

- **We are enjoying increasing optimism over prospects of a global economic recovery.**
- **We are less than convinced.**
- **In this month's Tyndall Comment, Andrew Hunt explains how much of the recovery in financial markets can be attributed to strong liquidity. This is driven by central bank programmes rather than any improvement in our 'real' economies, which remain weak.**
- **Peter Lynn comments on the unprecedented rise in the New Zealand Dollar. "All countries want the lowest currency." They cannot all have it.**
- **Our currency is hurting our exporters and prospects for recovery in our 'real' economy.**



Greg Campbell  
Managing Director

## An Unconvincing Recovery...

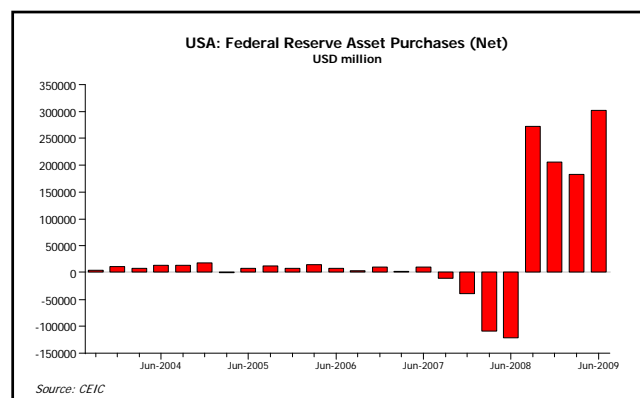
Optimism over the prospects for a global economic recovery has increased markedly over recent months, particularly as asset prices have recovered around the globe. In practice, we have observed that there is often a tendency to assume that an equity market recovery does indeed signal an impending economic recovery, perhaps because rising asset prices seem to 'pressure' forecasters to move their anticipated growth numbers upward. We, however, are less convinced in the equity and the other financial markets' predictive powers, instead believing that there are other processes driving asset markets at present.

It has become very apparent over recent months that the global financial system, far from shrinking and becoming a mere 'utility' for the real economy as some believed that it would following last year's crisis, is once again expanding in size and if anything becoming further divorced from the real economies. During a recent visit to an Asian central bank, the staff with whom we met expressed amazement that despite their domestic economy still being weak and suffering from a marked degree of profit-sapping deflation, they were experiencing record capital inflows into their domestic equity and high-end property markets. Unfortunately, this story seems not to be unique:

the seemingly awkward *juxta position* of large capital flows and resurgent asset markets with still weak or weakening real economies appears remarkably common - obvious as it is in South Africa, South America, Eastern Europe and much of the OECD.

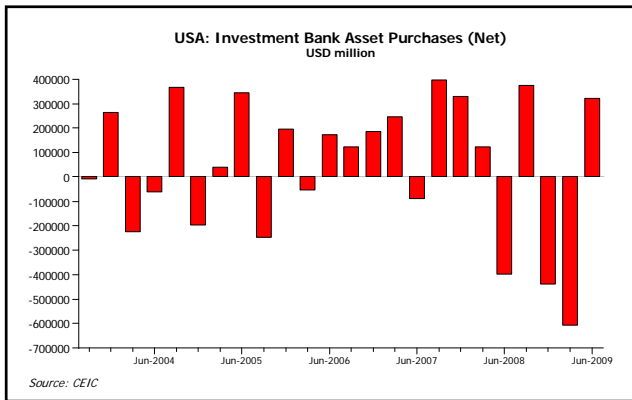


Andrew Hunt  
International Economist



We believe that the primary reason for the recovery in financial markets is simple cash flow: the massive asset purchase programmes now being operated by a number of central banks, including the Federal Reserve, the ECB, the Bank of England and the Bank of Japan,

coupled with a politically 'incorrect' and perhaps rather surprising resurrection of the investment banking sector has led to a situation of strong liquidity within the financial systems.



