

Fortnightly Agri Update

17 October 2018



Dairy: Supply side

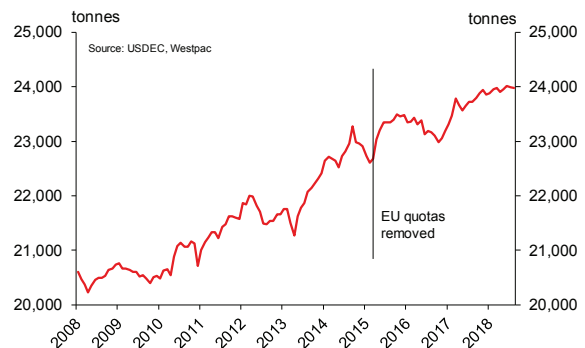
Last week Fonterra downgraded its milk price forecast for the current season to a range of \$6.25-6.50 per kilo. In its statement it assigned much of the blame for weak dairy prices on strong supply growth. In this Fortnightly Agri Update we look at some of the detail around how milk supply is evolving in key parts of the world. While the new season has started strongly in New Zealand, production growth has slowed among the other major exporters.

There are four big dairy exporting regions – New Zealand, the European Union, the US and Australia – that together account for 87% of global dairy exports. How milk production, and subsequently exports, from these regions evolves can significantly impact global dairy prices.

In aggregate, milk production growth in the top 4 dairy exporting regions is up around 1% on a year ago, but the pace of growth has slowed in recent months. On a seasonally adjusted basis, milk production has been broadly flat over the last three months.

European milk production is up 1.9% for the year to August compared to last year. Milk production in parts of the region was affected by very hot dry weather over the summer. While conditions have now cooled as the Northern Hemisphere moves into autumn, farmers now face higher feed costs which will reduce margins and may weigh on production growth going forward.

Milk production by top 4 exporters



Another influence on Europe's milk supply is the existing stockpiles of skim milk powder. These built up during the period of low prices from mid-2014 through to 2016, but have since started to be run down as product has aged and been sold off. Despite milk production running a little ahead of last season, European exports of key products are lower.

In the US, milk production has also grown modestly, up 1.1% in the year to August. This compares to 1.4% growth in 2017 and 1.8% growth in 2018. But alongside this relatively modest lift in US milk production, a greater proportion of dairy production is finding its way onto world markets via a notable lift in export volumes. Almost 17% of milk production in the year to July was exported, up from 14% in the year earlier. On the ground, the US Dairy Export Council describes milk production growth as remaining in

“slow gear” as tighter margins lead to some culling of cows. They expect continued moderate production growth over the final three months of the year.

In Australia, dry weather is hitting milk production in Victoria, New South Wales and Queensland hard. This has led to nationwide milk production falling 3.6% in August compared to the same time a year ago. But it’s not just prolonged drought that is affecting milk production in Australia. High water and feed prices and low milk returns are also playing a role, leading some to suggest that it’s not just weather dampening milk production and that the sector will continue to contract beyond this season.

Outside the top four, but still worth noting, is milk production in South American countries, in particular Argentina. Milk production in South America follows a similar season pattern to Australia and New Zealand with production peaking around October. Consequently, weather-induced variations in production can exacerbate (or offset) variations in New Zealand’s seasonal production patterns.

Milk production in Argentina has grown strongly this year, up 6.8% for the year to July, although the pace of growth has reportedly slowed recently. This is a period of recovery for the sector after it was hit hard by poor weather conditions including floods in 2016 and 2017, high production costs and infrastructure challenges. These factors also contributed to a sharp drop in exports. However, while conditions have been much more favourable this year, farmers in Argentina in particular face a much broader set of obstacles than farmers in other parts of the world as they try to remain competitive on international markets. Even if milk production in Argentina grows 5% over 2018, this would only bring milk production back to around 2010 levels.

Against this backdrop, milk production growth in New Zealand is something of an outlier. New Zealand milk production was running 4.7% ahead of last season in August, with the season to date up 5.5%. Fonterra has reflected this strong start to the season in its own forecasts, noting that it now expects its own milk collections to be up 3% this season (up from its May forecast of 1.3% growth). However, while many parts of the country have enjoyed favourable weather in recent months, farmers are on high alert for the prospect of El Nino conditions developing. As always, weather conditions will be key in determining how milk production evolves over the back half of the season.

So on balance, we’re not so sure that soft dairy prices in recent months can be entirely pinned on strong growth in global milk supply. While this is undoubtedly part of the story (especially in New Zealand in recent months) the outlook for demand is equally important. In particular, how Chinese demand for dairy imports is evolving will be critical in determining the direction of prices from here. We’ll take a look at this side of the equation in later Fortnightly Agri Updates.

