

Third time lucky?

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Summary

- > The monthly *Property Focus* publication is aimed at providing investors and prospective homeowners with an independent appraisal of recent developments in the property market, as well as our recommended borrowing strategy. In this issue, the feature article is on recent trends in migration flows.

The month in review (page 2)

- > What a month to remember. Both the Official Cash Rate and the NZ dollar hit new highs. The Reserve Bank replied, by entering the foreign exchange market in a bid to cap the currency. There looks to be some sign of softening in partial indicators, although the property market looks to be holding up well.

Property gauges (page 3)

- > The battle continues, with affordability, debt servicing and the RBNZ saying slowdown, but liquidity and restricted supply providing support.

Economic backdrop (page 5)

- > Inflation remains the primary focus of the Reserve Bank. To ensure that inflation is unreservedly squashed, the Reserve Bank hiked the Official Cash Rate for the third time in four months. The first signs of the engineered economic slowdown are being detected but it is still early days.

Borrowing strategy (page 6)

- > While we believe the Reserve Bank has finished raising interest rates, the risk profile remains skewed to the upside, and we struggle to see an easing for at least 18 months in the absence of a major event. We see little value in 5-year lending rates around 9 percent and continue to favour the slightly more expensive 2 and 3-year rates, which provide greater flexibility to take advantage when rates eventually move down.

Feature article – migration (page 7)

- > Net migration inflows have eased over recent months and this is expected to correspond into a softening in housing market activity over the latter part of this year. Although a relatively unpredictable flow, we see further downside risks for net migration over the coming 12-18 months.

Key forecasts (page 11)

The month in review

What a month to remember. Both the Official Cash Rate and the NZ dollar hit new highs. The Reserve Bank replied, by entering the foreign exchange market in a bid to cap the currency. There looks to be some sign of softening in partial indicators, although the property market looks to be holding up well.

When the going gets tough...

- > **RBNZ Monetary Policy Statement – June.** The RBNZ increased the Official Cash Rate (OCR) by 25 basis points to 8.00 percent. The latest rise was to make sure that the Reserve Bank's desired slowdown in domestic demand does eventuate. Though the Reserve Bank acknowledges that there are early signs of softening, they admit that it is too early to be confident that this will continue. The RBNZ continues to expect recent increases in lending rates to eventually act to slow activity over the second half of this year. However, given the sizeable boost to NZ's terms of trade from higher world dairy prices, the Reserve Bank identified concerns about medium-term pressures on resources and inflation.

...the tough get going.

- > **RBNZ Currency Intervention – June.** The dust hardly had time to settle from the 25 basis point rise in the OCR, before the RBNZ intervened in the currency markets (by selling NZ dollars for US dollars), spurred on by the NZD hitting a new post-float high of 0.7640. What has really got the market buzzing is what signal it is potentially sending about monetary policy, particularly coming hot on the heels of a hawkish June *Statement*. After all, it seems peculiar to intervene if you are actively considering hiking rates!

Activity in the housing market remains at lofty levels

- > **REINZ housing data – May month.** Despite recent mortgage rate increases, the NZ housing market remains robust with average number of days to sell unchanged at 28 days in May and near historical lows, and house price growth still elevated. The seasonally adjusted number of house sales reversed its recent monthly declines and rose 1.2 percent.
- > **Building Consents – April month.** Residential building consents posted a modest 0.7 percent increase in April. On an ex-apartment basis, consents rose 2.2 percent in the month. Both came after falls in March. The level remains elevated and there is still a strong pipeline of activity in the non-residential construction sector.

Migration slowed.

- > **External migration – May month.** Migration recorded a net inflow of 360 (s.a.) in May, taking the annual total to 10,682. Annual migration inflows continue to ease after peaking at over 14,700 in November 2006.

Gravity pulled retail sales back from the stratosphere.

- > **Retail sales – April month.** Total retail sales fell 1.2 percent in April, while core sales fell 0.9 percent, both weaker than market expectations. On the face of it, it appears an early indication of softening activity. However, the decline does need to be put in perspective. It follows surprisingly strong monthly increases in February and March.
- > **Mortgage lending - April.** Mortgage borrowing increased by 1.2 percent (NZ\$1.7b) in April, which followed on a strong 1.6 percent increase in March. Annual growth in mortgage borrowing (14.5 percent) accelerated to its fastest rate of increase since the middle of last year.

Assessment

Mixed messages.

