

Fortnightly Agri Update

7 August 2013

GlobalDairyTrade Auction Results

- In light of the contamination issue, the auction results for Fonterra could have been worse. Overall, prices came back modestly, falling by 2.4%.
- However, prices for Fonterra's products fell relative to the prices of competitors' products.
- Notably, dairy prices remain very high.
- While short contract prices fell, long contract prices rose, indicating that the impact of the contamination issue may potentially be temporary.
- That said, the greatest risk is around the long-term hit to reputation. Time will tell on that front.
- On this evidence, we are holding our forecast of Fonterra's milk price for 2013/14 at \$7.40 per kg of milk solids for the time being.

Overall, world dairy prices fell 2.4% in Tuesday night's GlobalDairyTrade auction; a modest fall in light of the whey contamination issue and the 5.3% rise in the previous auction.

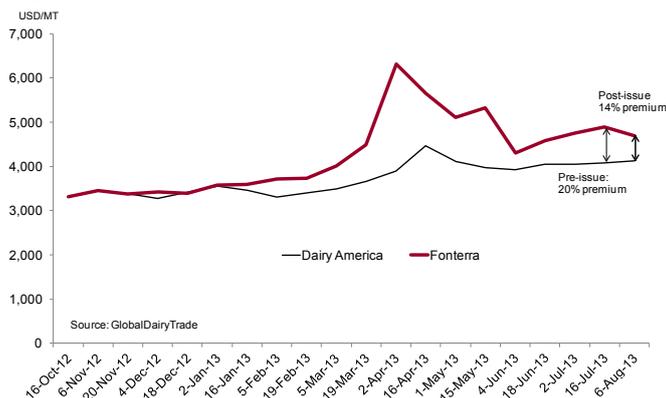
The fall in prices was broad-based with all products, except some minor products, recording falls. Butter recorded the largest fall (down 5.5%) while AMF was not far behind falling 4.9%. The key WMP and SMP prices fell by 1.6% and 3.0% respectively.

In general, prices remain high. The 2.4% fall followed a 5.3% rise in the previous auction. Prices are the sixth highest on record and are over 70% higher than a year ago.

Also the fall is not significantly different to what we were expecting prior to the whey contamination issue. We had pencilled a fall of around 20% over the remainder of 2013. In particular, we were expecting some payback following the unexpected rise after the previous auction.

However, Fonterra prices did fall relative to its competitors, particularly in SMP. All of Fonterra's SMP contracts fell relative to the last auction. On the other hand, Dairy America and Arla's prices rose (while Amul's prices did fall they are very recent supplier of products on the auction platform and have yet to establish a reputation). In the one directly comparable product, Fonterra's premium over Dairy America narrowed from 20% to 14% (see chart).

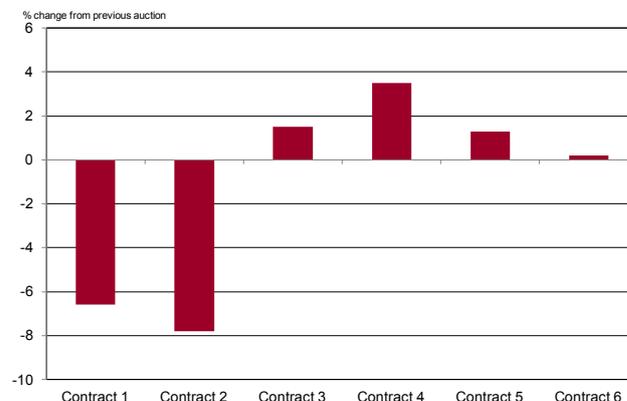
GlobalDairyTrade skim milk powder prices - Medium heat regular contract 2



Where Fonterra has less competition, prices fell by less. WMP prices were down 1.6% (Fonterra is the dominant producer and has only one small recent competitor). In contrast, SMP prices fell 3.0%; Fonterra has three competitors in this product type.

While short contract prices fell, long contract prices rose, indicating that the impact may potentially be temporary. WMP contracts for delivery in two months time, for example, fell by 8%. In contrast, contracts for delivery in three to six months time rose by up to 4%.

