

Equity markets have rallied over recent weeks, despite the mixed performance of economies around the world. In New Zealand, the rally has been significant, accompanied by a strengthening New Zealand dollar. The latter is an unwelcome ingredient for our economy.

In this month's Tyndall Comment, Peter Lynn discusses the New Zealand rally and probability of whether we have seen the bottom of the market yet. He also explains why the NZD rise is not sustainable.

Andrew Hunt presents the return of investment bankers, describing their critical role in the revitalisation of debt markets and warns of the potential pitfalls still ahead. The oft quoted "green shoots" of recovery – are they real or just more economic gyrations?

Andrew, our International Economist based in London, will be in New Zealand in August. Pencil in a date to join us at one of his presentations.



Greg Campbell
Managing Director

The Boys are Back in Town

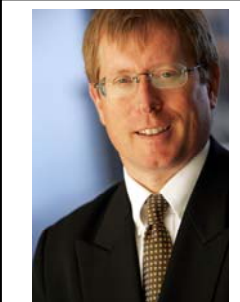
In the eighteenth century, Adam Smith (perhaps the father of free market economics and whose face now rather inappropriately adorns one of the UK's bank notes – the current regime being anything but *laissez faire* in its attitudes to the economy) suggested that the collective result of numerous individuals following their own economic self-interest rates would underpin economic growth and therefore benefit society as a whole. Some three hundred years later, Spielberg's 'trailer' for the inevitable sequels that were to follow the first Jurassic Park movie noted that nature would always find a way to perpetuate its species. The same seems to be true of investment bankers.

We believe that there is mounting evidence that the remains of the US investment banking sector and its counterparts in the Euro Zone, UK and Japan are dusting down their asset growth models of the mid 2000s and once again expanding their balance sheets with increasing enthusiasm. Although hard data on their activities is hard to acquire, we are beginning to see the foot prints emerge of an intriguing paper-trail. For example, in late 2008, the US investment banks apparently borrowed at near zero interest rates more than \$150 billion (at an annual rate) from the US central bank, the Federal Reserve. The investment banks then used these funds to purchase Government Bonds, a safe asset that yielded considerably more than the banks' heavily subsidised cost of funding.

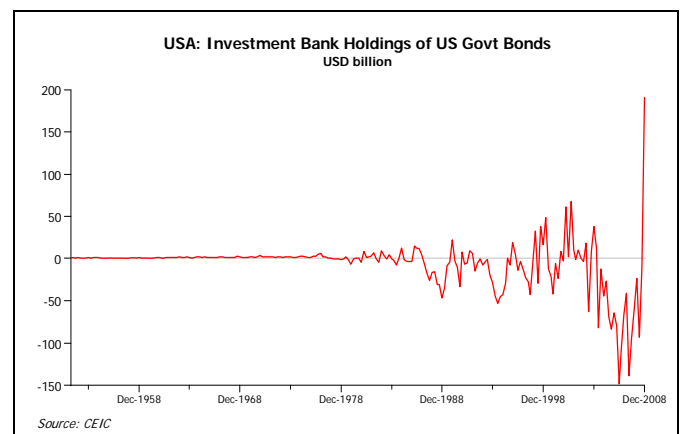
For the government, this was a happy situation: the purchase of such a large quantity of bonds by the

formerly defunct investment banks significantly helped to ease the financing burden of the rapidly expanding budget deficit and the 'extra' interest income that the banks earned in this transaction will undoubtedly have helped to recapitalise their highly compromised balance sheets. Therefore, for all concerned this was a happily symbiotic relationship and in some sense there was even a

pleasing circularity in the arrangement – the banks were providing the funds with which the government was in turn using in its efforts to recapitalise the banking system.



