

Economic Weekly

19 March 2018

Watching LIBOR-OIS spreads

Last week, the sharp rise in the London Interbank Offered Rate (LIBOR) compared to the Overnight Indexed Swap (OIS) has put markets on edge (see the Chart of the Week below). Attention will remain firmly on the LIBOR this week. On top of this, attention will also be on the US Federal Reserve, the RBNZ and the BoE rate announcements this week. We also take a look at last week's slightly softer than expected Q4 GDP release on page 2.

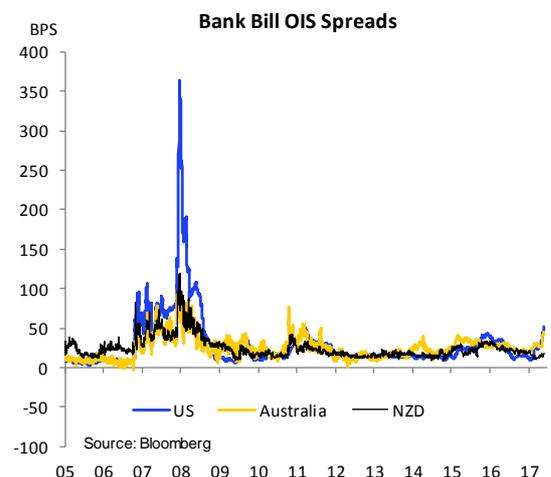
Key events and views

Key Insights	NZ Q4 GDP weaker than expected.
Foreign exchange	Events, not the tone of data, will dictate near-term NZD direction.
Interest rates	Large moves in NZ interest rate markets see the NZ yield curve flatten.
Domestic events	GDT auction, net migration and the RBNZ interest rate announcement.
International events	US Fed and Bank of England interest rate announcements, Australian employment.
Calendars	NZ and International calendar of upcoming economic events.

Chart of the Week: LIBOR-OIS spread widening

Ever since the Global Financial Crisis in 2008, LIBOR-OIS spreads have become a key measure of credit risk. To provide some background, [LIBOR](#) is the average interest rates that banks charge each other for short-term, unsecured loans and includes an element of credit risk. On the other hand, the [OIS](#) reflects a country's central bank rate over a certain period. Credit risk is not a major determinant in the OIS. In the US, the spread has averaged 26bps since 2002. However, a 41bps lift in LIBOR since 1 February has seen the spread widen to 51bps. The Australian spread has also doubled (now 44bps) relative to its long-term average. However, in NZ, the spread remains below average.

What does all of this mean? While spreads are still well below GFC levels and do not suggest we are nearing the next credit crisis, it does suggest a tightening in credit conditions. If LIBOR remains elevated, or continues to lift higher, **the impact on funding costs could be the equivalent of a rate hike.** And although New Zealand's spread has not lifted sharply like in the US or Australia, given a substantial amount of our wholesale funding happens offshore, NZ will still feel the impact of the changing offshore markets. It will be interesting to see whether the RBNZ references the increasing spread and possible consequences in Thursday's Official Cash Rate review.



Key Insights this week: 2017Q4 GDP recap

Q4 GDP lifted 0.6%, slightly weaker than ASB's forecast and market median expectation of 0.8%, and marginally below the RBNZ's February Monetary Policy Statement (MPS) forecast (0.7%).

Economic growth was weighed down by a 2.7% fall in agricultural activity.

Stats NZ noted that cattle and sheep farming and milk production were affected by the volatile weather, with wet conditions in spring followed by drought conditions in early summer. This sector performed much weaker than we had anticipated, and we were a little surprised as according to our own seasonally-adjusted data the fall in dairy production occurred over Q3. Meanwhile, the relatively large spike in meat processing due to higher slaughter rates was offset by a fall in dairy and alcoholic beverage manufacturing.

Looking through weather-related impacts, the rest of the detail in Q4 GDP was remarkably resilient, with many of the services sectors growing stronger than we had expected. Areas leading growth included wholesale trade, retail trade, business services and a bounce back in housing market activity.

