

Rural Economic Note

Global Dairy Trade Auction

20 November 2019

The high plateau

- We bump up our 19/20 milk price forecast by 50 cents to \$7.50/kg.
- We also set our initial 20/21 forecast at a bullish \$7.50/kg, and we have lifted our long-run forecast range to \$6.50/kg to \$7.50/kg.
- Almost as importantly, we now believe that milk price volatility has fallen structurally.

Summary

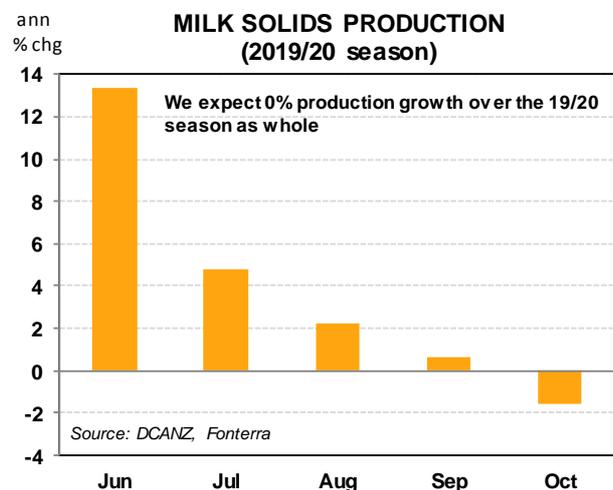
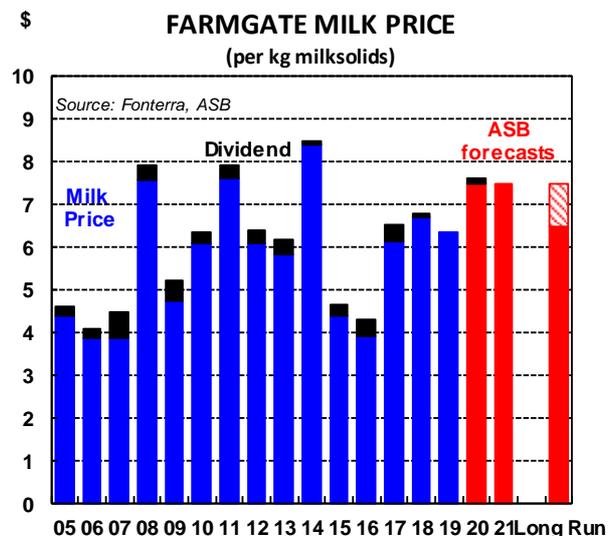
Global dairy markets are tight. NZ October production was 1.5% down on October 2018. Meanwhile, Northern Hemisphere production growth is also soft, with annual production growth only marginally above flat in both the EU and the US. In short, production growth in the key dairy exporters is insufficient to meet growth in global demand.

Accordingly, global dairy prices are lifting. Overall dairy auction prices have lifted 8% since early September at a time when the spring flush normally forces prices lower.

With no quick fix to soft global production in sight, **we have bumped up our 2019/20 milk price forecast by 50 cents to \$7.50/kg.** Note the NZ dollar is also helping, with the NZD/USD averaging around US\$0.65 so far this season. This average is materially down on the average over 2018/19.

Looking further ahead, we are also bullish on the milk price prospects for 2020/21. **We set our initial 20/21 milk price forecast at \$7.50/kg.** Notably and unlike the 19/20 season, Fonterra is likely to be able to capture the full benefit of the weaker NZ dollar.

Almost as important as our bullish milk price view, our observation is that milk price volatility has fallen. Indeed, **we believe that the fall in milk price volatility is structural in nature.** In that sense, the farmgate milk price is moving to a higher plateau.



19/20 milk price forecast bumped up

Following the dairy auction overnight, **we have bumped up our 2019/20 milk price forecast by 50 cents to \$7.50/kg**. Recall that we mentioned after the previous auction that we were on the verge of revising. We now believe global dairy prices and the market outlook warrant that revision.

First, **auction prices have lifted materially over the past two auctions**. Notably, skim milk powder (SMP) prices have cracked US\$3,000/MT for the first time since August 2014. Meanwhile, whole milk powder (WMP) prices have hit their highest level since December 2016. Indeed, with SMP prices surging over 20% since August, the WMP-SMP premium is moving back towards its historical norms.

