

Farmshed Economics

Records tumble in all directions

September 2019



ASB

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Records have tumbled in all directions over the last three months – and we literally mean in all directions. That is, the rural and financial sectors have set record highs in the case of lamb prices and record lows in the case of interest rates. Records have tumbled in the wrong direction too, with Fonterra posting a 2018/19 record loss.

Starting with the records in the right direction, lamb prices have set fresh record highs in September. The nationwide price hit \$8.55/kg this month, eclipsing the previous record high of \$8.43/kg set back in September 2018. Beef prices are not far behind. Over the past few months, P2 steer prices, for example, have been tracking neck and neck with the record-setting 2015/16 season. And we’re going to stick our necks out and say that we anticipate fresh record high (P2 steer) beef prices in October.

Looking at financial markets, interest rates have tumbled in the opposite direction. In August, the Reserve Bank (RBNZ) cut the Official Cash Rate (OCR) to a record low of 1.00%. Benchmark interest rates have also set fresh record lows over the quarter. Indeed, 1- through 5-year swap rates have fallen by between 90-110 basis points since the start of 2019.

Meanwhile, the wrong records tumbled at Fonterra, after it announced a \$605m net loss after tax. The 2018/19 loss was the worst on record, and over three times the 2017/18 loss, which itself was a record loss at that time.

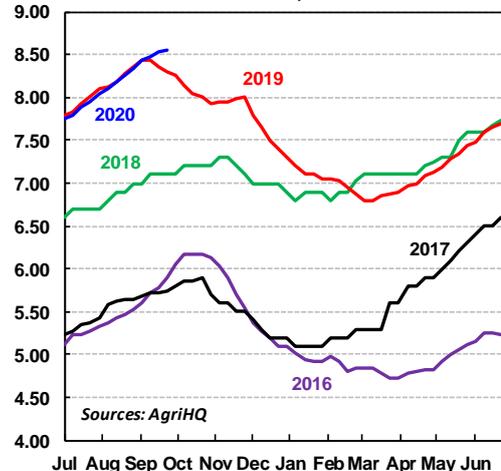
Turning to the outlook and with African Swine Fever continuing to disrupt Chinese protein markets, we anticipate that meat prices are likely to remain at or near the record highs over the rest of 2019. Moreover, seasonal patterns aside, prices should remain healthy over the late summer and autumn. On the dairy outlook, we are positive on balance. We stick with our bullish 2019/20 milk price forecast of \$7.00/kg. However, we are healthily sceptical on Fonterra’s earnings per share forecast (15-25 cents), although we would welcome any upside surprise.

Key Rural Data:

Chart of the Month:

As at 27 September 2019	Current	3 mths ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	97.1	100.4	90.5	→
Lamb Price Index (NZD)	135.0	121.6	131.8	→
Beef Price Index (NZD)	107.3	98.1	103.7	↗
Wool Price Index (NZD)	90.7	94.1	101.8	↘
Interest Rates:				
90-day bank bills	1.14	1.64	1.9	↘
2-year swap	0.95	1.35	2.04	→
5-year swap	0.95	1.44	2.41	→
Exchange Rates:				
NZD/USD	0.6297	0.6719	0.6686	→
NZD/CNY	4.49	4.61	4.58	→
NZD/GBP	0.5124	0.5293	0.5113	↗
Milk solids production (ytd % chg]**	3.8	2.4	5.4	↘
Fonterra Shareholders' Fund	3.49	3.85	4.90	→

LAMB PRICES, June Years



*Direction of change over the next 6 months. **As at August 2019.

Rural Fact or Fiction?



In the 17th century, some tulip bulbs reportedly fetched more than 10 times the annual income of a skilled craftsworker.

Answer on page 3

Rural Commodities Outlook

Dairy – The wrong records tumble

Dairy Index (USD), 27 Sep: 97.1 ↓3.3 (qpc)

Fonterra's financial performance went from bad to worse in 2018/19. Over financial year it posted its largest ever loss of \$605m on top of the \$196m loss last year (read more [here](#)).

