

In our last quarterly report we discussed 2011 as being the year of validation for the success of global central bank and government policy intervention in solving the great financial crises. On balance, we believed it had gone just about as well as possible and this year we would see the private sector successfully taking the baton from government and leading the economic recovery.

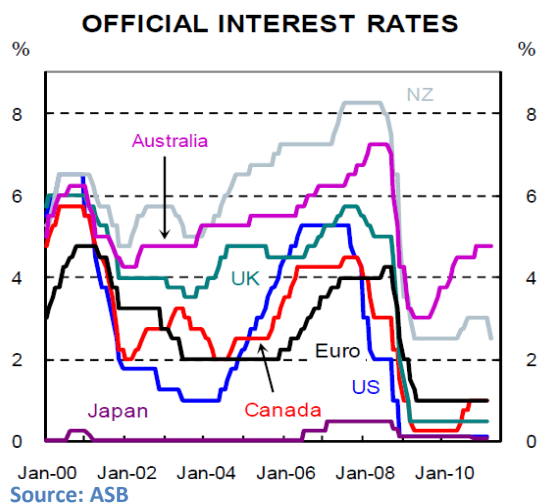
Despite the devastation of the Japanese earthquake, the nuclear reactor disaster and the ongoing rising tensions in the Middle East and North Africa, the global economic recovery remains intact.

This quarter we look at the global drivers for a continuation of this recovery and the risks for derailment. Closer to home, we take the same snapshot for New Zealand.

The Positive Drivers for Global Recovery

Stimulatory Policies Continue

Aggressive stimulatory monetary policies remain firmly in place for the western world. Of the advanced economies only the European Central Bank has blinked so far into this recovery by recently raising rates 0.25% to 1.25% as a signal of its intentions (European inflation is now running at 3 year highs). The US maintains its 0 – 0.25% interest rate policy and remains committed to buying US treasuries using its second round quantitative easing (QE2) program to keep yields and the cost



of money down for longer. Despite consistently better economic data in the US, high unemployment rates and low credit growth keeps the Federal Reserve on vigil.

The Japanese disasters mean the Bank of Japan will keep their already long term stimulatory monetary policies in place with further stimulation required in addition to the recovery impetus.

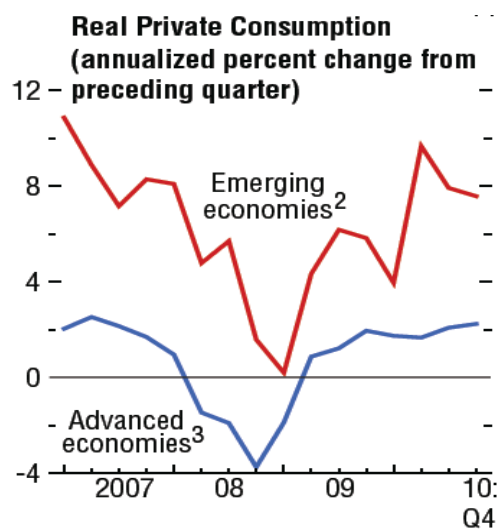
The low cost of money arising from these monetary conditions is likely to underpin economic expansion in advanced economies through 2011 but remain a source of inflation for emerging economies as a significant portion of these funds find their way into those higher returning markets.



Advanced economy governments also remain committed to stimulatory fiscal policy settings but with higher public debt levels the focus is on efficiency with lower corporate and personal tax rates as well as re-targeted spending programs. As public debt rises to levels that threaten to undermine financial system confidence, spending will have to be funded from cuts to other areas of public activity. We expect this will be major theme (and increasing source of social disruption) in 2011.

Increasing Domestic Demand likely from Emerging Economies

Longer term, the wide imbalances that exist between surplus and deficit countries must narrow. This requires surplus countries like China to change the shape of their economy and gain more economic growth from domestic activity than from export activity. While there have been signs of reducing trade surpluses (and a recent trade deficit) for China and other emerging economies over the last year, most of this has been driven by weaker advanced country demand for their exports rather than



Source: IMF

structurally greater domestic demand. Those emerging countries with more open capital markets such as the South American economies are making a more significant contribution to the re-balancing process as their appreciating currencies increase their capacity for imports. We expect to see a greater role from China and other non-Japan Asian countries to this rebalancing process in 2011 particularly, as increasing pressure comes on China to let its currency appreciate (they have allowed it to appreciate only 3% against the USD since July 2010).

