

## Bracing for the impact

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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 debt servicing.

### The month in review (page 2)

- > Housing market data is showing absolutely no sign of the slowdown that the Reserve Bank desires, although it will take some time for recent interest rate increases to be reflected in the data. The recent resilience in economic data and the deterioration in core inflation measures has seen a further OCR increase from the Reserve Bank.

### Property gauges (page 3)

- > Our property gauges point to ongoing momentum in the short-term, although it is too early to see what impact the Reserve Bank's interest rate increases and stern warnings will have on the property market.

### Economic backdrop (page 5)

- > Inflation pressure is becoming disconcerting. It looks increasingly like a greater growth sacrifice will be required to get inflation under control.

### Borrowing strategy (page 6)

- > Mortgage lending rates have increased sharply following the March *Monetary Policy Statement*. While it now looks like the April OCR increase will be the last in the current cycle, the risk to interest rates is still to the upside. Relative value in the mortgage curve remains with 2 to 3-year fixed lending rates.

### Feature article – Debt servicing (page 7)

- > Household debt servicing burdens are in uncharted territory given the recent rise in interest rates. While a strong labour market remains a key source of support to the housing market, the risk remains that the debt burden eventually bites.

### Key forecasts (page 9)



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## The month in review

**Housing market data is showing absolutely no sign of the slowdown that the Reserve Bank desires, although it will take some time for recent interest rate increases to be reflected in the data. The recent resilience in economic data and the deterioration in core inflation measures has seen a further OCR increase from the Reserve Bank.**

**No slowing in housing equals higher interest rates.**

- > **RBNZ OCR Review.** The Reserve Bank increased the OCR by 25 basis points to 7.75 percent. The resurgence in economic activity late last year and early this year, and recent signs of re-acceleration in non-tradables inflation forced the Governor's hand. However, the tone of the statement was not as hawkish as expected.
- > **REINZ housing data – March month.** The seasonally adjusted number of sales fell by 1 percent, but the level remains at a robust 9,105. The average number of days to sell a house dropped to 28 days (s.a.), while the median house price posted a new record high of \$343,500.
- > **Quotable Value housing data – March month.** QV data recorded a 9.8 percent increase in residential property values over the year to March.
- > **External Migration – March month.** There was a monthly net inflow of 630 (s.a.) people, taking the annual net inflow to 12,080. More NZ residents are heading overseas.
- > **Building Consents – February month.** The number of residential building consents issued rebounded slightly in February (up 5.8 percent, seasonally adjusted), from low levels the previous three months. The monthly trend measures for residential and ex-apartment consents continue to fall, pointing to soft growth in residential construction activity over the middle to second half of 2007.
- > **NZIER Quarterly Survey of Business Opinion – March quarter.** The QSBO suggests that the Reserve Bank's March interest rate hike and NZ dollar strength have dented business confidence. But the survey's activity indicators firmed and indicators of pricing and resource pressures deteriorated, making for an unfriendly read for the Reserve Bank.
- > **National Bank Business Outlook – April month.** Business confidence and own activity expectations have eased, but the survey's composite growth indicator remains consistent with 2½-3 percent economic growth, and show ongoing pressure on inflation and resources.
- > **Mortgage interest rates increase.** Mortgage interest rates have increased across the curve following the Reserve Bank's March *Monetary Policy Statement*.

**Pricing and resource pressures within the economy remain intense.**

## Assessment

**The Reserve Bank will remain on alert.**

There is little in the data released over the past month to suggest that the Reserve Bank's desired slowdown in housing and consumer spending is coming to fruition.

Of course, data is notoriously lagging but what is becoming increasingly clear is that the inflationary under-currents the Reserve Bank is facing are more extensive. Moreover, the inflationary story is broadening beyond the housing market. Non-tradable (domestic) inflation was 1.2 percent in the March quarter (an annual rate of 4.1 percent), and would still have been 1.2 percent if housing (which has historically made a large contribution) was excluded. In this environment, the Reserve Bank will remain on alert, and interest rates will remain high until they see signs of the required slowdown.

