



**GLOBAL  
INVESTORS**

# quarterly strategic outlook / december 2009



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## Executive Summary

2010 will provide the next chapter in the unfolding story of the recovery from the Global Financial Crisis. The themes of 2010 will be the strength of the recovery, especially in developed markets, and whether we see progress on the much needed structural changes in the global economy to make that recovery sustainable.

As the recovery gathers momentum, 2010 will also see the gradual removal of the huge and, in some countries unconventional, interventions to support the global financial system and economy as the global financial crisis was playing out.

2010 will see the continued (re)building the foundations of the new global economic environment. All the right noises are being made at a G20 level. The challenge now is the extent to which these commitments translate to policy actions in individual countries.

The outlook for equities remains positive in 2010, but returns are moving to a lower trajectory. Valuations are still reasonable, especially compared to bond and cash yields, plus profit growth is about to turn positive after two years of declines. We also think higher than average margins will see profits continue to surprise on the upside throughout 2010. Emerging market equities is still the asset class in which we are most optimistic, where concerns of a bubble seem overblown, at least at this stage.

The outlook is not without risks. There will be further writedowns in the banking sector in 2010, and if these are significant, there could be another knock to confidence. Sharply higher yields on government bonds are another key risk, caused either by higher inflation expectations and/or budget deficit concerns. With inflation likely to be contained at least in 2010, the authorities could extend bond purchase programs if yields rise too aggressively.

## Our views in summary

Asset class	Near-term view	Medium-term view	Current Position
Global equities	Positive but returns are moving to a lower trajectory. Emerging markets look more attractive.	Positive on current valuations.	Overweight
Australasian equities	Should largely track developed equities. Australia expected to do better than NZ.	Positive on current valuations. Australia's higher growth potential translates into higher earnings potential.	Overweight (over AUS/ under NZ)
Emerging equities	Expect relative outperformance to continue, but will be susceptible to any renewed bouts of risk aversion.	Should do very well on the back of relatively high GDP and earnings growth, plus lower leverage.	Overweight
Property & infrastructure	Increasing investor risk appetite could see further positive returns but questions are now being asked on listed property valuations.	Asset class looks fully valued, especially global listed property. Expect returns to be below other growth assets.	Underweight
International bonds	Government yields look expensive but relatively wide credit spreads plus hedging premium makes this the most attractive income asset.	Further spread contraction will be harder to come by and low government bond yields will see more modest returns over the medium-term.	Underweight
Domestic bonds	Government bonds offer some equity downside protection but the market is more worried about OCR hikes next year and doubling of supply.	Unattractive due to low long-term government bond and swap yields.	Underweight
Cash	Rates are at historical lows and it will be some time before we see 'neutral' again.	Growth asset classes look more attractive over the medium-term.	Underweight
Currency	The high correlation with global equities and commodities appears to be breaking down.	The NZD looks overvalued, particularly against the USD and GBP.	Below benchmark hedge (MSCI basket)

### Disclaimer

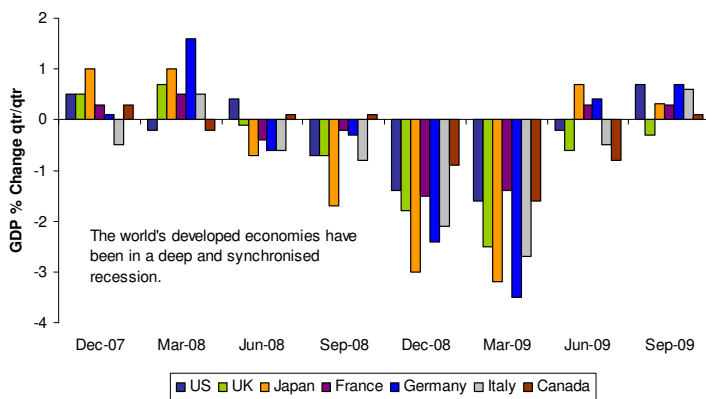
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## Themes

### Global growth outlook

As we move into 2010, the worst of the Global Financial Crisis (GFC) is behind us. Perhaps the biggest surprise of 2009 came late in the piece when many of the countries hardest hit by the crisis reported such strong growth.

Synchronicity



Source: OECD, AXA Global Investors

That growth, so far, has turned out much as we expected: driven by the huge stimulus measures that were put in place during the darkest days of the crisis. A strong inventory cycle has also assisted the rebound.

A good sign has been the strong recovery in global trade. The freeze in economic activity that occurred during the GFC was most dramatically demonstrated by the sharp fall in exports in many countries. Japanese exports were down 50% year on year at the start of 2009, but have recently improved to being down only about 20%.

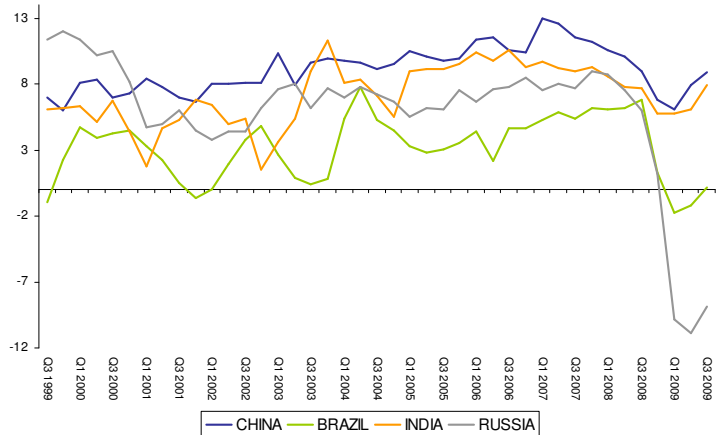
Yet there is still reason to be cautious. In developed markets there is, at least at this point, not much sign of a sustained improvement in final demand.

