

Lyfords Economic Commentary

January 2009

Lyford Asset Management is pleased to bring you this summary of investment markets over the past month.

Year in Review: 2008

The great unwind

2008 was a remarkable year and will be placed alongside the likes of 1929, 1931 and 1937 in the annals of history as one of the worst for capital markets.

The year was typified by market turmoil, volatility and uncertainty, but the overriding theme was 'global deleveraging' as companies and investors sought to reduce debt. Difficulties in accessing capital and of transacting in the now illiquid credit markets were destructive by-products of this, with the abrupt lack of confidence in financial institutions nearly resulting in the complete failure of the financial system as we know it.

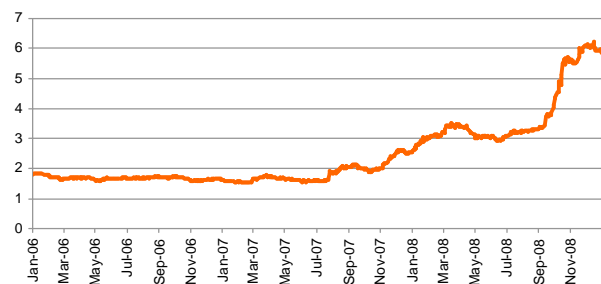
In January 2008, US Federal Reserve Chairman Ben Bernanke announced that the Fed was "ready to take substantial additional actions as needed to support growth, and provide adequate insurance against downside risks". It is unlikely he imagined just what these actions would eventually entail or the extent to which he would need the help of central banks and governments the world over to put them in place.

The year began with a hangover from the unravelling of the US sub-prime mortgage market, which started in August 2007. Over the course of 2008, it became clear the bursting of the US housing bubble had ramifications more far-reaching than many had believed possible. As households, companies and financial institutions were forced to de-lever, no asset class was spared and forced selling saw drastic price drops across the board.

The result was the sternest test of the global financial system since the Great Depression and the near freezing of credit and cash markets - the backbone of the global economic system.

In September and October, the world changed as the credit worthiness of a number of large financial institutions was called into question. Markets were suddenly driven by fear and panic as events unfolded; Lehman Brothers filed the largest bankruptcy in US history, and credit and cash markets seized up further as banks refused to lend to one another. Credit spreads rose sharply.

US Investment Grade Corporate Bond spread over 10yr US Govt Bond



Fortunately, authorities did not stand idly by and, as early as January, governments implemented unprecedented actions aimed at ensuring the stability of the financial system. It was an evolving process, but by year-end, a whole raft of new packages, bailouts, lending programmes, guarantees and facilities had been unveiled.

One of the outcomes for the financial system will undoubtedly be greater regulation and - as if to emphasise this - 2008 was book-ended by two huge fraud cases. A rogue trader at Société Générale was uncovered in January, and in December an investment advisory business operated by Wall Street icon Bernard Madoff was finally revealed to be nothing more than a huge 'ponzi' scheme (a type of illegal pyramid scheme).

Global economy falters

The world economy initially appeared to be holding up well despite the sub-prime mortgage crisis worsening in the US. Both hard and soft commodity prices continued to rise for the first half of the year, as did oil prices.

The commonly held belief was that while US GDP would be weak, global growth would be bolstered by developing regions, in particular the BRIC countries. As recently as September, consensus forecasts for the next 12 months' global GDP were 2.5%. However, by year end, these had been ratcheted down to 0.5%, with downgrades in all countries, developed and developing.

As the events of late September, October and November unfolded, it became apparent that the US was not alone in facing difficult

times ahead. In Europe, consumer and business confidence measures fell to levels not seen since the early 1990s.

At year-end, most industrialised countries were either in or on the brink of recession thanks to collapsing industrial production, falling exports and rising unemployment. Both the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have slashed their forecasts for global growth in 2009 and 2010.

A key challenge going forward for governments and central banks will be to spur consumer confidence following the huge hit consumers have taken in 2008. With house prices falling after years of appreciation and sharemarkets down heavily, the net worth of home-owners and savers/investors has been severely eroded. Consumers will be forced to spend less and save more.

In the US and a number of countries elsewhere, the problem of falling house prices was compounded further by people taking equity out of their properties for consumption via home equity loans (i.e. borrowing more). A fall in house prices can then leave a home owner in a negative equity scenario. Rising unemployment is compounding the problem, leaving more people unable to afford their mortgage.

The meltdown in financial markets, and the rapidly slowing growth in developed countries, laid to rest the theory that the fortunes of developing markets were 'decoupled' from the larger developed markets. As it became clear the US sub-prime mortgage crisis was a global issue, emerging economy equity and debt markets capitulated.

The much-discussed BRIC countries (Brazil, Russia, India and China) suffered, with the Brazilian *real* and Russian *rouble* devaluing sharply. Some forecasts for Chinese growth next year are "only" 5% - significantly down on recent years and well below the IMF's forecast of 8.5%.

Developing nations everywhere were plunged into varying degrees of crisis. Argentina dipped into the pension funds it had privatised in recent years, while Iceland, Ukraine, Hungary and Serbia all appealed to the IMF for emergency funding, and Ecuador defaulted on its government bonds.

