ANZ Research

NZ Forecast Update: Farmgate milk price

2 September 2022

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Contact

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Farmgate milk price forecast revised up

Key points

- We have revised our farmgate milk price forecast for the 2022-23 season up 25c to $8.75/kg milksolid (MS) but highlight that uncertainty remains high, with considerable risks on both the downside and upside.
- Our forecast for the 2021-22 season is unchanged at $9.30/kg MS.
- The NZD is assumed to appreciate just a little across our forecast period, moving to USD0.63 by March 2023 and then holding near this level.
- Global economic conditions are worsening, which is expected to impact global dairy consumption.
- Milk supplies are constrained due to high farm input costs, so the lack of supply is countering the weak demand at present.

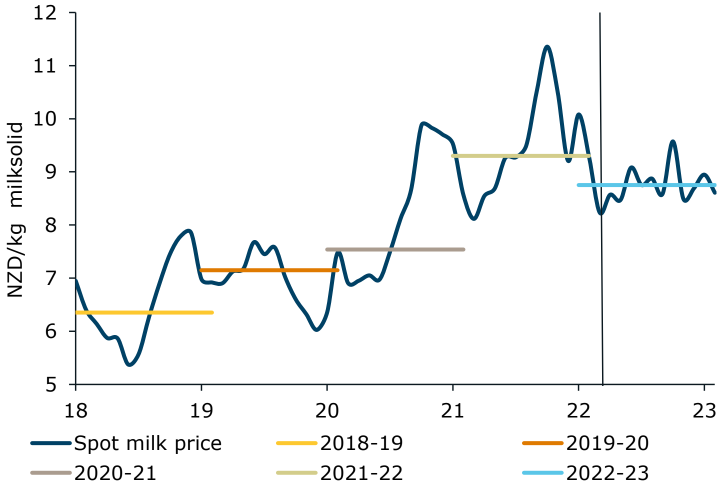
Balancing forces of supply vs demand

Our milk price forecast for the current season has been revised up 25c/kg MS to $8.75/kg MS, but this does not mean that downside risks are behind us. In fact, global risks have probably increased further in recent months and it is not yet clear whether the drop in global milk supply will be sufficient to offset the ongoing weakness in demand for dairy products.

At this stage, we see the supply side of the equation having the upper hand in the near term but this is likely to change as we move towards the end of the 2022 calendar year. Global economic conditions look set to deteriorate, reducing demand for dairy products.

There is still a lot of uncertainty as to the direction of pricing for the remainder of the season. Prices of dairy commodity futures trading on the NZX/SGX platform trend steadily higher for the current season. There has also been a lift in the value of milk price futures, with the current season contract currently priced at 9.60/kg MS.

Figure 1. Farmgate milk prices



Source: Fonterra, ANZ Research

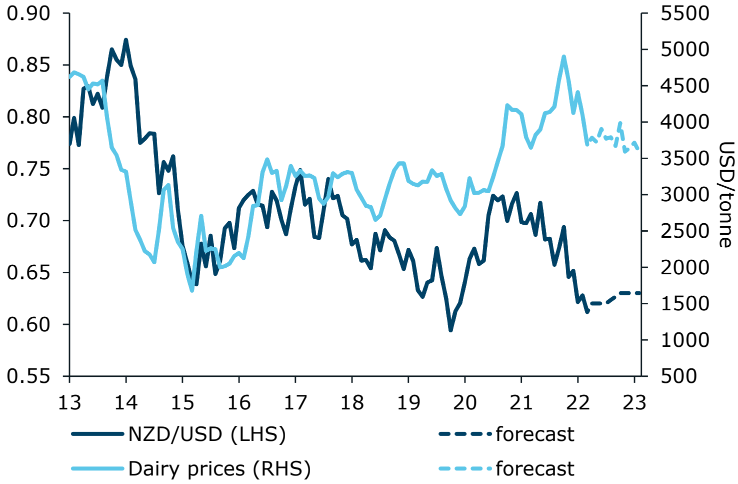
Both the global supply of dairy and demand for dairy products are weak at present and are therefore countering each other. In this environment we expect to see some stability in pricing over the next month or so, but the market could easily trend up or down from here.

This uncertainty in pricing is reflected in Fonterra's own milk price forecast range for the 2022-23 season, which was revised down to $8.50-$10.00/kg MS in late August. This range also encompasses most of the independent forecasts, but the range of forecast milk prices is definitely wider than usual for this time of the season. This is not surprising, given the high levels of uncertainty both within the dairy markets and the wider global economy.

Weak currency bolsters farmgate prices

The NZD is expected to appreciate slightly throughout this season. Much of the current season's FX requirements will have already been hedged, so the relative weakness we are currently seeing in the NZD will have a limited impact on the current season's milk price.

Figure 2. Dairy prices vs NZD



Source: GDT, NZX, RBNZ, ANZ Research

In an historic context the NZD is very weak compared to dairy commodity prices. While demand for NZD to purchase our exports is one factor that influences the value of our currency, there are many drivers. Sometimes differences in interest rates influence demand for foreign currency as investor funds move into countries offering higher returns.

At present the weakness in the NZD has more to do with strong demand for USD than anything specific to our currency. We expect the NZD to gradually appreciate, rising to USD0.63 by March.

