Farmshed Economics

Bringing back an old favourite

July 2017

An old favourite is back. Yes, butter is back on menus, with scientists now reassuring us there is no reason to avoid butter in our cooking or on our sandwiches. As a result, global demand for butter has surged, and this is good news for the NZ dairy sector. Indeed, this demand surge is likely to lead to a higher milk price on average over coming seasons.

On 24 July, Fonterra increased its 2017/18 milk price forecast to $6.75/kg, in line with our long-held forecast. Fonterra noted that global demand for dairy, including milk fat, is strengthening.

The fact that Fonterra has lifted its forecast so early in the season suggests some further upside to this new milk price forecast. In fact, current commodity market prices are consistent with a milk price around the $7.00/kg mark.

The picture is similarly rosy for lamb prices. Prices have continued to lift over the last month. All up, this continued price strength is setting up a positive 2017/18 season.

However, there is a spanner in the works of beef prices. Japan has moved to lift the import tariff from 38.5% to 50%. As a result of the Japanese tariff move, beef prices are likely to struggle to reach the $6.00/kg this spring as we had hinted at in previous editions of Farmshed Economics.

Meanwhile, wool prices are an outlier relative to other agriculture and horticulture sector prices. Indeed, while other commodity prices paint a rosy picture, 39 micron wool prices sit nearly 40% below their 10-year average level. Moreover, the long-run outlook is weak and we expect the lean times to continue over over 2017 and into 2018.

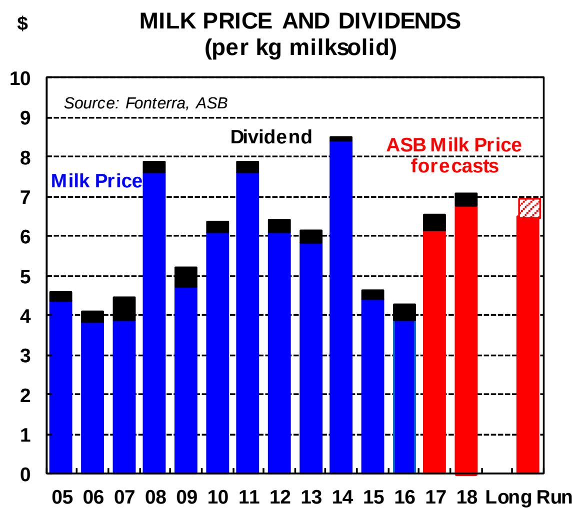
Turning to financial markets, we expect interest rates to remain low by historical standards, reinforced by a likely neutral Reserve Bank stance in its upcoming announcement. Lastly, the NZD hit a two-year high against the USD in late July. We expect some heat to come out of the NZD in the near term.

Key Rural Data:

As at 28 July 2017	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	205.1	202.0	137.6	↗
Lamb Price Index (NZD)	208.2	206.6	171.9	↘
Beef Price Index (NZD)	273.4	280.4	262.8	↘
Wool Price Index (NZD)	74.5	74.5	121.9	→
Interest Rates:				
90-day bank bills	1.94	1.98	2.28	→
2 year swap	2.22	2.33	2.06	↗
5 year swap	2.76	2.87	2.16	↗
Exchange Rates:				
NZD/USD	0.7513	0.7334	0.6998	↘
NZD/CNY	5.06	4.97	4.67	↘
NZD/GBP	0.5720	0.5629	0.5337	↘
Milk solids production (ytd % chg]**	-0.6	-0.7	-1.4	↑
Fonterra Shareholders' Fund	6.05	6.00	5.66	→

*Direction of change over the next 6 months. **As at May 2017.

Chart of the Month:



Rural or Fiction?

? In ancient times, Europeans referred to invading Vikings as “butter eaters.” This was for good reason as it was so precious to the Vikings that they were buried with large tubs of butter to take with them into the afterlife.

Answer on page 3

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Rural Commodities Outlook

Dairy – Butter butters better

ASB Dairy Index (USD), 28 Jul: 205.1 ↑1.6% (mpc)

On 24 July, Fonterra increased its 2017/18 milk price forecast to $6.75/kg, in line with our long-held forecast. Fonterra noted that global demand for dairy is strengthening.

The fact that Fonterra has lifted its forecast so early in the season suggests some further upside to this new milk price forecast. Indeed, Fonterra noted that its forecast is "prudent". We agree and note that current commodity market prices are consistent with a milk price around the $7.00/kg mark.

The recent market strength has been led by demand for butter and other milk fats. And with inventories low and suppliers struggling to meet this demand, we suspect that the surge in butter prices may not be over yet.

