Fortnightly Agri Update

22 August 2018

Low for longer

Interest rates are important for farmers, both directly in terms of borrowing costs, and indirectly through their effects on the exchange rate. In this Agri Update we detail why we expect interest rates to remain low for even longer than we previously thought.

The New Zealand economy has performed much as we expected this year. In our forecasts we allowed for a slowdown in growth in the first half of this year, due to business uncertainty about the effects of the new Government's policies and a cooling housing market. We expect this to be followed by a pick-up in activity by the end of the year on the back of increased government spending.

We also said that the Reserve Bank's forecasts of economic growth were too optimistic and would have to be scaled back. In turn, that would see the RBNZ push out the expected timing of interest rate hikes, and the exchange rate would fall.

This is exactly how things have panned out. In its August Monetary Policy Statement, the RBNZ projected that the first hike in the Official Cash Rate would be delayed until late 2020, a full year later than previously thought. The RBNZ's language was even more pointed, stating that the next move in the OCR could be either up or down, and noting in later media interviews that they are "nearer to the trigger point" for interest rate cuts.

This change of tone is more than can be explained by the economic news alone. It seems there has been a systemic change of approach at the central bank since Adrian Orr took over as Governor. Reading between the lines, we believe that the new regime will prove keener to shore up economic growth when it flags, and more willing to take a chance when inflation shows signs of rising.

We were previously expecting that the OCR would begin rising in November 2019. We've now pushed that timing out by six months to May 2020. We continue to expect rate increases to be gradual once they do begin, with a peak OCR of 3% which is still quite low relative to history.

What about the alternative: could the next move in the OCR really be a cut? We don't see this as an imminent prospect. The RBNZ has made it clear that rate cuts will depend on the economic data falling short of their forecasts. Our view is that the next reads on quarterly GDP and inflation will comfortably exceed the RBNZ's (quite low) expectations. Also, the New Zealand dollar is now lower than the RBNZ assumed, which will add more to imported inflation over the coming year or so.

That said, there's always the chance that something unexpected, such as a slowdown in world growth or a rise in unemployment, could tip the RBNZ into cutting rates. And the fact that the RBNZ is openly considering rate cuts in what is a fairly benign economic environment means that we have to take this prospect seriously. We put the odds of a rate cut within the next year at around one in three.

Whether or not the RBNZ actually cuts, the message for the market is that interest rates will stay low for even longer. Wholesale interest rates have fallen, and this is starting to be passed through into lower home loan rates. That may also flow through into lower business and agricultural borrowing rates.

The change in the outlook for interest rates also favours a lower New Zealand dollar (bearing in mind that interest rates are only one of many things that can push the exchange rate around). That's most obviously the case against the US dollar, where the central bank is well down the path of raising its own cash rate, and is expected to continue doing so through to the middle of next year. New Zealand interest rates have in many cases fallen below US interest rates – a fairly rare occurrence, which reduces the relative appeal of the NZ dollar to investors.

We still expect the NZ dollar to reach a low point of 64 cents against the US dollar late next year. However, as with our OCR forecast, we expect the currency to remain low for a longer period, giving exporters a more favourable exchange rate on average over the next couple of years.

The softer NZ dollar may be less obvious against some of the other major currencies, which are facing downward pressures of their own. Europe and Japan are still relying on negative interest rates and bond purchases to stimulate their economies, and higher interest rates are a distant prospect. We expect Australian interest rates to remain low for even longer than in New Zealand (no rate hikes until 2021). And China has allowed the yuan to fall as one way to offset the impact of tariffs on Chinese imports into the US. While we don't think the authorities will be comfortable with a continued slide in the yuan, that may depend on how far the US-China trade war escalates.

