24 January 2019

Food Prices In An Uncertain World

- World economy slowing
- But forecast strong enough to see primary product prices flat to up this year, helped by supply tightness
- We lift our 2018/19 milk price forecast to $6.25
- China outlook increasingly important
- Brexit deadline looms
- CPTTP a positive, amid a myriad of risks

World economic growth is slowing with concerns that it might turn into a slump. This raises downside risks to NZ's primary product prices. We expect further deceleration in the world economy, but not a deep downturn. Uncertainty indicators are very high. If the world economy can hold together well enough, NZ's product prices are expected to be flat to up this year on average aided by pockets of supply side tightness.

There has been plenty happening offshore with potential influence on NZ primary export prices. For example, over recent months there has been a material drop in oil prices then a bounce, global equity markets have gone wobbly, Chinese growth indicators have eased, US-China trade tensions remain, and the Brexit deadline looms. We take a brief look at these developments and what they might mean for the NZ primary sector in 2019.

Oil and food

Brent crude oil prices hit a peak of over $US86/bbl in early October, before sliding to almost $US50/bbl just before Christmas. Prices have subsequently bounced to currently sit around $US61/bbl. Such moves can matter for NZ and not just for the strong influence they exert on domestic fuel prices, but also through the relationship with food prices.

Food and oil prices are positively correlated. The chart (opposite) shows the relationship between the UN's global food price index and Brent crude prices. It is not one for one by any stretch, but a positive association is clear enough.

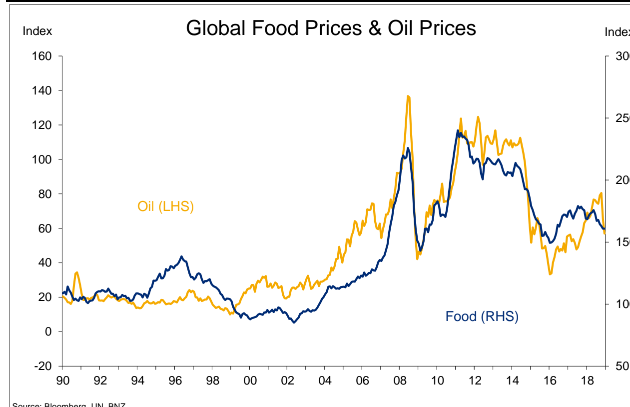
We think there are at least five factors behind the close relationship between oil and food prices.

1. Many of the individual items tend to be traded in US dollars, so these prices can move when the value of the US dollar itself moves.
2. Oil is an input to farming such that if prices rise the higher costs can restrict output ultimately pushing food prices higher and vice versa when oil falls.
3. Higher oil prices can drive up ethanol prices, which, in turn, can lift corn prices (as a significant feedstock to ethanol in the US) and vice versa. This direct influence on food prices is extended as changes in feed costs affect livestock related food production.
4. Derived demand – changes in oil prices influence oil producers' ability to pay for imported food (although this can be offset by movements in oil consumers' ability to pay).
5. Both food and oil prices are influenced by world demand and hence the cycle in global economic growth.

Oil prices up at $US86/bbl back in early October were getting stretched relative to food prices at the time. The oil price drop to around $US61/bbl now brings oil prices back in line rather than necessarily creating additional downside risk to food prices from here. Indeed, looking at the long term ratio of food prices to oil prices, food prices even look a touch on the low side.

Interestingly, the drop in oil prices from October to Christmas and then the bounce in January have had a rather limited influence on other commodity prices over the period. This suggests the moves have been largely due to oil industry specific factors. First a large increase in supply (including out of the US) weighed on prices. Then, expected OPEC cuts helped support prices. All, no doubt, mixed in with a fair dose of speculative spirits for good measure. The idea that the dive in oil prices has been driven by factors specific to that industry rather than, say, a signal that world demand has slumped, is important from a NZ perspective. It suggests world food demand has not fallen anything like the drop in oil prices might have implied at face value. That's a good thing.

Oil and Food Prices Closely Connected, But Not Always



Slower world economic growth

This is not to say that world economic growth indicators have not slowed in 2018. They have, as one would expect given global monetary policy has become less loose, the Chinese government's attempt to create a more balanced dynamic for its economy (less debt-financed growth), and as the drag from US-China trade tensions takes effect.

Global equity markets have been rattled. Early in 2018, markets fell on the back of rising US interest rates which actually had a positive aspect of being driven by stronger economic growth back then. But over recent months, market declines look more associated with concerns about the global growth outlook. The US-China trade tensions are front of mind for many with associated restraint on activity. A sharp slowdown in Europe and the looming Brexit deadline are not helping sentiment either. It all put markets on edge. The US S&P500 equity index fell as much as 20% from its October peak to Christmas, before bouncing to now only be down around 10%. Financial markets have 'priced in' a fair amount of bad news.

Food Prices Outperforming Oil and Equities

	Unit	Late Sep 18	Late Jan 19	Sep to Jan % change
S&P 500	Index	2914	2636	-9.5
Dow Jones Ind	Index	26458	24560	-7.2
FTSE 100	Index	7510	6843	-8.9
ASX 200	Index	6208	5844	-5.9
NZX50	Index	9351	9106	-2.6
Oil (Brent crude)	USD/bbl	83	61	-25.9
Lamb, UK leg	UKp/lb	209	209	0.0
Lamb, US french rack	USc/lb	1070	1050	-1.9
Beef	USc/lb	192	210	9.4
Dairy (GDT)	Index	917	945	3.1
Corn (US)	USc/bsh	356	379	6.4
Wheat (US)	USc/bsh	509	526	3.3
NZD/USD		0.662	0.679	2.6

The world economy certainly looks to be at an interesting juncture. It is slowing. The open questions are how far and how fast? We expect further slowing in global growth through 2019 which will be a headwind for primary product prices. This shouldn't really be a surprise after such a long period of expansion. But we do not back the view of some that a deep downturn is imminent. Some agreement between the US and China on trade over coming months is possible, which would help lift the general mood and outlook. So too would policy stimulus from Chinese authorities with some already appearing. The pricing out of further US Fed interest rate hikes has already also lifted market sentiment in the New Year.

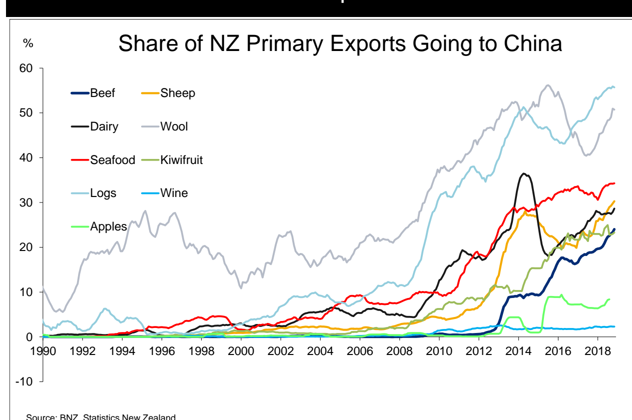
Of course, a US recession, or significant global economic slowdown, if it were to occur, would be materially negative for primary product prices (and the NZD). While we continue to monitor the risks of such, that outcome is not our central forecast.