While consumers around the world are becoming more confident, this is not leading to the usual rebound in spending. Consumers are remaining cautious and focussing on debt retirement. Deleveraging is happening and that's a good thing, but it is, and will continue to, keep overall growth subdued.

Economic growth has remained strongest in emerging markets. This has been a recurring theme of recent QSO's – that the recovery was going to be more robust in emerging markets, largely because they don't have the same debt overhang as the developed nations.

Year-on-year growth in China reached 8.9% in the year to September. India grew 7.9% on the same basis, helped along by a late monsoon season. While it would be a stretch to say China was saving the world, it is certainly helping growth in the region. Even New Zealand's return to growth in the June quarter of 2009, albeit somewhat modest growth of 0.1%, was partly driven by strong demand for logs from China.

BRIC Economies Y/Y GDP Growth



Source: Bloomberg, AXA Global Investors

The question for 2010 is the extent to which the global economic recovery gains traction and starts to build some momentum. We now need growth to move to the phase where it becomes self-supporting.

That continues to look most promising in emerging markets where the growth dynamics of urbanisation, technology catch-up and rising productivity growth will continue to support growth.

The outlook remains less rosy for developed markets. We continue to favour a subdued growth track for the key developed markets including the United States, United Kingdom and Japan. Interestingly, Japan's initially reported annualised 4.8% growth in the third quarter of 2009 has been revised down to 1.2%.

Two factors in particular support the subdued recovery scenario – continued deleveraging (rising saving rates) and high unemployment.

In the major developed economies, we believe the labour market will continue to be a drag on growth for some time. Job losses have been huge, and the recovery will not be easy.

In the United States the number of employed has fallen back to the same level it was in March 2004. While job losses appear to be stabilising, we believe strong job growth is some time away.

There has been a strong structural element to the recession, which means a structural recovery. More simply, there needs to be a shift in resources from old sectors to new sectors. In the case of the United States, that means a shift in resources from sectors focussed on domestic growth to sectors focussed on export growth.

That means that when the new jobs come, they may not be the same as the old jobs. That means a higher level of structural unemployment. People waiting to get their old car-making jobs back in Detroit (unemployment rate currently 17%) might be waiting a while.

So while the recovery is here, there is much that will keep it subdued and some things that could still go wrong. Recent events in Dubai suggest all is not fully back to health and that some stresses remain. We will, in all likelihood, see more of these stories in 2010. The good news though is that there is a new benchmark for “disaster” – the Lehman Brothers collapse.

While strong growth in emerging markets looks likely, the same cannot be said for developed markets, at least not yet. The risk is that while stimulus and the inventory cycle will underpin growth for the next few quarters, growth may dip down again in the second half of 2010 as the stimulus runs its course and if growth has not become more broadly based and self-supporting at that point.

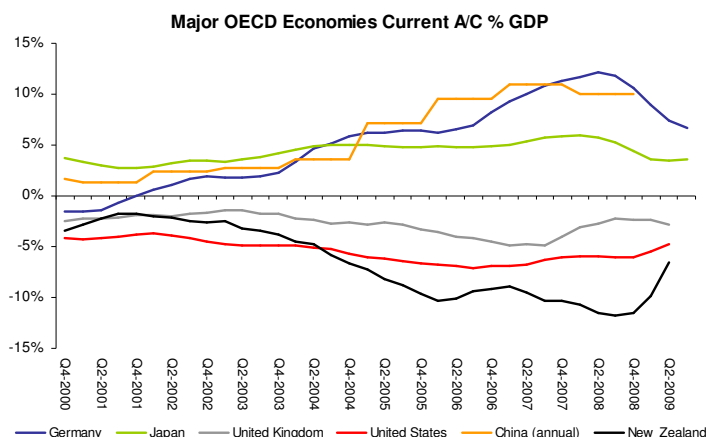
## Fixing global imbalances

For the global economic recovery to build and to become sustained, we need to see a reduction in global imbalances. That requires a co-ordinated effort amongst countries.

One of the most pleasing aspects of the response to the GFC has been the co-ordination of effort amongst countries. This didn't exist in the 1930s as the world was grappling with the Great Depression. At that time all countries wanted to export their way out of recession and sought lower exchange rates. But when everyone acts to achieve a lower exchange rate it becomes a zero sum game.

This time there is a better understanding that not everyone can export their way out of recession. Some clearly need to. Countries running large current account deficits need to export their way out of recession. This includes the United States, the United Kingdom and New Zealand. Others need to import their way out of recession. These are countries that are running current account surpluses such as China, Germany and Japan.

At first glance this rebalancing appears to be happening. At this point we believe this is more of a cyclical rather than a structural phenomenon. Take the New Zealand case for example. The improvement in our current account position in the year to September 2009 was the reflection of a weak economy. Imports were down sharply as was the profitability of foreign owned firms in New Zealand. This is not the kind of improvement we want to see sustained!



Source: OECD, AXA Global Investors

There is therefore still much work to be done to put these imbalances on a pathway to permanent improvement. Importantly, fundamentals need to reflect the desired outcome. Deficit countries need weaker exchange rates so their exports become more competitive. Surplus countries need appreciating exchange rates to make imports cheaper.

In general that scenario is playing out, in many cases indirectly. Countries such as the United Kingdom and the United States have undertaken policy measures (in both cases quantitative easing, i.e. printing money) that have led to depreciation in their exchange rates.

China is the interesting case at this point. We believe the world would be best served at the moment with an appreciation in the Chinese Yuan (CNY). China is maintaining its peg to the weak United States dollar. This has been costly to maintain.

When a country has its exchange rate pegged to another, it effectively pegs interest rates as well. If China continues to grow at a strong clip, which we expect it will, and if inflationary pressures remain benign in the United States, which we expect they will, China will need higher interest rates well before the United States.

