Investment Comment May 2009

1 Introduction

The purpose of this note is to provide a brief commentary on the investment markets for the month of May 2009. We look at index results, comment on local and global markets and raise issues that may be concerning trustees.

2 Index results

- Australasian Shares — NZSX 50 rose 0.9% and the Australian ASX 200 rose 1.4%.
- Global Shares — MSCI in local currency terms was up 5.7% and in unhedged terms was down 3.0%.
- Global Bonds — Barclays Capital Global Aggregate rose 0.4%.
- NZ Bonds — NZ Government Stock was down 0.9% and the NZ Corporate A index was down 0.4%.
- Currency — NZ dollar finished up 12.6% at 64.0 US cents.

3 Markets

No matter what negative economic news emerged, markets continued to rally through May. The S&P 500 rose a remarkable 5.3%, bringing the rally since 9 March to 35.9% at the end of the month (additionally the market has continued to rise in early June). Share market indexes around the world followed the US upwards, the standout among developed markets being Japan (up 7.9%).

Even the troubled global property market managed to record a gain of nearly 4%, while commodities spiked on improving sentiment for the global economy (oil up 30%) or on the outlook for inflation (gold up 11%).

Inflation concerns did push up interest rates and world government bond index fell 0.6% over the month. By contrast, corporate spreads contracted and the global aggregate index rose 0.4%. The pattern was similar locally with the NZ government stock index down 0.9% but the corporate A index only down 0.4%. Local cash now provides just 20-30 basis points per month, down from the 60-70 basis point level which had been the norm up until 8 months ago.

4 Economies

As alluded to above, not all news was positive. Recent weeks have seen the bankruptcy of General Motors, US house prices continuing to fall and unemployment in the States almost reaching 9%. However, the *“green shoots”* theme provided silver linings. The GM bankruptcy was widely expected, and mostly priced into the markets. The Case-Shiller house price index *did* fall for the month of March, but at -2.17% the change was slightly better than February’s -2.21%. And while the unemployment rate did increase from 8.5% to 8.9%, the lowest number of jobs were lost in the month of April since October 2008.

The US economy is far from out of the woods,. But there are glimmers of hope beginning to emerge. The Conference Board’s Leading Economic Index rose sharply in April, the first increase in seven months. The index is one of the few forward-looking measures and tries to predict the direction of the US economy over the next three to six months. The main contributors were stock prices, interest rate spreads and the index of consumer expectations. Detractors were the real money supply, building permits and manufacturers' new orders for (non-defense) capital goods.

5 Interest Rates

With views of a recovery beginning to gain traction, inflation expectations have risen somewhat. Not in the least due to the Federal Reserve exercising its right to employ quantitative easing. This sees the central bank effectively create money by the purchase of treasuries. Commentators are divided on whether this is exactly what the economy needs (Nobel laureate Paul Krugman arguing to fight deflation at whatever cost) or whether it may lead to inflationary environment in the future (investment analyst Marc Faber – *"Dr Doom"* – making headlines in late May with his suggestion of Zimbabwe-style hyper-inflation in the US).

Chinese officials expressed disquiet about the Fed's strategy, even suggesting moving away from the US dollar as the world's reserve currency. However, while there are signs that the Chinese are adding to their gold reserves, they continue to purchase large amounts of US debt.

Standard and Poor's cut their rating outlook for Britain from *"stable"* to *"negative"* in late May. The possibility of the country losing its coveted AAA rating sent shock-waves through the bond market, extending to the US where 10 year treasuries climbed from 3.50% to 3.73% in one day. Yields are now back up to their November 2008 level and this could be adding pressure to US mortgage holders.

6 New Zealand and Australia

National released its first budget in May. The new government held true to its promise to deliver few surprises, with the major policies being signalled well in advance. In main, the budget was designed to reduce government debt with the target to return the government to surplus. The personal tax cuts promised for the next 2 years were scrapped and the government also put on hold contributions to the NZ Superannuation Fund.

The budget received approval from international ratings agencies with Standard and Poor's revising the ratings outlook from *"negative"* back to *"stable"*. New Zealand's foreign currency rating stands at AA+.

7 Issues

With the NZ dollar climbing, hedging strategy will again gain precedence in the minds of Trustees. A fully hedged fund will have received the MSCI's 5.7% local currency return plus a pickup from the interest rate differential while unhedged funds will have fallen around 3%.

However, for tax paying funds under the Fair Dividend Rate (FDR) tax regime, hedging is no longer straight-forward. FDR does not apply to the hedge portion and so any gains from hedging will be taxed under the old Comparative Value (CV) method.

For example, in May, a US dollar hedge would have returned 12.6% to a 100% hedged the investor on a gross of tax basis (ie making up for the NZ dollar's rise). Under a 30% tax rate, the net return would only be 8.8% and the remaining 3.8% of the rise in the NZ dollar would not be offset. To correctly allow for this would require a hedging level of 143%. This would have returned 18.0% over the month gross of tax and 12.6% net of tax, off-setting the currency rise as intended.

Trustees should review their hedging arrangements to ensure they are providing the intended level of cover on a net of tax basis.

8 Outlook

While confidence in the markets and the recovery is building at the same time there remains a high level of uncertainty as to whether the gains can be maintained. We remain concerned that interest rates will continue to creep up although we expect global credit spreads to narrow. Of interest is the recent relative outperformance of global bond versus NZ bonds. Overall our outlook is little changed from last month, although there remains a large amount of work to be done to remedy household balance sheets.

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3 June 2009