Westpac Institutional Bank

Fortnightly Agri Update

3 February 2016

Beneath the headlines

Right now the global growth outlook is very divergent. While growth in a number of important developed economies is expected to improve over the year ahead, many developing economies are likely to continue to face strong headwinds to growth. In this week's Fortnightly Agri Update we explore what this might mean for the outlook for New Zealand's agricultural exports.

On the surface, the global growth outlook actually looks relatively positive (and certainly much rosier than you might think if you just looked at recent moves in oil and equity prices). But beneath this headline some important changes are taking place. In particular, we expect the US and Australian economies to improve, while Chinese growth is expected to slow appreciably. In more general terms, we expect high income, developed economies to become the engine room of global growth this year, while developing economies and commodity producers, especially those most closely tied to Chinese fortunes, are set to struggle.

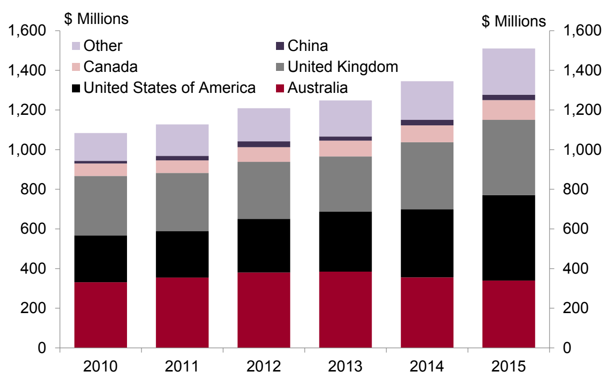
For New Zealand commodity exporters focused on exporting to China, this is likely to signal another challenging year ahead. For example, China is the key market for New Zealand log and dairy exports. In contrast, exporters who are shipping significant volumes of product into developed economies such as US, Japan, the UK or even Australia may have a brighter outlook this year. These are not only economies in which growth is accelerating, but they are also the places where consumers are likely to get a lift from sharply lower fuel prices which in turn should help support consumer spending.

Non-commodity exporters, or perhaps even exporters of more processed and highly manufactured primary products, are also likely to benefit from a weaker New Zealand dollar. Already the NZD/USD has fallen from 68.5c to around 64.8c this year and we expect it to fall further in the months ahead, weighed down not only by soggy prices for New Zealand's key commodity exports such as dairy and risk aversion sentiment in financial markets, but also by falling New Zealand interest rates. Increasingly, markets have started to come on board with our view that the Reserve Bank will cut the OCR further this year. And even the Reserve Bank itself seems to be joining the bandwagon. In its OCR Review last week they adopted an easing bias, saying "Some further easing may be required over the coming year". We're betting this is likely to happen at its March Monetary Policy Statement.

With all this in mind, one sector that is likely to enjoy a relatively positive vibe in 2016 is New Zealand's wine industry. Last week it hit the headlines after exporting $1.5bn of product in 2015. And while their exports to China have been growing in recent years, the biggest export market for NZ wine (by value) in 2015 was the United States (28.6% of wine exports) followed by the UK (25.1%) and Australia (22.5%). Exports into the US have grown particularly strongly over the last year, up almost 26%.

Winemakers have also enjoyed relatively good growing conditions last season with the 2015 vintage very highly regarded (though well down from the volumes recorded in the record 2014 vintage). Parts of the country have struggled with periods of dry weather in late 2015, most notably Marlborough, however in other parts of the country growing conditions have been more favourable, and there are high hopes for this year's vintage.

NZ wine exports



GlobalDairyTrade Auction Results, 3 February 2016

	Change since last auction	Price index USD/ Tonne
Anhydrous Milk Fat (AMF)	-6.6%	$3,486
Butter Milk Power (BMP)	-6.7%	$1,513
Butter	-8.3%	$2,905
Skim Milk Powder (SMP)	-2.2%	$1,792
Whole Milk Powder (WMP)	-10.4%	$1,954
Cheddar	-4.2%	$2,807
GDT Price Index	-7.4%	

