

NZ Forecast Update: Farmgate milk price

24 May 2021



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Contact

Susan Kilsby for more details.

Farmgate milk price forecasts at healthy levels

Key points

- We have revised up our farmgate milk price forecast for the 2020-21 season by 5c to \$7.75/kg MS.
- Our forecast for the 2021-22 season has been lifted by 40c to \$7.70/kg MS.
- Dairy commodity prices increased sharply earlier in the year and prices have been maintained at elevated levels, but we have allowed for prices to cool over the next 12 months.
- We continue to expect an appreciation of the NZD as our economy recovers, although the impact of future movements in the currency will be partially offset by currency hedging already in place.

Small lift in forecast for this season

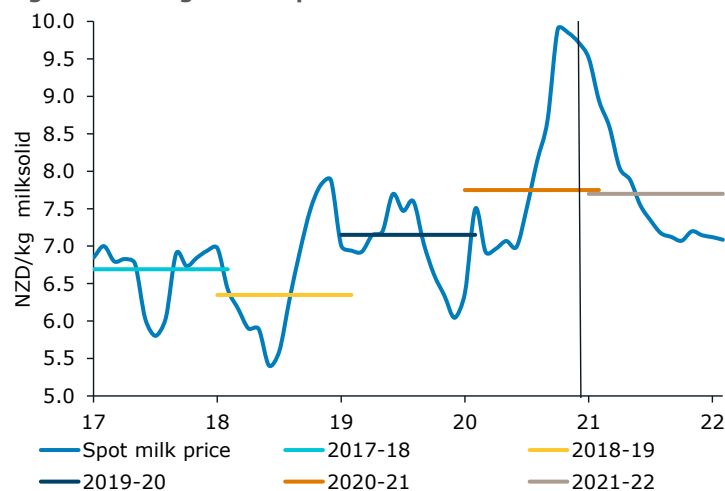
We have revised up our farmgate milk price forecast for the 2020-21 season to \$7.75/kg MS (from \$7.70/kg MS) as we move towards the end of the milk production collection period for the current season. This puts our forecast 15c above the mid-point of Fonterra's latest milk price guidance of \$7.30 - \$7.90/kg MS.

Dairy commodity prices have now stabilised at elevated levels following the sharp upward lift earlier in the year. Whole milk powder continues to comfortably trade above USD4,000/t.

The financial year only has a couple of months left to run and the volume of product traded during the winter months tends to be relatively low. This means that any movements in commodity prices over the next couple of months will have only a limited impact on this season's milk price.

Likewise, virtually all foreign exchange requirements will now be locked in, so any movement in the NZ dollar will also have minimal impact on the farmgate milk price for this season.

Figure 1. Farmgate milk prices



Source: Fonterra, ANZ Research

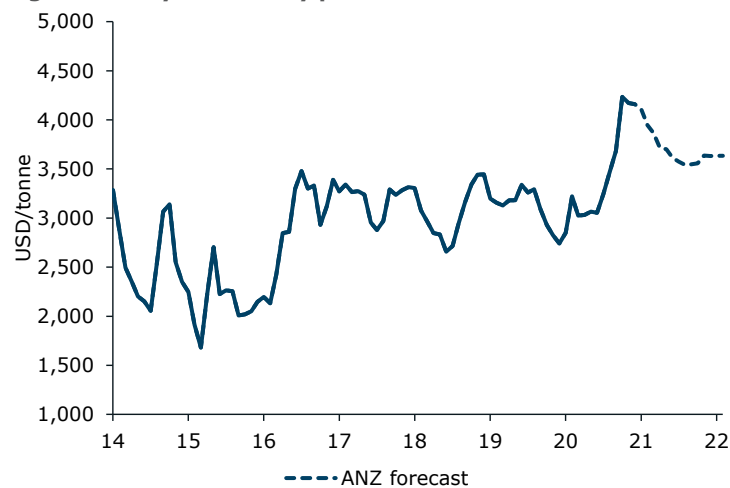
Strong opening milk price forecast for next season

We are now forecasting a \$7.70/kg MS farmgate milk price for the 2021/22 season.

The new milk production season will commence with dairy commodity prices at elevated levels. The only time WMP prices have been higher at this time of the year was in 2013. That was at the beginning of the season when farmers received a record milk price of \$8.40/kg MS.

