ANZ Research

New Zealand Dairy Update

17 October 2019

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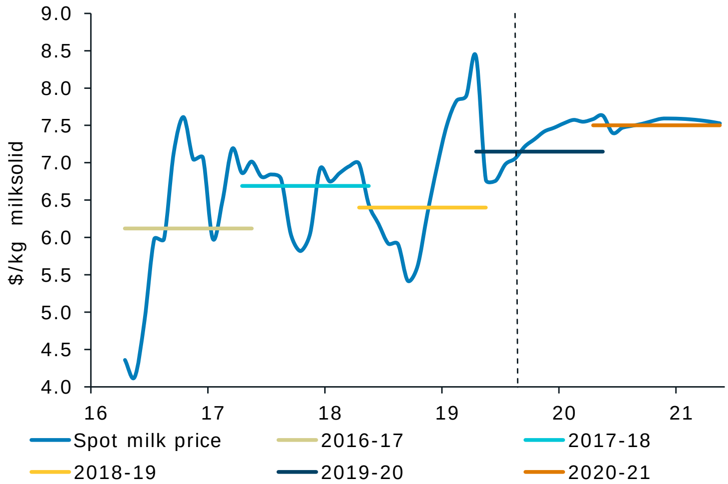
Onward and upward

- Global dairy markets have firmed on the back of minimal growth in milk supply. The lower NZD is also supportive of returns at the farmgate level.
- As reported in our recent Agri Focus our farmgate milk price forecast now stands at $7.15/kg MS for the 2019-20 season.
- We have also released a preliminary milk price forecast of $7.50/kg MS for the 2020-21 season.

Milk price update - summary

We forecast a farmgate milk price for the 2019-20 season of $7.15/kg MS. This is near the upper range of Fonterra's current guidance of $6.25 - $7.25/kg MS. Meanwhile the NZX milk price futures contract for the current season has lifted in the past month and is now trading above $7. Based on NZX futures and our exchange rate forecasts, we have a preliminary milk price forecast for the following season of $7.50/kg MS.

Figure 1. Farmgate milk price



Source: ANZ Research, Fonterra

Global commodity prices have steadily lifted in the GlobalDairyTrade events held recently, and the forward outlook for prices has also firmed, based on where future contracts for dairy commodities are trading.

The farmgate milk price has not exceeded $7 since the 2013-14 season when the milk price reached a record $8.40/kg MS. Milk prices then took a dive as global milk supply surged following the removal of milk production quotas in the EU.

As advised in our Weekly of 16 September and our Dairy Update of 26 September, there was a regrettable error in our 5 September analysis of the potential further write-down of Fonterra's Beingmate investment that led us to significantly overstate the potential implication for the final milk payout this season. We sincerely apologise for any unnecessary concern caused to dairy farmers.

Relatively tight global milk supply is currently supporting prices being achieved in the global dairy markets. Whole milk powder prices have steadily lifted, having gained 5.5 % since July.

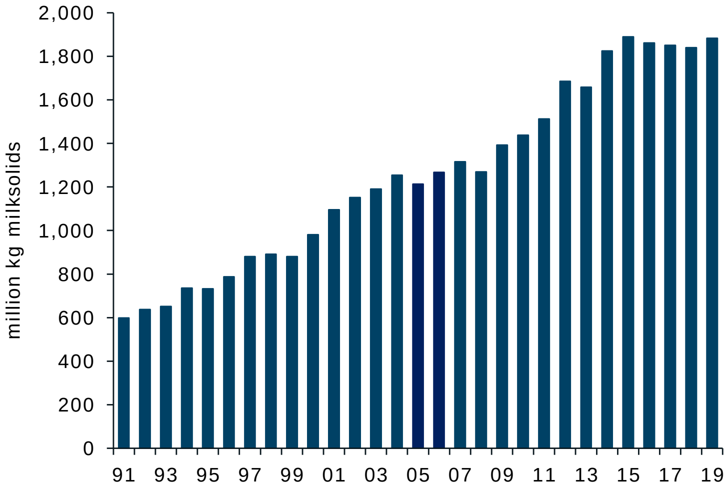
Despite the lift in the WMP price it is still more profitable to process milk into a combination of skim milk powder (SMP) and either butter or anhydrous milkfat than to produce WMP. Milk-processing companies in New Zealand tweak their product mix based on global prices and forward sales commitments to customers whilst taking into account their capacity limitations.

NZ milk production

Milk production in New Zealand is currently moving towards its seasonal peak. This typically occurs in the latter half of October in the North Island and in early November in the South Island. This difference is due to cows calving later in the South Island in order to align with pasture production growth rates. The typical seasonal lift in pasture production has occurred a little later than usual this season. This is because most parts of the country have experienced relatively cold weather during September, which means soil temperatures are not rising as quickly as most farmers would like. The upside is that pasture quality is high and with growth poised to lift we should see improved milk production through November and December relative to last season.

Milk production across the full 2019-20 season is expected to be marginally lower than last season. Stocks numbers are assumed to be relatively stable but productivity levels may be marginally lower in the short term.

