Farmshed Economics

Pain and glory

July 2021

It's been a glorious autumn and a cracking start to winter for commodity prices. With the global economy re-opening, consumption lifting and growth forecasts strengthening, demand for most major commodities have moved up sharply. Meanwhile, supply for many goods remains constrained. In aggregate, it's a potent combination for global prices.

With the NZD a little softer against the USD of late, a favourable exchange rate is turning 'good' global prices into 'outstanding' NZD prices. Our own ASB Commodities Index reached its highest level in its history in NZD terms at the beginning of July. We see scope for a little more depreciation in the NZD/USD in the near term, helping support farmgate returns across the board.

Dairy is the real star of the show at the moment. Prices have held onto their enormous gains from earlier in the year and are still trading around seven- or eight-year highs. Unsurprisingly, farmers have started to ramp up production in response, setting the stage for some solid export earnings for the sector. Prices will drift down from these heights from here, but we still expect a historically strong season, with a farmgate milk price of close to $8.20 kgms.

Happily, some of COVID's strugglers are starting to feel the love too. The pandemic impacted different sectors highly unevenly, even within agriculture, but gains this year are being well distributed. Beef and lamb prices fell sharply in COVID's aftermath but are rapidly rebounding as restrictions on the hospitality sector ease overseas. The scale of the comeback is such that we see scope for beef and lamb prices to hit record levels in the coming months.

Still, worker shortages and surging costs are causing farmers some pain. With the New Zealand border largely shut for quite some time now, worker shortages remain a big theme in the agri sector, and wages are under pressure. Tight global crop markets have sent feed costs through the roof.

We expect both high prices and rising cost pressures to persist over 2021. With global demand and supply finely balanced for most commodities, we see little prospect for a sharp price correction in the near term, and some may face further upside. On the other hand, labour woes and rising cost pressures look set to remain the proverbial fly in the ointment for some time to come.

Key Rural Data:

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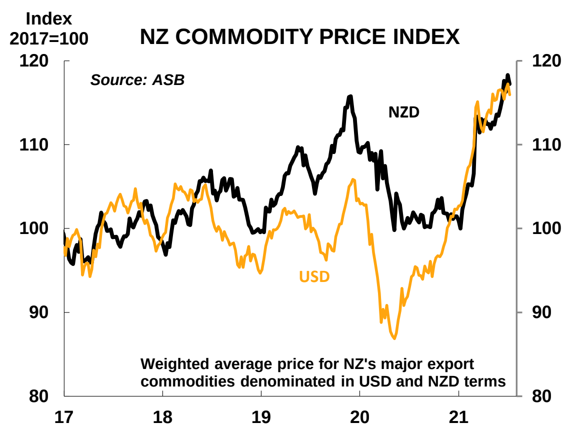
As at 09 July 2021	Current	3 mths ago	Year ago	Outlook
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	122.4	126.2	93.8	↘
Lamb Price Index (NZD)	132.6	103.1	110.2	↗
Beef Price Index (NZD)	102.1	85.9	92.7	↗
Farm Input Index*	1125	1123	1119	↗
Interest Rates:				
90-day bank bills	0.34	0.33	0.31	↗
2-year swap	0.86	0.45	0.22	↗
5-year swap	1.34	1.06	0.37	↗
Exchange Rates:				
NZD/USD	0.6983	0.7016	0.6530	↘
NZD/CNY	4.52	4.61	4.61	↘
NZD/GBP	0.5047	0.5074	0.5237	→
Milk solids production (ytd % chg]**	9.4	3.0	3.8	
Fonterra Shareholders' Fund	3.75	4.36	3.84	

Outlook indicates direction over the next 6 months. *As at Mar 21. **As at May 21

Chart of the Month:



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Rural Commodities Outlook

Dairy – The white stuff

ASB Dairy Index (USD), 09 July:	122.4 ↓ 3.0% (qpc)

Wow. What a ride for dairy. In March, prices surged to seven-year highs and have held their ground since then. Aggressive Chinese purchasing has been the order of the day as the country builds its inventories, keeping WMP prices well supported. Ongoing logistics disruption woes are also proving a boon, with buyers happy to pay a premium to secure product. With global dairy demand likely to outpace supply over the course of 2021, we expect prices to stay north of long-run averages for the bulk of the year.

All-up, our final forecast for the 20/21 season sits at $7.60 kgms. That would be a strong result in its own right, but it already pales in comparison to our 21/22 forecast, which sits at a whopping $8.20 kgms.

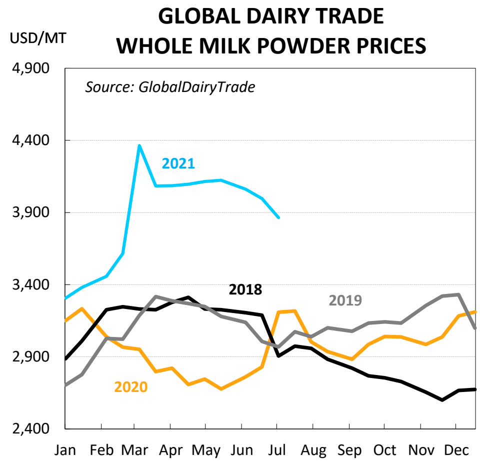
We caution there's an awful lot of guesswork this far out from the end of the season. Still, so far, we are seeing all the markings of another strong season. Even a farmgate price towards the bottom end of Fonterra's wide forecast range (i.e. nearer the $7.50 mark) would represent a solid result.

