



Agribiz

January 2013

Sheep and Beef Outlook

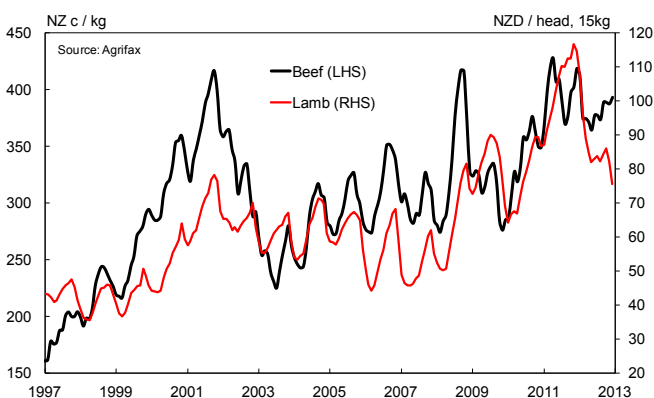
Parting of the red sea

Lamb prices have fallen hard over 2012. Meanwhile, beef prices are still at or near record levels. What's doing? Well, on one side it's a story of Americans wanting their clean fuels and their hamburgers too (even during a drought). On the other side, recession in Europe is constraining household spending, with luxuries like lamb increasingly off their menus. Improving Chinese growth and food demand may ride to the rescue, but not as fast as sheepmeat markets would like.

Beef and lamb prices are diverging

Both beef and lamb prices reached record levels over 2011, but their fortunes over 2012 have moved in opposite directions. Beef prices currently sit around 8% lower than their early-2011 high, while the November 2012 seasonal peak in lamb prices (where lambs are shipped to Europe in time for Christmas) was 30% lower than the same time in 2011 (Figure 1).

Figure 1: Beef and Lamb Prices



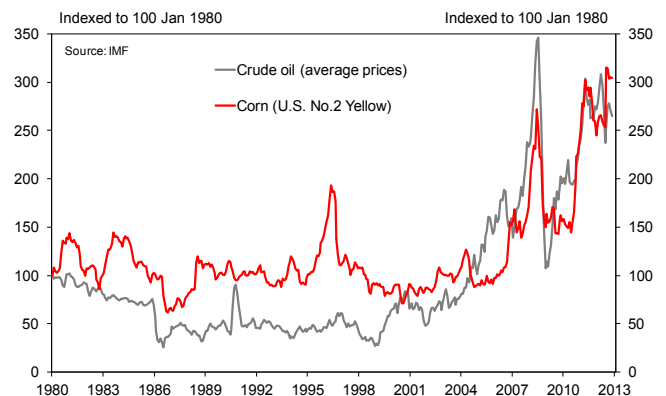
Drought has hit grain prices, driving up feed prices...

Drought in the northern hemisphere has hit world grain prices, and has driven up feed prices for US beef producers in particular. World corn prices reached record levels in August 2012, and in November 2012 remained around 20% higher than a year ago. American dairy farmers, for example, have seen their feed costs rise over 40% from October 2011 to October 2012, more than accounting for the 25% increase in their overall costs over the same period.

...compounded by US energy policy...

Grain markets, and thus cattle feed markets, are now also closely linked to energy prices because of their use in biofuel production. Grain and oil prices now move together much more closely than in the past (Figure 2). In the US, 13bn gallons of biofuel must be produced this year under rules designed to reduce both carbon emissions and the country's reliance on imported oil. This production will require the use of around 40% of the US corn harvest, and must be produced, no matter what the price of corn.

Figure 2: Oil and corn prices



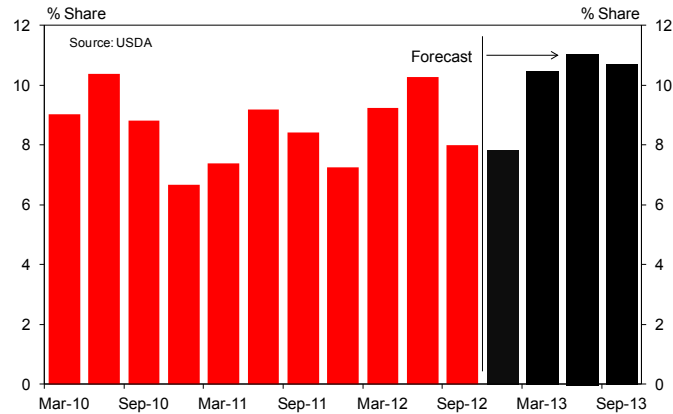
As corn is the major source of cattle feed, this extra demand is adding to upward pressure on feed prices, and in turn beef prices.

