



Fortnightly Agri Update

17 June 2015

Popping down to the dairy

Last week's unexpected OCR cut has thrust dairying even further into the economic spotlight, with the Reserve Bank making it clear that it was motivated by concerns about the impact of another year of low dairying incomes on the wider economy. With that in mind, we believe that the twice-monthly GlobalDairyTrade auction will play a crucial role in the timing and extent of future interest rate cuts.

The RBNZ surprised much of the market, including us, by reducing the OCR by 25 basis points to 3.25% at last week's *Monetary Policy Statement*. While the case for interest rate cuts this year had been growing, we didn't expect the RBNZ to move so soon, given that until now its concerns had been around wage- and price-setting behaviour. However, this time the RBNZ judged that the weakness in dairy prices presented a sufficient risk to domestic demand over the coming months that rate cuts were needed now, to bring inflation back to 2% within an acceptable timeframe.

The RBNZ's latest interest rate projection implies another 25bp cut to the OCR this year. However, the RBNZ was vague about the extent or timing of further cuts, simply noting that "this will depend on the emerging data". We currently favour another 25bp cut in September, followed by an extended pause.

However, given the RBNZ's new focus on the dairying sector, we judged that the most significant 'emerging data' would be the three GlobalDairyTrade auctions between the June and July OCR reviews. If world dairy prices continued to weaken in that time, we wouldn't hesitate to switch our call to a 25bp cut in July and probably more beyond that.

The first of those auctions, held last night, was inconclusive in that regard. The overall price index was down 1.3%, which was the smallest drop since the latest downturn began in March. The fall in the index was largely driven by one product (anhydrous milk fat), while milk powder prices were basically flat. Overall, the auction result offers the mildest of encouragements that world dairy prices may be bottoming out. However, it shed no real light on whether dairy prices will recover enough over the course of the season to meet Fonterra's milk price forecast (as well as our own).

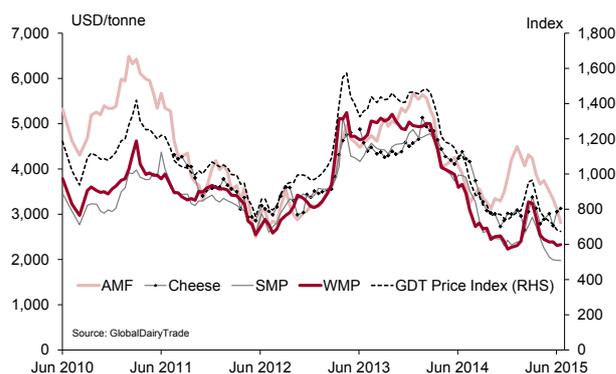
It's worth noting that the latest fall in dairy auction prices (in US dollar terms) was more than outweighed by the weaker exchange rate. The New Zealand dollar has fallen 3% since the RBNZ's surprise interest rate cut, and we expect a further drop towards 65 cents by the end of this year. In fact, on its own, our new exchange rate forecast would warrant an upgrade to our milk price forecast for this season. However, we won't be making a change at this point due to the significant uncertainty around world dairy prices at present.

As we've written before, our view is that a pickup in dairy prices depends on an easing of the factors that worked in tandem to depress prices last season. The latest developments on this front

have been mixed. On the positive side, Northern Hemisphere milk production continued to slow up until March in response to low prices. However, there are no figures yet on how production in Europe has fared since April, when the quota system was eliminated. There are very tentative signs that policy easing in China is starting to support growth, though milk powder demand has remained subdued to date.

Unfortunately, it now appears that Russia's 'temporary' ban on food imports from many Western countries will remain for an indefinite period. While New Zealand is not subject to the ban, it means that dairy products from other major producers such as Europe will continue to be diverted to markets that New Zealand also sells into.

