



# Fortnightly Agri Update

5 April 2017



## Balancing act

After a rocky ride in recent months, global dairy prices look to have found a base. In last night's GlobalDairyTrade auction prices rose 1.7%, building on the 1.6% rise a fortnight earlier. Whole milk powder prices have risen 5% over the past two auctions, to be back above US\$2,900/tonne. Although prices are still down nearly 20% this year, they're 40% above mid-2016's levels of just above US\$2000/tonne.

Following the extremely weak auction in early March (when whole milk powder prices fell 12%), the last two auction results have been encouraging. Global dairy prices have been known to over-run fundamentals and we had been concerned about further near-term downside in prices. But dairy markets had more resilience than we gave them credit for, as buyers stepped in to take advantage of lower prices. As a result, we've upgraded our forecast for this season's (2016/17) farmgate milk price from \$5.90/kgMS to \$6.00/kgMS – in line with Fonterra's latest forecast. At its half-yearly update Fonterra indicated confidence in its guidance for a 40 cent dividend, which would take the total cash payment to \$6.40/kgMS. For next season, a farmgate milk price in the low \$6's is our base case, although the uncertainty bands are wide at this early stage.

With the global dairy market looking broadly balanced at the moment, we expect global prices to track around current levels this year (albeit with the usual volatility). However, there are a lot of moving parts in play. On the supply side, the trend in global milk production has now turned, supported by improving farm gate milk prices, low feed costs, and favourable weather in key regions. Rising global supply is expected to cap the upside to dairy prices this year and, if weather conditions allow, there is a risk that

higher supply overwhelms the market (especially over the second half of the year) and leads to softer prices.

And while global dairy demand has improved over the past year, it's patchy across regions and products. China has driven the recovery in global import demand, with its dairy imports rising 13% in 2016. China's imports have risen further in the first two months of 2017, and ongoing growth remains a key balancing factor for global dairy markets.

By product, demand for milkfat has been strong, supported by Western consumers' push back towards natural food products and the rapidly developing Asian bakery market among other factors. This has pushed milkfat prices to around record levels this year. Meanwhile, skim milk powder prices are extremely depressed with it becoming somewhat of an unwanted by-product: EU intervention stockpiles have risen to a record level of over 400,000 tonnes – equivalent to 20% of 2016's SMP exports from the big-5 producers. Whole milk powder prices have been more moderate, but the risks ahead are interlinked with developments in milkfat markets. If milkfat demand can't keep up with rising US and European supply, this would weigh on fat prices and (assuming skim prices remained depressed) would likely see more NZ and European milk shifted into whole milk powder production.

### Global supply

One of the big surprises for global dairy markets this year has been the rebound in New Zealand's milk production, courtesy of plentiful summer and autumn rainfalls. At the end of November, production was running 3.7% behind a year earlier, but this had been pared back to 2.6% by February (2.2% if adjusting for the leap year last year). This

loss is expected to narrow further through to the end of the season in May as good pasture conditions allow farmers to milk more cows for longer. That said, severe rain as we write will create challenges for farmers in some regions.

The changing fortunes of New Zealand's season really caught the market's attention in February when Fonterra began upgrading its forecast milk collection. Fonterra are now forecasting its collections to be down 3% this season (about half of which is lost market share), compared to a 7% fall forecast earlier this year. This change resulted in a significant increase in the amount of product the market had to absorb, and was a key catalyst sending WMP powder prices back below US\$3000/MT in March.

Providing some partial offset to the upside surprise in NZ supply has been a continued contraction in milk production in Argentina, the 3rd largest exporter of whole milk powder (behind NZ and Europe). Milk production fell 13% in 2016 after flooding caused major challenges, and production was hit by another severe bout of flooding in early 2017. Argentina is an important supplier of milk products for the rest of South America, and ongoing disruptions to production have resulted in a significant decline in whole milk powder exports.

As milk production in the Southern hemisphere winds down, the focus turns North where a solid spring flush looks to be shaping up. Although European production in January was 2.5% below a year earlier, on a seasonally adjusted basis it's edged higher over the past couple of months. The significant lift in farm gate prices in recent months (to be 30% above mid-2016's lows), will encourage farmers to expand supply. The European Commission is forecasting milk production to rise 0.6% this year, with the strongest growth expected in the second half of the year.

