



**RODNEY'S RAVINGS** take an open-minded and at times irreverent look at topical economic issues. Unlike our pay-to-view reports, that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can sign up to the **RAVINGS** and for notification about forthcoming **Property Insights** and **Property Research** reports on our website – <http://www.sra.co.nz/lists/>.

## RODNEY'S RAVINGS

The share market and the economic recovery revisited

### EXECUTIVE SUMMARY

A Raving released in April titled ***Recessions and investing in the share market*** looked at the relationship between share market performance and economic cycles. As explained in that Raving: “My preferred approach to investing in shares is to wait for a good recession and when there are the early signs that the economy will soon emerge from the recession buy a selection of listed companies that have been particularly hurt by the recession but which are expected to live to fight another day.” This Raving can be accessed from our website via the following link – <http://www.sra.co.nz/pdf/Shares.pdf>.

Since April a number of economists and commentators both in NZ and internationally have warned that the rise in share prices since March reflects the market getting ahead of itself without underlying economic justification. The implication being that the share market rally will falter or reverse. Certainly, if another major negative shock comes along then the share market will take a hit. But based in part on the analysis of economic growth and interest rate prospects contained in our monthly **Interesting Times** reports there is good reason to expect the rally in share prices to continue for some time albeit with the inevitable volatility along the way.

Having taken my own advice and invested in the share market earlier in the year I am now sitting tight watching with amusement as the economists debate whether there will be a W-shaped recovery rather than the more traditional V-shaped one the leading indicators are pointing to. Back when I was buying shares they were debating whether it would be a u-shaped or L-shaped recovery (i.e. drawn and weak or non-existent). Provided nuclear bombs or infected pigs don't start falling from the sky the share prices of the group of companies that are particularly tied to the performance of the NZ economy should have lots of further upside over the next year or three.

My family trust holds shares in a number of the companies mentioned in this report. By viewing this report you acknowledge that you have received the disclosure statement that can be accessed via the following link to our website - <http://www.sra.co.nz/pdf/DisclosureStatement.pdf>.

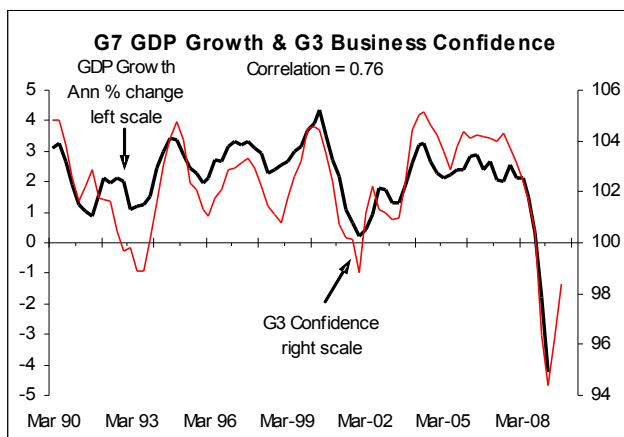
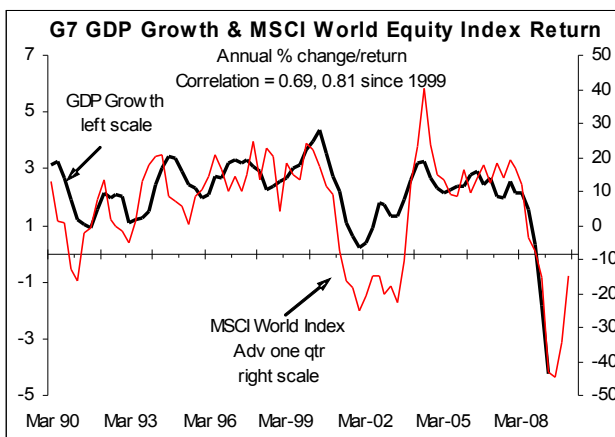


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### The share market and economic cycles revisited

In a presentation I gave to the NZ Shareholders Association AGM in July the charts below were used to demonstrate the normal relationship between the share market, economic growth and leading economic indicators. The black line in both charts show annual real economic growth in the major G7 countries (i.e. the US, Japan, Germany, France, Italy, the UK and Canada). The red line in the left chart shows the annual return in the world share market based on the MSCI World Index in USD terms. The red line in the right chart shows a measure of G3 business confidence (i.e. weighted average business confidence in the US, Japan and Eurozone). The best fit between the annual return in the world share market and annual G7 GDP growth is with the share market leading by one quarter. The best fit between G3 business confidence and G7 GDP growth is co-incidental. What this tells us is that the share market doesn't wait for either the historical economic data to be released nor does it wait for the likes of the business confidence surveys to be released. Share prices move up/down in anticipation of economic upturns/downturns. This should be no surprise. The behaviour of the world share market is the product of millions of people sniffing out what is going on at the coal face of the economy where signs of a recovery or downturn will be found first.



