

ASB Quarterly Economic Forecasts

Sensing some light



- The green shoots continue to show: global economic decline is losing momentum.
- However, the pace of global recovery will comparatively modest over the next few years.
- NZ's economy remains on track to stabilise around year-end, recovery building up in 2010.

Green shoots continue to gradually pop up around the globe, though the odd few have turned into yellow weeds. Industrial activity in Asia is starting to show some life after being walloped late last year and early this year and will continue to recover over the second half of the year. The US and the UK show signs of starting to stabilise, with Europe lagging. However, as we have previously noted, longer-term recovery in the global economy will be more modest than usual. Household deleveraging will constrain global consumer demand, including in NZ, and growing government debt in many countries will crimp long-term growth rates.

Our overall economic forecasts have changed little since our previous Quarterly. We expect the economy to bottom out around the end of the year, followed by a steady recovery over 2010. However, the mix is slightly different, incorporating a much stronger lift in housing construction but a more moderate lift in net exports.

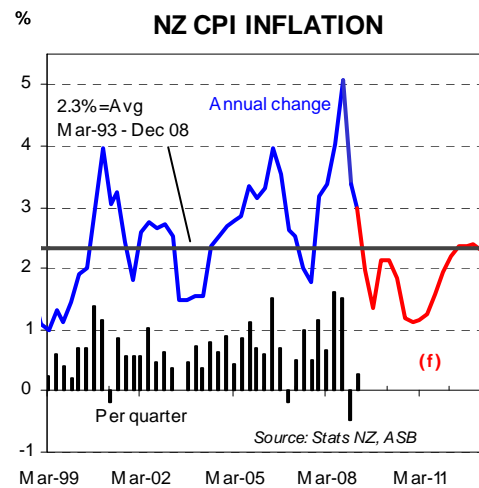
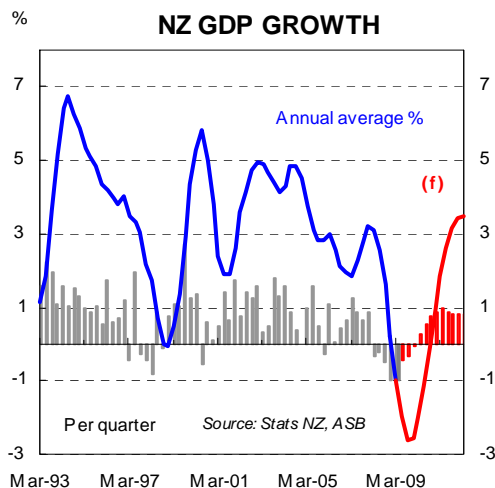
The challenge for NZ's export earnings is that even next year when the global economy expands, growth will still be weak. The strength of the NZ dollar against the US dollar, coupled with little outright weakness against other key currencies, means NZ lacks the boost it normally gets coming out of a recession.

In contrast, the housing market is showing stronger signs of recovery: having been the first part of the economy to succumb to downturn in 2007, it is also the first to turn the corner. Housing construction looks set to have a solid pick-up from late 2009. Home building activity has dropped considerably since the end of 2007, and with fewer people leaving the country population growth is on the rise.

Influencing monetary conditions will remain a challenge for the RBNZ. The OCR has reached the limit on being able to affect short-term interest rates, with domestic depositors dictating how far those rates can drop (the answer being no further). Global long-term interest rates are at the mercy of risk appetites (which have been improving) and the considerable waves of government debt issuance that will be a feature of years to come. Likewise, the NZ dollar has been relatively buoyant, lifting partly because sentiment towards the global economic outlook is starting to mend. But outright weakness in the US dollar has much to do with it, as safe-haven flows reverse and as some investors question the durability of the USD as a store of value.

We think it is possible the RBNZ cuts the OCR further to try and dent the strength of the NZD and long-term rates – or to reinforce its intention to keep interest rates lower for longer than market pricing currently implies. The impact of such actions would probably be modest, but if the NZD in particular remains stubbornly high the RBNZ may feel it is at least worth trying.

There is some light appearing at the end of the tunnel and it is probably not a train. However, even as some businesses may start to sense the worst is past, others have yet to fully feel the extent of the global downturn. We are not out of the woods yet, and a challenging environment will be with us for some time.



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General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Household saving and government debt

Fall in household wealth has triggered change in consumption patterns

In the wake of the credit crunch household wealth has declined and resulted in a marked change in consumer behaviour. There has been a U-turn on debt-fuelled consumption to a rise in household saving. The focus on balance sheet rebuilding will weigh on per-capita consumption for some time in a number of countries. This increase in saving is set to be partially offset by a rise in government debt. Governments toe a fine line between using debt to stimulate demand and establishing excessive debt burdens which crowd out future private investment.

Households more circumspect

Loss of wealth and increased uncertainty have limited the impact of stimulatory policy

In recent months, consumers' outlooks have dramatically changed. In a matter of months sharp falls in equity and house prices have dramatically reduced household wealth and at the same time job security has evaporated. It's not too surprising consumer confidence remains modest despite huge efforts to stimulate the economy. Tax cuts and record low interest rates have, rather than boost spending, at best prevented falls in spending from being larger. This is in stark contrast to the 'good times' when 9% interest rates were barely enough to convince households to slow down the rate at which they eagerly borrowed.