Figure 2: New Zealand milk production



Source: DCANZ

Longer term we anticipate New Zealand's dairy production will incrementally fall, but the speed of this fall will depend on where environmental legislation lands, the speed of change required to meet tougher new rules, and farmers' ability to find solutions to mitigate nutrient losses. The new regulations will put hard limits on production in some regions, and increase total production costs.

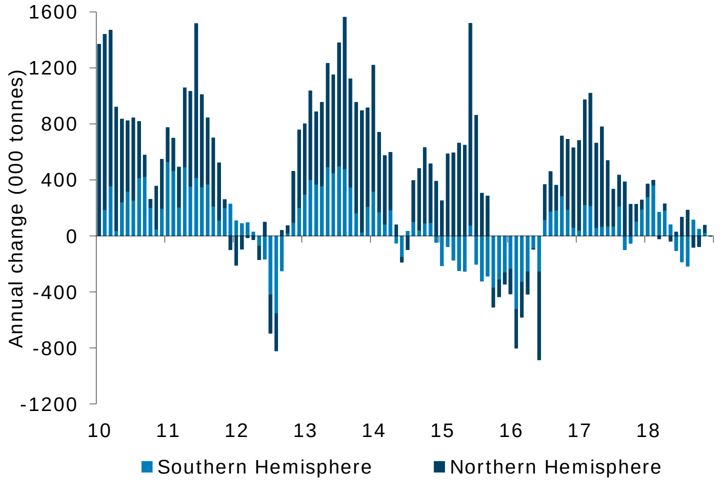
Production levels will also depend on whether the market is prepared to pay a premium for milk that is exclusively grass-fed. Supplementary feeding currently accounts for more than 10% of the milk being produced but this proportion could decrease quite quickly should further financial incentives or disincentives be introduced that are designed to reduce the use of supplementary feed. We are already beginning to see this happening – particularly regarding feeding palm kernel expeller (PKE).

De-intensification of dairy systems is expected to result in a decrease in production levels on a per hectare basis, but this is expected to be partially offset by higher production per cow. The quantity of land used to support dairy farms is likely to decrease as lower stocking rates decrease the demand to graze stock off the milking platform.

Slow global dairy production growth

Global dairy production growth is currently almost non-existent (figure 3).

Figure 3. Milk production growth for major exporters



Source: ANZ Research, DCANZ, Dairy Australia, CLAL, Datum, USDA

Milk production in the US has expanded by just 0.1% year to date. European production is on track to expand in 2019 by about 0.5%. Neither of these growth rates are strong enough to significantly impact the volume of dairy products being traded globally.

Production is even weaker in the next tier of dairy-exporting nations, Australia, Argentina and Uruguay. Australia's milk output this calendar year to date is back by 9% while Argentina is down 4% and Uruguay is tracking 7% lower year-on-year.

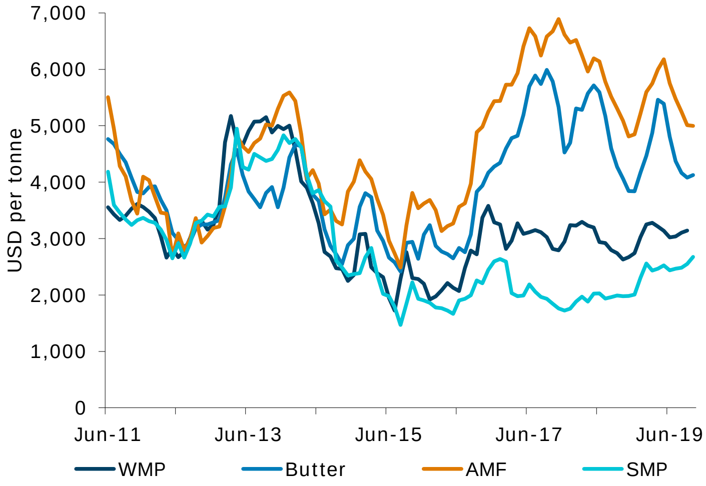
All up, it appears that the availability of globally traded dairy commodities will remain tight through the rest of this year. This situation is only likely to change when Northern Hemisphere supply lifts again during their spring, which won't impact global markets until about May.

Global dairy demand

Dairy commodity markets have firmed a little in recent months. Demand from China is strong, which is underpinning prices. At this point of the season the volume of dairy products being sold from New Zealand is at its seasonal peak.

WMP is trading comfortably above USD3000/t and is trending up, but SMP prices are nonetheless starting to close the gap (figure 4). Traditionally SMP has traded at about a USD100/t discount to WMP. However, in recent years this discount stretched out to more than USD1000/t. This was due to large stocks of this commodity being held in the EU public intervention scheme. These stocks have now been cleared, which has allowed for normal market forces to be at play again.

Figure 4. Dairy commodity prices



Source: GDT

Prices for dairy fats reached extremely high levels in recent years but receded earlier this year. Demand from developing markets is growing but the price of fat products is driven primarily by demand from developed markets, particularly Europe and the United States. Both of these markets are highly protected, meaning their butter price normally exceeds the global market price by a considerable margin. Butter prices in Europe have been trending down whereas prices in the globally traded market have been relatively stable in recent months.

