

ASB Rural Quarterly

Rural resilience set to be tested

May 2023



A message from the ASB Economics Team

Welcome to the inaugural edition of our Quarterly Rural Update - our go-to publication for all things agriculture.

Each edition we'll look at the demand and supply dynamics underpinning agri-commodity markets globally and delve a little into the outlook for the big beasts powering our primary sector and our most important goods exports.

We'll aim to cover a quick run-down of conditions in financial markets, with both rates and currency movements hot topics of conversation for many operators in the primary sector lately. In this edition we'll be discussing:

- The coming slowdown in the global economy and its implications for commodity prices and for financial markets more broadly.
- China's outlook, its varying impacts on NZ's different exports and why we're cautious about placing too much emphasis on its reopening.
- Mixed recent trends in farm expenses, with lower fuel, fertilizer, feed and labour costs on the cards, but compliance costs still a challenge for many.
- Our forecasts for the NZD, which we expect to shift a little lower and provide some offset to farmer incomes (depending on the magnitude).
- The trajectory of mortgage and business rates, which may be close to peaking as markets increasingly price stimulatory OCR cuts in the near future - though the debt servicing burden is still set to increase for many as more and more lending rolls onto higher rates.

In aggregate, it looks like the next eighteen months will be another challenging period for many farmers. Fortunately, many farmers have used the high farmgate returns of recent years to pay down debt and ensure they're in resilient shape. What's more, the NZ agri sector has a long history of weathering storms and coming out the other side stronger: from the UK's entry into the EU in 1973 to the removal of agricultural subsidies in the 1980s. It's likely the sector will need to employ some of that same resilience and adaptability over the next couple of years too. We'll be championing that resilience every step of the way.

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Commodities

Bullish Pandas and Bearish Eagles



Dairy

Prepare for landing



Meat

Protean protein



Forestry

Timber-tantrum



Interest Rates

Looking peaky



Currency

A flightless bird



To stay up-to-date on our commodity price views and our broader economic forecasts don't forget to [subscribe here](#).

Commodities

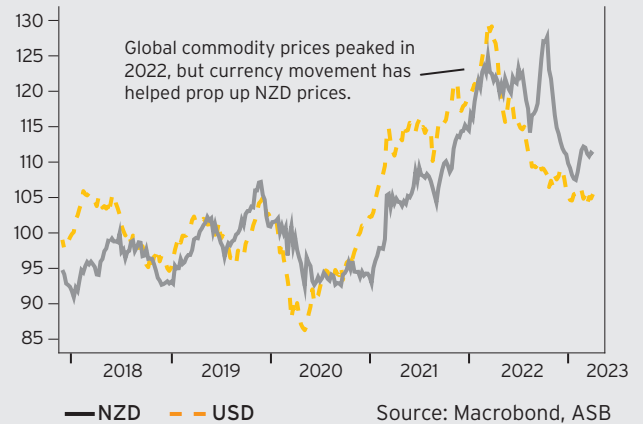


Bullish Pandas and Bearish Eagles

2022 was a challenging year

After peaking this time twelve months ago, agri commodity prices have eased substantially over the past year, with underlying USD prices down more than 20% since then. A softer Kiwi has partially offset the fall, with NZD prices only down about 15%. The lengthy shutdown of parts of the Chinese economy was a key driver of the push lower in prices, disrupting established food service channels. Combined with decelerating growth elsewhere, demand took a hit. The lifting in Chinese COVID restrictions late last year has thus helped fuelled optimism about a recovery in commodity demand over the remainder of the year.

ASB Commodities Index



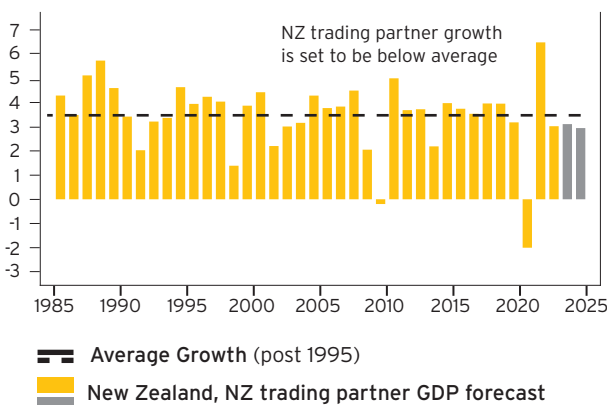
Some supply constraints are easing

Were it not for supply constraints on many goods, prices would have eased further by now. Elevated production costs, higher interest rates, regulatory change and labour shortages have crimped output and eaten into margins. Some of these challenges are here to stay for the foreseeable future, but some supply constraints have begun to ease over the last six months or so. In particular, key farm input costs have eased meaningfully, with global grain prices down about 15-20% from their peak and fertiliser and energy prices down about 40-45%. Costs are still elevated in an outright sense, but broadly speaking, supply looks to be past its lows for many commodities. All-up, improving supply and decelerating demand should be a recipe for relatively subdued commodity prices over the near and medium terms.

