

From Russia without love

- We have revised down our 2014/15 milk price forecast by 50 cents to \$5.30/kg of milk solids.
- The impact of the Russian import ban and weaker Russian dairy demand are compounding other factors pushing down dairy prices, such as very strong global dairy production and the temporary dip in Chinese demand.
- Recent falls in the NZD are helping to a degree, but at this stage not by nearly enough to offset the large dairy price falls.
- Despite this revision, our long-run view for the milk price remains unchanged.

Dairy markets can't catch a break. Earlier this year, bumper global production drove down prices. Now the effects of the Russian dairy import ban and the slumping Russian economy are helping sink dairy prices further.

Factoring in this extra weakness, we have revised down our milk price forecast to \$5.30/kg of milk solids. This is a 50 cent reduction from our forecast a month ago.

We had expected that NZ could stand to benefit from the Russian import ban. Russia banned our two biggest dairy export competitors, the EU and US (plus Australia), from its dairy markets. NZ was spared from the ban and some commentators expected that Russia would look to us to fill the dairy gap.

As it turns out, markets have anticipated that extra European milk, in particular, will hit markets soon. Moreover, Russian health authorities have yet to approve NZ dairy factories for export to Russia (as a consequence of last year's Fonterra contamination scare). This combination of factors has pushed the prices down for key EU exports such as cheddar and SMP over recent auctions, and NZ producers have been caught in the crossfire.

The Russian economy is also in a tailspin. The Russian rouble has fallen 10% against the USD since the end of June, increasing the price of imports. This will hurt Russian consumer demand, including for dairy. In this respect, war (or the threat of war) is most definitely bad for business.

We have cut our 2014/15 milk price forecast by 50 cents.

ASB milk price forecast cut to \$5.30/kg

We have cut our milk price forecast for the 2014/15 season to \$5.30 per kg of milk solids. This revision is a 50 cent cut from our previous forecast of \$5.80/kg.

Our \$5.30 forecast is also lower than Fonterra's forecast of \$6.00/kg. Although, Fonterra will update its forecast next week as part of its end of year results (scheduled for a 24 September release) – we expect the updated forecast revision to be of a similar magnitude.

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Our forecast weighted-average USD price for the season is around 9% lower than our previous forecast. Moreover, we have pushed back the timing of the recovery in prices.

This revision is largely owes to Russian developments and comes on top of other earlier developments like very strong global supply and

temporarily weak Chinese demand. Firstly, we see NZ being caught in the crossfire as European producers look to our export markets to find a home for product that can no longer be sold into Russia. And secondly, we see a shift lower in demand as the Russian economy slows and consumer demand, including for dairy, falls.

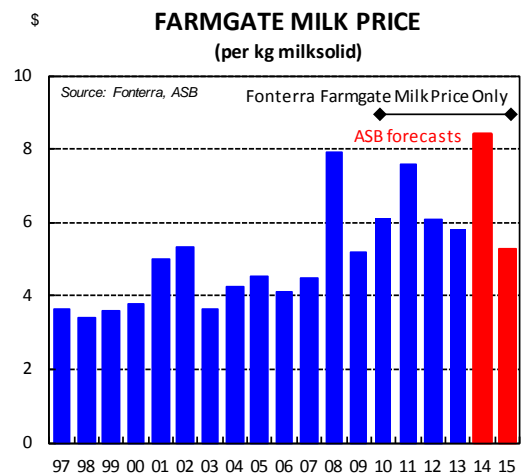
NZ is being caught in the crossfire between the Russian import ban and EU product looking new markets.

The NZD is helping to buffer lower auction prices. However, the NZD falls are still dwarfed by the dairy prices. The NZD has dropped from over USD 0.88 back in July to around USD 0.82 currently.

While our view for prices to stabilise and then over the remainder of the season as global production moderates and Chinese demand kicks back in to gear still holds, the starting point for the recovery is significantly lower than expected. Moreover, we are now much further into the season with approximately a third of auction volumes now sold.

	2013/14		2014/15	
	Fonterra	ASB	Fonterra	ASB
Milk Price*	\$8.40	\$8.40	\$6.00	\$5.30

* per kg of milk solids



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Beyond the current season, our long-term positive view for dairy prices still holds. We expect global dairy production growth to moderate and for Chinese demand to rebound heading into 2015. A lower NZD over 2015 and 2016 should also be supportive of the milk price.