Households' wealth reduced

NZ net household wealth has fallen by 9.2% over the past year

According to RBNZ estimates, New Zealand household wealth declined 9.2 percent over 2008. Declines in assets were led by a 7.5% fall in the value of housing stock, whilst financial assets declined 2.5%. To give some perspective, the decline has been small in comparison to the 126% increase in household net wealth over the preceding 7 years. Nonetheless, the balance sheet has deteriorated recently.

The declines in housing markets and falling household wealth have been international phenomena, and have manifested in a slowdown in credit growth and an increase in saving.

Job security

Fall in wealth an international phenomenon, savings rates increasing

Also contributing to the penchant to save more has been the fall in job security. Labour market indicators point to the weakest conditions since the early 1990s recession. Unemployment in NZ is expected to rise towards 8%.

Retail

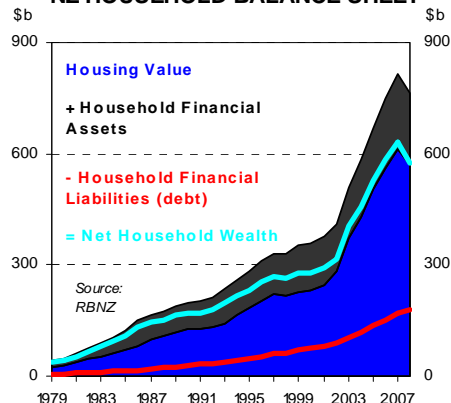
Job security concerns also boost precautionary saving.

The impact of increased saving and slower debt growth has made a striking impact on the retail spending figures. In NZ retail spending has fallen sharply with the weakness centred on durable purchases, vehicles in particular (items often purchased via finance).

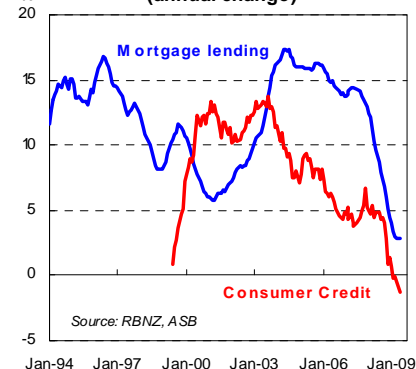
This change in behaviour and balance sheet readjustment by the household sector is fundamental to our outlook for subdued consumption growth over coming years.

Increased saving dents retail spending.

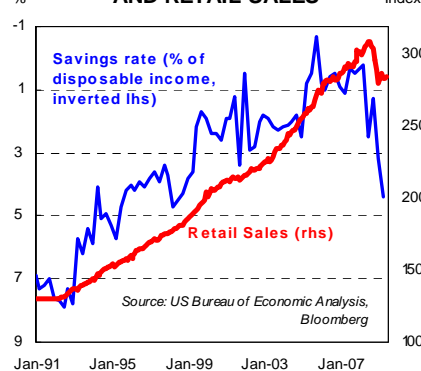
NZ HOUSEHOLD BALANCE SHEET



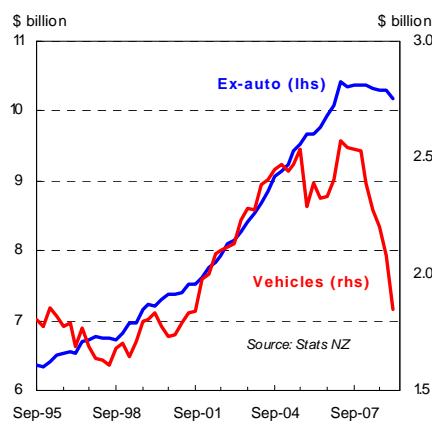
NZ HOUSEHOLD LENDING GROWTH (annual change)



US PERSONAL SAVINGS RATE AND RETAIL SALES



NZ RETAIL SALES VOLUMES



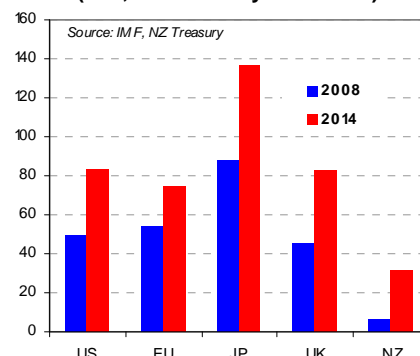
Government debt set to rise significantly

Households' gain, governments' pain

While household debt accumulation is slowing, governments' debt burdens are set to rise in its place. Faced with the potential for large-scale systemic bank failures, policy makers in the US and UK were quick to step in with an array of bailout and stimulus packages. These actions were successful in preventing the worst from happening, but come at a significant cost. Further still, government accounts are going to struggle to meet this additional cost as tax revenues fall sharply with the recession.

NZ's government has been fairly conservative, in part constrained by the threat of a credit downgrade. However, other governments have

NET GOVERNMENT DEBT % OF GDP
(IMF, NZ Treasury estimates)



Debt burdens daunting given ageing population

some worrisome debt burdens (see adjacent chart). These debt burdens are additionally concerning given the rising average age of developed countries' populations. As the Baby Boomer generation retires, repaying government debt will become more challenging. Without credible medium-term debt target strategies, governments run risk of households losing faith in the ability of future governments to provide social services, particularly pensions. In response, a Ricardian equivalence behaviour could take hold, as households further increase savings rates which would mute the effectiveness of current government stimulus. This has been Japan's experience since the 1990s.

