Agribiz

April 2012

Meaty Issues

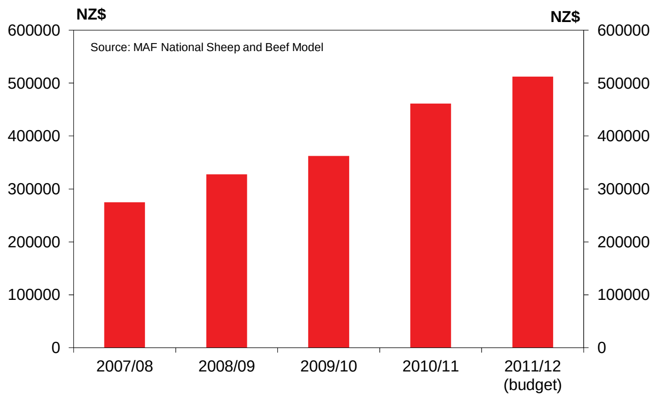
Taking an in depth look at developments in the meat sector

This quarter we take a closer look at developments in the meat sector. For a while meat was one of the weaker members of the agri-family, but the last year has seen a renewed optimism in the sector on the back of higher prices and improved profits. Looking ahead we wouldn't be surprised to see prices moderate further from current high levels, but in a number of markets supply side factors should act to limit the extent of price declines

The Current Situation

As dairy prices skyrocketed in 2007, New Zealand sheep and beef farmers were left in cloud of milk powder dust. It appeared as if white was the new gold and there was no doubt a pinch of envy in some quarters as farmers looked over the fences at their greener grassed neighbours. Indeed the relative attractiveness of dairy prices encouraged some to jump that fence. There was strong growth in conversions into dairy farming, particularly in the South Island. Strong returns for dairy farmers were also reflected in accelerating rural land prices. Prices for dairy land rose particularly strongly. By 2010 New Zealand had more dairy cows than people, but the smallest sheep flock in decades.[1]

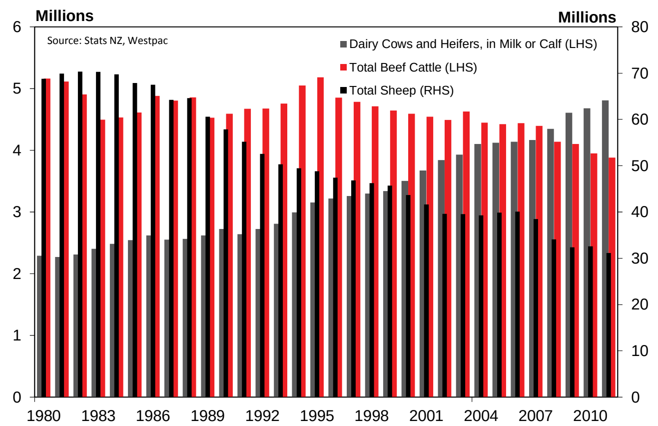
Figure 1: Net cash - national sheep & beef model (MAF)



But producers exiting from the meat industry (whether it is to switch into dairying or for some other reason) has an impact on beef markets. As producers culled stock, we saw a short term increase in beef supply (and downward pressure on prices). But clearly over a longer horizon, the decision by producers to exit the industry reduces supply. Yet before the effects of reduced supply could properly be felt, the Global Financial Crisis hit with a bang. The crisis hit demand for commodities hard and saw prices fall sharply – not only for meat but almost all commodities.

