

Dairy prices, the New Zealand dollar, interest rates and economic growth

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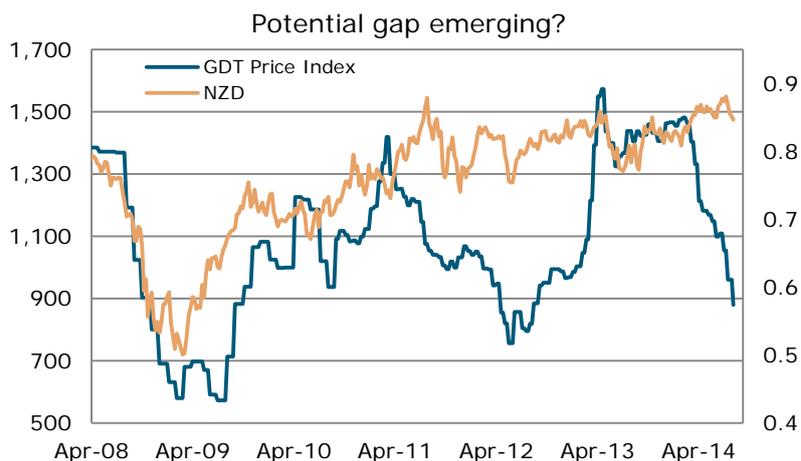
Dairy prices, as measured by the Global Dairy Trade Price Index, are now 41% off their February peak. Next year's forecast Farm Gate Milk Price of \$6.00, faces risk of a fall towards \$5.00 according to some estimates if current global dairy prices hold.

As mentioned in the Harbour Navigator on 17 June, there are two major themes playing out in international dairy markets that could help explain some of this weakness. Particularly, the supply-response from Europe on industry de-regulation is adding additional volumes to the globally traded market. Additionally, there appears to be a softening in demand from the Chinese market after having built significant inventories in anticipation of regulatory change. It is unclear when this inventory will be consumed, but markets are expecting Chinese demand to return towards the end of 2014 or early 2015.

This recent fall in prices comes on the back of the recently downgraded Fonterra Farm Gate Milk Price, which economists estimated to be lowering dairy incomes by \$3.5bn-\$4.5bn or 1.4-1.9% of GDP. No wonder many economists have called a turning point in economic growth, admittedly from a high rate of perhaps over 4% toward perhaps 3%.

With lower economic growth a possibility, it isn't surprising that the Reserve Bank called for a pause in the upward passage of interest rates. Today's news may strengthen that resolve.

With this background the real surprise is the minor adjustment so far in the NZ dollar. Yes the kiwi is down from a cyclical high of over 88cents, but at just over 84cents today the kiwi is still trading near the average for the past year and only 5% off the high. Even looking at global developments it is hard to see continued support for an exceptionally strong NZ dollar. US growth has clearly lifted, and while talk of geo-political risks may be increasing financial market risks, there is still an expectation that the US will commence raising their interest rates in 2015.



Source: Bloomberg

For investors, history suggests timing currency adjustments in portfolios is difficult, just ask anyone why the Euro has been so strong. Even so, when we stand back, the fundamentals for the NZ dollar have changed, and investment managers should at least be asking the questions if not taking notice in portfolios of both the potential for currency volatility and lower economic growth.

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