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In this issue:

Global business cycles

The baby booms...

Recovering from 2007's global credit correction

Heralding the first steps into the Portfolio Investment Entity regime

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Global business cycles

"The ups and downs of economic life, known as the business cycle, have provided a much smoother ride than they once did. That is why there has been such a clamour for financial and housing assets, and why firms and households have been more willing to take on debt. A lot is now riding on this golden age of stability continuing*."

Business cycles are periodic fluctuations in the rate of economic activity and are generally measured in terms of the levels of inflation (ie as reflected in the Consumers Price Index), employment and the Gross Domestic Product.

In the early 20th century, renowned economist Joseph Schumpeter developed the benchmark theory of economic/business cycles, which attempts to understand the ebb and flow of economic activity over time. In the modern context, however, the term 'business cycle' can refer to any one of a number of theoretical variations based on traditional and alternative economic models.

American economist Hyman Minsky was a pioneer in the development of a comprehensive model of global credit cycles. His model, represented below, examined how asset bubbles develop and overheat economies, eventually weakening market conditions and inexorably pushing them towards economic downturn.

Minsky's theory, which in many ways has been borne out over recent years, is that periods of economic and financial stability tend to lead to a lowering of investors' risk aversion. In turn, this leads to a willingness on the part of investors to borrow excessively, driving up asset prices.

According to Minsky, borrowers can broadly be divided into three categories. Firstly, 'hedge borrowers' are those who can meet both interest and principal payments out of their cash flow. 'Speculative borrowers', on the other hand, can only service the interest payments out of their cash flow. Healthy capital markets are crucial for these borrowers, as they need to refinance on a regular basis in order to service their debt principal.

continued ▶

At the bottom are 'Ponzi borrowers', who cannot service either interest or principal payments. They are called Ponzi borrowers after Charles Ponzi, an Italian who immigrated to America in the late 19th century and went on to become one of the greatest swindlers in US history. Ponzi's name has become synonymous with 'make money fast' schemes.

Ponzi borrowers constantly need to refinance their debt obligations and, therefore, need their investments (ie their home) to be persistently increasing in value to allow them to refinance off the appreciating house price.

During a period of credit expansion (ie a credit bubble), lending standards tend to loosen or fall. Most recently, this 'loosening' arose in the US (the world's largest and most influential economy) in the form of sub-prime mortgages, NINJA loans (ie No Income, No Job or Assets) and negative amortisation loans etc.

Economic commentators have suggested that about half of all US mortgage originations in 2005-2006 had such characteristics.

Such easy access to credit led to massive speculation on the US property market and this, in turn, led to burgeoning house prices and inflation. The US central bank, the Federal Reserve, increased interest rates to control these inflationary pressures and, quite suddenly, house price appreciation began to moderate.

As the US housing market cooled and interest rates started to bite, both speculative and Ponzi borrowers were suddenly faced with delinquency and default on their mortgages – and the global credit squeeze had begun.

We have now begun to see lower interest rates, particularly in the US, as weakening economic growth becomes a relatively greater threat than inflation. This has prompted much speculation regarding the direction of the global economy going forward.

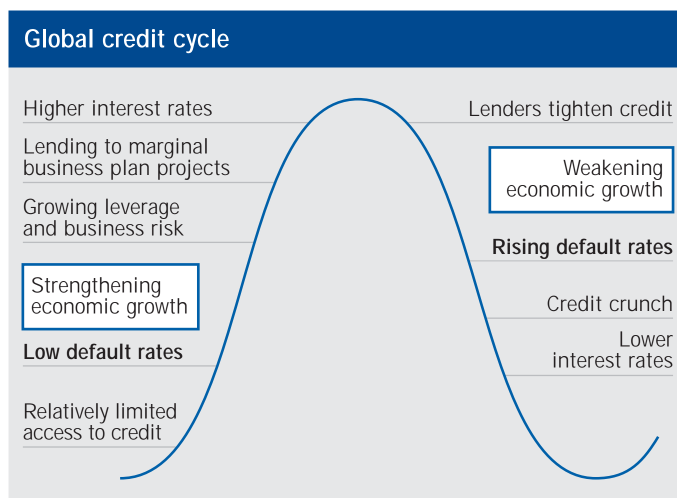
"The world economy has reached a decisive point. If that magical combination of growth and stability was just luck, it is now due for a long-postponed and painful correction*…"

Though central banks are now either guaranteeing bank deposits and making vast sums of money available to fund bank liquidity, the historical reality is that "attempts to fine-tune the economy through cheap money instead led to higher inflation and increased economic instability*."

However, it's important to take a macro or 'long' view in order to understand the cyclical, fluctuating nature of global economic performance. While we may indeed be experiencing a period of dramatic (and very costly) volatility in the global economy, this too shall pass…

The global credit cycle tracks the expansion and subsequent contraction of credit. During credit market upswings, access to credit is relatively cheap and economic growth strengthens. As the credit cycle peaks, lending criteria tend to tighten and credit begins to contract or become relatively more expensive. This leads to weakening economic growth.

A global credit cycle might go through some or all of these steps:



If we apply this model to several developed economies, we can make the following observations:

- New Zealand is transitioning from a period of high growth to a more moderate level of expansion. Interest rates remain high to reduce inflationary pressures.
- European economies are continuing to perform strongly, and this level of growth is attracting substantial equity and currency investment.
- The US is nearing the end of a long expansionary phase. The Federal Reserve has recently cut interest rates reflecting concern about the weakness in the US housing sector. Nevertheless, corporate default rates remain at historically low levels and economic fundamentals are persistently robust.

