

Retail Outlook

October 2009

Clawing our way back

- The economic vibe is hotting up (*front page*).
- Getting more for your money (*inside*).
- Consumers on a high (*back page*).

It's official – the recession has ended! After five consecutive quarters of decline, the New Zealand economy finally managed to record some growth in the June 2009 quarter. It is a tenuous end mind you – GDP increased just 0.1% in the quarter, which is hardly spectacular. But it is growth nonetheless.

The key growth supports came from just a few sectors. There was a strong increase in real estate and business services as lower interest rates and net migration boosted house sales. Meanwhile, Maori oil helped boost mining activity, and exceptionally cold weather saw electricity demand rise strongly. The impact of expansionary fiscal policy was also evident, with infrastructure investment dampening the decline in the construction sector and the April tax cut helping lift consumer spending.

However, there were still large contractions in construction, manufacturing, wholesale trade, and transport and storage. The encouraging aspect of the data is that the detail points to more growth to come. A truly massive inventory unwind is a case in point. Production will need to lift to replenish depleted stockpiles, especially now consumer spending is rising again.

The GDP result isn't the only good news we have received in the last few weeks. Recent economic data releases have also revealed a whopping improvement in the current account deficit (what we owe the rest of the world), rising house prices, continued net migration gains, and a big upward revision to Fonterra's dairy payout for the 2009/10 season from \$4.55 to \$5.10/kg of milksolids (we estimate that this lifts farmer revenue by over \$750m, the equivalent of 0.4% of GDP). Of most importance, though, has been the surge in consumer and business confidence. A precursor to any economic recovery is a return of confidence and New Zealand has that in spades (*see back page for details*).

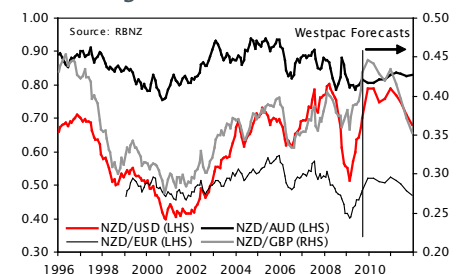
All this positive news will have the RBNZ seriously questioning whether they can really hold off lifting the OCR until late 2010 (as they reiterated in their September *Monetary Policy Statement*), especially when it comes on top of the latest inflation data. In the year ended September 2009 annual inflation fell to 1.7%. While that is relatively low, and well within the RBNZ's %1-3% inflation target band, it is concerning that after five quarters of recession inflation is not even lower.

The RBNZ still has a lot to weigh up before it takes any action – the sustainability of the global recovery, the degree of slack in the economy, the impact of the rising currency – but

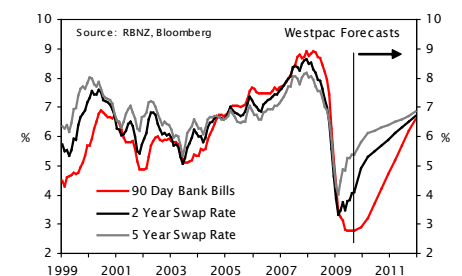
the case is mounting for interest rates to start returning to 'normal' levels sometime soon. We expect the RBNZ to begin tightening from March 2010. Indeed, a case can be made for an even earlier start, but we're not convinced that the RBNZ will be prepared to do an about-face on its recent soft tone too quickly.

We have also revised up our NZD forecast track, reflecting both the expectation of the earlier timing of rate hikes here, and the spill-over from a more aggressive tightening in Australia. We now see the NZD at 0.79 against the USD by year end, and just under 69.0 in trade-weighted terms (TWI).

NZ exchange rate



NZ interest rates



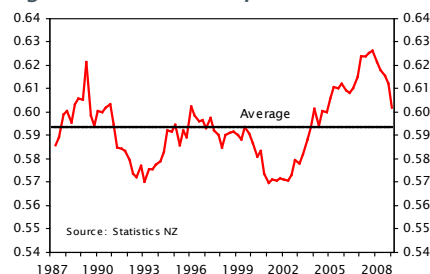
Getting more for your money

Economic forecasts from the RBNZ and Treasury have real consumer spending way undershooting real GDP growth over the next few years. We are not so convinced.¹

New Zealand Inc has undoubtedly been on a debt-funded spending splurge in the past decade. Net foreign liabilities (what we owe the rest of the world) increased from around 80% to 100% of GDP. But the rapid debt build-up didn't deliver quality economic growth: New Zealand's productivity flat-lined in the 2000s.

