



**GLOBAL
INVESTORS**

Quarterly Strategic Outlook / June 2011



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Executive Summary

The economic recovery in the United States has hit another soft patch. This serves as a reminder of the difficult nature of the recovery. We believe the recent weakness will prove transitory, however we continue to expect no tightening in monetary conditions in the US this year.

Debt issues in Europe continue to be a key focus for markets. Greece continues to be the centre of attention, although there is also renewed concern about Portugal in particular. The problem continues to be exacerbated by political procrastination. The simple fact remains that there is no easy answer to the problem.

Growth in China is also slowing, with GDP growth of 9.0% expected this year. Together with a weaker outlook for the US, the disruption to global supply chains from the devastating Japan earthquake and fiscal consolidation having a constraining effect on growth in other key developed economies, we now see global growth of 4% in 2011. This is down from 5% in 2010.

Over the last six months or so we have been busy changing the mix of our diversified portfolios. Following a period of strong performance for growth assets, from late last year we began to take profits and reinvest funds into more defensive assets. This has proven to be a profitable strategy, as market conditions have recently become more challenging.

Our portfolios are now neutral on the growth/income split. Our overweight to global equities is offset by slight underweights to commodities and global property. We are slightly overweight NZ listed property and underweight NZ equities. We are neutral across the income mix of cash, NZ bonds, and global bonds. We are short the NZ dollar overall, especially against the USD and Sterling, and we have a long NZ dollar position against the Australian dollar.

Our Views in Summary

Asset Class	Near-term view	Medium-term view	Current Position
Global equities	Near-term headwinds as global growth momentum slows	Despite a long worry list, valuations are very supportive for this asset class over the medium term. Should perform well if the global economy grows close to trend	Overweight
Australasian equities	As for global equities, reduced global growth momentum might hold back performance	More expensive than global equities so less upside over the medium term	Underweight
Emerging equities	Inflation is a real threat to the region and policy makers must deal to this, reducing growth momentum	No real question about growth prospects but EM no longer trades at a discount so risk adjusted returns will be much lower than the last decade	Neutral
Property & infrastructure	Sluggish, in line with equity markets over coming months	We like the high yield offered by the NZ property sector and the gradually improving fundamentals	Neutral
Commodities	Downward pressure expected, after a strong run, driven by weaker global growth momentum	Structural bull market still in play, but significant downside risk after a very strong run	Underweight
Global bonds	Weaker global growth and reduced risk appetite are supporting factors but risks increase later in the year as policy tightening comes into focus	Expect modest returns, given low government bond yields. Massive sovereign issuance suggests upside risk to yields over the medium-term. Credit spread contraction now probably complete	Neutral
NZ bonds	Upside risk to yields as the economy improves and tightening comes into focus	NZ's fiscal position is much healthier than the major developed countries so sovereign debt concerns pale in comparison.	Neutral
Cash	Low rates equals low returns. Simple as that.	Rates will need to normalise over the medium-term and while cash offers a lower expected return than other income assets it comes with much less risk.	Neutral
Foreign currency	Domestic factors are positive, but after a strong run there is downside risk	The NZD remains significantly overvalued against the USD and GBP in a long term context, but significantly undervalued against the AUD	Overweight foreign currency

US Hits another Soft Patch

A slew of recent weak data is pointing to another soft patch for the US economy. Flat real incomes, a drop in consumer confidence and slowdowns in both jobs growth and the manufacturing sector are once again reminders of the difficult non-linear nature of the US recovery.

It is predominantly the household sector that continues to hold things back as deleveraging continues, high commodity prices constrain household budgets, unemployment remains high and the housing market continues to struggle to form a solid foundation. After a sharp fall in May, consumer confidence is back to its lowest level in six months.

Real disposable incomes have flat-lined since the start of the year. The boost that was to come from the cuts in the payroll taxes in January has been completely offset by higher commodity prices. In the second quarter of the year consumption will likely struggle to post a stronger result than the annualised 2.2% achieved in the first quarter. Even that soft number was only achieved by a reduction in the savings rate from 5.4% in January to 4.9% in April.

On the bright side the recent softening in commodity prices, if sustained, could provide some respite to household budgets as the year progresses.

