Property Focus
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TAKING THE PLUNGE

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Summary

- Our 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 favoured mortgage borrowing strategy. In this issue we feature an overview of the key macro issues that will shape 2009.

The month in review (page 2)

- Some real estate indicators are starting to suggest a base is forming in the property market, but this needs to be read in conjunction with near record declines previously. Interest rates continue to fall, which is providing a lifeline to the property sector, although once again they need to be interpreted within the context of a severe economic downturn.

Property gauges (page 3)

- Several indicators in the real estate market are starting to turn and point in the right direction. But after such a huge overshoot on the way up, they will likely undershoot on the way down.

Economic backdrop (page 5)

- 2009 will be a tough year, and that's putting a positive spin on it. We expect New Zealand to remain in recession until mid-year, meaning six consecutive quarters of economic decline. The property market, which was first-in, would naturally be expected to be first-out. However, the challenge over 2009 will come from a rising unemployment rate, which risks setting off a second leg to the correction.

Mortgage borrowing strategy (page 6)

- Mortgage rates continue to fall, particularly for longer maturities, which have "caught up" with earlier falls in short-term fixed rates. As a result, fixed rates are now close to 7 percent for terms ranging from 6 months to 5 years. As the RBNZ cuts the OCR further, we expect to see mortgage rates fall further. However, we need to be mindful of what's priced in already, widening margins and the likelihood that long-term rates don't fall as far as short-term rates.

Feature article – Key macro issues for 2009 (page 7)

- In this article, we outline some of the key themes we see evolving over the year ahead which we expect to play an influential role in New Zealand's economic prospects and hence the housing market. Most point to a very challenging 2009, as the economy adjusts and rebalances.

Key forecasts (page 24)

The month in review

Some real estate indicators are starting to suggest a base is forming in the property market, but this needs to be read in conjunction with near record declines previously. Interest rates continue to fall, which is providing a lifeline to the property sector, although once again they need to be interpreted within the context of a severe economic downturn.

This diving board still has a little spring in it.

> **Building Consents – November.** Residential building consent issuance recorded a small technical rebound in November, rising 4.3 percent. However, this follows a 19.7 percent fall in October, which took issuance to its lowest level (seasonally adjusted) on record. In fact, excluding apartment issuance, residential consent issuance continues to tumble, falling another 4.0 percent in November, following a 7.3 percent fall in October.

> **REINZ housing data – December.** In seasonally adjusted terms house sale volumes rose 27 percent, although they are still down 23 percent on a year ago. The median number of days to sell (seasonally adjusted) rose slightly, from 47 days in November to 49 days, although still down on the peak of 57 days in July. The median house price fell to $328,500 from $337,500, to be down 4.8 percent on a year ago (although 6.7 percent from its peak).

Mortgage lending takes a trip through the Bermuda Triangle.

> **Mortgage Lending – November.** Household credit growth for the month of November recorded a 0.1 percent decline, the first drop since the series began in 1991. Annual household credit growth was 5.2 percent, but the more timely 3-month annualised rate eased to 1.8 percent in November.

> **Westpac Consumer Confidence – December quarter.** Westpac/ McDermott-Miller's consumer confidence figure eased following the surge in the previous quarter. It seems that the tough economic climate ahead is slowly dawning upon consumers, who were previously buoyed by cheaper petrol, tax cuts and lower mortgage rates. Consumers remain very cautious, and the reading on whether it is a good time to buy a major household item continues to oscillate around zero - which does not bode well for retail spending in the months ahead.

Atlantis, here we come.

> **Net Migration – November.** Permanent and long-term arrivals fell, and departures rose. And it wasn't just the usual exodus to Australia as well, although that continued with the net annual outflow to Australia now the highest on record at 35,300 (surpassing the previous peak of 33,700 in the January 1989 year). Indeed, departures to all other countries continue to rise.

Assessment

Volume based indicators suggest the property market has started to find a base, but within the context of huge falls over the previous year. This is in part a natural outcome as a bungy cord dynamic comes to the fore. As attention turns to 2009, the obvious question is will prices stop falling. The answer in our eyes is “no”. Certainly, the Reserve Bank is providing support by cutting interest rates aggressively. But such action needs to be read in conjunction with the economic climate and a world-wide recession. NZ is now facing not only a recession, but the longest one we've seen since the 1970's. As far as the property market goes, all eyes will be on the job market, with anecdotes and evidence pointing to a rapid rise in the unemployment rate.

Property gauges

Several indicators in the real estate market are starting to turn and point in the right direction. But after such a huge overshoot on the way up, they will likely undershoot on the way down.

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

Will we see a crisp, clean tuxedo, once the wet suit is peeled off?

> **Affordability.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (adjusted 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.

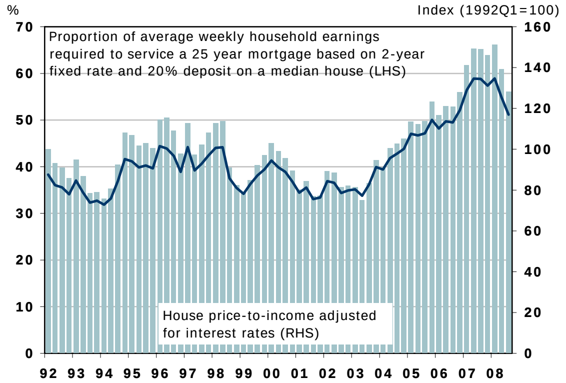
> **Liquidity.** We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.

> **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.

Fixed mortgage rates have dropped considerably over the past fortnight, especially at the longer-end of the mortgage rate curve. Despite positives coming from lower mortgage rates and tax cuts, the outlook for the New Zealand real estate market remains a challenging one over the next 12 months.

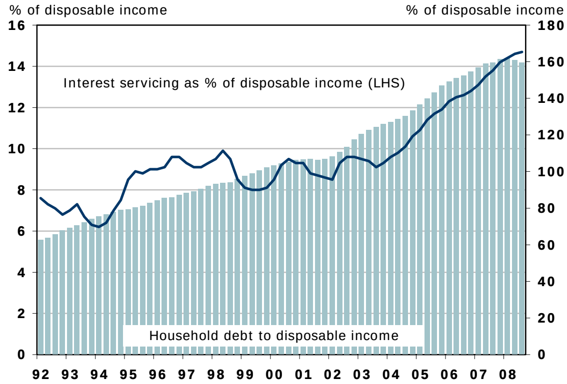
Indicator	Level	Direction for prices	Comment
Affordability	A long way to go	↓	Housing affordability has improved to the most affordable levels in two years, but is still "expensive".
Serviceability / indebtedness	Peaked	↓	Serviceability looks to have peaked, but remains high.
Interest rates	Here comes another one	↑	Mortgage rates have eased in anticipation of another large cut to the OCR.
Migration	Deflated	↔	Annual net migration, while positive, continues to ease.
Supply-demand balance	Excess demand	↔↑	Not on an even keel as demand has held up but supply has eased to a six-year low.
Consents and house sales	Rock bottom?	↔	Knocking on 16-year lows.
Liquidity	Wave-like	↓	Liquidity feels the squeeze.
Globalisation	Man overboard	↓	A new recruit to the "dive" club.
On balance		↓	Hypoxia (inhaling a breathing gas that contains insufficient oxygen to support normal activities).

Housing Affordability



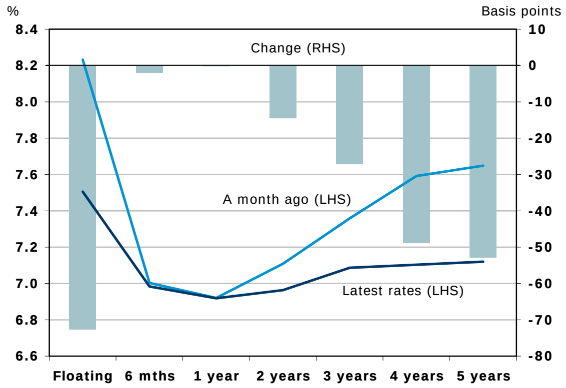
Sources: ANZ National Bank, Statistics NZ, REINZ, Reserve Bank

Serviceability and indebtedness



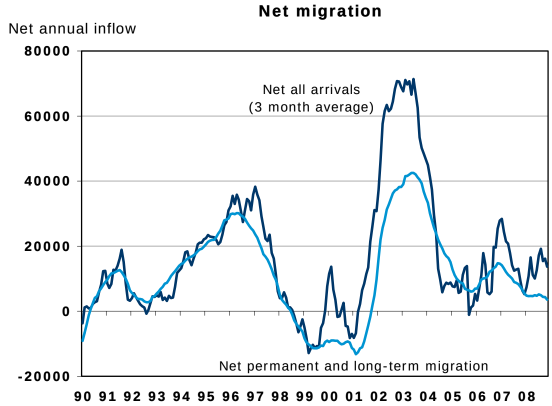
Sources: ANZ National Bank, Reserve Bank

New customer average residential mortgage rate



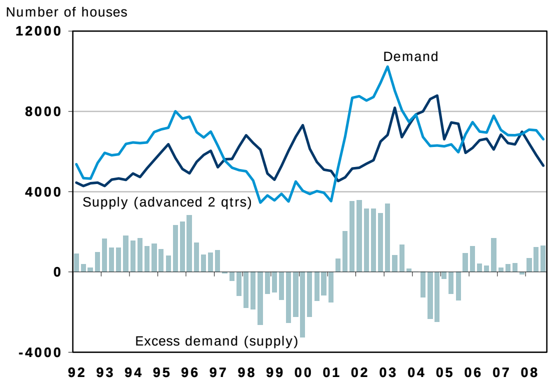
Sources: ANZ National Bank, Reserve Bank, www.interest.co.nz

