

## Wool Outlook 2009

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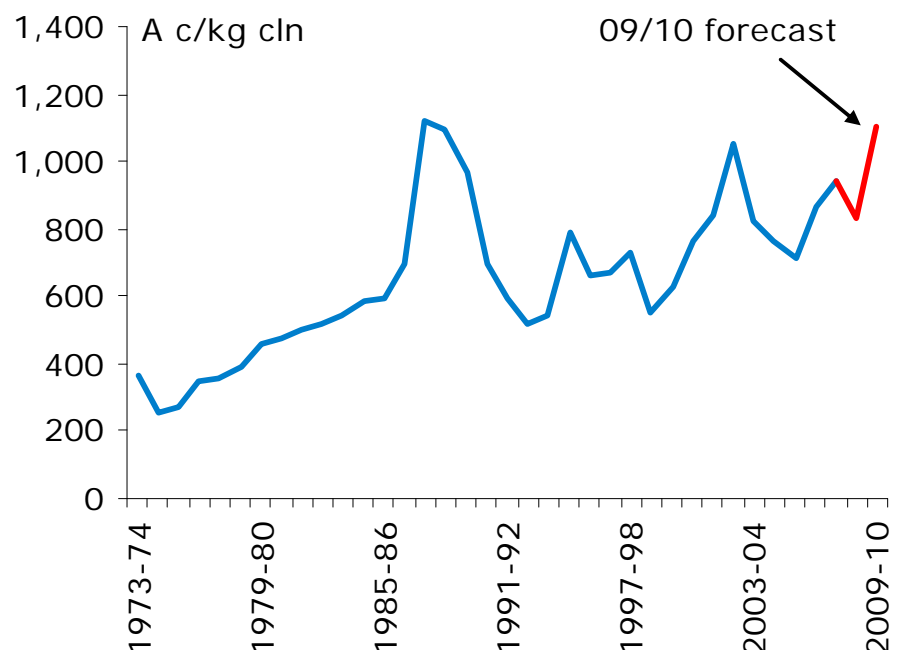
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### Key Points

- Along with most other agricultural commodities, global wool apparel prices have been caught in the slipstream of the general malaise surrounding the global financial crisis and global economic downturn.
- The liquidation of the Australian sheep flock has continued in the 2008/09 season, with ANZ forecasting the flock will be just 75 million head at 30<sup>th</sup> June 2009, down 4% y-o-y.
- The next 12 months will be one of the toughest and bleakest periods for wool demand seen in several decades.
- December 2008 retail sales in the US and UK highlight a major downturn in consumer spending in the mid to upper end apparel and luxury goods segments.
- The major hope for the Australian wool industry in 2009 is the prospect of a falling A\$ - without this the EMI is likely to spend much of its time around current levels.
- Based on a weaker dollar, we could see the EMI rally to 900 Aus c/kg clean by June 2009 and for the 2009/10 season average 1,100 Aus c/kg clean.
- This would create somewhat of a paradox for the Australian wool industry. Despite some of the worst demand conditions at retail in decades, the EMI (A\$ terms) in 2009/10 could reach one of its highest levels.

**Chart 1. Australian EMI wool prices – season averages**



## Wool prices have been caught in the slipstream .....

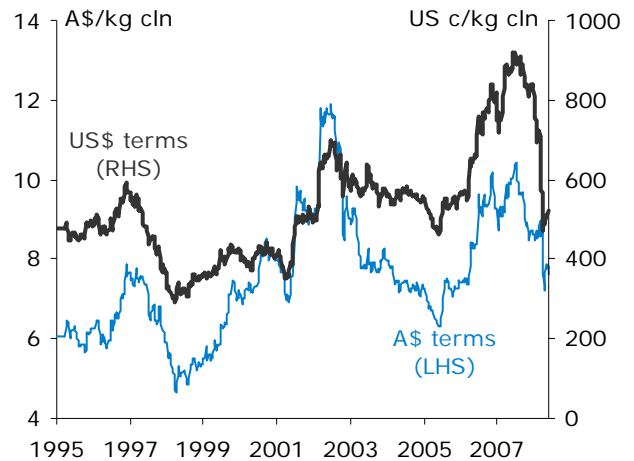
Along with most other agricultural commodities, global wool apparel prices have been caught in the slipstream of the general malaise surrounding the global financial crisis and global economic downturn.

The Australian Eastern Market Indicator (EMI) peaked in February 2008 at 910 US c/kg clean, rising by 80% or 400 US cents in the two years leading up to this. This peak easily surpassed the previous highs recorded in the 2002/03 and 1997/98 season.

In the last 12 months, wool prices have retraced all of these gains, with the EMI now back to 510 US c/kg clean (down 50%). In A\$ terms, the weaker A\$ has provided a part buffer against these large falls, with A\$ wool prices falling only 30% in the last 12 months.

