Retail Outlook

January 2011

Looking forward to 2011

- The year ahead *(front)*.
- Housing outlook key for retail sector *(inside)*.
- Confidence falls *(back page)*.

New Zealand's economic recovery during 2010 failed to live up to the promise that it showed in the early part of the year. GDP growth for the calendar year was 1.5%, compared to the 2.5% growth that *Consensus* were forecasting at this point last year. Certainly nature played a spoiling role in many ways, and there are lingering question marks around GDP measurement, but it's fair to say that NZ hasn't capitalised on the growth-friendly conditions seen at the start of the year. Yet many of those conditions are still in place, and indeed they form the basis of our more hopeful outlook for 2011.

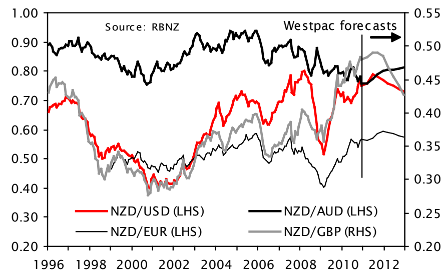
The pillars of growth that we see for 2011 are the same as those we saw for 2010. The first pillar is a substantially improved export performance relative to much of the last decade, with NZ well-placed to meet the developing world's rapidly growing demand for protein. By the end of 2010, world prices for our export commodities were over 50% above the averages of the previous year – and the gains have been more broad-based than just dairy prices, with sharp rises for meat, wool and logs. The higher NZD has only been a partial offset; local currency prices were at record highs in 2010.

The second pillar is an upturn in residential construction, although the driving forces have changed somewhat. By the end of 2009, low mortgage rates, stronger net migration and a low level of new building were helping to revitalise the housing market. But changes to the tax treatment of property – confirmed in the May Budget – saw a renewed slump in housing turnover, prices and building approvals. The most recent figures tentatively point to sales stabilising, which, if sustained, should eventually lead to prices flattening out in the coming months. But the issue remains that current levels of building activity are too low to meet population growth and this will have to be addressed eventually. On top of this, reconstruction after the Canterbury earthquake – while a negative for the nation's finances – will go a long way towards filling the hole in the construction sector's order books. Rebuilding will boost the level of activity over several years, with the peak growth impact likely in the second half of 2011.

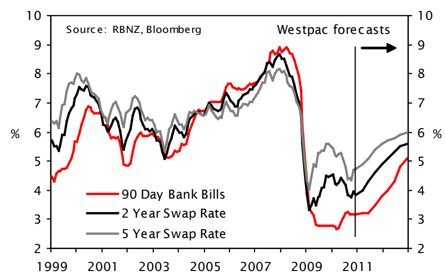
So, if anything, the two-speed aspect of the economic recovery is likely to be even more pronounced this year with export-related sectors leading the charge. While for retailers that does not immediately equate to good news, we do think 2011 will be a better year than 2010 in terms of household spending. We see domestic consumption growing 2.4% on average over the next couple of years, although that is fairly modest compared to the driving role it played in the last upturn. High levels of household debt and a relatively flat housing market mean that household spending growth is likely to be constrained by income growth – which has been soft to date, but is expected to pick up from here.

Monetary policy will remain supportive through 2011, with the RBNZ marking down its interest rate projections even further in its December *Monetary Policy Statement*. We think the RBNZ is unlikely to shift to a more hawkish stance in a hurry. The fact is that the inflation environment is likely to appear quite benign through 2011, outside of the one-off impact of the GST hike; the issue is about setting policy this year with regard to conditions in 2012 and beyond.