Putting numbers around this and factoring in some residual weakness from Russian dairy market developments, we have pencilled in a \$6.50/kg milk forecast for the 2015/16 season. For the 2016/17 season and beyond we assume an average milk price of \$7.00/kg as further income and protein consumption growth continues in markets, particularly such as China, and help keep prices high by historical standards.

GlobalDairyTrade prices flat overnight

Dairy prices were flat in the last night's dairy auction. By product the auction results were mixed. Milk powders posted modest gains, with WMP and SMP up 0.6% and 0.9% respectively. Casein was also up 1.3%. Heading the other way were AMF, butter, BMP and cheddar prices. These products all posted falls of around 2%, except BMP fell nearly 7%.

Overall prices now stand 42.4% lower than a year ago. Since the most recent peak in February of this year, overall prices are down 44.5%. With this auction technically down -0.01%, prices have fallen in 14 out of 15 auctions over this period.

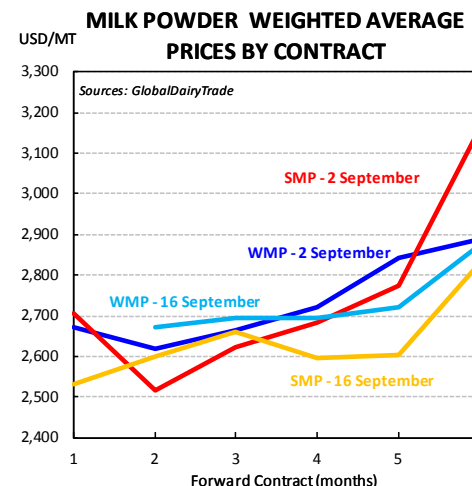
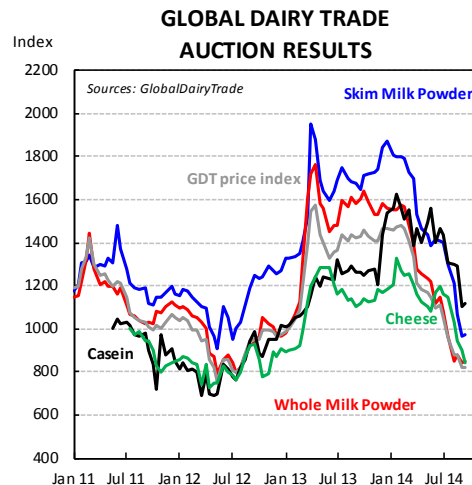
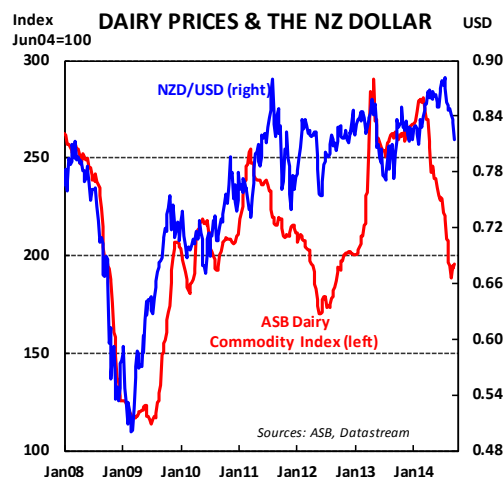
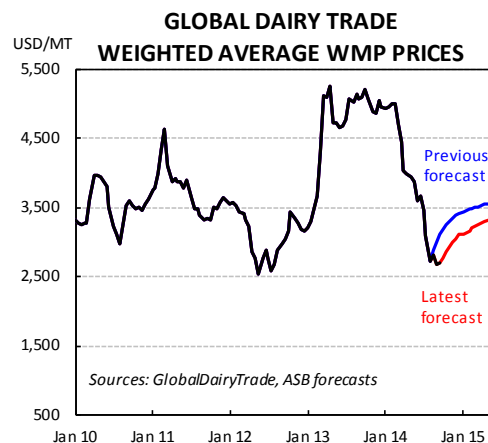
Cheddar has been the big recent loser. After holding up better during the Feb-Jun period, cheddar prices have fallen close to 30% over July, August and September. This may be a further sign of the Russian import ban in play as Russia is the largest buyer of cheddar from the EU. That product will now have to find another home (e.g. other markets where NZ is selling) or be stockpiled.

Overall, forward prices point to less future price support than previously. For example, WMP contracts for delivery in 4 and 6 months' time fell between roughly \$10 and \$120 from the previous auction.

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