

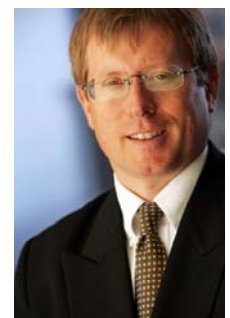
Economic Impact of the Earthquake

Even from as far away as the other side of the world, last month's tragic events in Christchurch have touched us deeply and the author – and his family – can only offer our heartfelt sympathies to the many that have been affected by the earthquake. Against the scenes that we have witnessed on TV, any economic analysis of the situation is clearly of very minor importance but it is in reality one of the few things that we personally can offer.

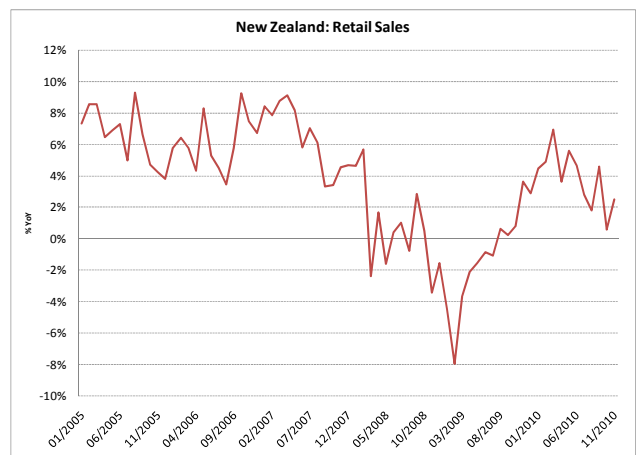
At present, it is estimated that the costs of the earthquake, in terms of rebuilding the infrastructure and guaranteeing residents' incomes is put in the region of \$15-20 billion, or almost 10% of GDP. By contrast, the Japanese Kobe Earthquake of January 1995 cost around NZ\$150 billion but this represented a much smaller 2.5% of national GDP and, although the tragedy clearly affected equity prices at the time of the event, the exact magnitude of the impact is hard to discern since the earthquake occurred contemporaneously with Nick Leeson's "Rogue Trader" shenanigans at Barings. The impact on Japan's currency and debt markets was extremely modest and essentially invisible in any longer term time series. Therefore, given the difference in relative size it is difficult to draw too many conclusions from Japan's 1995 experience.

Financially, we note that the New Zealand Earthquake Commission holds around \$5 billion in assets, together with a quantity of re-insurance and an explicit credit line from the Government. Given the existence of the fund and the state guarantees, we would envisage that the costs of the tragedy will be met roughly 50/50 from overseas and domestic sources, a situation that suggests that once the overseas funds are repatriated in due course, there may be some upward pressure on the currency from that source. This may though, to some extent be offset in the near term by thoughts that the RBNZ may reduce interest rates, particularly in light of the fact that the economy had already appeared quite sluggish. As to whether the RBNZ will react we have little to offer, save an impression that they may feel some merit in nudging rates down a notch given that growth in the economy was probably already a little lower than they had envisaged at the time of their previous rate hikes. We will be travelling to the RBNZ in a few weeks to gain a better understanding of their position.

For earnings estimates within the equity market, the prospect of the near term impediment to economic growth should likely be offset by the expectation that in the future economic activity will be lifted by any rebuilding and postponed consumption. Indeed, this is perhaps one lesson that we can take from Japan; if we observe Japan's production output in the mid 1990s it is clear that the Kobe Disaster caused a short period of weakness but that within a few months the level of actual production had regained its previous trend and we would imagine that the New Zealand share



