

Let's not get carried away

04 June 2009

Authors:

Warren Hogan
Head of Australian Economics and
Interest Rates Research
+61 2 9227 1562
Warren.Hogan@anz.com

Amy Auster
Head of Foreign Exchange and
International Economics Research
+61 3 9273 5417
Amy.Auster@anz.com

Katie Dean
Senior Economist
+61 3 9273 1381
Katie.Dean@anz.com

Tony Morriss
Senior Market Strategist
+61 2 92266757
Tony.Morriss@anz.com

Riki Polygenis
Economist
+61 3 9273 4060
Riki.Polygenis@anz.com

Dr. Alex Joiner
Economist,
+61 3 9273 6123
Alex.Joiner@anz.com

Amber Rabinov
Economist
+61 3 9273 4853
Amber.Rabinov@anz.com

Daniel Bae
Analyst
Daniel.Bae@anz.com
+61 2 9227 1272

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For ANZ Economics & Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

Macro Update: No technical recession in Q1, but challenges remain

- National accounts figures this week highlighted the relative resilience of the Australian economy. Real GDP expanded by 0.4% in Q1 2009, with Australia avoiding a "technical recession".
- But it was not all good news. Production and gross domestic income contracted and there was evidence of distress in many pockets of the business sector.
- Looking forward, there remain some significant challenges ahead for the domestic economy and we expect flat to moderately negative economic growth for the remainder of 2009.

Interest Rates: RBA leaves door open for further cuts

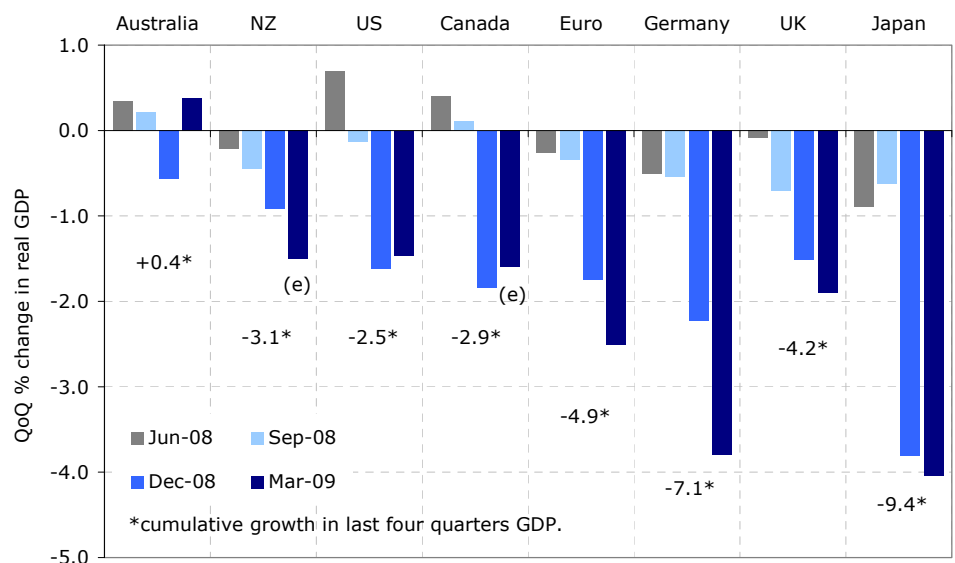
- A dovish stance on the policy outlook has helped to offset the impact of strong data in local financial markets.
- Consolidation in US bond markets should allow local market rates to recover some ground.

FX: A higher AUD/USD trading range

- The rally in the AUD/USD continued this past week, with the currency sailing to 8-month highs on a weak US dollar and solid local data flows.
- Last night marked the first major pull-back for the AUD in some weeks, dipping 3 US cents from a peak above 0.8250 to consolidate around US\$0.80. Despite this recent fall however, overall market momentum remains supportive for the AUD.

Chart of the week

Figure 1: GDP growth for selected advanced economies



Source: Bloomberg

Riki Polygenis
 Economist
 +61 3 9273 4060
 Riki.Polygenis@anz.com

Alex Joiner
 Economist
 +61 3 9273 6123
 Alex.Joiner@anz.com

Macro Update: No technical recession in Q1, but challenges remain

- National accounts figures this week highlighted the relative resilience of the Australian economy. Real GDP expanded by 0.4% in Q1 2009, avoiding a second consecutive quarter of contraction and a "technical recession".
- But it was not all good news. Production and gross domestic income contracted and there was evidence of distress in many pockets of the business sector.
- Looking forward, there remain some significant challenges ahead for the domestic economy and we expect flat to moderately negative economic growth for the remainder of 2009.

