Farmshed Economics

Trade tension temperatures rising

June 2018

Global trade tensions have escalated further over June. For rural NZ, the escalation is becoming more real as China and the US have included agricultural products in their protectionist measures and as the NZD falls along with the currencies in some of our key export markets. Indeed, we have now seen dairy auction prices weaken materially on these heightened risks. If the trade tensions escalate further and weigh on overall global economic growth, then other sectors could be next.

So far, the trade tensions have weakened the currencies (against the USD) of some of our key export partners. This weakness makes those exports priced in USD more expensive – potentially, this could dampen demand for our exports. Moreover, the increasing trade tensions pose material risks to global economic growth. If this risk eventuates, then global demand, including for NZ agricultural exports, could fall and prices could weaken further.

Ironically though, selected NZ export prices stand to gain from the scheduled 25% lift in Chinese tariffs on US agricultural imports. Higher tariffs on US imports increase their price. Accordingly, NZ goods become relatively cheap, boosting their demand – this demand may in turn underpin NZ export prices.

By product, NZ dairy prices have the most to gain. The US is the third-leading exporter to China, after the NZ and EU.

In addition, Chinese tariffs on US feed imports may also boost demand and prices for NZ dairy, beef and lamb. This dynamic occurs as the tariffs on feed imports increase feed costs and weaken the competitive position of China's domestic producers relative to NZ's. In turn, this move is likely to dampen Chinese domestic agricultural production, meaning more imports will be needed to fill the gap.

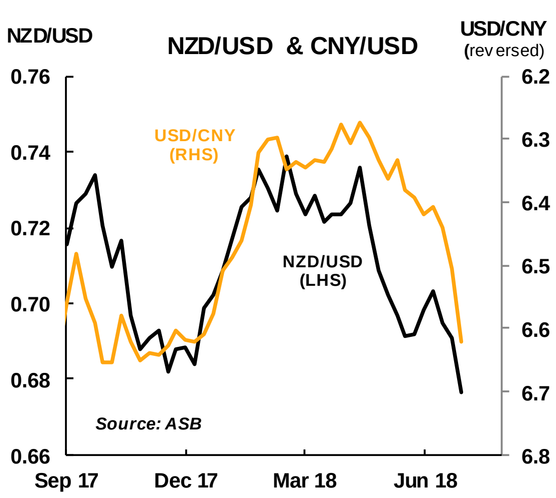
Meanwhile, the weaker NZD is already providing some offset to any potential fall in NZ export prices. However, there is an increasing risk that for some sectors that offset might not be enough. Watch this space!

Key Rural Data:

As at 29 June 2018	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	91.7	93.5	93.8	→
Lamb Price Index (NZD)	130.0	124.5	109.3	→
Beef Price Index (NZD)	110.2	108.4	116.3	→
Interest Rates:				
90-day bank bills	1.94	1.93	1.96	→
2 year swap	2.15	2.20	2.28	→
5 year swap	2.53	2.66	2.79	↗
Exchange Rates:				
NZD/USD	0.6766	0.6918	0.7287	→
NZD/CNY	4.48	4.42	4.98	↘
NZD/GBP	0.5123	0.5198	0.5729	→
Milk solids production (ytd % chg]**	-0.6	-0.9	-0.6	↑
Fonterra Shareholders' Fund	5.44	5.33	6.00	→
Grape Harvest, 2016 (tonnes)	419,000	N/A	396,000	↗

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

Chart of the Month:



? ***Rural Fact or Fiction?***

Red wine and dark chocolate should be included as part of a healthy diet.

Answer on page 3

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Rural Commodities Outlook

Dairy – Signs of spillover

Dairy Index (USD), 29 June:	91.7 ↓-1.9% (mpc)

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).

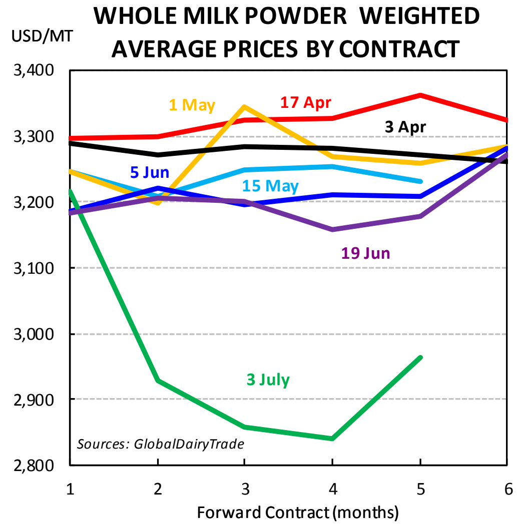
The most recent dairy auction showed the first signs that trade tensions are spilling over into NZ commodity markets. In the 3 July auction, overall prices fell 5.0%, with whole milk powder down 7.3%.

