OnePath Outlook 2012

January 2012

When forming a view on how the capital market investment landscape is likely to unfold in the near term, global macro issues are always key considerations. As the global economy looks to recover from the financial crisis of 2007/08, we are placing a larger than normal weighting on these macro issues as the possible outcomes for each range from catastrophic to benign.

Proceed with caution

Due to the ever-increasing level of interconnectedness between the various areas of the capital markets, how these issues play out will influence every asset class we invest in. Specifically, the principal considerations influencing our decisions are:

- the state of the US economy, the prospects of a hard landing in the Chinese economy; and
- the ongoing sovereign debt crisis in Europe.

As a volatile 2011 drew to a close, one could be forgiven for looking forward to a more positive outlook for the US over the coming year. After all, the last few months have delivered a string of better economic data in the US, which was encouraging for a sustained improvement in the growth prospects of the western world. Key leading indicators improved for a second consecutive month, while the jobless claims and payrolls indicated continued improvement in labour markets. Even the US housing market is showing promising signs of stabilisation.

However, after digging a bit deeper the outright level and momentum in these indicators remains very weak and the probability of recession in the US remains high. It is difficult to see the recovery in the US developing into a strong sustainable recovery, while the consumer and government continue to reduce debt, and corporates lack the confidence to commit capital to new projects. It is especially difficult to see why the US economy should decouple from Europe, which is likely to dip into recession as fiscal austerity is stepped up. In addition, China, the key driver of global growth to date, is set to slow meaningfully in the coming year, even as the government winds back policy tightening.

China – the global growth engine

The seemingly unstoppable growth engine that is the Chinese economy has been one of the few bright spots globally over recent years. The willingness of government officials to stimulate the economy with infrastructure spending has seen the economy grow at an impressive pace. However, this cannot continue indefinitely, and at some stage, domestic consumption needs to take on a larger role in the economy to fill the void as government spending is reduced. If this does not happen, there is the risk of a sudden contraction in the economy, a so-called 'hard landing'.

The Chinese economy is currently experiencing a 'managed economic slowdown', in particular aimed at the previously 'red hot' property market. Although we don't expect a hard landing in the Chinese property market, a faster-than-expected slowdown is likely to have negative implications for commodity prices and countries with high exposure to China's growth.

European tremors continue

On top of the issues confronting the US and Chinese economies, another important consideration for 2012 will be the resolution to the European sovereign debt crisis. This is an imminent risk for global capital markets, and we don't believe the final chapter in this saga has been written yet. While the spectrum of possible outcomes for Europe is broad, the likely scenarios in the immediate future involve either a disorderly default of one or more of the debt-stricken nations, or a muddle-through scenario where harsh austerity and rescue packages put together by the European Central Bank (ECB), International Monetary Fund (IMF) and European Commission are enough to keep the monetary union intact.

Neither of the aforementioned scenarios set the stage for positive growth prospects for the European region, and it is expected that Europe will endure a recession for at least the first two quarters of 2012. Sovereign debt ratings of larger core European countries such as France have already been downgraded by some ratings agencies, and further downgrades cannot be ruled out.

Liquidity tap wide open

We expect the ECB to continue to ease rates in the first quarter, and while the rhetoric remains firmly against a Fed-like quantitative easing programme, evaporating demand for peripheral debt will likely require the ongoing use of the ECB's balance sheet in some form to avoid contagion beyond the peripheral nations to 'too big to fail' nations such as Spain and Italy. The Bank of England has already embarked on another substantial quantitative easing programme and the US Federal Reserve has indicated that it is prepared to use additional monetary tools to battle further deterioration in the US economy.

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This extraordinarily loose monetary policy has the potential to fuel a liquidity-induced rally in risky asset classes, particularly those viewed as being able to provide some inflation protection. Zero-bound interest rates and unexpected inflation is ultimately negative for fixed interest rate products and US dollars, notwithstanding near-term support for these assets while adversity prevails. Quantitative easing in the euro zone, UK and US will also be detrimental to the purchasing power of the relevant currency, so we expect further weakness as respective policies are implemented to avoid deflationary outcomes. For this reason, we are likely to hedge international assets more rather than less in the coming year.

Sector outlook

International Equities

We continue to have confidence that multi-national companies with strong balance sheets are well positioned to protect margins in this environment. Our International Equity Fund remains focused on selecting such high-quality companies, which we believe will outperform over most economic and business cycles. However, with respect to the overall asset class, given a backdrop of slowing global growth, we are sceptical that current analyst expectations of above-trend earnings growth can be achieved. For this reason in the near term, we have a cautious outlook for equities, while macro uncertainties prevail.

