

# IN FOCUS: DAIRY

OCTOBER 2016





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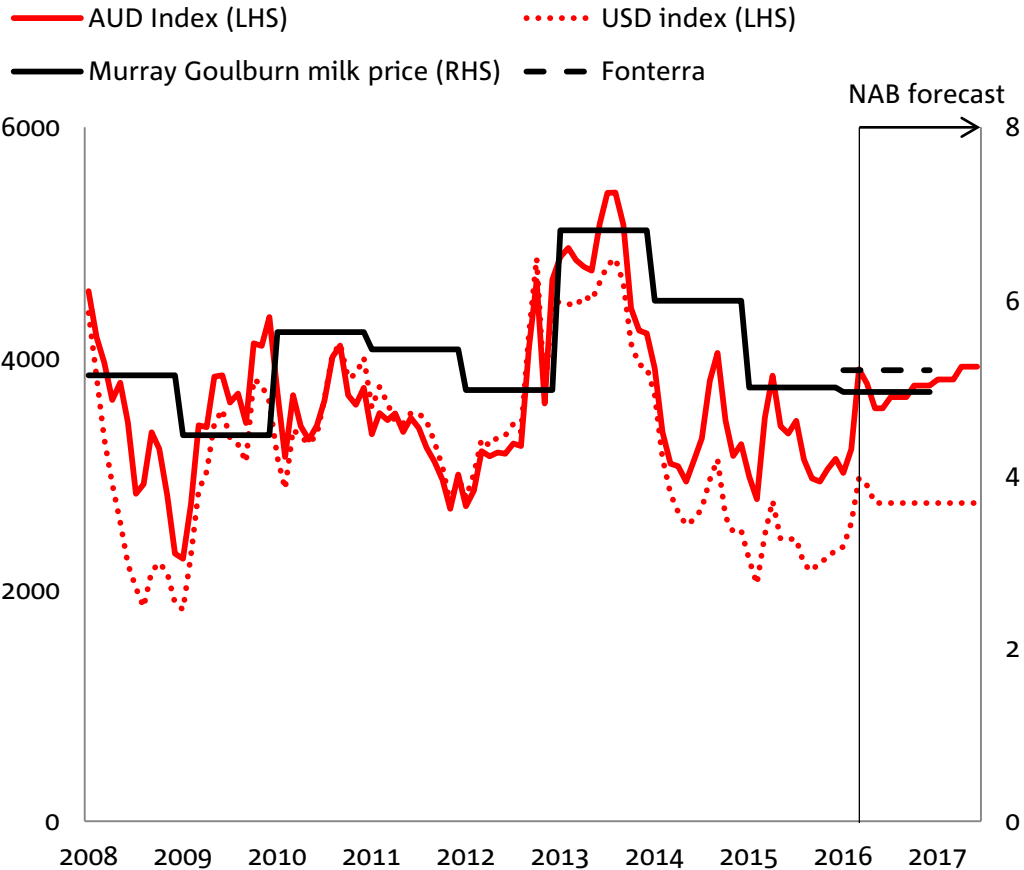
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## NAB WEIGHTED DAIRY EXPORT PRICE INDICATOR

\$/tonne (export price, LHS)

AUD/kg milk solids (farm gate price RHS)



Global dairy markets have faced very difficult conditions since plummeting in the first half of 2014, reflecting a combination of increased supply and sluggish global demand. However, the full force of the downturn was not fully felt by Australian dairy farmers until earlier this year when major processors Murray Goulburn and Fonterra substantially downgraded farmgate milk prices.

Recent Global Dairy Trade auction results, combined with a step-up last month from Australia's largest dairy processor Murray Goulburn and generally favourable seasonal conditions suggests that the situation is stabilising.

We upgraded our forecasts for dairy last month to reflect lower international supply conditions, with recent data from the European Union and New Zealand showing raw milk deliveries falling in August compared to the same time last year. While New Zealand is the world's largest dairy exporter, EU production levels are particularly important given the uncertain impact of the removal of milk production quotas last year on more efficient EU production regions (see page 7 for further details).

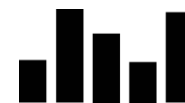
Although our forecasts do not point to major upside in global markets in the coming year, we expect a small depreciation in the AUD which should provide some upside. It remains to be seen whether this will flow through to farmgate prices. Dairy Australia's latest forecasts point to Victorian farmgate milk prices remaining below \$5/kg milk solids in 2016-17, although South Australia is expected to fare better. Input costs should provide some respite, with feed and fertiliser unit costs below last season.

