

Retail Outlook

July 2009

Looking to the recovery

- NZ is turning the corner after 18 months of misery (*front page*).
- Recovery will be people-led (*inside*).
- Consumers relieved (*back page*).

When we last published the *Retail Outlook*, NZ was entrenched in recession. Consumers were cutting spending sharply and businesses were slashing investment. At the time, the fear factor around the economic outlook was huge, driven by sharp downward revisions to global growth, crumbling business and consumer confidence, falling house prices, and the prospect of widespread job losses.

A few months on and we're pleased to say that we have seen an improvement in a broad range of global and domestic economic indicators, implying that the worst of the downturn has now passed. On the global front, the data continues to suggest a levelling out of activity in most of the major economies. Still, the hurdles for future growth remain large and economic forecasts remain weak.

At home, business confidence has risen strongly, albeit from record lows, while consumer confidence jumped to its highest level in 18 months in June (see back page for details). And, there are tentative signs that consumers are acting on that improved confidence: retail spending has been a little stronger than expected in recent months; household

lending has increased, suggesting an increased appetite for debt; and surveyed job security has improved. In addition, housing turnover has already risen markedly in response to low mortgage rates, and in recent months house prices have even ticked a little higher. But, as we highlight on page 2, the most promising development has been the sharp turnaround in net migration. The annual net inflow has risen from a low of 3,600 late last year to over 12,000 by June, and is set to reach well above 20,000 by the end of this year.

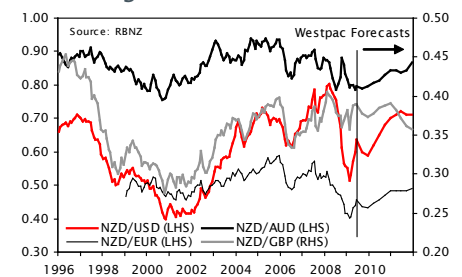
Against this backdrop, we have revised up our growth forecasts for 2010. Our forecasts now see calendar year GDP growth lifting to 2.6% in that year (1.1% previously), following an estimated 2.0% decline in 2009. Above trend growth of 3.6% is forecast for 2011. And, we no longer see the need for further interest rate cuts this cycle, although do not foresee interest rate hikes until mid 2010. The spare capacity that has built up in the New Zealand and global economies after the prolonged recession will likely keep inflation pressures at bay for some time.

There are still some substantial negative risks that could offset the positives: H1N1 influenza has the potential to elongate the recession by a quarter or so; and there is a growing likelihood that NZ will experience drought conditions again this summer. But at this point in time, we don't think that these factors warrant

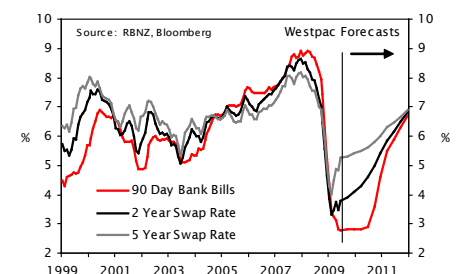
further rate cuts as a central view.

That said, we expect progress to be slow over the next six months. Strong net migration is expected to prevent house prices declines rather than create a boom. Consumption growth may swing out of negative territory, but growth is likely to be lacklustre for a while yet as unemployment continues to rise. Indeed, we expect the unemployment rate to rise from 5% currently to close to 7% by the end of the year, as the natural lags from a weaker economy to the labour market play out. So even if GDP growth does turn positive in the near term, for most it won't feel like a recovery for a while yet.

NZ exchange rate



NZ interest rates



Body count

There is little doubt that the past 18 months have been extremely tough for the retail sector. In the June Quarterly Survey of Business Opinion, a net 49% of merchants reported a decline in profitability and sales in the June quarter, while a net 55% reported a drop in new orders – all close to record lows in the survey which has been running since the mid 1960s. Fortunately though, some glimmers of hope are beginning to appear on the horizon. Foremost amongst them is surging net migration.

