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Economic Report

Rural Commodities Wrap

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24 August 2012

- **Global growth weighed down by weakness in big developed economies, emerging markets also slowing**
- **Australian farm sector mixed but likely to benefit from US drought, which could add around $6 billion in export incomes to the sector in aggregate**
- **Australian beef sector remains in solid shape, on solid herd rebuilding effort and robust export and production outlook, however, outlook a little weaker than at the start of the year**

Despite the more positive sentiment that the Euro-zone hasn't taken a turn for the worst, the global economy is currently in the grip of a broad-based slowdown. Conditions have deteriorated across the advanced economies with recessions either occurring or predicted across much of Europe and a slowdown in the pace of US growth. Similarly, conditions in Japan have softened, as industrial output and exports have slipped in recent months. In the big emerging market economies of China, India and Brazil, growth has also slipped in recent months. Brazil has been the worst affected, its growth slipping to under 1 per cent year-on-year in March, while Indian growth has slowed to its lowest since the 2009 trough. Chinese growth has been better maintained but here too the pace of expansion has fallen to its weakest since the first half of 2009.

Looking ahead, it is difficult to see rapid progress in Europe being made, so while recessions are likely to end as stock cycles turn and net exports pick-up, the outlook is for at best moderate growth in 2013. The US has better prospects, but these are conditional on it avoiding the drastic budgetary cutbacks outlined in current legislation. In the emerging economies, the situation is better as their slowdown owes more to the lagged effects of a tightening in policy than the sort of structural impediments facing the advanced economies. Policy is now being eased in China, Brazil and several Asian Tigers as price pressures fade and attention shifts to stimulating activity. As a result, we expect to see growth accelerate through 2013 across much of Asia.

As growth picks up in the emerging economies, European recessions end and confidence recovers as the worst downside risks are averted, global growth should pick up to around 3.4 per cent in 2013. This still represents a disappointing recovery from the deepest global downturn since the 1930s and jobless rates should stay high around the big advanced economies while both inflation and interest rates remain low.

2013 Outlook, Rural Prices & Production

Commodity	Production	Price
Wheat	-12%	20%
Beef	3%	-4%
Dairy	2%	-2%
Lamb	4%	-2%
Wool	1%	-15%
Sugar	12%	-5%
Cotton	-16%	-15%
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

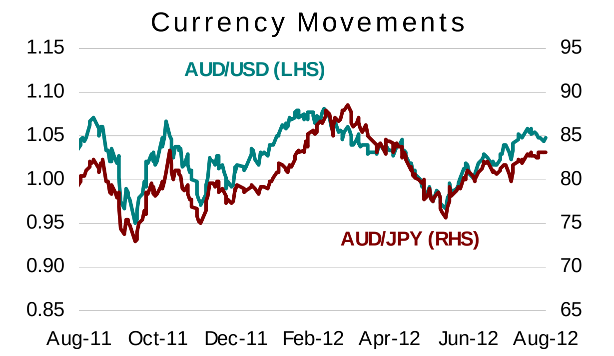
For Australia, business confidence has lifted on supportive comments out of Europe, the passing of the carbon tax 'hurdle' and lower interest rates. Conditions, however, have weakened across a majority of industry, with particularly sharp decline in retail and wholesale – possibly reflecting the unwinding of government compensation payments. The mining investment outlook remains strong despite softer commodity prices and some projects being scaled back. However, the ongoing restructuring of the economy is likely to maintain an upward bias on unemployment in the near term and keep consumers cautious. While activity is likely to moderate, reflecting a fiscal consolidation of the government sector and slowing consumption growth, a near-term rate cut now appears unlikely, particularly as the stimulatory effects of recent cuts are yet to filter through. If the RBA were to lower rates again, it would most likely occur at the bank-end of this year and would require a material slowing in the labour market and domestic activity.

The Australian farm sector remains in the right side of the multi-speed economy. Grains prices are up significantly due to the northern hemisphere droughts and this has flowed through to the livestock sectors. In all, we estimate that this has likely added around $6 billion in export incomes to the Australian farm sector. One such sector likely to benefit from the impact of the US drought over the medium term is Australia's beef sector, our commodity in focus this month.

