Farmshed Economics

He who dairies, wins

November 2021

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It increasingly looks like we are in for a record dairy season. We've lifted our milk price forecast to a whopping $8.75 kgms for the 21/22 season over recent weeks. After decelerating by more than expected over winter, dairy markets have done a 180. The 'supply response' we expected to relieve some of the pressure on prices looks unlikely to materialise in the near term. Its early, but our forecast would represent the highest milk price since Fonterra's founding.

Meat prices are also in good shape. As we predicted in our last *Farmshed Economics*, lamb prices burst through the record-breaking $9 mark during August and have continued to advance further. Beef prices aren't quite there yet but have also notched up sizeable year-on-year gains.

In short, commodity prices are still on the rise. The ASB Commodities Index reached an all-time NZD high at the beginning of October and has continued to move higher from there. Yet the most dramatic gains in commodity prices have been outside the agri-sector entirely. Energy prices have surged, with oil prices now up more than 70% on a year ago.

Labour pains and stretched shipping capacity remain big themes. Rather than the gradual return to normality that many hoped for, pandemic-era disruption continues to roil both the labour market and the logistics sector. The combo of strong commodity prices, surging freight costs and lofty wage pressures mean we now expect inflation to reach close to 6% towards the end of 2021.

Strong inflation and a tight labour market are a recipe for higher interest rates. Sure enough, the RBNZ has already bit the bullet and lifted the OCR for the first time in seven years. Further hikes look to be on the cards: wholesale and retail interest rate have already begun to lift in anticipation.

In short, the near term looks good for dairy, beef and lamb; but the outlook is more mixed for our other key agri exports. Our research suggests that meat and dairy are proving relatively resilient to freight disruption, while price gains should be sufficient to offset the impact of higher costs. For some other commodities though – think seafood, forestry, wine and some horticultural products – shipping challenges are proving to be more of an issue, and prices haven't risen all that much, or have even fallen.

Key Rural Data:

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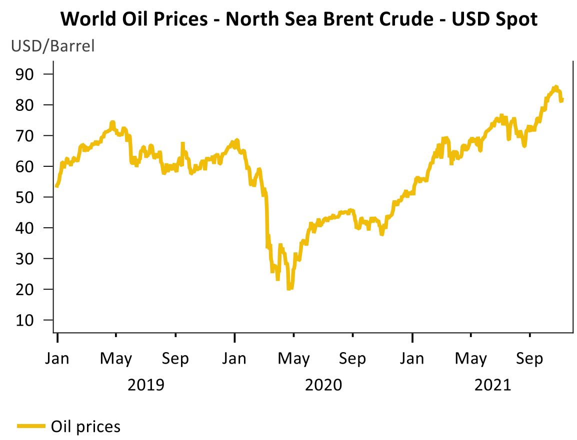
As at 29 October 2021	Current	3 mths ago	Year ago	Outlook
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	124.6	119.0	96.3	→
Lamb Price Index (NZD)	150.5	138.1	112.1	→↘
Beef Price Index (NZD)	116.3	105.5	95.9	→↘
RWI/ISL Container Throughput Index	108.9	107.2	104.1	→
Interest Rates:				
90-day bank bills	0.80	0.47	0.27	↗
2-year swap	2.26	1.04	0.00	→
5-year swap	2.63	1.42	0.10	→
Exchange Rates:				
NZD/USD	0.7155	0.6974	0.6661	→
NZD/CNY	4.58	4.52	4.45	→
NZD/GBP	0.5220	0.5071	0.5108	→
Milk solids production (std % chg]**	-3.1	1.6	2.9	
Fonterra Shareholders' Fund	4.00	3.75	4.60	

Outlook indicates direction over the next 6 months. *As at Sep 21

Chart of the Month:



Source: Macrobond, ASB

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Rural Commodities Outlook

Dairy – One for the history books

ASB Dairy Index (USD), 29 Oct: 124.6 ↑ 4.7% (qpc)

Over the last couple of months, the outlook for the dairy sector has shifted from 'great' to fantastic.' At the start of the season, we expected production to ramp up in response to strong global demand, relieving the pressure pushing up prices. But NZ production has been soft over spring, falling by 4% year-on-year in August and September.

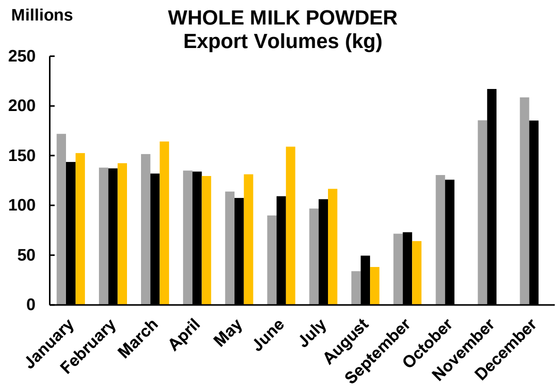
Buyers have taken notice of the tighter supply outlook, and the last handful of auctions have seen prices reverse their deceleration over winter. The futures market expects WMP prices to hold north of US$3,900/MT until end of the season. Though NZ production now seems poised to start ticking up, we expect the demand and supply balance will remain supportive. Our forecast for the 21/22 season now sits at a record $8.75 kgms.