Australia avoids a technical recession...

National accounts figures this week showed that the Australian economy remains relatively resilient in the face of the most severe financial crisis since the Great Depression. Real GDP expanded by 0.4% in Q1, following a 0.6% contraction in Q4 2008. Over the past year, Australia's economy has still expanded by 0.3%. This is the most robust result of all the major advanced economies in Q1 (see Chart of the Week on page 1).

... but areas of weakness remain

The positive GDP result is certainly encouraging for a number of reasons. In particular, households are clearly responding to government cash handouts and lower interest rates by increasing spending, providing much needed support to the retail sector which is Australia's largest employer. The strength of Australia's exports, despite the majority of our trading partners being in deep recession was also a welcome surprise, and reflects in large part our relatively lower reliance on manufacturing exports and our exposure to the China. Exports added 0.6ppt to economic growth in Q1.

But as RBA Governor Glenn Stevens highlighted in a speech today, the different signals given by the expenditure, income and production measures of GDP suggest we must be careful placing too much emphasis on the headline increase in GDP (aggregate GDP is an average of the three measures). While the expenditure (+1.1%) and income (+0.9%) measures of GDP both increased in real terms, the production measure fell sharply (-0.9%). Divergences between the three measures can be particularly great during periods of instability and large relative price changes.

In addition, some other often cited indicators of economic performance did not provide the same positive signals. In particular, measures of Australia's national income fell sharply, with nominal GDP down by 0.6% in the quarter and real Gross Domestic Income (GDI) fell by 1.4%. This is critical as income inflows, largely from the booming terms of trade, has been a key hallmark of Australia's recent economic success and a key driver of economic growth (through business investment and government revenues in particular). Income measures are expected to fall further from Q2; data today on the trade balance for April highlighted the sharp fall in export earnings about to be experienced from lower coal and iron ore prices.

There was also evidence that the Australian business sector overall was struggling in Q1, experiencing falling demand and cutting back on production, inventory levels and business investment. The large contribution to growth from falling imports of 1.6ppt was largely a reflection of this, with consumption, capital and intermediate imports all down sharply. The manufacturing sector again continued to bear the brunt of the downturn, with output in agriculture, mining, property and business services, wholesale trade and transport also contracting.

Snags ahead?

So what does all of this mean for Australia's near-term economic prospects? Does it alter the view that there will be negative growth outcomes to come? Unfortunately not.

On the upside, household spending is likely to remain at high levels in Q2 as the remainder of the government's cash handouts reach households. There is likely to be a positive contribution to growth from inventories; firms have run down stock levels aggressively in the past two quarters and these will need to be replenished. Some rebuilding of stocks could also provide a boost to production, although much of this will come from imports which will be an offsetting negative for growth. We can expect dwelling construction to start contributing to growth later in the year in line with the sharp rise in residential building approvals seen in recent months. And finally, the economy will gradually start to receive more impetus from the government's ambitious infrastructure spending agenda.

At the same time, this week's national accounts data highlighted the significant adjustment currently underway in business investment. The generally long and protracted nature of business investment cycles suggests this is likely to continue for some quarters to come.

We also expect some pullback in household spending in H2 once the stimulus from cash handouts disappears. While employment is so far holding up better than expected, measures of wage income in the national accounts all went backwards and household disposable income fell by 3.2% in nominal terms and 4.1% in real terms in the quarter. Moreover, we still expect employment to fall over the course of 2009. Some indicators in this week's data were encouraging on this front, particularly evidence of strength in the retail sector and falling unit labour costs (suggesting that wage pressures will not be a deterrent to firms planning on adding staff). However weakness across a range of industries and evidence that firms are cutting back on capital investment suggest that cutting back on labour investment is the next leg in the chain. The unemployment rate is therefore still expected to rise sharply by year end.

The trade outlook is a key unknown. Softness in export volumes is to be expected, with the rally of the Australian dollar clearly a headwind. The expected falls in bulk commodities prices are also seeing national incomes fall as the terms of trade dives. Yet these price falls may limit falls in volumes. The near term path for export volumes will also depend critically on how and when the global economy recovers. At least we can take comfort that China has made it fairly clear that they are looking to be the first to resume a "normal" growth path.

Bringing this all together, our best guess is that quarterly economic growth rates will be negative or flat for the remainder of 2009 before returning to slightly positive growth rates in 2010.

