Retail Outlook

August 2011

Swimming against the tide

New Zealand's economy has been gaining momentum, supported by high commodity prices, low interest rates and rebounding confidence. At the same time, clouds have gathered over the global economy and global financial conditions have taken another turn for the worse. That could mean challenging months ahead. But key drivers of growth further down the track – most notably the massive rebuilding task in Canterbury following the earthquakes – are New Zealand specific and unchanged.

A head of steam locally

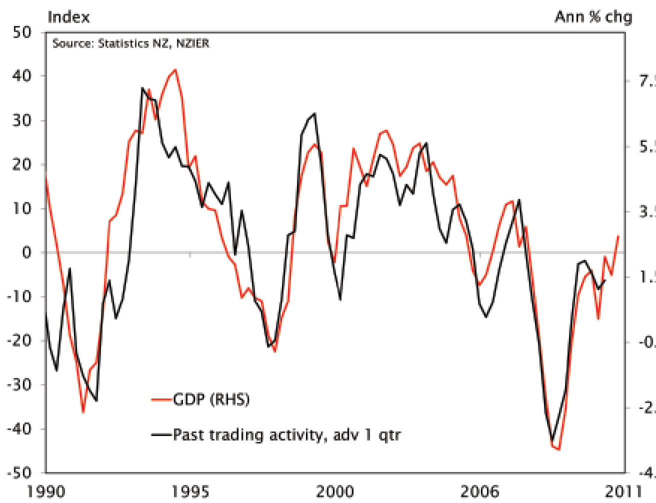
New Zealand's economic recovery gained momentum in recent months, even as the ground continued to shake in Canterbury. Although February's quake caused massive damage, disruption to GDP was more limited than initially feared – partly because there was widespread displacement of economic activity (activity migrated from one place to another, rather than disappearing altogether), and partly because of earthquake-related boosts to the likes of civil defence and insurance assessment. Add to this the news that activity in late 2010 was considerably stronger than first thought, and signs that momentum continued into the middle part of the year (businesses have reported continuing solid growth in trading activity, for example), and the New Zealand economy is on a much firmer footing than we feared 3 months ago.

That momentum reflects a rapid rebound in the confidence of both firms and households. Nationally, business and consumer confidence has recovered to (or even surpassed) pre-quake levels - no doubt helped in part by the Reserve Bank's interest rate cut back in March. A noticeable improvement in the housing market has also provided support for spending, especially in Auckland. Housing turnover there is up more than 20% on a year ago, while nationwide house sales are 12% higher. Although turnover had started to move higher before February's earthquake, the RBNZ's "insurance" interest rate cut in March almost certainly gave an extra leg up. House price gains however have been more modest. We continue to expect house prices nationwide to be up about 4% in 2011 before flattening off as rising interest rates start to hit home.

The other factor that has been helping both business and consumer confidence, particularly in the rural sector, has been recent strength in commodity prices combined with excellent growing conditions in many regions. That said, the factors that have been a drag on rural spending over the last year remain in the background. Rural property prices have broadly stabilised but show no signs of recovery to pre-recession levels. And high debt levels remain a concern for some in the sector, although improving cash flows have provided some relief.

Against this backdrop, consumers have gradually begun to open their wallets. Electronic card transactions have shown solid gains - despite retail activity in Canterbury remaining more than 6% below its pre-quake levels. Yet for many retailers, while the recent improvement in sales is no doubt welcome, they will still find that times are tougher than a few years ago. Adjusted for inflation, consumers are still spending 8.5% less per person than they were back in early 2007.

Economic growth and surveyed business activity



A chill wind globally

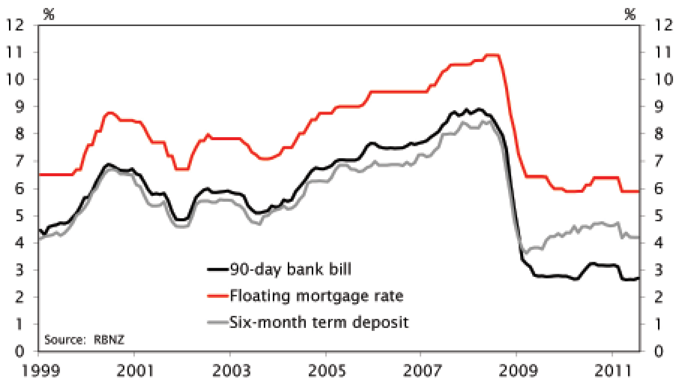
At the same time, things have been looking progressively more gloomy offshore - the global economy is slowing and in recent weeks global financial conditions have taken a distinctly nastier turn. Some of the economic slowdown we've seen doesn't come as a surprise. China and India need to slow to cool their overheating economies and avoid damaging inflation. And we always expected the massive problems faced by the US after the financial crisis to lead to years of anaemic growth (though not quite as anaemic as the latest figures indicate). But Australian consumer confidence has taken a bigger hit from last year's interest rate hikes and falling house prices than we expected. And as financial markets have woken up to the scale of the debt challenges facing the US and Europe, that's raised the spectre of a broader collapse in confidence, and even of renewed seizures in the global banking system.

