

# march of the markets – September 2010

Welcome to your investment reporting for the period ending 30th September 2010. As we noted in our last report we believed that the world was entering into a "multi-speed" investment environment with investment results varying from country to country, sector to sector and even stock to stock, depending on their relative performance. This has played out over the last six months as equity markets were hammered in the first few months of the reporting period due to worries about the fiscal stability of the PIGS (Portugal, Italy, Greece and Spain) and then staged a recovery in September as the policy response from governments provided investors with comfort that these economies would "muddle" through. Concerns about slowing growth in the United States also provided market volatility before this was allayed by a fiscal policy response by Obama. Whilst we continue to believe that a multi-speed environment is here to stay we are actually reasonably relaxed about the investment prospects for the next 12 months. Investor portfolios are in good shape with quality assets and no defaults and are well positioned to take advantage of any market rallies.

## Market Commentary

To use the classic cliché, the last six months has clearly been a period of two halves. The first period was brutal. After the euphoria of the 12 months to 31st March 2010 when markets recovered strongly the quarter for the period ending 30th June produced some quite different results. Witness;

- NZX 50 Gross down 9.1% for the quarter ending June 2010
- All Ords Accumulation Index (NZ \$) down 15.4% for the June quarter
- MSCI World Gross (50% Hedged) down 10.5% for the June quarter

Investment markets were dominated by the debt crisis in the eurozone. Heavy losses in May were followed by disappointing US employment and home sales figures (after house purchase incentives were finished) and together with evidence of a slow down in the Chinese economy saw global equity markets fall to new lows for the year.



"I've stopped carrying a briefcase. I don't like to flaunt my employment."

## Market Performance as at 30/9/2010

	3m	6m	1 year
MSCI (NZ Dollar)	6.2%	3.6%	5.8%
US Equities (NZ Dollar) Dow Jones	2.9%	3.8%	9.4%
European Equities MSCI Europe Gross	11.3%	1.6%	1.7%
Japanese Equities (NZ\$) Nikkei	1.4%	8.5%	2.2%
Australian Equities (NZ\$) All Ords	16.6%	1.3%	9.8%
New Zealand Equities NZSX 50 Gross	6.9%	2.8%	0.5%
NZ Property Securities NZSX Property Index	7.9%	3.1%	1.8%
New Zealand Cash 90 Day Bank Bill Index	0.8%	1.5%	2.9%

The “flash crash” downgrades for Greek, Portugese and Spanish debt, the rise in US jobless claims, signs of strains in credit markets, increased military tension in South Korea and concerns about the ecological and economic impacts from the massive oil leak in the Gulf of Mexico weakened investors’ already fragile confidence in an economic and market recovery.

Concerns about slowing growth in the United States also provided market volatility before this was allayed by a fiscal policy response by Obama. The Bernakie “put” was in play after Bernakie addressed central bankers at Jackson’s Hole on 27th August 2010 and stated that the United States would support another round of quantitative easing to keep the economy on a path to recovery. Markets reacted positively to this policy and recovered strongly over September.

Perhaps this last announcement is instructive of the path ahead. Governments’ generally will do whatever it takes to ensure that the recovery continues and deflation is averted. We also note that governments also refuse to “stand on the sidelines” any more. They will take action if it appears that the economy is faltering or in need of corrective action.

## Why Greece Matters

Greece’s economy, which has a total GDP of around \$330bn, is the 30th largest economy in the world. In some regards the preoccupation with the country’s issues appears to be a little over done. However, the Greek crisis has revealed three things. These are;

1. That glaring fault lines and structural shortcomings lie at the heart of the Euro project. The southern European states were given interest rates through their membership in the Euro system that were suited to monetarily conservative Germany and as a result these economies suffered

competitiveness sapping credit and housing booms that have distorted their economies. They must now restructure back towards their production rather than construction sectors and at the same time restore their competitiveness through either the adoption of a weak currency or a severe domestic deflation that will bring down property prices as well as Government and corporate revenues. Little wonder that the unemployment rate for under 25 year olds is currently 50%.

2. Many OECD governments cannot afford to carry on running deficits.
3. The global financial system remains in a fragile state.

