



Fortnightly Agri Update

2 September 2015

Reversal

International dairy prices rose a further 10.9% in last night's GlobalDairyTrade auction, a rebound that had been more or less anticipated by the rise in the NZX futures prices over the last fortnight. The price gains in the last two auctions have effectively reversed the plunge in prices in the two previous auctions, which had prompted us to lower our farmgate milk price forecast to \$3.70/kg. So, back up the forecast goes – we have returned to our previous forecast of a \$4.30/kg milk price for the current season. Our forecast of \$5.20/kg for next season remains unchanged.

It important to note that the change of forecast is entirely a reflection of short-term developments – specifically, Fonterra has signalled some mitigating actions to support prices this season. We haven't changed our view on the four deeper forces driving dairy prices that we have identified in the past: slowing emerging market demand, excess stocks in China, Russia's import ban, and the removal of the EU's production quota system.

The speed of the rebound in dairy prices underscores a point that we have been making for some time: world prices are very sensitive even to small unanticipated changes in supply. Often, buyers of dairy ingredients don't have a lot of flexibility in their requirements over the short term, and are willing to bid up in order to secure supply. In this instance, the market appears to have reacted strongly to Fonterra's announcement last month that it expects its milk collection to be 1.5% lower for this season, on the expectation that dairy farmers scale back in response to low prices.

Nevertheless, we're reluctant to take further significant price gains for granted, as the global milk supply situation is not clear cut. For one thing, Fonterra's forecast is just that – a forecast. For higher prices to be sustained, New Zealand dairy farmers will have to live up to that forecast. And while they have an obvious incentive to do so, the final outcome is still far from certain. Bear in mind that Fonterra made a similar forecast last season, predicting that drought would reduce milk collection by more than 3%. As it happened, the drought proved to be less severe than expected, milk production rose rather than fell for the season, and dairy prices promptly plunged again.

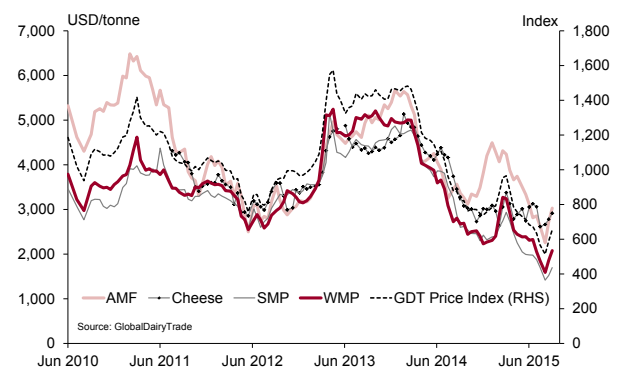
In addition, New Zealand's position as the 'swing factor' in the international dairy market is not as strong as it once was. Milk production in the Northern Hemisphere has grown substantially in recent years, partly in response to years of higher prices. While it is well recognised that current prices are below production costs for even the most efficient producers, the somewhat dated figures we have at present (up to June) show that Northern Hemisphere milk production has been accelerating, not slowing.

So we see our forecast as a balance between two equally plausible scenarios. In one scenario, buyers could scramble to secure supply as they have done in the past, pushing prices

even higher in short order. But in another scenario, Fonterra's production forecast may not pan out, low feed costs continue to encourage US milk production, and countries such as Ireland and the Netherlands continue to produce at a loss in order to establish market share after the removal of the EU quotas. In this case, world dairy prices could capitulate again.

And let's not forget the risk of El Niño. We're not weather forecasters, and even the professionals are uncertain as to how significant this will be for New Zealand this summer. But another drought here could push world dairy prices sharply higher – though obviously to the detriment of those regions that miss out on rainfall or don't have access to irrigation.

