

Dairy 2009 Situation and Outlook



October 2009

October 2009 Update

About this report

The Situation & Outlook process is designed to provide the Australian dairy industry and its stakeholders with an overview of the entire industry supply chain – from dairy farm inputs to consumer markets.

This is the first update to be released, following the publication of the annual Dairy 2009: Situation & Outlook report published in June 2009.

The report has been compiled with input from industry organisations and dairy companies, as well as a range of information sources.

This updated report

Summarises the operating conditions facing the Australian dairy industry supply chain, and ultimately affecting the profitability of dairy farms;

Summarises the highlights from the follow-up survey to the 2009 National Dairy Farmer Survey conducted in September; and

Provides a brief overview of the current industry status and the situation and outlook for the key drivers of the Australian dairy industry.

This Situation and Outlook Quarterly Update is published for information only. It is produced with due care and attention to accuracy, but Dairy Australia accepts no liability if, for any reason, the information is inaccurate, incomplete or out of date.

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Australian Dairy Supply Chain

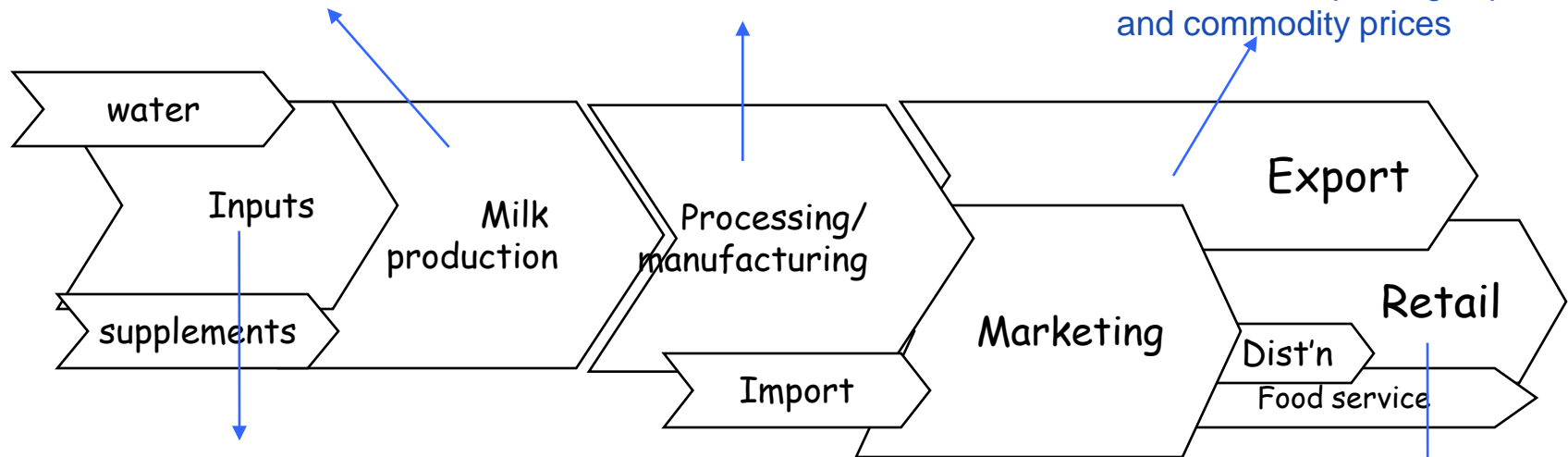
Highly variable seasonal conditions across dairying regions impacting on farmers' ability to manage low spring cash flow

Manufacturers carefully assessing market and product mix in order to maximise returns – including export vs domestic

Signs of demand recovery as economic outlook improves and buyers return to the market

Government stocks and intervention in the Nth Hemisphere overhanging market







Weak USD impacting export returns and commodity prices



Input prices continue to ease - with grain prices weakening due to increased supplies

Domestic market volumes and wholesale prices still holding steady - consumers 'economising'

Key driver outlook

	Global economy	Global demand	Australian market	Global supply	Inputs	Exchange rates
						
