

Fortnightly Agri Update

2 April 2014

Dairy downturn?

There was another sizable fall in dairy prices in last night's GDT auction. Prices fell 8.9% on a trade weighted basis, the biggest fall in a single auction since April 2012. This is the fourth consecutive fall in the index, which is now down 22% on a year ago (when prices were near recent peaks). There were lower prices across most of the range of products sold. WMP prices were down 8.4%, SMP prices down 9.6%, butter down 11% and AMF down 11.3%.

However we wouldn't advise hitting the panic button just yet. We have long been expecting dairy prices to soften in 2014, as producers around the world (including those in NZ) ramp up production in response to the high prices on offer. However, as is often the case in commodity markets, after holding up for longer than expected, the speed of the recent fall has been quicker than we had pencilled into our forecasts. While this creates a risk that prices could fall further, we remain relatively upbeat on the medium term outlook for demand for dairy, and therefore prices. For now we continue to expect WMP prices to remain above US\$4000/tonne in the 2014/15 season.

For the Reserve Bank, while the drop in milk prices may not be entirely unanticipated either, it does come at a time when the New Zealand dollar is rising strongly. This is clearly a combination that will tend to reduce inflation pressure, and if sustained could mean fewer OCR hikes are required over the next couple of years. If the RBNZ was thinking that 200bp of hikes are required over the next two years, it may now be thinking more along the lines of 175bp.

We are currently forecasting OCR hikes in April, June, July and December this year. We still believe that the April OCR hike is highly likely to proceed. However, the combination of a rising exchange rate and falling milk prices could put a question mark over the July hike.

While it is difficult to pin the blame for lower prices on any one particular event, there are probably a number of factors contributing to softer price action. Domestically, New Zealand production continues to run well ahead of last year's levels. This is despite very dry conditions in some parts of the country including Northland and Waikato. Farmers are bringing in supplementary feed to offset poor pasture conditions, which is helping to keep milk flowing. However, the dry weather is impacting pasture and stock condition which (depending on weather over the remainder of autumn and into winter) may have implications for production prospects in affected areas next season.

Some of this year's extra production is flowing through to an increase in product on offer via the GDT platform. For example, Fonterra currently is planning to offer 6% more WMP for sale via the GDT over the next 12 months than it was anticipating in early March.

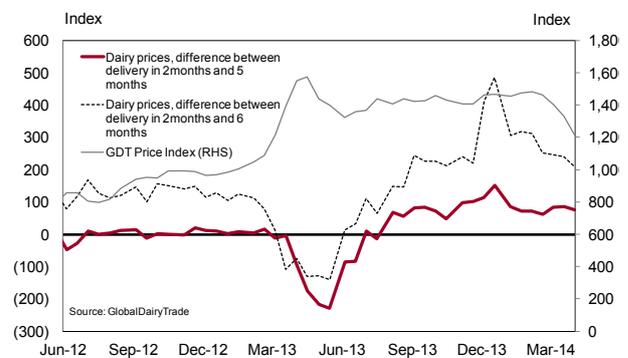
Elsewhere production is also increasing. While Australian production remains down on last year for the season to date (and

like in New Zealand is well into its seasonal decline) production has picked up during the first couple of months of this year. European production is growing strongly, while improved margins for American dairy producers (thanks to higher dairy prices and lower feed costs) should see output increase there too this year.

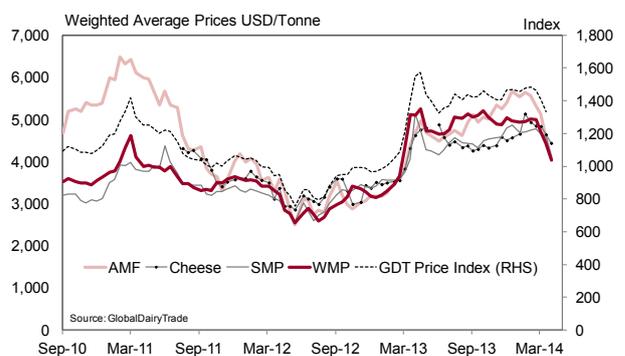
There may also be a seasonal element at play on the demand side of the equation. A lower tariff applies to the first 127,309 tonnes of milk powder imported into China in the new calendar year. While this is a very small proportion of Chinese imports of milk powder from NZ, it does create an some incentive for importers to stock up early. That stocking-up period has probably now passed, at the same time as the Chinese domestic production season is ramping up. Buyers on the GDT platform remain willing to pay more for product delivered at later dates (see chart), which supports the idea that this is a short-term dip in demand for milk.

A positive outlook for fundamental dairy demand was certainly the tone struck by Fonterra in its half year update last week. Despite unveiling a big fall in its net profit due pressure on margins because of the high cost of milk, Fonterra left its \$8.65 milk price and 10c dividend forecast for the current season unchanged.

