

NEW ZEALAND ECONOMICS ANZ PROPERTY FOCUS

DECEMBER 2010

INSIDE

The Month in Review.....	2
Property Gauges.....	3
Economic Backdrop.....	5
Mortgage Borrowing Strategy.....	6
Feature Article: Rural Land Prices.....	7
Key Forecasts.....	14

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LAND AHOY!

SUMMARY

Our monthly *Property Focus* publication is aimed at providing an independent appraisal of recent developments in the property market. This month we look at prospects for rural land values.

THE MONTH IN REVIEW

Housing market activity recovered somewhat in November, albeit off lows. Other indicators paint a lukewarm picture of the market in general. Abstracting from seasonal influences, we expect the market will remain subdued into early 2011.

PROPERTY GAUGES

House sales remain very low in relation to the dwelling stock, being 35 percent below historical averages. A mood of cautiousness still seems to be pervading the housing market.

ECONOMIC BACKDROP

The outlook for the economy remains subdued in the short term, with growth well below par for the coming months. Having our sovereign credit rating placed on negative outlook by Standard & Poor's was a timely reminder that the economy faces a multi-year period of deleveraging to get our national balance sheet in order. This, in effect, limits how strong the domestic economy can be, or to what extent it can drive the national economy. This will cap our trend rate of growth over a number of years. We remain more upbeat on prospects for 2011, although it will not be until the second half of the year that this manifests.

MORTGAGE BORROWING STRATEGY

Mortgage interest rates were unchanged again this month, having been steady for around three months now. We expect the Reserve Bank to keep the OCR on hold until the middle of 2011 with floating rates likely to follow suit. Recent comments from RBNZ Governor Bollard suggest he is in no hurry to raise the OCR, and this should keep short-term fixed rates stable. Breakeven analysis suggests the sweet spot for borrowers is anything up to 2 years.

FEATURE ARTICLE – RURAL LAND PRICES

In this month's special feature we look at recent trends in rural land prices. It is important for two reasons. Firstly, booming rural land prices saw significant spill-over into regional house prices, and tailwinds can turn into headwinds. Second, stabilising rural land prices are a key benchmark before rural chequebooks will be opened and the benefit of strong commodity prices will diffuse into the broader economy. Land prices remain under pressure and look set to remain so into 2011. Hence, we doubt the rural sector will suddenly start spending. Rather we suspect this will be a 2012 story as opposed to a 2011 dynamic.

THE MONTH IN REVIEW

SUMMARY

Housing market activity recovered somewhat in November, albeit off lows. Other indicators paint a lukewarm picture of the market in general. Abstracting from seasonal influences, we expect the market will remain subdued into early 2011.

STATISTICS NZ BUILDING CONSENTS - OCTOBER

The seasonally adjusted number of **new residential building consents dropped 2 percent in October**, with the level of issuance down 18 percent on a year ago. Excluding Canterbury, the number of consents rose 0.5 percent, but remains at historically low levels.

RBNZ CREDIT GROWTH - OCTOBER

The **level of mortgage lending to households was unchanged**, with the annual rate of change easing to an all-time low of 2.2 percent. The more timely annualised three month change was up 1.5 percent in October, unchanged from the preceding month but higher than the 1.2 percent growth rate recorded in August.

ANZ ROY-MORGAN CONSUMER CONFIDENCE - DECEMBER

Headline consumer confidence dipped in December. This survey also asks households their expectations of house prices. **Households expect house prices to go up by 1.5 percent per year on average over the coming two years.** At the same time households expect 3.5 percent general inflation; hence the underlying expectation is for real house prices to fall.

REINZ HOUSING DATA – NOVEMBER

Sales volumes (seasonally adjusted) rose strongly in November, up 19 percent. There was some evidence of a rebound in the Canterbury region, with sales in the Canterbury/Westland region up by 30.1 percent (s.a.). The REINZ House Price Index rose 1.3 percent in seasonally adjusted terms in November. However, **the trend in prices remains down, with prices in the 3 months to November 1.6 percent lower than in the 3 months to August.** The seasonally adjusted median days to sell ticked down to 44 days, and we estimate that the seasonally adjusted median days to sell for properties outside the Canterbury/Westland region remained at 47 days. On this metric the housing market remains weak, with the median days to sell considerably above the mid-30s range that was apparent at the end of last year.

RBNZ MONETARY POLICY STATEMENT

The latest *Monetary Policy Statement* paints a picture of **the RBNZ in no hurry at all to be lifting interest rates.** They are comfortable with the underlying inflation profile, and are confident that inflation expectations and wage demands will stay moderate. Given the weak state of the economy, this seems a reasonable assumption.

ASSESSMENT

We saw a fillip in housing market activity in November but it's hard to get overly excited about it. The level of activity is 65 percent of the average seen over the prior decade. Some support to the property market is being provided by low interest rates and a net migration inflow. But **the general spirit across most indicators remains one of sombreness with balance sheet repair the prime focal point.** It's hard to see this changing in the early part of 2011.

PROPERTY GAUGES

House sales remain very low in relation to the dwelling stock, being 35 percent below historical averages. A mood of cautiousness still seems to be pervading the housing market.

We use ten gauges to assess the state of the property market, and for signs that changes are emerging.

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (adjusted for interest rates), and mortgage payments as a proportion of income.

SERVICEABILITY / INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are both key gauges of activity in the property market.

LIQUIDITY. We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.