Data wrap

- **Credit** to the private sector grew at 0.1% in April, driven by housing credit.
- **AiG Performance of Manufacturing Index** improved to 37.5 in May, up from 30.1 in April.
- **TD Inflation Gauge** showed prices fell 0.3% in May, to be 1.5% in the year.
- **HIA new home** sales grew by 0.5% in April after a solid 3.1% rise in March.
- **Retail sales** expanded at a weaker than expected 0.3% in April.
- **Business indicators** reported profits contracted 7.2% in Q2.
- **Balance of payments** data saw the CAD narrow to \$4.6bn in Q1.
- **Building approvals** jumped a very solid 5.1% in April.
- **Government spending** expanded 1.5% in Q1.
- The **RBA cash rate** was left on hold at 3% at the June meeting.
- The **AiG Performance of Services Index** rose marginally to 39.9 in May.
- **GDP growth** expanded at a faster than expected 0.4% in Q1.
- The **trade balance** deteriorated sharply to record a \$91mn deficit.

Interest Rate Markets: RBA leaves door open for further cuts

- A dovish stance on the policy outlook has helped to offset the impact of strong data in local financial markets.
- Consolidation in US bond markets should allow local market rates to recover some ground.

RBA leaves door open for further cuts

The RBA surprised markets with an unexpectedly dovish stance on policy in the announcement that accompanied the decision to keep rates on hold at 3% this week's board meeting. In contrast to what has been increasingly positive news on activity and global market confidence, the RBA took the opportunity to restate a clear easing bias by noting:

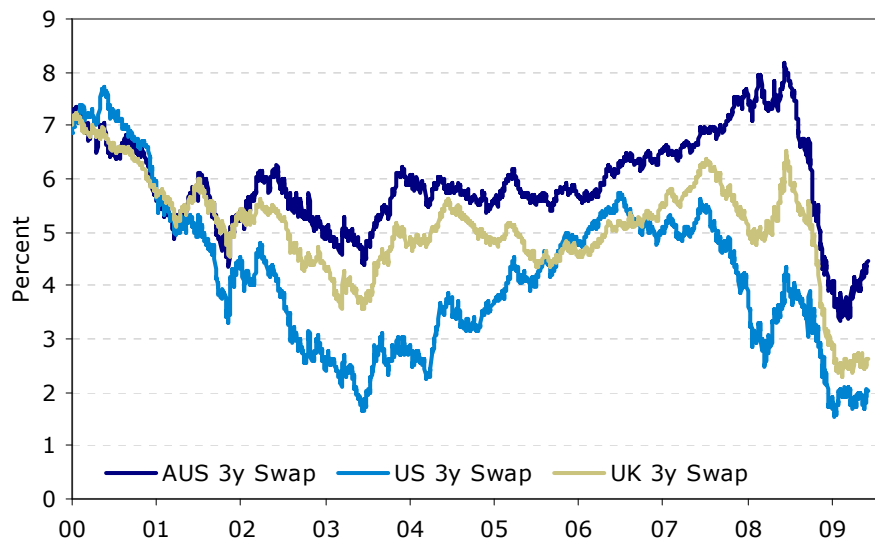
"The prospect of inflation declining over the medium term suggests that scope remains for some further easing of monetary policy, if needed. In assessing how it might use that scope, the Board will continue to monitor how economic and financial conditions unfold, and how they impinge on prospects for a sustainable recovery in economic activity."

In light of some positive surprises in recent data releases, continued gains for global stock markets and improvement in risk appetite one could ask what has prompted the RBA to stress such a clear easing bias?

The Federal Budget has now been handed down and there is clearly less scope for the same level of fiscal support for household balance sheets in coming months. The currency has shot higher in recent months peaking this week over US\$0.8250. Further, the TWI is up almost 25% since the start of February – a net tightening of financial conditions that will clearly help to bear down on imported inflation - while market interest rates have risen significantly in line with the sell-off for US Treasuries. As such both US and Australian yield curves have remained relatively steep.

Also concerning is the fact that local 3-year swap rates are up around 1.2% and 5-year swaps are up over 1.5% over the same period. In fact, local swap rates have risen far more quickly than equivalent rates in the US and UK – see chart below.

Figure 1: Swap rates



Source: ANZ & Bloomberg

Is the RBA trying to talk markets down?

