Summary

- International dairy commodity prices rose sharply through most of Q1 2011, before a sudden contraction wiped off around half the gains in mid-March.
- Pricing appears to have been initially squeezed up by improving demand, a poor Southern Hemisphere summer and a series of supply shocks in importing regions, before the devastating events in Japan rocked market sentiment, slashed grains futures, and sent dairy prices downwards.
- Assuming the Japanese nuclear crisis is brought under control, we expect that the net impact of the earthquake and tsunami will prove relatively limited for dairy.
- Much will depend on this, with other factors pointing to continued market tightness through Q2 2011, backed by improving consumption, ongoing shortages in key import regions and our expectations of a rebound in grain costs.
- Thus while sentiment may play a dominant role in setting market direction in coming weeks, Rabobank expects market fundamentals will reassert themselves and continue to sustain international prices at close to the levels evident in mid-March as we progress through Q2.

Prices

US dollar prices of international traded dairy commodities rose sharply through most of Q1 2011 before a sudden contraction wiped off around half the gains in mid-March.

The US dollar itself fell 3% during the period on a broad index basis, providing some upside influence.

Figure 1: Dairy Commodity Prices fob Oceania

Note: Whey is fob west Europe
Source: Rabobank, USDA

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- The rebound in local dairy sales has been far more modest, given patchy economic growth and limited job creation.
- This has left plenty of product available for export, with outgoing shipments rising strongly through Q4 2010, led by SMP and butter (up 14% and 23% respectively YOY). Export activity is expected to have remained vigorous through Q1 2011, buoyed by intervention destocking.
- Exceptional world market pricing is more than compensating for a strong euro at present, enabling FrieslandCampina to set a guaranteed milk price for March of EUR 36/100 kg, 29% up YOY and just below 2008 milk prices for that month.
- High milk prices are generating optimism throughout most of the EU going into Q2 2011 and, together with herd expansion, should ensure good supply growth through the period.
- Nonetheless, the pace of milk production growth is likely to ease to around 2% in YOY terms through Q2, given stronger YOY comparables and rising feed costs.
- Available supply for export will be boosted from 1 June with the tendering of 94,000 tonnes of SMP intervention stocks (and a small quantity of butter) for the deprived persons programme. However, the impact will be mitigated by the age of the product and reports that more marginal parties are interested in buying.
- Despite a more moderate rate of supply growth and a minor pick-up in local demand, supply will continue to outpace growth in local needs, bringing the prospect of export volumes rising considerably above year ago levels through Q2 2011.

**Figure 2: Milk Production Growth in Key Export Regions**

<table>
<thead>
<tr>
<th>Region</th>
<th>Latest month (Jan)</th>
<th>Last 3 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>3.3%</td>
<td>3.0%</td>
</tr>
<tr>
<td>US</td>
<td>2.3%</td>
<td>2.5%</td>
</tr>
<tr>
<td>NZ*</td>
<td>-0.4% for 3 months to Feb 2011</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>-1.0% (Jan)</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Argentina</td>
<td>16% (Jan)</td>
<td>9.9%</td>
</tr>
<tr>
<td>Brazil</td>
<td>-1.1% (Jan)</td>
<td>-2.0%</td>
</tr>
<tr>
<td>SUM*</td>
<td>2.7% (Jan)</td>
<td>2.1% (to Jan)</td>
</tr>
</tbody>
</table>

*Rabobank estimates

US

- Margins had dried up for US producers by late 2010, as a full domestic market reduced milk prices and grain costs jumped.
- But the global market delivered a ‘get out of jail free’ card to producers in the new year as international prices leapt and the gap between domestic and offshore pricing closed. By mid-March, near position Class III milk futures had risen by 40% on year-opening levels, outrunning even the grains price rally.
- Nonetheless, milk production growth continued to lose momentum, as farmers responded to what remained poor milk payments. January milk production growth, while still a relatively solid 2.3% YOY, was the slowest in eight months.
- While domestic sales have shown signs of improvement in recent months, growth remained short of that seen in milk supply, freeing up ample product for export and import replacement—made more attractive by a weak US dollar.