All else being equal, the CNY peg to the USD will become increasingly unsustainable in 2010.

And what of the exception to all of this: the New Zealand dollar? Given New Zealand economic fundamentals, the New Zealand dollar (NZD) should be weaker rather than stronger. At the moment we believe part of the strong NZD is that we are in better economic shape than the US and the UK. We believe the end of quantitative easing policies in both those countries may prove to be the catalyst for a weaker NZD.

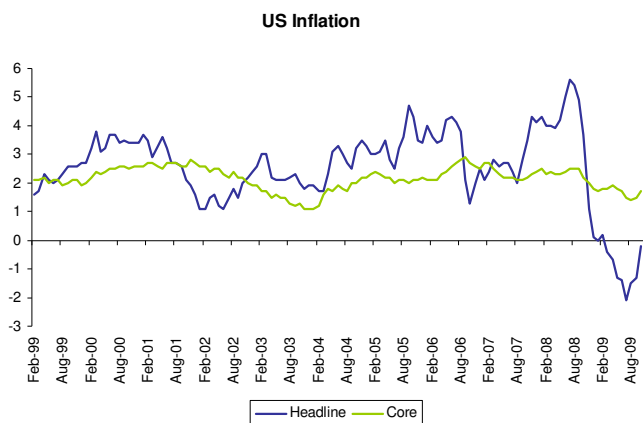
Of course there is more to all of this than just exchange rates. Policy settings in individual countries need to reflect the outcome of either greater consumption (imports) or greater exports.

The G20 understands the end-game and is making all the right noises. The challenge now is the extent to which “global noise” gets translated into the right policy action at home.

### 2010: the year of the “Great Unwinding”

If 2008/09 was the “Great Recession”, then 2010 will be the “Great Unwinding”. Huge stimulus, both conventional and unconventional, was put in place as the GFC was playing out and authorities around the world feared a period of debilitating global deflation.

While we would be loathe to ever rule anything out completely, the risk of deflation appears to have been averted. The deflation we did see was largely contained to commodities (predominantly oil). Core inflation remained remarkably stable through the period, albeit trending down in many countries.

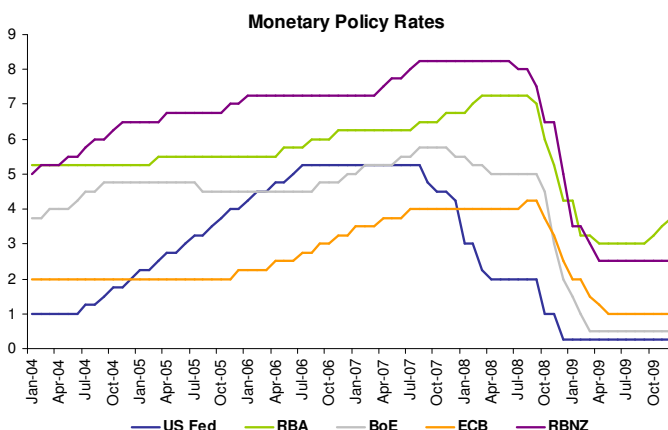


Source: US Bureau of Labour Statistics

As economic conditions continue to improve, we have to start thinking about the withdrawal of the stimulus. There are three considerations: monetary settings, fiscal settings and liquidity measures.

Some countries in the developed world (Israel, Norway and Australia) have already started to tighten monetary

policy from, at least what the Australian authorities were calling “emergency settings”.



Source: US Federal Reserve, RBA, BoE, ECB, RBNZ

Most developed countries will follow at some point during 2010. But in many of those cases, this will not be until later in the year. We agree with the US Federal Reserve’s assessment that they will be able to wait until the end of 2010.

This seems somewhat at odds with the reality of an economy that is running a large budget deficit, has interest rates at effectively zero, a weak exchange rate, and all of this in an environment of rising commodity prices. Normally one would put these factors together and the noise from the inflation alarm bells would be deafening.

The major factor on the other side of the equation is the significant degree of spare capacity in the economy. This is the result of the sharp contraction in activity during the recession and the subsequent subdued recovery. The so-called output gap will keep emergent inflationary pressures at bay for some time.

However, in the last edition of QSO we warned that spare capacity could yet turn out to be redundant capacity. That risk has in no way diminished over the last quarter.

Think of the labour market. We have already flagged the likelihood that the new jobs will be different to the old jobs. That means that as firms start to hire again, they may not find people with the right skills, despite a high level of unemployment. That would mean earlier than expected inflation pressure, with still high unemployment.

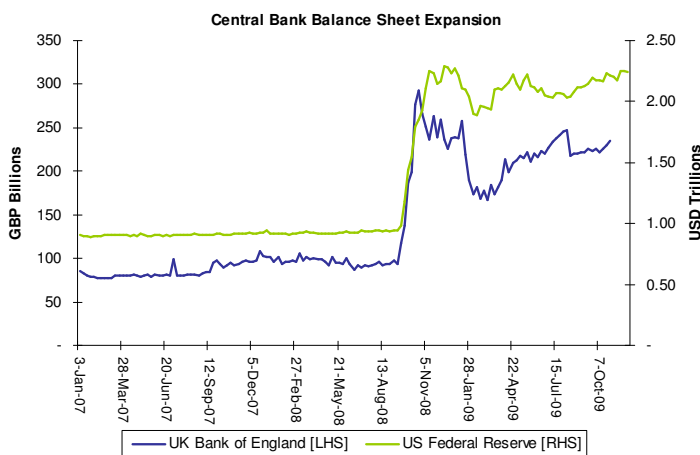
While we believe monetary policy will tighten in many countries in 2010, when that starts and how aggressive those rate rises will be, will vary from country to country.

