

# Fortnightly Agri Update

2 August 2017



## How much milk?

As the new dairying season gets under way in New Zealand, we take a look at the range of possible outcomes for global milk production. On balance, we see a stronger chance that milk volumes will exceed market expectations, which would put downward pressure on dairy prices over the coming year.

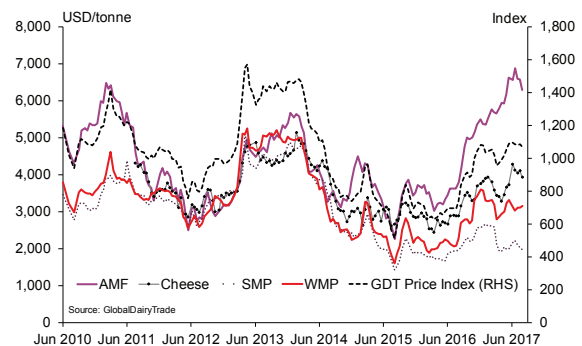
New Zealand's dairy industry produces largely for the international market, and we are the single largest exporter of dairy products. So changes in New Zealand's expected milk volumes – more precisely, unexpected changes – will have a significant impact on prices in the international market.

Fonterra reports that its milk collections were down by 2.6% last season. Part of that reflects its ongoing loss of market share to smaller processors; industry-wide milk collections were down just 0.6%. Fonterra's starting forecast for this season is for a 3.2% rise in volumes, which would make up for last year's decline, but not much more than that.

The global dairy market appears to put a lot of weight on Fonterra's guidance – changes in its milk volumes forecast are often followed by significant changes in international prices. So it's well worth reviewing the risks around how this forecast might change as the season progresses.

Milk collection figures for June showed a steep increase on last year. But this is the lull of the season, typically accounting for around 0.5% of the annual total, and tells us nothing about what the industry will be capable of producing in the peak period. However, there are other indications that production could end up substantially ahead of forecast this season:

### Dairy prices



- Last year's underperformance was largely in the first half of the season. Poor weather hindered pasture growth, and the low initial outlook for farmgate milk prices didn't provide farmers with much incentive to lift production. During the peak October-December period, industry-wide milk collections were down 5% on the previous season. But with a stronger outlook for dairy prices and – hopefully – no repeat of last year's weather, it should be easy to beat last season's performance over the next few months.
- Milk production picked up strongly in the second half of last season, and by March-April it was running 8% ahead of the previous year. What that implies is that the industry's productive capacity had grown significantly by early 2017 – and that the industry is coming into the new season with that same increased capacity.
- Lower slaughter numbers over the last year suggest that farmers are rebuilding their herds again, having cut back

during the two earlier seasons when milk prices were very low.

- Higher dairy prices will encourage farmers to invest in increasing output per cow, such as by bringing in additional feed. Palm kernel expeller seems to be coming back into fashion, despite Fonterra's discouragement: New Zealand imported 1075m tons of PKE over the first half of 2017, up 60% on the same time last year.
- One of the results of this year's wet weather is that moisture has penetrated deeply into the soil. That bodes well for pasture growth once the weather warms up.

All that said, it's very early in the season, and there is still plenty of opportunity for weather events – either flooding or drought – to set back milk production during the peak periods. But on balance, we see more scope for New Zealand's milk volumes to beat market expectations over this season.

What about production in the rest of the world? Europe has become more of a swing factor for dairy prices in recent years, particularly since the removal of the region's quota system in 2015, which gives dairy farmers more scope to increase production whenever prices are favourable. European production rose strongly over late 2016 and early 2017, in line with the rebound in world dairy prices. It has dropped back a bit in the last few months, but with farmgate milk prices generally above break-even levels, the incentive is there to produce more.

There's some uncertainty around the outlook for milk production in the Netherlands, one of the largest dairy producers in Europe, with predictions that new emissions standards will force farmers to reduce their herd sizes. However, there's no clear evidence yet that milk production in the Netherlands is underperforming the rest of Europe, and anecdotes suggest that farmers may send their cows to other parts of Europe rather than cull them, so the net impact on milk production could be small.

Milk production in the US is also on the rise. While the US has become a more significant exporter of dairy products in recent years, the prices that farmers receive (and therefore the incentives to produce more or less) are largely a product of domestic demand. Household incomes in the US are growing slowly but steadily, and the renewed fashion for butter in Western diets has also helped to boost prices.

Rounding out the world's top five exporters are Australia and Argentina, both of which saw a decline in milk production over 2016 (down 6% and 14% respectively). Production is no longer falling in these countries, and has picked up slightly in recent months.

We see the risks as being towards a strong lift in milk volumes, from both New Zealand and elsewhere, hitting the global export market over the coming year. Obviously, supply is only one half of the story – changing trends in demand are also important, just harder to identify. But on balance, we think we could see some downward pressure on world dairy prices over the coming months.

