

IN FOCUS: DAIRY

JANUARY 2018

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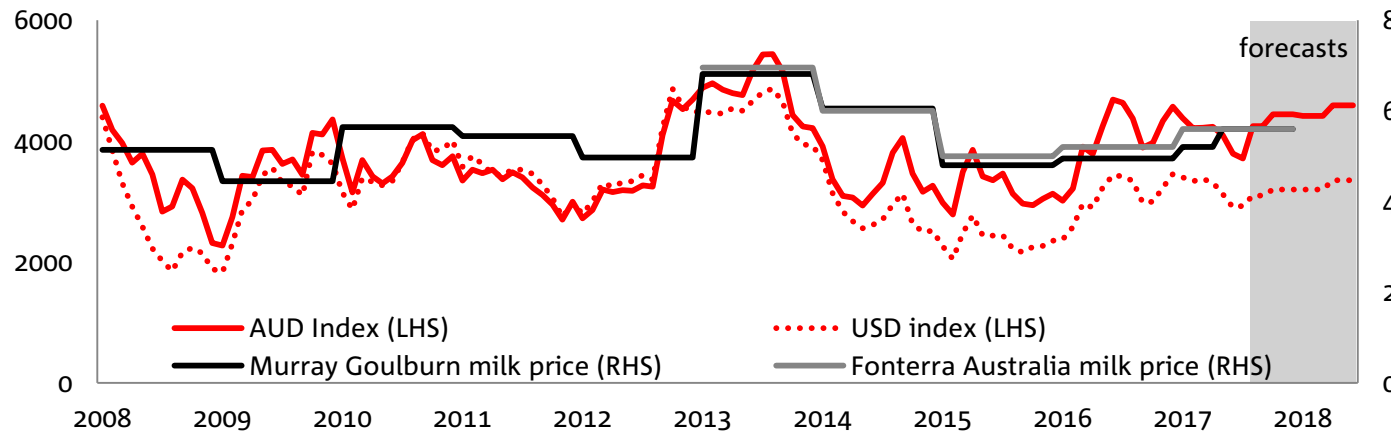
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OVERVIEW



NAB WEIGHTED DAIRY EXPORT PRICE INDICATOR

\$/tonne (export price, LHS), AUD/kg milk solids (farm gate price RHS)

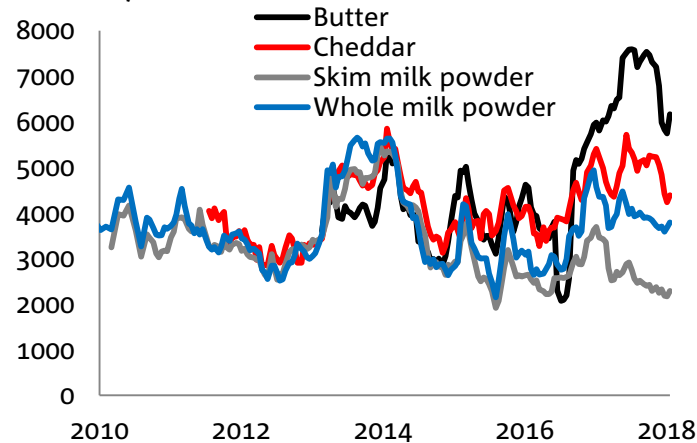


Dairy prices have trended downwards overall since mid last year, and although 2018 has brought some relief in USD terms, the higher AUD has eroded these gains.

Our forecasts do not point to major upside for global dairy prices in USD terms in the coming year, with any local gains coming primarily from our expectations of a lower AUD in the 70-75c range. However, the weakness in the USD (which recently saw the AUD touch 80 cents) could be a major challenge in the first half of this year.

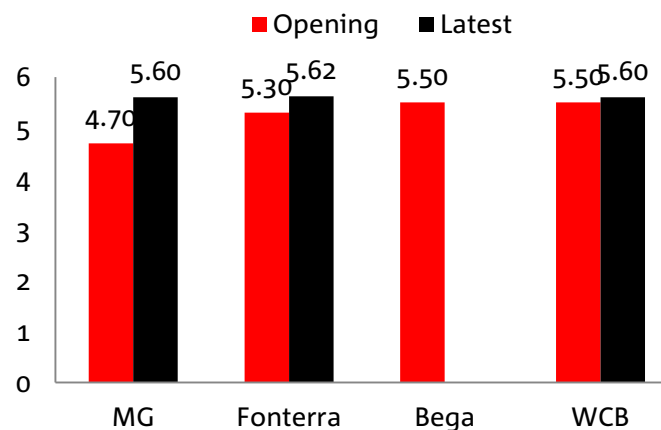
GDT AUCTION RESULTS

AUD/tonne



FARMGATE PRICES

Opening and latest (MG not whole year)



Farmgate prices look to be tracking reasonably well, with major processors all in the mid-\$5 range in AUD terms. Given the AUD and global market trends, there may be limited upside from here, these prices are close to the long run average (AUD5.90/kg milk solids nationally over the last 8 years).

