more give, less take

agribusiness

Economic Report

Rural Commodities Wrap

Michael Creed, NAB Agribusiness Economist

30 November 2012

- **Financial and commodity markets in a state of cautious optimism, but private sector weakness and austerity programs continue to weigh on economic activity**
- **Dairy prices to strengthen on high feed costs, weakening production prospects**
- **Australian dairy production outlook weaker as a tough winter and spring soften conditions, cash flow also becoming a concern**

As expected, the initial euphoria of central bank monetary easing measures announced through September and early October is beginning to wane. Broadly speaking, central bank actions have managed to avoid the worst thereby taking some of the tail risk out of financial and commodity markets. However, ongoing weakness in private sector demand coupled with programmes of fiscal austerity continue to weigh on economic activity, meaning markets do remain cautious. Nonetheless, risk assets have clearly become less volatile over the past couple of months and this is being reflected in the VIX Index – which has been tracking at fairly low levels by post financial crisis standards.

Providing a sizeable degree of support to commodity markets over recent weeks has been a promising run of economic data coming out of Asia. China's manufacturing sector is improving and recent indicators suggest that this should continue over the near-term. Similarly, South Korea appears to be emerging from its soft patch with industrial production partly unwinding three consecutive months of decline while Taiwanese production and exports appear to have lifted from its mid-year sluggishness. In contrast, the Japanese economy continues to under-perform as political tensions with China and weak demand from trading partners continues to weigh on Japanese activity.

In the US, we have started to see some encouraging signs for the economy with residential dwelling investment looking positive while signs are emerging of a slowing in household balance sheet repair. However, the recovery does remain quite tepid and confidence is still lacking. However, despite the slowly emerging positive sings, the threat of an impending fiscal cliff have kept markets on edge. Under a worse case scenario, the scheduled spending cuts and tax hikes could amount to 5 per cent of GDP. However, given the economic ramifications, we doubt that policy makers would allow the economy to walk off the edge of the cliff. As such, we think an 11th hour deal likely although we can expect to see increased volatility in markets in the lead-up to the deadline.

2013 Outlook, Rural Prices & Production

Commodity	Production	Price
Wheat	-30%	20%
Beef	3%	-8%
Dairy	-1%	-4%
Lamb	4%	-13%
Wool	2%	-16%
Sugar	21%	-20%
Cotton	-7%	-18%
Oil	–	2%

Source: NAB Group Economics
These forecasts represent year-on-year average changes in AUD price and production between 2011-12 and 2012-13 financial years

Domestically, the Australian economy appears to have stumbled into the December quarter. The NAB Business Survey revealed that business conditions hit their lowest level since May 2009 in October while forward indicators look quite subdued. Slowing mining investment, the ongoing impacts of a stubbornly high AUD coupled with fiscal tightening appear to be weighing on the near-term outlook. Further out, increased exports are likely to partly offset the impact of falling mining investment on GDP although solid economic growth outcomes will require non-mining demand to strengthen. On interest rates, the RBA left rates on hold in November and we now favour a 25 basis points reduction in December. After that, the risk of further cuts will remain for much of 2013, depending on inflation, house prices, domestic activity, commodity prices, the AUD and the extent of the mining investment slowdown.

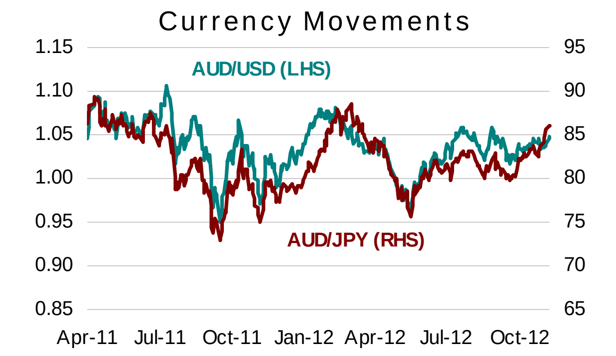
For agricultural commodities, markets have been fairly mixed over the past month. Grains prices have softened a little on expected demand rationing while the softs (sugar and cotton) remain subdued on an extremely comfortable supply-side. Livestock prices have softened as restocker demand remains soft and the persistently high AUD bites while wool has generally surprised on the upside, despite textile demand being quite soft. Consistent with wool prices, dairy has managed to buck the agricultural commodity trend as the market tightens on weakening production prospects, particularly in the northern hemisphere. This month, dairy is our commodity in focus.