New Zealand isn't immune to these developments. The obvious thing to watch here, of course, is confidence – rebounding consumer and business confidence has clearly mattered for the recovery we've seen to date. But we'll also be paying attention to borrowing costs, commodity prices and the NZ dollar, and the Australian economy.

- **Consumer and business confidence:** The latest surveys, from early August, showed business confidence falling but staying at historically high levels, and consumer confidence even eking out a small gain. What happens to business confidence will, if anything, be more important in coming months. After years of under-investment following the recession, there's an underlying need for residential and capital investment even outside Canterbury, and capital imports have been surging in the past half year – but investment and hiring decisions could end up being delayed, which would ultimately impact on household incomes and spending.

- **Borrowing costs:** Fears have been growing about the health of the European banking system, and this could yet lead to New Zealand banks having to pay higher costs for their funding. The good news is that the RBNZ is now unlikely to unwind the interest rate cuts that it made after the Christchurch earthquake before December – but if banks' offshore borrowing costs rise (as they did in 2008) mortgage rates may not fall as much as wholesale rates have fallen.

New Zealand wholesale and retail interest rates

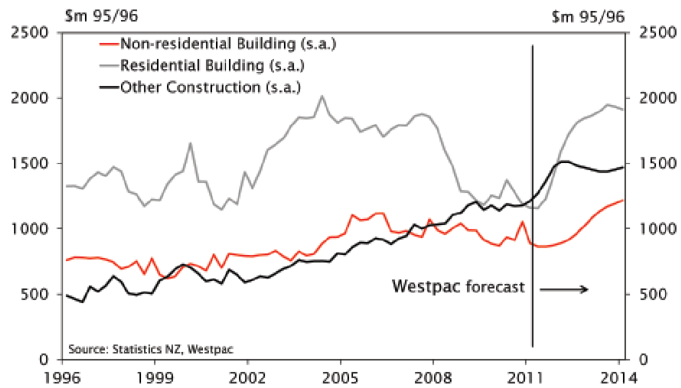


- **Commodity prices and the exchange rate:** We've been expecting commodity prices to ease for a while as China slows, but if they fall sharply confidence in the rural sector could take another hit. We could also see a period of volatility in the New Zealand dollar – with weaker global growth likely to push the Kiwi lower. That could be challenging for importers, and eventually dent consumers' wallets in the form of higher import prices. On the upside, slowing global growth also means declines in crude oil prices, which have already flowed through to lower petrol prices at the pump.

- **Australia:** One of the more worrying developments offshore has been plunging consumer confidence in Australia. Australian tourists are the lynchpin of the New Zealand tourism industry in terms of total spend and while the strong Australian dollar is making New Zealand an affordable destination, we think this will be trumped by the sharp drop in consumer sentiment. Fortunately the Rugby World Cup should provide a much needed fillip in coming months.

So we're back in choppier and more uncertain waters. But there's a couple of reasons to think that New Zealand is less vulnerable to another financial shock than it was back in 2008. The first is that the banking system is less dependent on short-term funding from overseas – the banks have a bigger local deposit base and more of their off-shore funding is long-term. That makes it easier to ride out a global financial storm.

Construction activity by sector



The second reason is that the growth we're expecting this time round is less dependent on what's going on in the US and Europe, or even on consumer confidence locally. Above all, there is the feature dominating New Zealand's economic landscape from 2012 – the reconstruction effort in Christchurch, which is mostly paid for by insurance payouts and government. And while commodity prices have eased and are likely to fall further in coming months, over the longer term we continue to think that rising Asian demand for food will outstrip supply and support prices at historically high levels. That's where a lot of the growth will come from over the next few years – not from another housing boom or from households taking on more debt (though this doesn't preclude growth in consumer spending). Regardless of what happens to the global economy, that's a critically important rebalancing that will ultimately leave the New Zealand economy in stronger shape.