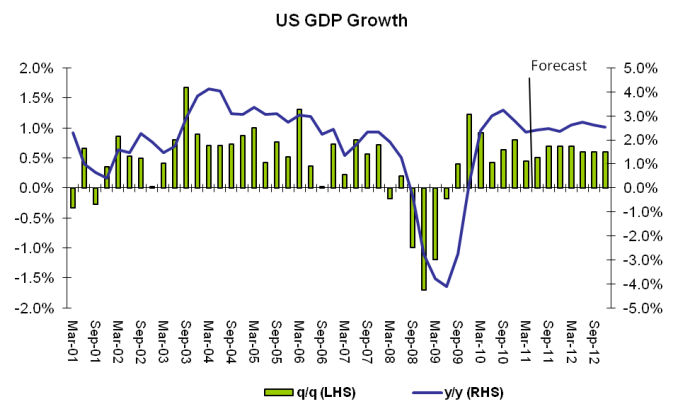
The most concerning development, at least for the Federal Reserve, is the rise in the unemployment rate over the last couple of months. After reaching a post-recession low of 8.8% in March of this year, the unemployment rate had risen back up to 9.1% by May.

The recent slowdown in productivity growth, however, is supportive of further jobs growth in the months ahead. Firms worked very hard during the recession to reduce costs and use their people more efficiently. Those gains have now been largely exhausted. Productivity growth is now down to an annualised pace of around 1% in the first quarter of 2011. That means future, albeit soft, growth will require more hiring from firms. That's good for jobs growth but not so good for costs and profitability.

While the general economic recovery continues to prove to be hard work, it's important not to lose sight of some of the good news. We argued early on in the recovery that we needed to see strong investment growth if we were to see a sustained improvement in economic prospects and a rebalancing of the economy towards exports. Indeed growth in both business investment and exports remains at good levels.

However, in recognition of the more recent data (which is hard to ignore) we have trimmed our full-year 2011 GDP forecast back down to 2.5% from 3% previously.

Further out, fiscal policy will be a significant drag on the economy as the US moves towards a more sustainable fiscal position. This is a necessary part of the post recession adjustment process, but as we have said before, it's important to strike the right balance between supporting economic growth and achieving fiscal consolidation. With that in mind we expect a similar growth outcome of around 2.5% in 2012.



Source: US Commerce Department and AXA GI

Federal Reserve “Exit Strategy”

The good news about fiscal policy doing a lot of the “de-stimulus” work is it takes the pressure off monetary policy. That’s not just a story for the US either: of the bigger advanced economies Europe and the United Kingdom are in the same boat.

The second round of quantitative easing ends in June. Given the recent weak activity data, the first question to be answered is: What about QE3? In the minutes from the April meeting, the Federal Open Market Committee (FOMC) stated there would have to be significant deterioration in the economic outlook before we saw another round of quantitative easing. Recent weakness in the partial activity data does not meet that rule.

In the meantime, the FOMC is appropriately focussing its attention and debate on the exit strategy.

There is agreement on what the first phase will look like: to stop reinvesting principal payments on their holdings of Mortgage Backed Securities (MBS). That will start the process of a gradual winding-down of the Fed’s balance sheet. Expect that to start occurring at the same time the Fed drops the line about keeping monetary conditions at current levels for an “extended period”.

The debate is focussing on the phasing of eventual asset sales (of MBS’s and Treasuries) and the raising of interest

rates. The Fed seems to be coming down on the side of taking a gradual approach to asset sales and using interest rates as the primary tightening tool.

One of the key considerations is what is the most inflationary: the low level of interest rates or the extreme level of excess reserves? Our starting assumption was that they would want to undertake a reasonable amount of asset sales before embarking on interest rate increases.

However we have some sympathy for the argument that if interest rates are used first and the economy takes a turn for the worse, the Fed can then resort back to the conventional policy tool: interest rates. It also means the Fed can embark on a long-term pre-announced strategy of reducing its balance sheet.

The Fed can continue to muse. We continue to believe there will be no monetary policy tightening in the US until 2012. Recent developments have simply served to reinforce that story.

