

Market Performance

As we mentioned in our last quarterly update we expected investment market conditions to remain volatile and they certainly have. The December quarter proved to be both volatile and negative for markets. The drivers of this remain the same as they have been for most of the year although the deterioration of the sub-prime mortgage market issues and greater concerns of a marked slowdown in the US economy (and possible recession) has really brought out the sellers.

The key issues impacting this market volatility can be split into two groups – those issues that are normal cyclical economic issues and those that are more structural (not normal) in nature.

The groups of issues are linked and this is creating a difficult and confusing environment for both the policy makers like the US Federal Reserve and investors alike as their thinking seesaws between which is the most important set of drivers to focus on and manage.

Group 1 – Economic Issues (cyclical downturn)

- 1) Falling US property prices. US consumer spending has been supporting global expansion for 16 years underpinned by a stable increasing house prices. Since 2006 US house prices have fallen with the US housing price index down 10%, new home prices falling 13% year on year to the end of November 2007 and home sales now at 9 year lows.
- 2) US Consumer confidence. While to date the US consumer has been remarkably robust they are now coming under real pressure as home prices fall and more recently with higher levels of unemployment (up to 5% from 4.4% in February) as building related and financial services industries shed staff.
- 3) US Inflation. The strong global demand for energy, materials and food has been finding its way to the petrol pump and supermarkets. Headline inflation in the US has been recently been high (4.3% and core inflation at 2.3%) and this has required the US Federal Reserve to maintain relatively tight interest rates to dampen the economy.

Put simply the US has run out of puff this year after many years of stellar economic growth. This is a normal economic cycle at play but extent of the slowdown is not yet known. Whilst a recent poll of 62 US economists showed a consensus that the US will not fall into recession several larger investment banking groups (Merrill, Goldman Sachs and Morgan Stanley) say a recession is now happening. Either way a slow down is likely.

However what is worrying markets more than usual at present is not just this normal economic cycle issue but also the structural issues that are in currently in play.

Group 2 – Banking System Stress (structural problem)

- 1) Non Bank Lending - Traditionally banks lend money to home buyers and have a direct relationship with the borrower. This transparency keeps the bank informed on the borrower's financial position and capacity. The banks in the US are in turn regulated by state and federal requirements with regards to their operations and capital adequacy requirements. Foreign and local lenders have been increasingly providing funds to US home buyers through non-bank channels. This funding has been made available via mortgage brokers and securitized investments – or pools of loans that have been grouped together and sold to funds managers, hedge funds and direct to investors. There is little transparency between the lenders and the borrowers and this creates a problem when things turn bad.
- 2) Leverage - The pools of loans were securitized into an investment and bought around the world by banks, funds managers, hedge fund managers and investment product manufacturers often funded by money they have in turn borrowed. In turn they thought they were protecting this leveraged position by insuring the risk of mortgage or loan defaults to other counter parties via sophisticated derivative instruments. In essence there has been an extremely highly geared lending market with no transparency and a maze of counterparty risk offsets around the globe supporting this lending to sub-prime mortgages.
- 3) Size of Losses- As US home prices fell, borrowers started to default on their loans (particularly in sub-prime loans) and lenders have been forced to recognise and make provisions for the losses on these loans. The complex nature of the securitized pools of loans and the web of derivatives that support them means that no one really knows how big the losses are or who has them. As time goes by more and more financial institutions (non-banks primarily but increasingly banks alike) are unwinding and recognising these losses. What looked like a US\$100bn to US\$250bn problem is now looking like an \$US500bn problem. That is a lot of capital to lose (about 4% of the total US home loan market) but it should be able to be absorbed over time.

- 4) Liquidity – As the mortgage default losses are taken onto the balance sheets of financial institutions will require more capital to maintain their lending activities. This demand for capital and the need for short term refunding has created a bottle neck in the US and global financial and banking system. As banks become more wary of lending money to each other (for fear of not getting their money back) a liquidity crises has occurred pressuring central banks to act by providing liquidity to banks and also to reduce interest rates.

Policy Confusion

Which set of issues should policy makers contend with? To help the banking system central banks have been injecting liquidity and they will continue to do this. A bigger decision is whether they should also reduce interest rates as well and quickly and run the risk of deeply entrenching inflation in the process. We consider their response in the “Outlook” section of this report.

