



Volatile road ahead until we've cut debt

Healthy growth may be some years away as markets fluctuate, writes **Michael Lang**.

THE CREDIT crunch turned into a global financial crisis last year, but markets shrugged off a recession and finished higher than they started. All's well that ends well, right? Wrong.

For the crisis to be over, we need to solve the cause — too much debt.

For the past 20 years, we have enjoyed a bull market. In 1987, interest rates were 16.8 per cent and inflation was 9.6 per cent. The sharemarket was in tatters and developers and second-home owners were broke.

The US Federal Reserve began reducing inflation by raising interest rates to slow borrowing. Monetary authorities around the world, including our Reserve Bank, followed suit. Inflation collapsed to 1 per cent.

With inflation under control, there was no need for high interest rates. As they fell around the world, shares, property and commodities soared in value. Between 1987 and 2007 the New Zealand share market, including dividends, rose 5.5 per cent a year. Property appreciated 7.5 per cent a year, bonds returned 8.5 per cent, while oil and gold returned 8.5 per cent and 3.7 per cent respectively.

As these assets rose, we became complacent, borrowing more than was prudent. New Zealanders' household debt

grew eightfold from \$19 billion to \$177b. Income only grew by around 200 per cent over the same period.

In America between 2000 and 2007 total debt increased to five times the rate of the nation's earnings and home prices soared 90 per cent. In 2007 we reached a global tipping point where, despite low interest rates, we were unable to afford more debt. The credit crisis occurred when everyone began to reduce levels of borrowing at the same time, causing global bonds, shares and property to fall.

Governments and central banks around the world rescued the global economy by nationalising, guaranteeing and supporting anything and everything and asset prices resumed levitating. As a consequence New Zealand's government debt is forecast to rise from 24 per cent of GDP to 36 per cent. America's is forecast



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to hit 100 per cent, and the United Kingdom's 120 per cent.

With personal debt levels unchanged and government debt rising, the global economy is unlikely to resume healthy growth for years.

As markets fluctuate between being stimulated by fiscal support and correcting as debt levels fall, asset prices will be volatile, the last thing

those who rely on investment portfolios want.

What it means

Investors should take less risk with money needed in the next five to seven years so capital invested for growth can be invested for at least one full economic cycle.

Kiwis need to diversify by asset class. The closer we get to retirement the more widely we should spread savings. A mix of asset classes helps mitigate volatility in any one class in any year.

Consider risk management through a strategy that either protects against the downside or includes expectations your long-term growth investments may halve in value.

Assuming a worst-case scenario will see investors borrow less when investing in property, or allocate less when investing in shares. If that asset falls, the investor will be prepared and not feel forced to sell at the wrong time.

Michael Lang is the chief investment officer at NZ Funds.

■ Martin Hawes returns at the end of the month.

BULL: Markets charged ahead for 20 years. AP