China Slowing

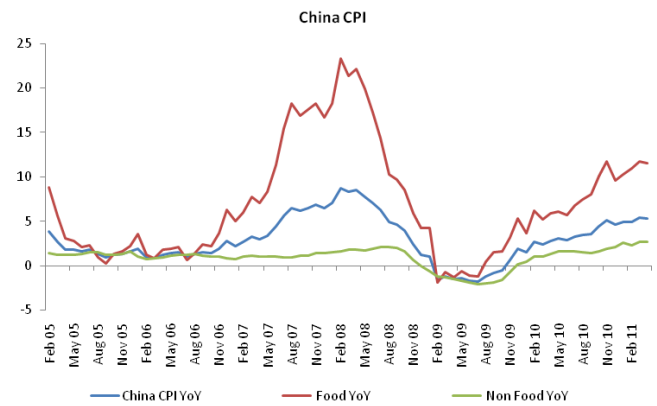
China is also slowing. You may recall we were surprised the economy did not slow more sharply than the decline from 9.8% in the fourth quarter of 2010 to 9.7% in the first quarter of 2011.

However, since then activity data has been generally weak. In particular retail sales growth has continued to decline, with growth in real terms now at its lowest level in 6 years.

Industrial output fell from 14.8% y/y in March to 13.4% in April. Looking further out the official PMI manufacturing index is softening, but at this point it is consistent with a gradual slowdown rather than a sharper hard landing.

Inflation appears to be peaking. The annual rate of increase slowed from 5.4% in March to 5.3% in April. Importantly, annual food price inflation slowed for the second month in a row, but non-food prices were stable.

Domestic factors that have been driving food prices higher seem to be on the wane. As a result we expect headline inflation to remain around current levels for the next few months and then decline into the end of the year.



Source: National Bureau of Statistics

Given the recent slowdown in the growth indicators and with (headline) inflation peaking, we think interest rate increases may be over. We still expect further increases in the Required Reserve Ratio to offset the expansionary impact of purchases of foreign exchange reserves.

Further exchange rate appreciation remains desirable, but this is as much about economic structure as it is about the cycle. China can't continue relying on strong investment and exports and relatively weak domestic demand (as a share of the economy). Exchange rate appreciation shifts some of the burden of adjustment to the tradable sector while delivering a boost to real incomes for households.

We continue to expect 9.0% GDP growth for China this year. This is slightly below average market expectations of closer to 9.5%.

Europe

Debt issues remain the key focus in Europe, with Greece remaining the centre of attention. Political procrastination however continues to be the biggest problem. The simple fact is there is no easy solution to Greek and wider European debt issues.

We remain of the view that Greek debt will be restructured. With debt expected to reach 158% of GDP this year and the current account deficit that is still around 9.5% of GDP, the only real questions are what restructuring looks like and when it happens.

There are two options, neither of them palatable. The first is to give Greece more time for reforms, those already made and those still needed, to have an impact on the economy. This would necessitate Euro Area members and the IMF agreeing to a new loan to cover Greece's borrowing needs out to, say, 2013.

The terms of the original bail-out package did not include the necessary refinancing of existing debt in the

order of €25b in early 2012. At the time it was expected Greece would be able to re-enter capital markets in 2012. That appears unlikely. Such an approach would also most likely require a softening of deficit reduction targets.

The second option is that debt restructuring happens now. We can't see any upside in this scenario and it is the pathway that is most likely to lead to contagion. In the finance sector, banks that hold large quantities of Greek debt are not likely to be sufficiently well capitalised to wear large losses now. In order to prevent a credit crunch, these banks would have to be recapitalised.

Portugal and Ireland are probably solvent but from the markets perspective, the jury is still out. In Portugal the recession will probably deepen before economic conditions start to improve. The key question regarding solvency will be what Portugal's sustainable rate of growth is as it emerges from fiscal adjustment. It probably needs to be in excess of 2% per annum.

Ireland is looking the better of the two as the current account has returned to surplus. That's good news as the country is now paying its way. Furthermore the tax take is up over 6% so far this year and while spending is flat, the underlying fiscal position is improving.

The bigger problem in Ireland is the banks. The Government is working towards a "smaller and more robust banking sector" which implies further deleveraging. It remains to be seen if the historical legacy proves too big a burden.

