

**Markets are seldom efficient at learning lessons.**

**Much has been written about the global “credit crunch” and the flow-on economic effects. This month, Andrew Hunt describes the credit boom well underway in China. This is much hyped and causing China’s economy to pickup. Sound familiar? A time for caution.**

**Peter Lynn takes stock of the extraordinary year, so far, for investment markets. And he shares some perspectives on what the remainder of the year holds in store for investors.**



Greg Campbell  
Managing Director

## Chasing the China Story

Economists in Central Banks are generally charged with identifying potentially excessive credit expansions and attempting to forestall them. Since, if they don’t succeed in controlling the credit system effectively, then situations such as that which emerged during 2007-8 are highly probable outcomes. Indeed, history is littered with credit booms that turned to destructive busts and therefore it is the consensus view that they should generally be avoided by the authorities. However, many economists and other analysts within the portfolio management industry also frequently attempt to identify nascent credit booms - not so they can be avoided, but so they can be exploited – initially by being “long” as the boom inflates and then by being “short” as the boom deflates.

**“Identifying a credit boom should be easy”**

In theory, identifying a credit boom should be relatively easy. Naturally, the rate of credit expansion will tend to be high and economic growth often rapid but there will also tend to be a great deal of optimism and ‘sales hype’ around that will at least seem to offer an alternative ‘fundamental view’ of why economy “X” might suddenly be the new hot *long term* destination for investment funds. Consequently, there is often pressure on the more

cynical credit boom follower to modify their stance as to the likely longevity of the credit-induced boom. Indeed, our second assignment when we joined the economics profession (the first having been to look at China’s price volatility-inducing behaviour in the natural rubber markets in the mid 1980s) was to look at the Lawson Economic Boom in the UK in the mid-late 1980s. The press were running stories over the UK’s economic renaissance and ‘structural advantages’ that would somehow make the economy impregnable and immune to future cyclicity but in reality the economy’s growth was simply the function of a household sector borrowing binge that was to subsequently end very badly in 1990-1992. Our third assignment was to cover Japan’s ‘Heisei Boom’ in the late 1980s and this subsequently proved to be one of the more destructive credit cycles in economic history.



Andrew Hunt  
International Economist

Quite simply, the Japanese authorities’ response to the economic implications of the rapidly appreciating Yen in 1986-7, and also to the threat potentially posed by the global equity market instability of late 1987, was to allow a dramatic expansion of domestic credit and to allow the creation of substantial ‘excess liquidity’ (particularly in the financial system). Unsurprisingly, this excess liquidity then gave rise to a boom in asset prices and a surge in foreign

investor interest as foreigners began to notice the strong returns being produced by the Nikkei Equity Index. In time, the credit boom also gave rise to stronger household consumption; moreover investment in the property sector (this was the period in which Japanese property prices soared to completely irrational levels); excessive investment by companies in plant and equipment; and to a weakening in the trade accounts. Unfortunately, what the excess liquidity did *not* do was to foster a restructuring of Japan's economy and in fact it, in many ways, encouraged the continuation of the old immobile economic model by hiding its short-comings behind a veil of asset price inflation, at least until 1990.

However, many investors and commentators associated the positive short term effects of the credit boom on Japan's supposed 'cultural advantages'. Despite the structural flaws that were already becoming apparent in the Japanese economy, this was the era in which we were all supposed to adopt Japanese business practices, eat sushi and to prepare for the Yen taking over as the global reserve currency. As a result of the investor hype, hubris and optimism generated by the boom (anybody wanting to remind or acquaint themselves with this feature of the boom should perhaps read the contemporary book 'The House of Nomura' for a succinct if unintended summary of how intense the pro-Japan marketing machine became), buying into the Japanese economic story became *de riguer*.

Of course, when the Bank of Japan finally changed its monetary course in late 1989 and began raising interest rates, not only did the excess liquidity disappear quite rapidly but so too did the optimism generated by the marketing hyperbole about Japan's potential to become the new economic super power, its inbuilt economic superiority, its better working practices and long term 'structural advantages'. In 1988, the world wanted to buy Japanese equities and emulate its business model but within a decade many of its former fans had become its biggest detractors

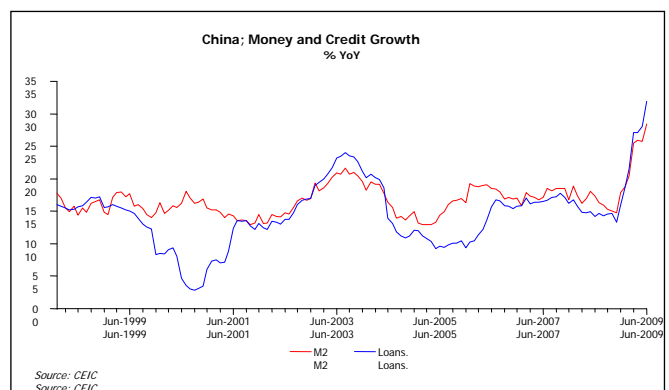
***“The hype regarding China has become so intense”***

as they switched from irrational exuberance to irrational pessimism, with a catastrophic impact on equity prices.

