

## > Portfolio Watch

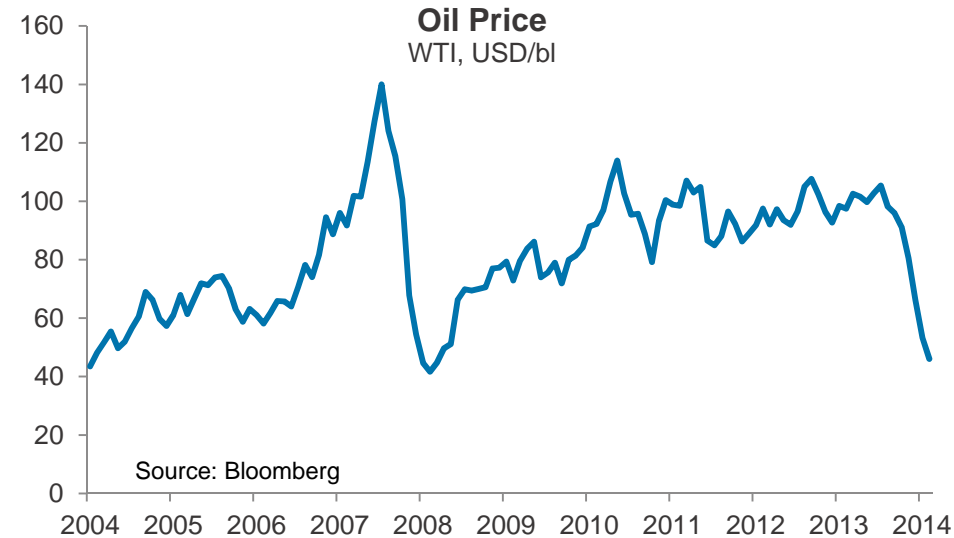


// Bevan Graham  
**AMP NZ Chief Economist**

January 2015

# Oil on slippery slope

- > The price of oil has continued to move lower in early 2015 with the prices now down close to 55% from the peak of mid-2014 (WTI, USD/b). This continues to be both a supply and demand driven phenomenon however our judgement is that excess supply is the more dominant factor.
- > To state the obvious lower oil prices are bad for producers but good for consumers. The net impact on the global economy is a positive for growth. Even in the US where the oil industry is becoming increasingly important, the net benefit will be positive.
- > The immediate inflationary impact is downward and will see many countries either in or flirting with negative inflation (the decision not to use deflation is deliberate – see next slide). However with lower oil prices good for growth the more medium term impact on inflation will be up.
- > We expect central banks to take an orthodox approach and “look through” the immediate disinflation, although they will be watchful of spill-over of second round effects.



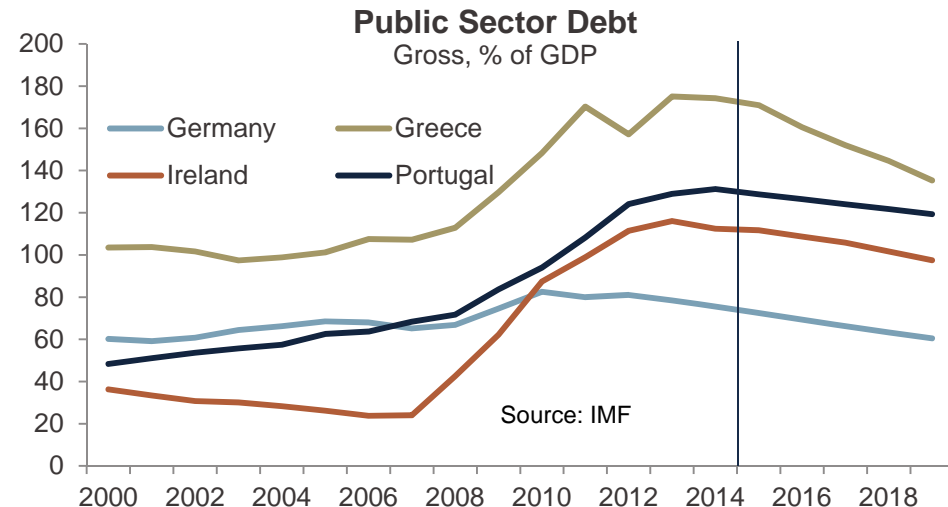
# Deflation in the euro zone...or is it?

- > Annual headline inflation moved negative in the euro zone in December. This is the result of sharply lower oil prices feeding through into inflation in a region already suffering low inflation.
- > This latest development is, at least in our view, best described as negative inflation. True deflation is a far more insidious problem involving widespread falls in prices, weak inflation expectations, contracting activity, falling asset prices and eventually falling nominal incomes.
- > The euro zone is not there yet but remains the region most at risk of deflation in the true sense of the word. The latest inflation developments will more than likely see the European Central Bank take further steps to meet its commitment to expand its balance sheet by €1 trillion.
- > Opposition from the Bundesbank and the upcoming ruling on the legality of the OMT by the European Court of Justice remain potential barriers to purchases of the sovereign bonds. For more on euro zone inflation and monetary policy click [here](#).



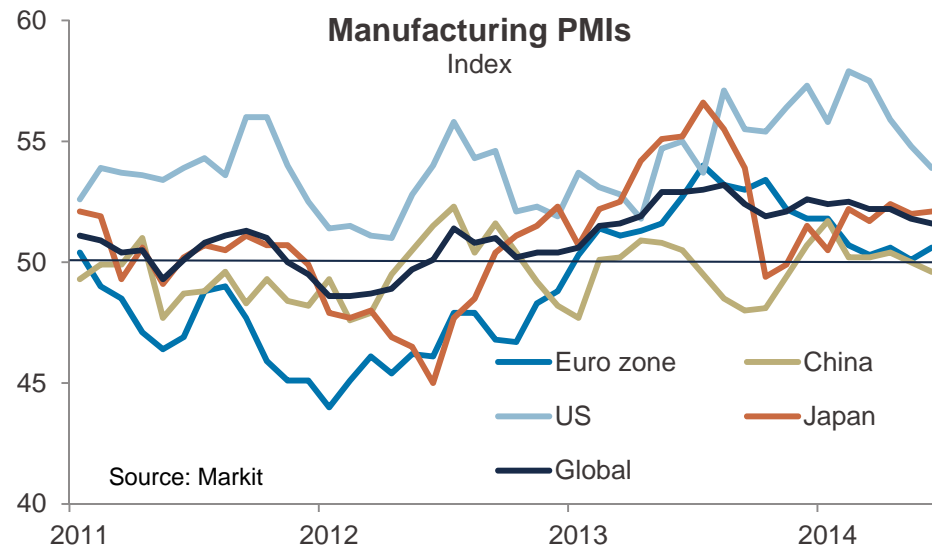
# Greece causing more euro zone worries

- > The recent failure by the Greek parliament to elect a new President has resulted in a snap election which will take place on January 25<sup>th</sup>.
- > This has again raised fears of a problematic Greek exit from the euro zone especially given the anti-bailout Syriza party is most likely to form the next Government. Helping Syriza's cause is austerity fatigue and chronically high unemployment. But while promising new spending to alleviate the austerity-induced "human catastrophe" the Syriza leader has recently softened his anti-bailout rhetoric.
- > While a change of Government appears likely, the end result is likely to see a compromise that allows Syriza to implement a scaled-back spending programme in exchange for further lengthening of debt maturities and interest rate relief.
- > Should exit occur the euro zone is arguable in better shape to withstand it. The ESM and OMT are better resourced and steps have been taken towards banking union. For more detail click [here](#).



