

IN PRIVATE

NEWSLETTER SPRING 2008
NEW ZEALAND EDITION



What goes up

Soaring oil and soft commodity prices have increased the gloom among some commentators, but ANZ's Chief Investment Officer, Kevin Armstrong, argues that we should look at history and not extrapolate disaster at times of price extremes.

An unusual market

Property is not all in decline – the rural market is having one of its best years in living memory. Will this influence other markets?

A family affair

Plunket can be a lifesaver for parents of young children.



QUALITY CONTACT

THE RESULTS OF OUR 2008 CLIENT SURVEY ARE NOW IN AND THANK YOU TO ALL OF YOU WHO TOOK THE TIME TO COMPLETE THEM.

Although some have expressed frustration at being asked, your feedback is always important to us to ensure we can continue to develop our service to meet your specific needs.

We apologise for the difficulties experienced with the on-line access of the survey – something we will definitely look to fix for next year.

Overall we were satisfied with the results, but there are areas we can improve on. One of the key messages we took out was that although we are good at reactively responding to you, a number of you would like us to be far more proactive in managing your needs and providing investment advice. We also need to be better at communicating to you the full breadth of our proposition – the products and services that we have available to help you create, manage and protect your wealth.

To address this we are going to be setting some new standards in service at ANZ Private Bank. Our aim is to become more client focused. This is about building stronger relationships and being more proactive in our conversations with you. We will tell you more about these changes as they develop over the coming months.

In order to achieve this we intend to increase the number of Private Bankers we have in our business. By spreading our clients across a larger number of Private Bankers we will create more time, which will enable us to increase our standard of service. This will, in many cases, mean a change in Private Banker. Whilst we understand this can be unsettling we believe it is a necessary step in improving the overall service that ANZ Private Bank delivers to you.

We couldn't publish this edition without addressing the issue that's on everyone's lips at the moment – the economy. Everyone's got their opinion, often based on hearsay, rumour and



the media. In this issue, we hear the facts from industry experts. They share with us insights about how the current climate is impacting on the investment markets and property market.

This is the beauty of having Private Banking services in such uncertain times, we can leverage the specialist expertise across our organisation to help you manage your investment needs. In particular, this is where the Private Banking Investment Committee comes to the fore, as it brings together independent research and expert opinion from a broad range of sources to help us make informed decisions. Please read what these experts have to say, and speak to your Private Banker if you have any questions or concerns. **IN PRIVATE**

Catherine McDowell

Managing Director, Private Banking

WE'D LIKE TO HEAR FROM YOU.

Please let us know any suggestions you might have for improving In Private, including the types of articles you'd like to read.

Contact your Private Banker or email Karen.Temaipi@anznational.co.nz

One year on



A YEAR HAS PAST SINCE THE CREDIT RELATED MALAISE EMERGED, AND FINANCIAL MARKETS ARE STILL EDGY.

While policymakers have been very pro-active in ensuring the global financial system continues to function and systemic risks are minimised – with actions ranging from slashing interest rates to injecting liquidity into the banking system – uncertainty remains over whether we are anywhere near the trough.

Some influential figures talk of the crisis only reaching a halfway point, with more losses yet to come. Close to US\$500 billion has already been written off thus far, though some estimates put the total losses at closer to US\$1 trillion. Some are as high as US\$1.5 trillion. Others expect further casualties to follow the way of US investment bank Bear Stearns, including a sizeable major financial institution. The recent difficulties facing Fannie Mae and Freddie Mac, with increasing rumours of a government bailout being needed, certainly do nothing to help restore investor sentiment. This, at a time when global financial institutions are in need of further capital to restore their depleted balance sheets. Commentators need to be prudent and responsible in their analysis. The danger is that rumour and innuendo become self fulfilling prophecies. Chicken Little's perennial fear helps no one.

