

Farmshed Economics

Spanner in the works

May 2018

ASB

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Mycoplasma Bovis (M bovis) is proving a real spanner in the works for parts of the rural sector. However, with the phased eradication plan now in place, farmers can begin to turn their attention to how they adapt. In many cases, change will be necessary and in the case of livestock tracking, some would say long overdue. Context is also important. Indeed, putting M bovis to one side, the rural outlook remains very strong. As such, we remain confident in the long-term rural prospects.

The dairy sector is case in point. On the one hand, M Bovis is causing uncertainty and adding to costs. For example, the industry share of the response costs equates to around 15c/kgMS. And potentially that's just for starters. Long-term changes to farm systems could lead to a more material lift in costs. On the other hand, the dairy price outlook is very strong. The new season has started with a hiss and a roar as evidenced by Fonterra's bullish opening season forecast of \$7.00/kg.

Meanwhile, the potential M bovis impact on the beef sector seems to have been a little lost in all the headlines. MPI reports at the current juncture 28 of the 70 restricted places are either beef or sheep & beef properties.

Turning to beef markets, we anticipate the impact from M bovis on prices is likely to be small. The slaughter of 126,000 head represents less than 3% of NZ's annual total. Also NZ is a relatively small beef exporter, so swings in beef production overseas and changes in demand have the dominant impact on beef prices.

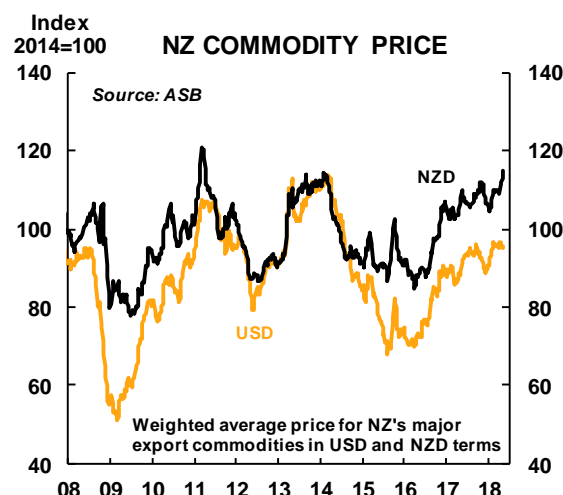
Looking at other sectors, the kiwifruit and lamb sector continue to post record highs. For starters, the 2018 gold kiwifruit has come in at a record high, up 25% from 2017. Moreover, we anticipate a record high for industry export revenue this season. Meanwhile, lamb prices remain very healthy. For the third month in a row, our data suggest that lamb prices were the highest ever recorded during a May month.

Key Rural Data:

As at 1 June 2018	Current	5 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	94.1	92.4	93.7	↗
Lamb Price Index (NZD)	125.8	119.9	106.4	→
Beef Price Index (NZD)	109.3	106.4	113.5	↘
Est. Gold Kiwifruit Crop, m trays, 2018	66.0	N/A	52.0	↗
Interest Rates:				
90-day bank bills	2.01	2.02	1.95	→
2-year swap	2.22	2.29	2.21	↗
5-year swap	2.65	2.77	2.70	↗
Exchange Rates:				
NZD/USD	0.6983	0.7085	0.7141	↗
NZD/CNY	4.48	4.49	4.86	→
NZD/GBP	0.5232	0.5142	0.5542	↘
Milk solids production (ytd % chg)**	-0.9	-1.3	-0.7	↗
Fonterra Shareholders' Fund	5.21	5.72	6.00	→

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

Chart of the Month:



Rural Fact or Fiction?

My grandmother told me that drinking a warm glass of milk before going to bed would help me fall asleep. Apparently, though eating two kiwifruit an hour before bed will also help fall asleep quicker.

Answer on page 3

Rural Commodities Outlook

Dairy – Spanner in the works

Dairy Index (USD), 1 June: 94.1 ↑1.9% (mpc)

The dairy sector is caught in the middle of good and bad news.

On the bad news side, Mycoplasma Bovis is causing uncertainty and adding to cost. In terms of cost, what we do know is that industry share of the response costs equates to around 15c/kgMS.

And potentially that's just for starters. While short-term on-farm costs are likely to be manageable, potential long-term changes to farm systems could be more material. In particular, moves towards self-contained farms could change the dairy farm cost dynamics for many.

On the good news side, the price outlook is strong. The new season has started with a hiss and a roar and the 'spot milk price' is well north of \$7.00/kg, adding credibility to Fonterra's opening forecast of \$7.00/kg.

Currently, there are a number of factors supporting the milk price. For example, the acute global butter shortage, soft NZ production and the recent fall in the NZD/USD are all boosting the milk price forecast.