Dairy buyers appear nervous about the fallout from the increasing trade tensions and the potential impact on dairy demand. Already, currencies for key dairy buyers have fallen, with the Chinese yuan down around 3% since the last auction. Meanwhile, Chinese stockmarkets have also taken a hit, with the main Shanghai market down nearly 10% over the same period.

Ironically though, NZ does stand to benefit from increased Chinese tariffs on US dairy products. These tariffs will make NZ dairy products cheap relative to US equivalents. In turn, Chinese are likely to increase their demand for NZ dairy products, which could underpin NZ dairy prices. The lower NZD will also help bolster NZD returns.

In addition, the dairy market is starting from a position of relative strength. For example, the 'spot milk price' (using the most recent auction result and the spot NZD/USD) is still sitting at a healthy $7.00/kg.

That said, the risk is that trade tensions increasingly weigh on global growth and then dampen global dairy demand. In this scenario, the milk price outlook will change. For now, though watch this space!



Lamb – In rude health

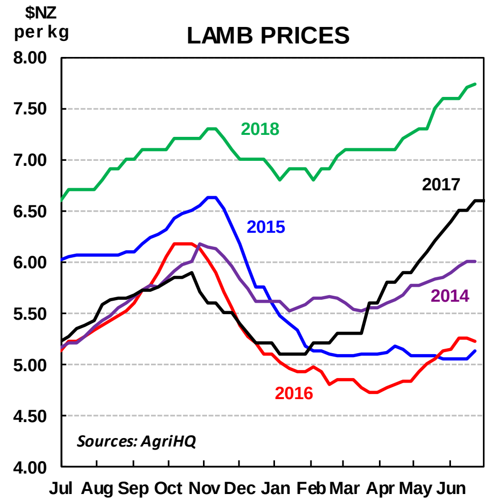
Lamb Index (NZD), 29 June:	130.0 ↑4.5% (mpc)

Lamb prices are in rude health! For the fourth month in a row, our data suggest that lamb prices were the highest on record during a June month.

Meanwhile, global lamb supply is tight, suggesting that prices are likely to remain high for the time being. For example, the UK lamb crop has been small, meaning less competition for NZ lamb. This is likely to support NZ prices in both the UK and wider Europe.

Demand in key markets also remains healthy. In particular, Chinese markets are cranking along, delivering not only higher prices but also a healthy 15% increase in NZ lamb export volumes.

On this basis, we expect lamb prices to remain very strong heading into the start of the new season. However like all sectors, increased trade tensions pose risks to this outlook. That said, with lamb prices in rude health, the sector is in a good position to weather upcoming storms.



Beef – Giving with one hand, taking from the other

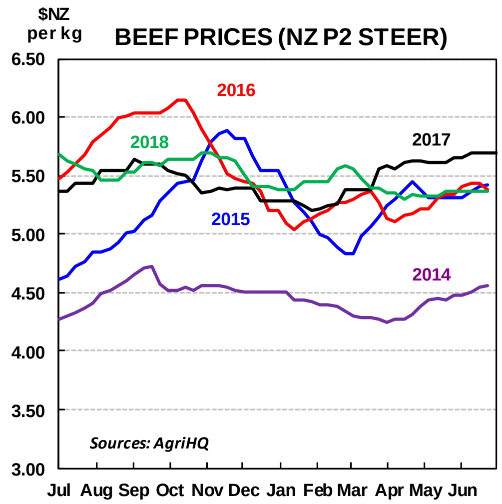
Beef Index (NZD), 29 June:	110.2 ↑1.7% (mpc)

In the first instance, the US-China trade tensions may have a small positive impact on NZ beef export prices. China will increase tariffs on US beef imports by 25% on 7 July. However, the US is not a major exporter to China, so this will not change market shares.

Nevertheless, NZ, Australia as well as Brazil (the key existing beef suppliers to China) stand to gain modestly as Chinese beef demand is growing fast. As such the tariffs on US imports will reinforce these positions.

In addition, Chinese tariffs on US feed imports are likely to boost demand and prices for NZ beef. This dynamic is occurs as higher inputs costs weaken the competitive position of China's domestic producers relative to NZ producers. In turn, this move is likely to dampen Chinese domestic beef production, meaning more imports will be needed to fill the gap.

That all said, the trade tensions pose a broader to global growth and this has potential to dampen global demand for beef. Watch this space!



Rural Commodities Outlook (continued)

Wine – Reaping the 2018 harvest

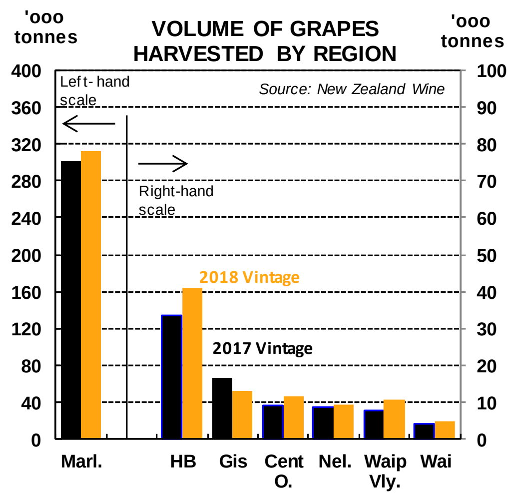
2018 Harvest (tonnes):	419,000 ↑5.8% (apc)

The 2018 grape harvest has improved on 2017. All up, the harvest was around 23,000 tonnes or 6% larger than last year's. A 4% lift in yield accounted for most of the lift in harvest.

