BERL Economic Update

June 2010

prepared by BERL for Taupo Moana Funds Ltd

- The Government's Budget speech rightly acknowledged "New Zealand's largest single vulnerability is now its large and growing net external liabilities. New Zealand now owes the world $168bn, or around 90 per cent of Gross Domestic Product (GDP)."

- In a world where financial institutions remain wary of debt, this places New Zealand in a weak position. The quest for higher productivity now takes on renewed urgency.

- The choice is clear. Either spending for consumption today is curtailed, or income is significantly lifted. Clearly, the latter option is more palatable.

- Short-term prospects for the New Zealand economy are underpinned by the infrastructure renewal projects currently underway. Central and local government have clear roles to play in this.

- Other elements of demand remain fragile. Jobless numbers remain above year-earlier levels and net migration inflows have eased in recent months.

- The export sector (except for a few selected commodities) remains under pressure from uncertain global growth prospects, and is not helped by a volatile exchange rate.

- The tradable sector (primary, processing and manufacturing industries) has contracted for three out of the last four March years. This sector's contribution to New Zealand's GDP is now smaller than it was seven years ago and indicates a lot of 'catching up' to do.

- Business investment was an immediate victim of the recession. Ongoing difficulties with accessing funds means a rapid upturn over the forecast horizon in business spending on new equipment, machinery or buildings is unlikely– even if businesses were in the mood for such spending.

- Consequently, we believe the signalled tightening of monetary policy is premature.

- Our forecast is for a comparatively modest recovery, as we have little confidence that business investment or exports will recover as strongly or as rapidly as others expect.

Economic update – Forecast summary and comparisons

KEY INDICATORS : FORECAST SUMMARY AND COMPARISONS

	2008	2009	2010	2011	2012	2013
Real GDP						
March year average % change						
BERL	2.8	-1.4	-0.4	1.1	2.0	2.7
Reserve Bank	2.9	-1.4	-0.3	3.5	3.6	2
Treasury	3.1	-1.4	-0.3	3.2	3.1	2.9
Current Account Balance						
March year % of GDP						
BERL	-7.8	-7.9	-2.4	-4.7	-6.6	-7.3
Reserve Bank	-7.8	-7.8	-3.3	-4.1	-5.3	-7.2
Treasury	-7.8	-7.9	-2.6	-4.4	-6.1	-7
Employment FTE growth						
March year average % change						
BERL	0.6	0.8	-1.5	-0.1	1.4	1.6
Reserve Bank	-0.2	0.7	-0.1	2.2	1.6	0.4
Treasury	0.8	0.9	-1.6	0.2	2	2.1
Export volume growth						
March year average % change						
BERL	3.0	-3.3	2.8	1.9	3.2	3.6
Reserve Bank	3	-3.3	2.7	2.2	5.1	2.7
Treasury	2.9	-3.4	2.8	1.6	4.7	3.5

Reserve Bank : Monetary Policy Statement, June 2010

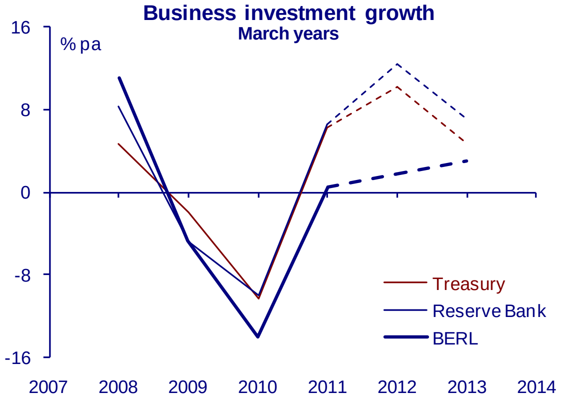
Treasury : Budget Economic and Fiscal Update, May 2010

Our assessment

The New Zealand economy remains in a fragile state with divergent views as to the nature and strength of the post-recession recovery.