### Don't wait for the economists to fire the starting gun

If the share market moves ahead of the official economic data and even ahead of the leading economic indicators does this mean economic forecasters can help investors assess when they should focus on the share market? Many economists have spent their time this year warning that the economic recovery would be slow and drawn out. Some economists/commentators have even warned that the rise in share prices since March reflects the market getting ahead of itself without underlying economic justification. The implication being that the share market rally would falter or reverse.



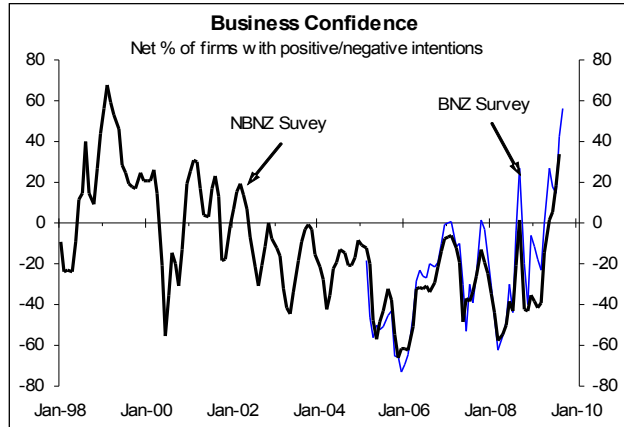
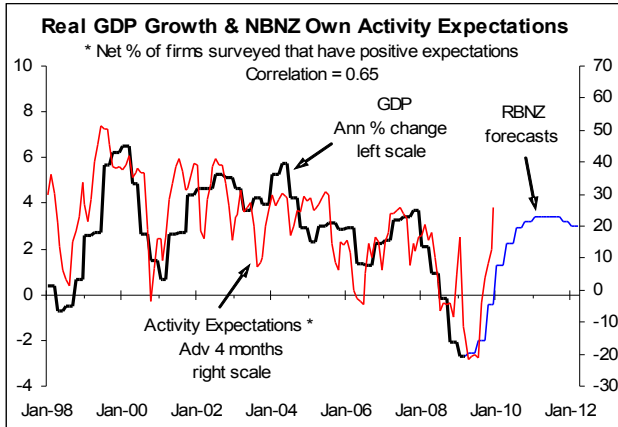
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The adjacent drawing best illustrates the RBNZ's approach to viewing/assessing the economic recovery. In Governor Bollard's words: "There is more evidence that the decline in economic activity is coming to an end, and that a patchy recovery is underway. However, the medium-term growth outlook remains weak." Source: <http://www.rbnz.govt.nz/news/2009/3745217.html>

