

IN FOCUS: DAIRY

JANUARY 2017

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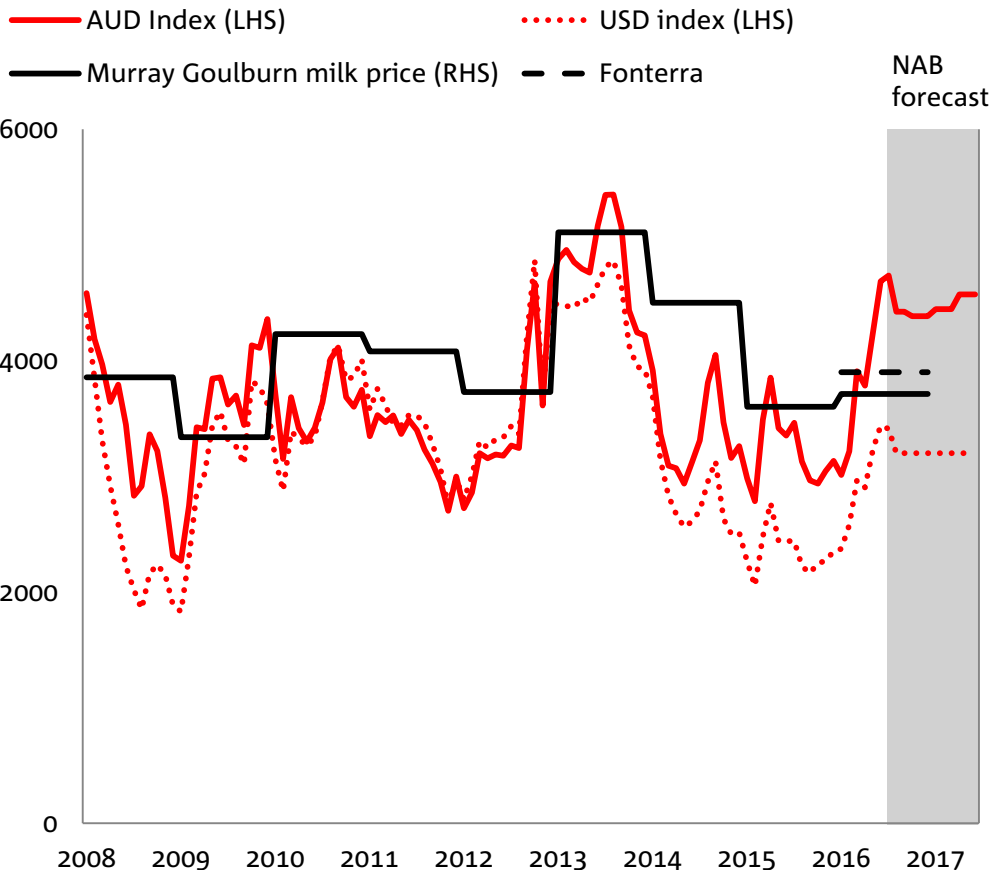
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NAB WEIGHTED DAIRY EXPORT PRICE INDICATOR

\$/tonne (export price, LHS)

AUD/kg milk solids (farm gate price RHS)



2016 was a very tough year for many Australian dairy producers, with farmers beginning the year amid extremely dry conditions in key dairy regions and steep cuts to farmgate prices. However, since the middle of 2016, we have seen steady improvements in both global prices and local seasonal conditions.

8 Global Dairy Trade auction results began to pick up in July last year. NAB's weighted dairy export price indicator now shows AUD denominated dairy prices at their highest level since March 2014. It is fair to say that the speed of this recovery exceeded our expectations, and we note that export prices are now nearly 30% above the long run average level from 2010 to 2016.

6 Data showing falling milk deliveries in most major exporters has been a key driver of the recovery. November production for New Zealand was down 4.5% year on year, October production for the European Union was off 2.9% year on year. The United States remains an outlier as cheap feed corn continues to underpin lower input costs. US production was up 2.4% year on year in November.

4 Australian milk production plunged last year, with October deliveries down 11.4% year on year. Production for the first 10 months of 2016 is down 7% and the ongoing impact of lower farmgate prices is clearly a major factor in lower Australian production. While the rally in international markets should see some further upside at farmgate, it is unclear whether production will respond as the seasonal peak is now over. If milk deliveries continue the pace set last year, 2016-17 seasonal production will be down 8.2% to 8.7 billion litres. Even if production recovers this year, seasonal production will likely still be down around 5%.

