more give, less take

agribusiness

Economic Report

Rural Commodities Wrap

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30 October 2012

- **Financial and commodity markets pacified by central bank monetary easing, but market attention shifting towards softening conditions in Asia**
- **Wheat prices soften in October on weaker-than-expected export pace out of US, outlook neutral with upside risk evident**
- **Australian wheat crop of 20.6 million tonnes forecast in 2012-13**

Over the past month or so, financial and commodity markets have been pacified to a large extent by the range of monetary easing measures announced by several central banks in response to ongoing demand concerns and a scaling back of policy stimulus measures. As a result, the downside risks from the European sovereign debt situation appear to have softened since the most recent announcement of stimulus and sentiment in financial markets is generally more upbeat than a couple of months ago. Rhetoric from the European Cental Bank and government officials has instilled more confidence in a co-ordinated effort to avert a dismantling of the Euro and extend support to struggling Euro economies. In response, the VIX index of volatility had until recently hovered around its lowest levels since before the financial crisis, thereby signalling improved market appetite for risk.

Despite recent improvements, however, it is unclear as to how robust market sentiment will be in the current global economic environment. Over the past twelve months or so, returns from stimulatory policy measures have diminished with every announcement. Unless these measures provide a real economic improvement, particularly in Europe and the US, we would not be surprised to see further bouts of safe-haven asset purchases, thereby driving down equity and commodity markets. The IMF revised down its global growth forecasts to reflect the subdued outlook for activity while we too have recently revised down global growth forecasts.

In terms of macroeconomic data, we have seen some positives over the past month or so. US GDP rose 2 per cent in the September quarter, supported by a solid rise in consumer spending while economic growth in the UK was also positive, albeit aided by the Olympics and the Diamond Jubilee impacted June quarter. In contrast, Euro-zone activity remains weak and Germany appears well and truly caught up in the maelstrom impacting the region. Market attention however, has shifted east, where economic data has surprised the market over recent months. In particular, the slowing of the trade-dependent economies of East Asia has come about more quickly than expected although more recent indicators look a little more promising.

2013 Outlook, Rural Prices & Production		
Commodity	**Production**	**Price**
Wheat	-30%	20%
Beef	3%	-6%
Dairy	1%	-4%
Lamb	4%	-4%
Wool	2%	-16%
Sugar	21%	-11%
Cotton	-7%	-15%
Oil	–	2%

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

Domestically, the economy is performing reasonably well in aggregate although the restructuring burden from the mining boom is taking a toll on activity and sentiment. The NAB Business Survey showed a pull back in business conditions in September while forward indicators remain concerning. In the near-term, domestic activity is expected to be weighed down by falling income growth from lower commodity prices, a still high AUD – which may be increasingly figuring in firms' re-structuring decisions – and fiscal tightening at both state and federal level. This general softness is now expected to persist through the remainder of the year and with recent developments globally, the RBA took out some additional insurance at its October Board meeting, lowering the cash rate to 3.25 per cent. Another rate cut is on the cards for a November meeting, although recent inflation data has partly lowered the likelihood.

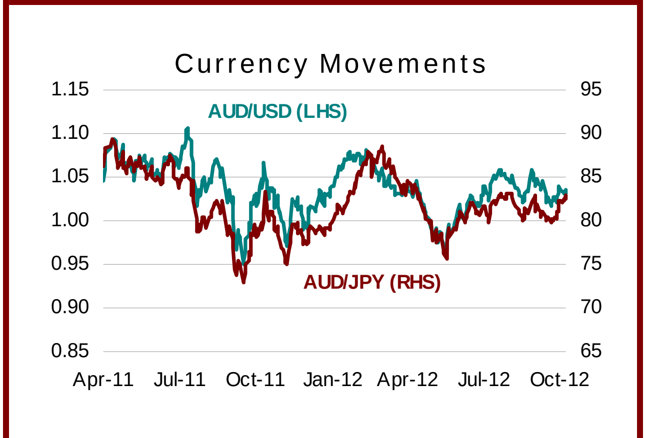
For the Australian farm sector, conditions are a little weaker than they were a few months ago. Drought conditions in the US and other key cropping regions in the northern hemisphere have supported prices. However, a dry spring has resulted in falling estimates for Australia's winter crop. Similarly, this has impacted livestock prices as restocker demand has waned over the past couple of months. Similarly, fibres continue to be weighed down by the impact of a weak global economy on the textile sector. On a more positive note, dairy prices appear to have bottomed out while the spring flush is on par with last year's efforts.

