Westpac
Institutional Bank

Fortnightly Agri Update

2 April 2015

End of an era

Yesterday marked the end of the European Union's milk production quota system, which had been in place since 1984. Under this system, member states were assigned an annual production quota, and any production above those levels would incur a fine, most recently set at €27.83 per 100kg of milksolids. The system was originally put in place to reduce the risk of overproduction, but it had come to be seen as inappropriate in a world of rapidly rising demand in the emerging market economies.

Naturally we've been asked whether this poses a challenge to New Zealand's dominance as an exporter of dairy products. Over the longer term, the answer is clearly yes. The quota system was a major factor behind the lack of flexibility in the global milk supply: between 2008 and 2013, the growth in China's demand for whole milk powder was almost entirely met by New Zealand, with minimal production growth elsewhere. The removal of the quota system means that global milk production can be more responsive to changing conditions, such as regional droughts or rapid shifts in demand. Hence, the sharp upward spikes in dairy prices that we've seen at times in recent years could be a thing of the past.

However, we don't expect to see a sudden transition as of April 1, for two somewhat related reasons. The first is that milk production in Europe has already risen sharply in anticipation of the quota removal; the second is that current milk prices don't favour a further ramp up in production from these already-high levels.

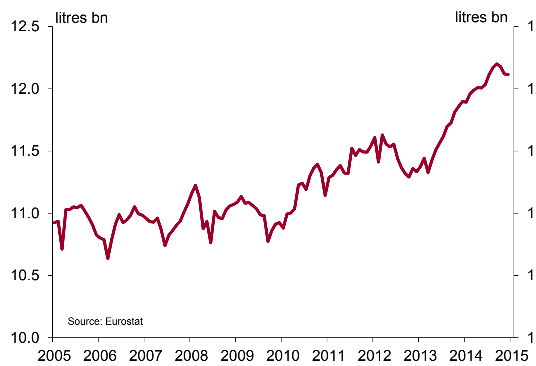
The chart to the right shows monthly milk production by EU member states (the data is published with a lag, so the most recent observation is December 2014). After a long period of flat or subdued growth, milk production began to rise sharply in 2013. For the season ended March 2014, eight countries were forced to pay a total of €409m in fines for producing in excess of their quotas. For them this was a sensible move: the high world dairy prices at the time more than covered the cost of the fines, and expansion provided the economies of scale that would be necessary for survival in a post-quota world.

The season ending March 2015 started off in a similar vein, with production continuing to rise rapidly. The fines for this season will be calculated later this year, but they're expected to be well in excess of the previous season's total, with almost every member state exceeding their quota. However, the price story has been very different this time. The near-record world prices at the start of the season gave way to a steep decline as the months went on. By late 2014 prices were below the cost of production for many dairy farmers, even before accounting for the overproduction fines. As a result, European milk production has begun to turn down since last September, although it remains at a very high level. The European Commission has forecast a lift in production of just 1% for the next season – and that forecast was made when prices were at a higher level than today.

In conclusion: the removal of EU quotas is likely to cap the upside potential for dairying returns in New Zealand in future years. But for the coming season at least, it's more likely that low milk prices will suppress competition from the higher-cost producers in Europe.

Turning to last night's GlobalDairyTrade auction, the 10.8% fall in the price index suggests that the 'drought premium' that was built into prices in February was now been fully unwound. We're inclined to wait and see whether the fall in prices reflects anything beyond drought effects, but our payout forecasts for both this season and the next are clearly on notice.

EU milk production, seasonally adjusted



GlobalDairyTrade Auction Results, 2 April

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-5.3%	$3,663
Butter Milk Power (BMP)	-25.1%	$2,130
Butter	-7.6%	$3,259
Skim Milk Powder (SMP)	-9.9%	$2,467
Whole Milk Powder (WMP)	-13.3%	$2,538
Cheddar	-10.5%	$2,787
GDT Price Index	-10.8%	

Payout Forecast Table

	2013/14	2014/15		2015/16
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	$8.40	$4.70	$4.90	$6.10

