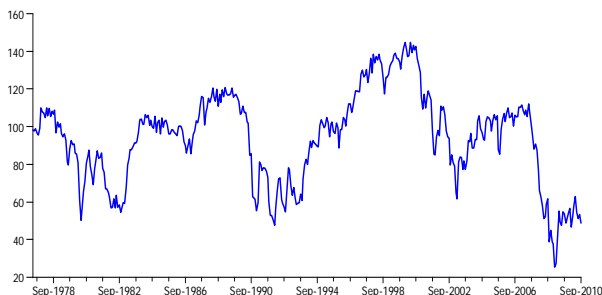


## Q E Round II ??

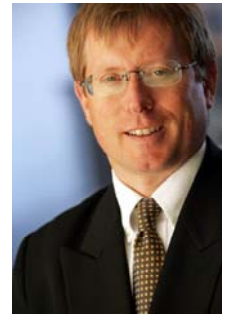
A fact that is not generally appreciated by the financial world, but only too keenly felt by many households at present, is the near lack of disposable income growth in much of the developed world. Indeed, we suspect that the steadfast refusal of consumer confidence indices around the world to recover towards their pre-crisis levels is largely due to this factor. This lack of income growth has occurred despite the albeit modest revival in employment conditions and in some cases even wages over recent months and it is primarily the result of the unwinding of the various government measures that were designed to support incomes during the darkest days of the Global Financial Crisis. The removal of the various subsidies, tax rebates and tax 'holidays' that were enacted a year ago has led to a marked reduction in household disposable incomes and we believe that it is this factor, perhaps more than any other, that has constrained household expenditure over recent months.

USA: Consumer Confidence index



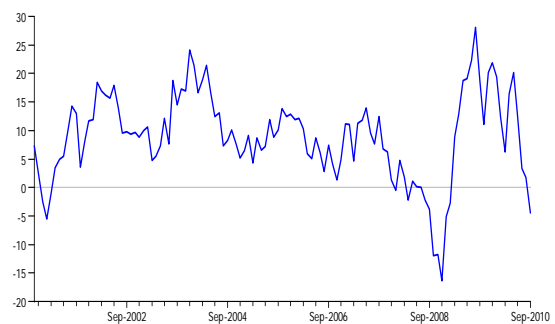
Given the weak level of income growth, significant increases in household expenditure have only been able to occur over recent months when individuals have been prepared to reduce their savings rates and therefore

spend more of their incomes and conversely, when they have chosen to save more, spending has naturally slumped. For example, during the first few months of 2010, rising asset prices in the US and elsewhere seem to have led households to feel wealthier and therefore encouraged them to save less and spend more but following the Greek debacle, savings rates rose around the world with an immediate adverse impact on spending patterns.



Andrew Hunt  
International Economist

USA: ISM New Orders - Inventories index



Initially, it seems that companies were slow to 'spot' this slowdown in personal consumption but by August-September, companies evidently began to notice that orders were declining and inventories of unsold goods rising. Consequently, companies are now beginning to adjust their production levels downward and in time we suspect that these weaker output trends will impact employment and hence wage income trends. If left unchecked, we could easily

imagine that rising savings rates and weaker still income trends will deliver what could prove to be a very significant slowdown in the global economy.

Of course, the US central bank and some others – although significantly not the ECB or the Bank of Japan - are moving to counter this anticipated or rapidly emerging slowdown but, given the lack of household income growth that we noted earlier, they can only stimulate growth in their economies if they introduce policies that are designed to reduce savings rates again. Of course, it is a moot point as to whether households should be encouraged to save less given their weak balance sheets and often under provisioned pension arrangements but nevertheless the Federal Reserve seems destined to try.

In order to achieve this feat, the Fed appears determined to begin a new form of 'Quantitative Easing Policy' by purchasing US government bonds in a sufficient quantity to force the yields on these securities down to what might be considered as being punitive levels for savers. At this point, the Fed evidently hopes that savers will quit Treasury bonds and move into other assets, such as corporate bonds or even now higher yielding equities. The Fed evidently hopes that the rise in prices in these assets will both help to ease the credit crunch and encourage households to save less and spend more.