	WRITEDOWNS AND CREDIT LOSSES (US\$B)	CAPITAL RAISED (US\$B)
Q3 2007	43.4	10.5
Q4 2007	169.7	45.8
Q1 2008	171.1	87.2
Q2 2008	107.2	170.0
Q3 2008	8.0	38.6
Total	499.4	352.1

Source: Bloomberg

Subprime write-offs represent only a portion of current challenges. With growth around the globe softening rapidly, and dreaded "R's" being speculated and reported across a number in the OECD, asset prices are under pressure, and this is naturally leading to deteriorating credit quality. Such a dynamic is accentuating the process of de-leveraging that is taking place across financial institutions. And when the financial system is de-leveraging, the same invariably occurs across the real economy. It's a vicious circle where falling asset values lower growth, dampen risk appetites, asset prices fall, even less growth, lower risk appetites.....and the spiral is in motion. Confidence resides at the heart of such spirals – positive and negative – and confidence remains absent.

Households – via their exposure to falling house prices – remain a key focal point, and find themselves having to build up precautionary saving in the face of job insecurity, rising food cost

and high debt levels. While this is a natural and necessary response in the current environment, it does put further downward pressure on asset prices in the near-term, leading to further write-downs and losses, more de-leveraging, subdued economic activity, another further bout of asset price decline and on it goes. The irony is that asset price deflation is currently occurring at a time when central banks are trying to grapple with elevated and rising consumer price inflation.

If there is a silver lining to recent events, it is that the global imbalances that have been troubling policymakers for years are slowly being corrected. The weak USD alongside a sharp cut in spending by US consumers is helping to improve the US's current account position. It was an adjustment that needed to happen. Unfortunately, it took a major period of financial dislocation to trigger it. Less spending by US consumers also means less income for someone else. We are already seeing a loss in growth momentum in Europe, with UK GDP flat in the second quarter and economic activity contracting in the Eurozone economies. Asian economies have not been immune, with the export orientated Japanese and Singapore economies contracting in the second quarter and Chinese growth also slowing. Proponents of decoupling, so prominent earlier this year, have largely been silent.

We also need to be mindful that the aggressive turn in the credit cycle we have seen is all about rewarding investors appropriately for risk. From 2002, mispriced risk advantaged borrowers at the expense of investors. The story going forward is simply the reverse. It's about earning more and borrowing less. Both are necessary adjustments for nations running material current account deficits such as New Zealand, Australia, the UK and the US. Correct interest rate pricing signals and current realignments are part of the process.

When do conditions stabilise? The almost schizophrenic movements in asset prices, particularly in equities, suggest a lack of conviction by market participants about the path forward. Huge rallies in equity markets occur when oil prices move lower or on any hint of positive earnings reports, but are equally savagely sold off on a whiff of credit related woes. Expect more of the same until investors become more confident that the last of the credit and subprime related losses have been written off, affected financial institutions have adequately restored their balance sheets, and house prices stop falling. It's a tall order but good things take time. Policy-makers are certainly doing everything apart from throwing in the kitchen sink. **IN PRIVATE**

Cameron Bagrie
Chief Economist

What goes up

THE ENGLISH POLITICAL ECONOMIST AND DEMOGRAPHER, THE REVEREND DR THOMAS MALTHUS, WROTE IN HIS 1798 TREATISE AN ESSAY ON THE PRINCIPLE OF POPULATION: "THE POWER OF THE POPULATION IS SO SUPERIOR TO THE POWER OF THE EARTH TO PRODUCE SUBSISTENCE FOR MAN, THAT PREMATURE DEATH MUST IN SOME SHAPE OR OTHER VISIT THE HUMAN RACE."



At the time the world's population is estimated to have been just under one billion. Since then the population of the world has grown almost seven fold and, despite frequent 'Malthusian' headlines to the contrary, global food production has more than kept pace with this growth.