Prices won't maintain these highs forever –we are starting to see prices ease for later-dated dairy auction contracts – but we continue to view a sharp correction as unlikely the given the global demand and supply balance.

Season End Milk Price Forecasts:

	2020/21		2021/22	
	ASB	Fonterra	ASB	Fonterra
Milk Price*	$7.60	$7.45-$7.65	$8.20	$7.25- $8.75

* per kg of milk solids (excluding dividend).



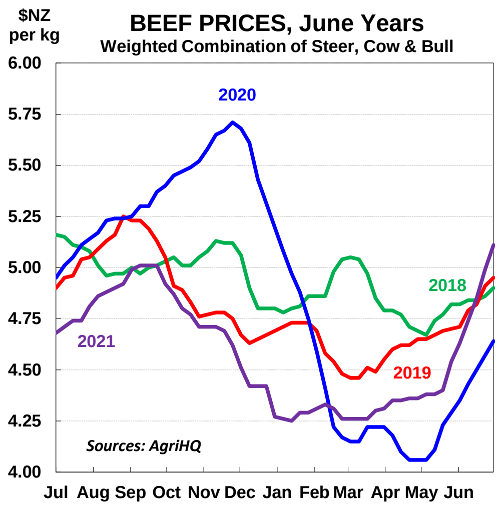
Beef – Bullish

Beef Index (NZD), 09 July:	102.1 ↑ 18.8% (qpc)

Beef prices took a tumble last year, as COVID shuttered restaurants and crimped demand for higher end cuts of meat. Now, as restrictions have begun to ease overseas (albeit unevenly given outbreaks of the Delta variant overseas), prices have picked up the pace sharply. Having lifted nearly 20% over the past quarter, prices are matching – or exceeding – their levels in the 2017-18 and 2018-19 seasons.

Prior to the pandemic, markets conditions were supportive, with the outbreak of African Swine Fever (ASF) decimating the Chinese pork market and triggering a global protein shortage. While the Chinese pig herd has recovered in size, renewed ASF outbreaks remain a concern and a wide range of exporters are finding support in the market.

We view market conditions as supportive and expect prices to hold onto their gains. While the moves in beef prices haven't been as spectacular as those for lamb, the prospect that prices could exceed their 2019-20 record peak remains live.



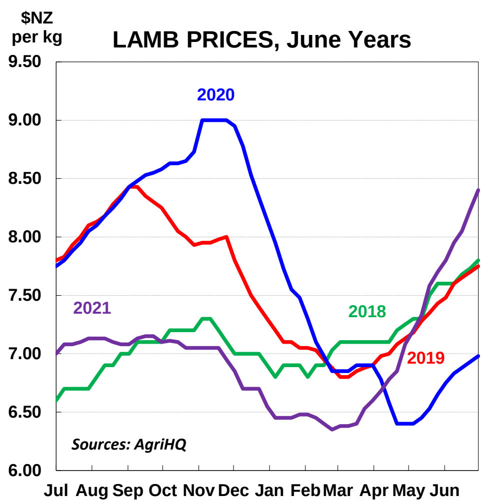
Lamb – Heading for a record

Lamb Index (NZD), 09 July:	132.6 ↑ 28.6% (qpc)

The recent recovery in the lamb market has been even more impressive than that for beef. Just as lamb markets were hit harder by COVID's initial impact and the closure of restaurants overseas, prices have been more exposed to upside as restrictions have eased. Combined with the supportive conditions pre-COVID (that aforementioned global protein shortage), the market is enjoying a strong winter.

NZD lamb prices have lifted nearly 30% over the last quarter. In fact, prices are currently hitting lofty levels for this stage in the season. We see further upside ahead.

With lambing tallies unusually low last spring, tighter supply is working in concert with the prospect of strong export returns to fuel stiff procurement competition. Our friends at AgriHQ note minimum price contracts for early spring are already hitting the $9 mark. In other words, the stage is set for NZD lamb prices to reach all-time highs over the spring, comfortably exceeding the 2019-20 season's peak.



