20 November 2019

Hot Milk

- **Dairy prices pushing higher**
- **As robust demand meets contained global supply**
- **We lift our 2019/20 milk price forecast to $7.40**
- **We continue to monitor many global risks**

The NZ milk price outlook continues to improve. Dairy prices have been firm in 2019 and have pushed higher over recent auctions. Indeed, today's 1.7% gain in the GDT Price Index is the fifth consecutive increase taking the cumulative gain to 8.3% since the most recent trough in early September. GDT prices are heading toward the top of a trading range that has held them since 2014 and are now a chunky 26.4% higher than a year earlier. Price gains have occurred as solid demand has bumped up against docile global supply.

Strong dairy demand from China (notwithstanding a slower economy there) has been an important component. Unsatisfied bidders stayed elevated at the auction overnight, indicative of solid prevailing demand conditions.

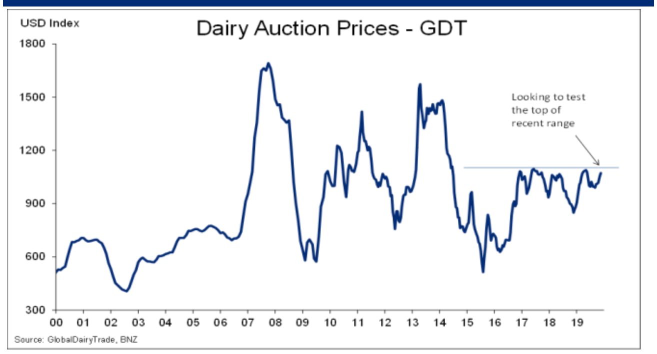
Meanwhile global milk supply remains subdued. In NZ, milk production started the current season strongly but has quickly eased back. Weather conditions have been variable, although not terrible. That said, conditions haven't been good enough for milk production to match last year's strong spring. October was down 1.5% on a year ago, although NZ season-to-date milk production is still tracking slightly above last season. Weather forecasts, in general, remain reasonable for NZ but we think production over coming months will continue to lag the strong levels from a year earlier. This will add ongoing support to international prices in the near term, although maybe not as much as might have been in the past when production quotas limited any supply response from the EU.

Improving international prices as international economic risks ease somewhat and NZ milk production lags last year have raised prospects for local milk prices, which have had ongoing support from a generally subdued NZD. On our calculations, dairy prices denominated in NZ dollars have lifted to their highest level since early 2014. With this, we nudge our forecast for Fonterra's 2019/20 milk price up to $7.40 from $7.10 previously. Such a result would see this season's milk price more than a $1, or 16.5%, higher than the $6.35 achieved last season. It would be the highest milk price since the record $8.40 back in 2013/14. Our milk price view includes further modest international price gains – as NZ production lags year earlier levels – before they are expected to ease back by season's end.

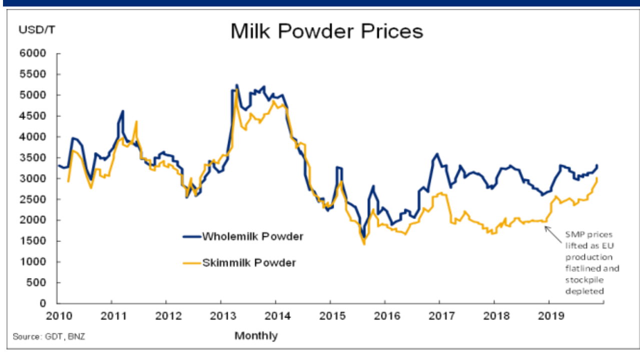
Elsewhere, Australian production has been hammered by drought and US milk supply growth has been modest (although has shown some recent signs of improving with a 1.3% y/y gain in October). EU production has been subdued and, with the previously massive stockpile of skim milk powder (SMP) well gone, this has transferred into a material pick up in the likes of SMP prices in 2019. SMP prices have lifted towards whole milk powder (WMP) prices (aided by fat prices retreating from highs, with further small declines in AMF and butter prices overnight). The 3.3% gain in SMP prices overnight sees those prices more than 53% above a year ago. WMP prices rose 2.2% overnight, to be up nearly 28% on a year earlier with an average price of $US3,321/T.