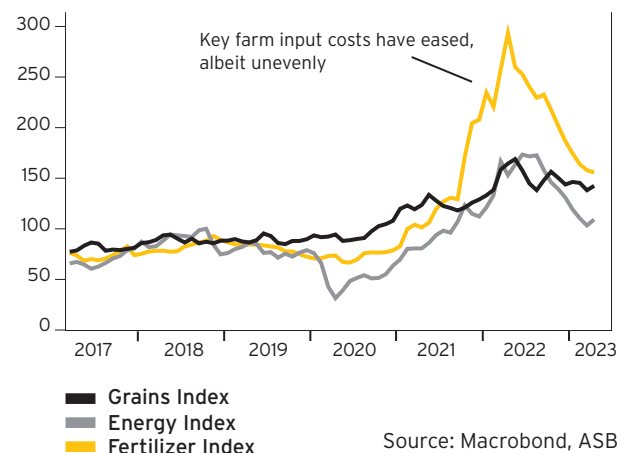
Global growth is set to slow this year

Economists expect Chinese GDP growth to bounce back from +3.0% in 2022 to +5-6% this year. But we're sceptical China's re-opening will drive commodity prices higher. Growth of 5-6% would still be far below what China has averaged over the past decade. China also only accounts for circa a quarter to a third of NZ goods exports, and growth is slowing in most other major economies. The consensus forecast for growth among NZ's trading partners sees growth remaining at 3% or below over 2023 and 2024. In our view, the risks to that estimate are towards the downside, with the potential for an economic contraction in the US currently underpriced by the market. With US inflation proving stubborn, the risk is that the Federal has to cool the economy by more than markets expect to get inflationary pressures under control.

NZ Trading Partner GDP (top 16) Annual Average Growth



World, Commodity Indices, World Bank, End of Period NZD



Dairy



Prepare for landing

Two consecutive high(ish) farmgate prices

The 2021/22 and 2022/23 seasons brought farmers an unusually high milk price. The combination of constrained dairy supply and the post-COVID expansion of the global economy was a potent combo for prices: at least until China's zero-COVID lockdown took out a chunk of demand. Even as those zero-COVID restrictions have eased, dairy prices remain down about 30% from their 2022 peak as of the time of writing. Fonterra has steadily revised its 2022/23 guidance lower - down to a (still comparatively elevated) \$8.20 per kgMS.

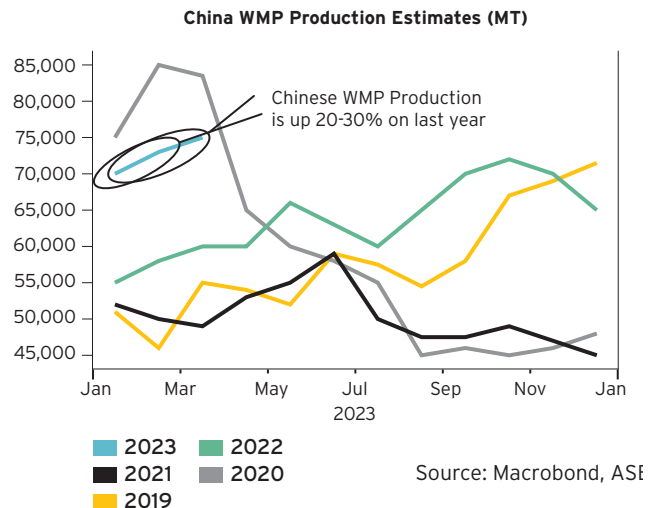
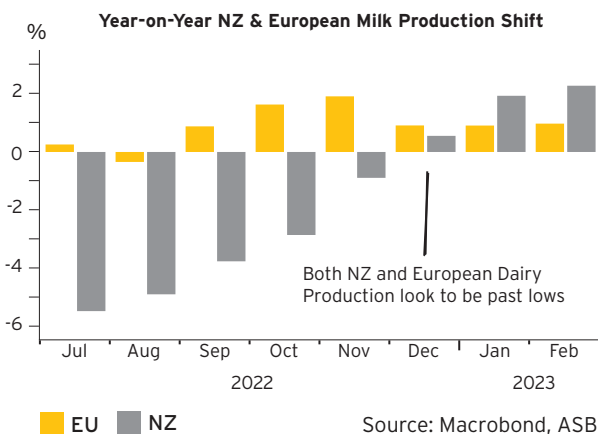


