# Farmshed Economics

## Eight ways to Sunday

July 2018

ASB



**While global US-China trade tensions remain front of mind, we pause in this month's edition of Farmshed Economics to celebrate a historic moment in lamb markets. That is, lamb prices have cracked the $8.00/kg mark for the first time on record. Indeed, with strength across most of our major lamb markets, lamb prices are strong eight ways to Sunday.**

Meanwhile, dairy auction prices have headed in the other direction over recent months. The catalyst for change has been the escalation in US-China trade tensions, amplified by a weaker Chinese yuan. The falling yuan has stinted Chinese buying power and lowered demand from our number one dairy market. For farmers, this means there's risk to our 2018/19 milk price forecast of $6.50/kg. In a similar fashion, Fonterra is likely to cut its $7.00/kg forecast later in August.

Beef prices remain solid, with per kg P2 steer prices posting a solid increase over July. However, risks are growing particularly in our key export market, the US. Indeed, we anticipate that growing US supply will put downward pressure on beef export prices over the remainder of the year.

It's a mixed bag for wool prices. Coarse wool prices have lifted off their 2017 lows, but remain low by historical standards. Meanwhile, prices for mid-micron and fine wools continue to go from strength to strength.

Looking at currency markets, the key move for farmers has been the NZD gaining ground against the Chinese yuan. Recall that China is our largest food export market. Thus, a weaker yuan decreases the buying power of Chinese consumers and this may lead to lower demand for our exports to China. Indeed, we have seen weaker dairy prices over recent months.

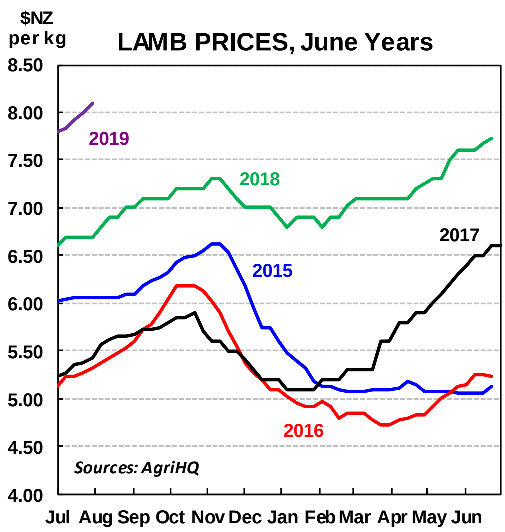
Finally, short-term NZ benchmark interest rates drifted lower over July. With the Reserve Bank on hold, we expect short-term rates to remain low for the rest of 2018, and into 2019. Meanwhile, we expect longer-term rates to drift modestly higher, following similar offshore moves, in the US in particular.

### Key Rural Data:

| *As at 3 August 2018* | Current | 5 wks ago | Year ago | Outlook* |
|---|---|---|---|---|
| **Rural Commodity Prices:** | | | | |
| ASB Dairy Price Index (USD) | 85.5 | 91.7 | 93.4 | → |
| Lamb Price Index (NZD) | 136.2 | 130.0 | 112.7 | → |
| Beef Price Index (NZD) | 114.2 | 110.2 | 115.2 | ↘ |
| Wool Price Index (NZD) | 64.8 | 68.7 | 60.9 | → |
| **Interest Rates:** | | | | |
| 90-day bank bills | 1.90 | 2.00 | 1.95 | → |
| 2-year swap | 2.12 | 2.15 | 2.19 | → |
| 5-year swap | 2.55 | 2.53 | 2.72 | ↗ |
| **Exchange Rates:** | | | | |
| NZD/USD | 0.6743 | 0.6766 | 0.7513 | → |
| NZD/CNY | 4.61 | 4.48 | 5.06 | → |
| NZD/GBP | 0.5184 | 0.5123 | 0.5720 | → |
| Milk solids production (ytd % chg]** | 12.1 | -0.6 | 20.4 | ↓ |
| Fonterra Shareholders' Fund | 5.09 | 5.44 | 6.10 | → |

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

### Chart of the Month:




### *Rural Fact or Fiction?*

**?**

While we associate drought with low production generally, drought and the associated reduction in pasture cover can lead to sheep to producing finer wool.

