ANZ Interest Rate Strategy Weekly

13 March 2008

Inside:

Authors:

Saul Eslake
Chief Economist
+61 3 9273 6251
saul.eslake@anz.com

Warren Hogan
Head of Markets Economics and Strategy
+61 2 9227 1562
warren.hogan@anz.com

Sally Auld
Senior Interest Rate Strategist
+61 2 9227 1809
sally.auld@anz.com

Patricia Gacis
Market Strategist
+61 2 9227 1272
patricia.gacis@anz.com

Khoon Goh
NZ Interest Rate Strategist
+64 4 802 2357
gohk@anz.com

Economic Update

- It seems increasingly likely that the Australian economy is approaching, or may even have reached, a 'tipping point', where the impact of tighter financial conditions outweighs the stimulus coming from higher commodity prices. Indeed, other factors have begun to reinforce the intent of monetary policy rather than to thwart it.
- Accordingly, we have made some downward revisions to our growth and monetary policy forecasts. We now expect growth in real domestic final demand, which reached an unsustainable 5.8% over the year to the final quarter of 2007, to slow to 3¼% through 2008 and 2½% through 2009. We expect the RBA to keep the cash rate at 7.25% for an extended period, and believe that the next move in rates will be down.

Strategy Update

- Commentary from the central bank and some soft sentiment data over the last week or so suggests that the RBA tightening cycle is most probably over. We envisage that rates will remain on hold at 7.25% for an extended period. We expect that the next change in the cash rate will be downwards, although not until the Reserve Bank is satisfied that underlying inflation is clearly decelerating towards the 2-3% target range. The February employment numbers reinforce that this deceleration may be a while away.
- Given the outlook for monetary policy and the possibility of mounting downside risks to the Australian economy, we expect Australian government bond yields to perform both on an outright and relative value basis. We recommend investors use any back up in yields to accumulate long duration positions in Australian fixed income.
- The 3s10s yield curve has reacted rapidly to the recent shift in monetary policy expectations in Australia. But given rate cuts remain a distant prospect for the time being, we expect the curve to range trade over coming months. There have been signs of stabilisation in the AUS-US 10-year spread in recent weeks; if the 3s10s yield curve has troughed then this is a good signal that the peak in the 10-year spread may be close.

NZ Strategy Update

- With rate hikes now seemingly off the table, the focus in the NZ rates market is on the start of the inevitable easing cycle. While activity data is starting to show signs of softness, inflation indicators remain stubbornly high.
- The market will start to be more attuned to the dataflow over the coming months. Q4 GDP data due at the end of the month will likely show a robust end to 2007 economic activity, but the market's focus will increasingly be on the forward looking indicators for signs of whether the downside growth risks that the RBNZ highlighted in last week's Monetary Policy Statement is evolving.
- Receiving interest is growing but the carry cost from a high 90-day bank bill rate due to the cash squeeze is limiting any moves lower in swap yields. The strategy therefore remains one of trading the ranges with the 2-year swap yield to stay within an 8.25% to 8.45% range.

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Economic Update

- **It seems increasingly likely that the Australian economy is approaching, or may even have reached, a 'tipping point'**, where the impact of tighter financial conditions outweighs the stimulus coming from higher commodity prices. Indeed, other factors have begun to reinforce the intent of monetary policy rather than to thwart it.
- **Accordingly, we have made some downward revisions to our growth and monetary policy forecasts.** We now expect growth in real domestic final demand, which reached an unsustainable 5.8% over the year to the final quarter of 2007, to slow to 3¼% through 2008 and 2½% through 2009. We expect the RBA to keep the cash rate at 7.25% for an extended period, and believe that the next move in rates will be down.

Other factors have begun to reinforce the intent of monetary policy

Up until the end of last year, the Australian economy had proven remarkably resilient to the progressive tightening of monetary policy which began in mid-2002. That was partly because the tightening of monetary policy had been very gradual – it took the Reserve Bank 4½ years (from May 2002 until November 2006) to raise the cash rate by two percentage points (as much as it did in seven weeks in 1994); and partly because the impact of tighter monetary policy was more than outweighed by other factors, including easier fiscal policy (repeated rounds of large personal income tax cuts) and the boost to incomes arising from sharply rising commodity prices.

However, since underlying inflation began clearly to break out of the 2-3% target range in the second half of last year, the Reserve Bank stepped up the pace of monetary tightening. Since last August it has lifted the official cash rate by a full percentage point – as much in seven months as it had done in the preceding 30.

And more recently, other factors have begun to reinforce the intent of monetary policy rather than to thwart it.

Although the Rudd Government remains committed to delivering the large income tax cuts which it promised during last year's election campaign, it is becoming increasingly likely that at least part of the stimulus which those tax cuts will provide from July onwards will be offset by other measures in the forthcoming Budget. More importantly, the Treasurer has indicated that the Government will 'bank' any additional windfall revenue gains accruing from further increases in commodity prices (such as the $8bn or thereabouts which is likely to flow into the Government's coffers in 2007-08 as a result of the impending large rises in iron ore and coal prices) rather than dissipate them in further tax cuts or cash handouts, as was the previous Government's wont.

RBA rate hikes are just one component of tighter financial conditions

More importantly and ominously, the global 'credit crunch' is now beginning to reinforce the tightening of financial conditions associated with higher official interest rates, in what increasingly looks to be quite a potent and profound manner.

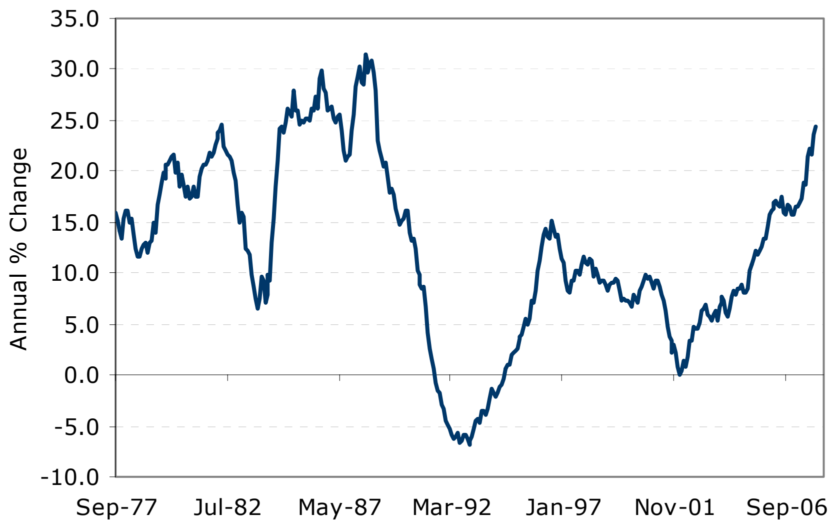
First, the interest rates actually paid by borrowers are rising by more than the Reserve Bank's official cash rate. Most obvious to the public eye, standard variable mortgage rates have risen by 25 to 35 basis points more than the cash rate, as banks have passed on some (but by no means all) of the increase in the cost of wholesale borrowings from which their mortgage lending is partly funded. Less obviously, fixed rates have risen by around 150 basis points since the middle of last year. A borrower who took out a three-year fixed rate mortgage three years ago, at just under 7%, will now be facing a jump in his or her interest rate of around 2 percentage points if he or she opts to fix for another three years, or closer to 2½ percentage points if he or she opted for a variable rate loan.

