Agribiz

January 2012

One way or another

An in-depth look at the outlook for interest rates and the NZD

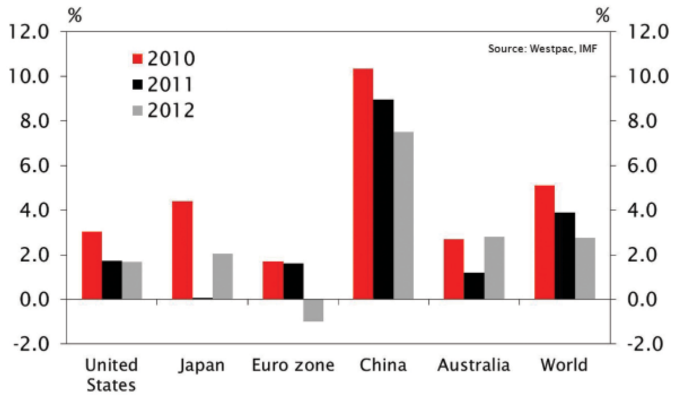
For the agriculture sector the international outlook is always important – perhaps second only in importance to the weather forecast. And right now, the international outlook remains pretty stormy. As we forewarned in last quarter's Agribiz, global growth has continued to slow and we're no closer to knowing what a solution to the Europe's debt problems might look like. This uncertainty is impacting the outlook for New Zealand interest rates and the New Zealand dollar. Both are key variables for farmers, and are the focus of this quarter's Agribiz report. The bottom line is that New Zealand interest rates are set to go up, one way or another.

Europe: Clear as Mud

European leaders continue to fight the spread of the Eurozone debt crisis beneath the shadow of bulging sovereign debt levels and increased scepticism about the ability of the fragile European banking system to cope with defaults. There has been little substantive progress over the past three months. The most recent European summit resulted in 26 of the 27 members of the European Union agreeing to proposals to tighten the Union's fiscal framework (the United Kingdom rejected the proposals). And while the leaders would have been aiming to somehow pacify markets (which have been pushing up the yields, and therefore cost of borrowing, for many Eurozone countries), they would also have been looking to convince European Central Bank (ECB) officials of the credibility of fiscal austerity measures, thereby creating a pathway for the ECB to play its part with further easing in monetary policy.

The ECB is playing hardball. A lasting solution to the crisis will require both fiscal austerity measures and Central Bank support (perhaps via bond purchases). The ECB wants to ensure that the austerity actually happens before agreeing to the monetary relief. In doing so, it is walking a fine line between providing too much support, which would remove the pressure for long-term sustainable reform and restructuring, and too little too late, which could tip countries like Spain and Italy into default. This political brinkmanship could lead to disaster if either side miscalculates. Even the best case scenario involves a severe recession in Europe, as well as ongoing market fragility.

Figure 1: Global growth by region

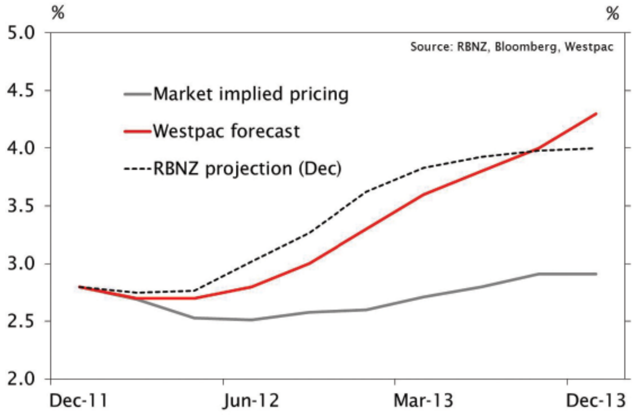


NZ interest rates will rise one way or another

In such a volatile and uncertain environment, caution is the prevailing sentiment in financial markets. International investors are becoming much more cautious about who they are lending to. And, when they are lending, they are charging a much higher price. Combined with a deteriorating outlook for global growth prospects, such an environment has important implications for the outlook for New Zealand interest rates.

