Westpac Institutional Bank

Fortnightly Agri Update

6 July 2016

On a break

Well, they did it. They finally really did it. On 24 June Britain voted to leave the European Union, against the expectations of analysts and bookmakers. But with no actual plan for leaving, and with a dwindling number of people seemingly willing to take ownership of the process, the UK and the rest of the world is set for a period of uncertainty that could stretch over several years.

At this stage it's impossible to make any firm predictions about the long-run implications of a 'Brexit'. Indeed, there are some plausible scenarios where Britain never ends up submitting an application to leave the EU at all. But that uncertainty in itself is a fairly toxic outcome at a time when the global economy is still fragile in many respects.

As for what this means for New Zealand's agricultural sector, it's clear that any change in our access to the UK market could be many years away. Once the UK applies to leave the EU, there would be a two-year period to negotiate the terms of the exit (which could be extended if necessary). In that time, the existing EU trade arrangements would still apply. In addition, the UK would need to negotiate bilateral or multilateral trade agreements with those countries that were previously covered by the EU rules, which could take several more years – and there's no reason to think that New Zealand would be at the front of the queue. In the absence of a trade agreement, WTO trade rules would presumably apply, which would mean some level of tariffs on our key exports to the UK.

The more pressing concerns for New Zealand exporters are more likely to be around economic conditions in the near term. Growth in the UK economy could slow sharply in coming months, particularly as firms put off investment and hiring decisions until there is greater clarity about how Brexit will work. And the NZ dollar has risen by 13% against the British pound since the Brexit vote, which will put a sizeable dent in our competitiveness in the UK market.

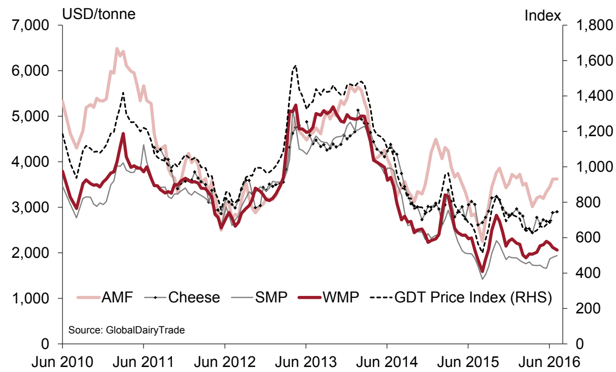
On the whole, the UK's importance as a trading partner for New Zealand has diminished over time, with the UK currently taking only around 3% of our goods exports. However, it is a significant destination for our exports of sheepmeat, wine and apples; these sectors are likely to see a hit to their returns in the coming months.

In contrast, the dairy sector doesn't have a strong direct exposure to Brexit risks, as both the UK and the rest of Europe are relatively small markets for our dairy exports. Global uncertainty does tend to weigh on commodity prices, which could depress returns in the short term; in that light, the 0.4% fall in prices in last night's GlobalDairyTrade auction was probably as good an outcome as could have been hoped for.

The other channel through which Brexit will affect New Zealand is through financial markets. There's a general view that the turmoil created by the Brexit decision will add to pressure on central banks around the world to lower interest rates further (or in the case of the US, to delay interest rate hikes). New Zealand can't expect to stand against the tide; either interest rates here will fall as well, or the widening in relative interest rates will push the New Zealand dollar even higher. We think the Brexit vote strengthens the odds that the Reserve Bank will cut the Official Cash Rate further to 2% at its August review.

Michael Gordon
Acting Chief Economist

Dairy prices



GlobalDairyTrade Auction Results, 7 July 2016

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	1.1%	$3,621
Butter Milk Power (BMP)	-7.5%	$1,552
Butter	-3.1%	$2,828
Skim Milk Powder (SMP)	2.6%	$1,938
Whole Milk Powder (WMP)	-1.6%	$2,062
Cheddar	-0.5%	$2,902
GDT Price Index	-0.4%	

Payout Forecast Table

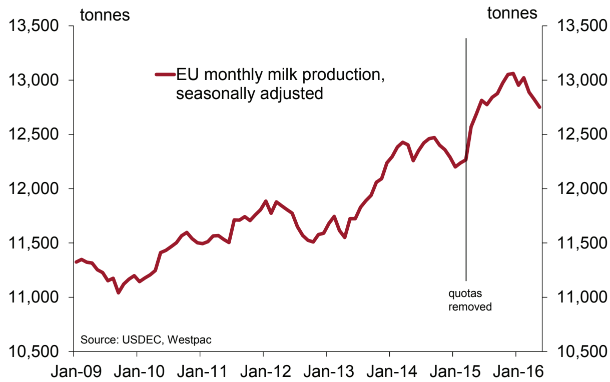
	2015/16	2016/17	
	Fonterra	Fonterra	Westpac
Milk Price	$3.90	$4.25	$4.60

