



Fortnightly Agri Update

16 July 2015

Dairy payout forecast slashed

World dairy prices fell heavily in last night's GlobalDairyTrade auction. The overall index was down 10.7%, with large declines for almost every product. Prices for some contract periods were 'limit down' (selling at their starting price, which for Fonterra is 15% below the previous auction). This implies that prices could have fallen even further if allowed, and that downward pressure is likely to spill over into the next auction in early August.

It is clearly a difficult environment for the global dairy market at the moment. The problems of oversupply and soft demand in the Northern Hemisphere are likely to have been compounded by fears of a fracturing of the euro zone, and a knock to confidence from the plunge in Chinese share prices.

We have made a significant downward revision to our forecast of Fonterra's milk price for the current season. We now anticipate a payout of \$4.30/kg, which would be even lower than last season's already very weak outcome. Note that Fonterra is likely to provide an update in the next few weeks, as its own forecast is now likely to be well below its initial estimate of \$5.25/kg.

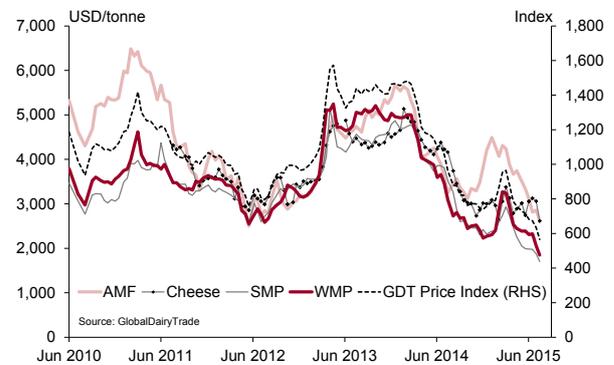
We're aware that some other analysts are pitching their forecasts even lower than ours. For clarity, we should note that our forecast is based on an average exchange rate of around US65c. Obviously the currency hasn't traded down to that level yet, but we expect it to fall to 62c by year-end, and based on our assumption about Fonterra's hedging strategy, an average of 0.65 over the course of the season is achievable. But, as with every assumption that goes into the milk price forecast, there is still substantial uncertainty around this.

The prospect of two consecutive seasons of very low milk prices will have implications for the Reserve Bank, given the level of concern that was already apparent in its June *Monetary Policy Statement*. We suspect that fixed-term interest rates will fall further as markets move to price in more aggressive interest rate cuts from the Reserve Bank. (Markets are currently pricing in 50 basis points of OCR cuts by year end; we expect more than that.)

The causes of the ongoing slump in world dairy prices are varied, but there's one popular story that we're sceptical of: the seasonal upturn in New Zealand's milk production. There are several problems with this story. First, production in New Zealand picks up at the same time that Northern Hemisphere production tails off, which helps to smooth out supply at the global level. Moreover, seasonality is as foreseeable as things get in this market, and buyers should be able to adjust their tactics accordingly, which would help to smooth prices.

One reason to reject the seasonality story is that it offers false hope: the idea that prices will improve once we get past the 'hump' in New Zealand's milk production. We believe the causes of the current weakness in prices are rooted elsewhere: a sustained oversupply of milk in the Northern Hemisphere, and soft demand in key markets such as China and the Middle East. These are the factors that will need to turn around before we see a sustained improvement in dairying returns.

NZD and commodity prices, adjusted for inflation



GlobalDairyTrade Auction Results, 15 July

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-10.6%	\$2,621
Butter Milk Power (BMP)	-4.4%	\$1,794
Butter	-9.5%	\$2,460
Skim Milk Powder (SMP)	-10.1%	\$1,702
Whole Milk Powder (WMP)	-13.1%	\$1,848
Cheddar	-13.9%	\$2,613
GDT Price Index	-10.7%	

Payout Forecast Table

	2014/15		2015/16	
	Fonterra	Westpac	Fonterra	Westpac
Milk Price	\$4.40	\$4.40	\$5.25	\$4.30

