

Farmshed Economics

Two-way traffic

August 2014



ASB

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It's been one-way traffic for dairy prices. Eleven of the last 12 dairy auctions have now recorded overall price falls. However the price falls have helped force other factors into play; namely, interest rates and the NZD.

Accordingly, we expect the NZD has now passed its peak and that the next OCR rise will be later than previously thought. Together these changes go some way to softening the dairy income blow.

Following the latest 8.4% fall in overall GlobalDairyTrade prices, we revised down our milk price forecast for the 2014/15 season for the second time in less than a month to \$5.80/kg of milk solids. Our revised forecast compares with Fonterra's July forecast update of \$6.00/kg.

In part, the steep dairy price decline and associated fall in dairy incomes also prompted a revision to our interest rate view. We now expect the next OCR increase in March 2014 rather than our previous call for a December 2014 hike.

Moreover, we expect that the NZD has passed its peak. Already the NZD has fallen to around 84 cents against the USD from over 88 cents at one stage in July. We expect the NZD to trade at around 85 cents for the rest of the year.

All up, these movements go some way to softening the income blow for dairy farmers over the year. In addition, they bring back some balance to the risk picture. The one-way traffic cannot continue indefinitely; any further dairy price falls should induce a lower NZD, less interest rate rises or both.

Meanwhile, the outlook for the meat sector remains bullish. While the lamb market is quiet, continued tight supply both here and in Australia points towards prices grinding higher over the season ahead. Beef prices also continue to hold up at a high level. In fact, continued high prices appear to have given beef farmers enough confidence to increase the beef cattle herd for the first time in eight years.

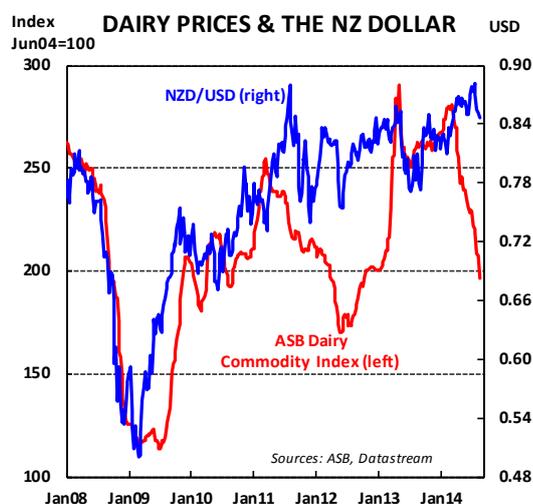
Lastly, the kiwifruit sector is showing signs of recovering from Psa. Export values for the June 2014 year are well ahead of expectations.

Key Rural Data:

As at 8 August 2014	Current	4 wks ago	Year ago	Outlook*
Rural Commodity Prices:				
ASB Dairy Price Index (USD)	196.3	220.3	259.2	↑
Lamb Price Index (NZD)	191.5	192.0	171.8	↑
Beef Price Index (NZD)	225.1	220.3	216.2	→
Interest Rates:				
90-day bank bills	3.67	3.67	2.64	→
2 year swap	4.08	4.23	3.42	↑
5 year swap	4.44	4.65	4.21	↑
Exchange Rates:				
NZD/USD	0.8462	0.8814	0.7833	→
CNY/NZD	5.21	5.47	4.80	↑
NZD/GBP	0.5045	0.5148	0.5124	→
Milk solids production (ytd % chg)**	10.1	9.6	-0.4	↑
Fonterra Shareholders' Fund	6.19	5.80	7.09	↑
Kiwifruit Export Values, June year (\$m)	930.6	N/A	934.0	↑

*Outlook indicates direction of change over the next six months. **Current data is May.

Chart of the Month:



Rural Fact or Fiction?



In the same way brown bread and brown rice are better for you than their white equivalents, brown eggs are more nutritious than white eggs.