We find very little to be rosy about in the results despite having known what to expect. Underlying profit continues to worsen, while what previously looked like one-off hits to the business (think Danone, Beingmate) are now becoming regular.

On paper, Fonterra has a new simplified and sensible strategy. But we remain healthily sceptical. After a string of poor results, only a subsequent string of strong results will make us believers.

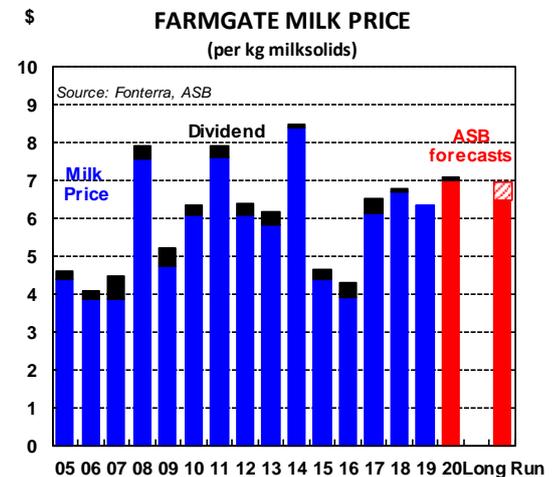
The lack of a dividend payment takes the shine off what was otherwise a good dairy season. The milk price was finalised at \$6.35/kg, marking the third season in a row that it has ended above \$6.00/kg.

Looking to 2019/20, we are on balance positive on the overall dairy market outlook. We maintain our 2019/20 milk price forecast of \$7.00/kg, but note that it's still early days in the season. Meanwhile, we take Fonterra's earnings per share forecast (15-25 cents) with a grain of salt, although we would welcome any upside surprise.

Season End Milk Price* Forecasts:

	2018/19		2019/20		Long Run
	Final	Fonterra	ASB	ASB	ASB
Milk Price*	\$6.35	\$6.25-\$7.25	\$7.00	\$6.50-\$7.00	\$6.50-\$7.00

* per kg of milk solids (excluding dividend)



Lamb – Two in a row

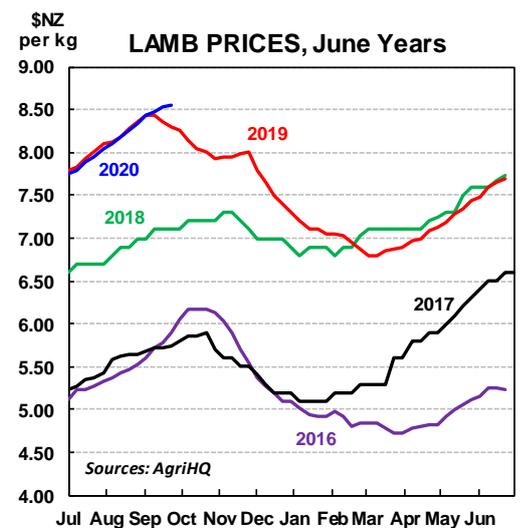
Lamb Index (NZD), 27 Sep: 135.0 ↑11.0 (qpc)

Lamb prices have set fresh record highs in September. AgriHQ reported that the nationwide price hit \$8.55/kg this month, eclipsing the previous record high of \$8.43/kg set back in September 2018.

As discussed in previous editions, African Swine Fever has decimated the Chinese pork industry, leading consumers to seek other proteins, including lamb from NZ.

Meanwhile, lamb export supply remains relatively tight both in NZ and in Australia. Moreover, the increasing number of conversions of sheep/beef land to forestry will reduce lamb supply over the coming few years. While not necessarily a great development for the sheep industry, these conversions will nonetheless underpin lamb prices for an extended period.

In the lead up to Christmas, we anticipate that prices will remain high and above \$8.00/kg for the most part. Heading into 2020, we expect prices to moderate as they normally do over summer and autumn. Also we expect further moderation as the Chinese pork industry recovers.