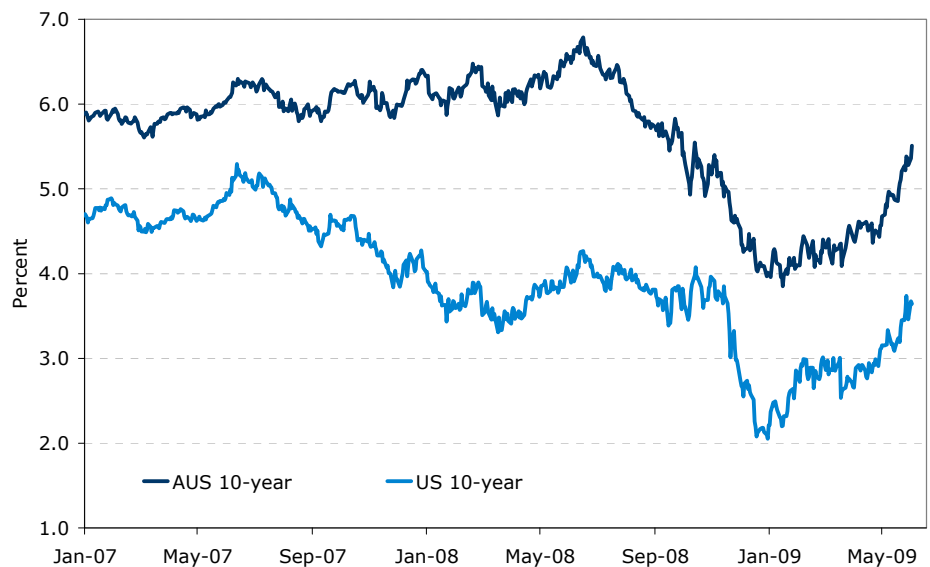
All of the above suggests one aspect of the RBA's communication could be addressed at limiting the advance of the currency and cap the rise in market

interest rates, both of which represent headwinds to the expected recovery in economic activity. Other central banks such as NZ and Canada have sought to cap the rise in longer-term rates by making a commitment to keep official cash rates at or below current rates into 2010.

On top of the economic reasons to expect weakness in GDP growth later in the year, further gains for market rates and the currency would put increasingly pressure on the RBA to strengthen the easier bias to policy, or to act on it.

We continue to expect market bonds to recover some ground in coming months in line with our expectation that the RBA will back into play later in the year. But this will require US bond yields to at least consolidate after rising sharply in recent months. This "normalisation" of bond yields has pushed US 10-year yields above 3.5%. The close correlation with local bonds can be seen in the figure below.

Figure 1: AUS and US 10-year yields



Source: ANZ & Bloomberg

Aussie-US spread remains constant

Surprising strength in local data and the growing expectation that the Fed might expand the scope of quantitative easing when the FOMC meets on June 25th helps to explain why the AUS-US bond spread has not narrowed further in this environment.

It would appear that the A\$ has benefited most from the outperformance of the economy and maintenance of a significant rate differential. The longer this dynamic remains in play, the greater the pressure on the RBA to act on the easing bias so that monetary policy once again works to address stresses elsewhere in the economy. And the extended pause to policy now in train can be seen to provide the RBA with a high degree of flexibility to address developments over coming months.

Amber Rabinov
 Economist, Foreign Exchange and
 International Economics Research
 +61 3 9273 4853
 Amber.Rabinov@anz.com

Katie Dean
 Senior Economist
 +61 3 9273 1381
 Katie.Dean@anz.com

FX: A higher AUD/USD trading range

Recommendation

The one-way move north in the AUD over the past few weeks turned around sharply overnight. While downside pressures exist, market momentum also supports further moves higher in AUD/USD purely on technical trading. While implied volatility has been very stable in recent months, a sharp spike in realised one-month vols this week is yet to fully flow through into implied vols. With large moves either way in spot AUD/USD possible in the short term, now marks a good time for both buyers and sellers to take out additional option cover.

