

Agribiz

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Dairy storms back into play

Amidst the bewildering drama of a skyrocketing currency, booming business and consumer confidence, rising unemployment, spectacular rallies in global share prices, dire news out of the UK and Europe, an astounding rebound in China, envious glares at Australia's good fortune, and games of chicken between Alan Bollard and financial markets, an economic marvel has been quietly unfolding for New Zealand.

World dairy prices have risen 88% in four months at Fonterra's online global auction. Recovering global demand, soft supply, strong positive momentum and premiums in future pricing suggest that there is more upside in the short term.

It is difficult to overstate the importance of the recent developments for the New Zealand economy. Dairy exports earn New Zealand around \$10 billion a year, and have now passed tourism as New Zealand's largest foreign exchange earner. They make up about 25% of goods exports. What happens to dairy prices has a massive impact on New Zealand's terms of trade, and hence purchasing power of our income. On this

sort of scale what happens with dairy can do more to help New Zealand "catch up with Australia" (or more realistically "keep up with") over the short term than any government policy is likely to do.

In this note we examine the drivers of the price action, the outlook for the next couple of years, and the implications for the New Zealand economy.

Recent price action

Fonterra's monthly global online auction provides a timely measure of the pulse of the dairy market. The average whole milk powder price in USD rose 13.7% in the November auction, making a total increase of 88% in just four months. This rise is so far just as sharp as the boom

kicking off in the second half of 2006, and we expect the price to rise further, though we've assumed a slower rise from here (*Figure 1*). The increase so far puts dairy prices on a par with the rebound in base metals prices for our "lucky" neighbour Australia.

What is driving the increase?

The usual suspect – the balance between demand and supply. There are also some non-market factors working, primarily in our favour.

Demand

Dairy prices were felled by a sledgehammer when the global financial crisis hit. But behind this, a long-term increase in world demand for dairy products is going on, driven by the urbanisation and westernisation of the exploding middle class in China and the rest of Asia, and rising demand from "petro-economies". This long term dynamic has not gone away – indeed the trend is being exacerbated by the skew of current world growth towards developing Asia. Figure 2 shows how the market for New Zealand's dairy exports has changed in recent years.

Figure 1: Whole milk price versus base metals prices

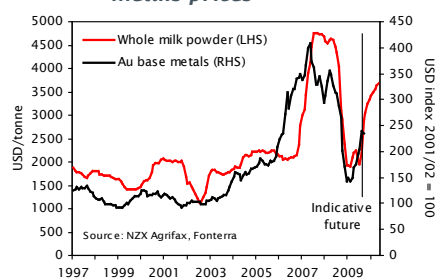
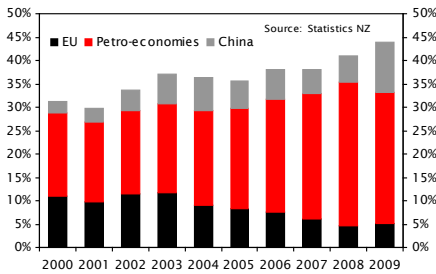


Figure 2: Destination of New Zealand dairy exports



More recently, demand from western nations has also been experiencing a cyclical recovery. US demand is now rising again, though remains below 2007 levels. Some recovery in demand in Europe is expected in 2010, and demand in parts of South America is robust.

As end-user demand rises and the world economic recovery strengthens, there has also been strong demand from supply chain restocking.

Supply

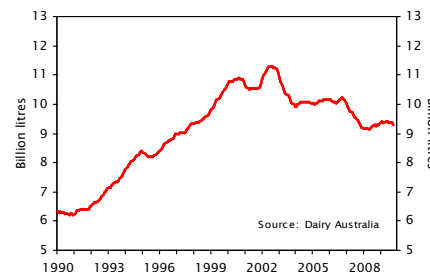
Global milk supply is soft.

