

Lyfords economic commentary

August 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

Global equity markets rallied in July and into August on better-than-expected earnings announcements, and further indications that the pace of economic contraction in the global economy is slowing. July was the fifth consecutive monthly gain, lifting the S&P500 nearly 50% off the 9 March low.

According to Bloomberg, around 76% of the 438 S&P500 companies that have reported June-quarter earnings so far have beaten expectations. However, S&P500 earnings growth is still down around 30% on the second quarter last year. Clearly, investors are looking through this trough.

At 14.7 times 12-month forward earnings expectations, the S&P500 is trading close to long-run "fair value estimates". With equity markets no longer as cheap as they have been, it will be important that leading indicators of growth are validated by signs of renewed economic activity in coming months.

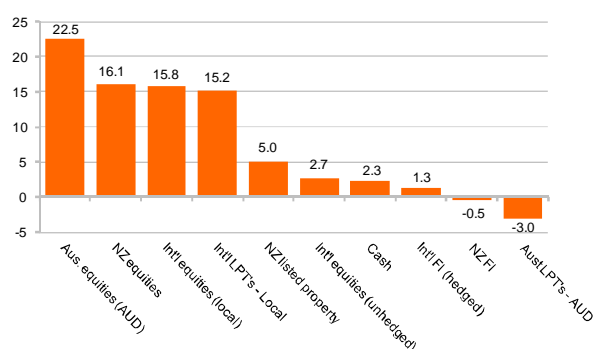
The collapse of Lehman Bros on 12 September 2009 was the start of a series of events that almost led to the complete collapse of the global financial system. Many of the most affected parts of the financial system now show no trace of the post-Lehman trauma. Investment grade credit spreads have narrowed to 285 basis points (bp), compared to 620bp at the height of the crisis. The TED spread (3 months Euro-dollars to 3 month T-bills) is now at 27bp, having peaked at over 450 and now below the average from 1990 to 2003 of 43bp.

Equity markets, with the exception of developing markets in Asia (especially China), have not fully recovered. The MSCI World index is 16% below the level it was when Lehman Bros. collapsed. Implied volatility (a measure of investor bearishness) has also made a marked improvement but is still well above (admittedly exceptionally low) 2005-2007 levels.

While managing the real economy will be the key consideration of policymakers, the apparent success of extraordinary policy measures will eventually lead to a withdrawal of these measures. Policymakers will be wary of the risk of inflation or another bubble forming and are likely to take into account asset prices more than they have done in the past. We don't see inflation as an immediate risk, but it

will become increasingly important that policymakers lay out a plan that will enable stimulus to be withdrawn without jeopardising the recovery.

Year to date % for major asset classes



Regional Economic Summary

United States

- While leading indicators in the US suggest growth could resume in the second half of the year, the real economy was still shrinking in the second quarter. GDP declined 1%, a marked improvement on the -6.4% contraction in the first quarter.
- The pace of US job losses slowed more than forecast last month, and the unemployment rate dropped from 9.5% to 9.4% – the first time in more than a year. Still, confidence among US consumers fell in July, a reminder that consumption will remain weak while consumers worry about their jobs.
- The US ISM manufacturing survey showed that business contracted at a slower pace and durable goods orders (excluding automobiles and aircraft) unexpectedly rose in June.
- Sales of existing homes in the US rose in June for a third consecutive month and purchases of new homes in the US climbed 11%. Federal Reserve Chairman, Ben Bernanke, commented that the housing downturn appears to be moderating.
- The S&P/Case-Shiller home-price index rose 0.5% from April, the first monthly gain since July 2006. However, prices are still down 17.1% from May 2008.

Europe

- The economic data flow out of Europe has delivered further evidence that policy actions by the European Central Bank and national governments are gaining traction. GDP in France and Germany was positive in the second quarter.
- European manufacturing and service industries contracted at the slowest pace in a year, and economic confidence rose to the highest level since November last year.
- However, the difficult economic environment was highlighted by industrial orders and retail sales which both fell more than expected.
- The jobless rate in the euro region rose to 9.4% in June – the highest since 1999. The Organisation for Economic Cooperation and Development has forecast unemployment in the region to reach 12% next year.

