

Fortnightly Agri Update

7 May 2014

Different directions

Dairy prices eased a little further overnight, with the headline GDT index down 1.1%. There were mixed outturns across individual products on offer. WMP prices eased 1.7% while SMP prices fell 2.3%. In contrast, AMF and Butter prices rose 2.4% and 1.6% respectively. Dairy prices look to be stabilising after sharp declines from February to April. We would expect to see a period of relative stability in dairy prices at around these levels over the next few months.

Notably (and unusually) dairy prices and the NZD have been heading in opposite directions in recent weeks. Overnight the NZD shot to 0.8780 against the USD – a fresh 3 year high and seemingly within reach of the 0.8842 high. The Reserve Bank Governor Graeme Wheeler also pointed out this discrepancy in a speech titled “The significance of dairy to the New Zealand economy”. The Governor noted that it believes the exchange rate is overvalued and does not regard its current level as sustainable. That view is unchanged from other recent comments. Interestingly though it went further, noting that if the NZD were to remain high in the face of weakening fundamentals such as falling export prices it becomes more “opportune” for the Bank to intervene in the currency market by selling NZDs. This means the RBNZ can tick the third of the four boxes that must be ticked before it intervenes. The NZD must be “exceptional” and “unjustified” plus intervention must be “opportune” and consistent with the inflation target. It is this final box the Bank may have trouble ticking. Given it has recently embarked on a tightening cycle to combat growing inflation pressure, a lower NZD would lead to rising imported inflation – a potential conflict for the Reserve Bank.

Interestingly, the Bank sounded fairly sanguine on debt in the dairy industry. Their view was that dairy farmers are taking a cautious approach in the current cycle, and that farm credit growth remains moderate. This may mean they are less likely to apply LVR-type restrictions (which have been applied to mortgage lending) to the farm sector.

Our own view is that we don't think the divergence between the currency and commodity prices can persist indefinitely. However, the continued strengthening NZD has led us to shade down our payout forecast for the current season from a milk price of \$8.65 to \$8.50. For now we're sticking with our \$7.10 forecast for the 2014/15 season. We'll get an idea on how Fonterra itself sees next season shaping up at the end of the month when the company is due to announce its opening forecast for the 2014/15 season, and will presumably take the opportunity to update its forecast for the current season if this has indeed changed.

The RBNZ speech also highlighted New Zealand's growing dairy trade with China. One factor adding to demand for NZ dairy products in China in recent years has been growing Chinese demand for imported infant formula. After the melamine scandal in

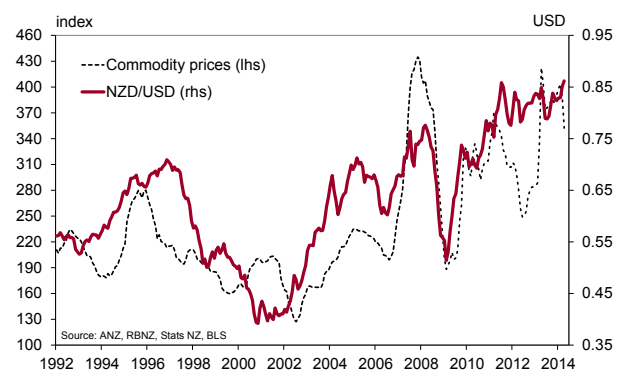
2008 Chinese consumers have been wary of domestically produced brands, and demand for imported product (which has a stronger reputation) has increased accordingly. Since the scandal, China has been progressively tightening the rules for domestic and imported infant formula as part of a wider general review of food safety laws.

While this process has been in progress for some time, for NZ infant formula manufacturers it culminated this week with the announcement of which companies had received approval to export product into China under new rules that require companies to demonstrate a close relationship between brand owner and the manufacturer.

In New Zealand, 6 of 13 infant formula manufacturers (both of final product and of powdered ingredients of these products which are on sold for further processing and packing) have been approved. This included Fonterra, Sutton Group and its joint venture partner Gardians, GMP Pharmaceuticals, Nutricia, Westland and Dairy Goat Cooperative. Probably the biggest name to miss out on the first round of registrations was Synlait Milk (NZ's 5th largest dairy company by turnover in 2012). However the Ministry of Primary Industries expects Synlait to be granted registration once its new production facility is up and running (scheduled for completion in June).

The NZ government has advised that the approved companies make up the majority of New Zealand's \$200m infant formula exports to China with infant formula exports accounting for a relatively small proportion of New Zealand's annual \$5bn dairy trade with China.

With the rules on imports being tightened around the world, this may provide opportunities for those suppliers left in the market. However recent developments serve to underscore the point that NZ producers need to be mindful of what the customer wants. What's more, safety and security of food supply will continue to be important for Chinese consumers (and regulators) and New Zealand needs to be careful to protect its enviable reputation.

