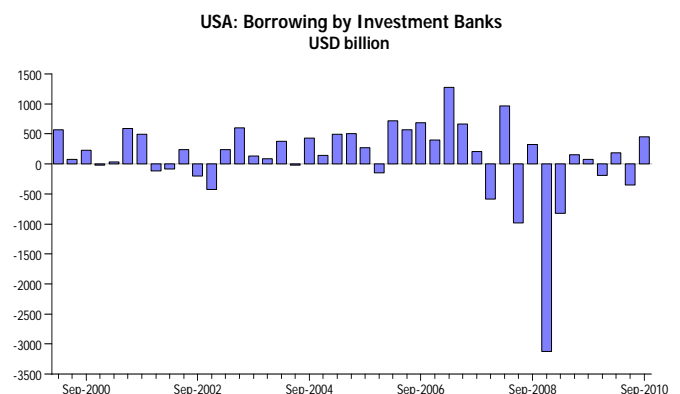


The Outlook for 2011

As 2010 drew to a close, we found financial markets apparently in a buoyant mood with expectations for economic growth and activity in 2011 generally being revised upward following a string of good data releases from the USA and many of the emerging markets. Judging by these events, investors could feel reasonably confident over the outlook for 2011 but, as ever, we have some reservations.

With regard to the financial markets themselves, we find that the recent rally in share prices has occurred against the backdrop of weakening bond markets and minimal trading volumes, a situation that is not usually a positive sign. Moreover, the rally in share and many commodity prices during the final months of 2010 seems to have been primarily the result of an expansion of balance sheets within the world's investment banks. These institutions, which were the perceived villains of the global financial crisis, have now returned to rude health and have emerged as substantial borrowers within the credit markets, as they seek to expand their balance sheets. These institutions are once again drawing on the generosity of the central banks' easy monetary regimes by borrowing heavily in the short term wholesale money markets and using the funds so raised to acquire assets with almost the same levels of ferocity that they employed prior to the crisis. While this may have been good for asset prices in the near term, it is a situation that we doubt is sustainable in the longer term.



It is not only the character of the recent rise in asset prices that leads us to be suspicious that 2011 will not be the 'easy year' that many expect. Although US retail and other consumer spending numbers have been quite buoyant of late, this spending has occurred against a background of little or no income growth – and falling disposable incomes in inflation adjusted terms. One of the unintended consequences of Bernanke's recent reintroduction of a quantitative easing policy (QEP) has been a flow of funds into the commodity markets and the resulting rise in food and energy prices is now eroding household spending power. In this sense, the QEP has clearly misfired.

Instead of being supported by income and employment growth, it seems that the recent rise in US retail activity has been financed from the huge fiscal transfers that the US household sector received late in the second quarter as the Administration redistributed the financial sector's repayment of TARP and other rescue fund monies into a further expansion of the state sector. These fiscal transfers, coupled with a fall in the savings rate amongst high earners, seem to explain the rise in spending in late 2010 but we would caution readers that the use of these transfers is a 'one time' event and that unless Obama enacts yet more fiscal measures (rather than simply extending existing ones), there will be no further marginal increase in household spending power in 2011 and thus consumer spending growth may have dissipated by mid-year.

Another factor that concerns us with the perception of an improved economic outlook for the US is that, try as we may, we can find neither statistical nor anecdotal evidence of a much heralded rise in capital expenditure by US companies. US capital goods orders are weak, shipments of the same are lacklustre and inventories of unsold capital goods seem to be piling up warehouses once again. It seems that although large companies are indeed cash rich, their confidence in the future is low and their profits are already beginning to come under pressure, with the result that CAPEX trends seem set to disappoint. In such an environment, jobs growth may also be hard to achieve, although the latter would seem to suggest that the authorities may at least attempt to continue to run expansive policy settings.

However, even with regard to policy settings, we are not convinced that the story is quite as simple as generally supposed. It is clear that China's economy, following a massive fiscal and monetary expansion and years of under-investment in its agricultural sectors, is now facing a significant wage price spiral that has already given rise to double digit rates of inflation in much of the country. For political reasons, the Chinese authorities seem unable to tackle this problem (they are continuing to run accommodative policies) and it seems that domestic inflation is rapidly beginning to 'infect' Chinese export prices, which have begun to rise in recent months.



