NEW ZEALAND ECONOMICS
ANZ AGRI FOCUS

AUGUST 2013

INSIDE

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WHEN THE WIND BLOWS, SOME BUILD WALLS, OTHERS WINDMILLS

FEATURE ARTICLE: CHINA IN FOCUS

China faces challenges re-orientating its economy and the current risks are skewed to the downside. Our Chinese economics team have recently revised down their growth forecasts, but believe the risks of a hard landing can be managed with appropriate policy assistance. The prospect of a hard landing, a financial crisis, and/or a long period of low growth is a scary thought. What matters most for NZ through the transition, and period of heightened uncertainty, will be how Chinese households fare, and the execution of business strategies by companies to target the right households and channels to market.

THE MONTH IN REVIEW

The brakes came on pasture growth in the late-June to mid-July period as wintry conditions took hold. Before this, pasture covers had recovered strongly in many drought-affected regions. A strong start to this season's milk production is expected. Sheep and beef farmers won't be so lucky, with drought effects to drag on production this season.

RURAL PROPERTY MARKET

The rural property market seems to have bucked the normal seasonal slowdown and drought effects. Both turnover and average prices across the main farm types have remained unusually robust this winter and up on last year. Improved prospects for farm incomes (especially dairy), historically low interest rates, a competitive lending environment, and strong competition for a limited number of properties are expected to result in continued rural property buoyancy this spring.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

International soft commodity prices have come under increased pressure recently. The weather risk premium priced into global grain markets is being unwound as the prospect of some large crops is becoming reality. For NZ commodities this will provide some downward pressure on in-market prices.

ECONOMIC BACKDROP

The trajectory for the NZ economy looks reasonably assured. We won't be knocking the ball out of the park, but look set for pretty solid growth.

BORROWING STRATEGY

Indicative rural fixed-lending rates have moved up for most terms since our last edition, with larger moves for longer terms. By contrast, the floating rate has not changed, reflecting an on-hold OCR. We still see some value in adding to fixed cover, but the recent rise in rates has taken some of the allure out of fixing.

EDUCATION CORNER: AFTER-EFFECTS OF 'QE' WITHDRAWAL

The environment over the last few years has been one of record-low interest rates, both here and abroad. The decision in June by the US Federal Reserve to set out a conditional timetable for winding down its quantitative easing (QE) programme flags an end to this golden era. Some conjecture surrounds how much soft commodities have benefited. We believe it would be naïve to assume soft commodity price trends are totally disconnected to wider asset class trends. Therefore, a winding down in QE is expected to exert some additional downward pressure on soft commodity prices. That said, the natural buffer for farm-gate returns from a reversal of this trend will be a lower NZD/USD, which should ease any pressure on farm-gate returns from lower in-market prices.

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SUMMARY

China is presented as a huge source of potential upside for New Zealand and the primary sector. However, China faces challenges re-orientating its economy. How does the economy balance an economic objective (less investment and more consumption) with a social one (more jobs), which means more investment? Will investment malfeasance and rapid credit accumulation ultimately require the piper to be paid? How does China unlock total factor productivity growth – the key to becoming a middle income economy? Can a centrally-planned economy truly outdo ones that are more based on market forces? It all adds up to a raised risk profile. Our China economics team believes the risk of a hard landing can be managed with appropriate policy assistance, but have recently revised down their growth forecasts. However, they note the current risks are skewed to the downside, with a structural "L-shaped" slowdown a real prospect, without appropriate policy assistance.

We're mindful of the obvious risks. There will be twists and turns. However, NZ is still small. We cannot feed the world: we're targeting niches as a producer, not trying to be a mass producer. What matters most for NZ through the transition, and period of heightened uncertainty, will be how Chinese households fare, and the execution of business strategies by companies to target the right households and channels to market. Respect the macroeconomic picture, but the ultimate buffer to this resides in getting the microeconomic agenda right.

INTRODUCTION

All the talk in just about every export business these days is about China and the untold opportunities for everything NZ produces, from a humble piece of fruit to a leg of lamb and everything in between (let's not forget milk powders also!).

It has been unprecedented in NZ's economic history how quickly our trade flows have changed for just about every one of our major primary sectors over the last five to ten years. **In fact China now accounts for 23 percent of the primary industries' total earnings, and is the largest earner for 11 out of 21 of the major primary sectors.** For the remaining 10 sectors, China ranks as either the second or third largest market for all but one (cheese). The wool industry, then forestry, skins, and seafood, have the largest exposures to China. The fastest-growing exposures over the last two years have been for meat, seafood, skins, and horticultural products.

New Zealand exports to China by primary sector

Sector	Value of Exports May-13 (NZ$)	Trading Partner Ranking	Total Exports All Nations (NZ$)	China's Share of Total	Percentage Change 2011 to 2013
Milk Powder	2,346	1	7,057	33%	25%
Logs	1,280	1	1,892	68%	31%
Sheepmeat	505	2	2,650	19%	197%
Wool	380	1	750	51%	11%
Crayfish	228	1	262	87%	144%
Pet Food	217	1	904	24%	32%
Malt Extract	188	1	670	28%	48%
Raw Hides	188	1	389	48%	71%
Confidential Items	177	3	1,122	16%	81%
Casein	171	3	1,226	14%	59%
Sawn Timber	170	2	1,088	16%	16%
Butter	169	2	1,898	9%	3%
Wood Pulp	164	1	578	28%	-21%
Beef	160	3	2,166	7%	1722%
Fish	133	2	812	16%	21%
Live Animals ex Horses	107	1	130	82%	183%
Kiwifruit	105	3	990	11%	30%
Cheese	104	4	1,445	7%	49%
Whey	103	2	684	15%	78%
Iron Ore	77	1	104	74%	119%
Tallow	70	1	160	44%	-38%
Sub-Total: Meat	682	2	5,257	13%	264%
Sub-Total: Dairy	2,976	1	12,741	23%	28%
Sub-Total: Wool	380	1	750	51%	11%
Sub-Total: Skins	199	1	571	35%	55%
Sub-Total: Horticulture	139	5	2,679	5%	48%
Sub-Total: Processed Agric	508	2	3,276	16%	20%
Sub-Total: Forestry	1,641	1	3,918	42%	20%
Sub-Total: Fish & Seafood	389	1	1,464	27%	64%
Sub-Total: All Primary	7,046	1	31,103	23%	37%

Sources: ANZ, Statistics NZ

The increase in exposure to China has been so rapid the inevitable question is now being raised by many sectors and businesses: how much is too much? It's a legitimate question when you eye the exposure of earnings for each of the major primary sectors, our current limited cultural and business understanding of the marketplace, and the sheer size and associated complexities of China's economy. The answer is that it all really depends on one's business strategy. Many a good business has thrived while being reliant on one cornerstone customer, but special management/risk mitigation strategies are usually required to handle any ups or downs in the relationship.

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More recently there have been increasing rumblings on some of the potential downside risks to the Chinese economy at both the macro and micro levels. **At the macro level obvious questions are being raised.** How does the economy balance an economic objective (less investment and more consumption) with a social one (more jobs), which means more investment? Will investment malfeasance and rapid credit accumulation ultimately require the piper to be paid? Rising global interest rate environments tend to shakeout poor investment decisions. How does China unlock total factor productivity growth – the key to becoming a middle economy? Most economies that try to take the leap from low to middle income fail. Total factor productivity ultimately requires market-driven incentives, the rule of law, and democracy. Those look a way off in China! Can a centrally-planned economy truly outdo ones that are more based on market forces? It all adds up to a raised risk profile.

These concerns are not new but have intensified with a weak external environment for exports, an acceleration of credit growth since 2008, and the rapid growth of a shadow banking sector as financial liberalisation has slowly started to take place. Lifts in global interest rates via the USA raise the prospect of Warren Buffet's line of "when the tide goes out you find out whose been swimming naked" coming to the fore.

At the micro level there have been a number of China-related issues for NZ's primary sectors since the start of the year. These have included two hold-ups of meat exports at ports, DCD concerns in NZ milk, Zespri's court case and subsequent prosecution for inappropriate invoicing practices, and an investigation into Chinese infant formula retail prices. While many of these seem to be teething issues, and the result of the rapid growth witnessed in recent years, they also reflect a Chinese economy that is undertaking many small policy reforms in lots of different areas in an attempt to engineer the next leg of growth. Given that trading has continued they have not been major, but in all cases there have been additional operating costs and/or lost revenue. While it is true that we now live in a faster-paced world compared with 50 years ago, it is worth remembering that it took a lot longer to build the trade and business relationships, systems etc we have with our more traditional markets who speak the same language.

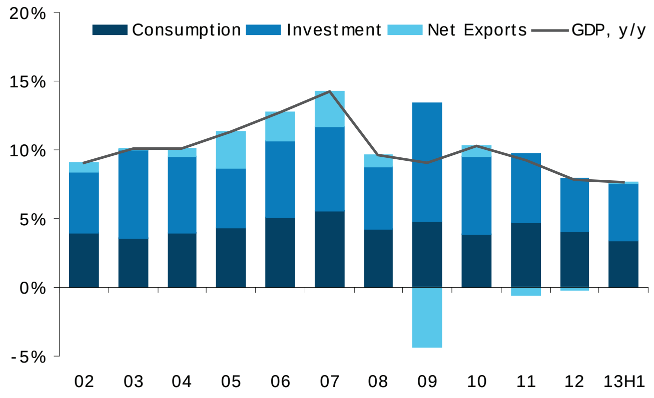
What these tensions are highlighting is that with increasing linkages and exposure to China there are also associated vulnerabilities and risks that need to be managed.

SO WHAT IS THE VIEW ON THE CHINESE ECONOMY AND WHERE IS IT HEADING?

At the end of July our China economics team revised down their 2014 growth prospects for China to 7.2 percent from 7.8 percent. That's slowing from a gallop to a canter. They expect that China will adopt a 7 percent growth target in 2014 and believe that with appropriate policy assistance the Chinese economy will smoothly descend to this slower growth profile throughout 2014. This has recently been reinforced by similar comments from the Chinese Premier Li Keqiang, suggesting 7 percent was the lowest growth policy makers would tolerate in 2013, with 7-7.5 percent an acceptable range. **However, the current risks are skewed to the downside of 7 percent, with a structural "L-shaped" slowdown a real prospect, without appropriate policy assistance.**

The near three decades of rapid economic growth and reduced poverty levels China has experienced are fascinating and remarkable, as well as a testament to China's success in implementing reforms in the face of many challenges. However, while the economy has managed to keep trucking along at a good clip since the events of 2008, its mix of growth and chosen policies have exacerbated many domestic and external imbalances that have built up over time.

China - Contributions to GDP Growth



Sources: ANZ, CEIC

The main macroeconomic challenges facing China's economy include:

- A weak global growth and external trade environment.
- Heavy reliance on capital investment for growth, which has a declining rate of return and has led to overcapacity issues.

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- Build-up of leverage in the financial sector, including local government and corporate balance sheets. This could affect financial stability and risks an adverse feed-back loop occurring between the real economy and financial sector if not properly managed.
- Low private consumption due to high domestic savings and labour market distortions caused by government policies.
- Political sensitivity toward market liberalisation in a number of key areas. Ultimately state dominance needs to morph into market influence to drive total factor productivity and wages higher, which are key to unlocking a sustained lift in living standards. It is also required to allow a rebalancing of economic growth away from investment toward greater domestic consumption.

WEAK EXTERNAL ENVIRONMENT

The more open China has become, the more reliant and interconnected it has become to the world. This means it cannot completely divorce itself from the changes occurring in Europe, China's largest trading partner.

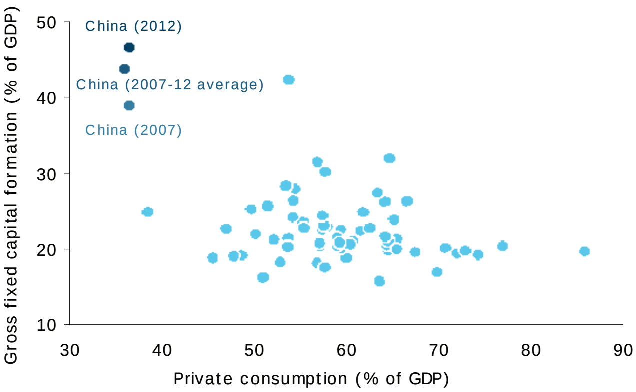
China's traditional growth model has been based on export-led industrialisation. This was firstly driven by the rapid expansion of China's manufacturing sector. The sector used a large urbanising labour force, low wages, foreign direct investment to import knowledge and technology, and a controlled financial sector (a pegged currency and freely available subsided credit, especially for state-owned enterprises) to flood the West with an abundance of cheap products. As critical mass was built over time, productivity improved, which helped boost wages. All these trends combined, energizing urbanisation and wage growth of the country's 1.35 billion people. **This led to large net export and fixed capital investment contributions to GDP and a very low consumption contribution.**

When the events of 2008 transpired and trading partners froze, causing the net exports contribution to GDP to tank, the first response was to enact a large investment stimulus package – implemented through a mix of fiscal, quasi-fiscal, and state-owned enterprise (SOE) spending.

Most of the spending was focused on investment, as opposed to putting more money back into households' pockets to boost private consumption. This and subsequent packages therefore supported domestic investment activity and reduced lay-offs during a period of great uncertainty.

While this allowed China to avoid a severe recession as occurred elsewhere, and had positive spillovers for global demand by increasing China's imports, it exacerbated the domestic imbalance between investment and consumption. The chart below from the International Monetary Fund shows how much of an outlier China is on both fronts, and also shows how China has become increasingly reliant on investment for growth since 2007.

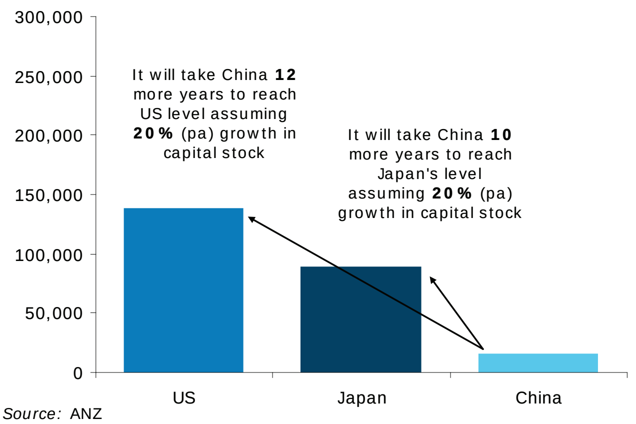
Private consumption and investment
(Industrial countries and emerging markets; average, 2006–12)



Sources: ANZ, CEIC

OVER-INVESTMENT

Capital Stock per Capita in 2011
(USD 2005 Price)



Source: ANZ

China still needs infrastructure investment in the next two decades to enhance the overall efficiency of the economy. In fact, it would take China 10 years of 20 percent annual growth in the capital stock per capita to reach Japan's current level, and at least 12 years to reach the US level, assuming the same growth rate. If quality is taken into account, the required investment needed is much more. Geographically, the Western and Central regions need a lot more to catch up with the Eastern seaboard.

