

**Diversified**

## Diversified's View

May 2010

*"The unfortunate reality is that the Greek populace has not yet really seen or even felt the pain." BCA Research GIS Weekly Bulletin of May 7<sup>th</sup>, 2010.*



Diversified Wealth Management Limited's two Unit Trust, Portfolio Investment Entities are weathering the market volatility well. The monthly Unit Price at April 30<sup>th</sup> 2010 was 1.1026 for the *Diversified* Balanced Fund – a mere 0.4% below the record price set in April. The newer and more volatile *Diversified* Dynamic Fund's Unit Price was is \$1.0112 – down 0.09% from April.

A joint Investment Statement for both Funds is available on our website, or by contacting our office or from associated Advisors.

*Diversified* also manages The Law Retirement KiwiSaver Scheme, which offers 'Balanced' and 'Dynamic' choices to its members. An Investment Statement for the Law Retirement KiwiSaver Scheme is available from leading Advisors, from *Diversified*, or directly from the scheme's own website: [lawretirement.co.nz](http://lawretirement.co.nz).

### Summary

- There are always risks, but recent market ructions have not derailed *Diversified's* core belief that robust global economic expansion is most likely to prevail over 2010 and into 2011.
- Neither of peripheral Europe's painful adjustments, nor major sharemarket swoons, are game-changers in our view.
- Global growth remains substantially synchronous across the major blocs, aside from minor divergences. Measures to support the PIIGS (low interest rates & euro), will be stimulative for core Europe. Eventual recovery of those undergoing IMF-imposed discipline may extend the expansionary cycle.
- Global prosperity will underpin rising corporate earnings this year. The macro-economic setting favours the Equities Asset Class, along with selected Commodities.
- *Diversified* finds yields on conventional Fixed Interest and particularly on Sovereign Bond Funds, to be generally inadequate.
- The 'safe-haven' attraction of gold bullion has ebbed with the GFC. Jewellery demand is down. Our model weightings have been trimmed from high to neutral.
- The NZ Budget 2010 gently nudges away from the 'Third Way' fallacy popularized by the UK & peripheral Europe. Our low base, relative to trading partners, should eventually lift growth rates here on more competitive levels.
- While *Diversified's* economic view remains positive, markets are no longer as cheap. As ever, the future is uncertain. Systematic diversification is maintained across all risk models.
- *Diversified's* formal, Quarterly strategy review currently underway, is not expected to result in radical changes to current asset allocations.

**Late Note:** Budget 2010 bestows tax advantages on Managed Funds over individual portfolios. *Diversified's* Balanced and Dynamic PIE Unit Trusts, and the Law Retirement Plan's KiwiSaver or Superannuation Schemes, will enjoy the new tax benefits.

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An Adviser Disclosure Statement is available on request and without charge, or may be accessed via our website.

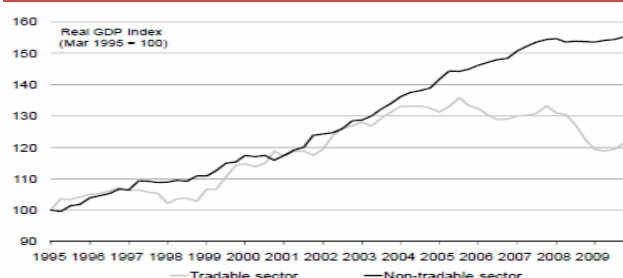
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## New Zealand – Pass mark for Budget

Budget 2010 nudges the NZ economy from its unsustainable, Greek-style path of the prior decade. Governments since 2000 had embraced the fabled ‘Third Way’ socialism. Massive transfer of resources, powers and intervention in most every aspect of the real economy, are now revealed to have crippled the UK and peripheral Europe with debt.

Taxes are determined by the size of government – and NZ’s has blossomed in the past decade; significantly faster than our rate of economic growth, and crowding the wealth creative sector into recession since 2004.

## Growth of non-Tradable vs. Tradable Sectors



Source: Treasury, Fiscal Strategy Report, 20 May 2010.