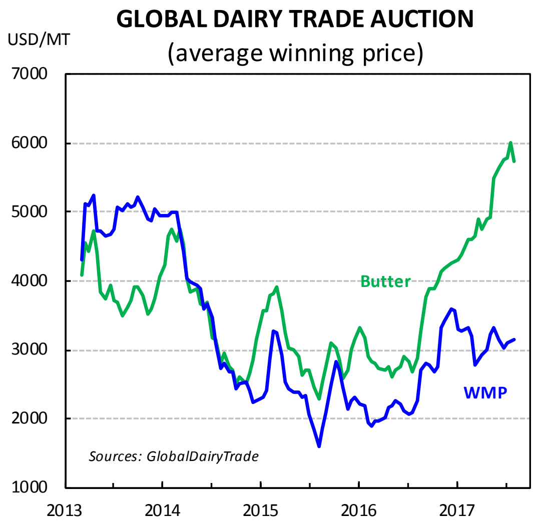
We are, however, mindful that the stronger milk price may spur NZ dairy supply growth in excess of what we currently anticipate, kick-starting the next dairy cycle. In turn and while we remain bullish on this season's milk price, we see a growing risk that the 2018/19 season milk price is soft.

Meanwhile, the other downside risk now in play is a stronger NZD. Indeed, the NZD has risen above US$0.75 this month. However, for now, healthy commodity prices largely offset the NZD strength. All up though, the Fonterra announcement reinforces the positive dairy outlook for the 2017/18 season and beyond.

Season End Milk Price Forecasts:

	2016/17	2017/18		Long Run
	Fonterra/ASB	Fonterra	ASB	ASB
Milk Price*	$6.15	$6.75	$6.75	$6.50-$7.00

* per kg of milk solids (excluding dividend).



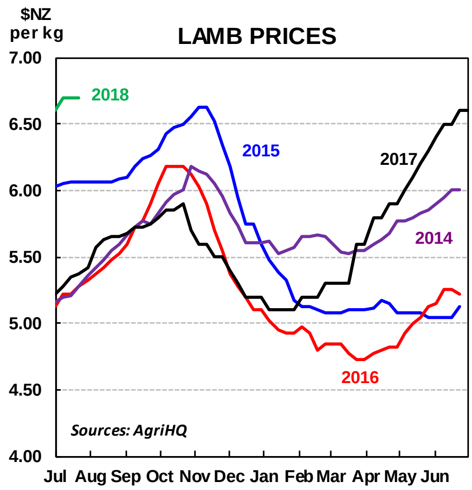
Lamb – Peaking high

Lamb Index (NZD), 28 July: 208.2 ↑0.8% (mpc)

Lamb prices continued their hot streak over July, although there are signs that prices may be closing in on a peak. Over the month, per kg prices lifted 1.5%, a more modest lift compared to the 5%-plus lifts of previous months.

That said, a seasonal peak in the high $6/kg range represents an excellent result. Indeed current prices are in stark contrast to last year's levels. Specifically as they stand, prices represent a circa 25% lift on last year.

While the price outlook is healthy, there are some headwinds in play. First up, earlier support for prices from low slaughter rates will fade as, weather permitting, we expect more normal slaughter levels this spring. In addition, the NZD has strengthened against the USD and Pound, 3% and 5%, respectively, over the past year. But all up, the underlying price strength is offsetting these headwinds, and setting up a positive 2017/18 season.



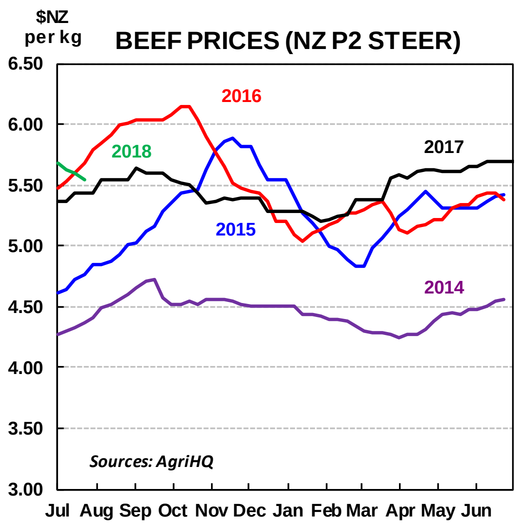
Beef – Japanese spanner in the works

Beef Index (NZD), 28 July: 273.4 ↓ -2.5% (mpc)

There is a spanner in the works of beef prices. While the market fundamentals for beef are still positive, a Japanese move to increase tariffs on beef imports is likely to hurt overall NZ beef export returns. On the back of surging beef imports, Japan has moved to lift the import tariff from 38.5% to 50%.

This will hurt overall export prices as, of our major beef markets, Japan is the highest paying. Indeed, the average beef export price in the Japan market was over 20% higher than the next-best market, and nearly 50% higher than prices than prices in the US, our largest market.

As a result of the Japanese tariff move, beef prices are likely to struggle to reach the $6.00/kg this spring as we had hinted at in previous editions of Farmshed Economics. Beef prices (P2 steer per kg) had already dipped 2.6% over the last month prior to the Japanese tariff announcement. With this in mind, prices are likely to drift lower over the remainder of 2017. Indeed, the Six Dollar Trifecta may have to wait for another day.



