

Economic and Market Commentary

Economic and investment market conditions remain extremely challenging with growth slowing faster than expected in all economies and many (like NZ) in a current state of contraction.

Anemic growth in OECD countries and a sharp spike in inflation are now the primary concern of policy makers.

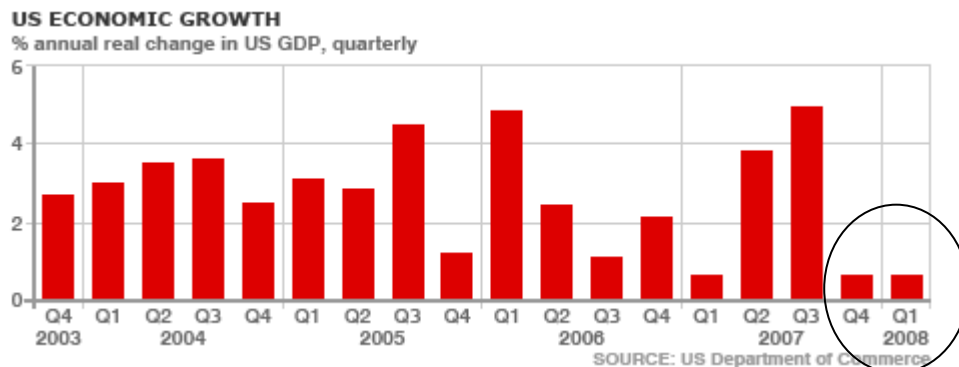
When we wrote to you in April the world was focused on dealing with the collapse of US residential mortgages and the ensuing global credit crunch. Strong central bank intervention culminating in the bail out of US investment bank Bear Sterns helped avert a global systemic collapse of the finance system. To date some \$350bn - \$400bn has been written off by banks and non-bank lenders on sub-prime mortgages and related securities. There are however more losses ahead and the estimates for these range widely from US\$400bn (Fitch Ratings) to US\$945bn (IMF). Certainly more sub-prime assets will find their way back onto bank balance sheets with further write-downs inevitable until the US real-estate market begins to stabilize.

Since March there has been increased confidence that the credit crunch is manageable. Banks have been raising capital (some US\$ 250bn to date) to shore up their balance sheets and inter-bank lending costs though still high have markedly improved. The spreads (interest rate risk premium) between US investment grade bond yields and US Government bond yields have also fallen from a high of 2% to less than 1% while junk bonds yield spreads have fallen from 6.3% to 4.5%. These spreads are still high but improving daily.

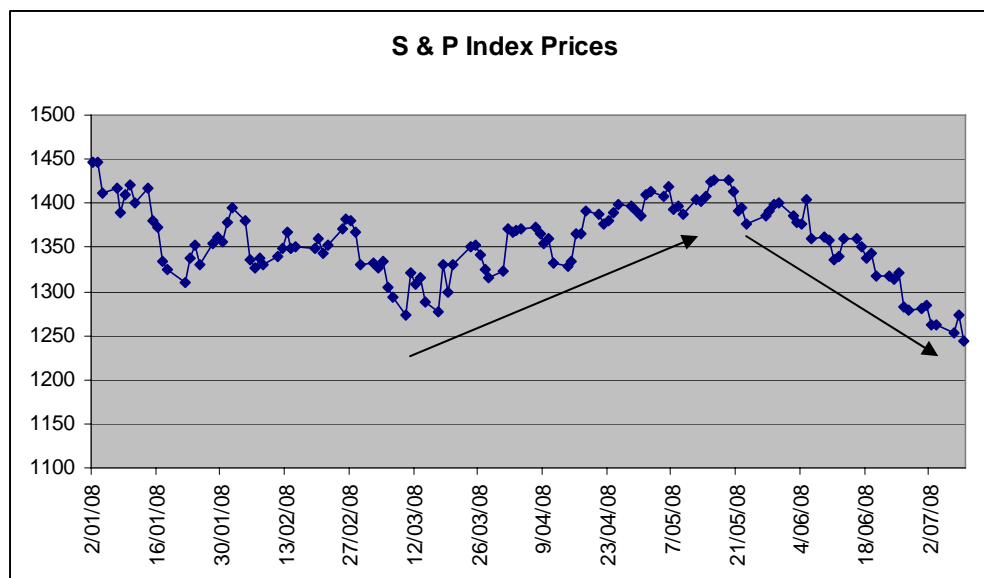
While still a very serious problem that is likely to wax and wane the global credit crunch appears to be working its way through. However, we do expect second round effects of credit contraction to impact the global economy for some time yet.