Meanwhile rates paid by business, which attract far less media attention, have risen by a lot more than mortgage rates. The 90-day bank bill rate, which is widely used as a benchmark for pricing business loans, has risen by about 1½ percentage points since last June; and the spreads above the bill rate charged by banks have also risen, implying that business loan rates have risen by considerably more than 50 basis points over and above the official cash rate.

Second, the debt securities markets – which for much of this decade have for many corporate borrowers provided a readily available and often cheaper mode of finance than borrowing from banks – have effectively closed down. Borrowers with maturing debt securities, and those seeking new or increased levels of debt, have thus been obliged to seek accommodation from the banking system.

Since the middle of last year the banking system has, in general, been able to meet this increased business demand for finance. Australian banks' lending to business has over the past twelve months grown at its fastest annual rate since the late 1980s (see Figure 1).

Figure 1: Business credit growth



Source: ANZ and RBA

However, unlike the debt securities markets, the banking system's capacity to meet demands for credit is ultimately limited by the level of bank capital. Under APRA rules, Australian banks must hold capital equivalent to at least 8% of the 'risk-weighted' assets on their balance sheet. In practice, partly reflecting the fact that Australian banks are also effectively subject to Federal Reserve rules which stipulate a minimum 'capital adequacy' ratio of 10%, this ratio is usually greater than 8%.

As at 31 December 2007, the capital base of the Australian banking system was just under $150bn, and it was supporting 'risk-weighted' assets of $1,465bn, implying a 'capital adequacy' ratio of 10.2%. If it is assumed (perhaps heroically) that banks' capital increases (through retained earnings, re-investment of dividends and perhaps other means) over the first half of this year at the same rate as it did over the second half of 2007, then banks can at most add a further $148bn of 'risk-weighted' assets to their balance sheet without their capital adequacy ratio falling below 10%.

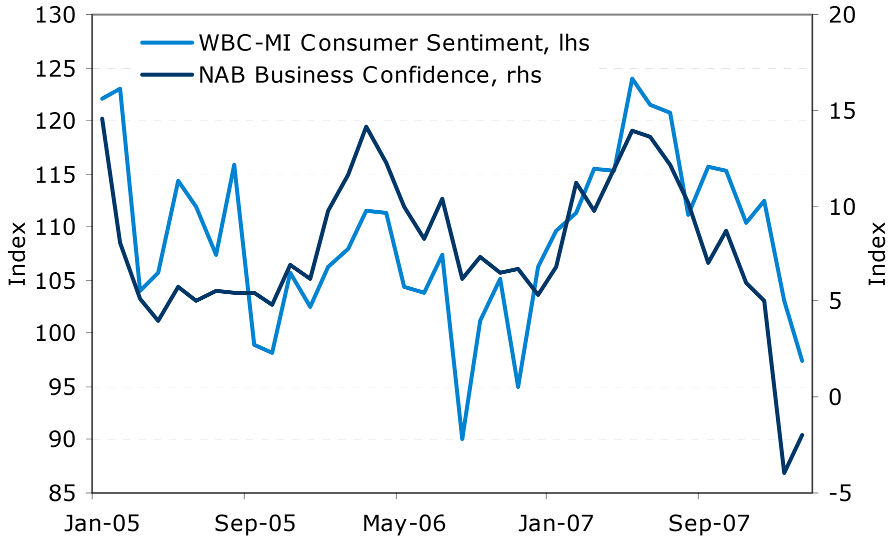
Yet according to Reserve Bank credit data, Australian private sector borrowers had some $243bn of securitized debt outstanding at the end of January, an amount which had already fallen by $10bn since August, when the securities markets began to seize up. Of course, only a proportion of this debt will mature in the next six or twelve months (and some of it, such as the $60bn of 'term' residential mortgage-backed securities, won't mature until the underlying mortgages are discharged). But clearly the banking system cannot both meet 'normal' growth in demand for credit and absorb maturing securitized debt that can no longer be 'rolled over' in the capital markets. Hence 'credit rationing', at least for business borrowers, is becoming a reality.

In practice, the global 'credit crunch' may well be the practical means by which Australia's 'unsustainable' (as it now appears) current account deficit is brought down to a more 'sustainable' level. In absolute terms, Australia has the fourth largest current account deficit in the world, and it has been financing it predominantly through the overseas borrowings of the Australian banks. A year ago, a current account deficit of $60bn or so was 'sustainable'. Today, it isn't.

Downward revisions to Australian growth forecasts

In his statement following the 4th March Reserve Bank Board meeting, Governor Glenn Stevens noted that there was 'tentative evidence that some moderation in household demand is beginning to occur'. That evidence, though still based on surveys of sentiment (see Figure 2) or otherwise anecdotal in nature, has since become noticeably stronger. It seems increasingly likely that the Australian economy is approaching, or may even have reached, a 'tipping point', where the impact of tighter financial conditions outweighs the stimulus coming from higher commodity prices.

Figure 2: Business and consumer confidence



Source: ANZ and Bloomberg

This judgement is now being reflected in our forecasts. We are emphatically not forecasting a recession, although we acknowledge that the risk of one is now greater than at any time since Australia last actually had one in 1990-91. Formally, we now expect growth in real domestic final demand, which reached an unsustainable 5.8% over the year to the final quarter of 2007, to slow to 3¼% through 2008 and 2½% through 2009. With the drag from the trade deficit expected to shrink, the slowdown in real GDP growth should be less pronounced, from 3.9% through 2007 to about 2½% during both 2008 and 2009.

However there is a non-trivial risk that the slowdown in both demand and output could begin earlier, and be deeper, than implied by these forecasts.

Reflecting these changes in the outlook, we no longer expect that the Reserve Bank will raise the cash rate another notch in May. Rather, we expect that the next change in the cash rate will be downwards, although not until the Reserve Bank is satisfied that underlying inflation is clearly decelerating towards (if not actually back within) the 2-3% target range. That may not be until the middle of 2009 – although once that condition has been met to the Reserve Bank's satisfaction interest rates could then fall quite swiftly.

Again, the risk is that this condition could be met sooner than we anticipate. Like the Reserve Bank itself, we are facing a very uncertain outlook, and our forecasts may need to adjust quickly.