Rural Commodities Outlook (continued)

Wool – Outlier

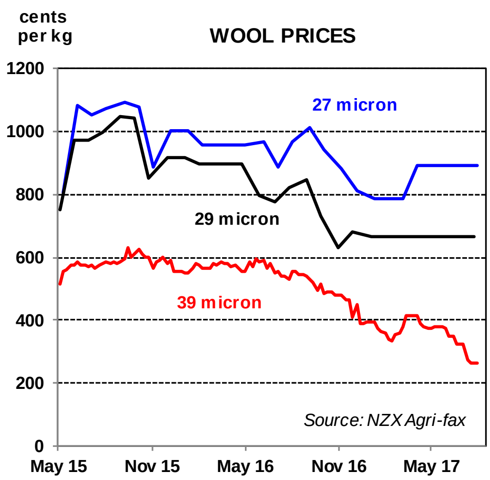
Wool Index (NZD), 28 July:	74.5 ➔ No change

Wool prices are an outlier relative to other agriculture and horticulture sector prices. Indeed, while other commodity prices paint a rosy picture, 39 micron wool prices sit nearly 40% below their 10-year average level.

Moreover, the long-run outlook is weak. In particular, competition from synthetic substitutes is strong as oil prices remain historically low. Moreover, any upward price impetus from recent falls in wool supply has had little effect.

The picture is not as bad for mid-micron wools. For example, following a modest pick up in April, 27 micron prices are largely unchanged compared to a year ago. Meanwhile, 29 micron prices are around 14% lower than July last year. Moreover, the global economy is strengthening and wool demand from apparel markets should improve.

All up, with the bulk of the NZ wool clip still coarse, we expect the lean times for the wool sector to continue over 2017 and into 2018.



Financial Markets Outlook

Interest Rates – No rush

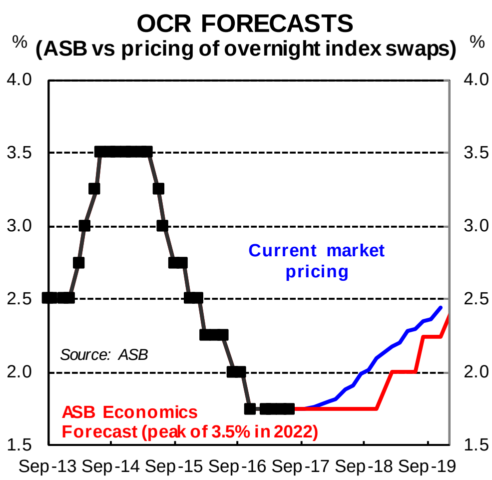
90-day bank bills, 28 July:	1.94% ↓ -0.04 (mc)

We expect the Reserve Bank to keep the Official Cash Rate (OCR) on hold at 1.75% on 10 August. More importantly, we expect the Reserve Bank to further highlight its neutral stance in that its next OCR move could be up or equally down. In fact, the inflation outlook has weakened over recent months, giving the Reserve Bank little reason to change its neutral stance.

For our part, while we still expect that the Reserve Bank will eventually lift the OCR, we now think that this lift will not come until early 2019. Previously, we expect that move to come in late 2018. Moreover, 2019 is a long way off, meaning no sense of urgency for the Reserve Bank.

For short-term rates, we expect this to translate into little change over the remainder of 2017 and into 2018. Meanwhile, longer-term rates may drift higher, following gradual lifts in offshore rates.

All up though, we expect rates to generally remain low by historical standards over 2017 and 2018.



NZ Dollar – Trump USD slump

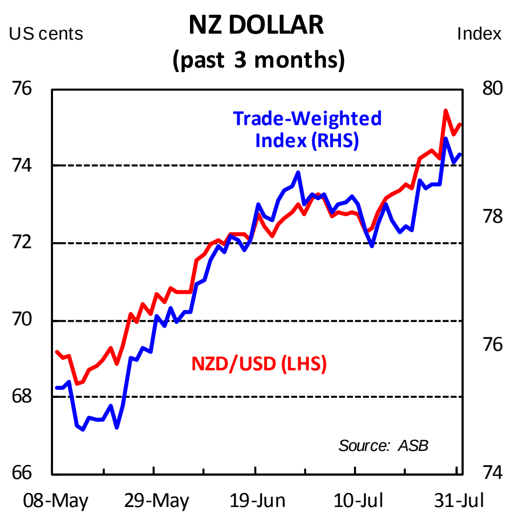
NZD/USD, 28 July:	0.7513 ↑0.0180 (mc)

The NZD hit a two-year high against the USD in late July. Weakness on the USD side of the equation has continued to drive much of the NZD's recent rise. In particular, the USD has weakened as it has become evident that much of US President Trump's policies are put on hold; his failure to repeal Obamacare over July has left his policy agenda in tatters.

Also underpinning the NZD are high NZ export prices. On this front, Fonterra's milk price forecast lift on 24 July further boosted the NZD.

More recently, a softer than expected NZ labour market release has taken some of the steam out of the NZD. For example, the number of people employed actually fell in the June quarter. As at the time of writing, the NZD was trading at US$0.7430 against the USD.

From here, however, we expect some more of the heat to come out of the NZD. In particular, a Reserve Bank announcement in line with our expectations above is likely to put downward pressure on the NZD in the near term.



Rural Fact or Fiction?

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Answer: Fact! Indeed, if butter prices lift any further from their current highs, perhaps re-visiting this tradition may not be out of the question.

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