

Weekly Commentary

11 June 2018



From ‘rock star’ to ‘support act’

In previous years, New Zealand was an outperformer on the global stage. Our solid rates of GDP growth encouraged high levels of net migration, and that in turn reinforced the strength in demand. More recently, however, we’ve seen the momentum in domestic activity fading, while conditions in other economies have firmed. We expect that the New Zealand economy will continue to underperform its peers for the next few years, and this will have important implications for both net migration and the NZ dollar.

With slowing GDP growth, New Zealand’s position on the global stage is starting to slip

As we’ve been highlighting in recent weeks, New Zealand’s economic cycle has now entered a more mature phase. Earlier in the decade, we were an outperformer on the global stage, with GDP growth running at rates of around 3.5% to 4% p.a. That was well ahead of what we were seeing in other developed economies, including Australia and the US.

Earlier drivers of growth, which included house prices and construction activity, have now moved into new phases and are providing less of a boost to economic activity than they once did. This has already seen annual GDP growth cool to 2.9% at the end of last year. And recent updates on economic activity indicate that growth has continued to soften in the early part of 2018. Notably, retail spending was softer than expected in the March quarter, rising by only 0.1%. On top of that, construction activity fell by 0.9% in the March quarter and has essentially been flat for around three quarters now. Underlying this softness in construction, home building has been trending broadly sideways since mid-2016. That pre-dates any uncertainty associated with the change in Government, and highlights the brake that capacity constraints and difficulties accessing finance are having on building activity, regardless of the large pipeline of work that is planned.

Putting it altogether, it now looks like GDP growth in the March quarter could be around 0.5% or even a little lower. That would pull annual GDP growth down to around 2.8%, which would be the slowest pace since 2014.

Softening GDP growth will be reinforced by a slowdown in net migration...

The slowdown in GDP growth has seen New Zealand’s position on the global stage slipping from ‘rock star’ to ‘support act’, as growth in other developed economies has lifted. In particular, we’re now underperforming the Australian economy, where GDP grew by 1% in the March quarter, to be up 3.1% over the past year.

The changes in New Zealand’s relative standing in the global economy will have some important implications. One key area that will be affected is net migration. In recent years, our favourable economic conditions and jobs growth made New Zealand a very attractive destination. That saw a strong lift in new arrivals to the country. It also encouraged larger-than-usual numbers of New Zealanders to remain onshore or come back from abroad (especially from Australia). Combined, those factors saw annual net migration rise to a record high of 72,000 in mid-2017, and pushed the rate of overall population growth above 2% p.a. That provided a powerful boost to demand and our productive capacity, reinforcing the other factors that were supporting growth.

From 'rock star'... continued

Net migration has been softening in recent months, slowing to a still elevated level of 67,000 in the year to April. We expect that it will slow substantially more over the next few years, as the New Zealand economy starts to lag its peers like Australia and the US. This will exacerbate the more general softening in economic growth, with smaller additions to our demand base, as well as reducing the degree of pressure on new home building (at least outside of Auckland).

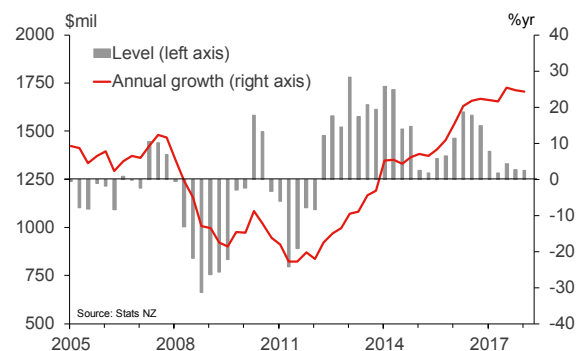
...however, a lower NZ dollar will provide a buffer

The other area where the New Zealand economy's underperformance will really matter is the exchange rate. In recent years, strong economic conditions saw the Kiwi soaring to 88 cents against the US dollar, and at one stage we flirted with parity relative to the Australian dollar.