Rising debt issuance lifts interest rates

The sheer size of US government debt issuance is starting to cause international discomfort. Demand for government assets and safe-haven buying has waned as risk appetites have improved. As a result, longer-term US Treasury yields have started to pick up noticeably. For now rates are merely returning to normal levels and increases are being capped slightly by Federal Reserve purchases. Nonetheless, governments need to be wary about the future risk of crowding out private investment with higher interest rates. Attempts to provide stimulus may be undermined if government borrowing lifts interest rates and lowers private investment. Such an outcome would not only be counter productive, but could also reduce the long-run growth potential of economies via lower levels of productive private sector investment.

Lessons from Japan

IMF's lessons from Japan, revisiting the 'lost decade'

The IMF recently held a seminar to explore the parallels between the current crisis and Japan's experience over the 1990s, identifying some valuable lessons applicable to the current crisis. ([Link to full report](#))

Japan's net government debt almost 90% of GDP

Japan's fiscal mistakes

Fiscal deficits averaged more than 5% of GDP between 1993 and 2000 and net public debt increased from less than 20% of GDP to 60% (net debt is now 88% of GDP, while gross debt is 196% of GDP). Despite large deficits, the IMF noted that the fiscal impulse was only modest and identified a number of factors that may have restricted its effectiveness:

Yet fiscal stimulus over the 1990s was relatively ineffective

- Land purchases made up a large share of public investment, which limited the economic impact;
- The 1997 recovery was short-lived due to sharp and premature increases in taxes;
- Low fiscal multipliers also limited the impact, in particular the inability for the private sector to respond due to a weak banking sector and corporates still undergoing the deleveraging process.

Lessons for today

The IMF concluded there are some important lessons to be applied to the current crisis:

Highlights the importance of using well-targeted plans and fixing existing banking sector problems first

- Fiscal spending must be well targeted to justify the use of debt;
- Ensure the banking sector is operating strongly, enabling credit growth to maximise the private sector's ability to recover;
- Identify a credible medium-term debt target early on, to prevent debt burdens from getting out of hand.

International

Economic forecasts stabilise

The OECD has revised its GDP forecast for OECD countries higher for both 2009 and 2010. The organisation now expects a contraction of 4.1% in 2009 (compared with -4.3% in March), and an expansion of 0.7% in 2010 (compared with +0.1%). While the forecasts are far from favourable, it was the first upward revision since June 2007. *Consensus Economics* releases fresh forecasts on a timely monthly basis and similarly to the OECD's forecasts the latest set for June showed signs of increasing optimism, particularly over the US growth outlook. However, the global economic outlook remains fragile and the recovery will be a long and arduous process. The factors that make recessions associated with financial crises longer and deeper also tend to mute recoveries when they finally arrive. Nonetheless, the general feeling is that the worst of the global growth contraction has passed, and indeed the worst case scenario has been avoided. A prolonged period of increasingly dire forecast revisions appears over.

Recessions associated with financial crisis typically longer and deeper

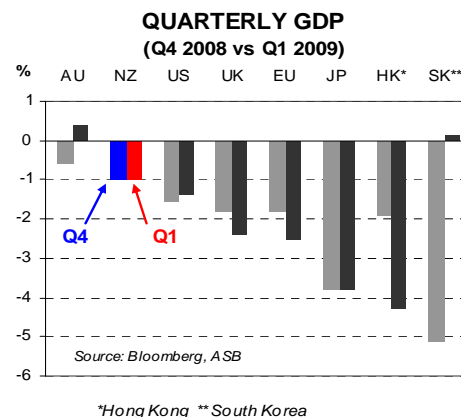
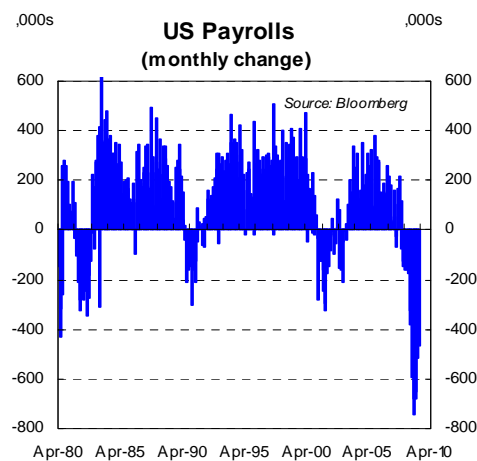
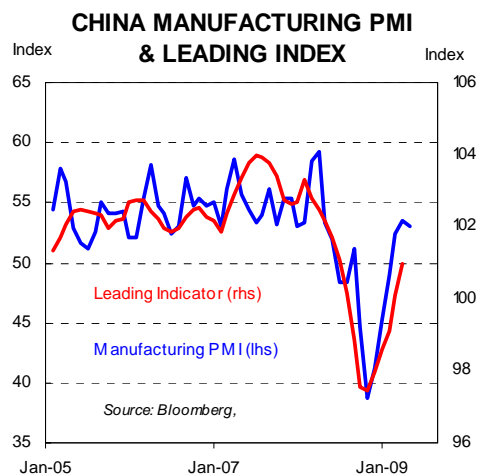
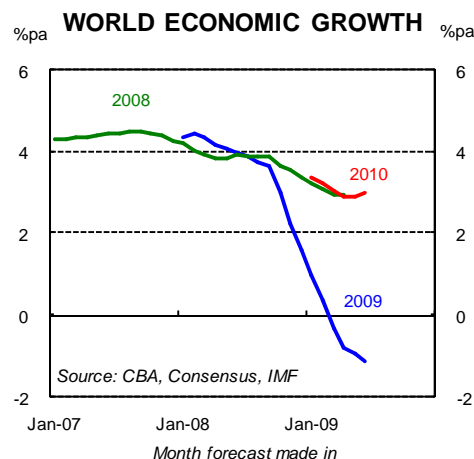
China is a critical component of future global growth. Manufacturing and business-activity indicators were positive in June, indicating expansion over H2 2009. The V-shaped recovery of the indices provides evidence the Chinese stimulus package, increased bank lending and tax breaks are having the desired effect on the economy. In contrast with the gauges in China which indicate expansion, the US equivalents are still indicating economic contraction, but are "less bad" than at the start of the year. Unemployment is still on the rise, and will likely peak at over 10% over the coming months. Importantly though, the average monthly employment decline through Q2 2009, while still indisputably severe, was a marked improvement on Q1 at -436k vs -691k. Consumer confidence in the USA can also be described as "less bad" rather than "good" at the moment. The gauges all point to further weakness in the US economy over 2009, but the rate of deterioration has slowed. The *Consensus Economics* forecasts in June expected the US economy to contract 2.8% in 2009, then expand 1.9% in 2010.