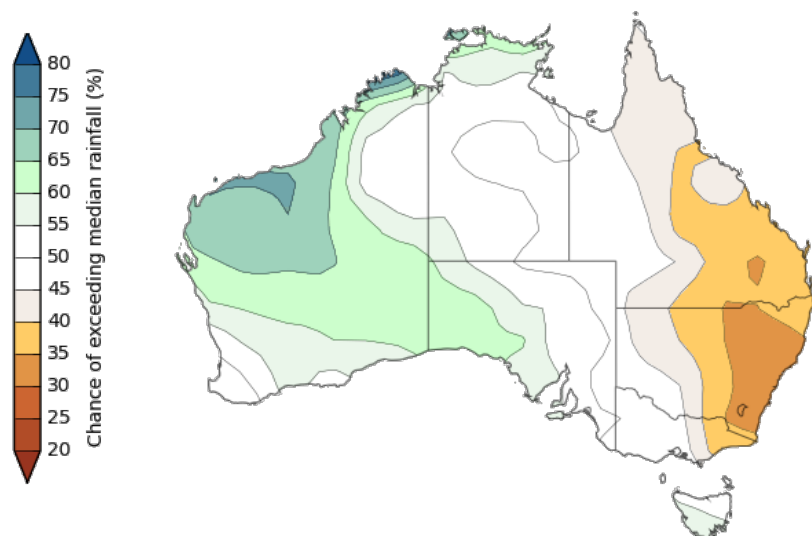
Source: Australian Bureau of Statistics, Global Dairy Trade, Dairy Australia, Fonterra, Murray Goulburn, [ABC](#) and NAB Group Economics

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



THREE MONTH RAINFALL OUTLOOK

January to March 2017



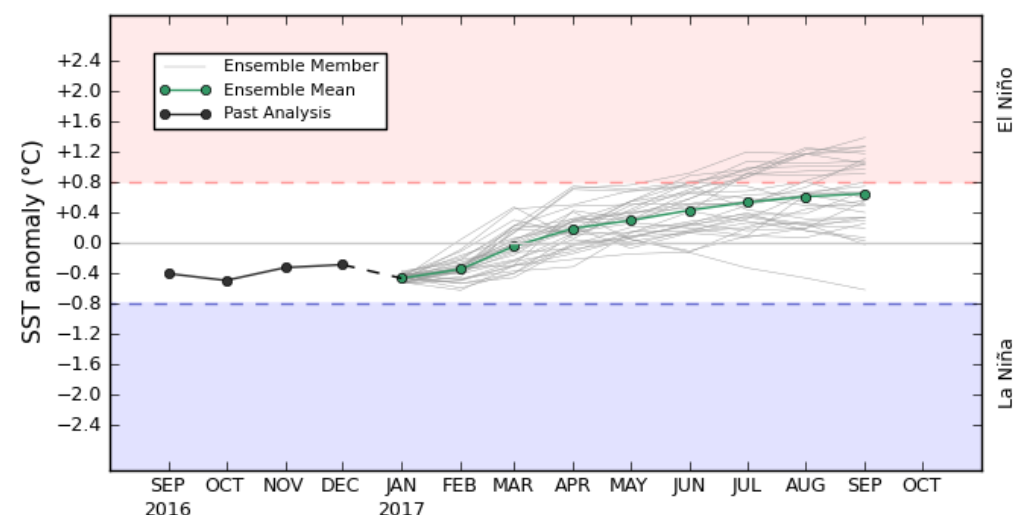
While the Bureau of Meteorology (BoM) had expected a hot, dry start to summer across eastern Australia, the picture so far has been much more mixed, with dryer conditions across coastal areas of northern New South Wales and Queensland, but wetter than average weather in parts of Victoria, Tasmania and all of South Australia. South west Western Australia also enjoyed above average rainfall.

BoM's three month outlook to March continues to project below average rainfall across much of Queensland, New South Wales and eastern Victoria.