## Property gauges

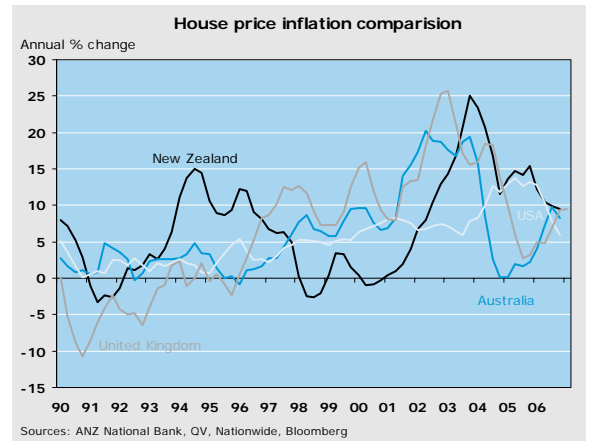
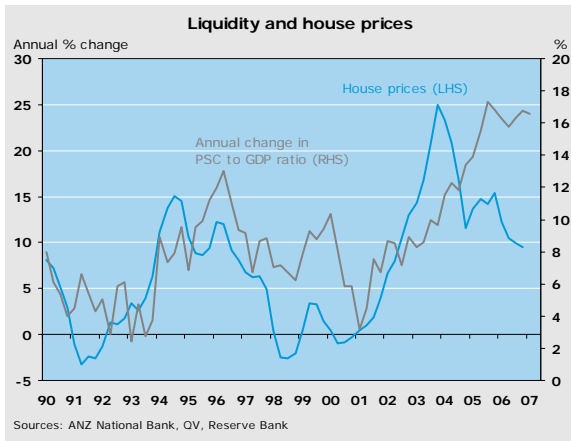
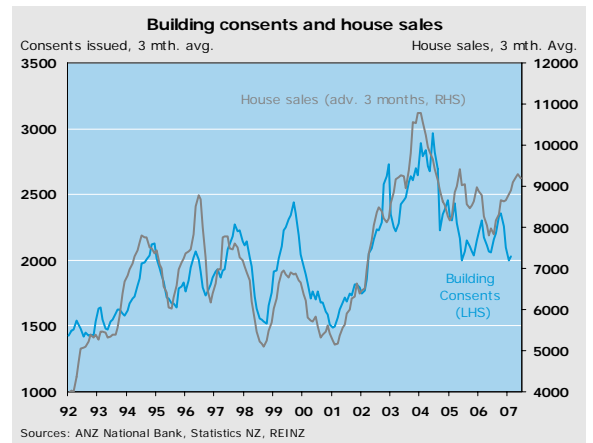
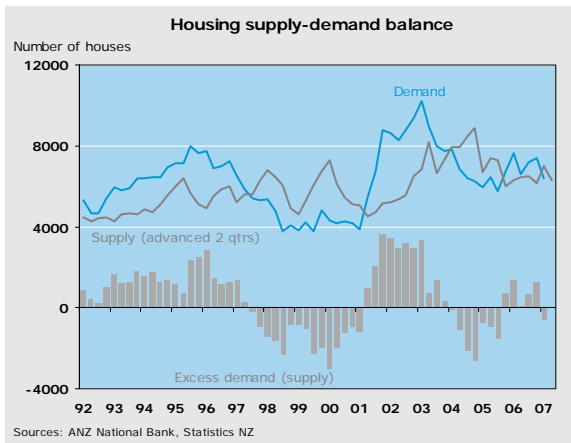
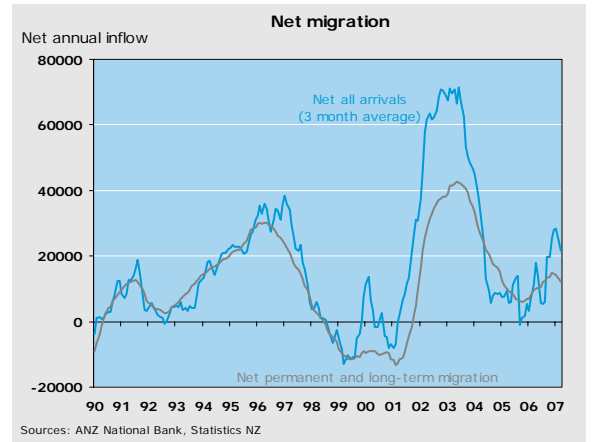
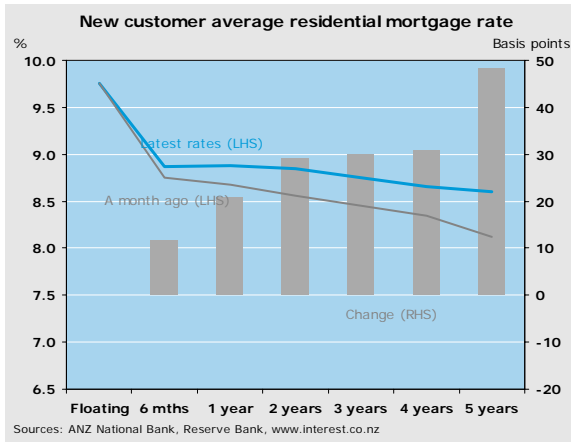
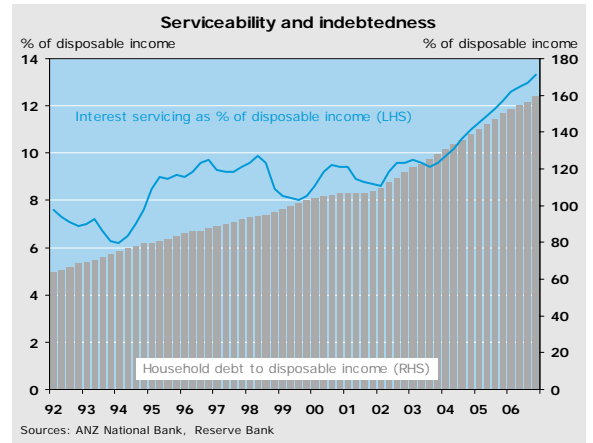
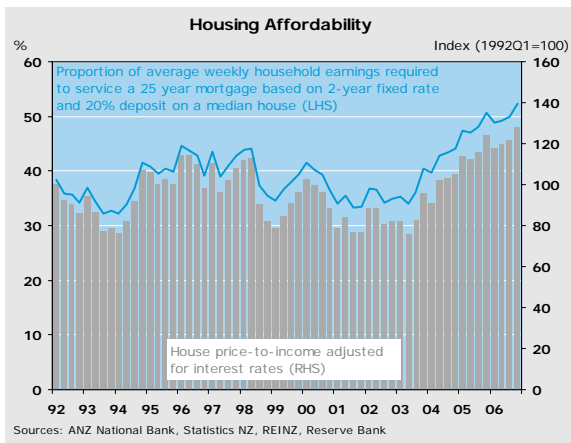
**Our property gauges point to ongoing momentum in the short-term, although it is too early to see what impact the Reserve Bank's interest rate increases and stern warnings will have on the property market.**