China critical to future global growth

US gauges still weak

Australia skirts recession

Across the Tasman, Australia has for now technically avoided recession, and in doing so has outperformed most of the OECD economies. This was due to decisive and substantive policy action by the monetary policy authorities and the Federal Government via significant and targeted fiscal stimulus measures. Australian exports have been resilient, boosted by a recovery in rural production. Moreover, resources exports were boosted by the relative good health of a number of trading partners (i.e. China and other emerging economies).



*Hong Kong **South Korea

The New Zealand Economy

NZ economy to remain in recession over 2009

The NZ economy has been in recession since the start of 2008, with 5 consecutive quarters of contraction so far confirmed. The initial phase of the downturn was relatively mild. However, since the escalation of the global financial crisis in September 2008, the pace of decline in output has accelerated. The weakness has been relatively broad-based across the economy, although manufacturing, construction, retail and wholesale trade have experienced the sharpest declines over the past year. Following aggressive policy action, business confidence has started to stabilise. Although we expect some further mild contractions in GDP, economic activity is broadly expected to stabilise over the latter part of 2009 and gradually recover throughout 2010.

Export activity

With the synchronised global recession well underway, GDP in NZ's main trading partners is expected to contract around 2.5% over 2009. Declines in consumer demand in the US, UK and Eurozone have heavily impacted industrial production and exports in the Asia Pacific. We are expecting a relatively drawn-out recovery, with trading partner growth expanding only 1.5% over 2010.

Global recession reduces demand for NZ exports

Almost half of New Zealand's merchandise exports are tied to agricultural production, for which export volumes are more dependent on weather conditions than external demand. For that reason, the NZ economy is more vulnerable to lower export prices. Weak global demand has seen commodity prices fall dramatically, and New Zealand dairy export prices have fallen almost 50% since their October 2008 peak.

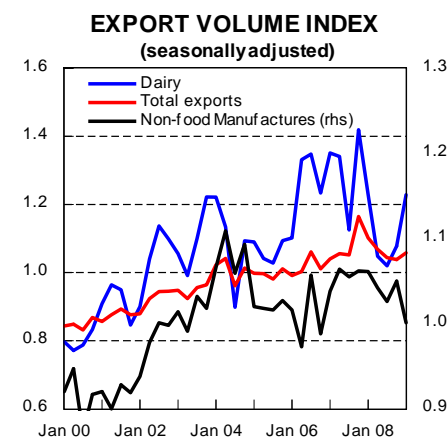
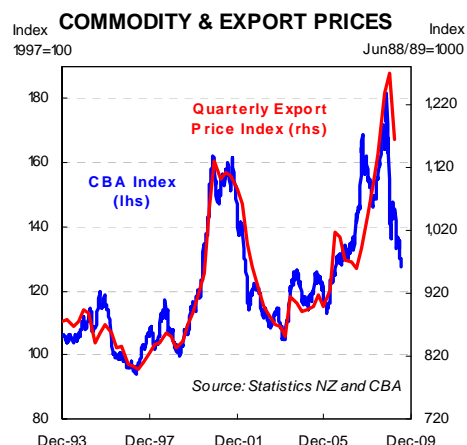
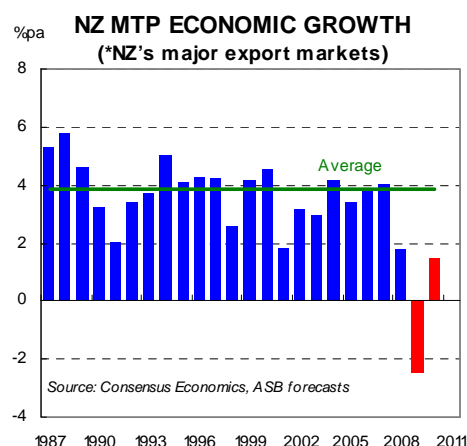
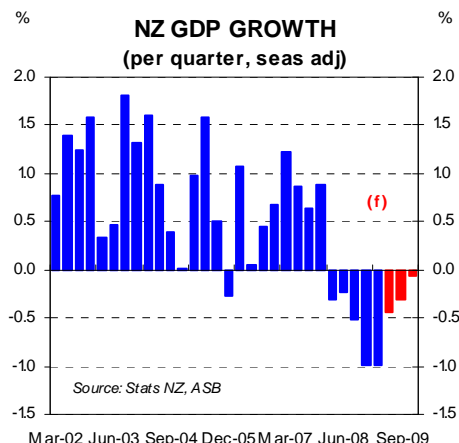
Export prices key channel for NZ