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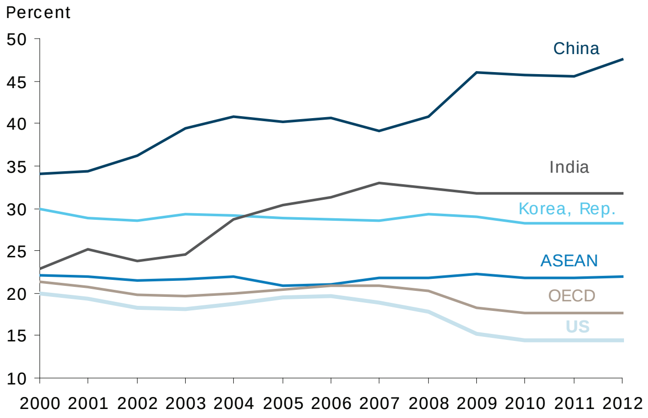
The problem has not necessarily been too much capital investment when seen in this light, but rather that it has gotten out of step with incomes and productivity, and has not always been well directed. As a result, the nation is suffering from severe overcapacity in a number of key sectors, leading to declining rates of return, and eventually financial stability concerns as debt levels increase and investments become non-performing. There is also a costly depreciation element of building something and then not fully utilising it for a number of years.

Gross Fixed Capital Formation as a % of GDP



Sources: ANZ, World Bank

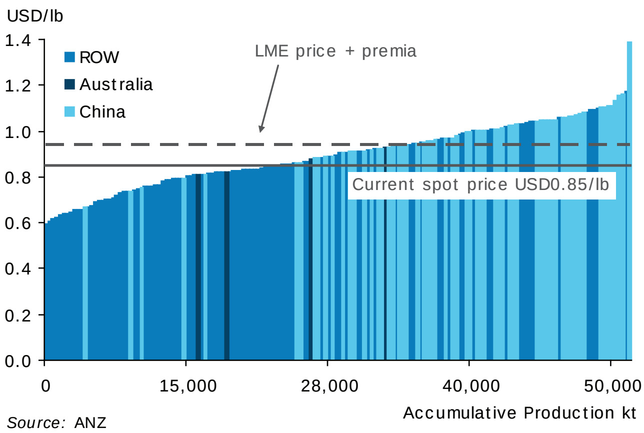
When China's fixed capital investment as a proportion of GDP (income) is compared with other countries, it suggests overcapacity has built-up and accelerated in recent years. Fixed capital investment running at 45 percent of GDP and total investment at 50-55 percent of GDP in recent years is the highest of any country ever, and far greater than when Japan rebuilt their economy post-World War II, or Korea's catch-up spurt in the 1980s. The existence of a vast underutilised transportation network and "ghost cities" underscore the point.

	Period	GDP Growth	Investment Share of GDP (%)	ICOR
China	1981-1990	9.3	35.2	3.8
	1991-2000	10.5	37.8	3.6
	2001-2011	10.6	43.4	4.1
Japan	1960-70	10.4	26.1	2.5
Korea	1981-91	9.7	30.4	3.1

Overcapacity issues are highlighted by China's diminishing rate of return of fixed capital investment on economic growth. Whereas it used to take 35 percent of GDP in fixed capital investment to get overall growth of 10 percent, it took nearly 50 percent of GDP in fixed capital investment to get growth of 8 percent in 2012.

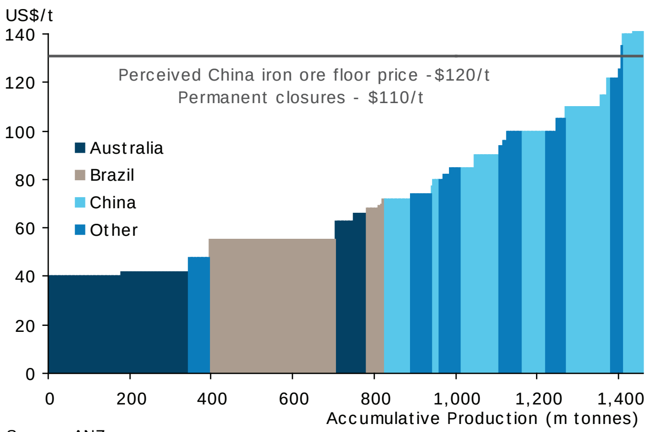
At an industry level this is best highlighted by the fact that many Chinese companies are sitting at the top end of cost-of-production curves for globally traded commodities, such as cement, steel, and aluminium. See the following two charts for aluminium and iron ore. In the aluminium sector, 93 percent of China's current capacity has a cash cost of production above current international prices. In the iron ore sector the figure is much less, but a lot of production still sits at the higher end of curve, and when international prices fell to $110 per tonne it highlighted overcapacity issues. This implies inefficient investment, overcapacity, and the need for some capacity to be shut down, or restructured to make it internationally competitive.

Global aluminium cost of production curve



Source: ANZ

Global iron ore cost of production curve



Source: ANZ

Some Chinese companies and industries have started to restructure and lay off staff recently amid overcapacity and a weak trade

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environment. For example, Rongsheng Heavy Industry, a major Chinese shipbuilder, recently laid off 8,000 workers, or around 40 percent of its workforce and sought government financial support. Policy makers are also being more proactive, ordering more than 1,400 companies in 19 industries to cut excess production capacity this year as part of efforts to shift toward slower, more sustainable economic growth. Steelmaking, ferroalloys, electrolytic aluminium, copper smelting, cement production, and paper-making are among areas being targeted by policy makers. Even in the dairy sector the recent consolidation of infant formula manufacturers (China Mengnui buying Yashili) is part of a wider push to consolidate dairy manufacturing and their brands to improve food safety standards.

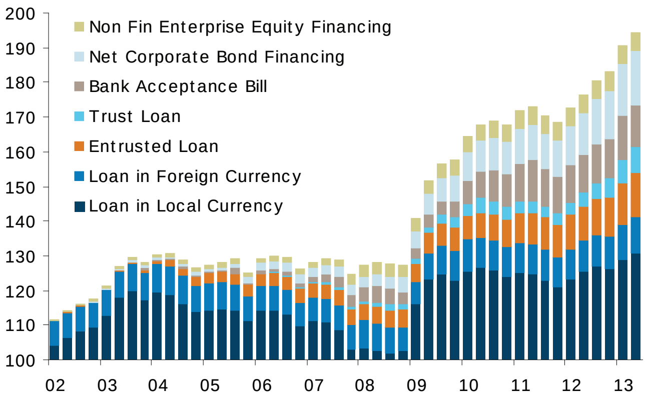
However, restructuring many of these companies and sectors is easier said than done. A large number are SOEs and there are many vested interests and political sensitivities to change. It seems every region wants to have several companies in each sector, so the necessary restructuring implies large labour and capital shifts within regions, which is also politically difficult.

There is no doubting that China's level of capital stock per capita is still low compared with other countries, and some inner-located regions require more development. However, the fact is that Chinese incomes are still a fraction of those of the richest countries, and recent studies have shown the rate of total factor productivity growth in China is low and falling. **So there is a real need to ensure investment does not get ahead of itself just for the sake of maintaining economic growth.**

History is littered with many examples of excessive investment ending in a hard landing, a financial crisis, and/or a long period of low growth. And these hard landings have not only occurred in cases of housing booms, but also over-investment in manufacturing: from the Soviet Union collapse, to the East Asian financial crisis in the 1990s.

FEEDBACK LOOPS

A large amount of the stimulus released in recent years has been delivered through credit expansion. The consequence has been a steady build-up of leverage in the financial sector, especially local government and corporate balance sheets. This is most apparent in the rapid expansion of total social financing since 2008, where after several years of stability total credit has jumped from 128 percent of GDP to 195 percent of GDP since 2008. We all know such expansion can erode financial strength if things get too out of hand, or the operating environment changes quickly for the worse leading to a loss of confidence on the part of lenders. What the flood of credit seems to have done is fuel speculative housing, prop-up inefficient SOEs, and increase financial institutions' risk appetite, which has fuelled an opaque shadow banking system.



Sources: ANZ, CEIC

While the assumption has always been that there is a government back-stop and a lot of fiscal room to mop-up any messes, more recent estimates by the International Monetary Fund suggest the fiscal headroom is considerably more limited than headline data implies. There is considerable off-budget and quasi-fiscal activity in China, primarily at the local government level, which has ratcheted up with more stimulus since 2009. In particular, borrowing by local government finance vehicles (LGFVs) has increased significantly since 2009. Expanding the definition of government to include LGFVs and off-budget funds, IMF staff estimate that in 2012 "augmented" government debt was 45 percent of GDP and the "augmented" fiscal deficit was around 10 percent of GDP. This large augmented fiscal deficit raises questions about local governments' ability to continue financing the current level of spending and service their debts. This has implications for financial system asset quality and the potential need for central government support.

Setting alarm bells ringing more recently was a spike higher in the interbank rate, and an initial reluctance by the Central Bank of China (PBoC) to stabilise it. This triggered fears of a financial crisis, disorderly de-leveraging, and an adverse feedback loop back into the real economy. The spike came about in mid-May as authorities started cracking down on the practice of using trade channels to bring hot money into the onshore market, and onshore liquidity conditions started to tighten up. Failing to anticipate the change, some banks missed payments on their interbank obligations, which in

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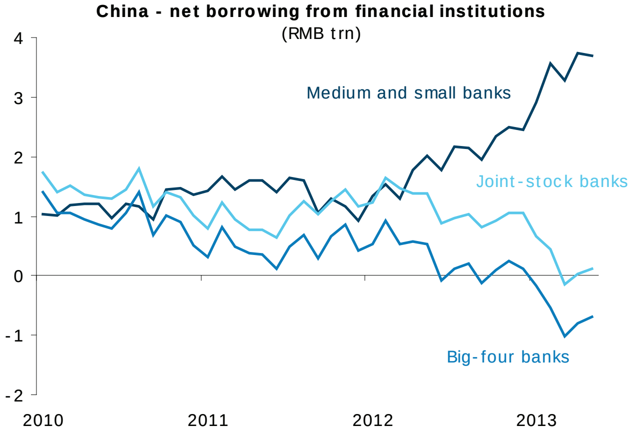
turn led to a minor panic in the interbank markets, thereby causing interbank rates to surge. The initial reluctance by the PBoC to stabilise it aggravated the alarm and caused a persistent high interbank rate for three weeks. While liquidity conditions have eased significantly after the PBoC's eventual intervention, complete normality has not yet returned.



Sources: ANZ, Wind

Past experience suggests that borrowing rates tend to be higher when volatility in the interbank rate is high. **Furthermore, China's interbank markets have developed rapidly in the past few years, and have become an important source of funding for small and medium-sized banks (as shown in the above chart). This structural change means tight liquidity conditions in the interbank market spill over to real economic activity.** This occurs through banks either passing on higher rates to the real economy, or reducing their balance sheet if the PBoC refuses to budge. As a result, a disorderly de-leveraging process could take place. Overall financial stress would increase and SMEs would be adversely affected.

The tighter inter-bank credit conditions are expected to start to affect the real sectors of the economy in the coming months:

- **First, our China team expects funding costs for property developers and LGFVs to rise further, and they could potentially find it more difficult to roll over funds.** Official data suggest that China's local government debt outstanding remains above RMB10trn, which means that even a 10bps rise in the funding cost will bring about RMB10bn in additional interest payments.
- **Second, SMEs will likely suffer amid tighter liquidity.** Past experience suggests banks normally reduce their exposure to SMEs when credit appetite eases. Given many of them are in the export sector, these sectors will experience a double whammy effect from both rising credit costs and the currently stronger RMB (especially against key Asian trading partners).
- **Third, some commercial banks who have issued high-yielding wealth management products (WMPs) to diversify their funding sources will still need to continue this amid tighter liquidity.** However, if the WMPs are scaled back as commercial banks lower leverage ratios, medium and small banks' lending capacity will also be constrained. As the medium and small banks mainly serve the SME sector, the SMEs will be further affected.

So while the PBoC has shown it is trying to pull on the reins with its reluctance to intervene, it also has to walk the tightrope between market discipline and over-tightening. If liquidity is too tightly rationed, banks may need to deleverage and will be unwilling to offer funds into inter-bank markets, exacerbating already sparse liquidity conditions. In this case, while the central bank has emphasised that it will definitely prevent a systemic crisis from taking place via a series of instruments, this risk would remain if the PBoC cannot strike the correct balance between disciplining the financial sector and maintaining market stability.

REBALANCING TO CONSUMER-LED GROWTH

Chinese policy makers widely acknowledge that rebalancing to more consumer-led growth is required. However, as New Zealand knows, re-orienting one's economy is tricky. In our case, we need to do the opposite – something that is generally true of the Western world. But re-orienting in the opposite direction is no easier. **Much of the required rebalancing in China involves tough political decisions and overcoming structural challenges, such as an ageing population.**

The flipside of "too little" consumption is households' high saving rate compared with other countries. In rural regions this has been steady, but in urban areas it has climbed from 20 percent of disposable income in the early 2000's to sit above 30 percent today. There are a range of explanations that tend to be cited:

1. Lack of a social safety net.
2. Limited health and education services.
3. Limited unemployment benefits.
4. Underdeveloped capital markets and consumer finance.

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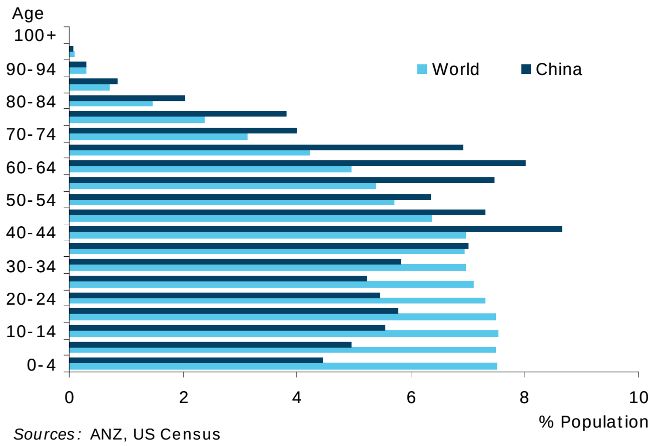
5. *Hukou*, a household registration system that prevents workers from becoming fully entitled residents in the regions to which they have migrated to work.
6. Limited property rights.
7. High social security contributions.

While policy makers can adjust these, and are making a number of tweaks, there are also structural reasons for households' high saving rate. These include demographics, such as an ageing population and imbalanced male:female ratio. Many countries that have an ageing population naturally save more and spend less, i.e. Germany and Japan. In China 1 in 3 people are expected to be of retirement age by 2050, compared with 1 in 9 currently; hence many are saving for retirement. The imbalanced male:female ratio from the one child policy means males often need stable financial credentials (i.e. high savings, own a house etc) to stand out in a tough marriage market.

China vs World Demographics in 2030



Sources: ANZ, US Census

Another often-cited reason for low private consumption is labour's low share of the economy's income, as well as labour laws. In fact while household's disposable income as a proportion of GDP increased in 2012, it was the first time since 2002 and follows a decline from 83 to 62 percent over this period. This is a function of the SOEs' and exporting companies' influence and place within the economy, as well as controls on capital markets. A traditionally weak currency has been used to boost exporters' and SOEs' earnings, but has reduced the purchasing power of households by making imports more expensive than otherwise.

Ultimately, as many of the required policy changes to engineer more consumer spending entail politically tough decisions, such as labour law reform, it is not going to happen overnight.

Reform also needs to walk the tight-rope between maintaining a certain level of economic momentum, while transitioning to a mix that is more balanced and durable.