Mixed economic signals, which is typical when an economy has reached an inflection point in the cycle. However, the housing market (a key focal point at the Reserve Bank) looks to be holding up well. While house price growth did slow over May (up a meagre \$1,000 on April – the smallest gain in 4 months), this could have easily been driven by the compositional mix of houses being sold. The average day to sell a house is the key gauge we monitor, and at 28 days, it remains low.

Property gauges

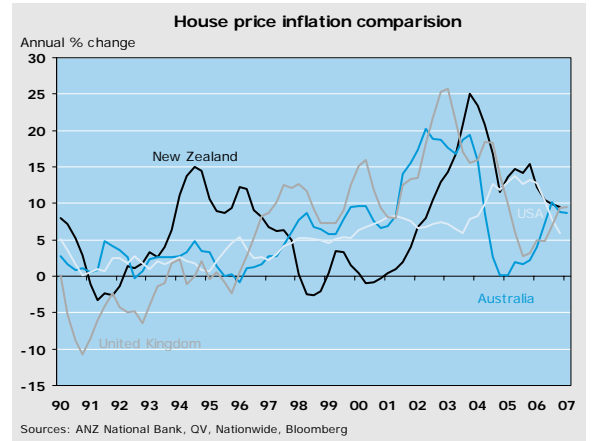
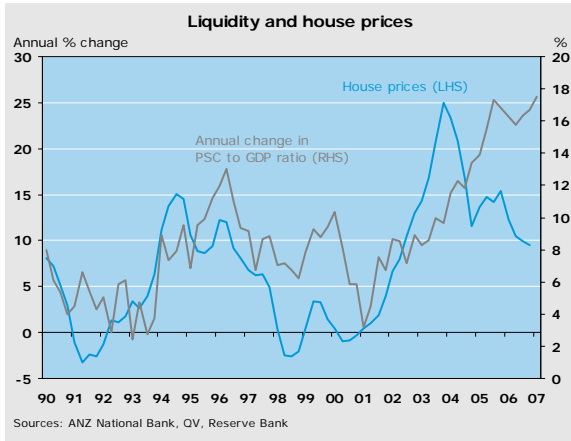
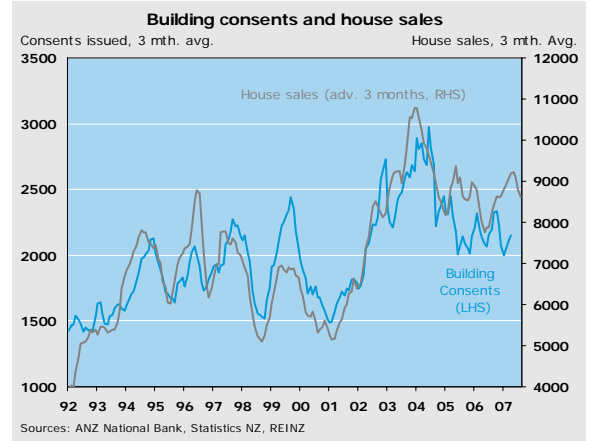
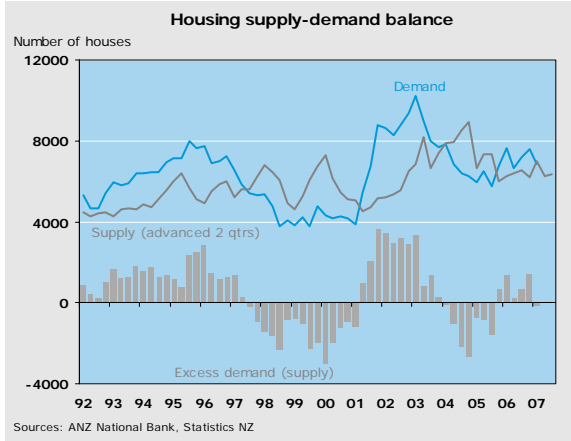
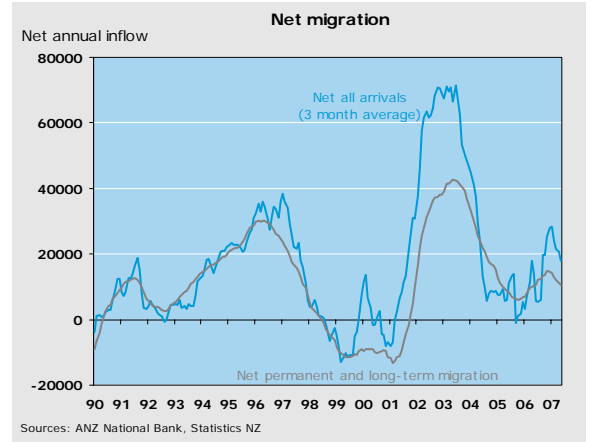
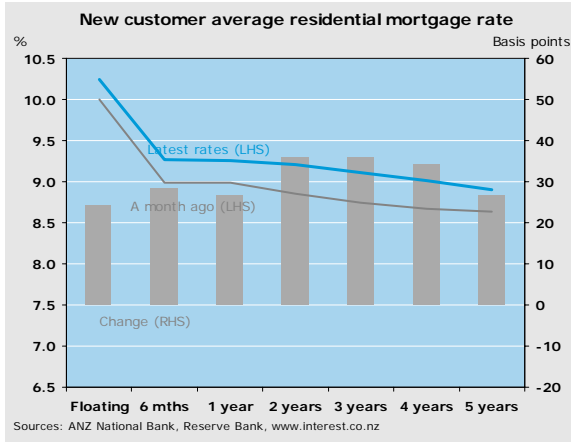
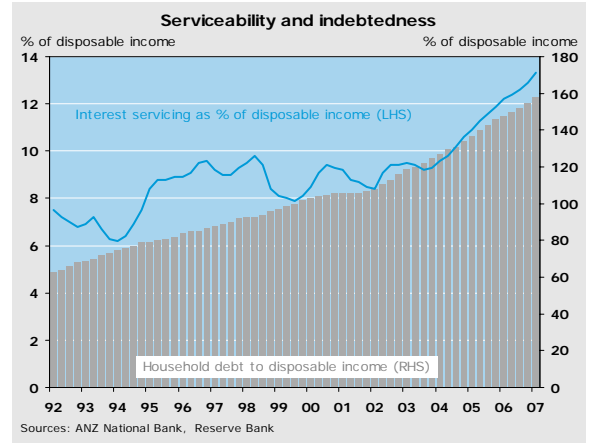
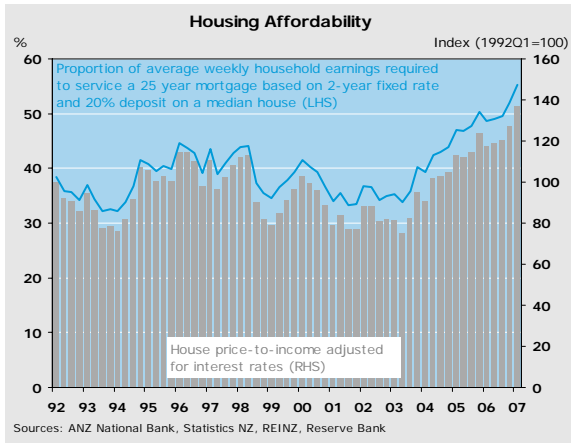
The battle continues, with affordability, debt servicing and the RBNZ saying slowdown, but liquidity and restricted supply providing support.

