

Rabobank Dairy Quarterly

Trend and Outlook for the International Market

Rabobank International

Authors

Tim Hunt
tim.hunt@rabobank.com
 Hayley Moynihan
hayley.moynihan@rabobank.com
 Marina Rebello
marina.rebello@rabobank.com
 Michael Harvey
michael.harvey@rabobank.com

www.rabobank.com/far

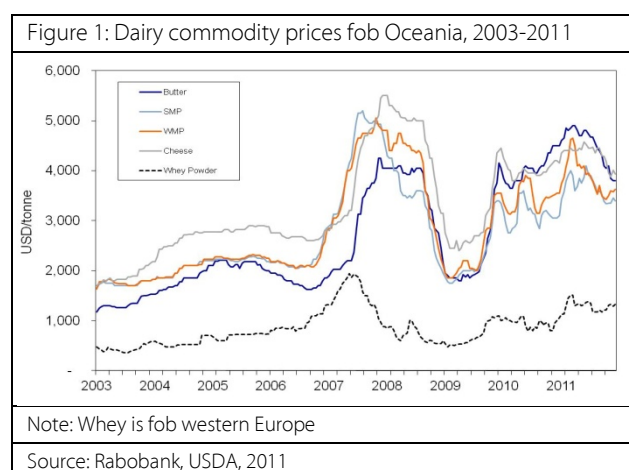
Summary

- The decline in global dairy commodity prices in train since March continued through the first half of Q4, before signs of a modest rally in late Nov/early December.
- Prices were weighted down by the continuation of strong supply momentum, weak demand in the Northern Hemisphere and light buying from China and Russia.
- The later rally, amidst an outstanding Southern Hemisphere supply season, appears to have reflected increased Chinese buying and the lengthening of purchasing programs from a range of importers to take advantage of the 15%-22% price falls from this year's peaks.
- Supply is expected to be abundant through early 2012, as the Southern Hemisphere works to clear the results of a strong season and milk production continues to outpace demand in the Northern Hemisphere.
- The market may struggle to digest available supply in Q1 2012, and stocks start to build, bringing the prospect of a return to a modest downward trend in pricing.

Prices

International dairy prices lost ground in the first half of Q4, before a modest rally kicked in during late November/early December. The net price impact of these phases varied by product, with butter and cheese closing mid-December some 8% down on opening quarter levels, SMP flat, and WMP and whey powder up 5% and 9% respectively in international trade.

Despite a volatile quarter for the US dollar, with a 5% difference between its high and low during the period, the currency ended up more or less where it started the period on a broad index basis.



After a brief hiatus, supply growth regained momentum in key export regions. Production was up 2.2% YOY in the three months to October, as excellent weather enabled Southern Hemisphere farmers to respond to highly profitable market signals and momentum carried Northern Hemisphere growth into the shoulder season despite tightening margins.

Despite a general deterioration in economic conditions and rising retail pricing, the market has managed to cope with this supply growth with only minimal damage to pricing (and even a small late rally). Importers soaked up additional volumes, with many taking advantage of light buying from China and Russia and falling prices to lengthen their purchasing programmes, before China itself appeared to increase activity entering December. After a poor Q3, consumption may have also improved somewhat in export regions in the closing months of the year.

As we enter 2012, milk supply growth is expected to slow as the Southern Hemisphere season winds down, the EU approaches the end of its quota year, and margins begin to bite in the US. But in Q1 dairy commodity markets will still be digesting the largest Southern Hemisphere spring peak in more than five years and possibly excess supply growth in the North. Given the economic context, the risk of excess stock accumulation remains material.

Supply side

EU

- EU milk production remained strong through Q3, rising 2.2% above prior year levels, on the back of good weather and high milk prices that ensured good margins over high feed costs.
- However, growth momentum slowed as the quarter progressed, and by October production sat just 0.8% above prior year levels. While milk prices remained high, rising fuel and fertiliser bills started to shrink margins. Farmers in some countries also eased back production in a pre-emptive bid to avoid overshooting quota limits for the April-March production year. Stronger year ago comparables also played a role.
- Supply was further boosted in recent months by the sell down of 78,000 tonnes of SMP from intervention via the 2011 MDP programme.
- Despite rising supply, exports rose by only 1% in milk equivalent terms in Q3, with a 17% rise in SMP shipments offset by declines elsewhere.
- While some import replacement occurred, the shift in the EU's net trade position accounted for only a small fraction of the increase in supply during the period.
- This suggests either that demand is holding up better than anticipated, or that stocks are starting to build.
- Impacted by stagnant job markets, deteriorating income prospects and high retail pricing, local EU demand for dairy varied considerably from region to region. Some pockets

appeared to be holding up well though declines clearly occurred in others.

