

# NEW ZEALAND ECONOMICS ANZ AGRI FOCUS

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## GOLDEN YEAR

### FEATURE ARTICLE: REVIEW OF RED MEAT SECTOR STRATEGY

In this month's feature article, we take a look at the future of a sector that has been a founding pillar of our fine nation – the red meat sector, or "dry stock" farming. We see a greater need for farmers to take ownership of the recommendations of the Red Meat Strategy report. The two main areas that need to be acted on by farmers right now are the application of best practice farm management, followed by the resolution of the inefficient procurement model. This will help in-market coordination and control – ensuring returns remain strong.

### THE MONTH IN REVIEW

A superb autumn in many regions has meant that the 2010–11 season will go down as a golden year for most in the agriculture industry, despite a topsy turvy start. The double whammy of record production and record prices for a number of sectors is a real boon.

### PROPERTY MARKET

The number of farm sales has ticked up to its highest monthly level since July 2008. The superfecta of new capital entering the market, low interest rates, a good outlook for commodity prices and reasonable climatic/pasture conditions is expected to continue to provide support.

### KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

Soft commodity prices are holding up remarkably well, as hard commodities have started to come under pressure. However, a higher NZD has muted the benefit back at the farm-gate in recent weeks.

### ECONOMIC BACKDROP

The NZ economy continues navigating three events simultaneously. Our high external debt and low national savings emphasise the need to rebalance. Commodity export prices continue to hit record highs. And the February 22nd earthquake has resulted in significant damage and disruption.

### BORROWING STRATEGY

In our view, there are three considerations. First interest rates will rise in the future. A secondary question is how quickly they will rise, and a third consideration is the premium to fix. The floating rate remains above both the 6 month and 1 year rate, and with the odds of another OCR cut extremely low, it makes little sense to select floating (unless you have other hedges in place).

### EDUCATION CORNER: COMMERCE COMMISSION EXAMINATION INTO THE PRICE OF FRESH MILK

On the face of it, it seems the rise in the price of fresh milk can be largely explained by the increase in international dairy prices and on-farm costs. Furthermore, the increase in fresh milk prices has not been out of step with the increase in the price of other staples.

# FEATURE ARTICLE: REVIEW OF RED MEAT SECTOR STRATEGY

## ASSESSMENT

In this month's feature article, we take a look at the future of a sector that has been a founding pillar of our fine nation – the red meat sector or dry stock farming. With the release of the Red Meat Sector Strategy we thought it would be timely to "look under the hood" of a sector that is currently enjoying better times after on-farm profitability hit a 50-year low in 2007-08. **The industry is worth nearly \$8 billion a year.** In addition, the industry occupies some 80 percent of New Zealand's pastoral farming area, which is one of New Zealand's competitive advantages, along with the high endowment of water.

The Red Meat Sector Strategy report is a large, weighty document, coming in at 167 pages. Its size reflects the complexity of the challenge the sector faces to achieve the stated vision of improving profitability to all participants within the chain. We would emphasise there are no silver bullets here, but stepping stones have been laid down for all the participants of the supply chain to consider. Whether they will, and how they might go about considering and implementing some of the report's suggestions, will be the interesting part.

The main report findings show the largest opportunities lie in improving the on-farm performance of farmers through existing best practice; trying to change the procurement model between farmers and processors; and greater coordination in-market to exert more control through scale. The report then breaks these down into somewhat of a roadmap for the next five years.

**We see a greater need for farmers to take ownership of the reform process.** They are the ones with the skin in the game. We think there are two main areas that need to be acted on by farmers right now.

- 1. The application of best-practice farm management. The potential gains are \$80,000 per annum per farm, or \$20 per stock unit, if "Joe Average" matching the performance of the top 20 percent of farmers.**
- 2. The resolution of the inefficient procurement model and its effects on in-market coordination and control. Shorter-term gains are approximately \$50,000 per annum per farm, or \$13 per stock unit. This needs to be solved if the sector is to grow.**

The first point can be acted on right now by applying the existing knowledge, technology and business systems being utilised by top-performing farmers across the sector. For the second issue there are certainly no easy answers. All-in-all, farmers have the final say in implementing and ensuring the success of many of the proposed initiatives. Farmers need to exercise their voting rights either way – not through apathy though. Farmers will be the main beneficiaries of change and, arguably, the most important element to realising change.

## INTRODUCTION

**New Zealand is delicately placed.** We have a major structural weakness via excessive national debt. Yet at the same time we are seeing record-high commodity prices, and our exporters are making massive inroads into the Asian region.

**It is clear from recent economic performance that policymakers, businesses, the banking industry and individuals cannot stand still.** Of course there is no magic bullet that will suddenly deliver economic nirvana and cure all ills. Magic potions tend to be snake-oil. Yet advancement is as much about evolution as it is revolution. A combination of good, well thought-out policy decisions can allow for advancement, just as poor decisions can result in the reverse. It goes without saying that the only way back up the ladder and returning New Zealand's income per capita to the top half of the OECD is through doing things better and smarter than our competitors.

**With this in mind we are committed to analysing some of the hard issues New Zealand is facing.** Of course, we do not profess to have all the answers. Yet this should not deter us from asking some hard questions and framing the issue in a more economically strategic manner. Our commentary on the Red Meat Sector Strategy is intended to add to the debate in an informed and apolitical manner, and educate as well as inform our readers on some of the challenges, trade-offs and choices involved.

# FEATURE ARTICLE: REVIEW OF RED MEAT SECTOR STRATEGY

## OVERVIEW OF REPORT

The Red Meat Sector Strategy report's stated vision for the various recommendations it makes is to **"improve the long-term profitability of all the participants in the red meat sector and thereby enhance the reinvestment and sustainability of the sector"**. There is a goal that provides hard targets for the vision, which is to "grow the New Zealand red meat sector to reach **a nominal annual export value of NZ\$14 billion by 2025**". To achieve this, exports would need to grow by just under 6 percent per annum, compared to their historical growth rate of 3 percent over the last 20 years.

The report then provides detailed background on the sector and parties involved. It includes details on the sector's operating environment, industry structure, importance to New Zealand, outlook, profitability, export markets and a mix of product sold, size of the sector and a breakdown of processing and supplier capability. This provides the background for the main course; its recommendations.

**Three main themes are identified early on as the sector's big opportunities: coordinated in-market behaviour, efficient and aligned procurement, and sector best practice – no surprises here.**

The report then goes on to talk about market engagement models, not only to be able to affect the proposed sector changes, but to also exert more control and power further up the supply chain, allowing returns to be optimised. The discussion of the engagement models is largely due to the current sector structure being explicitly outside the scope of the study. Therefore, the suggested models are provided as an alternative within the existing sector structure. The report concludes that within the existing sector structure the best market engagement model is "coopetition". A coopetition model is formal agreements focused on specific customers/markets to minimise direct competition and share resources for mutual benefit. The New Zealand avocado industry and the Lamb Company in North America are used as practical examples of what can be achieved through coopetition.

**Industry risks are then covered in three broad sections.**

**The first risk section covers competing land use activities.** The results show dairy is very attractive on the right countryside, and forestry (with associated carbon credits) could be on steeper land. However, this will depend on the future price of carbon and how the politics of climate change and related policies play out.

**The second risk section analyses the main risks that industry participants currently manage.** The main finding is that successful participants, wherever they operate in the sector, focus on the risks they can control. The main risks identified are listed in the table below.

On-farm risks	Procurement risks	Market risks
Fragmented leadership risk Climatic risk Financial risk Competing land use risk Inadequate succession planning risk	Legal risk – procurement and both sides breaking contracts with no penalty.	Market risk – access, demand and reputation Currency risk

**Excess processing capacity is then discussed as another industry risk.** The report suggests that the gap between the processors' installed capacity and their actual throughput has increased by 80 percent between 2006-07 and 2008-09. Using sector data provided by the majority of the processors, the overall cost of the extra capacity is estimated at approximately \$44-\$51 million per year for lamb and \$5 million for cattle. However, it is noted that with another step lower in lamb production in 2010-11, the costs will be considerably higher. The report concludes that the historical gap between installed capacity and actual throughput of 12.5-15 percent probably provides the balance that is required to manage the seasonal peak in production each year. The short and late peak period in 2009-10 is used as an example of when extra capacity was required by farmers because of the seasonal conditions.

**The main recommendations are captured in the last two sections of the report.** The first section is called "Capturing additional value for the sector". It identifies eight drivers of value in the sector and groups them under the three core strategy themes. Each of the eight value drivers has a section devoted to the issues the sector must improve on, how the supply/value chain should be positioned, the opportunities and implementation issues. It is stressed these value drivers need to be acted on within the next five years if the sector is to maintain critical mass, because of competition from other land uses.

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The eight high-level drivers identified as the areas that will capture additional value for the sector are briefly outlined in the table below.

Core Strategy Themes	High level sector value drivers
Coordinated in-market behaviour	<ol style="list-style-type: none"> <li>1. Grow share of market value – the ability to capture a larger proportion of the final sale price and/or achieve prices to increase revenues.</li> <li>2. Get better access to markets – the ability to maintain access to international markets without undue constraints (commercially, economically, politically and culturally).</li> <li>3. Make better use of scale – the ability to realise the benefits of scale (financial, contractual terms, market access and customer opportunities) through volume of branded and/or coordinated product to customers.</li> </ol>
Efficient & aligned procurement	<ol style="list-style-type: none"> <li>4. Select what to sell – the ability to differentiate the product/co-products in the eyes of the customer/consumer, giving relative advantage for the products against competitors or product substitutes.</li> <li>5. Increase certainty of supply – the ability to provide an increasing proportion of programmed seasonal supply or processing so that informed long-term investment planning can occur.</li> </ol>
Sector best practice	<ol style="list-style-type: none"> <li>6. Improve on-farm productivity – the ability to optimise the production environment, available production systems and increase influence through the supply chain.</li> <li>7. Improve business skills – the ability to understand, monitor and model business performance to inform business decisions – including the value of advice received.</li> <li>8. Develop farming systems – the ability to apply and integrate foundational science and technologies to capture how New Zealand’s unique attributes differentiate products.</li> </ol>

In closing, the report provides a road map with specific initiatives under each of the three core strategy themes. It also suggests that a central coordination group with adequate scale and resources, together with support from the Government, will be required to facilitate the proposed initiatives. **The table below outlines the key initiatives identified under each of the core strategy themes. In the report the initiatives are also mapped to a five-year timeline.** This provides key milestones for industry participants to deliver the change that is required to maintain critical mass and revitalise the sector.

Core Strategy Themes	Key Initiatives
Coordinated in-market behaviour	<ol style="list-style-type: none"> <li>1. Improve the sector’s product range, targeting a category approach to enhance the sector’s value proposition to customers and consumers.</li> <li>2. Review sector channels to market, to identify opportunities for enhancing the sector’s pathway to customers and to identify partnering opportunities with other New Zealand primary sectors.</li> <li>3. Develop an exporter charter that sets out the exporter’s commitments to service and quality.</li> <li>4. Develop a competition market engagement model to improve New Zealand’s ability to supply large emerging markets/customers.</li> <li>5. Identify priority markets to focus market access activity.</li> <li>6. Improve the supplier connection with markets and customers.</li> </ol>
Efficient & aligned procurement	<ol style="list-style-type: none"> <li>7. Develop a framework to formalise an annual commitment of supply to selected supply/value chain partners.</li> <li>8. Develop a comparative reporting framework with sector key performance indicators.</li> <li>9. Increase investment in consumer taste and product preference tests to deepen the sector’s understanding of performance and trends.</li> <li>10. Develop incentive-based pricing for all classes of stock.</li> <li>11. Develop a contractual framework for suppliers to support processing capacity rationalisation.</li> </ol>
Sector best practice	<ol style="list-style-type: none"> <li>12. Develop a complete nutrient management system able to optimise inputs for efficient conversion of animal feed to protein.</li> <li>13. Advance best practice animal welfare practises to further enhance production, quality and reduce the impacts on meat production.</li> <li>14. Develop an improved extension programme to improve the communications of science and technology.</li> <li>15. Develop progression pathways for young people to enter the sector.</li> <li>16. Improve sector information systems to ensure integrity of sector data and skills to gain access to timely information.</li> <li>17. Review the proposed ETS scheme to identify ways the ETS’s incentives can be redesigned to ensure continued sector growth.</li> </ol>

### THE VERDICT

**We like the spirit of the report and commend the authors.** Right from the outset we need to openly acknowledge the work and fortitude of numerous parties who provided insights. It is an incredible feat in itself to deliver such an extensive document with a comprehensive synopsis of the issues and a collection of recommendations. We do have some constructive criticisms, which we outline below, but we would like to emphasise that we find the document to be a useful contribution to discussion of the sector’s future.

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**We likewise commend the aspiration, up to a point.** \$14 billion is a huge step up from just under \$8 billion and it is important to set achievable metrics. And it does imply a growth rate in meat exports that is double the rate achieved over the past twenty years: a rate a little under 6 percent per year over the next 14 years. It sounds impressive, but in fact we wonder if the sector is selling its potential short! We'd expect the general economy to grow at around 5 percent per year on average in nominal terms. Export growth for the past two decades has averaged around 5 percent, a growth rate insufficient for the economy to pay its way, resulting in big current account deficits and higher offshore borrowing. We need to do even better! Moreover, if an increasing proportion of our exports is set to end up in the fast-growing Asian region, and the likes of China are growing at 8 percent, then 6 percent growth implies diminished import penetration into the area (i.e. our exports will not match expected Asia's expected import growth). There are naturally constraints from the production side here, such as land availability etc. Turning things up in rural production is not like making a widget. Yet we can't go past the basic maths. A sector that is postulated as being a key part of our strategic advantage has aspirations to grow mildly above the economy-wide "system". Why not aim even higher?

The report identifies three main areas where the ship has been heading in the wrong direction, **or where the greatest opportunities lie to revitalise the sector.**

- 1. Lack of in-market coordination.** This reduces the share of the end product price farmers receive, impedes brand positioning and the creation of new products/markets. It has also created an unnecessary number of middlemen.
- 2. Inefficient procurement model between farmers and processors.** This increases the cost of production for exports at the port in New Zealand, reducing the competitiveness of the sector. Moreover, it contributes to the lack of in-market coordination.
- 3. Poor on-farm performance.** This has occurred through not applying best practice farm management in a number of areas. This increases the disparity between the financial performance of the top 20 percent of farmers and the rest.

**While some might say things have changed, the reality is:**

- A 50-year low in profitability, some bad weather and intense pressure from other agricultural sectors means there is now a yawning gap in supply from New Zealand (strong wool, sheepmeat and venison specifically). This has helped push prices higher and restored some fat to farmers' margins. There is one thing to say to this: no industry or empire has ever shrunk its way to greatness!
- Many of the issues that led to the 50-year low in profitability have not gone away, but lie in wait ready to pounce. The three areas listed above need to be addressed if the sector wants a revitalised future.
- On the positive side, better profitability now allows the industry to invest for the future. There is probably no better opportunity than now to right the ship. When we eye progress on the trade front (forget Doha, focus on the bilateral agreements), the strategic importance of assets such as water, the emergence of the Asian consumer and subsequent demand for protein and fat, New Zealand is facing a once in a generational opportunity. We are not convinced the true upside is sufficiently acknowledged.
- The world economy and NZ.Inc is facing a pronounced period of change. The old model of farming for capital gains is being replaced by a stronger emphasis on yield and cash flow. Policymakers are taking steps with the soon to be implemented new prudential rural capital requirements for banks a prime example.
- There are a host of microeconomic issues that are simmering below the radar including succession, population aging, foreign versus local ownership of farmland, environmental issues, animal welfare, traceability and the list goes on.

**The strategy document goes some way to capturing all the main issues that need to be worked on to revitalise the sector.** It breaks them down into bite-sized portions and throws some timelines around things – this is all a good start.

**However, the key challenge is to galvanise farmers into action.** After all, they are the ones with the most skin in the game and the ones who will be the main beneficiaries of any change. **Our emphasis is on farmers, because ultimately they hold the key to implementing and ensuring the success of many of**

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**the initiatives that are outlined in the report. It is worrisome is that the majority of the proposed initiatives have been allocated to “strategy sponsors” to resolve.** These entities have the least skin in the game of anyone and will be only secondary beneficiaries of any change that occurs. The majority of the processing capacity is under a cooperative structure that is owned by farmers, who have the deciding vote here, like shareholders of any company. Farmers can also choose where, when and how they want to sell their stock. For better or worse, the main capital base for the sector is farmland, which farmers also own, although the value of this would be a lot less if the sector did not have the intellectual property that resides in the processing sector. All-in-all, farmers have the deciding say in implementing and ensuring the success of many of the proposed initiatives. **Farmers need to exercise their voting rights either way – not through apathy though.** Farmers will be the main beneficiaries of change and, arguably, the most important element to realising this change.

