2 October 2018

Meat and Milk Volumes Influencing Prices

- **Beef and lamb export volumes likely lower over coming year; fewer lambs in spring 2018**
- **Lamb prices set for another strong, mid-$7 average; beef prices seen easing**
- **Milk production forecast nudged higher**
- **We lower our 2018/19 milk price forecast to $6.30**

It's a good time of year to think about the meat and dairy export volume outlook for the coming 12 months, as the new season gets going. What is happening on farm now will have a large influence on the quantity sold ahead.

SHEEPMEAT

The recently released Beef+Lamb NZ New Season Outlook estimated the 2018 spring lamb crop to be 22.8 million head. If this is the final tally, it would be 3.8% down on last season. That equates to around 900,000 fewer lambs.

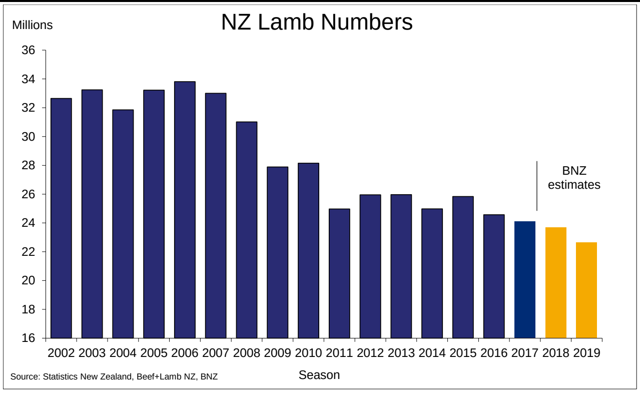
Fewer lambs are a function of a previous drop in breeding ewe numbers as well as an estimated pullback in lambing percentage from the previous season's record high. The number of breeding ewes as at the end of June 2018 is estimated at 17.4 million, down 2.1% from the same time a year earlier.

These estimates of breeding ewes and lamb numbers are unchanged from earlier guidance, albeit still subject to weather conditions through spring. They are what we had factored into our macroeconomic forecasts.

But early September brought a highly unwelcome cold and wet snap of weather with reported losses of around 100,000 lambs in the North Island alone. A couple of recent snow blasts in the South are hardly ideal either. It increases the chances that the final lamb tally comes in under the above estimates. We will wait to see what the first count is when it's released (usually in late November), but in the meantime we have lowered our lamb number estimate for this season to just under 22.7 million. This represents a 4.5% drop from last year and includes an estimated ewe lambing percentage of 124.6%.

After accounting for retentions, it suggests lambs available for export may dip below 19 million. Even assuming a slight weight improvement from last year's weather-affected level this indicates we should expect lamb export volumes to be down around 2% over the coming year. Meanwhile, mutton export volumes are

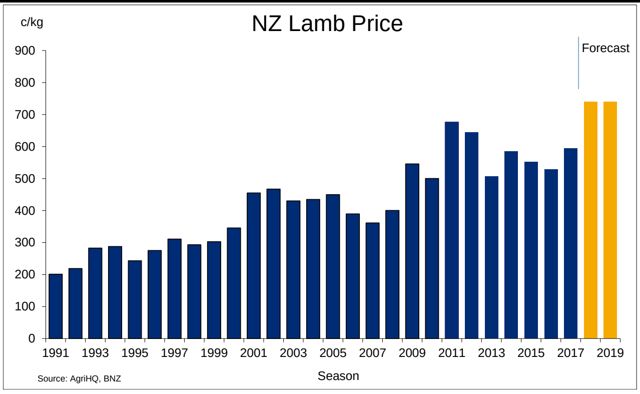
Fewer Lambs



expected to reduce by as much as 17% over the coming season following a high cull in the previous season.

One consolation of fewer lambs and less mutton available for export is that it supports prices, given NZ's influence on the world pricing (although less supply is hardly the best way to achieve that result). Our expectation is that international lamb prices will drift a touch lower over the season as demand conditions ease a touch and Australian supply increases (given drought conditions). Brexit remains a wildcard, with the current exit deadline date mid-season. Meanwhile, domestic procurement pressure should ease as we move into the new season. But we think that the high price starting point, tight supply, and a lower NZD will be enough to generate season average domestic farmer operating prices similar to previous season's $7.40/kg average. Such a result would be well above the past five year average of $6.00.

High Price



Of course, actual production, export volumes, and hence pricing will depend on how the weather pans out. If the brewing El Nino weather pattern were to eventuate and dent grass growth it could see slaughter brought forward, increased, or both – with downward pressure on prices.

