

Take a deep breath

- Dairy prices continue to search for a bottom, with overall prices down 8.4% in last night's auction.
- As a result, we have revised down our milk price forecast for 2014/15 by 40 cents to \$5.80/kg.
- With this revision out of the way and while risks are that dairy markets continue to overshoot, we also see factors supporting the milk price re-emerging by year end.

Dairy prices continue to search for a bottom. Overnight, overall dairy prices recorded a further 8.4% fall on the back of a circa 9% fall in the auction a fortnight prior. All up, compared to the same time a year ago, prices are down by 37%.

In our previous commentary we noted that should the recent falls continue a sub-\$6.00/kg milk price was possible. While we still maintain our view that prices will stabilise over the remainder of 2014, dairy prices have now crossed this threshold.

With this in mind, we have revised down our milk price forecast for the 2014/15 season by 40 cents to \$5.80/kg of milk solids. Our updated forecast compares with Fonterra's own forecast update from last week of \$6.00/kg.

In the heated moment of price declines, it is tempting to extrapolate the current falls. And if that were to eventuate, our milk price forecasts would drop further. On the other hand, we prefer that cool heads to prevail. Many of the factors pushing down prices are due to temporary boosts to supply. The production rebound from drought here in NZ will not repeat. Also, the NZD and dairy prices are out of whack, and we see a rising possibility of this gap closing over the year.

All up, we continue to expect dairy prices to stabilise and then recover by the end of 2014. However, predicting the exact timing of any price rebound remains an inexact science.

ASB milk price forecast cut to \$5.80/kg

We have cut our 2014/15 milk price forecast by 40 cents...

We have cut our milk price forecast for the 2014/15 season to \$5.80 per kg of milk solids. This revision is a 40 cent cut from our previous forecast of \$6.20/kg. Our \$5.80 forecast is also lower than Fonterra's forecast of \$6.00/kg (which Fonterra updated last week).

...and the risk of a milk price closer to \$5/kg is rising.

This reduction is another clear warning shot across farmers' bows. If prices stay near their current low levels for an extended period, the risk of a milk price closer to \$5.00/kg for 2014/15 season is rising.

However, we still expect dairy prices to lift from current lows by the end of 2014.

However, we still expect dairy prices to lift from current lows by the end of 2014. Production gains, owing both to better weather and the impetus from previously high prices, will wane, tightening global dairy supply. In addition, (Chinese) dairy stockpiles will clear. On this basis, we expect the downward pressure on prices to subside.

Dairy prices and the NZD remain out of alignment.

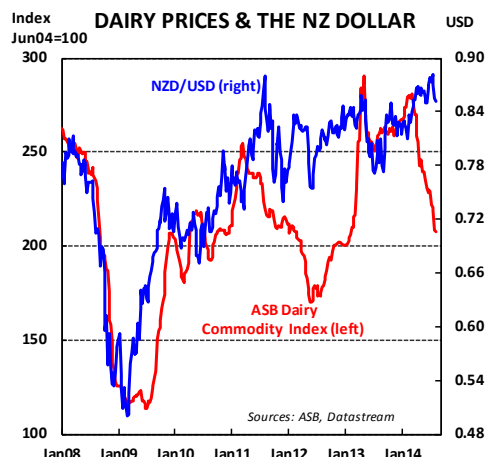
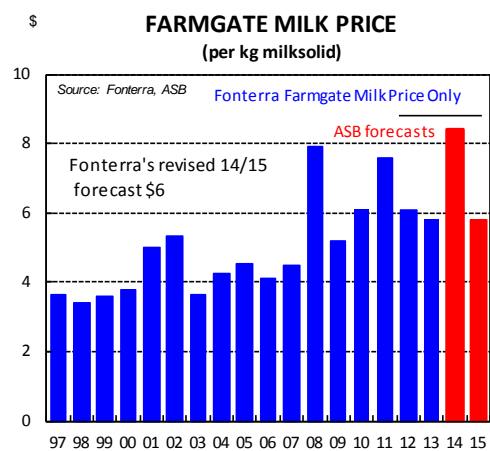
The other supporting factor coming more and more into the view is the NZ dollar. While the NZD is down from its highs last month, dairy prices and the NZD remain out of alignment. As a result, we see a rising possibility of this gap closing over the season.

