

Light at the end of the tunnel?

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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 analysis of which regions have a higher proportion of sections and apartments for sale, relative to other types of properties for sale on the real estate market.

The month in review (page 2)

- All aboard. An easing in interest rates later this year is the light at the end of the tunnel for home owners. Or could the light actually be a train coming in the other direction, carrying with it a huge supply of houses to the market and a weakening economy, and which portends of further house price weakness?

Property gauges (page 3)

- After being derailed by very high mortgage rates, housing affordability is finally adjusting in the right direction. But like a slow-moving freight train, the adjustment is taking its time.

Economic backdrop (page 5)

- The economy has run out of steam. The labour market has turned earlier than expected and economic sentiment has plummeted. While there remain a few positive factors, most have succumbed to the current tight monetary policy setting. Offshore, we are now on inflation watch.

Mortgage borrowing strategy (page 6)

- The big picture points to interest rates moving considerably lower over the coming years. However, the global inflationary backdrop and currency are likely to be sticking points over the timing. The 1 year fixed rate remains the sweet spot.

Feature article – Vulnerability update (page 7)

- Sections and apartments are often talked about as the most vulnerable parts of the property market. We have updated our table showing which regions have the most exposure to sections and apartments, relative to other types of sales. The relative rankings remain similar, although 70 percent of the regions have shown an increase in available listings of sections and apartments. This reinforces, to us, that this is an area of the property market where a large part of the correction will occur.

Key forecasts (page 9)



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The month in review

All aboard. An easing in interest rates later this year is the light at the end of the tunnel for home owners. Or could the light actually be a train coming in the other direction, carrying with it a huge supply of houses to the market and a weakening economy, and which portends of further house price weakness?

She'll be comin' round the mountain, when she comes.

> **RBNZ Monetary Policy Statement.** The Reserve Bank left the OCR unchanged but shifted to an easing bias, explicitly signalling "we are now likely to be in a position to lower the OCR later this year." However, this is conditional upon the economy continuing to slow and non-tradable inflation starting to ease. While the former is a given, going by recent partial data and confidence readings, the latter may continue to be a sticking point. The RBNZ will also want to see inflation and wage expectations stay well anchored.

Polar express.

> **REINZ housing data – May.** House sales (seasonally adjusted) fell 14 percent from April, and have halved from levels of a year ago. Despite the sharp fall in house sales, the median sale price remained resilient, staying flat from the previous month at \$345,000. However, this continues to overstate the "true" market with relatively more properties being sold in higher price brackets. The continual rise in the median days to sell, to a 6-year high of 47 days, tells us that sellers are still reluctant to adjust their price expectations down. They appear to still be holding out in the hope that the housing market will recover, and that they'll get the price they want.

Last train to Clarksville.

> **Barfoot and Thompson house sales – May.** Barfoot and Thompson housing data shows the Auckland housing market staying soft over May, with almost 15 month's worth of unsold homes, compared to only 4 month's worth a year ago. While house prices are still staying elevated, rising 2.7 percent in the month, they are down over 4 percent compared to a year ago.

> **NZ Budget.** A substantial tax cut package was announced, which is to be implemented in three phases, from October 2008. The Government's previously strong fiscal position is no more. A combination of much higher spending and lower tax forecasts has seen the operating balance run down from \$5.2 billion (2.9 percent of GDP) in 2007/08 to just \$0.2 billion in 2011/12 (0.1 percent of GDP).

Keeping a firm grip on the dead man's switch.

> **Mortgage Lending – April.** Housing lending growth slowed quite abruptly. Total household claims grew by just 0.3 percent in April. This is the smallest monthly increase since the series began in December 1990.

> **Building Consents – April.** Residential consent issuance rose a whopping 82.1 percent in April, following a 14.5 percent fall in March. Statistics NZ caution about placing too much weight on the seasonally adjusted numbers, due to greater variability than normal from the early Easter this year. Averaging over the last two months, ex-apartment issuance is down slightly compared to February, and some 15 percent lower compared to a year ago.

Runaway train.