Currency Movements

The AUD/USD has lifted since last month, briefly flirting with levels above 1.05. Early in the month, the AUD got a leg up from the RBA decision to leave rates on hold, which managed to push the AUD/USD through 1.04. 'Risk-off' then became the theme again as market fixation returned to the issue of the US fiscal cliff. Escalation of violence in the Middle East as well as very soft European data and market worries over Greece's finances also kept risk assets in check. Market concerns have since eased but a degree of cautious optimism persists.

Looking ahead, the global outlook will remain a key component of the AUD's direction. With many institutional investors underweight benchmark risk assets, any good news in Europe or the global economy could squeeze the AUD higher in December. Improving global sentiment coupled with changing RBA expectations could push the AUD/USD to 1.0510. The anticipation of the RBA December meeting will likely drive the AUD, with a break likely to follow the December 4 meeting. We currently expect the RBA to remain on hold, while market pricing has a 59 per cent chance of a 25 basis point cut.

Currency Movements



Source: Datastream

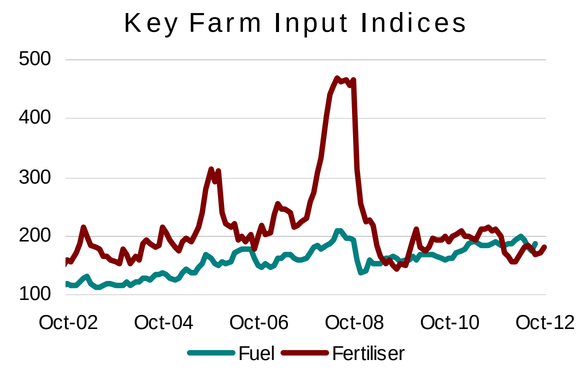
NAB Rural Commodity Index

The NAB Rural Commodity Index was up 4.1 per cent in October in AUD while the relative strength of the USD saw the index up 2.1 per cent. Driving the monthly result were price rises across most commodities with AUD increases in sugar, dairy and wool being the sharpest. In contrast, October saw some solid falls in livestock prices with both beef and lamb down significantly while cotton prices were also marginally weaker. Looking ahead, the near term outlook across various agricultural commodities is very much mixed and as such, we expect a relatively flat profile for the index overall in the near-term.

NAB Farm Input Indices

Input prices were up in October, with the NAB Weighted Fertiliser Index increasing 4.9 per cent in the month. Helping to drive the monthly result, natural gas prices were up a solid 22.5 per cent while Urea prices lifted 5.6 per cent. Partially offsetting this, Diammonium Phosphate (DAP) prices fell 1.1 per cent in the month. Looking ahead, prices appear neutral for now but a significant degree of upward pressure is likely to be exerted on prices over the coming months. Crop economics in South America do favour increased fertiliser intensity while demand into 2013 is likely to lift in the northern hemisphere as farmers seek to take advantage of current high prices. While a price spike is somewhat unlikely based off current fundamentals, fertiliser prices do have the capacity to move significantly higher from current levels given the likely demand situation. For fuel prices, monthly price data is still not yet available. However, Tapis crude oil prices did weaken in AUD terms in the months meaning fuel prices were likely subdued. This appears to have been brief, however, as prices have bounced back so far through November.

Input prices rising

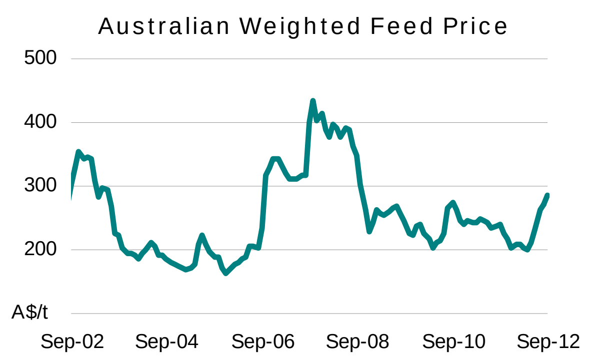


Source: Bloomberg, NAB Economics

NAB Weighted Feed Grains Price

Reflecting input cost pressures elsewhere, feed prices were up again in October, with the NAB Weighted Feed Grains price increasing 1.3 per cent. This represents the sixth consecutive monthly rise in prices with the price hitting its highest level since October 2008. Driving the monthly result were price rises across the board with the sharpest increases in sorghum (up 7.1 per cent) and maize (up 5.1 per cent) prices. In contrast, feed wheat prices managed to partly offset some of this pressure with prices falling 1.6 per cent in the month.

