

Fortnightly Agri Update

22 November 2017



Assurance in uncertain times

- Dairy futures contracts are growing in popularity.
- The GlobalDairyTrade platform is building a stronger base of sellers and attracting more buyers.
- The trend is towards a deeper global dairy market.

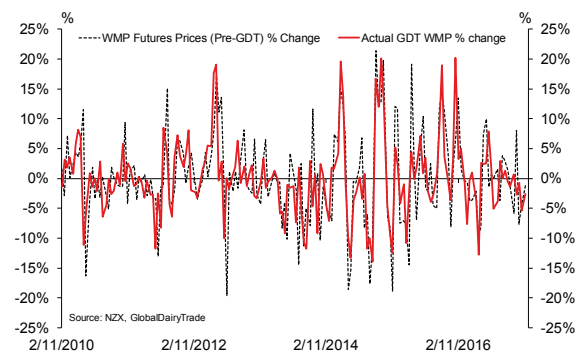
GlobalDairyTrade Auction Results, 22 November 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	0.0%	\$6,887
Butter	-5.9%	\$5,144
Butter Milk Power (BMP)	n.a	n.a
Cheddar	-4.2%	\$3,831
Lactose	n.a	n.a
Rennet Casein	-12.6%	\$4,644
Skim Milk Powder (SMP)	-6.4%	\$1,701
Whole Milk Powder (WMP)	-2.6%	\$2,778
GDT Price Index	-3.4%	-

Farmgate milk price forecasts

	2017/18		2018/19
	Westpac	Fonterra	Westpac
Milk Price	\$6.20	\$6.75	\$6.50

Predictive power of NZX WMP Futures



In this update, we explore the usefulness of dairy futures as a tool for New Zealand farmers to manage price volatility and risk, and how the dairy futures market has evolved since its inception.

Dairy farmers face a great deal of risks that can both increase or decrease their costs and revenue. Locally, one of the major risks of late has been extreme weather conditions, leading to wet pastures that increase the costs to produce and more importantly the ability to produce. In terms of the global economy, commodity prices, exchange rates and interest rates can all have a bearing on the returns to farmers for selling their milk to processors like Fonterra.

Around 95% of milk collected in New Zealand is exported, meaning that our farmers are exposed to the temperament of the global markets. Although global dairy demand

has picked up over the past year, it can be subject to unforeseen swings, which affect the prices paid to farmers by local processors. These swings in turn can affect New Zealand dairy farms' ability to manage cash flows and debt servicing. As such, there's a role in the market for products that provide more certainty around commodity prices.

The NZX defines a futures contract as an agreement to deliver/collect a specific quantity and quality of a given asset/commodity, at a specified date in the future, at an agreed price today. Trading on the futures market enables both farmers and processors to lock in prices and manage their degree of exposure to unfavourable movements in world prices.

In part, the role of futures contracts has grown naturally because of an improved platform for risk management. But outside of this trend, there is also a growing awareness among newer-generation farmers about managing risk better. Still, New Zealand farming methods have been rooted in traditional practices for many years, and ingrained culture appears to be a one of the major reasons why the uptake of dairy futures contracts still has a long way to go.

One of the key considerations in using futures contracts is whether the contract price accurately reflects the price of the underlying product (whole milk powder, anhydrous milkfat, and so on). As the futures market has attracted greater interest, we have observed an improvement

over time in the predictive power of futures prices. That makes these prices particularly useful as a real-time gauge of what's going on in the global dairy market, outside of the twice-monthly snapshots provided by the GlobalDairyTrade auction.

However, the fit is still far from perfect. We note that, on average, the NZX dairy futures predict the direction of change in GDT auction results within an acceptable margin of error when dairy product prices are under downward pressure, but less so when prices are rising.

Pricing tends to be a reflection of the sentiment of participants following preceding auctions. This has led to hit and miss outcomes at times, such as the recent tendency for futures prices to over-estimate the GDT auction results. But as the chart shows, this does not detract from the relative improvement in the predictive power of futures prices over time.

As the global market for dairy matures, the value and role of a fully functional futures market will be invaluable to New Zealand dairy farmers. Futures and other derivatives provide farmers with ways to manage cash flow, smooth revenue and manage debt servicing in the face of market uncertainty.