What's more, our analysis shows that dairy export volumes are proving to be among the most resilient of NZ's major exports amid all the logistics disruption – a fact Fonterra has been eager to trumpet. WMP (the largest component of dairy exports) and cheese (where price gains have been the strongest) are up circa 9% and 11%, respectively, on pre-COVID levels. And given how strong price gains have been, they should more than offset the impact even if those shipping capacity constraints start to bite. All-up, the stage is set for record dairy sector revenue this year.

Season-end Milk Price Forecasts:

	2021/22	
	ASB	Fonterra
Milk Price*	$8.75	$7.90- $8.90

* per kg of milk solids (excluding dividend).



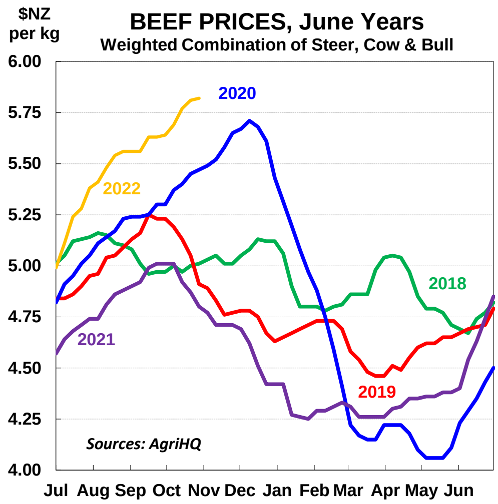
Beef – Our silver medallist

Beef Index (NZD), 29 Oct: 116.3 ↑ 10.2% (qpc)

The beef market hasn't been simmering as hotly as its ovine peer, but price gains over the past have been lofty, nonetheless. Our beef index – a weighted combination of steer, cow and bull – hit a record high in October. Prices are circa 22% up on where they were at this stage last season.

Competition for cattle among processors remains fierce and we expect prices to gain further in the near term. Underlying developments in the export market have been mixed but remain supportive. Aussie processing volumes are well below average, and US store volumes are down, despite the ramp-up in cow production. Meanwhile, China's embargo on Brazilian beef has caused a surfeit of product from the world's largest exporter but provides scope for NZ to expand its market in China.

Like dairy, our analysis shows that beef exports are also proving resilient to shipping disruption. Given the strength in prices, the stage is set for strong export sector revenue here too, though rising input costs mean farmers won't see all the benefit – margins are reportedly quite tight.



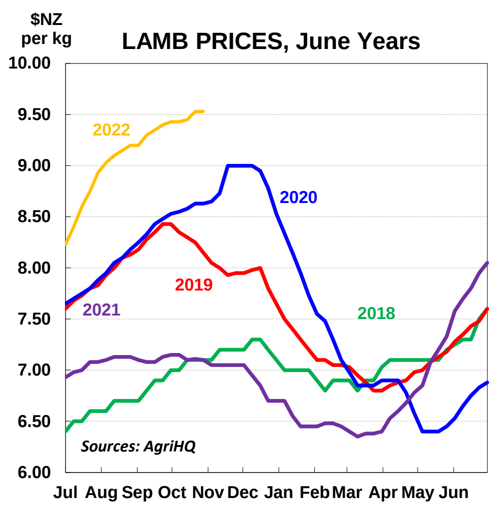
Lamb – Our gold medallist

Lamb Index (NZD), 29 Oct: 150.5 ↑ 10.2% (qpc)

Lamb slaughter prices hit a record high over winter. Tight supply and strong demand mean the outlook for lamb prices is even more constructive than that for beef. Orders for Chinese New Year are commanding strong prices. Broader forward export orders are also looking positive per AgriHQ.

Balanced against this strength in demand, near-term supply is looking tight across the board. NZ slaughter supplies are off to a slow start as the seasonal pick-up kicks off, while the Aussie lamb kill is way down. The upshot is that we expect only a modest seasonal drop in prices as we enter Autumn.

With the risk of sounding like a broken record, record export revenue is on the cards here too. Thus far lamb export volumes have been crimped by shipping issues – and closer to home, securing the skilled labour needed to produce those higher-end cuts remains a challenge, Still, those slightly softer volumes are set to be more than offset by record strength in prices. The flipside is that rising on-farm costs will eat a bit into margins here too.



Rural Commodities Outlook (continued)

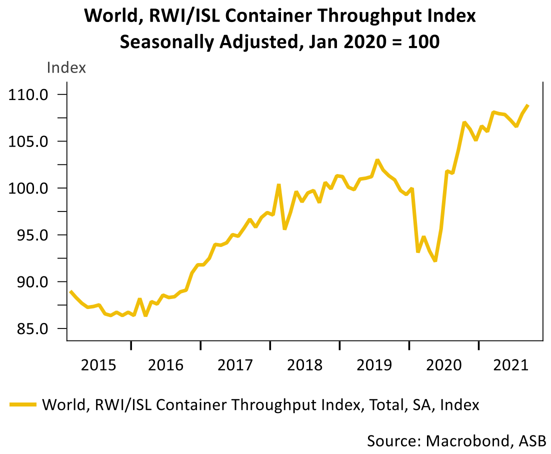
Shipping woes – All at sea

RWI/ISL Container Throughput Index, Sept:	108.9 ↑ 4.6% (apc)

Headlines around stretched shipping capacity, lengthy port delays and surging freight costs continue to dominate. Anxious noises have been emanating from exporters and importers in virtually every sector. Still, the impact on different agri commodities have been highly uneven.

