



PMI Residential Property Overview

Mid-year Update – New Zealand

MAY 2006

Summary

Interest rate rises towards the end of 2005 by the Reserve Bank undermined business and consumer confidence, and the combination of declining confidence and higher interest rates has helped to slow momentum in the housing market. Quarterly sales have dropped to their lowest level in over four years, while house price growth has also slowed and is now running at 10%pa (compared to 17%pa in October last year).

Despite a poor GDP growth result for the December quarter, the outlook for the New Zealand economy is reasonably good. The recent decline in the exchange rate will help growth in export volumes to recover, and prevent any further major slowdown in economic growth. Although the unemployment rate is anticipated to rise over the next year, the labour market is expected to remain relatively tight and household incomes are likely to continue to increase. Confidence is likely to recover once people realise the predictions of a recession were overly pessimistic.

Improved confidence and good income growth should help prevent price falls in most regions. Mortgagee sales are likely to be rare as people are generally able to service their debt. Residential property will continue to be a popular investment, particularly among baby boomers saving for retirement. Additionally, trends in interest rates and migration are becoming more favourable again for the housing market.

Nationally, real property values (after adjusting for inflation) are expected to record small increases over each of the next two years. Some provincial areas, with slower population growth and less attractive rental yields than 1-2 years ago, at most risk of price falls. However, any price declines will be modest when compared with the substantial rises that have occurred since 2003. The next two years represent a period of consolidation for the housing market, rather than a correction.

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Table 1: Economic indicators

Annual average % changes June years	1996-2005 Average	2003/04	2004/05	2005/06 Forecast	2006/07 Forecast	2007/08 Forecast
Real expenditures						
Private consumption	3.8%	6.5%	5.7%	3.5%	2.2%	3.3%
Government consumption	3.2%	4.9%	4.9%	6.8%	5.4%	6.1%
Residential investment	3.5%	13.0%	-2.6%	-2.7%	-1.5%	-9.0%
Non-residential investment	3.4%	6.2%	16.4%	10.4%	-11.7%	-2.0%
Total private investment	5.1%	13.8%	5.0%	-0.2%	-1.4%	1.0%
Total government investment	9.7%	23.6%	4.6%	12.9%	-0.6%	3.0%
Gross national expenditure	4.2%	8.1%	6.0%	3.1%	1.7%	3.3%
Exports of goods and services	4.3%	4.5%	0.9%	1.7%	3.8%	4.6%
Imports of goods and services	6.5%	14.4%	11.3%	4.1%	2.6%	3.9%
Gross domestic product	3.4%	4.2%	2.8%	2.2%	2.4%	3.5%
Households						
HLFS employment	2.1%	3.0%	3.4%	2.0%	0.6%	0.7%
HLFS unemployment rate (1)	5.7%	4.3%	3.7%	3.7%	4.3%	4.5%
Hourly wage	3.0%	3.5%	3.1%	4.8%	4.6%	3.4%
CPI (2)	2.1%	2.4%	2.8%	2.8%	2.1%	1.8%
NZ interest rates (3)						
10-year government bonds	6.6%	6.0%	6.0%	5.8%	5.8%	6.3%
90-day bills	6.6%	5.4%	6.8%	7.4%	7.3%	6.0%
Floating mortgage rates	8.5%	7.4%	8.7%	9.3%	9.2%	8.0%

Source: Statistics New Zealand, Reserve Bank of New Zealand, Infometrics forecasts
(1) Annual average for year ended (2) June on June, CPI ex credit prior to June 99 (3) Annual average rates

Economic outlook

Economic growth has stumbled over the last 6-9 months. The latest data shows that aggregate domestic demand growth has slowed from 8.2%pa at the end of 2004 to 4.5%pa for the year ended December 2005. However, that is still well in excess of GDP growth (1.9%pa).

The current growth slowdown is very much supply related. In simple terms, economic growth has been weak because a large proportion of the lift in domestic spending has been satisfied by imports, rather than domestic production. In addition, the combination of rising domestic costs (labour, fuel, interest rates) and a strong exchange rate has made trading conditions difficult for the export sector.

