Agribiz

A **quarterly update** from Westpac

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June 2009

Long road to full recovery

'Green shoots' of recovery are appearing in the world economy. Markets have got excited. This has brought major swings in commodity prices and even greater swings in the value of the NZ dollar. We think a sustained recovery is some way off. Here we give an update on the world, outline some reasons why NZ exports have fared better than others so far and give a view on where to next for our major commodity prices before touching on other factors affecting agribusiness in NZ.

World update

There has been much talk around international markets of the so called 'green shoots of recovery'. There are genuine increases in some indicators like consumer confidence in the US, investor expectations in Europe and general indicators like the Baltic Dry shipping cost index. Perhaps more importantly, tightness in credit markets has eased considerably. However, other indicators are merely falling at a slower rate and even those that have picked up remain at low levels compared with recent years. The test will be whether these initial green shoots develop further into a sustained recovery. We think this is still a few quarters away. For now, overall global economic conditions are still very weak. Latest consensus forecasts (May 2009) suggest New Zealand's trading partner economies will contract by 2.3% in 2009, followed by a frail recovery of 2.0% growth in 2010.

In the past year we have seen global incomes shrink, unemployment rise and demand retract. People around the world have reacted to the economic slump and changed their behaviour. People spend less on stuff when their incomes fall. But not all goods are affected the same way. The extent to which demand for products is affected by changes in income is what economists call the income elasticity of demand.

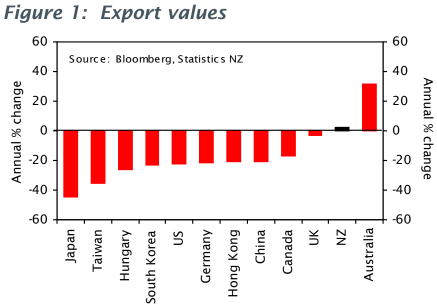
A major study by the USDA quantified this income effect across a range of goods and services for 114 countries.[1] The aggregated results are shown in Table 1. Luxury goods tend to be more sensitive to changes in income, while necessities are less sensitive. For example, on average across high income countries a 10% increase in income leads to a 13.03% increase in demand for recreation (seen as the most luxurious item), whereas the same increase in income leads to a 3.35% increase in demand for food, beverages and tobacco. The reverse is true when incomes fall.

Table 1: Sensitivity of consumption to changes in income

	Income level		
	Low	Middle	High
Food, bev & tobacco	0.729	0.602	0.335
Clothing & footwear	0.922	0.914	0.906
Rent, fuel & power	1.257	1.194	1.162
House operations	1.252	1.191	1.160
Medical care	1.641	1.338	1.251
Education	1.082	1.074	1.069
Trans & commun	1.279	1.206	1.170
Recreation	2.042	1.440	1.303
Other	1.593	1.327	1.245

A key point from a New Zealand agribusiness point of view is that food purchases are not being hit as hard as other goods and services. This adds weight to the cliché: people have to eat. The degree to which changes in income influence buying of various types of goods helps explain New Zealand's export performance over the past year relative to other countries. New Zealand's (and Australia's) positive performance are standouts across a broad range of countries. Of course, there are plenty of other factors at play in addition to changes in world incomes, including currency movements and supply side issues like last summer's drought. The drop in the NZ dollar from over $US0.80 early last year to $US0.50 early this year significantly helped maintain the value of our exports. The strong lift in the NZ dollar over recent months, if sustained, will no doubt hurt export growth from here. Exports from each country will have their own specific influences. Even so, it

Figure 1: Export values



[1] *'International evidence on food consumption patterns'*, USDA Technical Bulletin Number 1904, October 2003.

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does feel better to be making food and other primary produce rather than higher-end consumer durables such as cars when looking at New Zealand's relative export performance to date.

