

If the first quarter (Q1) 2.3% GDP surprise result – well above most analysts forecasts of around 1.5% proves anything it's what a thankless task economic forecasting is. Just when we're supposed to be experiencing a continuation of the slowdown that started brewing last year - a rare collision of particularly rosy - economic data suggests the economy is running gangbusters again. So are we really entering an economic slowdown or have we just talked ourselves into it due to inflation paranoia?

How to play the "managed" slowdown

Following the recent Q1 GDP surprise many economists upgraded their outlook for the agricultural sector and beyond. In fact, following this announcement, broker UBS NZ upgraded its growth outlook while revising higher its household spending, business investment and household spending forecasts. So does that mean the economy isn't coming off the boil? Well, not exactly, it just means most so-called "experts" misjudged the severity of current slowdown.

What's made economists stop and re-think their growth forecasts is the recent rally in world commodity prices, up more than 26% in the past year. But uncertainty over how long prices for beef and lamb and other primary commodities - especially a sharp turnaround in dairy prices - can remain at such high levels is giving forecasters a major headache. With global economic growth now peaking, support for Kiwi commodity prices is expected to weaken. Having concluded that commodity prices aren't sustainable the broker is more concerned with what's happening on the consumer spending horizon.

Confidence waning

What UBS is more concerned about is that the "blind" consumer confidence - currently propping up the GDP figures - could be severely hit by additional interest rate hikes. The net affect is expected to see household consumption (2.8% for the quarter, 6.95% annually) drop significantly. As a result, the massive upside surprise within the Q1 GDP figures has done little to change consensus expectations of a continued slowdown.

Recent figures suggest consumer confidence is already starting to sour. According to the UBS Retail Sales Predictor –showing car sales, building consents and credit card billings looking decidedly soft - we're heading for the weakest retail volume growth results in several years (as the impact of recent rate hike start kicking-in).

Self-imposed slowdown

To simplify "economic-speak", what we're really entering, explains UBS director David Lane is a "managed" or self-imposed slowdown to ensure the economy doesn't overheat. Finance Minister Michael Cullen's prognostication that growth will indeed cool-off in the year ending 31 March 05 – down from 3.6% to 31 March 04 (4.4% to 31 March 03) – is

one few will argue with. But there's considerable uncertainty over how much of a slowdown we need to keep inflation in check. At face value, Cullen's 2.8% GDP growth numbers look decidedly low, some economists are forecasting growth of 4.5%. Given the strength of the underlying economy, Rob Mercer head of research with Forsyth Barr claims we'd need to see some pretty aggressive rate hikes to curb the current rate of growth significantly below 3% this year.

Inflationary pressures

Nevertheless, with capacity utilisation - a measure of the extent to which firms use their staff, plant and equipment capacity - continuing to run at extremely high levels, the Reserve Bank of NZ (RBNZ) is presiding over mounting inflation pressures. Whether we like it or not, inflation is expected to (temporarily) rise above the RBNZ's 3% comfort-zone in 2005, due to the lower exchange rate and higher oil prices. But to Mercer, the risks of it hitting anywhere near 4% remain marginal at best.

The market understands the need to curb inflationary forces. But it hopes the governor of the Reserve Bank Allan Bollard can control them without choking growth. There's a lot of speculation over whether more rate hikes are in the offing. But to UBS the case is pretty clear cut for another up 25bp (basis point) increase (to 6.0%) on 29 July followed by a further 25bp hike to 6.25% in September. Due somewhat to these rate hikes, UBS expects the pace of growth to halve, bottoming out in first half 2005.

Riding the slowdown

Based on UBS's forecasts, GDP growth will start to look decidedly more benign during the second quarter (Q2) before it starts going backwards in Q3 on the back of those interest rate rises. So assuming they're right, how should retail investors play the current equity market, especially considering their ability to tap into the rural sector's upside is extremely limited?

Given that the local equity market looks fully or over-valued on any measure, Lane recommends focussing on defensive stocks unlikely to suffer significantly from interest rate sensitivity. Within this environment, he says the decision to avoid domestic cyclicals and stocks with considerable consumer leverage - is somewhat of a no-brainer.

Go defensive

Much of the continued downgrades to consensus consumer sector earnings estimates has been driven by the poor performance of sector heavyweight, the Warehouse. Based on concerns it could suffer further multiple contraction, the consumer sector remains the largest sector underweight with the UBS model (share) portfolio. Meantime, due to low volatility to earnings, defensive qualities and relative attractiveness on the valuation front, UBS is overweight in both the telco and utilities sector.