Source: Australian Bureau of Statistics, Global Dairy Trade, Dairy Australia, Fonterra, Murray Goulburn, ABC and NAB Group Economics

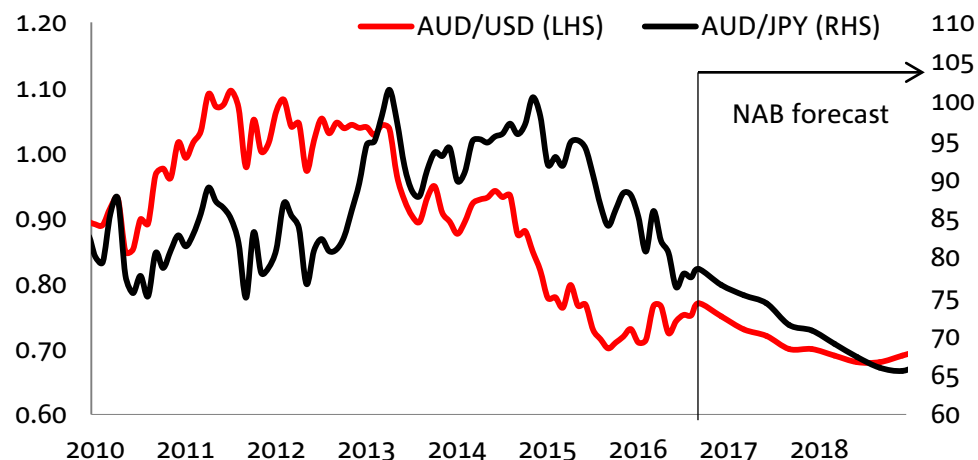
Note: chart shows Murray Goulburn farmgate prices (upper range for revised 2015-16 price) except 2008-09 which shows Dairy Australia's reported Victorian average value



# EXCHANGE RATES AND INTEREST RATES



## MONTHLY EXCHANGE RATES AND QUARTERLY FORECASTS



The AUD remains contained within the broad 0.7450 - 0.7750 trading range established over two months ago. We expect any change will likely come from the USD side of the equation. Ultimately, we still see the (inevitable) break coming to the downside. Looking into 2017, our forecasts show the AUD falling to 0.72 by mid-year and 0.70 by end-2017. We see the AUD falling into the high 60s in 2018.

We expect two 25bp cuts to the cash rate in May and August 2017 (to a new low of 1%). Monetary policy deliberations may then turn to the possible use of nonconventional policy measures if the outlook deteriorates further, although that is not in our forecast. Additionally, persistent weakness in CPI inflation could potentially trigger a rate cut even sooner than expected.

## NAB FX STRATEGY TARGETS

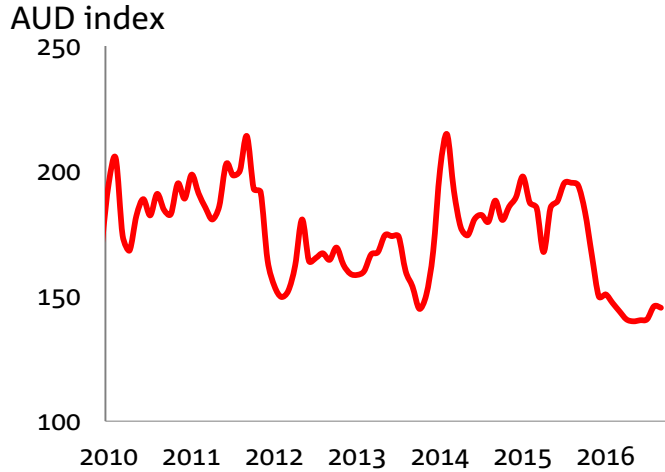
	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3
AUD/USD	0.75	0.73	0.72	0.70	0.70	0.69	0.68	0.68
NZD/USD	0.72	0.70	0.68	0.67	0.67	0.68	0.68	0.69
USD/JPY	102	103	103	102	101	100	99	97
EUR/USD	1.12	1.10	1.09	1.07	1.06	1.06	1.07	1.08
USD/CNY	6.70	6.70	6.68	6.65	6.65	6.65	6.63	6.60
AUD TWI	63.6	62.7	62.0	60.4	60.2	59.9	58.0	57.5