Feed grain prices up again in October



Source: ABARES, NAB Economics

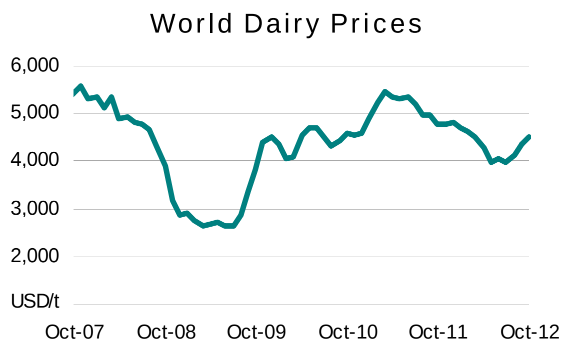
In Focus – Dairy

- **Global dairy prices strengthen on high feed prices and softening northern hemisphere production**
- **Prices to lift through late 2012 but to strengthen further in 2013 as EU and US production concerns become more apparent**
- **Australian milk production slowing on dryness and cash flow worries but still solid output expected, NZ production slowing after solid start but still near-record milk production expected in 2012-13**
- **US production down on drought and feed costs, EU production softens on poor performance from big exporters**

Dairy prices recovering

Dairy prices have bounced back since bottoming-out mid-year, with our weighted average dairy price in October up 13.3 per cent since the July trough while prices were up 3.7 per cent on a month earlier. More recently, prices appear to have settled over the past few weeks. Helping to weaken prices through mid-year was a softening production outlook from both the US as well as the big EU exporters. Overall, total US milk production forecasts have been revised down by a cumulative 5.4 billion pounds since June, while EU production has also come in very soft, declining 2.9 per cent year-on-year in August. Driving the weaker production outlook has been a combination of adverse weather, as well as high feed grain prices, which had seriously impacted dairy farm profitability across the northern hemisphere. As such, culling of dairy cattle has generally lifted in response. This, in conjunction with the southern hemisphere yet to ramp up production for the spring flush, saw availability tighten and hence higher prices.

Dairy prices bouncing back

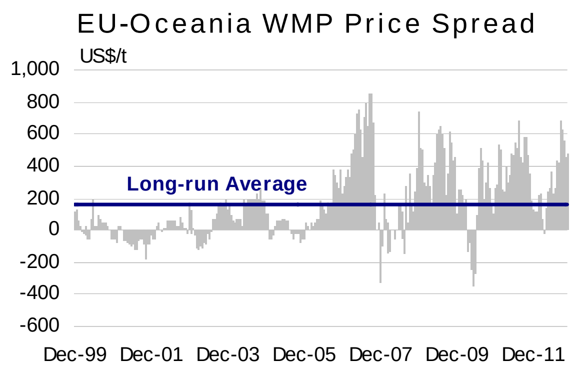


Source: NZX

Looking ahead, we are marginally bullish on pricing through the rest of 2012. The northern hemisphere is currently going through its low-point in the annual production cycle meaning that global market attention is focussed on the southern hemisphere producers. Helping support price, production prospects have undoubtedly softened in Oceania in recent months with cash flow problems and weaker pasture growth impacting both Australia and New Zealand. However, production prospects still look quite solid and this could temper near-term prices becoming too strong. While growth in New Zealand output is expected to be flat relative to last year, we do need to bear in mind that last year's was a record for New Zealand milk production. Similarly, Australian milk production of around 9.4 billion litres still represents a very solid outcome in terms of overall production levels, particularly given dairy cattle numbers. In all, this implies decent exportable surpluses out of Oceania that will need to be absorbed. Much of this can and will likely be absorbed by buyers through Asia as well as the Middle East, particularly before market focus shifts back towards the northern hemisphere spring. As 2013 unfolds, current conditions imply that prices should strengthen a little further through the first half of 2013 as Oceanic supplies are absorbed and the weaker outlook in the northern hemisphere becomes more apparent. The upward pressure on price is likely to intensify as we enter the spring flush in the northern hemisphere.