New Spectre

With a new found belief that the credit crunch would gradually resolve itself and with a US economy slowing but not falling into recession in the first quarter (as most economists had predicted) equity markets rallied steeply in April rising some 10% off their lows. Trading volumes increased and it looked as though investors were starting to look through the present economic issues to a better future.



In the background of the credit crises sharply rising commodity prices, particularly oil and grains has created a spike in global inflation. The spectre overhanging markets at present is that contracting economic growth from the credit crunch combined with rising inflation may trigger a destructive stagflation environment similar to that of the mid 1970s.



The concerns of a new low growth high inflation world spooked investors in May and markets sold off again erasing the gains of April. Share markets are now seeing multiple year lows with many sectors and individual company share prices back to 10 year + lows. General Motors share prices for instance is back to 1954 levels.

So how bad are global economic conditions really and how do we see things developing from here?

The Outlook

To get a picture of the future there are several key themes that need to be considered:

Global Growth

The credit crunch is presently constraining consumption in developed countries particularly the US and Europe and this is likely to slow their economic growth for some time. This slow down has been factored into current share prices. To date a US recession has not occurred but we are likely to see a contraction this quarter.

The 'decoupling' growth theory suggests that developing country growth would pick up the economic growth slack from developed western economies and this would keep the world ticking over.

The developing country growth (China and India being critical) would be supported by rising internal domestic demand underpinned in the longer term by their urbanizing and younger population demographics. These developing economies are expected to transition to a point where they were no longer reliant on western economy consumption of their exports to grow. Their domestic growth would take over and drive their economies onwards.

To date this theory is certainly playing out with China, India, Non-Japan Asia, the Middle East and other developing and emerging economies continuing to grow at high levels. Their growth rate is now being funded by their huge foreign currency reserves and surpluses accumulated over the years from exporting to western countries and the US in particular (which has effectively been funding developing country growth through running an increasingly large current account deficit).

World Growth Outlook

	Actual 2007	IMF Est. 2008	Credit Suisse Est. 2008	Goldman Sachs Est. 2008	Goldman Sachs Est. 2009
World	5%	3.7%	4.0%	3.1%	3.1%
US	2.2%	0.5%	1.5%	1.5%	1.1%
Euro Area	2.6%	1.3%	1.5%	1.7%	1.6%
Japan	2%	1.4%	1.3%	1.4%	1.5%
China	11.9%	9.3%	9.7%	10.5%	10%
India	8.6%	-	8%	7.8%	8.2%
Non-Japan Asia	9.4%	-	7.9%	8.2%	8.3%
Latin America	5.6%	-	4.3%	4.4%	3.8%

As the table above shows, forecasters are still expecting economic growth to remain positive overall for 2008 and 2009 albeit at a lower level. Over the next few years developed western countries are expected to re-balance their economies, stabilize and then gather pace again. We are seeing this in the US where the lower \$USD is assisting a dramatic recovery in their exporting numbers.

The question now is whether the oil and food price rise shocks have derailed this de-coupling scenario and lead to economies particularly the developing countries contracting greater than expected. It is this concern currently driving market sentiment and overshadowing fundamentals.