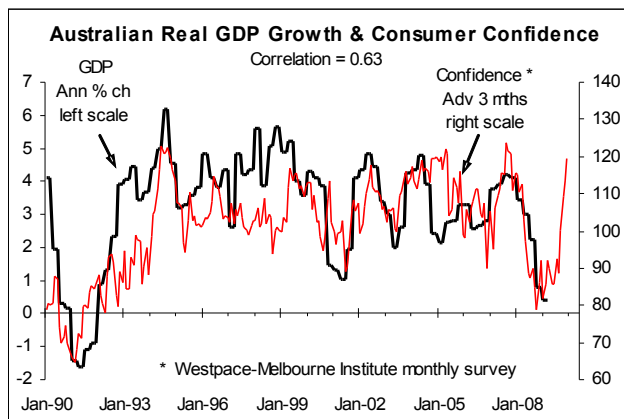
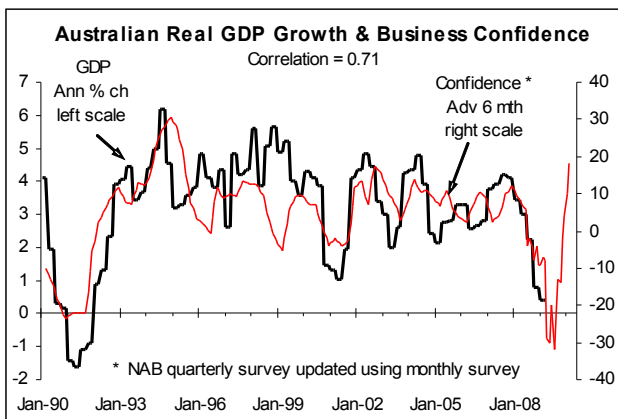
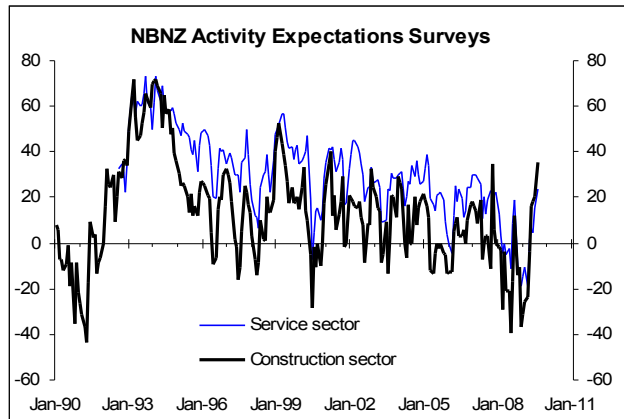
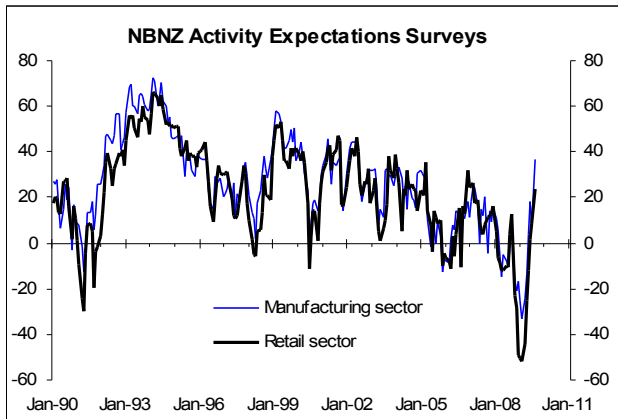
The expectation that the recovery will be patchy-weak forms the basis of the Governor's view that the OCR will remain "at or below the current level through until the latter part of 2010". While some industry groups will understandably applaud the Governor's stance and his view that the market is misplaced in betting that he will start hiking the OCR before late 2010, by burying his head in the sand he is condemning NZ to a continuation of boom-bust cycles. Consequently we recommend that clients gear-up and/or invest on the expectations of a much stronger economic recovery than the RBNZ is predicting, but equally we warn that down the track reality will win out and interest rates will end up being hiked much more than the RBNZ is predicting.



By contrast the RBNZ's view that the economic recovery will be "patchy" – a view held by a number of other economic forecasters - the leading indicators are pointing to a pretty broad-based, sharp recovery being imminent. The surge in the NBNZ survey of own activity expectations points to annual GDP growth rebounding to around 4% a year earlier than the RBNZ is predicting (left chart). An imminent sharp upturn in economic growth is also predicted by the business confidence surveys with the BNZ survey surging to 56% net positive in September (right chart).



The two charts below show the NBNZ activity expectations surveys for retailing, manufacturing, construction and the service sector, with all pointing to imminent sharp upturns in activity levels. The more in-depth leading indicator analysis contained our monthly **Interesting Times** reports confirm that we are on the cusp of a broad-based, strong upturn in economic growth.



It is no accident that the NZ economy is in the process of experiencing a strong recovery in economic growth, with the same happening in Australia for similar reasons (the two charts above show what two Australian leading indicators are predicting). In NZ's case the combination of sub-6% mortgage interest rates, a surge in net migration, a recovery in global growth, some fiscal stimulus and some healing of the

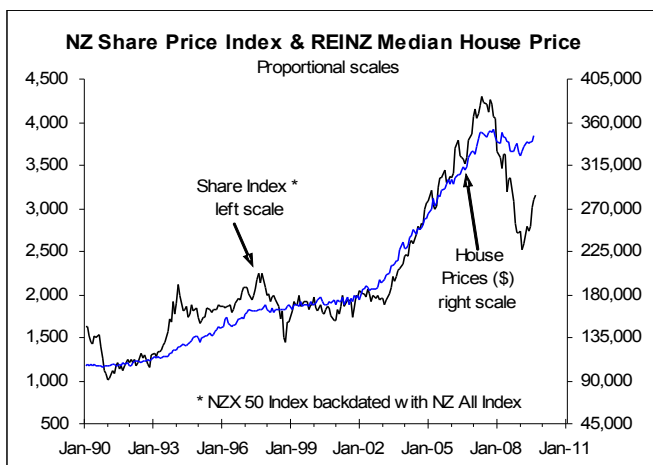


local credit crunch were always going to result in a strong rebound in growth despite a much higher NZD. As happens almost every cycle the RBNZ and most economists are focused too much on the negative impact of the rising NZD, which is partly because unlike us they didn't predict it happening (i.e. if you are serious about managing exchange rate risks you shouldn't be without our **Forex Prospects** reports).

