

Fortnightly Agri Update

20 May 2015

The perfect storm

In our latest quarterly *Economic Overview* we highlighted the perfect storm of forces that have depressed dairy prices over the last season:

Stronger global production: In a way, the dairy price boom in 2013 sowed the seeds of its own demise. The near-record prices on offer provided the incentive for a strong lift in milk production the following season, particularly in the US and Europe. That dynamic has since reversed: with prices now at very low levels, milk production in those two regions has started to fall again in recent months.

China's slowdown: The pace of GDP growth in China slowed further to 7% last year, a pace that we expect to be maintained over the next two years. But on a positive note, recent policy measures to stimulate the economy have been directed more towards the household sector, which is of most relevance to New Zealand's major exports to China.

Overstocking: Chinese demand for milk powder went ballistic in late 2013, first in response to drought in New Zealand, then on fears that an outbreak of foot-and-mouth disease would decimate China's own dairy herd. In hindsight, the fears of a disruption to the supply of milk were overstated; Chinese buyers found themselves holding greater stocks of milk powder than needed, and consequently have been less of a presence in the market in the past year. These buyers will eventually return once their excess stocks are run down.

Russia's trade ban: In the midst of the Ukraine conflict, Russia placed a ban on food imports from many Western nations last August. While New Zealand itself wasn't subject to the ban, it meant that dairy products from competing exporters such as Europe and the US had to find a home elsewhere. Russia is – or was – the world's second-largest importer of dairy products, so its absence from the market will have been a significant drag on prices. Whether the trade ban is allowed to expire on schedule this August is a matter of politics rather than economics, and admittedly the recent signs aren't good.

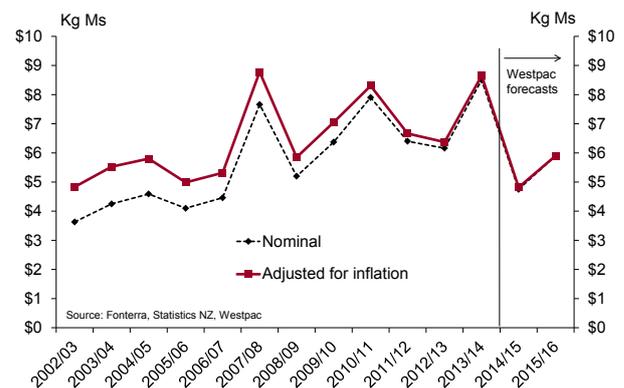
We don't expect all of these factors to be repeated over the next season, or at least not to the same degree. Nevertheless, there are signs that the global dairy industry has evolved since the 2008-2013 period when New Zealand was uniquely positioned to service the rise of the Chinese market.

Several years of higher dairy prices, on average, have incentivised other countries – including China itself – to expand capacity in their own dairying sectors, leading to greater flexibility in the global milk supply. The removal of excess production levies in Europe will play a part in that greater flexibility over the long term, although in the near term low milk prices are likely to be

a restraining factor on production growth. Consequently, it's possible that farmgate milk prices over coming years could be lower on average, after adjusting for inflation, than they were in the preceding five years.

In keeping with that idea, our forecast for a milk price of \$5.70/kg next season is below the average of the last decade, and the soft result from last night's GlobalDairyTrade auction puts the risks around our forecast to the downside once again. Note that our forecast is for the final price at the end of the season; we don't take a position on where Fonterra will pitch its own initial estimate for the season (due next week).