The recent drop in the currency, in combination with improved dairy volumes and a store of trees ready to harvest, should help revive export volumes over the next two years. The positive outlook for the world economy (growing at over 3%pa) will also help reverse the recent poor export performance. Growth in the volume of goods and services exports is predicted to lift from around 1% for the year ending June 2006 to almost 4% in the following June year.

With a high proportion of the growth in domestic demand over the past three years having been met by imports, demand for imports will decline as spending growth eases. That relationship is consistent with previous cycles, where import growth fluctuates more widely than domestic demand. The pace of

growth in import volumes is predicted to ease to around 2%pa by the end of this year, and then gradually pick up over 2007/08. However, that lift is anticipated to be limited by the falling New Zealand dollar pushing up the cost of imports.

The net effect of these export and import forecasts will prevent the current account deficit worsening much further from its present level of 8.9% of GDP. But any improvement is expected to be slow and small, and the current account deficit is likely to remain at over 8% of GDP throughout 2007.

The large current account deficit has been a factor behind the New Zealand dollar's fall this year, along with softening economic growth and an end to the interest rate rises by the Reserve Bank. Although the gap between domestic and overseas interest rates has shrunk over the last 12-18 months, it is still historically wide, suggesting that the weakness of the dollar may be overdone.

The drop in the currency has taken the pressure off the Reserve Bank to reduce interest rates - exporters had previously argued that they were being disproportionately punished for the recent bout of high inflation. The bulk of the pressure is now coming on the domestic economy, and the legacy from the monetary policy tightening of the last two years is likely to be felt for most of the next two years in terms of domestic demand growth.

The Reserve Bank is likely to be wary of cutting interest rates too early given the unexpected acceleration in house price growth over 2005. The Bank will not want to risk reigniting the housing market by cutting rates early. The government's expansionary fiscal stance will also help support domestic spending more than would otherwise be the case.

By early next year, with reduced inflation (and inflation expectations), GDP growth still under 2.5%pa, the real estate market having slowed, and much of the fiscal

Table 2: House sales by region

Year ended June	Northland		Auckland		Waikato/Bay of Plenty/Gisborne		Hawke's Bay		Taranaki/Manawatu/Wanganui		Wellington	
	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾		
1999	2,001	-5%	26,218	12%	11,622	-4%	2,606	7%	5,982	14%	11,422	8%
2000	1,825	-9%	23,222	-11%	10,303	-11%	2,779	7%	5,493	-8%	10,675	-7%
2001	1,760	-4%	21,983	-5%	9,515	-8%	2,438	-12%	5,097	-7%	9,913	-7%
2002	2,209	26%	31,405	43%	12,629	33%	3,163	30%	6,457	27%	11,308	14%
2003	2,809	27%	38,164	22%	16,691	32%	3,881	23%	7,632	18%	12,238	8%
2004	3,820	36%	40,431	6%	20,298	22%	4,135	7%	8,947	17%	12,255	0%
2005	3,340	-13%	34,469	-15%	18,139	-11%	3,648	-12%	8,160	-9%	10,740	-12%
Forecasts												
2006*	3,007	-10%	33,982	-1%	16,311	-10%	3,609	-1%	7,998	-2%	11,155	4%
2007*	3,158	5%	34,725	2%	17,007	4%	3,708	3%	8,080	1%	11,112	0%
2008*	3,031	-4%	32,509	-6%	15,984	-6%	3,454	-7%	7,517	-7%	10,333	-7%
Year ended June	Nelson/Marlborough		Christchurch		Other Canterbury/Westland		Otago/Southland		New Zealand			
	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾	Number	APC ⁽¹⁾		
1999	2,475	10%	7,503	-3%	2,977	4%	5,300	17%	78,106	7%		
2000	2,429	-2%	6,520	-13%	2,802	-6%	5,021	-5%	71,069	-9%		
2001	2,618	8%	5,931	-9%	2,584	-8%	5,787	15%	67,626	-5%		
2002	3,774	44%	7,645	29%	3,491	35%	7,779	34%	89,860	33%		
2003	4,145	10%	9,398	23%	4,944	42%	9,583	23%	109,485	22%		
2004	3,354	-19%	10,303	10%	5,431	10%	9,511	-1%	118,485	8%		
2005	3,041	-9%	9,542	-7%	4,543	-16%	8,170	-14%	103,792	-12%		
Forecasts												
2006*	3,006	-1%	9,575	0%	4,544	0%	7,967	-2%	101,155	-3%		
2007*	3,026	1%	9,636	1%	4,627	2%	8,092	2%	103,143	2%		
2008*	2,838	-6%	8,926	-7%	4,336	-6%	7,598	-6%	96,439	-6%		