Source: NAB

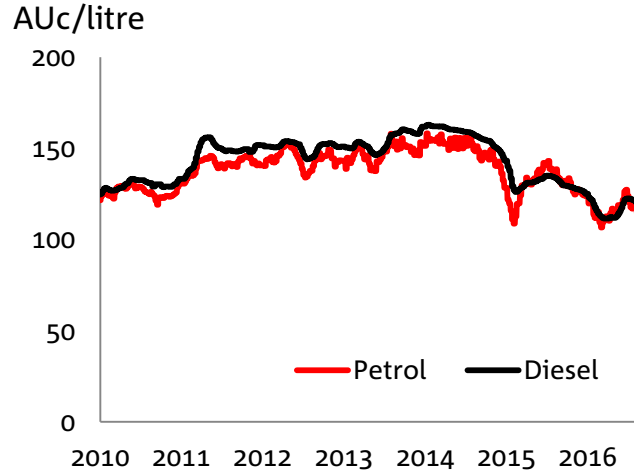
# FARM INPUT PRICES



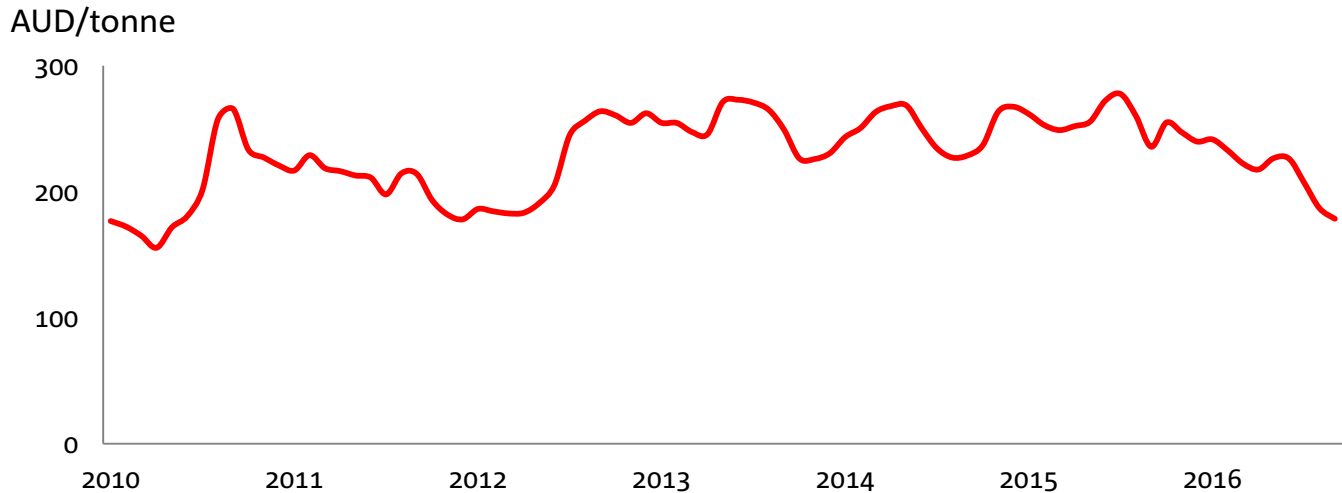
## NAB FERTILISER INDEX



## NATIONAL AVERAGE FUEL PRICES



## NAB WEIGHTED FEED GRAIN PRICE INDEX



The drop in global fertiliser prices of late 2015 looks to have ended, with relative stability in fertiliser prices since early this year. September saw the NAB fertiliser index off 0.4% as higher DAP and natural gas offset lower urea prices. The recent strength in global oil prices points to some upside for fertiliser in the coming months, although we note that prices remain at very low levels.

Weighted feed grain prices continue to fall, in line with continued weakness on global grain markets. The NAB feed grain price index fell 4.4% in September after falling almost 10% in August. We see strong signs that Australia is on track for a large winter crop, with the potential for greater than normal downgrades to feed quality if eastern Australia sees late season rain. Combined with good pasture availability and global weakness, we expect further downside pressure in domestic feed grain markets into 2017. NAB's index includes feed wheat, barley, oats and sorghum. Three quarters of the indicator is made up of feed wheat and barley.

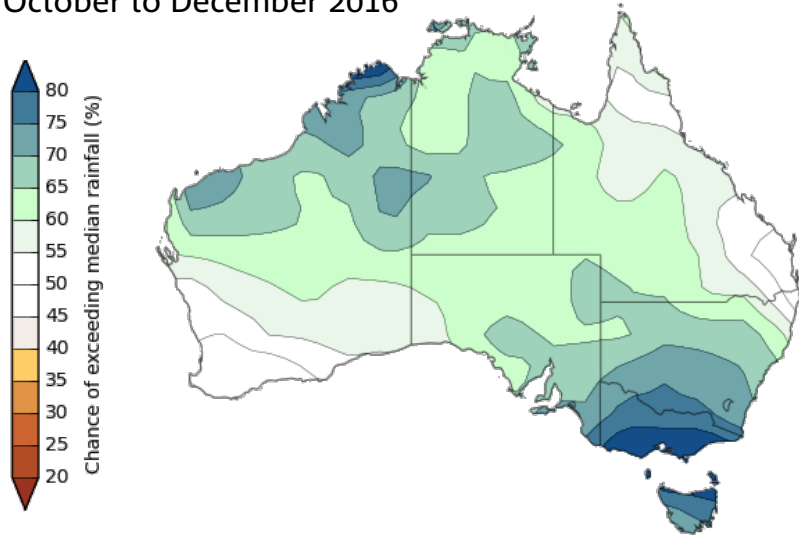
Source: Bloomberg, Profarmer and NAB Group Economics





## THREE MONTH RAINFALL OUTLOOK

October to December 2016



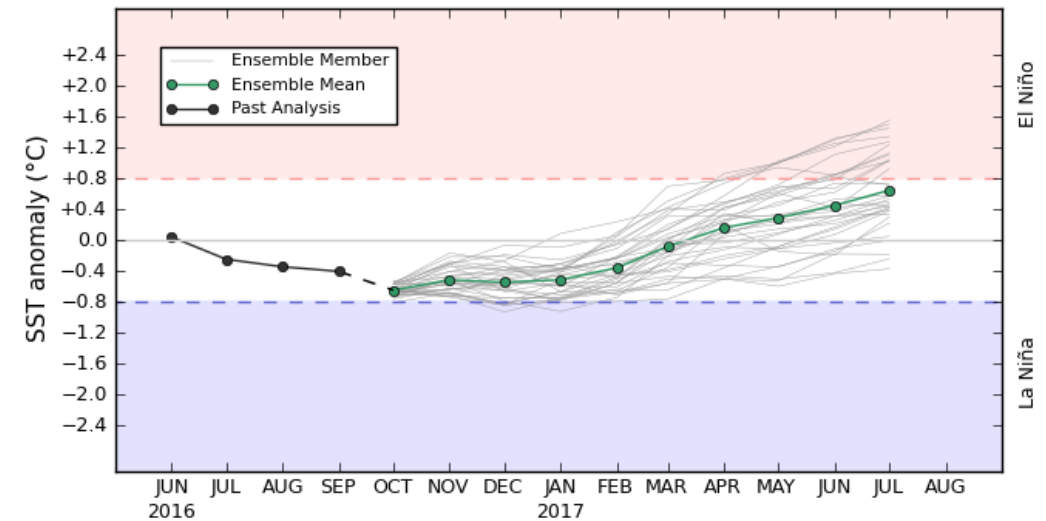
The Bureau of Meteorology (BoM) three month rainfall outlook to December points to generally average to well above average rainfall across most of Australia. Victoria, which accounts for around two-thirds of Australian milk production, is forecast to see very strong rainfall over the period. Reports suggest that very wet spring conditions are hampering production.