# PMIs consistent with softer patch in growth

- > Generally softer manufacturing PMIs are consistent with the current softer patch in global growth towards the end of 2014. We expect global growth to come in at around 3.3% in 2014, unchanged from 2013.
- > The lower global PMI since mid-year reflects lower production and new orders since the start of the year although an improvement in the employment index has provided some offset.
- > Despite softening also the US index remains the strongest amongst the world's major economies. This is still consistent with our expectation of around 3% GDP growth in the period ahead. That said, we'd like it to bottom out about now!
- > The China index softened further into the end of the year and is now under the 50 benchmark at 49.6. That is weaker than the official index which was 50.1 in December, although that is also on a deteriorating trend. Europe's PMI improved, which is mildly encouraging, and Japan's manufacturing sector appears to be benefitting from the sharp weakness in the Yen.



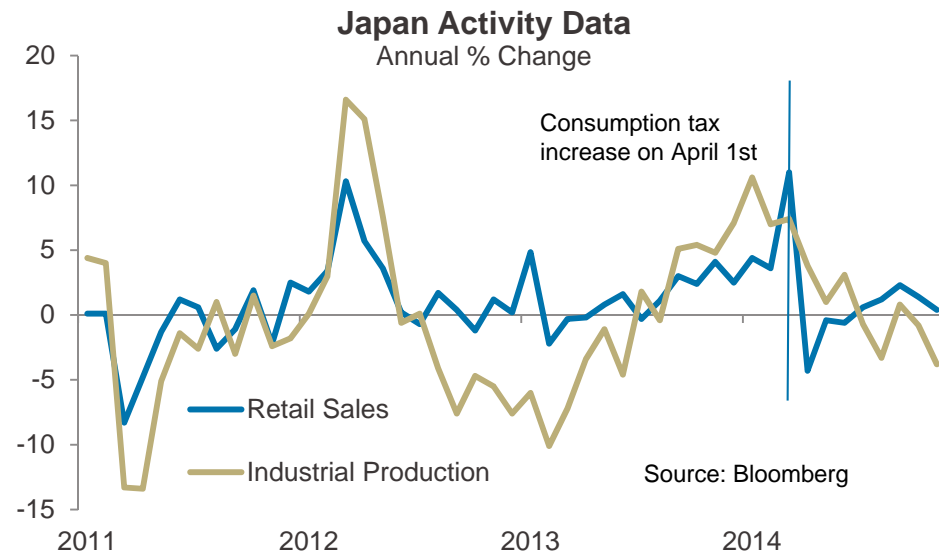
# US jobs and wages

- > A key part of our expectation of solid US GDP growth in 2015 is a solid performance from the labour market. The 12-month rolling average monthly payrolls gain now stands at 246k per month, its highest level since 2000. Furthermore, jobs growth appears to be increasingly broad-based.
- > The unemployment rate continues to fall, coming in at 5.6% in January. While this reflects a combination of both stronger jobs growth and continued declines in the participation it is a sign of diminishing slack in the labour market.
- > That said, wage growth continues to disappoint with annual growth in average hourly earnings remaining flat at around 2%.
- > Despite low wage growth higher consumer spending will be supported by more people in work. At the same time the wage data confirms the FOMC can remain patient in further normalising monetary conditions.



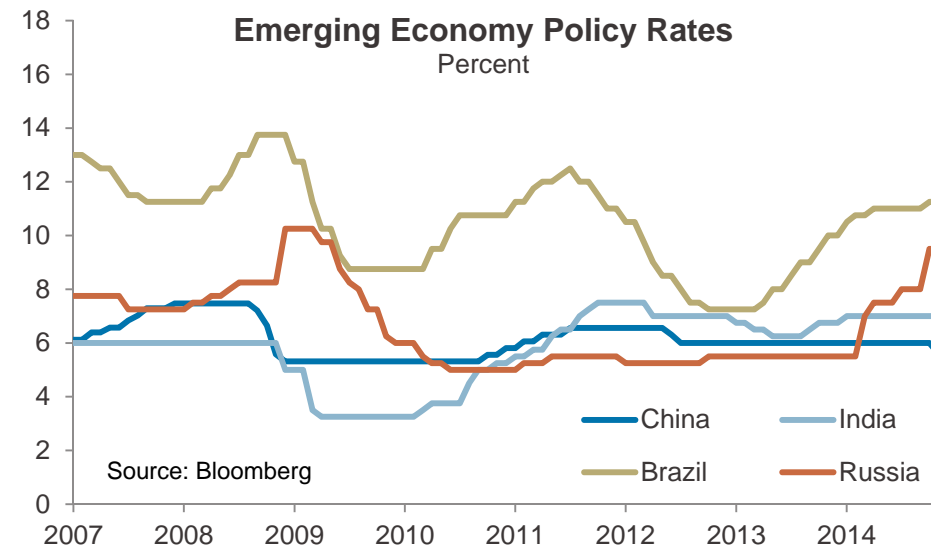
# Japan still struggling for traction

- > Growth in the Japanese economy is struggling for momentum. Annual growth in industrial production remained negative in the year to November, and while annual growth in retail sales has now been positive for five consecutive months, momentum is fading.
- > Continued soft data follows the downward revision to September quarter GDP growth to an annualised -1.9% from the initially reported -1.6%. This was contrary to market expectations of an upward revision to -0.5%.
- > We expect growth to be positive in the fourth quarter of the year but to remain relatively weak. The negative pullback from the “rush demand” seen ahead of the April 1<sup>st</sup> tax hike is fading but the decline in real disposable incomes and high inventory levels are likely to remain problematic for some time yet.
- > Annual average growth is expected to come in at 0.3% for calendar 2014, rising to 0.9% in 2015.



# Russia raises rates to restore ruble stability

- > The Russian economy has been hit by the double whammy of sharply lower oil prices and Ukraine-related sanctions. To be fair, growth was already on a deteriorating trajectory prior to these events which have served to expedite an already adverse trend.
- > The Ruble has fallen in response to lower commodity (oil) prices which is the orthodox response. However it is possible to have too much of a good thing. The sharply lower currency means inflation is likely heading to 10%.
- > The Central Bank of Russia (CBR) stepped in to stem the fall of the Ruble by raising short term interest rates to 17% in December. This will have a significant detrimental impact on economic growth.
- > We expect mildly positive growth in calendar 2014. Into next year we expect the impact of sanctions, lower oil prices, and sharply higher interest rates will intensify, leading to a contraction in output of around 4% over calendar 2015.





