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## Diversified's View

August 2011

***"Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions ..."*** Benjamin Graham (1894 – 1976)

***"... those who have not sold should resist the temptation to sell into panic."***

BCA Research, Special report, Aug. 5<sup>th</sup>, 2011.

The macro-economic situation and market reactions now unfolding form inputs to our formal strategy review now in progress. Our tactical horizon remains one-year to 18 months.

Diversified's investment strategies are available as:

- The Law Retirement Plan KiwiSaver Scheme;
- The Law Retirement Plan Superannuation Scheme;
- Diversified Wealth Management's 'Balanced' or 'Dynamic' PIE Funds;
- As Individually Managed Accounts for Private Clients through leading Authorized Financial Advisers.

DWM 'Balanced' Fund at 31<sup>st</sup> July was \$1.0602/unit.

DWM 'Dynamic' Fund at 31<sup>st</sup> July was \$0.9677/unit.

An Investment Statement is available at [www.diversified.co.nz](http://www.diversified.co.nz)

Law Retirement KiwiSaver Scheme's Balanced Fund at 31<sup>st</sup> July was \$1.03832/unit.

Law Retirement KiwiSaver Scheme's Dynamic Fund at 31<sup>st</sup> July was \$1.02715/unit.

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

### Summary

- Diversified's research had identified Western government deficits as being unsustainable, sovereign debt levels as excessive and State austerity inevitable. But we had assigned low probability of market reaction this side of American elections in November 2012. Neither the onset nor intensity of the recent market sell-off was correctly gauged.
- Consequently model strategies were not optimally prepared for the plunge sweeping financial markets. In fact, events transpiring are the inverse of the share market rebound in 2<sup>nd</sup> half 2011, for which model portfolios had been positioned.
- We remain somewhat puzzled, especially in the light of the Euro debt-crisis and USA credit down-grade, that Sovereign Bonds remain so favoured. Bond supply remains plentiful.
- Looking ahead - and accepting that economic risks have been suddenly elevated - we find the greater probability remains that a moderated pace of aggregate global growth will prevail over the coming year to 18 months.
- Heightened partisanship is likely to preoccupy American politicians until the Nov 6<sup>th</sup>, 2012 elections, but essentially, America's debt & deficit are manageable. It is Europe's debt crisis that is far more intractable. Importantly, Emerging Economies stand as engines of world growth, and investors' salvation.
- As expected, corporate earnings are very strong and generally exceed expectations – though shrugged off by markets in the recent context.
- In a world of turmoil, our free-floating NZ dollar is suddenly least frightening to currency dealers. We are price-takers amidst flight from major denominations. If persistent, a high NZ\$ would be unhelpful to sustained domestic prosperity.
- Model portfolios are very well placed to participate in a rebound. Diversified remain confident equilibrium will return to share markets, and fair value reassert in currency markets.
- Sadly, volatility is an inescapable part of investing. Patient investors have historically been rewarded over the medium and longer term.

Norman Stacey is an Investment Analyst and Portfolio Manager of the Diversified Wealth Management PIE Funds.

#### Disclaimer

Diversified's View is an economic commentary of a general nature. It is not intended to be personal investment advice and does not consider any individual's circumstances. Retail Investors contemplating an investment should consult a government Authorized Financial Adviser.

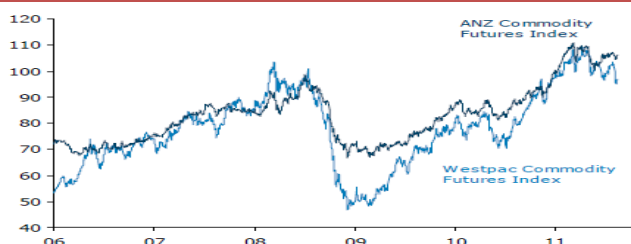
Expertise You Can Trust

## New Zealand – Relatively well-placed

New Zealand's economic concentration, its stage in the business cycle and even our geography, have been elevated to more relative advantages by recent global developments.

NZ's primary products are less stretched in their price-cycle than 'hard' commodities, while demand is closely associated with steadily rising prosperity in the most resilient global regions. Forestry and agricultural assets are being rediscovered by institutions seeking long-term investments, an alternative to long-bonds. Amidst the recent volatility in global financial markets, prices for NZ's traditional exports are relatively resilient.