Continuing Contribution from Developed Countries

During 2010 advanced economies re-gained momentum making a positive contribution to global growth (+3%). As stimulatory conditions abate this rate of growth is expected to be slightly lower but none the less will play a critical role to ensuring overall world growth stays at +4.5% levels.

In the US, stronger business data, improving consumer confidence and better employment numbers suggests their economy should produce a higher growth number in 2011 (+3%) than it did in 2010. In Europe the recovering UK, France and Spanish economies should assist Germany to produce a regional growth number of +1.7% (same as 2010).

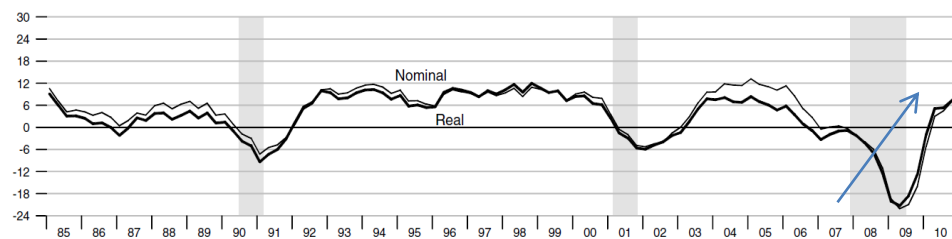


Strong Corporate Balance Sheets

Corporate earnings in the US and Europe recovered strongly in 2010 though primarily through efficiency gains and a greater focus on bottom line improvement. This earnings recovery when combined with already strong balance sheets (US corporates have record cash levels in reserve of US \$2.5 trillion) puts the corporate sector in a position to invest strongly for top line growth in 2011.

Private Fixed Investment

Percent change from year ago



US Private Fixed Investment –Source: Federal Reserve Bank of St Louis

S& P 500

companies

increased capital

spending by

\$22.3bn to

\$142.8bn in the

December 2010

quarter, the

biggest jump since 2004 (Source: Bloomberg). Corporates are also starting to gear their balance sheets again with corporate debt levels on the rise and up 15% year on year to the end of March 2011.

While in 2010 corporate investment activity was focused on inventory re-building, we expect this will turn into genuine investment for growth as consumer confidence improves in the US on better job prospects and further stabilization in real-estate prices. Rationalization of industry activity and a re-allocation of resources are taking place with a resurgence of mergers and acquisition activity.

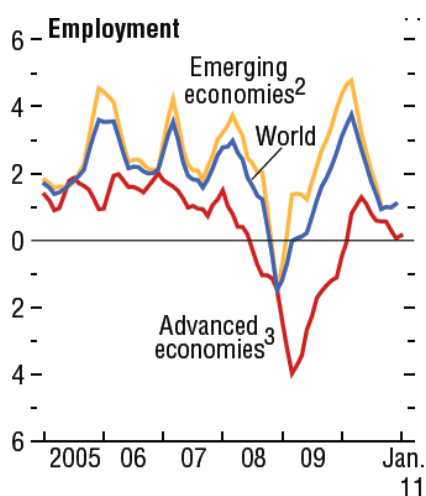
Inflation in Check for Advanced Countries

Rising commodity prices from strong emerging country demand are not yet translating to core inflationary pressures in advanced countries. This gives the US and Europe greater room to maintain stimulatory policies through this year. Advanced economy inflation is expected to rise to between 2% to 2.5% this year which suggests that the risks of a deflationary environment have been averted. The challenge for advanced countries now is to improve employment levels and avert the possible risk of stagflation (inflation without growth). As commodity supply adjusts to the demands of emerging countries the headline impact of rising energy and food prices should also abate later in 2011. Over the next few years advanced country inflation remains a significant risk on the back of what has now been 3 years of stimulatory policy settings.