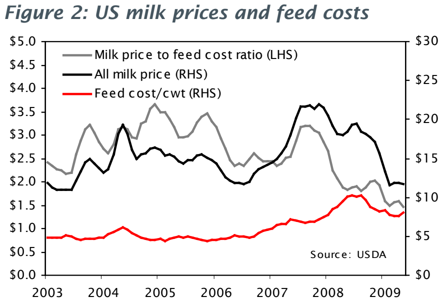
Dairy

Much has changed since the previous issue of *Agribiz* when we published our 2009/10 payout forecast of $4.50/kg. Let's recap. International dairy product prices found some stability over the past few months as Northern Hemisphere supply appeared to peak a touch under last year's levels and intervention buying programmes kicked in. This levelling off in prices was at a higher level that we had anticipated and encouraged us to lift our payout forecast to $4.90/kg since our last published view.

But. More recently, the NZ dollar has rocketed higher (against our expectations) and the US announced the reintroduction of export subsidies (this follows the reintroduction of EU export subsidies back in January). Both are negative for the payout.

Export subsidies will put downward pressure on international prices as they encourage more product onto the world market than would otherwise be the case. Moreover, subsidies encourage more production which is likely to dampen prices in the future. These effects are likely to have been part of the reason behind the 12.0% drop in powder prices in Fonterra's June auction including a larger 14.2% drop in prices for powder supplied in 6 to 8 months time. A key risk from the reintroduction of export subsidies is that they delay or slow the contraction in US milk supply that is currently underway. Low milk prices and high feed costs have encouraged cow culling in the US. The ratio of milk prices to feed costs dropped to 1.47 in May. A ratio level of under 3 is where farms are considered unprofitable and negative for future milk production.

Figure 2: US milk prices and feed costs



The USDA forecast a 1.5% reduction in cow numbers in the US in 2009 and a further 2.5% reduction in 2010. The latest Co-operatives Working Together (CWT) herd retirement programme that will see just over 100,000 cows culled over the US summer is part of this reduction. Despite improvements in average productivity (milk per cow), the USDA forecasts milk supply in 2010 to be 1.7% below 2008 levels.

The expected reduction in milk supply from the US is part of a general tightening in world supply. Droughts in parts of Latin America have dented production and supply from Europe is tracking lower than a year ago. The generally softer supply outlook will give some support to world prices, but substantial price increases seem unlikely this year as international demand remains weak and rising stockpiles overhang the market. Even if prices average around current levels for the next 12 months, average prices for the 2009/10 season will be around 25% below average prices for the 2008/09 season.

Market conditions (both for dairy products and foreign exchange) are changing so rapidly and violently it is difficult to be confident of any forecast at present. We remain of the view that international dairy prices in 2009 will bump around the average levels seen so far this year, before posting modest improvement in 2010. Our payout forecast for the 2009/10 season is now $4.70 assuming that the New Zealand dollar retreats back to around US$0.60.

Figure 3: Dairy prices

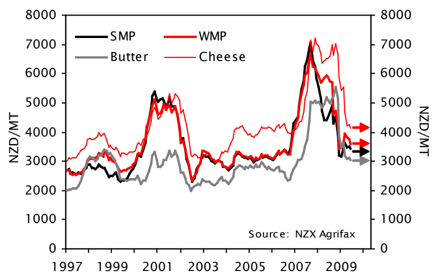
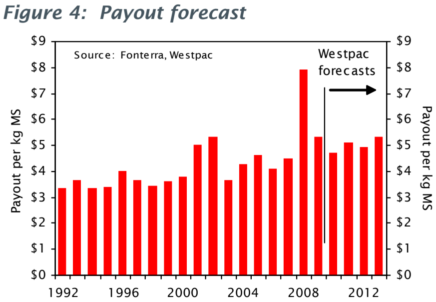


Figure 4: Payout forecast



However, in such a volatile environment we caution against extrapolating forward the latest data point, currency or dairy price.

We retain the view that world prices over the medium term will track above the historic trend as emerging market growth drives strong demand. This will help lift the payout back over the $5 mark in coming years.

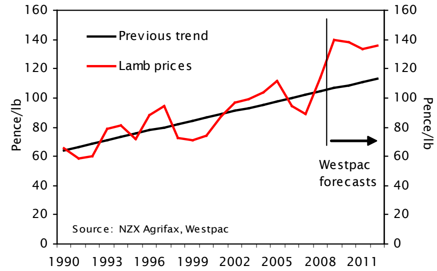
Lamb

International lamb prices continue to push higher. The lack of supply remains a major contributor to positive in-market prices. Increasing sales of higher-priced chilled product has also boosted returns.

