# NEW ZEALAND ECONOMICS
# ANZ AGRI FOCUS

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INSIDE



CONTRIBUTORS


**Cameron Bagrie**
**Chief Economist**
Telephone: +64 4 802 2212
E-mail: cameron.bagrie@anz.com
Twitter @ANZ_cambagrie

**Con Williams**
**Rural Economist**
Telephone: +64 4 802 2361
E-mail: con.williams@anz.com

**Mark Smith**
**Senior Economist**
Telephone: +64 9 357 4096
E-mail: mark.smith2@anz.com


## REALITY BITES: A DAIRY TALE

### FEATURE ARTICLE: DAIRY – MORE POLITICS THAN ECONOMIC LOGIC

Stepping back from the cyclical weakness in dairy prices, we've lowered our expectation of where the milk price will sit in the medium term (across the cycle) by $0.25-0.50/kg MS. We expect international milk powder prices to settle in a range of USD2,800-3,400/MT (mid-point USD3,100/MT in the medium term; that's down 10-15%. A weaker NZD across the cycle will partially counterbalance the fall in incomes, leaving incomes down 4-8%. As well as responding to cyclical weakness in prices in the near term, farmers need to think about removing $0.25-0.50/kg MS from cost structures in a sustained fashion.

### THE MONTH IN REVIEW

Dairy production is expected to be challenged this year as farmers look to reduce costs. A smaller 2015 lamb crop is expected with mixed scanning results and another reduction in ewe numbers. Forestry exports are under pressure from softer Asian demand and lower prices reducing harvesting rates.

### RURAL PROPERTY MARKET

While current market activity points to a situation of relative calm, there's a high likelihood a correction is in the wind this spring for dairy-aligned property. Second-tier and lower quality properties are expected to be the first to feel the chill. Higher quality and better-located properties are less likely to be put on the market.

### KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

Many of New Zealand's soft commodities have had a tough time over the past few months. However, New Zealand's financial framework has begun to respond with lower interest rates and a weaker NZD helping offset in-market price pressures. For dairy and some other sectors there is a need for further currency depreciation, but many other sectors are now receiving a decent boost at the farm-gate.

### BORROWING STRATEGY

Indicative rural lending rates have fallen in step with the 50bps of OCR cuts that have been delivered. Indicative longer-term borrowing costs are hovering around post-OCR lows. This may make fixing for longer seem an attractive proposition, but we note locking in now will prevent borrowers from taking advantage should interest rates fall further than is currently expected. We also remain cautious about fixing for longer given this reduces flexibility, and the upward-sloping curve also makes it a relatively expensive proposition.

### ECONOMIC BACKDROP

Persistently low inflation and looming commodity price headwinds have prompted a lower OCR, with more cuts to come. But while activity growth is softening, we are not writing off the economy just yet. Support continues from accommodative financial conditions, the construction sector pipeline, and booming net migration. This is a deceleration in growth, not a full-blown downturn – yet. The risks of the latter eventuating reside offshore – we're watching China and Australia.

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## SUMMARY

While dairy prices are weak in a cyclical sense, the current supply/demand balance is also being influenced by structural shifts in the marketplace, which have implications over the medium term. These include:

1. Increased European competition;
2. Rapid growth in New Zealand production;
3. A more subdued medium-term demand backdrop; and
4. Downward pressure on the global cost of production.

Some of these facets contain political elements with supply being supported via self-sufficiency drives or playing to interest groups.

The combination is enough to see us lower our expectation of where the milk price will sit on average over the cycle by $0.25-0.50/kg MS (from the nine-year average of $6.35/kg MS).

This is based on an expectation that dairy prices will settle in a range of USD2,800-3,400/MT (mid-point USD3,100/MT) in the medium term (though volatility is expected to continue to see prices cycle outside this range too). This is 10-15% lower than previously assumed.

We expect the NZD to provide a partial counterbalance at the farm gate with fair value for the NZD dropping by 4-6 US cents. This provides something of a buffer. The net effect is a sustained income loss of 4-8%.

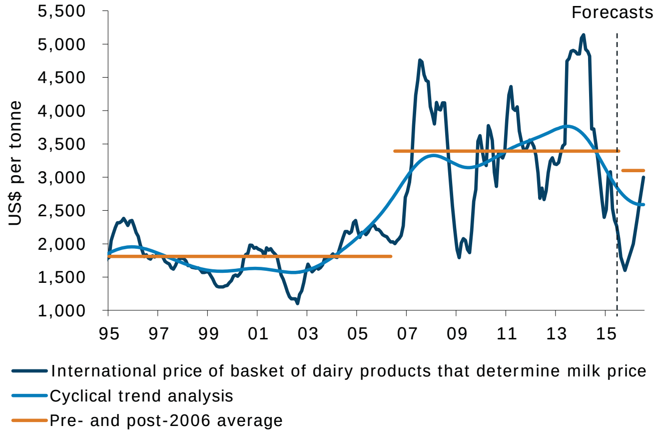
Put that through a discounted cash-flow model and it's enough to see rural farm values retract modestly. Of course adding cyclical dynamics on top (i.e. current dairy price weakness and farm losses) mean the correction in farm values will be a lot larger than that.

It doesn't have to be one-way traffic. A lot is going to depend on whether, and to what extent, farmers can reduce costs. Dairy NZ are targeting removing up to $1/kg MS in operating costs. That's tough, though the current position requires ambitious numbers. But we are more interested in the medium-term story. If dairy incomes are going to be $0.25-0.50/kg MS lower on average over coming years, then the cost side needs to exhibit similar falls – and this can't be achieved by cutting core expenditure that generates long-term efficiency and productivity, such as fertiliser, pasture renewal and animal health. Cuts in those areas this season seem inevitable – with an unavoidable impact on production – but they are not sustainable. Tough choices need to be made.

## INTRODUCTION

**Price volatility continues to plague the dairy market – this is the third significant downturn below the "global" cost of production since 2007. This volatility is the new normal.** In fact, while international dairy prices over the last nine years have averaged nearly double the pre-2006 era, the cycle in prices has more than doubled too. Fonterra recently placed in-market price volatility for wholemilk powder at +/-60% in the post-2006 period, double the pre-2006 period of +/-30%.

**FIGURE 1: TREND ANALYSIS OF INTERNATIONAL DAIRY PRICES THAT DETERMINE THE MILK PRICE**




Source: ANZ, GlobalDairyTrade, USDA

**There are a host of reasons why dairy prices have become more volatile over the past nine years. Common drivers of turns in prices in both directions have included:**

1. **Seasonal conditions** affecting production and the cost of feed supplements in the main exporting and importing countries.
2. Most milk production is still consumed locally, with global trade accounting for only around 10% of total production. However, there has been a **lift in the volume of traded dairy products as emerging market demand has risen, and market access and cool-chain infrastructure has improved. This has often resulted in mismatched supply and demand** due to seasonality of production, spill-over from excess milk in large markets, lack of transparency through the supply chain, and the general liquidity/available sources of key products on the international market at various times.
3. **Policy and regulatory changes** in key export markets, such as changes in export and domestic subsidies, and US biofuel mandates increasing international grain prices. We've seen the same

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in key import markets, such as the removal of trade barriers, changing food safety standards and implicit self-sufficiency targets.

4. **A fragile and volatile global economic environment post-2008 and the GFC.**

**This volatility has created some incredible opportunities, but also a number of management, business calibration and investment challenges for dairy farmers and the sector as a whole.** One key business calibration challenge is assessing what a sustainable land price and cost structure is to cope with the ups and downs.

The current bout of renewed weakness in international prices suggests to us that the market has well overshot. We are pencilling in recovery over 2016. A key driver here is our expectation that lower prices will reduce supply, leading to recovering price tension. However, **some of the drivers of the current downturn are structural in nature and not solely cyclical.** This means they are expected to stick around for a period of time.

**Generally the equilibrium milk powder price has been considered around mid-USD3,000/MT** and many forecasts have had an equilibrium-reverting tendency over the last 12 months. But has this changed? The average over the last nine years has been very close to this at USD3,400/MT, but with a wide monthly range of USD1,790 to USD5,140/MT. The milk price over the same period has averaged $6.35/kg MS, with a range of $8.40 to $4.40/kg MS (not including the current season).

**When the milk price went through the roof in 2013/14, we asked whether we were witnessing a structural shift in the evolution of prices** and whether we should be revising up estimates of where we thought milk powder prices would trade over the medium term. **We concluded "no"** on both counts.

**Two years on** and there are the normal questions about the cycle, but **the same (inverted) question must be asked about a structural shift.** Structural shifts require different management responses to cyclical ones.

**To answer the question we need to take a closer look at the current dynamics driving the market.**[1]

[1] This information has been gathered from a wide variety of information and data sources including: International Dairy Federation Network; OECD; AgriHQ, Bloomberg, Reuters and other news articles; Fonterra; European Commission; Chinese Dairy Industry Association; and AHDB Dairy.

## ISSUE 1: EUROPEAN COMPETITION

**European competition has increased in the key export regions of Africa, the Middle East and Asia (excluding China) over the last 12 months.** This increased competition has come about from a combination of:

1. **New on and off-farm investment in efficient producing Northern European regions** in anticipation of the end of production quotas in April 2015.
2. **The loss of Europe's largest export market, Russia**, in August last year (20-25% of Europe's exports prior to ban).
3. **A lower euro** as the European Central Bank has reduced interest rates toward the lower bound of zero and embarked on quantitative easing to try to reinvigorate economic growth. A lower EUR/USD has shifted competitiveness in favour of Europe. Historically, European intervention prices have acted as a price floor for key products, such as skim milk powder. While the internal European intervention price is unchanged, a lower EUR/USD has effectively shifted the implied USD and international price lower.
4. **Little consumption growth for many dairy products within Europe due to soft economic conditions and the mature nature of the market.** This has led to reduced domestic opportunities for sales growth and has seen the large multi-nationals look offshore for new opportunities.
5. **Generally lower feed costs and solid seasonal conditions.** This has lowered the cost of production.

Some of these influences provide only a temporary boost to European competitiveness, but others are expected to be longer lasting.

**The European milk quota system officially expired at the start of April**, with production upside now liberalised in those countries that had previously been constrained. The removal has been well signalled and supported by other Common Agricultural Policy reforms over the past 15+ years. Intervention prices, where the European Commission buys in public stocks, have been progressively lowered and subsidies paid to farmers have been largely "decoupled" from production, reducing the incentive to over-produce during periods of uneconomic margins.

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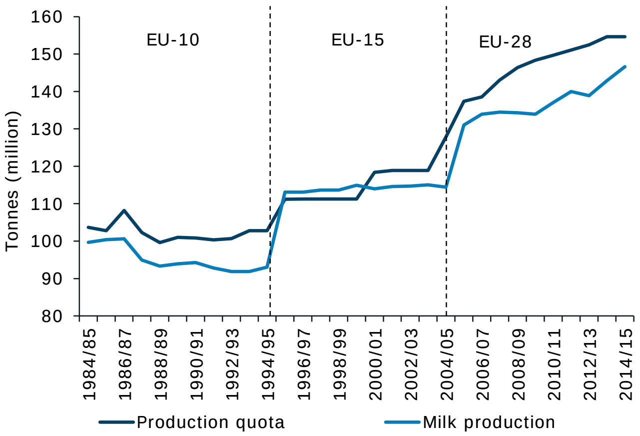
In 2013/14 only 8 out of 28 countries exceeded their milk production quotas, and at an aggregate level the European Union was 4.6% below the total allowable quota volumes. Although as many as 13 countries may have been over quota in 2014/15, the majority, including major producing countries such as France and the United Kingdom, have not been directly constrained by quotas in recent years. Most have instead been subject to market forces dictating how much milk should be produced.

**FIGURE 2: EUROPEAN PRODUCTION**




Source: ANZ, Eurostat, European Commission

**With this as the backdrop, the question then becomes, how much will international competition increase from those countries that have been held back in recent years?** There seem to be two parts to this. First, what is the production potential of the cost-efficient producing regions in Europe? And second, how much of this will displace inefficient production within Europe, and how much will find its way onto the international marketplace? There is also the question of in what form the extra milk might hit the international market (i.e. cheese, infant formula, skim milk powder, whole milk powder etc).

**With the exception of Cyprus, the countries that have regularly exceeded their milk quotas are in northern Europe, where most of the expansion in milk production has been and is expected to occur.** We estimate that countries that have been restricted by quotas, have additional expansion plans, and would be internationally competitive (on a medium-term price basis) equate to around 50% of Europe's current output. **There is a wide range of views on how quickly each region might be able / want to expand. There has also been an element of front-running** with an expansion of over 12.3 million tonnes (+9%) achieved between the announcement of milk quota removal in 2008 and now.

**Potential limitations to further expansion vary from country to country**, but include: availability of capital; environmental restrictions; availability of suitable land; competition from alternative land uses and other enterprises; fragmented ownership with poor liquidity in the land market (which slows consolidation and the creation of scale); and often a restrictive regulatory environment. **For us it all comes back to the milk price farmers will need to see in this part of the world to continue to invest.** New Zealand's experience suggests limitations to expansion become less of a restriction if the numbers stack up.

**The European Commission projects that from 2014 to 2024 milk production will expand at an average of only 0.8% a year (half the annual growth seen since 2008), but this depends on the milk price assumption used.** The research suggests the volume of milk produced is very sensitive to the milk price farmers get paid. They project the farm gate milk price to average €0.350/kg in the coming decade, considerably more than the current €0.308/kg in May. Under this scenario European Union milk could expand by a further 12m tonnes over the next 10 years. European Union exports would increase considerably over this period, with growth in the following categories expected: whey products (+50%), whole milk powder (+8%), skim milk powder (+39%), butter (+25%) and cheese (+50%). But equally, **should the milk price average around current levels then the European Union could end up exporting less product than it does now, so there is a fine balance to be struck, with causality running in both directions.**

**The other issue is how the less efficient regions (i.e. the other 50%) will respond to increased competition from the more efficient regions. Many support and regulatory mechanisms remain in place.** The key aim of the Common Agricultural Policy is to maintain food security, environmental standards, rural incomes, and animal welfare standards. Policy measures including intervention buying for certain products, a mechanism for smoothing seasonal production (private storage aid), support for products of a traditional nature or special geographic origin, and high import quota/tariffs all remain in place. **Taken as a package, these back-stops and the structure of some of the industries (small and vocal farmers) within the less-efficient regions suggest some risk that supply from this pool remains higher than expected despite increased competition from more efficient regions.**

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A recent example in the past month is protests by farmers in France, who erected roadblocks. This resulted in a promise from President Hollande of an increase in the milk price of EUR4/100kg (+13.5% on the current French milk price). It is unclear where the money is going to come from, but commentary suggests the bulk of it will have to come from within the dairy chain (retail, processors etc). This means there is less of an incentive for these businesses to reduce milk production and/or restructure their business.

**Given this backdrop it seems likely Europe's milk supply will be higher than desirable in the medium-term (3+ years).** It also means when margins are favourable the supply response from Europe is likely to be more swift than in the past, with production less constrained in efficient producing countries. This potentially lowers the upper band for dairy prices above a certain trigger level.

**With a mature domestic market, exporting is the only avenue for increased output.** Europe is home to some of the biggest branded dairy groups in the world (FrieslandCampina, Danone, DairyGold Arla, Lactalis, Nestle, Muller, Glanbia). The key point here is that these companies have strong brands (and intellectual property) that are well established in many global markets (more so than US companies, we believe). Many of these companies have been investing heavily to expand processing and storage capacity, as well as increasing their export outlets both through organic growth in existing markets, acquisition of in-market brands and in-country processing capability (including through joint ventures – e.g. Arla:Mengniu).

**In the powder markets most of the pressure, so far, has come on skim milk powder** with production up 19% in the last year. With the loss of the Russian market European processors have focused on skim milk as it has a longer shelf-life, there is an intervention backstop, and it's easier to sell the milkfat component on their domestic market. Nearly all of the increase has been exported into Africa, the Middle East and Asia (excluding China).

**TABLE 1: EUROPEAN MILK POWDER PRODUCTION (1,000 tonnes, April year-end)**

| Year | Whole milk powder | Skim milk powder |
|---|---|---|
| 2014/15 | 628 | 1,416 |
| 2013/14 | 668 | 1,194 |
| 2012/13 | 564 | 1,095 |
| 2011/12 | 581 | 1,150 |
| 2010/11 | 617 | 1,025 |

Source: ANZ, European Commission

**There have been a number of public announcements of new milk powder processing capacity with new facilities being built in New Zealand, the EU and US – although not all will be built as planned now.** A number of these plants have been commissioned to supply lucrative infant formula markets, which is expected to increase competition from Europe, particularly into China. Historically New Zealand has been the only provider able to meet China's whole milk powder product specification in the volume required (using specific bags and gas packing to extend shelf life). Any newly commissioned milk powder plants are expected to have this capability.