For example, as a result of the central banks' actions, the commercial banks have ample reserves, some of which they are expending by purchasing fixed income securities within the debt markets. Similarly, the investment banks have been provided with a seemingly elastic supply of 'cheap funding' and hence they have been re-expanding their balance sheets through aggressive securities purchases. Most surprising of all, however, is that the US Federal Reserve's massive purchases of mortgage securities seems to have reliquified the former owners of these securities and allowed them to go on an equity and corporate bond buying spree, both within the US and externally. Faced with such huge flows, it is not surprising that financial markets have benefited and apparently flourished.

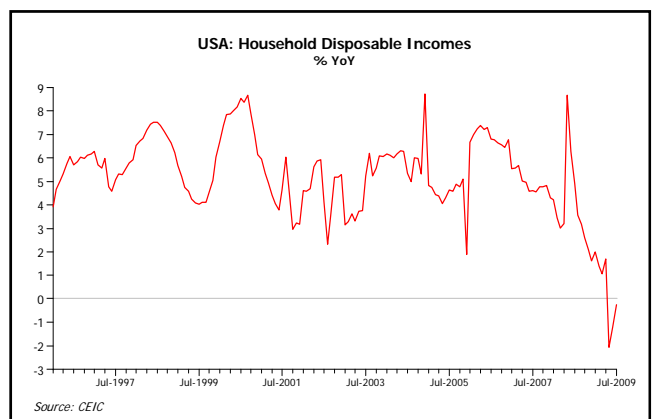
However, what is also abundantly clear from the economic data that little of the activity in the financial system is spilling out into the real economies. Equity markets may be booming and perhaps creating some positive 'wealth

***“We expect the global economy to remain weak over the next year”***

effects' for their owners but there is little or no new equity issuance, a situation which implies that real world companies are not materially benefitting from the boom in share prices. Moreover, even when investors sell their existing stocks of financial assets to the authorities, they seem to be re-investing the proceeds in other financial assets or using the money to pay down their own debts, suggesting

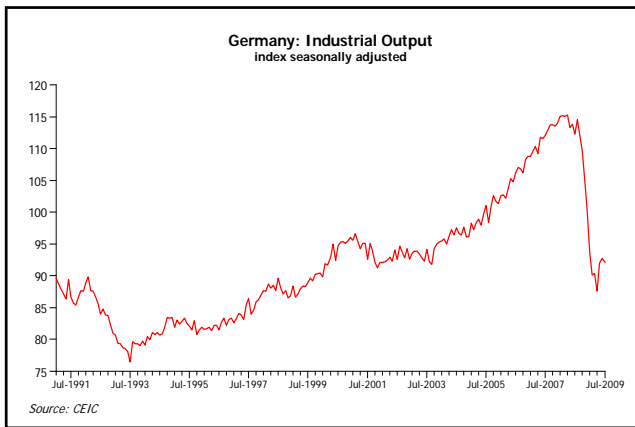
that their 'spending power' within the real economy is not rising as a result of the financial markets' recovery. We also find that the recent boom in corporate bond issuance has been used by the companies which were lucky enough to issue new debt to acquire a 'rainy day' stock of financial assets, rather than to boost employment or investment. Meanwhile, in the commercial banking system, there are currently no signs of a pickup in lending to either households or small companies, both of whom usually depend on credit flows from this source. Quite simply, although activity and even credit growth may be returning to the financial sector, it has yet to leak out into the real world and therefore we expect the global economy to remain weak over the next year.

Nowhere is the dichotomy between financial versus real world clearer than in the USA. Although the economy is enjoying odd months of stronger activity in response to specific fiscal measures such as the Bush tax cuts of 2008 or the latest 'Cash for Clunkers' car subsidies, underlying trends remain soft in the economy, particularly with regard to household incomes. Indeed, US disposable income growth has now turned profoundly negative which, given the household sector's now well established preference for saving (something which it must do if it is to repair its overstretched balance sheets), implies that consumer spending cannot rise on a systematic basis. Certainly, there may be odd months of strength, such as that which we are experiencing currently, but in general we expect consumer spending and hence overall economic growth to remain resolutely sluggish.



In Japan, one might have expected the domestic economy to have fared relatively well during the slump given the private sector's low debt burden and generally strong balance sheets but the authorities' weak fiscal position and the challenging demographic situation within the economy seem to have resulted in a severe

domestic slowdown alongside the more predictable weakness that has occurred in the export sector. With both the domestic and external sectors facing headwinds, we can expect little growth in Japan in the medium term.

