PERSONAL INVESTMENTCENTRE
FINANCIAL PLANNERS AND INVESTMENT ADVISERS

Autumn 2012

"It takes seven times the average wage to buy an average house in Auckland"

Inside this issue:

From Pete's Desk

Well here we are almost through April and can you believe the weather we have had for the school holidays! 2012 has kicked off on a solid early run with a reasonable lift in share markets on the back of a number of improving indicators around the world. Key economic numbers out of the USA have been looking better; China appears to have engineered a successful slowdown of its economy which was previously showing signs of overheating. It's early days yet, too early to say we can bank the early gains and too early to say the world is firmly on a recovery path. We will undoubtedly see some further on-risk off-risk periods going forward and Europe in particular has further risk. The French Presidential elections, particularly if they lean heavily socialist, could create market nerves. Egypt has recently cut off gas supplies to Israel so things are not settled in the Middle East either. Our view is that Australasian share markets are reasonably priced and conditions will in time allow valuations and earnings to move upward. The thorn in the side for investors remains a continuation of extreme low interest rates for a while yet.

We have included within this newsletter an article by Chris Watling of Longview Economics. I have heard Chris speak at a number of Portfolio Construction Forum Conferences in Australia and I am always intrigued by his view and thought you might like to see his take on China—hope you don't find it too technical.

"An investment in knowledge always pays the best returns"

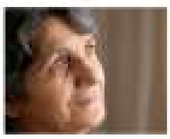
Benjamin Franklin

Another interesting article I have read of recent times in the Herald (written by Anne Gibson) was headed "Only Canada's house –price ratio tops NZ". This was a different take on an old theme, it was comparing house prices to rents over 21 countries. It showed a relationship between the price of buying a house and the amount of rent which would be generated from that house. The resultant price-to-rent ratio was "an analogue of the price-to-earnings ratio used to judge the equity value of listed firms. It said that NZ properties were 68% overvalued compared with the rent generated, the 2nd highest. It considered that NZ house prices were 20% overvalued compared with income, giving an average 44% overvalued when both rents and income were taken into account. However of the 21 countries studied buying a house still looked like a good option compared to renting. Rising rents were helping to cut into a backlog of unsold homes.

I remain of the view, banks encourage people into a residential property with not enough equity, which will be painful enough when interest rates rise again let alone any downward move in market prices.

Some other interesting stats to ponder on this subject are :

- In the last three years US house prices have fallen up to 50% and yet interest rates are lower than us at 3-4%.
- Where it takes seven times the average wage to buy an average house in Auckland and nine times in Sydney the multiple is less than half this level in other parts of the world.
- Places like Ireland and Spain house prices have also fallen 40-50% yet we all happily believe "It's different here and could not happen".

China—from the front line (an update on the bubble thesis)

Chris Watling—Longview Economics

I recently visited a number of business people and local experts in Shanghai and Beijing as part of a touring party out of Australia. While garnering some insights into the key short term Chinese issues—in particular the rumours surrounding a coup in China earlier this month, as well as the short term economic outlook (see below) - the most intriguing insight/information that we picked up relates to the longer term sustainability of the Chinese model of economic growth.

In particular it has further confirmed our view that, in the long term, China is a bubble. In analysis written some 15-16 months ago we laid out our argument that China has in recent years undergone significant misallocation of capital. In particular, using Chinese housing construction data, average household size and average house sizes, we estimated that approx. 74 million residential houses had been built which were currently standing empty. We also estimated that there has been a high level of overbuild in the commercial sector—while record high investments rates of GDP highlight that over investment has been happening across a variety of sectors (including roads, railways, factories and so on).

Intriguingly, our recent visit to China (our 2nd visit) adds anecdotal evidence to that view. In particular, throughout the week, we encountered plentiful evidence of misallocation of capital on a grand scale, including:

* *Viewing several expensive and empty low end, mid range and luxury apartments in Shanghai. Hearing accounts of empty suburban commuter towns just outside central Shanghai which, while empty not just for a few months but for years, are all owned. For example we viewed a luxury two bedroomed Shanghai apartment in a high rise block of apartments that was situated about 45mins drive from Central Shanghai in a typical area of the city. It was priced at US$1.2 million. It was empty, although owned, and had been empty for the past two years. An equivalent flat in London (i.e. in a reasonably good area 45mins car drive from the CBD) would perhaps sell for £350K to £600K. This was recounted to the group by a local property consultant from a well known Western international property company (NB the consultant was a Westerner who has lived in China for several years and is a bull on Chinese property despite an awareness of the overbuild).*
* *Driving for two hours on the almost empty six lane Beijing to Chengde highway (especially as we got beyond an hour outside of Beijing)*

Learning of the plans for new power generation stations despite the current significant underutilisation rates of the current installed generation capacity (on some estimates an approx. 50% utilisation rate). Most intriguing though is the insight given to us by a local Beijing professor during a discussion of China's energy outlook as to why overinvestment is occurring. The answer lies in local politics. To progress in the 1 million persons strong Communist Party ambitious future national leaders must work in many different jobs within the Communist Party across the country as they work their way up the party structure. One of those roles, typically as they move close to a national position is as a regional leader.