The strategic outlook for Australian fixed income

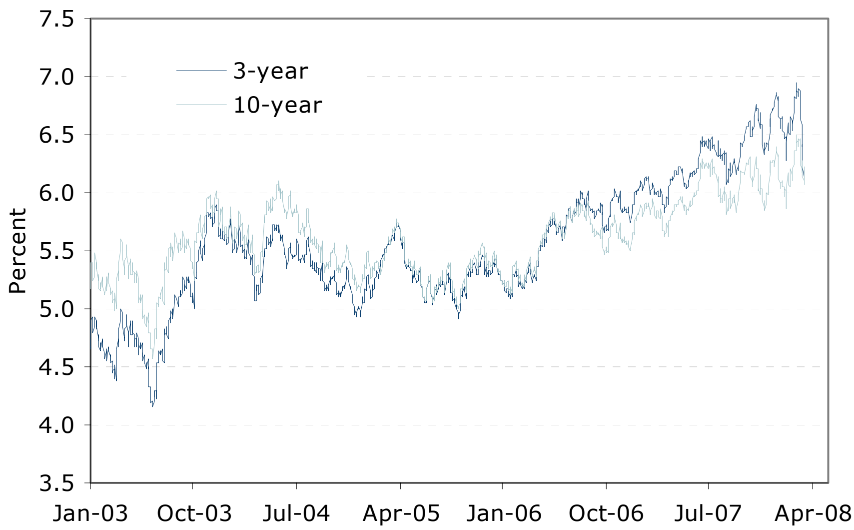
Sally Auld
Senior Interest Rate Strategist
+61 2 9227 1809
sally.auld@anz.com

- **Commentary from the central bank and some soft sentiment data over the last week or so suggests that the RBA tightening cycle is most probably over.** We envisage that rates will remain on hold at 7.25% for an extended period. We expect that the next change in the cash rate will be downwards, although not until the Reserve Bank is satisfied that underlying inflation is clearly decelerating towards the 2-3% target range. The February employment numbers reinforce that this deceleration may be a while away.
- **Given the outlook for monetary policy and the possibility of mounting downside risks to the Australian economy, we expect Australian government bond yields to perform both on an outright and relative value basis.** We recommend investors use any back up in yields to accumulate long duration positions in Australian fixed income.
- The 3s10s yield curve has reacted rapidly to the recent shift in monetary policy expectations in Australia. **But given rate cuts remain a distant prospect for the time being, we expect the curve to range trade over coming months**. There have been signs of stabilization in the AUS-US 10-year spread in recent weeks; **if the 3s10s yield curve has troughed then this is a good signal that the peak in the 10-year spread may be close**.

Time to buy Australian Government bonds

The RBA has given us a tentative indication that the peak in the interest rate cycle may have been reached. So far, this view has been vindicated by a fall in consumer confidence data, softer business conditions data and a weakening trend in retail sales. Given the marked tightening in financial conditions in the Australian economy over the last six months or so, risks are clearly skewed towards a run of soft data in coming months.

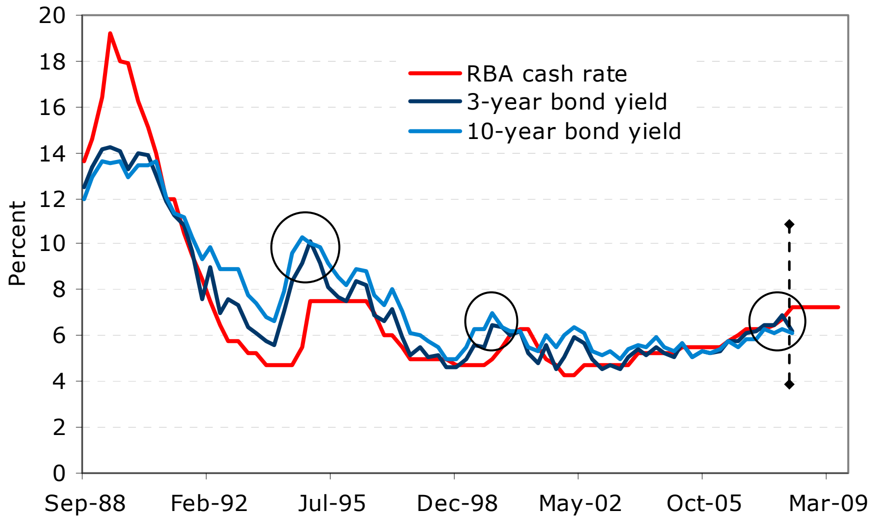
Figure 3: Australian government bond yields, daily data



Source: ANZ and Bloomberg

A month ago, we suggested targets of 7.0% for 3-years and 6.5% for 10-years as attractive strategic buy levels for Australian fixed income. Figure 3, together with recent price action, suggest that those levels look like representing the local – and most likely, cyclical – peak in yields. We think that the approach to Australian fixed income over coming weeks and months is a “buy the dips” strategy. We recommend investors use any back up in yields to accumulate long duration positions in Australian fixed income.

Figure 4: RBA cash rate and term interest rates



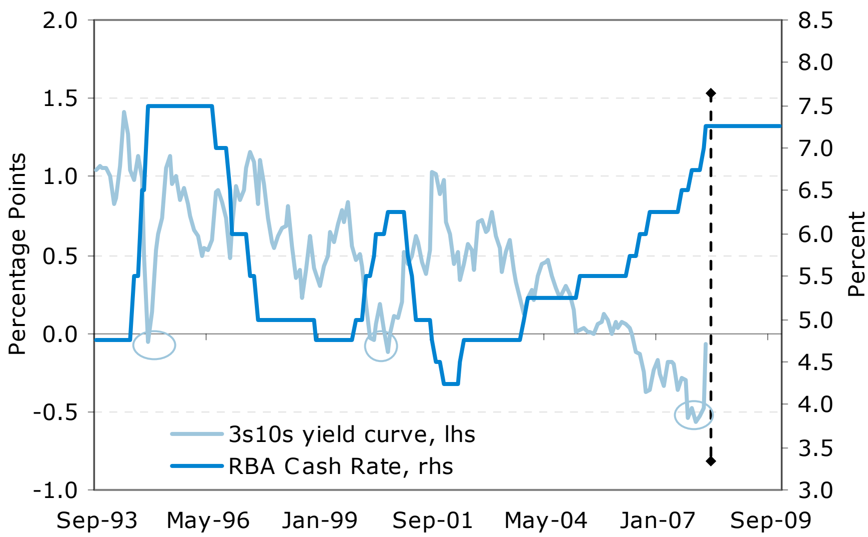
Source: ANZ and Bloomberg

Figure 4 illustrates the relationship between the RBA cash rate and term interest rates, using quarterly data. The pre-emptive nature of markets means that bond yields often reach a peak ahead of the peak in the cash rate. Historically, the 3-year bond yield peaks around anywhere from 1 to 9 months ahead of the peak in the RBA cash rate. Recent price action is consistent with the idea that we have seen the cyclical peak in government bond rates for the cycle.

The 3s10s yield curve

A few weeks ago, we were puzzled as to why the 3s10s yield curve was not more inverse. We thought that a hawkish RBA and the prospect of consecutive monthly interest rate rises should have been enough to see the curve move towards -60bps and beyond. But with the benefit of hindsight (and a lesson learnt for next time!), it is clear that price action in the yield curve was not puzzling. Rather, the curve was sending us an important signal, highlighting the risk that the peak in the tightening cycle was nigh.

