Westpac Institutional Bank

Fortnightly Agri Update

8 February 2017

Sky High

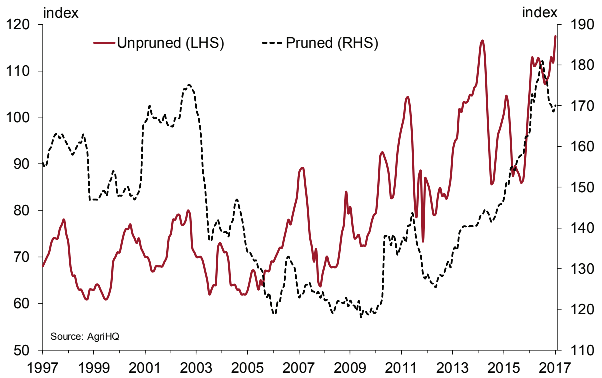
The forestry sector has been enjoying a bumper run. Log prices (according to the AgriHQ index) in 2016 were up 14% from 2015. And prices have started this year on a positive note, edging up to a new record high. Rapid growth in domestic construction and a turnaround in Chinese demand have been key factors underpinning elevated prices. While Chinese demand is expected to remain steady this year, it may falter next year. Combined with rising supply, this would see export prices come under some downward pressure. In this fortnight's Agri Update, we take a closer look at recent trends affecting log markets and prices.

Firstly, looking at the domestic market, the demand for logs has continued to strengthen. This isn't surprising as residential investment has continued to push higher. Residential building consents rose 13% in the year to November, as the winding down of post-quake reconstruction in Canterbury was more than offset by strong growth in Auckland and other regions. Demand for building has been boosted by persistently elevated levels of net immigration and rising house prices. Residential building is expected to track higher for the next couple of years, which should continue to bolster demand for structural logs in particular.

But while the domestic market has remained firm, the big turnaround over the past year has been in the export market with in-market US dollar prices up around 10%. And here, it has been all about China. Chinese demand for logs accelerated in 2016, with softwood log imports rising 13% from 2015. While GDP growth continued on its gradual downward trend to 6.7% (from 6.9% in 2015), there was a notable improvement in the housing market. House price growth broadened across cities, after previously being dominated by exceptionally strong growth in a few of the large "tier-1" cities. And improved sentiment flowed through into real estate construction, which picked up after treading water through 2015.

So there's no doubt that Chinese demand has strengthened. But how sustainable is it? Port inventories were reported as rising from December to January, although are at moderate levels and not indicative of a market widely out of balance at present. And while there is some uncertainty about how the market will fare following the Chinese new year lull, we see demand remaining solid through 2017. The Chinese government has its 19th National Congress in November, and will be keen to maintain an accommodative stance and keep momentum strong ahead of this. What's more, tighter controls to stem currency outflows may provide an additional boost to the Chinese housing market as more local residents look to the housing market for investment opportunities. Overall, these factors should help underpin solid Chinese demand for logs this year, in turn keeping in-market prices propped up at relatively high levels, although demand may falter a bit in 2018.

Log prices



On the supply side of the equation, New Zealand log exporters certainly capitalised on the resurgence in Chinese demand. Log shipments to China were particularly strong in the second half of last year, up a whopping 40% from 2015H2. For 2016 as a whole, log exports to China rose 11%. With China taking around 2/3 of our log exports, this drove a 9% gain in overall log exports.

Prices lingering at elevated levels should encourage a pick-up in broader global supply. New Zealand's main competition in the Chinese market comes from Russian, US and Canadian producers. Russia's log exports to China tapered off in the latter part of the year, after earlier strength. With oil prices lifting off their lows, the Russian Ruble has appreciated over 20% in the past year to the highest level since October 2015. While this will have eroded Russia's competiveness somewhat, the Ruble is still significantly weaker than prior to the oil price collapse in mid-2014. In the US, gradual strengthening in the housing market should stoke domestic demand for logs, although the recent rise in mortgage rates might dampen momentum in home building. Canadian exports to China are somewhat of a wildcard, due to an ongoing trade dispute between the US and Canada. This may see more Canadian logs head to China, and late last year there was a strong pick-up in Canadian log exports to China.