Anne Boniface
Senior Economist

GlobalDairyTrade Auction Results, 17 October 2018

| | Change since last auction | Price index USD/Tonne |
|--------------------------|---------------------------|-----------------------|
| Anhydrous Milk Fat (AMF) | 1.0% | 5,106 |
| Butter | 2.4% | 4,114 |
| Butter Milk Power (BMP) | - | - |
| Cheddar | -1.8% | 3,404 |
| Lactose | 1.5% | 926 |
| Rennet Casein | -1.7% | 5,426 |
| Skim Milk Powder (SMP) | 0.0% | 1,977 |
| Whole Milk Powder (WMP) | -0.9% | 2,729 |
| GDT Price Index | -0.3% | 896 |

Farmgate milk price forecasts

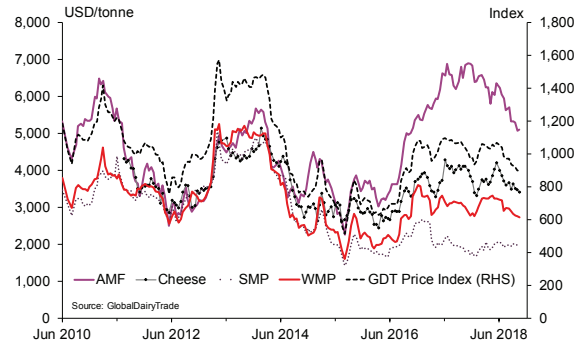
| | 2018/19 | |
|------------|---------|---------------|
| | Westpac | Fonterra |
| Milk Price | \$6.25 | \$6.25-\$6.50 |

Beyond the farm gate

Dairy

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

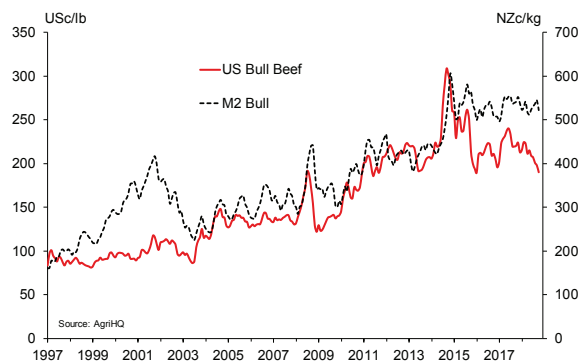
Dairy prices were down slightly overall in last night's GlobalDairyTrade auction, although the results by product were mixed. Whole milk powder prices were down 0.9%, skim milk powder was unchanged, and fats prices rose a little. This month Fonterra announced a second downgrade to its milk price forecast for this season, this time expressing it as a range between \$6.25 and \$6.50 per kilo. Our current forecast is at the bottom end of that range, and we see further downside risk to that if dairy auction prices continue to creep lower.



Beef

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

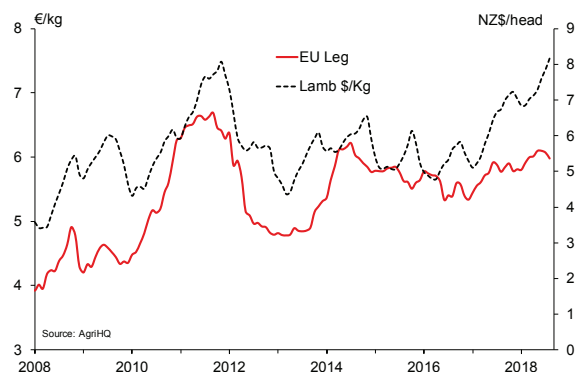
There is little sign of an improvement in US demand, as prices there continue to track lower. Beef is facing increased competition in the US from relatively cheaper proteins, and some of the major cattle regions are gripped by drought which has led to a rise in domestic slaughter numbers. Similarly, drought conditions in Australia have led to a sharp rise in slaughter numbers, with ABARES forecasting a 10% rise in beef export volumes for the 2018 calendar year.



Lamb

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

Domestic prices are holding up, but will come under pressure on the back of the usual seasonal pickup in supply. Beef and Lamb NZ is forecasting a 3.8% fall in New Zealand's lamb crop this season. As always, weather will play an important role. It was a very poor start to spring for some farmers with recent snow storms leading to significant lamb losses in the eastern and central North Island. There is also a risk of an El Nino drought this summer that could see nationwide lamb numbers shrink even further than forecast.



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

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