For that reason, we're not ready to join Fonterra in upgrading our farmgate milk price forecast for this season. In July Fonterra increased its forecast to \$6.75/kg; in contrast, our forecast remains at \$6.50/kg.

### Michael Gordon

Senior Economist

### GlobalDairyTrade Auction Results, 2 August 2017

|                          | Change since last auction | Price index USD/Tonne |
|--------------------------|---------------------------|-----------------------|
| Anhydrous Milk Fat (AMF) | -4.9%                     | \$6,289               |
| Butter                   | -4.9%                     | \$5,747               |
| Butter Milk Power (BMP)  | 0.4%                      | \$2,198               |
| Cheddar                  | -4.8%                     | \$3,932               |
| Lactose                  | -4.3%                     | \$787                 |
| Rennet Casein            | -4.4%                     | \$6,122               |
| Skim Milk Powder (SMP)   | -3.0%                     | \$1,966               |
| Whole Milk Powder (WMP)  | 1.3%                      | \$3,155               |
| GDT Price Index          | -1.6%                     |                       |

### Payout Forecast Table

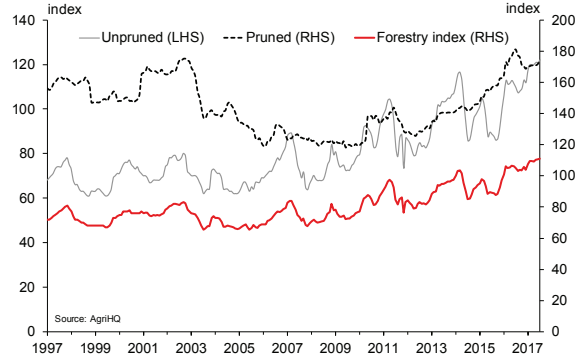
|            | 2016/17  | 2017/18  |         |
|------------|----------|----------|---------|
|            | Fonterra | Fonterra | Westpac |
| Milk Price | \$6.15   | \$6.75   | \$6.50  |

# Beyond the farm gate

## Forestry

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

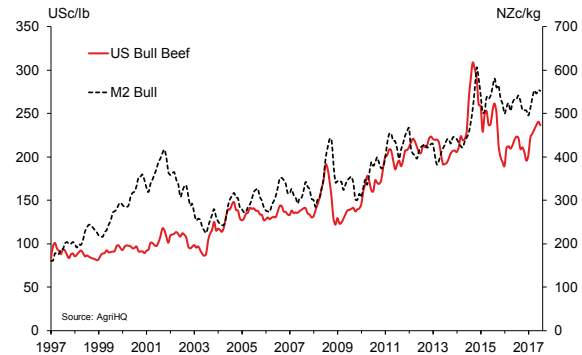
Log prices have remained firm this year. AgriHQ's log price index edged higher in July, and was up 5% on a year earlier. The outlook for construction in New Zealand continues to underpin high prices in the domestic market and we expect this to continue, with a large amount of residential building planned over the coming years. That said, the global outlook especially in China remains the focus. Chinese demand for logs is expected to remain a key driver through this year as the Chinese government aims to present a strong economy ahead of November's National Congress. However, Chinese demand has its uncertainties, and combined with rising global supply (encouraged by high log prices), export prices could come under some downward pressure heading into next year.



## Beef

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

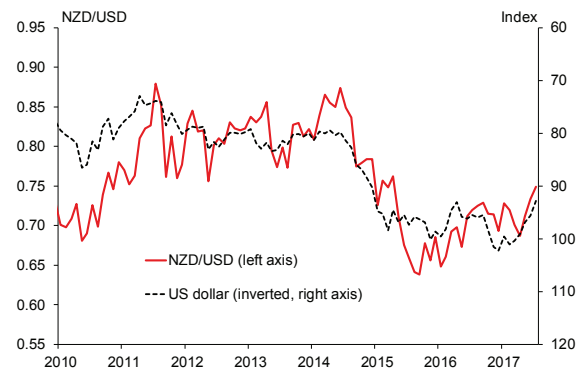
Global beef prices pulled back a little in July, though they are still well up on the same time a year ago. Ongoing tight supply from Australia and New Zealand, and decent US consumer demand off the back of a strengthening economy, have seen retailers scramble for product ahead of the peak summer consumption 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.



## NZ dollar

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

The New Zealand dollar has risen strongly in recent weeks. Some of this stems from reduced optimism around the US dollar: the Trump administration's planned growth policies are facing increasing obstacles, and lower than expected inflation has cast some doubt on how far US interest rates will need to rise. Meanwhile, the global market continues to regard the New Zealand economy in a positive light. Interest rate markets are factoring in increases in the Official Cash Rate over 2018, a view that we don't share.



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



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