We use eight gauges to assess the state of the property market, and whether warning signs are emerging.

- > **Affordability.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (augmented for interest rates), and mortgage payments as a proportion of income.
- > **Serviceability / indebtedness.** For existing homeowners, serviceability relates interest payments to income while indebtedness is measured as the level of debt relative to income.
- > **Interest rates.** Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.
- > **Migration.** A key source of demand for new housing.
- > **Supply-demand balance.** We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.
- > **Consents and house sales.** These are both key gauges of activity in the property market.
- > **Liquidity.** We look at growth in private sector credit relative to GDP to assess the availability of credit in supporting the property market.
- > **Globalisation.** We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

Mortgage rates have risen, with most of the lending rates at or over 9 percent. This, combined with a slowing migration record and recent headline job restructuring, is playing into the Reserve Bank's hands. The question is have they got the patience to wait for the inevitable to happen, or are they willing to go once more to firmly hit that last nail into the inflation coffin.

Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Affordability continues to deteriorate sharply, not helped at all by rising mortgage rates.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden keep hitting new highs and show no signs of consolidating.
Interest rates	High	↓	Interest rates are virtually all over nine percent and will remain high for some time yet.
Migration	Medium	↔	Migration inflows are beginning to slow.
Supply-demand balance	Neutral	↔	Close to balance, in line with a slowing migration inflow.
Consents and house sales	On the up?	↔	The real estate market still looks to be supply constrained.
Liquidity	High	↑	Liquidity remains abundant and the demand for credit appears to be resilient at this stage.
Globalisation	Cheap in world terms	↑	On a relative basis, NZ property is still cheap.
On balance		↓	Hands up those that think the Reserve Bank has done enough?