China's important

For now demand for NZ's primary products has been holding up well, underpinned by China. This is highlighted by China's market share rising for nearly all of NZ's major primary export products over the past 12 months. This is despite a cooling in China's macroeconomic indicators. It suggests that the positive structural forces of food demand in China have been outweighing cyclical economic softness. We expect more of the same in 2019, assuming further slowing in Chinese economic growth is orderly.

China's market share of NZ's primary exports is material. For agricultural and forestry products overall, China accounts for around 28% of NZ exports. It raises the issue of concentration risk. It's not nearly as much concentration as NZ ran with the UK prior to the 1970s, but it's not insignificant. Of course, this doesn't mean NZ shouldn't sell more produce to China just because it already sells a lot there. But it does pay to be aware of the rising concentration and potential fallout if conditions were to deteriorate rapidly in that market and plan accordingly.

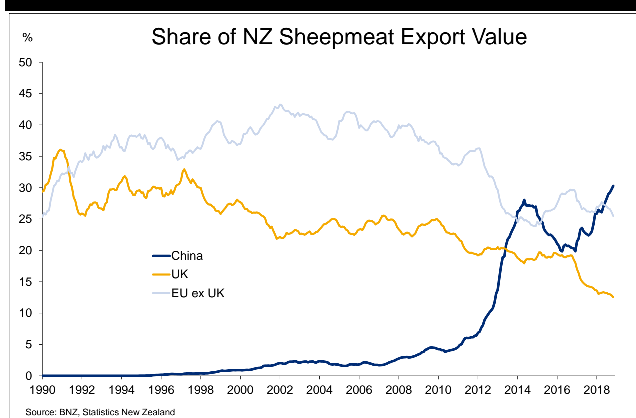
China's Market Share of NZ Exports Continues to Grow



Meat has seen some of the biggest Chinese market share changes over recent times, including last year. China now takes 30% of NZ's sheepmeat exports and 24% of beef exports. Ten years ago these shares were 3.2% and 0.1% respectively. Most recently, African Swine Fever in China may have generated extra demand for imported meats including beef and lamb, as consumers look to replace any shortfall in domestic pork supplies.

Gains in China's market share for NZ sheepmeat has also coincided with the UK's share dipping sharply post the June 2016 Brexit vote. The EU's share has drifted lower. Of course what happens to NZ's 228,000+ tonne European sheepmeat quota is one important aspect to watch when, or if, actual Brexit occurs. At least maintaining current market access to the individual UK and EU markets could prove important if the Chinese market were to stumble.

Major Market Shares of NZ Sheepmeat Exports



Despite all the trials and tribulations lurking offshore, it is important to recognise that not all is negative and uncertain on the international trading front. Indeed, the CPTTP has just come into force. Officials estimate that this has the potential to ultimately deliver $222m per year in tariff savings for New Zealand once the deal is fully implemented over coming years. And the Government is looking to advance negotiations with the EU and RCEP group of countries, while also making progress with upgrading the existing trade deal with China.

Supply side tightness

Meanwhile, there are some signs of tightening supply for some key sectors that are expected to support prices in 2019. Dairy is an example. Stalled EU milk production and a rapid unwind in EU skimmilk powder stocks, slowing US milk production growth, and shrinking Australian milk supply bode well for some price improvement. Global dairy prices have already shown some bounce despite a very strong NZ milk season to date. The 11% lift in auction prices over the past four auctions has been a touch more than we had previously forecast and also a bit earlier than anticipated. Solid demand as well as constrained supply appears to have been in play. Reflecting these recent moves, we tweak our 2018/19 milk price forecast upwards to $6.25 from $6.00. This includes some further dairy product price gains over coming months.

Sheepmeat supply also looks tight beyond this season's peak. It is difficult to see a quick lift in NZ lamb supply in the year or two ahead given low breeding ewe numbers and a record lambing percentage this season. Meanwhile, dry conditions saw elevated sheep and lamb slaughter in Australia last year which will limit supply ahead when flock rebuilding occurs. These supply side factors should offer price support in the respective areas.

Price outlook

Pulling it all together, we expect world prices for NZ's major primary export products to be flat to mildly higher in 2019 albeit with variation across individual products. We expect something similar for prices in NZ dollars, given the benign outlook we have for NZD.

The clear downside risk to this view is ongoing disturbance in global financial markets foretelling of a sharper world economic slowdown than currently anticipated. This would most likely see softer international pricing, although the NZ dollar would be expected to weaken and soften the blow to domestic farmers in that scenario. But assuming an orderly economic slowing offshore, we see the combined positives of structurally improving food demand in China and some supply tightness as enough to generate some price improvement. There will also be some initial benefits from the CPTPP trade pact filtering through this year.

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Outlook for Borrowers

- **There have been several key market developments over the holiday season.**
- **These include: the RBNZ has proposed to significantly increase capital requirements for NZ banks; the US Federal Reserve has signalled "patience" and there is a good chance the US tightening cycle is complete; the global growth outlook has deteriorated.**
- **Compared to November, these factors point towards a later start date to OCR hikes and less upward pressure on longer-term NZ rates.**
- **We still think OCR cuts are unlikely, given the labour market remains extremely tight and core inflation is gradually increasing to target.**
- **We think the most likely outcome is that NZ wholesale fixed rates are relatively stable for most of the year amidst an unchanged OCR. There are scenarios where wholesale fixed rates are higher and lower.**
- **Short-term wholesale fixed rates are close to the 90 day rate, and are attractive for hedging based on our view the OCR is not cut. Compared to November, we're less convinced longer-term fixed rates will move higher this year, but given they are near record-low levels, borrowers may want to consider dips to put on hedges.**

Summary of Developments since November

Since the November Borrowers Update, there have been substantial declines in wholesale fixed rates. Short-term wholesale fixed rates declined to their lowest levels on record a few weeks back, while longer-term fixed rates have fallen to within vicinity of record lows. The market has reverted to pricing an almost 50% chance of an OCR cut by the end of 2019 (see chart).

