New Year, New Zealand

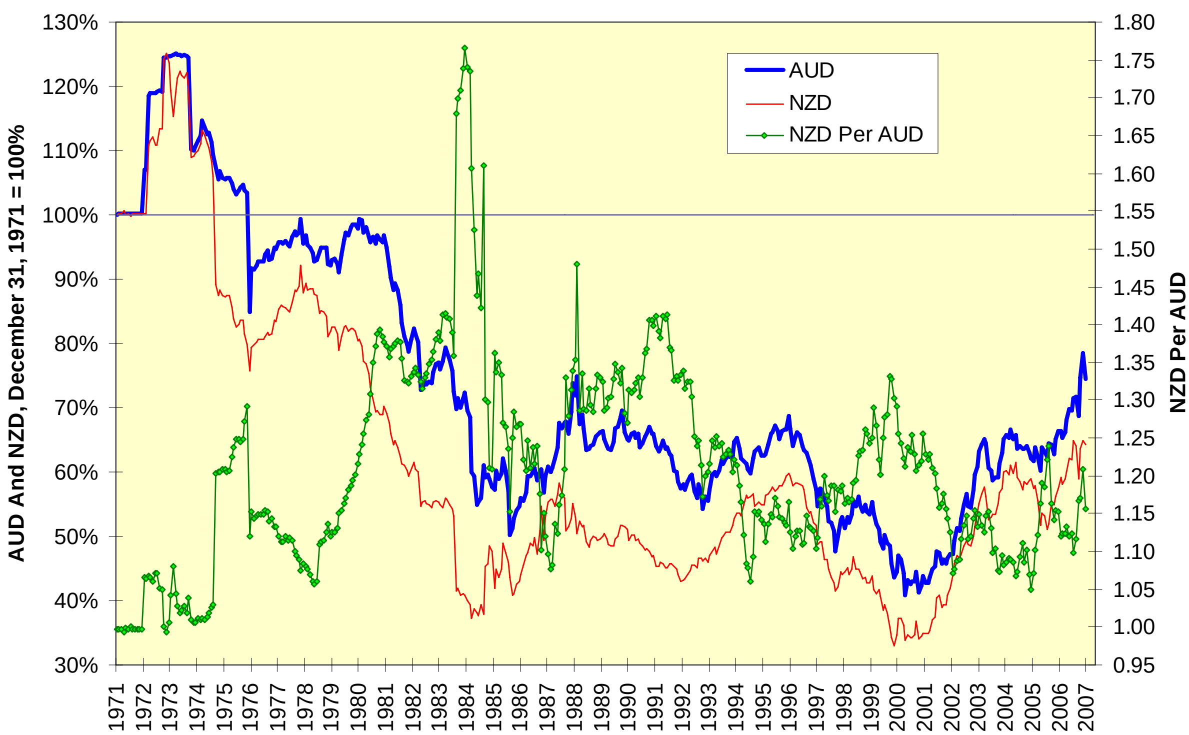
Baseball teams are forever searching for a leadoff hitter. Financial markets have a permanent one, permanent at least until some fool goes and moves the International Date Line when no one is watching, and that is New Zealand. This, eight long years ago, is when we found nothing would happen with Y2K. Nine years ago this was where the first interbank trade in the euro was transacted.

I have had a modest soft spot in my heart ever since I lived in Bermuda in the 1980s. The island, which lies but a short distance from the U.S. and Canada and a slightly longer one from Europe, imported its butter and cheese not from either side of the Atlantic, but rather from New Zealand, which is about as far as you can get. Why? The U.S., Canada and Western Europe all subsidize dairy products to the point where they are non-competitive in world markets. It was cheaper to ship it from New Zealand than from New York, and if there is a better lesson in the folly of agricultural subsidies, I would like to hear about it.