At times of extreme emotion in any investment market, it is important to view price action over an appropriate time frame. Such a perspective is unlikely to be found in media headlines; these sound bites reflect only the most recently dramatic price movements of anything. Nonetheless, it is very easy to get swept along in the emotional doom saying of modern-day Malthusians, and there have been many over the last year.

We are repeatedly told food and energy inflation are the biggest economic threats that the world now faces. The UN Secretary-General, Ban Ki-moon, recently described the escalation in food prices as the worst international crisis since World War II. Towards the end of the first quarter of this year, the global news media ran story after story along these lines.

The prices of rice, wheat and many other staples were rocketing, amid scenes of rioting in the developing world and rationing in the developed world. These stories appeared as prices were accelerating and the logic of insatiable demand and limited supply offered no hope of there being any end in sight. However, history has repeatedly shown that ever accelerating price trends do reverse, and generally quite dramatically.

The chart, "Wheat US\$/Bushel", shows the last five and a half years of price action in wheat. Until about a year ago the price had meandered between a low of around US\$3 and a high of US\$5 a bushel, but then it started to accelerate and in the last week of February this year, as the panic started to take hold, the price shot up 30% in just one week to peak at about US\$12 dollars. Over the next three months, even while disaster headlines continued to appear, the price collapsed back to less than \$5. Similar, although less extreme, reversals have now been seen in rice.

It should serve to highlight the danger, from an investment perspective, of getting swept up by the media in the apparent

certainty of an already well established and accelerating trend continuing.

At times of emotional extremes it's important to take a long-term perspective. The chartt, "CRB Foods Index", shows the last 40 years of food price inflation as measured by the Commodities Research Bureau. It's clear that over the last eight years prices

WHEAT \$US/BUSHEL



have been rising, but it's also important to note that food prices now are only 43% higher than they were 33 years earlier, an annualised rate of increase of barely 1%.

At the same time as food inflation has been making the headlines, the soaring price of oil has also caused concern. Once again, the sensible arguments of supply and demand appear to justify why ever higher prices are inevitable. These arguments range from peak production having now passed to the insatiable demand of the emerging economies. It's remarkable how different the world apparently looked just seven years ago: then the price of oil was below \$20 and OPEC held a crisis meeting to address supply issues as they feared the price may fall to \$10 or even \$5 a barrel, given the slowing global economy and the steep falls in global equity markets.

CRB FOODS INDEX



Sentiment about oil prices has undergone a remarkable reversal this decade, with fear of a glut by producers now being replaced by a fear of shortages.

Such swings in sentiment surrounding the abundance or otherwise of oil have been seen before, although many may say – rather worryingly from an investment perspective – that ‘this time it’s different’. Movements in investment markets of all sorts are always different, but usually not as different as those highlighting the difference we would like.

The previous occasions when the world has supposedly been on the brink of an energy crisis have occurred after the price has moved up a lot. In 1972 there was a book called *Limits to Growth* which forecast the world had only 20 more years of oil; in 1914 the US Bureau of Mines warned there was only 10 more years of oil left in the world; and in 1939 the US Department of the Interior forecast another 13 years of oil; and 12 years later they amended that to another 13 years.

In the past it has been clear that a high oil price has ultimately driven the solution to the problem of high oil prices through substitution and demand destruction. The same has been true in other commodities and is the primary reason commodity prices have repeatedly displayed extreme peaks and troughs.

The current crisis and escalation in price may be different from previous cycles but, even if it is, it would be foolish to believe that oil prices are now on a one-way path higher. Human ingenuity and exploration have defied many gloom-ridden forecasts of the end of oil.

Clearly there can only be a finite amount inside the Earth, but to forecast when or even if the last drop will be extracted has always been a long shot, and a long shot that seems only to be made near peaks in the oil price, not troughs. Ultimately the last drop of oil extracted from Earth will be worthless, and that will be why no more will be taken.

Almost 150 years ago the east coast of America was facing a very different energy crisis; a famous headline of the time was: “Energy Crisis Looms – World to go Dark – Whale Blubber Scarce”.

