

# Lyfords economic commentary

July 2009

Lyfords brings you this summary of investment markets over recent weeks. Please contact your Business Development or Relationship Manager if you have any questions or require further information.

## Key Market Developments

Markets consolidated throughout most of June and into the start of July. After three consecutive months of strong performance, the market was overdue for a breather. With the US and European company reporting season approaching investors were weighing up the probability of potential earnings disappointment.

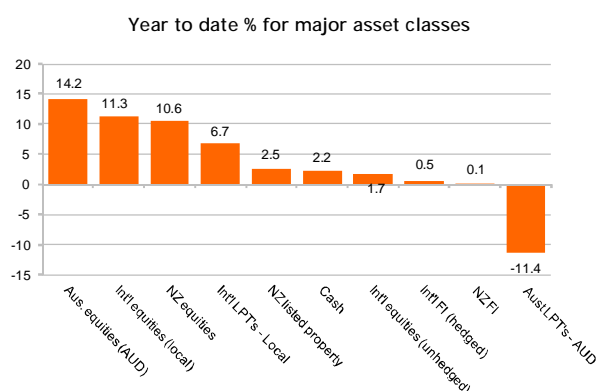
So far, earnings results have been better than expected, on balance, and equity markets responded by erasing the June/July losses in less than a week. Risk is back in favour; US treasuries and the dollar were sold, while oil prices and commodity currencies rallied. Credit spreads are now back to pre-Lehman levels, evidence that the Federal Reserve's unorthodox policy actions, aimed at ending the credit crisis, have been effective.

The S&P500 is now trading on a 14x multiple of forward earnings expectations, which is approaching a historical long run average for the measure. The valuation gap has closed in anticipation of earnings recovering, so the market will be very sensitive to the remaining second quarter earnings results and any further guidance that US corporates may provide this month.

Evidence of healing in the financial sector is apparent: Goldman Sachs kick-started the reporting season by posting a 65% gain in earnings on the second quarter last year and 35% higher than the average analyst estimate. Gains were buoyed by record revenues from trading and stock underwriting. JPMorgan Chase & Co. also reported a gain in profit for the first time since 2007. While the favourable result was mostly on the back of investment banking fees, the bank warned of further losses on consumer loans.

The US Private-Public Investment Programme (PPIP), established to buy as much as US\$40 billion in assets from banks, has finally started almost four months after it was proposed. However, this version of the plan has been scaled down from the original proposed programme, which aimed to buy up to US\$1 trillion in "troubled" assets. The programme includes nine of the largest bond managers but excluded PIMCO which had earlier pledged its support. PIMCO's

reversal has created some uncertainty about the design of the initiative.



## Regional Economic Summary

### United States

- US Gross domestic product shrank at a 5.5% annual pace in the first three months of the year. However, leading economic dataflow released in the past month has shown that some areas of the economy, such as housing and manufacturing, are seeing a smaller pace of decline. This is consistent with a statement from the US Federal Reserve that the worst of the "slump" has passed, "The freefall environment of the first quarter and late last year is definitely over, but we have yet to see convincing signs of a vigorous recovery."
- The Institute for Supply Management's factory index rose in June for a sixth straight month to 44.8, (this is still 5 points below the 50 point score that indicates growth). Industrial production also fell less than anticipated adding to signs that the pace of contraction in the US manufacturing industry is slowing; in part thanks to a significant global inventory re-build.
- However, companies are unlikely to start hiring in the labour market until there is a sustainable gain in demand and that requires a substantial improvement in consumer confidence. The University of Michigan consumer confidence survey slipped in July, after four months of gains.
- Retail sales rose 0.6% more than forecast, the biggest gain since January. However, after excluding purchases of cars and petrol, purchases dropped for the fourth consecutive month.