From inflation to deflation in just one year

To say that central banks around the world embarked on an easing bias in 2008 is something of an understatement. In the second half of the year, the major central banks all adopted a rate-cutting policy in response to the freezing of credit markets. As well as monetary policy, a number of other responses from the 'monetary toolbox' were implemented, with the assistance of national governments. Massive amounts of liquidity were pumped into the global financial system via government guarantees, and extended credit and repo facilities offered by central banks.

At the start of the year, the main concern of most central banks was that of inflation, driven by rising oil and food prices. The European Central Bank (ECB), appearing to have taken on the mantle of the inflation-fighting German *Bundesbank*, increased rates as recently as July, despite indicators for economic growth weakening.

Such a scenario led to fears of stagflation - slowing economic growth and rising prices. This scenario was epitomised one day in June when US employment data showed a half percent rise in unemployment on the same day oil prices increased by \$11 per barrel!

The Reserve Bank of Australia (RBA) also raised rates in 2008 but most other major central banks remained on hold for the first half of 2008. The US Fed was the exception, as it cut rates by 125 basis points (bp) in January (including a 75bp intra-meeting cut - the first since September 2001) and 75bp in March in response to tightening credit markets and the Bear Stearns failure.

As the crisis reached its zenith in September and October, central banks acted quickly and in a co-ordinated fashion. Cuts of 100bp and more became common place and the central banks of the US, the European Union, Australia, the UK and New Zealand cut rates by 175, 275, 175, 300 and 250bp respectively in the final quarter.

This left the target rate in the US at 0-0.25% and the Fed also effectively moved to a "quantitative easing" policy, which focuses on increasing the supply of money in the financial system, rather than the rate at which funds are lent.

The RBA, ECB, Bank of England and Bank of Japan had target rates of 4.25%, 2.5%, 2%, 5% and 0.1% respectively, while bond markets were pricing in further falls in interest rates.

Central banks have spent the last few years battling to keep inflation in their target bands as oil and food prices rose to record levels. As prices for most commodities have since fallen sharply, inflation pressures eased and central banks exhibited a greater willingness to begin the easing cycle.

Instead of inflation, the main concern for central banks at year-end had become *deflation* - a decrease in the price level of goods and services. In some ways, this is viewed as a greater danger than inflation as it can lead to a deflationary spiral, which is harder to manage using traditional monetary policy measures. Demand for goods and services declines on the basic premise of "why buy now when it will be cheaper in the future".

TAFs, TSLFs, PDCFs and TARP

The events in the financial markets during 2008 were so extreme that the traditional monetary policy tool of adjusting interest rate levels was simply not enough to restore calm and confidence in market functionality. Fiscal stimulus packages from governments

and previously unheard of facilities from central banks were implemented across the board.

In the US, the Bush administration passed a US\$160 billion fiscal stimulus package early in the year and president-elect Obama made it clear one of the first moves of his new government would be a second, much larger package in the region of US\$1 trillion.

China highlighted its increasing impact on global growth with a 4 trillion yuan (US\$586 billion) fiscal stimulus package in October that will focus on infrastructure projects. Other governments around the world followed suit, all with the objective of offsetting the developing shortfall in consumer and business demand.

Other actions taken by central banks/treasuries were focused on providing liquidity to cash and credit markets, as banks became increasingly nervous about lending to one another.

In the first half of the year, the Fed put in place the Term Auction Facility (TAF), the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF). These allowed banks and primary dealers (investment banks) to bid for and access cash, with increasingly lenient collateral requirements. Other central banks around the world introduced similar packages.

The US Treasury went one step further in September/October, eventually convincing the US senate to pass the Troubled Asset Relief Program (TARP), initially promoted as a package to purchase illiquid assets from banks to free up their balance sheets and encourage further lending.

However, the first half of the US\$700 billion package was instead used almost exclusively for direct capital injections into banks and insurance companies. The idea of using taxpayers' money to increase banks' capital had initially been rejected by US Treasury Secretary Henry Paulson and other heads of Treasury. But once the British government announced that British banks would get a £50 billion permanent capital injection in the form of preference shares, other countries quickly jumped on the bandwagon.

The Irish government then pledged to guarantee savers' deposits and, again, other governments were forced to follow suit or risk a run on bank funds.

The end of an era

2008 will be remembered as the year in which the reign of investment banks over Wall Street ended – as the highly geared model they had employed imploded, bringing down some institutions that had operated for over a century.

By year-end, the financial landscape was very different from 12 months earlier; a number of esteemed financial institutions rich in history were operating in a different capacity or undergoing bankruptcy proceedings. Bear Stearns – the first to be hit – was

purchased by JPMorgan, in a bid supported by the Fed, after the bank suffered a run on investments in March amid concern over future write-downs. A period of relative calm followed, apart from some US mortgage lenders being seized by federal regulators following bank runs.

September was one of the most action-packed months in the history of financial markets. First, the US Government placed Fannie Mae and Freddie Mac – the largest US mortgage finance companies – in a conservatorship.

Then all within a week:

- Investment bank Lehman Brothers filed for bankruptcy as the authorities decided it wasn't too big to fail;
- AIG on the other hand – the largest global insurer – was deemed too big to fail and required a punitive US\$85 billion two-year loan from the Fed to continue operating;
- UK lending giant HBOS was taken over by Lloyds TSB; and
- Merrill Lynch was taken over by Bank of America.

