all, business investment continued to make a robust combination. However inventory rebuilding still accounted for around half the growth in quarter.

The growth in consumption also needs to be interpreted with caution as a good portion of this was fuelled by government stimulus measures. This impetus will clearly fade as that stimulus runs its course.



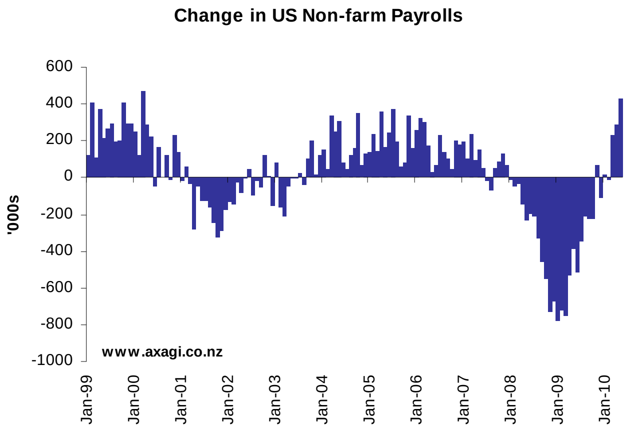
Source: US Commerce Department and AXA Global Investors

As with many "mature" economies the current recovery in the United States must be different from those seen previously. Growth needs to be driven from the productive sector and, more precisely, the export sector. Net exports have been a positive contributor to growth over the last 12-months.

In line with a productive sector recovery, the US manufacturing sector is performing well. The Institute of Supply Management Performance of Manufacturing Index has hovered around a level of 60 over the last two months. A reading over 50 indicates the manufacturing sector is expanding while a reading under 50 suggests the sector is contracting.

Importantly the export index was at 62 in May, its highest level since the December quarter of 1988. This bodes well for future production and for the rebalancing of the economy we are looking to see for the recovery to be sustained.

As expected, the recovery in the labour market has been slow in coming. The recent modest recovery in jobs has been supported by temporary hiring's for the US Census, so the headline number has been overstating the strength of "real" jobs. On a more positive note, manufacturing jobs have now been rising for 6 months.



Source: US BLS, AXA Global Investors

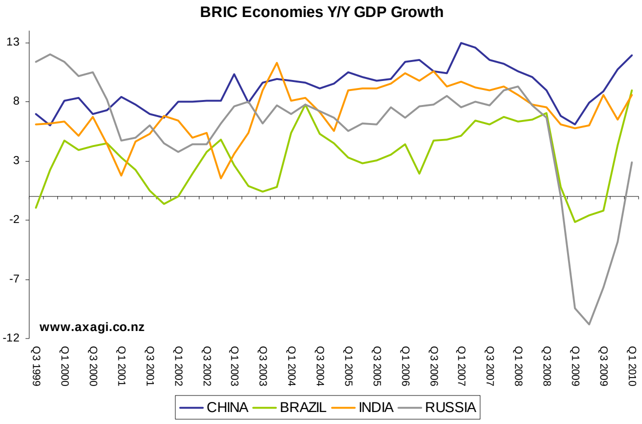
Further jobs growth will be important for the sustainability of the US recovery, especially consumption. But job growth is expected to remain subdued, in line with the overall economic recovery. We expect the US unemployment rate will still be around 9% at the end of the year. Indeed the unemployment rate actually rose between April and May as more people joined the labour force (a positive sign), but did not immediately find jobs.

Inflationary pressures are non-existent in the US economy. The Federal Reserve's preferred measure of inflation, the private consumption deflator from the national accounts rose at a 0.6% annual pace in the first quarter of the year. This underscores the Fed's intention to keep interest rates low for an extended period.

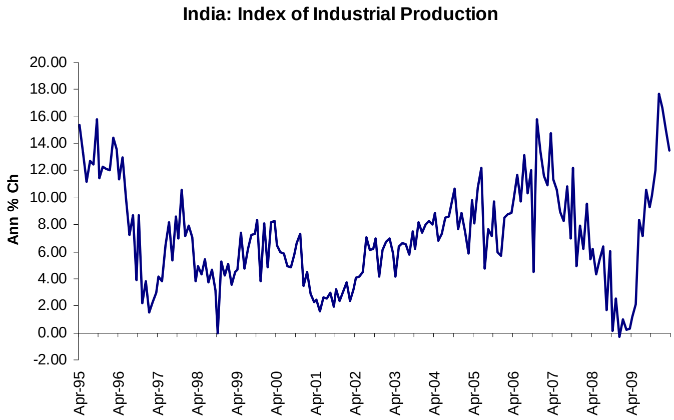
There are clearly positive signs in the US economy. Indeed we believe it is strong enough to withstand any fallout from lower growth in Europe. Six months ago that may not have been the case. And of course the US still has its own not insignificant budget deficit to get under control.

emerging markets going strong

Growth in the key emerging market has recovered strongly. China GDP growth hit 11.9% in the year to March 2010. India recorded 8.6% and Brazil 9.0% over the same period. Russia is also recovering well after a sharp contraction in activity that was more to do with commodity (oil) prices than the direct impact of the Global Financial Crisis.



