Farmshed Economics
Playing it safe

May 2016

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Sometimes playing it safe is the way to go. It seems that's how Fonterra has approached the new season's milk price forecast. It's also possible that the Reserve Bank takes a similar approach and keeps the Official Cash Rate (OCR) on hold on 9 June. For our part though, we expect the Reserve Bank to cut the OCR and that the milk price will lift from its low starting point over the course of the new season.

Fonterra played it safe with its opening season milk price forecast of $4.25/kg on 26 May. The forecast appears to be based off recent dairy prices, with no future price increases built in. For contrast, Westland set its opening some 50 cents higher.

This weaker than expected forecast keeps the squeeze on farm cashflows and is also likely to lead to a greater production decline over the new season. Lower production should translate into an extra boost for prices, so in a way, a lower milk price now, may result a higher milk price later.

While we expect the Reserve Bank to cut the OCR on 9 June, there is a clear risk that they too may play it safe. Recent data point to a cut, but the Reserve Bank may other things on its in mind. In particular, the hot local housing market and upcoming major offshore developments may give it reason to wait and see.

Meanwhile, meat prices have sprung back to life. In particular, lamb prices have woken from their long slumber, with the price of 17.5kg lambs jumping around 11.4% over the past month. Similarly, beef prices seem to have caught a second wind. On both fronts, it looks like the recent price gains have further to run over the rest of the year.

On a weaker note, feed grain prices have yet to find a bottom. Since the last time we wrote about feed wheat prices, prices have fallen another 6%. Moreover, we are yet to see any light at the end of the price tunnel.

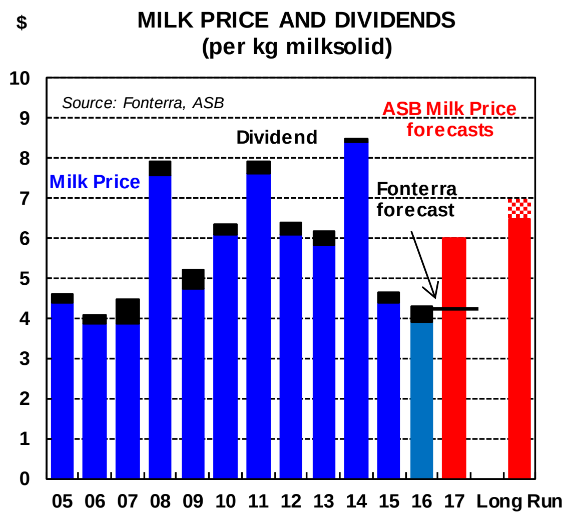
Lastly, we've lowered our NZ dollar forecasts against all major currencies, with the exception of the Australian dollar.

Key Rural Data:

As at 27 May 2016	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	131.0	133.4	149.5	↑
Lamb Price Index (NZD)	171.6	151.7	161.6	↗
Beef Price Index (NZD)	272.2	238.6	235.1	↗
Feed Wheat Prices ($NZ/tonne)	286.0	296.0	369.0	↘
Interest Rates:				
90-day bank bills	2.39	2.40	3.48	↓
2 year swap	2.30	2.30	3.43	↓
5 year swap	2.50	2.55	3.71	↘
Exchange Rates:				
NZD/USD	0.6698	0.6975	0.7314	→
NZD/CNY	4.40	4.52	4.53	→
NZD/GBP	0.4580	0.4773	0.4722	→
Milk solids production (ytd % chg]**	-1.7	-1.6	3.2	↘
Fonterra Shareholders' Fund	5.72	5.81	4.90	↗

*Direction of change over the next 6 months. **As at April 2016.

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

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Rural Commodities Outlook

Dairy – Playing it safe

ASB Dairy Index (USD), 27 May: 131.0 -1.8% (mpc)

Fonterra played it safe with its opening season milk price forecast of $4.25/kg. The forecast appears to be based off recent dairy prices, with no future price increases built in. Moreover, Fonterra doesn't appear to have built in much in the way of gains from a lower NZD. In comparison, Westland's milk price forecast range of $4.55/kg to $4.95/kg better reflects our and other commentators' views of the current price outlook.

Meanwhile, Fonterra reaffirmed the 2015/16 milk price at $3.90/kg. There was some respite for farmers, with Fonterra bringing forward 2015/16 retrospective payments. But all up, the combined announcements keep the squeeze on farm cashflows. Indeed, the low milk price forecast sends farmers a strong signal to keep focusing on lowering costs.