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.

With ongoing support from both the labour market and inwards migration, our gauges point to momentum being maintained in the property market in the near-term. Countering this support, the Reserve Bank has delivered two OCR increases, and mortgage interest rates have increased sharply. The property market remains on notice.

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	↓	Interest rates have increased sharply over the past month. Recent strong data flow will keep the RBNZ on alert, and interest rates will remain high for some time.
Migration	Medium	↔	Migration inflows still positive, albeit starting to ease.
Supply-demand balance	Neutral	↔	Slight excess demand emerging due to migration inflows and natural population growth.
Consents and house sales	On the up?	↔/↑	A strong month for house sales in March but was this a last throw of the dice before interest rates increased?
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>The Reserve Bank is now actively engineering its desire for the market to slow</b>



## Economic backdrop

**Inflation pressure is becoming disconcerting. It looks increasingly like a greater growth sacrifice will be required to get inflation under control.**

### > Soft landing insufficient.

The New Zealand economy has achieved the fabled "soft-landing", with annual growth rebounding above 2 percent (courtesy of a 0.8 percent increase in the December quarter 2006), after slowing to one percent earlier in the year. Compositional aspects of the economy's performance continue to provide the Reserve Bank with discomfort – interest rate sensitive sectors (private consumption and residential investment) posted strong growth in the quarter. Partial data to date point to this momentum in economic activity at the end of last year being maintained into the first quarter of 2007. Housing market activity, credit growth and confidence indicators suggest growth will remain robust into mid-year.

Inflation pressure is picking up within the domestic economy in line with solid demand. The March quarter CPI showed a strong increase in domestic inflation pressures, with these broadening beyond the housing market. Non-tradables ex housing inflation rose a disconcerting 1.2 percent in the quarter, and the number of CPI classes rising by more than 5 percent a year is at a level last seen in 2001.

Dampening this inflation pressure requires a growth sacrifice. It's a zero sum game. The stronger the inflation pressure, the greater the growth sacrifice to quell pricing behaviour. And it is better to have a hard landing now than a crash landing later, which is a likely prospect if inflation pressures are left unchecked.

