Farmshed Economics

Trick or treat?

October 2018

The team at Farmshed Economics would like to wish all our readers a Happy Halloween. And to get into the Halloween spirit, we have sprinkled some Halloween parlance through this month's edition. Indeed, in rural and financial markets there are number of tricks and treats, mixed in with the odd skeleton or two.

Is strong dairy production a *trick or a treat*? On the whole, we land on the *trick* side of things as higher production is being more than offset by a lower milk price. For an average farm, we estimate recent forecast changes are likely to reduce farm incomes by around $20,000.

Meanwhile, the lamb sector is still firmly in *treat* territory. Prices have come off the boil, but they remain very high. And over the rest of the season, we expect prices to remain healthy.

For the beef sector, however, we view current firm prices as more of a *trick*. Over the next six months or so, we anticipate that strong US production will lead farmgate prices lower.

In comparison, coarse wool prices continue to struggle. Indeed, farmers continue to operate on *skeleton* prices compared to their historical averages. Mid-micron wool prices, however, are faring better. That said, we expect all wool prices to drift lower over coming months.

Meanwhile, benchmark interest rates remain near record lows. Moreover, we anticipate that rates will remain low over the coming six months. In this sense, interest rate markets have *candy* to spare.

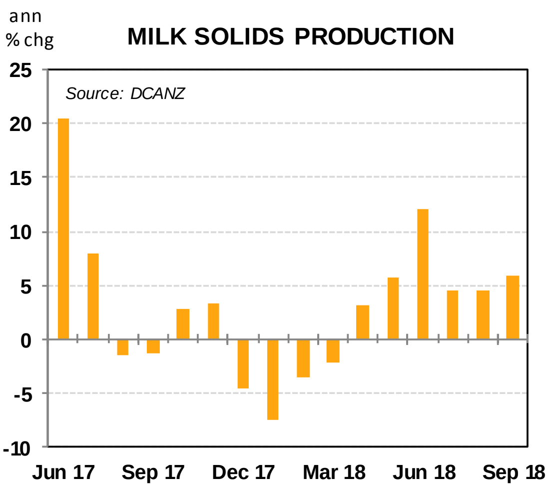
Lastly, the NZD has continued to trade a narrow range over the past three months. Looking ahead we anticipate that it will remain near current levels. Notably, the NZD has not been *spooked* by financial market volatility. Global sharemarkets, in particular, have posted large declines. For example, an index of global sharemarkets shows a circa 10% fall since around mid-September.

Key Rural Data:

As at 26 October 2018	Current	5 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	79.7	80.8	91.2	→
Lamb Price Index (NZD)	134.5	139.6	120.8	↘
Beef Price Index (NZD)	109.5	116.2	112.4	↘
Wool Price Index (NZD)	65.4	67.1	61.4	↘
Interest Rates:				
90-day bank bills	1.89	1.91	1.95	→
2-year swap	2.01	2.04	2.17	→
5-year swap	2.32	2.40	2.68	↗
Exchange Rates:				
NZD/USD	0.6512	0.6619	0.6966	→
NZD/CNY	4.52	4.55	4.61	→
NZD/GBP	0.5074	0.5079	0.5281	↗
Milk solids production (ytd % chg]**	5.6	5.4	-0.1	↓
Fonterra Shareholders' Fund	4.83	4.89	6.26	→

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

Chart of the Month:



? *Rural Fact or Fiction?*

We all know that tomatoes are fruit, but did you know that pumpkin is also a fruit?

Answer on page 3

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Rural Commodities Outlook

Dairy – Production trick or treat?

Dairy Index (USD), 26 Oct:	79.7 ↓ -1.4% (mpc)

The 2018/19 dairy production season has started with a hiss and a roar. Data published last week show that for the season to September, production is 5.6% ahead of last season.

Some of the reason for the healthy production numbers in annual change terms is that last season's growing conditions were so poor. Indeed, at different times last season, weather was either too wet or too dry in some parts. In contrast, this season so far, the weather and thus growing conditions have been favourable, helping production start strongly.

Farmers have also been in position to take advantage of the favourable weather. In particular, farm cashflows are positive. Accordingly, farmers are spending more on pasture maintenance (via fertiliser application) and on animal health. This spending is helping boost production per cow.

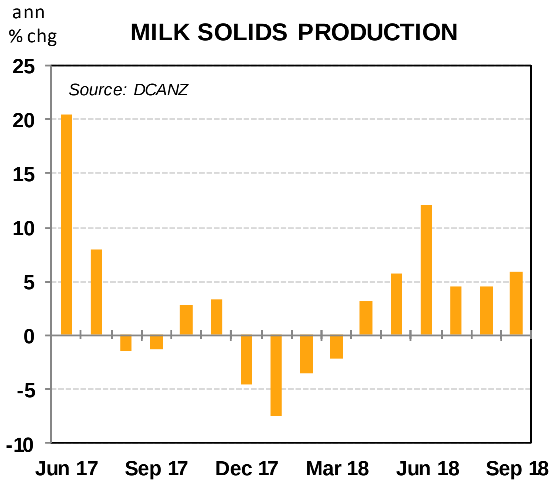
With all this in mind this month, we doubled our 2018/19 production growth forecast from 2% to 4%. Indeed, after three seasons of declining production, production is on track to set a new record high.