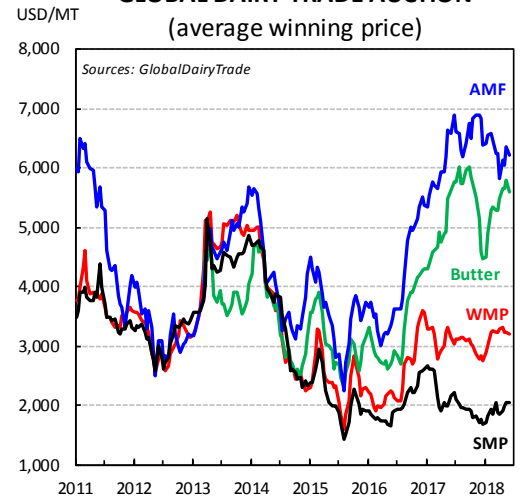
We also add Mycoplasma Bovis to list of price supports. In particular, the slaughter of dairy cows is likely to add to upward pressure on dairy prices over the next year. NZ is the world's largest exporter of whole milk powder and butter. With the cull dampening NZ production, global dairy prices are likely to be higher than would have otherwise been the case.

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).

GLOBAL DAIRY TRADE AUCTION (average winning price)



Lamb – High note

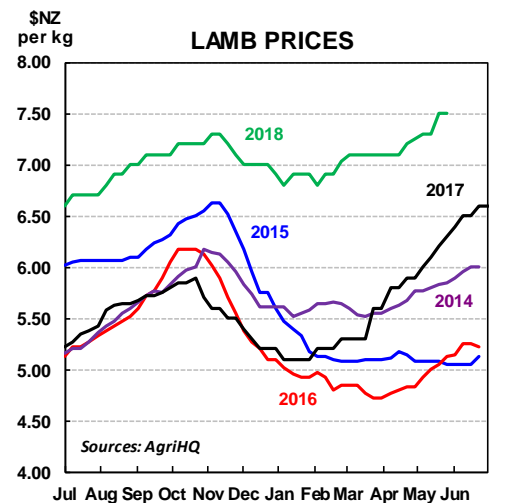
Lamb Index (NZD), 1 June: 125.8 ↑4.9% (mpc)

We are running out of superlatives for lamb prices. For the third month in a row, our data suggest that lamb prices were the highest ever recorded during a May month.

Meanwhile, lamb supply is tightening as the season draws to an end. On this basis, prices are likely to drift even higher in the short term.

Meanwhile, underlying demand remains solid. Indeed, all key export markets are paying 14% or more so far this season compared to last season. In particular, Chinese markets look robust, delivering not only higher prices but also a healthy 7% 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. The only question is when does consumer price resistance kick in. So far there is no real evidence that we have reached this point. As a result, lamb prices are likely to maintain their high note through 2018.



Beef – M Bovis impact on prices likely to be small

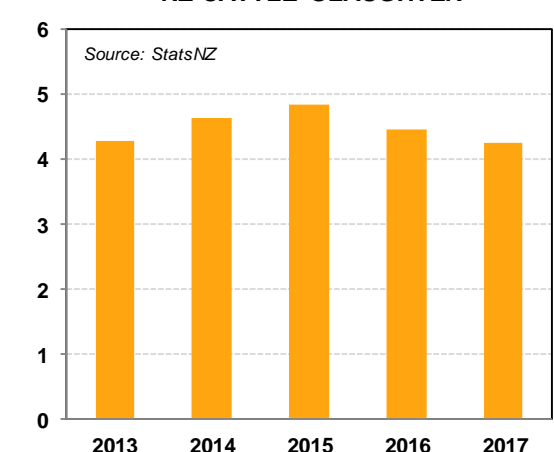
Beef Index (NZD), 1 June: 109.3 ↑2.7% (mpc)

The potential Mycoplasma Bovis impact on the beef sector seems to have been a little lost in all the headlines. However, a significant share of the restricted places have beef cattle; MPI reports that at the current juncture 28 of the 70 restricted properties are either beef or sheep & beef properties.

Across the sector, the impact is likely to be largest for farms heavily reliant on animal movements such as beef traders. As a result, some of these farms may need to make rapid changes to their trading model.

Turning to markets, we anticipate the impact from Mycoplasma Bovis on beef prices to be small over the next year. The slaughter of 126,000 cattle represents less than 3% of NZ's annual slaughter. Also NZ is a relatively small beef exporter so swings in beef production overseas and changes in demand have the dominant impact on beef prices. As a result, we expect beef prices to track at around current levels over the next six months.

NZ CATTLE SLAUGHTER



Rural Commodities Outlook (continued)

Kiwifruit – bumper 2018 crop

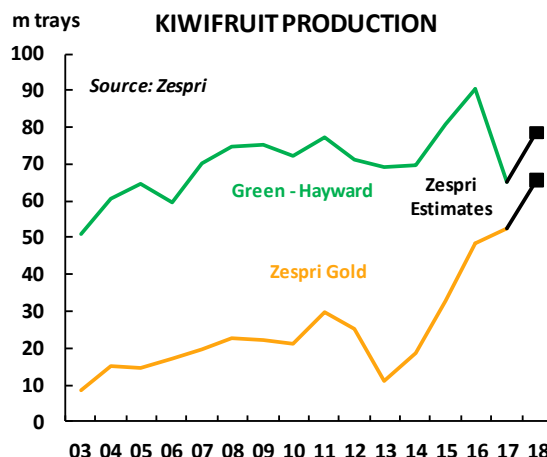
Est. Gold Crop, 2018: 66m trays ↑25% (apc)

The 2018 kiwifruit crop looks like it's going to be a bumper one. The gold crop is a record high, up an estimated 25% from 2017. The green crop also looks healthy, likely to be up by an estimated 21% with a little over half of the crop still to be packed.