Near-term, we anticipate that prices in Oceania are likely to face a certain degree of upward pressure emanating from pressures in the northern hemisphere. As the graph below demonstrates, the price spread between European and Oceanic WMP prices has widened significantly over recent weeks. In our view, this implies that Oceanic prices will need to strengthen to pare back some of the spread. This becomes particularly evident given that production prospects in the northern hemisphere are likely to be soft during their spring flush. This implies that lower Oceanic prices should encourage a pull-forward of purchasing decisions of some buyers in order to avoid potentially higher prices when northern hemisphere production prospects become more apparent.

Price spread supporting Oceania prices

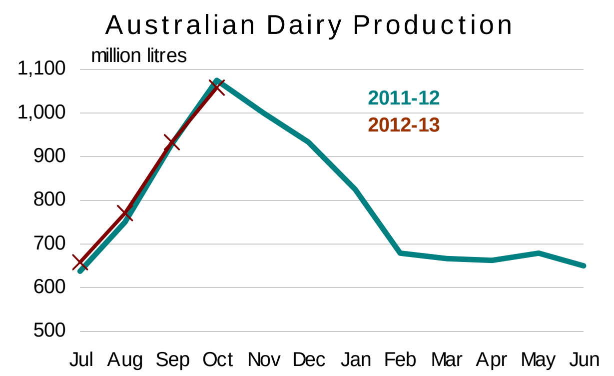


Source: USDA, NAB Economics

Australian Outlook

In aggregate, the 2012-13 season was off to a good start with dairy production up 1 per cent year-to-date in October. However, more recently growth appears to have slowed with year-on-year growth in October down 1.4 per cent, compared to positive growth rates earlier in the season. As has been the case for some time now, regional variations persist, with production in those regions likely to have export market access continuing to outperform the rest. Reflecting this, year-to-date production in Victoria was up 1.8 per cent in October, buoyed by a solid 7.7 per cent increase in the northern part of the state. Echoing Victoria, Tasmanian milk production was up 1.5 per cent year-to-date while a solid season so far in the Riverina has helped offset weakness elsewhere with New South Wales milk production down 0.1 per cent. Elsewhere, production continues to contract with Queensland dairy production down 3.5 per cent, South Australian milk production down 2 per cent while Western Australian production was down 0.7 per cent.

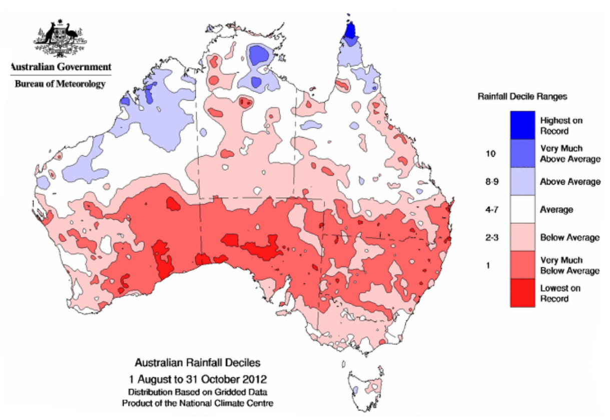
2012-13 season starts off well but slowing



Source: Dairy Australia

Looking ahead, we expect total Australian milk production will likely reach around 9.4 billion litres in 2012-13, down around 1 per cent on last year's milk production. Helping to support Australia's production prospects, conditions in northern NSW and southern Victoria appear to be holding up the aggregate figure, where the uplift in water availability has provided significant support to milk production over the past two years. As of early September 2012, water availability along the Murray-Darling Basin was at 97 per cent, hence underpinning the solid performance across these regions. Elsewhere, however, conditions have been a little more challenging. Hot, dry conditions through spring have generally impacted pasture and feed availability. Similarly, feed grain prices have become restrictively high and with fertiliser costs also up, cash flow issues are emerging as dairy prices have not yet fully recovered from recent dips. As such, it is hardly surprising that production levels are down across the rest of Victoria, NSW, Queensland, SA and WA.

