

## Bigger picture

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### Summary

- > The monthly *Property Focus* publication is aimed at providing investors and prospective homeowners with an independent appraisal of recent developments in the property market, as well as our recommended borrowing strategy. In this issue, the feature article is on the key "big picture" themes that we see shaping the property market.

#### The month in review (page 2)

- > The picture painted by housing market data will not provide the Reserve Bank with a great deal of comfort. Yet from a wider perspective, the overall economy has underperformed expectations. Against a backdrop of weaker than expected GDP growth and inflation, it is unlikely that the Reserve Bank will make good on its threat in December to raise interest rates.

#### Property gauges (page 3)

- > Our property gauges are showing that momentum has been maintained, but vulnerabilities on the part of affordability and indebtedness remain.

#### Economic backdrop (page 5)

- > Recent economic developments suggest that further interest rate increases are less likely than they were a month ago. Nevertheless, while domestic inflation pressures remain elevated and persistent, the Reserve Bank will continue to talk tough, and interest rate cuts are a way off.

#### Borrowing strategy (page 6)

- > Higher longer-dated interest rates have reduced their attractiveness. While a shorter-dated 1 year rate looks expensive at present along the curve, it now looks better value when we look at the 2 year profile for interest rates. Current market expectations that interest rates will remain high for another 2 years seems a tad excessive to us.

#### Feature article – Housing market themes (page 7)

- > We outline our thoughts on the themes that may shape the property market over the year ahead. We remain relatively optimistic about the medium-term prospects for the property market, but note that there are considerable challenges over the years ahead.

#### Key forecasts (page 11)



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## The month in review

**The picture painted by housing market data will not provide the Reserve Bank with a great deal of comfort. Yet from a wider perspective, the overall economy has underperformed expectations. Against a backdrop of weaker than expected GDP growth and inflation, it is unlikely that the Reserve Bank will make good on its threat in December to raise interest rates.**

### House sales still strong.

> **REINZ housing data – December month.** Housing market momentum was maintained in December. Median house prices (\$330,000) and days to sell (29) were unchanged from November. House sales increased 4.6 percent in seasonally adjusted terms.

### Net inward migration continues to creep higher.

> **Migration – November month.** In seasonally adjusted terms, there was a net migration inflow of 1,860 in November. Net migration continues to creep higher, and is now at 14,760 per annum, more than double last year's gains. On an annualised quarterly basis the net inflow has accelerated to 17,400.

### Consents consolidating after their 4 month surge.

> **Building Consents – November month.** The number of residential building consents fell 12 percent in November, after four relatively strong months. The trend value of non-residential consent issuance continues to increase, though the rate of growth has been easing over recent months. Costs per square metre (an indicator of construction costs) looks to be stabilising. While the three month average of costs per square metre was up 9 percent on a year ago, we note that the more timely three month average versus the preceding three months actually fell slightly. While we remain coy about reading too much into this, we nonetheless take such stabilisation as an indication of where the trend for construction costs will be headed in the second half of the year.

### Mortgage borrowing remains strong.

> **Mortgage Borrowing - November month.** Mortgage growth of \$1.8 billion was recorded in November, an acceleration from a rise of \$1.4 billion in October. Annual mortgage growth has been hovering around the 14 percent mark for the past three months.

### NZ economy less robust in September but composition stronger.

> **GDP – September quarter.** The NZ economy grew 0.3 percent over the September quarter, well below the Reserve Bank's December *Monetary Policy Statement* pick of 0.7 percent. The more erratic expenditure-based measure recorded a 0.6 percent increase. Within that measure, residential investment rebounded 3.9 percent from the weakness recorded in the June quarter. The composition of the GDP data was not as weak as the headline figures suggest, with a sharp contraction in inventories weighing heavily. These are expected to be rebuilt, exerting an upward influence on December and March quarter expectations.

### Headline inflation easing.

> **CPI – December quarter.** Consumers prices fell 0.2 percent in the December quarter. The key non-tradables inflation component increased a smaller than expected 0.8 percent.

### No tax personal tax cuts.

> **Half Year Economic and Fiscal Update.** The half yearly update of the Government's accounts recorded a larger than expected surplus. The Government signalled a business tax package in the region of \$1 billion to come through in *Budget 2008*. Personal tax cuts were not put on the agenda, with Finance Minister Michael Cullen wary of adding fiscal stimulation at a time when the Reserve Bank wants to rein in domestic spending.

