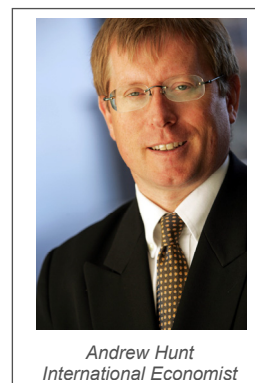


# Monthly Comment

February 2012

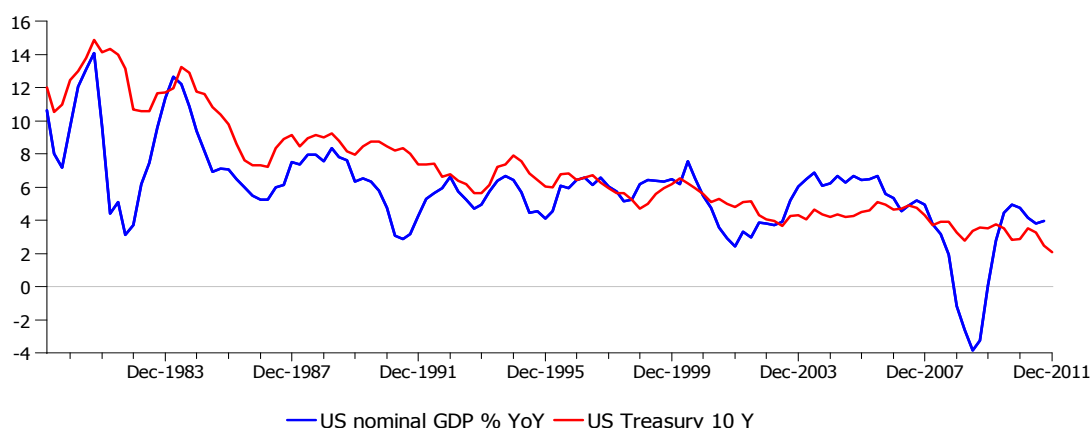
## Can We Afford to Retire?

In the 1970s and particularly in the early 1980s, bank deposit rates around the world were relatively high and savers at least felt that they were earning solid returns that might keep them in their 'Golden Years'. In fact, in the early 1980s, most savers were indeed earning good returns thanks to the high real inflation adjusted interest rates that were on offer: for a while one could gain 10% real yields in USD as Volcker took over at the US Federal Reserve. However, as global central banks finally began to win their war against inflation from the mid 1980s onward (or a little later in New Zealand's case), the rates on interest on offer from the simple bank deposit began to fade in both real and nominal terms. Indeed, had interest rates not declined, they would of course have become too high for the economies and certainly too onerous for private and public sector debtors to bear in anything other than the short term.



The first reaction amongst savers to this falling deposit rate event was to 'lengthen their duration' by notionally moving up the yield curve into longer duration government bonds; these seemed to be as safe as deposits but the yields were initially at least, higher. Savers were in effect sacrificing some of their liquidity / ability to access their funds so as to maintain their income yields. However, by the late 1980s and early 1990s, yields on these instruments had also begun their long fall, an event that has continued over recent years and which has taken yields down to levels that essentially offer investors little or no income. It is a fact of economics that nominal bond yields and nominal GDP growth rates cannot diverge for long without causing the government solvency problems (this is what has just occurred in Greece with calamitous results) and so we can argue that the "death of inflation" since the 1980s, which has brought nominal GDP growth rates down, has also robbed savers of the high yields that they might once have obtained from government bonds.

**USA: Treasury 10 Year Yield**  
% pa



Faced with both declining deposit rates and bond yields, investors began to move notionally up the risk curve into corporate bonds, but, by the late 1990s, rates on these instruments had also been forced down as well. The next move was into even riskier equities and of course into property (the 1990s) but, by the late 1990s, both of these had become relatively low-yielding and seemingly expensive, with the result that the (actuarial) expected returns from these instruments began to decline as well.

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Having by then exhausted the spectrum of conventional instruments, investors then were obliged to move towards the more exotic, such as derivatives, leveraged hedge funds or the use of greater gearing in their own portfolios. The more adventurous investors became and the higher the prices and valuations of the different asset classes became (with the help of Greenspan's great monetary experiment of the 1990s and 2000s), the more expected future returns began to diminish as asset prices became ever more richly priced.

