

Fortnightly Agri Update

4 February 2015

Here we go again

The emerging drought in New Zealand is now clearly having an effect on dairy prices – something that we've been warning about recently, although the speed of the move has caught even us off guard. We have revised up our forecasts of Fonterra's farmgate milk price by 20c/kg for both this season and next season.

Dairy product prices rose by an average of 9.4% in last night's GlobalDairyTrade auction, a move that included a 19.2% surge in whole milk powder prices. The performance was still fairly uneven across the range of products – indeed, some fat products such as AMF and cheddar saw substantial price declines – which points to constrained supply for particular products as the main factor behind it, rather than a broad-based increase in demand.

The jump in milk powder prices follows last week's warning from Fonterra of significantly lower milk volumes over the first half of 2015 – the second such warning in the space of two months. Fonterra has noted that the interaction between dry weather and low milk prices has a particularly potent impact: with prices low, farmers have limited scope to bring in additional feed in order to maintain milk production, instead relying on their own stores of feed and on rainfall to spur grass growth. As a result, milk production for this season will be even more vulnerable than usual to drought.

Fonterra now expects full-season milk collection to be down 3.3% on the previous year. To put that in context, the short but severe drought in 2010 led to a 2% drop in full-season production, while the prolonged drought of 2007-08 saw a 4.3% drop. So this year's drought is shaping up to be one of the harshest in recent history – at least in terms of milk production. Of course the ultimate impact is highly dependent on the weather over the next month or two, but we see Fonterra's estimate as a plausible base case.

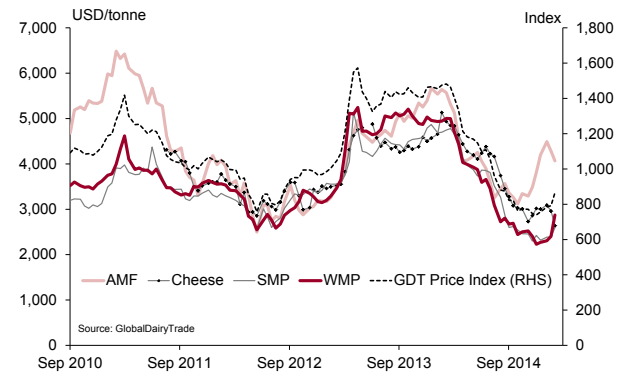
In the last few issues of the *Fortnightly Agri Update* we've been warning that a drought this summer would put upward pressure on world dairy prices, above and beyond the recovery from low levels that we (and Fonterra) were already anticipating. New Zealand is the world's biggest exporter of dairy products, so any disruption to supply from here can have a significant impact on the global market, as the rest of world is unable to increase their own supply quickly enough in response. Indeed, the 2013 drought saw such a sharp rise in world dairy prices that it ended up ending up being a net positive for industry-wide revenue (though partly offset by higher feed costs).

We've argued that the global supply situation is not as stretched this time around – milk production in the Northern Hemisphere has grown strongly over the last year, and Russia's ban on imports from several Western countries has put a substantial amount of

product back on the world market. Hence, our milk price forecast assumed that world prices would rise as a result of drought, but remain well short of their previous highs.

Last night's auction, however, raises the risk that we do see some dramatic price swings after all. We've revised up our forecast of this season's milk price from \$4.80/kg to \$5.00/kg, but we feel this is conservative and is highly subject to how prices perform over the next few auctions. We've also revised up our forecast of next season's milk price from \$6.20/kg to \$6.40/kg, which would put it slightly above the average of the last decade.