The report does acknowledge this to some extent with quotes such as “the solutions proposed in the strategy are not simple. They are about changing mindsets, attitudes and relationships as much as they are about changing physical things”. And “while some sector participants will be looking for a structural change to be a catalyst for the sector to change, this is not a pre-requisite”. **The challenge to farmers must also be extended to service providers, or trusted advisors, such as accountants, farm consultants, lawyers and bankers.** In many instances farmers will lack the necessary skills and knowledge to understand what is required and why. This is where service providers and trusted advisors need to ensure they are up to speed and can provide the support required to make enlightened choices and instigate changes to their clients businesses and business practices.

At both a high and low level there is very little in the strategy document that underlines to farmers that they will be the main beneficiaries, **nor does it clearly articulate the size of the prize.** There are three slightly different versions of the vision, which is not ideal. The first part of the three different visions is consistent, in that an improvement in the long-term profitability of all participants in the red meat sector is desired. The second parts of the three visions have mixed themes of investment, sustainability and competitiveness. What is concerning is that the accompanying goal provides no linkage to the vision, metrics for individual participants to aspire to, nor definition of the concepts mentioned. The goal to grow nominal exports to NZ\$14 billion by 2025 does not in itself ensure profitability to all participants. Nor does it ensure reinvestment, sustainability or competitiveness. **A vision that articulates long-term profitability to all participants to create greater wealth would be more appropriate.** By default the creation of more and more wealth implies reinvestment, sustainability and competitiveness. **This should be followed by a goal to grow farmer net incomes and return on assets by a certain level within a certain timeframe, if they undertake the key initiatives within the report.** Think of the ambitious target of a \$150 lamb Federated Farmers put up a few years ago - supported by initiatives to back up the vision/goal. The same applies for the other participants within the red meat sector.

**To be fair, the need to develop sector key performance indicators is flagged as a first up initiative for “strategy sponsors”. We hope it will add some more context to what the size of the prize is for all parties, but in particular to farmers.** Otherwise why bother undertaking any of the initiatives? Moreover, this should be extended to a lower level for the 17-odd key initiatives outlined above in the overview of the report. What might each of these deliver to a farmer and processor financially, or from a risk management perspective? We have made a start below, but lack all the industry information that has been collected through the strategy process to complete the table. We think it would be well worth completing, to try to galvanise some action from farmers and put some hard targets on the initiatives.

### THE SOLUTIONS – ON FARM

**Cutting to the chase, there are two chestnuts that need to be cracked as soon as possible.** One is well recognised, with no easy answers and many suggestions. The other is something that is probably not so well recognised, but the answers are already available and easier to implement.

**Starting with the one that is not so well recognised, but easier to resolve, an issue for the sector is the disparity between the financial performance of the top 20 percent of farmers and the rest.** The gap in cash performance between the two has doubled over the last 20 years. This is a new aspect to the 50-year low in profitability that many have not fully considered. Yet research has shown that the gap is not

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dependent on the class of land, farm size, region or age of operator. In the majority of cases it actually comes down to an individual's business and financial acumen. Therefore, there is an opportunity to close this gap.

To galvanise farmer action right now to address this initiative we, propose three simple questions. If you can answer yes to all of these questions then you are probably on the right track. If not, you should get started on implementing these disciplines in your business right now.

1. **Do you have a business plan?** If you do not know where you want to end up, it is difficult to get there. The Landcorp example in the back of the strategy document is comprehensive in its approach.
2. **Do you have a budget that you treat as a living document?** Good financial disciplines such as budgeting follow any other form of management. Plan, implement, control and evaluate. For budgeting a cashflow forecast is the plan, spending the money is implementation, reviewing spending compared to forecast budget at end of month and adjusting accordingly is control, and asking whether a budget was achieved and whether it delivered the set goals is evaluation.
3. **Do you benchmark your physical and financial performance and link it back to the goals in your business plan?** It is impossible to know where you sit if you do not benchmark yourself. Imagine the All Blacks not benchmarking their speed, fitness and strength. We would not have backs that are now bigger and stronger than the forwards from a few years ago.

**Addressing this issue can be resolved with current knowledge, technology and business systems.** It is not rocket science, but the things mentioned here and in the report are critical elements to the success of any business. Cracking this also helps resolve some of the other industry issues. But don't worry, the sector is not alone; many other New Zealand sectors face similar challenges and our fellow meat and fibre producers across the ditch have recently identified the same issue. Ask how many of your individual friends outside farming have goals and a budget that they follow strictly. **This is good-hard-look-in-the-mirror stuff, but not rocket science.**

**The potential increase in performance is immense. Around \$20 per stock unit in net profit has been identified as the difference between the top 20 percent of farmers and the average. For a "Joe Average" farm of 4,000 stock units this is an \$80,000 a year difference. Not bad when profitability has averaged \$64,000 per annum per farm over the past decade.**

Stepping-stones suggested in the report also bring in some other farm management disciplines that are critical to the financial success of a sheep and beef farm. These include:

1. **Improving the management of pastures through matching land type with its optimal use** – renewing pastures, tailoring and targeting fertiliser use and improving stock mix (complementary species with different grazing habits, improving fencing, etc).
2. **Improved on-farm genetics through tracking both flock/herd and individual animal performances** – animal robustness/suitability to the environment, parasite resilience, growth rates, size of primal cuts, and progressively, animal quality attributes that influence taste and shelf life.
3. **Improved farming practices through better knowledge of the biological systems on farms** – optimal use of drenches, efficiency of forages through the ruminant system, use of crops to manage environmental risks or increase animal weight gain, condition scoring and specialist tests to target management on-farm (soil testing, animal immunity testing, etc).
4. **Improving business skills through increased use of technology and different practices** – having a written business plan, regular weighing of animals, use of weather stations to inform animal rotations, the measurement of each paddock's metabolic energy, increased data capture and monitoring (use of spreadsheets and farming management software to manage costs and production).

**We concur with this, and many of the improvements can be achieved immediately, with the help of specialised knowledge in some cases. Figure 32 (on page 107 of the report) in the strategy report implies that sector best practice comes after resolving the issues with procurement and coordinated in-market behaviour. We would argue many of the proposed initiatives under sector best practice can and should start right now.**

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### THE SOLUTIONS – OFF FARM

**The other chestnut that is well recognised, but which has no easy answers, is the inefficient procurement model between farmers and processors. Solving this conundrum within the existing sector structure, or through a new one, will allow greater in-market coordination to take place.** The result will be lower operating costs (for farmers and processors) and increasing market power. **One farmer quote that epitomises this is “We are not fighting the farmer down the road, across the fence, or the processor who provides us a service – we are fighting other producers of protein”.** It is important all farmers understand this concept and act accordingly. It involves moving away from a spot market model to fixed supply directly to processors.

**The trouble is there are many different ways to resolve this, and the report outlines a number of possible avenues to help resolve the issue.** There is qualitative detail on what the potential benefits of solving the inefficient procurement model might be to farmers and other participants. There are also some ideas that look at initiatives to help alleviate the situation within the existing sector structure. However, whether this will deliver the step change that the report highlights is needed in the next five years is debatable. A case in point is the many broken promises on both sides of the divide when it comes to supply contracts between farmers and processors. But in saying this there has been a lot of hand wringing over the last eight or so years, maybe even longer, that has led to little resolution in this space. So maybe the softly, softly approach of small steps is a better way to go. This is how the New Zealand dairy sector got to where it is today. The creation of Fonterra didn't happen overnight, nor did the performance that we see from Fonterra today. Many dairy farmers will remember attending farmer meetings in the mid 2000's when dissatisfaction in Fonterra's performance was pretty high. **The increase in long-term profitability to all the participants will be greater from solving this issue than any other.**

**We think a quantitative estimate would be more powerful.** While it is difficult to calculate some of the potential quantitative benefits from solving the inefficient procurement model, numbers are needed to galvanise farmers into action. The processing capacity numbers that are provided are probably a case in point, but it is only one piece of the puzzle. The numbers read something like this: the processing sector in the long run needs installed capacity of 12.5-15 percent above actual throughput (unless on-farm risks are better managed by farmers, in which case this could be further reduced). There is a balance here given the seasonal nature of our pastoral farming system. Because of the large drop-off in lamb numbers, the gap between the installed capacity and actual throughput has increased by 80+ percent over the last 4-5 years. **This means that installed capacity versus actual throughput is now perhaps operating in the range of 70-75 percent for sheepmeat. The annual cost of this is \$50 million per year, or \$4,000 per farm. This is relatively low when compared to the potential \$80,000 lift in performance per farm in getting an average farm to perform like the top 20 percent of farmers.** While it is difficult to see what is included and not included in the \$50 million. There are a couple of further points that need to be drawn out. One is, yes, there is a cost of shutting down excess capacity. This may be \$10 million per million head of lambs because of redundancies and the like, but what is the payback period? Overall, the sector has lost around 5 million head of lambs (-20%) since 2006-07, so to get capacity back to optimal, it would suggest the cost would be perhaps \$50 million. **If the sector is losing \$50 million per year then the payback period of rationalisation is 1 year which seems like a no-brainer to us.** Of course the problem is that the benefits of rationalisation accrue to the entire sector, especially farmers, not the individual processor/shareholders who bear the shut-down costs. Otherwise the issue would have resolved itself already. We emphasise we are joining the dots here, as we don't have the raw data to do the exact calculation, but it seems the payback period for rationalisation would be very short. A view on the future flow of livestock would also need to be considered to complete this analysis.

To try to get a sense of what the combined quantitative benefits of resolving the procurement and in-market coordination issues might be, we have constructed the table below. **While by no means comprehensive in its approach to all the initiatives outlined in the strategy document, it starts to give a sense of the size of the prize from cracking these two chestnuts.** Many of the possible gains outlined are shorter-term (2-4 years) and will ensure the industry is well placed to be able to grow profitability.

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Medium Term Opportunity	Sub Category	Strategic Measure Baseline	5-Year Goal	What is it worth to NZ farmer per year?
Supply Chain Efficiency	Optimal Processing Capacity	Capacity currently running at 70% for lamb and 80% for beef.	Increase to 90% with efficient procurement model	<b>+\$5 per lamb</b> (around 5% of current farm-gate value). Mutton is a question mark. <b>+\$18 per cattle beast</b> (uses 2.0% of farm-gate value for 80% to 90% movement. Assessment in report would only put potential at \$2.5-\$5 per head). It should be noted there are other industry figures that put processing capacity in the 50-60% range. This would infer the figures here are on the conservative side.
	Transportation	Total cost as a percentage of end retail value, split for NZ and offshore components of supply chain.	Decrease to XX% (data not available) for each component of supply chain.	<b>Lamb +\$0.50 per head</b> <b>Mutton +\$0.25 per head</b> <b>Beef +\$5 per head</b> Change from average to top 20% as outlined in document.
Culture and economic signals between farmers & exports	Supply Contracts	Percentage of industry supply contracted on a 12 month basis between farmers & exporters.	Increase to 75-80%.	<b>Lamb +\$0.50 per head</b> <b>Mutton +\$0.50 per head</b> <b>Beef +\$5 per head</b> This has a lot of inter-linkages with management of margins and coordinated in-market behaviour, as well as supply chain efficiency. This is where the main benefits would accrue. However, as outlined in document changing from average to top 20% would decrease procurement costs for industry.
	Management of in- market margins between export and importer/retailer	Farmer return as a percentage of end retail value.	Increase to, or hold at 50% for lamb and mutton. No data on beef yet.	Up to <b>\$30 per lamb</b> back in the 2006-2008 period. If industry is to grow this needs to be sorted! Here is no data for beef or mutton but could be significant. However, the global beef market is much larger than sheepmeat and therefore the same control cannot be exerted with NZ supply.
Product Transformation	Chilled product	Percentage of total meat production sold as chilled product.	Increase from 25% to 75% for lamb. Beef will depend on margins between manufacturing beef and other cuts/markets.	Value ratio for chilled lamb to frozen is approximately 1.9 to 1.0 at the port in NZ. Chilled is higher cost but is also where greater value can be extracted from consumers. This is longer-term but is critical to supporting returns and growing new markets.
	Lamb Pelts	Farmer return as percentage of end retail value.	Increase from XX% to XX% (data not available) for pelts and hides.	<b>Lamb \$10 per lamb</b> at the smaller end of the scale. This is the value that has been lost since 2000 through lack of coordinated market behaviour. <b>Cattle \$20 per hide?</b> Majority of hides sold to Italy for high fashion and the like, opportunity to capture a greater proportion of end value is large.
Foreign Exchange Rates	Management of Foreign Exchange Rates	Match competitor's performance (i.e. dairy) against spot foreign exchange rates.	Since its inception Fonterra's effective exchange rate conversion for its earnings has added \$0.20 per kg MS (+4.0%). Beat spot market by 4%.	<b>Lamb +\$4 per head.</b> <b>Mutton +\$2.8 per head.</b> <b>Cattle +\$36 per head.</b> Biggest advantage is better risk management of peaks and troughs in currency. Volatility has increased in recent years.
<b>Total</b>				<b>Lamb +\$20 per head (+19% on average prices)</b> <b>Mutton +\$3.6 per head (+5% on average prices)</b> <b>Cattle +\$84 per head (+9% on average prices)</b>

The table is broken down into four categories that focus on different parts of supply that will help alleviate the procurement issue and ensure better coordination in-market. **Overall, the results show, where some data is available, the combined benefit of these would be \$20 per lamb, \$3.60 per adult sheep and \$84 per cattle beast. The combined benefit for the average farmer is somewhere in the region of \$50,000 per year.** This doesn't quite match the \$80,000 that was identified from on-farm improvements,

## FEATURE ARTICLE: REVIEW OF RED MEAT SECTOR STRATEGY

largely due to in-market margins for lamb and beef improving as supply has been reduced over the last little while.

In the dark days of 2006-2008 when sheep returns were a measly \$5-10 per stock unit, coordinated in-market behaviour was failing very badly because of heavy discounting to shift product. **The combined loss from the port in New Zealand to the supermarket shelf was up to \$30 per lamb.** This was in the margins wholesalers, re-processors and supermarkets were taking. While this is no longer on the table because we have reduced New Zealand's lamb kill from 26 million head to a forecast 19.3 million head this year if the strategy of improving on-farm financial performance and production is to be successful, then the overall supply of lamb and beef is going to increase again sometime in the future. Are we again going to lose \$30 per head further up the supply chain again? If so, what is the net effect? Probably not what is desired, or envisioned by the strategy. So solving the procurement issues will allow better in-market coordination and processing capacity to be optimised, through the proposed growth phase. This allows production to increase while not substantially reducing returns, which is what is needed if the industry wants to grow and have a revitalised future; otherwise dairy and forestry will prevail. Ultimately, for the industry and farmers specifically, this involves moving away from the spot supply market to fixed supply.

We again emphasise that no industry has ever shrunk its way to greatness. New Zealand does have the critical mass and expertise in sheepmeat, strong wool and venison to be able to exert control and coordination of product that is traded across borders – similar to what the New Zealand dairy industry has achieved over the last 10 years and continues to pursue with investment in China, India and Brazil. **While the exact benefits of this control are difficult to put a number on, our quick and dirty analysis would suggest the potential size of the prize is \$50,000 per average farm in the shorter-term, with the ability to improve on this in the future.**

**The whole issue of rationalisation is implicitly but not explicitly addressed.** You can easily see why, when you consider the vast array of stakeholders involved. It's an issue that seems to be tactfully tip-toed around. We say the issue is implicitly covered because delivering on the other initiatives such as the productivity of the lower-quartile farmers and more focused management will raise output and lessen over-capacity issues. If farmers commit 100% of their stock to particular processors, this will clearly highlight where the over-capacity currently is and market forces will dominate from that point on. However, by various parties own admissions, they exist to maximise the return to their respective co-operative shareholders – get they are currently not doing this. A merger would remove fixed costs from the industry and enable a higher return to the farmer. However, some short-term costs would need to be borne to achieve this.

### THE UPSHOT

**The question we put to farmers: Is the \$130,000 (approximately \$33 per stock unit) at stake for the Joe average farmer enough to galvanise farmers and other industry participants with skin in the game into action?** History would suggest not and the lack of critical analysis of the report by others might also suggest apathy. This is not to downplay the report itself; such quantification is incredibly difficult. Ultimately the success of this process will be governed by actions. One thing is for sure, farmers and other participants cannot sit on the fence, otherwise there may well be a lot more contemplating converting to either dairy or forestry in the very near future. The strategy document does emphasise a number of good points and covers a vast array of things that need to be further examined. As part of this, we would like to see further analysis on the two issues we have discussed to inform farmers' decision-making, and most importantly, inspire more action. Service providers and trusted advisors have a part to play here too.

