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Dunedin Council of Social Services Governance Forum

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Create, Grow & Sustain **YOUR** wealth

Setting the scene

- Financial crisis started in the US 2007
- Boom & bust in the US housing bubble – house prices peaked in 2005 / 2006, started drop once interest rates started to increase late 2006
- Easy credit conditions – in 2005, median house deposit by US first home buyers was just 2%
- Speculation – in US during 2005 / 2006 40% of houses were purchased for investment reasons or holiday homes
- Sub-prime (high risk) lending – in 1994 US\$35B sub-prime mortgages written (5%), by 2006 it was US\$600B (20%)
- Increased debt burden (over leveraging) – Americans have ~ US\$25 Trillion in debt
- Development of complex structured investments – MBS, CDO, CLO
- Tentative signs of some thawing starting to show – repayment of TARP.



The impact

- Home equity values fell from US13 Trillion at the peak to US8 Trillion by the end of 2008
- Investment values fell through the floor, mortgage defaults go through the roof – “Jingle Mail”
- Banks stopped lending to each other, the world flow of money dries up as banks hold onto their funds
- Central banks step in to improve liquidity
 - US made available \$700B to troubled banks
 - UK Government partially nationalised banks
 - NZ & AUS Deposit Guarantee Schemes used to improve confidence
- April 2008, IMF estimates global losses for financial institutions in excess of US\$1 Trillion
- Talk of 1920’s type Depression – but now not likely!



The NZ Story

- New Zealanders ongoing fascination with property
- Full employment, low interest rates, high consumer confidence – the worlds a great place!
- Access to easy credit – see it, want it, but it now - forget saving, the ever increasing value of my house will cover everything
- Younger generations haven't been exposed to recessions before
- World wide financial crisis impacts – everyone heads for safety, move from risky to risk averse
- Businesses hit first by the rising cost of funds and slowing demand for goods – focus moves from profit to survival
- Consumers next as they try to repair their personal balance sheets – trying to spend less and save more / reduce debt
- Less money being spent in the economy, businesses (particularly consumer discretionary) struggle – unemployment starts to rise
- No quick fix – will be years rather than months



The NZ Story

- Inflation – likely to remain within the target band for next 12 months, less than 3%
 - Predicted that the Official Cash Rate will remain at or lower than the current rate until the latter part of 2010
- Interest rates – a paradox
 - The Reserve bank has cut OCR 5.75% in the last 11 months **BUT** mortgage rates are now creeping back up. WHY?
 - Cost of borrowing for banks is rising, having to pay more for deposits and the source funds from offshore. No relief until the financial crisis abates.
 - The great unknown is the Governments Deposit Guarantee Scheme which is scheduled to end at 12.01PM 12nd October 2010
- Unemployment – on the way up, expected to peak at around 8% 3rd quarter 2010
 - Unemployment rose in the March quarter to a six year high of 5% and is expected to rise further.
 - New Zealand business confidence reached its lowest since 1974. 65% of firms expect this situation to worsen over the next 6 months.
 - People working longer – retirees money not earning as much



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The NZ Story

- Migration – more ex-pats coming home as situation overseas worsens
 - More people competing in the job market. NZ net migration shot up to a 6 year high of 11,200 people, an increase of 129% from 2008.
 - Permanent and long-term departures decreased by 2100 people (1500 less moving permanently to Australia and 500 less to the UK).
 - On the positive side, it should help support / stabilise the Housing market
- Currency (NZD v's USD)
 - Moving in parallel with the DOW – recognition of risk, and we are seen as risky
 - Generally expected that it should weaken, but no one can agree when or by how much
 - Forecasting 50 – 55cents against the US. WHEN?
- Government spending reduced
 - Cost of funds increasing - S&P AA+ announcement was good for us
 - Lower profits, less tax
 - More unemployment, more benefits paid



Local Impact

- Otago generally better protected than some – the South is better placed than the North
 - Generally, by nature, more conservative / not as much debt
 - Agricultural focus in our region –
 - Dairying has had a good run, now sheep & beef coming to the fore
 - Recovery driven by global consumption particularly China / India urbanisation
 - Dunedin is a University city - continual influx of students and funds each year, likely to be more given the lack of employment opportunities
- Greater demand for social services
 - Not getting any easier, it will be end 2010 / beginning of 2011 before we see any substantial improvement in the economy
 - Food banks
 - Budget advice
 - Counselling
 - Changing demographic – people who were previously considered “well off” calling on services