Goldman Sachs and Morgan Stanley, the only two of the 'big five' Wall Street banks left standing, applied to become commercial banks regulated by the Fed in order to diversify their funding base.

Financial institutions that survived the fall-out are now facing a markedly different environment in the future. The models that applied in recent years will need to be significantly altered going forward, and more capital will be required. Added to this will be an undoubtedly tougher regulatory environment as the idea that the market is self-regulating and only needs oversight has proved flawed.

In addition, the hedge fund industry was significantly impacted by the reduced availability of leverage from investment banks, forcing them to sell assets, which only compounded the pressure on asset prices.

Bonds awaken from slumber

A year ago, it was noted that bonds had awoken from a four-year slumber, as yields fell sharply from the beginning of the credit crisis in August 2007. In 2008, they continued to rally with a vengeance and global government bond yields fell to record levels. This was particularly true in the US where the safe-haven bid for short-dated

US Treasuries saw them trade at negative yields on more than one occasion!

Ten-year US government bond yields fell over 180bp to 2.21% at year-end and a similar pattern was observed in Europe where 10-year bonds fell 140bp to 2.95%. The aggressive easing policy implemented by various central banks saw yield curves steepen dramatically, but as long-end rates continued to fall, curves flattened somewhat towards the end of the year.

Once again, government bonds have shown themselves to be one of the few true diversifiers in times of crisis. For 2008, global sovereign bonds (hedged into NZD) returned a handsome 15.3%.

Equity markets under fire

January 2008 set the scene for the year in sharemarkets, with volatility spiking and markets falling sharply. The near collapse of Bear Stearns made for a shaky March but the rapid action by the Fed to stabilise the financial system meant the period through to the end of August was one of relative calm, with markets trading sideways.

The relative calm was suddenly broken in September when another much larger wave of selling ensued following the events described above. Sharemarkets collapsed and the MSCI World Index fell more than 10% (in local terms) during September.

Despite the US Congress passing the TARP legislation in early October, the index fell a further 16% in that month and the sell-off continued into the first three weeks of November.

Market volatility reached previously unprecedented levels in the final quarter. For example, the S&P500 Index had 27 days in which the index moved at least 5%. In comparison, there were only 27 days of such moves during the 50-year period from 1950 to 2000.

As the year limped to a close, sharemarkets staged a muted 'relief rally', as it appeared action taken by central banks and governments would not allow any more significant failures and the MSCI (local terms) gained over 16% from its mid-November lows, ending the year down 38%.

MSCI World Index (Local)



As the credit crunch unfolded in late 2007, much was made of the strength of companies' balance sheets, which would allow them to cope with a difficult environment. While this was true for a number of sectors, the massive write-downs and deterioration of financial companies' balance sheets and the subsequent freezing in credit markets meant even good companies had difficulty accessing debt.

Merger and acquisition deals and private equity buyouts all but dried up in 2008. Attention was suddenly focused on company debt levels again and a number of companies were sold down heavily on the basis they were over-leveraged.

The unwinding of the private equity/M&A boom is likely to see an increased supply of stock, as previously privatised businesses attempt to raise equity by returning to the public markets. Added to this oversupply of stock will be dividend cuts and capital raisings from a range of public companies looking to preserve and/or shore up capital.

No region was spared from the blanket selling, with the UK (-28%) the only major market not to fall by at least a third. Markets in North America (-37%), Europe (-43%) and Japan (-43%) fell by amounts not seen for decades. Emerging markets fared even worse, with the MSCI Emerging Market Index down 46% in local currency (-53% in USD).

At the sector level, the traditionally defensive sectors held up better than the broader market. Healthcare (-22%), consumer staples (-22%) and utilities (-30%) were the best performers in 2008. Financials (-53%) was the worst-performing sector for the second year running, as financial institutions all over the world suffered huge write-downs from illiquid and impaired assets, and concern over future earnings.

Materials and energy, the best performers in 2007, continued this trend for the first half of the year, as oil and commodity prices set record highs. However, the second half saw prices collapse and materials finished 47% lower for the year, ahead of only financials.

The focus on company debt levels brought the listed property/Real Estate Investment Trust (REIT) sector under the microscope and it became clear a number of these investment vehicles were over-leveraged (particularly in Australia). Sources of funding dried up in 2008 so that some of the more-heavily-gearred REITs had difficulty rolling over debt and saw their share prices plummet, which in turn put further pressure on their debt covenants.

The UBS Global Property Index fell 42.6% for the year, bringing to a sharp halt the 'purple patch' the sector enjoyed from the late 1990s.

Commodities super-cycle not so super after all

For the first half of 2008, commodities continued where they left off in 2007, gaining on continued demand from developing countries and speculative interest in futures markets. As prices appeared to defy gravity in the face of slowing growth expectations, some industry 'experts' professed that commodities were still in a super-cycle in which demand would continue even if economic growth in some regions slowed.

The speculative interest in commodity markets based on this premise accounted for some part of the heady gains made in the first half of 2008. However, the second half saw a complete reversal; with credit markets freezing up, demand and prices

plummeted. The Baltic Dry Freight Index (an often-cited leading indicator of global growth) fell 73% in October alone, as demand for commodities evaporated.

