Rabobank Dairy Quarterly

A Slow Squeeze Coming

Rabobank International

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Summary

- Dairy commodity prices fell through April and May before a small rally in June brought a 14-month bear market to at least a temporary end.
- Prices were pushed down by exceptional supply growth in export regions, which generated more product than could be soaked up amidst weak demand in western markets and only modest growth in import buying from emerging markets.
- A small 'realisation' rally followed in June, as stock accumulation through the Northern Hemisphere peak proved lower than feared, and buyers moved to cover short-term needs.
- Supply growth is expected to lose momentum through 2H 2012 as farmers see further reduction in milk prices and as weather normalises.
- Demand will remain lacklustre in the face of a weak global economy, slowing the pace of price recovery, even given relatively limited excess stocks to work through.
- The market looks most likely headed for stable pricing through Q3, yielding to a slow squeeze in Q4, with the price recovery gaining legs in early 2013.

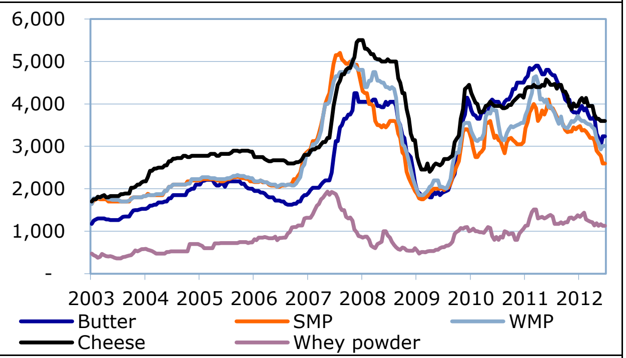
Prices

Dairy commodity prices fell through April and May before a small rally in June brought a 14-month bear market to at least a temporary end. As at late-June, USD FOB Oceania prices were down 9%-18% down on opening quarter levels.

The US dollar rose 3% on a broad index basis over the same period, contributing marginally to downward pressure.

Figure 1: Dairy commodity prices FOB Oceania, Jan 2003-Jun 2012

USD/tonne



Note: Whey powder is FOB western Europe

Source: Rabobank, USDA, 2012

The market was dragged down by a surge in supply growth in train since December. Still high farmgate prices, favourable weather and quota expansions in the EU remained the key drivers. Production growth in the 'Big 7' export regions climbed to just shy of 4% YOY in both March and April.

Demand in these export regions proved unable to soak up this wave of additional milk, with consumption growth at best marginal in the US and the EU in particular.

After a small cutback in February, import regions did expand purchases from the world market through March and April, led by a drought-ridden Mexico. But buying increased at a far slower pace than evident through late 2011 partly due to strong milk supply growth in Russia and India, reducing their import requirements. Import demand proved insufficient to soak up all of the increased surpluses from export regions.

More milk was channelled to storable commodities as a result, and stocks began to rise— pushing prices further down.

Supply growth is almost certain to have abated somewhat in May and June—as weather normalised, low milk prices began to bite in the US and those regions growing fastest in year-on-year terms (largely in the Southern Hemisphere) entered their seasonal trough.

Once past the Northern Hemisphere seasonal peak, it also became clear that excess stock accumulation was less than many had feared. EU PSA butter stocks rose to 90,000 tonnes by late-June, a level not seen since 2009, and US commercial holdings of NFDM pushed well beyond even 2009 levels in April. But no stock was accumulated in intervention schemes on either side of the Atlantic. As a result, known milk powder stocks were actually significantly lower than 12 months prior (given the selldown of EU intervention stocks in 2H 2011). While known butter stocks were up, the small base means they are more or less in line with the average over the last 3 years. New Zealand too appeared to enter June with smaller unsold stock than feared. Indeed India may face the greatest stocks challenge, with anecdotal reports of up to 100,000 tonnes of excess SMP in private storage.

The realisation that the worst had passed, and had proved less bad than expected, brought short-term coverage from a range of buyers waiting for further price falls—and hence a small rise in pricing in June.