*Answer on page 3*

Nathan Penny – Senior Rural Economist – 649 448 8778 – nathan.penny@asb.co.nz

# Rural Commodities Outlook

## *Dairy* – Fonterra milk price forecast cut on horizon

Dairy Index (USD), 3 Aug: 85.5 -6.7% (mpc)

Dairy prices have shifted lower. Since May, overall dairy prices have fallen 9%, with whole milk powder prices down 8%. Notably, once strong butter prices have plunged 17%. Initially, with global demand still firm, a quick price rebound looked possible. But this no longer appears likely.

The catalyst for change has been the escalation in US-China trade tensions, but the mechanism through which dairy prices have been impacted has been currencies. The Chinese yuan has fallen against not just the USD, but also the NZD.

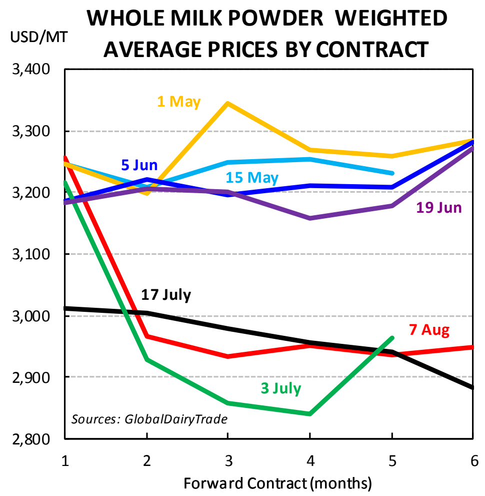
The falling yuan has stinted Chinese buying power and lowered demand from our number one dairy market. Moreover, as the US-China trade tensions drag on, the more likely the yuan is to stay at this lower level, with Chinese dairy demand likely to remain lower too.

It follows that lower demand equals lower prices. For farmers, this means there's risk to our 18/19 milk price forecast of $6.50/kg and Fonterra's $7.00/kg forecast. We had already factored in some downside risk from improved NZ production this season. But lower global dairy demand comes on top of this. The low NZD is providing some offset, but not by enough to fully offset the overall dairy price fall. For now, we stick with $6.50/kg, but we formally put our milk price forecast under review.

**Season End Milk Price* Forecasts:**

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

* per kg of milk solids (excluding dividend).



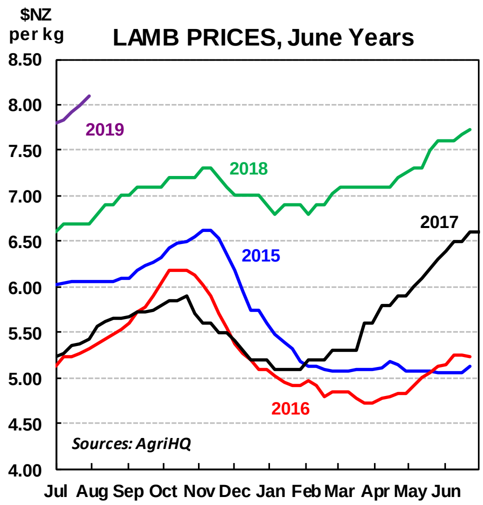

## *Lamb* – Eight ways to Sunday

Lamb Index (NZD), 3 Aug: 136.2 4.8% (mpc)

Lamb prices have cracked the $8.00/kg mark! In fact, our data suggest that lamb prices now sit at their highest ever levels, with the previous record high coming set back in 2011.

Prices are strong across our key markets and reflect generally healthy global economic growth and demand. US and EU (excluding the UK) prices are particularly strong. EU prices for the season to date sit 22% higher than for the same period a year ago (in NZD terms), while US prices are up 19%. These increases compare to the overall 16% lift in NZ lamb export prices in NZD terms.