Steady growth in US milk production continues, with output in the first two months of 2017 2.4% higher than a year earlier. With low feed costs ensuring decent margins, the US dairy herd has grown to its largest in 20 years and solid growth in production is expected to continue. While strong domestic demand, especially for milkfat, has seen much of the growth absorbed internally, there has still been strong growth in skim milk and whey powder exports.

## Global demand

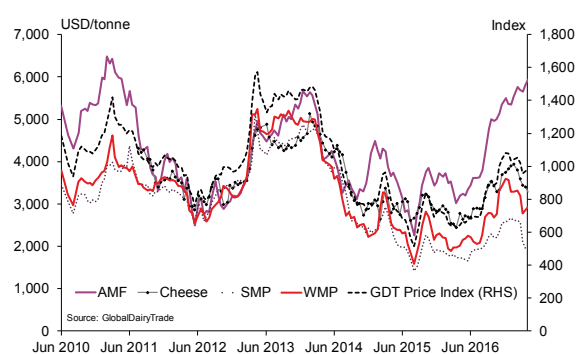
China plays a key role in global dairy markets, and its recovery in import demand over the past year has provided significant support to global dairy prices. After strong growth in 2016, China's dairy imports increased further in early 2017. Part of this recovery in China's imported demand reflects issues within China's domestic dairy industry, with domestic milk production declining in 2016. Ongoing financial pressure within the sector, and a relatively high price of domestic dairy products is expected to underpin continued growth in imports this year. In addition, demand in South East Asia has been steady in recent months.

Another area to watch on the demand side is Mexico, where rising trade tensions with the US have the potential to cause some short-term disruption in global dairy markets. Mexico

is the US's largest market, accounting for around 25% of its dairy exports. A recent deal that saw Mexico buy 15,000 tonnes of skim milk powder from Europe (more than Mexico usually buys from the region in a year) underscores the shifting trade dynamic. This could push US dairy products elsewhere, potentially into Asia where US exporters have existing trade relationships, thereby increasing competition in the short-term as the product finds a new home. That said, with global import and export volumes unchanged, any impact on prices should be short-lived.

Demand from oil-dependent Middle East and North Africa region remains uneven. For the most part, demand has been subdued, as low oil prices and ongoing conflicts remain a significant drag on incomes. These trends are unlikely to change in the short-term. However, demand from Algeria (which is New Zealand's second largest individual dairy export market) has bucked the trend, with imports rising to make up for a short-fall in domestic milk production.

## Dairy prices



**Sarah Drought**  
Economist

## GlobalDairyTrade Auction Results, 5 April 2017

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	2.5%	\$5,936
Butter	-1.6%	\$4,751
Butter Milk Power (BMP)	-12.2%	\$1,588
Cheddar	-4.4%	\$3,288
Lactose	2.2%	\$927
Rennet Casein	6.9%	\$6,260
Skim Milk Powder (SMP)	-0.8%	\$1,913
Whole Milk Powder (WMP)	2.4%	\$2,924
GDT Price Index	1.6%	

## Payout Forecast Table

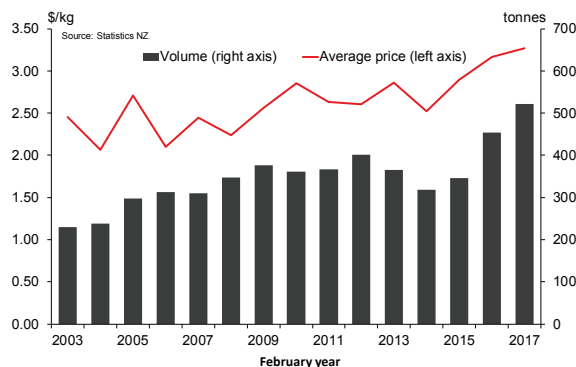
	2016/17		2017/18
	Fonterra	Westpac	Westpac
Milk Price	\$6.00	\$6.00	\$6.10