Currency Movements

In light of our revision to RBA policy, whereby we no longer expect any further cuts to the cash rate in the current cycle, our forecasts for the AUD/USD have been revised up modestly through the remainder of 2012 and 2013. This has been reflected broadly by a level shift upwards in our forecast profile by around 2 to 3 cent over the forecast horizon. As such, by year end we expect the AUD/USD to average around 1.00, easing back to 0.97 by the end of 2013. On balance, we expect the currency is likely to continue to trade down to levels more consistent with the traditional drivers of the AUD/USD such as hard commodity prices, interest rate differential and risk appetite. This requires that official and private international portfolio adjustments in favour of AAA-rated Australian credits run their course. How quickly this recent source of exceptional demand for the AUD dissipates, remains a matter of much conjecture and so a key source of uncertainty in the forecast.

Currency Movements



Source: Datastream

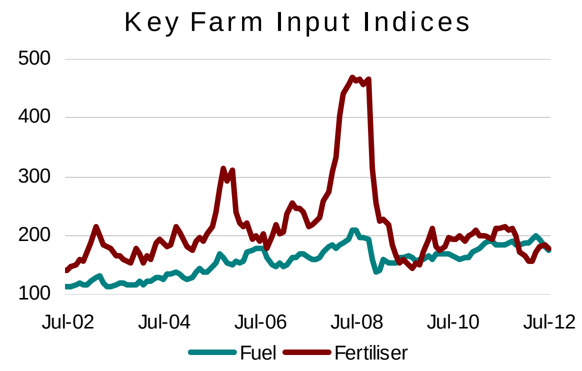
NAB Rural Commodity Index

The impact of the US drought has certainly been felt in the Australian farm sector, with the NAB Rural Commodity Index rising 5.3 per cent in AUD terms in July, completely reversing the fall in the Index evident since January. A strengthening AUD through the month did manage to take some of the icing off the cake, however, with the Index rising 8.2 per cent in USD terms in the month. In AUD terms, price rises were recorded across most commodities with wheat leading the way (up almost 25 per cent). Sugar, lamb, beef and barley also recorded price increases. Partially offsetting this were falls in dairy and cotton while wool prices were flat. Looking ahead, we expect further strengthening of the Index although another sizeable increase like that recorded in July appears unlikely at this stage.

NAB Farm Input Indices

Helping to support margins in aggregate, input costs were down in July. Fertiliser prices largely unwound the price increases of the previous two months with the NAB Weighted Fertiliser Index falling 4.3 per cent in the month. Driving the monthly result were falls in Diammonium Phosphate (down 6.8 per cent) and natural gas (down 3 per cent). In contrast, urea prices were up 3.2 per cent in the month. Looking ahead, the outlook for fertiliser markets is somewhat mixed. Urea markets appear quite comfortably supplied while Diammonium Phosphate appears tighter given demand in South East Asia. Natural gas also is likely to weaken a little given strong inventories. Fuel prices also weakened with the fuel index down 2.4 per cent in July. Recent weakness in fuel prices is likely to be short-lived, however, as global crude oil prices have again lifted through August, with Brent prices up almost 10 per cent since the start of the month. Recent strength in oil prices is likely to be felt at the bowser and we expect that the fuel index will lift significantly in August.

Fertiliser up, fuel prices drop

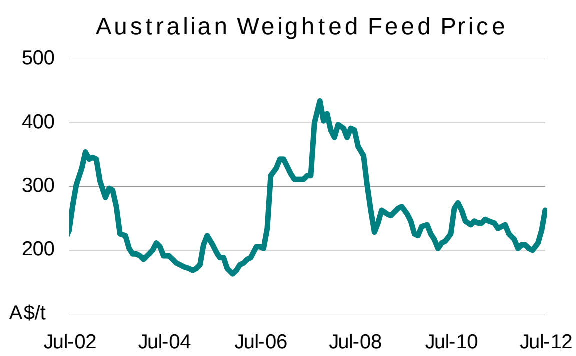


Source: Bloomberg, NAB Economics

NAB Weighted Feed Grains Price

The rally in global grains and oilseeds prices has certainly been felt on the domestic feed market. In July, the NAB Weighted Feed Grains Price increased 13.7 per cent while prices were up 25.4 per cent on May levels. At $263.40/t, the NAB Feed Grains Price sits at its highest level since October 2010, when wheat prices spiked due to Russian export bans. Driving the monthly result were price rises across most feed grains. Sorghum (up 21.6 per cent), triticale (up 19.4 per cent), barley (up 14.8 per cent) and feed wheat (up 13.7 per cent) recorded sharp rises. In contrast, maize prices recorded a more modest increase (up 2.3 per cent) while oats prices were relatively flat through the month (down 0.8 per cent).

