First leg of the trifecta

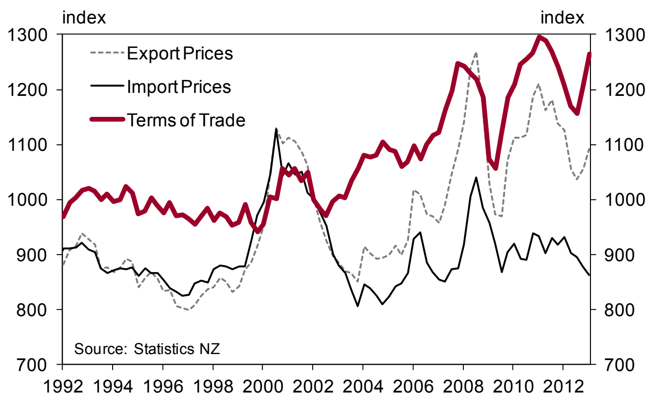
Q2 Terms of trade review 2013

- **New Zealand's terms of trade are booming.**
- **Dairy will steal all the headlines, but an accelerating domestic economy and high dollar also shine through in the data.**
- **Export volumes retreated with the drought, but a wet autumn and mild winter bode well for a strong rebound.**
- **Import volumes are racing ahead too with the aforementioned Kiwi dollar still high and household and business confidence soaring.**
- **We expect the terms of trade to hit a 40-year high in the September quarter, and then to remain high into 2014.**

Overseas Trade Indexes (qtr % chge)

	2012Q3	2012Q4	2013Q1	2013Q2
Terms of Trade	-3.2%	-1.2%	4.2%	4.9%
Export Prices	-6.3%	-1.9%	2.0%	3.4%
Import Prices	-3.2%	-0.7%	-2.2%	-1.5%
Export Volumes (s.a.)	7.8%	-0.5%	0.1%	-6.7%
Import Volumes (s.a.)	0.8%	-1.6%	3.2%	3.9%

Export and Import Prices



New Zealand's terms of trade are booming. Today's data showed that in the June quarter of 2013, the terms of trade rose 4.9%. Dairy prices dominated, with a whopping 13.6% increase.

Other export prices were a mixed bag, with roughly an even split of rises and falls. Forestry prices rose 4.2%, adding to the 2.6% gain in March. While dairy grabs many of the headlines, it's onwards and upwards for this quietly-achieving sector.

Drought was the catalyst for the Q2 dairy price spike recorded in today's data. But other factors have since kept prices high. These include a weak world supply, strong demand from key markets such as China and Fonterra's recent announcement of its further move into the value add business (adding to demand for raw materials).

Export volumes fell 6.7% in the quarter as the June quarter bore the full brunt of the summer drought. Dairy and meat export volumes fell by over 18% and 7% respectively. This will offset the effect of higher prices, leaving overall export receipts roughly square.

However, as we have regularly pointed out the drop in export volumes will be temporary and overall total export revenues will hold up very favourably over the rest of the year. What's more dairy prices remain high and are set to stay high for longer than we initially expected a few months ago.

With a wet autumn and mild winter we expect agricultural production and thus exports to rebound quickly over the rest of 2013. We've pencilled in a 5% rebound in dairy production volumes this season. While the meat sector will take longer to recover, overall agricultural export volumes will rebound strongly this season.

Import volumes are racing ahead too as the Kiwi dollar remains high and household and business confidence soars. The TWI rose 0.7% over the quarter, while the manufacturing sector, for example, is at its most confident since 2004.

In this quarter, the categories to surge were passenger motor cars (up 28%) and transport equipment (industrial (up 74%)). Consumption goods fell 0.5% for the quarter, but don't expect that to be low for very long – households are opening their wallets once again.

What is stark to us is the resilience of various sectors of the economy. The tradables sector has shown with this data its resilience in the face of drought. Also, the slowdown in Chinese growth has passed to date with no material impact on dairy, forestry or meat prices. Throw in dairy prices defying the botulism alarm, and the sector is proving very adept at weathering storms.

The housing sector is set for its own resilience test with the introduction of the LVR measures. As we have outlined we think the market, barring a few weak months at the end of 2013, will kick on again from early 2014.

Meanwhile, Canterbury is resilience personified. Recent regional growth estimates showed Canterbury growing at double the national average.

Add the three factors up and the economy is set for a rapid acceleration in growth over the next 12 months. From 2.5% annual growth currently we expect 3.7% over 2014. So what is going to knock this booming trio off their stride, and when?

Eventually the terms of trade boom will end, although we think it has around two to three years to run. The impetus will come from increased dairy supply with the US and to a lesser extent Europe the likely sources of medium term production growth.

That said, we think food and export prices have moved structurally to a higher level. And this bodes well for New Zealand's long-term income prospects.

On the other hand, the Canterbury rebuild is temporary. We expect activity to peak between 2015 and 2016 and then for the rebuild to gradually wind down its growth contribution over the following years.

Of the three booms the housing market has the biggest target on it. While we don't hold out much hope for the newly-minted LVR tools, good-old fashioned interest rates rises will eventually send house prices spinning lower.

Market implications

There was no market reaction following the release.

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