Economic backdrop

Inflation remains the primary focus of the Reserve Bank. To ensure that inflation is unreservedly squashed, the Reserve Bank hiked the Official Cash Rate for the third time in four months. The first signs of the engineered economic slowdown are being detected but it is still early days.

Inflation is still very much alive and kicking.

> A case of third time lucky?

Inflation remains the key theme shaping the business cycle. Core inflation pressures are elevated and are necessitating a period of sedate growth. Our discussions around the country continue to highlight a disconcerting inflationary under-current. The RBNZ's forecasts show inflation remaining in the upper end of the 1 to 3 percent policy band over the coming three years, and highlight the lack of inflation headroom.

But it won't be for much longer if the RBNZ has its way.

Financial conditions have tightened. The Reserve Bank has increased its Official Cash Rate three times this year to 8.0 percent. The currency is historically high on the back of yield demand, and fixed lending mortgage rates are all above, or very close to 9 percent. Countering the sizeable tightening in financial conditions has been strong commodity prices (notably dairy), infrastructure investment, and expansionary fiscal policy. While such forces will support the economy, the overall tightening in financial conditions is expected to see the economy slow over the second half of 2007.

The economic pie is precariously placed on the window ledge to cool.

There are very early signs that the economy is turning. Consumer confidence has eased, business confidence has fallen sharply and migration inflows have come off their peak. However, it is far from conclusive, and the Reserve Bank is clear in its desire to see a sustained moderation in activity, and notably within the housing market. Monetary policy is expected to remain restrictive for some time as the Reserve Bank engineers the slow-down in the economy required to alleviate inflation pressure.

> Outlook for the property market

Has the Reserve Bank done enough? It's the million dollar question everyone is asking. Fixed lending rates have now converged on 9 percent. Six months ago you could have gotten a mortgage around 8 percent. The additional 1 percent in borrowing cost will add \$40 per week to a \$250,000 mortgage.

Housing momentum still prevails, for now.

Against this backdrop there are still a lot of positives around the country that should not be overlooked. Government spending and stratospheric dairy prices will add support to growth, employment and hence the housing market. But the more growth (inflation impetus) provided by these areas, the harder the Reserve Bank needs to hit another part of the economy. What one sector receives, Dr Bollard will take away from another. It's just a question as to how high rates need to go in order to engineer the desired outcome. Watch for that high NZ dollar to start impacting on exporters as well, with growing anecdotes of pending job losses.

Looking forward, we believe the real test for the housing market is likely to emerge around July, when the full impact of the massive surge in fixed lending rates to 9 percent manifests. From a borrower's perspective, there is now no place to run. Historically, the housing market has slowed around 3 months after interest rates have moved up. We expect this cycle to be no different. However, the real issue the Reserve Bank is facing is whether such a moderation will be temporary (i.e. six months) or sustained over a couple of years. Curbing inflation pressure requires the latter trajectory, and this means interest rates are likely to remain high for some time to make sure it happens.

Borrowing strategy

While we believe the Reserve Bank has finished raising interest rates, the risk profile remains skewed to the upside, and we struggle to see an easing for at least 18 months in the absence of a major event. We see little value in 5-year lending rates around 9 percent and continue to favour the slightly more expensive 2 and 3-year rates, which provide greater flexibility to take advantage when rates eventually move down.

> Key themes

Three themes dominate our interest rate view at present.

- **The risk profile for rates remains skewed to the upside**, with the Reserve Bank's June projections noting little inflation headroom, and incorporating a scenario that included a further movement up in rates. We put the odds on a further lift in the OCR at one in three.
- **Irrespective, it is difficult to see rates moving down for a long-time**, with 2008 *Budget* a likely sticking point given the sizeable impetus it will provide to the economy. While historically there has been a small window between the end of a tightening cycle and start of an easing cycle, such an outcome relies on the emergence of some sort of shock, and we cannot see anything on the horizon at present.
- **When rates do come down, it is likely to be aggressively**. History shows that central banks typically end up behind the curve (keeping rates too high for too long) and we expect this cycle to be no different. We continue to favour an aggressive easing cycle, but not until 2009.

> The choice?