Dairy commodities trading on the NZX Dairy Derivatives market have generally firmed in the past few months. This is particularly the case for the longer-dated contracts, which are trading at or above the price of the nearer dated contracts, whereas earlier they were trading at a discount.

There is a risk that global consumption of dairy products may ease, which would reduce the upward pressure on prices. Global economic growth has certainly waned, but we are yet to see this translate into reduced dairy demand. In developed nations we are seeing a trend away from consumption of liquid cows' milk as plant-based products increase their share of this market. But at the same time, we are seeing growing consumption of cows' milk in developing nations, providing an offset.

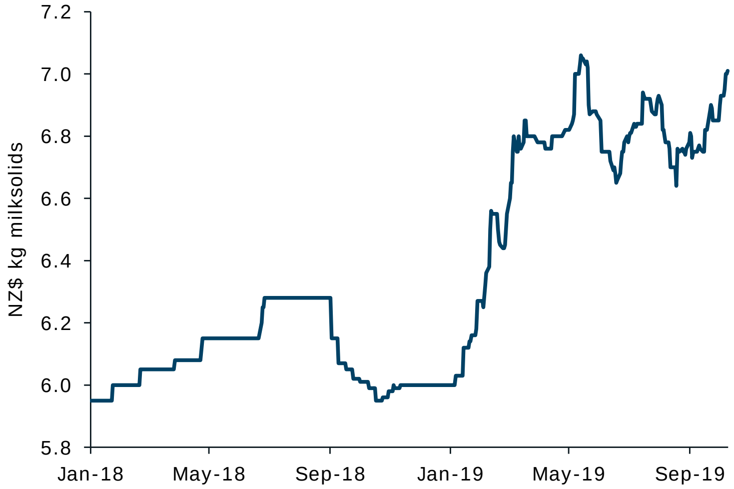
NZ milk price

The current strength in the global dairy commodity markets, combined with the weaker NZ dollar, has the potential to bolster returns to farmers here in New Zealand.

The September 2020 milk price futures contract (for the current dairy season) has trended up over the past month to now once more trade above $7/kg MS (figure 5). While this is still shy of our own forecast, it is above the mid-point of Fonterra's current milk price forecast, which sits at $6.75/kg MS.

In contrast, there has been little movement in the September 2021 milk price futures contract, which is currently priced just above $6.50/kg MS. The level of interest in trading this contract has risen recently as farmers look to mitigate uncertainty by locking in a portion of their future earnings.

Figure 5. NZX milk price futures 2019-20 season contract



Source: Reuters

Our preliminary milk price forecast for the 2020/21 season is $7.50/kg MS. This forecast is based on the prices of the NZX futures contracts dated from June to September 2020, and the current ANZ exchange rate forecasts.

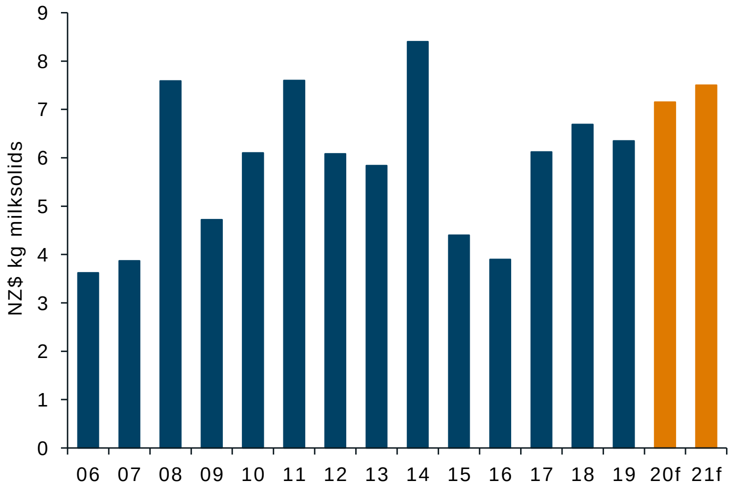
At this point there is naturally a high level of uncertainty around this forecast as both commodity prices and exchange rates have the potential to move considerably. Global demand is the key risk, in our view, rather than a surge in global production.

Our preliminary forecast for a higher price than this season is primarily supported by the forecast lower NZD/USD as the commodity prices used in the equation are similar to current levels. A movement in the NZD of one cent has about a 15c/kg MS impact on the milk price.

Exchange rate forecasting is challenging at the best of times, but in terms of forecasting the milk price the impact of this is mitigated by the fact that New Zealand's currency and dairy price tend to move broadly together. However, the NZD has recently underperformed where dairy prices would broadly indicate it 'should' be, and there is potential for this to unwind, seeing the NZD lift as global economic and trade risks subside.

Still, despite the uncertainty, it is encouraging that the outlook for dairy farmers' incomes is positive at a time when increasing costs mean the break-even price is trending upwards.

Figure 6. Fonterra milk price



Source: ANZ Research, Fonterra

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