

Economic Weekly

16 April 2018

The Mystery of the Missing Inflation

Solving mysteries was much easier in the heydays of the Hardy Boys and Nancy Drew: around 200 pages and all was clear. In contrast, the ongoing riddle of low inflation in NZ continues to puzzle despite many a page devoted to discussing it. With this Thursday's inflation print we expect annual inflation to drop back to 1% – see Page 2 for further details. Other key local events for the week are the GlobalDairyTrade auction (early Wednesday morning) and REINZ housing market data. The global scene remains in focus, with trade tensions and geopolitical tensions elevated. Offshore events include the Q1 print for Chinese GDP, the RBA Minutes, speeches by various Fed members, the US Federal Reserve 'Beige Book', various 2nd-tier US data and Australian employment data.

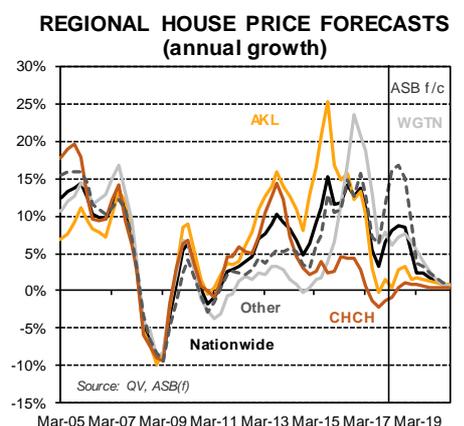
Key events and views

Key Insights	Inflation missing in action
Foreign exchange	The NZD traded in tight ranges over the last week amid historically-low volatility.
Interest rates	Risks for local rates are broadly balanced, with the risk of curve flattening.
Domestic events	GlobalDairyTrade auction and CPI are key this week.
International events	Q1 China GDP, UK CPI, China GDP, Australian employment data and US retail sales.
Calendars	NZ and International calendar of upcoming economic events.

Chart of the Week: Regional house prices

The heat has clearly been out of the Auckland and Christchurch housing market for a while, though the election-related slowdown in sales activity has faded. Meanwhile, Wellington price growth may have slowed but is still near 10% per annum. **What hasn't got much attention, though, is the pace of growth in NZ outside of the 3 main centres.** Dunedin and broader Otago prices are also not far off 10% growth, according to the March Quotable Value price measures. What is astonishing is the pace of annual price growth in some parts of NZ: 24% in Opotiki, 26% in Central Hawkes Bay, 24% in South Wairarapa, and 16% in the MacKenzie District according to the March QV data.

Although we do expect annual nationwide house price inflation to slow, there is a lot of divergence in regional housing markets at present. Sustained booms in parts of the country can and do spill over to other parts, through factors such as people reassessing the lifestyle benefits available outside the main centres or property investors seeking higher yields. Tomorrow's REINZ housing data will give another update on how the housing market is settling after the recent change in Government and easing of the RBNZ's lending restrictions.



Key Insights this week: Government giveth and taketh in Q1

We expect the CPI to have lifted 0.4%* qoq in Q1, with annual inflation subdued 1%. Our forecast is weaker than the RBNZ's inflation forecast published in the February MPS of +0.6% qoq, 1.1% yoy. Despite still-strong housing-related inflation and a 10% lift in the tobacco excise tax, underlying inflation pressures are expected to remain weak. Further weighing on inflation in Q1 is the introduction of one year's free tertiary education. With the annual CPI likely to fall back to the bottom of the inflation band, the RBNZ will be feeling little rush to change policy settings. However, we do expect inflation pressures to increasingly build over the coming years and for the RBNZ to respond by lifting the OCR in August 2019.

Tobacco, rent and construction costs up

Breaking our forecast down, the key drivers of inflation pressures over Q1 are expected to come from higher tobacco prices, higher rent costs and a further lift in housing construction costs. Higher tobacco costs reflect another round of the Government's 4-year

annual 10% excise tax which was announced in the 2016 budget. Rent costs are also expected to have lifted in Q1. Rent costs tend to have a seasonal peak in Q1 (in line with the start of the school and university year). However, this year rent costs appeared to be particularly high in centres like Wellington as a shortage of rental properties impacted prices. Construction costs are also expected to continue to lift as capacity constraints in the construction sector continue to push prices higher. Construction costs in the CPI (which represent the cost of building a new home excluding the land) are currently running at over 5% per annum, far higher than Q4's 1.6% headline CPI.

