

20 March 2019



## Dairy Outlook Improving But Risks Remain

- **Dairy price rise continues**
- **On tightening global supply and robust demand**
- **We lower our NZ milk production expectations**
- **2018/19 milk price forecast increased to \$6.50**
- **And 2019/20 up to \$6.70, as world economic risks recede from highs**
- **Positive for NZ terms of trade, incomes; not so GDP**
- **We continue to monitor many global risks**

Dairy prices continue their ascent. Today's 1.9% gain the GDT Price Index is the eighth consecutive increase and takes the cumulative gain to 26.2% since November last year. It is a material move higher as solid demand has bumped up against tightening global milk supply.

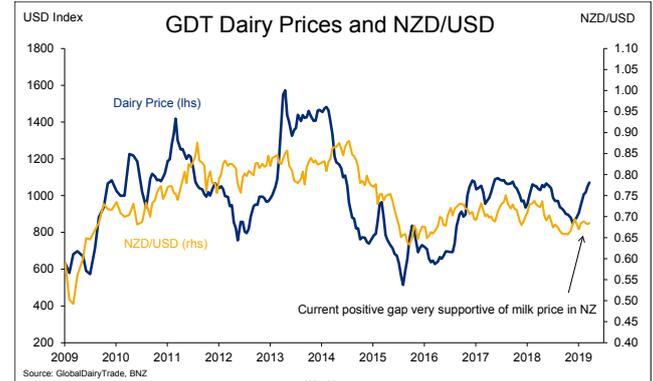
This includes in NZ with a bout of dry weather dimming late season milk production prospects. NZ weather conditions had been generally superb through spring and early summer but deteriorated significantly over the past couple of months. Penalties for excessive use of some supplementary feed are likely to have added to the weather's downward influence on milk production. While some recent rain will help at the margin, we don't think it will be enough to prevent milk production falling behind a year ago, in the last third of the season.

Fonterra has reduced its forecast milk collections for the full season twice over recent weeks. The co-op now forecasts just a marginal gain in milk collections compared to the previous season; this follows expectations of a 3% gain less than a month ago. That is quite some change over a short space of time and has given a boost to wholemilk powder prices.

For NZ's milk production as a whole, we have revised down our forecast to between a 1% and 2% gain for the 2018/19 season from 4% previously. The flipside of lower volume is higher prices. The cumulative push higher in dairy prices has been more than we factored in a couple of months ago. Having previously noted upside risks, we formally adjust our 2018/19 milk price forecast higher to \$6.50 from \$6.25 previously. This view includes auction prices generally maintaining their recent strength if a tad lower than current by season end.

Fonterra reiterated its milk price forecast range of \$6.30 to \$6.60 this morning at its interim results. So our new forecast sits in the top half of Fonterra's current forecast range.

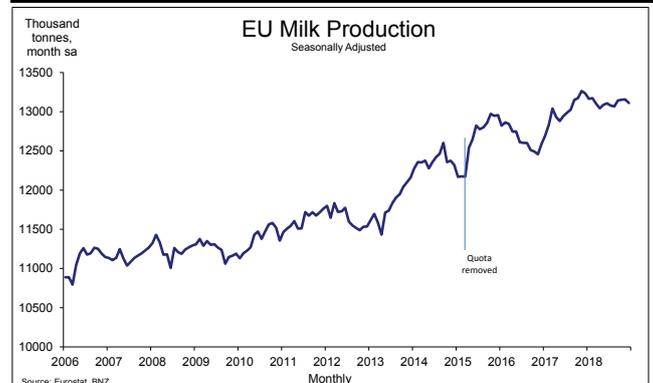
### Higher Dairy Prices, Stable NZD: Good For Milk Price



From a macroeconomic point of view, recent dairy market developments are positive for NZ's terms of trade and incomes but a near term drag on production and real GDP. In simple terms, it means more value, less volume.

Of course, NZ's late season supply concerns meet an already tightening global market with EU milk production essentially static following a poor summer last year and previously massive stockpiles having been unwound. Australian production has struggled with poor weather conditions all season and is well down on a year ago. US production continues to rise, albeit slowly. Meanwhile, demand has been strong. Price gains support this notion as do an elevated number of unsatisfied bidders at recent auctions including this morning's. All of this has played a role in supporting prices over recent months.

