Fortnightly Agri Update

17 May 2017

Step up

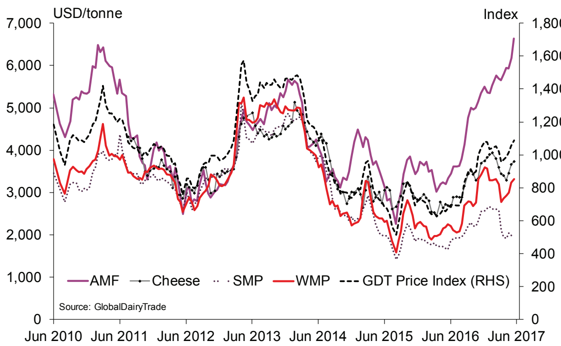
Dairy prices put in another strong showing at last night's GlobalDairyTrade auction. Prices overall rose 3.2% - that was the fifth consecutive rise and took prices to the highest levels this year. Although relatively small volumes are sold at these prices as New Zealand's production winds down to its seasonal low, it's an encouraging result nonetheless.

Milkfat prices continued to outperform with prices for anhydrous milk fat and butter rising sharply to record highs, around double the levels from a year earlier. Whole milk powder prices edged another 1.3% higher to $3,300/Tonne. Prices have now risen 20% since early March, and are nearly 50% higher than a year earlier when they were lingering just above US$2,200/Tonne. That's important as it means a higher starting point for prices as the new 2017/18 season begins in June. So while we continue to expect global prices to ease back later this year off the back of rising supply, the recent gains provide a solid foundation for the farmgate milk price.

Of course, the NZ dollar also has an important bearing for the farmgate price, and developments in the Kiwi have also been supportive. The NZD/USD is lingering around 68-69 cents, down from 73 cents in January. We're forecasting the NZD/USD to ease towards the mid-60s by middle of next year, off the back of rising US interest rates and a strengthening NZ dollar.

Taking all that on board, we've bumped up our forecast for the 2017/18 milk price to $6.50/kgMS (from $6.10/kgMS previously). That will be a step-up from the $6/kgMS milk price expected for the season just finishing, just shy of an extra $1 billion of farmgate income. While for some farmers the additional income will go straight to paying off the

Dairy prices



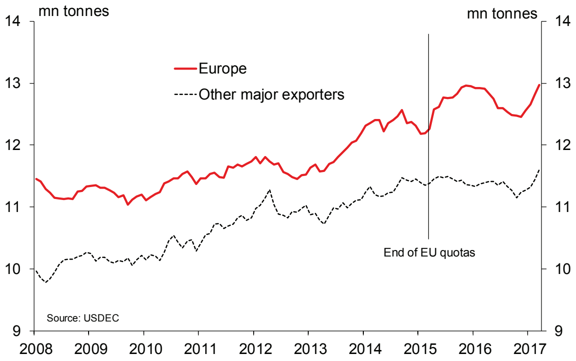
support loan from Fonterra, it will further shore up sentiment within the industry and support spending in dairy-intensive regions. Fonterra is expected to announce its opening forecast for the season after its board meets next week. It's likely to start with a conservative forecast, perhaps something in the low-$6s.

The recent gains in global prices have been impressive against a backdrop of improving global supply, especially from Europe and New Zealand. We're expecting milk production to continue trending higher over the remainder of this year, as farmers respond to higher farmgate milk prices and feed costs remain low. That's likely to see dairy prices come under a bit of downward pressure.

Notably, European production has firmly changed course following the retrenchment last year. Production in March was flat on a year earlier, and after adjusting for seasonal patterns, production has been rising since November.

That positive trend is expected to continue, even as environmental restrictions in the Netherlands (which accounts for around 10% of the region's production) weigh on growth. As a significant exporter off a large production base, swings in European production can result in large swings in the volume of product hitting global markets – highlighted by the surge in the region's production in 2015 that overwhelmed the market. In the US, production in March was up 1.7% on a year earlier, and steady growth looks set to continue.

Global milk production



Locally, we're expecting New Zealand's production to increase as the new season really ramps up from September. While there have been some concerns that the deluge of rain in March and April would impact production, we view this as taking the edge off an exceptional end to the 2016/17 season, rather than having a sustained impact. Importantly, the recovery in margins is expected to see some farmers increase herd numbers (which has been borne out by low numbers of culled cows so far this year), and provides greater scope for use of supplementary feed (although recent rain has hampered the grain harvest and may reduce the availability of locally sourced feed). As always, New Zealand's production will be subject to the weather. But after a terribly wet spring in 2016, last year's production should be a relatively easy benchmark to beat, resulting in some decent year-on-year growth through the second half of 2017.

While it's always more difficult to get a decent gauge on the demand side of the equation, recent price gains suggest import demand has been a bit better than we'd given it credit for. Signals from China have remained positive, with Chinese buyers capturing a high proportion of product offered at GlobalDairyTrade auctions over the past couple of months. Renewed momentum in the Chinese economy this year should continue to support conditions at the household level (in turn, supporting demand for dairy products), although growth is expected to slow a bit next year. However, with China's dairy industry still struggling with low profitability, milk growth has been limited, meaning consumption growth will need to be met by import growth for a while yet.

There was also solid growth in import demand from Algeria (New Zealand's second largest dairy export market) and Mexico in early 2017. Russia creates a wild card for dairy demand in 2018, with the embargo on imports from a number of Western countries expected to lapse in 2017 (although may well be extended further). But while lifting of the embargos will support demand, Russia's import demand is likely to remain much lower than a few years back due to the poor performance of the Russian economy and the lower Ruble that's made imported dairy products relatively expensive.

