



Fortnightly Agri Update

18 March 2015

Reversal of fortune

The revival in dairy prices came to a halt in last night's GlobalDairyTrade auction. The overall price index was down 8.8%, with sizeable price declines across of the products offered. This effectively reverses half of the sharp bounce in prices that began in February.

There will no doubt be a range of suspects offered for the fall in prices (and indeed the market seems to have been primed for a fall this time), but we prefer to focus on two. The first is an issue that we raised in our previous *Fortnightly Agri Update*: the impact that weather conditions in New Zealand can have on global milk supply. In late January Fonterra announced that it expected full-season milk production to be down 3.3% on the previous season, due to dry conditions in many parts of the country and limited incentive to buy additional feed due to the low payout forecast.

Although Fonterra reiterated this forecast earlier this week, developments over the last couple of months suggest that the impact of dry conditions has not been as bad as feared. To achieve Fonterra's forecast, milk production in the next three months would have to be lower than during the drought-stricken 2012/13 season. That season was affected by a particularly intense dry spell over March and April; given that soil moisture is now improving, it's hard to see that experience being repeated.

We are now forecasting Fonterra's full-season production to be down 0.5% on the previous season. (If the smaller players continue to gain market share, industry-wide production should be up slightly.) A smaller than expected disruption to the global supply of milk means it's appropriate that some of the 'drought premium' that was embedded in dairy prices in February should be unwound.

The second factor is exchange rates. The US dollar has strengthened considerably this year, reaching an 11-year high on a broad index, as markets have come to expect the US central bank to start lifting interest rates in the next few months. On its own, a stronger US dollar means that any commodity price expressed in US dollar terms – as they are in the GlobalDairyTrade auction – will be lower.

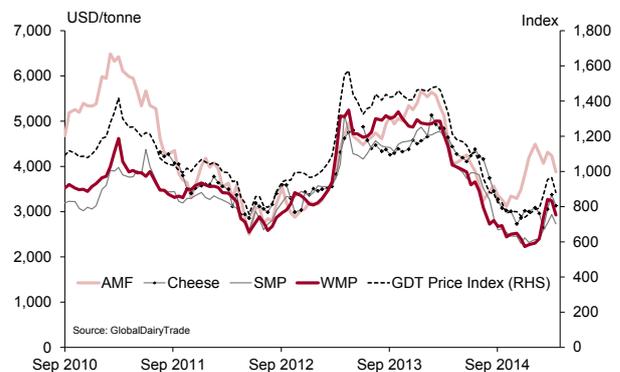
However, there's more to the exchange rate story than this. A big part of the US dollar's strength has been due to a sharp fall in the euro, as the European Central Bank has embarked on a new monetary easing programme. Consequently, dairy exports from Europe are becoming relatively more competitive on the world market, which will tend to weigh on dairy prices in NZ dollar terms.

We have downgraded our forecasts of Fonterra's farmgate milk price for both this season and next season, largely to account for the reduction in the 'drought premium'. The timing of the fall in

dairy prices means that it matters much more for next season's payout than for this season: we've shaved off 10c for this season (down to \$4.90/kg, still higher than Fonterra's current guidance) and 30c off next season (down to \$6.10/kg).

A smaller than expected hit to milk production also means that we should see a smoother profile for GDP over the next year or so. Previously we were expecting GDP growth to slow to 0.4% in the March quarter; we now expect it to be closer to 0.6%. The subsequent boost to GDP growth towards the end of this year, as milk production returns to normal levels, will be smaller as a result.

