QUARTERLY INVESTMENT STRATEGY UPDATE

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Portfolio strategy summary

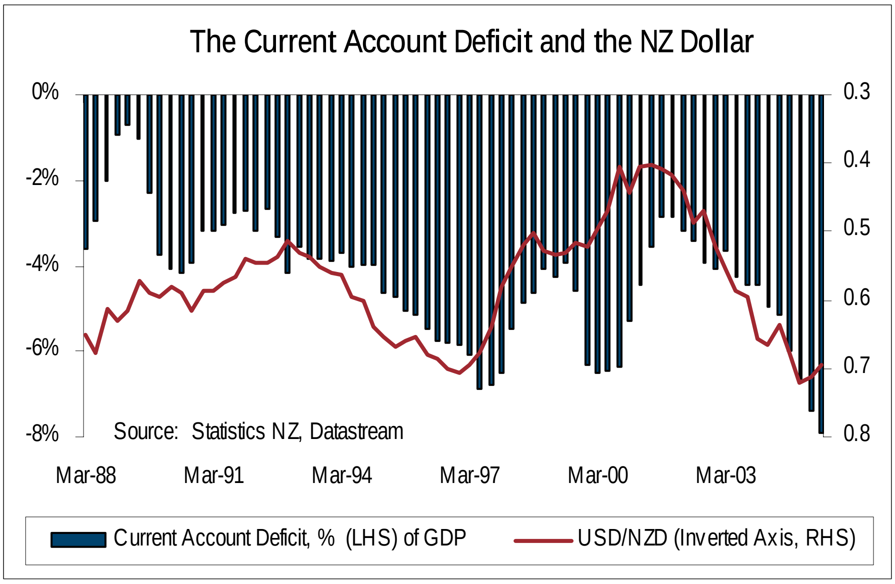
This table summarises our key portfolio strategies. For a full explanation of the thinking behind these views, see the individual reviews of asset class valuations.

Asset class	Current portfolio weighting	Description
Australasian Property	Underweight	We are now concerned that low capitalisation rates will limit future returns, although some sectors may see sufficient rental increases.
Australasian Infrastructure	Overweight	Defensive assets with rising cash flows such as infrastructure are favoured in the current environment.
Australasian Shares	Neutral	The poor outlook for the local economy is likely to have some impact on the equity market. Valuations have not become too stretched but cost pressures are likely to limit the potential for earnings growth.
International Shares	Neutral	International equities, especially outside the US, are still trading on attractive valuations despite their recent gains.
Emerging Market Shares	Overweight	Emerging markets remain one of the clear valuation opportunities for investors.
NZ Bonds	Underweight	New Zealand bond yields are still too low given stubbornly high inflation pressures.
International Bonds	Underweight	International bond yields remain well below our estimates of fair value. We continue to avoid long-dated international bonds.
NZ Cash	Overweight	Short-term interest rates have moved higher and are likely to go further. Once this is fully reflected in bond yields we may see good opportunities to move out of cash.
Currency Hedge	Underweight	The New Zealand dollar is vulnerable. We are now positioning our portfolios with lower than normal currency hedging levels.

In recent strategy updates we have considered developments in global housing markets, the conundrum of low bond yields, the outlook for a change in trend in the New Zealand dollar and the effects of terrorism on markets. This quarter we look at New Zealand's current account deficit, which has reached an embarrassing 8% of GDP, and the inflation rate, which has reached a concerning 3.4% per annum.

New Zealand's Current Account deficit – making the US deficit look small

The current account deficit has reached 8% of GDP, and a further deterioration to an astonishing 10% of GDP is possible in the coming year. In comparison, the US current account deficit is around 6.3% of GDP. Yet offshore investors have been relatively unconcerned – our high interest rates are too enticing and more than compensate for any concerns about our appalling deficit. Can anything be done to force an adjustment, or will time take care of things naturally?



In order to answer these questions, we need to determine how much of the deficit is cyclical i.e. as a result of cycles in the economy and the currency, and how much is structural or more permanent. As shown in the above graph, even at times when the currency is at a cyclical low and the economy is weak, the current account struggles to improve beyond the 3-4% of GDP range.

The country's massive $11.9 billion deficit can be split into several key components:

- The transfers balance, which is small and not worth worrying about.
- The balances in goods and services, which have traditionally been either a small deficit or a small surplus. The goods balance has deteriorated to a $3 billion deficit, and merchandise trade data suggests that a further deterioration lies ahead. Fortunately, the services account continues to run a small surplus of around $900 million, largely due to tourism exports.
- The largest contributor to the current account deficit is the $10.3 billion investment income deficit. A couple of years ago, it was closer to $7 billion.

