

Brace yourself

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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 mortgage rate levy proposed by Dr Cullen.

The month in review (page 2)

- > Another month of continued strength across housing market indicators, much to the ire of the Reserve Bank. After giving the housing market every opportunity to slow, and being cautious towards the need to raise rates – constantly barking but failing to bite – the Reserve Bank's patience looks to have run out.

Property gauges (page 3)

- > Our property gauges point to near-term momentum, but the real threat of higher interest rates hangs in the air. While households may be interest rate in-sensitive, will businesses be the same when it comes to jobs?

Economic backdrop (page 5)

- > The Reserve Bank has delivered its bluntest message yet: housing activity slows or interest rates move up. Brace for at least one 25 basis point increase in the Official Cash Rate. After waiting for the housing market to turn voluntarily, the Reserve Bank looks set to take more active steps to engineer it.

Borrowing strategy (page 6)

- > The Reserve Bank looks set to increase interest rates in March. We see one rate rise and then a slight easing at the end of 2007, before a more aggressive easing after the 2008 *Budget*. This sees us favour the 2 or 3-year rates over the 1-year at this juncture, in order to take advantage of lower rates in 2009.

Feature article – a mortgage levy (page 7)

- > Talk of a mortgage levy to quell the housing market has been raised and quashed. Stepping back, the economic rationale is questionable. If policy-makers are serious about reducing the nation's dependence on housing as our savings vehicle, there are other policy options to pursue.

Comment – rents (page 8)

- > Rents have lagged house prices over this economic cycle. Given tight housing supply and a desire from the Reserve Bank for housing activity to slow, we see upward pressure on rents over the coming years.

Key forecasts (page 11)



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The month in review

Another month of continued strength across housing market indicators, much to the ire of the Reserve Bank. After giving the housing market every opportunity to slow, and being cautious towards the need to raise rates – constantly barking but failing to bite – the Reserve Bank’s patience looks to have run out.

House sales still strong.

> **REINZ housing data – January month.** Although the number of house sales fell 1.3 percent (seasonally adjusted), the level remains elevated at over 9,300. The average days to sell a house fell to 31 days, from 32 days in December, while the median house price eased slightly to \$327,000. On balance the housing market is clearly not experiencing the moderating trend the Reserve Bank requires.

No workers left to employ.

> **NZ labour market data.** NZ labour market data was mixed, with employment growth down 0.1 percent, but the unemployment rate fell to 3.7 percent. Wage inflation accelerated in the December quarter, up one percent to a new annual peak of 3.2 percent. The Reserve Bank will be concerned at the acceleration in wage inflation, as it points to the impact of the tight labour market filtering through into wage setting behavior.

Net inward migration continues to creep higher.

> **Migration – December month.** In seasonally adjusted terms, there was a net migration inflow of 1,160 in December, taking the annual total to 14,610. The current level of net migration is running above the Reserve Bank’s projections, and will provide further support to the housing market and retail spending, both of which the Bank wants to see moderate.

Consents consolidating after their four month surge.

> **Building Consents – December month.** December residential building consents fell 4.9 percent (in seasonally adjusted terms), building on the 11.6 percent fall recorded in November. Ex-apartment consents rose 2.8 percent. The monthly trend measures for residential and ex-apartment consents both fell. This will provide the Reserve Bank with some comfort that construction activity is likely to ease over the first half of 2007. Certainly there is anecdotal evidence that a swathe of consents were issued around the September quarter in order to beat fee increases, and recent movements appear to reflect some unwinding from that strength.

Mortgage borrowing remains strong.

> **Mortgage Borrowing - December month.** Mortgage borrowing increased by \$1.44b in December, taking annual growth to around 14 percent. This fits with December REINZ data that recorded robust housing market activity, and is likely to remain a concern to the Reserve Bank.

A mortgage levy is floated... and quickly ditched by the PM.

> **MoF Cullen proposes mortgage levy.** Dr Cullen said this month that he is seriously considering imposing a levy on home mortgages. Such a levy has serious implementation and enforcement issues to work through. The political consensus that would be required for it to be introduced looks difficult, suggesting that if it was introduced it would not be for some time.

Assessment

No joy for the Reserve Bank on slowing housing activity.

The picture remains one of vigour across housing market indicators. Migration gains and job security have seen housing confidence rise to close to a three-year high. Credit growth is strong and liquidity is abundant. The housing market remains bullet-proof.

