

Market Commentary

THE RATIONAL BUBBLE

NZFUNDS

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Investment in a real asset such as shares (which entitle the owner to all future cashflow generated by a brand or asset), property (representing a scarce and physical asset) or commodities (representing an economic input into the factors of production) is far more likely to preserve investors' capital than holding any form of IOU (be it bank deposit, foreign currency or government bond) when the monetarisation of the world's current debt stock pile begins.

I was taught that the first thing to do when confronted with a bubble is to buy into it. The second, to understand why it is unsustainable. Understanding its fallibility assists with timing one's exit.

Investors are today confronted with a bubble and are "rationally" participating, knowing that should global financial markets plummet again, governments and central bankers the world over will underwrite any short term losses in order to prevent a drawn out period of 1930s-style debt deflation.

When confronted with the collapse of the global financial banking system, personified by Lehman Brothers but including the likes of HBOS, Merrill Lynch, RBS, Wachovia and AIG, investors (rightly) priced in the financial armageddon, driving asset classes to multi-year lows. At the time we were confronted with (still) high valuations by historical standards and a once-in-a-generation peak in consumer indebtedness. In order for the consumer to reduce the mountain of debt it had accumulated over the preceding 25 years, the excessive consumption (which makes up two thirds of most Western economies) would have to fall. This would lead to lower economic growth and therefore lower investment returns for a prolonged period of time. There was nothing irrational about the fear that investors exhibited in early 2009.

However, the very fact that we all fully understood the problem meant that the outcome was altered. Investment markets are circular, because investors are both readers of the market statistics as well as inputs into the determination of those statistics. George Soros calls this phenomenon the "reflectivity of investment markets". The

implication is that markets trend but also that this trend may be altered by a determined participant.

Governments and central banks around the world were determined to change the trend and the "known" outcome. As a result, governments guaranteed, rescued and spent whilst central bankers printed money. Six months later economic growth is rebounding - forced upward, not by a resumption in private sector spending or investment, but by governments' fiscal and monetary stimulus.

Investors may have a short memory, but that is all that is needed to participate in the current bull market. Investors faced almost an identical situation in 2000 (high consumer indebtedness and excessive valuations). Following a 50% share market fall, Alan Greenspan (the then Chairman of the Federal Reserve of the United States) aggressively cut interest rates to prevent a prolonged recession and succeeded in reflating asset prices back to their March 2000 highs. Investors who reacted to Greenspan's actions participated in a 110% rise in global shares, 50% rise in gold, 160% rise in commodities and a bull market in everything from residential property to art. There was nothing "irrational" about their exuberance then, nor should there be now.

With the benefit of hindsight, it is apparent that all Greenspan succeeded in doing was to postpone the inevitable and perhaps make the subsequent collapse even worse. Today, Western consumers (including New Zealanders) are more heavily indebted, and our economies more dependent on consumption, than ever before. To prevent a 1930s-style private sector deleveraging, Western governments are now in the process of indebting the public sector. The rational investor knows what happened last time central bankers intervened to rescue the economy. Little wonder then that global shares have risen 60%, Chinese shares 100% and commodities 30% all in six months.

The current bubble is therefore totally rational and is likely to surprise investors in its strength and longevity. For example, NZ Funds, believes that the phenomenal rise in China's share market is not linked to rational valuation.

That is not to say it is irrational to participate in it. Current extended valuations based on seven year average earnings indicated China is trading on a little over 20x earnings. There is no reason it will not revisit 45x earnings seen in late 2007 given unprecedented fiscal and monetary stimulus being employed by China's central government – in line with its Western counterparts. This implies China could double from here.

What makes this bull market fallible is that too much debt brought about the recent crash, and debt levels have not changed. All that has happened is that much of the debt has been transferred or underwritten from private balance sheet to public balance sheets. The day of reckoning appears to have been postponed for a second time.

But the reflexivity of markets theory implies that knowing global markets remain vulnerable to a further collapse – because of their elevated debt levels – means there is unlikely to be a second crash of a similar magnitude to that of 2007-2008. Should asset markets collapse again, and it is highly likely that they will, governments and central bankers have shown themselves unwilling to tolerate a 1930s debt deflation process during which unemployment soars and GDP collapses. Instead, they are likely up their rate of money printing, paying off their indebtedness by debasing their currency. In such an environment real assets will rise in value, if only in normal terms, while IOU's such as bank deposits will progressively lose their purchasing power, and paper currencies and sovereign debts face the very real prospect of collapse.

For further information please contact:

Michael Lang Ph: 09 377 2277
Principal and Chief Investment Officer
NZ Funds

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