Major discussion points	<p>Asian economies recovering faster than EU, USA and Australia.</p> <p>Asian countries lifting other economies out of economic slump.</p> <p>Modest signs of recovery in US and EU, but risks are still weighted on downside.</p> <p>Stronger performance of Australian economy increasing the likelihood of further interest rate rises.</p>	<p>International buyers returning to the market with increased activity, as commercial inventories have cleared and refilling of supply pipeline begins.</p> <p>Consumer demand supported by lower retail prices, particularly in Asian markets.</p> <p>Signs of improved consumption patterns have emerged in large volume markets such as China, Russia, US and Europe.</p>	<p>Domestic consumption remains robust.</p> <p>Growth returning to supermarket cheese sales.</p> <p>Consumers continue to seek value through private label offerings.</p> <p>Dairy product wholesale price trends have remained steady in recent months.</p> <p>Interest rates likely to continue rising, cutting discretionary spending.</p>	<p>Market forces limiting milk production growth around the world.</p> <p>Production growth has slowed in US, Brazil and many parts of Europe in 2009.</p> <p>Slowing sales of surplus product to government intervention stores.</p> <p>Existing government stockpiles provide an ongoing anchor on world market prices.</p>	<p>Grain prices continuing to trend down due to strong local crop prospects and large northern hemisphere harvests.</p> <p>Strong AUD pushing down import costs, forcing oil and fertiliser prices lower.</p> <p>Increasing interest rates will increase financing costs</p> <p>Water allocation on Goulburn and Murray Systems increased to 30% and 29% respectively.</p>	<p>Australian dollar to remain high while local economy outperforms the EU and USA.</p> <p>US dollar weak against most major currencies increasing import affordability and supporting higher export offers from EU and NZ.</p> <p>Global financial institutions predict wide range for AUD (68-95 US cents) but Australian banks are forecasting 85-93 US cents through to the end of 2010.</p>

Impact on operating conditions or key driver status:

Positive



Steady



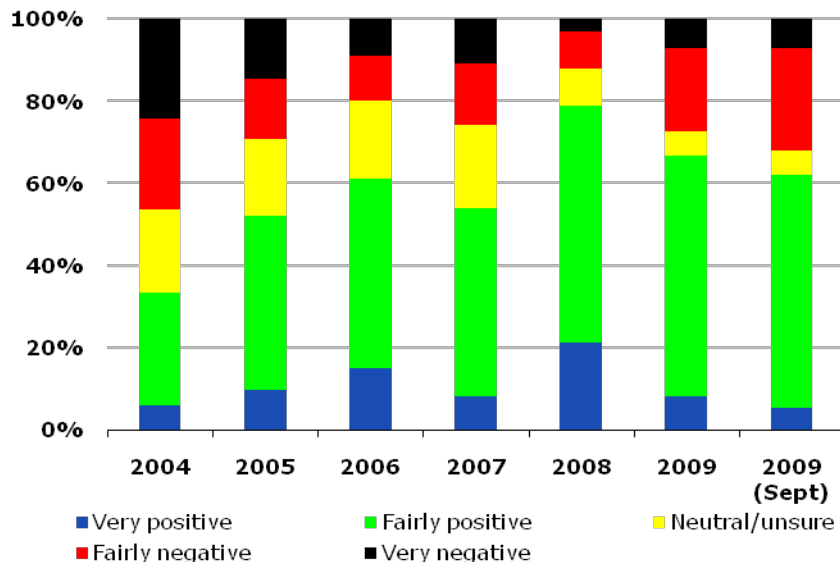
Negative



The Australian dairy industry in October 2009

- o Australian dairy farmers are **facing the immediate challenge of managing tight cashflow with highly variable Spring conditions**. However as positive signs of a turnaround for the industry are emerging, farmer plans hang in the balance.
- o The **lowest opening farmgate milk prices for 5 years** mean **many dairy farmers are currently operating at below break-even levels**, despite falling input prices.
- o An estimated 95% of farmers surveyed in early September have had their farmgate price significantly reduced in 2009. In response farmers have implemented multiple strategies - mainly restructuring debt (43%) and reducing herd numbers (37%), while 34% have cut the amount of feed.
- o **Confidence has been impacted**, however 60% of farmers remain positive about the industry's future. This is an encouraging result, underpinned more recently by improving market signals, further easing in input costs – particularly grain - and some good mid-Spring rainfall.