It’s a portrait that worries the Reserve Bank. Strong housing market activity is in turn placing pressure on resources, with the construction sector a key inflation culprit. The Bank has given the housing market every opportunity to slow. Poor communication on their behalf hasn’t helped their goal, and it has been difficult to “read” the Reserve Bank over the past six months. In October we thought a hike was required but they failed to deliver, indicating a very high threshold to raise rates. Their December communication flagged a potential hike but data proved to be mixed and looked to lack a smoking gun. However, given the nuances at their January *OCR Review*, a hike is clearly now more certain than not. After being cautious towards the need to raise rates, the Reserve Bank’s patience looks to have run out.

Property gauges

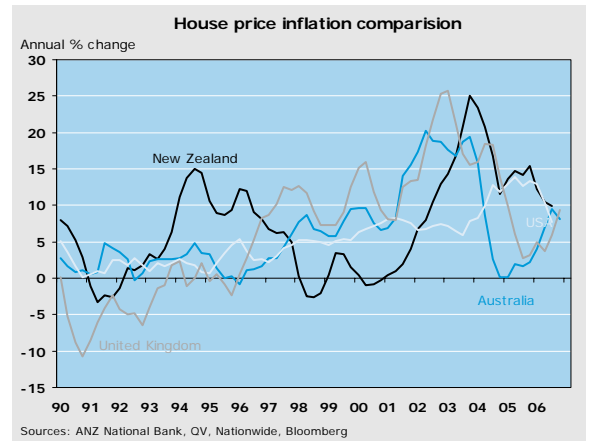
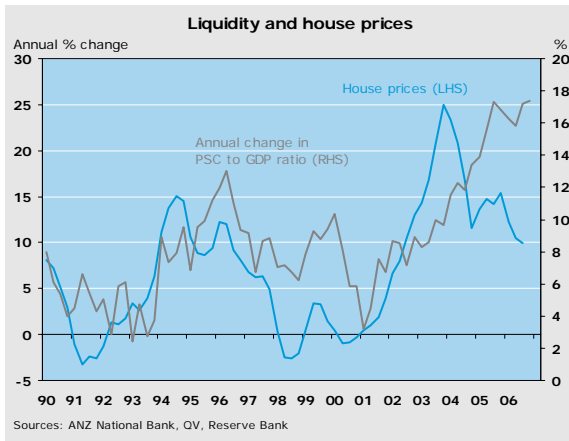
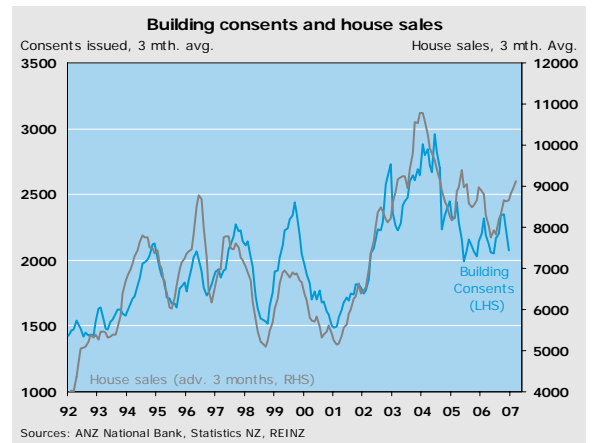
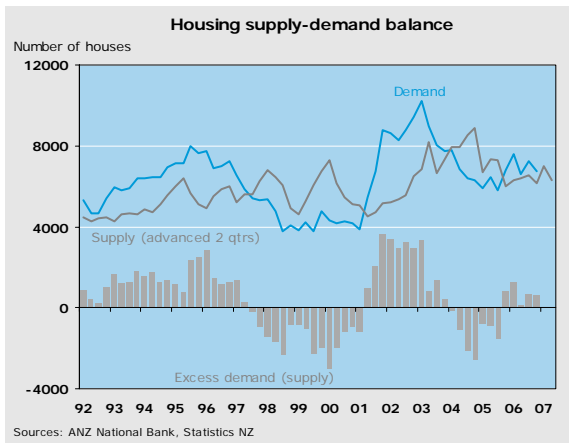
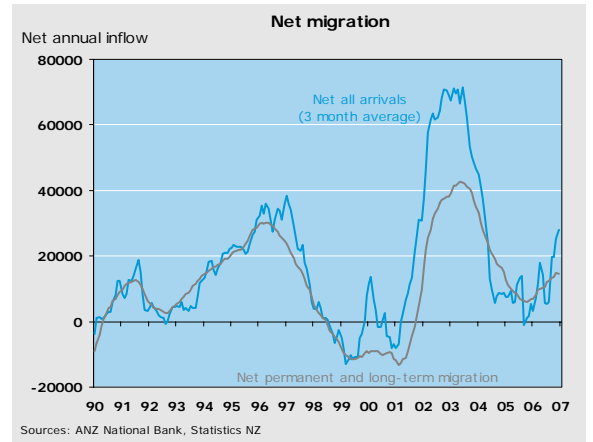
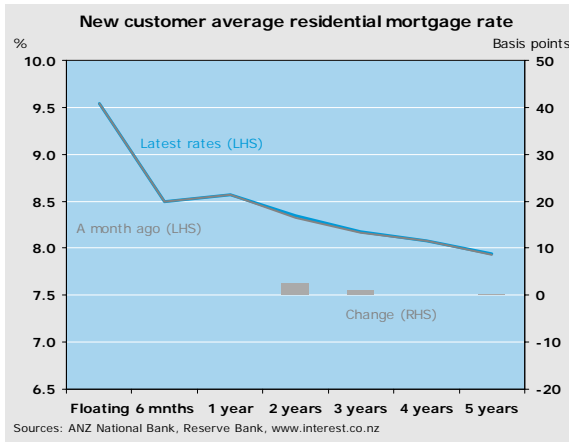
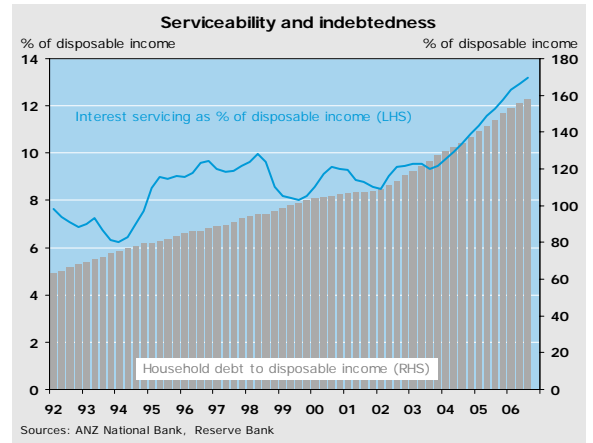
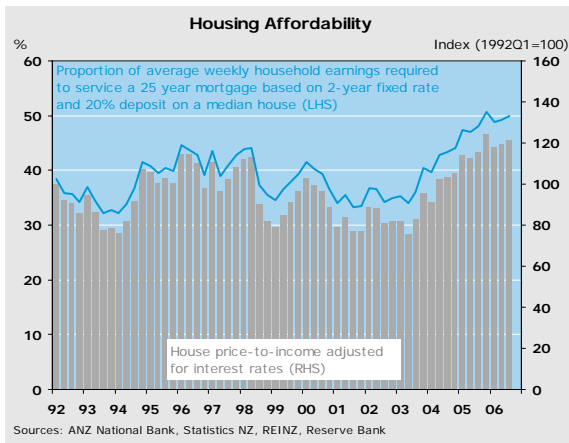
Our property gauges point to near-term momentum, but the real threat of higher interest rates hangs in the air. While households may be interest rate in-sensitive, will businesses be the same when it comes to jobs?