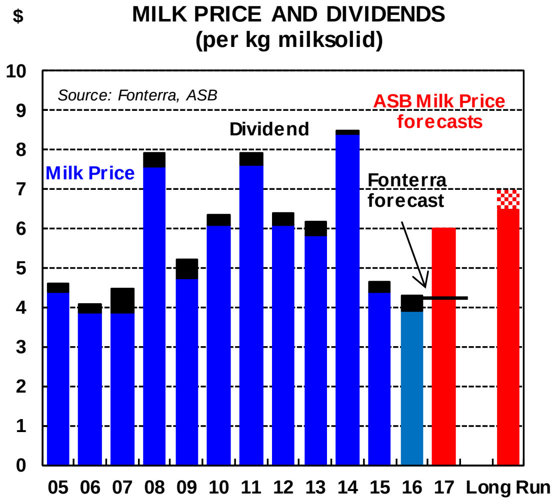
As a result, the weaker than expected milk price forecast is likely to lead to a greater production decline over the new season. We now expect production to fall 5% compared to this season, whereas based on a milk price forecast closer to $4.80/kg, we had expected a more modest 3% fall.

And this is the one silver lining, if there can be one; that is, a bigger NZ supply adjustment will reinforce the eventual uplift in global dairy prices. On this basis, we continue to expect a milk price of $6.00/kg by season end.

Season End Milk Price Forecasts:

	2015/16	2016/17		Long Run
	Fonterra/ASB	Fonterra	ASB	ASB
Milk Price*	$3.90	$4.25	$6.00	$6.50-$7.00

* per kg of milk solids (excluding dividend).



Lamb – Shot in the arm

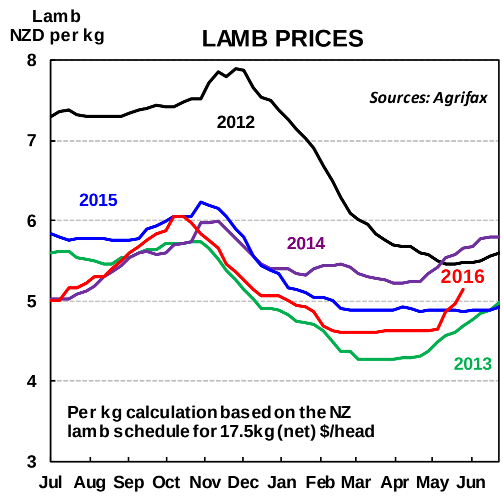
Lamb Index (NZD), 27 May 171.6 13.1% (mpc)

As we hinted at in last month's edition of Farmshed Economics, lamb prices are finally heading higher. For example, the price of 17.5kg lambs has jumped around 11.4% over the past month.

Moreover, this increase is on top of the normal seasonal increase we expect at this time of the year. Indeed, the 11.4% increase is over double the normal increase.

While, we have long fingered weakening NZ supply as likely to support prices, we can now add tightening Chinese domestic supply. Reportedly, Chinese lamb producers are now no longer receiving a 30% local premium on their meat. As a result, we expect local supplies to fall and for Chinese buyers to turn to NZ to fill much of the gap.

Tightening supply has certainly given prices a short-term shot in the arm. We are similarly bullish on the longer term, where we expect the deal to export chilled meat to China may provide longer-lasting support to lamb prices.



Beef – Second wind

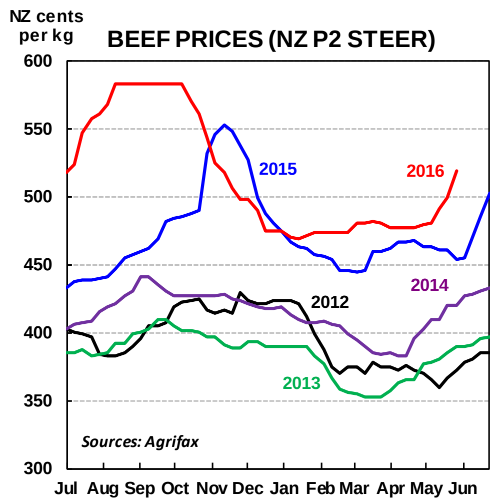
Beef Index (NZD), 27 May: 272.2 14.1% (mpc)

We may have sold beef prices a little short in last month's edition of Farmshed Economics. We indicated back then that we expected prices to merely remain high, when, in fact, prices seem to have caught a second wind.

Moreover, based on the speed of this increase, we expect prices can rise further from here. Feasibly, prices could lift another 5-10%, and thus we wouldn't rule out prices surpassing the record levels set back in Spring last year.

For now, it seems that the long-awaited rebound in US beef production is still in its infancy. Add in growing Chinese demand and it's likely that prices are unlikely to come off the boil in 2016.

Nonetheless, all good things do come to an end. However, on the basis of the above, that seems to be next year's story.