The following comments by the Governor in the September Monetary Policy Statement are at the heart of the nonsense: "For growth to be sustained in the medium term there is a need for improved competitiveness in the export sector and a continued recovery of household savings. This rebalancing is required to stabilise New Zealand's external payments position. If the exchange rate were to continue its recent appreciation and/or the recovery in house prices were to undermine the improvement in household savings, then the sustainability of the present recovery will be brought into question."

The irony is that by committing to keep the OCR low the Governor is ensuring that the domestic economic recovery, led by the housing market, will be strong and that the desired recovery in household savings will not eventuate. While strong economic growth is just the sort of thing forex traders love so the NZD is likely to head higher this year, undermining the international competitiveness of exporters and firms competing against imports. By ignoring the leading indicators the Governor risks ending up looking stupid, but of more concern it means the boom-bust cycles that the RBNZ has sponsored in the past will continue. The "unbalanced" nature of the economic recovery raises some issues over how long economic growth can be sustained but it doesn't mean we aren't heading for a strong economic recovery nor does it mean we can't have at least a couple of years of decent economic growth.

### Where to from here for the economy and the share market?



The NZX 50 share market index has risen around 25% from the trough level experienced earlier this year versus a 7% increase in the REINZ median house price. But having fallen much more during the recession the share market looks much more attractive than the housing market from a "value" perspective (see our **Housing Prospects** reports for insights into the value of housing as an investment option).

The increase in share prices has removed much of the extreme negative sentiment that existed early in the year but the market shouldn't be close to pricing in the prospect of above average growth over the next year to be followed most likely by another year of at least average growth.

As covered on page 2, the share market leads the economic growth data by around one quarter give or take (i.e. if my views on economic growth prospects are close to the mark then the share market should have further significant upside potential over the next year or more). My view is based on the best analysis of economic growth prospects available and the experience of having worked in the share broking industry as an economist-strategist for 12 years.

Equity strategists – at least the ones worth their salt – describe the current environment as the "sweet spot" in the share market cycle. It is when share prices don't yet price in the full extent of the potential economic recovery and the central bank is still in "go for growth" mode. This period generally lasts until the strong rebound in economic growth has been confirmed in the official economic data to the extent that the central bank gets worried about inflation sufficiently to have hiked interest rates to levels that start to threaten growth prospects. With the Governor showing signs of digging his heels in over his commitment to keeping the OCR at or below 2.5% until late-2010 monetary policy should remain pro-growth for some time to come, which should be good for the share market.

Governor Bollard seems to be trying to show he is smarter than the markets, which is a dangerous game for a central banker to play when the leading indicators say the market is right. But based on the Governor's recent comments and his pro-growth behaviour between 2002 and 2006 the odds seem to favour him ensuring that the economy gets every possible chance to put in a good performance over the next couple of years. As with any market it will be a rocky road as investors become repeatedly more and less convinced that the economic recovery will unfold/continue. Then once the economic recovery has



been confirmed the game will be about accessing how long economic growth will run hot enough to justify further increases in share prices before the RBNZ spoils the party. And also as markets tend to behave, the rise in share prices is likely to outstrip rationality or the predictions of the share broking analysts. But focusing on when the run in the share market will end is getting ahead of the current game.

The run of the mill share market investors have been known to have a few bad habits:

- (1) To be tempted to buy shares after they have already performed exceptionally well for a sustained period on the misplaced expectation that they will necessarily keep doing the same.
- (2) To bear the pain of owning shares during a slump in the market just to bail out near the bottom.
- (3) Having missed the very bottom in the market decide they have missed the boat altogether and sit on the sidelines until greed finally gets the better of them.