Source: Bureau of Meteorology

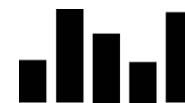
BOM POAMA MODEL LONG-RANGE EL NINO OUTLOOK

Monthly mean NINO 3.4 – 1 January 2017

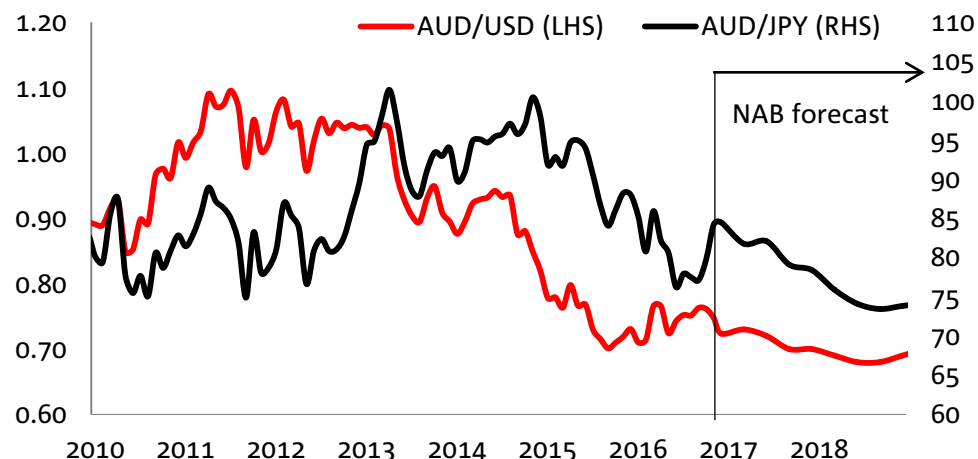


The Bureau of Meteorology's long range outlook for El Niño points to a return to neutral conditions this autumn before moving close to El Niño by spring this year. While long range forecasts are naturally uncertain, a move close to El Niño this spring is generally associated with below average rainfall in eastern and northern Australia. This may impede pasture growth in Victoria's highly seasonal dairy areas, although it is probably too early to speculate about spring pasture conditions with any accuracy.

EXCHANGE RATES AND INTEREST RATES



MONTHLY EXCHANGE RATES AND QUARTERLY FORECASTS



USD gains in 2017 are likely to be front-loaded as Trump's economic plans unfold and the probability of enactment factored in. But the USD cycle is already quite mature and our base case is only sufficient to generate single-digit percentage gains for the USD.

We retain our view that the RBA will be forced to cut rates by 25bps in each of May and August 2017, confronted with a weak growth outlook for 2018, a possible rise in unemployment and ongoing low inflation. At the very least, rate hikes in 2018, as some in the market are predicting, appear extremely unlikely. The risks appear more tilted towards an earlier cut in our view should the recent slowdown in domestic activity indicators continue.

A 70 cent AUD in 2017 is not dependent on RBA cuts but if these eventuate they would make a sub-0.70 Aussie more likely.

NAB FX STRATEGY TARGETS

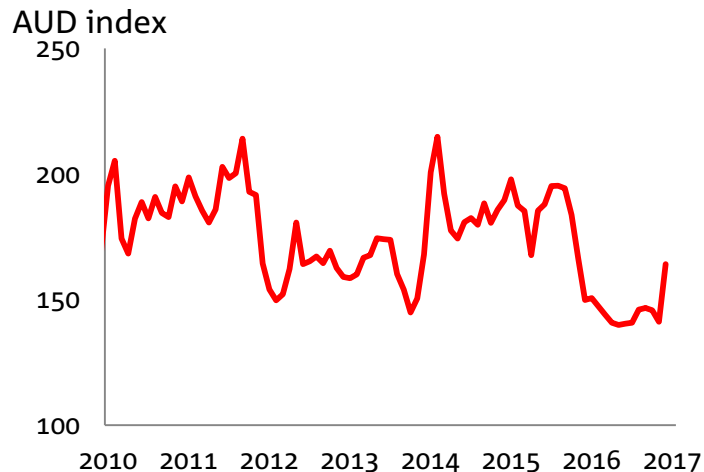
	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4
AUD/USD	0.73	0.72	0.70	0.70	0.69	0.68	0.68	0.69
NZD/USD	0.70	0.68	0.67	0.67	0.68	0.68	0.69	0.69
USD/JPY	115	115	118	118	120	120	122	122
EUR/USD	0.98	1.00	1.02	1.04	1.05	1.06	1.08	1.10
USD/CNY	7.20	7.24	7.18	7.17	7.18	7.16	7.15	7.12