Answer on page 3

Rural Commodities Outlook

Dairy – double down

ASB Dairy Index, 8 August: 196.3 ↓ 10.9% (mpc)

Dairy prices continue to search for a bottom. In the most recent GlobalDairyTrade auction, overall dairy prices recorded an 8.4% fall on the back of a circa 9% fall in the auction a fortnight prior. All up, compared to the same time a year ago, prices are down by 37%.

In the July edition of Farmshed Economics, we noted that should the recent falls continue a sub-\$6.00/kg milk price was possible. While we still maintain our view that prices will stabilise over the remainder of 2014, dairy prices have now crossed this sub-\$6.00 threshold. With this in mind, we have revised down our milk price forecast for the 2014/15 season by 40 cents to \$5.80/kg of milk solids. Our revised forecast compares with Fonterra's July forecast update of \$6.00/kg.

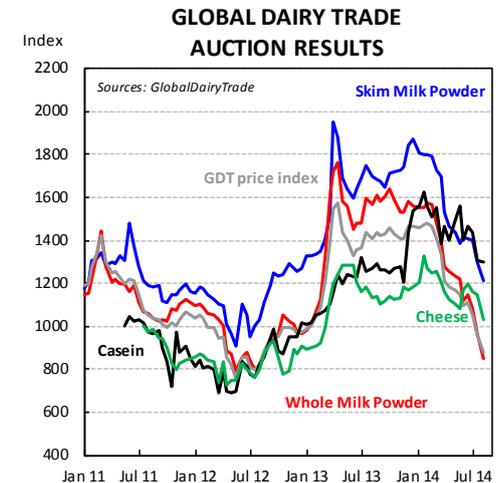
In the heated moment of price declines, it is tempting to extrapolate the current falls. And if they were to continue, our milk price forecasts would drop further. On the other hand, we prefer cool heads to prevail. Many of the factors pushing down prices are due to temporary boosts to supply. The production rebound from drought here in NZ will not repeat. Also, the NZD and dairy prices are out of whack, and we see a rising possibility of this gap closing over the year.

All up, we continue to expect dairy prices to stabilise and then recover by the end of 2014. However, predicting the exact timing of any price rebound remains an inexact science.

Milk Price Forecast:

	2013/14		2014/15	
	Fonterra	ASB	Fonterra	ASB
Milk Price*	\$8.40	\$8.40	\$6.00	\$5.80

*per kg of milk solids



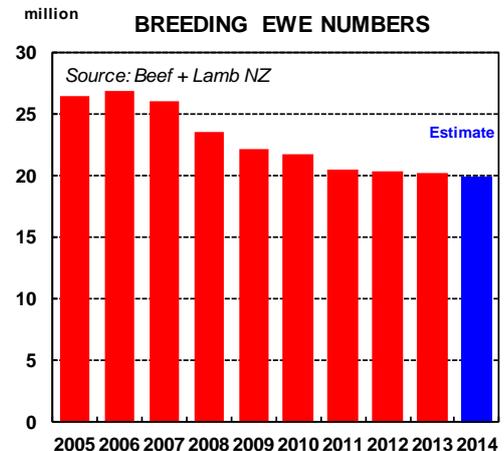
Lamb – Taking stock

ASB Lamb Index, 8 August: 191.5 ↓ -0.3% (mpc)

While the quiet period for both lamb demand and production continues we have an opportunity to take stock quite literally. Beef + Lamb NZ's 2014 Stock Number Survey has shown lower sheep numbers as at the end of June, with breeding ewes for example 1.4% lower compared to the same time a year ago. The lower numbers mainly reflect continued land use change towards dairy and dairy support activities, particularly in Southland.

While the sheep flock is lower, Beef + Lamb expect an improved lambing percentage to increase this season's lamb crop by 0.3% compared to last season. Supportive climatic conditions during mating are likely to have boosted the lambing percentage by an estimated 1.5 percentage points, or by enough to offset the impact from lower breeding numbers.