Seasonal conditions have been mixed, with Gippsland in particular seeing very dry conditions in 2017. Summer rain has been somewhat kinder in Victoria, although a drink would be welcome in much of the state. The Bureau of Meteorology's outlook points to average to wetter than average conditions for the coming months. Still, we don't expect major increases in Australian milk production this season.

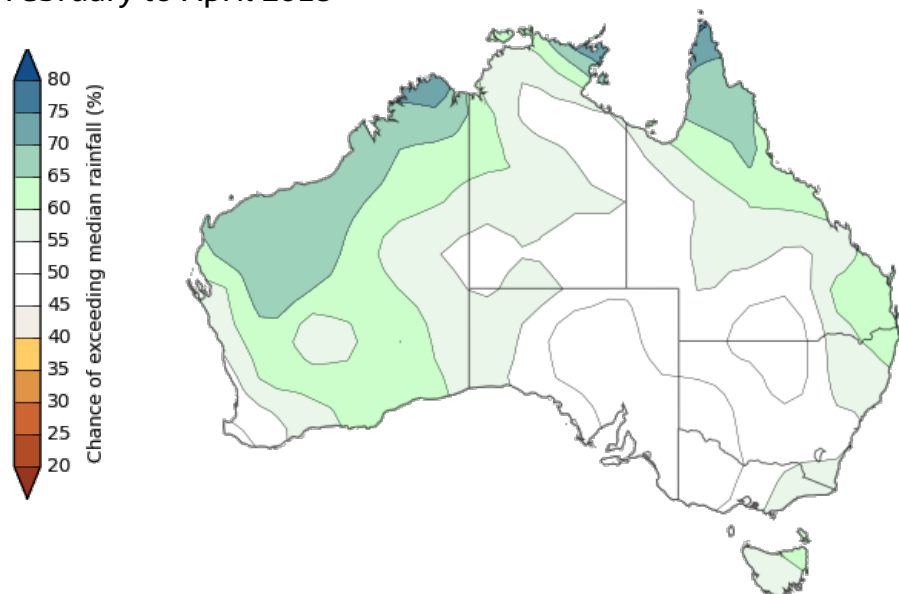
Source: Australian Bureau of Statistics, Global Dairy Trade, Dairy Australia, IBISworld and NAB Group Economics
Note: chart shows Murray Goulburn farmgate prices except 2008-09 which shows Dairy Australia's reported Victorian average value. MG latest farmgate prices apply from 1 November 2017 and are not retrospective.

