

Fortnightly Agri Update

4 June 2014

Further weakness in dairy prices

Last week's big news was Fonterra's announcement of its opening payout forecast for the 2014/15 season. As expected, its pick of a milk price of \$7/KgMs was well down on the current season, but probably not as low as some had been braced for. It did however accord closely with our own outlook and the \$7.10 forecast we made back in early February.

However, it is early days, and there is plenty of water to go under the bridge yet before the payout is finalised. This was illustrated by another tweak to Fonterra's 2013/14 payout forecast, which was downgraded to \$8.40 (previously \$8.65). But this is still 20% higher than Fonterra's pick at the start of the season. Of course forecasts can move in the other direction too. While the opening season forecast for the 2008/09 season was also \$7, the final payout was 27% lower at \$5.10. With such a volatile history, it's little wonder that (as we noted in the last Fortnightly Agri Update) farmers are taking a relatively cautious approach to the current period of strong revenues.

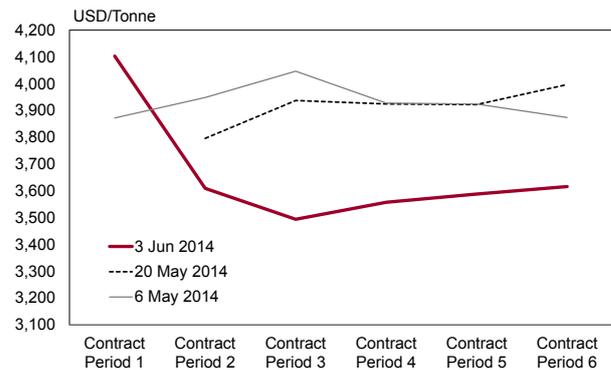
One reason forecasting the payout is such a challenge is because it requires a view on both commodity prices and the NZD – both notoriously volatile. This was illustrated well by last night's surprisingly weak GDT auction. On a trade weighted basis prices fell 4.2%, but perhaps more importantly the detail was even softer. Particularly surprising was the 8.5% fall in Whole Milk Powder (WMP) prices. In contrast Skim Milk Powder (SMP) prices rose 2.1%. This reverses the recent trend of SMP prices coming under greater pressure than WMP prices as northern hemisphere production reaches a seasonal peak while southern hemisphere producers wind down for the season (NZ dominates global traded WMP markets, while the US and EU are significant SMP exporters).

Interestingly, bidders in last night's auction were willing to pay less for WMP with later delivery dates. Amongst Fonterra products on offer, WMP for shipment in 3 months registered the lowest price. This is a change from previous auctions where buyers had generally been willing to pay at least as much if not more to secure supply at later dates. There was a similar pattern in the June auctions a year ago, so this might be in part due to seasonal supply factors, but we will be closely watching developments in this trend.

While we are reluctant to read too much into a single event (auctions can be volatile from fortnight to fortnight) last night's outturn very clearly introduces downside risk to our \$7.10 payout forecast, which was predicated on WMP prices averaging around \$US4,000/tonne over the season (they were down to around \$US 3,600/tonne in last night's auction).

That said, currency markets reacted strongly to last night's weak auction outturn. The NZD/USD fell 30 pips on the news. And weaker dairy prices will also have been discussed in RBNZ deliberations ahead of its OCR decision next week. While, like us, the Bank has long been expecting dairy prices to soften this year, they may have been surprised by the extent of recent falls which could, on its own, make it less inclined to raise the OCR.

Weighted average WMP Prices



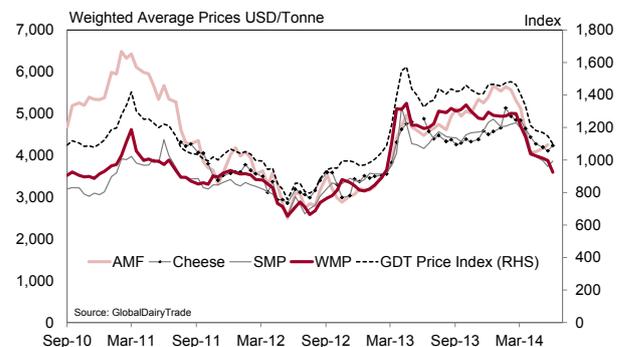
GlobalDairyTrade Auction Results, 4 June

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-5.0%	\$4,058
Butter Milk Power (BMP)	1.9%	\$3,628
Butter	0.0%	\$3,634
Skim Milk Powder (SMP)	2.1%	\$3,863
Whole Milk Powder (WMP)	-8.5%	\$3,594
Cheddar	8.0%	\$4,236
GDT Price Index	-4.2%	

Payout Forecast Table

	2013/14		2014/15	
	Fonterra	Westpac	Fonterra	Westpac
Milk Price	\$8.40	\$8.40	\$7.00	\$7.10

