

## Fortnightly Agri Update

21 January 2015

**The D word**

At the end of last year we drew attention to the emerging risk of another drought in early 2015. Since then, a month of hot, dry weather across much of the country has brought the issue into sharp focus. It's already clear that there will be some hit to farm production this year, but it's the amount of rain over the next month or so that will determine the severity of any drought.

Interestingly, the Australian Bureau of Meteorology announced yesterday that the immediate risk of an El Niño weather pattern has now passed, which at the least reduces the risk of a severe 1998-style event. But as we've noted before, the last three droughts in New Zealand (2008, 2010 and 2013) weren't generated by an El Niño pattern.

For dairy farming, droughts tend to have opposing effects. Milk production obviously falls, but New Zealand is a big enough player in the global dairy market that any disruption to supply here can significantly boost world dairy prices. It's fair to say that New Zealand's market power today is not as strong as it was during the last few droughts, as Europe and the US have had more success in boosting their own milk production in the past year. But that's an argument against dairy prices surging to record highs as they did during those last few droughts; it doesn't negate the point that prices rise when supply falls short of expectations.

For meat production, on the other hand, dry conditions are unquestionably a negative factor. There are a growing number of reports of sheep and beef farmers sending livestock to slaughter earlier than usual, which is stretching meat processors' capacity and forcing prices lower. Early slaughter also means less than ideal animal weights.

In the last few issues of the Fortnightly Agri Update we've placed a lot of emphasis on supply conditions across various markets. This time we'll also give a brief update on global demand – specifically China, which has long been our most important export market for dairy products and increasingly so for other primary products such as lamb and wool. Westpac's Senior International Economist characterised 2014 as a year best forgotten for China, but argues that the outlook for 2015 is better. He made the following comments on the latest Chinese data:

"The Chinese economy reportedly expanded by 7.3%yr in the December quarter. That is unchanged from Q3. We were expecting 7.2%yr, as was the market consensus. The NBS puts the quarterly seasonally adjusted change at 1.5% versus 1.9% in Q3, 2.0% in Q2 and 1.6% in Q1. Nominal GDP, which we argue is usually a more reliable gauge of underlying demand conditions than the real growth rate, slowed markedly from 8.5%yr from 7.8%yr, after an isolated bounce to 9.0%yr in Q2. For the calendar year, real GDP expanded 7.4% versus 7.7%yr across both 2013

and 2012. We observe that while real GDP essentially hit its annual target, the nominal outcome is a major undershoot relative to the implicit [albeit unrealistic] objective of 11%."

"The best comparison period for the current phase, where domestic demand sits well below 8% growth on an annual basis, is 1997 to 2000: the Asian Crisis/SOE restructuring era, when bad loans approached 50% of banking system assets. While overall conditions, and more importantly balance sheets, are nothing like as bad as that, the disinflationary atmosphere is similar and so are the subdued confidence levels, with some major demand segments genuinely struggling. Relative strength in exports, personal consumption and infrastructure are cushioning the downside, up to a point, but in aggregate, we feel that 2014 was a year best forgotten."

"On the important matter of forward momentum, in our mind the signs are actually not too bad at all, notwithstanding the bleak write-up of the backward looking GDP figures. The December data, on balance, indicates that conditions are no longer deteriorating, and given that policy has turned, and the US is set to have its best year in a long time, the cyclical outlook looks respectable. That needs to be balanced by a realistic assessment of the strength of the negative structural forces impinging upon growth. Having retreated to ponder that fundamentally qualitative problem, we have emerged comfortable with the idea that full year growth in 2015 is more likely to come in just shy of the 2014 outcome than it is to move materially below 7%."

**Global Dairy Trade Auction Results, 21 January**

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-5.0%	\$4,286
Butter Milk Power (BMP)	-6.4%	\$2,559
Butter	0.1%	\$3,564
Skim Milk Powder (SMP)	1.0%	\$2,389
Whole Milk Powder (WMP)	3.8%	\$2,402
Cheddar	-4.3%	\$2,961
GDT Price Index	1.0%	

**Payoff Forecast Table**

	2013/14	2014/15		2015/16
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	\$8.40	\$4.70	\$4.80	\$6.20

