

## Diversified's View

May 2011

**"...the easiest part of the bull market in global equities is over, but bear market conditions are also absent."**

Chen Zhao, Managing Editor, BCA  
Research Global investment strategy,  
Special report, April 21, 2011

*Diversified* is an independent formulator of leading portfolio investment strategies. The objective is to position investors ahead of likely events. Model strategies apply a tactical asset allocation – based on a one-year to 18 month horizon – to a context of systematic diversification.

*Diversified's* model strategies are applied to:

- The Law Retirement Plan KiwiSaver Scheme;
- The Law Retirement Plan Superannuation Scheme;
- *Diversified* Wealth Management's 'Balanced' & 'Dynamic' PIE Funds; and
- Via AFA's as Individually Managed Accounts for private Clients.

The Unit Price for *DWM* Balanced 'PIE' Fund at 30<sup>th</sup> April 2011 was \$1.1731. The Unit Price for the newer *DWM* Dynamic 'PIE' Fund (at 30<sup>th</sup> April 2011) was \$1.0855. An Investment Statement is available at [www.diversified.co.nz](http://www.diversified.co.nz)

The Unit Price for Law Retirement KiwiSaver Scheme's Balanced Fund at 30<sup>th</sup> April was \$1.14614.

The Unit Price for Law Retirement KiwiSaver Scheme's Dynamic Fund at 30<sup>th</sup> April was \$1.14437.

Investment Statements for KiwiSaver are available from the scheme's website: [www.lawretirement.co.nz](http://www.lawretirement.co.nz)

### Summary

- NZ Budget Tweaked bits, but Gov't essentially unchanged.
- For employees, participating in KiwiSaver to the extent of subsidies remains the best return from any legal investment. For the self-employed, the attraction is less attractive, though still worthy at a more modest level.
- The global economic expansion is intact. The world will be more prosperous over *Diversified's* one-year to 18 month, tactical horizon.
- Recovery from the Great Financial Crisis persists. Notably monetary and fiscal stimuli are still operating.
- Both the paces of growth and inflationary pressures depict a two-speed world. Emerging economies are knocking up against sustainable limits, while Developed economies generally have excess capacity.
- Outside NZ, many Developed countries are moving to tame the growth of government.
- Strong global aggregate growth favours 'growth' asset classes. Corporate earnings should continue to grow. High commodity prices are projected to endure, favouring producers.
- Prevailing bond yields are inadequate for the risks. At some point – and likely within our tactical horizon – bond yields are likely to rise sharply.
- The future is never knowable. Systematic diversification in remains the sole recognized defence against the unknown.
- *Diversified's* second formal strategy review of 2011 is currently underway.

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An Adviser Disclosure Statement is available on request and without charge.

Expertise You Can Trust

## New Zealand – ‘Smiling on the Spot’

We Kiwis have not been economically clever in recent times. New Zealand was in recession in 2004, before the Great Financial Crisis or the Christchurch earthquakes. Sub-par economic expansion, growth of debt, expansion of government and bureaucratic intrusion into all facets of life, commerce, business and now vocational licensing, is a less productive use of national resources than elsewhere. The May 19<sup>th</sup> Budget aims to slow the rate of growth of government, while hoping the economy, and as a consequence government's taxes, grow at a faster pace.

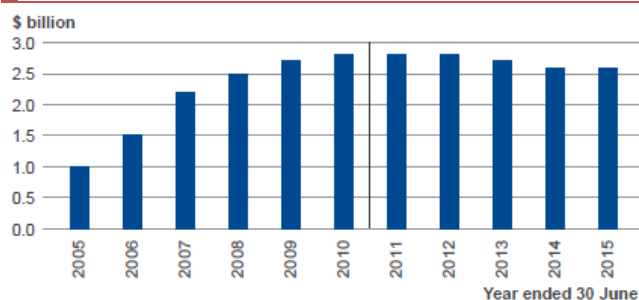
### NZ Gov't Fiscal Data, June Yrs, (in NZ\$ billions)

	2011	2012	2013	2014	2015
Core Crown Expenses	72.8	73.0	72.6	74.1	77.1
Core Crown Revenue	57.0	61.1	66.4	71.5	76.4
Deficit	-6.7	-9.7	-4.1	-0.7	+1.3

Source: Excerpted from Budget, 'Minister's Executive Summary', 2011

Advocates of Working-for-Families will be pleased the Budget chose to preserve this major redistribution. Costs had ballooned two-and-a-half fold over the initial five years. Budget changes will taper the unaffordable increasing expense of the programme, sustaining the value of benefits to near current.