Dairy prices continue to search for a bottom

Dairy prices have come under sustained pressure since the turn of the year, particularly from extra global milk supply. Overall, prices

	2013/14		2014/15	
	Fonterra	ASB	Fonterra	ASB
Milk Price*	\$8.40	\$8.40	\$6.00	\$5.80

* per kg of milk solids



Continued price declines have been a surprise.

have fallen around 41% since February, with WMP prices down nearly 46%.

The continued price declines have been a surprise. The latest fall was the 11th fall in the last 13 auctions. Moreover, today's 8.4% fall came on the back of a combined 14% fall in the two auctions prior.

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

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.

Commodity and in particular dairy markets can and do overshoot.

Commodity, including dairy, markets can, and do, overshoot. With this in mind further price falls are a possibility. However, we expect a rebound in dairy prices by year end as most of the recent price drivers are one-off or temporary in nature.

Dairy prices to rebound by year end

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.

However, we expect a rebound in dairy prices as most of the current price drivers are temporary in nature.

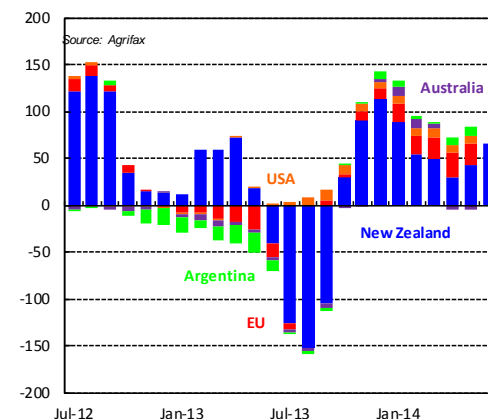
Lastly, Chinese dairy stocks will diminish over time, particularly as underlying Chinese economic growth and demand remains robust. Similarly, current low dairy prices are likely to begin to attract back to market the same buyers who were put off by last year's high prices.

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

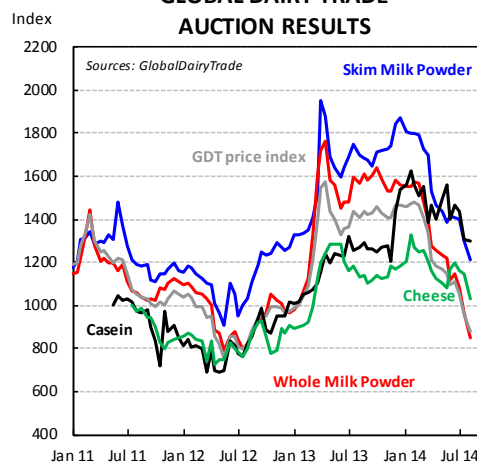
In this respect we take some comfort from higher SMP prices. In this auction, the weighted average SMP price was around US\$500 higher than the same WMP price. SMP is indicative of the global dairy market position (most major producers export SMP; WMP is more reflective of NZ's dairy market). As NZ production returns to normal over 2014, we anticipate that WMP prices will lift closer to SMP prices. Similarly for both products prices for later-dated contracts were generally higher than earlier-dated ones (particularly excluding the WMP contract for delivery in one month's time).

Also, it's early days for this season. Around 80% of product for this season's milk price have yet to have their prices set. As a result, a lot can and will probably happen between now and the season's end.

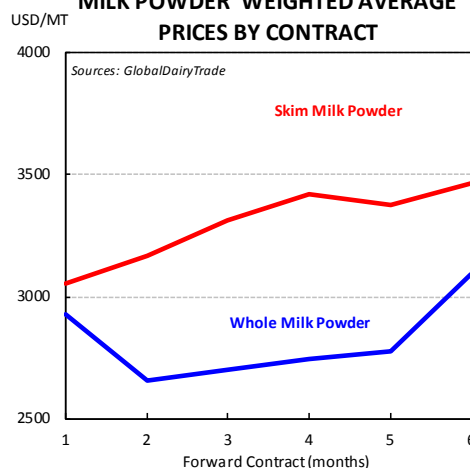
3mth annual change (000's MT) **WMP EXPORTS BY MAJOR EXPORTER**



GLOBAL DAIRY TRADE AUCTION RESULTS



MILK POWDER WEIGHTED AVERAGE PRICES BY CONTRACT



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