The NZD/USD is now back around US\$0.70, and we expect it will fall to around US\$0.64 cents over the coming year. Strengthening US conditions are likely to see the Fed continuing to gradually hike the Federal Funds Rate, while softening economic conditions in New Zealand will keep the RBNZ on the sideline for some time yet.

The Kiwi has also lost some altitude against its Aussie counterpart, and is now down around AU\$0.92.

Residential construction



With the RBA expected to remain on hold for even longer than the RBNZ, we see less downside on this front. Nevertheless, with Australia's relatively firmer economic outlook, we expect the NZD/AUD cross rate will ease back to around AU\$0.90 cents by the start of next year.

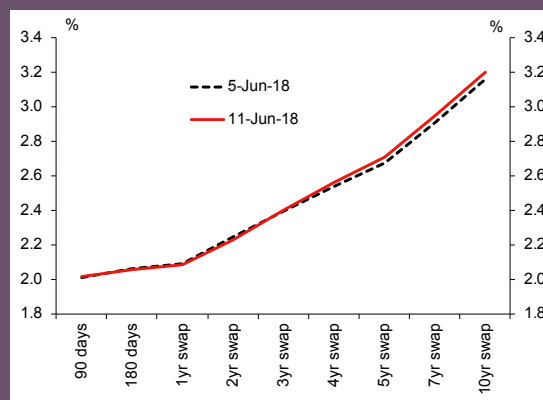
The depreciation of the NZ dollar over the coming year will provide a buffer for the economy, boosting export returns and cushioning the effects of slowing activity in other parts of the economy.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter fixed terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



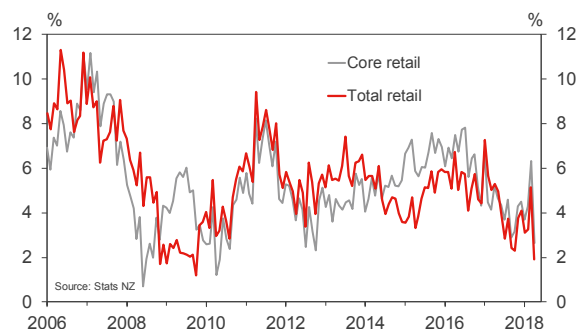
The week ahead

NZ May retail card spending

Jun 12 Last -2.2%, WBC f/c: +1.6%

- Retail card spending fell by 2.2% in April. That followed a large gain in the previous month, which may have been affected by the timing of the Easter holiday. Nevertheless, the size of the April fall was surprising. Looking at the broader trend in spending, it looks like after a solid start to the year, some of the momentum in spending is fading.
- We expect that spending will rise by 1.6% in May as earlier volatility fades. Nominal spending levels will also be boosted by increases in fuel prices.
- Spending continues to be supported by strong population growth and low interest rates. However, this strength will be challenged later this year by the slowdown in the housing market that is underway.

Card transactions, annual % change



NZ May REINZ house sales and prices

Expected in the week beginning Jun 12,

Sales last: -3.3%, Prices last: 3.8%yr

House sales fell 3.3% in April after a similar sized decline in March. House price inflation also softened, slowing to an annual rate of 3.8% - that's well down on what we saw in recent years. The weakness in April was most pronounced in the upper North Island - Northland, Auckland, Waikato and Tauranga. In these regions, which account for about half of New Zealand's population, both house prices and house sales fell noticeably.

- We expect the housing market to slow further over the rest of this year as the new Government rolls out a range of policies aimed at cooling housing speculation. The first of these changes came at the end of March, when the bright-line test for taxing capital gains on investment properties was extended from two to five years.