GDT auction prices



GlobalDairyTrade Auction Results, 18 March

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-8.4%	\$3,877
Butter Milk Power (BMP)	-11.6%	\$2,635
Butter	-9.4%	\$3,555
Skim Milk Powder (SMP)	-5.5%	\$2,731
Whole Milk Powder (WMP)	-9.6%	\$2,928
Cheddar	-7.4%	\$3,130
GDT Price Index	-8.8%	

Payout Forecast Table

	2013/14	2014/15		2015/16
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	\$8.40	\$4.70	\$4.90	\$6.10

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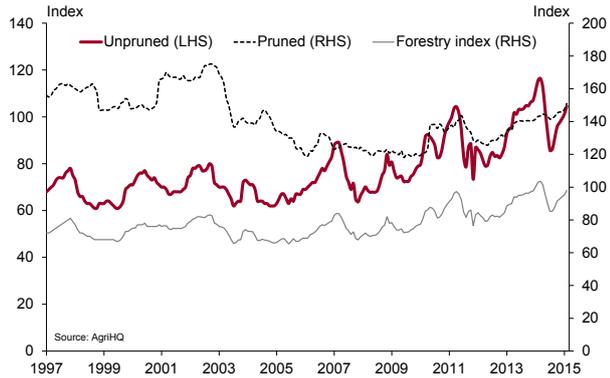
Beyond the farm gate



Forestry

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

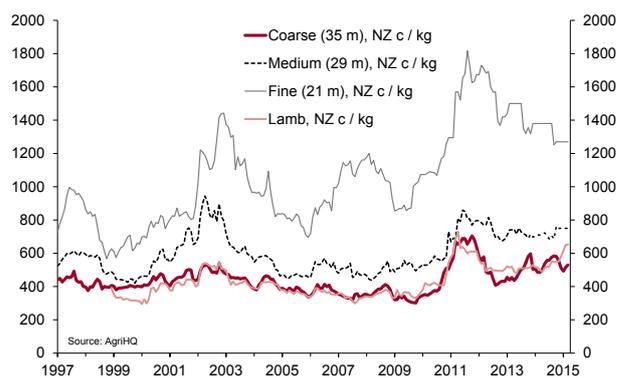
Average prices have rebounded by 12% over the last six months according to the Agrifax forestry price index. However, much of this gain has come from a lower New Zealand dollar and falling transport costs, with world prices for logs steady. Housing construction in New Zealand remains on an upward trend, albeit from low levels in recent years.



Wool

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

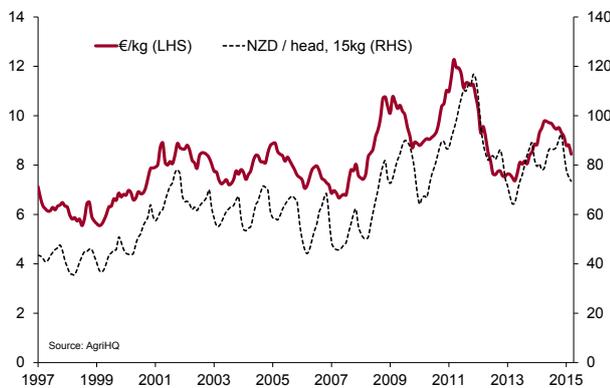
Wool prices have been mixed across grades recently, with no clear direction. Competition from oil-derived synthetic materials is likely to emerge as a challenge to wool prices over the course of this year, although prices have remained resistant to date.



Lamb

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

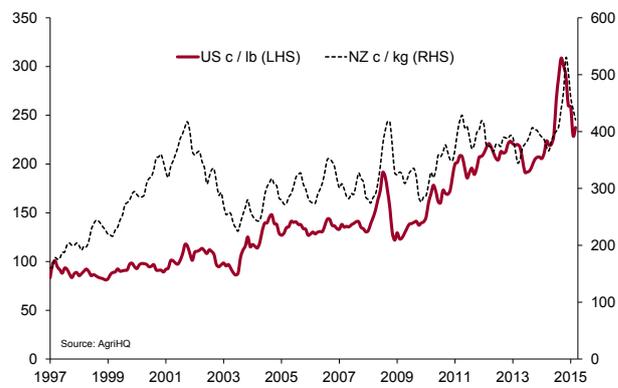
Dry conditions have led to early slaughter in many parts of the country, putting pressure on processors' capacity and pushing down schedule prices. Early slaughter will reduce the available supply later in the year.



Beef

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

The US port disputes have been resolved and prices in the US are ticking higher again. However, clearing the backlog of imported meat will take some time, suggesting that the improvement will be gradual. Prices are expected to settle at relatively high levels, with US beef supply still not in a position to gear up quickly.



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

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