GlobalDairyTrade Fonterra whole milk powder prices



Implications

On the evidence of last night's auction, it does not seem that the contamination issue is evolving into a serious negative for the wider economy. The world is still paying high prices for most New Zealand dairy products.

However, it is still very early days. The contamination issue still has the potential to become a serious negative for the economy. If things did evolve in that direction, the main impact would be a much lower New Zealand dollar. Other impacts would be lower farmer and Fonterra shareholder incomes and higher long-term interest rates.

We expect continued volatility in markets over the coming weeks as information from the contamination issue comes to hand. In particular, we will be watching for reports of bans or import restrictions such as increased testing requirements emanating from key markets such as China.

The biggest risk remains around the long-term hit to Fonterra's and New Zealand's reputation. This will be hard to quantify and will remain an ongoing challenge for exporters and government officials alike. Time will tell on that front.

At this juncture, we are holding our forecast of Fonterra's milk price for 2013/14 at \$7.40 per kg of milk solids. However, the forecast will be under review as much uncertainty remains.

Market reaction following the auction was minor. The NZ dollar fell briefly against the US dollar from 78.95 cents to 78.80. However, within an hour it had recovered and then some to 79.18.

Nathan Penny
Economist

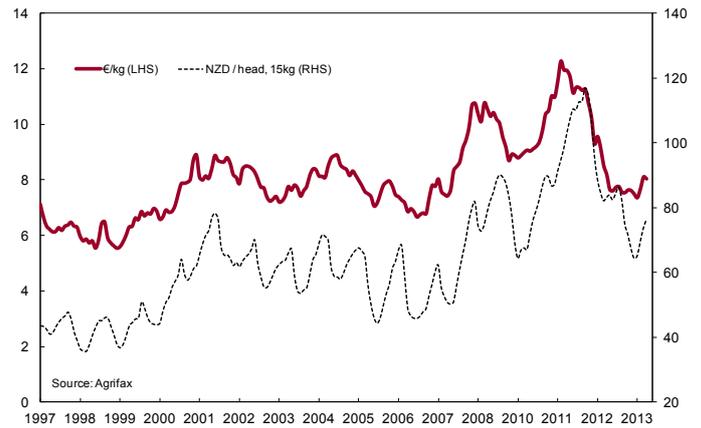
See overleaf for sector outlooks.

Beyond the farm gate

Lamb

	Current price level compared to 10 year average	Next 6 months
Trend	Below Average	↑

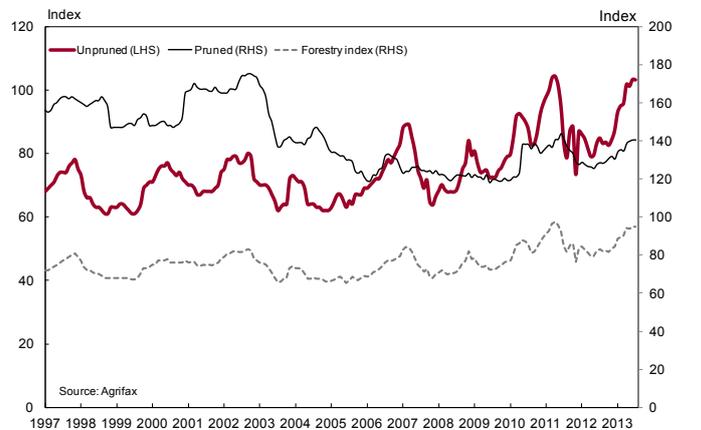
It appears that the Chinese market continues to pick up slack in world sheepmeat markets. Prices in NZD terms rose 1.5% in July, despite marginally weaker prices in Europe and a higher NZ dollar against the euro and pound. Over the June quarter, the Chinese market accounted for 25% of sheepmeat exports by value – up over 1% from the March quarter. However, the Chinese economy has hit a soft patch, which may peg back demand. This all comes against the backdrop of constrained export volumes from both New Zealand and Australia in the season ahead. Overall, we expect prices continue to grind upwards as lower lamb production dominates, while we watch for signs of slowing exports to China.