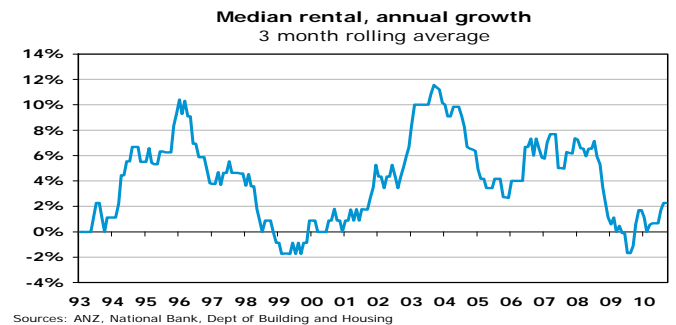
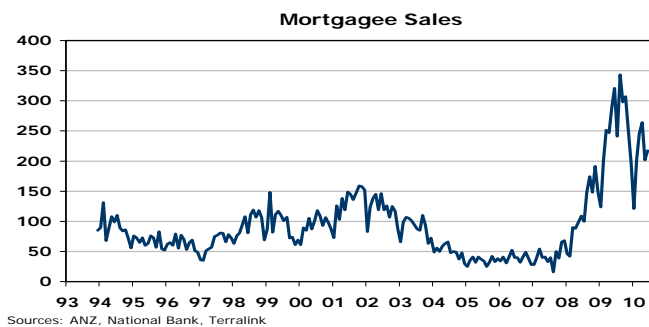
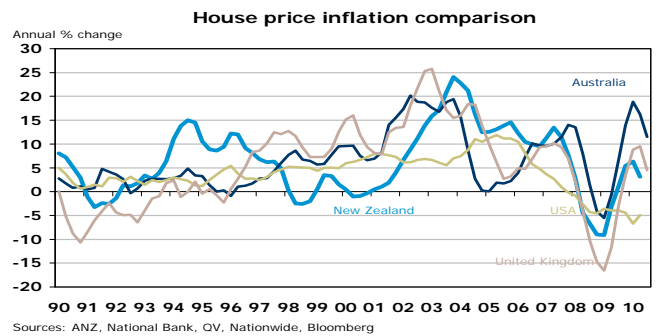
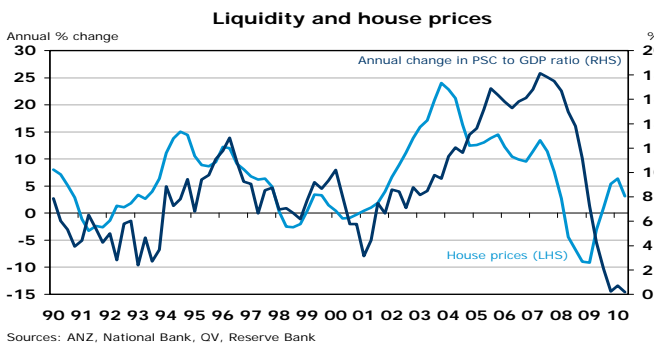
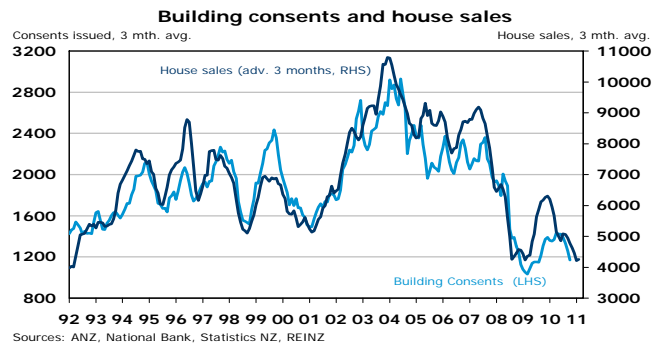
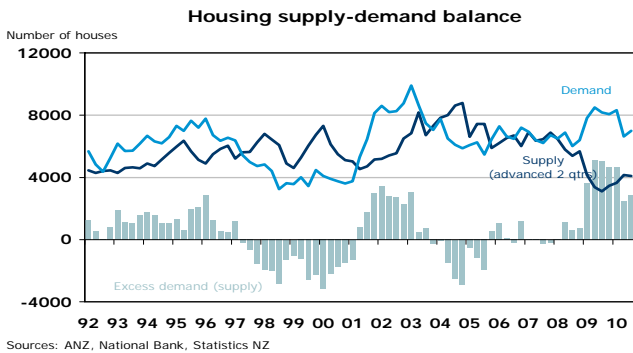
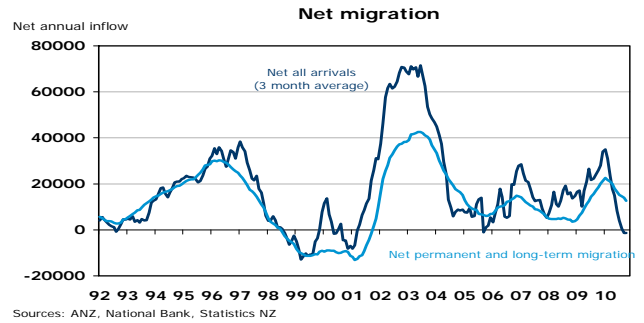
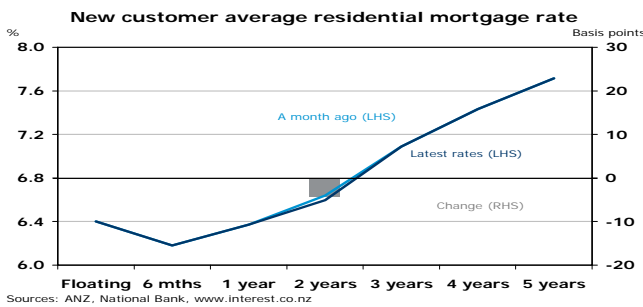
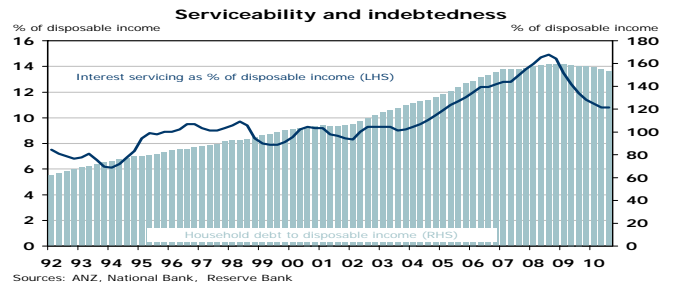
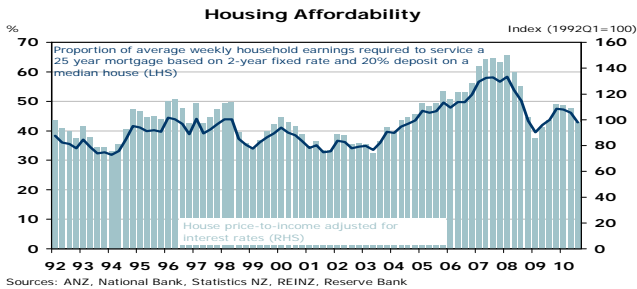
GLOBALISATION. We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

MORTGAGEE SALES. We look at how mortgagee sales are tracking for an indication of distress in the property market.