Improving Employment, Consumer Confidence and Consumption

Though proving sticky, unemployment rates are finally starting to turn. In the US unemployment levels have fallen from a headline level of 9.8% to 8.8%. In the UK unemployment rates have



dropped marginally from 8% to 7.8% and the Euro area from 10.2 % to 9.9%. While these are modest improvements they mark a turn in the recovery and most importantly the shape of these numbers shows the private sector is now re-employing and soaking up the increasing and ongoing trend in public sector cuts.

As employment rises, consumer confidence and consumption data will continue to improve in advanced countries through 2011 and assist in the recovery process.

The Risks for Derailment

Japanese Crises

The cost of the Japanese earthquake ranges widely with estimates from \$US180 billion to \$US300 billion. No doubt it will be one of the costliest natural disasters in history with insurance only expected to cover 20% of the costs. However, it is important to bear in mind, that at \$US300 billion, the cost represents about 5.5% of Japan's \$US 5.5 trillion economy. Certainly a large number but by comparison to Christchurch's estimated 12% of GDP, the Japanese economy is more than capable of funding the re-building cost.

Of greater concern is the supply disruption arising from the earthquake damage and the unknown outcome from the ongoing radiation fallout of the Fukushima Daiichi reactor. While only 6% of Japan's economy is in the affected area, the global nature of interrelated supply chains means that critical componentry made in the region (chemical, plastics, electronics and industrial metals) is impacting global manufacturing activities for many industries. The extent of supply chain disruption is not yet clear but it remains a risk for global production in 2011.

Hopefully we will see a successful containment of the nuclear reactor in the next few months which will calm markets and re-focus them on the positive mid-term economic benefits that a re-building program will bring.



Middle East and North Africa Uprisings

The political and social uprisings in Middle East and North Africa (MENA) region is creating supply side concerns for oil, driving up global prices particularly for the European market. To date, the main impact has been Libya which accounts for 2.5% of world supply but is the one of the largest suppliers of oil to Europe (77% of its exports). No doubt this potential disruption is focusing Europe's military interest in moving things along in Libya.

On its own Libya poses little threat to the global energy supply as OPEC countries currently have excess capacity of approximately 4.5% of global oil requirements which they can bring on line if required. Of greater concern, is the risk of wider disruption if wholesale civil unrest spreads potentially to the major oil producing countries of Saudi Arabia, Iran and the UAE. MENA countries account for approximately 35% of world oil production. The risks to the supply of oil pose a significant threat to global economic activity in 2011 and Brent Crude oil prices have risen to \$US125 barrel, approaching the 2008 highs of \$138 per barrel.

Weak Sovereign Balance Sheets

Advanced country government debt levels continue to rise at an alarming rate as they expand their balance sheets to shore up economic activity. The US has the highest all time non-wartime gross public debt level of 97% of GDP in 2010 and this is expected to pass through 100% of GDP shortly.



Source: IMF

The UK including its costs for financial sector intervention is running at 149% (58% without). Meanwhile, Greece, Ireland and Portugal have all required significant funding to keep their doors open.

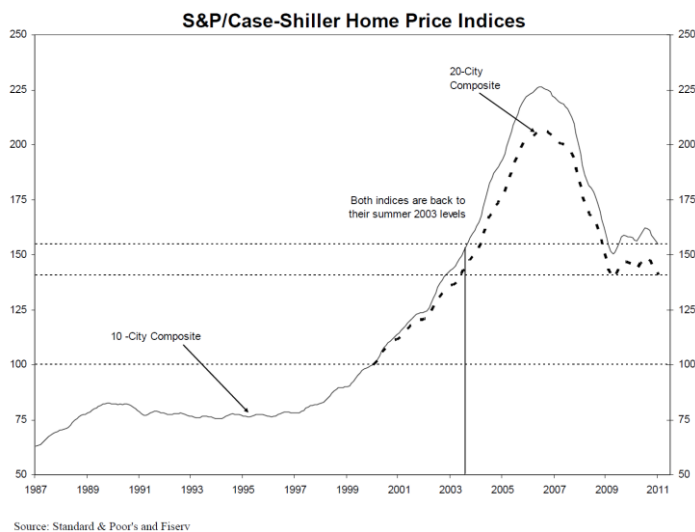
While government spending has been critical to stave off the great financial crises, maximum debt headroom is now being reached. UK, US and Eurozone government operating deficits must be addressed with a credible path for fiscal

responsibility required this year. We expect a sharper markets focus on sovereign debt this year and where we previously thought the re-structuring of weaker sovereign debt may take place in 2013-15 there is an increasing probability it will happen this year as the cost of funding Greek, Irish and Portuguese debt becomes increasingly unsustainable. Any re-structuring will have a significant impact on bond holders' balance sheets and possibly trigger another financial system crises should counter party confidence collapse.