Dry conditions impacting production

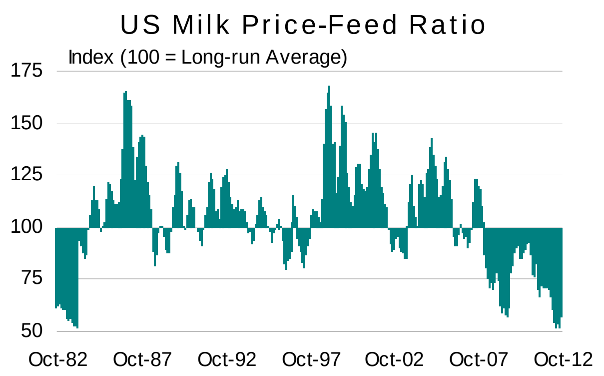


Source: BOM

US Outlook

Dairying conditions in the US have been quite challenging on account of the impact of the drought while lower dairy prices and higher feed costs are significantly eroding margins. As such, we have seen a sizeable downgrade in expected dairy production for both 2012 and 2013. In June, USDA estimates for US milk production stood at 202.2 billion pounds while the most recent forecast for US production sits at 199.7 billion pounds. Looking ahead, US milk production is expected to remain soft through the December 2012 quarter while a very lacklustre performance is expected through the first half of 2013. The dairy cattle herd, having come under considerable pressure from lower dairy prices and high feed costs, is expected to contract 1 per cent in 2013. Similarly, milk production is expected to remain broadly flat at around 199.7 billion pounds, as the falling herd is partly offset by improving milk per cow in the second half of 2013. Despite the weak outlook, however, the recent USDA forecast was improved on a month earlier due in part to weaker than expected feed prices and a gradual recovery taking place in global dairy markets.

US Milk-feed Ratio and Milk Production



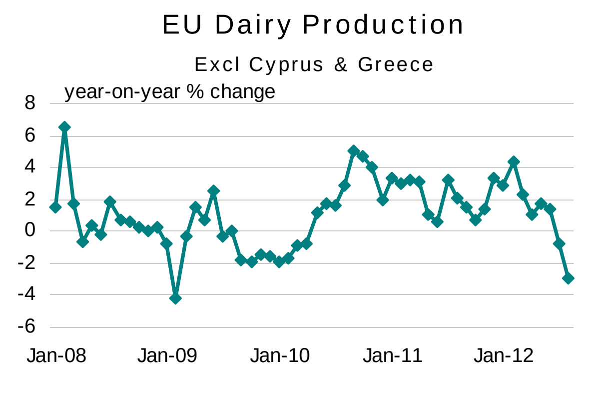
Source: USDA, NAB Economics

EU Outlook

Heading into the final quarter of 2012, production prospects have soured for the big EU dairy exporters. Unfavourable weather across major producers, plus the impact of high feed costs on profitability have squeezed production over recent months. On the whole, EU 27 (excluding Cyprus and Greece due to lack of timely data) dairy production fell 2.9 per cent year-on-year in August while year-to-date production growth also slowed, down to 1.2 per cent. Driving these results were fairly soft results from the big EU exporters, explaining the strengthening EU prices relative to Oceania. Germany was hardest hit, with milk deliveries down 8 per cent year-on-year in August while French production was down 4.2 per cent. Similarly, milk production in the Netherlands and Belgium were down around 0.8 per cent while Irish production fell 5 per cent. Reflecting weakness in the other major producers, UK production was also down, falling 3.9 per cent year-on-year. Overall, sluggish results over recent months imply that forecasts for 2012 production growth could be a stretch and would require the final quarter to come in significantly higher than last year's. Overall, 2012 production is likely to come in at around 0.5 per cent lower in our view, while the first part of

2013 will be very much dependent on how input costs play out over the coming months. This could be offset by the elimination of milk quotas by 2015, which could provide incentive for some farmers in the big exporters to begin lifting production in advance.

EU Milk Production



Source: Eurostat

New Zealand Outlook

Doug Steel – Economist, BNZ

Pre-season expectations of a reasonable return from last season's bonanza have been pared. This is a result of strong early season flows and diminished El Niño risk. The season started strongly. In fact, milk flow in the low-volume first three months of the season were almost 15 per cent up on the same period last year. Despite this, we think the 2012-13 New Zealand milk production season overall would still do very well to match last year's record.

