Fortnightly Agri Update

6 March 2019

Brexit Bluster

The UK is due to leave the European Union in just 23 days. Yet just what will happen in the UK in the coming weeks and how its trading partners, including New Zealand, might be affected remains highly uncertain. In this week's Fortnightly Agri Update we outline the options of where to from here for Brexit, and investigate what they might mean for New Zealand's agricultural exporters.

The UK's planned exit from the European Union is less than a month away and political negotiations both in the UK and between the UK and the rest of Europe have hit an impasse.

An exit agreement proposed by UK Prime Minister May is due to be voted on by Parliament on the 12th of March and looks likely to be defeated. With the clock ticking down, the PM has stated that should this happen, she would table motions allowing Parliament to vote on two pivotal issues.

- First, MPs would be asked to vote on whether they support leaving the EU without a Withdrawal Agreement. This is what's known as a no-deal or 'hard' Brexit where the UK leaves the EU on the 29 March with no agreements in place about what the relationship would be like in the future. This would lead to big disruptions between EU and UK transport and trade. We expect this motion be defeated.
- Second, assuming MPs reject a 'no-deal' Brexit, they will be asked whether to seek a short extension (with May proposing around 3 months) to the negotiation period with the EU. We expect that this motion will pass.

After noting the upside risks to our milk price forecasts for both 2018/19 and 2019/20 season in recent weeks, ongoing dry weather and a further lift in dairy prices in last night's auction has seen us formally cement this risk into our forecast. We have revised up our farmgate milk price for this season to $6.40 (previously $6.30) and $7.00 (previously $6.75). See the back page of today's Fortnightly Agri Update for further detail.

GlobalDairyTrade Auction Results, 6 March 2019

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	3.9%	$5,837
Butter	3.7%	$4,657
Butter Milk Power (BMP)	-	$3,480
Cheddar	6.0%	$3,888
Lactose	0.6%	$1,009
Rennet Casein	-0.1%	$5,649
Skim Milk Powder (SMP)	-4.3%	$2,462
Whole Milk Powder (WMP)	6.0%	$3,186
GDT Price Index	3.3%	1,048

Farmgate milk price forecasts

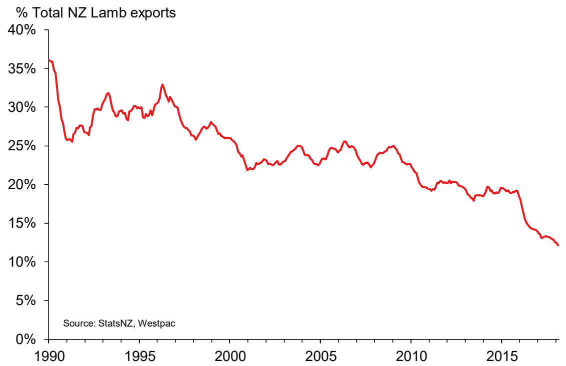
	2018/19		2019/20
	Westpac	Fonterra	Westpac
Milk Price	$6.40	$6.30-$6.60	$7.00

But just because the British Parliament can agree on something, doesn't mean the EU will fall into line. Indeed, there are suggestions that the EU may prefer a longer delay of up to 2 years. Ultimately, we expect that the EU and UK will reach some form of exit agreement. In particular, we regard a 'no deal' Brexit as very unlikely while a second UK referendum is a growing possibility. But while some kind of deal is likely to eventually be nutted out, the exact terms of any agreement are unclear.

So what does all this mean for nervous New Zealand exporters?

Industries with the greatest exposure to the UK include lamb exports and wine. However, with the rise of China in particular as a key trading partner for many New Zealand exporters, the UK's importance has reduced dramatically. In the year to January 2019, just 12% of sheep meat exports and 24% of wine exports were shipped to the UK (that compares to 23% and close to 30% a decade ago).

NZ lamb exports to UK



While there are few certainties about what lies ahead, the New Zealand Government has put some measures in place to attempt to mitigate some of the potential post-Brexit barriers to trade. In particular, it has signed two bilateral agreements:

- Sanitary Measures Applicable to Trade in Live Animals and Animal Products (the Veterinary Agreement)
- Mutual Recognition in Relation to Conformity Assessment (the Mutual Recognition Agreement)

These agreements are intended to come into effect if the UK leaves the EU without a deal, or at the end of any transition period that the EU and UK agree to. The agreements recognise the food production standards here and in the UK, ensuring that our two countries can continue to trade on the same terms as they currently do after Brexit.[1]

Yet even with this backstop in place, there are two ways New Zealand agricultural exporters (and exporters more broadly) may be affected by Brexit outcomes. The first is slower growth in the UK and a weaker pound impacting demand for New Zealand exports. While only around 3% of New Zealand goods exports and 6% of our service exports head to the UK, predictions are that a "no deal" Brexit in particular could have a large negative impact on the British economy. For example, the Bank of England thinks a 'no deal' Brexit could have an impact on the UK economy of similar size to the Global Financial Crisis. Even on our own, more optimistic outlook where the worst case scenarios are avoided, GDP growth in the UK and Europe is expected to be weak in 2019. Depending on the twists and turns of the Brexit negotiations, we could see increased financial market volatility although this is likely to be UK-centric.

Secondly, exporters may be directly affected by interrupted access to European markets and changes to trade flows. Currently, New Zealand is able to export some meat and dairy products into the EU (including the UK) with no or only low tariffs imposed. After Brexit, this quota is likely to be split across the two regions based on how much of our exports each has taken in previous years.