It is difficult to imagine that demand is anything but weak given the world recession and weak economic conditions in our key lamb markets of the UK and Europe. However, reports have been reasonably upbeat. People appear to be eating more lamb in the comfort of their own home as tough economic times discourages dining out. This is encouraging for ongoing lamb sales.

The outlook for lamb prices is positive. We have long been of the view that international lamb prices are on a structurally higher path compared to previous trends. We anticipate prices to average more than 20% above the trend line since 1990 as global lamb supply contracts *(see Figure 5)*.

Figure 5: World lamb prices

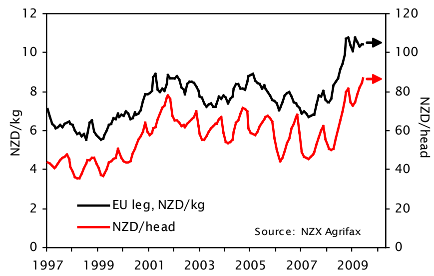


Sheep numbers in Australia are at their lowest level since 1916 and destocking continues in the UK and mainland Europe. New Zealand sheep numbers at their lowest since 1950, with the drought and conversion to dairy amplifying declines in recent years. The lack of lamb is expected to offset any weakening in demand in the short term, keeping prices up.

At home, fewer sheep and a lower lambing percentage last spring gave an estimated 23% reduction in the number of lambs available for slaughter this season.

We see no recovery in lamb numbers next season. We are pencilling in a similar lamb crop (just over 27 million) for next season on the assumptions of fewer sheep but an improved lambing percentage (weather gods willing).

Figure 6: Lamb prices



Prices at the farmgate are expected to remain good thanks to the buoyant in market prices. We forecast prices at the farmgate to average around $5.30/kg this season, up from the $4.00 average last season. We have increased our forecast for the 2009/10 season to $5.30/kg (from $4.80/kg previously) as we anticipate the ongoing tightness in global supply will offset any weakening in international demand. The forecast farmgate price includes an average NZD against the euro and pound of around 0.43 and 0.36 respectively. Higher exchange rates than those would likely see farmgate prices lower than forecast.

Beef

Demand for beef in the US is holding up despite consumers dealing with rising unemployment and severely dented balance sheets. However the composition of this demand has changed with a shift towards the grocery and fast food sectors and away from dining out. A similar story is true in Japan, while beef demand is weak in Korea.

US beef prices have increased over recent months as reasonable overall demand met tightening supply. The USDA expects US beef production to ease 0.1% in 2009. This follows a high cow and calf slaughter in 2008 that reduced cattle inventory numbers. Herd liquidation is expected to continue this year, but at a slower pace. The rising share of heifers on feed lots points to a lack of breeding herd expansion. This evolving trend, along with the proportionally large cow slaughter, suggests further decline in total cow inventories during 2009. Beef production in 2010 is expected to drop 2% on the expectation of a smaller 2009 calf crop and anticipated herd rebuilding. Tighter US domestic beef supply (and increasing exports to Asia) will result in the US importing more product and likely put upward pressure on prices.

International beef trade flows are under going realignment as US product returns to the major Asian markets (following its previous ban due to BSE). Over the coming 18 months we expect more US beef to be bound for Asia including the key markets of Japan, Korea and Taiwan. This dynamic will likely reduce returns for NZ beef in these markets. As a result less NZ (and Australian) beef will head to Asia and more will be sent to the US.

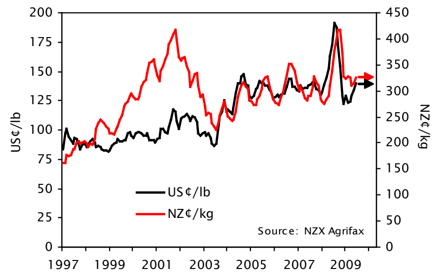
To add complexity to the outlook for international beef markets at present is the expectation of a large contraction in Argentine supply and a possible sharp retreat in Russian demand. These issues add more uncertainty to a very dynamic international beef market.