REINZ house prices and sales



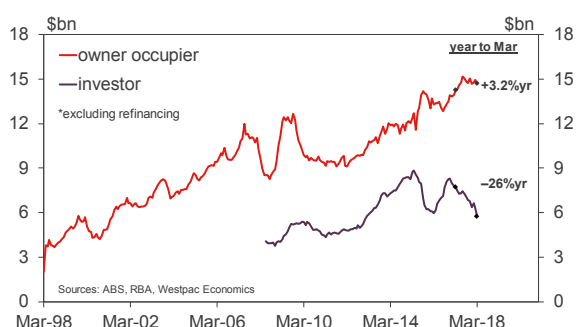
Aus Apr housing finance (no.)

Jun 12, Last: -2.2%, WBC f/c: -3.0%

Mkt f/c: -1.8%, Range: -3.0% to -0.5%

- After holding relatively steady through most of 2017 and early 2018, Australian housing finance approvals showed a notable pull back in March. The total number of owner occupier approvals declined 2.2% to be down 3.5%yr but the real weakness was around the value of investor approvals which dropped 9% to be down 16.1%yr. Combined, the total value of approvals ex refi fell 4.6% to be down 6%yr. Industry figures suggest owner occupier approvals declined again in April - we expect the official figures to show a 3.0% drop. Housing markets remained soft but stable through the month. More recent data suggests the Sydney and Melbourne markets have seen a further deterioration through May and early June, likely relating to tightening lending standards.

Housing finance approvals

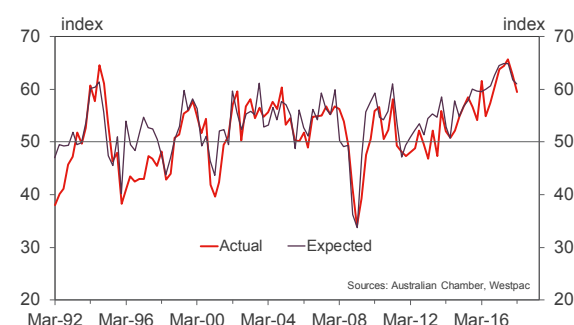


Aus Q2 AusChamber-Westpac survey of Industrial Trends

Jun 12, Last: 58.3

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector and insights into economy-wide trends. The Q2 survey was conducted after the Federal budget during May and the start of June. In Q1, the Actual Composite moderated to 58.3 from 63.4 in Q4, after an uptrend to 65.7 in September 2018 from a base in June 2015 of 55.1. Strength is centred on a lift in new orders and output as well as increased overtime and an uplift in employment. Manufacturing is benefitting from a rise in public infrastructure, non-mining business investment, and above par world growth with a relatively low AUD. However, against this are moderate consumption constrained by slow wage growth and the fading of the homebuilding boom.

Westpac-AusChamber Composite indexes



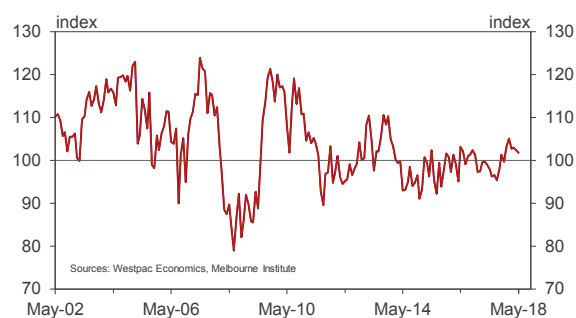
The week ahead

Aus Jun Westpac-MI Consumer Sentiment

Jun 13 Last: 101.8

- After a promising start, sentiment has drifted lower as the year has progressed. The index slipped to 101.8 in May despite what appeared to be a relatively well-received Federal Budget that included the announcement of personal income tax cuts. While it is still above 100, indicating that optimists outnumber pessimists, the sentiment index is well below the 105-115 levels typically associated with a robust consumer. Family finances remain a clear area of weakness. Factors that may influence this month include: a strong March quarter GDP result with growth lifting above 3%; continued slippage in dwelling prices, now down 1.1%yr nationally; a further rise in petrol prices, average pump prices hitting \$1.53/litre nationally in early June, up over 20c since mid-March. Financial markets were subdued, the ASX retracing 1% after a 5.7% surge last month and the AUD down over 1c vs the USD.