Oil began the year at US\$96 per barrel and by year-end it had more than halved to just under US\$45, after reaching record highs of US\$147 mid-year and falling as low as US\$33 in December.

Metals and other hard commodity prices followed a similar path.

Agricultural commodity prices held up slightly longer, and even though the NZ dollar remained at elevated levels, Fonterra paid out a record-high \$7.90 per kilogram of milk solids for the 2007/2008 season. However, as with other commodities, the last months of the year saw prices fall. The falling kiwi provided some insulation to farmers, but even so, the latest Fonterra forecast for the current season is \$6 per kilogram of milk solids, and many industry observers feel this will be downgraded heavily before the season closes.

NZ Commodity Prices



NZ dollar carried lower

The US dollar advanced in 2008, gaining over 12% on a trade-weighted basis in the second half of the year, as investors sought the safety of US Treasuries. Initially, the US dollar continued its weakening trend of the last six years, as the US Federal Reserve cut interest rates earlier and more aggressively than other central banks.

As money markets, and hence dollar funding for European banks dried up, the US dollar rallied against most major crosses. The exception was the Japanese yen, which strengthened as carry trades (sell JPY/buy high-yielding currency) were unwound due to increased risk aversion.

Carry trade currencies such as the Australian and New Zealand dollars, and - at a riskier level - emerging currencies such as the Brazilian *real*, were the big losers for 2008. The Australian dollar in particular fell a long way in a very short space of time. Having nearly reached parity with the US dollar mid-year as hard commodity prices advanced, it fell over 37% in just under four months. At one stage, the Aussie dollar had fallen further than even the Icelandic *krona* - the currency of a country that was practically bankrupt following the collapse of its three major banks.

The New Zealand dollar followed a similar path to the AUD, albeit in a slightly more orderly fashion. After hitting record highs of nearly US\$0.82 early in the year, the kiwi remained above US\$0.75 till late June before falling to six-year lows at around US\$0.525.

US dollar weakness into the year-end - and a slight increase in risk appetite - saw the kiwi strengthen to finish 2008 buying US\$0.596. On a trade-weighted basis, the NZ dollar fell 21.7% for the year, providing some relief for exporters who had been operating in a strong kiwi environment for the best part of four years.

New Zealand

New Zealand was not immune to the deteriorating global outlook, and the local economy entered its first recession since 1997 as the global financial crisis took its toll on domestic growth.

As shown in the chart above, New Zealand commodity prices dropped dramatically. Having endured a drought in 2007 when demand was rampant, by the end of 2008 the problem was oversupply, as the credit markets that lubricate the global trade machine seized up.

The slowdown in the New Zealand housing market, which had began late in 2007, gained momentum in 2008. While median prices fell in all regions, the correction was nowhere near as severe as those observed in the US and some European countries. The affordability of houses has subsequently improved, thanks to the fall in prices and the reduced mortgage rates that followed the Official Cash Rate (OCR) lower.

As focus swung from inflation fears to easier monetary policy, the Reserve Bank of New Zealand (RBNZ) was in many ways the envy of other central banks. Governor Bollard's rate-tightening discipline over recent years now left plenty of room for cutting rates.

After holding at 8.25% for the first half of the year, rates were cut to six-year lows of 5% in December, with further cuts priced in by the market.

National won the November general election comfortably to end Labour's nine-year run in parliament. Being an election year, a raft of tax cuts were offered by both of the main parties and these will provide some relief to the New Zealand consumer entering 2009.

Australia

For most of 2008, Australia continued in much the same vein as recent years, buoyed by strong demand for commodities from developing markets. However, the second half of the year saw dramatic reductions in metal and hard commodity prices.

In June, Rio Tinto secured an 85% increase in the iron ore contract price with Chinese steelmaker Baosteel. But by year-end, as negotiations for the next contracts began, a reduction of around

40% was being mooted by the Chinese. The freezing of credit markets meant the cost of debt was well above levels of recent years, so that a number of mining and resources companies were forced to cut staff and shelve capex projects that were no longer viable.

The Australian property market also had a mixed year, initially holding up well in the major cities, with the exception of some outer suburbs. By year-end, there was more evidence of price weakness, with housing starts and auction clearance rates plunging. However, price falls in most cities were modest compared to other developed countries, and the lower interest rates improved housing affordability.

After five straight years of returns above 14%, Australian stocks followed sharemarkets around the world and fell by more than 38%, dropping back to 2005 levels.

M&A activity had been a key driver over recent years and, as debt markets seized up, this activity came to a shuddering halt. The battle between two of the largest resources companies in the world (in which BHP Billiton was bidding for Rio Tinto) came to an end. BHP withdrew its bid in November citing the rout in commodity prices and concern over Rio's high debt levels.

Two of the four main Australian banks announced they had some exposure to either sub-prime debt or monoline insurance companies. Relative to their international peers, these exposures were very small and while the Australian banks were not without their problems, they emerged from 2008 in reasonable shape despite having required substantial capital raising at discounted prices.

Monthly Sector Summary

As at 31 December 2008

International shares

The MSCI World Index advanced 1.1% in local terms over December, tentatively continuing the relief rally from the lows of 20 November. A variety of measures of volatility, fear and risk aversion subsided from the extreme levels of mid-November, but remain high compared to their longer-term average.

