Farmshed Economics

Springs both ways

October 2016

This spring has been good and bad. Mainlanders have welcomed good spring growing conditions, particularly in Otago and Southland. Whereas in the north, there have been some cases of 'too much of a good thing'. That is, it has been wet, very wet, in the Waikato and the surrounding districts.

This 'big wet' has slammed the brakes on the dairy production in an area representing circa 40% of NZ's production. For example, Fonterra has reported that October milk collections in the Waikato are running 10% behind this time last season. Moreover, the likelihood that this production can be made up later this season is low.

The flipside of a weaker production outlook is firmer dairy prices. We expect that, with weak production largely locked in for the season, prices will continue to firm. As a result, we stick with our milk price forecast of $6.00/kg.

Also meat prices have been working both ways. Firstly, beef prices have remained healthy over recent months, despite predictions that they will moderate. In contrast, lamb prices have been falling behind recently. After tracking above last year's level over August, prices slipped below last year's in mid-September, where they have remained ever since.

Meanwhile, feed grain prices are showing signs of bottoming and are even beginning to hint at a lift. And while that's good news for growers, it is less positive for feed grain buyers.

The one-way bet on interest rates may also be drawing to a close. We expect that interest rates are nearing their bottom. At the same time, we also caution that interest rates have the potential to rise in the not too distant future.

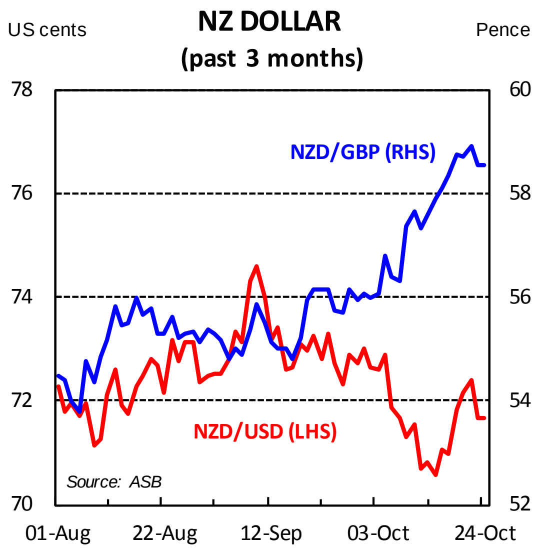
Lastly, the Pound has been under the pump as the Brexit fallout continues. In early October, the Pound sustained its biggest intraday drop since the Brexit referendum on 24 June. For NZ, lamb and wine exports are most vulnerable to a weaker pound.

Key Rural Data:

As at 21 October 2016	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	174.3	172.6	164.6	↗
Lamb Price Index (NZD)	191.0	173.7	200.9	↘
Beef Price Index (NZD)	256.3	245.7	284.0	→
Feed Wheat Prices ($NZ/tonne)	274.0	272.0	318.0	↗
Interest Rates:				
90-day bank bills	2.12	2.24	2.86	↘
2 year swap	2.13	2.12	2.78	↘
5 year swap	2.36	2.29	3.08	→
Exchange Rates:				
NZD/USD	0.7168	0.7270	0.6812	→
NZD/CNY	4.85	4.85	4.33	→
NZD/GBP	0.5858	0.5591	0.4413	→
Milk solids production (ytd % chg]**	-0.8	-2.4	2.5	↓
Fonterra Shareholders' Fund	5.90	5.85	5.32	↘

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

Chart of the Month:



~~Rural~~ Rugby Fact or Fiction?

? The All Blacks actually have a few more games to go before they set the record for the most consecutive wins.

Answer on page 3

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Rural Commodities Outlook

Dairy –Too much of a good thing

ASB Dairy Index (USD), 21 Oct:	174.3 ↑1.0% (mpc)

Sometimes it appears you can have too much of a good thing. And this spring it has been a case of too much rain. In particular it has been wet, very wet, in the Waikato and other parts of the North Island.

This 'big wet' has slammed the brakes on the production in an area representing circa 40% of NZ's production. For example, Fonterra has reported that October milk collections in the Waikato are running 10% behind this time last season. Moreover, the likelihood that this production can be made up later this season is low.

For us, this development is the confirmation that NZ production will fall hard this season. We have forecast a 5% nationwide decline compared to last season. And on this basis, we expect dairy prices to continue their rise over the season.

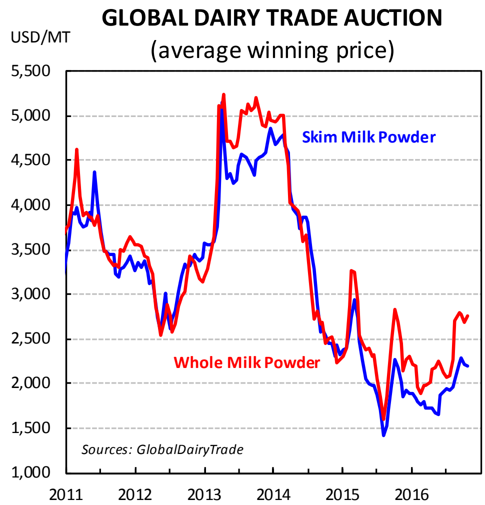
Dairy markets, however, need a little more convincing. While markets appreciate that a drought can stunt production, wet weather hurting production is a harder sell.

