

THE DEBT CRISES

The current European debt crises should never have been allowed to perpetuate to this extent. Collectively Eurozone country debt levels are similar to the US (82% of GDP), which is high but not unmanageable. So the real problem in Europe is the distribution of their debt and the political desire of stronger countries to assist weaker the ones.

Greece, Ireland, Portugal and to a lesser extent Spain and Italy have been under excessive foreign debt pressure for years, particularly since 2008. Greece cannot repay its debt and will have no choice other than a default or the undertaking of debt restructure with lenders losing possibly as much as 60%. Until Greek debt is cut and until a sufficiently sized Eurozone rescue package has been created, investment markets will remain skeptical and volatile keeping the European financial system at significant risk.

The response to the debt crisis to date, has been a series of implemented austerity measures with weaker Eurozone members cutting Government spending just at the time their fragile economies are trying to recover from the 2008 and 2009 recession. This risks a vicious cycle of cutting spending further, as tax revenues fall, as their economy weakens, so they cut spending further. Clearly a circuit breaker is needed and sufficient time given to enable their private sectors to provide the growth. Stronger Euro members understand this and know they need to provide additional financial support during these difficult times. Politically though, Germany in particular, faces a hostile constituency reluctant to pay the price of bailing out weaker southern neighbours. So the politicians move slowly and only feel empowered to make provisions as the crises boils to a point that justifies action. It is a dangerous game and one that has come close to unhinging European and global financial markets.

G20 members and now the IMF are putting significant pressure on for a co-ordinated plan. At the time of writing Eurozone members were on the point of committing greater funding for the European Financial Stability Facility. This funding will enable the European Central Bank to resume their buying of bonds from distressed Governments (Greece, Spain and Italy) to help cap their re-funding, reintroduce yearlong loans for banks in addition to the shorter funding lines they are already. This will all help restore European banking system confidence. Additionally, the European Commission is pushing for a co-ordinated capital injection for weaker banks most exposed to Greek, Spanish and Italian debt.



Though currently resisting it, we expect the ECB will also cut rates this quarter as evidence of slower regional growth comes to hand and inflationary concerns are put to one side for now. They have room to move their current rate down from 1.5% and this should provide additional assistance by reducing funding costs. The UK has decided to keep their rates on hold at present despite stagnant growth numbers.

The proposed level of overall support is however a temporary solution designed to stabilise markets in the shorter term and we expect the final funding required for longer term stability will be in the order of €1 trillion or more. This will require greater commitment from wealthier countries (read Germany) as well as assistance from the IMF.

Once Euro banks are sufficiently covered we expect some form of Greek default or restructure with most banks saying they are already in position to handle this. The Greek debt write-down will need to be significant – probably as much as 50% (€200bn) of their foreign debt to give them a decent chance of long term recovery. Such a write down cannot be afforded for Spanish and certainly not for Italian debt. Ring-fencing Greece is crucial.

Eurozone members seem resolved in retaining their common currency and it seems likely Greece will remain a member even after default/restructuring of its debt (we might argue they have no ability to exit the Euro). For the Euro to survive and thrive, Eurozone members will either have to commit to a centralized fiscal (as well as monetary policy) union or significantly change the requirements for membership.

The Eurozone has both the economic and financial capacity to deal with their sovereign debt crisis but assistance from the IMF will be required to restore initial order. While many are discussing the prospects of a full blown international financial system crisis, it is very unlikely. Measures put in place by the G20 in 2008 provide mechanisms for dealing with any international freeze and the US banking system in particular is in a far more robust position.

US Treasury Secretary, Timothy Geithner recently testifying before the Senate Banking Committee in Washington, saying “the direct exposure of the U.S. financial system to the countries under the most pressure in Europe is very modest, Our firms, and this is true across the largest institutions in the United States, again are in a much stronger position if you look at their capital levels, levels of leverage, how they’re funded.”



Sovereign Debt Long-Term

The indebtedness of western countries is certainly a long term fix. During the Great Financial Crises in 2008, western governments had the dual task of rescuing their financial systems (bank bailouts) and then spending money to stimulate economic growth. This has been an expensive process and the public debt ceiling for many has been reached (80%+ of GDP) leaving little capacity to spend and further stimulate economic activity.

Indebted countries like Greece, Spain, Portugal, Ireland, Italy and to a lesser extent the UK are all adopting austerity policies to slow their growing debt. US spending cuts are also underway. These cuts will be contractionary for growth leaving more of the economic recovery to the private sector. For those countries worst affected it means a lower standard of living as social services and benefits are cut. A slower growth path through austerity also means pushing back the time-frame for a reduction of debt.