GDT auction prices



Anne Boniface – Senior Economist

Beyond the farm gate

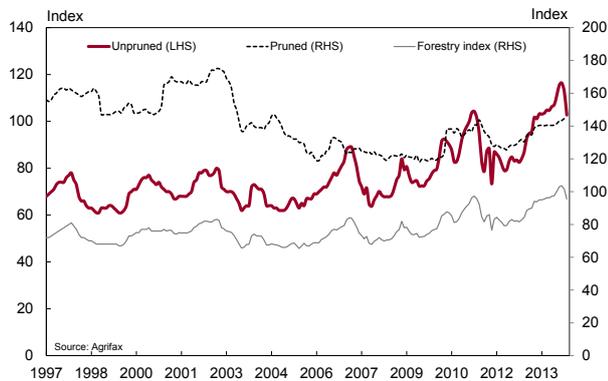


Forestry

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

Log prices have dropped sharply under the weight of large log inventories accumulating in China during the first quarter. Chinese log imports had reached record volumes, and with weaker demand from end users as the pace of residential construction in China slows, unpruned log prices have fallen 12% from their recent peaks. We suspect they could fall further in the near term as import volumes (both from NZ and other suppliers) adjust.

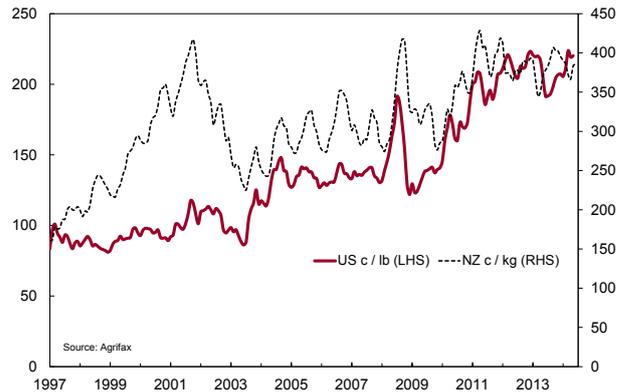
Domestic demand for structural logs continues to hold up well on the back of ongoing growth in building activity. In April, residential building consents (excluding apartments) were up 24% on a year ago. Strong growth in residential construction is set to continue to climb, led by Auckland and Canterbury.



Beef

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

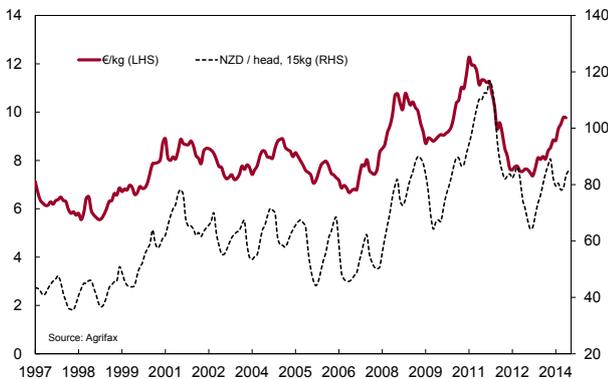
Beef prices have eased a touch but remain at very elevated levels. NZ cow slaughter will climb as the dairy season finishes, adding to supply on international markets. Australian exports have been particularly strong, reaching record levels in the 12 months to May. The fact that international prices have remained high, despite this increased supply, suggests demand remains robust.



Lamb

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

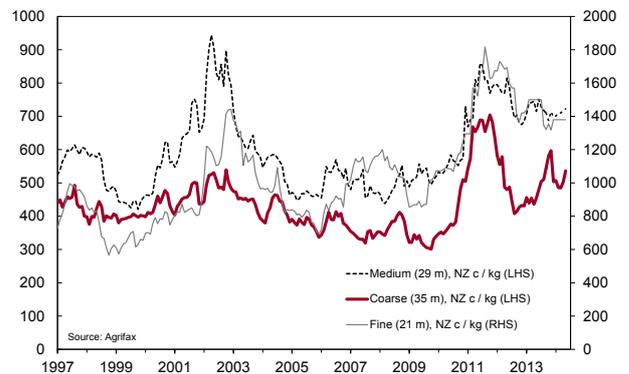
International lamb prices have continued their strong run, on the back of solid demand from traditional markets such as the UK and Europe, as well as China. Recent terms of trade data for the March quarter showed the volume of lamb exports up 5.8%. We think the trend of improving global lamb prices should still have a little further to run in the coming months, supported by relatively tight global supplies.



Wool

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

Coarse wool prices have improved after trending lower in the early part of this year. Tight supplies globally, combined with the gradually improving outlook for growth in developed countries such as the EU and US, should see a period of relative stability in prices.



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

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