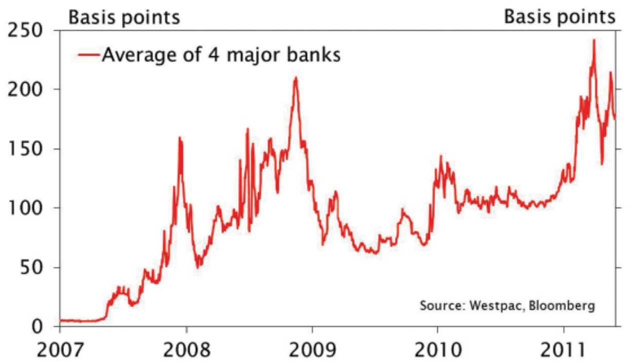
In the short-term, uncertainty, volatility and the small probability of a catastrophic European outcome is keeping the Reserve Bank of New Zealand firmly on the sidelines and the Official Cash Rate unchanged at an historic low of 2.5%. Domestically the patchy and uneven recovery of the last couple of years has struggled to maintain momentum. Blindsided by two major earthquakes, sub-par growth has translated to muted underlying inflation pressure (although headline inflation has been boosted by last year's tax changes and GST increase) giving the RBNZ scope to wait and see. For its part, the rural sector has remained cautious in the face of strong income growth.

Figure 2: 90-day rate forecasts



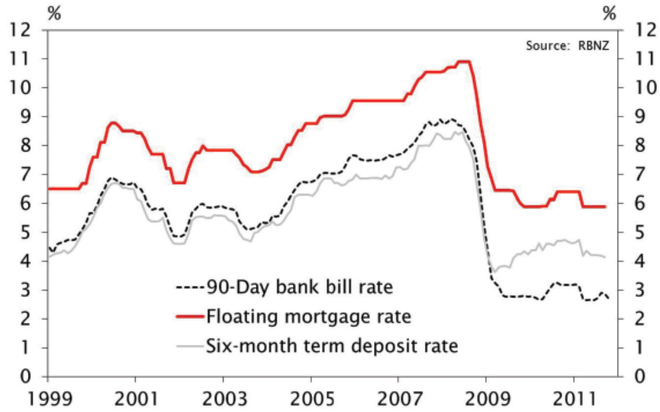
Debt repayment is still a priority for many farmers and many in the sector remain cautious about the international environment, though good growing conditions have certainly been a positive. We don't think the first OCR hike will be until the September quarter next year (just a little later than the Reserve Bank was signalling in the December MPS). But while the first OCR move may be some time away yet, eventually the OCR will rise as reconstruction in Canterbury (and activity elsewhere) soaks up spare capacity in the economy and leads to inflationary pressure.

Figure 3: Five year Australian bank credit default swap spreads



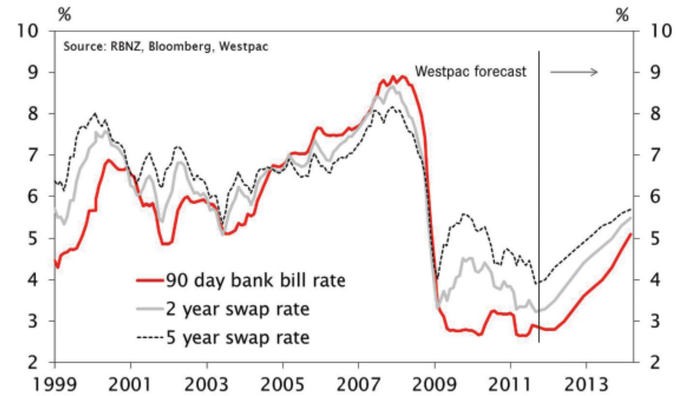
Despite our forecasts for the OCR to remain on hold for the better part of a year, retail interest rates in New Zealand could still rise during that time because of the higher cost of funds New Zealand Banks are now facing. Turbulence and uncertainty in offshore markets has translated to a higher cost of funding for banks around the world. The credit default swap spreads (CDS spreads) on Australian banks are a good indicator of the impact in our region.

Figure 4: 90-day, mortgage and term deposits



Australian banks' CDS spreads have now been elevated for several months. Although New Zealand banks now rely considerably less on offshore funding than they did before the Global Financial Crisis, if funding costs remain elevated banks will eventually pass that cost on to both borrowers and savers. In other words, the wedge between retail (both mortgage and deposit) and wholesale interest rates could widen further.