The finger of blame has often been pointed at the NZ consumer, largely on the premise that the debt fuelled an unsustainable consumption splurge that saw household consumption as a share of GDP catapult in real (i.e., inflation adjusted) terms. Indeed, as Figure 1 illustrates, the share increased from 57% to 62.5% in just 5 years. The prognosis by government officials therefore is that the consumer is set for numerous years of belt tightening as payback for the years of gluttony. We beg to differ.

Figure 1: Real consumption % GDP



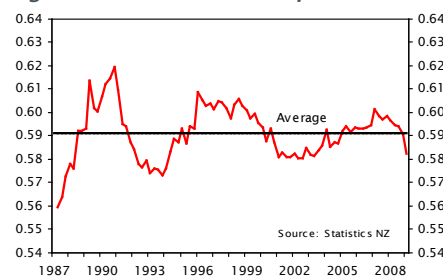
While there is no denying that the household sector piled on debt through the mid-2000s (the ratio of household debt to disposable income increased from 105% in 2000 to 160% in 2007), it is not the only explanation for the surge

in consumption through that period. Changing relative prices is also a key factor. Or more specifically, cheaper imports were a key component of the consumption growth in the 2000s.

Lies, damn lies, and statistics

To help explain, we need to look at consumption's share of the economy in nominal terms rather than real (i.e., including inflation). Recasting the data in this manner (see Figure 2), leaves you with an entirely different perception. The relative consumption boom of 2002 – 2007 was modest by historical standards and, as a share of the economy, is now below its long term average.

Figure 2: Nominal consumption % GDP



So why the massive divergence between consumption's share in nominal and real terms? In pure accounting terms, the explanation lies with prices. Inflation of consumer goods prices was less than average inflation in the rest of the economy – particularly from 2002 to 2007. But the reason is the terms of trade (ToT).

The ToT is the ratio of export prices to import prices, both expressed in NZ dollars. For a given volume of exports, the ToT measures how much by way of imports we can afford. A rise in the ToT basically means New Zealand gets more for what it produces. So we can consume

more, without producing more. Between 2002 and end 2007, New Zealand's ToT rose around 20%. That represented a massive relative price shock to the benefit of the NZ economy. A big part of the story has been the China factor: China's rapid growth has helped push up NZ's commodity prices and the integration of their manufacturing capacity into the global economy lowered the price we pay for many imported consumer goods.

Conclusion

An adjustment to NZ's outsized debt has already begun, and will likely continue. That means there will be slower growth in the economy (compared to 2000 – 2007) as increased leverage will not play as big a role as it has in the past decade. But the point of this note is that NZ Inc has to do that adjustment, not just the consumer.

Looking at the share of real consumption to trend GDP, with the popular perception that the increase in consumption was mostly debt funded, the natural conclusion would be that the consumer is going to relatively under-perform the general economy over coming years. Both Treasury and RBNZ forecasts are for real consumption growth to way undershoot real GDP growth over upcoming years.

However, looking at the consumption share on a nominal rather than real basis, and recognising that the consumer has experienced a very favourable relative price shock, suggests that the consumer sector does not have further big adjustment ahead of it. As such, we expect the sector to perform on a par with the broader economy over the next few years.

¹ This is an excerpt from our Westpac Bulletin, "Getting more from your money", 20 August 2009.

