

Farmshed Economics

Dairy back on track

August 2016




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Dairy prices are back on track. On 25 August, Fonterra upgraded its 2016/17 milk price forecast by 50 cents, taking it to \$4.75/kg of milk solids. While some are wary of a repeat of last season's false dawn, we are more confident. Indeed, the dairy cycle has kicked in on the back of irreversible reductions in the dairy herd. Accordingly in our view, this price correction is sustainable.

The forecast upgrade came off the back of a surge in dairy auction prices over August. Indeed, we have long argued that rapidly falling global production would eventually be the catalyst for a price correction. With that now the case, Fonterra tentatively agrees. At the same time, Fonterra remains wary of lifting the milk price forecast too high at this early stage of the season.

In contrast, we expect dairy auction prices to build on August's gains over the remainder of 2016. With this in mind, we continue to expect a finalised milk price for the season of \$6.00/kg.

Meanwhile, meat prices are a mixed bag. Lamb prices have made tough work of August; however it's early days in the season. The bigger test for lamb prices awaits over the spring. In particular, Brexit's precise impact on UK consumers and their demand for lamb will have a large bearing on where prices settle.

On the other hand, beef prices remain healthy, with NZ and Australian supply tight. Although, with global beef production and exports increasing elsewhere, prices are likely to moderate heading into 2017.

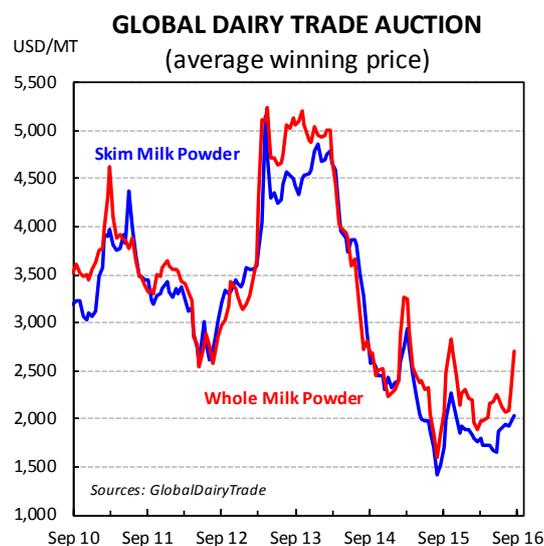
Wool prices have drifted lower over recent months, but remain high by historical standards. All up, we expect wool prices to continue their drift lower.

Turning to financial markets, the Reserve Bank cut the Official Cash Rate as expected on 11 August. It also signalled another cut to follow and gave a hint of another. However, despite the cut, the NZD has strengthened, helped in part by the recovery in dairy prices. From here, we expect the NZD to remain high, and for this to partially offset any commodity price gains.

Key Rural Data:

Chart of the Month:

As at 26 August 2016	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	156.2	137.1	130.9	↑
Lamb Price Index (NZD)	176.1	174.7	180.4	↔
Beef Price Index (NZD)	258.0	263.3	300.5	→
Wool Price Index (NZD)	124.2	125.3	138.9	↓
Interest Rates:				
90-day bank bills	2.23	2.28	2.88	↓
2 year swap	2.01	2.08	2.84	↓
5 year swap	2.12	2.18	3.15	↘
Exchange Rates:				
NZD/USD	0.7281	0.7208	0.6686	→
NZD/CNY	4.84	4.78	4.27	→
NZD/GBP	0.5569	0.5448	0.4260	→
Milk solids production (ytd % chg]**	-0.7	-1.5	11.7	↓
Fonterra Shareholders' Fund	5.92	5.69	4.77	→



*Direction of change over the next 6 months. **As at June 2016.



Rural Fact or Fiction?

Following the heavy snow this month in some parts, it's interesting to note that snow comes in different colours.

Answer on page 3

Rural Commodities Outlook

Dairy – Back on track

Dairy prices are back on track. On 25 August, Fonterra upgraded its 2016/17 milk price forecast by 50 cents, taking it to \$4.75/kg of milk solids.

The upgrade came off the back of a surge in dairy auction prices over August. Overall dairy auction prices jumped 20.1% over the month, while key whole milk powder prices surged 30.6%.

As we have long argued, rapidly falling global production would eventually be the catalyst for a price correction. Fonterra now tentatively agrees. That said, Fonterra remains wary at this early stage of the season.

In contrast, we expect dairy auction prices to build on August's gains over the remainder of 2016. With this in mind, we continue to expect a finalised milk price for the season of \$6.00/kg.

