Fortnightly Agri Update

4 October 2017

Winning S-tree-k

- Demand for logs continues to remain high.
- China is the central source of this rally
- Pruned and Unpruned logs are showing healthy pricing action
- Competition and supply remains firm, but demand continues to outweigh supply side risks.
- Environmental concerns from the Chinese Government may play on downside risks.

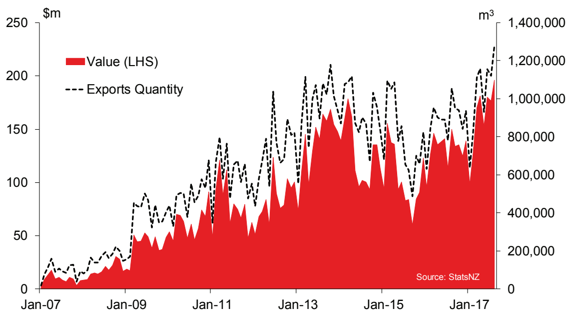
Forestry has been one of the few outperforming industries in New Zealand's agriculture sector. Log prices (according to the AgriHQ index) have been operating 30% better on average than their long-term trends. Export log prices in particular have sustained their strength from the beginning of the year and shown little signs of giving in. Its outperformance has been due to a mixture of factors driving demand, a key being the pace of construction activity. Globally, demand and construction activity remains firm, but domestic construction is running into constraints on growth. In this fortnight's Agri update, we will look into the recent developments and affecting the market and prices in the year to come.

Domestic Factors

While the domestic demand for logs has kept at a reasonable pace, the rate of growth is likely to be moderate. This is largely due to the issues facing the housing market in New Zealand, especially Auckland. In particular, construction sector activity has slowed and become flat in recent months. The main constraints have been a tightening of credit and shortages of skilled labour.

Over the medium to long-term, we expect that residential building will pick up, as Auckland will need to meet demand, despite sectoral constraints. Notwithstanding the gradual pace of the pick-up, residential construction requirements will be a boost to structural logs/timber demand. Adding to the short-term support for prices trending upward are the poor weather conditions that are affecting the harvesting of trees. Comparatively wetter conditions to previous seasons have left many forests especially in the central North Island tougher to harvest. That being said, production continues to track above 2016 levels.

Log exports to China

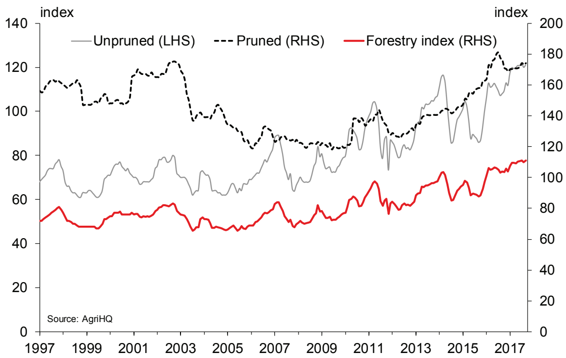


Global Factors

The global economic environment has been firming throughout this year and showing signs of strength in the manufacturing and construction sectors. Unsurprisingly, China remains the biggest driver of the upbeat global outlook. In particular import demand from China for New Zealand logs has consistently risen. On a three-month average, New Zealand logs made up 35% of total log imports in July. At the same time, log imports from Russia (China's second largest source) were down from 29% to 25%.

Chinese housing construction is expanding rapidly in tiers two and three cities, with tier one construction easing to normal levels. We expect China's economy to slow next year, which would affect log prices but Chinese demand for housing construction over the medium to long-term is expected to rise as a greater proportion of the populace transition into the middle class.

Forestry



Risks to the pace of this rise are China's financial regulation and environmental policies. These policies are the Chinese government's means to rebalance the economic activity in the lead up to five yearly National Congress in November. Recent financial regulation policies have led to a crackdown on the lending practices of banks, restricting the ease of access to credit for many industries including construction.

Moreover, a recent introduction of air pollution controls have also reduced the ability of major industrial sites like Beijing to process logs. Short-term effects are likely to boost import demand as operations from the main industrial sites shift to the outer regions that have less restrictive controls. Nevertheless, constraints on in-market supply are unlikely to hamper construction and logging activities for long as the adjustment is already underway.

Globally, New Zealand's log exports have been relatively consistent with historical trends. Indian log imports appears to be a bit abnormal compared to seasons passed. Although NZ log exports to India are down 4% year to date, exports are outperforming the normal annual pattern. This may be temporary, but with the Indian government ordering a review of a better utilisation of urban land, the potential for a boost in softwood demand for residential construction could have upsides for our logging exports to the subcontinent. Other destinations for New Zealand log exports such as South Korea and Japan have been within their long-term averages.

A new development in demand is in the rebuild efforts following the wake of destruction in the path of hurricanes Harvey and Irma. As a result, the US will be seeking to procure extra supplies of softwoods that tend to come from Canada. But, the disputes on new tariffs on Canadian lumber into the US have seen exports down 15% year to date. These barriers may open channels for New Zealand's log exports as a whole, potentially as supplies are directed towards the US at premiums.