Source: NAB

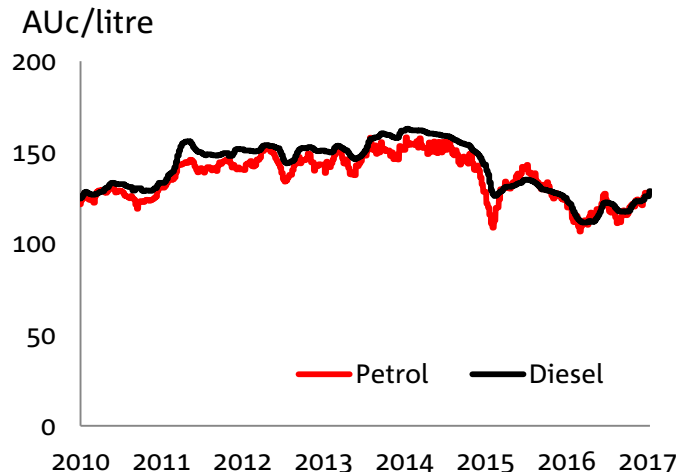
FARM INPUT PRICES



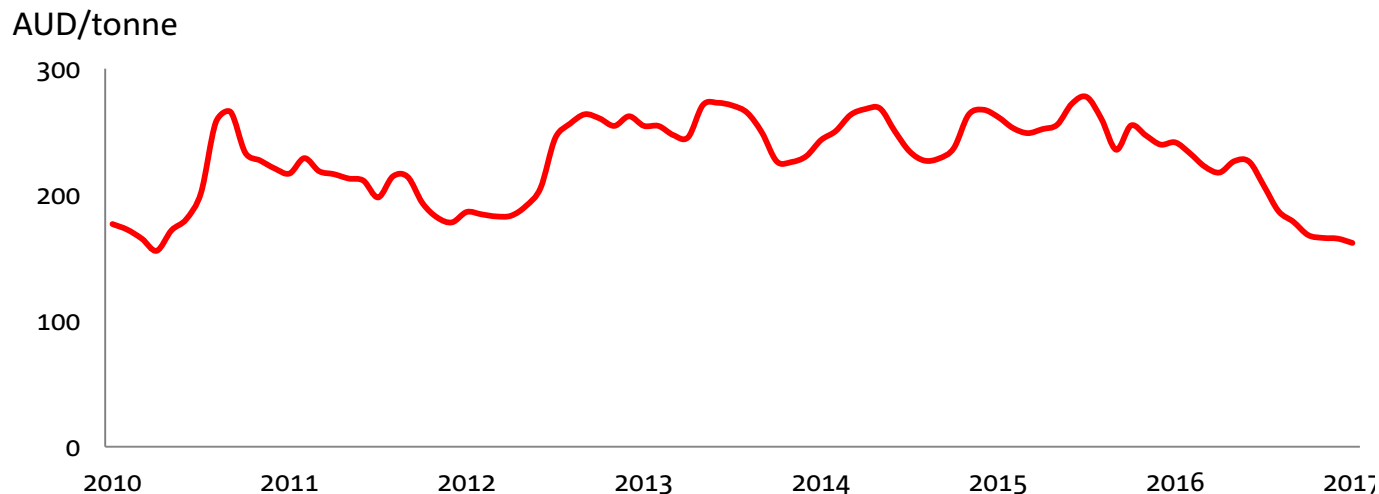
NAB FERTILISER INDEX



NATIONAL AVERAGE FUEL PRICES



NAB WEIGHTED FEED GRAIN PRICE INDEX



Source: Bloomberg, Profarmer and NAB Group Economics

Feed prices remain very low in the wake of a bumper grain and hay season across eastern Australia. NAB's weighted feedgrain price index currently stands at its lowest level since April 2010 and we see little upside in global grain markets this year amid exceedingly strong supply (although USDA data showing a sharp drop in US winter wheat planting may have some impact). Domestically, the combination of a record grain harvest and quality downgrades in some areas ensures that there will be ample feed grain for some time to come. NAB's index includes feed wheat, barley, oats and sorghum. Three quarters of the indicator is made up of feed wheat and barley.

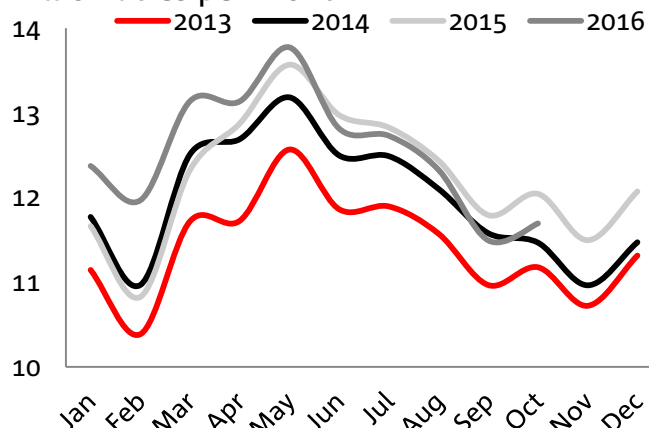
Fuel and fertiliser prices present something of a mixed picture. Fuel prices have risen since their nadir in March last year. Most recent data show national petrol prices averaging 128.3c/litre and diesel averaging 128.6c/litre. The NAB fertiliser index jumped 16.2% last month on higher US natural gas prices. While we expect the factors (notably cold weather) pressuring US gas prices to mitigate over the coming months, the upward trend in oil prices suggests that fertiliser will become more expensive for farmers in 2017.

