

Economic Report

Rural Commodities Wrap

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June 2010

Farm incomes set to fall in 2010-11

- Rural Commodity Price Index to increase by 1.5 per cent in AUD terms in 2010-11
- Net value of farm production to fall by 11 per cent in 2010-11

In the 2010 calendar year, we currently expect global economic growth to rise by around 4.2 per cent. Although financial markets have experienced losses in recent weeks due to concerns focused on the euro area, there are continued signs that the recovery in the US is underway and that prospects in non-Japan Asia remain robust.

We are currently expecting Chinese growth to reach 10½ per cent this year before slowing to 9 per cent as the Chinese administration gradually unwind expansionary monetary and fiscal policy settings.

The threat of more strict fiscal austerity measures in the euro area have caused us to marginally revise down our European growth forecasts. That said, we have consistently predicted that a prolonged period of deleveraging (both public and private) would weigh on the growth outlook for the European and US economies over coming years.

NAB's domestic activity and labour market forecasts have not been significantly changed over the past few months. Recent NAB monthly business surveys have reported some moderation in conditions, as the economy transitions from activity supported by public spending to growth sustained by private sector demand. Nevertheless, NAB surveys indicate that confidence remains at high levels across both large and small-to-medium sized businesses in Australia. We are forecasting the Australian economy to grow by around 3 per cent over the 2010 calendar year followed by 3¾ per cent over 2011.

The [NAB Post Farm Gate Agribusiness Survey](#) for the March quarter was released last month, showing improving business conditions and increases in agribusiness confidence and profitability.

2010 Outlook, Rural prices & production

Commodity	Production	Price
Wheat	3%	-3%
Beef	-3%	6%
Dairy	1%	10%
Lamb	-8%	0%
Wool	0%	6%
Sugar	1%	-25%
Cotton	32%	-1%
Oil	-	5%

Source: NAB Economics

These forecasts represent year-on-year changes in AUD price and production between the 2010-11 and 2009-10 financial years.



Turbulence in currency markets

Recent events in the euro area have prompted investor risk aversion and declining commodity prices, causing a broadly based depreciation in the Australian dollar.

In response to the continued risk of sovereign default across many European economies (especially Greece, Italy, Ireland, Spain and Portugal), European finance ministers in early May announced a 'European Financial Stabilisation Mechanism' comprising €750bn of funding support for embattled countries. Despite this, financial markets continued to focus on the weak growth prospects in Europe likely to ensue with widespread fiscal consolidation, selling many commodity classes and increasing holdings of low-yielding, low-risk, currencies.

Due to perceptions of the Australian dollar as a relatively risky currency leveraged to movements in global commodity prices, the exchange rate has fallen over the past few weeks. Most relevant for Australian agricultural producers, our currency has fallen by 10.6 per cent against the Japanese Yen, 9 per cent against the US dollar, 5.1 per cent against the NZ dollar, 4.9 per cent against the Indian Rupee and 1.6 per cent against the South Korean Won.

Movement in AUD between 21 April - 31 May

	% change
Japanese Yen	-10.6
US Dollar	-9.0
NZ Dollar	-5.1
Indian Rupee	-4.9
Sth Korean Won	-1.6

Source: RBA

Looking forward, we expect the strong fundamentals of the Australian dollar (high and rising interest rates, strong non-rural commodity price growth and a global economic recovery) to eventually reassert themselves. This should see the currency appreciating over the second half of 2010 assuming that the fears surrounding the euro area begin to subside.

NAB's 2010-11 Grain Production Forecasts

Australian wheat production is forecast to increase by 3 per cent in 2010-11 to 22.2 million tonnes. While pre-planting rains on the east coast of Australia were good, some recent dry conditions have led to declining subsoil moisture levels. Recently, however, rain conditions have improved (with further rain forecast), boding well for yields and further planting activity. While the west coast remains very dry, there continue to be signs of an increase in planting activity, lifting yield potential in that area.

Given the poor outlook for barley prices, the area planted to barley in 2010-11 is forecast to fall by around 8 per cent. As a result, Australian barley production is forecast to decline by 11 per cent in 2010-11 to 7.2 million tonnes.

In contrast, the season is looking well placed for an expansion in canola plantings, with NAB forecasting production to increase by 13 per cent in 2010-11 to 2.15 million tonnes.