Andrew Hunt
International Economist



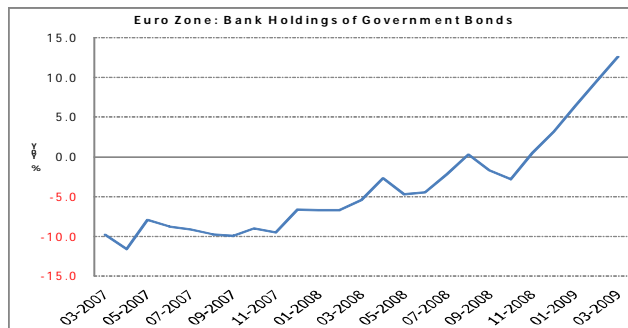
Unfortunately, it is the nature of investment bankers (who may be avaricious but who are also very smart) to look for better returns whenever possible and doubtless it did not take these institutions long to realise that they could better the returns that they were earning on Treasuries simply by investing in lower quality credits. Consequently, we believe that in the middle part of the first quarter of this year, the investment banks took their holdings of Treasuries (which they had purchased with the Fed's money) and used them as collateral in order to borrow yet more money from a variety of lenders, even including the Federal Reserve itself. It appears (although we have no conclusive proof as yet – only circumstantial evidence) that the investment banks then embarked on a process which saw them leverage the funds that they had raised in this fashion through the derivatives markets into a variety of risk markets, including the higher yield bond markets. Indeed, we suspect that it has been these flows from the investment banks that have underpinned not only the recent improvement in the US's domestic corporate bond markets but also in international bond markets as well.

For US companies, this re-vitalisation of the private debt markets has been most fortuitous. As recent data releases have emphasised, both conventional bank lending flows to the corporate sector and the commercial paper markets have remained exceptionally weak, thereby implying that the only still-functioning credit channel to the corporate sector has been the bond markets. Without the continued activity within the longer term bond markets, the US corporate sector's financial predicament would doubtless have been very much worse over recent months and therefore we can argue that the activities of the newly resurgent investment banks has exerted a positive impact on the real economy as a whole, just as Smith predicted that such profit-maximising behaviour would.

Moreover, it also appears that the resurgent bond markets have helped to revitalise international capital movements in Australasia and the emerging markets. Certainly, Australia, New Zealand and many emerging markets have witnessed a marked improvement in their external capital account transactions and this return of foreign capital may have helped to foster an easing of effective credit conditions in some of the economies concerned (although probably not in New Zealand it seems), an event which will have been at least a little supportive of growth prospects in these economies. Moreover, we suspect that it is these flows which have been behind the recent appreciation in many of the recipients' currencies, including the AUD and, to an albeit lesser extent, the NZD.

Meanwhile, in Europe and Japan, there is also growing evidence that the investment arms of the commercial banks have also been using their respective central banks' offers of cheap funding to acquire rapid acquisitions of domestic government bonds and we find that, in both regions, the banks' appetite for public sector bonds has actually

exceeded the supply of new bonds. Consequently, the European and Japanese banks have been creating a 'net' injection of funds into the bond and financial markets in general and we believe that this will have also proven beneficial to the countries concerned. Indeed, various sources suggest that the European corporate bond markets are currently booming and we suspect that this improvement in funding conditions owes much to the return of the banks to the bond markets over recent months.



In some senses, the resurgence in the investment banking sector has proved both Smith and Spielberg right. The investment banks have managed to perpetuate their former business models and thus maintain themselves and their profit growth (witness their recent strong earnings reports) despite their brush with extinction only a few months ago and, in so doing, they have opened what in reality is a new and beneficial transmission mechanism into the real economies for the Fed's and others' expansionary policy regimes. Moreover, we also suspect that it is the sheer weight of money involved in these flows that has allowed global risk markets, such as the equity markets, to rally over recent weeks, despite the still mixed tone of the data from the real economies.

Certainly, although equity and other risk markets have been able to take some encouragement from the recent improvement in the various

global production data series that are available, it remains the case that the level of end-user demand in much of the developed world for this extra production remains very limited indeed, a situation that could cause production trends to weaken once again before year end. Therefore, we suspect that it has been the improvement in liquidity trends described above that has played the primary role in the recent improvement in financial market conditions.