House-house Deleveraging & Weaker Real-Estate Prices

While showing signs of stabilization the critical US real estate market remains weaker than expected with a continuation of distressed sales impacting house prices further in the first quarter.



prices were down -3% from their January 2010 levels and down -1% on a monthly basis according to S&P / Case-Schiller. At best the market is bouncing along the bottom but certainly not yet recovering. While unemployment levels remain elevated and excess housing (approximately 1 million units above normal) units remain to be cleared, prices are likely to stay weak to flat for the rest of this year. A flat

housing market will constrain consumer spending even as employment improves and is another reason why the US Federal Reserve will keep interest rates lower for longer - certainly into 2012.

Commodity Prices to Act as a Potential Drag

Buoyant economic conditions in emerging economies staved off a global depression. Emerging market demand including China accounted for more than 70% of demand growth (Source: IMF)



Commodity Price Indexes - Source; Bloomberg

during the great financial crises but as developed countries now come back on line the global demand for commodities is outstripping supply and driving prices sharply higher – up approximately 32% year on

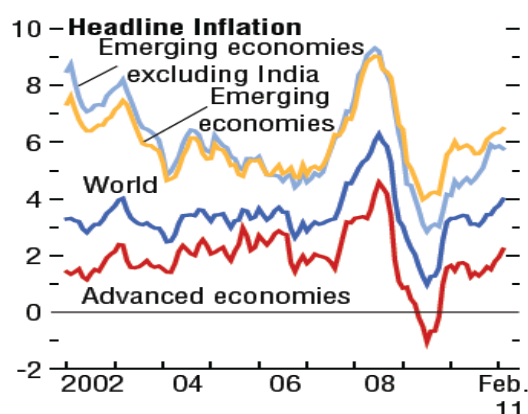
year. Longer-term supply will

grow to address this imbalance but this is likely take several years. We expect commodity prices will rise further through 2011 until emerging market growth is tempered with tighter growth policy. Rising commodity prices act as a brake or tax on consumption activity which will impact advanced country recovery where incomes are still under pressure and households remain in the process of de-leveraging.



Emerging Market Inflation & Economic Growth Impact

Easy credit conditions, large capital inflows and low fixed exchange rates combined with expansionist policies have all contributed to increasing inflationary pressures with headline inflation



of +7% expected for developing economies in 2011. China has recently recorded an inflation level of +5.9% which is probably conservative. While we expect policy responses to contain this overheating in the short term, the continuing rise in emerging market incomes will likely introduce longer-term structural inflation risks. This will remain an ongoing challenge for setting a sustainable speed for growth for these economies.

Source: IMF

ON BALANCE

The structural risks of sovereign debt and country account imbalances remain the greatest threat to a sustained and even global economic recovery. These threats will not recede for years and are likely to get worse before they get better. None the less, a genuine global recovery is underway with the critical US and European economies starting to contribute in a self-sustaining manner.

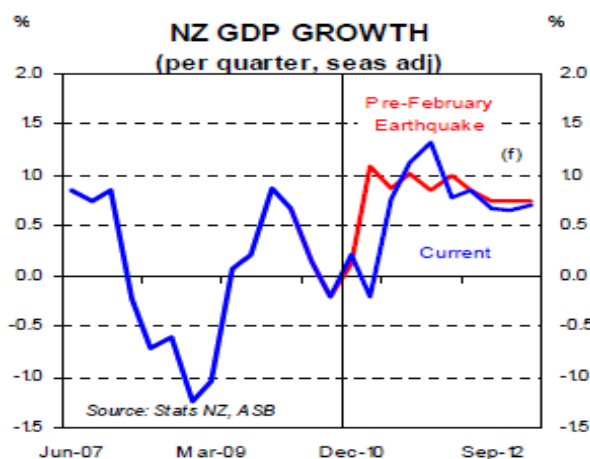
The Japanese nuclear crises and the MENA social uprisings remain potential “Black Swans” but on balance are unlikely to derail the recovery unless they very significantly deteriorate.