In particular, we expect the global supply correction to accelerate, and for this to lift dairy prices further this year. For example, we expect heavy and record slaughtering to translate into a 5% fall in NZ production this season. Similarly, our view is that the EU production slowdown is more advanced than most other analysts currently factor in.

Lastly, recent NZD movements are not enough to offset the dairy price gains. For example, while overall dairy auction prices lifted by more than 20% in August, the NZD lifted a more modest 3%.

ASB Dairy Index (USD), 26 Aug: 156.2 ↑13.9% (mpc)

Season End Milk Price Forecasts:

	2015/16	2016/17		Long Run
	Fonterra/ASB	Fonterra	ASB	ASB
Milk Price*	\$3.90	\$4.75	\$6.00	\$6.50-\$7.00

* per kg of milk solids (excluding dividend).

GLOBAL DAIRY TRADE AUCTION (average winning price)



Lamb – Tough work

Lamb prices have made tough work of August. After tracking above last year's level over July, prices have now slipped below.

However, it's still early days. The bigger test for lamb prices awaits over the spring. In particular, just how Brexit impacts on UK consumers and their demand for lamb will have a large bearing on where prices settle.

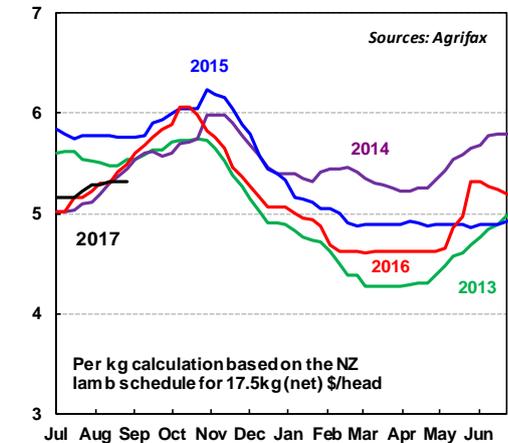
Similarly, the NZD will have a large role to play. Since the last edition of Farmshed Economics, the NZD has strengthened further against both the currencies of our leading lamb markets i.e. against the Pound and the Chinese Yuan.

Meanwhile, tight local supply should underpin prices to a degree. We expect this tightness to continue, and for this underpinning to remain in place over the remainder of the year.

All up, while we expect prices to improve over the remainder of 2016, the risk is that they continue to remain subdued compared to previous years.

Lamb Index (NZD), 26 Aug: 176.1 ↑0.8% (mpc)

LAMB PRICES



Beef – Marching to a different drummer

NZ beef prices are marching to a different drummer. Indeed, while global beef prices are weakening, NZ prices remain healthy. For example, P2 steer prices sit around 26% higher than their 10-year averages.

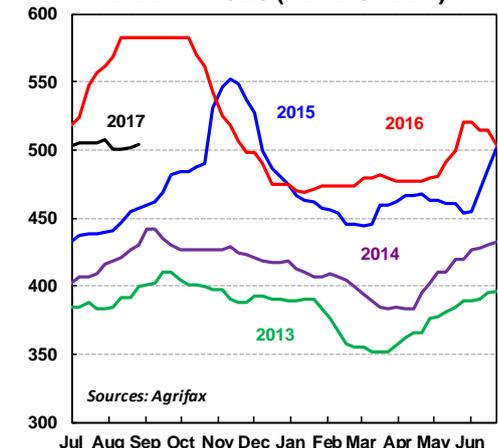
For now lack of supply both locally and from Australia is keeping NZ beef prices high. In particular, Australian beef production has slowed as the Australian beef herd rebuilds. Moreover, the rebuilding is likely to continue over the rest of this year and into 2017, and lack of Australian beef opens the door for NZ exporters.

Elsewhere, beef production is rising. Expanding US production will put pressure on beef prices over time. Also, Brazil is upping the ante, having been granted fresh access to the US market earlier in August.

All up, we expect beef prices to fluctuate around current levels over the next six months. However, heading into 2017, we expect prices to moderate, but to remain high by historical standards.

Beef Index (NZD), 26 Aug: 258.0 ↓-2.0% (mpc)

BEEF PRICES (NZ P2 STEER)



Rural Commodities Outlook (continued)

Wool – Off the boil

Wool Index (NZD), 26 Aug: 124.2 ↓ -0.9% (mpc)

Wool prices have drifted lower over recent months, but remain high by historical standards. For example, coarse wool (39mm micron) prices are back about 9% from their 2016 highs, but remain nearly 20% above their 10-year averages.

