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Global equity markets are vulnerable to a pull back after the recent recovery, and returns from the equity market over the next year could be characterised by a long period of consolidation rather than strong performance, says investment management company NZ Funds.

Michael Lang, Chief Investment Officer of NZ Funds, says "The 12 August statement by the US Federal Open Market Committee confirms that economic activity is leveling out". However, Lang warns that may not translate into higher equity market prices. "Global equities are currently pricing in a normal recovery which is why we have seen a bounce in equity markets. The Fed's statement confirms our in-house view that we have probably seen the end of the financial crisis and what is now the beginning of an economic recovery. However, we expect the recovery to be more muted than normal and we are likely to see a long period of consolidation with low nominal GDP growth."

One of the reasons for NZ Funds being more cautious on global equities is that the Baltic Dry Index (BDI) has started to trend down. Lang says, "The Baltic Dry Index is a good indicator of global economic trade and since 2002 it has been well correlated with global equity markets. Recently, however, there has been divergence between the BDI and the equity markets. Global equity markets are reaching new highs, but the Baltic Dry Index has dropped and the equity market could follow."

The BDI is one of the purest leading indicators of economic activity. It measures the demand to move raw materials and precursors to production, as well as the supply of ships available to move this cargo. Consumer spending and other economic indicators are backward looking, meaning they examine what has already occurred. The BDI offers a real time glimpse at global raw material and infrastructure demand. Unlike stock and commodities markets, the BDI is totally devoid of speculative players. The trading is limited only to the member companies, and the only relevant parties securing contracts are those who have actual cargo to move and those who have the ships to move it. These ships primarily transport a range of commodities including coal, iron ore and grains.

The BDI fell sharply from about October to December 2008. Lang says shipping costs declined while companies used existing stock and ran inventories down to extremely low levels. He says, "In early January this year, there was some restocking and that was associated with a bounce in the Baltic Dry Index and a recovery in global equity markets".

BALTIC DRY INDEX



Source: Bloomberg.

The fact that the BDI has started to fall again indicates that the bounce we have seen may be coming to an end explains Lang. "The bounce was caused by firms restocking their inventory from zero back up to a modest level of stock. Restocking can make it look like the world is recovering, when in fact all that is happening is that things are bouncing back to a new, but much lower, base."

Lang says it is important to remember that despite the Fed's confirmation that economic activity is leveling out, this has not been a normal economic cycle as the global recession was the result of an unprecedented financial crisis. He says, "As a result we expect the recovery to be slower with economic activity likely to be lower for a long period of time. The level of indebtedness in the US is still extremely high and it will take some time for consumers to reduce that debt to a sustainable level before they can start spending again and fuel a strong recovery."

Lang says US savings data indicates that consumers are resuming a lower level of consumption in order to pay down their debt.

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