The improvement in New Zealand's other significant log export markets, such as India and Korea, has been more modest. While India started the year with a hiss and a roar, demand faltered from November when the Government unexpectedly demonetised the two highest-value currency notes. This led to cash shortages, significantly disrupting payments and trade. New Zealand's log exports in Q4 were down nearly 50% year-on-year, which pared annual growth back to only 2%. That said, even with ongoing disruption in the near-term, the Indian economy is still expected to grow at a rapid pace of 7.2% this year. And for Korea, New Zealand's log exports rose 3.4% in 2016, but a subdued outlook for housing this year will weigh on demand.

Of course, in thinking about export returns, the NZ dollar and shipping costs play an important role. The NZD/USD found a new lease of life over the past year, rising around 15% to just over 73c currently. But with interest rates in the US set to move higher this year, while the Reserve Bank here is expected to keep the OCR unchanged, our forecasts are for the NZD/USD to decline to 67c by year end. That said, the US dollar (and NZD/USD by default) will remain highly sensitive to developments around US fiscal policy. On the shipping front, rising oil prices have seen shipping costs lift off their lows. But with oil prices not expected to push any higher, this should see shipping costs remain low.

Sarah Drought
Economist

GlobalDairyTrade Auction Results, 8 February 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	4.0%	$5,765
Butter	4.9%	$4,593
Butter Milk Power (BMP)	-7.5%	$2,254
Cheddar	-3.7%	$3,798
Lactose	12.4%	$910
Rennet Casein	-0.4%	$6,445
Skim Milk Powder (SMP)	0.1%	$2,608
Whole Milk Powder (WMP)	1.0%	$3,314
GDT Price Index	1.3%	

Payout Forecast Table

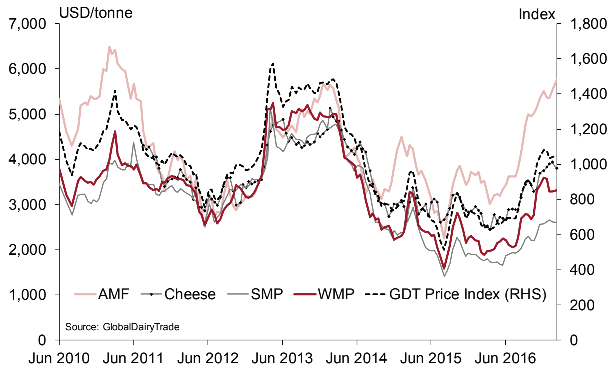
	2016/17		2017/18
	Fonterra	**Westpac**	**Westpac**
Milk Price	$6.00	$6.20	$6.50

Beyond the farm gate

Dairy

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

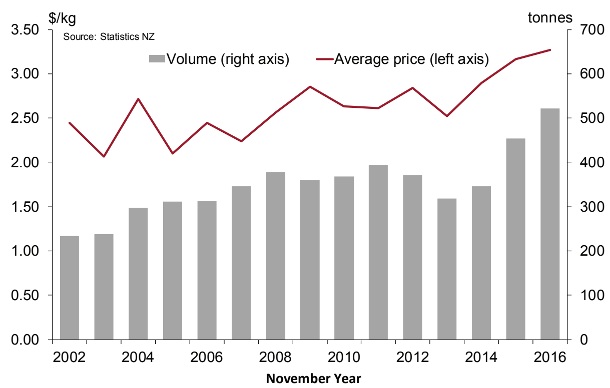
Dairy prices have found some stability over the past month. In last night's GlobalDairyTrade auction, prices rose 1.3% following the 0.6% gain in the previous auction. Within last night's move, whole milk powder prices rose 1% to $3,314/tonne, while fat-based products continued to outperform. AMF and butter prices rose 4% and 4.9% respectively. This took AMF to levels last seen in 2011. Meanwhile, skim milk powder prices were broadly stable at $2,608/tonne. After falling away a bit through December, buyer interest out of China has improved this year. The fact that it held up in this auction that coincided with the Chinese New Year, provides a positive signal for demand ahead. Tight global supply remains an important factor underpinning prices at these levels, with production in most major exporting regions continuing to decline on a year-on-year basis. But production should begin to stabilise in the coming months, and we continue to expect to see some moderation in prices. New Zealand's milk production was down 3.6% in the 7 months to December, but the pace of decline had eased as we moved into 2017. We expect production to end the season down 3-4%, although rapidly drying conditions in some parts of the North Island could see a sharp end to the season in some regions.