Table 1. Farmgate milk price sensitivity table (2022-23 season)

			NZD/USD effective				
		USD/t	0.64	0.65	0.66	0.67	0.68
Commodity price basket	15%	4350	10.75	10.55	10.35	10.20	10.00
	5%	3975	9.65	9.45	9.30	9.10	8.95
	Base	3780	9.05	8.90	**8.75**	8.55	8.40
	-5%	3585	8.50	8.35	8.15	8.00	7.85
	-10%	3405	7.95	7.80	7.65	7.50	7.35
	-20%	3030	6.85	6.70	6.60	6.45	6.30

Source: ANZ Research

The CNY has also deteriorated against the USD and has actually fallen a little more than the NZD has. Although prices for dairy products may have weakened in USD terms, in local currency terms the prices haven't decreased as much, which is supportive of the farmgate milk price.

Demand impacted by deteriorating global economic conditions

Dairy commodity prices are currently being impacted by both falling demand and falling supply. Whether dairy commodity prices rise or fall through the remainder of this season depends on which of these forces proves the most dominant.

At present, weaker global demand has resulted in prices coming off the lofty levels reached earlier in the year. Demand for dairy products will be impacted by deteriorating global economic conditions. Economic growth is slowing in many large economies that are also large consumers of dairy products.

Global economic growth is expected to drop back to 2.6% in 2022, which is about half the pace of growth attained in 2021 (+5.5%).

China's economy is now expected to expand by just 3.0% this year, compared to 8.1% last year. This is significant, as China is by far the largest importer of dairy products. Many other Asian economies also rely on China to fuel their own economic growth.

Dairy products are also considered a luxury item by many Chinese consumers, rather than a necessity like most New Zealanders consider dairy products to be. Unfortunately the cohort who are vulnerable to the current challenges facing China's residential property sector are also likely to be the consumers who have increased their appetite for dairy products in recent years.

Global demand for dairy products does tend to erode when dairy products are at excessively high prices, such we have seen over the past year or so. Falling prices will help make dairy products more affordable to a wider range of consumers and will therefore bolster demand. We are now starting to see some global buyers return at current prices, a positive for short-term demand.

The expected increased demand for dairy products at lower prices, combined with tight global supply, will put a floor under dairy commodity prices. However, any upward movement in prices is also expected to be limited by the global economic challenges ahead, which will curb consumption.

Milk supply issues

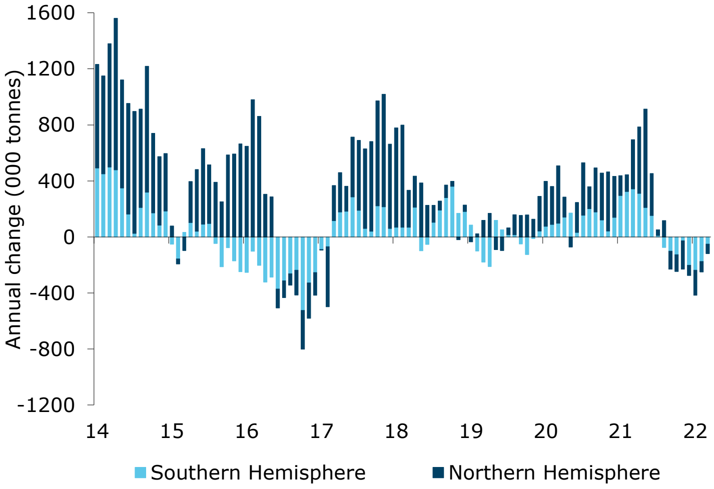
Global milk production is under pressure as hot conditions and drought or else excess rainfall impact the major milk-producing regions in the Northern Hemisphere.

Drought is widespread in Europe, the United States and China. Cows do not tolerate hot conditions well, and milk production tends to fall during hot summers like this one. The extreme heat is also having a detrimental impact on crop production, which will limit feed supplies for the remainder of the year and make it increasingly expensive to feed dairy cows. The drought is also impacting energy production as rivers dry up in China and Europe.

Gas supplies in Europe are also very tight due to reliance on supply from Russia. Europe has been rebuilding its gas reserves ahead of winter but this has meant some factories have had to close down. The high gas costs mean fertiliser production in Europe has been drastically cut, with just one third of plants currently operating.

Fertiliser restrictions will limit crop production not just in Europe but also elsewhere. Food security is a major issue at present, and it is expected to worsen later this year. If there is a shortage of food, then some of the crops normally grown to feed livestock may be diverted to human consumption. Accessing feed is expected to be challenging, and the feed that is available is expected to be expensive.

Figure 3. Growth in milk production in key dairy-producing regions



Source: DCANZ, Dairy Australia, USDA, Eurostat, CLAL

Excessively hot weather and extremely heavy monsoon rains have caused huge floods in India and Pakistan. Both of these countries produce a lot more milk than New Zealand does, but neither country is a major exporter of dairy products due to their high domestic demand. The major consequence will be less dairy products available to consumers in these two countries. They may therefore import small quantities of dairy products, which will add to the global demand.

Global milk supplies were already falling prior to the impact of the hot summer weather and monsoon rains, due to the higher costs of production. High feed prices, partially driven by high fertiliser and fuel prices, are really impacting the economics of farming, particularly in countries where dairy cows are housed. Pasture-based farmers like New Zealand’s are actually relatively better off, as they have a smaller exposure to feed costs. However, they are still facing massive increases in costs due to higher fertiliser prices.

Labour is another cost that has risen in most parts of the world, including New Zealand, making it more expensive to produce milk.

Summary

Global dairy markets remain finely balanced. The rapid drop in global milk production is expected to tip the scales and push dairy commodity prices slightly higher in the coming months. But before the season is out we are likely to see pricing trend lower again as the deterioration in global economic conditions starts to impact demand for dairy products.

The only certainty is that global risks remain high and therefore we can expect a high degree of volatility in the global dairy markets as market information and sentiments tips the scales in either direction.

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Last updated: 1 September 2022

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