WESTPAC DAIRY UPDATE

Milk price forecast update.

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Plan for the worst, hope for the best.

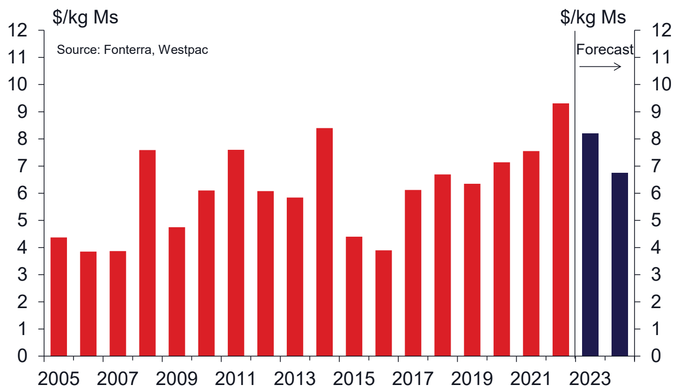
- The short-term outlook for global dairy prices is weak and the timing for any price recovery is highly uncertain.
- Reflecting this uncertainty, we have lowered our 2023/24 milk price forecast to $6.75/kg i.e. in line with the midpoint of Fonterra's updated forecast range ($6.00/kg to $7.50/kg).
- There are some offsetting factors in play which are easing cashflow pressures for some farmers.
- However, it's clear that the 2023/24 season will be tough and in many cases farmers will be focused on loss minimisation.

Farmgate milk price forecasts

	2022/23		2023/24	
	Westpac	Fonterra	Westpac	Fonterra
Milk price	$8.20	$8.10-$8.30	$6.75	$6.00-$7.50

We have lowered our 2023/24 milk price forecast by 75 cents to $6.75/kg. If achieved, the milk price would be the lowest since the 2018/19 season ($6.35/kg). But more pertinently, it would be the lowest in inflation-adjusted terms since the 2015/16 season ($3.90/kg or circa $4.90/kg in June 2023 dollars).

Farmgate milk prices

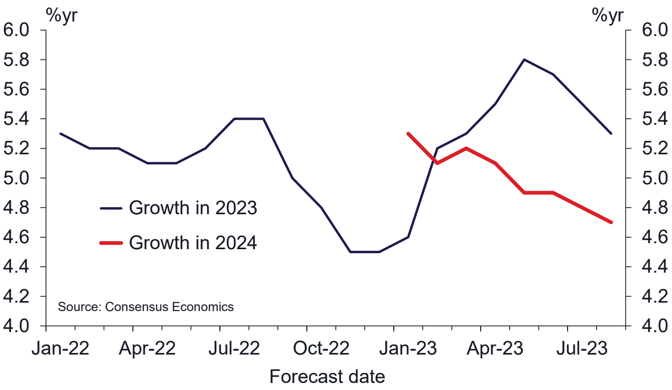


In lowering our forecast to $6.75/kg, we have adopted the midpoint of Fonterra's updated forecast range ($6.00/kg to $7.50/kg). By doing so, we have also adopted a similarly conservative approach (to Fonterra) to the milk price forecast at this highly uncertain juncture. Note that if current auction prices were to persist until the end of the season (and assuming 0.61 for the NZD/USD), the milk price would likely come in towards the bottom end of Fonterra's forecast range.

China demand outlook – a crisis of confidence.

The key driver of the weak short-term price outlook is weak Chinese demand, noting that China is comfortably our largest dairy market. Unlike most economies post their Covid lockdowns, China's post lockdown bump in economic activity has underwhelmed expectations. Indeed, we have progressively cut our outlook for Chinese economic growth for 2023. From 6.2% in June, we have sliced our forecast to 5.7%, and then to 5.2%. If anything, consensus forecasts have stepped even lower, notably for 2024 with the forecast presently sitting at around 4.7% (and this forecast was made prior to last week's very disappointing July data).

China GDP growth – Consensus forecasts



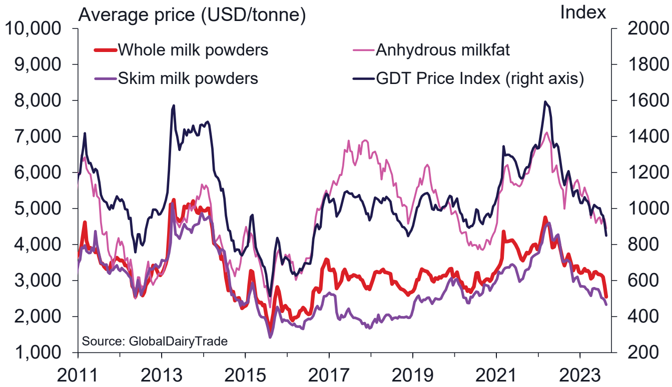
Curiously, rising costs of living and/or interest rates do not explain the underperformance of the economy. Indeed, consumer prices actually fell a touch over the July year. Rather Chinese businesses and households are suffering a crisis of confidence. The housing market remains key to the Chinese economic psyche and any pickup in activity. It remains very weak following the bursting of its speculative bubble and the government's housing market reforms.