Consequently, by the late 1990s and early 2000s, investors had become desperate for expected returns in what had become expensive and low-yielding markets and so they began to need more volatility, so that they could try to gain excess returns above the potential market through trading, complex structures or information advantages – they began to look for “alpha” (in the investment lingo). Hence, as massive risk-taking became ever more prevalent, one symptom of this became (rather amusingly) the wholesale hiring of mathematicians from the world's best universities in the hope that these boffins could somehow design models that could produce returns for their employers. As the level of total risk in the system began to grow exponentially, though, so too did its intrinsic fragility. Indeed, it was this path that ultimately led to the rise – and subsequent fall – of the CDOs and the Global Financial Crisis (GFC).

By the mid-2000s, investors' apparently pressing demand for strong returns where there were none intrinsically to be found had led to the explosion in leverage, risk-taking and the “casino culture” that existed within some of the world's banks. It is ironic that perhaps the central banks' greatest success in the modern era – namely their conquest of inflation – led ultimately to their greatest failure – the global credit boom that ultimately led to the GFC.

The basic problem for investors who want incomes from their investments (either for its own sake or simply to justify higher market prices for their investments) is that there is only so much available in an economy that is growing at a finite rate. We noted earlier how interest rates cannot diverge too far from GDP growth rates over the longer term and since GDP is the sum of all incomes in the economy, this is the effective upper limit on long-term investment returns. Therefore, in order to gain high yields, the underlying economy must grow rapidly, preferably in real terms (high nominal interest rates but low real interest rates may feel good but actually are of no benefit to savers seeking to fund future consumption).

The question then becomes how does one generate real growth? The last few years have shown that expansionary monetary or fiscal policies may be successful at generating short bursts of economic growth and optimism in financial markets but they have also shown that, when these policies are reversed, as they always are, the growth and asset market returns that they have created are quickly reversed. For example, the US and other countries' huge fiscal expansions of 2009 did deliver growth in 2010 but, as fiscal policy was tightened once again in 2011, the growth and buoyancy in investment markets was reversed all too swiftly.

We would argue that strong sustainable growth cannot come from contrived fiscal or monetary policy actions but rather from the supply side, namely entrepreneurs and real world investors creating products that people want to buy. The late Steve Jobs provided a huge boost to the South Bay area of San Francisco, not by gaining artificial government stimulus funds, but by bringing products to the markets that people wanted to buy. It is for this reason that Palo Alto real estate prices are still rising, four years after the national markets peaked.

Not every country can have a Jobs, Gates or other trailblazer, but in the US, UK and Australasia it is notable that the fastest rates of income growth are increasingly to be found amongst the self-employed or micro-businesses. These companies receive little or no direct help from governments, they often need little capital but they do produce incomes and they do generate rising tax receipts for cash-strapped governments. In short, these small businesses could become the cure for the current global economic and investment world malaises. If these companies grow, then so will the economies and the ability for savers to meet their retirement income goals.

What these companies do need, though, are political, social, educational and most of all regulatory environments that favour and support their growth and we would suggest that it will be the countries that produce these conditions that ultimately will emerge first from the current slump. The US has some momentum in this regard, as do the UK and we suspect New Zealand, although the UK seems handicapped by its failing education system (the cause of the recent surge in youth unemployment in an otherwise fully employed labour market). Japan tends for cultural reasons to be less supportive of entrepreneurs and Europe's regulatory environment can simply be stifling. This would seem that this is one area in which the “Anglos” have an advantage, if their governments choose to capitalise on it.

For investors at the current time, we would argue that asset markets are today relatively cheap following last year's poor performance and hence the recent rally may continue a while longer, until either the next crisis in the weakening European economy erupts or a fiscal tightening in the USA is finally obliged to occur. Longer term, more sustainable investment returns will likely only be found by identifying those companies and countries that can create endogenous growth from the bottom up. These will allow one to retire whereas chasing markets may not be so profitable, unless one is a truly talented trader.

**Andrew Hunt**  
**International Economist, London**

**Andrew's Summer 2012 New Zealand Visit**

Timaru – Community Trust Conference	Thursday, 15 <sup>th</sup> March	1.15 pm	
Christchurch	Monday, 19 <sup>th</sup> March	9.00 am	The George Hotel
Wellington	Monday, 19 <sup>th</sup> March	4.00 pm	Wellington Club
Auckland	Tuesday, 20 <sup>th</sup> March	7.30 am	Northern Club Wholesale Clients
		10.00 am	Northern Club Advisor Focussed Session

Full details to be circulated shortly or contact [helen.mckenzie@tyndall.co.nz](mailto:helen.mckenzie@tyndall.co.nz) for further information.

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