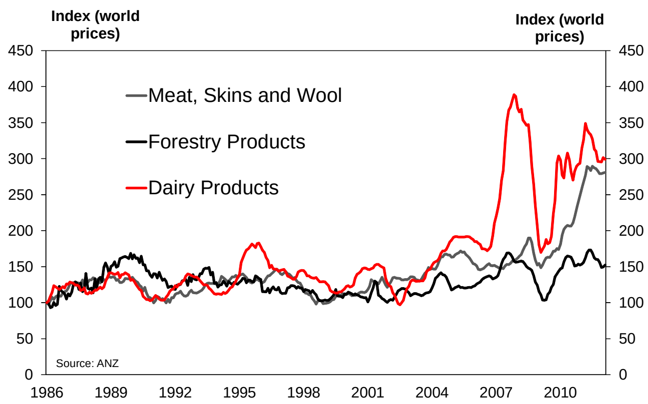
And so when the world economy recovered, and demand for food rose again, supplies of meat producing animals were tight, and prices accelerated rapidly. Over 2011 beef prices were around 18% above their 5 year average in NZD terms, while lamb prices were 38% higher.

Figure 2: NZ stock numbers



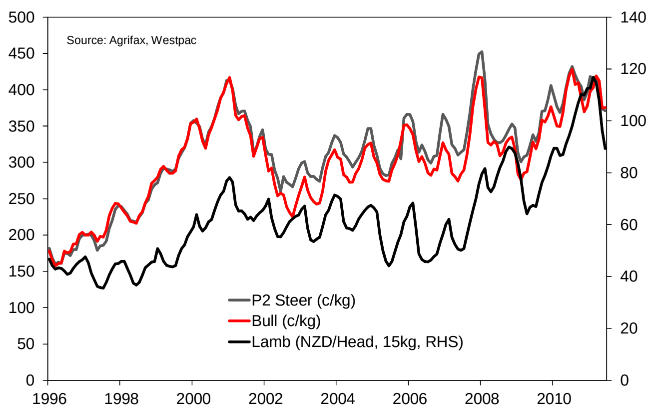
1. Of course productivity improvements have provided some offset to the decline in sheep breeding numbers. Higher lambing percentages and heavier finishing weights mean lamb production has actually held up better than the decline in sheep numbers might suggest.

Figure 3: Commodity prices by sector



In early 2012, prices for meat, particularly lamb, have moderated. Anecdotally reports suggest demand for lamb in both the US and Europe has softened and there has been strong competition from Australian product in some markets. At the same time, supplies from New Zealand have gradually started to lift. Strong pasture growth in New Zealand this season has encouraged domestic producers to retain stock on farm for longer. Consequently, slaughter numbers and export volumes have were below seasonal averages in late 2011. Since then, slaughter volumes and exports have started to pickup, and average weights are up. Some farmers may have been hoping that heavier weights would help offset lower prices, though in the near term we think the likelihood is they will coincide with softer demand and risk sending overall returns south.

Figure 4: Meat prices



So where to from here?

Our expectations are that commodity prices of all persuasions will continue to come under pressure through to the middle of the year as cyclically slower demand growth in key Asian economies coincides with struggling consumer demand in developing economies. However abstracting from near-term softness, there is strong evidence to suggest that income growth and urbanisation primarily in Asia, Latin America and oil exporting countries will likely underpin stronger prices over the next decade than the last. Essentially what we're expecting is a soft-ish year within a strong decade.

However we would note that while emerging economies, in particular China, have become the biggest destination for New Zealand dairy and forestry, developed economies remain the biggest markets for New Zealand meat exports – although their relative importance has been declining (figure 5 and 6). Nonetheless, it leaves meat exports susceptible to weak consumer confidence and spending and high unemployment in the US and Europe. And with beef and lamb relatively expensive protein choices, households may substitute them with cheaper alternatives such as pig meat and poultry – especially when household budgets are being squeezed. Increasing concern about the environmental costs of meat consumption may also change consumer behaviour.

