

# NEW ZEALAND ECONOMICS ANZ PROPERTY FOCUS

## COUNTING THE COST

SEPTEMBER 2010

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### SUMMARY

Our monthly *Property Focus* publication is aimed at providing an independent appraisal of recent developments in the property market. This month we look at the economic impact of the Canterbury earthquake.

### THE MONTH IN REVIEW

The housing market remains in limbo, with average selling prices still trending marginally down. The moderation in net migration isn't helping. But fixed mortgage rate cuts and an on-hold RBNZ may help to prop the housing market up.

### PROPERTY GAUGES

A large supply of existing dwellings on the market, ongoing household de-leveraging, low income growth and a moderation in net inward migration are constraining housing market activity. However, residential consent issuance remains at a low level relative to core demand which is leading to some tension in the market. We still expect the tension between balance sheet (i.e. debt and affordability) and supply-demand dynamics to be dominated by the former.

### ECONOMIC BACKDROP

The economy has softened in recent months. Caution remains evident in domestic spending, with a moderating tone also evident in measures of business and consumer sentiment. De-leveraging remains pervasive as households, farms and other businesses concentrate on improving balance sheets. On top of this, the Canterbury earthquake is likely to weigh on economic activity in the short-term. De-leveraging, a switch in the mix of growth with the domestic economy weaker than the tradable sector, and cautious optimism remain key features. We see this picture continuing for a while yet with momentum rebuilding over 2011.

### MORTGAGE BORROWING STRATEGY

Floating and short term fixed rates have held steady over the past month, but there have been small cuts to fixed rates for terms of 2 years or more. This may seem counter-intuitive given that the RBNZ has lifted the OCR twice since June. However, fixed rates (particularly for longer terms) tend to be heavily influenced by global interest rates, and these have moved to extremely low levels in anticipation of further quantitative easing (QE) by the US Federal Reserve.

### FEATURE ARTICLE – THE CANTERBURY EARTHQUAKE

We recently visited Christchurch to assess the earthquake impact firsthand. While the damage bill is expected to be substantial, we were pleasantly surprised to see that the majority of Christchurch was operational. Dislocation in pockets is obvious, but a huge proportion of the population is getting on with business.

# THE MONTH IN REVIEW

## SUMMARY

The housing market remains in limbo, with average selling prices still trending marginally down. The moderation in net migration isn't helping. But fixed mortgage rate cuts and an on-hold RBNZ may help to prop the housing market up.

## CANTERBURY EARTHQUAKE

Looking past the big **one**.

The earthquake damage bill is expected to be substantial, and the dislocation is obvious in pockets. Much has been made of the supportive impact of reconstruction activity over 2011 and 2012 which looks like being around 2 percent of GDP. To the Christchurch area alone, this sort of stimulus is massive. While this will undoubtedly support activity in the region, we suspect the near-term hit to confidence, the displacement, the hit to household balance sheets from the quake, higher costs of insurance and displacement effects from other areas will partly mitigate the aggregate economic flow-on. The net effect is still positive, but not of the boom variety.

## RBNZ MONETARY POLICY STATEMENT –SEPTEMBER

A softer outlook over the next **two** years.

As widely expected, the Official Cash Rate was left unchanged at 3 percent. The RBNZ acknowledged that **the growth outlook had "softened somewhat"** since their July Review, with growth for 2010 and 2011 significantly revised down relative to the June MPS. We expect a resumption to the tightening cycle from March next year, but the tightening cycle will be protracted and won't be in a straight line. We see the OCR ending 2011 at around 4¼ percent.

## SNZ BUILDING CONSENTS – JULY

A **three** percent drop in building consents.

Including apartments, the seasonally adjusted number of new dwellings authorised rose by 3.1 percent in July. **Excluding apartments, consent issuance fell by 5.3 percent.** Smoothing through some of the monthly volatility, we note the three month average number of consents are down 1.1 percent compared to the previous three months. On an ex-apartment basis the fall is larger (down 6.4 percent compared to three months earlier).

## REINZ HOUSING DATA – AUGUST

House sales drop over **four** consecutive months.

A 3.3 percent fall in the number of houses sold in August (the fourth successive monthly drop) confirms **the housing market remains weak.** Sales volumes are considerably below year-earlier levels and are low in relation to the dwelling stock. The trend in selling prices remains down, with prices in the 3 months to August 0.3 percent lower than the three month average to May. While the median days to sell ticked down to a seasonally adjusted 43 days, it remains considerably above the mid-30s range that was apparent at the start of 2010.

## NET MIGRATION – JULY

A net **five** thousand new folks arrive to our shores.

The latest result was stronger than expected, but the key message is that **the NZ economy is receiving less support from net inward migration** than it was at the start of the year. Annualised net PLT immigration has eased from just over 21,000 persons in the three months to January to just 5,600 in the three months to July.

## ASSESSMENT

The housing market remains sidelined, courtesy of the re-balancing that's occurring across the economy. The housing market is an integral part of the economy, but it simply can't lead or dominate the growth agenda given weak household balance sheets and the need for the economy to derive more earnings centric growth. Hence, housing continues to under-perform the wider economy.