Currency Movements

The AUD has been buoyed by improving global economic data including China's September quarter GDP figures and the October 'flash' PMI, as well as local data which has lowered market expectations of a November rate cut. Over the near-term the AUD could come under a little pressure. Despite the recent CPI result, the AUD is sufficiently high relative to commodity prices that the case for a November rate cut remains. Overall, it appears a case of not if, but when. If the RBA holds off in November, the AUD is likely to rally, but will find resistance as rates sentiment shifts in favour of December.

The global outlook remains a key component of the AUD's direction. Amid the current uncertainty regarding political outcomes (US, China and Europe), incoming readings on the global economy will be important. However, the AUD is already fully priced for improving activity. The irony may be that further evidence of improved US growth raises US yields and with the RBA easing, this erodes the AUD's rate advantage. With potential AUD returns moving lower and the currency again looking very expensive, the downside remains more likely for the AUD. The risk in the period ahead is that US election uncertainty sees risk markets pressured and the USD supported. There is also plenty of Euro-zone uncertainty and the political leadership change in China. These are all capable of driving periodic sell-offs in the AUD over the coming weeks.

Currency Movements



Source: Datastream

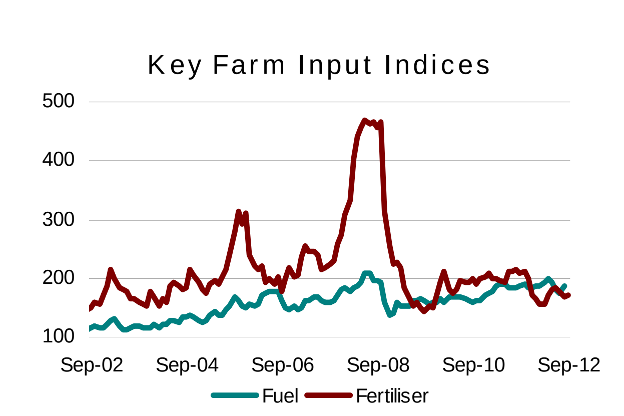
NAB Rural Commodity Index

The NAB Rurual Commodity Index was up 3.5 per cent in September in AUD terms while the impact of a lower AUD saw the index up 3 per cent in USD. Despite the headline result, however, commodity prices were very mixed through the month. Supporting the index, dairy prices were up significantly while barley, wool and wheat recorded more modest price increases. Cotton prices were broadly flat while price falls were recorded for beef, lamb and sugar. Looking ahead, we expect the index to strengthen in the coming months as dairy continues to recover while meat prices are likely to bottom out.

NAB Farm Input Indices

Fertiliser costs were up in September, with the NAB Weighted Fertiliser Index increasing 1.1 per cent in the month. Helping to drive the increase, fertiliser prices were up across the board with solid rises in natural gas and urea prices. In contrast, Diammonium Phosphate prices had a flatter profile through the month. As we enter the final months of 2012, upward pressure is likely to be exerted on fertiliser markets from the demand side. Planting programs across India and South America will need to be watched as higher commodity prices are likely to support increased fertiliser intensity. There is considerable room for prices to move given their current levels relative to recent history. In terms of fuel prices, monthly data for September is not yet available. However, given that in month average terms, AUD denominated Tapis crude oil prices were down around AUD4/bbl in the month, motorists likely received a brief respite from elevated prices in August.

