Over the Fence

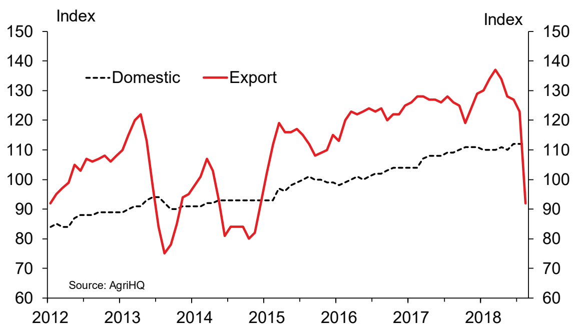
2 August 2019

Back down to earth with a thud

Log prices have fallen sharply in recent weeks. This month's *Over the Fence* report looks at recent developments and considers prospects from here. We also contemplate the potential impact of the plunge in log prices on the wider New Zealand economy.

Following the strong run of recent years, New Zealand log prices came back to earth with a thud this month. According to AgriHq data, export log prices plunged 25% in July month to be down 27% on a year ago.

Log prices



So what's going on? Perhaps the first thing to note is that lower log prices shouldn't come as a complete surprise. Back in March our Fortnightly Agri Update publication noted that we expected to see some softening in log prices. That said, the magnitude and speed of the recent declines have undoubtedly been a surprise.

There were a range of reasons we were expecting log prices to moderate and many of these have now come home to roost. Perhaps most importantly, the sector appears to have been caught in the crossfire of the China-US trade war which has continued to ratchet up this year.

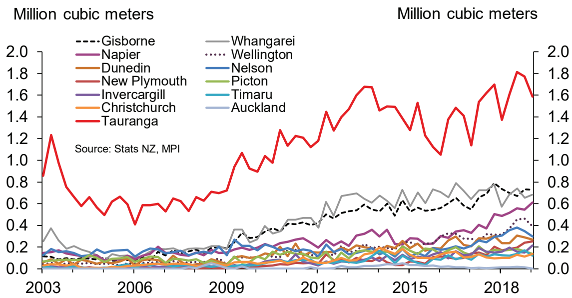
While NZ logs are commonly used for boxing concrete in China, some also make it into manufactured products including wooden furniture. And while construction activity in China should benefit from measures aimed at supporting domestic growth, manufactured exports have been hit hard by the trade war. In addition, broader business sentiment both in China and further afield is being depressed by the ongoing trade tensions. This is likely to be spilling over into investment and production decisions.

One reason we have been more sanguine than some others to date about the impact of the trade war on global growth has been the potential for Chinese exporters to shift production offshore. Certainly there is the potential for this to occur with the likes of furniture exports. Vietnam for example is a significant supplier to the US market. However, Vietnam is not currently a major destination for NZ logs. And while this could change over time, in the short term this type of shift is likely to weigh on demand for NZ logs.

To insulate Chinese exports from the impact of the sharp increase in US tariffs, Chinese policymakers have allowed the Yuan to depreciate. Over the last 18 months, the CNY/USD is down around 9%. While that's helped offset higher tariffs for exporters, it has also increased costs for Chinese importers. And with NZ log prices already at very high levels, this increase may be another factor weighing on demand.

Slowing demand has coincided with strong New Zealand supply, leading to a lift in log inventories on wharves in China. Some of these are expected to be temporary, depressing prices for a relatively short period, while others might be much more long lasting. For example, log exports to China from Europe have been rising. The increased supply of spruce logs from Germany has in part been a response to a beetle infestation. Foresters have been chopping down many damaged trees as the attempt to limit the spread of the spruce beetle. While this is likely to increase the supply of logs to China in the near term, we would expect this to be temporary. However, there has also reportedly been growth in the volume of logs heading to China from other destinations including South America, Finland and Russia.

Log export volumes by port



Another more lasting reason behind rising imports of European logs has been block trains. Block trains are typically used for the transportation of bulk goods, carrying a single commodity from one origin to one destination, without being split up. There are an increasing number of these trains travelling between Europe and China as part of China's Belt and Road initiative. This initiative is, in part, a huge infrastructure and investment project aiming to improve trade linkages between China and many other countries from South-east Asia to Eastern Europe and Africa. The rail route (the "belt" part of "Belt and Road" – the road part refers to shipping lanes) follows the ancient Silk Road trading route which connected Europe and China.

For European exporters block trains provide another option for transporting bulky commodity exports directly to China, cutting transport times significantly. This comes at a time when bulk shipping costs may start to come under upward pressure with new rules around sulphur emissions soon due to take effect soon.