Consumer Sentiment Index



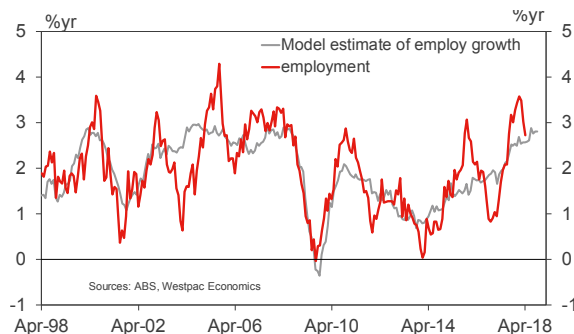
Aus May Labour Force - total employment '000

June 14, Last 22.6k, WBC f/c: 17k

Mkt f/c: 19k, Range: 8k to 32k

- Employment rose 22.6k in April beating both the market (20k) and Westpac's (17k) expectations. Full-time employment rose by 32.7k while part-time fell 10.0k. Past employment results were revised with March now -0.7k (was +4.9k) and February is now -7.4k (was reported as -6.3k last month and originally reported as +17.5k). The three month average gain in April was just 4.9k compared to an average of 27.7k for the previous year. Momentum in employment stalled in early 2018 and annual employment growth dipped to 2.7%yr from a January peak of 3.6%yr. The leading indicators are still pointing to sound monthly employment prints as is estimates of population growth. However, due to base effects our forecast +17k gain in employment has the annual pace dipping to 2.6%yr.

Jobs Index model of employment



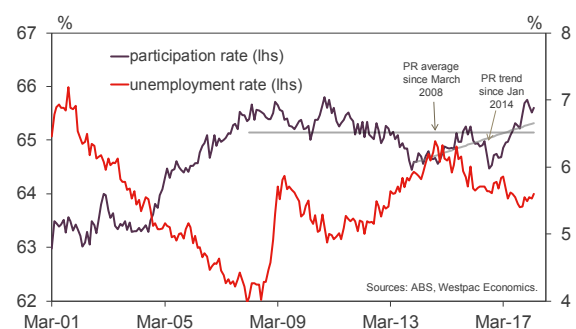
Aus May Labour Force - unemployment rate %

June 14, Last 5.6%, WBC f/c: 5.5%

Mkt f/c: 5.6%, Range: 5.4% to 5.6%

- Despite a sound print on employment in April the unemployment rate rose to 5.6%, (5.60% at two decimal places) a full percentage point on 5.5% in March (5.53% at two decimal places). This jump was due to a 33.2k lift in the labour force with participation bouncing to 65.61%.
- The strength in female participation has been driving the overall lift in participation. However, it is the weakness in male employment, given the recent strength male participation, that is behind the lift in unemployment.
- We are forecasting a flat participation rate for May which means that after rounding, the forecast +17k in employment is enough to lower the unemployment rate to 5.5%.

Unemployment and participation rates

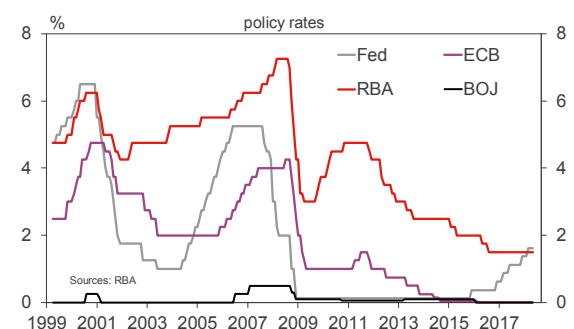


US Jun FOMC meeting

Jun 13-14, last 1.625%, WBC 1.875%

- Based on market pricing, the June FOMC decision is as certain as they come, with all anticipating a further 25bp increase in the fed funds range, to a mid-point of 1.875%. While trade and political uncertainty has swirled across the globe this month, the focus of the Committee remains the domestic US economy. There, there is strong cause for another step in the normalisation of policy. To put it simply, employment growth is strong; residual slack in the labour market low; inflation is near target; and wage gains are (finally) showing some momentum. Adding the anticipated positive influence of fiscal policy through 2018 and 2019, the US economy should remain in strong shape, and capable of digesting further hikes. Post decision, all eyes will be on the forecasts and press conference. Our expectation is gradual will remain the operative word, in line with recent communication.