> **External Migration – April.** There was a seasonally adjusted monthly net inflow of 440 people in April, slightly above the average of the past six months of 300 people. Annual net migration inflows appear to be stabilising around the 4,700 level. Over the past 12 months, a net 30,575 people have permanently departed for Australia – the highest number since 2001 and, interestingly, also the last time the NZ housing market recorded negative annual house price growth.

Assessment

Apart from an unexpected blip up in building consents, all of the latest real estate indicators eased again. While expectations that interest rates will fall are a positive, the housing market still looks to be in the early stage of adjusting. Interest rates need to fall a long way to have a meaningful impact, given that the average rate borrowers are looking to refinance from is currently over 9 percent.

Property gauges

After being derailed by very high mortgage rates, housing affordability is finally adjusting in the right direction. But, like a slow-moving freight train, the adjustment is taking its time.

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

A broad gauged track.

- > **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.

Roll-on/roll-off.

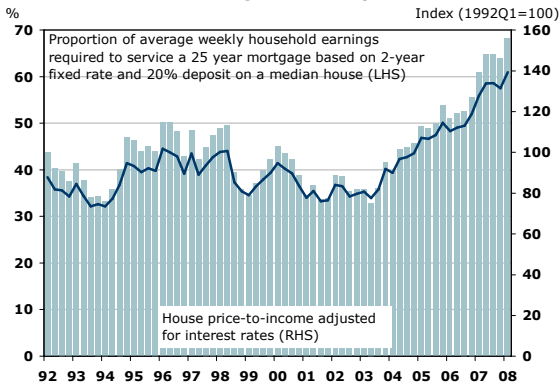
- > **Globalisation.** We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

Between the tracks.

Most gauges continue to point towards continued weakness. Looking at the key affordability gauge, the rubber band remains taut, and it is hard to see a correction not continuing.

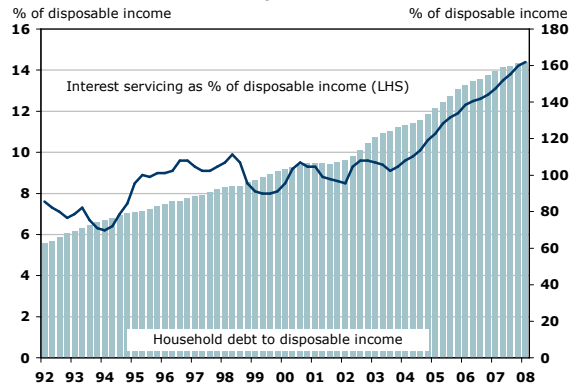
Indicator	Level	Direction for prices	Comment
Affordability	Expensive	↓	Like a slow-moving freight train, housing affordability is finally adjusting in the right direction.
Serviceability / indebtedness	High	↓	Some days it just feels like you're just working on the chain gang.
Interest rates	High	↔/↓	All aboard the Chattan-looser choo-choo!
Migration	Medium	↔/↓	What feels like a relatively deserted carriage following the recent rush hour squash.
Supply-demand balance	Neutral	↔	A whistle stop at Petticoat Junction.
Consents and house sales	Consents blip up, sales head lower	↓	Derailed.
Liquidity	High	↓	A narrowing in the gauge of the credit criteria track.
Globalisation	Not that cheap	↔	Reliving the glory days with a ride on the Trans Europe Express
On balance		↓	Reminiscent of a hobo singin' the Brakeman's Blues.

Housing Affordability



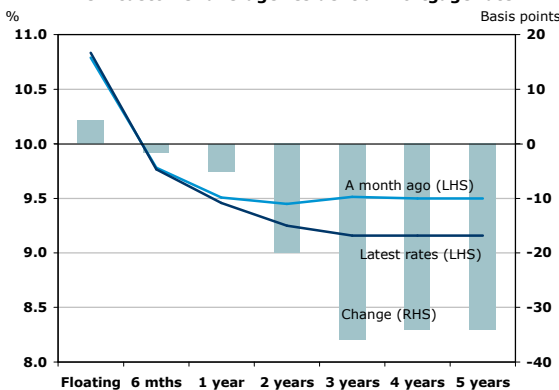
Sources: ANZ National Bank, Statistics NZ, REINZ, Reserve Bank