## PROPERTY GAUGES

A large supply of existing dwellings on the market, ongoing household de-leveraging, low income growth and a moderation in net inward migration are constraining housing market activity. However, residential consent issuance remains at a low level relative to core demand which is leading to some tension in the market. We still expect the tension between balance sheet (i.e. debt and affordability) and supply-demand dynamics to be dominated by the former.

We use ten gauges to assess the state of the property market, and for signs that changes are emerging.

**AFFORDABILITY.** For new entrants into the housing market, we measure affordability using the ratio of house prices-to-income (adjusted for interest rates), and mortgage payments as a proportion of income.

**SERVICEABILITY / INDEBTEDNESS.** For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

**INTEREST RATES.** Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

**MIGRATION.** A key source of demand for new housing.

**SUPPLY-DEMAND BALANCE.** We use dwelling consents issuance to proxy supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

**CONSENTS AND HOUSE SALES.** These are both key gauges of activity in the property market.

**LIQUIDITY.** We look at growth in Private Sector Credit relative to GDP to assess the availability of credit in supporting the property market.

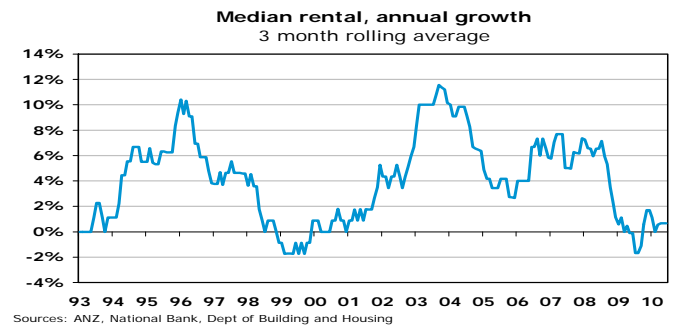
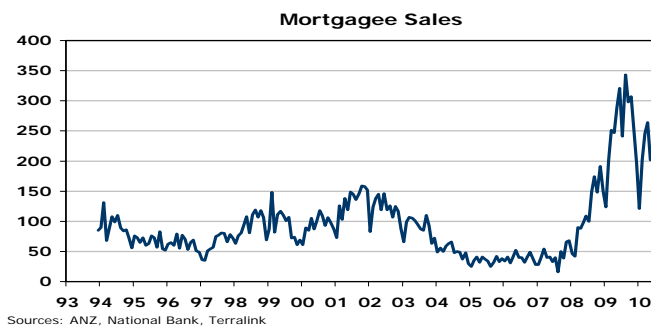
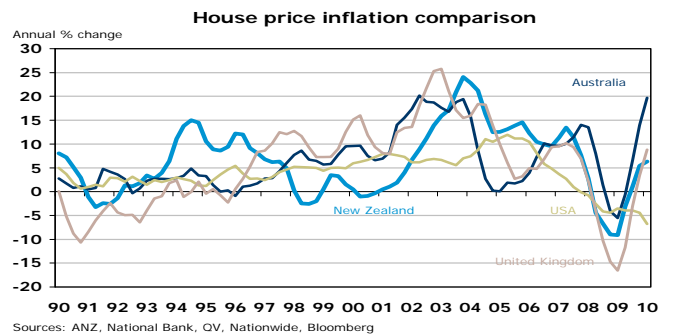
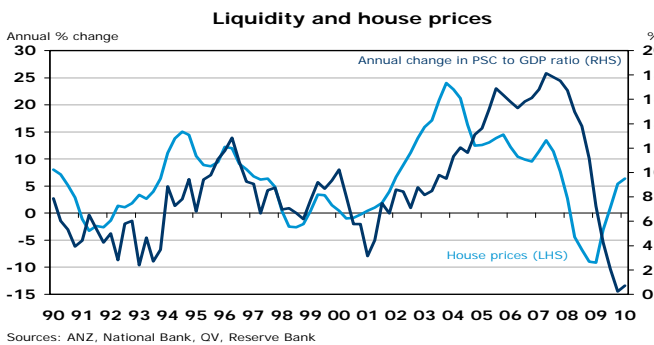
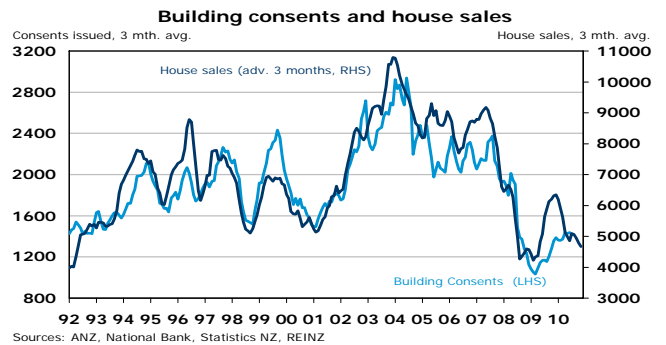
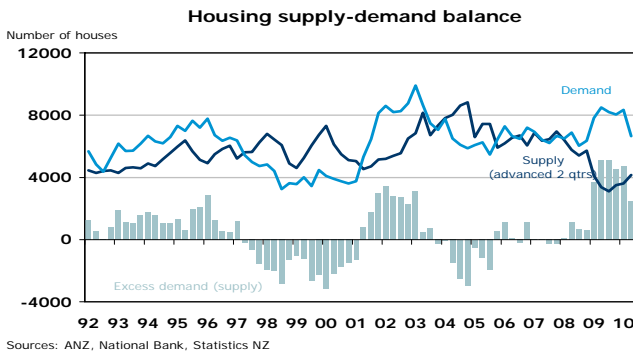
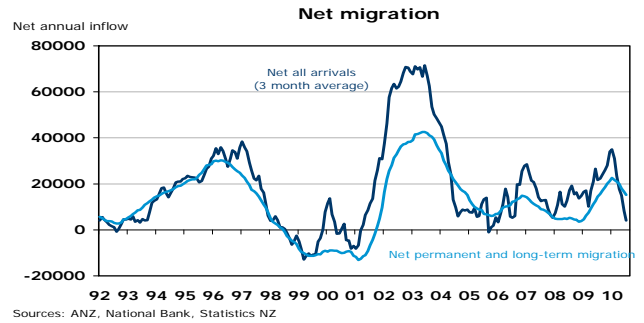
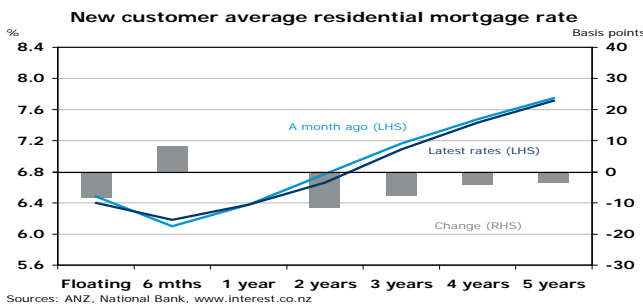
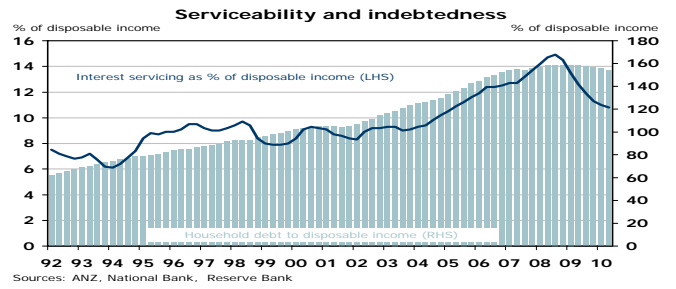
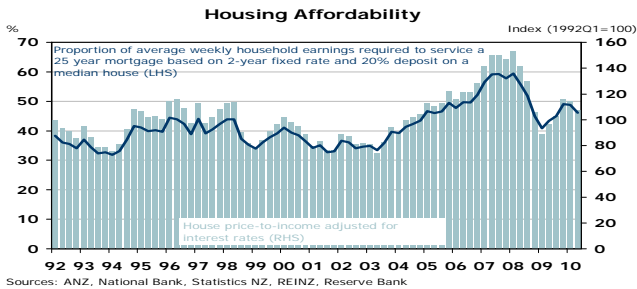
**GLOBALISATION.** We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that globalisation is playing in NZ's property cycle.

