Westpac Institutional Bank

Fortnightly Agri Update

20 August 2014

The fickle NZD

Dairy prices showed signs of stabilisation in last night's GDT auction. The headline trade weighted index fell 0.6%, which included a 3.4% lift in whole milk powder prices, the first upward move in WMP prices since mid-June, although clearly not nearly enough to make up for the 26% decline seen in prices over July and early August. In contrast, skim milk powder prices fell sharply.

But while any sign of a stabilisation in dairy prices will be welcomed by those in the dairy sector, there also remained little sign that buyers expect prices to rise strongly in the near future. For example WMP, buyers were only slightly more willing to pay more for product with later delivery dates.

After the last couple auction results (which included a more than 10% fall in WMP prices a fortnight ago), we've shaved 20c off our payout forecast for this season, moving to a milk price of $5.80. Fonterra last revised its own milk price forecast on the 29 July (moving from $7.00 to $6.00). It could take the opportunity to announce any further changes to this outlook around the time its 2014 financial results are released on 24 September.

Achieving a $5.80 milk price still relies on both a strong rebound in commodity prices by year's end, and a small drop in the NZD. Should either of these factors fail to live up to our expectations, the final payout for the 2014/15 season could still be south of $5.80. Of course the reverse is also true. An unexpectedly sharp fall in the NZD or a faster rebound in dairy prices would see us moving our forecast upwards.

The strong NZD has been a cause of consternation for farmers and growers in recent months. Dairy farmers and forestry owners in particular have watched international prices for their products tumbling, while the NZD peaked above 88c in July and has subsequently dropped only a little to around 84c.

But while commodity prices are one important driver of the exchange rate, they are by no means the only factor at play. Other important influences on the NZD include New Zealand's interest rates compared to interest rates in the rest of the world (and the outlook for both) and relative economic growth prospects. In addition market sentiment (appetite for risk) can also play a big role at times.

Over much of 2014 the strong domestic economy has required the RBNZ to raise interest rates at a fairly rapid clip, as well as clearly communicating its view that even at current levels (now 1% higher than where they started the year) interest rates are still too low. What's more, offshore events also supported a stronger NZD. In Europe the European Central Bank was forced to undertake further stimulus measures to try and free up lending/credit channels, while in the US markets pared back their expectations of the pace eventual Fed tightening.

If anything, the NZD could have gone higher, given where the terms of trade got to. Now, with the terms of trade falling, some but not all of the strength has come out of the currency. The NZD has fallen from above 88c to almost 84c today. And we think there is room for the NZD to fall further yet. While the RBNZ remains in pause mode, and currency markets dwell on what lower dairy prices mean for the NZ economy, we're forecasting the NZD/USD to average 83c over the remainder of the year. The Reserve Bank too has been railing against the strength of the Kiwi, using increasingly more aggressive language to signal its discomfort describing the currency as "unjustifiable" and "unsustainable" leading us to conclude it was seriously contemplating intervention (selling NZ dollars to try and lower the value of the currency). But the improving outlook for commodities on the back of a more buoyant Chinese consumer next year, could see the NZD rise a little in the New Year. We're unlikely to see a markedly weaker NZD until 2016 after central banks in the US and Australia have launched their tightening cycles and markets start to look forward to an eventual easing cycle from the Reserve Bank.

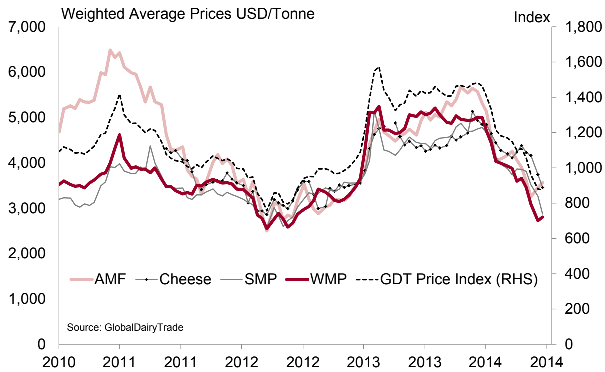
GlobalDairyTrade Auction Results, 20 August

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	3.6%	$3,566
Butter Milk Power (BMP)	-2.5%	$3,886
Butter	4.9%	$2,940
Skim Milk Powder (SMP)	-12.0%	$2,874
Whole Milk Powder (WMP)	3.4%	$2,804
Cheddar	-7.9%	$3,453
GDT Price Index	-0.6%	

Payout Forecast Table

	2013/14		2014/15		2015/16
	Fonterra	Westpac	Fonterra	Westpac	Westpac
Milk Price	$8.40	$8.40	$6.00	$5.80	$6.60

