Fortnightly Agri Update

7 November 2018

Feeling the pinch

As we've noted in many of our Agri Updates this year, we've seen broad-based strength in New Zealand commodity prices for much of 2018. And while commodity prices have softened in recent months, international prices for most export products remain at historically elevated levels. However, the revenue side of the ledger is only half the story for farmers and growers looking to turn a profit. In this fortnight's Agri Update we look at the second half of the story – how the cost side of the ledger is evolving.

As expected, New Zealand's export commodity prices have started sliding in recent months, with commodity prices down 3% in world price terms on a year ago. Slower growth in China has played a role, while in some markets, increasing global supplies have also weighed on prices. Yet while prices for many commodities are off their recent peaks, they remain relatively elevated. In world price terms, NZ commodity export prices are 2% above average levels of the last five years.

However, prices (and revenues) are only part of the equation for a successful businesses. Increasingly, farmers and growers (like other New Zealand firms) are facing growing pressures on the cost side of the ledger. Stats NZ's farm expense price index shows farm expenses (excluding livestock) across all farms was up 2.3% in the year to June. Expenses for horticulture are increasing the fastest, with annual cost inflation of 3.6% over this period. This compares to 2.4% for dairy farms, 2% for cropping farms and 1.8% for sheep and beef farms.

In today's Agri Update we've published our forecast for 2019/20 milk price which is $6.75. We discuss this further in our dairy section on the back page.

GlobalDairyTrade Auction Results, 7 November 2018

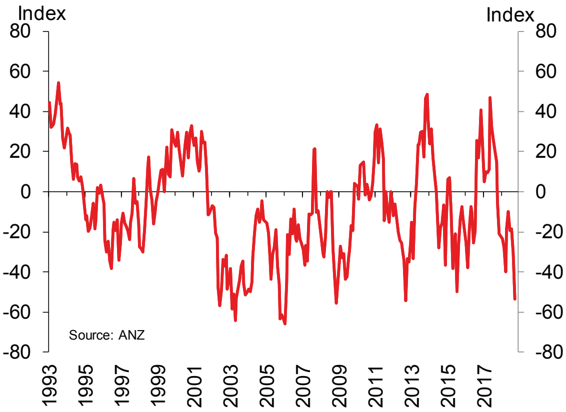
	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-1.3%	5,044
Butter	-1.7%	4,045
Butter Milk Power (BMP)	0.8%	2,568
Cheddar	-4.6%	3,250
Lactose	-2.7%	902
Rennet Casein	-2.9%	5,327
Skim Milk Powder (SMP)	1.2%	1,997
Whole Milk Powder (WMP)	-2.9%	2,655
GDT Price Index	-2.0%	877

Farmgate milk price forecasts

	2018/19		2019/20
	Westpac	Fonterra	Westpac
Milk Price	$6.25	$6.25-$6.50	$6.75

Rising costs are crimping profit expectations. In the monthly ANZ Business Outlook survey, profit expectations of those in the agricultural sector deteriorated sharply in October, and have been in negative territory (with those expecting profits to worsen over the year ahead outnumbering those expecting profits to improve) since November last year. While we tend to agree that profits are genuinely under pressure, we would treat the degree of deterioration in this particular survey with some caution. On this measure, profitability expectations in the agricultural sector are now at their lowest level since October 2012. That implies profit expectations are at worse levels now than during the most recent dairy downturn when the milk price fell as low as $3.90. The result is also in contrast to Fed Farmers confidence surveys which suggested a small improvement in profit expectations of its members between their January and July surveys.

Profit expectations agri sector



In terms of Stats NZ's estimates of the costs farmers face, there have been strong increases in insurance premiums, cost of repairs and maintenance and freight. Anecdotally, dairy farmers in particular are facing higher compliance costs on the back of tighter environmental regulations. Wage and salary costs have also been steadily trickling higher thanks to the gradual tightening of the labour market. And the horticulture sector in particular will also probably feel the impact of the lift in the minimum wage. (Although that said, to date, wage and cost inflation in the horticulture sector is running at the same pace as that of the wider agriculture sector.)

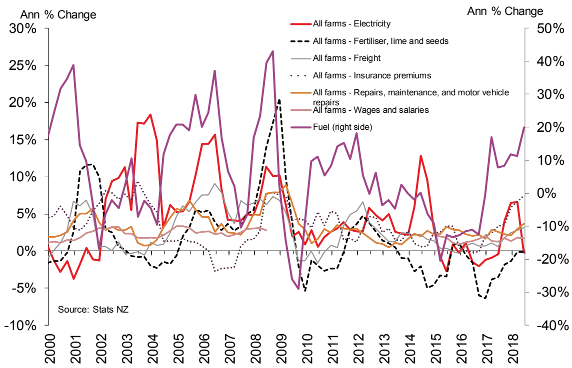
The weaker New Zealand dollar is pushing up the price of imports more broadly. Of course for most farmers and growers a weaker New Zealand dollar is not all bad news. All else equal is will lift farm and orchard gate prices by increasing the value of exports in NZ dollar terms.