The weakness in export demand has also been evident in lower export volumes of non-food manufactures and aluminium. Non-pastoral exports and tourism will feel more pressure over the next year. Over recent months, this weakness has been temporarily offset by strong volumes of agricultural-related exports, in particular, dairy, as production recovers to pre-drought levels. Export volumes of fruit, logs and oil have also been strong in recent months. The timing of agricultural export strength has coincided with dramatic declines in import volumes (in line with reduced domestic demand).

Non-agricultural export volumes starting to decline, further pressure to come

New Zealand's current account deficit has narrowed to 8.5% of GDP in Q1. However, New Zealand remains highly indebted to the rest of the world, with net external liabilities totalling 98.2% of GDP. As global access to credit is likely to remain challenging and expensive for some time, New Zealand will need to reduce its external reliance on debt over time.

NZ external indebtedness remains a key vulnerability



Net migration turns around, provides timely boost to domestic demand

Net migration

A key development over the past few months has been the pick up in net migration, with NZ adding 11,200 net new migrants over the May 2009 year. The turnaround comes as the number of New Zealanders leaving to Australia and the UK has fallen, with fewer employment opportunities abroad. We expect current trends will continue, lifting net migration to a peak around 25,000 later this year. The increase in population base will help support demand for housing construction and retail spending, which are currently at cyclical lows, partly offsetting the impact of falling per-capita demand.

NZ housing market recovers off lows

Housing

The housing market staged some recovery over recent months, with housing turnover lifting sharply off its lows although remaining below average. Low interest rates and lower house prices have tempted potential buyers back into the market. In addition, the recent pick up in net migration also provides a floor under housing construction. The recovery in demand suggests prices are likely to stabilise very soon. However, rising unemployment, low affordability and a pick up in longer-term interest rates are likely to limit the scope for house prices to rise significantly.

Consumer spending falls, particular on cars

Consumer spending

Consumer spending contracted sharply over the first quarter of 2009, with weakness centred on lower vehicle purchases. Households have experienced a fall in net wealth and face an uncertain employment outlook. In response, households are opting to increase precautionary savings (or pay down existing debt faster), at the expense of retail volumes (consumer durables in particular).

Businesses remain under pressure

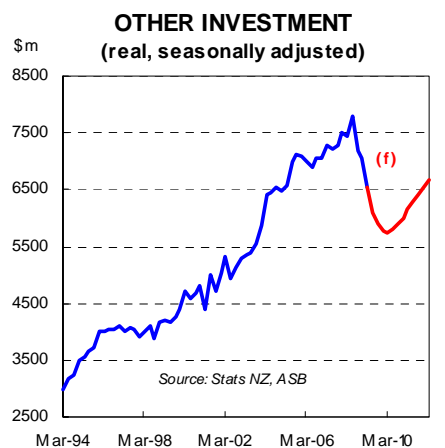
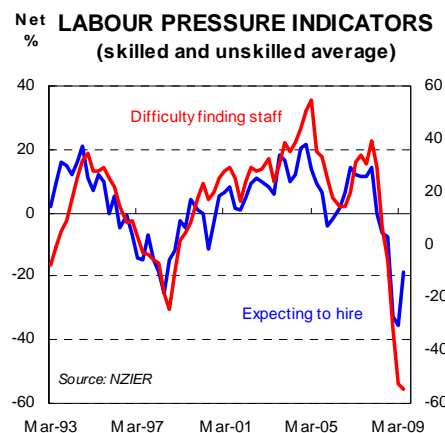
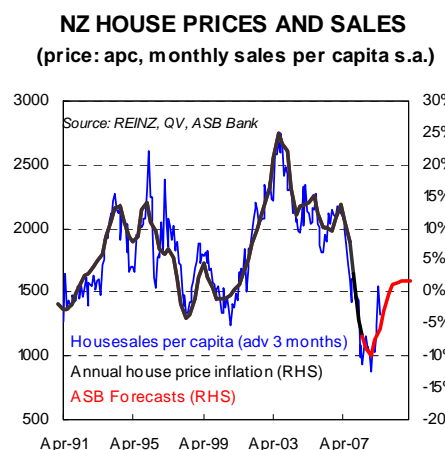
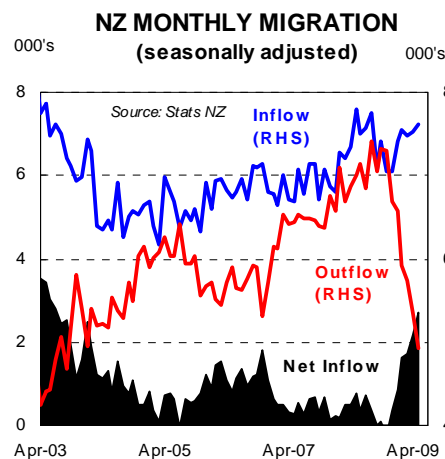
Investment and Employment

