

Dollar drops after rating cut.

- **Currency** – NZD/USD tumbled to US\$0.7600 following NZ's credit rating downgrade last week.
- **Dairy** – Fonterra sets several records in 2011 season. Lower NZD provides more comfort for the 2012 season.
- **Lamb** – Season looking good for lamb producers. Short-term drop for NZD/GBP will be positive for prices.
- **Beef** – NZ beef prices have held up recently. Short-term drop in NZD will offset weakness in international market.

International market volatile, but focus on NZ finances.

Global markets have been focussed on the lack of a concrete plan to tackle the European debt crisis as well as the likelihood of a global economic slowdown. However, on Friday the NZ market was focussed on our own finances. Standard and Poor's followed Fitch Ratings in downgrading NZ's sovereign foreign currency rating to AA, from AA+. S&P and Fitch also downgraded the local currency rating from AAA to AA+. However, there remains some disagreement between rating agencies, with Moody's NZ credit rating now two notches higher than S&P and Fitch. Moody's earlier reaffirmed its stable outlook for its NZ rating for the time being.

Credit rating downgrade saw NZD drop to US\$0.7600.

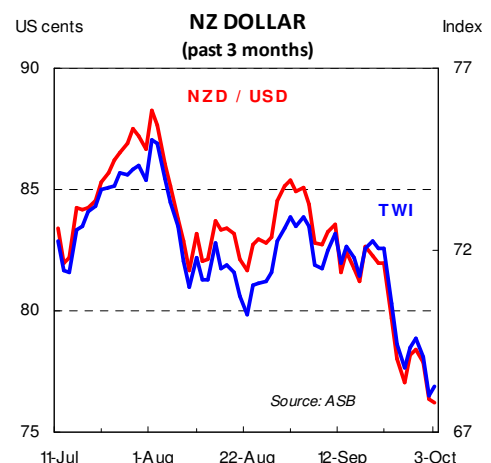
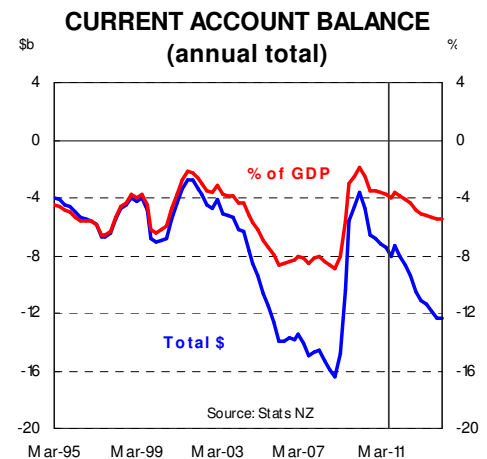
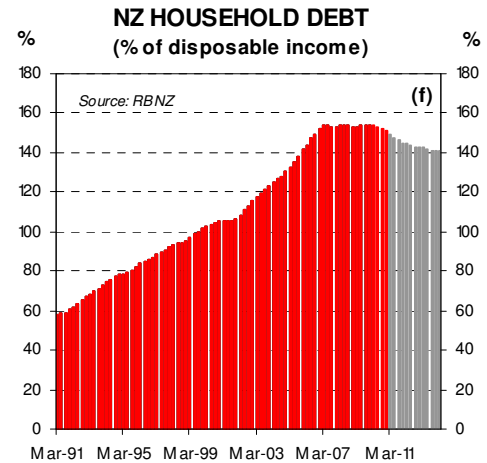
The immediate reaction to the downgrade was borne primarily by the NZ dollar, which has settled around US\$0.7600 from US\$0.7800 immediately prior to the first announcement from Fitch. The interest rate reaction has been muted, with swap rates up 2-3 basis points and bond yields up 12bp in total.

We expect some further movement, but fundamentals will direct market.