Recent heavy rain, combined with the outlook for more to come, presents a risk to wheat quality in eastern Australia, even if the headline production number is strong. Should this eventuate, it is likely that there will be an above average volume of feed-grade wheat in eastern Australia in the first half of 2017, easing feed prices for dairy farmers.

Source: Bureau of Meteorology

## BOM POAMA MODEL LONG-RANGE EL NIÑO OUTLOOK

Monthly mean NINO 3.4 – 9 October 2016



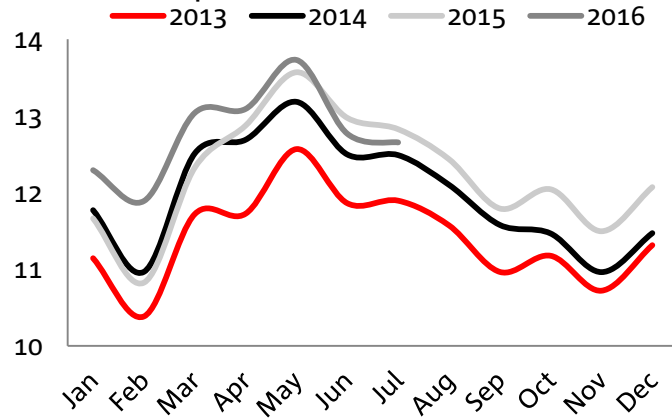
The Bureau of Meteorology's long range outlook for El Niño points to a return to neutral conditions, moving close to El Niño by winter 2017. The BoM ENSO tracker remains on La Niña watch (placing the chance of a La Niña event at around 50%). This outlook suggests wetter than average conditions for the rest of the year but points to risks in winter-spring 2017.

# PRODUCTION TRENDS: EUROPEAN UNION



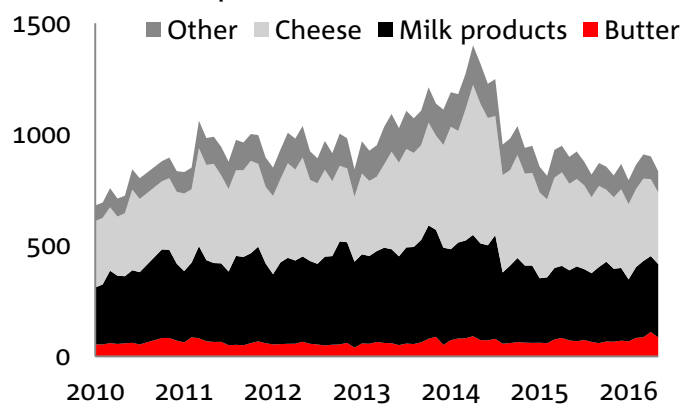
## MONTHLY MILK PRODUCTION – EU28

Billion litres per month



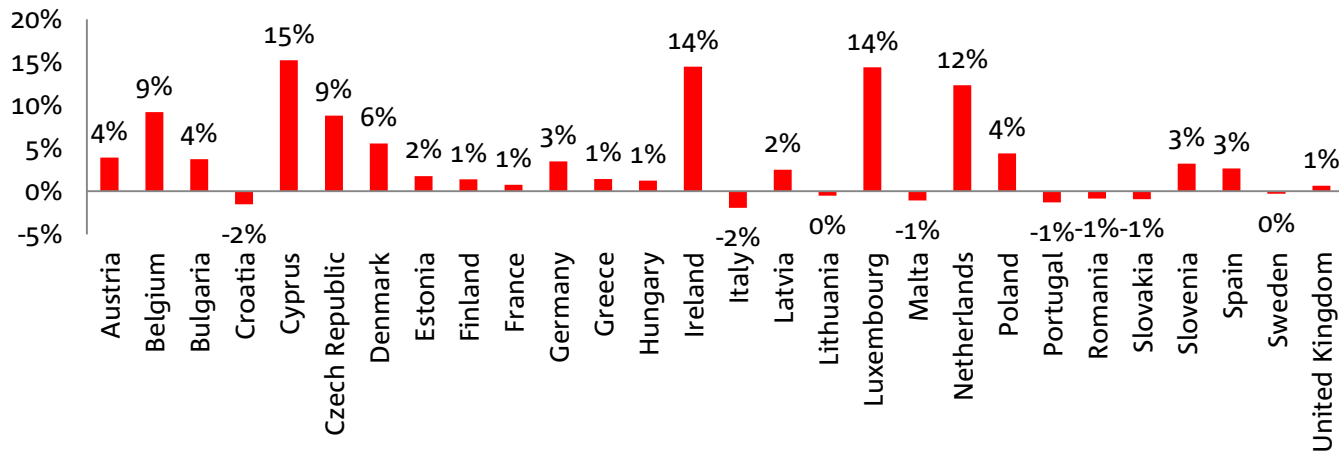
## VALUE OF EU DAIRY EXPORTS

USD millions per month



## CHANGE IN MILK PRODUCTION 2014-15 TO 2015-16

Raw milk, 1 July to 30 June



The European Union is the world's second largest dairy exporter and also enjoys a substantial domestic market of some 510 million inhabitants.

