



Fortnightly Agri Update

16 July 2014

How low can they go?

Dairy prices fell 8.9% in last night's auction and prices have now fallen 35% since February, significantly further than we were expecting early in 2014 when we first published our \$7.10 payout forecast for the 2014/15 season. In our last *Weekly Economic Overview* we revised down our payout forecast to \$6.40, but the size of last night's drop has compelled us to make a further downward revision to this payout forecast. We're now forecasting a milk price payout of \$6. Even this forecast remains sensitive to auction results over the coming weeks.

There are a number of factors that have weighed on international dairy prices over the last few months. Milk production has been increasing around the globe. NZ dairy farmers enjoyed a stellar 2013/14 season with production up strongly, while US and European producers have both been upping production in response to the incentives provided by improved margins.

However at the same time as global supply has been increasing, it has also become increasingly clear that softer demand is weighing on dairy prices. In our view, particularly important has been the slowing Chinese economy and associated weakness in Chinese consumer demand. As we detailed in last week's Fortnightly Agri Update, the Chinese economy has clearly decelerated this year, as policymakers progress with their aims of increasing the role played by the market (and price signals) in the allocation of resources and rebalancing the Chinese economy away from an over-reliance on investment led growth. The household sector, a key source of demand for many NZ exports, is still in a slowdown phase. The monthly *Westpac MNI Consumer Sentiment survey* fell to its lowest level in more than a year in June, and the housing market looks soft. This, combined with reports of Chinese dairy buyers having more than sufficient stocks on hand to meet demand after strong buying earlier in the year, appears to be having a big impact on dairy markets.

We don't think the current slowdown in China will be permanent. Chinese authorities will be keen to preserve their 7.5% GDP growth target for the year, and will further ramp up stimulus measures if the slowdown goes too far. However, in the near term the outlook for the Chinese consumer remains wobbly. This could mean we see dairy prices soften a little further over in the next few auctions.

The 13% fall in dairy prices over the last two auctions has come not only as a surprise to us, but probably the Reserve Bank as well, and it will be one of the key pieces of news being digested by the central bank ahead of next week's OCR review. The fact the currency markets have largely ignored the substantial fall in dairy prices since February (the NZD/USD only fell around 30 pips on the auction result announcement and continues to trade well above 87c) will be compounding the impact on the Bank's inflation forecasts, potentially leaving them pondering whether

they need to be in such a hurry to raise the OCR again next week. Much will depend on the other key piece of data ahead of next week's decision, June quarter CPI data out at 10.45am this morning. A much weaker than expected outturn will have us carefully assessing our OCR forecasts.

Our \$6.00 payout forecast assumes prices soften a little further in the near term, before rebounding fairly strongly later in the year on the back of a seasonal lift in Chinese demand. But with current WMP prices sitting at \$3,088 USD/tonne, our working assumption that WMP prices average \$3,700 USD/tonne over the 2014/15 season which underpins our \$6.00 milk price forecast could yet prove to be too optimistic and we will be monitoring forthcoming auction results closely.

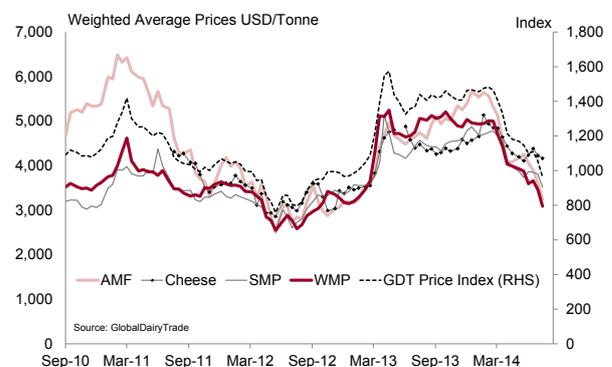
GlobalDairyTrade Auction Results, 16 July

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-10.0%	\$3,250
Butter Milk Power (BMP)	-4.6%	\$4,426
Butter	-1.1%	\$3,144
Skim Milk Powder (SMP)	-7.1%	\$3,516
Whole Milk Powder (WMP)	-10.9%	\$3,088
Cheddar	-1.6%	\$4,164
GDT Price Index	-8.9%	

Payout Forecast Table

	2013/14		2014/15	
	Fonterra	Westpac	Fonterra	Westpac
Milk Price	\$8.40	\$8.40	\$7.00	\$6.00