INTERNATIONAL PRODUCTION TRENDS



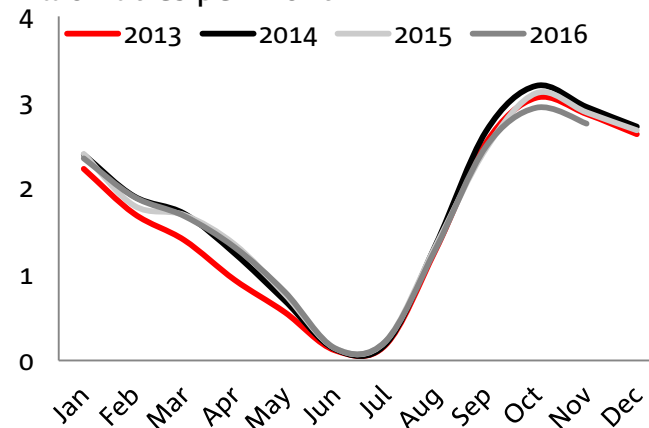
MILK PRODUCTION – EU28

Billion litres per month



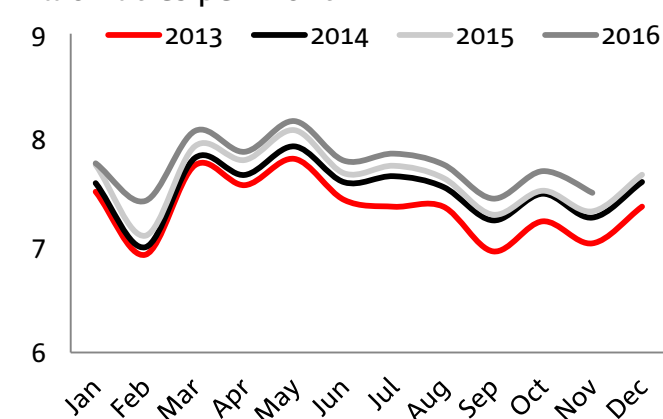
MILK PRODUCTION – NEW ZEALAND

Billion litres per month



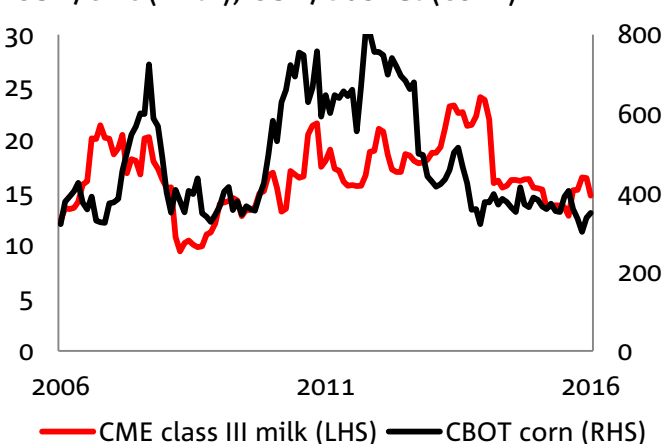
MILK PRODUCTION – UNITED STATES

Billion litres per month



US DOMESTIC MILK AND CORN PRICES

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



Production trends in the world's major dairy regions have generally shown (with the exception of the United States) falling production this year.

New Zealand is the world's largest dairy exporter, accounting for around a third of global trade. Milk production was down 4.5% year on year in November.

The European Union is the world's second largest dairy exporter and also enjoys a substantial domestic market of some 510 million inhabitants. EU production was previously constrained by quotas, but their removal in March 2015 saw rapid expansion in milk production in parts of the EU, particularly in Ireland, the Netherlands and the Czech Republic. More recent data show production falling in response to lower prices and the Milk Production Reduction Aid Scheme, which effectively paid farmers to lower milk production. October production for the European Union was off 2.9% year on year.