**The Economist, The global economy – 'The turning point' (20 September 2007)*

The baby booms…

During the post-war baby boom (1946 to 1965), over 1.125 million babies were born in New Zealand – over 77 percent more than in the preceding 20 years.

Over the next 50 years, the 65+ population will more than double to 1.18 million by 2051 and is expected to peak at 1.23 million in the late 2060s.

The number of centenarians is projected to climb from 300 in 1999 to 12,000 in 2051 and 18,000 by 2101.

New Zealand is, once again, in the midst of a baby boom, with 60,470 births in the 12 months to March 2007 – the highest number since 1974.

Source: Statistics New Zealand (www.stats.govt.nz) *The New Zealand Herald 'Baby boom underway in NZ' (March 26, 2007)*

Recovering from 2007's global credit correction

2007 will be remembered as the year that global credit markets experienced extraordinary levels of volatility, with global media dining out on the drama of it all...

Low interest rates in the US during the period 2001 to 2002 stimulated growth in the world's largest economy and led to an increase in the demand for housing. As prices rose at double-digit rates in 2004 and 2005, the housing 'boom' in the US turned into a housing 'bubble'. Much of this was fuelled by speculation and lax lending practices.

Growth in the US economy led to concerns about inflation and prompted a series of 17 interest rate increases by the Federal Reserve, America's central bank, over the period June 2004 to June 2006. At this stage, US homeowners were starting to feel the impact of higher interest rates and some were finding it difficult to meet their mortgage payments.

Most susceptible to higher interest rates were the so-called 'sub-prime' borrowers – people with poor credit histories, few collateral assets or patchy employment records, making them more risky from the lender's perspective. These borrowers typically took adjustable rate mortgages which offered low (or no) money down and low initial payments which then tended to balloon over the following years.

A further problem was that as US economic growth started to slow in 2006, many sub-prime borrowers began to lose their jobs. The default rate on sub-prime mortgages roughly doubled at this time, relative to what it had been two years earlier.

Many investment banks around the world had bundled large pools of sub-prime mortgages together to create residential mortgage-backed securities (RMBSs). These RMBSs were then pooled together to create collateralised debt obligations (CDOs), which were sold to a range of investors from hedge and pension funds to unit trusts. In this way, exposure to the US housing market and, in particular, the sub-prime segment of this market spread to a range of investors around the globe.

During the first half of 2007, the impact of delinquencies in the US sub-prime mortgage market was being felt in credit markets. By July, many investors were trying desperately to sell securities with sub-prime exposure. This selling spread to credit markets with no exposure to the US sub-prime sector, creating a knock-on effect. Investors were panicked by the flow of bad news emanating from the credit sector and many chose to exit at the bottom of the market and realise substantial losses.

The result was a global credit market in which there were too many sellers and not enough buyers, and significant downward movements in the prices of credit investments ensued.

Falling prices led to a dramatic rise in risk aversion among investors, reducing their willingness to invest and pushing yields into a steep climb. The varied quality of structured credit assets also made it difficult for banks (generally heavily invested in this area) to accurately value the assets they held,

leading to conservative downward revaluations across large numbers of high-quality credit assets.

The outcome of this extraordinary situation was that banks in most developed economies became increasingly distrustful of each other's financial stability and inter-bank lending came to a grinding halt. Credit markets had stalled – precipitously.

This forced central banks in Europe and the US to pump vast amounts of cash into the banking system to prevent a full-blown crisis. The UK joined in somewhat belatedly, but only after one of their largest mortgage lending banks edged towards collapse.

By early September, however, a degree of functionality had finally returned to credit markets. Although credit asset prices have remained volatile, the markets' focus has now turned to recovery.

Overall, the global 'credit crunch' massively increased investor risk aversion and prompted a 'flight to quality', meaning investors (particularly in the US) moved en masse towards very secure, low-yielding assets such as Treasury Bills.

In New Zealand, this flight to quality was most apparent in the finance industry, as nervous investors chose not to (re)invest in this high-yield, relatively high-risk asset class – thereby cutting off funds to finance companies and forcing them into a rapid series of liquidations.

More recently, the global credit markets have shown more signs of recovery, with both bonds and credit products such as RMBSs and CDOs trading better. This activity is slowly rebuilding investor confidence and, as a result, credit asset prices globally are gradually stabilising.

In order to avoid, or at least moderate, the impact of future volatility in investment markets, all investors should talk to their professional financial adviser about diversification within their portfolio. In conjunction with an active management style, diversification amongst assets and across geographic regions and different levels of risk leads to more stable investment returns. It also creates a portfolio of holdings better able to withstand the inevitable periods of volatility that occur in all investment markets.

Heralding the first steps into the Portfolio Investment Entity regime

1 October 2007 saw the introduction of a new taxation regime for managed funds in New Zealand – the Portfolio Investment Entity (PIE). An investor investing in a PIE enjoys tax treatment not available to non-PIE managed funds. Investing through a PIE attracts a tax treatment similar to investing directly into the underlying investments. The advantages of investing in a PIE are summarised in the table below.

If you have any questions about your current investments or to learn more about the advantages of investing in a PIE, please contact your professional financial adviser.

	PIE	Direct Investment	Non-PIE managed funds
No capital gains tax from the disposal of New Zealand and certain Australian shares.	✓	✓**	✗
Investors taxed at their marginal tax rates on investment income.	✓	✓	✗
Tax rate capped at 30% in most instances.*	✓	✗	✗
No impact on family assistance, child support and student loan repayments.	✓	✗	✗
No need to file a tax return in most instances.	✓	✗	✗

*Capped at 33% tax for 2007/08 income year.
**Assumes an investor who is not a trader.

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