With recovery momentum in place, investors should be optimistic for their portfolios but accept there will be short term set-backs during the year.



NEW ZEALAND

Closer to home, our fragile recovery was certainly set back but not derailed by the February 22nd earthquake. While Christchurch continues to pick up the pieces and move from survival mode into recovery action the economic impact is still being understood. Rebuilding costs range as high as \$25bn and a massive 12% of our GDP. The quake is expected to knock off 1.5% to 2% of our expected GDP growth this year and where a pre-quake growth number of 4% was expected for 2011 it is likely to be sharply lower and closer to 1%.



Source: ASB

Funding for the re-build will come from a combination of EQC (and EQC reinsurance covers), private insurance (and reinsurance covers) and the public purse. Unfunded public costs are estimated at \$8.5bn to date (including the potential AMI bailout) which puts significantly more pressure on already strained public accounts despite the fact the costs will be realized over a number of years.

Positive Drivers for New Zealand

Christchurch Re-Build

With re-construction activity already taking place on infrastructure, followed by residential re-building expected to start in earnest in late 2011 and commercial property replacement taking several years the economic benefits resulting from the re-build will be substantial and will last for years to come. 2012 GDP growth estimates range up to 4.5% with as much as 2% of this coming from the reconstruction activity. Longer term, Christchurch has the ability to re-position its CBD as a highly attractive business destination.

Fresh Capital Injection

Statistics New Zealand estimates the reinsurance funds flows from the September quake are already flowing into NZ and could be as high as \$3.6bn so far (and driving up our \$). Additional reinsurance flows of \$6bn are expected from the 22nd February quake. This will provide New Zealand with large current account surpluses and inject significant new capital into the country. This will be highly stimulatory for growth as the funds are applied to re-construction. The flip-side will be higher insurance premiums and inflationary pressures.



Stimulatory Policies

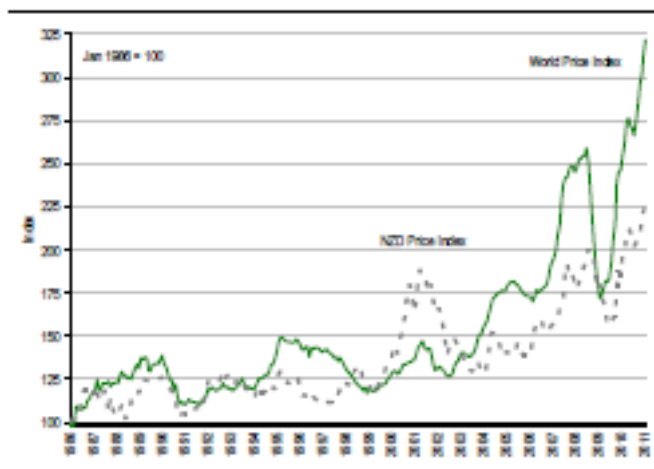
Following the quake, the Reserve Bank provided an emergency 0.5% cut in cash to provide some relief for private and business funding costs. Given the low growth rate prospects for 2011, the first rate increase is now not expected until March 2012. In the meantime, inflationary pressures (mainly headline inflation) are building which will require attention in 2012.

As part of the recovery program, the Government has re-set its fiscal priorities including reducing personal and corporate tax rates from October 2010 to encourage investment and increased spending on infrastructure activities.

The impact from these changes are only just starting to be felt with reduced corporate taxes in particular assisting NZ business at time when profits are under pressure. The reduced corporate tax rate of 28% also provides some competitive advantage with Australia (30% corporate tax rate).

Commodity Prices

Commodity exporters continue to reap the benefits of the world wide rise in commodity prices. According to the UBS, world prices for NZ main commodity exports has risen 87.1% since the dip following the great financial crises in early 2009. Despite recent weaker dairy prices and the lower



Source: ANZ

USD and GBP exchange rates, the outlook for NZ commodity exports remains upbeat with emerging market demand to continue in 2011 and Japanese demand (particularly for timber) likely to rise as they begin their re-building. Manufacturing exporters to the critical Australian market are also benefiting from the strong AUD exchange rate.