Secondly, **global dairy supply is tight**. NZ production growth is slowing. October production was 1.5% down on October 2018. Meanwhile, Northern Hemisphere production growth is also soft, with annual production growth running at less than 1% in both the EU and the US. In short, production growth in the key dairy exporters is insufficient to meet growth in global demand.

Accordingly, **we anticipate that prices will lift further over coming months**. With growing conditions patchy across the country, production is unlikely to match last season's bumper numbers. Markets won't fully appreciate or price in the weakness of October production until Fonterra releases its production numbers later in the month.

A weaker NZ dollar is also underpinning the milk price. So far over the 19/20 season, the NZD/USD has averaged around US\$0.65. While Fonterra's hedging position means that it won't fully capture this NZ dollar fall, the exchange is likely to be a significant improvement on US\$0.69 achieved in the 18/19 season.

We set our initial 20/21 milk price forecast at a bullish \$7.50/kg

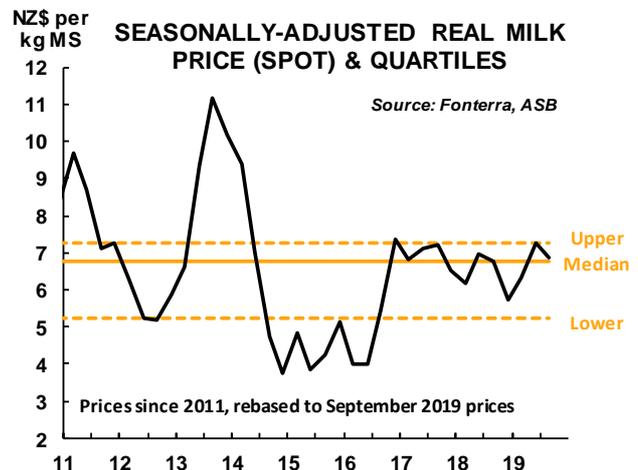
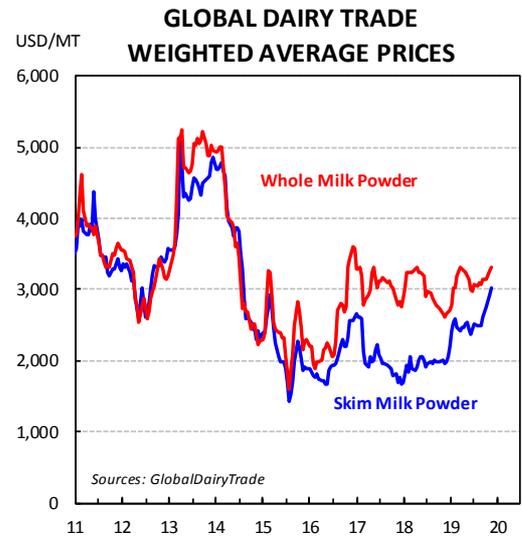
We have also set our initial 20/21 milk price forecast at a bullish \$7.50/kg. Notably and unlike the 19/20 season, Fonterra is likely to be able to capture the full benefit of the weaker NZ dollar. We have assumed that Fonterra will achieve US\$0.64, around two cents lower than our 19/20 assumption. At current dairy commodity prices, a one-cent move in the currency adds around 14 cents to the milk price.

In terms of global dairy markets, **we expect a modest improvement in global supply over the 20/21 season**. This improvement is likely to lead a modest decline in dairy commodity prices. But fundamentally, we believe that global supply is constrained so the supply response will be modest by historical standards (more on that below).

Milk price volatility has fallen structurally

Milk price volatility is falling. The charts below show that the real milk price has tracked close the 10-year median over 2017, 2018 and 2019. In turn, the 5-year average standard deviation of the milk price has fallen by around a third since the start of 2018.

These data support our view that global dairy markets have settled since the super cycle of 2013-2016. This view is on the basis that global production (and export) growth is moderating as all producers run into constraints including:



1. **Environmental and regulatory constraints** – maximum sustainable nutrient levels have been reached in many regions and countries. Greenhouse gas emissions considerations are also becoming a factor, highlighted locally by the passing of the net zero carbon bill.
2. **Capital constraints** – banks have tightened access to credit, with the RBNZ capital requirements as a catalyst, and *Overseas Investment Office* restrictions have seen new overseas capital dry up; and
3. **Competition for resources** – returns have lifted for other sectors, including for sheep & beef, horticulture and forestry sectors. Meanwhile, agriculture is increasingly competing with other sectors for water and land e.g. urban housing and water requirements, tourism and recreation, and conservation.