**MORTGAGEE SALES.** We look at how mortgagee sales are tracking for an indication of distress in the property market.

**RENTAL GROWTH.** We look at growth in the median market rent as an indication of whether it is a better time to buy versus rent, and how rental yields are shaping up for the property investor.

Indicator	Level	Direction for prices	Comment
Affordability	Improvement likely	↔/↓	Affordability is improving again, but houses are still expensive relative to income.
Serviceability / indebtedness	Easing	↓	Debt continues to be paid down.
Interest rates	Unchanged	↔	Small changes from last month and RBNZ flagging interest rates to move up more slowly.
Migration	Easing	↔	A key positive for the housing market is evaporating.
Supply-demand balance	Out of kilter	↔/↑	Not much demand, but what is being built is insufficient to satisfy even that.
Consents and house sales	Headwinds ahead	↔/↑	Little action in either statistic.
Liquidity	Illiquid	↓	May have turned the corner, but remains very illiquid.
Globalisation	Lagging behind	↔	The lucky country leads the way.
Mortgagee sales	Peaked?	↔	Dropped in June, but remains elevated.
Median rent	Still flat	↔	Not much happening.
On balance		↔/↓	Becalmed with slight downward bias.

# PROPERTY GAUGES



## ECONOMIC BACKDROP

The economy has softened in recent months. Caution remains evident in domestic spending, with a moderating tone also evident in measures of business and consumer sentiment. De-leveraging remains pervasive as households, farms and other businesses concentrate on improving balance sheets. On top of this, the Canterbury earthquake is likely to weigh on economic activity in the short-term. De-leveraging, a switch in the mix of growth with the domestic economy weaker than the tradable sector, and cautious optimism remain key features. We see this picture continuing for a while yet with momentum rebuilding over 2011.

### OUR CORE ECONOMIC VIEW

**The world remains stuck between the old normal and the new normal.** The terms *old normal* and *new normal* are probably the most overused phrases in economic circles at present, for what the global and New Zealand economies are facing is in fact nothing new at all. Credit growth cannot continue to grow at two to three times the rate of GDP. Household spending cannot become disconnected with earnings indefinitely. The bigger picture is one of a shift in economic momentum around the globe. While the tone of data across OECD nations (excluding Australia) remains somewhat schizophrenic, good one week and bad the next, Asia continues to surge ahead. Momentum in China remains strong, and likewise across most of the Asian region. This is tremendously important for the NZ economy with the region now taking 39 percent of our exports.