Turning to export returns, the NZ dollar plays an important role. New Zealand's trade-weighted index (TWI) has eased slightly from its highs of late, largely due to election uncertainty and some relative strength in other trading partner currencies. Despite this, the NZD/USD is expected to remain around $US0.70 for the remainder of this year. We expect the RBNZ will keep the OCR on hold for quite some time, so with US interest rates on the rise and balance sheet normalisation underway this month, the exchange rate will largely reflect US developments.

Overall, the outlook for both the domestic and export markets for New Zealand's forestry industry is looking firm. We expect prices to remain high underpinned by broad based demand. Challenges to supply may attract a premium in the near to medium term, but are temporary. On balance, forestry is expected to continue to produce above average returns for a considerable period.

Shyamal Maharaj
Economist

GlobalDairyTrade Auction Results, 4 October 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-3.4%	$6,504
Butter	-3.6%	$5,837
Butter Milk Power (BMP)	-10.3%	$1,804
Cheddar	1.9%	$4,109
Lactose	n.a	n.a
Rennet Casein	0.9%	$6,123
Skim Milk Powder (SMP)	-1.4%	$1,895
Whole Milk Powder (WMP)	-2.7%	$3,037
GDT Price Index	-2.4%	

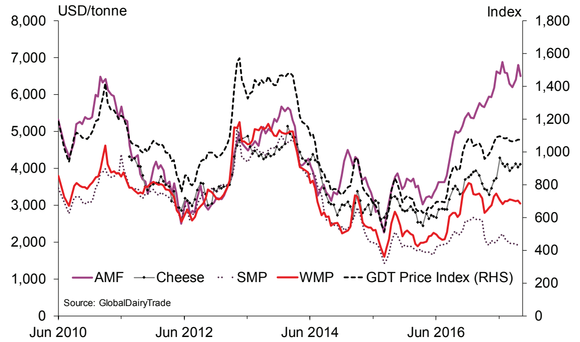
Payout Forecast Table

	2016/17	2017/18	
	Fonterra	Fonterra	Westpac
Milk Price	$6.12	$6.75	$6.50

Beyond the farm gate

Dairy

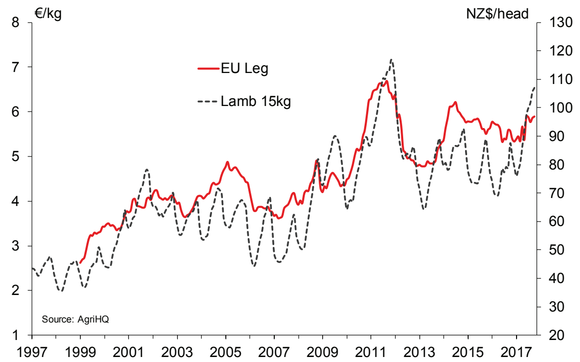
	Current price level compared to 10 year average	Next 6 months
Trend	Average	➔



Last night's GlobalDairyTrade auction saw a 2.4% decline in the overall dairy price index. Whole milk powder prices fell by 2.7% to US$3037/t. Milk fats have also fallen, AMF and butter falling an average of 3.5%. The fall was a surprise given that in the lead up to the auction, whole milk powder futures had priced in a gain of 5%. Futures were likely to be a reflection of Fonterra's September Global Dairy Update suggesting that poor weather conditions are hampering milk collections, which on a seasonally adjusted basis are down. However, with the auction result suggests that global dairy demand may not be a robust as thought. Our forecast farmgate milk price for this season remains at $6.50/KgMs, compared to Fonterra's forecast of $6.75.

Lamb

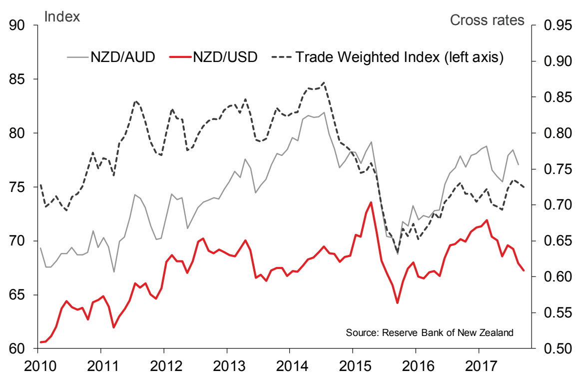
	Current price level compared to 10 year average	Next 6 months
Trend	Above Average	↓



Prices for lamb schedules continue to firm, especially in the lead up to the chilled meat trade that kicks off next month. In particular, the average export value of lamb in August rose 20% on the same time last year. Europe continues to be the epicentre for market demand, with prices in our top two European destinations by volume (Germany and Netherlands), driving export values up by 38.5% on average compared to August 2016. China continues to show consistent gains in demand, and is set to be a key destination leading into the latter months of this year. That being said, prices are expected to soften beyond the seasonal uptick we are in now.

NZ dollar

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



A recent rebound in the US dollar, election uncertainty and other downside risks continues to weigh down on the NZD/USD. Factors supporting the US dollar are firming US economic conditions and the FOMC formally announcing that balance sheet normalisation will begin this month. In addition, US interest rates will be a driving force of the inevitable rebound in the US dollar towards the latter months of this year. Moreover, current market pricing is indicating an 80% probability of another rate hike in the US in December, in line with our expectations. Going forward, the outcome of the election is certain to influence the NZD, but beyond this, the exchange rate will be firmly dependent on developments from the US.

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

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