Serviceability and indebtedness



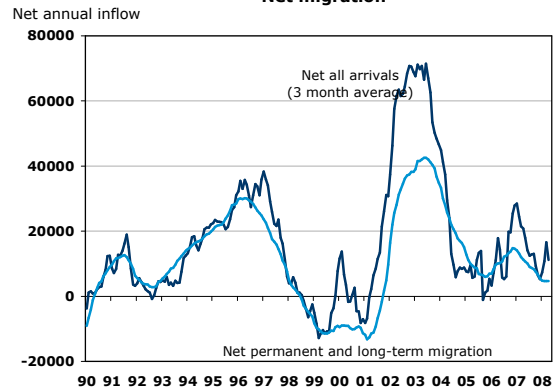
Sources: ANZ National Bank, Reserve Bank

New customer average residential mortgage rate



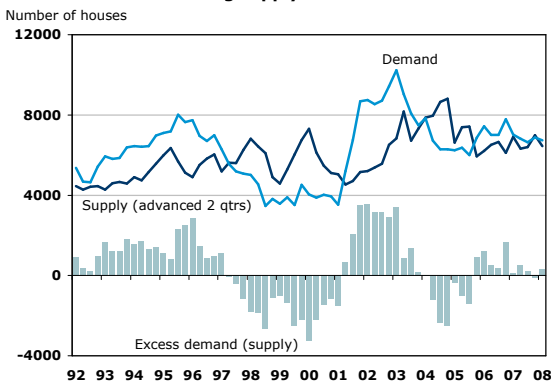
Sources: ANZ National Bank, Reserve Bank, www.interest.co.nz

Net migration



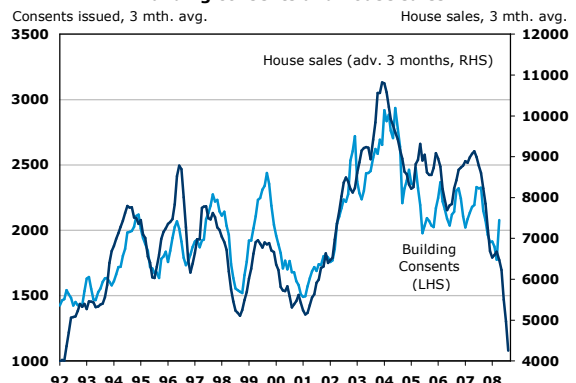
Sources: ANZ National Bank, Statistics NZ

Housing supply-demand balance



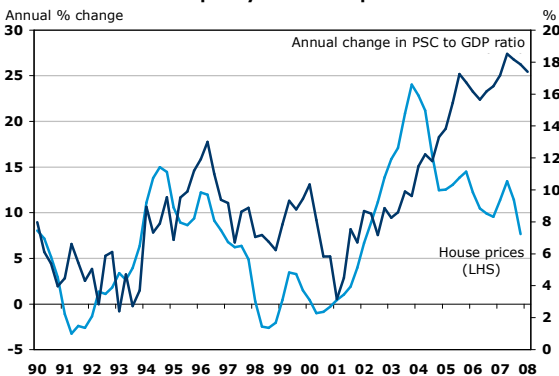
Sources: ANZ National Bank, Statistics NZ

Building consents and house sales



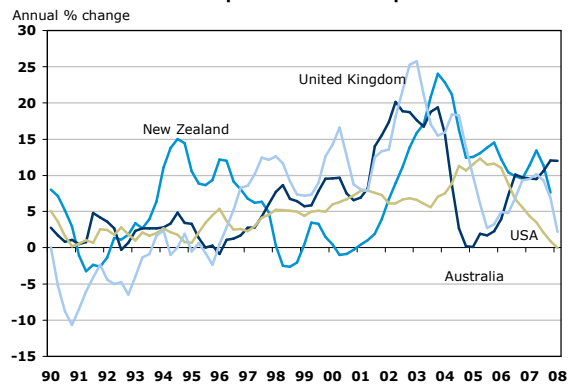
Sources: ANZ National Bank, Statistics NZ, REINZ

Liquidity and house prices



Sources: ANZ National Bank, QV, Reserve Bank

House price inflation comparison



Sources: ANZ National Bank, QV, Nationwide, Bloomberg

Economic backdrop

The economy has run out of steam. The labour market has turned earlier than expected and economic sentiment has plummeted. While there remain a few positive factors, most have succumbed to the current tight monetary policy setting. Offshore, we are now on inflation watch.