We expect the broadly steady lamb crop will see lamb supply remain tight and support lamb prices over the season. Reinforcing this price support, Australian supply also remains tight, with Australian lamb exports expected to be down around 9% over the same period.



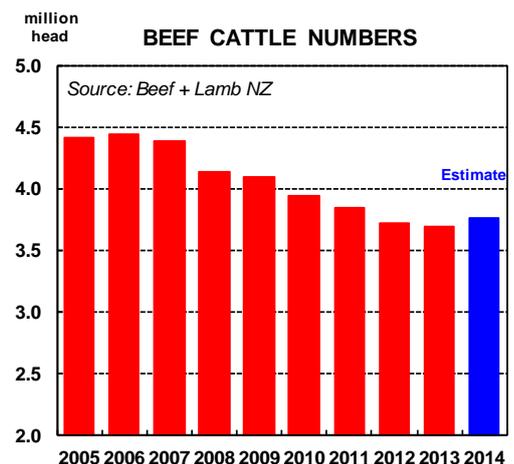
Beef – Bucking the trend

ASB Beef Index, 8 August: 225.1 ↑ 2.1% (mpc)

Beef + Lamb NZ also estimated the number of beef cattle at 3.76 million head as at 30 June 2014, which was up 1.6 per cent on the previous June. This was the first increase in the herd since 2006, and reflects trade stock being held over for greater weights in light of current good returns. Most of the increase was driven by a 2% lift in North Island numbers.

That said, breeding cows were down 3.2% for the year. The impact of last season's dry conditions continues to weigh heavily on Northland, Waikato and Bay of Plenty herds.

Despite the increase in beef cattle numbers, the level of beef prices is still likely to be determined by offshore supply movements, particularly in the US market. On that front the market picture is unchanged from July. With the US beef herd still at historic lows, we expect beef prices to remain high over this season, and potentially into next season as well.



Rural Commodities Outlook (continued)

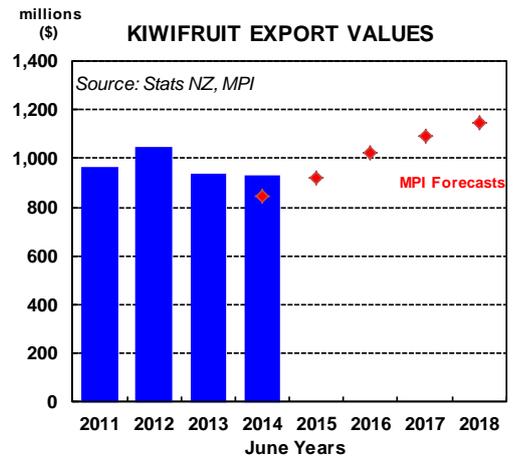
Kiwifruit – Comeback kid

2014 June Year Export Values: \$930m ↓ -0.4% (aacp)

Back in June, the Ministry of Primary Industries (MPI) forecast the Kiwifruit industry to begin to rebound from the impact of Psa. After falling by around 22 million trays or 20% from 2012 to 2014, total export volumes were expected to steadily recover over the next four years. And with it MPI expected kiwifruit export values to exceed \$1bn by the 2016 year after dipping below that level over 2013 and 2014.

The latest export data suggest the kiwifruit export recovery is well on track. If anything, progress is ahead of MPI forecasts. Export values for the year to June 2014 were \$931m compared to the MPI forecast of \$843m. In fact, at this level, export values were already ahead of the \$921m forecast for the 2015 year.

Looking at markets, exports to China were up nearly \$16m or 15%, while solid gains were also reported in exports to Singapore (up 50%), Malaysia (up 10%) and the EU (up 3%). While not yet out of the woods, indications are that the industry's recovery from Psa is, so far, going to plan.