Risks are tilted towards a softer 2023/24

Forecasts for the 2023/24 season milk price vary wildly as we approach crunch time, some forecasters touting the possibility of a milk price as high as \$10.00 per kgMS. Fonterra's opening guidance range sits at \$7.25-8.75, with a midpoint at \$8.00. We're more conservative in our expectations and expect a price at the \$7.25 mark. Fundamentally, our view rests on our expectations that dairy consumption will slow this year in line with the global economy. Improvements in Chinese demand are likely to be largely offset by softer demand elsewhere. China is by far the dominant buyer for NZ dairy exports, but it still only accounted for about half of NZ's milk powder exports in past years and just under a quarter of overall global milk powder imports. On the supply side, global dairy production looks to be past its lows, with both NZ and European production making tentative year-on-year improvements. In aggregate, that should be a recipe for a less-tight global dairy market.

What's more, China might be slow off the mark

While China is the bright spot for dairy exporters, recent GDT auction results suggest that demand for dairy imports is set to pick up only gradually. China accumulated substantial whole milk powder stocks during 2022 amid strong local production and COVID-driven disruption to usual consumption patterns. Those stocks have started to ease as 2023 has begun, but because of falling imports rather than weaker local production or a pick-up in consumption. Chinese WMP production is actually up circa 25-30% on this point in the last three seasons, while WMP consumption has trended to its lowest levels since early 2020 even as COVID restrictions have eased. China may take advantage of the current lull in prices to further rebuild inventories, but it's unlikely to compete hard for prices while the domestic environment looks as it does.



Meat

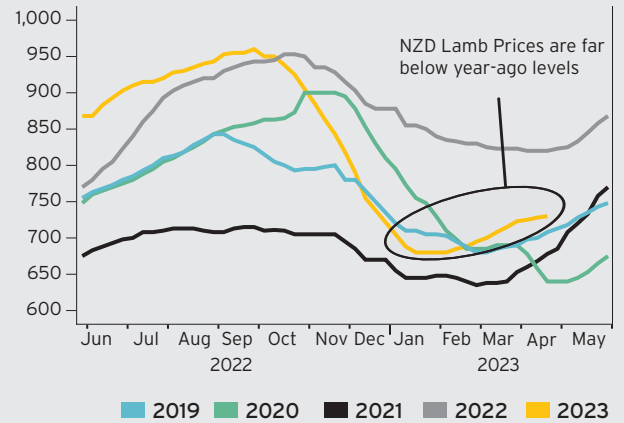


Protean protein

Global protein prices have been cooling

Cooling demand is also increasingly weighing on global protein prices too. Having spent the 2021/22 season hovering around record highs courtesy of strong demand and tight supply, underlying US dollar beef and lamb prices have eased over 2022/23. As of the time of writing, beef prices are down about 5-10% year-on-year in USD terms, while lamb prices are as much as 10-15% down over the same period. The outsized fall in lamb prices reflects a higher starting point: having spent much of 2021/22 up more than 40% annually, high retail lamb prices have reportedly seen overseas consumers substitute for cheaper meats. Fortunately, the lower Kiwi has helped offset those unfavourable moves in underlying prices - lamb prices are only down about 11% year-on-year in NZD terms, and beef prices are largely flat.