FOMC going it alone on rates



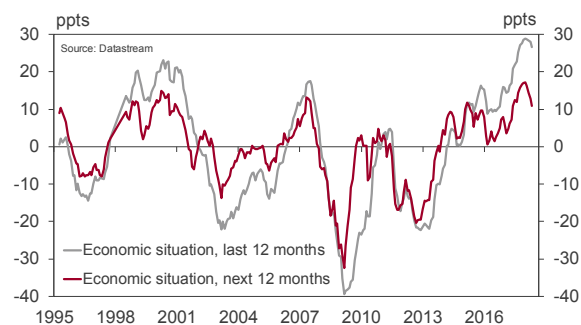
The week ahead

US Jun ECB meeting

Jun 14, deposit rate, last -0.40%, WBC -0.40%

- These are certainly interesting times for Europe. The past month has shown that the region's political instability is certainly not behind it. In addition, in early 2018, the economy has looked decidedly more fragile than anticipated.
- For policy makers, this calls for restraint. The awkward point however is that this is all occurring at a time when the market is desperate for guidance on the ECB's intended tightening of policy: first an end to the asset purchase program; then, at some stage, a rate hike(s). Recent comments by Council members imply discussions will be had at the June meeting, though (as evinced by the past) this does not mean detail will soon be forthcoming to the public. Look for loose guidance on the path forward at this press conference, followed by a concrete plan by September.