SEASONAL CONDITIONS



THREE MONTH RAINFALL OUTLOOK

February to April 2018

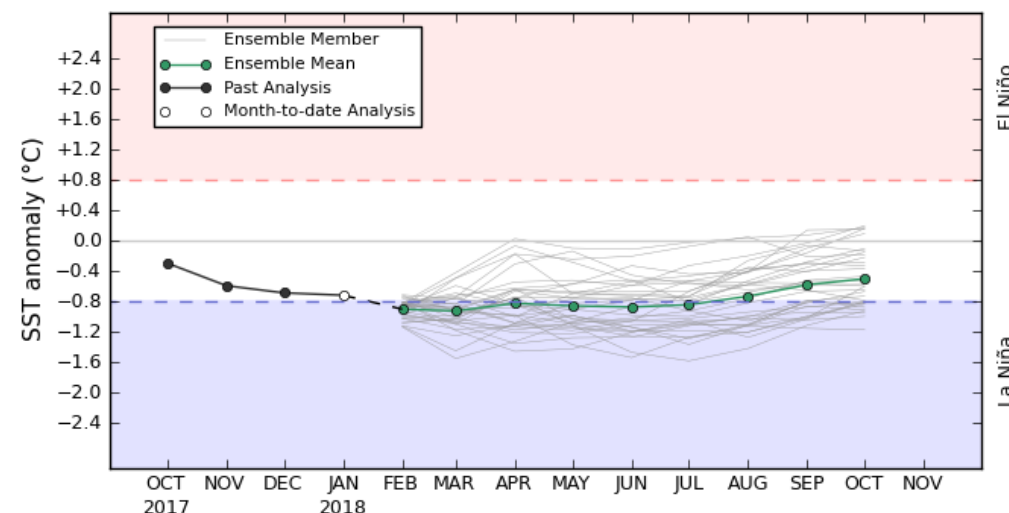


The Bureau of Meteorology's latest three month climate outlook points to average to wetter than average conditions across much of the country. The Kimberley, Arnhem Land and Cape York are expected to see much wetter than average conditions over the next three months.

Australia's dairy regions are forecast to see average to above average rainfall conditions, which should provide a decent autumn break should they transpire.

BOM POAMA EL NINO LONG RANGE OUTLOOK

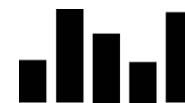
Issue date 14 January 2018



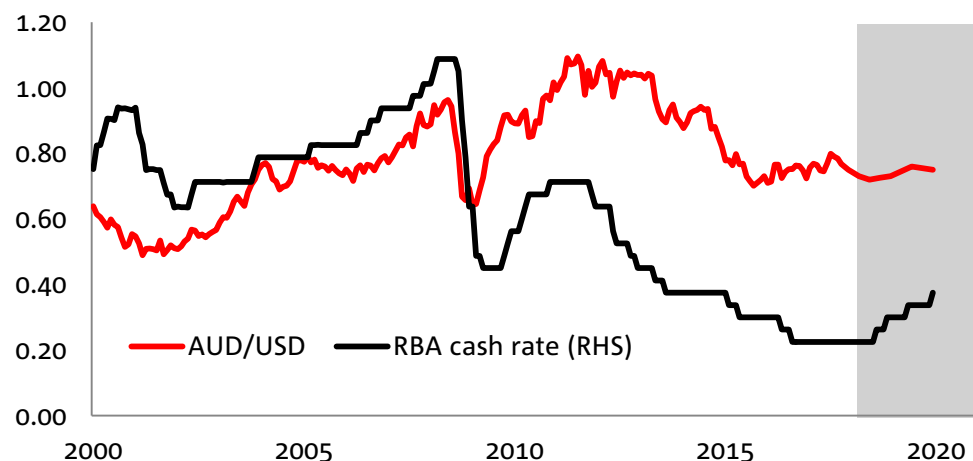
The latest Bureau of Meteorology ENSO wrap up shows that the weak La Niña event that developed late last year continues. The Bureau's forecasts point to the event decaying in autumn, although the event should continue long enough to meet the three month requirement to declare 2017-18 a La Niña year.

The POAMA long range outlook points to close to La Niña conditions continuing throughout the forecast period to October. This tends to be associated with above average rainfall, although is difficult to predict.

EXCHANGE RATES AND INTEREST RATES



EXCHANGE AND INTEREST RATES INC. QUARTERLY FORECASTS



NAB FX STRATEGY TARGETS

	2018Q1	2018Q2	2018Q3	2018Q4
AUD/USD	0.73	0.72	0.73	0.73
NZD/USD	0.68	0.68	0.69	0.70
USD/JPY	115	116	117	118
EUR/USD	1.20	1.21	1.24	1.26
USD/CNY	6.59	6.55	6.52	6.50
AUD TWI	60.9	59.8	60.0	60.3

Source: NAB

Multiple factors have conspired to push AUD/USD firmly back into the 0.75-0.80 dominant 2017 range, even touching 0.80 last week. This is clearly challenging to our 0.73 end-Q1 forecast, but we aren't compelled to alter our '070-0.75' 2018 view.

