Farmshed Economics

Shot in the arm

March 2017

The meat sector has had twin shots in the arm. Last month, it was lamb prices receiving a boost. This month, it is beef prices' turn. Beef's boost comes from a somewhat unlikely source, Brazil. There, a corruption scandal has done serious damage to the food safety image of what is the world's largest beef exporter. However, Brazil's loss, in part, can be NZ's gain.

On the back of the Brazilian meat scandal, we now expect beef prices to remain high over 2017. In fact, prices may challenge record highs at some stage this year. With several countries placing import bans on Brazilian beef, demand for NZ beef will rise this year, particularly from China. While some countries have since lifted their bans, it will take a while for Brazil to regain consumers' trust. In the meantime, NZ beef can fill some of Brazil's gap.

Meanwhile, lamb prices have kicked on following last month's gains. Driving prices higher are very low slaughter rates, with farmers holding on to stock as feed is plentiful. There has also been some good news on the demand front, with the announcement of Chinese approval for chilled lamb imports from NZ.

Turning to dairy, this summer and autumn so far have been good, with rain and moderate temperatures helping farmers recoup some of the early season production losses. However, this higher-than-anticipated production has led dairy prices lower. As a result, we have revised our 2016/17 milk price forecast down by 50 cents to $6.00/kg, but have retained our $6.75/kg forecast for 2017/18.

Wool prices have recovered some lost ground, but remain low. From here, we are hopeful that prices can drift higher over the year.

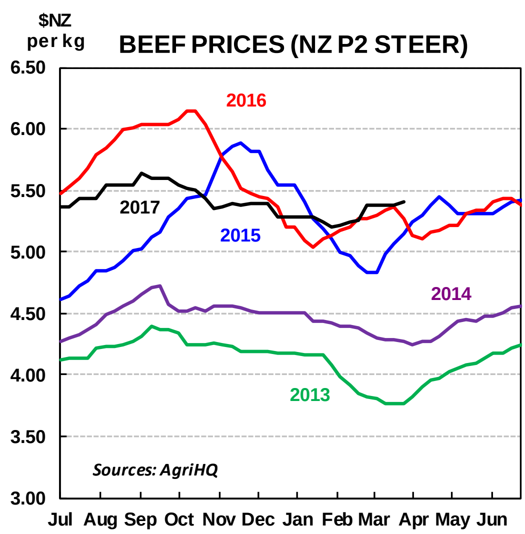
In financial markets, we expect most interest rates to largely track sideways over the next six months or so. In particular, we expect the Reserve Bank to remain on hold for the foreseeable future. Meanwhile, dairy prices have led the NZD lower. Offshore factors also remain in play. In particular, US President Trump will continue to keep markets, and the USD (and NZD), on tenterhooks.

Key Rural Data:

As at 24 March 2017	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	184.6	194.7	127.6	↗
Lamb Price Index (NZD)	179.5	168.4	151.5	→
Beef Price Index (NZD)	268.1	252.2	240.4	↗
Wool Price Index (NZD)	88.6	86.9	131.5	→
Interest Rates:				
90-day bank bills	1.98	1.99	2.33	→
2 year swap	2.36	2.36	2.30	↘
5 year swap	2.97	2.99	2.62	↗
Exchange Rates:				
NZD/USD	0.7029	0.7204	0.6797	↘
NZD/CNY	4.84	4.95	4.40	↗
NZD/GBP	0.5636	0.5778	0.4694	↑
Milk solids production (ytd % chg]**	-2.6	-2.9	-2.6	↗
Fonterra Shareholders' Fund	6.15	6.36	5.90	→

*Direction of change over the next 6 months. **As at February 2017.

Chart of the Month:



Rural Fact or Fiction?

? The population of Ireland has yet to recover from the Irish potato famine.

Answer on page 3

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Please refer to the important disclosures at the end of this document

Rural Commodities Outlook

Dairy – Double-edged sword

ASB Dairy Index (USD), 24 Mar: 184.6 -5.2% (mpc)

This summer and autumn so far have been good for the key NZ dairying regions. In fact, rain and moderate temperatures have helped farmers recoup some of the early season production losses. For example, this month we lifted our production forecast for the season to a 2% decline on last season, from as much as a 5% drop forecast at one stage.

However, higher production is a double-edged sword. That is, the more-than-anticipated milk quickly translates into lower dairy prices. For example, whole milk powder (WMP) prices have fallen 19% over 2017 as markets have absorbed this extra (unanticipated) milk.