After a strong start to this season, annual production growth rates appear to have slowed up a lot through the peak production period. Generally good early season weather conditions have faded. It has been a bit dry in places for this time of year, particularly in the North Island. Weather forecasts suggest more of the same over coming months. This is likely to see monthly milk production dip below year ago levels as we go through the second half of the season, especially given the strong performance last year. Outside the climatic vagaries season-to-season, fundamentals, like ongoing land conversion to dairying and the associated increase in cow numbers, continue to provide underlying trend growth in New Zealand milk production. This underlying growth will help prevent overall production from falling too much, if at all this season even through climatic conditions are unlikely to match last year's ideals. As such, we expect 2012-13 to be flat relative to 2011-12.

Comments from the Field

The spring conditions being experienced at the moment are very welcome. A bit of moisture and sun goes a long way, although in the Heytesbury, this came a bit later than they would have liked but looking back at last year, there was no spring at all. Current conditions are allowing a good silage harvest and also should cater for a good hay harvest as well, which in the end should replace stocks that had been exhausted over the last twelve months. The immediate crop areas are also looking fantastic up the Hamilton Highway areas. However, cash flow has been quite poor and some dairy farmers are struggling as they enter into a high cost period of the year with fertiliser and harvest.

Colin Hammond – Agribusiness Manager, Greater Green Triangle, Victoria

In South Gippsland, milk production is expected to be back on last year due to a very tough winter and spring. The decline is expected to be at least 5 per cent as cows fail to peak as they have over the past two years. Additionally, we are seeing low levels of confidence due to low commodity prices and a high AUD. Farmers are very reluctant to spend and many are banking on significant step ups in milk price for the season to be a reasonable one. After huge amounts of rain down here, land is eventually drying out. Silage is well below average on quantity and quality and grains prices are also up approximately 30 per cent on last season. As a result of this, fodder costs are expected to be well above average this season.

Brian Gannon – Agribusiness Manager, Leongatha, Victoria

Whilst the last report from northern Victoria was one of farmer optimism towards the industry, conditions have softened a little in the current environment. The current costs of fodder conservation in all forms, combined with the lowest milk cheques of the year are putting significant pressure on cash flows. Although grain prices have risen significantly, this should be able to be overcome with the ability to grow feed in amounts that we haven't seen for some time. For some this has been a double edged sword with fertility being an issue for high producing cows running hot. As with other regions, producers are looking forward to price step ups over the coming months to assist with managing payments.

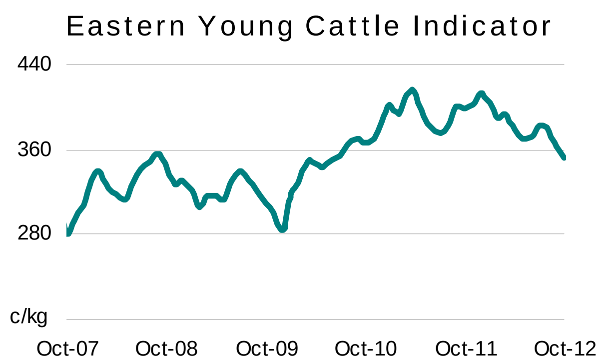
Megan Hodge – Agribusiness Manager, Shepparton, Victoria

Overall, the season has been below average due to low commodity prices and a high AUD. Cash flow appears to be a problem although many expect to see an improvement in the second half of the season with an expected end of season step up in price. Production levels on most farms appear to be up on last year while hay and silage production has been quite good which will ease the requirement of bringing in high levels of purchased stock feed and grain. A big focus recently has been on increasing the usage of home-grown fodder to reduce reliance on grain.