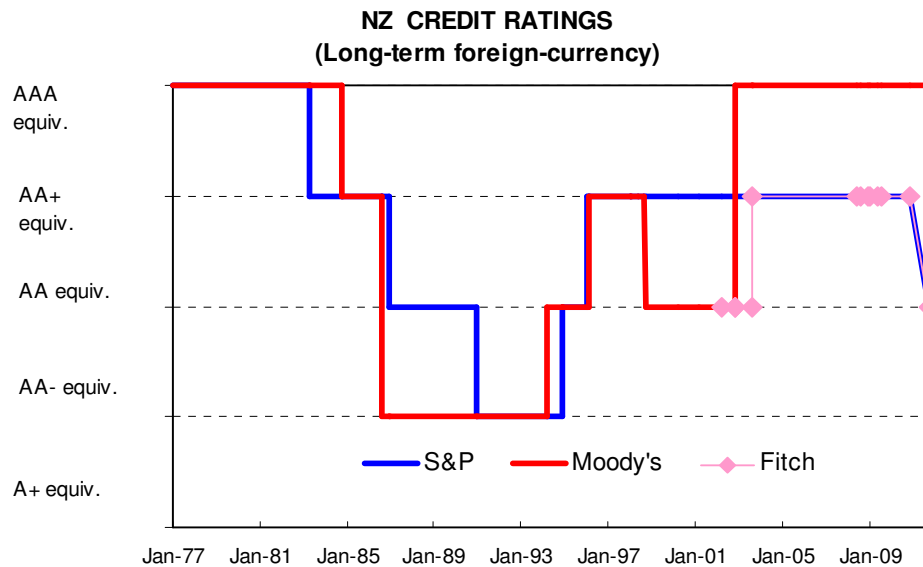
Historically the immediate reaction to past downgrades has been modest. Much of the market movement around a ratings downgrade tends to be in response to the underlying economic environment, rather than the ratings change itself. We expect that will largely be the case following the downgrades: the European debt crisis and consequent concerns about the global economy will continue to dominate the trends in the NZD and interest rates. Even at the lower AA rating, NZ appears more stable than many other countries receiving downgrades. Nevertheless, the global backdrop is one of nervousness about external liabilities.

New Zealand's current credit ratings

Fitch's and S&P's downgrades means NZ's sovereign foreign currency credit rating is now AA for two agencies, AAA for one.



Historical trend for NZ's credit ratings.



The domestic currency rating is AAA equivalent for Moody's and now AA+ from Fitch and S&P. NZ Government debt is primarily denominated in NZ dollars.

Reasons for the downgrades

Focus on NZ external liabilities.

The common concern of all the credit rating agencies is less the level of (low) government debt but NZ's overall external indebtedness.

1. Strong relative Government position.

NZ's net core Crown debt is only 20.4% of GDP (as at 31 May 2011), and we forecast it to peak at 31%. Gross government debt, currently 37.6%, is expected to peak under 40% of GDP. These figures are a far cry from the ratios of the US and the more solid countries in Europe. But NZ's net international liabilities are 70% of GDP.

2. Long-term current account deficit.

NZ runs a persistent current account deficit. Currently the ratio is low, at 3.7% of GDP. However, we forecast it to lift to levels higher than nominal GDP growth over coming years. If NZ's current account goes back to persistently averaging above 5% of GDP then the country's dependence on foreign creditors (and vulnerability to disruption) would continue to increase.

3. Low savings culture.

The issue of a structural savings imbalance was a key consideration in Fitch's decision. The agency noted that "the downgrade partly reflects Fitch's view that the sustained shift in the domestic savings/investment ratio required to narrow the [current account] deficit sustainably is unlikely within the forecast period." NZ households' indebtedness has stabilised relative to incomes, but as yet there has been no meaningful reduction as seen in the US and UK. Fitch noted the Government has introduced policies that will help promote household savings but that "changing deep-seated behaviour is likely to be difficult".

Longer-term impacts to focus on fundamentals.

Longer term impacts of a downgrade

In the past, the immediate reaction to a downgrade has been modest. Much of the market movement around a ratings downgrade tends to be in response to the underlying economic environment, e.g. bond yields trend lower for a period in response to weak economic conditions.

However, a downgrade in the current environment of uncertainty risks having a bigger impact over time.

NZD was weaker before the downgrade.

Foreign exchange

The NZD weakened over the past two months in response to the global uncertainty. However, the credit rating downgrade has seen an even weaker NZ dollar. On Monday morning, the NZD was trading just over US\$0.7600. We expect the NZD may see further downward pressure over the short term as the market digests the news.

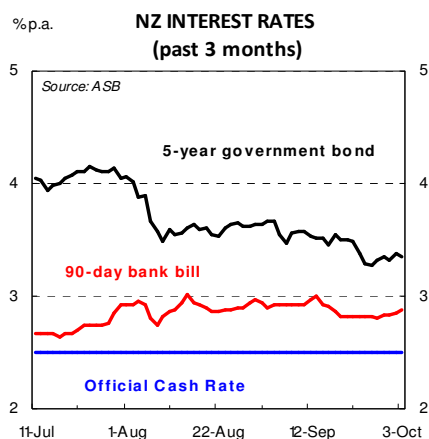
We still expect it to grind higher once stability resumes.

Despite the current concerns about Europe and US growth, we continue to expect above trend global growth this year and next. IMF forecasts released in September were consistent with this view. Over the medium term, NZD should find support from improving global sentiment, strength in key export commodity prices, improving GDP growth boosted by the Canterbury rebuild, and re-firming expectations of rate increases from the RBNZ next year. Our medium-term view is that the NZD/USD will move back into the low/mid US\$0.8000 mark over 2012.

RBNZ on hold till 2012.