The table on the following page presents announced capacity investments in driers that are expected to have the capability to supply China. **Adding the European investments together suggests up to 600,000 metric tonnes of capacity could be in the pipeline. With a mature domestic market, a significant amount will be exported.** New Zealand exported 1.8 million tonnes of powder in the last 12 months, so if all this is added, Europe's additional capacity would be equivalent to nearly a third of New Zealand's current annual exports. This would represent a significant increase in competition were it to come to pass.

While this increased capacity will no doubt be aligned with traditional strengths in skim milk powder production, **the product mix is expected to be able to "flexed" if market conditions are favourable.** And many customers are said to have improved their ability to use different product mixes. At the moment most of the increased output has come in the form of skim milk powder (see Table 1), but output and exports of wholemilk powder need to be carefully watched as this is New Zealand's "bread and butter" so to speak.

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**TABLE 2: SELECTED MILK POWDER PROCESSING PROJECTS**

| Owner | Location | Output (kt p.a.) | CAPEX (USDm) | On-stream | Source |
|---|---|---|---|---|---|
| Fonterra | Darfield NZ | 225 | $400 | Q4 2013 | http://www.stuff.co.nz/the-press/business/6569578/Darfield-milk-deal-set-to-bring-billions |
| Fonterra | Pahiatua NZ | 140 | $190 | Q3 2015 | http://www.stuff.co.nz/business/farming/dairy/69681072/fonterras-235-million-stateoftheart-rebuild-of-pahiatua-dairy-factory |
| Yashili & Danone | Pokeno NZ | 52 | $175 | Q4 2015 | http://www.stuff.co.nz/business/farming/dairy/67880554/Opening-of-Yashilis-212-million-plant-delayed |
| Yili & Oceania Dairy | Glenavy NZ | 47 | $171 | Q4 2016 | http://www.nbr.co.nz/article/chinas-yili-spend-214m-infant-formula-plant-bd-134272 |
| Yili & Oceania Dairy | Glenavy NZ | 95 | $240 | Q4 2019 | http://www.nzcta.co.nz/chinanow-profile/1717/yili-opens-first-major-overseas-factory-in-new-zealand/ |
| Westland | Hokitika, NZ | 65 | $80 | Q4 2015 | http://www.stuff.co.nz/business/farming/dairy/9459213/Westland-Milk-eyes-infant-formula-expansion |
| Synutra | Brittany, France | 100 | $125 | Q1 2015 | http://www.efeedlink.com/contents/03-19-2014/2499cc8c-d0df-4e58-a052-5884899e64a9-a181.html (infant formula production) |
| Glanbia | Bellview Ireland | 100 | $210 | Q1 2015 | http://www.morganmckinley.ie/article/glanbia-are-hiring-new-belview-plant-kilkenny |
| DairyGold | Mitchelstown, Ireland | 40 est. | $55 est | Q2 2014-20 | http://www.irishexaminer.com/business/dairygold-lifts-capacity-with-117m-investment-in-cork-287841.html |
| DairyGold | Mallow, Ireland | 60 est. | $75 est | Q4 2015-20 | http://www.dairygold.ie/images/news/pdf/Dairygold%20Mallow%20redevelopment%201%28High%20Res%29.pdf |
| Glanbia | Kilkenny | 100 | $300 | Q2 2015 | http://www.irishtimes.com/business/agribusiness-and-food/flagship-glanbia-dairy-facility-opens-in-kilkenny-1.2127525 |
| Friesland Campina | Borculo Leeuwarden | 200 est. | $180<br>$140 | Q4 2015-17 | http://www.frieslandcampina.com/english/news-and-press/news/corporate-news/2014-09-05-uitbreiding-productiecapaciteit-leeuwarden.aspx<br>http://www.foodprocessing-technology.com/projects/frieslandcampinas-milk-powder-plant-borculo/ |
| Aria | Denmark Germany | 42 | $125 | Q2 2015 est. | http://www.dairyreporter.com/Manufacturers/Arla-boosts-German-processing-capabilities-with-110m-investment |
| Uelzena | Neumünster, Northern Germany | 60 | $80 | Q1 2014 | http://www.ingredients.uelzena.com/en/technology/production-site-neumuenster.html |
| Cayuga Milk Ingredients | Auburn, NY | ~50 | $100 | Q2 2015 | http://www.syracuse.com/news/index.ssf/2014/08/miracle_in_a_central_new_york_cornfield_a_101_million_milk_processing_plant_grow.html |
| USA | USA | +25% of current footprint | | 2015+ | http://www.wsj.com/articles/dairy-factory-gears-up-for-production-1420765811 |
| GEA as supplier | Strong orders from various customers | | | 2015+ | http://www.dairyreporter.com/Processing-Packaging/Asian-milk-powder-demand-drove-120m-Q4-deals-GEA |

Source: as noted

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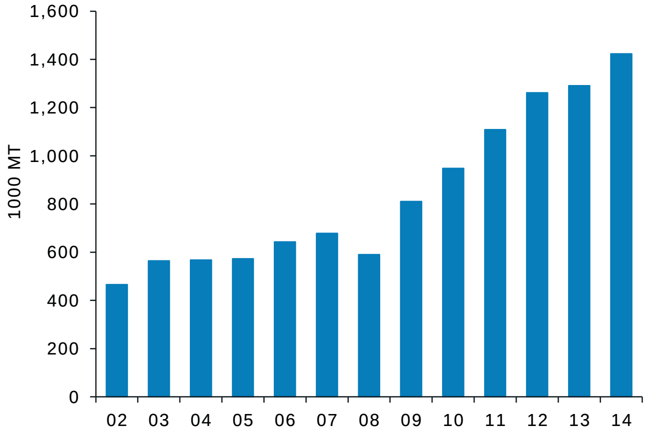
## ISSUE 2: STRONG NEW ZEALAND PRODUCTION

As we have outlined in many previous editions of the *Agri Focus,* **New Zealand has experienced a very strong period of milk supply growth** that has caught even Fonterra by surprise in recent years (i.e. they have struggled to process the seasonal peak). This has been promoted by the industry as capturing the opportunities that have arisen over the last nine years, keeping dairy products "front of mind" in many end markets (competing products are ever present), and continuing to maintain New Zealand's global scale and relevance in tradable dairy products.

**Over the last nine years total New Zealand milk supply has increased by nearly 44%.** Two-thirds of this has been due to more cows, and the other third via more milk per cow. Indeed, productivity growth has been above trend over the last five years due to a change in farm systems and lift in farm management practices.

FIGURE 3: NEW ZEALAND WHOLEMILK POWDER EXPORTS




Source: ANZ, AgriHQ

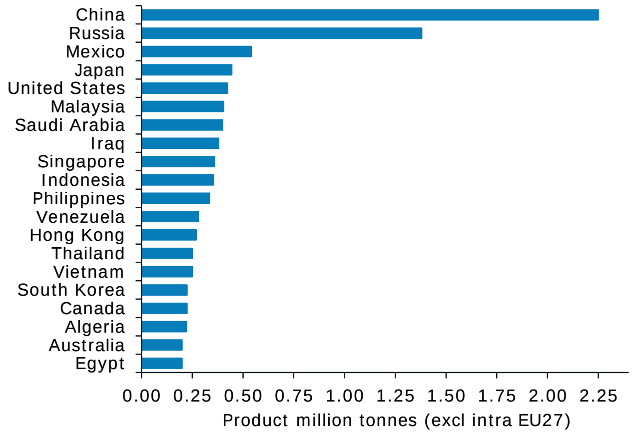
**A lot of this extra milk has been turned into wholemilk powder.** GIRA estimate that between Fonterra's formation and end-2013 a total of 180/MT per hour of new drying capacity was installed across New Zealand, which increased production by some 800,000 tonnes at the end of 2013 (nearly a three-fold increase). In the last 12 months there has been another wave of new investment in various New Zealand processing capabilities across all the main players. In 2014/15 about $1.7 billion worth of new processing and associated facilities has been completed and a further $1.2 billion has been earmarked for the coming year or so.

**While such things are difficult to judge, current market dynamics suggest some of this investment may have gotten ahead of itself.** If this is the case it will create a period of overcapacity. The length of the period of overcapacity will inevitably be dictated by the demand backdrop.

## ISSUE 3: A MORE SUBDUED DEMAND BACKDROP

**The trend in international dairy prices is driven primarily by demand dynamics and the cost of production for the major exporters and importers.** There needs to be a sufficient margin for exporting countries to be incentivised to invest and expand production capability to fulfil any growth in import demand. Domestic producers in growth markets where market access is being freed up also need to be competitive with imported product. Otherwise there is a need for structural adjustments (cost of production, scale etc) in domestic supply, as cheaper imports will be favoured over domestically sourced product, outside of the fresh milk category. The exception to the latter could be China, where food safety concerns with local production persist, resulting in a surge in liquid milk imports too (320,100 tonnes in 2014, up from 93,150 in 2012).

FIGURE 4: TOP 20 GLOBAL IMPORTS (12 MONTHS TO SEPTEMBER 2014)




Source: ANZ, Fonterra

**Consumption levels of dairy products vary substantially across the globe.** Based on OECD data, per capita consumption (in milk equivalent terms) is currently only around 50 kg in Asia and 145 kg in South America. This compares with 345 kg in Europe and 280 kg in North America. **The regions of Asia, South America and Africa have seen the fastest growth in consumption since the mid-2000s.** However, there are wide differences between the countries within these regions. The strongest growth has occurred in South America, led by Brazil, Colombia and Venezuela. India, China and Indonesia are responsible for the lion's share of growth in Asia.

The two biggest drivers of the demand for agricultural commodities is population and income growth. **In developed markets, overall dairy consumption is fairly mature and only gradual increases (0.4-0.5% per annum) are expected in consumption.** The big medium-term opportunity for New Zealand

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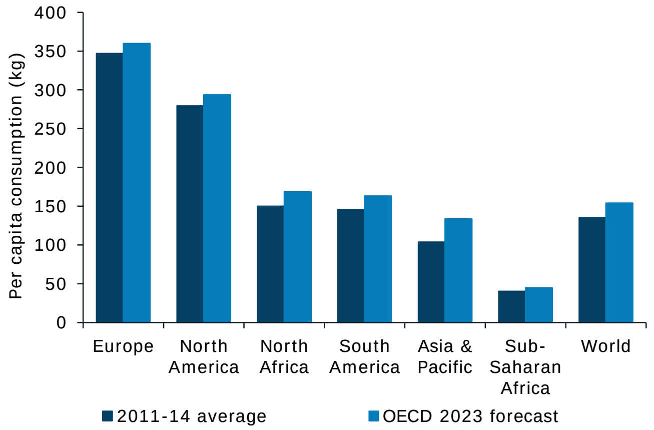
is improved market access into the likes of Mexico, Japan and the US through free-trade agreements, such as the Trans-Pacific Partnership. They make up three of the top five largest dairy importers. But recent commentary suggests New Zealand will receive a sub-optimal outcome at best for dairying through the Trans-Pacific Partnership. And even then, as in all trade agreements, the reduction in tariffs and increase in quotas takes some time to occur (i.e. 15+ years usually). So it's highly unlikely to deliver much in the medium term.

**Elsewhere the lion's share of demand growth is going to come from developing markets.** The potential across the major developing markets varies considerably but population growth, the strong lift in real incomes in emerging countries, urbanisation, modernisation of emerging countries' food industries and the shift to more westernised diets make for a favourable long-term mix.

**FIGURE 5: DAIRY CONSUMPTION BY MAJOR REGION**




Source: ANZ, OECD

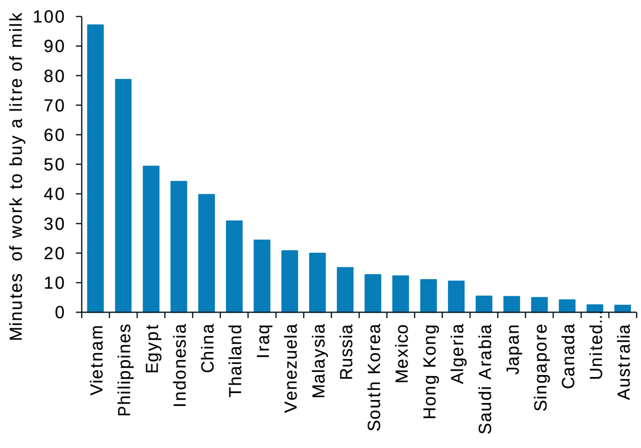
**Demand growth across the different countries and product categories is going to be uneven though. This unevenness is going to be influenced by cultural differences and affordability.** The difference in per capita consumption between the likes of Europe and Asia stems mostly from cheese. Typically, the first dairy products to gain traction in emerging markets are liquid, powdered and/or condensed milk, dairy beverages, yoghurts and infant milk formula. Acquiring a taste for cheese usually comes later and in many cases this still hasn't occurred. **Indeed, in many Asian countries low levels of cheese and butter consumption reflect different cooking styles and established locally produced substitutes made from soybeans and other products.** The growth in foodservice offers some opportunities for cheese (a target from Fonterra through the dividend side of the ledger), but outside of this it might be tough going.

**Overall there is expected to be more demand from emerging markets for products such as infant formula and specialised dairy products that provide dairy's main nutritional benefits (i.e. proteins and vitamins), plus more advanced paediatric nutrition and bone and digestion proteins.** This highlights that the growth across the main product categories is going be uneven and favour those export regions with the right intellectual property and processing capability. These trends are also likely to change the mix of dairy consumption in developed markets too.

**The second influence is affordability in emerging markets. Demand growth won't occur at any price point; it needs to be affordable, as dairy is an ingredient in many cases and a basic necessity.** While there are strong lifts in real incomes occurring in emerging markets, households still spend a large proportion of their disposable income on food (25%+). Demand elasticity varies greatly across the major importers, but the lesson from the high prices in 2013 was that as the record wholesale product prices were fed through to retail prices, demand growth in many emerging markets came off the boil.

**The affordability issue is best highlighted by the wide divergence in the amount of work required to earn enough money to purchase a litre of fresh milk.** In many cases New Zealand's main markets sit at the higher end on this measure. For the likes of China it take 16 times more work for the average Chinese consumer to be able to purchase a litre of milk compared with the average consumer in the US.

**FIGURE 6: AFFORDABILITY OF FRESH MILK ACROSS MAJOR IMPORTERS**




Source: ANZ, Numbeo, World Bank

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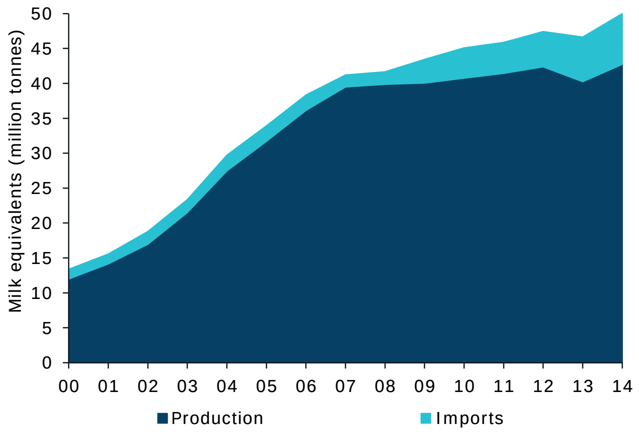
**Manufacturers and other intermediaries also need to fight more aggressively for market share to prompt lower retail prices for dairy products.** Lower retail prices would stimulate a larger demand response, especially from more price-sensitive emerging markets. There has been a notably longer lag than usual between wholesale and retail prices adjusting this cycle. In part, this is likely to reflect lower earnings results for many of the manufacturers and intermediary businesses in recent times, and the need to try to recoup some of this. This, combined with more challenging economic conditions for many of the major importers, is making for a more subdued demand backdrop at present.

## KEY FOCAL POINTS OF WEAKER IMPORT DEMAND

### China

**China remains a market that is difficult to read.** We expect it will remain this way for some time, and we place a high likelihood on it being a swing buyer as its domestic industry continues to restructure. This is likely to continue to accentuate price cycles in the medium-term.

