Farmshed Economics

2016: Upsets, comebacks and lessons

December 2016

2016 has been a wild and at times unpredictable ride. The most stunning developments have been political. There, lightning struck twice, with first the Brexit, followed by Donald Trump's stunning upset victory. The reverberations, particularly of Brexit, were keenly felt in financial markets. At home, the dairy sector downturn and recovery dominated, although John Key's shock resignation and the Kaikoura earthquakes also featured. The rural star for 2016 has been the horticulture sector, and in particular the comeback kid, kiwifruit.

While on the theme of comebacks, this edition of Farmshed Economics also features a Special Topic: 'Lessons from the dairy downturn, Part I.'

With the holidays approaching, we thank you for your support and ongoing readership. And from all the team at Farmshed Economics, we wish you all a very Merry Christmas and very prosperous 2017.

Looking at developments over December, we lifted our 2016/17 milk price forecast by 50 cents to $6.50/kg on 21 December. At the same time, we nudged our 2017/18 forecast higher by 25 cents to $6.75/kg. With that in mind, dairy farmers can take time out over Christmas and look forward to better times over 2017.

Turning to the meat sector, beef prices continue to hold at healthy levels. Looking at lamb markets, prices are taking baby steps towards improvement.

Also, we expect rural land prices to lift over 2017. Indeed, the recovering dairy sector is likely to see both a greater number of farm sales and lifting prices.

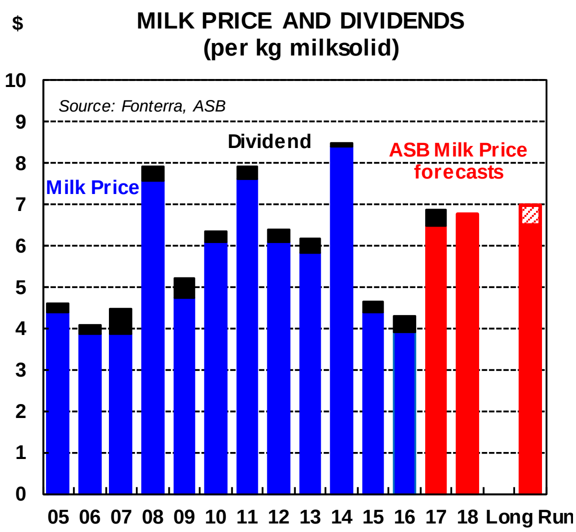
Lastly, interest rates are on the up, following US rates higher. All up though, interest rates are likely to remain low over 2017 and into 2018 compared to historical averages. Meanwhile, Donald Trump's election victory has put a rocket under the US dollar. Since his election, the NZD has dived from around US$0.7380 to US$0.6920.

Key Rural Data:

As at 16 December 2016	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	198.0	194.2	144.7	↗
Lamb Price Index (NZD)	170.7	179.4	170.6	↘
Beef Price Index (NZD)	248.0	248.6	246.9	→
Rural Land Price Index	3235	3115	3085	↗
Interest Rates:				
90-day bank bills	2.04	2.05	2.75	→
2 year swap	2.45	2.31	2.86	→
5 year swap	3.08	2.82	3.26	→
Exchange Rates:				
NZD/USD	0.6971	0.7017	0.6723	→
NZD/CNY	4.85	4.83	4.34	→
NZD/GBP	0.5578	0.5684	0.4418	↗
Milk solids production (ytd % chg]**	-3.7	-3.1	-2.8	↘
Fonterra Shareholders' Fund	5.95	5.89	5.82	↘

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

Chart of the Month:



? *Rural Fact or Fiction?*

When excited, the bare skin on a male turkey's throat and head turns blue; when ready to fight it turns red.

Answer on page 3

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Rural Commodities Outlook

Dairy – Full circle

ASB Dairy Index (USD), 16 Dec: 198.0 ↑1.9% (mpc)

Back in February, we lowered our 2016/17 milk forecast from $6.50/kg to $6.00/kg. The $6.00/kg forecast served us well as we effectively drew a line in this dairy cycle's sand. In other words, our $6.00/kg forecast demonstrated our confidence that the milk price would turn this season.

However, now we have come full circle and revert back to a forecast of $6.50/kg. At the same time, we nudge our 2017/18 forecast higher by 25 cents to $6.75/kg. So why the move?

First up, prices have lifted sooner and higher than we had factored in.

Secondly, we believe global dairy production is going to get worse before it gets better. And in turn, we expect dairy prices can go higher in early 2017.