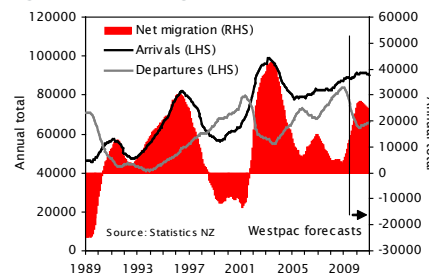
Immigration has a very large impact on New Zealand's population and economy, sometimes adding or subtracting 1.25% to/from annual population growth. Immigration can have a positive impact on the supply-side of the economy via labour supply and capital for investment, but historically the demand-side boost has dominated, at least in the short term. The good news for retailers is that net migration is currently turning upward quickly after a few years dominated by an exodus to Australia.

Figure 1 shows that while arrivals are continuing at trend, departures have fallen off sharply since the end of last year. Digging further into the numbers confirms that it is predominantly the behaviour of New Zealand citizens rather than foreign migrants that is driving the cycle (unlike the last two migration cycles): a few more New Zealanders are coming home, and a lot fewer are leaving.

We anticipate that the current trends in migration will continue, meaning annual net migration of 25,000 in both 2009 and 2010. Our migration forecast assumes that the current trends will strengthen for another couple of months, and will

then moderate. Migration trends are persistent, so we are confident that migration will remain strong for some time. However, it is impossible to predict just how much higher net migration will go before it peaks.

Figure 1: Net migration flows



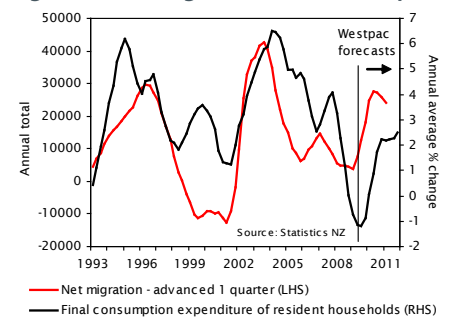
Economic implications

Stronger net migration has economic implications for the housing and labour markets, as well as consumer spending. It is a clear positive for the housing market – that is, construction, rents and house prices. More people arriving (or fewer leaving) mean more people squeezing into the available stock of houses. We must either build more houses, or if we cannot, the price of accommodation will rise.

For the labour market, in theory, the impact is more ambiguous. On the demand side, more people means extra economic activity and jobs. But on the supply side, more people competing for jobs could lengthen dole queues. In practise, the demand effect massively outweighs the supply effect, so higher net migration reduces unemployment. An extra 50,000 people has only a tiny 1.5% impact on the working age population, but a massive impact on the number of people needed to build the houses required to accommodate the new population.

In terms of consumption, net immigration has a big impact (Figure 2). In particular retailing of big-ticket items gets a boost when newly arrived migrants set up home. This migration cycle will likely have a smaller impact on consumption than previous cycles, since it is more about fewer people departing than more people arriving. However, more people means more sales, so retailers should see at least some benefit. Indeed, after contracting almost 1% in the year to December 2009, we expect real (i.e. inflation adjusted) consumer spending to grow just over 2% in the year to December 2010 (up from our previous forecast of 0.3%).

Figure 2: Net migration and consumption



A word of warning

The twin house and share price busts have forced many New Zealanders to take a long hard look at their overall wealth and long-term spending power. When all is said and done, we must recognise that high consumer spending from 2002 until 2007 was unsustainable. The long overdue correction to a more sustainable level of spending, financed by income rather than debt, is underway. On a per-person, inflation-adjusted basis we are now spending close to 9% less than two years ago. But with the current account balance still grossly in deficit, the transition to more sustainable levels of spending still has a way to run.

