Farmshed Economics

COVID-19: what we know and what we don't

March 2020

Stay safe, stay well and kia kaha!

From the team at Farmshed Economics

COVID-19 is changing our world. The social impact has parallels with war time, while it's likely that the economic impact will be largest seen in most people's lifetimes. Comfortingly though, many aspects of farming will stay the same. However, in a number of other aspects, we are venturing into the unknown.

Let's start with what we do know.

Agriculture (read food production) has been classified as an 'essential business'. In other words, farmers can be confident that they will remain open for business in almost any circumstance during the COVID-19 outbreak.

Similarly, the supply chains that agriculture feeds into have also been classified as essential. Accordingly, farmers can be relatively confident that their food is going to be processed and shipped to markets both domestically and offshore. However, in many cases, there may be delays and extra costs involved.

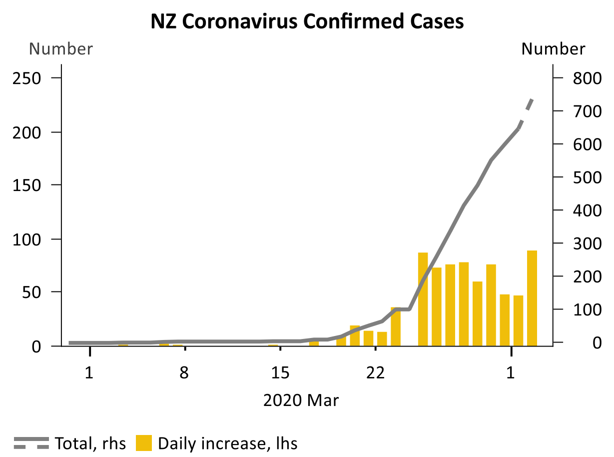
Encouragingly, farmers can also expect that there will be a base level of demand for their food production. Households in NZ and abroad will continue to eat. In fact, demand for staple and relatively affordable foods may even rise.

Meanwhile, governments and central banks are pulling out all the stops to alleviate the worst impacts of the outbreak. One notable upshot of this for farmers is that interest rates are likely to be helpfully lower for longer.

So what don't we know?

Crucially, we don't know with any certainty where global food prices will settle. The greatest uncertainty lies in the demand for foods for which NZ was previously commanding premiums for. The horticulture sector is case in point. Successful varieties and NZ brands developed over years like rocket apples, gold kiwifruit and sauvignon blanc risk becoming luxuries that some households can no longer afford.

Chart of the Month



Source: Macrobond, ASB

*As at 2 April 2020

Similarly, we don't know which of our markets will hold up and which ones will struggle. We are more confident that the Chinese and some other Asian economies will rebound sooner than most and that this will provide some food demand over and above the base level. However, we suspect that the US and European economies are going to struggle with very low growth for an extended period, giving little impetus for food demand and prices from these markets.

The outbreak is also likely to flare up sporadically. Global income growth and thus food demand is likely to be similarly uneven and is likely to lead to renewed food price volatility.

This means the forecasts in this edition are subject to change. Accordingly, it pays to be prepared for range of outcomes. Indeed, we believe that adaptability will be a key attribute that farmers will need to call upon over coming years.

Kia kaha translates to 'be strong'. Maybe in terms of the health of our farms we should also be striving to 'be flexible' as well?

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

The 'Spanish Flu' is named as such as Spain was the epicentre of the outbreak.

Answer on page 3

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Rural Commodities Outlook

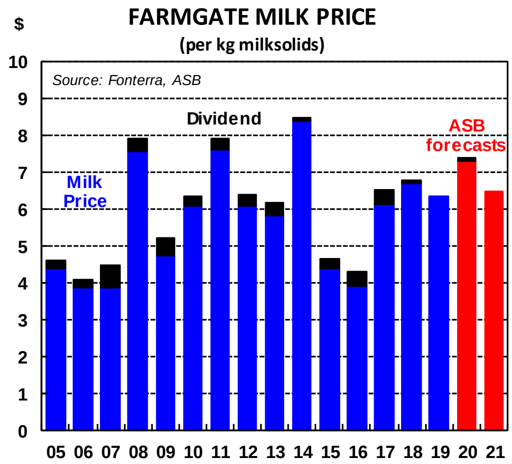
Dairy – 19/20 forecast holding firm; 20/21 lowered

Dairy Index (USD), 27 Mar:	96.7 ↓-4.1 (qpc)

Season End Milk Price* Forecasts:

	2019/20		2020/21
	Fonterra	ASB	ASB
Milk Price*	$7.00-$7.60	$7.30	$6.50

* per kg of milk solids (excluding dividend)



Despite steep auction price falls over February and March, we've held our 2019/20 milk price forecast relatively firm. Indeed, we've made just two minor 10c revisions this year, from $7.50/kg down to $7.30/kg as it stands.