## THE MONTH IN REVIEW

### ASSESSMENT

The superb autumn in many regions has meant that the **2010–11 season will go down as a golden year for most in the agriculture industry, despite a topsy-turvy start.** The winning quinella of record production and prices for a number of sectors has been a real surprise to many, given where both were placed this time last year. This autumn has been described as one of the best in the last four years, but perhaps more near normal prior to that. **A once in a lifetime La Nina event has been a contributing factor.** However, the Southern Oscillation Index has now been reported back near neutral levels heading into winter.

### GOLDEN YEAR – DAIRY

The 2010-11 dairy season, which is nearly at a close, looks like it is going to end as a golden year. Fonterra's season end milk price of **\$7.50 per kilogram of MS, plus a dividend of around \$0.25 after retentions, will be the highest on record.** In addition, record production during the autumn means annual production is now going to **be close to 4 percent+ ahead of last year and another all-time record. Combining the two certainly makes for some flush bank accounts.** A large proportion of this has been used to repay debt. This has been reflected in agricultural credit numbers, which show a decline of \$900 million since September 2010 to \$46.3 billion (-1.8%). This is despite the number of farm sales and prices picking up. Of course some of this has been from new sources of capital entering the rural property market. **The forecast 2011-12 season opening \$6.75 per kilogram of MS, plus a dividend of around \$0.25 after retentions will only add further momentum to these trends.**

Some of the strongest production results have been in the upper and central North Island and central South Island. The upper North Island, which was affected by drought last year, is showing production gains of around 10 percent on last year. The central North Island, which accounts for around a third of New Zealand production, is showing gains of 5 percent on last season. The other big mover has been the central South Island, up around 5.5 percent. The middle of country was not so drought-affected last year so has similar production this year.

### GOLDEN PRICES – MEAT & FIBRE

**The farm-gate prices received for meat and fibre products this autumn have been nothing short of spectacular.** The seasonal peak in production has also come later. The key reason for this is that farmers have not had the same number of stock to finish, because of the wet winter/spring, so have held stock longer to add more weight. Some stock were also checked during the dry spell in November and December, so have taken longer to finish. Farmers have also held on to stock in expectation of prices continuing to rise, which they have. **Overall lamb production is now running 12.6 percent behind last year,** with this split evenly between both islands. However, because farmers have opted to cull deeply into their breeding flock and hold finishing stock for longer, the average per head weight for lamb **has increased to 17.9 kilograms (+1.5% on last year).** This indicates an all-time record of 18 kilograms per head is on the cards. Overall mutton production is still running 22 percent ahead of last year, but is beginning to run thin as farmers assess stock levels for the 2011-12 season.

**Beef production is 0.7 percent ahead of last year.** This has come from an increase in cull cows from the dairy herd. **Overall cow production is up nearly 5 percent on last year at 551,000 head.** Dairy farmers have also extended milking this season to take advantage of the good pasture conditions and record payout. This has delaying cull cows being turned-off. Steer, heifer and bull are all back on last year by 0.9, 1.0 and 2.0 percent respectively. Venison production is running only 0.6 percent behind last year, from slightly lower slaughter numbers. Wool exports are down 3.4 percent on last year.

### GOLDEN PRODUCTION – HORTICULTURE AND VITICULTURE

Some big crops have some smiling, but others concerned about what the flow-on effects might be for prices. PSA continues to dominate the local kiwifruit scene; the real estate market is dead with virtually no sales. On a brighter note, Zespri's indicative price ranges for the new season look to be down only marginally on last year despite a large increase in yields. Returns are forecast to be similar to last year, as the large increase in yields is expected to be offset by slightly softer prices. **The overall 2011 crop has been forecast at 104 million trays, up 3.0 percent from last year.** However, the average size of kiwifruit this year is large because of the warm, wet conditions late in the season. This will decrease the taste and the premium price received for better tasting fruit. It looks like the **2011 grape crop is in excess of 320,000+ tonnes versus market demand of 280,000 tonnes,** leaving a large gap between the two.

# RURAL PROPERTY MARKET

## SUMMARY

The trifecta of lower interest rates, record commodity prices and good climatic/pasture conditions seems to have delivered a much-needed shot in the arm for rural property prices, especially dairy and dry stock. While the number of sales remains low on a historical basis, the signs of life mentioned in our last update are starting to flow through into the numbers, especially the number of farms changing hands. The agriculture sector as a whole is still carrying too much debt. But it seems those that are well capitalised, as well as new capital entering the rural property market (from individual overseas investors, through to large institutional investors/schemes) are starting to turn the tide. **There were more farm sales reported in April than any other month since July 2008, just prior to the GFC.**

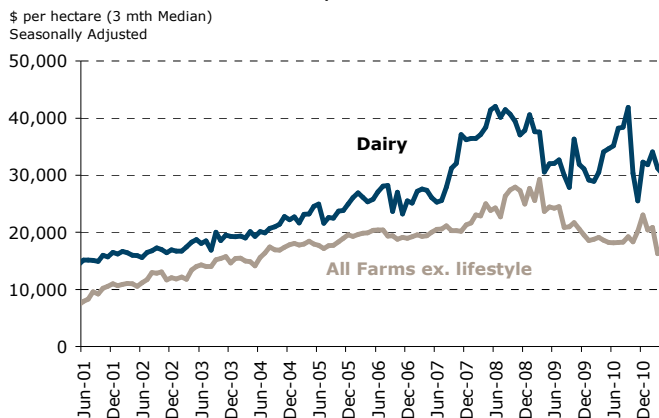
## COMMENT

The rural property market for livestock blocks now looks to have found a floor on the back of new capital entering the farming scene, improved returns from very favourable financial conditions and a lift in confidence fuelled by better climatic/pasture and financial conditions. However, some of the land prices being paid at the top end still translate into a decidedly average cash yield and this could be setting a potentially false floor.

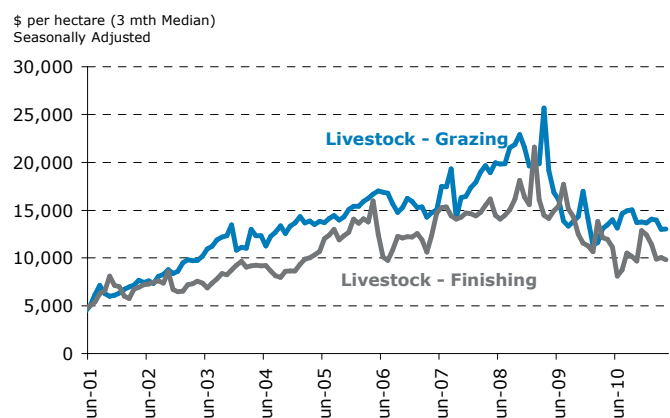
The tables and charts below show the official statistics from REINZ for the three-month period ended April (i.e. February, March and April farm sales). The table is broken down into farm sales by each of the main farm types, for the number of sales during the three-month period and the median price per hectare. The figures have also been seasonally adjusted and therefore the components may not necessarily add to the total. While the data is volatile, it is the best available regarding current market conditions.

3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10 - Year Av.	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	38	30	30	94	↑	↑	↓
	Median Price (\$ per ha)	30,200	31,200	34,100	25,900	↓	↓	↑
Livestock - Finishing	Number of Sales	33	29	31	79	↑	↑	↓
	Median Price (\$ per ha)	9,800	10,000	12,000	11,000	↓	↓	↓
Livestock - Grazing	Number of Sales	133	100	117	258	↑	↑	↓
	Median Price (\$ per ha)	13,000	13,000	13,000	13,600	↔	↔	↓
Horticulture	Number of Sales	25	23	33	63	↑	↓	↓
	Median Price (\$ per ha)	158,200	145,600	143,200	140,600	↑	↑	↑
Arable	Number of Sales	10	5	7	21	↑	↑	↓
	Median Price (\$ per ha)	22,800	22,000	28,400	23,000	↑	↓	↓
All Farms ex. Lifestyle	Number of Sales	259	209	240	551	↑	↑	↓
	Median Price (\$ per ha)	17,700	16,300	18,700	17,900	↑	↓	↓
Lifestyle	Number of Sales	1,102	975	1,131	1,659	↑	↓	↓
	Median Price	448,000	450,000	437,000	355,000	↓	↑	↑

### Farm Sales, Median Price



### Farm Sales, Median Price



## RURAL PROPERTY MARKET

**Looking at the detail, the rural real estate market looks to be showing the first signs of life, with the number of sales ticking up to their highest monthly level since July 2008.** And anecdotes suggest there is more to come over the next couple of months. The increased turnover in farm sales supports our view of the rural real estate market stabilising. However, the turnover in farms (number of sales) still sits at under half the 10-year average, so don't expect prices to suddenly take off in the near-term and recapture the heady heights of 2008. Buyers remain cautious and are taking longer on proper due diligence, which is not a bad thing. Farms that are in decent locations, with good productive soils, favourable climate and first-rate facilities/infrastructure are selling at reasonable prices. We expect that the building of further momentum in the rural property market will be governed by cash yields, which will be influenced by a myriad of future factors. **The two biggest drivers over the coming 12 months will be commodity prices and interest rates (as long as the weather Gods continue to smile). We expect there to be some tightening here, with slightly lower commodity prices in 2012 and slightly higher interest rates.** This means while the number of farms sold is likely to continue to increase, which is healthy for the marketplace, buyer expectations of having to pay higher property prices are likely to be some way off. **This is because the figures on "cash return on asset" are still decidedly average compared to alternatives, and debt repayment still has some way to run, especially in the dairy sector.** This is despite the financial conditions for the sector being at an all time high. Those investing new capital into the sector are particularly diligent in this area; if the numbers don't stack up, then they will not invest. This is, and will continue to be, a key challenge for vendors. So vendors need to make sure their property is put forward in its best possible financial light.

Looking at the components of the table on page 12 shows there was **a 24 percent increase in the number of farm sales in the three month period ended April (excluding lifestyle blocks). There were 152 farms that changed hands in April, the most since 154 in July 2008.** The preceding three April months - 2010, 2009 and 2008 - saw 103, 108 and 264 sales, respectively. **The median price for all farm sales has also recently moved higher, but is distorted by the high proportion of dairy and grazing farms.** In total 259 farms were sold in the three month period ended April 2011. After a lean spring period, the continued slow grind higher in the total number of farm sales is encouraging and we expect this has further to run. Nevertheless, the turnover of 259 farms for the three-month period ended April **is still only on par with this time last year, and under half of the average level seen over the last 10 years.** Grazing properties accounted for the largest number of sales, with a 51 percent share of all sales in the three months to April. Dairy properties accounted for 15 percent, finishing properties 13 percent and horticulture properties 10 percent.

**The median price for dairy properties is showing some stability around the \$3.5m mark, or \$30,000 per hectare.** While there is considerable variability around the median price, depending on the quality of the property being sold and region, this has now been the median price over the last eight months. The April month saw 24 dairy farms sold at an average sale value of \$29,200 per hectare and \$34 per kilogram of milk solid. The average farm size was 177 hectares and the average production per hectare across all dairy farms sold in April was 863 kilograms. The 24 April dairy farm sales was up on the 15 sold during March and 12 in April 2010. Dairy property prices have been particularly strong in the main New Zealand dairy regions, with Taranaki and Canterbury registering good prices compared with the last couple of years. Overall, turnover is beginning to pick-up and prices are gravitating toward the \$30,000 per hectare mark, or \$35 per kilogram of milksolid level. The forecast 2011-12 \$7.00 per kilogram of MS (in total) gives an investment multiple of between 5-5.5, which is in line with historical averages. We are, admittedly, sceptical that historical averages that precede the GFC will be a good guide going forward. The continued paying down of debt in the dairy sector is also likely to constraint potential price increases for the next several seasons.

The confidence coming from higher returns for meat and fibre products is starting to filter through to grazing, finishing and arable land sales, with volumes increasing markedly for the three months ended April and values holding. Grazing land is stabilising around the \$13,000 per hectare level and finishing \$10,000-\$11,000 per hectare. While volumes have increased on this time last year, prices are probably back by \$1,000 per hectare for both types. Arable is stabilising around \$22,500 per hectare. Turnover has increased on last year but values are back by \$5,000 per hectare. **We expect to continue to see an increase in sales, but expect cash returns will continue to contain any price increases. Average cash returns are still too low to support significant amounts of debt. Horticultural sales continue to be hit hard by lower returns and confidence in the pipfruit and viticulture industry and by PSA concerns in the kiwifruit industry.** Local valuers believe the historical capital rate against orchard gate return for kiwifruit has been 18-22 percent for green and 25-30 percent for gold. Anecdotal evidence suggests this will increase by at least 5 -10 percent.

## ECONOMIC INDICATORS

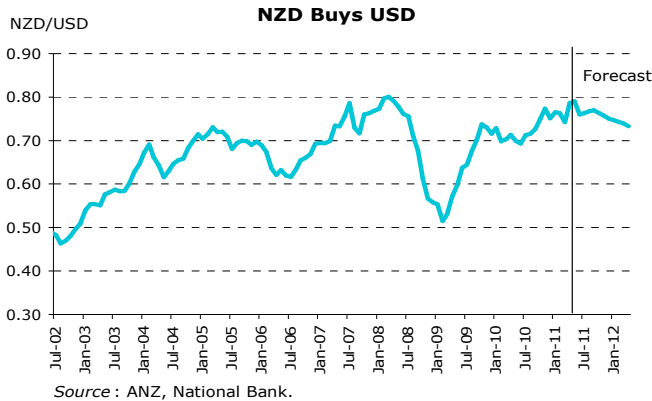
### Exchange Rates

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZD/USD	0.79	0.79	0.70	↑	↑
NZD/EUR	0.55	0.55	0.56	↑	↓
NZD/GBP	0.48	0.48	0.48	↑	↑
NZD/AUD	0.73	0.75	0.80	↓	↓
NZD/JPY	66.2	65.6	64.4	↑	↑
NZD/TWI	68.8	68.6	66.0	↑	↑

The combination of a 2011 Budget that has averted the likelihood of a credit downgrade, a record opening Fonterra forecast for 2011–12 and higher surveyed inflation expectations has sent the NZD up again.

From a fundamental point of view, we are likely to see ongoing interest in NZ government bonds from offshore investors, especially for the new 2023s that the DMO intends to issue. If so, then NZD could continue to outperform in the near term. A continuation of high commodity prices will also be important.

The EUR continues to be vulnerable as Greek restructuring talk intensifies. Fitch has recently cut Greece's rating to B+, placing it well below investment grade. Spanish elections are not going well for the ruling party, with suggestions the new regime may "get honest" about the state of Spain's books. The US debt ceiling issue continues to bubble away in the background. These two issues are creating a currency tug-of-war between the EUR and USD. US data continues to improve but the gulf between headline and core inflation continues to widen. Confidence indicators are improving and Fed officials seem to be acknowledging economic improvements. However, they are very reluctant to signal in any way the end of the current monetary accommodation. FX markets often lead other asset classes at major inflection points; therefore, we need to be aware of the potential unwinding of the low USD.

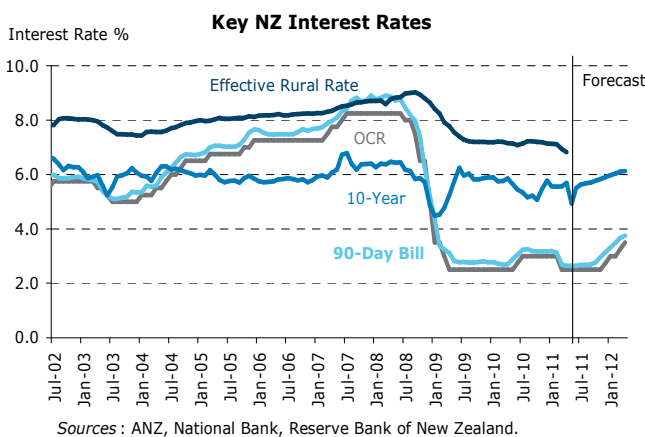


### NZ Interest Rates

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Official Cash Rate	2.50	2.50	2.50	↔	↔
90 Day Bill Rate	2.65	2.65	2.89	↑	↓
1 yr	2.89	2.89	3.46	↓	↓
2 yr	3.46	3.46	4.09	↓	↓
3 yr	3.37	3.96	4.59	↓	↓
5 yr	3.94	4.76	5.07	↓	↓
10 yr	4.92	5.68	5.65	↓	↓
Effective Rural Rate	6.83	6.95	7.16	↓	↓
Agricultural Debt (\$B)	46.25	46.66	46.03	↓	↑

Farmers continue to benefit from historically low interest rates and the proportion of debt on maturities on less than one year continues to increase, going from 37 percent last year to 55 percent now. We expect this trend to continue, but with interest rates bottoming out and set to rise sometime in the future, this provides interest rate risk that will need to be actively managed.