Source: Bloomberg, AXA Global Investors



Source: MOSPI and AXA Global Investors

There is an element of base effect in these numbers, particularly China, India and Brazil. March 2010 annual growth is based off March 2009 – the weakest point of the recession. In all three cases, we believe annual growth will be lower when June data is released.

Nevertheless growth in these major emerging economies is exceptionally strong. Strong growth in China and India is having a positive spill-over effect into broader Asia. Regular readers of *Quarterly Strategic Outlook* will recall that even in the darkest days of the crisis, the recovery in growth would be strongest in emerging markets, or to be more precise, the countries that were not weighed down by high levels of household and public sector debt.

But with strong growth comes other challenges – managing the high level of capital inflows and the building risk of inflation.

In our view, not managing inflation pressures presents one of the biggest risks to long term prosperity in emerging markets. With the recovery we expect to see in global growth, commodity prices are also expected to track higher. Commodity prices have a higher direct impact on measured inflation in emerging markets given their relatively unsophisticated CPI baskets.

India has the highest inflation rate (13.3%) in the G20. India was at risk of overheating in the period immediately preceding the GFC and seems to have gone straight back there.

Likewise the Brazilian central bank, the Banco Central do Brazil, is also hiking rates. They increased the Selic rate by another 0.75% to 10.25% following the release of the March GDP data. But in a similar pattern to that playing out in India, Brazilian industrial production has slowed in recent months.

It is, however, the risk of overheating in China that has captured the market's attention. Strong growth with rising inflation, high foreign reserve accumulation and a strong property market are fuelling concern of a "China bubble". (For more on bubbles in China, see the *Asset Strategy* section.)

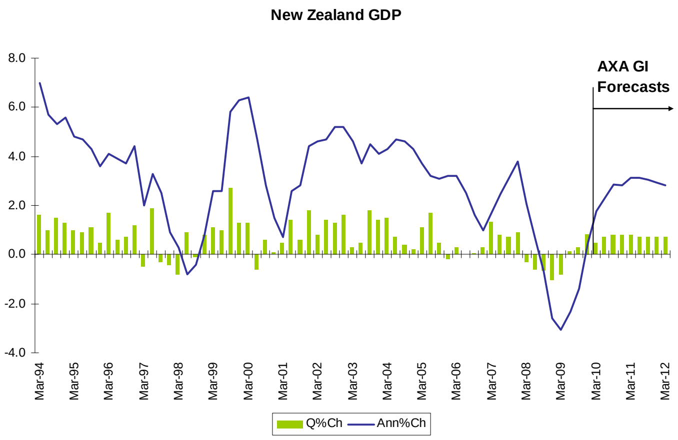
Chinese authorities have already lifted the reserve requirement ratio three times and have implemented measures to cool the residential property market. We believe interest rates will also need to be raised soon. With that will be a likely appreciation in the Chinese Yuan (CNY) which is currently pegged to the United States dollar. Such a move would be positive for China by helping keep inflation in check, but also positive for a rebalancing in global growth as a higher CNY will make imports cheaper and help support domestic demand.

We continue to be positive about the outlook for growth in the key emerging markets, and the importance of these countries for the overall global recovery. While emerging markets account for about 50% of global GDP (on a PPP basis), they have accounted for around 75% of global economic growth over the last 5 years. Given the structural headwinds facing many developed countries, that's a trend we don't expect to see change anytime soon.

While they don't have the same structural challenges as many developed countries, they have structural challenges none-the-less. Taking the right steps to contain inflation and avoid the excesses that could flow from high capital inflows should be welcomed. Yes – these measures will lower near-term growth, but they increase the chances of a sustainable economic recovery

New Zealand

The New Zealand economic recovery continues to be subdued. This will be reinforced with the release of March quarter GDP in a couple of weeks time which is expected to show quarterly growth of 0.5%, lower than the 0.8% recorded for the December quarter of 2009. Nevertheless, this will be our fourth consecutive quarter of economic growth. We expect more of the same in coming months.



Source: Statistics New Zealand and AXA Global Investors

The subdued nature of the recovery reflects, as it does for many developed countries, already stretched household balance sheets and soft residential property activity. This is in turn keeping a lid on growth in consumption. These have been the traditional drivers of economic recoveries in New Zealand.

This time it has to be different. We need to see strong export growth for a sustained recovery. Our major trading partners are helping out in that regard, with Australia, China and South Korea amongst the strongest global growth performers.

