NEW ZEALAND ECONOMICS
DAIRY AND RBNZ UPDATE

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A LOT TO DIGEST

KEY POINTS

- **We have cut our 2014/15 milk price forecast again to $5.25/kg MS**. Dairy price action remains weak, with forward curve pricing into the peak of the NZ production season soft. Question-marks surround China's inventory situation, and European production needs to find a home elsewhere given Russian sanctions. It's a poor combination.
- If our revised forecast materialises, it represents an **approximate $5.1bn (or 2.2% of GDP) hit to dairy revenue compared to last season.** The hit to cash-flow isn't as bad as the headline numbers, but it's a hit nonetheless.
- **The long-term picture for dairying hasn't changed,** but current developments bear witness to the old adage that "what goes up must come down".
- **Mechanically putting a milk price of $5.50/kg MS (incl dividend) into our average farm model yields a breakeven result**, though there is huge industry divergence around that figure. While farmers are still backing an improvement in prices later in the season and cash-flow looks better than the headline result it's unlikely to be slash and burn. But the cheque-book will be put away and a reduction in advance rates come Fonterra's next update would now shift this reaction into more extreme territory.
- **The key for whether financial stress might start to emerge will be the outlook for 2015/16.** If there is another skinny year this is where cash-flow starts to dry up. At present we have a milk price forecast of $6.50/kg MS, which would avoid such a situation. But we're on notice.
- Amidst forestry and dairy price declines, **other soft commodity prices have held up. But more of these now look to have done their dash.** The NZD has started to adjust, but by an insignificant margin.
- **The risk profile surrounding the economy is far more symmetrical than what it was 3 months ago.** The outlook is now akin to the March 2013 *MPS* when there were clearly both "upside and downside risks to this outlook". It's not just the likes of a low dairy payout; the NZD is lagging, the global scene is far more wobbly and some geopolitical aspects (Russian sanctions) have had clear implications for soft commodities.
- **The economy still has considerable pep.** Our central scenario has GDP growth of 3% in 2015. However, there are **more risks to manage**.
- **The RBNZ should move to a more neutral policy stance at next week's *Monetary Policy Statement* albeit with a soft tightening bias behind the scenes and in the technical projections.**
- **Inflation is projected to be closer to the bottom of the policy band in H2 2014 than the 2% target point and we have greater uncertainty heading into 2015.** The RBNZ has an inflation target not a growth one and inflation has consistently been in the bottom half of the band since 2009 (ex the 2011 GST related spike). It's time for an extended cup-of-tea. If the situation changes the RBNZ can shift as appropriate. But a rapidly evolving risk profile needs to be recognised. The outlook for the economy is more balanced.

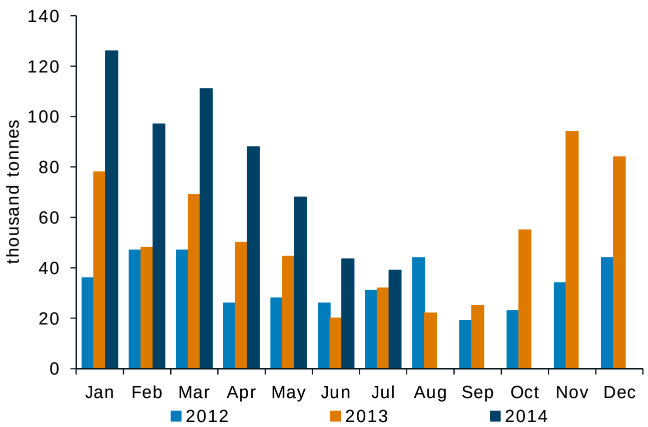
DAIRY AND RBNZ UPDATE

There has been a lot to digest in the dairy industry in recent weeks. On the markets side there was another decent fall in the GlobalDairyTrade TWI index of 6% overnight, with declines across all products. Overall the TWI prices are now down 44% since its peak in February, but milk powders are back by even more (-47%). **While last week it was probably too early for Fonterra to revise down their end of July milk price forecast of $6/kg MS, the gap between this and current spot prices continues to grow.**

Current prices are having a material impact on the outlook for the farm-gate milk prices in 2014/15. This is due to present auctions having a higher weighting as we move into the peak of seasonal supply. With Fonterra's currency hedging largely locked in around the early NZD/USD 0.80's this means there is nearly full flow through from international prices to the farm-gate. **Last night's auction prices technically translate into a milk price around the mid $4's kg MS mark, highlighting a $1.50kg MS gap at present.** Luckily year-to-date prices achieved are higher than this thanks to better results (higher level) earlier on, but this highlights the potential downside risk at present if prices do not recover.

