

## Irrational or rational exuberance?

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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 the ANZ Property Investor Survey.

### The month in review (page 2)

- > The Reserve Bank increased official interest rates to 7.50 percent, and left further increases on the table. They are examining other means through which they might force the housing market to cool its heels. Housing market data is showing little sign of the desired slowdown.

### Property gauges (page 3)

- > Our property gauges point to near-term momentum, but Reserve Bank warnings should not go unheeded. While higher interest rates may take time to bite on household spending, the Reserve Bank has made it clear that consolidation is required.

### Economic backdrop (page 5)

- > After waiting for the housing market to turn voluntarily, the Reserve Bank has taken more active steps to engineer a moderation, raising the OCR to 7.50 percent. The housing market remains on notice.

### Borrowing strategy (page 6)

- > Mortgage lending rates have increased sharply following the March *Monetary Policy Statement*. The risk to rates remains to the upside. We continue to see value in 2 year fixed lending, with longer term rates looking a tad high relative to averages.

### Feature article – ANZ Property Investor Survey (page 7)

- > The ANZ conducts a survey of property investors each year. The survey allows us to gain insights into the typical property investor, the results they achieved, and their expectations for the future. The 2007 survey has just been completed, and we report on the more interesting results.

### Key forecasts (page 9)



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## The month in review

**The Reserve Bank increased official interest rates to 7.50 percent, and left further increases on the table. They are examining other means through which they might force the housing market to cool its heels. Housing market data is showing little sign of the desired slowdown.**

**Reserve Bank's patience with the housing market has run out.**

**Little sign of moderation in housing market activity.**

**Mortgage borrowing remains strong.**

**One hike and door open to another.**

- > **RBNZ Monetary Policy Statement.** The Reserve Bank delivered on its January threat, increasing the Official Cash Rate 25 basis points to 7.50 percent at their March *Monetary Policy Statement*. The Reserve Bank has clearly lost patience with the ongoing resilience of the housing market. Ironically, the tough message that they wanted to deliver with their *Monetary Policy Statement* was diluted by talk about supplementary instruments, including "tightening of tax rules applying to housing investment and changes to bank capital requirements to help moderate the amplifying effect of credit on the housing cycle."
- > **REINZ housing data – February month.** The number of house sales was largely unchanged (down -0.3 percent, seasonally adjusted), and remains at an elevated level above 9,200. The average number of days to sell a house was unchanged at 31 days, while the median house price posted a new record high of \$335,000.
- > **Quotable Value housing data – February month.** QV data recorded a 9.3 percent increase in residential property values over the year to February. This is a slight improvement over the 8.8 percent increase recorded in the year to January.
- > **Migration – February month.** Two small monthly net permanent and long-term net migration inflows in January and February (+410 and +520, seasonally adjusted, respectively) have seen the annual net inflow ease to 13,150. The Reserve Bank will take some comfort that migration inflows are not accelerating, but at current levels, the net inflow will continue to provide a support base to the housing market.
- > **Building Consents – January month.** The number of residential building consents rebounded in January (up 3.9 percent, seasonally adjusted), following December's fall. The increase was due to a pickup in apartment consent issuance. Ex-apartment consents fell 4.5 percent. The monthly trend measures for residential and ex-apartment consents continue to fall, and at an accelerating rate.
- > **Mortgage Borrowing - January month.** Mortgage borrowing increased by \$1.5b in January, taking annual growth to around 14 percent. Ongoing robustness in mortgage lending suggests limited near-term slowing in the property market.

## Assessment

Data released over the past month suggests that the residential property market continues to ignore the Reserve Bank's warnings. Policy makers will take some comfort from a slowing trend in residential consent issuance, and from the lack of acceleration in net inward migration. But more timely indicators (REINZ, mortgage lending statistics) and anecdotes suggest that the residential property market is far from showing the moderating trend the Reserve Bank wants to see.