Oil and Other Commodity Prices

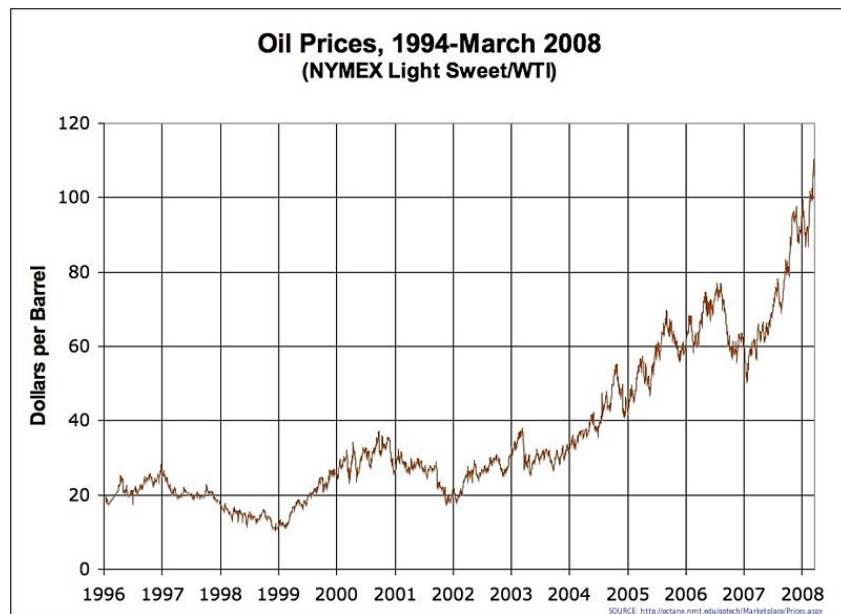
Oil has doubled in price in the last year and has risen seven fold in the last 10 years. Food prices are also rising. Rice has risen 250% in 12 months, wheat and corn 150%.

These higher fuel and staple food prices are driving up inflation globally at a time when disinflationary effects such as the credit crunch and falling real estate prices are also taking place.

Commodity Price Indexes to 30-6-08

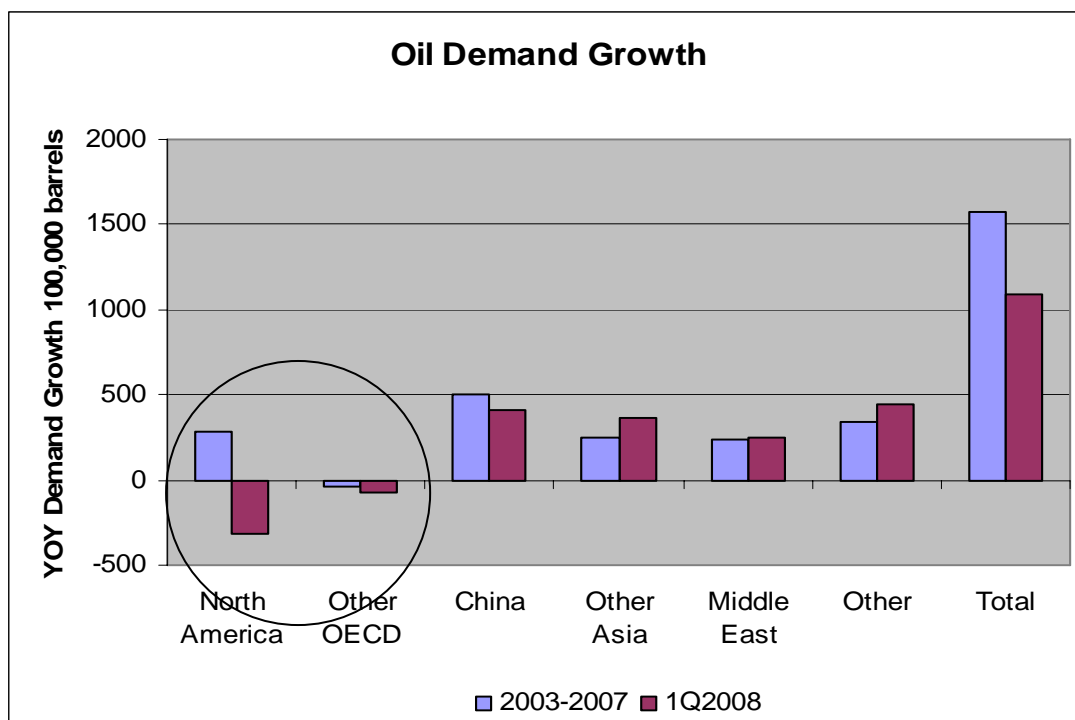


Recently oil prices reached new highs of US\$145 per barrel and there has been much conjecture on the cause of this rise. Is it purely a supply/demand issue or are speculators driving the price up?



Though investors have been buying commodities as a hedge against inflation and a weaker \$USD this is not the core reason prices are rising. Having reviewed extensive research on the issue we believe the price rises are a structural demand/supply issue.