In Italy the main problem is the sluggish recovery. Debt will likely reach 120% of GDP this year according to the EU Commission, but potential growth is probably only 1%, if not less. On the positive side the net external position is only -20% of GDP, making a debt crisis unlikely. Italian government bonds are largely held by the public. The long-term solution here is reform to boost growth prospects otherwise the debt burden will become unsustainable.

Spain appears to be solvent. Government debt is 60% of GDP, however there is talk of "hidden debt" amongst Spanish public entities. Estimates of that are about 4% of GDP, so by year-end Spanish debt is likely to be around 70% of GDP. This is actually not bad by European standards.

The weak link for Spain is the net external asset position of -77% of GDP. But helping Spain's case is the rapid improvement in its current account deficit from 10% of GDP in 2008 to 4% by the first quarter of 2011.

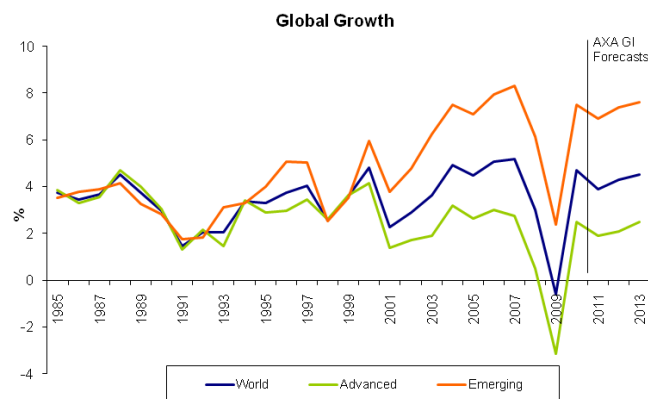
Fiscal austerity can be expected to have a significant constraining effect on Europe-wide economic growth in the years ahead. Even Germany is likely to slow this year in the face of lower global growth. That's something even a hawkish European Central Bank can't ignore.

Japan, UK and Global Growth

In Japan the economic outlook remains uncertain following the devastating Tohoku earthquake and tsunami. Prior to the earthquake growth appeared to be regathering momentum following a soft finish to 2010. At that point it appeared the economy would grow around 1.6% in 2011. We have now pulled that back to 1.0%. However, we now expect a stronger 2012 as reconstruction efforts get underway with growth of 2.5% likely.

In the United Kingdom, we are not as optimistic on the growth outlook as the market consensus. We think the aggressive fiscal austerity program there will constrain growth by more than most seem to be expecting. We continue to expect GDP growth of 1.6% in 2011.

The outlook for Japan and the UK together with the weaker US growth outlook and the modest slowdown in China has our 2011 global growth forecast at 4%. That follows 5% in 2010. It has been our expectation for some time that growth in 2011 would be lower than that achieved in 2010, but that slowdown is now expected to be more marked.



Source: IMF and AXA GI

In line with the slowdown in growth, there has been a shifting-out of expectations of tightening monetary conditions in the key developed markets. We're happy about that.

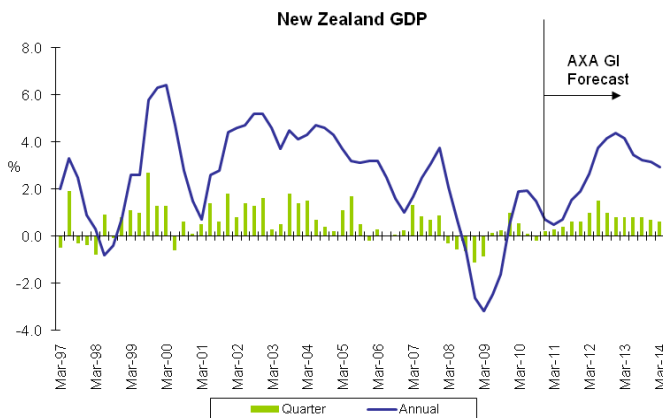
In the US the first tightening in interest rates is now not expected until September 2012. In the United Kingdom there is no tightening expected until March 2012 and even the ECB's risky strategy of tightening monetary conditions is being watered down and may yet be derailed completely. This also reflects the growing

realisation that fiscal policy will be doing much of the “destimulus” work this cycle.

New Zealand and Australia

Growth in both countries has been impacted by the immediate consequences of significant natural disasters. Australian GDP contracted 1.2% in the first quarter of 2011 and New Zealand is expected to post another flat GDP result for the same period. The impact of the series of seismic events in Christchurch has kept New Zealand’s growth subdued since September last year.