Data roundup

The volume of sales plunged a record 2.9% in the first quarter of 2009 – double the previous record decline set during the 1997 Asian crisis. Sales volumes have now fallen for six quarters running, and are 6.8% below their June 2007 peak. Leading the decline was a massive 11.4% fall in car sales, to be 32% down from the 2007 heyday, while furniture and floorcoverings (-3.5%), hardware (-4.5%), and appliances (-5.9%) also all reported sizeable contractions. The only market segment to

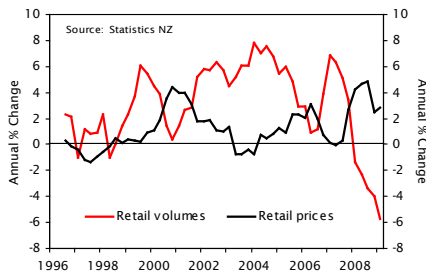
post a convincing increase in sales in the first quarter was supermarkets (possibly as people cut back on takeaways and eating out).

More recent monthly data suggest that the April 1 tax cut, lower interest rates and surging net migration have given spending a lift in the April / May period. Still, looking at the detail for May sales it appears spending may have been boosted by the colder than usual start to winter. Clothing and softgoods retail sales rose

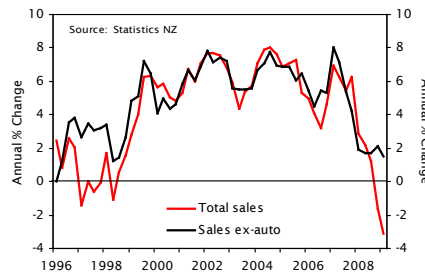
12.6% and appliance retailing rose 3.7% in the month. A bringing forward of purchases of winter woollies and heaters would then see a matching dip in June.

By region, sales growth in Auckland is rising, lifting for the third consecutive month in May. The South Island, with the exception of Canterbury, has also posted three consecutive monthly gains. Sales remain weak in Waikato and the lower North Island, although the pace of decline is beginning to ease.

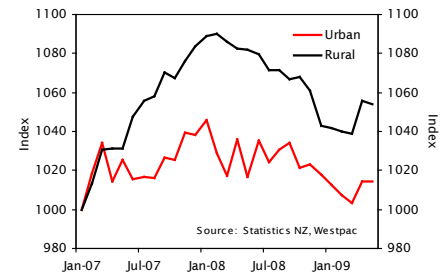
Retail volumes and prices



Retail sales



Rural versus urban retail sales



Retail Sales actual (\$ millions)

Storetypes	Months			Quarters		
	May-08	May-09	Annual % change	Mar-08	Mar-09	Annual % change
Supermarkets and Grocery	1,156	1,245	7.7	3,632	3,755	3.4
Fresh Produce	74	81	8.7	220	238	8.1
Liquor	97	100	3.4	305	310	1.6
Other Food	62	64	2.3	179	180	0.2
Takeaway Food	102	107	5.6	294	300	2.0
Department Stores	315	311	-1.2	863	831	-3.6
Furniture and Floor Coverings	117	101	-14.2	355	305	-13.8
Hardware	122	114	-6.6	381	347	-8.9
Appliance	197	198	0.4	566	561	-0.9
Recreational goods	165	177	7.6	587	587	0.0
Clothing and Softgoods	227	235	3.5	604	581	-3.8
Footwear	44	46	3.7	105	113	7.7
Chemist	151	154	1.5	433	448	3.6
Household Equipment Repair	32	31	-2.0	84	85	1.3
Other Retailing	221	226	2.3	666	752	12.9
Accommodation	187	174	-7.0	791	772	-2.5
Bars and Clubs	102	96	-5.7	310	294	-5.0
Cafes and Restaurants	308	322	4.7	1,026	1,003	-2.3
Personal and Household Goods Hiring	19	18	-0.7	58	62	6.6
Other Personal Services	146	140	-3.6	434	430	-0.8
Subtotal	3,843	3,941	2.5	11,892	11,953	0.5
Motor Vehicles	620	522	-15.7	2,015	1,544	-23.4
Automotive Fuel	631	512	-18.8	1,810	1,553	-14.2
Auto Electrical, Smash Repair, Tyres	129	121	-6.6	353	356	0.7
Automotive Repair and Services	177	172	-2.5	497	475	-4.3
Total	5,399	5,268	-2.4	16,567	15,881	-4.1

Phew!

