Farmshed Economics

Spring is in the air

September 2018

Spring is here and agricultural production has started the new season well. And unlike previous seasons, the weather has played ball. Dairy production, for example, is well ahead of this time last season. Accordingly, a good start to the production season sees a spring in the step of most farmers. But it does pay to remember that there is some payback from higher production in the form of lower prices.

As mentioned above dairy production has hit the ground running this season. For the three months to date, production is running 5.4% ahead of the same three months last season. All up, we anticipate production growth of 2% compared to last season.

However, production growth in excess of this level would likely lead to additional dairy price weakness. Indeed, we anticipate for our $6.50/kg 2018/19 milk price forecast to hold, NZ production growth needs to be at 2% or below.

Meanwhile, lamb prices are starting to come off the boil. After peaking at $8.43/kg earlier in the month, prices have dropped 13 cents/kg or 1.5%. Nonetheless, the season as a whole is shaping up as a healthy one. Also, the outlook for forestry prices is similarly healthy.

We are a little more wary over the outlook for beef prices. Global supply is strengthening. On that basis, we anticipate that beef prices will head lower over the season.

Current financial markets, however, are helping the rural sector. Benchmark interest rates dipped to very low levels over September. In fact, the 2-year swap rate fell to just 3 basis points above record lows. Also, the rising prospect of an Official Cash Rate (OCR) cut could see rates head lower.

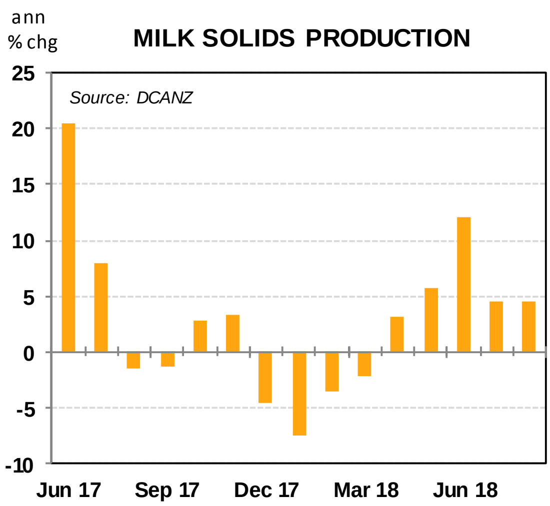
Meanwhile, we expect the NZD to underpin commodity prices in NZD terms over the rest of the year (note, though, some imported input costs may rise). And if the OCR cut scenario plays out, even more support could be on its way.

Key Rural Data:

As at 28 September 2018	Current	5 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	80.8	82.6	93.8	→
Lamb Price Index (NZD)	139.6	140.4	118.6	↘
Beef Price Index (NZD)	116.2	118.7	113.0	↘
Forestry Price Index (USD)	96.1	98.1	104.1	↘
Interest Rates:				
90-day bank bills	1.91	1.91	1.95	→
2-year swap	2.04	1.98	2.21	→
5-year swap	2.40	2.32	2.74	↗
Exchange Rates:				
NZD/USD	0.6619	0.6624	0.7341	→
NZD/CNY	4.55	4.53	4.84	↗
NZD/GBP	0.5079	0.5110	0.5440	↗
Milk solids production (ytd % chg]**	5.4	7.7	1.7	↓
Fonterra Shareholders' Fund	4.89	5.01	6.22	→

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

Chart of the Month:



? *Rural Fact or Fiction?*

Tennis racquet strings are made from catgut.

Answer on page 3

Nathan Penny – Senior Rural Economist – 649 448 8778 – nathan.penny@asb.co.nz

Rural Commodities Outlook

Dairy – Production hits the ground running

Dairy Index (USD), 28 Sep:	80.8 ↓ -2.2% (mpc)

Production has hit the ground running this season. For the three months to date, production is 5.4% ahead of the same three months last season.

Indeed, so far the weather has been very favourable. Mild winter temperatures and soil moisture levels have both supported growing conditions across most of the country. In addition, with a healthy milk price and positive farm cashflows, farmers have been encouraged to give production their best shot.

It is, however, still early days in the season. The first three months of the season traditionally account for just 8% of the season's production. Hence there is a lot of water (or milk) to go under the bridge.

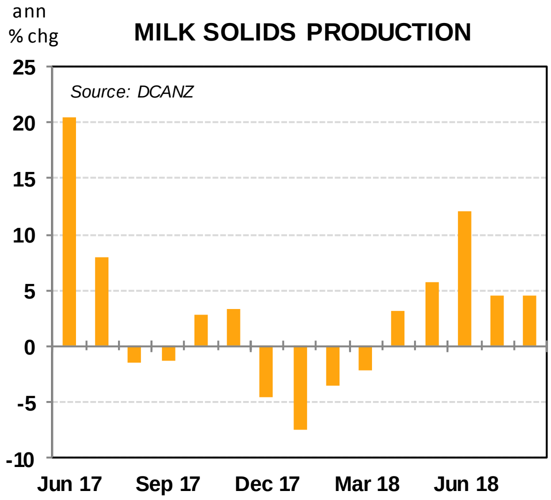
Healthy production is not all good news, however. Recent auction price falls can in part be traced to the strong start to the production season. Specifically, dairy auction prices fell 2.1% over September and have started October with another fall.

