



Fortnightly Agri Update

5 February 2014

Eyes to the East

High prices for New Zealand's commodity exports, in particular dairy, have become a feature of the New Zealand economic landscape. In aggregate, New Zealand's export commodity prices (in world prices) reached a new record high in January while the terms of trade are sitting at a 40 year high. Although tight international supplies have been important in some cases it is certainly not the only factor at play.

At the heart of the matter is China. Urbanisation, increasing incomes and changing diets mean Chinese households are consuming more dairy products. Add to that cultural factors such as relatively low rates of breastfeeding and young children living apart from parents and it is easy to understand how demand for dairy products has outstripped local supply, and just why New Zealand exports are filling this gap. New Zealand's dairy exports to China jumped 79% in 2013 compared to a year earlier - led by whole milk powder exports which are up an impressive 97%. Over a third of our dairy exports are now destined for China.

But it's not just about milk. China is now our single most important merchandise trade partner and in particular, it has ramped up its imports of a wide range of agricultural products from New Zealand. As the Reserve Bank noted in a recent speech, China is now New Zealand's largest export market for all major agricultural commodities with the exception of beef (where is second to the US). But even in this sector, as we highlighted in last week's *Fortnightly Agricultural Update*, China's importance is growing rapidly.

And all this has been happening at a time when domestic growth has been rather modest by Chinese standards. Our forecast of GDP growth of 7.4% this year is noticeably slower than in the recent past as the Chinese leadership prioritise the quality of growth over its quantity.

It's also notable that although China has been sucking in resources from many different parts of the world to fuel its growth, growth in imports from New Zealand has far outpaced growth in imports from other developed countries (see chart).

Given this evidence, it's not a long bow to draw to conclude that the Free Trade Agreement (FTA) between China and New Zealand, signed in 2008, is working strongly in New Zealand's favour. But even this is unlikely to be the only factor at play. New Zealand's enviable reputation, stringent food safety rules (even given recent high profile scares) and high bio security standards all contribute to New Zealand exporters being well placed to meet China's growing demands.

In large part, the drivers of Chinese demand appear to be structural rather than cyclical. That bodes well for the outlook for New Zealand's commodity prices for some time yet. And although the current sweet spot with high commodity prices and favourable growing conditions is unlikely to persist indefinitely, the fundamentals supporting strong demand from China should limit the downside on prices.

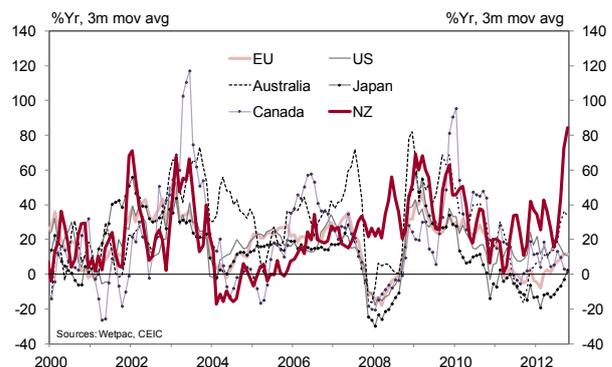
GlobalDairyTrade Auction Results, 5 February

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-1.2%	\$5,569
Butter Milk Power (BMP)	-1.2%	\$4,775
Butter	2.6%	\$4,745
Skim Milk Powder (SMP)	0.0%	\$4,746
Whole Milk Powder (WMP)	1.4%	\$5,005
Cheddar	-4.30%	\$4,935
GDT Price Index	1.4%	

Payout Forecast Table

	2013/14		2014/15
	Fonterra	Westpac	Westpac
Milk Price	\$8.30	\$8.40	\$7.10

Chinese Imports from Developed Markets



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See overleaf for sector outlooks.