Accordingly, we expect markets will wait for data over the next month or two to confirm weak production before bidding prices higher again. All up, we continue to expect a finalised milk price of $6.00/kg for 2016/17.

Season End Milk Price Forecasts:

	2016/17		2017/18	Long Run
	Fonterra	ASB	ASB	ASB
Milk Price*	$5.25	$6.00	$6.50	$6.50-$7.00

* per kg of milk solids (excluding dividend).



Lamb – Falling behind

Lamb Index (NZD), 21 Oct:	191.0 ↑9.9% (mpc)

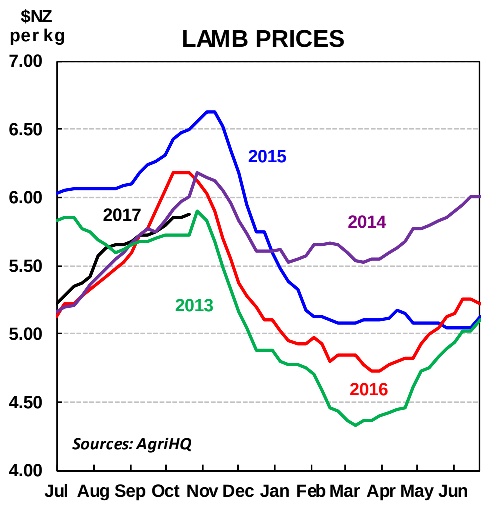
Lamb prices have been falling behind recently. After tracking above last year's level over August, prices slipped below last year's in mid-September, where they have remained ever since.

Also, prices look set to remain sub-$6.00/kg this spring. Indeed, while the seasonal peak may still be a week or two away, it's unlikely that between now and then prices will break through that threshold.

At this stage, we await for more price data to give us a feel for Brexit's impact. Our expectation is that prices weaken as UK demand falls and as NZ lamb becomes more expensive on the back of the weaker Pound. This Brexit impact is likely to dominate the short-term lamb market outlook.

Moreover, the NZD continues to do no favours. In particular, the NZD has strengthened a further 3% against the Pound since the last edition of Farmshed Economics.

All up, we expect prices to soften in the short term. Looking to later this season, we expect falling lamb production to begin to underpin prices.



Beef – Echo boom

Beef Index (NZD), 21 Oct:	256.3 ↑4.3% (mpc)

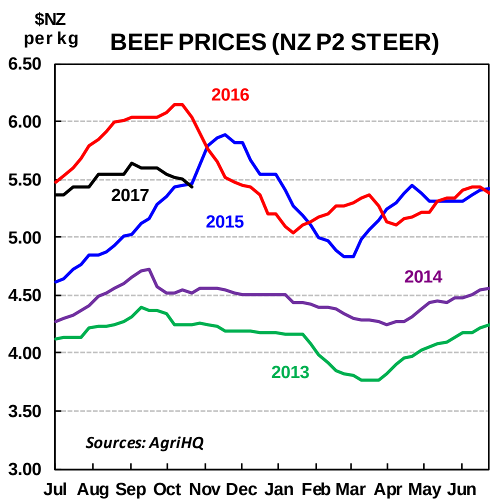
When all is said and done, beef prices haven't moved much lately. Since July, (P2 steer) prices have sat 14 cents either side of $5.50/kg.

This narrow range is despite the general view that prices would decline. In particular, the accepted view was that recovering US beef production would weigh on prices.

However, lack of supply both locally and from Australia is keeping NZ beef prices high. In particular, Australian beef production has slowed as the Australian beef herd rebuilds. Moreover, the rebuilding is likely to continue over the rest of this year and into 2017, and the lack of Australian beef opens the door for NZ exporters.

Indeed we expect the combined Australia and New Zealand tightness to keep prices firm in the short term. In fact, there is a chance that these factors push prices towards $6.00/kg before the end of 2016.

All up, it seems that moderating beef prices is next year's story.



Rural Commodities Outlook (continued)

Grains – A shot in the arm

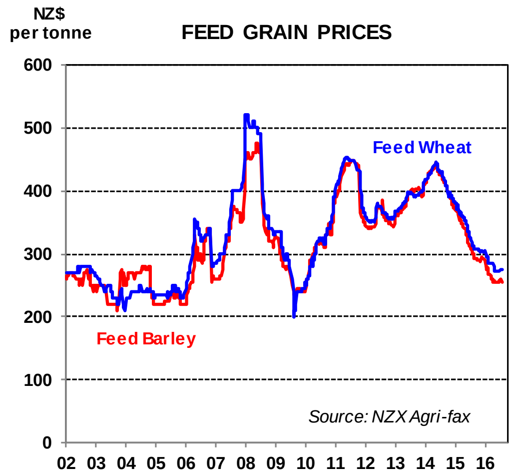
Feed Wheat, 21 Oct: $274/tonne ↑0.7% (mpc)

Feed grain prices are showing signs of bottoming. Feed barley prices have been largely flat since August, while feed wheat prices have crept nearly 1% higher.