The 2010 Budget seeks to slow the rate of government expansion. The Budget aims to contain further expansion of Core Crown Expenses, to +19% (\$64.8 billion to \$77 billion) over the next four years. Net Debt will expand by +137% (\$26.6 billion to \$77.8 billion). Politicians and pundits ponder whether the current tax re-allocations are ‘fair’. But Deficits are only deferred taxation, and one wonders at the intergeneration fairness of a national debt commanding \$1,200 p.a. from every man-woman-and-child beyond 2015, simply to service interest.

The Budget offers a mild inducement for Kiwis to save, via a concessional maximum-tax-rate of 28% - provided investment gains are achieved. This is somewhat less than Australia’s 15%, or Canada’s 0% rates levied on savings for retirement. Meanwhile, NZ’s government will continue dissaving through 2015.

The good news is - and assuming a strong external environment - NZ’s economic trajectory should be sound if unexciting. Projected growth is for a globally undemanding, but realistic pace, given our history. There is little room for contingency. Back-sliding, cost blow-outs or tax short-falls, would jeopardize NZ’s AA+ credit rating.

## Key Economic Projections – March year-end

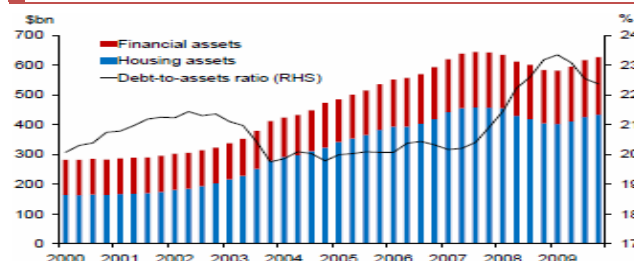
	2010	2011	2012	2013	2014
GDP % yoy	-0.3	+3.2	+3.1	+2.9	+3.0
Inflation (CPI) yoy	2.2	5.9	2.4	2.4	2.4
Unemployment	7.1	6.2	5.5	5.1	4.6
Curr.Acct (%GDP)	-2.6	-4.4	-6.1	-7.0	-7.3
90-Day BB % p.a.	2.70	4.3	5.2	5.4	5.7

Source: Excerpted from BEFU, May 2010

Challenges will include, isolating the GST-hike related inflation spike, of 2011. Whilst supposedly offset by lower income taxes, many current wage, benefit or other allowances, include or assume automatic CPI increases, which may exacerbate inflation in the years following.

Adaptive Kiwis are already responding to market signals. The ratio of debt is falling and that of financial assets is gaining.

## Kiwi Investors – step in the right direction



Source: RBNZ Financial Stability report, May 2010.

Positive surprises might include a major Oil & Gas strike in NZ waters, or a big mineral discovery or scientific break-through, to which NZ now seems more disposed.

*Diversified’s* strategy review is expected to confirm a neutral allocation to NZ, and with foreign currencies diversified, rather than swapped back to NZ\$.

## Australia – High-growth economy

A Federal election is expected later this year (constitutionally, the writ may be delayed to February 2011). While the incumbent Labor Party is expected to be returned, polls now indicate a greater campaign and distraction, than was earlier envisioned.

The Australian government’s proposal to surtax efficient Resource producers, to subsidize other sectors, is environmentally wasteful. Efficient Miners extract all ‘ore’ down to the lowest grade matching their costs-of-production – usually at the edges. Any increase in cost reduces the size of each ore-body geometrically. By-passed material is never economically recoverable, and is

wasted. New, 'high-grade' mines must be discovered and opened to meet global demand for basic materials.

Fortunately, Australia's legacy of good growth policies finds their economy sufficiently strong to absorb some mistakes.

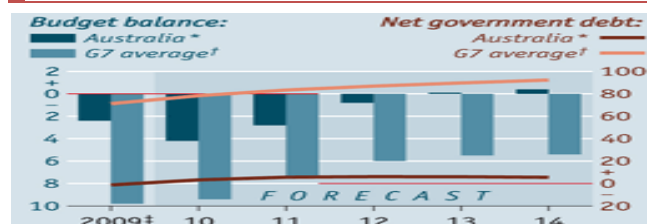
#### Key Economic Forecasts - Australia

	2010	2011	2012
GDP % yoy	3.2	3.4	3.5
Inflation (CPI) yoy	2.4	2.8	2.9
Unemployment	5.2	4.7	4.5
Curr. Acct (%GDP)	-4.5	-4.0	-4.5
90-Bill Rate % p.a.	5.0 (Dec)	5.05 (June)	

Source: ANZ Australian Economics Toolbox, 18 March, 2010

Australia's fiscal and debt positions remain the envy of Western governments. Australia's modest deficit is projected to be eliminated by 2013. Elimination of deficit will leave cumulative net government debt, at a very low and stable level.