Greece was the “canary in the mine” in highlighting these issues to investment markets. Investors in this part of the world would have noted the relative strength of the NZ dollar over the last six months. Quite simply put governments in financial trouble have limited options in making their finances balance. They can make their people work harder, pay more tax and for longer, or have a range of policies that let their exchange rate fall. We saw what happened when the first scenario was suggested to the Greeks: they rioted!

## The Age of Austerity

We have entered the age of austerity. It has already arrived in Europe and is destined for the United States. Governments through out Europe are cutting social spending and raising taxes – or contemplating doing so. As the welfare state and the bond market have collided, the welfare state is in retreat (little surprise new British Prime Minister, David Cameron, wants to shrink the size of the British government by a sixth by 2015). To ease the impact that bond markets have on countries and to ease pressure on weak countries in Europe we have seen the European Central Bank buying the bonds of weaker borrowers. The ultimate hope is to buy time.

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*“Must you tell us what our daily share of the national debt is every time we sit down to dinner?”*

Many Governments are in the “horns of a dilemma”; with out spending cuts and tax rises a high deficit might choke the economy. But these same policies also may threaten growth. That export led recovery stimulated by a lower currency is looking more attractive for many countries every day (and conversely that trip to Europe by New Zealanders’ spending NZ dollars)!

One has to remember that most European countries are not necessarily worried about a lower currency. If you are a German export manufacturer or trying to sell Air Bus Planes out of France a lower currency will be very helpful indeed. Indeed most governments (including New Zealand)

around the world are seeking an export led recovery, not a consumption led recovery.

We do not believe however that we will see governments defaulting on debt. The International Monetary Fund noted recently that countries usually default on their debt when interest payments soak up an unsustainable large part of budget revenues. Yet, after interest payments, many countries primary budget deficits are not generally that large. Greece for example, has a cyclically adjusted budget deficit of 10% of GDP this year. To stabilise the debt to GDP ratio by 2012 would require a move to a primary budget surplus of 5% of GDP (a budget tightening equal of 15% of GDP). Yet, even if Greece defaulted on half its debt, the adjustment required to stabilize the debt ratio would still amount to 12.8% of GDP. The debt issue is not so much in government finances but more in private debt.

The issue of “de-leveraging” economies has attracted a lot of debate over the last few months. It does beg the question is the level of debt in some economies really excessive?

The United States for example has household debt at 119% of disposable income in the first quarter of the year (lower than its peak of 129% in 2007) but still higher than its 30 year average of 90%. By comparison household debt in New Zealand is now 160% of disposable income, up from 100% ten years ago and 50% twenty years ago (no wonder the government has a focus on savings!).

But are these levels of debt excessive? Focusing on aggregate debt levels alone ignores the structural decline in interest rates world wide and the rise in asset prices. In New Zealand, net equity in housing has grown from 240% of incomes to 375% over the last ten years. And in the United States, helped by lower US interest rates, debt defaults and reduced borrowing, US household debt service payments amounted to 12.5% of

disposable income in the March 2010 quarter (down from a peak of 14% in late 2007). Economic theory suggests that the household saving ratio should be more closely related to changes in net wealth; if your wealth to income ratio increases, you need to save less of your income each week to achieve a certain retirement nest egg. United States consumers and indeed consumers in New Zealand have been focusing on saving and reducing debt. The key question is how far through this debt reduction and savings exercise are consumers?

The United States is probably further through than New Zealand largely due to household equity equating to property being a massive 70% of the total equity of the average New Zealander's net wealth. In other words, the US savings rate is broadly where history suggests it should be given the decline in net wealth. And if US asset prices are close to a bottom (as seems likely), further significant shifts in the US household saving rate seem unnecessary. This is a positive for the US economy. New Zealand on the other hand has work to do in this area.