Fertiliser up, fuel prices drop

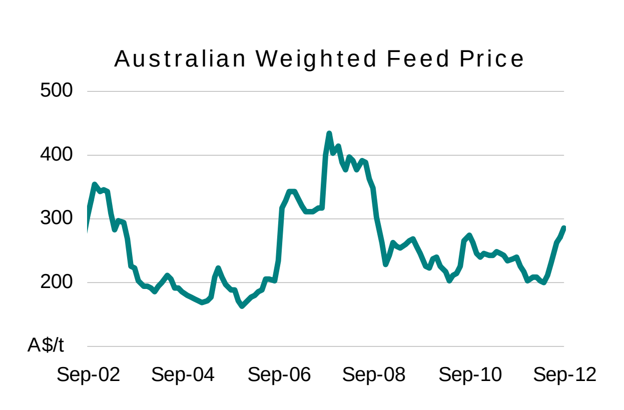


Source: Bloomberg, NAB Economics

NAB Weighted Feed Grains Price

The impact of northern hemisphere droughts has clearly been felt in Australian feed grains prices, with the NAB Weighted Feed Grains prices increasing 4.7 per cent in September, to be almost 20 per cent higher over the year. At $285.30/t, the NAB Feed Grains Price sits at its highest level since October 2008 although is still some way off its record high of more than $400/t, thanks in large part to the strength of the AUD. Driving the monthly result, prices were up across the board with sorghum (up 11.3 per cent) and maize (up 4.5 per cent) prices recording the largest increase. Other feed grains recorded more modest price increases through the month.

Feed grain prices lift in July



Source: ABARES, NAB Economics

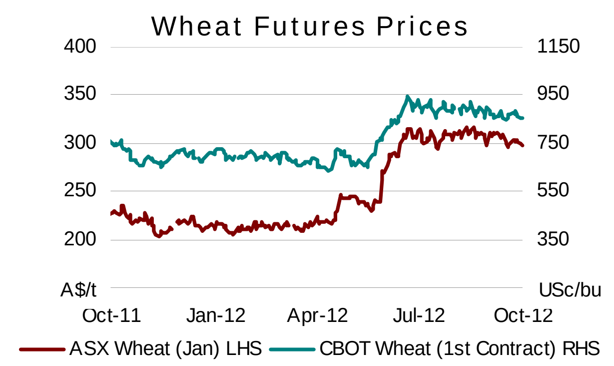
In Focus – Wheat

It has been a mixed season for the Australian wheat industry. On one hand, the impact of the northern hemisphere droughts – which have decimated crop prospects in the US, large chunks of Europe and the Black Sea – has seen a sizeable lift in prices. In October, the ASX January 2013 contract so far is up 22 per cent on June levels. On the other hand, however, the Australian wheat crop has not been immune from its own issues. Overall, we expect an Australian crop of 20.7 million tonnes in 2012-13, well down on last year's record of 29.5 million tonnes, and slightly below the decade average of 21.1 million tonnes. Nonetheless, the impact of higher prices implies that in aggregate, the gross value of Australia's wheat crop is likely to remain very strong and could come in at around $7 billion in 2012-13.

Wheat prices soften in October

Wheat prices have broadly softened through October with CBOT futures having traded within a range of 846-875USc/bu through the month, well down on the highs of 925USc/bu recorded around mid-September. In month average terms, wheat prices so far through October are down around 2.1 per cent on last month while the ASX January contract is down around 1.6 per cent since last month.

Wheat prices softer through October

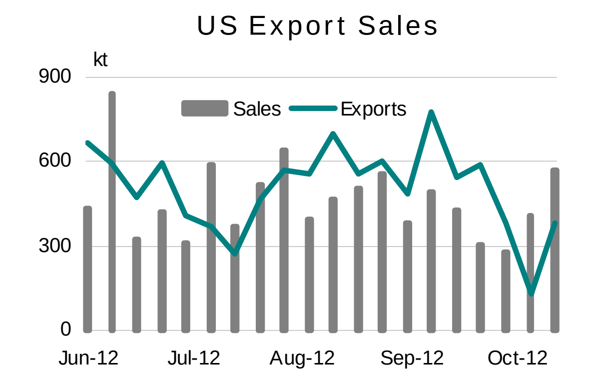


Source: Bloomberg

Despite the USDA WASDE report lowering global wheat production to 653 million tonnes in 2012-13 and indicating a shortfall of 25 million tonnes, wheat prices have come under pressure from the lacklustre pace of US exports over recent weeks. Notwithstanding the recent uplift in US exports, US export sales have generally disappointed, with recent result requiring export sales to average around 531 kt per week in order to meet USDA estimates. US prices had been too high to encourage export sales or feed usage while supply from the Black Sea was still in the mix. As such, prices through October so far have generally struggled to break free of the recent ranges observed.

