

# march of the markets – “Goodbye recession: Hello recovery”

Welcome to your portfolio report for the period ending 30th September 2009. If you are one of our long term investors you will have recalled our quite bullish commentary for the period ending 31st March 2009 even though the investment results did not reflect investors' actual portfolio performance. In large part this was because the March report was focused on the positive prospects for investment market performance looking forward as opposed to “looking at the train wreck in the rear vision mirror”.

If you are an investor, who upon receiving your portfolio update, immediately turns to the performance page you will have no doubt been delighted to see how well your portfolio has performed over the last six months. Markets have rallied strongly in response to the realisation that the world is no longer looking over the edge of an 'abyss'. Let's face it: last year we were facing a melt down of the world wide financial system. The co-ordinated policy response from governments' world-wide have averted a depression. We now view the world in a more positive frame of mind.

## The hard work begins

Investors will have noted the strong performance across all asset classes in their portfolio. There appears to be two schools of thought as to how the world may play out in the future.

### 1. Scenario One: Robust recovery

This school of thought believes that investors should get positioned for a global economic recovery that's about to surprise on the upside. That may sound crazy given what we have just gone through but one does have to review a number of positive factors. These include;

- a. Over 70% of United States companies beat analyst forecasts over the recent reporting period. This was largely due to companies cutting costs and raising capital over the last six months. Analysts look at



*“Someday, gentlemen, I promise you—the heady days of ‘Come a ti yi yippie yippie yay’ will be back.”*

the fact that US companies have piled up cash faster compared with interest costs which will set the scene for a surge in mergers and acquisitions (the take over bid by Kraft of Cadbury is the first sign of this trend), especially as investors demand that companies start thinking about M & A to fuel growth. It's a “do deal” market as investors realise

Market Performance as at 30/9/2009			
	3m	6m	1 year
MSCI (NZ Dollar)	4.8%	10.0%	(9.0%)
US Equities (NZ Dollar) Dow Jones	2.7%	(1.2%)	(17.1%)
European Equities MSCI Europe Gross	9.8%	19.8%	(5.2%)
Japanese Equities (NZ\$) Nikkei	(2.4%)	6.7%	(1.4%)
Australian Equities (NZ\$) All Ords	18.8%	35.2%	10.8%
New Zealand Equities NZSX 50 Gross	13.1	22.0%	2.3%
NZ Property Securities NZSX Property Index	17.1%	18.1%	(0.3%)
NZX Corporate Investment Grade Index	3.0%	5.5%	3.8%
New Zealand Cash 90 Day Bank Bill Index	0.7%	1.5%	4.7%

how resilient cash flows have been in this market.

We suspect that those companies sensitive to world growth will perform better than those with more defensive qualities and high dividend yields and will likely to be take-over targets in some cases.

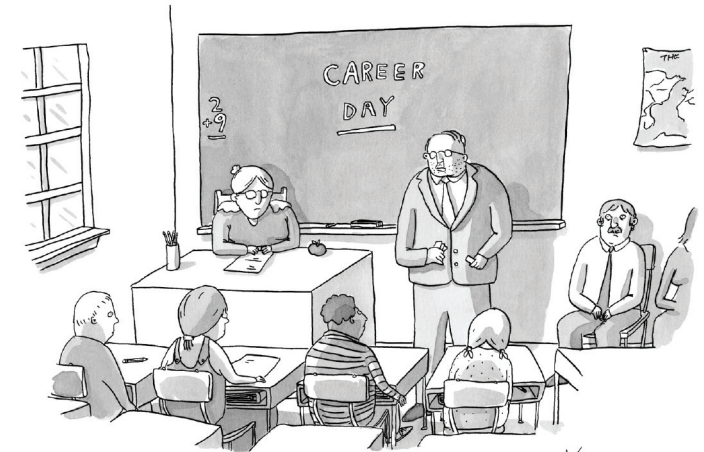
- b. The fiscal stimulation programme has yet to “hit” the world economy. Take the United States for example. The record US\$787 billion fiscal stimulus programme created great headlines in February but the delivery has necessarily been slow – only US \$58bn was due to be paid out by 30th September 2009. The “big hit” arrives in 2010. And that’s just the delivery schedule. The multiplier effect (or how a dollar spent flows through the economy) will take several more quarters for the impact to be felt.
- c. Inventory Re-Build. The United States inventory cycle has been run down. It was announced in September 2009 that the level of inventories in the United States was just over one month (meaning that it would only take one month for the United States to consume their inventory) the lowest it had been for several years. Inevitably this level of inventory will be re-built which will be positive for earnings and employment.
- d. World Growth. Even the International Monetary Fund, who had been delivering pessimistic growth forecasts over the first half of the year, believes that we will see a slow down in the retraction of the global economy in 2009 and an eventual rebound in 2010.