### Cost of 'Working-for-Families' subsidies



Source: 2011 Key Facts for Taxpayers, 19 May, 2011

For KiwiSaver, the Budget's cuts are more and new taxes more material – but still leave significant incentives for savers. Changes from:

- July 2011, the matching tax credit will reduce to 50c per member's dollar contributed, to a maximum \$521 p.a. (previously \$1043)
- April 2012, Employer's 2% matching contribution will be taxed at the employee's top tax rate (previously exempted);
- April 2013, the minimum employee contribution rate, and the employers matching contribution, will each rise to 3% gross.

Importantly, the Budget did sufficient to avoid a credit downgrade. Key to restoring fiscal balance is the acceleration of Gross Domestic Product. During the next 12-18 months the NZ Economy should move with a quick pace. Further, and beyond 'one-off' stimuli attributable to the Rugby World Cup trappings and to Christchurch re-build, economic growth should be sustained at better than the recent pace.

Government functionaries advise they have been granted new powers from July 1st, and an eight-person squad is poised, to inspect files of AFA-registered, Retail Financial Advisers.

### Key Economic Projections (March year)

	2011	2012	2013	2014	2015
GDP Growth % p.a.	1.0	1.8	4.0	3.0	2.7
CPI Inflation Ann %	4.5	3.1	2.4	2.5	2.6
Unemployment % s.a.	6.8	5.7	4.8	4.8	4.6

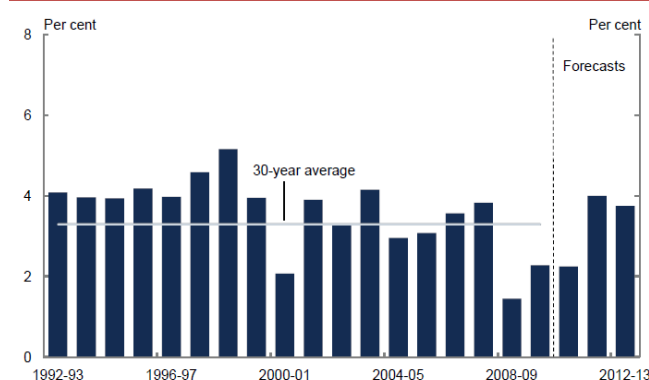
Source: Treasury, BEFU, May 2011

NZ's tardy arrival to the global economic recovery, ironically now places it in a relatively attractive situation. An allocation to NZ provides portfolio investors with both regional diversity as well as an improved economic prospect. Meanwhile, competing countries may be entering a more volatile phase of their economic expansionary cycles.

## Australia – Budgets was a cuzzie

Australia's Federal Budget on May 10<sup>th</sup> had been uncannily similar in tone to that of NZ, with a larger-than-expected-deficit, improving in a few years. Tweaking shunned structural change, while maintained most current social programmes with gently expanding expenditures. Natural disasters (floods and cyclones in their case), were blamed for the short-fall of prior official projections. Australia's more robust economy may facilitate return to surplus in the 2012/13 year. Tricky issues – in their case an Emissions Trading Scheme / carbon tax – were avoided.

### Australia's Real Growth – above 30-year average



Source: Australian Budget, Statement 2: Economic Outlook, May 10 .

Australia's pace of growth is expected to be above its 30-year average throughout our tactical horizon. Inflation nudging the 3% barrier will command the Reserve Bank of Australia's attention. Further Official Cash Rate hikes are expected.