### NZ (ANZ Index) vs. Australian (Westpac Index) Commodity Futures Indices



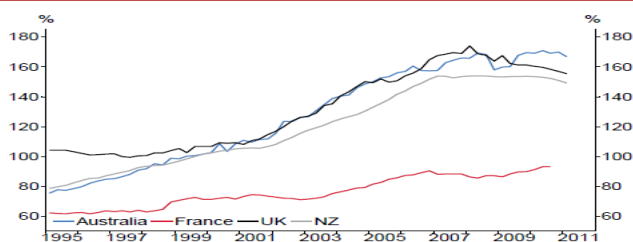
Source: ANZ Market Focus, 15 August, 2011

NZ's economic performance lagged during the 2009/10, recovery phase from the Great Financial Crisis. Domestically, pent-up demand still remains, unemployment has further to decline and pressures on monetary condition settings have reduced. A massive task to rebuild Christchurch underpins NZ's construction industries. Meanwhile, the clling Australian economy may slow the outflow of skills. The extreme market volatility and economic uncertainty offshore serve to defer the onset of our Reserve Bank's monetary conditions from historically loose 2.5%. Market expectations for the onset of a tightening cycle commencing with a hike to the Official Cash Rate, in September, is now expected to be deferred.

New Zealand's indebtedness is reasonably, but not robustly, manageable as the great global super-cycle in debt draws to a close. The ratio of sovereign debt (including SOE's) to Gross Domestic Product is at about 40% - but growing by about NZ\$300 million per week – compares favourably. More disturbingly, Household debt is up with the more profligate, challenging that of European nations whose creditworthiness has recently become topical.

Corporate Balance sheets are the bright spot, with debt levels a modest by historic comparison, profitability robust and Earnings healthy.

### NZ Household Debt Compared – as % of GDP



Source: RBNZ Analytic Notes No.1, August 2011

As welcome, exciting and as much fun as the Rugby World Cup may be, one-off and transitory events are seldom game-changing for medium-term economic trends. An expected 95,000 visitors is estimated to spend a total of NZ\$700 million (including airfares); equivalent to about two weeks of our Deficit. Growth reverting to near NZ's sustainable rate is expected to follow.

### Key Economic Forecasts - % change Year-on Year

	Dec 2011	Mar 2012	Dec 2012	Mar 2013
<b>Growth (GDP)</b>	+4.9%	+4.8%	+3.3%	+3.3%
<b>Inflation (CPI)</b>	3.3%	3.1%	2.6%	2.9%
<b>Unemployment</b>	+5.9%	+5.6%	+5.3%	+5.3%
<b>Current Acct (% GDP)</b>	-3.6%	-3.9%	-4.9%	-5.0%

Source: Selected data from ANZ Market Focus, 15 August, 2011

Risks to NZ's relatively rosy economic outlook include a further rise in the NZ\$ exchange rate. Stress among sophisticated exports (high-value manufactures, language schools, tourism etc), would derail employment assumptions.

*In the land of the blind, the one-eyed man is king.* NZ's manageable debt position, its pole position to supply Asia's rising demand for protein, and our gathering domestic upswing are enviable investment attractions in a somewhat jaded world currently.

*Diversified's* formal strategy review is expected to confirm allocations to NZ of at least near current, and to favour the growth asset classes.

## Australia – Natural Disasters fading

From hurricane & flood induced contraction of -1.2% in the first quarter of 2011, Australia's recovery has been neat. But growth (aside from the mining sectors) has distinctly softened. Uncertainty over global conditions, presents different economic challenges ahead. (It may surprise that only 2% of Australia's workforce is directly employed in mining and maybe 0.25% in mine construction)

'Slowing' is an over-used term. Australia's normalized rate of economic expansion is projected to be lesser, but accelerating to around a still useful 2.5% p.a. growth over 2H 2011. Leading Economic Indicators highlight consumer and business caution is elevated, savings are expected to lift slightly and the pace of new building set to taper in the three to nine months ahead.

Australia's Reserve Bank will be pleased on the inflation front. The rate of wage-rise trimmed in the second Quarter – to 0.7% for those in the private sector, and 0.9% for those on government wages. Cuts to their Official Cash Rates are now expected as soon as December, and of a full 100 basis points to 3.75% within our tactical horizon.