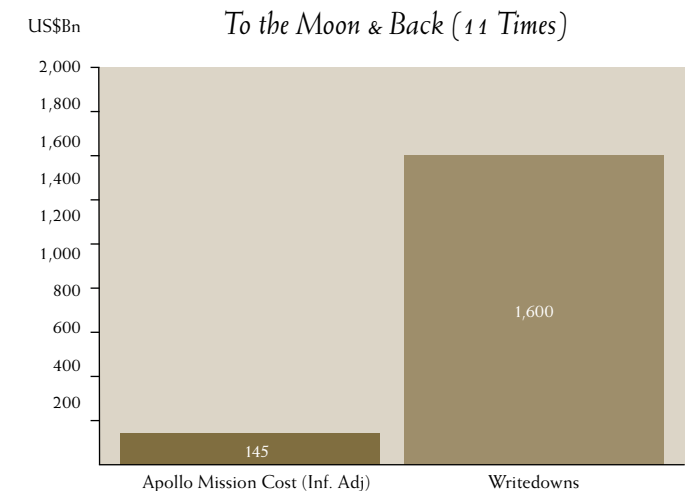
The second part of the six month period saw central banks and governments respond with a range of monetary and fiscal policy responses designed to keep the global economic recovery on track. These parties have realized that if the world is to avoid a “double dip”, then central banks and governments must find a way to ease the new credit crunch and the world's fiscal authorities must find a way to credibly delay their fiscal cuts a little longer.

As Alice (from Alice in Wonderland) once noted, *“There's no use trying, one can't believe in impossible things”*.

The Queen replied, *“I daresay you haven't had much practice. When I was your age, I always did it for half an hour each day. Why, sometimes I've done as many as six impossible things before breakfast.”*

Let's hope that these very hard issues can be managed before breakfast!

That's not to say that the Global Financial Crisis (“GFC”) is over, but certainly our view is that the worst certainly is. Let's be frank, the cost of the GFC has been enormous. To put the write downs suffered by banks in the United States in perspective, the cost of the NASA programme to put the man on the moon was one eleventh of the total of the write downs suffered (adjusted for inflation).



As we noted in our last report markets do go through investment cycles of despair, hope, growth and optimism. It was instructive that many United States companies in the latest reporting round generally met market expectations. The issue is now more one of sentiment.

Warren Buffet, the “Sage of Omaha”, and arguably the world's most successful investor said on recently of the United States, *“I'm a huge bull on this country, we will not have a double dip*

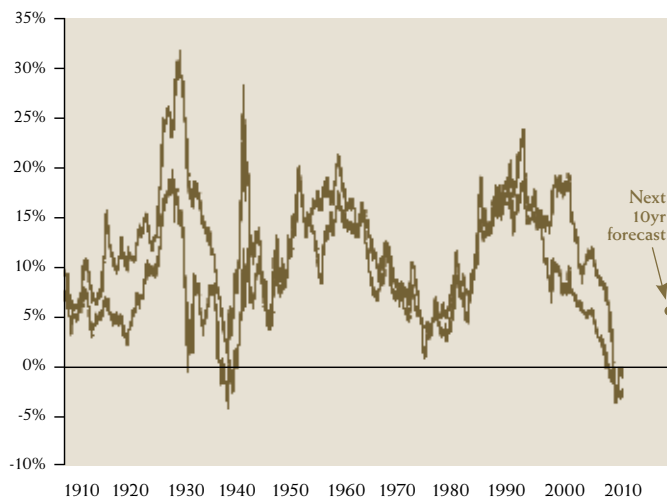
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*recession at all. I see our businesses coming back almost across the board. I've seen sentiment turn sour in the last three months or so, generally in the media. I don't see that in our businesses. I see we're employing more people than a month ago, two months ago."*  
(AFR, 15th September 2010)

The long term view is still positive. Valuations still remain fair and companies that have rising margins, earnings growth and strong balance sheets should perform strongly over the next 12 months.

We do note that the last ten years has been one of the most difficult for equity investors in history. But as investor, one must always look forward whilst making sure that they have risk management programmes in place. The key point to note when looking at the possible long term performance of equities is that the starting point is so low. The long term sale sign is "out"! The next chart bears this out.

10-year US Equity Returns



As an investor it is worth noting that markets historically move off their lows. It is also worth noting that even with a lower GDP growth framework for economies we do not have to see massive earnings growth before this translates into solid market performance.