NZ exchange rate



NZ interest rates



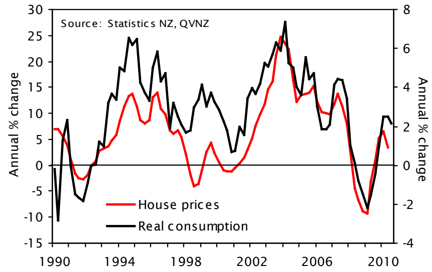
Housing holds the key

The outlook for the housing market is integral to the outlook for consumer spending. The last year has demonstrated New Zealanders' reluctance to spend while the value of their biggest asset is falling. Looking ahead, we see signs of stabilisation in the housing market, which should help underpin improved growth in retail spending.

Evidence suggests, and retailers will likely attest, that when the housing market is strong and house prices are rising rapidly, consumers are more willing to spend. However this relationship is coloured by a recent past where both house prices and consumption have been driven by shocks that tend to push both in the same direction. In contrast, the recent tax changes which have been a crucial driver of housing market developments in 2010 made property investment a relatively less attractive proposition, while at the same time, leaving more money in households' pockets. In 2010, it appears as if the negative wealth effects from falling house prices dominated, with consumption volume growth averaging only 0.3% per quarter. Looking ahead to 2011, improving sentiment and stabilisation in house prices combined with modest employment growth, should provide a more stable backdrop for household spending to pick up the pace.

In New Zealand, the relationship between house prices and consumption has been a strong one *(Figure 1)*. Recent RBNZ research suggests that house prices have a relatively quick and large impact on household spending in New Zealand.[1] They find that over the long run, a permanent 1% increase in gross household assets, leads to a 0.08% increase in consumption. This is a much stronger effect than in other countries, though perhaps an unsurprising one given the importance of housing assets in Kiwi's net wealth (in 2009 housing comprised some 74% of New Zealand household assets).

Figure 1: Real consumption and house price growth

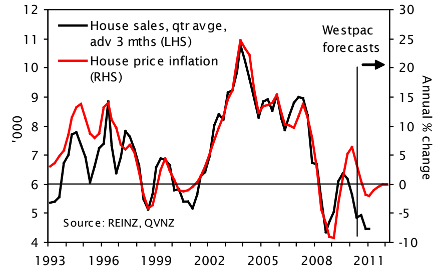


In the real world, unlike in a modelling exercise, we like to think house prices don't just spontaneously increase (or decrease), but respond to changes in economic fundamentals which increase demand or reduce supply (or are expected to do so in the future). Importantly, many of these factors influence house prices and consumer spending in the same direction, for example, income and employment growth, changes in net migration and movements in mortgage rates. In contrast, we think the biggest influence on the housing market in 2010 was the reduction in income tax rates introduced in the May 2010 Budget (and signalled months earlier).

Lowering the top tax rate from 38¢ to 33¢ reduces the tax-shelter value of property ownership. In turn, this reduces the investor value of housing, making it less attractive relative to other investment alternatives. Conversely, lower tax rates also increased disposable incomes (even after accounting for the increase in GST).

In recent months, falling house prices seem to have won out. But over the longer-term we think consumers will shift their focus. Looking ahead to 2011, early indications are that the housing market has stabilised, albeit at a lower level of activity than we saw last decade *(Figure 2)*. Leading indicators of price movements such as the volume of house sales and the number of days to sell look to have bottomed out – although settling at a much lower level of activity. Combined with lower fixed-term mortgage rates and an improvement in migration trends, we think house prices are on track to broadly maintain current levels in 2011. The RBNZ has a more pessimistic outlook for house prices, with its' December *Statement* assuming a further 2% decline in the first half of this year. This in turn drives their more moderate view on household spending, as under their scenario households further increase their saving rates in order to shore up their balance sheets. We think the most recent signs of stabilisation in the housing market will challenge that view.

Figure 2: House prices and house sales



If house prices remain broadly stable in 2011, it should help stave off any dramatic further worsening in household's balance sheets and, when combined with anticipated wage and employment growth, provide a solid platform for household spending to pick-up in line with income growth.

