Retail Outlook

May 2011

Green shoots among the rubble

- February's devastating earthquake severely disrupted retail activity in the Canterbury region, and caused a plunge in consumer confidence
- But in New Zealand as a whole, spending has shown surprisingly strong momentum
- The outlook for house prices has also improved, so spending should be better placed to grow in line with rising incomes

In the weeks after the 22 February Christchurch earthquake, it looked as if disaster might smother the economic recovery which was beginning to emerge after a disappointing 2010. While we remain cautious for the growth outlook in the months ahead, it's starting to look as if those fears haven't come true – and looking forward to the second half of 2011, the reasons for optimism start to mount.

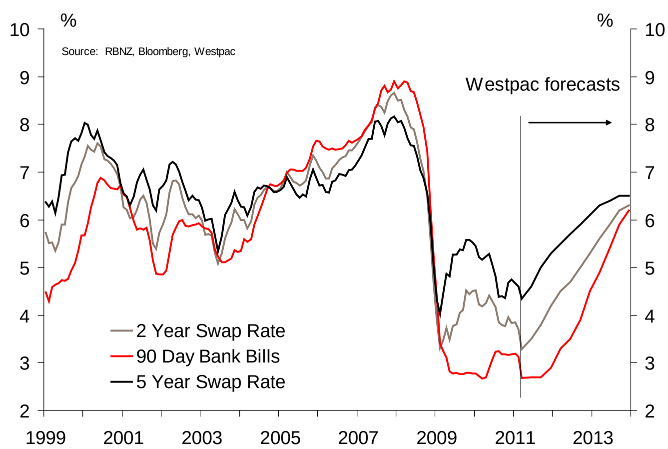
Certainly, the quake caused massive disruption to the Canterbury region, destroying infrastructure, damaging buildings, and shutting down the prime commercial zones in Christchurch's CBD. The best indicator we have of retail spending in Canterbury – Paymark's electronic transactions data – showed a more than 11% plunge in sales over the months of February and March in the region. Tourism appears to have suffered, with a more than 11% fall in visitor arrivals to New Zealand since February. And a lot of people left Christchurch for Australia in the weeks after the earthquake, ticking '1 year or more' on their departure card.

Of particular concern, surveyed consumer confidence nationwide fell to levels last seen in early 2009, when the country was reeling from global and local recession (see page 4 for details). Granted, that seemed due more to pessimism about the economy as a whole, than about respondents' own financial situation. But it was the risk of such a fall in confidence, along with the earthquake's economic disruption, that the Reserve Bank had in its sights when it cut the Official Cash Rate by 50 basis points in early March.

It's early days yet, but the flow of data and anecdote is starting to suggest that spending is holding up better than this drop in confidence threatened, and than we feared back in March. Outside Christchurch, transactions data have continued to post solid growth. In Christchurch itself, spending appears to have bounced back in April, though it's still well below pre-quake levels. And business confidence, at least, appears to have recovered much of its losses in April.

Our view has always been that the housing market is key to the outlook for spending, as property is most people's single biggest asset and its value affects their saving behaviour. House prices appear to have stabilized across most of the country (with some localized upward pressure in Auckland). That's in line with our assessment that house prices have now largely incorporated the impact of last year's tax changes on the value of rental property. Indeed we now expect modest growth in house prices this year, given support from low interest rates and housing shortages in Auckland and Christchurch. This should encourage household saving rates to stabilize as well, meaning that spending can start to grow more in line with incomes.

NZ interest rates



On the income front, the latest labour report was another piece of positive news, with surprisingly strong employment growth outside Canterbury. And looking ahead, there are several reasons to expect growth. By the second half of this year, Christchurch should move from recovery mode to reconstruction mode – reconstruction mostly financed by reinsurance payments from overseas (see our feature on the Christchurch earthquake for more details). The Rugby World Cup could, according to the Reserve Bank, add $700mn to the economy directly. And strength in commodity prices should increasingly flow through to the broader economy. Farmers have been understandably cautious given the swings in export prices seen in recent years, and farm prices 20% below their peaks. But farm prices, like house prices, appear to be stabilizing, rural confidence has picked up, and debt in the agri sector is not spread evenly, leaving many operators well placed to take advantage of investment opportunities in the year ahead. While we don't expect commodity prices to remain at recent highs, we also don't expect the trends towards urbanization and development in China and India to be complete any time soon, leaving us very optimistic for the medium-term export outlook.