Source: Real Estate Institute of New Zealand; * Infometrics forecasts (1) Annual percentage change

stimulus having worked its way through the economy, the Reserve Bank is likely to have the confidence to cut interest rates. The official cash rate is predicted to decline from 7.25% to 5.75% during 2007.

Consumer and business confidence have been undermined by slowing income growth and shrinking profit margins. Fears about the level of the dollar, the possibility of a slump in the housing market, and rising debt-servicing costs also explain the poor sentiment.

However, economic growth is likely to recover over 2007/08 as the housing market avoids any significant price falls, export growth responds to the lower dollar, and interest rate decreases spark an increase in consumer confidence.

There are two main reasons why the slowdown in domestic demand is unlikely to produce more than a temporary dip in GDP growth:

- Businesses and households have not sufficiently taken into account the impact of a large spending surge from the government. Government consumption is expected to replace private consumption; government investment is likely to make up for the slowdown in residential investment; and increases in transfer payments (around \$850m over the next year as part of the Working for Families package) should ensure that household incomes do not collapse.

- A big proportion of the reduction in domestic demand will be reflected in much weaker growth in demand for imports. Growing household caution is likely to have the largest impact on plans for purchasing big-ticket items, which are predominantly imported.

A hard landing for the economy appears unlikely. Economic growth is forecast to hold at between 2% and 2.5%pa over the next 18 months.

Sales activity

The most recent house sales data shows that activity in the residential property market is finally slowing. There was a modest 2.4% drop in sales volumes over the 2005 calendar year, but the annualised rate of sales over the March 2006 quarter is the lowest since the end of 2001.

The biggest drop in sales over the last few months has generally occurred in provincial areas. Sales in the three main centres are only down about 9% on a year ago, compared to a 14% average drop in the other regions.

The cooling in provincial housing markets is good news for the Reserve Bank. Since the start of 2004, property values in the main urban areas have been rising more slowly than in the provinces, with Auckland and Wellington in particular lagging behind. If lower sales activity flows through into slower price growth in

the provinces, the Bank will be on its way to stabilising the housing market.

There are a number of contributing factors to the impressive price growth in the provinces:

- Strong growth in rural incomes around 2001 and 2002 added vibrancy to the regional economies.
- Improved population growth, as fewer New Zealanders headed overseas, increased demand for housing.
- Overseas investors (particularly Australians) have perceived the rental yields on offer in New Zealand provincial towns to be attractive, particularly when compared to the low yields on offer in their own country. This interest from Australia has probably been strongest since house price growth across the Tasman stalled in early 2004. New Zealand investors, faced with relatively low yields in the main centres, have also looked out of town for better cash-flow opportunities.

The outlook for house sales activity over the next two years is influenced by the following factors:

- Floating mortgage rates are set to hold at around 9.5% for the rest of this year. But recently, fixed rate mortgages have dropped back from their highs. For example, the five-year rate has fallen from 7.95% in December 2005 to under 7.5%. This suggests that the worst of the interest rate squeeze could be over.
- Net migration appears to have bottomed out. The annual net flow has climbed from 6,000 in November 2005 to 9,739 by March.



- The only factor to drive real estate activity significantly lower is consumer confidence. However, consumer confidence is not expected to remain at low levels for long. Household income growth is likely to hold up, with growth in real disposable incomes average 3.6%pa over the next two years. And the labour market is anticipated to remain relatively tight as the unemployment rate stays comfortably below 5%.

Consequently, sales activity is expected to hold relatively steady over the next two years, with the annual sales total hovering around 100,000 houses.

