ECONOMICS

9 Feb. 08

Markets Monthly

Fallout continues into 2008.

- **Global shares posted further losses in January, and a strong NZD compounded the decline.**
- **Ongoing USD weakness remains the key FX theme.**
- **Central banks are divided, as they weigh up growth threats and ongoing inflation pressures.**

US data and events continued to paint a gloomy picture in early 2008. The concerns about a US recession grew, as the housing sector weakened further and credit conditions tightened despite considerable Federal Reserve action to ease liquidity conditions. The Fed cut the federal funds rate a total of 125bp in two steps in the second half of the month. This helped settle conditions in global financial markets and assisted money markets to return to some form of normality. US 10-year bond yields started the month at 4.08%, but quickly started to fall as the month began with very weak non-farm payrolls data for December. The US unemployment rate lifted from 4.7% to 5.0% in the month. December retail sales and manufacturing reports were also disappointing. Coupled with the effect of the ongoing sub-prime crisis and significant global fall-out in equities markets, the US 10-yr bond yield fell to a four and a half year low of 3.29% on January 22. The US 2-year bond yield fell as low as 1.84% on the same day, after a surprise 75bp rate cut by the US Federal Reserve failed to fully soothe market recession fears. US bond yields rebounded later in the month as credit and equity markets began to stabilise and the Federal Reserve cut a second time (by 50bp to 3.0%). Australasian bond markets were subject to conflicting forces in January. High domestic inflation data on both sides of the Tasman pointed to the prospect of cash rates remaining high, or rising further, while recession concerns and large interest rate cuts in the United States exerted downward pressure on yields. The latter factor resulted in a net 24bp fall in Australia's 10-year yield over the month to 6.09%, and a net 15bp fall point to 6.27% for the 10-year yield in New Zealand. Thin trading conditions and risk aversion weighed on the currency early in the month. The NZD was strong against the USD, GBP, and Euro, but weakened against the AUD and JPY. The NZD strength is eroding gains from offshore investments, and continues to make life difficult for many local businesses that export, or compete with importers. On a trade-weighted basis, the NZD was down 0.5% for the month, driven lower mainly by a 4.5% drop against the JPY. We expect a period of volatility in financial markets during the next few months, but are comfortable with the policy responses we are seeing from central banks globally.

Date	Instrument	31-Jan-08	Month %	Quarter %	Year %	5-Year %
Cash	NZ cash rate	8.25	0.00	0.00	1.00	2.50
	NZ 90-day bank bill	8.73	-0.16	0.08	1.06	2.89
	US 90-day bank bill	3.24	-1.49	-1.67	-2.12	1.92
	NZ - US 90-day bank bill	5.49	1.33	1.75	3.18	0.97
Fixed	NZ 5-year gov't stock	6.92	-0.23	-0.04	0.56	1.32
Interest	NZ 10-year gov't	6.27	-0.15	-0.21	0.20	0.28
	NZ 10-year swap	7.54	-0.22	-0.28	0.48	1.11
	AUS 10-year gov't	6.04	-0.32	-0.14	0.10	0.87
	US 10-year gov't	3.64	-0.43	-0.85	-1.18	-0.32
Equities	NZ - NZX50 (NZ$)	2722	-9.2%	-13.4%	-15.6%	39.4%
	AUS - All Ords (A$)	5697	-11.3%	-16.0%	-1.1%	94.1%
	JAP - Nikkei (¥)	13592	-11.2%	-18.8%	-21.8%	63.0%
	UK - FT100 (£)	5880	-8.9%	-12.5%	-5.2%	64.8%
	US - S&P500 (US$)	1379	-6.1%	-11.0%	-4.2%	61.1%
	WORLD - MSCI (US$)	1466	-7.7%	-12.8%	-2.3%	91.1%
	MSCI in NZD (NZ$)	1877	-8.4%	-14.5%	-13.9%	33.5%
Exchange	NZD/USD	0.781	0.7%	2.0%	13.5%	43.1%
Rates	NZD/AUD	0.878	-0.3%	5.9%	-1.4%	-5.4%
	NZD/JPY	83.1	-4.5%	-5.4%	-0.6%	28.0%
	NZD/GBP	0.394	1.4%	6.4%	12.4%	19.4%
	NZD/EUR	0.526	0.1%	-0.8%	-0.9%	4.4%
	NZ TWI	0.717	-0.5%	1.0%	4.4%	19.3%
	EUR/USD	1.484	0.7%	2.8%	14.5%	37.1%

Equity indices are the respective end of month closes. Interest rates and exchanges rates are at 5pm NZ.