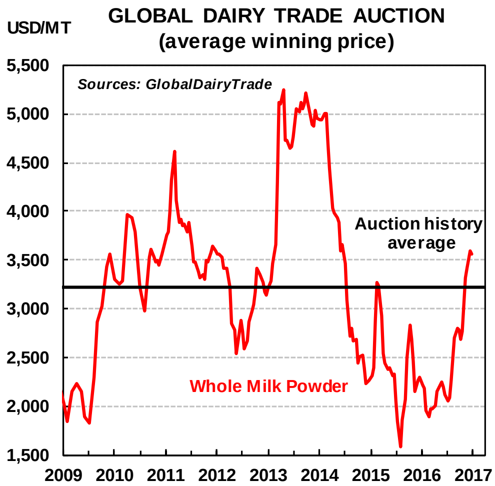
Lastly, President-elect Donald Trump has put a rocket under the US dollar, boosting the NZ dollar milk price, particularly heading into 2017/18.

While farmers can now take time out over Christmas and look forward to better times over 2017, we can already see the next dairy cycle taking shape. Indeed, we see a risk that prices could overshoot this season or next. If, as a result, that sparked a large global production response, then another dairy price cycle would likely soon follow.

Season End Milk Price Forecasts:

	2016/17		2017/18	Long Run
	Fonterra	ASB	ASB	ASB
Milk Price*	$6.00	$6.50	$6.75	$6.50-$7.00

* per kg of milk solids (excluding dividend).



Lamb – Baby steps

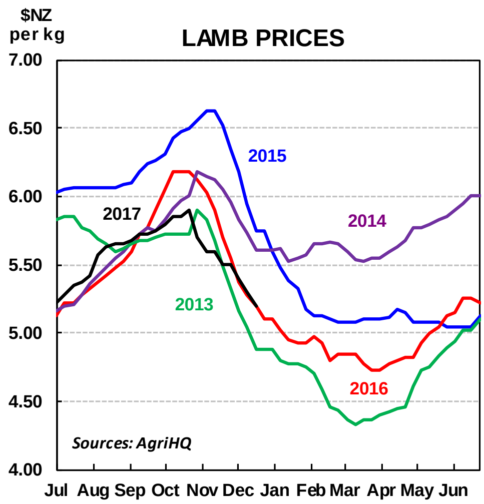
Lamb Index (NZD), 16 Dec: 170.7 ↓-4.9% (mpc)

Lamb prices are taking baby steps towards improvement. For example, since the last edition of Farmshed Economics, the gap between per kg prices (see chart) this year and last year has now closed.

As expected tigh*/*t production is underpinning prices. It remains a similar story over the ditch, with Australian production also tight.

The Chinese market has continued to lead the way, although there are reports of other markets improving too. While the shipping window for the Chinese New Year has passed, it appears prices are likely to remain firm. AgriHQ also reports better demand from the US and surprisingly from the UK. Recent oil price lifts may also generate better demand from the Middle East over time.

However, the weak Pound and euro continue to constrain further improvement in prices. As a result, we expect any improvement in prices to come in baby steps for now.



Beef – Second, wait, third wind

Beef Index (NZD), 16 Dec: 248.0 ↓-0.2% (mpc)

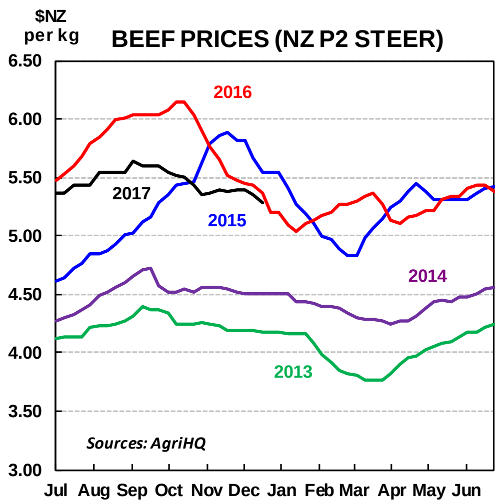
Since the last edition of Farmshed Economics, prices are largely unchanged. Indeed that has been the theme since July.

On balance, we expect prices to track sideways to start 2017. First up, the NZD has fallen against the USD, giving beef prices in NZD terms a little breathing space (see NZ dollar section).

Secondly, we expect a low cow cull in early 2017. With the milk price improving and the dairy herd down on previous seasons, farmers are likely to want to hold on to as many cows as possible. As a result, a low cull should support beef prices.

Third, lack of Australian supply is also likely to keep NZ beef prices high. Australian beef production has slowed as the Australian beef herd slowly rebuilds. That lack of Australian beef continues to keep the door open for NZ exporters, and thus keep prices firm.