Several commentators, backed by a range of survey indicators, expect a strong upswing over the coming year as the export sector recovers lost ground on the back of a more favourable global climate. Other commentators, backed by a range of data, see a more muted recovery in the light of further risks to the global climate coupled with the impact of ongoing domestic imbalances.

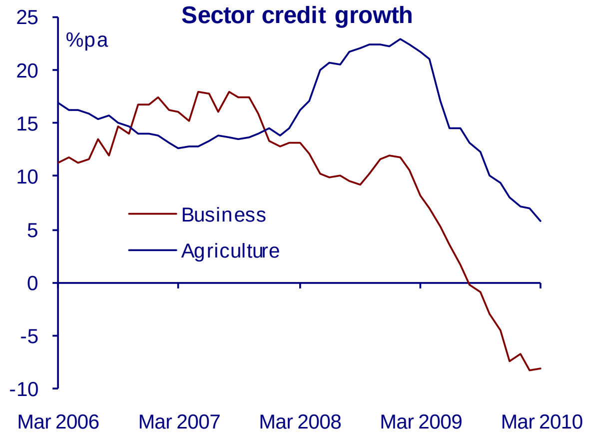
The latest forecasts from the two official agencies are informative in that they highlight the assumptions underpinning their expected recovery. The Reserve Bank of New Zealand (RBNZ) and the Treasury see a rapid increase in economic growth over the coming quarters, with expansion in GDP averaging over 3% over the year to March 2011.



Budget May 2010
RB Monetary Policy Statement June 2010
BERL Forecasts June 2010

Of more importance, this growth is underpinned in the official scenarios by a rapid rebound in business investment. Both agencies see businesses renewing, upgrading and/or adding to existing machinery, equipment and buildings rapidly over the forecast horizon. From a 10% contraction in the year to March 2010, growth in the order of 6% in the year to March 2011, and another 12% in the following March year are expected.

While such a rebound is in line with previous experience (in particular, the recovery that followed the recession of the late 1980s/early 1990s), we believe such a reversal to be optimistic.



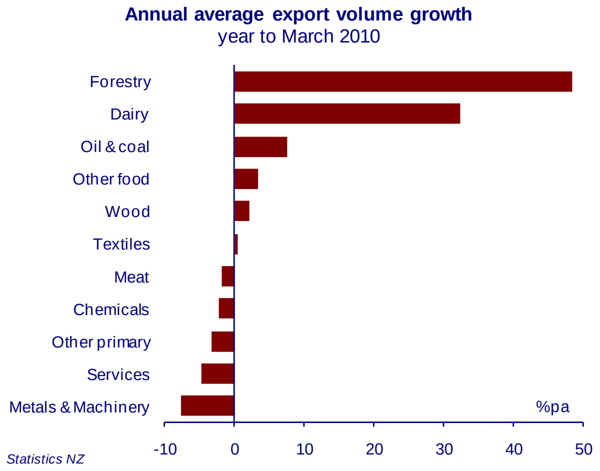
RBNZ

Our concerns are twofold. Firstly, sufficient funds to facilitate a rebound in business spending are unlikely to be available. Credit supply to the business sector remains well below year-earlier levels (8% down, as at March). That available to agriculture was 6% up on a year-earlier, but its rate of expansion is rapidly slowing.

Secondly, the outlook for demand is unlikely to encourage business spending. While the Australian market remains buoyant, financial turmoil haunts Europe and the strength of the recovery in the US is unconvincing.

Further, the domestic scene could at best be described as treading water. Cost pressures from increased GST, the ETS scheme, and increasing mortgage interest rates are expected to erode most of the gains from imminent tax cuts. As a result, the domestic household sector will not provide the primary impetus for a sustained recovery.

The net migration inflow has also recently stalled. This could cause the recovery in house building, which remains at very low levels, to also stall.



This leaves the export sector as the potential driver of the recovery. Recent headlines suggest this is the case.

