Farmshed Economics

Financial leg up

August 2018

Inside this edition: Pg.

We here at the Farmshed Economics team don't often focus the discussion on financial markets. Nonetheless, current financial market conditions are worth highlighting. Indeed, the weak NZ dollar is very supportive of rural sector incomes, while very low interest rates are helping keep a lid on costs.

Benchmark interest rates dipped over August, taking them near to record lows in many cases. Long-term rates have led the way, with the 5-year swap rate falling 24 basis points since the end of July. Moreover, we anticipate interest rates are likely to remain low over 2018 and 2019 as we don't expect the Reserve Bank to begin lifting the Official Case Rate until February 2020.

Meanwhile, the weak NZ dollar is giving a leg up to commodity prices in NZD terms. For example, beef export prices in USD terms are actually lower than this time a year ago. It's only when we look export prices in NZD terms that they are higher than a year ago.

Turning to dairy markets, Fonterra announced not one, but two forecast revisions over August. Firstly, Fonterra advised that it had cut its 17/18 milk price forecast by 5 cents to $6.70/kg. Fonterra also advised that it would cap its dividend at 10 cents/kg this year. Then in late August, Fonterra trimmed its 18/19 forecast by 25 cents to $6.75/kg.

Lamb prices on the other hand, continue to head for the sky. Over August, the per kg price lifted a further 35 cents to $8.35/kg. AgriHQ even hinted that prices could hit $9.00/kg by October.

Meanwhile, beef prices are holding up at solid levels. That said, we suspect this may not last as market fundamentals have taken a turn for the worse.

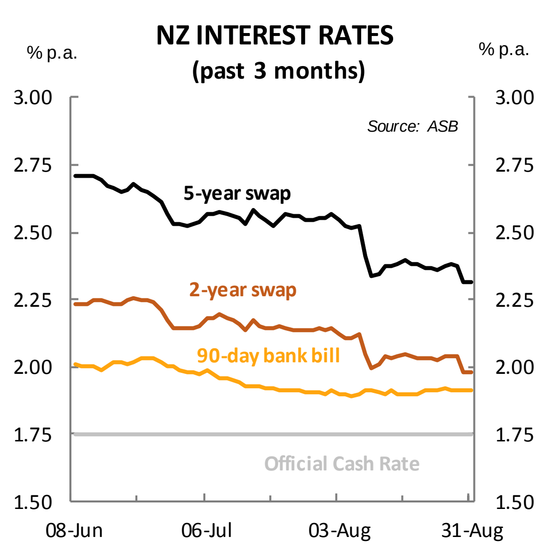
Lastly this month, we took a look at farm expense inflation. Notably, feed prices are rising on the back of firm demand both locally and offshore. From here, we anticipate that overall input prices will continue to rise at or near the current annual lift of 3%.

Key Rural Data:

As at 31 August 2018	Current	5 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	82.6	85.8	91.7	↘
Lamb Price Index (NZD)	140.4	134.5	115.2	↗
Beef Price Index (NZD)	118.7	113.8	112.3	↘
Farm Input Inflation (annual % change)	3.0	3.1	1.1	→
Interest Rates:				
90-day bank bills	1.91	1.91	1.96	→
2-year swap	1.98	2.13	2.20	→
5-year swap	2.32	2.55	2.67	→
Exchange Rates:				
NZD/USD	0.6624	0.6789	0.7240	→
NZD/CNY	4.53	4.63	4.81	→
NZD/GBP	0.5110	0.5181	0.5618	→
Milk solids production (ytd % chg)**	7.7	12.1	12.8	↓
Fonterra Shareholders' Fund	5.01	5.16	6.21	→

*Direction of change over the next 6 months. **As at July 2018.

Chart of the Month:



? *Rural Fact or Fiction?*

Daffodils can make your dog sick.

Answer on page 3

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Rural Commodities Outlook

Dairy – Double cut

Dairy Index (USD), 31 Aug:	82.6 -3.7% (mpc)

Season End Milk Price* Forecasts:

2017/18	2018/19			Long Run
Fonterra/ASB	Fonterra	ASB		ASB
$6.70	$6.75	$6.50		$6.50-$7.00

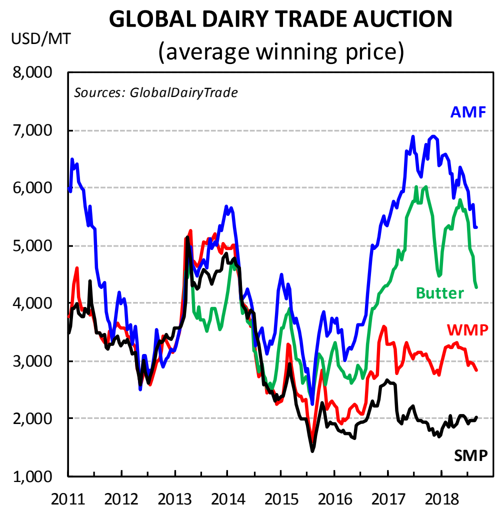
* per kg of milk solids (excluding dividend).

August was not a month to remember for dairy farmers. Over the month, Fonterra made, not one, but two milk price forecast cuts.