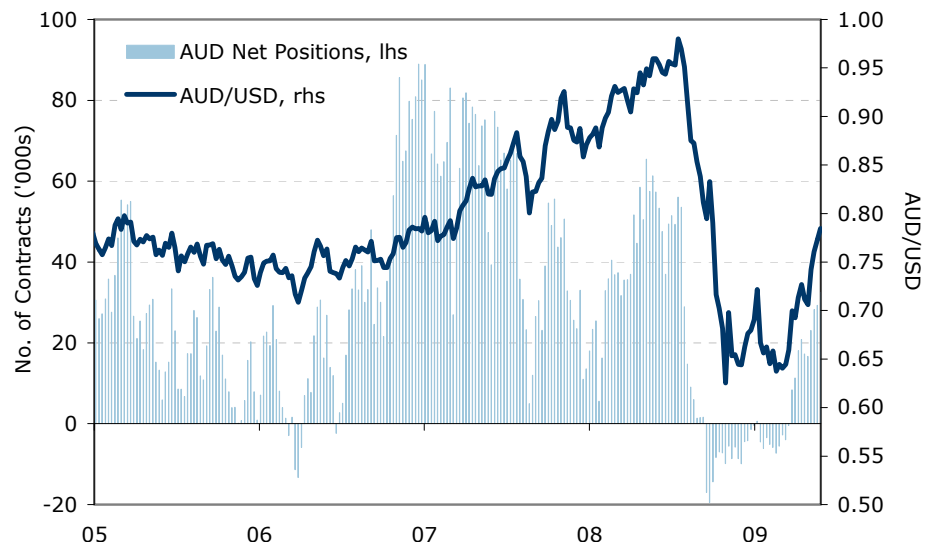
Overview

The rally in the AUD/USD continued this past week, with the currency sailing past the key 50% retracement level between 2008's high and low of 0.7930 without pausing for breath. Although last night marked the first major pull-back for the AUD in some weeks, dipping 3 US cents from a peak above 0.8250, now consolidating around 0.80, overall market momentum remains supportive for the AUD.

In this environment, the traditional underlying drivers of the AUD/USD – commodity prices and interest rates – have been overwhelmingly swamped by the effects of investor sentiment (the return of risk appetite as seen via the rally on global equity markets), a build in FX market positioning (see Figure 2), and the broad-based weakening in the USD. For instance, the difference between our model-driven fair value estimate of the AUD/USD and the actual end-of-month close was 13 US cents in May, as compared to an (absolute) average of just over 2 US cents since 1991.

In the speculator market, International Money Market (IMM) positioning suggests there is potential to further build AUD longs. The IMM AUD/USD net long position is still well below the highs recorded over 2006 and 2007. A rush to extend longs in the short-term, chasing this rally in the AUD/USD, could see the AUD/USD quickly break through the next topside level of 0.8380. However at the same time, this same positioning heightens the risk of more severe downside moves if a reversal becomes apparent, as investors move to quickly unwind long positions.

Figure 2: IMM AUD/USD positioning supporting the move higher in spot

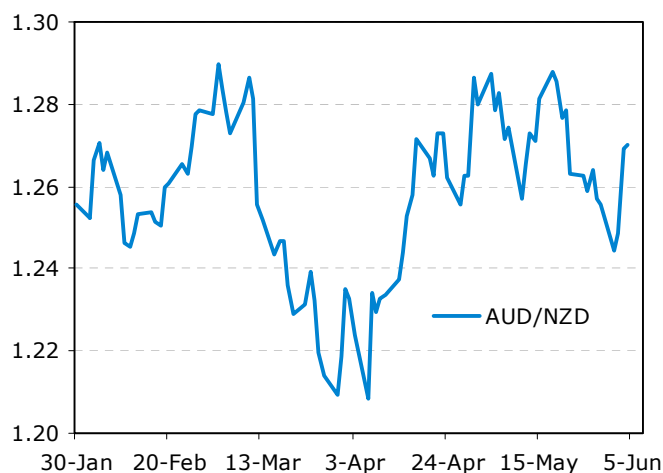
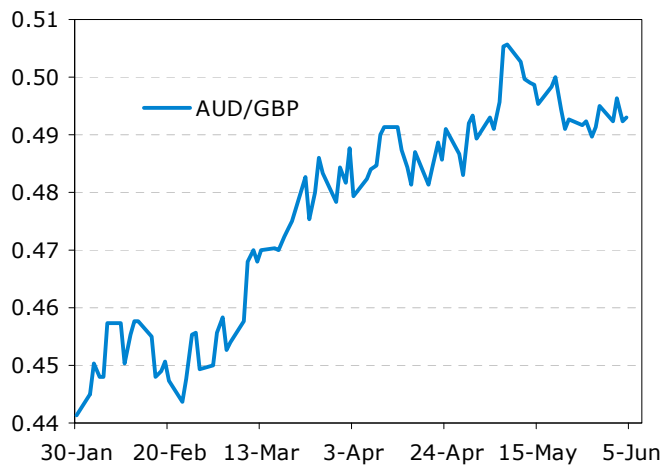
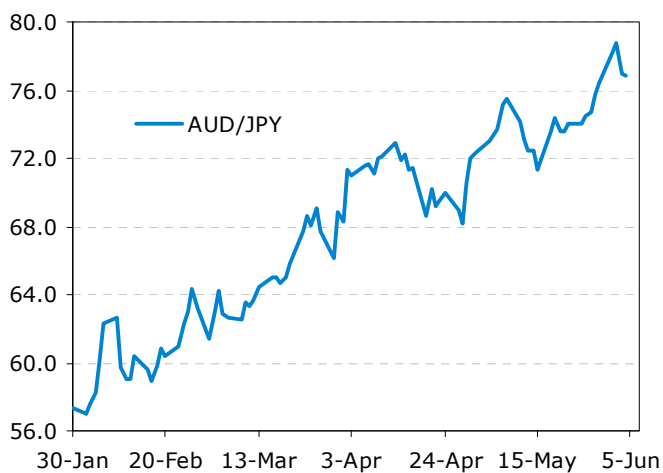
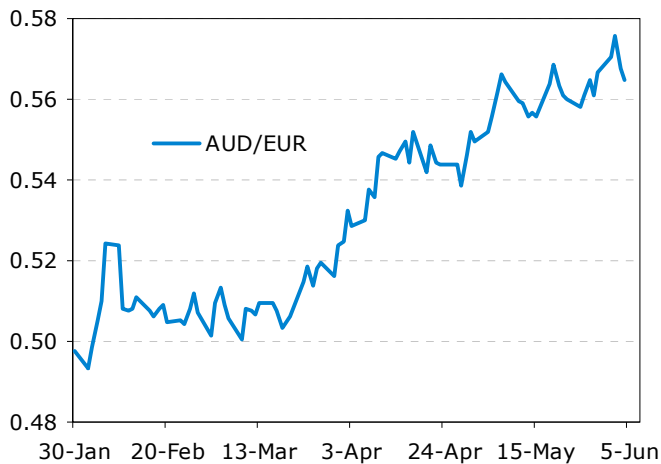