Net migration



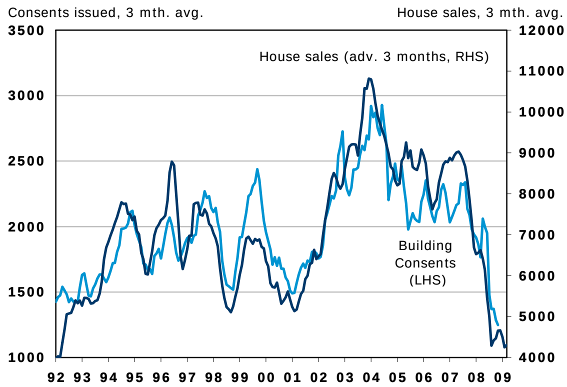
Sources: ANZ National Bank, Statistics NZ

Housing supply-demand balance



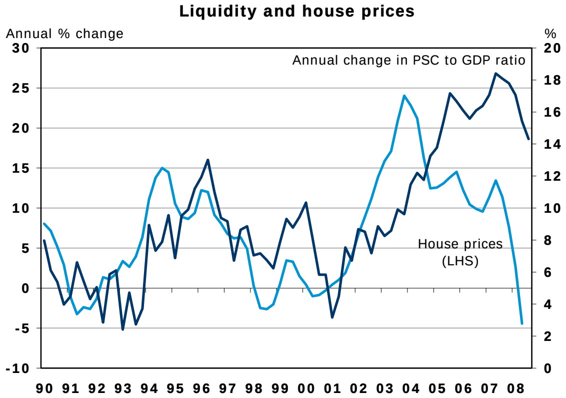
Sources: ANZ National Bank, Statistics NZ

Building consents and house sales



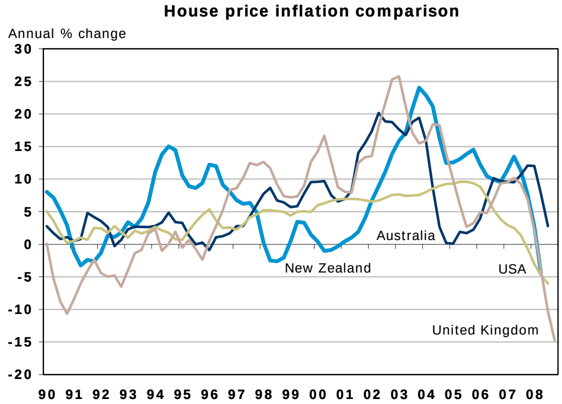
Sources: ANZ National Bank, Statistics NZ, REINZ

Liquidity and house prices



Sources: ANZ National Bank, QV, Reserve Bank

House price inflation comparison



Sources: ANZ National Bank, QV, Nationwide, Bloomberg

Economic backdrop

2009 will be a tough year, and that's putting a positive spin on it. We expect New Zealand to remain in recession until mid-year, meaning six consecutive quarters of economic decline. The property market, which was first-in, would naturally be expected to be first-out. However, the challenge over 2009 will come from a rising unemployment rate, which risks setting off a second leg to the correction.

Our core economic view

The Hunt for the Red OCRober.

The economic environment hasn't improved since our last issue of *Property Focus,* and suffice to say, conditions have deteriorated. A telling economic indicator that has been released since the Christmas holidays is the NZ Institute of Economic Research's *Quarterly Survey of Business Opinion* (QSBO). As a whole, the survey is at its worst in thirty years. This would suggest that not only will the final quarter of 2008 be a negative outturn, so too will be March 2009 and potentially the same for June. That would result in New Zealand recording six consecutive quarters of negative economic growth. In light of this protracted drop in economic activity, we expect the Reserve Bank of New Zealand to trim 100 basis points off the Official Cash Rate (OCR) later this month, with the potential for another cumulative 100 points to be shaved off the OCR over the next couple of scheduled monetary policy reassessments.

We were already reasonably downbeat on the economy's prospects over 2009 when we presented our *Quarterly Economic Forecasts* at the end of last year, with an expectation of a contraction in GDP of 1.1 percent over the year. However, following the QSBO we now expect the contraction to be closer to 2 percent than 1 percent – surpassing the weakness over 1990/91. But a flipside to our expectations of a more pronounced trough is also a sharper recovery over late 2010 and into 2011.

Around the globe there has been a further deterioration in economic conditions, and this is being felt in NZ via less demand for exports, falling tourism numbers (and bookings) and lower commodity prices. New Zealand is not immune to the deepest global recession we have seen in more than 30 years. Moreover, it's coming at a time when pockets of the domestic economy such as retailing and housing are doing it tough. Hence, the economy is desperately short of economic engines. As time moves on we're also seeing the recession broaden and deepen. It started in Auckland, but is now rapidly moving south.

In our view, the next leg of the business cycle will be driven by a marked deterioration in the labour market. To date, employment has been showing its natural lagged response, but with flat growth over the first three quarters of 2008, the general expectation (or perhaps hope) was that the dip would prove to be short-lived. In the current environment that is now clearly unrealistic. We foresee employment falling by over 2 percent in 2009, and consequently, we expect to see the unemployment rate rise to at least 7 percent, with potential upside risk. This in turn risks setting off round two for the property market.

Mortgage borrowing strategy

Mortgage rates continue to fall, particularly for longer maturities, which have "caught up" with earlier falls in short-term fixed rates. As a result, fixed rates are now close to 7 percent for terms ranging from 6 months to 5 years. As the RBNZ cuts the OCR further, we expect to see mortgage rates fall further. However, we need to be mindful of what's priced in already, widening margins and the likelihood that long-term rates don't fall as far as short-term rates.

Our view

Mortgage interest rates are likely to gradually drift lower as the easing cycle continues. We also expect to see the floating rate fall so that it is either equal to, or below all fixed rates, with the exception of the 6 month rate – a situation that hasn't prevailed for almost 9 years. Generally speaking, this is good news for borrowers, and one of the few positives that comes from an economic slowdown. However, there are three limiting factors:

1. these expectations are already partly "factored in". This means that we need to see the general flow of news and data deteriorate even more markedly for interest rates to move even lower. We think this is likely, but the proof will be in the pudding, so to speak;
2. margins are under pressure. Wider wholesale funding margins means wider mortgage margins. As has been the case for some time now, falling market (or "swap") interest rates will not be reflected point for point in mortgage rates;
3. the tendency for short-term interest rates to fall further than long-term rates as we near the end of the easing cycle. This means that when the time comes to extend the length of your fixed mortgage, you should expect to pay a higher rate. This is almost inevitable.

Themes we favour in the current environment

As interest rates move lower, it will naturally be tempting to fix your mortgage at a rate that seems attractive relative to recent history. Getting this right clearly depends on getting the timing right, and is complicated by the third point raised above. That is, as the general level of interest rates falls, it will cost more to fix for a longer period. While this isn't the case at the moment, the gap between short- (i.e. < 2yrs) and long-term (3yrs+) wholesale interest rates is widening, and this will soon be reflected in mortgage rates. This has the effect of discouraging borrowers for opting for the more costly longer terms – however at some stage, it will pay to do so.

Play it safe and swim between the flags.

Historical experience (here and overseas) shows that long-term rates don't tend to fall as far as short-term rates. At some stage then, borrowers may wish to consider taking a step up into a more expensive longer-term fixed rate if they would like longer-term certainty. However, we don't believe that time has come yet, and we favour floating, or short-term fixed rates like the 6 month. The obvious problem of fixing for longer (even for just 1-2 years) now is that you will be tied in, and won't be in a position to lengthen should long-term mortgage rates bottom out sooner rather than later. By contrast, by remaining floating, or fixing for just 6 months, you will have the benefit of being able to review the situation later in the year.

Key macro issues for 2009

In this article, we outline some of the key themes we see evolving over the year ahead which we expect to play an influential role in New Zealand's economic prospects and hence the housing market. Most point to a very challenging 2009, as the economy adjusts and rebalances.

There are a host of assumptions that underpin any set of economic forecasts. Some of these are cyclical in nature, some are structural. From the outset we have to acknowledge some BIG picture macro assumptions that underpin or anchor our view – particularly in regard to the international environment. From these themes also flows the outlook for the property market.

Our baseline assumption is that the worst has passed for the credit crisis itself, but the actual healing process will prove to be elongated (with the odd spike of nervousness, such as we are seeing now). That is, credit conditions will take time to return to more "normal" settings, and by normal we mean levels that were apparent a decade ago as opposed to between 2001 and 2006. However, the real economic consequences are likely to linger for some time, probably for another 24 months as we experience a significant global recession. We are now only starting see the real economic consequences of the financial crisis as we enter leg two of the adjustment process. The process of de-leveraging around the globe will continue to be a significant influence, particularly for asset prices. Inflation concerns are dead, at least for now. The current credit malaise is truly global, hence no region has the ability to drag the others out as we navigate the deepest and most pronounced global recession in close to 30 years (and arguably longer).

What follows are our seven major themes for the New Zealand economy in 2009, which implicitly underpin our economic and financial market views, and also how we see the property market performing.