Against this backdrop, the Reserve Bank's decision to increase the OCR was no surprise. It will be interesting to see whether this increase has a noticeable effect on housing market activity. Certainly newspaper headlines ("Landlords' reply to Bollard: Who Cares?", NZ Herald, 10 March) the day after the rate hike announcement suggest that it will take more – more time for the effect of the rate hike to be felt, or more action from the Reserve Bank. While resilience remains, the Reserve Bank's threat to raise interest rates further cannot be discounted.

## Property gauges

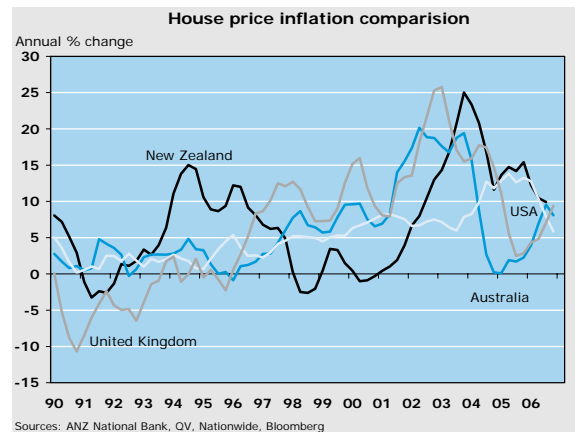
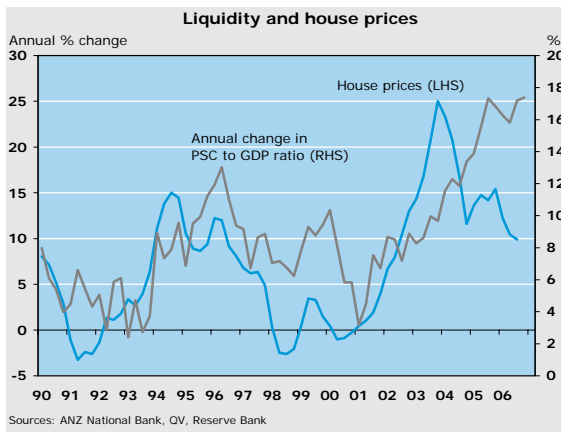
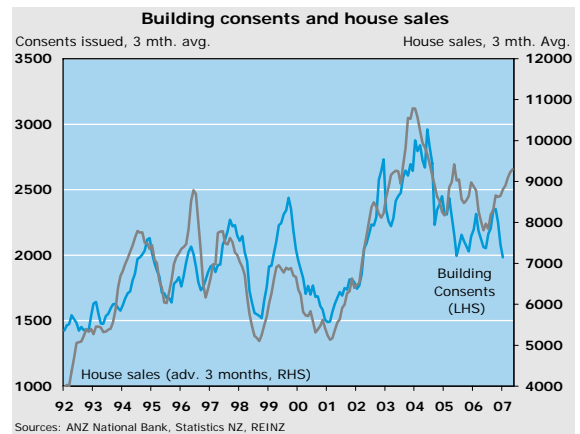
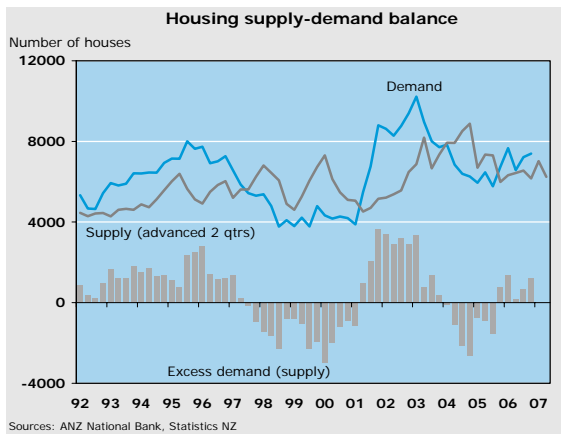
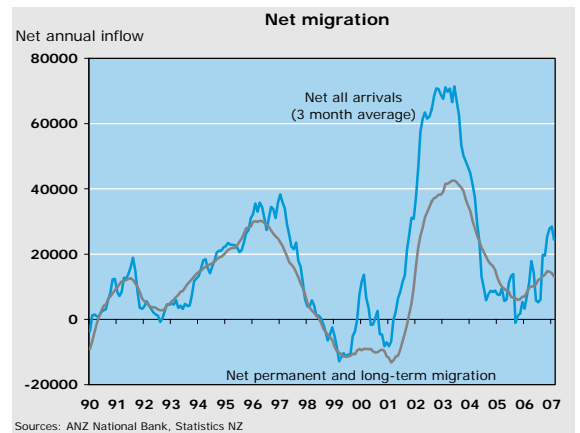
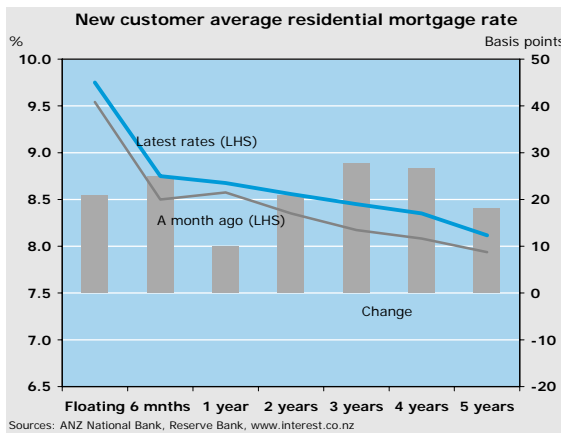
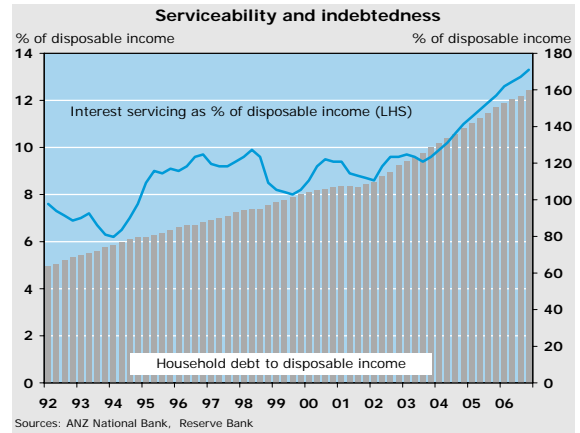
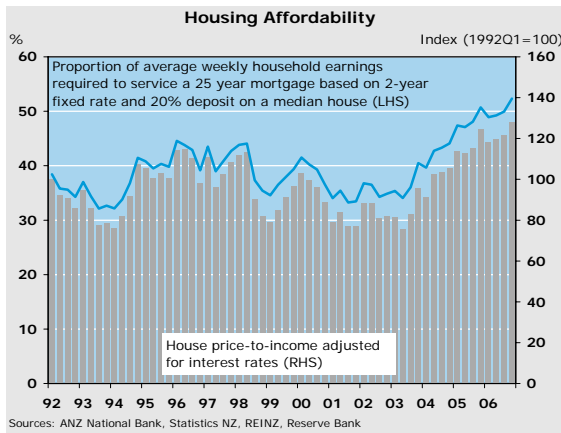
**Our property gauges point to near-term momentum, but Reserve Bank warnings should not go unheeded. While higher interest rates may take time to bite on household spending, the Reserve Bank has made it clear that consolidation is required.**