Figure 5: AUS 3s10s yield curve and monetary policy cycles



Source: ANZ and Bloomberg

Certainly, recent price action in the 3s10s curve is consistent with the idea that the RBA has reached the peak in the tightening cycle. Steepening in the yield curve is historically associated with slowing economic growth and a lower policy rate – see Figure 5.

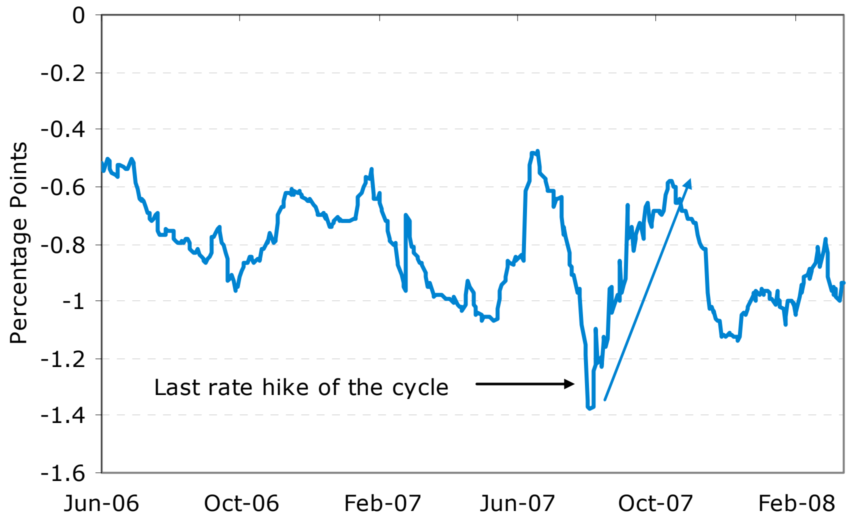
So the recent steepening in the 3s10s yield curve is consistent with the view that the cyclical peak in yields may have been reached. Technical indicators also emphasise the significance of recent price action. Figure 6 shows the 3s10s yield curve using weekly data. The recent move in the yield curve has seen the long term flattening trend (in place since Q3 2001) broken. We would view this as a particularly meaningful turn of events, implying that that the yield curve will continue to steepen from here on in.

Figure 6: AUS 3s10s curve, weekly data

Source: ANZ and Bloomberg

One issue for investors to come to grips with in thinking about how far the curve might steepen is the timing of rate cuts. Given the current levels of inflation and inflation expectations, we suspect rate cuts might be some time coming (late 2009?). The cash rate could remain at 7.25% for a while. In this context, a look at the New Zealand experience might be instructive. The RBNZ implemented its last rate hike of the cycle in July 2007. As Figure 7 shows, the 2s10s yield curve steepened around 80bps in the wake of the July rate hike and a more dovish accompanying statement from the RBNZ.

Figure 7: NZ 2s10s yield curve, daily data



Source: ANZ and Bloomberg

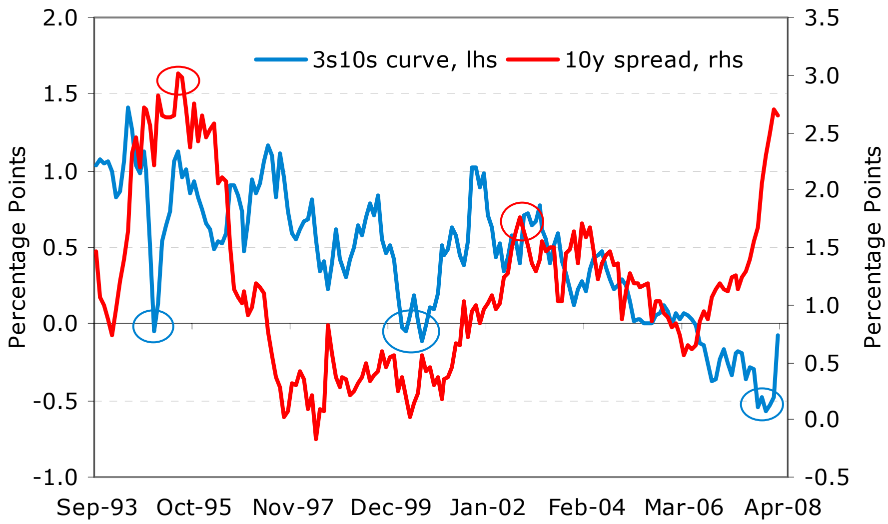
But any steepening was essentially short lived, as the market came to grips with the prospect of higher rates for longer. Even at its last OCR, the RBNZ gave little indication that it was considering rate cuts. This could turn out to be the risk for the Australian yield curve over the next 6-9 months – a short, sustained bout of steepening, followed by re-inversion as the prospect of rate cuts becomes more remote.

So we suspect that the most likely outcome for the Australian 3s10s curve in coming months is a range trade scenario. Given the curve is already 50bps off its lows, the trading range is likely to be -20bps to +10bps. The next leg of steepening is unlikely to occur until the RBA signals a commitment to ease monetary policy.

The AUS-US 10-year spread

The AUS-US 10-year spread remains close to 13 year wides. There has been little support for the spread given the sharp widening witnessed over the last 6-9 months. But we are increasingly of the view that the peak in the spread may be close. Figure 8 illustrates the 10-year spread and the 3s10s yield curve. In the last couple of interest rate cycles, the trough in the yield curve has been a good signal that the peak in the AUS-US 10-year spread is close. In 1994, the spread peaked 7 months after the trough in the yield curve. In 2001, the lag was 24 months (but was probably lengthened by the fact that the Fed had a lot more easing to do than the RBA).

Figure 8: AUS 3s10s curve and AUS-US 10-year spread



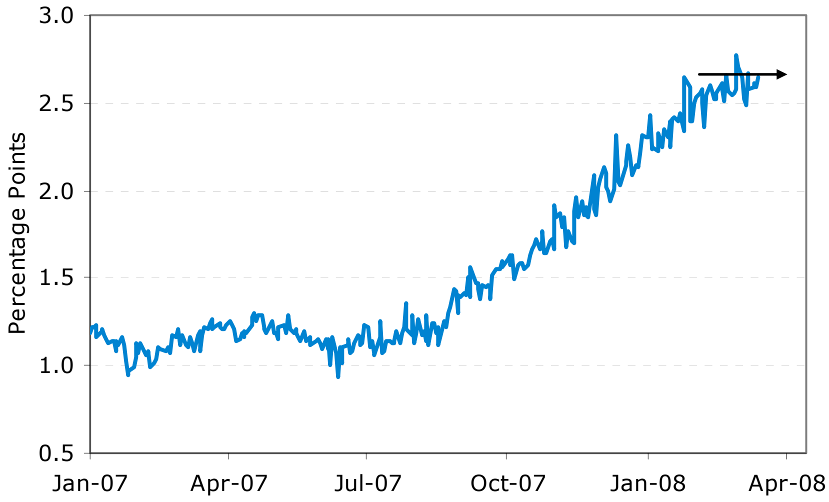
Source: ANZ and Bloomberg

This time around, the RBA hasn't yet started to ease policy, while the Fed is getting closer to the trough in the Funds rate. This means that there is scope for the cyclical wide in the 10-year spread to occur quite soon after the trough in the 3s10s curve.