Beef – Records poised to tumble

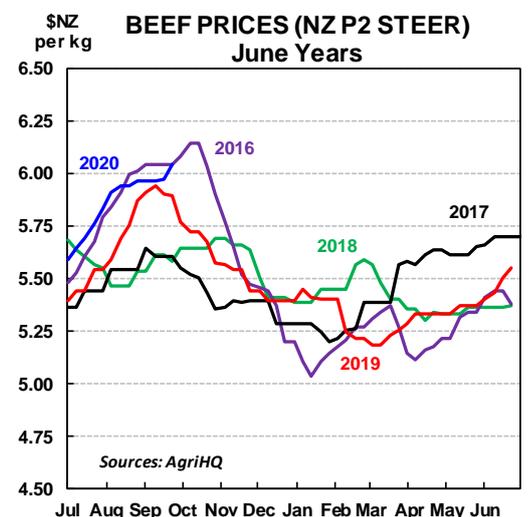
Beef Index (NZD), 27 Sep: 107.3 ↑9.4 (qpc)

Beef prices are closing in on record highs. Over the past few months, P2 steer prices, for example, have been tracking neck and neck with the record-setting 2015/16 season.

Similar to the dynamic in lamb markets, African Swine Fever has decimated the Chinese pork industry, leading consumers to seek other proteins, including beef from NZ. The US-China trade war is also restricting two-way agricultural trade between the US and China. While China does not import a large amount of US beef, it does rely on the US for a large proportion of its feed inputs for domestic beef production. All up, we anticipate that these factors will continue to underpin Chinese demand for NZ beef.

Also part of the demand mix is renewed interest from US buyers. Indeed, after trading at a discount to Chinese prices, prices in the US manufactured beef market have regained their premium of late.

All up, we anticipate that beef prices will set fresh record highs, most likely at some stage over October.



Rural Commodities Outlook (continued)

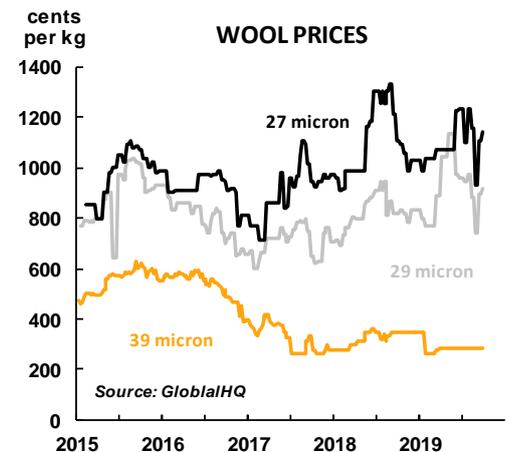
Wool – “Wearing” the brunt

Wool Price Index (NZD), 27 Sep : 90.7 ↓3.6 (qpc)

Recently, we have noted that NZ’s food exports have been holding up despite softening global economic growth. Indeed, spending on essentials like food tends to hold up during periods of weak growth, in contrast to spending on luxuries which can rapidly fall. So far, this view is holding, with NZ dairy, meat and fruit demand and prices all firm.

Wool prices, in contrast, may prove the exception to the rule. Often NZ wool ends up in higher-end apparel markets which are sensitive to economic growth. With these markets weak, demand for NZ wool has fallen, lowering prices for NZ fine and medium wool.

Moreover, US tariffs have targeted Chinese clothing imports. With China importing wool from NZ for clothing production and then export, these tariffs will make the end price for US consumers higher. As such, US demand is falling, leading to lower demand for NZ wool and thus putting downward pressure on wool prices.



