

SELECT – March 2008 Investment Review

The first quarter of 2008 will be remembered for a long time as one of the worst yearly starts for financial markets in history. With a global financial system reeling under the impact of a liquidity and solvency crises, credit markets, property and shares have retreated dramatically.

Market Performance

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).

Asset Class	Market Returns March 2008 Quarter
NZ Dollar (Trade Weighted Index)	-2.5%
NZ Cash	+2.0%
NZ Fixed Interest	+2.7%
Global Fixed Interest – 100% hedged to NZ\$	+3.9%
NZ Shares	-14.1%
Global Shares – 50% hedged to NZ\$	-11.1%
Alternative Assets – 50% hedged to NZ\$	-5.1%

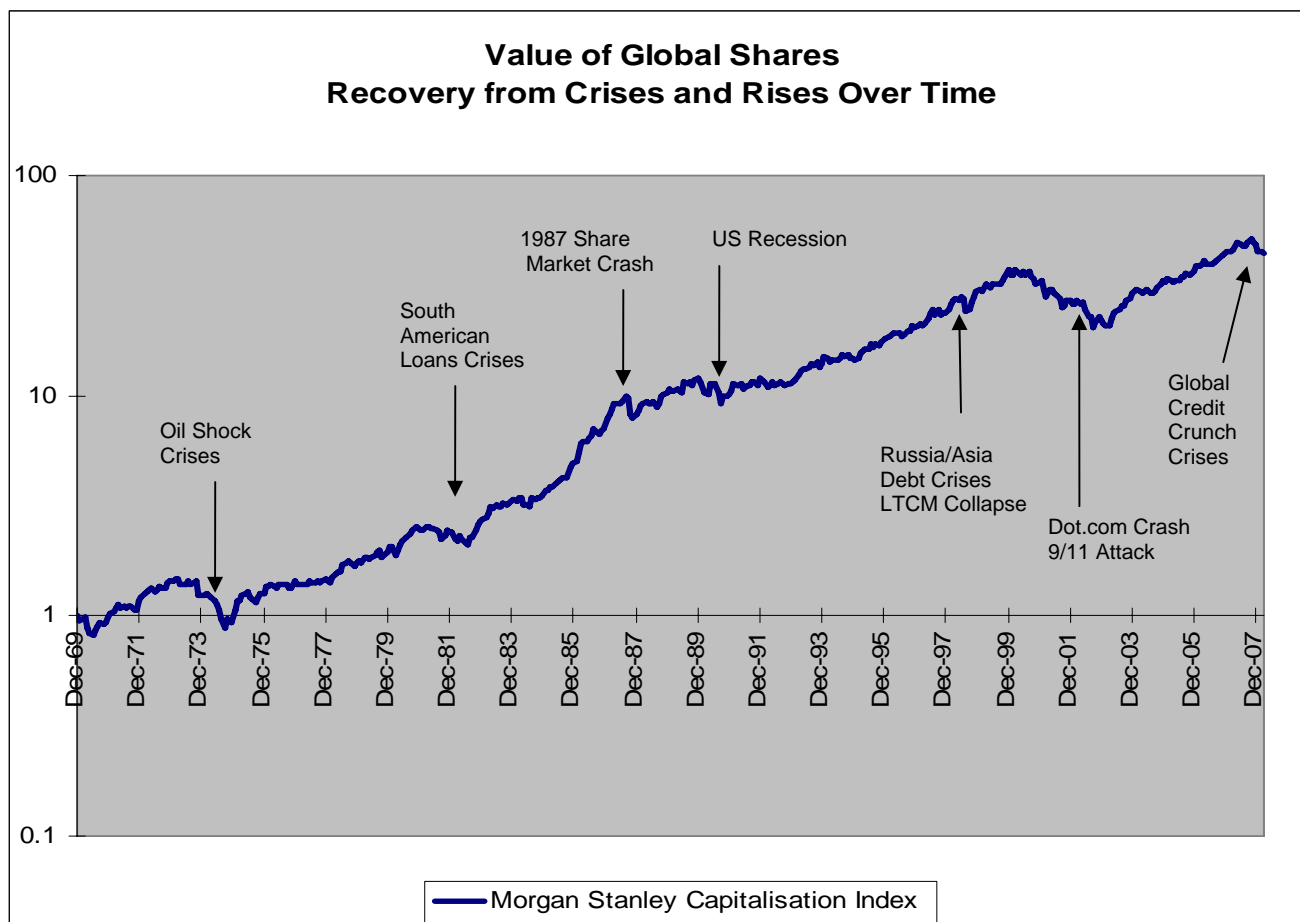
Notes: Returns are derived from market benchmarks and are before tax.