**The NZ economy is caught between the same contrasting dynamics.** The near-term growth outlook remains around trend with de-leveraging, extended balance sheets and caution restricting the magnitude of the recovery. We continue to expect a stronger 2011, led by a cyclical rebound in business and residential investment. Weakness or more de-leveraging in 2010 is a key factor supporting a stronger upturn eventually. The improving labour and housing market outlook will also provide support. The Rugby World Cup and improving trading partner growth are expected to translate into improved export returns. NZ's terms of trade is up 13 percent from a year ago. Commodity prices sit at or near record highs. The income boost from this will percolate through the economy in 2011. Despite a pending income boost, there is still huge attention towards the de-leveraging dynamic, which is a precursor to strong and sustainable growth. Household debt relative to income has fallen from 159 to 154 percent. The current account deficit is down to 2.4 percent of GDP.

**While the de-leveraging dynamic is advancing, it is ongoing.** The household sector still has a negative savings rate and is no longer benefiting from the wealth effect of surging house prices. Housing- and retail-related pockets of the economy remain very weak and small-to-medium sized businesses in particular are under a lot of pressure. This is leading to an overhang of cautious optimism across the economy. It's still optimism because the economy is seeing positive momentum. But it's of the cautious variety because people are simply not spending as they adjust to the new normal. We are seeing a different mix to growth and business owners are naturally being cautious in regards to hiring and investing in such an environment. And this in turn is accentuating conservatism across consumer spending behaviour. This is a dynamic we expect to continue for a while yet.

**While challenges are obviously extensive, we are becoming more upbeat.** Right through 2009 and 2010 we've been less sanguine in our projected economic prospects than most commentators. Put simply, we didn't believe the global or NZ economy could rid itself of a credit crisis in the space of 18 months. But at this present juncture, we suspect sentiment has turned unduly bearish, somewhat of a flip-flop from the optimism that was rampant in late 2009 and early 2010. While reason for caution remains, we must not lose sight of the support being provided by policymakers, loose financial conditions (which track GDP and are pointing to 3 percent growth) or progress that has been made fixing balance sheets. In regard to the latter, NZ seems to be taking its medicine (i.e. getting its house in order) more quickly and in a more sustainable fashion than a host of other nations around the globe. This is where weak retailing and housing is actually a good thing at present. A key part of this also reflects the opportunities the likes of Asia presents for NZ.Inc. Unlike a lot of nations, NZ has a pretty clear steer on where it needs to head or what activities can underpin the export and earning sector – a precursor to any sustainable recovery. A host of other nations still have to identify what these are before they can set a course.

**We see momentum building across NZ.Inc in 2011 and have pencilled in growth close to 4 percent.**

The Rugby World Cup and recent seismic developments in Canterbury are obviously key here, but even in the absence of such dynamics we'd be upbeat. Slowly but surely momentum around the globe is building and a recovery is in place and the more the NZ economy de-leverages in 2010, the more optimistic we feel about 2011. This is not without risks of course and we put a 1 in 4 chance of a double-dip global recession. But for now we've got our legs, fingers and toes crossed.

## MORTGAGE BORROWING STRATEGY

Floating and short term fixed rates have held steady over the past month, but there have been small cuts to fixed rates for terms of 2 years or more. This may seem counter-intuitive given that the RBNZ has lifted the OCR twice since June. However, fixed rates (particularly for longer terms) tend to be heavily influenced by global interest rates, and these have moved to extremely low levels in anticipation of further quantitative easing (QE) by the US Federal Reserve and as expectations of a weaker global recovery have pushed out the timing of when central banks will need to start raising rates. We expect global rates to remain low, keeping a lid on fixed rates. However floating rates are a different story. While the RBNZ left the OCR unchanged and adopted a cautious tone at the recent September *Monetary Policy Statement*, it did warn that rates still needed to rise gradually over the next few years. Floating rates are thus set to rise in future, probably from early 2011, so it makes sense to consider fixing. In our view, the 2 year is the "sweet spot".

### OUR VIEW

With the Reserve Bank (RBNZ) likely to keep policy on hold for the remainder of the year, **we expect mortgage rates will stay low for some time yet**. Judging the exact timing of the next OCR rise (and hence the likely timing of the next floating mortgage rate rise) is pretty tricky at the moment, particularly given the disruptive effect of the Canterbury earthquake. What we are sure of is that the near-term effect will be negative. The economy was already showing signs of losing momentum, but the earthquake has entrenched it. That being the case, we expect policy to be on hold for at least the remainder of the year. However as we look to 2011, with the Rugby World Cup kicking off and earthquake re-building set to get underway, it's hard to see the RBNZ leaving policy on hold beyond March. **But whereas the RBNZ were sounding an upbeat tone in June, warning of taking the OCR to 6 percent over the next 2 years, they now see the recovery as being more tepid, with the OCR set to rise more gradually, to around 4½ percent**. This is a substantial view change from the RBNZ, and we suspect they may have swung too far (from being overly upbeat in June to overly downbeat now). Nonetheless, we concur with the spirit of the RBNZ's message. Indeed, as we have long maintained, this recovery will be slower, and with structural and regulatory changes having an upward impact on actual interest rates, the OCR has less work to do. It's not just that credit growth is stagnant, held back by household deleveraging, but **with more borrowers now on floating rates, the RBNZ's assertions that monetary policy will have more "bite" this time around** are being realised.

