

Monthly Comment

January 2012

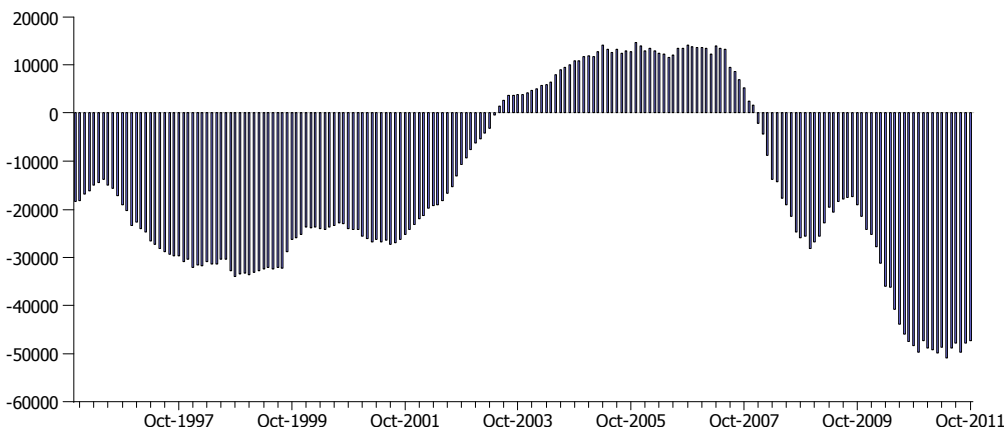
The Outlook for 2012

Following the economically traumatic events of 2008-9, many governments around the world reacted by easing both their fiscal and monetary policies. In terms of their effects, the easing of fiscal policy in the West clearly provided a temporary but, unfortunately, only one-time boost to economic growth in the developed world and it is now also clear that the primary impact of the easier monetary policies in the West was merely to create a revival in asset prices (as investors sought better returns away from the collapsing interest rates offered on bank deposits) and an explosion in capital flows to the emerging markets.



These quite unprecedented (in sheer scale) capital flows to the emerging world were ultimately recycled by the local banking systems into new and, initially at least, economically expansionary credit booms in the developing world. Unfortunately, two years later, it is clear that these credit booms have simply proved to be “inflationary” and distorting for the economies concerned, with the result that many of the emerging market capital flow boom recipients are now significantly overheated and, as a result of their now weaker underlying trade account positions, they have become dependent on continued capital inflows from the West at a time in which the West’s ability to provide these capital flows has been diminished by the Euro crisis. For example, Brazil’s economy (despite its commodity wealth) is now running a significant current account deficit as a result of the surge in imports that was occasioned by the credit boom that itself resulted from the initial surge in capital inflows. The existence of this deficit implies that Brazil must now “borrow” or source foreign savings to finance its negative trade gap, thereby implying that it has gone from being a simple recipient of capital flows to a country that is dependent on them, a situation that it must now address if it is to improve its long-term economic prospects and move its economy onto a more sustainable path.

**Brazil: Current Account Balance
USD million over 12 months**



Meanwhile, in the Western economies, it is also clear that the huge stimulus that was provided to the domestic economies by the equally unprecedented coordinated fiscal easing of 2009 has not only ceased, it has begun to reverse as austerity has become the new buzzword in policy circles. Many governments now fear that they could become the “next Greece” if they do not control their levels of government borrowing and, particularly in the other members of the Eurozone, this has led to an acute and again unprecedented coordinated tightening of fiscal policy, even as many of the OECD’s household sectors have continued to wrestle with their own balance sheet problems.

Therefore, even before one considers the implications and possible effects of the Euro crisis, it is clear that the world economy faces a number of important and potentially destabilising challenges in 2012, such as how to manage the withdrawal of the West’s fiscal stimulus and how to unwind what had become an unstable and damaging capital flows/credit-driven economic cycle within the emerging markets.

One thing that we can suggest is that economic growth in this environment may turn out to be a scarce commodity. In the OECD, the removal of the fiscal stimulus will clearly provide a substantial headwind to economic growth that we suspect may be amplified in many cases by the local household sector's own continued need for further balance sheet consolidation and austerity. Specifically, as Western governments raise taxes, reduce expenditure levels and remove their other support measures, they will implicitly reduce the cashflow receipts of the private sector, thereby reducing the resources available to the latter for its own saving and debt reduction needs, a situation that we suspect will result in sharp falls in private expenditure and hence economic activity as households and companies react to the drop in cash inflows by reducing their outgoings.