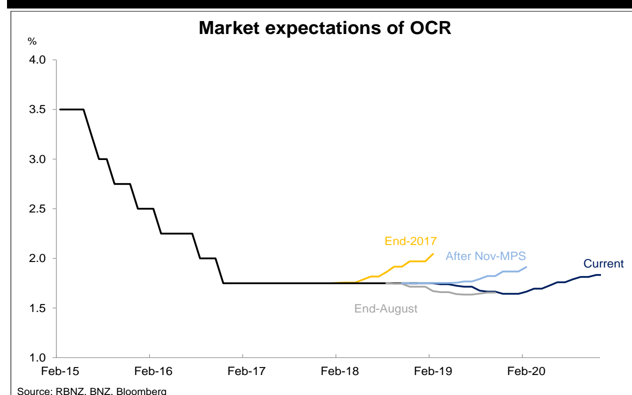
There have been a number of important developments that have taken place over the past two months, both domestically and offshore, which have driven these market movements.

1. RBNZ proposes higher capital for banks

Domestically, the key event has been the RBNZ's proposal that NZ banks should significantly increase their capital.[1] Banks hold capital to protect against the risk of losses on the loans they make. If banks don't hold enough capital, an economic downturn could cause losses severe enough to cause a bank to fail, putting peoples' deposits at risk.

The RBNZ has proposed a significant increase to the minimum amount of capital that NZ banks hold, in order to reduce the risk of bank failure. The changes are proposed to take place over a five year period, over which time the RBNZ envisages that the big NZ banks might retain their profits to increase their capital levels (rather than paying profits out as dividends to shareholders).

The market is back to pricing rate cuts into the NZ curve



Banks raise funds in two ways – through debt (including wholesale funding and deposits) and equity (including retained earnings and issuing shares to investors). Equity is the most expensive way for banks to raise funds, as it is more risky for investors than debt. The RBNZ's proposal to increase the proportion of equity that banks use to fund themselves is therefore likely to increase the costs to banks to provide credit (i.e. make loans) to the economy.

The RBNZ said it expects only a minor change to borrowing rates for banks' customers, possibly because it expects shareholders to accept lower returns on their investments in NZ banks. However, if banks sought to maintain their margins, it raises the risk that they might pass on their higher average cost of funding to borrowers, in the form of higher lending rates.

It is this latter scenario which has possible implications for the OCR. If banks increased lending rates to the real economy independent of the OCR, the RBNZ wouldn't need to tighten the OCR by as much, and it could, in principle, even consider cutting the OCR to offset it.

The actual impact on the OCR outlook depends on the final form of the capital requirements (the RBNZ will announce its decision by the end of June) and the reaction of the banks (how much, if any, of the cost increase they pass on to borrowers and over what time period). There is considerable uncertainty around the magnitude of the impact on lending rates, but the direction is likely to be upwards.

The RBNZ proposes that the capital changes are phased in over a five year period and broader macroeconomic

[1] Interested borrowers can read more on our preliminary thoughts here. The RBNZ's non-technical summary also contains an overview of the proposal.

developments are likely to still be the major driver of the OCR over this time. But, realistically, the uncertainty around the impact of higher bank capital requirements is likely to increase the hurdle for OCR hikes this year.

2. Federal Reserve signals "patience" with monetary policy

December saw significant volatility in global financial markets. The S&P500 fell 15% between the start of December and Christmas eve. Even after a recovery over the remainder of the month, December ended up being the worst month for US equities since Lehman Brothers collapsed in October 2008. In another sign of broader jitters, the spread between yields on corporate bonds and US Treasuries reached their widest levels since 2016.

The sharp market movements reflected investor concerns about slowing growth in Europe and China and increased speculation that the US economy could fall into recession in late-2019 or 2020. The Federal Reserve hiked its cash rate to 2.5% in mid-December, but the subsequent tightening in financial conditions and some signs of slowing in US economic data has seen Fed officials switch to more dovish rhetoric. Chair Powell has said muted US inflation gives the Fed scope to be "patient" as it watches how the economy evolves this year.

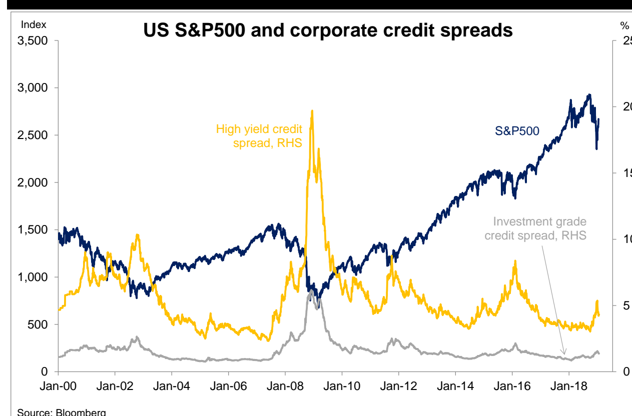
The Fed is highly likely to be on hold in the first half of this year. With US growth set to slow later this year, we think there is a good chance that the Fed's tightening cycle is now complete. A resumption of rate hikes is still possible, but is likely to require an increase in US inflation pressure, above target, and there are few signs of that as yet.

The market now expects the Fed to be on hold this year and prices a 50% chance of a rate cut by the end of 2020. We now expect the US 10 year rate to be contained within a 2.50% to 3% range for most of this year. The upside to the US 10 year is likely to be capped in an environment where the hurdle for Fed hikes is high. But conversely, if the Fed is done with its tightening cycle, the risk of a policy mistake (i.e. the Fed "overtightening" and a US recession) is reduced; this should limit the scope for US yields to fall sharply from here. We think the risk of a US recession over the coming few years is still quite modest.

3. NZ data mixed, but RBNZ unlikely to move in a hawkish direction any time soon

At the end of November, we pushed back, and reduced the extent of, OCR tightening built into our forecasts. We remarked at the time that the RBNZ was displaying a very real reluctance to even suggest interest rates might rise. Broader macro developments since then have been mixed. On the one hand, NZ non-tradables inflation surprised on the upside which, taken in conjunction with the extreme tightness in the labour market, suggests

Financial conditions tightened sharply at the end of 2018



domestic inflationary pressures are building. On the other hand, global growth expectations have been marked down and the risks from offshore have risen. That's an environment where central banks globally, including in NZ, are likely to be more cautious about raising rates. We forecast two rate rises, starting in November, although the risks are to a later start date.