United Kingdom

- The UK remains mired in recession, with construction, banking and business services continuing to contract through the second quarter. GDP contracted 0.8% from the first quarter – more than twice as much as the median economist forecast.
- The Bank of England surprised markets by expanding their version of quantitative easing program, by £50 billion. The move reflects the limited signs of economic stabilisation.
- There have, however, been some signs that the recession is easing. UK house prices increased for a third month in July and manufacturing unexpectedly jumped in June. Household and business confidence has also picked up in July.

Asia Pacific

- China's manufacturing expanded for a fifth month as record lending and government stimulus continues to drive the recovery. The central bank governor, Zhou Xiaochuan, said that the nation's policymakers will take their cue from the US on when to end economic rescue efforts. Premier Wen Jiabao said that China will maintain a "moderately loose" monetary policy and "proactive" fiscal stance to bolster domestic spending in the face of slumping exports.
- The Government's efforts have so far successfully offset a collapse in exports, but the recovery remains fragile. In July, exports and new loans tumbled and industrial output rose less than estimates.

Australia

- Rising consumer and business confidence, and a stronger-than-forecast labour market boosted confidence that Australia's economy would expand in the second quarter. Australian home-building approvals rose the most in four years.
- The Reserve Bank of Australia (RBA) said its next move on interest rates is likely to be an increase after it scrapped a prediction that the economy will fall into a recession. RBA

Governor Glenn Stevens, said "with the cash rate at an unusually low level and the global economy stabilising, movement towards a more normal setting of monetary policy could be expected at some point."

New Zealand

- It is likely that New Zealand is emerging from recession, but early signs of an export-led recovery could be quashed if the currency continues to rise. As elsewhere in the world, job losses will be the major issue for the economy through 2009.
- Business confidence rose to a 10-month high in July as companies became less pessimistic about profits and as credit became easier to secure. Still, the unemployment rate rose to 6% in the second quarter as companies cut production and jobs.
- The Reserve Bank of New Zealand kept its benchmark interest rate unchanged for a second month and implied it could cut rates if a rise in the currency threatened the recovery. Reserve Bank Governor Alan Bollard said, "The forecast recovery is based on a further easing in financial conditions. If this easing does not occur, the recovery could be put at risk".
- New Zealand's commodity export prices were little changed in July after gains in world markets were all but wiped out by the stronger currency. The NZ dollar has surged 32% against the US dollar in the past six months and could threaten the possibility of an export-led recovery.

Monthly Sector Summary

As at 31 July 2009

International shares

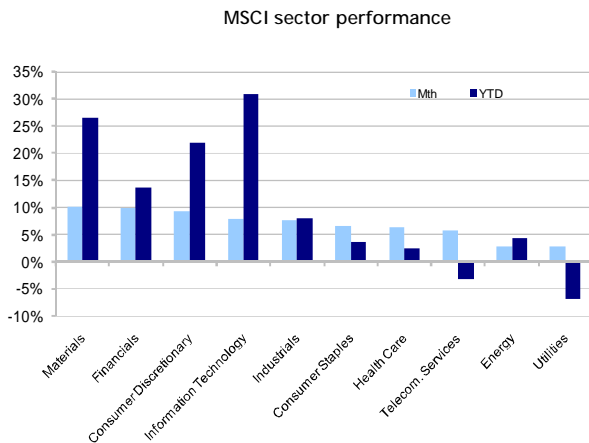
The MSCI World Index in local currency terms was up 7.5% for the month of July, the fourth strong month in the last five. Year to date, the index is now up 13.0%. Returns to unhedged New Zealand-based investors were up 6.8%, with the NZ dollar 2% higher against a weaker US dollar.

After a pause in June, the risk rally continued in July and equities posted impressive gains. The month began on a shaky note, with unemployment figures in the US and Europe printing worse than the median economist forecast. Better-than-expected economic data and positive earnings surprise from companies' second-quarter reporting buoyed sentiment, and the last three weeks of the month saw a strong rally in all global regions.