## Europe

- The Organization for Economic Cooperation and Development said in June that the outlook for the euro-region economy remains "grim." Gross domestic product in the 16-member euro region shrank 2.5% in the first quarter of this year. However, as in the US, the rate of contraction within the euro region has clearly moderated in the second quarter with measures of consumer sentiment, business confidence and manufacturing improving. Industrial output in Germany surged the most in almost 16 years in line with the global inventory cycle. In contrast, German investor confidence unexpectedly fell in July, suggesting the recovery in Europe's largest economy may take longer to materialise.
- The European Central Bank kept its key interest rate at a record low and pledged to buy covered bonds. This is the ECB's equivalent of the Federal Reserve's quantitative easing program.

## United Kingdom

- While there have been encouraging signs of improvement, the outlook for the UK economy remains uncertain with unemployment set to continue rising for some time. Bank of England Deputy-Governor Charles Bean said the economy is probably "bumping along the bottom."
- UK unemployment claims rose the least in a year in June, adding to evidence that the worst of the recession may have passed. Reports also showed the housing market improved last month and retail sales rose from a year earlier.

## Asia Pacific

- China, the world's third-largest economy, grew 7.9% in the second quarter from a year earlier. This result followed the slowest pace of growth in China for almost a decade, for the first quarter of 2009. China is the only one of the 10 biggest global economies that is expanding, thus highlighting the role the nation may play in easing the global recession. While China cannot save the world by itself, its recovery is definitely a positive.

## Australia

- Australia was one of the few major economies, along with China and India, to expand in the first quarter as government handouts and the lowest interest rates in year spurred demand. However, the Australian economy faces the same headwinds of rising unemployment. The unemployment rate rose to 5.8% in June, the highest in almost six years
- Australia's retail sales increased by twice as much as economists estimated in May. Sales have been assisted by the government's stimulus package, and economists are expecting another boost from income-tax cuts which came into effect last month.

## New Zealand

- The NZ property market continues to recover off very low levels and retail sales rose for the third month in four. Record low

interest rates and falling prices are helping the property market recover. The news from the property market is adding to signs that low interest rates and income tax cuts will help the economy as a whole emerge from recession later this year. However, it is not clear how robust the recovery will be while consumers remain concerned about jobs.

- Reserve Bank Governor Alan Bollard kept the benchmark interest rate unchanged last month for the first time in a year, saying household spending may rebound. "There were some tentative sign of housing-related spending picking up, although this is from a low base and the pickup in housing demand has been relatively modest to date."

## Monthly Sector Summary

As at 30 June 2009

### International shares

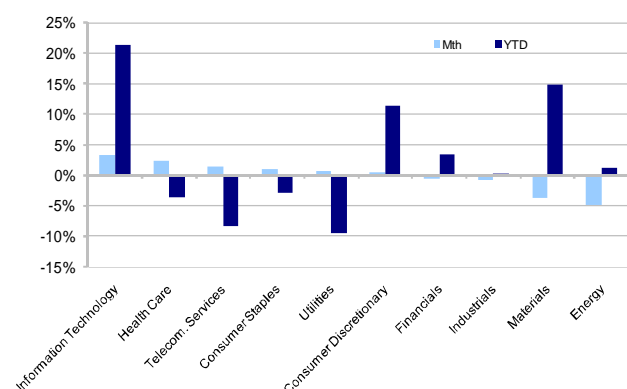
The MSCI World Index in local currency terms was flat for the month of June, after rising for three straight months beginning in March. Year-to-date the index is up 5.2%. Returns to un-hedged New Zealand-based investors, in June, were down -1.7%, with the NZ dollar continuing to rally, up 1.7% on a MSCI weighted basis.

The rally from March continued through the first few weeks in June, but investors became reluctant to add to these positions since many of the early signs of recovery were already fully priced into global equity markets. Price action was consistent with a V-shaped global economic recovery, but this is a scenario predicted by very few economists.

