

Fortnightly Agri Update

17 December 2014

Milk dryer

We know it's currently fashionable to talk up the idea of a second year of low farmgate milk prices. But there are also signs of a significant upside risk emerging to next season's milk price – though for entirely undesirable reasons.

In recent issues we've been emphasising that in the global market for dairy products, supply matters a lot. The short but severe drought early last year in New Zealand sent world prices soaring to record highs in the space of a few months. That was compounded by fears that drought in China would curtail supply as well, driving a surge in the volume of China's imports of dairy products. In hindsight, that fear seems to have been misplaced or at least overstated, contributing to the reported overhang of inventories in China that has been weighing on prices this year.

In an article last year, "Drought, Chinese Mums and the price of milk"¹, we noted that New Zealand has effectively become the swing producer in the whole milk powder market. During last year's drought the industry-wide revenue gain from higher prices actually outweighed the revenue loss from curtailed production, though we do have to remember that farmers faced higher feed costs and the benefits of high prices were heavily skewed towards those regions that had access to water.

On that note, the production update from Fonterra last week deserves some serious attention. Milk collection over the first half of the season (June to November) was consistently strong, up 4% on the previous season. However, Fonterra has revised its forecast of full-year milk production to be unchanged from last year (the previous guidance was around 3% growth). The implication is that production over the second half of the season (December to May) is expected to be down 3.6% on last season. That would be quite a significant turnaround given the trend of increasing cattle numbers and rising productivity.

In fact, on a daily basis, milk collection has already slowed down to year-ago levels. Fonterra puts this down to two connected factors. First, the low farmgate milk price for this season means that dairy farmers are less likely to bring in supplementary feed to boost production, relying instead on rainfall and grass growth. Second, some parts of the country, particularly in the east, are looking drier than usual.

The latter is a typical symptom of El Niño, a weather pattern that tends to be very tough on New Zealand's agricultural sector. NIWA have been warning for several months of the risk of an El Niño pattern developing over summer, and they currently put the odds at around 70%, though the severity of such an event remains unclear. It's worth noting that the last three droughts in New Zealand occurred without as strong a signal as we have today; last year's drought, described as the most severe in decades,

came with no warning whatsoever. Now that the warning signal is flashing for the first time since 1998 (another severe drought), it would be folly to ignore it.

A combination of drought conditions plus lack of money for extra feed would be a major blow to milk production in 2015. It may take some time for international markets to pick up on this risk – but once they do, history gives us an idea of how far prices could be squeezed higher.

The Fortnightly Agri Update will be taking a break over the New Year period; the next issue will be published on 21 January.

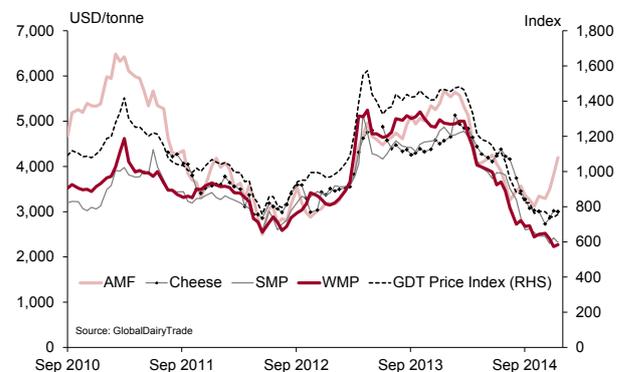
GlobalDairyTrade Auction Results, 17 December

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	10.8%	\$4,200
Butter Milk Power (BMP)	-9.5%	\$2,466
Butter	10.4%	\$3,145
Skim Milk Powder (SMP)	-3.2%	\$2,320
Whole Milk Powder (WMP)	1.4%	\$2,270
Cheddar	-0.6%	\$3,002
GDT Price Index	2.4%	

Payout Forecast Table

	2013/14		2014/15		2015/16
	Fonterra	Westpac	Fonterra	Westpac	Westpac
Milk Price	\$8.40	\$4.70	\$4.80	\$6.20	\$6.20

GDT auction prices



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Senior Economist

¹ Available at www.westpac.co.nz/assets/Business/Economic-Updates/2013/Bulletins-2013/Drought-Chinese-Mums-and-the-Price-of-Milk.pdf