We do note however that the world is still expecting GDP growth of over 4% this year with most of this growth coming from the emerging market sector and the weak link being Europe. This result is somewhat of a paradox for investors. It is becoming very clear that we are seeing a series of major structural changes in the global economy. We believe that investors may have re-learn much of their investment theory with respect to emerging markets.

The GFC must be the wake up call. The unthinkable has happened. Default on debt, failure of major banks, a dollar crash, a potential return to depression economics has all happened in the GFC. Throw in aging populations in many developed countries and many of the structural problems that are evident in developed countries, not emerging market economies. Emerging markets today provide a stark contrast to developed markets in terms of their demographics, debt levels (basically emerging markets "took their medicine" in 1998 and got their savings rates and economies in order) and GDP growth rates. The table to the right provides the raw data.

We are of the view that the structural changes outlined above are permanent and that investors should have a specific emerging market exposure in their portfolio. However, we are also mindful of the fact that this sector has been quite volatile historically and will probably continue to be so in the future. There the question of how we implement this strategic allocation, minimising cost and how we manage some of the investment risk are all issues that we working on before we

make an allocation to this sector. We expect that this work will be finished before the end of the calendar year. We will keep you informed on any developments.

Categories	Emerging	Developed
Population 2015 forecast	6.0 billion	1.3 billion
Population Growth 2010-20 forecast	1.2%	0.2%
Share of Global Economy	39%	61%
2015 forecast (PPP exchange rates)	(52%)	(48%)
5Yr GDP Growth % 2011-15 forecast	6.6%	2.4%
Average Leverage (2008 government + household debt/GDP)	53%	140%

## Savings In Focus

Perhaps one of the biggest announcements with respect to savings recently was the formation of the Savings Working Group by the Government. The topic of savings is now very much firmly on peoples' minds. The Global Financial Crisis has very clearly focused countries world wide on their abilities to build, attract and retain capital. This issue, allied with the demographic Baby Boomer "time bomb" moving relentlessly to retirement, means that savings and capital is on firmly on

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Shanahan

*"Remember, son, it's never too early to start saving for retirement."*

the government's agenda. This is an extraordinary shift. You may recall that in 1998 over 92% of New Zealanders voted against Winston Peter's superannuation scheme in a national referendum. Less than ten years later over 1.5 million New Zealanders have joined a scheme called KiwiSaver. My own view is that it was case of "build it and they will come" as well as a societal shift in terms of attitudes towards savings.

One cannot help but cast your eye across the ditch and view Australia's capital markets. For example,

As at the end of June 2010 we had only \$6.3bn of managed funds invested in domestic equities. Australia had A\$495.4bn.

This statistic is even more cringe worthy when one notes that New Zealand managed funds invested in domestic equities declined from \$7.2bn in June 2000 to \$6.3bn. Australia over the same time period surged from A\$188.9bn to A\$495.4bn. Little surprise that the capitalisation of the NZX rose from \$49.7bn to just \$50bn over the same period. The value of ASX companies rose from A\$682bn to A\$1,257.7bn over the same period!

The last word on savings should come from Treasury. According to them, "A permanent increase in national savings will take the pressure off domestic resources which will allow, on average, lower interest rates to maintain lower inflation. As the premium on New Zealand interest rates relative

to interest rates elsewhere would be smaller, it would be expected that the exchange rate would be lower. This would be beneficial to the export and import competing sectors."

Most of us would be jumping for joy if national savings delivered lower interest rates and a lower NZ dollar.

### New Zealand Interest Rates

Perhaps the biggest change over the last six months has been the "soggy" economic performance of the New Zealand economy. This performance has not been helped by the collapse of South Canterbury Finance and the Christchurch

earthquake. Allan Bollard, the Reserve Bank Governor, recently noted that the debt weighing on the New Zealand economy is now starting to drag the economy down over the long term. The profligacy of the last few years is now being paid for! He noted,

*"Over the last year, despite high and rising export commodity prices, increased employment and economic recovery more generally, household and corporate spending has risen only modestly. As a result, credit growth has been very weak..."*

As we noted earlier the New Zealand economy still has some work to do in getting control over its debt levels. The probable outcome means lower growth for longer, lower interest rates for longer and lower asset prices for longer. Between the mid 1990's and early 2000's house prices were in a range of three to four times disposable income. From present levels they would still have to fall to get back into that range. If one throws in household debt to income, debt servicing costs and house prices to income ratios these all suggest that any one looking for quick capital gains from the housing market is trying to "set fire to wet wood."