- *US cow culling.* The US has culled a quarter of a million cows in 2009, putting pressure on production. US dairy production in October was around 1% below last year and is expected to be constrained over the remainder of the year and into next. The US Department of Agriculture forecasts lower milk production in 2010 than in 2009, which was itself down on the previous year. This would be the first back-to-back declines in annual US milk production since 1969.
- *Drought in South America.* Production across much of South America has been affected by drought.
- *Seasonal factors in NZ.* Overall New Zealand dairy production is expected to be similar to, or marginally higher than, last year (lower in the North Island given unfavourable weather to date, but higher in the South Island as recently converted dairy farms get up to full flow).

- *Poor growing conditions in Australia.* The start to the Australian dairy season has been poor. This season is shaping up to be a continuation of the trend decline in milk production seen since 2002 due largely to water constraints. Dairy Australia's forecast for 2009/10 milk production is 9.0 billion litres, 4% down on the previous season.
- *Seasonal impacts in Europe.* Production in Europe is currently at its seasonal trough.

The key through 2010 will be how Northern Hemisphere farmers respond to the higher prices.

Figure 3: Australian milk production (annual total)



Non-market interventions

- Offsetting supply constraints to some degree are large stockpiles in Europe and the US that built up in response to government price support measures. But these stockpiles are well-known and prices are still rising, indicating market participants still expect a supply squeeze over coming months. The stocks have already stopped rising and in some cases are starting to be unwound.
- As prices rise, export subsidies are being cut. For example, European export subsidies for skim milk powder were removed in October, followed by subsidies for whole milk powder, condensed milk, cheese and butter being cut to zero in November.
- New Zealand has recently negotiated free trade agreements with Malaysia and the Gulf Co-operation Council.

Around 40% of Fonterra's exports now go to countries that have free trade agreements with New Zealand.

Latest payout prediction

All this adds up to a higher payout to dairy farmers. Fonterra have lifted their forecast for the 2009/10 season to \$6.05 per kilogram of milksolids. This compares to a \$5.10 forecast made in September, and a \$4.55 initial forecast.

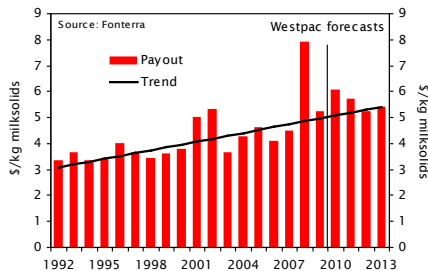
The rise in the NZ dollar means the increase in the NZD dairy price and the payout to farmers is less spectacular than the rise in USD dairy prices. But as we have noted before, this does not mean that the gains in world prices are lost to NZ; rather they are partly redistributed around the economy towards consumers and businesses, who are experiencing cheaper imports than they would otherwise.

Hence the increase in the dairy payout does not fully capture the benefits to New Zealand Inc. of the rebound in world dairy prices. But it makes for a pretty nice story nonetheless.

Uncertainty remains high

There is a considerable degree of uncertainty around forecasting the payout, with the NZ dollar and weather conditions around the world particularly hard to pick! We have some confidence regarding the fundamentals of tightening supply now and ongoing solid demand growth out of Asia, but growth in western nations, which also has a big influence on commodity prices, is more precarious. The lesson of the past three years is that dairy prices are in an ever-changing and volatile environment. Given these vagaries, we think it prudent to set budgets on the basis of a payout around \$5.70 for next season, with a 5 year average view of around \$5.40. Current conditions provide upside risk to this forecast, but as we have seen lately a lot can change in 5 months let alone 5 years!

Figure 4: Fonterra payout per kg of milk solids



As always, there are risks. Much uncertainty remains around the shape and speed of the world economic recovery. Closer to home, there are risks around the impact of potential tax changes, banking regulations regarding funding and capital requirements, and the speed at which ultra-low short term interest rates are increased. Even so, the dramatic improvement in global economic indicators and dairy prices in particular make for a much improved backdrop compared to six months ago.