### Australian Key Economic Forecasts – June 30 Year

	2010/11	2011/12	2012/13
GDP %	2.25	4.0	3.75
Inflation (CPI) %	3.25	2.75	3.0
Unemployment s.a. %	5	4.75	4.50

Source: Commonwealth Budget, Overview. May, 2011

Australia remains an important investment destination worthy of a significant allocation. It's higher Cash Rates, familiar governance, linkage to higher growth areas of the world, secure commodity production and pro-development policies, prove useful for portfolio additions.

## International - Still recovering from GFC

Although the global economic recovery from the depths of the Great Financial Crisis is now well advanced, many of the economic measures invoked to combat it are yet to be unwound.

A two-speed world appears to be unfolding. Very vigorous growth in Emerging markets is in some instances above the sustainable capacity, without triggering excessive inflation – fortunately amidst still accommodative macro-economic settings. But with China as exemplar, other regions are managing their economies competently and success is spreading. Sequentially, other Asian countries, and even Africa, are moving to be characterised by booming domestic prosperity, high credit growth and they are attracting big capital inflows. By contrast, policymakers in Developed economies are grappling to wean still fragile recoveries off monetary and fiscal stimuli, now clearly unaffordable.

The probability is that the global economic outlook throughout *Diversified's* one-year to 18-month tactical horizon will be of sustained economic growth at, or near, the current pace. Growth in Emerging Economies is expected to be two-and-a-half fold, that of the Developed world.

Expectations for growth over the next 12 months, as depicted by successive iterations of the IMF's World Economic Outlook, show the rebound since 2009 distinctly tapering.

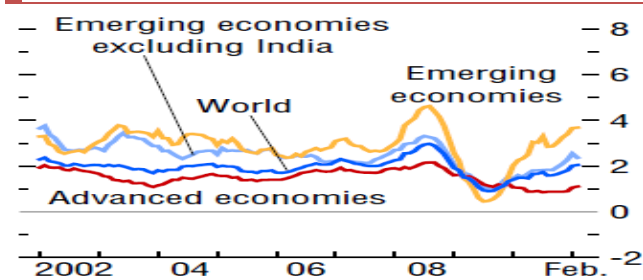
World Economic Outlook - % gain in GDP, 1-yr ahead

Region/Country	WEO Oct 2010 (for 2011)% p.a.	WEO January 2011 (for 2012) % p.a.	WEO April 2011 (for 2012) % p.a.
<b>Developed World</b>	<b>+2.2</b>	<b>+2.5</b>	<b>+2.6</b>
- USA	+2.3	+2.7	+2.9
- Euro Zone	+1.5	+1.7	+1.8
- Germany	+2.0	+2.0	+2.1
- UK	+2.0	+2.3	+2.3
- Japan	+1.5	+1.8	+2.1
Newly Industrialized Asia	+4.5	+4.3	+4.5
<b>Emerging &amp; Developing World</b>	<b>+6.4</b>	<b>+6.5</b>	<b>+6.5</b>
- Latin America	+4.0	+4.1	+4.2
- Russia	+4.3	+4.4	+4.5
- India	+8.4	+8.0	+7.8
- China	+9.6	+9.5	+9.5
ASEAN 5	+5.4	+5.7	+5.7
Sub-Saharan Africa	+5.5	+5.8	+5.9
<b>Aggregate World Growth</b>	<b>+4.2</b>	<b>+4.5</b>	<b>+4.5</b>

Source: IMF WEO, April 2011.

As the global expansion lengthens, greater economic uncertainty should be anticipated. While strong and widespread growth remains the probability, the accelerating phase has passed. Going forward, sentiment and markets are more likely to be fearful to other travails in Emerging markets, or to burgeoning debt problems and faltering growth, as stimuli are withdrawn in Developed economies; especially as excessive inflation builds.