The deterioration in the goods balance has been largely cyclical. Strong domestic demand and a high currency have encouraged import growth and left the export sector struggling to keep up. Interestingly, growth in commodity exports has recently been disappointing despite record highs in commodity prices, but other manufactured exports have recorded robust growth.

New Zealand's growing import bill has been influenced by several factors. Firstly, imports of capital equipment have been strong. This is a positive trend – many businesses are facing capacity constraints, new investment should have a positive impact on future economic growth and productivity, and the cheapest time to invest is when the currency is high. Secondly, some of our growing import bill has been driven by higher oil prices, which is largely outside of our control. Thirdly, import volumes of durable consumer goods rose 14% in the year to June – a trend which is more concerning as it has largely been funded by increased debt.

New Zealand's other problem is the growing investment income deficit – although a significant portion of this is structural, its deterioration has also been cyclical. The fact that an investment income deficit has existed for some time is a structural issue and reflects the strong interest shown by offshore investors in owning local companies as well as our need to access their capital (which is unlikely to change). It is also a cyclical issue – when the New Zealand economy is performing well, the profits earned by those offshore-owned companies tend to increase.

Another growing portion of the investment income deficit is interest payments on debt, largely reflecting overseas borrowing by banks to fund New Zealand households' insatiable demand for borrowing. Once again, this is partly structural (New Zealanders have been spending more than they earn for well over a decade) and partly cyclical (the housing market has been booming). The banking sector's offshore debt now accounts for 63% of New Zealand's net foreign debt. In 1998, the Reserve Bank Governor at the time, Dr Brash, said in a speech that "…a significant part of those foreign savings is being used not to generate faster economic growth but simply to buy ourselves larger houses." Nothing has changed.

New Zealand clearly has a growing problem that cannot continue indefinitely. Is there a solution?

The most likely scenario is that a combination of slower domestic spending growth and a lower currency will enable the current account deficit to finally reduce. Herein lies the dilemma - our interest rates are not yet high enough to discourage borrowers, but are high enough relative to the rest of the world to encourage ongoing inflows of foreign capital and keep our currency at high levels. This is expected to change. Offshore investors will finally notice that given a slowing economy and a huge current account deficit, maybe New Zealand dollar denominated assets aren't the best destination for their savings. As the trend in the New Zealand dollar finally changes, it will only reinforce this shift in investor sentiment.

Unfortunately, small adjustments may not be enough. It could take a sharp fall in the currency and a recession to see the current account deficit improve significantly. Even then, it would probably only result in a cyclical improvement. Changing the long-term structural trend would require a more significant and permanent shift in behaviour.

Is Inflation getting out of control?

During the early 1990s, New Zealand led the trend toward inflation targeting. An explicit inflation target was set (at 0% to 2%) and the authorities did little to deny the rumour that the Reserve Bank Governor's pay packet was tied to the achievement of this objective.

This clear targeting showed the public that the Reserve Bank was serious about its objective, and it gave decision-makers a framework on which to forecast future inflation. The transition from a volatile and highly uncertain inflation path to one that was low and stable had obvious benefits for businesses. A significant source of uncertainty was removed from the decision-making process and the general quality of investment in the economy improved. Economic growth increased, as did real incomes.

Over time, the degree of inflation-fighting resolve has clearly diminished. The inflation target was changed to 0-3% in late 1996, and again in 2002 to 1-3% "on average over the medium term", with the added caveat of avoiding "unnecessary instability in output, interest rates and the exchange rate". Recent data has shown that even this more relaxed target has been breached, with a 3.4% outcome for the year to September 2005. We believe that New Zealand's inflation rate could reach 4%-4.5% in the year ahead.

We have no doubt that the Reserve Bank is as vigilant as ever, but the problems remain for forecasters who now face inflation outcomes that could be three percentage points above the mid-point of the target range of a few years ago.

What are the effects of this new volatility in the inflation rate? Just as low and stable inflation improved economic outcomes, higher and more unpredictable inflation has a very real economic cost.

Businesses suffer if they are unable to pass on price increases. This may vary considerably across different sectors, but the worst affected would be those who are price takers on their outputs and have a high oil or labour component in their inputs.

