Westpac Institutional Bank

Fortnightly Agri Update

22 February 2017

Better balance

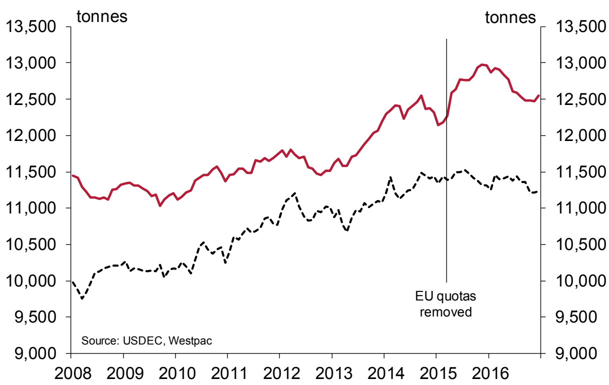
Dairy prices fell 3.2% in last night's GlobalDairyTrade auction, following modest gains over the previous two auctions. Whole milk powder prices fell 3.7% to $3,189/MT, with fat-based products continuing to outperform. While whole milk powder prices have fallen to the lowest level since October last year, they are still 55% higher than mid-2016. Overall, dairy markets have found themselves in a much more balanced position this year, as last year's retrenchment in global supply begins to taper off, while demand has remained steady.

In New Zealand, production conditions in most regions have been much more favourable over the past few months following a horrid spring. Fonterra's milk collections in January were down only 1.4% from the previous year, a far cry from the 8.3% decline recorded in October, and losses for the season to date have been pared back to 4.9%. And as a result of better conditions, Fonterra has upgraded its forecast for the season's milk production, from a loss of 7% to 5%. Consequently, they bumped up their expected offerings on the GlobalDairyTrade platform over the next 12 months by 1.6%, which looks to have been a key catalyst behind last night's fall in prices. We had taken a less pessimistic view on production for this season, and taking account of Fonterra's declining market share over time, Fonterra's forecast now broadly aligns with our own view for a 3% fall in nationwide supply. Decent rainfalls over the past couple of weeks will have kept the summer dry at bay in many areas, adding a further boost to short-term production prospects.

Looking abroad, supply conditions remain tight but as in New Zealand conditions look to be stabilising. The largest reduction in milk volumes has been in Europe (which was also responsible for the lion's share of the -earlier surge in global supply). Milk production in December was 3% lower than a year earlier, an improvement from a 3.5% decline in November. And on a seasonally adjusted basis, production has been edging higher over the past couple of months. The trends in European production are key for the outlook for global supply. With farmgate prices rising in recent months, we should see some supply response as the year goes on, although environmental constraints especially in the Netherlands may hold back some production. Large stockpiles of skim milk powder also need to be released onto the market at some stage.

On the demand side, we'd characterise conditions as steady rather than stellar. China's imports of whole milk powder recovered in 2016, following a particularly soft patch in 2015, and in auctions this year, we've seen buyer activity from China rebound after dropping away a bit late last year. We expect China's growth prospects to hold up this year as the Chinese government will be keen to maintain a strong economy in the lead up to November's National Congress. This should bolster employment prospects, and underpin household demand. However, this positive outlook is balanced against uncertainty about the Trump Administration's protectionist trade policies, and what these might mean for trade conditions and demand for commodities across the spectrum.

Milk production, top 5 exporters



Pulling it all together, we expect global prices to ease a little bit more in coming months as the stabilisation in global supply materialises. We continue to forecast a farmgate milk price of $6.20/kgMS this season, and have pencilled in $6.50/kgMS for next season. With a majority of this season's production already sold, there would need to be a sharp decline in prices to create material downside for this season's forecast, but next season's forecast is a different story. And of course, its's not just uncertainty about where global milk prices are headed, but also the NZ dollar. The NZ dollar has been resilient this year, with the NZD/USD currently around 71 cents. But with rate hikes on the cards in the United States this year and next, the US dollar is expected to strengthen, and push the NZD/USD lower. We're forecasting the NZD/USD to fall to 67 cents by year end, and track a bit lower in 2018.

Sarah Drought, Economist

GlobalDairyTrade Auction Results, 22 February 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	-1.3%	$5,693
Butter	0.2%	$4,598
Butter Milk Power (BMP)	-12.9%	$2,090
Cheddar	-5.3%	$3,590
Lactose	6.8%	$966
Rennet Casein	-5.8%	$6,135
Skim Milk Powder (SMP)	-3.8%	$2,574
Whole Milk Powder (WMP)	-3.7%	$3,189
GDT Price Index	-3.2%	