GDT auction prices



Anne Boniface, Senior Economist

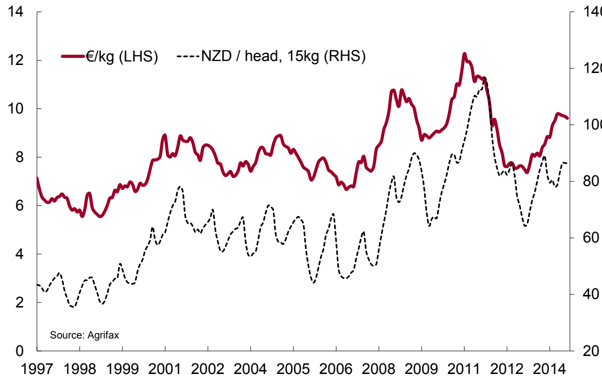
Beyond the farm gate

Lamb

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

Beef and Lamb New Zealand's 2014 stock survey recorded a 3.2% decline in sheep numbers (to 29.8million) in the year to June 2014. But with ewe condition and feed supplies more favourable at mating this year, the lamb crop is expected to remain fairly flat (up just 0.3%) despite a decline in breeding ewe numbers.

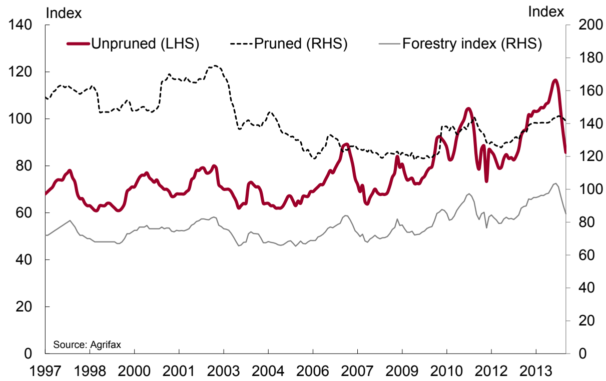
Improved lamb prices this year are likely to continue to encourage ongoing productivity gains in the sector. Demand for NZ exports in traditional markets such as the UK appears to have remained relatively buoyant, despite a strong lift in domestic slaughter there. Coupled with solid demand from emerging markets, this has supported prices. With Australian production expected to moderate next season, the outlook for prices going forward remains favourable.



Forestry

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

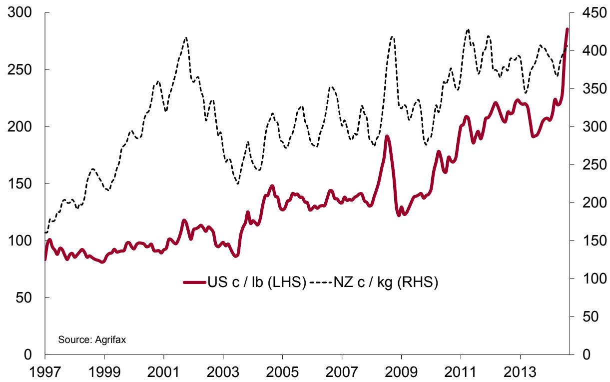
Like dairy prices, log prices have been a bellwether of Chinese demand. Unpruned log prices fell another 8% on the Agrifax measure in July, and are now down 26% from their March highs. The slowing housing market in China has weighed on demand, leaving middlemen caught with unexpectedly large inventories. There have been anecdotal reports that these inventories are now starting to stabilise. If this trend continues it should provide some support to prices going forward though a significant recovery prices is likely to rely on an improved Chinese housing market.



Beef

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

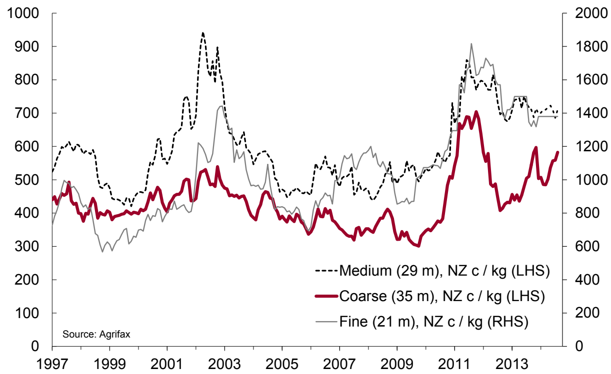
Beef prices have remained elevated in the last few weeks, as tight US supplies continue to dominate markets. USDA data shows that on July 1st this year, cattle inventories were at their lowest level since this particular survey began in 1973. While numbers are expected to grind higher on the back of record prices, improved pasture conditions and lower fed costs, this will take time. In the meantime, producers in Australia and New Zealand remain well placed to fill the gaps. Locally, favourable prices and climatic conditions helped support the first increase in beef cattle numbers since 2006/07 in Beef and Lamb New Zealand's 2014 stock survey. Beef cattle numbers were up 1.6% in the year, with the bulk of the increase coming from herds in the North Island.



Wool

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

Coarse wool prices remained broadly unchanged over the last month. Locally, supplies are reported to be tight. The improvement in coarse wool prices has seen the premium between fine and coarse wool prices decline, but it is not yet back to the late 2013 lows. The theme of tight supply also continues globally. In their most recent forecasts, ABARES expects Australian wool production to reach a record low in the 2014/15 season on the back of a significant reduction in the national flock.



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

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

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