Fig 1: Farmers' attitude to industry future

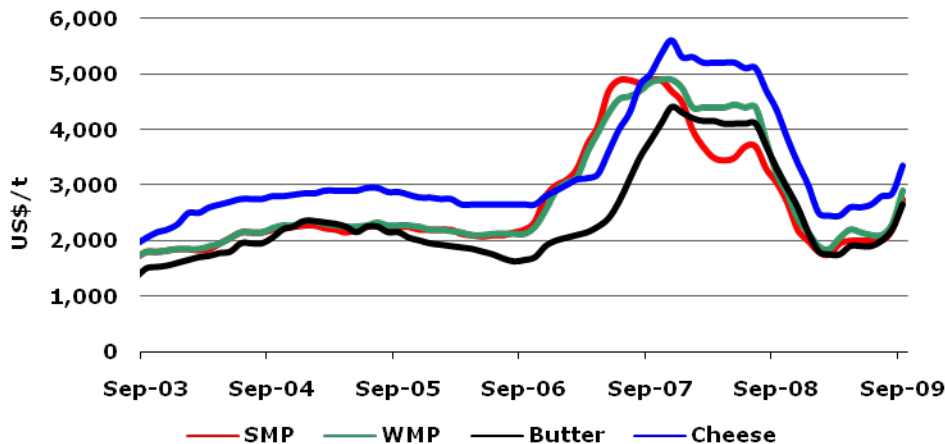


- o The timing of improved signals is critical for 43% of farmers surveyed in the lower Murray Darling Basin who will decide whether to continue dairying before the end of 2009. Decisions will be based on irrigation water allocations, now the best for four years at this stage of the season, milk prices and Spring rainfall.
- o More generally, the proportion of farmers surveyed in September considering **leaving the industry in three years time increased to 16% compared with 3% in March**. This response is understandable given the severe financial stresses on farmers at that time. While conditions are improving for some, farmers are continuing to assess their options carefully.
- o **Dairy Australia's forecast for 2009/10 milk production is 9.0 billion litres, 4% down on 2008/09 production**.
- o This reflects the impact of farmer exits from Northern Victoria/southern Riverina, wet conditions in Tasmania and the reported reductions in cow numbers and supplementary feeding rates across the industry.
- o **International commodity prices have increased sharply in US dollar terms over the last quarter**.
- o After running down stocks over a number of months, there are now **clear signs of increased buyer activity, and a greater willingness to purchase ahead of immediate requirements**.
- o While the rapid turnaround in commodity prices is good news, a recovery in demand may be prematurely burnt off by too rapid an increase in prices.
- o Ideally, a gradual economic recovery would lead to steady improvements in dairy commodity prices and more sustainable pricing for the longer term. However, **while uncertainty around a sustained global recovery remains, international dairy market conditions are likely to remain volatile**.

The Australian dairy industry in October 2009

- o Signs of **slowing US production, and the likelihood of lower supplies from the southern hemisphere, coupled with improving demand are bringing the international dairy market back into balance.**
- o However, **EU and US government intervention and stockpiles will continue to have a negative impact on market sentiment** until they are removed.
- o Assuming there are no further global economic shocks, international **powder prices are likely to trade above US\$3000 per tonne over the coming months, while butter prices should maintain their recent gains, given a recovery in Russian demand.**

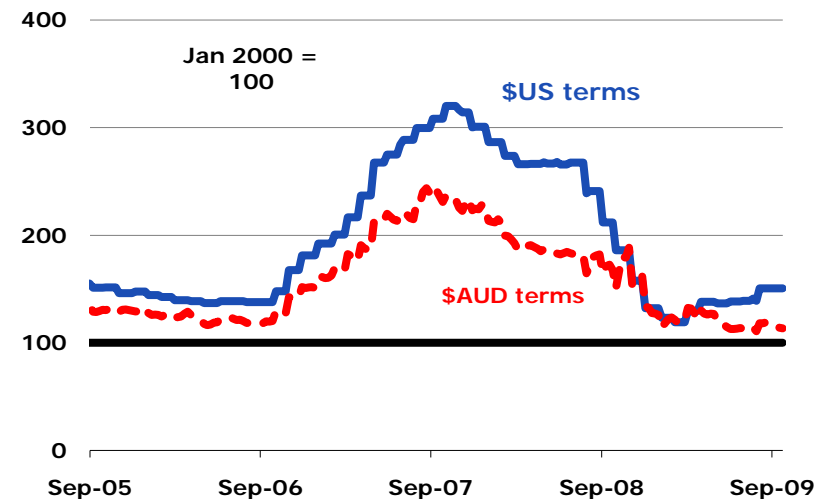
Fig 2: Spot export prices Sep 2003 to Sep 2009



- o **Currency movements are having a major influence on Australia's export prospects.** The US dollar has weakened against the Australian dollar, and most major currencies.

- o While this has **eroded returns to exporters in local currency, it has also underpinned some of the improvement in dairy commodity prices, by improving the purchasing power of importing countries, and increasing the offer prices of competing exporters in US dollar terms.**
- o **Current forecasts for the Australian dollar vary widely - from 68 to 92 cents by December 2010, with a number of financial institutions currently upgrading their forecasts.** The large range continues to reflect the continued **uncertainty surrounding the world economy in 2010.**
- **The strength of the Australian dollar poses the major threat to improved farmgate prices in 2009/10.** Current commodity market and exchange rate settings suggest a **full year price of between \$4.00 and \$4.30 per kg MS in southern regions.**

Fig 3: Export index Sep 2005 to Sep 2009



The Australian dairy industry in October 2009

Good news

- o Demand conditions continue to improve in key markets. Retail prices are easing, economic conditions are improving and consumer sentiment is rebounding.
- o A gradual unfreezing of trade finance has helped underpin the market recovery.
- o The Australian market continues to provide good growth and steadier returns.
- o Fresh supply of dairy products is stagnating in most parts of the world, which is helping to bring the market into better balance.
- o Sales of surplus powder and butter into government stockpiles in the Northern Hemisphere are drying up.
- o First substantial mid-spring rains in southern dairying regions since 2005. Improved water allocations for farmers in Goulburn and Murray systems.
- o Domestic consumption growth in South and North America is limiting export product availability.