A notable feature of dairy markets at the moment is the record price divergences that have opened up across products. Milkfat has been extremely sought after, boosted by Western consumers' push back towards natural food products, and growing Asian bakery and foodservice markets. That's pushed milkfat prices to record highs. At the same time, skim milk powder has become an unwanted by-product, weighed down by record levels of European stockpiles, while whole milk power prices are in a moderate middle ground. At the moment, elevated milkfat prices are balancing out the depressed price of skim milk. But a key risk is that milkfat demand can't keep up with rising milk supply, or that high prices choke off demand. A fall in milkfat prices would weigh on the dairy price complex as a whole by encouraging a switch towards whole milk powder production.

GlobalDairyTrade Auction Results, 17 May 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	8.2%	$6,631
Butter	11.2%	$5,479
Butter Milk Power (BMP)	7.0%	$1,980
Cheddar	0.6%	$3,726
Lactose	2.0%	$967
Rennet Casein	-3.7%	$6,259
Skim Milk Powder (SMP)	1.0%	$1,998
Whole Milk Powder (WMP)	1.3%	$3,312
GDT Price Index	3.2%	

Payout Forecast Table

	2016/17		2017/18
	Fonterra	Westpac	Westpac
Milk Price	$6.00	$6.00	$6.50

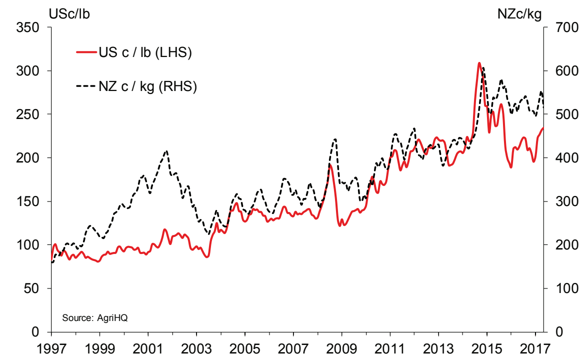
Sarah Drought
Economist

Beyond the farm gate

Beef

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

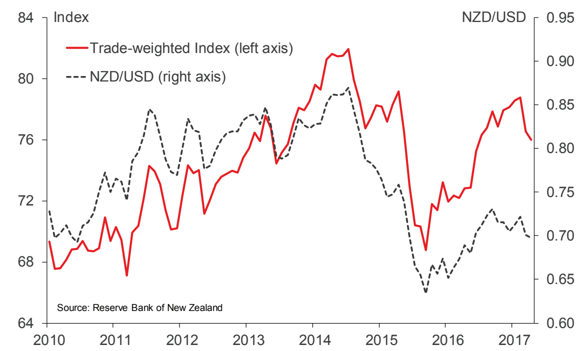
Global beef prices have continued their strong run, to be 10% higher than a year ago. Ongoing tight supply from Australia and New Zealand, and decent US consumer demand, have seen retailers scramble for product ahead of the peak summer consumption period. That market tightness has been despite a rise in US beef production, with first quarter production up 7% on a year earlier. Instead, those gains in production have largely headed offshore, with export growth to Japan and Korea particularly impressive. With the US recently granted access to export beef to China by July for the first time since 2003, competition in the Chinese market looks set to intensify further following the re-entry of Brazilian beef in 2015. That makes New Zealand's trial of chilled meat exports especially important, as it provides an opportunity to gain a foothold in the less-crowded, higher-value segment of the market.



NZ dollar

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

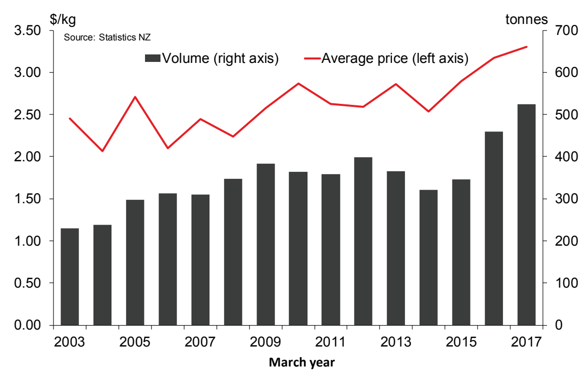
The NZ dollar has been on the back foot this year, as financial markets pared back the probability of RBNZ rate hikes in 2017. On a trade-weighted basis, the NZ dollar has fallen 6% since January, with the NZD/USD depreciating from around 73 to 68 cents currently. While we may see some consolidation in the NZD/USD this year, it's is expected to track down towards the mid-60s by mid-2018 off the back of rising US interest rates and a stronger US dollar. However, despite the recent depreciation, exporters to Europe (particularly the UK) and Australia continue to face historically high rates. And that's not expected to change anytime soon, as Brexit-related uncertainty is expected to weigh on the pound, while ultra-loose monetary policy keeps the euro low. Our year-end forecasts for NZD/GBP and NZD/EUR are 57 cents and 66 cents respectively. We're forecasting the NZD/AUD to remain around its current level of 93 cents.



Kiwifruit

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

The 2017 kiwifruit harvest got off to a slow start as the Bay of Plenty, New Zealand's prime kiwifruit region, was hit by heavy rain in March and April (the wettest two-month period since records began in 1890). While the harvest seems to have come through the deluge of rain largely unscathed, wet orchard conditions at the end of the growing season increases the risk of Psa disease, which swept through the region from 2010 to 2013. Putting that risk aside (which growers will be ever-vigilant about), the outlook is positive with the sector continuing to benefit from strengthening demand for gold kiwifruit, especially from Asia. While export volumes this season are expected to decline as green volumes fall, export receipts will fare better due to ongoing growth in the much higher-priced SunGold volumes as more vines reach full maturity.



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

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