Westpac Institutional Bank

Fortnightly Agri Update

19 March 2014

Showtime

After sitting on the sidelines for the last 3 years, the Reserve Bank entered the fray again last week – raising the OCR by 25 basis points. The move certainly shouldn't have come as a great surprise to most interested observers, farmers or mortgage holders. The Bank has done everything it possibly could to warn the NZ public and financial markets that higher interest rates were on their way. Consequently, while stories of 'mortgage pain' and 'savers gain' may have hogged the headlines, there was actually a relatively muted reaction to the announcement in both interest rate and exchange rate markets. While the NZD and interest rates both rose a little, the size of the response was probably in proportion to the bank's updated forecasts and slightly higher 90 day interest rate projections.

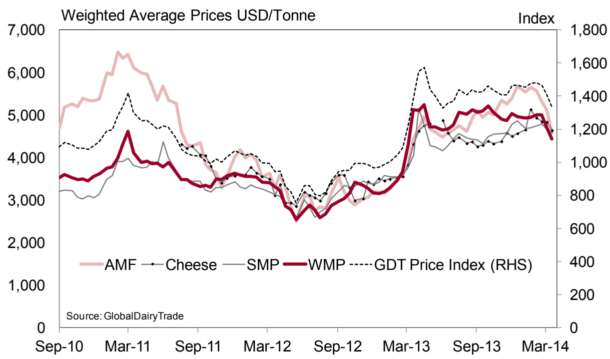
The Bank is now more upbeat on its GDP growth forecasts and also more optimistic about New Zealand's potential rate of growth over the next few years. Commenting on the latter, the Bank noted that stronger net migration, higher than expected labour force participation and greater investment in capital equipment over the last few years have all helped increase New Zealand's potential rate of growth. Yet despite this there are signs of burgeoning inflation pressure, not just in Canterbury where the rebuild continues to gather steam, but also more broadly. The RBNZ is now forecasting inflation to hit 2% by the middle of this year, and to then remain there or thereabouts throughout the forecast horizon (which extends out to March 2017). That doesn't leave a lot of breathing space for a central bank that has a firmer focus on the 2% midpoint of the 1 to 3% target band.

The Bank's inflation forecasts would be a lot stronger if it weren't for the high New Zealand dollar keeping a lid on inflation in the traded goods sector. While the Bank doesn't think the level of the NZD is sustainable in long the long run, it does acknowledge that the high terms of trade (which in turn have been boosted by strong export commodity prices) have been a key pillar of support for the currency.

So what does all this mean for those in the rural sector? Floating interest rates are expected to move higher over the course of this year (and beyond) as the Bank increases the OCR to try and keep a lid on burgeoning inflation pressure. We think the Bank is planning a series of follow up rate hikes. The next is likely to be in April with another 25 basis point increase expected in June and July. Then, they will likely to pause to assess how the economy is responding (after all the NZ economy hasn't had to deal with a tightening cycle for quite some time!), before hiking at a more gradual pace over the next couple of years. We're forecasting the OCR to peak at around 5.5% by the end of 2016.

Right now, fixed term interest rates are roughly consistent with our view of where the OCR is headed over the next few years, making us indifferent between fixed and floating. But markets are notorious for overshooting. Should they get ahead of themselves (and anticipate a larger hiking cycle than we think likely) then fixed interest rates might rise above where they are now for a period. Similarly, a rush of mortgage holders looking to fix home loans also has the potential to push fixed rates higher. Borrowers who value certainty in their payments over the near term might want to consider fixing their interest costs.

GDT auction prices



GlobalDairyTrade Auction Results, 19 March

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-10.7%	$4,578
Butter Milk Power (BMP)	4.6%	$5,253
Butter	-4.4%	$4,534
Skim Milk Powder (SMP)	-1.7%	$4,584
Whole Milk Powder (WMP)	-5.8%	$4,439
Cheddar	-4.10%	$4,641
GDT Price Index	-5.2%	

Payout Forecast Table

	2013/14		2014/15
	Fonterra	**Westpac**	**Westpac**
Milk Price	$8.65	$8.65	$7.10

Anne Boniface
Senior Economist

Beyond the farm gate

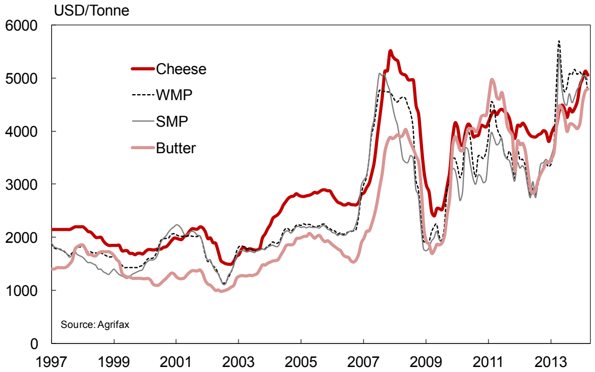
Dairy

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

Dairy prices registered a second consecutive chunky fall in last night's GlobalDairyTrade (GDT) auction. The headline trade weighted index was down 5.2%. There were mixed outturns across the products on offer, but key products WMP, SMP, AMF and butter were all significantly softer. WMP prices have now fallen 11% over the last two auctions. Following the last auction we suggested the hike in volumes offered by Fonterra on the GDT platform might have weighed on prices but while volumes are well up on last season there was no similar change in forecast prior to last night's event to help explain the weakness.

