

Fortnightly Agri Update

18 May 2016

Dairy Debt

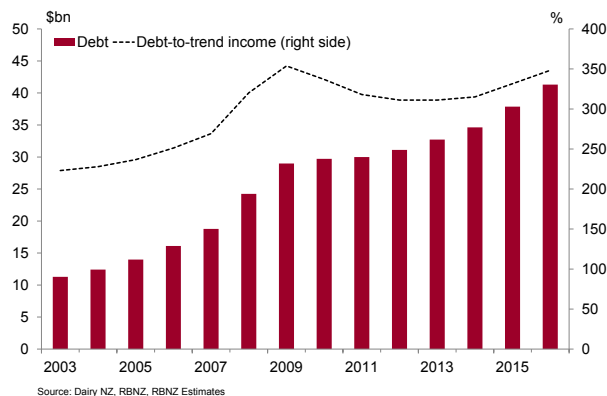
Prices nudged higher again in last night's GlobalDairyTrade auction, rising 2.6%. Prices rose for most products on offer, including a 3% lift in whole milk powder prices.

The end of May marks the close of the 2015/16 dairy season. And the 2016/17 season comes into sharper focus. Clearly much can happen in the more than 12 months before the 2016/17 payout is finalised. However, at this point, our view remains that a sustained improvement in dairy prices will be a story for 2017. We expect the pace of growth in global milk supply to slow in response to low international prices, but this is likely to be gradual. This year, prices are likely to continue to stumble around near current levels. On this basis we remain comfortable with our forecast of a \$4.60 farmgate milk price for 2016/17. Fonterra is due to announce its opening payout forecast for the 2016/17 season at the end of this month.

This outlook for dairy prices and the dairy sector more generally has consequences for both the New Zealand economy and New Zealand's financial system. Accordingly, the Reserve Bank is keeping a very close eye on developments from both a monetary policy and a financial stability perspective. We'll get a read on how the RBNZ is viewing the impact of the dairy downturn on the broader economy when the RBNZ considers its interest rate settings in its quarterly *Monetary Policy Statement* next month. For the record, we expect the RBNZ to take this opportunity to reduce the OCR by another 25 basis points to 2% and keep the door open a crack to the possibility of further rate cuts.

But last week, we got an update on how the dairy downturn is impacting the stability of New Zealand's financial system in the RBNZ's half-yearly *Financial Stability Report*. Along with the ramp up in housing debt, the outlook for the dairy sector remains one of the biggest risks on the Reserve Bank's radar for New Zealand's financial system. Ultimately, the Reserve Bank's stress tests of the five largest dairy lenders (where they modelled the impact of a range of 'stress' scenarios on bank balance sheets and loan portfolios) have led them to conclude that banks remain well placed to withstand the expected impact of a severe downturn in the dairy sector.

Bank loans to the dairy sector (June years)

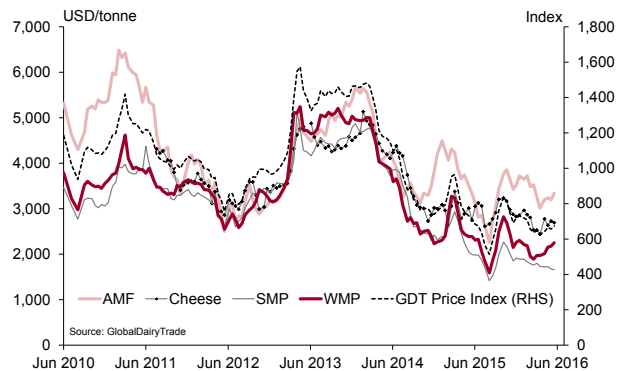


However, with dairy incomes set to remain under intense pressure for a third consecutive season, dairy debt is rising strongly (the RBNZ's trend dairy debt to income ratio is nearing its 2009 peak) as farmers look to bridge the gap between revenue and expenditure. Banks have been taking a medium term outlook on lending to the sector and this, in conjunction with low interest rates, has limited the impact on land prices so far.

But the longer dairy prices remain low, the more pressure on the sector is building. Increasing debt will only fill the gap temporarily. Ultimately debt will need to be repaid, and in the meantime, higher debt levels leave the sector more vulnerable to negative surprises. Both lenders and the RBNZ will remain on high alert for some time yet.