Source: ANZ, Bloomberg

This week's key risk events include: tonight's ECB meeting, with any hint of a move to QE or further rate cuts to weigh on the AUD (and the EUR); tomorrow night's US non-farm payrolls (look for a better than expected result to boost the AUD); and next week's domestic data roll call of business and consumer confidence, and employment data set to provide further potential for volatility.

AUD/USD Key levels: 0.7730 – 0.8380. A very wide range! Last week's key topside resistance at USD0.7930 should provide strong support on the downside, with breaks lower likely to be limited to 0.7730. On the upside, all eyes remain on a push through 0.8380. Consolidation above this level could set up a move towards the next major barrier at 0.8940.

AUD cross view



AUD/EUR Key levels: 0.5560 – 0.5810

- AUD/EUR pushed solidly above last week's suggested topside level of 0.5710 to peak close to 0.58. However, the USD rally on markets overnight quickly put an end to this move, with the cross now consolidating around 0.5650. Nonetheless, upward momentum remains firmly entrenched, with the 100-day moving average (MA) having risen solidly above the 200-day MA. Good downside support exists at 0.5560.
- Tonight's ECB meeting will be a key event. Some ECB officials have suggested this week the ECB could still cut rates, and the ECB could also expand its covered bond purchase program.

AUD/JPY Key levels: 70.4 – 79.5

- AUD/JPY surged to a new eight-month peak of 79.5 this week as AUD/USD was carried higher by rallying equity markets and increased risk appetite. Although the cross fell just shy of the key 50% retracement level between 2008's high and low of 79.8, momentum should see the 100-day MA close above the 200-day MA within a week or two.
- Global risk appetite and the fortunes of the USD are likely to remain the key driver of the JPY in the near term. Look out for next week's Japanese machine and machine tool orders data, which are good indicators of trends in industrial activity.

AUD/GBP Key levels: 0.4790 – 0.5050

- GBP/USD continued to be the surprising outperformer on global FX markets this week, surging almost 5% to a new recent high above 1.6650. AUD/USD has more than kept pace with this move in the GBP/USD, and this has seen AUD/GBP well supported above 0.4900. However, the cross remains in a steady downward channel.
- Tonight's BoE meeting should have little impact on the cross, with no rate cut expected and a short-term extension of QE unlikely. Keep an eye out for potential 'green shoots' in next week's UK industrial and manufacturing production data, which have been in contraction since early 2008.

AUD/NZD Key levels: 1.2490 - 1.2720

- Downside pressure on the AUD/NZD persisted until yesterday's risk turnaround, with the cross rallying to a 5-day high back around 1.27.
- Next week's key risk event is Thursday's RBNZ meeting, with markets expecting rates to be cut 25bps to 2.25%. However, our NZ colleagues forecast that the RBNZ will leave rates on hold at 2.50%, an outcome which would provide good support to the NZD/USD and could limit further short-term upside in the AUD/NZD. Also watch out for a continued improvement in the NZ PMI for April as another sign of stabilisation in global manufacturing activity.

ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
Economic activity (annual % change)				
Private final demand	6.0	4.1	-2.2	-1.8
Household consumption	4.3	2.2	0.9	0.9
Dwelling investment	2.7	2.5	-6.8	8.4
Business investment	13.8	13.8	-10.1	-15.5
Public demand	2.8	5.3	1.6	5.8
Domestic final demand	5.4	4.4	-1.3	-0.1
Inventories (contribution to GDP)	0.6	-0.6	-0.4	0.6
Gross National Expenditure (GNE)	5.9	3.8	-1.8	0.5
Exports	3.3	3.9	-0.8	-1.2
Imports	11.4	10.3	-10.9	1.8
Net Exports (contribution to GDP)	-1.7	-1.5	2.5	-0.7
Gross Domestic Product (GDP)	4.0	2.3	-0.2	0.3
Prices and wages (annual % change)				
Inflation: Headline CPI	2.3	4.4	1.7	2.2
Underlying*	3.1	4.5	3.7	2.7
Wages	4.0	4.3	3.8	3.4
Labour market				
Employment (annual % change)	2.8	2.2	-0.3	-1.0
Unemployment rate (%)	4.4	4.2	6.1	8.0
External sector				
Current account balance: A\$ bn	-67.7	-51.0	-54.0	-79.4
% of GDP	-6.2	-4.3	-4.6	-6.6

*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
RBA cash rate	3.00	3.00	2.50	2.00	2.00	2.00
90 day bill	3.18	3.20	2.30	2.30	2.30	2.35
3 year bond	4.14	3.95	3.65	3.60	3.80	3.80
10 year bond	5.43	5.45	5.05	4.80	4.90	4.80
3s10s yield curve	1.29	1.50	1.40	1.20	1.10	1.00
3 year swap	4.37	4.30	3.95	3.90	4.10	4.10
10 year swap	5.82	5.95	5.45	5.15	5.20	5.10
International interest rates						
RBNZ cash rate	2.50	2.50	2.25	2.00	2.00	2.00
NZ 90 day bill	2.79	2.85	2.43	2.35	2.35	2.35
US Fed funds note	0.25	0.25	0.25	0.25	0.50	1.00
US 2 year note	0.97	1.00	0.90	0.85	1.25	1.50
US 10 year note	3.74	3.75	3.65	3.55	3.75	3.90
Japan call rate	0.10	0.10	0.10	0.25	0.50	0.50
ECB refinance rate	1.00	1.00	0.50	0.50	0.75	1.00
UK repo rate	0.50	0.50	0.50	0.50	0.75	1.50

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Jun 09f	Sep 09f	Dec 09f	Mar 10f	Jun 10f
Australia and NZ exchange rates						
A\$/US\$	0.8060	0.77	0.73	0.69	0.69	0.70
NZ\$/US\$	0.6354	0.61	0.57	0.52	0.51	0.52
A\$/¥	77.56	75.46	76.65	74.52	75.90	79.80
A\$/€	0.5668	0.55	0.58	0.56	0.57	0.58
A\$/£	0.4936	0.49	0.48	0.46	0.45	0.45
A\$/NZ\$	1.269	1.26	1.28	1.33	1.35	1.35
A\$/CA\$	0.8912	0.89	0.86	0.83	0.86	0.88
A\$/CHF	0.8593	0.87	0.88	0.86	0.90	0.95
A\$/CNY	5.507	5.26	4.99	4.71	4.71	4.77
A\$ Trade weighted index	63.80	62.34	60.44	57.42	57.40	59.12
International cross rates						
US\$/¥	96.2	98	105	108	110	114
€/US\$	1.422	1.39	1.26	1.24	1.22	1.20
€/¥	136.9	136	132	134	134	137
£/US\$	1.633	1.58	1.52	1.50	1.52	1.54
€/£	0.8708	0.88	0.83	0.83	0.80	0.78
US\$/CA\$	1.106	1.15	1.18	1.20	1.24	1.25
US\$/CHF	1.066	1.13	1.20	1.25	1.30	1.35
US\$ index	79.23	81.3	87.7	89.3	90.6	92.0
Asia exchange rates						
US\$/CNY	6.833	6.83	6.83	6.83	6.82	6.82
US\$/HKD	7.752	7.75	7.76	7.76	7.76	7.76
US\$/IDR	10060	10750	10250	9750	9500	10500
US\$/INR	47.13	50.00	48.50	48.00	47.00	47.50
US\$/KRW	1250.3	1325	1225	1150	1100	1225
US\$/MYR	3.493	3.60	3.60	3.55	3.50	3.50
US\$/PHP	47.263	48.50	49.00	48.00	48.00	47.00
US\$/SGD	1.441	1.52	1.53	1.52	1.51	1.51
US\$/THB	34.13	35.50	36.00	35.50	35.00	35.00
US\$/TWD	32.61	32.70	32.00	31.50	31.00	31.00
US\$/VND	17789	17800	18500	18500	18500	18500
Pacific exchange rates						
PGK/US\$	0.374	0.37	0.36	0.35	0.35	0.36
FJD/US\$	0.483	0.43	0.42	0.40	0.39	0.39

