

New Zealand and Australia are weathering global financial and economic distresses better than most. This is due, in part, to our continued ability to tap international credit markets.

However, in this month's Tyndall comment, we discuss our expectation that New Zealand's recession will deepen further in coming months. And, the different paths emerging for our and the Australian economies.

We also comment on the recent equity market rallies. Peter Lynn warns "don't be fooled".



Greg Campbell
Managing Director

The Hare and the Tortoise?

Economic conditions in New Zealand and Australia are substantially 'less bad' than in much of the Northern Hemisphere currently. There does not yet seem to be the acute level of financial and economic distress visible that we can see in the US and parts of Europe, despite the fact that both New Zealand and Australia were enthusiastic participants in the global credit boom and the fact that both countries relied to a very great extent on inflows of foreign funding to finance their respective domestic credit booms. Given that many of the other countries which also employed high levels of foreign financing for their domestic credit booms have since fallen by the wayside in the current global slump (Iceland being the most extreme example), the resilience of the Antipodean economies is remarkable.

Intriguingly, we find that both countries have been able to continue to tap international credit markets remarkably successfully over recent months, although no one is quite sure why this has occurred. Explanations for this relative success have ranged from the local institutions' long term experience in managing their foreign funding requirements; the beneficial effects of the government guarantees; the countries' assumed commodity exposures or even simple luck but, whatever the cause, the Australian and New Zealand banking systems have not suffered the funding pressures that have sunk Iceland, made life difficult for the UK banks and which now threaten to destabilize the Eastern European economies. Certainly, the banks are finding it a little more

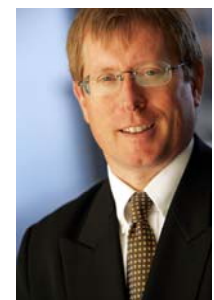
"We have been able to continue to tap international credit markets"

expensive to raise money from abroad and the inflows have not been as plentiful as they once were (hence the sudden reversal in the local currencies) but it nevertheless seems that these Southern Hemisphere countries have been the exception to the global 'rule'. Of course, this situation could change in an instant but at this time we see little reason to expect such a shift and therefore we expect

Australia and New Zealand to be spared the worst effects of the global banking crisis in the near term.

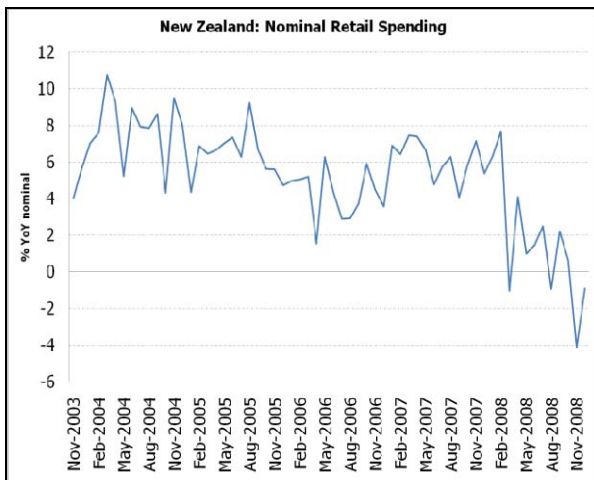
We also see the emergence of a marked difference between the two Southern countries' respective economic trajectories, although we doubt that this is appreciated at this time by many foreign-based commentators. In New Zealand, it is clear that despite the continued

access to foreign funding, the credit boom that had previously propelled domestic growth (and domestic house prices) is now ending in much the same way as has occurred in much of the rest of the OECD. Indeed, domestic credit growth has been effectively zero since last Spring (the time of the Lehman Debacle) and this is clearly constraining what had become a credit addicted private sector. Indeed, we have estimated that New Zealand households possessed an annual borrowing requirement of around NZD24 billion in



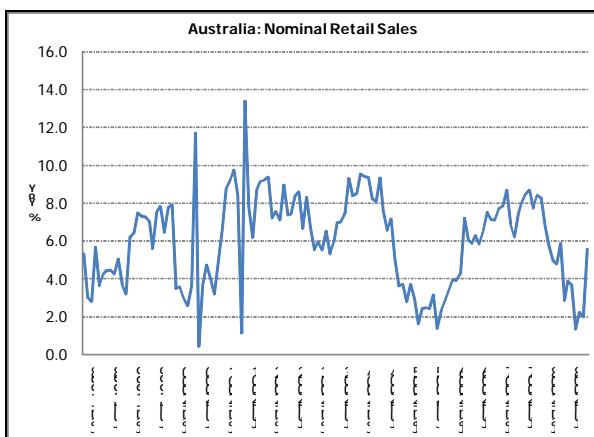
Andrew Hunt
International Economist

2008 and the fact that this financial deficit can no longer be financed is forcing a change in people's ability to spend. Hence, the housing market is beginning to weaken (particularly in the former 'hotspots' of Queenstown and Nelson) and the cash amount of retail spending is beginning to fall as people find they simply do not have the cash available to spend in the shops.