Figure 5: NZ Bovine meat exports by destination

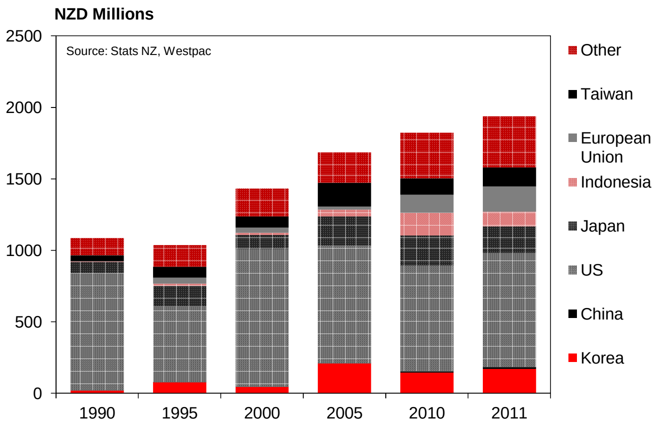
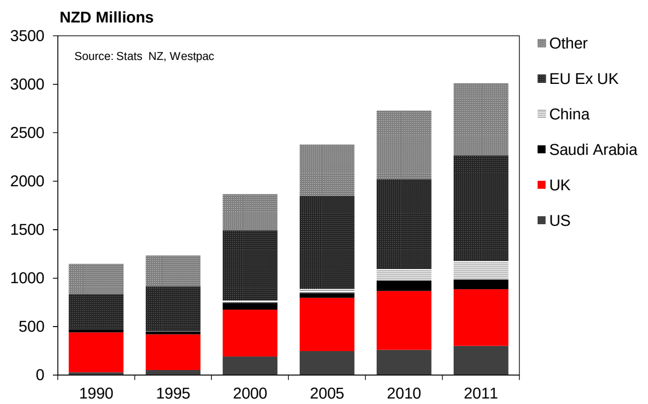


Figure 6: New Zealand sheep meat exports by destination



But it's not just about demand

Of course the outlook for supply is just as important as demand when assessing the outlook for meat prices. And New Zealand farmers aren't the only show in town when it comes to supplying the world's sheep meat and beef demands. In fact we're a pretty small player when it comes to globally traded beef. New Zealand exports comprise around 6% of global beef exports – a much smaller proportion than big players such as Brazil, United States and Australia. However we do make up a bigger chunk of international lamb markets. Around 40% of exported sheep meat originates in New Zealand. And combined, Australia and New Zealand supply around 75% of product available on world markets.

Figure 7: World trade in ovine meat, 2011

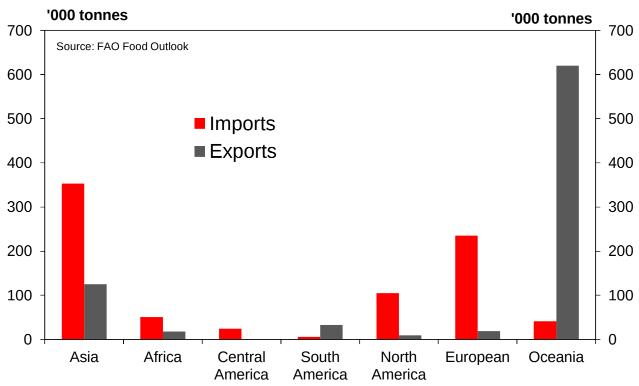
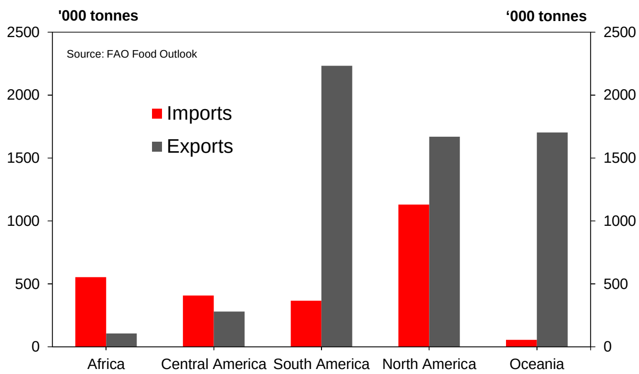