There are of course risks and challenges. The road will continue to be rocky in the next few months as Canterbury finds its feet. Hard on the heels of the feel-good factor of the World Cup, November's election will present voters with the prospect of government cutbacks in the years ahead. And while the RBNZ can afford to sit on its hands while wage growth remains subdued, by 2012 we do expect the Canterbury rebuild to lead to a rapid decline in the unemployment rate, rising costs, and interest rate hikes (we're picking the first hike to be in early 2012). But it increasingly looks as if 2011 could be the year for some much-needed recovery of margin in the retail sector.

Towards reconstruction

The 22 February Christchurch earthquake wrought a tragic human toll, and the post-quake economic data we have is only beginning to reveal the blow it dealt to the Canterbury economy. We are currently costing the loss of New Zealand economic activity due to quake disruption at $4bn. That represents 15% of Christchurch's annual economic output, or 2% of New Zealand's GDP growth.

At this early stage we have no accurate gauge of what the final repair bill will be. Both the Reserve Bank and The Treasury are working with assumptions of upwards of $15bn worth of damage from all the Christchurch earthquakes since September, combined. We have adopted the same figure as a working assumption for our forecasts. The $15bn is made up of $9bn in damage to residential housing and household contents, $3bn in damage to commercial and industrial buildings, and $3bn in damage to government buildings and infrastructure.

New Zealand is well prepared to meet costs of this magnitude. The Earthquake Commission (EQC) spent sixty years building up $6.1bn of reserves before September's initial earthquake. EQC was also partially covered by reinsurance contracts for both the September and February quakes. We estimate that EQC's funds will be depleted but not exhausted after these liabilities are met. The government has budgeted for an additional $5.5bn to cover earthquake-related spending, which is a small portion of its total liabilities. And New Zealand's private sector was also well insured – to a much greater extent than in disasters such as the 1994 Los Angeles and 1995 Kobe earthquakes. Private insurance companies will be liable for about $7.5bn, mostly reinsured overseas. While one major household insurer has used up its reinsurance cover and has received a capital injection from the government to assure policy-holders they would be paid out, the insurance sector can still largely be described as stable. This is also the Reserve Bank's latest assessment. But we do expect a large hike in insurance premia that could become a permanent cost to the New Zealand economy.

Once the insurance paperwork is done there will be a huge influx of money into the Christhurch region from overseas and from central government, all earmarked for rebuilding the city. This amounts to a stimulus package of 60% of Canterbury's pre-quake GDP, or over 7% of New Zealand's, spread over many years. A construction boom is almost inevitable once the aftershocks settle. Hawkes Bay experienced a similar boom after its devastating 1931 eartqhuake, in the midst of the Great Depression.

We expect that Christchurch reconstruction will be a major factor pushing annual GDP growth above 4% in 2012. While this is economic activity we would rather wasn't needed, it will help create jobs and boost incomes in an economy which still has a lot of slack. But further down the track, all this growth in demand is a sure recipe for higher inflation, and eventually the Reserve Bank will be forced to respond by hiking the OCR. Given the economy's weak starting point, we expect the central bank will wait until early 2012 before kicking off the tightening cycle. But the hikes could be quite rapid once they get going. At the same time, construction costs will be higher, and firms will have to compete with Christchurch as well as Australia for labour. This will end up dampening growth in other parts of the economy, including the housing market and consumer spending.

This box has been condensed from our April Economic Overview. Forecasts as at 13 May 2011

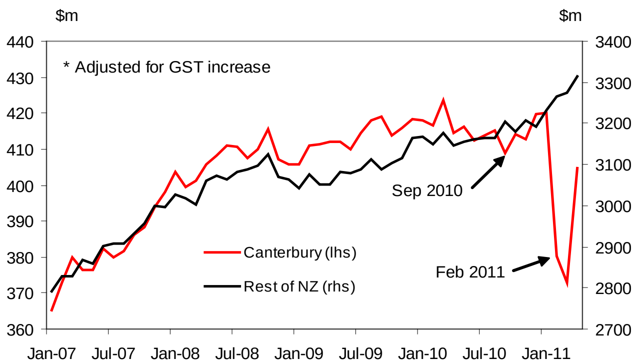
Data roundup

After a weak end to 2010, retail activity has picked up pace – both before and after the Christchurch earthquake. Retail sales had disappointed in the December quarter, falling 0.4% by volume. While some of the weakness can be chalked up to one-off factors – a post-GST hangover and the aftermath of the September Canterbury earthquake – these figures tell a more general tale of the consumer losing steam last year. That is not surprising: growth more generally stalled in the middle part of 2010, employment prospects dimmed, and house values began to fall again as tax changes reduced the benefits of property investment. With no income growth or perceived wealth increases to speak of, households reined in their spending accordingly.