Admittedly, the recent fall in fuel prices and the RBNZ's swift reduction in interest rates have helped to support household finances but, despite these moves, households in aggregate are having to tighten their belts and a domestic recession has resulted. Unfortunately, we suspect that this recession will deepen over coming months as the household savings rate continues to rise as people attempt to rebuild their finances. This increase in saving / reduction in spending will certainly hurt corporate revenues and profits, with clear adverse implications for the labour market and household incomes as the year progresses. Moreover, given the levels of over indebtedness present in some houses and parts of the dairy sector, we can expect the economic slowdown to set in motion an escalation of the problems already beginning to appear in these areas of the economy.

“We suspect that this recession will deepen over coming months”



In Australia however, it is apparent that credit growth has not yet come to an end and, although

the recent weakness in capital spending and exports has created a technical recession, it is clear that Australian households are still borrowing aggressively. Hence, retail spending is continuing to expand (albeit at a slower pace) and the local property markets remain at extremely expensive levels in comparison to income levels. Anecdotally, we found that many Australians still expect property prices to rise from here, despite their already low level of affordability.

Therefore, it seems to us that the Australian credit boom may roll on a little while longer, quite possibly with some help from the Chinese economy's surprisingly resilient demand for the country's mineral exports. Although China's economy is in a deep recession, large state subsidies are allowing companies to continue to produce goods despite the weak demand for those goods and hence China is continuing to import raw materials, despite its slowdown. This clearly is not a sustainable situation in the long term but for now China is continuing to support Australia's mining sector and by implication the whole economy.

Of course, ultimately Australia's credit boom will end (at what by then will be even more stretched levels and debt ratios) and China's current subsidy-driven production growth will have to subside or even unwind as inventories are reduced but until then, Australia's economy may surprise people with its strength and resilience, if only in the near term. Given this outlook, we would not expect further rate cuts from the Australian Central Bank (not least of all because domestic inflation remains stubbornly high) and we may even see a rebound in the Australian dollar.

In New Zealand, however, the weaker domestic environment and decline in inflationary pressures can be expected to lead to further rate cuts and quite possibly to a weaker NZD. Indeed, we gather that the authorities would quite welcome a weaker NZD and that they may even intervene to achieve such an aim. Admittedly, in the short term, we would not expect these rate cuts to create a new leg to the credit boom, given the growing desire within the population to save, but the rate cuts will make servicing existing debts somewhat easier. Therefore they will assist in the period of financial convalescence that New Zealand is now undergoing. Indeed, by 2012 or so, New Zealand's private sector, by foregoing growth in the near term, may emerge with relatively strong balance sheets and, this event, coupled with what by then should be a highly competitive currency, should provide robust foundations for a new economic cycle. Australia, in contrast, may at that point be entering its own period of financial consolidation. Despite their geographic proximity, it seems that Australia and New Zealand are now following fundamentally different paths.

Andrew Hunt, London

Bouncing Like A Dead Cat

As Jim Morrison sang, "People are strange" and not only when you're a stranger, but when you're an investor as well. How else to explain the gyrations in the sharemarkets of the world over the past month other than quirks of human behaviour?

We all know that markets are driven by fear and greed, but it is the extent of both and their impacts that still surprises. There also seems to be a third factor impacting on prices at the moment, which is some sort of combination of both fear and greed (and ego as well) in that those who have sustained big losses in particular stocks (or, indeed, in the market as a whole) are watching the strong price recoveries from "bottom levels" before bailing out completely – hence, sending the prices nosediving again.

These sorts of actions are keeping the overall market volatility incredibly high. Unfortunately, though, we have simply got used to sharemarket falls or rises of at least 2% in a day. Such movements (especially downwards) just did not occur in 2005 or 2006. However, as we noted in April 2007, they started occurring a few times in February and March 2007 and have increased in frequency as the months have progressed. Historically, our analysis shows that such falls seem to start occurring around 18 months prior to a large crash.

This was the case in the US in 1928 and 1929, it was the case in the US (and NZ) in 1986 and 1987 and indeed it occurred in many countries, particularly the US, in 1999 and 2000 (1999 is often remembered as a very strong year in the US sharemarket, when tech stocks rose alarmingly, but actually a majority of stocks fell in price during that year). In all of these cases, starting around 18 months prior to a large crash, there had been many daily stock price falls of 2% plus. Before that, again in all of these cases, the market would have suffered no more than one or two of these "shocks" in any six-month period.