Michael Gordon
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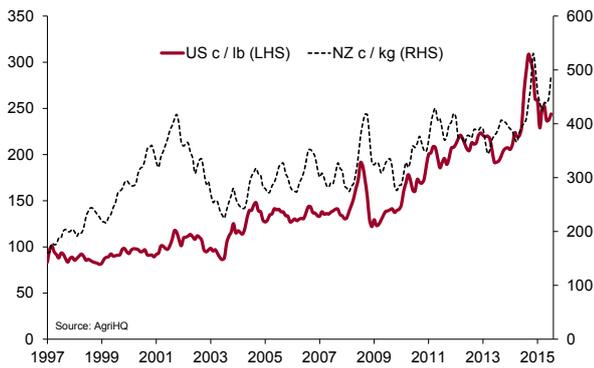
Beyond the farm gate



Beef

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

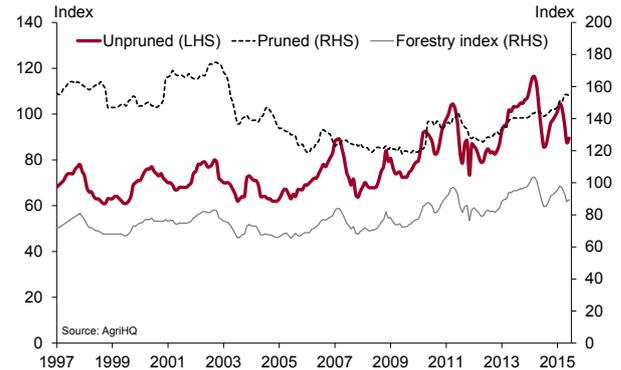
Imported beef prices in the US remain high, though on low volumes at the moment. US buyers are well placed to avoid a repeat of last summer's price spike, due to higher prices relative to other meats and ample stocks of imported product. A further decline in the New Zealand dollar this year is expected to boost returns.



Forestry

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

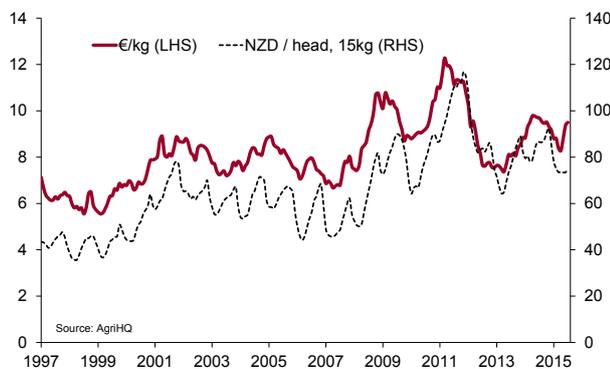
Unpruned log prices rose slightly in June after a sharp decline in the previous three months. The weaker NZD will go some way towards restoring the competitiveness of New Zealand's log exports. Demand for housing construction materials is holding steady nationwide, although the centre of growth is clearly shifting from Christchurch to Auckland.



Lamb

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

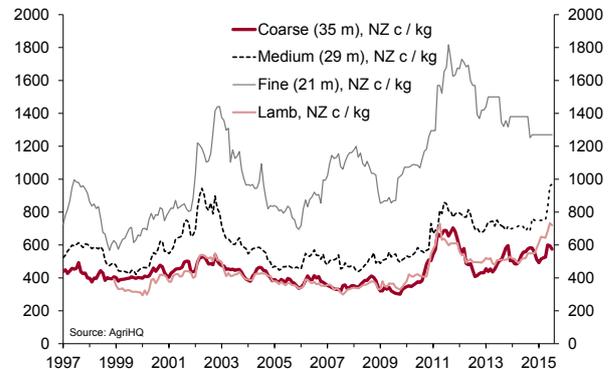
Chilled lamb prices in Europe have held up reasonably well, although global supply appears to remain ample. The weaker New Zealand dollar will help to support returns.



Wool

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

Wool prices have remained resistant to competition from oil-derived synthetic materials to date. Lambs' wool has been the standout, with growing demand from China in the last year; this has been joined by stronger prices for other grades in recent months.



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

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