Tyndall Comment
April 2010

A Divergent Global Economy

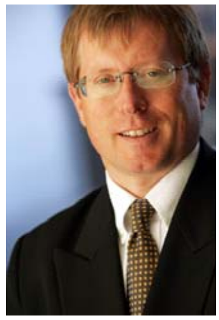
Perhaps pleasingly for economists, although probably not for anyone else, the global economy appears to be becoming ever more divergent and complicated to analyse. Pleasingly, household spending is beginning to strengthen in many of the emerging markets, primarily we suspect not as a result of their superior growth prospects or other perceived long term advantages, but because there has been a significant easing in their domestic monetary policy settings brought about by massive investment capital inflows from the West.

Did the developed economies fuel the excesses of the emerging markets?

Although Western monetary policies appear not to have generated strong economic recoveries in their domestic economies – and in fact domestic demand trends seem to be slackening at the margin in the West as household incomes come under pressure – the extraordinarily lax monetary policy conditions in these developed countries have both financed and encouraged unprecedented levels of capital inflows into many emerging markets. These immense inflows have in turn then obliged the local central banks to themselves become more expansionary and hence we are seeing an upturn in domestic demand in these countries. From the point of view of global growth, this domestic renaissance in the world's most populous nations can of course be welcomed but the individual central banks in many of these countries – and particularly in the fashionable BRIC[1] economies – are only too aware that these types of expansion can turn inflationary relatively quickly.

[1] Brazil, Russia, India & China

In fact, inflation rates in the BRICs are already moving up and these countries seem set to attempt to tighten their monetary regimes over the course of 2010, an event that may lead their currencies to appreciate but their growth rates to moderate.



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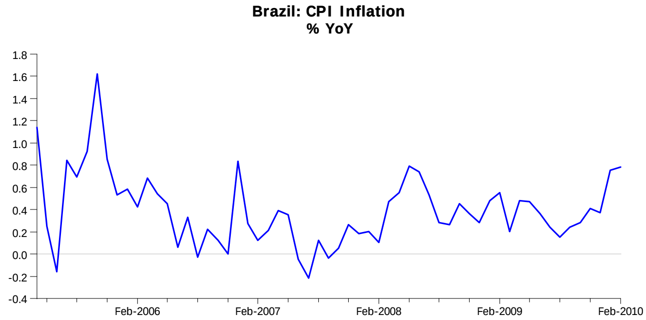
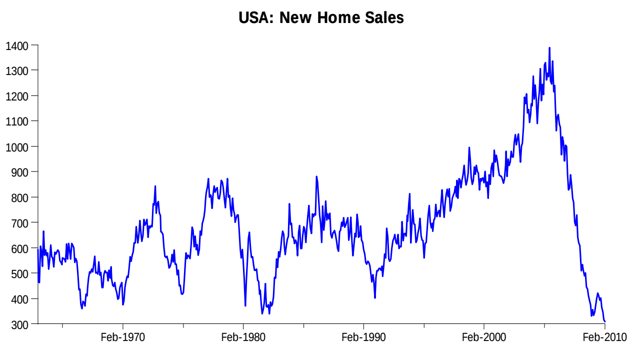


There has also been much talk of a tightening of monetary policies within the Western economies of late and, in some senses, the mere announcement of an intention to tighten by the European Central Bank, the Federal Reserve and the Bank of England actually represented an important first step in the tightening process. These central banks evidently wished to tighten not because they necessarily believed that their respective economies were recovering strongly but because they wished to put an end to some of the abuses of their monetary generosity – the Federal Reserve's purchases of Mortgage Securities had produced relatively few benefits for the US's struggling household sector but inadvertently it had provided funding to hedge funds while the ECB's generous lending facilities had been diverted into cheap financing for

Southern Europe's overly lax and counterproductive fiscal policies.

However, we suspect that in reality the central banks will not be able to remove their extraordinarily expansionary policy stance this year and in fact many have already moved back towards a more relaxed rhetoric. In the USA and the UK, the ending of last year's massive fiscal policy injections and in some instances rising tax burdens has led to a sharp collapse in disposable income growth that already appears to be sapping the household sector's ability to spend. The US housing market is widely assumed to be suffering a 'double dip' and the latest retail sales figures have tended to be disappointing. A similar pattern appears to be emerging within the UK and the prospect of a more generalised 'relapse' in these economies should ensure that both these central banks remain generally accommodative, even though this year's inflation rates seem set to be substantially higher than those experienced last year.