For a start, Fonterra's announcement that its exports were still making it to market, albeit with delay, was encouraging. During the height of the outbreak in China, Fonterra stated that "there has been a slow-down in processing [however] our product is [still being] cleared by… officials."

The season is also near its end, so the milk price is largely locked in. Meanwhile, the large NZD/USD fall offsets some of the auction price falls.

In contrast, looking to 2020/21, we are heading into the unknown. Indeed, COVID-19 has changed the world, including global dairy markets.

As per the theme of this edition, we take some comfort in that the dairy sector has been classified as 'essential'. In this sense, the dairy sector will remain 'open for business' at a level approaching normal. Moreover, the global demand for dairy staples is likely to be resilient, so there is likely to remain a base level of global dairy demand.

Turning to our 2020/21 forecast, there are many moving parts. Initially, we anticipate that the helpfully low NZD/USD can offset any lost demand over and above the base level and the subsequent dairy price weakness.

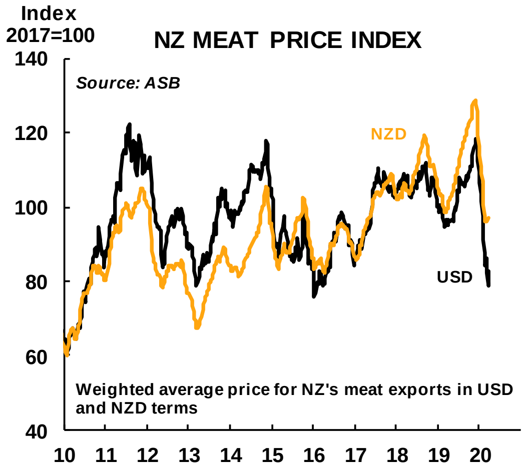
Looking further into the season, the question becomes will this dynamic hold? If anything, we are relatively more cautious on the outlook for demand and prices. And on this basis, we have lowered our milk price forecast from $7.50/kg to $6.50/kg.

There is one thing we are sure about. COVID-19 has brought dairy price volatility back to dairy markets. Back in late 2019, we stated that price volatility had reduced structurally. Sadly, this view no longer holds.

With the return of price volatility, we flag the risks around our new 2020/21 forecast. Indeed, a significantly wider range of milk prices is possible for the season than would have been the case pre-COVID-19. Accordingly, we believe it pays to be prepared a range of milk prices, including the possibility of a sub-$6.00/kg result.

Beef & Lamb – Rough ride

Meat Index (NZD), 27 Mar:	97.1 ↓-4.1 (qpc)



2020 has been a rough ride for the meat sector. Even before the COVID-19 outbreak, drought conditions were proving problematic for many parts of the country. Throw in the normal seasonal peak in slaughter and then the COVID-19-driven sharp fall in demand, and meat processors quickly ran short on both processing and storage capacity.

The impact of the above was two-fold. Farmers struggled to get away stock at a time when feed was at premium, leading to extra cost and tight cashflows. Secondly, meat have prices have fallen heavily since the start of the year. For example, weighted-average meat prices had fallen by around 30% in USD terms at one stage this year. The fact that meat prices finished 2019 at record levels and the large fall in the NZD/USD have, however, cushioned the impact of the price declines in farmgate terms.

Looking over the next three months or so, we anticipate that meat prices will stabilise. Rain has brought drought relief to many parts. Accordingly, this headwind on prices will begin to ease, albeit gradually given the COVID-19 restrictions on processing capacity. Similarly, as the Chinese economy gradually returns to normal, demand will get a temporary boost.

Looking to the spring and beyond, the meat price outlook is more uncertain. Key Chinese demand is likely to remain relatively firm, given the ongoing impacts of African Swine Fever and more normal growth in the Chinese economy. But demand from our other key markets (e.g. US and Europe) is likely to remain under sustained pressure over 2020 and well into 2021.

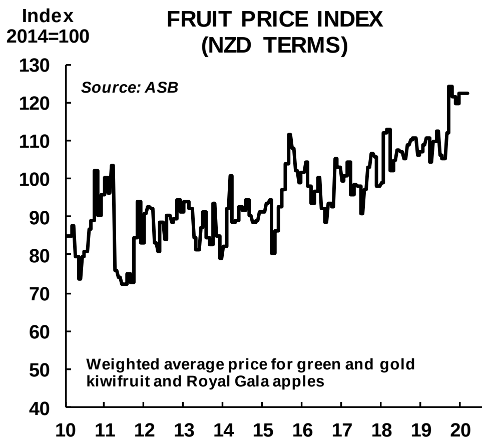
On this basis, we expect lamb prices to track near their five-year average i.e. around $6.00/kg. Meanwhile, we anticipate more downward price pressure in beef markets, and thus expect steer prices, for example, to track at below-average levels i.e. either side of $5.00/kg. At a more nuanced level, we anticipate that prices for mutton and other less expensive cuts are likely to fare better in comparison to other more expensive meats such as prime steaks or lamb racks. As in the dairy section above, we also flag the prospect of increased price volatility over coming seasons. Indeed, global demand is likely to wax and wane as both the COVID-19 outbreak flares up from time to time and as the global economic recovery comes in fits and starts.