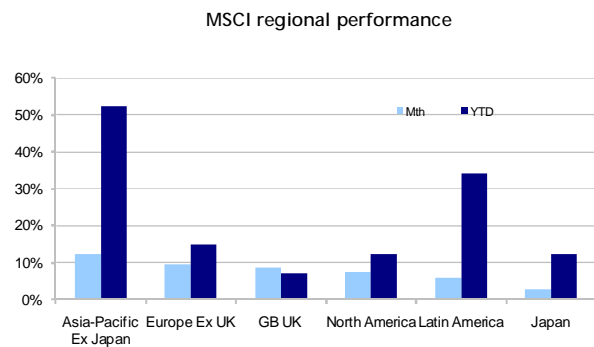
Financials (+9.9%) were second only to the materials sector (+10.1%) in July, as earnings from large US and European banks came in ahead of expectations.

Second-quarter trading revenues were strong in many cases and, while a number of banks also announced increased provisions for bad loans, market sentiment remained positive. Cyclical sectors

outperformed the more defensive sectors; although, all sectors had positive returns for July.



July saw solid gains across all global regions. Asia-Pacific ex-Japan continued to lead the way, buoyed by the fiscal stimulus provided by the Chinese government. The region is now up over 50% YTD in 2009 and is back to June 2007 levels already. The recovery in developing markets is nowhere near as spectacular, but Europe, UK, Japan and North America are all up around 10% year to date after a strong start to the second half of 2009.

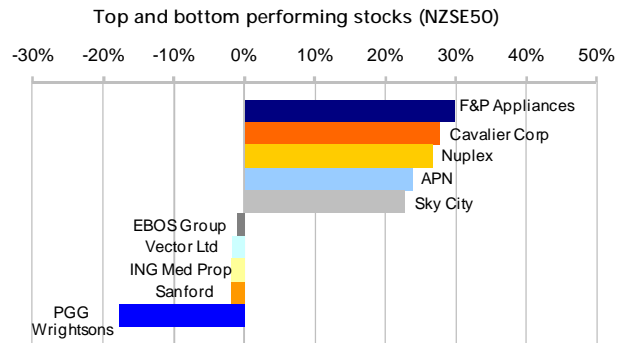


New Zealand shares

The New Zealand sharemarket rose by a stellar 7.9% during July, receiving a boost from the strong US market. The focus of investors during the month was on the better-than-expected US earnings season and the implications for equity markets around the world. This had positive flow-on effects for the New Zealand sharemarket, which is now up over 25% from its March lows.

Fisher & Paykel Appliances and Nuplex Industries were both in the top three performers during July (rising 30% and 27% respectively), together with Cavalier (up 28%).

PGG Wrightson was the worst performer, falling almost 18% during the month. The weaker dairy payout and strong currency were primarily responsible, while also of note was the fact that Craig Norgate stepped down from his position as chairman of PGG Wrightson following an announcement last month.

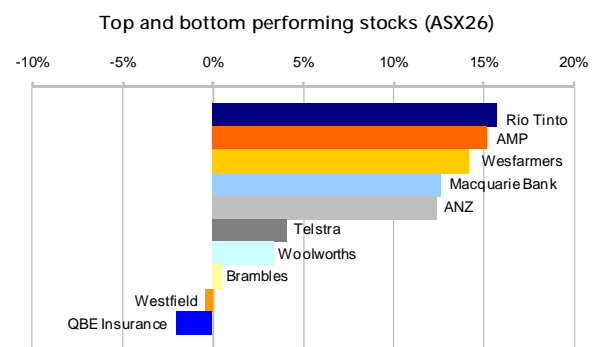


Australian shares

The Australian equity market rallied by 13.5% in just over two weeks from the intra-month low on 13 July, as a number of very strong results in the US June quarterly reporting season boosted global markets. The recovery was assisted by stronger-than-expected economic data and operating margin expansion, which was well ahead of consensus analyst forecasts.

Both the Resources (+8.1%) and Industrials (+7.0%) sectors performed very strongly in July, as gains were broad-based. Small caps (+9.0%) outperformed large caps (+7.2%) as the small resources sector (+11.6%) drove returns due to its operational leverage to global production.

This reporting season looms as one of the most critical in recent history. We expect that following the long earnings downgrade cycle, companies will report broadly in line or better. However, we believe the real story from the reporting season will be in management outlook comments and 2010 earnings guidance.