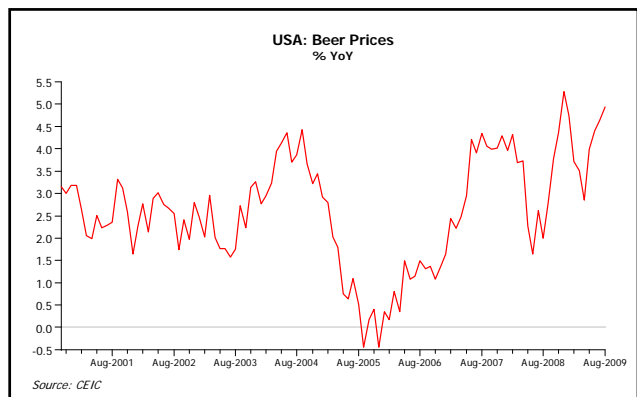


In Europe, fiscal policy has been used very aggressively in some countries to insulate the economies from the slump but, as the scope for this fiscal largesse is exhausted, we can expect renewed economic weakness as the fiscal stimulus is removed, particularly in countries such as the UK in which fiscal policy has been incredibly expansionary until recently. In Southern Europe, there may still be some leeway for further fiscal action but even here the governments will find themselves constrained in the years ahead. Unfortunately, as the regional economy remains soft, so too will Germany's export-dependent economy. We therefore believe that a sustained recovery within Europe is still some way off and that the period of maximum weakness for the UK lies ahead of us, a factor that should continue to weigh on sterling's external value.

One economy that has attracted considerable optimism of late has been China. China's authorities reacted albeit quite belatedly to the global slump by launching an unprecedentedly large domestic credit boom which appears to have been successful in reviving production trends in the economy as well as stimulating the local asset markets. Unfortunately, the revival in production does not seem to have been accompanied by a revival in domestic demand with the result that inventories have piled up at an unsustainable rate. Given the inventory situation and the authorities' stated desire to rein back the credit expansion in order to protect both the balance of payments and 'cost push' inflation pressures (although Chinese demand is weak, the rise in production is already encountering some supply bottlenecks which could lead to higher inflation in 2010), we feel

that China's economy is much more likely to slow in 2010 than remain strong, as indeed is India's economy. In India, inflation and current account deficit problems have emerged of late and the authorities are clearly signalling an imminent monetary tightening in order to cool the economy. Brazil, meanwhile, has proved to be very successful in recycling its recent large capital inflows into a domestic credit boom which should keep domestic spending growth reasonably firm over the next year or so but, in aggregate, we expect growth in the BRICs to slow in 2010 rather than accelerate.

For investors, the failure of the global economy to recover in 2010 will clearly pose a threat to corporate earnings but on a more positive note, the lack of an economic renaissance should allow the major Western central banks to continue their accommodative stance, a factor which should be supportive for both bond and equity markets. Therefore, on a medium term view, we expect the recent cash-flow-driven revival in asset markets to broadly continue, although there may well be substantial 'air pockets' along the way.



For example, the combination of rising government sales taxes, an ending of Asian export price deflation (itself caused by the removal of last year's 'emergency discounts') and some specific supply shortages in some markets (such as toys and beer – areas in which

the credit crunch has destroyed more 'supply capacity' than 'demand') are all likely to combine to cause a substantial jump in headline inflation rates in early 2010. The announcement of higher inflation and weak economic growth could well pose a substantial test for asset markets but, as these inflationary 'special factors' dissipate as 2010 continues we would expect financial markets to regain their composure.

It seems that both bond and equity markets may therefore be 'choppy' over the next six months, as could currencies. In particular, we suspect that the US dollar's increasing role as a funding currency for foreign investors will keep the US currency weak while asset markets are inflating, but strong when they are falling, with the result that its trend over the next year or so is relatively flat against the major currencies.

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## The Rise of the New Zealand Dollar and Hedging

With the very cheap airfares on offer, it seems a great time to be contemplating an overseas holiday at the moment. That is, of course, assuming that you still have enough money left over from the recession and your job is relatively secure (assuming you still have a job, that is).