The big news over the past month was the Ukrainian government announcing export bans effective from the 15th of November, although the impact of this on prices was not huge. This was partly due to exports this year out of the Ukraine being largely unchanged from last year but also due to the market already anticipating the move. Prices out of the Black Sea had been quite low in recent months therefore justifying a rapid export pace. Nonetheless, with Black Sea supply now becoming more expensive, importers have shifted demand away towards Europe where stockpiles are approaching 14 year lows. As Black Sea supply is exhausted or demand rationed, a solid support level is likely to build up under prices through late 2012 and into 2013. The big question is whether importer demand eventually shifts back to the US, which is still quite expensive. In addition, some price support is likely to come from Australia and Argentina. Australia's crop is likely to come in lower than current USDA forecasts of 23 million tonnes while Argentina has experienced some flooding and yield losses, however, the market has likely priced these in meaning upside risk from this is somewhat limited. Similarly, the harvest is currently underway so there is little scope for any significant production cutbacks from here.

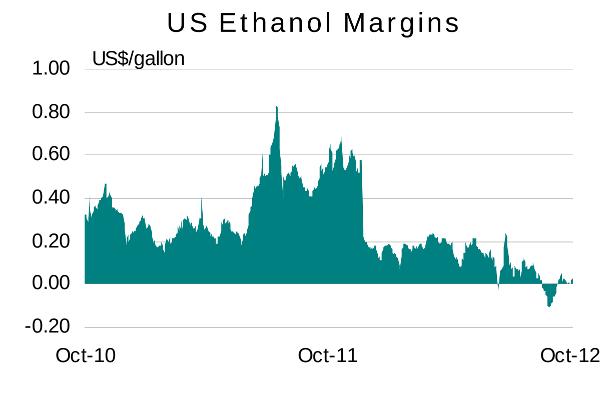
Weak US export sales weighing on prices



Source: USDA

With production prospects largely settled in the southern hemisphere, market attention is shifting back towards the northern hemisphere and in particular, planting conditions through parts of the US, Black Sea and Europe. Winter wheat in the US has caused some concern given the slow pace of emergence, especially through the northern Hard Red Winter regions. The key area to be watched will be the planting of the corn and soybean crops in South America, where the impact of heavy rainfall could see a lowering in corn acreage. This would be very supportive of wheat given current tightness in US stocks. In short, the world needs a big corn and soybean crop next year and if this fails to materialise, we are faced with even tighter feed grain balance sheets. However, the usage side also needs to be accounted for. Ethanol margins have moved into negative territory while crush margins in China are negative for vegetable oil.

US Ethanol margins subdued



Source: CARD

Also supportive of prices is China's import program. In September, Chinese wheat imports were up 196 per cent on a year earlier while export pace so far through this year implies that the USDA's estimates of China's imports may be a little too low. With a number of analyst estimates pegging the Chinese crop much lower than the official USDA forecast of 118 million tonnes, the solid export pace already evident could continue through the year. In all, this will provide another solid underpinning to what is an already tight market. Taken together, however, much of these bullish influences on price have largely been priced in. Our view for prices based off fundamentals is therefore relatively neutral although risk is definitely skewed to the upside, particularly if southern hemisphere corn and soybean production disappoints. However, in the absence of another supply shock, the wheat balance sheet does appear relatively comfortable compared to the last time prices were this high. This could limit upside price potential.