In Japan, meanwhile, deflation remains firmly entrenched and the domestic economy continues to languish despite the recent slight improvement in the country's exports to Asia. With the current lax fiscal policy stance apparently reaching the limits of its sustainability, the Bank of Japan has been obliged to become more expansionary despite its internal reservations over the use of Quantitative Easing Policies and we can expect this central bank to remain expansionary for at least the next 12 months.

The European Central Bank has, of course, suffered a traumatic period of late as it has attempted to deal with the implications and fallout from the Greek Crisis. In practice, the Greek, Spanish and Portuguese economies should not have joined the Euro when they did and, as a result of their mistimed entry and subsequent behaviour, they now find themselves in intractable uncompetitive positions that we believe simply cannot be solved through fiscal retrenchment and enforced cost deflation. Ultimately, we believe that Greece's public and private sectors will be forced to default on many of their existing debts and the outlook for Spain is only marginally better. However, at present, political forces within the Euro Zone are preventing these necessary defaults and this political impasse is threatening – in a very real sense – to tear the Euro project apart at its core.

The woes of the ECB

Faced with its own potential imminent unemployment, the ECB has been obliged to supply yet more liquidity to the Euro Zone financial system and further guarantees about the outlook for short term interest rates, a situation that we strongly believe represents a *de facto* re-imposition of its former quantitative easing policy regime. Therefore, although we expect Euro Zone economic growth rates to remain lacklustre – if not depressionary in the struggling peripheral countries – we also expect local monetary conditions to remain relatively accommodative and the currency to become steadily cheaper, to the benefit of some of the region's exporters.

For investors in financial markets, this situation poses something of a quandary. Many emerging markets are experiencing faster rates of economic growth but in some cases this growth has already started to become inflationary, thereby creating the potential for adverse policy actions by the local authorities, although we doubt that they will be able to slow their economies significantly in the near term. In the West and Japan, we expect to witness the opposite situation of persistently slow growth but continued easy monetary regimes against a background of modestly higher inflation rates.

Currency markets continue to offer good trading opportunities for the speculators

For the currency markets, we would suggest that tighter monetary regimes in the emerging markets and also in the commodity currencies, such as Australia, Canada and New Zealand, should lead to further gains for these currencies against the major currencies, although we should caution that the BRIC economies – and particularly Brazil and China – are already beginning to look quite uncompetitive, a factor that may limit profit growth in their manufacturing sectors this year despite their superior growth rates. Amongst the major currencies, the Bank of England and the ECB clearly now have preferences for weaker currencies and we would broadly expect them to have their wishes granted.

For global financial markets, these various cross-currents of continued slow developed world growth and higher inflation in the emerging markets, coupled with the ongoing situation within the European single currency system, argue for continued nervous trading conditions over the next few months. However, ultimately we suspect that both bonds and equities will gain in price terms from the continued relaxed stance of the major central banks, although this may leave the markets looking expensive relative to their 'fundamentals' and therefore vulnerable to any reversal in the central banks' policy stances in 2011. Just as occurred during much of 2009, the immense weight of money that is being generated in financial markets by the major central banks' easy policy regimes at present may support asset markets for much of this year, even as growth and inflation trends ultimately disappoint many observers.

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Andrew's 2010 New Zealand presentation dates:

Winter Series		
6 August	7.15am	Auckland, The Auckland Club, breakfast
	12.30pm	Wellington, The Intercontinental
26 August Workplace Savings Forum		Convention Centre, Christchurch

Other Tyndall Manager Presentations:

23 April	10.30am	Ken Eich & Stephen Chen from **Davis Advisors** (one of the five managers within the Tyndall Multi-Manager Global Equity Fund) @The Auckland Club
26 April	12.30pm	Terry Berkemeier, one of the three Global Portfolio Managers within the Tyndall Global Equity Fund managed by **Capital International Inc** @The Wellington Club, for a lunch presentation.
27 April	7.30am	@The Auckland Club, for a breakfast presentation.
Week of 14th June		Calvin Ho from JP Morgan Alternative Asset Management will be in NZ. Dates/Venues TBA.

For further details of presentations, please contact enquiries@tyndall.co.nz