NAB Rural Commodity Index

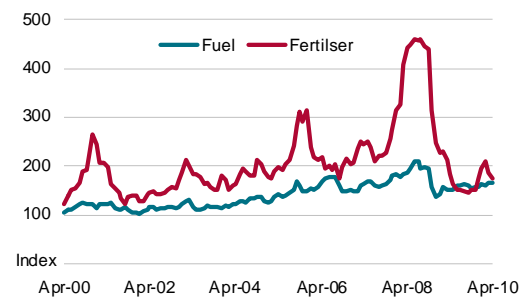
The NAB Rural Commodity Index increased by 5.6 per cent in AUD terms in the March Quarter 2010 as higher prices for beef, lamb, cotton, sugar, wool and dairy offset lower prices for wheat, barley and wine.

Looking ahead, the Index is estimated to fall by 6.2 per cent in 2009-10 as forecast weaker prices for grains, dairy and wine is partially offset by higher prices for lamb, wool and sugar.

Initial forecasts for 2010-11 are for a 1.3 per cent increase in the NAB Rural Commodity Index, driven by expectations of higher beef, wool, dairy and wine prices.

Farm input costs fall

Key Farm Input Indices



Source: NAB Group Economics

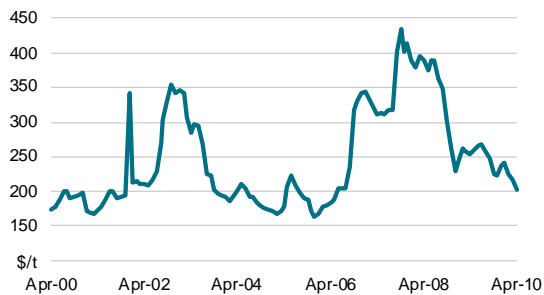
NAB's Farm Input Indices

NAB's AUD weighted fertiliser index fell by 6 per cent in April after falling by 12 per cent in March. Of the components, the largest price falls have recently been in natural gas and urea, although Diammonium Phosphate (DAP) prices also moderated over the period. This trend seems to have continued in May, although natural gas prices are beginning to show some signs of strengthening.

The petrol index fell by 1 per cent in AUD terms in April 2010. Petrol prices are forecast to fall by around 3 per cent in 2009-10 as the significant increase in the AUD offsets an 8 per cent increase in the price of Tapis oil.

Domestic feed grain prices continue to fall

Australian Weighted Feed Price



Source: NAB Group Economics

NAB's Weighted Feed Grains Price

NAB's Weighted Feed Grains Price declined by 7 per cent in April 2010 to average \$202 per tonne, as a result of lower prices for all major feed grains other than maize.

NAB's Weighted Feed Grains Price is calculated using delivered Sydney region prices for barley, oats, sorghum, maize, feed wheat and triticale, and is weighted on the basis of historical domestic grain usage statistics.

Net Value of Farm Production

In 2009-10, the net value of farm production is expected to fall by 42 per cent to around \$4.7 billion, reflecting flat Australian farm production and weak rural commodity prices.

In 2010-11 the net value of farm production is forecast to fall a further 11 per cent to \$4.1 billion. This derives from our expectation of a modest rise in the value of farm production and a 3 per cent increase in total farm cash costs.

Locust situation

Over the past few months there has been significant locust migration to southern regions with reports of damage to autumn fodder, vegetable, canola and cereal crops.

During early April, many swarms moved into the Murray Valley and Northeast regions of South Australia, Northwest and North Central Victoria and the southern Riverina in New South Wales. Through the rest of April, further migrations occurred with high density egg laying in these regions. Indeed, the eggs of current swarms are due to hatch between late August and October this year, with some government bodies predicting that the current situation has the potential to lead to an outbreak matching or exceeding the 2004-05 season.

Commodity In Focus

Australian and New Zealand Dairy

- Dairy prices have recently rebounded after falling significantly over 2008 and early 2009.
- Dairy demand is being supported by the urbanisation of India and China.
- Chinese dairy imports grew by 45 per cent in the year to April 2010.
- Overall, despite the risks to global growth marked by recent disruption in financial markets, the outlook for both the Australian and NZ dairy sectors are positive.