Feed grain prices lift in July



Source: ABARES, NAB Economics

In Focus – Beef

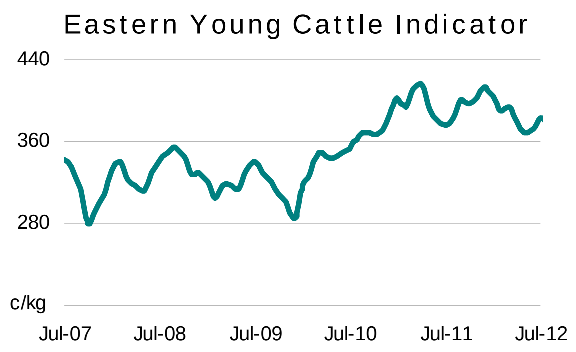
- **EYCI recovering, but to remain weaker in 2012-13, to fall 4 per cent in year-average terms**
- **Rebuilding of Australian cattle herd well under way with number of cattle at their highest level since 1977, rebuilding to continue but slow in coming years**
- **Australian beef production to increase 2.5 per cent in 2012, accelerating to 3.3 per cent in 2013 as impact of greater cattle numbers materialises into higher production**
- **Australian beef exports to remain robust, driven by increasing exports to the US, South East Asia, China and the Middle East. Japan, Korea, Indonesia to remain challenging markets**

The outlook for the Australian beef industry remains in solid shape. The wettest two years on record have generally supported the herd rebuilding effort which has progressed faster than expected while exporters have seen a sizeable boost to incomes, with the emergence of new markets and the impact of dwindling cattle herds in key exporters. Nonetheless, conditions in the beef industry have weakened a little since we last covered beef as our commodity in focus. Global financial market volatility coupled with falling global trade means that consumers in key markets remain very cautious. Similarly, the AUD has been supported by hard commodity prices remaining historically high and global demand for AAA-rated assets. On balance, however, we think the industry is very much on solid footing and likely to take advantage of the ongoing urbanisation in developing economies and dwindling cattle numbers in key exporters.

Australian cattle prices recovering from weakness in early 2012

The Eastern Young Cattle Indicator continued to build on the recovery evident in June, with prices in July lifting 2.8 per cent in month average terms, although prices so far through August have weakened a little on levels evident in late July. Helping to strengthen prices through July, yardings were down on average on June levels, although increased supplies late in the month, coupled with relatively poor quality across saleyards has generally weakened prices in recent weeks.

Australian cattle prices recovering



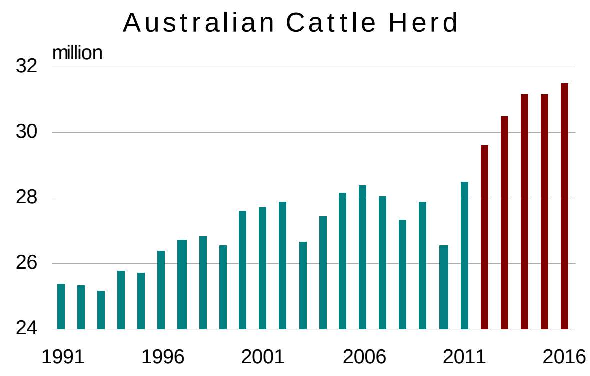
Source: MLA

The outlook for beef prices remains solid by historical standards, however, we think a return to prices evident in early 2011 is unlikely. Australian prices are likely to be torn between a number of competing influences, including the short-term impact of increased US beef supplies in global markets, a weaker consumer sector in most key trading partners, subdued global beef production and rising import demand in the US, Middle East and South East Asia. At the same time, the AUD is expected to weaken from current levels while Australian domestic supply is lifting. In all, this suggests to us that the EYCI is likely to average around 375 c/kg in 2012-13, around 4 per cent lower than 2011-12 levels on average. Nonetheless, put into a broader historical context, this represents a price 10 per cent above its decade average.