Michael Gordon
Senior Economist

GlobalDairyTrade Auction Results, 22 August 2018

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-6.9%	5,321
Butter	-8.5%	4,392
Butter Milk Power (BMP)	-	n.a.
Cheddar	-4.7%	3,484
Lactose	-	914
Rennet Casein	2.8%	5,138
Skim Milk Powder (SMP)	-1.3%	1,951
Whole Milk Powder (WMP)	-2.1%	2,883
GDT Price Index	-3.6%	935

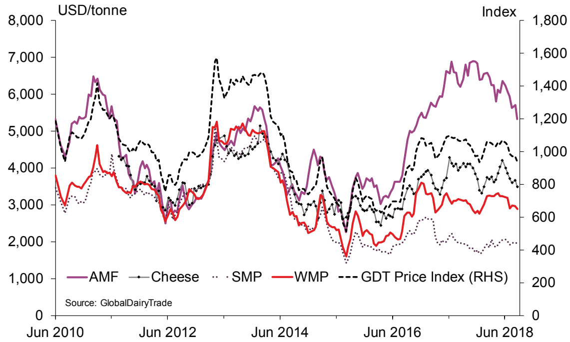
Farmgate milk price forecasts

	2017/18		2018/19	
	Westpac	Fonterra	Westpac	Fonterra
Milk Price	$6.70	$6.70	$6.50	$7.00

Beyond the farm gate

Dairy

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

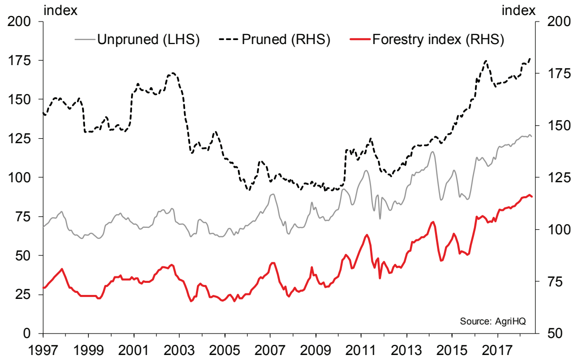


Dairy prices fell 3.6% in the latest GlobalDairyTrade auction, with a particularly sharp fall in prices for fats. Milk powder prices saw more modest declines. Slowing demand in China, a weaker Chinese yuan and concerns about the impact of growing trade tensions are potentially weighing on prices.

We recently upgraded our farmgate milk price forecast for this season from $6.40/kg to $6.50/kg, on the basis of a stronger performance for skim milk powder as stockpiles in Europe are run down. The latest auction result isn't out of line with our milk price forecast but does present some downside risk. We continue to view Fonterra's $7.00/kg forecast for this season as too optimistic.

Forestry

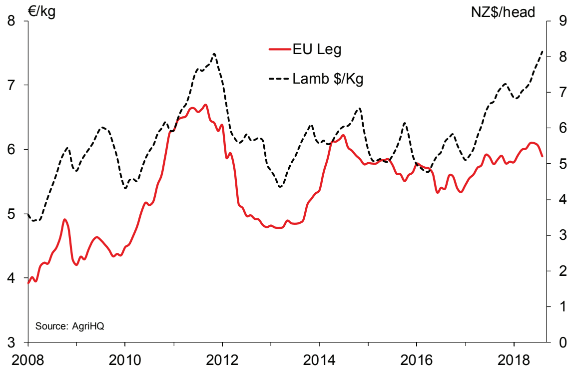
	Current price level compared to 10 year average	Next 6 months
Trend	High	➘



Recent talk of softer demand from China is now starting to filter through into log prices. China has allowed the yuan to weaken in recent weeks in response to the tariffs imposed by the US, which in turn has reduced the prices that wood processors are willing to pay. The Chinese authorities are unlikely to be comfortable with an ongoing decline in the yuan, due to the risk of capital outflows and financial instability. Chinese demand for logs used to make export products such as furniture has also taken a direct hit from the US tariffs, whereas demand for logs for domestic use is still strong.

Lamb

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



Lamb prices have held up relatively well in the face of increased supply from Australia. However, international prices have eased recently, and the pressure is likely to increase in the coming months. While the sizzling UK summer might be enjoyed by holiday makers, it is also reportedly depressing demand for lamb. China is also an increasingly important lamb market, and the falling yuan has made imported lamb relatively more expensive.

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

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