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Westpac Institutional Bank

Digesting Dairy Prices

Update of dairy payout forecasts

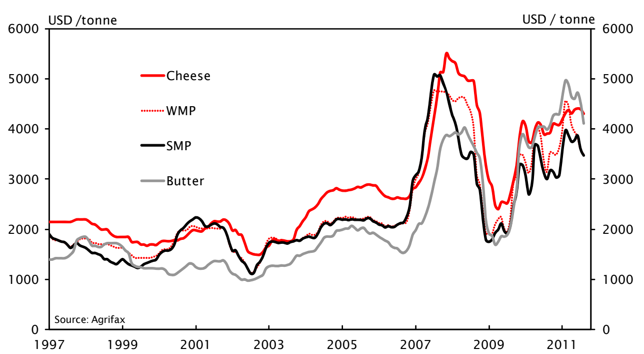
- **Dairy prices have been falling and recent turmoil in financial markets adds a layer of uncertainty to the outlook.**
- **We've lowered our own forecast for the current season's payout to $7 – this is a little below Fonterra's opening forecast payout.**
- **But situations like this are where a floating currency is helpful. Lower commodity prices should put downward pressure on the NZD, buffering farm gate incomes.**
- **Over a longer horizon, we maintain our view that ongoing volatility in dairy prices will be around an upward trend, driven by population and income growth, urbanisation and changing dietary preferences in emerging markets (particularly in Asia).**

While the headlines have been dominated by the carnage in markets of all persuasions over the last week, farmers (like others) will be thinking about how it affects them – and more specifically, how recent developments might affect payout prospects.

Global dairy prices started falling well before the recent turbulence in financial markets. Whole milk powder prices have led the fall, down over 20% from their early March auction levels. Northern hemisphere production has posted solid gains, particularly in Europe, while New Zealand had a strong finish to the 2010/11 production season. At the same time, global growth prospects have deteriorated.

In one sense, the decline in dairy prices is not such a big surprise. For a while now we've been expecting commodity prices to moderate in the second half of this year, based mainly on our prediction that growth in emerging market economies would slow. Of course, the unexpected turmoil in recent weeks adds a new dimension of uncertainty to the outlook, raising the possibility of a confidence-driven drop in prices. While this didn't eventuate in the latest Fonterra globalDairyTrade auction (instead prices continued to gradually slide lower) we're not sure the volatility has disappeared for good.

Dairy product prices



We are forecasting global growth to slow appreciably (from 5% in 2010 to 4.1% in 2011 and 3.5% in 2012), but we certainly don't expect another worldwide recession. Importantly for dairy prices, the weakness is likely to be concentrated in rich developed economies. The US, Eurozone and the UK are expected to remain key regions of weakness as structural debt concerns continue to weigh on prospects. In contrast, slower growth in emerging market economies, where the growth in dairy consumption has been so strong in recent years, is likely to be policy induced, as authorities seek to keep growth at a sustainable speed. With this in mind, we're expecting the entire basket of dairy product prices to trough only around 25% below recent peaks (this compares to price falls in the order of 50% during the global financial crisis) before starting to rebound.

Regular globalDairyTrade auction results provide a very useful, timely and transparent gauge for how dairy prices are tracking in Australasia, but we need to remember that not all Fonterra's production is sold via this platform (though the proportion is growing, from about 10% of the value of NZ exports in 2009 to almost 25% of the value of exports in 2010[1]). The remainder of production is sold via other methods, with the price potentially agreed some time in advance. Similarly, due to Fonterra's active currency hedging strategies, the average NZD/USD conversion rate over the season can vary considerably from moves in the spot rate.

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Nevertheless, given the strength of the New Zealand dollar, we've assumed a significant step-up in the average NZD/USD rate for the 2011/12 and 2012/13 season (from an assumed 0.67c in 2010/11 to 0.76c in 2011/12). This combination means we're now expecting a $7 payout/kgms for a 100% share-backed Fonterra farmer – a little lower than Fonterra's opening forecast of $7.15-$7.25 made in late May.

Product	Most recent Peak	% Change from peak
Butter	Feb 2011	-17%
SMP	Feb 2011	-13%
WMP	Feb 2011	-23%
Cheese	June 2011	-2%
Casein	June 2011	-2%

Source: Agrifax data, Westpac Calculations

	Payout[2]
2009/10	**$6.70**
2010/11(f)	**$8.10**
2011/12(f)	**$7.00**
2012/13(f)	**$6.00**
2013/14(f)	**$6.80**
Average (2009-2014)	**$6.90**

Our assumption is that dairy prices start to recover from mid 2012 as global growth prospects improve, supply tightens and current volatility weighing on markets recedes. Strong multi decade trends of population growth, urbanisation, increasing income and changing dietary requirements should see demand rising more quickly than supply, putting upward pressure on prices at this horizon.

While these forecasts incorporate our central view on the likely evolution of commodity prices, and the NZD, there is clearly a very wide range of plausible outcomes for both commodity prices and the NZD over the next few years. As always when forecasting, the further out we look, the greater the uncertainty around expected outcomes. But it is the relationship between commodity prices and the NZD which should provide a buffer for kiwi dairy farmers from the full force of international gyrations as softer commodity prices go hand in hand with a lower NZD.

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1. USDA Foreign Agricultural Service, GAIN Report NZ1107, May 2011.

2. Payout forecast assume a 100% share backed farmer and is before retentions.