Testament to the importance of short coverage, rather than firm backup from improved demand, and the lack of confidence in late year prospects, the rally was strongest in contracts for near term delivery on both global Dairy Trade (gDT) auctions and the CME.

The prospects for further upward price momentum will depend largely on how quickly global supply loses momentum and whether we see any improvement on the demand side in 2H 2012.

Supply side

EU

- Farmgate milk prices in the EU fell by less than seen in some regions in 1H 2012. The depreciation of the euro against the US dollar provided some insulation from falling prices on international markets, while co-operatives appeared reluctant to pass on the full extent of the softening that did occur.
- Nonetheless, downward price pressure mounted through Q2, and by June FrieslandCampina's guaranteed milk price stood at EUR 0.32/kg, some 16% below prior year levels.
- Milk production rose by 2.5% in Q1 YOY on the back of firm milk prices, good weather and quota expansions.
- As milk prices fell, reducing margins over high input costs, and as a cold and wet spring delayed grass growth, milk supply growth slowed in the west. However, with milk supply still expanding rapidly in the east, where weather has been far better, EU milk production was still up 2.1% YOY in April.
- This was well in excess of local requirements. Sales volumes at best stagnated as the EU economy deteriorated, forcing further job cuts and undermining consumer confidence.
- With the aid of a declining euro, more product was shifted onto the international market place. Exports rose 9% in the three months to April in milk equivalent terms, led by over 20% growth in shipments of SMP and whey. Fat proved more difficult to shift, with shipments down 25%.
- Rising milk production, attractive SMP prices and declining exports of fat brought accumulation of butter stocks through the spring flush, with PSA stocks reaching 90,000 tonnes by late-June. However, with prices staying above intervention levels, no intervention stocks have accumulated.
- EU stocks are thus a fraction of those accumulated by this time in 2009 (during the global financial crisis); at that point the EU had 180,000 tonnes of butter and 150,000 tonnes of SMP.
- Heading into Q3, Rabobank expects farmgate milk prices to generally drift down across the EU as recent commodity price falls are finally passed back to the farmgate.
- Rabobank expects that milk production growth will slow in 2H to less than 1%, as farmers respond to recent and expected price declines, tightening margins over input costs. Quotas will also restrict growth in regions where farmers are keen to expand (quotas expand only another 1% in the 2012/13 season).
- However even this is likely to prove more than the domestic market can soak up. Retail prices are now falling, but any relief this affords consumers is likely to be offset by actual and feared job losses, as well as lack of income growth.
- This should free up additional volumes of product for export in 2H, with some risk of a further stock build if the international market does not want it.

US

- Milk production growth is gradually losing momentum in the USA. YOY growth has been slowing since February, and by May came in at 2%, the lowest in 8 months.
- Farmers have seen the full force of commodity market falls reflected at the farmgate, with milk prices now down 23% since last June.
- With rising alfalfa prices and only limited falls in corn and soymeal, margins have been savaged, pushing those not hedged or vertically integrated well into the red.

Figure 2: Milk production growth in key export regions

YOY percentage change

	April 2012	Feb[3] through April 2012
EU	2.1	2.1
US[2]	2.0	3.2
NZ[1, 2]	10.0	12.0
Australia[2]	3.9	4.8
Argentina	6.5	7.0
Brazil	4.0	0.3
Total[1]	3.7	3.3

[1]: Rabobank estimates, [2]: May and three months to May, respectively
[3]: Leap year adjusted