FIGURE 7: CHINESE DAIRY CONSUMPTION




Source: ANZ, OECD

**To us the good medium-term prospects still look intact.** Total consumption and imports still grew in 2014 despite some evidence that lower income growth and higher retail prices slowed demand growth. Import data clearly shows continued growth across all categories outside of whey, although a lot of the growth was front-loaded at the start of 2014. Year-to-date imports are back 30% in 2015. Whole milk powder, skim milk powder and butter are the worst affected categories with import demand back 54%, 31% and 29% respectively.

**These are all categories in which New Zealand has a large and growing market share.** The other categories have not been affected to the same extent. While the year-on-year comparison is ugly, year-to-date imports in 2015 are still up 5% on the same period in 2013, with growth across most categories. New Zealand's market share of 90+% for whole milk powder is not expected to remain as high in the medium-term, with increased competition from Europe expected (as noted above).

**Several dynamics appear to be suppressing China's import demand at present:**

1. **Domestic supply has bounced back more strongly than anticipated.** Part of this is being sustained by dairy processors being obligated to support upstream dairy farmers, where they are committed to purchasing a minimum amount at a price above going market prices. As the dairy processors are buying raw milk that is not needed, they are converting it into milk powder to improve shelf life. This is creating excess powder inventory.
2. **Estimates of milk powder inventories have ranged from 100,000-450,000 tonnes in recent months.** This implies stocks could be anywhere between 5-21% of annual consumption. Recent price action and import volumes suggest they are at the higher end of estimates.

TABLE 3: CHINESE DAIRY IMPORTS (TONNES)

| Product | 2012 | 2013 | 2014 | 2015 (YTD) | Annual change | YTD change |
|---|---|---|---|---|---|---|
| Butter | 24,256 | 33,205 | 51,039 | 21,566 | 54% | -29% |
| Casein | 12,479 | 12,536 | 15,450 | 6,646 | 23% | 0% |
| Cheese | 38,811 | 47,316 | 65,973 | 27,018 | 39% | -11% |
| Liquid | 93,154 | 183,321 | 320,151 | 138,946 | 75% | 23% |
| Whey | 378,380 | 434,069 | 404,433 | 155,063 | -7% | -4% |
| SMP | 167,553 | 235,019 | 252,840 | 90,908 | 8% | -31% |
| WMP | 411,071 | 628,662 | 680,034 | 227,265 | 8% | -54% |
| Other | 134,895 | 144,316 | 156,435 | 67,046 | 8% | -11% |
| **Total** | **1,260,599** | **1,718,444** | **1,946,355** | **734,458** | **13%** | **-29%** |

Source: ANZ, USDA

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3. The **trader community that got badly burnt holding too much product in the downturn appear reluctant to re-enter** (also due to their likely inventory position).
4. **Substantial changes in the regulatory framework in response to ongoing domestic milk quality issues have seen a number of joint ventures formed between multi-nationals and domestic Chinese manufacturers.** As these relationships continue to evolve it appears the supply chain is becoming more integrated. This is perhaps creating more direct sourcing of certain products through these joint ventures.
5. **Growth and high margins in the infant formula category appear to have come off the boil.** We believe New Zealand's ingredients have been overweight in this category in recent years, but have little data to substantiate this point. It is believed approximately half of New Zealand whole milk powder goes to the recombining sector for cultured and blended milk products, with the remainder repacked for consumer use. Lower margins in high-value segments will have a knock-on effect to ingredient prices that manufacturers are willing to pay.
6. **Retail prices in many of the main dairy categories have been slow to adjust** to lower wholesale prices, especially in the fresh milk category (the lion's share of consumption).

**Of these dynamics the largest medium-term threat is higher domestic supply within China reducing import demand.** Given the production challenges the industry faced in 2013/14 we thought perhaps a 2-3 year window could open up for higher imports. However, this appears to have been well wide of the mark, with recent reports showing domestic supply increased by 6% in 2014 and a further 4% in 2015 year-to-date despite a fall in farm-gate prices. This signals that domestic supply is proving more resilient than first thought.

**The Government continues to drive a lot of the development.** Key policy changes have focused on creating a more integrated supply chain between producers and manufacturers, improving quality standards, and promoting larger-scale operations. Larger-scale operations are being favoured as a way to improve quality and standards more quickly, manage natural resources and environmental concerns, and reduce compliance and monitoring costs. A number of subsidies have been provided to help build larger-scale operations and to purchase better genetics, equipment etc.

**Producing milk in China is not cheap though.** Productivity metrics and production costs reflect the added difficulties of farming in China, including limited access to skilled labour, particularly on large-scale farms, and climatic/natural resources limitations, which impact on things like feed quality. The lack of suitable agricultural land and competition for this with other food crops (which are favoured by government food crop self-sufficiency policies too) constrain farmers' abilities to grow feed; as such China's dairy industry is heavily dependent on imported feed from the US. Land is typically divided into small parcels that cannot be bought or sold, so leasing of land for larger-scale farming ventures requires cooperation with local government and good knowledge of the regulatory processes in China. Dairying also struggles with access to water, with around 80% of China's water resources located in southern regions, whereas most of the dairy herds are based in northern regions.

**The very high costs of producing milk in China are starting to make processors question the logic of trying to increase domestic supply.** Current global milk powder prices are vastly cheaper than what local milk can be produced for (estimated to be around USD5,000/MT for whole milk powder). The safety record of imported product is also higher. However, there is a growing voice for more government support for domestic dairy farms, with a circa 20% fall in farm-gate prices so far.

**Many of the large-scale farms are now listed companies, which means market forces will come into play via the profit motive.** Profit margins are being hit by high overhead costs and falling revenues. Whether investors will continue to support these farming companies is questionable. Should investors want to exit their positions then it will make it extremely difficult for these farming companies to continue to expand as they have done in recent years.

**At the other end of the scale, peasant farmers are also being hit hard by low milk prices.** These farms don't have the scale to be able to negotiate high milk prices, but they generally can operate at a much lower cash cost than the large-scale farms. Milk hygiene continues to be a concern on these farms, which is the main reason why the Chinese Government has been pushing its dairy industry towards large modern farms.

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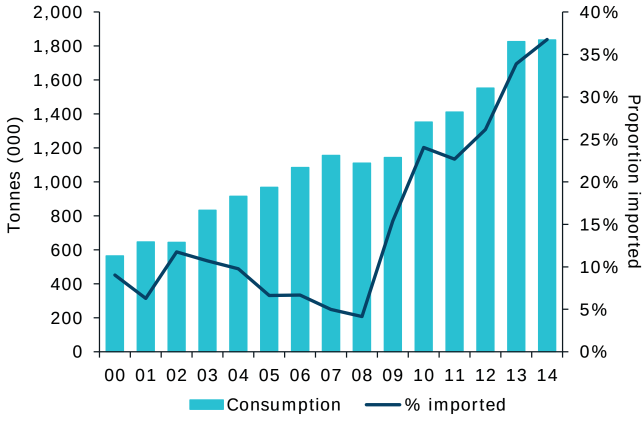
**FIGURE 8: CHINA'S CONSUMPTION OF WHOLE MILK POWDER**




Source: ANZ, OECD

**At this stage it is unclear whether the Government values its domestic milk supply enough to justify increasing subsidies further, and what implicit self-sufficiency target they might have.** The current behaviour of domestic dairy processors, obligated to support upstream dairy farmers and committed to purchasing a minimum amount at a price above going market prices, suggests there are self-sufficiency targets being promoted. Recently the Chinese Dairy Industry Association suggested import growth will slow to 3% over the next decade – more on the grounds of slower demand growth than higher domestic supply, but this is well down on the 15.5% growth seen over the previous decade. It is also just half what Fonterra has assumed in their strategy plan of 6% import growth from China. So there seems to be a disconnect here.

With these dynamics at play, medium-term import demand is set to slow and competition build. **Logic suggests counter-seasonal supply needs (which New Zealand can provide), ongoing milk quality concerns with local production, and the high cost of production for local supply should support high import growth. But this logic won't apply to the same degree if there is an implicit self-sufficiency target, meaning government policies will provide industry assistance for overcoming these hurdles, as well as improving milk quality standards.**

## Russia

**Russia is driving toward self-sufficiency in dairy production.** Belarus has historically supplied around half of Russia's needs and this is expected to continue, given political ties. For the other half of the market this is expected to be a net loss of global import demand – as figure 4 shows, this is significant. The other half of Russian imports was historically provided by Europe and the Ukraine (30-35% market share), with South America and New Zealand supplying less than 10% of the market.

**The initial ban effectively meant nearly 2.5 billion litres of milk needed to find a new home following the ban. This equated to around 12% of New Zealand's annual supply.** This figure is likely to increase if Russia is successful in achieving self-sufficiency. There are many structural impediments to achieving this goal, but they have nearly achieved it in other industries such as poultry. The Government has recently announced a large support package of around USD11 billion for livestock producers (not all for the dairy industry though) and are expected to continue to extend import bans to reduce competition. Consumption has also fallen due to the tough economic conditions and reduced access to imported products. All up this is a significant net loss in import demand that is expected to persist in the medium term.

## Oil-dependent countries

**Countries that are heavily dependent on oil for a living have accounted for 24% of New Zealand's dairy export earnings over the last four years.** By number oil-dependent countries have accounted for 15 out of the top 40 export destinations and have been some of the fastest growing in recent years. In aggregate they have been just as important as China, and AgriHQ estimate they have accounted for around half of global import demand for whole milk powder in recent years.

**Low oil prices look like they are set to stay around for some time as the OECD battles for market share, the US shale oil revolution continues, and there is a continued shift to alternative energy options.** This potentially lowers oil-dependent countries' purchasing power and willingness to pay high prices. However, in some key countries, such as Algeria/Venezuela, government programmes account for a large share of dairy imports. Recent comments from some of these key importers have suggested high fiscal surpluses mean there won't be cutbacks for social programmes. That said, when we look at the performance of some economies such as Venezuela and Egypt, we are sceptical this will be the case.

**With the loss of the Russian market and oil-dependent countries' demand expected to be more sluggish even at lower prices, there's a big burden for China and the other Asian markets to carry. And if you take China out of the picture then things look very bad indeed.**

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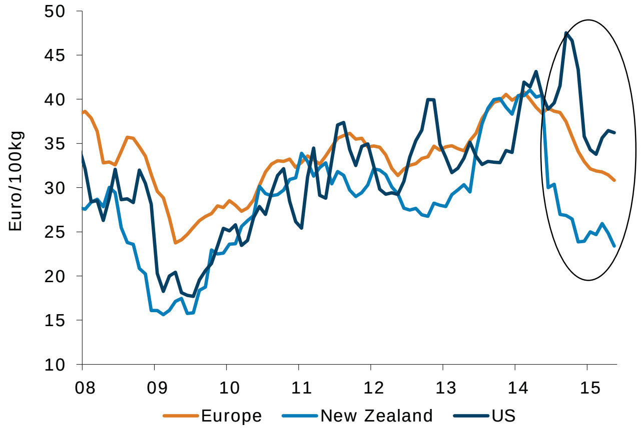
## ISSUE 3: DOWNWARD PRESSURE ON THE COST CURVE

**New Zealand has thus far borne the brunt of the downturn in farm gate prices across the three major export regions.** Europe and the US have been somewhat protected by their large domestic markets and trade barriers, which shelter them from direct export competition. Current international prices are considered well below the cost of production for all major exporters and therefore are unsustainable in the medium term.

### FIGURE 9: STANDARDISED MONTHLY FARM-GATE PRICES



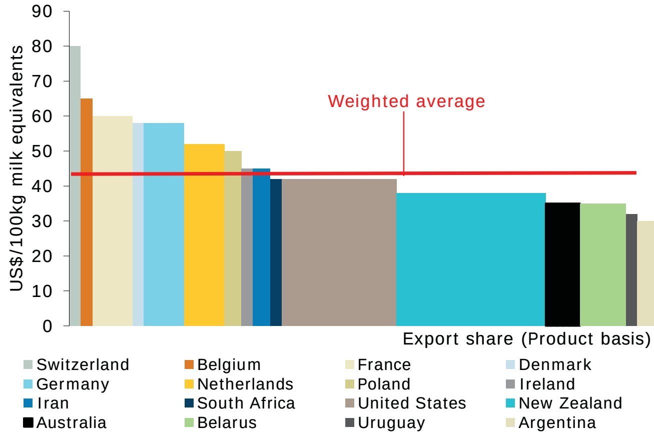

Source: ANZ, Datum

**We are seeing downward pressure on the cost curve from lower energy, fertiliser and feed prices, a higher USD and low global interest rates.** The latter has reduced capital constraints and help speed up the expansion of larger-scale operations (2000+ cow operations) in many regions. This has seen these operations' share of milk supply grow significantly in many export countries and China in recent years. Outside of China, many of these operations have a lower cost of production due to a number of efficiencies (see October 2014 *Agri Focus* on the US dairy sector).

**These dynamics mean milk output can be sustained at a lower farm-gate price.** But the key question is by how much? So far milk supply has proved more inelastic to lower farm-gate prices than historically has been the case.

The recently published annual report from the International Dairy Federation provided an update of the average cost of production for the main producing and exporting countries. The analysis includes a capital charge on land and other capital. It also includes an opportunity cost for an owner/operator labour. The milk equivalents have been standardised to 4% fat and 3.3% protein.

### FIGURE 10: AVERAGE COST OF PRODUCTION FOR 16 TOP EXPORT COUNTRIES




Source: ANZ, IFCN, Fonterra

**Key take-outs were:**

- **The weighted average cost of production for the 16 top export countries over the past several years was USD43/100kg milk equivalents. This translates into costs of around USD0.44 per litre.** It has increased significantly over the last decade due to higher input costs, especially feed and to a lesser degree, fertiliser and energy. Many of these cost hikes have unwound somewhat in the last 12 months and are forecast to stay low for some time.
- **New Zealand milk was benchmarked through the last several years at USD34-38/100kg milk equivalents.** This translates into approximately USD0.35-0.39 per litre, or NZD6.38-7.13/kg MS when using an exchange rate of 0.73 for NZD/USD (this is where our fundamental "fair value" model estimate has averaged over the last 3 years).
- **The cost of milk production varies considerably amongst countries** and different farm systems within a country. Year-to-year variation also exists and is affected by weather conditions, inputs costs (i.e. feed) and decision making.
- **Farmers in some regions are able to produce at lower cost than farmers in others** due to a combination of natural factors (including climate, soil and proximity to feed) and man-made factors (including herd genetics, availability of technology and operator expertise).
- **Southern Hemisphere producers continue to have a cost advantage over Northern Hemisphere rivals, but the gap has closed** and is likely to now be even smaller, given lower grain prices i.e. wheat, corn and soybeans.

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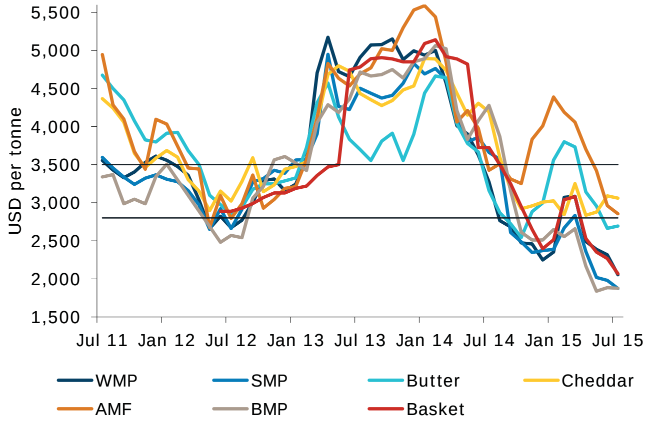
- **A generally lower-than-usual USD in recent years has kept the cost of production higher** (in USD terms) in many exporting countries. This has now reversed somewhat with the USD-TWI up 15% over the last 12 months.
- **While New Zealand is still well placed, our traditional position as the lowest-cost producer continues to be eroded.** Lower international grain prices and high New Zealand land prices are likely to have seen the gap close further in the last 12 months.
- **China's average cost of production is assessed to be between USD50-60/100kg milk equivalents.**

**Analysing the cost of milk production for the key exporters suggests a milk price of at least USD35/100kg milk equivalents is required for the lower-cost producers to be incentivised to increase production.** In Europe something around the USD45-55/100kg milk equivalent mark will be required to stimulate investment in additional milk supply. This was higher than the European Commission recently estimated; they concluded that a milk price around the USD40/100kg milk equivalent level would stimulate export growth. The US sits around the top 15 export countries' average at USD42/100kg milk equivalents, but as our analysis in the October 2014 Agri Focus: Eye Spy showed, there is a wide distribution between small and large-scale operations.