The Westpac McDermott Miller Consumer Confidence Index pushed back into positive territory in the June 2009 quarter as consumers once again heaved a collective sigh of relief.

The Index lifted 10 points between the March and June 2009 quarters, to 106.0. This is the highest level of confidence since the December 2007 quarter, when the Index was at 110. 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. The survey was conducted from 2-16 June.

The lift in confidence in the June quarter appears to be related more to what hasn't happened, rather than what has. Although the global economy is still in recession, the risk of a Depression-like scenario has greatly diminished. And, here in NZ, people are still losing their jobs and house prices are still lower than a year ago, but the situation is not as bad as some of the disaster scenarios that had been touted. That will have supported the recent lift in confidence.

By far the biggest factor driving confidence higher this quarter was reduced anxiety around the short term economic outlook. However, not everyone is convinced the 'good' news to date will lead to a recovery over the next 12 months – a net 28% of respondents still expect bad economic times over the coming year (from a net 57% in March and a net 52% in June 2008). Importantly, consumers remain extremely optimistic about the medium term – a net 56% expect better economic times over the

next five years, the highest reading on record. The long term average for this component is a net 30%.

Consumers' assessment of their current financial position improved marginally over the quarter, although a net 26% of respondents still say they are worse off now compared to a year ago. That compares with a net 28% in the March quarter, but we note that this is a marked improvement from a year ago when cost pressures were at their highest – back then a net 41% of respondents said they were worse off. Moreover, an increasing proportion expect to be better off in year's time, at a net 13% of respondents, up from a net 6% in March.

The good news for retailers is that perceived purchasing power has lifted to its highest level since the December 2007 quarter. A net 16% of respondents said now is a good time to buy major household items – up 6 points from the March survey and up 26.3 points from June last year. Lower interest rates will clearly be having an impact, but so too is the strong competition for sales, which is pushing down prices.

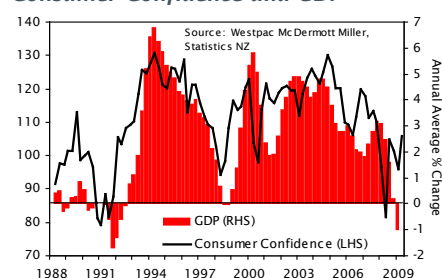
Regional and demographic split

All regions recorded an improvement, with the exception of Waikato. The sharpest increases were in Taranaki/Manawatu/Wanganui (up 15.6 points to 109.5) and Auckland (up 13.2 points to 108.6), with double digit increases also reported in Canterbury, Otago and Southland. We find the increase in these latter regions somewhat surprising given the strong rural component and the fact that the NZD has continued to push higher over recent months. A possible explanation for the surge in confidence could be the better outlook for lamb.

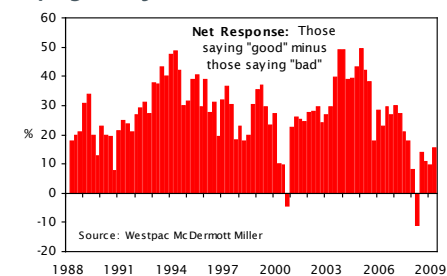
However, overall rural consumers are still the least optimistic of the three groups.

By demographic grouping, the 18-29 age group is by far the most optimistic. Males are more optimistic than females, with the margin opening up in recent quarters.

Consumer Confidence and GDP



Buying a major household item



Regional Consumer Confidence

	Jun-08	Mar-09	Jun-09
Northland	78.2	91.8	101.6
Auckland	80.8	95.4	108.6
Waikato	78.8	98.2	98.0
Bay of Plenty	86.9	93.4	103.2
Gisborne/ Hawkes Bay	78.9	98.3	106.6
Taranaki/ Manawatu-Wang.	80.2	93.9	109.5
Wellington	92.8	97.8	102.5
Nelson-Marlborough West Coast	77.5	96.9	105.0
Canterbury	81.7	98.7	109.7
Otago	76.4	93.4	104.6
Southland	72.8	93.8	104.0
New Zealand	81.7	96.0	106.0