The Risks for Derailment

Christchurch

While there will be a net long term positive benefit from the re-building process the impact on GDP for 2011 is significant. We don't like to think about it but further earthquake damage could delay the re-building process and add to already significant costs. Further large damage could also result in permanent long-term redistribution of the population and economic activity.



Fiscal Headroom

The cost of the recession and the earthquake means Government borrowings requirements for 2010/11 will come in at approximately \$16.5bn or 8% of GDP. While our total public debt levels are modest by western country standards at approximately 30% (about 60% of this is borrowed from overseas) total Government and Corporate overseas borrowings are closer to 130% of GDP. These levels of total foreign debt make the international ratings agencies anxious particularly with the Government running a structural cash deficit with lower tax revenues.

While the Government is quite rightly maintaining a lower tax policy to stimulate private sector growth it will need to make a substantial re-adjustment of public spending activities in the May budget. Otherwise we risk a credit agency downgrade which would have a significant impact on our cost of capital and impact our recovery.

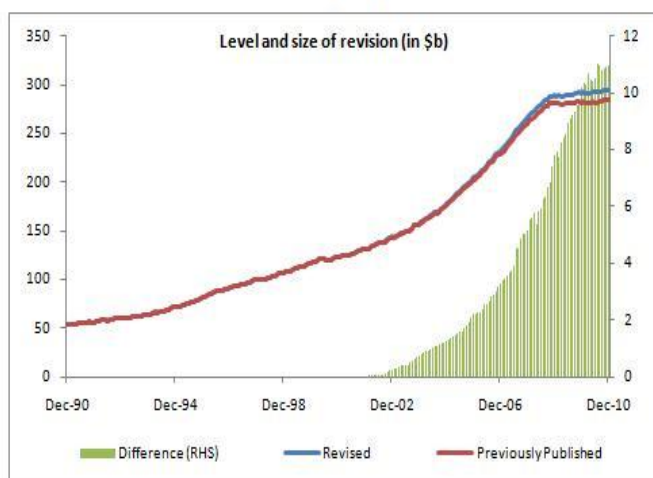
Confidence

After a strong re-bounce in 2009 business confidence continued to improve through mid-2010 only to fall following the September quake and then fall again following the February 2011 earthquake. Though we expect this to be a temporary impact but there is a risk that it becomes more systemic given the tentative nature of the recovery to date and the reluctance of companies to invest.

Credit Growth

Private sector credit growth remains flat. Mortgage lending fell in December for the first time since Reserve Bank records started in 1998. While there were signs consumer credit was growing again early in the year, we expect the trend of household debt reduction will continue until property prices stabilize (QV values down -5.9% from 2007), employment prospects improve and confidence returns.

Resident Private Sector Credit excluding Repos (PSCR_{XR})



De-leveraging will be beneficial for the longer term but is likely to act as a brake on growth for the next year or two. Interestingly, commodity exporters, particularly dairy producers, are using their profits to repay debt which is reducing the flow of these profits into the wider community. Again as farm prices stabilize we expect a greater economic impact from their income.



Capacity Constraints & Inflation

We have limited labor and materials resources to cope with the Christchurch re-build. While overseas resources will provide some assistance, locally, shortages will mean delaying infrastructure, commercial and residential construction elsewhere in the country. As capacity constraints start to bite later in 2011, we expect inflation will continue its rise with core inflation rates at the top end of the RBNZ band at 3% and possibly higher. Inflation is not likely to derail a recovery but will provide some speed limits for growth in 2012.

The greater risk of the capacity constraint is the removal of resources from the rest of the country where growth is critical for a balanced economic recovery.

ON BALANCE

Our fragile recovery has been driven by the strong demand for our commodity exports while domestic demand remains weak as households focus on debt repayment and businesses remain wary of the prospects of recovery. With increasing business optimism in 2010 the economy felt it was coming out of the trenches only to be set back by the September and February earthquakes. 2011 will be a much softer year than most people were planning. We will get some welcome respite from the World Cup, particularly for the tourism industry. Looking out to the end of the year the prospects for New Zealand are much stronger with domestic demand and business investment to improve sharply with the re-build and exporters continuing to enjoy high commodity prices.