RENTAL GROWTH. We look at growth in the median market rent as an indication of whether it is a better time to buy versus rent, and how rental yields are shaping up for the property investor.

Indicator	Level	Direction for prices	Comment
Affordability	Improving	↔	Affordability is back on an improving trend.
Serviceability / indebtedness	Deleveraging	↓	Interest servicing has troughed and the de-leveraging phenomenon continues.
Interest rates	Lower	↔	The only change has been a drop for 2 year fixed mortgage rates.
Migration	Easing off	↔	There was a sharp rise in departures in October.
Supply-demand balance	Gap remains	↔/↑	The imbalance has crept wider.
Consents and house sales	Lack of action	↔/↑	House sales have rebounded.
Liquidity	Stall speed	↓	People focusing on repairing balance sheets, so credit is not driving the market.
Globalisation	Turned the corner	↔	The global momentum in house price growth has run out of puff.
Mortgagee sales	Lifting	↔	Remains elevated.
Median rent	Gaining momentum	↔	Inching up.
On balance		↔/↓	Small improvement into year end.

PROPERTY GAUGES



ECONOMIC BACKDROP

The outlook for the economy remains subdued in the short term, with growth well below par for the coming months. Having our sovereign credit rating placed on negative outlook by Standard & Poor's was a timely reminder that the economy faces a multi-year period of deleveraging to get our national balance sheet in order. This, in effect, limits how strong the domestic economy can be, or to what extent it can drive the national economy. This will cap our trend rate of growth over a number of years. We remain more upbeat on prospects for 2011, although it will not be until the second half of next year that this manifests.

OUR CORE ECONOMIC VIEW

Recent data has tended to print on the weaker side of the ledger. Current weakness in housing and retailing are two obvious examples of the transition in growth away from the spending side of the economy, with historically high commodity export prices holding the prospect of the earning side of the economy driving things forward. However, for now, deleveraging and the process of balance sheet repair is curtailing the flow-on to the general economy.

Anecdotes from our travels around the country suggest the economy is not moving with any great impetus or underlying momentum. Retailing remains tough. Housing soft. A combination of small niggly factors is also weighing down on the economy, including a lower lamb kill, PSA, and a drought in some regions. Some sectors are doing well but there is not the critical mass to drive the economy strongly forward at present. The economy appears schizophrenic where one week of positive developments, but not the following week. Activity remains patchy and skittish. Part of this skittishness reflects the deleveraging headwinds for the economy: it's difficult to spend for today and save for tomorrow (or fix balance sheets) at the same time. Beyond that, housing remains the key feel-good bellwether, and valuation metrics suggest either house prices need to fall further or remain flat for a while to come (and let the correction come via rising incomes). A mixture of the two seems to be occurring in a reasonably orderly adjustment process, though the market is very splintered. Some pockets remain well supported, but others such as various land developments are under downward pressure with no real buyers.

S&P's decision to put New Zealand on credit rating on negative outlook was a timely reminder the economy faces an elongated adjustment process, which will occur voluntarily or involuntarily (with the latter the route some eurozone nations look set to follow). So grumpy growth, and a few ups and downs, remain the spirit of our economic assessment.

A weaker economy is expected to keep the RBNZ on the sidelines until the middle of 2011. This is providing an important crutch to the economy by keeping interest rates low. While the NZD/USD exchange rate remains high courtesy of a weak USD, the NZD/AUD is low courtesy of a yield differential that favours Australia and a higher country risk premium here. This is providing tremendous support and stimulation to the export sector.

The coming few months are likely to be telling for the economy, and particularly for small-to-medium size enterprises. Demand remains fickle, and SMEs have a relatively larger exposure to housing and retailing. The Christmas period is shaping as key, and anecdotally people's wallets are neither flush nor readily open. Promotion-driven spending is putting pressure on retail margins. There is likely to be some fallout in the new year, although there is still over a week till Christmas so it may still come together.

We remain more optimistic regarding prospects for 2011. Deleveraging and spending restraint is setting the scene for a more broad-based recovery. The mix of growth is more important than growth itself. Earthquake-related reconstruction will provide a modest boost, as will activity associated with the Rugby World Cup. The British Lions tour in 2005 underpinned a 1.7 percent rise in GDP in one quarter alone. Beyond one-offs, financial conditions remain supportive. Commodity prices are at record highs. The flow-on to the general economy is being restricted by a strong focus on de-leveraging, but this process will pass over time. New Zealand's terms of trade have risen 17 percent in a year. **So one-offs drive 2011, and the real terms of trade substance is expected to support growth in 2012.**

Risks abound and there is more downside than upside. Europe remains fractured. The UK, US and Japanese economies remain weak. Better demand is coming from Asia (in fact it's really the only source of demand) but China's economy is grappling with imbalances. A two-speed economy remains apparent in Australia. Some states such as Western Australia are booming but retailing and the like has come off the boil in New South Wales. It's a patchy, inconsistent picture. Following a deep and profound financial crisis we should not be surprised. It's a tall order to imagine everything coming together and for strong growth over 2011. The probability of a setback or two remains high.

MORTGAGE BORROWERS STRATEGY

Mortgage interest rates were unchanged again this month, having been steady for around three months now. We expect the Reserve Bank to keep the OCR on hold until the middle of 2011 with floating rates likely to follow suit. Recent comments from RBNZ Governor Bollard suggest he is in no hurry to raise the OCR, and this should keep short-term fixed rates stable. Breakeven analysis suggests the sweet spot for borrowers is anything up to 2 years.

OUR VIEW

A weak and patchy economy implies interest rates look set to remain low for a while yet. That was the message delivered by the RBNZ last week and we concur with it. While you'd never want to rule out interest rates moving up in early 2011, it's hard to see the catalyst. In fact we can see some risk that the next movement in rates could be a cut. That's a small risk at present but three months ago the probability was effectively zero. The mere fact we can put that on the table is testament to how fickle demand is across the economy at present.

We've pencilled in the next move in the OCR as being up, from the middle of the year. This effectively pushes out the decision into a zone where we believe we could get sufficient "good" economic news to justify raising rates. At present the real message is simply that it remains a way off.