## Assessment

The housing market maintained its momentum heading into year end – something that will provide little comfort to the Reserve Bank. Nevertheless, they will take comfort from softer readings across the wider economy, and are unlikely to deliver on their December *MPS* threat of higher official interest rates. However, the pickup in the housing market through late 2006 reaffirms that we are unlikely to see lower official interest rates any time soon.

## Property gauges

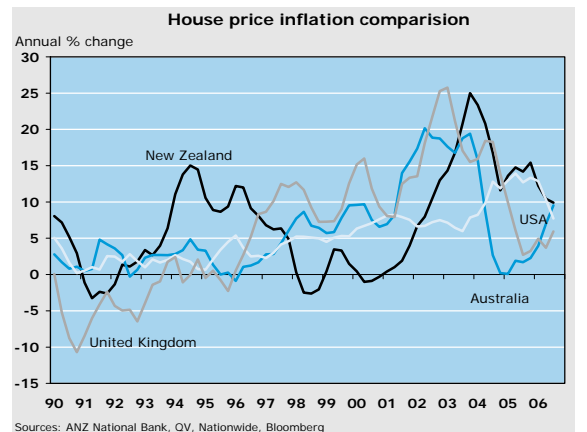
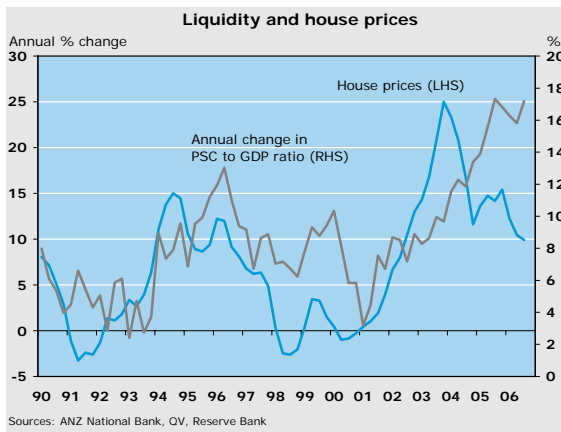
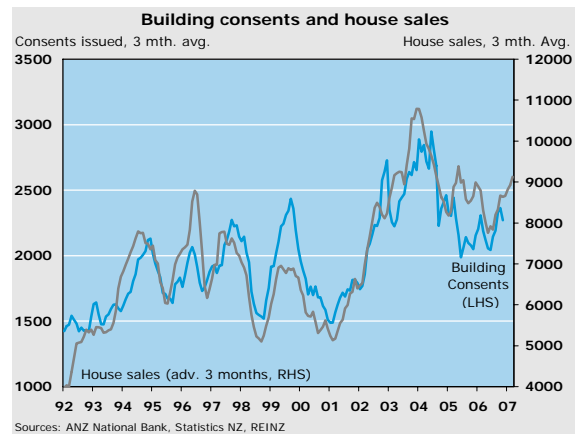
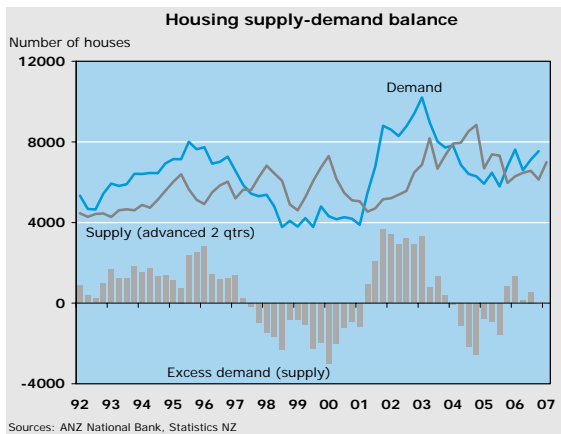
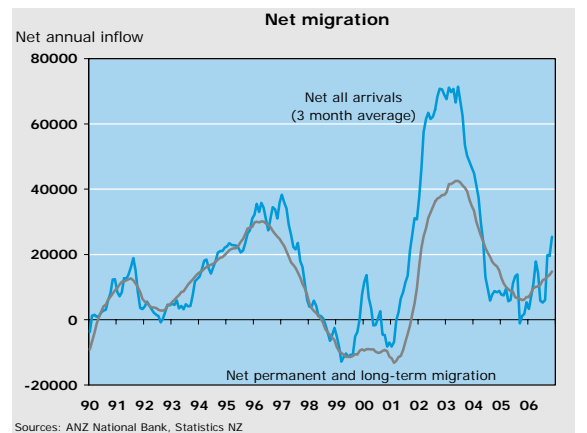
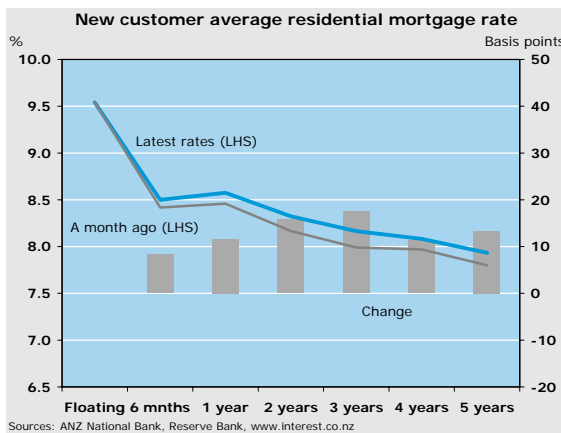
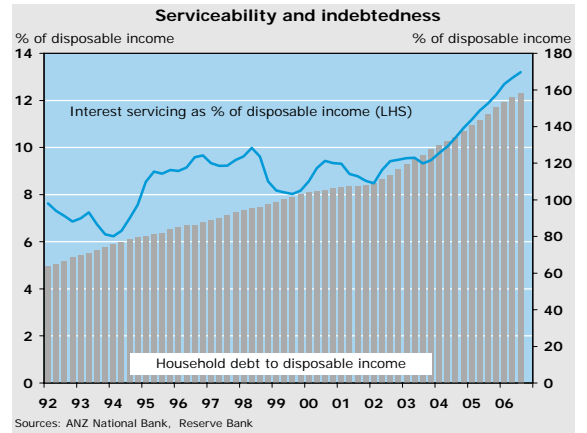
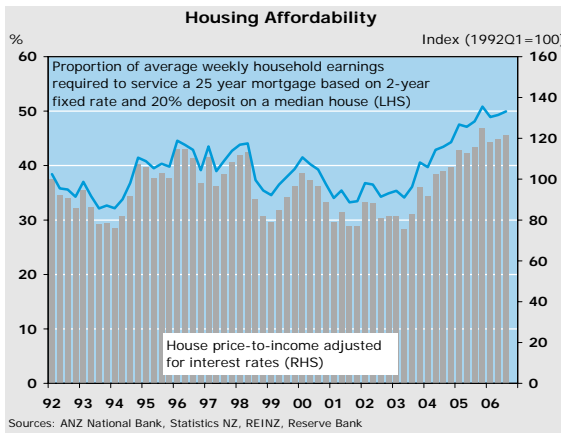
**Our property gauges are showing that momentum has been maintained, but vulnerabilities on the part of affordability and indebtedness remain.**