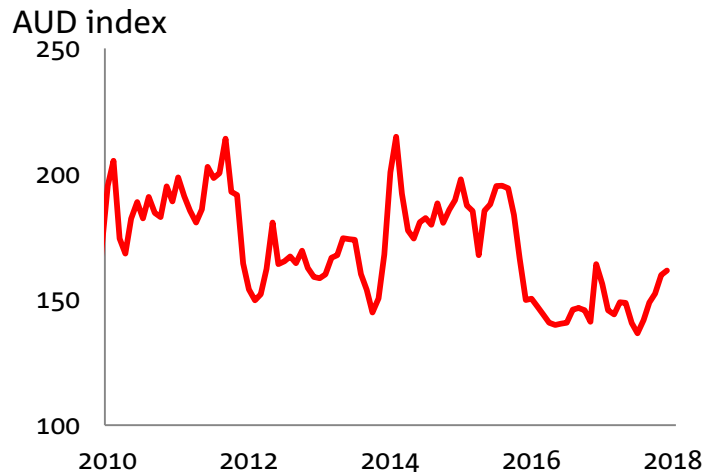
We maintain the view that in 2018, AUD/USD will spend a considerable time below 0.75. Yet in seeking to understand the forces that have driven the pair up from its 0.75 early December low, We think the main forces that have driven the AUD to 80 cents – USD weakness, strong commodity prices, probable M&A flows and super-strong risk sentiment, are unlikely to persist over the course of 2018. When one of these factors turns against the AUD, others often do at the same time. In September, it was both the USD and commodity prices, which quickly flipped commodity currencies from out to under performers. However, a clear break into this lower trading range is evidently at risk of coming later than suggested by our forecasts published in December (0.73 for end Q1 and 0.72 for end Q2 2018).

The RBA will be reluctant to raise rates until there are reliable signs that wages growth and inflation are moving in the right direction, especially as the cooling housing market has simultaneously lessened the urgency for RBA rate hikes. However, we expect that stronger labour market conditions will see wage growth lift over time. Additionally, the RBA's concerns around household balance sheets are unlikely to dissipate, especially as levels of household debt continue to rise faster than incomes. On balance, for now, we retain our view that the RBA will begin gradually lifting interest rates in H2 2018 as the unemployment rate falls further.