Borrowers should remain in no hurry to fix. For one, the OCR does not look like it is going to move up for a while. Second, when they do, the RBNZ – like us – is projecting a very slow rise in rates. Thirdly, the RBNZ expects the endgame for rates to be around 4.5 percent for the OCR, a far cry from the 8 percent plus seen during the last cycle. There are a number of reasons for why this is so. They include higher bank funding costs (which impact the borrowing rate as opposed to the OCR), prudential policy changes and an economic environment that look set to remain prone to ups and downs.

Regular readers will be familiar with our breakeven analysis, which we use to gauge the potential value in a chosen strategy. As we always reiterate when introducing the concept, breakeven analysis doesn't help much when it comes to choosing between fixed and floating, but it is helpful when considering a set of fixed rates over a given timeframe.

As was the case last month, the 6 month breakeven in 6 months is 6.55%. That's only 0.20% above the current 6 month rate. While we don't think the RBNZ is in any hurry to lift rates, odds are that there will be one rate rise by the middle of 2011 and hence chances are the 6 month rate will be above 6.55% in 6 months. As such, **the 1 year rate looks attractive – though less so relative to last month.** Similarly, as it was last month, the 1 year breakeven in 1 year's time is at 6.85%. That's just 0.40% above the current 1 year rate, which isn't much. Or put another way, the decision is effectively asking borrowers to decide whether the RBNZ will be hiking more or less than 50 basis points over the coming year. We think 50 is a minimum, though they will be in no hurry. **2 year mortgage borrowing therefore also looks reasonably attractive.** However, when we compare longer-term fixed rates against their breakevens, we find that the RBNZ would have to raise the OCR by a long way to make long-term fixing beneficial.

Mortgage Rates		Breakevens			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	6.20%				
6 months	6.35%	6.55%	7.05%	6.65%	7.78%
1 year	6.45%	6.80%	6.85%	7.21%	8.00%
18 months	6.65%	6.75%	7.16%	7.55%	8.11%
2 years	6.65%	7.01%	7.43%	7.74%	8.25%
3 years	7.10%	7.43%	7.78%	8.04%	8.40%
4 years	7.45%	7.73%	8.01%		
5 years	7.70%				

RURAL LAND PRICES

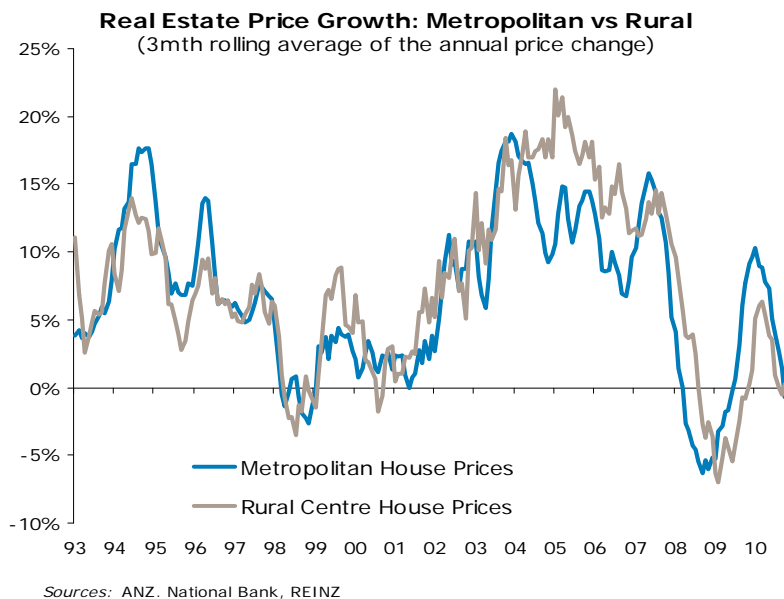
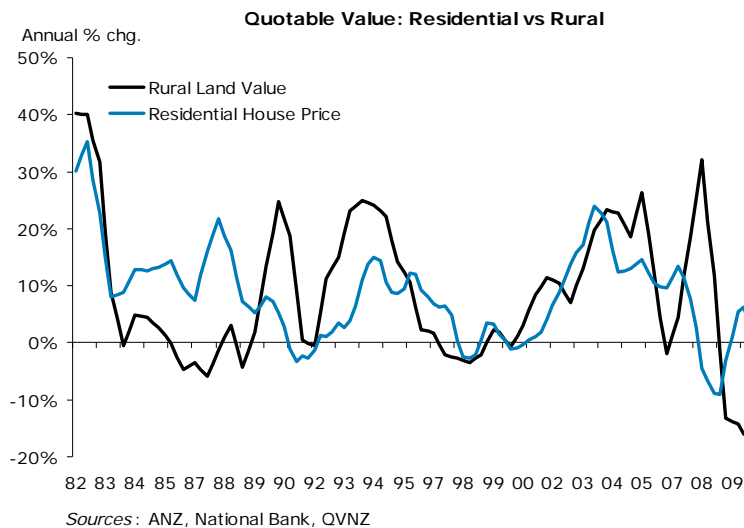
SUMMARY

In this month's special feature we look at recent trends in rural land prices. It is important for two reasons. Firstly, booming rural land prices saw significant spill-over into regional house prices, and tailwinds can turn into headwinds. Second, stabilising rural land prices are a key benchmark before rural chequebooks will be opened and the benefit of strong commodity prices will diffuse into the broader economy. Land prices remain under pressure and look set to remain so into 2011. Hence, we doubt the rural sector will suddenly start spending. Rather we suspect this will be a 2012 story as opposed to a 2011 dynamic.

THE REASONING

Why comment on rural land prices in our property focus?

Firstly, there is strong correlation between property prices and rural land prices. This is hardly surprising as most property transactions have been influenced to a degree by the same dynamic: the appetite to borrow. Some of the strongest performing regions in terms of house prices from 2000 to 2007 were rural-aligned. The out-performance of rural aligned house prices from 2000 to 2008 was related to strength in the rural property market.