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.

Steady net migration inflows and a strong labour market are providing ongoing support to the market. Our gauges point to ongoing momentum in the property market in the near-term, with trends in both house sales and building consents remaining strong. The black clouds of record debt servicing and indebtedness, and a Reserve Bank that wants to see a slower housing market, continue to sit on the horizon.

Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Affordability appears to have stabilised, but remains at historically high 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 but maybe not enough?	↓	Interest rates have moved up over the past month and there is still a bow-wave of mortgages rolling off from the mortgage war of 2 years ago at higher rates.
Migration	Medium	↑/↔	Migration inflows continue to drift up, providing support to the market.
Supply-demand balance	Neutral	↔	Slight excess demand emerging due to migration inflows and natural population growth.
Consents and house sales	On the up?	↔/↑	Momentum in housing market activity has been maintained, while consent issuance has consolidated following 4 strong months.
Liquidity	High	↑	Liquidity remains abundant and demand for credit strong.
Globalisation	Cheap in world terms	↑	NZ property is still cheap on a global basis. Market becoming integrated with Australia.
<b>On balance</b>		↔/↓	<b>Property gauges point to ongoing momentum in the property market. But valuation indicators remain stretched and we are fundamentalists at heart.</b>



## Economic backdrop

**Recent economic developments suggest that further interest rate increases are less likely than they were a month ago. Nevertheless, while domestic inflation pressures remain elevated and persistent, the Reserve Bank will continue to talk tough, and interest rate cuts are a way off.**

### > Not enough to pull the trigger

The ongoing resilience shown by the NZ economy in the build up to the Reserve Bank's December *Monetary Policy Statement* saw the Bank raise the prospects of further increases in the Official Cash Rate (OCR). These threats were followed by a slew of positive data, particularly from the housing market and consumer spending, and resulted in financial markets moving to fully expect an OCR increase at the January *Review*.