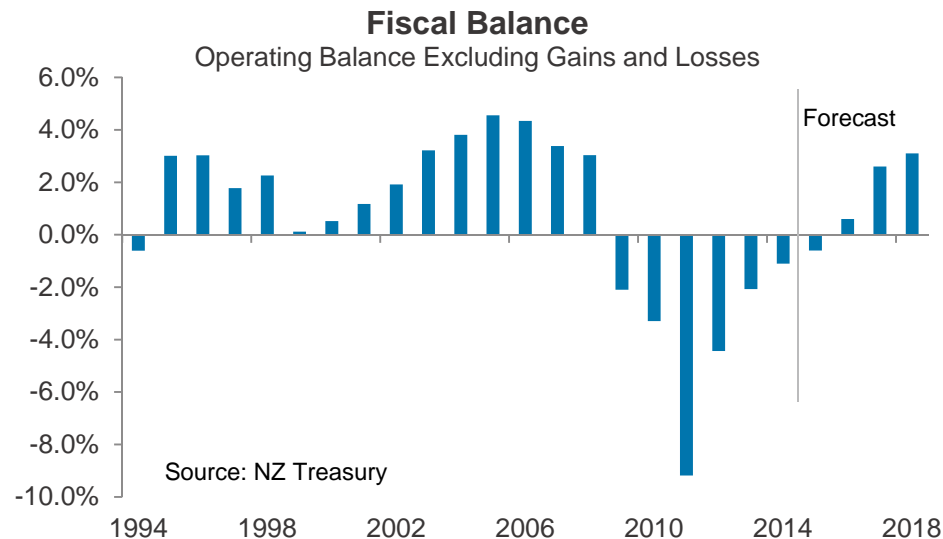
# China dis-inflation

- > China activity data for November recorded the expected slowdown as a result of the APEC shutdown. In particular growth in industrial production slowed to 7.2% yoy, down from 7.7% in October. Retail sales continue to hold up well, coming in at 11.7% growth in the year to November vs expectations of 11.5%.
- > The more important story right now is the deceleration in inflation which is giving the central bank room to move on monetary policy. Lower inflation no doubt in part reflects lower commodity prices, but it also reflects weak demand. November CPI data surprised on the downside but rebounded slightly in December – largely off the back of higher prices for fresh food as the weather deteriorated.
- > The drift lower in inflation over recent months, particularly non-food inflation, raises the likelihood of further cuts in interest rates in the first few months of 2015 although the recent blip higher might have reduced the urgency for action.



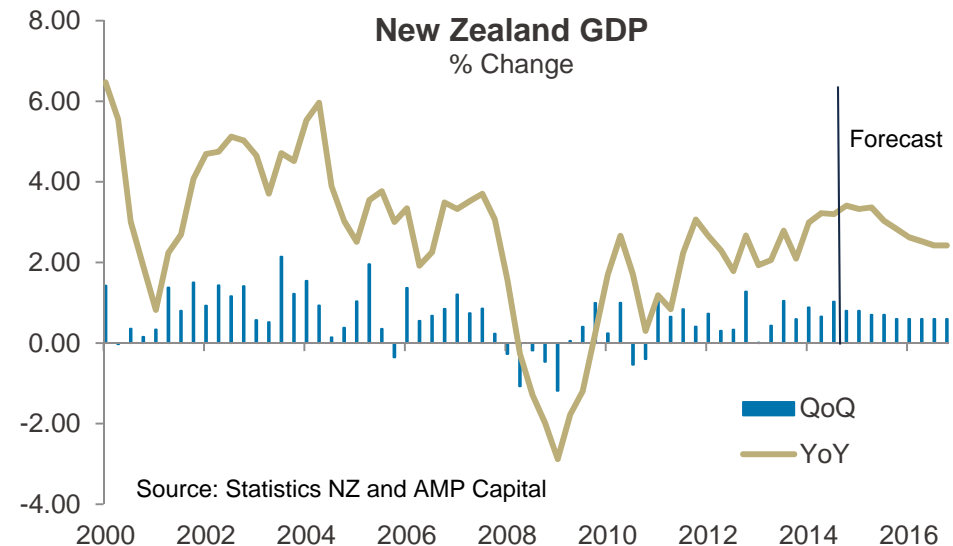
# NZ half-year fiscal update

- > The obligatory New Zealand pre-Christmas half-year fiscal update from the New Zealand Treasury revealed the expected near-term deterioration in the Crown's accounts.
- > The forecast surplus for FY 2015 in the operating balance (OBEGAL) at the time of the May Budget of +0.2% has deteriorated to an expected deficit of -0.2% of GDP. That's on the back of lower-than-expected near-term nominal GDP growth.
- > In our view there has been too much (mostly political) emphasis attached to the achievement of a surplus in the current fiscal year. The trend is the more important story. In that respect the path from a deficit of -9.2% of GDP in FY 2011 to a surplus of +3.1% of GDP in FY 2018, assuming it is achieved, will represent a more that creditable turnaround.
- > Key risk to the projections is the GDP growth outlook. A bigger hit to growth off the back of lower dairy prices will have a flow through to operating balance and net debt forecasts.



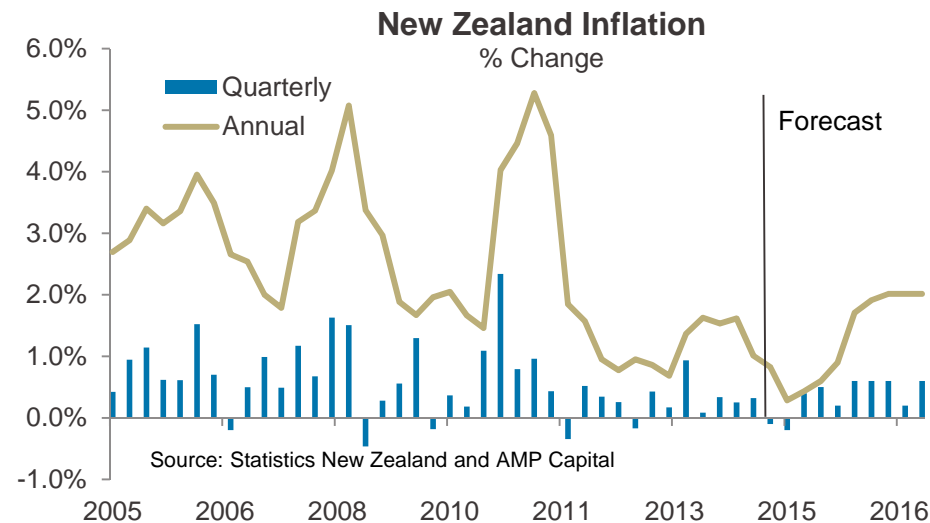
# NZ GDP stronger...and weaker...than expected

- > New Zealand September quarter GDP growth came in at a better-than-expected 1.0% qoq. However the more interesting development was the downward revision to prior growth.
- > The revised data has shifted the peak in quarterly growth rates. Given the latest Q3 data and our expectation of around +0.9% growth in the December 2014 quarter, the last six months of 2014 are now expected to be the strongest period of the expansion.
- > The previous peak in the annual growth rate of 3.9% in the year to June 2014 has been revised down to 3.2%. We expect annual average growth of 3.2% in calendar 2014 followed by 3.1% in 2015.
- > Lower than previously reported growth has obvious implications for productivity and, more ambiguously, the output gap. One thing we can say is that lower growth helps explain continued lower-than-expected inflation outcomes.



# Deflation in New Zealand?

- > Here at home, calls for interest rate cuts will grow louder over the next few months as headline inflation heads well below the bottom end of the Reserve Bank's 1-3% target band and remains there for the duration of 2015.
- > Those calls will be disappointed. Continued low inflation has the Reserve Bank on hold for most if not all of this year, but I still think the next move interest rates is up, it's just a question of when and by how much. Cuts are ruled out for the extra impetus to the housing market which data is already benefitting from a second wind on the back of lower fixed rate mortgages.
- > The answer to those questions will be answered not by the price of oil but rather the ability of the New Zealand economy to continue to grow at an above-trend pace without generating inflationary pressures. In my view that will largely be determined by the extent to which wages respond to continued falls in the unemployment rate as 2015 unfolds.