But overall pressures still soft

This discrepancy between annual construction costs and the headline CPI highlights that although some prices are running away others remain flat or are even falling. For example, annual communication costs have been largely falling since 2007 and audio-visual equipment prices have been falling since 2000. Even international travel is getting increasingly inexpensive with annual international travel costs falling since March 2015.

Education, international flights and communication key drags

More specifically, in Q1 we are expecting education costs, communication costs and the cost of international flights to be the key drags on inflation. The fall in education costs reflects the first step in Labour-NZ First's free tertiary education policy, with the first year of study becoming free this year. The Labour-NZ First coalition is expected to make the second year free in 2021 and the third in 2024. Falling communication costs continue to reflect the impact of technological improvements and increased competition. On the other hand, seasonal weakness is behind the forecast fall in international airfares over the quarter.

Inflation outlook slowly lifting

There will be a lot of noise impacting Q1's result. For example, while the Government's tobacco tax will boost inflationary pressures, on the other hand the changes to tertiary education costs in 2018 will be a drag on inflation. **Putting these one-off movements to the side, the picture is likely to be one of still-subdued core inflation pressures.** As a result, we think the RBNZ will tread cautiously and wait for sustained evidence of rising core inflation pressures before raising the OCR. **Looking forward, we expect that higher wages and an improving domestic outlook will support inflation, and that the RBNZ will lift the OCR once it sees evidence of these factors lifting core inflation.** However, we believe it will take some time yet for these pressures to show up convincingly in the CPI and, as a result, do not expect the RBNZ to lift the OCR until August 2019.

CPI breakdown Q%	Sep-17	Dec-17	Mar-18
Food	1.1	-1.7	0.5
Alcohol & tobacco	0.7	-0.6	4.0
Clothing & footwear	0.2	-1.2	0.6
Housing & h/h utilities	1.0	0.6	0.7
H/h contents & services	0.7	-1.5	0.8
Health	0.5	-0.3	0.0
Transport	-1.1	3.2	-0.7
Communication	-1.3	-1.5	-1.0
Recreation and culture	-0.1	0.8	0.2
Education	0.1	0.2	-3.0
Misc. goods & services	1.3	0.3	0.3
CPI	0.5	0.1	0.4
Tradable	0.2	-0.3	-0.1
Non-tradable	0.7	0.5	0.8
CPI Annual	1.9	1.6	1.0

*Please note that this forecast could be revised slightly as a result of the changes to the CPI expenditure weights.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.7352	0.7295	0.7242	0.7001	FLAT	0.7250	0.7450	UP
NZD/AUD	0.9464	0.9483	0.9308	0.9228	FLAT/DOWN	0.9350	0.9450	DOWN
NZD/JPY	79.05	78.06	76.67	76.21	FLAT/DOWN	77.0	81.0	UP
NZD/EUR	0.5962	0.5942	0.5883	0.6559	FLAT/DOWN	0.5850	0.6050	FLAT
NZD/GBP	0.5163	0.5176	0.5198	0.5570	FLAT/DOWN	0.5050	0.5250	UP
TWI	75.6	75.0	74.4	75.9	FLAT/DOWN	74.5	76.50	FLAT

^ Weekly support and resistance levels * Current as at 9.30am Monday; week ago as at Monday 5pm

NZD Recap

The NZD has traded in tight ranges over the last week, with volatility in the FX market remaining at historically-low levels for most NZD crosses. The USD index modestly firmed following US, French and British airstrikes in Syria in the weekend, but the NZD has remained resilient, having risen since the previous week against the USD, AUD, Yen and TWI. The strong global backdrop and calming in trade tensions between the **China and the US have been the major catalysts**. Signals from Chinese President Xi that China would back dialogue to resolve disputes and would open up its markets to international competition supported risk sentiment. **Despite the shift up in US interest rates following the firmer US CPI print and Fed Minutes**, the NZD has remained elevated against the USD, having peaked at just below 74 US cents on Thursday. The NZD/AUD touched a 9-month high of 95.3 Australian cents on Thursday, having spent the week in an elevated 0.946 to 0.953 range, with recent NZD strength consistent with relative commodity price movements.

