

Markets Monthly

Risk aversion is the current theme.

- Increasing risk aversion drove markets in July.
- Sharemarkets and bond yields fell as some investors switched to less risky investments.
- The NZD fell sharply in late July, after previously posting fresh post-float highs.
- NZ short term interest rates bucked the trend, increasing on the RBNZ OCR rise on July 26.

Part of the NZD's rise in recent months has been put down to the 'carry' trade: the borrowing of a low interest rate currency such as the yen to invest in currencies paying high interest. Risk aversion has been a focus of late. Worries about defaulting 'sub prime' mortgages in the US are now causing a repricing of credit again – much as happened in late February/early March when global markets reeled when Chinese equity prices slumped. The nervousness of global investors has caused riskier investments to get repriced, included carry trades, and as a result the NZD came off its peak with a thump in late July.

Concerns about the US housing market, sub prime mortgages, and indeed the health of the overall US economy all weighed heavily on US shares in July. The US S&P 500 index was down 3.2% for the month. Sharemarkets elsewhere could not buck the trend, with all the major markets posting declines over July. The New Zealand sharemarket was down 0.5% over the month.

The New Zealand Dollar ended July roughly where it started – just shy of US \$0.77. However, during the month the kiwi set fresh post float highs, peaking at US \$0.8112 on 24 July. Currency markets can move very quickly – the kiwi lost 5 US cents between 24 July and 1 August. The risk aversion theme caused a flight to the safe investments such as government bonds. This drove down yields. US 10-year Government bond yields fell a massive 24 basis points over the month, to end the month at 4.80%. Local long-term NZ fixed interest rates also declined, but by a more modest 8 basis points. In contrast with falling yields on long-term government stock, the return on cash increased during the month, reflecting the Reserve Bank's 25 basis point increase in the Official Cash Rate. The RBNZ looks set to be on hold from here, with the bank stating "we think the four successive OCR increases we have delivered will be sufficient to contain inflation".

Date	Instrument	31-Jul-07	Month %	Quarter %	Year %	5-Year %
Cash	NZ cash rate	8.25	0.25	0.50	1.00	2.50
	NZ 90-day bank bill	8.56	0.20	0.49	1.07	2.63
	US 90-day bank bill	5.36	0.00	0.00	-0.13	3.54
	NZ - US 90-day bank bill	3.20	0.20	0.49	1.20	-0.91
Fixed	NZ 5-year gov't stock	7.34	0.21	0.57	1.18	1.09
	NZ 10-year gov't	6.66	-0.08	0.54	0.81	0.14
Interest	NZ 10-year swap	7.71	-0.01	0.32	0.92	0.55
	AUS 10-year gov't	6.03	-0.24	0.14	0.19	0.09
	US 10-year gov't	4.80	-0.31	0.17	-0.19	0.41
	US 10-year gov't	4.80	-0.31	0.17	-0.19	0.41
Equities	NZ - NZX50 (NZ\$)	3203	-0.5%	-0.3%	12.4%	67.6%
	AUS - All Ords (A\$)	6188	-2.0%	0.5%	24.8%	104.0%
	JAP - Nikkei (¥)	17249	-4.9%	-0.9%	11.6%	74.6%
	UK - FT100 (£)	6360	-3.7%	-1.4%	7.3%	49.8%
	US - S&P500 (US\$)	1455	-3.2%	-1.8%	14.0%	59.6%
	WORLD - MSCI (US\$)	1566	-2.3%	-0.8%	18.0%	88.5%
	MSCI in NZD (NZ\$)	2036	-2.3%	-4.8%	-4.9%	15.2%
Exchange Rates	NZD/USD	0.769	0.1%	4.2%	24.1%	63.6%
	NZD/AUD	0.894	-1.3%	0.2%	10.5%	4.0%
	NZD/JPY	91.4	-3.6%	3.7%	29.1%	62.2%
	NZD/GBP	0.379	-1.4%	2.4%	14.0%	26.6%
	NZD/EUR	0.561	-1.9%	3.6%	15.5%	17.4%
	NZ TWI	0.737	-1.5%	3.0%	19.3%	37.1%
	EUR/USD	1.372	2.0%	0.6%	7.5%	39.4%

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

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General Advice Warning

As this advice has been prepared without considering your objectives, financial situation or needs, and before acting on the advice, you should consider its appropriateness to your circumstances. The Bank as a provider of investment, borrowing and other financial services undertakes financial transactions with many local corporate entities. This may include any corporate issuer referred to in this report.

Cash

- The RBNZ raised the official cash rate (OCR) on July 26th.
- The OCR has been hiked 4 times this year, and stands at 8.25%
- The NZ 90-day rate steadily increased in the run up to the meeting. 90-day Bank Bills are now trading at the highest level since the OCR was introduced in 1999. The 90-day bill rate ended the month at 8.56%, up 20 basis points.
- The four rate hikes will reduce the risk of an unsustainable rebound in domestic spending activity. Financial markets are currently pricing low probability of an increase in the Official Cash Rate in the coming months.