Payout Forecast Table

	2016/17		2017/18
	Fonterra	Westpac	Westpac
Milk Price	$6.00	$6.20	$6.50

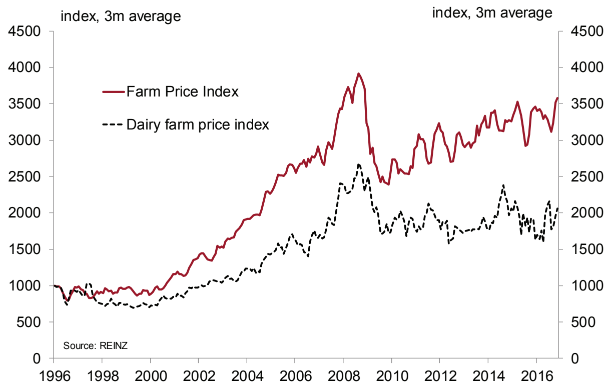
Beyond the farm gate

Land prices

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

The REINZ farm price index showed a further rise in prices in January, taking prices 4% higher than a year earlier. Within this, dairy farm prices have performed strongly, recovering from a soft patch in early 2016 to be up 9% from a year ago. The improved outlook for the farmgate milk price has helped shore up sentiment within the industry, and is no doubt helping to support dairy farm prices. That said, turnover of dairy farms remain relatively light, and anecdotally, interest in lower-quality farms remains patchy. With two tough seasons still fresh in memory, and many farmers needing to get balance sheets back in order, we wouldn't expect to see a strong run-up in prices in coming months.

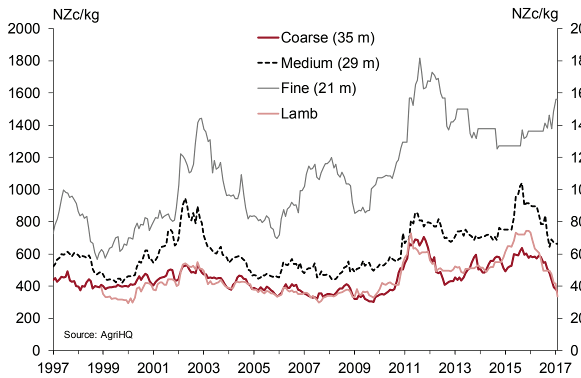
REINZ farm price index



Wool

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

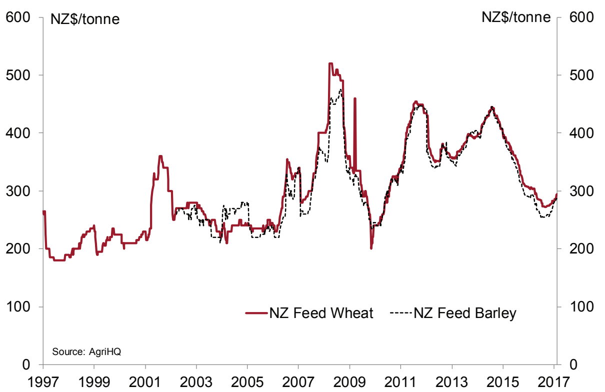
Wool prices have been under significant pressure with prices for coarse wool down around 35% from a year earlier. This fall in prices reflects a decline in Chinese demand (which has accounted for over half of New Zealand's exports in the past couple of years). One reason for soft demand appears to be fibre substitution; China has been running down its large cotton stocks, while low oil prices (despite rising from 2016's trough) continue to make synthetics fabrics relatively attractive. Pressure on wool prices intensified further this year as New Zealand's wool production begun rising to its seasonal peak. While low prices might mean less wool makes it to auction (as growers struggle to cover shearing costs), prices are likely to remain under pressure until production begins to taper off (typically from March). Thereafter, a recovery in Chinese supply is vital for a sustained rebound in prices. Prospects for fine wool (such as merino), however, have remained more positive, with prices up 14% over the past year.



Grain

	Current price level compared to 10 year average	Next 6 months
Trend	Low	➔

NZ feed grain prices have been edging up in recent months, although still remain lower than a year earlier. Some improvement in prices isn't surprising, given the significant improvement in the dairy sector outlook which will have made farmers much more open to purchasing supplementary feed. Globally, grain stocks remain ample. Global wheat and corn production are at record levels, keeping prices low. For overseas dairy and beef farmers who operate more feed-intensive systems, low grain costs are helping to keep input costs well-contained, making it more economical to lift production for any given final product price.

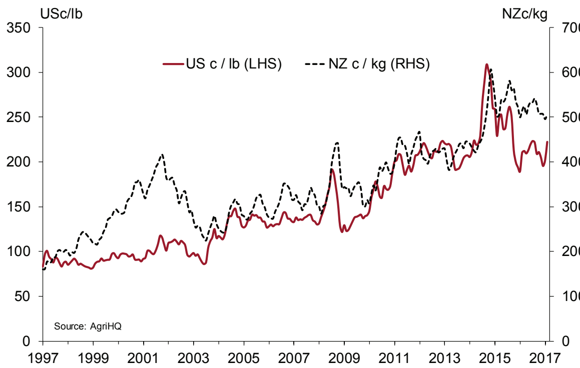


NB: Trend arrows indicate direction of change in world prices.

Beef

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

Beef markets found some renewed support over the past month, with near-term supplies, including from New Zealand, falling a little short of expectations while end-use demand in the US remains strong. While US supply is expected to record another year of solid growth, this is balanced against declining beef production in Australia as farmers continue to rebuild herds. Meat and Livestock Australia expect Australia beef exports to fall 5% in 2017. With Australian supply expected to be the tightest through the first half of the year, US manufactured beef prices are expected to track broadly sideways for the next few months but might come under some downward pressure later in the year. Meanwhile, prices for prime cuts have been under some downward pressure as competition heats up across markets. US exports into Japan and Korea have picked up, and in China, exports from Brazil have risen rapidly since Brazil re-gained market access in 2015.



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