We have to note from that outset that we haven't taken a lot of joy penning most of these themes. As commentators it is sometimes difficult to get the appropriate balance between awareness (forewarning) without sounding like Chicken Little. But we also have a responsibility to tell it like it is. The hope is that by informing people of the scale of challenges ahead, the smoother the inevitable transition will be.

1. First-up we need to accept that the environment has changed and the time for complacency has ended.

Over 2008 we were often surprised at the complacency towards global developments. Facing the biggest financial crisis in 80 years, NZ's Achilles' heel, namely a huge external liability position, meant that the economy was already under the spotlight and set for a rough ride. This didn't mean anyone needed to push the panic button (and "Chicken Little" style analysis does more harm than good), but neither did it mean trying to bury one's head in the sand.

But clearly, just as in dealing with grief, the cycle of change evolves slowly. First comes denial, then anger, and after that acceptance. We appear somewhere between legs one and two.

A lot of the change we envisage will involve getting back to basics and adhering to traditional fundamentals – such as traditional loan-to-value ratios, focusing on cash-flow, lowering expectations towards potential capital gains from asset prices, looking at cash-flow, the fundamentals of the investment, paying close attention to cash-flow...........did we mention how important cash-flow was likely to be? Relationships and trust, as opposed to purely price, will become more influential. For many, this will merely be a case of going back to the way things were. This is true, to a degree. We also expect considerable structural changes across the global economy over the coming decades. Facing a once in a generation crisis, we struggle to see the world remaining as it was.

Changes will likely include the growing importance of scale and certainty. Once again, trust will form the linchpin of relationships. We fully expect to see shifts in global monetary policy mandates, which are likely to involve an implicit targeting of asset prices.

There also looks to be some key negative risks as well, notably when it comes to attitudes towards protectionism and an inevitable rise in regulation (particularly of financial institutions). These sorts of changes, and less capital accumulation in the near-term, have us increasingly thinking about the supply side capacity of the global economy (and NZ) going forward. After all, it is the trend rate of growth that is more important in the long run than the cycle. Some small nudge lower in long-term potential growth rates seem warranted, but at this stage, "small" is the appropriate term.

In such an environment of inevitable change, it is all about concentrating on the basics: relationships, identifying areas of comparative advantage and driving productivity growth. But the first step is moving beyond blame and accepting that the environment has changed for good.

2. Do not underestimate the significance of NZ's current account rebalancing process.

NZ's external position is poor. The current account deficit – or the difference between what we save and what we invest as a nation – sits at 8.6 percent of GDP, and we see a real risk that it breaches 9 percent this year. This is one of the highest deficits in the developed world. Years of running these deficits have left NZ with a large stock of net foreign liabilities, which is currently just below 90 percent of GDP.

Even prior to current global malaise, the unbalanced nature of growth always meant that the NZ economy was set for an "adjustment" at some stage. This will be where the composition of growth shifts away from the spending side of the economy towards the earnings side, giving some much needed spine to growth. Such adjustments typically involve a fall in the currency to stimulate the export sector (and discourage imports), and a substantial contraction in the domestic economy including the housing market.

We tend to think about the magnitude of any required current account adjustment as being sufficient to stabilise the ratio of net foreign liabilities to GDP. This broadly requires a current account deficit of around 4.5 to 5 percent of GDP (compared with 9 percent now). Moreover, with a relatively low trade elasticity with respect to the currency (0.4), this requires a larger volume response (on both export and imports) in order to see a substantial improvement in the current account.

The current global predicament, which is essentially a process of de-leveraging and a return to more traditional fundamentals, adds three dynamics to NZ's current account realignment process.

> **NZ can no longer look towards a steady and orderly baton change** and reorientation from the domestic to the export sector over 2009. Given the global backdrop which involves weak demand and declining commodity prices, a weak export sector and unchanged domestic demand will make the external position worse, not better.

> **We doubt merely stabilising the external position will be sufficient** in the current global environment, where attention to fundamentals is more prevalent and investors are literally being spoilt for choice. S&P's decision to place NZ on a negative credit outlook in light of such external imbalances reinforces this point. Investors (and ratings agencies) will need to see improvements both in the flow (current account itself) and the stock of external liabilities. Hence we expect a more aggressive current account realignment process, which involves a more pronounced currency cycle and a deeper contraction in domestic demand. In effect, a structural adjustment at a time the economy is in the midst of a cyclical downturn.

> **It is unrealistic to expect a de-leveraging domestic economy to fill the growth void left by a struggling tradable sector in 2009.** Certainly policymakers are taking aggressive action to underpin the domestic economy via interest rate cuts, tax cuts and more fiscal stimulus. But such action needs to be interpreted within the scale of global developments, deteriorating job prospects (refer theme 5), and the state of the NZ economy. Indeed, a case can be made for policymakers to stand aside and let the adjustment pan out. But we know that this goes against both the economic and political reality. Even central banks – acting aggressively to support households – are aware that while they have independence, that independence is operational only and is at the discretion of the government of the day. Finally, it would be truly ironic if the nation managed to spend its way out of a spending–fuelled jam, given that this is what got us into trouble in the first place!

Typically, commentators and economists such as ourselves tend to focus on the currency related aspects of a current account rebalancing process. **Our expectations for the NZD/USD heading below 45 cents and for the NZD/JPY to head towards the low 40s** certainly entail this.

But the implications go far wider.

> **A rebalancing process for the economy means lower growth and hence lower earnings over the coming years.** We are not equity market analysts and will leave that to the experts. But the historical experience has been that the equity market tends to languish during periods of current account realignment.

> **A rising risk premium for the economy will not be solely centred on the currency market.** The old rules now apply – those wanting to borrow money for longer will have to pay more. Instead of the yield curve being overly flat (or even inverted), reflecting the weight of money, it will be overly steep, reflecting a shortage of money. So while policy rates may fall (partly to compensate for this very effect), the reality is that absolute interest rates paid by everyday risky borrowers (and that's you and me!) will be higher over the medium-term.

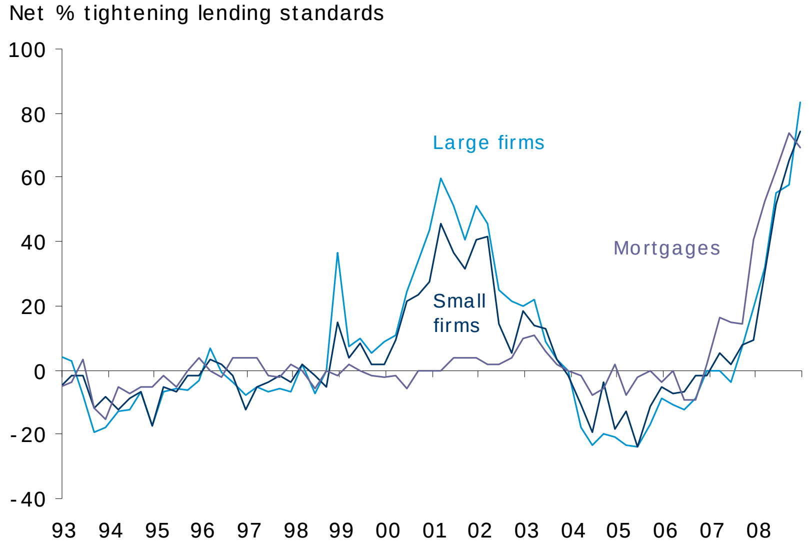
> **Who funds the deficit matters.** Over the past decade, it has been primarily the private sector that has funded the current account deficit, largely through financial intermediaries. As the housing market has boomed, the nation has borrowed huge amounts of money to fund it. There is no doubt we are set to see a switch in the funding of NZ's current account deficit from the private sector to the public sector. Typically we'd call this neutral, although we need to appreciate that private sector funding gets distributed into asset prices (and hence drives the wealth effect for spending), whereas public sector funding is directed into other areas, such as infrastructure. Indeed, a dollar of

government investment does not completely offset a dollar of private sector investment, owing to the higher multiplier effect from the latter. More worrying are the trends in sovereign credit default swap spreads (a measure of default risk), which have widened considerably, including for New Zealand. Recent rating agency actions will only compound this issue and we now live in a world where global investors are literally spoilt for choice. Rather worrying is that a home bias is starting to emerge when it comes to investment decisions. In this environment everyone is naturally looking domestically for cash and funding, as opposed to looking offshore. But with everyone locally competing aggressively for cash, this is putting upward pressure even on the cost of borrowing domestically. While many commentators tend to focus on wholesale lending rates, the more appropriate barometer is actually deposit rates. The problem in NZ's case is that we always end up going back to the same issue: a limited pool of domestic savings. It's like playing musical chairs; someone misses out.