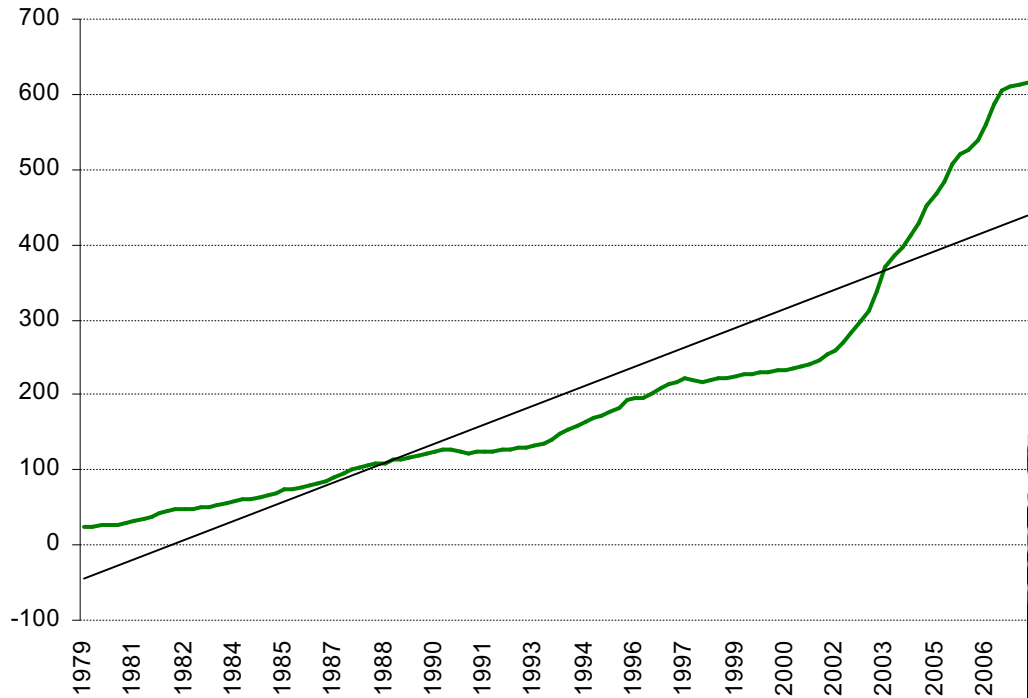
Local Impact

- Less money available from funding sources
 - Funding providers investment portfolios have been significantly impacted by the effects of the financial crisis
 - Focus on survival means that business are retaining more funds to protect themselves
- However a possible silver lining
 - Generally the sharemarket is 9 – 12 months ahead of the economy
 - Significant improvement in the last 3 months – Dow has increased nearly 30% since march 2009
 - Is it sustainable? It is promising, but still more water to go under the bridge yet, believe we may see further pull back / consolidation
 - Improvements in portfolio values should flow through to funding organisations coffers – more funds available for distribution, but likely to remain cautious



NZ house prices since 1979

Average house price hit 6x household income in 2007, usually trade at 3x



A 30% fall is needed to get back to trend

Meanwhile in America...banks are demolishing houses in foreclosure. Cheaper to level them than finish and sell them

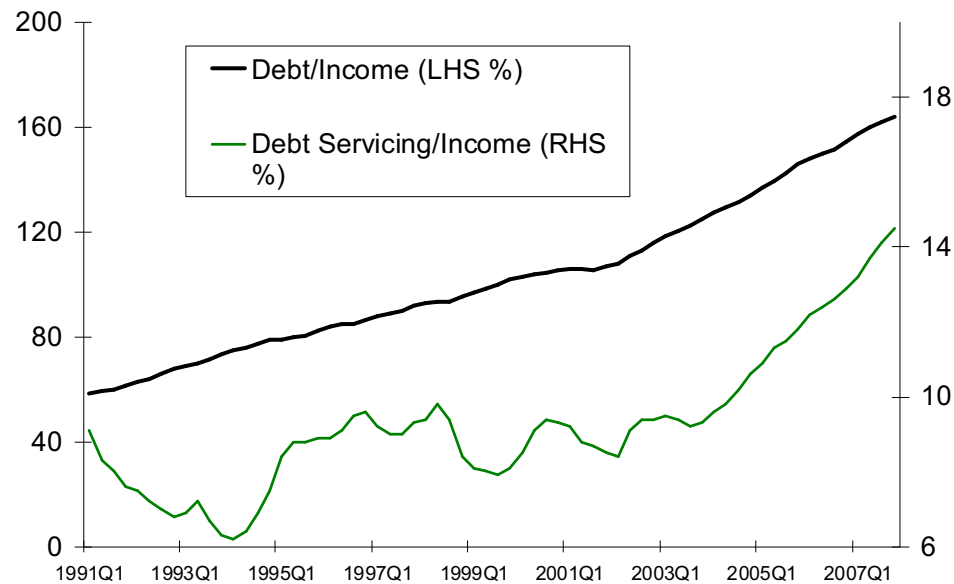


You can't fix the debt bubble with more debt

Deleveraging (paying down debt) is only solution, and it will take time

Many governments trying the 'sugar rush' solution – trying to keep spending going by making debt more easily available