It seems that every 7 to 10 years we have some form of financial markets and or economic crises and each time it has a different shape and feel.

Probably the greatest lesson we can learn from the recent 'Credit Crunch' crises is that in the pursuit of wealth we seem to have an infinite ability to find creative ways to disguise risk and reassure ourselves that we know better.

Whether it be the 1930s depression, 1970s energy crises, 1980s South American loan defaults, 1990s Savings and Loans Crises, Asian Crises, Russian Crises, Dot Com bust...we simply find another way to dust ourselves off and get back on the field.

Through all these crises global productivity and global real wealth keeps rising. Despite the set backs every few years we are driven to improve our own circumstances.



This time around it will also be no different. To move forward we need to understand what has happened and is happening, how big the problem is and how it can all be dealt with. And while things are being repaired investors (by their nature optimists) will try and look through this mess to the future. This is important to understand.

While we get more negative news around systemic financial market issues and their management and slowing economies, investors are trying to see past this and so shares and other assets will rise in value well before any new foundations have been re-built.

Global Credit Crises

What has happened?

Over the last 7 years and following a determination by the US Federal Reserve to avert a deflationary crises in 2001-2002, we saw very easy monetary policy taking place in the US while Japan and China were also running easy monetary policies to promote growth. While

Chinese funds have been put into building productive capacity, in the US these funds were used to over invest in housing stock (like we have in NZ), inflate asset prices and effectively fund consumerism.

The modern development of complex financial derivatives, funding structures and other debt securities has enabled global capital to flow more swiftly from the lending countries to the borrowing countries.

At the heart of the credit crunch this financial engineering facilitated enormous leverage and gearing in effect an immense inverse pyramid of debt that at its point is balanced on a very narrow base of real assets.

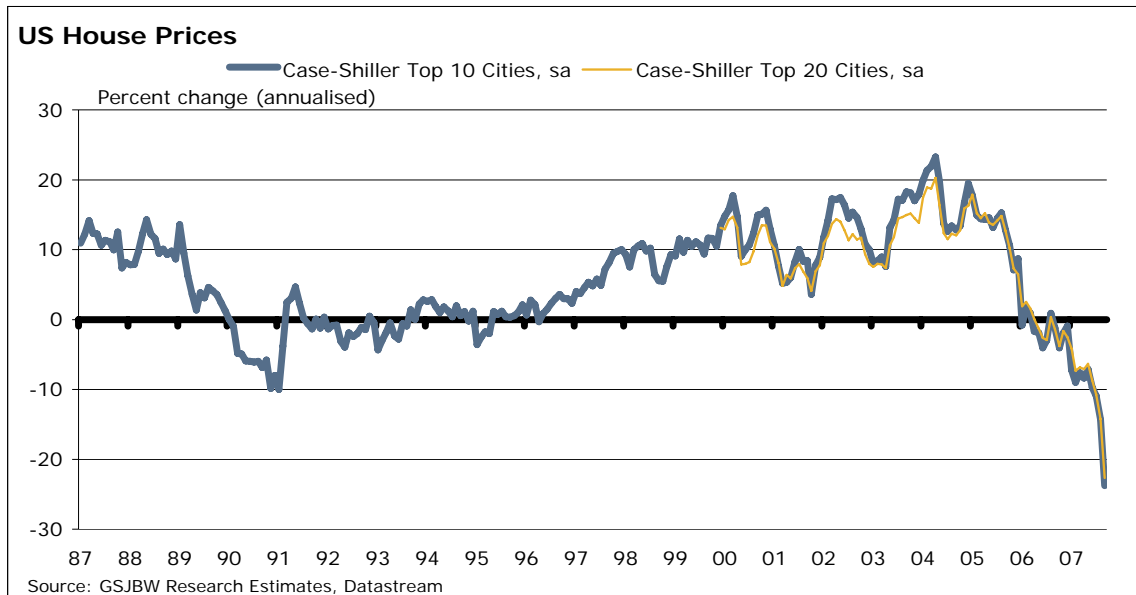
The assets at the base of this pyramid largely comprise US home mortgages. From 2006, property developers in the US kept adding to the oversupply of housing stock to keep their businesses growing. As the market ran out of buyers for these houses, loans were provided to increasingly incapable borrowers.

