



Fortnightly Agri Update

19 November 2014

Freedom isn't free

This week Australia and China completed the negotiations for a bilateral free trade agreement (FTA), a process that has been going on since 2006. The new FTA removes tariffs on a wide range of agricultural and manufactured goods, and provides improved access for services, investment and work arrangements. The benefits to both countries will be significant. Modelling by our Sydney colleagues back in 2005 estimated a benefit to Australia of around \$US18bn spread over the next ten years, while China's gain would be \$US64bn. The massive increase in trade between the two countries since then means that those figures are likely to be a substantial underestimate.

We've seen several competing views as to whether the Australian agreement will be good or bad for New Zealand, which signed an FTA with China back in 2008 – the first developed country to do so. Our view is that the simplest answer is the best: to the extent that we will lose some of our 'specialness' in the Chinese market, the Australian FTA is a negative for New Zealand *on balance*. But that balance includes a range of smaller positives that could partially counteract the main negatives.

The main effect for New Zealand will be that Australian exports of agricultural products, particularly dairy and meat, will become more price-competitive in the Chinese market as the tariffs are phased out over the next several years. That in turn will put downward pressure on the prices that New Zealand exporters can garner in China.

However, this could create a number of positive second-round effects (this is by no means an exhaustive list):

- Lower prices will help to boost demand for meat and dairy products in China. New Zealand may be able to capture some of the resulting increase in volume, even if we lose market share relative to Australia.
- The boost to Australian incomes will benefit New Zealand firms that export to Australia.
- Fonterra reportedly controls about 20% of the Australian milk pool. The value-added on these Australian dairy products will benefit shareholders in New Zealand.

The magnitude of the effects, both positive and negative, will depend to some degree on Australia's ability to ramp up production for the Chinese market. On that note, we'd caution about using New Zealand's experience as a guide. Up until 2008, New Zealand was actually a laggard in terms of engaging with the Chinese market. Our share of exports going to China had been

flat for several years, despite China's rapidly growing share of the global economy. So the surge in exports to China since 2008 was largely about playing catch-up (the share of our exports going to China has been above the global average in recent years, but it doesn't stand out as being particularly high among our peers in the Asia-Pacific region.) In contrast, Australian exporters are already deeply involved with China; it's not obvious that they need an FTA to galvanise them into action.

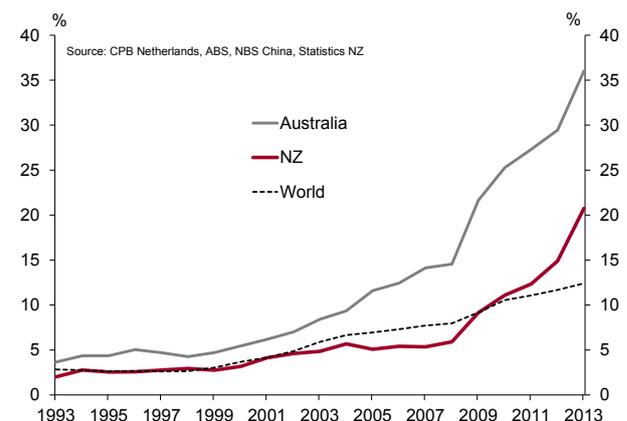
Global Dairy Trade Auction Results, 19 November

| | Change since last auction | Price USD/Tonne |
|--------------------------|---------------------------|-----------------|
| Anhydrous Milk Fat (AMF) | 6.1% | \$3,490 |
| Butter Milk Power (BMP) | 1.4% | \$2,511 |
| Butter | 6.0% | \$2,656 |
| Skim Milk Powder (SMP) | -5.7% | \$2,299 |
| Whole Milk Powder (WMP) | -5.1% | \$2,400 |
| Cheddar | 5.0% | \$2,861 |
| GDT Price Index | -3.1% | |

Payout Forecast Table

| | 2013/14 | 2014/15 | | 2015/16 |
|------------|----------|----------|---------|---------|
| | Fonterra | Fonterra | Westpac | Westpac |
| Milk Price | \$8.40 | \$5.30 | \$4.80 | \$6.20 |

Share of total exports going to China



Michael Gordon
Senior Economist

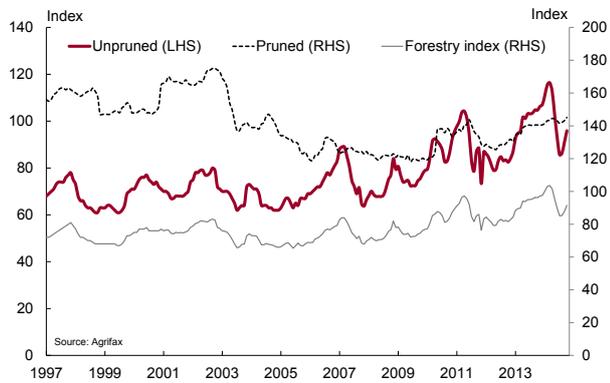
Beyond the farm gate



Forestry

| | Current price level compared to 10 year average | Next 6 months |
|-------|---|---------------|
| Trend | Average | ↗ |

