

# Economic Weekly

21 May 2018

## Budget spreads the butter prudently

The new Government's **Budget** came and went with few ripples, with a **focus on maintaining a sound fiscal position**. Meanwhile, the GlobalDairyTrade auction showed that **butter prices are on a charge**, bringing the prospect this Thursday morning that Fonterra nudges up its milk price forecast for the current season and starts off with a \$6.50+/kg forecast for the new season. The US Fed's meeting minutes and Chairman's speech will be the week's main highlights.

### Key events and views

<a href="#">Key Insights</a>	The Budget erred on the side of prudent fiscal settings.
<a href="#">Foreign exchange</a>	The NZD was a touch softer against the USD over the week.
<a href="#">Interest rates</a>	The grind higher in US yields filtered through to NZ.
<a href="#">Domestic events</a>	Thursday's Fonterra milk price forecasts; trade balance.
<a href="#">International events</a>	US Fed in focus with meeting minutes and Chairman's speech.
<a href="#">Calendars</a>	NZ and International calendar of upcoming economic events.

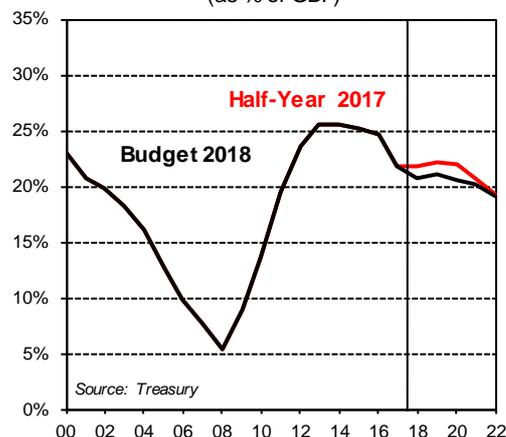
### Chart of the Week: Net government debt

Last week's **first Budget for the new Labour-NZ First Government turned out to be a fairly orthodox one**. There weren't any major policy announcements on the day, a reflection of the 100-day plan push that had already seen some of the Labour Party's big-ticket promises already allocated their cash in December's Half Year Economic and Fiscal Update.

**The big-picture fiscal figures are very prudent on the face of it.** The Government continued its commitment to bringing net debt below 20% of GDP by 2022. We anticipate the Government will still have some challenges in balancing its debt commitment: it will need to manage pressures to increase spending, and we see some risk that revenues do not grow quite as strongly as the Treasury forecasts.

**One change to the underlying forecasts was a pushing out of when KiwiBuild activity takes off**, realistic given the challenges the construction sector faces. A material lift to housebuilding will need innovations such as [these](#) to help boost building productivity.

**NET CORE CROWN DEBT**  
(as % of GDP)



## Key Insights this week: Budget 2018 Review

### Key points:

- Budget 2018 showed the Government is keeping to its self-imposed fiscal responsibility rules.
- However, we anticipate less tax revenue than Treasury and a marginally less rosy fiscal picture over the 5-year forecast period.
- All things considered though, this Budget was solid and should boost the Government’s fiscal credibility.

### Passing the first fiscal credibility test

The new Labour-NZ First Government has effectively passed its first fiscal credibility test. The Budget and the healthy forecasts showed that the Government is on target to achieve its fiscal targets. In particular, the Budget showed that net debt is on track to fall below 20% by 2021/22.

In part, the Treasury’s slightly generous economic and tax revenue forecasts (in our view) have helped the Government get there. However, we do agree with the general trends that the Budget forecasts provided and acknowledge that this Budget was a prudent one. Indeed, despite much discussion on the potential for fiscal largesse, the Budget showed restraint in the level of expenditure, particularly in the context of recent years (see chart).

### Meanwhile, there weren’t a lot of new initiatives to focus on.

Indeed, the main spending increases come in baseline increases for health, education and housing: “rebuilding critical public services” as the Government put it.

### Operating Surpluses nudge lower

The first Budget operating balance estimates under the new Government made for healthy reading. The Operating Balance Excluding Gains and Losses (OBEGAL) increases gradually from 1.1% of GDP in 2017/18 through to 2.1% of GDP in 2021/22.