Thanks to the complexity and multi-layered nature of the products supplying these loans borrowers were able to obtain credit way beyond any level of sensibility and worse still the lenders had no line of sight to the bad loans they were making.

Lenders kept the funds flowing through investment banks and off balance sheet bank operations. In the middle of all this investment bankers created ridiculously sophisticated structures that know one knew how to value (including themselves). Their annual bonuses were good though...!

Today these borrowers are in crises and increasingly in default with their houses worth less than their loans. It is important to get a sense of perspective of the size of this problem.

- US economy (annual GDP US\$14.1 trillion)
- US credit market debt US\$47trillion
- US Residential real estate US\$21 trillion
- **US home loans US\$10 trillion**
- US\$830bn in sub-prime or low quality mortgages (most written in 2006)
- 20% of sub-prime is now thought to be delinquent with some 6% already in foreclosure. This will rise.
- US average home prices have decreased -11.4% from their highs (S & P / Case Schiller Home Price 10- City Index). In some areas such as San Bernardino, Orlando, Los Angeles, Las Vegas, prices have fallen from their highs some -25% to -35%.



- Commentators are suggesting a further fall of 5-6% in average US home prices.

If we assume as much as 60% of the sub-prime debt becomes delinquent (and it could be higher) then losses are likely to be in the vicinity of +US\$500bn. Citigroup is estimating US\$300bn in losses, the G7 Finance Ministers US\$400bn Goldman Sachs thinks it could be US\$1trillion.

To date some US\$250 billion in sub-prime mortgages or their related securities have been written off and last week we saw further announcements of write downs from UBS and Lehman Brothers. So it appears we may have some way to go!

While this problem looks incredibly large the financial system should have been able to cope with the write-downs and losses over time. Unfortunately, the opaque nature of the problem means there is a flow on effect to wider debt markets and finally to share markets (which have sold off some US\$1.5 trillion in value since the end of 2007).

The resulting 'credit-crunch' has really been a crises of faith. Credit markets rely on the ability of someone to repay their loans and this includes overnight and other short term loans that banks make to each other. As mortgage and asset backed securities fail credit market participants including the largest commercial banks have all been looking at each other wondering who holds the bad debt and whether they might default on their obligations.

This fear has driven an extreme flight to quality with many institutions not lending to each other at all or only at very high prices. This is now affecting all forms of funding with banks hoarding liquidity to protect their own balance sheets not making new loans and not rolling over loans forcing borrowers to sell their asset to repay the debt (bonds, property and shares).

When we looked out at markets in December 2007 things looked difficult but containable if there was concerted central bank and Government policy action. Unfortunately the US Federal Reserve while acknowledging and responding to the problem did not move fast enough.

The result was a near global financial market meltdown in February and March with some commentators comparing it with the financial crises in the 1930s depression (which it is not).

However, if left to their own devices credit markets looked like they were entering into a so called 'death spiral' where falling asset prices triggered more margin calls or loan defaults requiring more assets sales which triggered more margin calls. Good assets were being sold down with not so good assets as investors scrambled for liquidity to meet debt obligations in this fast unwinding market.

In mid March with things well out of hand, the US Federal Reserve and Government finally stepped aggressively into the market to provide stability and liquidity through a number of initiatives including interest rate cuts (a total of 3% since last year), new short term lending facilities to banks and also non-banks (total US\$300bn), a line of credit for JP Morgan to buy out a collapsed Bear Sterns, reductions in capital requirements for the Government wholesale mortgage lenders Freddie Mac and Fannie Mae (US\$200bn capacity increase) and a number of other measures as well.