Those drivers have now turned, and it appears that retail spending has followed suit. Disruption from the February earthquake has delayed the release of March quarter retail sales (the data are due to come out mid-June). But monthly electronic card transactions data are pointing to a turnaround in the new year, with the value of transactions up 5% (seasonally adjusted) since December. Not surprisingly given the more than 10% increase in petrol prices this year, some of the increase in electronic spending is due to fuel prices.

But 'core' (ex fuel and motor vehicle) spending was up a very solid 4.8% over the same period, with gains in hospitality and durable goods spending as well as food. In Canterbury itself, transactions plunged 11% over February and March, but Paymark data (which make up about 75% of total credit and debit card transactions) show an 8.5% rebound in April. This is encouraging, even though it still leaves Canterbury spending 3.5% below pre-February levels.

Paymark card transactions, s.a.



Retail sales volumes (seasonally adjusted)

Storetypes	$m Dec-10	Quarterly % chg Jun-10	Sep-10	Dec-10	Ann % chg Dec-10
Supermarket and grocery stores	4170	0.8	0.0	1.9	1.0
Specialised food retailing (excluding liquor)	321	2.4	-2.6	0.4	-1.4
Liquor retailing	314	-0.7	-5.2	1.1	-8.5
Non-store and commission based retailing	156	-5.7	-4.5	-3.2	-15.9
Department stores	921	0.3	-0.6	0.2	1.4
Furniture, floor coverings, houseware and textile goods retailing	396	3.7	-1.9	-9.4	-6.3
Hardware, building and garden supplies	1141	-1.3	1.0	-3.3	-0.9
Recreational goods retailing	463	-4.0	0.3	0.8	-4.6
Clothing, footwear and personal accessory retailing	877	5.6	0.8	2.3	10.6
Electrical and electronic goods retailing	630	4.3	3.9	-1.6	9.8
Pharmaceutical and other store based retailing	1072	0.3	-1.0	-2.0	-0.1
Accommodation	635	6.2	-0.4	-1.0	9.6
Food and beverage services	1623	-2.0	0.1	0.6	-2.6
Core industries total	**12713**	**0.2**	**0.0**	**0.0**	**0.6**
Motor vehicle and parts retailing	1859	4.0	1.7	-8.2	1.1
Fuel retailing	1692	-4.0	-5.1	6.4	-4.4
All industries total	**16270**	**0.6**	**-0.4**	**-0.4**	**0.2**

Electronic card transactions values (seasonally adjusted)

Industry group	$m Apr-11	Monthly % chg Feb-11	Mar-11	Apr-11	Ann % chg Apr-11
Consumables	1447	1.3	0.3	2.3	13.0
Durables	983	-2.6	2.9	0.9	3.6
Hospitality	582	-0.3	0.1	2.4	6.3
Services	156	1.1	-1.5	-0.4	6.4
Apparel	267	-5.0	3.1	1.9	4.8
Core retail	**3290**	**-0.4**	**1.2**	**1.6**	**8.1**
Motor vehicles excl. fuel	104	0.9	-0.6	2.2	5.9
Fuel	617	2.6	2.0	1.0	15.7
Retail	**4019**	**-0.0**	**1.6**	**1.5**	**9.5**
Non-retail excl. services	1131	2.0	-1.0	1.3	6.0
Total	**5302**	**0.5**	**0.5**	**1.7**	**8.5**