Near-term outlook

Our expectation is that the NZD will continue to trade in tight ranges, despite a number of potential catalysts that could see more significant moves. An escalation of geopolitical tensions in the aftermath of the Syrian airstrikes would likely weigh on the NZD in favour of traditional safe-haven currencies, while a further widening in bank bill spreads would likely be NZD negative. Chinese Q1 GDP (Tue), the German ZEW survey (Tue), and Bank of Canada (Thur) policy announcement will be looked for confirmation on whether the robust and broad-based expansion remains on track, which would be NZD and AUD supportive. The next round of EU-UK Brexit trade talks are held this week (Mon-Wed), with signs of progress GBP supportive. **The historically high NZ goods Terms of Trade are another key NZD support**, with dairy prices expected to hold around current levels at this week's GlobalDairyTrade auction. Current positioning is currently in favour of the NZD. A softer than expected Q1 NZ CPI (ASB expects +0.4% qoq versus the 0.5% qoq market consensus and the 0.6% qoq RBNZ) print could trigger some NZD weakness.

Medium-term outlook

Our medium-term bias remains for a weaker USD, reflecting the stronger environment for global growth and narrowing USD interest rate differentials as other central banks contemplate policy tightening ahead of the Fed. **The NZD TWI is expected to remain broadly supported** by NZ's solid economic outlook, strong NZ commodity export prices, historically-high Terms of Trade and strong demand as global central banks/other real money managers continue to increase NZD exposures.

ASB foreign exchange forecasts

(end of quarter)

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
	<< actual		forecast >>					
NZD/USD	0.71	0.72	0.73	0.74	0.75	0.76	0.79	0.75
NZD/AUD	0.91	0.94	0.90	0.90	0.90	0.90	0.90	0.89
NZD/JPY	80	77	78	78	79	79	79	81
NZD/EUR	0.59	0.59	0.59	0.59	0.59	0.60	0.60	0.59
NZD/GBP	0.53	0.51	0.53	0.53	0.53	0.53	0.54	0.54
NZD TWI	74.3	74.3	74.7	75.0	75.1	75.7	76.6	74.0

Interest Rate Market

<u>Wholesale interest rates</u>	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.75	1.75	1.75	1.75	FLAT	UP
90-day bank bill	2.03	1.97	1.93	1.96	FLAT/UP	UP
2-year swap	2.32	2.25	2.26	2.27	FLAT/UP	UP
5-year swap	2.75	2.69	2.72	2.80	FLAT	UP
10-year swap	3.20	3.14	3.19	3.27	FLAT	UP
10-year govt bond yield	2.82	2.79	2.88	2.94	FLAT	UP
Curve Slope (2s10s swaps)	0.88	0.89	0.93	1.00	FLAT	DOWN

* Current as at 9.30am Monday; week ago as at Monday 5pm

Market Recap

Local swap interest rates start the week 5-9bps higher in yield than a week ago, with firmer increases in shorter-term rates contributing to the flatter curve. The week has also seen a modest widening in NZD bank Bill-OIS spreads, which are currently 28bps for the 3-month tenor (see our recent [note](#)). US swap yields were 6-7bps higher than a week ago, with 10-year Treasury yields up 5bps to 2.83%. Signals from Chinese President last week that China would back dialogue to resolve disputes and would open up its markets to international completion provided a significant boost to risk sentiment. The Fed Minutes were more explicit than most had expected, with the possibility of four rather than three hikes for 2018 and the likelihood of policy settings potentially reaching levels that were “a neutral or restraining factor for economic activity”. Two-year US Treasury yields briefly touched their highest level since 2008.