Of more concern, and we would argue urgency, is the need to get fiscal policy back to a more sustainable path. We argued right from the start of the GFC that the course of action taken by easing fiscal conditions considerably was the right course of action to avert economic depression, but was never going to be the long-term solution.

Fiscal policy needs to be brought back to a more sustainable path so that we can go back to worrying about the things we were worried about before the GFC. Many countries were facing mounting fiscal pressure from ageing populations, the rising cost of healthcare and unfunded pension liabilities.

Those pressures have now become more imminent as many countries now face these issues from a level of lower operating balances and higher public debt. We discuss this issue in more depth in the next section.

The final, but perhaps earliest, of the stimulus-unwinding we expect to play out next year relates to many of the unconventional measures taken by authorities to boost liquidity during the crisis. This has seen a significant increase in the balance sheets of central banks such as the US Federal Reserve and the Bank of England.



Source: US Federal Reserve, Bank of England

The loans the Fed has made to commercial banks are now sitting as reserves on the banks' balance sheets. This could result in a significant rise in lending – and money supply and inflation – as economic conditions improve. This excess liquidity will therefore have to be mopped up before that occurs.

The good news on this front is that households have been showing, in our view, the right behaviour of reducing debt, rather than returning to borrowing as confidence returns. But it still remains to be seen if this is a long-term shift in behaviour, so a reduction in these

reserves is still the prudent course to take when the time is right.

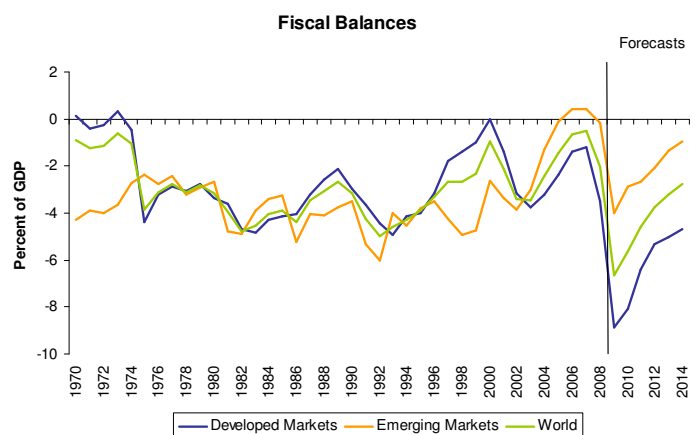
### Long-term fiscal challenges

Even before the GFC, many countries, mostly developed, were facing growing fiscal challenges. This was most notably from the aging of the baby-boomer generation. This was projected to lead to an increase in the proportion of the population in retirement, and therefore a decrease in the proportion of the population in productive employment.

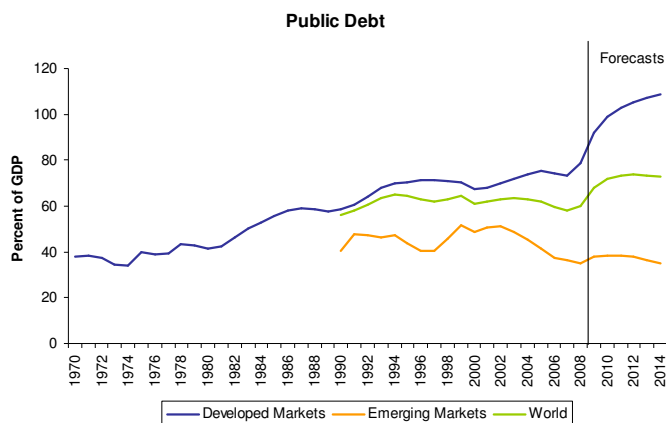
This would, in turn, put pressure on the (relatively) smaller tax-base to fund the growing costs of healthcare, education, infrastructure and retirement incomes. A “no policy change” scenario would see growing budget deficits into the future and rising public debt ratios.

A lot has changed in the last 12-months. A deep and synchronised global recession has been met with expansionary fiscal policies introduced (amongst other measures) to support aggregate demand to prevent a collapse of the global economy into a deflationary spiral. As we said at the time – that was the correct short-term response, but was never going to be the long-term solution.

That means that right now, the starting point for assessing our ability to cope with the longer term fiscal challenges is considerably more challenging with lower fiscal balances and higher public debt.



Source: IMF



Source: IMF

Recent research from the International Monetary Fund (IMF) shows that for developed economies, on average, to get the debt to GDP ratio down to 60% within the next two decades requires steadily improving the cyclically adjusted primary fiscal balance from a deficit of 3.5% of GDP in 2010 to a surplus of 4.5% in 2020 (an 8% adjustment!!) and then keeping it there for the following 10 years.

As the IMF points out, not renewing the fiscal stimulus gets us part way there, but only by about 1.5%, or less than a quarter of the 8% shift required. The job ahead is still immense.

Importantly, it is unlikely that economic growth will do the job by itself. That means serious fiscal reform is ahead, and the earlier we start, the less dramatic that reform will need to be.

This will mean looking at things like the costs of healthcare, pension entitlements and how governments fund infrastructure.

The risks of doing nothing are as equally immense as the challenges of trying to fix the problem. Persistently higher debt levels means higher interest rates (and a vicious cycle of higher interest costs leading to higher deficits leading to higher debt leading to higher interest costs...) and less ability to cope with future economic shocks. In the recent GFC, the private sector was bailed out by the public sector. Who bails out the public sector?

Exit strategies from the current stimulatory fiscal conditions are not just important in terms of the medium-term inflation outlook, but also from a long-term fiscal sustainability perspective.

Bond yields globally are heading higher as deficit countries look to fund what may now be large long-term deficit positions. This will crowd out private sector

investment and supports the case for a period of subdued economic growth from developed countries.