Mal Dumesny – Agribusiness Manager, Warrnambool, Victoria

Key Commodity Prices

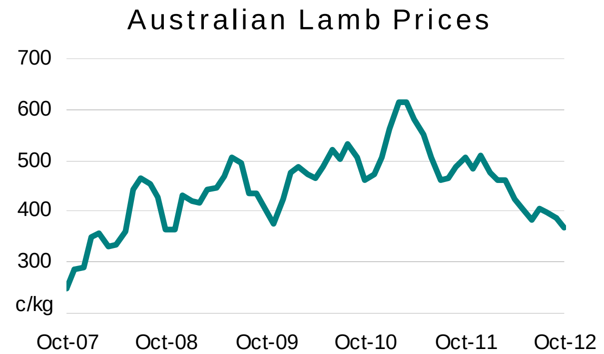
Cattle prices down on weak restocker demand, soft exports to Japan and Korea



Source: MLA

The cattle market has continued to soften with the Eastern Young Cattle Indicator falling 3.1 per cent in October, hitting its lowest point since June 2010. So far through November, prices have continued to soften with the EYCI recently dipping below 340c/kg. Helping to soften prices has been the solid increase in saleyard numbers while restocker demand has been fairly soft over the past couple of months. In addition, the impact of the high AUD and US drought appear to be weighing on exports. Year-to-date exports to Japan were down 6.5 per cent in October due to very strong competition from US beef supply, which is up due largely to a sizeable increase in dairy cattle slaughterings. At the same time exports to Korea were down 16.3 per cent year-to-date as domestic supplies had been quite strong. Looking ahead, we are still positive on price, although the December quarter is likely to remain quite weak, particularly as the market is faced with the seasonal increase in US cattle slaughterings.

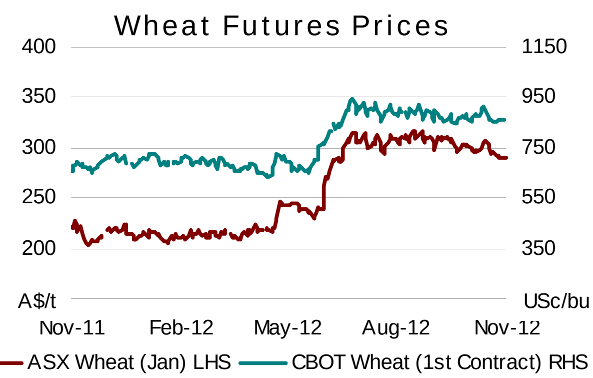
Lamb prices hit lowest levels since 2007



Source: MLA

Consistent with the direction of cattle prices, lamb prices also softened in October, with the Heavy Lamb Indicator down 5.6 per cent in the month. Prices through November have softened further, with heavy lamb prices hitting their lowest point since 2007 while trade lamb prices have come very close to sub 300c/kg levels. Helping to soften prices has been a very strong lift in supply, with lamb slaughterings up 13.2 per cent in September due in large part to hot and dry conditions. This sharp increase in supply has resulted in a very strong export program with lamb exports up 11 per cent in October year-to-date due to a very solid increase in exports to China and the Middle East. Looking ahead, we think prices are likely to remain subdued in the near-term although should strengthen medium term as global supply is still quite tight.

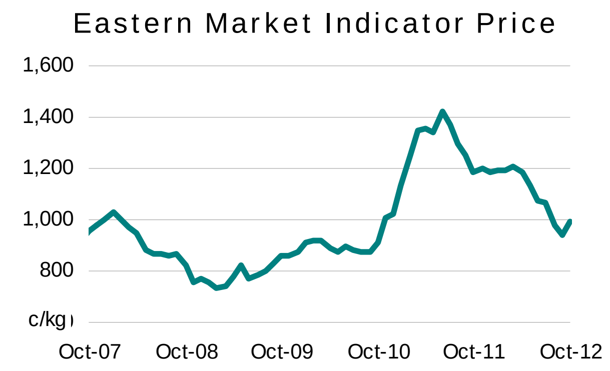
Wheat prices soften on bearish USDA report



Source: MLA

Wheat prices have broadly come off since last month as grains and oilseed markets absorbed the bearish tone set by the USDA WASDE report. The November report saw global wheat ending stocks revised up to 174.2 million tonnes thanks to assumed demand rationing pushing consumption lower. Similarly, soybeans and corn stocks were also revised higher meaning little support came from across the complex. This has basically seen funds unwind net long positions, with wheat down around 15k contracts while net long positions in soybeans are at their lowest level since July. More recently, markets have received some degree of support from the US winter crop conditions, with just 33 per cent of the crop rated good-to-excellent. Looking ahead, fundamentals suggest a neutral outlook for price. As we roll into the new year, prices will start receiving direction from northern hemisphere winter crop development and the South American corn and soybean harvest.