Shyamal Maharaj
Economist

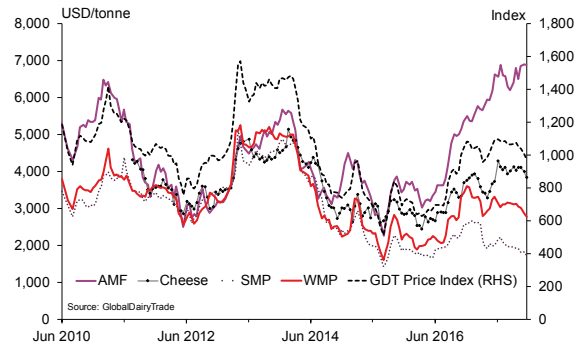
Beyond the farm gate

Dairy

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

Last night the GlobalDairyTrade platform had its 200th auction, which saw a 3.4% decline in the overall dairy price index. Prices fell despite dairy futures pricing in a slight rise. Whole milk powder prices fell by 2.7% to US\$2,778/t, while butter prices fell by 5.9% to US\$5,114/t. The decline in dairy product prices since the middle of this year, despite milk production forecasts being cut back in that time, suggests ongoing softness in demand.

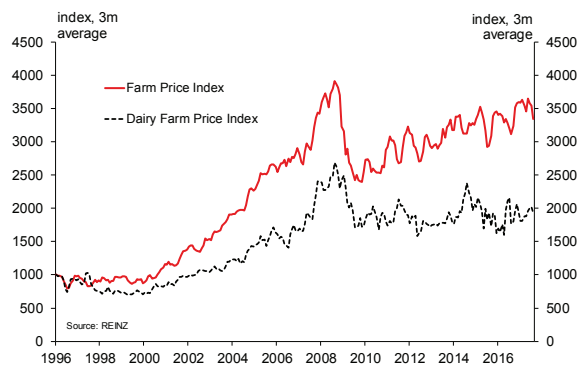
Factors continue to reinforce our farmgate milk price forecast for this season at \$6.20/KgMs. With our view that China's economic growth will slow next year, we see downward pressure mounting on dairy commodity prices. A lower exchange rate will soften the impact to some extent, but this will matter more for next season's farmgate milk price, which we forecast at \$6.50/KgMs.



Land prices

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

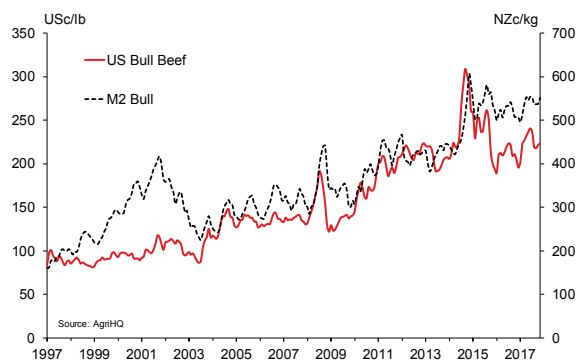
Farm sale prices saw their usual seasonal decline in October. Compared to a year ago, the REINZ All Farms Price Index is up 7% and the Dairy Farm Price Index is up 9%. Turnover remains subdued, with the number of farm sales in the three months to October down 26% on the same time last year. Uncertainty around the impact of the new Government's policies are likely to weigh on decisions about land use over the coming year. Policy priorities include reducing net carbon emissions to zero by 2050 (which will likely mean including agriculture in the Emissions Trading Scheme), improving water quality, and restricting foreign purchases of land and other assets that are deemed sensitive.



Beef

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

Prices for beef schedules are showing temporary strength as we enter a period of heightened demand and constrained supply. In particular, US imported beef prices firmed further, beyond the expectations of many exporters. Prices remain firm because of the continued shortage in schedules available on the spot market. However, manufacturing beef is expected to come back on stream going into 2018 as the US boosts supply. We are already seeing a ramping up of production of manufacturing beef from Brazil, driven by their view of growing Chinese demand. Prices are likely to stay firm through the New Year, but going into 2018, prices will ease following this seasonal uptick.



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

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