- Whether recent supply growth has been headed for local demand or stocks, the risks of the latter will increase as we progress into 2012.
- Rabobank expects milk supply growth to continue to slow in the closing months of the current quota year, but it will still expand. Milk prices remain high. The FrieslandCampina guaranteed milk price for December was set at EUR 37.50, 5% higher than year-ago levels. Quota management will limit growth in Ireland, Austria and possibly Germany too, but will not preclude growth.
- Supply will be again be supplemented by further sales from intervention, with another 37kt due for disposal by 1 Feb 2012 under the 2012 MDP programme.
- The ability of the domestic market to absorb even these modest increases in supply is questionable. Consumers are starting to see some retail price relief, but this is largely marginal and comes off extremely high price levels. With the EU most likely moving into recession, employment growth and income expectations will be poor.
- This is likely to free up ample EU product for export growth in early 2012, which will be competitively priced given the recent decline in the Euro.
- There is a considerable risk that the volumes available will be more than the international market will want, bringing the prospect of an inventory build-up, particularly as the 2012 supply season begins to build after March.

Figure 2: Milk production growth in key export regions, Aug-Oct 2011

YOY percentage change		
	October 2011	August through October 2011
EU	0.8	1.5
US	2.1	1.8
NZ*	7.7	8.9
Australia	4.2	3.8
Argentina	11.0	13.5
Brazil	-1.4	-3.0
Total*	2.2	2.2
* Rabobank estimates		
Source: Rabobank, AMI, USDA, DA, CEPEA, Alimentos Arg., 2011		

US

- Milk production growth picked back up again after summer and came in at 2.1% in October YOY.
- High producer returns in the first half of the year encouraged a 1% YOY herd expansion in Q3, the strongest rate of growth for several years. While margins have tightened since, the impact on supply growth to date has been limited.
- Mild weather also pushed yield growth above that seen during the heat-impacted Q2.

- Growth came mainly from the western states, with declines registered in the north-east due to shortages of alfalfa and quality issues with available supply.
- As with the EU, it is difficult to track exactly where this supply expansion went. Exports actually fell back below prior year levels through Q3, while imports were up considerably.
- According to official data, the domestic market was also extremely weak through Q3, with consumption of cheese and liquid milk falling 1.8% and 1.3% respectively in YOY terms.
- And yet there is no evidence of a stock accumulation in the US market to date.
- As we enter 2012, the bottom line for the US is that the local and global markets are unlikely to need more milk from US farmers in Q1 than they produced in the same period this year.
- Domestic demand will be weak, as consumers continue to keep a tight rein on spending in the face of weak employment growth, stagnant real incomes and financial uncertainty.
- And opportunities to further expand exports will be limited in the near term.
- Coming months are thus expected to see a further squeeze in farm margins as prices continue to edge downwards.
- There is a considerable risk that supply will outpace market requirements nonetheless, with potential for stocks to build above desired levels as we progress through Q1.

New Zealand

- NZ milk flows were up 9 % YOY for three months to October, continuing a strong run of growth in train since March 11.
- Across all regions, producers enjoyed one of the best spring and early summer periods for many years.
- The additional milk flow translated into a 9% expansion in Q3 exports. Increased tonnages were led by butter (+22%), cheese (+18%) and SMP (+9%) due to higher product returns and declining WMP shipments to China.
- Local supply chain disruptions kept October exports 12% below prior year levels.
- While milk flows will decline seasonally through Q12012, the platform is in place for a solid shoulder season, with good feed availability and cow condition. The net 4% reduction in the forecast milk price for the season to NZD 6.50/kgMS is likely to have little effect on growth over this period.
- However, the rate of milk production growth is likely to ease to around 4% YOY through Q1 2012 presuming normal summer conditions prevail and the stronger year-ago comparables.
- The strong supply peak will ensure good YOY growth in export volumes through Q1 2012.