However, both economies are expected to recover strongly in the period ahead reflecting respectively the repair work from the floods in Australia and the New Zealand earthquake. Despite the poor start to the year, Australia is expected to grow 3% in 2011 followed by 4.0% in 2012. In New Zealand the forecasts are 1.8% and 4.0% over the same periods.



Source: Statistics New Zealand and AXA GI

Australia’s challenge has been the two-speed economy. The resources sector has been very strong reflecting strong demand for industrial metals from China, while the interest rate sensitive sectors of the economy have been struggling.

Household and business sector deleveraging has been a key feature of the recent poor growth performance of the New Zealand economy. While that has been bad for growth in the recent past, it’s indicative of important balance sheet repair work going on behind the scenes that bodes well for a stronger, more sustainable recovery further down the track.

As growth recovers we expect further tightening in monetary conditions in Australia. The Reserve Bank of Australia has already done a considerable amount of work. From a low of 3.0%, the cash rate has been raised progressively to 4.75%. We expect another 50-75 basis points of tightening in the months ahead.

The Reserve Bank of New Zealand has considerably more work to do. The easing in monetary policy in March following the February earthquake took the Official Cash Rate (OCR) back down to the low of 2.5%. With unit labour costs already at 2% (the mid-point of the Reserve Bank’s inflation target range) and the sharp recovery in activity ahead, we expect to see a 50 basis point increase in the OCR in December 2011.

From there we expect the OCR to be increased steadily to 4.5% by the third quarter of 2012, at which point the Bank can probably afford to pause and reflect. Indeed the latest interest rate forecast track from the Reserve Bank’s June Monetary Policy Statement is largely in line with this view.

We continue to believe the labour market will be a significant constraint on New Zealand growth. While we expect demand for labour to rise sharply in the year ahead, we are concerned about whether the pool of available workers has the right skill sets to fill those jobs. That will put upward pressure on wages. It appears to us the Reserve Bank (and the market generally) is significantly underestimating the likely inflation consequences of a tight labour market.



Bevan Graham
Chief Economist

Asset Strategy

Dynamic Asset Allocation

Over the last six months or so we have been busy changing the mix of our diversified portfolios. Following a period of strong performance for growth assets, from late last year we began to take profits and reinvest funds into more defensive assets. This has proven to be a profitable strategy, as market conditions have recently become more challenging.

This is best illustrated by comparing the changes to our Dynamic Asset Allocation model from the current target position to that held as at 1 December 2010.

The Table below shows our Dynamic Asset Allocation tilts, measuring the percentage point deviation from the benchmark weighting for the various asset classes that make up the diversified portfolios.

Asset	Current	1-Dec 2010	Change
Cash	0	0	0
NZ Bonds	0	0	0
Global Bonds	0	-5	5
ANZ Property	1	-1	2
Global Property	-1	-2	1
Infrastructure	0	0	0
NZ Equities	-1	-1	0
Australian Equities	0	2	-2
Global Equities	2	1	1
Emerging Equities	0	5	-5
Commodities	-1	1	-2
Total Income	0	-5	5
Total Growth	0	5	-5
Foreign Currency	3	6.4	-3.4

The current position shows little variation from the benchmark position, with a neutral mix overall between growth and income assets. However, the “change” column shows our activity over the past six months.

The key change has been to sell down 5% of growth assets to fund a 5% increase in income assets. This has been achieved by taking profits in two of the most volatile asset classes, emerging market equities and commodities. We have also recently sold some Australian equities. The portfolios have been further de-risked to the extent that within the growth mix itself we now have a greater tilt towards property assets, a lower risk asset class.

The increase in income assets has been focused towards closing the pre-existing underweight position to global bonds. The other key change to the portfolios has been the approximate halving in foreign currency exposure, on

our view that the NZ dollar wasn't about to depreciate in a hurry, despite the over-valuation relative to long-run norms.

In our view, the de-risking of the portfolios has been entirely appropriate, given our lack of conviction that growth assets would continue to shine, as the global economic recovery matured and as some of the key concerns – such as the Europe debt situation – looked likely to remain for some time yet.

