GLOBAL VIEW

5th February 2009

FEBRUARY 2009 NEWSLETTER

Hi John,

The Times they have Changed

Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone
If your time to you
Is worth savin'
Then you better start swimmin'
Or you'll sink like a stone
For the times they are a-changin'.

To see the Bob Dylan video click here.

My last GLOBAL VIEW was the November issue. Since then things have been changing so much in the global economy – for the worse – any newsletter would have been out of date by the time it was written. To quote Bob Dylan's classic song - the times they are a changing.

But now it's clear the times have really changed.

Banks have been bailed out by governments with packages which addressed the overlapping problems of too little capital, banks fearful of lending to each other, the inability to roll over corporate loans, and the risk of depositor withdrawals. Similar packages were implemented in Australia and New Zealand.

Initially we all thought it looked like that had worked and there were signs of recovery. But now it's clear the financial markets are still in disarray and the credit crisis has broken loose into the real economies of both developed and emerging countries.

It's the countries whose exports have been hit by the collapse in global demand that have been hit hardest. These include Germany, Japan, China, India and even in the "lucky" country, Australia.

Every day we hear of more job losses.

New Zealand has not been spared. The collapse of commodity prices has hit our largest company, Fonterra, and this has had a flow on effect to dairy farmers, rural towns and businesses. See front page of last Thursday's Herald click here. It's possible rural land prices will face considerable downward pressure reflecting reduced dairy prices and credit availability.

The latest IMF report expects "the world economy to slow to a virtual standstill this year" To read the Reuters report click here.

And in the U.S. – where it all started - New York University professor Nouriel Roubini predicts the U.S. financial losses from the credit crisis may reach US$3.6 trillion. To see the Bloomberg article click here.

If you're interested in how it all came about I recommend you read the following article by Michael Lewis,

the author of the book Liar's Poker, which covered his experiences in Wall Street in the 1980's. To see his article click here. It's great reading and well worth printing out to read at your leisure.

So that's the international scene – and it's not pretty.

Interest rates down again

Globally, the reduction in interest rates has been dramatic. In October/November last year:

- The U.S. Federal Reserve cut the Fed Funds rate by 0.5% to 1%. Now its "target range" is 0.0% - 0.25%.
- The Reserve Bank of Australia cut it's cash rate by 0.75% to 5.25% - the lowest level since December 2003. Now it's 4.25% and is expected to drop to 3.25% - or less - when they meet tomorrow.
- The Bank of England cut its key interest rate by 1.5% to 3.0% - its lowest point since 1954. Now it's 1.5%
- The European Central Bank reduced rates to 3.25% Now it's 2.0%
- The Bank of Japan cut its key interest rate for the first time in seven years to 0.3% - the lowest amongst the major economies. Now it's 0.1%
- The Bank of Canada lowered its benchmark lending rate to 2.25% from 3% Now it's 1.0%.

Here in New Zealand, in October the Reserve Bank cut our Official Cash Rate by an unprecedented 1.0% to 6.5%. This was the third cut in succession. The last one before that was July 2003. In December they cut it by a further 1.5% to 5.0%. Now it's down another 1.5% to 3.5%.

Their decision brings the cumulative reduction in the OCR since July 2008 to 4.75%. For a history of the OCR since its inception in March 1999 click here.

Announcing the reduction, Reserve Bank Governor Alan Bollard said "*the news coming from our trading partners is very negative. The global economy is now in recession and the outlook for international growth has been marked down considerably since our December Monetary Policy Statement.*"

"*Globally, there has been considerable policy stimulus put in place and we expect this to help bring about a recovery in growth over time. However, there remains huge uncertainty about the timing and strength of a recovery.*"

"*The extent of the decline in global growth prospects and the ongoing uncertainty has played a large part in today's decision. We now expect the impact on New Zealand of these developments to be greater than we did in December, as a result of a more negative outlook for the terms of trade and exports, and tighter credit conditions.*"

But as I said in the November GLOBAL VIEW, it's now very clear that interest rate reductions are not sufficient on their own to stimulate an economy. The New Zealand Herald's editorial last Wednesday, summed it up pretty well. To see the editorial click here.

So why are lower interest rates now losing their potency in stimulating growth?

- It's one thing to make credit cheap but yet another to make consumers want to borrow money at all – as they have seen their wealth eroded from the loss in the value of their houses and investment portfolios and from finance company failures.
- In the recessionary environment we are experiencing, lenders need to be convinced borrowers can meet their interest and repayment obligations – credit is tighter.
- The global credit crunch has meant the ability for New Zealand banks to borrow offshore is tighter and more expensive and they consequently have less to lend.

- Government support for banks has gone into strengthening their balance sheets – having written off so much from dodgy loans - rather than lending the money out.

But there are other aspects to low interest rates we should examine.

First it's bad for depositors. Bank term deposit rates for 1 year are now in the 3% - 5% range compared with 8% - 9% six months ago. This will result in people looking at other investment options, including:

- Government guaranteed finance companies. Expect deposit rates to come down as they become flush with funds. Lending rates will continue to reflect the risk profile of the borrower. Currently lending rates remain high awaiting current deposits to mature and many finance companies who were quick to take up the government guarantee are locked in to high deposit rates. Expect to see a lowering of both their deposit and lending rates as they struggle to compete with banks.