Until 31 March 2015, dairy production was artificially constrained through a system of production quotas for member states. This limited production in more efficient EU dairy producers such as Ireland and the Netherlands.

The removal of these quotas saw rapid production growth in some areas, particularly in Ireland, the Netherlands and the Czech Republic. Some countries, the EU's largest dairy producer Germany, have seen significant terms in absolute terms.

While Ireland and the Netherlands look to be defying the EU production downturn for now, there appears to be sufficient pull-back elsewhere for Union-wide milk production to have fallen over the past two months compared to the same time last year. In the short term, EU milk production will be suppressed by the Milk Production Reduction Aid Scheme, which will see farmers paid to lower their milk production.

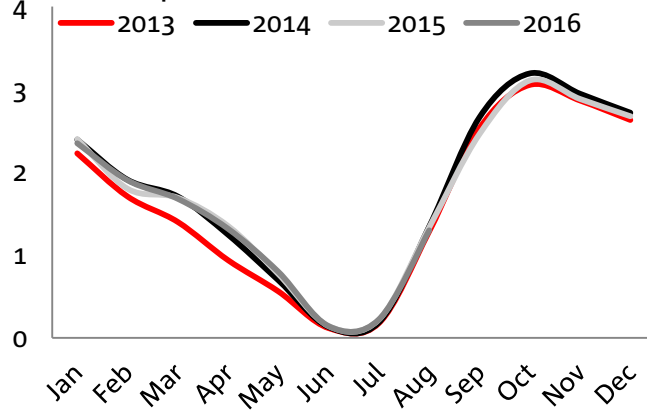
Source: Eurostat, European Commission and NAB Group Economics

# PRODUCTION TRENDS: NEW ZEALAND



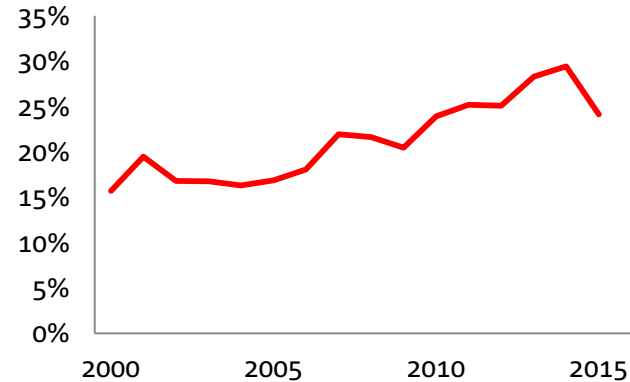
## MONTHLY MILK PRODUCTION - NZ

Billion litres per month



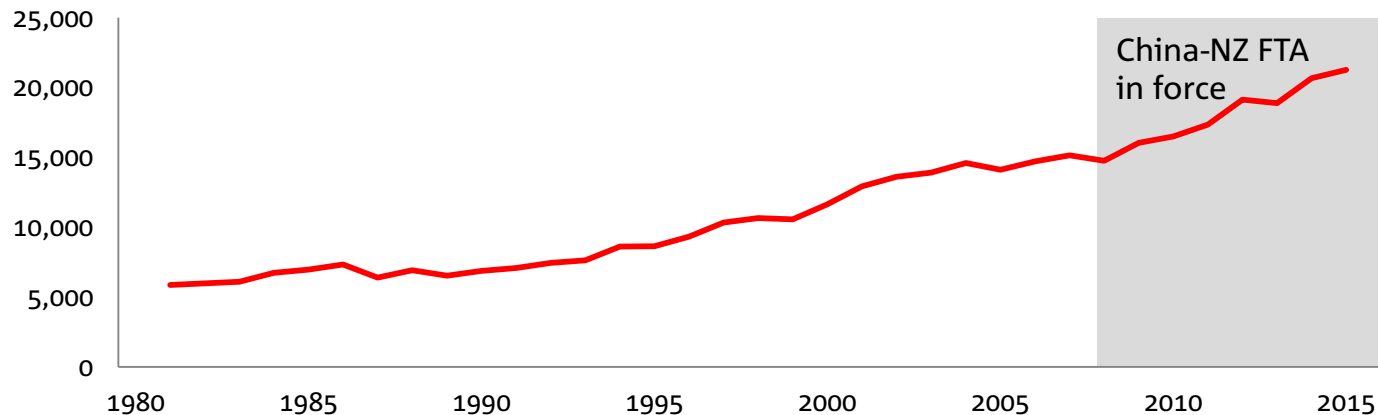
## DAIRY SHARE OF MERCHANDISE EXPORTS

Share of total, annually



## ANNUAL MILK PROCESSED - NZ

Million litres per annum



New Zealand is the world's largest dairy exporter, accounting for around a third of global trade. Its prominent position in the global dairy industry is reflected in dairy's prominence in the New Zealand economy, with dairy accounting for 24% of the country's merchandise exports last year.