**Michael Gordon**  
Senior Economist

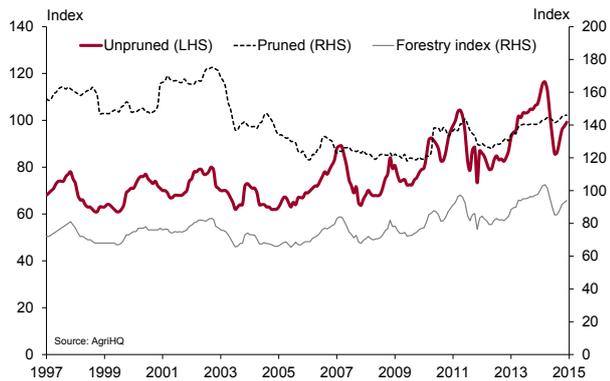
# Beyond the farm gate



## Forestry

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

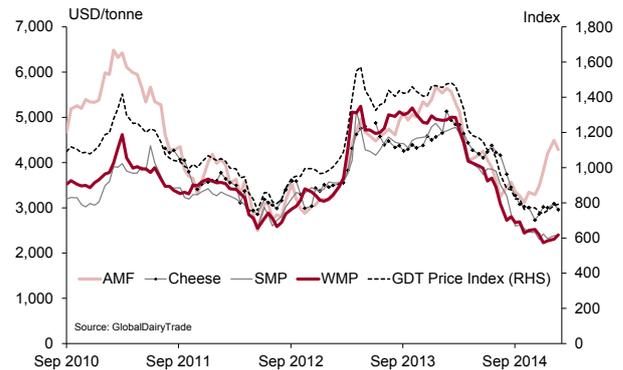
World prices for logs have stabilised in the last few months, and with a weaker New Zealand dollar in that time, local currency prices have rebounded by 8.9% according to the Agrifax forestry price index. We suspect that prices have improved as harvesting has pulled back to match demand. There are very tentative signs that steps by Chinese policymakers to revitalise their housing market are having some impact. Housing construction in New Zealand remains on a strong upward trend, albeit from low levels in recent years.



## Dairy

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

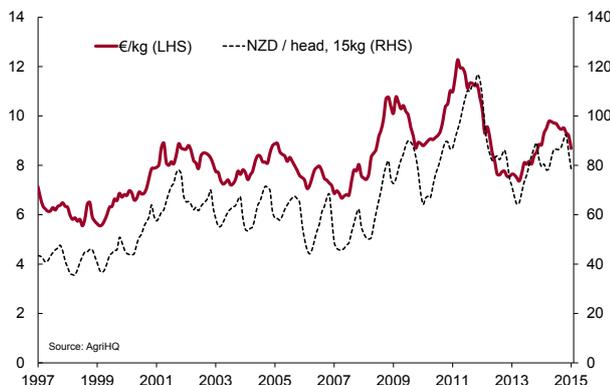
Dairy prices rose 1% in this week's GlobalDairyTrade auction, with whole milk powder up 3.8% but fat products shedding some of the sharp gains they had made in the last few auctions. Overall, prices are doing more or less what they need to do to meet our forecast of a \$4.80/kg milk price for this season and \$6.20/kg next season. There's still a steep requirement for prices to rise further in coming months, but with the risk of drought increasing in the last month, now doesn't seem to be the time to abandon that view.



## Lamb

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

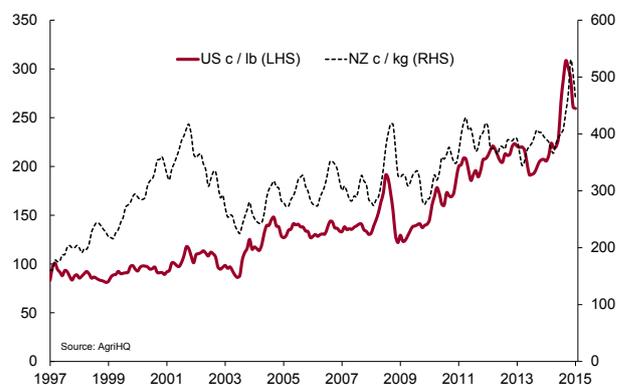
Dry conditions have led to early slaughter in some parts of the country, putting pressure on processors' capacity and pushing down schedule prices. The impact on prices from here will depend crucially on how much rain falls, and where, over the next month or two.



## Beef

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

There are tentative signs that US imported beef prices have stabilised at above-average levels. Imports from Australia and New Zealand have done much to fill the supply gap in the last six months, but there's a general sense that US supply is not in a position to gear up quickly. On its own this would suggest a stabilisation in NZ schedule prices in the next couple of months, but dry conditions and early slaughter could continue to have a depressing effect on prices.



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

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