New Zealand household debt and servicing as % of income



Sources: RBNZ, ABN AMRO Craigs

Treat your economy like a marathon runner

Muesli bar or chocolate bar?

Deleveraging or more Debt?

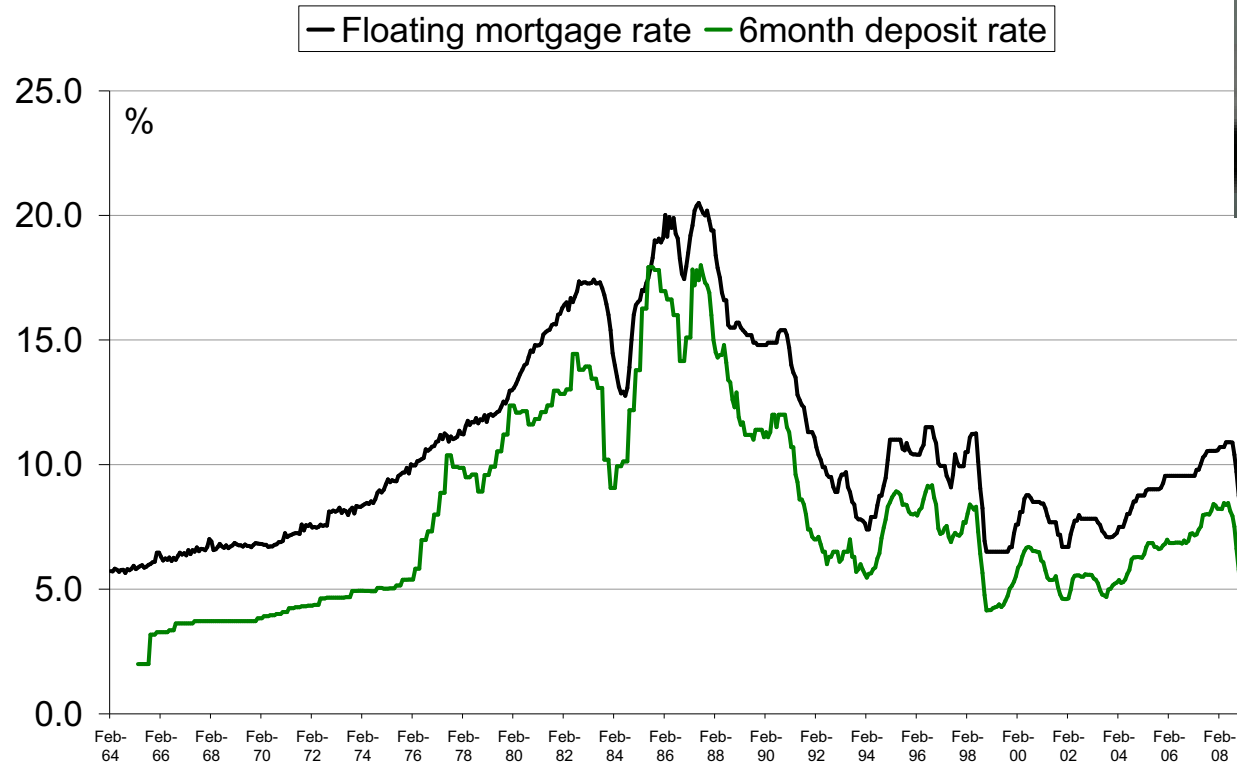


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Interest rates back to the '60s

The last time interest rates were this low we were using pounds and pence
Our cosy existence of 8% risk-free returns has gone



Source: RBNZ



Low rates may be here for a while

RBNZ will probably look to keep short term rates low to provide degree of comfort for those with debt on floating rates



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Budget – nicely done given limited room to move



Balancing the books the priority

Rating upgrade to 'stable' good for householders trying to reduce debt

NZ Super Fund debate pointless...unaffordable any way you look at it

No pension for 40-somethings, or at the very least an entitlement age of 75yrs...but we already know that – I don't know many of my fellow 40-somethings that believe for one minute that there will be a pension there for them at age 65.