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.

A tight labour market continues to provide the backbone for housing market activity, while steady net migration inflows are keeping demand elevated. Our gauges point to ongoing momentum in the property market in the near-term, although the threat of higher interest rates is real. On the face of it, when looking at debt indicators, households should be getting squeezed. Yet higher interest rates appear to be innocuous at present. The real impact of tighter monetary policy on households will manifest through business sector employment plans. Watch this space.

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 and going higher	↓	Interest rates are basically unchanged from last month with an interest rate effectively priced in by the market for March.
Migration	Medium	↑/↔	Migration inflows continue to support.
Supply-demand balance	Neutral	↔	Slight excess demand emerging due to migration inflows and natural population growth.
Consents and house sales	On the up?	↔/↑	Momentum in housing market activity has been maintained, while consent issuance has consolidated.
Liquidity	High	↑	Liquidity remains abundant and demand for credit strong.
Globalisation	Cheap in world terms	↑	NZ property is still cheap on a global basis. Market becoming integrated with Australia.
On balance		↔/↓	Property gauges point to ongoing momentum in the property market. But valuation indicators remain stretched and we are fundamentalists at heart.



Economic backdrop

The Reserve Bank has delivered its bluntest message yet: housing activity slows or interest rates move up. Brace for at least one 25 basis point increase in the Official Cash Rate. After waiting for the housing market to turn voluntarily, the Reserve Bank looks set to take more active steps to engineer it.

> Locked and loaded

When we look at the economy in general, there is a clearly dichotomised picture. The housing market is going gangbusters. Consumer spending is picking up. Across the business sector the general feeling is one of things being patchy, and the economic environment being testy – a theme that is emerging across the Q4 profit announcements for key firms. The rural sector is under pressure, and some export industries such as forestry are really struggling.

Inflation remains the key theme shaping the business cycle. The moderation in growth seen over 2005 and 2006 has failed to ease capacity or inflation pressure. The unemployment rate remains close to a 21-year low. The economic slow-down – yes there has been one with growth around 2 percent on average over the past 2 years – has not felt like a traditional slow-down. The New Zealand economy does not tend to have soft landings. Various asset classes have continued to perform strongly. The slow-down has been unevenly shared. Businesses have borne the brunt via falling profits while households have been insulated by a strong labour market.

The problem with the soft landing is that inflation pressure – which is uncomfortably high – is not dissipating. Growth needs to ease further. Financial conditions are not yet tight enough. After raising the prospects of further interest rate increases in their December *Monetary Policy Statement*, the Reserve Bank turned the heat up further in their January *Official Cash Rate Review*. The *OCR Review* message was unequivocal: unless the housing market and consumer spending showed a slowing trend, they would raise the OCR. Interest rate markets have an 80 percent chance of a rate hike priced in for March, with a potential follow up rate hike either in April or June.

> Outlook for the property market

It is difficult to go past the housing market slowing. Admittedly the consensus has been saying that for over a year, and the market continues to surprise with its vibrancy. There is still considerable support being provided via a strong labour market and accelerating net migration inflows.

Yet against this backdrop we need to be mindful of the wishes of the Reserve Bank. After all, they have the instrument at their fingertips to achieve the desired outcome. The direct impact on the housing market via one or two small rises in the Official Cash Rate is likely to be small. In a low unemployment and job secure environment, households are naturally interest rate insensitive. However, we know from late 2005 that when the Reserve Bank decides to up the ante through higher rates, house sales fall, days to sell a house rise, and prices stabilise – quickly.

The direct impact of higher interest rates is only one channel monetary policy impacts on the economy and housing market. Higher interest rates raise business borrowing costs and lower profitability. High interest rates are typically associated with a higher currency. Such forces heavily influence the business sector. When businesses consolidate or come under pressure, costs become a strong focus, and eventually this includes jobs. It is at this juncture that the real bite from monetary policy hits households. The Reserve Bank is going to get its wish. It is just a question of how many interest rate hikes it is going to take to achieve it.

The warning is blunt...

...housing activity slows or interest rates move up.

At least one hike now looks inevitable.

The Reserve Bank will engineer its wish of a slowing market.

Borrowing strategy

The Reserve Bank looks set to increase interest rates in March. We see one rate rise and then a slight easing at the end of 2007, before a more aggressive easing after the 2008 Budget. This sees us favour the 2 or 3-year rates over the 1-year at this juncture, in order to take advantage of lower rates in 2009.

> Nowhere to run!

The Reserve Bank looks locked and loaded for an interest rate hike in March after indicators suggest the moderation in the housing market and domestic demand they require is a long way off. This has effectively been priced in by the market, along with a reasonable probability of a follow up hike in April or June, and therefore the NZ wholesale yield curve is largely unchanged from last month. Mortgage rates are also basically unchanged.

> Up they go

The fact that our view around the interest outlook has changed means it is not surprising that our recommended borrowing strategy has also changed since last month.

We now see the Reserve Bank increasing the Official Cash Rate by 25 basis points in March and then have pencilled in two cuts in late 2007 and early 2008. We see these as being removal of the late cycle insurance policy from March, but concerns over medium-term inflation pressure and stimulatory fiscal policy in the 2008 Budget will limit the scope for the Governor to consider further moves back to a more neutral setting. An aggressive easing cycle looks set for 2009.

As a result, the short-end of the curve has reduced its attractiveness and we now favour 2-year or 3-year rates in order to take advantage of lower rates in 2009.

Although locking in a 5-year rate will reduce flexibility, the fact rates remain below 8 percent suggests they have some merit and we recommend that a portion of borrowing occur here in order to diversify risk as there is still a non-trivial probability that rates remain high for some time. The longer part of the curve has grown in attractiveness, particularly given that we feel New Zealand's recent economic experience may be repeated in other countries i.e. higher official interest rates for longer given elevated core inflation. This should see New Zealand longer-term rates increase or at a minimum remain elevated.