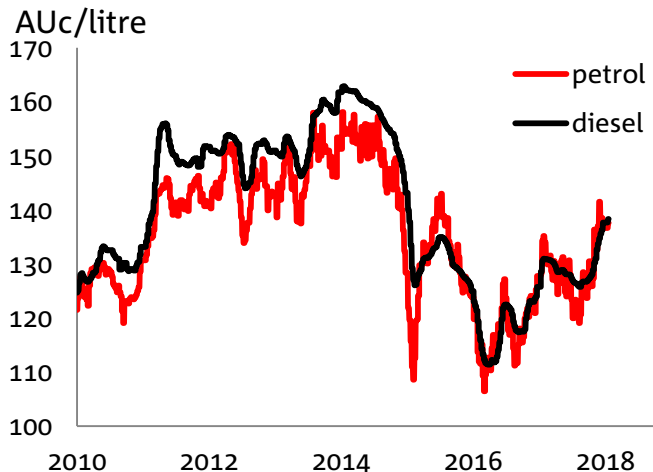
FARM INPUT PRICES



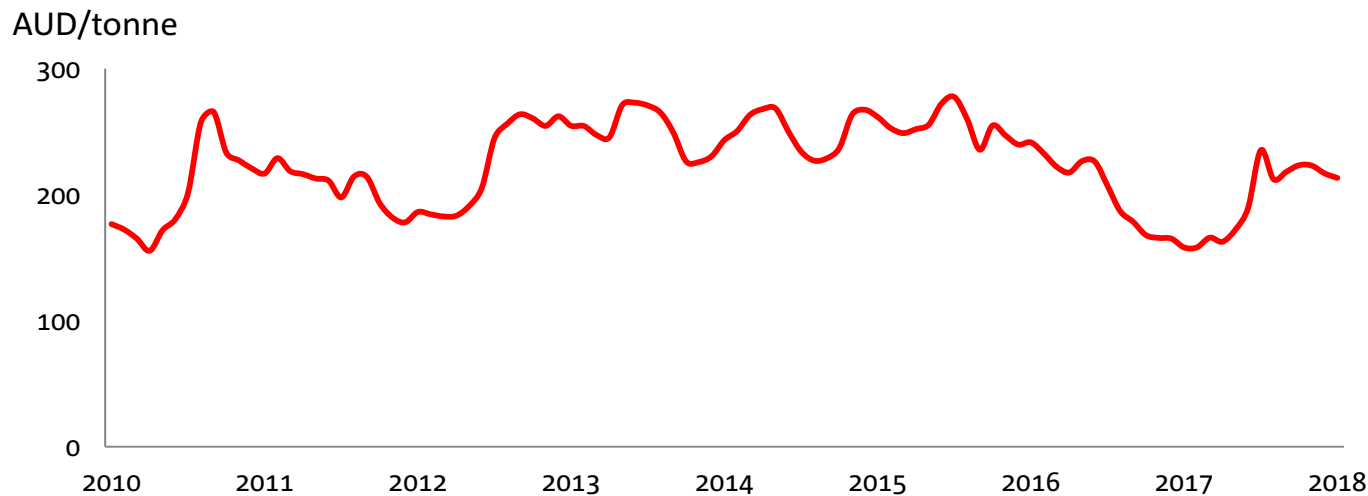
NAB FERTILISER INDEX



NATIONAL AVERAGE FUEL PRICES



NAB WEIGHTED FEED GRAIN PRICE INDEX



Source: Bloomberg, Profarmer and NAB Group Economics

Feed prices jumped substantially in mid-2017, reflecting domestic premiums associated with a patchy winter cropping season. The NAB weighted feed grain price index is tracking at \$218/t for January (to date). However, global grain prices remain in the doldrums, which should put downward pressure on domestic feed prices once the NSW and Queensland sorghum crop is harvested (depending on yields). Another consideration is that our index is a national measure, whereas the biggest premiums have been in northern NSW and Queensland. Victoria, where two-thirds of Australian dairy production is concentrated, has seen a much better cropping season.

Fuel prices present something of a complicated picture. Oil prices have risen reasonably quickly of late, underlined by Brent touching USD70/bbl last week. The unexpected strength of the AUD has blunted some of this impact, although national petrol prices have now reached 137.6c/l and diesel 138.3c/l. This represents a roughly 10c/l increase in the price of petrol over the past year. If the AUD falls this year at the same time as petrol prices increase, further increases at the bowser are highly likely.

The NAB fertiliser index gained 1.1% in December, but finished the year down 1.5% on a year on year basis.