The housing market will determine where interest rates head over the near-term. If you are bullish, and expect the market to remain strong (there are certainly good arguments for this such as limited supply), then lengthen your duration and take a 5-year rate. Interest rates are set to move up further and not come down for a long time. If you are more circumspect – such as ourselves – target the 2 and 3-year part of the curve. Our cautiousness stems from the vulnerabilities we see in the market when looking at debt serviceability. At some stage, monetary policy and interest rates are going to pack some punch. If there is one thing we know from markets in general, and history, it is that turning points when they emerge tend to sneak up on us, and be more aggressive in nature.

Our suspicion is that an untoward event will emerge at some stage. Typically such events are globally driven, and quickly transmit to the New Zealand economy and housing market. Around the globe there are a host of candidates, including a US housing market that is struggling, signs of tighter lending criteria, global imbalances, and an equity bubble in Asia. History tells us that unforeseen events do occur, and the global economy – while strong – does look fragile in areas. Yet we struggle to incorporate such an outcome into our core prognosis. Nonetheless, the potential for such a development is still relevant, and leaves us biased towards borrowing strategies that allow for a degree of flexibility.

> Themes we would recommend in the current environment

- **Take a balanced (diversified) approach.** A balanced approach to spread risk by having exposure to different parts of the yield curve.
- **We see the 2 and 3-year rates as more favourable than the 1-year at this stage.** There is still a chance that the Reserve Bank will increase the Official Cash Rate further, and at the very least, it doesn't look like they will be cutting interest rates until late 2008. Taking a two or three year term now will allow you to take advantage of lower rates in the second half of 2008, or early part of 2009.
- **We struggle to see value in the 5-year rate at present.**

Rates high for longer is the overarching theme...

...although borrowers should maintain a degree of flexibility.

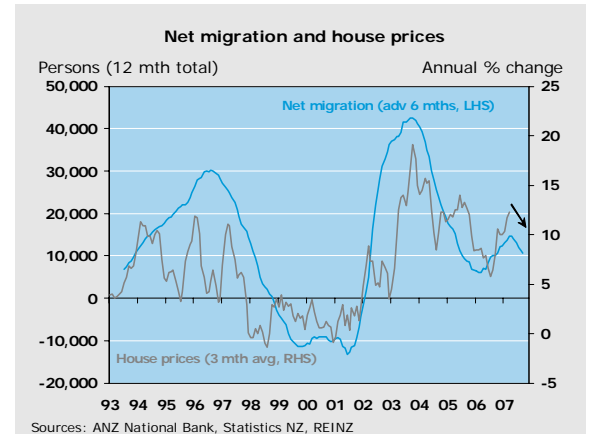
Two to three-year rates retain their position as the most attractive (relatively speaking).

Feature article – migration

Net migration inflows have eased over recent months and this is expected to correspond into a softening in housing market activity over the latter part of this year. Although a relatively unpredictable flow, we see further downside risks for net migration over the coming 12-18 months.

> Overview

Net migration inflows have eased over recent months to around 10,500 per annum. Looking at the trend in timelier 3 month data, migration is running around 5,000 annualised. At current levels, migration still provides a base level of support for the housing market, but is a far cry from the 42,000 plus reached in mid-2003, which was one of the key factors that stimulated the latest housing market cycle.



The net migration pattern in New Zealand tends to operate in large cycles. Because it is the difference between two large numbers – arrivals and departures – large swings in either can have a material impact on the net figure.

> Arrivals: some key trends

- **The number of permanent arrivals has stabilised.** In the 12 months to May 2007, the number of arrivals was 82,400. This has remained relatively stable over the past six months, although is well down on the peak of close to 99,000 in 2003, but up from a recent trough of 78,000 in the year ended March 2005.
- **It is the UK, not Australia where most of the immigrants arrive from.** In the late 1980s Australia was the largest source of permanent arrivals. However, the UK is now the largest source, with currently around 22,000 people arriving each year (27 percent of the total). This proportion has grown steadily since 2002, although has now stabilised. In the past 12 months, strong growth in arrivals has come from South Africa, Germany and Latin America and could be an indication that firms are looking to less traditional regions to help alleviate skill shortages.
- **The prime working age (25-39 years old) makes up the largest proportion of arrivals.** It is not surprising that this characteristic dominates the arrivals numbers given that residency and work permit requirements are skewed towards this age bracket. There has also been strong growth in the arrivals of those over 60 years old, although they make up a small proportion of the total.
- **There are now significantly less foreign students arriving.** Foreign student arrivals peaked in mid-2004 but have since collapsed. An appreciating NZD over the past few years and bad publicity surrounding education standards (including the collapse of some large institutions), are likely influences. However, there are still over 90,000 foreign fee-paying students in New Zealand. They spent an estimated \$1.2 billion in 2006 on tuition fees and living expenses, accounting for 10.2 percent of total services exports. What distinguishes foreign students from tourists is the impact they have on the property market.