Underlying demand

The slide in net migration appears to be reversing, although the turnaround is still relatively small, and is being driven mainly by a big reduction in outflows of non-New Zealanders relative to this time last year. This drop-off may be temporary, or it may be an indication that international student numbers are no longer declining as rapidly. Regardless, there is little scope for this relatively small category to contribute to further increases in net migration.

An essentially flat trend in net migration is predicted over the next two years. This forecast is predominately based on a rising trend in New Zealander departures (driven by a shrinking gap between economic growth in New Zealand and overseas destinations), offset by growing numbers of non-New Zealand citizen arrivals, stemming from increases in residency approvals and work permits.

The decline in the occupancy rate (number of people per dwelling) is also accelerating - the children of the baby boomers are now starting to leave home. This is expected to help to limit the oversupply of housing that develops between now and 2008.

Demographic factors are one reason why the surge in property values over the last four years could be sustained over the short-to-medium term. The baby boomers are in their peak earning years, and saving for retirement is becoming

increasingly urgent. For many, property is the asset class of choice, with its multitude of tax benefits (from loss-attributing qualifying companies to the lack of a capital gains tax) making it a very attractive investment vehicle.

With the weight of money being invested in housing likely to be a medium-term phenomenon, and good income growth throughout the forecast period, house prices are not expected to fall on average. This positive combination of income and demographics suggests that the apparent

oversupply of residential property over the next couple of years will be absorbed by the market relatively comfortably (although there may be pockets of softness, such as the Auckland apartment market).

Table 3: Population growth by region

Year ended June	Northland	Auckland	Waikato/Bay of Plenty/Gisborne	Hawke's Bay	Taranaki/Manawatu/Wanganui	Wellington
1999	0.4%	1.3%	0.6%	-0.2%	-0.6%	0.4%
2000	0.3%	1.4%	0.5%	0.0%	-0.6%	0.4%
2001	0.0%	1.4%	0.2%	0.0%	-1.0%	0.6%
2002	0.7%	2.9%	1.0%	0.5%	-0.2%	1.2%
2003	0.8%	3.1%	1.3%	0.3%	0.1%	1.4%
2004	0.7%	2.0%	1.1%	0.5%	-0.1%	1.2%
2005	0.6%	1.4%	0.7%	0.0%	-0.5%	0.7%
Forecasts						
2006*	0.2%	1.7%	0.6%	-0.1%	-0.4%	0.6%
2007*	0.6%	1.5%	0.8%	0.2%	0.0%	0.5%
2008*	0.5%	1.4%	0.7%	0.1%	-0.1%	0.4%
Year ended June	Nelson/Marlborough	Christchurch	Other Canterbury/Westland	Otago/Southland	New Zealand	
1999	1.0%	0.4%	0.2%	-0.9%	0.5%	
2000	1.1%	0.3%	0.4%	-0.4%	0.6%	
2001	1.0%	0.4%	0.7%	0.2%	0.6%	
2002	1.7%	1.5%	0.8%	0.9%	1.5%	
2003	2.1%	2.0%	1.2%	0.9%	1.8%	
2004	1.9%	1.6%	1.2%	0.7%	1.3%	
2005	1.2%	0.9%	0.9%	0.3%	0.8%	
Forecasts						
2006*	1.2%	1.5%	0.6%	0.2%	0.9%	
2007*	1.0%	1.2%	0.9%	0.1%	0.9%	
2008*	0.9%	1.1%	0.8%	0.0%	0.8%	

Source: Statistics New Zealand, * Infometrics forecasts



Around the regions

The Northland property market was one of the strongest performers throughout 2005, but there have recently been signs that the market is losing momentum. Sales volumes over the March quarter were down 19% on the previous year, compared to a 12% drop nationwide, and properties are staying on the market longer before selling. It is also likely that property investors have been discouraged from buying in Northland due to the region's rental yields being the lowest in the country. These indicators suggest that, although house price growth is still the strongest in the country (at 24%pa), growth in property values is anticipated to quickly slow through-out the rest of 2006. Little movement in house prices is expected between now and mid-2008.