## 2. Scenario Two: Troubled waters still lie ahead.

- a. Relief! It’s like the lyrics from one of The Door’s song: “I’ve been so low for so long that it seems like up to me.” Some commentators believe the recent rally of

the Sharemarkets is in many ways like a “relief” rally. Relief in so far as the world did not blow up! A recent study by Reinhart and Rogoff has documented 260 separate banking crises since 1800 and suggested that these were not a new phenomenon. What is different this time, however, is the more widespread leveraging of the whole financial system which has increased systemic risks around the world. The potential for a profound crisis was huge.

- b. The reality is that we have achieved some stability in the financial system but the problems of the world’s banks are probably not over. We believe we will see continued solvency and liquidity problems in the United States as banks grapple with rising impaired assets and the requirement from central banks to raise more capital to support their balance sheets. The trend of tighter credit will also be felt in New Zealand. As we commented in one of our earlier commentaries New Zealanders’ are not aware of how tough it will be to get credit in the future. Higher capital and liquidity requirements as well as balance sheets having to be “risk adjusted” (basically more capital is required for business and farming lending) to reflect different types of lending will all take a toll on the level of credit available to borrowers both in New Zealand and overseas. In a recent presentation to investors I noted “...that three years ago your bank manager took you to the rugby: now you take your bank manager to the rugby!” How times have changed.
- c. Jobless Recovery. This is a term New Zealanders will hear a lot more of over the next few years. Technically New Zealand moved out of recession in the June 2009 quarter with a positive growth number but with unemployment



Kanin

*“I’m between jobs right now, so if you kids would give these business cards to your parents that would be primo helpful.”*

looking to hit almost 8% in New Zealand and over 10% in the United States for many people it won’t feel like a recovery. Of course the unemployment number only tells part of the story: it does not reveal the number of people who have moved to part time work or have had their hours reduced. We believe that most economies world wide have plenty of capacity. Any increase in economic activity may just see people move from part time to full time work: the level of unemployment may take a long time to actually decrease. Add to this the psychological impact of uncertain times in people actually still employed and you will start to see savings rates increase. The long term impact of these two factors cannot be underestimated. Governments have done an amazing job in keeping the economy going. But let’s face

it – they have borrowed to do so. We all understand you can only borrow so much before your lender says “no more”. The issue for economies world wide will be in say two years time when governments cannot borrow any more and the fiscal stimulation packages have been spent. Will the consumer step up and start spending? This is the key question for the future. The US consumer for example produces 70% of the GDP of the US. If they don't step up then who will? What will this mean for economies over the next five years? In some ways we need to see changes in behaviour world wide. Consumers in the United States and New Zealand need to save more and consumers in Japan, China and Asia need to spend more.