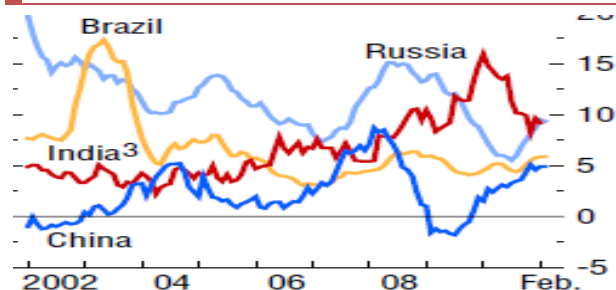
## Global Inflation – again, the same 'two-speed' world



Source: IMF WEO, April 2011

Key Emerging Markets are clearly testing their respective, non-inflationary limits of growth. Accepting that levels have been elevated by fuel and food prices, and with some wariness, *Diversified* gauges inflation will be managed, without seriously impeding economic expansion, for the duration of our current tactical horizon.

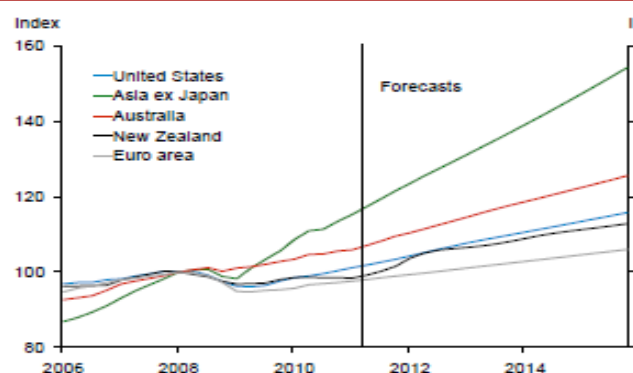
## Emerging Market Inflation - elevated but manageable



Source: IMF WEO, April 2011

No long-term investment strategy can be regarded as prospective without a significant consideration for, and generally a worthy allocation to, the projected high-growth areas of the world. As we have repeatedly pointed out, the widely followed, MSCI Index, based as it is on market capitalization, is inversely prospective for the opportunities ahead. It is consequently an unsuitable model.

## Projected Regional Growth (Mar 2008 = 100)



Source: RBNZ Financial Stability Rept, May 2011

*Diversified* is currently assessing regional and sector influences and probabilities, as part of our formal strategy review process. The provisional impression is that the global economic expansion is largely as our last review. In our view, the economic growth continues to favour the 'growth' asset classes.

## Fixed Interest – Bonds carry Risk

Reserve Bank of Canada Governor, Mark Carney, in a leaked presentation, recently opined that he was increasingly worried about big country's failure to tackle their deficits and debts before borrowing costs spike. We concur, noting the USA's second Quantitative Easing programme (QE II) finishes June 30<sup>th</sup>.

US 10-year Treasury Bonds currently yield just 3.13%. One measure of fundamental value is that 10-yr bonds should be priced to yield GDP growth plus inflation. The USA's underlying nominal GDP growth expectation over the coming years is between 4.5% and 5%.

If fundamental values eventually reassert across bond prices— as we expect, capital values will be at risk. Further, asset sectors priced relative to bonds, including 'infrastructure', commercial property and zero-coupon instruments, are also vulnerable to a sell-off.

And there is no shortage of Bonds. Restoring fiscal balance in Europe is complicated by the intensifying stress in peripheral members, and in USA by political stand-off until at least November 2012. As for NZ, Credit Rating agencies are a growing influence in encouraging fiscal discipline.

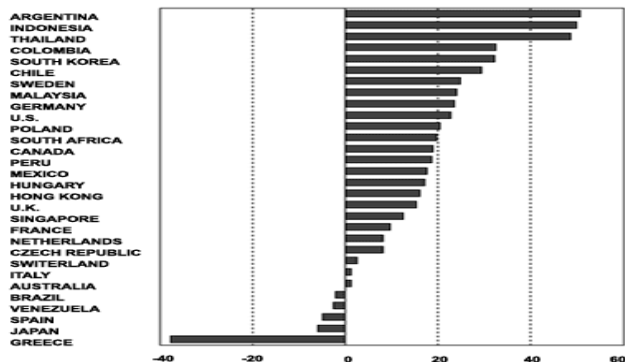
In many places, Cash as an asset class is currently yielding negative Real rates of return (especially after inflation and tax), and Official Cash Rates seem destined to remain low for some time yet.