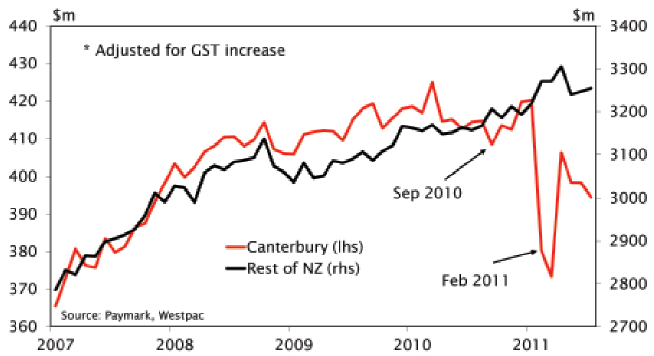
Data roundup

The earthquake-delayed March quarter retail trade figures showed New Zealand consumers starting to crack open their wallets again in the early part of this year, even if it was only to blow some of the cobwebs out. Electronic transactions data since then have been indicating further momentum in spending, despite an ongoing hit to Canterbury retail activity from the February earthquake.

Retail sales volumes rose 0.9% in the March quarter, just barely reversing their decline through the second half of 2010. The rise in sales was in part due to the easy gains to be made after the post-GST hangover (last year, purchases of some big-ticket items had been brought forward into September to beat the 1 October increase in GST). Outside these categories, sales volumes were relatively steady. Fuel volumes (-3.9%) were weighed down by the disincentive of sharply higher prices (up nearly 10% for the quarter), but this doesn't seem to have been a significant drag on consumers' willingness to spend elsewhere. Excluding fuel and cars, retail sales volumes were up 0.7%.

Beyond the March quarter, electronic card transactions data have been pointing to an ongoing pickup in spending (the latest values we have are for July). Despite further rises in food and fuel prices, the gains have mainly been in the 'core' (ex fuel and motor vehicle) category (up 4.2% since March), led by spending on clothing, hospitality and services. Paymark data (which make up about 75% of total credit and debit card spending) show that some of these gains reflect a pickup in Canterbury spending from its March lows, though more recently spending nationwide has continued to improve even as the Canterbury recovery has stalled. Canterbury spending remains more than 6% below pre-quake levels.

Paymark card transactions, s.a.*



Retail sales volumes (seasonally adjusted)

	$m	Quarterly % chg			Ann % chg
Storetypes	**Mar-11**	**Sep-10**	**Dec-10**	**Mar-11**	**Mar-11**
Supermarket and grocery stores	4137	0.0	1.6	-0.4	1.8
Specialised food retailing (excluding liquor)	327	-2.4	0.6	1.7	1.9
Liquor retailing	307	-5.0	0.7	-2.2	-7.0
Non-store and commission based retailing	215	-4.6	2.8	31.8	21.6
Department stores	916	-0.5	-0.1	-0.4	-0.7
Furniture, floor coverings, housewares and textile goods retailing	428	-1.4	-9.6	8.0	-0.4
Hardware, building and garden supplies	1147	0.6	-2.6	0.3	-3.2
Recreational goods retailing	460	0.4	0.6	-0.6	-3.5
Clothing, footwear and personal accessory retailing	880	1.0	1.9	0.6	9.2
Electrical and electronic goods retailing	661	3.5	-0.3	4.1	11.5
Pharmaceutical and other store based retailing	1075	-1.0	-1.4	-0.4	-2.1
Accommodation	607	-0.3	-1.8	-3.6	-0.2
Food and beverage services	1651	0.2	0.8	1.4	0.6
Core industries total	**12810**	**-0.1**	**0.0**	**0.7**	**1.3**
Motor vehicle and parts retailing	1976	1.7	-8.2	6.3	3.3
Fuel retailing	1626	-5.1	6.4	-3.9	-6.9
All industries total	**16411**	**-0.4**	**-0.4**	**0.9**	**0.6**

Electronic card transactions values (seasonally adjusted)

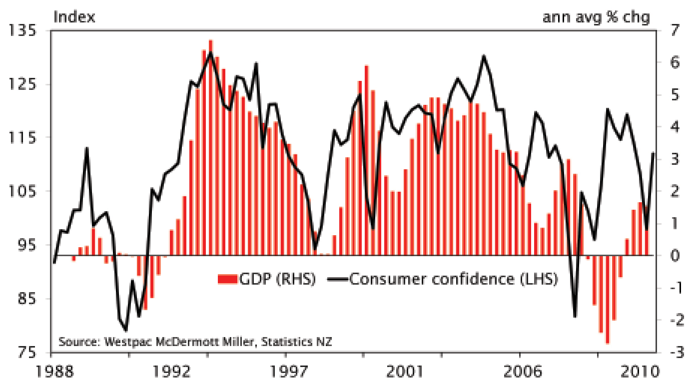
	$m	Monthly % chg			Ann % chg
Industry group	**Jul-11**	**May-11**	**Jun-11**	**Jul-11**	**Jul-11**
Consumables	1465	0.1	1.3	0.2	10.1
Durables	998	-1.1	2.4	0.2	3.5
Hospitality	617	1.7	2.3	1.5	10.4
Services	163	3.5	0.8	0.2	7.5
Apparel	278	-1.7	4.7	0.8	6.7
Core retail	**3372**	**-0.1**	**2.1**	**0.5**	**8.0**
Motor vehicles excl. fuel	106	1.3	1.0	-0.7	5.4
Fuel	556	-4.6	-3.7	-1.4	13.4
Retail	**4041**	**-0.7**	**1.1**	**0.4**	**9.0**
Non-retail excl. services	1137	0.9	-0.9	0.3	6.0
Total	**5334**	**-0.1**	**0.7**	**0.2**	**8.2**