**The global average cost of production at USD$43/100kg milk equivalent translates into a milk price of around the USD0.44 per litre mark. Converted to a milk solids basis this is USD5.85.** Analysing the more efficient European producers down to the bottom quartile, and doing some partial readjustment for lower costs, suggests a medium-term breakeven band of USD$0.30-0.40 per litre (for around 60-70% of global export trade). Turning this into a whole milk powder equivalent (i.e. including processing and transportation costs for an efficient processor) suggests **prices need to be between USD3,150 and USD4,000 per tonne to encourage longer-term investment in supply capacity.**

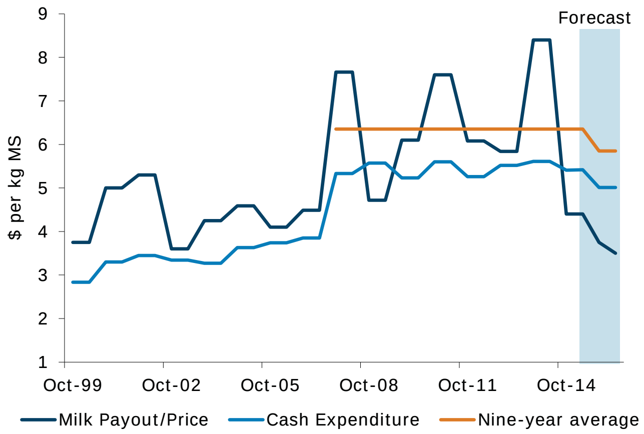
**FIGURE 11: DAIRY PRODUCTS – NZ EXPORT MARKET PRICES**




Source: ANZ, GlobalDairyTrade, USDA

**Current international prices are a long way below this band. If sustained, this is likely to lead to under-investment**, which will eventual require catch-up at some point. However, there are a number of adjustments included in the on-farm cost numbers, including a capital charge and opportunity cost for owner/operator labour. This means cash costs are lower than the above bands imply; many are likely to be able to remain in business at a lower breakeven cost for a period of time, even if there is no new investment. **These dynamics help explain why supply has been less elastic in the face of the rapid decline in prices this time round, as it has also been associated with a reduction in key costs for many regions.**

**FIGURE 12: HISTORICAL FARM-GATE PRICES**




Source: ANZ, Dairy NZ, Fonterra

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**Generally the equilibrium price for powders has been considered to be around the mid-USD3,000/MT mark, with a band of USD3,300-4,000/MT. Over the last nine years Fonterra's notational basket that is used to calculate the milk price has averaged USD3,400/MT, which on average fundamental model estimates of a 0.73 NZD/USD translates to around a mid-$6/kg MS milk price. Over the same period the milk price has averaged $6.35/kg MS.** Generally the equilibrium band over this period has been considered to be somewhere between $6.0-$7.0/kg MS. However, actual outcomes have seen a number of outliers over this period (due to inherent volatility in dairy markets).

| Fonterra Milk Price Component Scenarios (NZD/kg MS) | | | | | | |
|---|---|---|---|---|---|---|
| | NZD/USD | | | | | |
| Basket of NZ dairy products | USD | 0.67 | 0.69 | 0.71 | 0.73 | 0.75 |
| | 2200 | 4.18 | 4.00 | 3.83 | 3.67 | 3.52 |
| | 2500 | 5.03 | 4.82 | 4.63 | 4.45 | 4.27 |
| | 2800 | 5.87 | 5.65 | 5.43 | 5.22 | 5.03 |
| | 3100 | 6.72 | 6.47 | 6.23 | 6.00 | 5.79 |
| | 3400 | 7.57 | 7.29 | 7.03 | 6.78 | 6.54 |
| | 3700 | 8.41 | 8.11 | 7.83 | 7.56 | 7.30 |

While there is no off-the-shelf model we can put the numbers in and spit out a result, **we believe the medium-term supply/demand balance as outlined above, and downward pressure on the cost curve, mean the new equilibrium band could now be somewhere between USD2,800-3,400/MT, with a mid-point of USD3,100/MT. This is a 10-15% reduction on the previous band.**

If the price of our largest export is going to be lower, the fair value of the NZD/USD is lower too. We estimate the resulting weaker terms of trade would imply the NZD/USD should average 0.04-0.06 lower over time. **Using these new parameters implies a milk price range around the mid-$5.0 to mid-$6.0/kg MS, with a midpoint of $6.00/kg MS. This implies the medium-term farm gate price could be $0.25-0.50/kg MS lower than has been achieved on average over the last nine years ($6.35/kg MS).** Of course, as we mentioned in our introduction, volatility is expected to persist and the table highlights there is a wide range of possible outcomes in any given year. We have found the milk price calculation to be very dynamic, especially with the correlation between the NZD/USD and international dairy prices!

**Of course if the new midpoint is closer to the mid USD2,500/MT mark because the confluence of current supply/demand events proves more powerful, then a medium-term milk price of closer to the low-to-mid-$5/kg MS could occur.** But this would be well below where we would consider the global breakeven cost curve. Such an outcome would likely lead to a period of under investment, which given long-term trends of population and income growth etc, would eventually lead to another correction. Farmers need to be wary of this, as politics in the form of Russian sanctions, Europe's Common Agricultural Policy, US Farm Bill changes, China's support for domestic large-scale operations, and the OECD play for market share in oil markets seem to be driving things more than economic logic and favourable long-term trends.

## SOME KEY CONCLUDING REMARKS

**The net effect of lower prices (on average) and a weaker NZD as an offset is an assumed 4-8% fall in dairy incomes.** Remember that's not just a one off; it's expected to be sustained. Put that through a discounted cash-flow model and it's enough to see rural farm values retrace modestly. Of course, cyclical dynamics (i.e. current price weakness) means the correction in farm values in the near-term will likely be a lot larger than that (see page 16).

**The management response to ongoing, structural weakness in prices differs to a temporary cyclical dip.** The latter can be navigated more easily than the former. You can get away with temporary adjustments or band aids in a temporary price lull, but that doesn't cut the mustard when changes are permanent.

**A strong focus on costs/productivity will be required.** Dairy NZ are targeting removing up to $1/kg MS in operating costs. That's tough, though the current position requires ambitious numbers. But we are more interested in the medium-term story. If dairy incomes are going to be $0.25-0.50/kg MS lower on average over coming years, then the cost side needs to exhibit similar falls – and this can't be achieved by cutting core expenditure that generates long-term efficiency and productivity, such as fertiliser, pasture renewal and animal health. Cuts in those areas this season seem inevitable – with the unavoidable impact on production – but they are not sustainable. It's not going to be an easy equation to balance.

# THE MONTH IN REVIEW

## SUMMARY

On the two West Coasts soils are saturated and pasture covers are generally below where they were at the same time last year. On the East Coast conditions are patchy with soil moisture generally below capacity and water tables in need of more rain. Dairy production is expected to be challenged this year as farmers look to reduce costs and respond to lower revenue signals. A smaller 2015 lamb crop is expected given mixed scanning results and another reduction in ewe numbers. Forestry exports are under pressure from softer Asian demand and lower prices that are reducing harvesting rates.

## MOTHER NATURE

**Winter weather conditions have not been optimal for most farmers.** It has generally been cooler than average over much of the country in July with snow to low levels. This has pushed down soil temperatures in many regions. The West Coasts of both Islands and Southland have received plenty of rain recently leaving soils saturated and at field capacity. This combination has led to poor utilisation and below-average pasture cover as new season milk begins to flow and lambing begins on early country.

**On the East Coast of both Islands conditions are still patchy with soil moisture generally below capacity and water tables in need of more rain.** Areas in North Canterbury remain under significant feed pressure after failing to recover in the autumn. Most have de-stocked by 30-60% versus numbers wintered the year before. A significant amount of supplementary feed has also been used to get remaining stock through the winter.

**There has been a lot of talk about El Nino conditions intensifying and their possible impact in the spring and summer.** Typically during an El Nino event the country tends to experience stronger or more frequent winds from the West and South-West, leading to dry conditions in the East and more rain in the West. The 2014/15 season certainly had some hallmarks of this, especially for the East Coast of both Islands. With low water tables in many East Coast regions and soils in need of some more moisture many will be keeping a nervous eye on forecasts of what the spring/summer period might hold. This will need monitoring as it evolves. **Recent El Nino episodes have not led to the "typical" conditions that accompany such an event, making it impossible to draw any firm conclusions on possible outcomes. But this event does appear to potentially be a very strong one.**

## DAIRY

**We're picking a 2-4% fall in milk production this season.** Reasons are numerous. The 2014/15 season finished up posting a new record of 1.89 billion kg milk solids (+3.6%); that's a high base to build on. With milk price signals low we expected a material farm management response this season as farmers trim supplementary feed, general expenditure and reduce stocking rates. This all adds up to less production. These effects are most likely to show up during the summer period, as opposed to the spring. That said, pasture covers in many areas are reported as being below last year and the 2014 spring delivered very strong early milk flow.

## MEAT AND FIBRE

**Another year; another decline in breeding ewe numbers is expected.** Mutton turn-off has remained persistently above expectations throughout 2014/15 and **is pointing to another 300,000-500,000 head reduction in ewe numbers. Scanning results are mixed, but generally seem to be 10-15% below last year.** With many eastern regions having low pasture covers heading into lambing, **these dynamics clearly point to a smaller 2015 lamb crop.** Mutton and lamb turn-off has been higher than expected in the North Island, perhaps suggesting the rotation into beef cattle is going to be larger than expected.

**Wool exports finished the 2014/15 season up slightly (+1.4%), defying the large drop in sheep numbers coming into the year.** High prices over recent months are likely to have seen some stock rundown, but yields would have also needed to be above average to achieve such a result.

**Year-to-date total cattle production is up nearly 11% to 2.27 million head.** Nearly 70% of the increase is due to cull cows, which will be over 1 million head for the first time ever. While there is no split of origin available, the majority of the increase will be budget dairy cows turned off in response to lower milk prices. The other area of increase is bull beef (+11%).

## FORESTRY

**Year-to-date log export earnings are back by nearly 16% on the same period last year. The drop hasn't just been China (-20%)**; export volumes to South Korea and Japan have also fallen substantially. The drop in volumes is due to lower demand in Asia, lower prices reducing harvest rates on smaller woodlots, and high inventory levels in China, which have persisted for most of the year. Lumber exports have been under pressure too and are back by 4.5% year-to-date. Lower demand from Asia and Australia has been behind most of the softness.

# RURAL PROPERTY MARKET


## SUMMARY

While current market activity points to a situation of relative calm, there's a high likelihood a correction is in the wind this spring for dairy-aligned property. Total property turnover remains not too far off the long-term average and the price per hectare has pushed through the $30,000 mark for the first time ever. However, recent anecdotal reports are highlighting that large-scale dairying operations are struggling to attract buyers, while second-tier or distressed properties are receiving discounted offers. Smaller grazing and finishing blocks still appear to be attracting good buyer interest and prices though.


**Total monthly turnover has continued to cool from the historical highs reached 18 months ago. The average farm value, meanwhile, has continued to trend up to a new record high.** The mix of enterprises and locality of recent sales appear to have been influential, with more activity centred around the Auckland/Waikato area. The average all-farm price reached $30,800/ha in June, which was a new record and eclipses the GFC peak. Turnover of dairy-aligned property has stabilised in recent months and prices have popped higher, reflecting a higher-than-usual proportion of sales in the Waikato area, rather than a genuine lift in prices. Grazing turnover continued to run around 80% of its long-term trend, but prices continued to trend higher. Horticulture and arable turnover continues to run well above their long-term trends and prices are oscillating at historical highs.

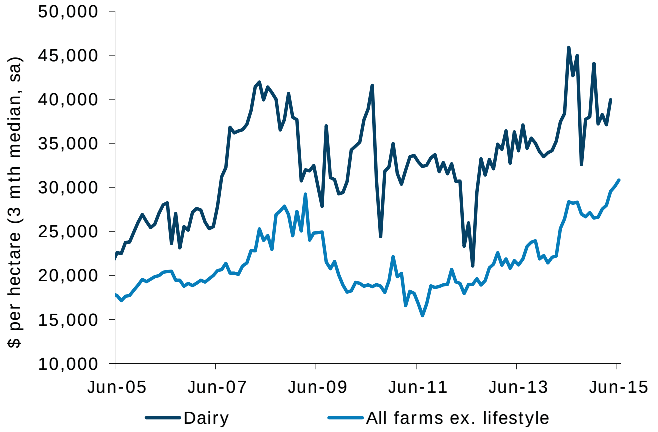
**More timely anecdotes of market behaviour tell a different story** with reports that large-scale dairying operations are struggling to attract buyers and second-tier or distressed properties are receiving discounted offers.

**The question in the rural property market is no longer whether dairy-aligned land values will fall, but rather how large the fall might be.** The extent of financial pressure that is now going to be placed upon the sector over at least the next two years from back-to-back low farm-gate milk prices

FARM SALES BY FARM TYPE

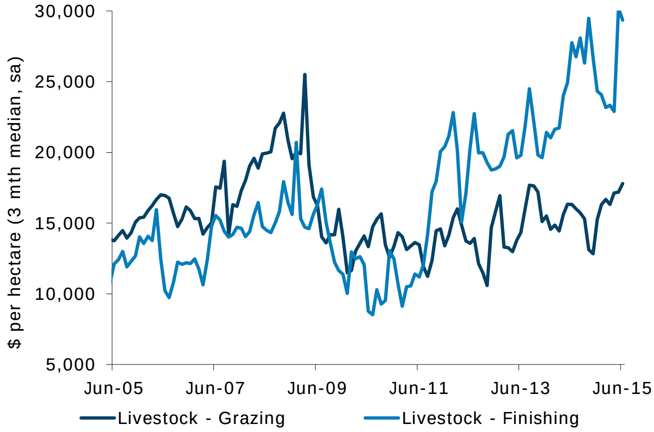
| 3-Month Seasonally Adjusted | | Current Period | Previous Period | Last Year | 10-Year Average | Chg. P/P | Chg. Y/Y | Chg. P/10yr |
|---|---|---|---|---|---|---|---|---|
| Dairy | Number of Sales | 63 | 64 | 66 | 67 | ↓ | ↓ | ↓ |
| | Median Price ($ per ha) | 39,900 | 37,100 | 37,400 | 32,600 | ↑ | ↑ | ↑ |
| Livestock – Finishing | Number of Sales | 63 | 62 | 86 | 66 | ↑ | ↓ | ↓ |
| | Median Price ($ per ha) | 29,300 | 30,200 | 27,800 | 16,600 | ↓ | ↑ | ↑ |
| Livestock – Grazing | Number of Sales | 169 | 174 | 198 | 204 | ↓ | ↓ | ↓ |
| | Median Price ($ per ha) | 17,800 | 17,200 | 16,000 | 15,600 | ↑ | ↑ | ↑ |
| Horticulture | Number of Sales | 65 | 64 | 49 | 43 | ↑ | ↑ | ↑ |
| | Median Price ($ per ha) | 229,600 | 225,500 | 182,500 | 153,400 | ↑ | ↑ | ↑ |
| Arable | Number of Sales | 37 | 36 | 32 | 20 | ↑ | ↑ | ↑ |
| | Median Price ($ per ha) | 42,400 | 48,900 | 47,900 | 30,200 | ↓ | ↓ | ↑ |
| All Farms ex. Lifestyle | Number of Sales | 413 | 404 | 467 | 431 | ↑ | ↓ | ↓ |
| | Median Price ($ per ha) | 30,800 | 30,100 | 28,400 | 21,600 | ↑ | ↑ | ↑ |
| Lifestyle | Number of Sales | 1,974 | 1,845 | 1,490 | 1,517 | ↑ | ↑ | ↑ |
| | Median Price | 546,000 | 546,000 | 510,000 | 454,000 | ↔ | ↑ | ↑ |

FARM SALES, MEDIAN PRICE




Source: ANZ, REINZ

FARM SALES, MEDIAN PRICE




Source: ANZ, REINZ

# RURAL PROPERTY MARKET

means there are going to be some casualties and a correction in land values. The real test is likely to come this spring, given continued downward pressure on international milk prices and forecast estimates for farm-gate prices in 2015/16. This is expected to further erode the confidence that has supported activity and prices over the past year. Most farmers are expected to hunker down and focus on their existing businesses rather than expand in a period that is going to stretch even the best businesses in the industry.