Such regional positions will typically last 3 years or so. In order to progress from regional leader to a national level the regional leader must hit his targets as set by the Central Government. Within these targets one of the most important is GDP growth. A regional leader, if he wishes to advance, must hit his GDP targets as set by the government in each five year national plan. That national planning framework then determines the regional targets. In the case of reaching a GDP target the most effective way is to undertake ambitious and large infrastructure projects. Some mix of these projects, coupled with encouraging private and overseas business investment, will ensure that the local leader reaches his GDP target. Power generation plants, given they take one to two years to build, can deliver significant levels of GDP

China—from the front line (continued)

growth over the tenure of the politician's appointment. This is the essence of the overinvestment in China—a story of target driven investment motivated by political ambition and not driven by a freely traded price signal. Eventually the excess in the system will need to be cleared out. The more significant the excess that has been built up then the greater the bust after the boom.

The challenge, as with all bubbles, though is timing the end. The logic, in essence, is that bubbles are built on speculative money and credit, in turn facilitated by loose monetary policy (cheap money) and leverage in the financial system. Once monetary policy tightens credit becomes less freely available, buyers dry up and the overleverage and overexposure becomes apparent. If you follow this theory then China's economic boom should, therefore, continue until monetary policy is tightened meaningfully and money becomes tight.

Clearly in the 18mths to the end of 2011 China has been tightening monetary policy. The party however retains strong control over the money that it provides for the economy, in particular the main five banks are all majority government owned (typically 80-90%) while the capital account is largely closed. As such China isn't at this stage vulnerable to sudden capital flight which is a key, typical vulnerability of emerging economies—whether flight by overseas capital or a procyclical tightening of credit within its own financial system as experienced in the West during the Global Financial Crisis. Neither a western style credit crunch nor a typical emerging market crisis is likely in China at this stage. Equally, the explosive growth of China's central bank's balance sheet illustrates its willingness to engage in Quantitative Easing. As such money should not become overly tight in the near term and the economy wide overinvestment and housing bubble should continue for now (albeit that house prices have experienced some modest weakness in recent months).

Consequently, we continue to see a soft landing for China in 2012 as being the most likely outcome. This was also the consensus amongst those we met in China. In particular, while the government remains able to maintain a closed system and the economy remains effectively state led and controlled, the government is able to create as much credit as it chooses especially while consumer price inflation remains under control. (The Chinese government regulates electricity and oil prices with the SOE taking any losses necessary from a rising input prices. The government is also heavily involved in influencing food prices by stockpiling grains and other foods and releasing these onto the market during periods of price spikes. Given food and energy account for around 40% to 50% of the CPI basket this enables the government to exert considerable influence of CPI). A loss of control over CPI or more likely a continued internationalisation of the Renminbi and with that, an opening up of the capital account and emergence of a current account deficit, would create the environment in which the fallibility of the government becomes apparent and the unwinding of the excess begins.

Currently though those vulnerabilities don't exist, so China should be able to continue to expanding its central bank's and financial system's balance sheet to create the credit it needs to build the infrastructure projects it needs so that it can ensure that, as always, it hits its targets. In the long term, though, China looks increasingly at risk of stumbling at the GDP per capita ceiling of US$10 to US$15K per person, a barrier many emerging economies have struggled to break through over recent decades. If correct, today's expectations for China's economy in 20-30 years appear wildly overstated. It also raises the possibility that the size of the Chinese economy will fail to overtake the US anytime in the next two decades.

Light Relief

"A gossip is one who talks to you about others, a bore is one who talks to you about himself; and a brilliant conversationalist is one who talks to you about yourself".

Personal Changes

Just a gentle reminder….

It is important that you advise us if you:

⇒ Change your bank account

⇒ Change your address

⇒ Change your Will

Bank account and address changes are obviously important to ensure that withdrawals and correspondence get to the right place but it is also important if you change your Will. This could mean that your investments may need to be set up differently i.e. if you set up a Tenants in Common structure or a Trust structure. Our recommendation would be 'if in doubt—give us a call" to ensure your portfolio meets current requirements

OUT OF THE OFFICE

Lynne and Peter will be out of the office from:

26th to 30th April (incl)

Also Thursday 3rd May

16th & 17th May

Michele will be ably "manning the deck" during these times so if you are needing anything please phone her on the office number 354 7900 between 8.30am to 3.30pm.

AEGIS TAX SUMMARIES—DUE MAY 2012

Tax summaries are due to be printed in May 2012. We are now able to provide PDF copies direct to your Accountants and some Accountants have indicated that they would prefer this method. It is therefore imperative that you advise any change of tax consultant; particularly if we are providing copy of the summary directly to them.

For those that prefer to receive the tax summaries first to then pass on please be aware where an Estate or Trust is involved we provide extra reports; such as financial cash account transactions etc. **It is most important that you pass these onto your Accountant also—do not keep them in your files.**

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