

October 2008

"Energy and persistence conquer all things."

Benjamin Franklin

The financial crisis entered a new phase

In September, the financial crisis that started in the middle of last year entered a new phase. The collapse of Lehman Brothers - the fourth-largest US investment bank - was probably the primary catalyst.

Lehman was a key financial market intermediary and counterparty, with most financial institutions having exposure to this bank, either through securities or through derivative contracts. Lehman's default therefore created an environment in which financial market participants refocused their attention on counterparty risk and were only prepared to deal with the strongest and most capitalised banks.

Any banking model is dependent on the confidence of its investors. Given recent defaults and the losses experienced by most banks, confidence in financial institutions has been very weak, especially amongst institutional investors. As a result, the global money market system froze due to unwillingness on the part of banks to lend to each other. This created:

1) An environment in which banks were required to seek government assistance.

For example, Fortis - the largest Belgian financial services firm - was partially nationalised by the Dutch, Belgian and Luxembourgian governments; Hypo Real Estate was rescued by the German government; and, in the UK, the British government sidestepped competition rules to ensure that Lloyd's takeover of HBOS goes ahead.

2) A flow-on effect, whereby companies were unable to access financing.

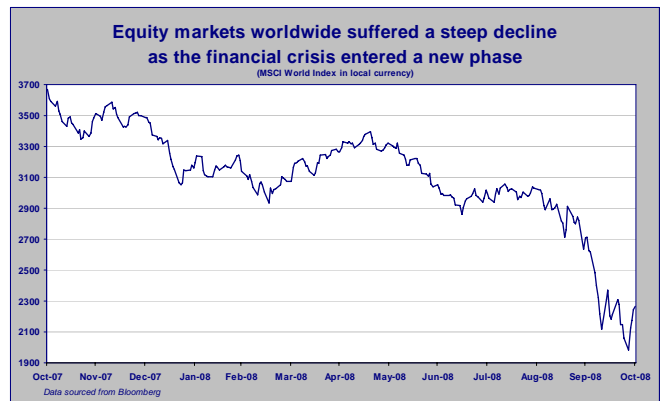
Equity markets worldwide suffered a marked downturn...

The backbone of the global economy is its banking system. The freezing up of this system has implications for global economic growth, as companies need credit in order to grow.

In an attempt to restore confidence and encourage lending, central banks are providing commercial and investment banks

with funding. Governments across the world have also committed to recapitalise the banking system. For example, the US government has recently passed a US\$700b 'financial rescue package', while the British government has decided to invest in main street banks.

However, financial markets often move faster than the implementation of corrective measures, as evidenced by the recent downturn in global equity markets. This selling appears to have been driven by fear, as equity investors reduced their holdings. A number of managed funds have also had to sell their positions to fund investor withdrawals, thereby exacerbating the decline.



...and New Zealand followed suit (though to a lesser degree)

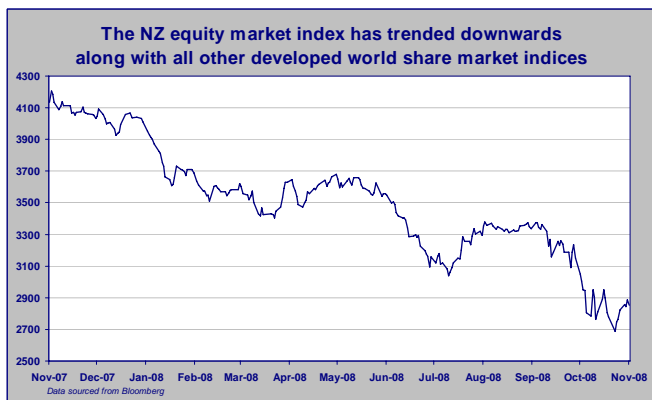
Similar to the experience in global equity markets, the New Zealand share market also suffered sharp downward moves during September and October.

However, the performance of the local market was noticeably better than that of offshore markets. This is evident by comparing the performance of the MSCI World Index - which was down 24% for the three months to 31 October, to the NZX50 Index - which was down 15% over the same period.

The following factors have contributed to this relative out-performance. Firstly, during extremely volatile market conditions, when risk aversion is at the forefront of investors' minds, there appears to be a bias towards higher-yielding stocks.