**During most downturns turnover has suffered as vendors have chosen to sit tight and wait for market conditions to improve, leaving prices soft, but not in free-fall. This soft-landing theory could be tested as cash losses accumulate** and any projected recovery gets pushed out. Recent anecdotal reports, as noted earlier, are soft and in some cases downright worrying. That said, smaller grazing and finishing blocks still appear to be attracting good buyer interest and prices. The spring period will provide a clearer picture of market direction and sentiment.

**To us the lift of 10-20% seen over the last two years or so is likely to quickly come out of the market. We wouldn't rule out something larger but are mindful of key legs of support, notably:**

1. **Historically low interest rates** are pushing investors and capital further out the risk curve in the search for return and yield.
2. **A larger pool of buyers than pre-2008**, which includes a wider range (country and type) of foreign investor interests and domestic equity investors from outside the sector.
3. **Productivity and cost efficiency improvements.** We believe the gains many farmers and sectors have achieved in recent years have been under-appreciated.
4. **Lower inflationary pressure** in recent times placing less pressure on cost structures compared with the 2002-2011 period.
5. **Adjustments in the NZD and interest rates.** Both will act as key shock absorbers if a full-blown rout across dairying looks like taking hold.

**That said, the biggest issue for dairy farmers will be finding the cash-flow for any new investment over the next while.** Given where current prices have gotten to it seems highly likely further pressure will come on advance rates later this year (impacting the second half of the financial year). This sentiment aligns with market feedback that larger-scale operations are struggling to attract offers, whereas smaller parcels of land are still moving.

**It's not all doom and gloom for the property market though.** While dairy-aligned property has driven a lot of activity in recent years, there is scope for the other sectors to pick up the slack. **Anecdotal feedback suggests that enquiries for meat and fibre properties have picked up** on better valuations and more stable returns. **Horticulture sales activity remains high** and in-market prospects for the likes of the big three – pipfruit, kiwifruit and wine – look solid, which is attracting more investor interest.

Examining the backward-looking indicators, the REINZ dairy land price index (per hectare measure), which adjusts for compositional differences, has slipped 13% since the start of the year, but is elevated compared with two years ago (+20%). Specifically, **in the month of May, 23 dairy farms were sold at a median sale value of $35,800/ha, or $37 per kg MS.** The median farm size was 147 hectares and the median production/ha was 959kg MS. **In the month of June, 15 dairy farms were sold with an average sale price of $26,900/ha, or $35 per kg MS.** The median farm size was 108 hectares and production/ha was 767kg MS.

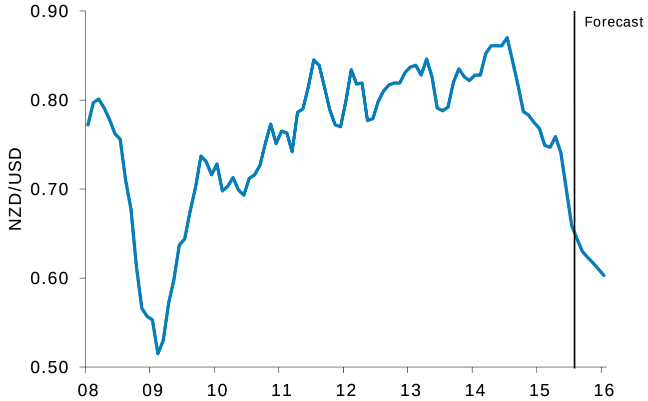
Turnover of finishing properties continues to hover around its 10-year average, but grazing property turnover has slipped back to 80% of its 10-year average in recent months. **Prices for finishing properties continue to trade at very elevated levels, nearly double the 10-year average.** Part of this appears to be compositional, with a higher-than-usual proportion of sales occurring in the Auckland/Waikato area. **Grazing property prices have traded at the top of their two-year range ($14,000-$18,000/ha) in recent months. The turnover for arable properties remains high, but prices appear to be trending down toward the 10-year average.** Lower local feed prices and fewer small seed contracts in recent times seem to have taken the shine off the market.

**In the horticulture sectors property turnover and average prices remain historically high.** There is no split by sector, but a large proportion of activity has focused on Auckland and the Bay of Plenty. The Bay of Plenty activity is kiwifruit orchard sales. **Including this year's crop we have seen sale prices of $300,000-$350,000/caha for well-located green kiwifruit orchards and $425,000-$500,000/caha for gold orchards.** Most of the buyers are well established and have experience in the industry. Many are involved in the post-harvest industry and are looking to secure future supply.

# ECONOMIC INDICATORS

| EXCHANGE RATES | Current Month | 3 Mth Trend | Last Year | Chg. M / 3M | Chg. Y / Y |
|---|---|---|---|---|---|
| NZD/USD | 0.661 | 0.701 | 0.870 | ↓ | ↓ |
| NZD/EUR | 0.605 | 0.631 | 0.642 | ↓ | ↓ |
| NZD/GBP | 0.425 | 0.451 | 0.509 | ↓ | ↓ |
| NZD/AUD | 0.873 | 0.906 | 0.927 | ↓ | ↓ |
| NZD/JPY | 80.64 | 85.54 | 88.52 | ↓ | ↓ |
| NZD/TWI | 70.40 | 72.50 | 79.50 | ↓ | ↓ |

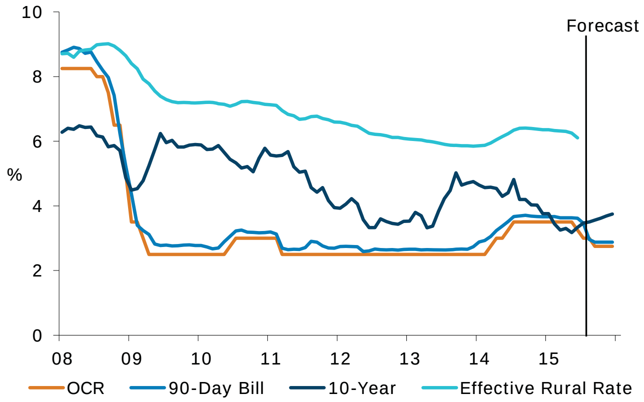
## NZD BUYS USD




Source: ANZ, Bloomberg

| NZ INTEREST RATES | Current Month | 3 Mth Trend | Last Year | Chg. M / 3M | Chg. Y / Y |
|---|---|---|---|---|---|
| Official Cash Rate | 3.00 | 3.25 | 3.50 | ↓ | ↓ |
| 90 Day Bill Rate | 3.34 | 3.57 | 3.67 | ↓ | ↓ |
| 1 yr | 2.99 | 3.20 | 3.90 | ↓ | ↓ |
| 2 yr | 2.88 | 3.14 | 4.14 | ↓ | ↓ |
| 3 yr | 2.76 | 3.08 | 4.33 | ↓ | ↓ |
| 5 yr | 2.95 | 3.16 | 4.55 | ↓ | ↓ |
| 10 yr | 3.44 | 3.33 | 4.82 | ↑ | ↓ |
| Effective Rural Rate | 6.10 | 6.29 | 6.24 | ↓ | ↓ |
| Agricultural Debt ($b) | 56.07 | 54.95 | 51.85 | ↑ | ↑ |

## KEY INTEREST RATES




Source: ANZ, RBNZ

**The NZD / USD is in the vicinity of what we think is its long-run fair value** – after adjusting for our estimates of where terms of trade will settle. It is also not far off its post-float average (around 0.63) and the 15-year average (around 0.67).

**We expect the NZD / USD to move under fair value.**

**On some levels there is reason for caution. The NZD has already declined precipitously.** When it touched 0.65c in mid-July the NZD/USD had fallen some 26% compared to just a year earlier. That's a large move in a short space of time. Also, though the RBNZ is cutting the OCR, a large yield differential remains.

**But the bigger picture still points lower.** Domestic fundamentals are weaker (widening current account, RBNZ cutting rates, lower commodity prices) and we expect the USD will continue to strengthen as the Fed lifts rates. We are forecasting the NZD/USD to ease to 0.61 by year end. This (critically) assumes China remains stable; there is a growing risk it won't. The next stop would be sub-0.55 under that scenario.

**Directional signals in regard to other currency pairs are mixed. The NZD / AUD is likely to remain above long-run averages (broadly 0.88-0.92).** Australia is facing similar economic challenges to New Zealand (weaker commodity prices, terms of trade and China risks), but also faces a weaker fiscal position, and a weaker productivity story. The OCR is expected to remain higher in New Zealand.

**We expect the NZD / EUR to remain elevated.** The euro region's economic challenges remain. Short-term interest rates are negative across most of the region. Greece flare-up risks remain, though the real issue is what happens if a bigger nation elects the same sort of anti-austerity populist Government and kicks up a fracas.

**We expect the RBNZ to cut rates by another 25bps in September.** Inflation is low and growth is soft. The OCR is headed lower. We're not convinced the economic story is weak enough as yet to justify four cuts in a row, and central banks do tend to be reactive as opposed to proactive. Accordingly, we have a fourth cut six months later in March, as recognition of the risk profile for rates. We expect the RBNZ will maintain an active easing bias during this period and attempt to keep jawboning the NZD lower.

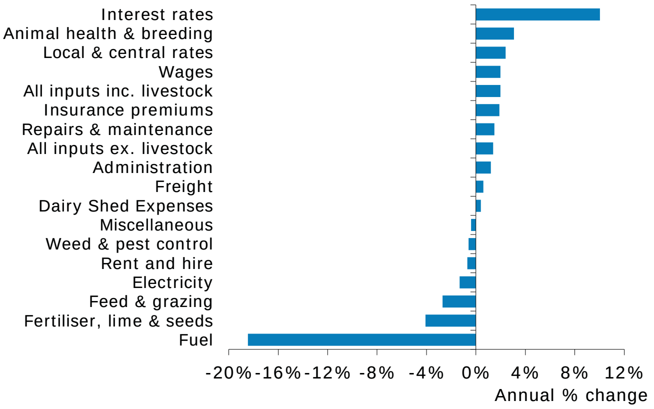
**Prospects for further reductions in the OCR are expected to keep short-end interest rates low.**

**The outlook for the long end is less clear cut.** US developments are key; with the Fed about to raise rates, long-term rates should be biased up. However, we can't see the Fed moving aggressively, **so any movement up should be a slow drift.**

# ECONOMIC INDICATORS

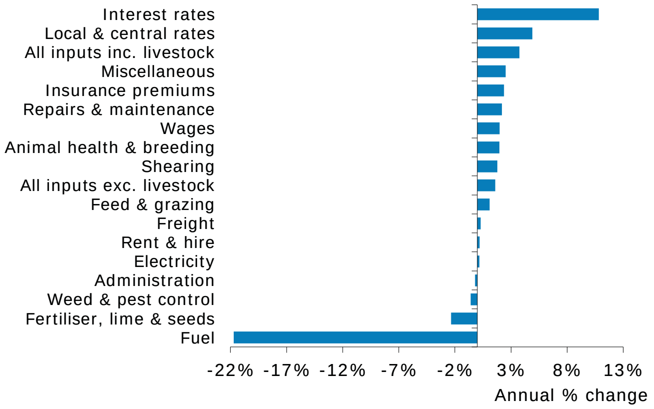
| INFLATION GAUGES | | | | | |
|---|---|---|---|---|---|
| Annual % change | Current Qtr | Last Qtr | Last Year | Chg. Q/Q | Chg. Y/Y |
| Consumer Price Index | 0.3 | 0.1 | 1.6 | ↑ | ↓ |
| Farm Input | -0.2 | 1.9 | 0.6 | ↓ | ↓ |
| Net Imp. Margins PPI | -17.1 | -12.9 | 19.6 | ↓ | ↓ |

### FARM EXPENSES MOVEMENT 2014/15 – DAIRY



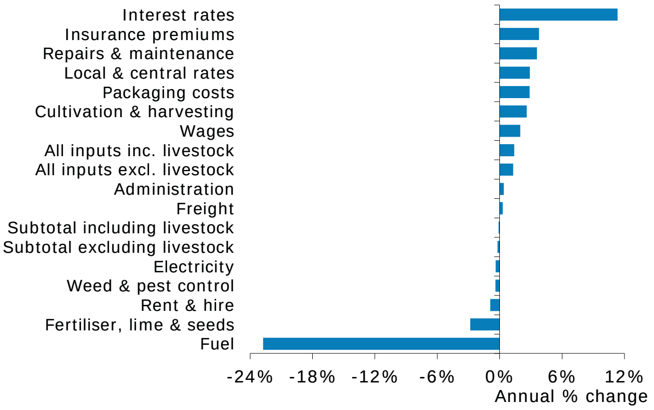

Source: ANZ, Statistics NZ

### FARM EXPENSES MOVEMENT 2014/15 – SHEEP & BEEF




Source: ANZ, Statistics NZ

### FARM EXPENSES MOVEMENT 2014/15 – HORTICULTURE & FRUIT GROWERS




Source: ANZ, Statistics NZ

Statistics NZ's **latest survey of on-farm cost movements for 2014/15 showed an annual increase of 1.4% for the "all farms" measure (excluding livestock).** This was above general inflation for the broader economy, but follows 3 years of benign farm costs movements. In fact **on-farm costs have moved up by an average of only 1.1% per year over the last three years. This is a far cry from the 2002 to 2012 period where they moved up by an average 3.2% per annum.**

Cost increases were similar across all farm categories in 2014/15. **Sheep and beef experienced the largest annual increase in farm costs, at 1.6% y/y (excluding livestock). Dairying experienced a 1.4% y/y increase, and horticulture and fruit growers a 1.3% y/y increase.** For horticulture and fruit growers this annual increase follows a 0.4% decrease in 2013/14, implying little recent upward pressure on cost structures.

**For the first time since before the Global Financial Crisis of 2008 the biggest upward lift across the main farming categories occurred in interest rates (10.0-11.3% of costs).** This was due to the 100bps lift in the OCR that occurred last year, given the majority of borrowing are on shorter terms. Local and government rates (2.4-4.9% y/y), insurance premiums (1.9-2.4% y/y) and repairs & maintenance (1.5-3.6% y/y) were the biggest increases across all farm categories too. Another upward movements of note in the dairy sector included animal health and breeding (3.1% y/y). For horticulturists other cost pressures included packaging (2.9% y/y) and cultivation & harvesting (2.6%). **Wages moved up by 2% y/y** and there were generally small increases for insurance, animal health & breeding, and repairs & maintenance.

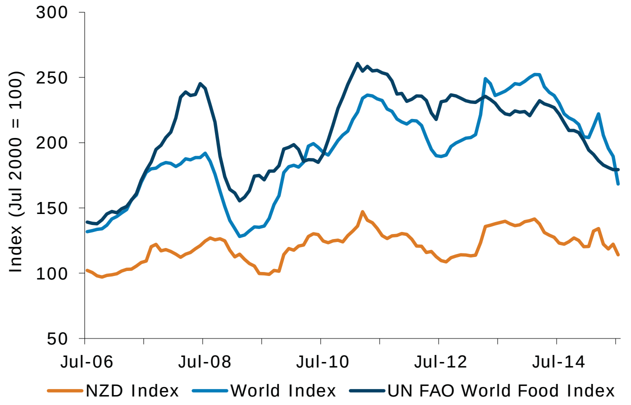
**At the other end of the spectrum fuel costs fell on average by 20.5% y/y, while fertiliser, lime & seeds and electricity costs were also down 3.3% on average.** Fuel costs make up between 3.9% and 1.8% of on-farm costs, so the decline in fuel costs offset around half of the annual increase in on-farm costs. So it seems the farming community have at least gained some small benefit from a structurally high NZD and lower international oil prices – though both are changing rapidly.

For dairy farmers there were also declines in dairy grazing costs (2.7% y/y) and electricity (-1.3% y/y). For horticulturists there were small declines in rent & hire costs, electricity and weed & pest control. Sheep & beef farmers benefited from a small decline in weed & pest control too.