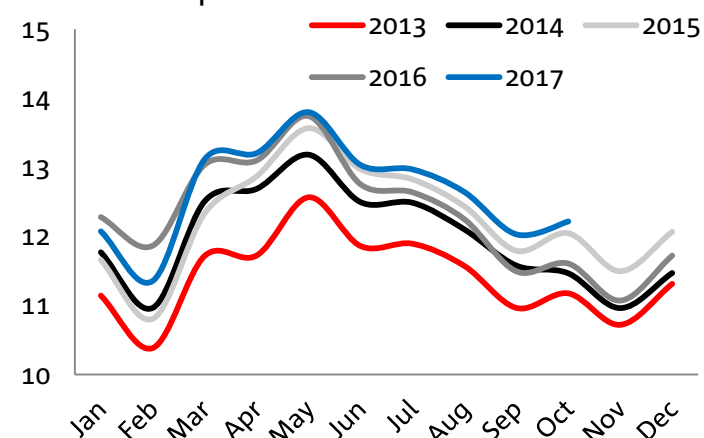


INTERNATIONAL PRODUCTION TRENDS



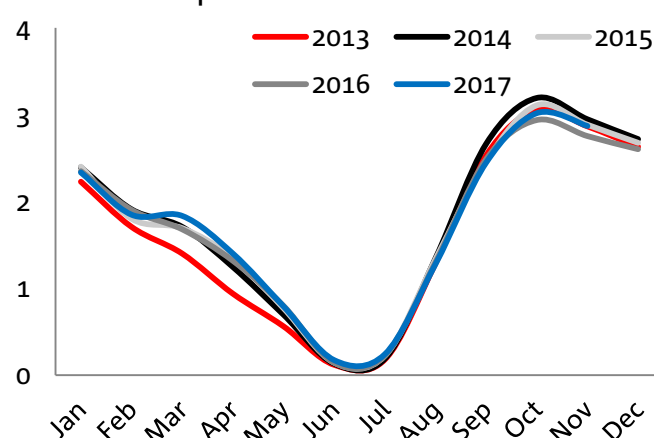
MILK PRODUCTION – EU28

Billion litres per month



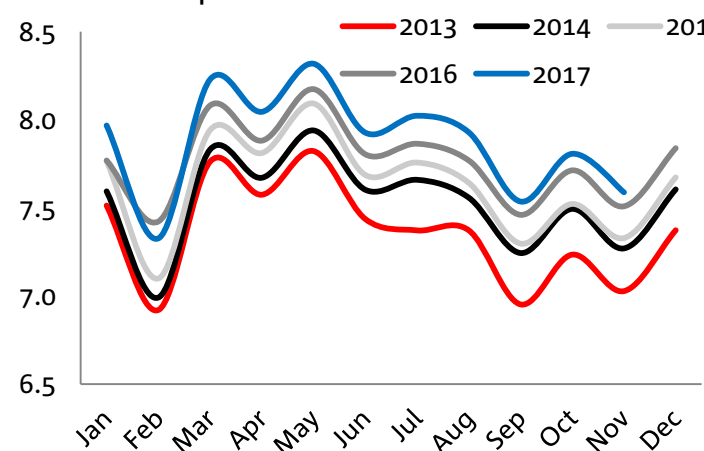
MILK PRODUCTION – NEW ZEALAND

Billion litres per month



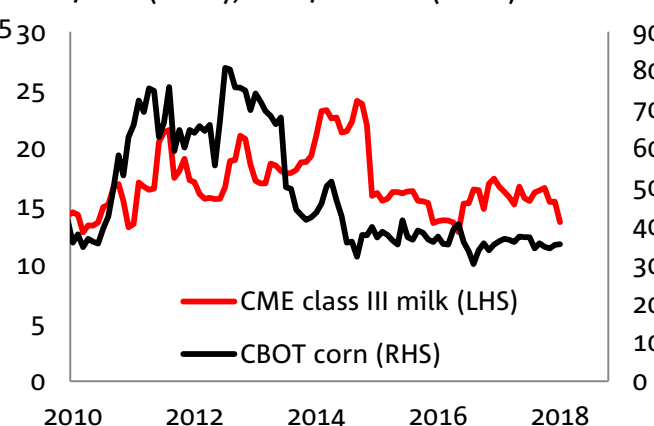
MILK PRODUCTION – UNITED STATES

Billion litres per month



US DOMESTIC MILK AND CORN PRICES

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



Both the European Union and the United States have recorded higher milk deliveries in the last few months, with October 2017 EU deliveries up 5.3% year on year (although the previous year was effectively suppressed by EU intervention), and US deliveries up 1.1% year on year in November.

Both producers have seen upward production pressure over the last few years, albeit for different reasons. The EU's abolition of milk quotas in 2015 allowed for production increases from efficient producers such as Ireland and the Netherlands. In the US, cheap farm inputs, particularly feed, have allowed for the sector to expand despite lower milk prices.

BNZ reports that recent rains in NZ should improve production somewhat, with good follow up rain is needed. Fonterra milk collections for December were down 6% year on year. BNZ forecasts that NZ milk production for the 2017-18 season will be down in the order of 2%, but that farmgate prices should be in the order of NZD 6.30/kgms, slightly lower than Fonterra's estimate.

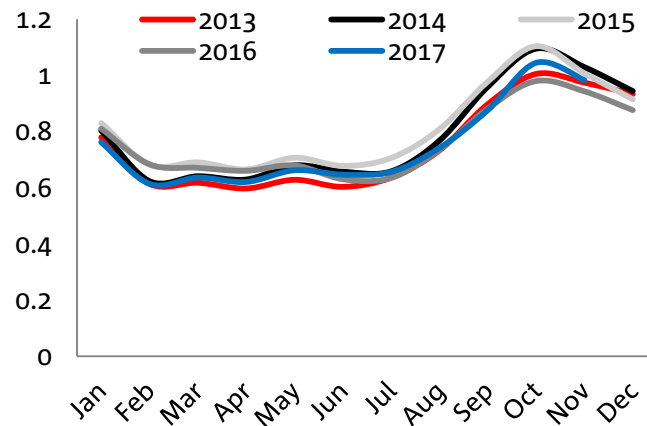
Source: Eurostat, European Commission, clal.it, DCANZ, USDA, Bloomberg and NAB Group Economics

