24 May 2017

# Commodity Winds are Now Tail Ones to Trade

- April's $578m trade surplus beats market
- As exports do better, like we thought
- Imports maintain core momentum
- Fonterra pitches 2017/18 milk price at $6.50
- An understandable start but where will it finish?
- Scant NZD response to this morning's NZ news

| Trade Balance - April 2016 | | | |
|---|---|---|---|
| $NZ million | Actual | Mkt Expected | Previous |
| Exports | 4,750 | 4,400 | 4,605 |
| Imports | 4,172 | 4,100 | 4,328 |
| Monthly Balance | +578 | +267 | +277 |
| Yearly Balance | -3,481 | -3,790 | -3,710 |

After a rough December quarter, New Zealand's merchandise exports look to be rebounding quite well this year, while imports are largely maintaining their good momentum. So were the messages of this morning's April trade account. And today's milk price announcements by Fonterra were a further reminder that the commodity sector is now providing tailwinds to the economy, after cross-winds last year.

Starting with the trade figures, the point about them was that exports beat market expectations. They increased 9.8% on year-ago levels, whereas the market was looking for an annual gain of less than 2%. The outcome was more in line with our pick of 6% y/y, and the upside signals we noted around commodity export prices in the month.

Prices for New Zealand's main commodity exports in April were up 20.5% on the corresponding month last year, according to the ANZ indices, in NZ dollar terms. While this might be a peak, we don't expect this annual rate of inflation to subside much, if at all, over the coming months. And so we should continue to expect to see some good exports figures on the back of this.

The monthly exports data continue to suggest volumes are rebounding too, after a large sag in Q4 (that seemed largely a timing issue). This wasn't obvious in the fact dairy export tonnage in April was down slightly on year-ago levels. But bear in mind these were running markedly negatively over prior months. And we should expect positive annual comparisons to begin to show soon. In this vein, the nation's milk-solids production in April was up 6.8% on a year ago. As a more general observation, we expect next season's production to be up about 3.5% on the season that is just winding up.

As for April's merchandise imports these were 4% higher on an annual comparison. This was close to the market's, and our, expectations. There were no lumpy items – on either the import or export side – so these are relatively clean reads.

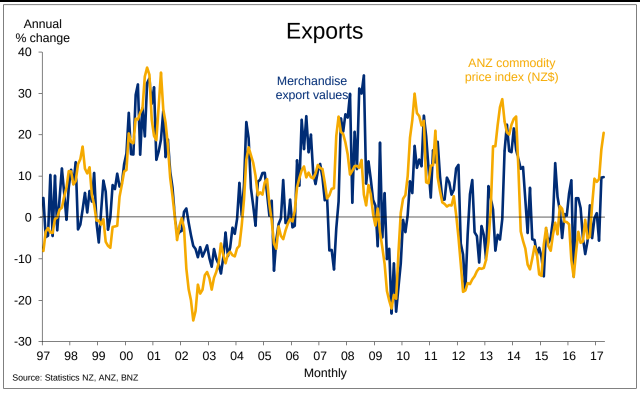
Yes, there was a big rebound in oil imports in April, after a weak spot in March (to do with volume). But even excluding oil, imports were up 3.2% y/y. This kept a reasonable story around core imports, once we take into account influences from the currency on prices. If there is a laggard, it would appear to be in consumer goods imports now, but by dint of intermediate goods (ex oil), and capital goods sustaining the momentum of their recent thrust.

If there were any impingements on April's international trade – based on it being holiday-rich this year, and subject to disruptions in getting goods to and from ports because of the vicious storms – then the actual results can be interpreted as that much more robust.