Interest rates

The RBNZ left the Official Cash Rate unchanged at the September meeting. Comments also suggested it will take a wait-and-see approach to the current market volatility. Global growth forecasts have recently been pared back and any slowdown may negatively affect NZ's recovery. Given this, we are not expecting any increase to the OCR until March 2012, meaning short-term NZ interest rates are likely to stay lower for longer.

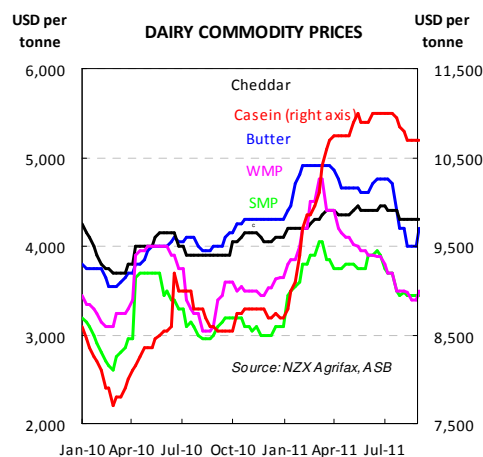


Downgrade may mean lift in longer-term rates.

However, the credit rating downgrade will also affect interest rate markets. The interest rate yield curve is likely to steepen as short-term rates remain anchored, but longer term risks remain.

But short-term rates lower for longer.

Beyond the immediate reaction, global trends will dominate. Presently global interest rates (beyond crisis countries) are being kept low by concerns over global growth, and we expect that influence will reassert itself.



Fonterra caps off bumper year

Plenty of records for Fonterra.

Fonterra announced its final milk payout for the 2011 dairy season in September, capping off a series of records for the year. The all-up payout for 100% shared suppliers was \$7.90 per kilogram of milk solids after retentions. Other records included: highest production, highest revenue and lowest gearing.

Drop in NZD will help payout for current year.

Fonterra also achieved an average hedged exchange rate of US\$0.7200 – 5c lower than the average spot exchange rate over the season. This positively boosted the payout for farmers. The recent declines in the NZD will be welcomed by Fonterra (as by all other exporters) and will help to offset the gradual declines we have seen for commodity prices over past few months. While Fonterra reaffirmed its payout forecast for the 2012 season, we have been concerned that the high NZD would negatively impact the payout in the coming year, unless we saw a lift in USD dairy commodity prices. While dairy commodity prices remain strong, we are yet to see the increases that occurred through the early part of the 2011 season. However, the lower NZD will provide a good buffer for the payout (in the short-term) and provides more comfort for the current forecast of \$7.15-\$7.25 per kgms.

Despite global uncertainty, dairy outlook remains sound.

Commonwealth Bank's agricultural commodities specialist, Luke Matthews, recently released a report on the global dairy industry. He remains positive about the dairy outlook, despite the recent international uncertainty. Global dairy prices will remain historically high over the next few seasons. Prices should remain supported by strong Asian demand and constrained northern hemisphere production. But the worsening global economic outlook still presents a substantial risk to dairy prices. During the GFC, world WMP prices slumped 65% from USD5,000/t to USD1,850/t. GFC Mark I caused a sharp contraction in global dairy consumption.

Lower exchange rate may offset easing international beef market

Beef market will be boosted by lower NZD.

The lower NZD/USD will no doubt be welcomed by beef processors and in turn by NZ farmers. Local schedule prices have been holding up well, despite some pressure coming on international markets and until recently an unfavourable currency. It is possible that lower supplies, combined with higher demand as a result of increased Rugby World Cup partygoers, may have held the schedule at reasonable levels.

This will offset weaker international market.

The international market continues to look uncertain. US beef supplies have lifted, with more cows being culled as a result of dry pasture conditions. In addition to this, a soft US economy and weaker consumer confidence will likely impact on US beef demand. We have for some time been waiting for US imported beef prices to decline, but they have remained relatively strong despite negative influences.

The recent weakness for the NZD could not have come at a better time. We continue to expect US market prices to tail off, but declines are now likely to be offset by a lower NZD/USD exchange rate (in the short-term at least). While we aren't getting too excited about strong price increases in the coming season, the potential for a lower NZD over coming months should at least underpin the market.

Good year for lamb producers ahead

Higher numbers shouldn't impact on market prices.

The season continues to look promising for lamb producers in NZ. While seasonal conditions are looking positive for a strong lamb crop, production increases will still be limited by the higher slaughter seen through the 2011 season. Expectations are for an increased lamb kill in the year ahead, but this is unlikely to fill the supply gap for the international market.

There has been talk that UK consumers are balking at the recent high prices, but product continues to move. This, combined with the recent easing in the NZD versus GBP should provide the backdrop for another good season for farmers. The international market continues to remain volatile, making it very difficult to predict pricing over the coming twelve months. However, given the information currently to hand, we continue to expect prices to average around \$110 per head.

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