But extra milk also means a lower milk price forecast – this month, we also trimmed our milk price forecast by 25 cents to $6.25/kg. All up, the net impact of these forecast changes is negative. Looking at an average farm for example, the changes equate to a reduction in income of circa $20,000.

Season End Milk Price* Forecasts:

	2018/19		Long Run
	Fonterra	ASB	ASB
Milk Price*	$6.25-50	$6.25	$6.50-$7.00

* per kg of milk solids (excluding dividend).



Lamb – Treat

Lamb Index (NZD), 26 Oct:	134.5 ↓ -3.6% (mpc)

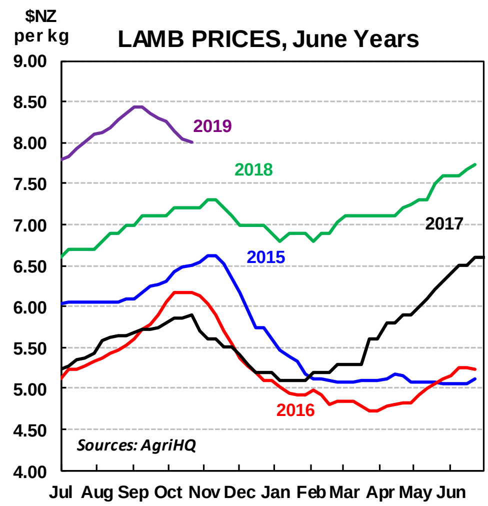
Lamb prices have moved from a boil to a simmer. After starting the month at $8.30/kg, prices have dropped by 30 cents/kg or 3.6%.

Nonetheless, prices remain extremely high. October prices averaged 11% above October 2017. Moreover, October prices were 29% higher than average previous over the previous five October months.

Looking over the rest of the season, prices also look set to remain healthy. Lamb supply is constrained both over in the Tasman and locally. Indeed, Beef+Lamb NZ estimates that this season's lamb crop will be nearly one million smaller than last season's.

Meanwhile, global demand remains firm. In particular, Chinese and US demand is solid where prices for the 2017/18 export season finished 18% and 21% up on 2016/17, respectively.

Although, we expect prices to moderate in line with the usual seasonal pattern, the 2018/19 season is shaping up as a healthy one for farmers.



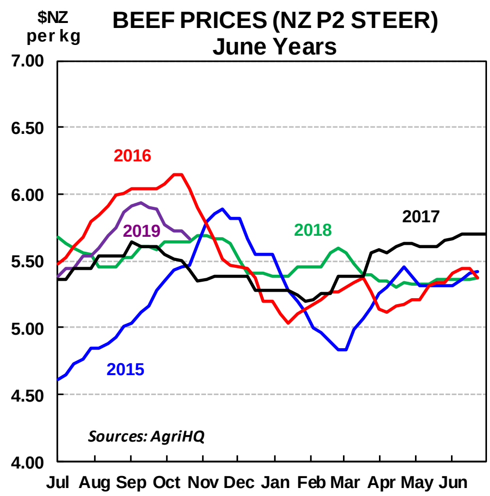
Beef – Trick

Beef Index (NZD), 26 Oct:	109.5 ↓ -5.8% (mpc)

As mentioned in previous editions of Farmshed Economics, we are wary of the outlook for beef prices. Indeed a month ago, beef prices were comfortably (5.6%) ahead of this time last year. However, this gap has now closed so that beef prices are effectively the same as a year ago.

First up, demand from the US – our largest beef export market – is soft. US production is strong and domestic US beef prices are plunging as a result. Add to the mix weak US chicken and pork prices, and we anticipate that soft US beef demand and prices are likely to persist into the new year.

At this juncture, the weak NZD is helping to cushion the blow. For example, the NZD/USD is around 5 cents or 7% lower than this time last year. But our expectation is that over the next six months the weak NZD won't be enough to offset weak world prices. As a result, farmgate prices (in NZD terms) are also likely to head lower too.



Rural Commodities Outlook (continued)

Wool – Skeleton coarse wool prices

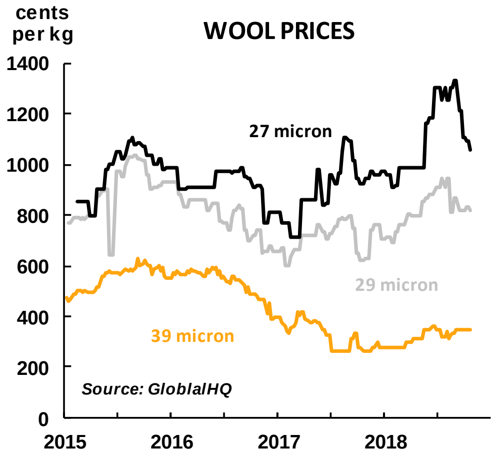
Coarse/Fine Index (NZD), 26 Oct:	65.4.1 ↓-2.6% (mpc)

Overall, coarse wool prices have fared a little better so far over 2018. In the 10 months to date, 39 and 37 micron wool prices have lifted 23% and 11%, respectively.