3. The credit channel of monetary policy will play a huge role.

A rapidly expanding piece of economic literature over the past decade has been devoted to the credit channel of monetary policy. This channel works in addition to the conventional monetary transmission mechanism. Generally, the credit channel operates via two means. The first is the balance sheet channel, which sees deteriorating financial conditions affect borrowers' net worth by reducing current cash flows or securable assets, thereby influencing their external finance premium. The second is the bank (or any financial intermediary) channel, which influences investment behaviour via the cost and availability of credit. **At the heart of the channel is appetites towards risk, including the borrowers' side.**

US Federal Reserve senior loan officer lending survey



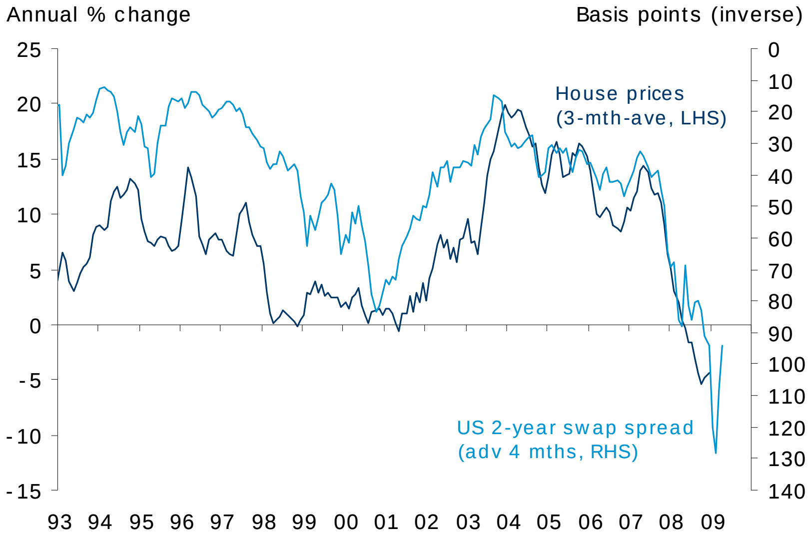
Sources: ANZ National, US Federal Reserve

Both domestically and internationally, we have seen the credit channel at work over the preceding years. The credit channel boosted the economy (and asset prices) beyond expectations at the top of the cycle, and in fact kept the economic cycle going far longer than expected. A spiral of rising asset prices, spending, profits, employment, confidence (exuberance), exceptional appetites for risk, rising asset prices…and so on took hold until a circuit breaker (in this case, the US subprime crisis) came along to turn the credit cycle. Subsequently we are seeing the reciprocal cycle take hold as the combination of falling asset prices, altered lending standards (lower loan-to-value ratios and stricter criteria), altered risk appetites, re-priced credit risk and a capital preservation mentality amongst financial institutions take hold. This can be seen from the US Federal Reserve's survey of senior loan officers.

The significance of the credit channel should not be underestimated.

> **The channel has been hugely influential in determining asset valuations on the way up.** This is evident in the relationship between global swap spreads (this has historically been a proxy for credit availability, cost and risk appetites in general) and NZ house prices. While people point to migration and interest rates as being influential drivers of the housing market, the reality is that the former was slowing since 2005 and debt servicing burdens continued to rise. But this did not stop house prices from reaching ever frothier levels. Only when the US swap spread started to rise and the credit cycle turned sharply, along with risk appetites, did NZ house prices start to head lower. These risk appetites were not just about the supply of credit from offshore, but also the demand, as bullet proof attitudes towards property prices in particular manifested. Of course we have seen swap spreads narrow of late, which is technically a positive. However, we also need to appreciate that this looks more "technical" than "real". The recent disconnect between swap spreads and credit spreads mean that the narrowing in the former in recent months likely overstate any improvement in actual credit conditions. Risk appetites remain flaky, and that's putting an optimistic spin on it.

House Prices vs US 2-year Swap Spread



Sources: ANZ National, REINZ, Reuters

> **Modern macroeconomic models are not adequately equipped to handle the dynamics of the credit channel,** due to its behavioural aspects which are difficult to put into simple equations. Hence, the science or model driven aspects (not that policymakers are overly prone to this) to monetary policy decisions is taking a back-seat as pragmatism prevails. Not quite "seat of the pants" stuff, but certainly a lot more art, intuition and the odd bit of hope.

> **The strong counter that the credit channel is having against the traditional monetary transmission channel means that it falls on central banks to do more on the policy front.** We have already seen this with very aggressive actions by central banks around the globe, and

the bias remains to do more. The RBNZ still has ammunition up its sleeve. But with fiscal policy in a potential rating downgrade bind, the onus rests on the Governor to make more use of all the tools at his disposal.

> **Monetary policy can lose traction at times like this.** Lower interest rates are all well and good. But they will do little to ease the pain when cashflow is tight or non-existent. A worker who has lost his job, or a business facing losses will still have trouble servicing their debt obligations.

> **There is also a reciprocal to doing more when the credit channel is "tight".** When credit conditions eventually return to normal, financial conditions will ease rapidly as liquidity is finally unleashed and credit is allowed to flow freely once again. Central banks will then need to quickly return policy towards neutral to guard against an overshoot on the other side. The RBNZ will be no different and interest rates will certainly not be moving up in the 25 basis point increments that we saw during the last tightening cycle.

In New Zealand, we see both the direct and indirect consequences of the credit channel. In terms of the direct channel, it has been well documented that providers of finance in some areas (such as motor vehicle retailing) have withdrawn in some instances; mezzanine based finance has disappeared from all but a few; access to consumer finance has become tougher; and 20 percent deposits are now stock standard for new housing loans across the core banking system. All are dynamics that will constrain spending and activity –significantly.

But it is arguably the indirect channel that is even more relevant. Lending appetites and the perceived overall health of the financial system around the globe determine risk appetites in general, and the cost and availability of term funding to current account deficit nations (and even good players). This makes the global process of de-leveraging all the more important for NZ's prospects. The first stage of the recovery has already started. Thanks to Government guarantees and a host of measures aimed at boosting interbank liquidity, credit markets have started to open up again. And while investors are prepared to invest in bank-issued bonds that are government guaranteed, the banks that issues these bonds typically need to pay a guarantee fee to the government. So while some measures of credit risk such as bank issuance margins, swap spreads, and the spread between the 90 day bill rate and the cash rate have fallen in most countries, in many cases, banks are finding that overall funding costs remain high (and may have even risen) once adjusted for the guarantee fee. Guarantees and the like can get the money flowing, but they aren't free. The problem of "skeletons in the closet" also remains, and could be significant, and until firms fully "fess up" to losses, it's difficult for investors to invest with any confidence. And finally, investors are also looking for signs that an end to the malaise is in sight, and in that regard, signs that US house prices are stabilising is key. That hasn't happened yet - but given the importance of house prices in the American psyche, and the importance of US consumers to the global economy - it will be an important stage.

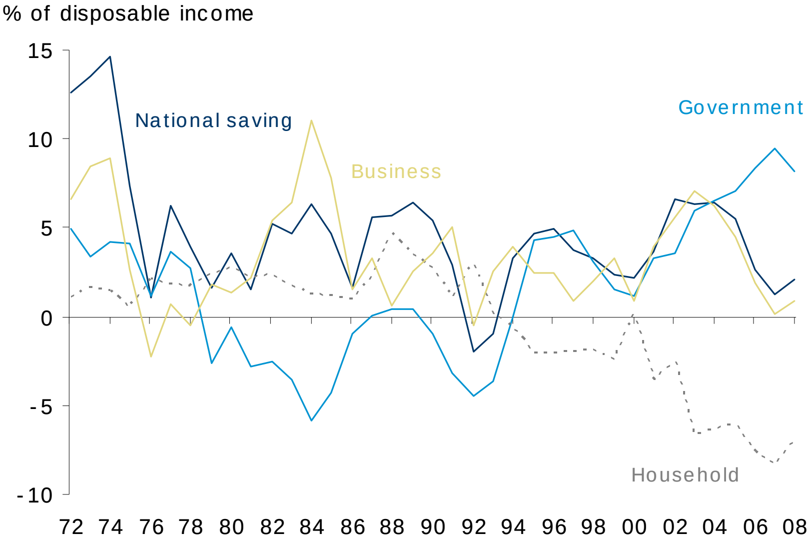
The issue goes wider. As global players increasingly withdraw from peripheral markets and focus on their home patches (one form of de-leveraging), the onus rests more on local players – particularly for current account deficit nations – to fill leveraging voids. The ability to fill such voids is not only constrained by the access and cost of global credit, but the dynamics of the current account rebalancing process outlined in theme two.

4. Beyond the financial crisis itself, this is a household story.

Stepping beyond the credit crisis itself, it is household balance sheets that are in need of repair. Indeed, this is a fundamental distinction (and abstracting from some isolated sectors) from previous credit cycles, which have tended to be business centric.

Given the limited sectoral balance sheet information in NZ, probably the easiest way to illustrate the point is via a breakdown of the savings rate between households, businesses and government. Even then, we caution that the data is somewhat iffy. Nonetheless, looking at the broad trends in the savings breakdown highlights a few notable aspects. **Households have been consistent dis-savers since the early 1990's, and materially so since 2000.** Public sector savings has increased in tandem with the deterioration in household saving over that time. The business sector has very much remained net positive savers with the odd exception.