Strong terms of trade will also help underpin the New Zealand recovery. As mentioned above, we remain bullish on commodity prices with soft commodity prices also expected to benefit from strong growth in emerging markets.

In order for the recovery to continue to build impetus, we need a rebalancing in resources within the economy from the non-tradeable sector to the tradeable sector. Yes, we have wanted this before, but this time we need it.

In that respect we wanted Budget 2010 to take a balanced approach to fiscal consolidation and support for economic growth and, more precisely, the rebalancing in the economy we need to see.

We think the Government did a pretty good job. A shift in tax away from income (household and company) to consumption is a positive move. Greater support for the innovation system through increased spending in Research Science and Technology was also welcome. What we liked most about the science spending was the part tagged to improve linkages between the science community and business. There is little point in investing in science if the end result is not able to be commercialised.

In general we believe the Budget was good for productivity and therefore real wages, but was also pro-saving which will help with another of our imbalances, the current account deficit.

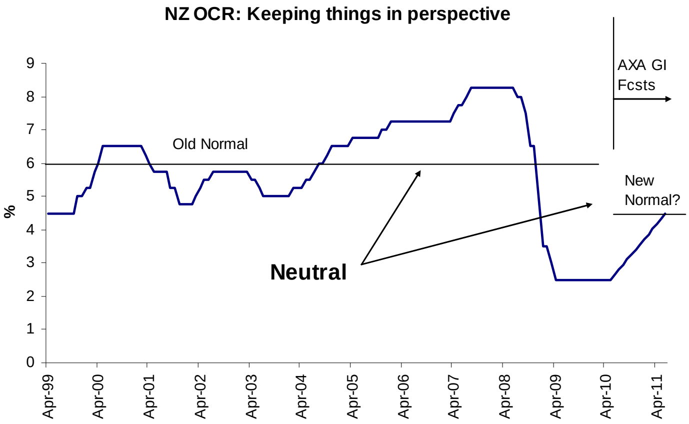
The disappointing part of the Budget was the lack of action on some of the longer term fiscal trade-offs. The deterioration in our fiscal position since the GFC has brought forward the need to act on some of our longer term fiscal challenges, such as the ageing population and the costs of state funded pension entitlements at their current level.

This is not so much whether we can afford state funded pensions at their current level but whether we want the current level of entitlement instead of the other things we could have like lower debt, greater support for the innovation system, or even lower taxes.

We need to get our fiscal position back to where it was so that we are in a better position to weather the next global (or indeed local) economic or financial crisis.

We see economic growth of around 3% in each of the March 2011 and 2012 years. While this is lower than that forecast by the Reserve Bank in its recent Monetary Policy Statement, we agree with the need to start removing the extreme level of monetary stimulus in the economy.

The Bank raised the Official Cash Rate by 0.25% to 2.75% at its June meeting. We expect they will follow up with another 0.25% at its next review on July 29.



Source: RBNZ and AXA Global Investors

Argument prior to the tightening around the appropriateness or otherwise of the first move was seriously missing the point. Monetary conditions are still extremely stimulatory and will remain so for some time, even as the Bank continues to raise the OCR.

The more interesting debate for this cycle is the extent of the tightenings. There is good reason to believe that the neutral cash rate is somewhat lower than it was before. Higher bank funding costs and the rebalancing we expect to see play out in the economy all suggest a more muted interest rate cycle this time around.

By starting early and taking a gradual approach, the Bank is increasing the prospects of such an eventuality playing out. This will be good for the cost of capital over the whole economic cycle.

Bevan Graham
Chief Economist

asset strategy

international equities

Global equities are down for the quarter-to-date, largely due to concerns over European sovereign debt. Greece is at the centre of the drama, with debt-refinancing worries necessitating a rescue package from the European Union and IMF.

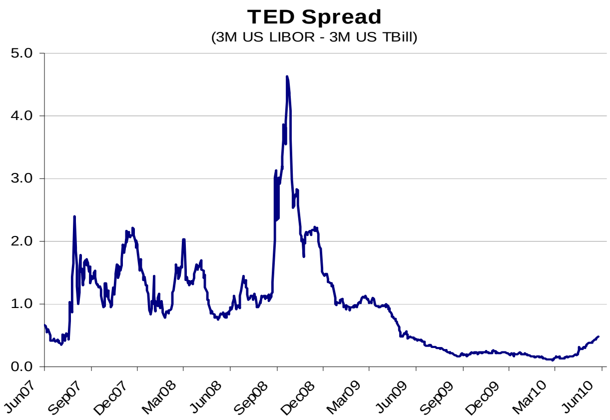
outlook

Having just lived through extreme times it is understandable that markets now see all events in the extreme. Thus, the very real Greece crisis is not only seen as a crisis for Europe, but also the globe. Yet Greece's economy is about the same size as Venezuela; which is not a country one would expect to dictate the course of global markets. Certainly "all the world's a stage" but countries like Greece don't usually have a part in most global dramas, until now.