# KEY COMMODITIES: OVERALL INDEX AND DAIRY

| SOFT COMMODITY PRICE INDICES | | | | | |
|---|---|---|---|---|---|
| | Current Month | 3 Mth Trend | Last Year | Chg. M/3M | Chg. Y/Y |
| ANZ NZD Index | 114 | 121 | 123 | ↓ | ↓ |
| ANZ World Index | 168 | 197 | 230 | ↓ | ↓ |
| FAO World Food Index | 179 | 183 | 222 | ↓ | ↓ |

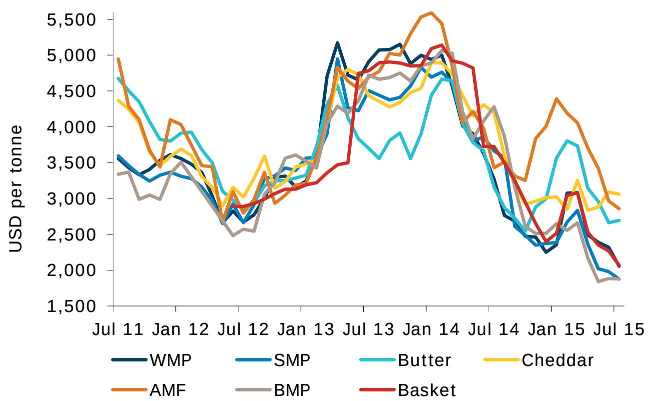
## SOFT COMMODITY PRICE INDEXES




Source: ANZ, FAO

| OCEANIA DAIRY PRICE INDICATORS | | | | | |
|---|---|---|---|---|---|
| USD per tonne | Current Month | 3 Mth Trend | Last Year | Chg. M/3M | Chg. Y/Y |
| Milk Price YTD ($ per MS) | 3.31 | 4.05 | 6.10 | ↓ | ↓ |
| Milk Price Forecast ($ per MS) | Mid 3's | 5.00 to 5.25 | 6.00 | ↓ | ↓ |
| Whole Milk Powder | 2,054 | 2,253 | 3,274 | ↓ | ↓ |
| Skim Milk Powder | 1,875 | 1,958 | 3,663 | ↓ | ↓ |
| Butter | 2,694 | 2,772 | 3,163 | ↓ | ↓ |
| Anhydrous Milk Fat | 2,855 | 3,080 | 3,428 | ↓ | ↓ |
| Butter Milk Powder | 1,878 | 1,867 | 4,281 | ↑ | ↓ |
| Cheese | 3,060 | 3,010 | 4,195 | ↑ | ↓ |

## DAIRY PRODUCTS – NZ EXPORT MARKET PRICES




Source: ANZ, GlobalDairyTrade

**The rout in global soft commodity prices has continued.** The FAO World Food Index is back 24% since its peak nearly two years ago. Dairy and sugar have been at the forefront of the downturn, but none of the sub-indexes (meat, cereals, oils) have escaped the fall. Growing conditions in the key Northern Hemisphere regions look fairly good, suggesting there will be no basing dynamic just yet. Given this, global feed prices could well drop further.

**One area that has been under-appreciated in the livestock sector is just how much of an effect this has on the cost of production for many of our direct and indirect competitors.** Combined with a historically low cost of capital, which has allowed expansion in large-scale operations, lower energy and transportation costs, a strengthening in the USD and continued productivity improvements in a low-inflation environment, we believe the cost of production for global producers has fallen markedly from the highs seen around 2012/13. This matters, as it allows output to be maintained even at lower farm-gate prices. Of course this isn't the sole dynamic that has driven soft commodity prices lower, but it suggests the price floor could now be lower than it has been over the last decade or so.

**Dairy markets are capitulating and have broken through key levels at recent auctions.** On an outright value basis both New Zealand's wholemilk powder and milkfat products have looked cheap. They are below the cost of production for all major producers; in the affordable zone for price sensitive low-income countries; are substantially cheaper than local supply in many major import markets; are cheaper than other key export competitors (namely the US & Europe); and are at all-time cyclical lows. All this doesn't seem to mean too much at present with the market struggling to digest higher seasonal volumes from New Zealand, China buyers nowhere to be seen, especially for important New Zealand products such as powders and butter, and many other markets in Africa, the Middle East and Asia (ex. China) seemingly having covered their immediate requirements through imports over last six months.

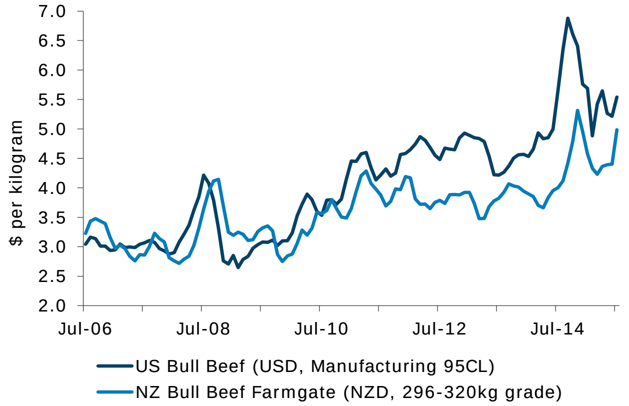
**While milk supply growth across major exporters has slowed to zero, production is still at high levels** thanks to previous growth. Offshore product and farm-gate prices started to come in more aggressively as July progressed, suggesting milk output should start to shrink over the next 6-odd months. Combined with less milk from New Zealand this should eventually help rebalance the market at some point. Most major processors have recently pushed estimates of the timing of this back toward the first half of 2016. With this as the background the 2015/16 season is shaping up as incredibly tough. **We have cut our farm-gate milk price forecast to the mid-$3's/kg MS, with downside risks.** The market is almost unanimous prices will head lower as New Zealand tries to sell its seasonal peak. Ironically the lower things go the higher the likelihood of a larger upward correction at some point, but in our opinion this will not be in time to save the 2015/16 milk price. Budget for the worst and hope for the best.

# KEY COMMODITIES: BEEF AND LAMB

| BEEF PRICE INDICATORS | | | | | |
|---|---|---|---|---|---|
| **$ per kg** | **Current Month** | **3 Mth Trend** | **Last Year** | **Chg. M/3M** | **Chg. Y/Y** |
| NZ Bull Beef[1] | 4.98 | 4.39 | 4.00 | ↑ | ↑ |
| NZ Steer[1] | 5.27 | 4.61 | 4.28 | ↑ | ↑ |
| NZ Heifer[1] | 4.70 | 4.04 | 3.70 | ↑ | ↑ |
| NZ Cow[1] | 3.67 | 3.08 | 2.76 | ↑ | ↑ |
| US Bull Beef[2] | 5.54 | 5.34 | 5.63 | ↑ | ↓ |
| US Manu Cow[3] | 5.08 | 4.88 | 5.37 | ↑ | ↓ |
| Steer Primal Cuts | 8.01 | 8.18 | 7.56 | ↓ | ↑ |
| Hides[4] | 59.0 | 64.9 | 76.8 | ↓ | ↓ |
| By-Products[4] | 52.4 | 51.9 | 56.7 | ↑ | ↓ |

[1] (NZD, 296-320kg Grade Bull & Steer), (NZD, 195-220kg Grade Heifer) (NZD, 160-195kg Grade Cow)
[2] USD, Manufacturing 95 CL [3] USD Manufacturing 90 CL [4] USD$ per Hide

**BEEF INDICATOR PRICES**

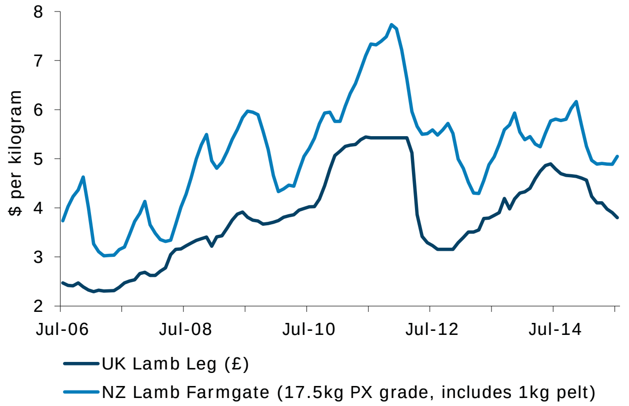



Source: ANZ, Agrifax

| LAMB PRICE INDICATORS | | | | | |
|---|---|---|---|---|---|
| **$ per kg** | **Current Month** | **3 Mth Trend** | **Last Year** | **Chg. M/3M** | **Chg. Y/Y** |
| NZ Lamb[1] (NZD) | 5.05 | 4.89 | 5.81 | ↑ | ↓ |
| UK Lamb Leg (£) | 3.80 | 3.99 | 4.79 | ↓ | ↓ |
| Rack US (USD) | 15.1 | 15.4 | 16.8 | ↓ | ↓ |
| Flaps (USD) | 4.19 | 4.54 | 5.90 | ↓ | ↓ |
| Skins[2] | 3.08 | 2.65 | 5.14 | ↑ | ↓ |

[1] 17.5kg PX grade, including 1kg pelt [2] USD per skin

**LAMB INDICATOR PRICES**




Source: ANZ, Agrifax

**Beef prices continue to outperform, but the question remains, for how long?** Contract prices in the $5.80-$6.10/kg range for the spring period are looking positive and provide an indicator of direction into October. **The US remains the centre of attention.** US cull cow supply continues to track 14% behind the 5-year average. Combined with lower seasonal supply out of New Zealand and the lower NZD, this is supporting farm-gate prices.

**However, we would be cautious about extrapolating this into the summer period.** The US beef cut-out value (weighted value of all primal cuts) has dropped over the last month. Part of this is seasonal, but there also seem to be growing concerns about beef demand in the second half of 2016. **The main focal point is that white meat (-30%) and dark meat (-50%) values are dramatically lower than the same time last year.** We believe foodservice beef consumption, which is what New Zealand exports, is less elastic than it's made out to be. But given the gap that has opened up is so stark, many foodservice operators are likely to focus promotional offerings on the cheaper/better margin alternatives. **The other area of pressure for US producers has been exports**, which have suffered from a stronger USD and weaker Asian import demand. New Zealand exports and market pricing in key Asian markets such as Japan and South Korea have also been weaker recently.

**Farm-gate lamb prices have stalled for most of the year due to sluggish import demand from the two main markets, the UK and China. Both destinations continue to pose problems, especially for frozen product.** This has seen more lamb shipped to other European markets, the US and the Middle East.

**Lamb schedules have lifted recently** due to a higher proportion of chilled activity, some reported procurement pressure, and a lower NZD. **Contract prices around mid-$5/kg for August, moving up to low-$6/kg in the North Island and high-$5/kg in the South Island, provide some direction for prices over the next quarter.** Key for price direction beyond this will be how the 2015 lamb crop turns out. As mentioned In the Month in Review (page 15) we see this as smaller, which should be price supportive in the summer (depending on seasonal conditions).

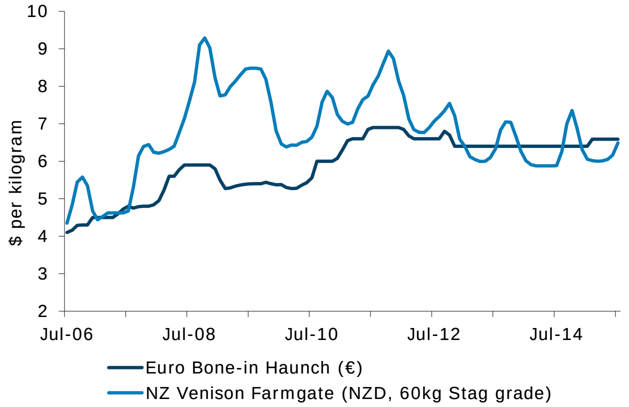
**China is expected to continue to be weak for a while yet as inventories are likely to take some time to work through.** The UK and European markets remain difficult with an overhang of earlier imports of New Zealand product (and local product in the UK case). The offset is that other markets are expected to be able to pick up the slack. Combined with less New Zealand supply this should be price supportive, particularly during the key speciality occasion periods (Christmas, Easter and Chinese NY).

# KEY COMMODITIES: VENISON AND WOOL

| VENISON PRICE INDICATORS | | | | | |
|---|---|---|---|---|---|
| **$ per kg** | **Current Month** | **3 Mth Trend** | **Last Year** | **Chg. M/3M** | **Chg. Y/Y** |
| NZ Stag[1] | 6.49 | 6.08 | 5.89 | ↑ | ↑ |
| NZ Hind[1] | 6.39 | 5.98 | 5.78 | ↑ | ↑ |
| Euro Bone-in Haunch (€) | 6.59 | 6.59 | 6.40 | ↔ | ↑ |
| Boneless Shoulder (€) | 4.93 | 4.87 | 4.50 | ↑ | ↑ |
| Loin (€) | 16.2 | 15.9 | 13.0 | ↑ | ↑ |

[1] (60kg Stag AP grade), (50kg Hind AP grade)

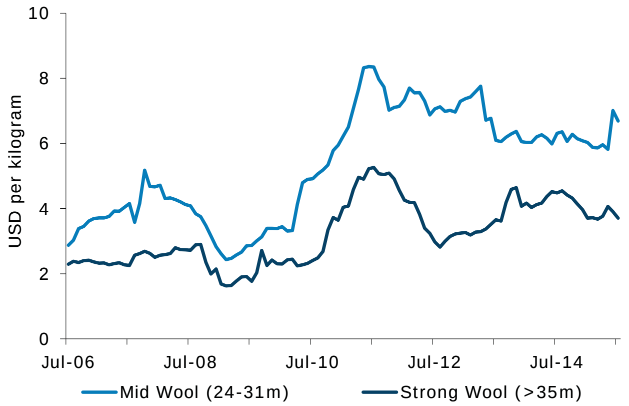
### VENISON INDICATOR PRICES




Source: ANZ, Agrifax

| CLEAN WOOL INDICATOR PRICES | | | | | |
|---|---|---|---|---|---|
| **$ per kg** | **Current Month** | **3 Mth Trend** | **Last Year** | **Chg. M/3M** | **Chg. Y/Y** |
| NZ Mid Wool (24-31m) | 10.16 | 8.57 | 7.26 | ↑ | ↑ |
| NZ Strong Wool (>32m) | 5.63 | 5.34 | 5.16 | ↑ | ↑ |
| USD Mid Wool (24-31m) | 6.71 | 6.26 | 6.31 | ↑ | ↑ |
| USD Strong Wool (>32m) | 3.72 | 3.91 | 4.48 | ↓ | ↓ |

### WOOL INDICATOR PRICES (CLEAN)




Source: ANZ, Beef + Lamb NZ, Wool Services International

**Chilled venison production has commenced for the European game season. Combined with a significant depreciation in the NZD/EUR this is lifting farm-gate prices.** October contract prices have been around the $8/kg mark, providing price direction for the next couple of months. This indicates in-market prices are firmer than last year and a lower currency is being passed through. Farmers will welcome the lift after two years of sub-par returns.

**Production throughput has slowed recently and year-to-date is now running 6% behind last year.** Weaner deer numbers on the ground as at 30 June 2014 were 7% lower than the year before. While this indicates seasonal production is running in line with expectations, there is a marked difference between hind and stag turn-off. Stag production is back nearly 10% and hind production just 3%. This indicates a further decline in the breeding herd, which is likely to push venison production back below 400,000 tonnes over coming years. Lower stag production suggests farmers are retaining a few more for velveting due to very high recent prices.

**Wool prices have remained buoyant, particularly for fine crossbreed and lamb's wool. Indeed lamb's wool was at decade highs recently, touching NZD7.45/kg.** Things have dropped off a touch at recent auctions as some offshore buyers have found prices a bit too rich, but they remain at elevated levels relative to the last five years. The buoyant prices have been attributed to a shortage of auction wool and exporters struggling to source enough wool to fulfil specific contracts. A lack of auction supply is due to previous high clearance rates, more wool being sold via other channels on fixed contracts, and passed-in wool at auctions selling afterwards.

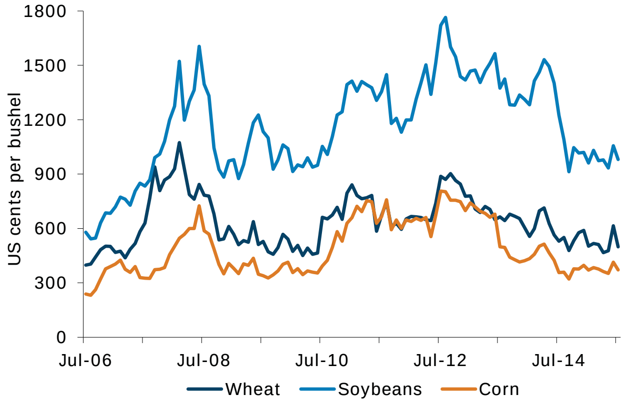
**The flow of wool has clearly been toward China in recent months**, one of the few things for which they have been willing to pay more. In the 2014/15 season China imported 15% more wool. Interestingly they accounted for 67% of the finer end of the clip, versus 42% of the stronger crossbreed wool during this period. Australian wool prices and exports to China also surged over the second quarter, with much of the lift attributed to restocking. Chinese mills ran particularly "hand-to-mouth" for wool last year, with weak imports in the first half of 2014. Import volumes later in 2014 failed to rectify this earlier supply shortfall. This left wool stocks in China particularly run-down heading into 2015, with China having to restock aggressively in preparation for the upcoming Northern Hemisphere winter season. The peaking in auction prices during June suggests restocking has taken place. However, tighter medium-term supply from both New Zealand and Australia is expected to remain price-supportive, especially for the finer end of the clip.

