

Fortnightly Agri Update

2 December 2015

Dance of the (NZ) dollar

Dairy market developments often dominate headlines about the agricultural sector. After all dairy is the New Zealand's biggest agricultural export earner. And the industry's footprint is felt throughout the country with a recognisable presence in regional economies from Northland right down to the deep south. The sharp drop in dairy incomes over the last couple of seasons means a multibillion-dollar pay cut for the New Zealand economy.

But things could be looking even worse for dairy farmers if the NZ dollar hadn't moved lower in response to falling international dairy prices. In fact other exporters whose international prices haven't deteriorated to nearly the same extent (or have even improved) have actually seen their farm gate prices lift on the back of the weaker NZ dollar, which has tumbled from a high of above 78cents against the US dollar in January this year to around 66.77 now. Looking at an overall trade-weighted basket of commodities, New Zealand exports are actually now 3% higher than they were 12 months ago even though they are down 12% when measured in world prices.

So with the currency developments such an important part of farm gate returns, where to from here for the Kiwi? Our view is that the currency will remain under pressure over the coming year, falling to around 62c against the US dollar by June 2016. Although the exchange rate can be affected by a wide range of factors (and forecasting exchange rate developments is notoriously difficult), there are three elements which are key to our outlook.

The first is the outlook for domestic interest rates. We expect the RBNZ to deliver another rate cut next week, reducing the OCR to 2.5%. However, unlike markets, we don't think this will be the end of the current easing cycle. Instead, our view is that low inflation will eventually compel the Reserve Bank to cut interest rates to just 2% next year. We would expect lower interest rates in New Zealand to put downward pressure on the NZ dollar.

The second important factor is the outlook for global interest rates – in particular US interest rates (which tend to impact interest rates not only in the US but right around the world). We expect the Federal Reserve to raise interest rates for the first time since 2006 later this month. But perhaps even more importantly, we think the strength in the US economy will see the Fed continue to lift rates over 2016 more quickly than the market expects. These rising interest rates should provide support for a stronger US dollar against other currencies – including the NZD.

The third factor worth mentioning is the outlook for NZ export commodity prices themselves. When the international prices of NZ's commodity exports are high, the NZD tends to be high

and conversely when NZ commodity prices are low, the NZD tends to be low. Overall we think NZ export commodity prices will remain under pressure over the next year or so. While dairy prices in particular are likely to rise in response to sharply lower NZ dairy production as the El Nino weather pattern weighs on pasture growth and milk supply, we think Chinese consumer demand could remain muted over the year ahead with the Chinese economy forecast to slow further in 2016.

Anne Boniface

Senior Economist

Exchange Rate Forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ GBP	NZD/ JPY	NZD/ EUR	TWI
Dec-15	0.64	0.94	0.43	78.1	0.60	70.5
Mar-16	0.63	0.95	0.43	77.5	0.61	70.4
Jun-16	0.62	0.94	0.42	76.9	0.60	69.3
Sep-16	0.62	0.93	0.42	77.5	0.59	69.0
Dec-16	0.62	0.90	0.41	78.1	0.58	68.1
Mar-17	0.62	0.89	0.40	76.3	0.57	67.5
Jun-17	0.62	0.87	0.39	76.3	0.56	66.8
Sep-17	0.62	0.86	0.38	76.3	0.55	66.2
Dec-17	0.62	0.87	0.39	77.4	0.56	66.7
Mar-18	0.62	0.86	0.38	77.5	0.55	66.3

Global Dairy Trade Auction Results, 2 December

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	2.3%	\$3,519
Butter Milk Power (BMP)	-5.6%	\$1,729
Butter	5.7%	\$3,009
Skim Milk Powder (SMP)	3.2%	\$1,918
Whole Milk Powder (WMP)	5.3%	\$2,260
Cheddar	-1.5%	\$2,829
GDT Price Index	3.6%	