Our view of the situation is that Greece could very well default in the next five years, but given less than 0.7% of European banking assets are exposed to Greece, the risk to the wider financial system is manageable. The other countries that make up the swine-line acronym (PIIGS) are unlikely to default, though Portugal has more work to do than the others. Portugal represents 0.8% of European banking assets.

There are no defaults on the near-term horizon however, thanks to the €750 billion joint European Union / IMF stability package. But that just removes the refinancing risk over the next few years, not the solvency risk.

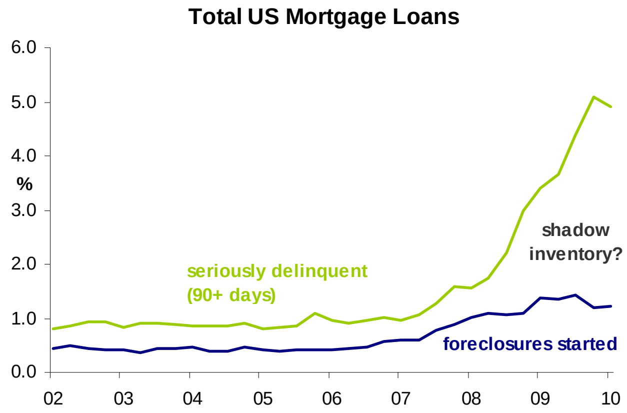
Our view that the risk is manageable is supported by key bank sector risk indicators, such as the TED spread – the spread between 3-month Treasury bills and interbank rates. The TED spread has risen only modestly over the last quarter, and is nowhere near GFC levels.



Source: Bloomberg, AXA Global Investors

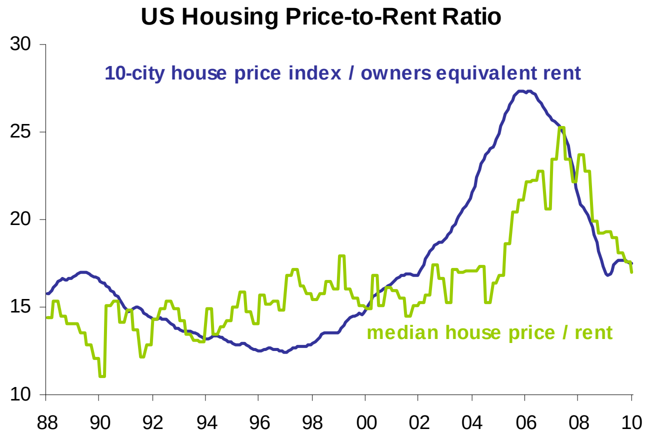
Developments in the US are just as noteworthy as those in peripheral Europe. US house prices fell for the sixth month in a row in March and we think there is more than the usual seasonal weakness at play.

The number of homes for sale is rising again and supply could jump higher still judging by the amount of shadow inventory not captured by the data. There has been a suspension of delinquent loan foreclosures by the US housing authorities over the last 6 months, but the moratorium ended in April. So, more foreclosure sales are likely to hit the market in the next few months.



Source: Bloomberg, AXA Global Investors

The relationship between housing supply and prices points to price weakness throughout 2010. A large decline (>10%) looks unlikely though, given house prices look reasonable against measures such as rent and income. Plus the growing economy will provide some support.



Source: S&P, US Census, BLS, AXA Global Investors

Nevertheless, even modest declines will create a headwind for the US banking sector. With European banks under pressure from peripheral Europe exposure, developed market lending growth will be a struggle.

Given this, we reduced our target weight to international equities over the quarter, though we remain slightly overweight on the view that markets will eventually move higher on the back of 1) above-trend global growth propelled by emerging markets and 2) a margin-led sustained recovery in profits driven by low wage costs. Competition from a globalised labour force and higher-than-average unemployment are the reasons behind an extended period of low labour costs.

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

emerging markets

Emerging markets declined along with developed markets for the quarter-to-date, but they did outperform a little, as worries about Europe weighed more on advanced economies.

outlook

Given emerging markets are a high beta asset class it is somewhat unusual for them to outperform developed markets when the latter declines.

Emerging markets (EM) are characterised as high beta markets because their short-term returns are usually an amplification of developed market returns.

In equation form:

$$\boxed{\textbf{EM Return} = \alpha + \beta\textbf{(Developed Return)}}$$

Short-term investors worry about the high beta because when global equities fall, emerging markets usually fall even more; as they did during the GFC.

As long-term investors we worry less about the beta and focus more on the alpha (α). A positive alpha tells us emerging markets more than compensate for the risk involved[1].