#### Deficit & Debt - as percentage of GDP



Source: *The Economist*, 13<sup>th</sup> May, 2010

*Diversified's* tactical positions currently favour Australia for its development heritage, higher growth and linkage to expected global expansion. Equities and Cash rates are attractive.

#### International - Expansion looks intact

*Diversified's* process applies tactical tilts based on our proprietary view of macro-economic fundamentals, determined with a one-year to 18-months horizon. Our outlook and settings are formally reviewed quarterly.

Whilst suddenly extremely topical, troubling Western deficits, burgeoning cumulative debt levels (atop rising dependency ratios, aging demographics with commensurate health costs), are not new.

Nevertheless, our review finds the greater probability is still that broad global growth at a robust pace will prevail. Economic expansion among the major trading blocs - China, India, Brazil, Japan, USA and even 'core' Europe - remains synchronous. Although distracting, Greece's

economy is 1/12<sup>th</sup> that of Germany's, or 1/9<sup>th</sup> that of France. For Europe as a whole, the lingering low official interest rates, easy credit and currency depreciation - necessary to soften recessions in peripheral Europe - are coincidentally very stimulative for the larger, industrialized and export-oriented, core nations.

#### GDP Growth Outlook for Calendar 2010 (% y-on-y)

Region/Country	Survey in Jan 2010 (for calendar 2010)	Survey in Apr. 2010 (for calendar 2010)
<b>Developed Wld</b>	<b>+2.1</b>	<b>+2.3</b>
- USA	+2.7	+3.1
- Euro-land	+1.0	+1.0
- UK	+1.3	+1.3
- Japan	+1.7	+1.9
<b>Emerging Mkts</b>	<b>+6.0</b>	<b>+6.3</b>
- Brazil	+4.7	+5.5
- Russia	+3.6	+4.0
- India	+7.7	+8.8
- China	+10.0	+10.0
<b>World total</b>	<b>+3.9</b>	<b>+4.2</b>

Source: IMF's World Economic Outlooks, Jan., 2010 & April, 2010

Financially, Europe is integrated. To a very significant extent, core Europe are creditors to the excesses of Portugal, Ireland, Italy, Greece & Spain - collectively known as the PIIGS.

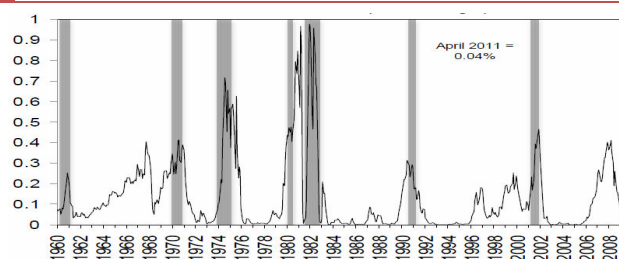
#### The PIIGS Problem is Europe's Problem - European Banks Foreign Exposures in US\$ billion

Bank Nationality	Greece	Portugal	Spain	%
Germany	45	47	238	26%
France	79	45	211	26%
UK	15	26	110	12%

Source: Data after BCA's, GIS Weekly of May 7<sup>th</sup> 2010

We take comfort in statistical evidence the probability of the fabled 'double dip' recession in flagship USA is negligible - 0.04% probability to be precise.

#### American Economy - Probability of Recession



Source: NY Federal Reserve, May 10th, 2010

Beyond our tactical horizon, the global outlook is more disparate. The ingrained Western (including Japan) habit of mistaking debt for income is speeding toward a demographic wall. Already high tax levels – are inadequate to fund age-related ‘entitlements’ and face diminishing tax-bases. Exploding national debts are unsustainable. Generally, Emerging Markets by comparison, appear fiscally prudent and flexible.