World Dairy Conditions

After having declined by over 50 per cent by mid-2009 from their peak in late-2007, US dollar dairy prices have rebounded since then. The strength in prices over the past year has coincided with a gradual recovery in global economic growth, largely supported by strong conditions in developing economies. In particular, Chinese demand for milk powder as well as Indian consumption of butter have been strong. These demand conditions have been combined with a relatively unresponsive supply picture, as cow herds in the North Atlantic countries and Australia have declined. As such, the strength of prices is consistent with currently tight conditions in the dairy market.

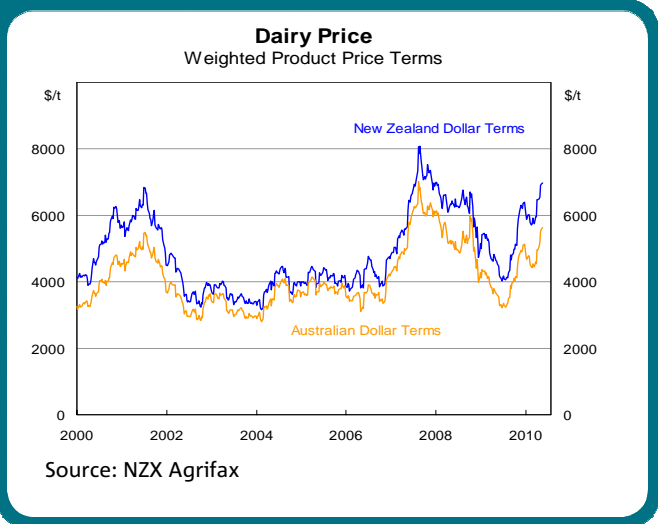
While this area benefited from an improvement in seasonal conditions and a late season increase in water allocation, Dairy Australia argue that the impact on production was more than offset by declining southern industry product prices for much of 2009. Elsewhere, Tasmania, as well as some northern regions, have experienced some flooding over the past year, limiting pastures and cow productivity.

Dairy Australia estimate that domestic per capita consumption of milk was steady in 2008/09, while per capita consumption of other key categories declined. Even so, the continued strength of Australian population growth means that aggregate domestic dairy demand is estimated to have grown over 2009/10.

For Australian dairy exports, the fortunes of developing economies remain important. The recovery in global economic conditions has been largely driven by a strong rebound in China that has had positive spillover effects for other countries in the region. For the dairy industry specifically, China continues to grow as an importer of whole milk powder with increased urbanisation and rising protein consumption per capita.

In annual average terms, Chinese dairy imports grew by 45 per cent in the year to April 2010. Nevertheless, the Australian Bureau of Agricultural and Resource Economics (ABARE) recently noted that many Asian consumers are lactose intolerant, meaning that average consumption of fluid milk and milk fat is likely to remain below the level of other countries at a similar stage of economic development. Also, the last few years have been characterised by problems in China's milk industry, with producers being found to have contaminated milk in order to pass health authority testing of protein levels (a chemical, 'melamine', was added to boost protein readings). This has caused China to be more reliant on imported milk since 2008, with the shutdown of some domestic producers.

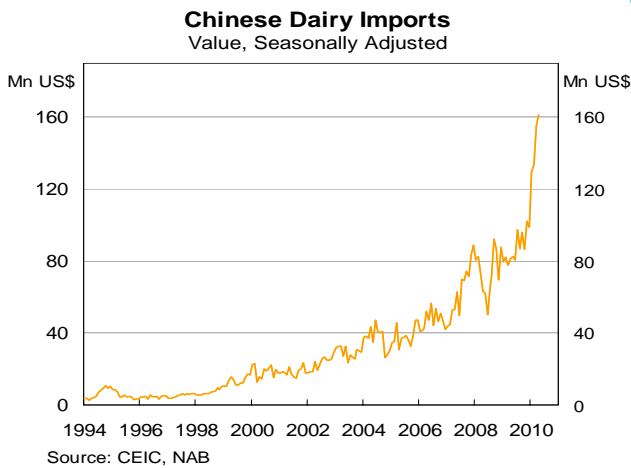
World dairy prices have rebounded



Australian conditions

Volatile product prices in the past few years along with some adverse seasonal conditions have been the main reasons for weaker Australian dairy production. Dairy Australia anticipate that Australian milk production will fall by roughly 5 per cent in 2009/10, with supply from the key northern Victoria/Riverina area expected to

