RESEARCH
ECONOMY WATCH

3 December 2018

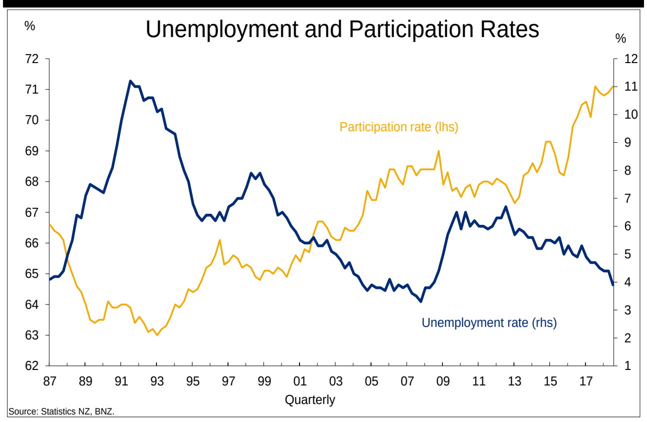
Activity Defying Confidence

- **Business, farmer confidence measures negative**
- **But actual activity, employment, production is up**
- **More milk is pushing dairy prices down**
- **We lower our 2018/19 milk price forecast to $6**
- **Lamb price forecast nudged higher to $7.50**
- **Watching many risks**

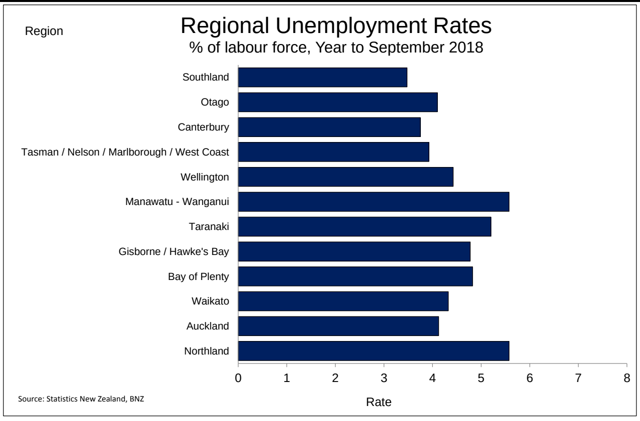
Business confidence is stuck in the mud. For one reason or another, businesses appear gloomy about the outlook for the economy and have been for some time, according to the various surveys covering such things. Meanwhile, the hard economic data shows the economy tracking along at a reasonable pace. It's a similar story in agriculture – confidence measures low, but actual activity indicators positive.

For the economy, one needs to look no further than the labour market to see signs that it is defying weak confidence. Labour demand is strong and employment solid. Latest figures show that there were 73,000, or 2.8%, more people employed in the three months to September compared to the same period last year. That's strong growth, even if it has slowed a bit over the past couple of years. It is certainly strong enough to see unemployment continue to track downwards. Indeed, the unemployment rate has lurched down to 3.9% in the latest quarter; its lowest level in 10 years. Such numbers can be a bit volatile quarter to quarter, but even the average unemployment rate over the past year, at 4.3%, is getting down to levels not seen since the Global Financial Crisis took its toll back in 2008/09. Moreover, strength is widespread. Nearly all major regions have an unemployment rate below their respective 10 year average.

Labour Market Is Tight



Lower Than Normal

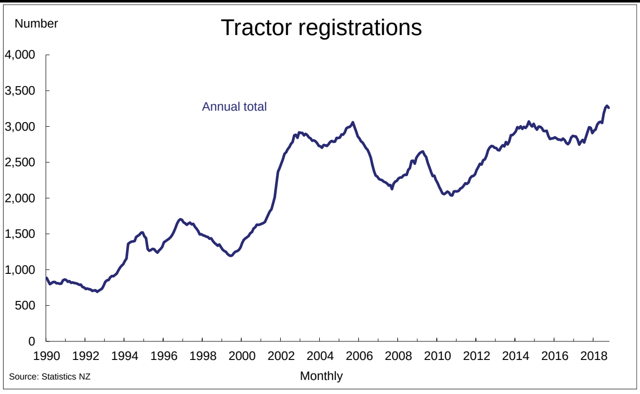


This is clearly positive economic news. But it does come with the drawback of making staff very difficult to find, right across the skills spectrum. Many businesses are expressing difficulty in finding labour. This certainly applies to those farmers looking to take on more people. A recent Federated Farmers survey found a net 37% of farmers said recruiting skilled and motivated staff was difficult. This is the most widespread difficulty farmers have had finding appropriate labour in at least 9 years (when the survey stated). While challenging, it is not surprising given the prevailing conditions of the wider labour market with its low unemployment rate and its record high labour market participation.