Wool has not been alone in this rise and fall in prices. Global prices for wheat, canola, cotton and dairy have all fallen by similar amounts (after also rising to multi-decade highs in most instances), highlighting the impact the global asset price bubble (and the bursting of) has had on commodity prices in the later part of the cycle.

Chart 2. Australian EMI



## Australian sheep flock still heading south.....

The liquidation of the Australian sheep flock has continued in the 2008/09 season, with ANZ forecasting the sheep flock will be just 75 million head at 30<sup>th</sup> June 2009, down 4% y-o-y. This will take the Australian sheep flock to near 100 year lows, with 1916 the last time the sheep flock was at current levels.

In terms of flock outgoings, despite some slowdown in slaughterings in the second half of 2008, notably for lamb, recent trends are still well above sustainable levels.

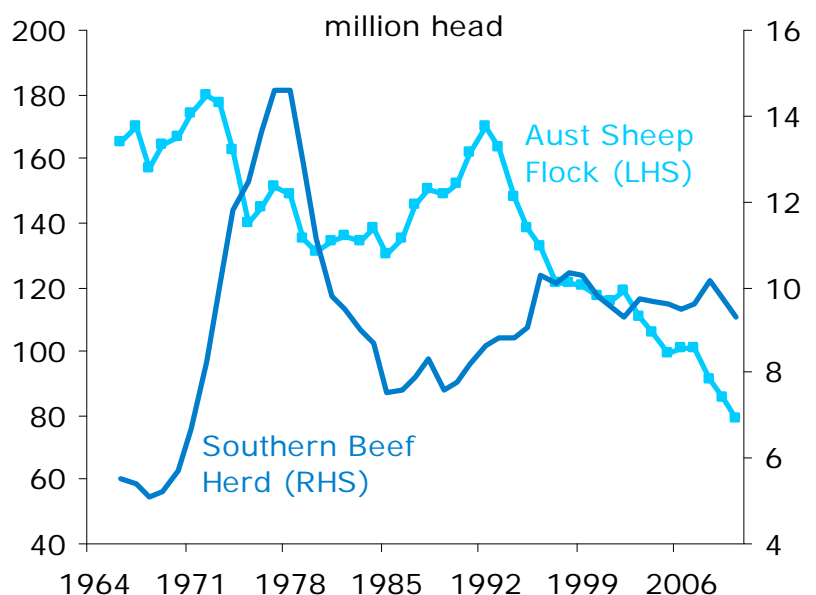
For the Australian flock to stabilise in the 2009/10 season and remain at 75 million head on 30<sup>th</sup> June 2010, slaughterings (sheep and lambs) and live sheep exports all need to fall by 15-20% from 2007/08 levels. Or put another way, in 2007/08, total slaughterings and live sheep exports reached 37 million head, but for the Australian sheep flock to stabilise, this figure needs to fall to around 31 million head in 2009/10.

While this is feasible with a return to normal seasonal conditions in 2009 (in 2003/04 and 2004/05 slaughterings and live sheep exports were around these levels), what is unknown is how much of the recent fall in the flock can be attributed to changing enterprise mix (sentiment away from wool) versus destocking from the drought.

One way to try and answer this is to look at the other key livestock industries in Australia and how producers have reacted to below average rainfall. Isolating the southern beef herd (excluding Queensland, WA and NT), herd numbers fell from 10.2 million head at 30<sup>th</sup> June 2006 to 9.3 million in June 2008, a 10% decline. The southern dairy herd has fallen by 9% over the same period. This compares with the Australian sheep flock which has fallen by 14% in two seasons.

With lower sheep numbers, Australian raw wool supply will be constrained for at least another 12-18 months, although this is not expected to be a major factor in price movements in 2009.

Chart 3. Australian beef and sheep numbers



## Demand weakness throughout 2009.....

Demand will hold the key for wool prices in 2009.

The next 12 months will be one of the toughest and bleakest periods for wool demand seen in several decades. Given the global economic outlook, including a 'synchronised' recession across much of the developed world, we do not expect wool demand to begin to recover until 2010.

This downturn will be particularly tough for wool apparel given:

1. Despite talk of the importance of China for the Australian wool industry (both processing and retail consumption of wool), the bulk of Australian apparel wool is still consumed in the high end markets of the developed or 'advanced' world – USA, Western Europe, UK, Japan and South Korea. And it is here where the full extent of the global downturn is happening. Global economic growth is falling sharply with 2009 looking like one of the worst years for 'advanced' economies since the 1930s.
2. This recession is being 'consumer led' in countries like the USA and UK. US retail sales fell for the sixth straight month in December 2008, with evidence consumers are pulling back on luxury items and 'trading down' to lower price point items.