Currency markets often take a keen interest in outturns from dairy prices but there has been little discernable reaction to the last couple of GDT results. Instead, the currency has tracked higher in March. Consequently prices have fallen around 12% when measured in NZ dollar terms over the last couple of auctions.

While we have been talking about softer dairy prices for some time, over the last couple of auctions prices have fallen more quickly than we had pencilled into our forecasts. Should this trend continue, it could pose downside risk to our 2014/15 payout forecast.

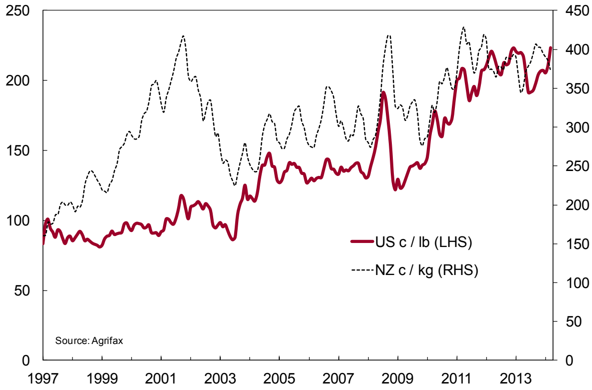


Beef

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

US domestic beef supplies remain very tight, with cattle numbers starting 2014 1% lower than levels a year ago, which is flowing through to reduced slaughter numbers. This was the 16th year of decline in beef cow inventories since 1996, which will continue to weigh on US beef production over the next couple of years as producers gradually rebuild herds.

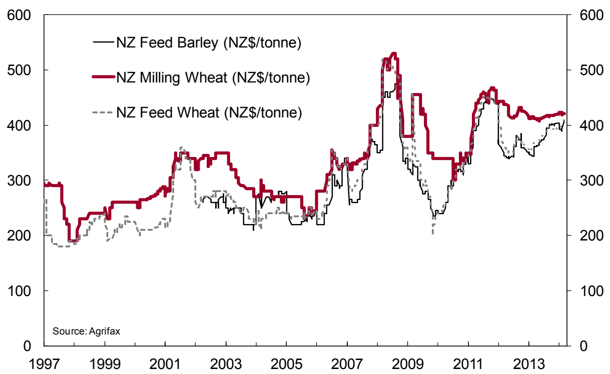
In contrast to tight US supplies, Australian beef exports have been boosted by culling in response to persistent drought conditions persist across much of eastern Australia. Australian producers are also optimistic about increased trade with South Korea on the back of an FTA due to be signed shortly by the two countries. While this is not great news for New Zealand producers, it could potentially provide opportunities in other regions if an increased proportion of Australian beef exports are diverted to Korea.



Grains

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

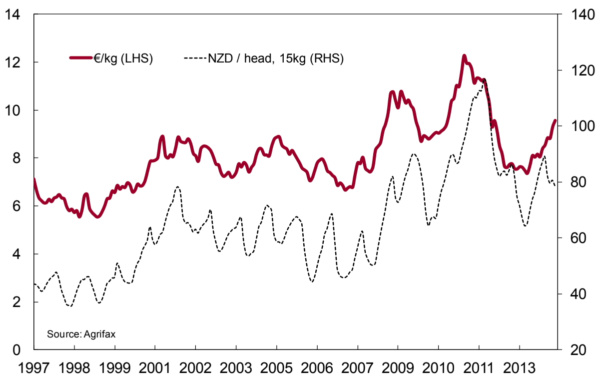
NZ Feed grain prices rose over the course of 2013 and have broadly consolidated at these levels at the start of this year. Looking ahead, local prices may be supported by tight supplies, with the ongoing conversion of arable land into dairying (particularly in Canterbury) coinciding with high demand for feed grain in the region. Agrifax reports strong demand for maize grain in the North Island as dry conditions for dairy farmers and the high payout on offer underpin demand for supplementary feed.



Lamb

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

International lamb prices have continued to edge higher in recent months although recent NZD strength has weighed on local prices. Domestically tight supplies, a remnant of last summer's drought and good pasture conditions encouraging farmers to add more weight to stock, should underpin prices during the seasonal decline over the next few months. Steady demand from China, and improved prospects in the UK economy in particular, combined with tight international supplies should continue to support prices.



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

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

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