But not only is the supply of logs out of Europe increasing, the volume of New Zealand logs being shipped to China is also very high. New Zealand is a big supplier of softwood logs into China. In the year to March 2018, around 17 million cubic metres of New Zealand logs were shipped there. That's around 80% of all New Zealand log exports. That's almost a 7-fold increase on a decade earlier.

Looking ahead, the volume of New Zealand log exports is likely to grow in the coming decades as changes in land use will be a key part of New Zealand meeting its climate change emissions target goals. While not all trees planted under this goal will be exotic plantation forests, it's likely that a significant portion will be. Indeed, recent Government policies, including the Government's billion trees programme, have directly targeted tree planting and investment in the sector. Over the coming decades, this is likely to further increase New Zealand log exports.

Where to from here?

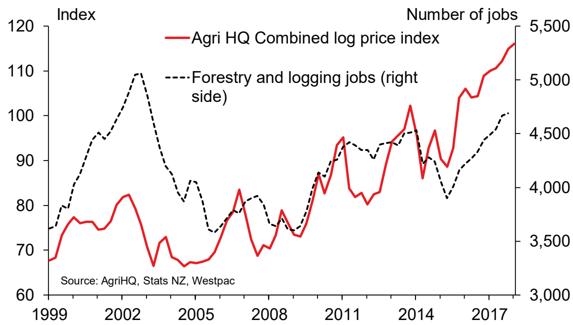
We can't be certain how much further log prices will fall from here. For now we've assumed log prices ease another 15% over the next couple of months, which would make this episode comparable to the last time log prices fell sharply, in 2014. Then, export log prices fell almost 40% between March and July (based on the Agri HQ log price index).

This will bring about a supply response. Unlike food commodity exporters such as dairy or meat, when log prices drop trees can simply be left unharvested.

Anecdotes suggest smaller foresters are most likely to halt harvesting, while larger operations will probably continue to supply export markets. Some of these forest owners had already been harvesting less mature trees to take advantage of the high prices on offer (a strategy that has evidently paid off). And many are unlikely to harvest small blocks at current prices. This could impact regions like Otago, Southland and the Wairarapa, where there is a relatively high proportion of small harvesting operations.

In contrast, larger forestry operations are less likely to turn the tap off. Many of these operators may have longer term contracts that may at least partially insulate them from the recent drop in prices. They are also more likely to be cognisant of the downstream impacts on associated industries, and reluctant to see skills and expertise leave the sector, possibly permanently. Consequently, the reduction in harvesting in regions such as the central North Island, where there are a number of large scale operations, could be smaller.

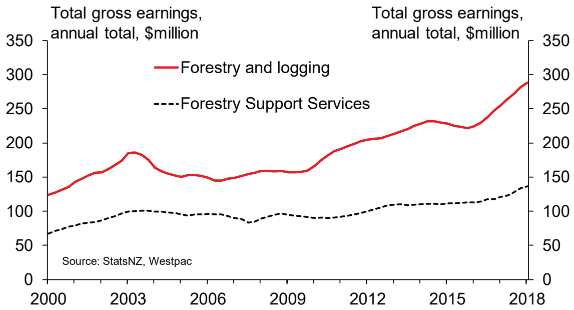
Forestry and logging jobs and log prices



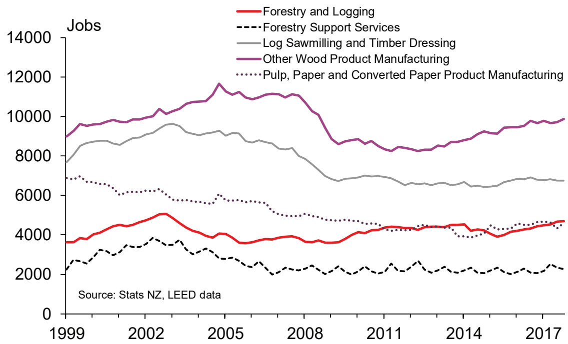
Nonetheless, fewer trees being harvested will inevitably result in fewer jobs in the industry, a reduction in hours worked, and less demand for a myriad of associated services such as transport and shipping. Around 4,700 people are currently employed in forestry and logging jobs in the NZ forestry industry with around 28,000 employed in the wider forestry and wood processing sector.