European HH confidence turning down



Data calendar

| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|------------------------------------|--------|---------------|------------------|--|
| Mon 11 | | | | | |
| NZ | May REINZ house prices, %yr | 3.8% | - | - | Policy changes are being rolled out... |
| | May REINZ house sales | -3.3% | - | - | ... to dampen house price inflation over the coming years. |
| | Q1 manufacturing activity | 1.0% | - | - | Earlier lift in petrol & coal manufacturing likely to reverse. |
| Aus | Queen's Birthday holiday | - | - | - | Public holiday (except Qld & WA). |
| Chn | May aggregate financing, yuan bn | 1561 | 1300 | - | Tentative date - 10-15. |
| UK | Apr trade balance, £b | -3091 | - | - | Trade and manufacturing have been resilient to date... |
| | Apr industrial production | 0.1% | -0.1% | - | ... but there are signs that conditions are softening. |
| | Apr construction activity | -2.3% | - | - | Earlier softness was related to inclement weather. |
| Tue 12 | | | | | |
| NZ | May retail card spending | -2.2% | - | 1.6% | Core to bounce after holiday volatility. Fuel prices up also. |
| Aus | Apr housing finance | -2.2% | -1.8% | -3.0% | Latest data pointing to further softening in conditions. |
| | Q2 AusChamber-Westpac survey | 58.3 | - | - | Manufacturing sector generally positive. |
| | May NAB business survey | 21 | - | - | Conditions well above avg on construction & bus services. |
| Eur | Jun ZEW survey of expectations | 2.4 | - | - | Politics and trade to shock confidence? |
| UK | Apr ILO unemployment rate | 4.2% | 4.2% | - | The labour market remains tight despite other headwinds. |
| US | May NFIB small business optimism | 104.8 | 104.8 | - | Very happy at present. |
| | May CPI | 0.2% | 0.2% | 0.3% | Core prices likely up 0.2% in month. |
| | May monthly budget statement \$bn | 214.3 | - | - | Interest in monthly numbers will grow with deficit. |
| Wed 13 | | | | | |
| NZ | May food price index | 0.1% | - | -0.2% | Softness expected in fruit/veg, non-alcoholic beverages. |
| Aus | Jun Westpac-MI Consumer Sentiment | 101.8 | - | - | Budget bump not enough to offset weak finances in May. |
| | RBA Governor Lowe | - | - | - | 'Productivity, Prosperity & Wages', Melbourne 1:30pm AEST. |
| Eur | Apr industrial production | 0.5% | 0.0% | - | Softer momentum for manufacturers likely. |
| UK | May CPI | 0.4% | 0.3% | - | Oil will boost near term inflation. Core close to BOE target. |
| | Apr house price index, %yr | 4.2% | - | - | Price growth in London remains weak, other regions firmer. |
| US | May PPI | 0.1% | 0.3% | - | Soft Apr put pay to concerns re upstream price pressures. |
| | FOMC policy decision, midpoint | 1.625% | 1.875% | - | Fed's Powell press conference after FOMC decision. |
| Thu 14 | | | | | |
| Aus | Jun MI inflation expectations | 3.7% | - | - | Will rising petrol prices boost expectations? |
| | May employment | 22.6k | 19.0k | 17.0k | Indicators suggest the soft patch will pass but the pace ... |
| | May unemployment rate | 5.6% | 5.6% | 5.5% | ... of employment growth to slow to 2.6%/yr. |
| Chn | May retail sales ytd %yr | 9.7% | 9.7% | - | Consumer in robust shape. |
| | May industrial production ytd %yr | 6.9% | 6.8% | - | PMI's pointing to continued strength for manufacturing. |
| | May fixed asset investment ytd %yr | 7.0% | 6.9% | - | Housing robust in early-2018; other sectors mixed. |
| Eur | ECB policy decision, deposit rate | -0.40% | -0.40% | -0.40% | Evidence of discussion re end of QE to come to fore? |
| UK | May RICS house price balance | -8% | - | - | Housing demand remains weak, esp. in London. |
| | May retail sales | 1.6% | - | - | Real income squeeze, uncertainty weighing on spending. |
| US | Initial jobless claims | 222k | - | - | Very low. |
| | May retail sales | 0.2% | 0.4% | 0.5% | Better incomes should flow to spending, to a degree. |
| | May import price index | 0.3% | 0.5% | - | US dollar gains to moderate import price growth. |
| | Apr business inventories | 0.0% | 0.3% | - | Have been volatile over past year. |
| Fri 15 | | | | | |
| NZ | May BusinessNZ manufacturing PMI | 59.8 | - | - | Manuf. conditions firmed, incl. increase in forward orders. |
| Aus | RBA Assistant Governor Econ Ellis | - | - | - | At Infrastructure Partnerships Australia lunch, Syd 1:30pm. |
| Eur | Apr trade balance €bn | 21.2 | - | - | Will likely soften with global PMI's. |
| | May CPI %yr final | 1.9% | 1.9% | - | Flash saw headline jump on energy; core subdued. |
| US | Jun Fed Empire state index | 20.1 | 18.0 | - | Regional surveys volatile but strong. |
| | May industrial production | 0.7% | 0.3% | - | ISM's continue to well and truly outpace actual activity. |
| | Jun Uni. of Michigan sentiment | 98.0 | 98.4 | - | Very positive; labour market key. |
| | Apr total net TIC flows \$bn | -38.5 | - | - | Of greater interest amid trade tensions. |
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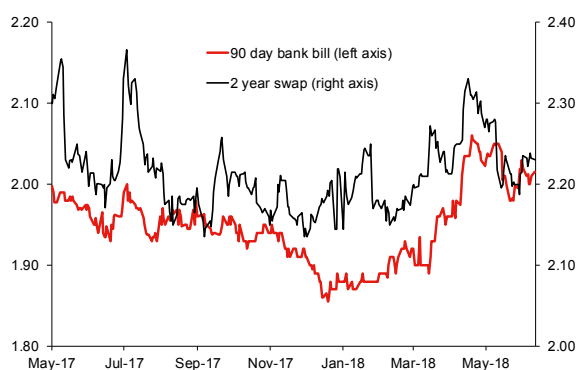
New Zealand forecasts