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.

Same story, different month. The tight labour market continues to provide the backbone for housing market activity, and steady net migration inflows are keeping demand elevated. Our gauges point to ongoing momentum in the property market in the near-term. Recent interest rate increases will take time to impact on borrower behaviour due to the prevalence of fixed rate mortgage borrowing.

Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Affordability has deteriorated, worsening to record levels.
Serviceability / indebtedness	High	↓	Household indebtedness and the debt servicing burden continue to hit new highs and show no signs of consolidating.
Interest rates	High and going higher	↓	Interest rates have increased sharply over the past month. The RBNZ raised the OCR and threatened more to come.
Migration	Medium	↑/↔	Migration inflows still positive.
Supply-demand balance	Neutral	↔	Slight excess demand emerging due to migration inflows and natural population growth.
Consents and house sales	On the up?	↔/↑	Momentum in housing market activity has been maintained, while consent issuance has consolidated.
Liquidity	High	↑	Liquidity remains abundant and demand for credit strong.
Globalisation	Cheap in world terms	↑	NZ property is still cheap on a global basis. Market becoming integrated with Australia.
<b>On balance</b>		↔/↓	<b>Property gauges point to ongoing momentum in the property market in the near term. But the extent to which many are stretched leaves us nervous about prospects.</b>



## Economic backdrop

**After waiting for the housing market to turn voluntarily, the Reserve Bank has taken more active steps to engineer a moderation, raising the OCR to 7.50 percent. The housing market remains on notice.**

### > Follow through...

Enough is enough. The residential property market's failure to show signs of moderating, along with the risks to the Reserve Bank's credibility if it continued to bark but failed to bite, saw them increase the Official Cash Rate at the March *Monetary Policy Statement*. Slower economic growth has not translated into reduced capacity constraints and medium term inflation pressures. This month's hike was "aimed at reducing the risk of an unsustainable rebound in activity" and can be thought of as an insurance policy against upside surprises in the economic outlook.

There is a real chance of a follow up move. The Reserve Bank signalled that "further tightening may be required". Partial indicators for the first quarter of 2007, while mixed to a degree, suggest that a firm base is forming, and this would place elongated and persistent pressure on inflation trends. So while we remain coy about calling a further interest rate increase, the bias for rates is clearly to the upside at present. The Reserve Bank is also looking at other instruments (to supplement the OCR), although it is difficult to see anything materialising anytime soon.

Internationally, a slowdown in the US housing market has resulted in a growing number of delinquencies at the subprime end of the market (subprime lending is targeted at borrowers with poor or no credit histories). While differences between the US subprime market and the New Zealand mortgage market suggest that we are unlikely to undergo similar stresses, the difficulties in the US highlight that the New Zealand market is vulnerable with the potential to turn sharply. A rising house price environment can cover many potential difficulties, but when price increases start to slow this can place pressure on more marginal market participants, and result in a sharp turnaround in the market.

### > Outlook for the property market

There is still considerable support for the housing market coming through from a strong labour market and reasonable net migration inflows. Nevertheless, the Reserve Bank has made its desire to see a slowing housing market abundantly clear. While Dr Bollard may not be entirely comfortable with raising interest rates to achieve this end game, he will do so if forced. Prospects of supplementary instruments to support the Official Cash Rate are, realistically, a diversion that are unlikely to be in force in the foreseeable future. Nevertheless, they are an indication of the Reserve Bank's frustration at the muted impact of interest rates on the housing market.

As we have noted previously, the direct impact on the housing market via one or two small rises in the Official Cash Rate is likely to be small. In a low unemployment and secure job environment, households are naturally interest rate insensitive. However, we know from late 2005 that when the Reserve Bank decides to up the ante through higher rates, house sales fall, days to sell a house rise and prices stabilise – quickly.

The indirect impact of higher interest rates on the housing market, through higher business borrowing costs, lower profitability, and a potentially higher currency have a marked impact on the business sector. When businesses come under pressure, costs become a stronger focus, and eventually this includes jobs. This focus on costs will be a major theme over the year ahead. If the labour market is impacted, this will be when monetary policy really hits households, and consequently, the housing market.

**One hike done....**

**...and prospect for another**

**Action in the US subprime market highlights how quickly a market can turn.**

**The housing market may be interest in-sensitive.**

## Borrowing strategy

**Mortgage lending rates have increased sharply following the March *Monetary Policy Statement*. The risk to rates remains to the upside. We continue to see value in 2 year fixed lending, with longer term rates looking a tad high relative to averages.**

### > End of their tether

The March Official Cash Rate increase had been expected by financial markets, and was largely priced into wholesale interest rates. Despite some uncertainty about the strength of the Reserve Bank's willingness to raise rates further surrounding the announcement, their message that they would do what it takes to ensure that the desired slowdown occurred has been taken on board. Markets are attaching a reasonable probability of a follow up hike (currently around 65 percent chance of a rate hike by June is priced into wholesale interest rate markets).