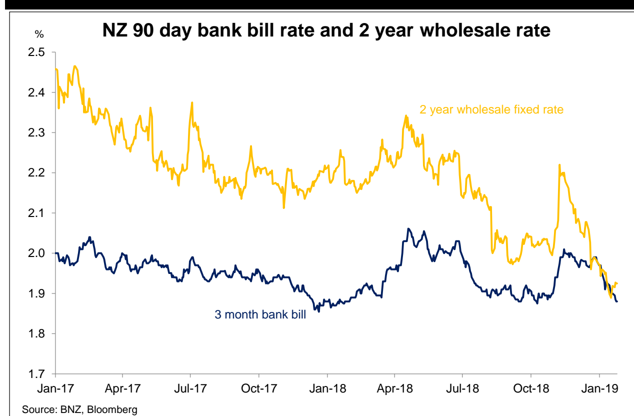
While the NZ unemployment rate is sub 4% and core inflation is not far from the 2% midpoint, which would usually argue for rate hikes, it's hard to see a catalyst for the RBNZ shifting in a hawkish direction any time soon, especially in an environment of heightened market volatility and concerns around global growth. Additionally, the uncertainty around what that the RBNZ's proposed increase to bank capital might mean for mortgage and business lending rates is another factor that argues for the RBNZ keeping rates on hold for some time.

Short-Dated Wholesale Fixed Rates (1-3 yr)

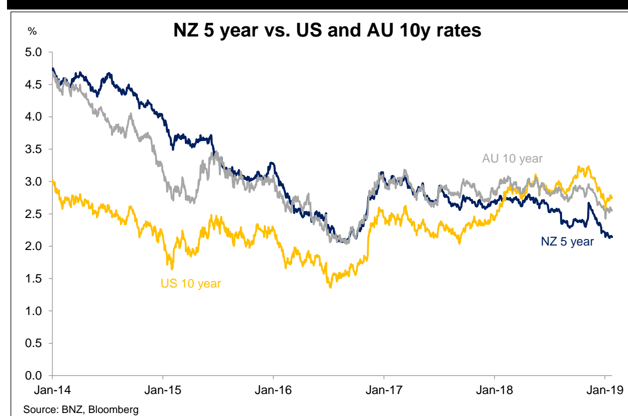
Short-term wholesale fixed rates have declined to record low levels this year. There have been two drivers of this. First, OCR expectations have declined, with the market now pricing a 50% chance of an OCR cut and only a very gradual pace of rate hikes from 2020 onwards. Second, the 90 day bank bill rate has declined this year (over and above the change in OCR expectations), putting further downward pressure on short-term wholesale rates.

The 2 year wholesale fixed rate is now at similar levels to the 90 day bank bill rate, implying that there is little "cost" to hedging for short-terms. If the next move in the OCR is a hike, then wholesale fixed rates at current levels present an attractive, low-cost opportunity to put on short-term hedge cover. Short-term fixed rate hedges also provide protection against any potential rise in the 90 day rate independent of the OCR outlook, for instance if pressures on bank funding were to emerge.

2 year wholesale fixed rate reached record low levels



NZ longer-term fixed rates are also near record-low levels



Clearly, if the RBNZ were to cut rates over the next few years, then borrowers would be better off sticking to floating rate exposure. In our view, it would likely take a material deterioration in the global economy to trigger RBNZ rate cuts this year. Admittedly, offshore risks have risen, but we still view OCR cuts as unlikely, given the NZ economy is basically at "full employment" (not a situation central banks would usually consider rate cuts) and underlying inflation is gradually moving towards target.

Longer-Dated Wholesale Fixed Rates (5-10 yr)

The two major influences on longer-term wholesale fixed rates are the expected path of the OCR and movements in global longer-term yields. The fall in NZ longer-term fixed rates over the past few months has been similar to that seen in the US and Australia, suggesting global factors have been at play (see chart).

We have had a consistent view over the past 12 months that the Federal Reserve would hike by more than that priced-in by the market and this would push US rates higher. This trend towards higher US rates played out through much of 2018, with the US 10 year rate hitting a high of 3.25% in November. But the recent change in tone from Federal Reserve officials and likely slowing in US growth later this year (as the Trump fiscal stimulus wanes) means we have revised our outlook lower, and we now expect the US 10 year rate to go broadly sideways this year. This removes one potential source of upside impetus for NZ longer-term wholesale fixed rates.

Of course, this doesn't preclude NZ rates moving higher, independent of US rates. But it puts more onus on domestic drivers (i.e. the OCR outlook) to trigger higher NZ longer-term rates.

On that front, we have low conviction that the market will shift towards pricing a more aggressive OCR tightening cycle any time soon. First, the global outlook is more uncertain, and that's an environment where the RBNZ is likely to remain cautious. Second, the RBNZ's proposed changes to NZ bank capital requirements will linger in the background for some time. The market is unlikely to shift towards pricing rate hikes until there is more clarity on the effects of the policy. Third, longer-term NZ wholesale rates embed expectations of where the OCR will ultimately end up. If banks were to pass on higher costs to borrowers, then this would imply the RBNZ wouldn't need to raise the OCR by as much this cycle, which might in turn keep longer-term NZ rates from rising too much.

Our core view now is that NZ longer-term wholesale fixed rates will go broadly sideways this year, like US rates.

There are risks in both directions. The scenario where longer-term NZ rates move higher might involve a combination of higher NZ inflation and an easing in concerns around the global economy. It might transpire that banks don't raise mortgage and business lending rates in response to the RBNZ's bank capital proposal. Given the economy is already close to the RBNZ's twin objectives (employment is near its "maximum sustainable level" and core inflation is close to target), it's conceivable the RBNZ could shift towards a tightening bias later this year. This would generate a large increase in NZ longer-term fixed rates, in our view.

The alternative scenario involves some combination of a material downturn in the global economy, banks raising lending rates for households and businesses, and weaker NZ economic data which could prompt the RBNZ to cut rates. NZ longer-term wholesale fixed rates would fall to record-low levels.

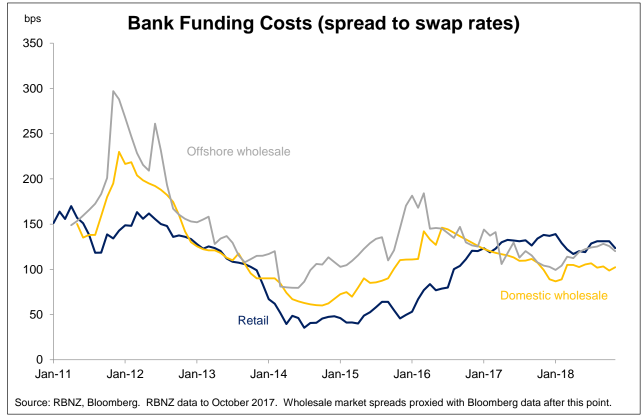
Given that longer-term wholesale fixed rates are higher than the 90 day bank bill rate, there is a "cost" to hedging for borrowers. That "cost" of hedging for longer-terms is at its lowest level since the middle of 2016. Provided the next move in the OCR is indeed a rate hike, we think longer-term hedges make sense over a multi-year horizon (even if we don't expect much movement for most of this year). Borrowers may want to consider using dips to put on hedges.

