Farmshed Economics

Springing back into action

September 2016

The dairy sector sprang back into action this September. Dairy auction prices continued where August left off, recording further gains. Fonterra then surprised by lifting its milk price forecast by 50 cents. And the good news kept coming from Fonterra, with its annual results showing much improved profits. Meanwhile the meat sector was busy too, with the green light for Silver Fern Farms deal highlighting the month.

September may well end up being the month that dairy farmers put the dairy downturn to bed. First up, the 2015/16 milk price was finalised at $3.90/kg – the lowest milk price since 2006/07.

However, dairy auction prices added another 10% over the month to August's 20%, helping switch the focus to better times ahead. Fonterra then surprised by lifting its 2016/17 milk price forecast to $5.25/kg, and backed that up with a much-improved profit announcement. Moreover, we expect dairy prices to lift again later in the season; hence we stick with our 2016/17 milk price forecast of $6.00/kg.

There was also plenty of action in the meat sector. Indeed, the green light for the Silver Fern Farms deal may signal a similar turning point for the industry. While the success or otherwise of the deal will reveal itself over time, at the very least the deal is likely to generate some sector change over coming years.

Looking at meat markets, September prices ended on a high. Although, we are sceptical that the price lifts can be maintained. Meanwhile, forestry prices have been firm over 2016. However we expect prices to drift lower heading into 2017, particularly as the Chinese housing market starts to turn down.

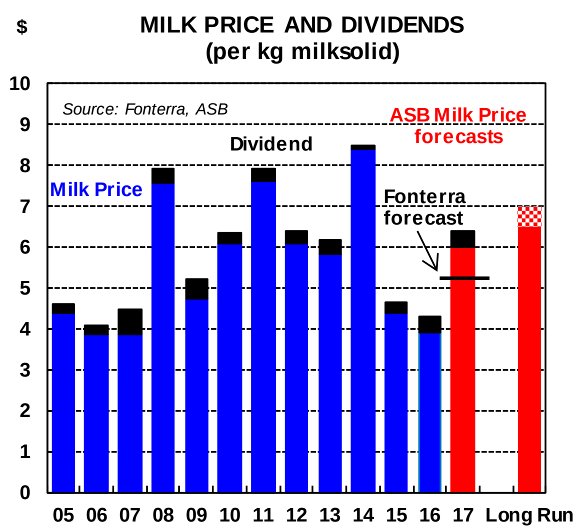
Lastly, the Reserve Bank kept the Official Cash Rate at 2.0% this month. However, we expect a cut in November and we also see a high chance of another cut in 2017. Meanwhile, the NZ dollar remains high, holding back farmgate returns. In particular, we view the sheepmeat sector as most vulnerable to a high NZD.

Key Rural Data:

As at 30 September 2016	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	172.2	156.4	153.8	↗
Lamb Price Index (NZD)	194.2	176.1	195.3	↗
Beef Price Index (NZD)	268.7	258.0	289.3	→
Forestry Price Index (USD)	160.2	159.3	137.4	↘
Interest Rates:				
90-day bank bills	2.20	2.23	2.83	↘
2 year swap	2.04	2.01	2.74	↘
5 year swap	2.16	2.12	3.08	↘
Exchange Rates:				
NZD/USD	0.7287	0.7240	0.6386	→
NZD/CNY	4.86	4.83	4.07	→
NZD/GBP	0.5615	0.5510	0.4207	→
Milk solids production (ytd % chg]**	-2.4	-0.2	2.5	↓
Fonterra Shareholders' Fund	5.95	5.92	5.33	→

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

Chart of the Month:



Rural Fact or Fiction?

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With pasture growth cranking up over September, it's interesting to note that the tallest variety of grass can grow to over 45m in height.

Answer on page 3

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Rural Commodities Outlook

Dairy – Springing into action

ASB Dairy Index (USD), 30 Sep:	172.2 ↑10.1% (mpc)

The dairy sector certainly sprang back into action this September. First up, dairy auction prices continued August's lift, adding another 10% to August's 20% surge.

Fonterra then surprised by lifting its milk price forecast by 50 cents to $5.25/kg. The milk price forecast upgrade signalled that Fonterra is increasingly confident that prices will remain at this new higher level over the season. In that sense, Fonterra is coming around to our view that August and September's price lifts are sustainable.

The good news kept coming from Fonterra, with its annual results showing much improved profits. Earnings per share settled at 51 cents, compared to 29 cents in 2014/15. Meanwhile, the cash dividend was also confirmed at the previously-indicated 40 cents.