While it would not be impossible for a new record to be set in the 2021/22 season, we think it is much more likely that commodity prices will temper as the season progresses.

Figure2. Dairy commodity price basket



Sources: GDT, NZX, ANZ Research

Dairy commodity markets are relatively balanced at present, explaining the stability we are currently seeing in prices. However, it is highly likely that markets will correct at some stage and previous downward movements in prices have tended to be quite sharp.

Factors that could trigger a price correction include a milk supply response in the major dairy exporting and importing regions, supply chains and storage facilities filling up, or any fall in consumer demand. While it is difficult to see any of these factors occurring in the short term, there is not a lot of transparency in dairy markets, and it's worth bearing in mind that sharp price movements do tend to surprise market participants on a regular basis.

Table 1. Farmgate milk price sensitivity table (2021-22 season)

		NZD/USD effective					
		USD/t	0.69	0.70	0.71	0.72	0.73
Commodity price basket	20%	4410	10.05	9.85	9.70	9.55	9.35
	10%	4040	9.00	8.85	8.70	8.55	8.40
	Base	3675	8.00	7.85	7.70	7.60	7.45
	-10%	3310	7.00	6.85	6.75	6.60	6.50
	-20%	2940	5.95	5.85	5.75	5.65	5.55
	-30%	2570	4.95	4.85	4.75	4.65	4.55

Source: ANZ Research

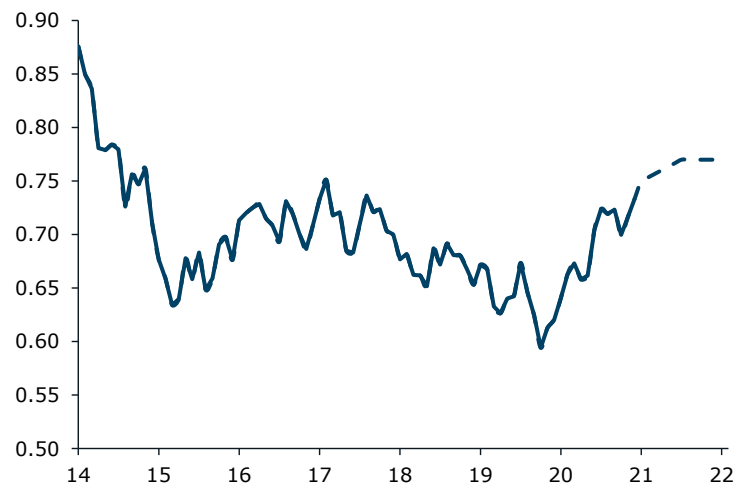
The other factor that has a large influence on the farmgate milk price is the NZD. We continue to anticipate the NZD will generally appreciate over the next 18 months, as NZ's economy benefits from strong commodity prices. We currently expect the NZD will climb to USD0.77 by December.

The final milk price for the 2021-22 season will only be known in September 2022 and a lot could happen before then. We are currently in a period of extreme economic volatility, which makes forecasting even more problematic

than normal. Taking a conservative view on next season's milk price is appropriate in the current environment.

The NZ dollar is expected to continue to firm as the year progresses. We anticipate the NZD will be worth USD0.77 by December. However, a portion of FX requirements for next season will have already been locked in, so we anticipate the effective NZD/USD rate for the 2021-22 season will be nearer to USD0.71.

Figure 3. NZD/USD



Source: RBNZ, ANZ Research

Demand growth versus supply growth

Global milk supply growth has been modest over the past year, and has been outpaced by the growth in demand.

Looking forward, milk output is expected to rise a little more quickly in the year ahead, but will still be curtailed in most regions. Whether this growth in output will outpace the growth in demand remains questionable due to the uncertainty surrounding demand.

Demand for dairy products is expected to be somewhat boosted by the gradual increase in opportunities for social interactions that is expected to occur as vaccines are rolled out. Vaccination rates are high in the US, which means there will be more opportunities to hold sporting events. These tend to be catered with high volumes of dairy products, boosting dairy demand.

In the past year we have seen the US export a little more dairy product into markets that we also serve, such as South East Asia. At present there is plenty of demand for our dairy products from other markets – particularly China – so the increased competition has not hindered prices.