Figure 8: World trade in bovine meat, 2011



In Australia, sheep numbers have been declining, reaching their lowest level since 1887 (at 68 million head) in 2009/10. However favourable growing conditions in Eastern States as the drought broke as well as strong sheep meat and wool prices on offer have seen farmers start rebuilding flocks. The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects Australia's sheep flock to climb to 81million head in 2012/13, and expand further, albeit at a slower pace, in the following 3 years. This in turn will eventually lift lamb production, although in the near term holding onto stock for flock rebuilding will dampen supply. Nonetheless, ABARES expects Australian lamb production to rise by 7% in 2012/13, with the bulk of this extra production flowing into export volumes which are expected to rebound in 2012/13, climbing 11%.

What's going on with US beef production is particularly important for a couple of reasons. Not only is the US still the primary destination for New Zealand beef exports but because the US is also a big exporter and key competitor for NZ product in some export markets. Right now, domestic supplies of US beef are tight thanks to an increase in exports (helped in part by a weak USD) and shrinking domestic production following drought conditions in South and South-western regions and high feed costs which have lowered producer returns. The USDA expects US beef production to be down 8.5% in 2012, although the decline in exports is expected to be much smaller. This creates opportunities for those exporting into the US – the USDA has pencilled in 9% growth in imports in 2012.

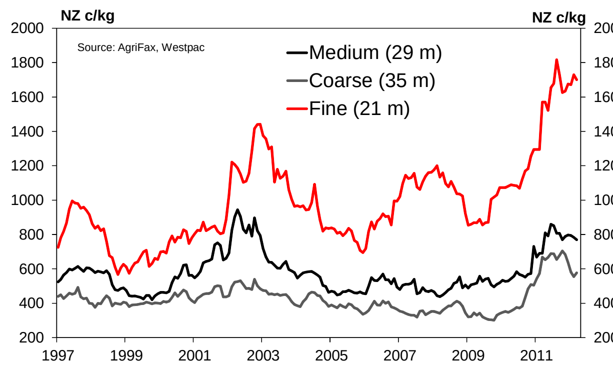
Over the medium term Brazil is expected to be one of the leaders in global beef export growth according to the latest FAO-OECD Agricultural Outlook. Like New Zealand, Brazil is able to take advantage of extensive pastures when feed is expensive and productivity of farmers continues to improve.

However we would also note that meat markets can be highly fragmented - often according to market restrictions (eg access to markets during foot and mouth outbreaks). And consequently, prices can vary within these sub-sectors.

Wool – the icing on the cake

For some time now wool has been the sideshow to meat's flashier headline act. Revenues from wool production paled in comparison to more lucrative meat sales. But in response to recovering demand, low stocks and some supply disruptions, wool prices joined other commodity prices in their migration northward in 2010/early 2011. And they have actually held up pretty well since their mid-2011 peak – particularly finer wool prices. In the near term we expect prices to be underpinned by expected weaker production in South Africa, Uruguay and Argentina. Looking ahead we expect to see further moderation in fine wool prices on the back of soft consumer demand in developed economies. Over a longer horizon growth in flock numbers in both Australia and New Zealand will add to global supplies driving prices lower.

Figure 9: Wool prices



NEW ZEALAND DAIRY INDUSTRY AWARDS TRUST

Beyond the farm gate

Global Growth

2012 is expected to be a game of two halves for the global economy. Growth is expected to slow in the first half of the year. We've already seen evidence of this with growth deteriorating most severely in the Eurozone which has been hit hard by the sovereign debt crisis, but also throughout Asia, and in particular China. But we expect a rebound in activity later in 2012 on the back of stimulatory monetary and fiscal policy in Asia. We think this global growth outlook will translate into easing export commodity prices through until about mid-year, before more positive sentiment and a pickup in demand lifts prices toward the end of the year.

Elsewhere there are tentative positive signs emerging from the US economy. The housing market has shown cautious signs of improvement, albeit off exceptionally depressed levels, and labour market data has also taken a more positive tone. However we are sceptical, that at least some of the apparent improvement may be down to unusual seasonal conditions.