While business confidence has perked up somewhat, firms are still grappling to cope with reduced demand. Employment and Investment intentions remain weak as firms continue to trim costs. Business investment has contracted since the second half of 2008, largely falling as a result of number of large one-off items (such as planes and oil drilling platforms) imported earlier in 2007 and 2008. Further weakness is likely, particularly in non-residential building construction and plant and machinery. Government spending and preparation for the Rugby 2011 World Cup will provide some offset.

Business investment likely to remain weak

Unemployment set to rise

The fall in employment has been reasonably muted to date, suggesting a reduction in average hours worked has reduced the extent of layoffs. We expect far fewer job losses compared to the 1987-1991 recessions. Nonetheless, with unemployment rising toward 8%, wage inflation pressures are likely to subside considerably over the next year.



Inflation: low for a long time

Underlying inflation pressures easing

Wage growth likely to be weak

Increases in construction costs slow

Higher NZD mutes tradable inflation

Inflation likely to remain close to bottom of band

RBNZ on hold till latter part of 2010

Short-term risks remain to downside

RBNZ frustrated OCR losing traction

Inflation continues to fall sharply from 2008's petrol-induced peak, and the unravelling of the spike will drive the annual inflation rate down further in the September quarter. However, masked by the gyrations in the headline rate lies a gradual reduction in underlying inflation pressures. The marked weakening underway in the labour market will pare wage growth considerably. Furthermore, anecdotes suggest a greater prevalence for employers and employees to agree to wage freezes in order to minimise job losses. Housing construction cost increases have now started to moderate in the wake of considerable falls in building work, and will contribute to lower inflation over the next year. Pricing power is also going to remain weak in the current environment.

On top of softer domestic inflation pressures, tradable inflation will remain muted. We expect the NZ dollar will, if anything, rise further.

Over 2010 and 2011 we expect inflation will remain around the bottom of the 1% to 3% target band. That leaves the RBNZ little margin to the downside of its inflation target. Though the Policy Targets Agreement has the flexibility to allow a period of inflation outside the target (as it did when inflation persistently averaged above 3%), it would be desirable if the economy was more vigorous and inflation closer to the mid-point.

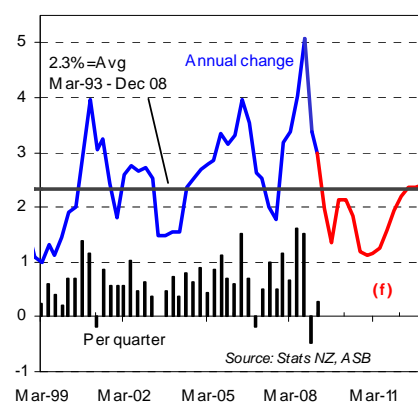
RBNZ: between a rock and a hard place

Back in April the RBNZ said it expects "to keep the OCR at or below the current level [2.5%] through until the latter part of 2010", and reiterated that expectation in June. Ultimately the state of the economy and outlook for inflation will determine when the RBNZ eventually starts lifting the OCR. But the inflation environment is such that the RBNZ can leave the OCR at an extremely low level over the next year.

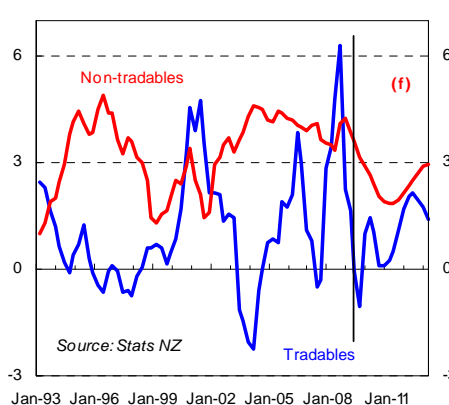
Eventually inflation pressures will lift in NZ and around the globe. But worrying about high inflation remains premature. In the short term the main risk is of inflation falling uncomfortably low. Over the next 6 months or so the risks remain skewed to the RBNZ making further efforts to add stimulus to the economy.

The RBNZ chose to keep the OCR on hold in June. However, if it does want to deliver more stimulus at some point it is stuck between a rock and a hard place. The OCR has reached the point where its influence on short-term rates is diminished: deposit rates (more precisely, depositors) are in the driving seat. However, alternative actions to try and influence wider monetary conditions, such as foreign exchange intervention or the purchasing of long-term bonds to try and drive down long-term interest rates, appear even less palatable to the RBNZ.

