NEW ZEALAND ECONOMICS
NEW ZEALAND DAIRY UPDATE

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GREATER GESTATION ISSUES

KEY POINTS

- **We have cut our 2014/15 milk price forecast again to $4.35kg MS.** That's well below break-even for many dairy farmers and represents an **approximate $6.9bn (or 3.1% of GDP) hit to overall dairy revenue compared to last season.**
- **We also anticipate a softer opening price for 2015/16 to be announced in May around the $5.75/kg MS mark (previously $6.50/kg MS)**; although we expect a further uplift toward the low $6/kg MS mark by the end of the season.
- While dairy prices have shown signs of basing of late, **key reasons behind the downgrade include**:
  - A more prolonged and modest recovery in dairy prices, combined with a strong NZD.
  - The uptick in supply from the major global exporters has been the largest in 8-years. The bow wave in milk and inventory will take the market some time to clear.
  - There is increased competitive pressure from Europe.
  - Chinese domestic milk supply appears to have increased and more wholemilk powder is likely to have been manufactured. Seasonally import demand isn't expected to pick-up until the back end of 2015.
  - While current international prices are below the cost of production, it is taking longer than expected for these to feed through to all major markets and farm-gate prices.
  - Oil dependent nations have been a key source of demand in recent years. We are anticipating (and are already seeing) some pull-back as collapsing oil prices affect their economic outlooks.
- **We project milk powder prices to recover** to around the US$2,800-$3,000 per tonne mark by the middle of the year and then US$3,300-US$3,500 per tonne by early 2016.
- **Cashflow is set to tighten dramatically.** While cashflow at $6.00/kg MS for a fully share-backed farmer in 2014/15 (deferred and advance milk price + dividend) isn't quite as bad as the headline figures, this changes rapidly in the middle of 2015 and is where a softer opening figure for 2015/16 will hurt. A poor year followed by a marginal one is hardly lights out, but it will create stresses.
- **The next 18 months will be difficult for farmers' cash-flow and ability to balance the books,** particularly for those regions where pasture conditions have deteriorated and softer production beckons. It will necessitate a cut in not just capital and discretionary expenditure, but also core operating expenditure to breakeven and avoid a debt blowout. That will create some gestation issues across the economy.
- **The economy has pep from other sources to absorb low pay-out challenges.** The outlook for the economy is still respectable (though hardly stellar). **However, we are becoming more and more alert with each passing day to a weakening global scene,** which risks impacting other commodities and demand, with the situation being complicated by a NZD that is disconnected with local fundamental. Monetary policy will need to remain accommodative for longer.

NEW ZEALAND DAIRY UPDATE

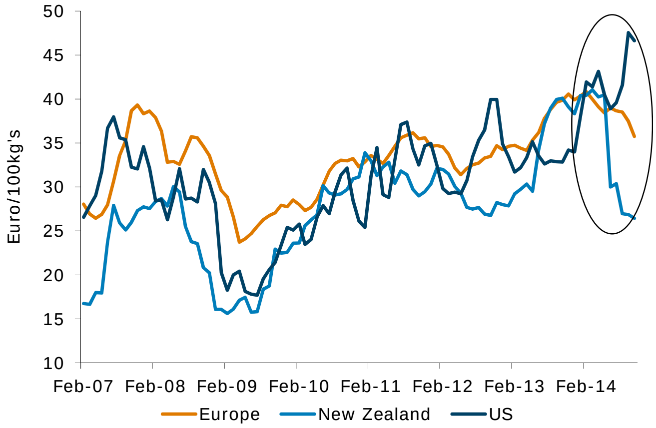
We have cut our 2014/15 milk price forecast again to $4.35/kg MS. We also expect a softer opening milk price forecast of $5.75/kg MS (previously $6.50/kg MS) for 2015/16 come May; although expect a further uplift toward the low $6/kg MS mark by the end of the season. While dairy prices have shown signs of basing of late, there are a number of key reasons behind the downgrade.