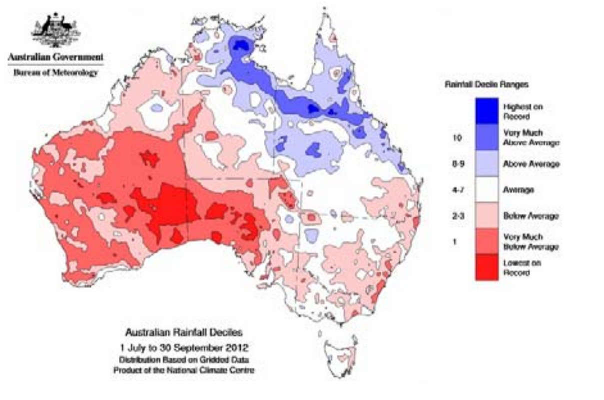
Chinese imports up significantly

Source: MLA

Outlook for the Australian Crop

Seasonal conditions for the Australian wheat crop have been quite lacklustre over recent months as the crop enters the critical development period, resulting in a significant decline in both official and analyst estimates since earlier in the year. Highlighting this, the following figure underscores the lack of rainfall evident throughout the cropping season, with much of the wheat growing regions receiving below average rainfall through winter. Coming into spring, where seasonal temperatures lift, rainfall was needed to replenish what was a weak subsoil moisture profile across many cropping regions. However, October rainfall had generally disappointed and as a result, yield potential softened from that evident in August or even September. As a result, we have forecast an Australian wheat crop of 20.6 million tonnes in 2012-13, down from last year's record 29.5 million tonnes. A summary of crop conditions in each of the states is provided below.

Australian crop hampered by dry spring



Source: BOM

In central Queensland, minimal frost damage and consistent rainfall leading up to the harvest has managed to lock in a solid yield outlook for the region. Reflecting this, the recent seasonal outlook by the Queensland DPI (Department of Primary Industries) suggests that yield expectations for most areas within the region could come in at 40 per cent above their long-term average. In contrast, conditions in southern Queensland have generally been disappointing. A dry winter coupled with frost towards the end has resulted in yield damage and yields are expected to come in below average. Taken together, we anticipate a Queensland wheat crop of 1.1 million tonnes, down from 1.8 million tonnes last year.

In New South Wales, seasonal conditions have generally worked against the wheat crop over the past few months. Yield prospects have generally suffered on lower rainfall, while lower than average minimum temperatures have resulted in severe frosts across pockets of the state. Aside from the Riverina, much of the state did not receive the yield saving rainfall that was necessary given the weak upper subsoil moisture profile. Surprisingly, given the finish, early harvest results from Southern Queensland and northern New South Wales suggest lower than average proteins. Overall, we are forecasting a New South Wales crop of 6.5 million tonnes in 2012-13, down from 7.9 million tonnes last year. Interestingly, the carryover from last season does imply that New South Wales will remain well-supplied, despite a solid drop in production in 2012-13.

Consistent with the rest of the east coast crop, Victorian crop conditions have generally suffered in recent months. In particular, large parts of the Mallee – which has suffered from a very weak subsoil moisture profile – missed the late saving rains needed to lock in yields. However, some regions around the Murray, such as Swan Hill and into the Riverina, did receive some late rains through October. Overall, we expect a

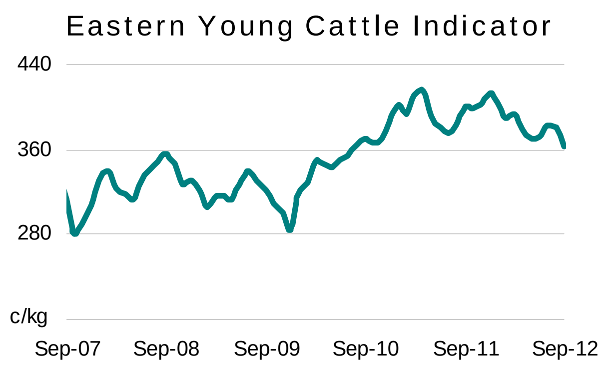
Victorian wheat crop of 2.8 million tonnes in 2012-13, down from 3.6 million tonnes last year.

In South Australia, rainfall in October did manage to save parts of the crop from further yield damage, although the result was very much mixed across the state. Parts of the Eyre Peninsula and Yorke Peninsula missed out as did parts of the Mallee. Overall, we expect a South Australian crop of 3.8 million tonnes in 2012-13, down from 4.4 million tonnes last year.

In Western Australia, below average rainfall through the winter resulted in average to poorer conditions, especially tending north and east, coming into October. Seasonal warming meant that rainfall was desperately needed to offset the trend decline in yield potential evident since August. However, rains in October generally missed the struggling cropping regions and we are faced with a Western Australian wheat crop of around 6.4 million tonnes in 2012-13, down from 11.7 million tonnes last year.