#### Selected National/ Regional Deficits & Debts

	Fiscal Deficit (balance)		Cumulative Gov't Debt as % GDP	
	2010	2011	2010	2011
Germany	-5.3%	-4.6%	82%	85%
Greece	-9.8%	-10.0%	123%	130%
Ireland	-12.2%	-11.6%	81%	93%
Italy	-5.4%	-5.1%	127%	130%
Portugal	-7.6%	-7.8%	91%	97%
Spain	-8.5%	-7.7%	68%	74%
Japan	-8.2%	-9.4%	197%	204%
United Kingdom	-13.3%	-12.5%	83%	94%
United States	-10.7%	-9.4%	92%	100%
Asia <sup>1</sup>	-3.5%	-3.6%	40%	41%
Central Europe <sup>2</sup>	-4.4%	-3.9%	28%	29%
Latin America <sup>3</sup>	-2.4%	-2.0%	37%	35%

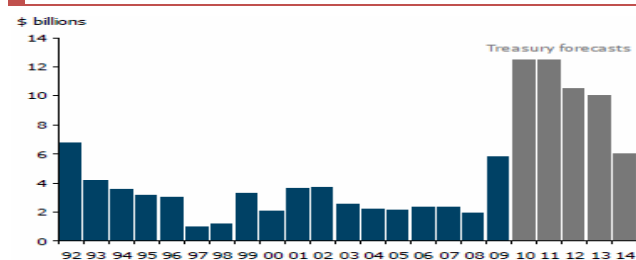
Source: Selected data from BIS Working Paper 300, March 2010, Table

The situation amplifies *Diversified's* stance that Emerging Economies should command attention at least proportional to their relative economic importance, in strategy considerations. We find the popular artifice of sharemarket capitalization weightings to be inversely prospective.

#### Fixed Interest – Yields low; supply infinite

Even within ‘fiscally conservative’ NZ (relative to average Western national indebtedness), the planned trajectory for issuance of new Government bonds shows no shortage of supply ahead.

#### NZ Bond Tender programme – June years



Source: ANZ 2010 Budget Review.

Yet yields on Sovereign Bond are at or near record lows for most issuers - and still attracting record inflows.

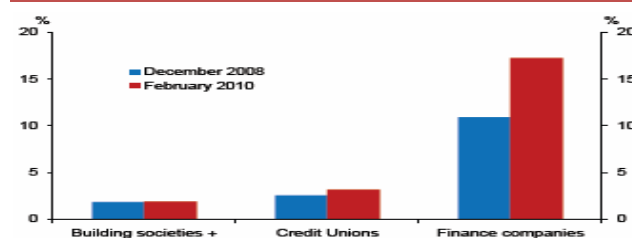
#### 10-yr Bond Yields – are Paltry

NZ	Aust.	UK	USA	Germany	H-K	Japan	Brazil
5.6%	4.5%	4.7%	3.50%	3.00%	2.16%	1.3%	10.0%

Source: Variable sources, collated by *Diversified*, in mid May, 2010.

Investors with portfolio allocations underweight in Gov't Bonds can take comfort that, if they miss out now, regular Gov't Bond tender programmes across the West guarantee many more opportunities to enter the market. Good of 'em, huh?

#### NZ Finance Co's – Crown Guaranteed, Non-performing Loans as Percent of Lending.



Source: RBNZ Financial Stability report May 2010

Directors, managers and celebrity promoters of failed NZ finance companies may like to blame the global financial crisis, the US mortgage crisis or whatever. But the reality is that Finance Companies engaged in imprudent lending - some of it benefiting non arms-length parties. Amidst this very same setting, Building Societies and Credit Unions contained losses to manageable levels. Sadly, non-guaranteed investors' often face far more severe losses than the 17%-of-the-book, tax-payers are on the hook for so far.

*Diversified's* model allocations to Fixed Interest are at minimum levels required for diversification purposes. For NZ we currently favour relatively short (2 to 3-yr) maturities. Internationally, we favour Corporate issuers including Utilities and selected Emerging Markets for sovereign debt.