This outbreak of inflation in China is not merely of academic interest to the West; over the last 20 years western economies have increasingly reconfigured their supply chains to rely on goods produced in China and hence the higher rate of cost price inflation in China carries with it the threat of higher import prices and indeed higher inflation in the West. As China inflates, retailers in Europe, the USA and elsewhere will come under margin pressure and hence pressure to raise their own selling prices and hence, we fear that inflation in 2011 may also be higher than the markets are currently expecting. We have already seen higher than expected inflation in the UK and elsewhere as a result of rising import costs and this has begun to constrain the Bank of England and others' ability to support their domestic economies' growth rates. Therefore, even policy settings may be a little less predictable than people are currently expecting.

Elsewhere in the global economy, there are many other uncertainties that concern us. Not only is China overheating with rising rates of inflation but so too are Brazil and India and we can expect the authorities to attempt to slow these economies in due course. In Korea and Singapore, economic growth, contrary to most people's expectations, is slowing under the pressure from their overvalued exchange rates and we also expect Australia's once 'indestructible' economy to finally succumb under the weight of its own high debt burden and weak domestic income growth. Indeed, we expect that Australia may defy its optimists by slowing sharply in 2011.

In Japan, meanwhile, we believe that there is a major policy shift occurring with regard to the way in which economic policy is being conducted. Having attempted a series of demand-boosting measures over the last 20 years, the authorities now appear set on attempting a radical reform of the supply side economy. In an effort to revive the weak economy, the authorities seem intent on removing what demand stimulus they are offering so as to clear out the 'dead wood' in the economy and force the remaining private sector to become 'fitter'. In the long term, we are optimistic that this will create an important turning point for the economy but in the near term the policies are likely to create a new recession just as those of Thatcher in the UK and Douglas in New Zealand did at similar points in their nations' histories. Japan may be beginning on a road to an improvement in its underlying situation but in the near term the costs in terms of lost output, unemployment and corporate distress may be quite significant.

Finally, another source of volatility for the global economy is likely to come from Europe. Quite simply, we do not believe that the solution to the Euro area's problems lies in a deflation of

incomes in the periphery. In fact, if incomes continue to decline in the periphery, we believe that not only will the level of private and public sector defaults continue to rise (or the need for IMF-style rescues increases exponentially) but also that Europe's population will quickly tire of the Euro system and elect governments that will seek to extricate their economies from its strictures. Indeed, such a scenario could occur as quickly as March in the case of Ireland. Consequently, we believe that if the Euro is to survive, it must do so as a weak currency in which inflation is structurally higher, particularly within the core countries such as Germany. This will not be a popular stance amongst Germany's traditionally inflation-wary population and consequently we expect the Euro to remain a source of market instability and concern for much of the year. In such an uncertain environment, global currencies can be expected to remain volatile, although on balance the USD may perhaps gain at the margin amongst its major peers.

In the near term, we expect equity markets to begin 2011 well as the investment banks continue to leverage themselves back into the markets but, as inflation fears continue to mount on the back of China's runaway boom and the Bank of Japan's less accommodative stance, global bond yields may continue to rise. By the middle of the year, though, we would expect concerns over not only inflation but also the sustainability of global growth to emerge and markets to suffer a new round of instability as governments debate how to react to what by then may be a troubling stagflationary environment.

Far from being a year of steady improvement, we suspect that 2011 may be as volatile as its immediate predecessors but at least it may start well for equity investors and for those of a mind to look for longer term themes, Japan's equity market may offer something of a buying opportunity before 2011 draws to a close.

Andrew's 2011 New Zealand Presentation Dates

Monday, 21 March 2011

9.00 am

Christchurch

The George Hotel

3.45 pm

Wellington

Wellington Club

Tuesday, 22 March 2011

7.15 am

Auckland

Northern Club

Andrew Hunt

International Economist

London

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- New Zealand fixed interest and cash
- Socially responsible funds
- Global equities
- Global fixed interest
- Alternative investments

If you would like further information on Tyndall and how we can help you, please contact:

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