All up, it seems that moderating beef prices is a story for the autumn, if not winter, of 2017.



Rural Commodities Outlook (continued)

Rural Land Prices – Turning the corner

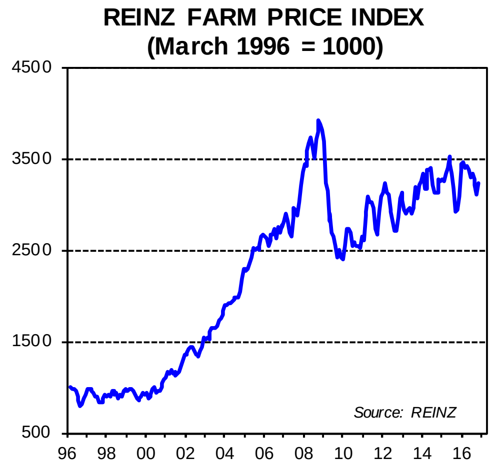
Farm price index, Nov:	3235 ↑3.9% (mpc)

Rural land prices are set to pick up. For the three months to November, REINZ reported that rural land prices were 4.9% higher than in the same three months in 2015. We expect that the turnaround is set to continue.

By and large, we expect the dairy sector to provide the push higher over 2017. For a start, the dairy farm sales are rising, with 31 sold over November, 4 more than over November 2015.

But more importantly, the milk price has turned a corner, boosting rural confidence. After last season's $3.90/kg milk price, we expect a lift to $6.50/kg for this season; this puts the majority of farmers well back into profit territory.

Meanwhile, the rest of the rural sector is largely positive, with soft lamb prices the main exception. All up and for now, we expect the dairy turnaround to dominate the rural land market scene.



Financial Markets Outlook

Interest Rates – On the up

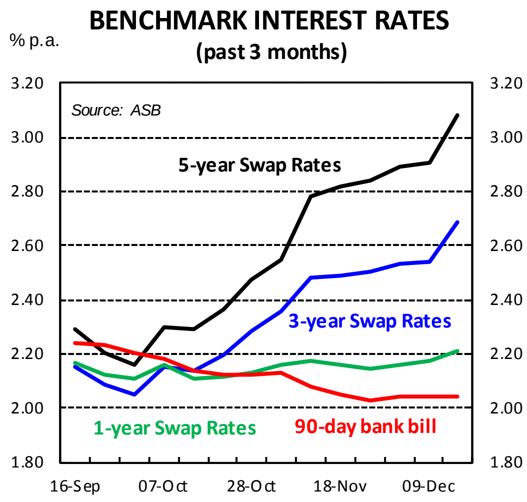
90-day bank bills, 16 Dec:	2.04% ↓ -0.01 (mc)

Interest rates are on the up. Well at least, medium- and longer-term benchmark rates (see chart) have lifted noticeably since around the start of October.

These medium- and long-term rates have followed US rates, in particular, higher. On 14 December and as expected, the US Federal Reserve lifted rates for the first time in 2016. Moreover, with the US economy continuing to improve, more hikes are likely over 2017. Accordingly, these lifts are likely to feed through to NZ medium- and long-term rates.

Meanwhile, we expect the Reserve Bank to be on hold for the foreseeable future. As a result, we expect local floating and short-term rates to remain largely where they are heading into 2017.

All up though, interest rates are likely to remain low over 2017 and into 2018 compared to historical averages. Moreover, we anticipate any rises over the next couple of years are likely to be modest.



NZ Dollar – Trump rocket

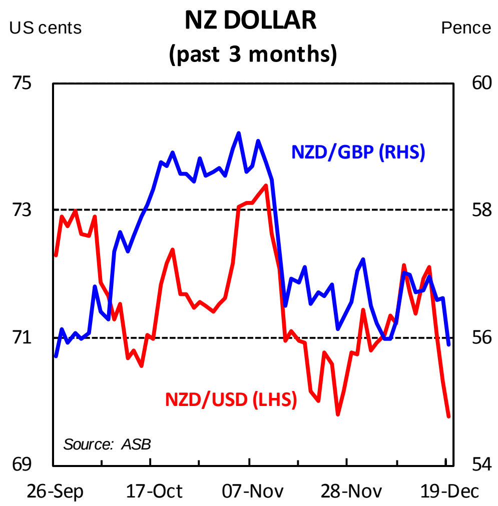
NZD/USD, 16 Dec:	0.6971 ↓ 0.0046 (mc)

Donald Trump's election victory has put a rocket under the US dollar. Since his election, the NZD has dived from around US$0.7380 to US$0.6920.