However, these expectations have now been pared back significantly. GDP data released just prior to Christmas suggested that the economy had not been as resilient in the September quarter as the Reserve Bank had expected. Consumer prices fell in the December quarter, with a smaller than expected increase in the much-watched housing component. This, along with weaker than expected building consents data, sharp falls in crude oil prices (which fed through into retail petrol prices falling 5 cents per litre already this quarter), and a stronger NZ dollar have all increased the downside risks to the Reserve Bank's inflation forecasts, and make it less likely that they will raise interest rates. With the economy growing only modestly, and inflation below 3 percent (albeit as a result of sharp falls in petrol prices, which the Bank has said it will look through), it is difficult for them to raise interest rates.

Notwithstanding a lower headline inflation rate, the Bank will remain concerned about both the elevated level and persistence of medium-term inflation pressures, with the housing market a key source of such pressure. The more elongated and persistent the strength is in the housing market, the greater the upwards influence on medium-term inflation trends. Dissipating core inflation pressures requires a sustained period of sub-trend growth, which includes considerable softening in the housing market.

### > Offshore developments providing Reserve Bank with some traction

Signs of stabilising growth across indicators in the US, along with a surprise rate hike from the Bank of England, have had a notable impact on foreign interest rate sentiment, and wholesale rates have risen sharply (US 2 year Treasury note yields have increased 40 basis points over the past month). These offshore moves have placed upward pressure on longer dated yields in New Zealand, and have also flowed through to fixed mortgage rates, which have all now converged on 8 percent. Average fixed mortgage rates are generally 10-15 basis points higher across the board than the average written in December, providing the Reserve Bank with some much needed traction further along the yield curve. Rises in longer-term rates have effectively removed the ability of borrowers to "hide" from high 1 and 2 year rates through taking out a low 5 year rate.

### > Outlook for the property market

A strong labour market at present and accelerating net migration inflows should maintain a floor under housing market activity over the months ahead. Yet higher interest rates are expected to progressively bite, the recent run-up in the currency is hurting the export sector, business profits are down, which will impact on labour demand, the market looks extended, and this is a very elongated housing cycle. It all questions just how long the property market can maintain its bullet-proof persona.

**Reserve Bank threatened further rate hikes...**

**...but economic developments make it less likely that they will need to deliver those hikes.**

**Nevertheless, it will be some time before the Reserve Bank even considers softening the stance of policy.**

**Housing market risks are increasing.**

## Borrowing strategy

**Higher longer-dated interest rates have reduced their attractiveness. While a shorter-dated 1 year rate looks expensive at present along the curve, it now looks better value when we look at the 2 year profile for interest rates. Current market expectations that interest rates will remain high for another 2 years seems a tad excessive to us.**

### > Crouch and hold...

The Reserve Bank put interest rate hikes back on the table at their December *Monetary Policy Statement* and financial markets sat up and took notice. This, coupled with a reassessment of prospects for monetary policy overseas, has seen the NZ wholesale yield curve rise over the past month. Mortgage rates have also increased.

### > ...Engage!

The recent increase in lending rates across the mortgage curve has subtly altered our recommended borrowing strategy.

Firstly, higher fixed lending rates in the 3-5 year part of the curve have reduced their attractiveness. Second, while we concur with the market that any cut in interest rates is a long-way off, the current 1 and 2 year borrowing rates in effect have a material probability of a hike factored in. This is at odds with our core view of no change, and an easing cycle in 2008. Admittedly, the risk profile is pointing towards a more elongated period of higher interest rates. But put simply, the market already seems to be running with this as a core view.

### > Our view

We remain coy over how long recent housing market strength will continue into 2007, particularly with the rural sector already starting to turn. History shows that the residential and rural cycles are never too far divorced.

In the near-term we expect official interest rates to remain on hold, and a hawkish bias to be maintained. At some stage in 2008 we expect to see an aggressive easing cycle as the housing market turns. The risk profile is certainly towards higher rates for longer, although we consider interest rates at current levels broadly reflect this risk already.