As 2009 has progressed, it has become more and more affordable to travel to the US or Japan, as the New Zealand dollar (NZD) has embarked on a recovery of unprecedented proportions against the greenback (USD) and the yen. In fact, in the past seven months, the NZD has moved from USD 0.5008 at the end of February to USD 0.7234 at the end of September (it temporarily hit USD 0.7300 at around midday on 23 September).

This movement is a 44.4% rise in the value of the NZD relative to the USD. Since the March 1985 float, the largest previous seven-month rise in the NZD/USD rate had been 19.3% (in the period to April 2003). So this latest rise has

***"The NZD has risen  
44% vs the USD in  
seven months"***

been more than twice as strong as any historical rise in such a time period.

It is a similar story for the Japanese yen, with a 32.2% rise over the past seven months (it was closer to 40% for the seven months ended August). The previous biggest rise over such a period for the yen was only 20.5%. Note that, in contrast, the NZD is only up 4.6% against the

Aussie dollar over the same period, as the AUD has climbed 38.1% against the USD.

One of the main reasons for this strength in the Australasian currencies is the re-emergence of the carry trade as risk appetites have increased after the early March lows. When short-term interest rates are close to 0% in the US, Japan and Europe, it is little surprise that obtaining higher yields in the currencies of the stable economies of Australia and New Zealand will take place. Speculation that these two countries (especially the former) will be the first developed countries to raise interest rates only encourages capital inflows to them. The result is that, as always, it is supply and demand driving the NZD direction and, unfortunately, the NZD (and the New Zealand economy) is at the mercy of these capital flows.



*Peter Lynn, CFA  
Head of Strategy*

For example, there is a belief that the Indian Central Bank has been a significant purchaser of the NZD. Protests from the RBNZ that the NZD is at too high a level have little impact against the might and resources of the Indian Central Bank.

The RBNZ though, is not the only central bank desiring a low local currency – they all are. In the current environment, with fiscal stimuli all used up, still rising unemployment, very slow recovery in the consumer sector and almost-zero interest rates in the developed world, a weaker currency may be the only policy option left for central banks to help their economies

recover. The problem is that currency movements are a zero-sum game – a rise in one currency is offset by a fall in another. Although all countries want the lowest currency, they can't all have it.

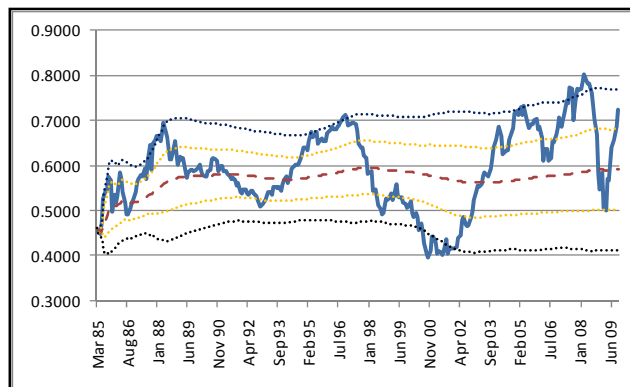
The capital flows that result from these movements cause a significant amount of volatility for the NZD. If you look at the annual standard deviation of spot rate movements (against the USD) for all of the most traded currencies in the world, over the last year they have all generally been around the 15-20% level. However, the AUD volatility is at 27.8% and the NZD is at 30.5%, which highlights how these smaller currencies are more subject to the whims of global capital movements.

We all know the NZD is high at the moment, but what everyone wants to know is where it is going next. Investment market forecasts are notoriously inaccurate and currency forecasting is the most difficult. In my 16 years in this industry I have witnessed several currency managers ruin a couple of years of positive currency gains with a single quarter when the currency markets moved sharply against them. So trying to predict the NZD's direction is an exercise fraught with danger.

Keeping that in mind, though, we often need to establish how much currency hedging to apply to portfolios. We tend to apply a currency hedge only to the global equities portion of funds (on the rationale that global bonds and other asset classes follow a more stable underlying return profile that we do not want to jeopardise with volatile currency exposures). Unless a "set and forget" policy is required (that is, never change the hedge ratio), some expectation of the likely future direction of the NZD helps determine this ratio.