WHAT MATTERS

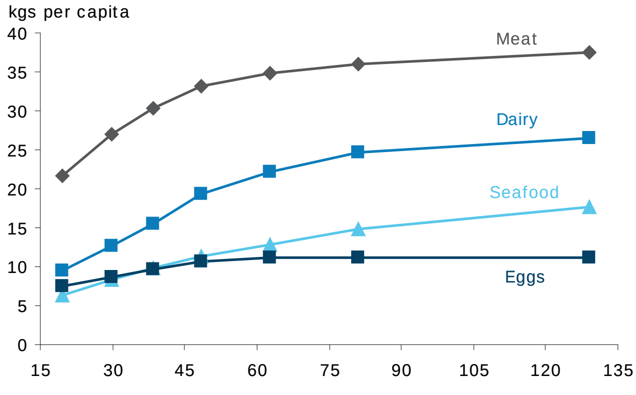
Given the size of exposure of all New Zealand's primary sectors to China, the prospect of a hard landing, a financial crisis, and / or a long period of low growth is a scary thought (though low growth in China is a rate most countries can only dream about). What really matters though is:

1. **How Chinese households fare through such a period.**
2. **The chosen business strategies, as well as execution of them within the marketplace.**

Critical for the primary sector is how Chinese household incomes fare. Even if headline growth does slow because investment growth slows, or there is an adverse feed-loop from jitters in the financial markets back into the real economy, as long as household incomes hold up, demand for New Zealand's primary goods should too. Any reforms that are aimed at boosting consumer spending and wages are positive for demand and in-market prices.

What ultimately matters though is how individual NZ companies and sectors are responding and executing on the opportunities in China. As we have mentioned in previous *Agri Focus* articles, such as our December 2012 article on the Modernisation of China's food industry, China is now the world's largest food and beverage market.

Annual per capita purchases of livestock products, by income level



Sources: ANZ, China National Household Survey

New Zealand's slice of the pie is in accessing the wealthiest 30 percent of urban households. Their incomes have reached a level such that

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overall consumption intake has stabilised, but they spend as much as five times more than those in the lowest-income brackets on New Zealand-oriented products such as dairy, seafood, and meat. Much of the spending reflects higher per-unit spending in the search for quality due to food safety concerns, but there is an increasing presence of processed and packaged products in their shopping baskets.

Our study also showed that the three most attractive regions for New Zealand's primary exports are Shanghai, Tianjin and Beijing, which have a combined population of 57.3 million. Most estimates are that New Zealand could feed between 40 and 80 million people. So potentially these three regions (4.2% of China's total population) could take New Zealand's entire production.

So we reckon it doesn't matter so much what headline growth in China is, but more how the wealthiest 30 percent of households are faring and what New Zealand businesses are doing to capture their patronage. Don't get us wrong – any adverse fallout in China will have consequences, notably to our largest trading partner Australia. We're simply backing secular aspects to the story to provide some durability and longevity to the story. Ups and downs will invariably need to be worked around. Moreover, we sometimes become too fixated with China itself that we often overlook that the agri story is far broader than China alone. Think India, Indonesia, Mexico and the provision of agri related services in South America too.

Lessons from those who have gone before have shown that essential elements for success include:

- Strong business relationships built up over time and based on mutual trust.
- An intimate knowledge of a targeted market segment.
- Cultural understanding of tastes and business practices.
- Local staff or collaborators.
- Some scale, as everything is super-sized compared with New Zealand, and therefore collaboration will often be required within a sector.
- Patience, with a long-term view because of the time and cost of becoming truly established.

Map of China's regional rankings for most attractive NZ food and beverage export destinations

THE MONTH IN REVIEW

ASSESSMENT

The brakes came on pasture growth in the late-June to mid-July period as wintry conditions took hold. Before this, pasture covers had recovered strongly in many drought-affected regions. A strong start to this season's milk production is expected. Sheep and beef farmers won't be so lucky, with drought effects to drag on production this season.

The end of autumn and start of winter generally featured above-average soil temperatures and reasonable moisture. This allowed a stronger-than-anticipated recovery in pasture covers in most drought-affected regions and fuelled good growth of winter feed crops. This alleviated earlier concerns about the late planting and low yields of winter feed crops in some regions.

As winter has progressed there have been several isolated storms and wet and cold snaps. The wet and cold snaps delivered heavy snowfall to many high-altitude areas and torrential rainfall elsewhere. The isolated storms caused some damage, especially the areas that experienced high winds. However, in general the events were well forecast, allowing farmers sufficient time to move stock and equipment to safety, limiting animal stress/losses and property damage. Stock in high-altitude areas that could not be moved prior to the snowfall were subsequently rescued over the next couple of days. **The colder weather, associated drop in soil temperatures, and waterlogged pastures – especially in the South Island – put the brakes on pasture growth in the late-June to mid-July period.** Combined with higher animal intakes this has seen winter feed crops being worked through more quickly and imported feed demand increase.

DAIRY

Total NZ milk production finished the 2012-13 season back 1.6 percent y/y at 1.657 billion kg MS. It was a season of two halves. The first eight months of the season saw production growth of 6.5 percent versus the same period the year before. When the drought hit, production came to a screaming halt, dropping by 18.5 percent y/y over the last four months of the season. The stark contrast in milk production numbers between the two islands highlights the impact of the dry conditions. Overall milk production in the North Island finished back 7 percent y/y, whereas South Island production increased by 7 percent y/y.

Expectations are building of a strong start to the 2013-14 milk production season. The general feeling is that dairy farmers have managed to navigate the summer dry conditions better than past droughts. The first half of winter allowed a much quicker-than-anticipated recovery in pasture covers. A higher payout forecast allows for the use of more imported feed, and cows are reported to be in good condition, especially those that had a longer than normal break from milking. **We believe milk production has scope to grow by 3-6 percent in 2013-14 if climatic conditions are around normal.** Despite an increase in the cull cow slaughter of 30 percent over the past year, extra heifers and 80 or so new dairy conversions coming online this spring are expected to lead to a slight increase in the number of cows milked. If average yields per cow return to slightly above trend (345 kgs MS) at 350-360 kgs MS, then production growth of 3-6 percent is achievable.

MEAT AND FIBRE

Lambing has just begun for some farmers, with an estimated 2 percent of the flock having given birth. All the discussion in the meat industry is on restructuring and the potential size of the 2013-14 lamb crop. As the dry conditions have broken, mutton slaughter has remained stronger than expected. It is currently tracking around 22 percent above last year. This implies an extra 500-600k fewer breeding ewes at the beginning of lambing. While the vast majority of the decline has been in drought-affected regions, South Island slaughter has also lifted as dairy expansion continues. Scanning results have been mixed, with drought-affected regions reporting declines ranging from 5-30 percent y/y. In general, flocks with high genetic fertility and farmers who were proactive in managing the dry conditions – i.e. destocked early and fed supplement prior to tupping – have fared better.

However, combining this evidence with fewer ewe hoggets being mated, **suggests the 2013-14 lamb crop could be at least 2 to 2.5 million head (or 8 to 10 percent) down versus last year. Such a result would mean lamb production in 2013-14 has a high likelihood of being well below the recent low of 18.9 million in 2010-11.** Of course the weather during lambing and the remainder of the season will have a large influence on the size of the final lamb crop (lamb survivability) and average weights achieved during the season.

HORTICULTURE AND VITICULTURE

The national average Sauvignon Blanc yield was 13.1 t/ha, which was just slightly below the 2011 record of 13.4 t/ha. **This led to a 26 percent y/y increase in the total Sauvignon Blanc grape crop to 228,800 tonnes.** The other white varieties also posted very high yields, which lead to a substantial y/y increase in the volume of Chardonnay, Riesling and Pinot Gris. Pinot Noir yields were 6.6 t/ha leading to a 36 percent y/y increase in volumes.

RURAL PROPERTY MARKET

SUMMARY

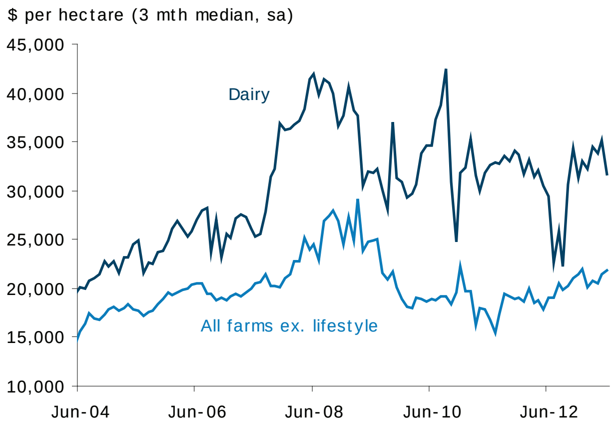
The rural property market seems to have bucked the normal seasonal slowdown and drought effects. Both turnover and average prices across the main farm types have remained unusually robust this winter. High turnover was fuelled by strong sale volumes in the upper North Island regions, which were some of the worst affected by the 2012-13 drought. Elsewhere, turnover was flat to slightly lower in the bottom of both the North and South Islands. Improved prospects for farm incomes (especially dairy), historically low interest rates, a competitive lending environment, and strong competition for a limited number of properties are expected to result in continued buoyancy this spring. Whilst welcome, some emerging evidence of pre-2008 financial crisis behaviours is not.

The absence of the normal seasonal slowdown in recent months, and the confidence brought by a higher dairy payout forecast, suggest activity levels for dairy-aligned pastoral properties could be very buoyant this coming spring. Anecdotal evidence continues to point toward a shortage of properties to meet demand, with farms for sale attracting strong interest and multiple offers as competition rises. However, the reported lack of listings could hold the spring market back, and we could struggle to see monthly turnover move above 80-90 percent of the 10-year average. If a continued shortage persists then higher prices will be needed to attract additional properties to the market. Add in low interest rates, investor fund interest, and a competitive lending environment, and things could really start to heat up as summer arrives. Moreover, in some of the recent activity that has taken place we have started to see evidence of pre-financial crisis behaviours (chasing capital gain etc) emerge. Such dynamics may ultimately draw the ire of the RBNZ who have warned about debt levels in previous financial stability reviews. Therefore, they will be closely watching developments as the dairy payout hits wallets.

FARM SALES BY FARM TYPE

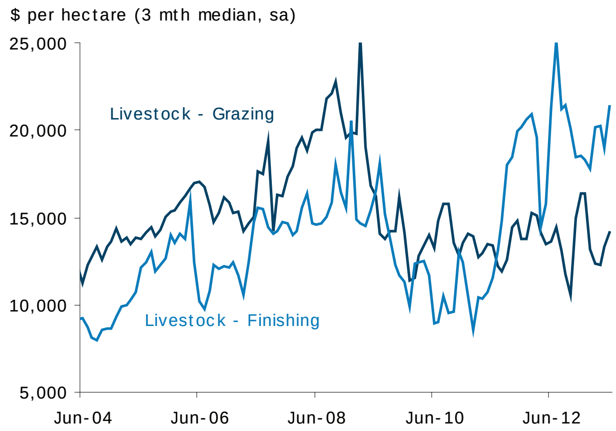
3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	54	60	37	74	↓	↑	↓
	Median Price ($ per ha)	31,700	35,100	29,500	29,200	↓	↑	↑
Livestock – Finishing	Number of Sales	66	75	58	64	↓	↑	↑
	Median Price ($ per ha)	21,400	18,900	21,300	13,500	↑	↑	↑
Livestock – Grazing	Number of Sales	187	176	169	232	↑	↑	↓
	Median Price ($ per ha)	14,200	13,400	14,000	14,900	↑	↑	↓
Horticulture	Number of Sales	34	30	26	50	↑	↑	↓
	Median Price ($ per ha)	120,000	127,900	129,600	146,600	↓	↓	↓
Arable	Number of Sales	18	17	10	19	↑	↑	↓
	Median Price ($ per ha)	30,600	31,700	24,700	25,600	↓	↑	↑
All Farms ex. Lifestyle	Number of Sales	382	379	326	474	↑	↑	↓
	Median Price ($ per ha)	21,900	21,500	19,100	19,700	↑	↑	↑
Lifestyle	Number of Sales	1,659	1,657	1,415	1,608	↑	↑	↑
	Median Price	496,000	499,000	469,000	409,000	↓	↑	↑

Farm Sales, Median Price



Sources: ANZ, REINZ

Farm Sales, Median Price

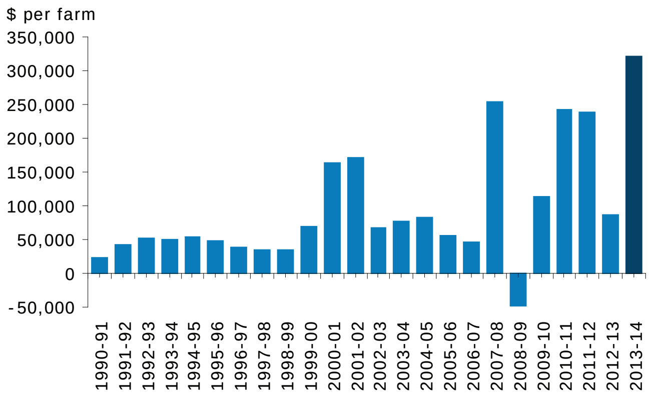


Sources: ANZ, REINZ

RURAL PROPERTY MARKET

All the talk is how the high dairy payout forecast will drive activity in the rural property market this spring. The market is notorious for activity and pricing following a one-year ahead outlook for incomes. The current forecast milk price of $7.5 plus extras certainly makes budgets for 2013-14 look very rosy.

Average dairy farm profitability before tax



Sources: ANZ, Dairy NZ

While the last financial year won't be remembered as stellar, the new season could well be – if Mother Nature is kind and farmers maintain disciplined expenditure. The chart above shows that if milk volumes lift back to trend, and farm expenditure is held at levels close to 2012-13, then the average profit before tax for a dairy farmer could be a record $393,300, or $2,790 per hectare. While expenditure is likely to lift and interest bills will be higher – taking some of the cream off the top – they would have to lift substantially for it not to be a new record for take-home farm incomes.

How much might find its way back into the rural property market and general economy is still debatable though. Drought-affected farmers need a good year to rebuild cash reserves and resilience into their business (i.e. replenish feed stocks). The latest Dairy NZ survey data for 2011-12 shows an average dairy farm now has a loan-to-value ratio (LVR) sitting around the 45 percent mark. This, combined with rising interest rates in 2014, could start to see some accelerated debt repayment from those with LVRs toward the higher end of the spectrum. Other uncertainties also remain, such as:

1. **Increasing environmental compliance standards** from the Sustainable Dairying Accord. These will no doubt see more capital expenditure in the areas where standards are being lifted.
2. **Fonterra shares remain stubbornly expensive**, which will reduce appetites to pay higher property prices. Since the introduction of TAF late last year nearly $2,000-2,500 per hectare of additional capital is required to become fully shared.
3. **Farmers are also looking to build more resilience into their business** (e.g. capital expenditure to mitigate against cost of production rises) to cope with the forecast continued ups and downs of international dairy prices.