### > 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.
- **Take a 1 year rate now, in anticipation of more favourable 2-year rates in early 2008.** This approach is consistent with our core economic view that rates are set to fall aggressively from late-2007/early 2008. Those bearish the property market should be hedging here.
- **If cash-flow is an active constraint,** look at extending the term of the loan. While this means paying more in interest costs, at least it provides some cash-flow relief in the near-term (albeit limited given the current shape of the yield curve).

**Interest rates up across the curve from last month.**

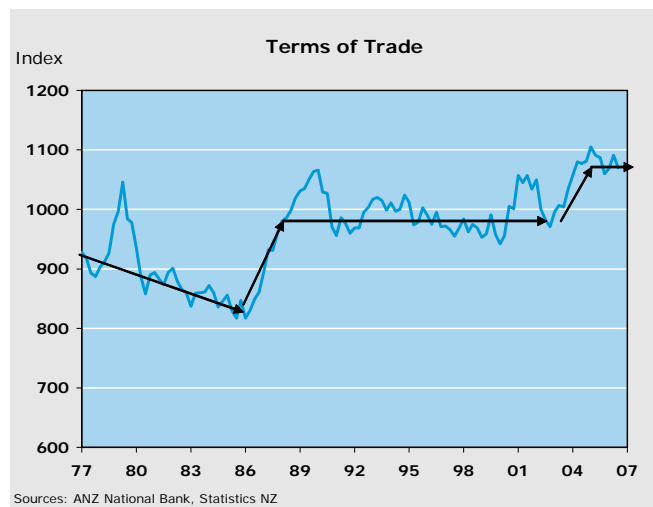
**We continue to favour a balanced approach to spread the risk.**

## Feature article – Big Picture themes for housing market

**We outline our thoughts on the themes that may shape the property market over the year ahead. We remain relatively optimistic about the medium-term prospects for the property market, but note that there are considerable challenges over the years ahead.**

**Our medium-term outlook for the property market remains optimistic...**

**We remain bullish towards the medium-term prospects for the property market** given our generally upbeat view of the New Zealand economy's long-term prospects. Ultimately it is the strength in the economy that will determine how the property market performs over the medium-term. People tend to become fixated with where the economy and housing market is headed over the coming year and they mix up the cycle with the trend when talking about growth or prospects for the property market. While economic performance may fluctuate from year to year (and likewise the property market), ultimately it is the trend rate of growth (i.e. on average over say a ten year period) that matters. There are numerous reasons to be optimistic about the longer term prospects. Our terms of trade (the price of what we export relative to what we import) has shifted to a higher structural level. We are getting a better price for what we export relative to what we import, and we are wealthier as a consequence. If we are wealthier we can spend more on other goods, and New Zealanders have a love affair with housing! As a broad generalisation we need to sell less milk, steak, fish or trees to pay for that car, DVD, or article of clothing. Productivity growth, outside of the public sector, is strong. For the property market more specifically, land is in fixed supply, while population growth, both natural and from immigration, is likely to continue to boost demand. This all leaves us with a naturally optimistic view of property as a long-term investment.



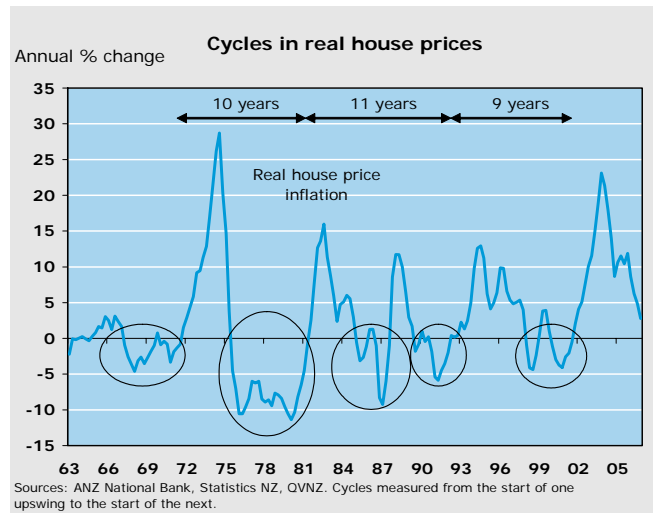
**...and we are not buying into arguments that an aging population will have a material impact on the market.**

**Talk of a pending glut courtesy of baby-boomers exiting doesn't wash with us.** While an argument can be made that some of the wave of baby boomers retiring will possibly look to sell investment properties to free up cash for their retirement, the impact of this is not expected to be material. New Zealand's population will continue to grow (Statistics NZ projects the resident population will be over 5 million by 2050) albeit at a slowing rate of increase. And even allowing for the impact of an aging populace on living arrangements (Statistics NZ estimate that the aging of the population will see the average household size fall from 2.6 people per household in 2001 to 2.4 people in 2021) there will still be underlying demand for additional housing. Some change to ownership patterns may occur, but ultimately, there will be more people and they will need somewhere to live.