Production has surged since the China – New Zealand free trade agreement came into force in October 2008, up 44% from 2007-08 to 2014-15. However, the downturn in prices looks to be affecting output, with August 2016 monthly milk production down 2.7% year on year.

BNZ's latest 2016-17 milk price forecast is NZD5.30/kg milk solids, noting a wide error band at this stage of the season and with risks to the forecast tilting towards the upside, with very wet weather on the north island hampering production.

For more detail on BNZ's New Zealand dairy forecasts see the [October 2016 BNZ Rural Wrap](#).

Source: Dairy Companies Association of New Zealand, LIC, Dairy NZ, Fonterra, Statistics New Zealand and NAB Group Economics



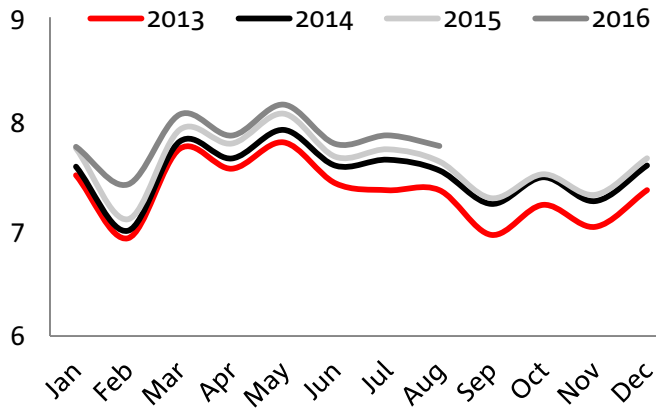


# PRODUCTION TRENDS: UNITED STATES



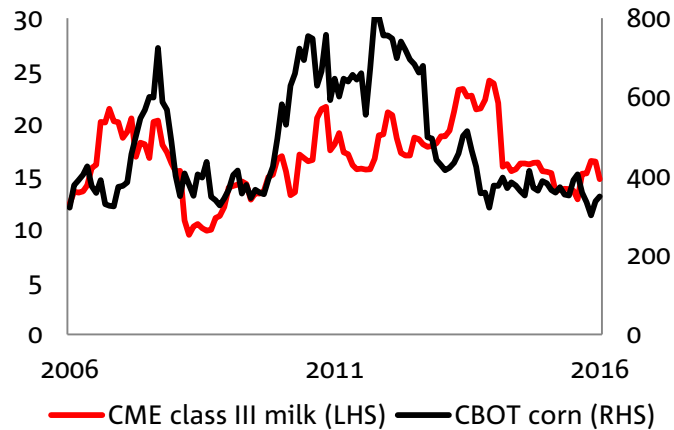
## MONTHLY MILK PRODUCTION – US

Billion litres per month



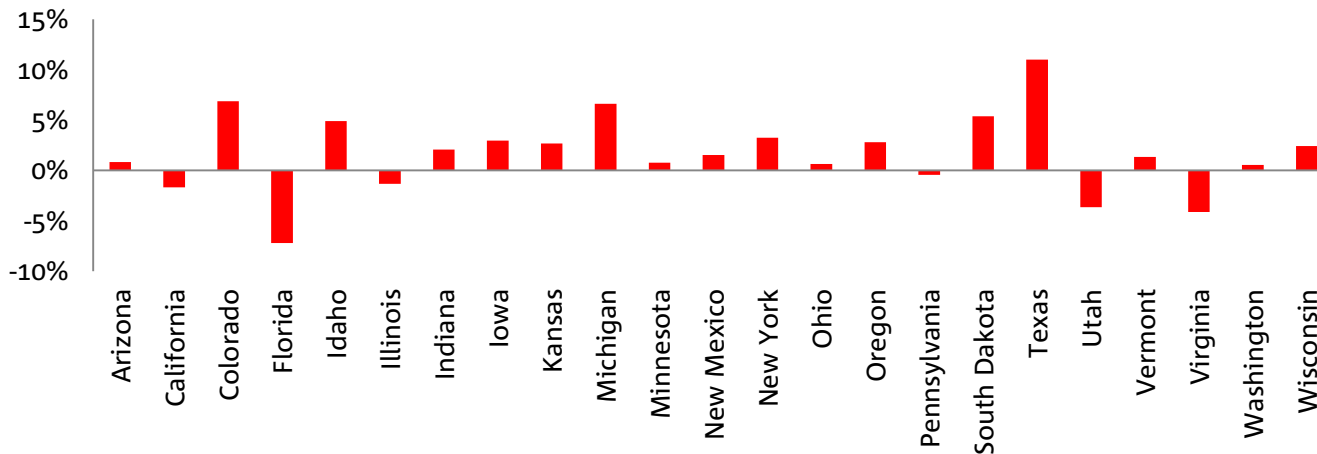
## MILK AND CORN PRICES

USD/cwt (milk), USD/bushel (corn)



## CHANGE IN MILK PRODUCTION – YOY TO AUGUST 2016

Per cent change, 23 major milk producing states



The upturn in US dairy production continues unabated, with recent production data showing 2016 volumes on track to exceed 2015. This continued strength in production is a function of low feed corn prices and a relatively buoyant domestic market keeping margins higher than elsewhere (although wholesale manufacturing milk prices remain very subdued).