Still-strong demand from investor funds (both foreign and domestic) and those with strong balance sheets, combined with historically low interest rates, a shortage of suitable properties, and competitive lending environment **are likely to see modest upward price pressure emerge on any dairy-aligned property.**

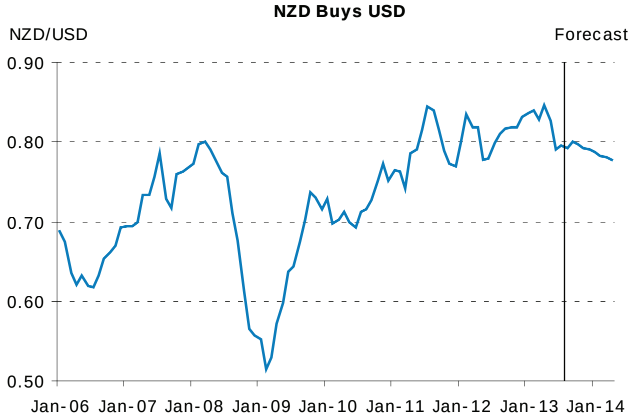
Examining the backward-looking indicators for the rural property market on page 11 shows the turnover of dairy properties was solid in May and June. **In the month of May, 19 dairy farms were sold, at an average sale value of $34,930/ha, or $35 per kg MS.** The average farm size was 95 hectares and the average production/ha was 995 kgs of MS. **In the month of June, 17 dairy farms were sold with an average sale price of $19,630/ha, or $27 per kg MS.** The average farm size was 170 hectares and the average production/ha was 729 kgs of MS.

Finishing land prices have continued to oscillate around the $20,000/ha mark over the last two months. **This supports our observation that prices have settled into a range of $18,000-$20,000/ha, with volatility outside this range driven by the monthly mix of sales.** Activity levels were the strongest in the lower half of the South Island and Waikato. **The number of sales of both grazing and arable land also picked up over the same period.** Average arable prices held above the $30,000/ha mark extending a trend evident since early 2013. However, on closer inspection the average sale price in the Waikato in recent months has been extremely high, perhaps artificially lifting this trend. **Grazing land prices improved from their lows earlier in the year.**

In the horticultural scene interest in green kiwifruit orchards has continued to pick up, with confidence improving as Psa has been less prevalent. Prior to the end of last year there were limited sales, and those who did sell averaged $90-$110k/canopy ha. In recent months there has been a larger number of green orchard sales ranging from $130-$160k/canopy ha. **The viticulture land market has also been fairly strong with a number of sales at $180-$200k/ha in prime areas.** This was driven by wineries looking to expand their production base. However, the large vintage this season has seen the market take a recent breathier as potential buyers wait to assess whether export demand is robust enough to ensure no excessive surplus emerges.

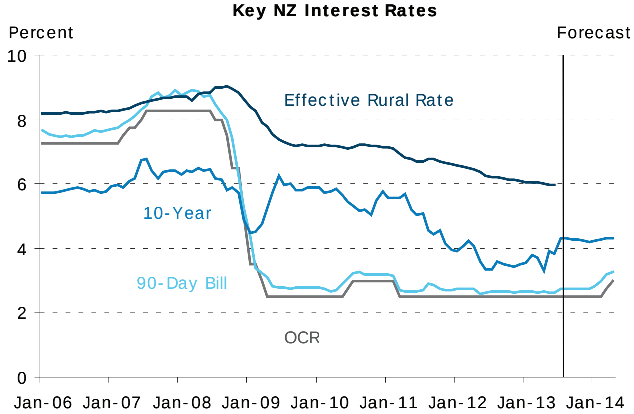
ECONOMIC INDICATORS

EXCHANGE RATES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZD/USD	0.80	0.79	0.80	↑	↓
NZD/EUR	0.61	0.60	0.65	↑	↓
NZD/GBP	0.52	0.51	0.51	↑	↑
NZD/AUD	0.86	0.84	0.78	↑	↑
NZD/JPY	79.1	77.1	63.1	↑	↑
NZD/TWI	74.5	73.4	72.9	↑	↑



Sources: ANZ, Bloomberg

NZ INTEREST RATES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Official Cash Rate	2.50	2.50	2.50	↔	↔
90 Day Bill Rate	2.64	2.65	2.59	↓	↑
1 yr	2.76	2.48	2.33	↑	↑
2 yr	2.87	2.48	2.37	↑	↑
3 yr	3.10	2.54	2.42	↑	↑
5 yr	3.37	2.69	2.84	↑	↑
10 yr	3.93	3.32	3.57	↑	↑
Effective Rural Rate	5.95	5.98	6.25	↓	↓
Agricultural Debt ($b)	50.59	50.16	47.48	↑	↑



Sources: ANZ, RBNZ

NZD/USD is back on the front foot again, having experienced a significant rebound off early July's low at around 0.77. Once again the culprit has been shifting monetary policy expectations. **But whereas expectations that the Federal Reserve's QE program was on borrowed time saw the NZD get toppled in May (as the USD strengthened), in the past few weeks the fear has been that QE won't be pared back as quickly as first thought. Add to that mildly hawkish overtones from the RBNZ, and you have a recipe for a stronger NZD.** Backward-looking as this assessment is, it's a useful discussion to have, as in our view it adds weight to the NZD's recovery, with the obvious implication being that the move won't be fleeting.

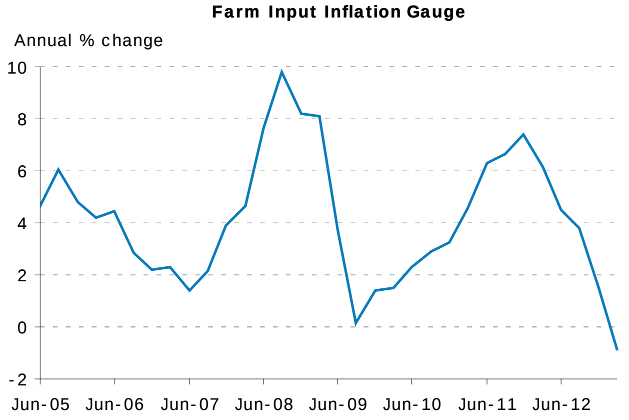
Looking ahead, the NZD is vulnerable to stronger US data, and to renewed talk of Fed QE "tapering". However we prefer to view the market as having corrected off oversold lows, and as we look to the traditional period of low volatility that normally accompanies the Northern Hemisphere summer, we expect the so-called "carry" currencies to be well supported.

NZD/AUD has been a particularly strong performer. While moves in this cross are also well justified by the shifting relative economic fortunes and relative interest rates between the two countries, this cross is now technically overbought. Exporters are already having a tough time in Australia, and a higher cross won't help the situation. As such, we see scope for this cross to correct somewhat in coming weeks.

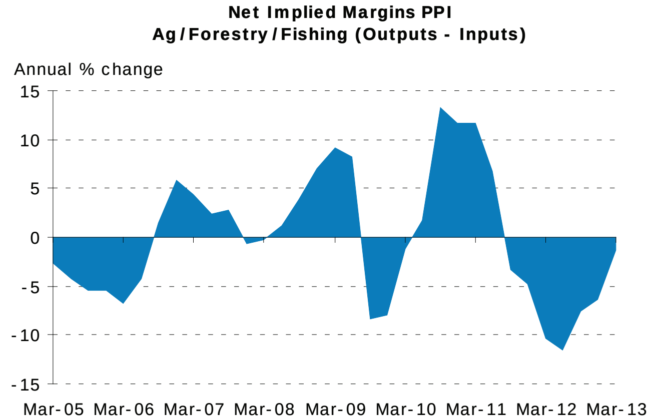
Interest rates have also notched higher, led by the long end of the curve. We see scope for some consolidation in the near term as the market prices out relatively aggressive expectations for rate hikes. Our forecasts have the OCR moving up by 50bps each year for the next 3 years, whereas markets are pricing this in over the next 2 years. However, it is clear that the low for rates is in for the cycle, and any correction lower should be seen as exactly that. Indeed, in a trend sense, we expect rates to continue trending gradually higher over time.

ECONOMIC INDICATORS

INFLATION GAUGES					
Annual % change	Current Qtr	Last Qtr	Last Year	Chg. Q/Q	Chg. Y/Y
Consumer Price Index	0.9	0.9	1.6	↓	↓
Farm Input	-0.8	1.5	6.1	↓	↓
Net Imp. Margins PPI	-1.4	-6.4	-10.3	↑	↑



Sources: ANZ, Statistics NZ



Sources: ANZ, Statistics NZ

On-farm inflation pressures have been at a low ebb lately, but this could be all about to change. **The high dairy payout forecast is raising the prospect of pricing pressures emerging for a number of key inputs.** Recently livestock, land values, and feed prices have begun to show some signs of life, potentially a bellwether of things to come. While these are focused on the productive side of the business, how price pressures evolve for the other fixed costs within dairying businesses will be crucial to bottom-lines in 2013-14 and beyond. **In past years a higher dairy payout has seen greater cost pressures, reducing margins. The two other years with a dairy payout above $7 per MS have led to pricing pressure above 5 percent for total farm inputs. The pressure also flowed into the following season, even when the payouts were lower.** While a certain component of farm expenditure is flexible, looking back, upward adjustments have occurred quickly and have not been easily unwound subsequently. We believe there is a danger a similar situation will emerge over the next 12 months, which could reduce profitability this year and next if not well managed.

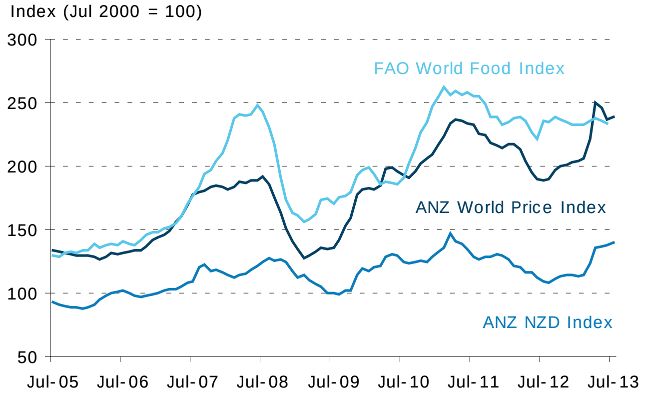
With a volatile milk price forecast to continue, it is important that expenditure and this year's profit is directed to the parts of the business that build financial resilience to such changes and/or boost productivity. In essence this is future-proofing for a year with a lower payout, but also ensuring the opportunities of a higher payout year can be captured. **For the other primary sectors there is a real danger the cost pressures from the dairying sector will spill over into their sectors, as generally the different sectors' costs of inputs move in tandem.**

Quarterly PPI margins improved in March for the second quarter in a row as soft commodity prices continued to improve and cost pressures remained subdued. All sectors except the sheep and beef sector showed an improvement. The largest increase was for horticulture and fruit growing, followed by dairy. This led to the annual decline in aggregate PPI margins slowing from -6.4 percent to -1.4 percent. Overall, the index is now 12 percent below its 2011 March quarter peak. **Within sectors, horticulture and fruit growing benefited from improving output prices for wine, kiwifruit and apples. In the dairy sector it was a similar story, with the improvement in international dairy product prices leading to a quarterly increase of 5 percent.** However, on a yearly basis, dairying is still back 9 percent. **In the sheep and beef sector a 7.8 percent drop in output prices drove a 4 percent q/q decline in net margins.**

KEY COMMODITIES: OVERALL INDEX AND DAIRY

ANZ COMMODITY INDEX	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
ANZ NZ Index	140	138	109	↑	↑
ANZ World Index	239	236	189	↑	↑
FAO World Food Index	233	235	221	↓	↑

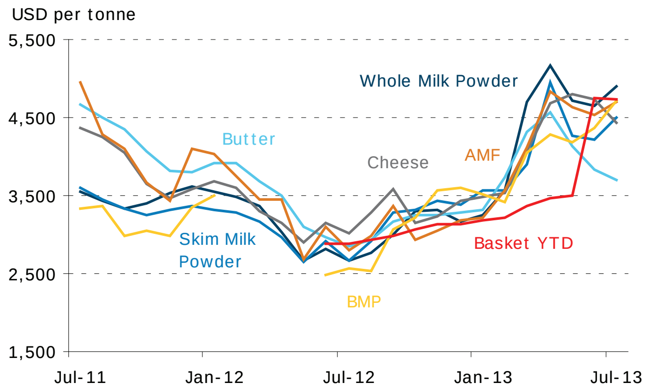
Soft Commodity Price Indices



Sources: ANZ, FAO

OCEANIA DAIRY PRICE INDICATORS USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Whole Milk Powder	4,907	4,656	2,672	↑	↑
Skim Milk Powder	4,503	4,224	2,663	↑	↑
Butter	3,700	3,834	2,850	↓	↑
Anhydrous Milk Fat	4,693	4,533	2,795	↑	↑
Butter Milk Powder	4,718	4,363	2,573	↑	↑
Cheese	4,435	4,727	3,023	↓	↑
Basket YTD	4,726	4,744	2,890	↓	↑
Milk Price YTD ($ per MS)	8.20	8.10	5.10	↑	↑

Dairy Products - NZ Export Market Prices



Sources: ANZ, GlobalDairyTrade, USDA

In-market prices for NZ's main soft commodities have slipped by 4.5 percent since April, but remain at historically high levels. However, the big talking point since our last update has been the re-rating of the NZD/USD into a lower range. So despite in-market prices slipping since April, aggregate farm-gate returns have risen by nearly 3 percent over the same period.

International soft commodity prices as measured by the FAO index have come under increased pressure recently. **The weather risk premium priced into global grain markets is being unwound as the prospect of some large Northern Hemisphere crops is becoming reality. For NZ's main soft commodities this will provide some downward pressure on in-market prices through two channels.** One will be an improvement in the price competitiveness of substitute products, i.e. soy for dairy. The other will be an improvement in margins for livestock producers (dairy, beef and other meat proteins, for example) that use feed-based systems. This will boost yields, production, and exports in 2014.

Dairy farmers seem to have won the quinella of a slightly lower NZD and international dairy prices stabilising at very high levels. **While it's still early in the season, this is raising the prospect the farm-gate milk price could finish at an all-time high – our current forecast is $7.40 per MS.**

In short, milk supply across the globe is more expensive to produce these days and is struggling to keep pace with demand, so higher prices are required. This has particularly been the case for powders and protein products. The drought in NZ and Australia's main exporting region was the straw that broke the camel's back, and now an empty pipeline means inventories need to be replenished. **While a supply response is expected to build, especially in 2014, the replenishment of the pipeline is expected to support prices at elevated levels until later this year.** While some buyers have shied away from purchases at current price levels, strong demand from Asia continues. In fact, total dairy exports to the region have grown by 24 percent over the last 12 months, compared with 9 percent elsewhere. However, most of the increase has been directed to China, which accounted for 87 percent of the growth in Asian sales. Milk powder and whey products accounted for 98 percent of the growth to China. Higher fat content product sales also increased, but at a more modest pace. **The two key countries to watch for a supply response will be NZ and the US.** Lower feed prices are expected to support milk growth in the US during 2014. US stocks of butter and cheese have built up to high levels, also placing pressure on global prices, as this extra product is being offered at lower prices than many other sources.