Looking at monthly USD returns from December 1987, when MSCI EM series begins, to 31 May 2010, gives the following equation:

$$\textbf{EM Return} = 0.6\% + 1.14\textbf{(Developed Return)}$$

As we would expect the beta, is greater than 1.0. But the alpha is 0.6%. This means over the last 22 years EM investors received 0.6% **per month**, above that expected from an efficient market.

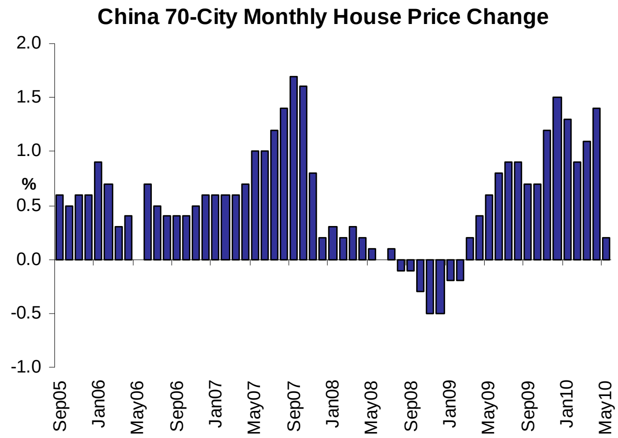
To be sure, some of this excess return was one-off gains from valuation multiple expansion. Emerging markets were much cheaper than developed markets 20 years ago, whereas they are now only a bit cheaper.

Nevertheless, we expect the alpha to remain greater than zero going forward, for reasons we've listed before: better growth prospects, lower private and government sector borrowing, less financial sector risk, plus reasonably attractive valuations.

That doesn't mean there won't be some bumps along the way. At current growth rates, emerging market economies are doubling in size every 11 years. China's economy is doubling every 7 years. You simply can't have that level of growth without some misallocation of resources, sector bottlenecks and price volatility. China's property market is a good example of that.

We remain of the view that China's residential property market is not in bubble territory. Yes prices are rising faster than income for the first time in a decade, but we don't think this will last.

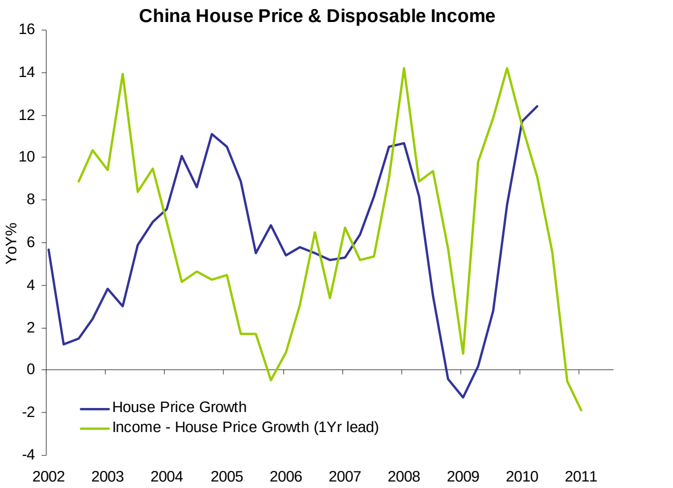
The authorities are intent on slowing price gains and recent measures seem to be working. Sales are declining and house prices rose only 0.2% in May, the smallest gain since the current cycle began.



Source: Bloomberg, AXA Global Investors

[1] We are not talking about alpha here in the usual manager 'excess return' sense

Also, because China homeowners can typically borrow much less than those in other countries, rising house prices usually cure themselves. People just can't keep borrowing to purchase homes with ever-increasing prices. This is why income minus house price growth is a reasonable indicator of future prices. If income rises faster than house prices, prices tend to rise, and vice versa.



Source: Bloomberg, AXA Global Investors

From worrying about a house prices rising too quickly only a month ago, some are now concerned prices might fall too fast and lead to a wider economic slowdown. That might happen. But if the Chinese authorities do over-tighten we would expect them to quickly reverse track to keep growth around 8-to-9%; as they did during the 2008 housing correction

Long-term investors should certainly follow these developments but they shouldn't lose sleep over them. Instead they should focus more on the alpha factors i.e. emerging markets' higher growth, lower leverage, less financial sector risk, and still attractive valuations.