Regionally, the Waipara Valley has bounced back from last year's difficulties, with the harvest up by over a third. In addition, the Hawkes Bay, Central Otago and Wairarapa all saw harvests jump by over 20%. Of the main wine regions, only Gisborne saw its harvest dip (by 20%), while Marlborough posted a modest 4% lift.

The larger harvest will support export volume and value growth this year. In the year to May 2018, export values lifted 3.2% compared to the year earlier, mainly due to higher export volumes, with prices down marginally.

We expect this year's larger harvest to put some downward pressure on prices. Also, given wine's relative luxury status it is more likely to get see global demand suffer in the fallout from trade tensions.



Financial Markets Outlook

Interest Rates – Still low, with a hint of lower

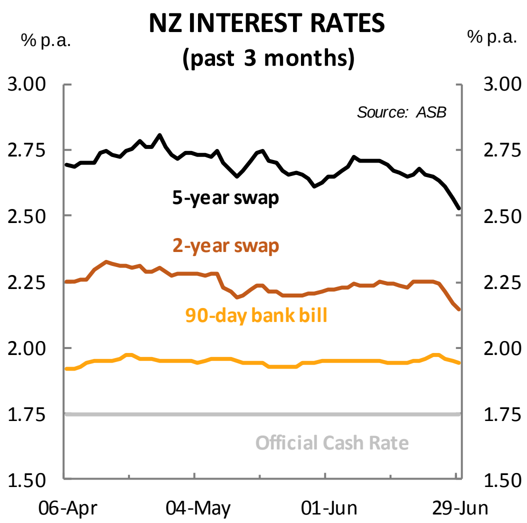
90-day bank bills, 29 June:	1.94% ↑ 0.01 (mc)

The Reserve Bank (RBNZ) kept the Official Cash Rate on hold at 1.75% on 28 June. The OCR has now been at 1.75% since November 2016.

But the RBNZ did give itself more wriggle room than previously. The Bank stated "the [OCR] will remain at 1.75% for now". The addition of 'for now' raises the possibility of the next OCR move being a cut. Indeed, interest rate markets have begun to price in this possibility. As it stands markets have factored in a 14% chance of an OCR cut by November.

Looking at benchmark rates, this move plus the concerns around the US trade tensions have driven some rates lower over June. In particular, benchmark 3- and 5-year rates fell by around 10 basis points over June, while 2-year rates also fell.

For our part, we now expect the first OCR hike to come in November 2019, from August previously. Also we note an increased chance that the next move is a cut rather than a hike. All up, this points to rates remaining low, if not lower, over the remainder of the year.



NZ Dollar – Weaker with a catch

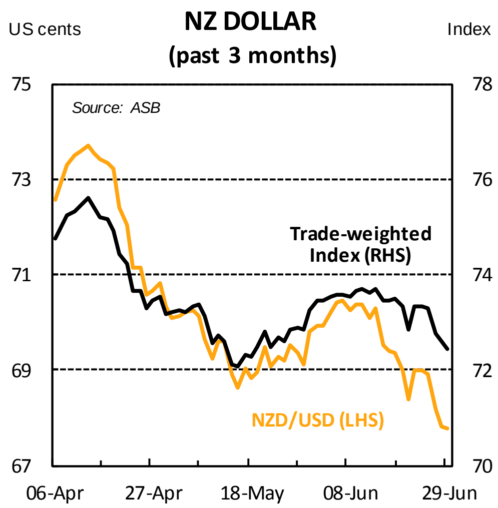
NZD/USD, 29 June:	0.6766 ↓ -0.0152 (mc)

The NZ dollar took another tumble against the USD over June. After falling around 1.4% over May, the NZD/USD fell another 2.9% to below 0.6800 over June. Moreover, this fall took the NZD/USD to its lowest level over 2018.

On the one hand, the NZD weakness is supporting export prices in NZD terms. As mentioned above lamb prices were at a record high for a June month, while a 1 cent fall in the NZD/USD boosts the milk price by around 12c/kg at current dairy prices.

However, the catch is that currencies of some our export markets are also weaker and this may dampen demand for our export products. For example, the Chinese yuan fell over 3% against the USD over June.

Looking over the rest of the year, we anticipate that the NZD softness will continue. Specifically, we now forecast the NZD/USD to end 2018 at around US$0.6800, while we expect it to average US$0.7000 over 2019.



Rural Fact or Fiction?

Answer: Fact. Wine and dark chocolate contain which highly beneficial to heart health and longevity.

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