Fortnightly Agri Update

16 May 2018

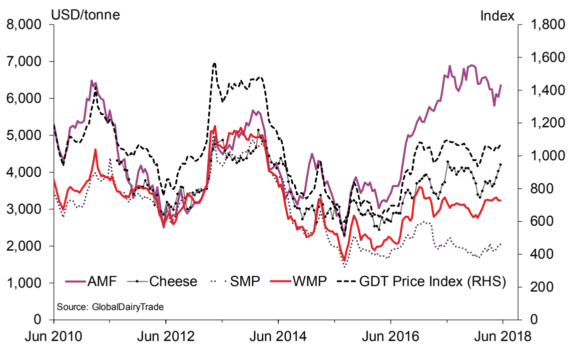
Dairy debrief

As the 2017/18 dairy season draws to a close, we take a look back at the year that was, and offer some thoughts about what the next 12 months might hold for the industry. For once, the commodity price outlook is relatively stable. We've downgraded our forecast for next season's milk price to $6.40 – a third consecutive year of $6 plus milk price. Yet the sector is facing big challenges on many other fronts.

The 2017/18 dairy season comes to a close at the end of May. While the farmgate milk price of $6.55 will remain a forecast for a while yet, it's unlikely to change significantly from here in the final wash-up. A feature of the 2017/18 season has been the remarkable stability in dairy prices. The biggest change single move in GlobalDairyTrade auction mover the season was a 5.9% lift in February, as a period of unusually dry weather started to impact on milk production and Fonterra signalled it expected collection volumes to be well down for the season. The average absolute change in the headline GlobalDairyTrade price index was just 1.7% over the last year.

Beneath the headline, there were a number of important trends to emerge over the season. One has been the relative strength of butter prices on the back of a revival in demand for 'natural fats', in conjunction with tighter supply conditions. The flip side of higher butter prices is also increased production of skim milk powder (SMP), adding to downward pressure on SMP prices which have also been weighed down by uncertainty over how large European stockpiles (built up when SMP prices were particularly low a couple of years ago) will be released back into the market.

Dairy product prices



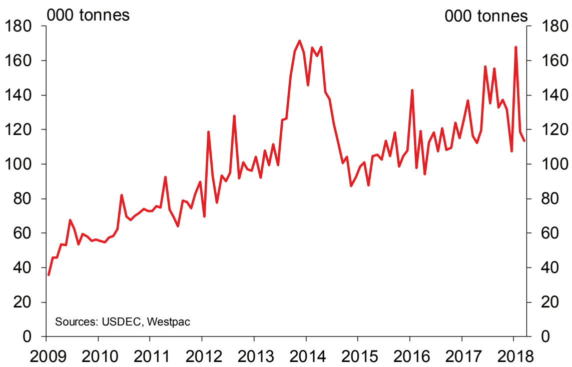
New Zealand production looks like it will finish around 1% lower this season than last. An impressive recovery given the 5% drop we saw in milk collections over the summer months. In Australia, milk collections this season are running more than 3% above last as the industry continues to recover from the sharp contraction in milk supply in the 2016/17 season. Meanwhile, in the United States and Europe, production in 2017 was up 1.4% and 1.7% respectively

Looking ahead, we expect this trend of relatively stable dairy prices to continue. Our outlook for the 2018/19 season assumes prices move between $US 2700 and $US 3200/ tonne with softness over the second half of 2018 giving way to firmer prices as we head into 2019. Global supply is expected to grow at a slightly more modest pace than last season. The NZ weather outlook (at this stage) appears relatively benign and supply growth is likely to be capped by relatively static cow numbers and an increased reliance on pastoral feed (Fonterra is due to introduce its Fat Evaluation

Index grading system for suppliers from September which is likely to discourage PKE usage).

Importantly, we also expect the slowdown currently in train in the Chinese economy to continue. While this is not concentrated in the consumer sector, we expect that consumers will eventually get caught up in the broader economic slowdown. Consequently, we expect the pace of growth in demand for dairy to slow relative to what we've seen recently.

China imports of dairy products



The third piece of the puzzle is the outlook for the NZ dollar. We've been of the view for some time that the fundamentals support a weaker NZD/USD. Until recently, markets haven't agreed. But this month the US dollar has finally taken flight as confidence in the FOMC's rate hike cycle grew and optimism over European and UK growth prospects faded. The NZD/USD has fallen from 73.8 cents in April to 68.65 cents now. And we think this move has further to go yet. We're forecasting the NZD/USD to fall to 64 cents by September next year. In our calculations for the 2018/19 payout we've assumed an average conversion rate of about 69 cents.

Put it all together and we're picking a $6.40 milk price this season (a shade lower than our previous forecast).

However, it's not just the commodity price outlook that is affecting the outlook for the sector over the year ahead. Dairy farmers are staring down the barrel of change on a number of fronts. With the change in Government, the regulatory environment is coming under increased scrutiny. Nutrient caps, the possible inclusion of agricultural emissions in the Emissions Trading Scheme (ETS), higher hurdles for foreign purchases of rural land, the simmering debate around water rights and the review of the 17 year old Dairy Industry Restructuring Act are just some of the issues the sector is currently grappling with. Many of the details around these changes are not yet clear. But what is clear is that they will add cost and complexity to doing business for farmers.