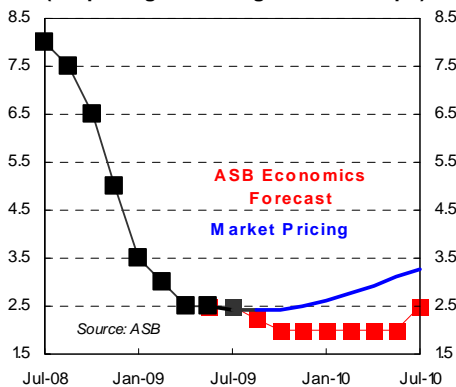
NZ CPI INFLATION



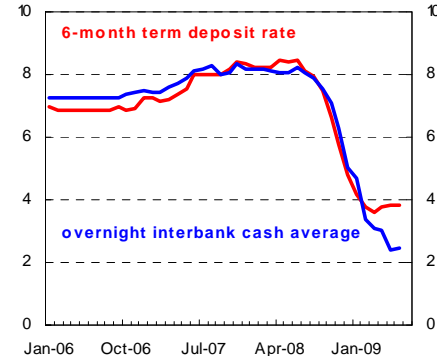
BREAKDOWN OF CPI INFLATION



OCR FORECASTS
(vs. pricing of overnight index swaps)



NZ TERM DEPOSIT AND OVERNIGHT CASH RATES



Least worst option

Scope for further cuts...

... as export sector remains under pressure

Market expectations for hikes too early

Upward pressure on longer-term interest rates likely to remain

NZD outperforms

USD weakness theme to dominate

NZD likely to remain supported

Range of views highlight uncertainties

Despite the OCR's loss of potency, we still think there is a realistic possibility that the RBNZ does cut the OCR again by 25bp in both September and October. The need to cut interest rates for households' benefit has passed: the housing market is picking up, and the 5.5% mortgage rates currently accessible are lower than any mortgage rate the RBNZ has records for (which for floating go back to 1964). However, it is the productive sectors that are still feeling pressure, one example being the sharp drop in the forecast dairy payout – a combination of low global dairy prices and an above-average NZD/USD.

Cutting the OCR is about the only option the RBNZ is willing to use to try influencing the NZD and long-term rates. Wholesale rates also imply an expectation the RBNZ will start lifting interest rates in early 2010, and a further rate cut would be a good way to knock that back and help contain wholesale rates.

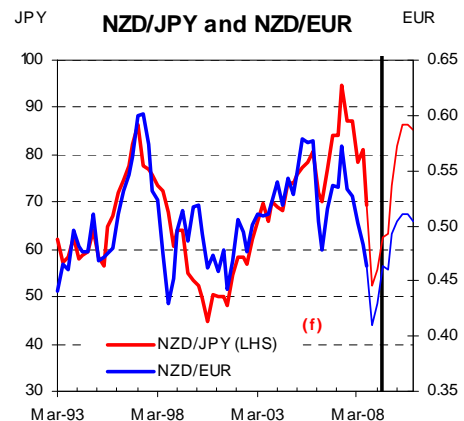
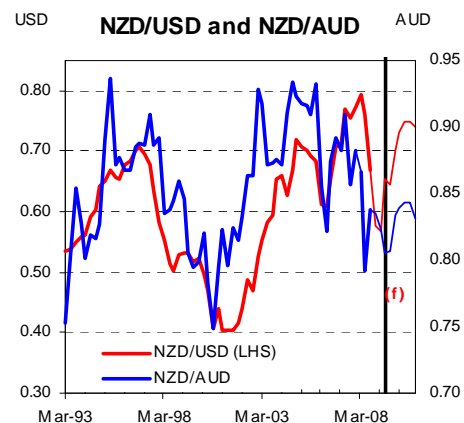
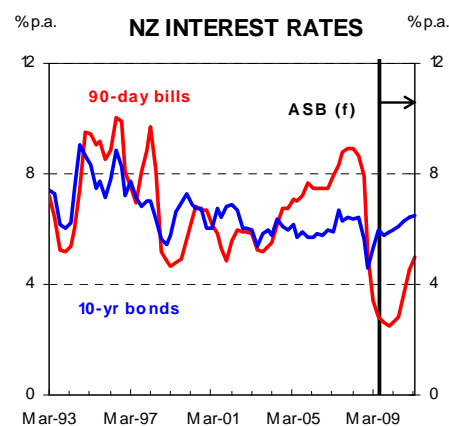
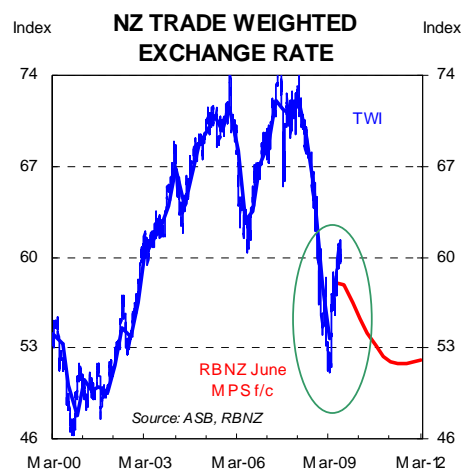
Pressures on global long-term interest rates look unlikely to fade, particularly as factors such as government debt issuance are going to be a fact of life for many years. Even once the RBNZ has eventually restored short-term interest rates to more normal levels it is likely that the shape of the yield curve will remain positive. As we have noted in recent [Home Loan Rate](#) reports, borrowing decisions increasingly involve weighing up how much you value the certainty provided by long-term fixed rates against the benefits of lower short-term rates.