# KEY COMMODITIES: GRAINS

| GRAIN & OILSEED PRICE INDICATORS | Current Month | 3 Mth Trend | Last Year | Chg. M/3M | Chg. Y/Y |
|---|---|---|---|---|---|
| NZ Milling Wheat[1] | 403 | 406 | 448 | ↓ | ↓ |
| NZ Feed Wheat[1] | 358 | 364 | 440 | ↓ | ↓ |
| NZ Feed Barley[1] | 343 | 351 | 437 | ↓ | ↓ |
| Palm Kernel Expeller[1] | 235 | 237 | 307 | ↓ | ↓ |
| US Wheat[2] | 5.0 | 5.2 | 5.3 | ↓ | ↓ |
| US Soybeans[2] | 9.8 | 9.9 | 12.2 | ↑ | ↓ |
| US Corn[2] | 3.7 | 3.8 | 3.6 | ↓ | ↑ |
| Australian Hard Wheat[1] | 452 | 424 | 382 | ↑ | ↑ |

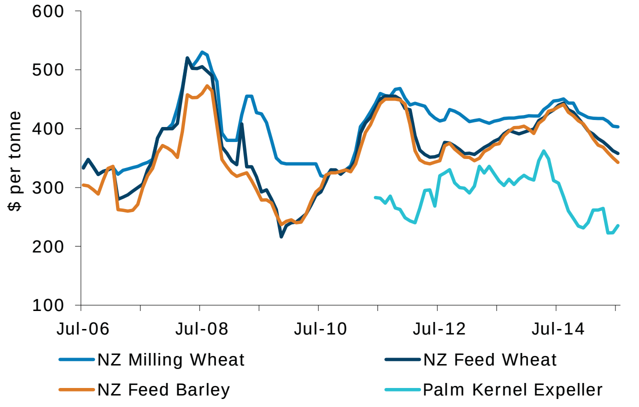
[1] NZD per tonne
[2] USD per bushel

### CBOT FUTURE GRAIN & OILSEED INDICATOR PRICES




Source: ANZ, Bloomberg

### KEY NZ GRAIN PRICES




Source: ANZ, Agrifax

**The dairy sector's plight remains the focal point for grain, with it now estimated to account for 30-50% of domestic grain consumption.** It is also the major swing buyer, depending on pasture conditions and the milk price. Farmers are expected to cut back on extra supplementary feed given constrained cash-flow, but if seasonal and pasture conditions turn unfavourable at any point then their hand may be forced. Enquiry has reportedly picked up for spring delivery, but little has traded, with a Mexican stand-off with growers looking like it could develop. Spot feed wheat and barley prices are around the mid-$300/t mark and contract prices $15-$20/t above this.

Maize prices are also trading around the mid-$300/t after earlier getting down into the low-$300/t due to storage issues. AIMI's recent survey of growers showed average yields from this year's harvest of maize grain and maize silage were roughly the same as last year. However, the area planted was smaller and total tonnage of maize grain harvested was 19% less than the year before. Planting intentions for the spring were up (+5%) on last year. But it remains to be seen whether low prices, additional maize imports and continued pressure on dairy prices will reduce final plantings. **Palm kernel remains the feed of choice for dairy farmers over the more expensive alternatives.** Prices have recently increased toward $230/t due to steady demand and a lower NZD. Year-to-date total imports are little changed on the same period last year, but have picked up recently.

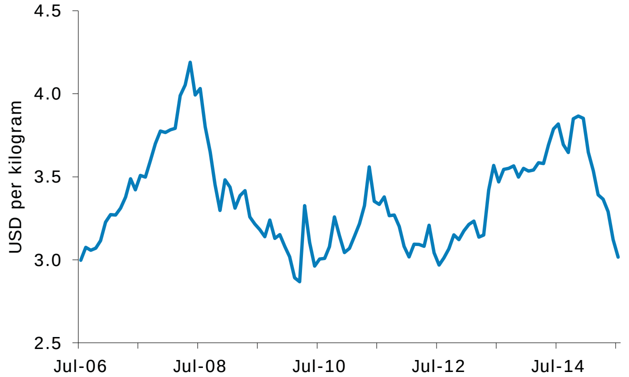
**Other industries are more reliant on the import market these days.** North American weather has been the main focal point for international grain markets in the last quarter. Prices rallied strongly through June as Canada was too dry while it was too wet further south in the US. Sentiment has since reversed, with rainfall in the second half of July in the Canadian Prairies and US weather also turning more benign. Much of the eastern US corn belt has been too wet, damaging summer crop yields. Market participants have been divided on the impact on overall US corn production given yield prospects are much higher in the western corn belt in states like Iowa and Nebraska. The uncertainty in weighing up the stark regional differences and the net impact on total US corn production helped support prices above USD4.0/bu in the first half of July despite corn looking overpriced against wheat. However, corn prices have since corrected, on the increasing view that average yields could still come in close to the USDA's current forecast of 166bu/ac. In the quarter ahead our forecast is for corn prices to trend lower to USD3.5/bu, while wheat prices could also re-test first half 2015 lows of USD4.6/bu.

# KEY COMMODITIES: HORTICULTURE

| HORTICULTURE PRICE INDICATORS | Current Month | 3 Mth Trend | Last Year | Chg. M/3M | Chg. Y/Y |
|---|---|---|---|---|---|
| Kiwifruit (USD per kg) | 3.0 | 3.1 | 3.8 | ↓ | ↓ |
| Apples (Weighted Index) | 247 | 241 | 239 | ↑ | ↑ |
| Average Wine Price[1] | 5.74 | 4.99 | 6.88 | ↑ | ↓ |
| Packaged White Wine[1] | 5.90 | 5.77 | 6.74 | ↑ | ↓ |
| Packaged Red Wine[1] | 9.31 | 9.10 | 12.41 | ↑ | ↓ |
| Bulk wine[1] | 3.23 | 2.81 | 3.68 | ↑ | ↓ |

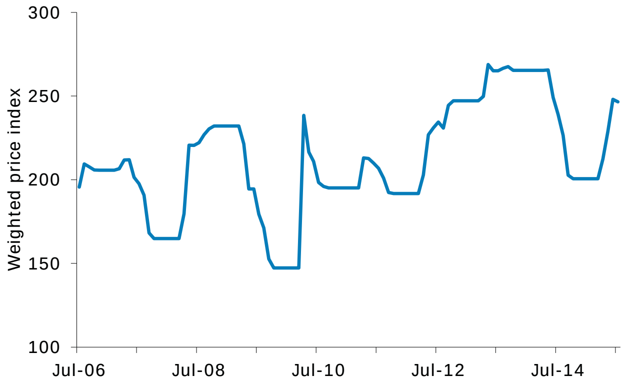
[1] USD per litre

### KIWIFRUIT INDICATOR PRICE



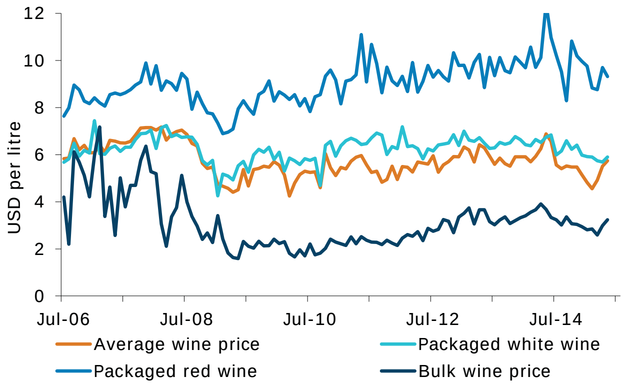

Source: ANZ, Zentrale Markt- und Preisberichtstelle

### APPLE INDICATOR PRICE INDEX




Source: ANZ, Zentrale Markt- und Preisberichtstelle

### WINE INDICATOR PRICES




Source: ANZ, NZ Winegrowers

**Zespri adjusted its price forecasts for the 2015 harvest recently with a drop for Green, but an increase for all other varieties.** The updated forecast range of $4.8-$5.2/tray for Green is down from last year's $6.01/tray and the earlier indicative range of $5-$5.5/tray. The drop in Green returns is driven primarily by increased competition from Chilean supply, which rebounded somewhat following a failure in 2014, and more competition within Europe on the shoulders of the season due to the Russian food import bans. Although Green returns are lower on a per-tray basis, returns on a per-hectare basis are expected to improve due to the large rise in average yields – from 8,872 trays per hectare in 2014 to over 11,000 trays expected this season.

**All other varieties have seen increases in per-tray return ranges. The returns range for Gold has increased to $7.6-$7.9/tray** from an earlier forecast of $6.7-$7.2/tray. This reflects a strong start to the sales season, with volumes tracking well ahead of forecast. As this will be many growers' first Gold3 crop, this will help further boost confidence and rebuild profitability. Foreign exchange movements between forecasts have also supported the improvement.

**The pipfruit sector is through the halfway point for the sales season. ENZA have reported European and UK sales have been better than anticipated.** Cox, Royal Gala and Jazz demand has been reported as solid, with prices above expectations. It is still too early to tell the final outcome for Braeburn sales as they are later this year. North America has proved more difficult with an overhang of Washington State crop. **Asia has been reported as fairly steady for both volumes and values.** Thailand, Hong Kong and Vietnam have been steady; Taiwan has been stronger than anticipated despite Chilean competition; and Japan continues to be challenging due to trade protocols remaining difficult to achieve.

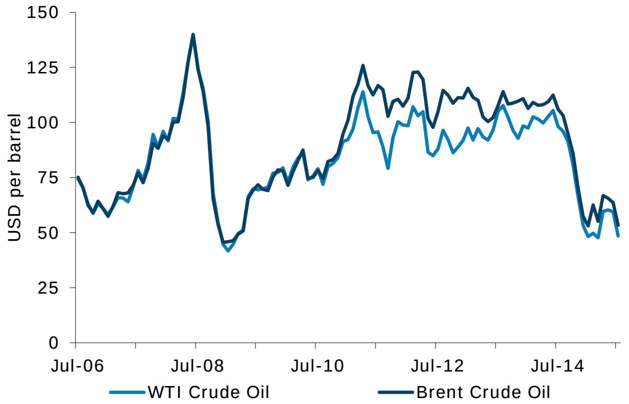
**In the wine market there is a continuation of the same themes. The UK and US remain the best-performing of the big three markets** with volumes up and prices fairly stable (UK down slightly and US up a bit). **The Australian market is proving tougher**, given a slowdown in economic growth and the high NZD/AUD. Volumes for 11 months to May are up 9%, but the average price is back 11%. Premium wine sales are expected to continue to grow to both the UK and US over the coming 18 months. Competition from Chilean Sauvignon Blanc is likely to increase in both these markets following a better growing season. Outside the big three markets some of the wealthier Northern European countries seem to be taking some more volume with solid growth in sales to the Netherlands, Denmark, Finland and Sweden. Canada has also taken larger volumes.

# KEY COMMODITIES: OIL, FREIGHT AND FERTILISER

| OTHER COST INDICATORS | | | | | |
|---|---|---|---|---|---|
| | Current Month | 3 Mth Trend | Last Year | Chg. M/3M | Chg. Y/Y |
| WTI Oil[1] | 49 | 60 | 98 | ↓ | ↓ |
| Brent Oil[1] | 53 | 65 | 106 | ↓ | ↓ |
| Ocean Freight[2] | 1,100 | 660 | 755 | ↑ | ↑ |

[1] USD per barrel, grade WTI
[2] Baltic Dry Index

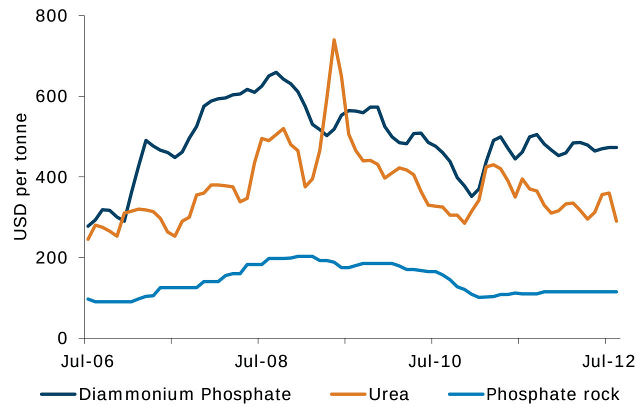
## CRUDE OIL INDICATOR PRICES




Source: ANZ, Bloomberg

| FERTILISER PRICE INDICATORS | | | | | |
|---|---|---|---|---|---|
| USD per tonne | Current Month | 3 Mth Trend | Last Year | Chg. M/3M | Chg. Y/Y |
| DAP (USD) | 473 | 469 | 499 | ↑ | ↓ |
| Urea (USD) | 290 | 343 | 370 | ↓ | ↓ |
| Phosphate Rock (USD) | 115 | 115 | 110 | ←→ | ↑ |
| Farm-gate DAP (NZD) | 865 | 833 | 797 | ↑ | ↑ |
| Farm-gate Urea (NZD) | 575 | 585 | 580 | ↓ | ↓ |
| Farm-gate Super phosphate (NZD) | 320 | 317 | 316 | ↑ | ↑ |

## INDICATIVE INTERNATIONAL FERTILISER PRICES




Source: ANZ, Bloomberg

**We continue to expect oil prices to trend gradually lower, particularly after August as the strong summer demand period comes to an end.** Crude oil inventories in the US are on the rise once more and are back in focus for the market. China's real activity indicators continue to show signs of slowing, and if equity market volatility continues, this could have a negative impact on energy demand from the country that consumes 10% of the world's oil. We maintain a short-term base case range of USD45-60/bbl in WTI, while Brent crude oil is likely to continue trading with a very tight spread of less than USD5.0/bbl.

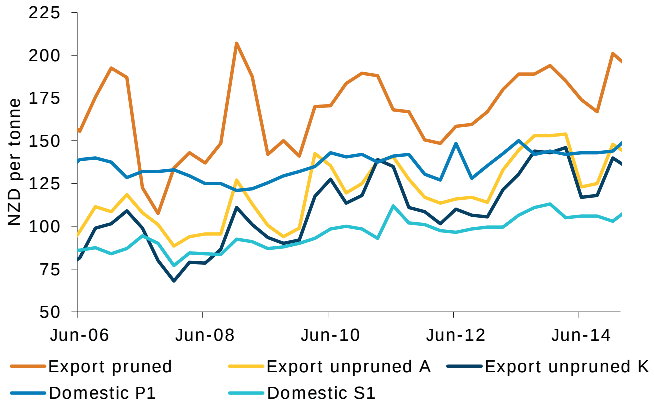
**An unseasonal build-up in US crude oil stocks was the catalyst for price weakness in July.** After US crude oil stocks peaked at 491 million barrels in late April, a steady decline since then had supported the recovery in oil until a shock increase in stocks in June saw the market sell off sharply. This is consistent with our view that the recovery in prices seen over the past few months resulted in more shale oil players re-entering the market. By mid July the number of active rigs in the US rose to 857, following three straight weeks of increases. The price of WTI crude, having fallen 17% in July, seems to have arrested the bounce in rig counts. But continued strong US oil production and the increase in crude oil stocks suggest prices need to be lower. Balancing supply and demand is likely to take more time. **Iran has also been a key factor for oil markets over the past month.** The recently concluded deal between Iran and the UN Security Council and Iran concerning their nuclear program should pave the way for the lifting of economic sanctions. The impact on prices will be two-fold. While potentially 30 million barrels of Iranian crude could be supplied to the market immediately via Iran's built-up stocks, the impact on sentiment is also significant. Iran's oil minister last week stated the country's intentions to regain lost market share, suggesting exports could more than double from 1.2mb/d to pre-sanction levels of 2.6mb/d, in the months after sanctions are lifted.

**Farm-gate fertiliser prices changed in early June. There was a $15/t fall for urea as a result of the recent decline in international prices.** This was offset to some degree by the fall in the NZD. Global markets have remained subdued and there are reports of high inventories weighing on prices. Prices are expected to stabilise from here. **The prices for the other main benchmarks have remained more stable. Combined with the drop in the NZD this has led to a lift in farm-gate super-phosphate and DAP prices.** Generally global demand has been fairly sluggish given a softer commodity price backdrop for most major crops.