Hot December stimulates household appetites

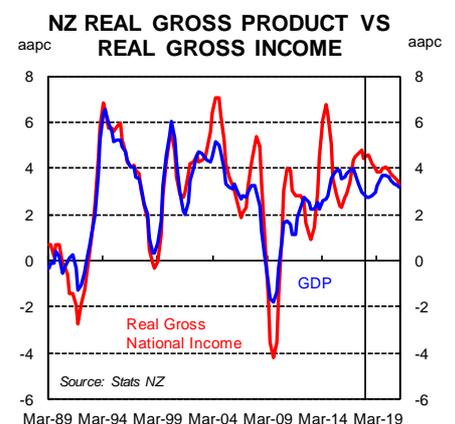
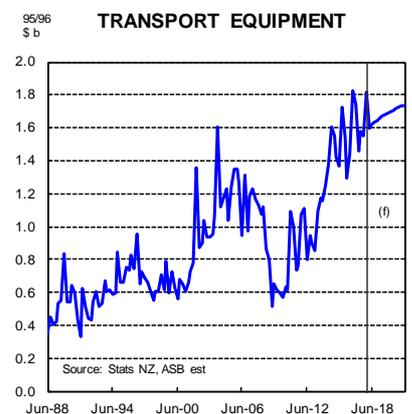
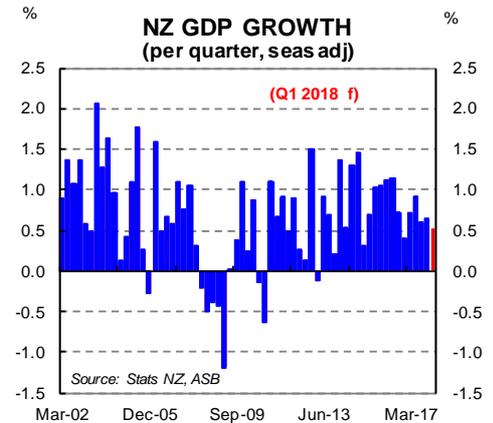
Retail spending growth was a key driver of growth, up 1.6% over the quarter led by strong food and beverage services. One area of surprise was more of the retail spending strength in Q4 was attributed to NZ households than short-term visitors (i.e. tourists), with exports of services falling. This was surprising given the higher number of short-term visitors over the December quarter, along with the lower value of the NZD, both of which tend to increase tourist demand. Nonetheless, **the hot start to summer in December did anecdotally increase beer and ice-cream demand**, which appears to have boosted household spending on non-durables. In addition, **signs of firm household demand will be an encouraging outcome for the RBNZ, suggesting that consumers weathered the election uncertainty and change in government well.**

Business activity strong heading into the end of 2017

Business services were another key area of growth in Q4. According to StatsNZ this was led by growth in computer system design services, advertising and marketing. As expected, **business investment received a boost from non-residential construction, plane imports** (there were two Dreamliners imported according to previously-released trade data) **and plant and machinery.** All of this activity suggests business activity remained steady over the second half of 2017. Indeed, investment in transport equipment has remained at very high levels since 2015, reflecting increased demand from both stronger population growth and increased tourism activity.

Temporary slowdown ahead on weaker business confidence

Looking ahead, we expect to see slightly slower growth over Q1. Business confidence has fallen and employment and investment intentions remain low. Low business confidence of late likely reflects elevated uncertainty due to the change in government. This suggests we could see some decision making delayed, which could temporarily weigh on economic activity over the first half of 2018. We expect that business confidence will gradually recover as more policy details are finalised. **The underlying fundamentals for growth remain supportive, and include low interest rates, record high Terms of Trade and increased fiscal stimulus.**



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.7217	0.7321	0.7413	0.6988	DOWN/FLAT	0.705	0.7300	UP
NZD/AUD	0.9354	0.9307	0.9313	0.9091	FLAT	0.9200	0.9400	DOWN
NZD/JPY	76.45	78.05	78.63	79.28	DOWN/FLAT	74.50	77.00	UP
NZD/EUR	0.5874	0.5940	0.5911	0.6487	DOWN/FLAT	0.5800	0.5950	UP
NZD/GBP	0.5177	0.5282	0.5249	0.5656	DOWN/FLAT	0.5100	0.5250	UP
TWI	74.5	75.0	75.6	76.0	DOWN/FLAT	73.50	75.00	UP

