Farmshed Economics

Old truisms hold

June 2020

COVID-19 has changed the world. It has brought the most social disruption that majority of us have ever seen. Meanwhile, the economic consequences of this disruption have begun to play out. The economic recession will be deep and probably the largest for a hundred years. But the more things change, the more some old truisms hold. In NZ's case, it remains a comfort in being a food producer in uncertain times like these.

Indeed, looking at recent commodity prices, we are left with a general feeling that it could have been worse. Firstly, dairy auction prices have fallen this year, but prices have not plummeted anything like they did during the dairy downturn.

Nonetheless, it pays to be cautious on the outlook for the season ahead, and Fonterra's wide forecast range of $5.40-$6.90/kg is indicative of the current level of uncertainty. But we are sticking with our $6.50/kg forecast as we expect ongoing resilience in global food and dairy demand.

The kiwifruit sector is another example of resilience in food demand. Exports have started the season very strongly, well up on 2019. Importantly, prices have lifted on the previous season, over and above the boost from the weaker NZD.

Meanwhile, meat prices are turning a corner. The worst of the local drought is over and processing capacity is slowly increasing. Meanwhile, we expect underlying global meat demand to hold up and thus for meat prices to rebound over the second half of 2020.

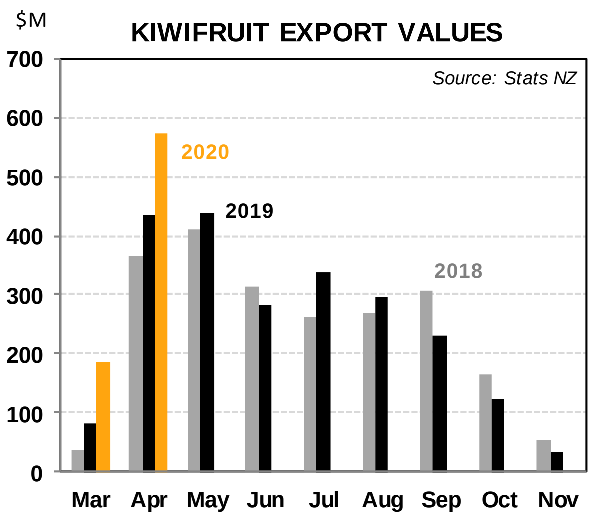
Turning to financial markets, interest rates have tumbled to record lows. Moreover, we expect that rates will remain at or near these record lows over the remainder of the year and beyond as the Reserve Bank pulls out all the stops to boost the economy. To date, the NZ dollar has also been helpfully low. Although we note that it has crept higher from its March lows, and if anything, it could drift a little higher from here.

Key Rural Data:

As at 22 May 2020	Current	3 mths ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	90.2	105.8	105.7	→
Lamb Price Index (NZD)	103.1	110.2	114.9	↗
Beef Price Index (NZD)	84.5	84.3	93.3	↗
Fruit Price Index (NZD)	120.4	122.5	109.9	→
Interest Rates:				
90-day bank bills	0.25	1.14	1.705	→
2-year swap	0.16	1.05	1.53	→
5-year swap	0.23	1.11	1.66	→
Exchange Rates:				
NZD/USD	0.6086	0.6346	0.6521	↗
NZD/CNY	4.34	4.46	4.51	→
NZD/GBP	0.4992	0.4896	0.5126	→
Milk solids production (ytd % chg]**	0.5	0.5	2.6	→
Fonterra Shareholders' Fund	3.61	3.99	4.21	→

*Direction of change over the next 6 months. **As at April 2020.

Chart of the Month:



? *Rural Fact or Fiction?*

Barley was used to set the standard for the measurement of an inch.

Answer on page 3

Author: Nathan Penny – Senior Rural Economist

Rural Commodities Outlook

Dairy – Eyes wide open

Dairy Index (USD), 22 May:	90.2 ↓14.7 (qpc)

On 21 May, Fonterra set its opening 2020/21 milk price forecast range at a wide $5.40-$6.90/kg, reflecting the heightened uncertainty from COVID-19. Fonterra noted that "COVID-19 adds significant uncertainty into the process of forecasting what will happen to global dairy prices over the next 15 months." Indeed, the $1.50/kg range is considerably wider than last season's opening range of $1.00/kg.

Our forecast of $6.50/kg is towards the top of Fonterra's range. However, we agree with the cautious approach that Fonterra has taken at this juncture. In particular, we have noted there is a risk that the milk price could dip below $6.00/kg and have regularly suggested farmers prepare for this contingency.