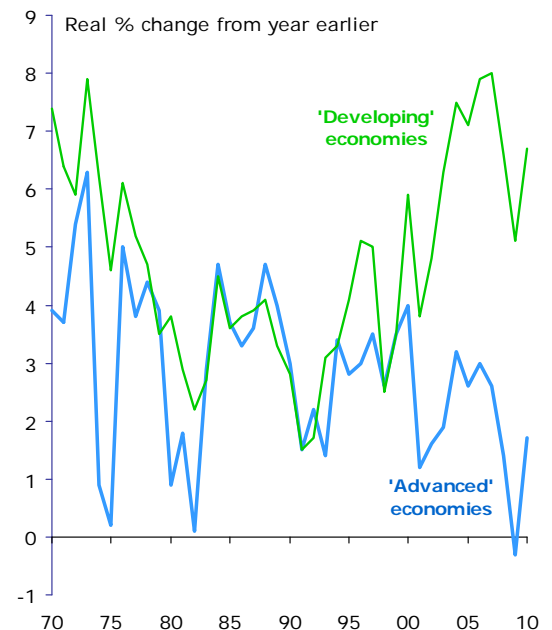
Tiffany and Co. reported US holiday sales fell by 21% while Saks Inc., the US luxury clothing chain, reported sales fell by 19% y-o-y in the five weeks ending 3<sup>rd</sup> January 2009. Saks, one of the retailers the Australian wool industry partnered with its 2007 Test Marketing Campaign, heavily discounted designer labels by as much as 70% over this period. In the last 12 months Saks share price has fallen by 77% and in 2009 aims to cut inventory by 20%, staff costs by 9% and capital expenditure by 50%. Neiman Marcus, the luxury speciality retail department store in the US, reported a dramatic 28% slump in sales for stores open more than 12 months.

Across the Atlantic, the sentiment is just as worrying. According to the British Retail Consortium survey, the decline in UK retail sales in December was the worst since the series began 14 years ago, with sales in non-food items very bleak. Marks and Spencer, the UK's flagship department store and largest clothing retailer, reported sales fell by 7% over the Christmas period along with a 1.75 percentage point cut to margins driven by promotions and discounting.

3. With falling asset and house prices, rising unemployment plus some households having a relatively high level of debt, a key theme moving forward is the 'rebuilding' of household balance sheets. Under this scenario, households and consumers will look to pay down debt and generally spend less, increasing their savings rate over coming years. Unfortunately this shift in household behaviour may take some time to play out, as those households with high debt levels will take some time to reduce their debt to more sustainable levels.

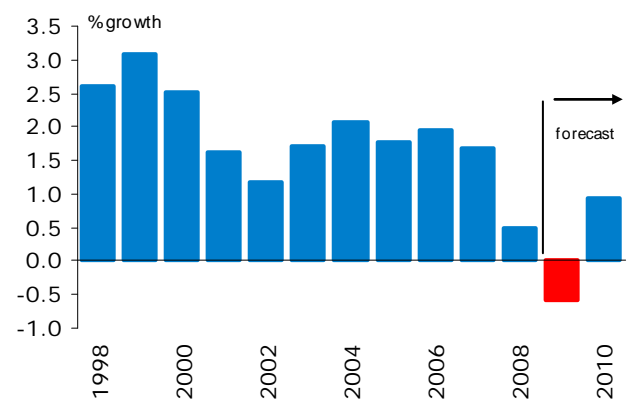
This decline in household spending is reflected in the latest *Consensus Forecasts* for household spending growth in 2009. Household consumption growth forecasts are one of the few indicators available for future retail sales growth. Taking a weighted average of developed countries based on final wool consumption, 2009 is expected to be the worst period for private household spending in over a decade.

Chart 4. Global economic growth



Source: IMF World Economic Outlook; ANZ Economics & Markets Research.

Chart 5. Household spending growth



Source: ANZ Economics and Markets Research, Consensus Forecasts. USA, Japan, Germany, France, UK, Italy weighted by wool retail consumption

- The prospects for mid to high end fashion sales, where wool consumption occurs, is likely to remain weak for much of 2009. For the key sales period for wool apparel, the northern hemisphere Autumn/Winter period, wool's presence at retail in 2009/10 is likely to be lower, losing share to lower priced cotton and synthetics. Decisions on fabric/garment type and style are made many months before the garment actually gets to the store. For the decision making period for northern hemisphere Autumn/Winter 2009/10, it is likely that the downturn in discretionary spending will still be significant, and as such retailers will continue to be very 'risk averse', keeping inventory costs low and generally remain cautious. All of which is likely to work against wool having a strong presence in the upcoming season.