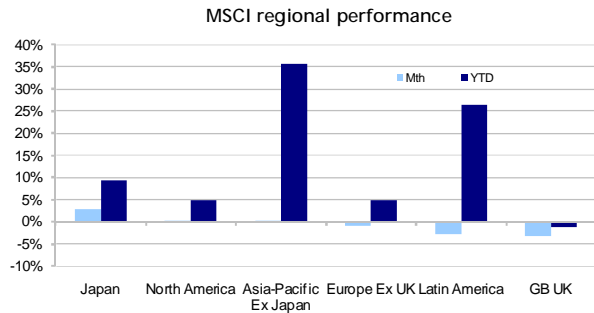
In the US, forward PE's were closing in on historical averages, leaving less room for earnings to disappoint, as the second quarter earnings season drew nearer. While analysts had already revised down earnings expectations for the quarter, they are looking to see whether companies signal that they need to cut costs further in order to protect margins, since this will have a negative impact on the expected recovery in earnings.

Energy (-5.0%) and materials (-3.7%) sectors gave back some of their recent gains from the strong rally in commodity and oil prices in May. Information technology companies led the way in June and the sector has outperformed all others year-to-date.

MSCI sector performance



June was a benign month relative to the volatile start to 2009. Apart from Japan (+2.9%) all regions were either flat or slightly down, with the UK performing worst, falling 3.3%. The UK is the only region down year-to-date, with other developed markets up between 5% and 10%. The recovery in developing markets slowed slightly in May, but Asia Pacific ex-Japan (+35.7%) and Latin America (+26.5%) are still outperforming other regions year-to-date.

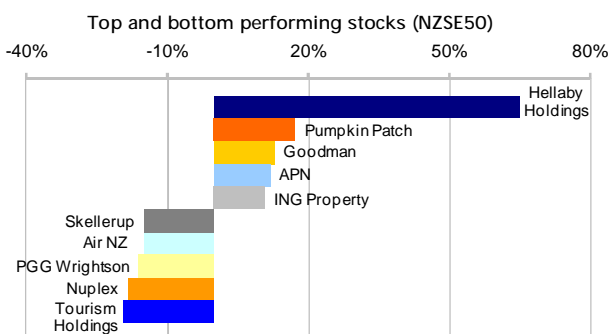


### New Zealand shares

The New Zealand sharemarket rose 1.2% during June, outperforming global equities, which were flat overall in local currency terms.

Telecom was one of the strongest performing stocks during the month (+8.8%) after the Commerce Commission announced their findings regarding sub-loop unbundling. The result was viewed as positive for Telecom. Telecom also benefited from the recent launch of its new mobile network, which is generating positive publicity for the company, after years of being at a technological disadvantage to its major local competitor, Vodafone.

At the other end of the scale, Air New Zealand closed down 15.1% after reporting passenger numbers were down -9.9% for May. So far tourism numbers show no marked decrease from the global swine flu pandemic, and certainly the impact has been muted compared to the decline in visitors in the wake of the SARS outbreak in 2003.

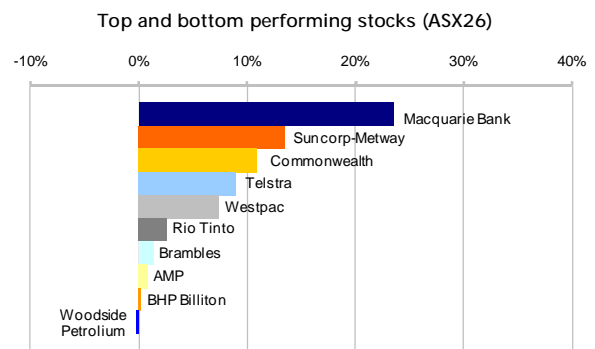


### Australian shares

The Australian equity market rose for the fourth successive month, delivering a return of +4.0% in June, and the longest run of monthly positive returns since May 2007. Interestingly, as yet another positive month passes; investor confidence in the sustainability of the improvement in economic data continues to gain momentum.