Financial Markets Outlook

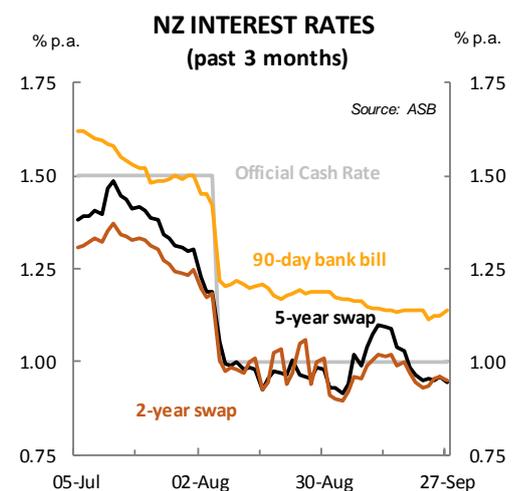
Interest Rates – Record lows

90-day bank bills, 27 Sep: 1.14% ↓-0.50 (qc)

In August, the Reserve Bank (RBNZ) cut the Official Cash Rate (OCR) to a record low of 1.00%. We think that the RBNZ cut again this November and there is a risk of further cuts in 2020.

Benchmark interest rates have also set fresh record lows over the quarter. Indeed, 1- through 5-year swap rates have fallen by between 90-110 basis points since the start of 2019.

Over the remainder of 2019 and early 2020, NZ’s benchmark interest rates, particularly for short and medium terms, could track a touch lower. Looking to mid-2020 and beyond, the risks to borrowing rates are more balanced. Over this horizon, the impact of higher bank capital requirements will also come into play. These changes are likely to lift banks’ funding costs and thus borrowing rates, plus the availability of credit could tighten. This picture will become clearer once the RBNZ’s makes its final decision on capital requirements in December.



NZ Dollar – Another helping hand

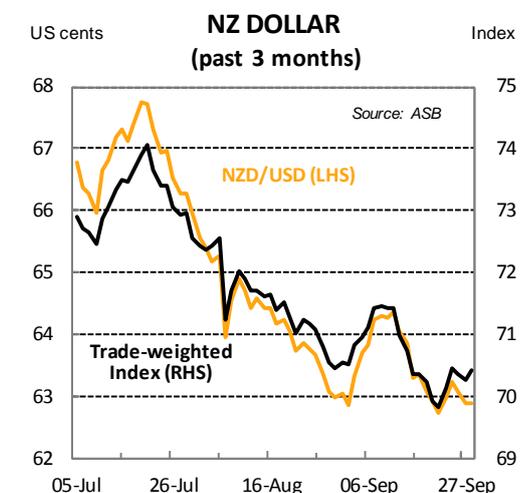
NZD/USD, 27 Sep: 0.6297 ↓0.0422 (qc)

A further fall in the NZD has given an extra boost to all NZ commodity prices in NZD terms. Since the last edition of Farmshed Economics, the NZD/USD has fallen by over 6% (up to the time of writing).

The NZD/USD has traded as low as US\$0.6270 this quarter. This is the lowest level for 10 years.

The lower currency is in response to record low NZ benchmark interest rates. This follows the Reserve Bank of New Zealand cutting the Official Cash Rate (OCR) by 25 basis points to a record low of 1.00% in August. We expect another 25 basis point OCR cut in November and the possibility of further cuts in 2020.

Our view is largely in line with currency market pricing. As a result, the NZD/USD is likely to trade sideways over the remainder of 2019 and into 2020.



Rural Fact or Fiction?

? **Answer: Fact!** Some tulip prices reached extraordinarily high levels and then dramatically collapsed in February 1637. This period became known as *tulip mania* and it is generally considered the first recorded speculative bubble.

ASB Economics & Research

Chief Economist
 Senior Rural Economist
 Senior Economist
 Senior Economist
 Senior Economist, Wealth
 Senior Economist
 Data & Publication Manager

Nick Tuffley
 Nathan Penny
 Mark Smith
 Jane Turner
 Chris Tennent-Brown
 Mike Jones
 Judith Pinto

nick.tuffley@asb.co.nz
 nathan.penny@asb.co.nz
 mark.smith4@asb.co.nz
 jane.turner@asb.co.nz
 chris.tennent-brown@asb.co.nz
 mike.jones@asb.co.nz
 judith.pinto@asb.co.nz

Phone

(649) 301 5659
 (649) 448 8778
 (649) 301 5657
 (649) 301 5853
 (649) 301 5915
 (649) 301 5661
 (649) 301 5660

asb.co.nz/economics

 @ASBMarkets

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