- d. Housing. Housing statistics in the United States seem to have stabilised recently with slight increases in both turn over and prices. In New Zealand net migration flows and a lack of stock also seem to have supported house prices. However, any weakness in the labour market will reflect in a long-term weakness in the housing market. When people lose jobs, wages don't grow as much and it's harder to for people to pay their mortgages. Add to this issue the fact that many New Zealander's have over leveraged personal balance sheets and it does not take much of a “head wind” to put people into serious financial trouble.
- e. Deflation. One area of concern for policy makers is that the credit crunch may produce deflationary prices. This is where prices of goods and services decrease due to falling demand and or a lack of money supply. I personally am not worried about this issue. We have been having goods like computers in state of deflation for decades. The real danger of deflation is not that goods and services keep getting cheaper; it is that debts grow in real terms which could leave many home owners unable to pay their mortgages.

It is hard to see policy makers in New Zealand signing off on a policy frame work that would produce this result especially given our obsession with property!

### What does it all mean?

Our own view is that both schools of thought are probably correct. Companies that are leveraged to world wide growth and who have re-constituted their balance sheets are likely to surprise on the upside over the next few years. However, we do not believe that we will return to the halcyon days of the credit-fuelled growth as subdued economic activity may be the new normal as the deleveraging unleashed by the financial crisis may restrain growth in major western economies in the coming years. We expect markets to produce a solid performance over the coming 12-18 months but with a question mark moving past this time frame as we see how the consumer starts to spend again.

We do believe that the market based system did not fail, its governance did. Over the coming months expect to see governments impose tougher capital and liquidity requirements on banks as well as caps on executive remuneration. For those of you who remember what it was like dealing with banks in the 1970's it will produce a feeling of de ju vu! We are going back to the past! In some ways this will not be too bad a thing as most people agree that it as too easy to get credit in the past. That won't be a complaint in the future!

The behaviour of some of the organisations and their executive that failed during the credit crunch are now viewed with disbelief. As an illustration of how organisations failed to live up to their hype, I enclose a few samples from failed banks in the United States:

Organisation	Slogan
Washington Mutual	Whoo hoo!
Lehman Brothers	Where vision gets built
Indy Mac	You can count on us
Capital One	What's in your wallet?
Morgan Stanley	World wise

One can think of any number of witty rejoinders to these slogans. Of course New Zealand has not been immune to this type of hype. Remember Provincial Finances “Solid as I reckon” and any number of unfortunate other slogans from failed investment organisations. As custodian of your investments we tend to take a more level headed approach to investment and do not buy into the hype of the market. We also do not shy away from telling it like it is. Frankly it has probably cost us business over the last 10 years. As Teddy Roosevelt once said “I never give people hell: I just tell them the truth, they think it's hell!” Our investment philosophy is based on a conservative and tested philosophy that is focused on delivering long term absolute returns.

*We restate our key message from our last portfolio report. Investors have defensive portfolios with no impaired assets, a strong income stream locked in and are well positioned to perform well as markets continue to recover over the course of 2009 and 2010.*

## Portfolio Performance as at 30th September 2009

If a week is a long time in politics then 12 months in the equity markets must be an eternity! A year after the collapse of Lehman Brothers sent the US economy into a tail spin, markets seem to have more confidence about the world economy's prospects. We have been pleased with how portfolios have fared over the last six months. Not only have quality bonds rallied as credit spreads have fallen thus increasing the value of bonds in our portfolios but equity markets have also rallied across the board and our investment managers have also performed well.

Whilst we have been pleased with the performance over the last six months we are particularly pleased with the performance of our portfolios over the last 12 months. When one considers that this period saw the demise of Lehman Brothers and severe market turbulence in many portfolios, to have a positive performance over 12 months for many portfolios, we believe, is a stunning result. Perhaps most importantly for investors our focus on absolute returns means that you do not have to claw back significant negative returns before your overall portfolio moves into the "black". This cannot be underestimated. For example an investor who has a 30% loss actually has to recover close to 50% to get back to "square one". The ability to preserve capital in difficult markets is crucial in ensuring that your portfolio makes money over the long term. Unfortunately many investors (particularly retired investors) have found this out the hard way and many have suffered losses that they may struggle to claw back. Equity market volatility coupled with fixed interest investments in receivership have devastated many portfolios over the last few years. In contrast we have been pleased to see how investors who have stayed the course with us over the last few years have been rewarded in terms of a strong portfolio performance.