Indeed, as both the public and private sectors attempt to save, we could find that a classic "paradox of thrift" dynamic evolves, whereby the rise in savings *rates* and the reduction in expenditure is so strong that incomes fall and the economies shrink by so much that actual nominal savings do not rise in cash terms. Indeed, we have already witnessed in Greece and Ireland that successive austerity budgets have actually left the overall size of the budget deficits unchanged as the economic weakness that they engendered has reduced private incomes and hence the available tax base.

In terms of the countries likely to be most affected by this problem, we would suggest that the relatively highly indebted countries of Southern Europe who are also under the greatest pressure to embark on fiscal austerity programmes are the most at risk, while in the USA, the reluctance to tighten fiscal policy further may actually work in that economy's favour, in the near term at least. Although US households are hugely indebted, the Administration's desire not to tighten fiscal policy combined with the still beneficial effects of the weak dollar policy in the post-crisis world should allow the US economy to continue to expand in 2012, albeit only modestly.

Elsewhere in the OECD, Japan's economy may also expand modestly in 2012 on the back of the earthquake reconstruction projects, although even here we expect weak or contracting levels of private sector demand. In Germany, there may be some modest growth in domestic demand this year but from the point of view of overall GDP, the likely contraction in the country's exports will tend to offset this with the result that we only expect a very modest expansion in Germany this year. In the Southern Hemisphere, Australia's long credit/capital flows driven boom seems likely to finally come to an end and it is notable that personal income growth in the economy has already faltered. Although the central bank may attempt to counter the slowdown with an easier monetary stance and in all likelihood a softer currency, we suspect that the country's huge household sector debt burden will ensure that growth here too remains minimal. New Zealand may fare better; although the household sector is also heavily indebted, income growth has been quite upbeat by global standards of late as a result of the farm product price boom and this should continue to provide some support for the economy in 2012, albeit at the probable expense of some deterioration in the current account balance.

In the emerging markets and particularly in the much-hyped BRIC economies, we expect 2012 to represent a more difficult year as the countries are obliged to wean themselves off their capital flow dependency and also as many of them begin to tackle their own fiscal problems. In particular, Brazil, India and China each grew rapidly in the years following the Global Financial Crisis but much of this growth was either due to the impact of capital flows or unsustainably expansionary fiscal policies that must now be reversed. Indeed, we expect Brazil's economy to flirt with a recession in 2012, China's economy to undergo a sharp economic slowdown (to virtually no growth in per capita terms) and India's rate of growth is already slowing sharply. Moreover, the slowdown in these economies will have negative implications for growth rates in the rest of the EM world.

These forecasts, sober though they may seem, are all predicated on the assumption that the Euro does not break up in 2012. While we can see sound economic and even political reasons for the Euro to break up in the long term, we suspect that the ECB's latest actions coupled with the various rescue funds that have been enacted will allow the Euro system to remain intact this year. Unfortunately, we doubt that any of the measures so far announced will solve the Euro's underlying and fundamental design faults but we suspect that 2012 will appear much like 2011 with regard to the Euro – sentiment will wax and wane between optimism and pessimism but essentially the system will soldier on without either a successful resolution or a capitulation and this will provide a volatile environment for risk assets (and we would increasingly describe many sovereign bonds as risk rather than safe assets in this world).

Overall, we expect 2012 to be a challenging one for investors. There may well be periods of optimism in markets when new “Euro packages” or even a new Quantitative Easing regime is announced in the USA ahead of the elections but we also expect to experience moments of despondency within markets as well when summits fail or economic growth disappoints. In this difficult environment, we would tend to overweight US assets while avoiding Eurozone and EM assets, but in practice we suspect that 2012 will be a trading year in which investors should buy what is cheap and sell what is expensive as the different asset classes move relative to one another; what investors should probably not attempt is to momentum invest or “chase markets”. There will be bond market rallies and equity market rallies and those swift enough to capitalise may be able to gain some excess returns, but in general 2012 may be another challenging year for investors.

Andrew Hunt

International Economist, London

Andrew’s Summer 2012 New Zealand Visit

Timaru – Community Trust Conference	Thursday, 15 th March	1.15 pm	
Christchurch	Monday, 19 th March	9.00 am	The George Hotel
Wellington	Monday, 19 th March	4.00 pm	Wellington Club
Auckland	Tuesday, 20 th March	7.30 am	Northern Club
		10.00 am	Northern Club

Full details to be circulated in late January or contact helen.mckenzie@tyndall.co.nz for further information.

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