As we have previously discussed, the world remains in a highly un-balanced state. The west has borrowed too much to fund low productivity consumption and has effectively been living beyond its means for too long. Emerging countries have done the opposite building massive savings from surplus trade to the west and then providing funds back to the west to fund their consumption. The worst of this occurred in the last 10 years and it will take at least this time to re-address some of the imbalances.

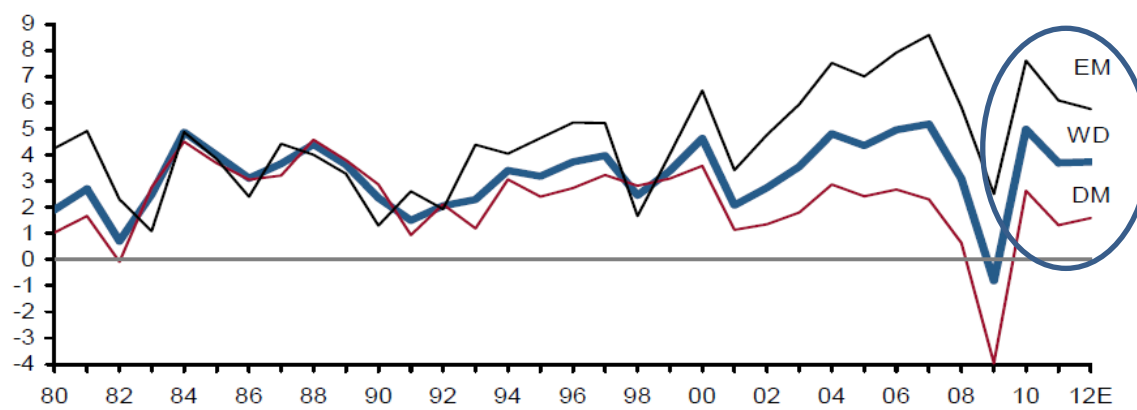
To date there are only tentative signs that this re-balancing is underway. In the west households have cut debts and begun saving quickly, businesses have cut expenses and debts, they are becoming more efficient and have started re-allocating resources to more productive areas. Weaker western currencies (particularly the US and Euro) have helped them accelerate exports and trade numbers are improving. In China and other emerging markets, wages and domestic consumption is on the rise shifting economic growth to more internal activity rather than exports. Emerging markets are also trading more with each other with lower export numbers to the west. As western growth slows this trend will become more marked. Meanwhile western exports to emerging countries are rising, particularly for food and more recently finished luxury goods.

It is very early days but this world re-balancing process will accelerate over the coming years gradually improving the external account position for the indebted west. It is also worth remembering that emerging markets have a vested interest in western economies stabilizing and growing.



ECONOMIC OUTLOOK

Global growth prospects are now lower. At the beginning of 2011 the IMF was forecasting economic growth for 2011 and 2012 at 5%. This has been revised down to 4% for 2011 and 2012 with a higher risk of recession in Europe and possibly the US. Credit Suisse have a lower global growth outlook for 2011 and 2012 at 3.7%. Most of their downward revision is for developed markets (DM) dropping to 1.3% growth for 2011 and 1.6% in 2012. Emerging markets (EM) remains more resilient. The chart below from Credit Suisse shows their slower outlook for 2012.



Source: Credit Suisse, Thomson Reuters Datastream

USA

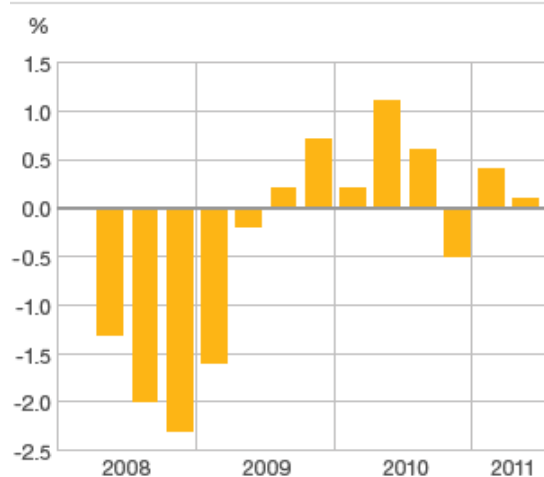
US growth now looks more like +1.5% for 2011, with recent data suggesting they will skirt recession. The US is recovering faster than Europe following extensive policy stimulus over the last two years. A sharply weaker USD is also assisting exports and businesses are starting to step up their investment (+1.1% in August). US second quarter 2011 economic growth numbers were recently revised up to +1.3%, while manufacturing numbers were better than expected (ISM Index at 51.6 showing expansion) while construction spending was also stronger in August. Unemployment remains high at 9.1% and until this improves households will be cautious, unlikely to increase spending and more focused on building savings. Despite very low interest rates and easy credit supply households and small business are not borrowing. In the short term this impacts recovery and we may see additional efforts from the Federal Reserve this quarter should unemployment conditions deteriorate. Incredibly, US corporates are sitting on more than USD 2 trillion in cash reserves giving them significant capacity to invest. The US only wants for better business and consumer confidence which is currently being hampered by the European debt crisis and US Congress political intransigence.