Most indicators of the Auckland property market remain much weaker than in other parts of the country. House price growth (6.8%pa in March) is well below the national average, with Auckland City the softest part of the region. Rental growth is barely positive, reflecting a persistent oversupply of low-quality apartments. Consequently, residential building activity in Auckland over the year to February was down almost one third on the previous 12 months, with apartment construction particularly weak (48% lower). However, the recent improvement in net migration hints at improved prospects for the Auckland housing market, and property prices in the region are expected to be among the fastest growing over the next two years, especially once the apartment market starts to recover.

House price growth in the Waikato/Bay of Plenty/Gisborne (WBG) region has slowed sharply since August last year, easing from 26% to 12%pa. The Bay of Plenty

market has been particularly soft for over a year, but trends in Waikato and Gisborne have also turned down in recent months. Sales volumes over the March quarter were 24% lower than in March 2005, giving the region the largest decline in real estate activity in the country. With rental growth easing (most notably in the Bay of Plenty), it now appears that the region's property market is headed for a period of consolidation. Despite more favourable conditions for exporters, house prices are expected to be largely flat in WBG over the next two years.

Hawke's Bay has also experienced a significant slowdown in house price growth, down from 26%pa in September 2005 to 8.3% by March this year. A cooling in rental growth over the same period suggests that the region's property market is becoming oversupplied, a result that would be unsurprising given the lack of population growth in Hawke's Bay



Table 4: Median house prices by region

June Quarter (1)	Northland		Auckland		Waikato/Bay of Plenty/Gisborne		Hawke's Bay		Taranaki/Manawatu/Wanganui		Wellington	
	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)
1999	151.2	4.7%	235.0	0.8%	154.8	3.3%	128.4	4.9%	99.1	0.4%	174.1	7.5%
esv	147.3	-2.5%	238.8	1.6%	158.0	2.0%	120.8	-6.0%	103.4	4.3%	188.3	8.2%
2001	153.5	4.2%	245.7	2.9%	159.2	0.7%	125.7	4.1%	102.0	-1.4%	196.0	4.1%
2002	159.7	4.0%	264.3	7.6%	166.2	4.4%	132.2	5.2%	107.9	5.8%	204.8	4.5%
2003	162.6	1.8%	290.3	9.8%	178.0	7.1%	156.7	18.6%	113.7	5.4%	226.8	10.7%
2004	190.1	16.9%	331.3	14.1%	194.8	9.4%	208.0	32.7%	133.1	17.0%	266.8	17.6%
2005	242.1	27.4%	368.5	11.2%	246.3	26.5%	238.7	14.7%	172.0	29.3%	286.7	7.4%
Forecasts												
2006*	273.4	12.9%	403.6	9.5%	280.0	13.6%	266.8	11.8%	200.8	16.8%	322.0	12.3%
2007*	271.9	-0.5%	427.5	5.9%	285.1	1.8%	277.6	4.0%	200.6	-0.1%	341.7	6.1%
2008*	274.8	1.1%	445.0	4.1%	287.2	0.8%	275.4	-0.8%	198.6	-1.0%	353.6	3.5%
June Quarter (1)	Nelson/Marlborough		Christchurch		Other Canterbury/Westland		**Otago/Southland		New Zealand			
	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)	\$'000	APC(2)
1999	139.0	-3.7%	153.3	1.8%	117.5	13.0%	93.6	1.4%	170.0	3.7%		
2000	143.4	3.2%	156.8	2.2%	113.2	-3.7%	98.1	4.9%	173.0	1.8%		
2001	151.1	5.3%	152.3	-2.8%	109.4	-3.4%	96.3	-1.8%	174.8	1.1%		
2002	159.8	5.8%	154.5	1.4%	109.2	-0.2%	108.9	13.0%	187.0	7.0%		
2003	211.3	32.2%	174.8	13.1%	122.0	11.8%	131.6	20.9%	207.3	10.9%		
2004	264.8	25.3%	229.0	31.0%	162.1	32.9%	187.5	42.5%	244.3	17.8%		
2005	266.2	0.5%	263.7	15.1%	198.5	22.5%	205.3	9.5%	277.2	13.4%		
Forecasts												
2006*	293.3	10.2%	295.5	12.1%	220.8	11.2%	229.6	11.9%	309.0	11.5%		
2007*	323.9	10.4%	307.7	4.1%	224.9	1.8%	240.9	4.9%	323.2	4.6%		
2008*	339.3	4.8%	307.8	0.0%	219.0	-2.6%	241.5	0.2%	330.4	2.2%		

Source: Real Estate Institute of New Zealand; * Infometrics forecasts (1) Average median price over three months to June; (2) Annual percentage change
Composite regions are weighted average of each region's median prices.