Overall, dairy market fundamentals continue to look healthy. Indeed, we would be forecasting a higher milk price if it were not for still elevated – if down from its peak – global economic uncertainty. Prices may head higher anyway, especially if NZ milk supply is crimped by more

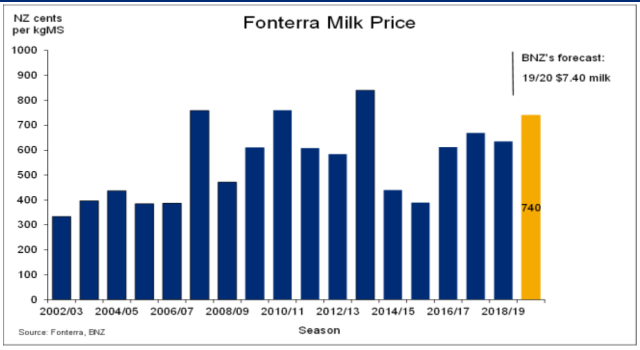
Looking to Test Range Top



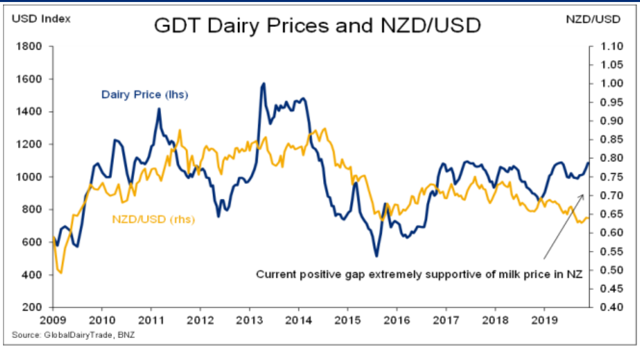
Better Skim



Looking Good



A Very Positive Mix



than expected on poor grass growing conditions. For perspective, we estimate if international prices maintain their current levels through the remainder of the season, it would be enough to generate a milk price around the top end of Fonterra's current forecast range of $6.55 to $7.55.

Since Fonterra announced that forecast in late October, GDT prices have lifted 5.5%. Of course, with some milk already sold, these price gains will not apply to the entire season's milk and the slight lift in the NZD over the last month or so will take some edge off. But it's clear the balance of developments to date favours the top half of the range rather than the bottom half.

We have been a bit cautious – although not necessarily bearish – on dairy prices all year given the considerable global growth risks prevailing. But the longer international prices have been resilient to – and even increased in the face of – slower global growth and world economic uncertainties, the brighter the prospects for milk prices in NZ have become. This has only been enhanced by a generally low NZ dollar, especially relative to buoyant offshore dairy prices. Moreover, while many global risks remain, they have eased somewhat on the prospect of a partial US-China trade deal. Higher global risk appetite provides a better backdrop for international dairy prices.

Also from a risk perspective, another positive is that dairy prices are not particularly out of line relative to the likes of grains, oil, or even gold.

That said, such improvements in risk appetite can, and do, change quickly. It would be remiss to fully discount downside risks with global uncertainty still prevalent. Elevated uncertainty and, as yet, unresolved trade tensions could still dent demand enough relative to supply and weaken prices ahead. In general, a sudden stop in demand still looks the bigger downside risk to prices rather than a burst of milk supply (although we'll be keeping an eye on the latest lift in US production to see if it has legs and EU production next season, just in case).

From a macroeconomic perspective, higher dairy prices are positive for NZ's terms of trade and the nation's purchasing power. It supports nominal incomes. However, support to real GDP via this channel needs to be calibrated to how much revenue is actually spent (as opposed to saved or used to pay down debt) and netted against one of the recent price drivers – namely lower milk production. For now, all considered, the balance looks growth positive. It also supports our view that the current account deficit will narrow over coming quarters.

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