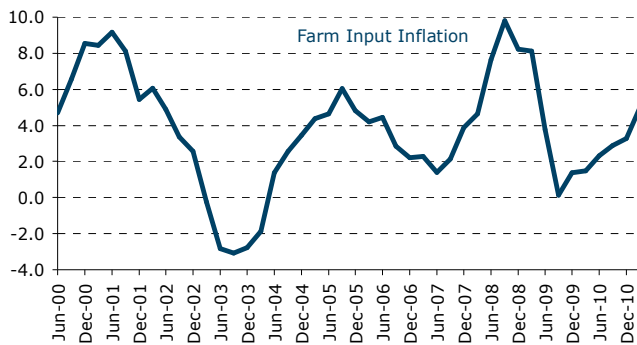
The level of foreign interest in the NZ bond market has lowered longer-term rates, as have lower US bond yields. The RBNZ's relaxed stance has also helped – but when we look ahead, we are becoming increasingly uncomfortable with the idea that NZ rates are set to stay as low as forward rates imply. We expect the OCR to climb to 4.75 percent in 2 years time, yet the market is pricing in something closer to 4.1 percent by that time. This difference is large enough as it is, but it looks even worse when one considers that the forward interest rates have a habit of "over-pricing". **Through rates will eventually rise, the end point will be lower compared with previous cycles due to the shape of the yield curve**, which is encouraging more borrowers to float, giving the OCR greater punch. The RBNZ is also using other tools such as prudential policy to better target inflation.



## ECONOMIC INDICATORS

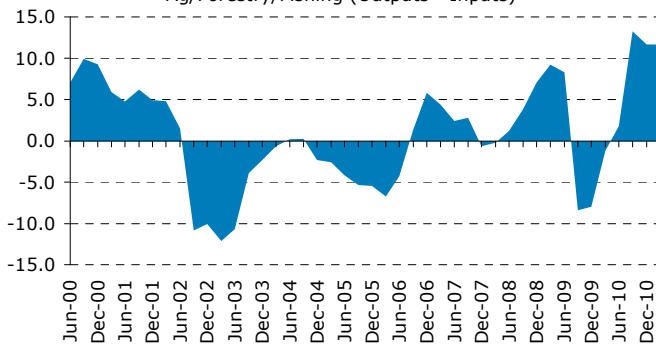
Inflation Gauges					
Annual % Change	Current QTR	Last QTR	Last Year	Chg. Q/Q	Chg. Y/Y
Consumer Price Index	4.5	4.0	2.0	↑	↑
Farm Input	5.0	3.3	1.5	↑	↑
Net Imp. Margins PPI	11.7	11.7	-1.2	↓	↑

Annual % Change **Farm Input Inflation Gauge**



Sources : ANZ, National Bank, Statistics New Zealand.

Annual % Chg **Net Implied Margins PPI**  
Ag/Forestry/Fishing (Outputs - Inputs)



Sources : ANZ, National Bank, Statistics New Zealand.

Despite a number of one-offs during the back end of 2010, core on-farm inflation remains sticky. Annual on-farm inflation for the year ended **March 2011 has now, increased to 5 percent.** This was well up on last years 1.5 percent and the 2010 calendar year of 3.3 percent.

Looking out over the next 12 months **farmers need to keep a tight rein on costs as inflation expectations increase.** A failure to do so will erode the profitability current commodity prices are bringing.

In the rural sector, **wage and contract charge expectations have increased** with many farm workers and service providers wanting a slice of the action.

Other key areas to be on notice for are the effects of **higher petrol and diesel prices spilling over into other categories of farm working expenditure,** such as freight and fertiliser spreading costs. International fertiliser prices are on the move, but the higher NZD should help here. Last but not least, **insurance premiums** since the Christchurch earthquake will continue to be adjusted higher as companies reassess risks and balance sheets.

The chart to the left measures the annual percentage change between the prices received for rural outputs and price changes in costs of production (excluding labour costs and interest charges). This proves a good proxy for the relative change in margins received for the primary goods produced and manufactured by the rural sector.

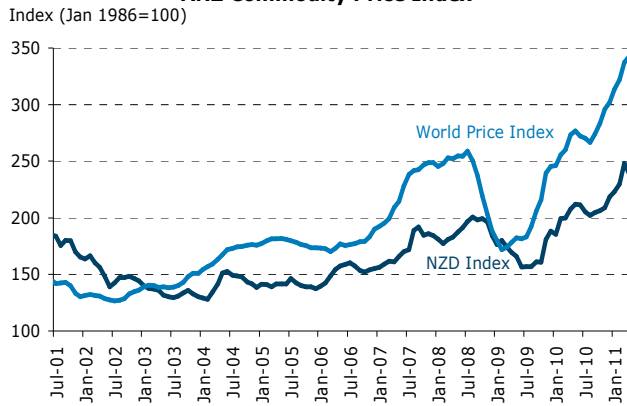
**The sharp rise in commodity prices at the start of 2011 has outpaced the rise of input costs.** The annual change for the first quarter of 2011 was 11.7 percent. **The last three quarters is the strongest period of gains seen for net margins in the primary sector since the early 2000's, when the NZD/USD was at an all-time low.** This time round it has been high commodity prices outpacing the rise in the NZD, which recently hit fresh post-float highs against the USD. Cumulatively since the middle of 2010, there has been a 8.3 percent increase in net margins for the entire primary sector. Net margins are likely to continue to increase, albeit at a slower rate, as gains in commodity prices slow and inflation ticks up. This is subject to tight cost control continuing.

## KEY COMMODITIES

### ANZ Commodity Index

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Index	239	248	208	↓	↑
World Index	342	337	273	↑	↑

### ANZ Commodity Price Index



**Soft commodity prices are holding up remarkably well, at a time when hard commodities have started to come under pressure as speculative funds exit positions.** Prices for silver, aluminium and copper have decreased by 14, 7.6 and 8.4 percent respectively over the last 6 weeks.

In April the ANZ Commodity Price Index in world terms increased by 1.6 percent, but decreased in NZ terms by 3.9 percent. The appreciation in the exchange rate outpaced in-market price gains in April leading to the decrease in NZ terms. The new highs were driven by broad-based increases across most commodities. Looking forward, any drop is not expected to be substantial, with key commodities, such as dairy, showing signs of stability at heady heights.

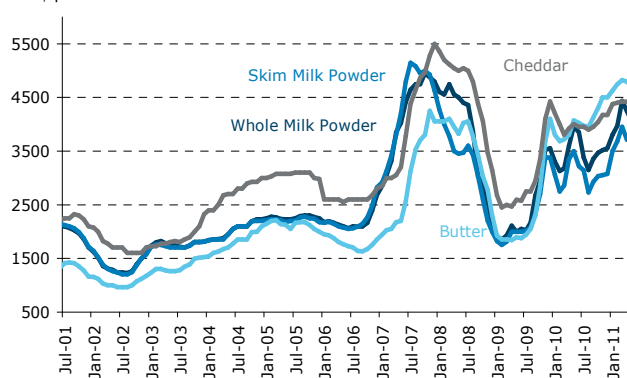
The largest increase recorded in April was for the price of apples. This reflects a lift in prices as the first of the new season export crop reached the northern hemisphere markets.

### Oceania Dairy Price Indicators

USD per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Whole Milk Powder	4,050	4,242	3,960	↓	↑
Skim Milk Powder	3,750	3,713	3,500	↑	↑
Butter	4,700	4,800	4,075	↓	↑
Cheddar	4,425	4,417	4,000	↑	↑
World Basket	4,231	4,293	3,880	↓	↑

**Dairy prices continue to hold up at remarkably high levels, even given recent falls.** Prices for fat-based products have been much more stable than powders in recent months, but the latest prices for butter and anhydrous milk fat show signs of easing, down 2.1 and 5.8 percent respectively over the last month. Whole milk powders have shown similar signs of consolidation, decreasing to USD\$4,000 per tonne. Skim-milk powder is expected to fall further as production from the main producers, NZ, US and EU, increases. Overall powder prices are back between 5–9 percent since the start of the year.

### Dairy Products - Oceania Export Market Prices

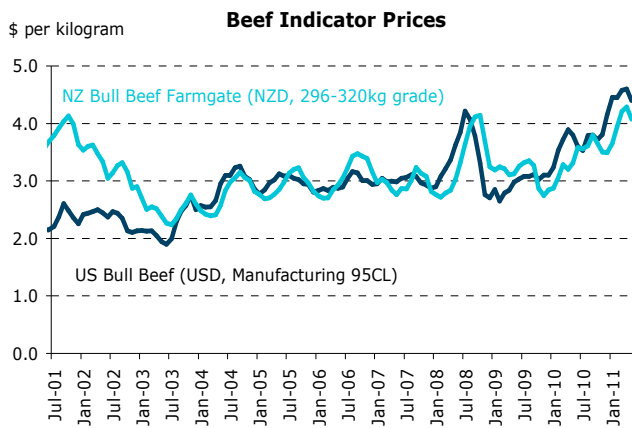


The current resilience of international dairy markets continues to emphasise the underlying strength of demand from China, wider Asia and the Middle East. The increases in production from the EU, US, NZ and Australia is starting to see more product on the international marketplace. 2010-11 production in NZ is forecast to be a record at 1.5 billion kilograms of MS (+4% from last year). Production in the US is forecast to be 1.4 percent up on last year and with a very low USD they have increased their exports. EU production has experienced similar gains to the US, up 3.0 percent on last year. Australian dairy farmers are also flush with grass for the first time in a number of years. Production is up 1 percent on last year. China will close nearly half its milk processors following a nationwide safety crackdown after a number of food safety issues. Reportedly 426 out of 1,176 processors will not have their licenses to operate renewed, with a further 107 forced to suspend production until improvements are made. In addition, India recently sanctioned a major increase in SMP, butter and butteroil imports in an attempt to control rising domestic prices as increasing national production fails to keep up with demand.

## KEY COMMODITIES

Beef Price Indicators					
Dollars per kilogram	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Bull Beef <sup>1</sup>	4.08	4.29	3.32	↓	↑
US Bull Beef <sup>2</sup>	4.40	4.60	3.80	↓	↑
NZ Steer <sup>1</sup>	4.14	4.32	3.41	↓	↑
NZ Heifer <sup>1</sup>	4.08	4.29	3.34	↓	↑

<sup>1</sup> (NZD, 296-320kg Grade Bull & Steer) (NZD, 195-220kg Grade Heifer)  
<sup>2</sup> (USD, Manufacturing 95CL)

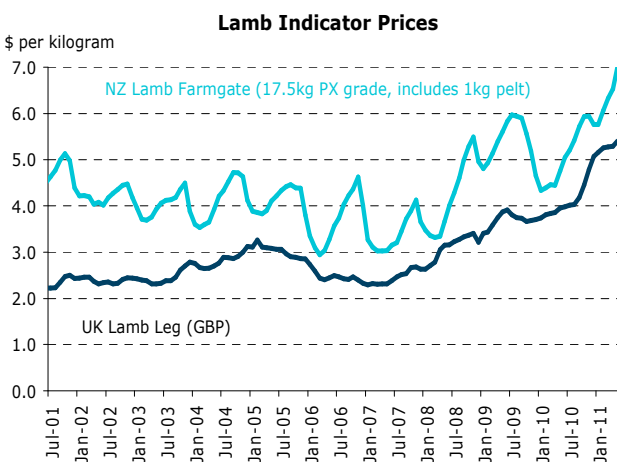


There has been an apparent lack of appetite for retailers and quick service restaurants to pass on higher wholesale costs for ground beef to consumers. However, it seems US retailers are finally passing on their increased costs, with the retail price of ground beef now at all-time highs. Year-on-year US retail ground beef is up 12.1 percent. Chicken prices over the same period have risen only 1.8 percent. In response, retailers are featuring ground beef less, with McDonalds and Burger King increasing the number of chicken offerings on their menus and decreasing the number of beef offerings. The reduced margins for beef has led to a stand-off with wholesale beef buyers aware of the higher beef production in NZ from more cull cows. Drought in some Southern US States, particularly Texas, has pushed more beef to market also, but this has been more than offset by a decline in other states. These dynamics have led to a decline in the manufacturing price of 6.5 percent since mid April. The hand-to-mouth approach has lowered inventory levels, with peak demand near expect prices to stay firm. **Fixed contract money currently on offer in NZ corroborates a firm picture over the winter.**

In Asia, the finding of radiation levels in excess of the legal limit in Japanese beef has raised the prospect of increased demand for imported meat. In South Korea, NZ's third largest market in 2010, the foot-and-mouth alert has been lowered. This effectively ends the restrictions on stock movements and sales.

Lamb Price Indicators					
Dollars per kilogram	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Lamb <sup>1</sup> (NZD)	7.00	6.53	4.76	↑	↑
UK Lamb Leg (GBP)	5.40	5.29	3.95	↑	↑

<sup>1</sup> (17.5kg PX grade, including 1kg pelt)

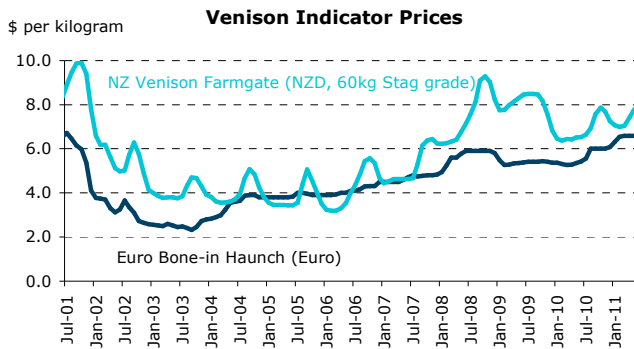


**Prices for lamb both in NZ and overseas continue to break new ground.** A long procession of holidays and national events in Europe has helped things along over the last eight weeks. In many cases UK supermarkets have discounted the retail price of lamb below the wholesale price during these events. The shortage of product available has become most obvious in the middle cuts where the value is normally higher, but volume available per animal is low, compared to cuts such as legs and shoulders. Despite negative margins for retailers, anecdotes are when one buyer does not want to pay current prices, another appears. **All indications are pricing will be above \$7.5 for the rest of the 2010-11 season.** This will mean a record season average price of \$105+ per lamb. In-market prices are now 65 percent higher than the previous peak in early 2005, after which they fell dramatically. Many buyers have been committed for this season, but based on this season's margins, most will view lamb as unprofitable and make purchasing decisions accordingly next season. Production in Australia and NZ is well below historic levels and flocks in major importing countries continue to decline. This situation should prevent a repeat of the 2005 episode but some softening in pricing is expected in the 2011-12 season.

## KEY COMMODITIES

## Venison Price Indicators

Dollars per kilogram	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Venison <sup>1</sup>	7.80	7.40	6.51	↑	↑
Euro Bone-in Haunch (EUR)	6.60	6.60	5.36	↔	↑

<sup>1</sup> (60kg Stag AP grade)

**Stronger procurement premiums look like they will drive venison prices back towards their 2008 peak.** A forecast reduction in venison this coming season has seen some very attractive contract rates being offered lately heading into next season.

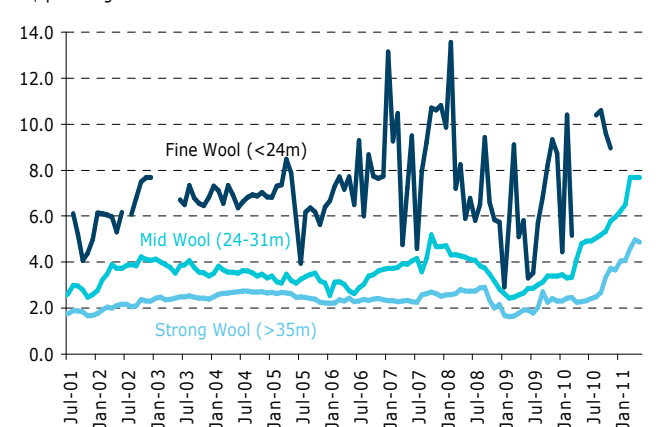
Overall venison production has been largely unchanged this year, despite early forecasts of a 10 percent drop. Male slaughter numbers have increased 1.6 percent from this time last year, offset by female slaughter down 2.5 percent. This is indicating stability in the NZ herd and perhaps some slight rebuilding in hind numbers for the first time since 2002. Average season schedule prices for 2010-11 have reflected the stability in production, largely unchanged at \$7.40 per kilogram for the year-to-date. Lower production and inventories as well as an improving German economy should see in-market venison prices move higher and keep pace with other proteins such as lamb and beef. With these dynamics importers have been reported as keen to secure product early, with this reflected in schedule prices also.