Added to this, the US Government had announced tax cuts that would inject substantial stimulus into the economy (estimated at 1% of GDP).

The most important thing that happened was the Federal Reserve and US Government saying they would now do whatever it takes to restore financial market stability. This eased market concerns and they rallied on the back of this intervention and intent.

Where will the crises lead now?

Short Term

It may well become financial market history that the Bear Sterns collapse and rescue on March 14th 2008, was the turning point in the crises. Normally an investment bank such as this (even as prestigious as BS) would be allowed to fall over but the fact that the Federal Reserve effectively bailed it out shows just how bad things were. If Bear Sterns had been left to fall over the counter party impact and flow on damage would have been too much. We could have had a systemic collapse of the global financial markets with trillions of dollars at risk.

For now, the US Federal Reserve is focusing on nothing else but system stability and markets are now taking them seriously. This is a good thing and bad thing. The good news is that the worst of the crises may well be behind us. The bad news is that the stimulus from tax and interest rate cuts along with the propping up of bad loans (and their issuers) may draw out a slower write down of bad assets and hence slower recovery process.

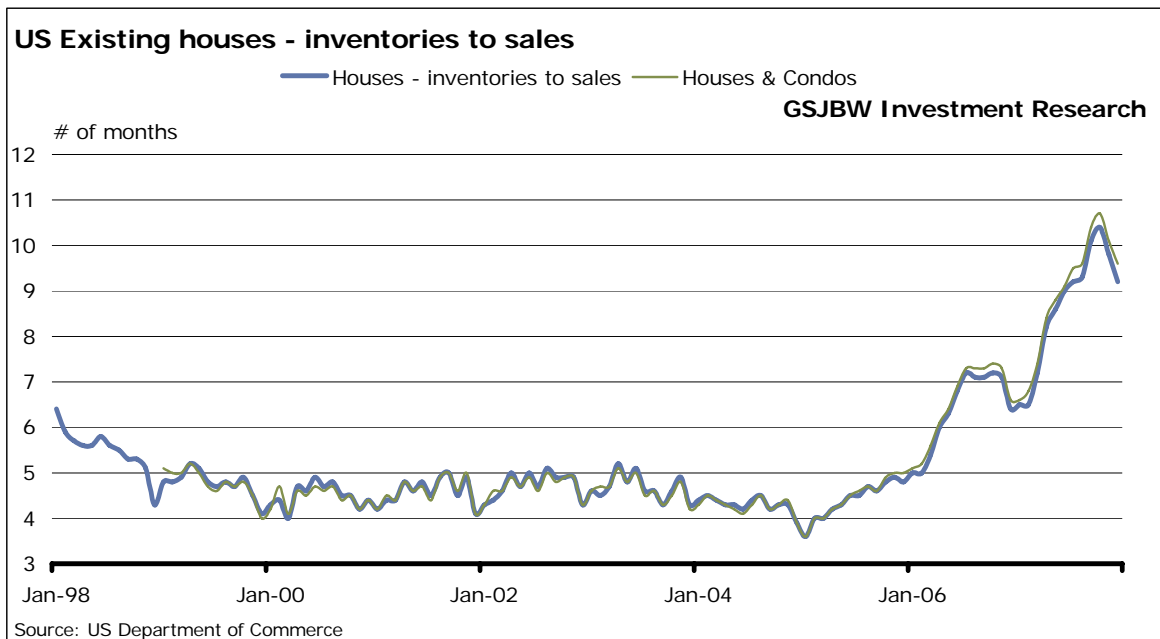
Markets have already started to respond positively to the intervention. Over the last two weeks the inter bank lending market has started to free up with the cost of short term funding coming down from crippling levels to merely excessive levels. Share markets and some debt markets are bouncing back (sharply) as clearly oversold assets have been bought by bargain hunters. Market volumes have been improving, volatility levels have been dropping and investors are starting to focus a little more on fundamental issues again.

Over the next few months we can expect to hear further bad news in the form of poor economic news, lower earnings outlooks, defaulting mortgages, financial institution collapse or near collapses and a continuation of falling property prices. This will be countered by further interest rate cuts in the US and cuts in UK and Europe. These cuts along with the stimulatory policies being put in place will provide a buffer against the bad news. Recovery in markets will be uneven and jagged but it will come and strategic and patient investors will be rewarded.