Net migration inflows have eased.

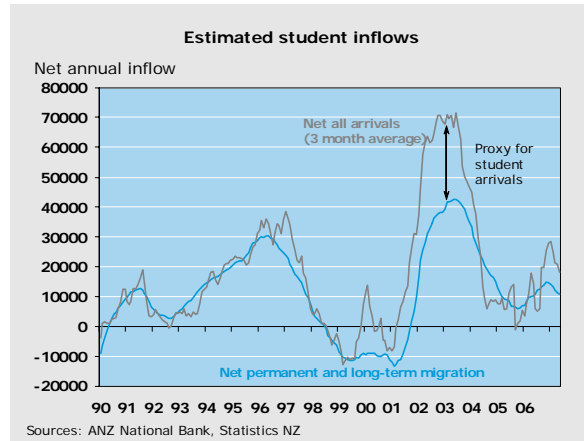
UK is the largest source destination for arrivals.

Foreign student numbers have slumped...

Tourists typically stay in short-term commercial accommodation such as hotels and motels. Foreign students, depending on the length of their courses, require longer-term accommodation. This is an additional source of demand for housing.

...but those that did arrive appear to have stayed.

- **Those students that that did arrive look to have stayed.** Inflows (as proxied by the difference between the annual net inflows of all arrivals and departures, and annual net PLT migration) may have dried up, but the fact that there has not been a corresponding outflow over the past couple of years suggests that the students who came have remained in the country, either to continue their studies or to work.

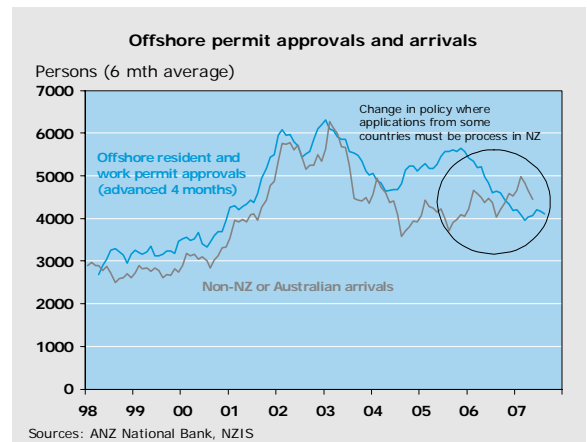


Government policy is important.

- **Government policy plays an important role in determining arrival numbers.** Those without New Zealand or Australian citizenship typically require a permit to settle permanently in New Zealand. The Government's flagship immigration policy is its Skilled Migrant Category. It is a system where prospective migrants earn points based on their education levels and previous work experience. The Government is currently in the process of reviewing the Immigration Act 1987. If this legislation passes, there will be significant changes to the way appeals are handled. There will be just one independent tribunal to handle reviews and appeals of migration decisions rather than the four that currently exist. It will also be much easier to deport someone and use classified information in the deportation decisions. Although an improvement, the impact of this legislation is more a tidy up of a currently complicated system and should have very limited macroeconomic impact.

Skill shortages will support demand for overseas migrants.

- **We expect permanent arrivals to remain steady.** A tight labour market and continued demand for skilled labour will provide an attraction for new migrants. Although there has been a decline in the number of offshore approvals for work and residence applications (which provide a reasonable lead for future arrivals), this is likely due to changes in immigration policy that require processing to be done in New Zealand for applications from certain countries. This can be seen by the large bulge that occurred over 2004-05, and then the fact that arrivals are now tracking above the number of offshore approvals.



Departures: some key trends

The number of people leaving has increased slightly...

...with most going to Australia.

The risk remains that more make the move over the Tasman as the NZ economy slows.

- **Permanent departures have increased over recent months.** In the 12 months to May 2007, the number of permanent departures was 71,700. It has hovered around the 70,000 per year level for the past 2 years, but has recently shown signs of an increasing trend.