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

NZD Recap

The NZD ended the week slightly down on a TWI basis, with the small climb in the first half of the week being unwound by subsequent falls. Risk sentiment took a back seat given personnel changes within the Trump administration renewed trade and geopolitical tensions, and with the escalation of trade tariffs being mooted by the US, and with the diplomatic spat worsening between the UK and Russia. Larry Kudlow, President Trump's new chief economic advisor, signalled support for a strong dollar, while indicating that the Trump administration was readying a larger round of tariffs against Chinese imports. Short-term Libor (London interbank offering rate) rates in the US and Australia have jumped in recent weeks, tightening financial conditions and raising questions about whether risks might be brewing within credit markets (moves in NZD rates have been more modest). As such, safe-haven currencies tended to benefit, with the NZD steadily losing ground against the yen, USD, UK Pound and euro. The NZD rose to a 1-month high against the AUD. Local data generally had a modest impact on the NZD, notwithstanding the widespread NZD fall following the release of weaker than expected Q4 GDP.

Near-term outlook

Events, not the tone of data, will dictate near-term NZD direction. An intensification of trade tensions could push the NZD lower, with the imposed US steel tariffs due to come into effect at the end of the week. The neutral tone of the RBNZ statement and on-hold OCR decision is likely to have a fleeting impact on the NZD, but the bulk of currency volatility is likely to result from the Fed decision released an hour earlier to the RBNZ. The markets will focus on the tone of the statement (the first under new Fed Chair Powell) and how continuous it was with previous ones. Also under scrutiny will be the published forecasts. **Revisions of the published December 2017 "Dot Plots" (3 hikes in 2018 and 2 in 2019) will likely trigger more significant USD reaction.** The Bank of England policy decision (likely to lay the ground for a May hike), the March RBA meeting Minutes (Tue), a prospective US government shutdown and this week's G20 Finance Ministers meeting will also provide opportunities for NZD volatility.

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 its 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)

	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
			<< actual	forecast >>					
NZD/USD	0.73	0.72	0.71	0.72	0.73	0.74	0.75	0.76	0.79
NZD/AUD	0.95	0.92	0.91	0.90	0.90	0.90	0.90	0.90	0.90
NZD/JPY	82	81	80	79	78	78	79	79	79
NZD/EUR	0.64	0.61	0.59	0.60	0.59	0.59	0.59	0.60	0.60
NZD/GBP	0.56	0.54	0.53	0.53	0.53	0.53	0.53	0.53	0.54
NZD TWI	78.4	76.4	74.3	74.6	74.7	75.0	75.1	75.7	76.6

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	1.93	1.90	1.91	1.96	FLAT	UP
2-year swap	2.26	2.23	2.17	2.30	FLAT	UP
5-year swap	2.71	2.76	2.73	2.99	FLAT	UP
10-year swap	3.19	3.27	3.29	3.56	FLAT/UP	UP
10-year govt bond yield	2.83	3.00	2.98	3.27	FLAT/UP	UP
Curve Slope (2s10s swaps)	0.93	1.04	1.12	1.25	FLAT/DOWN	FLAT

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

Market Recap

The NZ interest rate curve flattened sharply over the week, as short-term interest rates lifted and longer-term rates fell. The moves at both ends of the curve were relatively large. The fall in longer-term rates partly follows the drop in US rates over the week, but also reflects **strong demand for NZ Government bonds**. Last week's \$2 billion new bond issue (maturing April 2029) was very well received, seeing strong demand.