Europe

The health of the corporate sector in Europe has been excellent with companies delivering strong earnings growth over the first part of the year. The financial turbulence during the last two quarters has delivered a significant shock to business and consumer confidence. This will impact consumption and investment in Europe particularly for those economies now subject to deep cuts in Government spending. The weaker Euro will continue to provide benefits to exporters but domestic activity is

UK GDP growth, quarter on previous quarter Q1 2008 to Q2 2011



Source: ONS

likely to be sharply lower. Avoiding a recession in Europe will be a near run thing with growth forecasts at 1% overall. Germany is forecast to lead growth with 2.1% in 2012 while Spain & Italy will be flat and Greece will continue its recession in 2012. We expect the ECB will cut rates soon to provide additional stimulus.

Conditions in the UK have also been weak and look weaker into 2012 though they are likely to avoid recession. Recent UK manufacturing data has improved (PMI +50.3 from 49.4) marginally suggesting some stabilization in activity.

The Bank of England recently held interest rates steady but embarked on an additional round of debt asset purchases (£75bn) from banks to steady their balance sheets, reduce their cost of funding and provide additional liquidity as a precaution to the European crisis.

Japan

Following the March earthquake and nuclear disaster, industrial activity has recovered as fast as could be expected and there have been no sustained or major power outages. The impact of the quake on economic growth has been severe and the economy will likely contract -1% this year. With industrial disruptions now largely out of the way and reconstruction efforts accelerating there will be a boost for Japanese domestic activity next year although the softer outlook for Europe and the US will hamper exports. The IMF forecast Japanese growth of 2% in 2012 (this might be ambitious).

China & Emerging Markets

Chinese policymakers have been firmly focused on inflation management for most of 2011 particularly as western capital floods in seeking a higher returning environment. While Chinese

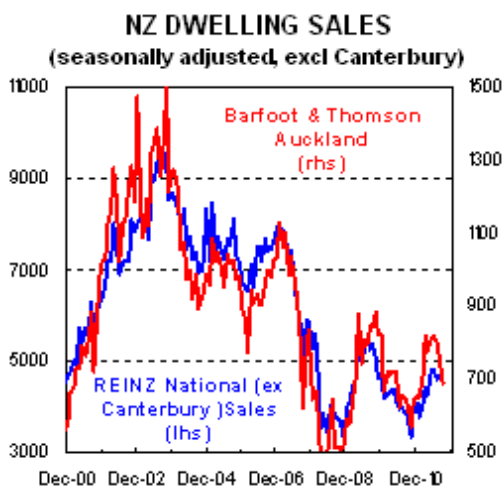


growth is moderating their economy remains robust. More recently exports have risen, industrial production is higher and property construction is also picking up again. China is forecast to grow at 8.6% this year (down from 10.3% in 2010) despite markedly slower western growth. Investment markets remain vigilant to the risk that heavy handed inflation management might slow China too quickly. This could pose a greater threat to global growth momentum than any US recession.

Elsewhere, emerging markets are also managing inflation risks with higher interest rates, currencies (China re-pegged the Yuan 5% higher to the USD) and capital controls being implemented. India's industrial production was down heavily in July and August on tighter monetary action. Should the headwinds from a slowing west require it, emerging countries can loosen monetary conditions quickly. They also have healthy balance sheets to implement further fiscal stimulation if required. The IMF forecasts emerging economies to grow at 6.1% in 2012 (down from 7.3% in 2010) which is still sufficient to maintain global growth momentum.