Both industry and the Government are lobbying against this change as dividing up the existing quota in this way could hamper the ability of New Zealand exporters to respond to changing demand conditions between the two regions. This could lead to reduced demand for NZ meat exports if consumers are faced with paying higher prices for NZ lamb exports that fall outside the quota. However, New Zealand has been utilising less than 100% of its allocated quota in recent years (62% in 2017) as exports have been redirected to markets such as China. So even if current lobbying is unsuccessful, this change may only have a relatively small impact.

Similarly, changes in trade flows between the EU and the UK could provide both challenges and opportunities for NZ exporters. If UK sheep meat exports to Europe (its largest market) are disrupted, this could lead to increased domestic supply, reducing demand for New Zealand product (although we would note that New Zealand's lamb exports to the UK are dominated by sheep legs while UK exports are dominated by carcasses). Ultimately, this type of disruption should provide temporary, however the risk is that changes in trade flows could put downward pressure on prices.

Over a longer horizon, much will depend on the successful negotiations of free trade agreements with the UK and EU post Brexit. Comments on progress to date have been positive however as always, access for agricultural products are likely to be a delicate point in future negotiations.

Anne Boniface
Senior Economist

[1] Source: MPI - https://www.mpi.govt.nz/exporting/overview/market-access-and-trade-development/preparing-for-brexit-and-a-possible-no-deal/

Beyond the farm gate

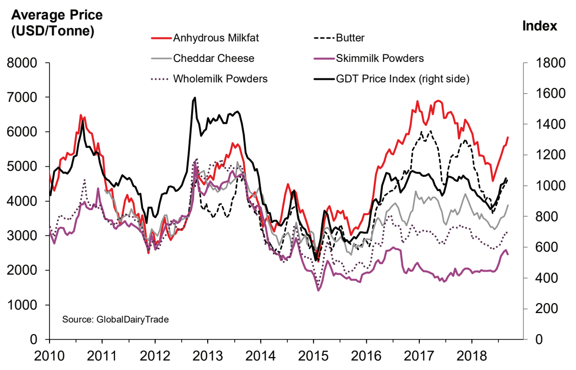
Dairy

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

Dairy prices rose further in last night's GlobalDairyTrade auction. The headline index was up 3.3%, boosted by a solid 6% gain in whole milk powder (WMP) prices. WMP prices are now at their highest level since the middle of last year.

We think concerns about the impact of recent dry weather on NZ production have been one of the factors underpinning the most recent lift in milk prices. And while there has been some rain in parts of the country in recent weeks, it certainly hasn't been enough for many farmers. For its part Fonterra has downgraded its outlook for growth in milk production this season, and is now expecting 2% growth in its milk collections (previously 3%). We expect some of the price increase we've seen over the last month or so may be unwound when weather conditions normalise. Looking further ahead a combination of slower growth in NZ milk production in the 2019/20 season, and ongoing modest growth in European and US dairy production in 2019, steady demand from China and a weaker NZ dollar should all help support a modest lift in farmgate milk prices next season.

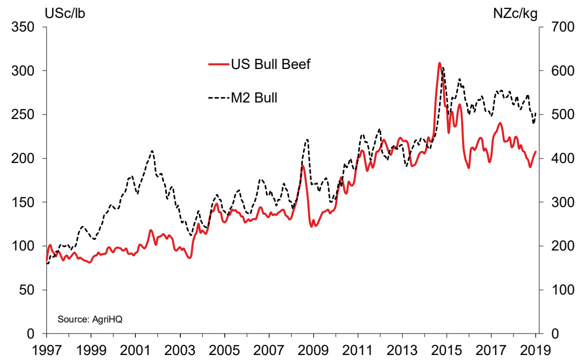
This leaves us forecasting a $6.40 milk price this season (previously $6.30) and $7 next season (previously $6.75). For its part, last week Fonterra lifted its own milk price forecast for this season to $6.30-6.60 (previously $6-6.30).



Beef

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

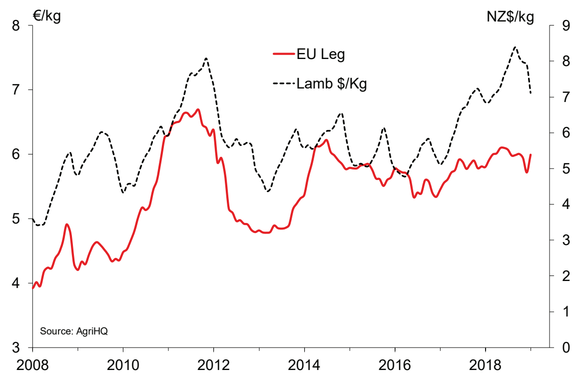
US imported beef prices have lifted noticeably in recent weeks, with reports of an increase in US import demand on the back of reduced US availability. We expect this improvement will be temporary. With the NZ dairy season coming to a close over the coming months increased supply from NZ should put downward pressure on US imported prices.



Lamb

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

Local lamb prices have come under pressure in recent weeks, as the dry weather has reportedly led to some farmers reducing stock numbers as they start to run short of feed. This follows a period where farmers were holding on to stock for longer over the early part of summer on the back of very strong pasture growth. Both these factors are likely to exaggerate normal seasonal patterns. This sector will also be watching Brexit developments particularly closely over the next few weeks.



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

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