'Flower-power' generation must spend less, save more and do our own saving for retirement



S&P upgrade big news for the NZD

NZD versus USD since 2008



NZD up 2c after budget and rating upgrade – given problems overseas and our rating upgrade our dollar may hold its ground

Our estimate of fair value is 55c but our currency may trade above here for period of time given NZ's relative positioning v US

Treasury are forecasting NZD TWI to fall 19% from 61 to 49 by March 2010

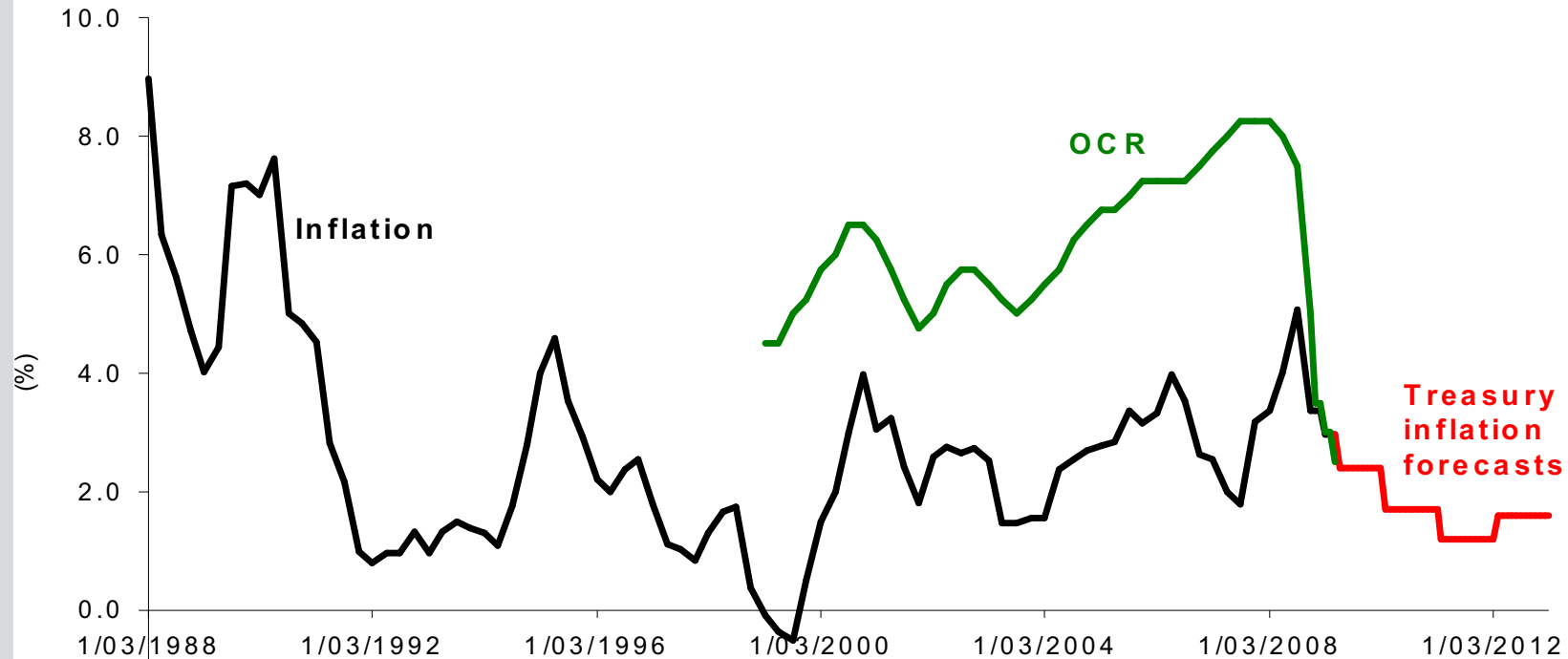
In my view, currency forecasting is beyond the realm of human endeavour and FX forecasts should not drive investment strategy

Despite NZD strength it remains prudent strategically to diversify a proportion of a portfolio into offshore assets for protection against 'NZ risk'. And tactically, the high NZD means those offshore assets will currently cost you less NZ Dollars



Inflation expectations...are low

Treasury's latest forecasts (released in the Budget) predict CPI to stay under 2.0% until 2013



How to calculate long term inflation expectations

2017 Govt bond yield	5.3%
- 2016 Govt inflation linked bond yield	3.4%
= expected inflation	1.9%



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