The Chicago Board of Exchange VIX Index (the so-called 'fear' index) fell 28% over December. TED spreads - a measure of the willingness of banks to lend to one another - narrowed by 60 points. Returns to unhedged New Zealand-based investors were down 3.2%, with the NZ dollar rising, predominantly on US dollar weakness.

The month began badly, with US non-farm payrolls showing that over half a million jobs were lost in November - the biggest fall in 34 years. The Fed continued the easing policy, cutting rates to effectively zero. Elsewhere in the world, good news was equally scarce, with factory indexes in Europe, Russia, China and South Africa showing record contractions in production.

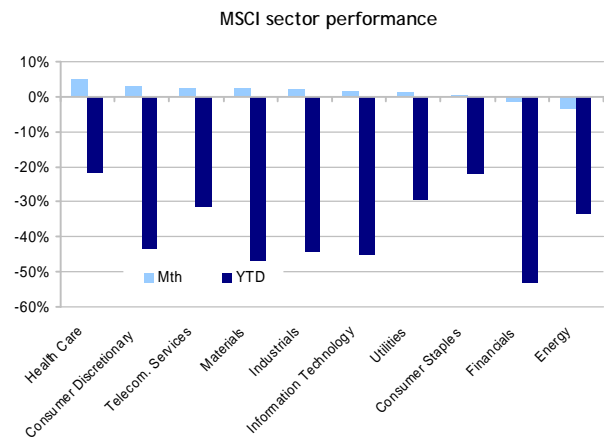
The future of the three largest US auto companies was in doubt early in the month. The US senate initially rejected a proposed package as it felt the companies and their workers unions were not making enough concessions. The Bush administration eased concerns immediately after the package was rejected by announcing they would allow the car companies access to TARP (Troubled Assets Relief Programme) funds, a move it had previously been opposed to.

The US Treasury Secretary urged Congress to "release the remainder of the TARP to support financial market stability" after the first US\$350 billion was allocated in barely three months. The lack of transparency regarding the first half of the TARP has been criticised by US lawmakers, and some are demanding more help for struggling homeowners.

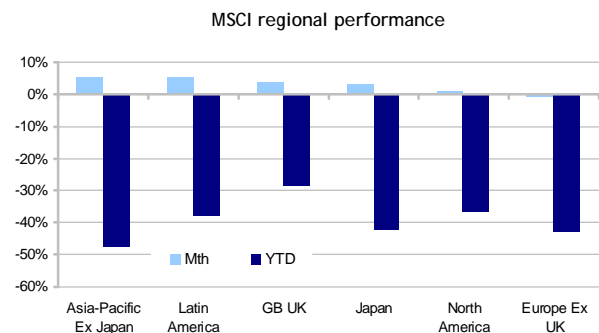
A dreadful year for sharemarkets ended with the unveiling of a fraud case in the US, possibly involving as much as US\$50 billion. Wall Street stalwart Bernard Madoff managed money for a number of hedge funds and fund of hedge funds, utilising a 'split strike conversion' trading strategy. On 11 December, he admitted he had instead been running a huge 'ponzi' scheme, whereby investors' interest payments and redemptions were being paid out from new clients' contributions.

Financials and energy were the only sectors to post negative returns in December. Goldman Sachs, UBS and Deutsche were among 12 banks that had their ratings or outlook cut by S&P, citing increased risks for the whole banking industry.

Oil prices fell for the sixth straight month, despite talk from OPEC that it would be cutting production. There was a much smaller dispersion in the returns of the different sectors compared to the wild swings observed from September through to November.



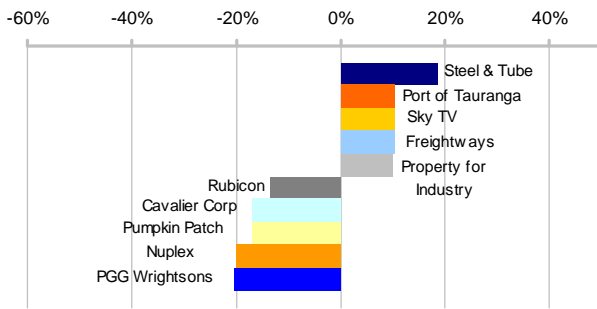
All markets, with the exception of Europe (-0.6%), made gains in December. The larger developed markets underperformed emerging markets and developing Asia for the second straight month. North American markets (+1%), Japan (+3.7%) and the UK (+2.9%) trailed those of Latin America (+5.3%) and Asia Pacific ex-Japan (+5.5%).



New Zealand shares

After experiencing a rough ride during 2008, the domestic sharemarket managed to end the year on a positive note, with the NZX50 index rising marginally (+0.28%) in December. However, this could not disguise the 33% decline for the calendar year, as the global credit crunch pushed the domestic economy into recession and caused widespread selling of equities across the board. It was the third-worst calendar year fall in over 50 years, superseded only by falls in 1987 (when the market fell 48%) and 1990 (when it fell 40%).

Top and bottom performing stocks (NZSE50)



The RBNZ cut the OCR by 150bp in early December, taking it to 5%, its lowest level since November 1999. This provided some support to domestic equities early in the month; however, ongoing concerns about the global economy saw this rally quickly run out of steam.