Bank Funding Costs

Most borrowers' total interest rates are constructed as a combination of wholesale rates, credit costs and bank funding costs.

There has been little change to bank funding costs over the past few months (see chart). Retail term deposit rates have been stable. The volatility in global markets has pushed up wholesale funding costs offshore for NZ banks, but this has been partially offset by a lower cost of hedging FX risk. Our estimates of bank funding costs are shown in the chart below.

Bank funding costs have remained reasonably stable



Source: RBNZ, Bloomberg. RBNZ data to October 2017. Wholesale market spreads proxied with Bloomberg data after this point.

While there hasn't been much movement over the past few months, there are potentially major changes coming in the future due to the RBNZ's bank capital proposal. The potential consequences from a bank funding perspective are:

- If NZ banks are better capitalised, they should be seen by investors as "safer". Therefore they should be able to borrow in wholesale funding markets at lower spreads.
- If NZ banks retain profits over the next five years to increase their capital levels, it implies they will have less need to use other funding channels (i.e. deposits and wholesale funding) to raise money. This might see banks reduce term deposit rates and face lower wholesale funding spreads.

In isolation, these two effects would lower bank funding costs. Working in the other direction, NZ banks would need to hold significantly more equity, or capital, and this is the most expensive form of funding available to banks. The RBNZ thinks the net effect would likely be an increase to banks' overall costs of providing credit to the real economy.

There is still a lot of uncertainty. First, the RBNZ's proposal is still being consulted on; it expects to announce the conclusion of its review by the end of June. Second, there is a five year implementation period proposed, so the effects may not be visible for some time. We will keep borrowers abreast with developments in this space.

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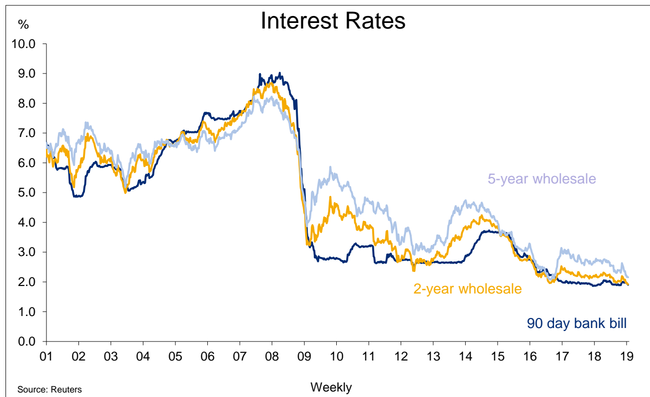
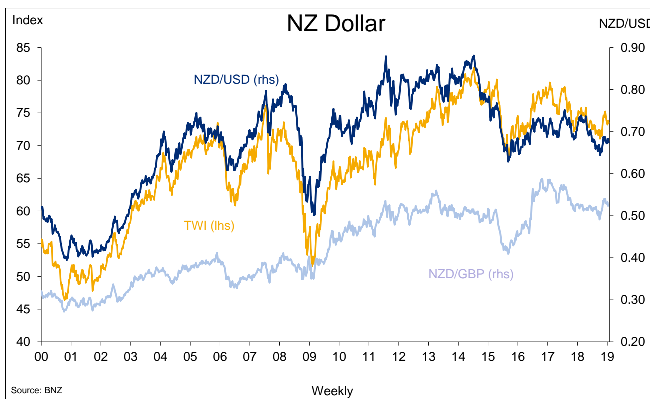
Key Macro Drivers for Commodity Producers

Interest Rates



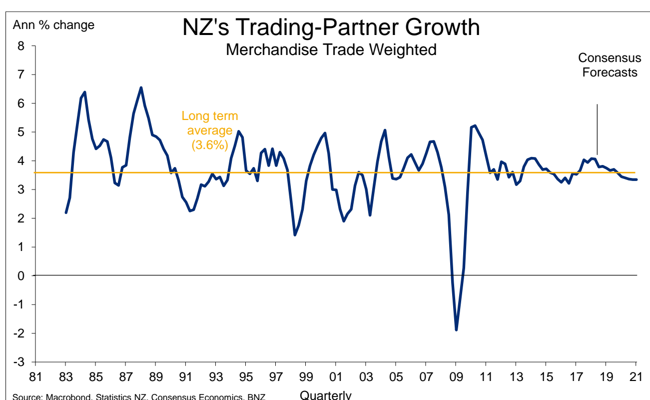
The Reserve Bank held the Official Cash Rate (OCR) steady at 1.75% at its early-November Monetary Policy Statement. The Bank reiterated its intention to keep the OCR on hold until into 2020. Since then economic growth has undershot, oil prices have declined, and the NZD outperformed. The RBNZ has also proposed lifting commercial bank capital requirements that will likely put at least some upward pressure on lending rates over coming years. Global equity markets have been wobbly. It all has encouraged the market to price in half a chance of an OCR cut this year. Arguing against a rate cut is a robust NZ labour market, rising core inflation, and firming dairy prices. We think the most likely outcome is that NZ wholesale fixed rates are relatively stable for most of the year.

Foreign Exchange



We think the odds favour the NZD to outperform last year's 5% fall against the USD. The market has already priced in a fair degree of global growth weakness. Recent data suggest a recovery in NZ's terms of trade is underway (dairy prices have improved, oil prices have fallen). Relative NZ-US monetary policy was a clear negative factor last year, which at least doesn't look like extending as the US Federal Reserve reassesses the need for further interest rate hikes. Our year-end target for 2019 remains at USD0.70. The upside scenario is one where USD structural headwinds regarding its twin deficits take hold. The downside scenario is if the US-China trade war doesn't end as we expect or our constructive view of the global economy proves to be wrong. We see NZD/GBP and NZD/EUR heading lower, but it is highly dependent on Brexit developments.