Moreover, US beef producers have not culled as they would normally following a drought, keeping upward pressure on prices. With the US cattle herd already at its smallest in 60 years, US beef producers were in a stock rebuilding phase. This low stock level has limited the amount of culling taking place, and in turn limited any downward pressure on prices from culling.

...creating opportunities for beef producers like NZ

Higher US cattle feed costs are creating opportunities for pasture-based and lower-cost producers like New Zealand. The US is New Zealand's major beef market, accounting for around 40% of our beef exports. By 2013 the US Department of Agriculture expects imports to account for over 10% of the total US beef market by March 2013, of which New Zealand beef exporters will grab their share.

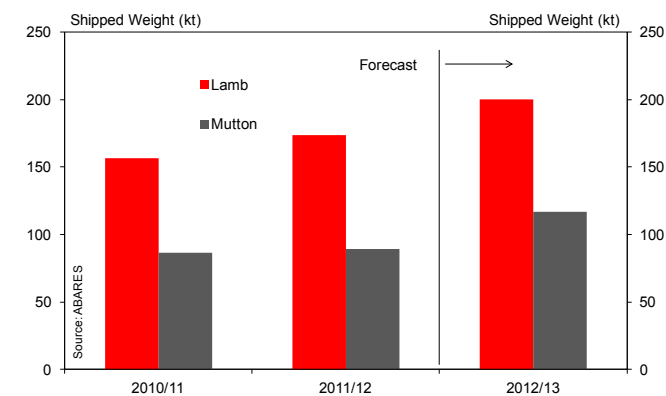
Figure 3: Imports share of US beef market



In contrast Australia lamb exports are rising...

New Zealand's main competitor in sheepmeat markets - Australia - is increasing its exports, putting downward pressure on world lamb prices. Similarly to New Zealand, Australia's largely pasture-based farming system is less affected by high feed costs. Moreover, favourable seasonal conditions in recent past seasons have permitted strong flock rebuilding. As a result, 2012/13 lamb production is forecast to increase by 15% and export volumes to reach a record 200,000 tonnes.

Figure 4: Australian Sheep Meat Exports

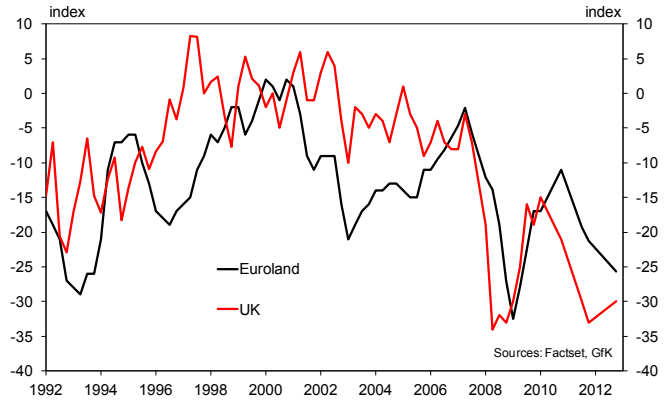


...and with European markets weak, lamb prices have fallen

Demand for lamb is weak as the key European and UK markets struggle with recession, putting downward pressure on lamb prices. Europe and the UK receive over half (55%) of New Zealand's sheepmeat exports and the lion's share of the prime lamb cuts. Household confidence is low in these markets and European economic recession is expected to last into 2013. With

this in mind, the outlook for this market in what is a luxury product will remain weak.

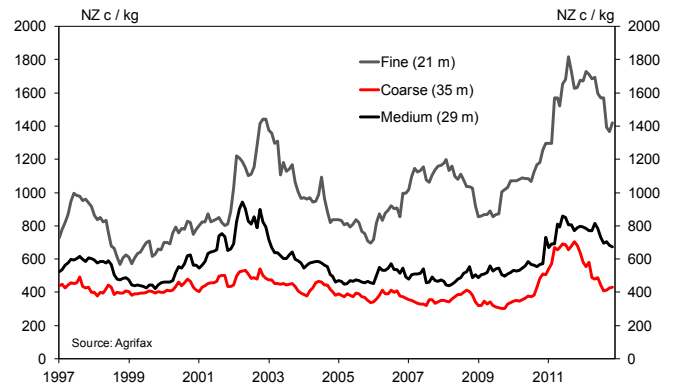
Figure 5: European and UK Household Confidence



Improving Chinese growth will help food and wool markets

With Chinese economic growth recovering, demand for wool is increasing which is providing support for wool prices. We expect Chinese growth to accelerate to 8.8% in 2013 from 7.8% in 2012. As China accounts for 45% of New Zealand's wool exports, this points to upward price pressure over 2013. Accordingly, improving wool prices will offset some of the lost income from weak lamb prices for some farmers.

Figure 6: Wool Prices



Looking more long-term, sustained developing country growth, particularly China, will add to demand for food and support food prices over the next decade or more. The dairy industry is an obvious beneficiary of this trend to date.