Local corporate news was thin on the ground ahead of the Christmas period.

Australian shares

The ASX200 finished the year on a slightly more positive note, declining by only -0.3% in December. This brings the total return for calendar 2008 to -38.0%, making it the worst calendar year ever, according to JP Morgan. However, from a positive perspective, the market did manage to close the year 11% above its lows.

The RBA continued its fiscal stimulus with another reduction in its cash rate, cutting by 100bp to 4.25%. In total, the rate has been reduced 300bp since September, from 7.25% to 4.25%.

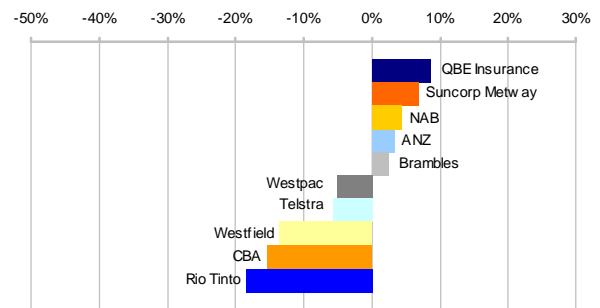
The best-performing ASX sectors were information technology (+19.1%), consumer discretionary (+8.0%) and industrials (+5.6%). The worst performers included property (-12.3%), telecommunication services (-5.5%) and utilities (-1.8%).

Testament to the continued tight credit markets were the ongoing secondary equity issuances, done at reasonable discounts in a market that was hardly conducive to such exercises. CBA, Westpac, Bendigo and Adelaide Bank all raised equity to shore up balance sheets. For some, however, equity raisings may be too late as OZ Minerals became the latest large cap casualty of lending conditions, being forced to suspend its stock for much of the month while it tried to renegotiate its US\$560 million debt.

Telstra underperformed as investors grappled to understand the consequences of its exclusion from the \$9 billion tender to build a national broadband network, given it willingly failed to comply with all tender requirements.

Also of consequence was the collapse of the recently announced merger proposal between Qantas and British Airways, as neither company could agree on key terms of the deal.

Top and bottom performing stocks (ASX26)



International fixed interest

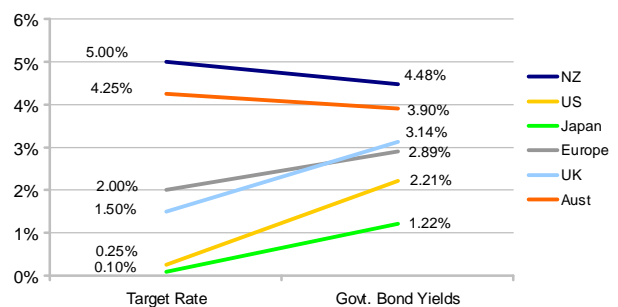
December was characterised as a month where the world weighed up the economic consequences of the financial market chaos. Growth forecasts were slashed, central banks cut rates aggressively and interest rates fell.

Leading the rate cut charge, the Fed slashed its Fed Fund rate to a target of 0-0.25%, basically using up the last of its traditional monetary policy firepower. The ECB also cut rates aggressively, moving 75bp to 2.50% and the Bank of England dropped 100bp to 2.00%. Closer to home, RBA cut rates 100bp to 4.25%, while our own RBNZ cut rates an unprecedented 1.50% to 5.00%.

Economic data globally was nothing short of disappointing. Unemployment is rising, growth is slowing, and business and consumer confidence remains very low. Governments are committing billions of taxpayer dollars to supporting businesses, which raises questions about the extent to which governments can continue to keep supporting ailing companies.

The US auto sector is a case in point. During the month, the US Government announced a US\$13.4 billion support package for the automakers, stating that the economic costs of not supporting this industry would be too much for the US economy to sustain.

Regional yield curves



On the back of central bank rate cuts, interest rates fell globally. Short rates also fell aggressively, with US Treasury bill yields falling to below 0% at times. US 10-year Treasury yields fell 71bp, German 10-year rates fell 31bp and Australian 10-year rates fell 61bp.

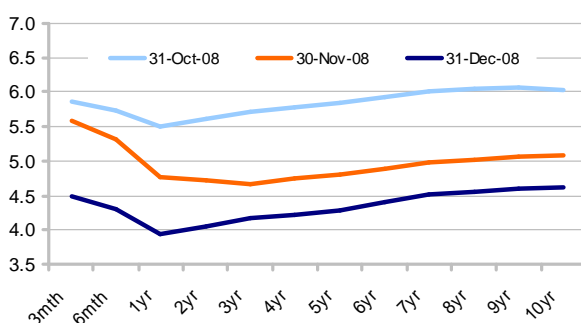
New Zealand fixed interest

In its statement accompanying the December interest rate cut, the RBNZ said it now considered monetary conditions as expansionary. While clearly very concerned about the global financial and economic conditions, the bank remained somewhat upbeat, expecting a moderate rebound in growth in 2009.

The release of the December economic and fiscal update projected the end to New Zealand's 15-year run of fiscal surpluses. The Treasury is now expecting an annual operating deficit of around 3% of GDP –although, assuming a slightly worse global economic outcome, this deficit could rise to as much as 5% of GDP. The September quarter GDP confirmed a third consecutive quarter of economic decline.