At the time, whale oil was the primary source of lighting for the developed world. By the mid 1800s whales were becoming scarce and the price of their oil had started to rise. With the onset of the American Civil War in 1861, many whaling boats were converted to troop carriers and so the supply of whale oil dwindled further. The result was that from the 1830s to the 1860s the price of whale oil surged 540%. This was a crisis, but it’s perhaps not surprising that in this period the technique of distilling kerosene from oil was developed, and that by the 1860s cheap refined kerosene began to drive whale oil out of the lighting market. In 1870 John D Rockefeller formed Standard Oil – the oil boom had begun.

By 1896 the price of sperm whale oil, that had sold for \$1.77 per gallon in the mid 1850s, had collapsed to 40 cents, but it still could not compete with refined petroleum which was by then selling for just 7 cents a gallon.

Sheikh Yamani, the former Saudi oil minister, said: “The Stone Age came to an end not for a lack of stones, and the oil age will end, but not for a lack of oil.”

When any outcome appears obvious to the majority, at least in investment markets, and a price trend begins to get extrapolated way into the distant future, it’s likely that particular trend is rapidly approaching an important reversal. The time to be excited or worried about the prospect of higher oil prices was in 1998 at \$11 a barrel, not now when it has already increased more than thirteen fold. As was seen in wheat, the downside risk in any market that has already risen dramatically in a parabolic fashion can be very large. **IN PRIVATE**

Kevin Armstrong

Chief Investment Office

Investing in Uncertain Times

INVESTORS USED TO THE RELATIVELY BENIGN AND STABLE FINANCIAL MARKETS OF RECENT YEARS NOW FIND THEMSELVES IN A VERY DIFFERENT ENVIRONMENT.



Economic fundamentals have changed, with significant implications—and some new risks—for investors.

For example, investors with significant New Zealand dollar cash deposits are facing the very real risk of declining interest rates. While many overseas central banks have signalled that they are prepared to raise interest rates to combat the growing threat of inflation, the Reserve Bank of New Zealand has indicated quite a different direction.

Having maintained a tight monetary policy for some time to restrain inflation pressures, the Reserve Bank lowered the Official Cash Rate (OCR) in their July review. At that time they noted the weakness in domestic economic activity, and the risk that the economy could slow further. As a result they also noted, provided the outlook for inflation continued to improve, they expected to be able to lower the OCR further in coming months.

At the time of writing the result of the Reserve Bank's review of the OCR in early September is not known. However the direction for interest rates is clear—they are set to fall, and the easing could be relatively rapid. This is significant for investors holding cash deposits. Over recent times the interest rate environment has made it relatively easy and straightforward to get a good return from cash. In the current environment, holding cash is unlikely to be so rewarding.

In a falling interest rate environment it clearly makes sense to hold less in cash and to invest more in longer dated bonds or other fixed rate investments where the current high yields can be locked in. We are fortunate in New Zealand that high quality bonds provide real (ie above inflation) yields. In many other developed market economies this is not the case.

With the turmoil in credit markets set to continue for some time, it is more important than ever to distinguish between 'quality' bonds and others. At Private Banking we define a 'quality' bond as one with an AA- or higher credit rating from S&P, and these are the issues we have been focusing on for the last year or so. Lower rated debt offers the prospect of a higher yield, but with risks attached.

Of course one of the keys to building any investment portfolio is diversification. With global economies slowing and inflation

remaining above target in most countries, it is not surprising that share markets have been falling sharply. In this sort of environment it is understandable for investors to want to shun shares and stick to the local bond market. However, all corrections lead to buying opportunities, and waiting for markets to recover before buying is never the best option. Therefore we see this as a good time to be starting to build a diversified portfolio.

We recognise that every client is different. Some want to take advantage of our Investment Management Service – a fully managed portfolio structured to meet their needs. Others prefer a more hands-on approach, while still benefiting from our expertise and our access to capital markets.