Long Term

There are some significant long term impacts arising from the current credit crises including:

- Unwinding years of leverage. Asset prices will continue to deflate in some markets (particularly in property) for some time and this will have a large deflationary effect while also reducing household wealth.
- Unsold house inventories are running around 9 million homes suggesting a market oversupply of 3-4 million homes. It will take 2-3 years to soak up approximately 3-4 million in excess housing stock. Equilibrium in pricing may take another 12 months though this will make housing more affordable to many again.
- US Consumers (and NZ ones as well) have been dissaving by spending their home equity on living expenses. Rising home prices have been used to offset excess spending over incomes for years. US consumers will not be able to spend in the same way.



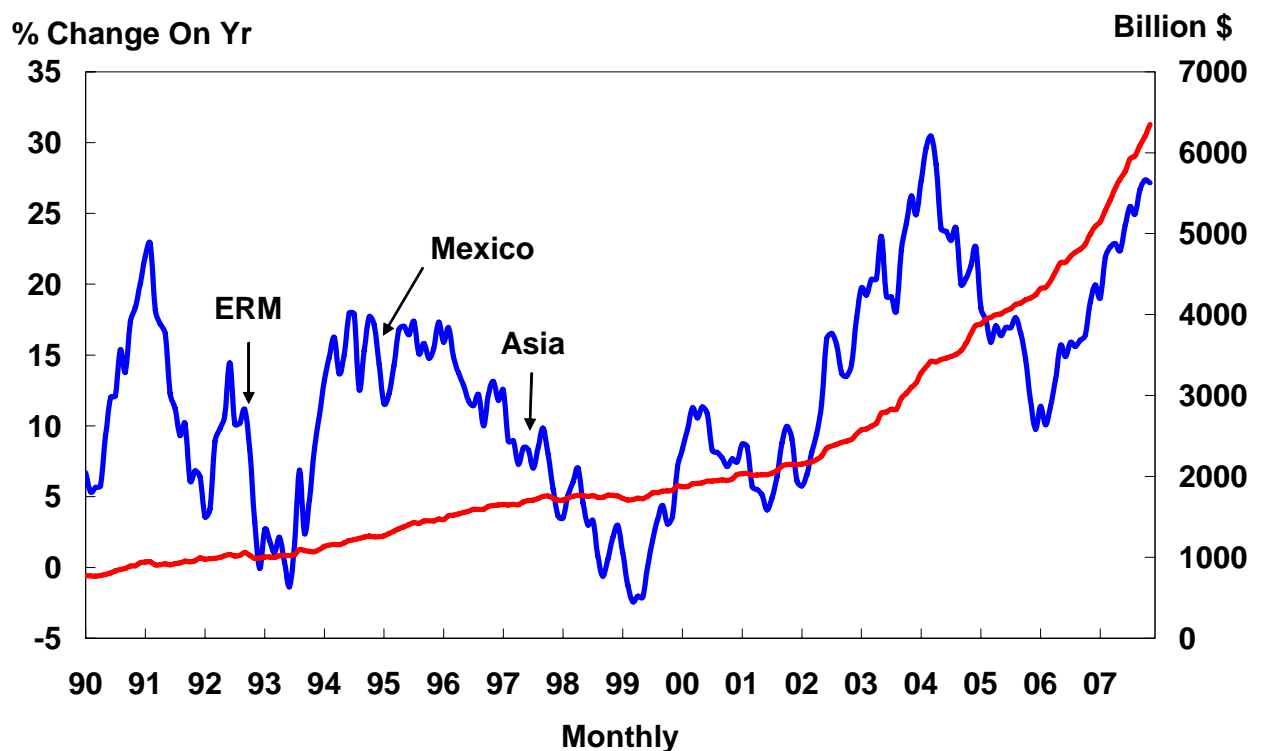
- Some credit markets may never recover. The days of banks and non-bank institutions securitizing debt and then on selling them to investors looks like it is over.
- Re-regulation of US lending institutions is on the way. The US Federal Reserve has recently announced sweeping reforms and is extending its oversight controls to insurance companies, hedge funds, non-commercial banks and other financial institutions.
- US Mortgage lending standards are being rapidly overhauled and regulated. This will not only reduce credit to marginal borrowers but likely slow the whole credit process and impact on future credit growth (having an economic impact).
- A long term lower \$US will stimulate US exports (already happening) and increase investment in US production facilities (re-industrialization).
- Changes to moral sentiment. Investment bankers like their corporate counter parts of the late 1990s (Enron and World Comm as an example) have increasingly made their super profits from leveraging their balance sheets and hiding risk in complex products to be resold to investors. The profits have been staggering and so have their bonuses. We are likely to see a change in the way these organizations remunerate themselves or further regulation by a new US Government to ensure they do.