Near-term NZD interest rate outlook

A key focus for NZD short-term, will be whether the widening in Bank-bill OIS spreads has further to run. Given the moves towards the end of the week, and wider outright spreads for AUD and USD markets, risks to NZD rates are tilted to the upside. However, there is the **potential for a modest rally in local markets** on a softer-than-expected Q1 CPI print (ASB +0.4% qoq versus the 0.5% qoq market consensus). Last week’s speech by RBNZ Assistant Governor McDermott (see our note [here](#)) suggested that the new Policy Targets Agreement will continue to provide the Bank with considerable flexibility, and we do not see any OCR moves till late 2019, slightly later than implied by current market pricing. **Local rates for longer maturities will largely take direction from what is happening offshore.** An escalation in geopolitical tensions could see some retracement in yields, although a number of speeches by Fed members should reiterate that the US economy is robust and interest rates remain on track to move up. Chinese Q1 GDP (Tue), the German ZEW survey (Tue), and Bank of Canada (Thur) policy announcement should likely support the eventual firming in NZD yields, with Australian labour market data likely a cause for some volatility.

Medium-term outlook

Our core macro view is that the RBNZ will start lifting the OCR in Q3 of 2019. We expect a moderate pace of tightening by historical standards, and a low OCR endpoint of around 3.5% this cycle. We now expect a total of five Fed hikes until the end of 2019 (two more in 2018, two in 2019). This should see local wholesale interest rate yields continue to outperform US comparators. **Our expectation of a flatter NZD curve crucially depends on the assumption that local yields remain reasonably well anchored to global counterparts and that the lift in global yields is modest.**

ASB interest rate forecasts

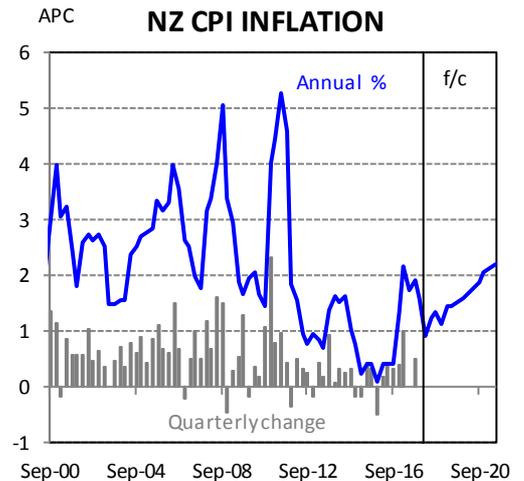
(end of quarter)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	1.88	2.0	2.0	2.0	2.0	2.0	2.5	3.0
NZ 2-year swap rate	2.21	2.2	2.2	2.3	2.4	2.5	3.0	3.5
NZ 10-year Bond	2.75	2.7	3.2	3.3	3.3	3.4	3.5	3.5

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
GlobalDairyTrade Auction, whole milk powder, %	17/4	Overnight	1.6	-	No change
REINZ house sales, March, %mom, s.a.	17/4	9.00 am	+3.1	-	-
CPI, Q1, %qoq	19/4	10.45 am	+0.1	+0.5	+0.4

We expect prices to be flat at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago whole milk powder (WMP) prices lifted 1.6%. At the current juncture, futures pricing suggests WMP prices will fall by up to 1%. Stepping back however, global dairy markets are largely balanced. As a result, we expect WMP prices to continue trading water over coming auctions.

Our preliminary forecast suggests the Q1 CPI lifted a muted 0.4% qoq, with annual inflation dropping to +1.0% yoy, the lowest annual inflation rate since September 2016. A key drag on inflation pressures this quarter is the change in tertiary education policy, with students receiving one year of free education under the Labour-NZ First coalition. Outside of this, housing costs are likely to remain the key driver of inflation with gains expected in both rental costs and construction costs.