**Nonetheless, with the OCR at just 3 percent, the next move is up. The obvious question is, how quickly**, as this is the key judgment when it comes to deciding whether to fix or not. One starting point is the RBNZ's own 90-day bank bill rate projections. These show the bill rate rising to 4.54 percent over the next 2 years, with an average of around 3.84 percent over the whole period. That's 64 basis points above the current bill rate of 3.2 percent. By contrast, 2 year fixed mortgage rates are only 49 basis points above the floating mortgage rates. So long as the relativities between bill rates and floating mortgage rates remain fairly constant, that implies that 2 year fixed rates are "cheap" relative to the RBNZ's projections. Given our view that the RBNZ has potentially swung too far, and has taken too downbeat a view on the economy, we do see some risk of their projections (and the actual path rates eventually follow) being revised higher. **As such, we see some merit in fixing a portion of mortgage borrowing at current levels, with the 2 year the "sweet spot"**. Indeed, whereas the RBNZ see 90 day bills at 4.54 percent by September 2012, our forecasts have them closer to 5.5 percent.

**Regular readers will be familiar with our breakeven analysis, which we use to gauge the potential value in a chosen strategy**. It doesn't help much when it comes to choosing between fixed and floating, but it is helpful when considering a set of fixed rates over a given timeframe. By comparing the choices available, breakeven analysis provides a set of figures showing where rates need to be in future to make two strategies equivalent, enabling better choices. Indeed, when thinking about the next 2 years, there are several choices you might consider if you wanted to fix. For instance, you might consider fixing for 2 years; or a "split" strategy like fixing for 1 year, and then for another year in 1 year; or fixing for 6 months, and then again in 6 monthly intervals over the remaining 18 months, and so on. Breakeven analysis allows you to compare these strategies against one another, and the table overleaf shows breakevens as they currently stand. To illustrate the current situation, when thinking about the next 2 years as a time horizon, you might be contemplating whether it is better to remain floating, be fixed for 2 years at 6.69%, or to fix for 1 year at 6.45%, with a view to re-fixing in a year for another year.

**Although floating is cheaper, it's not cheaper by much, and as noted above, even a gradual series of rates rises like that projected by the RBNZ will see floating rates rise quickly enough to make fixing**

# MORTGAGE BORROWING STRATEGY

**beneficial.** The next question is which fixed rate do you choose? At the moment the 1 year breakeven in 1 year's time is at 6.93%. That's just 0.48% above the current 1 year rate, which isn't much, especially when you consider that the RBNZ is almost certain to lift the OCR by at least that amount (i.e. at least 2 rises of 25bps) over the next year. As such, we think the 2 year offers better value.

Mortgage Rates		Breakevens			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
<b>Floating</b>	6.20%				
<b>6 months</b>	6.35%	6.55%	7.05%	6.81%	7.72%
<b>1 year</b>	6.45%	6.80%	6.93%	7.26%	7.92%
<b>18 months</b>	6.65%	6.80%	7.19%	7.55%	8.06%
<b>2 years</b>	6.69%	7.03%	7.43%	7.74%	8.21%
<b>3 years</b>	7.10%	7.43%	7.78%	8.04%	8.37%
<b>4 years</b>	7.45%	7.73%	8.01%		
<b>5 years</b>	7.70%				

# THE CANTERBURY EARTHQUAKE

## SUMMARY

We recently visited Christchurch to assess the earthquake impact firsthand. While the damage bill is expected to be substantial, we were pleasantly surprised to see that the majority of Christchurch was operational. Dislocation in pockets is obvious, but a huge proportion of the population is getting on with business. We would never downplay the distress and trauma that people have been through. But if news reports continue to paint an overly negative bias, the greater the potential negative impact on areas such as tourism in 2011. Balance needs to be struck and responsible heads need to be at the fore. Back of the envelope estimates suggests an immediate negative impact on GDP of -0.6 percent in Q3. Much has been made of the supportive impact of reconstruction activity over 2011 and 2012. While this will undoubtedly support activity in the region, we suspect the hit to household balance sheets from the quake, higher costs of insurance and displacement effects from other areas will partly mitigate the aggregate economic flow-on. While rebuilding activity will support growth, this only takes balance sheets back to where they were preceding the event.

## SOME KEY METRICS

The Canterbury region is an important part of the New Zealand economy, accounting from between 8 and 20 percent of various activity measures.

Recent estimates for key metrics	Canterbury region	% of NZ
Regional GDP (\$b)	27	15
Population (000)	566	13
Number business enterprises (000)	65	13
Retail sales (\$b)	8.5	13
Employment (000)	334	15
House Sales	9400	15
Expenditure by international visitors (\$b)	0.9	16
Expenditure by domestic visitors (\$b)	1.4	16
Visitor guest nights (m)	5.1	16
Overseas visitor guest nights (m)	2.5	19
Value of Cargo trade (\$b)	8.2	10
Passenger movements at Christchurch Airport (000)	1614	18

Sources: ANZ, Tourism Research Council, NZIER, Statistics NZ, REINZ

## OUR IMPRESSIONS ON THE SCENE

**We visited Christchurch two weeks ago to make a first hand assessment of the damage.** It seemed imprudent to talk authoritatively about the implications of the earthquake without visiting the area and talking to local people and businesses. **Our initial reaction (and this extended throughout the day) was that the city had held up well.** This is not to downplay what has obviously been a traumatic emotional and financial time for many people and their families. But big portions of Christchurch were operational.