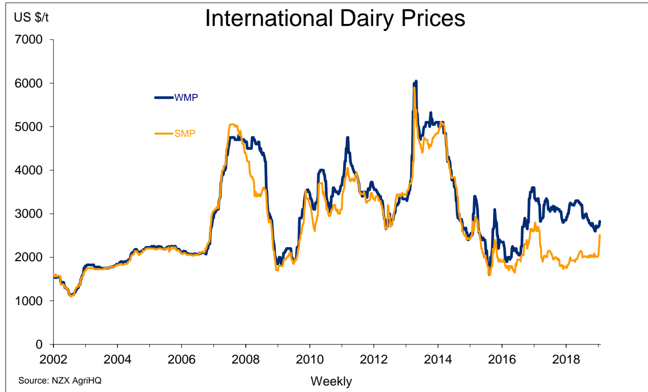
Global Growth



Global growth is slowing following global monetary policy becoming less loose, the Chinese government's attempt to create more balanced growth, and the US-China trade tensions causing some angst. A bout of equity market volatility has also cast a shadow on the outlook. We expect further slowing in global growth through 2019 which will be a headwind for primary product prices, but we do not back the view of some that a deep downturn is imminent. Some agreement between the US and China on trade over coming months, which is possible, would certainly help lift the general mood and outlook. So too would stimulus from Chinese authorities. The pricing out of further US Fed interest rate hikes has already lifted market sentiment in the New Year. Overall, New Zealand trading partner growth in calendar 2018 is expected to come in around 3.8%, before slowing to 3.6% in 2019 and 3.4% in 2020.

Key Commodities

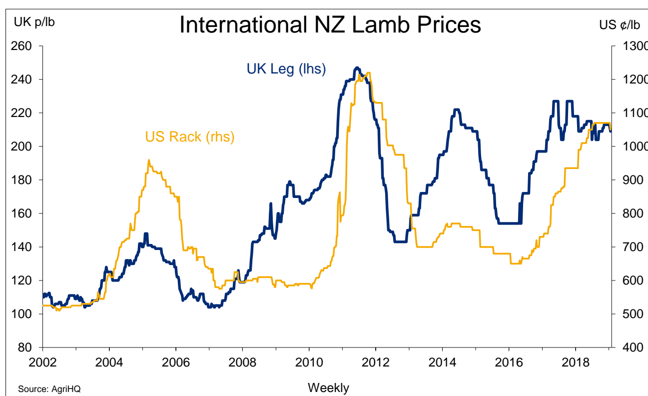
Dairy



Global dairy prices have regained their mojo with GDT prices lifting more than 11% over the four auctions to mid-January. This follows a downtrend in 2018. And it's despite strong NZ production which we expect to be up 5% on last season. Flat EU milk production and the previously massive EU stockpile of skimmilk power (SMP) rapidly depleting to zero is boosting prices. SMP prices have jumped sharply. Chinese demand has been strong. We nudge our 2018/19 milk price forecast up to $6.25 (from $6.00). This includes some further dairy product price gains offshore. There is upside risk if EU milk production continues to struggle and downside if China's economy were to slow sharply.

	Current	Month ago	Year ago	Next 12 months
Whole milk powder (US $/t)	2825	2688	3000	↑

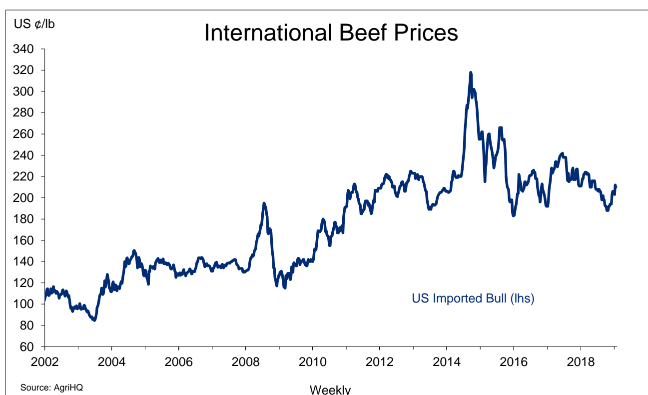
Lamb



The spring might just be coming out of lamb prices as supply tightness eases a little near term. NZ lambs will be forthcoming in volume as good growing conditions have encouraged many farmers to keep lambs on farm to date. And the Lamb Crop 2018 report from Beef+Lamb NZ showing a 0.7% drop in lamb numbers was a smaller drop than some previous estimates. But, looking over the coming year or two, supply is expected to remain relatively tight. We forecast operating prices in 2018/19 to average around $7.60/kg, a few percent higher than last season's very strong $7.40. Brexit remains a wildcard, with deadline near.

	Current	Month ago	Year ago	Next 12 months
Lamb leg (UK p/lb)	209	213	218	↓

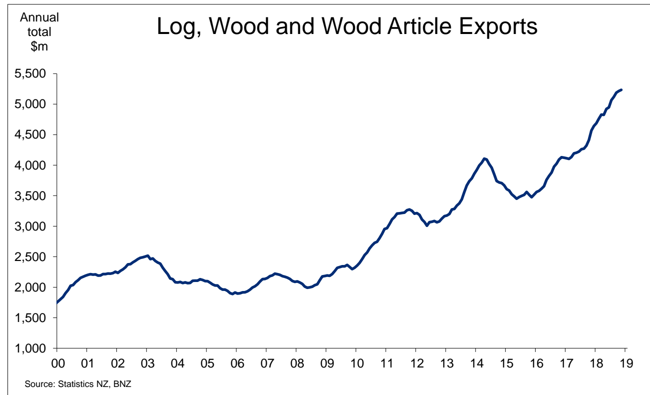
Beef



US beef prices have improved over the past month, after trending lower in 2018. A sign that demand is no longer being overwhelmed by supply. Meanwhile, Chinese demand continues to expand driving a rapid increase in its share of NZ beef exports. China now accounts for 24% of NZ's beef exports, up from 16% two years ago. Elsewhere, the CPTTP trade deal will see the benefit of lower tariff costs now filtering through. Beef prices in 2018/19 are expected to be a few percent below last season, given 2018's declines.

	Current	Month ago	Year ago	Next 12 months
Imported bull (US ¢/lb)	210	206	218	→

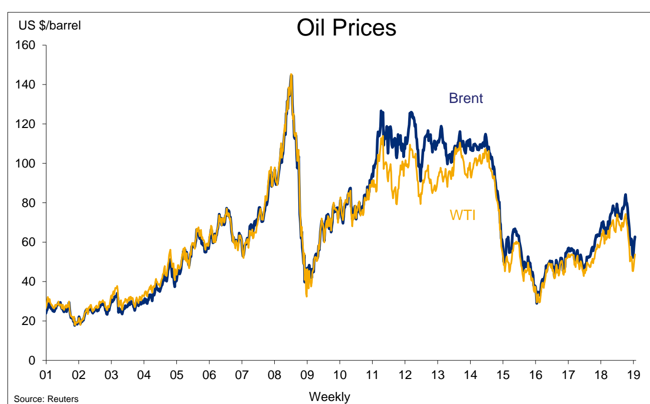
Forestry



The annual value of log, wood, and wood article exports has been a strong march higher over recent years. Indeed, at more than $5.2b in the year to November 2018, exports have lifted by more than $1b in the past two years alone. China remains the major buyer offshore and increasingly so. Growth there remains positive, but continues to slow. Some indicators suggest the slowdown is accelerating. Downward pressure on forestry prices is not a given, given reportedly low stock levels and policy loosening by Chinese authorities, but it is something to watch. Domestic construction forecasts remain buoyant.