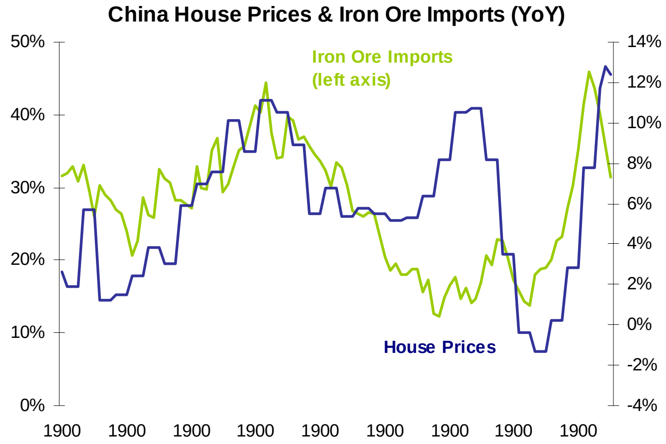
australasian equities

Australasian equities are down for the quarter-to-date on European sovereign debt jitters. A new resource profit tax and worries of a China slowdown also weighed on Australian shares, though they are staging something of a recovery at the time of writing.

outlook

On top of European debt concerns, Australia's resource sector took a double-hit during the quarter. The first came from a potential overreaction by China to slow their property market. The second was in the form of a new Resource Super Profits Tax (RSPT) on mining, which is scheduled to apply from mid 2012.

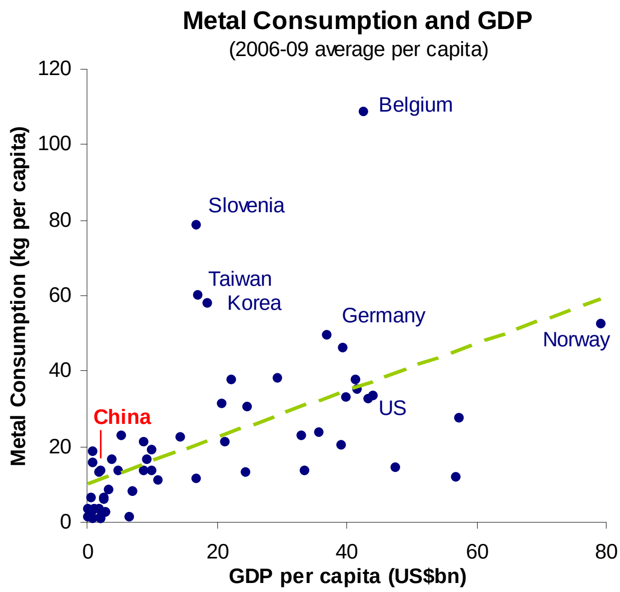
China is the world's largest importer of iron ore and about a third of steel demand is used in property construction. In the short-term then, Australia's iron ore exports will depend on China's management of the property boom. The worry is if the property boom turns to bust, so will metal prices and volumes.



Source: Bloomberg, AXA Global Investors

It's worth noting that while Chinese property prices might fall in the short-term, demand for metals might not follow because the state and local government are planning to build or renovate 6 million affordable homes.

In the medium-to-long term, Australia's iron ore export growth looks assured. China's economy is relatively metal intensive given its focus on industry, infrastructure and property. This means its metal consumption is high relative to GDP. However, metal consumption is still low on a per capita basis and as rural migration continues and income per capita rises, so will metal consumption.



Source: IMF, AXA Global Investors

Australia's proposed 40% tax on non-renewable resources is a real negative for resource sector profits, given it is in addition to the corporate tax rate. With the scheduled reduction in the latter from 30% to 28%, the effective tax rate could be as high as 56.8%.

While lower (or no) mining investment would be positive for commodity prices and revenues in the medium-term, higher unemployment due to project cutbacks could be too much for the government to bear.

According to reports, A$20 billion of new projects have been shelved since the RSPT was announced. Given the backlash, the Rudd government will probably have to soften the tax burden in its present plan. One contentious issue that needs addressing is the tax applies to any profit over the risk-free rate. Surely there should be a risk premium added, as mining is a little more risky than investing in government bonds.

The other Australian budget measures were generally positive for equities. A planned reduction in the corporate tax rate from 30% to 28% should be welcomed by the remaining 80% of the market that is non-resource. Also, the increase in compulsory superannuation to 12%, from 9% presently, is positive in that it will lead to more domestic equity funds which should result in higher valuation multiples and a lower cost of capital.

If it didn't before, New Zealand's 2% compulsory employer contribution for KiwiSaver members now looks distinctly meagre in comparison. Lower personal tax rates and higher GST from October should encourage saving but one doubts it will be enough to get our household saving rate back into positive territory.

That New Zealand's household saving rate is still a shocking -13.7% (of disposable income) is all you need to know to explain why this recovery won't be consumer-led; absent another property boom there are limits to how much more consumers can borrow to spend. The negative saving rate also helps explain our persistent current account deficit, high cost of capital and foreign indebtedness. Along with Greece we remain one of the few countries to exhibit a negative household saving rate.