Fixed interest

- Local long-term fixed interest rates declined over July, with the 10-year NZ Government Bond yield dipping 8 basis points.
- Continued mortgage fixing activity from banks saw wholesale swap rates rise over the month. The one year rate rose 18 points, and the two year rate rose 10 points.
- US government bond rates fell due to a flight to safety from shares and riskier credit investments to bonds. 10-year yields fell 24 points in the month. Despite the concerns about the slowing US economy, inflation risks remain. The US Federal Reserve bank left the Fed Funds Rate on hold in early August. On balance, we expect US long-term rates will move higher.
- US 10-year Government stock is now trading around 4.75% in early August. The NZ 10-year rate continues to trade above 6.50%. We expect a period of volatile sideways action in interest rate markets, including NZ rates.

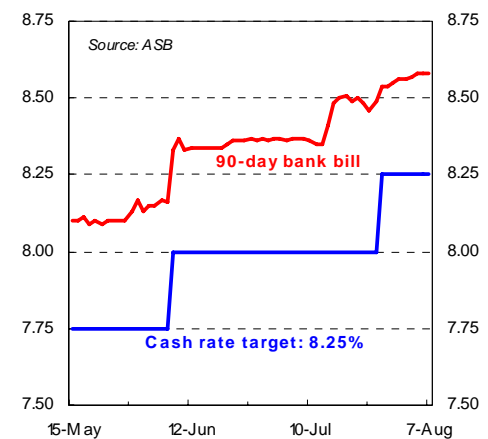
Equities

- July was negative for global shares, with all the major markets posting declines.
- The US market leads the decline. Concerns about the US housing market, sub prime mortgages, and indeed the health of the overall US economy all weighed heavily on US shares in July. The US S&P 500 index was down 3.2% for the month
- The NZD had little impact on offshore returns over the full month, as it ended July roughly where it started.
- The MSCI index of world shares posted a 2.3% decline in US dollars and New Zealand dollars for the month.

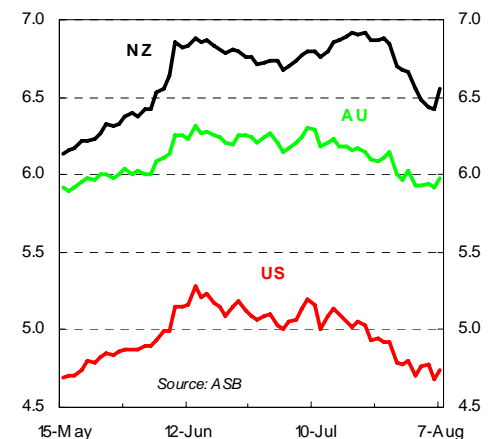
Exchange rates

- The NZ dollar rallied through May, June and July, and set a post float high of US \$0.8112 on July 24th.
- The NZ dollar lost 5 cents US in the last week of July, ending the month at US\$ 0.769.
- Despite the 5 cent decline, the NZD is still painfully strong for exporters, who struggle with the exchange rate at these levels. Our 12-month outlook for a lower NZ dollar remains in place. However, the high interest rates available in New Zealand are expected to hold up the NZ dollar for the coming months.

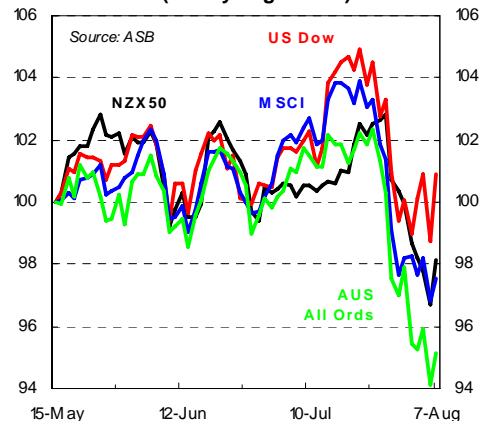
NZ SHORT-TERM RATES



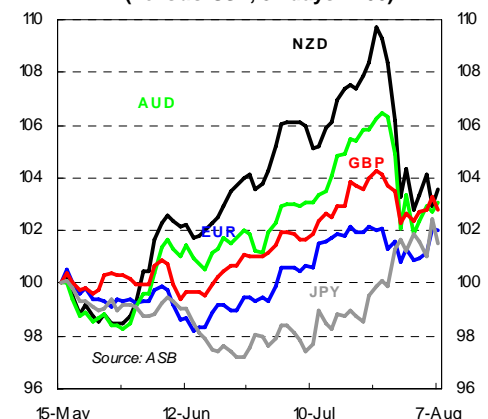
10-YEAR BOND YIELDS



**SHARE INDICES
(84 days ago = 100)**



**EXCHANGE RATE INDICES
(versus USD, 84 days =100)**



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