We are not convinced that a rate hike will be delivered but we acknowledge that the risks to interest rates remain to the upside. The trade-off for no increase will be a sustained period of rates at current levels. This is where our interest rate view has changed over the past month – previously we had envisaged that the Reserve Bank may have been able to ease rates slightly towards the end of 2007 before delaying further cuts until after the 2008 *Budget*. Now, those late 2007 cuts are looking unlikely. With rates appearing to be higher for longer, interest rates across the mortgage curve have been increased.

### > Don't look down

The subtle shift in our interest rate expectations does little to alter our recommended borrowing strategy. With the next moves in the Official Cash Rate likely to be in the form of aggressive cuts in 2009, the short-end of the curve remains unattractive and 2-year or 3-year rates should be considered in order to take advantage of lower rates in 2009.

Recent increases in 5-year fixed mortgage rates reduce the attractiveness of fixing for these longer terms. These rates still offer some cash flow relief (8.15 percent compared with 8½ percent in the two to three year part of the mortgage rate curve) but the outright interest rate is now high from a historical perspective. The trade-off between short term cash flow relief and being locked in at higher rates for longer (and not being able to take advantage of lower rates when the Reserve Bank starts to ease policy or the housing market turns), has shifted back towards favouring staying away from this part of the yield curve.

### > 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 five-year part of the curve at present.** While providing near-term cash-flow relief, longer-term rates look expensive relative to historical benchmarks, and you risk being locked in at a high rate and missing the opportunity to re-finance lower, when the housing market does turn.

**Higher wholesale interest rates have flowed through into mortgage borrowing rates.**

**The 2-3 year rates seem more favourable.**

## Feature Article – The ANZ Property Investors Survey

**The ANZ conducts a survey of property investors each year. The survey allows us to gain insights into the typical property investor, the results they achieved, and their expectations for the future. The 2007 survey has just been completed, and we report on the more interesting results.**

**Everyone is optimistic about property prices.** Only 2 percent of respondents expect prices will fall over the year ahead. The median price expectation over the year ahead is 5 percent, 7.5 percent for 5 years, and more than 10 percent over the next decade.

We concur with the generally optimistic view of property. There have been structural improvements in the economy. Better economic growth on average will underpin income growth, and housing demand. The New Zealand property market is becoming integrated with offshore property markets. Demographic, retirement and migration trends are supportive of some regions in particular. Housing continues to have a considerable tax advantage, although there may well be a slight tightening up going by nuances from the Reserve Bank!

But the magnitude leaves us a little perplexed. House prices have averaged 9.2 percent since 1960, and 2.4 percent in real terms (i.e. removing the impact of higher inflation). Or even looking at more recent times, nominal house price growth has averaged 7.1 percent since 1990, and 4.7 percent excluding inflation. It is precisely this sort of exuberance that the Reserve Bank is seeking to quell. This does not mean the Reserve Bank is anti-property investment. Merely that the magnitude of the expected gains would ultimately place considerable stress on the economy. If incomes are expected to grow at 5 percent, and house prices double that, the housing market becomes progressively unaffordable. As a nation we will likely still be living beyond our means, taking on progressively more debt. While a fundamental principle of finance is that debt is a cheaper source of funding than equity, it does not come without risks, particularly if the value of the asset sometimes falls. And that is precisely what has happened on three occasions since 1991.

**People are still looking to accumulate property, with a net 50 percent of survey respondents expecting to buy over the coming year.** This ties in with the generally bullish long-term view of property, but also with the difficulties the Reserve Bank is having reining the market in. Of the remaining 50 percent, the principle reason for not buying is that rents are too low against the cost of property. Only 17 percent of respondents do not plan to buy in the next 5 years.

**The median gross yield for residential property investment is 4½ percent, while half the respondents reported negative net yields.** So property tends to be run at a loss, with only 4 percent of respondents reporting net yields between 3 and 5 percent. This suggests that investors have strong expectations of further capital gains to compensate for poor rental returns. This is consistent with the expectation noted above that property prices will keep increasing.