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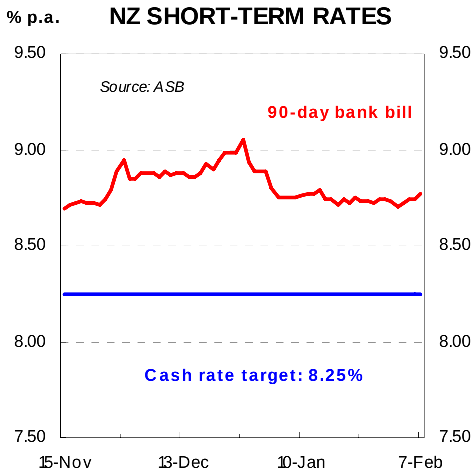
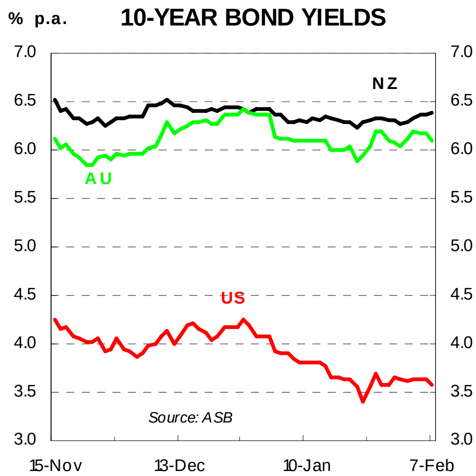
Cash

- The Reserve Bank of New Zealand held the Official Cash Rate at 8.25% at the January review. Ongoing inflation pressure means the RBNZ looks set to hold the OCR at the current level through 2008.
- US-related global growth concerns, set against the backdrop of 125 bps of emergency Fed rate cuts over January complicate the picture.
- A rise in the liquidity premium demanded by investors has seen bank bill yields rise again over November and December, briefly spiking to over 9%, before easing through January to trade back around 8.75%.
- NZ cash yields look set to remain high in the coming months.



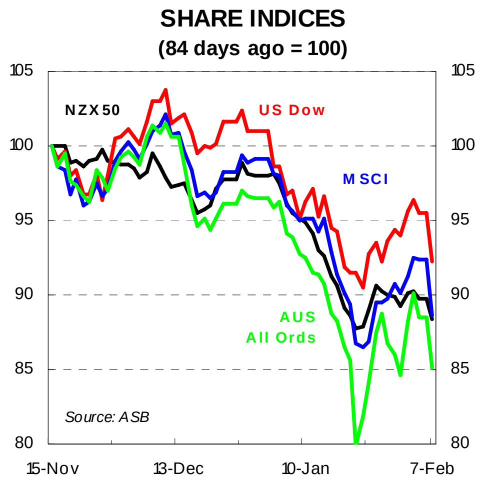
Fixed interest

- The 10-year NZ Government Bond yield eased 15 basis points. The yield on the 5-year bond eased 23 basis points.
- Volatility has continued in global bond markets, with the yield on US 10-year bonds ranging between 3.4% and 4.1% over the past month.
- A low level of mortgage fixing activity from NZ banks continued in January. Wholesale swap rates eased around 20 to 30 bps over the month. New Zealand's high yields are once again in focus as US rates fall.
- Wholesale rates and hence mortgage rates remain very high.
- We expect a period of volatile sideways action in interest rate markets, including NZ rates. Long-term Government bond yields eventually should rise from today's levels, once the current risk aversion subsides.



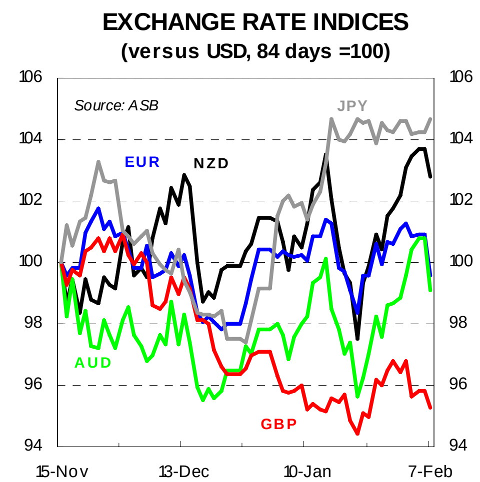
Equities

- January was negative for global shares.
- All the markets monitored in this report declined, with the Japanese market posting the largest decline.
- Concerns about the US housing market, sub-prime mortgages, and indeed the health of the overall US economy continue to remain the main concern for market watchers and investors.
- Once again, the NZD strength had an impact on offshore investment returns, deepening losses in NZD terms.
- The MSCI index of world shares posted a 7.7% loss in US dollars and a deeper 8.4% loss in New Zealand dollar terms for the month.
- We expect a period of volatility in sharemarkets during the next few months.



Exchange rates

- The weak USD continues to be the main FX theme.
- The NZD was strong against the USD, GBP, and Euro, but weakened against the AUD and JPY. The NZD strength is eroding gains from offshore investments, and continues to make life difficult for many local businesses that export, or compete with importors.
- On a trade-weighted basis, the NZD was down 0.5% for the month, driven lower mainly by a 4.5% drop against the JPY. In early February the NZD twi has strengthened 1%.
- We expect USD weakness to continue in the coming months. The NZD is expected to trade in the in the current US 0.75 – 0.80 cent range, before easing against an eventually recovering USD in late 2008.



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