New Zealand

Our economy is progressing well and gaining momentum. Christchurch's quake has had a lesser impact on economic growth than expected with activity dispersed rather than disappearing. Despite continued shaking, Christchurch's economy is re-bounding and will accelerate as reconstruction efforts increase (subject to any further quakes). Insurance cover remains a significant hurdle and in



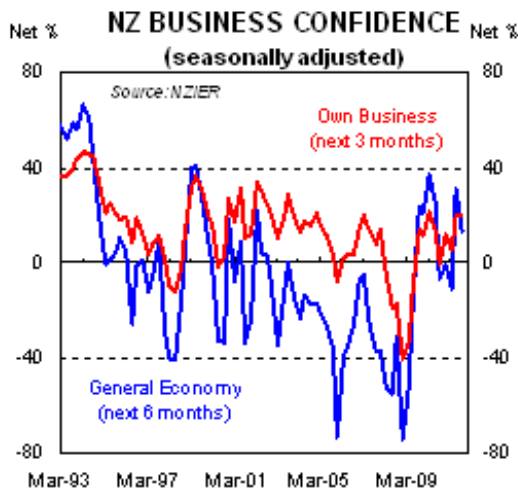
the absence of a near term commercial solution the Government is likely to step in and underwrite residential re-building activity.

Elsewhere building consent numbers are better (off a very low base) though private non-residential construction activity remains soft. Improving net migration numbers (now positive) and tighter housing supply will likely underpin home prices though listings remain down and sales numbers are still weak.

While global growth prospects are moderating, our key trading partners' fortunes are more closely linked to the emerging country growth story. This should shield us from the worst of any European and US slowdown. Our key trade partner Australia, has also had a tough year with floods severely impacting their economic activity. They are now recovering from this which should particularly benefit NZ manufacturing exports into 2012. Though broader global commodity prices have fallen over the last four months, NZ export commodity prices have generally been robust (dairy is softer)



and our recently weaker dollar means the value of our exports in NZ dollar terms is continuing to rise.



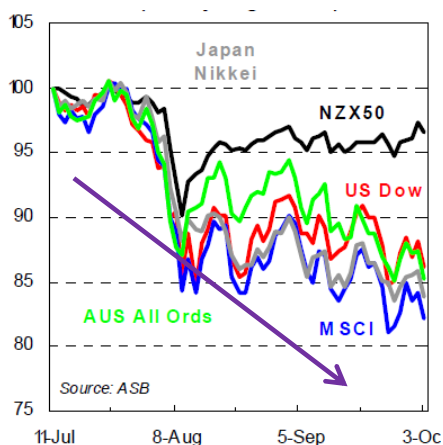
NZ business confidence has been affected by the global turbulence though business intentions to hire and invest remain positive. The unemployment rate remains flat at 6.5% and capacity constraints for labour and materials is starting to rise in Canterbury. Consumer spending is also up with retail activity improving led by Christchurch. However households and businesses continue to be generally conservative with their spending and investment focussing on debt reduction (particularly in the agricultural sector) with overall credit growth remaining weak.

Despite an accelerating economy, the Reserve Bank is taking a cautious approach waiting to see how conditions evolve offshore before lifting interest rates. We expect the official cash rate to remain on hold until at least March 2012 particularly as the recent credit downgrades to NZ may impact the cost of our offshore debt funding.

Barring any global meltdown as occurred during 2008, the prospects for growth in New Zealand for 2012 and 2013 look very encouraging with forecasts of 3.5% to 4% in 2012 and 2013.

MARKETS REVIEW AND OUTLOOK

During the September quarter more than \$US 10 trillion was wiped off world sharemarkets. Major European markets fell about -25% while the US, Japanese and UK markets have all fallen around 12% to 14%. Australia was off -13% while New Zealand was less impacted at -5%.



As reported by Bloomberg, the benchmark measures for 36 of 45 nations in the MSCI All-Country world Index posted declines of 20% or more from their peaks this year, meeting the common definition of a bear market. Besides the U.S., only the U.K. and New Zealand have not dropped 20% or more from this year's highs in April. Emerging country sharemarkets also followed suit (-14 to -24%) and have taken a battering over the quarter.



Given the impressive earnings growth from companies around the world (including Europe) in the first two quarters of 2011 this recent sell off has been a surprising outcome driven largely by the sudden change in expectations for recovery in the US and Europe. As discussed in the opening section of this report additional negative market sentiment has also been created by the political intransigence in the US and Europe. Markets remain concerned about a workable solution to rescue the European banking system and while recent announcements suggest some progress is being made (and share markets are recovering on this news) investment markets will remain on edge until solutions are actually implemented.

Technically, sharemarkets have been well oversold. Global share markets are now 2-3 standard deviations below their 10 year average values and are trading on price to earnings ratios (forecast 12mth earnings) of approximately 12.1 times against an historical average of more than 18 times. The Eurostoxx 600 index measure for European companies shows they are currently trading at 9.6 times forecast earnings. In the US, the Standard & Poors 500 index is trading at 12.7 times current earnings which is the lowest since 1985 and on forecast earnings the US market is 36% below its 50 year average value. While slower growth prospects are likely to revise down earnings growth prospects for US and Euro companies into 2012, markets appear to be pricing in a recession for those economies and then more again for the financial system uncertainty. As we enter into the 3rd quarter company earnings reporting season this week we will gain a better picture for 2012.