With properties being run at a loss, it is not surprising that **LAOC's are the most common ownership vehicle.** 55 percent of respondents hold their investment properties in a Loss Attributing Qualifying Company (LAOC). 36 percent hold properties privately in their own name.

**Gearing is not high, which we take as testament to the long-term nature of investors.** 62 percent of respondents reported a gearing ratio of 0.5 or less. Furthermore, the average approximate market value of residential properties recorded was \$1.47m, and the average equity held in residential properties was \$700,000. This suggests that property investors are, as a generalisation,

reasonably well placed to weather any contraction in property prices, or even to expand their property portfolio.

**The mean household income of the property investors surveyed was between \$80,000 and \$90,000 per annum**, excluding investment property income. This appears to contradict the general perception that property investors tend to be in the \$100,000+ income brackets (37 percent of respondents fit into this income bracket). 14 percent of respondents earn less than \$40,000 per annum, which goes to show you do not need a high income to get into property investing. The income distribution of survey respondents also contradicts the broad proposition that the change to the top marginal tax rate has been a key source of demand for residential property as an implicit tax dodge.

**Investors are of a diverse age.** While the age of property investors tends to be more "bunched" than the population as a whole, there is still a high degree of age diversity. 60 percent of respondents to the survey were under 50 years of age. Only 12 percent were over 60. This age profile suggests that the bow wave of properties which some commentators are expecting to hit the market as property investors retire is far from imminent.

**The average number of residential properties owned by survey respondents is five**, which suggests that most are serious property investors. At the same time, a number of survey respondents also reported having other investments (predominantly in shares, bonds, and managed funds). While this provides a hint of diversification in investment portfolios, the survey does not provide a more detailed breakdown of portfolios, leaving question marks about the extent of portfolio diversification.

#### > The upshot

Property investors are naturally optimistic and the ANZ Property Investors Survey bears this out. While we concur with the broad sentiment, we need to sound a cautionary note. As mentioned above, the magnitude of the expected gains among survey respondents would ultimately place considerable stress on the economy. Recent strength in the housing market (and consumer sector more generally) has resulted in economic imbalances (in the form of an unsustainable current account deficit) and inflation pressures that are of concern to the Reserve Bank. To combat these pressures, the Reserve Bank has made it clear that it wants to see a moderation in housing market activity and consumer demand. We have already seen interest rate increases to try to engineer this result, and the Reserve Bank has signalled that they are prepared to increase interest rates further if such a moderation does not occur.

We note that both the Reserve Bank and Minister of Finance are looking at tightening up on the use of LAQC's and stricter enforcement of existing tax rules on capital gains (made on properties that are bought with the intention of selling for a profit). Given the results of our survey, a clamp down of this nature would appear to have implications for many residential property investors. While uncertainty remains, the Reserve Bank and Government's investigations are still in the exploratory stages at present and will not be acted upon for some time. Changes will also prove to be unpopular with the electorate, raising doubts about the political will to follow through on them, and changes potentially raise more issues than they would correct. Consequently, while we recommend that property investors keep a close eye on developments, they should not be overly concerned yet.