Dairy

Global dairy prices have renewed their downward slide in recent weeks, as strong growth in supply amongst global exporters (including New Zealand) weighs on prices. New Zealand dairy production will set a new record this year, thanks to favourable weather conditions which have ensured strong pasture growth. But high prices on offer globally have also encouraged herd expansion abroad, particularly in the US.

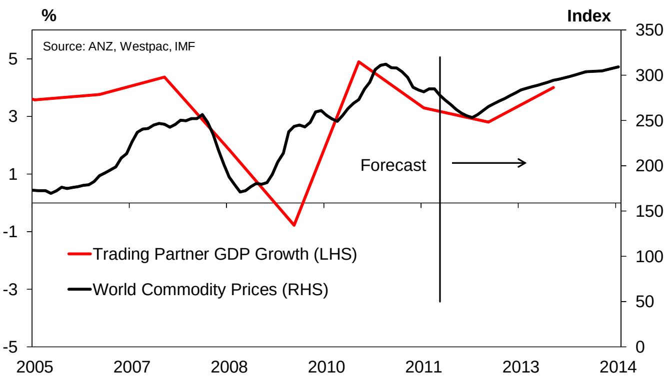
Fonterra recently shaved back its forecast payout for the current production season to $6.75-6.85, citing the strong NZD and softer commodity prices as important factors, but noted that it expected commodity prices to improve in the second half of the year. This is consistent with our own view, however we expect even a recovery in prices in the second half of 2012 will leave next season's payout below the current season. Our own payout forecast is $6 for the 2012/13 season.

Forestry

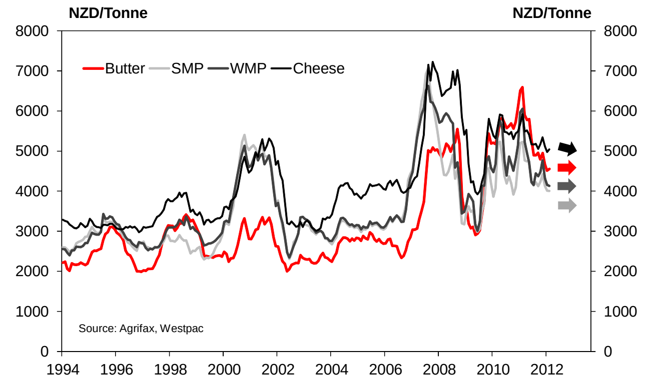
Forestry prices have eased a little further in recent months. Reports are that in China large inventories continue to weigh on prices there. We wouldn't be surprised to see prices moderate a little further in the coming months as growth in China continues to slow. In Australia, the other key destination for NZ wood exports, the housing market remains subdued, with residential building consents near cycle lows. However, the relatively low value of the NZD/AUD continues to provide support to exporters supplying Australian markets.

Forecast Key:
General pace and direction of prices expected over the next 12 months

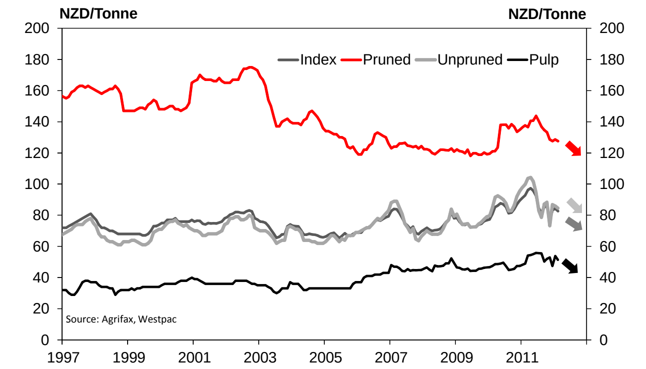
World GDP growth



Dairy



Forestry



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