To be sure, significant devastation was evident in some suburbs, but in others, many houses appear to have escaped with little more than a toppled chimney. We also got the feeling that while the damage was widespread, most dwellings were still habitable. Despite clear evidence of damage in the suburbs, many businesses were open – and that's a key ingredient to "moving on". Yes, there were collapsed premises on street corners in some suburbs, and reasonable damage in the central city, but what stuck us was the stoic attitude most local business people were taking. Kiwi ingenuity was in abundance with firms relocating to vacant premises and getting on with the job. Real estate agents report that enquiries for retail and office space have surged. We suspect many moves will take place quickly given vacancy rates prior to the earthquake.

To be fair, we hit the ground 6 days after the event itself, but after visiting a number of people and industries, **we were surprised at how quickly many had returned to business as usual.** Obviously, this was not universal, but the key point was that dislocation was well in the minority. Manufacturing for instance looks to have come through pretty well unscathed.

## THE CANTERBURY EARTHQUAKE

While we recognise the trauma and distress that people in the region have been through, **we were concerned that if an overly negative spin was placed in reporting on the earthquake impact, it could scupper confidence and the recovery in the region.** Tourism bookings, both offshore and domestic, are made in advance. While tourists are obviously circumventing Christchurch at the moment, the real test will come six months out. As one person we spoke to noted: if you looked at the media coverage, you get an impression of Hiroshima, whereas nothing could be further from the truth. Balance needs to be struck and responsible heads need to be at the fore.

**Vital infrastructure has held up well.** Christchurch Airport and Lyttleton Port are open and operational, electricity supplies are stable for most of the region, with major routes outside of the CBD open. Indeed, the operators and designers of the backup continuity plan for the city and anyone that has anything to do with the maintenance or restoration of key infrastructure deserves a medal for their efforts. Christchurch may well become a global blueprint for other cities around the globe in regard to crisis management.

**However, there is still considerable disruption.** While thankfully there was no immediate loss of life, the human costs of the quake are becoming apparent with heightened stress levels and inadequate sanitation contributing to health related issues. After being closed for a week, most schools reopened. This is a key issue. Families come first, and until schools are completely reopened, a fair proportion of the workforce will simply not be returning to work.

### WHAT IS THE SCALE OF THE DAMAGE?

**Updated estimates of the extent of damages have been revised up to \$4 billion**, which is around 0.6 percent of the country's net capital stock. Prior to visiting Christchurch, we suspected this could be on the light side. After visiting and eying the landscape, it seems pretty realistic to us, although the reality is that it is impossible to tell what the degree of indirect damage (repair as opposed to rebuild) will finally be. At the time of writing the number of claims received by the Earthquake Commission (EQC) totalled 66,000, with 81 percent from Christchurch City. But this is forecast to grow to 100,000. Estimates suggest anything from 2,000 to 4,000 homes will need to be demolished so a fair degree of the claims seem likely to be of the repair variety. Taking a mid-point of 3,000 and assuming an average rebuilding cost of \$200-250k per unit (the majority of the affected suburbs are of below average values), you get to \$600-750 million straight away. On top of that you have core infrastructure, commercial property, broader repair jobs, home and contents insurance, and potential land reimbursement for those suburbs that are too unstable to support reconstruction as well.

**Or looking at things from a different angle**, recent accounts suggest that around 100,000 of the 160,000 dwellings in the quake zone have suffered more than just light damage. We conservatively estimate the value of the Canterbury dwelling stock as being around \$70bn. Assuming the average claim of around \$20,000 per dwelling (a conservative estimate given building costs) this will translate into \$2bn of residential building work. This will partly be funded by EQC, which has up to \$2.5bn of reinsurance cover. Non-residential construction and infrastructure work could easily be worth \$1bn to \$2bn.

**The insured losses are not the full costs.** Many firms and households do not have comprehensive insurance cover that will fully compensate them for damages, or loss of earnings. Moreover, much of the local and central government infrastructure is not insured.

### WHAT ARE THE POTENTIAL IMPACTS ON ECONOMIC ACTIVITY?

**From the outset we have to acknowledge that anyone who can give a precise estimate of the earthquake impact is likely to be pulling your chain.** There are simply too many uncertainties, not to mention the unquantifiable impact on the psyche and confidence. Nonetheless, it is our job to do precisely that. So what follows are some broad thoughts. Rather than focusing on the numbers themselves, we would encourage readers to focus on some of the channels the economic impact will likely manifest.

- **For a start we need to acknowledge that there has been a material pool of capital lost.** A lot of this is insured and attention is naturally focused on the rebuild associated with the destroyed capital – the positives. But we need to remember the starting position: NZ is a nation that is too heavily indebted, and having a pool of that capital that debt was linked to is hardly something to write home about. Certainly, the Government balance sheet including EQC will kick in here, but we can't go past the obvious: a huge pool of capital has been destroyed and it will take time to be replaced. So while the rebuild will support growth, this

## THE CANTERBURY EARTHQUAKE

will only take balance sheets back to their original position, and in the case of the likes of the Governments balance sheet, the loss is permanent.