GDT auction prices by delivery date



GDT auction prices





GlobalDairyTrade Auction Results, 2 April

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-11.3%	\$4,062
Butter Milk Power (BMP)	-15.0%	\$4,211
Butter	-11.0%	\$4,040
Skim Milk Powder (SMP)	-9.6%	\$4,126
Whole Milk Powder (WMP)	-8.4%	\$4,033
Cheddar	-3.50%	\$4,438
GDT Price Index	-8.9%	

Payout Forecast Table

	2013/14		2014/15
	Fonterra	Westpac	Westpac
Milk Price	\$8.65	\$8.65	\$7.10

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Senior Economist

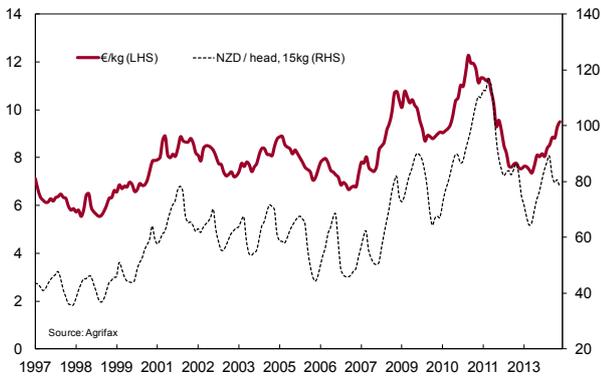


Lamb

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

International lamb prices have continued to move higher over the last couple of months. We think that with supplies still relatively tight in both Australia and New Zealand, and demand conditions improving in some key traditional markets such as the UK, prices could still increase further over the coming months. Demand from less traditional, but increasingly important markets such as China also appears solid.

Internationally, NZ and Australia are two dominant global exporters of lamb, however New Zealand has distinct trade advantages when it comes to exporting to China and the EU. New Zealand's Free Trade Agreement with China means New Zealand lamb exporters face much lower tariffs than their Australian counterparts, while New Zealand's tariff-free quota for exports to the EU is much larger than Australia's.

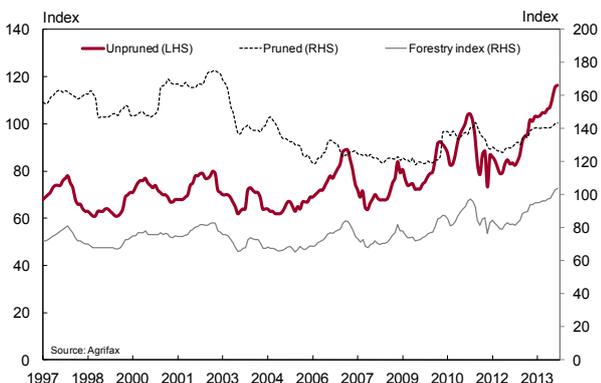


Forestry

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

Log prices remained at record highs in March, thanks in large part to strong demand from China. There are however now reports of growing Chinese inventories. While this is yet to be reflected in prices, there is the potential for higher inventories to weigh on prices over the next few months.

A pickup in building activity is also supporting domestic demand for timber. Excluding the volatile apartment category, residential building consent issuance rose to its highest level in 6 years in February, and continues to be driven by a pickup Auckland and Canterbury. We expect building activity to strengthen further from here.



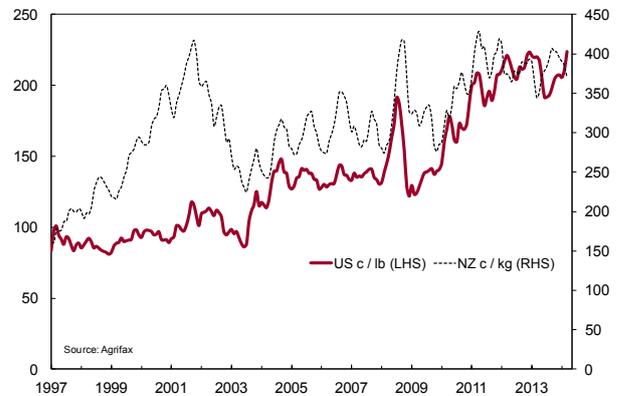
NB: Trend arrows indicate direction of change in world prices.

Beef

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

US domestic beef supplies remain very tight, with cattle numbers starting 2014 1% lower than levels a year ago, which is flowing through to reduced slaughter numbers. This was the 16th year of decline in beef cow inventories since 1996, which will continue to weigh on US beef production over the next couple of years as producers gradually rebuild herds.

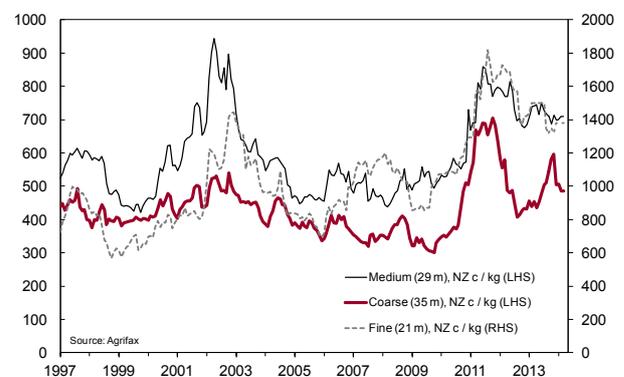
In contrast to tight US supplies, Australian beef exports have been boosted by culling in response to persistent drought conditions across much of eastern Australia. Australian producers are also optimistic about increased trade with South Korea on the back of an FTA due to be signed shortly by the two countries. While this is not great news for New Zealand producers, it could potentially provide opportunities in other regions if an increased proportion of Australian beef exports are diverted to Korea.



Wool

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

Wool prices have trended lower over the last few months – particularly for coarse wool. That said, tight international supplies (particularly in Australia and NZ which ABARES reported accounted for just over 60% of international raw wool exports in 2012) should help put a floor under prices. And with growth prospects improving in some key end user markets such as the US and parts of Europe, this should also provide some support for demand.



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