Fortnightly Agri Update

5 July 2017

Shifting ground

Market opinion about where the world's central banks are heading has been through some abrupt changes recently. Over the last several years central banks have kept interest rates at historically low levels, in the face of persistently low inflation. But with the world economy gaining some momentum, and signs that inflation is picking up from its lows, there's growing speculation that central banks will be looking to return interest rates to more normal levels. As a result, longer-term interest rates have risen sharply in the last week, reversing most of their decline over May and June.

This has two implications for New Zealand's financial markets and the wider economy. The first is that when there's a global trend towards higher or lower interest rates, longer-term interest rates in New Zealand tend to go along for the ride, even if the RBNZ keeps short-term rates anchored. The second implication is that differences in interest rate movements across countries can affect exchange rates. If central banks overseas are raising interest rates while the RBNZ remains on hold, then barring any other influences we'd expect to see a lower New Zealand dollar.

We'd caution that the recent jump in interest rates has been driven more by market opinion than by the central banks themselves. Financial markets are fickle, prone to running ahead of central bank actions and seeing collusion where it doesn't exist. The reality is that each central bank is facing a different set of economic conditions; some of them are clearly more inclined to hike interest rates than others, but we doubt that this will amount to a worldwide trend.

US: The US market has by far the greatest influence over global interest rates. While the US was at the epicentre of the Global Financial Crisis, it also saw what was arguably the most aggressive response to the crisis by policymakers, and as a result is now further down the road to recovery. The Federal Reserve began to raise interest rates from near-zero levels in December 2015, although there was a year-long wait until the next increase, and the pace of hikes has only picked up in the last six months. The Fed has signalled that it expects raise interest rates again this year and into next year. It has also said that from later this year it plans to start running down its holdings of corporate and government bonds, which it bought in the years after the crisis in order to suppress longer-term interest rates.

GlobalDairyTrade Auction Results, 5 July 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-3.5%	$6,596
Butter	-0.1%	$5,775
Butter Milk Power (BMP)	10.8%	$2,264
Cheddar	-3.2%	$4,051
Lactose	-3.3%	$839
Rennet Casein	-2.7%	$6,133
Skim Milk Powder (SMP)	-4.5%	$2,090
Whole Milk Powder (WMP)	2.6%	$3,111
GDT Price Index	-0.4%	

Payout Forecast Table

	2016/17	2017/18	
	Fonterra	Fonterra	Westpac
Milk Price	$6.15	$6.50	$6.50

Market opinion on the Fed's actions hasn't actually changed much recently. What has changed, however, is that the inflation trend is no longer the Fed's friend. Headline inflation was rising in early 2017 as oil prices rebounded from their lows, but in recent months this effect has waned. Core inflation, which takes out volatile items like fuel, has also pulled back in recent months and remains well below the Fed's 2% target. So far, the Fed seems to regard this slowdown in inflation as temporary, and has maintained its intention to keep raising interest rates. But the risk is that the Fed could turn more cautious on rate hikes if inflation remains stubbornly low.

Europe: The outlook for European interest rates is unclear. The European Central Bank is the only major central bank that is still adding stimulus to the economy, by buying government bonds in order to drive longer-term borrowing rates down. Recent comments by ECB officials suggested that they were looking to 'taper off' those bond purchases soon, but the message has been muddled. Bond purchases seem to be having the desired effect, with economic activity gaining some momentum in Europe. But there is still a lot of slack left in the labour market, so the risk of an inflation breakout seems low. The case for higher interest rates is still some way off in our view.

UK: After the shock 'Brexit' vote in June last year, the British pound fell sharply. This has pushed up the prices of imported goods and boosted the inflation rate to 2.9%. The Bank of England appears to be moving towards hiking interest rates, although we think that the market is overestimating the odds. In the last BoE committee meeting 3 out of 8 members voted for a rate hike. But one of those members has since left, and BoE Governor Mark Carney has since commented that now is not the time for rate hikes. It's also worth noting that the BoE, in its role as banking regulator, has just increased capital requirements for UK banks. This works as a quasi-rate hike, as it increases banks' overall cost of funding, which will then be reflected in lending rates.

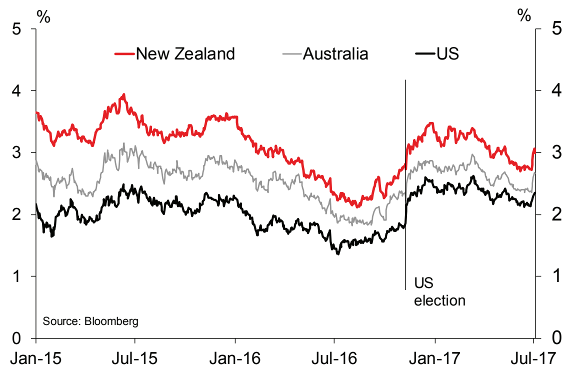
Canada: The Bank of Canada seems the most inclined towards raising interest rates in the near future. As oil prices – a major export item for Canada – have recovered from last year's plunge, the interest rate cuts that were cut in place last year may no longer be required. While New Zealand doesn't have strong economic links with Canada, the market sometimes views it as a bellwether for other commodity-exporting economies.