The New Zealand sharemarket is trading at about 13x forecast earnings. This is about 10% below its long term average while analysts are expecting 10% to 15% earnings growth for 2012 given our more positive economic outlook. From an income perspective the NZ sharemarket is currently generating a dividend yield of approximately 5.8% which is certainly attractive when compared to cash and bond yields.

A recent article from Citigroup shows the US sharemarket is at a historically cheap level compared with US bond yields. The chart below from Citigroup shows the gap between the Standard & Poors 500 company earnings yields versus the yield from US 10 year treasury bonds since 1970. The difference in yields rose to 6.5% recently after peaking at 7% in March 2009.



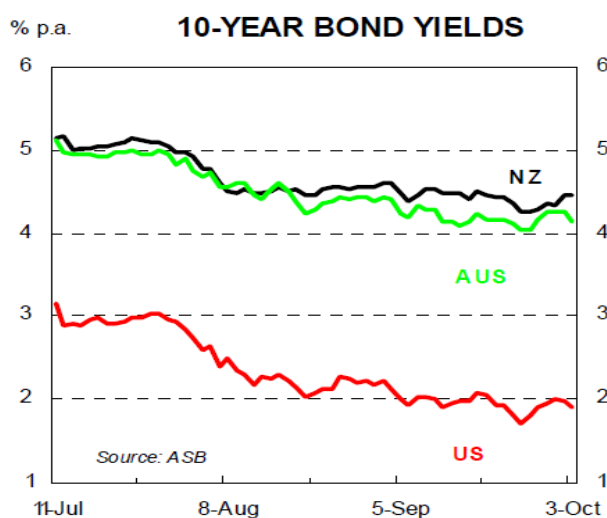
STOCKS' OUTSIZED YIELD

● Spread between S&P 500 Index earnings yield and 10-year Treasury yield



Source: Citigroup

Safe haven (US, Japanese and German) bond prices rallied over the quarter as risk aversion drove money back into these already expensive markets. US 10 year treasury yields fell to 1.6 % though have recently risen back to 2% while 30 year US bonds are at 3%. Given the latest US inflation rates



are 3.8% investors are losing money in real terms by investing in bonds and cash. The US Federal Reserve recently announced a new stimulus initiative to funnel \$US400bn into purchasing longer dated Treasuries which will keep longer term interest rates lower for longer and hence borrowing costs lower. This will help underwrite US bond prices for the time being and have an on-flow effect for global bond market pricing.

Australian and New Zealand bond prices also rose over the quarter driving yields down to levels not seen since March 2009. The recent downgrade of New Zealand's sovereign ratings by Standard and Poors as well as Fitch (due to concerns of growing external debt) had little impact on prices which rallied after the announcements. Ratings agencies are downgrading sovereign credit around the world and well after the fact (markets have already priced it in). Italy, Spain, UK, NZ, and the US have all been downgraded this quarter with more likely to come. The difference in interest rates for bonds of higher risk European countries remain at historically high and wide levels reflecting the acute uncertainty of those economies.

Deleveraging is still underway in the US, UK and European real-estate markets. Excess homes supply, persistently high unemployment and lower economic growth rates are expected to constrain home prices in general but some areas within those markets are doing better than others. We note US new



home constructions are actually on the rise. Australian and New Zealand residential prices have been remarkably resilient. Australian home prices higher in the September quarter following sharp falls earlier in the year.

In NZ, residential property prices have crept up but on lower turnover, farm sales are the best in nearly 2 years with the underlying trend in sales suggesting further rises in activity.

Source: Bloomberg. Commodity price indexes



Commodity prices continued their fall over the September quarter on weaker global growth prospects. Materials, energy and industrial metals prices were all lower while soft commodities held up relatively well and are likely to be more resilient given emerging market incomes growth. In particular Asian demand for food is strong which should be long term beneficial for NZ exporters.

While developing countries are maintaining a watchful eye on inflation, western country cash rates will remain low for an extended period until the current financial system crisis passes and sufficient growth re-emerges. The US Federal Reserve has signaled their cash rate (0.25%) may be on hold until 2013 while the European Central Bank the Bank of England could cut their rates this quarter. As discussed, the NZ official cash rate will likely be on hold until at least March 2012 although bank term deposits in the meantime may rise should offshore funding pressures rise.

