22 July 2015

Dairy: Up, Down, or Sideways?

- Milk price outlook uncertain
- Is the milk price forecast range really $2.40 to $5.00?
- We lower our forecast 2015/16 milk price to $3.80
- Dairy drop part of why the RBNZ will cut the OCR
- While NZD is also providing broad support

International dairy prices have been under severe downward pressure over recent months as ongoing supply expansion, soft demand and trade embargoes weigh. Near term indicators are poor.

We are of the view that prices remain weak near term, but will recover over the following 12 months. Recent further weakness in general commodity prices such as oil and a reversal in international grain prices following previous gains supports the view that dairy prices will remain weaker than previously anticipated in the near term.

We adjust our 2015/16 milk price forecast lower, to $3.80 per kilogram of milksolids (from $4.30 most recently). This is part of a wider downward revision to milk price forecasts over recent months such has been the hit from factors like ongoing global milk supply expansion, higher than anticipated WMP inventory in China raising questions of underlying demand, USD strength and EUR weakness, the extension of the Russian trade ban on many Western dairy products, and general weakness in commodity markets and associated rise in risk aversion.

Our view also includes recovery from late 2015. Some possible reasons for some price improvement from late 2015 include:

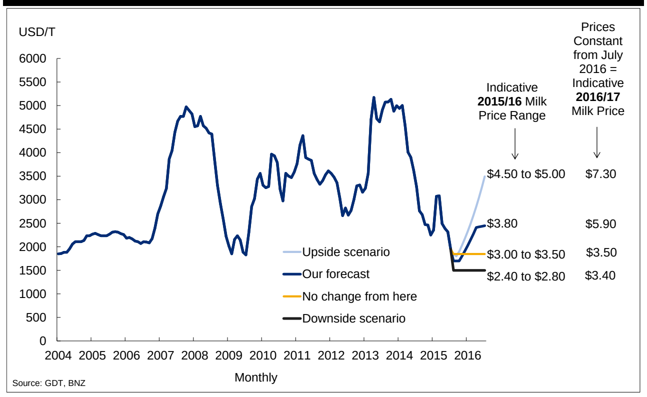
- The cycle – current very low prices will discourage production (globally) and encourage consumption.
- The balance of milk prices to grain prices internationally points to supply growth slowing down.
- Weather risk – the El Nino weather pattern that continues to strengthen could dent NZ production this season (as well as lift global food prices more generally). While restricted NZ production may lift milk prices, it is hardly a good way for it to occur.
- Californian drought – continues to dent milk production from the biggest producing state in the US (production down 4% y/y in June). US milk production overall continues to expand but at a much slower rate.
- Chinese import demand is anticipated to increase, but remains dependent on Chinese milk production, demand and level of inventory.
- A chance that Russia removes its current ban (that now extends into 2016). While perhaps a low probability, and it would be unlikely to see a full and immediate return to previous buying levels, it would be a material positive to international pricing.
- No major lift in EU production (overall) following the removal of production quota limits earlier this year, given current economics.

With so many factors moving in the international dairy market at present we continue to emphasise the very wide range of possible outcomes for the 2015/16 milk price. It is entirely possible for prices to move higher than our forecast, just as much as it is for prices to go lower.

Our $3.80 figure represents our best estimate of the middle of a very wide range of potential outcomes when the season's figures are finalised in over 12 months' time. It is underpinned by wholemilk powder (WMP) prices remaining weak in the near term before approaching US$2,500/T by mid-next year (amid a host of other assumptions regards international product prices, product mix, operating costs, and foreign exchange rates – the latter includes our forecasts of the NZD and an assumption on what this may mean for actual average conversion rates over the season).

Given the considerable uncertainty at present, it is useful to look at alternative scenarios based on WMP and what these might mean for the 2015/16 milk price. In addition to our forecast, we look at three alternatives: no change from here, a downside scenario and an upside scenario.