While deficit countries previously had time to consider their responses to future fiscal challenges, that time frame has now shortened considerably given the lower operating balance and higher debt starting points. Action to address long-term fiscal challenges is needed now.

## The changing geo-political landscape

Being long-term investors, we are thinking beyond just 2010. The GFC has been the biggest economic event since the Great Depression. While the worst of it may well be behind us, it seems to us that the global economy is now on a pathway to somewhere different. In this context, it's up to us here at AXA GI to work out what "different" means.

We mention above that one pleasing aspect of the response to the GFC has been the degree to which the response was co-ordinated amongst countries – both developed and emerging. In the early days of the crisis we saw co-ordinated interest rate cuts and central banks from around the world co-ordinating their broader efforts to prevent the global economy from spiralling down into economic depression and a period of debilitating deflation.

Now that the worst of the crisis is over, it is pleasing to hear the commitments being made at a multi-lateral level to co-ordinating the stimulus exit strategies that will play out in 2010. It is also pleasing to hear of the understanding that has evolved around the need to rebalance the global economy and to put it on a pathway to higher sustainable growth.

It is interesting that all of this work (talking, planning, implementing) is happening at a G20 level. It's the "20" that is most interesting. It wasn't that long ago that we were only interested in what was being discussed and decided at a G7 level – the heart of the developed world.

But the world has changed and balance of power is, at least initially, broadening. It may well, in time, change. The G20 incorporates the emerging markets that are likely to be the powerhouse of the global economy over the next few years.

The emerging markets will also be a big part of the solution to building the new post-GFC global financial system and economy. We know that emerging markets will be the strongest growing economies in the foreseeable future and that developed markets will find growth tougher going. Indeed the IMF estimates that by

2014, emerging markets will account for 51% of the global economy.

So the emerging markets need to have their say. This will present some challenges to the prevailing economic and political orthodoxy.

Much of the global financial system and economy were shaped by the G7. That influence will now be tested. Belief in the free flow of capital and a belief in floating exchange rates for example, both of which have been a core premise underpinning the economic development of the developed world, are not shared as widely amongst emerging countries such as China and India.

There is a more immediate challenge. All the right commitments are being given at the G20 level – commitments to building a stronger global economy, restoring confidence in the global financial system and to free trade.

The risk is that commitments made on the global stage don't get translated into domestic policy actions at home. The commitments are immense. Let's hope they are too big to fail.



**Bevan Graham**  
Chief Economist

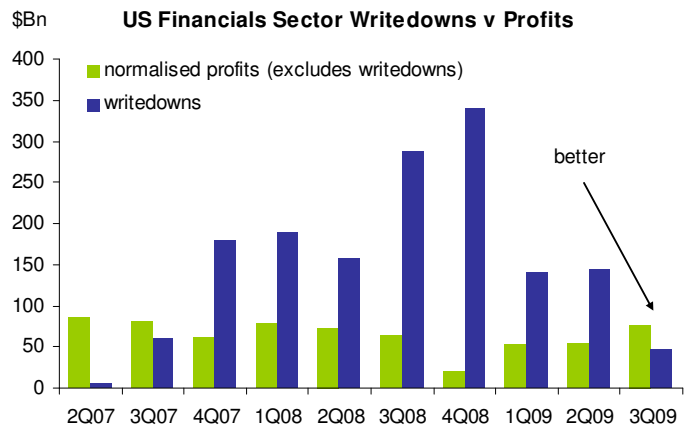
## Asset Strategy

### International Equities

Global equities continued to rise over the quarter, though at a much lower trajectory. Better than expected earnings and economic growth contributed to the gains.

### Outlook

The outlook for global developed equities remains positive. Valuations are still reasonable, especially compared to bond and cash yields, plus profit growth will turn positive this quarter after two years of declines. We also think higher than average margins will see profits continue to surprise on the upside throughout 2010 (see previous QSO).



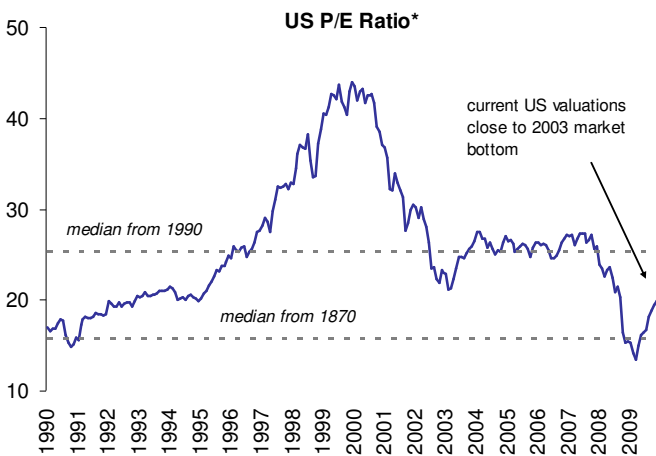
Source: Bloomberg, US BEA, AXA Global Investors

Strong earnings are needed to offset these writedowns – which will be higher if US house prices turn negative again. A steep, positive yield curve will help here as banks generally borrow short and lend long, pocketing the difference. This is another reason why the authorities are likely to keep cash rates low in 2010.

Sharply higher yields on government bonds are another key risk, caused either by higher inflation expectations and/or budget deficit concerns. With inflation likely to be contained at least in 2010, the authorities could extend bond purchase programs if yields rise too aggressively.

### Emerging Equities

Emerging market equities maintained their outperformance versus developed markets over the quarter, supported by strong growth in China and India plus higher commodity prices.



Source: Shiller, S&P, AXA Global Investors (\*earnings = 10-year inflation adjusted average)

It's also likely high unemployment in the developed world will persuade central banks to maintain low interest rate policies, leading investors into riskier assets in search of higher returns.

The outlook is not without risks. There will be further writedowns in the banking sector in 2010, and if these are significant there could be another knock to confidence.