## Clean Wool Indicator Prices

Dollars per kilogram	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZ Fine Wool (>24m)	NA	NA	0.00	↔	↑
NZ Mid Wool (24-31m)	NA	9.76	6.86	↑	↑
NZ Strong Wool (>32m)	6.15	6.31	3.26	↓	↑
USD Fine Wool (>24m)	NA	NA	0.00	↔	↑
USD Mid Wool (24-31m)	7.67	7.67	4.80	↓	↑
USD Strong Wool (>32m)	4.86	4.96	2.28	↓	↑

**New Zealand prices for wool peaked in April, up a massive 100 percent on last year.** However, as other fibres such as cotton and synthetic have peaked, so has wool. In recent weeks, the clean price for strong wool has dropped from \$6.50 per kilogram to \$6.10. The stronger NZD/USD, moving from 0.75 to 0.80 over the last eight weeks, has also weighed on farm-gate returns.

## Wool Indicator Prices (Clean)



New Zealand is not alone in seeing prices lift considerably during the last 12 months, with demand for wool and prices very strong in Australia and Europe. Price increases are being driven a strong demand for raw materials from textile manufacturers but mainly the shortage in supply of substitute materials such as cotton for garments, and synthetic fibre for carpet. Some of this demand has reportedly tapered off, as margins have started to turn negative for manufacturers recently.

**The view for the next few months continues to look bright but below recent peaks.** An increase in the supply of cotton and synthetics will cap moves higher for wool. Recent reports have suggested a 12-15 percent increase in the global area planted in cotton. However, this is only likely to be enough to help rebuild all-time low inventories. High prices have also slowed mill usage and placed pressure on downstream textile margins, as fragile consumer spending makes it difficult for retailers to pass through higher costs. Longer-term supply of coarse wool is not likely to lift dramatically for some time as global sheep flock numbers are expected to remain low. And cotton is expected to be priced closer to synthetics, a reversal of the last decade.

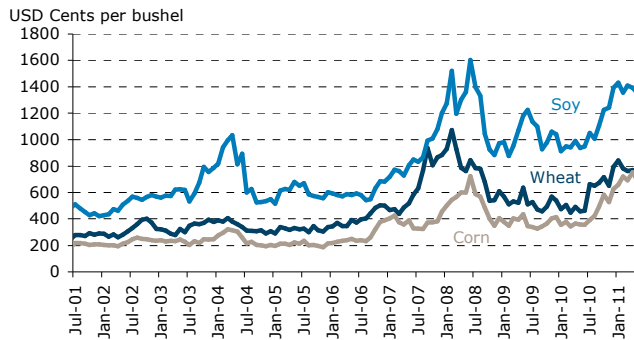
## KEY COMMODITIES

### Grain & Oilseed Price Indicators

USD cents per bushel	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Wheat	7.6	7.7	4.6	↓	↑
Soy	13.5	13.9	9.4	↓	↑
Corn	6.9	7.5	3.6	↓	↑
Australian Hard Wheat <sup>1</sup>	340	345	265	↓	↑

<sup>1</sup> NZD per tonne

### CBOT Future Grain & Oilseed Indicator Prices



Sources : ANZ, National Bank, Bloomberg.

### Generally global grain markets look to have peaked at the start of April.

Markets are now trading on weather events in the Northern Hemisphere as planting has been delayed in the US and Canada. Parts of France and Germany look dry.

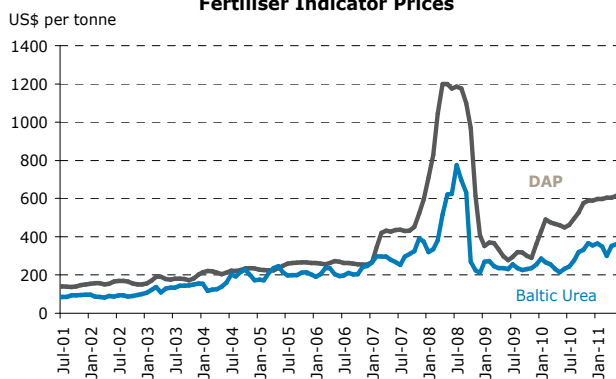
In the last 12 months global corn prices have more than doubled, and in April corn again reached the record high set in the 2008 commodity boom. These prices are justified for two reasons: **a disappointing US corn yield for the 2010 harvest and solid demand sharply reducing global stocks to just 8 weeks of supply.** Given the existing supply and demand imbalance, and the fact northern hemisphere new crop supplies are five months away, we expect prices to stay at or near record highs until some certainty exists around new crop production.

Wheat's fate will increasingly hinge on price movements in the corn market. The underlying stock situation for wheat is materially better than most other agricultural commodities, but any sharp correction in wheat will be limited whilst corn remains at elevated levels. Weather has also affected the production of US Hard Red Winter. This is likely to cut US medium protein wheat production by at least 20 percent. Of greater concern will be the consequence of a lack of rainfall in May in Western Europe. Moisture levels in much of France, Germany and the UK have been substantially below average over the last two months. On the demand side, Chinese import demand is forecast to remain strong as local production has also been affected by weather events. Positive livestock and biofuel margins in the US and Europe, which have seen increased substitution between grains, supporting all crop markets, is expected to continue over the next several months also.

### Fertiliser Price Indicators

USD Dollars per tonne	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
DAP	615	606	461	↑	↑
Urea	360	350	215	↑	↑

### Fertiliser Indicator Prices



Sources : ANZ, National Bank, Bloomberg.

The global fertiliser market looks to be turning upwards on the back of shorter supplies and favourable crop economics. Urea is showing stability around the \$350 per tonne level, despite a drop in March. It is expected to hold around this level until June, in line with lower seasonal demand. Strong demand from the United States and India, rising production costs, and potentially constrained Chinese supplies are expected to press prices higher in the second half of 2011.

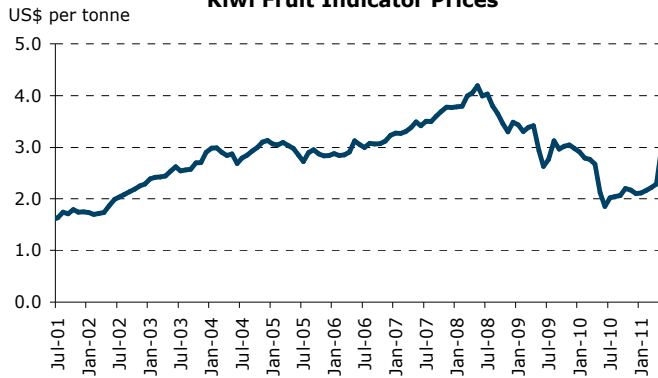
In the past month DAP has seen a rise caused in part by plant shutdowns in Tunisia and constrained rock supply in North Africa from the civil unrest. All phosphate commodity prices have also risen on the back of strong crop economics. However, the slow pace of US corn plantings could result in lower corn acreage. If this shifts corn area into alternative crops this could result in surpluses of DAP in the US, with corn being the highest user within the group of key field crops. Demand out of India has also been reported as strong.

## KEY COMMODITIES

### Horticulture Price Indicators

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Kiwifruit (USD per kg)	3.0	2.3	2.1	↑	↑
Apples (Weighted Index)	230	245	247	↓	↓

### Kiwi Fruit Indicator Prices



### New season pricing for Kiwifruit looks reasonable despite the uncertainty created in the Japanese kiwifruit market by the earthquake and tsunami.

The Japanese market makes up approximately 30 percent of NZ's export returns. However, the other markets of Germany, China, Korea and Taiwan continue to show signs of incremental growth in prices.

Yields for the new season have been reported as 8,400 trays per hectare for Green and 11,200 for Gold. This is up from 7,600 trays per hectare for Green last season and 9,400 for Gold.

Indicative per tray orchard price ranges for 2011 are \$6.80-\$7.40 for Green, \$11.60-\$12.20 for Gold and \$8.30-\$8.90 for organic green. These are slightly softer than this year's season-end per tray prices of \$7.30 for Green, \$12.65 for Gold and \$9.10 for organic green.

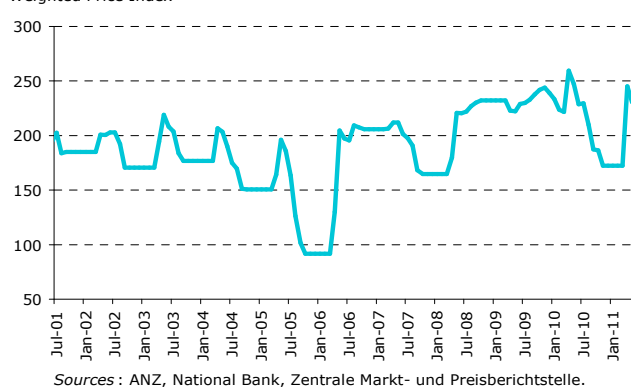
### Therefore, overall per hectare returns are likely to be higher than last season as the increase in yields offsets slightly lower prices.

The grape and vineyard industry remains under pressure due to oversupply, as the volume of grapes exceeds the ability of the market to absorb the finished product. **It looks like the 2011 grape crop is in excess of 320,000+ tonnes versus market demand of 280,000 tonnes, leaving a large gap.**

This situation will take some time to improve. Sauvignon Blanc accounts for around 60 percent of the crop and has seen a nearly 50 percent drop in price since 2008. Renegotiated contracts, lower prices, crop management, fruit without a home and vine extraction are all difficult issues for many growers at present and will continue to remain so.

Wineries are re-thinking branding strategies, product mix and volumes amongst other business decisions. There is some concern that the NZ brand is being devalued by a surge in the volume of wine exported in bulk rather than bottled form. Inventories remain high and slow to clear (down perhaps 5-10 percent from peak). Distribution chains are being rationalised, sometimes because part of the chain has gone out of business. There is a big challenge to bring supply and demand into alignment whilst maintaining the value of the brand and some profit to all parts of the industry. Some growers have bucked the trend with long-term commitment to the industry and large investment in meeting customers' requirements and nurturing their brands.

### Apple Indicator Price Index

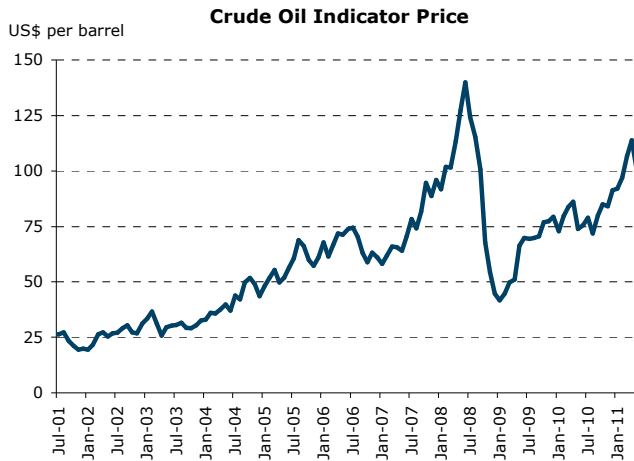


## KEY COMMODITIES

### Other Cost Indicators

	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Crude Oil <sup>1</sup>	100	114	74	↓	↑
Ocean Freight <sup>2</sup>	1,200	1,269	4,078	↓	↓

<sup>1</sup> (US\$ per barrel)  
<sup>2</sup> (Baltic Dry Index)



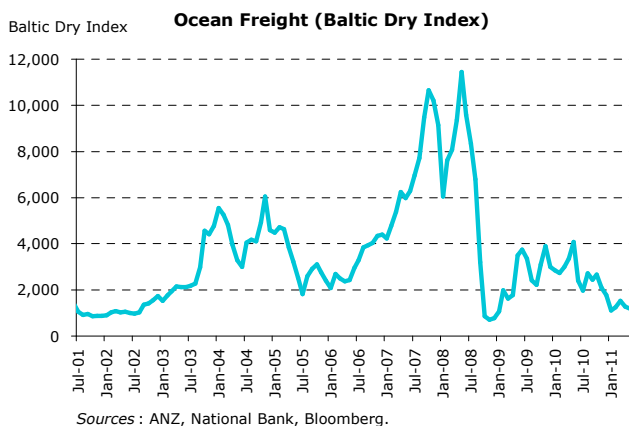
**A mixture of one-off supply factors has blurred the oil price outlook.** Ongoing tension in the Middle East and question marks over the short-term supply situation in the US Gulf Coast (home to 25 percent of the country's oil capacity) has created a choppy price backdrop. However, prices look cheap (compared to other commodities), and as the dust settles on these one-off issues, bullish fund activity should return on the back of an improving US economy. Prices should also respond to a pick up in US summer driving demand, which will potentially cause a drop in domestic inventories. **We expect US WTI (West Texas Intermediate) crude oil prices to average US\$105/bbl in 2011 and European Brent crude oil to average US\$116/bbl.**

Despite being lower quality, we expect Brent prices to sustain a US\$3-5/bbl premium to WTI going forward. Structural issues with US oil inventory holdings, and a stronger Asian appetite for heavier, or lower quality crudes, suggests Brent will be a better supported market.

Longer-term refined global oil supply, including unconventionals, is forecast to rise only slightly to 92.8 mbbls/day in 2012 (+0.4%). A slowdown in growth this year is expected after a 1.6 percent rise in 2010. This is due to depleting oil & gas production fields from non-OPEC countries, and a conservative pace of growth from OPEC members who are keeping to their target quotas to maintain current prices.

We expect demand to rise by 1.8 percent in 2011 and 1.1 percent in 2012 after strong growth of 3.7 percent in 2010. This is driven largely by emerging markets. China could surprise on the upside, with a looming thermal power supply squeeze creating additional demand for alternative energy sources. Demand in the US is recovering, albeit slowly amid a gradual fiscal retrenchment. European economies remain fragile.

The Baltic Dry freight index did increase by nearly 38 percent from January to March. It was helped by reports of modest iron ore and coal trade into China. However, more recently the fragile market expects the supply of vessels will outweigh improved trade flows. According to Simpson Spence & Young Shipbrokers the number of active capesize ships will rise by a fifth this year, threatening oversupply and keeping freight rates suppressed. The group predicts that over 90mt of new capacity will enter the capesize market, equivalent to an additional 200 ships. This oversupply points towards further weakness for the rest of 2011 and into 2012.



## ECONOMIC BACKDROP

### SUMMARY

The NZ economy continues to navigate three events simultaneously. Our high external debt and low national savings emphasise the need to rebalance. Commodity export prices continue to hit record highs. And the February 22nd earthquake resulted in significant damage and disruption. These events are complementary in some facets but opposing in others. While patches of weakness and challenges remain, the economy looks to be moving into a firmer zone. We expect a springboard style recovery to emerge in the second half of the year.

### OUR CORE ECONOMIC VIEW

**The economy remains polarised.** Better savings performance remains a critical pre-requisite for a sustained upturn to take hold. The problem with saving though is that it detracts from growth in the near term and exacerbates economic challenges. Improvements in the household savings rate over the past three years (from -8.9 to +0.5 percent of disposable income) is a solid sign of structural improvement in the economy, but this has necessitated additional cyclical weakness. The global environment remains fickle, though strong commodity prices continue to hold out the prospect of an export-led recovery. Economic challenges arising from seismic events continue to cast a shadow over prospects.

**The economy had better momentum in early 2011 than is widely acknowledged.** Quake aside, it's becoming clear the economy had better momentum in the early part of 2011. Strong employment growth, a falling unemployment rate and stronger mortgage approvals are testament to an economy that started 2011 with a different feel to how 2010 closed. While historical, this better tone is still important, for it has provided a better base to absorb seismic challenges and global ructions, both of which are ongoing. **Momentum is set to step up further.** Loose financial conditions and rapidly recovering business confidence are foretelling better times ahead. The key question at this juncture is whether such indicators are providing the same head-fake and mis-representation we saw 12 months ago. Back then, we saw the same signals yet the economy failed to kick on and at the time we were somewhat sceptical of prospects. "This time is different" is a graveyard term, but we're more encouraged in 2011 than at any time in the past few years, for a number of reasons.