- **Australia maintains its strong pulling power over New Zealanders.** Because New Zealand and Australia effectively operate as a single labour market, it is not surprising that almost half of all permanent departures are to Australia. As such, emigration to Australia is a key influence on the aggregate migration pattern. Job prospects across the Tasman have a strong pull effect, displaying a strong

correlation with the Australian unemployment rate in the past. This relationship broke down in 2001 when tighter welfare restrictions for New Zealanders caused a temporary skip in departures, followed by a fall which was exacerbated by the events of September 11 as New Zealanders delayed or put off their travel arrangements. Over recent months, the number of departures to Australia has begun to increase after a period of stability. The risk remains that with a strong labour market in Australia, higher wages and diverging tax policies, the number of departures will increase further.

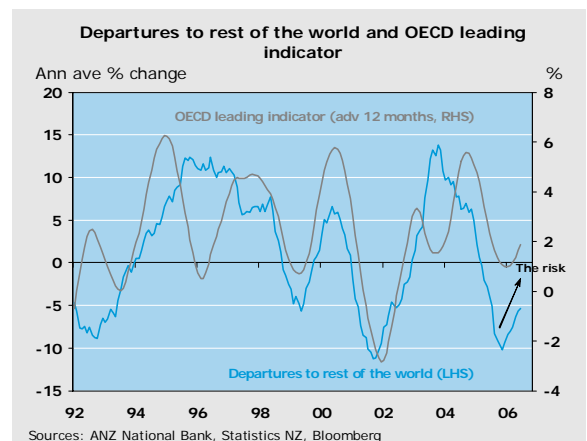
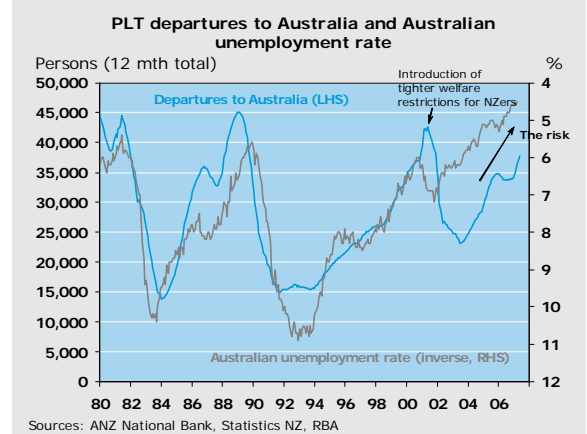
- **A strong global economy could also see an increased number of New Zealanders depart.** Just like with departures to Australia, prospects for global

growth tend to be a key driver of departures to the rest of the world. At the moment, departure numbers are down from a year ago. But with prospects for global growth looking attractive, especially relative to New Zealand's economic outlook, the risk is firmly for an increase in the number of New Zealanders heading overseas for their traditional, or extended, OE.

We see downside risk to net migration over the next 12 months.

> Outlook

Although we expect permanent arrivals to remain relatively steady over the coming 12-18 months, we see downside risks to net migration courtesy of an increase in the number of New Zealanders departing. Put simply, divergent economic prospects are expected to see emigration continue to rise. One implication from this is that migration is a consequence, as opposed to a cause, of the business cycle.



This would remove a key pillar of support for the housing market.

If the risks we highlight for net migration were to eventuate, a pillar of support for the housing market would be removed. However, we do not foresee a scenario where net migration turns negative, as it did during the 1998-2000 period. For that to occur, the New Zealand economy would have to be in recession and we would have to have some restriction on immigration (i.e. limit the numbers arriving). RBNZ work has flagged the potential for the Government to use this in order to help ease the pressure on house prices. But we do not expect this policy lever to be pulled. The lags would be too long. Moreover, it is departures as opposed to arrivals that are the big swing variable for migration, with the former beyond the control of policymakers (from the New Zealand side at least).

STATISTICAL ANNEX

Weekly mortgage repayments table (based on 25 year term)