The economic slow-down will be engineered. Financial conditions are now very tight. The NZD is high. The Reserve Bank has been clear in its desire to see a moderating trend in domestic demand in order to quash this inflation pressure, and they have delivered two OCR increases in the past two months to engineer this. Two and five year fixed mortgage lending rates have risen 47 and 63 basis points, respectively, since February. Households are in for a nasty jolt. If the housing market shows no sign of slowing over the coming months, brace for more bitter medicine.

### > Outlook for the property market

We are siding with the Reserve Bank on the outlook for the property market. They say it is going to slow, and have the instrument to ensure this happens. Just as we have been surprised with the resilience of the property market, our suspicion is that the turning point could be very sharp. 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. Watch this space. The US experience, which has seen sharp falls in home sales, and problems in the sub-prime residential lending market, has emphasised the importance of the housing market to the overall economy.

That said, strength in the New Zealand labour market continues to provide considerable support to the housing market. Net migration inflows, which have provided a substantial boost recently, have softened from their annual peaks in late 2006, but are still lending support to the market. These factors should continue to provide a base level of support to the housing market for some time. Longer-term we remain bullish about economic prospects, and property is ultimately linked to how the economy performs as a whole. Looking at longer-term trends there is a lot to be positive about. Soft commodity prices are surging, and will continue to do so as Asia evolves from industrialisation to consumerism. Lifestyle is becoming more important. NZ is not yet fully discovered.

**Soft landing achieved.**

**Inflation is too high....**

**...which means growth and the property market need to slow.**

**The Reserve Bank will win.**

**Longer-term the outlook remains positive.**

## Borrowing strategy

**Mortgage lending rates have increased sharply following the March *Monetary Policy Statement*. While it now looks like the April OCR increase will be the last in the current cycle, the risk to interest rates is still to the upside. Relative value in the mortgage curve remains with 2 to 3-year fixed lending rates.**

### > Two hikes.

Up rates go.

The Reserve Bank's patience with a resurgent economy saw them increase interest rates at the March *Monetary Policy Statement*. The data flow since that *Statement* has remained unfriendly towards the Bank's stated desire of slowing momentum in the housing market and consumer demand, and has seen them deliver a subsequent OCR hike at the April *OCR Review*. The steady increase in wholesale interest rates (which reflected growing expectations that the RBNZ would have to hike again) has been reflected in mortgage interest rates, which have also increased substantially over the past month. Two-year fixed rate mortgage interest rates have increased from 8.4 percent in February to 8.85 percent at present, while 5-year interest rates are up to 8.60 percent (from below 8 percent in February).

More chance of a hike than a cut.

The statement accompanying the Reserve Bank's April *OCR Review* was notable more for what it didn't say than what it did. Unlike recent statements, this one lacked any direction on the bias for future policy moves. This should certainly not be taken to mean that they are in "neutral mode"... while the Bank has not committed to another rate hike, the tenor of upcoming data (particularly relating to the housing market and domestic demand) will be important. Given the resurgence in non-tradable inflation, and the disturbing broadening of inflation pressure, there is still more chance of a further OCR hike than a rate cut. Nevertheless, we believe that the April tightening will be the last in this current cycle, although any OCR cuts are certainly a long way off.

### > Don't look down.

2-3 year rates seem more favourable.

Recent moves in mortgage lending rates (with the longer-term rates up as much as 63 basis points over the past two months, but more modest increases at the shorter-end of the curve) have reinforced our view about the relative attractiveness of borrowing around the 2 to 3-year part of the curve. Over the next few months, the risk on interest rates is still to the upside. Beyond that we expect an aggressive easing cycle to start at the end of 2008. Based on this, 2-year or 3-year rates look to contain the most value.

The sharper increase in 5-year rates over the past two months (up more than 60 basis points since February) has negated any advantage that might have been had from a cash flow perspective.