new zealand Retailers association

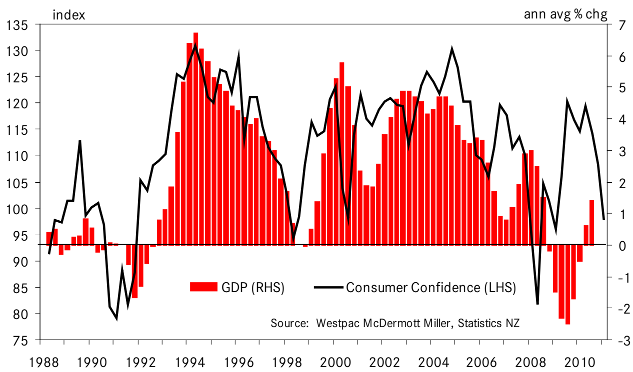
Consumer confidence plunges

The New Zealand Consumer Confidence Index fell 10.4 points to 97.9 in the March quarter. The survey was conducted in the weeks following the devastating 22 February Christchurch earthquake. Across the board, consumers were much more pessimistic about the near-term economic outlook. Other details of the survey were less gloomy.

Consumer Confidence Indices[1]

	Dec-10	Mar-11	change
Consumer Confidence Index	108.3	97.9	-10.4
Present Conditions Index	97.3	96.2	-1.1
Future Conditions Index	115.6	99.1	-16.5

Consumer Confidence and GDP



The Westpac McDermott Miller Consumer Confidence Index plummeted in the March quarter, from 108.3 to 97.9. The survey was conducted during the period 1 – 13 March 2011, between one and three weeks after the 22 February Christchurch earthquake – clearly the dominant influence on the outturn. This is the lowest that confidence has been since March 2009: less pessimistic than at the depths of early 1990s recession or the Global Financial Crisis, but akin to levels seen during the 1997-1998 Asian Crisis. An index number under 100 indicates that pessimists outnumber optimists, although the historical series average may be above or below 100. The survey's margin of error is 2.5% at a 95% confidence interval.

Looking into the detail, there was one clear driver of the fall in confidence: consumers were much more pessimistic about the near-term economic outlook. The net percentage of households expecting bad economic times over the next 12 months surged from 9.7% in December to 46.5%. Longer-term (5-year-ahead) economic expectations, expectations for households' own financial situation, and their readiness to buy big-ticket items, also declined, but by much less. Indeed, looking back on how their own financial situation had changed over the past year, on net households were slightly less negative than in December. The fall in confidence was across the board – geographically, by age, by income group, by gender. Not surprisingly, confidence fell more in the South Island, but steep declines were also seen in (earthquake-prone?) Wellington and Gisborne-Hawkes Bay. The very steep fall for Canterbury (by 19.5 points to 90.4, the lowest since June 2008) has to be interpreted with caution: out of respect for earthquake-affected residents, Christchurch households were not interviewed, and were replaced in the survey by additional households from the rest of Canterbury. The effect of this could go either way, as it shifts the sample towards (historically less optimistic) smaller urban and rural areas, but also excludes those worst affected by the disaster.

The survey also repeated an additional question asked in March and June last year, on the impact of changes to the tax and benefit system on households' financial situation. It seems that respondents have increasingly accepted that the combined impact on their financial situation of the GST increase and personal income tax cuts would be broadly neutral – 40% now report 'no change', nearly double the 24% in June last year. In June 37% expected the impact on their financial situation to be positive; that number has fallen to 29%. Respondents in the upper socio-economic group continue to be more positive about the tax and benefit changes than the lower socio-economic group, and people aged 50 or over are still more negative than younger folk. This age and income split matches our assessment of how the changes affect different groups: lower income tax is a clear benefit to most people, but more so for high income earners. And our assessment is that the tax changes have had a negative impact on house prices, which is by-and-large a boon to the young and a detriment to the old. Also, higher GST lowers the value of existing savings. But there has been a remarkable convergence of the different groups towards a more neutral view, with the upper-income and young having become less positive on net, and the lower-income and old less negative.

Regional Confidence Data

Region	Mar-10	Dec-10	Mar-11
Northland	107.7	97.3	90.9
Auckland	119.5	109.5	101.6
Waikato	113.0	109.6	103.4
Bay of Plenty	114.0	101.2	95.2
Gisborne/Hawke's Bay	108.5	104.4	94.2
Taranaki/Manawatu-Wanganui	108.2	101.6	97.1
Wellington	118.6	115.1	101.6
Nelson-Marlborough/West Coast	107.7	106.2	91.1
Canterbury	118.0	109.9	90.4
Otago	104.4	113.2	97.4
Southland	103.0	104.0	92.8