Sectoral saving rate



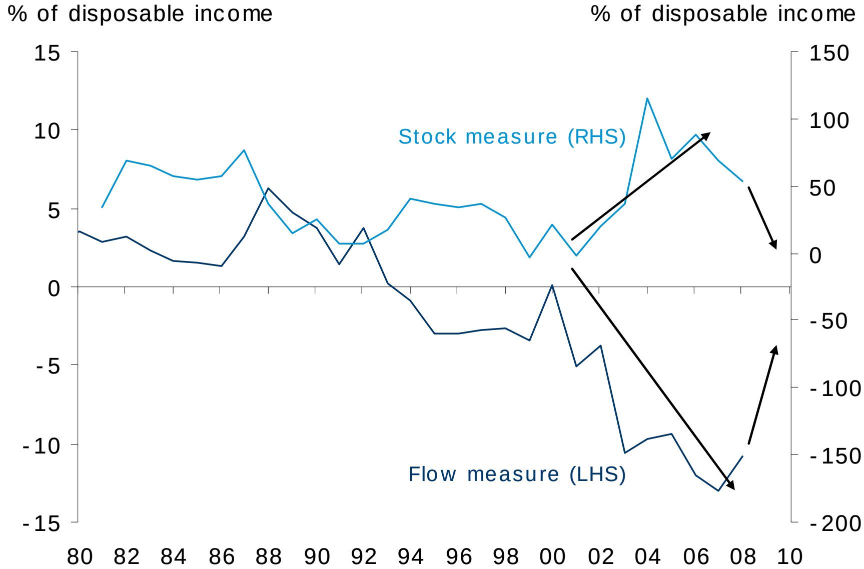
Sources: ANZ National, Statistics NZ

Looking at other indicators such as debt to income and debt servicing ratios, all point to the household sector needing to consolidate. This not only impacts on the dynamics of the downturn, but also on any expected recovery. For sure, steps can be taken to assist those in vulnerable positions, such as term refinancing and repayment holidays. But this is merely shuffling growth from one-year to the next, as opposed to altering the reality. We have already seen the first legs of the downturn, largely contained to the consumer and housing related sectors. But so far it has been largely of the "recession lite" variety. Household de-leveraging is a fundamentally different proposition to business sector equivalents. It is a simple question of levers. Facing weak balance sheets, businesses typically enter into lock-down mode, start cutting costs, deferring investment, and stream-lining inventories etc. Non-core assets can be disposed of in extreme cases. Households on the other hand, only have one lever to pull, and that is to reduce non-discretionary income. Hence, a household de-leveraging process takes longer to play through.

Of course, the detractors can always point to stock based measures of household savings, which have shown an improvement over the period when the flow based measure of household savings has been

declining. That is, the large "paper profits" on the back of house price increases encouraged households to spend more than they earn. But three-quarters of NZ households' total assets are tied up in housing, and with the housing market now correcting, the stock measure of savings is set to fall sharply over the year ahead. In fact, we've already started to see this, with the Spicers Household Savings Indicators showing a 3.9 percent decline in household net worth in the September 2008 quarter, led by falling house prices.

Household saving rate



Sources: ANZ National, Statistics NZ, RBNZ

In our eyes this only makes the outlook for house prices even more important in influencing the outlook for consumer spending. For if the dis-saving by households over the past decade was premised on the assumption that house prices never fall, then 2008 and 2009 is a huge wake up call. Falling household net worth, driven by lower house prices, risks creating a vicious circle where households seek to save more to compensate. While such a response is intended to repair their balance sheet, the resulting reduction in consumer spending risks leading to lower activity, profits, less employment, further falls in house prices and so forth. Indeed, there is every chance that non-linear effects start to take a strong hold, particularly when the negative wealth effect takes over.

There are a couple of other important aspects to this household story. **First, sectors heavily tied to the consumer and housing sectors will remain under pressure throughout this year, as household wallets remain firmly shut.** Domestic demand will continue to be a material drag on growth prospects in 2009, until such time as household balance sheets are back in reasonable shape.

Second, traditional credit shocks have tended to be business centric, and financial institutions have typically responded by reallocating capital away from the high beta asset to the low beta asset (traditionally housing). When coupled with aggressive interest rate cuts and a more productivity driven mantra from businesses, this has tended to sow the seeds of a recovery (traditionally a V-shaped one). However, there is no real benchmark for us to compare how financial institutions will respond this time around given that it is households (the historically low beta asset) that are most vulnerable. In addition, the low beta asset has limited scope to drag out the high beta asset given existing balance sheet positions. Hence, its another reason to watch the entire credit channel of monetary policy outlined in theme three.

5. The next leg of the cycle: productivity / jobs.

The recession which started in early 2008 was unusual in the sense that it was driven by the household sector. Drought conditions also contributed, along with high petrol prices, high food prices, the lagged effects of previous monetary policy tightening, and a housing market starting to correct. But in general the 2008 recession was reasonably narrowly concentrated, although broadened as the year progressed. In the early stages, firms were naturally looking towards the historical definition of a recession where two successive quarters of negative growth was followed by recovery. Employment was showing its natural lagged response, but with flat growth over the first three quarters of 2008, the general expectation (or perhaps hope) was that the dip would prove to be short-lived. That is now clearly unrealistic.

Going forward, five dynamics are dominating our thinking on employment prospects:

> **There has been huge concentration risk** within employment growth over the past five years, with two thirds of all new jobs accounted for by construction, retailing, and business services. These sectors are implicitly linked to the property cycle and “spending” side of the economy – the very sectors that remain in the firing line of the inevitable current account rebalancing process. While labour shortages are still apparent in select industries, including education, agriculture, health and IT, the reality is that most of the labour input growth within the economy over the past five years has been either directly or indirectly hinged to the property market, with an apparent implicit expectation that the market only moves one way.

> **Firms have been hoarding staff,** with employment growth outstripping hours worked since mid-2005, resulting in a fall in the number of hours worked per employee. While some of this will reflect the tightness of the labour market itself (and being forced to offer more flexible approaches to working), this dynamic does not fit with the part-time/full-time split, nor other measures of under-employment.

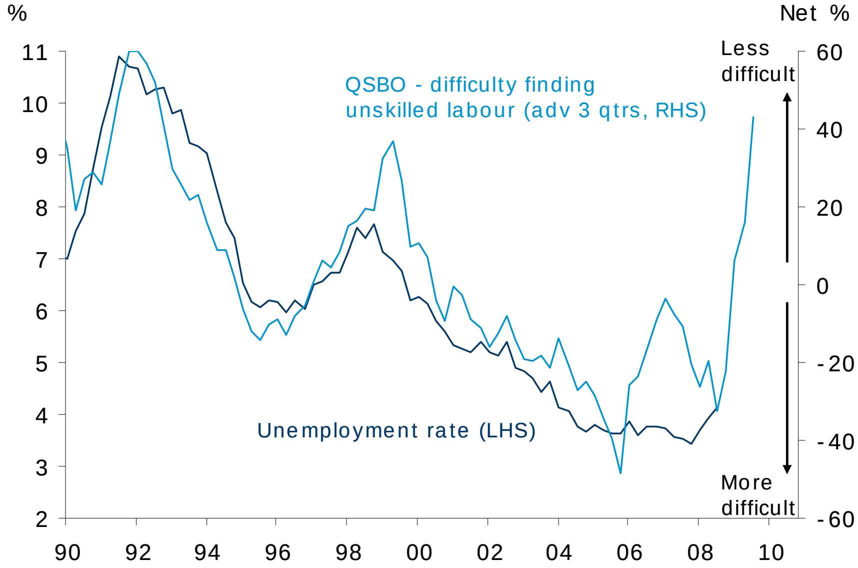
> **The recession is deepening and broadening beyond the household sector,** with global events now engulfing the tradable sector. With corporate profits already taking a dent from last year’s domestic recession, there is less headroom to absorb the impact of the global credit crisis and the resulting downturn in the global economy. This is being exacerbated by declining asset prices (including equity values), which is forcing management to take a sterner cost conscious line to support earnings.

> **The recession is now expected to be of considerable length,** with a minimum of five quarters. No longer can firms look towards a recovery as justification for holding on to underutilised resources.

> **Around 40 percent of the current labour force has not seen or experienced anything like current economic conditions.** Across a lot of nations it’s been close to 17 years since unemployment rates have been set to move up so rapidly. This inexperience “dynamic”, which in part has manifested in a lack of a savings buffer, is a key risk in our view in terms off setting of non-linear type responses.

The resulting rise in the unemployment rate, perhaps towards 8 percent (our official view is just over 7), represents the next leg of vulnerability for the domestic economy. If consumers and the housing market were already giving way when the unemployment rate was low, then a rapid deterioration in the job market and much smaller wage increases over the coming year will exacerbate weakness in domestic demand.

Unemployment rate and difficulty finding labour

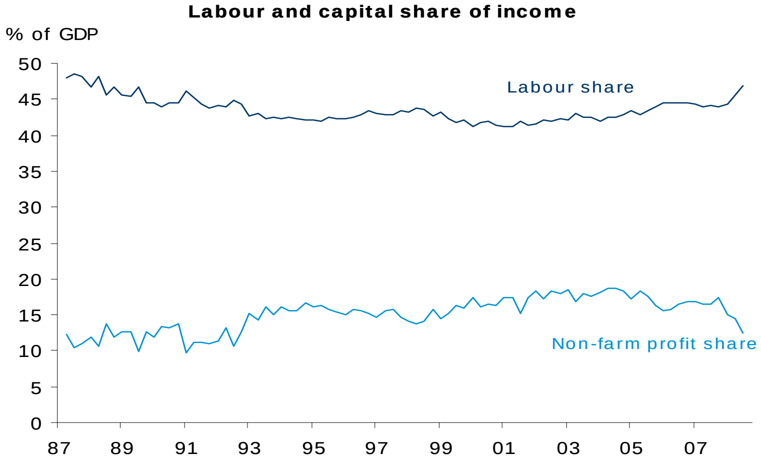


Sources: ANZ National, Statistics NZ, NZIER

On the one hand, businesses know that by shedding labour, they could inadvertently cause the downturn to intensify, further worsening their financial situation. But on the other hand, doing nothing in the face of declining profits is not an option either. **Businesses are caught in a "prisoner's dilemma",** where a higher payoff can be gained from cooperating (in this case, all retaining staff), but in practice they find it extremely difficult (though not impossible) to coordinate their activities **and the resulting outcome is a Pareto-suboptimal solution** (i.e. higher unemployment rate and weaker growth).