** Otago/Sutherland data is not comparable to that previously published due to changes in data presentation by the REINZ.

combined with historically high levels of residential building activity. Consent numbers over the year to February were up 23% on the previous 12 months, implying that the oversupply of housing in the region is likely to worsen as the new houses are completed. House prices in the Hawke's Bay area have been very resilient over the last 3-4 years, but modest price falls are likely by mid-2008.

The property market in Taranaki/Manawatu/Wanganui was one of the last to gather momentum in the upturn of the last few years. Even now, house price growth in the region is still among the highest in the country (19%pa in March). High rental yields have attracted property investors from other parts of the country (and offshore) to buy housing in the region, driving prices up and yields down. Residential building activity is still growing strongly in response to the lift in prices, but demand from investors is

already likely to be on the wane. As in many other parts of provincial New Zealand, an oversupply of housing means there is a risk of price falls over the next two years, particularly in South Taranaki and Wanganui.

The Wellington property market has been one of the most robust performers in the country over the last year. It is the only region where sales volumes over the year to March 2006 were higher than the previous 12-month period (up 2.1%). Although house price growth has not been as spectacular as in many provincial areas, property values in Wellington have been less affected by the nationwide market's slowdown over the last six months. Despite the good price growth, rental yields in the region have recently shown signs of improving. With public sector employment likely to outpace total job growth over the next 1-2 years, the prospects are good for property values in Wellington.

House price growth in Nelson/Marlborough (NM) continues to be very weak, following the rapid increase in property values between 2002 and 2004. But the Marlborough market has shown more positive signs since the start of this year, with annual price growth reaching 11%pa in March. Improved confidence in the Marlborough market could spill over into Nelson property values over coming months, particularly as trends in interest rates and net migration start to improve. Solid population growth and relatively low levels of house building activity mean that, ironically, property in NM may now be undervalued compared with other parts of New Zealand, and there may be a resurgence in house price growth in the region over the next 12-18 months.

Indicators of the Christchurch property market are currently mixed. Growth in both sales volumes and house prices is better than the national average. Price growth, in particular, has been quite



robust since August, recording only a small easing from 14% to 11%pa by March. But rental growth has slowed to just 1.8%pa, and house building activity has not recovered to the same extent as in other parts of the country. Despite the lack of rental growth, the Christchurch housing market may be less oversupplied than other parts of the country. Although house price growth will continue to taper off over coming months, property values in the region are not expected to decline.

The housing market in Provincial Canterbury and Westland has continued to perform well, in part due to the increasing popularity of living outside Christchurch and commuting into the city. Price growth has accelerated again over the last few months (back up to 24%pa), while sales volumes have also done better than the national average. The strength of demand for housing in the region is best indicated by rental growth which, at 12%pa, is the highest in the country. But building activity remains at unsustainably high levels. Even with a slowdown in residential construction later this year, the large increase in the supply of housing in the region is likely to erode

the potential for further price rises over 2007 and 2008.

A resurgence in house price growth in Central Otago has not been repeated across the rest of the Otago/Southland (OS) region. Prices in Central Otago were up 19% over the year to March, compared to 9.9% in Coastal Otago and just 2.5% in Southland. As a result, rental yields in Central Otago have come under significant downward pressure.

Residential building activity in the region has shown a large improvement over the last 6-9 months. The annual consent total rose 4% over the year to February 2006, compared to an 18% fall recorded in the year to July 2005. A lack of population growth in OS remains an issue for parts of the housing market over the medium term, but the ever-increasing importance of Central Otago may help average property values for the region to perform better than previously anticipated.



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