Meanwhile, **short-term rates were influenced by a sudden lift in the spread between 90-day bank bills and the 90-day forward pricing of the overnight cash rate (the 90-day Overnight Indexed Swap)**. These lifts have been led by **developments in US markets**, but also influenced in part by **technical developments in Australia** short-term money markets. In the US, a short-term mismatch of supply and demand in short-term money markets is presumed to be behind the current squeeze in credit conditions. US credit supply has been stronger than usual in recent weeks, as the US Treasury had to hold off on issuance earlier in the year until the debt ceiling was raised. The US Treasury is now making up for lost time. At the same time, demand for holding US Treasuries is waning, with the Fed's program to reduce its balance sheet and the market bracing for further Fed rate hikes this year. Also, recent US tax changes may be reducing holdings of short-term offshore US denominated assets, as US corporates look to repatriate earnings.

Near-term NZD interest rate outlook

The RBNZ is widely expected to leave the OCR unchanged at 1.75% and issue a short statement very similar in tone to February's Monetary Policy Statement. **The RBNZ's OCR review will be overshadowed** by the upcoming change in Governor and Policy Targets Agreement (see our full preview [here](#)), but also by the **Fed announcement at 8am prior**. **The Fed is widely expected to hike the Fed Funds rates by 25 basis points**. We also expect the Fed to revise its GDP growth forecasts higher, and we see some risk the Fed's median Fed Funds projection is upgraded to include four hikes this year, from three. **The Fed announcement is a key event this week and we expect NZ rate markets will remain largely in a holding pattern ahead of Thursday, although some retracement of last week's large moves is possible.**

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 till the end of 2019 (three 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)	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
			<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.25
NZ 90-day bank bill	1.96	1.96	1.88	1.9	1.9	1.9	2.0	2.0	2.5
NZ 2-year swap rate	2.33	2.21	2.21	2.2	2.2	2.3	2.4	2.5	3.0
NZ 10-year Bond	2.97	2.96	2.75	3.0	3.2	3.3	3.3	3.4	3.5

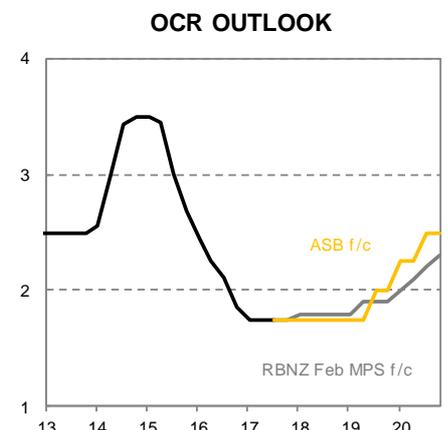
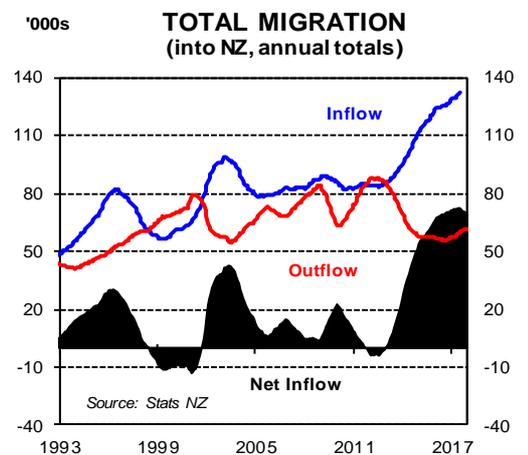
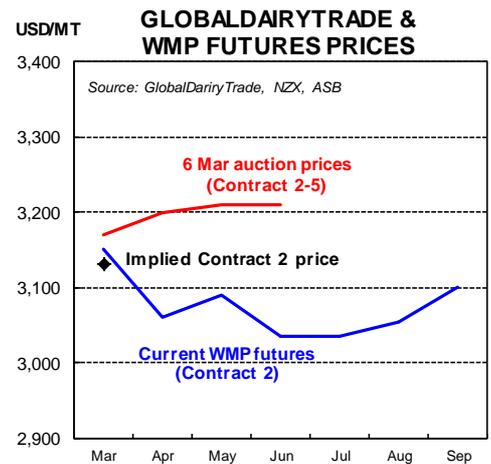
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
GlobalDairyTrade Auction, whole milk powder, % change	20/03	Overnight	-0.8	-	-1 to -3
Net Migration, Feb, people	21/03	10.45 am	6,210	-	6,000
RBNZ Interest Rate Announcement	22/03	9:00am	1.75	1.75	1.75