| Economic Forecasts | Quarterly | | | | Annual | | | |
|----------------------------------|-----------|------|------|------|----------------|------|-------|-------|
| | 2017 | 2018 | | | Calendar years | | | |
| % change | Dec(a) | Mar | Jun | Sep | 2016 | 2017 | 2018f | 2019f |
| GDP (Production) | 0.6 | 0.5 | 0.7 | 0.8 | 4.0 | 2.9 | 2.6 | 3.2 |
| Employment | 0.4 | 0.6 | 0.2 | 0.3 | 5.8 | 3.7 | 1.4 | 1.4 |
| Unemployment Rate % s.a. | 4.5 | 4.4 | 4.4 | 4.5 | 5.3 | 4.5 | 4.6 | 4.6 |
| CPI | 0.1 | 0.5 | 0.6 | 0.7 | 1.3 | 1.6 | 2.1 | 1.4 |
| Current Account Balance % of GDP | -2.7 | -2.7 | -3.1 | -3.5 | -2.2 | -2.7 | -3.6 | -3.7 |

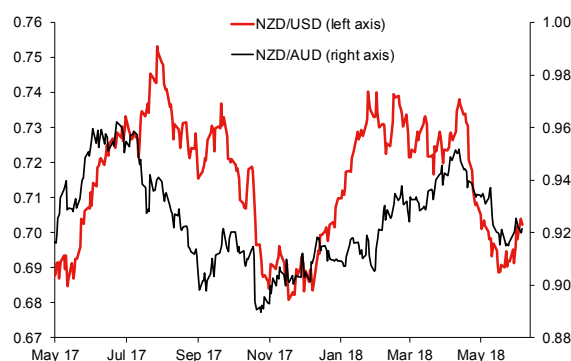
¹ Annual average % change

| Financial Forecasts | Jun-18 | Sep-18 | Dec-18 | Mar-18 | Jun-19 | Sep-19 |
|---------------------|--------|--------|--------|--------|--------|--------|
| Cash | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 |
| 90 Day bill | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.10 |
| 2 Year Swap | 2.20 | 2.20 | 2.30 | 2.40 | 2.55 | 2.70 |
| 5 Year Swap | 2.70 | 2.75 | 2.90 | 3.05 | 3.15 | 3.25 |
| 10 Year Bond | 2.90 | 3.00 | 3.20 | 3.30 | 3.35 | 3.40 |
| NZD/USD | 0.69 | 0.68 | 0.67 | 0.65 | 0.65 | 0.64 |
| NZD/AUD | 0.92 | 0.91 | 0.91 | 0.90 | 0.90 | 0.91 |
| NZD/JPY | 75.9 | 75.5 | 75.0 | 74.1 | 73.5 | 71.7 |
| NZD/EUR | 0.58 | 0.57 | 0.57 | 0.56 | 0.55 | 0.53 |
| NZD/GBP | 0.51 | 0.52 | 0.53 | 0.53 | 0.53 | 0.52 |
| TWI | 72.1 | 71.4 | 70.9 | 69.5 | 69.6 | 68.9 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 11 June 2018

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 1.75% | 1.75% | 1.75% |
| 30 Days | 1.90% | 1.89% | 1.88% |
| 60 Days | 1.95% | 1.93% | 1.96% |
| 90 Days | 2.02% | 2.00% | 2.05% |
| 2 Year Swap | 2.23% | 2.20% | 2.21% |
| 5 Year Swap | 2.71% | 2.66% | 2.67% |

NZ foreign currency mid-rates as at 11 June 2018

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.7028 | 0.6920 | 0.6966 |
| NZD/EUR | 0.5967 | 0.5922 | 0.5830 |
| NZD/GBP | 0.5239 | 0.5196 | 0.5142 |
| NZD/JPY | 76.7660 | 75.89 | 76.15 |
| NZD/AUD | 0.9259 | 0.9156 | 0.9240 |
| TWI | 73.8800 | 72.87 | 72.93 |

