

Warning signs

- Dairy prices continue to slide; overall prices were down 8.9%, with WMP prices down 10.9% in last night's auction.
- Factoring in these recent falls we have lowered our 2014/15 milk price forecast to \$6.20 per kg of milk solids.
- While we continue to expect that dairy prices will recover over the remainder of 2014, if current trends continue, then possibility of a sub-\$6.00 milk price will continue to rise.

Milk prices continue to slide. Overnight, overall dairy prices recorded a further 8.9% fall on the back of a circa 5% fall in the auction a fortnight prior. All up, compared to the same time a year ago, prices are down by around a third.

These falls are more than we had factored in previously. In our recent commentary we have noted that we expected dairy prices to stabilise through the middle of 2014 before recovering. We would thus expect to have seen clearer signs that prices were stabilising at this juncture. But these signs have yet to emerge.

With this in mind, we have revised down our milk price forecast for the 2014/15 season by 80 cents. We now forecast a milk price of \$6.20/kg of milk solids, compared to our \$7.00/kg forecast from back in May.

That said, if current trends continue our milk price could head lower. As such, the possibility of a sub-\$6.00 milk price for the 2014/15 season is rising.

ASB milk price forecast cut to \$6.20/kg

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We have cut our milk price forecast for the 2014/15 season from to \$6.20 per kg of milk solids. This is an 80 cent cut from our May forecast of \$7.00 per kg. Our \$6.20 forecast is also lower than Fonterra's current forecast of \$7.00 per kg, though clearly Fonterra is likely to revise its view before too long (at or before the August board meeting).

...and the possibility of a sub-\$6.00 milk price in 2014/15 is rising.

This reduction is a clear warning shot across farmers' bows as even with this significant revision, we see the risks still skewed to the downside of this forecast. The possibility of a sub \$6.00 milk price in 2014/15 is rising.

With this in mind it's worth pointing out that our forecast assumes that dairy prices first stabilise and then recover over the remainder of 2014 (see chart at the bottom of the page). This is the view we have maintained over much of the year, but that view is clearly now under threat.

Dairy prices remain under pressure

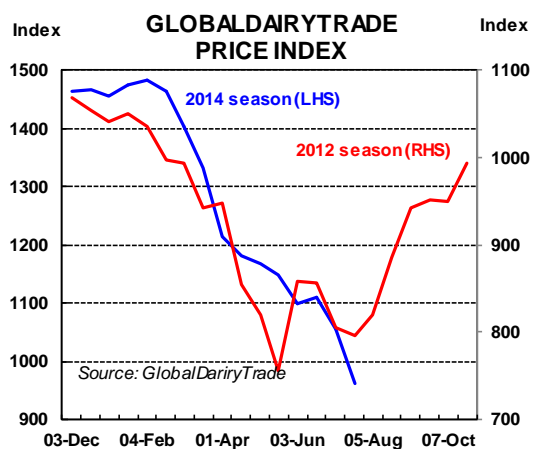
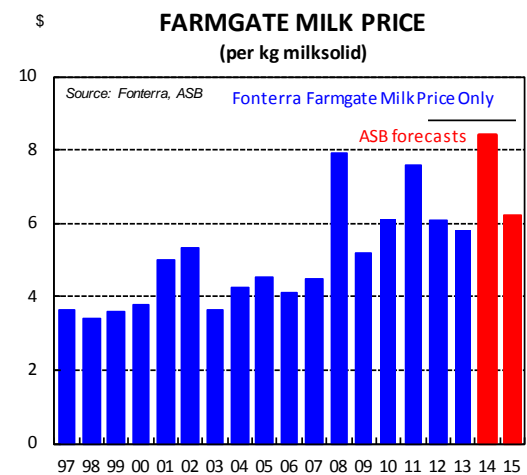
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Dairy prices have come under sustained pressure since the turn of the year, particularly from extra global milk supply. Overall, prices have fallen 35% since February, with WMP prices down nearly 39%.

This pressure firstly came from the stellar NZ production season where production has lifted by around 10% the season prior. Production has also lifted strongly in Europe and to a lesser extent the US and China.

	2013/14		2014/15	
	Fonterra	ASB	Fonterra	ASB
Milk Price*	\$8.40	\$8.40	\$7.00	\$6.20

* per kg of milk solids



The other source of pressure has been from lower demand, although we see this as a temporary dip. Chinese buyers, in particular, appear to have stockpiled dairy products plus the Chinese economy has slowed over the year, with this impact being felt by consumers as well.