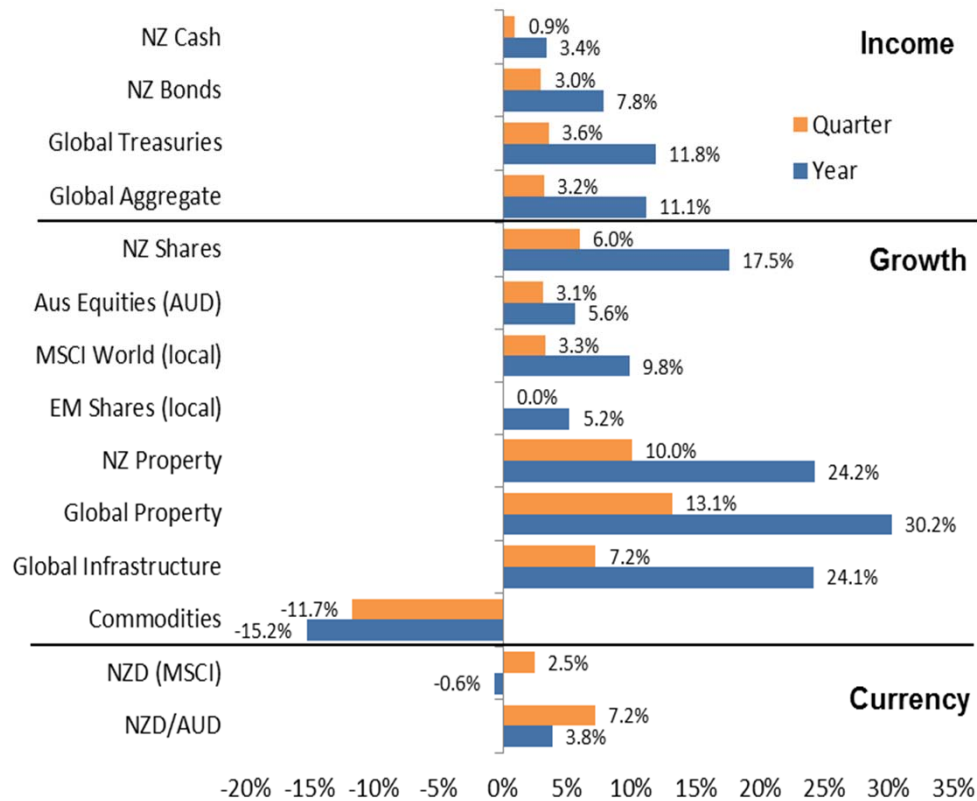
## > Asset strategy



// Keith Poore  
**Head of Investment Strategy**

# December quarter asset returns

## December 2014 Returns



- > Fixed interest produced healthy returns in the December quarter on the back of some softer activity data, a sharp decline in oil prices and associated lower inflation expectations.
- > Returns from global equities were also generally solid thanks to gains in US and Japanese shares. Both markets continue to experience earnings growth and policy support. Emerging market equities were flat with gains in Asia offset by declines in Latin America and EM Europe.
- > Returns from domestic shares were strong which coincides with the strong local economy. Relatively high dividend yields and a low exposure to oil stocks also contributed to the gains.
- > Property and infrastructure were the best performing asset class over the quarter. Given their income characteristics these assets benefit from lower global bond yields
- > A fall in oil prices led a large decline in commodities over the quarter. This was largely due OPEC's decision not to cut production in the face of slowing global demand.
- > The NZ dollar moved higher over the quarter, especially against the JPY, EUR and AUD.



# Australasian equity movers – December quarter

**NZX50 + 6.0%**

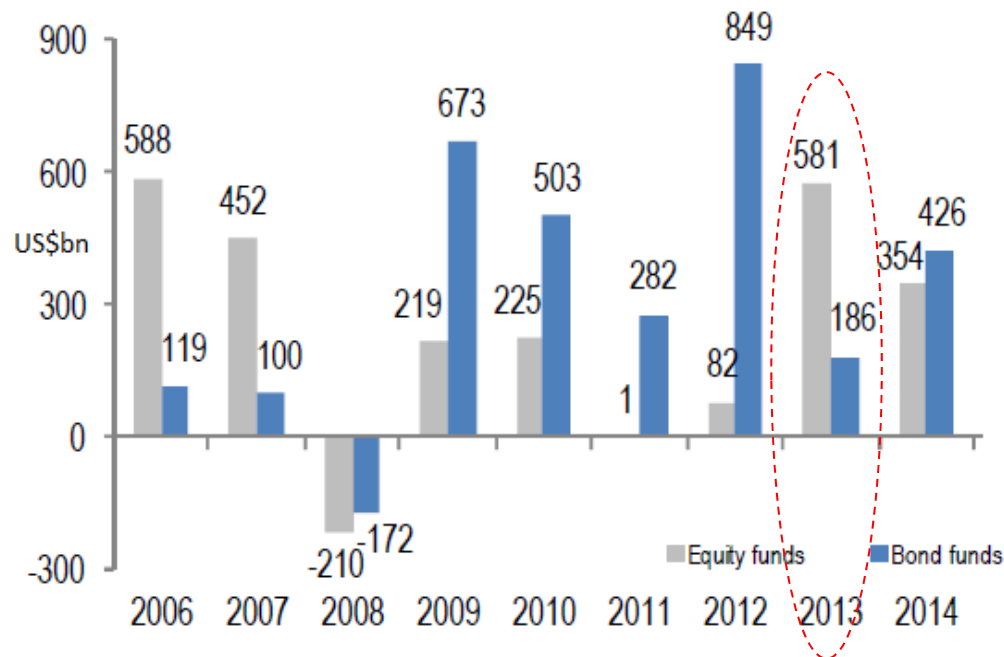
Leaders	End Price	%Chg	Points↑	%Idx Mv	Laggers	End Price	%Chg	Points↓	%Idx Mv
21) Fisher & Paykel He...	6.25	+20.42	+51.6719	+16.50	41) Xero Ltd	16.15	-25.23	-37.8893	-12.10
22) Meridian Energy Ltd	1.76	+23.08	+36.2630	+11.58	42) Fletcher Building Ltd	8.30	-5.47	-28.8633	-9.21
23) Ryman Healthcare ...	8.52	+9.09	+31.1809	+9.95	43) Kathmandu Holding...	2.16	-31.65	-17.6968	-5.65
24) Auckland Internatio...	4.23	+9.87	+30.7509	+9.82	44) Guinness Peat Grou...	.45	-24.37	-10.7321	-3.43
25) Chorus Ltd	2.66	+46.96	+29.5612	+9.44	45) SKY Network Televi...	6.04	-4.13	-8.8652	-2.83
26) Air New Zealand Ltd	2.47	+27.32	+23.8167	+7.60	46) OceanaGold Corp	2.20	-18.52	-8.4703	-2.70
27) Spark New Zealand...	3.115	+4.88	+23.1773	+7.40	47) New Zealand Oil & ...	.63	-17.11	-3.9253	-1.25
28) Mighty River Power...	2.98	+16.18	+23.0181	+7.35	48) Fonterra Co-operati...	6.01	-4.60	-2.9649	-.95
29) Z Energy Ltd	4.63	+16.92	+14.1210	+4.51	49) Westpac Banking C...	34.60	-3.11	-2.5967	-.83
30) Contact Energy Ltd	6.38	+6.69	+12.9031	+4.12	50) Skellerup Holdings ...	1.42	-8.97	-2.3673	-.76
31) SKYCITY Entertainm...	3.88	+6.30	+11.7115	+3.74	51) Pacific Edge Ltd	.85	-8.60	-2.2245	-.71