Bad news

- o Strength of Australian dollar is offsetting improvement in commodity prices.
- o The strength of the Australian economy is likely to prompt the Reserve Bank to continue lifting interest rates into 2010. This will support a higher Australian dollar and lift financing costs for the industry.
- o EU and US market intervention entrenched for next 12 months. Surplus government stocks still exist in the Northern Hemisphere and remain an anchor on the market.

Key questions

- o How will farmers respond to recent step-ups, improved Spring rainfall and water allocations and weakening grain prices? How will the improvements in some of these factors affect those considering exiting and the industry's 2009/10 production?
- o Is global economic recovery sustainable or will it falter? Will we see a U, V or W shaped economic recovery with further shocks?
- o With lower prices for all dairy producers internationally, how successfully will farmers be able to manage margins over the coming months, and which exporting regions will be most competitive?
- o Are we seeing strategic buying in response to low prices, or a genuine consumer-led demand recovery?
- o With policy instruments back in favour (subsidies, intervention) in the Northern Hemisphere, will governments bow to pressure to continue and expand the levels of support?
- o What quantities of new season product will be supplied from the Southern Hemisphere?

Issues to look out for

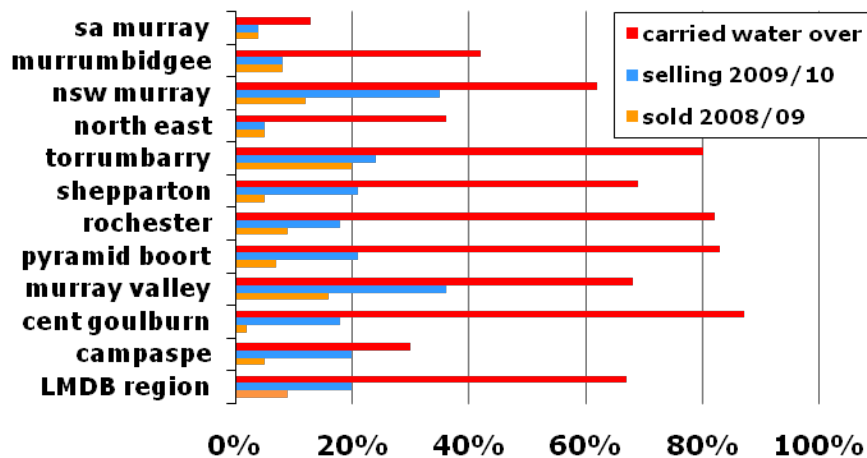
- o Although conditions in the Russian dairy market are improving, the government is now pursuing a range of policies that could again disrupt trade.
- o The Australian dollar has been driven by interest rate differentials rather than increased commodity prices. What will be the currency impact of future interest rate increases combined with commodity price recovery?
- o The prospect of NZX futures as a viable risk management option for the industry.

Industry insights

Lower Murray Darling Basin survey

- o 380 dairy farmers in the lower Murray Darling Basin were surveyed in August as an input into the Lower Murray Darling Basin Inquiry into the factors shaping dairying in the region in the next five to ten years.
- o 43% of farmers surveyed indicated they will be making significant decisions regarding the future of their business before the end of 2009. The key factors influencing their decisions will be milk price, seasonal conditions and irrigation allocations over that period.
- o A significantly larger proportion of farmers were planning to sell permanent irrigation water entitlement in 2009/10 compared with 2008/09. While some 58,320 ML were sold in 2008-09, projected sales of permanent water for 2009-10 were almost 120,000 ML.
- o Use of carryover water was significant with 67% of surveyed farmers carrying over an average of 35 ML for use in the current season.

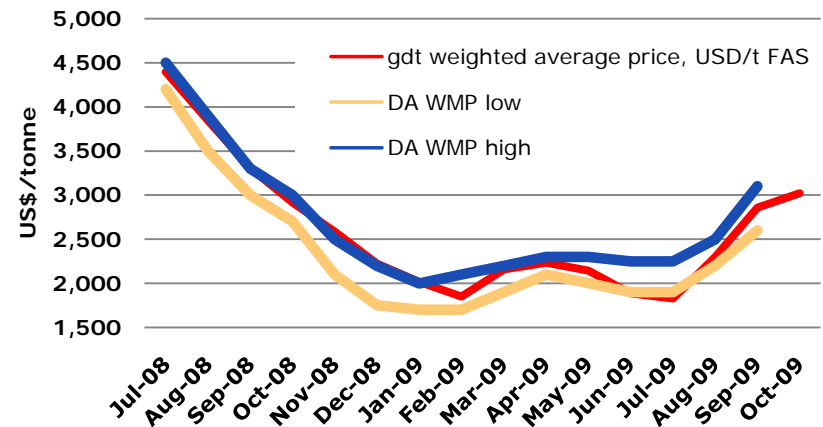
Figure 4: Water entitlements in lower Murray Darling Basin