Tight supply continues to underpin wool prices. Beef+Lamb estimates that as at June 2016 the sheep flock has declined by 3.0% or 900,000 head compared to June 2015. Supply is also tight across the Tasman.

However, demand is patchier and the high NZD isn't helping. Importantly, Chinese demand is soft, although better demand from Europe and Australia is making up some of the lost ground.

Over the next six months, we expect wool prices to drift lower, but to remain above their long-term averages. With China our largest wool market, soft demand there is likely to outweigh the positives on the supply side. At the same time, we expect little, if any, help from the NZD.



Financial Markets Outlook

Interest Rates – Cut, pause, cut

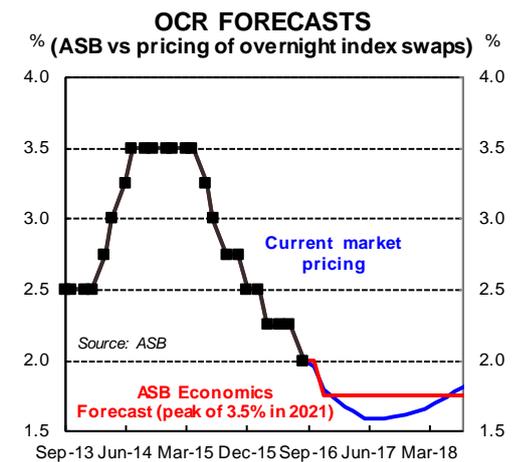
90-day bank bills, 26 Aug: 2.23% ↓ -0.05 (mc)

The Reserve Bank (RBNZ) cut the Official Cash Rate (OCR) by 25 basis points as widely expected on 11 August. It also signalled another cut to follow and gave a wee hint of another.

Financial markets on the day, however, were underwhelmed. Markets acted on their disappointment by immediately taking the NZD higher by around a cent against the USD and by taking benchmark interest rates higher as well.

This was the market reaction the RBNZ was hoping to avoid. Indeed, the high NZD is making it very difficult for the RBNZ to achieve its inflation target.

As a result, we continue to expect the RBNZ to cut again, in November. However, if the NZD stays strong, a September cut would be possible. In addition, there is a growing chance that the RBNZ lowers the OCR to 1.5%. Indeed, the NZD has maintained much of its strength following the cut.



NZ Dollar – Cooling its jets

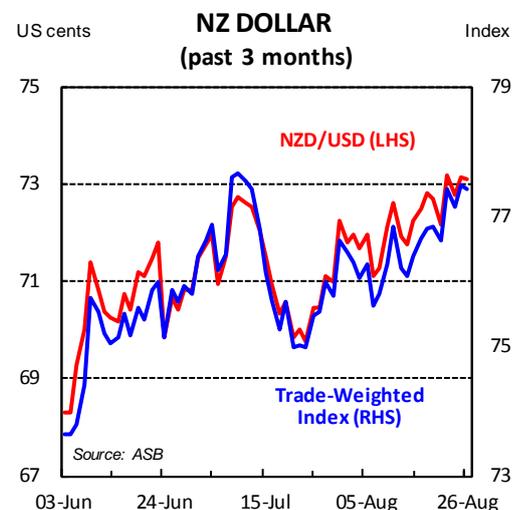
NZD/USD, 22 Aug: 0.7281 ↑ 0.0073 (mc)

The NZD hit 2016 highs over August, spurred on partly by the recovery in dairy prices over the month. The year's high of US\$0.7365 was recorded on 27 August.

Since then, the NZD has cooled its jets. In particular, the US Federal Reserve has given a firmer indication that interest rates will rise this year, making holding the USD more desirable for investors. As a result, the NZD has dropped back to US\$0.7236 at the time of writing.

However, the NZD remains well-supported. NZ interest rates remain high globally, even factoring in a further Reserve Bank cut (or cuts). Also, we expect dairy prices to continue their rise over the remainder of the year.

Overall, we expect the NZD to retain much of its strength this year. In particular, we see strength against the AUD as dairy prices rise, while iron ore (Australia's largest export) prices fall. As a result, a strong NZD will dampen export prices this year.



Rural Fact or Fiction?

? **Answer: Fact!** Actually, snow is colourless, but it can contain dust or algae that give it different colours. Orange snow fell over Siberia in 2007 and pink snow (watermelon snow) covered Krasnodar (Russia) in 2010.

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