Westpac Institutional Bank

Fortnightly Agri Update

6 November 2013

The bigger picture

Every once in a while it is useful to stop and take a step back and look at the bigger picture. It can be easy to get bogged down in day to day volatility in milk or lamb prices, but many of the strategic decisions farmers (and other business owners) need to make are based on an outlook that extends far beyond the next season.

For this reason, we've spent some time putting together our forecasts for how the economy might evolve over the next decade. Of course it's worth issuing a few health warnings at the outset. Long-run forecasts are not precise predictions. In reality the economy will be thrown in one direction by surprises we simply can't see coming – we can't forecast droughts, disease outbreaks, or earthquakes just to name a few. But that doesn't mean long run forecasts can't be useful. They are a way of outlining our assumptions for how the current cycle might play out and give some basis for planning, given what we do know today.

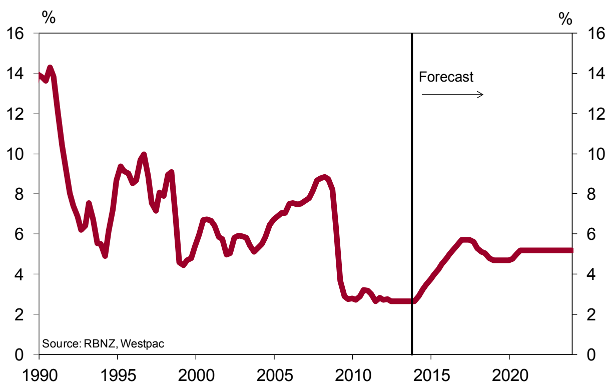
For those in the rural sector, two "biggies" are exchange rates and interest rates. (Though for the record: we expect New Zealand's GDP growth to be slower on average over the coming decade as the population ages and "NZ Inc" struggles to make significant productivity improvements, and we expect average inflation to creep higher as politicians tinker with the RBNZ's objectives.)

The good news for New Zealand commodity exporters is that we remain firmly optimistic on the longer-term outlook for global food prices (though volatility will remain a feature and prices are set to come under downward pressure in the near future as supply increases).The rapid growth of Asian demand, changing appetites and consumption patterns as well as increasing incomes all favour New Zealand's position as a net food exporter. This view in turn means we expect the NZ dollar to remain relatively high against the USD. We expect it to average around 71 cents over the next decade compared to 73 cents over the previous one.

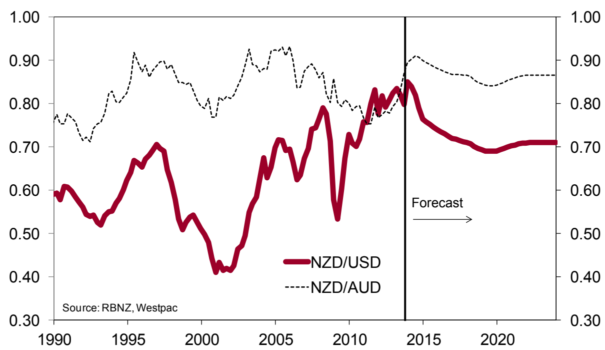
Interest rates are expected to be lower over the next decade than they have been over the last one. But that doesn't mean they will stay as low as they are now. Over the next few years the OCR is set to rise as the Canterbury rebuild, rising house prices and stronger export revenues have the New Zealand economy bursting at the seams. But by 2017 the pace of the rebuild will be slowing and the economy will be responding to higher interest rates. The RBNZ will embark on an easing cycle.

Just how high the OCR will have to go to keep inflation within the RBNZ's target band and the Bank starts to take its foot off the break and ease it back onto the accelerator depends on just what the speed limit for the NZ economy is. That is where interest rates need to be set in order for the economy to be able to hum along at full capacity without putting upward or downward pressure on inflation. Of course if you're on a road trip from Cape Reinga to Bluff, road conditions change and so does the speed limit. In the aftermath of the Global Financial Crisis (GFC), this speed limit interest rate setting for the New Zealand economy fell – perhaps from 6 ½% to about 4 ½%. But we expect it to increase to about 5% over the next few years as inflation expectations rise, bank funding costs return to more average levels and the recent shift toward more saving by New Zealanders and globally at least partially reverses as memories of the Global Financial Crisis fade. So for the RBNZ to be able to put downward pressure on inflation, it will need to slow the economy by raising the OCR above this level. We're forecasting the OCR to peak at 5.5% by the end of 2016.

90-day interest rate



NZD/USD and NZD/AUD exchange rates



Anne Boniface
Senior Economist

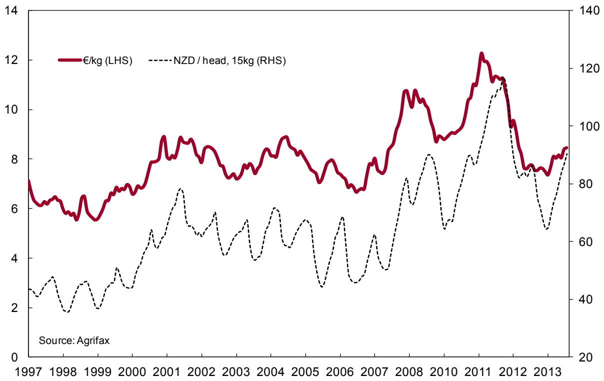
See overleaf for sector outlooks.