- Trustee companies and solicitor nominee companies. Not being government guaranteed they will need to offer better deposit rates. Generally they have a loyal clientele of depositors and have continued to lend prudently throughout the credit crisis here.

- Fixed interest securities, like corporate bonds, may not be popular with investors moving from term deposits and investments like the above as their value before maturity will drop if market rates rise – and they're low now – or if the issuer falls out of favour. For a good article on this see Brent Sheather's column in last Saturday's herald click here.

- The share market will come into favour again as listed companies fall into a pattern conducive with an economic downturn and their share prices reflect this. Shares with good sustainable dividend yields - based on revenue rather than revaluations - will be well sought after.

- I wouldn't be surprised to see more investors coming back into the residential property market as lower interest rates make the rental yield more attractive. Distressed sales may result in attractive buying opportunities when it's uncertain where residential prices are heading. But I'd be amazed if house prices declined here as much as they have in the U.S. and Europe where there was a massive oversupply of new houses and extremely loose lending practices. In his latest Weekly Overview, BNZ economist Tony Alexander says "*I would have greater confidence in my ability to extract rent increases over the next few years from a canny property purchase. This is because of plummeting construction, the 20% deposit requirement, a likely migration improvement later this year, and the rise in the unemployment rate pushing more people into the rental market for a longer period of time*."

- Commercial property is looking particularly attractive as yields and purchase prices become more realistic. Good tenancies are the key to obtaining loans at a time credit is tight. Expect to see property syndication come back into favour as the property "funds" - whose units sell at large discounts to asset backing - struggle to attract investors and institutions are busy managing their existing property portfolios. Properties with strong long term tenancies are particularly attractive for syndication. I've seen a few of these already.

Second, a reduction in the Official Cash Rate should result in an immediate reduction in floating rates. And it has. As global rates fall we are starting to see a reduction in fixed rates too. However the wider lending margins in the wholesale funds the banks draw on means fixed rates may not fall as much. Also let's not forget New Zealand's got one of the highest current account deficits in the developed world which adversely affects the availability and cost of offshore funds.

As the world economy improves watch for the time to lock in the relatively low longer term fixed interest rates.

Good to be here

New Zealand has not been immune from the biggest global financial crisis in 80 years. But our major commodity export base is food - which is far different from that of Australia (minerals), China (cheap manufactured goods), Japan (automobiles, electronics). So you'd expect New Zealand to be less susceptible to falling consumer spending in places like the U.S. and the U.K. where those goods have been highly sought after.

And let's not forget we have been partly insulated from the drop in commodity prices by the falling New Zealand dollar. In March 2008 our dollar was worth 82 U.S. cents – now it's worth 51.

Contrary to some of the negative sensationalism we see in the press, the latest reports from respected economists like Rodney Dickens are quite positive about New Zealand's position in the world.

In the executive summary of his latest Monetary Policy Briefing, Rodney says "*when we assess how the global economic shock is impacting on NZ currently and the extent to which it may impact given the peculiar nature of NZ's export base and the role the exchange rate plays in insulating NZ from global shocks, we conclude that the RBNZ is most likely and yet again over-estimating how badly the local economy will be hit. In addition it is possible the major mechanism by which the crisis has been hurting the NZ economy – the freezing of overseas funding by local banks – could be on the mend over the next couple of months. So provided a fresh batch of nuclear bombs aren't delivered to the door of Chicken Licken's bomb shelter by the crisis, we believe the biggest surprise this year could be how strongly the economy recovers.*" To subscribe to Rodney's reports click here.

(By the way, the nuclear bomb that Rodney mentions above, would, in my view, be the introduction of "protectionism" that turned the severe recession of 1929-1931 into the depression of 1931-1933. That's a digression and another story, but if you'd like to see how politics could upset everything, read this article by David Kotok here.)

And to see 10 reasons to feel good from interest.co.nz CEO, Bernard Hickey click here.

It you're looking for funds for property or business there are investors and lenders out there. To obtain money it's back to basics. Knowing where to go, the criteria they're looking for, and a proper presentation are all essential.

Some other thoughts

There's one good thing about this global credit crisis - it's so bad it will just have to be fixed. So I think we'll come out of it quicker than many people do.

But a result will be a shift in the developed world's attitude towards spending and debt. At the margin households will be concentrating on meeting mortgage payments, having enough food on the table for the family, ensuring the children's educational needs are looked after, and their retirement nest egg is replenished. Attitudes towards non-essential spending and debt have changed.

And both lenders and investors will realise cash flow is king. To see my view on this read my last GLOBAL VIEW here.

This is not just a cyclic event. It's a far more secular shift like that our parents or grandparents experienced from the great depression of the 1930's. The 2001 – 2007 experience of cheap money and easy credit has proved to be a nightmare for many.

Yes, the times they have changed. And some of us will have to start swimming or sink like a stone.

Cheers

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