**Equities – “The things that will destroy America are prosperity-at-any-price, peace-at-any-price, safety-first instead of duty-first, the love of soft living, and the get-rich-quick theory of life” . . . Teddy Roosevelt. US President 1901 - 1909**

Amidst extreme volatility recently befalling senior sharemarkets, it is a useful discipline to have a one-year to 18-month, tactical horizon. We gauge aggregate

markets will in all probability be higher over that period. Consistent with expecting continuing global prosperity, we view the current market volatility, as a 'correction' within a continuing Bull Market. A consolidating 'shake out' of speculative fervour, following the impressive, 'V'-shaped rebound of the past year, may be salutary. At the risk of being famously wrong, the broad market advance we expect to resume.

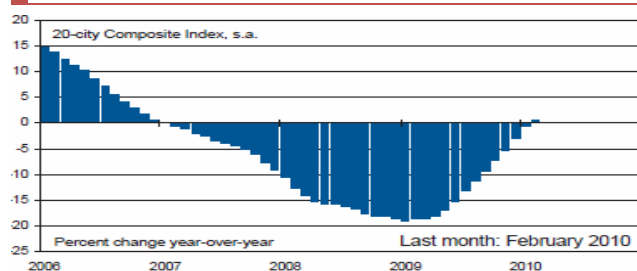
During the Great Financial Crisis, and throughout Developed and Emerging Markets alike, corporates pruned overhead, lifted productivity and now have excess capacity. Survivors' earnings have already expanded in tandem with deflation; a factor we gauge will continue. Meanwhile, input costs, including energy, lag the recovery. A period of above-average, sharemarket returns, underpinned by earnings expansion is likely to characterize our tactical horizon.

*Diversified's* model strategies advocate a full weighting to the Equities Asset Class. While 'defensive' styles have been retained in 'Balanced' models, long-only styles and deflation trades now predominate in 'Dynamic' risk profiles.

## Property – some sectors basing

Now without reason, the severe tumble of USA residential house-prices has been attributed as the underlying cause of the Great Financial Crisis. Regardless, the rate of falling has progressively abated since early 2009, and has now ceased. However rumours abound that Commercial Property sector is less efficient in achieving a similar price-clearing level.

### US House Prices – Case-Schiller Index



Source: DundeeWealth Economics, April 2010

*Diversified* finds Property less compelling than other Asset Classes. However –from a 'zero' allocation prior to the GFC - models recently re-engaged. An initial allocation is small and features a large and diversified Australian-based fund specializing in Retail Property internationally. From a low base, Retail Sales are already showing statistical pick-up as a result of successful deflation.

## 'Commodities & Commodity Producers' Shares

Commodities as an Asset Class have latterly been embraced by some institutional managers as 'the next big thing'. Frequently claimed attributes of an allocation - heightened portfolio diversification, a hedge against possible inflation, and leverage over global growth (particularly of resource hungry, Emerging Markets) – are accurate but not new.

We do note the rally in prices is now well advanced. While the real and lucrative absolute gains recorded by many physical commodity prices recently have been impressive, they may also have a cyclical factor. Investors should be cautious. The long-term (200 year) trend for commodity prices has been downward.

*Diversified's* preferred access to the commodity Asset Class now, is via shares in Commodity Producers. Physical prices need only remain at lofty levels – and can even dip a little – for producers' earnings to prosper.

### Gold:

'Gold Bugs' impressed by headlines & euphoric claims of "New Highs", should check their currency. In fact the price of Bullion for Kiwi's peaked back in February 2009, at a delightful \$NZ1859 per troy ounce.

### Gold Bullion in NZ\$



Source: *Diversified's* Research, end April 2010

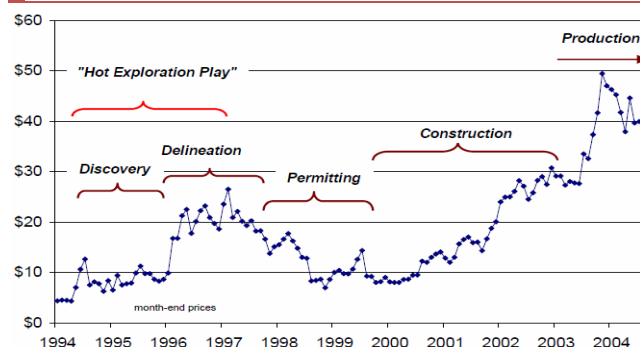
*Diversified* introduced a 3% allocation to physical gold bullion model strategies back in 2004. From there, the recommended weighting peaked at 13%, coincident with the height of the Great Financial Crisis. Model weightings were then trimmed into buoyant markets. The model weighting now stands at a neutral level (around 5% for Balanced profiles); and this retained for systematic portfolio diversification.

