

We continue to deploy a pragmatic view of world economic circumstances. The level of economic weakness has surprised even us.

In this month's Tyndall Comment, we discuss the arrival of the "Asian Depression" and the ongoing woes in the Euro Zone countries. We cover why New Zealand will face a protracted difficult period, even though authorities are doing the right things. New Zealand interest rates will need to drop further to continue to attack our economic weaknesses.

In short, we expect that a genuine global recovery is up to two years away. We will be managing this challenging environment with intense deliberation.



*Greg Campbell
Managing Director*

The Myth of Decoupling

As regular readers of our Commentary will no doubt be aware, we have tended to be on the pessimistic side of economic forecasters over the last year or so. However, even we must admit to having been surprised by the speed of arrival and the degree of severity of the current Asian Depression.

If the Japanese government's manufacturing industry surveys are to be believed (and they usually should be), Japanese industrial production will have fallen by a third between the end of September 2008 and the end of March this year, a situation that will have resulted in production falling all the way back to levels not seen since 1983, before the bubble economy of the late 1980s was even thought possible. Of course, one can argue that Japan has faced particular headwinds in dealing with the current global downturn: the collapse in global investment in plant and equipment has clearly hit Japan's heavy industries badly and the decline in consumer investment in durable goods, coupled with the strength in the Japanese currency, has also badly affected Japanese export prospects. However, at the same time we must note that Japan is not alone in Asia in terms of being badly affected by the global downturn.

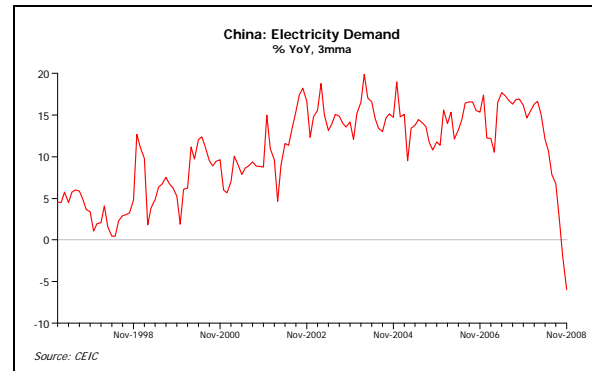
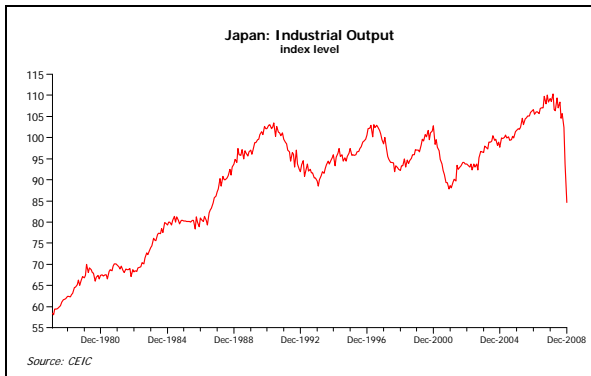
Despite its weak currency, Korea's GDP declined by 5% in the fourth quarter of 2008 alone. Elsewhere, Singapore fared only marginally better in the fourth quarter and Taiwan's economic data is now so bad that to 'annualise' the rate of decline appears nonsensical! Overall, Asian GDP and production trends are now even weaker than those

encountered during the worst moments of the Asian Crisis in 1997-8 with the result that even Asia's reputedly much-improved corporate financial health is now under significant stress once again.

Unlike the 1990s' Asian Crisis, and contrary to many forecasters' expectations, China's economy has also been forced to endure a recession as part of the current global slowdown. Although China is officially expected to grow by 6% or more this year (which suggests that the published GDP data will be somewhere close to this), it is clear from the industrial production, energy demand, cement and corporate data that China's economy is either in or very close to a recession at present, despite the government's introduction of what was described as a 'massive stimulus plan'. Despite Beijing's hefty fiscal intervention, a probable implosion in private sector investment trends - caused not only by weak markets but also China's increasingly suspect competitiveness position - and a significant weakening in consumption activity has pushed China into what is probably its first recession in the modern era. It remains to be seen how this slowdown will interact with the country's still problematic food supply situation and its political regime; the country is clearly facing challenges on many levels at present.



*Andrew Hunt
International Economist*



More promisingly, India's economy has fared rather better than China's in the current slowdown, in part because domestic demand has proven surprisingly resilient but the other members of the 'BRIC Club' are clearly faring as badly as China. Russia's economy is beset by balance of payments problems, a weakened credit system and a recession that appears as severe as those in Asia. Brazil's economy is also making heavy weather of the current crisis, hamstrung as it is with the 'hangover' from its own recent credit bubble and the effects of falling commodity prices. Far from providing a 'diversification bet' for investors, the BRICs have proved to be as vulnerable as any to the global credit crisis.