RURAL LAND PRICES

Second, income generation across the economy is being supported by strong commodity prices, but weak rural land prices and the process of deleveraging are curtailing the flow-on to the economy. Once rural land prices stabilise and demand starts to pick up, we'll start to see the impact of strong commodity prices diffusing into the general economy (read: housing and retailing). Such a dynamic is not the only factor at play in terms of the outlook for the domestic economy, but it's certainly an important one. Previous editions of *Property Focus* have made reference to the rebalancing process the economy is facing, which in effect is getting more earning centric growth to support spending desires. **Better earnings (which in NZ's case can come from stronger commodity prices) is a means of restoring some affordability to property prices via better income generation. Stabilisation in rural balance sheets is a precondition to this occurring.**

THE HISTORY

Rural land values tripled between December 1999 and December 2008, going from \$5,000 to \$15,600 per hectare. There were a number of drivers: higher commodity prices during various periods, an inflow of overseas capital, land use change and urban creep, and low interest rates. On top of that, credit played a major role, with rural sector debt rising from \$11.8 to \$42.3 billion (+360 percent). During this period, annual credit growth averaged nearly 15 percent, with peaks of up to 25 percent. We saw the same dynamic in the household sector with debt to income rising from 101 to 159 percent. So while some may point to migration, and the like, as being the big driver of house prices, or commodity prices driving rural land prices, the common denominator across both has really been credit and debt.

Unfortunately, agricultural returns did not keep up with the scorching pace that was set by credit growth, and farmers' balance sheets got slightly out of whack, with ever increasing amounts of term debt. During this period the average rate of return from 2000-01 to 2009-10 for the average sheep and beef farmer declined from 3-5 percent to near 0-½ percent. While dairy returns were at a higher level, their returns also decreased from an average of 8-10 percent in 2000-01 to 2 percent in 2008-09, with one notable outlier year. However, the decrease in returns and larger amounts of debt were disguised by appreciating land values and stable equity ratios. In effect rural land got caught in the same frenzy as house prices: a fixation with capital growth as opposed to the underlying yield and cash-flow.

Year	Average Sheep and Beef Farm		Average Dairy Farm	
	Rate of Return (%)	Equity (%)	Rate of Return (%)	Equity (%)
2000-01	4.6	81	8.5	63
2001-02	4.4	81	9.5	63
2002-03	2.4	80	3.6	62
2003-04	1.2	82	3.5	65
2004-05	1.2	82	3.0	68
2005-06	0.2	81	2.6	63
2006-07	0.0	80	2.2	64
2007-08	-0.4	79	6.0	64
2008-09	0.5	79	1.6	57
2009-10p	1.5	70	5.5	51

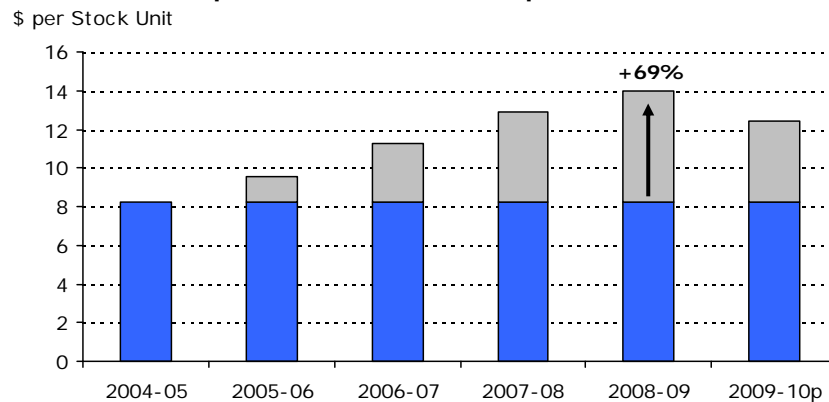
Sources: ANZ, National Bank, Beef & Lamb NZ, Dairy NZ. p: provisional

The accumulative effects of the growth in credit can be seen by the dramatic increase in the interest cost per productive unit. The interest cost per stock unit on the average sheep and beef farm increased 68 percent from \$8 per stock unit in 2004-05 to \$14 per stock unit at its peak in 2008-09. The average dairy farm experienced slightly larger growth in interest costs of 79 percent over the same period, going from \$0.90 to \$1.60 per kilogram of milksolid, but with a skewed distribution to those who brought late and converted too much land all at once.

This does not mean the investment was bad, though it was certainly risky in terms of a lot of factors needing to go right for an adequate return or payoff to manifest. Hindsight is of course a wonderful thing but post the global financial crisis risk is being repriced with greater focus on yield and cash-flow. Like a lot of sectors, this is taking the rural sector a bit of time to get its head around and in the meantime an asset price bubble has been pricked and is in the process of deflating.

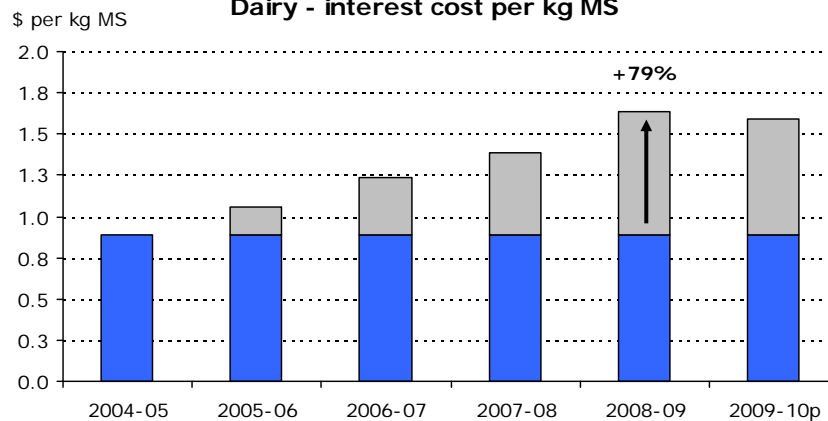
RURAL LAND PRICES

Sheep & Beef - interest cost per stock unit



Sources: ANZ, National Bank, Beef + Lamb NZ

Dairy - interest cost per kg MS



Sources: ANZ, National Bank, Dairy NZ

CURRENT STATE OF PLAY

We believe the overall market is off 25-30 percent from its peak. Some pockets have shown more extreme movements and REINZ data shows a more exaggerated decline. From a peak of \$1,821,000 in July 2008, the median farm sale price fell to just \$914,000 in November last year, a drop of 50 percent, but has since recovered to \$1,052,000 in the period ended October 2010. But the median sale price is heavily influenced by the type of farm sold so tends to be biased. Just 167 farms were sold during the three-month period ended October 2010, the lowest on record. This is in sharp contrast to the previous five years where the average number of sales for this period was 510, with a peak of 700.