Unfortunately, there are also a number of problems associated with the current situation. Firstly, many central bankers regard many of the derivative instruments in which the investment banks are now dealing as being the next potential 'weapons of mass destruction' and therefore they are uneasy with many aspects of the process. At the same time, it is equally apparent that many politicians and members of the press are unhappy that the investment banks are now making huge sums of money again, so soon after they were rescued with public funds. Consequently, there is now a move in some central banks – possibly including the US Federal Reserve – to provide less liquidity and fewer credit

“Re-vitalisation of the private debt markets has been most fortuitous”

facilities to the banks and it is already apparent that this change in official attitudes is beginning to effect financial market conditions.

“We would urge investors...to pay close attention”

Indeed, one of the most striking features of the last few weeks has been the rise in US Treasury bond yields and we would firmly place the causation for this event on the signs that the Fed has become less generous with regard to its dealings with the investment banks. Of course, we suspect that the Fed is not pleased that long term yields in the economy are rising and it will probably step up its own purchases of Treasury bonds as a result but the fact that yields are nevertheless still rising suggests to us that, on a net basis, global liquidity conditions are tightening at the margin, a factor that could soon act to constrain the current rally in risk assets and high yielding currencies around the world.

At the very least, we would urge investors in equities and in high yielding currencies such as the NZD to pay close attention to the gyrations in the US T bond market at present – continued weakness in US bond markets could yet have significant negative implications for world markets.

Please mark your diary:

Andrew’s August visit to New Zealand is planned as follows:

<i>Wednesday 5th</i>	<i>7.30am Breakfast in Auckland at the Auckland Club 2.15pm Lunch in Christchurch at The George Hotel</i>
<i>Thursday 6th</i>	<i>ASFONZ Forum speaker – Late afternoon</i>
<i>Friday 7th</i>	<i>7.30am Breakfast in Wellington at the Wellington Club</i>

Invitations to follow in early July.

The Rally Continues

As May ended, the sharemarkets completed their third consecutive positive month in a row. Since March 3, the NZX 50 Index is up 17.5% to the end of the past month. There hasn’t been a three month rally (using full calendar months) of this magnitude since the three months ended January 1999 – over 10 years ago!

The same thing has happened on the global stage, although on an even bigger scale. The MSCI World Index (in local currency terms) is up 34.2% from its March 9 bottom to the end of May. There hasn’t been a three month period of this magnitude (either positive or negative) in the 40-year history of this index.

Unfortunately for New Zealand investors in global equities, unless you were hedged, you have not reaped the full benefits (or even many of the benefits) of this large global rise, as the NZD has risen in concert. The NZD has been the strongest currency in the world over the past three months, rising against every one of the 16 other most traded currencies over that period.

The biggest rise has been against the weak USD, where the NZD fell to USD 0.4927 on March 2, but then rallied strongly to USD 0.6405 on May 31, or a 30% rise. To put this NZD rise into perspective, compare the local currency MSCI World Index return of 34.2% quoted above (from March 9 to May 31), with the NZD unhedged MSCI World Index return over that same period. It was only 10.3% -- still good, but significantly reduced by the currency effect.

“This NZD rise is not sustainable”

This NZD rise is not sustainable. Since the end of May, the NZD has continued to push up to close to USD 0.6600, which is the same level it was at in September 2008, before the OCR cuts saw it plummet away into the 0.5000’s. It is, again, causing significant angst for exporters and is certainly not what the RBNZ wants. Dairy farmers, already seeing a much reduced 2009 payout are getting a double whammy as the relatively high NZD further reduces the NZD value of their milk production. There could well be further falls in this payout level, which, as the media has pointed out, has sizeable effects on the whole New Zealand economy. I expect the NZD to fall away from these high levels. If it doesn’t, the RBNZ could well intervene to force it down. In a global game of having reduced currencies, New Zealand is the biggest loser so far, despite making tremendous strides over the previous six months.



Turning back to the New Zealand sharemarket, it is interesting to see if this pattern of a large rise immediately following a large fall is par for the course. Although we all know that what happened in the past almost never recurs exactly the same in the future and is, at best, only a weak guide to future patterns, looking at past New Zealand sharemarket shocks of a similar magnitude to those suffered in the current economic environment may help us better understand what the future could hold. At the very least, it provides a perspective.