Improving commodity prices, reflected in better terms of trade and increased dairy payout forecasts, suggest a favourable environment. Export volume growth over the year to March was a respectable 2.8%, and the balance of payments figures also reported a 20-year low in the current account deficit. However, the detail within the current export picture is far from promising.

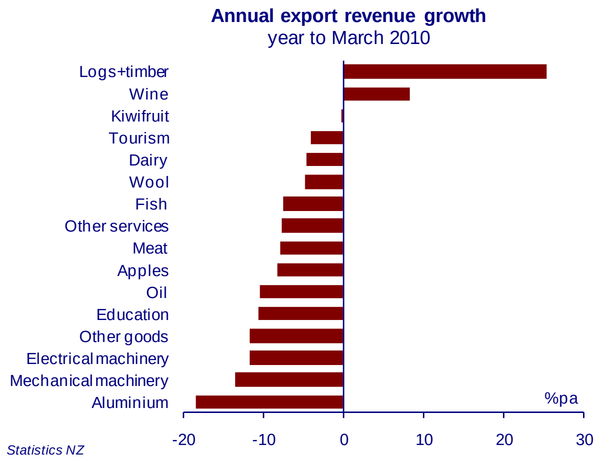
The average 2.8% growth in export volumes is disproportionately concentrated in a few categories – and the expansion is heavily dominated by forestry and dairy exports. Among the categories recording falls in export volumes are two of our top three earners – meat and services (including education and tourism).

Translating the volume picture into revenue earnings growth provides an even bleaker picture.

The 2.8% increase in annual export volumes translates to a 7.5% reduction in annual export revenues – indicating that only a few commodities are enjoying the benefits of favourable prices. And the above picture confirms only a narrow group of exports returning better than previous year revenues.

So how was a 20-year low in the current account deficit recorded? In a nutshell, spending declines during a recession and in particular spending on imports. If we do not record an improvement in the current account during recessionary times then the future of the New Zealand economy is indeed bleak indeed. However, the real challenge is to record a current account improvement during a growth phase. Now that would be an achievement worth writing about.

Many point to resurgent business confidence as an indicator underpinning growth prospects. We argue that the turnaround in reported confidence should be viewed as reflecting short-term relief that the recession is over, rather than any fundamental factor indicating a bright future.



Others highlight comparisons with the recovery profile after previous recessions to support a rapid turnaround in business investment. We suggest such comparisons may be misleading, given the differences in the underlying causes of this recession. In particular, the recession of 20 years ago did not originate in the finance sector. Business investment declined a lot later during that recession – in response to the decline in demand – and recovered quickly as demand returned.

Further, that recession did not occur against the backdrop of weak global demand. Consequently, the export sector led the economy out of the recession 20 years ago due to the presence of favourable global demand, as well as a gently declining exchange rate. This time around the export sector has to cope with an uncertain and unstable global environment and little sign the NZ$ will begin to trend downwards.

While modest, if not negative, we believe our assessment of the short-term prospects to be realistic. We have difficulty seeing a growth episode that would propel inflation towards heights that justify the interest rate increases forecast by the authorities. The outcome of increasing costs of funds to business, in an already difficult business environment can only defer, if not subvert, recovery prospects. But, this appears to be a lesson we seem reluctant to learn.

Consequently, the BERL forecast is for a comparatively modest recovery. We have little confidence that business investment or exports will recover as strongly or as rapidly as others expect.

Labour market

LABOUR MARKET INDICATORS 000s people

June quarter	2008	2009	2010	2011	2012	2013
Full-time employment	1,677	1,652	*1,642*	*1,652*	*1,683*	*1,724*
Part-time employment	507	514	*512*	*518*	*523*	*528*
Total employment	**2,184**	**2,166**	***2,154***	***2,170***	***2,206***	***2,252***
FTE employment growth %	0.6	-1.2	*-0.6*	*0.7*	*1.8*	*2.3*
Unemployment	**88**	**134**	***163***	***184***	***184***	***172***
Official unemployment rate %	3.9	5.8	*7.0*	*7.8*	*7.7*	*7.1*
Labour force	**2,272**	**2,300**	***2,317***	***2,354***	***2,390***	***2,424***
Participation rate %	68.2	68.2	*67.8*	*67.9*	*68.1*	*68.2*
Not in labour force	1,059	1,073	*1,103*	*1,113*	*1,122*	*1,131*
Working age population	3,330	3,372	*3,420*	*3,467*	*3,511*	*3,555*