The New Zealand Government bond market returned 2.32% for the month, outperforming Cash, which returned 0.53% over the same period.

NZ Government bond yield curve



New Zealand listed property

The New Zealand Property Index (Gross) returned 0.28% in December, in line with the NZX50 Index (Gross). The listed property sector has outperformed the broader New Zealand sharemarket by 2.3% for the quarter and 10.8% for the 12 months to the end of December, with a -20.8% return compared to -31.6% return for the NZX50 (Gross).

After a busy month of quarterly and half-yearly results in November, December was more subdued, with just a few announcements regarding property acquisitions and disposals. ING Property Trust made two announcements during December detailing the unconditional sale of nine properties for a total consideration of \$64.5 million. Goodman Property Trust also

announced the sale of an industrial building in Manukau for \$15.6 million.

The best-performing listed property trusts (LPTs) during the month were Property for Industry (+10.0%), followed by ING Property Trust (+5.0%) and Kiwi Income Property Trust (4.8%). The worst performers during the month were National Property Trust (-15.8%) followed by Goodman Property Trust (-5.3%).

Australian listed property

The S&P/ASX 200 Property Accumulation Index returned -10.5% in December, significantly underperforming the broader sharemarket, which slipped -0.3%. The sector had its worst year in 2008 with a -54.0% return, significantly underperforming the broader equity market over the quarter by -14.6% and over the full year by -15.6%.

The main reason for this underperformance was the sector's dependence on debt markets in an environment where credit availability became uncertain and significantly more expensive.

International listed property

After the worst two months of performance in the history of global real estate securities, there was a modest recovery in December. Global real estate stocks in the UBS Investors Index were up 8.3% while the MSCI World Equity Index gained 1.1%. (All returns are stated in local currencies.)

Year-to-date through December, global real estate stocks lost 42.6% versus a decline of 38.3% for the MSCI World Equity Index.

The US REIT market (+17.2%) had by far the best absolute performance among public real estate markets, and the best relative performance versus the broader US sharemarket (+1.3%).

Currency

Through the first half of December, the USD fell heavily against most major currencies. The Fed slashed interest rates to effectively zero, and investors worried that the combination of quantitative easing and burgeoning fiscal debt would undermine the value of the USD. At the same time, hopes of a government bailout for troubled US automakers and the Fed's purchase of agency debt helped stabilise sharemarkets and risk appetite a little.

As a result, investors took profits and squared up long USD positions ahead of the holiday period. The USD fell about 10% on a trade-weighted basis, EUR/USD surged from around 1.2550 to above 1.4000 and USD/JPY plunged to a fresh 13-year low of 87.14.

By the end of the month, the USD had stabilised a little as it became evident that interest rates around the world would likely converge in 2009. The Bank of England Deputy Governor warned that “the bank rate is still at 2%, so we still have some margin to go yet, but of course we may find ourselves getting them all the way to near zero”.

At 0.10%, Japanese interest rates are already effectively zero, but Japanese officials were clearly unhappy about the rapid appreciation in the JPY and made thinly veiled threats about currency intervention.

Some real-money demand was noted while the NZD/USD was below 0.5400, but the fortunes of the local currency were largely governed by USD sentiment. NZD/USD surged from nearly 0.5200 to above 0.6000 in the middle of the month, but finished the year closer to 0.5800. Against the AUD, the NZD finished mostly unchanged at A\$0.8323.

INGNZ Asset Allocation

| Asset Class | Relative Position | Rationale |
|------------------------------|-------------------|---|
| International Equities | 6 | Policy makers continue to respond to a deteriorating situation in the banking and credit markets, yet despite these measures stability has not yet returned. The second round effects of the credit crunch are becoming increasingly apparent as economic data flow continues to disappoint in all major regions. The de-leveraging of financial institutions and households will be a slow process, and an increase in earnings losses and default rates is inevitable. While equity markets have discounted much of the negative earnings outlook, we need more convincing signs that credit markets are recovering to re-engage fully in equity markets. |
| Domestic Equities | — | We have closed out our underweight to Domestic/Australasian equities after a significant improvement in valuation. The outlook for economic and earnings growth remains uncertain, but the RBNZ has showed a willingness to rapidly ease monetary conditions. We can expect domestic sentiment to improve in anticipation of better macro fundamentals, but the negative sentiment from offshore will continue to weigh on the sector for a time yet. |
| Domestic Listed Property | 5 | The sector is trading at a significant discount to NTA, more than compensating for the likely decline in asset values as cap rates rise. In addition, high occupancy rates and under-renting bode well for rental growth, even in a slowing 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, although higher gearing levels in Australia remain a risk for the sector. |
| Global Property | 6 | Valuations have improved considerably, with listed entities trading at significant discounts to NAV, although NAVs will be declining over the year ahead. High occupancy and rental growth are positives for the sector and structural support comes from institutional demand for real estate and regional development of tax efficient structures. However, with current financial conditions, the sector is suffering under the weight of the de-leveraging process. |
| International Fixed Interest | 6 | 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, however, is increasingly under-valued and is pricing in well above average default activity. Defaults will continue to rise however. |
| Domestic Fixed Interest | — | NZ government bonds have similar attributes to global bonds in this economic climate, but overall our expected returns are slightly higher. Again, credit looks attractive. |
| Cash | 5 | Expected returns from NZ cash are coming down as the easing cycle plays out, increasing the relative attractiveness of other income-generating asset classes. For now, however, it remains a source of stability in returns |
| NZ Dollar | 6 | Short-term movements will continue to be driven by fluctuations in the US dollar. However, over the medium term, slowing global growth, narrowing interest rate differentials and a large current account deficit, particularly in an environment where funding will be hard to come by, are negatives for the NZ dollar. This justifies hedging levels below benchmark with a medium-term view. |