- US Government support. Rescue packages for marginalised homeowners and distressed borrowers are likely to appear under a new democratic US Government. This will be stimulative and likely inflationary.
- Short selling restrictions. Some short sellers (including large hedge funds) have been taking part in coordinated attacks against companies with heavy exposures to debt. These attacks have been preceded by market rumours and false statements. There are securities commission investigations underway in the US, UK and Australian markets on these trades. Re-regulation of short selling practices is likely.

At the heart of the problem the US has been long spending more than it earns and running up large external deficits that have been funded by overseas lenders (China, Japan, Singapore, Europe and the Middle East). The same can be said for New Zealand. At some point this balance has to be readdressed through lower exchange rates and trade re-balancing. In the case of the US this will now be a long process that could take years if not decades.

But is us also important to remember that despite the credit crises and write down of sub-prime loans, global savings are actually in good shape.

Global Foreign Exchange Reserves (Red Line) vs Global Sharemarket Growth (Blue Line year on year).



These savings will find their way (over time) to buying distressed debt and other bargains that have now arisen as a result of the crises. They will also finding their way into re-capitalising the balance sheets of the largest financial institutions that are at risk. Over time these

financial institutions balance sheets will be restored, write-downs will be fully taken, and tighter regulation will create a more robust and more sensibly risk adverse financial system.

The Economic Outlook

Economic Growth

As the credit crunch crises continues to unwind, global de-leveraging is taking place. This is reducing the value of assets (US house prices) and reducing the capacity of economies as debt is withdrawn. The withdrawal of credit will have an impact on global economic growth particularly the US for the next year (as much as -1% of GDP).

The US is likely to be the worst affected in the short term and while there is still some argument about whether it is in recession, there is no doubt the US economy is slowing rapidly and may only achieve a very low level of growth in 2008 (likely less than 1% growth).

The IMF has re-cut and lowered its global growth forecast 3 times within the last year and while their latest forecast shows a marked decrease in global growth momentum (not seen since 2002) it is still positive and only marginally below long term growth trends.

	IMF October 2007 Outlook for 2008	IMF March 2008 Outlook for 2008
World	4.8%	3.7%
US	1.9%	0.5%
Euro Area	2.1%	1.3%
Japan	1.7%	1.4%
China	10%	9.3%

Source: International Monetary Fund

As we have said in the past, China and Asia ex Japan will remain the critical contributors to world growth for the next few years.

Inflation

Against this global back drop of slowing growth inflation remains a real concern. Rising food, energy prices and raw materials prices have driven up global inflation. China long a source of deflation through cheaper goods prices is now battling internal inflation levels of 6% and more. Arguably, it has begun to export inflation as its goods prices rise (probably not as fast however as other global suppliers).

Global inflation has fallen from the early 1980s highs of about 14.5% p.a. to less than 2% in recent years. Over the last 3 years, global inflation has been rising again and is now forecast to reach 3.8% this year. BCA Research believe long term global inflation is likely to flatten out and stay in the 2-3% range.

Our view is that while inflation has rapidly risen for food, energy and materials their prices are not likely to rise at the remarkable rate. The de-leveraging and fall in asset prices will also have a significant deflationary affect particularly, in the US.

This is the gamble that the US Federal Reserve is also taking and that inflation in the US can be contained in the medium and longer term despite reducing interest rates from 5.25% to 2.25%.