Last night's GDT auction confirmed earlier suspicions that Oceania prices are yet to stabilise and the auction before was bargain hunting as opposed to a stronger bid tone returning. In market there is a lot going on that is making it difficult to forecast what might happen from here. However, at present it is difficult to see a catalyst for higher prices despite them being below the cost curve for all the major exporters. The market is sending confusing signals with high prices in the likes of the US due to a strong domestic demand, but plunging prices for Oceania and European product.

FIGURE 1. CHINA WHOLE MILK POWDER IMPORTS



Source: ANZ, China Customs

For Fonterra's milk price it is the milk powder prices that matter the most. In this space the Chinese are still digesting the strong imports from the first half of the year. Import volumes in the seven months to July 2014 were up 67% on the same period last year, but the rate of growth has decreased. The buying pattern has been similar to what usually occurs, but the likelihood of the normal uptick by the end of the year given an overhang of inventory looks increasingly shaky. This combined with the seasonal step-up in New Zealand supply means it is a struggle to see any material lift in the likes of whole milk powder prices before next year.

Fonterra look to be trying hard to match GDT supply with customer demand with a reduction in forecast near and long-term supply at the last two auctions, but this hasn't been enough. **Fonterra's WMP offerings on GDT over the next three months are large.** During this period Fonterra plan to place approximately 220,000 tonnes of WMP in total on GDT. At over 70,000 tonnes per month the volumes on offer are 27% higher than the same period last year and 7% greater than Sept-Nov 2012. Last year WMP sales via GDT were down due to tight supply following the 2013 autumn drought. **Additionally WMP is now more attractively priced relative to other product streams due to the fall in the price of skim milk powder (SMP)**. Therefore processors in New Zealand and Australia are now more likely to increase the manufacture of WMP during the early part of the season before processing constraints are reached when milk intakes attain their seasonal peak.

In the skim milk powder and milk fat markets the full force of European sanctions are flowing through now, with an anticipated increase in supply despite heading into the seasonal lull. Last night's GDT auction registered a 9.5% fall in SMP prices, which are down 26% since sanctions on European exports to Russia were announced. **In times of surplus milk, Europe gravitates toward SMP (and butter) production due to a longer shelf life compared with other products and government support programs.** So despite European supply now heading into the seasonal lull and the European Commission announcing support measures, such as opening Private Storage Aid until the end of the year, the market seems to be anticipating high supplies. The EU SMP intervention price is €1700/tonne, which equates to approximately US$2250/ tonne (last night's GDT SMP auction price was US$2,600/t, highlighting there could be further downside to go). The intervention price basically provides a floor in the market providing manufacturers with some price certainty during times of over-supply.

DAIRY AND RBNZ UPDATE

Given these in-market dynamics, it is difficult to see a catalyst for a material improvement in the milk price at present. We are therefore cutting our 2014/15 milk price forecast to $5.25/kg MS.

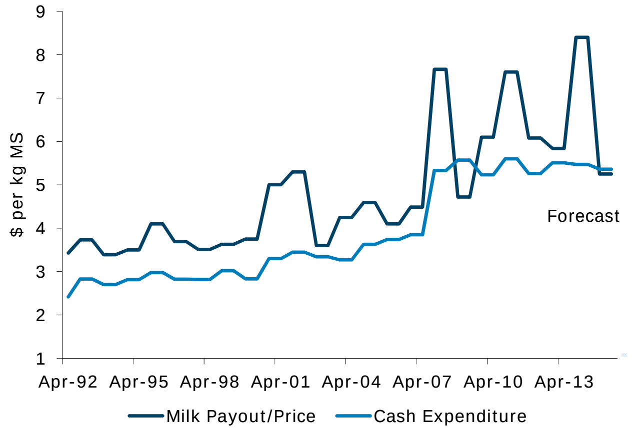
FONTERRA MILK PRICE COMPONENT SCENARIOS (NZ$ per kg MS)