While OPEC oil production remains steady at present, non-OPEC production is actually falling at a faster rate than anyone expected (down -1% this year against and expected +1% supply increase). Meanwhile developing country demand (notably China and India) is rising faster than expected at 3.5% this year (China at 7% this year).



To counter this rise in demand and fall in production there are several forces at work to reduce oil prices.

- 1) Ethanol production is rapidly providing substitution alternatives at the margin. Corn ethanol production is profitable with oil at these prices (though ironically driving up grain prices).
- 2) Demand collapse in the US and Europe. The demand for oil is also falling faster than anyone had expected. With \$4 gallon petrol prices Americans are radically changing their motoring habits. The International Energy Agency estimates US demand growth for oil in 2008 has reduced by -310,000 barrels a day. The US is the worlds greatest consumer of oil at 21 million barrels a day (China 7 million bpd) therefore any slow down in their consumption will have an impact on price.
- 3) In June the Chinese Government started to lift the cap on oil subsidies and raised prices 20%. Other Asian countries are starting to follow suit. The Chinese now need to balance their requirement to keep economic growth on track while helping to stabilise world prices, reduce inflation and preserve their foreign reserves (the cost of oil subsidies this year alone by developing nations is estimated at \$US330bn).

So while developing economies are still increasing their net demand for oil we expect it will be at a slower rate as subsidies fall away and as western economies rapidly reduce their demand.

Looking forward the issue for oil will be falling supply. New or additional production (Brazil, Iraq, Russia) is not likely to replace falling production from mature fields. Therefore global net demand has to fall quickly and be sustained for oil prices to fall. We believe demand is falling quickly but having said that a higher oil price regime (US\$100+ per barrel) is here to stay and we are facing a new energy world and the uncertainty of this places global growth at risk.

Meanwhile grain price rises (staple world food) have been driven up by a combination of crop diversion to ethanol production, decreasing arable land, water shortages, crop failures and crop diversion to feed protein production. Ironically, the diversion of land production to ethanol is estimated to be the primary reason (as much as 75% according to a recent World Bank report) for the rise.

The increasing wealth of developing countries is also generating sharp increases in demand for non staple foods. Many Asian countries are now net importers of both oil and staple foods and this is unsustainable and threatening economic growth in the region.

Longer term food production will be less of a problem than oil with new farming lands being prepared in Russia, Eastern Block countries and places such as Kazakhstan. Interesting countries like the US, Canada, Russia the European Union and Australia are all net food exporters. Until more production comes on stream food prices are likely to remain high and add to geopolitical pressures.

Inflation

The combination of rising oil and food prices has markedly increased global inflation expectations as shown in the table below.

	Actual 2007	Goldman Sachs Est. 2008	Goldman Sachs Est. 2009
World	3%	4.8%	3%
US	2.9%	4.1%	3.2%
Euro Area	2.1%	3.5%	2.4%
Japan	0%	1.6%	1.0%
China	4.8%	6.8%	3%
India	4.5%	7%	4.7%
Non-Japan Asia	4.4%	6.6%	3.8%
Latin America	5.5%	7.5%	6.2%

This table also shows an expectation that while inflation is rising it is also likely to abate later this year and into 2009. Central bankers to date are generally adopting a wait and see approach to the sudden rise in inflation (except the ECB which has just raised rates 0.25% to 4.25%) believing it is not structural and will fall.

There are a number of very good reasons why inflation will fall (and bond markets are certainly pricing in a reduction in current inflation levels). These include:

- 1) Monetary conditions despite rate cuts are tight as the contraction in credit supply is reducing domestic and commercial demand for goods and services.
- 2) Falling asset prices – in real estate and share markets is also reducing demand.
- 3) Higher oil and food prices is changing consumer behavior and also reducing demand.
- 4) Unemployment is rising globally and this will suppress wage inflation as well as reduce aggregate demand.
- 5) Stabilising supply costs. Lower demand will reduce supply side costs for materials and unemployment will maintain or reduce labor costs.

These impacts are currently being felt globally and the consensus view is that inflation will stabilize and then fall this year.

The Credit Crunch

From various estimates it looks like the writedowns on mortgage losses are about 50% of their way through. This is of course if US real estate conditions don't deteriorate a lot further which they may. US house prices are now down some -15% but there are some early indications conditions may be starting to stabilize (new home sales growth actually rose in May).