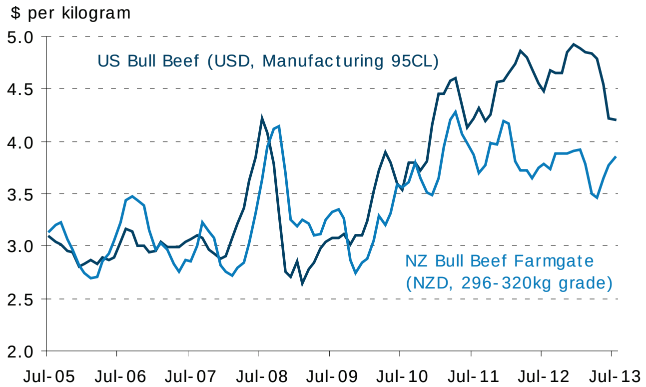
KEY COMMODITIES: BEEF AND LAMB

BEEF PRICE INDICATORS					
$ per kg	**Current Month**	**Last Month**	**Last Year**	**Chg. M/M**	**Chg. Y/Y**
US Bull Beef[1]	4.20	4.22	4.48	↓	↓
NZ Bull Beef[2]	3.85	3.78	3.79	↑	↑
NZ Steer[2]	4.00	3.88	3.84	↑	↑
NZ Heifer[2]	3.39	3.29	3.25	↑	↑

[1] USD, Manufacturing 95CL

[2] NZD, 296-320kg Grade Bull & Steer, NZD, 195-220kg Grade Heifer

Beef Indicator Prices

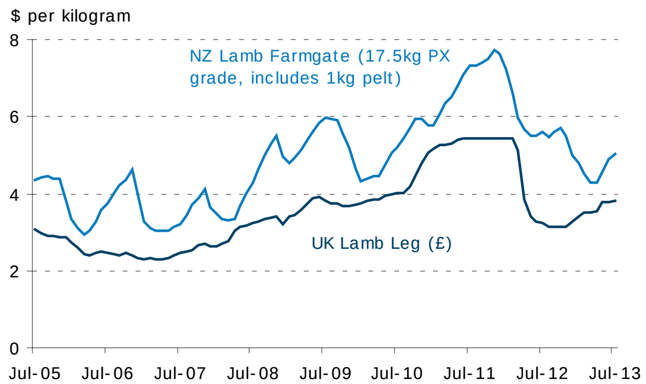


Sources: ANZ, Agrifax

LAMB PRICE INDICATORS					
$ per kg	**Current Month**	**Last Month**	**Last Year**	**Chg. M/M**	**Chg. Y/Y**
NZ Lamb[1] (NZD)	5.04	4.88	5.59	↑	↓
UK Lamb Leg (£)	3.83	3.79	3.23	↑	↑

[1] 17.5kg PX grade, including 1kg pelt

Lamb Indicator Prices



Sources: ANZ, Agrifax

There has been a dramatic fall in US manufacturing beef prices in recent months. The trigger seems to have been a surge of supply from NZ and Australia between March and June, combined with a higher-than-expected US cow slaughter.

Australia shipped the most beef ever in a single month in June, totalling over 100,000 tonnes for the first time. There is little sign of throughput slowing in the short term, with meat-processing companies reported to be heavily booked into August. There has not been an increase in shipments to the US, but this has put pressure on every NZ beef market, particularly those in Asia. Within the US, cow slaughter has been running 7.5 percent ahead y/y for the first five months of 2013. This has largely been due to continued dry conditions in the larger cow-calf states. High grain prices have also been influential and resulted in more weight being added to finishing stock outside feedlots. As grain/feed prices reduce from a better growing season in the Midwest, profitability is forecast to improve and should result in lower supplies as we enter 2014. Many quick service restaurants have also focused their promotions on chicken products this year due to the expectation of high beef prices. However, the price of chicken has gone up considerably in recent months, which may bring an increase in interest in beef products.

NZ farm-gate prices initially responded to the drop in in-market prices. However, the slower supply of prime cattle in June as pasture conditions improved, the passing of the peak of the cull cow slaughter, and the NZD remaining at a lower level, have helped improve returns.

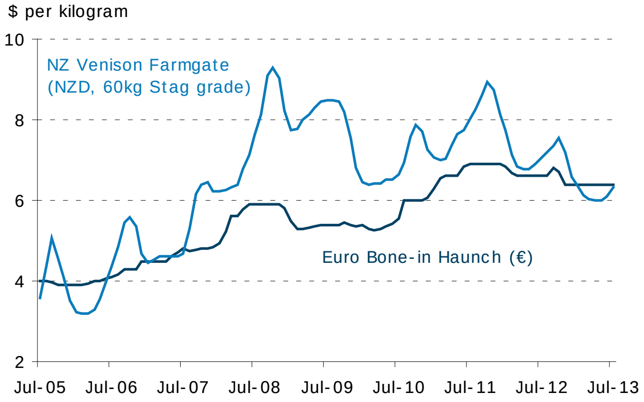
We have increased our forecast 2013-14 season average lamb price to $100 per head for a 17.5 kg carcass. In addition to the reasons we have provided before for a rising lamb schedule, supply now looks like it will be tighter than first expected across the major producers, and the NZD now appears to have peaked. The seasonal lift in schedule prices has not been quite as strong as expected so far though. In part it seems the hold-ups of meat at the ports in China and then subsequent release of product has taken some time for importers and consumers to work through, reducing demand. Throughput has also been higher than expected reducing procurement premiums paid by processors. During June total throughput was actually up 1 percent y/y. The charge was led by the North Island, probably reflecting that the East Coast and parts of the Central North Island had not fully recovered from the drought. Leg and forequarter demand remains good and that, coupled with limited supplies, continues to provide opportunities for NZ exporters to push prices higher. As has been the case for many months, demand for middle cuts is weak in comparison.

KEY COMMODITIES: VENISON AND WOOL

VENISON PRICE INDICATORS					
$ per kg	**Current Month**	**Last Month**	**Last Year**	**Chg. M/M**	**Chg. Y/Y**
NZ Venison[1]	6.33	6.10	7.07	↑	↓
Euro Bone-in Haunch (€)	6.40	6.40	6.60	↔	↓

[1] 60kg Stag AP grade

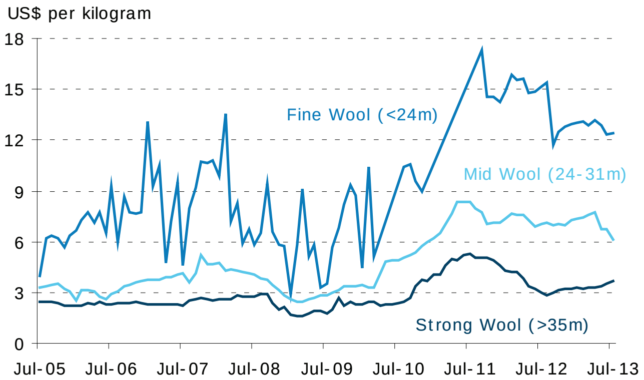
Venison Indicator Prices



Sources: ANZ, Agrifax

CLEAN WOOL INDICATOR PRICES					
$ per kg	**Current Month**	**Last Month**	**Last Year**	**Chg. M/M**	**Chg. Y/Y**
NZ Fine Wool (>24m)	15.58	15.58	19.05	↔	↓
NZ Mid Wool (24-31m)	7.73	8.56	8.85	↓	↓
NZ Strong Wool (>32m)	4.64	4.45	3.74	↑	↑
USD Fine Wool (>24m)	12.39	12.32	15.20	↑	↓
USD Mid Wool (24-31m)	6.15	6.77	7.06	↓	↓
USD Strong Wool (>32m)	3.69	3.52	2.98	↑	↑

Wool Indicator Prices (Clean)



Sources: ANZ, Beef + Lamb NZ, Wool Services International

In the last 12 months venison production has only increased by 2 percent, reflecting a stable breeding hind population in recent years. **However, over the drought-affected period of February to May, slaughter numbers increased by 6 percent y/y. This was led by a 15 percent increase in hind slaughter**, whereas stag throughput dropped 7 percent y/y over the same period. Most of the increase was driven out of the North Island (+36 percent), but there was also an increase in the South Island (+8 percent). It seems this could lower breeding hind numbers by 12,000 head in 2013-14, which would push total production down toward the 400,000 mark and near the low of 391,900 head in 2010-11. The contrast between the stag and hind numbers also suggests farmers lowered breeding hind numbers and perhaps held on to finishing stock during this period. This suggests there could still be a good supply of stags for the upcoming game season in Europe, especially in the South Island where total stag production was back 11 percent y/y over the drought-affected period.

In-market major European customers have been quiet until recently, as they've waited for the game season. **Over the last five years the schedule price has lifted by 11 percent on average between July and October. A similar lift is expected this year, with stable in-market prices and NZD. Lower hind throughput could see a slightly stronger lift.**

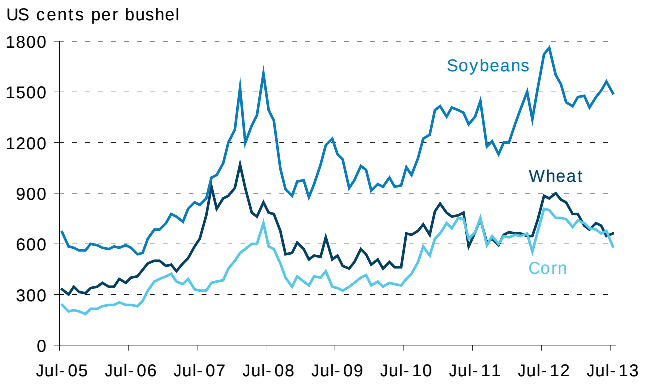
The 2012-13 season saw lower, but relatively stable, wool prices for most grades. The average strong wool price at auction was about 30 percent lower than the previous year. The number of bales sold at auction was down 1 percent y/y and pass-in rates were down 38 percent y/y. **More recently, auctions in the new season have seen better prices for strong micron wool, as some auctions have been cancelled** due to the colder weather in the South Island delaying shearing and causing wool that has been shorn to build-up. This has caused some demand to build up, and combined with the lower NZD, has lifted farm-gate returns. Solid demand from Asia, parts of Europe, and the Middle East have been behind the pent-up demand. **Despite auction volumes (by number of bales sold) being down slightly in 2012-13, total clean exports are up 15.3 percent y/y from July-12 to May-13.** Sales to North Asia have increased by 20.6 percent over this period. China continues to dominate with in the region, taking 52 percent of total NZ exports. Europe has also seen an increase, with exports up 12 percent y/y. Germany has been leading the charge (+30 percent), but there has also been some improvement from traditional buyers such as Italy and the UK. Tighter supply of crossbred wool from the major exporters, a slight pick-up in US demand for carpets, continued growth in domestic Chinese demand, and stable substitute fibre prices are expected to continue to support wool prices at higher levels than last year.

KEY COMMODITIES: GRAINS

GRAIN & OILSEED PRICE INDICATORS					
USD cents per bushel	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Wheat	6.5	6.5	8.9	↑	↓
Soy	14.9	15.6	17.2	↓	↓
Corn	5.9	6.8	8.1	↓	↓
Australian Hard Wheat[1]	370	376	348	↓	↑

[1] NZD per tonne

CBOT Future Grain & Oilseed Indicator Prices



Sources: ANZ, Bloomberg

Domestic feed wheat and barley prices have taken a breather lately after being pushed higher by dairy farmers for spring delivery. Demand is expected to remain buoyant from the dairy sector, fuelled by the high milk price, but most other buyers (feedmillers and other industries) have their short-term needs covered.

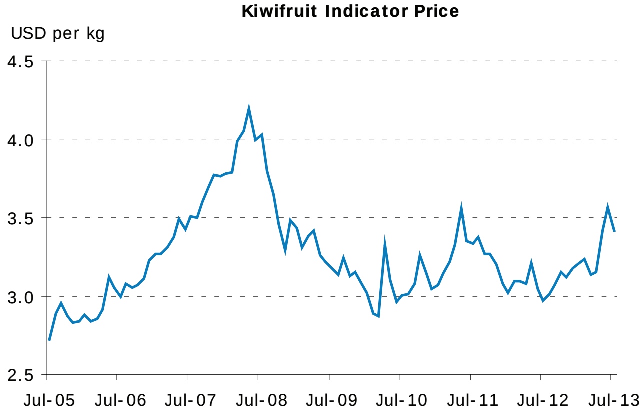
Most other buyers want to see what happens internationally before committing beyond the spring. US corn futures for the new season at the end of the year have tumbled to a 33-month low of US$4.85/bu recently as the USDA confirmed the planted area to be 94.7 million acres, the highest since 1936. This took the market by surprise, as many expected a drop in the planted area, because wet weather delayed planting. Combined with crop-growing conditions having been fairly good (running around the 10-year average) across the main states, this has reduced the weather risk premium priced into markets as the season has progressed.

Wheat prices have followed corn prices lower. The global supply of wheat is also expected to increase. European and Black Sea wheat crops are expected to rebound from last year's drought. The harvest currently underway in Russia is producing yields that are 20-30 percent ahead of last year's, for example. Australian wheat prices have followed global prices lower, but not quite to the same extent. Domestic feed requirements in drought-stricken areas have supported prices, and the drought is raising some concern about production in the coming season. **The prices for NZ and Australian feed wheat have been much closer this season, which usually results in more NZ grain being used in compound feed systems.** However, the recent rise in the NZD/AUD and lower in-market prices could support more imports, but in the shorter-term there will not be a large amount of supply available before the next harvest.

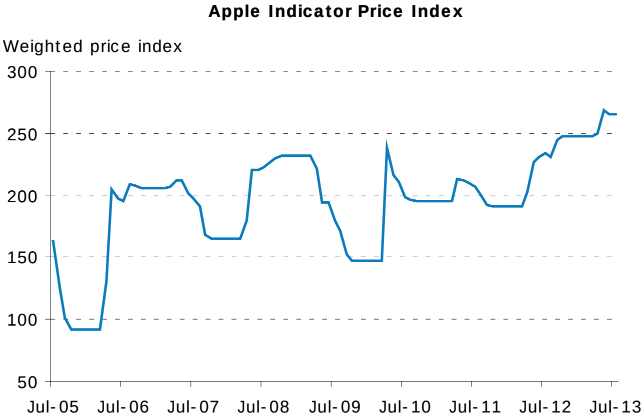
Palm kernel prices are not expected to drop from current levels before spring, despite nationwide stocks appearing to be adequate. Demand from the dairy sector is expected to remain robust, but delivery is also less assured as there has been a big push from the Ministry for Primary Industries to tighten the biosecurity requirements on all PKE imports. This includes all PKE imports from the 12th of August having to come from approved facilities. This could potentially result in higher compliance costs and price premiums being built into the cost of importing PKE into New Zealand.

KEY COMMODITIES: HORTICULTURE

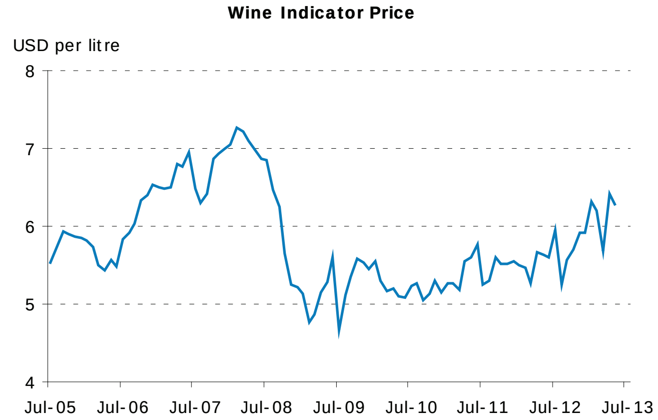
HORTICULTURE PRICE INDICATORS	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Kiwifruit (USD per kg)	3.4	3.6	3.0	↓	↑
Apples (Weighted Index)	265	265	234	↑	↑
Wine (USD per litre)	6.3	6.4	5.6	↓	↑



Sources: ANZ, Zentrale Markt- und Preisberichtstelle



Sources: ANZ, Zentrale Markt- und Preisberichtstelle



Sources: ANZ, NZ Winegrowers

The 2013 grape vintage came in at 345,000 tonnes, which was up 28 percent on last year and much higher than initial expectations. It was also 5 percent larger than the all-time record crop in 2011. It seems near-record yields were achieved for a number of varieties. The national average Sauvignon Blanc yield was 13.1 t/ha, which was slightly below the 2011 record of 13.4 t/ha. This led to a 26 percent y/y increase in the total Sauvignon Blanc grape crop (68 percent of the total national crop), to 228,800 tonnes. The higher yields seem to have been driven by a warm and calm flowering period for many regions in December 2012; a number of wineries easing restrictions on yield controls; and some areas of vineyards that were planted several years ago now having reached their full productive capacity.