Our core economic view

The slowdown has broadened into a crunch and is no longer just a housing market story. Economic sentiment has weakened for both households and firms. Consumer confidence continues to plunge, while businesses' own activity indicators remain anchored in negative territory. Both are at levels seen in past recessions. Not surprisingly consumers are shutting their wallets with March quarter retail sales volumes posting the biggest decline since 1997. Outside of food and fuel, consumers are cutting back on their spending, as their discretionary incomes get squeezed from higher cost of living pressures. The low level of consumer confidence portends of a further spending retrenchment.

Additionally, the labour market looks to have turned earlier, with a large fall in employment and a rise in the unemployment rate recorded in Q1. The labour market tends to be a lagging indicator and, the fact that it weakened early, indicates more softness in the economy to come. Hiring intention surveys suggest the employment fall may not be a statistical quirk.

Nevertheless, there are still areas of support for the economy. Earlier and larger tax cut stimulus were announced in the *Budget*. The dairy payout for the current 2007/08 season has been revised higher again, from \$7.30/kg ms to \$7.90. And international credit conditions have improved, with swap and credit spreads starting to narrow, albeit at still high levels.

Netting out these factors, the economy is going backwards. Given the headwinds facing the domestic economy, we continue to envisage an elongated adjustment process despite support factors such as dairy and tax cuts.

A very weak growth prognosis has improved the medium-term outlook for inflation, particularly non-tradable or domestic inflation, which is what the Reserve Bank controls. Bottom-line is that it's impossible to pass on price increases if people are not buying. This will give the Reserve Bank scope to cut interest rates soon.

Traditionally, easing cycles tend to be sharp and aggressive. Indeed, we suspect the big picture over the coming three years is one of rates moving 200 to 300 basis points lower. However, some persistence on the inflation front means the timing could be a reasonably drawn out affair, and the cycle could be staggered, and stop-start in nature. This is not a classic way to run policy, but likely necessitated by still persistent inflation from food and petrol, and the likelihood that the currency will continue to fall, thereby exacerbating inflationary pressure.

Offshore developments

The global economy continues to weaken. In the US, the prevailing theme at present remains one of a weak economy, but having found a base. We have seen five consecutive months of pay roll job loses in the States. Historically, this has occurred only during times of recession. Across the Atlantic, the dataflow has been printing consistently weaker than expected. European retail sales contracted for the third successive month.

International attention has now swung towards rising inflation, which means an even weaker growth outlook to counter. Two areas are on our radar at present. Firstly, the impact of weaker US growth and rising inflation on emerging markets. Second, the political aspects to rising food and related inflation. People have to eat — and thus, politics and economics may be on a collision course.

NZR: New Zealand's R.....

The little engine that could!

Doubting Thomas's and the tanking engine.

Could the Orient Express be the next to be murdered?

Mortgage borrowing strategy

The big picture points to interest rates moving considerably lower over the coming years. However, the global inflationary backdrop and currency are likely to be sticking points over the timing. The 1 year fixed rate remains the sweet spot.

Our view

Good news. Interest rates are set to fall. Historically, they tend to fall a long way when the easing cycle starts, and we envisage a similar outturn over time.

While welcome, the reason interest rates are set to fall is hardly encouraging for those engaged in the property sector. For one, growth within the economy has come to an abrupt stop, and in fact looks to be contracting. Second, the housing market is leading the charge, and the unemployment rate is now moving up. Finally, it's hard to see lower interest rates providing a huge fillip to prospects given the average mortgage rate rolling off is still 8 percent and retail rates are currently 9 plus. Headwinds in the form of global uncertainty, higher credit costs and a weak economy continue to mount. This adjustment the property market is facing will be a drawn out process.