**ASX200 + 3.1%**

Leaders	End Price	%Chg	Points↑	%Idx Mv	Laggers	End Price	%Chg	Points↓	%Idx Mv
21) Commonwealth B...	85.65	+13.76	+67.5456	+4.75	41) BHP Billiton Ltd	29.37	-13.29	-58.0814	-4.08
22) Telstra Corp Ltd	5.97	+12.64	+33.4506	+2.35	42) Santos Ltd	8.25	-39.65	-21.2659	-1.49
23) CSL Ltd	86.68	+16.87	+23.8839	+1.68	43) Woolworths Ltd	30.68	-10.40	-18.0535	-1.27
24) Australia & New Z...	32.09	+3.78	+12.9961	+.91	44) Origin Energy Ltd	11.67	-22.04	-14.6202	-1.03
25) Westpac Banking ...	33.16	+3.17	+12.7827	+.90	45) Woodside Petrole...	38.01	-6.38	-7.3942	-.52
26) Westfield Corp	9.02	+21.07	+12.0725	+.85	46) Wesfarmers Ltd	41.72	-2.76	-5.3305	-.37
27) Amcor Ltd/Australia	13.58	+19.86	+10.9164	+.77	47) Fortescue Metals ...	2.74	-21.26	-5.0703	-.36
28) National Australia...	33.60	+3.26	+10.1336	+.71	48) Oil Search Ltd	7.89	-11.55	-4.8508	-.34
29) Qantas Airways Ltd	2.40	+72.66	+9.1783	+.65	49) WorleyParsons Ltd	10.08	-34.29	-4.6341	-.33
30) Brambles Ltd	10.63	+11.66	+6.9750	+.49	50) Iluka Resources Ltd	5.95	-24.30	-3.2163	-.23
31) Transurban Group	8.58	+11.14	+6.5670	+.46	51) Liquefied Natural ...	2.42	-41.69	-3.2111	-.23

# The 'Great Rotation' into equities lasted one year

## Global Retail Fund & ETF flows



- > Retail investors bought more bonds than equities in 2014.
- > Central banks, pension funds and insurance companies also bought more bonds in 2014 which helps explain the rally in yields over the year.

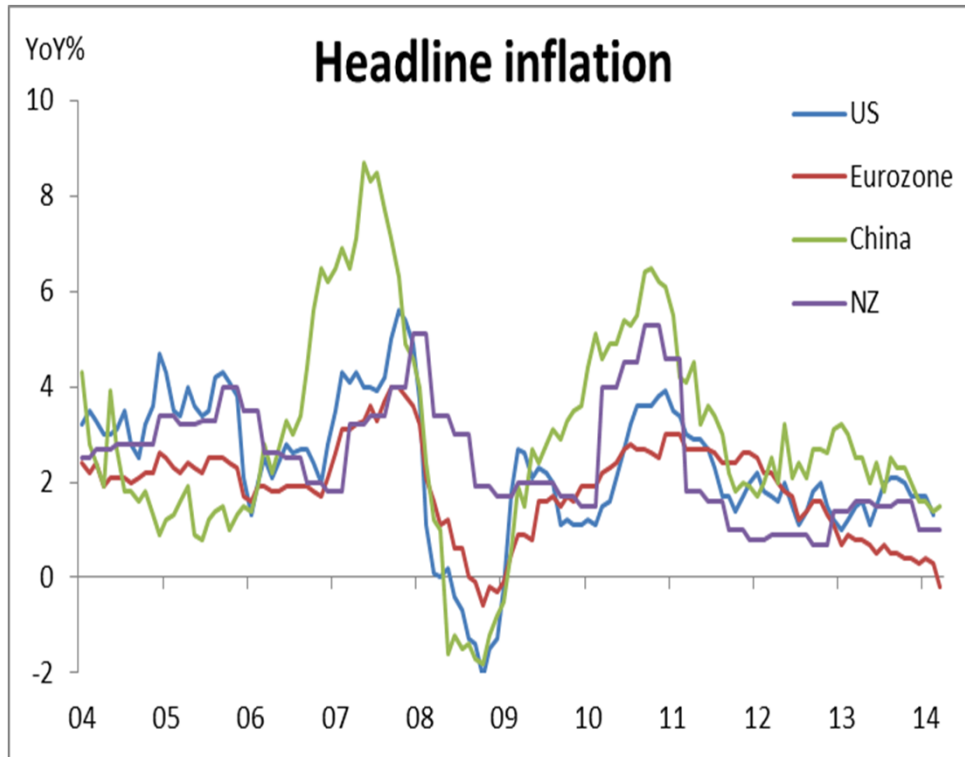


## Global bond yields surprised on the downside in 2014

Region	2014 Year End			2013 Year End		
	10 Year Bond Yield	10 Yr Inflation Expectations	Economic Activity (PMI)	10 Year Bond Yield	10 Yr Inflation Expectations	Economic Activity (PMI)
United States	<b>2.17</b>	1.68	53.9	<b>3.03</b>	2.23	55.0
Euro zone	<b>0.54</b>	1.15	50.6	<b>1.93</b>	1.76	52.7
United Kingdom	<b>1.76</b>	2.58	52.5	<b>3.02</b>	3.12	57.0
Japan	<b>0.33</b>	0.76	52.0	<b>0.74</b>	1.09	55.2
New Zealand	<b>3.67</b>	1.68	55.2	<b>4.72</b>	1.96	56.4

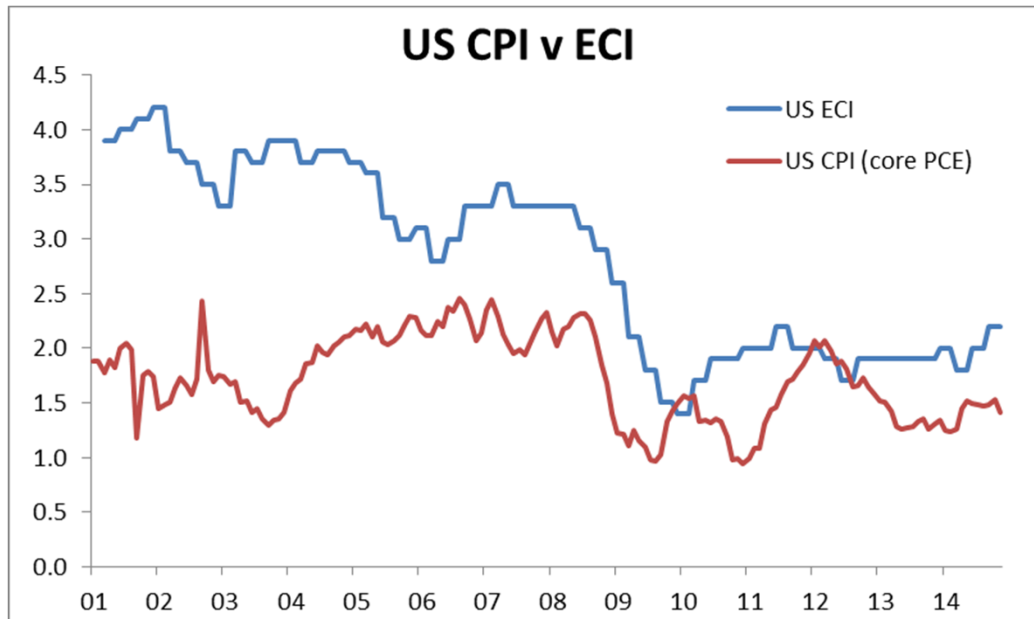
- > Lower inflation expectations and slower economic activity helps explain much of the decline in bond yields over 2014.
- > Declining bond yields also helps explain why the higher dividend asset classes (property, infrastructure, NZ shares) were the top performers in 2014.

# The lack of inflation remains the key theme



- > The lack of inflation remains the key theme in the investment landscape at the moment.
- > It is way too early to write inflation's obituary but it seems the low inflation backdrop and its consequences of low global rates and rising asset prices will be around for some time yet.
- > In view of the backdrop, we think rising interest rates in the US will be need to be accompanied by higher growth, which will ultimately be positive for shares given valuations are not overextended.
- > We expect rising US rates to modestly pull up global long term yields, lift the US dollar higher, and by implication push the New Zealand dollar lower.