A more modest recovery in dairy prices, combined with a strong NZD is weighing on the outlook. We are skeptical the required bounce in spot WMP prices to US$3,500/t by July (+52%) to achieve current forecasts will materialise. GlobalDairyTrade (GDT) prices through the peak sales period have been consistent with a sub-$4/kg MS milk price and need to lift a long way to achieve current industry forecasts. **At this stage we suspect the recovery will be gradual through the first half of 2015 and gather more momentum in the second half of the year.** We are projecting milk powder prices to recover to around the US$2,800-$3,000 per tonne mark by the middle of the year and then US$3,300-US$3,500 per tonne by early 2016.

The uptick in supply from the major global exporters has been the largest in 8-years. The bow wave in milk and inventory will take the market sometime to clear. Over the last 18 months monthly milk supply from the major exporters has averaged annualised growth of 3.5%, which is well above medium term growth (8-year period) that has been closer to 1.9%. **This has translated into more exportable supply from the major exporters.**

The timing and magnitude of the impact on prices of all the additional milk has been uneven across the different product categories and major producers. This has caused pricing mis-matches and lagged farm-gate supply adjustment across several major exporters. These anomalies are now beginning to correct, but only slowly so far.

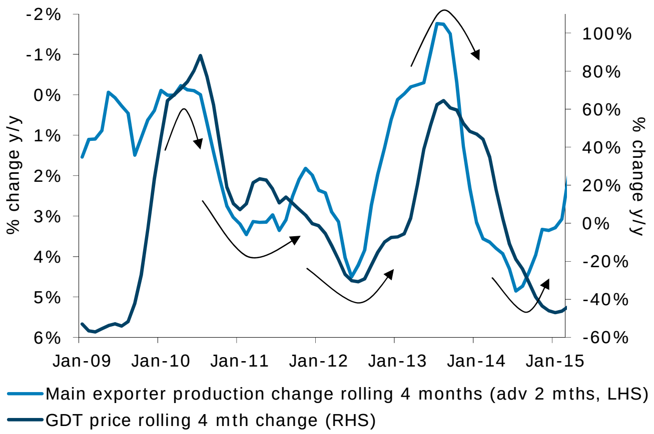
FIGURE 1. STANDARDISED MONTHLY FARM-GATE PRICES



Source: ANZ, Datum

New Zealand farm-gate prices have so far borne the brunt of the downturn, but the effects of lower dairy product prices are now starting to be felt more widely. The spread in farm-gate prices between New Zealand and Europe/US is presently at its widest in the last 8-years. **Reduced farm-gate prices across the US and Europe combined with low prices in New Zealand will eventual slow supply growth and help to re-balance the market.** This looks to have already started to occur.

FIGURE 2. MILK PRODUCTION GROWTH VS GDT PRICE CHANGES



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

We are anticipating milk supply growth of 1.3% in 2015 across the three major export regions (NZ, Europe and US), who account for nearly 70-75% of total cross broader trade. **If milk supply growth slows to this level across the main exporters it implies current GDT prices will lift by 30-40% by the second half of 2015.** The recovery is likely to be toward the bottom end of this range though. The current bow wave of milk and inventory will take the market sometime to clear; Europe is likely to have high exportable supplies in 2015 despite softer milk supply growth; and demand from the major importers looks weak until at least the second half of 2015, if not longer.

Europe's exportable supply is expected to remain high due to the ban on exports to the Russian market and weak demand even if it re-opens in August. Russia was Europe's largest export market at 22% prior to the ban and accounts for 12-15% of global import demand. Even before the ban there were moves afoot to restrict imported dairy products and boost domestic support for farmers. This and the current political situation imply the ban will last much longer than August this year. And even if the ban was lifted, import demand will likely be weak due to the collapse in Russia's economic fortunes with the fall in oil prices and the dramatic 50% decline in the rouble. Combined with trade restrictions and both point to a dramatic decline in dairy consumption. This will mean Europe will focus more on milk powder production, where additional capacity has been added for post quota removal in efficient producing countries and in many key secondary New Zealand markets. Weak domestic economic conditions and a lower Euro are also expected to increase the attractiveness of exporting over the domestic market. So while supply growth might moderate export competition is expected to remain high.