> 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.** Our economic forecasts have one interest rate hike in March but then limited cuts until after the 2008 Budget. Therefore taking a two or three year term now will allow you to take advantage of lower rates in the second half of 2008, early part of 2009.
- **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 basically unchanged from last month.

The 2-3 year rates seem more favourable.

Feature article – a mortgage levy

Talk of a mortgage levy to quell the housing market has been raised and quashed. Stepping back, the economic rationale is questionable. If policy-makers are serious about reducing the nation's dependence on housing as our savings vehicle, there are other policy options to pursue.

A mortgage levy has been talked up again.

Earlier this month the Finance Minister raised the possibility of a discretionary mortgage interest levy on home mortgages as an additional tool in an attempt to slow down the housing market. The idea of a mortgage levy arose from joint work by the Reserve Bank and Treasury early last year on Supplementary Stabilisation Instruments (SSI). The report focused on six main policy options, of which the mortgage levy was one, though none of the alternatives appeared palatable at that time.

Looking at the wider backdrop, the real issue is one of concern over the strength in the housing market and undue pressure that tighter monetary policy places on other sectors of the economy, most notably the tradable sector. In effect, a levy can be considered an attempt to cure the disease without killing the patient. Certainly when you look across the various sectors of the economy, it is the housing sensitive sectors such as construction and finance and business services that have experienced some of the strongest growth either in terms of activity or employment, and associated pressure on capacity.

The economic rationale is questionable.

The economic rationale for such a policy is questionable.

- It is a distortion in the market. What is the rate of the levy? Who determines the timing? What is the regulatory cost? Avoidance would see an offshore mortgage provider emerge.
- It disadvantages small businesses, with a large amount of small business lending being secured and undertaken via the housing market.
- It potentially questions the operational independence of the Reserve Bank, given the levy will likely be set by Government officials with monetary policy considerations in mind.

Moreover, the monetary policy lever is not broken. Its effectiveness has undoubtedly been blunted by borrowers targeting fixed lending rates, which has provided insulation from a higher Official Cash Rate. A global phenomenon of low international interest rates has suppressed New Zealand 3 to 5 year lending rates. But as global interest rates have risen of late, so too have 3 to 5 year lending rates. Borrowing rates have moved up without the Reserve Bank doing anything. Migration has been an equivalent source of housing support. If migration is adding excessively to housing related pressure and inflation, then there are alternative and more effective policy levers to control this.

The PM officially killed the idea.

As both the Reserve Bank and Treasury noted, there are serious implementation and enforcement issues to work through. Looking beyond economics, political consensus is required for a mortgage levy to be introduced, and it looks a hard sell to the electorate. The idea was officially killed by the Prime Minister, two days after the Finance Minister's comments.

So where does that leave policy-makers? The backdrop is one of vulnerability. While housing is, and will continue to be, a great asset class to hold, having all our eggs in one basket leaves the economy vulnerable to a change in sentiment.

There are other policy mechanisms.

If New Zealand and policy-makers are serious about reducing such vulnerabilities, curbing housing related excesses and raising savings, there are policy mechanisms beyond a heavy handed mortgage levy that could assist. A stronger focus on growth, tax relief to foster savings and greater signalling of private provision for retirement would be steps in the right direction.

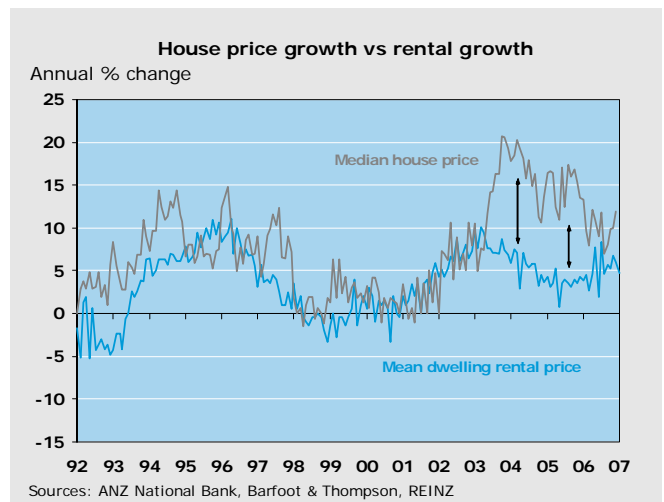
Comment: rents

Rents have lagged house prices over this economic cycle. Given tight housing supply and a desire from the Reserve Bank for housing activity to slow, we see upward pressure on rents over the coming years.