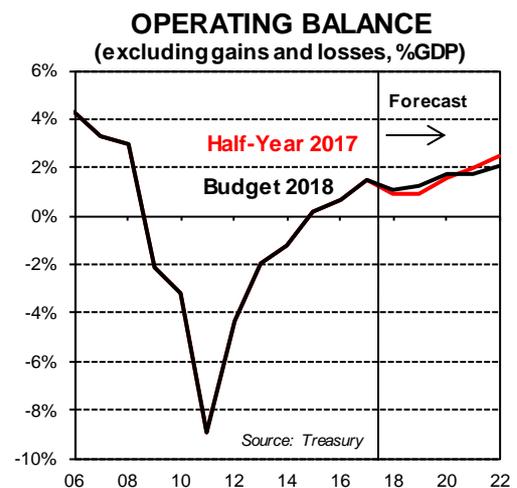
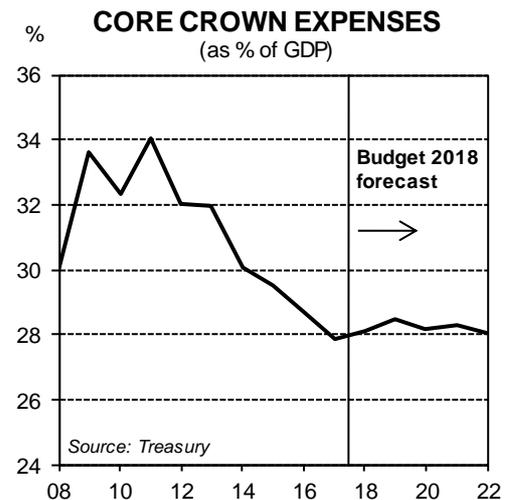
To our surprise however, the OBEGAL estimates were only a touch lower than as at the Half-Year Update. For example, the 5-year total of Budget OBEGAL was just \$400m less than the 5-year total included in the Half-Year Update. Generally though, we aren’t as bullish as the Treasury. We expect smaller operating surpluses, on the back of lower economic growth and thus less tax revenue than the Treasury expects.

The Budget also found room for extra spending. On top of additional revenue, the Government found additional room via reprioritisation. Budget 2018 operating allowances were thus increased to \$2.8bn, from \$2.6bn previously, and subsequent Budgets also got lifts of around \$500m.

### Key policy initiatives built on the 100-day plan

The five key themes in Budget 2018 built on similar themes from the 100-Day Plan. The themes are:

- Rebuilding critical public services;
- Taking action on child poverty, housing and homelessness;
- Promoting economic development and supporting the regions;
- Enhancing and protecting our natural resources;
- Enriching New Zealand’s culture and identity.



The **Rebuilding critical public services** theme accounted for the largest share (57%) by far of operating spending in Budget 2018. This was well-signalled by the Government as this theme includes the health, education and justice sectors as well as some welfare spending. Breaking this theme down further, **Health grabbed the lion's share of the spending**, with \$3.2bn in operating spending over the four years. In the Government's words: "Budget 2018 puts our district health boards back on track to deliver the quality care New Zealanders expect and deserve, when they need it". Education also accounted for a large share, with a total \$1.6bn operating spending allocated over the five years.

**Infrastructure spending was also a focus of this Budget.** The Budget forecasts include core Crown capital spending totalling \$41.8 billion. Indeed, through to 2021/22 capital allowances have increased \$300m in each Budget. Specifically allowances have been set at \$3.7 billion for Budget 2019, \$3.4 billion in Budget 2020, and \$3.0 billion from Budget 2021 onwards.

### Net Debt on track to fall below 20% of GDP by 2022

The net debt track also showed a steady decline over the forecast period (see chart on page 1). The Budget showed net core Crown debt falling from 20.8% of GDP in 2017/18 to 19.1% of GDP in 2021/22. Notably, net debt reaches 19.1% of GDP by 2012/22 as signalled by the Government.

As per the comments above, **we are less bullish than the Treasury** in this regard. We expect higher net debt over the forecast period. That said, we still expect net debt to decline over the forecast period and anticipate that the Government is still likely to get net debt below 20% of GDP by 2021/22.