Contacts

ANZ Economics & Markets Research

Saul Eslake	Chief Economist	+61 3 9273 6251	Saul.Eslake@anz.com
Fiona Allen	Business Manager	+61 3 9273 6224	Fiona.Allen@anz.com

Australian Economics and Interest Rates Research

Warren Hogan	Head of Australian Economics and Interest Rates Research	+61 2 9227 1562	Warren.Hogan@anz.com
Tony Morriss	Senior Rates Strategist	+61 2 9226 6757	Tony.Morriss@anz.com
Katie Dean	Senior Economist	+61 3 9273 1381	Katie.Dean@anz.com
Riki Polygenis	Economist	+61 3 9273 4060	Riki.Polygenis@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com
Daniel Bae	Analyst	+61 2 9227 1272	Daniel.Bae@anz.com

Foreign Exchange and International Economics Research

Amy Auster	Head of Foreign Exchange and International Economics Research	+61 3 9273 5417	Amy.Auster@anz.com
Amber Rabinov	Economist	+61 3 9273 4853	Amber.Rabinov@anz.com

Commodities and Industry Research

Mark Pervan	Head of Commodities Research	+61 3 9273 3716	Mark.Pervan@anz.com
Julie Toth	Senior Economist	+61 3 9273 6252	Julie.Toth@anz.com
Doug Whitehead	Soft Commodity Strategist	+61 3 9273 6684	Doug.Whitehead@anz.com
Paul Deane	Rural and Regional Economist	+61 3 9273 6295	Paul.Deane@anz.com

Property and Financial System Research

Paul Braddick	Head of Property and Financial System Research	+61 3 9273 5987	Paul.Braddick@anz.com
Ange Montalti	Senior Economist	+61 3 9273 6288	Ange.Montalti@anz.com
Dr. Alex Joiner	Economist	+61 3 9273 6123	Alex.Joiner@anz.com

Foreign Exchange and Interest Rates Research (London)

Tim Riddell	Currency and Interest Rate Strategist		Tim.Riddell@anz.com
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Asian Economics Research (Singapore)

Paul Gruenwald	Chief Economist, Asia	+65 6419 7902	Paul.Gruenwald@anz.com
Tamara Henderson	Director, Currency & Rates Strategy	+65 6216 1845	Tamara.Henderson@anz.com
Yeo Han Sia	Associate Director , Currency & Rates Strategy	+65 6419 7930	HanSia.Yeo@anz.com
Franklin Poon	Economist , North East Asia	+852 3929 5340	Franklin.Poon@anz.com
Chang Wei Liang	Analyst, Economic Research	+65 6216 1838	WeiLiang.Chang@anz.com

New Zealand Economics Research (Wellington)

Cameron Bagrie	Chief Economist, New Zealand	+64 4 802 2212	Cameron.Bagrie@anz.com
Khoon Goh	Senior Economist	+64 4 802 2357	Khoon.Goh@anz.com
Philip Borkin	Economist	+64 4 802 2199	Philip.Borkin@anz.com
Steve Edwards	Economist	+64 4 802 2217	Steve.Edwards@anz.com
Kevin Wilson	Rural Economist	+64 4 802 2361	wilsonk1@anz.com
David Croy	Interest Rate Strategist	+64 4 802 2286	David.Croy@anz.com

Research and Information Services

Marilla Rough	Senior Information Officer	+61 3 9273 6263	Marilla.Rough@anz.com
Manesha Jayasuriya	Publications Coordinator	+61 3 9273 4121	Manesha.Jayasuriya@anz.com

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Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522

100 Queen Street, Melbourne, Victoria, 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

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