Argentine supply is contracting following high slaughter rates in recent years. Given the smaller herd and drought conditions, the calf crop is expected to only reach 10 million head in 2009, down from an average of 13.5 million in previous years.

Russia has been a key source of growth in beef demand over recent years – driven by strong economic growth. Russian beef imports in total have increased by 61% in volume over the past five years and by a whopping 332% by value. NZ has been a part of this growth with NZ beef exports to Russia hitting $18.9 million last year, compared to just $0.1 million five years ago. Disconcertingly, the strong beef demand from Russia looks set to cool sharply over the coming 18 months as the Russian economy is expected to shrink by 3.5% in 2009 with only a modest recovery expected in 2010.

Overall, we forecast international beef prices to average around current levels over the coming 18 months, but a high degree of volatility is expected as the various demand, supply and trade issues iron themselves out. We anticipate returns at the farmgate in the 2009/10 season to average around current levels ($3.20/kg for bull beef), but this is dependent on a lower NZ dollar. The sharp rise in the NZ dollar over recent months threatens to pull down average prices for the coming season.

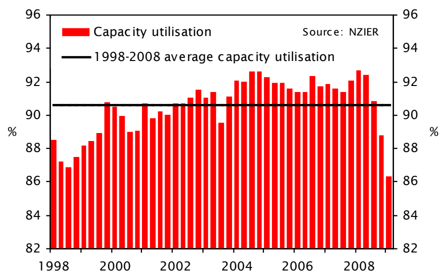
Figure 7: Beef prices



Inflation

The domestic inflation outlook is weak. A widespread softening in demand (especially relative to supply) points to considerably lower consumer price inflation outcomes over the coming two years compared to recent years. Reduced demand has led to a rapid fall in capacity utilisation (and rise in unemployment) over recent quarters (see chart). In general, firms are less willing to raise prices risking a further drop in capacity utilisation and profitability. This leads to less inflation. A major plus for NZ agribusiness is that less inflation should see a stop to the high and widespread cost increases of recent years, in addition to low interest rates that a benign inflationary outlook encourages.

Figure 8: Capacity utilisation



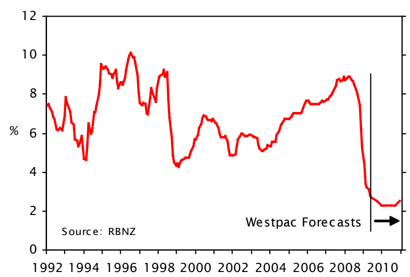
Interest rates

There are many pressures on interest rates are present. Starting with the OCR we cannot phrase the outlook better than the way the RBNZ put it in their April 30 statement 'we expect the OCR at or below the current level through until the latter part of 2010'. The main message from this is not whether the OCR is eased a nudge further or not in 2009, but that short-term interest rates are likely to remain low for an extended period.

The outlook for longer-term rates is more mixed. Upward pressure is coming from signs of global economic recovery, concerns about increased borrowing by governments around the world as they fund recent expansions in spending to combat recession and the longer term inflationary consequences of printing more money. Downward pressure is coming from narrowing credit spreads globally (and domestically as the risk of credit downgrade has markedly reduced), low inflation outlook and the domestic monetary policy outlook of low short-term rates for an extended period.

Our view remains that there is no urgency to fix for longer terms at the moment. Short-term rates are significantly lower than long-term rates and the RBNZ has signalled that they will remain so for some time. Consequently, we anticipate the trade-off between fixed and floating rates to be much the same in three or six months' time as it is today.

Figure 9: NZ 90 day interest rate



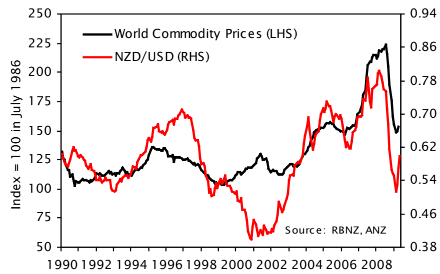
New Zealand dollar

Perhaps the best way to understand movements in the NZ dollar over the past year or so is to view it as an indicator for the health of the global economy. The rationale is this: if the world grows strongly, demand for commodities rise, commodity prices lift and along with them the prospects for NZ exports and economy. Better prospects for the NZ economy sees the NZ dollar bid higher (thereby sharing the benefits across the economy away exporters to others including consumers). The improving outlook for the world, even if stronger world growth is only in the distance at present, has been one reason behind the recent rise in the NZ dollar.