Looking ahead to the new season, we are optimistic that prices will remain very healthy, but at the same time we are wary of growing risks. In particular, escalating US-China trade tensions could derail global economic growth and reduce global lamb demand. The other risk is that consumer price resistance can kick in at these record levels. But for now, lamb prices are strong eight ways to Sunday.




## *Beef* – Delicately poised

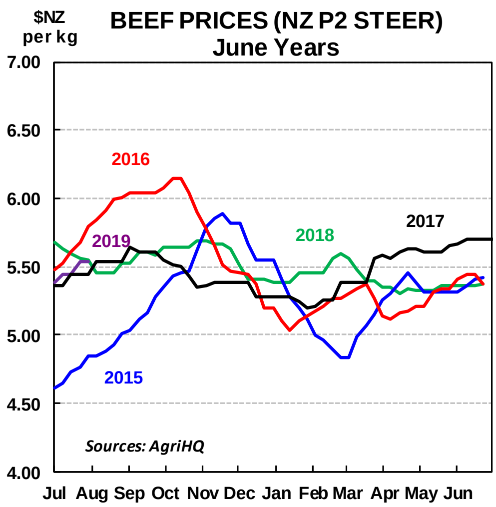
Beef Index (NZD), 3 Aug: 114.2 3.7% (mpc)

Beef prices remain solid. Over July, prices lifted, with per kg P2 steer prices up 3.7%.

However, risks are growing particularly in our key export market, the US. US domestic beef prices are falling as domestic beef supply rises. Also according to AgriHQ, rising supplies of pork and other beef substitutes could put further downward pressure on US beef prices.

In addition, the Chinese market is under pressure from a weaker Chinese yuan. Over the past month, CNY/NZD has fallen over 3% and this may dampen Chinese demand for beef.

For now though, farmgate prices (in NZD terms) have been largely unscathed. The seasonal shortage of beef may be one reason prices are holding up, while another supporting factor is the weaker NZD against the USD. All up, beef markets are delicately poised. On balance though, we anticipate that beef prices may drift lower over the next six months or so.



# Rural Commodities Outlook (continued)

## *Wool* – Different yarns

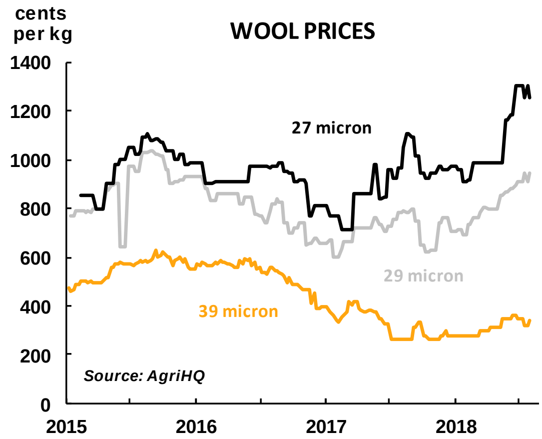
Wool Index (NZD), 3 Aug: 64.8 ↓-5.6% (mpc)

Coarse wool prices have lifted off their 2017 trough, but remain low by historical standards. Moreover, the sharp lift in prices over May and June this year proved short-lived. Since peaking at $3.60/kg, prices have fallen 6% to $3.40/kg.

It's a very different story for mid-micron wool. 2018 has been a cracking year so far. 27 micron prices are up 29%, while 29 micron prices are up an impressive 33%. Moreover, 27 micron prices are near record highs, albeit the AgriHQ prices series is over a short period.

We expect mid-micron prices to remain near these high levels over coming months. In particular, the relatively healthy global economy and firm consumer demand will help to underpin these prices.

However, for coarse wools, the outlook remains modest as demand remains structurally weaker. As a result, we anticipate that prices will track sideways over the remainder of the year.