Beyond the farm gate

Lamb

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

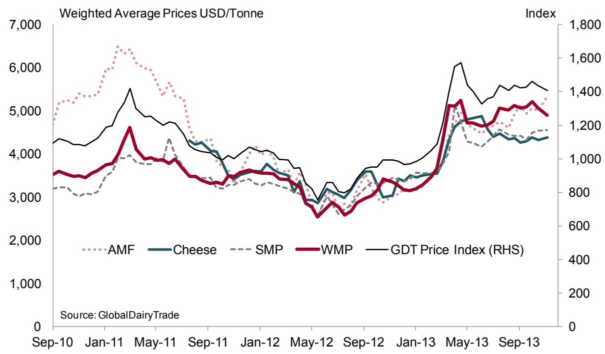
Lamb prices in both world and NZD terms have continued to edge higher. Constrained Australasian supply (lamb production is forecast to fall by about 7% in 2013/14 coming off the back of the highest slaughter since 1971/72 last season, while New Zealand lamb numbers are expected to post a similar sized decline) should help underpin prices. The growth outlook in key European markets is also improving – albeit off a low base. We revised up our economic growth forecasts for Europe and the UK this month – and though we would struggle to describe this outlook as strong, it is, nonetheless, and improvement on the pace of growth seen over the last couple of years.



Dairy

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

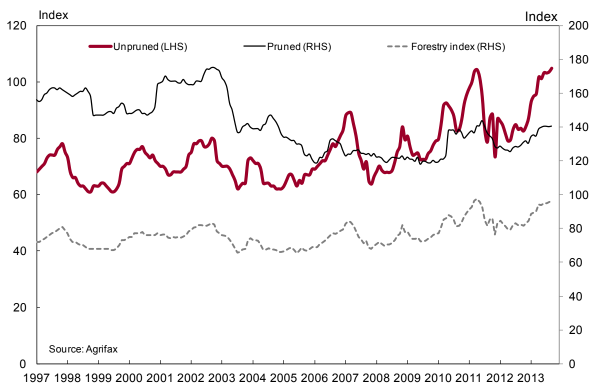
There were mixed results in last night's GlobalDairyTrade auction. Prices for most products on offer rose, but importantly, WMP prices fell further (down 3.7%). The headline index fell 1.8% and is now almost 11% below April's highs. The key reason we expect to see prices ease further is increasing supply. Domestically milk production is estimated to be running a bit under 5% ahead of last year and Fonterra has upped its forecast of product on offer through the GDT platform over the next 12 months. In the US milk production in the September quarter (although a seasonal low) was running 1.5% ahead of the same period last year. The pace of growth there will likely pick up further over the coming months as producers look to take advantage of improved margins.



Forestry

	Current price level compared to 10 year average	Next 6 months
Trend	High	↓

Forestry prices held at very high levels in October. For now, demand for logs out of China remains strong with reports that this is causing congestion issues for shipments in both NZ and China. Strong exports are also putting upward pressure on domestic log prices. Domestically, construction activity continues to accelerate as the pace of the Canterbury rebuild picks up. This should provide an additional source of demand, and keep prices elevated by historical standards, but we remain of the view that prices will moderate from their current exceptionally high levels.



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

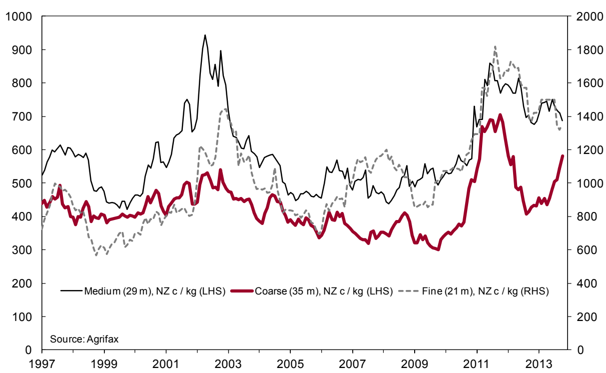
GlobalDairyTrade Auction Results, 6 November 2013

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	6.9%	$5,343
Butter Milk Power (BMP)	1.8%	$4,524
Butter	-7.0%	$3,529
Skim Milk Powder (SMP)	0.5%	$4,559
Whole Milk Powder (WMP)	-3.7%	$4,891
GDT Price Index	-1.8%	

Wool

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

Wool prices remain high with demand for coarse wool particularly strong on the back of tight supplies. In contrast consumer demand for fine wool products in key European markets is likely to remain muted as growth prospects in the region show few signs of substantial improvement.



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