- Net exports rose 300% on prior-year levels in Q4 2010, exceeding milk production growth over the same period. Export growth momentum remained strong through at least January 2011.
- Q2 2011 is likely to bring a consolidation of the improved position in US farm profitability seen in recent months.
- An improving local economy and, inroads into unemployment in particular, are expected to bring a further improvement in local sales of dairy, though retail inflation will be a headwind.
- A strong international market, and demand for US product to plug global market shortages, will likely combine to sustain high pricing on the domestic commodity markets, though heavy cheese stocks remain a risk for negative basis.
- This should in turn sustain high milk prices for farmers, bringing the prospect of solid profitability for those growing feed, and above break-even conditions for many buying it in.
- Nonetheless, milk production growth is expected to continue to moderate through Q2, reflecting poor earlier returns to milk production and a desire by producers and their financiers to rebuild equity, rather than expand.
- Export volumes, which are thought to have remained well above prior year levels through Q1, are likely to fall in YOY terms in Q2, reflecting low stock levels and a more balanced domestic market.

New Zealand

- New Zealand milk flows dropped well below the previous year during Q4 2010 as a result of drought conditions in key regions. A more favourable scenario unfolded during Q1 2011 with La Niña summer rains arriving at reasonably regular intervals. Milk production bounced back rapidly and has held close to usual seasonal levels since – but will not recover the production lost in the ‘hole’ that appeared during Nov/Dec 2010.
- Farm gate milk prices are closely mirroring international commodity prices, increasing by 9% in February 2011 to what Fonterra is currently forecasting to be the second highest milk price on record at NZD 7.50/kgMS. This will ensure a highly profitable year for farmers in most regions.
- With lower than expected milk supply, product mix will continue to favour WMP, with cheese and casein the main casualties in export supply. Q4 exports of WMP were up 22%, while cheese and casein fell by 22% and 15% respectively.
- Milk flows are expected to end the season during Q2 around 1%-2% ahead of 2010, assuming a favourable autumn and a near record milk price combine to stimulate production through grown and purchased feed to outweigh the early season drought. Export volumes and product mix will reflect the lower milk availability during early 2011 but are likely to reach similar volumes to the previous year by Q2 2011

Australia

- Despite the buoyant Australian dollar, solid commodity prices allowed most exporters to step up milk prices during Q1.
- Southern Australia farm gate milk prices are expected to finish 2010/11 in the range of AUDS.30 - 5.50/kgMS, which is the second highest full-year price on record.
• Difficult weather conditions have impacted milk production, down 0.5% YOY in the 3 months to January 2011.
• A plentiful supply of feed and a return to profit after recent step ups, could bring a stronger finish to the production season.
• But while Rabobank expects national milk production to register a small YOY gain in Q2, the volume of milk will come too late to significantly bolster export supply.

Argentina

• Milk production in Argentina was rebounding strongly from drought at the turn of the year, showing 10% YOY growth in the three months to January. Exceptionally high milk pricing delivered good margins over feed costs.
• The rebound in milk supply, high offshore pricing, supply shortfalls in Brazil and unfettered access to the world market ensured a sharp climb in export volumes, which rose 44% in milk equivalent terms through Q4 2010, and further accelerated in January 2011.
• Rabobank expects milk production to continue to expand handsomely through Q2. The weather is favourable, and farm gate prices continue to offer an attractive margin, though the milk-corn price ratio has softened from its 2010 high. The rate of growth will likely slow to closer to 5% through Q2 given a less weak prior year period.
• This should still be sufficient to enable strong year-on-year export growth through Q2.
• The experience of 2007 suggests that rising retail price pressure in an election year warrants keeping a close eye on potential moves to restrict exports, though there are no murmurs to suggest this is in any way imminent.

Brazil

• While the Brazilian economy has blown off some steam since 2010, it remains a formidable engine for local dairy sales.
• Despite high milk prices, any chances of local supply keeping up with demand (let alone exporting) through the turn of the year were ended by adverse weather and rising feed costs.
• Meaningful export volumes thus failed to materialise even through the supply peak of late 2010, while imports surged to plug the local market shortfall.
• While milk prices are expected to remain high in coming months, the local market is expected to remain short of product given the seasonal decline in production, unfavourable weather and high feed costs.
• In Q2 Brazil may be not only be a net importer, but a net importer of some significance.

Demand side

At least up to March, conditions for end-use of dairy generally improved in most regions, with import buying further boosted by localised market developments.

Economic growth continues in the West, with encouraging, if modest, signs of employment growth. In the US, food service sales have been tracking well, and most recent data shows a pick-up in cheese sales volumes more than offsetting ongoing contraction in liquid milk sales. The expansion of developing country economies may have slowed somewhat, but it remains strong, and listed dairy companies continued to report brisk sales in markets like the Philippines, Malaysia and China through at least through Q4 2010.