We expect prices to drift lower at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago whole milk powder (WMP) prices fell by 0.8%. At the current juncture, futures pricing suggests WMP prices will fall by over 2%. Better NZ weather recently (i.e. rain) has helped improve NZ's production outlook. Reflecting the improvement, Fonterra has lifted its WMP auction offer volumes for the remainder of the season. Indeed, we think the 17% WMP price lift since the end of 2017 is overdone and will unwind further overnight.

We expect a monthly permanent and long-term (PLT) net inflow of about 6,000 persons in February, with annual net PLT inflows strengthening marginally to 70,300 persons. Recent outturns have shown signs of net immigration regathering momentum, led by a strengthening in permanent and long-term arrivals. PLT departures, by contrast, have remained low at around 5,200 persons per month. We still expect net PLT inflows to moderate as PLT departures pick up, but risks are tilted towards the tailing off in net immigration being later and less pronounced than what we had previously expected. Annual visitor arrival numbers are expected to either print or remain very close to record highs. We will be closely watching Chinese visitor numbers for signs of a rebound.

We expect the RBNZ will leave the OCR unchanged at 1.75% at the upcoming OCR Review. The economic outlook has not changed materially from 6 weeks ago when the RBNZ released its February Monetary Policy Statement. **We do not expect any change in the RBNZ's assessment of risks** (numerous, but broadly balanced) and guidance on monetary policy (accommodative for a considerable period). **This OCR Review is likely to be overshadowed by market perceptions around the incoming Governor Adrian Orr,** and details of the new Policy Targets agreement once it's released (possibly late this week). **We continue to expect the RBNZ will not hike the OCR until the second half of 2019.** Furthermore, we believe the risk of an OCR cut has lifted in recent months given the unexpectedly low Q1 inflation outcome and near-term downside risks to inflation.



Major International Events for the week ahead

Data	Date	Time (NZT)	Market	ASB
Reserve Bank of Australia Board Minutes	20/03	1:30 pm	-	-
Australia CoreLogic House Price Index, Q4, %chg	20/03	1:30 pm	0.0	0.0
UK CPI, February, %yoy	20/03	10:30 pm	2.8	2.9
UK ILO Unemployment Rate, January, %yoy	21/03	10:30 pm	4.4	4.4
Australia Unemployment Rate, February, %	22/03	1:30 pm	5.5	5.5
US Federal Reserve Interest Rate Announcement, %	22/03	7:00 am	1.50-1.75	1.50-1.75
Eurozone Composite PMI, March, Points	22/03	10:00 pm	56.8	57.0
Japan CPI, February, %yoy	23/03	12:30 pm	1.5	1.6
Bank of England Interest Rate Announcement, %	23/03	1:00 am	0.5	0.5

The **Reserve Bank of Australia's** March Policy Statement accompanying the interest rate decision contained a surprise. Specifically, rather than Governor Lowe reiterating that the Bank expects growth to be, "a bit over 3% over the next couple of years" he stated that, "the Bank's central forecast is for the Australian economy to grow faster in 2018 than it did in 2017. Considering that growth in 2017 was 2.3% this looks like the RBA may be feeling less comfortable with its forecasts for growth to be around 3%. The **Board Minutes** are an opportunity for the RBA to provide more clarity on this.

The monthly **Australian CoreLogic data** point to a flat outcome for national dwelling prices over Q4 2017.

Australian employment rose by 16.0k in January following a 33.5k lift in December. And the unemployment rate moved a touch lower thanks to a fall in the participation rate. Leading indicators are consistent with robust employment growth over coming months. As such, we have pencilled in 20k lift in jobs over the month for the unemployment rate to hold at 5.5%. Sample rotation means that the odds are skewed towards the participation rate nudging up a touch.