This sort of adjustment sounds significant but we need to put it in perspective. Firstly, there is the base effect. According to QV, rural land values rose around 300 percent between 2000 and 2009, so much of the correction has merely been recoil from extended or what some would call irrational exuberance. Secondly, the adjustment seen to date has been relatively orderly. A recovery in farm incomes has been incredibly important here for it is allowing the rural sector to de-leverage in a sensible fashion via income generation (and cost control) without some of the irrationality that can sometimes appear when the economy or asset price cycle turns. Part of the reason for this has been a pretty mature attitude on the part of New Zealand's financial institutions. While there has of course been the odd inevitable forced sales following such a speculative unwind in the market, what's going on looks a far cry from the sort of responses we've seen in the likes of the mid 1980's and 1990's.

The average dairy land price per kilogram of milk solids has fallen to \$33 from \$37 in July, \$40 in June and \$45 in May: broadly 30 percent in 6 months. For the 2010 calendar year to date, the average dairy farm price has been \$3,120,000. This translates into an average price per hectare of around \$27,000,

RURAL LAND PRICES

down from the peak of \$35,000 in 2008-09. The ripple effects of surging dairy prices supported farm prices on the way up, but have now operated in reverse, and in some sectors are exposing weak underlying cash-flow and returns. Indeed, a negative by-product of surging farm prices over 2000 to 2008 was that it disguised poor cash-flow positions or underlying returns in a number of areas such as red meat and wool. With asset prices under pressure, poor underlying returns are now being exposed. This is far from across the board, with a massive gap between good / strong operators and the other end of the spectrum.

Finishing land has been a slight exception to current trends, with the median price for finishing land increasing 7 percent on last year to \$1,146,000. This could be statistical "median" noise rather than a reflection of where the underlying market is placed, but it highlights the fact that there are some willing buyers who have cash available if a good-quality property is placed on the market. Arable and grazing land have shown declines of 7 and 13 percent respectively to \$1,131,000 for arable properties and \$935,500 for grazing.

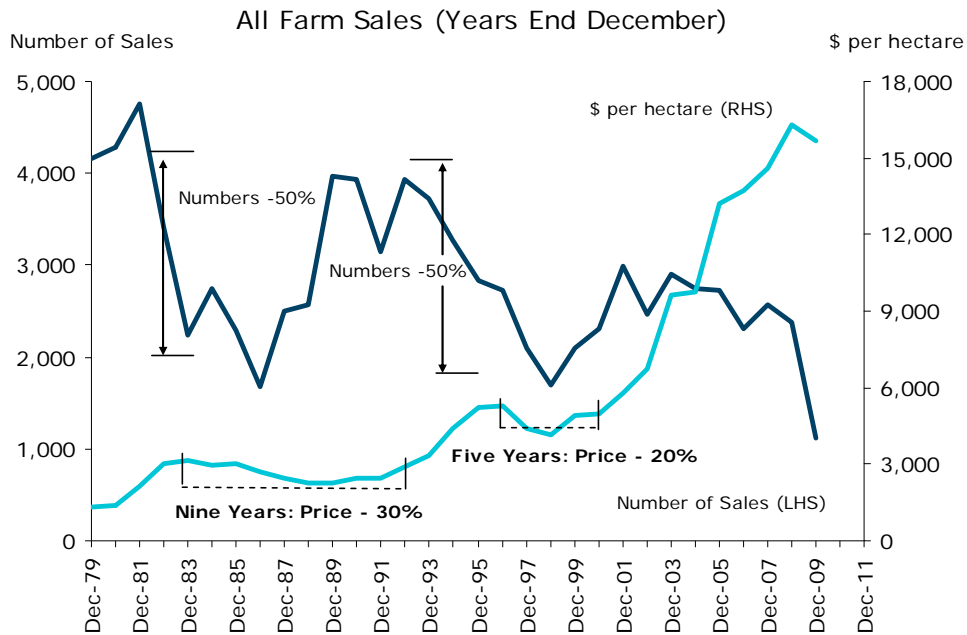
All in all the rural real estate market clearly remains under pressure with a back-log of farms beginning to emerge and the number of days taken to reach agreement between buyer and seller continuing to increase. Throw in widespread dry conditions over the Christmas and New Year period, the average time to sell will only increase and the number of sales is likely to decrease further. With farm sales at an all-time low of 167, this tells us of a yawning gap between purchaser and vendor price expectations, and is also symptomatic of weak demand for credit, with deleveraging dominating. Indeed, credit growth in the rural sector has now slowed to an annual increase of 2.4 percent. While still positive, this is a long way behind the double-digit growth experienced during the rest of the 2000s. More importantly, the rate of credit growth needs to be read in conjunction with income growth. While credit growth is still rising in a nominal sense, the agriculture sector is de-leveraging when we take account of the income side of the equation.

It seems these dynamics are finely balanced at present, with the downside risks likely to see land prices remain under pressure during 2011, extending the time before land sales and values start to stabilise and recover. The widespread dry conditions are of large concern, along with the time to get balance sheets back in order, policy changes regarding overseas investment and the time it will take to clear the back-log of property that has accumulated. **The scarcity of land argument and ability to change land use still holds true, with new land uses as diverse as milking sheep and forestry for carbon credits some of the new prospects on the horizon.** This along with the broad-based strength in commodity prices and low interest rates, should provide a bottom of around 30 percent below the peak for land values.

WHAT AND WHEN IS THE TURNING POINT?

History is not always a good pointer to the future and as always there are different factors at play this time round, but it is still instructive. **However, the two previous periods where land prices declined were preceded by a decrease in the number of farm sales of up to 50 percent, with land values then decreasing by 20 and 30 percent from the peak. It then took 9 and 5 years for land values to recover.** The 1980s decline in land values was characterised by deregulation of the farming sector, low on-farm productivity, drought and the share market collapse. The decline at the end of the 1990s was the Asian Financial Crisis and drought again. This time round it has been the Global Financial Crisis, high debt levels, combined with volatile earnings and the possibility of drought extending the pain.