Basket of NZ Dairy Products	NZD/USD					
	USD	0.75	0.78	0.80	0.83	0.87
	2500	4.43	4.26	4.15	4.00	3.81
	2600	4.60	4.43	4.31	4.16	3.97
	2700	4.78	4.60	4.48	4.32	4.12
	3000	5.31	5.11	4.98	4.80	4.58
	3200	5.66	5.45	5.31	5.12	4.88

Source: ANZ

Dairy farmers should be budgeting conservatively in the current environment. **While it has to be remembered that the hit to cash-flow isn't as bad as the 'headline' number suggests, the size of recent reductions is likely to start to reduce advance rates in January through to May 2015.** At present the cash-flow impact in 2014/15 for a 100%-share backed farmer is a 12% reduction ($7.59 to $6.65/ kg MS) from the year before. This is a lot less than the headline reduction of 26% from $8.50 to $6.25 kg MS.

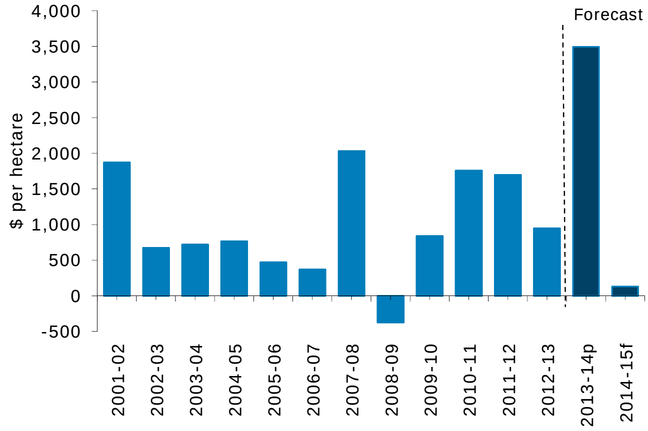
FIGURE 2. DAIRY MILK PRICE VS. CASH EXPENDITURE (INCLUDING INTEREST & RENT)



Source: ANZ, Dairy NZ

Mechanically, putting a milk price of $5.25/kg MS into our average farm model yields a breakeven result. Farmers are likely to start to take the knife to budgets to avoid a loss and a re-run of 2008/09 events. While farmers are still backing an improvement in prices later in the season and cash-flow looks better than the headline result it's unlikely to be slash and burn. But the cheque-book will now be put away and a reduction in advance rates come Fonterra's next update would shift this reaction into more extreme territory. A reduction in advance rates come Fonterra's next update (likely when the 2013/14 annual results are released later this month) looks increasingly likely in the current environment.

FIGURE 3. AVERAGE DAIRY FARM PROFITABILITY BEFORE TAX

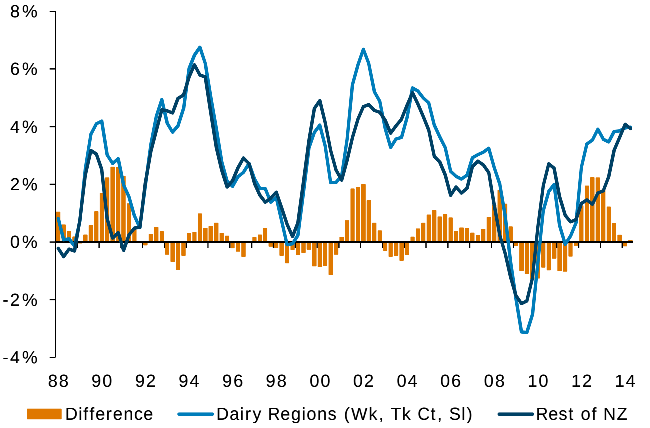


Source: ANZ, Dairy NZ

As we've said before the key for whether financial stress might start to emerge will be the outlook for 2015/16. If there is another skinny year this is where cash-flow starts to be hit. At present we have a 2015/16 milk price forecast of $6.50/kg MS, which would avoid such a situation.

