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"In the middle of every difficulty lies opportunity..."

Albert Einstein

Emerging markets to drive global growth

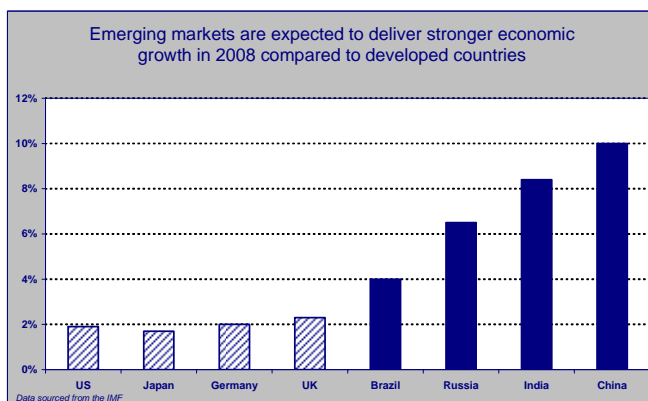
Events in the US have continued to dominate financial market activity during the quarter to 31 December 2007. The slowdown in the US housing market in particular has been a cause of great concern for its central bank and government.

To help support the weakening economy, the Federal Reserve (Fed) - the US central bank - cut its target interest rate by 0.25% in both October and December to 4.25%. The Bush administration has also brokered a 'rescue package' with the mortgage industry which should see some homeowners benefit by having their 'sub-prime' mortgage rates frozen for up to five years.

Sub-prime mortgages are those made to homeowners of lesser credit quality. Many of these sub-prime mortgages were offered at low introductory rates and are later reset to higher rates. This has resulted in an increase in delinquencies as these homeowners are often unable to afford the higher payments.

A slowdown in the US - the world's largest economy - will have an impact on global growth. It is for this reason that the IMF - an international organisation of 185 countries established to oversee the global financial system - has lowered its forecast for global growth in 2008 from 5.2% in July to 4.8% in October.

However, in recent years the US's role as the engine of global growth has lessened with emerging economies such as Brazil, Russia, India and China (nowadays referred to as the BRIC countries) experiencing significant growth.



It is anticipated that emerging markets should continue to expand and drive global growth for the time being.

Global equity market volatility continues

During the fourth quarter of 2007, similar levels of volatility were experienced in global equity markets compared to the third quarter. A heightened awareness of risk among investors, coupled with uncertainty as to whether the US will go into recession, have been major contributing factors.

It is during such times that equity markets can be particularly sensitive to new releases of economic data. One or two announcements of positive data can lead to these markets rebounding strongly, whereas a release of negative data can result in a quick exit by investors.

The MSCI World Index - which tracks the performance of share markets in 23 developed economies - was down -2.9% in local currency terms for the quarter to 31 December 2007. What have been regarded as tough times for investors in global equities may seem less so when we consider that the same index returned above 18% in local currency terms for the 18-month period to 31 December 2007.



Of the major indices, the best performing for the quarter was the DAX30 - an index of 30 blue-chip German companies - which returned 2.6%. The worst performer was the Nikkei - an index of Japan's top 225 blue-chip companies - which was down -8.8%.

The best performing share market in 2007 was in China where its benchmark CSI300 Index was up 162% for the year. Although this seems extraordinary, it is difficult to imagine that such stellar performance will be repeated in 2008.

Many believe we are witnessing the creation of another stock market bubble, where investors are prepared to pay increasingly higher prices for a given level of earnings. With valuations of Chinese companies being more than double those of their peers in the US, we may see investors tempted to invest elsewhere.

New Zealand equities take their cue from offshore markets

The volatility experienced in global equity markets and concerns about a possible recession in the US have continued to influence our local equity market over the past quarter. The benchmark NZX50 Index - which tracks the 50 largest local stocks - was down -5.3% for the period.

Contributing to this weaker performance has been the strong New Zealand dollar. This has had the effect of lowering the earnings - reported in NZ dollars - of companies that derive a portion of their revenue from offshore markets.

High domestic interest rates and a relatively positive outlook for economic growth have helped keep the NZ dollar strong over recent months.



It is also worth noting that, in November, changes made to the composition of certain MSCI global and regional indices resulted in a number of our companies being moved from the main indices to a small cap index. Therefore, passive funds that track the performance of the main indices would have sold out of these companies.

On a positive note, at present the local equity market seems fairly valued. Going forward, it should be supported by the flow-on effects of more funds being channelled into KiwiSaver, as well as investors taking advantage of the tax benefits gained by investing in Portfolio Investment Entities (PIEs).

New Zealand's economic outlook remains healthy

The domestic economy is displaying mixed signals at the moment with certain sectors such as housing slowing, while others such as dairy are booming. On balance, it is expected that growth is to remain relatively robust - with the IMF forecasting our economy to expand by 2.3% in 2008.

As the New Zealand economy is closely tied to that of Australia, as well as many of the Asian economies which are experiencing significant growth at present, the impact of a slowing US economy should be muted.

Rising inflation is the Reserve Bank of New Zealand's (RBNZ) biggest concern at present. The high oil price, coupled with increasing food prices and rising wages due to a tight labour market, have been contributing factors.

The RBNZ is mandated to maintain inflation at between 1 and 3%, on average, over the medium term. It is anticipated that inflation should move above 3% in 2008 and may even reach as high as 4%.

After increasing the Official Cash Rate to a high of 8.25% in July, the RBNZ has kept rates on hold at their subsequent meetings. With inflation expected to rise further, any cut in the RBNZ's target rate is still some way off.

Central banks provide additional liquidity

The crisis in global credit markets - which began in July last year - showed signs of improvement in October. With buyers returning to the market, the prices of certain structured credit assets started to stabilise. However, the area experiencing the most difficulty is those securities that have an exposure to the troubled US housing market.

In November and December, a number of financial institutions announced that they expect to report further mortgage-related writedowns in the fourth quarter. This once again unsettled credit markets and dampened investor sentiment, with many deciding to sit on the sidelines until market conditions improve.

The credit crisis has made money 'scarce' and, to alleviate this lack of liquidity, a number of central banks across the world announced a co-ordinated plan to provide additional funds to banks over the year-end period.

As an example thereof, the European Central Bank took the unprecedented step of injecting US\$500b into the banking system in December. This had the effect of decreasing the cost of borrowing between banks, which have been reluctant to lend to each other since the start of the credit crisis. Banks have preferred to hold onto any spare cash they may have, as opposed to lending it out.

The Fed also announced that it will continue to provide extra funding for 'as long as necessary' to help restore faith in the money markets.

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