Agribiz

October 2011

Welcome to the danger zone

The outlook for the agricultural sector during uncertain times

Extreme volatility in financial markets over the past few months has hit the headlines – and not just in the business section. In this quarter's Agribiz, we take a look at the risks a deteriorating global outlook may pose for New Zealand's agriculture sector. Clearly the risk is lower world prices for New Zealand's primary exports. However shifting export markets, tight supply in some sectors and the floating NZD should provide some support for prices and trends supporting higher food prices over the longer-term remain in place.

A chill wind has been blowing in from offshore in the past month. Global growth is slowing, and world financial markets have taken a marked turn for the worse, spooked by poor economic data in the US and increasingly concerning sovereign debt problems, especially in Europe. With markets becoming more convinced that some struggling Eurozone economies will be forced to default on their debt, others are weighing up how the already stretched European banking sector will cope with these losses and what, in turn, this might imply for banks in other parts of the world.

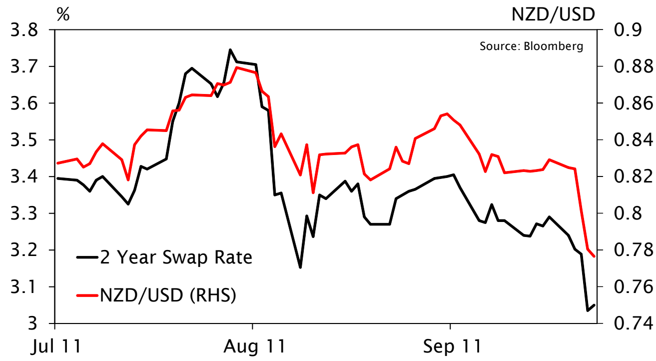
Beyond the US and Europe there are intermittent signs of slowing growth, but for different reasons. In China and other emerging market economies, authorities have been applying a handbrake to growth as they worry about high inflation and the risk of asset price bubbles developing. To date, it looks as if activity there is still heading for a soft landing. In Australia growth has been slowing as consumers batten down the hatches as they bear the brunt of rising interest rates and falling house prices.

Meanwhile, around the world policy makers, economists, business owners and farmers alike are keeping one eye on developments in the Eurozone, wary that the deteriorating outlook there may spillover to a sharp slowdown in global growth, causing their own economies to stall. In New Zealand, these fears have led the RBNZ to delay the inevitable tightening cycle.

So how's New Zealand holding up?

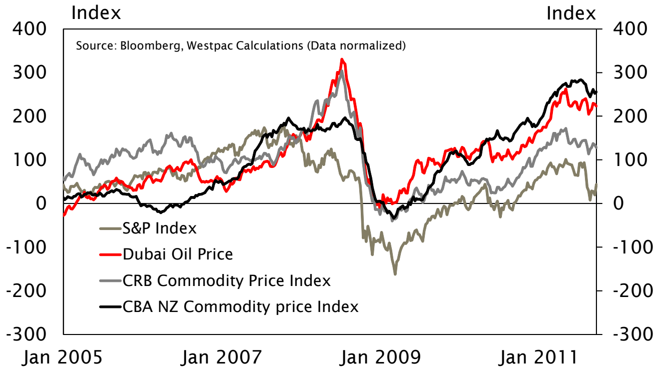
Effects on New Zealand's real economy have so far been fairly muted. Since markets took fright in early August domestic share markets have tended to follow offshore markets lower, but have not fallen nearly as far (as we go to press, the NZX is down 4.7% compared to the S&P which has fallen 12%). Interest rate and exchange rate markets have been choppy, with both NZD and interest rates lower now than in early August.

Figure 1: NZ Interest rates and the NZD



Perhaps most surprising is the relative strength shown in commodity markets. Uncertain and volatile markets tend to put downward pressure on commodity prices, while a slower outlook for global growth also implies less demand for commodities (and therefore lower prices).

Figure 2: Oil, commodity prices and share markets



Yet to date, while uncertainty persists and global growth is looking shakier, commodity prices have displayed some resilience. Oil prices are down 5% from early August levels while closer to home, CBA's index of NZ commodity prices (in USD) is down 3.4% (from late July), CRB's index of food prices is down 5.8% while the aggregate CRB index has fallen 10%.

We expect that we'll see softer demand from the US, Europe and key economies in Asia put downward pressure on key primary product prices in the coming months. But longer-term trends are still pointing up, and prices should remain above Global Financial Crisis lows.

Changing export markets

One reason we're cautiously optimistic for a limited decline in commodity prices in general, and food prices in particular, is the shifting power base of demand. No longer is the marginal growth in demand for commodities coming from the big, wealthy western economies, but instead it is coming from the fast growing emerging market economies in Asia, South America and in particular China. This trend is clearly visible in the demand for oil, but also in New Zealand's own trade patterns.