Implications for the NZ economy

The upward revision in the dairy payout from \$5.10 to \$6.05 is directly worth around \$1.3 billion in farmer incomes, equivalent to 0.7% of GDP. And as mentioned above, that understates the total benefit to the country, in that additional benefits are distributed to consumers and businesses via cheaper imports from the higher NZD, and the multiplier effect of farmer spend.

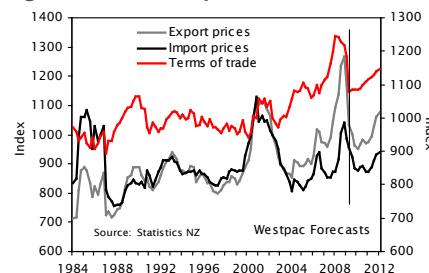
We would expect the income boost to start showing up in activity indicators in the dairy-intensive regions. On-farm discretionary spending was cut aggressively given the squeeze on cashflows from the initial \$4.55 forecast. Recent developments will significantly improve cash flows and allow maintenance expenditure to resume.

It is important to note that we are not anticipating a rapid return to “boom times” in the dairy sector. The industry has expanded rapidly in recent years

and is carrying a high level of debt. The current boost to incomes will inevitably bring the full spectrum of responses, although we suspect a large share will go into consolidation efforts rather than an immediate ramping up of discretionary spending or further expansion. But that is not to downplay the importance of recent developments – the boost to incomes will be very welcome indeed.

From an economy-wide perspective, higher dairy prices raise New Zealand’s terms of trade (the ratio of export prices to import prices). Of course, in an ideal world it would be better to have prices for all our export products rising rather than one or two rising sharply and others not so. Subdued commodity prices more generally, along with an anticipated rising trend in world oil prices, will dampen the overall increase in the terms of trade (Figure 5).

Figure 5: Terms of trade



Interest and exchange rates

Attention is now turning to when and how quickly the extreme policy stimulus put in place around the world will be removed. The Reserve Bank of Australia has already started lifting their cash rate from its low of 3%. It is a matter of time before the RBNZ follows, although currently weaker economic conditions in New Zealand relative to Australia justify lower rates here. Our pick is for the first hike in the OCR to be in March 2010.

Short-term rates are likely to remain low for some time in the major economies, but the risks to longer-term rates are generally pointing up. Term rates could

be pressured higher as governments globally compete for funds to pay for their sizeable stimulus packages and the markets’ focus switches from slumping growth toward higher inflation down the track.

At home, long-term rates are also likely to rise once the next RBNZ tightening cycle gets underway, though the longer the term, the less responsive they tend to be. The RBNZ is also tightening the rules around banks’ sources of funding, which will contribute to higher long-term lending rates – even more so when demand for loans starts to pick up again.

The NZD has rocketed higher over recent months, generating much talk and angst among exporters. A main driver of the stronger kiwi through 2009 has been the improving outlook for the world economy, especially growth prospects in Asia and Australia, and its generally supportive consequence for commodity prices. The NZ dollar is likely to remain above its inflation-adjusted average against the US dollar, British pound and euro given the relative economic weakness in those regions, while the kiwi is likely to be below average against the Australian dollar over the coming year.

Figure 6: NZ exchange rate

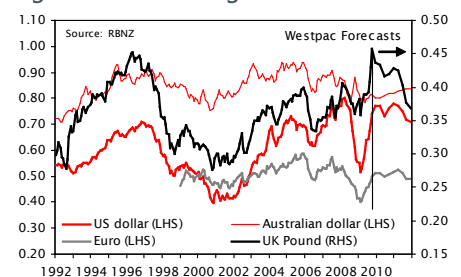
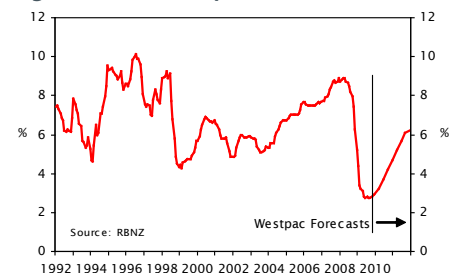