Major International Events for the week ahead

Data	Date	Time (NZT)	Market	ASB
US Retail Sales, ex-auto, fuel, March, %mom	17/04	12:30 am	0.4	0.3
Reserve Bank of Australia April Minutes	17/04	1:30 pm	-	-
China GDP, Q1, %yoy	17/04	2:00 pm	6.8	6.8
UK ILO Unemployment Rate, February, %	17/04	8:30 pm	4.3	4.3
UK CPI, March, %yoy	18/04	8:30 pm	2.7	2.7
Australia Unemployment Rate, March, %	19/04	1:30 pm	5.5	5.5
UK Retail Sales, ex auto, fuel, March, %mom	19/04	8:30 pm	-0.4	-
Eurozone Current Account, February, €bn	19/04	8:00 pm	-	30
Japan CPI, March, %yoy	20/04	11:30 am	1.1	1.2

The **Reserve Bank of Australia's outlook for the Australian economy** has been well telegraphed and we are unlikely to gain any new major insights in the April Minutes. The Governor did, however, make a comment in his April Statement around some tightening of financial conditions in US dollar short-term money markets that have flowed through to Australia. This could potentially influence the outlook for domestic monetary policy, if it were to persist.

China's Q1 GDP growth is likely to be steady in light of solid Jan-Feb data. Retail sales are expected to grow steadily as well. Industrial production growth has likely eased in March while fixed asset investment growth is expected to slow due to deleveraging.

Australian employment rose by 17.5k in February and the unemployment rate inched higher to 5.6% on a rise in the participation rate. We expect to see jobs growth of 25k over March along with a small easing in the participation rate. This would push the unemployment rate down to 5.5%.

Already-released March CPI data for Tokyo suggest **Japan's headline inflation rate** would have likely decelerated to 1.2%pa over the month. Core inflation is still well short of the Bank of Japan's 2%pa target.

Favourable employment conditions and elevated consumer confidence point to a modest increase in **US March retail sales** data (which feeds into the GDP calculation).

We anticipate February **UK ILO unemployment** data will show an unchanged rate of 4.3%. We anticipate UK average weekly earnings will print around 2.8%.

We anticipate the **March UK CPI** will print at around 2.7% yoy.

March UK retail sales data will likely be affected by inclement weather-related effects. Consequently, headline data are likely to disappoint.

We anticipate the **February Eurozone current account** will print at around €30bn. Over February, data tend to slip slightly compared to January, reflecting seasonal factors.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast	
							Market	ASB
Mon 16 Apr	20:10	JN	BOJ Amamiya speaks at IMF, FSA and BOJ's FinTech conference					
Tue 17 Apr	09:00	NZ	REINZ house sales	Mar	y%ch	1.2	~	~
	11:30	AU	ANZ Roy Morgan Weekly	Apr	Index	115.1	~	~
	13:30	AU	RBA April Meeting Minutes					
	14:00	CH	GDP	Q1	q%ch	1.6	1.5	~
	16:30	JN	Industrial production	Feb F	m%ch	4.1	~	~
Wed 18 Apr	11:50	JN	Trade balance	Mar	¥bn	2.6	~	~
	12:30	AU	WBC leading index	Mar	m%ch	0.9	~	~
	13:00	AU	Skilled vacancies	Mar	m%ch	0.6	~	~
Thu 19 Apr	10:45	NZ	CPI	Q1	q%ch	0.1	0.5	0.4
	13:30	AU	Unemployment rate	Mar	%	5.6	~	5.5
	13:30	AU	NAB business confidence	Q1	~	6.0	~	~
Fri 20 Apr	11:30	JN	National CPI	Mar	y%ch	1.5	~	~