PRODUCTION TRENDS: AUSTRALIA



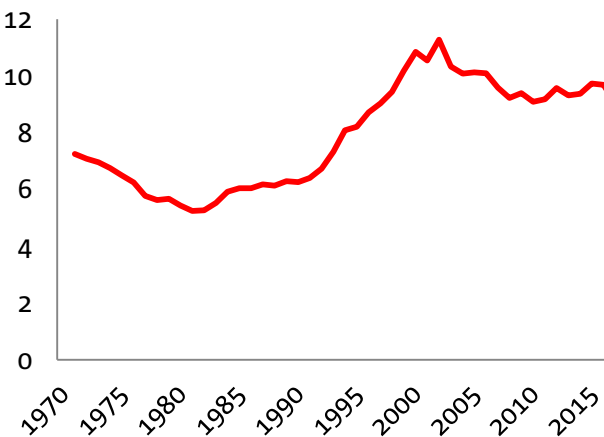
MONTHLY MILK PRODUCTION

Billion litres per month



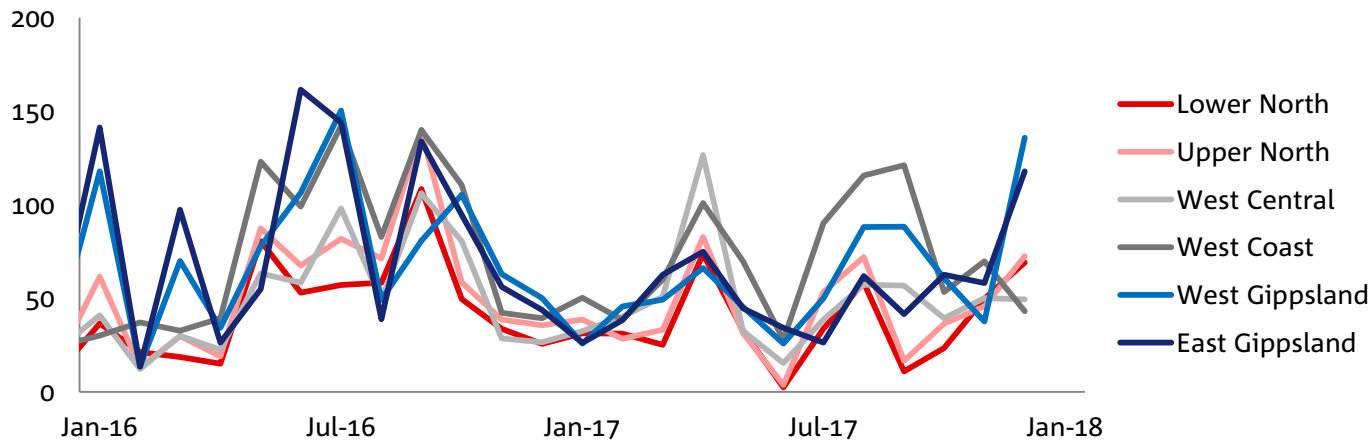
ANNUAL MILK PRODUCTION

Billion litres per annum



MONTHLY RAINFALL IN VICTORIAN DAIRY REGIONS

mm, district average



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

Australian milk production plunged 6.9% to just over 9 billion litres in 2016-17, reflecting a combination of the ongoing price shock and very wet spring conditions in northern Victoria in particular. More recent data show a partial recovery from this low, with Dairy Australia reporting that November milk deliveries were up 4.3% year on year in November.

Improved farmgate prices are arguably supporting production, although Murray Goulburn's opening price of \$4.70 was a major shock and was quickly adjusted.

Most major processors have now announced step-ups to the mid-\$5s range this season (although Murray Goulburn's latest only applies from November). However, we do not expect a major upturn in Australian dairy production at least for some time.

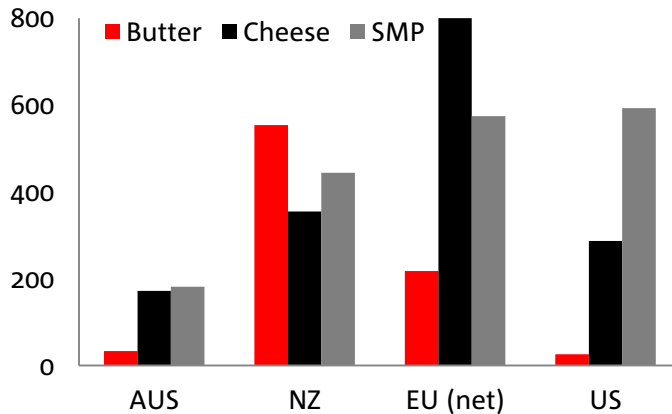
A major change for the sector will come when Saputo purchases the assets of Murray Goulburn (subject to regulatory approval). Saputo currently controls around 1 billion litres of milk through its subsidiary Warrnambool Cheese and Butter. The acquisition of Murray Goulburn will add another 2 billion litres, giving it around a third of the market (roughly the same position as Murray Goulburn before the step-down).