Savers clearly suffer if they have locked in a fixed income stream on the assumption that it will provide a positive, inflation-adjusted return. The higher inflation rate robs them of purchasing power and discourages them from adding to their savings.

The fate of investors will also vary. Those who choose assets with incomes that rise with inflation will be well insulated. However, those with fixed cash flows or assets that suffer significantly under rising inflation will be forced to reassess their portfolio positions. International assets may be very useful to have, as rising inflation often results in a decline in a country's exchange rate. Local investors with international assets would see them rise in value in New Zealand dollar terms.

We do not think that inflation is getting out of control. However, it is going to remain high and volatile for some time to come. This imposes costs on the economy – costs that result from inflation itself and others that come from the Reserve Bank's efforts to contain inflation. These are likely to be primarily felt by savers and households, although investors could also be affected depending on their level of preparedness.

After several years of 20%+ returns, the 2005 year has so far seen the local sharemarket underperform relative to many other major markets. Given the cyclical economic downturn that is currently underway in New Zealand, domestic equities face a somewhat tougher environment over the next few years. We expect returns to reduce towards a more modest 5-10% range, broadly consistent with a period of relatively flat share prices but with investors continuing to enjoy a reasonably healthy dividend yield. Although we are not concerned about the risk of a sharp decline in share prices at this stage, we are nevertheless wary of several risks that the market faces:

- Although economic activity appears to be holding up well to the higher interest rate environment and a soft landing is still the most likely outcome, the risk of a hard landing increases with each rise in the Official Cash Rate.

- We expect offshore investors to increasingly shift their focus away from interest rates and towards the slowing economy and very large current account deficit. If the New Zealand dollar declines as expected, offshore investor perceptions regarding future returns from local assets will reduce, discouraging new investment.

- The outlook for company profitability would have been stronger under a National-led coalition compared to that under Labour.

New Zealand companies are generally well placed to weather the relatively soft economic downturn that lies ahead. They have enjoyed several years of double digit earnings growth, and because strong investment spending has tended to be funded out of retained earnings or equity raisings rather than debt, balance sheets have strengthened. Nevertheless, with economic growth slowing and cost pressures increasing, profitability is expected to be squeezed.

Risks during the next few years are expected to be concentrated in sectors that are exposed to the consumer spending and housing cycles. As the housing market finally responds to higher interest rates and very low net migration levels, house price appreciation will stall. This will have a flow-on effect onto wider retail spending.

Recent research into New Zealand's corporate sector by the Reserve Bank suggests that the retail sector has less ability to absorb a slowing in turnover and increased cost pressures than other sectors. Wage bills will face several years of strong rises, firstly due to the direct impact of a rise in the minimum wage to $12 an hour, and secondly due to flow-on effects as other workers seek to restore relativity. The retail industry not only has a significant concentration of employees earning the minimum wage, but it also has the lowest margins and the least ability to absorb this additional cost. In contrast, the widest margins are in the transport sector (providing some scope to absorb sharply higher petrol prices) and the services sectors.

The UK and Australia provide some useful foresight into the likely outlook for consumer spending in New Zealand during the next few years. Household wealth in both countries has started to shrink because debt levels are still rising but house price appreciation has stalled. Although retail spending growth has slowed in response, this has not been dramatic. Recent declines in household wealth have only offset a small fraction of the huge gains made over the previous few years i.e. household balance sheets are still healthy.

The other sector that could be affected by the slowdown in residential building activity is construction. However, small companies are most exposed to this slowdown. At present, the impact of the slowdown in residential building activity on large companies such as Fletcher Building is being offset by strong growth in infrastructure spending and other non-residential building activity.

We have weighed our expectation of more modest domestic returns and increased risks surrounding the local market against a still positive global economic outlook and expectations of a weaker New Zealand dollar. We believe that better opportunities exist elsewhere and have recently trimmed our overweight position in New Zealand equities.

Where are these better opportunities expected to lie?

The Australian economy is also expected to grow at a more modest pace, although its fundamentals are less of a concern. The authorities have successfully engineered a soft landing for the housing market and the risk of an upward spike in interest rates is lower. Australian company valuations have not risen as much as for New Zealand companies and the outlook for earnings growth is slightly better. We still see the Australian market as an appropriate means of achieving diversification for New Zealand investors.