Forestry

	Current price level compared to 10 year average	Next 6 months
Trend	High	↓

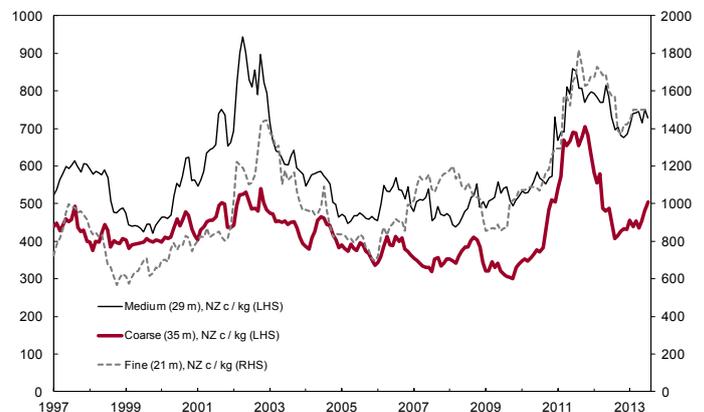
To date the so-called wall of wood appears to be finding a Chinese home. The forestry price index was steady over July at a very high level. Unpruned log prices are the fourth highest on record, while pruned log prices remain well above their ten-year average. This is impressive given that export volumes in the first half of 2013 were 14% higher compared to a year ago. Prices will be supported by the recovery in the US housing market. However, Chinese demand has driven most of the pickup this year. And, with the Chinese economy entering in a soft patch we expect prices to come off the boil, but to remain high by historical standards.



Wool

	Current price level compared to 10 year average	Next 6 months
Trend	Above Average	→

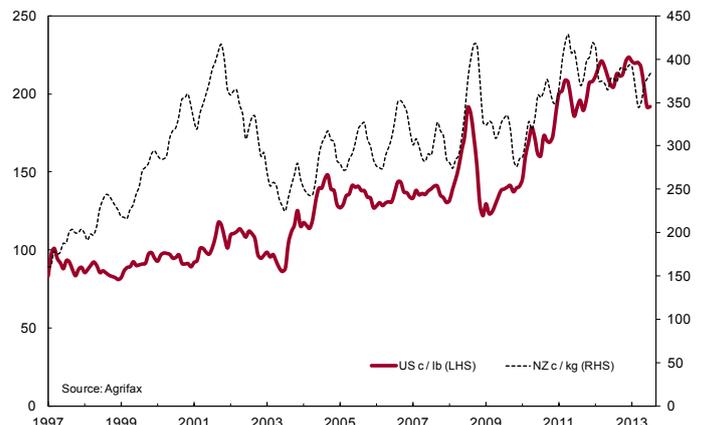
Fine and medium wool prices have consolidated their gains at an above average level, trading largely sideways over the last few months. Coarse wool prices, on the other hand, have risen 16% since April. This may be due to an improving US housing market. As the US housing market recovers further, the rise in coarse wool prices may continue. The outlook for fine and medium wool prices is subdued. Scope for further growth in demand for end products appears limited. As a result, we expect further divergence between coarse wool prices and fine and medium prices. With the prices of two out of three wool types flat, we expect world wool prices to generally hold around their current levels over the next six months.



Beef

	Current price level compared to 10 year average	Next 6 months
Trend	High	↓

World beef prices held up well at a high level in July despite an influx of Australian beef into the key US market. World beef prices remain 25% above their historical averages for July. Australian beef exports to the US set a fresh record for a single month as drought induced record slaughter levels across the Tasman. With world prices trading water, the fall in the NZ dollar against the US dollar pushed up prices in NZD terms. Drought also continues to linger in the US West and South-west. As a result, slaughtering is expected to lead to high US beef production. Overall, we expect these factors to push world beef prices down over the next six months. However, world prices are likely to remain high by historical standards.



NB: Trend arrows indicate direction of change in world prices.

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