- **There will be an immediate negative impact on September quarter economic activity.** The Canterbury region accounts for 15 percent of national GDP and the impacted area is around 10 percent of GDP, so there will be a nationwide impact. Any estimate requires some heroic assumptions, so here are ours. We assume the quake contributed to a 40 percent loss of economic activity in the affected area in the week following the event, with losses diminishing to 20 percent in week two and 10 percent in weeks 3 and 4. We suspect this broadly mirrors what is happening on the work front. This gives us an initial impact of -0.6 percent of GDP in the September quarter. Confidence and the shock and awe factor likely inflate this, but offsetting it has been the immediate reconstruction response. So net-on-net we're left with around -0.6 percent. Considering droughts or electricity crisis in the past have had substantial impacts on activity, -0.6 may seem light, but remember, this is only the September quarter, and only the month of September was impacted.
- **The first major wildcard is the impact on confidence.** There will be the obvious temporary displacement impacts on tourism activity and retailing but the wildcard is the impact on the psyche. We certainly saw a lot of positivity (if you could call it that) on our trip to the region, but whether this is of true substance remains to be seen. We doubt people are going to be in a hurry to spend a lot over the coming months until they are aware exactly where they stand financially in the wash-up. This is a process that could take months, and will mitigate the optimism being shown in the construction sector. Suffice to say that the likes of the RBNZ has a role to play here in terms of demonstrating leadership and pragmatism in its decision making. The RBNZ has scope within the policy targets agreement to look through the impact of natural disasters and while last week's decision to not change the OCR was decided in advance of the quake, the RBNZ looks to be displaying pragmatism and a preparedness to support the economy by keeping the OCR at 3 percent until early 2011.
- **The second major wildcard is the impact on land and asset values.** We envisage that property transaction costs will rise (i.e. seismic tests required for insurance purposes) and we doubt buyers will be jumping at the gun after recent events. Stronger demand for residential rental accommodation is likely to underpin dwelling rents in the region and property values for residential rentals, whereas earthquake damage has effectively reduced the supply of inhabitable dwellings in the region. Conventional valuation metrics suggest that while property prices are still overvalued, property values will be supported by the high cost of replacing a dwelling and risks of a growing dwelling shortage in the quake aftermath. Our inklings remain more with the former.
- **The earthquake could be the proverbial straw that leads to a number of business closures.** The first important point here is the opening position. Small and Medium sized Enterprises (SME) have huge exposure to retailing and housing, sectors that are a far cry from being economic cheerleaders. July and August were tough months. The second important point is that most don't tend to have disruption insurance, and are less inclined to have more broad insurance cover. According to estimates from the Ministry of Economic Development (MED), Canterbury has a higher proportion of SMEs than the national average – early 2009 figures place the number of enterprises employing zero to 19 people at just over 59,000 in the Canterbury region alone (just over 90 percent of the total number of businesses in the region and around 40 percent of total employment). About half of these firms have been in operation for less than five years. For sure, a lot of businesses will be seeing rebuilding related activity as an opportunity, but the challenge is whether the balance sheet can stretch that far. According to our contacts, there are going to be some issues here.
- **We are closely watching the tourism sector.** Forty-five thousand offshore tourists come through Christchurch international airport each month. There will be the obvious displacement effects as a number of tourists simply by-pass Christchurch. But tourism – both local (think the convention and conference market which is huge in Christchurch) and global, are both typically booked six months in advance. So the real test will come in Q1 2011.
- **Insurance impacts.** New Zealand insurance claims will be funded by global reinsurers overseas. While the damage done by the earthquake was substantial and is likely to have been one of the biggest insurance events in our history, it pales in comparison to major disasters overseas. Reinsurance companies typically set premiums on a global basis, making adjustments for local events. Given that earthquake risk applies

## THE CANTERBURY EARTHQUAKE

nationwide, the likelihood is that nationwide premiums will rise as a result. As an illustration, assuming that the costs of home and contents insurance increase by 10 percent (which some would deem conservative given increases in insurance premiums of late), the additional cost to households is approximately \$180m per annum or 0.2 percent of household consumption. Higher insurance costs will also filter through into higher rents and will add to business cost structures.

- **Of course all this needs to be read against the obvious boom to construction and durable related spending.** As noted earlier, \$4 billion seems about right, which spread over two years is broadly an economic impulse of around 1 percent of GDP per annum. We expect that the work will be spread over at least two years, with non-residential work getting the higher priority. Although there is some spare capacity in the industry and building regulations are likely to be relaxed, overseas experience suggests it is likely to take a number of years.

**As a rough guide, we have pulled together the table below.** The numbers themselves are largely meaningless in our eyes. The key point is to illustrate some of the broader channels that will manifest. While our analysis has centred on the Canterbury region, we also need to bear in mind that displacement and dislocation in some regions can also typically lead to a substitution effect in others. The earthquake is likely to have had an impact on business and consumer confidence, with greater caution in households and business spending likely to weigh on economic activity.