NZD: not an underperformer

Currency performance is a bit like picking the best horse in a certain kind of adhesive factory: in isolation the fundamentals of most currencies are unappealing, but exchange rates are a relative game. NZ's financial system has been one of the soundest, and the economy – despite being in a protracted recession – has recently been outperforming those of NZ's key trading partners. The NZD has generally held up against most major currencies. However, the main influence has been the weak USD as safe-haven flows reverse and concerns over the long-term value of the USD have reared.

As global economic recovery takes hold we expect the NZD to lift slightly on a broad basis. We continue to expect the USD to weaken further over the next year, pushing the NZD/USD higher, with a similar story for NZD/JPY. For the other major currencies (AUD, EUR, GBP) we anticipate relatively mild appreciation, and with the exception of the NZD/GBP for these cross rates to remain at or below their respective 10-year averages.

Just as we are expecting a high NZD/USD, some expect a very weak one. That lack of consensus should be taken as a reminder of the benefits in these uncertain times of hedging any foreign exchange exposure you have.



ECONOMIC FORECASTS

ASB economic forecasts		Dec-08	Mar-09 << actual	Jun-09 forecast >>	Sep-09	Dec-09	Mar-10	Jun-10	Mar-11	Mar-12
NZ GDP real	AA%	0.2	-1.0	-2.0	-2.6	-2.5	-2.0	-1.2	1.9	3.5
private consumption	AA%	0.1	-0.7	-1.3	-1.7	-1.8	-1.2	-0.4	1.4	2.0
dwelling construction	AA%	-17.1	-22.9	-26.8	-28.2	-23.1	-16.7	-4.0	23.6	8.7
other investment	AA%	0.8	-2.9	-10.6	-14.6	-17.6	-17.8	-13.5	1.5	8.6
exports	AA%	-1.5	-3.3	-4.7	-5.3	-3.7	-3.1	-3.4	-0.6	4.9
imports	AA%	2.5	-4.2	-11.5	-15.2	-15.1	-10.8	-5.6	2.4	4.7
NZ GDP real	A%	-2.0	-2.7	-2.9	-2.7	-1.8	-0.5	0.4	3.1	3.3
NZ GDP real	Q%	-1.0	-1.0	-0.4	-0.3	-0.1	0.3			
NZ CPI	Q%	-0.5	0.3	0.6	0.9	0.3	0.3			
NZ CPI	A%	3.4	3.0	2.0	1.3	2.1	2.1	1.8	1.2	2.2
NZ house prices (QV index)	A%	-8.9	-10.0	-7.5	-5.8	-3.0	-0.1	1.3	1.8	2.3
NZ unemployment (sa%)	Qtr	4.7	5.0	5.5	5.9	6.4	6.9	7.4	7.7	7.3
NZ private sector wages (LCI)	A%	3.2	3.1	2.9	2.4	2.1	1.8	1.5	1.2	1.6
NZ current account (\$b)	Yr	-16.1	-15.2	-13.1	-11.5	-10.9	-11.2	-11.5	-11.0	-10.6
as a % of GDP	Yr	-9.0	-8.5	-7.3	-6.4	-6.1	-6.2	-6.4	-5.9	-5.4

A% = percentage change since same quarter the previous year
AA% = percentage change for year ending quarter since the previous year

FINANCIAL FORECASTS

ASB interest rate forecasts (end of quarter)	Dec-08	Mar-09	Jun-09 << actual	Sep-09 forecast >>	Dec-09	Mar-10	Jun-10	Mar-11
NZ cash rate target	5.00	3.00	2.50	2.25	2.00	2.00	2.00	4.50
NZ 90-day bank bill	5.11	3.38	2.84	2.6	2.5	2.6	2.8	5.0
NZ 3-year swap rate	4.92	4.52	4.50	4.5	4.6	5.0	5.3	6.1
NZ 10-year gov't stock	4.62	5.32	5.96	5.8	5.9	6.0	6.1	6.5
ASB foreign exchange forecasts (end of quarter)	Dec-08	Mar-09	Jun-09 << actual	Sep-09 forecast >>	Dec-09	Mar-10	Jun-10	Mar-11
USD per NZD	0.578	0.568	0.652	0.65	0.70	0.73	0.75	0.73
GBP per NZD	0.401	0.399	0.394	0.40	0.41	0.42	0.42	0.41
AUD per NZD	0.835	0.823	0.806	0.81	0.83	0.84	0.84	0.82
JPY per NZD	52.2	55.7	62.7	63	74	82	86	84
EUR per NZD	0.411	0.429	0.463	0.46	0.49	0.50	0.51	0.50
TWI	56.3	57.0	61.4	61.2	66.2	68.9	70.5	68.6

<http://reports.asb.co.nz/index.html>

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