Statistics NZ and BERL calculations *BERL Forecasts*

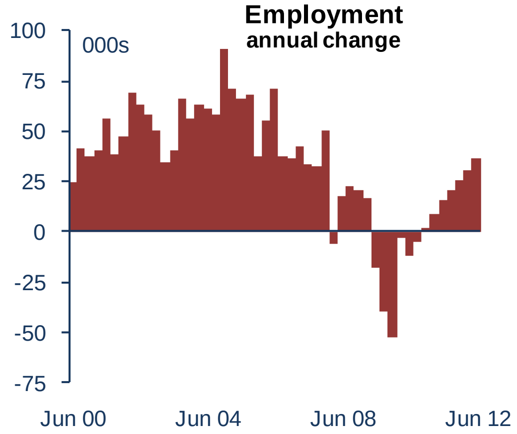
The employment market may now be at a very significant turning point. Annual growth in the number of people employed as measured by the Household Labour Force Survey (HLFS) has fallen from an increase in employment of 30,000+ per year in 2007, to a decline of 53,000 in the year to December 2010. In March 2010 employment was only 3,000 people less than in March 2009, which is a turnaround of 50,000 people within a year. Does this indicate a sharp turning point leading to strong employment growth from now on or could the economy continue to stagger?

At first it seemed to be a remarkable reversal in just three months of the trend decline, and was heralded as such by many in the media. However, there are two major problems to interpreting this reversal. Firstly the increasing fluctuations of this HLFS data series around the trend, and secondly the need to find causal factors that may explain the reversing of a trend that has been declining for about five years. The most direct approach to interpreting this potential turning point and in finding an explanation is to examine the changes in specific industries.

Fluctuations around the trend

The increasing volatility in employment changes is due to the surveyed responses or the economy fluctuating more widely. Whatever the cause, if we fit a simple trend to the unadjusted data (e.g. a five-quarter moving average) we find that the fluctuations around that trend over the last five years have been in the range of plus or minus 20-25,000.

This means that the apparent major improvement in the employment change to March 2010 may be accounted for by a reversal of this fluctuation. This would conclude that the trend level in year to March 2010 may be the same as the trend level in year to December 2009.



Statistics New Zealand

Causal factors in the medium term can derive from increases in investment, generally caused by increasing migration driving dwelling construction; private sector business investment; or public sector infrastructure investment.

We expected the migration factor and the intended infrastructure investment to show through as growing employment in construction. However, this lead indicator has not arrived as net inward migration slowed quite sharply in the early months of 2010 and pressure on residential building has not been high.

Another major driver is a low exchange rate. The average TWI exchange rate since 1985 has been about 60 on the index. There have been sustained periods since the early 1990s when the TWI has been below the average. During this time there has been strong employment growth.

The periods when a low TWI initiated and stimulated employment growth were after the fiscal recession of the early 1990s, from about 1992 to 1995, and from 1999 to about 2004. In periods when the TWI was above the average for a considerable time, this initiated a steady fall in employment growth. These periods were from 1995 to 1998 and from 2005 to the present.

The RBNZ is now forecasting a fall in the TWI from 67 at present to 61 by 2012. This is still above the long-term average and is therefore unlikely to provide a strong stimulus to employment growth.

We find this forecast puzzling: how can the RBNZ forecast a declining TWI when they are also forecasting the 90-day interest rates to double to about 6% in two years? Further, during this period the rates in the UK, US and Europe are expected be about 1.5%. We would expect that the interest rate differential would encourage the carry trade flow into New Zealand, driving the NZ$ up.