Key: — Neutral 5 Overweight 6 Underweight

At a glance as at 31 December 2008

Indices

| | Level | 1-month % change | YTD % change | 1-year % change | 3-year ann. % change | 52-week high | 52-week low |
|--------------------------------|----------|------------------|--------------|-----------------|----------------------|--------------|-------------|
| Index close at: | 31/12/08 | 28/11/08 | 31/12/07 | 31/12/07 | 31/12/05 | | |
| MSCI World Index (G) | 2151 | 1.1% | -38.3% | -38.3% | -9.0% | 3323 | 2797 |
| Asia Pacific | | | | | | | |
| MSCI Asia Pacific ex Japan (G) | 596 | 5.5% | -47.7% | -47.7% | -2.4% | 825 | 623 |
| NZSX50 (G)** | 2716 | 0.2% | -32.8% | -32.8% | -6.9% | 3843 | 2569 |
| ASX200 | 24801 | -0.3% | -38.4% | -38.4% | -3.9% | 38434 | 22264 |
| Nikkei 225 | 8860 | 4.1% | -42.1% | -42.1% | -18.1% | 14601 | 6995 |
| Americas | | | | | | | |
| Dow Jones | 8776 | -0.6% | -33.8% | -33.8% | -6.4% | 13137 | 7449 |
| S&P500 | 903 | 0.8% | -38.5% | -38.5% | -10.2% | 1440 | 741 |
| Nasdaq | 1577 | 2.7% | -40.5% | -40.5% | -10.6% | 2551 | 1295 |
| Europe | | | | | | | |
| MSCI Europe (G) | 3709 | 0.7% | -38.5% | -38.5% | -7.8% | 5672 | 4677 |
| FTSE100 | 4434 | 3.4% | -31.3% | -31.3% | -7.6% | 6377 | 3665 |
| France CAC | 3218 | -1.4% | -42.7% | -42.7% | -12.0% | 5421 | 2839 |
| Germany DAX | 4810 | 3.0% | -40.4% | -40.4% | -3.8% | 7759 | 4015 |
| Property | | | | | | | |
| NZSX Property (G) | 1873 | 0.2% | -20.8% | -20.8% | -1.8% | 2309 | 1782 |
| Aust LPTs (G) | 18007 | -10.5% | -54.0% | -54.0% | -17.3% | 35327 | 17138 |
| Int'l LPTs - USD (G) | 322 | 9.9% | -47.6% | -47.6% | -12.0% | 664 | 473 |

* 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+ | 0.7046 | 7.4% | -19.6% | -19.6% |
| EUR+ | 1.3953 | 9.8% | -4.3% | -4.3% |
| GBP+ | 1.4575 | -5.2% | -26.5% | -26.5% |
| JPY+ | 90.8 | 5.0% | 18.8% | 18.8% |
| NZD+ | 0.5864 | 6.6% | -23.4% | -23.4% |
| NZD/AUD | 0.8323 | -0.8% | -4.8% | -4.8% |
| NZD/GBP | 0.3575 | -0.4% | -7.5% | -1.3% |
| NZ TWI | 55.63 | -5.8% | -22.5% | -21.8% |

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

10-year bonds

| | Yield | 1 month chge | 1 year chge |
|-----------|-------|--------------|-------------|
| Australia | 3.99% | -0.61% | -2.33% |
| Germany | 2.95% | -0.31% | -1.36% |
| NZ | 4.63% | -0.45% | -1.75% |
| UK | 3.02% | -0.75% | -1.49% |
| US | 2.21% | -0.71% | -1.81% |
| Japan | 1.17% | -0.23% | -0.34% |

Source: Bloomberg

Economic data

| | GDP qtr on qtr | GDP yr on yr | CPI yr on yr | Unemployt rate |
|-----------|----------------|--------------|--------------|----------------|
| US | -0.1/-0.5 ann. | 0.70 | 2.00 | 7.20 |
| Japan | 0.40 | 1.50 | 1.00 | 3.90 |
| Germany | -0.50 | 0.80 | 1.40 | 7.60 |
| Euro | -0.20 | 0.60 | 1.60 | 7.80 |
| UK | -0.60 | 0.30 | 3.90 | 3.30 |
| Australia | 0.10 | 1.90 | 2.20 | 4.40 |
| NZ | -0.40 | -0.10 | 2.20 | 4.20 |

Central bank target rates

| | Rate |
|-----------|-------|
| NZ | 5.00% |
| US | 0.25% |
| Japan | 0.10% |
| Europe | 2.50% |
| UK | 1.50% |
| Australia | 4.25% |

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