Double negative

Dairy commodity prices have moved in a downward trajectory since the beginning of the 2018/19 season, putting pressure on returns at the farmgate level. A stubbornly strong NZD is also negatively affecting returns. While higher commodity prices and a lower exchange rate are forecast to materialise before the end of the season, it is now unlikely these movements will come soon enough to support our previous milk price forecast. We have therefore revised our milk price forecast for the 2018/19 season to $6.10/kg milksolid (MS) (previously $6.40).

The revised forecast assumes an improvement in dairy commodity prices in the second half of the season. Whole milk powder prices are forecast to average 6% higher than today’s prices across the remainder of the season. In order to reach the lower end of Fonterra’s current $6.25/kg MS forecast dairy, commodity prices would have to average 10% higher than current prices.

The NZD remains relatively strong against the USD. This in part reflects a shift in pricing for the RBNZ from rate cuts to hikes, an unwind of short positioning within the speculative community, and up until recently, an improvement in global risk appetites. However, a slowdown in global economic growth, together with tightening global liquidity, is expected to put downward pressure on the NZD in time. Dairy company hedging means there is a delay in exchange rate movements flowing through to the milk price. Therefore, any downwards movement in the currency will now have a greater influence on next season’s returns than the current season.

Figure 1: Average farm profitability before tax

Farm profitability for the current season has been revised down due to the fall in the forecast milk price and lower returns for cull dairy cows. Upwards pressure on farm working expenses has also been assumed, primarily due to the tight labour market and higher compliance costs.

Next season’s milk price is expected to be slightly stronger than the current season – assuming some recovery in dairy commodity prices alongside a weaker NZD. However, the majority of the improvement in income is expected to be offset by higher farm working expenses.
NZ milk picks up slack from Northern Hemisphere

Market demand for dairy commodities remains robust, with the weaker prices primarily a function of growth in global milk supply rather than a demand issue. Global milk supply has been bolstered this year by steady growth in output in the United States and Europe combined with excellent growing conditions in New Zealand back in the autumn and now in the spring. While the extra milk has put pressure on prices, it is being absorbed by the market, and global stocks are starting to be worked through.

Milk supply in the Northern Hemisphere is easing back while the seasonal lift in production in Oceania is maintaining growth for the five largest exporting countries close to 1%. Growth over the past decade has averaged 1.5%, so the slower pace should help put a floor under prices.

Farmers in both the United States and Europe are no longer in expansionary mode as returns relative to costs don’t support growth. Feed is in short supply in Europe, and what is available is expensive, reflecting less forage harvested earlier this year due to drought.

Therefore, at some point during the next few months, markets should tip back in favour of suppliers – but the exceptionally good start to the New Zealand dairy production season is delaying this recovery.

October milk intakes were at record levels, which is important given this is the peak supply month of the season. Conditions for pasture production have generally been favourable. Compared to last season, milk supply is up 6% on a milksolid basis. These figures look especially strong due to the comparison with last season’s extremely poor spring.

Global demand is robust, but as usual is highly dependent on China – the world’s largest importer of dairy commodities. The evident slowing of China’s economy is yet to manifest in weaker demand for dairy commodities. Thus far the concurrent trends of urbanisation and desire for safe, nutritious food are offsetting any decrease in consumer discretionary spending power.

If global milk supply growth expands more quickly in the coming months this will delay the expected recovery in commodity prices and put further downward pressure on the milk price. The risk of extra milk production primarily lies with New Zealand.

Figure 2: Milk production growth for major exporters

Source: ANZ, Dairy Australia, DCANZ, CLAL, Datum, USDA, European Commission
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