Moreover, most recent data suggests that import buying continues to expand vigorously. Q4 import volumes rose 12% on prior year levels (and 25% above pre-crisis levels) in milk equivalent terms, led by, though not restricted to, strong buying from the world’s three largest dairy importers: China, Russia and Algeria.

Moving into Q2 2011, the situation in Japan warrants attention. Japan is the world’s third largest economy, a top-five global dairy importer and the number two cheese buyer on the international market. Forecasting nuclear meltdowns is beyond our competency, but as assumptions are required, we assume the nuclear situation in Japan stabilizes, leaving the main impact as that of the initial earthquake and resulting tsunami. If this is indeed the case, then the impact may prove surprisingly limited. Despite the heavy localized disruption and cost of rebuilding, history suggests that the net impact of similar natural disasters on GDP is likely to be limited once stimulatory responses are accounted for. From a dairy perspective, there is likely to be little impact on any of milk supply, consumption or trade. We note that cheese imports were largely unimpeded by the 1995 Kobe quake, though conscious that the current situation is probably worse.

Beyond Japan, there are several reasons to believe that conditions will remain supportive for good demand growth for dairy through Q2. We expect further economic improvement in the US and EU, if at a slower rate than Q4, but importantly more job creation, while the prospects for the developing world still look sound. Retail prices will face upward pressure from rising commodity costs in coming months, but outside of the US, retail prices remain well above 2007/08 levels, possibly giving processors more room to move in many regions before they are forced to pass on the latest round of commodity cost increases (or limiting the extent to which retail prices move up).

There are also reasons for optimism for robust demand for imports. We see little reason to forecast a near-term slump in Chinese buying, India has not only banned dairy exports but come to the market to plug up a market shortfall for the second time in 3 years, Korea had opened up its borders to 23kt of duty free cheese in the wake of an FMD crisis which saw the slaughter of 8% of its herd; and countries like Taiwan and Sri Lanka have cut import tariffs. We estimate that some growth in Chinese imports combined with these other events will effectively tighten the market by around 1.4 billion litres through H1 2011 YOY.

North Africa and Middle East (together accounting for around 17% of global imports) remain an arc of instability at present. But disruption to trade in countries like Libya is likely to be more than offset by strong buying from other countries rushing to ensure that food shortages and price inflation do not add to rioters’ complaints, financed by high carbon energy prices. Russia also remains short of product, with demand continuing to exceed the pace of supply recovery after the 2010 drought.

Based on our stated assumption for Japan, and weighing up the likely impact of the various positives and negatives that will be in play, we believe that the demand for dairy will continue to generally improve through Q2 2011, and that import demand will further expand in YOY terms, though at a slower pace than seen through 2010.
Outlook

Rabobank expectations

- The market enters Q2 with an unusually long, complex and, in many cases, as yet unsettled list of events to process as it grapples with what constitutes fair market value for dairy commodities in coming months.
- The greatest uncertainty surrounds how events in Japan will progress.
- At the time of writing we adopt the assumption that Japan’s nuclear crisis does not escalate, and the net impacts of the earthquake and tsunami on the local economy and dairy trade are temporary and reasonably limited once stimulatory responses are accounted for.
- Otherwise, we consider the outlook for global consumption growth to be positive, with the headwinds of rising retail price inflation largely offset by job growth and rising incomes.
- And while growth in import buying will slow through coming months, we see little immediate concern that would justify calling a significant contraction in buying from any of the key deficit regions.
- On the supply side, the Northern Hemisphere is headed for a good spring peak. But we believe grain prices will rise again and limit enthusiasm to produce milk; more milk is likely to be soaked up by domestic consumers than 12 months ago and Southern Hemisphere processors have little left to sell through Q2 after a weak season and brisk sales.
- We therefore conclude that, while sentiment may play a dominant role in setting market direction through the balance of March and into early April, market fundamentals will reassert themselves and continue to provide strong support for prices, which will likely trade at close to the levels evident in mid-March in international markets as we progress through Q2.
- Risks that would trigger an alternative scenario for dairy commodity pricing are addressed below.

Downside influences

- Japan experiences a full nuclear meltdown, seriously impacting local dairy consumption and the global economy.
- Russia, China or Algeria put on the brakes and reduce purchases from the world market.
- EU and US supply overshoots beyond the approximate 2% growth we anticipate from each through Q2.

Upside influences

- Further export bans and reductions in import barriers and/or increased subsidies for consumers in developing countries (which reduce supply or increase demand at any given price point on the world market), measures which proliferated in the 2007/08 commodities boom.
- The Indian deficit proving greater than initially indicated.
- A greater than expected spike in grain prices pushes up production costs.

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