A More Cautious View on Growth Assets

Our view of the markets should be seen as cautious towards equity markets, rather than outright bearish. To be sure, in our last QSO we recognised the potential for a short-term correction in equity markets. But we also recognised that equities remained attractively priced compared to income assets like cash and bonds, so it didn't seem appropriate to become too bearish, in light of our focus on the medium-term.



Source: AXA GI

That view still remains. From a pure valuation perspective, it's hard to be overly bearish about equity markets. The chart above shows the forward price/earnings ratio for the MSCI World Index. As at the end of May, the ratio was 11.9, well below the average of the last 25 years or so.

Given very low interest rates, one would expect the P/E ratio to be above, rather than below, historical averages. In other words relative to bonds, equities remain attractively priced.

Of course, one can't solely rely on valuations to guide asset allocation decisions. Equity markets also looked reasonably priced against bonds in the lead up to the global financial crisis. One must also factor in the macroeconomic environment.

The Macro Environment has Deteriorated for Equity Markets

Two years ago, the macroeconomic environment was downright positive for equity markets. The best time for equity markets is coming out of a recession, with policy easing and declining inflation. Those macro conditions helped generate very strong returns for equity markets.

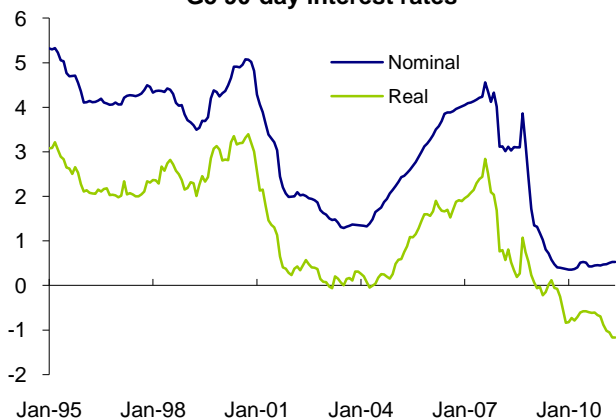
Two years on, the macro environment is a lot less positive for equity markets. The global economic recovery is maturing, so there is less impetus to profit growth, particularly with profit margins at the top end of historical norms. And, with higher inflation pressures, monetary policy is tightening, albeit much more so in the emerging market world than developed markets. Two years ago fiscal policy was incredibly easy, but it has tightened considerably in Europe now and the US must soon join that trend.

In other words, the macro environment has shifted from being a strong tailwind for equity markets towards being a slight headwind.

How much those headwinds increase will depend on how fast central banks will have to tighten monetary policy. The chart below shows how low short term interest rates currently are in the G5. We believe that global inflation pressures remain modest, outside of the commodity price dynamic, and without a great deal of confidence on the growth outlook, the major central banks are likely to adopt a very slow and gradual pace of policy tightening.

Sustaining a low interest rate environment for some time yet should be a positive dynamic for equity markets. Other positive factors remain, as mentioned last quarter, such as strong corporate balance sheets (outside the finance sector), which is leading to increased merger and acquisition activity, increases in dividends and share buybacks.

G5 90-day interest rates



Source: AXA GI

Emerging markets have struggled to perform this year, with the MSCI Emerging Market index flat for the first five months of the year in local currency terms. This comes as no surprise, given the more challenging macro conditions for the region, with high inflation pressures encouraging central banks in the region to continue to tighten monetary policy to try and slow their economies.

Emerging markets had had a massive outperforming run over the previous couple of years, leading to stretched valuation metrics, which was the key to our sell-down from late last year.

As we near the end of the tightening cycle for the region, we might be more encouraged about the performance of emerging market equities, but ideally we'd like to see better valuation metrics before re-establishing an overweight position.

We recently sold down our overweight position to Australian equities, based on the medium-term downside risk to the Australian dollar, an expected correction to commodity prices, a weaker housing market and banks struggling to perform in a deleveraging environment.

While we remain slightly underweight NZ equities, that reflects the subdued outlook for profit growth for the market we see over the medium term and lack of valuation support compared to global equities. As we have seen recently, the local market performs relatively well in a "risk-off" type of market. Any short-term correction in global equities should see further relative out-performance of local equities.