Resources (+0.2%) significantly underperformed Industrials (+5.7%) during the month, as both the resources sector and the market were driven by the BHP/RIO iron ore joint venture announcement, plus the A\$4.2 billion Rio Tinto rights issue. Commodity prices were mixed over the month, with the RBA commodity price index falling by 1.7%, driven by coking coal, thermal coal and iron ore.

The Financials performed very strongly, led by the banks, with Commonwealth Bank and Westpac in particular, reversing the relative performance of the major banks experienced during May. The Retail sector continued its very strong performance, posting the highest sector return for the month, driven by the rapidly improving consumer confidence and demonstrated by higher retail sales. Several Government stimulus payments and lower mortgage rates have all helped improve sentiment.



### International fixed interest

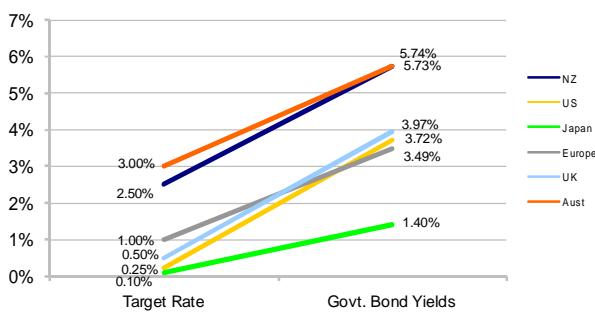
Global bonds hedged into NZD returned -0.71% for the month of June.

No major central banks cut interest rates any further during June, mainly because there is almost no room for further cuts. The US Federal Reserve is downsizing some of the programmes that were established to provide financial institutions with emergency sources of liquidity. However, many of the liquidity programmes remain in place, and it appears the intention is to withdraw these gradually as market conditions allow. For the past several months, government bonds and government guaranteed bonds have been preferred by investors seeking safety.

Globally, higher unemployment, contracting GDP and lower commodity prices are causing declining revenues. This, combined with difficulty in refinancing maturing debt, will cause default rates to rise. Moody's are forecasting the default rate for sub-investment grade issuers to reach 13.5% by November 2009; however, this new forecast is slightly lower than previous forecasts. At the end of June, S&P reported that 160 rated issuers had defaulted globally year-to-date, over four times the number of defaults during the same period in 2008.

10-year US Treasury notes were 3.55% at the end of June, compared to 3.59% at the end of May. US Treasury auctions appear to be well supported, indicating that current yields appropriately reflect supply risks. New Zealand 10-year yields rose over June, ending the period at 5.93% from a level of 5.76% at the end of May. 90-day rates ended the month at 2.80%, around the same levels of the previous month.

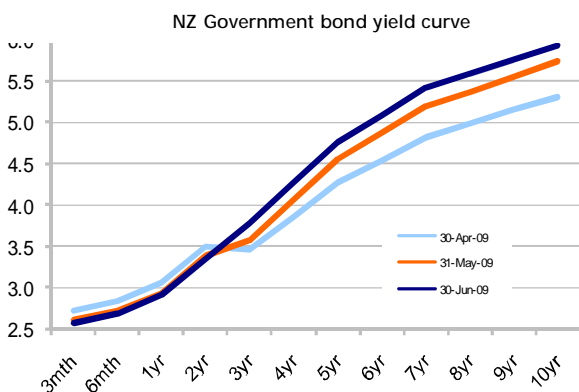
Regional yield curves



## New Zealand fixed interest

The New Zealand Government bond market returned -0.34% for the month, underperforming Cash, which returned 0.22% over the same period. The NZX All-Swaps Index returned -1.06% for the month, while the NZX Corporate A-Grade Index returned 0.89%.