Trump has stated that he is likely to loosen the fiscal purse strings. In his sights are infrastructure spending and tax cuts, including for corporates. The prospects of corporate tax cuts has seen investor money start to head back to the US as after-tax corporate returns are likely to be higher over the Trump years.

Meanwhile, US interest rates are rising and further supporting the USD. The US economy is steadily improving, with the US Federal Reserve now confident enough to raise interest rates this month and signal more to come over 2017.

All up, the weaker NZD (stronger USD) is supporting farmgate prices, particularly for beef and dairy. However, with the NZ economy strong, we expect the NZD to largely hold its own over 2017.



Rural Fact or Fiction?

Answer: Fact! One wonders what colour they turn around Christmas time.

Special Topic

Lessons from the dairy downturn – Part I

Lessons:

1. **Global dairy cycles come and go, come and go…**
2. **NZ has an over-sized effect on the global dairy cycle.**
3. **Meanwhile, farmers in all parts of the world respond and change behaviour when they are losing money.**

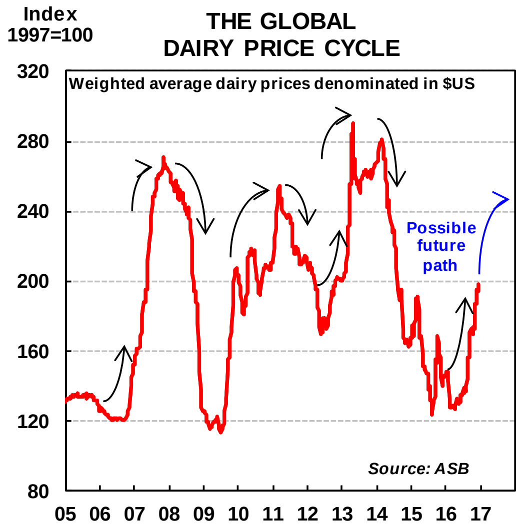
In this Special Topic, we reflect on the recent dairy downturn. For starters, our aim is to pull out some key lessons based on our observations during this latest dairy cycle. Later, most likely early in the New Year, we would like to point out ways that the sector may adapt to or even influence the global dairy cycle. We suspect, for example, that NZ farmers aren't entirely hostage to the whims of global dairy markets. But that's for next year, for now; here are the three key lessons we have learnt.

Lesson 1: global dairy cycles come and go, come and go…
Looking back at this downturn, one of the reasons the Farmshed Economics team was confident that the milk price would lift was our belief in the global dairy cycle. Indeed, our belief was that the cycle was alive and kicking, and that it was a matter of when, and not if, it would kick in. So why were we so confident?

Firstly, commodity cycles have been around for millennia. And hence, will be around for millennia to come. On that basis, we thought that for the dairy cycle not to kick in, something would have had to have changed drastically.

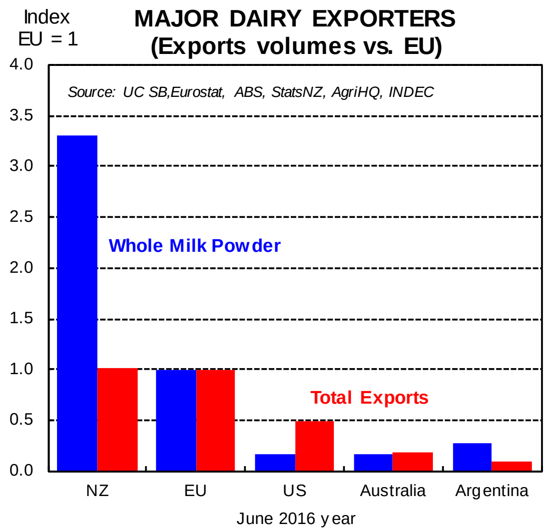
In that regard, some commentators pointed to lifting EU quotas as drastically changing the dairy export game. But for us, lifting quotas did not materially change the EU's competitive position – the EU remained by and large a high-cost producer.

As a result, we expected that the low milk prices would eventually impact on the EU in the same way low milk prices were impacting here in NZ. In other words, the dairy cycle was going to kick in, and that has been borne out over 2016 (see also lesson 3).



Lesson 2: NZ has an over-sized effect on the global dairy cycle
NZ is a large dairy exporter. Actually it's the largest. Over the June 2016 year, NZ exported 2% more dairy products (measured in metric tons) than the second-largest exporter, the EU.

When it comes to whole milk powder (WMP), our largest export, NZ dwarfs all other exporters. Over the same June year, NZ exported more than three times the level of EU WMP exports. In fact, NZ exported more than double the amount exported by the four other major exporters combined.