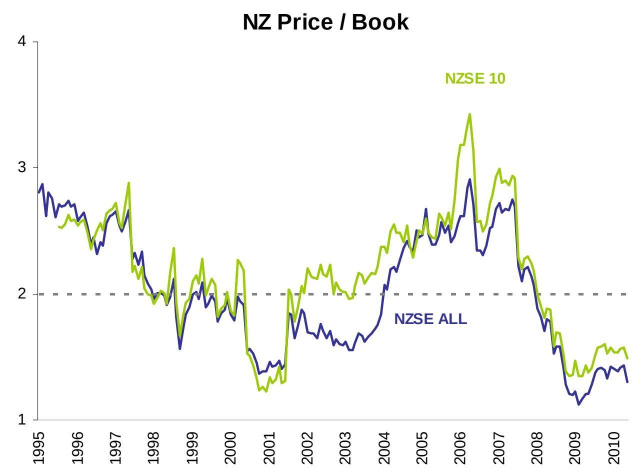
The IMF released an interesting paper in May, comparing Australia's and New Zealand's potential growth rates post the global crisis. A high cost of capital is one of the reasons they estimate NZ's potential growth to be 0.8% below Australia's. Lower terms-of-trade gains and lower population growth are the other two.

It's fairly evident that until we get our savings rate up, NZ GDP and earnings growth will continue to lag Australia's. We can safely forget about closing the gap in levels until then.

Still, the surprise cut in New Zealand's company tax rate to 28% is positive for earnings. Higher expected milk prices will also be positive for NZ company earnings, but given there is little direct listed equity exposure to dairy, the benefit will be through second-round effects on the economy.

In its June annual *Situation and Outlook*, MAF forecasts milk prices to rise 18% from 2010 to 2014. However, all of this gain is due to exchange rate depreciation with USD milk prices expected to be lower in 2014. That looks pessimistic. The joint OECD/UN *Agricultural Outlook* (released a day later) looks more realistic. They forecast dairy prices to be between 16% and 45% higher in real terms over the next 10 years due to sustained growth in emerging markets.

New Zealand stocks also look good value following the recent decline.



Source: Bloomberg, AXA Global Investors

But when you factor in Australia's direct listed commodity exposure and higher relative growth prospects, Australian stocks still look better value. We remain overweight Australia and underweight New Zealand equities.

property and infrastructure

Listed property markets are down for the quarter-to-date along with all other growth assets. NZ listed property is down by more than global property at the time of writing, with tax changes in the NZ budget adding to commercial property sector woes.

outlook

Rising vacancy rates and falling rental yields previously had us forecasting zero dividend growth for NZ listed property for the next 5 years. Given the recent budget, we now think even that is a big ask.

The budget implications for commercial property are:

- Removal of tax shield on building shell depreciation expected to reduce payouts by ~8%.
- Decrease in PIE tax rate to 28% from 30% will lift payouts so overall reduction ~6%.
- Depreciation on chattels is 'under review' and if this is excluded payouts could decline by a similar quantum.
- Valuation adjustment is less than 6% because claimed depreciation must be repaid on building sale (essentially it's an interest free loan)

Given rising vacancies, falling rents and dividend cuts, NZ listed property returns will probably lag other growth assets - especially when you consider many investors hold property stocks for the income.

As a result, we increased the underweight to NZ listed property over the quarter, reallocating the funds to Australasian equities. We also remain underweight global listed property, where valuations still look expensive. The portfolios are at benchmark allocations for global listed infrastructure.

international and domestic bonds

Global government bond yields declined about half a percent for the quarter-to-date, on the back of the flight-to-safety trade. Global credit spreads moved in the opposite direction but not by as much, resulting in reasonable returns from global bonds. Domestic government bonds and credit took their lead from offshore.

outlook

The flight-to-safety trade will see bonds do the opposite of equities in the near-term but low bond yields provide the anchor to returns over the medium-term.

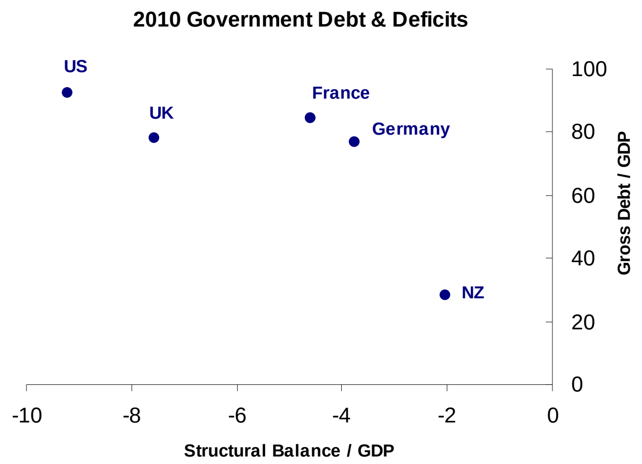
The latest bout of risk aversion has pushed US 10-year government yields to 3.2%. Last quarter we thought the 10-year yield looked expensive at 3.7% so it looks even more expensive now.