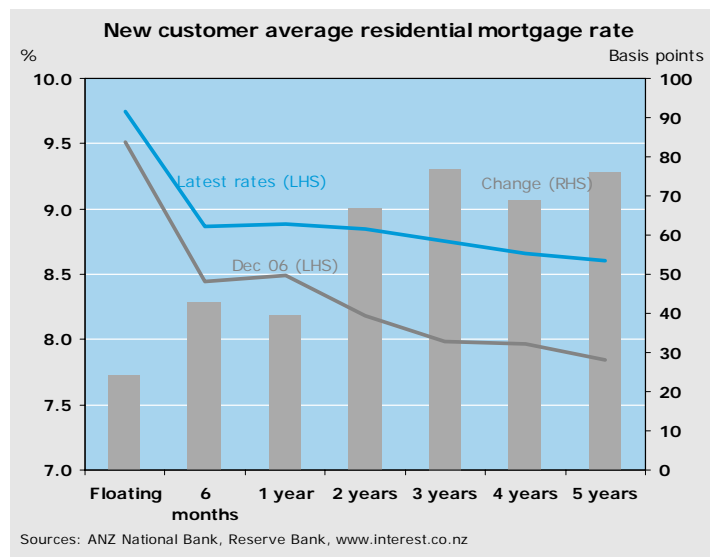
### > Themes we would recommend in the current environment

- **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.**

## Feature Article – Debt servicing

**Household debt servicing burdens are in uncharted territory given the recent rise in interest rates. While a strong labour market remains a key source of support to the housing market, the risk remains that the debt burden eventually bites.**

Households are in for a shock. There has been a massive jump in retail (mortgage) lending rates over the past few months. Across the major retail banks, mortgage lending rates are up between 25 and 63 basis points on their levels at the end of February, and the entire fixed mortgage curve is firmly above 8.5 percent. When compared with their level at the end of 2006, interest rates are up as much as 77 basis points.

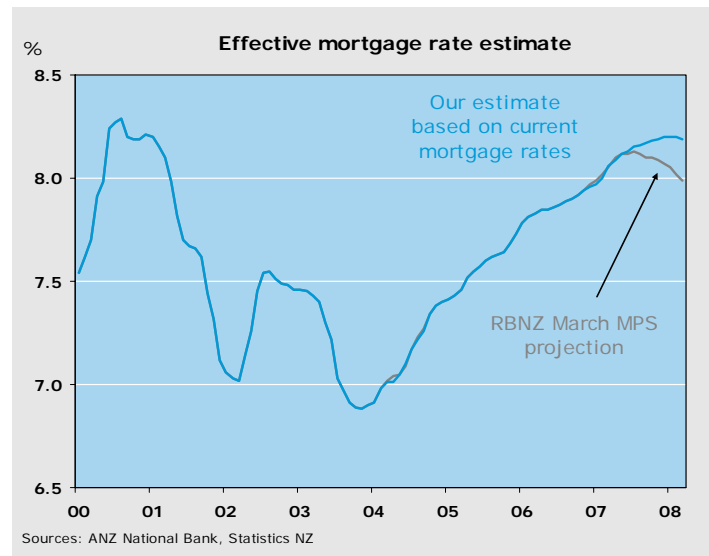


These interest rates, of course, only apply to new borrowers and those whose mortgages come up for review (except for those on floating rates, who will face higher rates immediately). Others, who are still on (older) fixed rates, remain insulated from the recent interest rate increases – for the time being.

Because of this, carded lending rates are not the most meaningful measure of the impact of mortgage interest rates on household spending behaviour. To address this, a measure of mortgage interest rates that the Reserve Bank looks at is the “Effective Mortgage Rate”. This is the weighted average mortgage interest rate that prevails on all mortgage lending (as opposed to new lending). The drift to fixed rate mortgages (in late 2002, 57 percent of mortgages by value were fixed, and this proportion is now around 84 percent) has slowed the transmission from the Official Cash Rate to the effective mortgage rate. The OCR is up 275 basis points since the start of 2004, but the effective rate is up only 110 basis points over the same time period. The effective mortgage interest rate has been grinding higher from 6.9 percent at the start of 2004 to 8.0 percent at February 2007.

It is possible to examine the impact of recent mortgage interest rate increases on the effective mortgage interest rate into the future (making some bold assumptions about the future path of interest rates and the profile of existing fixed mortgages coming up for renewal). For example, we know that there are around \$33 billion of fixed rate mortgages coming up for renewal over the next 12 months, with around 30 percent (\$10 billion) due around April, May, and June this year. Reserve Bank data shows that the mortgages due for renewal over the next 12 months have a weighted average mortgage interest rate of 7.7 percent. For these borrowers, if current fixed rates are not changed, the interest rate increase they experience when refinancing will be 85 to 115 basis

points higher. By extending this to the rest of the mortgage lending curve, we can calculate future movements in the “effective” interest rate.