Reserve Bank Governor, Dr Alan Bollard, cited, "signs that international economic activity is stabilising, and international financial conditions are improving" as key reasons for not cutting further at this stage. This gives the RBNZ time to observe whether previously delivered cuts will be sufficient to revive the economy. Dr Bollard did not rule out further cuts; though, any cuts would likely be in 0.25% steps going forward. Dr Bollard also reaffirmed previous guidance, that, "we expect to keep the OCR at or below the current level through until the latter part of 2010."



## Currency

In June, the NZD/USD chopped around in a 0.6280 – 0.6550 range for most of the month, largely dependent on shifts in US dollar sentiment. The NZD ended the month 1.4% higher at 0.6460 against the USD, gained 2.2% against the JPY, +1.9% to 0.4598 against the EUR, but down -0.5% against the GBP. The NZD/AUD continued to trade a tight range, but ended the month 0.4% higher at 0.7998.

The kiwi traded in a range close to year-to-date highs, on the back of shifting US dollar sentiment and while the market mulled over the likelihood that the global recession may be coming to an end. Risk aversion continued to moderate, so the diminishing need for the

safety of US treasuries weighed on the US dollar. Weak US dollar sentiment was also driven by overstated inflation concerns as a result of unconventional policy actions and calls from some quarters for an alternative reserve currency. The use of a broader range of assets for sovereign reserves is a risk for the longer term prospects for the US dollar; however, for now, the US dollar remains the safe haven asset of choice without an obvious viable alternative.

While movements in the NZ dollar were mostly dependent on US dollar sentiment, the domestic indicators also suggested that the recession could be moderating. The RBNZ seemingly supported this view by leaving rates unchanged at 2.50%; although, an easing bias remains in place with rates likely to remain low until later in 2010. This caused NZ-US swap rates to rise initially, only to slip along with global rates as interest rate markets became more realistic about the global backdrop and inflation expectations.

International dairy prices also began to weaken again, underscoring the risk that the low in the dairy price cycle may not have been reached yet. We remain hopeful that this is just a bout of market jitters, but expect this uncertainty to continue to weigh on the rural sector of the NZ economy over coming months.

## New Zealand listed property

The New Zealand Property Index (gross) returned +2.94% in June, outperforming the broader equity market (NZX50 gross), which had a return of +1.24%, by 1.70%. Despite strong performance in May and June, the sector has underperformed year-to-date with gross return of -5.4% compared to 3.6% for the broader equity market and over the last 12 months with a gross return of -17.8% compared to -11.1% for the NZX50 Index.

Despite the encouraging returns, spurred in part by the re-investment of dividends paid during June, it was a quiet month in terms of news flow. ING Property Trust (ING) announced the sale of 3 properties for a total of \$21.5 million, while ING Medical Properties Trust (IMP) announced the sale of its Thames St property in Melbourne for A\$2.8 million. Other news included Kiwi Income Property Trust announcing a new nine-year lease to Vero Insurance in Vero Centre, increasing the building's weighted average lease term (WALT) from 3.8 to 5.1 years.

There were some particularly strong moves during the month led by Goodman Property Trust (GMT), up 12.8% following the strong performance of its Australian-listed manager and significant shareholder, Goodman Group. ING Property Trust (ING) was the second-best performer with 11.1%, after further success at de-leveraging through asset sales. These were followed by National Property Trust (NAP) with 9.4%. The worst performers were AMP NZ Office (APT) with -7.89%, failing to gain traction due to the overhang caused by its giant \$201 million capital raising during May, followed by Kermadec (KPF) with -4.55% and Property for Industry (PFI) with 1.7%.

## Australian listed property

The Australian Property sector saw its fourth consecutive monthly rise in June with the index up 4.6%, outperforming the broader equity market (ASX 200) which had a gross return of 4.0%, by 0.6%. The index has now rebounded 40.0% from its March 2009 lows, but despite this strong bounce, the sector continues to underperform

the broader market on a year-to-date and 12-month basis by 22.0% and 22.2%, respectively.