GlobalDairyTrade Auction Results



GlobalDairyTrade Auction Results, 2 September

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	11.7%	\$3,029
Butter Milk Power (BMP)	30.0%	\$1,829
Butter	8.1%	\$2,746
Skim Milk Powder (SMP)	11.7%	\$1,698
Whole Milk Powder (WMP)	12.1%	\$2,078
Cheddar	4.7%	\$2,913
GDT Price Index	10.9%	

Payout Forecast Table

	2014/15		2015/16		2016/17	
	Fonterra	Westpac	Fonterra	Westpac	Fonterra	Westpac
Milk Price	\$4.40	\$4.30	\$3.85	\$4.30	\$5.20	\$5.20

Michael Gordon
Senior Economist

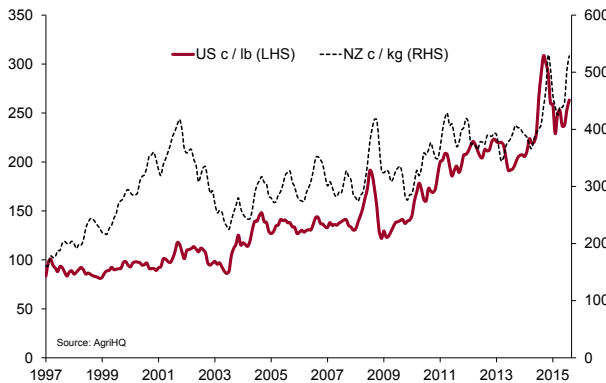
Beyond the farm gate



Beef

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

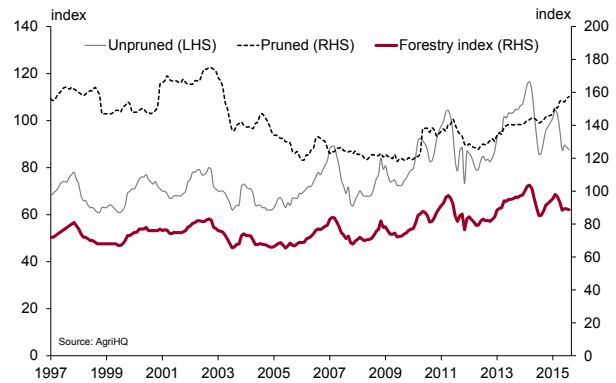
New Zealand's beef exports to the US are on track to exceed this year's quota by around 10%, in the absence of any changes. However, exporters are likely to take mitigating actions such as putting product into cold storage or selling into other markets. This could depress prices over the next few months, before rebounding next year.



Forestry

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

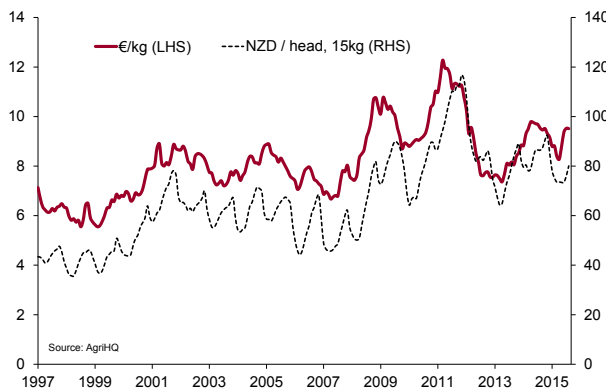
Unpruned log prices softened in August, due to slow demand and high inventories in China. A pickup in Chinese house prices is enabling developers to sell off their existing holdings, but has yet to boost new construction. In contrast, domestic demand remains strong, with housing consents reaching a ten-year high in July.



Lamb

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

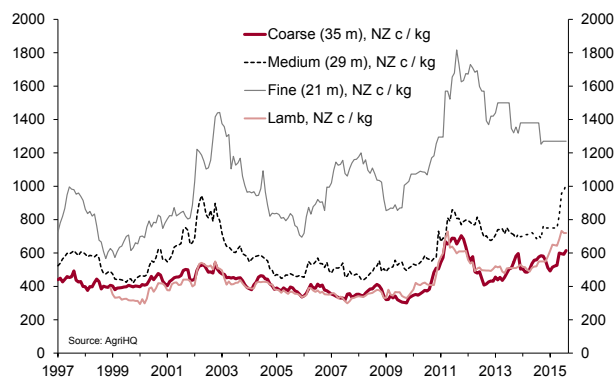
Chilled lamb prices in Europe have held up reasonably well, although global supply appears to remain ample. The weaker New Zealand dollar will help to support returns.



Wool

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

Wool prices have risen further across most grades, supported by growing demand from China. However, growing concerns about the pace of economic growth in China mean that it is unclear how long these prices will be sustained.



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

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