# Beyond the farm gate

## Kiwifruit

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

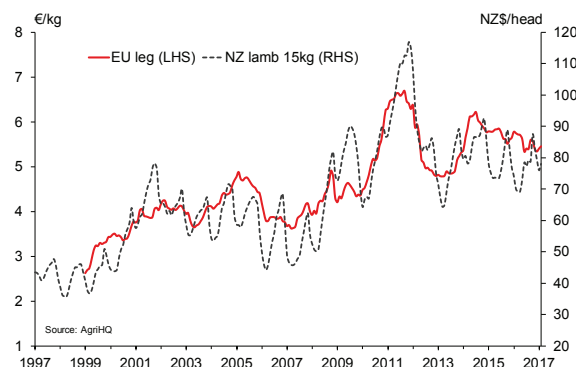
The 2017 New Zealand kiwifruit season is now underway, with the first of Zespri's shipments leaving our shores a fortnight ago. While it will be hard to match 2016's record harvest and export receipts (which rose a whopping 19% to \$1.7 billion), the outlook for the sector remains bright. Export volumes are expected to decline this season due to a reduction in green kiwifruit, although overall receipts will fare better given ongoing growth in the much higher-priced SunGold volumes as more vines reach full maturity. The sector continues to benefit from strengthening demand for gold kiwifruit, especially in Asian markets. Last season saw particularly strong growth in demand from Japan and China, the two largest markets.



## Lamb

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

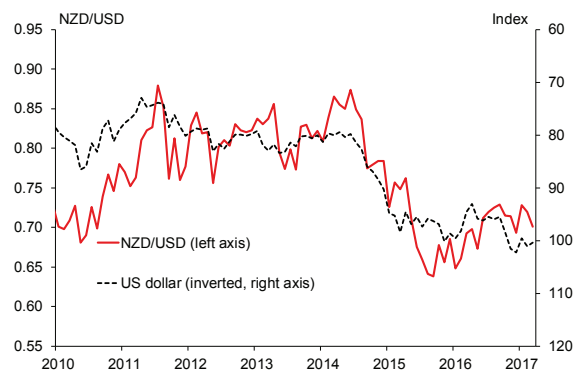
Constrained supply continues to dominate global lamb markets. While New Zealand's lamb slaughter has been improving, cumulative season throughput in early March was still down 7% from a year earlier. Tight supply is underpinning higher prices in offshore markets, and has resulted in processors competing strongly to secure volume. As a result, schedule prices have improved over the past month (to be up 17% year-on-year), whereas they would typically soften following the completion of the chilled Easter trade. Within Europe, leg prices in the UK have outperformed, and are 32% higher than a year ago. However, further price gains might start having detrimental effects for long-term demand, while there is also significant uncertainty about the future state of UK demand as Brexit negotiations progress. Meanwhile, China's demand for sheepmeat has continued to strengthen, boosting the NZD prices for frozen forequarter and flap exports, which are nearly 30% and 50% higher than a year ago.



## NZ dollar

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

The NZ dollar has eased around 3% on a trade-weighted basis since January, but it's still 5% higher than a year ago. We expect the NZ dollar TWI to ease this year and next, although movements will likely be mixed across currencies. We're forecasting the NZD/USD to depreciate to around 67 cents by year-end and towards the low-60s by the end of 2018. This is underpinned by a forecast for a slightly stronger US dollar as the Federal Reserve continues on its path of gradual policy tightening. Meanwhile, exporters to Europe will likely face continued currency headwinds. The NZD/GBP is forecast to linger around 56-57 cents over the coming year, with Brexit negotiations expected to weigh on the British pound. And with monetary policy in the euro area expected to remain very stimulatory, the NZD/EUR is forecast to remain around 66 cents.



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

# Contact the Westpac economics team

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**Michael Gordon**, Acting Chief Economist +64 9 336 5670

**Satish Ranchhod**, Senior Economist +64 9 336 5668

**Sarah Drought**, Economist +64 9 336 5696

**Any questions email:** [economics@westpac.co.nz](mailto:economics@westpac.co.nz)

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