Payout Forecast Table

	2015/16		2016/17
	Fonterra	Westpac	Westpac
Milk Price	\$4.60	\$4.50	\$5.20

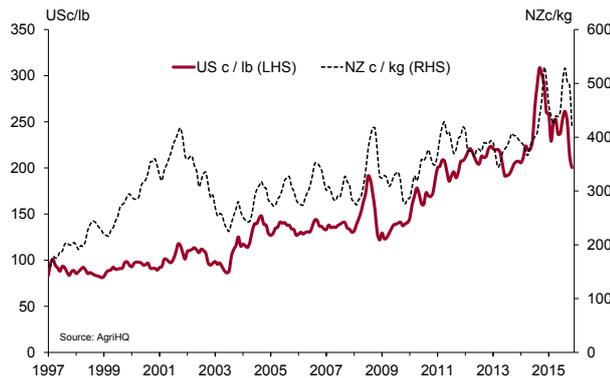
Beyond the farm gate



Beef

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

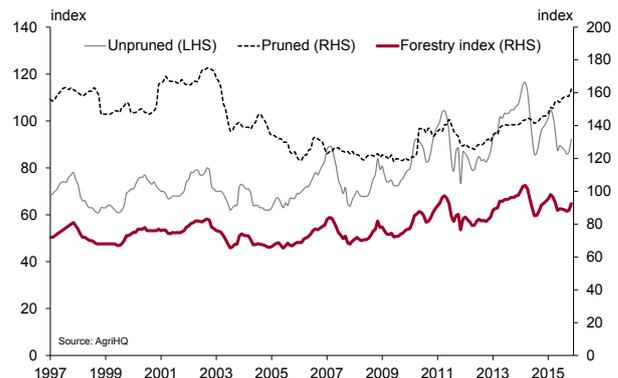
With both New Zealand and Australia rapidly approaching their tariff-free import quotas, US buyers have substantially lowered their prices for delivery over the end of this year. In addition, strong early season cow culling locally, and ample supply from Australia have weighed on imported beef prices in the US. However, Australian shipments to the US are showing signs of slowing from record levels.



Forestry

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

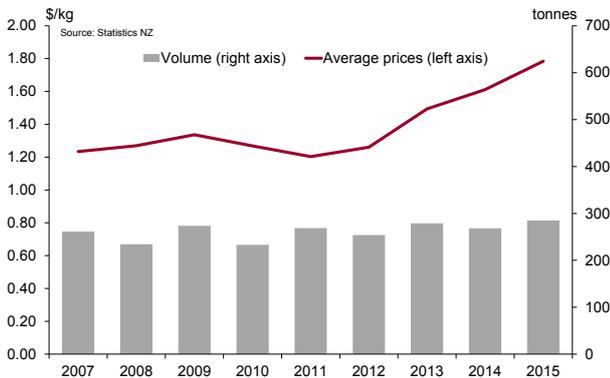
Log prices have improved noticeably in recent months, apparently as supplies in China have tightened. But with suppliers likely to respond to improved prices by lifting supply, and the soft Chinese economy (and weaker renminbi) likely to be a headwind to a sustained lift in demand for NZ logs for a while yet, we are sceptical that the recent spike in prices will be maintained.



Apples

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

Trade figures up to October show that prices improved further in the latest season, on broadly steady volumes. El Niño presents a substantial risk for next season; the previous El Niño in 1997-98 caused substantial issues with fruit quality.

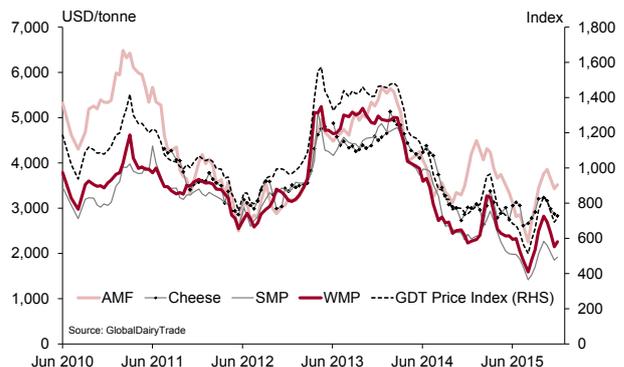


Dairy

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

Dairy prices bucked their recent run of weak outturns by lifting 3.6% in last night's auction. Within this there was a 5.3% lift in the key whole milk powder prices. The improvement in prices was broadly in line with expectations and leaves us comfortable with our current forecast farm gate milk price payout forecast of \$4.50.

What's more, our take on international dairy markets is little changed following last night's outturn. For now dairy prices seem to have found support around current low levels. Over the coming months, we expect to see some further improvement in prices as El Niño starts to bite and NZ milk production continues to track well below last season's levels. However ongoing growth in global supply (especially out of Europe), combined with muted international demand for dairy products (particularly in China) will probably keep a lid on the extent of any improvement in dairy prices for a while yet.



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

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Satish Ranchhod, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

David Norman, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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