Figure 7: NZ 90 day interest rate

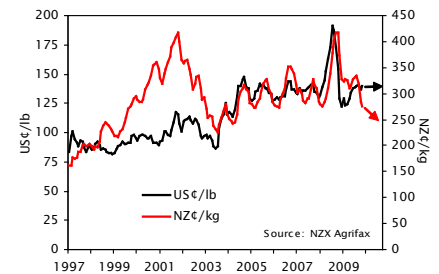


Beyond the farm gate

Beef

International beef prices have been sluggish over the past six months. Despite some improvement in economic conditions in the US, domestic cow prices have eased as cow culling has exerted downward pressure. Prices for imported product have held up, but are at risk of moving towards domestic prices as New Zealand and Australia supply comes onstream. On the positive side, we expect US supply to tighten in 2010 and improving economic conditions in Asia should underpin stronger demand and provide some support to prices. We anticipate international prices around the same level as today in a year's time, but the strength of the NZD is likely to see lower beef prices on average at the farmgate this season.

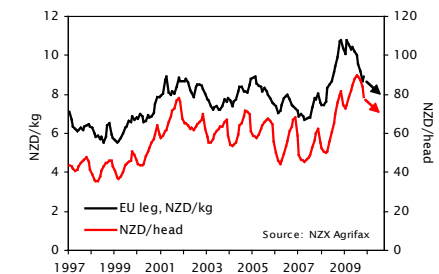
Beef prices



Lamb

Lamb prices at the farmgate look set to fall more than usual as the new season stock comes through. Despite the lack of lamb supply globally and signs of improving demand giving support to international prices, the strong NZD (especially against a weak British pound) has dented the outlook for prices at the farmgate. A high domestic lambing percentage has lifted the number of lambs tailed to almost 29 million, up more than 6% on last season. The additional domestic lamb supply will have some downward effect on price. Lamb prices may be down as much as 15% from last year's \$5.50/kg season average. As usual, the Christmas trading period in the UK and Europe will be important as will the behaviour of the NZ dollar over the bulk of the processing window.

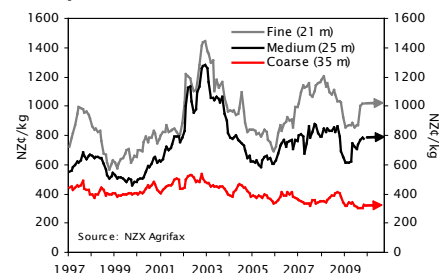
Lamb prices



Wool

The outlook for strong wool prices is soft. Carpet demand is likely to remain weak for some time as housing markets around the world take time to recover, suppressing demand. However, there have been some positives over recent months. Housing consents in the US appear to be forming a bottom and economic conditions in Australia point to a surge in house building ahead. Meanwhile supply is tightening on the back of fewer sheep. Strong wool prices ticked a little higher. Even so, the strength of the NZD is still a major negative. The outlook for fine wool prices is brighter, with rising consumer confidence around the world the precursor to more spending on high-end apparel.

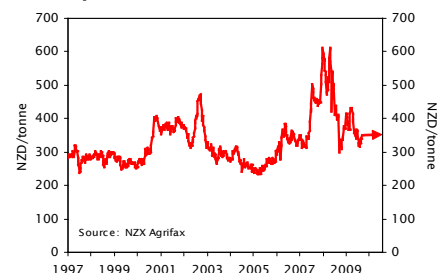
Wool prices



Grain

Global grain production is projected to fall 1.8% in 2009/10, from last year's record 1,793 million tonnes. This is a smaller decline than the 4% drop projected only a few months ago. The smaller drop in production combined with a further upward revision to carry-over stocks means global grain supply is projected to be around 2% higher in 2009/10. High carry-over stocks remain a feature of the domestic grain markets, although prices appear to have stabilised and are showing some signs of improvement. Feed markets have perked up a little with the lift in dairy payout. Anticipated reduced planting will help supply realign with demand.

Wheat prices



Forecast Key:
General pace and direction of prices expected over the next 12 months

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