Key Commodity Prices

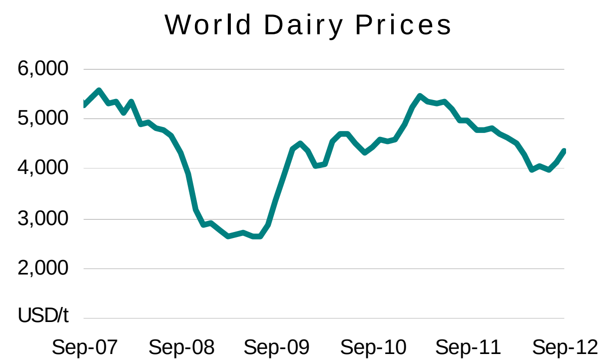
Cattle prices down on subdued restocker demand, weaker demand from Japan and Korea



Source: MLA

Cattle prices hit their lowest level since 2010 in September with the Eastern Young Cattle Indicator falling 4.8 per cent in the month, while so far through October prices have softened further, dipping below 350c/kg. Helping to push prices lower, dry weather across large parts of the east coast has meant that restockers have become increasingly cautious over the past couple of months while slaughter rates have increased. Little price support is coming from the external sector at the moment, with exports to both Japan and Korea having slowed considerably over recent months. Exports to the US, however, remain quite strong, up 43 per cent year-to-date in September. Interestingly, export prices have held up quite well, with US 90cl prices hovering around the 400c/kg mark while FOB prices in Japan still look solid. Looking ahead, we expect some near term weakness in prices due to the impact of recent dry weather on restocker demand although this should be limited by solid US demand for Australian beef.

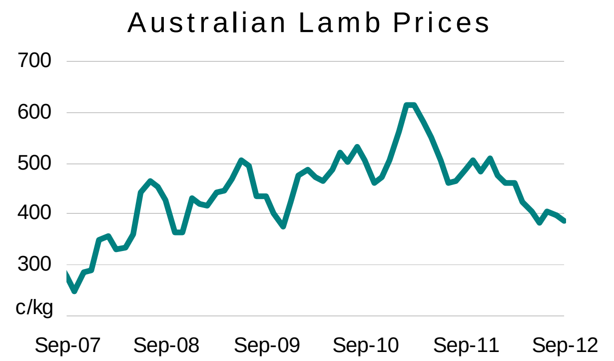
Recovery in dairy prices continues through September and October



Source: NZX

It appears that the worst of the bear market in global dairy prices is over, with our weighted average dairy price in September increasing 5.7 per cent in September, up 9.5 per cent from its low point in the cycle in May. In October, recent strength has been maintained with prices up around 3.5 per cent on September levels. Helping to push prices higher in recent weeks, northern hemisphere production has been very weak, with milk production in both the US and EU underperforming over recent months. Similarly, Chinese demand for wholemilk powder over the past month or so has been exceptional, with imports in September more than double what they were last year. Chinese demand has generally been pushed by relatively expensive domestic WMP production while a favourable tariff rate in early 2013 has also helped. Looking ahead, prices may come under a little pressure as the Oceanic spring flush hits full steam. The question will be on whether this can be absorbed in the current environment.

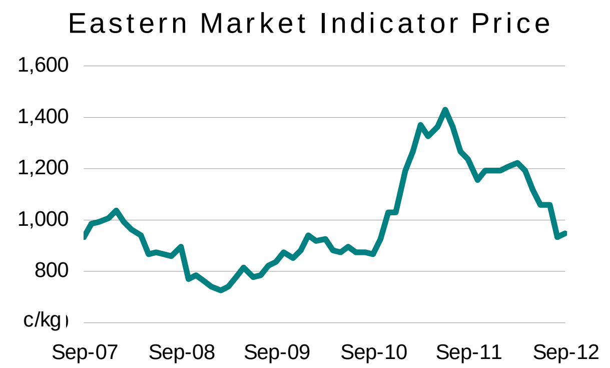
Lamb prices down on dry spring, increased supplies



Source: MLA

Having fallen quite significantly since the March quarter, lamb prices remained subdued through September, falling 2.6 per cent in the month to be more than 20 per cent lower over the year. This weakness in prices was sustained through October with heavy lamb prices down almost 6 per cent so far in the month (in month average terms). Similar to cattle prices, lamb prices have been subdued largely as a result of the dry start to spring, which has severely limited restocker demand. As such, restocker prices have borne the brunt of the price falls over recent months. Increasing volumes of lambs have also been solid direct-to-works, meaning that overall supply within the domestic lamb market is strong. When thrown in with weaker exports, this has taken its toll on the market. Looking ahead, prices should strengthen from current levels, however near-term weakness in prices appears inescapable at this stage.