But lamb markets may take longer to develop

However, the prime cuts of lamb that New Zealand producers generate most of their income from will be out of reach for many developing country households for some years. Nonetheless, the potential is there to develop top-end markets, as evidenced by the development of the New Zealand tourism market. Annual Chinese tourist arrivals have overtaken British arrivals in 2012, becoming our second-largest market. The challenge for lamb producers will be to develop their own niche within this growing top-end market.

Rural Land Market Outlook

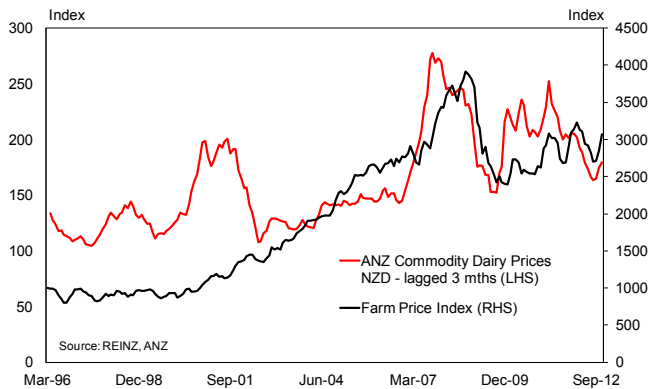
From a walk to a trot

With 2012/13 forecast to be a low year for the Fonterra payout, farm prices have largely gone sideways over 2012. However, historically low interest rates, including competitive long-term rates, combined with improving food prices suggest that farm prices will rise in 2013. With interest rates set to rise in the second half of 2013, the supportive conditions for farm prices may not last.

Farm prices generally reflect food prices

Farm prices generally reflect farm incomes, where much of the variation stems from food prices. As an illustration, we've used dairy prices as a proxy for food in Figure 7 (since dairy products are the most globally traded and transparent of New Zealand's food products). The correlation with farm prices has doubled since around 2006.

Figure 7: Farm and Dairy Prices

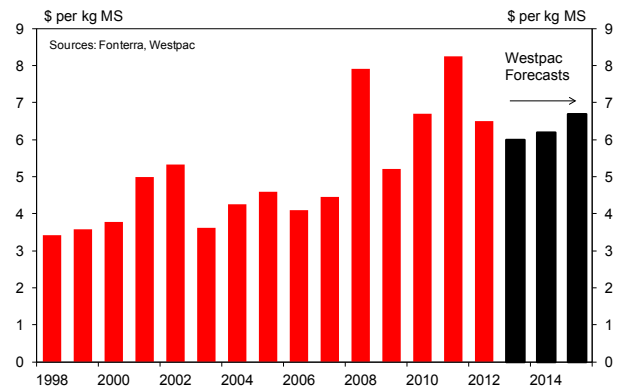


The connection has been quite apparent recently: the REINZ farm price index showed that farm prices fell 14% from January to August, as world food prices fell and Fonterra initially forecast a substantially lower payout for the new season. Farm prices have since picked up and in November were up around 5% on a year earlier. Forecasts of the dairy payout have a pronounced signalling effect on farm prices.

Farm prices should rise as food prices improve...

We expect the forecast dairy payout for the 2012/13 season to mark the low point, with modest increases in the following seasons (Figure 8). An upturn in China's economic growth and the lingering effects of drought in the US and elsewhere have combined to support prices through the second half of 2012. These factors have allowed Fonterra to increase its initial payout forecast, though still falling short of the previous season.

Figure 8: Fonterra Dairy Payout (before retentions)



Our view is that the long-term prospects for farming – and generally for food production – are favourable for New Zealand. Demand for food, particularly protein, will grow in developing countries as incomes rise and diets change. At the same time, world food production remains constrained by finite land and water resources. With this in mind, we expect farm prices to begin reflecting these improved income prospects.

...with support from low interest rates in 2013...

We expect the Reserve Bank to keep the Official Cash Rate at record low levels for some time longer, starting to increase it steadily from the second half of 2013. Even so, interest rates are likely to remain at levels that support higher farm prices over the year. The current two-year swap rate is around 2.7%, less than half the 10-year average of 5.7%. Similarly, mortgage and business lending rates are at or near record lows, which will support demand for rural land and put upward pressure on farm prices.

...but rising rates are likely to cap prices from 2014

However, we believe that once interest rates do start rising, they will go further than markets are currently anticipating. Borrowers are already starting to drift from floating to fixed rates, and an increase in this flow would put further upward pressure on fixed-term rates.