The US dollar has also been sold in its own right given concerns about US debt and printing excess money. The mirror of a lower US dollar is a higher NZ dollar. As the US dollar gets sold against other currencies this tends to lift nominal commodity prices further encouraging buying of the NZ dollar.

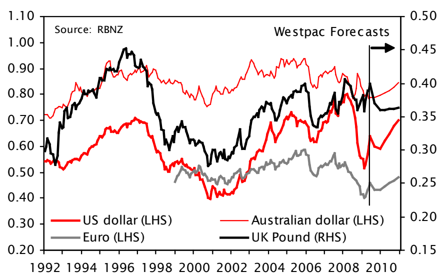
Overlaying this channel is risk appetite. At US$0.50 earlier this year, the NZ dollar was lower than it would normally be given the level of world commodity prices *(see Figure 10)*. A large part of this gap we put down to the fear factor circling world markets at that time. Appetite for risk around the world has increased markedly over recent months as the 'green shoots of recovery' appeared and the NZ dollar is now closer to the historical level implied by world commodity prices.

Figure 10: NZD versus world commodity prices



We suspect the return of risk appetite may be over done and a genuine recovery in the world economy is still some way off (see front section). Despite the current strong upward momentum, we see the NZ dollar lower over coming quarters as the current appetite for risk unwinds a little.

Figure 11: NZ exchange rate



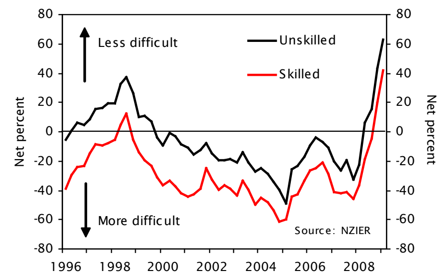
Government accounts

Budget 2009 outlined how much the government books have moved into the red against a backdrop of recession and declining tax revenues. Prior to the Budget there was a risk that deficits and increased in borrowing would persuade rating agencies to cut NZ's credit rating. That did not happen. In fact, S&P kept NZ's rating at AA+ and increased the outlook from negative to stable. The immediate response was for longer-term wholesale interest rates to fall and the NZ dollar to rise as the risk of credit downgrade was effectively removed from market pricing. Still, the big hole in tax revenues does see deficits for the foreseeable future. This will see borrowing increase markedly and may yet put some upward pressure on longer-term interest rates.

Labour market

The recession is now hitting the labour market. Employment fell in the first quarter of 2009 and we expect more job losses over the coming year. Wage growth is expected to slow from 5% in 2008 to less than 2% through 2010. On the positive side, more slack in the labour market means that farming operations will find it easier to retain and attract staff, with applicants also likely to be of a higher calibre. In fact, according to the April 2009 *Quarterly Survey of Business Opinion (see Figure 12)*, finding both skilled and unskilled labour is at its easiest in more than 30 years. An expected surge in net migration will add to this ease, as a result of a steady inflow of foreigners, less kiwis leave and more kiwis come home as the UK and Australia look less attractive. Our view is that by the end of this year, net migration will add around 20,000 people, or 0.5%, to the population.

Figure 12: Firms' difficulty of finding labour



Housing market

NZ's equivalent of the global 'green shoots of recovery' is most evident in the housing market. House sales, after adjusting for the usual seasonal effects, have jumped an impressive 74% in five months, from rock bottom to something more akin to average levels. Moreover, it is taking fewer days on average to sell a house – another indicator of improvement. Most of the pick up in recent months can be attributed to two factors: lower mortgage rates and rising net migration. We suspect house prices rose around 1% in the second quarter of 2009, on a like-for-like basis, but with mortgage rates now well off their extreme lows we do not expect house price appreciation to continue into the second half of 2009. This is one to watch: sustained increases in housing activity and prices could be a catalyst for bringing the eventual lift in interest rates forward.

NEW ZEALAND DAIRY INDUSTRY AWARDS TRUST

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