

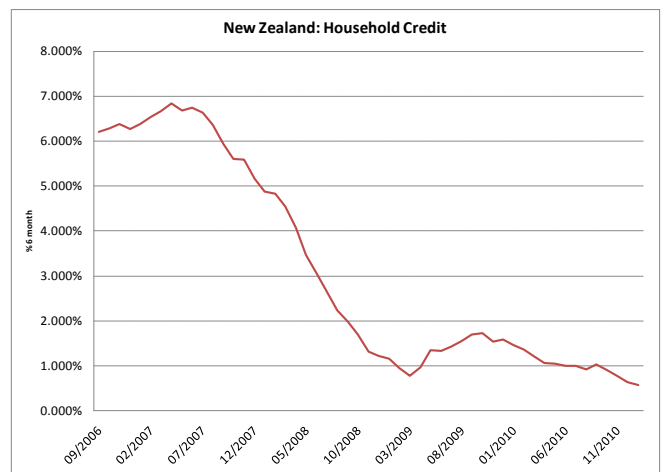
New Zealand after the Quake

Even before the tragic second Canterbury Earthquake, the effects of which we recently saw firsthand, it had become apparent that the domestic New Zealand economy was simply “flat-lining” at close to a zero growth rate. There had been a bounce in activity in late 2009 and early 2010, although we suspected that this bounce was largely the result of the housing and credit markets beginning to at least function again following the global credit crisis, but this bounce had faded even prior to the first earthquake as the RBNZ’s move towards a tighter stance and the household and farm sectors had increasingly turned their attention to strengthening rather than expanding their balance sheets.



Unsurprisingly, this situation within the economy was to change following the first Christchurch earthquake which implicitly transformed this already ‘soft environment’ into an outright weak one, although as 2011 began there were some signs of confidence gradually returning to the economy. The farm sector seemed at last ready to spend some of its improved earnings stream and at the same time the beginnings of the reconstruction effort following the first quake began to feed through into increased levels of economic activity in the Christchurch area. The credit numbers were, however, remaining downbeat and we were relatively sceptical that the economy would enjoy a revival in 2011. It was, however, at this point that the second and far more catastrophic earthquake arrived.

It is always difficult to estimate just what impact a natural disaster will have on consumer and business sentiment. Our visit to Christchurch revealed a business sector that evidently wants to get back to work wherever possible but the infrastructure to allow such a return is clearly lacking and it is not yet known when this situation will be resolved. It seems that at this time the geologists and seismologists simply do not know just when and if the Christchurch fault will stabilise and hence when the greater part of the reconstruction effort can begin.



Until the answer to even this basic question is known, it is of course impossible to estimate the costs of any rebuilding – the current estimate of the equivalent of 8% of GDP seems quite back of the envelope and we and others would argue that it is probably significantly too low. During our visit, we learned that on the assumption of six day weeks, 20 hour work days; it may still take eight months simply to clear the rubble given the existing stock of haulage vehicles and the compromised state of the road network. Overall, it seems that if Christchurch is to be rebuilt, it is a project that may take a decade to complete once the geologists announce it safe to begin and we find it difficult to believe that the costs can be accurately gauged at this time. We would also note, however, that events in Christchurch will now oblige building owners to look again at the state of

their defences, a scenario that may conceivably result in heavy levels of new expenditure outside the Canterbury area that are currently almost impossible to estimate.

Meanwhile, as to the effect that the quake has directly had on current activity in an area of the economy that produces some 15% of New Zealand GDP, the data is clearly mixed. Some small businesses have effectively been closed down by their inability to enter their former premises (and given the lack of continuity, this may result in their long term failure / closure) but other companies appear to have relocated to the surrounding area or even further afield. Clearly, the tourist industry has been hard hit throughout the South Island, although some lesser centres around Christchurch such as Tekapo are apparently enjoying a boom as tour parties are diverted from the city.

Indeed, we found that while there are many signs of weakness in the local economy, there are also signs of strength, although these may be caused by "substitution effects" that imply little or nothing about the aggregate data. Adding to the statistical puzzle is the fact that Statistics New Zealand, who would in theory be charged with collecting this data, had its headquarters in the 'Red Zone' and its offices are closed and inaccessible.

Given these problems, the outlook for output growth and levels in the economy is, as we note above, shrouded in uncertainty but it is generally thought that the Christchurch rebuilding programme will not begin until 2012. Until then, the combination of the household sector's already established risk aversion / de-gearing bias, coupled with the direct and indirect disruption from the quake is expected to continue to depress economic activity, particularly in the first part of the year. More positively, there is some suggestion that higher farm sector incomes and still reasonable external demand trends may yet help the economy to improve (independently of the rebuilding effort) later this year, but even this cannot be known following the effects of the Japanese disaster. The compromising of parts of Japan's port infrastructure is expected to handicap key New Zealand exports to Japan (particularly the forthcoming kiwifruit harvest), since many of New Zealand's exports traditionally went via the Sendai area.