There is a similar pattern in agriculture with low confidence but buoyant activity. Farmer confidence has been weak (although not universally so). Some of this relates to government with concern around regulation, compliance costs, and policy uncertainty. But there are other factors like profitability coming under pressure from rising costs or disease outbreaks like Mycoplasma bovis or the fickle weather including the threat of an El Nino weather pattern over coming months or concern around Brexit outcomes or US-China trade tensions.

But, just like in the broader economy, rural activity data continue to show decent expansion despite weak confidence. Take recent milk and meat production for instance, both are up around 6% on a year ago. There is nothing quite like decent grass growth on the back of generally very good weather conditions to kick things along in that regard.

Chugging Higher



It is not just production proving robust. Other indicators have shown backbone too. For example, there were 3,262 tractor registrations in the year to October. This is up 9% on the same period a year ago, taking tractor registrations to their highest level since 1977.

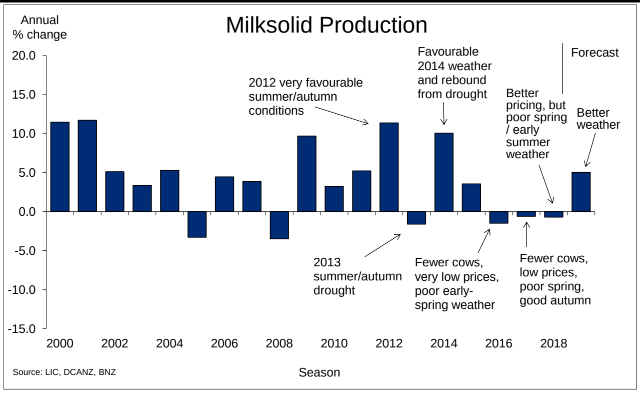
There are a few possible drivers of solid farm spending indicators, even though confidence has been on the weak side. One is generally buoyant primary product pricing over recent times, with particular and ongoing strength in lamb and venison. Beef prices had been good over recent seasons, but have pulled back of late while milk prices have been reasonable although the outlook has faded during this season. Farmers may have been encouraged to buy imported capital equipment sooner rather than later while cashflows were solid and ahead of price hike risk as the NZD generally declined through 2018. Low interest rates might have helped at the margin. Of course, low confidence may ultimately weigh on investment, spending, and activity ahead. But, for now at least, there are at least a few indicators suggesting activity is tracking along ok.

More milk, lower price

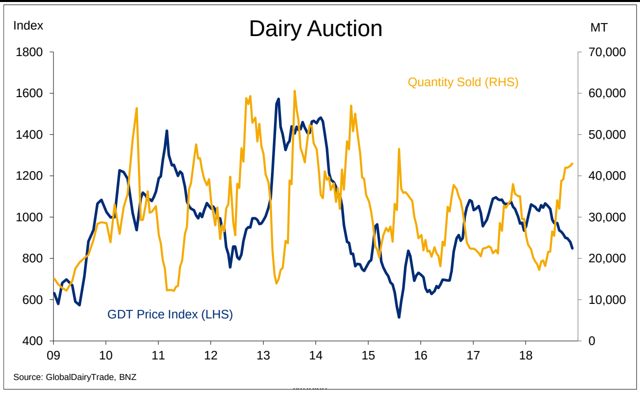
One of the downsides of the stellar run up to peak milk production in October this year is that it has put downward pressure on dairy prices.

NZ milk production in October was 6.5% higher than a year ago, lifting production for the season-to-date 6.0% above the same period last year. The increase has been stronger than we anticipated and sees us lifting our forecast for milk production growth for the season as a whole up to 5% (from 2% previously). This would see milk production easily reach an all-time high, surpassing the previous peak in 2014/15. The weather has been generally favourable, although not without incident with too much rain recently causing flooding in parts of the bottom half of the South Island. Somewhat perversely we continue to monitor the risk of an El Nino weather pattern, although NIWA suggests weather patterns may differ from what is normal under El Nino. It's still worth watching even if recent rainfall will keep pastures going into the New Year. Ongoing favourable weather could easily see more milk production than forecast.

