Westpac Institutional Bank

Fortnightly Agri Update

20 January 2016

Darkening clouds on the horizon

Dairy prices fell 1.4% in last night's GlobalDairyTrade auction. While this probably wasn't as weak as we had feared given the global backdrop, dairy prices over January have still been weaker than we had pencilled into our forecasts. This, combined with receding drought risk in New Zealand, has led us to lower our payout forecast for this season to $4.20.

Many equity and commodity markets around the globe have started 2016 in a decidedly downbeat fashion. Oil prices in particular have hit the headlines, plummeting to levels not seen in more than a decade. The weakness has coincided with a number of positives on the supply front; Iran's re-entry to international markets, robust US oil production, the refusal of OPEC nations to curtail their production in the face of signs of excess supply and large inventories.

But the recent weakness in oil prices can't just be attributed to a jump in supply. Instead, very low oil prices are also a symptom of renewed concerns around the outlook for global growth and in particular the health of the Chinese economy. This is evidenced by the fact that it's not just oil prices that have been tumbling. Hard commodities such as copper and iron ore have also been under pressure.

In this environment, last night's 1.4% fall in dairy prices (which included a 0.5% fall in whole milk powder prices) perhaps wasn't as bad as it might have been. Nonetheless, combined with the fall in prices at the early January auction, it's certainly not good news.

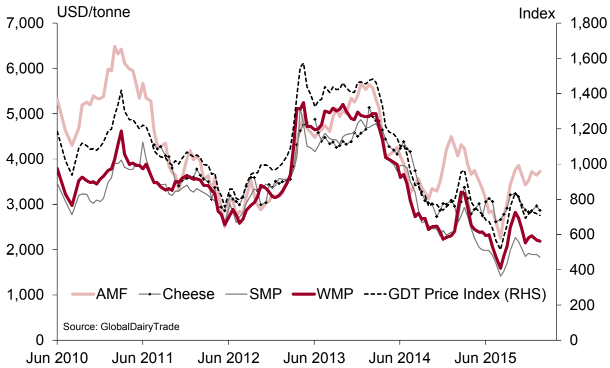
Late last year, our forecast of the 2015/16 farm gate milk price was $4.50 per KgMs. This was based on the potential for an El Niño induced drought to impact on New Zealand milk production. But after decent rainfall in many parts of the country so far this year, the risk of a severe drought appears to be receding. And as we get further past the peak production period, even if dry weather set in now, overall milk production would be less at risk.

NIWA maps of soil moisture deficits around the country show that although many parts of the country are drier than average for this time of year, conditions are not nearly as parched as they were at the same time last year.

In the areas where conditions have been amongst the driest, including much of the East Coast of the South Island, many dairy farms are irrigated. This has mitigated the impact of the very dry conditions. Fonterra recently reported that while its nationwide milk collections are down 4% for the season to date, the bulk of the reduction has been in the North Island (off 6%). In contrast, milk collections in the South Island are only running 1% behind last year's levels.

Our updated $4.20 farm gate milk price forecast assumes prices whole milk powder (WMP) prices over the 2015/16 season average around $2200 USD/tonne this season and an average conversion rate for the season of about 0.69c. That's pretty close to where WMP prices are sitting today (WMP prices averaged $2188 in last night's GlobalDairyTrade auction). Clearly there are risks on both sides of this forecast. European milk production continues to grow strongly and should concerns about global growth and financial market volatility intensify further, we could see prices fall. But balancing this risk, prices are already at very low levels and globally food prices have held up relatively well in the current round of financial market turmoil. Looking further ahead, our overriding view is that strong growth in global milk supply combined with subdued demand from China, is likely to keep a lid on prices for much of this year. Consequently, we are forecasting a farm gate milk price of just $5.20 next season.