The flow through to the New Zealand economy and especially rural regions will be material if there isn't an improvement and our milk price forecast of $5.25/kg MS materialises. The headline reduction is equivalent to an approximate $5.1 billion hit to dairy revenue, or 2.2% of GDP. This would be similar to what occurred in 2008/09 and if you look at the performance of dairy aligned regions through this period it wasn't pretty. Of course there were other things going on during this period following the GFC, but nevertheless the inference for the growth profile is clear.

FIGURE 4. ANNUAL ECONOMIC GROWTH, DAIRY-ALIGNED REGIONS VS REST OF NZ



Source: ANZ, Statistics NZ

DAIRY AND RBNZ UPDATE

One of the offsets to dairy and forestry weakness has been other commodity prices incrementally improving. However, more of these are now looking to have done their dash. Examples include fruit prices being under pressure in Europe (one of NZ's main markets for the likes of kiwifruit and apples) due to a large stonefruit crop (largest in the last 10 years); weather impacting consumers fruit purchase decisions; sales in June/July affected by the FIFA World Cup; and Russian bans. In the sheepmeat sector there is real caution to push prices too much higher for fear of repeating 2012 when lamb was priced off the menu for many consumers. In the likes of the beef sector the fundamentals are still strong, but with a 37% lift in US manufacturing prices since the start of the year, some pull back is highly likely. This all adds up to a substantial fall in New Zealand's terms of trade and limited improvement if dairy doesn't bounce back.

Despite the decline in dairy prices, we're not turning bearish on the economic outlook yet. Yes, commodity prices and the terms of trade matter hugely. But the economy still has considerable pep. Migration inflows are still huge (a noted source of upside inflation potential the RBNZ noted in the June MPS), confidence is still robust, construction sector activity is picking up and firms' are still investing and hiring. Our central scenario has growth of 3% in 2015; very respectable across international peers. However, there are clearly more risks to manage.

However, the risk profile surrounding the economy is far more symmetrical than it was 3 months ago. The outlook is now akin to the March 2013 *MPS* when there were clearly both "upside and downside risk to this outlook". The RBNZ may have alluded to this in the June *MPS* scenarios (falling dairy prices and strong migration covering both bases) but those scenarios now look decidedly more real. It's not just the likes of a low dairy payout; the NZD is lagging, the global scene is far more wobbly and some geopolitical aspects (Russian sanctions) have clear implications for soft commodities. You can argue till the cows come home (no pun intended) about whether it's geopolitics, or expectations of QE (or something else) that is driving European bond yields lower, but the fact that German Bund yields stand at just 0.9% tells you a lot about the state of play there. Pan-European growth ground to a halt in Q2, and inflation continues to fall, lifting real yields.

Back home here, technically, house prices are starting to gravitate backwards (quarter on quarter). There are upside scenarios too, notably migration is pushing above the RBNZ's projections. However, the balance of risks has clearly shifted.

Inflation has now been sub-2% since 2009 (after adjusting for the GST and energy price spike in 2011). While there are the obvious inflation risks north, persistent low inflation outcomes risks getting overly ingrained in pricing and inflation expectations setting behaviour and there are now some real question marks over the forward drivers of inflation. We're not convinced a new paradigm has arrived so forward risks (the likes of migration) still need management, but certainly some influences (such as stronger productivity growth and credit growth below the rate of nominal GDP) are being understated as inflation suppressants.

The RBNZ should move to a very neutral policy stance in next week's *Monetary Policy Statement* albeit with a soft tightening bias behind the scenes. The interest rate projections will invariably project a rising trajectory, but that'll be nothing more than the central tendency and mean reverting tendency of any macroeconomic model. That'll display a soft tightening bias but nothing more than that.

A more neutral stance may validate or end up with interest rates lower, but that's appropriate. Some will have palpitations for fear of fuelling housing again. However, financial stability risks courtesy of housing can be managed by prudential means if necessary. The outlook for the economy is no longer asymmetrical. Inflation is projected to be closer than the bottom of the policy band in H2 2014 than the 2% mid-point target. There is greater uncertainty over the evolution of inflation in 2015. The RBNZ has an inflation target not a growth one.

If the situation changes so too can the RBNZ's view (and ours). We've seen enough to alter ours and the previously flagged 100 basis points of rate hikes we had penciled in for 2015 looks pie in the sky stuff. There are still some risks that point that way, but there are now pending risks that suggest the OCR might not move much at all. Something between the two seems most likely.

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