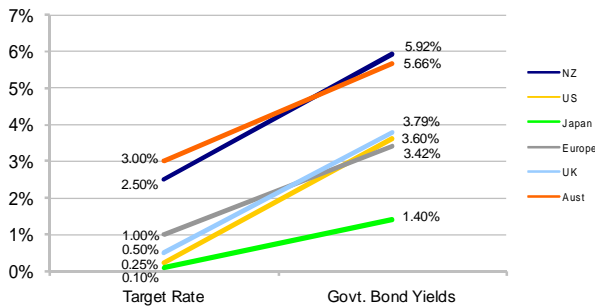
International fixed interest

US bond yields went sideways in July. At first glance, this seems remarkable given the huge improvement in global sentiment and risk appetite during the month. However, market participants seem to understand the fragility of the anticipated global recovery and that it will only materialise if interest rates remain low.

As such, despite an onslaught of US Treasury supply (where foreign central banks continue to show solid demand for US bonds), US 10-year bond yields finished the month more or less where they started around 3.50%.

Credit spreads globally continued to narrow as the unwinding of the “Armageddon” scenario gave investors more confidence to hold credit.

Regional yield curves



New Zealand fixed interest

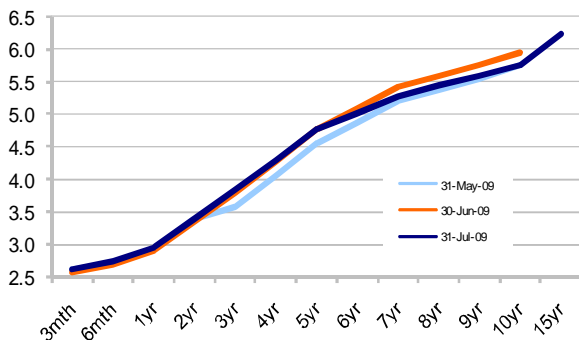
The New Zealand Government bond market returned 0.78% for the month of July, outperforming Cash, which returned 0.24% over the same period.

New Zealand’s longer-dated bond yields finished slightly lower, driven mainly through buying associated with the maturity of the 15 July 2009 Government bond.

While both the RBA and RBNZ left rates unchanged, the central banks’ stances started to diverge. The RBA has moved to a neutral policy stance – acknowledging that the downside risks to global growth have diminished and that Australian economic activity has tended to surprise on the upside.

Meanwhile, the RBNZ remains concerned that the New Zealand economic recovery may be derailed by the recent tightening in financial conditions (thanks to the recent strength of the NZD and upward pressure on longer-dated New Zealand interest rates). As such, the RBNZ reaffirmed that its policy rate will remain low until the second half of 2010.

NZ Government bond yield curve



Currency

In July, the NZD/USD climbed to a 10-month high, trading above US\$0.675 before ending the month at US\$0.659, up 2.1% from the end of June.

The NZD gained 0.3% against the JPY, +0.7% to 0.4630 against the EUR, and +0.7% against the GBP. The NZD/AUD ended the month down -0.9% at AUD\$0.7925.

The NZ dollar fell as low as US\$0.621 early in July after Fonterra’s auction showed milk powder prices fell 3% in June. Improving risk appetite saw investors pare back safe-haven positions in currencies like the USD and JPY. The USD Index has fallen about 4% to a 10-month low of 77.45 since the start of July. Growth-sensitive currencies like the AUD and NZD tended to benefit from the paring back of these safe-haven positions.

Fitch downgraded New Zealand’s sovereign rating outlook from stable to negative. This saw the NZD lose a cent in the wake of the announcement, but it was quickly back where it started within 24 hours. The substantial Eurokiwi and Uridashi maturities over the month of July passed without incident and the currency wasn’t affected by the RBNZ maintaining its easing bias.

Commodity prices had another strong month, although the appreciation in soft commodity prices was not as rapid as seen in hard commodities like industrial metals, gold and oil. New Zealand commodity prices (as measured by the CBA series in USD terms) rose 4.8% in July, whereas Australian commodity prices (as measured by the CBA series in USD terms) rose 8.7% during the month.

New Zealand listed property

The New Zealand Property Index (gross) returned +8.26% in July, outperforming the broader equity market (NZX50 gross), which had a return of +7.91%, for the second-best monthly return since the announcement of the PIE tax regime.