Strong Chinese demand for dairy imports



China and New Zealand

Aided by rising dairy trade, China has now replaced the United States as New Zealand's second most important export market (behind Australia). This reflects both the strength of Chinese growth as well as weaker import demand from the US. There have also been specific issues supporting trade, including tainted milk from Chinese producers and the tariff reductions associated with the NZ-China Free Trade Agreement that came into force in late 2008. In the first three months of 2010, NZ agricultural exports to China rose by almost 18 per cent from a year earlier.

In NZ dollar terms, dairy is the most significant NZ export to China with the industry explaining a large part of the increase in bilateral trade over the past decade.

New Zealand Supply Conditions

Focusing on NZ supply conditions, the climate has been unusually dry in the North Island and the north-east of the South Island, adversely affecting recent milk production. The latest National Institute of Water & Atmospheric Research outlook notes that mean temperatures are likely to be above average in the North Island and average to below average in the South Island between May-July. Near normal seasonal rainfall is likely in many places, but normal to below normal rainfall is expected in eastern regions. Nevertheless, recent rainfall is likely to have given producers in the more arid areas greater optimism.

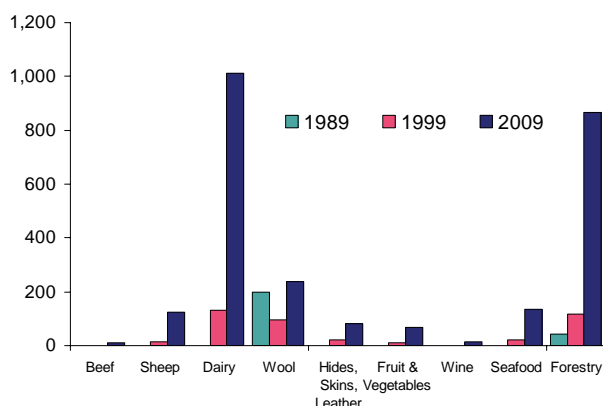
Dairy Price Outlook

Overall, despite current risks around global growth with some disruption to financial markets, the outlook for both the Australian and NZ dairy sector is positive.

We are expecting Chinese GDP growth to rise by 10½ per cent for 2010, underpinning a strong demand outlook for the dairy industry. Nevertheless,

as recently discussed by ABARE, only a small share of global dairy production enters world trade and small changes in production or consumption of dairy products in the major dairying countries can lead to volatility in world dairy product prices. As such, the regional disparity and lumpiness in the pattern of the global economic recovery is likely to continue to be reflected in some volatility in dairy prices over the period ahead.

NZ exports to China - by product (NZ\$m)

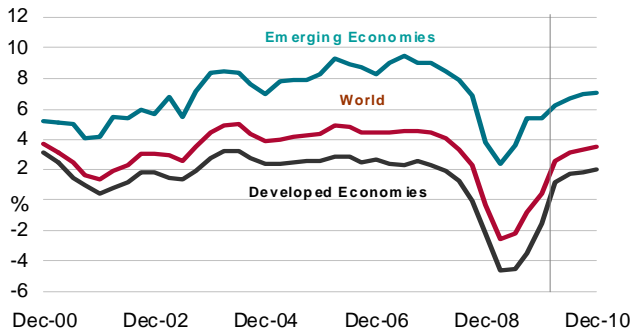


Source: Statistics New Zealand

Key Macro Drivers for Commodity Producers

Global Economic Growth

Global Growth Outlook

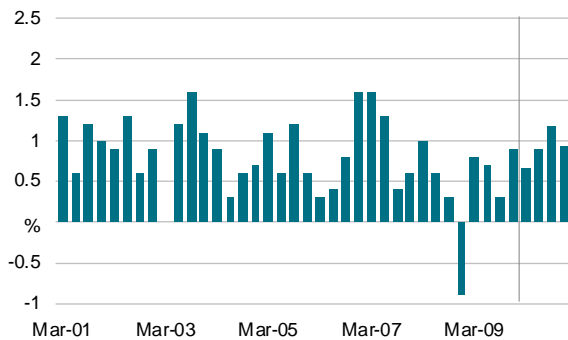


Source: Thomson Datastream, NAB

The fiscal austerity measures in the euro zone have caused us to marginally revise down our European growth forecasts. That said, we have consistently predicted that a prolonged period of deleveraging (both public and private) would weigh on the growth outlook for the European and US economies over coming years. World GDP growth is likely to be heavily reliant on the strong contributions from China and India in the next two years. Over the 2010 calendar year we expect world GDP growth of 4.2 per cent, followed by similar growth over the year after.