NZD Lamb Prices - c/kg



Source: Macrobond, ASB

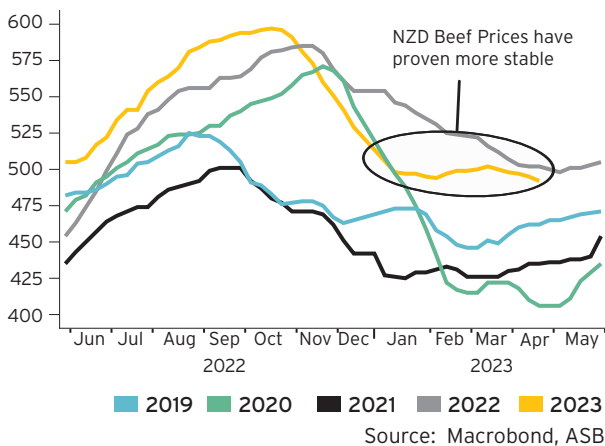
A muted 2023/24, with an NZD offset

We expect lamb and beef prices to make only modest gains over the latter half of the 2022/23 and 2023/24 seasons. With global growth slowing, global protein demand is unlikely to surge, but returning food-service demand from China (more on that below) will help support prices and we expect demand for beef and lamb to remain north of historical levels. In a reversal of last season's trend, we expect lamb prices to outperform their bovine peers given their relatively tighter supply outlook, with beef exports from Australia and Brazil set to increase over the season. More easing in the NZD can help further support farmgate returns.

Asia to drive growth, with ASF a key swing factor

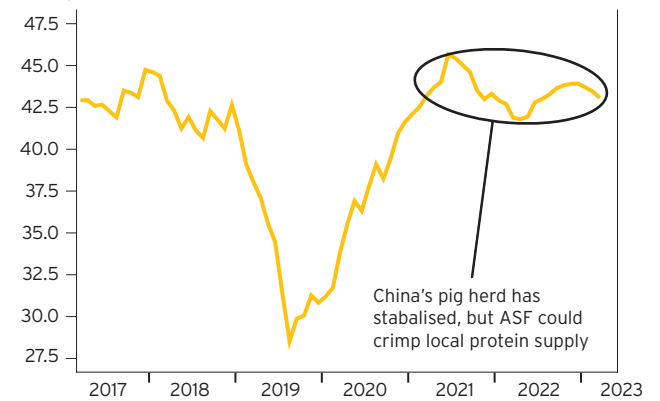
With growth declining in the US, EU and UK, export growth for beef and lamb will be Asia-driven over the remainder of this season and next. We expect the Chinese recovery to be consumption-driven, which is a positive for food exporters. To that end, we'll be keeping an eye on China's efforts to contain the spread of African Swine Fever, with sources reporting an increase in infections over early 2023. 2019's experience shows outbreaks can spread rapidly, drastically tightening pork supply and boosting beef and lamb consumption as a substitute. At this stage, we're not expecting a repeat, but the situation is fluid and even a modest worsening in the outbreak can offer protein prices further support.

Weighted NZD Beef Price - c/kg



Source: Macrobond, ASB

China Sow Inventory (Stock)



Source: Macrobond, ASB

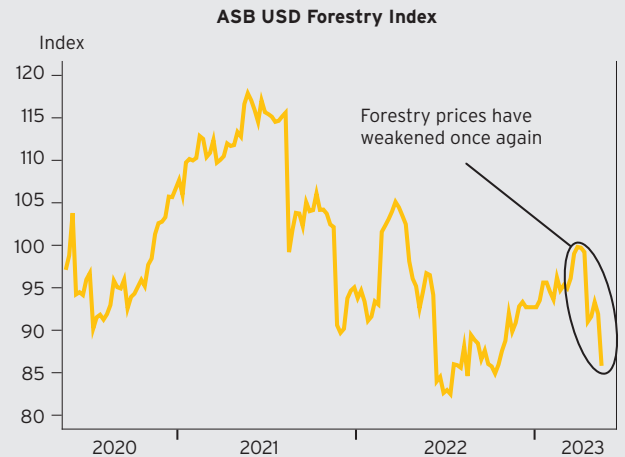
Forestry



Timber-tantrum

A subdued eighteen months

Having risen to record highs around this time in 2021, forestry prices have been more subdued over the past eighteen months. Of all NZ's major export sectors, the forestry sector is by far the most dependent on the Chinese market, and hence suffered the most from the Chinese slowdown. In a given year, nearly 60% of NZ forestry exports are China-bound, compared with about 40% off dairy exports, 40% of meat exports and only 20% of horticulture exports. Meanwhile, domestic demand has been progressively slowing too, with higher interest rates, low population growth and a less acute housing shortage all cooling the domestic property market. If there is one consolation prize for exporters, it's that freight costs have eased substantially over the same period.