The large 2013 vintage promises to provide the first surplus since 2009, depending on how exports perform. An anticipated 10 percent bounce-back in exports after the reduction this year would keep the surplus to just 4 million litres (2 percent of total annual sales). Within this, just a 5 percent lift in Sauvignon Blanc exports would lead to a slight supply deficit despite the 26 percent increase in the 2013 harvest. This is because the smaller crop in 2012 created an estimated supply deficit of 29 million litres in 2012-13 – despite year-to-date exports being back 5 percent on the same period last year. Unchanged export volumes would create a supply surplus of 5.4 million litres, or 3 percent of total annual sales. This shows the ability of current export volumes to soak up the extra supply from this year's harvest.

This year's kiwifruit crop is selling well. Despite the later harvest, over 50 percent of the crop has been shipped – well ahead of this time last year. **The good-tasting fruit from high dry matter levels is driving high repeat purchases despite a smaller size profile.** Consumer research has confirmed that higher levels of dry matter convert to sugars in the fruit and this is proven to increase both consumers' enjoyment of the fruit and their intention to purchase again.

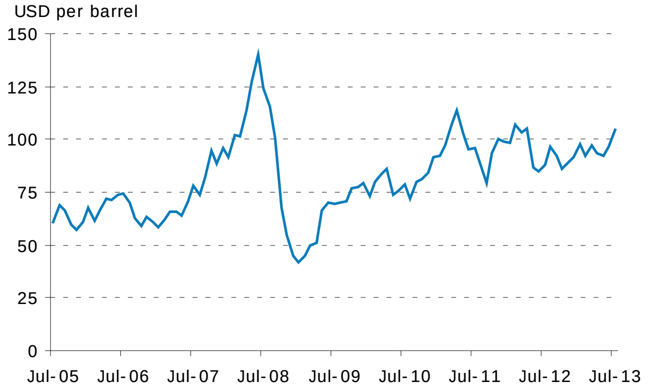
The record sunshine levels in New Zealand this summer have contributed to this record-tasting vintage crop. The Bay of Plenty region produced 81 percent of Zespri's New Zealand-grown kiwifruit last year and it had the highest sunlight levels on record in January, February and March this year. This corresponded to the lowest rainfall levels ever recorded, which has resulted in slightly smaller but great-tasting kiwifruit. **Combined with lower fruit loss from a short storage period this should be a boost for farm-gate returns.**

KEY COMMODITIES: OIL, FREIGHT AND FERTILISER

OTHER COST INDICATORS					
	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Crude Oil[1]	105	97	88	↑	↑
Ocean Freight[2]	1,082	1,171	897	↓	↑

[1] USD per barrel, grade WTI
[2] Baltic Dry Index

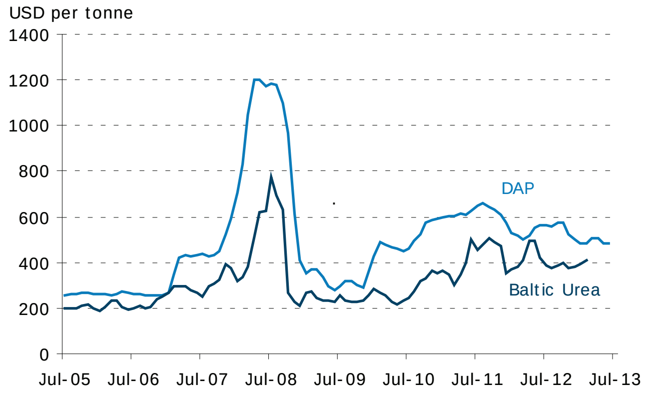
Crude Oil Indicator Price (WTI)



Sources: ANZ, Bloomberg

FERTILISER PRICE INDICATORS					
USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
DAP	478	485	564	↓	↓
Urea	321	344	420	↓	↓

Fertiliser Indicator Prices



Sources: ANZ, Bloomberg

Oil markets should hold up in the coming months. However, bouts of profit-taking could be apparent as oil prices become perceived as overvalued. Oil has held up much better than other commodities despite weaker Chinese growth and expectations of US Fed asset tapering. **We expect US oil markets to outperform Brent near-term.** While the two contracts tend to move in a similar direction, an uneven global economic recovery and divergent demand trends should continue to support a better-performing US crude market. We also expect market participants will continue to factor in declining US stocks as domestic transportation bottlenecks are alleviated. Supply shocks could also emerge from geopolitical risks in the Middle East, and the onset of the third quarter US hurricane season.

WTI has recently re-established a strong positive correlation with US equities, and a lift in earnings following recent improved US data flows should buoy the outlook for US oil consumption this year. Markets have been pencilling in easing transportation bottlenecks to the US Gulf Coast. The return of the Tulsa East refinery, the start of a new 250k bbls/day CDU at Whiting, and the start or ramp-ups of several new pipelines should occur near-term. As a result, inventories at Cushing should experience drawdowns. A more active hurricane season is also on the cards, and could prompt a tighter supply outlook.

Demand fundamentals look less favourable for Brent oil. The onset of slower seasonal demand in Q3 and a softer Chinese growth outlook could be a drag. North Sea production should return to normal following maintenance. Saudi Arabia also continues to raise production to maintain market share, which could offset some of the supply losses from rising Middle East tensions and tighter Russian supplies. **That said, rising geopolitical risk and associated potential regional supply shocks are expected to support both oil markets.**

Lower international fertiliser prices have recently started to flow through to the farm-gate in NZ. Both fertiliser companies have recently dropped their prices for diammonium phosphate (DAP) and Urea. Ravensdown lowered the price of urea by $55 a tonne to $660/t and DAP by the same amount to $865/t. Ballance reduced prices for six products, including a $75 drop in urea prices to $640/t, a $70 drop to $850/t for DAP, and a $13 drop to $335/t for superphosphate. **International prices are expected to remain under some pressure** from new supply continuing to come onboard in the US and elsewhere. China is also likely to boost exports in the near term as there are lower export taxes in Q3. In addition to more ample supply, a shorter planting window in the Northern Hemisphere reduced demand this growing season.

ECONOMIC BACKDROP

SUMMARY

The trajectory for the NZ economy looks reasonably assured. There is a lot of macroeconomic stimulus (such as a city rebuild and supportive financial conditions) in the pipeline and a high dairy payout adds additional impetus. We won't be knocking the ball out of the park – the national balance sheet is still weak and the NZD high – but look set for pretty solid growth. We're keeping an eye out for potential spoilers of course. While we can identify obvious candidates, including the outlook for our largest trading partner, we're still constructive on the NZ outlook.

OVERVIEW

The trajectory for the economy looks reasonably assured. Confidence is up – both in the consumer and business arena, financial conditions are still incredibly supportive, commodity prices are buoyant, the global scene is stable (for now), the housing market is strengthening, we're rebuilding our second-largest city, and we're faced with addressing a shortage of housing in our largest city. That's the nucleus of a pretty reasonable growth path.

The story is broader than this, with the platform for upturn and a pure expansion being laid by progress in the microeconomic arena over the past four years. New Zealand businesses have spent a long time becoming "fighting fit", recalibrating for a different economic climate. Our fabled period of "grumpy growth" has provided some benefit, namely prospects for rising productivity growth, which is the key to higher living standards and wages. You can see semblances of this in the rural sector too: the thirst for knowledge and innovation to push the productivity boundaries really stepped up over the past four years. Throw this together with leadership and credibility on the fiscal and government fronts and all of a sudden NZ's economic story is becoming more noticed. Once you get some critical mass, swing variables such as migration start to run in your favour. Positivity can spiral upwards, with success breeding success.

This doesn't stop us from looking for factors that could upset the apple cart.

It's hard to pinpoint anything local. In fact, two localised initiatives – a city rebuild and addressing housing shortages in our largest city – represent huge growth pipelines. They'll throw resource and capacity spanners into the works at some stage, but that'll be a sign that we're getting growth and higher wages, so we'll choose to see the glass as half full on that one. There is the obvious party pooper – monetary policy – though benign current inflation, better co-ordination between monetary and fiscal policy, microeconomic initiatives (e.g. steps targeted at the Auckland property market), a swathe of mortgages floating or fixed for less than a 6 month duration (meaning any OCR changes will quickly bite), and prudential policy tweaks mitigate the potential for heavy-handed monetary policy. The currency remains problematic, but less so than it has been though the NZD/AUD has moved up a lot. The Government is not spending a lot of money – that's a headwind – and we're still recovering from severe drought. But both are being dealt with.

It's the global scene we continue to ponder. NZ cannot divorce itself from what's happening abroad: witness the recent rapid rise in local wholesale interest rates – largely US-driven. The growth outlook for the US economy is looking more and more assured, implying we've probably seen the low for interest rates (though the foot is only being taken off the accelerator as opposed to applying the brakes). This leaves two key focal points.

- **Europe is still indebted and inflexible**, meaning it lacks the ability to re-orient itself and get growth – a critical condition for solvency. It's a potent mix: we'll see another wave of negativity emerge at some stage. This will impact commodity prices, credit costs, confidence *et al*.
- **Who is most vulnerable to higher interest rates in the US?** With an improving US economy comes rising interest rates. The level is still low but they've nonetheless moved up, and the risk-free safe haven asset (represented by US 10-year bonds) has now been re-priced (downwards in price; upward in yields). It is the bellwether for assets across the board: if the "risk-free" asset goes down, others must follow. Nations that have seen high rates of credit growth during the period of quantitative easing will be focal points of vulnerability, along with heavily indebted sovereigns who are seeing nominal yields rise. Among others, the finger is being pointed at China's large and opaque shadow banking sector. China is our second-largest trading partner, and the largest trading partner of our largest trading partner, Australia.

The conventional wisdom is that if Australia catches the flu, we'll get a cold. The reasoning seems simple enough: Australia is our largest trading partner. They account for 21 percent of New Zealand's good exports and 32 percent of our services (primarily tourism) exports. **But the evidence for this received wisdom is not, in fact, overwhelming in recent times.** The two economies have diverged on the growth stakes – largely via NZ underperforming. The reverse is possible too.

So net on net, NZ's growth trajectory looks reasonably assured, though not without risk. We're not talking a huge economic upswing, but certainly relative to global peers we're looking like a rock-star. **Unfortunately that'll be a factor keeping the NZD in an elevated trading range.**

BORROWING STRATEGY

SUMMARY

Indicative rural fixed lending rates have moved up for most terms since our last edition, with larger moves for longer terms. By contrast, the floating rate has not changed, reflecting an on-hold OCR. While the mild move up in fixed rates partly validates earlier calls to fix for longer terms, even after the rise, term rates are still low by historic comparison. We still see some value in adding to fixed cover, but the recent rise in rates has taken away some of the allure of fixing. As term rates ratchet higher, more caution is thus required. Indeed, given our long-held view that the OCR will rise only gradually, fixing is no panacea. It does offer certainty, but it is more expensive!

OUR VIEW

While the floating rate has not changed, the steady rise in global long-term interest rates has pushed indicative rural lending rates higher, led by the long end. For example, the 2 year rate is up 0.2 percent, while the 5 year rate is up by twice as much, around 0.4 percent. As a consequence, it now costs more to fix.

While at face value, the rise in rates and "steepening" of the term curve partly validates our earlier calls for those with a hankering for certainty **to fix for longer terms**, there is no guarantee that fixing will prove to be the most cost-effective choice over the long term, even for those who have already fixed. As has always been the case, it is the path of the OCR that will ultimately determine the effectiveness of fixing.

With rates on the move, this begs the question: is it still worth fixing? In what follows, we find that on balance, it probably still is. However, as rates inch higher, it will become increasingly less attractive. We also reiterate what has been a catch-cry for us – that fixing is no panacea. While it does protect against a change in rates, it does cost more, and everyone will place a different value on certainty.

We now return to the question whether it is still worth fixing. We prefer to answer the question in a two-step process, asking first if rates have scope to fall again. If there is, then there is an argument to hold off. However, if there is not, we then ask, how quickly might rates rise? After all, it is the speed at which rates may rise (or fall) that has tended to shock most people in the past. The expected speed of change will also inform us on the most appropriate term to select. Indeed, from a cost perspective, the goal is to achieve the lowest overall cost of funds over time, **and at the moment the choices are to either pay less now knowing you'll likely pay more later (by staying floating), or pay slightly higher rate now that won't change (by fixing).**

By now it should be clear that we do not expect rates to fall. Global interest rates are on the rise as the US Federal Reserve moves closer to unwinding its QE programme, and the RBNZ have made it clear that "removal of monetary stimulus will likely be needed in the future". That's code for "OCR increases are coming". So holding off paying fixed here on the expectation that rates may fall significantly (beyond established trading ranges), seems likely to prove futile.

That being the case; how quickly might rates rise? While our forecasts have the OCR on hold till March, beyond this we expect the OCR to be 50bps higher in a year's time, 100bps higher in 2 years time, and 150bps higher in 3 years time.

Of note, when we compare our forecasts to breakevens implied by the term structure of interest rates, we see a similar expectation. However, breakevens generally rise more quickly than our forecasts. Take 1 year breakevens as an example. As the table below shows, the current term structure of interest rates is consistent with the 1 year rate rising from 5.79 percent to 6.61 percent in 1 year, 7.20 percent in 2 years, and 7.49 percent in 3 years. That's a slightly faster pace of increase than our forecasts for the OCR (which one would expect to move broadly in step with 1 year rates) over the next 2 years, but a slower pace in the 3rd year. **So that makes the maths on the decision between fixed and floating something of a line call.**

Rural Lending Rates (incl. typical margin)		Breakeven rates			
Term	Current	in 6mths	in 1yr	in 2 yrs	in 3 yrs
Floating	5.65%				
6 months	5.69%	5.89%	6.40%	7.04%	7.37%
1 year	5.79%	6.15%	6.61%	7.20%	7.49%
2 years	6.20%	6.54%	6.91%	7.35%	7.62%
3 years	6.53%	6.81%	7.10%	7.48%	
4 years	6.77%	7.02%	7.26%		
5 years	6.97%				

If the economics are a line call, **what else might influence the decision? One obvious candidate is the value placed on certainty.** Fixing gives certainty, and even after the recent moves, the level of fixed mortgage rates is still low by historic comparison. The "trouble" is, so too are floating rates, and as our OCR forecast demonstrates, we expect them to rise only gradually, thanks to a host of factors including the low inflation environment, support from macroprudential policy, and the tight fiscal environment. Certainty comes at a cost. Not only is fixing more expensive right from the outset, but if rates don't rise by as much as breakevens show, it might work out to be more expensive in the long run. We thus see the decision to fix as marginal, and urge readers to balance cost against their need for certainty and flexibility. This is likely to mean a mix of fixed and floating is best.