globalDairyTrade...12 months on

- o Fonterra's online WMP auction system *globalDairyTrade* has now been operating for over 12 months, and has gained acceptance as an important market indicator. Fonterra has expanded the platform to include Australian origin WMP and will also sell AMF in auctions from November.
- o Auction prices jumped 26% to an average of US\$2,301/t in August, ending a three month trend of falling results and driving prices back to levels not seen since November 2008.
- o With September average prices rising a further 24.2%, to US\$2,848/t, average WMP prices increased 56% or US\$1,029/t in just two months.
- o Forward contract prices were broadly inline with spot prices, indicating buyers were confident about rebuilding inventory levels.
- o Results achieved at the beginning of October (average increase of 5.1%) suggest the market is digesting the strong gains over the past two months.

Fig 5: gDT average WMP prices vs DA WMP price range



September farmer survey

Key results

- o In early September, 340 dairy farmers across Australia who were surveyed in March were re-interviewed to update intentions and attitudes.
- o The **timing of the survey found farmers at a low point** – dealing with the reality of the 2008/09 step down and the lowest opening farmgate prices in 5 years, and seasonally low Spring prices. Many had also received limited late Winter rainfall.
- o Since the survey was conducted, many regions have received good rainfall, grain prices have continued to weaken, step ups have been announced by two major companies, and market signals look increasingly positive. These developments are likely to have shifted sentiment significantly from the results reported here.
- o Generally survey respondents expressed **greater confidence in their own dairy business than they have in the wider industry, both locally and nationally.**

Figure 6: Positive Attitude to national industry

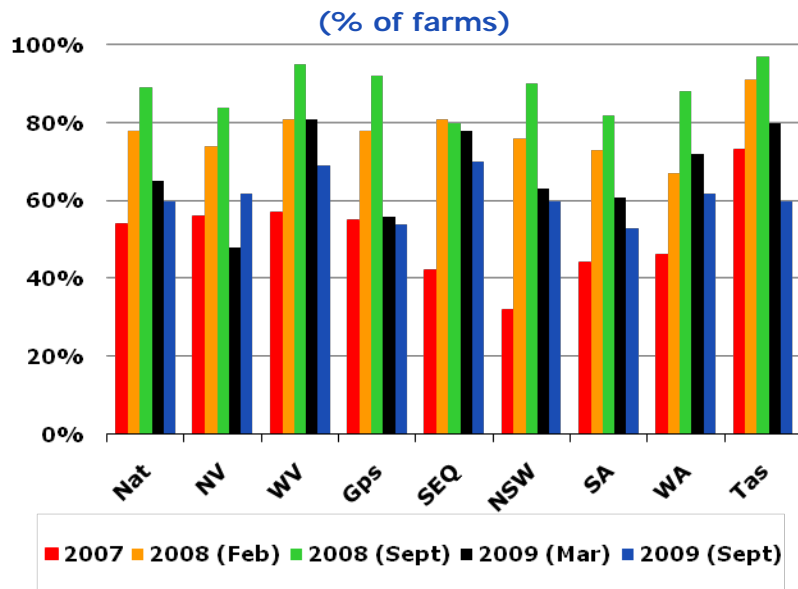
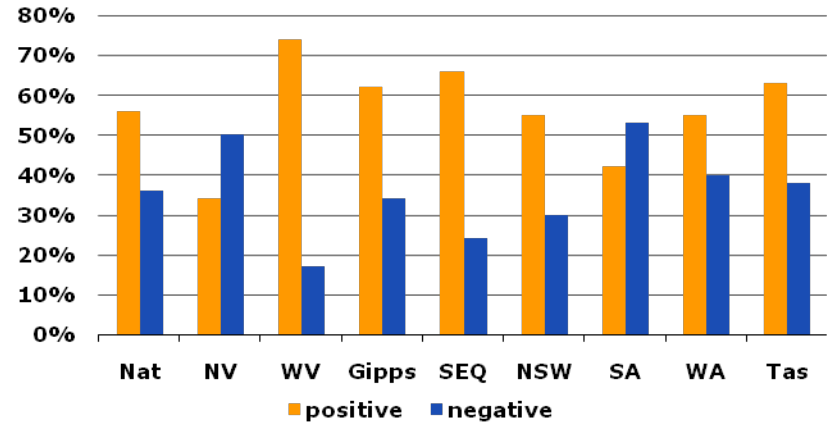
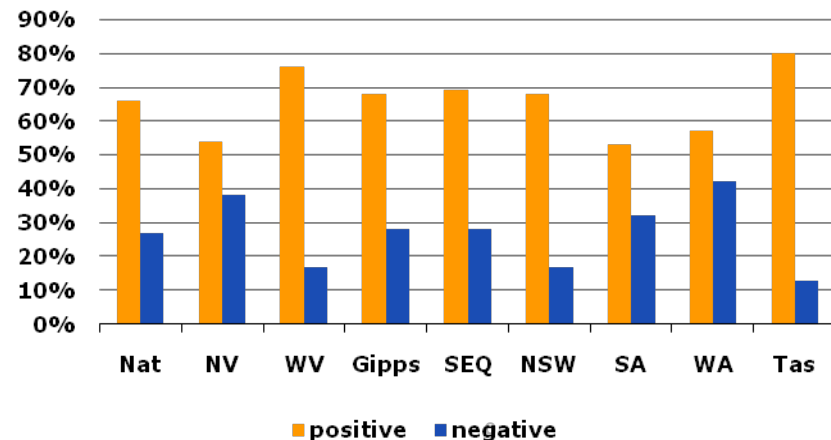