### Australian Key Economic Forecasts – Calendar Year

	2011	2012
<b>GDP %</b>	1.0	2.5
<b>Inflation (CPI) %</b>	3.7	2.9
<b>Unemployment s.a. %</b>	5.09	5.5

Source: Westpac Australia & NZ Weekly, 22 August 2011

Australia's current economic boom has been a lengthy one. High expectations are embedded and may be fully priced in. Risks to the downside exist. Projections for global growth are more delicate than earlier, and demand for 'hard' commodity exports more sensitive, to the extent they may be raw materials for re-export to Europe or USA. Australia continues to offer diversification and deeper markets than NZ. Model strategies consider 'Australasia' as the 'home market', but within that may favour the NZ sector ahead.

## International – End of the Great Debt Super-Cycle?

Amidst panic headlines and emotive financial market ructions, it bears re-iterating that the greatest probability is still that economic expansion will prevail, on an aggregate global basis. Sure, Europe's debt crisis is severe, but it is far from new and has in fact been a decade in the making. And the US situation is more one of dysfunctional political partisanship, than fiscal crisis.

### Real GDP Growth Expectations – % p.a.

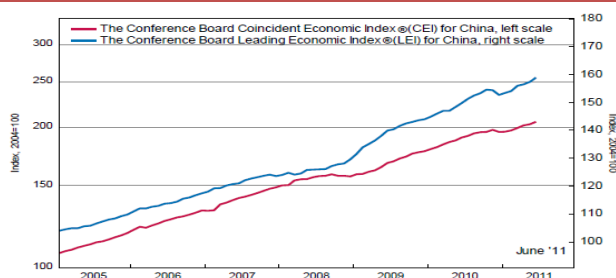
Region/Country	2011 (forecast)	2012 (forecast)
<b>Developed World (OECD)</b>	<b>+1.3</b>	<b>+1.8</b>
- USA	+1.5	+1.2
- Euro Zone	+1.7	-0.4
- UK	+1.0	+0.5.0
- Japan	-0.5	+4.0
-NIE's	+4.3	+3.0
-Australia	+1.0	+2.5
-New Zealand	+2.4	+4.5
<b>East Asia ex-China</b>	<b>+4.9</b>	<b>+3.6</b>
<b>Emerging ex East Asia</b>	<b>+5.4</b>	<b>+4.9</b>
- Brazil	+4.5	+3.6
- Russia	+4.8	+4.0
- India	+8.5	+8.5
- China	+9.3	+8.2
Middle East	+4.6	+4.0
- Africa	+5.5	+5.0
<b>Aggregate World Growth</b>	<b>+4.1</b>	<b>+3.5</b>

Source: Selected data from Westpac Economics (&IMF), August 2011.

The Table above demonstrates the critical role of Emerging Economies collectively, in achieving a reasonable pace of aggregate global growth.

Mercifully for the global economic outlook, leading economic indicators for the exemplar of Emerging Economies, China, are both intact and robust.

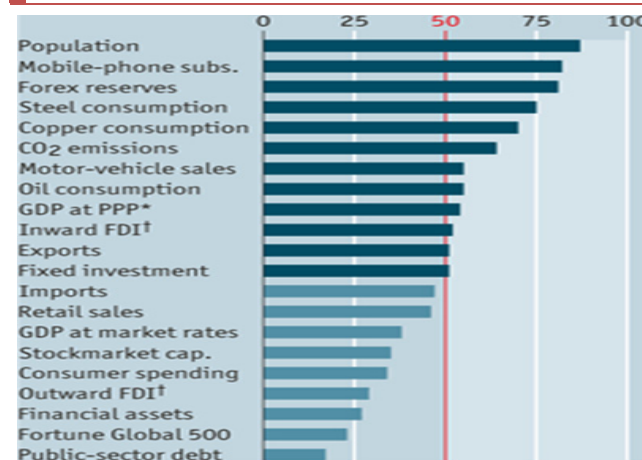
### China – Leading Economic Indicators



Source: The Conference Board, August 16<sup>th</sup>, 2011

Emerging Economies collectively look up to the task. The rising economic significance of Emerging Markets, is a reality often under-estimated by commentators, as well as by index constructors. Emerging Economies have blossomed, to now constitute over half of key economic components.

### Emerging Economies' World Share - % in 2010



Source: The Economist, Print edition of August 4, 2011.