NZ milk production growth is a case in point. Between 2001 and 2015, NZ annual production growth averaged close to 5%. However, since then production has been effectively flat. Indeed, the net number of dairy conversions over recent years has been zero or below, and given the stricter consenting process and other environmental pressures plus tighter lending standards, we expect this trend to continue.

As a result, **we believe that constrained production growth will translate into smaller amplitude in both the production and milk price cycles over coming seasons.** Other cyclical factors such as drought, swings in dairy stocks and bio-security scares will remain in play, but the constraints on dairy producers to ‘overshoot’ the market are likely to be the key factor driving the structural reduction in volatility.

We also lift our long-run forecast range to \$6.50/kg to \$7.50/kg

With all of the above in mind, **we also lift our long-run forecast range to \$6.50/kg to \$7.50/kg.** Effectively, that means we believe that over the next ten years the milk price is going to average closer to \$7.00/kg than the circa \$6.00/kg it has averaged over the last 10 years.

Similarly and given our view that milk price volatility has reduced structurally, **we believe that future troughs in the global dairy cycle will see the milk price bottom out in the \$5.00/kg range.** Recall that the milk price reached as low as \$3.90/kg in the dairy super cycle.

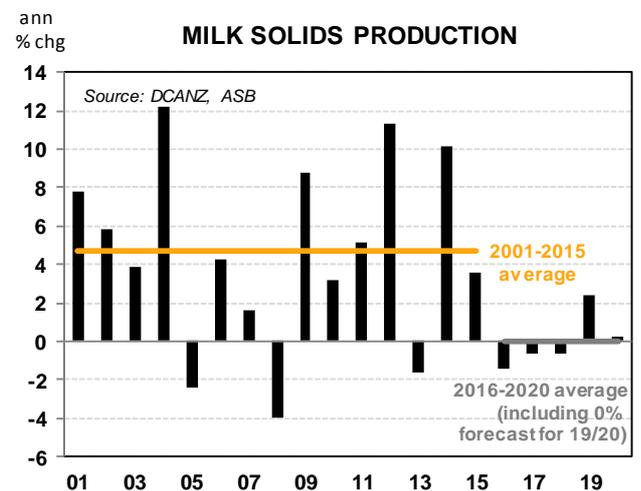
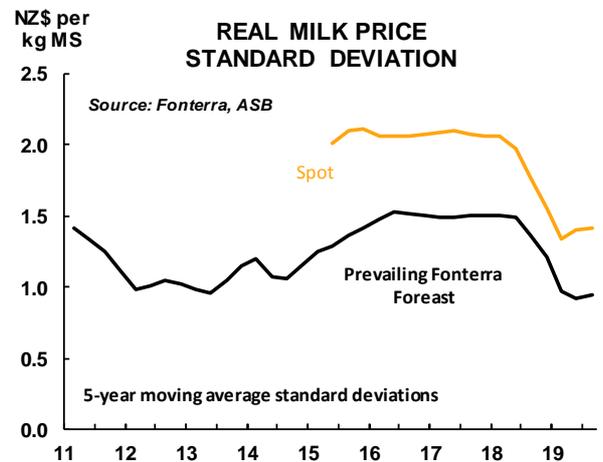
Our lower long-run NZ dollar forecasts further underpin our long-run forecast. Specifically, we expect the NZD/USD to average US\$0.69 over the next ten years, with an end point of US\$0.72. Previously, we had forecast an average of US\$0.73.

All up, we maintain our positive outlook for the dairy sector. **These forecasts emphasise our view that food producers are regaining market power back from global buyers as food becomes increasingly scarce.** In that sense over coming years, we see that the shoe is moving to the other (farmers’) foot.

Farmgate Milk Price Forecasts

	2019/20		2020/21	Long Run
	Fonterra	ASB	ASB	ASB
Milk Price*	\$6.55-\$7.55	\$7.50	\$7.50	\$6.50-\$7.50

* per kg of milk solids (excluding dividend).



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