# There is more to low inflation than plunging commodity prices

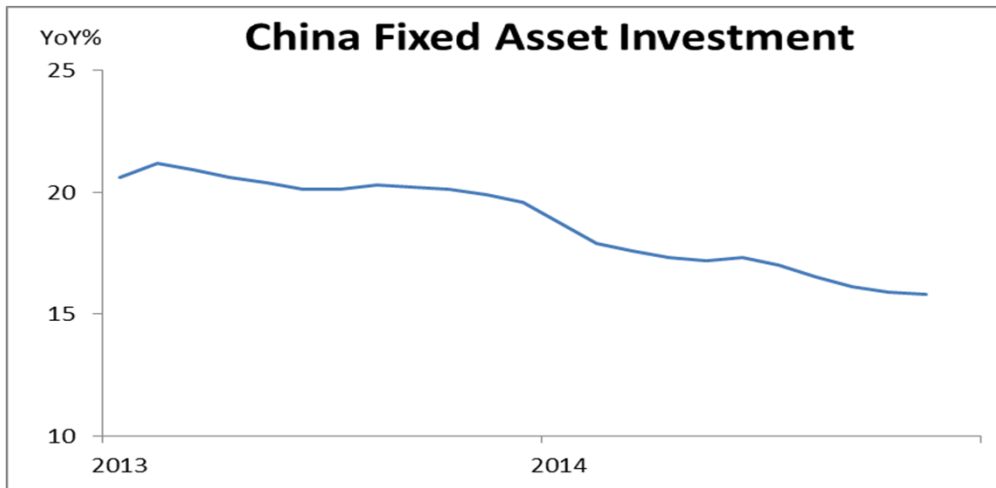


- > The US consumer price index (CPI) and employment cost index (ECI) compares price inflation of a fixed basket of goods and a fixed basket of jobs.
- > Assuming non-inflationary employment costs (i.e. productivity) is 1.5% over the longer run then a CPI target of 2% corresponds to 3.5% ECI target.
- > The ECI has ticked up recently but only to 2.2%.
- > Why are US employment costs so low? Spare capacity in the US labour market plus competition from technology and globalisation.

## China is also contributing to low global inflation and rates

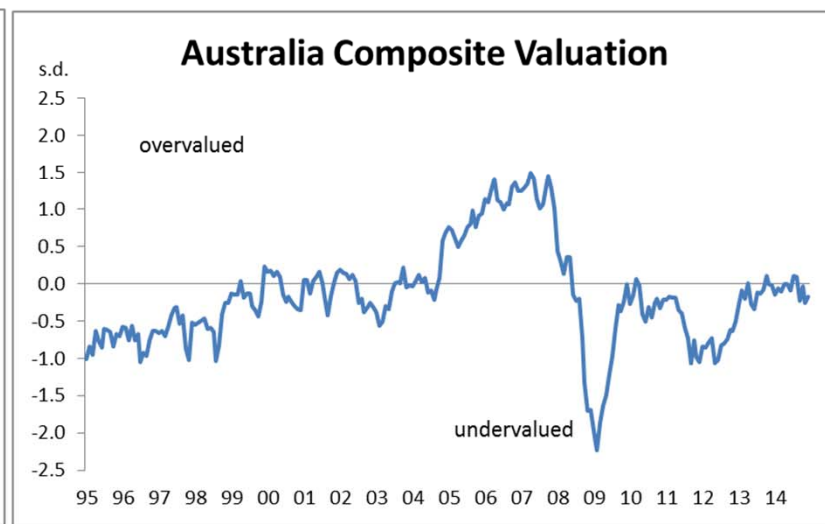
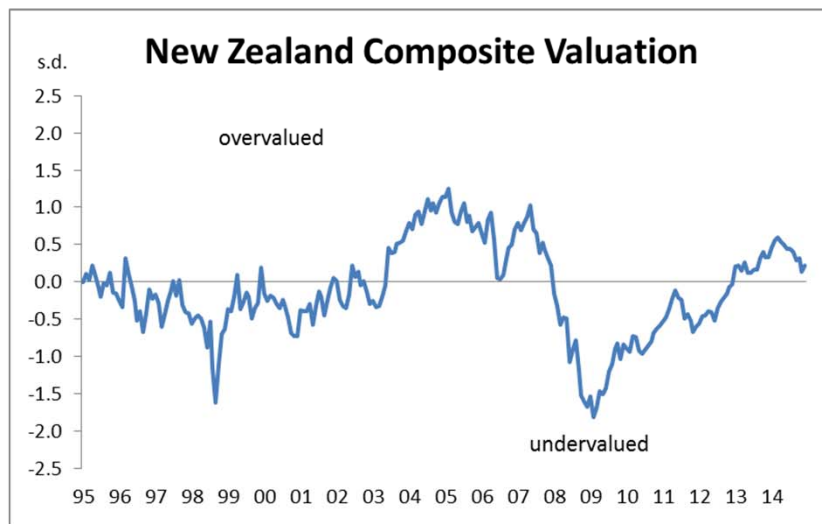
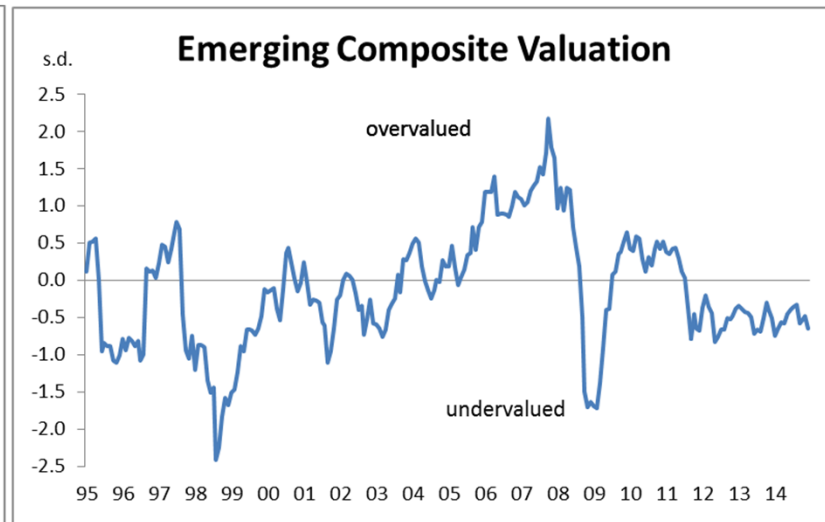
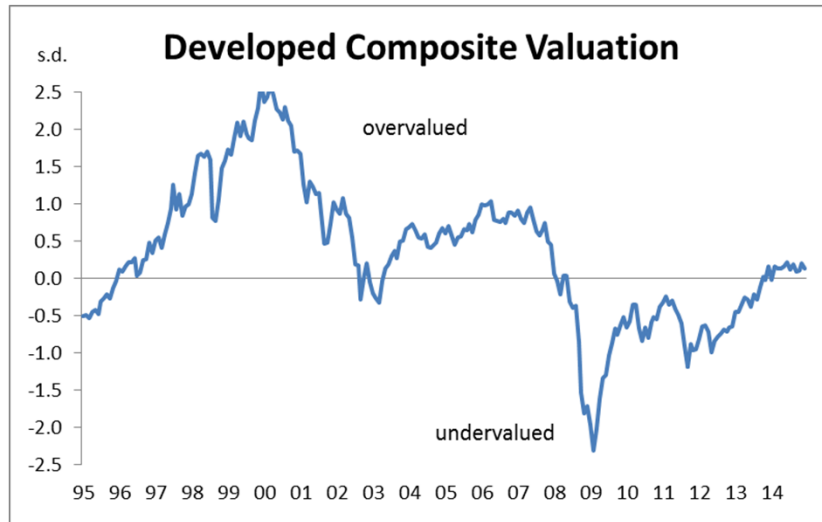


> Producer price inflation in China, the modern-day workshop of the world, remains in negative territory and the trend towards positive inflation has broken down.