Figure 3: Growth in consumption of oil

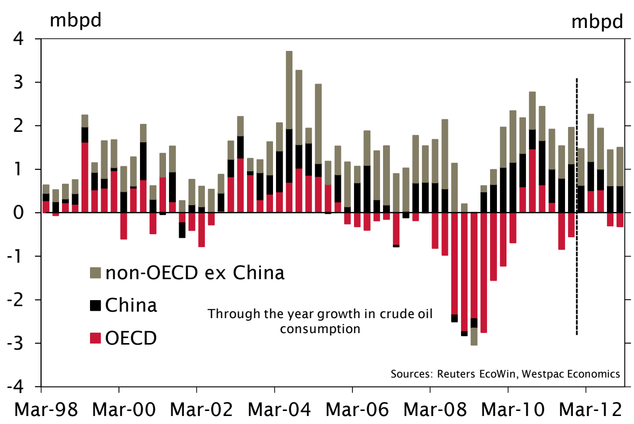
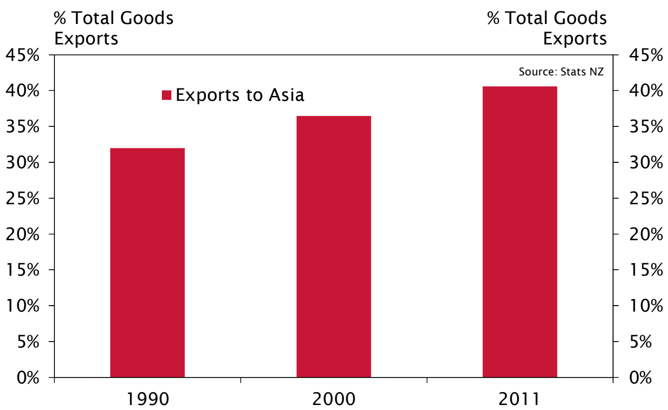
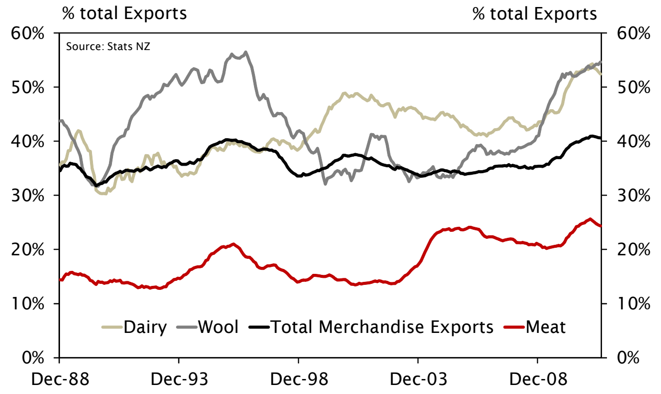


Figure 4: NZ Trade with Asia



In 1990 New Zealand sent around 32% of its traded exports to Asia by 2000 the country was sending 36.5% of its goods exports there, and for the year to August 2011, we sent 40.6%. The trend is even starker for exports of agricultural commodities. Around 44% of New Zealand's meat, wool and dairy exports (combined) go to Asia. Despite the bad news on Greece (and others) drivers of these long run trends have not changed.

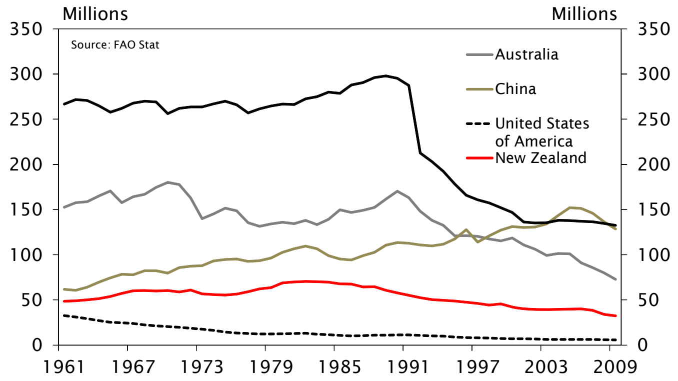
Figure 5: primary product exports to Asia



Tight supply

As any first year economics student, business owner or farmer will tell you, the worst possible combination for sellers is when falling demand coincides with increased supply. Fortunately for some of New Zealand's key exports, tight global supply has played a part in the run-up of prices, and these conditions have not yet eased substantively.

Figure 6: Sheep count (selected countries)



The lamb market is one such example. While at first glance this sector may have been particularly susceptible to a deteriorating outlook for consumer demand in Europe and the UK (49% NZ lamb exports head to the European Union, predominantly higher value cuts), supplies in this market are also particularly tight. This has helped push NZD lamb prices 30% higher over the last year.