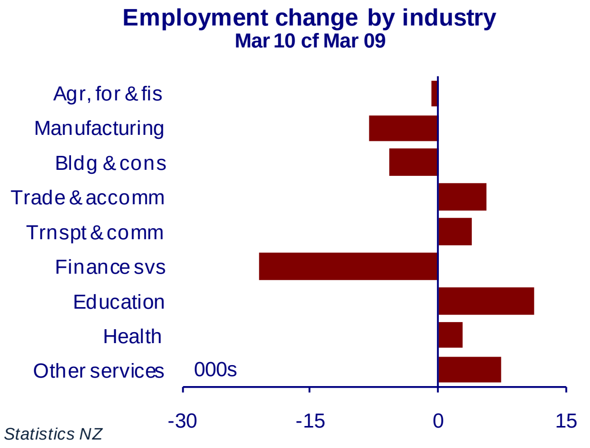
The other possible driver of employment growth could be increased credit, which would feed through to a recovery in asset prices including houses. This wealth effect would stimulate more consumption. This could well be the case if the interest rate differential again causes short-term inflows that increase private sector credit in New Zealand at rates higher than our GDP increase in current prices. This would be a recovery for all the wrong reasons, and could possibly result in another asset price/mortgage easing/finance company balloon-and-bust cycle.

Employment change in lead industries

Twenty-seven, or one-half, of the 53 industries in our database had a reduction in employment between March 2009 and March 2010.

Prospects are still reasonably strong in our primary-based exports, with logs to China doing well and commodity prices up. However, the drought has reduced volumes so we cannot take advantage of prices. While the mining sector is looking good, this is likely to show through in export receipts rather than significant employment increases.

There is still talk of major infrastructure investment projects and programmes, and some have started. However these projects have not yet emerged in the data as major employers. Employment in the general construction and construction trades sectors in the March quarter 2010 was about 6,000 fewer or 3% less than 12 months before.



The main increases in employment continue to be in education and health, and food and beverage processing and manufacturing. There is some continuing increase in household services and hospitality. And there are some industries, like basic material wholesaling and air transport, where reasonably small increases of 5,000 to 11,000 were registered in the 12 months.

Not much should be read into this though because, in any sample survey like this, smaller numbers are always problematic. Basic material wholesaling could be related to the handling commodities like logs, metals and oil, but again the numbers are small so the sampling errors are large.

From this industry scan there are one or two 'green shoots' emerging, like the basic material wholesaling, air transport and other household services sectors, where we could assign positive growth. As well there is steady growth from social services, and food and beverage processing. However, these 'green shoots' (apart from food and beverage processing) are not the stuff that strong employment growth is made of.

Unemployment

Since the beginning of 2009, the unemployment rate has been in the range of 5.6% to 6.8%.

Widespread confidence was expressed when the March 2010 figures showed an unadjusted unemployment rate of 6.6% of the labour force. As discussed in our employment analysis, the employment figure for the March quarter 2010 is well above the trend, and consequently the unemployed figure is likely to be on the low side.

We have previously indicated that the unemployment rate is expected to be between 7% and 8% through much of the forecast horizon, and we are going to retain this forecast. This is likely to bring some stress into the labour market and society through 2011 as households are confronted with weak employment and income growth, and significant increases in mortgage bills. Mortgage rates could lift from 6% to 9% by 2012 if the RBNZ sticks to its present projection of the 90-day interest rate, presumably reflecting their expectations of OCR changes.

An unemployment rate in the 7% to 8% range could dampen pressures for wage increases, and may have monetary economists considering (as they did in the early 1990s), that the Non-Accelerating-Inflation Rate of Unemployment (NAIRU) in New Zealand is close to 7%. Retaining unemployment at this target rate could be the rationale for the RBNZ signalling the doubling of the 90-day interest rate over the next two years. Such a view would be mistaken. Returning now to a NAIRU of 7% overlooks the non-accelerating inflation that New Zealand had between 2001 and 2008 when the unemployment rate was between 5.4% and 3.3%. Over these eight years unemployment averaged just 4.4% of the labour force.