Dairy prices and the NZD



GlobalDairyTrade Auction Results, 7 May

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	2.4%	\$4,170
Butter Milk Power (BMP)	-1.2%	\$3,713
Butter	1.6%	\$3,892
Skim Milk Powder (SMP)	-2.3%	\$3,873
Whole Milk Powder (WMP)	-1.7%	\$3,928
Cheddar	-1.8%	\$4,195
GDT Price Index	-1.1%	

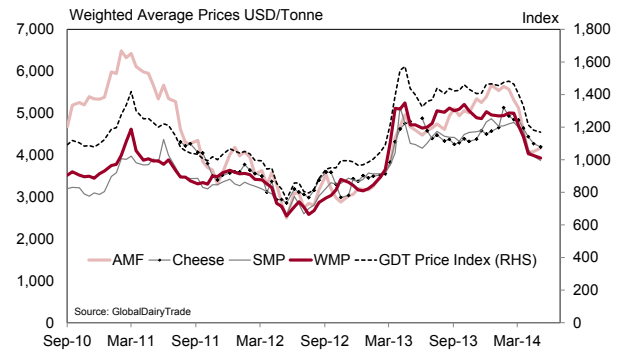
Payout Forecast Table

	2013/14		2014/15
	Fonterra	Westpac	Westpac
Milk Price	\$8.65	\$8.50	\$7.10

Anne Boniface

Senior Economist

GDT auction prices



Beyond the farm gate

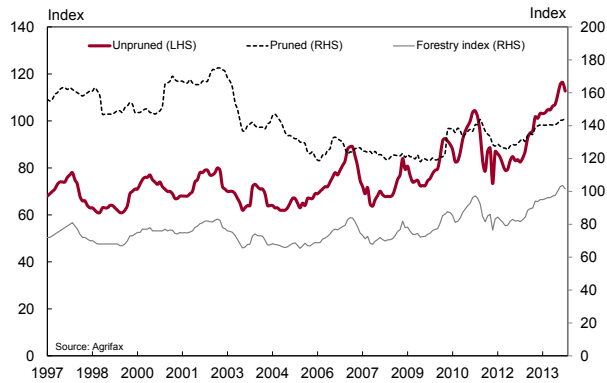


Forestry

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

Log prices continue to hover near record levels, but expectations of a correction are building on the back of a build-up in inventories after record Chinese log imports. Those imports have come not just from NZ but also from other places around the world such as Russia.

In New Zealand building consent issuance continues to grow, and this should support demand for construction materials. However housing markets in other parts of the world remain sluggish. In the US building has been hampered by poor weather at the start of the year. The outlook in Australia is stronger, with March consent issuance pointing to growth slowing but activity remaining at a relatively high level.

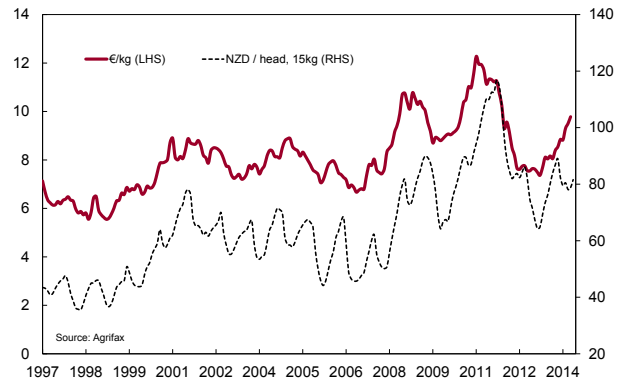


Lamb

	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, supported by tight supplies and improving demand conditions in key traditional markets such as the UK. Demand from less traditional, but increasingly important markets such as China also appears solid and we think prices could improve further over the coming months.

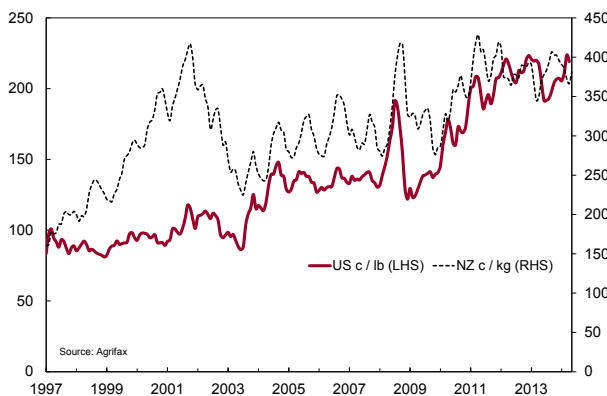
Beef and Lamb recently released its mid-season update. Because of last year's drought, the lamb crop is expected to be down 1.9% this season compared to (although this decline isn't as large as Beef and Lamb initially anticipated). The 5.3% fall in slaughter numbers is partially offset by higher carcass weights.



Beef

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

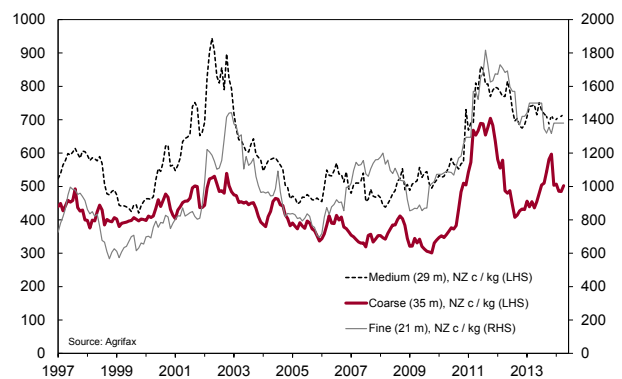
International beef prices have eased a touch, but remain at a high level. Global supplies remain tight (especially in the US), and this should continue to support international prices for some time yet. Australia (an important international beef exporter) has recently signed free trade agreements with South Korea and most recently Japan, both important destinations for Australian (and New Zealand) beef exports. While New Zealand is in the process of negotiating an agreement with Korea (and of course is involved in TPP negotiations) Australia's successful negotiations will undoubtedly help give Australian producers a leg up in these markets. For New Zealand perhaps the only silver lining would be potential opportunities in other regions if an increasing proportion of Australian product is destined for Korea and Japan.



Wool

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

Coarse wool prices have stabilised over the last few weeks, 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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