



Fortnightly Agri Update

21 October 2015

Running dry

World dairy prices fell 3.1% in last night's GlobalDairyTrade auction, after a run of very strong gains in the previous four auctions. This was a softer result than we expected for this auction, but it reinforces our earlier caution about assuming too much in the way of further price gains this year. There has been no pullback in the Northern Hemisphere milk supply in recent months, despite the fact that prices remain below break-even levels in many regions.

While New Zealand's milk production has fallen short so far this season, the full-year outlook remains highly uncertain. Fonterra's latest update confirmed that its milk collection for the season up to September is running more than 5% behind last year's levels. Early culling and cost control by dairy farmers has no doubt been a factor in the drop in production. However, this partly reflects decisions that were made on the basis of a \$3.85/kg milk price; with Fonterra now forecasting a \$4.60/kg milk price the need for restraint is slightly less pressing. Moreover, there is a wide divergence in milk collection across regions, which suggests that pasture growth also played a major role in the low production numbers.

Full-season output will depend heavily on the expected El Niño weather pattern this summer. NIWA recently upgraded its assessment and ranks the current pattern as almost as strong as the 'super El Niños' of 1982-83 and 1997-98. El Niño means that the prevailing weather comes from the west, which typically means a very dry summer for the east of the country.

However, we'd caution about using those earlier El Niño events to gauge the economic impact this time around. The shape of the agricultural sector has changed significantly since 1998. Firstly, there has been a major expansion of dairying in the regions that are vulnerable to El Niño, largely at the expense of sheep and beef farming. Around 80% of the increase in the dairy herd since 1998 occurred in the South Island. (While we don't have the equivalent figure for milk production, it would be even higher as South Island cows tend to more productive.)

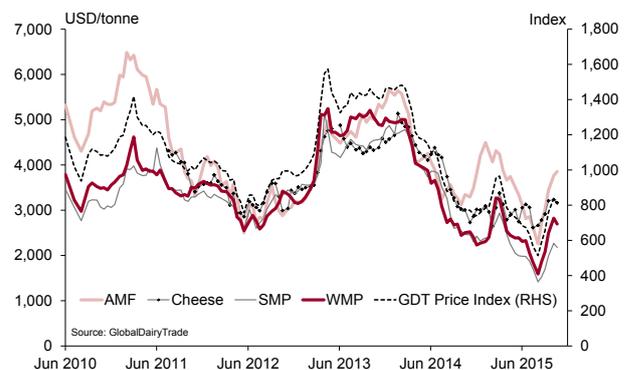
This matters for a drought's impact on farm incomes. Recent droughts have arguably been revenue-positive for the dairy sector as a whole (though not for the drought-afflicted areas), as the drop in milk production has been more than offset by a rise in world prices. In contrast, a drought forces sheep and beef cattle to be sent to slaughter earlier, at lower weights, which depresses both prices and volumes.

Secondly, there's the development that has enabled the spread of dairying to drier regions: irrigation. A recent NZIER report estimated that the expansion of irrigation over the last decade added more than \$1bn to the value of farm output in a normal

year. It's harder to pin down the value of irrigation during a drought year – it's not a get out of jail free card, as water still has to be carefully managed – but it will provide a sizeable mitigant compared to the 1998 drought. Canterbury, the farming region that is most likely to be in the firing line of El Niño, accounts for almost two-thirds of the irrigated farmland in New Zealand.

Our updated economic forecasts, which will be published in our quarterly *Economic Overview* next month, will assume that drought will subtract 0.6 percentage points from GDP growth over the first half of 2016. But we recognise that at this stage there's a wide margin of uncertainty around the actual impact.