Indeed, there are some early signs that the AUS-US 10-year spread has started to show signs of stabilization (see Figure 9). The spread has traded sideways for the last 6 weeks or so, and given that the US front end is now pricing for a terminal Funds rate sub 2%, we think the spread will struggle to push wider on changing expectations of US and Australian monetary policy.

The main risk for the AUS-US 10-year spread in the next few months could be a bullish flattening of the US 2s10s yield curve (i.e., US 10-years to 3%). But we think this unlikely, given that ongoing troubles in the US banking system essentially demand a steep yield curve for some time. And the respective economic cycles in the US and Australia suggest that yields in Australia have a lot further to fall over the next 12 months than yields in the US.

Figure 9: Signs of stabilisation in the AUS-US 10-year spread



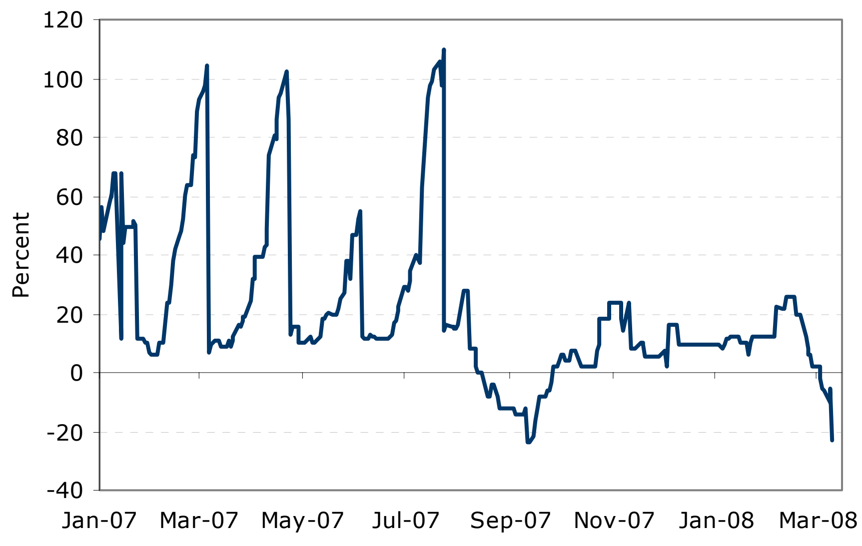
Source: ANZ and Bloomberg

New Zealand Strategy Update

Khoon Goh
NZ Interest Rate Strategist
+64 4 802 2357
gohk@anz.com

- **With rate hikes now seemingly off the table, the focus in the NZ rates market is on the start of the inevitable easing cycle.** The RBNZ has indicated that the OCR will remain where it is for a significant time. Clearly, inflation remains a concern, which food price data for February, showing a 0.8% increase for the month, and another rise in petrol prices to an all time high yesterday, would have reinforced. Yet, February's housing market data showing falling house prices for the third month in a row, falling house sales and a jump in the number of days to sell a house, also reinforce the downside growth risks ahead.
- **Today's retail sales number for January may not have shown the softness we were looking for, but the details tell us that apart from grocery and fuel spending, both of which are price related, consumers are paring back on discretionary items**. Looking ahead, retail sales growth will continue to moderate in the months ahead. Consumer confidence has moved lower, and more households do not think now is a good time to buy a major household item. With the housing market heading south and annual house price inflation set to record a fall next month, we expect consumers to pare back on discretionary spending as the wealth effect turns negative.
- The market will start to be more attuned to the dataflow over the coming months. Q4 GDP data due at the end of the month will likely show a robust end to 2007 economic activity, but **the market's focus will increasingly be on the forward looking indicators for signs of whether the downside growth risks that the RBNZ highlighted in last week's Monetary Policy Statement is evolving**. Our expectation is that the economic data relating to Q1 will turn consistently soft. But the market may not be prepared to rally just yet as Q1 inflation numbers look to be slightly higher than the RBNZ's latest projections, judging by recent rises in food and petrol prices.
- **Nonetheless, current OIS pricing has no further chance of a hike priced in, with close to a full rate cut by September, which is where we have penciled in the start of the easing cycle**. Receiving interest is growing but the carry cost from a high 90-day bank bill rate due to the cash squeeze is limiting any moves lower in swap yields. The strategy therefore remains one of trading the ranges with the 2-year swap yield to stay within a 8.25% to 8.45% range.

Figure 10: Percent chance of a 25bp rate hike over the next 3 months



Source: ANZ and Bloomberg

Trade Bank 2008

Figure 11: Trade Bank

Trade	Entry	Exit	Profit
Short Mar-08 30 day IB futures contracts	31-Jan-08	14-Feb-08	20bps
3s10s curve inversion	31-Jan-08	14-Feb-08	-6bps
Paid AUD1y1y swap	31-Jan-08	14-Feb-08	32bps
			46bps