During the 2014 downturn in log prices the number of forestry and logging jobs fell by about 700 and we expect we could see a similar sized impact from the current downturn. However, this probably understates the effect on the local economy. Some of those affected will be contractors (rather than employees), who are not picked up in this data. What's more, those who retain their jobs are likely to be working fewer hours or have pay rates cut as demand for associated services falls. Some regions will also feel a bigger impact than others with forestry jobs concentrated in east coast of the North Island, Northland, Tasman/Nelson, and Southland.

Forestry sector employee earnings

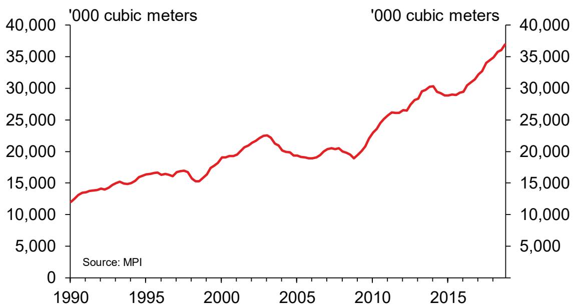


Forestry jobs by sector

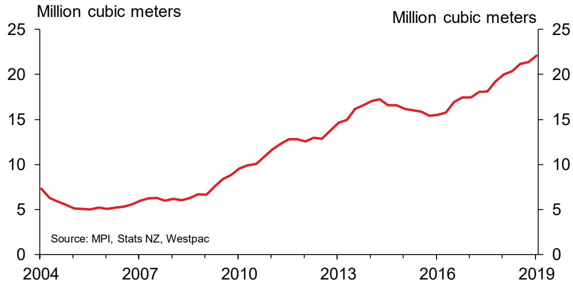


Of course, while the fall in prices will lead to a supply response, logging won't drop to zero. Larger forest owners will continue harvesting for the export market, with some additional volume being directed to local saw millers. Based on past episodes, we would expect to see around a 10% fall in log export volumes. Impacts will also vary by region. In Gisborne for example, a large proportion of forests are approaching maturity, which could potentially mean the fall in log prices has a significant impact on revenue as logs will still need to be harvested.

New Zealand roundwood removals



Log export volumes



Perhaps one silver lining for the sector is the current high level of residential construction activity in New Zealand. With around 40% of logs diverted to local processors, this is still a significant market, driven in part by local demand for building supplies. On that front, domestic construction activity remains strong. New Zealand consent issuance is at a multi-decade high, led by building activity in Auckland. This should support further modest growth in construction activity this year and next. While domestic log prices may take some time to adjust (in the 2014/2015 episode domestic log prices only fell around 5%) at worst, domestic saw millers should at least find it easier to secure log supply.

Summary

After a strong performance over the last few years, the recent sharp fall in log prices will come as an unwelcome shock for the sector. While this is not the first time the forestry sector has faced such a price correction, we think the impact of sharply lower log prices will ricochet through the local economy. What's more, this comes at a time when the local economy is also facing significant headwinds on other fronts.

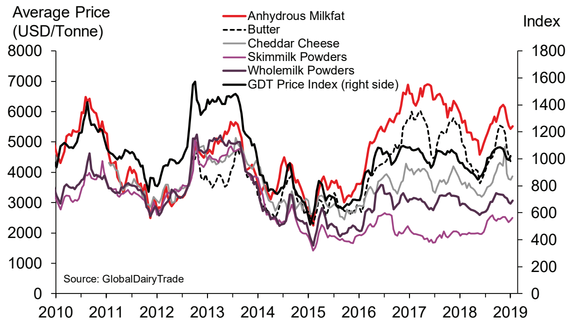
While some of the factors driving the recent price correction will be temporary, others are likely to prove longer lasting. Indeed, increasing competition to supply China is only likely to grow. And given China's dominance across a broad swathe of New Zealand's commodity exports in particular, it is a risk other sectors are also likely to be wary of.

Anne Boniface
Senior Economist

Beyond the farm gate

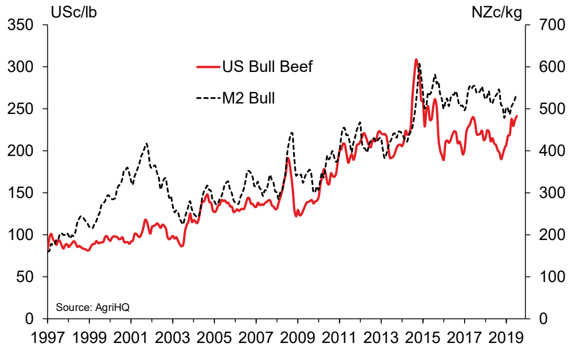
Dairy

Dairy prices reversed their recent run, posting a modest rise in the latest GlobalDairyTrade auction. Global supply looks set to remain relatively tight this year, although New Zealand production will be a key swing factor over the second half of the year. Nationwide milk production was up 14% in June, the first month of the new season. June, however, only accounts for a very small proportion of the season's milk collections with volumes gradually ramping from here before reaching a seasonal peak in October. Chinese demand will remain a critical factor in the coming months. Despite increasing evidence that the trade war between the US and China has been impacting the manufacturing sector, there has been relatively little sign of a direct impact on consumers to date. Should this change, dairy prices could come under downward pressure. We remain comfortable with our $6.90 milk price forecast.



