

NZ Forecast Update: Farmgate milk price

9 November 2020



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Farmgate milk price forecast revised up

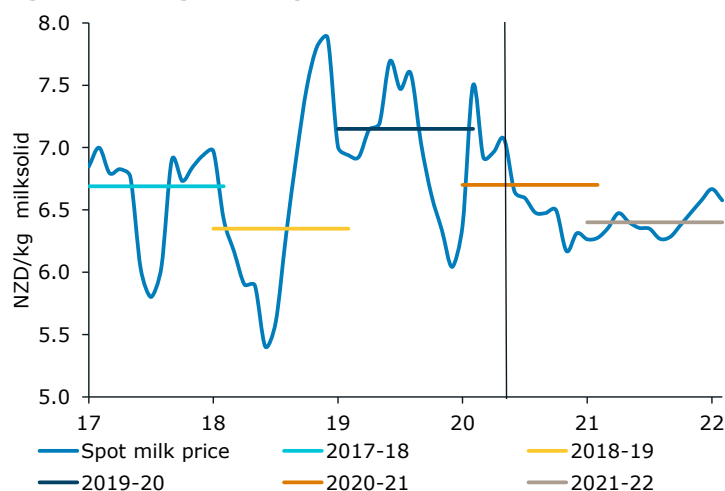
Key points

- We have revised up our farmgate milk price forecast for the 2020-21 season by 20c to \$6.70/kg MS.
- Our initial forecast for the 2021-22 season is \$6.40/kg MS but this forecast is subject to a high degree of uncertainty.
- Dairy commodity prices have outperformed expectations, but we remain cautious regarding the outlook.
- Our outlook for the NZD remains unchanged with a medium-term forecast of NZD/USD 0.65.

Milk price forecast revised up

We have revised up our farmgate milk price forecast for the 2020-21 season to \$6.70/kg MS, from \$6.50/kg MS. Global dairy commodity prices continue to defy expectations, consistently delivering good returns. However, we remain cautious about the outlook, and the scope for dairy commodity prices to soften.

Figure 1. Farmgate milk prices



Source: Fonterra, ANZ Research

Global milk volumes increasing

A lift in global milk supply, combined with slightly softer demand, is expected to temper dairy commodity returns in the coming months. Global milk supply is expanding year-on-year in the main dairy-exporting regions (Europe and the United States), but this growth won't really be felt for some months. This is mainly because current production is easing in line with the typical seasonal pattern as these regions head into the Northern Hemisphere winter. Farmgate prices in both regions are high enough to support some additional expansion.

Dairy incomes in the United States are currently supported by state programmes to supply food to the needy. This has bolstered the price of cheese in particular, which is now trading at very high prices within the US market. It is estimated that approximately a third of dairy farm incomes in the United States is being derived from the government support packages.

These support packages won't last forever and now that voting in the US Presidential Election is complete there is reduced incentive to keep the packages in place, no matter which party is in power. But it will take some months before the effects of this stimulus package start to unwind. Therefore, in the shorter term we are seeing steady expansion in US milk production.

In Europe, milk returns are more modest relative to production costs, and the strong growth in milk output seen earlier in the season is now starting to wane. August production across the EU-27 (which now excludes the UK) lifted just 0.5% y/y. But strong production earlier in the season means there has been more dairy products manufactured, including whole milk powder.

European cheese and skim milk powder is very competitive in global markets but European butter continues to be priced well above the norm. Similarly, US skim milk powder exports are also very competitive globally and their butter is also trading at a discount to NZ product. These conditions may lead to a downward correction in the price of NZ product as it becomes more aligned with goods sourced from elsewhere. NZ product can trade at a premium, but these excess returns are generally short-lived.

The EU-27 exported 7% more dairy product from January to August this year compared to the same period last year (when measured on a milk equivalent basis). The increase in the volume of dairy products exported globally, combined with the expectation that demand may soften along with incomes, means heightened downside risk for dairy commodity prices.