Capital raisings continued to be a key feature again in June, although down from the \$3.8 billion raised in May, with a total of \$1.8 billion raised for de-leveraging purposes by Mirvac (\$1.1 billion), ING Office Fund (\$415 million) and FKP Property Group (\$324 million). It was also a month of asset sales with institutional grade asset markets showing signs of life with close to \$1 billion of assets changing hands. Other news included China Investment Corp (CIC) committing to a \$485 million finance facility for Goodman Group alongside Macquarie Bank.

The best-performing Real Estate Investment Trusts during June were Goodman Group (GMG) with 48.0%, as a result of CIC's support, followed by Macquarie Countrywide (MCW) with 35.3% and Charter Hall (CHC) with 23.3%, both of these continued to re-rate on improved investor sentiment following successful de-leveraging. Worst performing were ING Office Fund (IOF) with -10.7%, GPT Group (GPT) with -3.9% and Bunnings Warehouse Properties Trust

(BWP) with -3.0%, all down largely on profit-taking following recent strong runs.

### International listed property

Global real estate stocks were almost flat in June, slightly stronger in the Asia-Pacific region and weaker in the US and Continental Europe. Stocks in the UBS Investor ex-Australia and New Zealand Index produced a negative total return of 2.6% in the month, while the MSCI World Index of broad-market stocks was flat, down less than 0.1%. (All returns are stated in local currencies.) Year-to-date, global real estate stocks in the UBS Investors ex- Australia and New Zealand Index have produced a negative return of 13.3% versus a positive return of 5.2% in the broad global equity market. In the second quarter, global real estate stocks ex-Australia and New Zealand Index recovered significantly, up 13.3%, while the broad global market was up 16.8%.

## INGNZ Asset Allocation

Asset Class	Relative Position	Rationale
International Equities	—	The many measures undertaken by policy makers have gone some way towards laying the foundation for an improved stability in financial markets, and there have been some early signs that the pace of the decline in economic growth is slowing. Further signs of recovery will be taken positively by investors. However, capital raisings, dividend cuts and corporate defaults will continue to remind equity markets that the effects of the credit crunch will be with us for some time.
Domestic Equities	—	The New Zealand equity market's characteristics, such as high dividend yields and limited exposure to financial stocks, have made it more defensive than global equities. However, NZ shares will struggle to make significant ground against the headwinds of difficult economic conditions. Even though monetary conditions are significantly more accommodative, corporate NZ will be capital constrained for a time yet.
Domestic Listed Property	5	The sector is trading at a significant discount to Net Tangible Assets (NTA) more than compensating for the likely decline in asset values as cap rates rise. In addition, long lease terms, high occupancy rates and under-renting will help offset the impact of a weak economy. Dividend yields are extremely attractive especially as cash rates are set to fall. We expect the NZ LPT market to behave more defensively amid the uncertain global environment.
Global Property	6	Listed entities are still trading at a significant discount to Net Asset Values, even though NAV's have declined substantially over the past year. Dividend yields are now very attractive relative to interest rates. A significant amount of capital has been raised, helping restore balance sheets; however, the sector is still suffering from weak physical property markets.
International Fixed Interest	—	Global government bonds will continue to be the safe haven destination in times of crisis, declining inflation and monetary easing. Over the medium-term, the outlook for government bonds is less attractive as government deficits rise. Global credit offers attractive yields despite recent spread narrowing, and is pricing in well above average default activity. However, defaults will continue to rise sharply, particularly in the high yield space.
Domestic Fixed Interest	—	NZ government bonds have similar attributes to global bonds in this economic climate, but overall our expected returns are slightly higher.
Cash	6	Expected returns from NZ cash are unattractive over the next 12 months with short term interest rates expected to remain low for some time. This increases the relative attractiveness of other income-generating asset classes.
NZ Dollar	—	While the medium term fundamentals for the NZ dollar are not particularly supportive, the dominant driver in the current environment is US dollar sentiment, which is likely to remain weak while the US economy rebalances. At these levels, the NZ dollar is not sufficiently under or overvalued to justify an active position away from the hedging benchmark.