Illustrative 2-year impacts	
	% GDP
Tourism	-0.1pa
Asset values / wealth effect	-0.1pa
Higher premiums	-0.1pa
Q3 and Q4 disruption including confidence	-0.9
SME dislocation	-0.1
Rebuilding / durable upswing	+2.0
<b>Aggregate net impact</b>	<b>+0.5</b>
* 2010 impact only. Aggregate impact does not sum due to rounding. Sources: ANZ, National Bank, NZIER, Statistics NZ	

## KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

		Mortgage Rate (%)													
		5.75	6.00	6.25	6.50	6.75	7.00	7.25	7.50	7.75	8.00	8.25	8.50	8.75	9.00
Mortgage Size (\$'000)	200	290	297	304	311	319	326	333	341	348	356	364	371	379	387
	250	363	371	380	389	398	407	417	426	435	445	455	464	474	484
	300	435	446	456	467	478	489	500	511	522	534	545	557	569	581
	350	508	520	532	545	558	570	583	596	610	623	636	650	664	677
	400	580	594	608	623	637	652	667	682	697	712	727	743	758	774
	450	653	669	684	701	717	733	750	767	784	801	818	836	853	871
	500	725	743	761	778	797	815	833	852	871	890	909	928	948	968
	550	798	817	837	856	876	896	917	937	958	979	1000	1021	1043	1064
	600	870	891	913	934	956	978	1000	1022	1045	1068	1091	1114	1137	1161
	650	943	966	989	1012	1036	1059	1083	1108	1132	1157	1182	1207	1232	1258
	700	1015	1040	1065	1090	1115	1141	1167	1193	1219	1246	1273	1300	1327	1355
	750	1088	1114	1141	1168	1195	1222	1250	1278	1306	1335	1364	1393	1422	1451
	800	1160	1188	1217	1246	1274	1304	1333	1363	1393	1424	1454	1485	1517	1548
	850	1233	1263	1293	1323	1354	1385	1417	1448	1480	1513	1545	1578	1611	1645
900	1306	1337	1369	1401	1434	1467	1500	1534	1567	1602	1636	1671	1706	1742	
950	1378	1411	1445	1479	1513	1548	1583	1619	1655	1691	1727	1764	1801	1838	
1000	1451	1486	1521	1557	1593	1630	1667	1704	1742	1780	1818	1857	1896	1935	

Housing market indicators for August 2010 (based on REINZ data)

	House prices (Ann % change)	3mth % chng	No of sales (s.a.)	Mthly % chng	Avg days to sell (s.a)	Comment
Northland	4.1	-4.6	93	(-6%)	78	The weakest 3 monthly shift in house prices
Auckland	-0.9	-1.8	1,528	(-1%)	37	The number of sales hit an 18-month low
Waikato/BOP/Gisborne	1.1	0.5	601	(-3%)	69	The second longest time to sell a house
Hawke's Bay	8.4	-0.7	166	(+1%)	53	The strongest annual increase in prices
Taranaki	7.0	-1.8	210	(0%)	57	The second strongest annual gain in prices
Manawatu-Whanganui	-6.1	1.5	148	(-1%)	54	The largest annual fall in house prices
Wellington	0.3	1.9	540	(-7%)	42	Most similar to the national average
Nelson-Marlborough	1.3	-0.2	154	(-10%)	50	The largest drop in sale numbers was here
Canterbury/Westland	6.6	3.8	678	(-7%)	38	Strongest 3-month house price growth spurt
Otago	2.3	-4.0	87	(+57%)	63	A partial rebound in sale numbers
Central Otago Lakes	-2.7	2.3	214	(-8%)	36	The second lowest annual rise in prices
Southland	-2.4	-1.7	115	(+2%)	32	Recorded the shortest time to sell a house
NEW ZEALAND	0.8	-0.4	4,550	(-4%)	43	Housing market activity remains weak

## Key forecasts

Economic indicators	Actual			Forecast						
	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12
GDP (Ann Avg % Chg)	-1.6	-0.4	0.8(f)	1.8	2.1	2.3	2.4	3.0	3.8	4.1
CPI Inflation (%)	2.0	2.0	1.8	1.6	4.6	4.8	5.6	5.3	3.0	2.9
Unemployment Rate (%)	7.1	6.0	6.8	6.6	6.4	6.1	5.7	5.5	5.4	5.5
Interest rates	Actual			Forecast (end month)						
	Jul 10	Aug 10	Latest	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11	Mar 12	Jun 12
Official Cash Rate	2.75	3.00	3.00	3.00	3.25	3.75	4.00	4.25	4.75	5.25
90-Day Bank Bill Rate	3.1	3.2	3.2	3.3	3.7	4.2	4.3	4.7	5.2	5.5
Floating Mortgage Rate	6.1	6.5	6.5	6.5	6.8	7.3	7.5	7.6	7.9	8.4
1-Yr Fixed Mortgage Rate	6.5	6.4	6.4	6.5	6.8	7.1	7.2	7.6	8.0	8.2
2-Yr Fixed Mortgage Rate	7.3	6.8	6.8	7.1	7.3	7.6	7.8	8.1	8.3	8.4
5-Yr Fixed Mortgage Rate	8.5	7.7	7.7	8.2	8.3	8.5	8.8	8.8	8.8	8.8

# IMPORTANT NOTICE

## NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

### Qualifications, experience and professional standing Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

### Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

### Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

### Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

### Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

### Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

### Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- ING (NZ) Holdings Limited (ING), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ING and its related companies, including ING (NZ) Limited, may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

### Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

### PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:



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- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

### Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

### Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

### Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

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