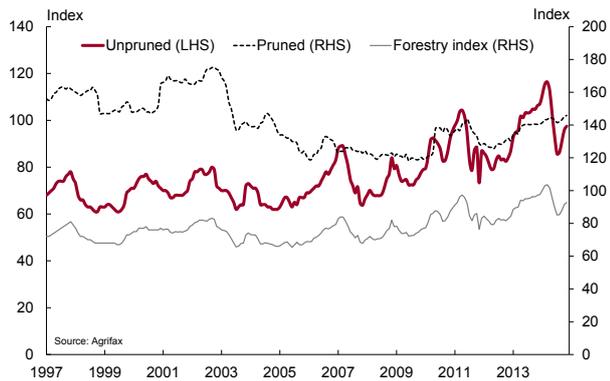
Beyond the farm gate



Forestry

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

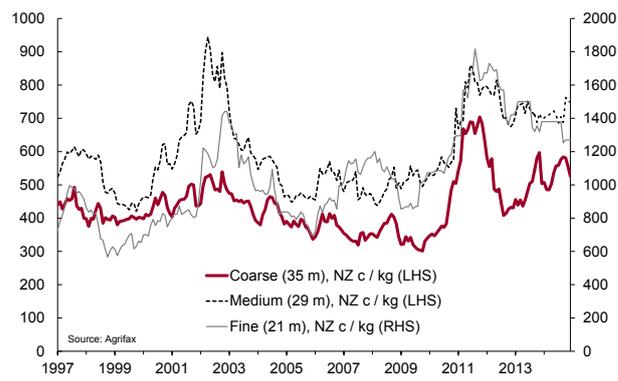
World prices for logs have stabilised in the last few months, and with a weaker New Zealand dollar in that time, local currency prices have rebounded by 8.9% according to the Agrifax forestry price index. We suspect that prices have improved as harvesting has pulled back to match demand – in contrast to dairy, where global milk production has continued to rise this year. There are very tentative signs that steps by Chinese policymakers to revitalise their housing market are having some impact.



Wool

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

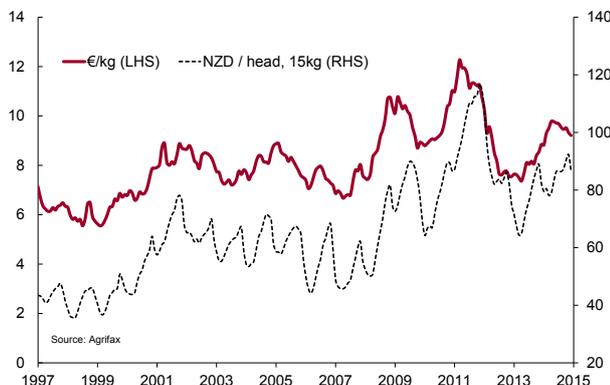
Wool prices have been mixed, with medium wool prices remaining at high levels but coarse wool prices losing altitude in recent weeks. Supplies remain tight locally and internationally, with New Zealand supplies at auction running behind last year's levels.



Lamb

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

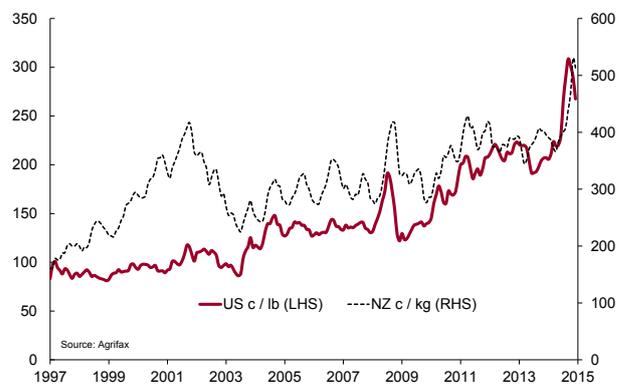
Global lamb production is adequate to meet demand at the moment. UK slaughter numbers and weights have improved on last year, and Australian lamb production is also running substantially above year-ago levels, although this may detract from supplies later in the season. Slower growth in China and weaker demand for luxury goods has weighed on pelt prices, taking some of the shine off total lamb returns for farmers.



Beef

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

Imported bull beef prices in the US have unwound more than half of the 45% spike seen over the US summer, with supply from Australia and New Zealand now in full swing. Prices paid by New Zealand processors have followed the US market with a lag of around two months, so while they have started to fall in recent weeks, it's likely that they have substantially further to go. Low cattle inventories in the US, partly due to drought, suggest that the longer-term upward trend in beef prices should remain intact.



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

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