Fortnightly Agri Update

18 October 2017

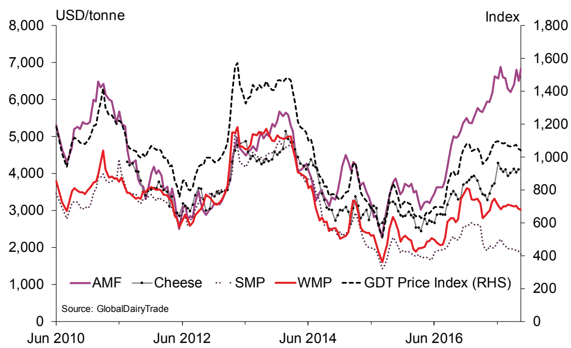
Dairy demand down

- Fonterra has downgraded forecast milk collections to 1,540 million KgMs for 2017/18.
- Recent auction results suggest subtle readjustments on the demand side.
- Chinese economy to see re-balancing that may affect consumption of dairy.
- However, world growth prospects are looking firm going forward.
- Our forecast remains at $6.50/KgMs, but downside risks may emerge.

There have been a few developments in the dairy market since our last significant update. We discuss the mixture of risks facing the market and what this means for prices. Most importantly is what implications lower production volumes and our forecast for slightly softer Chinese economic growth will have on dairy demand. Furthermore, this update will seek to provide some colour to our forecast milk price payout in comparison to Fonterra's payout ($6.75/KgMs).

Last night's GlobalDairyTrade auction saw a 1.0% decline in the overall dairy price index. Whole milk powder prices fell by 0.5% to US$3,014/t. Butter prices fell by 2.5% to US$5,736. Notably the supply story has been soft with caution to the weather. Further to this, we have determined that the additional volumes of WMP offered to the auction is not significant enough to have countered supply side issues. Notably, we may be seeing demand side weaknesses materialising, as the auction is one of the indicators of global demand, which has shown softer results in the last few months.

Dairy prices



Notably, this is the second time we have seen overall dairy prices fall, despite the auction being preceded by signs of tighter supply. While we were anticipating a pullback in prices this year, the actual outcome of auctions have been softer than expected.

In their recent Global Dairy Update, Fonterra downgraded their expected milk collections to 1,540 million KgMs. This is a growth rate of 1% from the previous season and significantly below the 3.2% expected at the onset of the season. The reason for this is the relatively soggy start to the new season and this notably hampered production. More importantly, the weather has already had a notable impact on production and milk collections.

A downgrade of milk collections has a significant impact on volumes entering the internationally traded dairy market. We think the forecast is suitably conservative, but note this is still highly dependent on how the weather pans out during the peak of the season.

Aside from supply side issues, the recent auctions suggest some caution on the demand side. It is unsurprising that China's consumer base is important to the on-going success of New Zealand's dairy industry. The rapid growth in China's middle class has been fundamental to the rise in demand and strong price action we have seen since the end of 2016. However, persistent concerns around the composition of the growth has led to some scepticism on China's performance going forward.

Our forecast for economic growth for China in 2018 is 6.2%, which is a dip from the 6.7% we expect this year. The Chinese government has their National Congress this week to begin their discussions around the vision for China over the next five years. A central theme of the meeting has signalled a strong desire to discuss reforms of credit appetites and attitudes. We are anticipating that the potential reforms in this space could lead to a slowdown in in the industrial economy (manufacturing, investment and at the margin exports) capping the growth opportunities for consumption.

The downside risk for the consumer is around corporate profitability and firms' willingness to hire. However, we maintain this to be a downside risk at this stage rather than a structural shift away from NZ dairy products.

Although any potential reforms may have immediate or near term effect on demand and by extension dairy prices, we expect prices to firm as demand from China strengthens going into the long term.

Putting all these factors together, we see that the risks to production will limit the total volumes milk collections for the 2017/18 season. However, we maintain our view that production volumes have room to pick up above the expected collections from Fonterra's update despite the poor weather.

On a global scale, we expect supply to certainly point to the upside of the previous season's volumes. Of the factors driving demand, we expect that the outcome of the National Congress will provide colour around the size of influence an economic reforms may have on Chinese demand for our dairy products going into 2018.

On balance, we retain our forecast farmgate milk price of $6.50/KgMs, though the risks are mounting to the down side. Our forecast is already lower than Fonterra's $6.75/KgMs, where other market forecasters have been to date.