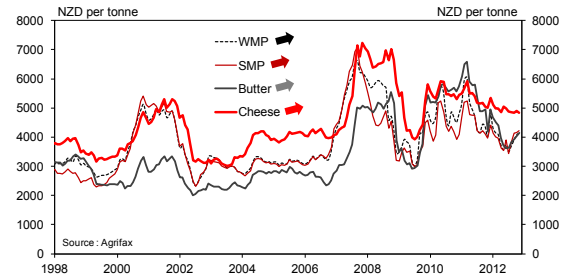
Overall, we think the balance of higher food prices, against an uptick in interest rates, still lies in favour of higher farm prices in 2013. However, we expect rising interest rates will dominate in 2014, capping further farm price rises.

Beyond the farm gate

Dairy

World dairy price increases outpaced the dollar over the last six months, leading us to revise our forecast of Fonterra's payout for the 2012/13 season to \$6.00/kg before retentions. Fonterra then revised its own forecast to \$5.90-\$6.00, some three weeks later (a 25c jump on its previous forecast). GlobalDairyTrade prices have risen 28% since May on a trade-weighted basis, compared to the 9% NZD appreciation over the same period. We expect recovering economic activity in China over 2013 to drive demand for dairy products, while the lingering effects of drought in the US and elsewhere continue to constrain supply. This combination should result in higher prices. Meanwhile, the NZD is forecast to average around USD 0.85 over the next year.

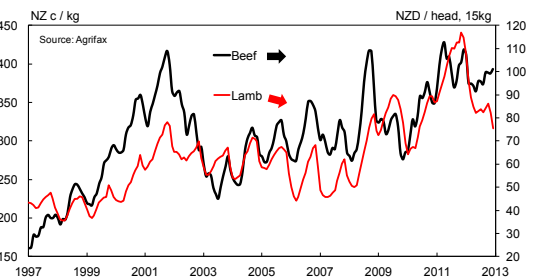
Dairy



Beef and Lamb

World beef prices posted new highs in December, while prices in NZD terms were not far behind. World prices face resistance at this level, but we see them edging higher as US beef supplies remain tight. While we expect demand to improve in tandem with an improving world economy, the high dollar may eliminate the upside for NZD prices. After stabilising mid-2012, world lamb prices have headed south for the northern winter. Lambs shipped in time for Christmas did not command the premium that they have in previous seasons. This weakness reflects the weak European and UK markets; we forecast the euro zone economy to contract by 0.4% in 2013. Also, with the Australian lamb slaughter forecast to increase 6% over 2012/13, competition will be hot in other markets (US and China). These factors will keep the downward pressure on lamb prices over 2013.

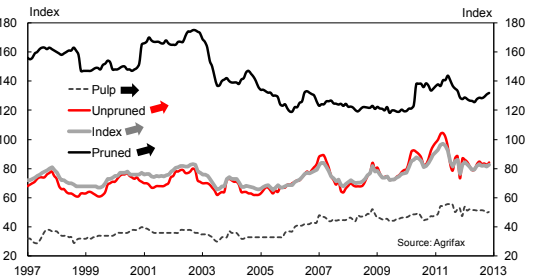
Beef and Lamb



Forestry

Log prices have lifted since hitting their lows in the first half of 2012. In contrast, pulp prices have crept lower over 2012. On balance, forestry prospects are improving: in particular, the Australian and US housing markets are showing signs of life, while improving economic growth in China will support demand for logs. Looking at the competition, Russia is shifting its focus away from logs to processed timber and has largely exhausted its supply of readily accessible wood – it has plenty of forest left, but has yet to develop the necessary infrastructure to extract the timber. Also, exports from Canada and the US were down 24% in the September quarter compared to a year ago.

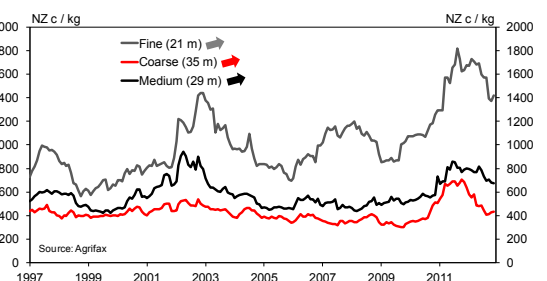
Forestry




Wool

Having fallen from record levels in 2011 wool prices appear to be stabilising; fine wool prices fell 25% from August 2011 to October 2012, but have risen 4% since. The stabilisation coincides with the improving Chinese economy, and we see Chinese growth and demand for wool improving further over 2013. While other markets are weak, the combination of the increasing Chinese demand along with low wool stock levels should drive firmer wool prices into 2013.

Wool



Forecast Key:

 General pace and direction of prices expected over the next 12 months

Prepared by NZ Economics, Westpac, PO Box 934, Auckland

For further information contact Nathan Penny ph: (09) 336 5669, email nathan_penny@westpac.co.nz or Dominick Stephens ph: (09) 336 5671

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