Already-released data for Tokyo suggest a small acceleration in **Japanese inflation** pressures. However, core inflation remains well below the Bank of Japan's target of 2%pa.

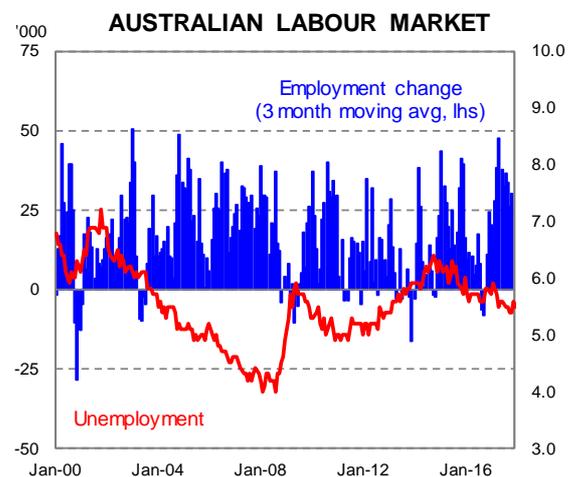
We anticipate the February **UK CPI** will print around 2.9%. UK CPI will print at levels around 3% until the second half of the year, when base effects will lead to CPI declines.

We anticipate January **UK ILO unemployment** will print around 4.4%. Average weekly earnings growth will print around 2.5%.

At his second meeting as the **US Federal Reserve** chair, Jerome Powell will – for the first time – increase the funds rate and attend the post-meeting press conference to explain the Fed's **policy decision and forecasts**. The Federal Reserve may increase its GDP forecasts for 2019 and 2020 modestly to reflect increased government infrastructure spending. We see a risk the Fed changes its Funds rate projection for 2018 to include four instead of three hikes, but retain two hikes in 2019.

We anticipate the March composite **Eurozone PMI** will print at levels around 57.0pts, indicating solid demand.

The **Bank of England** will likely leave interest rates and asset purchases unchanged at 0.5% and £435bn respectively.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast	
							Market	ASB
Mon 19 Mar	12:50	JN	BOJ summary of opinions					
	12:50	JN	Trade balance adjusted	Feb	¥bn	373.3	~	~
	14:30	CH	China February property prices					
Tue 20 Mar	11:30	AU	ANZ Roy Morgan Conf index	Mar	Index	116.0	~	~
	13:30	AU	House price index	Q4	q%ch	-0.2	~	0.0
	13:30	AU	RBA March Meeting Minutes					
	17:15	AU	RBA's Bullock takes part in Panel in Sydney					
	18:00	JN	Coincident index	Jan F	Index	114.0	~	~
	19:00	JN	Machine tool orders	Feb F	y%ch	39.5	~	~
Wed 21 Mar	10:45	NZ	Net migration	Feb	~	6,210	~	6,000
	12:30	AU	WBC leading index	Feb	m%ch	-0.2	~	~
	15:00	NZ	Credit card spending	Feb	m%ch	-0.6	~	~
Thu 22 Mar	09:00	NZ	RBNZ official cash rate	Mar	%	1.75	1.75	1.75
	13:30	AU	Unemployment rate	Feb	%	5.5	~	5.5
	13:30	JN	Nikkei Japan PMI	Mar P	Index	54.1	~	~
	15:00	CH	Bloomberg Feb. China Economic Survey					
	17:30	JN	All industry activity index	Jan	m%ch	0.5	~	~
Fri 23 Mar	12:30	JN	National CPI	Feb	y%ch	1.4	~	1.6