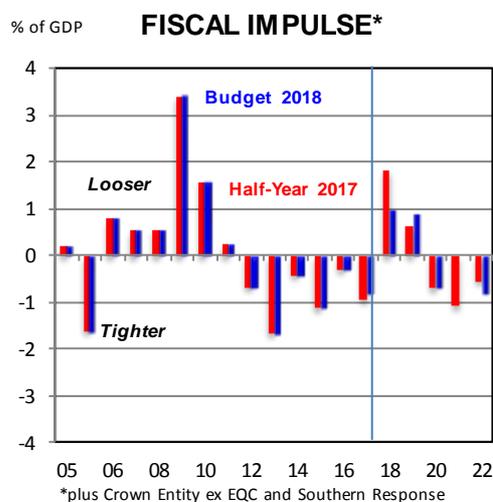
### Economic Forecasts – solid outlook

The Budget economic projections depicted a solid outlook for the NZ economy, with annual average growth (June years) in a 2.5% to 3.4% range over the projection period. The Budget listed the usual supports, including the strengthening global economy and rising export prices, the terms of trade remaining close to record levels, strong population growth, accommodative monetary policy, rising household wealth and steady growth in household incomes.

The fiscal impulse suggested that fiscal policy will be supporting growth both this fiscal year and next, before policy moves to a more neutral phase. Increased government operating and capital spending (which includes the new Families Package), was expected to contribute to a pick-up in the pace of growth over 2018/19. Thereafter, growth in total government spending was forecast to slow and tax revenue to strengthen, which helps to restrain the build-up of demand pressures in the economy.

The Treasury's growth forecasts were stronger than ours in the near term, but lower than ours for later years. Our forecasts have a stronger outlook for private consumption (and higher wage inflation outlook), but we are less upbeat than Treasury on the outlook for residential and wider investment. We view activity in the residential sector to be at its peak given capacity constraints and cost pressures, whereas the Treasury has assumed further growth.

With this in mind, it is not surprising that our nominal GDP (from the June 2020 year onwards), tax and thus OBEGAL forecasts are lower than Treasury's. The Treasury also appears to have banked more of this year's extra tax revenue over the forecast period than we have assumed. As mentioned above, **we are a touch wary of the Treasury's more bullish forecasts, although we mostly agree with the general trends.**



## Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6922	0.6960	0.7242	0.6885	FLAT	0.6800	0.7050	UP
NZD/AUD	0.9198	0.9215	0.9384	0.9275	FLAT	0.9100	0.9300	FLAT
NZD/JPY	76.77	76.13	77.95	76.70	UP	75.00	77.50	FLAT
NZD/EUR	0.5880	0.5820	0.5867	0.6196	UP	0.5700	0.6000	FLAT
NZD/GBP	0.5137	0.5132	0.5143	0.5314	UP	0.5050	0.5200	FLAT
TWI	72.9	72.6	74.4	74.72	UP	72.00	74.50	FLAT

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

### NZD Recap

The NZD TWI starts this week at a similar level to last week after earlier approaching 2018 lows midway through last week, but the NZD is lower against the USD. The NZD found some support over the weekend following the announcement by US Treasury Secretary Mnuchin that plans to impose sweeping tariffs on Chinese products would be put on hold as negotiations to reduce the US trade deficit with China continued. **USD strength remained the predominant currency theme**, with the greenback buoyed by higher US Treasury yields, and heightened geopolitical tensions. This had seen the NZD TWI trough mid-way last week at 72.2, with the NZD as low as 68.5 US cents and 91.4 Australian cents. The initial currency impact of Budget 2018 was modest (see our Budget review [here](#)). The euro weakened against the NZD as concerns over the election of a populist Italian coalition government weighed on the euro. The NZD recovered from mid-week lull to end higher against the yen, following the release of weaker than expected Japanese GDP and inflation data.

### Near-term outlook

**Improving US-China trade-related developments bode well for financial market sentiment. As such, we expect AUD and NZD to outperform against most major currencies this week. New Zealand's solid domestic backdrop and record terms of trade should be NZD supportive**, particularly with Fonterra likely to revise up its 2017/18 milk price forecast on Thursday and announce another healthy milk price forecast for the coming season. Barring further improvement in risk sentiment, USD strength is expected to remain the dominant theme in currency markets. High US yields look to be a key USD support. While US Treasury yields have eased in recent days, they remain close to multi-year highs. Thursday's Fed Minutes and the Friday speech by Fed Chair Powell look to be the pivotal events. The NZD is expected to be range bound against the AUD, with Australian Q1 construction work data and the speech by RBA Governor Lowe likely to have a fleeting currency impact.