Australia: There was some market speculation that the Reserve Bank of Australia would follow its UK and Canadian counterparts and signal that the next move in interest rates will be up. However, the RBA wasn't having a bar of this – its July policy statement was largely unchanged from the previous one, concluding that current interest rate settings are appropriate. While the jobs market in Australia has been strengthening this year, there has been a marked slowdown in the housing market after a recent tightening of lending rules.

What does all of this mean for New Zealand? Firstly, it's unlikely that the RBNZ will feel obliged to mimic any of its overseas counterparts. Economic conditions here are probably most similar to Australia: solid economic growth and an improving jobs market, but a softening housing market. The inflation rate recently jumped up to 2.2%, just above the 2% midpoint of the RBNZ's target range. But this was largely due to temporary impacts from food and fuel prices, which could end up depressing the inflation rate by this time next year. The underlying picture seems to be one of a gradual rise in inflation, which requires low interest rates to keep it going. So we don't expect the RBNZ to raise the Official Cash Rate this year or next year – in contrast to market pricing for a rate hike by mid-2018.

The second issue is what this might mean for exchange rates. The answer is likely to vary by region. If market expectations for rate hikes are overcooked in both the US and New Zealand, for instance, then the impact on the NZD/USD exchange rate is ambiguous. However, in those regions where there is a more plausible case for rate hikes, such as the UK or Canada, we may see some further softening of the NZD against their respective currencies.

Global long-term interest rates



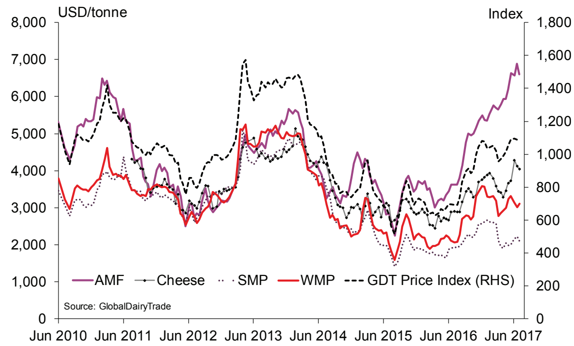
Michael Gordon
Acting Chief Economist

Beyond the farm gate

Dairy

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

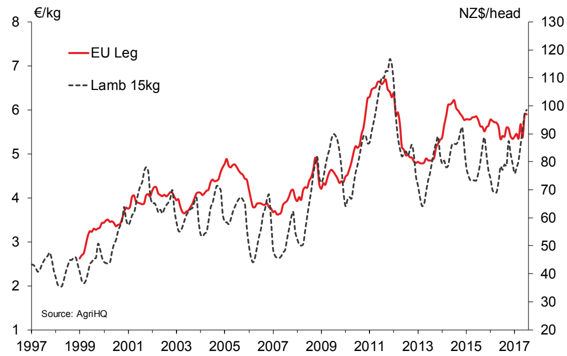
There was a mild 0.4% fall in dairy prices in last night's GlobalDairyTrade auction. The product mix was effectively a mirror image of the previous auction, with a 2.6% rise in whole milk powder prices but declines for most other products. We're expecting a modest fall in dairy prices over the rest of this year, as global milk production bounces back from last year's depressed levels. Global demand continues to grow at a subdued pace, and stockpiles of milk powder remain substantial, especially in Europe. Russia recently extended its ban on food imports from the EU until the end of 2018, though it has yet to make a decision on the ban from other Western markets, which currently runs to the end of this year.



Lamb

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

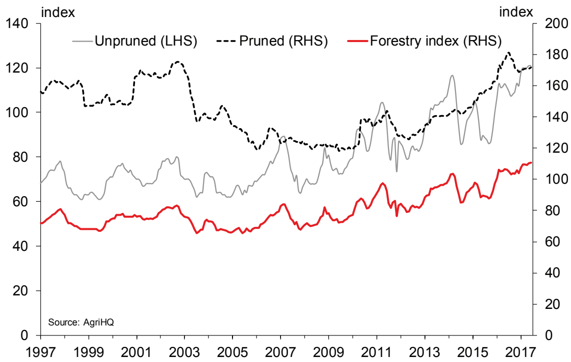
Market conditions for lamb remain strong, underpinned by tightness in supply from both in New Zealand and elsewhere. In New Zealand poor weather conditions affected the quality and availability of feed, while in Australia low slaughter numbers have mainly been due to flock rebuilding. Demand is set to firm in the coming months, due to the increased demand for chilled lamb products that tends to peak around October for the Christmas trade. The recent UK snap election, which saw the Conservatives loses their majority, has added to the uncertainty around the outlook for the UK economy, and its capacity to negotiate trade agreements.



Forestry

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

Log prices have continued to firm this year. AgriHQ's log price index in June was higher than a year earlier, and it remains above the ten-year average. The outlook for construction in New Zealand continues to underpin high prices in the domestic market and we expect this to continue, with a large amount of residential building planned over the coming years. That said, the global outlook especially in China remains the focus. Chinese demand for logs is expected to remain a key driver through this year as the Chinese government aims to present a strong economy ahead of November's National Congress. However, Chinese demand has its uncertainties, and combined with rising global supply (encouraged by high log prices), export prices could come under some downward pressure heading into next year.



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

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