When it comes to stock picks Lane favours natural monopolies - mainly infrastructure assets that have typically moved from state ownership over the past 15 years - which typically outperform the broader index, whether GDP growth is weak or strong. He also likes the look of what UBS calls a

“power group” of stocks (low beta stocks) which operate in favourable and defensive industry structures. Based on UBS research these two groups of stocks have consistently and materially outperformed the index over the past 12 years.

Not surprisingly, the UBS share model portfolio holds nine of the 12 stocks within the natural monopolies group. “The key compelling trend we find is the continued steady out-performance of companies that are either in natural monopoly/oligopoly positions or have shown some ability to exercise market power,” says Lane.

But unless we’re heading for a recession – and there’s nothing to indicate one – Mercer warns against ignoring domestic cyclical stocks completely. Due to pricing power, a strong economic backwind and sound fundamentals, he’s added Tourism Holdings and Fletcher Building to his other key stock picks including: Sky TV, AIAL, Telecom, Contact Energy and Sky City.

Slowdowns and recoveries

Interestingly enough, those who are tentative about investing in equities during an economic slowdown have nothing to fear. Mercer says there’s sufficient evidence to suggest that the best two periods for equities are indeed slowdowns and recoveries. In fact, based on his figures, average returns during a slowdown and an overheated economy are 13.5% and 6.5% respectively (-21% during a recession). So assuming these figures are right, it’s in everyone’s best interests that the economy doesn’t overheat.

Finding value

Meantime, with commodity prices at record levels and the construction sector holding up well, the short-term outlook for growth remains good. Admittedly, the discount shares were trading at may have closed, but Mercer claims there’s still value to be found at current levels. Up 10% (year to date) equities continue to perform well with the NZSX50 Gross Index up 4.0% for the first quarter. “We think you want to be in stocks controlling their own destiny. Those stocks wired to domestic markets are not a bad place to be,” says Mercer. “With average gross yields running at 7% for 2004 and forecast to reach 7.8% in 2005, it’s going to be pretty hard getting investors to switch out of shares into bonds when the return is 1% lower.”

Boxout

Top UBS picks

Stock	Broker’s comments
Auckland Int’nl Airport Ports of Tauranga	Leverage to tourism growth favourable. Has a more defensive import/export mix, we expect ongoing market share gain.

Natural Gas Corp	Valuation looks fair on a PE and EV/EBITDA basis, but we also see the potential for upside from corporate activity.
Telecom NZ	Defensive natural monopoly, supportive yield.
Telstra	Defensive natural monopoly, supportive yield.
Sky City	Current discount to analysis valuation and multiples analysis are reasonably attractive.
Contact Energy	Despite its absolute valuation multiple it's trading at a 15% discount to our price target and ranks equal first across our overall stock screening.
Sky TV	Despite having run towards our valuation parameters it remains a key overweight in our portfolio.
Waste Management Group	Defendable industry position, valuation doesn't look challenging.
Fletcher Building	Despite that FBU is a cyclical exposure, we don't think the valuation multiples are too challenging and remain overweight in our portfolio.
Westpac Bank	The asset is reasonably defensive valuation metrics are not challenging compared to ANZ.

Key indicators

- NZ\$ to bounce higher before trending to around US58c sometime next year.
- Economic growth will slide back under 3% in 2005.
- Official cash rate to reach 6.25% by September.
- Inflation to temporarily rise above 3% in 2005.
- Slower economic growth will see employment growth slow.
- GDP growth slowing (year on year) to 2% by 3Q.
- Wage costs likely to rise due to labour shortfall.
- Commodity prices on the way down.
- Bond Yields move higher 2004 following US Fed tightening.

Global equity returns

Source (Datastream, ABN Amro)

Index	1M1	3M	6M	12M	2Yr
S&P 500	1.8%	1.3%	2.6%	17.1%	7.4%
NASDAQ	3.1%	2.7%	2.2%	26.6%	18.3%
FTSE 100	0.8%	1.8%	(0.3%)	10.7%	(2.1%)
S&P ASX 200	2.1%	3.4%	7.1%	16.7%	4.8%
Hang Seng	0.7%	(3.1%)	(2.3%)	28.1%	7.7%
MCSI World	2.2%	2.1%	4.8%	20.7%	6.7%
NZSX 50 Gross	3.9%	4.0%	10.0%	21.9%	16.1%

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