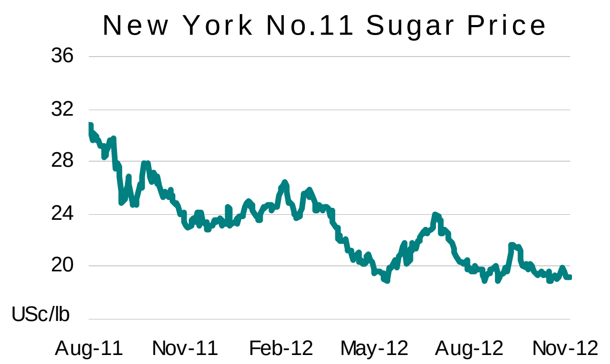
Wool prices up in October, further price strength evident through November



Source: AWI

Defying softness in the cotton market, as well as the weakness evident at the retail end of the textile sector, wool prices managed a solid increase in prices in October, with the Eastern Market Indicator increasing 5.5 per cent on a month earlier. Prices in November have shown further strength, with the EMI hitting 1019c/kg in the week closing 23 November. Interestingly, price results have generally surprised as increased offerings appear to have been absorbed by a solid buying effort from Chinese, European and Indian buyers. As was the case last month, the finer varieties have generally outperformed the broad and coarse merino types. While recent price strength is welcome, we think the sustainability of recent prices appears to be questionable. Wool is very expensive relative to competing fibres in textile blends while at the retail end, market conditions are not exactly supportive of recent price levels.

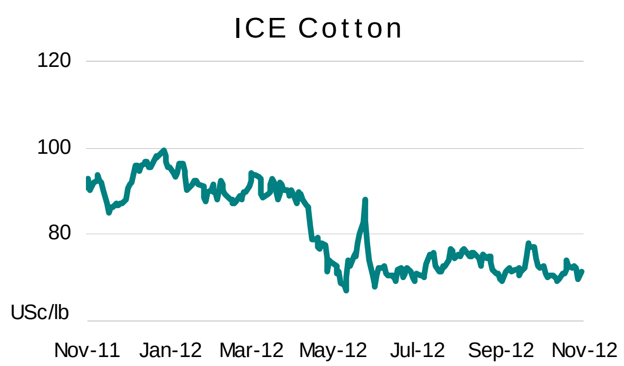
Sugar prices subdued on conclusion of Brazilian Centre-South harvest



Source: Bloomberg

With the Brazilian Centre-South harvest coming to a close, sugar prices have little room for movement on the upside as weather-related risk premiums have now come out of price. As a result, we are now left with the fundamentals and this doesn't paint a bullish picture. According to recent Unica estimates, Brazilian Centre-South production was up 1.6 per cent by mid-November year-to-date. At the same time, recent estimates of a global surplus have been lifting. The International Sugar Organisation lifted its forecast for the 2012-13 surplus to 6.2 million tonnes which would represent a third consecutive year of surplus. In addition, with Chinese sugar production bouncing back, we can't rely on a solid Chinese import program acting as a support mechanism for price. Perhaps unsurprisingly, funds are now at near-record short positions while prices continue to trade at sub 20USc/lb levels.

Cotton weighed down by bearish fundamentals



Source: Bloomberg

Cotton prices have been fairly range-bound over the past month while prices in month-average terms have marginally weakened since October. A solid result for US export sales did manage to provide some support, with exports managing to now run at what is considered a more normal pace. However, the medium-term outlook for prices continues to be weighed down by an exceptionally well-supplied market. Recent USDA forecasts point to a global stocks-to-use ratio of 75.5 per cent, a new record. At around 270 days of usage, this excess supply needs to be absorbed by the market. Added to that, global textile demand remains soft with consumers sectors globally weighed down by a myriad of issues ranging from fiscal austerity, financial market volatility, household balance sheet rebuilding and elevated fuel prices. Overall, low prices are needed to absorb excess supply and it is perhaps unsurprising that many market forecasts point to prices averaging less than 70USc/lb through 2013.

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