## ANZ Industry Forecasts

ANZ expects apparel wool prices in US\$ terms to track sideways for most of 2009 on the expectation of no significant rebound in raw wool demand until 2010. On an optimistic scenario, the price recovery could commence late in 2009, but our central case and most likely outcome remains subdued wool prices (US\$ terms) through to 2010. Outside of our central outcome, rather than the potential for any significant upside in wool prices in key user currencies, a greater risk or higher probability would be a further fall in prices rather than any significant price rises.

However, given the extent of recent falls, current prices appear more sustainable and may have indeed already hit a cyclical low. For 21 micron wool, our forecasts are for prices to trade between US\$5.00-\$5.50 in 2009. At these levels wool would trade at around four times the value of cotton. In 2008, wool traded as high as six times the price of cotton.

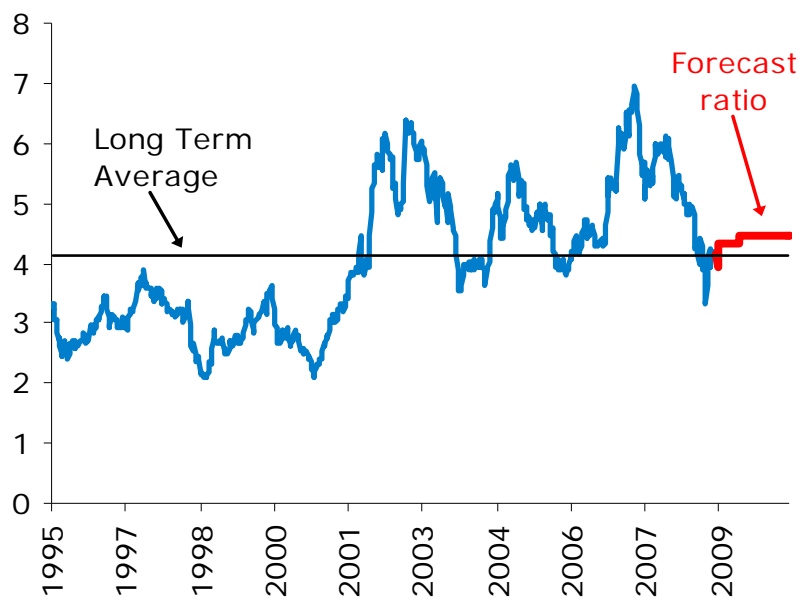
Given our forecasts are for relatively flat wool prices in US\$ terms, currency movements are likely to be the largest factor for A\$ wool prices in 2009. That is, the major hope for the Australian wool industry in 2009 is the prospect of a falling A\$ - without this the EMI is likely to spend much of its time around current levels.

Australian dollar fundamentals point to further weakness against the US\$, with ANZ forecasting the A\$ to have fallen to 58 US cents by June 2009 and average 55 US cents in the 2009/10 season. Based on a weaker dollar, we could see the EMI rally to 900 Aus c/kg clean by June 2009 and for the 2009/10 season average 1,100 Aus c/kg clean.

This would create somewhat of a paradox for the Australian wool industry. Despite some of the worst demand conditions at retail in decades, the EMI (A\$ terms) in 2009/10 could reach one of its highest levels.

On the supply side, we forecast Australian shorn wool production to stabilise at 365 mkg greasy in 2009/10, with fewer sheep shorn but higher fleece weights in anticipation of a return to normal season conditions in south eastern Australia.

Chart 6. 21 micron wool to cotton price ratio



## ANZ Industry Forecasts

**Table 1. ANZ Australian Wool Supply Forecasts**

	02-03	03-04	04-05	05-06	06-07	07-08	08-09f	09-10f
Closing Sheep Numbers (million hd)	99	98	96	92	85	79	75	74
% change	-7%	-1%	-2%	-4%	-8%	-7%	-4%	-2%
Fleece Weight (kg greasy/hd)	4.25	4.51	4.57	4.25	4.23	4.07	4.10	4.35
% change	-3%	+6%	+1%	-7%	0%	-4%	+1%	+6%
Shorn Wool Production (mkg greasy)	446	475	489	473	450	400	365	365
% change	-13%	+6%	+3%	-3%	-5%	-11%	-9%	0%

**Table 2. ANZ Australian Wool Price Forecasts**

	02-03	03-04	04-05	05-06	06-07	07-08	08-09f	09-10f
A\$ EMI (c/kg clean)	1,049	820	767	713	864	945	835	1,100
% change	+25%	-22%	-7%	-7%	+21%	+9%	-12%	+32%
AUD/USD	0.58	0.71	0.75	0.75	0.78	0.90	0.71	0.55
% change	11%	22%	6%	-1%	5%	14%	-21%	-22%
US\$ EMI (c/kg clean)	612	583	576	532	677	846	590	610
% change	+39%	-5%	-1%	-8%	+27%	+25%	-30%	+3%

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