The Developed World's indebtedness has been years in the building. The IMF had forecast its average ratio would exceed 100% of GDP this year. Each nation's ability to service high debt loads varies immensely, not least according to its size already made due to commitments to 'entitlements', as well as already utilized avenues of taxation.

Europe's sovereign debt crisis is the most refractory. An experiment in unlimited government is now finding physical limits. Having explored limits of taxation of income, State expansion continued, funded by debt issuance. In 2008 only eight of the European Union's 27 members exceeded the 60% of GDP upper limit set by the European Commission; by 2010 14 members did. The Crisis is that mounting debt servicing cost command a rising portion of tax revenues - and especially income taxes can be raised no further. Europe's 'Tax Wedge' (the tax payable by a single worker on the average wage, from gross pay) is already excessive.

### Tax Wedges Compared – from average wage

Country	Tax Wedge
France	49.3%
Germany	49.1%
Italy	46.9%
Spain	39.6%
Portugal	37.7%
Greece	36.6%
Japan	30.5%
USA	29.7%

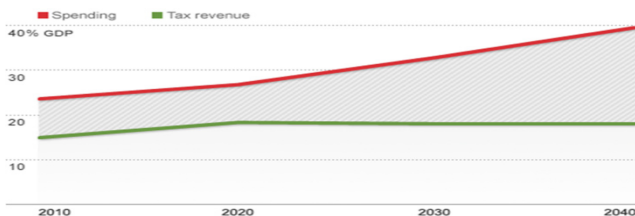
Source: OECD Centre for Tax Policy & Admin. 11 May 2011.

The Table amply show why Germans might be testy at bailing out Greece. Social unrest is likely to be increasingly prevalent throughout our tactical horizon. Additional taxes (financial transaction tax), will be extracted, even as 'entitlements' are cut very significantly. In the words of distinguished economist, Dr Pippa Malmgren (3<sup>rd</sup> August, 2011), "... there's going to be a lot more austerity than you may imagine. For example, the Italians are going through their first round of serious belt tightening. What the public doesn't understand is that this is

**round one of five, six or seven rounds. The amount of austerity that's required to make the books balance is huge".**

Compared to Europe, the USA's debt 'problems' are readily soluble – through political goodwill and compromise to close the deficit will be required. USA Federal spending is – currently a modest 24% of GDP, but on a trajectory to reach 40% of GDP by 2040.

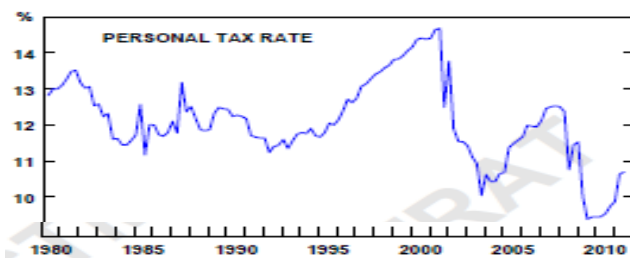
#### USA – Federal Gov't as % of GDP



Source: CNN Money July 2011 data from Govt Accountability Office.

And the USA enjoys huge tax flexibility. Federal revenues are significantly below their 18% of GDP, average, and existing levels of income and excise taxes are very low by international standards. There is as yet Federal Value-added Tax. American taxpayers – after allowing for deductible mortgages, retirement saving etc. – have an effective tax rate of only 10.8%.

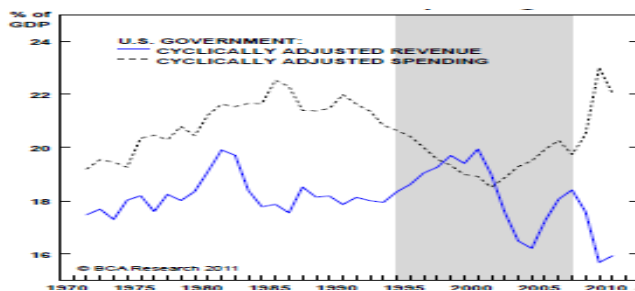
#### Effective Personal Tax Rates in USA



Source: Adapted from BCA Special Report, 19 August, 2011.

The USA's deficit is easily solved the same way as any enterprise: simply cut expenses and raise revenue.

#### USA Federal Gov't - Gap between Spending & Revenue



Source: BCA Research, Special Report, 19 Aug., 2011

The USA's political battle is essentially an ideological one, on whether government should be 24% or 40% of GDP. The deficit can then be readily closed, and debt growth stopped.