The incidence of a number of these market shocks would seem to herald some fairly disappointing equity performance ahead. Similarly, their absence seems to imply that the overall trend should be upwards.

So it continues to surprise me when, during the huge rally that occurred in March, many supposedly intelligent commentators on the market expressed such positivity over the future outlook. "The worst

of the banking crisis is over" was heard numerous times after the March 9 low (which for the MSCI Index, was the lowest level since 2002).

This March rally started off with Citigroup saying, on March 10, that it was having the best quarter since 2007, which shouldn't have been a surprise given the very favourable environment that the US government and Federal Reserve had established for banks to trade in.

And so this particular bear market rally drove on, including the strongest two-week rally in the US since 1938 – seriously – until JP Morgan's CEO Jamie Dimon spoke for the whole banking sector on March 28, when he said that March had been a tougher environment than the first two months. The next two days were pretty weak for the market and one suspects that this rally may now be over.

This is about the sixth of these bear market rallies (or "dead cat bounces") that we have seen in this crisis so far. The previous one lasted from 21 November 2008 (when the US Government first bailed out carmakers) to 6 January 2009 (when US job loss figures were announced 200,000 higher than forecasts expectations for both November and December). This was the strongest rally since World War II. Remember that optimism that coincided with Obama's inauguration? It didn't last long in the markets.

That rally was preceded by four bounces (all of very much the same order of magnitude, 7.5%) from 16/7/08 to 11/8/08, from 15/4/08 to 19/5/08, from 11/3/08 to 7/4/08 and from 27/11/07 to 10/12/07. Notice that all of these rallies are also around the same length – three to five weeks. Also, during all of these cases, there were several comments that "the worst was behind us" (even in the 2007 one) and an amount of optimism that the ensuing period would be the start of the next bull market.

We will likely see more of these rallies that could be of the same 20%+ order of magnitude that the last couple of rallies have been. This was certainly the case in Japan in the 1990s.

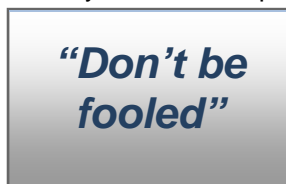


*Peter Lynn, CFA
Head of Strategy*

"This is about the sixth of these dead cat bounces"

From 15/12/1989 to 15/10/1998, the Topix Index in Japan fell 66.0%. However, within this almost nine-year bear market, there were many double-digit rallies and even some fantastic ones over 35%. In 1990, just a few months after the large 1989 crash, the Japanese market went on a two-month tear of 18.3%. Towards the end of that year, it rose 23.4% in just over three weeks. Early in 1991, it rose 23.1% in two months. In 1992, it rose 28.8% in a two-and-a-half week period. In 1993, it rose 35.9%. 1994 saw a 26.8% rise over the first half of the year and the last two months of 1995 rose 17.5%. With several more rallies in 1996 and 1997, it just shows you how much it dropped in between the rises to result in such a large overall fall. And each time during these rallies, there was optimism that this was the bull market that would lead Japan out of its mire. And after each rally, a new bottom was soon found.

Back to the current time and there are some good signs around that there can be some strong bear market rallies in the remainder of 2009. The US Fed has now started quantitative easing, which is starting to result in some funds flowing into US households. In addition (and important for this part of the world – see Andrew's column), the Chinese government is happily subsidising its industrial sector to keep on producing, which doesn't seem to make any sense when there is weak demand for their products, but keeps the global demand for raw material commodities high. The result is a happier place for equities.



*“Don't be
fooled”*

However, any such rallies are unlikely to be sustainable. While there remains uncertainty regarding the global banking industry, volatility is likely to continue. We still have no idea what the banking system's total losses will be: are the current IMF estimates (USD2.2b) realistic, or are the loss levels well over USD3b? How much more nationalisation of the global banking system is required? How much more will European banks be impacted by the crisis in emerging Europe? How are the Aussie banks managing to get away with very little impact, or is that still to come?

There are a lot of big questions here and these are just on the banking system. There is also the ailing car industry and the airline industry (or, in fact, the hospitality industry) is not having a wonderful time. There are questions over the likely level of global unemployment and, finally, whether all of the fiscal and monetary policies enacted by governments all over the world are going to be effective. Some of these questions will only be resolved in 2010, which will make that a bit of a bellwether year.

So, enjoy the rallies while they last (March was the best month for global equities since April 2003 – and the best month for emerging market equities since 1983!). But don't be surprised if people in the markets continue to exhibit some pretty strange behaviour. Just don't be fooled by them.

Peter Lynn, CFA
Head of Strategy
1 April 2009