We see no evidence that unemployment higher than that will reduce wage pressures. Rather, given other price pressures on households in the near future, the high mortgage rates caused by the RBNZ's monetary settings could be expected to cause increased pressure for wage increases, with the risk of initiating wage-price inflation. This is rather ironic given that the RBNZ settings ostensibly aim at engendering an expectation of low CPI inflation.

Employment assessment

Taking these factors into account, our short-term assessment is that the economy will continue to stagger and then slowly recover.

The underlying trend will be for small reductions in employment in the years to June 2010 and September 2010. Thereafter the annual employment increase will slowly grow. The visitor flow for the 2011 Rugby World Cup and the broadening impact of the infrastructure investment should lift employment growth to 16,000 in the year to June 2011. This is about half the number needed to employ the increase in the working age population waiting to participate in the labour force. By June 2012 we expect more normality to have returned, and employment to grow by 31,000 and by a further 41,000 in the year to June 2013.

Given the fluctuation now inherent in the data series, we expect there to be some dire predictions and some super-optimistic talk of burgeoning growth at random times when some of the survey announcements are made.

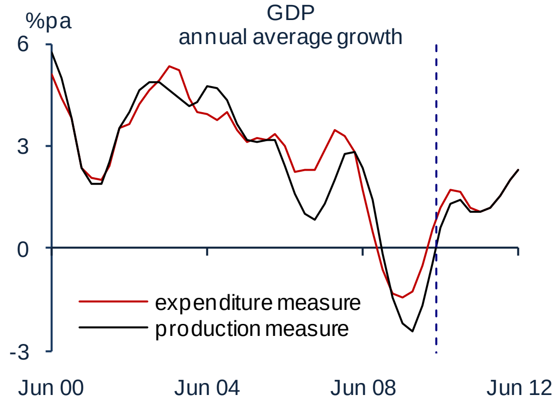
GDP growth

The 0.6% increase in GDP recorded for the first three months of 2010 took average growth for the year to March to -0.4%.

The quarterly figures made promising reading, with a 0.8% increase in agriculture; 3.1% in other primary (driven by 5.3% in fishing and 4.4% in mining); 1.7% in manufacturing (led by 7.8% expansion in machinery & equipment manufacturing); and 1.0% in construction.

The agriculture, fishing and mining performance is promising in that these quarterly numbers reinforce positive average growth over the year to March – i.e. 2.3%, 12.0% and 3.8%, respectively. However, the manufacturing sector remains in catch-up, with the quarterly expansion still leaving average activity over the year to March at 6.5% **below** those of the previous year. Within manufacturing, the largest annual contraction has been in the machinery & equipment sector – activity here was down 16% on the previous year. Similarly, activity in the construction industry for the year to March averaged 8.1% below that of a year ago.

Defining the agriculture, other primary and manufacturing industries together as the tradable sector (noting that the manufacturing industry includes all the primary product processing activities) yields an even bleaker story. This tradable sector has contracted for three out of the last four March years -, a 3.2% decline in the year to March 2007, followed by a 1.4% expansion, a 4.2% contraction for the March 2009 year and a further 2.8% in this latest March year.



Statistics New Zealand

This sector is now smaller – in terms of contribution to New Zealand's GDP – than it was in the March 2003 year.

The picture is not much prettier when looking at the expenditure side of the GDP equation. Again, while the quarterly figures depict an encouraging recovery – with export volumes and real business investment figures expanding, a slightly longer perspective indicates an economy in catch-up.

Business investment for the year to March 2010 was 14% down on the previous year. This takes this important (in the sense of setting the platform for future productivity improvements) category back to levels last seen in the year to June 2004. As a proportion of total GDP, business investment now accounts for 13%.

Exports, on the other hand, have recorded a promising 2.8% expansion in volumes over the year to March 2010. However, the detail within the current export picture is far from promising.