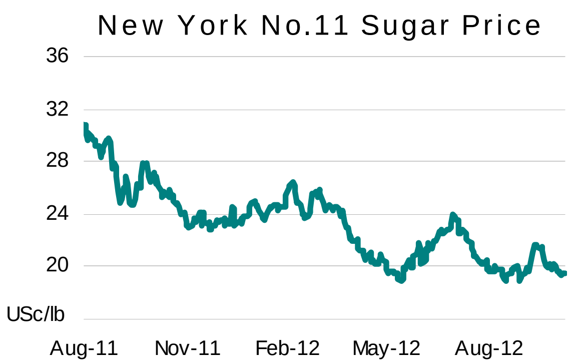
Wool prices up marginally in September but to remain under pressure



Source: AWI

Wool prices managed to show some strength in September with the Eastern Market Indicator lifting 1.5 per cent in the month, while so far through October, prices have managed to push through the 1000c/kg mark. Interestingly, when looking at the finer end of the market – which had been a drag on prices in recent months due to very subdued demand and a solid increase in superfine supplies – prices have actually outperformed the broad and coarse merino types over recent weeks. Looking ahead, however, we think the wool market is likely to come under considerable pressure. Around a third of global supply hits the market through the December quarter in line with the spring flush. At the same time, we are looking at a market where demand conditions continue to soften. With economic conditions in Europe already weak and given recent softness in East Asia, upside potential to price is severely limited.

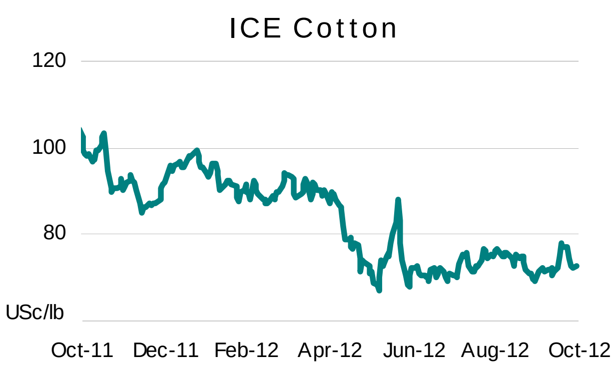
Sugar prices lift then soften on Brazilian Centre South crush



Source: Bloomberg

Sugar prices started October on a positive note, with prices reaching around 21.60USc/lb early in the month, while speculators went from net short late September to net long. However, there was little in the way of fundamentals to support this shift. News of a fairly weak Brazilian Centre South crush through the second half of September probably lent some support to the move while there were reports of India intending to increase imports of raw sugar. However, prices pulled back mid-month as the Brazilian Centre South crush improved through the first half of October, with sugar production up 57 per cent year-on-year. Also holding back prices, USDA analyst estimates for Chinese sugar production were pegged at 14.6 million tonnes, potentially suggesting a weaker Chinese import program in 2012-13. This weakness was further supported by reports of Chinese and Indian buyers cancelling contracts.

Cotton prices up on quality issues in US



Source: Bloomberg

October has been quite a volatile month for cotton. The USDA WASDE report proved to be quite bearish for cotton early in the month. This saw ending stocks lifted to a record 79.11 million bales on the back of production increases for Brazil, India, Pakistan and China, as well as a sizeable downward revision to Chinese consumption estimates. But mid month, cotton prices managed to find support as certified stock fell to extremely low levels as the early US crop had suffered from high micronaire problems afflicting the Southeast and Delta growing regions. Prices since then have softened. Looking ahead, higher prices could eventuate on the back of the quality issues impacting the US and the relative scarcity of high grade cotton. However, this shortage could be filled through late 2012 and early 2013 when US, Indian, West African and Uzbekistan cotton becomes available. Similarly, this is against the backdrop of a fairly sluggish demand environment within the textile sector more broadly.

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