Figure 5: Bank bills, 2 and 5 year swap rates



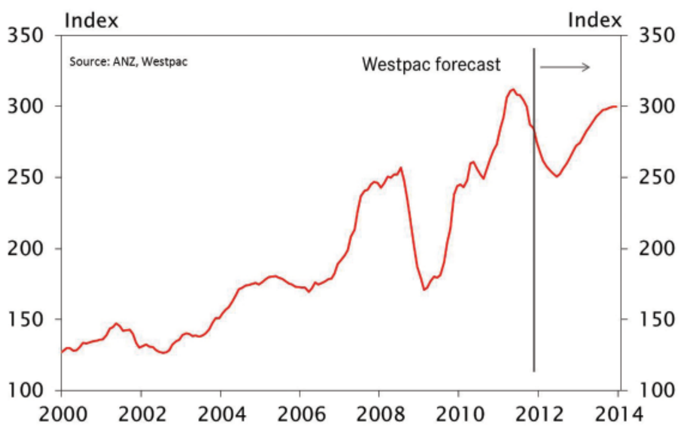
Yet although retail lending and deposit rates could rise independent of OCR moves next year, they have actually come down a bit recently, especially at the longer end of the curve, due to falling global interest rates. This has resulted in the yield curve flattening and some of the lowest fixed interest rates in years on offer. And, with the latest *Monetary Policy Statement* making it clear that there is limited scope for fixed rates to fall further (the Bank needed to generate a much more pessimistic global growth scenario in order to justify an outlook where interest rates remained unchanged at 2.5% over the forecast horizon) there is probably limited scope for further falls in fixed mortgage rates from here.

Of course, there remains a risk of a catastrophic Eurozone outcome and this may create a world in which the RBNZ does cut rates (at 2.5% it certainly has more scope to do so than other developed economies where interest rates are sitting much closer to zero). But this would also probably be a world where banks' funding costs are increasing sharply, meaning retail lending rates would not necessarily fall. Given our view that markets are currently underestimating how quickly interest rates will rise over the next few years, we see 2-3 year fixed interest rates as relatively attractive option.

The exchange rate: better news for farmers

At the risk of sounding like a broken record, we will once again reiterate our view that the outlook for the NZD is inextricably tied to the outlook for export commodity prices. Against a deteriorating global growth backdrop we maintain our view that commodity prices are likely to ease further from their current levels over the coming months as the pace of demand growth slows. But even at their trough, our forecasts have New Zealand export commodity prices are well above average levels for the last decade.

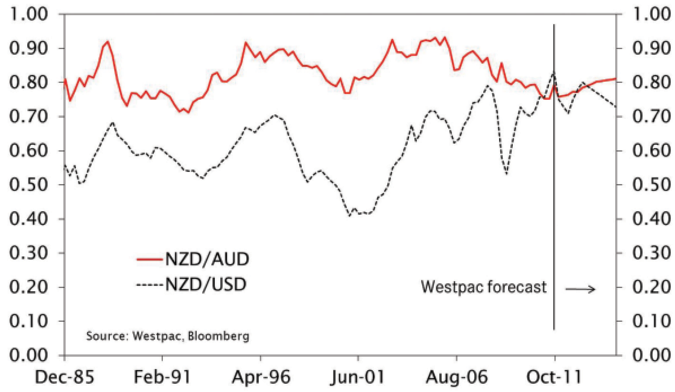
Figure 6: Commodity price forecast



Therefore we think the NZD will come under further downward pressure against most currencies in the coming months which should help buffer farm gate prices. On top of this, with no comprehensive resolution to the Eurozone crisis expected any time soon, risk aversion is likely to remain a dominant sentiment in markets. In this environment the NZD tends to weaken relative to safe haven currencies such as the USD.

Yet over a longer horizon interest rates differentials and recovering global food prices should move in favour of a higher NZD. While we firmly believe the next move policy rates in New Zealand will be up, interest rates in major economies such as the US and EU are firmly anchored as low as they can go for the foreseeable future.

Figure 7: NZD/AUD, NZD/USD forecasts



The exception to the rule, and there is always one, is against the Australian dollar. The NZD/AUD has remained persistently below its historical average for around three years now. Relative growth rates, interest rates, and relative terms of trade have all been in favour of a higher AUD. All three drivers are turning around, but we don't expect NZD/AUD to rise until global credit stress has dissipated. As New Zealand is the more indebted of the antipodean pair, the NZD/AUD cross rate tends to underperform during bouts of global credit stress.

Figure 8: Currency forecasts

Financial Forecasts	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
NZD/USD	0.75	0.73	0.71	0.75	0.78	0.80
NZD/AUD	0.76	0.76	0.76	0.77	0.77	0.78
NZD/JPY	57.8	55.5	54.0	58.5	63.2	67.2
NZD/EUR	0.57	0.58	0.59	0.61	0.61	0.63
NZD/GBP	0.49	0.49	0.49	0.50	0.49	0.49
TWI	67.1	66.6	66.2	69.0	70.6	72.4