GDT auction prices



GlobalDairyTrade Auction Results, 17 June

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-8.9%	\$2,814
Butter Milk Power (BMP)	10.0%	\$1,975
Butter	3.3%	\$2,707
Skim Milk Powder (SMP)	-0.2%	\$1,978
Whole Milk Powder (WMP)	-0.1%	\$2,327
Cheddar	2.4%	\$3,128
GDT Price Index	-1.3%	

Payout Forecast Table

	2014/15		2015/16	
	Fonterra	Westpac	Fonterra	Westpac
Milk Price	\$4.40	\$4.40	\$5.25	\$5.40

Michael Gordon
Senior Economist

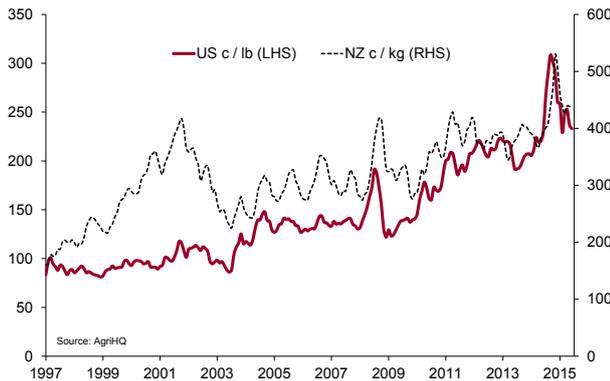
Beyond the farm gate



Beef

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

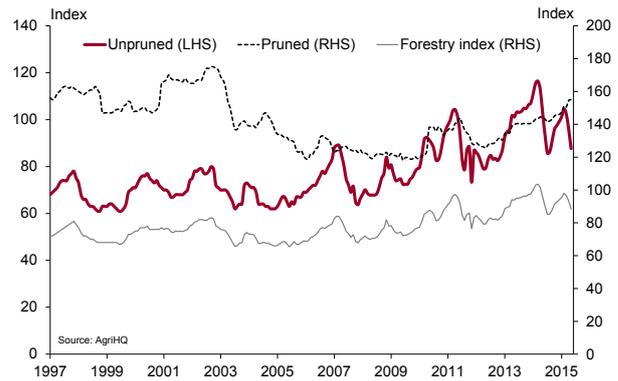
US beef prices remain high, although well off last year's peaks as demand is now being well serviced by supply from Australia and New Zealand. The early cull as a result of the dry summer is now having an inverse effect on slaughter numbers, which were about flat on year-ago levels in March and April.



Forestry

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

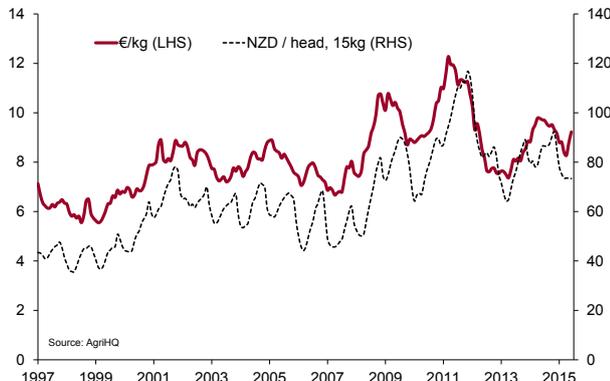
Export log prices have fallen sharply again in recent months, as excess stocks have built up at Chinese ports and the weaker ruble has made Russian logs more competitive. In contrast, domestic log prices have risen further. Demand for housing construction materials continues to grow, although quake-related activity in Christchurch is expected to peak this year.



Lamb

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

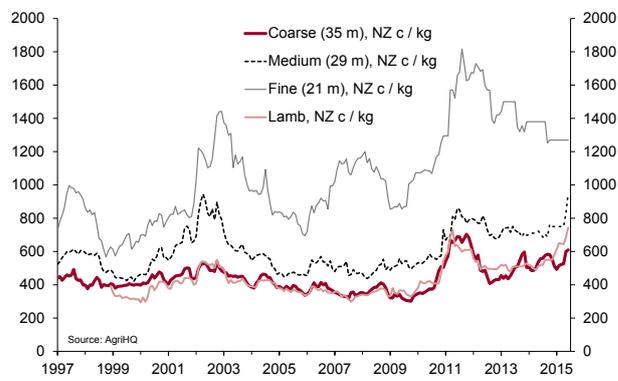
Good growing conditions in the UK, Europe and China mean that the global supply of lamb is likely to remain plentiful this year. The dry summer in New Zealand probably had less of a depressing effect on prices than initially feared: lamb slaughter numbers spiked in January, but have been significantly below year-ago levels since then.



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 significantly stronger prices for most other grades in recent weeks.



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

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