Moreover, NZ production will be a key factor for the direction of dairy prices over the remainder of the season. We anticipate production growth of 2% compared to last season. Production growth in excess of this level would likely lead to additional dairy price weakness and vice versa. Indeed, we anticipate for our $6.50/kg 2018/19 milk price forecast to hold, NZ production growth needs to be at 2% or below.

Season End Milk Price* Forecasts:

	2018/19		Long Run
	Fonterra	ASB	ASB
Milk Price*	$6.75	$6.50	$6.50-$7.00

* per kg of milk solids (excluding dividend).



Lamb – Coming off the boil

Lamb Index (NZD), 28 Sep:	139.6 ↓ -0.6% (mpc)

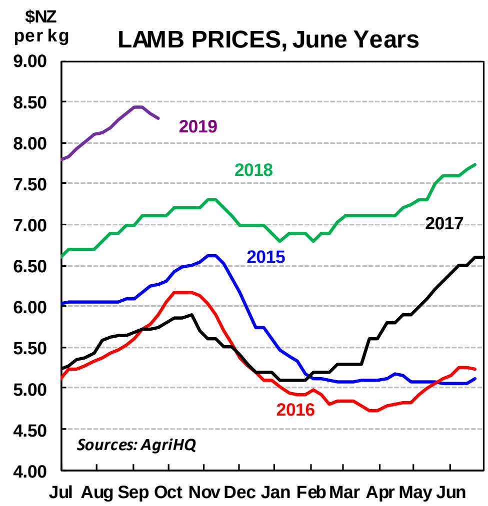
Lamb prices are starting to come off the boil. After peaking at $8.43/kg earlier in the month, prices have dropped 13 cents/kg or 1.5%.

But prices remain extremely high. And with the Christmas trade underway, we expect prices to remain at or around these current levels for the next month or so.

Looking over the rest of the season, prices also look set to remain healthy. Lamb supply is constrained over in the Tasman, while Chinese demand remains firm. Meanwhile, local supply is also tight.

Traditionally, lamb prices fall by an average of $1.20/kg from the spring peak through to the autumn low. On that basis, we anticipate autumn per kg prices are likely to still start with a seven. Even in a worst case scenario, prices are likely to be $6.50/kg or above come the autumn.

With the above in mind, the season is shaping up as a healthy one.



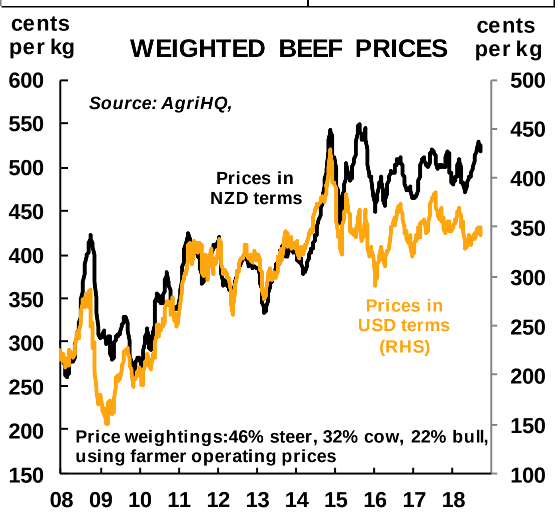
Beef – On guard

Beef Index (NZD), 28 Sep:	116.2 ↓ -2.1% (mpc)

We remain wary over the outlook for beef prices. While AgriHQ's weighted average price in NZD terms remains 8% above the 5-year average, several factors point to prices falling over the rest of the year.

First up, demand from the US – our largest export market – is looking soft. Both US production and stocks are lifting and beef prices are falling as a result. Add to the mix strong chicken and pork production, and we anticipate that soft US beef demand and prices are likely to remain for a while yet. A similar dynamic is playing out in Australia, although there extra beef supply is due to drought.

At this juncture, the weak NZD is helping to cushion the blow. For example, the NZD/USD is 6 cents or 8% lower than this time last year. But our expectation is that by the end of the year the weak NZD won't be enough to offset weak world prices. As a result, farmgate prices (in NZD terms) are also likely to start heading lower too.