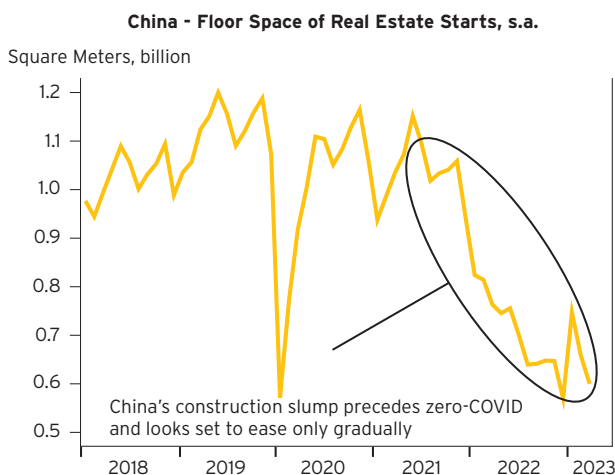
Source: Macrobond, ASB

Consumption-led China recovery will weigh

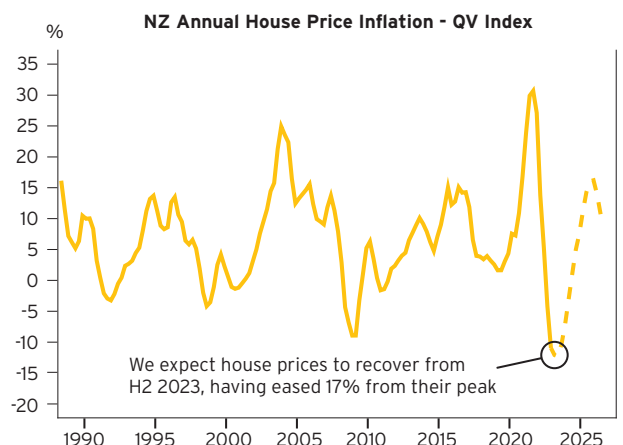
With the Chinese economy projected to rebound after its risible 2022 performance, some exporters will be hopeful that strengthening property market activity boosts forestry demand and supports global log prices. For our part, we expect any price gains to be modest. Our CBA colleagues expect China's recovery to be consumption- rather than investment- led. The Chinese Government's quota for special bonds - the primary mechanism through which it funds infrastructure spending, is set to be 7% lower in 2023, implying we shouldn't expect a renewed construction boom. The post-lock down pick-up in fixed asset investment is looking pretty modest, with activity well below pre-COVID levels. All-up, any increase in log demand looks to be modest in the near term.

Few supports from the domestic market

Support for the forestry market from the local property market is also looking fairly precarious. While the strong near-term pipeline of building work has kept construction activity looking pretty resilient up until this point, comparatively high interest rates and cooling house prices are increasingly weighing, with business surveys showing construction expectations are deeply in the red. That dynamic is set to remain a feature over remainder of 2023 and the beginning of 2024. The good news is that with net migration proving much stronger than anticipated and the RBNZ getting closer to the end of the hiking cycle, the housing market will turn eventually, but probably not until next year.



Source: Macrobond, ASB



Interest Rates

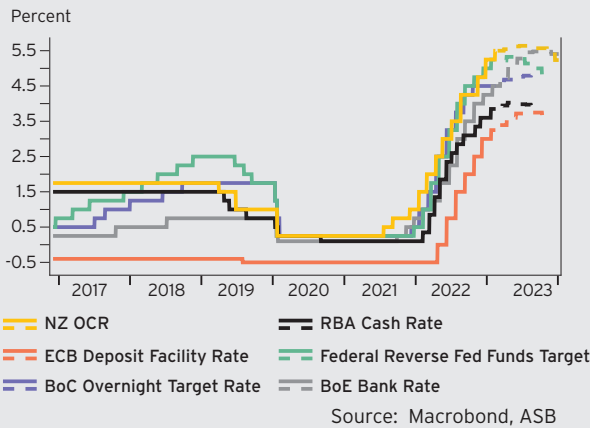


Looking peaky

Rates have come a long way

Facing sky-high inflation pressures and a tight labour market, the RBNZ has hiked the OCR by 525bps since late 2021. Annual inflation has stopped accelerating but is proving stubbornly difficult in getting back into the 1-3% target, hovering around the 7% mark. The Bank has been prepared to 'look through' recent volatility in financial markets in the US and keep the focus on inflation. Indeed, the RBNZ surprised economists by hiking the OCR a full 50bps in April, before signalling a pause after a subsequent 25bps hike in May.