However, we expect a rebound in dairy prices as some of these factors are one-offs.

Extrapolating these trends would take dairy prices down further. And in such a scenario, a sub-\$6.00 milk price is a possibility. However, we expect a rebound in dairy prices as some of these factors are one-offs.

Firstly, NZ production growth will return to something more normal (weather-permitting). We expect a lift of circa 3% over the 2014/15 season compared to the 10% lift recorded over the season just gone, particularly as the lower milk price forecast will be less of an incentive for farmers to increase production. For similar reasons, European production is unlikely to record back-to-back strong growth next season.

Lastly, Chinese dairy stocks will diminish over time and Chinese economic growth is also likely to rebound as authorities there move to ensure economic growth hits their stated target of 7.5% annual growth.

We anticipate that WMP prices will lift closer to SMP prices over 2014.

In this respect we take some comfort from higher SMP prices. In the most recent auction, SMP prices for the contracts for delivery in 2 to 5 months were around US\$250 higher than the same WMP contracts. With SMP indicative of the global dairy market position (most major producers export SMP, and WMP more reflective of NZ dairy market), as NZ production returns to to normal over 2014, we anticipate that WMP prices will lift closer to SMP prices over 2014.

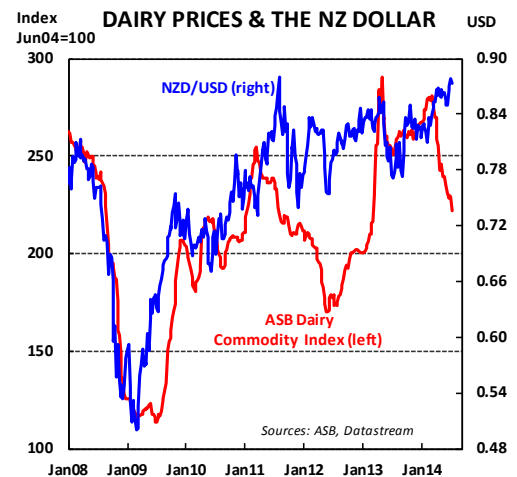
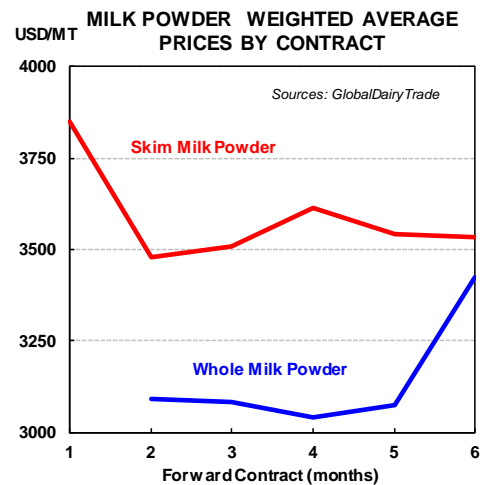
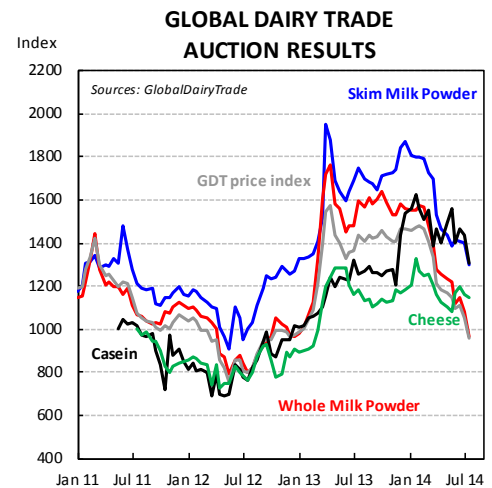
Only about 10% of product for this season's milk price have had their prices set.

Also, it's very early days for this season. Only about 10% of product for this season's milk price have had their prices set. As a result, a lot can and will probably happen between now and the season's end.

Implications and final thoughts

The NZD is currently high for understandable reasons – particularly the RBNZ's tightening cycle, coupled with the USD's weakness. But the currency isn't acting in its usual capacity as a buffer for the tradable sector at the moment. The 8.9% fall in dairy prices overnight, added to the series of falls over the year give one very good reason why we could see a lower NZD over the next year.

If the NZD stays trading near current levels, and dairy prices don't pick up over the season ahead, there are further downside risks to the 2014/15 milk price, and a sub-\$6.00 milk price is a risk as discussed above.



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