Australian Economic Growth Outlook

Australian Growth Outlook

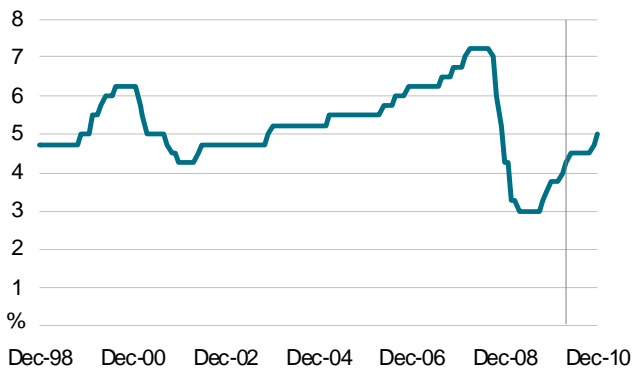


Source: ABS, NAB

Our domestic activity and labour market forecasts have not been significantly changed over the past few months. Recent NAB monthly business surveys have reported some moderation in conditions as the economy transitions from activity supported by public spending to growth sustained by private sector demand. Nevertheless, NAB surveys indicate that confidence remains at high levels across both large and small-to-medium sized businesses in Australia. We are forecasting the Australian economy to grow by around 3 per cent over the 2010 calendar year followed by 3¾ per cent over 2011. Such growth forecasts are consistent with the unemployment rate falling to around 4½ per cent by the end of 2011.

Further rate rises expected in 2010

Interest Rate Outlook

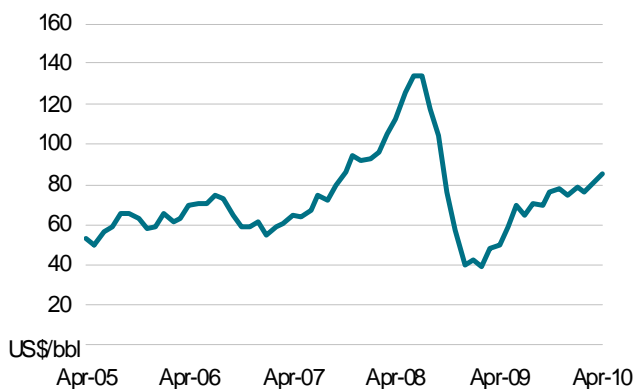


Source: RBA, NAB

Consistent with our expectation, the RBA increased the cash rate at its May board meeting to 4.5 per cent. The release of the minutes of the meeting indicate that the board feel that interest rates are now around 'average' levels, an appropriate setting given that the Australian economy currently appears to be growing at around its average pace. The board is now likely to pause in its monetary policy tightening (especially given recent falls on equity and commodity markets). From here, we expect the RBA to leave interest rates at current levels for some months while they review global and domestic economic developments. Eventually, however, further tightening of policy in the final months of this year is expected to take the cash rate to 5 per cent by December 2010 before rising to 6 per cent at the