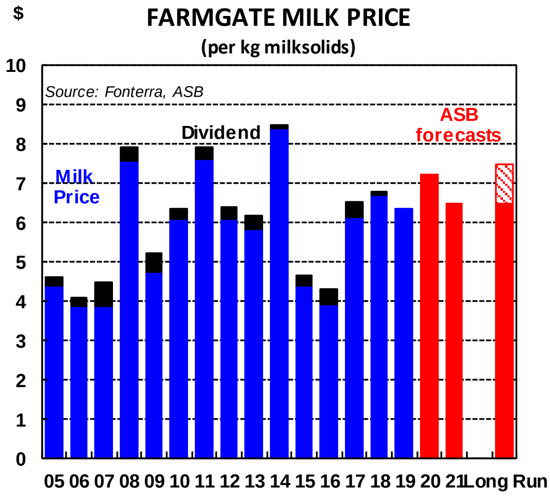
Looking at 2019/20, unsurprisingly Fonterra has reduced and narrowed its forecast range to $7.10-$7.30/kg. Fonterra notes that the revision is "in response to a softening of demand relative to supply which is pushing down prices." We have moved to adopt the $7.20/kg midpoint of the forecast range at this late juncture of the season.

While we share and endorse the cautious approach to the new season, we have noted signs of strength returning to global dairy markets. Indeed, we get the sense that dairy auction price falls could have been worse over recent months. Alas, we will need to see further evidence via strengthening prices to make the call that the worst of COVID-19 is behind us.

Season End Milk Price* Forecasts:

	2019/20		2020/21	
	Fonterra	ASB	Fonterra	ASB
Milk Price*	$7.10-$7.30	$7.20	$5.40-$6.90	$6.50

* per kg of milk solids (excluding dividend)



Lamb – Turning the corner I

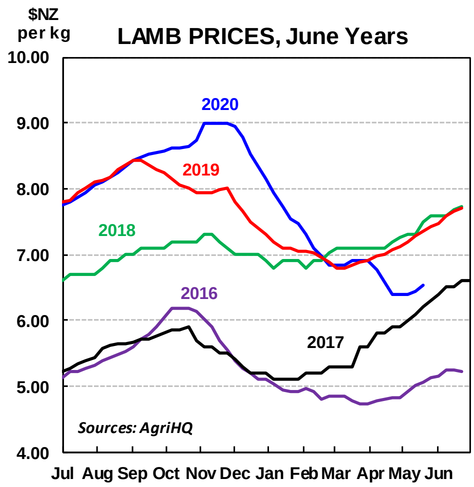
Lamb Index (NZD), 22 May:	103.1 ↓6.4 (qpc)

After tough first half of 2020, lamb prices look to be turning the corner. Prices have tentatively lifted 2.0% over the past two weeks.

While the price gain has been modest to date, the change in outlook gives us confidence that prices have turned. Notably, the worst of the drought is behind us (with the exception of perhaps Hawkes Bay). The peak slaughter has also passed, and thus processing capacity is starting to free up. Finally, as more countries lift lockdown restrictions global demand is set to rise.

On top of these short-term factors, underlying demand remains firm. In particular, African Swine Fever continues to crimp global protein supply and thus demand for NZ meat will remain firm.

All up, we expect relatively healthy lamb prices over the second half of 2020. Although we doubt that prices will challenge the record highs set over late 2019.



Beef – Turning the corner II

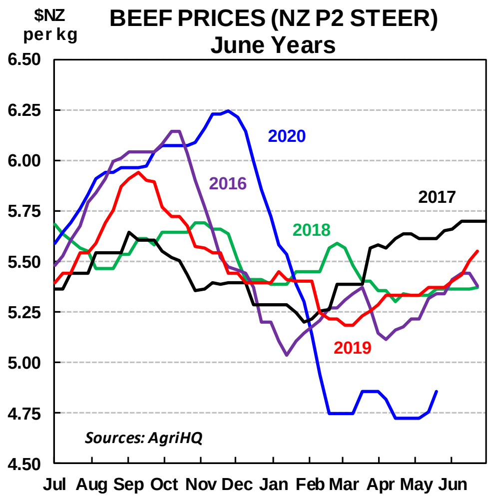
Beef Index (NZD), 22 May:	84.5 ↑0.2 (qpc)

After tough first half of 2020, beef prices also look to be turning the corner. Prices have tentatively lifted 2.8% over the past two weeks.

While the price gain has been modest to date, the change in outlook gives us confidence that prices have turned. Notably, the worst of the drought is behind us (with the exception of perhaps Hawkes Bay). Processing capacity is also gradually starting to free up. Finally, as more countries lift lockdown restrictions global demand is set to increase.

On top of these factors, a beef shortage has emerged in the US on the back of COVID-19 supply disruptions. Combining this situation, with the ongoing African Swine Fever supply issues, means that demand for NZ meat will remain firm.

All up, we expect beef prices to recover over the second half of 2020. Indeed, we anticipate that prices will head back to near their average levels over the past five years.