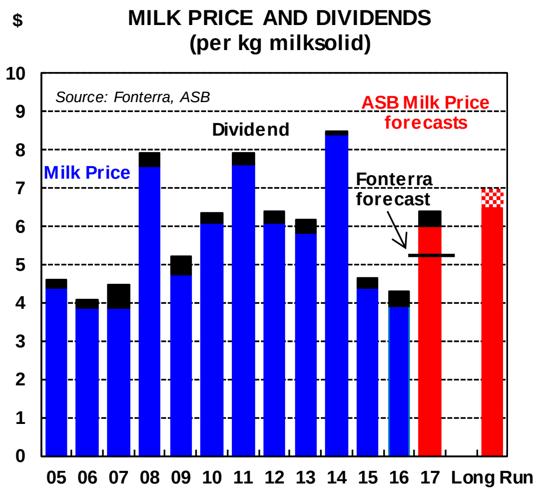
Indeed, we expect dairy is just getting started. For example, our view is that dairy markets have fundamentally shifted. In particular, farmers globally have responded to low milk prices by lowering production levels. Moreover, we expect global production to weaken further over 2016.

With that in mind, we expect prices to track around current levels, before lifting again later in the season. As a result, we continue to expect a finalised milk price of $6.00/kg for 2016/17.

Season End Milk Price Forecasts:

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

* per kg of milk solids (excluding dividend).



Lamb – A late run

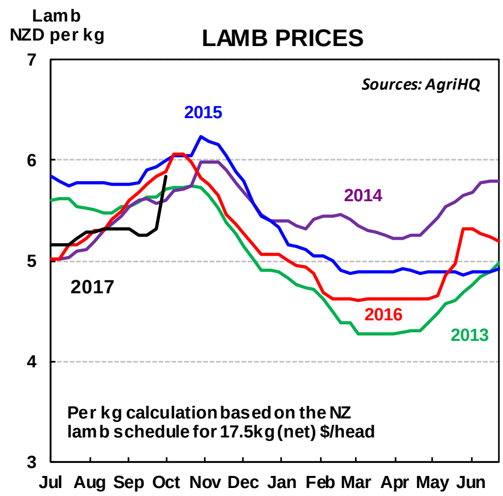
Lamb Index (NZD), 30 Sep:	194.2 ↑10.2% (mpc)

Lamb prices have made a late September run. In fact, for most of the month, prices tracked sideways, at a time of the season when prices normally steadily lift. But driven by very tight local supply, prices shot higher in the final week of September. The price per kg (for a 17.5kg lamb) rose over 50 cents or by around 10% from the week before.

According to AgriHQ analysts, a window of opportunity has opened in the UK chilled lamb market, boosting prices. However, they also caution this price impetus may be short-lived.

Meanwhile, in the other major market, China, drought has led to an increase in local supply. This extra supply is keeping a lid on prices in the short-term. That said, Chinese demand may recover down the track as farmers look to rebuild their flocks once the drought passes.

While farmers will welcome the sudden price rise, the risk is that prices soon fall and continue to remain subdued compared to previous years.



Beef – Head fake

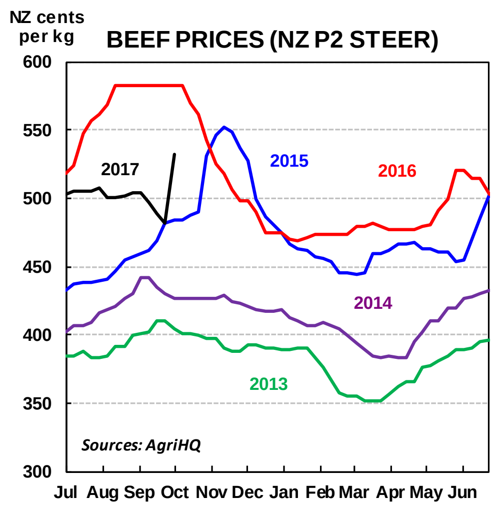
Beef Index (NZD), 30 Sep:	268.7 ↑4.1% (mpc)

Like lamb, beef prices have ended September on a strong note. P2 steer prices, for example, spiked over 10% in the last week of September. However, according to AgriHQ analysts the late September price rise may overstate things. With that knowledge and the general state of beef markets largely unchanged from August, we expect prices to soon return to the level prior to the spike.

For now, beef markets dynamics remain similar to last month. On the one hand, 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.

On the other hand, beef production is rising in the key US market. Also, Brazil is upping the ante on the back of better access to the US market.

All up, we continue to expect beef prices to largely track sideways over the next six months. However, heading into 2017, we expect prices to moderate, but to remain high by historical standards.



Rural Commodities Outlook (continued)

Forestry – Less rosy

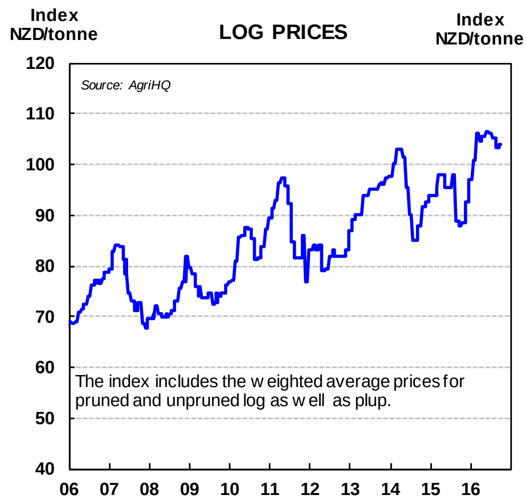
Forestry Index (USD), 30 Sep: 160.2 ↑0.6% (mpc)

Forestry prices have performed well this year. For example, the AgriHQ log price index ended September 35% above September 2015 in USD terms (and around 18% above in NZD terms).