Outlook for Australian Beef Production

The expansion of the Australian cattle herd continues unabated. According to recent MLA estimates, the Australian cattle herd is estimated to have reached 29.6 million head at the end of June 2012, up 3.8 per cent on a year earlier – the largest Australian cattle herd since 1977. Looking ahead, ongoing expansion of the Australian cattle herd is likely. Solid conditions have allowed producers to retain cattle and the proportion of female cattle slaughtered remains very low, hence indicative of further herd rebuilding. As such, the Australian cattle herd is forecast to increase a further 3 per cent by June 2013. Growth should begin to taper off, with the Australian cattle herd reaching 31.5 million head by June 2016.

Australian cattle herd expanding



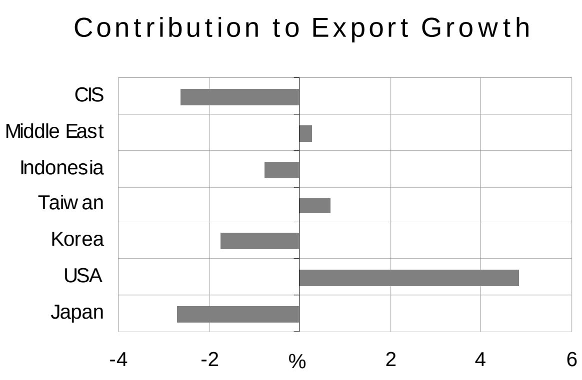
Source: MLA

With the herd rebuilding effort very much underway, cattle slaughterings have been fairly subdued with total cattle slaughtered down 2.5 per cent in 2011-12. However, favourable seasonal conditions, which have allowed producers to hold on to cattle for longer, have supported carcase weights. This has helped soften the decline in beef production, which was down only 0.8 per cent in 2011-12. Looking ahead, Australian beef production is likely to lift as the impact of a large Australian herd materialises into higher beef production. Reflecting this, recent MLA forecasts point to Australian beef production increasing 2.5 per cent in 2012 and a further 3.3 per cent in 2013.

Australian Beef Export Performance Strong

Despite the challenges imposed on beef exports – ranging from a stubbornly high AUD, a weaker global economic outlook and changing trade policies in key export markets – Australian beef exporters continue to perform exceptionally well. In 2011-12, Australian beef exports increased 1.2 per cent, while the value of Australian beef and veal exports increased 3.6 per cent, providing a healthy income boost to the Australian cattle sector. Interestingly, when one market proves troubling, the beef industry is very much adept in finding new export opportunities elsewhere. As such, declining exports to Japan, Korea and Indonesia have been more than offset by opportunities in the United States, China, Taiwan, Singapore, Middle East and Malaysia.

USA, Taiwan, Middle East driving exports



Source: MLA, NAB Economics

Broadly speaking, the outlook for Australian beef exports remains very strong. Globally, beef production is likely to remain subdued while income growth in developing countries is likely to support solid consumption growth. With Australia being one of the few major exporters increasing production this year, there will continue to be solid export opportunities for the Australian beef sector. However, given a weakening global economy, returns are likely to be a little weaker than previously expected as consumers are likely to favour manufactured beef rather than chilled beef. Overall, recent MLA forecasts suggest that Australian beef exports are likely to increase 1 per cent in 2012 and a further 4 per cent in 2013. In value terms, recent ABARES forecasts suggest that the value of Australian beef exports is likely to increase 0.4 per cent, thereby consolidating the gains of 2011-12. By region, we expect that exports to the US, South East Asia (excluding Indonesia), China and Middle East are likely to support growth. In contrast, Japan, Korea and Indonesia are likely to remain very challenging markets to operate in.