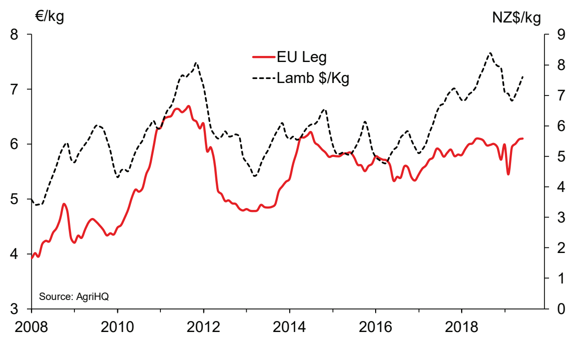
Beef

Beef prices continue to be supported by strong Chinese demand, in part due to the ongoing impact of African Swine Fever (ASF). With the ASF outbreak not yet under control, there is potential for further increases in demand for other proteins as Chinese consumers are forced to find substitutes for pork. This increase in Chinese demand, combined with solid demand from the US, relatively tight local supplies and very low beef production coming out of Australia mean the outlook for beef prices remains very favourable. The icing on the cake for farmers has been good pasture conditions for many over winter, thanks to relatively mild weather (until very recently).



Lamb

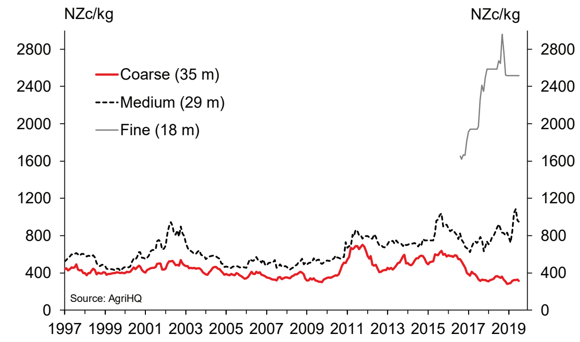
Against a backdrop of tight global lamb supplies, the impact of strong Chinese demand on prices has been particularly apparent. This has been exacerbated by the current seasonal low in New Zealand lamb supplies, pushing international lamb prices higher. With the NZ lamb crop expected to be down this season, and Australian farmers expected to start rebuilding flocks following drought conditions during 2018-19, high prices look likely to be maintained. That said, Brexit uncertainty continues to weigh on the economic outlook for the UK. With new Prime Minister Boris Johnson taking a much firmer stance than his predecessor (promising to exit the EU on the 31 of October, deal or no deal) the odds of a disruptive break from the EU appear to have risen.



Beyond the farm gate

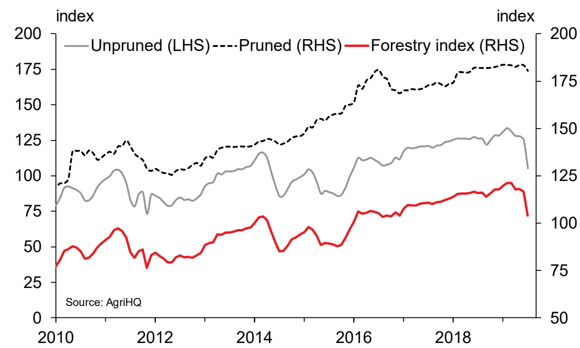
Wool

Coarse wool prices remain subdued, with little prospect of significant improvement in the near term. As an input into manufactured products such as carpet, this is another sector (in addition to forestry) that is likely to be impacted by the trade stoush between the US and China. Indeed, anecdotal reports continue to suggest Chinese demand at recent wool auctions has been weak.