Slower Developed World growth will lessen demand for commodities generally, and particularly for food and energy. Inflationary pressures will be alleviated, and fiscal discipline will postpone monetary tightening.

Losers from Europe's Credit Crisis, and USA's Credit down-grade, are politicians and central authorities – and deservedly so. Public confidence in financial institutions, central banks, treasuries and political leaders has been eroded. Reactions may mirror those across the Maghreb.

Although the possibility of a global recession is distinctly more elevated than earlier (inevitable for Europe, but only 38% probable for USA), the greater probability is that a moderated, but still good pace of aggregate global growth will prevail over the coming year to 18 months.

#### Political Dexterity in the USA Debt Ceiling Debate

*"The fact that we are here today to debate raising America's debt limit is a sign of leadership failure. It is a sign that the U.S. Government can't pay its own bills. It is a sign that we now depend on ongoing financial assistance from foreign countries to finance our Government's reckless fiscal policies. ... Increasing America's debt weakens us domestically and internationally. Leadership means that "the buck stops here." Instead, Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. Americans deserve better".*

Source: Senator Barack Obama, in voting against raising the debt ceiling to US\$9 trillion, on March 29<sup>th</sup>, 2006. (The August 2<sup>nd</sup> 2011 vote lifted the debt ceiling to US\$16.4 trillion).

*Diversified's* research and strategies were early movers in recognizing the economic significance and rise of Emerging Markets. Strategies have long pursued a GDP-weighted global spread.

#### Fixed Interest – 'a fatal attraction?'

Even if *Diversified* had correctly foretold the onset of the Sovereign Debt Crisis in Europe, or credit downgrade for USA on markets, it is inconceivable we would have advocated sovereign Bonds as the preferred asset class. We remain mystified finding US 10-year treasuries offer 2.07% gross yield, before tax and transaction costs, and with CPI inflation running at 2.9% (i.e. US Bonds make a loss in real terms). At time of writing, US Treasuries – down-graded to AA+ -yield as follows:

#### USA Key Interest Rates

US Treasuries	Price per \$100	Yield % p.a.
1-mth T-Bills		0.0102
6-mths		0.0254
5-Yr Note	102.28	0.9004
10-yr Note	100.15	2.0727
30-yr Note	106.19	3.2953

Source: Thomson ONE, 4:00 pm EDT, August 19, 2011

Why would investors bother to get out of bed in the morning to buy US Treasuries? There is certainly to be lots more issued while you sleep in.

Our research finds conventional Fixed Interest currently an unattractive asset class. Our formal review of strategy currently underway will test all assumptions.

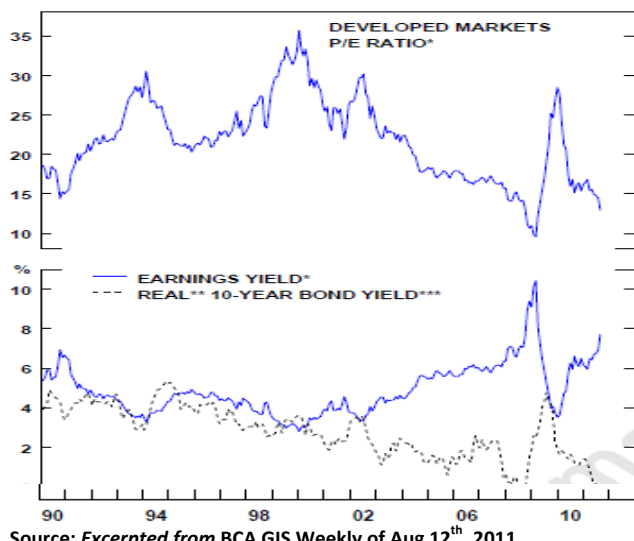
## Equities – Sentiment Grimmer than Fundamental warrant

*Diversified's* strategy research had anticipated a share market rally in latter 2011, commensurate with robust global growth re-establishing – and with the upturn expected to be led by USA. Models consequently favoured growth assets, and even producers of commodities. As events transpired, it was not a happy place to be.

*Diversified* is a fundamental house. We find sentiment a great deal direr than the most likely outcomes.

Still, on a fundamental basis, the Equities Asset Class, including those of the Developed World, offers sound valuation (13 times trailing earnings), solid Balance sheets and generating Earnings at multiples of Bond yields.