Shyamal Maharaj
Economist

GlobalDairyTrade Auction Results, 18 October 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	5.2%	$6,841
Butter	-2.5%	$5,736
Butter Milk Power (BMP)	n.a	n.a
Cheddar	-0.1%	$4,107
Lactose	n.a	n.a
Rennet Casein	-8.6%	$5,612
Skim Milk Powder (SMP)	-5.6%	$1,797
Whole Milk Powder (WMP)	-0.5%	$3,014
GDT Price Index	-1.0%	

Payout Forecast Table

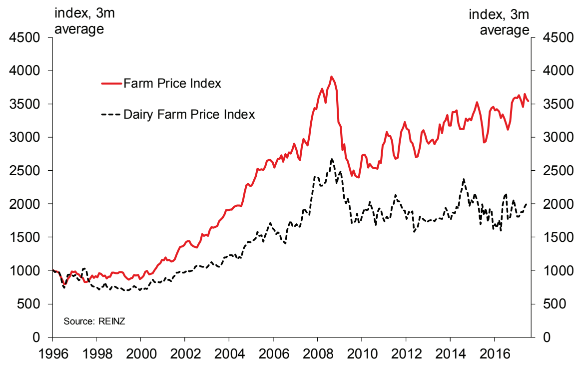
	2016/17	2017/18	
	Fonterra	Fonterra	Westpac
Milk Price	$6.12	$6.75	$6.50

Beyond the farm gate

Land prices

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

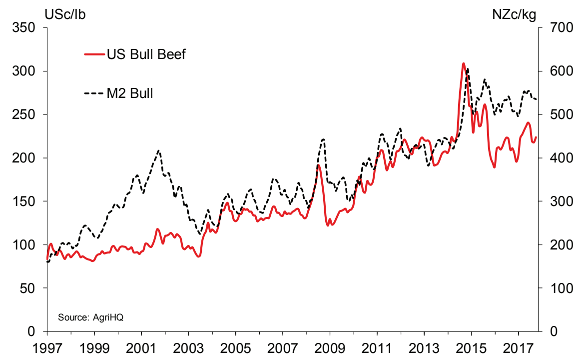
There has been little change in farm land prices, with the REINZ all farm price index down by 1.0% in the three months to September. At the same time, the number of sales were down by 30.2% in the three months to September. This followed a 12.9% decline in the three months to August. Wet weather over the past few months has significantly compromised the quality of pastures. And although the poor weather is not expected to persist, the costs of procuring additional land versus the need to solve problems on existing land seem to have materially influenced the decisions of farmers. The REINZ dairy farm price index rose by 0.8% in the three months to September, with a low number of sales.



Beef

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

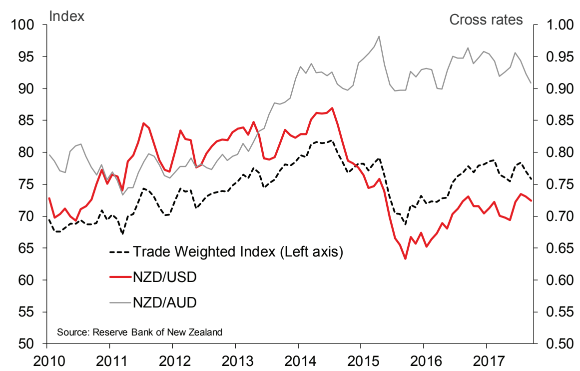
Anticipated boosts to supply coming from the Southern Hemisphere (Brazil, Australia and New Zealand) are being reflected in the prices for beef. US imported beef prices have eased, as the market is expecting a rise in New Zealand's bull production going into the Christmas trade. Although demand has kept prices generally firm through September, the expectation of rising supplies has been the driving factor. We expect strong seasonal demand will limit the downside for prices, but at the same time increasing supply will limit any potential upside.



NZ dollar

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

Political uncertainty continues to weigh on the exchange rate as the markets wait for an announcement on who will form the next New Zealand government. We are anticipating a softer NZD and stronger USD over the remainder of this year, and hence we expect the exchange rate to level off at US$0.70. Factors supporting the US dollar are firming US economic conditions such as rising manufacturing activity and declining unemployment. However, US inflation data has behaved differently to firmer US economic fundamentals. This has capped the pace of resurgence in the USD. Markets continue to expect another interest rate hike by December. Expectations for continued gradual tightening of US monetary policy means that the NZD/USD is likely to settle in the high 60s over 2018.



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

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