Australia

- With southern dairy producers taking advantage of good conditions through the spring flush, supply peaked in October some 4.2% up on last year.
- Processors announced the first milk price step-ups for farmers, but also cautioned about weakening conditions in the global market and their likely impact. Expectations for the full year price sit around AUD 5.30/kgMS: 6% shy of the previous year.
- Domestic consumption has been mixed, with milk sales boosted by discounting, but retail cheese sluggish.

- Exports were down 5% in Q3 YOY, though will build through the final stages of 2011 on the back of improved milk flows.
- Production is expected to continue to track more than 2% up on prior year levels into Q1 2012, with further upside possible due to ample supply of feed grain and irrigation water.
- With local demand growth likely to be modest at best, Australia will have a solid increase in product available for export through the early stages of 2012.

Argentina

- The phenomenal growth in Argentine milk production in 2011 continued beyond Q3, with October production up 11% YOY: posting the tenth record month for the year.
- On-farm margins have expanded, as milk prices have remained unseasonably firm and corn prices dropped further than they had abroad due to a good harvest and export controls.
- While domestic demand is also rising, most of the additional supply has been exported, fuelling a 50% increase in outgoing shipments in Q3 in milk equivalent terms, led by WMP and cheese. This pattern was interrupted in October by a trade conflict with Brazil, but will return to trend in November.
- Rabobank expects milk production to continue to expand handsomely over prior year levels as we enter Q1 2012, with downside weather risk mitigated somewhat by the widespread availability of relatively cheap supplementary grain.
- The rate of increase will slow to around 5% due to stronger prior year comparables.
- This will free up further supply to enable Argentina to continue to build its export industry in early 2012.
- Capacity expansions are now underway to ensure that the processing capacity is in place to sustain growth beyond the 2011/12 season.

Brazil

- Despite some improvement in recent months via falling corn prices, Brazilian dairy farmers continue to face low margins.
- Supply continues to trail last year's levels, with a 1.4% decline in October pushing the contraction into its thirteenth month.
- Attractive wholesale prices and supply shortfalls saw import volumes almost double in Q3, and accelerate in October.
- Nonetheless, supply shortages continued to restrict local sales growth in Q3 and push retail pricing up considerably.
- As we enter 2012, Rabobank expects producer margins to expand on the back of falling grain prices, opening the way for a rise in the usage of concentrate. Assuming this coincides with a normal rainy season, production will start to rise marginally above prior year levels early in the new year.
- However, this will still be insufficient to keep up with local demand growth. With local wholesale prices likely to remain above world price levels, imports are likely to rise a little higher through H1 2012.

Demand side

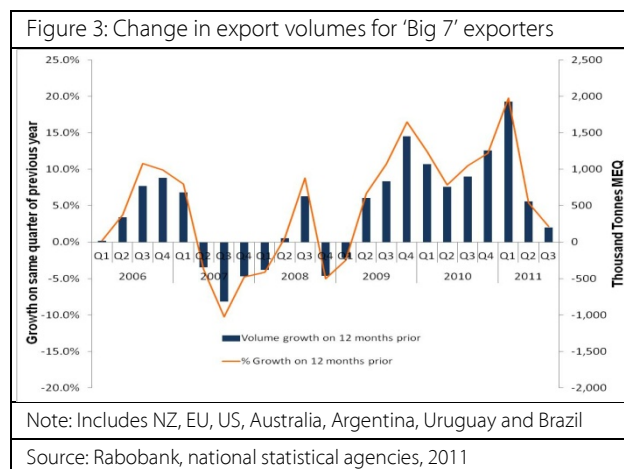
The global economy has deteriorated in recent months. Indicators suggest a slowing of growth both in OECD countries, where confidence has been undermined by the EU debt crisis, and in the developing world, due to tighter monetary policy and slowing trade growth.

Consumers are starting to see the first signs of price relief in the dairy case in the EU and US as recent reductions in commodity prices and milk costs are passed on to consumers. But the extent of relief is tempered by the high starting point for prices, while companies continued to push through significant price increases in the developing world at least through Q3 2011.