Beyond the farm gate

Dairy

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

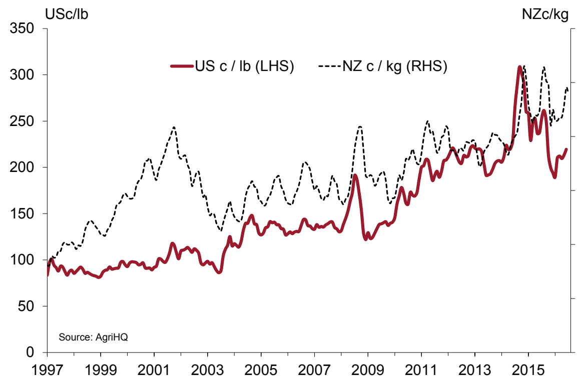
International dairy prices fell by 0.4% in last night's GlobalDairyTrade auction. For the third straight auction, whole milk powder prices fell while skim milk powder prices rose; their relative prices have now converged at around their historical average. We expect world dairy prices to remain more or less flat over the next few months, with a more substantial lift in prices not emerging until late this year. Northern Hemisphere milk production finally appears to be responding to low prices, but we would still view this with caution. The level of EU milk production has declined but it remains at a very high level, following the removal of the quota system last year. Global demand remains subdued, and Russia has extended its food import ban until the end of 2017.



Beef

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

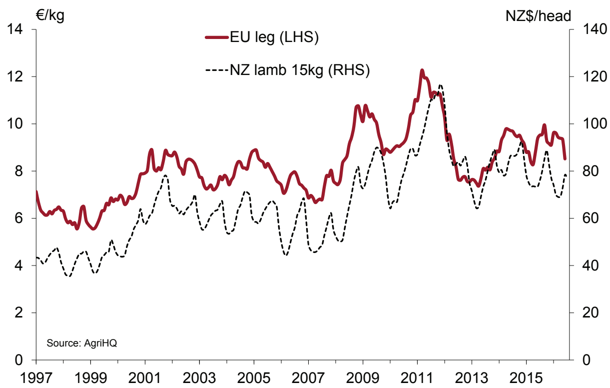
Over the medium term, international beef prices are likely to be underpinned by relatively tight global supply as beef exports from Australia, and to a lesser extent New Zealand, contract. However, this will be balanced against increasing domestic supplies in the US, with changes to market access for Brazil's chilled beef exporters an important wild card that could influence prices.



Lamb

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

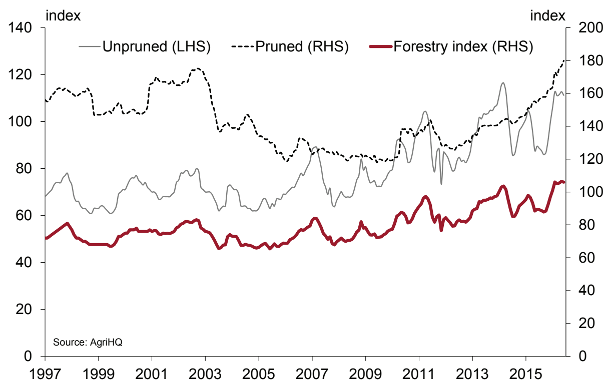
Lamb supplies are expected to tighten over the next couple of months, which could support local prices in the near term. However, lamb exports from Australia (who along with NZ are a major player in international markets) have been surprisingly strong in recent months, with increased lamb turnoff due to dry conditions into autumn in key lamb-producing regions. Meat and Livestock Australia expects this to reverse over the coming months. Over the medium term, we expect global lamb supplies to remain relatively tight. There has been a modest improvement in the demand outlook for lamb. The recent improvement in oil prices should help bolster incomes in the Middle East, and although the outlook for the Chinese economy remains soft, there are anecdotal reports of lower inventories supporting demand.



Forestry

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

International log prices were steady in June, so far defying our expectations of a decline. Domestically, the buoyant construction sector continues to support local prices. While building consents in Auckland have slowed recently, this likely reflects uncertainty around the Unitary Plan which should be finalised in coming months. Internationally, reported supplies remain relatively tight, but slower growth in key export markets and an eventual increase in supply are still expected to weigh on export prices over the rest of the year.



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

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