The sector performed strongly during July due to strong demand from yield-hungry retail investors who continued to gain greater confidence that the sector’s dividends provide attractive distribution yields compared to alternatives in the market. The sector also benefited from demand from institutional investors following the payment of the annual KiwiSaver member tax credits, which hit accounts in early July and needed to be re-invested by fund managers.

Partly as a result of this, the sector was driven higher by strength in the more liquid, large capitalisation listed property trusts (LPTs). ING Property Trust was the best performer, with a 13.1% return on increasing confidence that continuing asset sales would be sufficient to deleverage the vehicle, followed by Kiwi Income Property Trust and AMP NZ Office Trust with 10.0% apiece.

Goodman Property Trust also outperformed with 8.8% due to greater confidence that a capital raising was unlikely and that large stakeholder, Goodman Group, was unlikely to be a seller of units at any price. The major outperformers of the last 12 months, (ING Medical Properties Trust and Property for Industry), were the worst performers as investors switched into the trusts that offered the greatest discount to net tangible asset value.

Australian listed property

The Australian property sector saw its fifth consecutive monthly rise in July, with the index up 2.4%, albeit underperforming the broader equity market (ASX 200), which had a gross return of 4.9%.

Corporate news during July included the exiting of highly geared European investments by GPT Group and a string of portfolio devaluations reflecting further cap rate reversion as well as the first signs of falling portfolio rental income. On the positive front, the sector saw the first signs of mergers and acquisition (M&A) activity with a bid emerging for Tishman Speyer Office Fund (TSO).

The best-performing Real Estate Investment Trusts during July were Goodman Group with 37.8%, as a result of improving sentiment surrounding the imminent capital raising, followed by Mirvac Group with 18.1% and Astro Japan Property Trust with 16.2%, both recovering from recent profit-taking. Charter Hall -10.6%, Macquarie Countrywide -3.7%, Stockland -1.9% and Westfield -0.4% all underperformed as investors took on more risk and switched out of defensive names and stocks that had recently rallied.

International listed property

The second half of 2009 started off with solid gains in global real estate stocks. Every major market posted gains in the month. The UBS Investors Index Ex Australia and New Zealand of real estate stocks produced a positive total return of 9.9% in the month.

The bulk of global real estate companies reporting their second quarter results are meeting or exceeding analysts' projections. We expect earnings will fall this year and next, with declines of 4% or so in each year. Earnings recovery should commence in 2011. We emphasize that we expect most public real estate companies to continue to be profitable in absolute terms and continue to maintain adequate financial flexibility during this period.

Based on our estimates of Net Asset Value, global real estate companies, as a group, are selling at a premium of a little more than 10% to the value of their real estate assets today. Real estate company dividend yields are quite high on both an absolute and relative basis versus yields in the broader equity and debt markets today.

Along with the stabilising economies, the most encouraging factor this year in the environment for global real estate companies is the reopening of the capital market. More than \$40 billion USD of new public equity has been raised by nearly a hundred global real estate companies since the first of the year. New debt placement is difficult to quantify, but we believe it exceeds \$15 billion USD so far in 2009 for public real estate companies worldwide. This access to new capital is improving the stability of the public real estate industry and should enhance its competitiveness as attractive properties begin to come available in the next two-to-three years.