On the demand front, with Russia out of the market import, demand growth falls to China and others. Near-term the reverse of what occurred throughout 2013 and much of 2014 should start to apply as 2015 progresses. Lower wholesale product prices should start to feed through to retail prices improving affordability and stimulating demand growth once again. **But the prospects for many of the major importers still looks decidedly shaky, so we are cautious how quickly and strongly this dynamic flows through.**

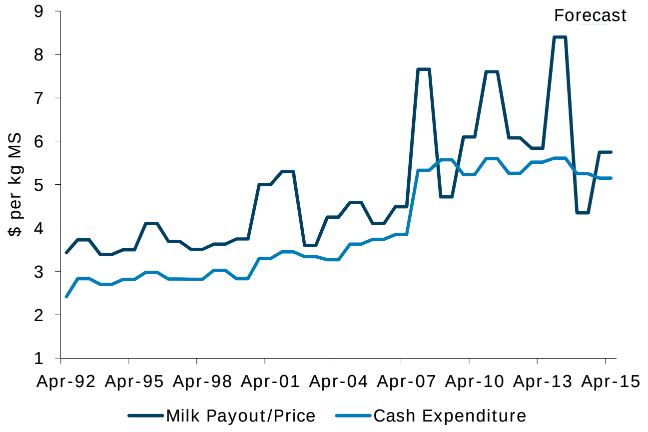
Much has been written about the drop in China's import demand and overhang of inventory from early 2014. Domestic production appears to have picked up, driven by high farm-gate prices, a mild summer and ongoing investment in large scale farms. Some of the increase will have been made into WMP, which combined with high imports from the first half of 2014 seems to be supressing import demand. **Overall, we suspect China's import demand will pick-up in the second half of 2015 as inventories are cleared, the seasonal peak in domestic supply (Q2) passes and lower wholesale product prices feed through to retail stimulating demand growth once again.** Medium-term import demand is expected to be supported by counter-seasonal supply needs, food safety concerns with local production and the high cost of production for local supply.

Outside of China, many of the other emerging Asian countries are very important secondary markets. Import demand from these markets look to be under pressure as their currencies depreciate against the USD. European exporters also appear to be targeting these markets due to better market access.

Oil dependent nations have been a key source of demand in recent years. We are anticipating (and are already seeing) some pull-back from the collapse in oil prices. Countries that are heavily dependent on oil revenue accounted for 24% of dairy export earnings over the last four years. By number, oil dependant countries account for 15 out of the top 40 export destinations and have been some of the fastest growing in recent years. In aggregate they have been just as important as China. Lower oil prices look like they are set to stay around for some time, which will potentially lower their purchasing power and demand. In some key countries, such as Algeria, government programmes account for a large share of imports. Recent comments from key importers have suggested high fiscal surpluses means there won't be cut back's for social programmes, suggesting government programmes will continue as usual. That said, **we have a foreboding feeling weaker demand from such a large buying group isn't positive for prices.**

All up with Russia out of the market, growth has to been driven by other regions. China is not expected to be back into the market in a big way until the second half of 2015, other emerging Asian markets and oil producing countries look decidedly shaky near-term too. Nevertheless, affordability plays a big part and as lower dairy product prices are passed through to retail, demand growth is once again expected to pick-up and support a modest recovery in import demand.

FIGURE 3. DAIRY MILK PRICE VS. CASH EXPENDITURE (INCLUDES INTEREST & RENT)



Source: ANZ, Dairy NZ

This will mean on-farm cashflow is set to tightened dramatically over the next 18 months. While cashflow at $6.00/kg MS for a fully share-backed farmer in 2014/15 (deferred 2013/14 payments, advanced milk price and dividend) isn't quite as bad as the headline figures, this changes rapidly in the middle of 2015 and is where a softer opening figure for 2015/16 will hurt. A poor year followed by a marginal one is hardly lights out, but it will create stresses.

The next 18 months will be difficult for farmers cash-flow and ability to balance the books, particularly for those regions where pasture conditions have deteriorated and softer production beckons. It will necessitate a cut in not just capital and discretionary expenditure, but also core operating expenditure to breakeven and avoid a debt blowout. That will create some gestation issues across the economy.

IMPORTANT NOTICE

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