In terms of price, we are bullish on gold prices, but a little more careful on green prices. For green (Hayward) and given the rise in supply, we anticipate an Orchard Gate Return (OGR, gross after packing costs) towards the bottom half of Zespri's forecast range of \$5.20 to \$6.20.

In contrast, we are more confident that export markets can bear the lift in gold supply. As a result, we expect a gold OGR closer to the top of Zespri's forecast range of \$9.40 to \$10.40.

Looking overall and with total production higher and the overall price firm, we anticipate record-high industry revenues for the 2018 season.



Financial Markets Outlook

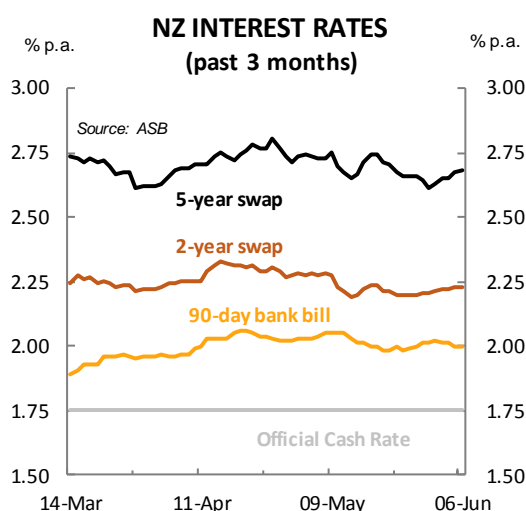
Interest Rates – Up or down

90-day bank bills, 1 June: 2.01% ↓ 0.01 (mc)

The new Reserve Bank (RBNZ) Governor, Adrian Orr, ushered in a new era over the month by clearly stating that the next Official Cash Rate (OCR) move could be “up or down”. For now though, the Governor expects to keep the OCR at the current 1.75% “for a considerable period of time.”

However, credit market pressures have acted against the RBNZ recently. These pressures have lifted 90-day bank bill rates, for example, by around 20 basis points since the start of the year. That said, credit market pressures are showing signs of easing. As a result, the RBNZ's stance and easing credit market pressures should help keep NZ short-term interest rates low for most of 2018.

By contrast, long-term interest rates may drift higher in line with rising global rates. In fact, we expect two more US Federal Reserve interest rate hikes this year on top of the hike back in March. All up and more broadly, we expect interest rates to continue to remain low by historical standards over the next six months.



NZ Dollar – May tumble

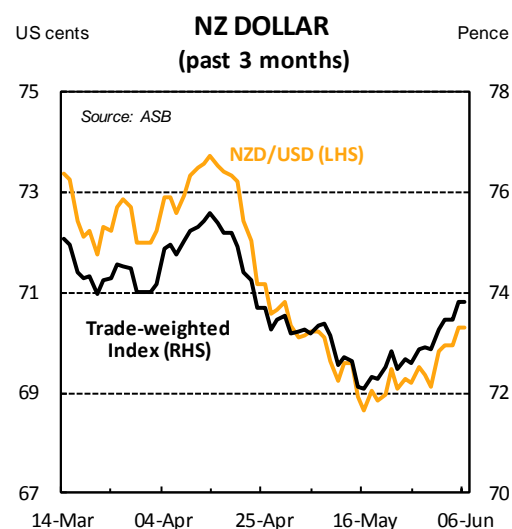
NZD/USD, 1 June: 0.6983 ↓ -0.0102 (mc)

The NZ dollar took a tumble against the USD over May. After approaching US\$0.74 in mid-April, the NZD/USD fell below 0.6900 during the month. Moreover, this fall took the NZD/USD to its lowest level over 2018.

Notably, the drop owes more to USD strength than it does to NZD weakness. The USD has strengthened as US interest rates have surged. For example, US 10-year Treasury yields broke through 3% for the first time in 4 years over May. Meanwhile, NZ interest rates have remained low.

The lower NZD is boosting commodity prices in NZD terms. For example, the low NZD made a sizeable contribution to Fonterra's bullish opening season milk price forecast of \$7.00/kg.

However, the commodity price boost from the NZD could prove temporary. Indeed, with NZ commodity prices firm, we expect NZD strength to return (the NZD has already climbed back to around US\$0.70 over the last week). On this basis, we expect the NZD/USD to average 0.72 over the remainder of the year.



Rural Fact or Fiction?

Answer: Fact. The kiwifruit also help you sleep more soundly and feel better rested when you wake up in the morning.

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