Given NZ's large share of global dairy exports, it should come as no surprise then that NZ has a large impact on the global dairy cycle. Put differently, that means changes in NZ supply have a large effect on global dairy prices.

Recent experience bears out this fact. NZ supply and exports surged following the record-high milk price in 2013/14. And as a consequence of the surge in production, global dairy prices sunk to very low levels. NZ farmers have then responded to the low global prices by reining in production; in turn, this response has led to a rebound in global prices, particularly for WMP, over the second half of 2016.

The other lesson we take from these points is that contrary to general belief, NZ farmers are not necessarily subject to the whims of global dairy markets. Indeed, NZ farmers have more pricing power than they are normally led to believe. In short, if NZ farmers produce the less, they will get paid more, with the net effect higher incomes overall.

With this in mind, we will explore early next year what this lesson means for NZ dairy in Part II of *Lessons from the dairy* *downturn.* That is we believe that the sector can do more to deliver higher prices to farmers, and also less volatile prices to boot. Watch this space!

Lesson 3: When farmers lose money, they change behaviour
This last lesson almost seems too silly to point out. But point it out we must. Early in the year, we argued that the level of global dairy production was unsustainable given that the majority of exporters were losing money.

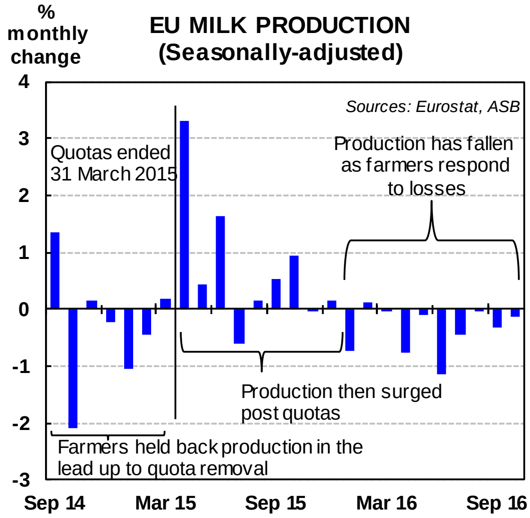
However, some commentators insisted that production could continue at these levels, via a combination of government support, including intervention schemes and other mechanisms. Our view was the best that these measures could hope for was to delay farmers' response.

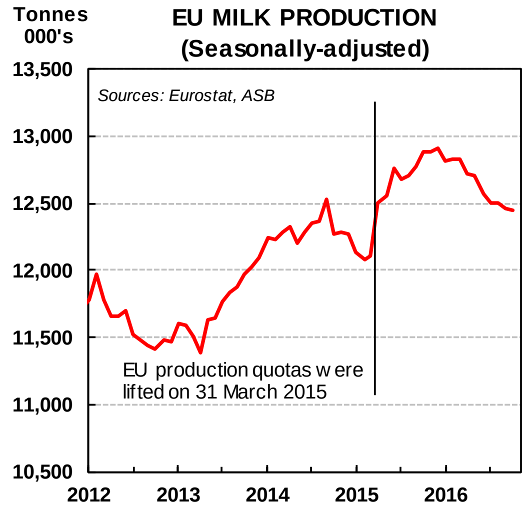
Generally, when farmers lose money they change things. For a start, they may reduce herd numbers i.e. send some animals to slaughter to generate some cashflow. Farmers may also reduce expenditure on items such as feed, fertiliser, maintenance and animal health. For example here in NZ, it is generally accepted that over this latest downturn, farmers have relied more on pasture for feed than in preceding seasons.

Moreover, these changes generally lead to less supply. And in turn, this supply fall generates a lift in prices. In other words, falling supply kicks off an upswing in the dairy price cycle.

This year, the EU has illustrated this simple concept well. Back in March 2015, production quotas were lifted and this generated a surge in production. But what we observed was that it soon became apparent to European farmers that this new higher level of production was unsustainable. Farmers were losing money and they needed to change behaviour. And so they did – from the start of 2016, EU production began to fall in seasonally-adjusted terms (and has fallen ever since, see charts).

In that sense, EU farmers are no different to their NZ counterparts.





Summary
As we come out of one cycle, we can already see the next taking shape.
With the above in mind, we can anticipate that the same lessons from this cycle or general rules will apply again in the next cycle. At the same time, we suspect, contrary to the widely held belief, that NZ farmers aren't entirely hostage to the whims of the global dairy cycle. Indeed, we would like to point out ways that the sector may adapt to or even influence the cycle. For that discussion, we'll see you back in the New Year.

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