In the table below we show the returns that were achieved over the quarter for each of the major asset classes. These are broad market returns (gross of tax) and can be used to benchmark the actual performance your portfolio received for the same asset classes in your portfolio reports.

Asset Class	Quarterly Market Returns
NZ Dollar (Trade Weighted Index)	+1.1%
NZ Cash	+2.1%
NZ Fixed Interest	+0.3%
Global Fixed Interest – 100% hedged to NZ\$	+3.3%
NZ Shares	-5.3%
Global Shares – 50% hedged to NZ\$	-3.9%
Alternative Assets – 50% hedged to NZ\$	-1.4%

Notes: Returns are derived from market benchmarks and are before tax or costs.

Global Outlook

Until now the US Federal Reserve has been trying to keep a lid on inflation by maintaining a relatively tight interest rate policy to make the economy slow down and deflate on its own accord as would happen in a normal economic cycle. Now however, they have to contend with a structural financial system problem.

By reducing interest rates to assist the banking system there remains a real risk that they reduce any cyclical economic adjustment and in particular inflation could also become structural and this is the dilemma the US Federal Reserve finds itself in.

However the markets believe the dysfunction in the financial system requires urgent action and responding by selling off assets in response to their concerns. The markets want the Federal Reserve to act by quickly reducing interest rates.

We believe the recent sell off in markets (January 2008) has been overdone and is now based on emotional issues with investors reacting to concerning banking system fears rather than any rational response to a slowing US economy (which does not warrant the recent sell off).

It is likely the US Fed will be forced to intervene with rate cuts in late January to assuage the markets. But it may do so reluctantly. We expect they will reduce interest rates some 0.5% (from 4.25% to 3.75%). Further cuts may be required in the quarter and over the year. At that point any inflationary consequences would then have to be dealt with once the financial system becomes more functional.

It certainly appears that unlike his predecessor Alan Greenspan (who focussed on keeping markets inflated), Bernanke is more traditional and happy to see a more normalised economic cycle occur (i.e. a slow down) to prevent the risks of system inflation.

While we are in for a period of continued uncertainty but we expect the financial system stresses in the US and globally will be resolved with the assistance of further liquidity provisions from central banks, capital injections from wealthy sovereign funds (China, Singapore, Middle East) that are awash with cash (estimated at \$USD 2 trillion) and further reductions in interest rates in the US. It will, however take time to work through (at least 6 to 9 months) and during this period losses from mortgage defaults will be better quantified and written down. This process will be messy and there are likely to be more surprises in terms of the size of the losses that will be incurred. *Interestingly it is worth noting sub-prime mortgages are ultimately secured by real assets (houses) and there are economic commentators that believe the write-downs and provisions are already overblown.*

Against this backdrop of a financial system work-out the US economy will slow next year and possibly have a recession. This slowdown is highly unlikely to be long lasting (become secular) and even the most negative economic forecasts are expecting a positive contribution to growth from the US in 2008. This growth will be weak at about 1% to 1.5% GDP growth (the IMF forecast 1.9%) with better though still subdued growth in 2009.

Despite having an economic slowdown in the US it is not falling apart it will have to work through the present banking system issues and through the large oversupply of housing stock which may take until 2009 to stabilise. It remains a well diversified and flexible economy that is remarkably resilient.

There is also a bigger game in town.

As we have discussed in previous reports the US however is playing a smaller and smaller role in terms of global economics. While it is still the largest contributor to world production (about 18%) China is now very close behind and in terms of adding to the growth of world production China and India have now its major contributors (China at 35% to 40% and India close to 10%. In fact the US contributes only about 7% to new world output growth (about the same as Europe).

The outlook for global growth is still very strong though at a slightly lower pace than 2007. According to the latest International Monetary Fund forecasts it expects healthy economic growth to continue into 2008 (see table below) though global growth would slow a little from 5.2 percent in 2007 to 4.8 percent in 2008.

	2005	2006	2007f	2008f
World	4.8%	5.4%	5.2%	4.8%
US	3.1%	2.9%	1.9%	1.9%
Euro Area	1.5%	2.8%	2.5%	2.1%
Germany	0.8%	2.9%	2.4%	2.0%
Japan	1.9%	2.2%	2%	1.7%
Africa	5.6%	5.6%	5.7%	6.5%
China	10.4%	11.1%	11.5%	10%
India	9.0%	9.7%	8.9%	8.4%

Source IMF, World Economic Outlook, October 2007.