There still remains a fair degree of uncertainty over how quickly rates could move down. Our core track has the Official Cash Rate falling from September, in steady 25 basis point moves — a safe “track” to present. However, we see a number of risks to this. For one, globally there is a lot of inflation, and all central banks excluding the RBNZ are now expected to hike rates. Their cash rates are far lower, and our economy far weaker, so there is a major difference. But there is no doubting central banks are on inflation watch, and while a lot of the inflation is coming from food and oil, which they'd traditionally look through, they have a structural and rising trend element to them which means they could be around for a while yet. A lot will depend on how emerging market economies — which are key drivers of global demand for commodities — fare.

We wouldn't be surprised to see this easing cycle far more staggered and stop-start-ish in nature. The big picture is still an overall easing, but we may see three 25 basis point moves then a pause, and a resumption of the same. An implicit acknowledgment that a lot of inflation in the pipeline exists. The Reserve Bank — like all central banks — has a tough path to navigate as it balances a very weak economy, with an inflationary backdrop around the globe.

The other area to watch at present on the retail interest rate front is the cost of credit and pure credit risk. Globally, we've seen credit spreads once again start to widen, and given one-third of New Zealand's bank funding is sourced from overseas, this carries an obvious cost. This means retail lending rates are once again at a delicate juncture, where we are balancing up expectations for lower wholesale rates (courtesy of the RBNZ) but wider credit costs. This means retail lending rates could prove to be a bit sticky.

Themes we favour in the current environment

We continue to favour relatively short dated borrowing. The one year part of the curve remains the “sweet” spot, the same as last month.

- > **Borrowers should continue to have a degree of diversification.**
- > **The 1 year part of the curve, and even shorter duration borrowing, looks to be the sweet spot at this juncture.**

**Boarding call:
The Hogwarts “1-Yr Fixed Rate” Express is now scheduled to depart from platform 9½.**

Feature article – Vulnerability update

Sections and apartments are often talked about as the most vulnerable parts of the property market. We have updated our table showing which regions have the most exposure to sections and apartments, relative to other types of sales. The relative rankings remain similar, although 70 percent of the regions have shown an increase in available listings of sections and apartments. This reinforces, to us, that this is an area of the property market where a large part of the correction will occur.

I think I can, I think I can.

The section and apartment sectors of the property market – traditionally more speculative areas – are often touted as being the pockets that are the most vulnerable at this stage in the property cycle. Higher interest rates or changes in the credit cycle often mean that these pockets can experience large price swings, relative to other types of property, as demand wanes.

The following table, which was last updated in February, shows the number of sections and apartments for sale, relative to the total number of properties on the market. It is based on data from the Trade Me website (which provided easy access to this type of data). Although it is somewhat of a crude indicator, we feel it is still reasonably effective nonetheless. The table ranks the various regions from highest to lowest and also shows their movement compared with February.

So what does it show?

- > Compared with February, close to 70 percent of regions have shown an increase in section and apartment listings relative to totals. The average increase in this ratio across the regions was just over 9 percent. The median increase was slightly less, at just over 6 percent. Across the country as a whole, the ratio of sections and apartments for sale relative to total properties is 29.1 percent. This is up from 26.8 percent in February.
- > The relative rankings of the regions are reasonably similar to February. The rankings of first three regions remained unchanged. Those regions that had a relatively high proportion of sections and apartments for sale in February, typically still have high proportions now, and vice versa. The biggest movers of note were Selwyn, which jumped 13 places, and Franklin, which jumped 12 places. Southland continued its slide down the rankings and now sits in 31st place, with a ratio of 19.5 percent. This is after it topped the rankings in October 2007 – when we first presented these statistics.
- > As the relative rankings are little changed, a similar composition remains – it's a holiday or retirement destination theme. Queenstown Lakes, Northland, Thames/Coromandel, Tasman and Taupo all sit toward the top end of the rankings, with a high exposure to sections and apartments. This could potentially mean they are more vulnerable, and we have heard anecdotes of some of these regions experiencing large falls in house prices.
- > Auckland City again ranks highly, with a large number of apartments listed. We have heard some horror stories emanating from the Auckland apartment market with properties selling for well under previous sale values. Part of this may be due to the collapse of some property investment companies, but it also likely to be a case of softness in the market.