Rising international fuel prices and the falling NZ dollar have also seen fuel costs skyrocketing on farm. On Stats NZ measures, fuel costs were up 20% in the year to June, and they have risen further since then as global oil prices rose to their October peak.

The good news for farmers (and others fuelling up their vehicles) is that we don't think the recent lift in international oil prices will be sustained. Higher international oil prices have been driven by a combination of firm global growth and some supply disruptions. Going forward, we expect some of these supply disruptions to unwind, global growth to cool a little and higher prices to entice marginal producers (such as shale oil producers) to switch production facilities back on, boosting supply.

In contrast, costs more closely linked to the domestic economy, such as repairs and maintenance, wage and salary costs, are likely to come under further upward pressure. Spare capacity in the economy has been eroded and the unemployment rate has fallen to 3.9%. What's more with measures of consumer price inflation now at their highest level in a year, this may start seeing inflation expectations edge up, feeding though to wage and price setting decisions.

Farm cost inflation



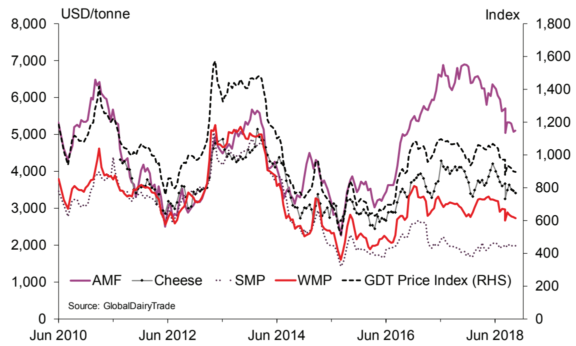
Anne Boniface
Senior Economist

Beyond the farm gate

Dairy

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

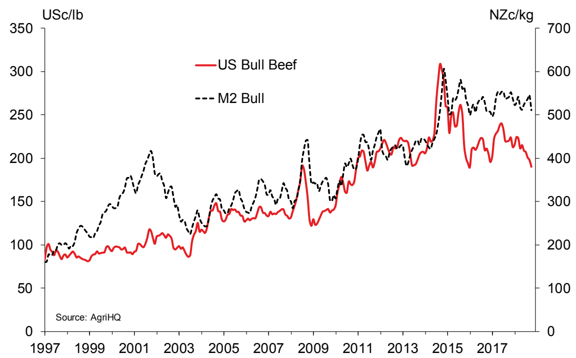
Further softness in dairy prices in last night's GlobalDairyTrade auction has concerned about downside risks to our milk forecast of $6.25. Auction prices would now have to rise significantly in 2019 to make $6.25 achievable. For now, we are going to stick with our $6.25 forecast as we think there are good reasons to expect this to happen (most notably slowing growth in global milk supply). However, we're conscious that the further prices ease in the near term, the more they will have to lift in early 2019 for Fonterra to achieve a $6.25 milk price for farmers. We've also today published our milk price forecast for 2019/20 of $6.75. Of course there are wide bands of uncertainty over the milk price at this horizon, but two key elements underpin this outlook. Firstly, we expect the weaker NZ dollar we've seen over the last year to boost NZ dollar revenues. Secondly, that an 'equilibrium' price for whole milk powder is probably higher than current levels. Combined, these two factors have us forecasting a modest lift in next season's milk price relative to the current season.



Beef

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

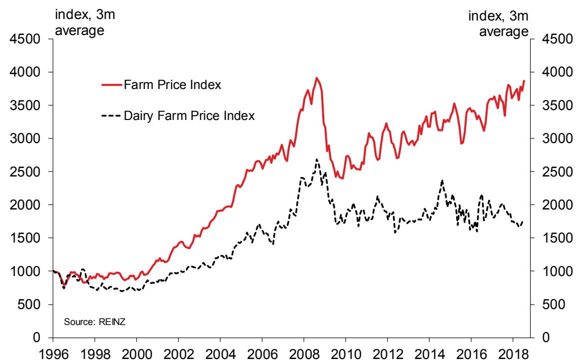
US beef prices have continued to come under pressure in recent weeks, as demand falters under the weight of increasing supply. On the bright side, the ratification of the CPTPP will be viewed as a positive development by beef exporters. Most notably, this is New Zealand's first free trade deal with Japan, and will eventually level the playing field with Australian beef exporters who are already benefiting from the FTA signed between Australia and Japan in 2015.



Rural Property Prices

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

Dairy farm prices eased a little further in October down 1.3% in the month and 15% lower than a year ago. In contrast, the aggregate farm price index rose 4% in the month and 9% higher on a year ago. Caution remains prevalent in dairy markets in particular as the sector continues to grapple with the changing regulatory backdrop. Weaker dairy prices may also be starting to weigh on sentiment in rural property markets.



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

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