International forecasts

| Economic Forecasts (Calendar Years) | 2014 | 2015 | 2016 | 2017 | 2018f | 2019f |
|-------------------------------------|------|------|------|------|-------|-------|
| Australia | | | | | | |
| Real GDP % yr | 2.6 | 2.5 | 2.6 | 2.3 | 2.7 | 2.5 |
| CPI inflation % annual | 1.7 | 1.7 | 1.5 | 1.9 | 2.1 | 1.9 |
| Unemployment % | 6.2 | 5.8 | 5.7 | 5.5 | 5.5 | 5.6 |
| Current Account % GDP | -3.0 | -4.7 | -3.1 | -2.3 | -2.7 | -3.8 |
| United States | | | | | | |
| Real GDP %yr | 2.6 | 2.9 | 1.5 | 2.3 | 2.8 | 2.5 |
| Consumer Prices %yr | 1.6 | 0.1 | 1.3 | 2.1 | 2.6 | 2.0 |
| Unemployment Rate % | 6.2 | 5.3 | 4.9 | 4.4 | 4.0 | 3.8 |
| Current Account %GDP | -2.3 | -2.3 | -2.3 | -2.6 | -2.5 | -2.4 |
| Japan | | | | | | |
| Real GDP %yr | 0.4 | 1.4 | 0.9 | 1.7 | 1.3 | 1.0 |
| Euroland | | | | | | |
| Real GDP %yr | 1.3 | 2.1 | 1.8 | 2.3 | 2.1 | 1.6 |
| United Kingdom | | | | | | |
| Real GDP %yr | 3.1 | 2.3 | 1.9 | 1.8 | 1.2 | 1.5 |
| China | | | | | | |
| Real GDP %yr | 7.3 | 6.9 | 6.7 | 6.9 | 6.3 | 6.1 |
| East Asia ex China | | | | | | |
| Real GDP %yr | 4.2 | 3.8 | 3.9 | 4.5 | 4.3 | 4.3 |
| World | | | | | | |
| Real GDP %yr | 3.6 | 3.5 | 3.2 | 3.8 | 3.8 | 3.7 |

Forecasts finalised 4 May 2018

| Interest Rate Forecasts | Latest | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| Australia | | | | | | | | |
| Cash | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| 90 Day Bill | 2.05 | 1.94 | 1.90 | 1.88 | 1.86 | 1.85 | 1.83 | 1.83 |
| 10 Year Bond | 2.80 | 2.90 | 3.05 | 3.20 | 3.10 | 3.10 | 3.00 | 3.00 |
| International | | | | | | | | |
| Fed Funds | 1.625 | 2.125 | 2.125 | 2.375 | 2.625 | 2.625 | 2.625 | 2.625 |
| US 10 Year Bond | 2.93 | 3.10 | 3.35 | 3.50 | 3.50 | 3.40 | 3.20 | 3.10 |
| ECB Deposit Rate | -0.40 | -0.40 | -0.40 | -0.40 | -0.30 | -0.30 | -0.20 | -0.10 |

| Exchange Rate Forecasts | Latest | Sep-18 | Dec-18 | Mar-18 | Jun-19 | Sep-19 | Dec-19 | Mar-20 |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| AUD/USD | 0.7608 | 0.75 | 0.74 | 0.72 | 0.72 | 0.70 | 0.70 | 0.72 |
| USD/JPY | 109.67 | 111 | 112 | 114 | 113 | 112 | 110 | 109 |
| EUR/USD | 1.1799 | 1.17 | 1.16 | 1.15 | 1.16 | 1.18 | 1.20 | 1.21 |
| AUD/NZD | 1.0832 | 1.10 | 1.10 | 1.11 | 1.11 | 1.09 | 1.08 | 1.09 |

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