INGNZ Asset Allocation

Asset Class	Relative Position	Rationale
International Equities	5	It is increasingly becoming clear that the initiatives put in place by policymakers have been successful in restoring confidence in financial markets. Leading indicators of growth are now at levels consistent with an improvement in the economic cycle. However, validation of the leading indicators of economic recovery will be required for the rally to extend beyond current levels. We are moderately optimistic that growth will resume later this year and could surprise with its strength. However, medium-term growth will be constrained by household deleveraging and unwinding of monetary and fiscal stimulus. The effects of deleveraging will limit consumption and investment for some time. Company earnings have surprised positively due to cost cutting and will benefit from operating leverage when top-line growth resumes. However, capital raisings, dividend cuts and corporate defaults will remain a feature of markets this year.
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. In the event of a cyclical recovery, the domestic equity market will underperform international equities, but will also benefit from an economic recovery and increased operating leverage.
Domestic Listed Property	5	The sector has rallied significantly in the past few months and the discount to Net Tangible Assets (NTA) has narrowed quickly as asset values fall. Long lease terms, high occupancy rates and under-renting have helped offset the impact of a weak economy. Dividend yields are still attractive especially while cash rates remain low. We expect the defensive NZ LPT market to underperform in a cyclical upswing, and will continue to reduce exposure as global economic prospects improve.
Global Property	6	A marked improvement in credit markets have helped global REITs restore balance sheets through capital raising and now may be well positioned to take advantage of still weak direct property markets. Dividend yields are still attractive relative to interest rates. We will look to close out this underweight as evidence unfolds in support of further stability in the fundamentals that support this sector.
International Fixed Interest	—	Global government bonds will continue to be the safe-haven destination in times of crisis, declining inflation and monetary easing. With central banks unlikely to move for some time, bonds remain attractive relative to cash. Over the medium term, the outlook for government bonds is less attractive as government deficits rise and monetary tightening begins to unfold. 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 bonds have similar attributes to global bonds in this economic climate, but overall our expected returns are slightly higher. We prefer NZ government bonds over cash
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 31 July 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:	31-July-09	30-June-09	31-Dec-08	31-July-08	31-July-06		
MSCI World Index (G)	2432	7.4%	13.0%	-18.8%	-6.4%	3685	2944
Asia Pacific							
MSCI AC Asia ex Japan (G)	908	12.3%	52.3%	0.7%	10.2%	1055	678
NZSX50 (G)	3016	7.9%	11.1%	-9.6%	-5.6%	3392	2411
ASX200 Accum.	29032	7.3%	17.1%	-10.2%	-1.0%	33652	21298
Nikkei 225	10357	4.0%	16.9%	-22.6%	-12.5%	13270	6995
Americas							
Dow Jones	9172	8.6%	4.5%	-19.4%	-6.4%	11790	6470
S&P500	987	7.4%	9.3%	-22.1%	-8.2%	1303	667
Nasdaq	1979	7.8%	25.5%	-14.9%	-1.8%	2473	1266
Europe							
MSCI Europe (G)	4166	9.2%	12.3%	-15.6%	-6.3%	6367	5008
FTSE100	4608	8.5%	3.9%	-14.8%	-8.1%	5649	3461
France CAC	3426	9.1%	6.5%	-22.0%	-11.9%	4559	2465
Germany DAX	5332	10.9%	10.9%	-17.7%	-2.1%	6554	3589
Property							
NZX Property (G)	1909	8.3%	1.9%	-7.8%	-4.3%	2146	1632
Aust LPTs (G)	16063	2.4%	-10.8%	-37.8%	-22.7%	30315	11200
Int'l LPTs (USD) (G)	373	9.5%	15.6%	-29.5%	-12.1%	733	549

* 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+	0.8318	3.0%	18.1%	-11.7%
EUR+	1.4243	1.4%	2.1%	-8.6%
GBP+	1.6696	1.4%	14.6%	-15.7%
JPY+	94.6	1.8%	-4.2%	12.4%
NZD+	0.6593	2.1%	12.4%	-10.2%
NZD/AUD	0.7925	-0.9%	-4.8%	1.7%
NZD/GBP	0.3950	0.3%	-1.8%	2.5%
NZ TWI	61.39	0.2%	9.3%	-6.6%

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

10-year bonds

	Yield	1 month chge	1 year chge
Australia	5.61%	0.08%	-0.61%
Germany	3.30%	-0.09%	-1.06%
NZ	5.75%	-0.19%	-0.38%
UK	3.80%	0.11%	-1.01%
US	3.48%	-0.05%	-0.47%
Japan	1.42%	0.06%	-0.12%

Economic data

	GDP qtr on qtr	GDP yr on yr	CPI yr on yr	Unemployt rate
	-0.3/-1			
US	ann.	-3.90	1.70	9.40
Japan	0.40	1.50	-1.70	5.40
Germany	0.30	-5.90	1.40	8.30
Euro	-0.10	-4.60	1.60	9.40
UK	-0.80	-5.60	1.00	4.90
Australia	0.40	0.40	2.20	5.80
NZ	-1.00	-2.70	1.60	6.00

Central bank target rates

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

Source: *Bloomberg*

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