Wholemilk Powder Prices And Milk Price



National Australia Bank

The chart shows these WMP price scenarios and the associated indicative 2015/16 milk price. It is also gives an indicative start point to the 2016/17 season if prices evolve as defined under these scenarios (along with other assumptions) to the start of that season.

No-change-from-here scenario

This scenario assumes prices remain at the mid-July auction's level for the entire season (as if world prices would ever sit still for a year!). Given the other uncertainties including the exchange rate, we estimate this would give a 2015/16 milk price in a range of $3.00 to $3.50.

Downside scenario

This scenario assumes further declines in WMP prices to US$1,500 in the near term and no recovery over the season. Such a scenario may involve an economic stumble in China denting dairy demand, lower oil prices, a further extension of the Russian trade ban, large EU production post-quota removal, weak underlying prices engaging EU intervention buying that delays price recovery, strong US milk production via lower grain prices, and/or favourable weather. The NZD would be expected to decline further under such conditions, but even so and given the other uncertainties, such an international situation would give a 2015/16 milk price in a range of $2.40 to $2.80.

Upside scenario

This scenario assumes price stabilisation initially and then solid gains in WMP to US$3,500 by the middle of next year. Such a scenario may involve some combination of a prompt and large return of buying from China, strong lift in oil and grain prices, a severe El Nino denting milk production, removal of the Russian trade ban, or major weather event in a major milk producing area. The NZD would be expected to be firm under such conditions, but even so and given the other uncertainties, we estimate this would give a 2015/16 milk price in a range of $4.50 to $5.00.

While this scenario may seem unlikely given current weak conditions, we note that in the three dairy price cycles within the past 10 years WMP prices have essentially doubled within a 12 month period. Is it darkest before the dawn at present?

Fonterra to revise down forecast

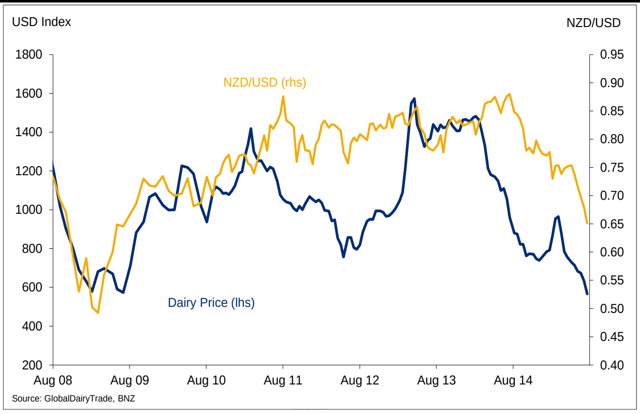
Fonterra is due to provide an update on its current $5.25 forecast following its board meeting on 7 August. Given the above, we would expect a downward revision. How much depends on many factors, including the co-op's view on where dairy prices track over the coming 12 months. One thing is for sure. There is plenty to consider.

Reserve Bank to cut interest rates

These scenarios are neither intended to scaremonger nor elevate expectations. They are simply designed to illustrate the degree of uncertainty at present and highlight the very wide range of possible outcomes that that generates. From a business risk and planning point of view, it bears thinking about. Whatever the outcome eventually turns out to be, one thing is for sure – the extreme volatility and uncertainty is wholly unhelpful.

The current dairy sector weakness and uncertainty reinforces our view that the RBNZ will cut the OCR by 25bps on Thursday, while framing a clear easing bias for potential follow up cuts depending how the economy evolves. Wholemilk powder prices are 20% below where they were prior to the RBNZ's June MPS, indicative of the degree of dairy price surprise to the Bank's expectations. Meanwhile, the materially lower NZD (associated with the dairy price decline), while only partial offsetting dairy's drop, is proving a sizeable boost to many other sectors and will become an inflationary force in time. It's a good reason to be cautious in cutting the OCR by 50bps. Even with the current weakness in dairy, the past few months proves just how fast things can change with primary product prices. It can work in both directions. Let's just see how things evolve.

GDT Dairy Prices and NZD/USD



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