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast	
							Market	ASB
Mon 19 Mar	00:01	UK	Rightmove house prices	Mar	m%ch	0.8	~	~
	07:30	EC	Bloomberg February Eurozone Economic Survey					
	10:00	EC	Trade balance	Jan	€bn	23.8	~	~
	13:40	US	Fed's Bostic speaks on Community Reinvestment Act					
Tue 20 Mar	08:30	UK	Bloomberg February United					
	09:30	UK	CPI	Feb	m%ch	-0.5	~	~
	09:30	UK	House price index	Jan	y%ch	5.2	~	~
	10:00	EC	ZEW survey expectations	Mar	Index	29.3	~	~
	15:00	EC	Consumer confidence	Mar A	~	0.1	~	~
Wed 21 Mar	09:30	UK	ILO unemployment rate 3	Jan	%	4.4	~	4.4
	14:00	US	Existing home sales	Feb	\$mn	5.4	5.5	~
	18:00	US	FOMC rate (upper bound)	Mar	%	1.50	1.75	1.75
Thu 22 Mar	09:00	EC	Markit Eurozone manufacturing	Mar P	Index	58.6	~	~
	09:00	EC	ECB current account	Jan	€bn	29.9	~	~
	09:00	EC	ECB Publishes Economic Bulletin					
	12:00	UK	Bank of England Bank rate	Mar	%	0.5	~	0.5
Fri 23 Mar	12:10	US	Fed's Bostic speaks on the Economic Outlook					
	12:30	US	Durable goods orders	Feb P	%	-3.6	1.6	~
	14:00	US	New home sales	Feb	000	593.0	620.0	~

Key Forecasts

ASB NZ economic forecasts

	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
			<< actual	forecast >>					
GDP real - Q%	0.9	0.6	0.6	0.5	0.8	1.0	1.0		
GDP real - A%	2.8	2.7	2.9	2.7	2.6	3.1	3.4	3.8	3.4
GDP real - AA%	3.3	3.0	2.9	2.8	2.7	2.8	3.0	3.2	3.6
CPI - Q%	0.0	0.5	0.1	0.3	0.4	0.5	-0.1		
CPI - A%	1.7	1.9	1.6	0.9	1.3	1.3	1.1	1.5	1.7
HLFS employment growth - Q%	0.0	2.2	0.5	1.1	0.6	0.7	0.6		
HLFS employment growth - A%	3.1	4.2	3.7	3.8	4.4	2.9	3.0	2.5	1.8
Unemployment rate - %sa	4.8	4.6	4.5	4.3	4.3	4.0	4.0	3.9	3.9
Annual current account balance as % of GDP	-2.6	-2.5	-2.7	-2.3	-2.3	-2.3	-2.2	-2.1	-2.1

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

	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
(end of quarter)			<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.25
NZ 90-day bank bill	1.96	1.96	1.88	1.9	1.9	1.9	2.0	2.0	2.5
NZ 2-year swap rate	2.33	2.21	2.21	2.2	2.2	2.3	2.4	2.5	3.0
NZ 10-year Bond	2.97	2.96	2.75	3.0	3.2	3.3	3.3	3.4	3.5

ASB foreign exchange forecasts

	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
(end of quarter)			<< actual	forecast >>					
NZD/USD	0.73	0.72	0.71	0.72	0.73	0.74	0.75	0.76	0.79
NZD/AUD	0.95	0.92	0.91	0.90	0.90	0.90	0.90	0.90	0.90
NZD/JPY	82	81	80	79	78	78	79	79	79
NZD/EUR	0.64	0.61	0.59	0.60	0.59	0.59	0.59	0.60	0.60
NZD/GBP	0.56	0.54	0.53	0.53	0.53	0.53	0.53	0.53	0.54
NZD TWI	78.4	76.4	74.3	74.6	74.7	75.0	75.1	75.7	76.6

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Senior Economist, Wealth
Economist
Publication & Data Manager

Nick Tuffley
Mark Smith
Jane Turner
Nathan Penny
Chris Tennent-Brown
Kim Mundy
Judith Pinto

nick.tuffley@asb.co.nz
mark.smith4@asb.co.nz
jane.turner@asb.co.nz
nathan.penny@asb.co.nz
chris.tennent-brown@asb.co.nz
kim.mundy@asb.co.nz
judith.pinto@asb.co.nz

Phone

(649) 301 5659
(649) 301 5657
(649) 301 5853
(649) 448 8778
(649) 301 5915
(649) 301 5661
(649) 301 5660

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