So while a slow down in the US will impact overall world growth its impact will be lower than in the past there is a bigger global story going on.

It is likely there will also be some slowing of the Chinese economy that has been running at break neck speed. Inflation in China is now around 7% which is a concern for the Government which is trying to cool activity.

Slightly slower growth is also anticipated for the Euro area as the European Central Bank remains habitually focused on containing any signs of inflation there. Japan remains relatively anemic though still a positive force and despite years of Government attempts to kick start domestic consumption higher levels of growth are not on the horizon.

As global growth will slow at the margin so we expect see the demand and price of energy and materials reduce in 2008. It will not be great but sufficient to reduce some inflationary pressures and support central bankers interest rate cuts. The anticipation of this slightly slower growth has recently been factored into market prices (and hence the recent decline in BHPs price).

Overall our outlook for global sharemarkets in 2008 is still positive although with the recent market correction part of the year will be devoted to recovery of the ground that has been lost.

Sharemarket valuations are now very attractive on both an historical basis and particularly when compared with current bond yields and have recently been oversold as emotion has now taken hold. Global sharemarket Price Earnings Ratios (ex Japan) are now at 10 year lows. We expect investors will return to the markets quickly on any positive news (or expected positive news) and this price recovery will be swift though delivered through a series of very volatile market movements over the next two quarters.

New Zealand Outlook

NZ remains more problematic with inflation remaining the key policy issue. Headline inflation is likely to be running well above the 1-3% Reserve Bank target (possibly higher than 4% at present). This means interest rates will remain higher for longer. For the reasons mentioned previously we expect energy prices will abate at the margin as global growth slows a little and this should help our inflation position this year but until the Reserve Bank sees signs of reduced consumer spending, contained wage inflation and a reduction in home prices (which is now happening) then high interest rates will remain.

As fixed rate home mortgages keep rolling over to the new higher interest rates this year we expect investors and home owners will come under further pressure forcing sales and further reducing real estate prices this year. Some economists are forecasting real estate prices to decline more than 20% from current levels (and possibly higher). There has already been a 2% decline in house prices in (December alone) with house prices now at 8 month lows while house sales are down 32% year on year.

With an outlook of high relative interest rates compared with the rest of the world and anticipated reductions of interest rates in the US and elsewhere the \$NZD is likely to remain stubbornly high and may rise higher further which will put greater pressure on exporters. Not good for our current account balances.

So far our primary industry and particularly dairy have been the only exporters to be protected from a higher \$NZD as their produce prices continue to be underpinned by global demand though we expect 2008 may prove a little less favourable for them as our trading partners have slightly slower economic growth.

Domestic economic growth will be sluggish at around 2.2% (down from a forecast 3% growth level in 2007) with lower company earnings growth (possibly 1% earnings growth outlook). A sizeable contribution to our growth this year will be coming from the dairy industry.

The failure of many finance companies and the global credit squeeze is likely to make funding conditions difficult which will directly impact property development activities, some business borrowings, consumer finance and also leveraged corporate actions.

Based on Price Earnings Ratio measures the NZ sharemarket is still relatively high and just above 10 year averages. We expect sharemarket returns will be positive in 2008 but relying more on yield than price growth. A focus on defensive high quality companies with reliable income streams will be important and exporters are likely to continue to have a tougher time for most of 2008.

Longer dated bonds remain expensive with shorter dated bonds offering better value.

As the economy slows and inflation looks contained the Reserve Bank will ease rate. This could well happen this year particularly if housing prices correct quickly and consumer confidences retreats. In the meantime we can expect a continuation of high relative exchange and cash interest rates.

Outlook Conclusion

- The US will slow down but recover and produce a positive economic year.
- Global growth will remain very strong at near 5% levels though slightly softer than last year. This will support global share markets in 2008.
- Closer to home NZ will also be working through some excesses with real estate likely to fall further.
- The NZ economy will slow and inflation will abate. We muddle through another year supported by global demand for our milk.
- We expect positive returns from global, Australian and NZ share markets though more subdued and certainly with periods of high volatility.
- Well balanced portfolios with good quality assets will cope with these conditions.