Figure 7: Attitude to industry future in local dairy region



- o 60% of respondents were positive about the future of the national dairy industry - down from 65%. 56% of respondents were positive about the future of the dairy industry in their region, while 36% feel negative.
- o 66% of respondents are confident about their own dairy business. Tasmanian respondents were most positive about their own businesses (80%), while negative sentiment is highest in WA (42%).

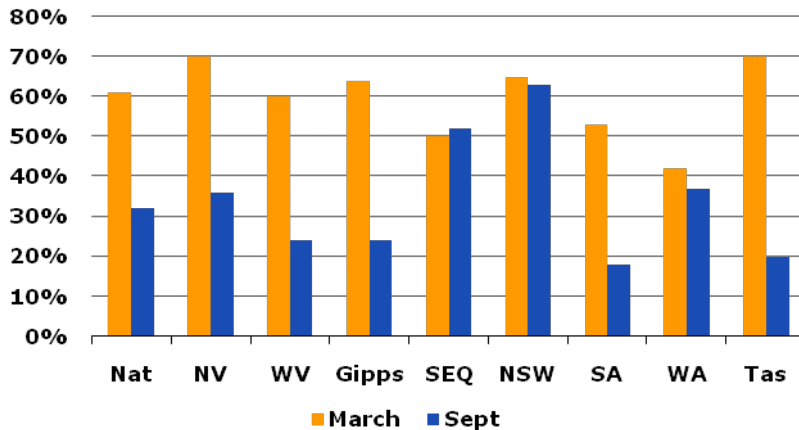
Figure 8: Attitude to industry future in own dairy business



September farmer survey

- o The proportion of respondents expecting higher production in three years time has fallen from 61% in March to 32% in September.
- o Among those expecting to increase production over the next three years, 33% attributed the anticipated increase to increasing herd size, 23% to seasonal improvement, 24% to feeding cows better and 19% to better genetics.

Figure 9: Expect to increase production in 3 years time



- o Average herd size in 2009-10 was expected to be slightly smaller than anticipated in February, with some 52% of respondents expecting to milk fewer cows and just 8% planning to milk more.
- o Respondents to the September survey lowered their production expectations for the current season, with 2009/10 volumes expected to be down around 8% on the predictions they made in March.

- o In March just 3% of respondents indicated that they intended to exit the industry within three years. In the subsequent six months, this proportion has risen to 16%.
- o The most notable increases in those considering an exit were in SA up from 5% to 32%, and Tasmania up from 0% in March to 18%.
- o Of the 95% of respondents who experienced a significant reduction in milk price, 91% have taken at least one course of action in response.
 - o 66% have reduced expenditure
 - o 43% have restructured debt
 - o 37% have reduced herd size
 - o 34% have decreased the levels of supplementary feed provided
 - o 23% of farms reduced staff levels
- o There were over 150 different responses implemented, indicating the diversity of individual farmer situations and the options available.
- o 77% of respondents who took action to counteract the reduced price regard the results as being fairly to very positive.
- o 54% of respondents who restructured finances regarded the outcome as very positive. 47% of respondents who contracted just one area, had a very positive outcome.

September farmer survey

Regional highlights

Northern Victoria / Riverina

- o 62% of respondents were positive about the future of the national industry, while 54% were positive about their own enterprise. Just 34% were positive about the future of the local industry.
- o 36% of farmers expect to increase production over the next three years, down from 70% six months ago.
- o All respondents in the northern Vic/Riverina region had experienced a reduction in milk price, and all had moved to make adjustments to their businesses.
- o 70% of respondents have extended debt or refinanced.
- o 14% expect to have left the industry in three years. It should be noted that since the survey, farmers in the region have received a significant increase in water allocations, and step ups by two major companies. The LMDB survey conducted in August (see box on Page 8) indicated these would be key factors influencing farmers decisions whether to exit the industry.