Source: ANZ

Chart Pack I

Chart 1: AUS 3-year and 10-year yields

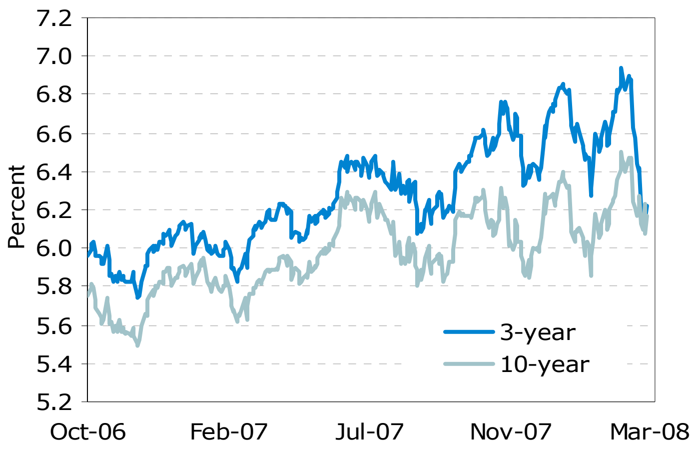


Chart 2: AUS 3s10s curve

Chart 3: AUS Bills/3s and Bills/10s curves

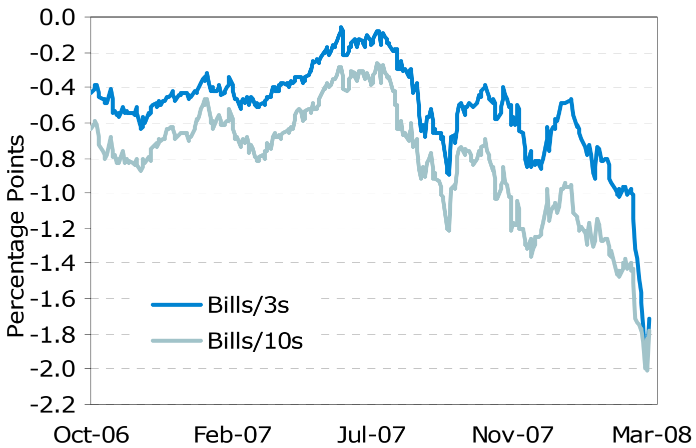


Chart 4: AUS-US 10-year spread

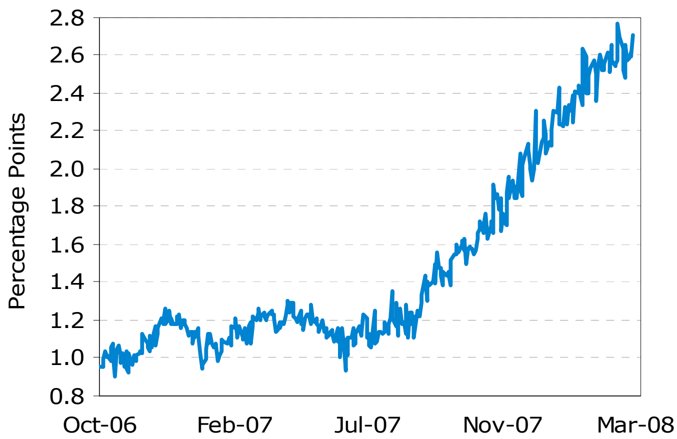


Chart 5: AUS 3-year semi-government spreads to bond

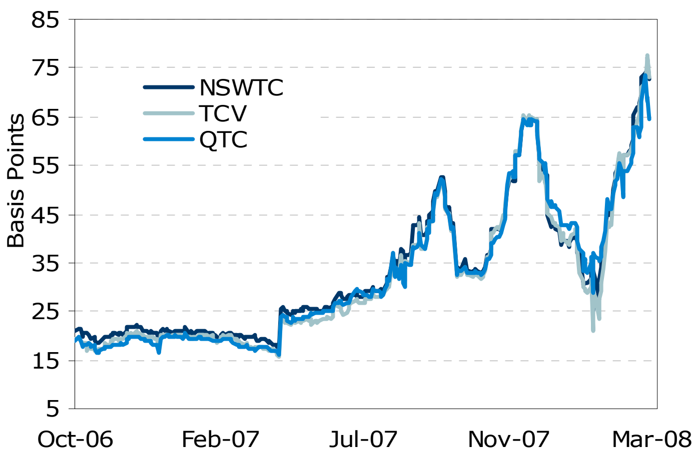
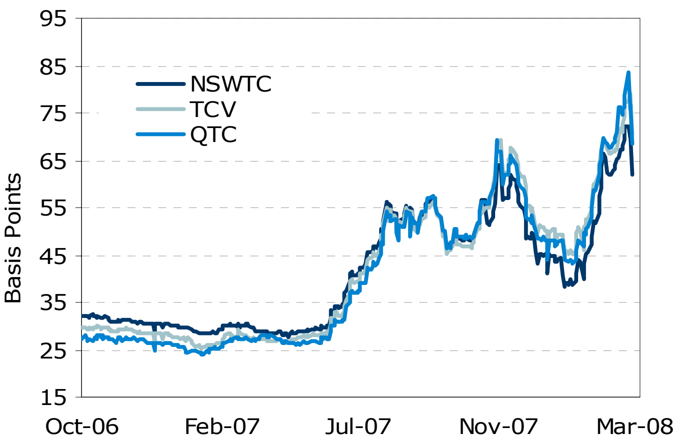