- **We've seen material progress across structural indicators.** The household savings rate is now positive. Net external debt has fallen from 90 to 82 percent of GDP in two years. Farmers are deleveraging (largely via income generation). Structural headwinds remain, of course, but they are less intense in magnitude than a year ago.
- **There is pent-up demand.** Business sector investment and residential investment sit at historical lows as a share of GDP. This is unsustainable.
- **Real cash-flow generation is upon us.** Dairy farmers now need to spend if tax bills are not going to be frightening (though we acknowledge some continued weakness in the rural sector). Fonterra's announcement of a 2<sup>nd</sup> successive year of strong payout is likely to be telling. Squillions are being spent in Christchurch. It doesn't compensate for complete loss in many cases, but it's still cash. And finally there is the Rugby World Cup. Such one-offs are not sufficient to bring about a sustainable recovery on their own, but they certainly help timing-wise.

**Of course challenges remain, the most significant of which Christchurch.** Repairing an estimated \$15-20b in damages from the Christchurch earthquake will be a multi-year undertaking and will require considerable resources. It is likely to check the economic rebalancing, with the upshot being a rising profile for external debt and large current account deficits. The rebuild is also putting pressure on the Government balance sheet, which means less money available for other uses. Yet a quick look over the partial indicators gives some reason for optimism regarding the resilience of the region. Business confidence in Canterbury has recovered sharply. Measures such as job ads have picked up nicely and we have not seen a jump in official benefit numbers, despite Government assistance being wound back. **We've pencilled in a modest cyclical upswing over the coming 18 months, but still remain mindful of structural challenges.** We express the latter via a lower trend growth rate for a number of years, terming it "grumpy growth". Huge transitional resource requirement shifts for the economy are still required. There will be growth, but don't expect it to be led by the sectors we've been used to, and will be more volatile and harder to achieve. In the near term we are more optimistic over the outlook in the second half of 2011. In short, we expect NZ to have some near-term cyclical fun in H2 2011 (read: push against the deleveraging headwind in Rugby World Cup year). A lower level of activity provides a larger springboard from which recovery can occur. History shows that the NZ economy turns on a dime and we expect this to pan out again.

# BORROWING STRATEGY

## SUMMARY

With the exception of the floating rate, which has been cut by 0.25 percent, rural lending rates are broadly unchanged or slightly higher compared to where they were when we published our last edition of the Agri/Rural Focus. The floating rate remains above both the 6 month and 1 year rate, and with the odds of another OCR cut extremely low, it makes little sense to select floating (unless you have other hedges in place). Like its wholesale counterpart, the rural fixed rate curve is steeply upward sloping. This is to be expected in an environment where interest rates are expected to rise – and makes selecting the right term tricky. For those looking to minimise cost, the 6 month and 1 year offer good value. But with the OCR set to rise from December, our favoured strategy is to fix for 6 months, and then look to fix for a longer period.

## OUR VIEW

**The economic landscape has changed significantly since the last edition of our Agri/Rural Focus.** Developments include the Budget, the Reserve Bank's decision to leave the OCR unchanged in April, an inflammation of the debt crisis in Europe, a higher Fonterra payout and a stiff rise in inflation expectations. Taken together, they paint a more upbeat picture of the medium term outlook, and **add weight to our view that the RBNZ is set to raise the OCR in December. However, December is a long time away, and with the rural lending curve as steep as it is, the question many will be asking is, is it better to fix now, or to wait until later on in the year?** For many borrowers, this is the proverbial \$64,000 question. The answer will be different for each borrower, depending on their risk appetite. However, many of the considerations will be similar. So what are they?

In our view, the **primary consideration is the assumption that interest rates will rise in the future** – after all, if this was not an assumption, why would you pay a premium to fix? **The second consideration is how quickly you expect interest rates to rise. The third consideration is your preparedness to pay a premium to fix** – or perhaps put another way, the price you are prepared to pay now to avoid being exposed to higher rates should they start rising to a point that would make you uncomfortable. Having laid the three considerations out, let's look at each in turn.

We believe the first consideration is fairly straightforward. That is, **we do believe interest rates will rise before they fall.** Although the RBNZ made no specific mention of the need to raise the OCR in the April OCR Review, they did note that "the current level of the OCR is likely to remain appropriate for some time". Since then, inflation expectations have risen sharply, business confidence has surged, and Fonterra has announced a higher payout. Furthermore, as we (the Bank's economics team) travel around the country we continue to receive anecdotes of improving activity, particularly from the rural sector. But it doesn't end there. Indeed, forestry, manufacturing and construction tend to be more upbeat than not. Retail is the obvious laggard – and because as consumers, we are participants, we tend to over-emphasise it. The reality is that retailing will be tough for a while. But let's not let that cloud the outlook – indeed, the productive sector is humming away in the background, and the foundations for strong and sustainable growth are being built.

**It is also worth stepping back for a moment, and considering just how low the OCR is at its current level.** Not only is it at a record low, but it is well below both the current level of inflation (4.5%) and the RBNZ's own survey of inflation expectations (3.0%). It is also below the 10 year average rate of inflation. **More than anything else, the fact that the OCR is negative in real (i.e. inflation-adjusted) terms is the clearest signal that it is on borrowed time.** As such, we believe an OCR cut from here is unlikely.

**The second consideration is the most difficult to make a judgement call on,** and although we have a view, we're not the ones making the decision. However, **instead of coming up with a view to how quickly rates will rise, we will turn the problem on its head, and use breakeven analysis to show how quickly the term structure of lending rates assumes interest rates will rise.** Readers can then compare these to their own expectations, and make a call from there, making an appropriate adjustment for your preparedness to pay a certainty premium.

So what do breakevens tell us? As the table overleaf shows, **future rates are assumed to be higher than current rates.** As an example, the 1 year rate is expected to rise from its current level of 6.75 to 7.24 percent in 6 months, then up to 7.85 percent in 1 year, to 8.80 percent in 2 years, and so on until it gets to 9.95 percent in 4 years. That's over 2 percent in 2 years, which seems like a pretty steep upward path to us, **implying that you either need to be convinced that rates will rise quickly, or put a very high value on certainty in order to want to choose a longer term rate.** Our own forecasts have the OCR rising by around that amount over the next 2 years, but as the OCR move progressively higher, it tends to have less of

## BORROWING STRATEGY

an impact on term rates. **We can therefore conclude that the market is pricing in a rate profile at least as high as what we expect.** And with the 6 month rate well below the floating rate, and the OCR not expected to rise till December, **our preference is to fix for 6 months, with a view to fixing for a longer period at a later date.** Remember, you can always extend a shorter term, but it can be costly to shorten a longer term.

Rural Lending Rates		Breakevens rates in				
Term	Current	in 6mths	in 1yr	in 2 yrs	in 3 yrs	in 4 yrs
Floating	7.00%					
6 months	6.60%	6.90%	7.58%	8.55%	9.20%	9.78%
1 year	6.75%	7.24%	7.85%	8.80%	9.40%	9.95%
2 years	7.30%	7.79%	8.33%	9.10%	9.68%	
3 years	7.80%	8.23%	8.68%	9.38%		
4 years	8.20%	8.60%	9.00%			
5 years	8.55%					

**Of course, as our third consideration implies, it's not always about the money,** and although many people are willing to pay a premium to fix, some may not have the ability to do so, and may prefer to stay floating. **Given that the implied rises in the 1 year rate (as shown in the breakeven table) are fairly close to our forecasts, borrowers may be tempted to select a longer term fix, such as the 2 year or 3 year.** Both do come at a premium to the floating, 6 month and 1 year rates, but the premium is a lot less than the premium for fixing for a much longer term like the 5 year. **As always, the trick is striking the right balance between certainty and cost.**

*\* We use breakeven analysis to gauge the potential value in a chosen strategy. It doesn't help much when it comes to choosing between fixed and floating, but it is helpful when considering a set of fixed rates over a given timeframe. By comparing the choices available, breakeven analysis provides a set of figures showing where rates need to be in future to make two strategies equivalent, enabling better choices. Indeed, when thinking about the next 2 years, there are several choices you might consider if you wanted to fix. For instance, you might consider fixing for 2 years; or a "split" strategy like fixing for 1 year, and then for another year in 1 year; or fixing for 6 months, and then again in 6 monthly intervals over the remaining 18 months, and so on. Breakeven analysis allows you to compare these strategies against one another, and we plan to publish them in each edition of this publication.*

## EDUCATION CORNER: COMMERCE COMMISSION EXAMINATION INTO THE PRICE OF FRESH MILK

### SUMMARY

A certain furore surrounds the price of fresh milk in New Zealand, culminating in the Commerce Commission undertaking preliminary analysis to determine whether a price control inquiry into retail milk is warranted. We need to acknowledge from the outset that this article intentionally stays clear of industry specific dynamics and the microeconomic forces that can sometimes determine the appropriateness of an inquiry - **it is not our place to comment on these details**. Rather, our interest is **in looking at comparable movements in other staples, rising input costs at the different levels of the supply chain and the relationship between rising international and domestic dairy prices**.

On the face of it, it seems the rise in the **price of fresh milk can be largely explained by the increase in international dairy prices and on-farm costs**. Furthermore, the increase in fresh milk prices has not been out of step with the increase in the price of other staples. **Its per unit cost when compared to other substitutes is particularly curious as it takes a considerable amount of money to produce, collect, transport, process and manufacture, store, ship and keep cool. In many cases milk is a far superior, nutrient-rich product.**

**If price increases alone are the precursor to an inquiry, then we would seem to need a lot of inquiries into other areas!** Of course this will not be the case. The real issue is how economic agents adjust to the realities of a rising trend in real commodity prices - a reverse of the trend seen over the prior century. New Zealand benefits hugely from such a trend, though there is a consumer cost along the way.

### INTRODUCTION

**Right from the outset we need to acknowledge the importance of protein-based products and milk in New Zealander's diets. An array of dairy products have all the building blocks for a vital and healthy diet, no matter what stage of life.** These important building blocks include a range of nutrients, such as calcium, protein, phosphorous, potassium, magnesium, zinc and vitamins A and B. Society is naturally very sensitive to changes in the price of such staples. However, it is at this juncture that the debate shifts and risks becoming ill-informed if emotive aspects dominate. Typically, we hear comparisons with certain fizzy drinks, or comments lamenting the high price of some branded items, or why the New Zealand product costs more than overseas counterparts. Some are relevant issues and some are not.

**The rising cost of milk must be considered in conjunction with, and not exclusive from:**

1. Comparable movements in other staples and substitutes;
2. Rising input costs at the different levels of the supply chain; and
3. International dairy prices.

**It is these points that are the key focal point of this article.**

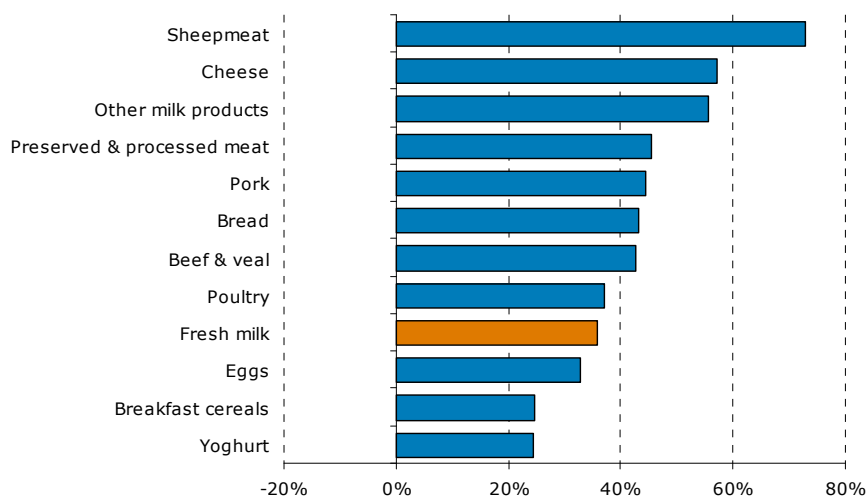
To dig a little deeper we look at how much other food staples have increased over the past 10 years and compare this with fresh milk. **The results are a little surprising**. Then we look at all the categories of farm working expenditure on a dairy farm to see how much they have increased over the last 10 years. **We also extend this analysis to the meat and horticultural sectors**. We take a quick look at the producer price indices for meat and dairy to get a gauge on how their aggregate margins have changed. Unfortunately, the specific processing and retailing (supermarket, local dairy etc) costs of production for fresh milk and how they have changed are difficult to source because of commercial sensitivity. Lastly, we examine the link between price movements in international dairy prices and how these are reflected in fresh milk prices. This highlights the potential opportunity cost for the dairy industry of subsidising milk to New Zealand consumers.

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### PRICE MOVEMENTS OF STAPLES

Looking at the price movements of key foodstuffs over a 10 year period shows that the price of fresh milk has increased by 36 percent over this period, or 3.6 percent per annum. Over the same 10-year period, the headline inflation rate has risen 31 percent. Interestingly though, the price of different types of meats, bread and other dairy products, such as cheese, have all increased more than fresh milk over the last 10 years! The price of sheepmeat is the front-runner, increasing 73 percent over the last 10 years, over twice the rate of headline inflation. There is some irony in this. Economists normally point to competition as a way of keeping a lid on prices and there is certainly a lot of competition in the sheepmeat industry, so much in fact that people are calling for consolidation! So here we have an industry that has more competition and fragmentation than the dairy sector, which has seen higher price rises! Of course, the underlying causes of price movements are far more extensive than that (i.e. reduced sheep numbers has led prices higher) but we still thought it worth noting.

**Retail price movements for key foodstuffs: 2000-2010**



Sources: ANZ National Bank, Statistics NZ.

Consumers do have a choice as there are substitutes, but they are not close ones and demand is relatively price inelastic (i.e. the good has some characteristics of a necessity, though we'd stop short of calling it a must-have). **A comparison with other liquid products also shows that milk is not overly expensive. It costs \$1.84 for a standard litre of milk, \$2.73 for a litre of bottled water, \$1.52 for a litre of fizzy, \$1.92 for fruit juice and \$5.12 for a litre of beer (according to Statistics New Zealand).** The price differential between milk and water is particularly curious in a country such as New Zealand where it is fine to drink water out of the tap.

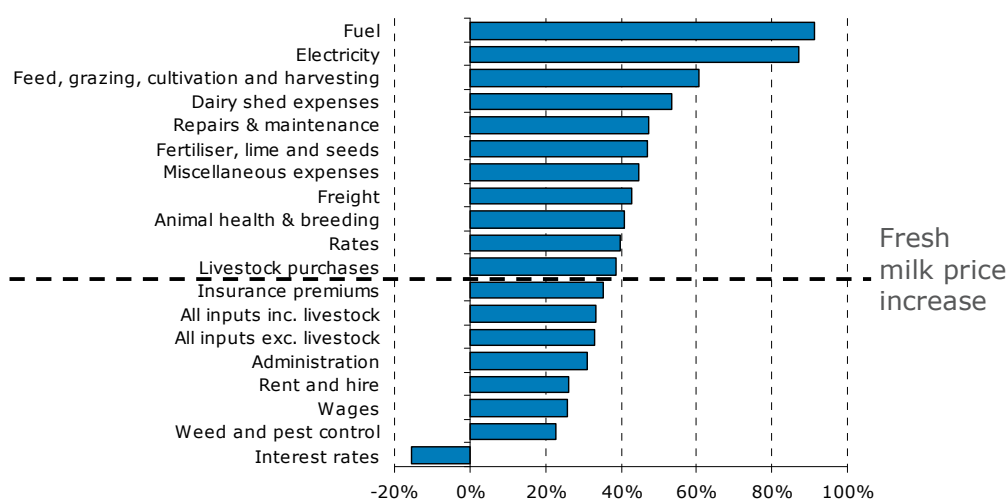
**In addition, we are trying to move up the value-added chain as an exporting nation but sometimes bemoan some brand-based products.** The suggestion that some branded milk products are priced too high seems perverse when we have constantly been told by various commentators, academics and successive governments that we need to build brands and market our products to add greater value (i.e. extract more money out of consumer wallets). Especially when you consider the tap water/branded water differential! It would be nonsensical to suggest that dairy companies should build brands offshore but not try to do the same in the domestic market. **The discontent at the price of branded milk products seems to go against all the business principles that various individuals have preached over the last 20 years.** And there is always the simple fact that if you cannot afford the branded product you can always purchase the unbranded one, which particularly in the case of fresh milk is very close in quality and content.

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### ON-FARM MOVERS AND SHAKERS

Turning attention to farm working expenditure reveals some other reasons why the price of staples have gone up so much over the last 10 years. **Dairy farm total input prices have increased by nearly 34 percent, 3 percent more than aggregate consumer prices, and 2 percent less than the price increase for fresh milk.** This would, on the face of it, seem to explain nearly all the observed milk price increase over the past 10 years. Ultimately, a complete examination would include other parts of the supply chain, notably the dairy processing sector, the two New Zealand supermarket chains and local dairies. This analysis would include margin and cost movements, but because of commercial sensitivity, it is difficult for us to obtain a complete dataset that would allow a full assessment for fresh milk.

