



Fortnightly Agri Update

17 February 2016

Slip sliding away

Dairy prices took another step lower in last night's GlobalDairyTrade auction. The headline index slid 2.8%, while whole milk powder prices were down 3.7%. Although lower prices were well signalled by futures markets, last night's confirmation will still come as a disappointment to the industry.

Nonetheless, while disappointing, last night's auction was consistent with our recently updated farm gate milk price forecasts. We are now expecting a milk price of \$4 this season and \$4.60 for 2016/17 season as recent themes of strong growth in supply and lacklustre demand show few signs of reversing any time soon.

On the supply side, while Southern Hemisphere production is contracting as producers respond to lower prices and fear of worsening weather conditions (Dairy Australia is forecasting a 1%-2% fall in Australian milk production in the year to June, New Zealand production is likely to be down around 2%). But Northern Hemisphere production, and in particular European milk production, is continuing to grow strongly. European milk production was up 5.3% in November compared to a year ago, while year to date production is running 2.2% ahead. This means Europe is producing around 2.7bn litres more milk in the 11 months to November than it did a year ago. To put this in context, NZ in total produced around 21bn litres of milk in the 2014/15 season. And perhaps even more importantly, European dairy exports are also expanding. The quantity of European SMP exports has increased 6% in 2015 compared to 2014, while butter exports are up a whopping 30%.

In contrast, while US milk production has also increased by 1.2% in the year to November (with the USDA forecasting a further 1.7% increase in 2016), relatively buoyant domestic demand for butter and cheese is soaking up some of this growth in supply. US butter exports more than halved in 2015 while cheese exports were down 14% and SMP exports were roughly flat. US producers in particular are also benefitting from lower feed costs, which are providing some offset to falling milk prices.

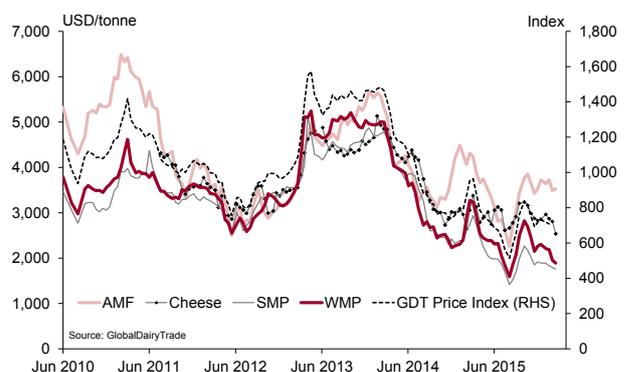
Meanwhile on the demand side of the ledger, Chinese demand for WMP remains lacklustre. While the removal of trade restrictions on Iran is certainly good news for New Zealand dairy (and other agricultural) exporters, on its own it's simply not big enough to fill the hole left by reduced Chinese demand (prior to the recent sanctions coming into effect NZ was exporting around \$200m dairy products to Iran per year).

Putting all this together and it still looks like a long tough road ahead for the dairy sector. To date, the sector has displayed impressive resilience. Farmers have trimmed as much fat from their operations as possible – cutting costs, shelving capital

investment plans, and increasing reliance on pasture based feed. And with necessity the mother of invention, anecdotally many have also come up with smarter ways of doing things, moving toward adopting best practise and generally improved productivity. Low international oil prices, falling interest rates and a benign inflation environment locally have also helped on the cost side of the ledger.

However, such measures can only continue for so long. If our forecasts are right, and many farmers are facing a third consecutive season where revenues are below costs, signs of stress in the sector are likely to increase. And the impact of this won't just be confined to the rural sector.

Dairy Prices



GlobalDairyTrade Auction Results, 17 February 2016

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	1.5%	\$3,527
Butter Milk Power (BMP)	-1.2%	\$1,496
Butter	-2.3%	\$2,834
Skim Milk Powder (SMP)	-1.4%	\$1,762
Whole Milk Powder (WMP)	-3.7%	\$1,890
Cheddar	-5.6%	\$2,535
GDT Price Index	-2.8%	