*Diversified's* model allocations to Cash as well as to conventional Fixed Interest are under review. Neither allocation to each asset sector is expected to rise significantly above the minimum levels required for diversification. A range of other measures will need to be engaged to methodically diversify Equity risks in portfolios.

## Equities – Equities to outperform

Fundamentally, relative valuations suggest Equities are likely to out-perform Bonds ahead. Share market valuations are at, or marginally below, 'fair value' by most conventional measures. The global economic setting will support improving corporate earnings. Meanwhile, the inflationary pressures and key election timings appear benign. Equities have performed well, and remain the favoured asset class for our one-year to 18-month, tactical horizon.

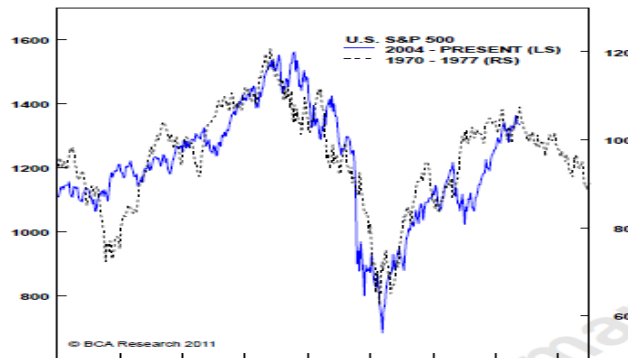
### Year-to-Date Share market Returns – in local currencies,



Source: BCA Research On-line Chartbook. Data to April 29<sup>th</sup>.

While remaining confident that Equities will in all probability continue to gain over the course of our tactical horizon as a whole, we caution that greater volatility should be expected. Economic deceleration, coupled with the strong market gains to date, traditionally leaves markets prone to mid-cycle corrections. Any dips are expected to be transitory, rather than the onset of something more serious

### Comparison current with prior Market Cycle



Source: Global Investment Strategy, Weekly Bulletin, May 20, 2011

The possibility of short-term dips is not neglected by *Diversified's* process. Trading opportunities are delegated as the domain of nimble and accomplished, active managers, selected in the portfolio.

*Diversified's* model strategies continue to favour Equities as an Asset Class, in full expectation that flattening of earlier trajectories, and greater volatility, are likely. Regional, national and sector variability is also likely to be heightened in the period ahead.

## Commodities – 'The Best Cure for High Prices is High Prices'

An earlier edition of *Diversified's* View noted that 'Rare Earth Elements' (REE) have relatively high crustal abundance, but also highly specialized extractive requirements. Applications are numerous and critical, though generally of small quantities. Abetted by China, REE caught the attention of speculators, dreamers and geologists globally. Prices have been driven up 10-fold since 2009 by supposed scarcity. Now, Goldman Sachs is predicting REE will be in surplus by 2013. From a shortage of 18,734 tons, they predict a surplus of 5,860 tons by 2014. Further, the price of a basket of REE is predicted to tumble from US\$227/kg in 2012 to \$82 in 2015.

Most commodity prices are at sufficient levels to encourage new production. The response time for most agricultural commodities is approximately one season – and plantings are up sharply. New energy and metal supplies generally have longer lead-times, but also respond to higher prices with increased supplies.

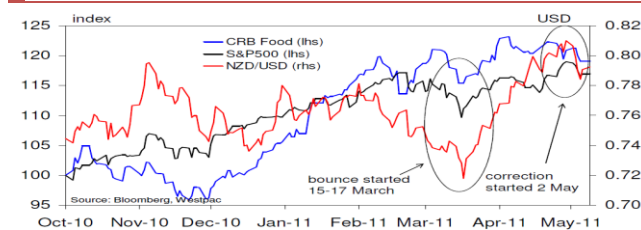
Again, the global growth setting is expected to sustain strong aggregate demand for most all commodities, for at least the duration of our tactical horizon. Prices overall are likely to remain elevated, though perhaps not significantly higher. The preferred access for investors at this stage of the commodity cycle is via Equity in commodity producers.