Consumer confidence rebounds

The Westpac McDermott Miller Consumer Confidence Index rose from 97.9 to 112 in the June quarter, fully unwinding March's earthquake-related decline. Confidence is now higher than in December, though still below mid-2010 levels (before confidence was hit by last year's economic slowdown and the first, September Christchurch earthquake).

Consumer Confidence Indices[1]

	Mar-11	Jun-11	change
Consumer Confidence Index	97.9	112.0	14.1%
Present Conditions Index	96.2	103.9	7.7 %
Future Conditions Index	99.1	117.4	18.4%



Consumer confidence has rebounded from the lows following the 22 February Christchurch earthquake, with a particularly strong lift in households' expectations for the coming year. (Survey interviews were conducted over 1 – 12 June. An index number of 100 indicates that pessimists outnumber optimists, although the series may be above or below 100 on average. The margin of error in the survey is 2.5% at a 95% confidence interval.)

Underlying this improvement was a rebound in households' near-term economic outlook. While a net 6.7% of households continue to expect bad economic times over the next 12 months, this represents a full reversal of March's decline in economic confidence (a net 46.5% expected bad times last quarter) and is the least pessimistic response since December last year.

But the Present Conditions Index also improved, rising from 96.2 to 103.9, meaning that a majority of households now see conditions as better than a year ago. This is partly because their assessment of their own financial situation continued to improve (though a net 18.3% still think they are financially worse off than a year ago). But there was also a jump in households thinking that now is a good time to buy a major household item (from a net 12.5% to a net 26%).

Headline confidence lifted in all parts of the country, and remains highest in the three main metropolitan areas (including Canterbury), as well as dairy country – Southland, Waikato and Bay of Plenty. But the details give a more nuanced impression of the mood in Christchurch following the quake (urban Christchurch is back in the sample after being excluded from the March survey due to earthquake disruption). Christchurch residents remain a lot worse off (relative to a year ago) than most of the country, but they expect some bounceback in their personal financial situation over the coming year (on balance 25% expect it to improve). And Christchurch residents' expectations for the New Zealand economy are now about as pessimistic as Wellingtonians', with a balance of 12% expecting bad times over the year ahead.

As well as national economic prospects, the survey asked respondents for their outlook for their regional economy. This reveals some interesting divergences:

- Cantabrians remain a lot more pessimistic for their region than for New Zealand as a whole, or for their own personal prospects.
- Auckland residents are not only the most optimistic for the New Zealand economy over the coming year, their optimism for their own region also saw a big rebound this quarter (a similar rebound was seen last December).
- Southland, Waikato and Taranaki are enjoying by far the strongest regional optimism in the country. What's more, this is the most optimistic that these regions have been since the late-2009/early 2010 rebound. This buoyant regional outlook in dairy producing regions is clearly a reflection of strong prices and growing conditions, but may also be a sign that farmers are finally beginning to spend in the high streets.
- While confidence among Wellingtonians remains relatively high overall, their outlook for their own city has become more pessimistic. This may be a response to the public sector cutbacks announced in the May Budget.

Consumer confidence by region

Region	Dec-10	Mar-11	Jun-11
Northland	97.3	90.9	105.4
Auckland	109.5	101.6	115.4
Waikato	109.6	103.4	112.5
Bay of Plenty	101.2	95.2	111.1
Gisborne/Hawke's Bay	104.4	94.2	108.8
Taranaki/Manawatu-Wanganui	101.6	97.1	109.7
Wellington	115.1	101.6	116.6
Nelson-Marlborough/West Coast	106.2	91.1	98.2
Canterbury	109.9	90.4	112.0
Otago	113.2	97.4	103.4
Southland	104.0	92.8	111.3

1. The Present Conditions Index is an average of responses to the questions regarding current personal financial situation and readiness to buy major household items. The Future Conditions Index is an average of responses to questions regarding next year's personal financial situation, the 1-year economic outlook, and the 5-year economic outlook.