Outlook in Key Export Markets

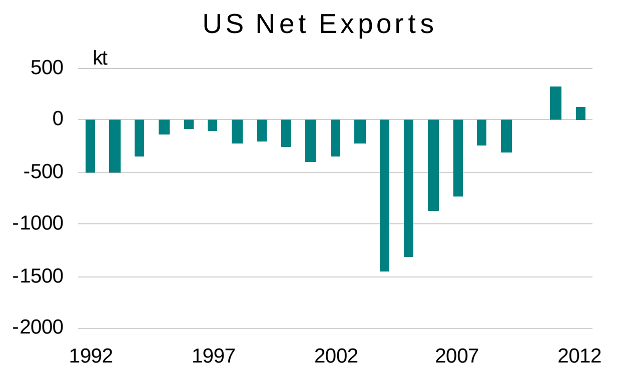
Japan remains a challenge for the Australian beef industry. In 2011-12, Australian beef exports to Japan declined 7.3 per cent, detracting 2.7 per cent from export growth. Helping to drive this weakness were a number of factors, including the impact from the tsunami/nuclear incident. Similarly, Japan has been considerably exposed to the slowdown in global economic activity as weakening global trade has flowed through to Japanese economic activity. Unsurprisingly, Japanese consumers are very much cautious at the moment. Japanese consumer sentiment remains weak and disposable incomes are likely to be squeezed by utility costs growing strong due in large part to the shut down of all but two nuclear reactors. With this in mind, we think that Japan is likely to remain a challenging market for Australian exporters. Any potential for demand growth is likely to be confined to frozen beef products (which now account for almost 60 per cent of Australian exports to Japan) rather than the more high valued chilled beef segment. Additionally, competition within the Japanese market is likely to be intense. With increased turn-off of the US cattle herd likely as a result of the drought, much of this increased supply is likely to find its way into the Japanese market. Similarly, the stubbornly high AUD is likely to remain a challenge. On balance, exports to Japan are likely to fall again in 2012.

In **Korea**, exports have come off considerably following the massive increase evident through 2010-11. In 2011-12, Australian exports to Korea were down 11.8 per cent. A large part of that decline is explained away by the market recovering from exceptional Korean import growth in 2010-11, due to the impact of foot and mouth disease. This unwinding is set to continue. At the same time, we think it likely that downward pressure is also likely to come from a weaker economic outlook. The growth momentum in the Korean economy has definitely slowed since mid-2011 with industrial production growth having slowed to just 1.5 per cent year-on-year, while manufacturing activity is contracting. Unsurprisingly, the consumer sector remains very cautious and retail trade has been quite weak. As such, Korea will prove to be a very difficult market for exporters in the near term. This is further exacerbated by the recent Korean-US Free Trade Agreement, which will reduce the 40 per cent tariff over the coming 15 years, at a rate of 2.7 per cent a year. In addition, the lifting of import restrictions on pork products will produce additional competition in the Korean protein market. Overall then, we expect that Australian exports to Korea are likely to continue to contract through 2012 and 2013.

In stark contrast to the big Asian markets, the **US** has been a key source of income for the Australian beef sector. In 2011-12, Australian exports to the US were up 28.3 per cent while high prices for US manufacturing beef have helped provide solid export incomes for the Australian beef sector. Looking ahead, the US market is likely to be a very lucrative market in the medium term. Recent USDA forecasts suggest that US beef production is expected to contract 4.4 per cent in 2012. With exports expected to contract 2.3 per cent, the US will rely on increasing amounts of imports over the coming year. As such, recent USDA forecasts suggest that US imports of beef are expected to increase almost 20 per cent in 2012 while the US will likely become a net importer again in 2013.

However, in the near term, the impact of the US drought will need to be watched closely. Farmers are likely to increase turn-off and cull cows to maintain cash flow, thereby increasing US supplies in the short-run. However, medium term, the impact of a lower cattle herd bodes very well for the Australian beef sector. Some risk is evident though, and in our view, conditions within the consumer sector will still need to be watched. US households are very much in the process of rebalancing and this is clearly showing up in consumption of animal protein, where cheaper meats and cuts are taking a greater share of consumption. For beef, this has meant that between 2007 and 2011, per capita consumption has fallen from 42.5 kgs to 37.3, while USDA forecasts point to per capita consumption declining to 36 kgs in 2012.