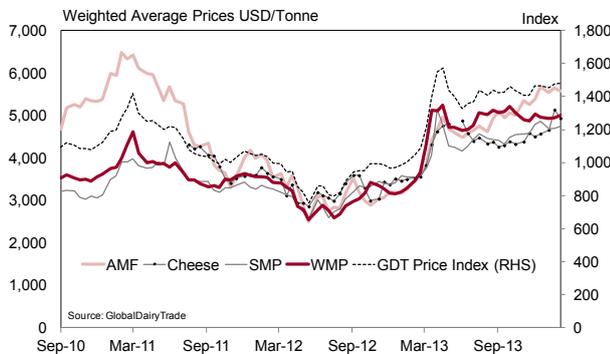
Beyond the farm gate



Dairy

Current price level compared to 10 year average		Next 6 months
Trend	High	↘

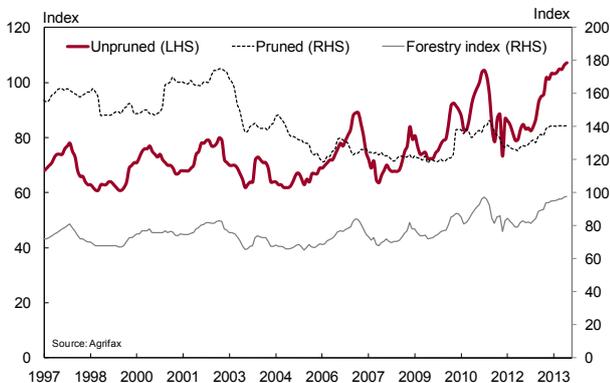
There was another solid global dairy trade auction last night. On a trade weighted basis prices rose 1.4%. Whole milk powder and skim milk powder prices continued to drift sideways (up 0.1% and down 0.5% on the last auction) while there was a big jump in cheddar prices. This further closed the gap between the two product streams which has been evident this season. Strong prices suggest demand from China for dairy products continues to hold up. We continue to expect to see dairy prices moderate in 2014 as global supply ramps up but it is starting to look as though this won't happen until closer to the middle of the year. Domestically production continues to run well ahead of last season, and the comparisons will only get more favourable as we move into the period where drought hit production hard in 2013. Nationwide production was 5.5% ahead of last year for the 6 months to November and we expect it to be up around 8.5% by the end of the season.



Forestry

Current price level compared to 10 year average		Next 6 months
Trend	High	↘

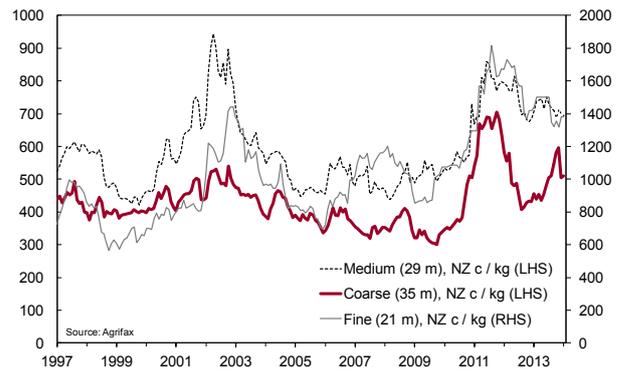
Strong demand from China for NZ logs pushed log prices up over 20% during 2013. Stats NZ reports that New Zealand is now the third largest exporter of logs in the world, after Russia and the United States. They report that in 2012 New Zealand supplied 8% of the total value of the world's log exports. Strong demand from offshore and increased building activity locally (as the Canterbury rebuild gathers steam) is putting upward pressure on log prices. While it is difficult to see prices taking a further step up from these already high levels, prices may drift sideways over the next few months.



Wool

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

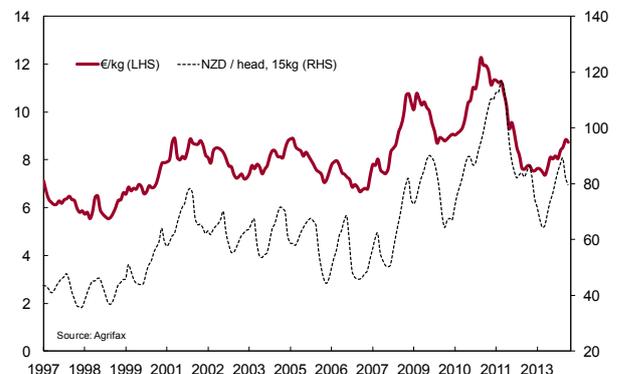
Local wool prices have started to climb again in recent weeks on the back of tight supplies. And there is a similar theme internationally. While Eurozone demand for high end wool products is likely to remain subdued, China is increasingly importing wool to manufacture products to meet its own demand for woollen apparel. ABARES reports that while China's exports of wool products to the US and EU are falling, this is being partially offset by increasing demand domestically and from South East Asia.



Lamb

Current price level compared to 10 year average		Next 6 months
Trend	Average	↑

International lamb prices have continued to edge higher in recent months. Domestically tight supplies, a remnant of last summer's drought and good pasture conditions encouraging farmers to add more weight to stock, should underpin prices during the seasonal decline over the next few months. While the Eurozone remains unambiguously weak, the UK economy has shown some positive signs in recent months, which may support consumer demand for lamb. Tight supplies in NZ and Australia should also help underpin prices. Locally many farmers are looking to take advantage of good pasture growth to improve finishing weights.



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

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