It's Not Australia

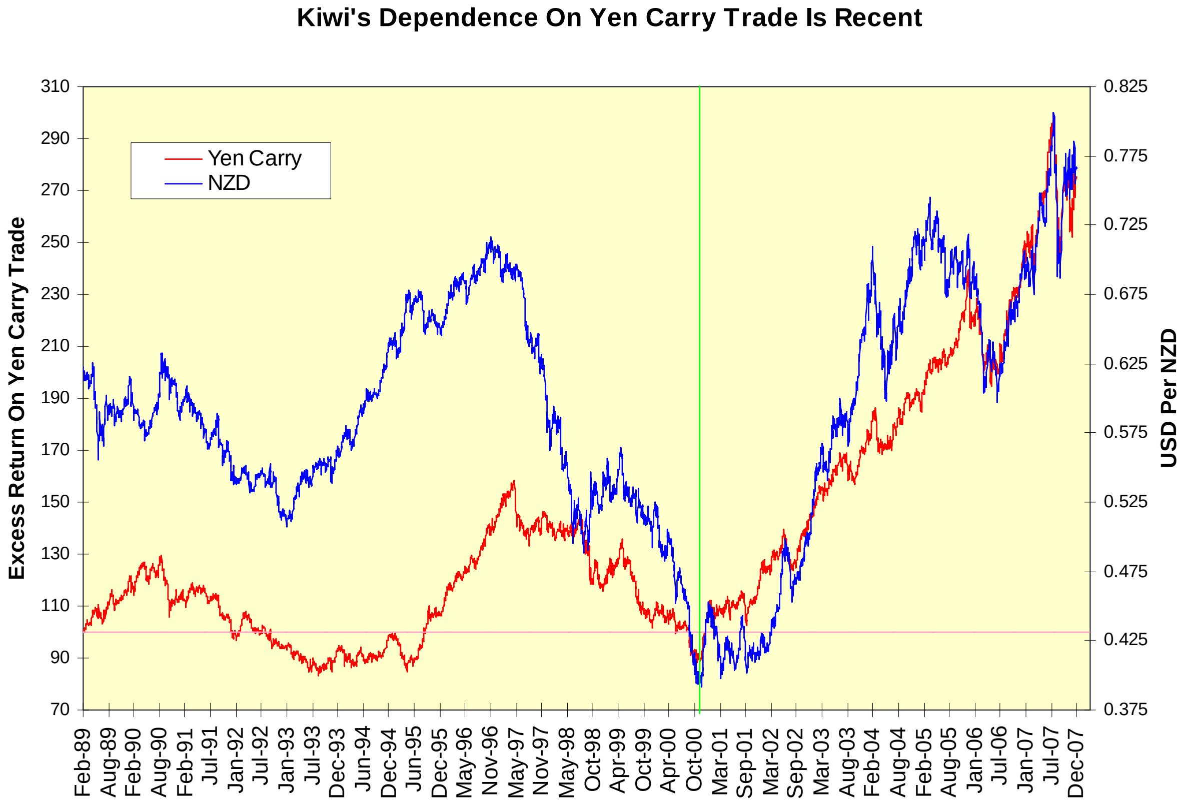
Even though it is 1,380 miles by air between Wellington, New Zealand and Sydney, Australia, the two countries get lumped together by virtue of relative proximity and their shared heritage in the British Commonwealth. And, as I noted in a column on Australia last October, pairing New Zealand against Australia makes even less sense than pairing Canada against Australia. The New Zealand dollar, (NZD, known affectionately as the "kiwi" after the fuzzy bird and equally fuzzy fruit of the same name) trades very differently than the commodity-dominated Australian dollar.

Australian And New Zealand Dollars



The Yen Carry

The real driver of the kiwi has been the yen carry trade, last discussed here in September. As we will see shortly, the Reserve Bank of New Zealand has kept interest rates at a very high 8.25% to restrain inflation. That has opened the door wide for traders to borrow the yen and lend in the kiwi. How profitable has this carry trade been? The average annual excess return has been 5.51% since February 1989.

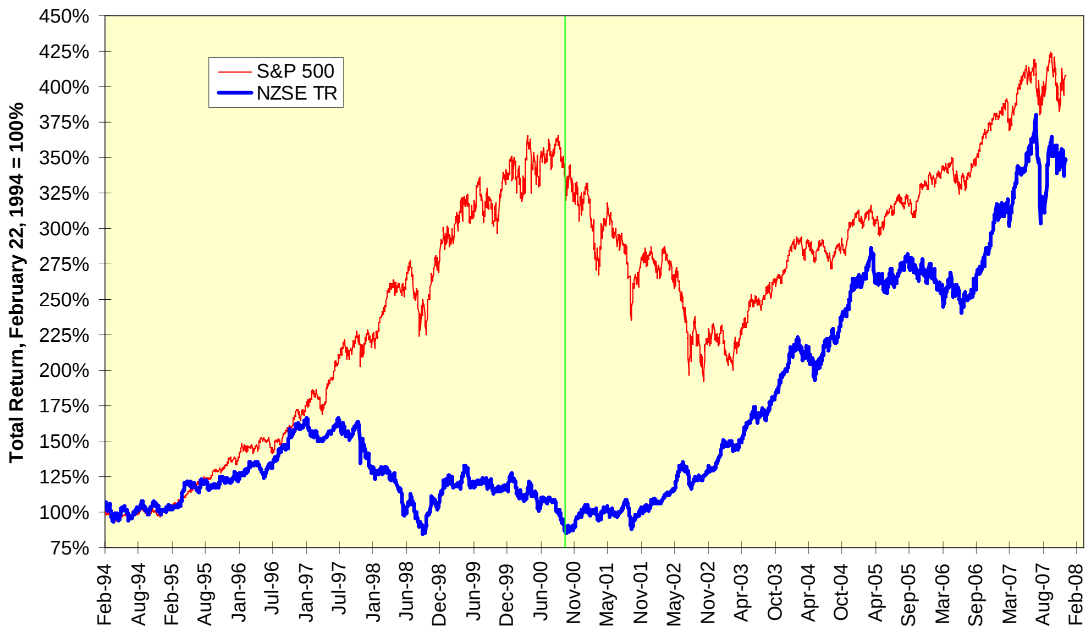


However, this trade has been anything but smooth. Note in the chart above how the currency's relationship to the carry trade only became close after October 2000. This was five months before the Bank of Japan embarked on its policy of "quantitative easing," which is a fancy term for shoving money down bankers' throats so hard…well, you complete that thought.