GDP Expenditure Annual Average % Change

Year ended March	2008	2009	2010	2011	2012	2013
Agriculture	*-2.2*	*-0.2*	*2.3*	*3.3*	*2.4*	*2.5*
Fishing, forestry & mining	*17.5*	*-3.0*	*6.9*	*3.9*	*2.2*	*2.2*
Manufacturing	*0.3*	*-5.8*	*-6.5*	*4.1*	*1.1*	*1.4*
Construction	*3.3*	*-9.5*	*-8.1*	*1.0*	*2.2*	*2.6*
Trade, trnspt & communications	*4.7*	*-2.3*	*-3.6*	*1.8*	*2.4*	*3.0*
Finance	*3.3*	*1.2*	*4.7*	*1.4*	*2.0*	*2.5*
Government	*7.1*	*4.7*	*0.6*	*1.0*	*2.3*	*2.9*
Other	*1.0*	*2.6*	*1.3*	*1.1*	*2.2*	*2.8*
Gross Domestic Product GDP	***2.8***	***-1.4***	***-0.4***	***1.1***	***2.0***	***2.7***

Statistics NZ *BERL Forecasts*

The average 2.8% growth in export volumes is disproportionately concentrated in a few categories. In particular, the expansion is heavily dominated by forestry and dairy exports, up 49% and 32% respectively. Among the categories recording falls in export volumes are two of our top three earners – meat (down 1.8%) and services, including education and tourism, (down 4.7%). The largest fall recorded here was for metals and machinery exports, down 7.7% on the year.

Consequently, exports now account for approximately 31% of annual GDP, a ratio that has not improved since 2005.

Our relatively sombre picture for GDP growth follows from our inability to see a confident driver for expansion over the forecast horizon.

Exports remain hamstrung by weak global demand and an unhelpful exchange rate (although robust Australian and Chinese markets will help selected commodities).

Business investment is likely to remain MIA, as uncertain global prospects coupled with credit availability concerns see firms in no mood to expand capacity.

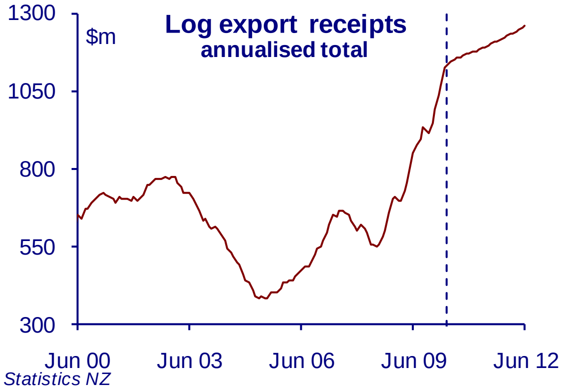
Housing investment may lift from their current lows, but the easing picture for net migration inflows sees this impetus being temporary at best.

Consumer spending, while temporarily spiking in a pre-GST rise surge before October, is unlikely to emerge as a driver until employment and income prospects solidify.

Forestry

The forestry industry seems to be the primary beneficiary in New Zealand of the locomotive Chinese economy.

Export receipts from logs and timber surged 25% in the year to April 2010. The latest three months have been impressive – registering export revenues up 44% on year-earlier levels.



Within these numbers, the shift very definitely has been in favour of logs, with revenues surging from a combination of additional volumes and favourable prices. The 9.7m m^3 of logs exported in the year to April 2010 is a historical high, well up on the previous best of 8.4m m^3 registered in the year to June 2003. The consequential $1.1bn in annual revenue, helped by a 5% increase in average prices, was a startling 50% up on the previous year.

Pulp

Pulp, on the other hand, continues to struggle. Total export volumes were 393,000 tonnes for the year to April 2010, down 7.6% on the previous year.

This is the lowest annual figure since 384,000 tonnes was recorded in the year to February 1997. Consequently, annual earnings are just under $250m, down 8.2% on a year ago and the lowest annual total since the February 1995 year.

Timber

Timber revenues have benefited from a recovery in volumes, countered to a degree by lower prices. As a result, the 9.6% increase in volumes over the past year has translated into revenue growth of 4.8%.