The relative strength in domestic markets has seen less US involvement in global export markets, although reports of higher stockpiles and in some cases dumping of milk may reflect some tempering of domestic demand. Nonetheless, with our forecasts for grain pointing to prices remaining low for the coming year, we see it as likely that US milk supply will remain elevated.

Source: USDA, Bloomberg and NAB Group Economics

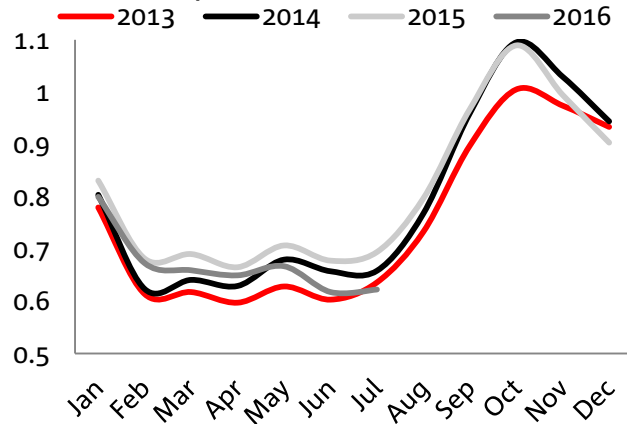


# PRODUCTION TRENDS: AUSTRALIA



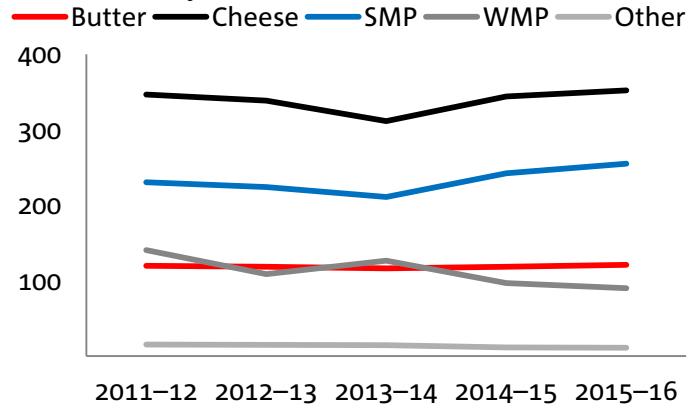
## MONTHLY MILK PRODUCTION

Billion litres per month



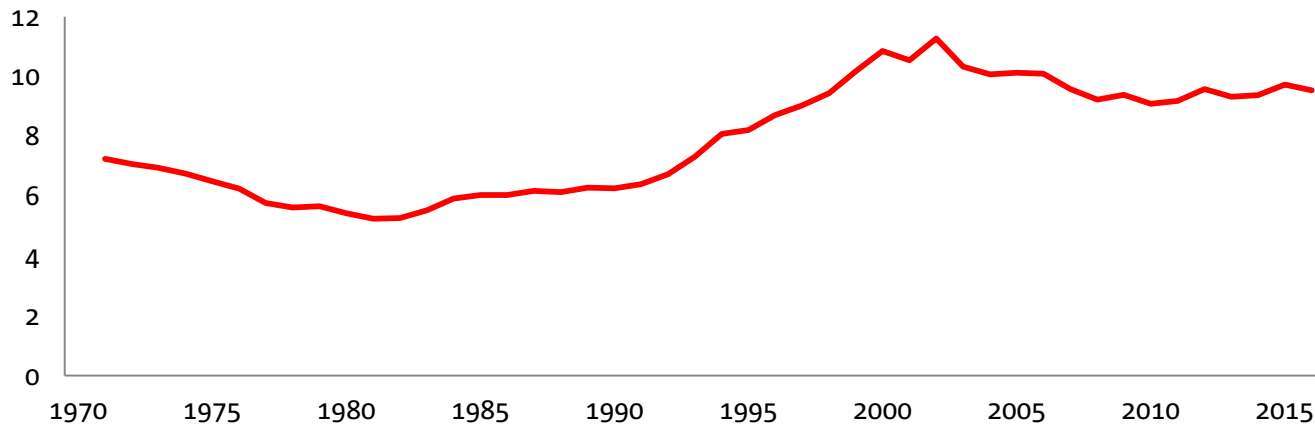
## DAIRY PRODUCT EXPORTS

KT annually



## ANNUAL MILK PRODUCTION

Billion litres per annum



Source: Dairy Australia, ABARES, European Commission and NAB Group Economics

Australian milk production fell 2% last season to around 9.5 billion litres, reflecting generally poor to very poor seasonal conditions (especially in Victoria) combined with low milk and high cull cow prices.

In a longer term context, this drop follows generally subdued national production after a peak of almost 11.3 billion litres in 2001-02. The deregulation of the industry in the early 2000s, combined with input cost pressure has seen the industry contract in volume terms. Industry performance has been uneven across dairying regions, with subtropical dairy facing structural challenges while Tasmania continues to grow.

In Victoria, which accounts for around two-thirds of national production, regional performance was likewise disparate last season. Dryland dairies in south west Victoria saw extremely dry seasonal conditions, while irrigated northern Victorian producers faced not only a poor season but elevated spot water prices. Gippsland was a mixed picture, with south-west Gippsland very dry but east Gippsland and the Macalister Irrigation District enjoying a more favourable season.