From here, we expect improving dairy prices to give grain prices a shot in the arm. Dairy prices have surged over the three months to October. Whole milk powder prices, for example, are up by a third. In addition, Fonterra's 2016/17 milk price forecast has lifted by $1.00/kg to $5.25/kg.

Moreover, we expect these dairy price gains to continue. For example, we expect global dairy supply to fall further. Accordingly, we expect a finalised milk price of $6.00/kg come season end.

Although we note that dairy farmers remain cautious at this stage, we anticipate that milk price forecast increases will lift confidence further over the season; eventually, this lifting confidence is then likely to translate into an increase in feed demand.



Financial Markets Outlook

Interest Rates – Nearing the bottom

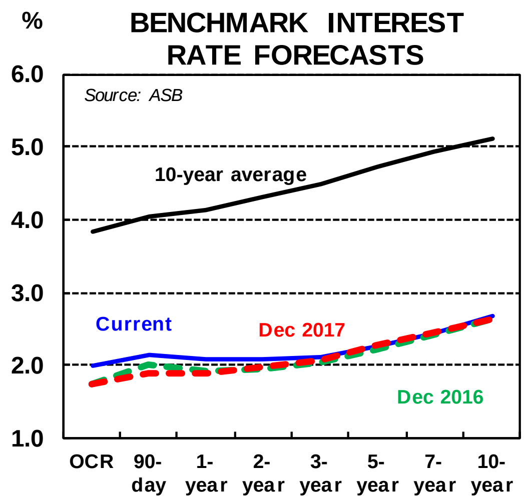
90-day bank bills, 21 Oct: 2.12% ↓ -0.12 (mc)

We expect the Reserve Bank (RBNZ) to cut the Official Cash Rate (OCR) on 10 November by 25bps. A 25bp cut would take the OCR to record low of 1.75%.

Indeed, the RBNZ has just about said that it will do as much. At its previous announcement on 22 September, the RBNZ continued to signal that "further policy easing *will* be required".

If the RBNZ cuts the OCR, we expect the majority of benchmark rates to fall a touch over the next six months. Although, with banks paying more for their offshore funding recently and deposit growth slowing, the floating rate falls, for example, may be less than the usual one-for-one.

We also caution that long-term rates may be unmoved over this period, and there is also a risk that they rise. In particular, an expected US Federal Reserve rate rise in December and the flow-through to NZ rates may offset the RBNZ cut. Even despite these risks, we still expect that we are in for a lengthy period of low interest rates by historical standards.



NZ Dollar – Pound dives

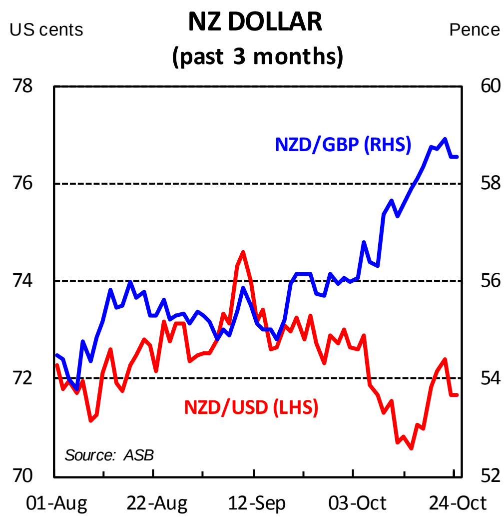
NZD/USD, 21 Oct: 0.7168 ↓ 0.0102 (mc)

On 7 October, the Pound sustained its biggest intraday drop since the Brexit referendum on 24 June. The Pound plunged around 6% against the USD and other major currencies at one stage.

The dramatic fall highlights the vulnerability of the British currency to Brexit developments. Indeed, the plunge may have been caused in part by European officials calling for tough Brexit negotiations.

For NZ, lamb and wine exports are most vulnerable to a weaker pound. The UK accounts for a little over 20% of our lamb exports by value. Similarly, the UK is an important market for wine, taking a little under a quarter of our exports by value in the year to June 2016.

These exports are likely to see lower UK prices as demand falls. The lower Pound will decrease the spending power of UK consumers and at the same time make local produce relatively cheap. Moreover, a slowing UK economy is likely to decrease demand further.



? **Rural Fact or Fiction?**

Answer: Fact! The mighty Cyprus, population 1.2 million, went on a 24-game winning run between 2008 and 2014.

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