Chart 6: AUS 10-year semi-government spreads to bond



Source: ANZ and Bloomberg

Chart Pack II

Chart 7: AUS swap curves

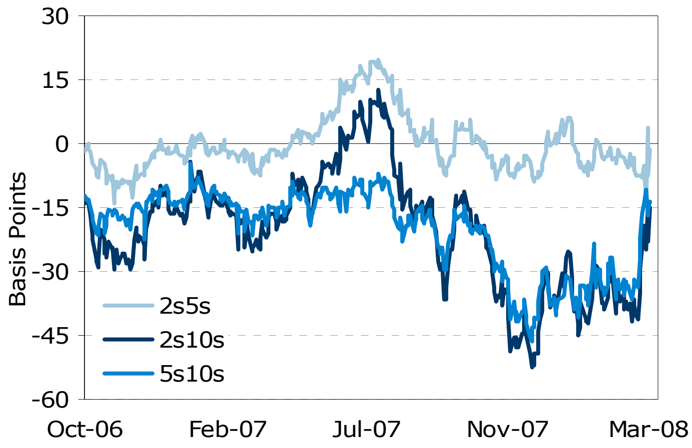


Chart 8: AUS swap yields

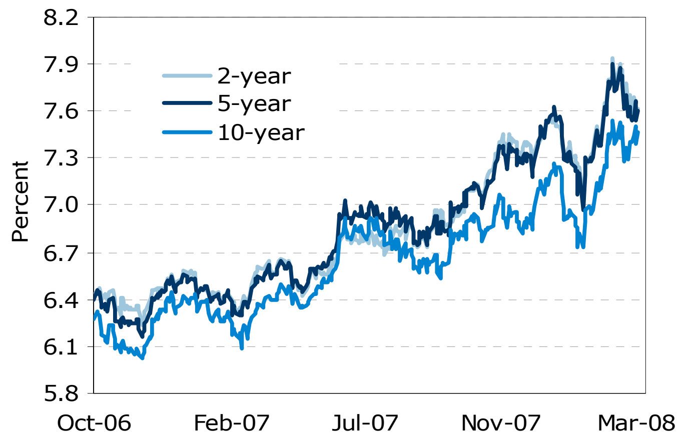


Chart 9: AUS swap/EFP spreads

Chart 10: AUS Drop to spot

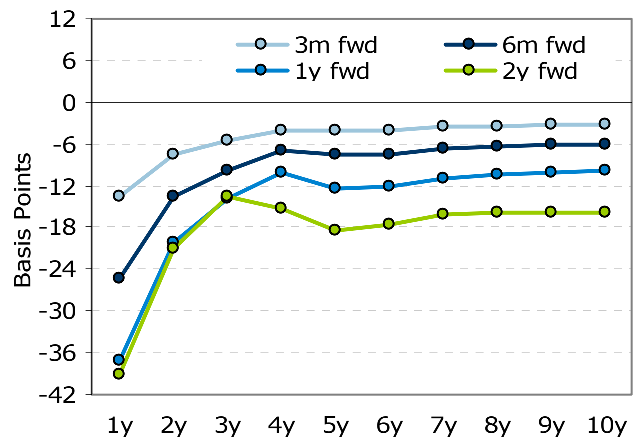


Chart 11: AUS Forward Curves

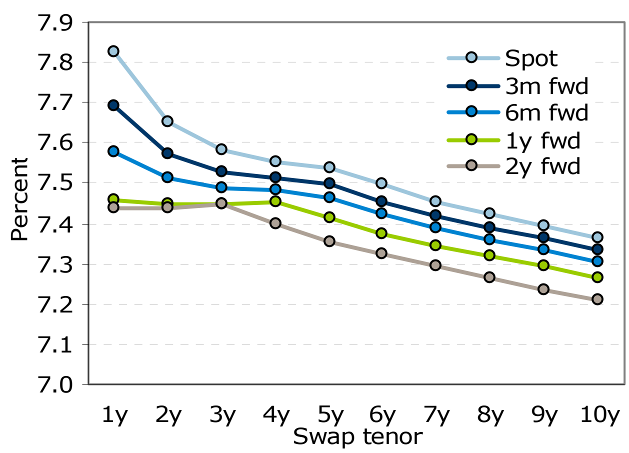
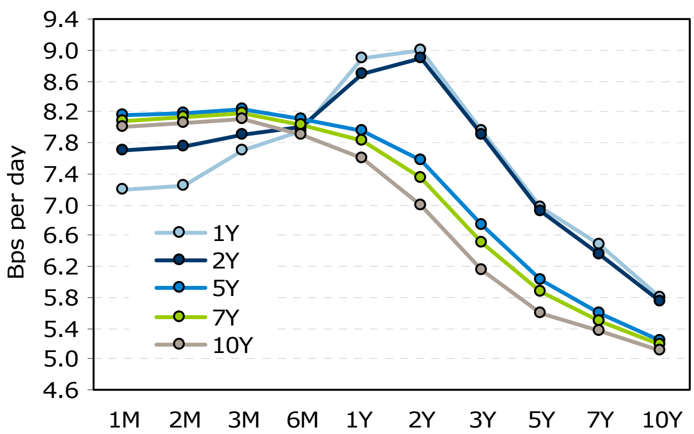