	Current	Month ago	Year ago	Next 12 months
S1/S2 log price (NZ $/t)	137	137	129	→

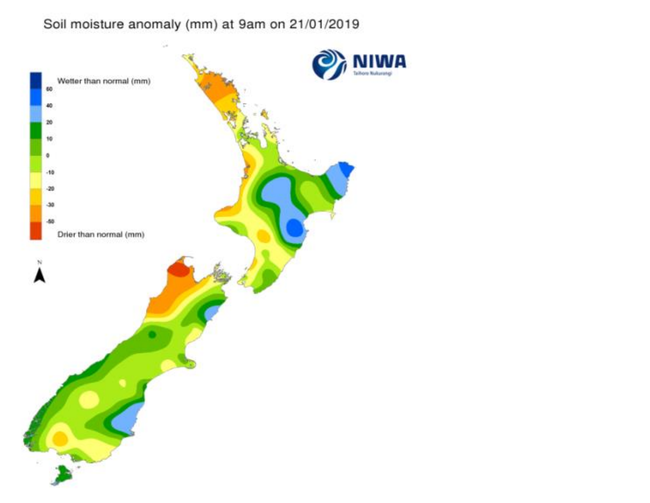
Oil



Oil prices have been on a roller coaster over recent months. After pushing above US$86/bbl in early October, Brent crude prices pushed down toward US$50/bbl just before Christmas, only to bounce back over US$60/bbl in the New Year. Concerns about oversupply drove the decline, before talk of OPEC+ production cuts offered support. The supply driven nature of the price movements and overall net decline from a few months ago is important from an NZ point of view, as it does not suggest that world demand for primary products in general has collapsed. It also removes at least some cost pressure that was getting quite intense a few months ago.

	Current	Month ago	Year ago	Next 12 months
Brent Crude (US $/b)	63	54	69	→

Soil Moisture Deficit (mm)



It's good to not be fretting about the impact of severe climatic conditions in the New Year, as seems to so often be the case at this time of the season. This is especially so given that last year's much discussed threat of El Nino hasn't developed into anything nasty. Sure there will always be pockets of the country under some pressure, but, in general, the weather gods have been kind. Certainly a lot better than last year that is for sure. Soil moisture levels are generally higher than they normally are for this time of year. NIWA forecasts near normal rainfall is likely for most regions during January to March, although the north of the North Island has about equal chances for below normal or near normal rainfall and the west of the South Island has about equal chances for above normal or near normal rainfall. It does look like anything to cause major issues for the agriculture sector as a whole.

Quarterly Forecasts

Quarterly Forecasts

Forecasts as at 24 January 2018

Key Economic Forecasts

Quarterly % change unless otherwise specified | Forecasts (Dec-18 onward)

	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
GDP (production s.a.)	0.9	0.7	0.6	1.0	0.3	0.8	0.5	0.7	0.7	0.8
Retail trade (real s.a.)	0.6	1.2	0.1	1.1	0.0	0.7	0.7	0.6	0.6	0.6
Current account (ytd, % GDP)	-2.7	-2.9	-3.0	-3.3	-3.6	-3.7	-3.4	-3.2	-3.1	-3.0
CPI (q/q)	0.5	0.1	0.5	0.4	0.9	0.1	0.3	0.5	0.7	0.1
Employment	2.0	0.5	0.6	0.6	1.1	0.0	0.6	0.5	0.4	0.4
Unemployment rate %	4.7	4.5	4.4	4.4	3.9	4.2	4.0	4.0	4.1	4.0
Avg hourly earnings (ann %)	2.0	3.1	4.0	3.3	3.6	3.7	3.4	4.1	3.6	3.8
Trading partner GDP (ann %)	4.1	3.9	4.0	4.0	3.6	3.7	3.6	3.5	3.6	3.5
CPI (y/y)	1.9	1.6	1.1	1.5	1.9	1.9	1.7	1.8	1.6	1.6
GDP (production s.a., y/y))	3.0	3.4	3.0	3.2	2.6	2.7	2.7	2.4	2.8	2.7

Interest Rates

Historical data - qtr average		Government Stock			Swaps			US Rates		Spread
Forecast data - end quarter	Cash	90 Day Bank Bills	5 Year	10 Year	2 Year	5 Year	10 Year	Libor 3 month	US 10 yr	NZ-US Ten year
2017 Dec	1.75	1.90	2.35	2.90	2.20	2.65	3.15	1.60	2.40	0.40
2018 Mar	1.75	1.90	2.40	2.95	2.20	2.70	3.20	2.20	2.85	0.10
Jun	1.75	2.00	2.35	2.90	2.25	2.70	3.15	2.35	2.90	-0.06
Sep	1.75	1.90	2.10	2.60	2.05	2.45	2.95	2.35	3.00	-0.45
Dec	1.75	1.95	2.00	2.55	2.00	2.35	2.85	2.80	2.85	-0.42
Forecasts										
2019 Mar	1.75	1.95	1.95	2.40	2.00	2.25	2.70	2.70	2.75	-0.35
Jun	1.75	1.95	2.00	2.45	2.10	2.25	2.70	3.05	2.75	-0.30
Sep	1.75	2.05	2.05	2.45	2.20	2.25	2.70	3.05	2.75	-0.30
Dec	2.00	2.30	2.10	2.50	2.30	2.30	2.75	3.30	2.75	-0.25
2020 Mar	2.25	2.45	2.20	2.55	2.45	2.30	2.75	3.55	2.75	-0.20
Jun	2.25	2.45	2.20	2.55	2.45	2.30	2.75	3.55	2.75	-0.20
Sep	2.25	2.45	2.20	2.55	2.45	2.35	2.75	3.55	2.75	-0.20
Dec	2.25	2.45	2.20	2.55	2.45	2.35	2.75	3.55	2.75	-0.20
2021 Mar	2.25	2.45	2.20	2.55	2.45	2.35	2.75	3.55	2.75	-0.20

Exchange Rates (End Period)