RURAL LAND PRICES



Sources: ANZ, National Bank, Quotable Value

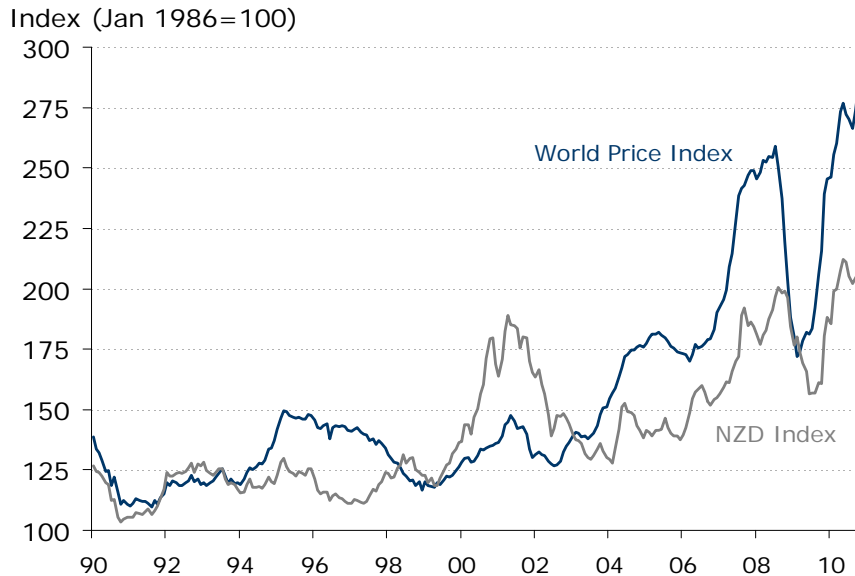
There are two schools of thought about where the bottom in land values might be, governed by different approaches to investing. One is based on comparative yields for investments and the different risk/return/effort profile to gain the return. The other is return and capital, which is governed by the same principles, but the investor usually has a longer time horizon in mind. This is based both on the ability to invest and change the land use, which changes the return and capital value of the land but also the scarcity of land argument when a longer time horizon is considered. **These dynamics provide a natural floor for land values and history suggests that on average this floor is 20-30 percent down from the peak.** On this basis the market may well be troughing already, although given the backlog of farms on the market at present this looks a stretch.

For now, we expect the Mexican stand-off between buyers and sellers to continue for the next little while as de-leveraging occurs and farmers focus on catch-up maintenance rather than splashing out on the next door neighbour's property. To end the stand-off and see land values increase will require sustained high commodity prices over several years, low interest rates, with some good weather to lift production and confidence. A reasonable season and a sustained period of better farm incomes are incredibly important to any chance of land values not moving lower again and the correction in land values to returns taking place in an orderly fashion. As long as these factors are supportive, the rural sector will be able to de-leverage in a sensible fashion via income generation and cost control. Talk of restrictions on foreign ownership is also not helping the market and will only exaggerate the decline and adjustment. There is not a sufficient pool of domestic cash available, which is the oxymoron in the whole foreign ownership debate: tightening foreign ownership rules is fine provided you have a savings-centric culture. New Zealand does not.

Income generation across the rural sector is very strong. Commodity prices sit at record highs. The dairy payout is the second highest on record at \$7.15 per kilogram of milksolid, lamb prices are near record highs, with an expected season average price of \$90 per head, wool seems to have materially lifted by 15-20 percent from the past couple of years, venison and beef have shown more modest gains of between 5-10 percent on last year and other sectors such as forestry continue to truck along.

RURAL LAND PRICES

ANZ Commodity Price Index

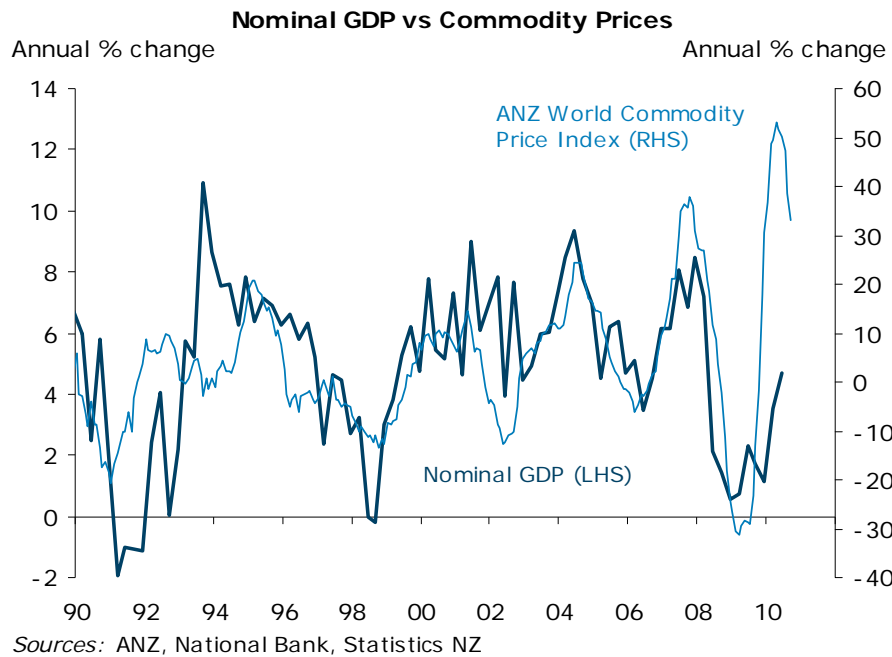


This is allowing the sector to deleverage quickly. However, the biggest threat to better bottom lines and farmer confidence is now mother nature, with a wet winter and early spring affecting 2010-11 meat production (2.8 million lambs less than last spring @ \$100 per head equals \$280 million) and now an early dry snap in major dairy-producing regions affecting milk and crop production. How this plays out over the next two weeks will influence farmer confidence, bottom lines and spending for 2011 and maybe even 2012. Northland and the Central North Island have now been declared a medium-level drought zone, triggering government relief packages. Together these regions represent close to 45 percent of New Zealand's total milk supply. Farmers are responding by increasing supplements to plug the feed gap, drying off parts of their herd, switching to once a day milking or extending milking to 16 hours and culling older and non-pregnant cows. While milk production peaked higher than the previous two seasons, the decline has been very rapid since. **We now know this is going to have a material effect on production but the question remains how much?**

On-going cost pressures also continue to crimp returns and farmer confidence continues to be held in check by the experiences of yesteryear and equity ratios declining because of lower land prices. These factors are keeping many farmer wallets tightly shut in the run into 2011. This is collaborated by many retailers in rural centres reporting very slow trade over the last few months.