Oil Outlook

World Oil Prices - WTI



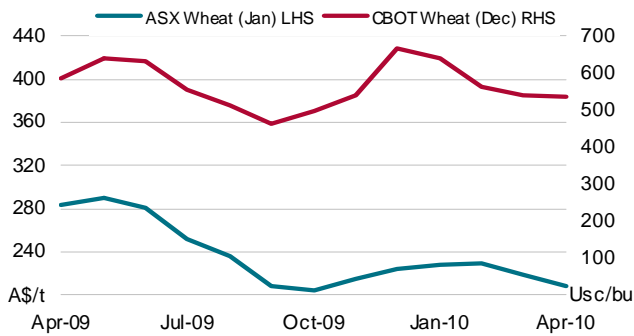
Source: Thomson Datastream, NAB

Oil prices rose strongly in April, breaking the range in which they have traded since October 2009. West Texas Intermediate (WTI) prices rose by 4 per cent, averaging US\$84.50 per barrel in the month. The increase in Tapis and Brent prices was even more notable, with both picking up by over 7 per cent. Nevertheless, the final week of April and the early weeks of May saw a significant weakening in oil prices, with a weaker outlook for global oil demand and an appreciation in the US dollar. So far in May, prices for WTI have fallen by over 10 per cent. This is consistent with our recent expectation that oil prices would moderate, although the recent decline has been more severe than we expected. Assuming an orderly resolution to problems in the eurozone, we expect a gradual rise in oil prices over the next few years as fundamental conditions in the US continue to improve.

Key Commodity Prices

High global wheat stocks keeps a lid on prices

Wheat Futures Prices

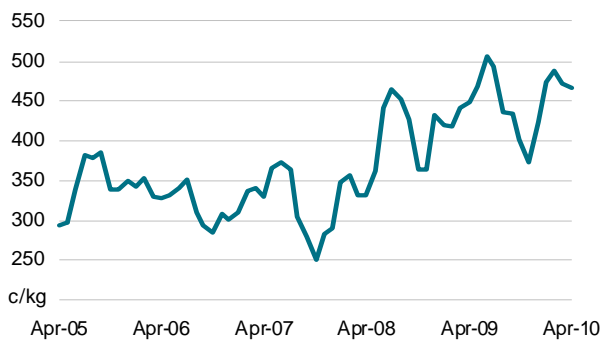


Source: Bloomberg

In month-average terms, wheat futures prices have weakened recently, falling on both the ASX and the Chicago Board of Trade (CBOT) in April (though they have increased slightly so far in May). Since the end of 2009, wheat prices have drifted downward, falling by 7.6 per cent between December 2009 and April 2010. One factor weighing on wheat prices has been an increasingly healthy supply outlook. While market participants widely anticipated a fall in the volume of wheat production in 2010, it now appears that this will be more than offset by abundant global wheat stocks. According to the US Department of Agriculture (USDA), while global wheat production is expected to fall by 1 per cent over 2010/11, wheat supplies are expected to be 2 per cent higher.

Lamb prices rise as supplies tighten

Australian Lamb Prices

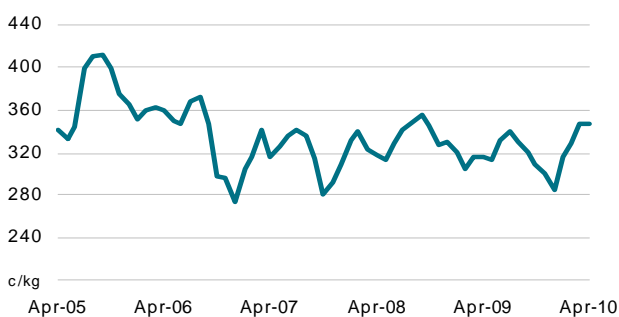


Source: Meat and Livestock Australia

The heavy lamb indicator price fell by 1.4 per cent in April 2010, following a 3 per cent fall in March. Despite this, at 466c/kg, the lamb indicator is roughly 37 per cent above the average since 2000. Limited (and dwindling) lamb supplies combined with stable domestic and international demand continue to upwardly support prices. Furthermore, historically, lamb supply has been relatively slow to come on line in response to rising prices and winter typically coincides with weak lamb production. As such, we expect prices to maintain their currently high levels in the period ahead as market conditions remain tight.