Elsewhere central bankers are not sure with the European Central Bank, Bank of England, New Zealand and Australian Reserve Banks all holding higher interest rate levels in the face of difficult credit and market conditions. Their resolve will be tested as house prices fall in all these markets and borrowers face higher costs as their fixed rate mortgages are re-set this year.

The Market Outlook

Global

The recent US Federal Reserve action on the credit crises is the first and most important step in providing a floor for financial markets. Sentiment currently rules investor behavior but with a restoration of system confidence over the next few months we will gradually see the focus return to fundamental analysis.

While technically we are currently in a bear market, we do not believe it will be secular or long term. While global growth is slowing further than we anticipated it remains positive and there is no shortage of global savings which are now coming back into the market to buy everything from distressed debt to bank bailouts and oversold municipal and corporate bonds to shares.

Corporate earnings in the US and globally will be weaker on the back of weaker economic growth but to a significant extent this has been factored into asset prices. Excluding the banks, these US corporations are also in surprisingly good shape as they have historically low levels of debt, low inventory levels and have not over invested in capacity.

With the sharp pull back in markets over the last quarter valuations for mature markets based on forecast earnings have also improved with global market Price Earnings Ratios around 14 times (with the US at 15 times, UK 11 times and NZ at 15 times).

Amongst the recent sell-offs, many sectors and individual companies have been oversold as part of the general stampede. They represent good buying though some areas (like financial stocks) still look high risk at present. Professional investors will take advantage of these times to add to their portfolios.

Our expectation is that global sharemarkets will track positively ahead for the rest of the year as investors and markets start to look through the current economic slow down to better times ahead. Good news will add more value than bad news will detract. There will be difficult periods on the way and it will only be with hindsight that we can say a market base has been formed and a new bull market commenced.

New Zealand

Despite the NZ economy turning in a stronger than expected 1% growth rate in the December quarter trading conditions look difficult. They also appear to be deteriorating and after economic growth of 3% + in 2007 it will be well down this year and likely in the range of 1% to 1.5%.

The global credit crunch has created difficulties here in NZ as we are large borrowers of overseas funds. Banks and particularly non-bank financial institutions are finding it increasingly hard to fund themselves. Banks have been issuing high interest securities to attract funds and investors have been abandoning higher risk issuers like finance companies and structured investment products. The collapse of 17 finance companies to date (and more likely to come) highlights the extent of the problem.

At 8.25%, NZ has the highest interest rate of any industrialized economy and the long-held tight monetary policy of the Reserve Bank is starting to take its toll with recent business and consumer confidence surveys plunging, housing sales down 50% year on year, house prices down -4.1%, weak net migration numbers and signs of weaker retail sales. Recent Barfoot & Thompson data shows Auckland house sales are down a massive - 56% year on year and prices down -7.6%.

Unfortunately inflation remains persistently above the Reserve Bank target at 3.3% and more worryingly inflation is starting to move on from rising food and energy prices (a global phenomenon) and feed into more dangerous local core inflation areas like wages.

Our tight labour market, with virtually full employment, is underpinning New Zealand's high private debt levels (and inflation). Slowing economic conditions will impact company bottom lines and very likely to generate unemployment this year (unless of course the Government keeps re-employing them!). Falling employment will be a key signal (along with falling house prices) to the Reserve Bank that inflation conditions are improving.

For now interest rates remain high, supporting the \$NZD. Exporters will continue to struggle, though some primary producers particularly dairy retain strong terms of trade. However, the drought will have a large impact on production this year and despite high global dairy prices a lack of supply could impact the economy as much as -1%.

Corporate earnings will be low this year with earnings growth forecasts at about 5% with a risk of earnings downgrades risks should conditions deteriorate further than expected.

Against this backdrop and after the recent significant correction in share prices, valuations now look fair against lower earnings expectations. NZ shares should still return a positive result this year through relatively high dividend yields and some share price growth.

Cash remains an attractive investment at present given market uncertainties. But, slowing economic conditions will see political and market pressure on the Reserve Bank to lower cash rates.

We think the environment is slowing faster than the Reserve Bank is anticipating and that we could well see an easing and cut in interest rates before the year is out.