EDUCATION CORNER: AFTER-EFFECTS OF 'QE' WITHDRAWAL

SUMMARY

The environment over the last few years has been one of record-low interest rates, both here and abroad. The decision in June by the US Federal Reserve to set out a conditional timetable for winding down its quantitative easing (QE) programme flags an end to this golden era. While we've seen an end to the era of incredibly low interest rates, it doesn't naturally follow that rates will trend higher in a sustainable fashion. In a post-financial crisis healing world, you don't see such trends; movements tend to be of the "drift" variety. However, the worm has turned: the lows for interest rates have now been seen.

Under QE, capital flowed from the core into the periphery (emerging markets). Investors moved out the credit curve in the search of higher returns (yields), lifting all asset prices. This process is now reversing. The associated re-pricing of US and various safe haven assets means the same for assets across the board. Some conjecture surrounds how much soft commodities have benefited from an abundance of global liquidity given the nature of the product (we have to eat and they're perishable). We believe it would be naïve to assume soft commodity price trends are totally disconnected from wider asset class trends. Therefore, a winding down in QE is expected to exert some additional downward pressure on soft commodity prices as monetary policy settings are normalised. That said, the natural buffer for farm-gate returns from a reversing of this trend will be a lower NZD/USD, which should ease any pressure on farm-gate returns from lower in-market prices.

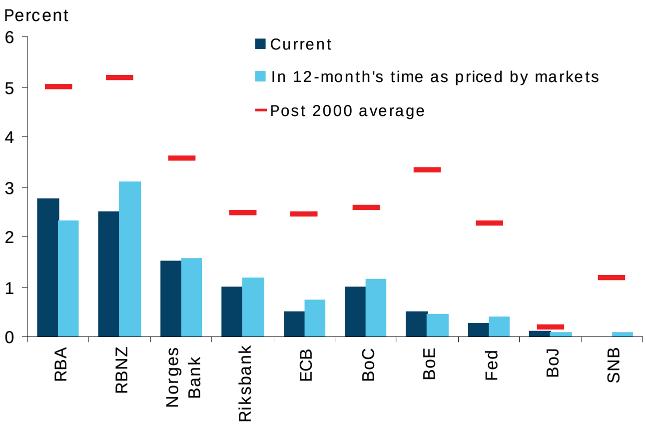
A TWO-BIT PLAYER AT AN INTERNATIONAL ROULETTE TABLE

The last few years have been characterised by interest rates being at multi-year (or decade) lows. Central banks have had their feet firmly on the accelerator for nearly five years. Policy rates everywhere have been well below their historical averages: that's a consequence of cleaning up an economic mess. In addition to record low policy interest rates, central bank printing presses have been working overtime. In their third bout of quantitative easing (QE for short) since the global financial crisis, termed QE3, the US Federal Reserve has been spending US$85bn per month on asset purchases (buying bonds and other financial instruments), to keep longer-term borrowing costs low. The central banks of Japan and the UK are also conducting large-scale QE programmes, whereas the European Central Bank has been using various mechanisms to try to grease the wheels and provide liquidity to facilitate greater bank lending. The end result has been historically low interest rates across the board – and not just in those countries carrying out QE.

Ample global liquidity and so-called money printing from the likes of the US has had four natural consequences:

- Interest rates have been lower than otherwise would have been the case. High prices (lower yields) for safe haven assets have supported valuations in other assets as investors have moved out the credit curve in the search of higher yields.
- The USD has been weak, making other currencies strong by default.
- Capital flowed from the core (think the US) into the periphery. Emerging-market economies have been a key beneficiary of this trend. Pegged currencies have, in effect, given emerging-market economies the same interest rates as the US.
- Liquidity has naturally flowed into wider asset classes, including soft commodities we suspect, especially when the fundamentals have been favourable. This has resulted in an increased correlation between price movements in financial and soft commodity markets.

Central Bank Policy Rates



Sources: ANZ, Bloomberg

In recent months the US Federal Reserve has been preparing financial markets for the eventual scaling back of the pace of quantitative easing. The US economy is the bellwether for longer-term interest rates: we all dance to their economic tune. Signs of improvement in the US economy have become more prevalent. It's not across the board, but more consistent. While in June the Fed noted that the withdrawal of stimulus would be data dependent, based on their current view this is expected to begin in September with net purchases to have ceased by the middle of 2014. With the federal funds rate close

EDUCATION CORNER: AFTER-EFFECTS OF ‘QE’ WITHDRAWAL

to zero, **the scaling back and eventually ending of QE3 is more akin to easing off the gas pedal than putting on the brakes. However, markets have been quick to respond:** US 10-year bond yields have risen from just over 1.6 percent since early May, to just over 2.58 percent at present.

THE STEPS TO THE EXIT DOOR

What steps are the FOMC likely to take in normalising policy settings? Remember in the first instance that US interest rates sit near zero, so the process of normalisation will be a long, drawn out one. The first step will be the winding down and eventual cessation of QE purchases. After that the Fed will start lifting interest rates – or tightening monetary policy in the usual manner, by increasing the fed funds rate.

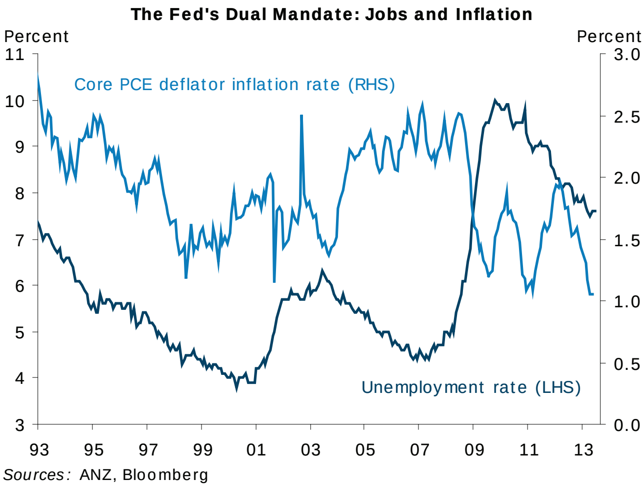
There is likely to be a significant interval between the two periods. Even after QE has been wound down (say, by mid-2014), the Fed are likely to leave the fed funds rate on hold for a significant period, with the majority of FOMC members in June signalling a 2015 start date to begin lifting it. Subsequent climbs in interest rates are likely to be gradual, as the Fed has long said that it “expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens.”

Sometime after the first increase in the fed funds rate, the third and final “step” is to normalise the Fed’s balance sheet (i.e. the total stock of bonds bought through QE). We say “step” as this is not necessarily a step that needs to be put into action. Rather, this process is a naturally occurring one – the Fed’s balance sheet will shrink on its own with the passage of time as bonds mature and borrowers prepay mortgage bonds. The Fed could accelerate this process by selling down its bond holdings, but comments from Fed governors to date suggest that this is unlikely. However, if the Fed were to sell bonds, this would happen after QE3 is wound down, and after the fed funds rate has been lifted.

At the current point in time, the FOMC is contemplating winding back the amount of stimulus it is providing through QE – step 1. In Ben Bernanke’s words, currently that is seen as likely to begin “later this year”. What was so important about these words is that for the first time they put a time frame around the “tapering” of QE that markets had earlier been contemplating. Some of the recent lift in US interest rates stems from the fear that the start of “tapering” marks the beginning of the tightening cycle, bringing back memories of 1994 when US 10yr bond yields rose by about 3 percentage points. However, it has been the unwinding of the QE discount that has added insult to injury. The presence of QE saw yields fall to levels well below those justifiable, or consistent with the economic outlook.

Looking ahead, although the Fed will move policy in a measured manner, **for markets it’s not about the here and now, but rather the long-term outlook.** And now that the Fed has signalled it is pressing the accelerator more gently, the market has jumped to the conclusion that it will soon have its foot on the brake. We have been here before – but what differs this time around is that US data is in better shape, adding some justification to the Fed’s actions. Indeed, had the market collectively believed the Fed was making a policy mistake and withdrawing policy accommodation too soon (as was the case after QE1 and QE2), bond yields would likely have fallen. They may well still do that, but for now, the focus is on an improving US economy, and rising interest rates.

What matters for the speed of the unwinding in Fed policy is how quickly the unemployment rate falls, with the Fed targeting a 6.5 percent unemployment rate before lifting the fed funds rate; **and how inflation evolves.** As the chart below shows, unemployment has been falling steadily, but this is partly the consequence of lower labour force participation as discouraged workers give up, rather than a strong labour market recovery. If monthly employment growth continues at its recent rate, the unemployment rate is likely to approach 6.5 percent by late 2014 to early 2015. At the moment, inflation (as measured using the core PCE deflator – the Fed’s preferred measure) is well below target, but it is likely to lift as the recovery broadens.



Sources: ANZ, Bloomberg

EDUCATION CORNER: AFTER-EFFECTS OF 'QE' WITHDRAWAL

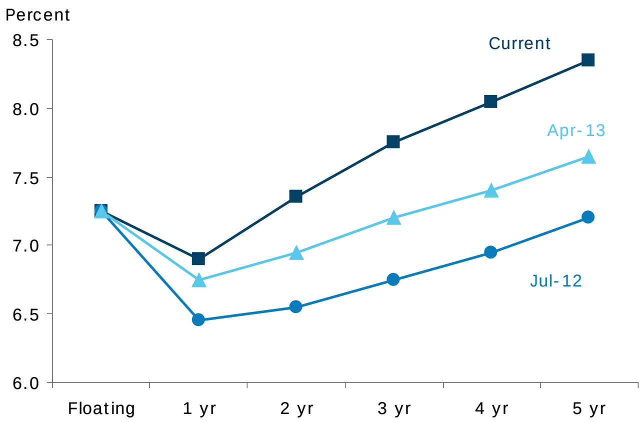
THE FLOW-THROUGH TO THE FARM-GATE

There are three broad channels through which the Fed's changing stance will affect NZ, and by default, farmers.

The first is via interest rates. Higher US interest rates have seen long-term (3+ years) wholesale rates lift in New Zealand. Technically, the most recent spike higher in global interest rates can be characterised as a "portfolio shock" caused by the buying/selling decisions of a market participant (admittedly extremely large) – as opposed to reflecting a sudden change in the outlook for the US economy (e.g. stronger-than-expected economic growth). In this light, the spill-over into higher NZ interest rates must be regarded as a negative spill-over. Obviously the Fed's decision was based on an expectation that US growth will improve. But the point is, the US economic outlook has not improved as much as the circa 0.9 percent rise in US yields (matched point for point here) would suggest at face value.

In New Zealand this has seen domestic long-term wholesale interest rates move up sharply since mid-April, **placing upward pressure on long-term carded interest rates for farmers.** This has led to a 55-70 basis point rise in fixed term (3-5 year) carded rural rates over the last three months, steepening the curve for farmers borrowing money. Year-on-year three to five year borrowing rates have lifted by over 100 basis points, with over half the lift being driven by the recent change in stance by the Fed.

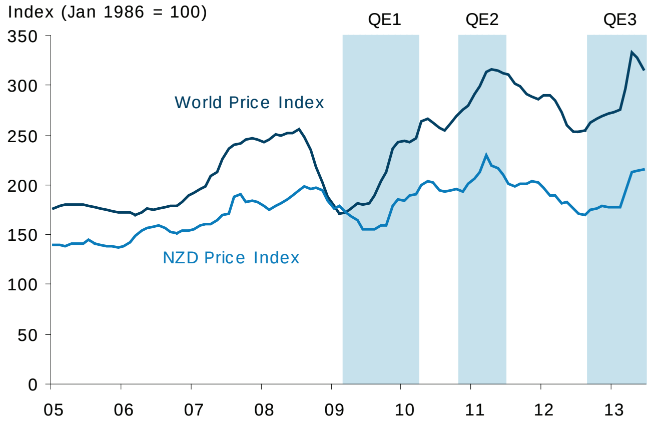
Carded Rural Interest Rates



Source: ANZ

The second channel is via soft commodity prices. Each of the three rounds of QE in the US has coincided with a significant lift in New Zealand's in-market prices for soft commodities. The first round saw a 45 percent lift, the second round a 16 percent lift, and the third a 24 percent lift so far. Why has this been the case? **There are several possible reasons.**

ANZ Commodity Price Index

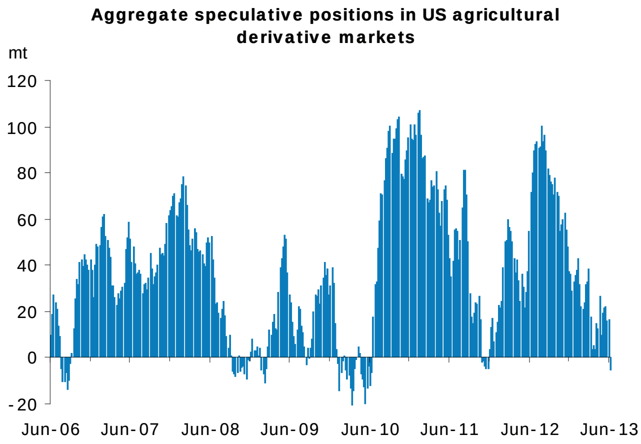


Source: ANZ

One is that QE has weakened the USD. Many soft commodities are still priced in USD as it is the global reserve currency, and the US is one of the largest producers and exporters of a number of key soft commodities (such as grains, dairy and meat). A lower USD has meant many key food importers have been able to avoid paying higher prices for imported food. Even China, who is a key global food importer with a managed currency, has seen some appreciation against the USD, supporting higher USD food prices.

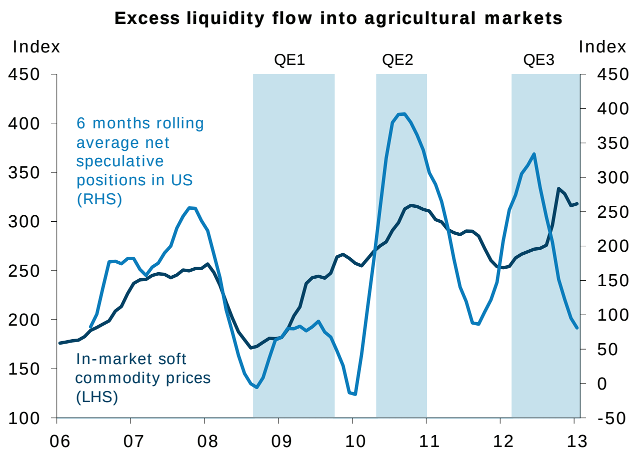
The second is that as interest rates have been held low, investors have been seeking out alternative investments and moved out the credit curve in the search of higher returns (yields). As the food story has become more well-known and better understood, investors have increasingly seen agriculture as a 'new' or untouched investment class. This has seen increasing investment directly into farmland and other assets along the food supply chain. Many food/agri companies listed on stock exchanges around the world have benefited and outperformed other sectors as investors have sought out these shares to gain a price and volume exposure to the food story. The other avenue has been increasing trading activity in agricultural derivative markets where investors can gain a price exposure to specific agricultural markets and price movements within these markets. This is highlighted by the following chart, which show net speculative positions in US agricultural derivative markets over the last seven years.

EDUCATION CORNER: AFTER-EFFECTS OF 'QE' WITHDRAWAL



Sources: ANZ, CFTC

In general, trading activity over this period has been very buoyant, and especially so when the fundamentals (i.e. a supply disruption) have been positive for prices within a specific market (i.e. corn). **While New Zealand's agricultural derivative markets are less well developed, and the US agricultural derivative market does not closely represent what we sell, overlaying this activity with our commodity price index for in-market prices shows there is some correlation in movements between the two.** This will be related to the US being both an end-market, and a direct (e.g. dairy) and indirect (e.g. substitution of beef for pork) competitor in some sectors. As QE is tapered and interest rates lifted these effects are expected to reverse somewhat.