Another way to think about labour force dynamics is the relative shares of income (GDP) across the economy. The past seven years has seen labour's share steadily rise as the unemployment rate fell to a historical low and wages rose, and the share accruing to non-farm profits fell. As a more cost conscious attitude prevails, we fully expect to see the trend in these relative shares reverse.

Labour and capital share of income



Sources: ANZ National, Statistics NZ

If there is a positive spin to be put on the resulting increase in the unemployment rate, it will eventually be reflected in better productivity performance. In the first instance, job shedding tends to add to productivity merely by taking out that low marginal worker. However, we need to remember that owing to concentration risks noted earlier, a lot of the reduction in employment is likely to come from less productive (earnings) pockets of the economy. In some instances this will free up resource availability for more productive areas. In a cruel twist of fate, this will not only sow the seeds on a more pronounced downturn, but also lay the groundwork for a stronger recovery. Commentators can point to interest rates, the currency and fiscal policy all they want as drivers of the business cycle. The reality is that a necessary condition for a turn in the business cycle and a sustained strong economic performance is better productivity growth. The seeds of this are starting to be sown – slowly – but this process will accelerate over 2009 and start to bear fruit from mid-2010.

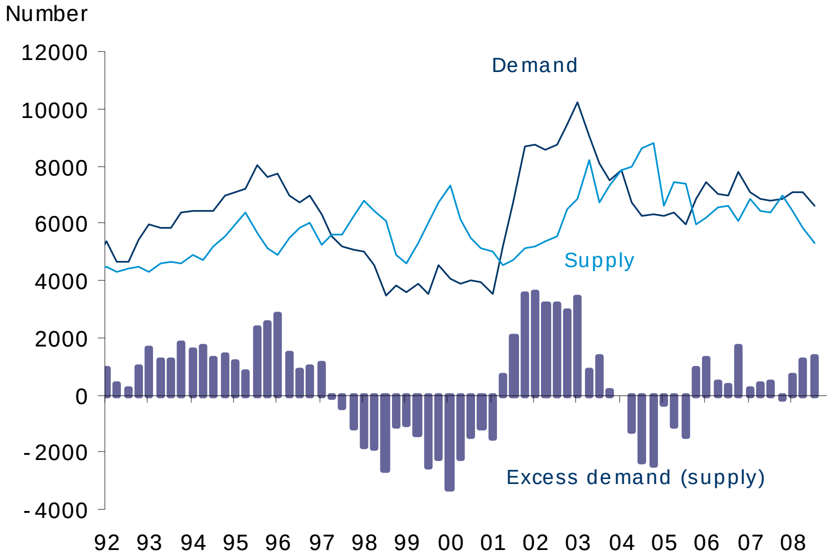
6. Forget house prices: concentrate on land prices.

When it comes to asset values, the conversation inevitably turns to house prices. It's hardly surprising given housing's dominance in the typical household balance sheet. We often hear predictions ranging from house prices will never fall, to expectations of a 30 percent decline.

However, there are a few aspects to the house price story that are not widely understood.

NZ has not experienced a housing bubble in a similar sense to the United States. Traditional housing bubbles result in excess supply. It's well documented that the US has a huge stock of houses relative to underlying demand, which is causing a huge drag on house prices. However, looking at NZ's housing fundamentals (which can be expressed as a combination of underlying population growth, migration and depreciation on the existing stock), no such excess supply exists. In fact, there has been an increasing excess demand building up due to the slump in building consents of late (with the exception of certain localities and there is certainly no shortage of beach houses!).

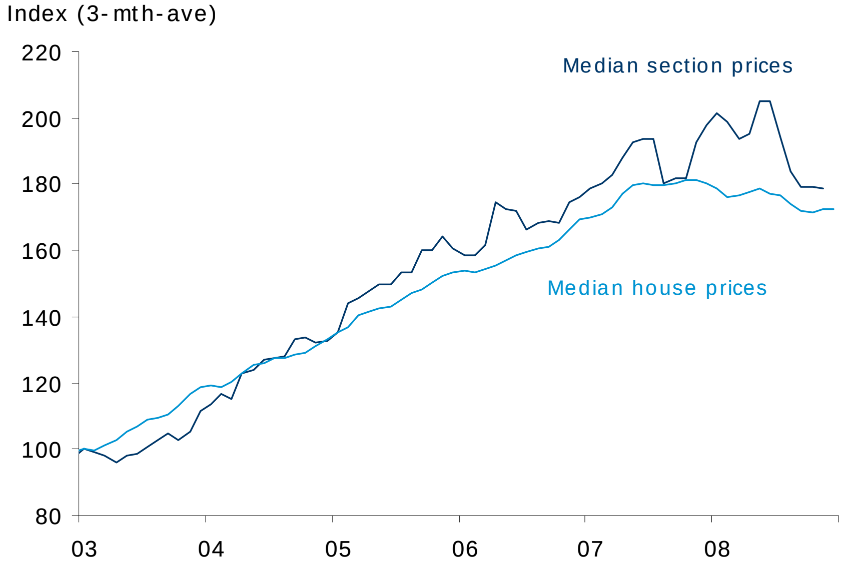
Housing demand and supply



Sources: ANZ National, Statistics NZ

This does not mean that NZ has not experienced a bubble. Certainly when you see house prices at close to eight times the average wage, it is difficult to argue that we did not experience a bubble of sorts. Yet we need to appreciate where it has come from. Most of the rise in house prices have come from the price of land, which between 2003 and 2007 has increased by 106 percent, while overall house prices has risen 79 percent over that time. In fact at their peak, section prices were up 112 percent. (NB: data in this area is rather limited and volatile).

House and section prices



Sources: ANZ National, REINZ

Some commentators point to restricted land supply and land use restrictions as reasons for section prices outstripping house prices. This is true to a degree. But it is hard to see such dynamics being the key influence when you look at the performance of rural property. Similarly the various property hot spots around the country (typically holiday or beachside destinations) that have definitely not had any shortage of land! Anecdotally this is easy to see on our travels around the country, and some regions have close to a decades worth of supply of land on the market. Regular readers of this publication will know it frequently tracks the composition of real estate listings (using TradeMe data, notably section's share of total listings), and what we've seen over the past year is that ratio rising from 18 percent to 25 percent, indicating an excess supply of land.

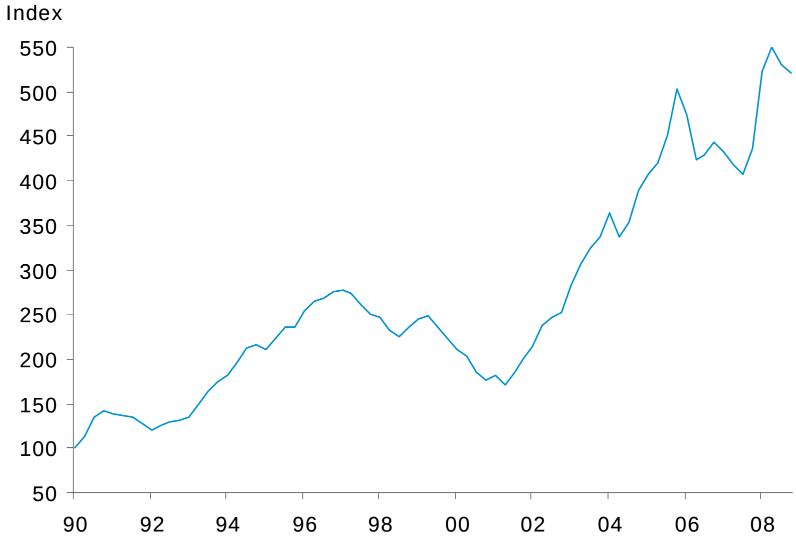
A lot of this has been driven by the general expectation prices never fall, only rise, a failure to differentiate between nominal and real prices, and relative insensitivity to real interest rates. Under such an assumption, chasing capital gains is the way to go, and if punters believe double-digit gains are on the cards, there is every incentive to keep piling in, irrespective of what interest rates are doing. The fact that property prices did rise strongly at the start of the housing boom only fuelled such expectations along with the ripple effects from lending from certain pockets in high risk areas. The historical experience has been that nominal house prices have seldom fallen, but when adjusted for inflation, house prices actually fell 40 percent during the late 1970's collapse. While everyone focuses on the benefit of the nominal value they often forget that the difference between nominal and real house prices manifests through inflation. So even during the nominal house price growth of the 1970's, investors were actually worse off as they faced double-digit borrowing rates.

Such price expectations about property extended into rural land prices as well. Certainly, the strong dairy payouts of the past few years helped cement an expectation of rising farm incomes, helping to argue for ever higher rural land prices. This caused a spillover into neighbouring land prices, and when coupled with easy and relatively cheap access to credit, helped prolong the property cycle.