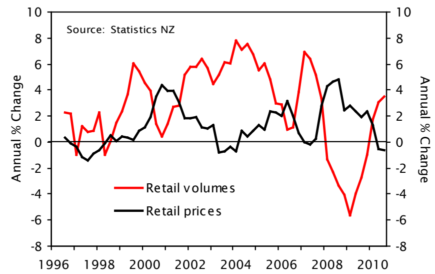
[1] De Veirman, E. and A. Dunstan, (2010), *"Debt dynamics and excess sensitivity of consumption to transitory wealth changes"*, RBNZ Discussion paper.

Data roundup

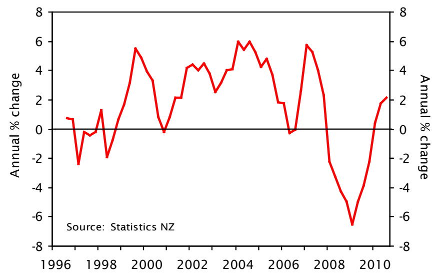
Retail sales were sprightlier than expected in the September quarter, with a 0.7% rise in volumes. Retail sales have continued their steady climb out of recession, although they are still some way below their peak levels. In nominal terms, retail spending growth has been remarkably steady during the recovery – and lifted 0.8% in the September quarter. Thus, the variation in 'real' spending has largely been driven by changes in prices. In other words, consumers still seem to be willing to spend, but only when the price is "right". Interpreting underlying trends has been difficult following the 1st of October GST increase. A step up in sales of furniture, appliances and vehicles – big-ticket items where a 2.2% price increase would be meaningful in dollar terms, and worth avoiding – boosted September sales. This effect unwound, as expected, in October. However, electronic card transactions data point to spending petering out as the year closed. December data, which should be free of GST distortion, showed fuel was the only category where spending was up in the month – where a rise was almost inevitable given petrol prices were up 5% over the period.

We have been watching data closely to see signs of Canterbury insurance payouts being spent in the region (by mid January, approximately $73m in contents claims had been paid out). To date, we only have electronic cards transactions data to interrogate, but it looks as if at least a portion of payout has been spent. Our preliminary estimates suggest retail spending in Canterbury was in the order of $10-15m higher than it might otherwise have been in December, had it followed national spending trends.

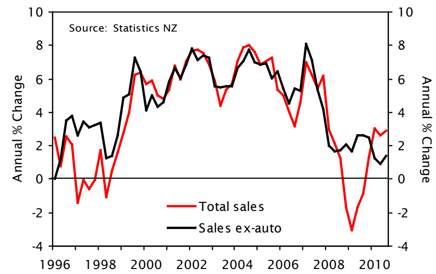
Retail volumes and prices



Per capita sales growth



Sales total vs ex-auto



Retail Sales actual ($ millions)

	Months			Quarters		
Storetypes	Oct-09	Oct-10	Ann % chge	Sep-09	Sep-10	Ann % chge
Supermarket and grocery stores	1,346	1,442	7.1	4,004	3,980	-0.6
Specialised food retailing (excluding liquor)	105	107	1.8	335	307	-8.1
Liquor retailing	106	104	-1.5	305	288	-5.5
Non-store and commission based retailing	60	49	-17.4	183	148	-19.3
Department stores	301	283	-5.9	818	832	1.7
Furniture, floor coverings, houseware and textile goods retailing	149	128	-14.1	434	446	2.7
Hardware, building and garden supplies	386	399	3.4	1,068	1,159	8.6
Recreational goods retailing	157	140	-10.4	440	409	-7.0
Clothing, footwear and personal accessory retailing	255	272	6.5	716	771	7.6
Electrical and electronic goods retailing	207	181	-12.1	638	655	2.7
Pharmaceutical and other store based retailing	341	340	-0.4	966	1,068	10.5
Accommodation	205	213	4.3	538	594	10.5
Food and beverage services	560	552	-1.4	1,560	1,581	1.4
Core industries total	4,177	4,212	0.8	12,005	12,239	2.0
Motor vehicle and parts retailing	591	548	-7.2	1,805	2,025	12.2
Fuel retailing	516	554	7.3	1,572	1,590	1.1
All industries total	**5,284**	**5,314**	**0.6**	**15,382**	**15,853**	**3.1**

Consumer confidence falls

The Westpac McDermott Miller Consumer Confidence Index declined in December 2010 for the second consecutive quarter, falling from 114.1 to 108.3. Confidence is now at the lowest level since June 2009 when the Index was at 106.0. 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 between 1-14 December.