# KEY COMMODITIES: FORESTRY

| FORESTRY PRICE INDICATORS | | | | | |
|---|---|---|---|---|---|
| | Current Quarter | 3 Period Trend | Last Year | Chg. P/3P | Chg. Y/Y |
| **Export: (NZD per JAS m³ f.o.b.)** | | | | | |
| Pruned | 193 | 181 | 185 | ↑ | ↑ |
| Unpruned A Grade | 142 | 132 | 154 | ↑ | ↓ |
| Unpruned K Grade | 134 | 125 | 146 | ↑ | ↓ |
| Pulp | 119 | 113 | 133 | ↑ | ↓ |
| **Domestic: (NZD per tonne delivered at mill)** | | | | | |
| P1 | 152 | 143 | 142 | ↑ | ↑ |
| P2 | 126 | 126 | 126 | ↔ | ↔ |
| S1 | 110 | 105 | 105 | ↑ | ↑ |
| S2 | 103 | 106 | 105 | ↓ | ↓ |
| Pulp | 53 | 51 | 50 | ↑ | ↑ |

**NZ FORESTRY INDICATOR PRICES**




Source: ANZ, MPI

**There has been a slight recovery in export log prices over recent months. However, much of the improvement has been driven by NZD weakness.** In-market prices remain stable, but at low levels.

**The situation in China hasn't changed too much and most commentators are fairly pessimistic on the likelihood of a significant recovery any time soon. High log stocks in China are struggling to fall much below 4 million m³ and hence in-market prices are struggling to recover.** The improvement in the housing market in tier one cities in China is not yet flowing through to sufficient new construction projects to clear the high log stocks. Construction in second and third tier cities is also being hampered by excess housing stock.

**Elsewhere, log and lumber exports to South Korea have been softer** due to a more challenging growth environment. **India has been a little more positive with better in-market pricing.** India does not have adequate forest resources and has a growing gap between demand and their wood resources. To bridge this gap as it grows they will need to boost imports.

**The pruned log market remains strong.** While some are still reporting an increase in the volume of pruned logs, there is still an overall shortage in the North Island. Price discrepancies between the North and South Island remain. Prices for the North Island held steady at a price of $165/t while South Island prices increased to an average of $151/t.

**While there is a slight influx of pruned logs in some areas, overall there is very little pruned wood available.** The current premium for pruned logs (over unpruned logs) is now $70 and could well increase. For forest owners this premium will make pruning financially viable in most situations. Most are expecting further price increases as demand outweighs supply for now. The "wall of wood" that is expected to be ready to harvest in the next couple of years may yield more pruned logs, but there are questions over the quality of this wood.

# BORROWING STRATEGY

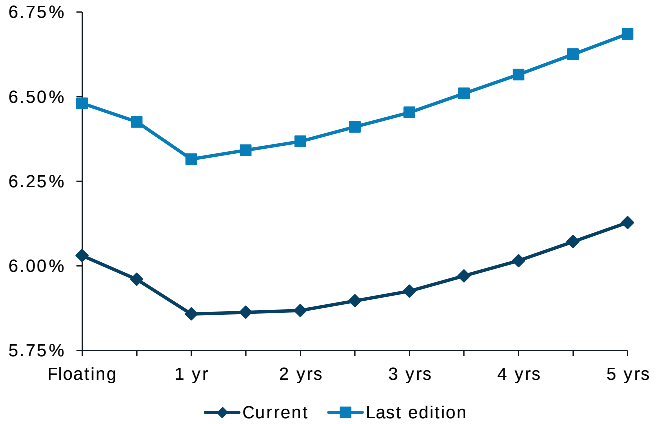

## SUMMARY

Front-end rural lending rates have fallen in step with the 50bps of OCR cuts that have been delivered since our last edition. Indicative longer-term borrowing costs are hovering around post-OCR lows and the curve has flattened. This may make fixing for longer seem an attractive proposition, but we note locking in now will prevent borrowers from taking advantage should interest rates fall further than currently expected. A lower OCR is priced into 1 and 2 year rates but the risk profile points to even more OCR cuts. While the carded curve is relatively flat we remain cautious about fixing for longer given the skewed risk profile.


## OUR VIEW

**Indicative rural rates have fallen significantly** since the last edition of the *Agri Focus.* This mostly reflects the 50bps of OCR cuts delivered by the RBNZ and confirmation that the RBNZ remains on an easing bias. Shorter-term rates (i.e. those for 2 years and less) are between 0.40% and 0.46% lower since early June. Lower global rates and a narrowing in local spreads have also contributed to slightly larger falls for longer-term tenors, with indicative longer-term rates around 50bps lower. While the curve as a whole has shifted lower, some of the recent steepening has been unwound and the curve has flattened marginally.

**FIGURE 1. INDICATIVE RURAL LENDING RATES**

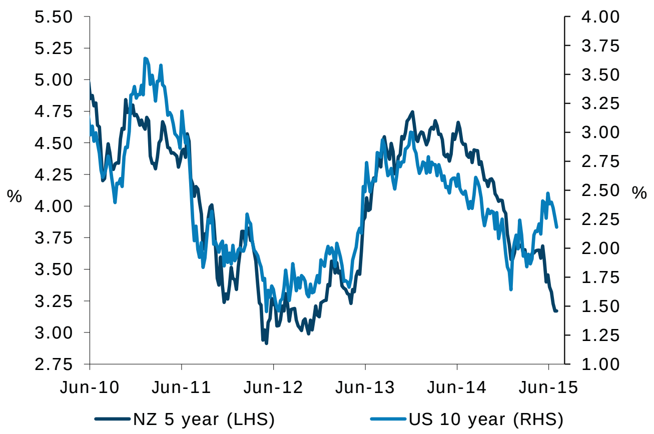



Source: ANZ, Bloomberg

**With 50bps of OCR cuts being delivered thus far, the question is, where to from here?** Recent RBNZ communications have confirmed that they remain on an easing bias, but that the lower NZD is doing some of the work for them – and they undoubtedly would prefer that the currency keeps falling. The problem here is that you probably need rate cuts for that to happen. Current market prices are signalling about 35bps of cuts by the end of the year, with the OCR expected to trough at about 2.60% by early next year. This has contributed to the lowest indicative borrowing rates being in the one to two year window. **We're of the view we'll see another cut in September but the RBNZ will then pause before cutting again in early 2016, so market pricing is not too far away from our central view.**

**Longer-term local rates are more sensitive to movements in global rates, and have fallen by 50bps on average.** The Fed kept rates unchanged in July but remains on track for a September hike. However, US Treasury yields have tailed off of late (see chart below), as the message of a gradual and cautious path of policy normalisation sinks in; **a "crawl off" in rates is expected this time around, unlike traditional tightening cycles.**

**FIGURE 2. NEW ZEALAND AND US INTEREST RATES**




Source: ANZ, Bloomberg

Indicative longer-term borrowing rates are hovering close to post-OCR lows. It would appear an attractive time to lock in. Indeed, our breakeven analysis (see table below), shows that interest rates need to rise only gradually in order for fixing to be worthwhile.

**However, fixing now would prevent borrowers from taking advantage of greater falls in interest rates than currently priced, which is where the risk profile resides.** It's hard to see the US Fed (the real driver of long-term rates) lifting rates aggressively, given the wider global scene. Locally, dairy prices are yet to base, let alone show signs of recovering. And the outlook for China remains very uncertain; trends in commodity prices are a worrying signal. There is an emerging risk the RBNZ has to cut by more than 100 basis points.

| Rural Lending Rates (incl. typical margin) | | Breakeven rates | | | |
|---|---|---|---|---|---|
| **Term** | **Current** | **in 6mths** | **in 1yr** | **in 2 yrs** | **in 3 yrs** |
| **Floating** | 6.08% | | | | |
| **6 months** | 5.99% | 5.83% | 5.91% | 6.12% | 6.28% |
| **1 year** | 5.91% | 5.87% | 5.92% | 6.17% | 6.33% |
| **2 years** | 5.91% | 5.94% | 6.04% | 6.25% | 6.51% |
| **3 years** | 6.00% | 6.04% | 6.14% | 6.40% | |
| **4 years** | 6.08% | 6.16% | 6.28% | | |
| **5 years** | 6.20% | | | | |

# ECONOMIC BACKDROP

## SUMMARY

Persistently low inflation and looming commodity price headwinds necessitate a lower OCR (and NZD), and we expect the RBNZ to unwind all of 2014's 100bps of hikes. But while growth is softening, we are not writing off the economy just yet. Support remains from accommodative financial conditions, the construction sector pipeline, and booming net migration. This is a deceleration in growth, not a full-blown downturn – yet. The risks of the latter eventuating reside offshore; our eyes are on China, and by association, Australia.

## GIVING BACK

**The risk profile for the economy has shifted more to the downside of late** and we can now see more obvious signs of waning momentum in some forward indicators, including business confidence and our *Truckometer*. Activity across key pro-cyclical parts of the economy, such as residential building work, has levelled out. It's not one-way traffic but a trend of moderation across the economy is clear.

**Whilst it's tempting to jump on the "glass half empty" band-wagon, we're still constructive on the broad trend for growth in the medium term.** A well-rounded microeconomic policy platform and our optimism regarding Asia in the medium term are constructive building blocks. New Zealand ranks highly internationally across numerous areas.

**However, the immediate focus is here and now, and key near-term economic risks include:**

- **Lower dairy prices.** This will pose challenges both to the dairy sector and to the wider economy, contributing to a 25% peak-to-trough fall in the goods terms of trade, a key measure of nationwide purchasing power. That's enough to knock up to 4 percentage points off GDP growth over the coming two years. We have lowered our 2015/16 estimate of the Fonterra milk price to mid-$3's/kg MS and still view this as having downside risks, given international dairy prices are yet to base. That's a massive hit to rural incomes.

- **Signs the Christchurch city rebuild has peaked, which removes a major pillar of support.** Whilst providing less impetus to growth, this will also allow resources across the construction sector to be reallocated to other regions, with no shortage of construction sector work at the national level.

- **Deteriorating structural metrics.** Household debt to income is rising, the current account is deteriorating, household saving is falling and Auckland house prices are surging; that's a potent mix. Lower interest rates are required to provide support to the economy but also risk inflaming housing further. Deteriorating structural metrics in combination with asset valuation largesse point to an elevated level of vulnerability.

- **The obvious global risks.** The trajectory for China remains uncertain. Commodity prices are coming under broad-based pressure, a disconcerting sign. Europe's malaise looks contained, but problems are unresolved. The US economy is performing well and the Fed looks on track to lift rates before year-end. This will test asset (equity market) valuations.

**Key support pillars remain across the economy.** Migration inflows (60k) are very strong. Many export earners outside of dairying are performing well (e.g tourism, pipfruit). Construction sector activity has yet to peak relative to GDP despite the Christchurch city rebuild topping out. Fiscal policy has scope to shift to an expansionary stance if required (and we have been promoting the need for such a shift).

**Inflation is low.** The RBNZ puts low inflation down to the NZD and lower petrol prices. However, the reasons for low inflation are broader. Core inflation is 1.3% y/y; non-tradable inflation (at 2% y/y) sits at a 14-year low; and inflation ex food, energy and petrol is even lower (+0.9% y/y). That means lower rates for longer.

**The RBNZ cut the OCR in June and July and we expect a further 50 basis points of easing thereafter.** Getting inflation back to the 2% target midpoint needs a lower OCR and NZD.

**The NZD has fallen of late, but it remains extended relative to valuation metrics.** A lower NZD remains the obvious release valve to offset the negative impact of weakening commodity prices. We expect the NZD/USD to head towards 0.59 over the coming 12 months. We are more neutral on the NZD/AUD, with Australia suffering similar economic challenges to New Zealand in the form of lower commodity prices and terms of trade.

**Lower interest rates and a falling NZD have delivered a material easing in financial conditions.** Trends in our financial conditions index bode well for a recovery in economic momentum. Just as night follows day, so too does day follow night.

**The risk profile for the economy, however, still points lower.** Dairy price action is worrying. Volatility across the Chinese equity market has everyone scratching their heads. The economy appears much weaker than official estimates portray. Thankfully, if necessary, the RBNZ could cut the OCR even further, the NZD would adjust even lower, and we'd expect fiscal policy to turn expansionary. New Zealand has its challenges, but also the firepower to manage them.

# KEY TABLES AND FORECASTS

| FX RATES | ACTUAL | | | FORECAST (END MONTH) | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Jun-15 | Jul-15 | 5-Aug | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 |
| NZD/USD | 0.675 | 0.659 | 0.654 | 0.63 | 0.61 | 0.59 | 0.59 | 0.59 | 0.59 | 0.59 |
| NZD/AUD | 0.880 | 0.902 | 0.886 | 0.86 | 0.85 | 0.83 | 0.84 | 0.84 | 0.84 | 0.84 |
| NZD/EUR | 0.604 | 0.600 | 0.601 | 0.60 | 0.62 | 0.58 | 0.55 | 0.53 | 0.53 | 0.53 |
| NZD/JPY | 82.68 | 81.67 | 81.24 | 76.2 | 74.4 | 72.6 | 73.2 | 73.8 | 73.8 | 73.8 |
| NZD/GBP | 0.430 | 0.422 | 0.420 | 0.41 | 0.41 | 0.39 | 0.38 | 0.38 | 0.38 | 0.38 |
| NZ TWI | 71.2 | 70.8 | 69.7 | 68.4 | 67.7 | 65.1 | 64.4 | 63.7 | 63.7 | 63.7 |

| INTEREST RATES | ACTUAL | | | FORECAST (END MONTH) | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Jun-15 | Jul-15 | 5-Aug | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 |
| NZ OCR | 3.25 | 3.00 | 3.00 | 2.75 | 2.75 | 2.50 | 2.50 | 2.50 | 2.50 | 2.50 |
| NZ 90 day bill | 3.26 | 3.10 | 3.03 | 2.90 | 2.90 | 2.60 | 2.60 | 2.70 | 2.70 | 2.70 |
| NZ 10-yr bond | 3.63 | 3.35 | 3.30 | 3.70 | 3.90 | 4.00 | 3.90 | 3.90 | 3.90 | 3.90 |
| US Fed Funds | 0.25 | 0.25 | 0.25 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 | 1.75 | 1.75 |
| US 3-mth | 0.28 | 0.31 | 0.30 | 0.60 | 0.85 | 1.10 | 1.35 | 1.60 | 1.85 | 1.85 |
| AU Cash Rate | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| AU 3-mth | 2.15 | 2.15 | 2.14 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 |

| ECONOMIC INDICATORS | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 |
|---|---|---|---|---|---|---|---|---|---|---|
| GDP (% q/q) | **0.5** | **0.6** | **0.6** | **0.7** | **0.7** | **0.7** | **0.7** | **0.6** | **0.6** | **0.6** |
| GDP (% y/y) | **2.4** | **2.0** | **2.0** | **2.5** | **2.7** | **2.7** | **2.7** | **2.6** | **2.6** | **2.5** |
| CPI (% q/q) | 0.4 | **0.5** | **0.2** | **0.6** | **0.4** | **0.6** | **0.2** | **0.5** | **0.6** | **0.7** |
| CPI (% y/y) | 0.3 | **0.4** | **0.8** | **1.7** | **1.7** | **1.8** | **1.8** | **1.7** | **1.9** | **2.0** |
| Employment (% q/q) | 0.3 | **0.4** | **0.4** | **0.3** | **0.3** | **0.3** | **0.3** | **0.3** | **0.3** | **0.3** |
| Employment (% y/y) | 3.0 | **2.6** | **1.8** | **1.4** | **1.5** | **1.3** | **1.3** | **1.2** | **1.2** | **1.2** |
| Unemployment Rate (% sa) | 5.9 | **5.9** | **5.9** | **5.9** | **5.8** | **5.8** | **5.7** | **5.6** | **5.6** | **5.5** |
| Current Account (% GDP) | **-3.8** | **-4.1** | **-4.6** | **-5.6** | **-6.1** | **-6.2** | **-5.9** | **-5.5** | **-5.2** | **-5.0** |
| Terms of Trade (% q/q) | **-5.7** | **-5.9** | **-7.4** | **-3.2** | **0.7** | **1.5** | **2.1** | **2.0** | **1.7** | **1.5** |
| Terms of Trade (% y/y) | **-10.8** | **-12.2** | **-16.8** | **-20.6** | **-15.1** | **-8.4** | **1.0** | **6.4** | **7.5** | **7.5** |

Figures in bold are forecasts. q/q: Quarter-on-Quarter, y/y: Year-on-Year

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