US government yields are very low compared to nominal GDP growth and given the massive amount of issuance coming to the market each quarter, we expect investors will increasingly demand a little more yield.

In fact, the outlook for core sovereign issuers could be grimmer than we thought. According to a recent paper by the *Bank of International Settlements*, under reasonable scenarios debt-to-GDP ratios in the US and UK could reach 200% of GDP sometime in the 2020's and 300% of GDP in the 2030's. And there we were just worrying about 100% ratios!

We are not forecasting a massive sell-off in yields. Not while pension funds, insurance companies and banks are mandated to buy government bonds. But more discretionary investors such as sovereign wealth funds - and indeed our investors - should demand more yield before adding to their holdings.

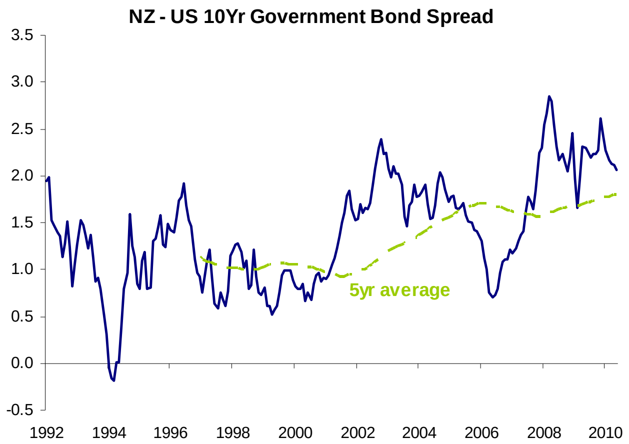
As the recent budget illustrated, New Zealand is in quite a different position to most other countries.



Source: IMF, NZ Treasury, AXA Global Investors

New Zealand's deficit and debt ratios are roughly a third of those in the UK, US, Germany and France.

The spread between NZ and US 10-year bonds is also above average, due to US monetary policy being on hold plus the flight to safety trade.



Source: RBNZ, US FRB, AXA Global Investors

These factors suggest NZ bonds are better value than their global counterparts. NZ bonds won't be immune to rising yields in the core countries. But if global bond yields rise due to massive issuance, NZ yields won't necessarily rise by as much.

Given the above, domestic bonds were moved to neutral from underweight over the quarter. We remain underweight global bonds. Credit spreads have jumped a little recently, but not by enough to tempt us to reduce the underweight.

currency

As is usually the case during periods of heightened global risk aversion, the NZD tracked global equities over the quarter. The correlation was especially high against the US dollar and Yen, the two carry-trade funding currencies. With current worries centred on Europe, the NZ dollar rose against the region's single currency. The NZ dollar also moved higher against the Australian dollar, as a sharp drop in base metal prices led traders to unwind long AUD positions.

outlook

It's highly likely the NZD/USD will continue to track global equities in the near-term. Having said that, the current spot rate is probably the best estimate of the near-term rate with markets evenly poised between fiscal and banking sector worries on the one hand, and the ongoing recovery in growth and earnings on the other.

Over the medium-term the NZD should gravitate towards 61 US cents, our assessment of fair-value. High commodity prices and rising NZ interest rates may support a NZD in the high 60 cents or even 70's for a while, but a return to current account deficits greater than nominal GDP growth and an eventual tightening in US monetary policy should ultimately bring about a fall.

Looking at the other major currencies, the NZD looks most overvalued against the British Pound. There are a number of factors weighing on the GBP at the moment including low growth and hence low interest rates, plus large budget deficits and debt-to-GDP ratios

The UK was hit particularly hard during the GFC, firstly because it had its own housing bubble, and secondly because the financial sector makes up a large chunk of the economy. The UK housing market is now showing signs of stability, if not recovery, and the financial sector will rise again in the future, especially given the growing importance of Asia which will look to London possibly more than New York. In short, UK growth is going to look better next year and interest rates will need to rise.

UK budget deficits are not going away anytime soon, but they will narrow over the next few years aided by stronger economic growth from 2011. But spending cuts will also need to be made and taxes will have to rise too. The bottom line is the GBP is under pressure for good reasons but some of these should become less of an issue in time.

Given our view, we retain a below-benchmark global equity hedge with the largest positions against the USD and GBP.

We also retain a 25% hedge against Australian equity currency exposure (the benchmark is zero), which we put in place in Q1 this year. Like currency forecasts in general, the current spot rate is the best estimate of the near-term NZD/AUD rate. Over the medium-term we expect the NZD/AUD to move towards fair value, which is in the mid 80 cent range on our estimates.

Keith Poore
Head of Investment Strategy