We recount this experience simply because we see many parallels between Western investors' views of Japan in 1989 and their current feelings towards China. Currently, the Chinese equity market is booming, the domestic economy at least *appears* to be bucking the global trend and there is already

much talk of a shift in the balance of global economic power as a result of China's rising economy and expanding financial presence. Indeed, once again, the talk is of the US dollar losing its global reserve currency status as a new challenger arrives in the global economy.

However, a closer look at China's available economic data casts some doubt on the true strength of China's economy and it also reveals the presence of an all too familiar domestic credit boom. By any standards, China's current 32% YoY rate of credit growth and its 28% rate of money growth appear not just excessive in an absolute sense but even more extreme when they are viewed in the context of China's still soft 4% rate of nominal GDP growth. China's credit system is clearly in full and hectic expansion mode at present and this credit boom is having its usual effects not just on domestic asset prices but also international investor sentiment it seems.



While we have no doubt that the credit boom has caused China's economy to pick up, we would also note that the hype regarding China's economic boom has become so intense that even the glaring inconsistencies in the China economic story seem to be being ignored. China is reporting a strong rise in the output of its energy intensive industries but no increase in energy consumption. Meanwhile, China's retail data is generally soft and the available inventory data suggests that whatever rise in production there is occurring, at least some of it is feeding not end user demand but inventories, which China's statisticians then classify not as 'stocks' but as 'investment'. Finally, even China's trade figures and its foreign exchange reserve figures seem open to question – they are certainly unlikely to be as strong as many are portraying. China's economy probably has picked up as a result of a modest (by Chinese standards) pick up in infrastructure spending and the current huge domestic credit boom but the extent of the recovery is probably very limited and its longevity open to question given the probable weakening state of China's external accounts.

In practice, we suspect that the People's Bank of China will continue to allow the credit boom to run for

another six to 12 months. Therefore, China's economy will continue to appear strong, its appetite for imports will continue to rise and this will provide some form of global economic stimulus, although we are not sure that even this second part of the story is as positive as some make out. It is true that China is importing more and particularly in the commodity markets, this has led to some increase in prices within the relevant markets. However, China's own export prices are continuing to fall rapidly and since China is a price-setter in many global consumer goods prices, the fact that China is simultaneously raising commodity prices, while depressing finished goods prices should be bad news for global profits, despite their (China's) bigger appetite for imports. The China story is not as positive and transparent as many suggest.



Moreover, once the Chinese central bank does tighten its monetary stance, as we believe that it will have to in 2010 as its own trade accounts weaken and the RMB comes under pressure, Chinese companies will find it increasingly hard to finance their by then extremely bloated inventory positions. At this point, we would not only expect a sharp slowdown in Chinese production trends but an overwhelmingly deflationary stock liquidation cycle is likely to unfold, to the discomfort of both Chinese

companies and their overseas competitors (who will have to match China's falling export prices). Like all credit booms, China's will one day end with negative consequences for them, its overseas suppliers and its competitors.

Consequently, our strategy with regard to China (and indeed the other BRIC credit booms of Brazil and India) will be to 'own them' or more precisely to speculate in them until we see signs that either domestic credit conditions are changing as a result of policy decisions or balance of payments constraints. Admittedly, we will have a bias towards being cautious – many people who have played the greater fool theory in markets (there will be a greater fool to buy our exposure at the top...) in the past have ended up 'going over the cliff' with the 'long term bulls' and previous credit booms have occasionally proved susceptible to adverse news items and other unforeseen developments but, for now, we will chase the ever expanding supply of money in China.

We are prepared to back the Chinese 'Gift Horse' for a while longer but we do recommend frequent looks in its mouth and we believe that these checks should centre on the inventory data and the external payments situation, although as we noted neither are well served by the available data.

There will be a time to sell the China theme, although it may not be quite yet

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## Half-Time Wrap Up

This seems about a month late, but I felt it was appropriate to stop and just have a look at where markets went in the first half of 2009 (well, actually now the first seven months). I am pleased that I waited an extra month, too, as July 2009 was another extraordinary month in what has been a pretty extraordinary year so far.

For most of the past five months returns seem to have been sensational and it has been easy to forget the absolute horror of the first nine weeks of this year, when it seemed that 2008's annus horribilis was going to repeat itself.

The numbers for the seven months to the end of July are in the table below. They are market (index) returns for all asset classes, with the exception of the specific Tyndall Funds' returns that do not easily fit within traditional asset classes (the latter are gross of tax and fees returns).