Central Bank Policy Rates Around the World



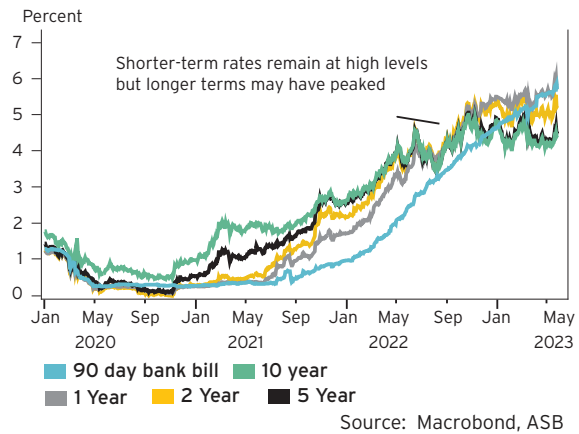
Downside risks are building

Given the degree of tightening that has taken place, speculation around when the Bank may start cutting is reaching fever pitch. The environment is extremely uncertain, but downside risks to the inflation outlook may be building. Net migration is picking up fast, and with economic growth slowing, demand for labour is likely to soften too. That should push the unemployment rate up and help cool wage pressures. Still, the risks aren't entirely one way, with those stronger migration figures also threatening to boost consumer spending and slow the descent of inflationary pressures. Our forecasts see the RBNZ cutting the OCR in mid-2024, with the cash rate trending to 3% by 2025. Financial markets are a bit more aggressive, with 100bps of cuts priced by this time next year.

The long and the short of it

In lifting the OCR, the RBNZ's goal has been to push up wholesale interest rates (swap rates), a key driver of bank funding costs. But volatility in financial markets stemming from a handful of bank failures in the US has put downward pressure on global yields over recent weeks; the NZ 2-year swap rate initially fell as much as 75 bps from its early March peak. The RBNZ's 50bps April hike was in part aimed at propping up wholesale yields lest they fall further and flow through into lower mortgage and business borrowing rates.

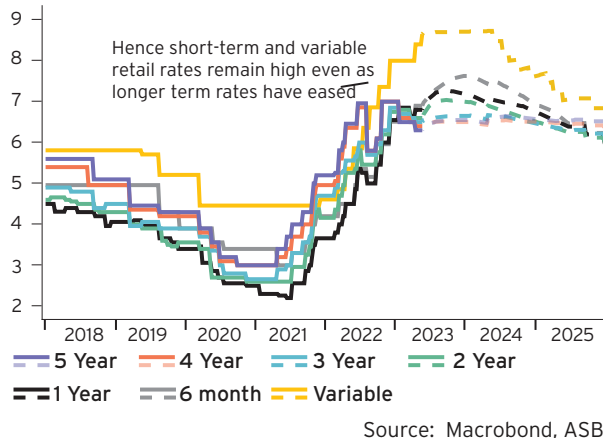
Wholesale NZ Interest Rates



What it all means for lending rates

The inversion in swap yields means that longer-term business and mortgage rates are generally below shorter terms. Longer term business and mortgage rates have eased off their peaks, but short term rates are likely to remain supported. We expect mortgage rates to begin easing from the latter half of 2024 as the economy slows and OCR cuts become an increasingly imminent. Still, given the size of recent mortgage increases, it would take a much sharper slowdown than we expect for rates to reach the lows they hovered around over the course of 2020 and most of 2021.