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast	
							Market	ASB
Mon 16 Apr	07:30	EC	Bloomberg April Eurozone Economic Survey					
	13:30	US	Retail sales ex auto	Mar	m%ch	0.2	0.2	~
	15:00	US	NAHB housing market index	Apr	Index	70.0	70.0	~
	18:15	US	Fed's Bostic speaks on the Economy and Rural Market Trends					
Tue 17 Apr	08:30	UK	Bloomberg April United Kingdom Economic Survey					
	09:30	UK	ILO unemployment rate 3 mth	Feb	%	4.3	~	~
	10:00	EC	ZEW survey expectations	Apr	Index	13.4	~	~
	14:15	US	Fed's Williams speaks on Economic Outlook at Event in Madrid					
	14:15	US	Industrial production	Mar	m%ch	0.9	0.3	~
	18:10	US	Fed's Evans discusses Economic Outlook					
	22:40	US	Fed's Bostic to speak on Economy at Bloomberg Event in Atlanta					
Wed 18 Apr	09:30	UK	CPI	Mar	m%ch	0.4	~	~
	09:30	UK	House price index	Feb	y%ch	4.9	~	~
	10:00	EC	CPI	Mar	m%ch	0.2	~	~
	15:00	CA	Bank of Canada rate decision	Apr	%	1.25	1.25	~
	19:00	US	U.S. Federal Reserve releases Beige Book					
Thu 19 Apr	09:00	EC	Current account	Feb	€bn	12.8	~	~
	09:30	UK	Retail sales ex auto fuel	Mar	m%ch	0.6	~	~
	13:30	US	Philadelphia Fed business	Apr	~	22.3	21.8	~
	23:45	US	Fed's Mester speaks on Economic Outlook and Policy					
Fri 20 Apr	14:40	US	Fed's Evans speaks on the Economy and Monetary Policy					
	15:00	EC	Consumer confidence	Apr A	~	0.1	~	~

Key Forecasts

ASB NZ economic forecasts

	Dec-17 << actual	Mar-18 forecast >>	Jun-18 forecast >>	Sep-18 forecast >>	Dec-18 forecast >>	Mar-19 forecast >>	Mar-20 forecast >>	Mar-21 forecast >>
GDP real - Q%	0.6	0.4	0.7	0.8	0.9			
GDP real - A%	2.9	2.6	2.4	2.6	2.8	3.3	3.4	3.0
GDP real - AA%	2.9	2.8	2.6	2.6	2.6	2.8	3.4	3.2
CPI - Q%	0.1	0.4	0.4	0.6	-0.1			
CPI - A%	1.6	1.0	1.4	1.5	1.3	1.5	1.7	2.1
HLFS employment growth - Q%	0.5	0.5	0.5	0.5	0.6			
HLFS employment growth - A%	3.7	3.2	3.7	2.0	2.1	2.1	1.8	1.5
Unemployment rate - %sa	4.5	4.4	4.4	4.4	4.3	4.2	4.0	3.9
Annual current account balance as % of GDP	-2.7	-2.4	-2.4	-2.4	-2.4	-2.3	-2.3	-2.4

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

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

ASB interest rate forecasts

	Dec-17 << actual	Mar-18 forecast >>	Jun-18 forecast >>	Sep-18 forecast >>	Dec-18 forecast >>	Mar-19 forecast >>	Mar-20 forecast >>	Mar-21 forecast >>
(end of quarter)								
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	1.88	2.0	2.0	2.0	2.0	2.0	2.5	3.0
NZ 2-year swap rate	2.21	2.2	2.2	2.3	2.4	2.5	3.0	3.5
NZ 10-year Bond	2.75	2.7	3.2	3.3	3.3	3.4	3.5	3.5

ASB foreign exchange forecasts

	Dec-17 << actual	Mar-18 forecast >>	Jun-18 forecast >>	Sep-18 forecast >>	Dec-18 forecast >>	Mar-19 forecast >>	Mar-20 forecast >>	Mar-21 forecast >>
(end of quarter)								
NZD/USD	0.71	0.72	0.73	0.74	0.75	0.76	0.79	0.75
NZD/AUD	0.91	0.94	0.90	0.90	0.90	0.90	0.90	0.89
NZD/JPY	80	77	78	78	79	79	79	81
NZD/EUR	0.59	0.59	0.59	0.59	0.59	0.60	0.60	0.59
NZD/GBP	0.53	0.51	0.53	0.53	0.53	0.53	0.54	0.54
NZD TWI	74.3	74.3	74.7	75.0	75.1	75.7	76.6	74.0

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