US likely to become net importer again



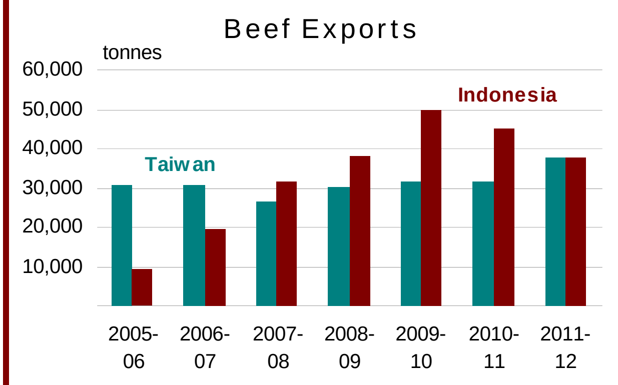
Source: USDA, NAB Economics

Australian beef exports to the **Commonwealth of Independent States (CIS)** fell considerably in 2011-12, down 34.6 per cent on a year earlier. However, despite the decline, the level of beef exports into the CIS looks robust. It does require mentioning that much of the strength of exports in 2010-11 was due to the Russian drought. When comparing with 2009-10 levels, Australian beef exports into the CIS are up 96.3 per cent, while the CIS has become Australia's fourth largest export market. Looking ahead, exports into Russia will be largely determined by price and at the moment, better returns appear on offer in the US. As such, we expect export growth to remain relatively flat through the remainder of the year, although some Russian importers may boost their imports in order to maintain quotas.

Indonesia remains a very challenging market for Australian beef exporters. Import restrictions saw Australian beef exports to Indonesia fall 16 per cent in 2011-12. Looking ahead, we expect exports into Indonesia to remain weaker and will likely weaken further in 2013 as the impact of the import quota limits any growth at all, while higher returns are likely elsewhere. Remarkably, the Indonesian economy continues to perform extremely well, growing 6.4 per cent year-on-year in June. As we have mentioned previously, this does point to higher per capita protein consumption and in a country of 240 million people with a climate and landscape not particularly conducive to large scale cattle farming, the sustainability of import restrictions is very much questionable.

With exports to Indonesia falling, **Taiwan** is emerging as Australia's fourth largest export market for beef. In 2011-12, exports to Taiwan increased 20.1 per cent. Looking ahead, we expect recent growth to be consolidated although similar to other Asian markets, there are likely to be some headwinds in the near-term. The Taiwanese economy is very much exposed to the slowdown in global trade and the slowing of Chinese economic growth. Reflecting this, year-on-year GDP growth was just 0.2 per cent in June. In such an environment, consumers are likely to choose other sources of protein than beef.

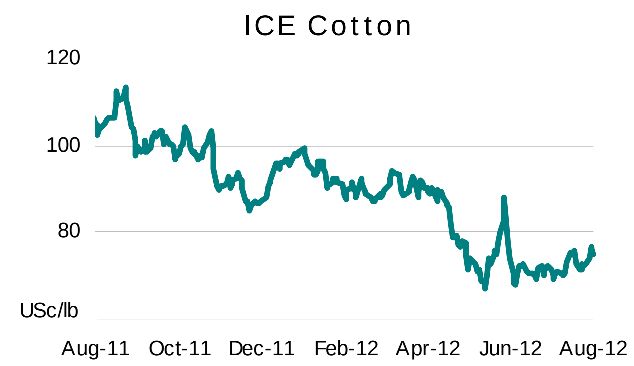
Taiwan overtaking Indonesia



Source: MLA, NAB Economics

Key Commodity Prices

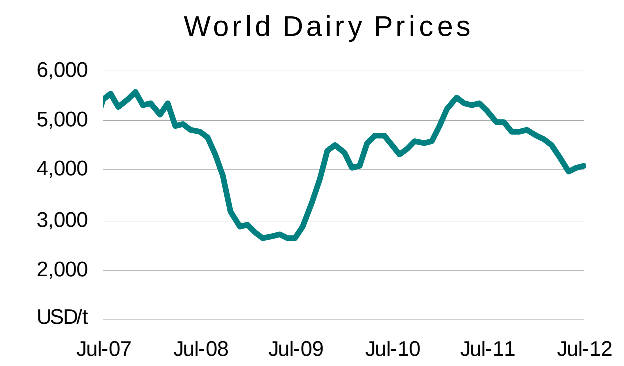
Cotton prices remain subdued on weak demand