The little red caboose always came last.

The upshot

The supply of sections and apartments relative to the total stock of houses for sale continues to increase. This is potentially a sign of unease and is one area where we expect the housing market "correction" to play out. With both types of properties exposed to high interest rates (low yield or high carry cost); likely diminished appetites to lend; credit dislocation in certain pockets; and land-banking – which has the potential to unwind quickly, we expect to hear more anecdotes of these types of properties coming under increased downward price pressure.

Number of sections and apartments for sale, relative to total properties for sale					
Rank	Region	Number of apartment and sections as % of total listings, Jun-08	Feb-08 %	% change from Feb-08	Feb-08 rank
1	Queenstown Lakes	52.5	52.1	0.9	1
2	Auckland City	51.2	43.8	16.8	2
3	Northland - Far North	45.5	42.7	6.5	3
4	Central Otago ex Qtwn	42.2	36.1	16.7	7
5	Northland - Whangarei	41.1	33.1	23.9	12
6	Thames/Coromandel	40.6	39.4	3.1	4
7	West Coast	39.7	36.6	8.3	5
8	Selwyn	35.9	26.3	36.4	21
9	Hauraki	35.5	28.9	22.7	16
10	Tasman	35.0	36.5	-4.2	6
11	Hurunui, Hanmer	34.1	32.5	5.2	13
12	Kaikoura	33.3	32.0	4.2	15
13	Taupo	33.2	35.2	-5.9	8
14	Waitaki	32.4	33.8	-4.1	9
15	Marlborough	32.3	33.5	-3.7	10
16	Papakura	30.3	33.2	-8.6	11
17	Wellington City	30.2	28.0	8.0	18
18	Rodney	29.9	32.4	-7.6	14
19	Franklin	28.3	16.7	69.8	31
20	Western BoP	28.1	28.4	-1.2	17
21	Gisbourne	27.2	27.2	0.0	19
22	Tauranga City	26.6	25.4	4.8	23
23	Waitakere	26.6	22.5	18.1	27
24	North Shore City	26.0	23.7	9.4	26
25	Whakatane	25.0	26.8	-6.8	20
26	Upper Hutt	24.8	15.9	56.3	32
27	Nelson City	23.3	26.2	-10.9	22
28	Taranaki	23.3	23.8	-2.1	25
29	Hamilton City	23.2	21.5	7.7	28
30	Waimakariri	21.4	20.3	5.9	30
31	Southland	19.5	24.1	-18.9	24
32	Kapiti Coast	18.6	20.7	-10.3	29
33	Manawatu/Wanganui	17.6	15.2	16.1	33
34	Dunedin City	17.4	15.0	15.9	34
35	Manakau City	16.0	14.0	14.1	36
36	Hawke's Bay	15.0	14.9	0.3	35
37	Christchurch City	12.6	10.8	17.2	37
38	Lower Hutt	10.9	7.8	39.6	40
39	Rotorua	10.6	9.4	13.0	38
40	Timaru	10.3	9.4	10.2	39

Statistical Annex

Weekly mortgage repayments table (based on 25 year term)