The big behemoths of the NZ agri sector have generally proven pretty resilient. Dairy export volumes are up significantly on pre-COVID levels, accounting for a little variance (less skim milk powder and fats, more whole milk powder and cheese). Beef export volumes are in a similar position, and while lamb volumes have been hit more, strong price gains (+35% year-on-year) will more than offset the revenue impact. Well-cemented supply chains and strong partnerships – think Fonterra and Silver Fern Farm's relationships with Maersk via Kotahi – have helped the big players.

On the other hand, the smaller export sectors are getting hammered. Wine export volumes are down sharply – around 11% year-to-date – on last year, while apple volumes are down an even larger 13% over the same period. Seafood exports have recovered from their COVID-crash but remain 13% below pre-pandemic levels. What's more, for many of these sectors, prices aren't likely to gain enough ground to offset the revenue impact.



Financial Markets Outlook

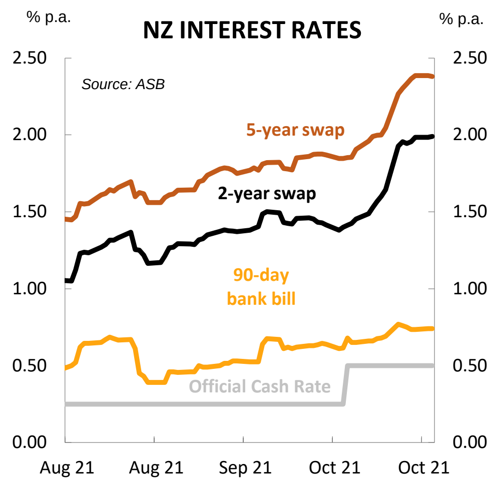
Interest Rates – Between time and tide

OCR, 29 Oct:	0.50% ↑ +0.25 (qc)

October was a watershed month in interest rate markets, with the RBNZ lifting the OCR for the first time in fully seven years. The Bank makes policy based on two goals: keeping inflation between the 1-3% mark and maintaining employment as close as possible to its maximum sustainable level over the medium term.

It's the former goal that the RBNZ's presently concerned about. Buoyed by strong commodity prices, lofty wage bills and surging freight costs, we expect annual inflation to peak well outside its target at the 6% mark towards the end of the year. The upshot is this that further hikes are coming and relatively quickly – the Bank won't want to wait.

Wholesale and retail rates had already begun to move ahead of the RBNZ's formal announcement, and the upward pressure has continued. As at the time of writing, the swap market sees the OCR reaching 2% in the middle of 2022, a shade more bullish than our own view.



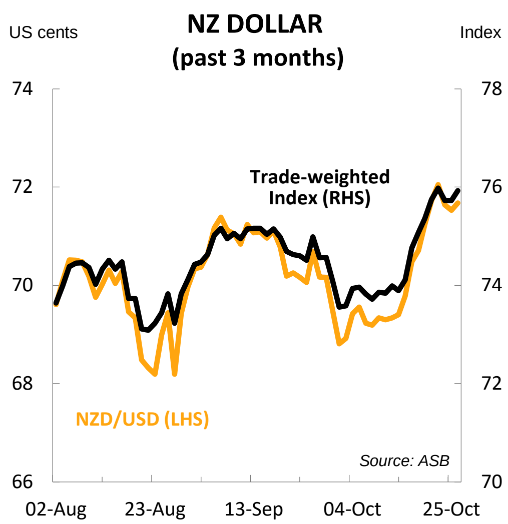
NZ Dollar – Stuck in the middle with U(SD)

NZD/USD, 29 Oct:	0.7155 ↑ +0.0149 (qc)

NZD/USD dipped to a nine-month low in the aftermath of the lockdown, but it's since firmed. As at the time of writing, NZD/USD is back near 0.72.

High commodity prices are a big part of the story – as prices for both hard (energy and metals) and soft (think meat and dairy) commodities have surged, commodity currencies (think AUD and NZD) have benefitted. Moreover, while the RBNZ has already begun hiking rates, other central banks – including the Fed – have been much more circumspect. The upshot means interest rate differentials continue to move in the NZD's direction.

Yet the NZD continues to trade in a lower range than those fundamentals would imply. For example, the last time agri commodity prices were this strong (in the 2013-2014 period), NZD/USD was trading above the 0.8000 mark. The underlying strength of the US economy, combined with periodic bouts of risk aversion, has meant NZD/USD has struggled to break above 0.7300. This dynamic has a bit longer to run, though increasingly we think the fundamentals will be strong enough to limit further dips below 0.7000.



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