We Are Overweight Local Listed Property

Turning to other growth assets, over the last six months we have been adding to local and global listed property. We saw NZ listed property as an attractive low-beta growth asset class, suitable for funds switched out of global equities at a time when income asset classes offered modest expected returns.

The asset class offers a decent gross yield of circa 10% compared to cash and bond yields of circa 3% and 5% respectively. The NZ commercial property market has been soft for several years now, but we are reaching the bottom of the valuation cycle. The listed property sector is at the high quality end of the market compared to most unlisted vehicles.

Vacancy rates are modest at the high quality end of the property spectrum. While rental growth is low at the moment, an improving NZ economy should lead to improving tenant demand and reduce any lingering downward pressure on rents. New supply ahead is modest, and lower than normal gearing for the sector

gives some balance sheet flexibility. Finally, the sector provides some sort of inflation hedge that the fixed income market does not provide. Not that we are particularly concerned about inflation at the moment, but the balance of risk lies with higher, not lower, inflation pressure in the future.

Downside Risk to Commodity Prices

We recently sold down our commodities exposure from 1% overweight to 1% underweight, following its very strong run.

We still see commodity prices as being in a structural bull market, but prices had become over-stretched, in our view, and it was time to take some profits.

Looking forward, slower global growth momentum could hold back the performance of industrial metal prices, especially in a world where emerging market central banks are actively trying to slow down their economies. A return to more normal climatic conditions should see a sharp reduction in agricultural product prices. The end of quantitative easing in the US and a renewed focus on the first tightening, might take the upward pressure off precious metal prices. And oil prices could well fall back as the Libya-induced risk premium built into current prices, fades.

A Cautious View on the Bond Market as Well

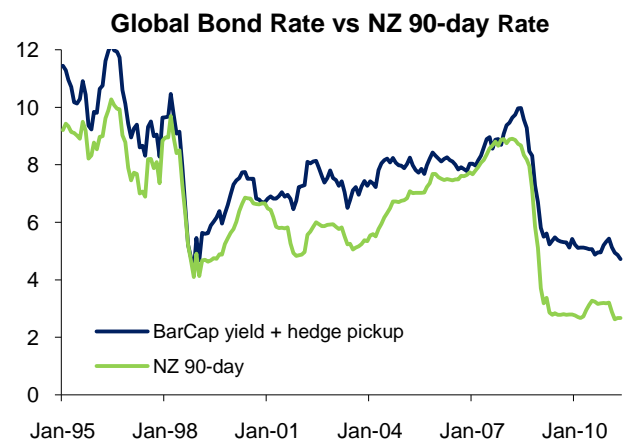
In selling down our exposure to growth assets we were torn between increasing cash weightings and closing up our underweight position to global bonds.

In the end we decided to close the underweight position in global bonds, consistent with a view that any major sell-off in the bond market was far enough into the future not to worry about, for now.

Cash itself is a highly defensive asset class and offers very low returns, a little over 3% per annum at the moment. To be currently overweight cash, one must be really bearish on growth assets and bonds to justify such a position.

Global bonds offer a circa 2% higher running yield than cash. Thus, in the absence of any increase in yields global bonds could be expected to significantly outperform cash.

We recognise that global bond yields are at historically low levels that are unlikely to be sustained. And we recognise the mammoth task that many large governments face in bringing down fiscal deficits and lowering public debt levels.



Source: AXA GI, Datastream

But we also recognise why global bond yields are so low. They are being held down by extremely low rates at the short end of the curve. We see any monetary policy tightening by the ECB and US Federal Reserve as very gradual, so low short rates are likely to linger for some time yet, probably for more than a year. At the same time we see inflation pressures receding, with lower commodity price inflation and weakening global growth momentum as further factors supporting the bond market.

The bottom line is that there is likely to be a time when shorting global bonds will be a profitable strategy, but we can't see any upheaval in the bond market over the balance of this year. So we are neutral on global bonds with a view to re-establishing a short position further down the track.

NZ bonds have had a very strong run over the last quarter but we don't see that trend continuing. Earlier this year, NZ economic data disappointed, we had the devastating Christchurch earthquake and a one-off easing in monetary policy. International investors, including the Chinese government, have been attracted to NZ's higher yielding government bonds to help diversify their portfolios. Demand at NZ's government bond tenders has been extraordinarily high. These factors have helped drive NZ bond rates down to historically low levels.