Dairy prices



GlobalDairyTrade Auction Results, 20 January 2016

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	2.4%	$3,724
Butter Milk Power (BMP)	-2.7%	$1,620
Butter	-5.9%	$3,162
Skim Milk Powder (SMP)	-3.2%	$1,835
Whole Milk Powder (WMP)	-0.5%	$2,188
Cheddar	-3.4%	$2,867
GDT Price Index	-1.4%	

Payout Forecast Table

	2015/16		2016/17
	Fonterra	**Westpac**	**Westpac**
Milk Price	$4.60	$4.20	$5.20

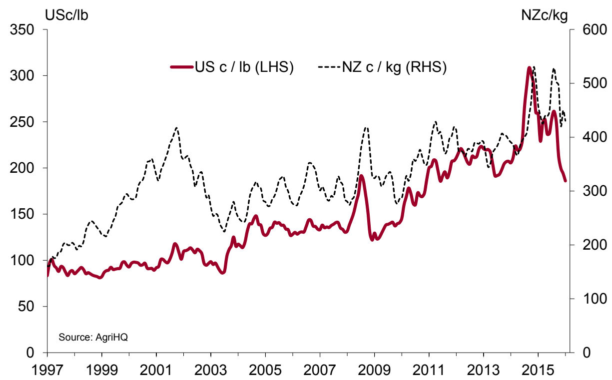
Anne Boniface
Senior Economist

Beyond the farm gate

Beef

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

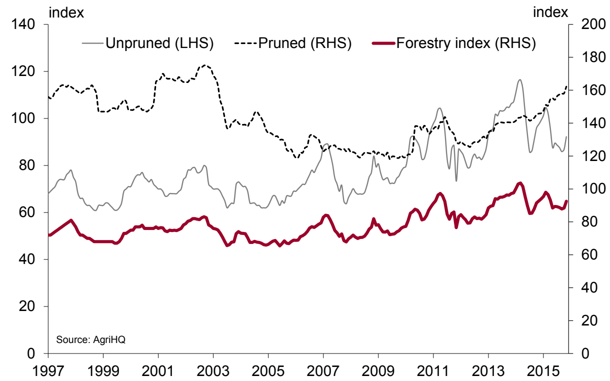
Beef prices have continued to ease in recent weeks. Looking ahead we maintain our view that Australian beef production is likely to moderate this year as pasture conditions improve, allowing farmers to rebuild herds. However, domestic supply in the US is also growing as the high USD and lacklustre international demand puts pressure on US exports. NZ beef exporters are likely to be caught in the middle of these two market forces.



Forestry

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

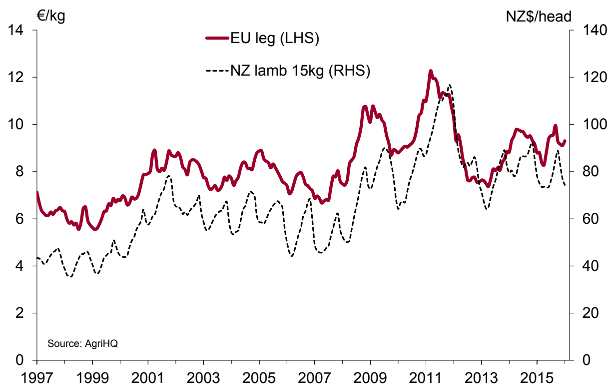
Log prices have improved noticeably in recent months, apparently as supplies in China have tightened. We are sceptical that the recent spike in prices will be maintained. Suppliers likely to respond to improved prices by lifting supply, and the soft Chinese economy (and weaker renminbi) likely to be a headwind to a sustained lift in demand for NZ logs for a while yet.



Lamb

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

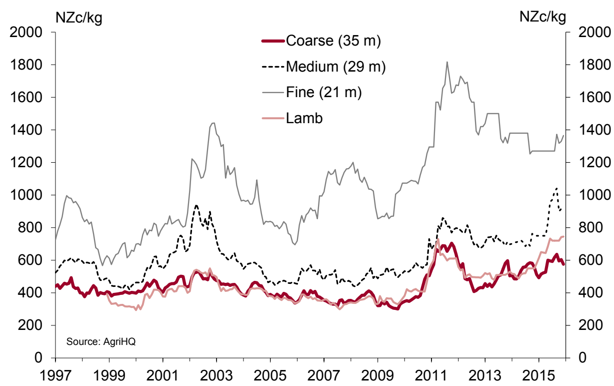
As we detailed in our last *Fortnightly Agri Update,* relatively tight supplies in NZ and Australia should underpin lamb prices this year. However, in recent weeks domestic lamb prices have come under further downward pressure on the back of strong slaughter volumes. Chilled lamb demand in the UK, however, seems to be holding up well.



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 cheap. While prices have help up relatively well to date, they could come under pressure in 2016.



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

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