Typically such high prices would be the precursor of a good time for all (refer chart below on commodity prices versus nominal GDP). The normal lag between strong commodity prices and the economy is around 6 to 12 months. **But weak rural balance sheets, mother nature and with rural land prices still under pressure, this lag looks set to be longer this time around.** Or put another way, people do not tend to spend when their major asset is falling in value.

RURAL LAND PRICES

**THE UPSHOT**

Strong commodity prices are providing massive stimulus to the economy. This is a key part of the positive medium term story for NZ.Inc. However **the diffusion of this into the general economy is being curtailed by attempts to restore some health to rural balance sheets, and downwards pressure on land prices. Mother nature is reinforcing the tendency to keep the cheque-book shut** (beyond immediate feed costs). It looks a tall order for things to come together in 2011 and the rural cheque-book to suddenly open, allowing the impact to diffuse into the broader economy. **At present this looks a 2012 story, and even then this is conditioned on commodity prices holding and extending recent gains and mother nature being kind.**

KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

		Mortgage Rate (%)													
		5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.25	8.50	8.75	9.00
Mortgage Size (\$'000)	200	290	297	304	311	319	326	333	341	348	356	364	371	379	387
	250	363	371	380	389	398	407	417	426	435	445	455	464	474	484
	300	435	446	456	467	478	489	500	511	522	534	545	557	569	581
	350	508	520	532	545	558	570	583	596	610	623	636	650	664	677
	400	580	594	608	623	637	652	667	682	697	712	727	743	758	774
	450	653	669	684	701	717	733	750	767	784	801	818	836	853	871
	500	725	743	761	778	797	815	833	852	871	890	909	928	948	968
	550	798	817	837	856	876	896	917	937	958	979	1000	1021	1043	1064
	600	870	891	913	934	956	978	1000	1022	1045	1068	1091	1114	1137	1161
	650	943	966	989	1012	1036	1059	1083	1108	1132	1157	1182	1207	1232	1258
	700	1015	1040	1065	1090	1115	1141	1167	1193	1219	1246	1273	1300	1327	1355
	750	1088	1114	1141	1168	1195	1222	1250	1278	1306	1335	1364	1393	1422	1451
	800	1160	1188	1217	1246	1274	1304	1333	1363	1393	1424	1454	1485	1517	1548
	850	1233	1263	1293	1323	1354	1385	1417	1448	1480	1513	1545	1578	1611	1645
	900	1306	1337	1369	1401	1434	1467	1500	1534	1567	1602	1636	1671	1706	1742
950	1378	1411	1445	1479	1513	1548	1583	1619	1655	1691	1727	1764	1801	1838	
1000	1451	1486	1521	1557	1593	1630	1667	1704	1742	1780	1818	1857	1896	1935	

Housing market indicators for November 2010 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a.)	Comment
Northland	-9.4	2.9	100	(-11%)	63	Weakest annual drop in house prices
Auckland	1.4	1.8	1,613	(+17%)	39	The shortest time to sell in November
Waikato/BOP/Gisborne	0.0	-2.0	578	(+10%)	65	The second slowest selling region in NZ
Hawke's Bay	-2.1	0.1	163	(+21%)	59	The median time to sell slowed considerably
Taranaki	0.8	-0.5	206	(+36%)	55	Reported the quickest time to sell in 7 months
Manawatu-Whanganui	-4.0	-3.6	149	(+30%)	51	Average sale price slipped to an 18 month low
Wellington	2.3	0.1	576	(+14%)	41	The second strongest annual price change
Nelson-Marlborough	1.4	-1.4	200	(+25%)	49	Number of sales hit a six-month high
Canterbury/Westland	-1.0	-4.4	669	(+30%)	47	The weakest three month price change
Otago	-5.3	-1.1	72	(+13%)	84	Recorded the longest time to sell a house
Central Otago Lakes	-3.9	-1.9	207	(+11%)	43	The median selling price slipped to 9 mth low
Southland	4.1	-2.9	121	(+37%)	45	The strongest annual rise in selling prices
NEW ZEALAND	1.3	-0.1	4,650	(+19%)	44	Rebound in sales but prices still trending lower

Key forecasts

Economic indicators	Actual			Forecast						
	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12
GDP (Ann Avg % Chg)	-0.4	0.7	1.5(f)	1.6	1.5	1.6	2.2	3.2	4.0	4.3
CPI Inflation (%)	2.0	1.7	1.5	4.1	4.4	5.2	4.9	2.9	2.8	2.5
Unemployment Rate (%)	6.0	6.9	6.4	6.3	6.2	5.8	5.6	5.5	5.5	5.6
Interest rates	Actual			Forecast (end month)						
	Oct 10	Nov 10	Latest	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12	Sep 12
Official Cash Rate	3.00	3.00	3.00	3.00	3.25	3.75	4.00	4.25	4.50	4.75
90-Day Bank Bill Rate	3.2	3.2	3.2	3.2	3.7	4.2	4.3	4.7	4.8	5.2
Floating Mortgage Rate	6.4	6.4	6.4	6.5	6.8	7.3	7.5	7.5	7.6	7.9
1-Yr Fixed Mortgage Rate	6.4	6.4	6.4	6.6	6.9	7.1	7.2	7.5	7.6	7.9
2-Yr Fixed Mortgage Rate	6.7	6.6	6.6	6.9	7.3	7.6	7.7	7.9	8.0	8.2
5-Yr Fixed Mortgage Rate	7.7	7.7	7.7	7.8	8.2	8.3	8.3	8.3	8.3	8.3

IMPORTANT NOTICE

NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

Qualifications, experience and professional standing Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- OnePath (NZ) Limited, as a wholly owned subsidiary of the Bank, is an associated person of the Bank. OnePath and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:



IMPORTANT NOTICE

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

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The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

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