Beef prices continue to trend sideways

Eastern Young Cattle Indicator

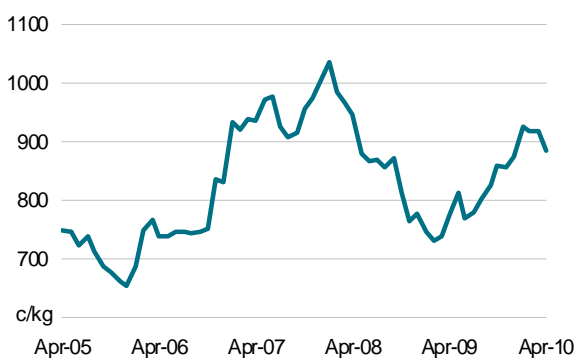


Source: Meat and Livestock Australia

The Eastern Young Cattle Indicator (EYCI) remains at the top part of the range in which it has traded since early 2006. In April, the EYCI averaged 346.5 c/kg. When accounting for economy-wide price inflation, the current value of the EYCI corresponds exactly with the average of the indicator since 1996. Recently, Indonesian officials denied the import permit of an Australian cattle ship at the port of Tanjung Priok, highlighting concern within Indonesia that imported cattle are causing a fall in prices received by local farmers. Looking forward, more severe Indonesian import restrictions would have especially large consequences for cattle farmers in Northern Australia, who historically send around 90 per cent of their cattle to Indonesia.

Wool Prices fall with weak growth in the large advanced economies

Eastern Market Indicator Price



Source: Australian Wool Exchange

The Eastern Market Indicator price for wool fell by 3.6 per cent in April 2010 and has now fallen by roughly 5 per cent since its recent monthly peak in January 2010. Over the month of April, the Eastern Market Indicator averaged 887c/kg which is around the average since 2000 on an inflation adjusted basis. Although supply of wool remains limited, these conditions appear to have been largely factored into the current wool price - depicted by the steady rise since early 2009. The recent moderation is likely due to continued tepid demand growth in the large developed economies in the EU and, to a lesser extent, the US. While we expect continued increases in wool prices, the pace of growth is likely to be gradual, consistent with our forecast for the recovery in growth in the advanced economies.

Tight global cotton stocks support prices

Cotlook A Index

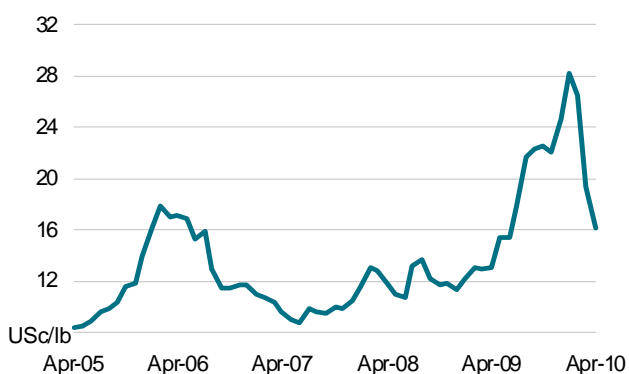


Source: Thomson Datastream

The Cotlook A index increased by 2.4 per cent in April 2010 to average US\$87.8c/lb, with prices continuing to be well supported in May. We expect cotton prices to remain above long-run average levels over the next few years, with the market balance tightening further. This view is supported by the US Department of Agriculture's (USDA) most recent world agricultural supply and demand estimates. The USDA expect meagre stocks to impede growth in cotton supplies as demand grows strongly with China relying more heavily on world markets. Over 2010/11, the USDA expect global consumption to grow by 2.8 per cent while supplies will increase by less than 1 per cent.

Sugar continues to fall off 30 year highs

New York No.11 Sugar Price



Source: Bloomberg

After rallying to near 30 year highs in January, sugar futures prices subsequently fell by roughly 50 per cent. Nevertheless, in the past two weeks sugar prices have risen as market participants question whether recent price declines (to levels that are below the cost of production) have been excessive. Looking forward, US sugar prices are likely to remain flat for a period with the new Brazilian crop harvest appearing healthy and the Indian monsoonal season yet to occur. Sugar demand remains solid, however, providing some upside risk to our sugar price forecast.

Despite the falling US sugar price, the recent depreciation of the Australian dollar has resulted in relatively strong returns to Australian sugar producers over the past few weeks.

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*Prices for NAB's outlook for 2009–10 rural prices and production are sourced from:

Lamb: Heavy Lamb Indicator Price. Wool: Eastern 123333 Market Indicator. Beef: Eastern Young Cattle Indicator.

Wheat: US hard red winter. Cotton: cotlook A index. Sugar: New York no. 11 futures price.

Dairy: Oceania, international cheddar cheese price.

Sources: National Livestock Reporting Service, Australian Wool Exchange, Bloomberg, and USDA

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