However, we are looking forward to potential buying opportunities this year as prices test levels that represent a sufficient margin of safety relative to long-run trend earnings. It is worth noting that our analysis suggests that the price of European equities already reflects a high level of uncertainty and risk aversion, with stocks trading close to 30-year lows based on our preferred long-term valuation metrics.

Australasian Equities

Notwithstanding the uncertainty in the global macro environment and risks to global growth, the underlying profile for the New Zealand economy is one of moderate recovery underpinned by the positive impact of the Canterbury earthquake reconstruction work in the second half of the year. Relative to their global counterparts, Australasian equities have the added attraction of high dividend yields, currently offering gross yields of 7.7% in New Zealand and 5.6% in Australia.

This year also features the potential commencement of the New Zealand Government's Mixed Ownership Model strategy, with the partial sell-down of Mighty River Power in the 3rd quarter this year seen as being the most likely initial candidate. We are supportive of the Government's move towards a private/public ownership model and look forward to participating in the process. As with any company we analyse before adding to our equity portfolios, we will undertake a detailed review of these companies' fundamentals and their future prospects to ensure pricing is appropriate. We are also mindful that the ability of the local market to digest these listings has the potential to impact market returns over the short to medium term.

The outlook for the Australian share market is likely to be muted for 2012 given a number of factors that could constrain economic growth. With much of the world in deleveraging mode, we consider it will be difficult for export-orientated economies such as Australia to grow at the levels they have experienced in recent years. Although we don't expect a hard landing in the Chinese economy, a slowdown from current levels will be a headwind for commodity prices and hence the Australian sharemarket. Under this scenario, the Reserve Bank of Australia is likely to continue cutting interest rates and the Australian dollar is likely to weaken.

Fixed Income

The recent data out of the US points to an improvement in the economic performance of the world's largest economy. It comes at a time where economies throughout the rest of the world appear to be slowing. However, this improvement has done little to change the outlook for US interest rates. Our view remains that should the US economy gain further traction over coming months, it won't be met with increased interest rate expectations. There are a lot of other stimulus measures to be removed in the US before monetary policy is tightened. As such, we see US interest rates remaining low for an extended period of time. Reductions in fiscal outlays, notably defence, will be an ongoing feature of US Federal policy development, and this will further negatively impact aggregate demand.

In Europe, we believe further monetary stimulus is required, and we expect the ECB to cut rates again in coming months. In New Zealand, there isn't the immediate requirement for interest rate moves in either direction. The Reserve Bank of New Zealand (RBNZ) is likely to maintain a slight tightening bias to its forecasts, but the financial markets are challenging that outlook and pricing in moderate interest rate cuts in 2012. It is our view that the RBNZ will keep rates unchanged for a reasonable period of time, but will remain flexible either to cut or hike as local and international economic developments dictate. In summary, this translates into a supportive outlook for longer-dated bonds, especially for those nations with sound fiscal accounts.

Australasian Listed Property

The New Zealand listed property sector is in relatively good shape with conservatively geared balance sheets, high portfolio occupancy levels and long-lease terms. While it is likely to continue to be a challenging environment with no dividend growth, as LPTs rebase to lower pay-out ratios, we are confident the sector's forecast gross distribution yield of 9.7% is deliverable. This attractive yield and its defensive characteristics should see the sector well supported around current levels.

The outlook for the Australian listed property sector has improved modestly. The market continues to show modest improvement, with demand for space remaining robust and limited new supply driving vacancy lower and improving the outlook for rental growth and property

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valuations. Funding costs continue to fall, and further rate cuts by the RBA are likely to support the weaker retail and housing sectors. As a result, we have a favourable view for the year ahead due to the sector's strong balance sheets, the potential for corporate activity and the underlying support from the welcome increase in the number of share buy-backs.

Global Listed Property

While there have been some setbacks in the road to economic recovery of late and macro-economic risks persist, we believe that they are not sufficient to derail the positive case for global real estate securities. The sector should be well supported, driven by an attractive dividend yield of approximately 4%, mid single-digit cash flow per share growth and relatively stable earnings multiples. In a 'new normal' world of low returns and economic uncertainty, real estate, including listed real estate, trading at discounted valuations should offer investors better-than-average return potential. This sector will particularly benefit should inflation expectations rise.

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