Source: Alimentos Arg., AMI, CEPEA, DA, Rabobank, , USDA, 2011

- High cull cows prices and vigilant financiers have seen herds liquidated. Quotas are now in force for at least one co-operative in California that does not have capacity to process additional milk.
- Still, the recent expansion of supply has easily outstripped local demand, which remains anaemic in the face of stagnant real wages, marginal job growth and rising retail dairy prices.
- The US industry continues to see a substantial improvement in its trade balance. Export shipments rose 9% YOY for the March/April period, while imports fell 12% .
- But even this has proved insufficient to avoid stock accumulation. April NFDM stocks rose to a level not seen since April 2000 (+52% YOY), while butter stocks are near the levels experienced in the summer of 2009 (+55% YOY) in May.
- With the recent small milk price rally countered by rising grain costs, US producer margins will be negative for some months.
- The weather has also gone from exceptionally favourable in Q1 to unusually hot and dry at the close of Q2, which will negatively impact feed growth and to some extent cow comfort.
- This, together with localised supply restrictions and high cull prices, will further slow growth in US supply, which Rabobank expects to come in at only around 1% in 2H.
- Factoring in ongoing if slow employment growth, cheaper gas prices and falling retail dairy prices, local consumers should be able to absorb these increased volumes.
- Rabobank thus expects US exportable surplus to more or less stabilise in 2H 2012 (having expanded in 9 of the last 11 half-year periods).

New Zealand

- Favourable weather conditions kept New Zealand milk production strong through to season's end, with supply up 12% YOY in the three months to May.
- The wave of additional milk through early 2012 was not initially reflected in full in export data. Q1 exports rose only 7% in

volume terms, with April shipments actually down 13% YOY (including a significant fall in shipments to China).
- The mismatch between strong supply growth and low export shipments to April reflected a temporary stock accumulation in New Zealand during this period.
- This appears to have been largely resolved since; the 25% increase in volumes sold through the gDT through April/May suggests that most of this stock has now been cleared.
- Falling international prices led Fonterra to reduce its forecast for milk prices for the season just finished by 5% in June. The co-operative also announced its first forecast for the 2012/13 season, down 13% on prevailing 2011/12 pricing.
- The reduction of prices for the new season is likely to have little impact on production prospects in the first half of the New Zealand season as farms have good feed supplies on hand, cows are in good condition and calving patterns are expected to be tight.
- Early season production is likely to track slightly ahead of last year through Q3 2012—weather permitting.
- However, matching the stellar 2011/12 production comparables will be harder as the season progresses. Another perfect autumn is unlikely, and with a lower milk price, the appetite to bolster production via purchased feed will be diminished as pasture growth slows.
- Export volumes through late Q2 and early Q3 2012 will be boosted by up to 25% due to the high volumes sold on gDT through April and May and the fact that New Zealand companies have generally sold down in anticipation of the new season. This is the seasonal low period for New Zealand exports and much more modest increases in comparable volumes will emerge by the end of Q3 2012 as new season milk flows get underway.

Australia

- While the Australian season is winding down, milk production continues to track above year-ago levels. May production was up 3.9% YOY despite flooding in the Gippsland region.
- Supplementary feed is plentiful and a round of milk payment step-ups has helped improve cash flows.
- As in New Zealand, export volumes have lagged year ago levels despite higher milk flows. At the end of April export shipments were 3.6% lower than the same period last year. Falls were registered for all major commodities, excluding liquid milk. At present it remains hard to gauge how much of this has been soaked up by the local market, has since been exported or is sitting in stock.
- At home, consumer caution is limiting market growth. Consumption of cheese is relatively flat, though promotion and price cuts have supported 3% growth in drinking milk sales.
- Despite the likelihood of opening prices in the range of AUD 4.40/kgMS, some 10% or so below prior year opening prices, farmers will enter the new season with momentum. Good soil moisture, satisfactory feed reserves and high water catchment levels provide a good launching pad (though confidence is being dampened by macro uncertainties).
- Rabobank expects milk production to rise by 3% in 2H, underpinning a small increase in exportable surpluses from Australia.

Brazil

- After 17 months of contraction, milk production in Brazil finally rose above prior year levels in March/April. However, the return to growth was driven more by a normalisation of weather after a drought 12 months prior than by any significant improvement in the fundamentals of milk production.
- Milk prices have increased by 2% since the end of Q1 as local market shortages worsened. However this has been more than offset by rising feed costs, on the back of the drop in soybean production and to a lesser extent a recent increase in labour costs. Producer margins actually contracted through Q2.
- Domestic demand has been weakened by the recent loss of economic momentum.
- But in spite of slowing market growth and a recent depreciation of the Brazilian real, milk powder imports were up 7% in the three months to May (YOY), assisted by falling world prices.
- While the coming months will see milk production in seasonal decline, Rabobank does anticipate that supply will continue to track marginally above prior year levels through 2H.
- As in recent months, this will largely reflect particularly weak year-ago comparables that were driven by adverse weather.
- Processors have been unable to pass on recent milk price increases into the wholesale market, given weak local demand and import competition.
- This will continue to restrict scope for farmgate milk price increases through 2H, and hence producer margins.
- In all likelihood milk supply growth will at best just track growth in local demand, sustaining or marginally increasing Brazil's net import position though 2H.