## New Zealand

The news coming out of New Zealand over the last few months has continued to improve. Our view outlined in our last report that New Zealand should emerge over 2009, "bloodied but unbowed" is definitely playing out. The following positive results have been received;

1. New Zealand's current account deficit shrank from 8.1% of GDP (which put us in the company of financial basket cases such as Iceland) to 5.1% in the year to 30th June 2009.
2. GDP figures for the quarter ending 30th June 2009 also revealed that, technically, the recession ended in the June quarter with GDP growth of 0.1%.
3. Fonterra announced that it was lifting its forecast payout from \$4.55 to \$5.10 per kilo of milk solids.

Against the positive news was the continuing head wind of a stronger NZ currency making it harder for an export led recovery and the growing realisation that unemployment is heading over 7% and moving to 8%.

The reality is that New Zealand was in a recession even before the credit crunch hit. Prior to this occurring the New Zealand economy was feeling the debilitating effects of a drought in the farm sector and from the RBNZ's previous high interest rate/strong currency regime. New Zealand actually was one of the first western countries into the recession and at the time of writing had actually been in six quarters of a technical recession.

The reality is the government has inherited a set of fiscal accounts that have deteriorated as the tax take decreases markedly as the recession bites. Pressure will be on the government to discontinue a number of spending programmes as well as look at how more tax can be raised.



*"I see no new taxes, followed by some new taxes."*

It is no coincidence that a number of reviews on how we are taxed are now gaining publicity. My own personal view is that I would not be surprised to see an increase in GST to say 15% at some stage in the future to help prop up the tax take. Consumption taxes are hard to avoid and fairly stable since spending patterns do not change from year to year. The big disadvantage is that they tend to fall on the poor rather than the rich. A crisis created by investment bankers could be paid for by shop assistants and office cleaners.

The rise in the New Zealand dollar is a largely a symptom that the appetite for global risk has risen sharply. Despite producing weak data, New Zealand is once again being inundated with foreign capital inflows from a number of

Key Fiscal Indicators Category	2008	2009	2010	2011	2012	2013
Operating Balance (\$M)	2384	-9303	-5729	-7111	7115	-5773
Core Crown Revenue (% of GDP)	34.4%	33.2%	32.2%	31.2%	31.5%	32.1%
Core Crown Expenses (% of GDP)	31.8%	34.9%	37.3%	36.9%	36.7%	36.3%
Gross Sovereign Debt (% of GDP)	17.5	24.8	29.1	34.2	36.9	38.7
Net Public Debt (% of GDP)	5.7%	8.7	15.6	21.8	27.1	30.9
Domestic Bond Issuance (\$M)	1900	5800	8900	11400	14500	14200

sources. The return of overseas capital has clearly led for a new credit boom if credit flows persist. We are not convinced that this can occur given the weak state of the New Zealand economy although we are seeing asset markets pricing this potential in. As a result we may see a marked overshoot of the NZD's external value. However, if global risk appetite were to fall away, the probable lack of a domestic recovery would probably offer little support for the NZD. Once the capital flows abate, it is probable that the NZD may reduce thus allowing the RBNZ's preferred export led recovery to finally take place. In reality, the NZD seems to have been a highly geared warrant of global capital market conditions and this may also be true of the local share market. It is interesting to note how closely correlated the NZ share market performance has been to the United States market over the last 12 months. Time will tell as to whether this trend starts to break down over the medium to long term.