In fact, none of the 'regional economic independence' stories have proved robust during the current crisis. Only 18 months ago, many expected the Euro area to sail through a US slowdown relatively unscathed but collapsing exports, weakened credit systems and deteriorating labour markets are all driving the region into its worst recession for generations. Clearly, Germany faces its worst recession for sixty years and although France's economy is expected to perform slightly better than its neighbour, the 'PIIGS' economies of Portugal, Italy, Ireland, Greece and Spain are now facing their worst economic crisis since the Great Depression. Indeed, Ireland's government already expects GDP to fall by 10% and the Spanish unemployment rate seems set to top 20%. Separately, Austria, by virtue of its large economic and financial exposure to the now crisis ridden former Eastern Bloc countries, is also facing severe difficulties of its own at present.

In fact, so severe is the level of economic weakness in some of these Euro Zone countries that the markets are now beginning to discount the fact that these countries may be forced to leave the Euro project entirely, a thought that even six months ago when we raised it in these pages, we wondered if it might be too extreme a view to even write about! Once again, we find that the pace and severity of the current crisis is surprising even us.

“[N]one of the ‘regional economic independence’ stories have proved robust...”

Naturally, parts of the UK press have begun to enjoy speculating over the possible demise of the Euro, although their comments are necessarily tempered by the fact that the UK is also facing a recession that will also be its worst for 60 years and which may also prove to be particularly protracted. Indeed, we suspect that it may be more than five years before UK growth can return to trend given the need for balance sheet convalescence in the private sector and – soon – the public sector as well.

Given these highly correlated and negative global trends, which we expect to remain relatively protracted – we think that a genuine global recovery is unlikely before 2012 – small open economies such as New Zealand will continue to face a very difficult period.

Admittedly, the RBNZ has acted appropriately by cutting interest rates and by allowing the currency to decline.

But the bottom line remains that international trade and tourism receipts will remain under pressure and the home-grown version of the credit crisis will continue to subdue the domestic housing, corporate and household sectors. Certainly, Australasia cannot expect to buck the global trend and we would expect that the NZD and indeed the AUD will remain absolutely weak but, in the current global deflationary environment in which any threat from inflation can only be short lived (a situation that should prove beneficial to bond rather than equity market investors in the medium term). The acceptance of a weaker currency should soften the pain associated with the slowdown and perhaps allow a prompt reaction to the global recovery when it finally arrives.

The weakening Kiwi dollar may re-ignite comments over the 'Pacific peso' but we must remember that the first countries to leave the Gold Standard, and to adopt soft exchange rates, were the first countries to escape the depression in the 1930s. Consequently, we believe that a weak NZD should be welcomed since it will soften the pain of the global recession / depression for New Zealand companies and individuals alike.

Andrew Hunt, London

The Audacity Of Hope

As the world watched goggle-eyed at the inauguration of America's 44th President, I wondered whether, in four years' time, "Yes, we can!" will have become "Yes, he did!". Certainly there was an amazing amount of hope being expressed by the average US citizen (and probably hundreds of millions in other countries), that the refreshment of the new regime will be enough to turn the tide of the deep ocean of recession, credit crunch and wildly increasing unemployment.

In New Zealand, we have a double dose of refreshment, of course, with our own new Government as well, although I don't quite see the same sort of hope being expressed here. Then again, New Zealanders are far too practical to jump on a bandwagon based predominantly on emotional expectation (except when supporting the Blues/Chiefs/Hurricanes/Warriors).

President Obama has certainly assembled a very good team of economic advisers. They have a great deal of experience, a fantastic understanding of market and economic forces and, seemingly, a commitment to aggressively solve the problems. The difficulty is that the problems seem to be getting much worse as time goes on. While the stimulus packages announced so far should be sufficient to stabilise the system and prevent major collapse, there is still not enough in them to supply much growth impetus. These stimuli have provided a lot of hope so far, but I fear what a possible reaction will be (by the markets) once there is a realisation that they simply won't be enough. We probably saw a bit of this reality occurring in the sharemarkets in January, with the worst January ever for the US market and the worst inauguration day returns, despite all that expectant fervour in Washington and beyond.

Of course, all of the stimulus packages and bailouts need to be paid for somehow. The obvious way for this to be done is through the issuance of government debt. With governments around the world already guaranteeing lots of bank debt, having large government bond issues is only going to increase the supply of government-guaranteed bonds in the market. This is placing upward pressure on bond yields (we saw the US 10-year yield increase from 2.2% to 2.8% over the course of January), despite the increasingly gloomy economic data that is coming out.

The danger for the US economy (and the global economy by implication) is that instead of a "U"-shaped economic curve (that is, a sharp fall, with a brief bottoming out before a sharp rise again – although the current cycle would be a rather long and protracted "U"), is that it is, instead, a "L"-shaped situation – that is, a long, flat period without any recovery in sight. This was, of course, what happened in the 1930s Great Depression (the most extreme example), although I definitely do not think we are going to replicate that.