Below is a table showing the five largest “drawdown” periods for the New Zealand sharemarket from my data (which goes back to 1931). A drawdown is the period from the top to the bottom of a cycle. The “Months to Recovery” column represents the number of months it took to regain all losses. The total recovery returns for two and three years are unannualised, cumulative returns. All data is based on full calendar months.

Period	No. of Mths	Max. Draw-down	Months To Recovery	Total Market Returns During Recoveries (%)			
				6m	1yr	2yr	3yr
06/51 - 11/52	18	-18%	17	4	17	36	47
07/73 - 10/74	16	-33%	22	34	22	49	43
11/86 - 05/87	7	-21%	4	-24	-27	-27	-24
09/87 - 02/88	6	-60%	101	43	42	41	18
09/97 - 09/98	13	-27%	15	28	24	32	27
05/07 - 02/09	22	-34%	?	?	?	?	?

There are several interesting features of this table, including the following:

- New Zealand has not really had a lot of crashes in the nearly 80 years of history;
- The majority of the crashes have occurred in the past 25 years;
- Unlike the rest of the world, we never had a crash during the early part of this decade (the bursting of the tech bubble), which had global drawdowns of nearly the same magnitude (or, in Europe’s case, even more) than the 07-09 financial crisis;
- The 1987 Market Crash was short, massive and took ages to recover from; contrast the New Zealand results with what happened in the US – drawdown of -29% and only 19 months to recover those losses;
- On average, each drawdown prior to the 07-09 Financial Crisis lasted approximately 16 months (which is actually pretty similar to global drawdowns’ lengths) and the average maximum drawdown was 32% (again almost the same as global averages);
- If we assume that the 07-09 Financial Crisis did conclude in February 09 (or early March), then it was, for New Zealand, a quite a bit longer drawdown than average (in fact, the longest large drawdown experienced) and was very close to the average drawdown magnitude (although that average was distorted by the -60% during the 1987 market crash);
- The New Zealand experience during the 07-09 Financial Crisis is of a drawdown that lasted longer than other countries around the world, but was of a significantly lower size (most global markets fell 50-60% over the crisis’ usual length of mid-late 07 to Feb 09)

The “Months To Recovery” column shows that there is no real pattern to how long it takes to recover from a major crash, although there is broadly an understandable correlation between the

size of the drawdown and the time to recover (although the length of the drawdown seems to have little bearing on that time to recovery).

Finally, it is also interesting to observe the patterns of returns during the recoveries, although we have to ignore the recovery from the 86-87 “mini-crash”, as it was followed four months later by New Zealand’s largest ever market shock. The 51-52 fall is isolated both chronologically from the other crashes, as

well as by its recovery pattern. Observing the final four columns for that early ‘50s market fall tends to suggest that recovery was a very steady, positive return.

The other crashes, though, earned the majority of their recovery in the six months following the bottom of the crash. This is an interesting result, because it means that if you had exited (or significantly reduced) your exposure to a market after it had fallen significantly, you had a very limited window in which to get back in to try to recover your losses. In other words, if things are getting very bad and you are still exposed, hang in there, because the rebound is likely to be short and sharp.

Of course, we have no idea whether this will apply to the 07-09 Financial Crisis. Did we hit the bottom in those early days of March? Have we seen a similar pattern of a very quick and large bounce back? Or have the past three months been a bear market rally that will ultimately lead to a new low either later this year or early next.

“There is still a lot of uncertainty”

While there have been much talked-about “green shoots of recovery” evident in some economic data, unemployment is still rising and there is still a lot of uncertainty out there on a wide range of issues, from complete recognition of global banks’ bad assets to the global automobile industry to whether all of the fiscal stimuli provided by the various governments will indeed be sufficient to reestablish growth in economies. Among the green shoots of recovery, we are still seeing a few yellow weeds.

I do not believe we will comfortably be able to say that the markets have bottomed (whether than bottom has already occurred or is yet to occur) until next year at least.

Peter Lynn, CFA
Head of Strategy
4 May 2009