Market Commentary

NZFUNDS

RESERVE BANK'S CATCH 22 MEANS AN INFLATIONARY FUTURE

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The Reserve Bank of New Zealand's survey of 2-year ahead annual CPI inflation expectations hit a twenty-year high of 3.0% today. The survey records the expectations of a range of commercial practitioners including analysts and businesses.

"The recent survey of inflation expectations looks through last year's one-off impact from rising GST rates, so it is a clean assessment of what inflationary expectations are," says Michael Lang, Chief Investment Officer at NZ Funds Management.

Lang maintains that inflationary expectations are an extremely powerful and worrying force in economics. "If businesses expect inflation to rise next year they will put up their prices in anticipation this year, which in and of itself creates inflation thereby validating their concern."

One of the perceived benefits of the Reserve Bank Act 1989 was that by enshrining the allowable amount of inflation in legislation, inflationary expectations could be brought and kept under control. It would appear they are once again out of control. Lang says that the below average rate of inflation experienced over the past twenty years may have more to do with globalisation and the resultant outsourcing to nations which offered lower labour costs than breakthroughs in monetary policy. The cost of labour in countries such as China and India is now rising and is expected to continue to rise for the next twenty years.

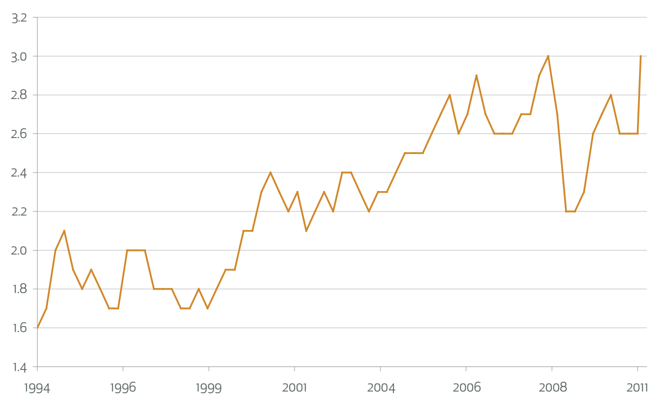
The previous high recorded in late 2008 was at the height of global economic activity, prior to the Global Financial Crisis. Lang says the Reserve Bank is caught in a catch-22 situation as the New Zealand economy is now significantly weaker than prior to the Global Financial Crisis and could not withstand the meaningfully higher real interest rates needed to dampen future inflation.

Personal debt levels remain high, the proportion of homeowners on floating rates remains relatively high and unemployment is not forecast to decline dramatically in the next two years. Unemployment is projected to remain 6.2% in a year's time and 5.7% in two years time. As a result, any meaningful increase in real interest rates would significantly impact on the domestic economy.

"Unlike the United States Federal Reserve, the Reserve Bank is not restricted by a dual mandate to target both inflation and employment – however, neither can it clamp down on inflation expectations to the extent the domestic economy stalls as that might lead to inflation rates breaching the bottom of the target band". Lang believes that given the fragile nature of the global economy, the Reserve Bank will err on the side of caution when raising interest rates.

"As a consequence, we are unlikely to see the level of interest rates needed to suppress further price rises in food, fuel and housing and we will therefore see significantly higher levels of future inflation. This will result in a wealth transfer away from individuals whose savings are held in term deposits toward the owners of real assets such as shares, property and commodities which tend to rise in value with inflation."

RESERVE BANK OF NEW ZEALAND 2-YEAR FORWARD CPI INFLATION EXPECTATIONS



Source: The Reserve Bank of New Zealand (RBNZ) Survey of Expectations.

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