Sources: ANZ, Bloomberg, CFTC

The third channel is via the exchange rate. The improving US economic outlook and "tapering" debate have been associated with a reasonable fall in the NZD vs. the USD. Ironically, this changing mix of monetary conditions is better aligned to the rebalancing requirements of our economy. **A lower NZD, all else equal, will feed through into higher inflation and improved farm-gate (export) returns, with both leading to a higher OCR. While all else is unlikely to remain unchanged, with in-market commodity prices likely to move lower, the economic flexibility of a floating NZD provides a buffer for any adjustments. Net on net it is likely to lead to improved New Zealand farm-gate prices.** There are a number of balls in the air, and we need to keep an eye on how both the exchange rate and global interest rates unfold, for these will be crucial inputs into how the interest rate environment and farm-gate prices develop here in New Zealand.

There are other channels of which to be mindful. The US economy may be looking better, but what about others? Europe remains a mess. The emerging market economies have been huge beneficiaries of low interest rates in the US (pegged/ managed currencies mean they've effectively had the same interest rates as Uncle Sam). Capital has flowed from the core into the periphery, including China. Now we're seeing flows reverse, from the periphery and back into core markets. That's raising question marks about the sustainability of activity in the periphery, and emerging market economies' growth trajectory: witness the recent performance across emerging market equities, and growing pricing spikes in short-term money markets that signal cash squeezes. The message here is not one of impending disaster, but one of interlinkages: we reside in a world that is increasingly "coupled". **This means the withdrawal of US policy stimulus will have implications that flow far beyond the US borders and into many financial variables that influence farmer and grower bottom lines and business viability. As our lead article articulates, China is getting a lot more attention, and it's not of the usual positive variety.**

In short then, we have entered a new phase.

Global interest rates are now heading broadly higher, and we are confident we have now seen the lows in long-term interest rates, which we expect to drift upwards over coming years. **However, we can also expect significant volatility** as the data evolves, and it is drawing a long bow to suggest the steep increases seen over the past few months will continue.

For New Zealand and farmers, this means six things.

- **Interest rates will drift up:** we say drift because we believe trends will remain elusive given vulnerabilities that will persist globally.

EDUCATION CORNER: AFTER-EFFECTS OF 'QE' WITHDRAWAL

- **The NZD has been re-rated into a new zone: lower.** However, like interest rates, we doubt we're set to see a clear downwards trend. The NZD has gone from trading and residing in an incredibly expensive zone to merely an expensive one.
- **The process of USD diversification (flows from the US into the periphery) being replaced by "reversification"** (from the periphery into the core) will result in heightened questioning over the durability of the Asian growth equation.
- **The re-pricing of USD Treasuries and other safe haven assets must ultimately mean re-pricing for all asset classes.** Some conjecture surrounds the degree to which soft commodity prices have benefited from the abundance of global liquidity, given the nature and limited shelf life of the product. We respect this, but believe it would be naïve to assume soft commodity price trends will be disconnected over the medium term from wider asset class trends. Long-term analysis of commodity trends shows cycles tend to be short and sharp at the top and long and deep at the bottom. Therefore, a reversal of these trends is also expected to exert downward pressure on soft commodity prices over 2014-15. That said, the natural buffer for farm-gate returns will be a lower NZD/USD, which should ease any pressure from lower in-market prices on farm-gate returns.
- **Volatility will remain the new norm.** Expect further bouts for interest rates and the NZD to move in fits and starts. A mixture of grinds up stairs and moves down the elevator. That's natural in a healing environment. The average recovery period post a financial crisis is around 7 years. We'll see a few more wobbles yet. It's difficult to imagine the removal of extraordinary policy stimulus not creating some extraordinary economic waves.
- **We'd encourage farmers to keep focusing on the microeconomic picture: these are the developments they ultimately control.** The list here is endless but boosting productivity, addressing environmental concerns, ensuring balance sheets are in order, building resilience into cost structures should all be focus areas on-farm. Off-farm it involves understanding the business strategies of partners and co-operatives that are being supplied and looking to support these activities through committed supply, but also other avenues of investment

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Jun-13	Jul-13	2-Aug	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
NZD/USD	0.778	0.785	0.789	0.80	0.79	0.78	0.77	0.76	0.75	0.75
NZD/AUD	0.840	0.847	0.884	0.86	0.86	0.86	0.87	0.87	0.87	0.87
NZD/EUR	0.597	0.597	0.598	0.60	0.59	0.57	0.55	0.54	0.54	0.54
NZD/JPY	76.65	79.07	78.56	84.0	83.0	81.9	84.7	83.6	82.5	82.5
NZD/GBP	0.510	0.513	0.522	0.52	0.52	0.52	0.51	0.49	0.48	0.48
NZ TWI	73.4	74.1	75.1	75.5	74.6	73.5	73.0	72.2	71.4	71.4

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Jun-13	Jul-13	2-Aug	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
NZ OCR	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.00	3.25
NZ 90 day bill	2.66	2.66	2.64	2.80	2.80	2.80	3.20	3.30	3.30	3.70
NZ 10-yr bond	4.13	4.22	3.61	3.40	3.40	3.50	3.70	4.00	4.20	4.50
US Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
US 3-mth	0.27	0.27	0.27	0.30	0.30	0.30	0.30	0.35	0.35	0.60
AU Cash Rate	2.75	2.75	2.75	2.75	2.75	2.50	2.50	2.50	2.50	2.50
AU 3-mth	2.82	2.67	2.81	2.90	2.90	2.70	2.70	2.70	2.70	2.70

ECONOMIC INDICATORS	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
GDP (% q/q)	**0.4**	**0.8**	**0.9**	**0.8**	**0.8**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**
GDP (% y/y)	**2.5**	**3.0**	**2.4**	**3.0**	**3.3**	**3.2**	**3.0**	**2.7**	**2.5**	**2.3**
CPI (% q/q)	0.2	**0.8**	**0.2**	**0.5**	**0.4**	**0.6**	**0.3**	**0.7**	**0.7**	**0.8**
CPI (% y/y)	0.7	**1.3**	**1.6**	**1.7**	**2.0**	**1.7**	**1.8**	**2.0**	**2.3**	**2.5**
Employment (% q/q)	**−0.2**	**0.5**	**0.4**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Employment (% y/y)	**0.2**	**1.1**	**2.5**	**1.2**	**1.7**	**1.6**	**1.4**	**1.3**	**1.2**	**1.1**
Unemployment Rate (% sa)	**6.3**	**5.9**	**5.8**	**5.7**	**5.6**	**5.6**	**5.5**	**5.5**	**5.4**	**5.4**
Current Account (% GDP)	**−4.7**	**−4.7**	**−4.7**	**−4.8**	**−4.8**	**−4.9**	**−4.9**	**−5.0**	**−5.2**	**−5.4**
Terms of Trade (% q/q)	**3.7**	**2.3**	**1.6**	**1.0**	**0.4**	**0.4**	**0.0**	**−0.2**	**−0.6**	**−0.5**
Terms of Trade (% y/y)	**3.2**	**9.1**	**12.4**	**8.8**	**5.4**	**3.4**	**1.8**	**0.6**	**−0.4**	**−1.3**

Figures in bold are forecasts. q/q: Quarter-on-Quarter, y/y: Year-on-Year

NEW ZEALAND'S 20 LARGEST EXPORT MARKETS

NZ'S TOP EXPORT MARKETS FOR THE 12 MONTHS ENDED JUNE 2013 (NZ$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Singapore	Hong Kong	Malaysia	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Algeria
Sheepmeat	2,664	7	554	213	45	4	537	237	12	28	41	1	43		91	1	4	9	135	87	9
Beef	2,146	13	172	933	194	114	28	16	43	34	27	34	128		18	37	11	21	29	86	
Other Meat	442	45	19	23	39	29	28	58	7	28	6	3	3		11	3	2		19	4	
Milk Powder	6,929	54	2,350	15	38	10			215	160	307	268	177	1	223	225	200	364	6		346
Butter	1,910	70	166	115	9	13	1		34	16	43	53	56	1	96	62	30	39	13	17	49
Cheese	1,442	212	100	51	314	133	12		10	17	27	62	35		69	59	16	18	29		26
Whey/Casein	1,858	47	285	671	205	50	3	143	59	1	21	46	13	7	29	21	1	1	8	31	1
Kiwifruit	972	67	107	23	262	43		187	9	30	12	10	82	3		2	7	4		4	
Apples	484		18	64	7		56	52	15	19	12	7	14	21		1	43	28	52	12	
Other Fruit/Vege	815	348	13	32	159	22	14	9	13	8	30	8	17	2	1	2	15	2	17	2	2
Wine	1,210	373	27	283	14	2	278	10	16	20	3	1	1			1	2	6	27	78	
Wool	743	45	377	19	19	2	46	40		7	6	1	8	30			7		1	3	
Skins/Hides	567	21	201	2	7	24	2	1		28		6	5	15			9				
Logs	1,922		1,307		153	281							10	163			4				
Sawn Timber	1,099	322	173	163	74	56	1	1	6	1	16	17	44	4	20	39	30	7	13	1	
Fibreboard/Plywood	355	47	27	12	204	1			1		6	20	4	4		11	1			1	
Wood Pulp	590	67	163		70	61			2		18	101	22	13		4	23				
Fish/Seafood	1,437	280	392	133	114	35	12	24	25	58	9	4	7		2	13	29	4	6	12	
Crude Oil	1,950	1,795			33				97												
Aluminium	1,000	79	35	44	461	131	56	2	1	12	1	3	3	16			3		73	2	
Remainder	15,183	5,640	1,239	1,319	530	576	312	165	323	349	249	192	194	446	67	190	194	66	176	207	1
TOTAL	**45,718**	**9,533**	**7,724**	**4,117**	**2,950**	**1,585**	**1,388**	**943**	**888**	**817**	**834**	**837**	**865**	**726**	**627**	**672**	**633**	**569**	**605**	**548**	**434**

NZ MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 12 MONTHS ENDED JUNE 2013 AND A 12 MONTH SPAN A YEAR EARLIER (NZ$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Singapore	Hong Kong	Malaysia	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Algeria
Sheepmeat	19	1	307	-43	-6	-1	3	-38	1	-9	-2		-10		7		1	-1	-27	-15	-1
Beef	136	-5	151	99	4	-11		-1	-1	-9	5	-61	-1		10	-4	4	-2	-4	-12	
Other Meat	-17	12	3	1	-1	2	1	-10	1	6		-9				1			-12		
Milk Powder	163	-15	635	2	14	-2			-14	82	-21	-19	6	-40	-29	-16	-27	-46	-3		67
Butter	-385	-30	-46	-7	-11	-12	1		-15	-4	-18	-4	4	-29	-7	-7	-19	-3	2	-10	-2
Cheese	23	-31	19	46	-15	20	-37		1	-1		13	8		9		2	-1	2		11
Whey/Casein	-58	-21	52	-109	-5	-3	-1	18	-2	-5	-6	15		3	5	-9	-1	1	3	-3	1
Kiwifruit	-105	2	13	-5	-63	-35		-28			-2	1	11			1	1		-1	1	
Apples	137		16	22	3		9	12	4	-5	1	1	-3	-2			17	12	19	6	
Other Fruit/Vege	-69	-68	4	-6	-29	-4	5	1	2	1	10	3		1	1		1		5		
Wine	33	-9	2	32	1		-6	2	2	2	1						1			7	
Wool	-138	-25	-36	-7	-2		-12	1		1	-2		-4	-9			-2	-1		-1	
Skins/Hides	-5	5	-18		-2	4	-4			-8		-4	2	-1							
Logs	355		369		-19	19							1	-12			-1				
Sawn Timber	-2	-7	34	8	-15	6	-1	-2			1	-8	12	1	-6	-15	-3	-5	9		
Fibreboard/Plywood	-38	-23	2	-2	-7						-4	-3	1	1	-1	4					
Wood Pulp	-35	4	-32		-20	-24			-7		-4	21	-1			-3					
Fish/Seafood	-43	11	123	-4	-21	-14	-1	7	-14	-118		3	-1			7	1	-1	-1	-3	
Crude Oil	-292	-348			33				50			-24									
Aluminium	-143	-12	1	-16	-132	13	6	1	1	-5	-1		1	-1			1		-4	-3	
Remainder	-506	-368	16	23	-142	74	-18	16	35	6	-31	54	35	-91	-2	-13	-26	-16	31	-7	-1
TOTAL	**-970**	**-927**	**1,617**	**34**	**-437**	**30**	**-55**	**-20**	**41**	**-65**	**-73**	**-20**	**63**	**-180**	**-14**	**-55**	**-51**	**-62**	**17**	**-38**	**75**

NZ MERCHANDISE EXPORTS ANNUAL CHANGE BETWEEN THE 3 MONTHS ENDED JUNE 2013 AND A 3 MONTH SPAN A YEAR EARLIER (NZ$M)

	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	Singapore	Hong Kong	Malaysia	Indonesia	Taiwan	India	Saudi Arabia	Philippines	Thailand	UAE	Nether-lands	Canada	Algeria
Sheepmeat	29	-1	93	-6	1		2	-2		2	-3		-5		-5		1		-6	-4	-6
Beef	-65	-2	53	-78	-5	-7	-3	-2	-1	-4	2	1	-10		7	-3		-1	-2	5	
Other Meat	9	4	2		-3	-2		9		3	-2	-1	1		-2					1	
Milk Powder	-61	4	63	-1	2	1			20	15	16	-8	22		-31	14	1	-54			-11
Butter	-2	-4	-12	-4	-8	1	1		-1	-1	-4	5	4		-4	-2	1	-1	1	-1	15
Cheese	-3	-8	-3		4	2	-10			1		1	4		-10			1	-2		
Whey/Casein	-111	-5	17	-103	-2	-1		-6	-2		-6	3			-1	-4	-1			-2	
Kiwifruit	-108	-2	-9	-2	-55	-21		-7	-1	-1	-3	2	-13				1	1			
Apples	91		12	19	1		5	7	2	-5		2					9	4	15	6	
Other Fruit/Vege	8	4		1	-11	-2	2		1	1	7	2	1		1		-1		2		
Wine	5	1	-3	7			2													-1	
Wool	-29	-5	-16				3	-1		1	-1		-2	-3			-1				
Skins/Hides	14	1	5		-2	1	-1			-2		-2		2							
Logs	121		113		-7	10								5			-1				
Sawn Timber	-1	-2	7	2	-6	1						-2	4	2	-5	-7	1		3		
Fibreboard/Plywood	-17	-7	-1	2	-8						-3	-1		1		1					
Wood Pulp	-7		-11		-20	-3			-2		-1	10		1							
Fish/Seafood	-31	-2	26		-15	-6	1		-1	-29	1	1	-1			5	5			-1	
Crude Oil	-43	-17							-26												
Aluminium	-2	-2	-1	-8	-4	20	-2		1	-5	-1								-3		
Remainder	-239	-161	-14	-45	-54	-2	11	16	22	-3	-2	6	12	-5	-5	-1	-2		10	-7	-1
TOTAL	**-442**	**-204**	**321**	**-219**	**-191**	**-8**	**10**	**14**	**13**	**-26**		**18**	**17**	**4**	**-54**	**4**	**11**	**-51**	**18**	**-4**	**-2**

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