Chart 12: Swaption volatility



Source: ANZ and Bloomberg

Chart Pack III

Chart 13: Credit Curves

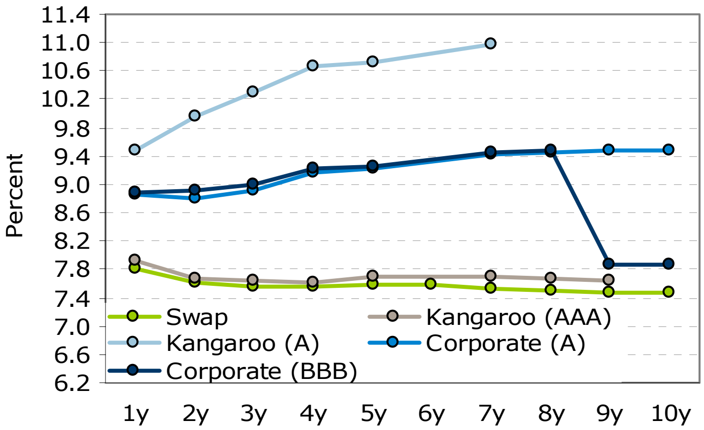


Chart 14: Government and Semi-Government Curves

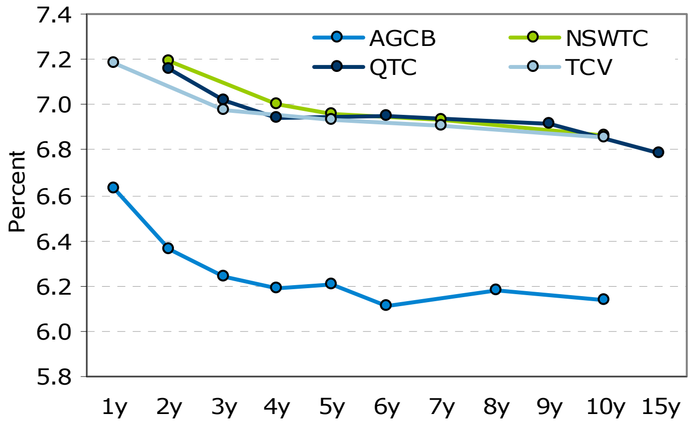


Chart 15: Corporate bonds spreads to ACGBs

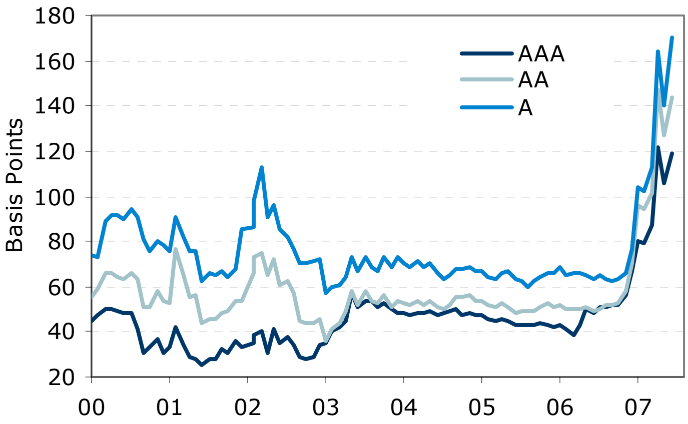


Chart 16: 5-year CDS spreads

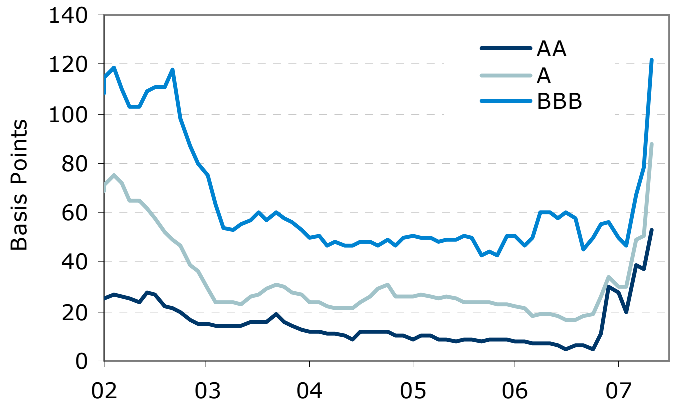


Chart 17: AUD/USD Basis swap spreads

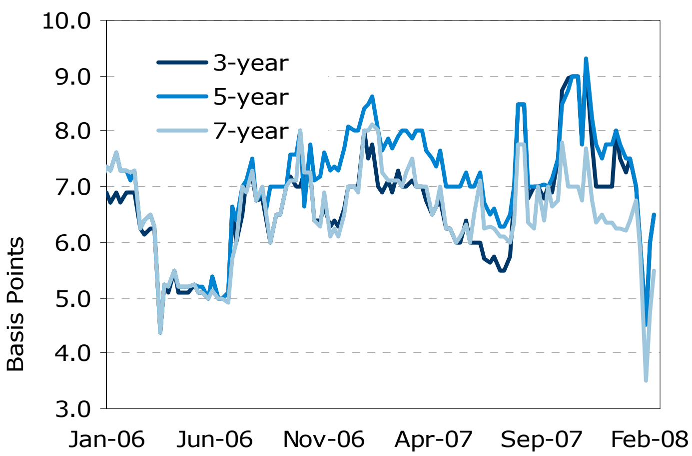
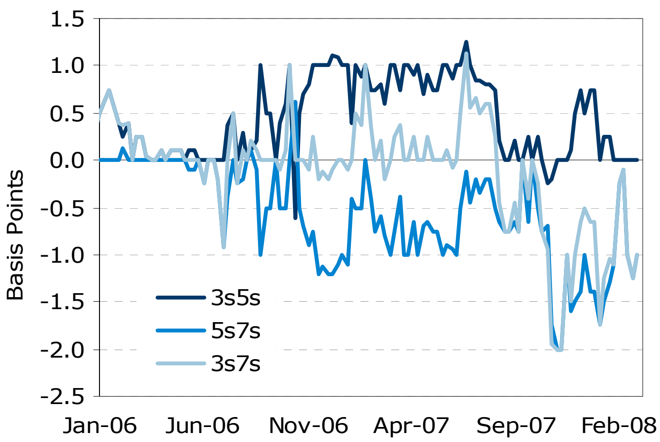


Chart 18: AUD/USD Basis swap curves



Source: ANZ, RBA and Bloomberg

Interest Rate Forecasts

	Current	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
United States						
Fed funds rate	**3.00**	1.75	1.50	1.50	1.50	1.50
2-year note	**1.53**	1.50	1.75	2.00	2.25	2.75
10-year note	**3.41**	4.00	3.75	3.50	3.25	3.25
2s10s spread (bps)	**188**	250	200	150	100	50
Australia						
RBA cash rate	**7.25**	7.25	7.25	7.25	7.25	7.25
90-day rate	**8.05**	8.00	7.85	7.60	7.40	7.10
3-year bond	**6.19**	6.55	5.95	5.50	4.60	4.35
10-year bond	**6.14**	6.40	5.95	5.50	4.75	4.75
3s10s curve (bps)	**-6**	-15	0	0	15	40
10-year spread to US (bps)	**273**	240	220	200	150	150
3-year swap spread (bps)	**137**	110	85	70	55	47
10-year swap spread (bps)	**129**	120	95	80	70	55
New Zealand						
NZ OCR	**8.25**	8.25	8.00	7.50	7.00	6.75
90-day rate	**8.91**	8.75	8.23	7.63	7.03	6.95
2-year bond	**0.00**	7.41	7.04	6.54	6.16	6.20
10-year bond	**6.36**	6.54	6.20	5.78	5.39	5.34
2s10s curve (bps)	**636**	-87	-84	-76	-77	-86
10-year spread to US (bps)	**294**	254	245	228	214	209
Foreign Exchange						
AUD/USD	**0.9378**	0.93	0.94	0.92	0.90	0.87
NZD/USD	**0.8044**	0.79	0.78	0.74	0.69	0.66
AUD/NZD	**1.1658**	1.18	1.21	1.24	1.30	1.32
USD/JPY	**100.57**	105	102	100	102	105
EUR/USD	**1.5565**	1.52	1.54	1.51	1.47	1.42
GBP/USD	**2.0297**	1.98	2.00	1.95	1.92	1.89
USD/CHF	**1.0110**	1.05	1.04	1.08	1.11	1.15

Source: ANZ and Bloomberg

ANZ Research

ANZ Research

Saul Eslake
Chief Economist
+61 3 9273 6251
saul.eslake@anz.com

ANZ Markets

Warren Hogan Head of Research +61 2 9227 1562 Warren.hogan@anz.com	**Sally Auld** Senior Interest Rate Strategist +61 2 9227 1809 sally.auld@anz.com	**Tony Morriss** Senior Currency Strategist +61 2 9226 6757 tony.morriss@anz.com	**David Croy** Senior Market Strategist, UK +44 20 3229 2070 croyd@anz.com
Katie Dean Senior Economist, Markets +61 3 9273 5466 katie.dean@anz.com	**Mark Pervan** Senior Commodity Strategist +61 3 9273 3716 mark.pervan@anz.com	**Patricia Gacis** Market Strategist +61 2 9227 1272 patricia.gacis@anz.com	

Economics

Tony Pearson Head of Australian Economics +61 3 9273 5083 tony.pearson@anz.com	**Amy Auster** Head of International Economics +61 3 9273 5417 amy.auster@anz.com	**Paul Braddick** Head of Financial System Analysis +61 3 9273 5987 paul.braddick@anz.com	**Fiona Allen** Business Manager +61 3 9273 6224 fiona.allen@anz.com
Julie Toth Senior Economist Industry +61 3 9273 6252 julie.toth@anz.com	**Jasmine Robinson** Senior Economist International +61 3 9273 6289 jasmine.robinson@anz.com	**Ange Montalti** Senior Economist +61 3 9273 6288 ange.montalti@anz.com	**Mark Rodrigues** Senior Economist Australia +61 3 9273 6286 mark.rodrigues@anz.com
Riki Polygenis Economist +61 3 9273 4060 riki.polygenis@anz.com	**Amber Rabinov** Economist, International +61 3 9273 4853 amber.rabinov@anz.com	**Alex Joiner** Economist, Financial System Analysis +61 3 9273 6123 alex.joiner@anz.com	**Wain Yuen** Economist, Australia +61 3 9273 6295 wain.yuen@anz.com

ANZ New Zealand

Cameron Bagrie Chief Economist +64 4 802 2212 bagriec@anz.com	**Khoon Goh** Interest Rate Strategist +64 4 802 2357 gohk@anz.com	**Philip Borkin** Economist +64 4 802 2199 borkinp@anz.com
Mark Elliott Technical Analyst +64 9 357 4080 elliottm@anz.com	**Steve Edwards** Economist +64 4 802 2217 edwards1@anz.com	**Kevin Wilson** Rural Analyst +64 4 802 2361 wilsonk1@anz.com

Important Notice

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522
10th Floor 100 Queen Street, Melbourne 3000, Australia
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:
Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
40 Bank Street, Canary Wharf, London, E14 5EJ, United Kingdom
Telephone +44 20 3229 2121 Fax +44 20 7378 2378

UNITED STATES OF AMERICA by:
ANZ Securities, Inc. (Member of NASD and SIPC)
6th Floor 1177 Avenue of the Americas
New York, NY 10036, United States of America
Tel: +1 212 801 9160 Fax: +1 212 801 9163

NEW ZEALAND by:
ANZ National Bank Limited
Level 7, 1-9 Victoria Street, Wellington, New Zealand
Telephone +64 4 802 2000