Overall, it seems likely that economic growth in 2011 will likely be minimal and that the economy will continue to operate with a significant negative output gap. We suspect that the existence of the latter was one reason that the RBNZ chose to reduce interest rates recently, although as one official remarked this in no way represents a magic cure for the economy's ills. Instead, we suspect that the move was a mixture of attempting to offer what assistance they could at the time to the economy; a probable desire to partially reverse the previous year's tightening move; and an eye towards longer term policy perspectives (see on) despite the near term outlook for inflation.

At present, the rate of inflation is elevated at around 4.5% as a result of one off tax changes that the central bank has been prepared to look through, as indeed we suspect that it will also look through any further increase in the inflation rate as insurance premia increase significantly following the earthquake. However, and crucially, the RBNZ is at pains to stress that given that the rebuild effort will not only absorb the economy's available spare capacity but also persist for perhaps a decade or more, its possible effects on inflation - though clearly extraordinary - cannot be regarded as being temporary and therefore they represent an important issue for the RBNZ. For the RBNZ, the core inflation target evidently remains sacrosanct despite the earthquakes and their likely impact on core inflation rates in the future.

Since either rebuilding or replacing Christchurch will involve heavy levels of construction activity and the diversion of considerable resources to the task, a situation that may create price inflating shortages elsewhere, the RBNZ, like the Bundesbank before it during German Reunification, will likely run a tighter monetary policy in the future if it sees the effect of the quake causing higher background inflation.

Given this assertion that they do not regard the inflationary implications of the quakes as being in some way 'excusable' from the inflationary targeting regime, it may seem somewhat strange that the board of the RBNZ chose fairly unanimously to cut interest rates at all during their recent meeting.

There was popular pressure for them to do so and the negative output gap situation probably warranted the move - as did the economy's pre earthquake softness. However, the latest rate cut

may now encourage even more of the population to move towards the use of shorter term variable rate mortgages and we might therefore wonder that, by encouraging the household sector to shorten the duration of its debt liabilities, the RBNZ is implicitly creating a situation under which any rate hikes that it initiates over the course of 2012-13 will be more effective than they might have been in the past when most people employed fixed mortgages. Indeed, during the mid 2000s, the high proportion of fixed rate mortgages effectively blunted much of the RBNZ's tightening moves, thereby obliging them into relatively larger rate hikes which in turn exerted a significant influence on the currency, a situation that was not always welcome. However, by in some sense encouraging the household sector to lower the duration of its liabilities, the RBNZ may be able to better tighten domestic conditions in the future without necessarily encouraging the currency to sky-rocket.

Consequently, while we expect NZD policy rates to rise in 2012-13 as the reconstruction effort gathers pace, the extent of the rise may be more modest than on previous occasions, something which may also be useful for New Zealand politically as well as from a currency perspective. Therefore, although we fully expect the RBNZ to tighten as the rebuild effort gathers pace, we may find that for domestic – and possibly - external reasons, the extent of the rise in interest rates may be quite modest by previous standards. Consequently, their impact on the NZD may be more muted, although we would nevertheless expect the NZD to come under pressure as the rebuild gathers pace in much the same way that the DEM did following German reunification.

In conclusion, although it is difficult to produce definitive forecasts in the current environment, we suspect that in the near term the major risks to growth lie firmly to the downside given the outlook for tourism, further business sector disruption in the quake-affected areas and the household sector's established trend to de-leveraging. Therefore, we broadly expect the economy to flat-line in 2011. However, once the reconstruction effort begins, we would imagine that the negative output gap within the economy may disappear quite rapidly as growth revives and we also expect this to elicit a response from the central bank quite quickly. Indeed, we believe that the RBNZ suspects that the economy and its growth will be quite volatile over the next few years; it will have to be quite active with regard to its own management of the various pressures. We would suggest that in order to perhaps protect the economy and particularly the inflation rate from any further instability and unnecessary volatility, the central bank may be prepared to tolerate more currency and interest rate volatility (it is clearly good news that New Zealand is not in a fixed currency regime....).

In summary, this year we would expect stable interest rates and potentially some modest softness in both the economy and the NZD (particularly after the insurance transfers have arrived) but as the reconstruction effort increases in 2012-13, we would envisage local interest rates rising by 2 – 3% over the following 18 months, with some negative impact on NZD bonds but a probable positive impact on the NZD.

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