Figure 9: Interest rate forecasts

Financial Forecasts	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
Cash	2.50	2.50	2.50	2.75	3.00	3.25
90 Day bill	2.70	2.70	2.80	3.00	3.30	3.60
2 Year Swap	2.80	3.00	3.30	3.70	4.10	4.40
5 Year Swap	3.50	3.70	4.10	4.40	4.70	4.90
10 Year Bond	4.10	4.10	4.20	4.30	4.60	4.80

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Beyond the farm gate

Dairy

Dairy prices have broadly stabilised following sizable falls in the first half of the year. The last few global dairy trade auctions have even registered modest gains. This is has been pretty solid result for the sector given ongoing uncertainty in global financial markets and deteriorating global growth prospects which have weighed on other soft commodity prices. Modest improvement in dairy prices along with a softer NZD over the last few months led Fonterra to upgrade its payout forecast for the current season to $6.80-$6.90. This is now in line with our own forecast of $6.90. Globally, milk production continues to expand. New Zealand farmers in many regions are benefitting from excellent pasture conditions which are translating to very strong output growth. Internationally milk production in Australia, US and Europe is running ahead of last year's levels.

Lamb

Tight supplies are likely to underpin lamb prices in the near term. Domestically, plentiful grass growth has allowed some farmers to hold on to lambs for longer. Others are choosing to rebuild flocks. Even if NZ Beef and Lamb forecasts of a 7% lift in the lamb crop this season eventuate, it is still the second smallest crop recorded in the last 55 years. Globally, supplies of sheep meat remain tight as producers look to rebuild flocks, encouraged by high prices. The Australian flock is expected to rise by 5.4% this season with lamb production expected to be up 9%.

Beef

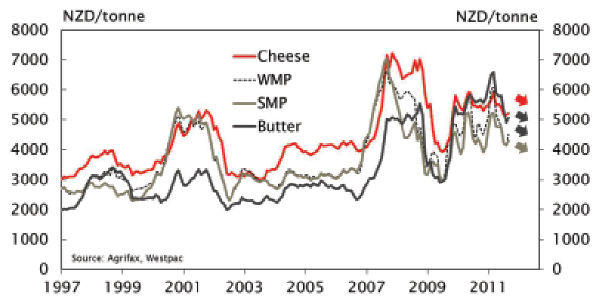
Beef prices have remained elevated over the last few months although conditions in the consumer demand conditions in the US remain challenging. The flip side is that in other export markets, competition from US beef exports is increasing as producers redirect product offshore and take advantage of a relatively weak US dollar. Australian beef exporters are clearly diversifying away from traditional destinations and towards ASEAN countries and the Middle East.

Wool

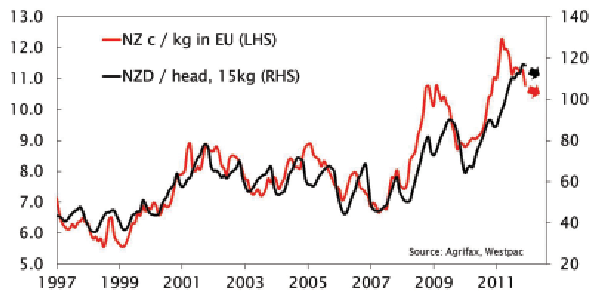
A softer NZD has provided some support to local wool prices. However, we still expect global wool prices will to come under downward pressure due to increased price competition from substitutes such as cotton and polyester. Demand for wool fibre from developed economies, in particular in Europe, is expected to slow more sharply, than emerging market demand.

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

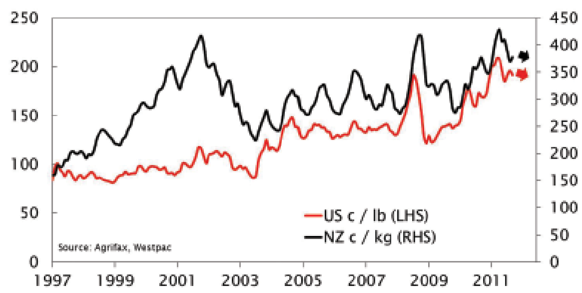
Dairy



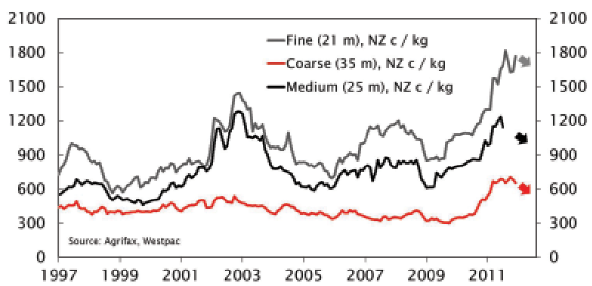
Lamb



Beef



Wool



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