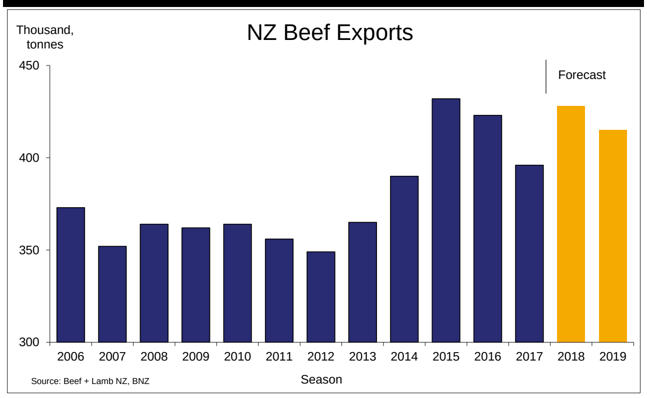
BEEF

Regards beef, Beef+Lamb NZ expects production to fall by 3.1% in the 2018/19 season with an equivalent anticipated reduction in export volumes. Expected reductions in cow and bull slaughter numbers are the key drivers, following large increases for both in the season just ending. Average weights are expected to remain relatively steady. This combination provides a beef export volume outlook a little weaker than we had factored in and so we adjust down accordingly. Beef prices in 2018/19 are expected to be around 5% lower than the previous season as softening in the US market is expected to more than outweigh the price positives of solid Chinese demand, less NZ volume, and a lower NZD.

Beef+Lamb note that while the impact of Mycoplasma bovis has an extreme impact on those farms directly impacted by the disease and following depopulation, it is expected to have little impact on the total cattle slaughter as the government-directed cull animals make up a small proportion. We have previously noted that the 152,000 cows that are expected to be culled under the multi-year Government/industry plan to try and eradicate the disease is a small share of both NZ's total cattle (1.5%) and a relatively small share of the typical annual cattle cull (3.5%). That said, we remain conscious of other negative influences stemming from the disease including elevated uncertainty, dents to confidence and morale, rising costs, and loss of efficiency as a result of restricted cattle movement. We continue to monitor developments around the eradication plan with interest.

Lower anticipated sheepmeat and beef export tonnage has pulled down our overall meat export volume forecast for the coming year from previously expecting a small rise to now expecting a modest decline. As ever, the weather will have a big say on the final export size and profile.

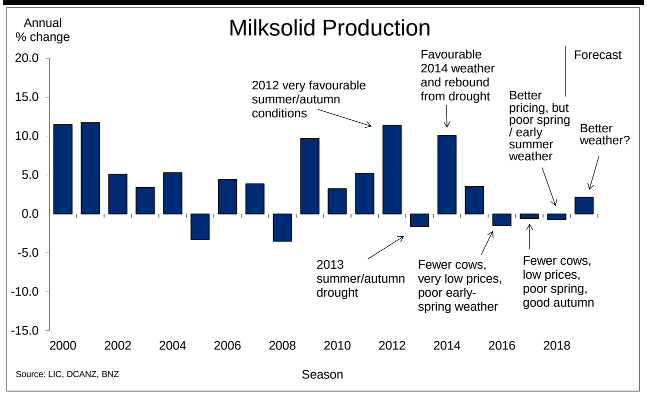
Lower Beef Export Volumes Expected



DAIRY

In contrast to meat volumes, the outlook for this season's milk production has improved. Part of this reflects a strong start to the milking season. Production in the first three months of the season is more than 5% above year earlier levels including a 4.6% gain in August – the first month of meaningful volume for the season. This follows from generally reasonable weather through winter and price incentives encouraging production. Meanwhile, Fonterra's forecast offer volumes on GDT have been significantly lifted for auctions during October, November, and December – supporting the case that good early season milk production is expected to continue. So we nudge our working assumption for full season milk production growth up to 2% from 1%, with an associated lift in the outlook for dairy export volumes into 2019. More milk this season would represent a bounce back from the weather-affected 0.7% drop last season, although production is expected to remain below its peak of 2014/15.