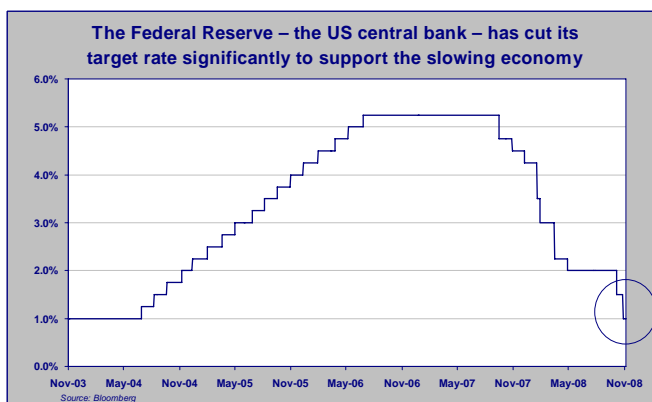
With New Zealand equities offering some of the most attractive yields in the world, investors have seen value in these stocks.

Secondly, as many New Zealand companies derive some of their income from offshore, the weakening dollar has helped improve their earnings outlook.



Governments around the world reacted in unison

The volatility witnessed during September and October saw governments and central banks around the world act in unison to prevent the credit rationing that has manifested itself, from getting worse. This was evidenced by a coordinated 0.5% interest rate cut by the central banks of the US, Canada, England, Europe, Switzerland and Sweden.



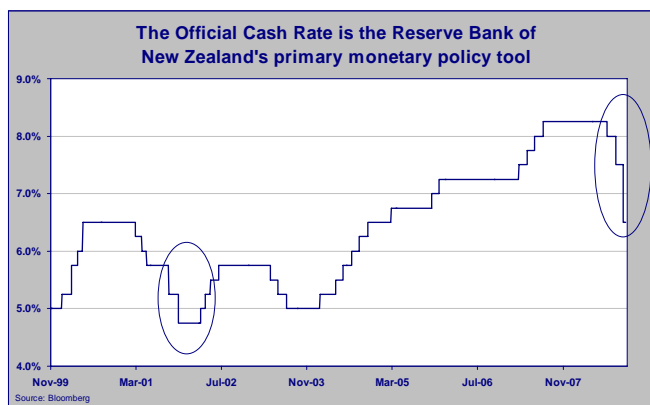
In the US and UK, the governments have taken an equity stake in some commercial banks. Additionally, countries such as Ireland, Germany, Australia and New Zealand have introduced government guarantees on bank deposits in order to boost confidence in their banking systems.

These are all necessary steps to help stabilise financial markets, particularly the government guarantees – which have been implemented to ensure that banks continue to function as the primary source of funding for corporate and household borrowers.

With the New Zealand economy in recession and the global financial crisis having escalated, the Reserve Bank lowered the Official Cash Rate (OCR) by 1.0% to 6.5% in October – its largest interest rate cut on record.

The Reserve Bank has indicated that more interest rate cuts are to follow, but that they will not be of the same magnitude. Some economists expect that the OCR could be reduced to a low of 5%

in the coming months – a not-altogether-improbable scenario given that it was cut to a historic low of 4.75% at the end of 2001.



Looking ahead, the sizeable interest rate cuts implemented by the Reserve Bank should also have positive flow-on effects for companies.

The extent to which credit markets have fallen indicates that they are pricing in a severe global recession. As a result, there may be less downside risk for these markets compared to other financial markets. It should also be noted that, in certain instances, the declines in the prices of these securities have been driven more by fear than the underlying fundamentals of the investments.

Data points to an easing of credit conditions

The coordinated steps taken by governments around the world are beginning to take effect, with a degree of risk appetite returning to some markets, particularly in Asia. This is being driven both by investor confidence arising from proactive central bank actions (and outcomes such as increased transparency from better enforcement and regulation of the financial markets) and by very attractive valuations in equities.

To place current equity valuations in context, more than US\$9.5 trillion was wiped off the value of stocks in global equity markets in October. This equated to almost a third of the total value lost this year. As a result, some investors are re-entering the market to capitalise on opportunities.

That said, however, it is likely that, at least over the medium term, volatility will continue to feature strongly in global markets. For example, despite the dramatic falls in October, the S&P500 (a broad-based US share market index) lost a further 10% over two days in early November – its worst fall since 1987.

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