Asset Class	7 Month Return
Emerging Markets (U)	34.3%
Australasian Small Cos (U)	32.6%
Tyndall Option Fund	28.6%
Tyndall Aggressive Fund	21.8%
Global Small Caps (H)	21.0%
NZ Equities	11.8%
Global Equities (H)	10.8%
Tyndall Balanced Fund	8.0%
Tyndall Income Fund	7.8%
Global Bonds (H)	4.4%
Multi-Strategy Fund (H)	3.9%
Global Property (H)	3.5%
Global Equities (U)	2.4%
Cash	2.2%
NZ Bonds	0.1%

Key: U= Unhedged H= 100% Hedged

There are certainly some surprises here. Perhaps the biggest is that there isn't a negative number in sight. Every sector is positive, which probably wouldn't have been expected after the end of the first quarter.

There are also some staggering returns for a seven month period, not least the Balanced Fund return. Emerging markets are the big winners, although they did fall 38.5% last year, which, if you do the maths, requires a massive 63% return to get back to the starting point. In fact, the return I have shown above for emerging markets is the unhedged NZD return. If I had used the hedged to NZD return, the performance over the first seven months of 2009 is 44.7%.

This shows how much the impact of currency has had on returns this year. The emerging markets difference is mainly related to USD movements, where the NZD started off the year at USD0.5844, before falling below USD0.5000 but then rising to USD0.6583 at the end of July. So hedging has proved a real benefit since about early March, although over the preceding 12 months, it hurt a lot as the NZD fell from about USD0.8000.

On a global currency basis, the difference between global equities hedged and global equities unhedged is also very dramatic. A fully hedged global equity return rose over 10%, whereas an unhedged return delivered a paltry 2.4% over the seven months, barely eclipsing cash.

Actually, the ranking of the asset classes themselves offer a relatively ordered listing that decreases in return with a decrease in risk (with the exception of unhedged global equities and global property). This simply shows that the rally since early March has mainly been the result of a repricing of risk.

The table below shows how those same asset classes/funds performed in 2008 calendar year and, with some exceptions, it roughly follows an inverse ordering. The worst performer over the whole period since the start of 2008 up until July 2009 (both tables combined) has been global property, which still has a long way to go to recover the large losses of last year. Unfortunately, there is little expectation of a resurgence in listed property security values, particularly on commercial properties, for some time, while the economic conditions remain so uncertain.

Asset Class	2008 Return
Emerging Markets (U)	-38.5%
Australasian Small Cos (U)	-44.2%
Tyndall Option Fund	-6.7%
Tyndall Aggressive Fund	-18.1%
Global Small Caps (H)	-30.0%
NZ Equities	-31.6%
Global Equities (H)	-39.5%
Tyndall Income Fund	4.6%
Tyndall Balanced Fund	-14.2%
Global Bonds (H)	11.2%
Multi-Strategy Fund (H)	-11.1%
Global Property (H)	-44.0%
Global Equities (U)	-21.9%
Cash	8.8%
NZ Bonds	15.8%

Key: U= Unhedged H= 100% Hedged

The best performer over this period has been the Tyndall Option Fund. This fund came through some fairly horrendous interest rate volatility in 2008, losing only a relatively small amount of value. It has certainly rebounded strongly, though, on the back of strong option premia in the highly volatile environment while not being impacted as much from interest rate volatility.

The question, of course, is how will these asset classes fare over the remainder of 2009. If only we knew. Most pundits seem to have an expectation that emerging markets will continue to deliver the highest returns. I have sympathy with that view, as some emerging markets have shown better-than-expected economic data, such as China and India, and there is still increasing demand for commodities and also expansions in manufacturing activity. China still seems to be getting what it wants, which means that shares leveraged to China and other emerging markets should do well. However, anyone who expects another 20%+ return from emerging markets in the remainder of the year is possibly a bit too optimistic. The reality may be that emerging will hold onto the strong returns made so

***“Returns seem to have been sensational”***

far (probably with a lot of volatility), whereas others may not.

Likewise, the Tyndall Aggressive Fund offers strong prospects to benefit from whatever the Australasian equity market will throw up. The Fund's ability to select stocks, regardless of whether they are in the index or not, gives it a huge advantage over more benchmark-tied options, especially passive funds.

***“Expect the domestic equity market to outperform”***

I also expect the New Zealand domestic equity market to continue outperforming its global counterparts. This is in complete contrast to what some other New Zealand fund managers have recently been predicting, but I still have a few question marks over the global situation, which could result in a late third-quarter setback. While New Zealand would be affected by implication (and sentiment), its reaction may well be more muted than that in, say, the US and Europe.

Finally, the Tyndall Option Fund should also continue to offer outsized returns, unless there is an unexpected bout of Treasury yield volatility. Otherwise, it should be able to continue to collect relatively strong premia and thus produce reasonably solid returns.

As alluded to previously, I see a lot of challenges ahead for the global property asset class. The outlook for commercial property is not particularly rosy, given the continued economic malaise and rising unemployment. If there is a sentiment change for global equities, global property could well turn south again as well.

Of course, we don't know what lies in store for us in the second half of 2009, although we are praying that we don't receive anything like the turmoil that was the second half of 2008. Time will tell.

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