The United States remains an outlier as cheap feed corn continues to underpin lower input costs. US production was up 2.4% year on year in November.

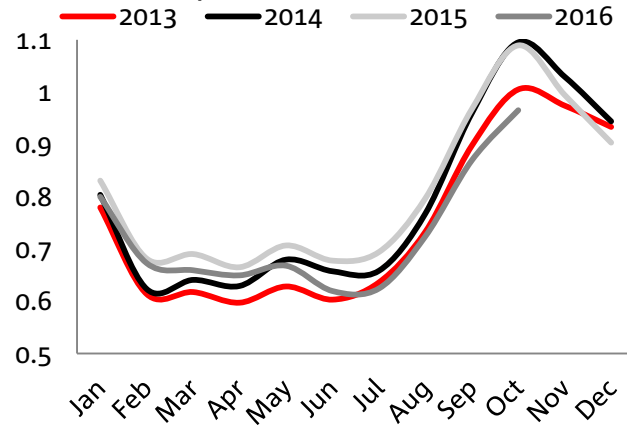
Source: Eurostat, European Commission, clal.it, DCANZ, USDA, Bloomberg and NAB Group Economics

PRODUCTION TRENDS: AUSTRALIA



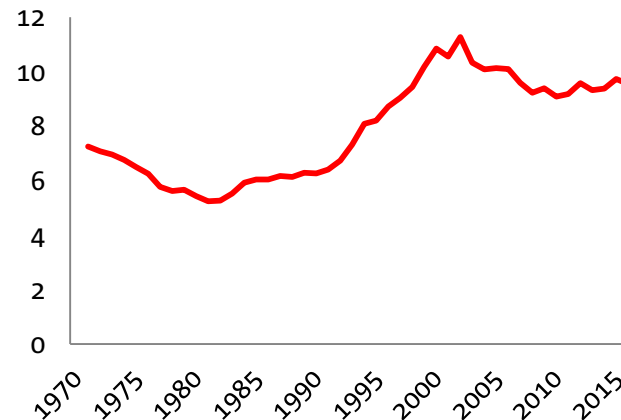
MONTHLY MILK PRODUCTION

Billion litres per month



ANNUAL MILK PRODUCTION

Billion litres per annum



Australian milk production plunged last year, with October deliveries down 11.4% year on year. Production for the first 10 months of 2016 is down 7%. While this fall partly reflects difficulties associated with a very wet Victorian spring, the ongoing impact of lower farmgate prices is clearly a major factor in lower Australian production.

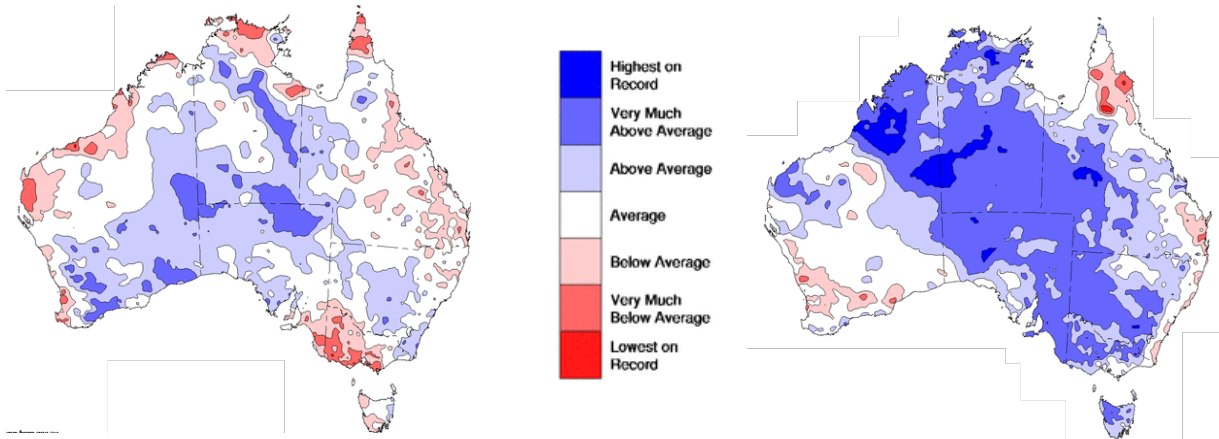
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We have some doubts about the ability for production to recover quickly, given recent herd thinning driven by low farmgate milk prices combined with good cull cow prices.

AUSTRALIAN RAINFALL DECILES

2015-16 season

2016-17 season to 31 December 2016



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