The second round affects of the credit crunch are being felt in the price and scarcity of credit in those countries that are net borrowers (like NZ). This is manifesting itself with scrooge like loan application requirements as credit is rationed out and also in the margins lenders can command on their loans. These second around effects will be played out for some time yet.

Conclusion

While rising oil and commodity prices have put near term economic growth at far greater risk than anticipated we expect the reduction in global demand will actually be deflationary and the effects of this will be seen in the second half of the year.

With higher permanent energy prices emerging countries like China will have to adapt as many of their currently profitable activities will no longer be viable (China uses 3 times the amount of oil per unit of GDP than the US). The costs of transport in particular will require their economies to seek efficiencies in new ways and change their mode of operation.

We have no doubt that the world will continue to grow and adapt to these challenges. In the meantime once lower inflation numbers start to come through share markets will focus back on the prospects for growth (albeit at a lower level) in this lower inflation environment. While investors keep one eye on credit conditions and inflation issues, share markets will remain volatile and subject to large shifts in investor sentiment.

Global share valuations are now trading on estimated Price Earnings ratios of 13.4x. This is a level which has not been seen since the early 1990s. Clearly a weaker world has been priced into share markets and any indication of improving conditions will be quickly translated into stronger share prices.

New Zealand

Closer to home conditions have deteriorated quickly in many parts of the economy. The recent National Business Outlook survey shows expectations for business conditions to remain firmly negative with some numbers at a record low.

The New Zealand Institute of Economic Research's Quarterly Survey of Business Opinion showed 40% of firms surveyed expect profits will fall. This is the most negative outlook since December 1982.

Residential home sales are down -44.5% year on year in June and residential building consents down -27% while non-residential consents are also down -9.2%.

The contraction of credit as a direct consequence of finance company failures (now 22 of them) and rationing by the banks, whose funding is heavily reliant on overseas borrowings, is de-leveraging our economy quickly. Debt funded corporate activity and property development activities have slowed to a crawl and with falling consents and construction activity the multiplier affect into the rest of the economy is large.

Our commodity exports, particularly dairy, remain buoyant and though we expect to see some weaker commodity prices, terms of trade should remain favourable for them given a weakening NZ\$.

The economy contracted -0.3% in the March quarter and the June numbers will show the country is in a recession. Last month Allan Bollard indicated that economic activity was now slowing enough to bring inflation back to the target 1-3% band (after spiking at 4.7% in September last year).

Given the speed as which conditions are declining, it is most likely the Reserve Bank will begin to cut interest rates from 11th September and we may well see something earlier than this on the 24th July. The markets have begun pricing in interest rate cuts with falling 90 day bank bill rates (now back near 8.5%) and longer dated bond yields also falling.

The currency is also coming under pressure as foreign investors sell the NZ\$ on the back of a lower interest rate outlook. The NZ\$ has already fallen to 7 year lows against a stronger AUD\$ and last month fell against heavily against other currencies as well (Yen -2.8%, GBP -3.3%, Euro -4.1%, USD -2.8%).

New Zealand Outlook

In our view interest rates should have been cut far earlier and as we stated in our March report we believed conditions were deteriorating faster than policy makers were expecting.

It is likely New Zealand is a recession and it may take several quarters to abate. It will certainly require further substantial easing in monetary policy over the rest of 2008 and into 2009 to help get things moving again. The new personal tax cuts will not be stimulatory and will be absorbed meeting higher food prices.

We can no longer expect high interest rates to support the NZ\$ and it is likely the NZ\$ will continue to come under pressure. Investors need to ensure their portfolios are adequately diversified into offshore holdings.

Falling interest rates also mean investors need to ensure their portfolios hold sufficiently high quality longer dated bonds to lock in rates.

Residential property is likely to come under further pressure particularly in non-urban areas as a combination of supply overhang and rationed credit continues to impact. Commercial property is also likely to feel the pressure due to credit contraction and weaker business conditions.

Meanwhile the NZ share market has been busily building in a very weak outlook for our economy with expectations of -10% earnings growth from the NZX50. Despite a decline in share prices, earnings expectations are keeping market forecast PEs around 14x while gross market dividend yields are now approximately 7.8%.

We believe that many NZ shares have now been well oversold and represent good long term value. Any anticipated improvement in the economic outlook will quickly buoy share prices.