Officials have begun to incrementally loosen lending policy settings. But further measures are likely necessary. Indeed, we expect additional stimulus, focused on encouraging first home buyers and smaller investors back into the market.

At the same time, we expect that Chinese officials will try to strike a balance, kickstarting growth in the economy without undoing the hard-won gains from previous reforms. Too little stimulus and the economy may stall; too much and a speculative bubble may return. This delicate balancing act results in clear risks to our forecasts for Chinese growth and in turn Chinese dairy demand. If anything, we suspect that the Chinese government may favour less rather than more stimulus than we have factored in.

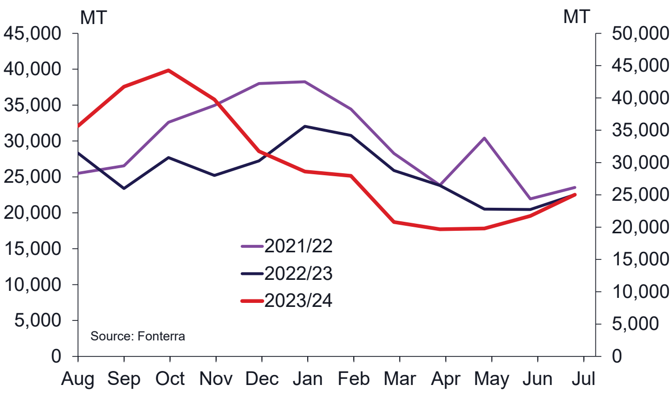
Global dairy prices have mirrored China's economic struggles. Since the start of the year, dairy auction prices have fallen by around 22%.

GlobalDairyTrade auction prices



Indeed, recent falls have picked up pace, with dairy buyer sentiment at a low ebb. At the last auction, prices fell 7.4% overall, with whole milk powder prices plunging 10.9%. The catalyst for the price slump was a sudden increase in auction volumes on offer. Ahead of the auction, Fonterra announced a 5.6% increase in auction volumes over the next 12 months.

Whole milk powder auction volumes on offer



We speculate that buyers expect prices to get worse before they get better. To this end, these buyers may have signalled to Fonterra that they no longer want to buy direct from Fonterra on a contracted basis. As a result, Fonterra has had to shift this product that it would have sold on contract to the auction platform, putting additional downward pressure on auction prices in the short term.

While continued soft Chinese demand accounts for most of the price weakness, other factors are playing a role. Firstly, a bumper autumn for New Zealand has boosted global dairy supply temporarily. Indeed, April and May production was up a combined 7.7% compared to the same period a year ago – both months set record highs. This late autumn surprise was enough to offset the very weak spring and thus lift production for the entire season above last season's level. Secondly, and as discussed in a previous report, New Zealand has not been well-placed to benefit from relatively high cheese prices. New Zealand dairy companies have limited (factory) capacity to produce more cheese. In the short term, these companies are stuck producing other less profitable products like whole milk powder. Indeed, a more optimal production mix, if it were possible, would result in a higher milk price. Thirdly, compounding the above factors is strong Chinese domestic dairy production. With much of this production funnelled into whole milk powder, there is additional downward pressure on whole milk powder prices.

Doing it tough.

For many farmers, this season's milk price is likely to be below their break-even point. Indeed, even after taking account of the cost-cutting measures that farmers are likely to take, DairyNZ's updated breakeven milk price estimate is around $7.50/kg. Note that break-even estimates vary widely by farm (and also in the calculation method), so that some farms may have larger deficits, while some may still even be in surplus.

However, there are some offsets in play. The recent payout from the sale of Fonterra's sale of its Chilean business has added $0.50/kg back into Fonterra farmers' cashflows at least, if not their farm profits. Also, Fonterra is set to pay a relatively healthy dividend in October of circa 40 cents per share.

The other potential source of relief is falling on-farm input inflation. Annual dairy farm input inflation was running as hot as 17% in the middle of last year. Now as at the June 2023, annual input inflation has fallen to 7% - by the end of the year, we expect to fall to the 3% to 4% range. If anything given the pace of declines to date and subsequent feed and fertiliser price reductions, input inflation could be close to flat by the end of 2023.

Those factors aside, the lower milk price is still the dominating factor. Indeed, improvements in farm profit margins are likely to need to wait until the 2024/25 season. For this season, it means that for many farmers the focus is likely to be on loss minimisation.

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