### Developed Market Equities – Price & Earnings



Source: Excerpted from BCA GIS Weekly of Aug 12<sup>th</sup>, 2011

For flagship USA, the dividend yield on the Dow Jones Industrial Average Index is greater than the yield on 10-year Treasury Notes. This situation has historically been a harbinger of good Equity returns in the period ahead.

The peaking of inflationary pressures across Emerging Economies should halt their monetary tightening, providing relief for corporate earnings and share markets.

We continue to find sustained global growth the most probable course – albeit at a lesser pace than envisioned earlier. The US share market pullback of the past Quarter (a 16% sell-off in markets generally augurs about 0.7% fall in GDP over the year ahead), is in our view excessive. *Diversified's* remains optimistic on the broad share market will advance over our tactical horizon as a whole.

**“Those who have not sold should resist the temptation to sell into panic”.** Chen Zhao, Managing Editor, Global investment strategy, August 5<sup>th</sup>, 2011.

## Commodities – Moderator

Commodities are the building blocks of prosperity. Demand for, particularly resources is a derivative of global economic expansion. Commodity prices have been reduced by the sudden revision downward of the global growth trajectory. The moderating effect is that lower prevailing prices for raw material will remove that drag on economic activity, and disproportionately for Resource-intensive Emerging Economies.

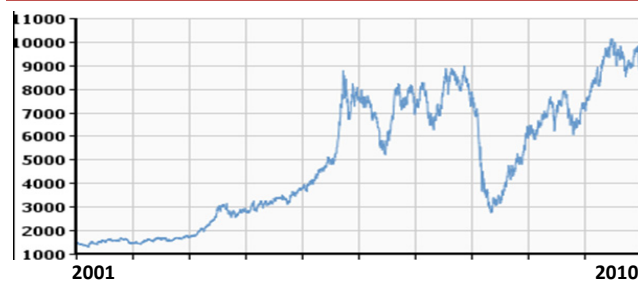
### Commodity Prices – Jan 3<sup>rd</sup> 2011 = 100



Source: The Economist, Print edition of Aug 8, 2011

Even for the doomster, there is some comfort to be found in the behaviour or the price of copper. “Dr” Copper is sometimes said to be the metal with a PhD in Macro-economics, for its historic record of price retreat pre-empting major economic recessions - including the GFC in 2008. Latterly, the price of copper dipped only slightly and from records, than a harbinger of something more serious.

### Copper Price - US\$/tonne, 10 years.



Source: LME Copper Price, Aug 19 2001 to August 19, 2011.

Gold has most recently been a major beneficiary of the flight from US\$, compounded by uncertainty bordering on panic over the debt crises. It should be noted that prior to the turmoil, demand for gold actually dropped by 17% during the second quarter of 2011, (Source: World gold Council, Aug 18<sup>th</sup>). The price of gold carries risk if calm breaks out.

*Diversified's* model strategies continue to hold a significant allocation to the commodity producer's shares. While producer's share-prices have been set-back more than average during the broad market sell-off, they are now well positioned to rebound if the outlook improves as we expect.

## Currency – NZ\$ unhedged

*Diversified's process* is based on economic fundamentals. Our considered stance is that a diversity of overseas currencies generally carries less risk. Policy is to not hedge back to NZ\$, in the absence of strong reason to anticipate appreciation by or local unit. Immediately prior to the recent uncertainty, we had no strong reason to expect New Zealand dollar to spike upward as it did.

When a reporting currency appreciates, the value of unhedged holdings offshore is reduced – a currency 'loss' on the foreign currency. Over the medium and longer-term, the NZ\$'s record is of oscillating around 'fair value'. ('Fair value' for the NZ\$ is currently estimated to be about US\$0.67, and A\$0.80.).

### A Very Significant Revision

The folks at ANZ Research have suddenly and very materially hiked their estimate for the NZ\$ exchange, notably against the US\$. ANZ's reversal – from forecasting depreciation from current levels to further appreciation – has repercussions for NZ's anticipated export-led expansion, is borne out.

### ANZ Consecutive Monthly Exchange rates, NZ\$ in US\$

	Dec 2001	March 2012	March 2013
15 <sup>th</sup> August	0.91	0.92	0.93
18 <sup>th</sup> July	0.81	0.73	0.73
Revision	+12.3%	+26%	+27.4%

Source: ANZ Market Focus of 18 July, and 15<sup>th</sup> August, 2011.