Source: Bloomberg

While grains and oilseeds prices have surged over the past month or so, cotton prices have remained subdued, with prices still trading below 80USc/lb. Supportive of prices has been the delay of the monsoonal rains in India. This, in conjunction with weaker prices, has seen forecast area fall to 11 million hectares this season. Similarly, high grain and oilseeds prices are likely to see cotton lose acreage in the US for the new crop, however, this is some time away. Over the near term, the market is likely to continue to be weighed down by what is effectively an extremely comfortable global market, reflected in a forecast stocks-to-use ratio of 69 per cent for 2012-13. Similarly, near-term attention will remain on the demand side of the equation, which is undoubtedly weak. Textile demand remains very poor, China is unlikely to provide any support while competing fibres are very competitive. As such, there is little to be bullish about in the near term.

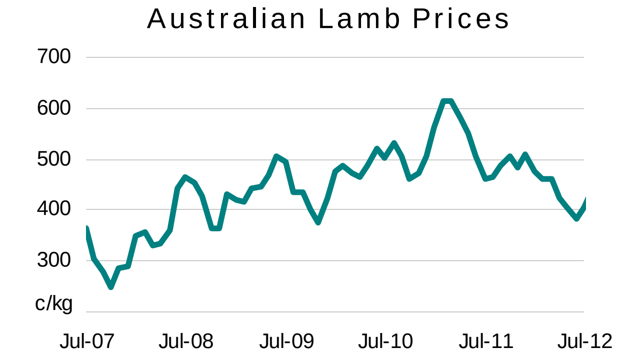
Dairy prices showing signs of recovery



Source: NZX

It appears that the global dairy market has bottomed out, with our weighted average dairy price in July increasing 1.2 per cent, the second consecutive monthly increase. Nonetheless, the slide in dairy prices since March 2011 has been very noticeable, with prices down 25 per cent off their peak. Looking ahead, we expect prices are likely to continue to stabilise with some upside likely through late 2012. Driving our view, the US drought has significantly weakened margins and widespread heat stress has clearly weakened US dairy production. Similarly, adverse weather in parts of Europe has seen EU production also slow. Attention will now be turning to Oceania and the looming threat of an El Niño does pose some upside risk to prices. Nonetheless, we are not getting too carried away over prices as the global market is likely to remain well-supplied. Furthermore, New Zealand's production outlook remains very strong.

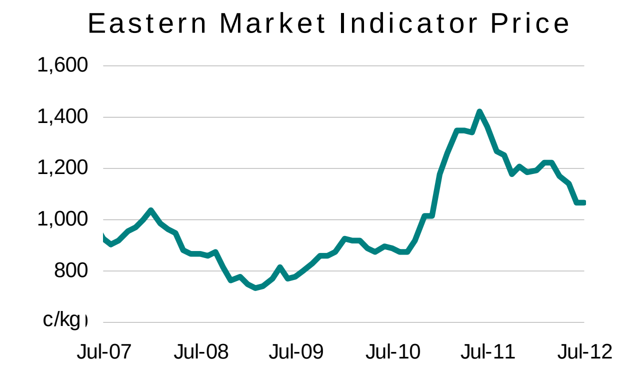
Lamb prices to lift in July but falter in August



Source: MLA

Having dipped to their lowest monthly average price since 2009 in June, lamb prices managed a bounce back in July, increasing 6.3 per cent in month average terms. So far in August, however, prices have again dropped, falling back below 400c/kg on the back of increased supplies reported in NSW and Victoria. Looking ahead, we maintain our view that lamb prices will need to strengthen. Despite a high AUD and recent economic weakness, the external environment remains very supportive of the Australian lamb industry. Reflecting this, lamb exports were up 12.6 per cent year-on-year in July. Support is likely to come from the United States, which will have to increasingly rely on imports of Australian lamb to meet consumption requirements, while conditions in both the Middle East as well as China are also likely to support the Australian market. As such, we expect a year-average price of 440c/kg likely.