## Currency – Cycles within cycles

*Diversified* is a fundamental house. We confess to being lousy predictors of short-term exchange rate swings. Portfolios were unhedged last month when the kiwi closed at US\$0.8074 (as we are generally).

In the short-term, the NZ\$ exchange rate is captive of foreign currency traders. The kiwi is reportedly the most traded currency in the world, in proportion to its float. Their perception either of value to our currency, or perceived risks elsewhere, or aversions arising to other currencies are near-term drivers. Medium and longer-term, the Kiwi will gravitate toward a 'fair value' – as determinable by the usual fundamental parameters.

### NZ\$ Medium-term Drivers



Source: Westpac presentation to SiFA Conference, Wgtn, May 8-10<sup>th</sup>.

The correlation between our currency and rising agricultural prices (Commodities Research Bureau – Food Index), and also with global risk appetite (Proxied by USA S&P 500 Index), becomes evident over time.

The inherent volatility of the NZ\$ suggests it would add risk to hedge to it. *Diversified* prefers diversification of currencies as a neutral stance, including that which arises from an unhedged, globally diversified portfolio. Some currencies rise as others fall.

As usual, we are indebted to brave folks at ANZ Research for currency cross-rate predictions.

### NZ\$ Exchange Rate Forecasts - Month-end

	June 2011	June 2012	December 2012
US\$	0.76	0.72	0.70
A\$	0.72	0.72	0.73
Euro	0.54	0.54	0.52
GBP (£)	0.47	0.46	0.45
Japan ¥	64.6	66.2	66.5
NZ\$ TWI	66.6	65.7	64.4

Source: ANZ Market Focus, 23 May, 2011

## Salient Rates, Indices, & Exchange Rates

Following are the April 30th, 2011 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 impact of NZ currency.

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

ACTUAL	30/04/2011	3 MONTHS	6 MONTHS	1 YEAR AGO
Prevailing Monetary Conditions Index	516	561	396	384
Prevailing NZ Cash Rate (90-day) - p.a	2.67%	3.21%	3.18%	2.70%
Prevailing 2011 NZ Govt Stock Yield - p.a	2.59%	3.35%	3.53%	3.89%
Prevailing 2015 NZ Govt Stock Yield - p.a	4.29%	4.53%	4.48%	5.23%
Prevailing 2016 NZ Govt Stock Yield - p.a	2.28%	0.00%	0.00%	0.00%
Prevailing 2021 NZ Govt Stock Yield - p.a	5.47%	5.50%	0.00%	0.00%
<b>CHANGE</b>				
NZX NZ Govt Stock Index	1196.05	1.8%	2.4%	7.7%
NZSE 50 (Gross)	3519.30	5.4%	6.5%	7.1%
NZSCI (Gross)	22317.40	2.1%	7.2%	6.0%
S&P/ASX200 (Australian)	4823.20	1.5%	1.9%	0.3%
<b>MSCI World Index (Capital)</b>	<b>1388.62</b>	<b>6.2%</b>	<b>13.6%</b>	<b>15.9%</b>
Dow Jones (USA)	12811.00	6.4%	15.2%	16.4%
NASDAQ	2874.00	4.5%	14.6%	16.8%
FTSE 100 (UK)	6070.00	1.9%	7.0%	9.3%
Nikkei DJ (Japan)	9850.00	-3.8%	7.0%	-10.9%
Hang Seng (Hong Kong)	23721.00	1.6%	2.7%	12.5%
NZD/USD	0.81	5.0%	5.4%	12.0%
NZD/AUD	0.74	-4.7%	-5.0%	-5.2%
NZD/JPY	65.76	3.8%	6.8%	-3.4%
TWI	68.22	-0.7%	2.0%	0.9%
	0.00			
Gold (US\$/oz., troy)	1563.70	17.9%	15.0%	34.3%
Crude Oil (WTI, US\$/bbl)	112.19	25.6%	37.8%	34.8%

### NORMAN W. STACEY, INVESTMENT ANALYST

Corporate and individual Investment Adviser Disclosure Statements are available free of charge, or may be viewed on our website