**Dairy farm input price movements: 2000-2010**

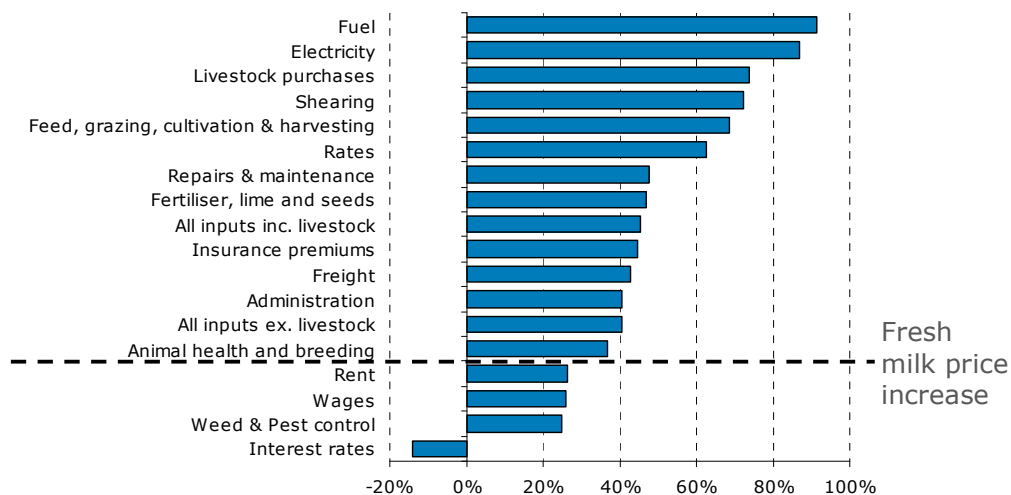


Sources: ANZ National Bank, Statistics NZ.

**Interestingly, 11 out of the 17 farm working expenditure categories have increased more in price than fresh milk.** The main culprits are fuel and electricity, which have increased a whopping 92 and 87 percent respectively over the last 10 years, or 9.2 and 8.7 percent respectively year-on-year. Other key culprits include service providers such as builders, mechanics, contractors, farm suppliers and the like. These categories show increases of between 4-6 percent per annum. The perennial farmer favourite of local rates brings up the rear, increasing 4 percent per annum, but still above the average rate of general inflation.

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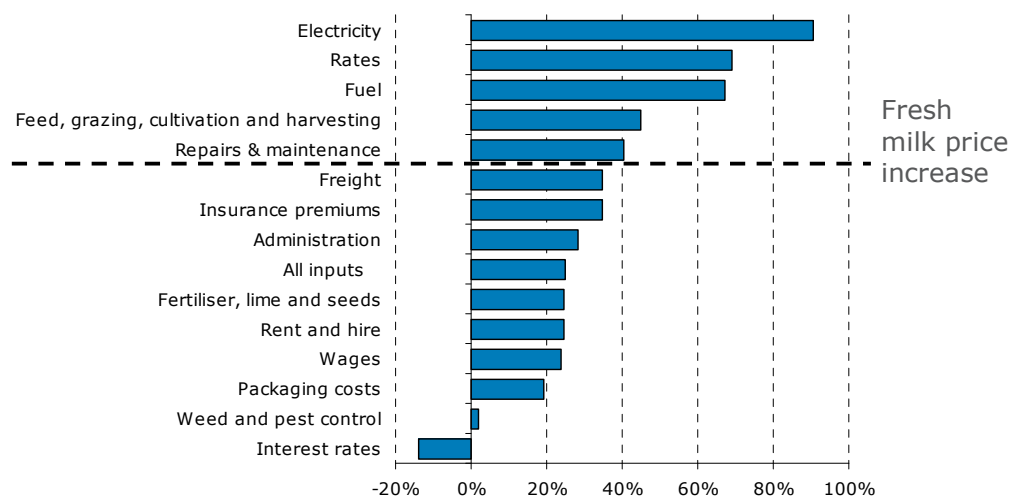
### Meat & Fibre farm input price movements: 2000-2010



Sources: ANZ National Bank, Statistics NZ.

Looking at input price movements for the average meat and fibre farm reveals similar themes to dairy but overall input prices have increased by 45 percent over the last decade, or 4.5 percent per annum. This is some 10 percent above dairy farms and nearly double horticultural businesses. This is in part why sheep and beef farming has been so tough over the last 10 years. The increase is in line with the rise in the price of beef in the supermarket but somewhat behind how much sheepmeat has recently risen. However, input cost increases are well above those for fresh milk. **Again, fuel and electricity are the front-runners, with service providers and rates prominent.**

### Horticultural farm input price movements: 2000-2010



Sources: ANZ National Bank, Statistics NZ.

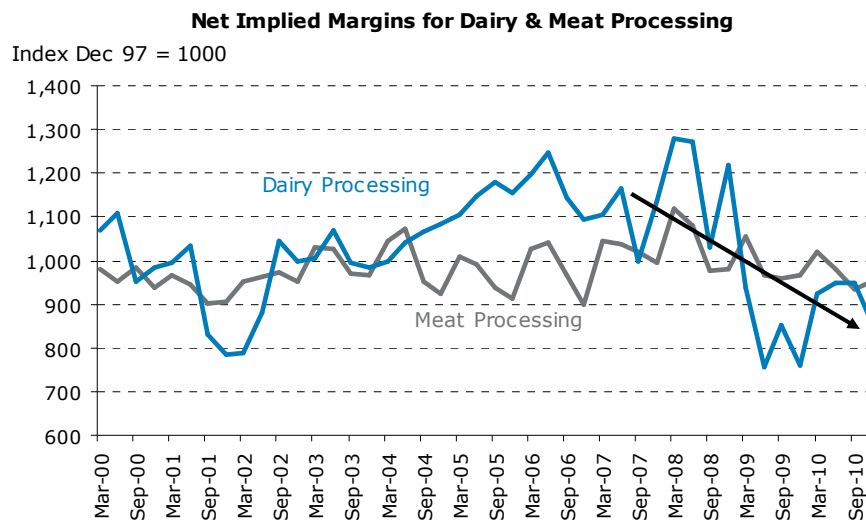
For horticultural businesses, input cost movements over the last 10 years were the lowest of all farm types at 25 percent, some 6 percent below headline inflation. Unlike in the livestock sector, which faced a cost-price squeeze in the mid 2000's, the horticultural sector has not had the same pressure on the cost side of the

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equation. However, horticultural businesses have also not received the same price increases for the goods they produce. **Electricity and fuel feature again and local rates make it into the top three.** Horticultural businesses are generally located closer to urban centres. Consequently, property values are higher and they have experienced very high rates of growth over the last 10 years. Therefore, horticultural businesses usually have higher rates and have experienced larger rate increases over the last 10 years.

### PROCESSING MARGINS

To add to the on-farm picture we can look at the producer price index margins for dairy and meat processing. This measures the difference between the quarterly percentage change in prices received for outputs (i.e. cheese, butter etc) and the quarterly percentage change in costs of production (excluding labour costs and interest charges). This proves a reasonable proxy for the relative change in margins received for the primary goods manufactured by the dairy and meat sector. **The results show net margins have in fact narrowed, especially over the last 4 years for dairy.** Over the last 10 years net margins for dairy processing have decreased by 12 percent and meat has been stable.



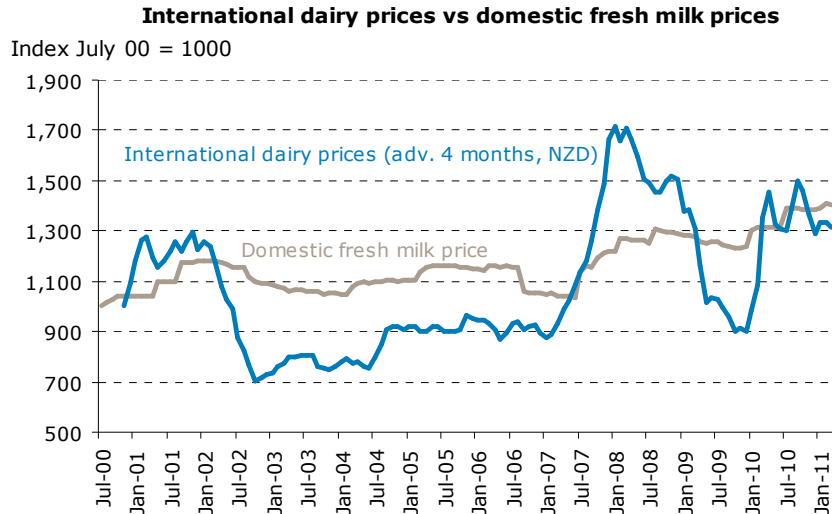
Sources : ANZ National Bank, Statistics NZ

While these are aggregates for the sectors, they do provide something of a gauge for fresh milk and other staples. The narrowing of margins is largely due to material costs increasing (i.e. milk and meat prices at the farm-gate). However, international prices for outputs, such as cheese and milk powders, have also improved, so the net effect of higher raw material costs should be offset to some extent when things are evened out over a season. **Overall, these results suggest margins in the meat and dairy processing sector have at least not been moving up, contra to common belief.**

### THE MISSING LINK

While cold comfort for consumers in New Zealand, **we export some 95 percent of our milk, so the broad direction in international prices is the major influence on domestic prices for fresh milk and other dairy products.** The same is true for most of the agricultural goods we produce. The chart below shows the relationship between the price movements for a basket of international dairy products and fresh milk in New Zealand. International dairy price changes have been advanced by 4 months, as this is the general lag before changes in international prices filter through to fresh milk prices on the shelf in the supermarket and local dairy. **Fresh milk prices have not moved out of line with the rise in international dairy products.** The price of fresh milk does not exhibit the same volatility as international dairy prices but the broad trends are the same. Less volatility in fresh milk is a function of retail food prices generally being relatively inelastic and 'sticky' in character.

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Sources : ANZ National Bank, USDA, Statistics NZ

International dairy prices have moved higher over the last four years due to a number of factors, but particularly increased demand from China, other parts of Asia and now the Middle East. With this as the backdrop, international prices rallied some 30 percent in the first quarter of 2011 because supply came under pressure in New Zealand and the Northern Hemisphere. This was largely due to adverse weather conditions; it was wet and cold in the Northern Hemisphere and dry in the North Island, where approximately 60 percent of New Zealand's milk production comes from. Prices have come off somewhat lately as supply has increased. **This will hold down the upward march in fresh milk prices, but a better global demand picture across emerging market economies is expected to result in higher average levels for commodity prices for years to come. We'll see cyclical bull and bear commodity market movements but within a secular rising trend.** New Zealand as a nation benefits hugely from a rising secular trend. To fully appreciate the importance of commodity prices you only need to look at the declining trend in commodity prices from 1960 to 1990 and steady decline in New Zealand's living standards. There were other factors at play behind the decline, but falling commodity prices was certainly important. Lower commodity prices though appealing to consumers, are not the path to rising incomes for a commodity-centric nation.

### CONCLUSIONS

**The price of fresh milk can be largely explained by the increase in international dairy prices and on-farm costs.** Furthermore, the increase in fresh milk prices has not been out of step with the increase in price of other staples. **Its relatively low per unit cost when compared to other substitutes is particularly curious as it takes a considerable amount of money to produce, collect, transport, process and manufacture, store, ship and keep cool. In many cases milk is a far superior, nutrient rich-product.**

**High dairy prices are clearly good for New Zealand as a whole.** But as with all economic shocks, the costs and benefits are distributed unevenly. New Zealand consumers have benefited indirectly, via spending multiples in rural regions, an improved fiscal position from higher tax takes, \$11 billion of export receipts from dairy alone and cheaper imports from a higher New Zealand dollar. **However, none of these benefits are as obviously visible as the hit to wallets at the supermarket.**

**Further up the supply chain, aggregate dairy and meat processor margins have narrowed.** However, it is difficult to source the last piece of the puzzle from supermarkets/local dairies because of commercial sensitivities. Therefore, we are unable to directly split out the margins and costs along the supply chain for fresh milk. However, the trend in international dairy markets (converted back to New Zealand dollars) does set the broad direction for

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fresh milk prices, especially when things are on the up and up. Higher commodity prices are a key support factor for New Zealand. They filter through to farmers' incomes, then the rest of the local community through farm or discretionary spending (albeit a large chunk of this income is currently going into debt reduction). **An empirical look at the components behind New Zealand's long-run economic performance reveals a strong link between the terms of trade, commodity prices, land prices, and economic growth.** A one percent change in the terms of trade has been associated with a 0.15 percentage point rise in national income. The reverse also applies when the terms of trade falls.

**If price increases of a good or service alone are the precursor for an investigation then New Zealand seems to need a lot of enquiries!** The list would start with electricity, fuel, rates (central and local body), and farm service industries such as builders, mechanics, contractors, farm suppliers and the like. Of course such a notion borders on the ridiculous, and the real intent is to highlight some misconceptions across pricing and particularly in regard to dairy-related products. However, we do note that **a lot of price rises do seem to manifest in non-contestable pockets of the economy** (i.e. those that do not face international competitive pressure like the agricultural sector does) **and this is where regulators' attention should be focused.** Persistent price rises in non-contestable pockets increases the cost base, reducing margins for those already in the export game and incentives for new businesses looking to enter.

**A related point but slightly off topic is that if farmers want to capture increased profits from the current higher commodity prices, they need to focus on the cost structure of their business.** The extent of cost-push forces shaping final output prices is worrying. Some commentators note that costs drive the final output price, which is true in part. However, we also suspect there is a "rising tide lifts all boats" feeder effect down the supply chain cost-wise. Farmers need to be aware of this when setting budgets for the 2011-12 season. We see inflationary pressures remaining to the fore and do not believe many farmers have been factoring in more expensive electricity, fuel/freight, wages and the like into their budgets. Especially the 9 percent year-on-year increase for some! In order to remain competitive it is critically important that on-farm costs are monitored and controlled. **This does not mean farmers should be cutting back on fertiliser** (especially given the amount that has been deferred in recent times) and other key farm inputs. **However, this does mean there is a need to focus on where the extra cash from higher incomes is best channelled, and to continue to improve the efficient use of inputs such as electricity, fertiliser and fuel.** Farm and shearer wages are another example where expectations have increased because of the higher farm-gate prices. Employees should be rewarded for performance, not just because farmers are receiving better prices.