Rural Commodities Outlook (continued)

Fruit – Premium pressure

Fruit Index (NZD), 27 Mar:	122.5 ↑2.2 (qpc)

The horticulture sector has been a real success story for NZ Inc. over recent years. Indeed, given the sector's growth we had begun to refer to horticulture as the 'fourth engine' of NZ's export sector. Key to the industry's success has been the development of new varieties, and the ability to extract premium prices for fruits such as gold kiwifruit, rocket apples, and, if we add viticulture into the mix, sauvignon blanc.



However, the world has changed. And with this change, premiums may erode. The COVID-19 outbreak will ultimately result in lower global incomes over 2020 and a slow drawn-out economic recovery in following years.

In this environment, households simplify their expenditure and look to extract maximum value for their dollar. They will still eat, but in a more conservative and affordable manner.

For fruit, this may mean households favour royal gala apples and green kiwifruit over rocket apples and gold (or red) kiwifruit, for example. The same principle is likely to apply for say sauvignon blanc relative to generic house wines. In turn, this may mean more resilient prices for cheaper varieties and steeper price falls or eroding premiums for the more expensive ones. In addition, higher gold kiwifruit production volumes this season, from new plantings coming online, are likely to put added pressure on gold prices over 2020.

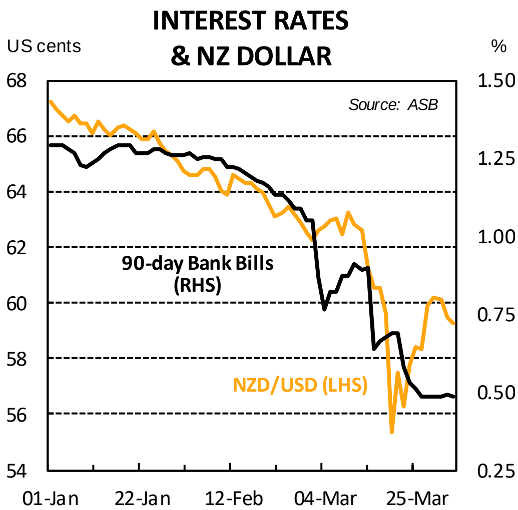
All up, this is likely to see horticulture growth slow over at least 2020 and 2021, particularly relative to recent record years. Nonetheless, while the 'fourth engine' may slow, it's likely to continue doing its bit to keep NZ's export plane flying.

Financial Markets Outlook

Interest Rates & NZ Dollar – Rates and NZD tumble

90-day bank bills, 27 Mar:	0.49% ↓-0.79 (qc)
NZD/USD, 27 Mar:	0.6019 ↓ -0.0681 (qc)

The COVID-19 outbreak sent financial markets tumbling over March. Global sharemarkets were particularly hard hit, but few financial markets were spared, with the exception of traditional refuges like gold.



As a result, global central banks collectively leaped into action over the month. The priorities for action, included providing economic stimulus via big cuts to interest rates and or so-called quantitative easing and relaxing some financial regulations. Central banks also moved quickly to assist the normal function of key financial markets.

The Reserve Bank (RBNZ) has been no different, throwing the proverbial kitchen sink at this unprecedented event. To list just a few of the RBNZ's measures: the OCR has been cut to its effective lower limit; quantitative easing has started for the first time ever in NZ; and, the much-talked-about bank capital requirements have been shelved for now.

The upshot for farmers is that interest rates have fallen to record lows across all terms. Further, rates are likely to remain lower for longer as the road to economic recovery post-COVID-19 is going to be long and slow.

Meanwhile, COVID-19 has also generated a steep fall in the NZD/USD. In fact during March, the NZD slid to its lowest level against the USD since 2009. The NZD also recorded significant falls against the euro and yen over the month.

The falling NZ dollar has provided a welcome boost or offset to weaker commodity prices. Indeed, dairy auction prices fell around 12% in USD terms over February and March, with the NZD/USD falling circa 7% over the same period.

Looking ahead, we expect the NZD/USD to gravitate towards US$0.60 or above. However, extreme currency market volatility in either direction is likely to continue in the weeks and potentially months ahead. With that in mind, there is a risk that the NZD offset to weak commodity prices won't always be there.

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~~Rural~~ Fact or Fiction?

Answer: False! World War I censors played down reported cases and deaths in Germany, the UK, France, and the US. However, the press was free to report the epidemic in neutral Spain. These stories created a false impression that Spain was especially hard-hit, thus giving rise to the name 'Spanish Flu'.

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