It is clear that as the recent mortgage interest rate increases flow through to more and more borrowers as their fixed terms come to an end, the effective mortgage interest rate being faced by housing borrowers will increase. By our estimates, over the remainder of 2007/early 2008, the effective mortgage interest rate will rise a further 20 basis points from the current 8 percent to around 8.2 percent.

By itself it seems small. However, the effective rate will continue to rise well through 2008 delivering closer to 40 basis points overall. Broadly speaking, if you have a mortgage rate fixed at sub 8 at present, you will be looking at one close to 9 percent at some stage over the coming 18 months. Unlike 2005, there is now nowhere along the mortgage curve where borrowers can duck for cover. Moreover, with the effective yield on residential property now around 4-5 percent, investors need a capital gain in excess of 5 percent.

Households' debt servicing burden is disconcerting. While the effective mortgage rate is now similar to 2000 (and ironically house prices fell in that year), households are now carrying more debt – in June 2000, household debt was 105 percent of nominal disposable income, this has risen to 159.6 percent of disposable income at the end of last year. The net result has been a near doubling in the ratio of household debt servicing to income. Back in 1994, 6.2 cents in every dollar went to mortgage debt. By 2000 it has risen to 9.2. It is now 13.3 cents, and set to rise further – refer page 3 and chart on page 4).

### > What does this all mean?

The interest rate increases that we have seen over the past month or so will take some time to filter through into spending behaviour. The marginal (new) borrower will feel the impact in their back pocket relatively quickly, but it will be some months before the full impact of the rate increases is felt across the economy as a whole.

But household debt servicing burdens are in uncharted territory given the recent rise in interest rates. While a strong labour market remains a key source of support to the housing market, the risk remains that the debt burden eventually bites. Our suspicion is that the market is likely to turn sooner rather than later.

## 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 March 2007 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a)	Comment
Northland	9.3	4.5	275	(+6%)	46	Second longest time to sell a house across NZ
Auckland	15.1	2.0	3,115	(+2%)	27	Auckland's time to sell drops to an all time low
Waikato/BOP/Gisborne	17.4	3.6	1,419	(+2%)	38	Annual house price growth hits a 15-month high
Hawke's Bay	-3.5	1.7	348	(+8%)	37	The Bay posted the weakest annual growth in prices
Taranaki	15.8	1.0	218	(+7%)	39	Prices continuing to ease from recent highs
Manawatu-Wanganui	28.1	4.5	457	(+5%)	31	The locality to record the strongest gains in prices
Wellington	16.1	0.7	1,044	(+22%)	23	The time to sell in the Capital hits a new record low
Nelson-Marlborough	16.6	-0.6	290	(-13%)	29	A return to normality following a buoyant February
Canterbury/Westland	12.8	2.7	1,230	(-4%)	26	The median house price hit \$300k for the first time
Central Otago Lakes	5.3	3.5	370	(+8%)	29	The strongest month of sales since December 2004
Otago	5.0	-1.8	139	(-7%)	54	Sales down, prices down and time to sell up
Southland	21.7	5.1	280	(+16%)	17	All good – a stark contrast to its neighbour's fortunes
NEW ZEALAND	13.7	2.2	9,105	(-1%)	28	Number of sales dipped again but remains above 9k

## 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	1.5	1.6	2.0	2.3	2.2	2.0	1.7	1.4
CPI inflation (%)	4.0	3.5	2.6	2.5 <sup>a</sup>	1.6	1.6	2.5	2.6	2.8	2.8
Unemployment rate (%)	3.6	3.8	3.7	3.7	3.7	3.8	3.9	3.9	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	7.75	7.75	7.75	7.75	7.75	7.75	7.75	7.25
90-day bank bill rate	7.7	7.7	8.1	8.1	7.9	7.9	7.9	7.9	7.9	7.2
Floating mortgage rate	9.5	9.5	9.8	9.9	9.8	9.8	9.8	9.8	9.8	9.1
1-yr fixed mortgage rate	8.5	8.6	8.9	9.0	8.9	8.8	8.4	8.1	7.6	7.2
2-yr fixed mortgage rate	8.2	8.4	8.9	8.9	8.7	8.6	8.2	7.9	7.5	7.2
5-yr fixed mortgage rate	7.9	7.9	8.6	8.6	8.5	8.4	8.3	8.0	7.7	7.6

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