Western Victoria

- o Confidence in the national industry had fallen from 81% in March to 69%.
- o This region was the most positive about the future of its local industry at 74%. 76% of respondents were positive about the future of their own dairy business.
- o The proportion of respondents in the region who anticipate that production will be greater in three years time has fallen from 60% to just 24%.

- o 98% of respondents have experienced a reduction in price and 93% have responded, mainly by reducing expenditure (79%).
- o 14% expect to have left the industry in three years time.

Gippsland

- o 54% of respondents were positive about the future of the national industry (down 2 points). Negativity towards the future was highest in this region (40%).
- o 62% of respondents were positive about the local dairy industry and 68% were confident in their own dairy business.
- o 24% expected to increase production over the next three years, down from 64%.
- o All respondents in Gippsland have experienced a step down and 88% have reacted, mainly by cutting expenditure.
- o 20% of respondents were considering quitting the industry by 2012/13 up from 6% in March.

Southern / Central NSW

- o 50% of respondents were positive about the national industry's future, down 13 points.
- o 63% expect higher herd production in three years time.
- o 10% of respondents did not expect to be dairying in three years time, up from 5% in March.

September farmer survey

Regional highlights

Northern NSW / Qld

- o The proportion of respondents positive about the industry's future has fallen from 78% to 70%, however this region remained the most positive.
- o 66% were confident about the future of the local industry, while 69% positive about their own business.
- o 52% of respondents expected production volumes to increase by 2012/13.
- o 3% of respondents expect to leave the industry over the next three years, down from 7%.

South Australia

- o 53% of SA respondents were positive about the future of the national dairy industry, with a high 39% feeling negative about the future.
- o SA respondents were the most negative of all regions, with 53% negative about the local industry, while 53% are positive about their own dairy business.
- o 32% of respondents expect to leave the industry within three years, up 27 points. The sharp increase in respondents planning to exit may reflect some specific issues around low long term contract prices being offered to some farmers in the region, as well as financial pressures being felt by some larger operators.
- o Just 18% of respondents in the region expect greater production in three years time, down 35 points.
- o 97% of respondents were affected by price reductions, with 61% cutting expenditure and 21% restructuring their finance.

Western Australia

- o 62% of WA respondents have confidence in the national dairy industry, down 10%.
- o 55% are positive about the future of the local industry and 57% are confident in their own business.
- o 37% are expecting their herd production to be greater in three years time, down 5 points.
- o While 92% of WA respondents have experienced step downs, 43% have restructured farm finances.
- o 10% of respondents now believe they will not be dairying in three years time, when in March none predicted this.

Tasmania

- o The proportion of respondents positive about the future of the national dairy industry fell from 80% to 60%.
- o 63% of respondents' were confident in their local industry while 80% are positive about their own business.
- o While 70% of respondents in March expected their herd to be producing more in three years time, this figure has now fallen to 20%.
- o 98% of respondents experienced a step down in milk price, with 95% responding, mainly by decreasing supplementary feed levels, herds sizes and staffing.
- o In addition to low milk prices, Tasmanian farmers were dealing with excessive rain which in some cases necessitated additional supplements as pastures became unusable. This has placed additional and ongoing pressure on cashflows, as many of these pastures will now require renovation.
- o The proportion of Tasmanian respondents considering an exit from the industry within three years has risen from 0% in March to 18%.

Global economy

- o Asian countries are leading the recovery from the global economic downturn. This reflects lower exposure to financial derivative products, improved banking systems following the region's own financial crisis in the late 1990s and large fiscal stimulus packages.
- o However, despite some positive economic signals, significant downside risks remain. Withdrawing stimulus too early could undermine confidence, and world economic growth would suffer if the economies of China or India were to falter.
- o The Asian Development Bank has suggested countries develop internal demand which would be positive for dairy consumption, and potentially imports of Australian dairy ingredients.
- o The IMF reported economic stabilisation is uneven and that the recovery will be sluggish forecasting a 1.4% contraction in 2009, and 2.5% growth in 2010.
- o Global organisations such as the World Bank and IMF agree that the recovery from an economic downturn caused by a financial crisis tends to be deeper, and longer, than a normal downturn.