The first cut took us by surprise. On 10 August, Fonterra advised that it had cut its 17/18 milk price forecast by 5 cents to $6.70/kg. Indeed, the surprise came as the updated forecast differed from that calculated under Fonterra's own *Milk Price Manual*. Fonterra also advised that it would cap its dividend at 10 cents/kg this year. Previously, it had planned to pay a dividend of 15-20 cents/kg. However, with its earnings for the year likely to disappoint, Fonterra preferred "keeping [its] balance sheet strong" and thus capped the dividend on top of the milk price forecast cut.

The second forecast cut was more in line with our expectations. On 31 August, Fonterra trimmed its 18/19 forecast by 25 cents to $6.75/kg. The revision follows weak dairy auction results over the last three months. Overall auction prices fell by around 13% over this period, although a weaker NZD/USD over the period has helped to offset some of this fall. The revision also brings Fonterra more in to line with our forecast of $6.50/kg.

Despite the revisions, milk price forecasts at $6.50/kg to $6.75/kg range still make for relatively healthy reading. Nonetheless, these moves emphasise again that dairy markets can and do change quickly.



Lamb – Running out of superlatives

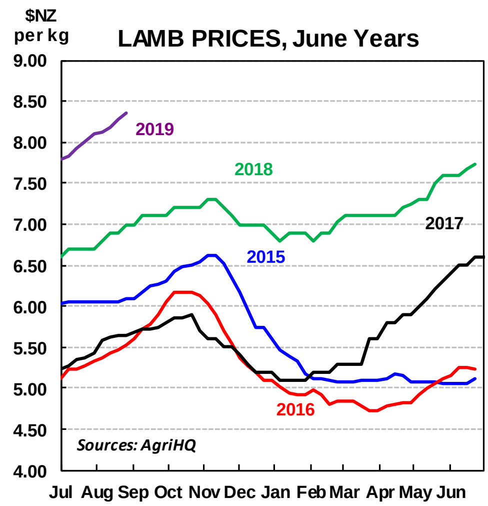
Lamb Index (NZD), 31 Aug:	140.4 4.4% (mpc)

We are running out of superlatives for lamb prices. Over August, prices continued their march higher, adding another 35c/kg over the month.

Prices are very strong across all our key markets, reflecting generally healthy global economic growth and demand. In particular, prices in the EU (excluding the UK) are leading the way. EU prices for the season to date sit 21% higher than for the same period a year ago (in NZD terms).

Looking over the rest of the year, prices also look like they have something left in the tank. AgriHQ reports that early signals are that lamb prices could test $9.00/kg in October.

All up, the lamb price outlook is very healthy. That said, we should point out some growing risks. In particular, the chance of a full-blown US-China trade war is increasing. In a trade war scenario, global economic growth could slow and reduce global lamb demand. The other risk is that consumer price resistance can kick in at these record price levels.



Beef – Looks can be deceiving

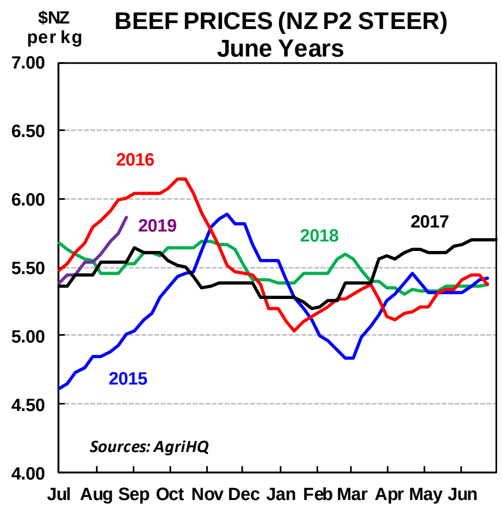
Beef Index (NZD), 31 Aug:	118.7 4.3% (mpc)

On the surface, beef prices look healthy. AgriHQ's weighted average price in NZD terms is around 6% higher than this time last year, and the price has lifted around 12% since mid-May.

But looks can be deceiving. All of the annual price increase described above owes to the weaker NZD, with AgriHQ's weighted price actually down around 2% in USD terms.

Moreover, beef market fundamentals are on shaky ground. In particular, US beef production is lifting, putting downward pressure on US prices. AgriHQ reports that the prices of imported beef in the US are down around 8% on an annual basis. There's also more supply likely to come on stream from Australia. There, the drought has pushed up the price of feed and in turn is leading to higher beef cattle slaughter.

In the short term, though, the seasonal lull in local production is likely to keep a floor under NZ prices. However, by the end of the year, we anticipate that beef prices will feel the pressure of increased global supply.