ASB Home Loan Rates



Currency

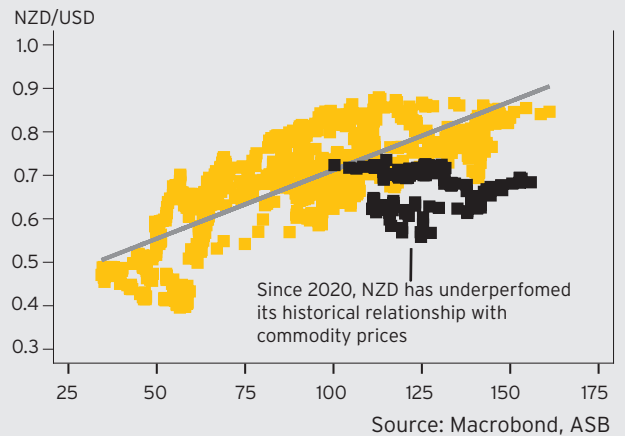


A flightless bird

It's been an unusual commodity cycle

Typically, the NZD has a strong relationship with commodity prices, with the Kiwi rising when agricultural commodities lift and vice versa. What's unusual about the past year or so is the breakdown in that relationship: the NZD didn't rise as high as we would have expected when agricultural prices were at their peak, and it's subsequently fallen more than we'd have expected given the more modest easing in commodity prices. The NZD spot rate continues to underperform our medium-term 'fair-value' model by a wide margin.

NZD/USD versus USD Dairy Indices
Black Dots Represent NZD performance from 2021 onwards



Two 'R's have capped NZD

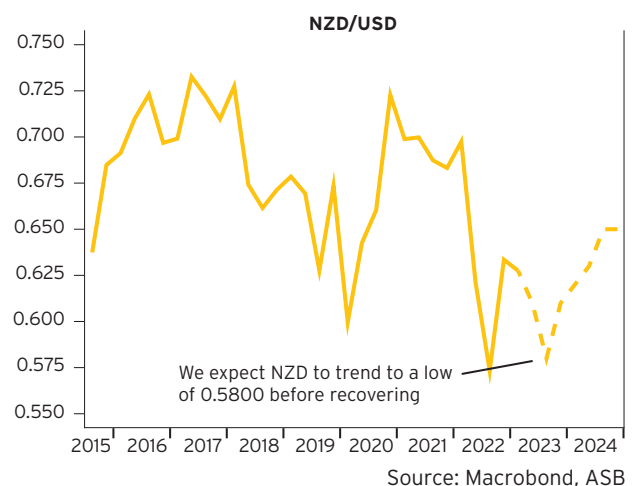
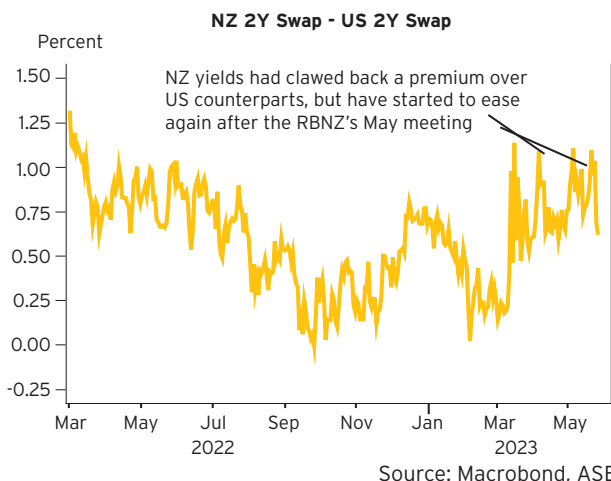
NZD's underperformance has two key drivers: risk and rates. Financial markets have been fractious given expectations that global growth will slow markedly this year. As a risk-sensitive currency, NZD usually depreciates when risk aversion is heightened. Meanwhile, aggressive signalling by the Federal Reserve has also pushed up US interest rates relative to those in NZ, helping support USD against the Kiwi.

Stable on the surface, movement below

NZD has begun 2023 still looking subdued, but stable. For most of the last three months it's traded in a narrow band of circa 2½cents around 0.6100-0.6360. That may be because the Kiwi's various drivers have shifted in opposite directions: relative interest rates have clawed back ground in NZD's favour, but commodity prices are easing, NZ's current account deficit has ballooned and risk sentiment remains mixed. The RBNZ's decision to hike the OCR by 'only' 25bps looks to have broken the balance, with relative interest rates shifting in NZD's disfavour and the Kiwi falling below 0.6100.

Lower from here

We're sceptical that the NZD and commodity prices will continue to decouple, with a decelerating global economy carrying clear risks for both. Broadly speaking, we expect the NZD to lose further ground over 2023, hitting a trough around 0.5800 in Q3. Most obviously, the prospect of recessions both in NZ and globally is a clear negative for risk sensitive currencies like NZD. The Fed's hawkishness relative to other central banks may also support USD. A weaker Kiwi should help offset some of the impact of lower commodity prices this year. It's a two-way street though - if global growth holds up better than we expect and commodity prices outperform, the NZD is likely to fare better accordingly given their historical relationship.



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