Whatever your requirements we have the investment service to suit. And, whichever service you choose, you can be confident that it is backed by a team of investment professionals, who understand how markets work and have the experience and the knowledge to make the right decisions.

If you would like to know more about any of our investment services and how Private Bank can help you manage your investment needs in uncertain times, talk to your Private Banker.

IN PRIVATE

Guy Fisher

Head of Investments



We're in a very unusual property market

You don't have to go far these days to be told property is in decline. This overlooks the fact that the market comprises three distinct sectors, which – very unusually—are moving in different directions.

In a nutshell, residential property is experiencing one of its most challenging years ever, the rural market is having one of its best on record and the commercial and industrial market is somewhere in between.

The residential property market is going through a significant correction after a long period of strong growth that simply was not sustainable. The economic downturn and the “credit crunch” has provided added bite to this market's reversal. The volume of transactions in the residential sector for the first 7 months of the year is down on average across the country between 50% and 60% on the same period last year. Pressure on values has been slower to be recognised, with the REINZ statistics showing only a slight decrease in median sale value. The sales statistics are often slow to filter through the system but being close to the action, Bayleys' agents report a softening in values of between 10% and 15%.

The commercial and industrial market has been affected by general negative investment market sentiment and by the demise of many “mezzanine” funders that provided the “top up” finance that facilitated much of the activity in the development sector of

the market. As a consequence there has been a slight slowdown in sale volume, much less than in the residential sector, and a reassessment of risk by investors, with a more noticeable yield gap opening up between prime and secondary property. Bayleys' agents in the field report a softening in secondary property yields of upwards of 2% and in prime yields of around 1%.

But there is still a reasonably good volume of sales being concluded and there continues to be an encouraging level of leasing activity, particularly at the smaller end of the market. While we've become absorbed with the challenges faced in our big city markets, we've also largely overlooked the fact it's a different, more optimistic world out there in the provinces. We have a rural property sector experiencing one of the strongest markets in living memory, with the value of rural sales transactions concluded by Bayleys in its last financial year up 38%.

The outlooks for agriculture across most sectors are the best since the 1950's. You cannot have one sector of an economy awash with cash for that not to impact on other markets. The indications we are getting from rural investors – some of whom are already out there looking—is that a good chunk of this money will come back into property. **IN PRIVATE**

Mike Bayley

A Family Affair

WHEN IT COMES TO SUPPORTING A WORTHY CAUSE, THERE ARE FEW MORE WORTHY THAN PLUNKET.

Since the Plunket movement was born in Dunedin in 1907 it has touched the lives of almost every New Zealander. Today, parents of more than 90 percent of new babies access some aspect of Plunket's services.

The services Plunket provides to New Zealand families are unique. For many parents of young children, at the end of their tether because their baby cannot feed properly or simply exhausted through lack of sleep, Plunket is – literally – a lifesaver. Through their car seat rental programme, toy libraries, parent education courses and support groups, mobile clinics and family centres they play a vital part in giving the next generation of New Zealanders the best possible start in life.

But of course, providing these invaluable services requires money and support. ANZ is proud to be a Star Sponsor of Plunket and the Principal Sponsor of the Plunket Annual Appeal – Plunket's most important fundraising activity. This year's annual appeal takes place from 13 – 19 October. Thousands of volunteers, many of whom have benefited from the existence of Plunket, are involved in door knocking, street collecting, and a myriad of fundraising activities to support the appeal. All money raised locally is used to support local Plunket services.



At ANZ, we are looking forward to the chance to show our support. ANZ staff will be organising events to raise money, and many ANZ staff will be using their Volunteer Leave to assist with the appeal or other Plunket initiatives. ANZ branches will be accepting donations and we will be promoting the Appeal in a variety of ways. We can't think of a better way to support our communities than through an organisation which has done so much for so many New Zealand families.

If you would like to help us support Plunket's invaluable work, talk to your Private Banker.

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