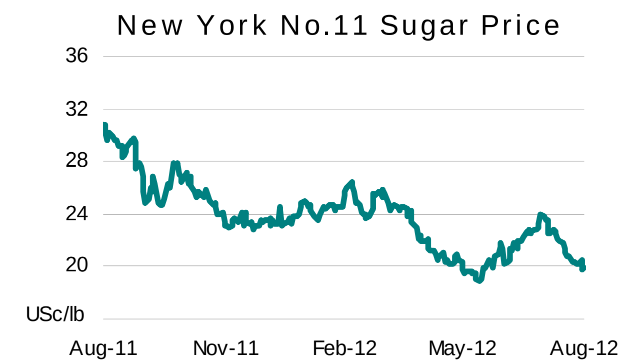
Wool prices slide further in August on lackluster demand



Source: AWI

Prior to the winter recess, wool prices were unchanged in July in month average terms. Since the winter recess, however, prices have fallen sharply, with the EMI falling below 1000c/kg for the first time since 2010 and closing at 949c/kg on the week ending 17 August. By variety, the fall in wool prices over recent months has been driven largely by superfine wool, where prices have fallen below levels evident at the start of 2008. This has been largely due to lacklustre demand, particularly from China. In contrast, broad merino and coarse wool have held up reasonably well. Despite the global wool market remaining historically tight, the demand side of the equation has weakened considerably since the start of the year. Over the coming months, we expect that downward pressure on prices is likely to be maintained as increased supplies hit the market through spring while demand is still fairly weak. Offsetting this to a large degree, global production is likely to remain weak.

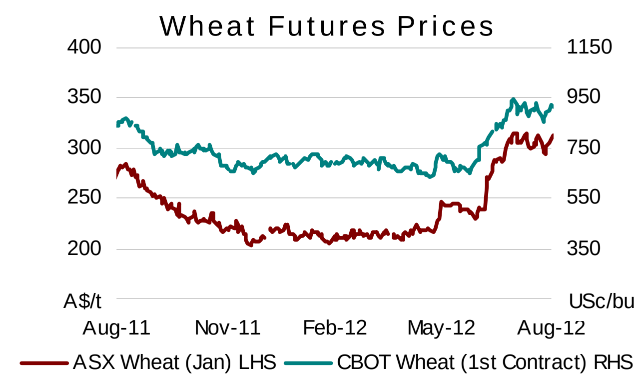
Sugar prices weaken on Brazilian Centre-South crush, Indian monsoon



Source: Bloomberg

Sugar prices have weakened in recent weeks with prices so far through August down around 12 per cent on levels evident at the end of July. Helping push prices lower has been the crushing progress in Brazil's centre-south, where dry weather has allowed the crush to proceed while also allowing sucrose content to rise. Also helping prices lower, the onset of monsoonal rainfall in India has allayed some concerns over the Indian harvest, where rainfall through the central monsoonal period has been close to normal. This has generally seen the weather-related risk premium come out of prices in recent weeks. However, some key cane growing areas in Maharasthra and Karnataka have received too little rain implying production in India is very much likely to come in well below last year's 26 million tonnes, with 24-25 million tonnes likely. In Australia, excess rainfall through May, June and July has diminished, but the harvest has been pushed back and there is the possibility of some cane loss.

Wheat prices lift on ongoing drought in the US, Black Sea



Source: Bloomberg

Wheat prices were up sharply in July, as the worst drought in the US in more than 50 years saw sharp downgrades to soybean and corn crops. Prices were further helped along by hot, dry conditions throughout the Ukraine, southern Russia as well as parts of Kazakhstan. Reflecting this, the USDA WASDE report in August proved bullish, despite the US numbers being somewhat bearish. Looking ahead, market attention is very much focussed on the FSU with ongoing issues over the Russian, Ukrainian and Kazakhstan crops. In particular, the market is now certain that Russian crop estimates are moving closer towards levels that triggered a twelve month export ban. Attention is also moving towards the Australian crop, where dryness across south west Western Australia has persisted, although recent rains have been encouraging. Elsewhere, the Mallee region remains dry and is likely to remain a concerns for the east coast crop.

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