New Zealand All-Ordinary Index

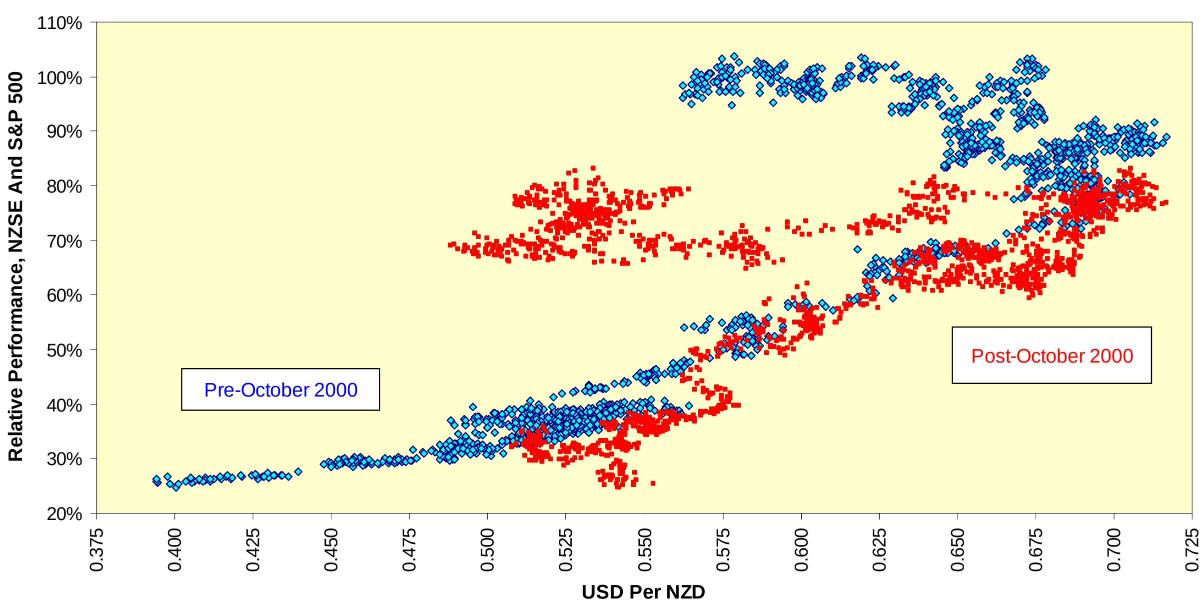
The money, as any drunken sailor worthy of the name could have predicted, changed behavior. If we map the total return of the New Zealand All-Ordinaries index (NZSE) in U.S. dollar terms against that of the S&P 500, we see just how badly the NZSE lagged the S&P 500 until the yen carry trade started propelling money into New Zealand. Even though the NZSE has underperformed the S&P 500 since February 1994, its USD return since October 2000 has been both higher and less volatile.

New Zealand Is A Slow And Steady Underperformer



And make no mistake about it: It is a wall of money and not the currency driving the NZSE in USD terms. In fact, if we split the sample into pre- and post-October 2000 segments, we see how the kiwi has been a non-factor in relative performance terms after October 2000.

New Zealand's Relative Performance Independent Of NZD In Carry Trade Era



Risk And Opportunity

The dependence on the carry trade carries a special risk, and that is what happens if and when the Bank of Japan finally decides to start raising interest rates back toward global levels. We saw in both May-June 2006 and again in August 2007 just how vulnerable global financial markets are to any whiff of this policy change.

The carry trade is safe for now; the Bank of Japan kept its discount rate at 0.50% on December 20, 2007, and signaled it would be on hold for the foreseeable future. And as an aside, I am getting old and gray waiting for this to change; I first started to write how the Bank of Japan could not keep interest rates at that level in 1996. I was right: They went lower.

Now here is a rarity for this day and age: Unless my *Bloomberg* search capabilities have failed me completely and utterly, there are no exchange-traded funds or country-specific closed-end funds for New Zealand denominated in U.S. dollars.

However, the largest stock in the NZSE, Telecom Corporation of New Zealand (Motto: No call is local, look at a map, pal) has an ADR (NZT). It is a high-beta representation of the NZSE with an r-squared, or percentage of variance explained, hovering near 50% over most data samples.

Several other large-capitalization stocks in the NZSE have ADRs listed, but when you get a "price unavailable" message back on the quote screen, it is best not to investigate further.

Finally, after all of the admonitions against pairing New Zealand against Australia, there is an open-end mutual fund, Commonwealth Australia/New Zealand Fund, with a 66.66% weight in New Zealand-domiciled stocks. Its total return in U.S. dollar terms over the past year of 16% certainly is respectable.

And if nothing else, insomniac traders and "tick freaks" can take pleasure knowing the global trading day will begin with them.