It seems this industry is inexorably destined to centre on the export of unprocessed logs. While this may serve us well in the short term, the question remains whether such a 'strategy' is in the best interests of the longer-term needs of an economy needing to further supplement its export earnings potential.

In addition, and arguably a more immediate issue, is the impact of the ETS. The impact of the ETS on competing land uses, as well as incentives for harvesting and replanting remains unclear. This uncertainty despite the rules of the ETS now being established does not help the industry to shift towards a longer-term horizon for its 'strategic' development.

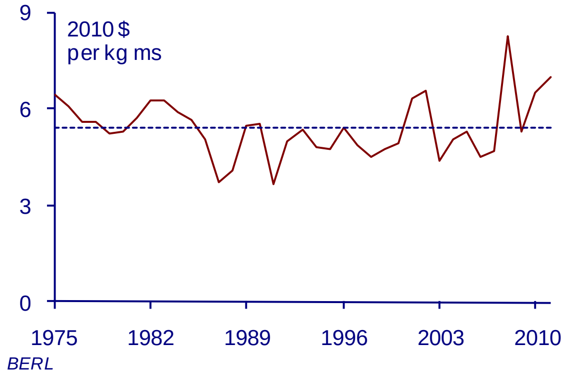
Consequently, we see little substantial change in this industry in terms of structure (whether unprocessed or not), capacity, increased value added, or unit values. This, therefore, projects an industry growing in line with external market demand for a commodity output.

Agriculture

Despite a tough trading environment over the past year or so, the agriculture sector has contributed positive growth to GDP. However, with expansion over the year to March 2010 averaging 2.3%, the emphasis has been on catching up on lost ground following two consecutive March years of contraction (2.2% and 0.2%).

The announced forecast dairy payout for the coming season is good news. The $6.50 for the season just completed is well above historical payouts – in long-term trend and in consumer price inflation-adjusted real terms. Further, the $7.00 forecast for the new season would be nearly 30% above the long-term (35-year) average in real terms.

Inflation adjusted dairy price payout
in real 2010$s terms



This will see a sizable injection – in the first instance – of funds into dairy-based regions. However, whether these funds will be translated into a regional stimulus – in terms of business investment or consumer demand – remains a moot point. The dairy sector continues to carry a significant burden of debt, with land price to productivity ratios well past their sustainable (or prudent) levels. Efforts to reduce outstanding debt levels are likely to be the first call on these funds.

The flip side of this positive picture is the meat sector. Sheep numbers continue their long-term fall, as pressure to convert land to other uses remains.

Consequently, the rationalisation of processing capacity continues, with the 821m tonnes in export volumes for the year to April 2010 almost identical to the 822m tonnes exported in the 2003 calendar year.

In terms of revenue, meat export receipts for the April 2010 year were nearly 8% below those of a year ago. Further, the $5bn recorded for that year took its annual average growth to 4% over the past 20 years. At first blush this may be impressive but against an annual average of 5% for all exports, our third (behind dairy and tourism) biggest earner is consistently returning a below average performance. This does not bode well for such a large category of the nation's earning capacity to be in long-term survival mode.

The wine sector has stepped in to help fill the growing hole in our export capabilities.

Wine receipts have expanded a phenomenal annual 22% average over the past 20 years. However, the latest total of just over $1bn remains relatively small – noting wool exports accumulated $1.4bn some 20 years ago. Similarly, the last decade has seen kiwifruit revenues increase by an average 9%pa to also take its annual total to just above the $1bn mark.

Early data for the current season suggests this year may be a difficult year for kiwifruit and apple receipts. The first couple of months indicate flat volumes and prices for kiwifruit, and significantly depressed volumes and prices for apples.

However, the medium-term outlook for wine and kiwifruit is relatively bright, with much anticipation over the release of the new red kiwi variety. In this context, suggestions to change the sales and marketing arrangements for this highly successful export should be approached with caution.

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