There is also anecdotal evidence that stocks of dairy products may be increasing in some markets, which may limit future demand. There is very little hard data relating to in-market stocks or domestic milk production in many of the large dairy-importing nations including China, Russia and Brazil. India is also a source of significant uncertainty – they tend to be relatively self-sufficient for dairy, so a small swing in their total milk production can see them move between being a net exporter and a net importer of dairy products. But a lift in in-market stocks would curtail future demand.

At this point, there is no evidence that dairy consumption is slowing, but it is unlikely that demand for dairy products will get through the current recession unscathed. So far that has been the case, but there is a long road to recovery for most economies and therefore an elevated risk that demand for dairy products will weaken.

Due to the elevated levels of uncertainty, our view of the future direction of dairy prices is more measured than the path of prices implied by the NZX Dairy Derivatives market. See Figure 2.

Figure 2. Dairy commodity price basket



Source: NZX, GDT, ANZ Research

More certainty in 2020-21 forecast

Despite elevated market risks, dairy commodity prices have performed better than expected so far this season. Typically, by this time of the season about half of the production for the year has been sold, providing some degree of certainty as to the milk price for the current season. Similarly, a large portion of the foreign exchange risk will have also been hedged, which will reduce any impact on the 2020-21 farmgate milk price should the New Zealand dollar appreciate considerably.

We expect the [NZ dollar to trade near USD0.65](#) for the remainder of the current dairy season, with a similar level to persist the following season as well. At present there is a massive degree of uncertainty as to where the NZ dollar will head in the future as it is very much influenced by global market forces. If global risks escalate further then we are likely to see downward pressure on our currency, but equally, if risk appetite improves after US elections, the NZD could well go higher. Global factors have generally been more influential this year.

Despite the incredibly uncertain outlook, dairy commodity markets have performed reasonably well so far this season. With a portion of sales now locked in we are sufficiently confident to move our milk price forecast up 20c to \$6.70/kg MS for the 2020-21 season. This is slightly below the mid-point of Fonterra's current forecast of \$6.30 - \$7.30/kg MS. It is also a little below the level at which milk price futures are currently priced (\$6.84 as of 6 November).

Table 1. Farmgate milk price sensitivity table (2020-21 season)

		NZD/USD effective					
		USD/t	0.63	0.64	0.65	0.66	0.67
Commodity price basket	10%	3270	7.90	7.75	7.60	7.45	7.30
	5%	3125	7.45	7.30	7.15	7.00	6.85
	Base	2975	7.00	6.85	6.70	6.60	6.45
	-5%	2830	6.55	6.40	6.30	6.15	6.05
	-10%	2680	6.10	5.95	5.85	5.70	5.60
	-15%	2530	5.65	5.50	5.40	5.30	5.20

Source: ANZ Research

Forecast released for next season

Our inaugural forecast for the 2021-22 season sits at \$6.40/kg MS. However, this forecast carries a very high degree of uncertainty. It is difficult to forecast this far forward at any time, let alone in the midst of the health and economic crisis we are currently in. Nevertheless we have put a line in the sand based primarily on future expectations for commodity prices.

We do expect to see some easing in prices in 2021 as larger volumes of milk are produced in the global exporting nations and the larger importing nations. Therefore we have factored in a modest softening of prices.

The NZX Dairy Derivatives market is more bullish on the outlook for next season. Sep 22 milk price futures (for the 2021-22 season) are trading at \$6.68/kg MS, having traded between \$6.55 and \$6.70/kg MS since mid-September. Trading in this contract remains relatively light. As at 6 November, there were 1806 lots (10.8 million kgMS) of open positions in the Sep 22 contract – very few compared to the milk price contract for the current season (Sep 21), which has 10,317 positions, equivalent to 61.9 million kgMS.

While dairy commodity prices have been extremely resilient to date, future risks tend to lie to the downside. So we continue to suggest taking a conservative approach to budgeting for the dairy season ahead.



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