Rural Commodities Outlook (continued)

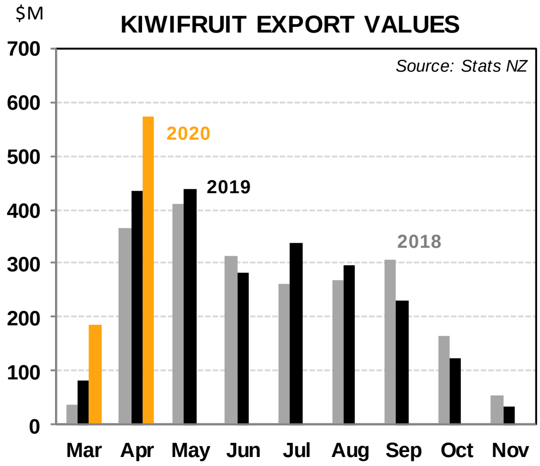
Kiwifruit – Excellent start

Kiwifruit Export Values, Apr & Mar:	$572m ↑ 32% apc

Kiwifruit exports have continued their excellent start to the season. Season to April export values were $572m, up 32% on the same stage a year ago. Meanwhile, gold export prices are tracking strongly, posting a 19% gain over the two months to date compared to a year ago. Notably, while the 7% fall in the NZ dollar (in trade-weighted terms) explains some of this strength, the bulk of the gain owes to strong demand.

However, we retain some caution. The global economy is in recession and the fallout will extend through the year, if not into 2021. Moreover, the gold crop is up 17% on 2019 and this extra volume may prove hard to move later in the season.

Nonetheless, this excellent start to the season has led us to upgrade our view. Zespri's OGR guidance for 2020 is $9.50-$11.00 per tray – we now favour the midpoint of this range. Meanwhile, we retain our optimistic view on the green OGR (Zespri's range is $5.00-$6.50 per tray) and favour around the $6.00 per tray mark.



Financial Markets Outlook

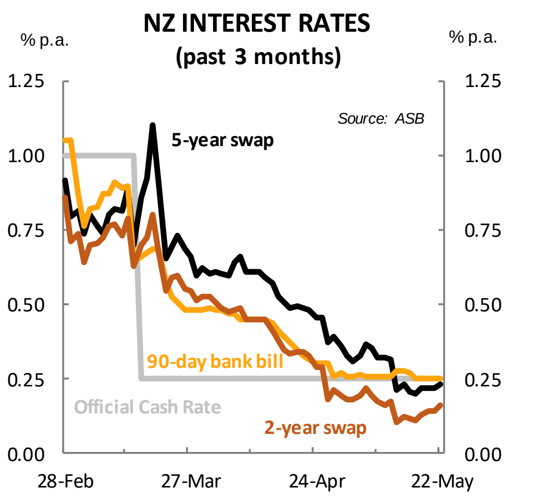
Interest Rates – Gamechanger

90-day bank bills, 22 May:	0.25% ↓0.89 (qc)

COVID-19 has proved to be a gamechanger for markets and has seen interest rates plummet. Central Banks around the world have pulled out all the stops to avert the most severe downturn since the Great Depression.

In NZ, recall that the Official Cash Rate (OCR) was cut to a record low of 0.25% in mid-March. On March 23 the RBNZ also introduced a $30bn Large Scale Asset Purchase programme (i.e. Quantitative Easing), that has subsequently been increased to $60bn. This, and the RBNZ not ruling out OCR cuts into negative territory, saw NZ interest rates hit record lows recently.

Over the next few years we expect NZ interest rates to remain near or at historically low levels. We have forecast for NZ wholesale interest rates to gradually drift higher off record lows as the NZ economy moves past the crisis stage. However, NZ interest rates could move lower again if COVID-19 causes a more prolonged economic recession.



NZ Dollar – Wild ride

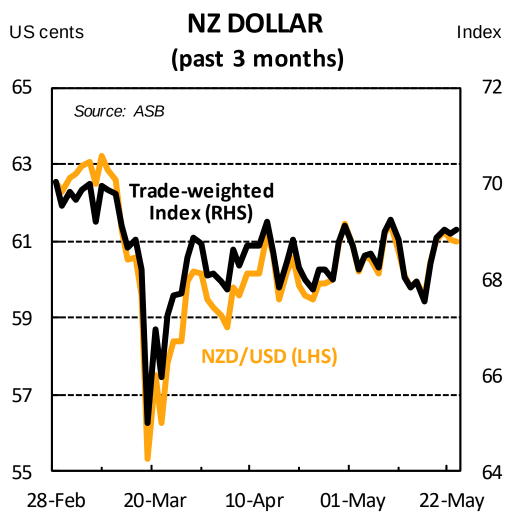
NZD/USD, 22 May:	0.6086 ↓ -0.0260 (qc)

The NZD has had a wild ride over the early part of the COVID-19 crisis. At one stage the NZD slid to around 55 US cents, before actions by NZ and global central banks helped restore some calm.

More recently, the NZD has recovered some lost ground. Indeed, at around 62 US cents, it is near where we'd expect it to be.

The near-term NZD outlook depends on COVID-19 developments in NZ and abroad. NZ looks to have addressed the health challenges better than most, while the Chinese economy and broader commodity prices have firmed. Although, in the current environment, ongoing bouts of financial market and currency volatility are possible. Further heightening of tensions between China and the US, could push the NZD lower.

In the medium term, we expect the NZD to rise against most currencies. The NZ economic recovery, our high Terms of Trade, more food-centric export mix, and eventual recovery in global growth will be key supports.



Rural Fact or Fiction?

? *Answer:* Fact! In 1324, King Edward II set the standard for the measurement of an 'inch' equal to 'three grains of barley, dry and round, placed end-to-end lengthwise'.

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