Data roundup

Retail sales are starting to rise again after being slammed during the recession. Sales volumes posted a 0.4% gain in the second quarter of 2009, following six consecutive quarterly declines. Rising net migration, an improving housing market, an increasing punch from the prior aggressive interest rate cuts and the April 1st tax cut have all helped to arrest the decline in sales volumes. But, even with the small improvement, the volume of

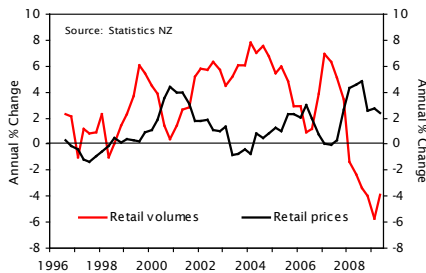
retail sales remains 6.6% below its peak more than 2 years ago. On a per person basis, sales volumes have dropped 8.7% from their peak in early 2007. Per person spending at the shops is at the same level as it was 5 years ago.

The good news is that we expect growth from this low base. Indeed, the most recent data for the month of August revealed much stronger than expected nominal sales growth (more than double

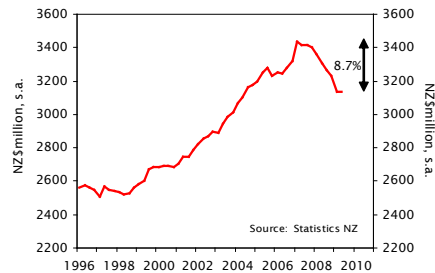
expectations). And, importantly, the recovery story has likely continued since August with electronic card transactions data and car registrations both pointing to a solid gain in retail sales in September.

By region, the strongest growth has been in Auckland, with sales on a strong upward trend since February. The weakest region has been Wellington, with the trend down 7.3% since March 2008.

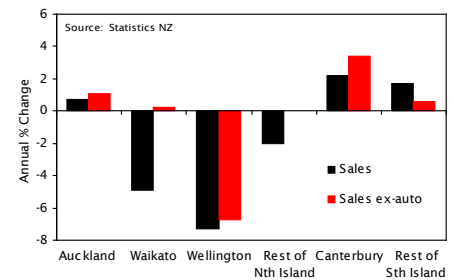
Retail volumes and prices



Per capita real retail sales



Regional sales



Retail Sales actual (\$ millions)

Storetypes	Months			Quarters		
	Aug-08	Aug-09	Annual % change	Jun-08	Jun-09	Annual % change
Supermarkets and Grocery	1,161	1,251	7.8	3,400	3,687	8.4
Fresh Produce	75	81	7.4	218	241	10.4
Liquor	97	98	0.5	282	290	2.9
Other Food	61	64	4.7	184	195	6.0
Takeaway Food	106	114	7.0	300	327	9.2
Department Stores	297	269	-9.6	901	891	-1.2
Furniture and Floor Coverings	113	107	-5.1	356	298	-16.4
Hardware	107	113	5.6	348	332	-4.8
Appliance	204	213	4.3	580	606	4.4
Recreational goods	160	173	8.0	511	533	4.2
Clothing and Softgoods	195	204	4.7	660	662	0.2
Footwear	33	32	-3.5	125	128	2.3
Chemist	155	152	-1.7	437	456	4.3
Household Equipment Repair	31	31	1.4	93	92	-1.9
Other Retailing	220	220	-0.3	653	658	0.7
Accommodation	197	188	-4.9	561	524	-6.5
Bars and Clubs	108	98	-9.7	301	277	-8.1
Cafes and Restaurants	309	317	2.5	923	948	2.7
Personal and Household Goods Hiring	17	18	7.8	57	57	0
Other Personal Services	148	148	-0.3	428	427	-0.1
Subtotal	3,795	3,889	2.5	11,320	11,627	2.7
Motor Vehicles	580	521	-10.2	1,877	1,588	-15.4
Automotive Fuel	624	518	-16.9	1,837	1,546	-15.8
Auto Electrical, Smash Repair, Tyres	119	121	2.3	376	366	-2.9
Automotive Repair and Services	162	174	7.9	507	509	0.3
Total	5,279	5,224	-1.1	15,917	15,636	-1.8

Consumers on a high

Consumer confidence rocketed higher in the September 2009 quarter, lifting 14 points from the June quarter survey. The Index now stands at 120.3, the highest in four years and well above the series average of 111.4.