Seasonal conditions this year are much more favourable but supply will continue to trend lower, in part because it is simply too wet in some areas.

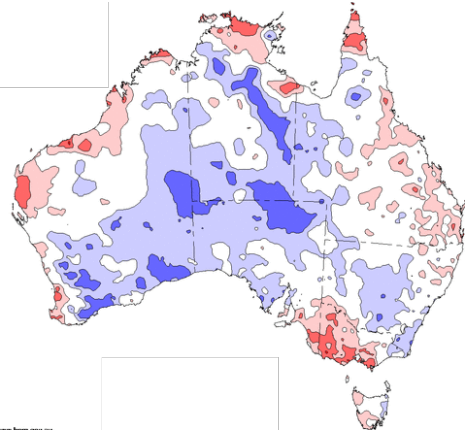


# IMPLICATIONS FOR FARM PROFITABILITY

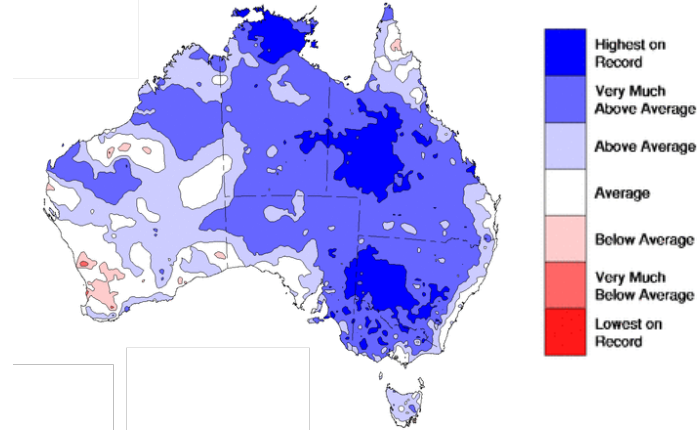


## AUSTRALIAN RAINFALL DECILES

2015-16 season

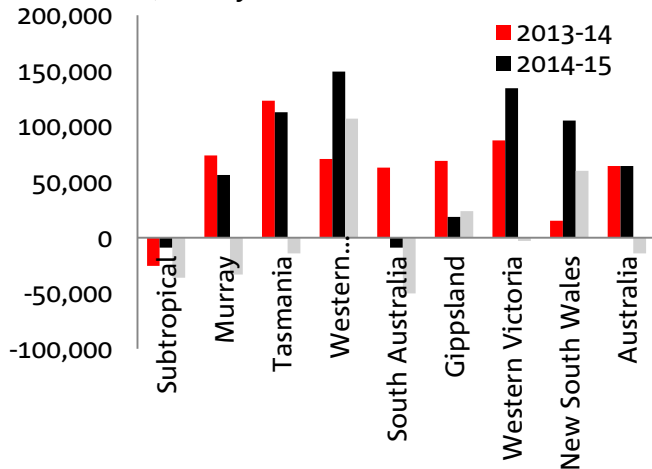


2016-17 season to 30 September 2016



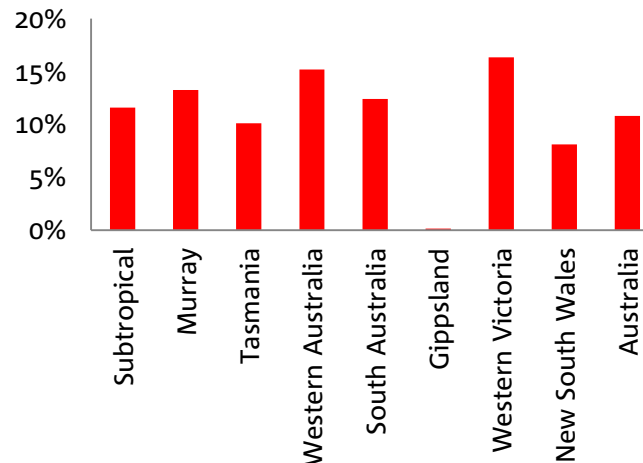
## AVERAGE FARM BUSINESS PROFIT

Raw milk, 1 July to 30 June



## AVERAGE FODDER BUDGET

Per cent change 2014-15 to 2015-16



Source: Bureau of Meteorology, ABARES and NAB Group Economics

Farm profitability came under intense pressure last season amid falling farmgate prices and intense seasonal pressures across much of Victoria, South Australia and Tasmania.

Average fodder budgets were generally much higher, led by western Victoria which was up 16% for the season. While Gippsland saw the lowest increase in feed costs, this likely reflects poor conditions in the south-west offset by east Gippsland and the MID.

Looking at this season, price pressures clearly remain but seasonal conditions are much more favourable, with a generally very good spring break and lower supplementary feed costs. However, too much rain is hampering production in some areas.

Yesterday, Murray Goulburn announced a step-up to farmgate prices, with a forecast of \$4.95/kg milk solids. Competitors' farmgate prices are generally higher (such as Fonterra at \$5.10/kg milk solids, with a forecast final price of \$5.20/kg milk solids). Dairy Australia's latest forecasts point to Victorian farmgate milk prices remaining below \$5/kg milk solids in 2016-17 (average businesses making a loss in the state for the season), although South Australia is expected to fare better.