Nevertheless, some caution will be needed over the next couple of years.

Yet there are equivalent areas to be mindful of, particularly over the coming 2 years.

- The property market has tended to follow a (approximately) 10 year cycle. We are currently in year five of the current cycle, which suggests that from an historical perspective at least, a period of consolidation is approaching. While real house price growth has eased of late, we note that the property cycle typically involves outright declines and weakness for at least three years.



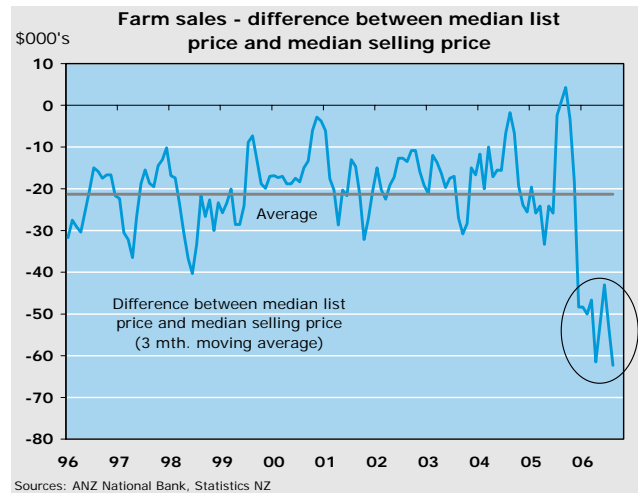
- **The economic cycle is working against the property market**, with further moderations in growth expected to see the unemployment rate gradually rise (albeit to remain low). Households' willingness and ability to take on additional debt has been bolstered by the relative security and certainty prevailing in the job market. Any deterioration in labour market prospects may dent housing market activity.
- **The Governor of the Reserve Bank is seeking a slow-down** – and he has the instrument at his fingertips to ensure it happens. The Official Cash Rate at 7.25 percent is one of the highest in the industrialised world, and is unlikely to be lowered any time soon. Fixed rate mortgage lending has insulated parts of the housing market from the impact of higher interest rates, but these are increasingly coming up for renewal at higher levels. The threat of higher interest rates remains real.
- **The market is overvalued.** As noted on page 3, the market does look extended across a number of metrics. The average house in New Zealand sells for eight times the average wage (i.e. a price-earnings ratio of 8), which is considerably more than the US and Australian equivalent ratios. Households are also carrying a lot more debt.

Of course such a combination does not mean a crash is pending. Such forces ultimately alter the risk profile on the investment as opposed to impacting directly on the return itself. Yet any investor knows that it is the combination of the two that determines the overall return, and on that front the property market appears to offer opportunity, yet at a material level of risk.

**Other themes we expect to materially shape the property cycle over the coming year and which we remain nervous towards include:**

- **A slow-down in the rural sector.** You only need to look at the massive house price growth in rural areas such as Gisborne, Hamilton and Southland to appreciate the massive impact farmer confidence and strong rural land prices have had. Admittedly some of the regions were cheap and prone to catch-up. Yet rural incomes are under pressure and

there is significant unease over the path for the currency. There is a sizeable number of properties already on the market and a widening gap between what the buyer is prepared to pay versus what the seller wants as evidenced by the growing gap between the median list price and sale price. The rural sector drove the last leg of the recent housing cycle and any slowdown in that sector could have implications for the residential property market in the rural centres.