However, the outlook for coarse wool prices remains soft. Notably, prices remain low compared to historical averages. Indeed, despite the firm global economy over 2018, 39 micron wool prices remain stuck 21% below their recorded average (since the start of 2015).

Mid-micron wool prices are faring better. Prices have fared well over 2018 as healthy global growth has translated to higher demand for apparel. 29 micron wool prices have, for example, lifted 16% so far this year.

From here, we expect prices for all wool types to drift lower. The global economy is slowing a touch, notably in China. While mid-micron prices are likely to remain at healthy levels, coarse wool prices are likely to drift to near historical lows.



Financial Markets Outlook

Interest Rates – Candy to spare

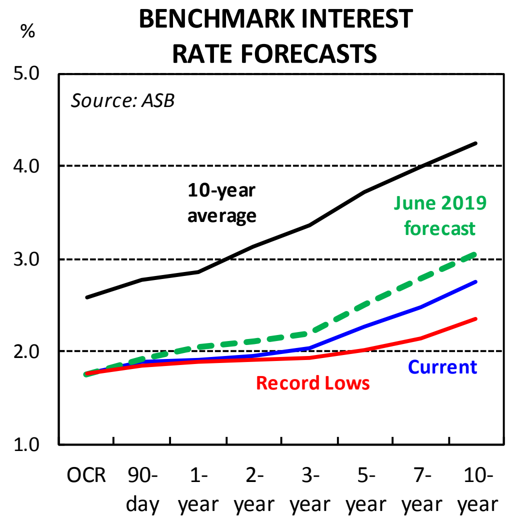
90-day bank bills, 26 Oct:	1.89% ↓ -0.02 (mc)

Benchmark interest rates remained at very low levels over October. In fact, the 1-year swap rate, for example, fell to just one basis point shy of the record low set back in August.

From here, we expect interest rates to largely tread water at these very low levels. For example, we anticipate that the Reserve Bank (RBNZ) will keep the Official Cash Rate (OCR) at its current level until early 2020.

Last month, we mentioned that benchmark interest rates could even head lower. However, that risk has receded somewhat after September quarter inflation came in at a higher than expected 0.9% for the quarter (1.9% in annual change terms).

Turning to the long-term outlook, we now anticipate long-run interest rates are likely to be lower than we previously thought. Specifically, we estimate that the neutral level of the Official Cash Rate is around 50 basis points lower than our previous estimate. If we are correct, this will help keep borrowing costs low for an extended period i.e. over the next 5 years.



NZ Dollar – Not spooked by sharemarket plunge

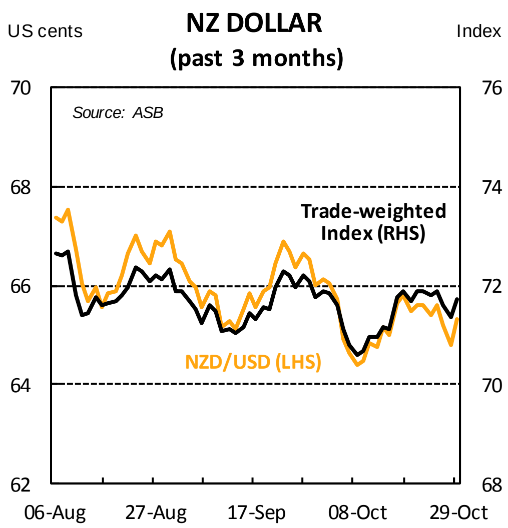
NZD/USD, 26 Oct:	0.6512 ↓ -0.0107 (mc)

The NZD has traded within a narrow range over October. Indeed, that has been the case over the past three months, with the NZD/USD trading between 0.644 and around 0.68.

Over the next six months, we expect the NZD/USD to continue to trade within this narrow range. Against a broader suite of currencies, we expect a similar trend, with the NZD likely to trade sideways for the most part.

Notably, the NZD has held up well, despite recent volatility in financial markets. Glboal sharemarkets, in particular, have posted large declines. For example, an index of global sharemarkets shows a circa 10% fall since around mid-September.

For now, the currencies under pressure are mainly in emerging markets. Brazil, Argentina and Turkey have seen their currencies slide. For the NZD to fall more, we will most likely need to see a broader economic slowdown, particularly in China. At this juncture, the likelihood of such a slowdown is low, albeit it is still a risk.



? **Rural Fact or Fiction?**
Answer: Fact. Pumpkin is a fruit as like tomatoes it's a product of the seed-bearing structure of flowering plants.

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