The impact of the recession on New Zealand's finances makes for sobering reading. The following table from the May Budget papers reveals how fast the government's finances will deteriorate over the next few years. When reading this it is important to note that the blow out in debt as a % of GDP is not so much because the government is spending more but that the tax take is reducing and that GDP is not growing strongly.

The table clearly highlights the difficult position the New Zealand economy is in. From an investor's view point it is clear that there will be strong competition for your investment dollar moving forward. The usual warning applies however; a focus on credit quality will be key to ensuring that your capital remains intact. We are also clearly in a part of the credit cycle whereby bad debts and impaired assets will rise for all financiers. A focus on strong reputable "names" in portfolios is paramount moving forward. Equity investors will

be rewarded over the next 12 months for taking risk while fixed interest investors may not be. Our quality mantra is now more important than ever!

We continue to focus on high quality bond issues and our portfolios have performed well as the strength of these investments have been recognised by the market over the last six months. We expect this trend to continue over the next six months.

### A wall of bond supply

As can be seen from the table to the left the New Zealand Government will have to issue a huge amount of bonds to fund the budget deficit. The "problem" for the government is probably not as bad as the raw figures suggest. What we are seeing at an economy wide level is that in a world of deleveraging, public sector debt is, to a large extent, replacing sector debt. The Japan experience over the 1990's suggests that a massive borrowing programme does not lead to rising bond yields. Factors such as easy monetary policy, low inflation and sluggish growth will also support the bond market. However, the trend in government issuance is likely to support a positive yield curve in New Zealand. What this means is that investors will be rewarded for investing longer term over the next few years rather than staying in cash. Please talk to your adviser about investment options in this sector should you have other funds to invest.

### Equities: Reward for risk

**An investor in equities in March had no where to escape from the "blast". Since then we have significant rallies in world markets that have undone some of the damage inflicted over the last two years.**

Our view in April that equities (International and Australasian) looked good value, especially relative to cash rates has also

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been confirmed by the market as investors returned to the market over the last six months. We still believe that investors will be rewarded for equity risk over the coming 12 months although this reward may come in spurts. The big issue at the moment is whether the market rally has got "ahead of itself" and we may see the market move side ways before it moves on as earnings confirmations are received. As noted in our previous comments we believe that the out look for equities is positive for the coming one to two years but we are mindful of the financial position of the consumer and whether they are able and willing to step up once governments have "maxed" out their debt levels.

The outlook for the listed property sector also appears to be sound. Despite higher vacancy rates in most property sectors starting to occur the listed property sector has performed extremely well over the six months. This has been for two major reasons. The first is that the market has realised that the sector had been oversold and the second reason was that these stocks are delivering strong income flows in a market with low cash rates. Not surprisingly investors have flooded back to this sector.

### **Bringing it all together!**

Our role is to help preserve and grow long term capital while "emotion and noise" abounds. It is pleasing to see that investors' portfolios have maintained their capital over the last two years and are now growing well.

I do caution about complacency however and about investors believing that the world is a benign environment now. My 20 years in this business has taught me that we will experience more "bubbles" in the future. There may not be a bubble originating in US sub-prime mortgages in the future, but there is no doubt in my mind that there will be unquestionably another bubble.

Greed and fear are part of human nature. They are the raw ingredients that feed market booms and busts so my advice is to start planning on other major market panics and collapses in your life time. As an investor this means maintaining your portfolio is a position whereby you can minimise any volatility, preserve capital and position your portfolio for the eventual upturn. Our processes and investment philosophy are based on these simple but powerful tenets.

Thank you for the opportunity, once again, to work together to help you achieve your financial goals. We appreciate your support and look forward to being of service to you in the future. Please feel free to contact one of our advisers or myself should you have any questions.

Kind regards



**Graham Duston, Executive Director**  
Funds Administration New Zealand Limited (FANZ)  
Phone 0800 502 442 or DDI (03) 963 4916  
Email [graham.duston@sbs.net.nz](mailto:graham.duston@sbs.net.nz)