- **How firms and businesses respond to falling profits.** Slowing economic growth and more recently the high NZ dollar has hit the revenue line of many firms, and rising costs (especially wages) are inflating the expenditure side. We suspect that the corporate sector will focus on cost containment this year. Precisely how and when this flows through to the workforce remains a million dollar question.
- **The potential for global contagion.** The US housing market slump has not yet filtered through into other markets. However, the risk remains that if global interest rates were to head higher this year, leveraged households will start to feel the effects, potentially causing a synchronised downturn in the global housing market.
- **Will there be any changes to investment rules for property?** Frustration at the inability of monetary policy to make significant inroads into slowing down the property sector in recent years has raised questions about favourable tax treatment received by property over other assets. The Reserve Bank and Treasury are looking at ancillary instruments to contain the property sector. New Zealand is a nation of dis-savers, and any move to encourage saving will dent our enthusiasm for property investment as our dominant savings vehicle. Any material changes to the incentives to save could have a material impact on the property market. At present there seems little political appetite for such a move although everyone acknowledges something needs to be done. Watch this space.

**Against this backdrop there are significant forces acting as buffers.**

- **Liquidity is ample**, both domestically (via the banking sector) and globally (the excess saving from Asian and oil-exporting economies). There is an abundance of capital looking for a home, and it is difficult to be overly pessimistic about economic prospects when this is the case.
- **Migration gains remain solid.** Annual net migration inflows troughed around 6,000 people in late 2005, and have subsequently ground higher to current inflows above 14,500. While we do not envisage a return to the 42,000-plus net inflows recorded in 2003, steady net inflows around

current levels will continue to underpin demand for housing. (Refer to the chart on page 4).

- **An eventual fall in the NZD will make NZ property cheaper.** While high interest rates in New Zealand are likely to continue to provide support for the NZ dollar over the next few months, ultimately it is the relative performance of the economy which matters for currency cycles. The New Zealand economy is expected to under-perform its offshore counterparts, and this should weigh on the NZ dollar through the second half of 2007. When the kiwi falls it is likely to fall quickly.

Collectively this leaves us with your typical two-handed economist view. We remain bullish in terms of our medium to long-term view for the housing market, but are very wary how the final leg of the current housing cycle could pan out.

## 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 December 2006 (based on REINZ data)

	House prices (Annual % change)	3 month % change	Average days to sell	Comment
Northland	20.0	7.3	42	Selling time dips but still the longest across the regions
Auckland	12.2	8.0	28	Its strongest annual growth in prices in over a year
Waikato	17.2	9.7	37	The second strongest rise over the past three months
Bay of Plenty	14.9	7.6	40	Days to sell hits a 12-month low but second longest in NZ
Gisborne	18.8	9.5	37	The third fastest growth in North Island house prices
Hawke's Bay	9.5	7.9	32	The second slowest annual growth in house prices
Taranaki	23.5	11.2	30	Highest annual growth in price across the North Island.
Manawatu-Wanganui	18.7	5.8	29	Average house sale price cracks \$250k for the first time
Wellington	17.3	7.7	20	The number of days to sell a house hits a 10-year low
Nelson-Marlborough	23.6	9.3	26	Days to sell at recent low, and prices keep getting higher
West Coast	2.0	0.0	38	A quieter market. Longest time to sell in South Island
Canterbury	13.4	5.5	25	Selling prices aren't keeping pace with nationwide trends
Otago	23.0	0.4	33	Finished the year strongly, average house price at highs
Southland	14.5	7.3	24	Second fastest turnover in the country
NEW ZEALAND	16.8	7.5	29	Average value of all houses sold in December tops \$400k

## 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 <sup>e</sup>	1.5	1.6	1.7	1.5	1.5	1.6	1.9
CPI inflation (%)	4.0	3.5	2.6	2.3	1.5	1.4	2.2	2.4	2.5	2.6
Unemployment rate (%)	3.6	3.8	3.9 <sup>e</sup>	4.0	4.1	4.2	4.2	4.2	4.3	4.4
Interest rates	Actual			Forecast (end month)						
	Nov 06	Dec 06	Current	Mar 07	Jun 07	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08
Official Cash Rate	7.25	7.25	7.25	7.25	7.25	7.25	7.00	6.50	6.00	5.50
90-day bank bill rate	7.6	7.7	7.7	7.7	7.5	7.4	7.0	6.5	6.1	5.6
Floating mortgage rate	9.5	9.5	9.5	9.5	9.4	9.3	8.9	8.4	8.0	7.5
1-yr fixed mortgage rate	8.4	8.5	8.6	8.5	8.1	7.7	7.2	6.8	6.6	6.6
2-yr fixed mortgage rate	8.1	8.2	8.3	8.2	7.9	7.5	7.0	6.8	6.8	6.9
5-yr fixed mortgage rate	7.8	7.8	7.9	7.9	7.7	7.5	7.2	7.1	7.2	7.4

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