Westpac have a more conventional forecast, strikingly similar to that derived from market forwards.

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

	Dec 2011	Mar 2012	Sept 2012
US\$	0.81	0.79	0.79
US\$ market forward	0.81	0.81	0.78
A\$	0.80	0.80	0.80
Euro	0.60	0.59	0.60
GBP (£)	0.53	0.50	0.49
Japan ¥	65	63	66
NZ\$ TWI	71.8	66.4	66.8

Source: Westpac Institutional Bank, Market Outlook, August 2011

*Diversified* is maintaining offshore allocations unhedged for now.

## Salient Rates, Indices, & Exchange Rates

Following are the July 31st, 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

Salient Rates, Indices & Exch Rates	Current	1 Mth Ago	3 Mths Ago	6 Mths Ago	12 Mths Ago	2 Yrs Ago	3 Yrs Ago	5 Yrs Ago
Prevailing Monetary Conditions Index	957	616	516	561	472	-71	865	445
Prevailing NZ Cash Rate (90-day) - p.a	2.79%	2.61%	2.67%	3.21%	3.28%	2.79%	8.36%	7.49%
Prevailing 2011 NZ Govt Stock Yield - p.a	2.92%	2.67%	2.59%	3.35%	3.72%	3.80%	6.15%	6.13%
Prevailing 2015 NZ Govt Stock Yield - p.a	4.03%	3.06%	4.29%	4.53%	4.68%	5.28%	6.13%	0.00%
Prevailing 2016 NZ Govt Inf. Ind. Yield - p.a	1.48%	1.67%	2.28%	0.00%	0.00%	0.00%	0.00%	0.00%
Prevailing 2021 NZ Govt Stock Yield - p.a	4.97%	5.10%	5.47%	5.50%	0.00%	0.00%	0.00%	0.00%

### CHANGE

Salient Rates, Indices & Exch Rates	Current	1 Mth Ago	3 Mths Ago	6 Mths Ago	12 Mths Ago	2 Yrs Ago	3 Yrs Ago	5 Yrs Ago
NZX NZ Govt Stock (Gross Returns Index)	1228.9	0.61%	2.75%	4.62%	6.84%	15.30%	26.12%	41.50%
NZX50 (Gross)	3395.63	-1.53%	-3.51%	1.70%	11.90%	12.58%	1.78%	-5.17%
NZSCI (Gross)	20977.2	0.53%	-6.01%	-4.02%	5.76%	9.99%	-6.77%	-7.22%
S&P/ASX200 (Australian)	4424.6	-3.63%	-8.26%	-6.93%	-1.53%	4.26%	-11.11%	-11.26%
MSCI World Index (Capital)	1306.5	-1.85%	-5.91%	-0.12%	16.15%	25.05%	-4.98%	-1.56%
Dow Jones (USA)	12143	-5.97%	-5.21%	0.86%	16.02%	32.40%	4.83%	8.42%
NASDAQ COMP	2756	-0.63%	-4.11%	0.18%	22.22%	39.30%	18.51%	32.58%
FTSE 100 (UK)	5815	-2.20%	-4.20%	-2.40%	10.59%	26.18%	7.27%	-1.97%
Nikkei DJ (Japan)	9833	0.17%	-0.17%	-3.96%	3.10%	-4.84%	-26.40%	-36.38%
Hang Seng (Hong Kong)	22440	0.25%	-5.40%	-3.91%	6.70%	8.97%	-1.61%	32.27%
NZD/USD	0.8793	6.62%	8.57%	13.99%	21.12%	33.17%	19.75%	42.33%
NZD/AUD	0.7999	3.52%	8.36%	3.29%	-0.37%	1.13%	2.60%	-0.71%
NZD/JPY	67.5	1.37%	2.65%	6.59%	7.52%	7.86%	-14.78%	-4.69%
TRADE WEIGHTED INDEX (TWI)	74.65	4.80%	9.43%	8.69%	10.48%	21.72%	13.55%	20.83%
Gold (US\$/f.oz., troy)	1627.88	8.09%	4.10%	22.69%	38.53%	73.97%	81.32%	155.45%
Crude Oil (WTI, US\$/bbl)	97.38	4.84%	-13.20%	9.00%	24.37%	53.62%	-20.30%	30.71%

NORMAN W. STACEY, INVESTMENT ANALYST