Profits have been applied to deflation trades. Allocations to Gold Producer's Shares - via an Exchange Traded Fund (ETF) complemented by share in one of the world's largest producers - - remain elevated.

### Junior Mining Promotions – not for the faint hearted

The rediscovery of profitability by established miners, facilitates promotion of projects “as rich as Croesus”. It is a field in which we have some little experience. In addition to issuer & geological risks, investors should be prepared for a lengthy and highly volatile trajectory, endured even by the small sub-set who successfully achieve production. The sector exemplifies reward being related to risk, and a great case for diversification.

### Share-Price Trajectory - Typical Successful Mining Play



Source: Salman Partners, Morning Metals Note, 19 May, 2010

### Currency – A diversified basket is least-risk

We conceded currency is potentially the most lucrative Asset Class; a fact eminently identifiable with hindsight. Sadly, future currency trends prove unfathomable. (If highly successful traders exist, they are certainly very private).

In the absence of a strong conviction of imminent appreciation, concentration in any single currency carries issuer risk.

*Diversified's* model strategies include exposure to all the major currencies, and are substantially diversified from NZ\$ risk.

### NZ\$ Exchange Rate Forecasts

	Dec '10	June '11	Dec '11
US\$	0.70	0.68	0.65
A\$	0.77	0.76	0.76
Euro	0.61	0.58	0.53
GBP (£)	0.47	0.46	0.43
Japan ¥	65.8	66.6	65.0
NZ\$ TWI	68.4	66.5	63.7

Source: Rounded from ANZ Market Focus, 17th May, 2010.

### Salient Rates, Indices, & Exchange Rates

Following are the April 30<sup>th</sup>, 2010 rates and selected equity market indices, relevant currencies, with their percentage gain or loss from that of three months, six months, and one year earlier. Figures are before taxation, fees or any impact from NZ currency.

ACTUAL	30/04/'10	3 Months	6 Months	One year ago
Prevailing Monetary Conditions Index.	+384	+217	+220	-475
Prevailing NZ Cash Rate (90-day)	2.70% pa	2.77% pa	2.79% pa	2.86% pa
Prevailing 2011 NZ Gov't Stock Yield	3.89% pa	3.99% pa	4.32% pa	3.45% pa
Prevailing 2015 NZ Gov't Stock Yield	5.23% pa	5.18% pa	5.49% pa	4.80% pa
CHANGE	Value	Gain or loss since...		
NZX NZ Gov't Stock [Bond] Index	1110.68	+1.2%	+3.4%	+3.8%
NZSE 50 (Gross)	3286.13	+3.8%	+2.2%	+19.9%
NZSCI (Gross)	21056.43	-0.6%	-0.6%	+21.6%
S&P/ASX200 (Australia) *	4807.40	+5.2%	+3.5%	+27.2%
MSCI World Index (Capital)*	1198.56	+7.1%	+8.4%	+35.3%
Dow Jones (USA) *	11008.61	+9.3%	+13.3%	+34.0%
NASDAQ*	2461.19	+14.6%	+20.4%	+43.2%
FTSE 100 (UK)	5553.29	+7.0%	+10.1%	+30.9%
Nikkei DJ (Japan) *	11057.40	+8.0%	+10.3%	+25.2%
Hang Seng (Hong Kong) *	21090.23	+4.4%	-3.7%	+37.9%
NZD/USD	0.72	+2.6%	-1.2%	+28.6%
NZD/AUD	0.78	-1.1%	-2.6%	+0.4%
NZD/JPY	68.04	+7.6%	+1.6%	+22.4%
TWI	67.62	+4.6%	+2.9%	+21.7%
Gold (US\$ / oz., troy)	1,164.55	+7.2%	+11.7%	+31.5%
Crude Oil (WTI, US\$/bbl)	83.20	+13.0%	+7.5%	+65.2%

\*Indices, figures and performances in respective local currencies unless otherwise stated.

### NORMAN W. STACEY, INVESTMENT ANALYST

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