GlobalDairyTrade Auction Results



GlobalDairyTrade Auction Results, 21 October

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	2.4%	\$3,856
Butter Milk Power (BMP)	3.2%	\$2,064
Butter	-11.1%	\$2,850
Skim Milk Powder (SMP)	-4.5%	\$2,178
Whole Milk Powder (WMP)	-4.6%	\$2,694
Cheddar	-2.2%	\$3,163
GDT Price Index	-3.1%	

Payout Forecast Table

	2014/15	2015/16		2016/17
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	\$4.40	\$4.60	\$5.30	\$5.20

Michael Gordon
Senior Economist

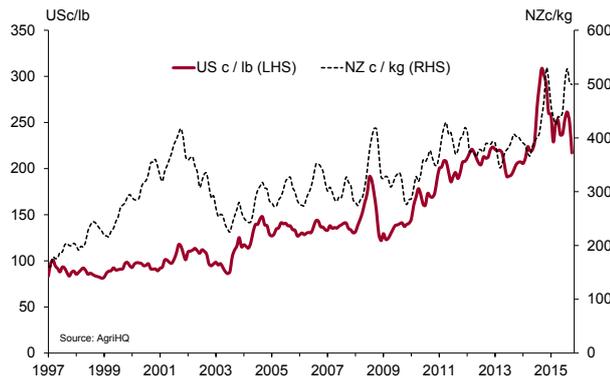
Beyond the farm gate



Beef

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

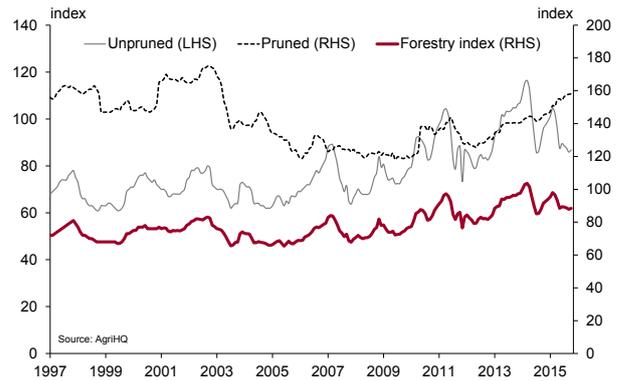
With both New Zealand and Australia rapidly approaching their tariff-free import quotas, US buyers have substantially lowered their prices for delivery over the end of this year. Prices are expected to recover early next year once the annual quotas are reset.



Forestry

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

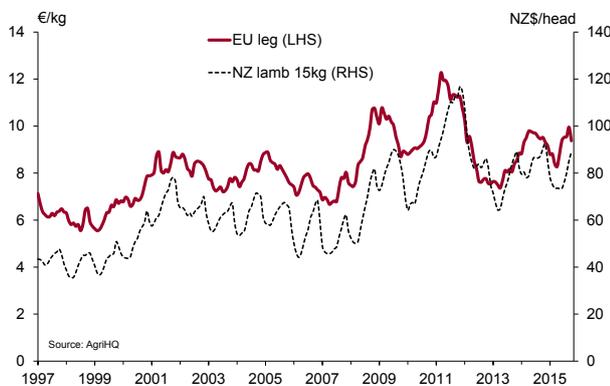
Log export prices have risen slightly on signs that Chinese inventories are now declining. However, the rebound in the New Zealand dollar is likely to undermine these gains. Domestic timber demand remains strong, with housing consents reaching an eight-year high in the year to August.



Lamb

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

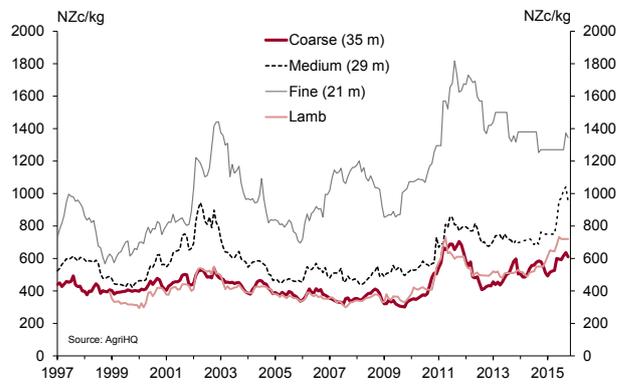
Returns in the European market have been undermined by the recent gains in the New Zealand dollar. Demand from China has picked up in recent months, although prices here are typically lower than what is available in other markets.



Wool

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

Wool prices remain supported by Chinese demand for wool for clothing. However, the rebound in the New Zealand dollar has reduced the competitiveness of New Zealand wool.



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

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