Globally, sheep numbers in key exporting countries have been in structural decline for decades (as wool lost its competitiveness against other fibres). While productivity improvements have helped lamb production, recent stock losses in New Zealand following last year's spring snow storms have cut breeding numbers, with the flow-on effects likely to continue to be felt over the next 12 months (Beef and Lamb New Zealand expect a 2.5% fall in the number of ewes this season).

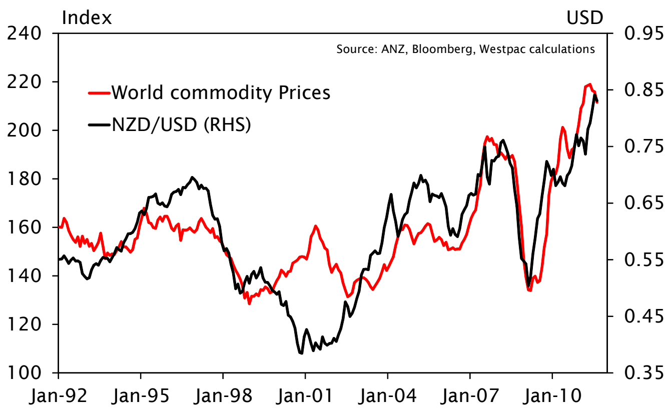
To some extent beef markets are in a similar (though not as extreme) boat. However, the near term factor complicating the outlook is the liquidation of stock in Mid Western US States hurt by drought.

Yet in other markets – including dairy – the supply constraints aren't quite as apparent. New Zealand dairy production has started strongly, both US and EU production is well up on a year ago. There, softer domestic demand combined with a lower USD and Euro could push product into export markets. Over a slightly longer horizon, the price of feed relative to the price of milk will be an important factor determining how much Northern Hemisphere output ramps up.

NZD should help cushion the blow for farmers

Another factor working in the favour of New Zealand farmers facing slower global demand is the NZ dollar and its relationship with commodity prices. If we do get a sudden and sharp fall in the prices of NZ commodity exports, past relationships suggest we would also a depreciation of the NZD which will help cushion farm gate returns.

Figure 7: The NZD and commodity prices.



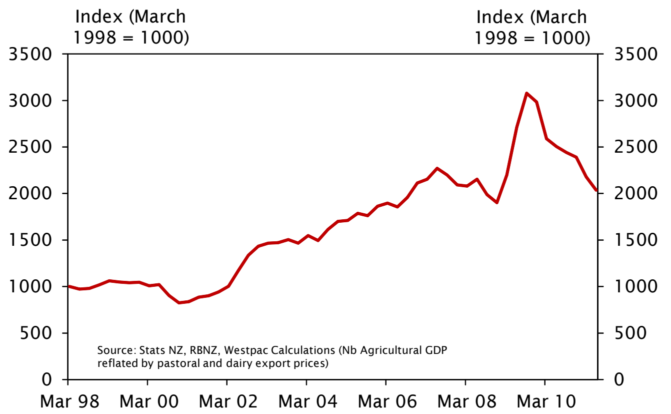
Falling commodity prices could come at a time when interest rates are on the way up

But it is not just through commodity prices that the deterioration in global financial market sentiment may be felt on New Zealand shores. Another important channel is via an increase in bank funding costs. Turbulence in financial markets has led to a sharp rise in credit default swap spreads (CDS) for Australasian banks. This basically means that banks now have to pay a higher premium when borrowing from overseas. Just how this affects local retail borrowing costs depends how long these CDS spreads remain elevated.

Since the Global Financial Crisis banks have placed greater emphasis on alternative, more stable (but more expensive) sources of funding. Combined with subdued demand for credit, this means banks currently aren't under pressure to access funds from offshore markets. However if offshore credit markets remain stretched, higher funding costs will eventually translate to higher retail interest rates, independent of changes in the Reserve Bank's Official Cash Rate. While this won't happen overnight (the immediate pressure has in part been alleviated by the sharp fall in wholesale interest rates we've seen already) if CDS spreads remain high, it will happen.

Rising interest rates, combined with lower incomes is an unwelcome combination for a sector where debt levels remain high. Rising agricultural incomes over the past year have been used by many farmers to reduce debt and this is likely to remain a priority for many in the sector (particularly given few signs of a rebound in rural land prices). Higher interest rates will slow the speed of this balance sheet repair.

Figure 8: Agricultural Debt to GDP ratio



But we remain in uncertain times

These are still early days in what is likely to be an extended period of uncertainty & volatility. Sovereign debt issues in the Eurozone and even the US will take years, if not decades to resolve. Over this period, there will be times when the world starts to look like a less friendly place for New Zealand's primary produce exporters.