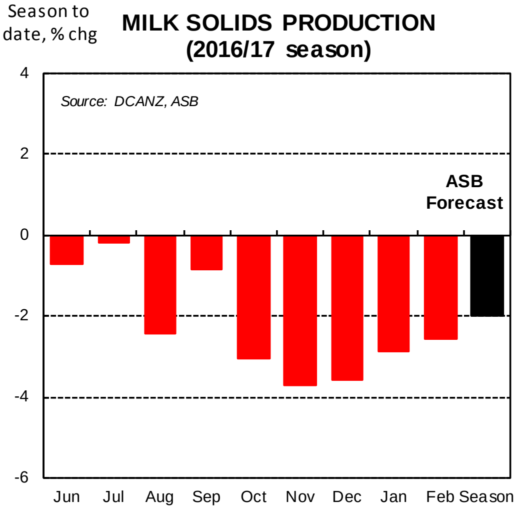
That all said, weather can only have a temporary impact on production and prices – eventually dairy fundamentals kick back in. On that front, we retain our positive outlook for the milk price over the medium term. And with the global dairy outlook positive, we expect relatively healthy global dairy prices over the second half of 2017 and beyond.

In that sense, we expect the milk price to take a detour downwards in the short-term i.e. this season, but our healthy forecast for next season remains in place. As a result, on 8 March we revised our 2016/17 milk price forecast down by 50 cents to $6.00/kg, but retained our $6.75/kg forecast for 2017/18. All up, we maintain our positive dairy sector outlook.

Season End Milk Price Forecasts:

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

* per kg of milk solids (excluding dividend).



Lamb – The grass is greener

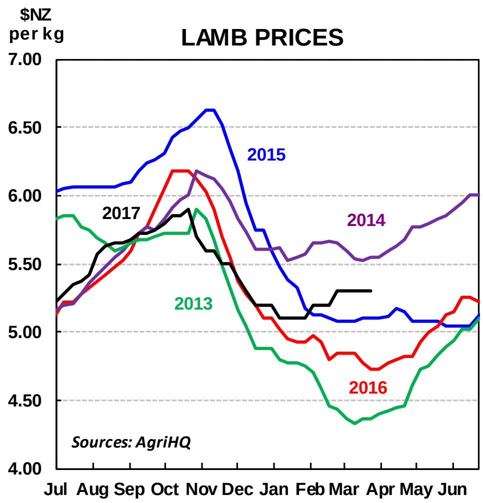
Lamb Index (NZD), 24 Mar: 179.5 6.6% (mpc)

Lamb prices have kicked on following last month's gains. Moreover, prices continue to widen the gap compared to this time last season. For example, the per kg price for a 17.5kg lamb currently sits 12% higher than a year ago.

Driving prices higher are very low slaughter rates. Farmers are holding on to stock as feed is plentiful. This is particularly evident in places like the Hawkes Bay as this time last year feed was scarce and farmers destocked.

As a result, we think some of the current price strength may fade over time. For example, low slaughter rates now are likely to lead to some catch up later on.

For prices to remain higher for longer, we also need to see demand lift. In that regard, there has been some good news following the announcement this month of Chinese approval for chilled lamb exports. This deal has the potential to add additional value to what is already our largest market by volume.



Beef – Operation Weak Flesh

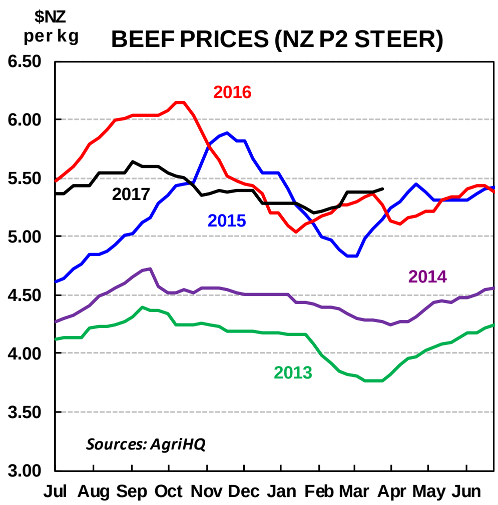
Beef Index (NZD), 24 Mar: 268.1 6.3% (mpc)

We've changed our view on beef prices – in the short-term, we expect prices to spike higher. Prices may even challenge the magical $6.00/kg mark.

Moreover, we expect prices to remain higher for longer. Previously, we thought prices would drift lower over the second half of 2017. In contrast, we now expect prices to remain healthy throughout the year.

The change in view comes as the world's largest exporter, Brazil, is racked by a scandal involving its two largest meat companies. Brazilian police, in a sting with the codename 'Operation Weak Flesh', accused meat inspectors of taking bribes to allow sales of rotten and salmonella-tainted meats.

Following the scandal, countries including China, South Korea, Japan as well as the EU have placed import bans on Brazilian beef. While China, for example, has since lifted its ban, the damage to Brazilian beef's reputation has already been done.