Mortgage Size (\$'000)	Mortgage Rate (%)													
	7.50	7.75	8.00	8.25	8.50	8.75	9.00	9.25	9.50	9.75	10.00	10.25	10.50	10.75
100	170	174	178	182	186	190	194	197	201	205	210	214	218	222
150	256	261	267	273	279	284	290	296	302	308	314	320	327	333
200	341	348	356	364	371	379	387	395	403	411	419	427	435	444
250	426	435	445	455	464	474	484	494	504	514	524	534	544	555
300	511	522	534	545	557	569	581	592	604	616	629	641	653	666
350	596	610	623	636	650	664	677	691	705	719	733	748	762	777
400	682	697	712	727	743	758	774	790	806	822	838	855	871	887
450	767	784	801	818	836	853	871	889	907	925	943	961	980	998
500	852	871	890	909	928	948	968	987	1007	1027	1048	1068	1089	1109
550	937	958	979	1000	1021	1043	1064	1086	1108	1130	1153	1175	1198	1220
600	1022	1045	1068	1091	1114	1137	1161	1185	1209	1233	1257	1282	1306	1331
650	1108	1132	1157	1182	1207	1232	1258	1284	1310	1336	1362	1389	1415	1442
700	1193	1219	1246	1273	1300	1327	1355	1382	1410	1438	1467	1495	1524	1553
750	1278	1306	1335	1364	1393	1422	1451	1481	1511	1541	1572	1602	1633	1664
800	1363	1393	1424	1454	1485	1517	1548	1580	1612	1644	1676	1709	1742	1775
850	1448	1480	1513	1545	1578	1611	1645	1679	1713	1747	1781	1816	1851	1886
900	1534	1567	1602	1636	1671	1706	1742	1777	1813	1849	1886	1923	1960	1997
950	1619	1655	1691	1727	1764	1801	1838	1876	1914	1952	1991	2029	2069	2108
1000	1704	1742	1780	1818	1857	1896	1935	1975	2015	2055	2095	2136	2177	2219

Housing market indicators for May 2008 (based on REINZ data)

	House prices (Ann % chng)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a)	Comment
Northland	-6.1	5.0	93	(-11%)	55	The annual price carnival is lacking some Puff 'n' Pull
Auckland	-0.6	1.1	1,278	(-9%)	45	A long queue waiting to sell is spilling out of Britomart
Waikato/BOP/Gisborne	-1.6	-3.9	536	(-17%)	50	Sales derailed near Tauramanui on the main trunk line
Hawke's Bay	-4.3	-2.0	166	(-6%)	52	The Bay Express is struggling to live up to its name
Taranaki	1.4	2.5	141	(-15%)	51	Train-sporters report a pick-up in annual price growth
Manawatu-Wanganui	1.1	-1.5	220	(-3%)	64	Days to sell have triggered the lahar warning system
Wellington	0.8	5.4	462	(-17%)	44	The 3 month change has traversed the Rimutaka incline
Nelson-Marlborough	2.7	-4.0	161	(-24%)	40	Washed out track on the TransCoastal's 3 month change
Canterbury/Westland	-2.3	-3.8	579	(-12%)	43	Annual house prices shivering on the TranzAlpine route
Otago	0.0	-0.1	177	(-21%)	51	Time to sell is rapidly moving up the Taieri Gorge track
Central Otago Lakes	1.0	1.0	73	(+5%)	78	The number of Kingston's house sales are on a Flier
Southland	13.0	-1.9	126	(-27%)	36	Sale numbers are heading South on the Southener
NEW ZEALAND	-1.4	1.6	3,966	(-14%)	47	Who'll save the helpless heroine tied to the train track?

Key forecasts

Economic indicators	Actual			Forecast						
	Sep 07	Dec 07	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09
GDP (ann avg % chg)	2.7	3.1	3.1f	2.5	1.8	0.9	0.5	0.6	0.8	1.3
CPI inflation (%)	1.8	3.2	3.4	3.8	4.6	4.3	4.1	3.4	2.9	2.7
Unemployment rate (%)	3.5	3.4	3.6	3.8	4.0	4.2	4.3	4.5	4.7	4.8
Interest rates	Actual			Forecast (end month)						
	Apr 08	May08	Latest	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10
Call rate	8.6	8.5	8.3	8.0	7.5	7.0	6.5	6.0	6.0	6.0
90-day bank bill rate	8.9	8.7	8.7	8.2	7.7	7.1	6.6	6.2	6.2	6.2
Floating mortgage rate	10.7	10.8	10.8	10.7	10.2	9.7	9.2	8.7	8.7	8.7
1-yr fixed mortgage rate	9.9	9.5	9.5	9.3	8.9	8.4	7.9	7.6	7.6	7.6
2-yr fixed mortgage rate	9.7	9.4	9.2	9.1	8.8	8.3	7.9	7.7	7.7	7.7
5-yr fixed mortgage rate	9.3	9.5	9.2	9.0	8.7	8.3	8.0	7.6	7.6	7.8

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