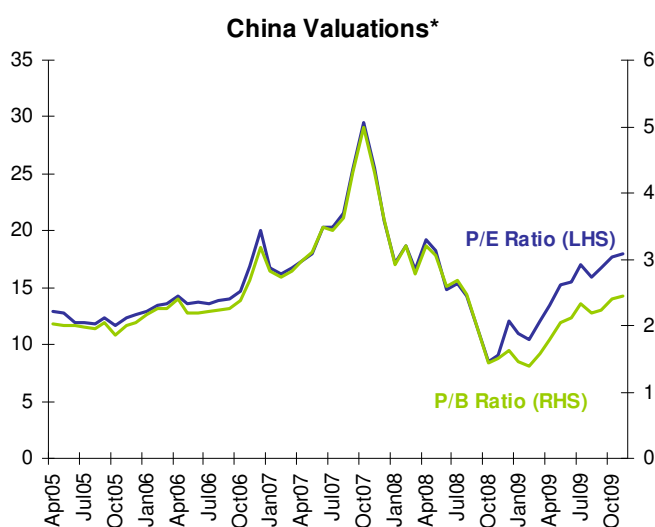


Source: Bloomberg, AXA Global Investors

## Outlook

Emerging market equities is still the asset class we are most optimistic on. Relative valuations, growth prospects, debt and financial sector risk all support an overweight to this asset class.

Concerns of a bubble seem overblown, at least at this stage. Take the most cited worry, China. The MSCI China Index is 35% below its 2007 peak and according to the World Bank, little of the recent lending surge has gone into the stock market, whereas more than half of the credit increase has been lending for infrastructure projects.



Source: Bloomberg, AXA Global Investors (\*25 largest Chinese companies listed on HKSE)

There has been little investment in China's manufacturing sector due to excess capacity, but on the flip side, this has contributed to a return to profitability due to a reduction in unit labour costs. Excess manufacturing capacity should also keep a lid on inflation for some time.

Growth in China is currently tracking around 9% and it is expected to improve further next year as a pick up in net exports and residential investment more than offsets the reduced growth impact from the Government stimulus. It appears the Government remains committed to stimulatory monetary and fiscal policy for the time being, while using administrative tools to curtail any excesses in the property and stock markets. For example, the authorities have re-introduced a sales tax on homes sold within five years and directed banks to increase the minimum down payment for a second house to 40%.

## Australasian Equities

Gains in Australasian equities have eased off over the last quarter. Rate hikes in Australia, expectations of hikes in NZ, and stronger currencies in both has weighed on the markets.



Source: Bloomberg, AXA Global Investors

## Outlook

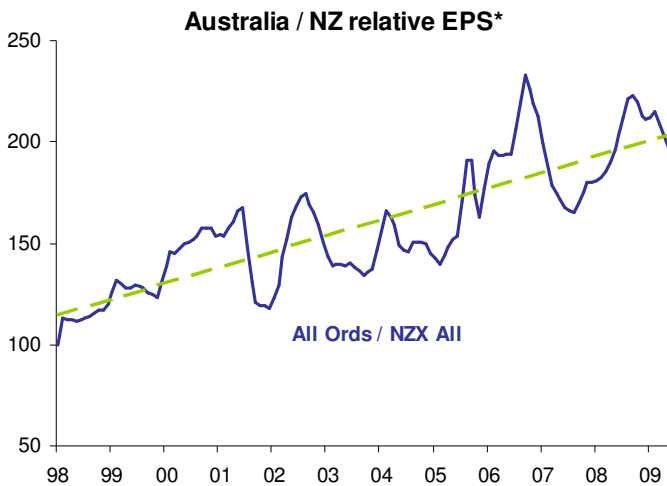
Earnings continue to decline in Australia making valuations based on trailing earnings seem expensive. Looking behind the aggregate data we see this is mostly due to low contracted commodity prices in the resource sector. A recovery in commodity prices bodes well for resource sector earnings in 2010 and beyond.

The outlook for the financial sector is more mixed. Low but rising bad debts in the banking sector will weigh on profits in 2010 but this will be offset by high interest margins and rising market share by the major banks. Either way, recent large equity issuance will dilute earnings to shareholders.

Outside of the resource and financial sector we expect profits to continue to grow along with the strong economy, as housing and business investment picks up the slack of the waning fiscal stimulus.

Mining investment is expected to be particularly high going forward. The A\$43 billion Gorgon LNG project was approved in September and the A\$12 billion Pluto LNG project, which has been under construction since 2007, is expected to start operating in 2011.

A high level of business investment is one reason why Australia's growth potential is higher than other developed countries – higher population growth is another. This is important for investors because higher growth potential translates into higher earnings potential.



Source: Bloomberg, AXA Global Investors (\*excludes companies with negative earnings)

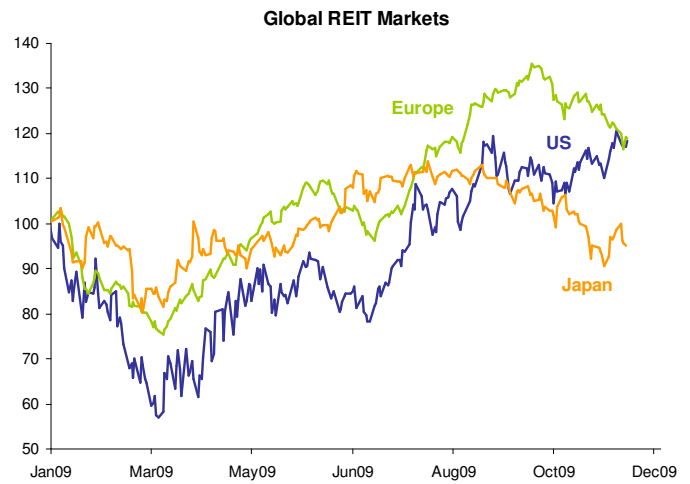
Considering where earnings are in the cycle, plus the higher potential, we believe an overweight to Australia is still warranted.