One of the stylised facts about rents is that they have typically followed house prices. Strong house prices need rental gains to sustain the yield on the investment.

This housing cycle has been different to previous cycles. Rents have not kept pace with house prices. While there are some obvious reasons for this such as interest rates being lower on average than previously, strong appetites for risk, and globalisation (particularly with the Australian property investor), these do not explain the magnitude of the massive divergence that has occurred over the past few years.

Looking at regional rental movements in the year to November 2006 we note that the provincial centres have experienced the most rapid growth (Gisborne 25%, Palmerston North 14%, New Plymouth 13%, Whangarei 11%), while the urban centres have been more subdued. This is consistent with growth in house prices over the same period.



Looking forward, we expect to see upward pressure on rents emerge.

- There is an under-supply of housing, with our supply demand balance indicator on page 4 indicating slight excess demand conditions.
- The demand for housing is likely to be curtailed by the Reserve Bank, which is set to raise interest rates further, while capacity bottlenecks and local council regulations make it difficult for the supply of housing to respond.
- Housing affordability is deteriorating, along with home ownership rates.

Of course the Reserve Bank is equivalently set to dent demand, which in turn will impact on the rental market. However, this will likely alter the market mix to renting as opposed to the aggregate level. Tenants still need somewhere to live! Looking at the broader picture, the story here is one of normalisation. Returning the yield on properties to a more sustainable rate requires either a material decline in property values, or upward movement in rents over time. History shows that property prices tend to be sticky and do not tend to adjust downwards. This leaves the gradual normalisation required in the hands of gradually rising rents. Certainly when you look at the average square metre cost of building a house at present (around \$1,200m²), rents need to move a long way to get yields back towards the cost of capital.

House prices have increased by 200 percent since 1991, and rents 70 percent. A lower cost of capital (interest rates are roughly half levels seen in the 1990's) accounts for half of the rise in house prices. This suggests there is a 30 percent house price-rent gap. Closing this gap suggests house prices need to flatten and rents increase by 6 percent per year over 5 years.

Rents typically follow house prices.

However, this cycle appears to be different.

There is a regional disparity in rental growth to date.

We expect further rental inflation over the coming year...

...and rental yields to return to more normal levels.

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 January 2007 (based on REINZ data)

	House prices (Annual % change)	3 month % change	Average days to sell	Comment
Northland	6.2	5.8	50	Largest decline in average sale prices
Auckland	14.5	4.6	34	Return to double-digit price growth
Waikato	6.1	4.8	45	Falling short of the national average
Bay of Plenty	12.4	6.9	52	Longest time to sell a house in January
Gisborne	11.7	2.5	46	Prices recover from a weak Christmas
Hawke's Bay	5.5	3.1	54	Longest time to sell a house in January
Taranaki	13.3	8.7	43	Strong price gains recently
Manawatu-Wanganui	11.9	3.6	36	Average sale price eases to a four-month low
Wellington	10.0	4.9	32	Days to sell at 3-year low (seasonally adjusted)
Nelson-Marlborough	17.4	4.3	40	Completes the South Island trifecta
West Coast	25.1	1.5	43	Recent price growth has looked to have stalled lately
Canterbury	11.7	2.5	35	Keeping pace with the national average
Otago	-6.0	2.7	42	Average sale prices weaker than a year ago
Southland	20.7	3.6	27	Shortest time to sell a house
NEW ZEALAND	10.8	4.5	38	Flaps down but still no touchdown

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	1.6 ^e	1.6	1.7	1.8	1.6	1.5	1.6	1.8
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	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2

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	7.50	7.50	7.50	7.25	7.00	7.00	7.00
90-day bank bill rate	7.7	7.7	7.7	7.8	7.7	7.6	7.2	7.2	7.2	7.1
Floating mortgage rate	9.5	9.5	9.5	9.6	9.6	9.5	9.1	9.0	9.0	9.0
1-yr fixed mortgage rate	8.5	8.6	8.6	8.7	8.5	8.3	8.1	7.9	7.6	7.3
2-yr fixed mortgage rate	8.2	8.3	8.4	8.4	8.2	8.0	7.8	7.7	7.5	7.2
5-yr fixed mortgage rate	7.8	7.9	7.9	7.9	7.8	7.7	7.7	7.5	7.5	7.4

Important Notice:

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