As if this list of challenges wasn't enough, in recent months dairy farmers have found themselves battling a biosecurity incursion – Mycoplasma bovis. A bacterium that can cause arrange of quite serious conditions in cattle such as mastitis, pneumonia, arthritis and late term abortions that don't respond to treatment. We've covered this topic in a recent Fortnightly Agri Update (click here). But concern in the sector has grown in recent weeks as the list of infected farms has grown, and the disease has become even more widespread with infection at three North Island farms now confirmed. 38 farms are infected, 70 more likely to be infected and hundreds more are under investigation. 22,000 cows are expected to be culled by the end of the month. While these numbers are still small relative to the size of the New Zealand dairy industry (with around 4.8 million cows and 12,000 herds).

The debate about how the cost of fighting the outbreak will be split has also started, with Minister of Agriculture Damien O'Connor pushing for the industry to pick up 40% of the tab that will likely run into hundreds of millions.

While the final call on eradication versus management has yet to be made, recent developments seem to swinging the dial in favour of containment and management of the disease. If this is the case, the industry is set to face increased costs for animal healthcare, and also potentially contributing to management of Mycoplasma bovis on an industry wide basis, just as other major dairy exporters Australia, Europe and the USA do.

But whichever way the path the industry goes down, already fragile confidence in the sector has taken a big knock. Not only by the incursion itself, but also widespread discontent about how MPI is handling the process. For now it remains a case of watch this space. It might well be a $6 plus milk price which provides the sector with some welcome stability over an otherwise turbulent year ahead.

Anne Boniface
Senior Economist

GlobalDairyTrade Auction Results, 16 May 2018

	Change since last auction	Price index USD/Tonne
Anhydrous Milk Fat (AMF)	5.8%	6,354
Butter	2.4%	5,787
Butter Milk Power (BMP)	n.a.	n.a.
Cheddar	4.4%	4,205
Lactose	-3.5%	687
Rennet Casein	-6.1%	4,876
Skim Milk Powder (SMP)	3.0%	2,047
Whole Milk Powder (WMP)	0.2%	3,226
GDT Price Index	1.9%	1,065

Farmgate milk price forecasts

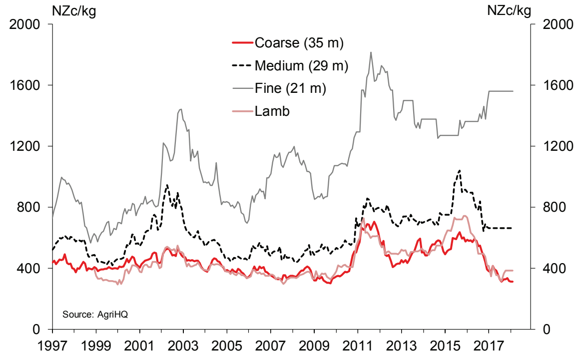
	2017/18		2018/19
	Westpac	Fonterra	Westpac
Milk Price	$6.55	$6.55	$6.40

Beyond the farm gate

Wool

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

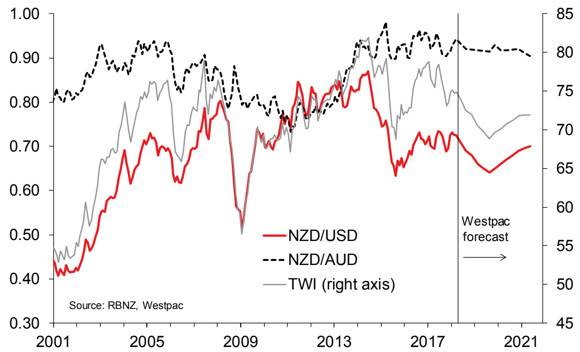
The Natural Fibre Exchange (NFE) has launched a wool market with bi-weekly trading events similar to GlobalDairyTrade Auctions and managed by CRA International – the company that also manages GDT auctions. The first trading even is due to kick off on the 22 May and aims to provide direct access to suppliers and a competitive market with transparent prices. It will be interesting to watch how this market evolves. For now, coarse wool prices remain comparatively weak, although there are some tentative signs that Chinese demand has improved in recent months.



NZ dollar

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

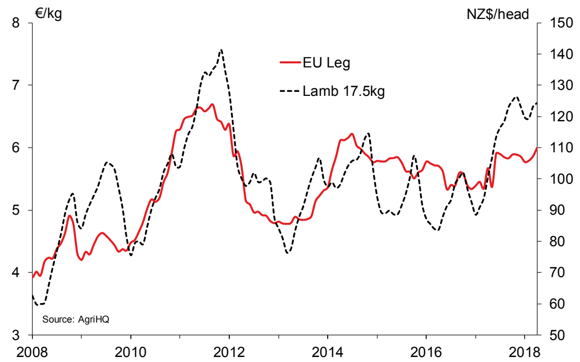
The NZD/USD has fallen sharply in recent weeks, mostly thanks to a strengthening US dollar. Two catalysts for the revival in the fortunes of the US dollar have been increased confidence about the outlook for US growth in the June quarter (after a bit of softness in Q1) and further increases in interest rates to levels that have seen currency markets sit up and take notice. The return of fundamentals to the driving seat in currency markets brings markets back in line with our own outlook. We expect the NZD to fall further over the coming year as the RBNZ remains on the sidelines, while the Federal Reserve continues to lift interest rates.



Lamb

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

Local lamb prices remain strong, although we continue to expect some moderation over the coming months. With China an increasingly important market for NZ lamb producers, a softer growth outlook there is expected to weigh on demand. In addition, the growth outlook for the UK has softened further over the last couple of months. However, this is balanced against near-term tightness in supply in both New Zealand and Australia.



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

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