GDT auction prices



Anne Boniface
Senior Economist

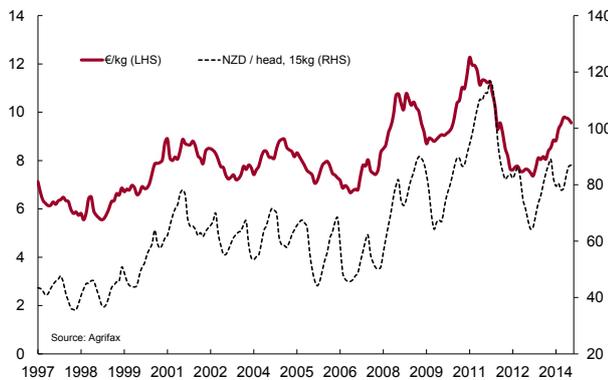
Beyond the farm gate



Lamb

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

New Zealand's main competition in lamb export markets comes from Australia. There, following an estimated 4% increase in slaughter numbers in the 2013/14 season, lamb slaughter is expected (by ABARES) to fall 7% in the forthcoming 2014/15 season with export volumes predicted to fall even further, down 12% on last season. Combined with improving demand from traditional markets, this bodes well for prices, and could mean opportunities for NZ lamb exporters in the forthcoming season.

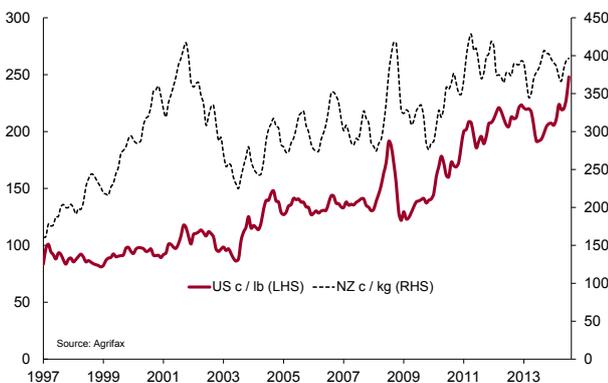


Beef

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

Beef prices have risen further in recent weeks, with peak summer demand running into very tight supply in the US. The rise in prices has occurred in spite of increased supply from the rest of the world, particularly from Australia.

New Zealand has been able to meet this demand to some degree; recent trade figures show that beef exports for the year to date are up 4% on last year. However, NZ cow slaughter is heading into the usual slow patch that follows the end of the dairying season.

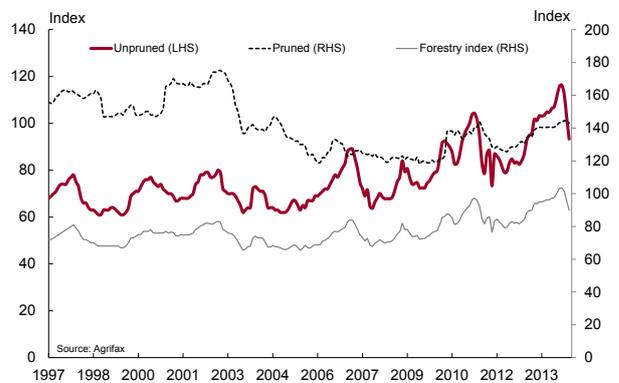


Forestry

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

Log prices have dropped further under the weight of large log inventories accumulating in China. Chinese log imports had reached record volumes in the early part of this year, and with weaker demand from end-users as the pace of residential construction in China slows, unpruned log prices have fallen 20% from their recent peaks. We suspect they could fall further in the near term as import volumes (both from NZ and other suppliers) adjust.

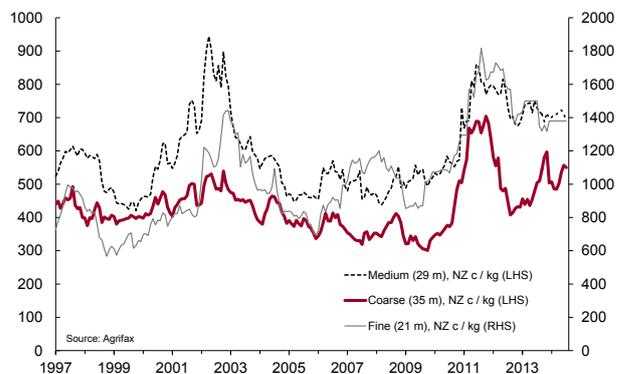
Domestic demand for structural logs continues to hold up well on the back of ongoing growth in building activity. In May, residential building consents (excluding apartments) were up 10% on a year ago. Growth in residential construction is set to continue, led by Auckland and Canterbury.



Wool

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

Coarse wool prices have improved in recent months. Locally, supplies are reported to be tight as the season draws to a close. The improvement in coarse wool prices has seen the premium between fine and coarse wool prices decline, but it is not yet back to the late 2013 lows. The theme of tight supply globally continues. In their most recent forecasts, ABARES expects Australian wool production to reach a record low in the 2014/15 season on the back of a significant reduction in the national flock.



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

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