GDT auction prices



GlobalDairyTrade Auction Results, 4 February

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-5.4%	\$4,067
Butter Milk Power (BMP)	-0.4%	\$2,436
Butter	6.1%	\$3,783
Skim Milk Powder (SMP)	6.7%	\$2,598
Whole Milk Powder (WMP)	19.2%	\$2,874
Cheddar	-11.1%	\$2,636
GDT Price Index	9.4%	

Payout Forecast Table

	2013/14	2014/15		2015/16
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	\$8.40	\$4.70	\$5.00	\$6.40

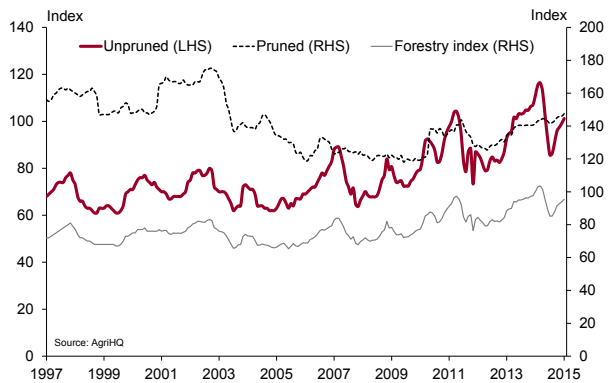
Michael Gordon
Senior Economist



Forestry

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

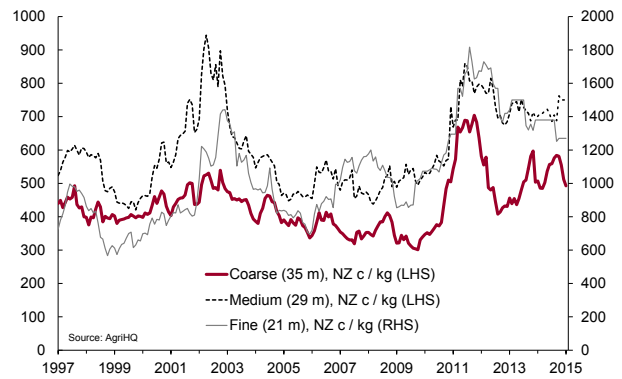
Average prices have rebounded by 12% over the last six months according to the Agrifax forestry price index. However, much of this gain appears to have come from a lower New Zealand dollar and falling transport costs, with world prices for logs steady. There are very tentative signs that steps by Chinese 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.



Wool

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

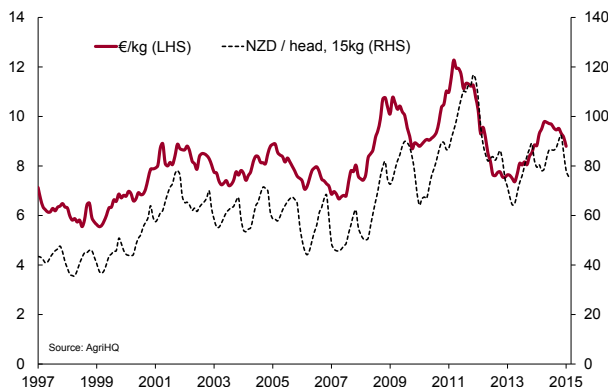
Wool prices have been mixed across grades recently, with no clear direction. Competition from oil-derived synthetic materials is likely to emerge as a challenge to wool prices over the course of this year, with the recent drop in world oil prices being one of the most dramatic in history.



Lamb

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

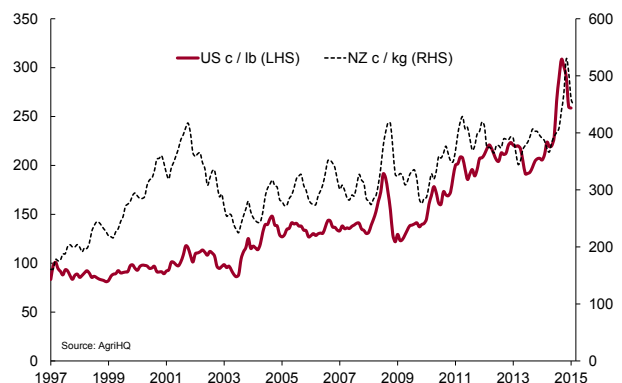
Dry conditions have led to early slaughter in some parts of the country, putting pressure on processors' capacity and pushing down schedule prices. The impact on prices from here will depend crucially on how much rain falls, and where, over the next month or two.



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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