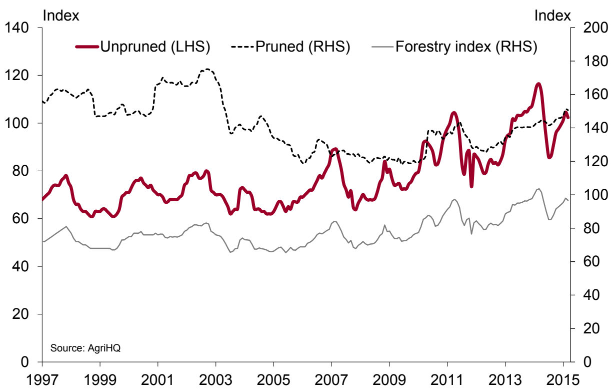
Michael Gordon
Senior Economist

Beyond the farm gate

Forestry

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

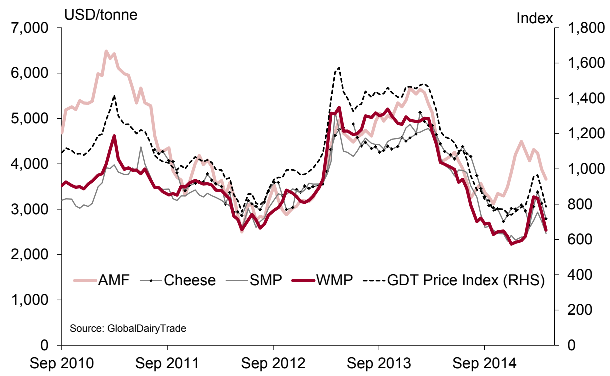
Average prices fell slightly in March but remain 13% above their mid-2014 lows, according to the Agrifax forestry price index. Much of this gain has come from a lower New Zealand dollar and falling transport costs, with world prices for logs steady. Housing construction in New Zealand remains on an upward trend, albeit from low levels in recent years.



Dairy

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

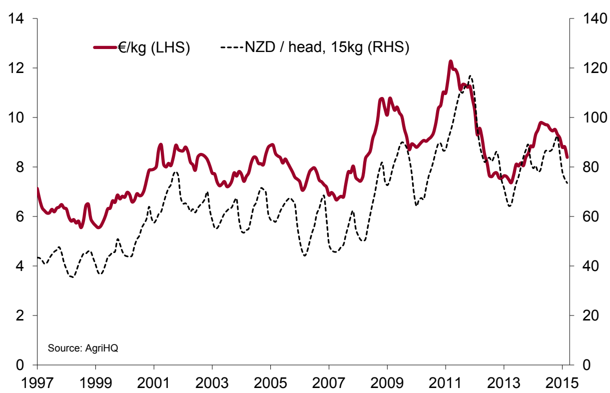
Another sharp fall in prices at the latest GlobalDairyTrade auction means that the drought premium that was embedded in prices in February has been fully unwound. This is consistent with our view that the impact of this summer's dry weather has been considerably less than initially feared. We now expect milk production for the season ending May 2015 to be around flat, in contrast to Fonterra's estimate of a 2% decline. Consequently, our forecast payout of $4.90/kg for this season is looking too high, and we will revise it in coming weeks.



Lamb

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

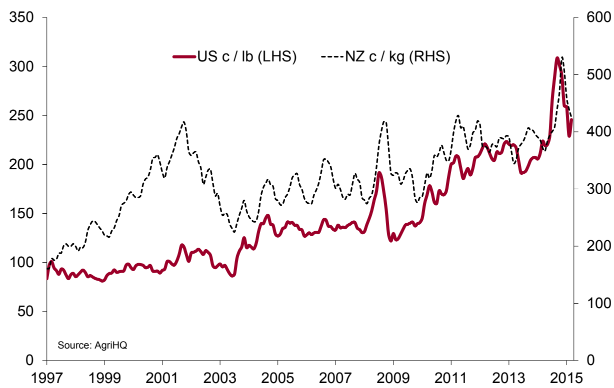
Dry conditions have led to early slaughter in many parts of the country, putting pressure on processors' capacity and pushing down schedule prices. Early slaughter will reduce the available supply later in the year.



Beef

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

US beef prices are heading higher again as the backlog of imported product is cleared and the summer peak in demand approaches. Locally, slaughter figures for February show that cattle slaughter is returning to more normal levels for this time of year, having been higher than normal in late 2014 to take advantage of high US prices. The earlier slaughter will mean reduced supply for later in the season, providing further support for prices.



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

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.