Key: — Neutral    5 Overweight    6 Underweight

## At a glance as at 30 June 2009

### Indices

	Level	1-month % change	YTD % change	1-year % change	3-year ann. % change	52-week high	52-week low
Index Close as at:	30-June-09	31-May-09	31-Dec-08	30-June-08	31-June-06		
MSCI World Index (G)	2263	0.0%	5.2%	-25.8%	-8.4%	3654	2853
<b>Asia Pacific</b>							
MSCI AC Asia ex Japan (G)	809	0.1%	35.7%	-11.6%	6.3%	972	647
NZSX50 (G)	2796	1.2%	3.0%	-12.5%	-8.0%	3416	2411
ASX200 Accum.	27054	4.0%	9.1%	-20.1%	-3.8%	33652	21298
Nikkei 225	9958	4.6%	12.4%	-26.1%	-13.7%	13603	6995
<b>Americas</b>							
Dow Jones	8447	-0.6%	-3.8%	-25.6%	-8.8%	11867	6470
S&P500	919	0.0%	1.8%	-28.2%	-10.2%	1313	667
Nasdaq	1835	3.4%	16.4%	-20.0%	-5.5%	2473	1266
<b>Europe</b>							
MSCI Europe (G)	3814	-1.8%	2.8%	-24.2%	-8.6%	6360	4828
FTSE100	4249	-3.8%	-4.2%	-24.5%	-10.0%	5649	3461
France CAC	3140	-4.2%	-2.4%	-29.2%	-14.2%	4559	2465
Germany DAX	4809	-2.7%	0.0%	-25.1%	-5.4%	6627	3589
<b>Property</b>							
NZX Property (G)	1763	2.7%	-5.9%	-18.6%	-6.3%	2146	1632
Aust LPTs (G)	15683	4.6%	-12.9%	-42.3%	-22.7%	30315	11200
Int'l LPTs (USD) (G)	341	0.1%	5.6%	-35.5%	-13.8%	733	522

\* Note: returns are in local currency, except where designated

\*\* Excludes imputation credits (G) = Gross, all other indices are capital.

### Currency

	Rate	1 month chge	YTD chge	1 year chge
AUD+	0.8064	0.7%	14.8%	-15.9%
EUR+	1.4033	-0.9%	0.4%	-10.9%
GBP+	1.6458	1.7%	12.8%	-17.4%
JPY+	96.4	-1.1%	-6.3%	9.3%
NZD+	0.6457	0.8%	11.5%	-15.3%
NZD/AUD	0.8008	0.2%	-2.9%	0.7%
NZD/GBP	0.3924	-0.3%	-1.1%	1.0%
NZ TWI	61.26	1.5%	9.0%	-9.7%

† vs USD (positive % represents a rise against the USD)

### 10-year bonds

	Yield	1 month chge	1 year chge
Australia	5.52%	0.24%	-0.93%
Germany	3.39%	-0.20%	-1.24%
NZ	5.93%	0.19%	-0.41%
UK	3.69%	-0.06%	-1.44%
US	3.53%	0.07%	-0.44%
Japan	1.36%	-0.13%	-0.24%

Source: Bloomberg

### Economic data

	GDP qtr on qtr	GDP yr on yr	CPI yr on yr	Unemployment rate
	-1.4/-5.5			
US	ann.	-2.50	1.70	9.50
Japan	0.40	1.50	-1.10	5.20
Germany	-3.80	-6.90	1.40	8.30
Euro	-2.50	-4.90	1.60	9.50
UK	-2.40	-4.90	1.00	4.80
Australia	0.40	0.40	2.20	5.80
NZ	-1.00	-2.70	1.90	5.00

### Central bank target rates

	Rate
NZ	2.50%
US	0.25%
Japan	0.10%
Europe	1.00%
UK	0.50%
Australia	3.00%