Turning to domestic shares, NZ earnings appear to have troughed and a pickup is imminent judging by producer price margins and business surveys. Indeed, confidence is broadening, with the agriculture, manufacturing and retail sectors joining the construction sector in becoming more optimistic. This can be put down to a few recent developments, including higher dairy prices (agriculture), robust Australian growth plus the weaker NZD/AUD exchange rate (manufacturing), high net migration and the wealth-effect of a recovering housing market (retail).

These are real positives, yet it's a pity confidence isn't being extended to investment intentions – although this is unsurprising given the economy's present spare capacity. Ultimately, if we want to match Australia's growth and earnings potential, we need to increase business investment. We remain underweight New Zealand equities.

### Property and Infrastructure

Faced with rising vacancies and falling property revaluations, most of the major global property markets lost ground since our last update. US listed property was one notable exception.



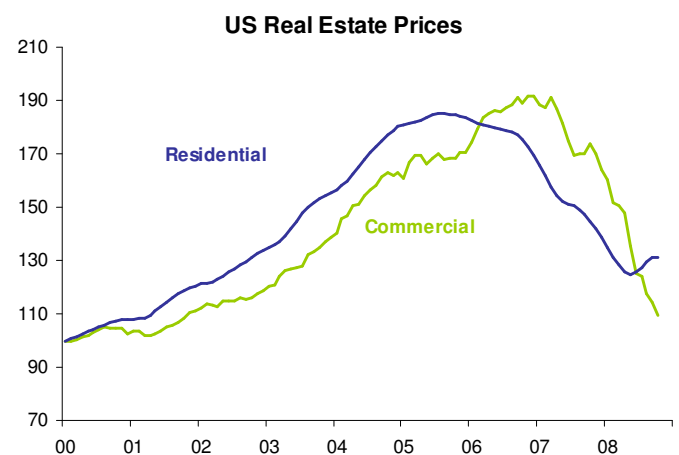
Source: Bloomberg, AXA Global Investors

### Outlook

Global property looks overvalued to us on most measures, especially in the US which represents close to 50% of the index. Recent share price gains and equity issuance have moved US dividend yields 1.5% below the 15-year average.

The US market is presently being supported by new accounting policies that allow lenders to avoid losses on commercial real estate. Thus there is no need to sell distressed assets, so the few properties that do come onto the market are well sought after.

Meanwhile US commercial property prices continue to decline, falling another 11% in the September quarter. Unlike the residential housing market, there is no end to the price declines in sight.



Source: S&P, Moody's, AXA Global Investors

New Zealand listed property looks better value with a dividend yield closer to 8%. Still, with NZ rental growth set to go nowhere (at best) over the next 5-years, dividend increases will be a rarity.

Consequently we retain a below-benchmark position in listed property, with most of the underweight concentrated in global property. The portfolios are at benchmark allocations for global infrastructure.

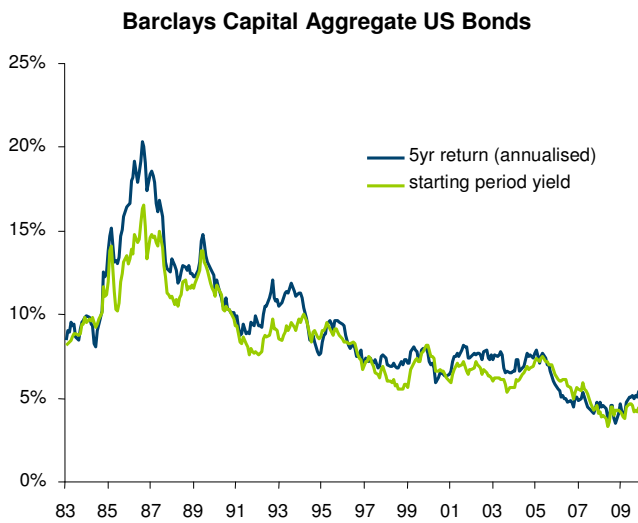
### International & Domestic Bonds

Global credit spreads have contracted a little further since our last QSO, offsetting slightly higher government yields, resulting in reasonable returns from global bonds. Domestic fixed interest returns have been more modest, with bond yields rising in anticipation of rate hikes by the Reserve Bank of New Zealand.

### Outlook

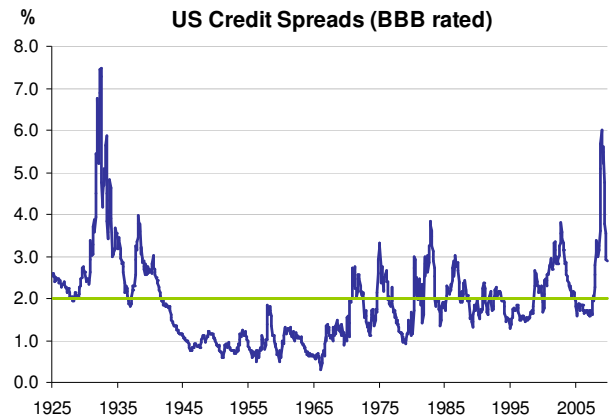
The Barclays Global Aggregate bond index is presently yielding a little under 3.0% (excluding the hedging premium), which is about half the 20-year average. Below average yields portends below average returns over the next few years.

Here's a chart we pull out every so often to remind investors the current index yield is one of the best predictors of bond returns over the next 5 years.