More Milk Reflecting Growing Conditions



Supply Up, Prices Down



Global dairy prices have been trending lower at the GDT auctions, as initially more milk out of the EU and latterly out of NZ pressured prices lower. Recent equity market wobbles and slower economic growth indicators out of China as US-Chinese trade tensions persist has not helped perceptions of demand. Meanwhile, a major slump in crude oil prices since early October is unhelpful for dairy prices. The GDT Price Index has yet to record an increase this season. The cumulative fall from the start of the season is a touch over 20%. For domestic milk prices, a generally lower NZD has been a support but not enough to offset the reduction in international prices and even less so given the currency has pushed higher over the past month.

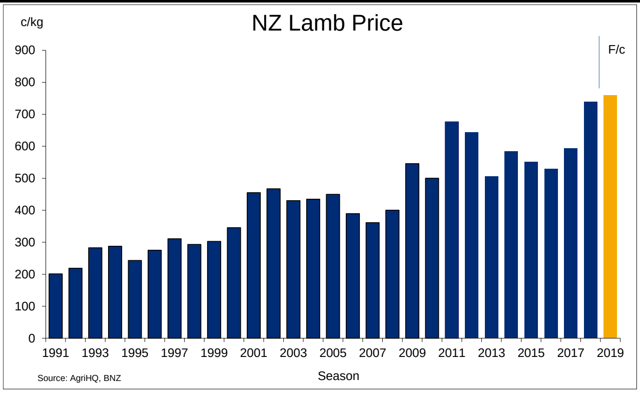
All considered, we nudge our 2018/19 milk price forecast down to $6.00 (from $6.30). This view includes some improvement in international prices over the remainder of the season. If that improvement were not to occur or especially if international prices were to continue falling, milk prices will likely end up lower than we currently think. Such a scenario would likely see a milk price under $6. The downside risk is easy to see.

On the other hand, some price support is possible with NZ milk production now past its peak, Australian production lower than a year ago, and EU production growth slowing. Indeed, EU milk production slipped just below year earlier levels in September. Expected slower milk production in the EU is a key reason why we think international dairy prices will improve over coming months. The EU skimmilk powder stock rundown is also expected to see downward price pressure fade over time. The NZX futures market shows higher prices ahead across the major dairy products, not that that ensures prices will actually track higher. At this point, we see $6.00 as sitting in the middle of a still wide range of possible outcomes by season's end. It suggests downside risk to Fonterra's current forecast range of $6.25 to $6.50. That is not to say that something in that range cannot be achieved. But we think it would require a decent rise in international prices from here, a much lower NZD, costs to fall, or the achievement of better-than-GDT prices for sales outside of that platform, or some combination of the above. Fonterra is due to provide a forecast update at its business update on 6 December. Market tone will also be influenced by the next GDT auction out the day before.

Better Lamb

Meanwhile, the lamb market is going from strength to strength. This has increased the chance that this season's average operating prices will come in higher than last season's $7.40/kg. Sure, prices are likely to ease on a seasonal basis over coming months, as more of the new season's lambs come forward, but the general tightness in supply and ongoing strong demand from China (despite slower economic growth indicators there) has been keeping prices above last year's already strong levels. We forecast $7.60 for 2018/19. Brexit remains a wildcard, as discussions continue with the current exit deadline in March fast approaching. A major slump in oil prices over the past month or so will not help lamb demand from oil producing countries.

Lamb Price Strength Persists



World watching

Overall prices for NZ's major primary export products have eased off their recent highs as supply increases in some areas and general demand cools with the outlook for global economic growth. The latter partly relates to the removal of monetary stimulus following economic recovery, led by interest rates hikes by the US Fed. The Fed doesn't want to hike too fast and unnecessarily choke the recovery, nor does it want to go too slow and risk overheating the economy. It's a difficult balance. And there are other (not necessarily unrelated) risks to monitor such as, US-Chinese trade tensions and its potential to dent world economic growth more than it already has, slower growth in China, wobbly equity markets, and Brexit whenever and however that actually occurs. The downside risks are obvious, although it need not necessarily turn out that way. US-China trade tensions could ease and an acceptable Brexit deal may get passed. Also, there is positive news in the recent ratification of the CPTPP trade deal set to bring tariff reductions as soon as the end of this year, kicking off the benefits that officials estimate has the potential to ultimately deliver $222m per year in tariff savings for New Zealand once the deal is fully implemented over coming years.

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