An index number over 100 indicates there are more optimists than pessimists, while a number under 100 indicates that pessimists outnumber optimists. The margin of error in the survey is 2.5% at a 95% confidence interval.

This is the second consecutive quarter that confidence has recorded a double digit gain – in the June 2009 quarter confidence lifted 10 points from 96.0 to 106.0. However, back then we put the improvement down to a collective sigh of relief – relief that the economy had avoided the doomsday scenario that was feared at the peak of the global financial crisis. Moreover, at 106.0, confidence was indicative of a period of flat consumer spending rather than growth. Certainly, the survey detail suggested a lack of conviction that a recovery was on its way.

However, consumers, regardless of age, income group, gender, or region, have shrugged off any doubts they had a few months ago and are now convinced that good times are on their way.

Expectations lead the way

All of the survey components recorded increases this quarter. But the dominant influence was a sharp turnaround in the short term outlook for the economy. A net 17% of consumers now expect good economic times over the coming year (the highest response since March 2005), up a massive 45.7 points from the June survey when a net 28.7% expected bad economic

times. The more upbeat global economic outlook and increasing talk that the NZ recession had ended will no doubt have fed these improved expectations. Rising house prices and signs that the labour market has held up better than expected will have also been influential factors.

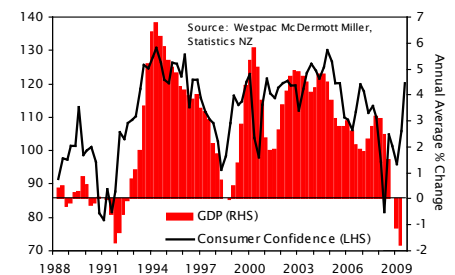
The other major mover this quarter was consumers' assessment of their financial position in a year's time. A net 24.3% of consumers are anticipating that the next year will be more lucrative – a seven year high for this series, and up from a net 12.7% in the June quarter. The strength of this result is surprising given our expectation that unemployment will edge higher over the coming year, thus contributing to slower wage growth. Rising house prices and the slower inflation rate are likely to be contributing factors.

Perceptions around the longer term economic outlook continue to reach new highs, although the gains were far less spectacular than for the short term outlook. Still, an overwhelming net 62.8% of respondents think there will be good economic times in the next five years. That is up from 56.4% in June and is well above the long run average of a net positive 30.3% for this series.

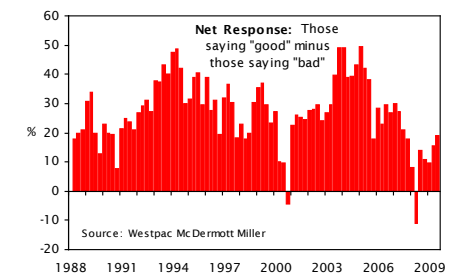
Gains in the remaining two component questions were far more muted, and paint a more sobering picture. A net 21.9% of respondents still say they are worse off financially now compared to a year ago, which serves as a reminder that current cash flows remain tight. An air of caution also exists in the response to the question around whether now is a good or bad time to buy a major household item. A net 19.2% of respondents say now is a good time to buy major household items – up just 3.6 points from the June

survey (the smallest increase of all the component questions) and still below the long run average of +27% on this measure. The enthusiasm consumers feel about the economy, along with the elevated NZD, has yet to translate into a greater willingness to buy big ticket items.

Consumer Confidence and GDP



Buying a major household item



Regional Consumer Confidence

	Sep-08	Jun-09	Sep-09
Northland	104.7	101.6	109.2
Auckland	101.3	108.6	122.7
Waikato	106.7	98.0	119.8
Bay of Plenty	109.5	103.2	116.2
Gisborne/ Hawkes Bay	103.5	106.6	115.3
Taranaki/ Manawatu-Wang.	100.6	109.5	119.4
Wellington	111.0	102.5	121.4
Nelson-Marlborough West Coast	104.3	105.0	117.9
Canterbury	106.9	109.7	122.7
Otago	103.8	104.6	117.4
Southland	108.0	104.0	122.8
New Zealand	104.8	106.0	120.3