A key theme we will be watching in 2009 is the performance of rural land prices, which have had an element of the same "it's all about capital gains" mantra. For sure it's hard to go past the reality that: the world has to eat; NZ has a strong comparative advantage in food production; water will become an increasingly valuable commodity; and structural changes around the globe, including the growing importance of Asia, are of huge benefit to NZ. But fundamentals and particularly cash-flow are still the key aspects of any investment decision and such gains tend to slowly accumulate over time. Our internal research on dairy conversions suggests economic returns on capital at less than the cost of funds. The business case relied on long-term capital gains, which historically had been significant. While capital gain was adding to wealth, it only added to cash when the asset was realised. It did not fund the cash flow in the interim. Cash flow has now become more important in a tighter credit environment.

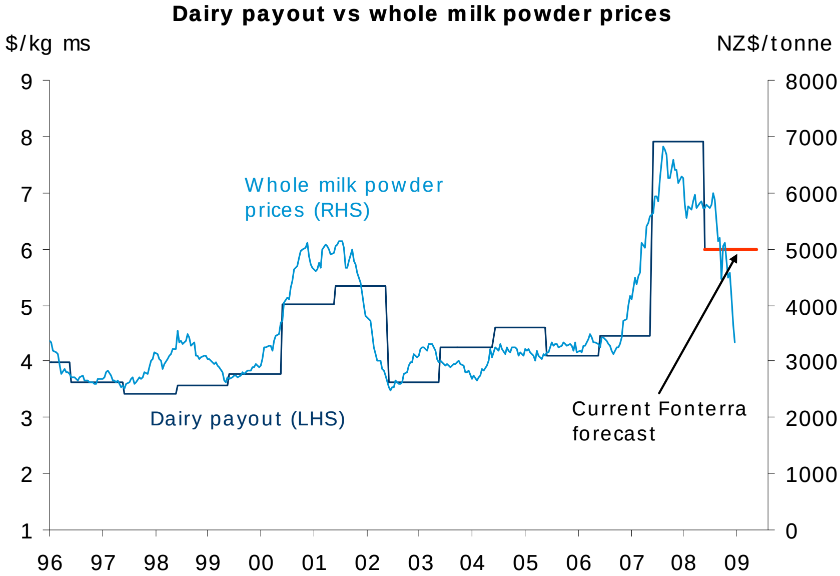
The past decade has seen a steady rise in the ratio of rural land prices to commodity prices, which means not only a good news "Asia and commodity price story" has already been built in, but a rather exceptional one at that.

Ratio of rural land values to commodity prices



Sources: ANZ National, REINZ, QV

What is clear at present is that rural land prices are going to face considerable downward pressure, with a weak global environment now manifesting in a cyclical unwind (within a structural upwards trend in our view) in commodity prices. **Nowhere is this more apparent than in the dairy sector,** with the payout under considerable downwards pressure and a figure close to $5 per kg/milk solid is looking likely for the 2008/09 season amidst growing stories of stockpiling and unsold supplies. Indeed, it may well even be that the 2009/10 payout is even lower.



Sources: ANZ National, USDA, Bloomberg

We see three implications from an unfolding in land prices.

> **The land aspect is key to linking our expectation that consumption as a share of GDP can continue to ease, even if residential investment – via the fundamentals – starts to find a floor.** That is, property prices will continue to fall even when we see actual building activity pick-up, with the corresponding negative wealth effect weighing on consumer spending.

> **The rural cheque-book is heavily pro-cyclical.** With rural incomes set to fall this year and possibly next, this will kick off a multiplier effect across rural regions. The uncertainty at present due to rapidly declining commodity prices mean we could see a sharp correction to rural land prices, which could trigger another leg in the regions. Moreover, we foresee strong ripple effects from weakening dairy prices across other land use and areas as well.

> **Weakening rural land prices will place downward pressure on regional house prices.** Rural house prices have outperformed urban equivalents since 2004, and part of this reflects the spillover from rising rural land and commodity prices. We see a strong reciprocal effect acting over 2009 as rural house prices fall faster than urban areas.

7. The alphabet of recoveries: a BIG U.

Beyond the crisis itself, we need to think about the inevitable recovery. As a scribe once noted; it's always darkest before dawn. All the bad news can be overpowering.

First-up, we need to be mindful of distinguishing between the business cycle and the longer-term trend. Looking beyond the business cycle, once NZ navigates the inevitable rebalancing process (which is the most challenging one we have faced in a long time), there is a need to appreciate the strong medium-term story for the NZ economy. The massive wealth shift occurring around the globe that is seeing Asia grow in importance can only be good news for NZ. While commodity prices are going through a corrective phase at present, we remain long-term commodity bulls. Asia looks set to remain a key engine for global growth over the next decade and given NZ's close proximity (and an exporter of products that Asia is increasingly demanding) NZ stands to benefit. Throw in the increasing importance that clean water has as a natural resource base, in a world where water will become scarcer, and there is huge potential for NZ to leverage off; just not in our usual borrow-and-spend sense.

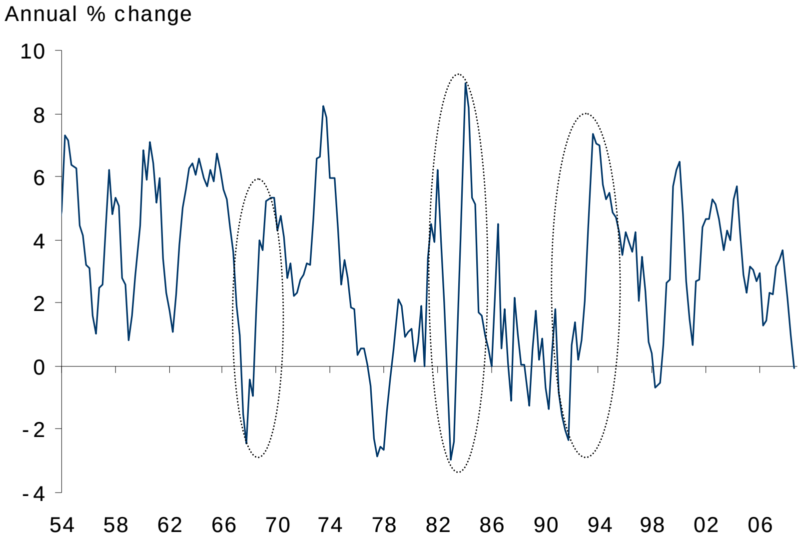
In terms of the business cycle, the obvious question is how long the adjustment lasts, and what indicators we should be on the look out for. The answer to the first question is how long is a piece of string? **Certainly, we see little reason for cheer or rejoicing in 2009.** In terms of the second, confidence gauges will be critical. But from a more structural aspect, we will be keeping a close eye on the current account deficit, the composition for imports, the savings rate and the ratio of consumption to GDP to name a few. All will provide indications from a structural perspective on the cycle. **A cyclical recovery cannot take hold until we see structural improvements across a number of areas.**

Around mid 2008 we started to formally call an L shaped economic cycle; largely on the back of what we perceived as an elongated adjustment period for the economy, and the household sector in particular. This is a theme that continues to resonate within our view as detailed in theme four above.

But we also need to be cognisant of other developments:

> **We are clearly now set for a deeper trough in the cycle itself including bigger and more declines in house prices,** with recent indicators clearly showing that the deceleration in the economy is intensifying (or the recession worsening). **However, when it comes to economies and cycles there is a clear bungy dynamic at work:** the more you fall, the closer you get to the bounce, and bounces tend to be inversely proportional to the fall in the first place. Even during very sharp economic corrections seen during 1967, 1982/83 and 1990/91, the corresponding recoveries have been sharp.

NZ long-term GDP growth



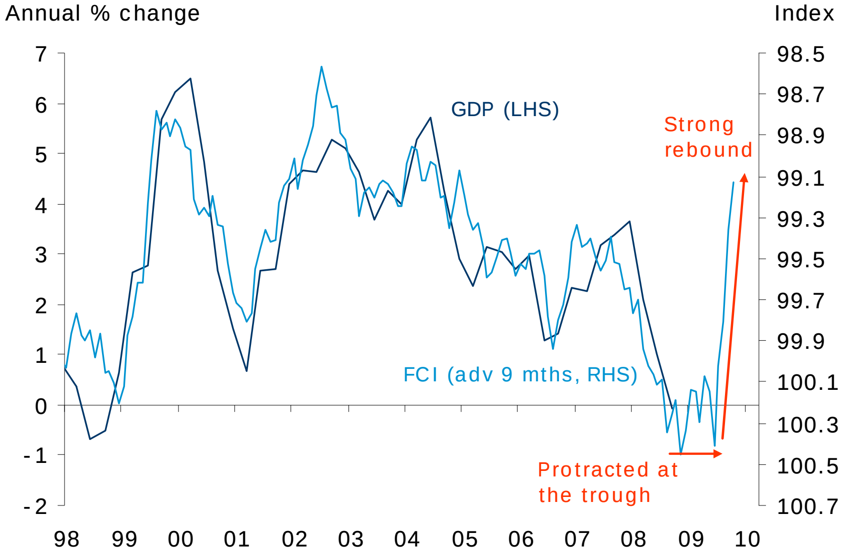
Sources: ANZ National, Statistics NZ, RBNZ

> **There is a huge non-linear dynamic in every economic cycle and we expect this effect will be particularly pronounced this time around.** Economists tend to rely on "linear" type models, which mean we have an inherent tendency to underestimate both the booms and busts. A quick look at some of the BIG picture drivers of NZ's economic cycle between 2002 and 2007 (the credit channel of monetary policy, labour hoarding, spiralling asset prices and anticipations of continued

double-digit gain) and you realise just how important the whole behavioural and confidence aspect to the economic cycle has been. These factors are now driving a deeper correction as they work in reverse. But these dynamics will also "snap" back when conditions stabilise.