Fonterra payout, including dividends



GlobalDairyTrade Auction Results, 20 May

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-4.8%	\$3,337
Butter Milk Power (BMP)	3.2%	\$1,930
Butter	-3.2%	\$2,911
Skim Milk Powder (SMP)	-3.6%	\$1,992
Whole Milk Powder (WMP)	-0.5%	\$2,390
Cheddar	-7.1%	\$2,745
GDT Price Index	-2.2%	

Payout Forecast Table

	2013/14 - Final	2014/15		2015/16
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	\$8.40	\$4.50	\$4.50	\$5.70

Michael Gordon
Senior Economist

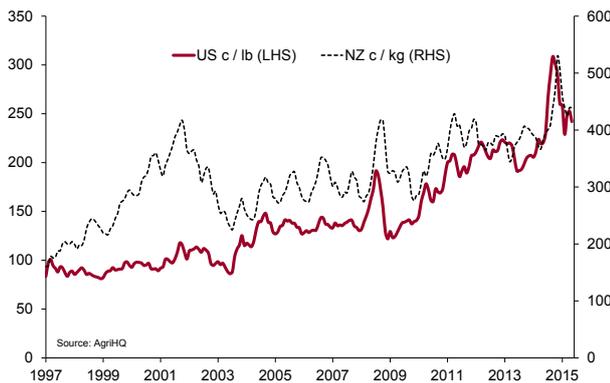
Beyond the farm gate



Beef

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

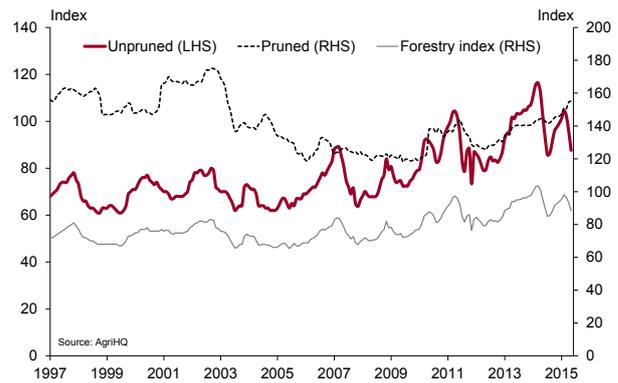
US beef prices remain high, although well off last year's peaks as demand is now being well serviced by supply from Australia and New Zealand. The early cull as a result of the dry summer is now having an inverse effect on slaughter numbers, which were down on year-ago levels in March.



Forestry

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

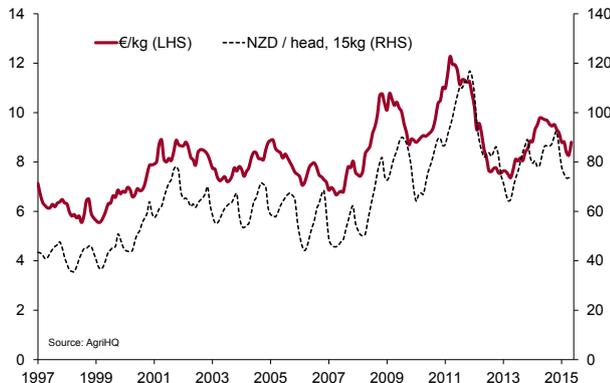
Export log prices have fallen sharply again in recent months, as excess stocks have built up at Chinese ports and the weaker ruble has made Russian logs more competitive. In contrast, domestic log prices have risen further. Demand for housing construction materials continues to grow, although quake-related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



Lamb

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

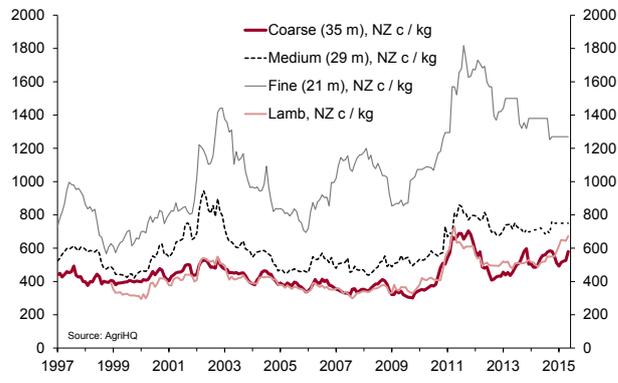
Good growing conditions in the UK, Europe and China mean that the global supply of lamb is likely to remain plentiful this year. The dry summer in New Zealand has probably had less of a depressing effect on prices than initially feared: lamb slaughter numbers peaked in January, but were significantly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



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.



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

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