Payout Forecast Table

	2015/16		2016/17
	Fonterra	Westpac	Westpac
Milk Price	\$4.15	\$4.00	\$4.60

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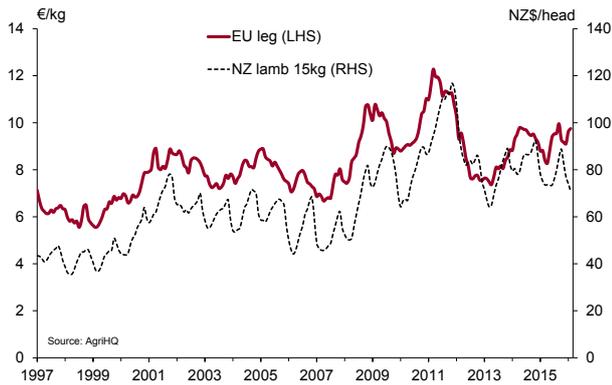
Beyond the farm gate



Lamb

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

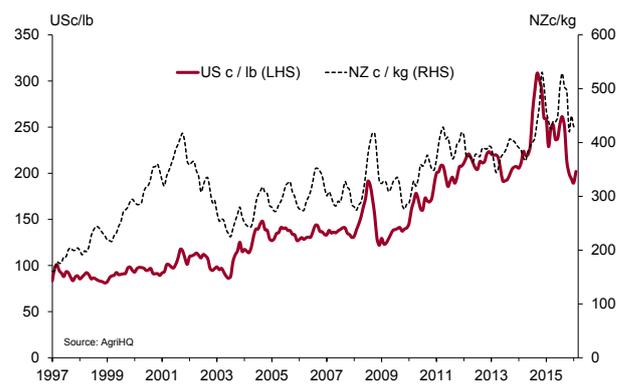
We continue to expect relatively tight supplies in New Zealand and Australia to underpin lamb prices this year. However, expectations of weaker growth in China and the Middle East (on the back of sharply lower oil prices) are likely prove a headwind to any significant improvement in prices



Beef

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

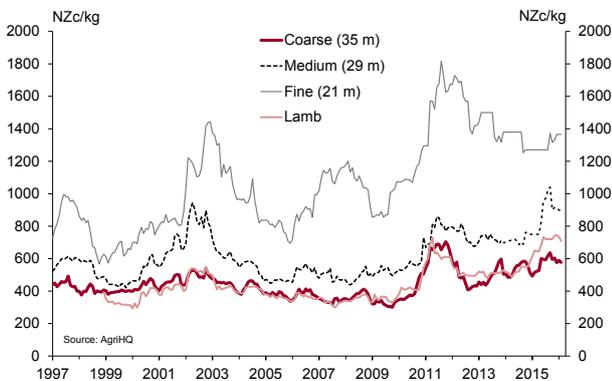
Although we expect to see beef prices moderate a little further in the near term, over a longer horizon, we expect tight international supplies, particularly out of Australia, to support prices. This is supported by recent data which showed Australia's beef exports to the US have slowed sharply in the New Year.



Wool

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

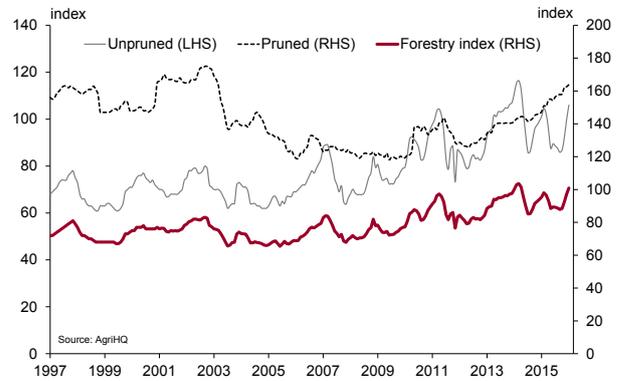
AgriHQ report reduced buyer demand in the most recent wool auctions late last year. Looking ahead, we expect subdued outlook for growth in China to continue to weigh on demand. Sharply lower oil prices will also make synthetic substitutes for wool relatively cheaper. While prices have held up relatively well to date, they could come under pressure in 2016.



Forestry

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

Log prices have improved noticeably in recent months, apparently as supplies in China have tightened. There have also been reports of improved demand from India. But we are sceptical the situation in China at least will be maintained. An overseas supply response to higher prices is inevitable, and the Chinese economy is softening again. In contrast, the domestic outlook is more favourable. We expect construction activity to pick up strongly over the first half of 2016, which should support domestic prices.



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

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