More Milk



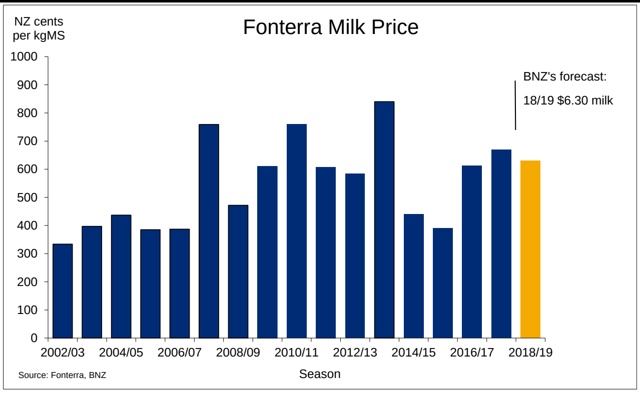
As ever, actual production will heavily depend on the weather. It is still early in the season and things can change rapidly. Indeed, the cold snap in early September will not have helped grass growth. Looking forward, a potential El Nino weather pattern could easily disrupt things and perhaps more than usual given the introduction of disincentives for excessive use of some supplementary feeds.

For now, increasing milk supply and the prospect of more has put downward pressure on dairy product prices. GDT prices have fallen. In fact, the GDT Price Index is yet to post an increase in the new season and we are nearly four months in. Prices are 14% lower than on day one of the season. Of course, not all of this is due to NZ supply. There have been many other factors involved such as an apparent easing in demand, as world economic growth indicators cooled a little, and milk supply from elsewhere has been reasonable which in part has been supported by generally low international grain prices. For domestic milk prices, a lower NZD has been a support but not enough to offset the reduction in international prices.

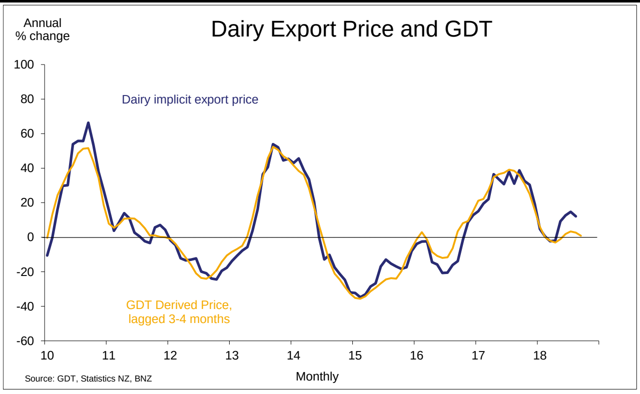
All considered, we nudge our 2018/19 milk price forecast down to $6.30 (from $6.60) having discussed the downside risks for some time. Our view includes subdued international dairy product pricing near term with some mild improvement into 2019. If that improvement were not to occur or especially if dairy prices were to move lower from current levels, milk prices will likely end up lower than we currently think. Indeed, given recent offshore price momentum the downside risks are easy to see. On the flipside, international dairy prices may soon find some support after NZ milk production passes its peak over the coming month or so and especially so if El Nino conditions were to affect production later in the season. Meanwhile, milk production in key offshore markets, while still positive, has been slowing. This may provide price support in time especially if the slowdown in milk supply were to continue. Oil prices recently pushing above $US80/barrel is another potential positive for dairy prices. And there was a hint of dairy demand improvement at the mid-September GDT auction (prices didn't fall as much as supply increased). At this point, we see $6.30 as sitting in the middle of a still wide range of possible outcomes come season's end.

Fonterra has recently revised its 2018/19 milk price forecast down from $7.00 to $6.75. In our view, there still appears downside risk to this forecast. That's not to say that that forecast cannot be achieved. But we think it would likely require international prices to post a reasonable rise, or the NZD to fall, or costs to fall, or achievement of better-than-GDT prices for sales outside of that platform, or some combination of the above. On the latter, there is some evidence that this might be occurring with implicit export prices doing better than recent moves in GDT prices, although the export price movements could also reflect other factors so it is difficult to be sure. The extent of selling off the GDT platform with its potentially better pricing may prove important to what milk price is finally achieved. If a significant amount of reference product has been sold off the GDT platform at materially better than GDT prices then it increases the chances that the season's milk price will be above our $6.30 forecast.

Milk Price Forecast Trimmed



Could This Sustain Strong Milk Price Forecasts?



Separately, Synlait recently lowered its 2018/19 milk price forecast to $6.75 from $7.00 and noted that the revised forecast assumes an improvement in dairy commodity prices in the medium term. That reinforces the idea that if international product prices do not improve, $6.75 will be difficult to achieve.

In any case, as is always the case, any outlook regards the primary sector is subject to change – and potentially quite quickly – given the numerous factors at play. It is a situation of having to roll with the punches as they come along, and with a business strategy designed to navigate through the various ups and downs.

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