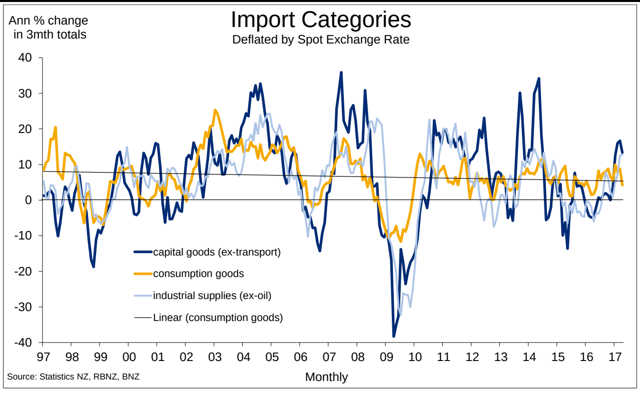
Bringing things together, April's trade surplus, of $578m, compared to market expectations of $267m, our $490m, and last April's reading of $350m. This trimmed the annual deficit to $3.5b, from $3.7b in the 12 months to March. This is broadly in line with our view the current account deficit will hold in at around 2.7% as a proportion of GDP over the first half of 2017.

Picking up on the dairy story, Fonterra's announcement first thing this morning was more good news. Its first milk price forecast for 2017/18 is $6.50. There is no poll for this, but we'd suggest this is within the bounds of expectations although perhaps toward the more positive end. But possibly less than the RBNZ has factored in – given its medium term circa $3,000/T for whole-milk powder projections and general currency view.

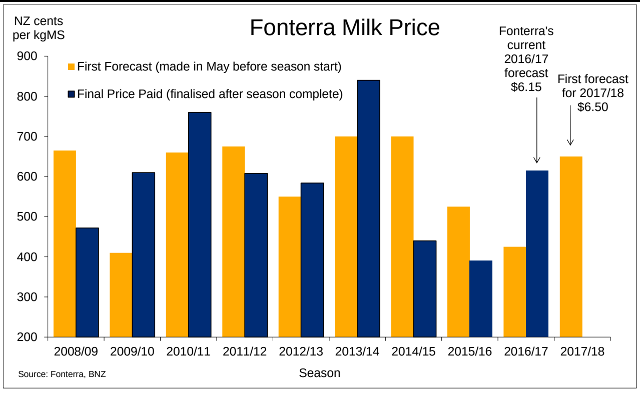
## Pricing Power



Solid




Much Better




This solid opening forecast of $6.50 suggests the co-op sees international dairy prices remaining quite firm through the season. It shows a degree of confidence. As usual, there will be those who say the forecast is too optimistic and others who say it's too conservative. What matters, ultimately, is where international dairy prices track over the coming 12-15 months. Eyes back on the GDT auctions.

Note that any forecast for the season ahead carries a very wide error bound around it. Our current forecast for the 2017/18 season is $6, but we have been highlighting the clear upside risks to this view given that it builds in some weakness in international dairy prices later in the year. We will stay with this view for now, but, as we have been noting, if prices don't drift lower the 2017/18 milk price will be higher than $6. Indeed, our calculations suggest if international dairy prices and currency hold at current levels then 2017/18 milk price could well end up being above $7.

Fonterra has also today lifted its forecast for the 2016/17 season, by 15c to $6.15. There is a lot more certainty around this figure as the milking season is drawing to a close. We suspected a lift was in order given recent dairy price gains. We had penciled in $6.10 and now lift this to $6.15. It is well above average breakeven estimates, which are in the low $5s, and a far cry from the prior season's milk price of $3.90. The lift from $3.90 to $6.15 represents a more than $4 billion lift in revenue to the dairy industry as a whole from last year's hole. Improving cash-flows are now being felt on farm.

To what extent will the $6.15 milk price forecast trigger repayment of the interest-free loans that farmers took up from Fonterra during the leans years? This depends on total advance payments – the nitty-gritty of the payment structure. So no loan repayments yet, but in time based on current forecasts.

Meanwhile, Fonterra continues to target a 40c dividend for the 2016/17 financial year, as it moves more milk into higher value products. At the same time, it continues to note margin pressure in its ingredients business stemming from higher milk prices. A 40c dividend on top of the $6.15 milk price forecast, gives a total forecast cash payout of $6.55 for 2016/17, all of $2.25 higher than the 2015/16 season's $4.30 ($3.90 milk plus 40 dividend).

A strong tailwind, in other words, much like we saw in April's merchandise trade figures too.

But by the reaction of the NZ currency to this morning's trade data, and Fonterra's announcements, this good news was well anticipated, already largely priced in. There were lifts in NZD on each piece of news, but only small, and nothing that really pushed on – albeit partly because of a bid coming to USD over the New Zealand morning and into lunch.

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