More recent data have shown a post-quake recovery in economic sentiment and increasing inflation pressures. The RBNZ has been relaxed about monetary policy, but the level of comfort must surely be reducing. The market isn't pricing in as aggressive a tightening stance as we think might be appropriate over the next 12 months.

That suggests upside risk to local bond rates over the balance of the year.

Downside Risk to the Strong NZ Dollar

Certainly, the strong NZ dollar is doing some of the tightening work for the Bank. The NZD-USD cross rate recently reached a 30-year high of \$US0.8260. Our approach of focusing more on the likely medium-term trajectory for the NZ dollar and thereby holding a short position has not been profitable. In the last QSO we recognised that we didn't really expect the NZ dollar to depreciate this year and it was likely to range trade at a richly priced level.

With the NZ dollar reaching new highs recently, we are now more comfortable in holding a short position. One factor supporting the NZ dollar has been the very bearish view held by many on the US dollar. This has become a very crowded consensus trade. So any change towards positive sentiment for the US dollar could potentially have a significant impact, reducing the NZD-USD cross rate.

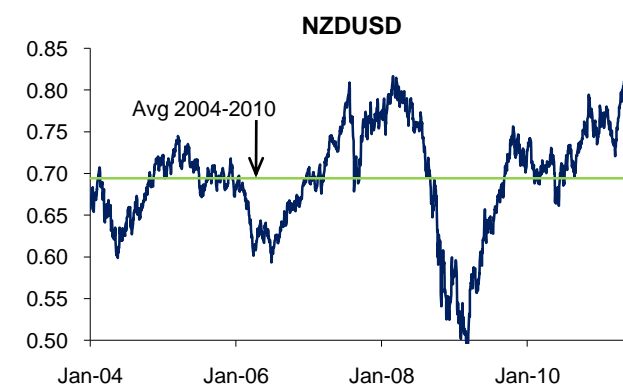
Interestingly, domestic factors have dominated the NZ dollar's trajectory this year. The NZ dollar was surprisingly weak in the March quarter at a time when global growth indicators were improving and commodity prices were rising. Domestic factors such as the Christchurch earthquake, weak local economic dataflow and the cut to the Official Cash Rate drove the NZ Dollar weaker, whereas usually commodity prices are the more dominating factor.

Then, in the current June quarter, commodity prices have been weak, but the NZ dollar has strengthened, supported by a more positive local economic dataflow and increasing expectations that the RBNZ may be forced to raise rates this year.

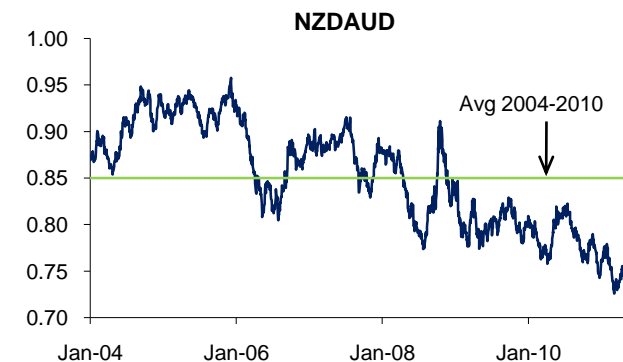
If domestic factors continue to dominate, then the NZ dollar would be well supported. Local economic data is gathering more positive momentum, and the balance of risk lies towards a more aggressive tightening stance than factored in by the market. On any strength, we would be looking for opportunities to increase the short position on the NZ dollar.

On our long-run valuation metrics, the NZ dollar is most over-valued against the US dollar and Sterling, followed by the Yen and Euro.

By contrast, the NZ dollar is historically cheap against the Australian dollar. We think there is plenty of scope for the NZD-AUD cross rate to appreciate over the medium-term. We see more downside risk to the Australian dollar compared to the NZ dollar from any commodity price decline, the gap between NZ-Australian short term interest rates is expected to close once the RBNZ kicks off the tightening cycle in the fourth quarter this year and, after a few years where the Australian economy has grown much stronger than the NZ economy, looking forward we see a similar growth profile.



Source: Datastream



Source: Datastream



Jason Wong
Head of Investment Strategy

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