Rural Commodities Outlook (continued)

Grains – Price bottom proving elusive

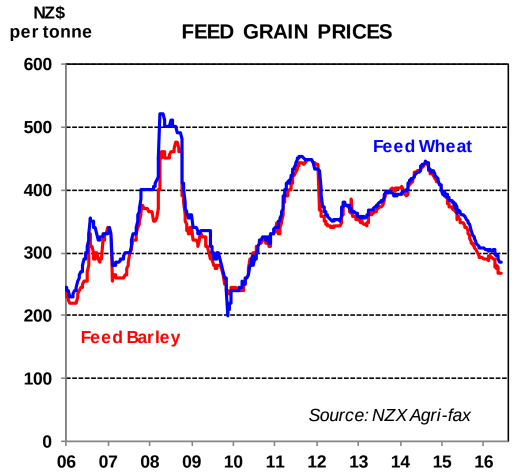
Feed Wheat, 27 May:	$286/tonne ↓ -3.4% (mpc)

Feed grain prices have yet to find a bottom. Since the last time we wrote about feed wheat prices back in January, prices have fallen another 6% with no end in sight.

We expect this price weakness to continue through this year. Global feed grain markets remain well-supplied. In particular, US inventory levels are very high. While demand via food and feed use may strengthen this year, we don't expect it to make a sufficient enough dent in stocks to force a price rise.

Locally, the demand news is weakening further. The continued weak dairy price outlook, combined with another expected drop in the size in the dairy herd, will constrain local demand for feed through the new dairy season.

All up, we expect feed grain prices to weaken further over the rest of the year. With this in mind, a price bottom is proving elusive and may have to wait until 2017.



Financial Markets Outlook

Interest Rates – Playing it safe II

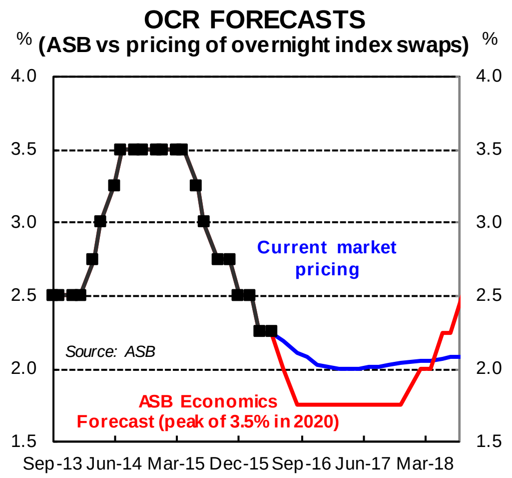
90-day bank bills, 27 May:	2.39% ↓ -0.0100

We expect the Reserve Bank to cut the OCR on 9 June. And with markets in two minds about whether they will cut or not, a cut should see interest rates head generally lower. However, the 9 June decision is a very tight call between cutting or waiting until August.

All up we judge that recent events increase the need for lower interest rates. The shift is not dramatic, but it is a downshift nonetheless relative to the Reserve Bank's previous forecasts. Indeed those forecasts indicated a further OCR cut was required.

On the flipside, the Reserve Bank may prefer to wait and see the results of key events, such as the British vote on EU membership and the US Federal Reserve interest rate decision, before acting. Moreover, the RBNZ may be worried that lower interest rates may further stoke the housing market fire.

If the Reserve Bank prefers to "play it safe", interest rates would creep marginally higher on the day. Either way, it's a very close call.



NZ Dollar – With a little help from our friends

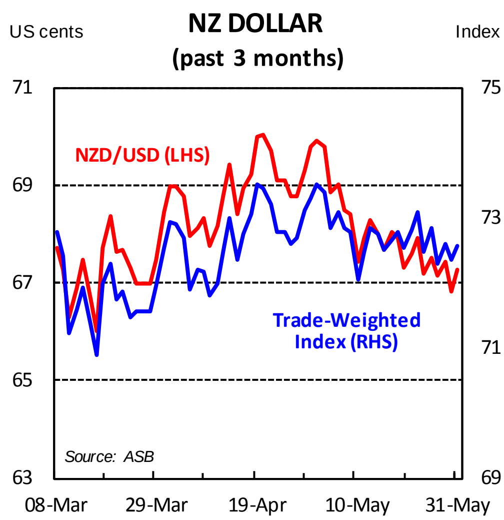
NZD/USD, 27 May:	0.6698 ↓ -0.0277 (mc)

The NZD has softened a little of late. In fact, since the last edition of Farmshed Economics the NZD has shed over two cents against the Greenback (USD).

First up, our cousins across the ditch have helped lower the NZD. The Reserve Bank of Australia cut its interest rate, and in turn lowered the AUD. And on the back the falling AUD, the NZD heading lower in tandem.

Secondly, some US Federal Reserve officials have helpfully indicated that US interest rates may rise soon, contrary to market expectations. This led to markets factoring in earlier US interest rate hikes, taking the USD higher relative to most currencies, including the USD.

As a result, we have revised down our NZD forecasts. Over 2016, we expect the NZD to trade around US$0.67 or US$0.68 before lifting to $US0.73 by the end of 2017. We have also revised down our NZD forecasts against the other major currencies, except the AUD.



Rural Fact or Fiction?

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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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