### Medium-term outlook

We believe the recent bout of USD weakness has ended. **We expect the USD to remain supported given the slight moderation in global growth over 2018 and the fact that the US Federal Reserve is now expected to tighten rates at a faster pace than other central banks. 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	0.72	0.72	0.72	0.72	0.74	0.75
NZD/AUD	0.91	0.94	0.95	0.94	0.92	0.91	0.90	0.94
NZD/JPY	80	77	78	77	76	75	74	81
NZD/EUR	0.59	0.59	0.59	0.59	0.58	0.58	0.57	0.57
NZD/GBP	0.53	0.51	0.52	0.51	0.51	0.50	0.49	0.53
NZD TWI	74.3	74.3	74.5	74.0	73.3	72.7	72.5	74.4

## 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	2.00	2.03	2.06	1.97	FLAT	UP
2-year swap	2.22	2.19	2.31	2.23	FLAT/UP	UP
5-year swap	2.73	2.65	2.76	2.75	UP	UP
10-year swap	3.23	3.14	3.22	3.23	UP	UP
10-year govt bond yield	2.83	2.71	2.86	2.83	UP	UP
Curve Slope (2s10s swaps)	1.01	0.95	0.91	1.00	UP	DOWN

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

### Market Recap

**Local swap yields lifted last week, with the curve (2s10s) modestly steeper as the increase was more pronounced in the longer-dated swaps.** Despite the release of the NZ Budget 2018 (and a slightly higher debt issuance than expected), NZ swap rates largely took their direction from offshore moves, in particular US rates. USD 10-year swap yields surged last week, hitting a 7-year high of just over 3.12% towards the end of the week, after starting the week below 3%. US 10-year yields are now 65bps higher than they were at the start of the year. There was no specific catalyst for the sharp move in US rates outside of the continual building of US Federal Reserve rate hike expectations. Over the weekend the US and China announced that any tariffs would be put on hold for now as the two nations continue to make progress on a new trade deal. The easing in trade tensions removes one potential barrier to yields moving higher still. In Europe, the move closer to a Five Star Movement and League coalition in Italy, as well as talk of a 250bn euro debt write-off, sent the Italian 10-year yield higher last week, to now be roughly 36bps higher than this time a week ago.

### Near-term NZD interest rate outlook

There is a chance we see some more upward pressure on NZD yields this week given the easing in trade tensions (for now) and the potential for volatility following release of the US Federal Reserve meeting minutes on Thursday morning (NZT). **The previous Fed minutes had a distinct hawkish air about them and there is a chance we see US longer-dated yields creep higher again if this is repeated.** The US Treasury is also scheduled to sell \$99 billion in fixed-rate coupon issues and \$16 billion in 2-year floating-rate notes which should also support bond yields.

**We are also continuing to watch developments in bank bill to OIS spreads.** However, the NZD 3-month spreads eased last week, with the NZD 3-month bank bill rate falling back towards 2%. So far, NZD spreads have remained below (narrowing) USD and AUD spreads.

### Medium-term outlook

Our core 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 four further Fed hikes until the end of 2019 (two more in 2018, two in 2019). This should see local wholesale interest rate yields climb less than USD 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.**

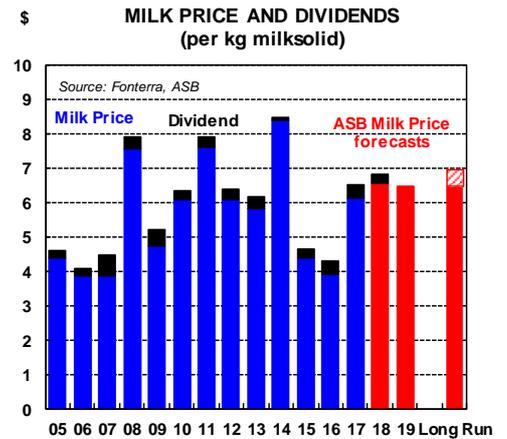
### ASB interest rate forecasts

(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	3.3	3.7
NZ 10-year Bond	2.75	2.7	2.9	2.9	3.0	3.1	3.3	3.4

## Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Fonterra opening season (2018/19) milk price forecast	24/05	8:30am +	-	-	\$6.50/kg +
Merchandise Trade balance, Apr, \$m	24/05	10:45am	-86	+198	+200

**On Thursday (from 8:30am NZT time), Fonterra is likely to open the new season (2018/19) with a healthy milk price forecast of around \$6.50/kg or above.** The global butter shortage, soft NZ production and a weakening NZD are all providing support to dairy prices in NZD terms currently. Fonterra will also give an update on its 2017/18 season forecast – **we anticipate that Fonterra may lift its current forecast of \$6.55/kg by 5 to 10 cents.** Since the previous Fonterra update on 21 March, overall dairy auction prices have lifted a touch. Moreover, the NZ dollar has slid around 3 cents against the USD over the same period, giving another reason to expect a modest upward move.