### EU Milk Supply Static



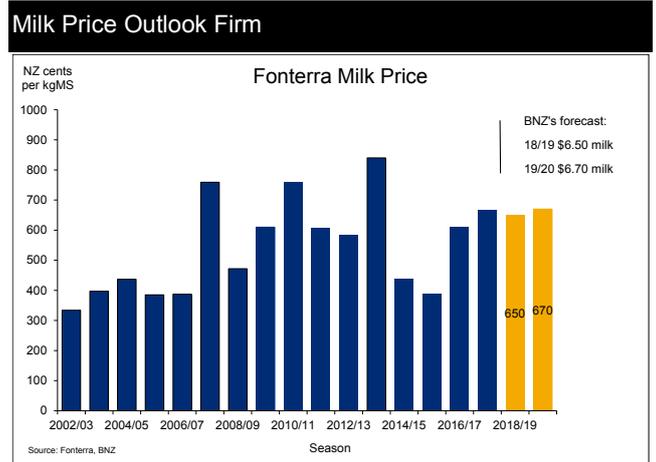
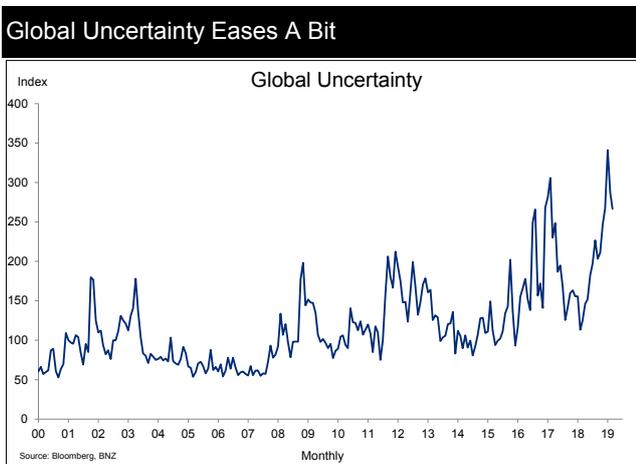
Next season

Focus is quickly turning to next season. Market optimism is very high which is understandable as global dairy prices are currently surging upwards and the NZD stable. This is adding some real gusto to milk price considerations for the 2019/20 season. However, while we can easily see scenarios where the 2019/20 milk price could come in well above \$7 next season, we remain a little wary of extrapolating current market conditions across all of next season at this point.

To be sure, we have been looking to lift our 2019/20 milk price forecast, as global milk supply growth has stuttered. However, we have been holding off revising upwards because of high levels of global economic uncertainty and the fact that economic growth has been slowing around the world, including in China. That said, global economic uncertainty measures have pulled back from recent highs. With the Fed halting interest rate increases and China providing economic stimulus the global economic outlook looks less worrisome. That is also the clear message from our risk appetite index rising strongly over recent months coinciding with a strong lift in global equity markets since the start of the year (following a sharp decline before Christmas).

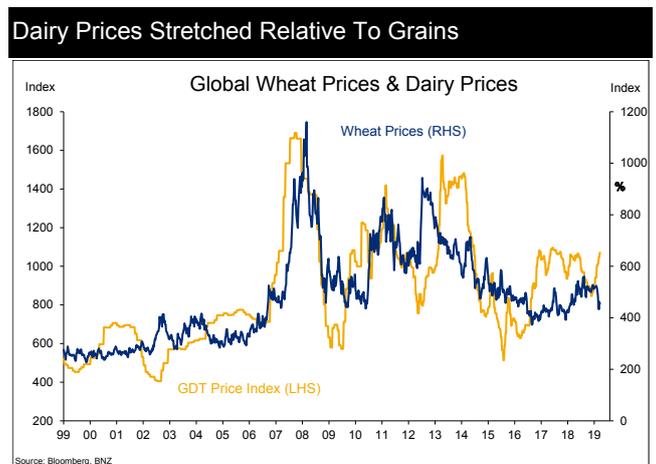
With uncertainty at least declining from its recent heights – lessening the risk around future demand conditions and supply still on the tight side – we formally revise our 2019/20 milk price higher to \$6.70 (from \$6.10 previously). To be sure, this still contains a fair amount of caution built in. Elevated uncertainty and world risks haven't unwound completely. Of course, uncertainty doesn't necessarily mean things will turn out weaker than anticipated. But, to us, it simply suggests some caution is warranted.

As a point of comparison, on our calculations, if current dairy prices and currency levels were to persist through next season, then the 2019/20 milk price would be around \$7.40. Further gains in auction prices would only add to



this figure. We will revise our milk price forecast higher again if uncertainty were to drop further, global risk appetite were to extend higher, and/or current strong positive dairy price momentum were to persist for long enough.

For now, we respect still elevated global economic uncertainty, slowing global growth and, as yet, unresolved trade tensions among the world's major economic areas. These factors may yet slow demand and weaken prices in time. While we expect the supply side to remain relatively constrained, there is a chance of some improvement in EU milk production following the continent's mild winter, current weakness in international grain prices lowering feed costs, and the recent improvement in dairy prices. The strength of run up to the Northern Hemisphere's seasonal milk peak will be important for pricing ahead, as will the finish to NZ's season. Of course, there is always potential for demand to be stronger than we anticipate and for supply to tighten further leading to even higher prices that current conditions indicate. At this stage of proceedings, still more than two months before the new season starts, error bounds around any point forecast are extremely wide.



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