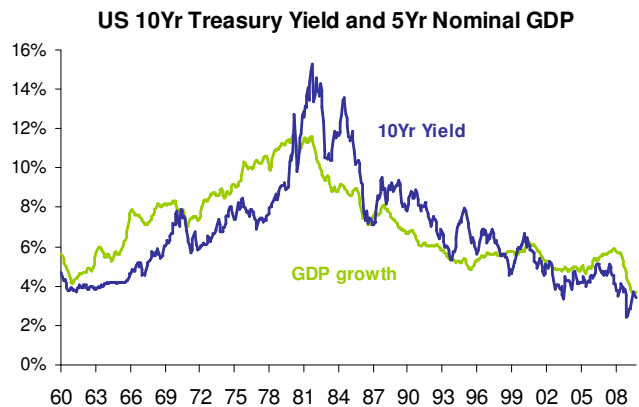
Source: BGI, AXA Global Investors

The chart below shows there are some opportunities left in credit, even though spreads are now half the level they were at the peak of the crisis.



Source: US FRB, Moody's, AXA Global Investors

It is government yields that look expensive. This can be shown by comparing US treasury yields to expected nominal GDP growth. Treasury yields tend to track nominal GDP growth because this brings saving supply and borrowing demand into equilibrium. Long-term US treasuries are presently yielding 3.4% while the IMF estimates 5-year nominal growth of 4.3% (2.3% real GDP + 2.0% inflation), so yields are almost 1.0% below expected nominal GDP growth.



Source: US BEA, FRB, AXA Global Investors

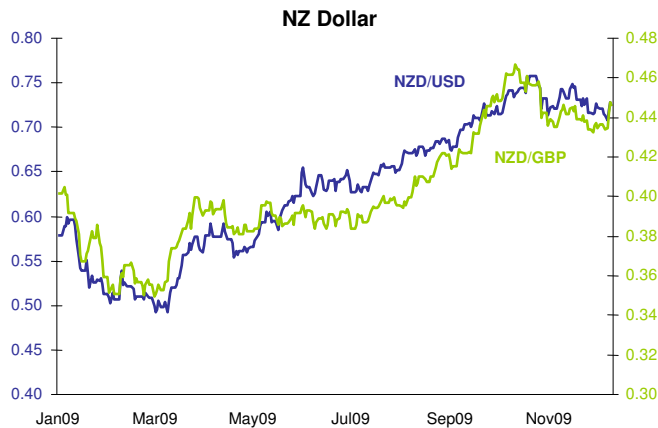
What's holding down long-term US Treasury rates? Besides the zero cash rate and Fed purchases of Treasury bonds, banks have been buying government bonds with maturing loans. This is the normal pattern following a recession but reverses as the recovery becomes established and the demand for credit picks up.

Budget deficits also present upside risk to yields. Financing recent deficit increases of 5.0% of GDP could raise long-term interest rates by 1.5% to 2.0% according to the IMF. This seems extreme but it shows where the risks lie. We remain underweight to global bonds.

The underweight to domestic bonds also remains in place. Relatively low yields, OCR hikes probably commencing in Q2 next year, government supply concerns, and higher longer-term funding requirements for banks, all support this position.

## Currency

The NZ dollar has risen a little further against the major currencies since our September update, though it is down about 5% from its October high.



Source: RBNZ, AXA Global Investors

## Outlook

While it has been the norm of late (and we've been saying it ourselves since March) it is now getting rather risky to assume rising global equity and commodity prices will lead to a higher NZ dollar.

After a +50% rise from its March 2009 low the NZD/USD recently moved within 10% of its all time high, yet equities and commodities still remain some distance from their 2007 high.

	Recent High	2007 High	Difference
NZD/USD	0.7582	0.8176	8%
S&P 500	1111	1564	41%
CRB Index	284	473	66%

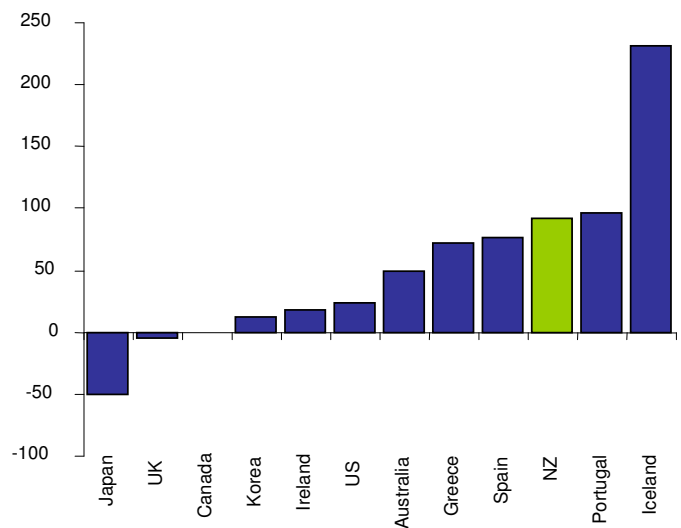
Source: RBNZ, Bloomberg, AXA Global Investors

We don't think it's worth chasing the last few cent gains in the Kiwi – especially when the NZD is 20% above fair value and the economy is structurally vulnerable.

New Zealand consistently runs high current account deficits (which is another way of saying we spend much more than we earn overseas) and unlike other countries where private saving has risen recently, partly offsetting government dissaving, Kiwi households continue to run large negative saving ratios (a jaw-dropping 13.7% of disposable income!).

As a result, New Zealand's net external liabilities remain large, higher than Greece and Spain's. This is not auspicious company, considering international rating agencies recently downgraded Greece and put Spain on negative watch.

Net External Liabilities % GDP



Source: RBNZ, AXA Global Investors

The below benchmark offshore equity currency hedge, put in place in September, still stands. When the NZ dollar eventually moves back to fair value, a lower hedge will see more of the corresponding offshore asset gains pass through to investors.



**Keith Poore**  
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