Westpac Institutional Bank

Fortnightly Agri Update

2 July 2014

The China lowdown

China is clearly a key market for New Zealand, taking more than a quarter of our primary product exports last year. And while China's success story is likely to continue over the long term, it is still subject to both the growing pains that come with economic development, and to the cycles of boom, over-exuberance and bust that every country faces. In this issue we take a closer look at where China currently sits in that cycle.

Firstly, it's important to note that China has just begun what could be some significant structural changes this year, a process that was kicked off last November at the Communist Party's third Plenum (a forum that is typically used to introduce major policy shifts). The leadership declared that markets would be upgraded from having a "basic" role to a "decisive" one in the allocation of resources, which implies an ongoing push towards deregulation and a greater reliance on price signals.

However, that leaves policymakers with a difficult balancing act on several fronts: one the one hand, discouraging some of the low-quality investment that has contributed to the GDP figures in recent years, dealing with the legacy of bad debts from previous poor investments, while at the same time maintaining their target of around 7% GDP growth per year, all while avoiding the perception that the government will always step in to underwrite growth whenever things start to slow.

Within that cluster of sometimes competing goals, it appears that meeting the growth target has come to the fore. Policymakers have already taken some measures to boost activity, such as selectively easing banks' lending restrictions and ordering local governments to bring forward their spending plans. Our view is that more stimulus is needed – and will be forthcoming – in order to hit the 7%yr growth target at year-end, and even then will probably come too late to avoid a dip below this mark in the September quarter.

There are encouraging signs that the steps taken to date are helping to stabilise growth in the industrial sectors. Manufacturers cut back production in the early part of this year in response to a build-up of inventories; that backlog of inventories now looks to be more or less cleared out, and demand has picked up enough to prompt a modest lift in production again.

However, the household sector – which is perhaps the more relevant to New Zealand's mix of exports – has yet to show any similar stabilisation. Admittedly, data on the Chinese consumer is fairly patchy, in comparison to the large amount of high-frequency data on industrial activity. The recently-launched Westpac MNI Consumer Sentiment Index is helping to fill that gap; the survey showed some signs of improvement in May, but plunged again in June to its lowest level in almost a year.

The housing market looks especially soft at the moment, with prices actually falling on balance in May. Starts for new home builds have slowed in the last few months, but with the substantial number of builds already under way, the market appears to be heading for a glut of new housing that, judging by past cycles, could take the best part of a year to work off.

For New Zealand's exports, the consumer slowdown means that we could see some further downward pressure on prices before stabilising towards the end of the year. This is particularly true of longer-lived products where unsold inventories can build up for some time before the market is able to clear. Unpruned log prices have fallen 20% from their peaks in recent months, as inventories have built up at Chinese ports. (In this case, the industry's solution will be to 'store' logs by leaving trees in the ground, to await a future pickup in Chinese demand.) Since dairy products can also be stored, it's also likely to take some time to work through the surge in global supply over the last year.

The decades-long process of urbanisation and rising incomes in China still bodes well for New Zealand's agricultural sector over the long haul. But dealing with the cycles of demand and supply will remain just as challenging as for any market.

GlobalDairyTrade Auction Results, 2 July

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-7.4%	$3,606
Butter Milk Power (BMP)	4.0%	$4,135
Butter	-13.6%	$3,181
Skim Milk Powder (SMP)	-0.9%	$3,810
Whole Milk Powder (WMP)	-5.4%	$3,459
Cheddar	-2.9%	$4,226
GDT Price Index	-4.9%	

Payout Forecast Table

	2013/14		2014/15	
	Fonterra	Westpac	Fonterra	Westpac
Milk Price	$8.40	$8.40	$7.00	$7.10

Michael Gordon
Senior Economist

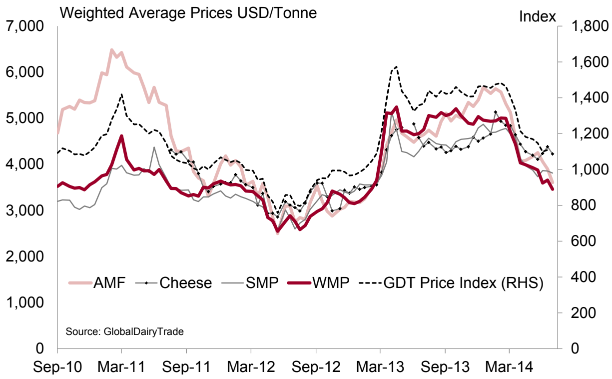
Beyond the farm gate

Dairy

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

Dairy prices fell 4.9% on a trade weighted basis in last night's GlobalDairyTrade auction. Prices are now below where they were last February, before the 'scarcity premium' resulting from a drop in global supply started to kick in.