The key points from the RBNZ's September monetary policy statement were;

1. The RBNZ left the OCR at 3.00% as widely anticipated. Of most interest was the tone of the accompanying statement. On the face of it the Governor is still inclined toward higher rates eventually: "Over time, it is likely that further removal of monetary policy support will be required". However we believe this is effectively a neutral stance: by pausing the RBNZ has acknowledged the fragility of domestic growth. Further hikes are off the table until that situation changes.

2. On the economy, the RBNZ clearly has been surprised at the lack of domestic resilience. "The household sector remains cautious, with consumer spending soft, house sales falling and house prices remaining flat. With continued soft demand for credit, this suggests household spending will not increase to the extent previously projected". The Governor also noted global uncertainty, but highlighted NZ's exposure to Australia and China as a positive offset (we concur).

3. Perhaps most meaningfully, the RBNZ appears to be gaining in confidence that upcoming GST price increases will not feed through to inflation: "the subdued state of domestic demand suggests this inflation spike will have little impact on medium term inflation expectations". This effectively frees the Governor's hand to focus on the output gap, which is signalling little inflationary threat.

For now, we will leave our forecast for fresh hike unchanged at Q1'11. However for us, like the RBNZ, this will depend on the domestic economy showing renewed momentum.

**BOTTOM LINE:** RBNZ signals a watch and wait mode. We expect no hikes until next year, and that will require the domestic economy to show increased vigour. Long dated bonds still offer investors value as we expect movement in the short end of the yield curve.

### Taxing Times

You will be aware that 1st October 2010 is a key date for tax changes. First up it is important to know that the increase in GST will not impact on your savings as KiwiSaver is exempt from GST. As you will also be aware the tax rates for personal income also changes on this date. The new

prescribed investor rates ("PIR") for investors in the Lifestages KiwiSaver Scheme will apply as follows from 1st October 2010:

- 10.5% if you are a New Zealand resident individual and your taxable income (other than PIE income) was \$14,000 or less and your combined taxable and PIE income was \$48,000 or less in either of the previous two income years.
- 17.5% if you are a New Zealand resident individual; and
- your taxable income (other than PIE income) was \$14,000 or less and your combined taxable and PIE income was more than \$48,000 but not more than \$70,000 (and you do not qualify for the 10.5% rate) in either of the previous two income years; or
- your taxable income (other than PIE income) was more than \$14,000 but not more than \$48,000 and your combined taxable and PIE income was \$70,000 or less in either of the previous two income years.
- 28% if you are a New Zealand resident individual and:
- your taxable income (other than PIE income) was more than \$48,000 in both the previous two income years; or
- your combined taxable and PIE income was more than \$70,000 in both the previous two income years; or
- you have not provided an IRD number or have not elected a prescribed investor rate of 10.5% or 17.5%.
- It is important to note that the top PIR rate from 1st October 2010 is now only 28% and that we will automatically re-adjust your PIR rate (12.5% to 10.5%, 21% to 17.5% and 30% to 28%) from 1st October 2010. You do not need to take any further action.



portfolio is positioned to minimise the impact of volatility and preserve capital where possible.

Once again, thanks for the opportunity to work alongside you to help you achieve your financial goals. We appreciate your support and look forward to being of service to you in the future. Please do contact us if you have any questions.

Kind Regards,

**Graham Duston, Executive Director**

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### The Road To Come

In our last investment commentary I made some cautionary remarks about the dangers of complacency. Although we continue to be quietly optimistic about the investment prospects for 2010 and 2011, we also believe there will be more surprises from the markets ahead. That is the nature of the beast. As an investor this means one thing: ensuring your

portfolio is positioned to minimise the impact of volatility and preserve capital where possible.