Argentina

- Milk production continues to grow in Argentina, with a 10.8% YOY increase in Q1 and 6.5% growth in the month of April.
- Producers continue to benefit from discounted corn prices (courtesy of an export tax on corn), helping to sustain a favourable milk/corn price ratio (currently at 2.4).
- Dairy exports are up 18% YOY in April and 29% for the first four months of 2012, although monthly performance has been volatile.
- So far, domestic consumption has absorbed most of the production increases that were not exported, although there is also some evidence of accumulation of stocks by the industry. Lower economic growth projections and high inflation levels might test domestic demand in the second part of the year.
- Industry players continue to face eroding competitiveness due to domestic inflation and a largely fixed exchange rate. The domestic market is currently more appealing than the export market, but is unlikely to remain so for long, bringing the prospect of further milk price declines.
- Entering Q3 Argentina farmers enjoy good soil moisture levels, though growth will likely be slowed by reduced milk prices and stronger year-ago comparables.
- Rabobank is factoring in 5% milk supply growth in 2H, much of which will be available for export.

Demand side

It now appears that the global economy further deteriorated in Q2 2012, with evidence of a simultaneous slowdown in growth in both the major OECD economies and the BRICs. The encouraging signs of growth in the US economy early in the year all but disappeared, with job creation stalling. The turmoil in the EU periphery began to infect even its previously healthy core, while China, Brazil and India have all reported substantial loss of momentum.

While retail dairy prices are now starting to fall in many regions, as commodity prices decline in train since mid-2011 start to get passed through, volume sales growth has proved elusive in western markets.

In the US, data for April and May continued to show the volume of liquid milk and yoghurt trailing year ago levels at retail level, with cheese sale stagnant. Anecdotal reports suggest that food service shipments are holding up better, but at best growing slowly.

In the EU, processors widely report depressed demand conditions, with the deterioration of the economy beginning to bite. In April, German retail sales of liquid milk sales fell, though cheese and butter are holding their ground. At EU level sales of yoghurt, drinking yoghurt and infant formula were all well down in the second quarter. Danone reported a substantial contraction in sales volumes for Spain, yet much of this is likely to reflect trading down to private label rather than trading out.

Sales in emerging markets are still generally expanding, though even here the rate of growth is uneven and appears to be slowing. Listed companies reported double digit sales growth in Vietnam and the Philippines in the January to March period. However, sales growth appears to be slowing somewhat in China, while companies reported declining sales volumes in Malaysia and Brazil as consumers responded to the steep price increases of late.

Import demand has continued to expand. After a hiccup in February, international trade grew 4% in March and 3% in April on the record levels registered 12 months prior. This expansion was all the more remarkable given the contraction of Chinese buying over the same period, once again demonstrating the depth of the international market. Amongst the other major buyers, Mexico was particularly active (taking in a third more powders from the USA in April) with strong buying also from parts of South East Asia and the Middle East.

Looking forward, most economists have in recent months revised downwards their expectations for the global economy over the balance of 2012. The EU economy will at best be stagnant and US growth will fall below 2%, as government continues to reduce spending and lack of confidence curtails private investment and consumption growth. Chinese growth will likely improve, as the government deploys its substantial capacity to pull monetary and fiscal policy levers, but elsewhere activity is likely to remain lacklustre. Consensus forecasts suggest 2%-2.5% growth in annualised real global GDP in each of Q3 and Q4—well short of the 20 year average (3.2%). Few are backing a marked improvement in early 2013.

Against this depressing background, at the least, consumers will likely see further reductions in fuel prices and an acceleration of cuts in retail dairy prices.