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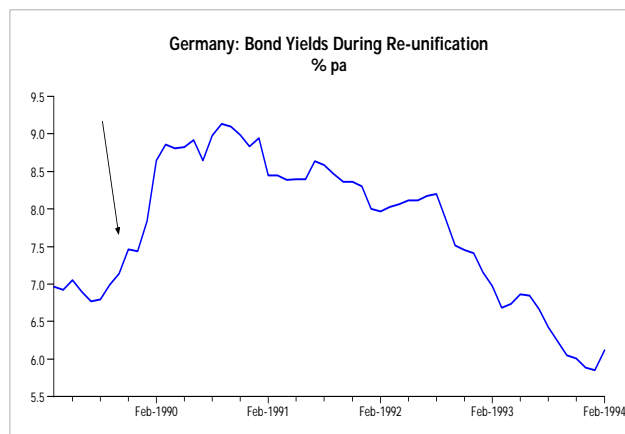
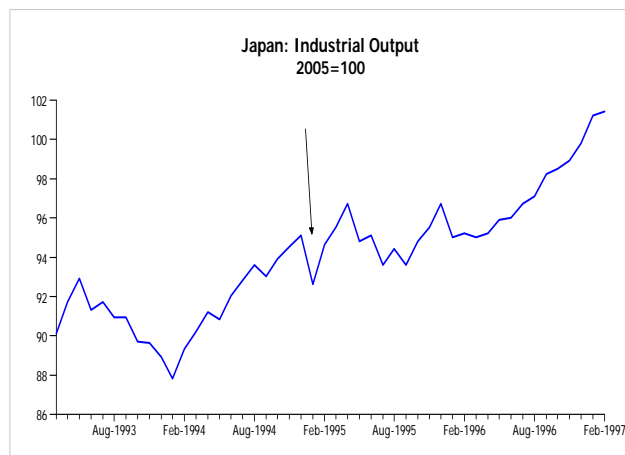
market will take this as a reliable precedent. Our only caveat here would be the impact that the disaster may have on tourism, although the airport is still clearly functioning as an international hub and gateway to the South Island tourist spots, there will likely be some disruption to the tourist industry in the medium term. We would hope that the rest of the world would not be so fickle as to avoid the South Island as a result.

For the bond market, the disaster is of perhaps more medium term significance. In as much as perhaps half of the costs may be born domestically through either increased government borrowing, domestic asset disposals or corporate fund raising, the earthquake will lead to an increase in the demand for capital within the economy which may place some upward pressure on real long term interest rates and borrowing costs. In this context, we note that the 1991-1995 redevelopment of the former East Germany (the rebuilding of the Eastern Lander was essentially a similarly sized project on a relative basis for the German economy) placed significant upward pressure on real interest rates. Moreover, and echoing our earlier comments, we note that the rebuilding of East Germany also placed upward pressure on the value of the then German Deutschmark as foreign capital was drawn in to help pay for the reconstruction (an event that in all probability led to the demise of the European Monetary System of that era).

Also from the perspective of the bond markets, we would suggest that the expenditure of such a large relative nominal sum in what will be a relatively short space of time may place some pressure on the South Island's – and indeed the whole economy's – stock of resources, particularly given the damage that will have occurred to the basic productive infrastructure. There is therefore something to suggest that once reconstruction starts and 'regular' consumption and production trends also return to their former trajectories, there may be some pressure on the economy's productive resources. This pressure could generate localized areas of overheating and perhaps even pockets of inflation. These too could spell bad news for local bond prices and it is not impossible that any higher inflation could lead to a more hawkish stance from the Reserve Bank in the medium term, even if they chose to reduce rates in the nearer term. Consequently, we suspect that the disaster will adversely affect bond prices and perhaps even earnings multiples in the equity market, which are of course sensitive to developments in long term interest rates.

The economic costs to New Zealand of last month's disaster are clearly affordable and of minor importance to the human tragedies that we have witnessed. At the margin, they argue for weaker NZD bonds, higher borrowing costs and perhaps a slightly stronger currency in the medium term but all of these events are well within the capacity of the NZ economy to bear.

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Andrew's 2011 New Zealand Presentation Dates

Monday, 21 March 2011	
9.00 am	Christchurch* The George Hotel
3.45 pm	Wellington Wellington Club
Tuesday, 22 March 2011	
7.15 am	Auckland Northern Club

* We are reviewing this presentation in light of the earthquake.

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