Other international equities markets are also more attractive than New Zealand's. The Japanese economy finally seems to be on the road to sustained economic growth. GDP figures have repeatedly surprised on the upside – for example, September quarter GDP growth was recently revised up from 0.3% to 0.8%. Business investment was revised upwards, consumer spending has improved and net exports are once again making a positive contribution to the economy despite the Yen's strength. Furthermore, land prices are starting to edge higher in the major cities.

These signs of an economic recovery hold the promise of a strong performance by Japanese stocks. In particular, our managers are finding opportunities in the banking sector, where companies are trading at only a fraction of the valuation of equivalent foreign banks. If the recovery in Japan brings higher interest rates, it will be a boon for Japanese banks, which currently operate on tight margins (it is hard to benefit from zero interest rate balances when the market interest rate is also zero!).

European shares are still a compelling restructuring story despite this year's strong price rises. Valuation levels are below those in the US market and earnings growth is also likely to be stronger. Economic growth looks weak at the Euro level, but there is considerable divergence in performance across countries. Although Germany and Italy are continuing to perform poorly, Ireland is still growing at around 5%, while Spain, Greece and Luxembourg are enjoying growth of over 3%. Furthermore, corporate balance sheets have continued to improve. Even in underperforming countries, companies have succeeded in boosting profitability as a result of prudent wage setting, productivity improvements, low interest rates and solid global growth.

When oil prices initially spiked higher, markets were more concerned about the negative implications for economic growth than they were about the upward impact on inflation. During recent months, the focus has shifted. Instead of viewing higher oil prices as an indirect tax and a constraint on spending, markets now fear a greater inflationary impact. It has been our view that the increase in oil and other commodity prices reflect a structural imbalance of supply and demand and will lead to an increase in inflation.

While inflation rates will not return to the high levels of a generation ago that undermined savings and distorted investment, they will stay stubbornly high and require considerable effort from central banks. This means that the current complacency in long-term bond markets will be shaken and markets will be forced to reflect the risk of higher interest rates.

The need for central bank response to the threat of inflation varies from country to country:

- In the US, the Federal Reserve is expected to continue along its path of measured rate rises, although the peak in the Fed Funds Rate is likely to be higher than previously thought.
- In the UK, another rate cut would probably be forthcoming if not for the inflation outlook. Economic growth has slowed significantly and the housing market has stalled.
- In Europe and Japan, speculation of a rate rise is premature. At best, the Bank of Japan will start by reducing the extent of quantitative easing as its deflation problem disappears.
- In comparison, New Zealand faces a greater risk that the oil-induced spike in inflation will be more than just temporary. Several years of strong economic growth have resulted in capacity constraints and unlike Australia and the UK, the housing sector remains buoyant and is continuing to underpin retail spending. The Reserve Bank may also need to fight the potential inflationary impact of the significant fiscal stimulus that lies ahead.

Alongside this relatively benign global outlook for short-term interest rates, we cannot ignore the fact that global bond yields are already out of line with fundamentals. Rising inflation is expected to finally force the long-awaited adjustment, and markets where yield curves are flat have the most to lose when this occurs. The US, Australian and New Zealand bond markets offer a very small margin between short-term and long-term interest rates. We believe that this has been caused by significant offshore investment flows and are worried that refinancing these flows could drive market interest rates higher. A more normal gap between short and long-term interest rates would imply bond yields that are at least 1% higher.

Valuation review: Property

Yields on listed property have remained low due to the weight of cash as investors have sought yield and anticipated further corporate activity. This has led to an upward adjustment in valuations and a tightening in capitalisation rates - a trend which has been evident among recent US acquisitions by Australian listed property trusts.

Such low yield levels are only justifiable if rental increases come through in a strong fashion. This has been possible during the last few years because strong economic and employment growth have created competition for space. Wellington, in particular, has benefited from healthy employment growth in the government sector, helping push vacancy rates to very low levels.

Although some uniquely located properties may be able to generate strong ongoing rental growth, others may not be so blessed. In Auckland, strong demand for well-positioned, quality properties close to the waterfront has pushed vacancy rates down, but this has been at the expense of second-tier properties. We are concerned that the pickup in commercial property demand and low vacancy rates could result in increased supply, which may inhibit the rise in rentals and leave prices vulnerable. At this stage, supply that is already in the pipeline is concentrated in the fringe and suburban locations, where demand for new, purpose-built space has been buoyant.

The outlook for the property sector generally remains positive. Although strong demand from investment funds appears to have resulted in a structural adjustment to valuations, the market is nevertheless showing signs of approaching a cyclical peak and the prospect of higher bond yields provides an additional source of uncertainty. We believe that infrastructure assets are more attractive in the current environment.