Payout Forecast Table

	2015/16		2016/17
	Fonterra	**Westpac**	**Westpac**
Milk Price	$4.15	$4.20	$5.20

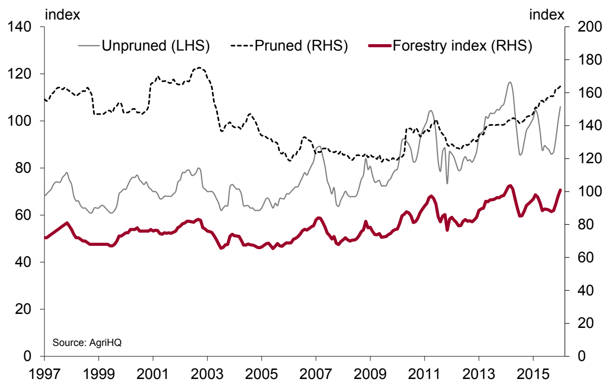
Anne Boniface
Senior Economist

Beyond the farm gate

Forestry

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

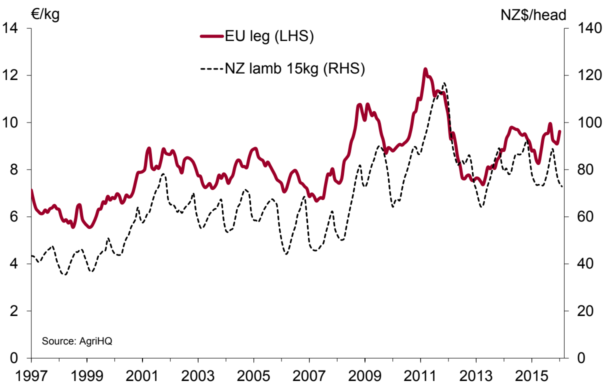
Log prices have improved noticeably in recent months, apparently as supplies in China have tightened. But we are sceptical that the recent spike in prices will be maintained. An overseas supply response to higher prices is inevitable, and the Chinese economy is softening again. In contrast, the domestic outlook is more favourable. We expect construction activity to pick up strongly over the first half of 2016, which should support domestic prices.



Lamb

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

We continue to expect relatively tight supplies in NZ and Australia to underpin lamb prices this year. However, expectations of weaker growth in China and the Middle East (on the back of sharply lower oil prices) are likely prove a headwind to any significant improvement in prices.



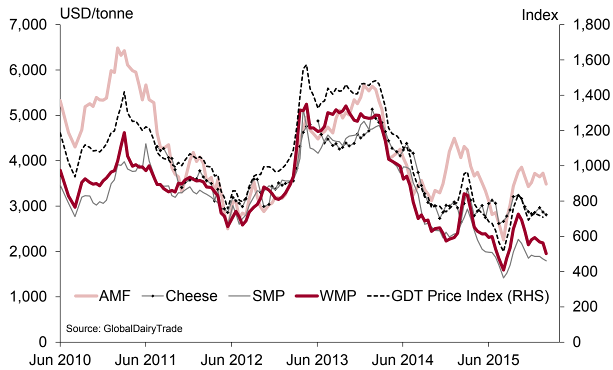
Dairy

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

Dairy prices tumbled 7.4% in last night's GlobalDairyTrade auction. Prices fell for all products on offer including a 10.4% fall in whole milk powder prices (WMP) and a 2.2% drop in skim milk powder (SMP). This was a bigger fall than we had pencilled in. It was also a bigger move than the 6% fall the futures had been signalling heading into the auction.

Dairy prices (like other soft commodity prices) had held up relatively well over the last month in the face of sharply lower oil prices and financial market pessimism driven by the growth outlook for China. However, we had been wary of the risk that broad-based weakness in commodities and financial market volatility could spill over into weakness in dairy prices. What's more, ongoing strong growth in milk production globally (European milk production was up 5% in November while domestic production was only down 1.2% in December compared to December 2014 as pasture conditions remained reasonable in many parts of the country) is ensuring ample supply for buyers.

Last night's GlobalDairyTrade auction introduces some downside risk to our freshly minted $4.20 farm gate milk price forecast for this year. But perhaps even more importantly, it also throws our $5.20 milk price forecast for 2016/17 season firmly into the spotlight. While there is plenty of water to go under the bridge between now and the end of next season, our 2016/17 farm gate milk price forecast assumes WMP prices average around $2400/tonne. But with WMP prices just $1952/tonne after last night's auction, these levels currently look some way off.



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

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