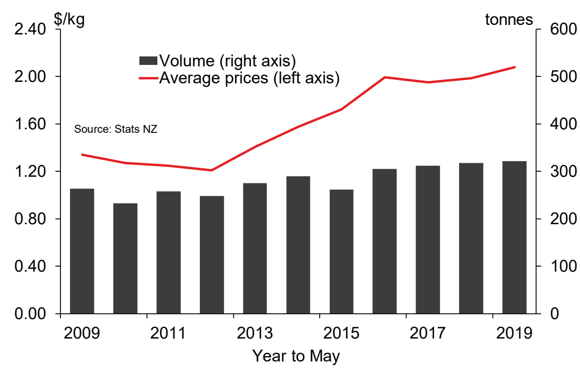
Forestry

Export log prices plunged 25% in July as strong New Zealand supplies coincided with slowing Chinese demand on the back of the US/China trade war. Prices look likely to fall a little further in the coming months. While domestic log prices have remained relatively stable, these could come under some downward pressure as logs are diverted back into domestic processing. Locally residential construction activity remains very strong, particularly in Auckland, which should help support demand for local timber.



Horticulture - Apples

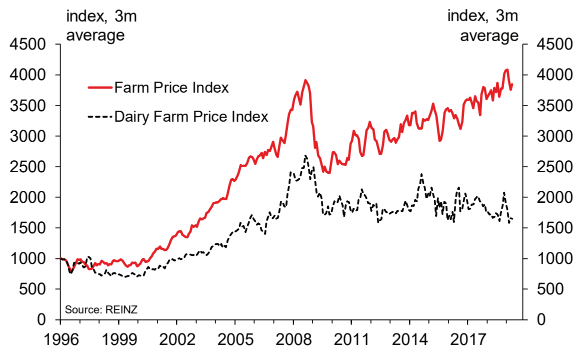
The pipfruit sector is enjoying a strong run of late as it reaps the rewards of investment in developing new varieties of fruit. There has been strong growth in demand from Asian markets for these new varieties of fruit which command premium prices. This is reflected in growth in the average price of apple exports, while growth in apple export volumes in recent years has been more modest.



Beyond the farm gate

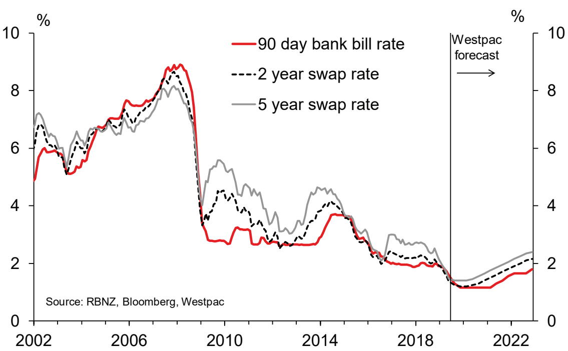
Farm prices

Rural real estate markets have remained soft with turnover continuing to linger at very low levels. The number of sales in the three months to June were 25% below the same time last year. The market for dairy farms in particular remains subdued with prices in this sector broadly flat on a year ago. Demand for other types on land, including forestry and horticulture remains firmer. Going forward, we expect farm prices will be supported by the recent drop in interest rates.



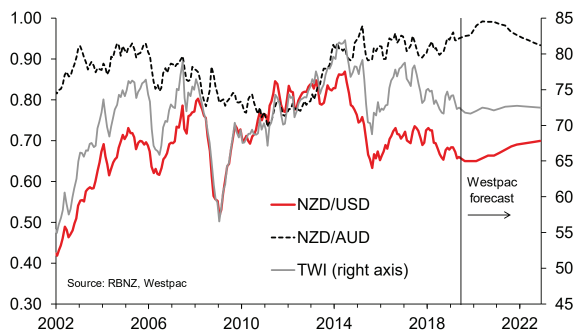
Interest rates

The domestic economy has noticeably weakened in recent months. Combined with ongoing concerns about the outlook for global growth, the potential impact of the US-China trade war, and stubbornly low inflation, this means the RBNZ is very likely to cut the OCR in August. Furthermore, we now expect the RBNZ to follow this with another rate cut in November, with the risk that this is brought forward to the September meeting if data in the coming months shows a further weakening in the economy and labour market.



Exchange rate

The Federal Reserve cut its policy rate for the first time in a decade in July. However, the accompanying statement was not as dovish as markets had been poised for. This saw the NZD/USD lose some ground. We continue to expect some further downward momentum in the NZD/USD over the next few months as markets pare back expectations of further policy easing from the Fed. In addition, the recent softness in commodity prices (including log prices) could also add to the downward momentum in the NZD. We expect the NZD/USD to linger in the mid-60s against the USD over the remainder of the year and into 2020.



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