Rural Commodities Outlook (continued)

Forestry – Still sitting pretty

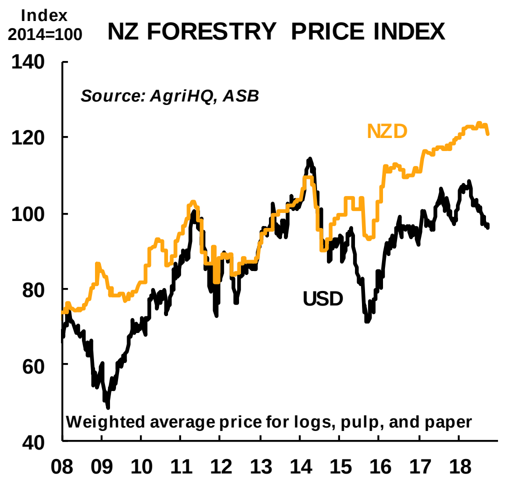
Log & Pulp Index (USD), 28 Sep:	96.1 ↓-2.1 (mpc)

Forestry prices are still sitting pretty in NZD terms. Indeed, forestry prices as measured by the AgriHQ Index are only 2.5% back from the record highs set back in July.

In USD terms, however, it's a different story, with prices down 12% on the April 2018 high. Most of that fall can be put down to USD strength. Indeed, the CNY/USD is down 9% over the same period.

It follows, that market fundamentals remain relatively healthy. In particular, the Chinese economy is solid and the Chinese housing market firm. On this basis, we anticipate forestry demand will remain firm and thus forestry prices will remain positive over the remainder of the year.

The continued ratcheting up in US-China trade tensions do, however, pose a risk to this otherwise positive outlook. Escalating trade frictions could begin to weigh on Chinese economic growth. In this scenario, forestry demand will wane and prices fall. Watch this space!



Financial Markets Outlook

Interest Rates – Chance of a cut

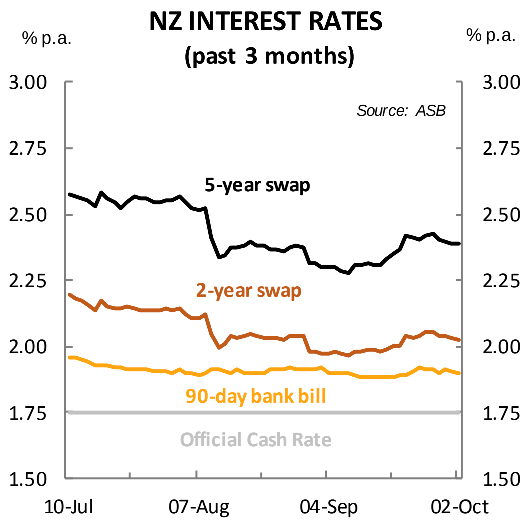
90-day bank bills, 28 Sep:	1.91% (No change)

Benchmark interest rates dipped to very low levels over September. In fact, the 2-year swap rate fell to just 3 basis points above the record low set back in August 2016.

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.

If anything, though, benchmark interest rates could head lower. Markets have currently priced in around a 25% chance of an OCR cut over the next year. For our part, we would put the risk of an OCR cut at higher than that.

Business confidence continues to slump and if this weak sentiment drags down overall business activity over the rest of the year then the RBNZ has said that it will cut the OCR. With that in mind, it's a case of 'wait and see' to how the economy performs over the rest of the year. And for interest rates, it's a case of 'low or lower'.



NZ Dollar – Sideways

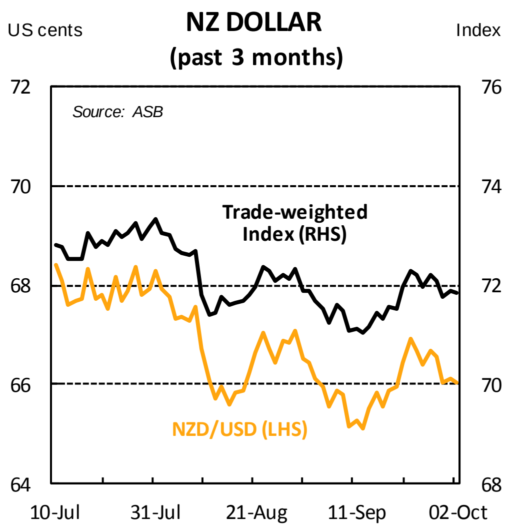
NZD/USD, 28 Sep:	0.6619 ↓ -0.0006 (mc)

The NZD largely tracked sideways over September. Indeed, for most of the past three months the NZD/USD has traded in a narrow three-cent range between 0.65 and around 0.68.

Over the remainder of the year, 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.

There is a scenario where the NZD does head lower, however. As described above in the interest rate section, there is an increasing chance that the Reserve Bank cuts the Official Cash Rate. If this scenario does eventuate, the NZD could also head lower. For example, against the USD, we would expect the NZD to fall to around the low 60's or even below.

If this scenario were to eventuate, the NZD would provide an additional boost to NZ commodity prices on top of what's already in play. Although, the price of some imported inputs could rise as well.



Rural Fact or Fiction?

Answer: False. Modern strings are made out of cow intestines, though sheep intestines have also been used in the past.

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

asb.co.nz/economics

@ASBMarkets