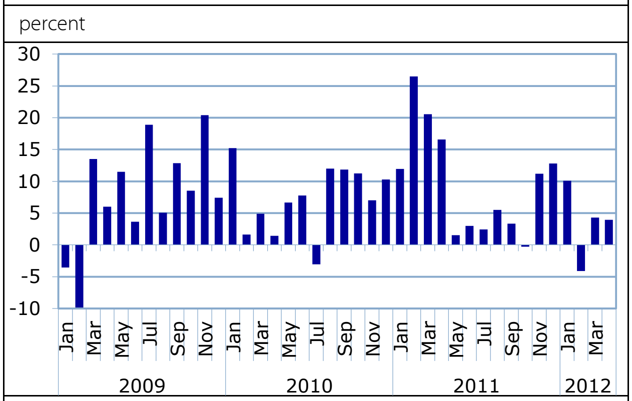
In the EU and US this may limit the damage caused to dairy sales volumes, but against a backdrop of high unemployment and stagnant wages, it is difficult to envisage anything but marginal growth in consumption through the balance of 2012.

Demand will expand in emerging markets, where consumers are still seeing strong real wage growth and structural trends underpin rising dairy consumption. But the rate of growth will be somewhat slower than in recent years given slowing economic activity.

And with real constraints on supply growth in deficit regions, ongoing quality issues regarding local milk, and a rising discount for imported product compared to local milk costs, Rabobank expects that import buying will exhibit further modest growth over the balance of 2012. India will likely remain in the sidelines as a buyer, facing a period of slower demand and ample local supply.

Nonetheless, with a fairly sober demand outlook, the prospects for market tightening will depend heavily on a slowdown in supply growth in the back half of the year.

Figure 3: YOY Change in export volumes for Big 7 exporters, Jan 2009-Apr 2012



Note: Includes NZ, EU, US, Australia, Argentina, Uruguay and Brazil

Source: Government Trade Agencies of 'Big 7', Rabobank, 2012

Outlook

Rabobank expectations

- After a period of surplus generation, by June the global dairy market had entered a rebalancing phase.
- The rate of price recovery will depend on the amount of excess stock accumulated during 1H, the time it takes supply growth to lose momentum and the prospects for any demand improvement.
- While data lags (and lack of reporting) mean the full extent of stock accumulation is not yet evident, as we enter 2H stocks would appear significant but not alarming—and should thus slow but not preclude price recovery once the market rebalances. But the rebalancing is likely to occur only gradually.
- Milk production growth will slow as 2012 progresses, as weather normalises and farmers see significant reductions in milk prices as 1H commodity price falls finally reach the farm gate. Rabobank forecasts aggregate supply in the Big 7 export regions to slip from around 3.2% in 1H to 1.2% 2H as a result.
- Consumption growth in these export regions is unlikely to see such significant shifts, as the benefits of falling retail prices are more or less offset by weak economic fundamentals, keeping consumption growth to just shy of 1% in 2H.
- Nonetheless, this should significantly rein in surplus growth in export regions over the balance of 2012.
- With import demand expected to continue to show modest growth (on already record levels), the market should enter a slow squeezing phase by Q4 as existing stocks are worked through.
- A weak euro will help restrain the initial pace of recovery, encouraging more EU product onto the world market.
- Assuming the continued loss of supply momentum, and even a small demand improvement, the market will significantly tighten in early 2013.

Downside influences

- A further deterioration in the EU economic crisis, and associated decline in the euro (which would shield EU farmers from milk price falls and encourage more EU product onto the world market).
- Substantial flows of exports out of India as local processors look to deal with high local stocks.
- Disruptions to trade with Venezuela if the election gets messy, or in Egypt if the political situation deteriorates further.

Upside influences

- Weather-related supply disruptions in key production regions, or further contamination/disease issues in import regions.
- A rally in feed grain prices, which would exacerbate margin pressure on farmers in intensive feed regions.
- Buyers and importers in many regions still don't appear to have a full pipeline for Q4, bringing the prospect of more short-term coverage later in the year if we see weather disruptions.

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