Rural Commodities Outlook (continued)

Wool – Down, but not out

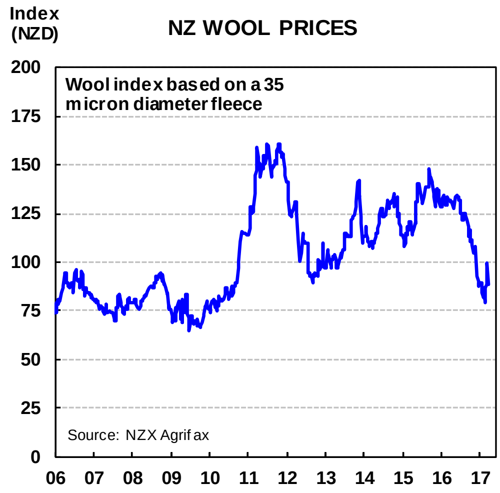
Wool Index (NZD), 24 Mar: 88.6 ↑1.9% (mpc)

Wool prices have recovered some lost ground, but remain low. For example, since February wool prices (as based on a 35 micron fleece, see chart) have bounced around 12%. However, this only partially reverses the circa 33% fall between mid-2016 and February 2017.

Indeed, wool's relative cheapness has stimulated demand. In particular, compared to other textiles NZ wool is good buying. AgriHQ reports that this fact has seen some Western European buyers return to the market.

The NZD has also started to play ball a little. For example against the USD, the NZD has fallen around three cents (4%) since wool prices hit their February bottom.

From here, we expect prices to drift higher. As well as better demand at these price levels, relatively tight supply should continue to underpin wool prices. However, prices are lightly to remain below the average level over recent years.



Financial Markets Outlook

Interest Rates – Rinse and repeat

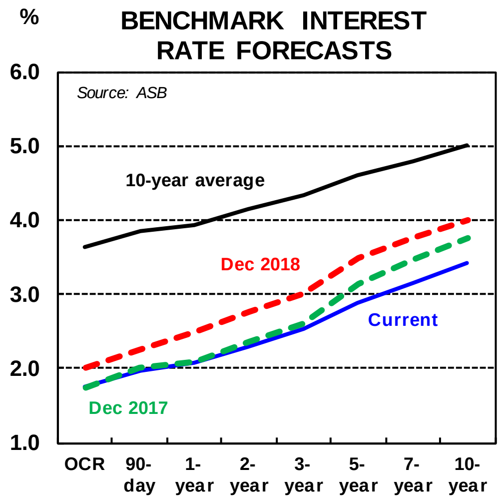
90-day bank bills, 24 Mar: 1.98% ↓ 0.01 (mc)

This month's interest rate commentary is a rinse and repeat of last month's. Namely, over the next six months or so, we expect most rates to largely track sideways. In particular, we expect the Reserve Bank (RBNZ) to remain on hold for the foreseeable future.

The RBNZ effectively repeated that itself earlier this month. "Monetary policy will remain accommodative for a considerable period." In other words, the RBNZ expects to keep the Official Cash Rate at 1.75% at least over 2017, but potentially over 2018 and into 2019 as well.

Meanwhile, offshore factors may push longer-term rates higher, but that may not be until later in the year. In particular, our longer-term rates are likely to reflect moves in US interest rates.

On that front, we expect the US Federal Reserve to lift its benchmark rates twice more this year. The US economy is gradually improving, with that fact highlighted by the Federal Reserve's decision to hike its rate this month and to signal further hikes later this year.



NZ Dollar – Trumped

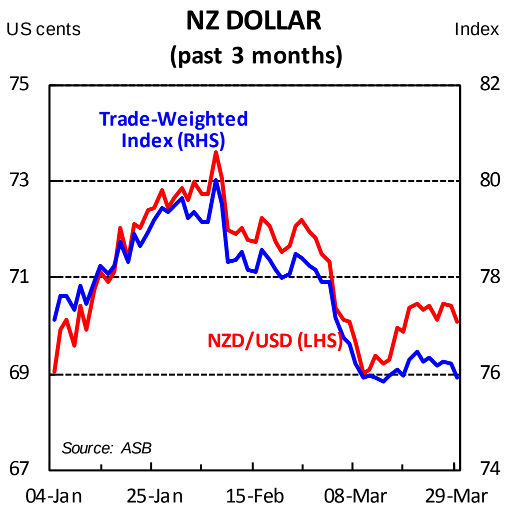
NZD/USD, 24 Mar: 0.7029 ↓ -0.0175 (mc)

Since the last edition of Farmshed Economics, the NZD has dipped against most currencies. For example, on a trade-weighted basis, the NZD has fallen around 3% over the month.

On the NZ side of the equation, lower dairy prices have led the NZD lower. As mentioned in the dairy section, whole milk powder prices (WMP) have fallen around 19% this year. Indeed, much of that fall came at the 7 March auction where WMP prices slid over 12%.

Meanwhile, offshore factors are also in play. For example, the US Federal Reserve lifted its benchmark rate over the month, making holding US dollars more attractive for investors.

Moreover, currency markets will continue to swing around on US President Trump's policy announcements. Given the failure to pass of his recent healthcare reform bill, his tax plans may run into similar roadblocks. Either way, Trump will continue to keep markets, and the USD, on tenterhooks.



? **Rural Fact or Fiction?**

Answer: Fact! Ireland's population pre-famine was over 8 million; it now stands at around 6.5 million.

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