For investors this situation would seem to provide a 'free ride' in that the Fed appears to be deliberately attempting to raise asset prices – be they bonds or equities – as a direct policy tool and hence we would imagine that both may perform well in the near term, although the US dollar may of course fall in the near term as the liquidity that the central bank creates spills out into other regions. The investment conclusions would seem, at first sight, to be obvious.

What concerns us is that much of this story is already well-known to market participants and we therefore wonder if any Fed-inspired rally in asset prices or fall in the dollar can be sustained beyond the end of the year. The Federal Reserve's Quantitative Easing Policy

rally may therefore not prove as long-lived as many expect. In addition, we also suspect that the US policy may not be welcomed with enthusiasm by some other countries, most notably within the Emerging World. In practice, we suspect that the Federal Reserve's anticipated domestic bond purchases will ultimately cause a wave of capital outflows from the US dollar into high yielding currencies such as the Australian or New Zealand dollars or into the Emerging Markets.

At this point, the recipient countries will have three options with regard to their own reactions to this situation. They could allow the capital inflows to push their currencies higher, to the detriment of their competitiveness and hence their own growth prospects – as Europe is already discovering to its cost and we fully expect this region to return to sluggish growth as the higher Euro takes its toll on both the economy directly and the mindset of its component populations. Alternatively, the recipient countries may chose to intervene to hold their currencies down but this action will tend to create excess liquidity and hence trigger inflation in their own economies. Finally, the recipient countries may simply decide that they do not wish to experience either of the above and instead they may chose to introduce direct capital controls, as indeed Thailand and Brazil have done already in an effort to keep the 'destabilising capital flows' at bay.

We would suggest that any or all of these policy responses may lead to an end to the now widely anticipated asset market rally. For example, if the Euro continues to rise, we believe that it will increase the level of pressure on the uncompetitive and depression-hit countries in the 'Periphery' that the Euro's very existence could become threatened. In addition, if the Emerging Markets either allow their currencies to appreciate, or they allow the capital inflows to cause higher rates of domestic price and cost inflation in their own countries, then the West will soon find that the price of importing the plethora of consumer goods that it sources from these areas will increase considerably,

thereby causing a probable global 'inflation ripple' later next year in the developed world.

Presumably, such an inflation scare would soon bring an end to the central bank-inspired asset price boom noted above. Indeed, we would suggest that it was the Fed's first attempt at a Quantitative Easing in 2009 that led to the inflation scare of early 2010 which, along with events in Greece, created much of the instability experienced in financial markets during the second quarter. Under this scenario, a new round of Quantitative Easing in the West may cause inflation to rise during mid 2011, with unfortunate effects on asset markets, savings rates and ultimately growth.

However, if the emerging markets or other countries adopt capital controls in response to the Fed's actions, as we suspect that they will do in the early part of next year, then they risk raising political tensions and even triggering higher tariff and other trade impediments that may prove deflationary for the global economy and hence prevent the Fed's policies from stimulating global growth.

In summary, although most financial markets seem determined that the Fed's fears of a double dip in the economy (which we believe is already occurring) will cause all asset prices

to inflate on a rising tide of liquidity (albeit at the expense of the value of the US dollar), we fear that much of this rally has already occurred and that the impact of the Fed's policies on third parties may ultimately cause either inflation, deflation or increased levels of political tension, or a combination of all three. At this point, markets may struggle to remain quite as sanguine over the state of the global economy as they appear at present. The bottom line is that with household income growth still minimal, it will be difficult to produce a sustainable recovery and attempts at subverting this situation may simply result in higher levels of financial and economic volatility over the medium term. Nevertheless, we must conclude that the Federal Reserve will probably still try to steer the global economy away from the fast-approaching double dip and financial markets may continue to welcome this in the near term, if not over the longer term.

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