> **Financial conditions have loosened – a lot.** Monetary policy's effectiveness may be diluted in the current environment, but it is not totally impotent. The RBNZ has already cut the OCR aggressively, and will do more this year to support the economy. The currency has similarly responded by falling, and the resulting easing in financial conditions point to a recovery by late 2009. This is even if we alter the weights in our financial conditions index to reflect a stronger credit or (negative) wealth related channel. An end of year recovery still looks six months too early to us given the structural challenges and current account rebalancing process, but we like the spirit of what our gauge is saying: a protracted and elongated trough relative to history, but then sharp recovery.

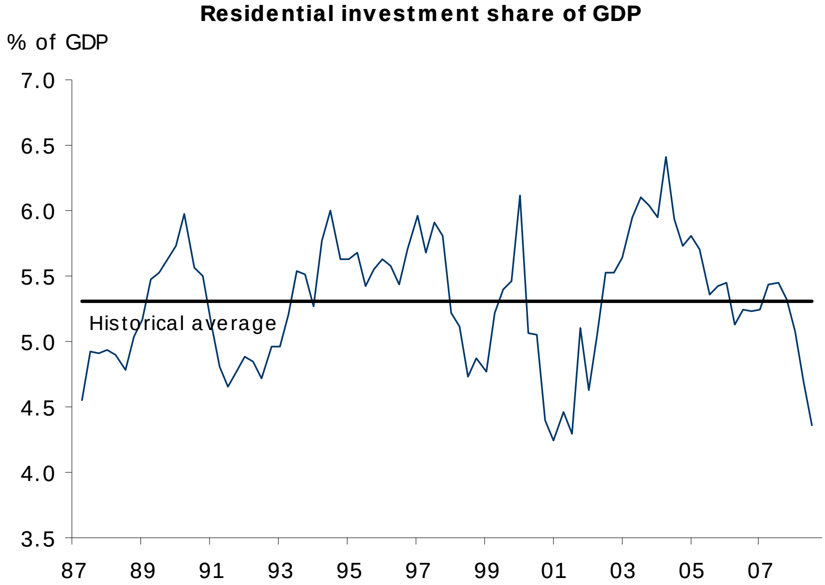
GDP vs Financial Conditions Index



Sources: ANZ National, Statistics NZ

> **There is a base effect at work.** GDP growth looks to have contracted for at least five consecutive quarters from Q1 2008, and the level of activity is nearing a low point whereby any pick-up will result in a technical bounce in the growth rate. Natural population growth of 1 percent per year will also provide support. If there is a positive surprise factor to be had over late 2009 and into 2010, it may well be that net migration could rebound in a similar fashion to post September 11, as poor prospects offshore encourage more New Zealanders to stay home, and even worse economic conditions in some countries encourage more to head to our shores or come home.

> **Some cyclical components of the economy are already at levels where pent-up demand is being flagged.** For example, the sharp decline in the ratio of residential investment to GDP has brought it towards historical lows. And while building consents numbers suggest more near-term weakness to come for residential investment, it is running below natural population demand and the depreciation on the existing stock; a condition which cannot continue for too long.



Sources: ANZ National, Statistics NZ

> **History has shown that strong pent up demand can lead to a strong rebound in activity.** This ranges from shortages in new housing stock and the need for consumers to replace durable goods, to businesses needing new plant and machinery because they have held off investing. Pent up demand tends to build during the downturn, and is typically unleashed at around the same time once the recovery takes hold, leading to a very rapid rebound in growth. For now, this is looking very much like a late 2010 story. In addition, with the Rugby World Cup being held in NZ in 2011, preparations in the lead-up for the event will further add to activity. For sure, we are still eyeing pent-up-demand dynamics within the scheme of the current account rebalancing process. But we can't ignore the former completely.

This combination has us shifting from an L to a BIG U; that is, a deeper contraction, but one which leads to a sharper (quicker) improvement in certain structural areas, helping to lay the groundwork for a more pronounced recovery.

But we have to stress that the dip will be far deeper. It will include further non-trivial falls in house prices, and the recovery will not start until 2010.

The bottom line

All up, our BIG picture macro themes for this year point to a very challenging 2009. We should not under-estimate the scale of the rebalancing process facing the economy. Much of this is being pre-determined by global events, but a lot still rests in our own backyard, namely correcting a huge current account deficit. The latter is a theme that weighs heavily within our economic and financial forecasts. The piper will be paid and the housing market will form a big part of the correction. The sooner he is, the quicker life will move on, and the stronger the inevitable recovery.

Statistical Annex

Weekly mortgage repayments table (based on 25 year term)

	Mortgage Rate (%)													
Mortgage Size ($'000)	5.50	5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.25	8.50	8.75
100	142	145	149	152	156	159	163	167	170	174	178	182	186	190
150	212	218	223	228	234	239	244	250	256	261	267	273	279	284
200	283	290	297	304	311	319	326	333	341	348	356	364	371	379
250	354	363	371	380	389	398	407	417	426	435	445	455	464	474
300	425	435	446	456	467	478	489	500	511	522	534	545	557	569
350	496	508	520	532	545	558	570	583	596	610	623	636	650	664
400	566	580	594	608	623	637	652	667	682	697	712	727	743	758
450	637	653	669	684	701	717	733	750	767	784	801	818	836	853
500	708	725	743	761	778	797	815	833	852	871	890	909	928	948
550	779	798	817	837	856	876	896	917	937	958	979	1000	1021	1043
600	850	870	891	913	934	956	978	1000	1022	1045	1068	1091	1114	1137
650	920	943	966	989	1012	1036	1059	1083	1108	1132	1157	1182	1207	1232
700	991	1015	1040	1065	1090	1115	1141	1167	1193	1219	1246	1273	1300	1327
750	1062	1088	1114	1141	1168	1195	1222	1250	1278	1306	1335	1364	1393	1422
800	1133	1160	1188	1217	1246	1274	1304	1333	1363	1393	1424	1454	1485	1517
850	1204	1233	1263	1293	1323	1354	1385	1417	1448	1480	1513	1545	1578	1611
900	1274	1306	1337	1369	1401	1434	1467	1500	1534	1567	1602	1636	1671	1706
950	1345	1378	1411	1445	1479	1513	1548	1583	1619	1655	1691	1727	1764	1801
1000	1416	1451	1486	1521	1557	1593	1630	1667	1704	1742	1780	1818	1857	1896

Housing market indicators for December 2008 (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	-6.7	8.1	121	(+44%)	57	Higher sale prices were measured in the last 3 months
Auckland	-4.3	2.6	1,458	(+12%)	40	Recorded the joint shortest time to sell a property
Waikato/BOP/Gisborne	-8.2	-3.7	655	(+28%)	61	Annual house price growth has sunk to a new low
Hawke's Bay	-3.0	0.3	175	(+39%)	60	The number of days to sell eased to a six month low
Taranaki	0.0	4.3	142	(0%)	53	House sale numbers lack buoyancy, relative to others
Manawatu-Wanganui	-8.4	-1.0	231	(+20%)	76	The median number of days to sell hit a new high
Wellington	0.0	1.1	509	(+15%)	53	Median house sale price unchanged from a year ago
Nelson-Marlborough	-11.2	-1.5	191	(+39%)	52	Suffering from house price hypothermia
Canterbury/Westland	-5.1	1.3	737	(+33%)	49	Sixth month that annual price growth is below NZ avg
Otago	-8.0	-1.2	241	(+48%)	51	Largest lift in the number of houses sold in the month
Central Otago Lakes	2.0	-8.8	74	(+9%)	82	Lowest 3 month change and time to sell at a 3 year high
Southland	-13.1	-3.6	125	(+8%)	40	More thrills and spills than the *La Quebrada Cliff Divers*
NEW ZEALAND	-4.8	0.1	4,760	(+27%)	49	Still needs more time in the decompression chamber

Key forecasts

	Actual			Forecast						
Economic indicators	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10
GDP (ann avg % chg)	3.1	2.5	1.7	0.4	-0.7	-1.5	-1.9	-1.8	-1.2	-0.2
CPI inflation (%)	3.4	4.0	5.1	3.4	2.3	1.5	0.6	1.8	2.6	2.2
Unemployment rate (%)	3.7	3.9	4.2	4.7	5.2	5.7	6.1	6.6	6.9	7.1
	Actual			**Forecast (end month)**						
Interest rates	Nov 08	Dec 08	Latest	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10
Call rate	6.7	5.4	4.0	3.5	3.0	3.0	3.0	3.0	3.0	3.0
90-day bank bill rate	6.2	5.2	4.1	3.6	3.4	3.3	3.3	3.3	3.3	3.3
Floating mortgage rate	8.8	8.1	7.5	6.5	6.0	6.0	6.0	6.0	6.0	6.0
1-yr fixed mortgage rate	7.3	6.9	6.9	6.7	6.5	6.3	6.1	6.1	6.1	6.1
2-yr fixed mortgage rate	7.5	7.1	7.0	6.8	6.7	6.6	6.5	6.6	6.6	6.6
5-yr fixed mortgage rate	7.9	7.6	7.1	6.8	6.9	6.9	6.8	7.0	7.0	7.0

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing

Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;
- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- The Bank has a joint venture relationship with ING (NZ) Holdings Limited (ING). ING and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or

- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

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