Valuation review: Infrastructure

We now favour listed infrastructure assets over property assets. Companies in this sector tend to hold a unique position. Prices are often linked to inflation, which provides an advantage over other sectors in the current, higher inflation environment. Furthermore, because their services are usually essential, demand tends to be unresponsive to changes in price. On the supply side, the capital intensive nature of the sector tends to be a significant barrier to the entry of new competitors, while regulatory, environmental and political issues can be a significant constraint on new supply by both new and existing players. We believe that investors require this regulatory certainty and inflation protection in return for the long-term commitment that infrastructure requires.

Many commentators highlight the urgent infrastructure needs of the emerging economies, but we believe that western economies also have a desperate need for infrastructure upgrading as a result of many years of underinvestment. This has created varying opportunities for different parts of the infrastructure sector. Substantially increased levels of government expenditure on the upgrading and maintenance of essential infrastructure, especially in the rail and road sectors, have been announced in both Australia and New Zealand during the last year. The private sector will play an important role in creating and managing these assets. Opportunities in this part of the sector are particularly evident in Australia, where companies such as Macquarie Infrastructure Group have taken advantage of the growing trend towards toll roads.

Investment in capital infrastructure is also required in the electricity sector, but regulatory and environmental constraints are likely to significantly hinder its construction. Such constraints will continue to restrict new supply and underpin profitability.

The New Zealand dollar is currently caught between conflicting pressures. The economy is running a very large current account deficit and an even larger household sector deficit. In addition, the risks of a hard landing have increased along with the prospect of further rises in our already high interest rates. However, these high interest rates have been a magnet for offshore investor funds, underpinning the New Zealand dollar. Our interest rates are so much higher than the rest of the developed world that our rising risk premium is being overlooked.

A significant source of upward pressure on the New Zealand dollar during the last few years has been the issuance of New Zealand dollar denominated bonds to investors outside New Zealand, most commonly in the Japanese market (Uridashi) and in the European market (Eurokiwi). Because these bonds are offered in small parcels, they have been very attractive to retail investors. However, they are not a new phenomenon, and history suggests that their popularity tends to coincide with cyclical peaks in both the New Zealand dollar and interest rates. Eurokiwi issues surged in popularity during the 1985-87 period and again in 1996-98.

The returns that offshore investors have received from these bond issues have been extremely volatile and primarily determined by exchange rate fluctuations. Investors who purchased Eurokiwi bonds around 1996-97 when the New Zealand dollar was near its peak realised returns that were significantly lower than they could have received if they had simply invested in German government bonds. It is therefore evident how a rise in investor perceptions of risk or expectations of a currency decline could see these issuances evaporate relatively quickly.

We believe that the New Zealand dollar is vulnerable to such a change in sentiment. Many commentators argue that because our external and household sector imbalances are easily funded, there is no need for concern. We do not share this optimism. We believe that there is the potential for the price of such foreign funding to rise as investors demand a higher risk premium. This may not occur while there are so few high yielding currencies in which Europeans and Asians can place their funds, but this will not always be the situation. US interest rates are now likely to rise further than previously expected and this will impact on the price of New Zealand's foreign funding.

We recommend that investors consider greater foreign currency exposures in their portfolios. There may not be an immediate positive impact on returns, but it will give greater economic diversification and provide a useful hedge against local inflation pressures.

Asset allocation: Conclusion

Our asset allocation views are clear – we favour international (particularly non-US) equities for the growth portion of our portfolios and a combination of infrastructure assets and cash for the defensive portion. We are becoming more cautious on local shares and are avoiding fixed interest exposure. Where we do have fixed interest exposure, it is positioned in shorter maturities and cash.

There are likely to be wide ranging performances across different sectors as some industries experience pricing benefits and others see margins narrowing. Also, some sectors will benefit from higher interest rates, while others will suffer. We favour active security selection as a means of identifying the best investments in each asset class.

Exchange rate volatility could follow the increased volatility in inflation outcomes. Central bank credibility will come under the spotlight and foreign investor sentiment could become fickle. The risk of a fall in the level of the New Zealand dollar seems greater than the risk of a rise.

Even in an uncertain and volatile environment, attractive opportunities still exist for investors. As the third quarter of this year demonstrated, positive results can be achieved even when some large sectors of the investment universe, such as the US sharemarket, post very modest returns.