Rural Commodities Outlook (continued)

Farm Input Costs – Feed and fuel cost combo

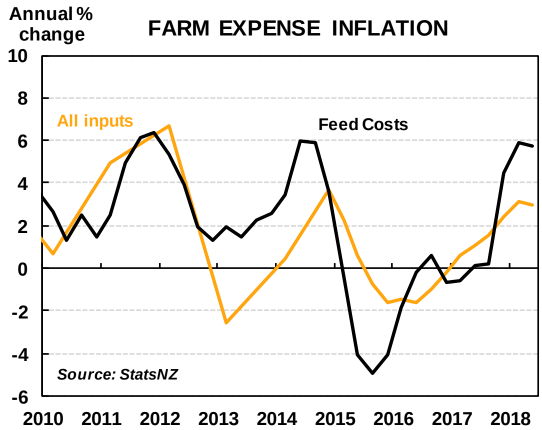
Annual Farm Input Inflation, June qtr:	3.0% ↓ 0.1 %pts

Farm input prices continue to rise. In annual change terms, farm input prices rose 3.0% in June 2018. Rising feed prices are driving much of the overall rise. Over the same period, feed prices jumped 5.8%.

Fuel prices have also climbed rapidly over the past year. Since June 2017, fuel prices have lifted 20%, with this lift coinciding with rising global oil prices, the weaker NZ dollar as well as rising fuel taxes.

From here, we expect input prices to continue rising at a similar pace. Dry weather offshore is likely to keep feed prices such as palm kernel high. Moreover, incomes are relatively healthy across most sectors, and, as such, livestock prices as well as feed prices are likely to continue to tick higher.

The one exception to this rule is likely to be wages. Wage pressures are likely to be relatively muted this year, but at the same time finding good farm workers will remain a challenge.



Financial Markets Outlook

Interest Rates – Nearing record lows

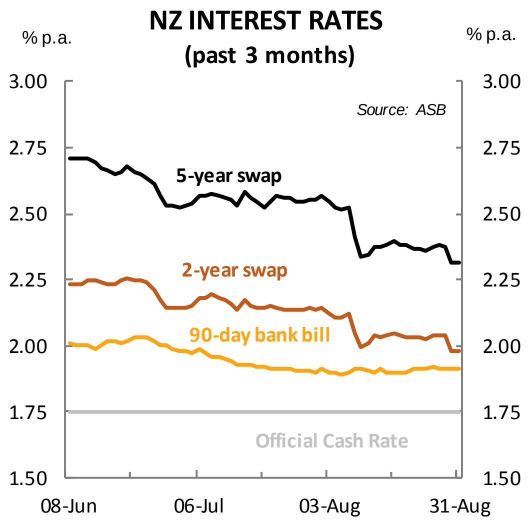
90-day bank bills, 31 Aug:	1.91% (No change)

Benchmark interest rates dipped over August. Long-term rates have led the way, with the 5-year swap rate falling 24 basis points since the end of July. But other rates have fallen by significant amounts too. The 2-year swap rate, for example, is down 21 basis points over the same period.

Moreover, benchmark rates are nearing record lows. For example, at 1.98%, the 2-year swap rate is just 4 basis points above its record low set back in August 2016.

Short-term interest rates have eased as markets are increasingly flirting with the possibility that the Reserve Bank (RBNZ) might cut the Official Cash Rate (OCR). In addition, easing credit market pressures have contributed to recent short-term interest rate falls.

We don't expect the RBNZ to cut the OCR, but we expect the RBNZ to remain on hold until February 2020. Meanwhile with regard to an OCR cut, the RBNZ recently stated: "we've been pushed nearer to that trigger point" by weak economic growth and slumping business confidence.



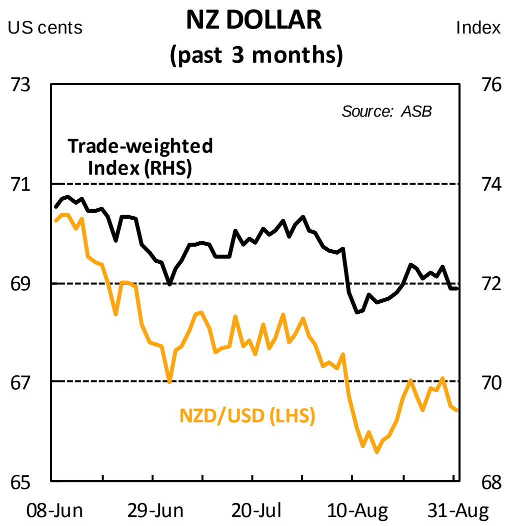
NZ Dollar – Leg up

NZD/USD, 31 August:	0.6624 ↓ -0.0165 (mc)

The NZD lost more ground over August. In particular, the possibility of interest rate cuts by the Reserve Bank spilled over into a weaker NZD. Indeed over the month, the NZD fell over 2% against the USD and on a trade-weighted basis.

The weaker NZD is boosting NZ commodity prices in local terms. For example, the ASB Commodity Price Index has lifted 6.6% annually in NZD terms. In comparison, the Index is down 2.5% on this time last year in USD terms. The NZD is giving beef prices a significant leg up (see beef section) with the NZD weakest against the USD and the US our largest beef export market.

That said, we note that the Chinese yuan has been even weaker recently than the NZD. With China the largest (or second largest) export market for most of NZ's commodities, further yuan weakness – in the absence of commensurate NZD weakness – poses a risk to the NZ commodity price outlook.



? Rural Fact or Fiction?
Answer: Fact. Daffodil bulbs contain natural pesticides which can make dogs sick, if they dig around them.

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