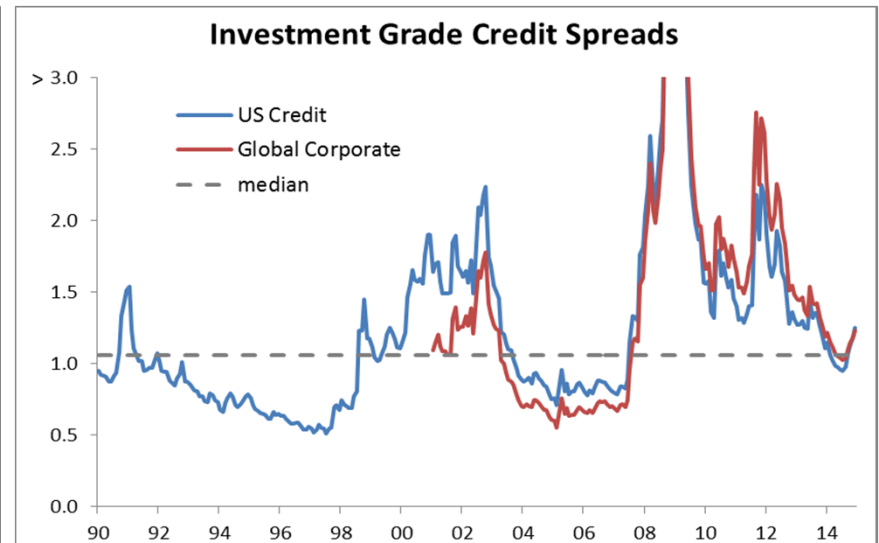
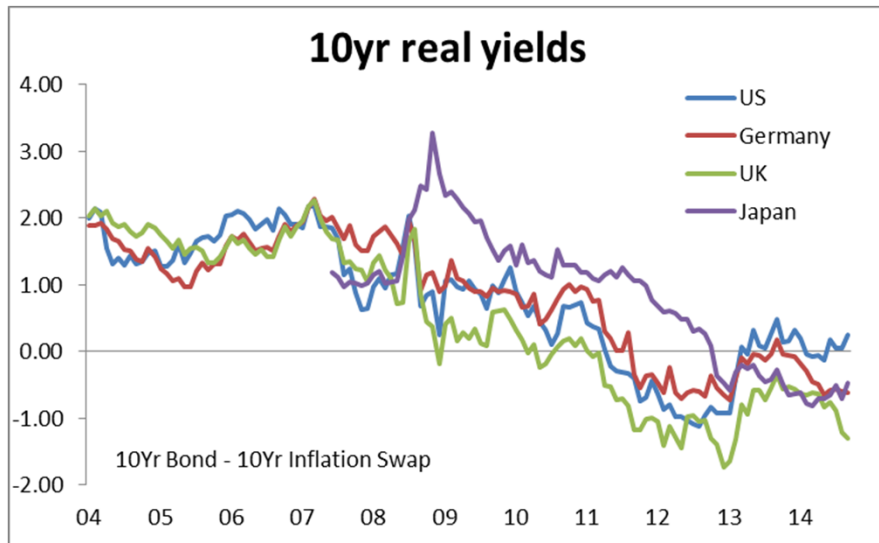


> A significant decline in fixed asset investment growth in 2014 also points to excess capacity in China.

# Positioning: Benchmark equities



# Underweight bonds / overweight cash

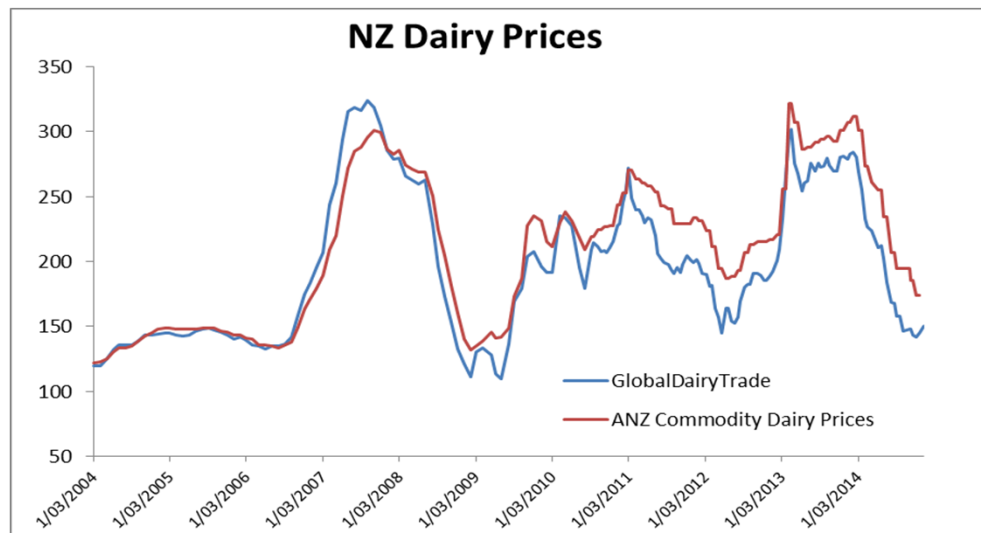
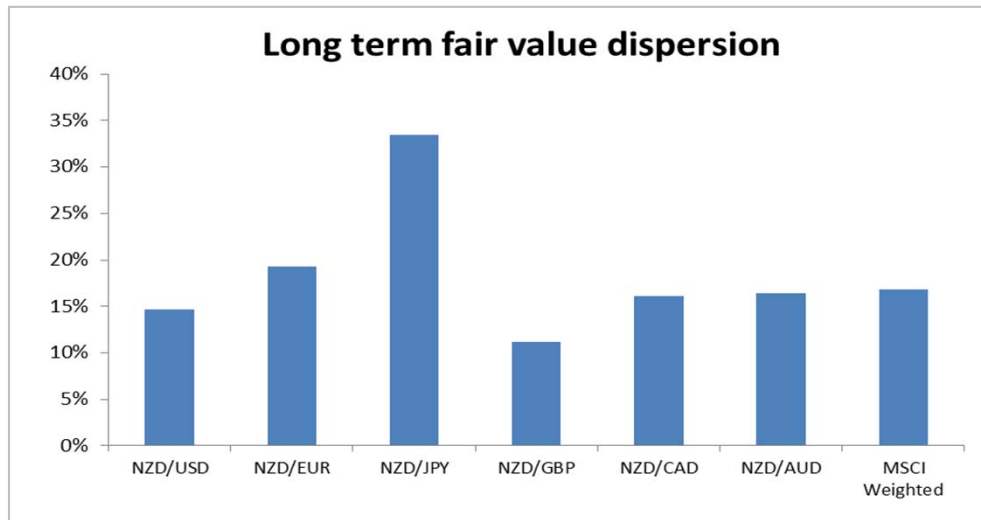