Global supply growth in the main dairy-exporting regions is expanding at about 1.5% y/y. A bounce-back from last year's drought means the Southern Hemisphere has been responsible for a lot of this growth – a trend that will not persist. Meanwhile growth in the Northern Hemisphere has been pretty subdued, but output in the US has picked up a little recently.

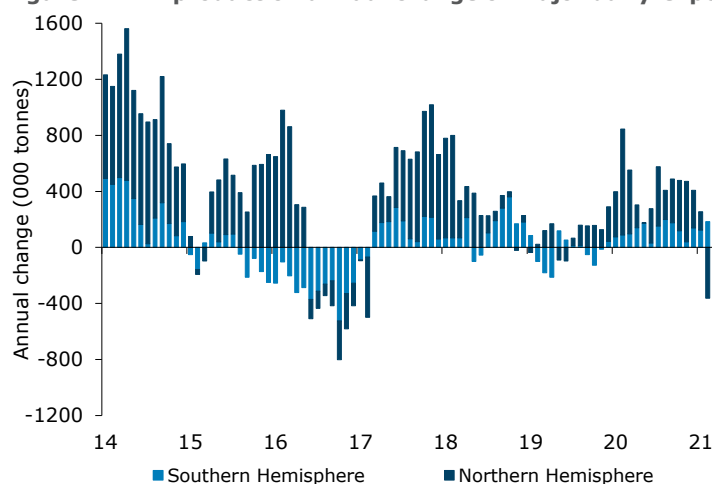
Milk supply in the US is increasing a little more quickly than previously anticipated. Output increased by 3.3% in April, with this mostly attributable to an increase in the number of cows in milk. Because it is driven by cow numbers rather than feed, this trend is likely to persist for some time. Milk prices are higher than normal in the US at the moment, but so are feed costs. Profit margins therefore remain slim, but it could be some months before we see any reversal in the number of cows being milked in the US.

Elsewhere in the world, milk supply growth is relatively modest. In the EU production is being contained by ever tightening environmental regulations and high grain prices. Production in the largest European dairy-producing

countries – Germany and France – is well behind the same time last season. Milk supply growth across the entire EU is unlikely to exceed 1% this year.

This level of growth should be readily absorbed by increases in internal demand for dairy products, so very little additional product should be exported from the EU.

Figure 4: Milk production annual change of major dairy-exporting countries



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

Demand for imported dairy products remains robust in China. As its consumption of dairy products grows, so too does the gap between what it can produce internally and its total demand. Imported dairy products fill this widening gap.

Farmgate milk prices remain high in China, indicating there is a strong deficit of milk relative to demand. Importing dairy products tends to be a cheaper option than producing milk locally – particularly for milk powders.

At present, New Zealand dairy products are trading at a premium to products sourced from elsewhere. Over time these margins are likely to erode, particularly for products for which there are plenty of sources. NZ butter rarely trades at a premium to European and US internal markets, which are both heavily protected by import tariffs. At present NZ is one of the more expensive sources for dairy products, and as supply from the Northern Hemisphere increases in the coming months, then it is highly likely these premiums will erode. Likewise, skim milk powder premiums are also unlikely to be maintained.

Buyers have less choice for WMP, which is typically supplied by NZ, EU or South America. Milk supply is not expected to expand rapidly in any of these regions, but there will be a seasonal lift in supply in Europe. So far, European companies have not made a lot of inroads selling WMP to China, with NZ continuing to dominate the product. European suppliers have instead focused on supplying northern Africa and the Middle East. Concentrating on nearby geographies makes a lot of sense, particularly at present when it is difficult and expensive to ship product around the globe.

Cautiously optimistic

There are plenty of reasons to be optimistic about the current state of global dairy markets. However, these markets are renowned for delivering surprises, and this should be considered when budgeting for the year ahead. Overall, we see dairy commodity prices gradually retreating during the 2021-22 season, but with prices starting at such a high level, higher-than-average milk prices should still be attainable.



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Sharon Zollner
Chief Economist

Follow Sharon on Twitter
[@sharon_zollner](#)

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
[@ANZ_Research](#) (global)



David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com



Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com



Liz Kendall (maternity leave)
Senior Economist

Research co-ordinator, publication strategy, property market analysis, monetary and prudential policy.

Telephone: +64 27 240 9969
Email: elizabeth.kendall@anz.com



Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com



Finn Robinson
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com



Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com



Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com



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