Anne Boniface
Senior Economist

Dairy prices



GlobalDairyTrade Auction Results, 18 May 2016

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	4.9%	\$3,340
Butter Milk Power (BMP)	16.2%	\$1,545
Butter	3.8%	\$2,697
Skim Milk Powder (SMP)	-0.9%	\$1,658
Whole Milk Powder (WMP)	3.0%	\$2,252
Cheddar	-0.8%	\$2,693
GDT Price Index	2.6%	

Payout Forecast Table

	2015/16		2016/17
	Fonterra	Westpac	Westpac
Milk Price	\$3.90	\$4.00	\$4.60

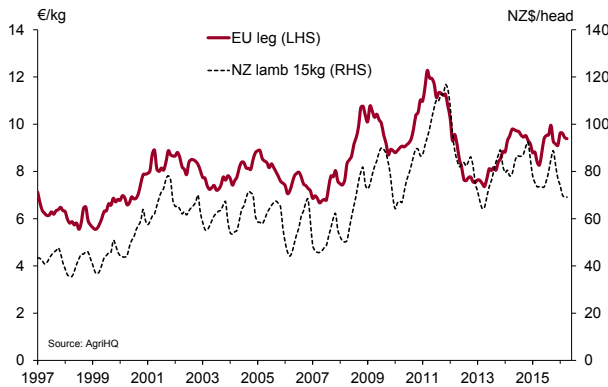
Beyond the farm gate



Lamb

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

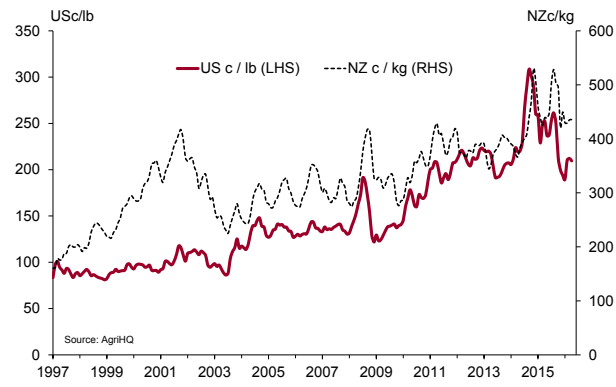
Lamb supplies are expected to tighten over the next couple of months which could support local prices in the near term. However, internationally there is little change to the bigger picture of tight global supplies and weaker demand growth in key markets such as China and the Middle East. The newly announced agreement with China, which opens up that market to chilled NZ meat exports, is a positive development for the sector. It should eventually provide an additional source of demand for higher value exports.



Beef

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

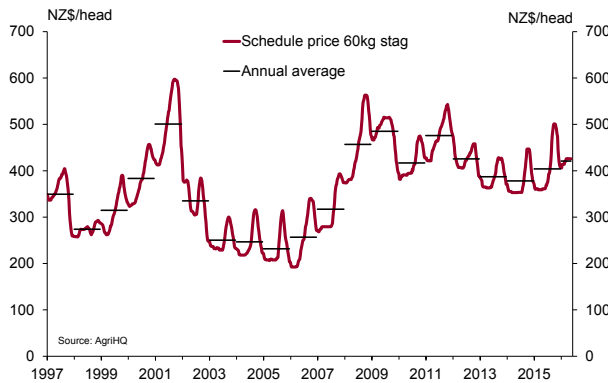
Over the medium term, international beef prices are likely to be underpinned by relatively tight global supply as beef exports from Australia and, to a lesser extent New Zealand, contract. However this will be balanced against increasing domestic supplies in the US with changes to market access for Brazil's chilled beef exporters an important wild card that could influence prices. A lift in New Zealand's cow cull as the local dairy season winds up will also add to domestic supply in the coming months.



Venison

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

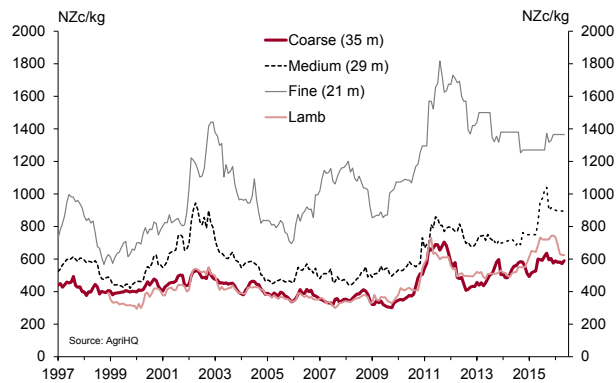
Venison prices are up 16% on the same period a year ago and have been benefitting from both the improved outlook in European economies and the weaker New Zealand dollar. The sector continues to push toward exporting a greater share of chilled product (the bulk of product currently shipped is frozen). The improved outlook for the sector may have encouraged farmers to hold onto breeding stock in recent months. This has depressed slaughter volumes but should support prices in the near term.



Wool

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

Wool prices are likely to remain under pressure over the coming months. That's due to a combination of low oil prices making synthetic alternatives to wool more attractive and a soft demand outlook from China.



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

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