## STATISTICAL ANNEX

## Weekly mortgage repayments table (based on 25 year term)

Mortgage size (\$'000)	Mortgage rate (%)													
	6.75	7.00	7.25	7.50	7.75	8.00	8.25	8.50	8.75	9.00	9.25	9.50	9.75	10.00
100	159	163	167	170	174	178	182	186	190	194	197	201	206	210
150	239	244	250	256	261	267	273	279	284	290	296	302	308	314
200	319	326	333	341	348	356	364	371	379	387	395	403	411	419
250	398	407	417	426	435	445	455	464	474	484	494	504	514	524
300	478	489	500	511	523	534	545	557	569	581	592	604	616	629
350	558	570	583	596	610	623	636	650	664	677	691	705	719	733
400	637	652	667	682	697	712	727	743	758	774	790	806	822	838
450	717	733	750	767	784	801	818	836	853	871	889	907	925	943
500	797	815	833	852	871	890	909	928	948	968	987	1,007	1,027	1,048
550	876	896	917	937	958	979	1,000	1,021	1,043	1,064	1,086	1,108	1,130	1,153
600	956	978	1,000	1,022	1,045	1,068	1,091	1,114	1,137	1,161	1,185	1,209	1,233	1,257
650	1,036	1,059	1,083	1,108	1,132	1,157	1,182	1,207	1,232	1,258	1,284	1,310	1,336	1,362
700	1,115	1,141	1,167	1,193	1,219	1,246	1,273	1,300	1,327	1,355	1,382	1,410	1,438	1,467
750	1,195	1,222	1,250	1,278	1,306	1,335	1,364	1,393	1,422	1,451	1,481	1,511	1,541	1,572
800	1,274	1,304	1,333	1,363	1,393	1,424	1,454	1,485	1,517	1,548	1,580	1,612	1,644	1,676
850	1,354	1,385	1,417	1,448	1,480	1,513	1,545	1,578	1,611	1,645	1,679	1,713	1,747	1,781
900	1,434	1,467	1,500	1,534	1,567	1,602	1,636	1,671	1,706	1,742	1,777	1,813	1,849	1,886
950	1,513	1,548	1,583	1,619	1,655	1,691	1,727	1,764	1,801	1,838	1,876	1,914	1,952	1,991
1,000	1,593	1,630	1,667	1,704	1,742	1,780	1,818	1,857	1,896	1,935	1,975	2,015	2,055	2,096

## Housing market indicators for February 2007 (based on REINZ data)

	House prices (Annual % change)	3 month % change	Average days to sell	Comment
Northland	18.8	12.1	44	Strongest price gains recently
Auckland	13.3	3.0	29	Prices rebound from a weaker January
Waikato	14.6	3.0	37	Days to sell revert back to the mid-30s
Bay of Plenty	7.1	3.3	51	Second longest time to sell
Gisborne	-5.1	-2.9	29	Gisborne's house prices have taken a hammering
Hawke's Bay	14.6	1.9	54	Selling in the Bay proves to be a waiting game
Taranaki	16.0	7.3	43	House prices take a breather from a month earlier
Manawatu-Wanganui	18.3	5.1	40	Days to sell up to a 13-month high
Wellington	23.4	2.6	22	Time to sell back to the low-20s
Nelson-Marlborough	1.9	1.2	27	House price growth eases to an 11-month low
West Coast	29.4	7.8	38	Bargain prices being snapped up
Canterbury	13.4	2.1	30	Recent price gains losing momentum
Otago	12.1	9.2	36	Solid price rises in the past 3 months
Southland	35.6	3.3	20	New Zealand's regional hot spot
NEW ZEALAND	15.8	2.9	32	Remains on cruise control but roadworks ahead

## Key forecasts

Economic indicators	Actual			Forecast						
	Jun 06	Sep 06	Dec 06	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
GDP (ann avg % chg)	1.6	1.4	1.7 <sup>e</sup>	1.7	1.9	2.1	1.8	1.6	1.6	1.8
CPI inflation (%)	4.0	3.5	2.6	2.4	1.6	1.5	2.3	2.4	2.5	2.6
Unemployment rate (%)	3.6	3.8	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2

Interest rates	Actual			Forecast (end month)						
	Jan 07	Feb 07	Current	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08
Official Cash Rate	7.25	7.25	7.50	7.50	7.50	7.50	7.50	7.50	7.50	7.25
90-day bank bill rate	7.7	7.7	7.9	7.7	7.6	7.6	7.6	7.6	7.6	7.2
Floating mortgage rate	9.5	9.5	9.8	9.7	9.6	9.6	9.6	9.6	9.5	9.1
1-yr fixed mortgage rate	8.5	8.6	8.7	8.6	8.5	8.4	8.2	8.0	7.6	7.2
2-yr fixed mortgage rate	8.2	8.4	8.5	8.4	8.3	8.2	8.0	7.9	7.5	7.2
5-yr fixed mortgage rate	7.9	7.9	8.1	8.1	8.1	7.9	7.8	7.8	7.6	7.4

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