Despite this context, global dairy demand appears to have proved remarkably resilient. The pace of consumption growth has slowed, but consumption has grown nonetheless. US sales of cheese and fluid milk both contracted through Q3, but appear to have shown signs of stabilisation in more recent months. Though significant sales declines are evident in parts of the EU, these are being partly offset by surprising pockets of demand elsewhere in the EU. Sales continue to expand in much of South East Asia and China, though reportedly at a slower pace than H1 2011.

Import demand certainly held up well through Q3, posting a small expansion on year-ago levels (based on export data from Big 7 exporters). Given reduced buying from China and Russia during the period, the buoyancy of trade is remarkable, with a range of players, particularly in South East Asia and Latin America, entering the market to take advantage of reduced prices.

Anecdotal evidence suggests China also came back into the market with increased vigour from mid-November, further buoying import demand.



The near term global economic outlook remains sobering. Things will get worse before they get better in the EU, and while the US is likely to avoid a recession, employment growth is expected to be scant across the OECD. The developing world will continue to fare better, but not by its own recent standards, as it is unable to completely decouple from the messy conditions expected in wealthier regions.

Pricing will show further modest declines at the retail level through Q1 2012 in the West, and at worst, will stabilise in developing regions. But this will provide limited comfort against a background of heightened economic uncertainty.

Import demand is likely to remain a bright light in the opening stages of 2012. China remains structurally short of milk, and having worked through inventory accumulated in H1 2011, most local processors will need to procure substantial volumes again to meet their requirements. Other buyers are likely to lengthen their buying programmes to take advantage of lower price levels, creating a

firm base for a modest increase in trade. But this might not prove enough to soak up the likely extent of spillage from export regions.

Outlook

Rabobank expectations

- The global dairy market has proved remarkably resilient in recent months. With minimal price impact, it has soaked up solid supply growth in the Northern Hemisphere and the first stages of a bumper Southern Hemisphere season, despite a deteriorating economic backdrop and weak buying for most of the period from Russia and China.
- Whether it can continue to do so in Q1 2012 is less certain.
- The market will need to digest the closing stages of the product surge from NZ, Australia and Argentina, while additional export supply will be available from the EU as momentum proves too strong for a stagnating local market.
- With economic growth in most key import regions set to slow in coming months, additional surpluses will likely overshoot their needs at current prices.
- This will place modest downward pressure on prices through the quarter, possibly representing the last stages of the current downturn, as prices drop to clear the market or in reflection of stock accumulation on the sell-side of the market.
- Factors that would lead to a worse or better outlook than anticipated are addressed below.

Downside influences

- A failure of EU authorities to progress in their efforts to stem their sovereign debt crisis would have negative flow-on impacts for the global economy and dairy demand.
- In the US, there is some concern that supply will outpace expectations of around 1% growth through Q1 2012, generating further surplus for disposal.
- While a repeat of the phenomenal purchase volumes seen 12 months prior are unlikely, we are still betting on a strong increase in Chinese purchasing in Q1 2012 from recent levels. If this doesn't eventuate, price downside will increase.

Upside influences

- While the NZ season to date has been exceptionally good, a dry late summer could still bring an end to YOY growth.
- Grain markets remain volatile and a significant upward shift in prices would reduce appetite for feed in many regions.
- The EU demand situation is far from transparent. If we are underestimating its resilience, the market will be tighter than forecast.

Rabobank International

Rabobank Food & Agribusiness Research and Advisory Dairy Global Sector Team Analysts

Australia – Michael Harvey
michael.harvey@rabobank.com

Argentina – Paula Savanti
paula.savanti@rabobank.com

Brazil – Guilherme Melo
guilherme.melo@rabobank.com

China – Martin Wu
martin.wu@rabobank.com

EU – Kevin Bellamy
kevin.bellamy@rabobank.com

EU – Marina Rebello
marina.rebello@rabobank.com

India – Shiva Mudgil
shiva.mudgil@rabobank.com

Mexico – Ken Shwedel
ken.shwedel@rabobank.com

New Zealand – Hayley Moynihan
hayley.moynihan@rabobank.com

USA – Tim Hunt
tim.hunt@rabobank.com

USA – Mak Kern
mak.kern@rabobank.com

USA – Vernon Crowder
vernon.crowder@rabobank.com

www.rabobank.com

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