## KEY TABLES AND FORECASTS

	Actual			Forecast (end month)						
	Mar-11	Apr-11	Today	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
NZD/USD	0.762	0.810	0.819	0.76	0.77	0.75	0.74	0.72	0.71	0.70
NZD/AUD	0.737	0.738	0.764	0.72	0.71	0.72	0.73	0.72	0.72	0.73
NZD/EUR	0.538	0.547	0.572	0.54	0.56	0.56	0.56	0.54	0.53	0.52
NZD/JPY	63.31	65.75	66.13	64.6	66.2	66.0	66.6	66.2	66.0	66.5
NZD/GBP	0.475	0.485	0.497	0.47	0.48	0.47	0.47	0.46	0.45	0.45
NZ\$ TWI	66.7	68.6	70.6	66.6	67.8	67.1	67.0	65.7	64.9	64.4
	Mar-11	Apr-11	Today	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12
NZ OCR	2.50	2.50	2.50	2.50	2.50	2.75	3.25	3.50	3.75	4.00
NZ 90 day bill	2.63	2.68	2.68	2.70	2.70	3.10	3.70	3.80	4.20	4.30
NZ 10-yr bond	5.66	5.44	5.08	5.50	5.70	5.90	6.10	6.20	6.20	6.10
US Fed funds	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.50	2.00	2.00
US 3-mth	0.30	0.27	0.25	0.35	0.35	0.35	0.85	1.60	2.10	2.10
AU Cash Rate	4.75	4.75	4.75	5.00	5.00	5.25	5.25	5.50	5.75	5.75
AU 3-mth	4.93	4.92	5.03	5.30	5.30	5.50	5.60	5.80	6.00	6.00
	ACTUAL			FORECAST						
	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13
GDP (% qoq)	0.2	<b>-0.4</b>	<b>0.1</b>	<b>1.4</b>	<b>1.8</b>	<b>0.7</b>	<b>0.9</b>	<b>0.9</b>	<b>0.8</b>	<b>0.7</b>
GDP (% yoy)	0.8	<b>-0.3</b>	<b>-0.3</b>	<b>1.3</b>	<b>2.9</b>	<b>4.1</b>	<b>4.9</b>	<b>4.4</b>	<b>3.3</b>	<b>3.3</b>
CPI (% qoq)	2.3	0.8	<b>1.0</b>	<b>0.8</b>	<b>0.7</b>	<b>0.6</b>	<b>0.8</b>	<b>0.7</b>	<b>0.6</b>	<b>0.8</b>
CPI (% yoy)	4.0	4.5	<b>5.3</b>	<b>5.0</b>	<b>3.3</b>	<b>3.1</b>	<b>2.9</b>	<b>2.7</b>	<b>2.6</b>	<b>2.9</b>
Employment (% qoq)	-0.4	1.4	<b>-0.2</b>	<b>0.4</b>	<b>0.5</b>	<b>0.5</b>	<b>0.4</b>	<b>0.5</b>	<b>0.4</b>	<b>0.4</b>
Employment (% yoy)	1.3	1.8	<b>1.8</b>	<b>1.2</b>	<b>2.1</b>	<b>1.2</b>	<b>1.8</b>	<b>1.9</b>	<b>1.8</b>	<b>1.7</b>
Unemployment Rate (% sa)	6.7	6.6	<b>6.6</b>	<b>6.3</b>	<b>6.3</b>	<b>6.2</b>	<b>6.2</b>	<b>6.0</b>	<b>6.0</b>	<b>6.0</b>
Current Account (% GDP)	-2.3	<b>0.3</b>	<b>0.2</b>	<b>-1.8</b>	<b>-1.6</b>	<b>-4.7</b>	<b>-5.0</b>	<b>-5.3</b>	<b>-5.6</b>	<b>-5.8</b>
Terms of Trade (% qoq)	0.6	<b>2.5</b>	<b>1.5</b>	<b>1.5</b>	<b>0.6</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.8</b>	<b>-0.8</b>
Terms of Trade (% yoy)	12.2	<b>8.3</b>	<b>7.8</b>	<b>6.3</b>	<b>6.2</b>	<b>2.8</b>	<b>0.5</b>	<b>-1.9</b>	<b>-3.3</b>	<b>-3.3</b>

## KEY TABLES AND FORECASTS

NZ's top EXPORT markets for the 12mths ended March 2011	NEW ZEALANDS' 20 LARGEST EXPORT MARKETS																				
	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	India	Taiwan	Indonesia	Hong Kong	Malaysia	Singapore	Thailand	Philippines	Saudi Arabia	Canada	Netherlands	Venezuela	UAE
Sheepmeat	2,731	13	137	281	62	4	585	239		55		46	66	13	4	1	86	115	103		15
Beef	2,010	15	8	773	212	167	31	17	0	123	142	39	13	42	7	36	10	114	27	0	19
Other Meat	440	18	8	20	44	24	32	74		3	23	17	3	7	1	1	9	3	22		
Milk Powder	6,262	69	1,897	2	22	3	0	0	47	158	196	31	294	218	300	258	241	0	1	454	248
Butter	2,250	89	140	77	19	22			83	77	46	18	48	42	42	88	113	13			4
Cheese	1,380	293	67	18	291	111	30	0	2	41	47	20	31	10	12	49	43	0	18	12	20
Whey/Casein	1,582	57	148	671	221	38	4	91	5	8	27	3	13	40	2	21	19	29	1	3	
Kiwifruit	978	53	72	31	287	65	0	207	2	63	5	23	11	9	5	1	0	4	0	0	3
Apples	346			58			43	46	9	24	4	18	7	7	18			6	55		10
other Fruit/Vege	582	250	3	31	138	21	4	3	1	16	2	6	26	14	9	1	0	1	3	0	0
Wine	1,076	335	13	229	11	1	290	5		1	16	2	14	1	1		60	25			4
Wool	705	79	200	0	104	86	0	0	14	32	100	0	27	3	35	9	0	0	0	0	0
Skins/Hides	550	36	224	25	-82	-66	61	35	59	-18	-91	47	-25	-3	-15	-9		4	1		
Logs	1,564	0	907	0	159	289	0	0	184	13	0	0	0	0	3	0	0	0	0	0	4
Sawn Timber	1,183	348	154	185	92	44	2	3	6	36	27	1	15	4	30	43	29	1	14		8
Fibreboard/Plywood	349	68	32	17	157	1	0	0	5	5	17	0	6	0	1	3	6	2	0	0	1
Wood Pulp	705	79	200		104	86			14	32	100		27	3	35	9					
Fish/Seafood	1,466	284	206	179	126	44	14	44	0	11	2	213	9	34	13	2	2	15	5	0	3
Crude Oil	2,017	1,862		76										7	52						
Aluminium	1,236	114	25	74	624	126	59	6	18	3	2	12	2	1	3	0	0	8	61	0	1
Remainder	15,273	6,084	944	1,207	688	443	355	156	465	198	229	317	208	270	177	191	74	158	178	12	82
<b>TOTAL</b>	<b>44,684</b>	<b>10,145</b>	<b>5,386</b>	<b>3,878</b>	<b>3,354</b>	<b>1,511</b>	<b>1,510</b>	<b>927</b>	<b>917</b>	<b>881</b>	<b>878</b>	<b>826</b>	<b>783</b>	<b>738</b>	<b>736</b>	<b>705</b>	<b>632</b>	<b>532</b>	<b>516</b>	<b>486</b>	<b>459</b>

NZ merchandise EXPORTS annual change between the 12mths ended Mar 2011 and a 12mth span a year earlier																					
	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	India	Taiwan	Indonesia	Hong Kong	Malaysia	Singapore	Thailand	Philippines	Saudi Arabia	Canada	Netherlands	Venezuela	UAE
Sheepmeat	-111	7	21	52	10		-96	-63		-4		-11	26	3	1	1	-35	14	15		3
Beef	268	6	-4	94	37	43	-3	7	0	5	30	0	2	4	2	6	7	-1	10	0	1
Other Meat	26	2	4	4	10	6	-6	3			2	-3		2				2	1	1	
Milk Powder	1,703	13	943	-7	2	-1	0	0	30	26	-53	9	11	22	140	10	57	-3	-4	147	43
Butter	625	21	40	-41	18	10			25	34	3	4	20	13	22	27	46	-7	-4	2	17
Cheese	53	32	14	-11	37	27	-18	0	2	4	12	1	10	0	2	-7	-5	-1	-8	0	3
Whey/Casein	201	7	39	186	7	5	1	18	3	2	-7		7	-11	-1	2	-3	-8	-1		
Kiwifruit	-95	7	7	-8	31	-4	-1	-91	0	-1	1	-4	0	-1	1	0	-1	2	0	0	0
Apples	-38		-1	-6			-12	-10		-1	-1		-3	-1	3				-3		-3
other Fruit/Vege	26	1	1	2	7	1	-2	-1	0	2	0	-3	10	3	0	0	0	0	1	0	0
Wine	40	7	-3	3	2		2	1				5	1	2				1	4		
Wool	93	0	86	0	-4	11	0	0	6	0	-21	0	6	1	8	-1	0	0	0	0	0
Skins/Hides	160	2	11	7	9	-11	13	11	-2	6	24	2	-5	-2			1				
Logs	428	0	286	0	41	9	0	0	91	4	0	0	0	0	2	0	0	0	-2	0	-1
Sawn Timber	187	62	24	-9	21	12	1	1		12	6	-3	8	1	11	18	20	1	7		-14
Fibreboard/Plywood	22	6	-2	-1	20	-1	0	0	3	0	2	0	2	0	0	0	-1	0	0	0	0
Wood Pulp	93		86		-4	11			6		-21		6	1	8	-1					
Fish/Seafood	151	14	86	30	1	6	0	24	0	-2	1	-23	2	-5	5	-2	0	4	0	0	0
Crude Oil	-120	303	-36		17						-73		-29	-338	37						
Aluminium	267	-9	-10	58	155	2	26	3	9	-17	-5	-3	-3	-4	-9	0	0	5	23	0	0
Remainder	1,147	360	-10	2	101	108	-4	3	93	20	8	66		-164	21	37	27	39	-1	3	22
<b>TOTAL</b>	<b>5,125</b>	<b>838</b>	<b>1,582</b>	<b>355</b>	<b>519</b>	<b>231</b>	<b>-99</b>	<b>-95</b>	<b>266</b>	<b>90</b>	<b>-94</b>	<b>38</b>	<b>63</b>	<b>-455</b>	<b>243</b>	<b>88</b>	<b>119</b>	<b>52</b>	<b>32</b>	<b>152</b>	<b>69</b>

NZ merchandise EXPORTS annual change between the 3mths ended Mar 2011 and a 3mth span a year earlier																					
	Global Total	Australia	China	USA	Japan	Korea	UK	Germany	India	Taiwan	Indonesia	Hong Kong	Malaysia	Singapore	Thailand	Philippines	Saudi Arabia	Canada	Netherlands	Venezuela	UAE
Sheepmeat	-1	17		21	4		-21	-1		-4		-14	7		1		-25	18	14		
Beef	77	2	-1	33	3	22	4	2	0	7	-18	-1	0	-1	0	0	0	4	3	0	1
Other Meat	14	-1	1	3	5	2	-2	4			-2	-1		1				1	3		
Milk Powder	501	3	318	0	0	1	0	0	-16	15	-25	4	3	-30	56	-17	29	0	-2	17	32
Butter	77	-1	34	-16	14	2			-4	13	-10		2	-1	5	-5	6				8
Cheese	-59	-20	-1	-1	-7	3	-8	0	0	0	5	-1	0	0	2	-10	-4	0	-9	6	0
Whey/Casein	76	1	15	70	-8	2	1	12	1	1	-6		2	3		-1	-2	-2	-1		
Kiwifruit	-22	2	0	0	-12	0	0	-12	0	0	0	0	0	0	0	0	0	0	0	0	0
Apples	7		-1				2	-2		2			1		-1				4		-1
other Fruit/Vege	10	-4	0	-2	10	3	-1	0	0	2	0	-3	0	0	1	0	0	0	1	0	0
Wine	-13	2		-8			-10					1						-3	1		
Wool	20	-8	15	0	7	2	0	0	0	0	-4	0	1	2	2	-1	0	0	0	0	0
Skins/Hides	56	8	20	1	-6		6	4	-3	1	5	3	-1	-2	-1	1		1			
Logs	133	0	96	0	-6	4	0	0	38	2	0	0	0	0	0	0	0	0	-2	0	0
Sawn Timber	13	8	4	-5	-1	1			3	3	1		1		2	5	-1		-2		-3
Fibreboard/Plywood	1	-2	0	0	2	-1	0	0	0	0	-1	0	1	0	0	-1	1	0	0	0	0
Wood Pulp	20	-8	15		7	2					-4		1	2	2	-1					
Fish/Seafood	36	-1	45	6	3	1	1	4	0	-2	1	-37	1	-6	1	-1	0	2	0	0	0
Crude Oil	1	77		-11										-50	-14						
Aluminium	23	-6	0	13	-24	22	11	-3	3	0	0	-3	-1	0	-2	0	0	0	9	0	0
Remainder	1,333	188	540	125	-26	129	-19	14	11	35	-47	-28	-2	-95	61	-18	28	49	24	23	50
<b>TOTAL</b>	<b>2,303</b>	<b>240</b>	<b>1,119</b>	<b>237</b>	<b>-43</b>	<b>195</b>	<b>-35</b>	<b>24</b>	<b>33</b>	<b>76</b>	<b>-105</b>	<b>-80</b>	<b>16</b>	<b>-176</b>	<b>115</b>	<b>-48</b>	<b>33</b>	<b>69</b>	<b>44</b>	<b>45</b>	<b>87</b>

## IMPORTANT NOTICE

### NEW ZEALAND DISCLOSURE INFORMATION

The Bank (in respect of itself and its principal officers) makes the following investment adviser disclosure to you pursuant to section 41A of the Securities Markets Act 1988.

The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

### Qualifications, experience and professional standing

#### Experience

The Bank is a registered bank and, through its staff, is experienced in providing investment advice about its own securities and, where applicable, the securities of other issuers. The Bank has been selling securities, and providing investment advice on those securities, to customers as a core part of its business for many years, drawing on the extensive research undertaken by the Bank and its related companies and the skills of specialised staff employed by the Bank. The Bank is represented on many bank, finance and investment related organisations and keeps abreast of relevant issues by running seminars and workshops for relevant staff and having its investment adviser staff attend external seminars where appropriate. The Bank subscribes to relevant industry publications and, where appropriate, its investment advisers will monitor the financial markets.

#### Relevant professional body

The Bank is a member of the following professional bodies relevant to the provision of investment advice:

- New Zealand Bankers Association;
- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

#### Professional indemnity insurance

The Bank (and its subsidiaries), through its ultimate parent company Australia and New Zealand Banking Group Limited, has professional indemnity insurance which covers its activities including those of investment advisers it employs.

This insurance covers issues (including 'prior acts') arising from staff fraud, electronic crime, documentary fraud and physical loss of property. The scope of the insurance also extends to third party civil claims, including those for negligence. The level of cover is of an amount commensurate with the size and scale of the Bank.

The insurer is ANZcover Insurance Pty Limited.

#### Dispute resolution facilities

The Bank has a process in place for resolving disputes. Should a problem arise, you can contact any branch of the Bank for more information on the Bank's procedures or refer to any of the Bank's websites.

Unresolved complaints may ultimately be referred to the Banking Ombudsman, whose contact address is PO Box 10-573, Wellington.

#### Criminal convictions

In the five years before the relevant investment advice is given none of the Bank (in its capacity as an investment adviser and where applicable an investment broker) or any principal officer of the Bank has been:

- Convicted of an offence under the Securities Markets Act 1988, or the Securities Act 1978 or of a crime involving dishonesty (as defined in section 2(1) of the Crimes Act 1961);
- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;
- Prohibited by an Act or by a court from taking part in the management of a company or a business;

- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

#### Fees

At the time of providing this disclosure statement it is not practicable to provide accurate disclosure of the fees payable for all securities that may be advised on. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

#### Other interests and relationships

When a security is sold by the Bank, the Bank may receive a commission, either from the issuer of a security or from an associated person of the Bank. Whether that commission is received and, if received, its value depends on the security sold. At the time of providing this disclosure statement it is not practicable to provide a detailed list of each security that may be advised on, the name of the issuer of that security and the rate of the commission received by the Bank. However, this information will be disclosed to you should you seek advice from one of the Bank's investment advisers on a specific investment.

In addition to the interest that the Bank has in products of which it is the issuer, the Bank, or an associated person of the Bank, has the following interests or relationships that a reasonable person would find reasonably likely to influence the Bank in providing the investment advice on the securities listed below:

- ANZ Investment Services (New Zealand) Limited (ANZIS), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. ANZIS may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- UDC Finance Limited (UDC), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. UDC may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- OnePath (NZ) Limited, as a wholly owned subsidiary of the Bank, is an associated person of the Bank. OnePath and its related companies may receive remuneration from a third party relating to a security sold by the Investment Adviser.
- Direct Broking Limited (DBL), as a wholly owned subsidiary of the Bank, is an associated person of the Bank. DBL may receive remuneration from a third party relating to a security sold by the Investment Adviser.

#### Securities about which investment advice is given

The Bank provides investment advice on the following types of securities:

- Debt securities including term and call deposits, government stock, local authority stock, State-Owned Enterprise bonds, Kiwi bonds and corporate bonds and notes;
- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

#### PROCEDURES FOR DEALING WITH INVESTMENT MONEY OR INVESTMENT PROPERTY

If you wish to pay investment money to the Bank you can do this in several ways such as by:

- Providing cash;

## IMPORTANT NOTICE

- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

### Record Keeping

The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

### Auditing

The Bank's systems and operations are internally audited on a regular basis. The financial statements of the Bank and its subsidiaries are audited annually by KPMG. However, this does not involve an external audit of the receipt, holding and disbursement of the money and other property.

### Use of Money and Property

Money or property held by the Bank for a specific purpose communicated to the Bank (e.g. the purchase of an interest in a security) may not be used by the Bank for its own purposes and will be applied for your stated purpose. No member of the Bank's staff may use any money or property deposited with the Bank, for their own purposes or for the benefit of any other person. In the absence of such instructions, money deposited with the Bank may be used by the Bank for its own purposes, provided it repays the money to you upon demand (or where applicable, on maturity), together with interest, where payable.

### NEW ZEALAND DISCLAIMER

The Bank does not provide investment advice tailored to an investor's personal circumstances. It is the investor's responsibility to understand the nature of the security subscribed for, and the risks associated with that security. To the maximum extent permitted by law, the Bank excludes liability for, and shall not be responsible for, any loss suffered by the investor resulting from the Bank's investment advice.

Each security (including the principal, interest or other returns of any security) the subject of investment advice given to the investor by the Bank or otherwise, is not guaranteed, secured or underwritten in any way by the Bank or any associated or related party except to the extent expressly agreed in the terms of the relevant security.

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