We've noted previously that the risks were to the downside of our milk price forecast of $7.10/kg for the 2014/15 season. The latest auction result solidifies that risk; we'll review our forecast over the next week, but it is likely to be something below $7.

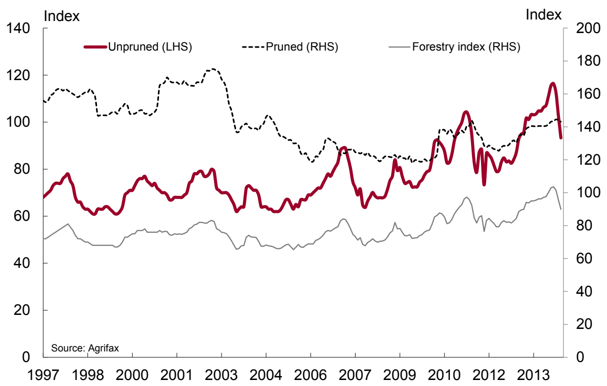


Forestry

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

Log prices have dropped further under the weight of large log inventories accumulating in China. Chinese log imports had reached record volumes in the early part of this year, and with weaker demand from end-users as the pace of residential construction in China slows, unpruned log prices have fallen 20% from their recent peaks. We suspect they could fall further in the near term as import volumes (both from NZ and other suppliers) adjust.

Domestic demand for structural logs continues to hold up well on the back of ongoing growth in building activity. In May, residential building consents (excluding apartments) were up 10% on a year ago. Growth in residential construction is set to continue, led by Auckland and Canterbury.

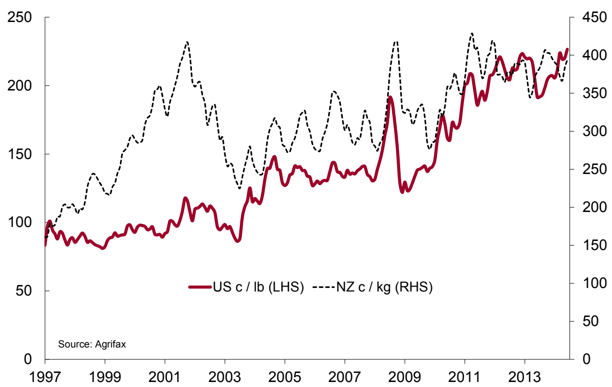


Beef

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

Beef prices have risen further in recent weeks, with peak summer demand running into very tight supply in the US. The rise in prices has occurred in spite of increased supply from the rest of the world, particularly from Australia.

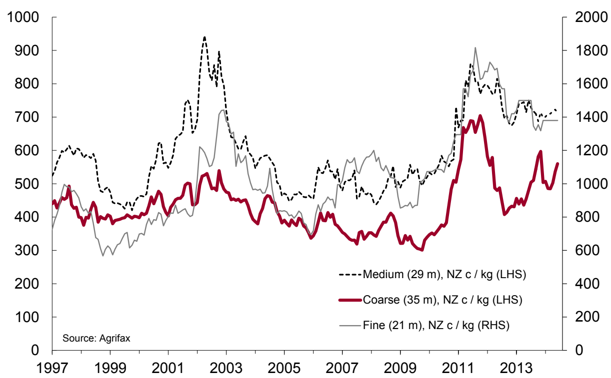
New Zealand has been able to meet this demand to some degree; recent trade figures show that beef exports for the year to date are up 4% on last year. However, NZ cow slaughter is heading into the usual slow patch that follows the end of the dairying season.



Wool

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

Coarse wool prices have improved in recent months. Locally, supplies are reported to be tight as the season draws to a close. The improvement in coarse wool prices has seen the premium between fine and coarse wool prices decline, but it is not yet back to the late 2013 lows. The theme of tight supply globally continues. In their most recent forecasts, ABARES expects Australian wool production to reach a record low in the 2014/15 season on the back of a significant reduction in the national flock.



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

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