Mortgage Size (\$'000)	Mortgage Rate (%)														
	7.50	7.75	8.00	8.25	8.50	8.75	9.00	9.25	9.50	9.75	10.00	10.25	10.50	10.75	
100	170	174	178	182	186	190	194	197	201	205	210	214	218	222	
150	256	261	267	273	279	284	290	296	302	308	314	320	327	333	
200	341	348	356	364	371	379	387	395	403	411	419	427	435	444	
250	426	435	445	455	464	474	484	494	504	514	524	534	544	555	
300	511	522	534	545	557	569	581	592	604	616	629	641	653	666	
350	596	610	623	636	650	664	677	691	705	719	733	748	762	777	
400	682	697	712	727	743	758	774	790	806	822	838	855	871	887	
450	767	784	801	818	836	853	871	889	907	925	943	961	980	998	
500	852	871	890	909	928	948	968	987	1,007	1,027	1,048	1,068	1,089	1,109	
550	937	958	979	1,000	1,021	1,043	1,064	1,086	1,108	1,130	1,153	1,175	1,198	1,220	
600	1,022	1,045	1,068	1,091	1,114	1,137	1,161	1,185	1,209	1,233	1,257	1,282	1,306	1,331	
650	1,108	1,132	1,157	1,182	1,207	1,232	1,258	1,284	1,310	1,336	1,362	1,389	1,415	1,442	
700	1,193	1,219	1,246	1,273	1,300	1,327	1,355	1,382	1,410	1,438	1,467	1,495	1,524	1,553	
750	1,278	1,306	1,335	1,364	1,393	1,422	1,451	1,481	1,511	1,541	1,572	1,602	1,633	1,664	
800	1,363	1,393	1,424	1,454	1,485	1,517	1,548	1,580	1,612	1,644	1,676	1,709	1,742	1,775	
850	1,448	1,480	1,513	1,545	1,578	1,611	1,645	1,679	1,713	1,747	1,781	1,816	1,851	1,886	
900	1,534	1,567	1,602	1,636	1,671	1,706	1,742	1,777	1,813	1,849	1,886	1,923	1,960	1,997	
950	1,619	1,655	1,691	1,727	1,764	1,801	1,838	1,876	1,914	1,952	1,991	2,029	2,069	2,108	
1,000	1,704	1,742	1,780	1,818	1,857	1,896	1,935	1,975	2,015	2,055	2,095	2,136	2,177	2,219	

Housing market indicators for May 2007 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a.)	Comment
Northland	15.4	5.6	257	(+7%)	45	The longest time to sell a house in the North Island
Auckland	12.5	6.1	3,070	(+5%)	27	Recorded the strongest price gains over recent months
Waikato/BOP/Gisborne	11.3	3.2	1,271	(+7%)	36	The number of days to sell remains at a 15-month low
Hawke's Bay	10.8	2.2	283	(-8%)	40	Behind the pack in terms of annual house price growth
Taranaki	20.3	1.1	191	(-8%)	31	Price growth has slowed over the past three months
Manawatu-Wanganui	18.6	4.7	425	(-6%)	32	Number of house sales hits a twelve-month low
Wellington	22.2	4.6	986	(+24%)	25	Strong rebound in the number of houses sold in May
Nelson-Marlborough	13.1	5.1	275	(-1%)	26	Coasting along at a similar clip to the national average
Canterbury/Westland	10.9	4.3	1,206	(+3%)	25	A lift in sale numbers, following three months of decline
Otago	9.8	2.4	333	(+3%)	27	Slowest annual house price growth across the regions
Central Otago Lakes	15.5	2.7	123	(-20%)	49	Registered the longest time to sell a property
Southland	36.2	5.8	240	(-1%)	20	House prices up by over a third from last year
NEW ZEALAND	14.8	5.1	8,465	(+1%)	28	Annual house price growth at an 18-month high

Key forecasts

Economic indicators	Actual			Forecast						
	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08
GDP (ann avg % chg)	1.4	1.5	1.7	2.2	2.5	2.5	2.2	1.7	1.5	1.5
CPI inflation (%)	3.5	2.6	2.5	1.7	1.6	2.5	2.6	2.7	2.8	2.9
Unemployment rate (%)	3.8	3.7	3.8	3.8	3.9	4.0	4.0	4.1	4.1	4.2

Interest rates	Actual			Forecast (end month)						
	Apr 07	May 07	Current	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09
Call rate	7.67	7.85	8.00	8.00	8.00	8.00	8.00	8.00	7.50	6.75
90-day bank bill rate	8.0	8.1	8.3	8.2	8.1	8.1	8.1	8.1	7.5	6.8
Floating mortgage rate	9.8	10.0	10.2	10.1	10.1	10.1	10.1	10.1	9.4	8.7
1-yr fixed mortgage rate	8.9	9.0	9.2	9.1	9.0	8.8	8.4	8.1	7.7	7.5
2-yr fixed mortgage rate	8.9	8.9	9.1	9.0	8.9	8.7	8.2	7.8	7.6	7.6
5-yr fixed mortgage rate	8.6	8.6	8.9	8.9	8.7	8.6	8.1	8.0	7.9	8.0

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