Kiwifruit

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

The horticulture sector, and kiwifruit in particular, has been a standout performer amongst New Zealand agricultural exporters of late. Export volumes and prices have risen strongly over the past two years, on the back of robust consumer demand and the success of new gold cultivars developed following Psa bacterial virus. Although the pace of volume growth will be more gradual from here, the industry should continue to perform strongly provided it can maintain its comparative advantage in meeting the tastes and preferences of Asian markets in particular.

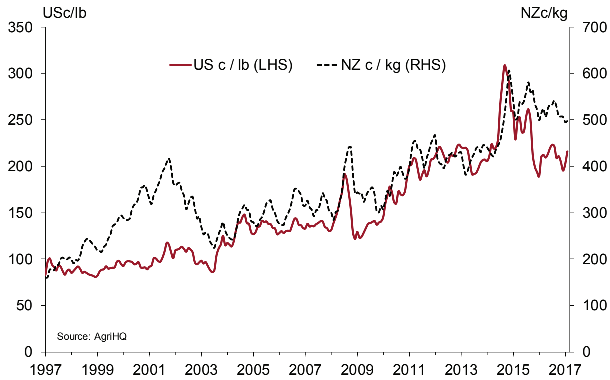


NB: Trend arrows indicate direction of change in world prices.

Beef

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

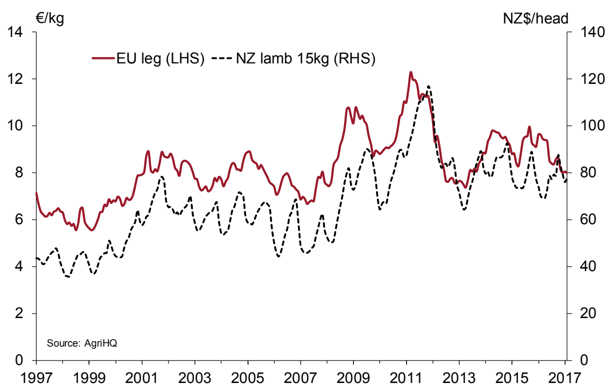
Beef markets found some renewed support over the past month, with near-term supplies, including from New Zealand falling a little short of expectations while end-use demand in the US remains strong. While US supply is expected to rise again this year, this is balanced against declining beef production in Australia as farmers continue to rebuild herds. Meat and Livestock Australia expect Australia beef exports to fall 5% in 2017. With Australian supply expected to be the tightest through the first half the year, US manufactured beef prices are expected to track broadly sideways for the next few months but might come under some downward pressure later in the year. Meanwhile, prices for prime cuts have been under a little bit of downward pressure as competition heats up across markets. US exports into Japan and Korea have picked up, and in China, exports from Brazil have risen strongly.



Lamb

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

Relatively tight supplies of lamb, especially from New Zealand, are helping to underpin in-market lamb prices. New Zealand's spring 2016 lamb crop was down 1.3% according to Beef and Lamb New Zealand, which was the smallest crop in over 60 years. In addition, slow lamb growth due to cool and damp spring conditions resulted in very low levels of lambs processed in Oct-Dec. Extremely dry weather on New Zealand's East Coast has also seen lambs offloaded early even though they were not up to finishing weight. As a result, there is a potential gap in supply for the UK's chilled Easter trade. While this should support in-market prices in the near term, the high NZD/GBP continues to erode NZ dollar returns. Chinese demand has also been more positive recently, especially for the cheaper cuts of sheepmeat, with in-market prices for flaps 60% higher than a year ago. Over the medium-term, Brexit continues to cloud the outlook. The weaker pound is significantly boosting the competiveness of UK sheep farmers, and market access is also uncertain.



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