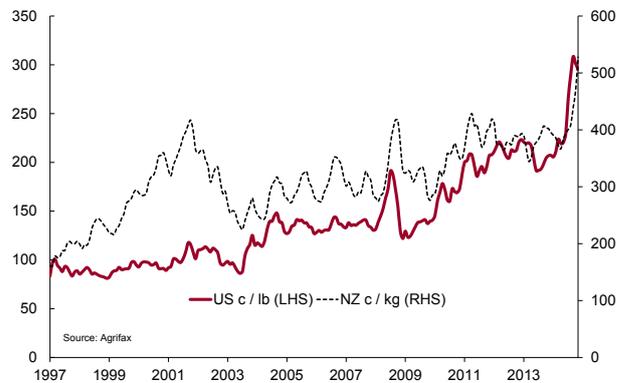
World prices for logs have stabilised in the last few months, and with a weaker New Zealand dollar in that time, local currency prices have rebounded by 7.5% according to the Agrifax forestry price index. We suspect that prices have stabilised because harvesting has pulled back to match demand – in contrast to dairy, where global milk production has continued to rise this year even as demand has slowed. The Chinese housing market is still in a slowdown phase, although policymakers have recently taken steps to revitalise demand by lowering mortgage rates and loosening mortgage restrictions. Solid growth in housing construction in both New Zealand and Australia should continue to support local demand for forestry products.



Beef

| | Current price level compared to 10 year average | Next 6 months |
|-------|---|---------------|
| Trend | Above Average | ↘ |

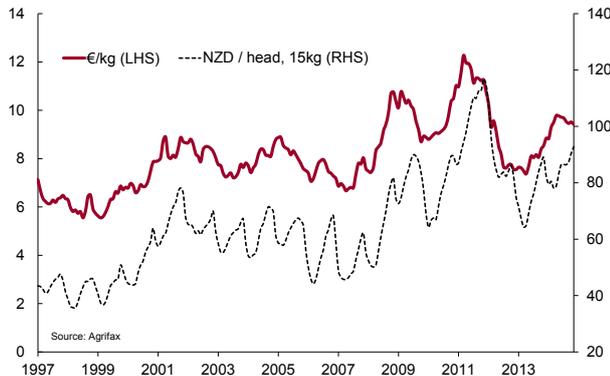
US beef prices have receded from their highs in the last few weeks. US supplies became extremely tight over the peak summer demand period, but imports (particularly from Australia) have helped to fill the gap. The US autumn cow slaughter is now getting under way, although record-low cattle inventories at the start of the season (going back to the start of the USDA's survey in 1973) should limit the extent to which prices fall.



Lamb

| | Current price level compared to 10 year average | Next 6 months |
|-------|---|---------------|
| Trend | Average | → |

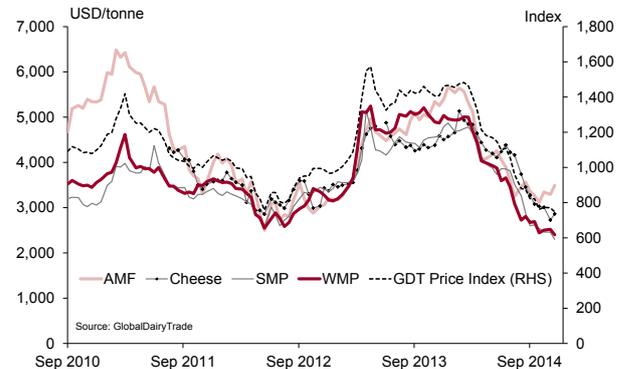
Global lamb production is adequate to meet demand at the moment. UK slaughter numbers and weights have improved on last year, and Australian lamb production is also running substantially above year-ago levels, although this may detract from supplies later in the year. Slower growth in China, and weaker demand for luxury goods, has weighed on pelt prices, taking some of the shine off total lamb returns for farmers.



Dairy

| | Current price level compared to 10 year average | Next 6 months |
|-------|---|---------------|
| Trend | Low | ↗ |

World dairy prices fell 3.1% in last night's GlobalDairyTrade auction, reaching their lowest level since August 2009. Prices for both whole and skim milk powder fell by more than 5%. In contrast, prices for value-added products such as cheese and butter, having been hit hard in the previous auction, saw a substantial rebound. Our forecast of a \$4.80/kg payout by Fonterra this season already allowed for some further near-term weakness in world prices, before a return to average levels over the course of next year. Hence, the latest auction result doesn't influence our forecast. Note that Fonterra will reportedly revise its current forecast of \$5.30/kg in early December.



NB: Trend arrows indicate direction of change in world prices.

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