Financial Markets Outlook

Interest Rates – Time out

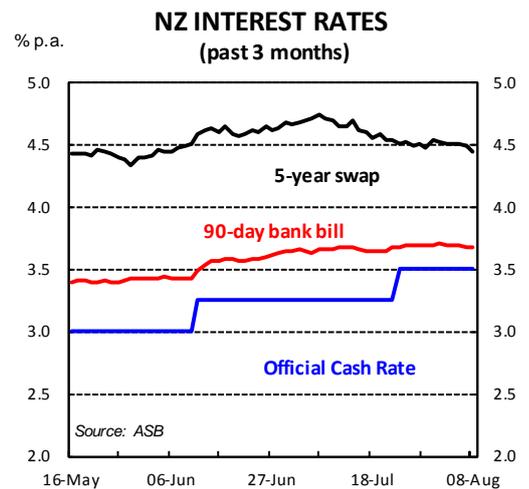
90-day bank bills, 8 August 3.67% → 0.0bps (mc)

As expected the Reserve Bank lifted the OCR by 25bps on 24 July. However contrary to expectations, it also very clearly communicated that it now intends to pause and take stock of the impact of the four hikes to date.

Since then, developments have called for an even longer pause from the Reserve Bank. With this in mind, we pushed out our call for the next OCR rise from December 2014 to March 2015.

Further large dairy price declines combined with continued strength in the NZD are the main catalysts for our changed view. Changes to the dairy outlook alone have trimmed circa \$4bn off national income over the year ahead. In addition, inflation remains subdued at 1.6%, while construction cost growth is well-contained in Canterbury for now.

Our long-term outlook for rising interest rates remains unchanged, if somewhat delayed. We expect the March 2015 OCR increase, to be followed by three further 25bp hikes, and for the OCR to peak during this interest rate cycle at 4.5% in December 2015.



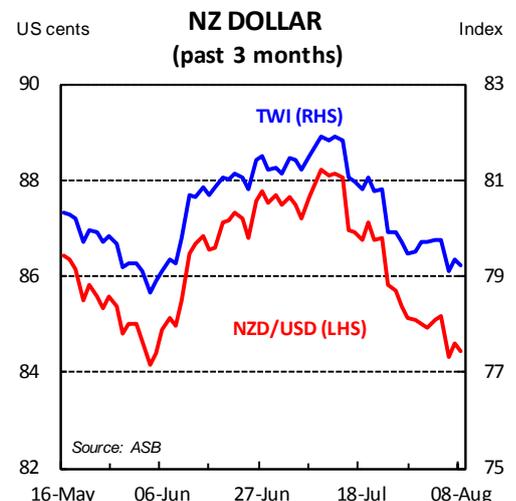
NZ Dollar – Passed its peak

NZD/USD, 8 August 0.8462 ↓ 0.0353 (mc)

Last month, the NZD TWI hit fresh post-float highs, with the latest high of 82.01 recorded on 14 July. At the same time, the NZD also approached to within touching distance of the 88.43 record high against the USD set back in 2011.

The NZD has been in retreat since then. Following the July Farmshed Economics, GlobalDairyTrade auction prices have fallen a further 17%. Also, the Reserve Bank took a big swing at the level of the NZD, calling it "unjustifiably high". This language was deliberate and raised the possibility that the Reserve Bank would intervene to bring the NZD down.

Currency markets have certainly taken notice, taking NZD over 3 cents lower, and trading at USD 0.8490 at the time of writing. We now also expect that the NZD has passed its peak. Our updated forecasts have it averaging around 85 cents against the USD from now until March 2015. From there, we expect it to weaken US 77 cents by December 2015.



Rural Fact or Fiction?

? **Answer: Fiction!** There is no nutritional difference between white and brown eggs. The egg colour depends on the breed of bird. For example, White Leghorn hens lay white eggs, while Rhode Island Red hens lay brown eggs.

ASB Economics & Research			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Senior Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5660	
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 301 5661	
Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778	

<https://reports.asb.co.nz/index.html>

ASB Economics

ASB North Wharf, 12 Jellicoe Street, Auckland

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