## Term Premiums

Market	Projected 10Yr Cash	Required Term Prem	Fair Value 10 Year	Current 10Yr	Relative Value	Indicative Term Prem
US	2.4%	0.5%	<b>2.9%</b>	<b>2.2%</b>	<b>-0.8%</b>	-0.3%
Europe	1.7%	0.5%	<b>2.2%</b>	<b>0.5%</b>	<b>-1.7%</b>	-1.2%
UK	2.4%	0.5%	<b>2.9%</b>	<b>1.8%</b>	<b>-1.1%</b>	-0.6%
Japan	1.1%	0.5%	<b>1.6%</b>	<b>0.3%</b>	<b>-1.2%</b>	-0.7%
NZ	4.5%	0.3%	<b>4.8%</b>	<b>3.7%</b>	<b>-1.1%</b>	-0.8%

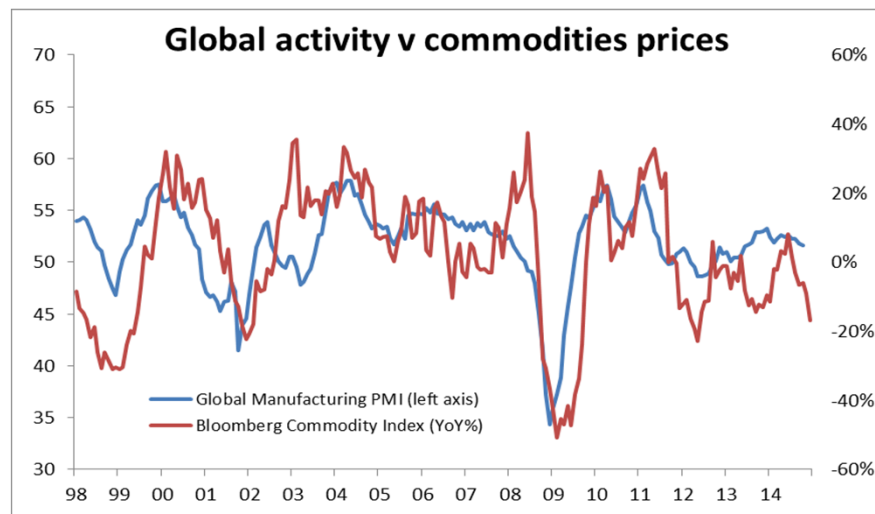
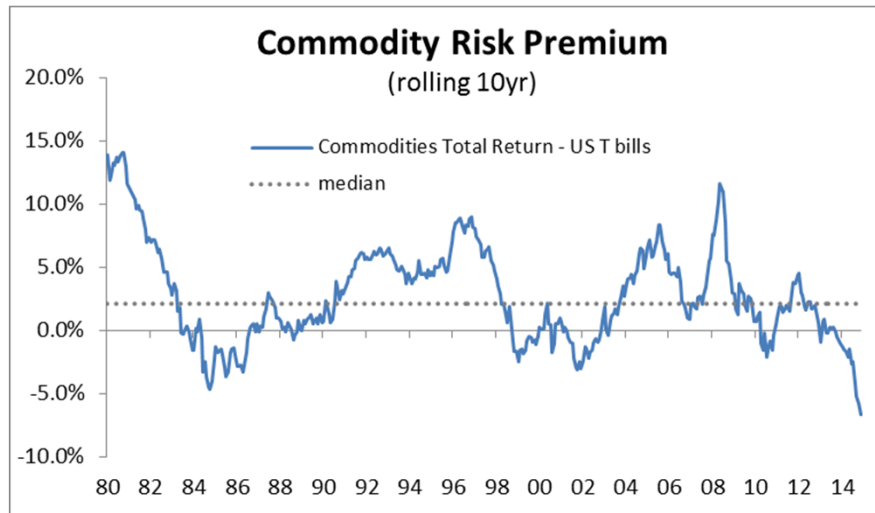
- > Long term real yields are very low or negative in the core global markets (top left).
- > Our estimate of the difference between bond and cash returns over the next 10 years (term premiums) are also low or negative.
- > Investors shouldn't expect global credit spreads to provide much, if any, protection against rising treasury yields given spreads are near long term median levels (top right).

## Underweight NZ dollar / overweight foreign currency



- > The NZD has traded in a range on 76.5-79.5 US cents since the correction in the September quarter. We expect further weakness against the US dollar over the coming year supported by US rate hikes and NZD overvaluation.
- > However NZD moves against the other currencies are harder to call. The Bank of Japan and ECB will not be raising rates for the foreseeable and both central banks are expected to undertake significant asset purchase over the next two years.
- > Australia's central bank will not undertake asset purchases but the ongoing slide in energy and metal prices has raised the chance of a rate cut this year.
- > Meanwhile, NZ dairy prices may be bottoming and the high NZD carry will continue to provide support in periods of low volatility.

# Overweight commodities



- > Broad commodity prices declined over 20% from the end of April to December. As a result, commodity prices are at 5-year lows and the commodity risk premium (commodity versus cash returns) is negative on a 10-year horizon. Given the higher risk of holding commodities versus cash we expect some mean reversion in commodity prices on a medium term horizon.
- > Elevated supplies and sub trend economic growth are the main reasons why commodity prices are at cyclical lows. We expect the global economy to grow close to potential this year, at the same time we expect the current level of commodity prices, if sustained, will begin to impact supply growth.
- > We believe a rising US dollar is the main negative risk for commodity prices in 2015. China's property slowdown is another risk but the recent cut in interest rates (and the likelihood of more) reduces the threat of a significant correction.
- > While commodity prices could go lower in the near term we believe the balance of risks have moved to the upside over a medium term horizon. Consequently we recommend a small overweight to the commodities asset class across diversified portfolios.



# Asset outlook and positions

Asset Class	Near-term view	Medium-term view	Position
Global equities	Expect a flatter and more volatile return profile going forward with risk of underperformance if bond yields rise faster than expected	At current bond yields, valuations are reasonable for this asset class over the medium term.	Neutral
Emerging market equities	Should recover from recent setback but Fed tightening and specific country/currency risks will mean the path will be volatile.	EM valuations remain in attractive territory but this is partly due to different sector compositions. Also, the direction of returns will depend on developed markets which are looking fully priced.	Neutral
Australasian equities	Will broadly track global equities. Strong domestic economy expected to underpin NZ shares despite above average valuations. Improving ex-resource sector earnings growth should support Australia shares.	Australasian shares are reasonably priced given current financial and economic conditions. Expect NZ to modestly underperform Australia over the medium term.	Neutral
Listed property and infrastructure	Should track global equities in the near-term with risk of underperformance if interest rates rise faster than expected	These sectors looks fully priced following recent performance. From an absolute perspective, the low real yield environment should provide support over the medium term.	Neutral
Commodities	The sharp decline in commodities, while explainable, is now looking overdone given global growth will approach potential this year.	Cyclical lows in a number of commodities suggests upside risk in the medium term.	overweight
Global bonds	Expect bond yields to be higher on a 12 month horizon as the US commences rate hikes this year. A modest US tightening cycle together with rates on hold in Europe and Japan should limit the rise in bond yields.	Expect low returns given low government bond yields. High NZD carry providing some offset to low market yields.	underweight
New Zealand bonds	Expect long-end and returns to take lead from US but relatively lower non-US yields could raise demand for NZ bonds.	As with global bonds, low yields foreshadow low returns over the medium term.	underweight
Cash	Cash rates are on hold for an extended period but risk is still to higher rates.	Expect similar returns from cash and bonds over the medium term but cash has lower risk of capital loss.	overweight
Foreign currency	The NZ dollar has had a meaningful adjustment but expect more modest declines in the near-term with the high carry providing some support.	The NZ dollar remains overvalued against the majors in a long term context.	overweight foreign currency

**Overall: neutral growth**

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