# Financial Markets Outlook

## *Interest Rates* – Steady as she goes

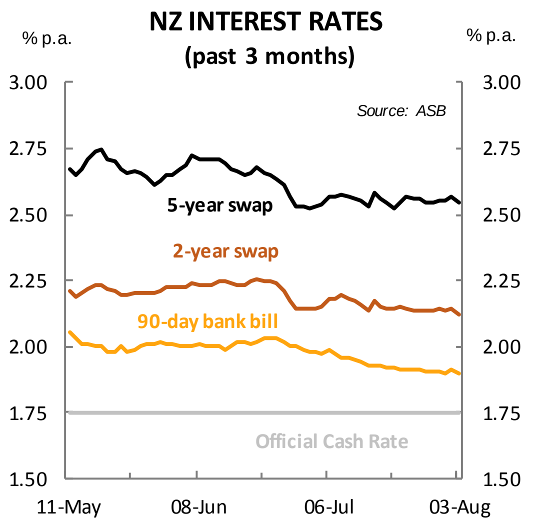
90-day bank bills, 3 Aug: 1.90% ↓ -0.11 (mc)

While the Official Cash Rate (OCR) was unchanged over July (and August), short-term benchmark interest rates have drifted lower. For example 90-day bank bills fell around 11 basis points over the month.

In the first instance, short-term interest rates eased as markets increasingly flirted with the possibility that the Reserve Bank might cut the OCR. Meanwhile, easing credit market pressures also contributed to the fall in short-term interest rates over the month.

While we don't expect the Reserve Bank will cut the OCR, we do expect the Reserve Bank to remain on hold for a prolonged period. Specifically, we expect the Reserve Bank to sit on its hands this year and most of next, before hiking the OCR in November 2019.

Meanwhile, longer term rates were steady (and low) over July. We expect long-term rates to remain near these low levels over coming months. Indeed, we anticipate that in general interest rates are likely to remain low over 2018, before gradually picking up over 2019.




## *NZ Dollar* – Chinese yuan loses ground

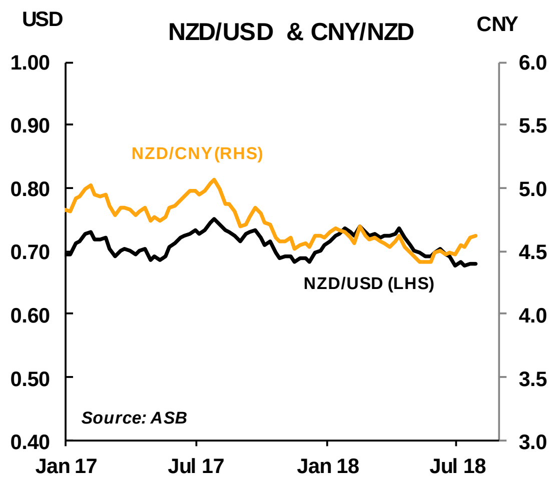
NZD/USD, 3 August: 0.6743 ↓ 0.0023 (mc)

The NZD was steady against all the major currencies over July, with one notable exception. That is, the NZD gained ground against the Chinese yuan. In contrast, the NZD traded within a tight 0.6667 to 0.686 range against the USD.

As China is our largest market for most of our food exports, this is a development that we are paying close attention to. Effectively, a weaker yuan decreases the buying power of Chinese consumers and this may lead to lower demand for our exports to China.

Already, we have seen weaker dairy prices over June and July. In part, we can attribute this to the weaker yuan as Chinese buyers were notably absent from auctions in July. Recall that overall dairy auction prices were down 6.6% over the month in line with the weaker yuan in USD terms.

In other markets, we have yet to discern a material impact on prices. However, with US-China trade tensions escalating, we are on the outlook for any wider impact.




**?** **Rural Fact or Fiction?**
*Answer:* Fact. Drought and the associated reduction in feed levels can lead to sheep to producing finer wool.

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