**We expect a small trade surplus in April.** Looking over the month, we expect export values to firm on the back of stronger meat export prices and volumes, while dairy export values are likely to remain flat. Meanwhile, we expect import values to remain firm as oil prices continue to lift. Looking at the annual balance, we expect the deficit to widen to \$3.8 billion.

## Major International Events for the week ahead

Data	Date	Time (NZT)	Market	ASB
Australia Construction Work Done, Q1, %qoq	23/05	1:30 pm	1.3	1.0
RBA Governor Lowe at Australia-China Relations Institute	23/05	8:00 pm	-	-
Eurozone Market Manufacturing PMI, May, Index	23/05	8:00 pm	56.0	-
UK CPI, April, %yoy	23/05	8:30 pm	2.5	2.5
RBA Asst. Governor Bullock at housing seminar in Holland	24/05	-	-	-
UK Retail Sales, April, %mom	24/05	8:30 pm	0.2	0.2

We are expecting a small increase in **Australian construction work** done over Q1. Non-residential building work should post a healthy increase while residential building work is likely to stay steady at a high level. Engineering work looks to have broadly stabilised now that the construction of the major LNG plants is almost complete.

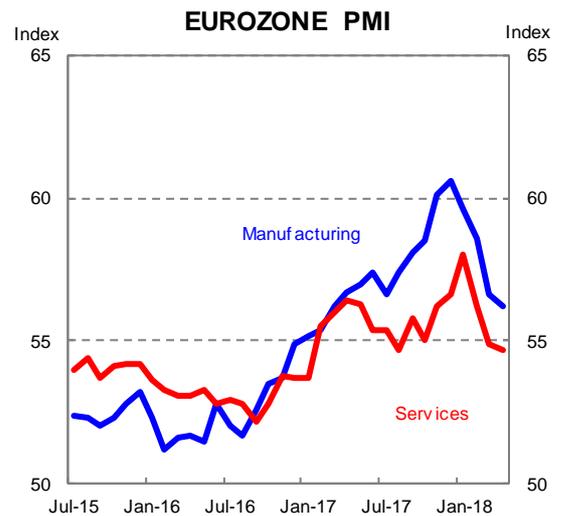
**Reserve Bank of Australia Governor Lowe** is scheduled to speak at the Australia-China Relations Institute on Wednesday this week. Lowe will talk about some of the uncertainties surrounding the outlook for China, including high debt levels.

**Reserve Bank of Australia Assistant Governor Bullock** is slated to speak at a housing market seminar in the Netherlands. She may discuss the recent and long-term trends in Australia's housing market.

The publication of preliminary **Eurozone PMI** estimates for May could surprise to the upside of expectations and therefore confirm that the soft patch in Q1 Eurozone economic data was transitory.

The recent downward move in **UK CPI** will likely have paused in April, reflecting annual tariff changes.

**UK April retail sales** may show a modest month-on-month improvement of around 0.2%, reflecting a rebound from the poor March print.



## Global Data Calendars

### Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast	
							Market	ASB
Mon 21 May	11:50	JN	Trade balance adjusted	Apr	¥bn	119.2	~	~
	15:00	NZ	Credit card spending	Apr	m%ch	1.0	~	~
Wed 23 May	13:30	AU	Construction work done	Q1	%	-19.4	~	1.0
	17:30	JN	Nationwide department sales	Apr	y%ch	0.1	~	~
	20:00	AU	RBA's Lowe gives speech in Sydney					
Thu 24 May	~	AU	RBA's Bullock gives speech in Amsterdam					
	10:45	NZ	Trade balance	Apr	NZD	-86.0	+198	200
Fri 25 May	11:30	JN	Tokyo CPI	May	y%ch	0.5	~	~
Sun 27 May	13:30	CH	Industrial profits	Apr	y%ch	3.1	~	~

### Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast	
							Market	ASB
Mon 21 May	00:01	UK	Rightmove house prices	May	m%ch	0.4	~	~
Tue 22 May	15:00	US	Richmond Fed manufacturing	May	Index	-3.0	~	~
	17:15	US	Fed's Bostic speaks to Atlanta Economics Club					
	19:05	US	Fed's Harker speaks in New York					
	22:30	US	Fed's Kashkari speaks at Moderated Q&A in Escanaba, MI					
Wed 23 May	09:00	EC	Markit Eurozone manufacturing	May P	Index	56.2	~	~
	09:30	UK	CPI	Apr	m%ch	0.1	~	~
	09:30	UK	House price index	Mar	y%ch	4.4	~	~
	14:45	US	Markit US manufacturing PMI	May P	Index	56.5	~	~
	15:00	US	New home sales	Apr	000	694.0	~	~
	15:00	EC	Consumer confidence	May A	~	0.4	~	~
	19:00	US	FOMC Meeting Minutes	May	~	~	~	~
Thu 24 May	09:15	US	Fed's Dudley speaks on Reference Rate Reform at BoE Event					
	09:30	UK	Retail sales ex auto fuel	Apr	m%ch	-0.5	~	~
	13:30	US	Initial jobless and continuing	May	~	~	~	~
	15:00	US	Existing home sales	Apr	\$mn	5.6	5.6	~
	16:00	US	Kansas City Fed manufacturing	May	~	26.0	~	~
	04:00	US	Fed's Harker speaks About Technology's Impact on Labor Market					
Fri 25 May	09:30	UK	GDP	Q1 P	q%ch	0.1	~	~
	13:30	US	Durable goods orders	Apr P	%	2.6	-1.5	~
	14:00	US	Fed's Powell Joins Riksbank's 350th Anniversary Conference					
	15:00	US	Uni. of Michigan sentiment	May F	~	98.8	98.8	~
	16:45	US	Fed's Kaplan, Evans and Bostic speak at Dallas Fed					

## Key Forecasts

### ASB NZ economic forecasts

	Dec-17 << actual	Mar-18 forecast >>	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
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	3.3	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	0.5	0.3	0.4	0.0			
CPI - A%	1.6	1.1	1.4	1.3	1.2	1.1	1.8	2.0
HLFS employment growth - Q%	0.4	0.6	0.5	0.5	0.6			
HLFS employment growth - A%	3.7	3.1	3.7	2.0	2.1	2.1	1.8	1.7
Unemployment rate - %sa	4.5	4.4	4.4	4.4	4.2	4.1	4.1	4.1
Annual current account balance as % of GDP	-2.7	-2.4	-2.4	-2.5	-2.4	-2.4	-2.6	-2.6

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	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
(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	3.3	3.7
NZ 10-year Bond	2.75	2.7	2.9	2.9	3.0	3.1	3.3	3.4

### ASB foreign exchange forecasts

	Dec-17 << actual	Mar-18 forecast >>	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
(end of quarter)								
NZD/USD	0.71	0.72	0.72	0.72	0.72	0.72	0.74	0.75
NZD/AUD	0.91	0.94	0.95	0.94	0.92	0.91	0.90	0.94
NZD/JPY	80	77	78	77	76	75	74	81
NZD/EUR	0.59	0.59	0.59	0.59	0.58	0.58	0.57	0.57
NZD/GBP	0.53	0.51	0.52	0.51	0.51	0.50	0.49	0.53
NZD TWI	74.3	74.3	74.5	74.0	73.3	72.7	72.5	74.4

#### ASB Economics & Research

Chief Economist  
Senior Economist  
Senior Economist  
Senior Rural Economist  
Senior Economist, Wealth  
Economist  
Publication & Data Manager

Nick Tuffley [nick.tuffley@asb.co.nz](mailto:nick.tuffley@asb.co.nz)  
Mark Smith [mark.smith4@asb.co.nz](mailto:mark.smith4@asb.co.nz)  
Jane Turner [jane.turner@asb.co.nz](mailto:jane.turner@asb.co.nz)  
Nathan Penny [nathan.penny@asb.co.nz](mailto:nathan.penny@asb.co.nz)  
Chris Tennent-Brown [chris.tennent-brown@asb.co.nz](mailto:chris.tennent-brown@asb.co.nz)  
Kim Mundy [kim.mundy@asb.co.nz](mailto:kim.mundy@asb.co.nz)  
Judith Pinto [judith.pinto@asb.co.nz](mailto: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

[www.asb.co.nz/economics](http://www.asb.co.nz/economics)

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