A number of events over the past few months are likely to have made consumers a little more edgy compared to September, including the early onset of drought in Northland and Waikato, renewed weakness in house prices through October, the rise in GST from 12.5% to 15% on October 1, and rising fuel prices in excess of GST. Add in the hard reality of life after the Canterbury earthquake (remembering that confidence in the Canterbury region actually lifted in the immediate aftermath of the earthquake according to our survey), and the Pike River Coal Mine disaster, and it is little surprise that confidence has fallen. Still, the fact that confidence has fallen, and indeed is now below year ago levels, suggests that consumer spending will remain modest in the near term.

The fall in confidence was across the board this quarter, with all five component questions recording declines and the falls evenly spread between current and expected conditions. However, the most influential factor was a fall in consumer perceptions of their purchasing power, with a net 16.5% of respondents saying now is a good time to buy a major household item, compared to a net 24% in the September quarter. That is the lowest response to this question since the June 2009 quarter.

Consumers are also less optimistic about the economic outlook, both in the short and longer term. A net 10% of respondents now expect bad economic times over the next 12 months, deteriorating from the 3% expecting bad times in September. Meanwhile, a net 48% expect good economic times over the next five years, down from a net 54.5% in September. Still, at these levels consumers clearly remain overwhelmingly optimistic about the future.

Consumers have also become more despondent about their own personal financial situation. A net 22% of respondents said they were worse off financially than a year ago, up from a net 17% last quarter. In terms of the coming year, consumers remain optimistic, but less so than last quarter, with a net 8.5% expecting their own financial situation to improve over the next 12 months – down from 13% in the September quarter and the lowest since March 2009.

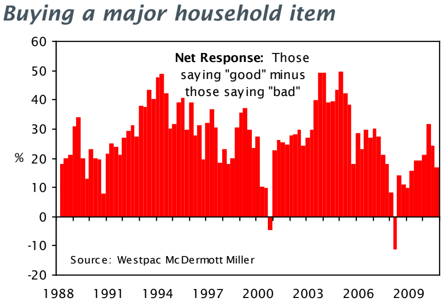
By region, the drop in confidence was almost across the board, with particularly sharp declines recorded in Northland and Canterbury. In Northland, we suspect the sharp fall can be largely explained by drought, while as suggested above the fall in Canterbury may be partly explained by an unwinding of 'response bias' in the September quarter. By rural/urban grouping, confidence remains the strongest in the cities by a decent margin, although the gap between rural and urban confidence continues to narrow.

By age, the fall in confidence was more pronounced among those aged 30 or over, and for those in the non-working socio-economic group. By gender, the decline in confidence was greater amongst females, with confidence down 7.5 points to 103.3 compared with a 2 point drop amongst males to 112.3.

Regional Consumer Confidence

	Dec-09	Sep-10	Dec-10
Northland	110.8	109.3	97.3
Auckland	121.5	117.3	109.5
Waikato	108.8	111.8	109.6
Bay of Plenty	120.7	106.8	101.2
Gisborne/ Hawkes Bay	109.9	107.8	104.4
Taranaki/ Manawatu-Wang.	115.1	110.9	101.6
Wellington	121.1	115.4	115.1
Nelson-Marlborough West Coast	116.4	104.3	106.2
Canterbury	116.9	120.6	109.9
Otago	104.4	110.7	113.2
Southland	112.8	112.4	104.0
New Zealand	**116.9**	**114.1**	**108.3**

Buying a major household item



Consumer confidence vs spending