AUSTRALIAN DAIRY TRADE



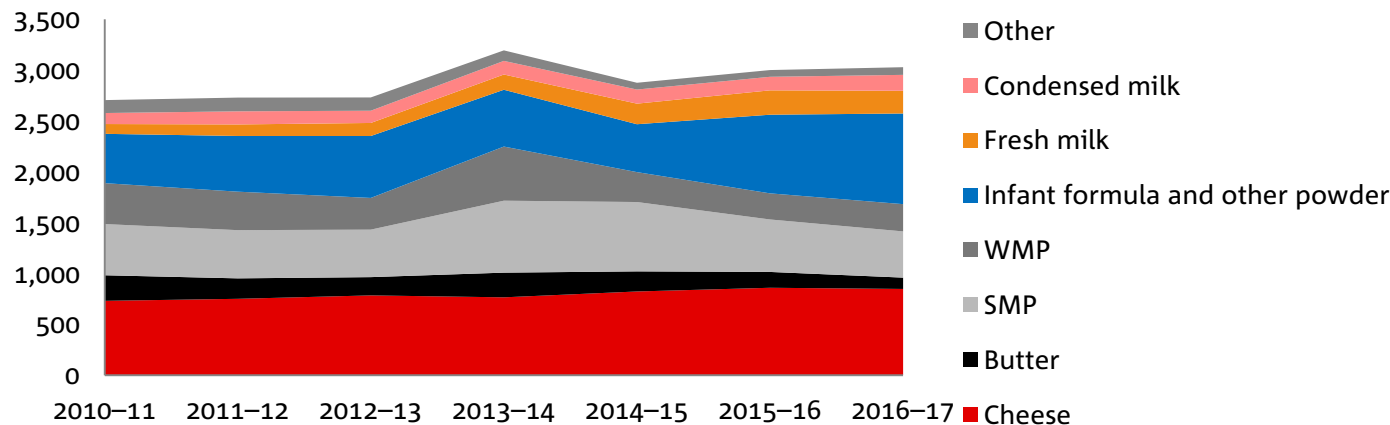
EXPORT VOLUME – SELECTED PRODUCTS

KT, 2016



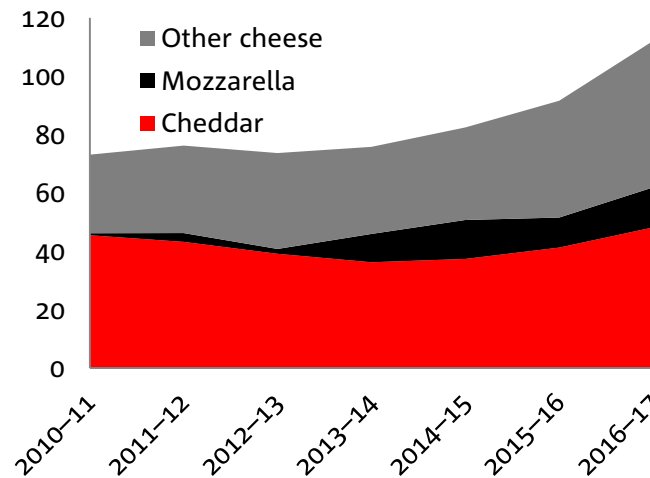
VALUE OF DAIRY EXPORTS BY TYPE

AUD millions per annum



AUSTRALIAN CHEESE IMPORT VOLUME

KT



Australian dairy export values have trended gradually higher over the past few years, excepting the outlier of 2013-14, which saw Chinese milk powder stockpiling push prices to very elevated levels.

The composition of exports has also changed, with whole milk powder and skim milk powder in decline in value terms, while other powders (such as infant formula) have become much more important. While infant formula is undoubtedly a growing and valuable product, Chinese regulatory activity has highlighted some of the risks of dependence on a single, large market.

Growing cheese imports are an ongoing issue for Australian dairy farmers and processors. Imported cheese is becoming more prevalent, particularly in the quick service restaurant sector, reflected in the volume of imported cheese growing 22.4% in 2016-17. Around one-third of the cheese consumed in Australia is imported, compared to around a quarter at the start of the decade (although Australia exports more cheese than it imports).

Source: ABARES and NAB Group Economics