Peter Lynn, CFA
Head of Strategy

However, it was also the situation that occurred in Japan in the 1990s. This, I believe, is the most similar predicament to what the world is in at the moment. Hopefully, the US authorities do not make

the same mistakes that were made in Japan, so we do not get a protracted "L". To achieve this we need the US Treasury and US Fed to make appropriate fiscal and monetary policy moves as well as "quantitative easing" to steer the economy through this recession and ensure

that it does not become a depression. The same needs to be followed by their counterparts in, especially, the UK, as well as the rest of Europe.

Both monetary and fiscal policy need to be carefully implemented in New Zealand as well. In terms of monetary policy, I believe Dr Bollard has done an excellent job in making the drastic cuts required. Remember, just seven months ago, the OCR was at a record high of 8.25%. Now it is at a record low of 3.5%, with 4% of that fall occurring in just over three months. That is the biggest drop in interest rates of any developed market and, temporarily, resulted in New Zealand having lower short-term rates than Australia.

But Dr Bollard still has, unlike Ben Bernanke, more OCR ammunition to play with. I expect to see the interest rates cut down to around 2% and then for them to stay at this level for at least the rest of the year and possibly well into next year. This will be required because the economic data coming out of New Zealand is likely to continue deteriorating. It

"Quantitative easing' is a word invented by central bankers because 'printing money'; smacks too much of Zimbabwe"
***Niels Jensen,
UK Investment Manager***



Fund Manager of the Year
New Zealand

hadn't actually been that bad in 2008, but during January the adverse news started gathering pace. Unemployment is continuing to rise upwards and I expect it to be at least 7% by the end of this year. The dairy payout reduction clearly makes things weaker for the rural sector and the final payout may turn out to be even less than the \$5.10 published recently.

Careful management of fiscal policy is also going to be a key (pun on the PM's name fully intended). While we have tax cuts scheduled for April 1 this year, they are not particularly large. Compare that with what has already been distributed in Australia, who always seem to have far more fiscal action compared with our words and small promises. The New Zealand government may just have to take more action in fiscal policy.

We were the first country to enter into a recession and the hope is that we will be the first out. Monetary and fiscal policy will be an important part of achieving this, but we are still at the mercy of global trends.

And how will the markets react in all this? We are just about to start the new reporting season for New Zealand companies. The New Zealand equity market already has around 10.5% earnings reductions priced into it. Any further disappointments from this will result in stocks being sold off, but there is an allowance for the deteriorating environment to not have much of an impact on the sharemarket. Hopefully, the New Zealand sharemarket will be able to show the first signs of light at the end of this disappointing tunnel. At the least, there are some very attractive yielding New Zealand stocks available at the moment.

Global equities will, to my mind, struggle throughout the course of the year. They will continue to be extremely volatile and there are likely to be several brief short-term rallies (just as there were in Japan in the 90s). I have seen some of my peers predicting global equity rallies of around 20-30% from now until the end of the year. I also saw the results of a New Zealand survey that showed that over 50% of respondents expected global equities to rally more than 10% in 2009. That survey was conducted in late 2008 and I wonder how many respondents would have wanted to change their predictions after January's poor global returns. I just cannot, though, see how such strong returns can be sustained in what is a terrible economic environment that is getting worse. In my mind, it is more hope than genuine expectation.

There are also several predictions published out there that global equity prices can rise by 30%-50% from here, without specifying a time period over which this increase will occur. These, of course, are not much use – global share prices will certainly rise by 50% from current depressed levels at some

stage in the future, so such a prediction is going to come true at some indeterminate future date. Even a stopped clock is accurate twice a day.

In contrast, US Treasury bonds are clearly in a bubble that may have a little more to go before it bursts. Asset-backed securities including mortgage-backs, in contrast, are still at record spreads, but there is so little liquidity in that market that there is little there to encourage these spreads to contract. There are signs, though, that that some buying is starting to occur there.

In New Zealand, there may be small amounts of capital gain to come from its government bonds. In addition, corporate bond yields are still very wide. The falling cash yield should put at an end those questions as to why investors should not leave all of their money in the bank, although the volatility in markets will mean that a lot of cash is still maintained. Finally, the New Zealand dollar should be expected to fall even lower as our interest rate falls further and the soft commodity prices also detract.

To summarise, though, we all live in a sort of hope that Obama's team can steer a steady path through some very turbulent times. The hope extends to New Zealand's governance team that it can deal with the global responses, as well as our own peculiar issues.

Peter Lynn, CFA
Head of Strategy
9 February 2009

A note for your diary:

Andrew Hunt will be visiting New Zealand in March:

Monday, 16th March, Tyndall presentation in **Christchurch**, 9:15am for a 9:30am start at the George Hotel

Monday 16th March Tyndall **Wellington** Presentation at the Wellington Club, 3:30pm for a 3:45pm start

Tuesday 17th March Tyndall Breakfast in **Auckland** at the Northern Club from 7:15am for a 7.30am start

Thursday, 19th March at Philanthropy New Zealand Conference at Te Papa in Wellington - 2:30pm Keynote address

Please contact Helen McKenzie for further details: 09 377 7220 or helen_mckenzie@tyndall.co.nz