	USD Forecasts					NZD Forecasts					
	NZD/USD	AUD/USD	EUR/USD	GBP/USD	USD/JPY	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI-17
Current	0.68	0.71	1.14	1.31	110	0.68	0.95	0.60	0.52	74.4	73.9
Mar-19	0.68	0.71	1.17	1.35	113	0.68	0.96	0.58	0.50	76.8	74.0
Jun-19	0.67	0.70	1.18	1.40	113	0.67	0.96	0.57	0.48	75.7	72.8
Sep-19	0.69	0.73	1.20	1.43	110	0.69	0.94	0.57	0.48	75.4	72.9
Dec-19	0.70	0.75	1.23	1.45	108	0.70	0.93	0.57	0.48	75.6	73.4
Mar-20	0.70	0.76	1.24	1.46	107	0.70	0.92	0.57	0.48	74.9	72.7
Jun-20	0.71	0.77	1.25	1.47	105	0.71	0.92	0.57	0.48	74.6	73.1
Sep-20	0.72	0.78	1.28	1.48	104	0.72	0.92	0.56	0.49	74.9	73.4
Dec-20	0.73	0.79	1.30	1.50	101	0.73	0.92	0.56	0.49	73.7	73.7
Mar-21	0.72	0.78	1.30	1.50	101	0.72	0.92	0.55	0.48	72.7	73.2
Jun-21	0.72	0.77	1.32	1.52	100	0.72	0.94	0.55	0.47	72.0	73.3
						TWI Weights					
						14.0%	20.7%	10.3%	4.8%	6.8%	

Source for all tables: Statistics NZ, Bloomberg, Reuters, RBNZ, BNZ

Forecasts

Forecasts as at 24 January 2019	March Years					December Years				
	Actuals		Forecasts			Actuals		Forecasts		
	2017	2018	2019	2020	2021	2016	2017	2018	2019	2020
GDP *-* annual average % change										
Private Consumption	5.8	4.0	3.0	2.2	1.7	5.4	4.7	3.0	2.4	1.8
Government Consumption	2.1	2.8	1.6	1.3	1.7	2.0	2.9	1.9	1.2	1.7
Total Investment	3.6	4.7	2.5	3.3	3.8	4.3	3.5	3.8	2.9	3.6
Stocks - ppts cont'n to growth	0.1	-0.3	0.2	-0.1	0.0	0.2	-0.2	0.3	-0.2	0.0
GNE	4.7	3.7	3.3	2.3	2.2	4.6	3.9	3.7	2.3	2.2
Exports	1.3	3.0	4.7	4.5	3.8	2.1	1.8	4.0	5.1	3.8
Imports	5.1	7.1	5.5	3.1	2.5	3.4	6.9	6.5	3.5	2.3
Real Expenditure GDP	3.7	2.6	2.9	2.7	2.6	4.2	2.6	2.9	2.7	2.6
GDP (production)	**3.6**	**3.1**	**2.8**	**2.7**	**2.5**	**3.9**	**3.1**	**2.9**	**2.6**	**2.6**
GDP - annual % change (q/q)	*3.1*	*3.0*	*2.7*	*2.8*	*2.4*	*3.4*	*3.4*	*2.7*	*2.7*	*2.5*
Output Gap (ann avg, % dev)	1.0	0.9	0.8	0.7	0.4	1.1	0.9	0.9	0.7	0.5
Household Savings (% disp. income)	-2.8	-1.8	-3.5	-3.3	-2.2					
Nominal Expenditure GDP - $bn	269.9	284.7	297.1	312.0	323.8	265.6	281.9	293.5	308.2	321.3
Prices and Employment -annual % change										
CPI	2.2	1.1	1.7	2.0	2.0	1.3	1.6	1.9	1.6	1.7
Employment	5.7	3.1	2.3	1.6	1.6	5.8	3.7	2.3	1.9	1.6
Unemployment Rate %	4.9	4.4	4.0	4.1	4.0	5.3	4.5	4.2	4.0	4.0
Wages - ahote	1.1	4.0	3.4	3.9	3.4	1.1	3.1	3.7	3.8	3.6
Productivity (ann av %)	-2.0	-0.4	-0.2	0.9	0.9	-0.9	-1.1	-0.3	0.7	1.0
Unit Labour Costs (ann av %)	4.0	3.5	3.0	2.4	2.4	2.8	3.7	3.6	2.3	2.4
External Balance										
Current Account - $bn	-6.9	-8.5	-10.0	-8.9	-10.5	-5.7	-8.2	-10.8	-9.1	-9.9
Current Account - % of GDP	-2.6	-3.0	-3.4	-2.9	-3.2	-2.2	-2.9	-3.7	-3.0	-3.1
Government Accounts - June Yr, % of GDP										
OBEGAL (core operating balance)	1.5	1.9	0.8	1.0	1.2					
Net Core Crown Debt (excl NZS Fund Assets)	21.8	20.0	20.7	20.8	20.5					
Bond Programme - $bn	8.0	8.0	8.0	9.0	9.0					
Bond Programme - % of GDP	3.0	2.8	2.7	2.9	2.8					
Financial Variables [(1)]										
NZD/USD	0.70	0.73	0.68	0.70	0.72	0.70	0.70	0.68	0.70	0.73
USD/JPY	113	106	113	107	101	116	113	112	108	101
EUR/USD	1.07	1.23	1.17	1.24	1.30	1.05	1.18	1.14	1.23	1.30
NZD/AUD	0.92	0.94	0.96	0.92	0.92	0.96	0.91	0.95	0.93	0.92
NZD/GBP	0.57	0.52	0.50	0.48	0.48	0.56	0.52	0.54	0.48	0.49
NZD/EUR	0.66	0.59	0.58	0.57	0.55	0.67	0.59	0.60	0.57	0.56
NZD/YEN	79.1	77.0	76.8	74.9	72.7	81.6	78.7	76.4	75.6	73.7
TWI	76.5	74.8	74.0	72.7	73.2	78.1	73.6	74.6	73.4	73.7
Overnight Cash Rate (end qtr)	1.75	1.75	1.75	2.25	2.25	1.75	1.75	1.75	2.00	2.25
90-day Bank Bill Rate	1.98	1.93	1.95	2.45	2.45	2.02	1.88	1.98	2.28	2.45
5-year Govt Bond	2.70	2.35	1.95	2.20	2.20	2.75	2.30	1.95	2.10	2.20
10-year Govt Bond	3.25	2.95	2.40	2.55	2.55	3.30	2.80	2.40	2.50	2.55
2-year Swap	2.30	2.25	2.00	2.45	2.45	2.40	2.20	2.00	2.30	2.45
5-year Swap	3.00	2.70	2.25	2.50	2.50	3.00	2.65	2.30	2.40	2.50
US 10-year Bonds	2.50	2.85	2.75	2.75	2.75	2.50	2.40	2.85	2.75	2.75
NZ-US 10-year Spread	0.75	0.10	-0.35	-0.20	-0.20	0.80	0.40	-0.45	-0.25	-0.20

[(1)] *Average for the last month in the quarter*

Source for all tables: Statistics NZ, EcoWin, Bloomberg, Reuters, RBNZ, NZ Treasury, BNZ

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