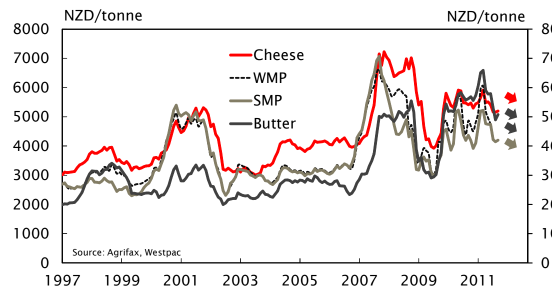
However lessons were learned during the GFC. Asian countries, led by the juggernaut Chinese economy, showed they had the ability to, if not completely decouple from Western Economies, post a strong rebound in growth while the US and Europeans muddled through. Lower commodity prices actually make growth easier for developing economies as they compete for scarce resources with other parts of the world. Urbanisation, income and population growth mean changing diets in the most populous parts of the world. This translates to increasing demand for food globally, and New Zealand remains well placed to meet this demand.

Beyond the farm gate

Dairy

Dairy prices have fallen significantly over the last 6 months – led by falls in WMP prices. Yet most recently, the pace of decline has broadly slowed and WMP prices actually rose slightly in the latest GlobalDairyTrade auction. Globally, production may be getting a near-term boost. At home, a mild autumn and winter (with the obvious exception of a few days of extreme snow) has left stock and pastures in good condition and early season production is running well above last year's levels. Estimates of US production for 2011 have been revised up to 1.5% growth on last season, in the Eurozone production is 1.5% above last year for the year to date. Yet persistently high grain costs continue to have the potential to limit the extent of global increases in production.

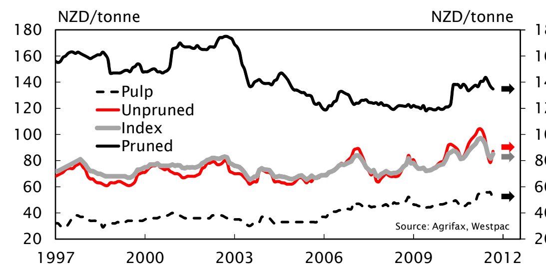
Dairy



Forestry

Agrifax's log price index (which measures returns from the whole forest) fell 12.5% between April and September before bouncing back in September. The main driver of the decline was a fall in the price of un-pruned logs, which in turn is increasingly driven by Chinese demand (with over 60% of NZ log exports heading to China). High inventories in China have been blamed for the sharp correction in prices, but there has also been increasing supply from US and Canadian producers. There remains the potential for a significant increase in supply to China if Russian log export tariffs are reduced, though there has been little news on this front of late.

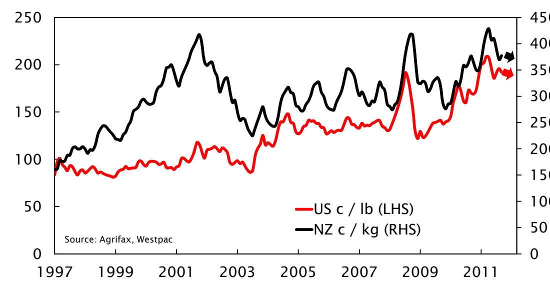
Forestry



Beef

Beef prices are below recent peaks, but remain elevated. In the US, New Zealand's biggest beef export market, supply has been boosted as producers there liquidate stock as severe drought across the Southern Plains continues. Total US beef cow slaughter since the 1st of July has risen 17% in the midst of severe drought. Increased slaughter, at a time when the US consumer remains fragile, is likely to assert downward pressure on prices in the near term, but tighten supply constraints over a longer horizon.

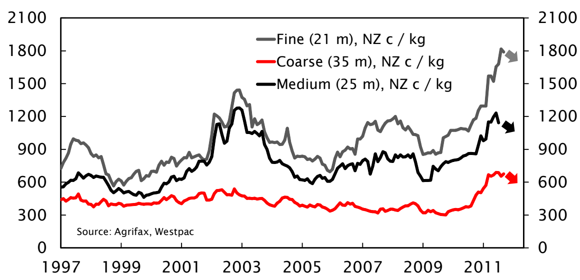
Beef



Wool

Wool prices have held up very well in recent months, and are in the order of 50% above levels of a year ago – though we suspect they have now passed their peaks. Prices for cotton, a competitor for wool fibre in some markets, have plunged, which in turn has boosted its competitiveness relative to wool. Sharply lower growth forecasts in the US and Europe are likely to put downward pressure on fine wool prices in particular.

Wool



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

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