There has been a mix of reasons for the price lift. Shipping rates have been extraordinarily low, on the back of low oil prices and excess shipping capacity. Chinese demand has improved as its housing market has picked up and inventories fallen. Meanwhile, local demand has been strong on the back of the construction boom.

From here though, we see the outlook for log prices as less rosy. In particular, we think the Chinese housing market is going to turn, lowering demand from our largest market. Also, shipping costs are creeping higher.

That said a few positives remain in play. For example, the Korean and Indian markets remain strong. On balance, we expect log prices to drift lower over the remainder of 2016 and into 2017.



Financial Markets Outlook

Interest Rates – How low can you go?

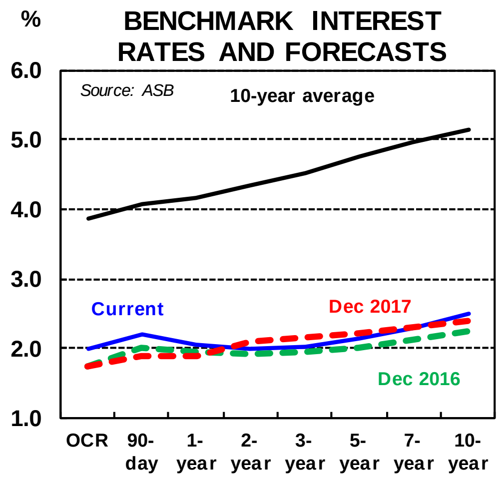
90-day bank bills, 30 Sep: 2.20% ↓ -0.03 (mc)

The Reserve Bank (RBNZ) kept the Official Cash Rate (OCR) at 2.0% as widely expected on 22 September. At the same time, it continued to signal that "further policy easing *will* be required". For our part, we expect that to translate into a 25 basis point cut to 1.75% in November.

Indeed, with inflation still largely missing and the NZ dollar strong, we see a high chance of another cut in 2017. In particular, the NZ dollar remains high despite earlier OCR cuts, keeping a lid on import prices, for example.

However, while floating and other short-term rates have some scope to fall further over the next 6 months, we see less room for longer-term rates to fall significantly from here. In fact, long-term rates are already at historically low levels.

A couple of factors could lead rates higher. First up, with a US Federal Reserve interest likely this year; longer-term NZ rates could mirror the move higher. In addition, rising funding costs for banks are another possible source of higher longer-term rates.



NZ Dollar – Sheepmeat sector most vulnerable

NZD/USD, 30 Sep: 0.7287 ↑ 0.0046 (mc)

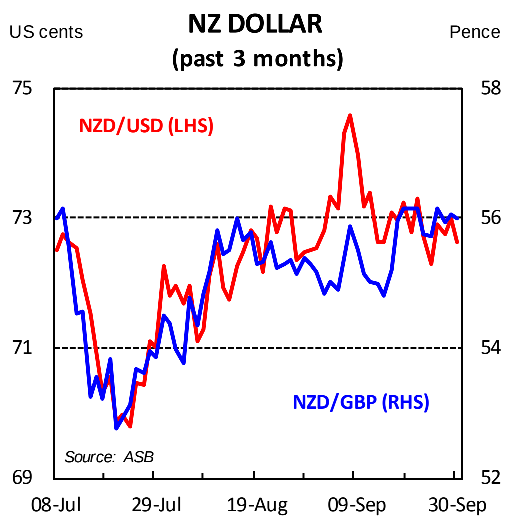
After surging in early September, the NZD has retreated almost back to where it began the month. Nonetheless, the NZD remains high.

For us, the sheepmeat sector is most vulnerable to a high NZD. In particular, Brexit and a weak Pound may force UK consumers to trade down from NZ lamb to other, cheaper, proteins.

Forestry is also in the NZD's firing line. Up to now, very low shipping rates, improving demand and tight supply have all supported log prices. But now we see the impact of these factors waning.

The high NZD will hit beef prices as well. However, with prices currently high, they are likely to fall from "excellent" to merely "good" over 2016/17.

Lastly, recent dairy price rises eclipse the NZD rise. For example, whole milk powder prices sit around 45% higher than their 2016 lows. In contrast, the NZD has lifted around 17% from its lows this year; the net effect is that dairy prices are up around 28% in NZD terms.



Rural Fact or Fiction?

Answer: Fact! *Giant Bamboo,* which can grow to over 45m, is actually part of the grass family.

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