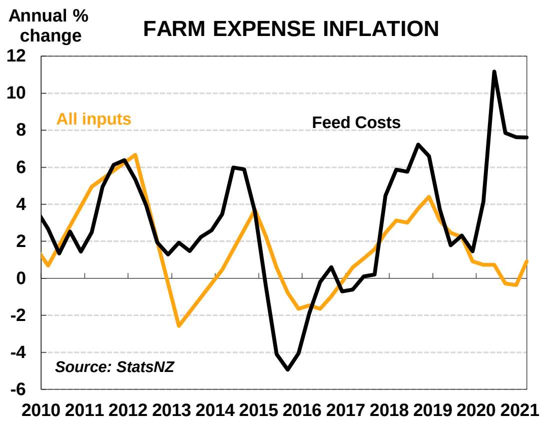
Rural Commodities Outlook (continued)

Farm Expenses – Costing the earth

Farm Input Index 31 Mar:	1125 ↑ 0.5% (apc)

Over recent weeks, gloomy headlines and anecdotes have continued to pile in from businesses – including farmers – about rising cost pressures.

Feed costs are the canary in the coal mine, notching up some big lifts. After spiking during the pandemic, feed prices have continued to advance. Globally, the grain and oilseed markets remain tight coming off the back of the 2020 season and are likely to remain so given this season's crop yields aren't projected to be enough to restore the balance. Prices are getting further support from China's insatiable demand for feed.



Labour woes are another big theme lately. With the NZ border largely shut for nearly a year and a half, seasonal worker shortages were already a constant theme, but the labour market has continued to tighten. Business surveys show difficulty finding staff at records highs, and staff turnover lifting sharply. It increasingly looks as if employment is running up against its maximum sustainable level, and we see wage pressures strengthening over the course of the year. We don't see limited prospects for quick relief – if anything the risks are increasingly pointing to a later opening in the NZ border given the spread of the more transmissible 'delta' variant.

Financial Markets Outlook

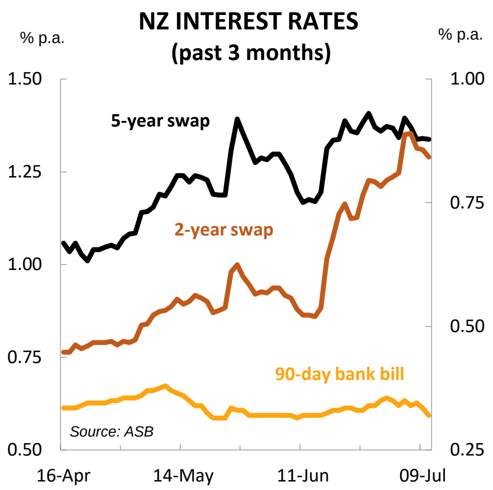
Interest Rates – Through the watershed

2-year swap, 09 July:	0.86% ↑ +0.41 (qc)

There has been a big shift in our interest rate outlook. Recent economic data have burst surged past expectations in dramatic fashion, and inflationary pressures have intensified markedly. Increasingly, there are signs central banks are beginning to think carefully about their timeline for unwinding the stimulus that has sent interest rates to historic lows over the past eighteen months.

The upshot is we now expect the RBNZ to lift the Official Cash Rate as early as August this year. We expect the Bank will remain cautious and data driven as it begins the tightening cycle, but the direction of travel is clear. Wholesale interest rates have begun to lift markedly in anticipation. We expect retail rates to follow suit before long.

We expect interest rates to peak at historically-low levels, but it's a prudent time to review your interest rate exposures to ensure they are appropriate.



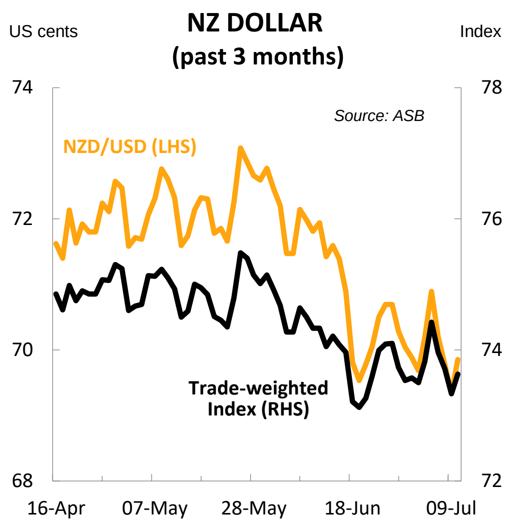
NZ Dollar – The greenback strikes back

NZD/USD, 09 July:	0.6983 ↓ -0.0032 (qc)

There's been a bit of give and take on the currency front of late. A range of indicators that would normally be quite bullish for the NZD have lifted: commodity prices are on a tear, NZ interest rates are set to rise ahead of rates offshore, and risk sentiment is on the up.

Yet the NZD has fallen against the USD lately. That's because the greenback is enjoying a moment in the sun. Typically, the USD is a 'countercyclical' currency, meaning it tends to fall in value when the economy is growing as investors shift away from 'safe' assets. But with the US economy diverging from much of the world (thanks to its turbocharged recovery), the USD is behaving like a 'normal' currency– lifting when the good times are rolling.

Our friends at CBA see the potential for a bit more USD strength over the medium term, and now expect the NZD/USD to drop a bit further in the short term (to 0.6650 by the end of the year), before resuming its climb north. For farmers, its fantastic news – strong commodity prices, but without the usual higher kiwi crimping farmgate returns.



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