Since its float on 4 March 1985, the NZD has historically moved in a cyclical fashion. Although, as the following chart of the NZD:USD rate shows, the frequency and amplitude of these cycles have not exactly established any sort of pattern yet (there have really only been three cycles since the float and the last one is quite distorted).

I have also plotted some statistics on the chart. A long time ago I was taught that one way of possibly predicting currency direction was to judge how far the level of the NZD relative to the USD was from its mean level. When it gets to two standard deviations away from the mean level it is supposedly due for a turnaround.



The mean (or average) level of the NZD has tended to be just under USD 0.6000. The two dotted orange lines represent one standard deviation above and below this mean (around USD 0.6500 and USD 0.5000, respectively). The two outside dotted lines are two standard deviations away from the mean. Note that the standard deviations are increasing in size as time has gone on.

The following table looks at returns since 1 January 1988 (which is as far back as I have hedged data) earned on the MSCI World Index if various hedge ratios were applied. I have used the MSCI World Index returns as the hedged return includes the hedging premium based on interest rate differentials between New Zealand and the US.

p.a.	A	B	C	D	E
Return	8.6%	6.2%	7.5%	8.1%	10.7%
Risk	14.6%	14.8%	13.8%	14.8%	15.1%

Key to hedging strategies:

- A. 100% hedging at all times
- B. no hedging ever
- C. 50% hedge ratio at all times
- D. No hedging whenever 2 s.d. more than the mean is reached, switch to 100% hedging when 2 s.d. less than mean is reached
- E. No hedging whenever 2 s.d. more than the mean is reached, switch to 100% hedging when 1 s.d. less than the mean is reached

Over this 20+ year period from the start of 1988 (when the NZD was USD 0.6585), there has been a benefit to hedging that is mainly attributable to the quite significant hedge premia available (note that these premia are now relatively insignificant after the yield curves have shifted from an inverted to a normal shaped curve and New Zealand short term interest rates have reduced substantially). The stability of these premia has also contributed to a lower risk level.

Maintaining a 50%:50% hedge ratio reduces the risk significantly, with the return expectedly in-between the hedged and unhedged returns. It does, though, get more interesting when one starts using the standard deviation levels as switching points.

Using two standard deviations as a turning point is not as effective as being fully hedged, as the currency level has only fallen south of two standard deviations below the mean for one period in the past 20 years. However, an interesting increase in return is achieved if one uses only one standard deviation below the mean as a point to start hedging again in conjunction with the upper two standard deviation level to take it off (strategy E in the table). I have looked at other strategies involving, for example, moving to 50% levels as you pass through the one standard deviation level, but none of them would have worked as well as strategy E above. No doubt someone smarter than me has devised an even better strategy than this.

There are some issues here, though. One is that there are other currencies than the USD, of course, and their patterns may be different, so just using the USD may also be suboptimal. Another major point is that this is all backwards-looking and, as we all know, the past is no guide to the future. For example, if you followed strategy E above, you would have fully hedged at the end of February and be now enjoying the sharp increase in the NZD since then. If though, the Indian Central Bank decided to suddenly withdraw its NZD investment, or risk appetites changed suddenly, then the NZD could well fall sharply from here. You would be fully hedged

***“A high currency does not help our economic recovery.”***

while the NZD falls all of the way to one standard deviation below the mean (currently a level of USD 0.5027. As a result, one may need more flexible strategies than the above and take consideration of future expectations for currency movements, economic conditions and interest rates.

The RBNZ certainly are not happy with the continued strength of the NZD. A high currency does not help our exporters lead our economic recovery. If it remains persistently high, there remains the possibility that the RBNZ could

intervene in the currency markets, as it did in mid-2007 (represented by a short, sharp blip in the earlier chart). As can be seen, though, that did not have much effect as the currency soon went higher than it had ever been post-float.

It is a difficult and risky enterprise trying to predict currency movements. Those who are successful over long periods are few and far between.

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***1 October 2009***