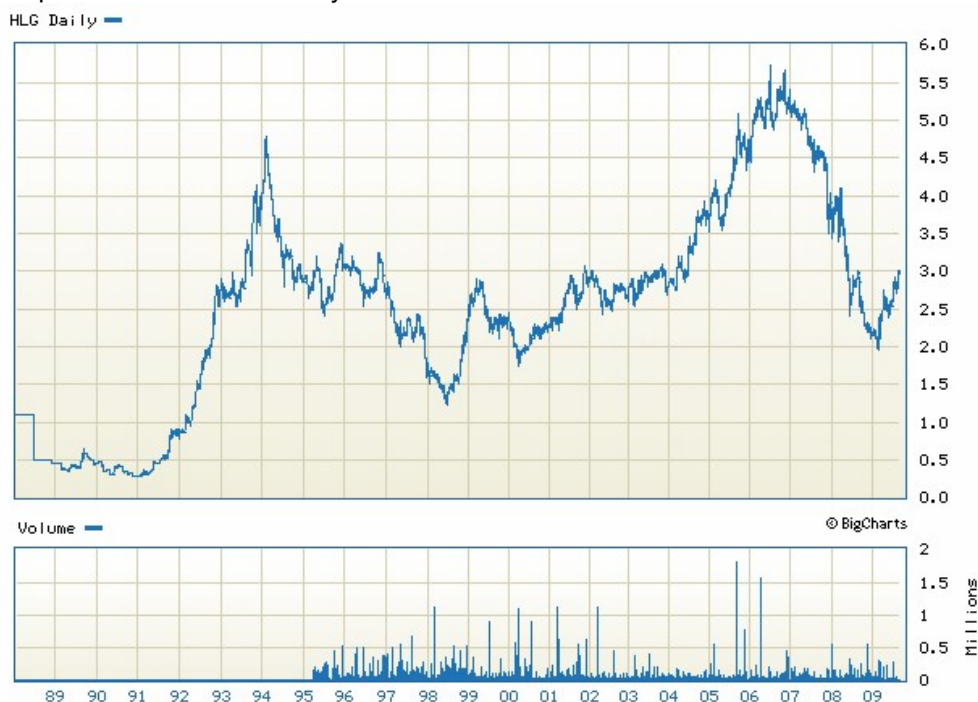
It is my assessment that the third point is currently applicable. The view that the share market has already delivered all the possible goodies is being reinforced by the likes of the doomsayer economists predicting that the economic recovery will falter (see the following two Ravings for recent examples of this - <http://www.sra.co.nz/pdf/DemystifyingDebt.pdf> and <http://www.sra.co.nz/pdf/HousingRecovery.pdf>).

Critical to assessing the share market performance are understandings of economic growth prospects and when the market prices in economic growth. I believe we are heading for a period of decent economic growth over the next couple of years. This view is supported by the current readings of the leading indicators but more importantly I believe it is pretty much guaranteed provided nuclear bombs or infected pigs don't start falling from the sky because NZ has a pro-growth central bank governor, while the share market tends to price in economic growth around one quarter in advance. The obvious conclusion being that the rally in the share market should have quite some time to run yet.

### **What sorts of companies should benefit most from the economic recovery?**

What the equity strategists call the "cyclicals" are the sorts of companies I focused on most. This includes selected retailers, transport companies, manufacturers and building companies, but it also includes some service sector companies that had been particularly hurt by the recession/financial crisis (e.g. banks). Looking at the share price performance of a couple of the companies I have invested in is insightful in terms of assessing how much of the economic recovery is already priced in.

Hallenstein Glasson (HLG) is a good example, being a long-standing listed retailer, with the chart below showing the share price performance since 1989. The HLG share price was under \$2.50 when I wrote the last Raving in April versus \$3.00 currently.



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Will the unfolding economic recovery and subsequent period of economic growth deliver share price performance like the 1991 to 1994 period or something more like 1999 to 2006? I can't say. In terms of the share price of an individual company like HLG it will depend on the performance of the management in addition to what the economy delivers in terms of growth in retail spending and what the RBNZ/market deliver in terms of interest rates. However, with the recovery in retail sales not yet even at the toddler stage there should be plenty of further upside in the share prices of many listed retailers.

Cavalier (CAV) is another company that provides insights into how the share price of a "cyclical" can perform during economic cycles (the chart below). CAV's share price was around \$1.75 back in April versus \$2.55 currently.



The NZX website [www.nzx.com](http://www.nzx.com) is a good starting point for assessing which listed companies behave like these two "cyclicals". In the "Search NZX" box on the top right corner of the home page type in the three letter acronym for any NZ listed company you are interested in. The following link will take you to the list of listed companies/securities - <http://www.nzx.com/markets/all-securities/>. After hitting the "Go" button some information on the company you are interested in will appear including a share price chart. Click on the share price chart to view it in detail – this can take a few seconds to load - and having done so you can select "All Data" under the "Time Frame:" option to see the full history of the company's share price. Nothing is easy but a few hours spent looking at the historical share price performance of the likes of retailers, manufacturers, transport companies, building companies etc will provide you insights into which listed companies best fit into the "cyclical" category. Further research is warranted but such a search should reveal a group of potential companies to invest in to play the domestic economic recovery theme I expect to last for some time yet (nuclear bombs and pigs aside). But this search should be the start of the process of working out what companies to invest in not the be all and end all.