Fig 10: IMF October 2009 projections

Economic growth, % change and (change from July forecast)

	2008	2009	2010
World output	3.0	-1.1 (↑0.3)	3.1 (↑0.6)
Advanced economies	0.6	-3.4 (↑0.4)	1.3 (↑0.7)
USA	0.4	-2.7 (↓0.1)	1.5 (↑0.7)
Euro area	0.7	-4.2 (↑0.6)	0.3 (↑0.6)
Japan	-0.7	-5.4 (↑0.6)	1.7 (N/C)
Emerging economies	6.0	1.7 (↑0.2)	5.1 (↑0.4)

**Fig 11: Crude oil prices
(US WTI, USD\$/bbl)**



Source: Bloomberg / World Bank

- o Economic recovery from a financial crisis is generally slower because households in developed countries increase savings (thus spend less) to rebuild lost wealth in house prices and superannuation.
- o The World Bank suggests crude oil price volatility should decrease as supply capacity improves. However, average prices will increase as oil becomes more difficult to extract.
- o **Global crude oil prices are forecast to increase gradually from US\$56/bbl in 2009, to US\$66/bbl in 2011 before hitting US\$75/bbl in 2015 as production costs increase.** This is well below peak prices of US\$140/bbl during June 2008, but more than double the average price of US\$35/bbl over the last 20 years. This will boost the income of key dairy importing countries in the Middle East and Russia.

Global economy

Update on fiscal stimulus packages

- o The G20 meeting in London in early September called on governments to continue economic stimulus measures until a global recovery is secured.
- o As well as agreeing to continue their expansionary packages until recovery is well entrenched, the G20 agreed on the need for a co-ordinated exit strategy, which would be underpinned by effective co-ordination between fiscal and monetary authorities, international co-operation and communication among countries regarding policy actions.
- o While more than half of the 5 trillion US dollars fiscal expansion committed to is yet to be spent, arguments are brewing about when to phase out the stimulus measures.
- o While Britain and the US are warning against tightening too soon, France and Germany, which have already emerged from recession, are keen to turn off the fiscal tap.
- o Australia's stimulus will not be trimmed until the nation's economic growth level has returned to a trend level of three per cent.
- o Australia is now the fastest-growing economy in the Western world – and the only Western economy that grew in the year to June.
- o Government deficits are growing rapidly and public debt has reached dangerously high levels. **High levels of public debt threaten to depress global economic activity in the longer-term** with figure 12 highlighting how much public debt exists in the developed world.
- o Germany and Japan are big suppliers of international credit, with Britain and the US heavily reliant on borrowing.
- o The IMF estimates the public debt of the ten richest countries will rise from 78% of GDP in 2007 to 114% by 2014.

Fig 12: General Government Gross Debt 2009

Country	% of nominal GDP
Japan	190
Italy	123
US	87
France	86
Eurozone	82
Germany	78
Canada	77
UK	75
Korea	33
NZ	27
Australia	16

Source: OECD

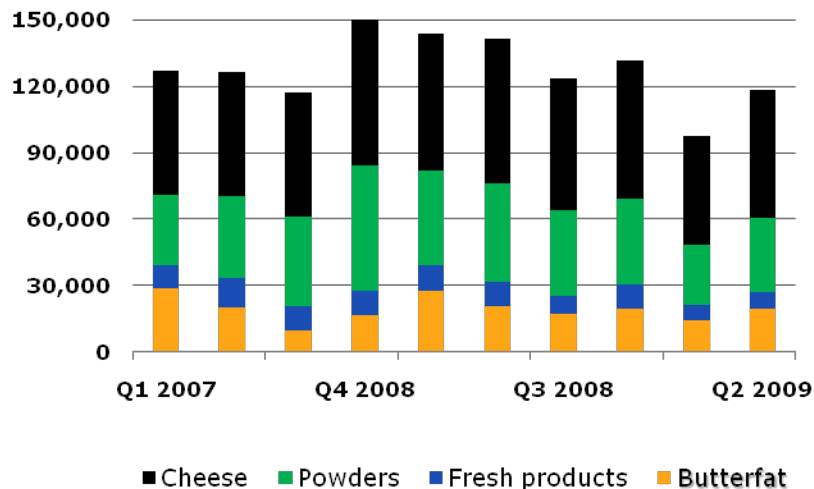
- o Since the economic crisis is so widespread, any recovery is unlikely to come from exports as it did post-war.
- o Debt-burdened consumers will be cautious and have a propensity to save more, which is expected to slow growth for several years, and impact on consumption.

Global demand

- o The outlook for global dairy demand remains mixed, with powders likely to fare better than butter and cheese.
- o **Global supply pipelines have largely been cleared**, and manufacturers have been running down inventories over the seasonal production low.
- o **Buyers appear to be strategically purchasing product in anticipation of a potentially limited availability in early 2010.** Chinese ingredient buyers are back in the market purchasing large volumes of powders as ingredients.
- o It is **unclear how much renewed demand is strategic buying**, now that prices are moving upwards, or whether it is **consumer-led demand**.
- o The downturn in high-end hotel and restaurant trade in all countries will continue, particularly in Asia and the Middle East. Low hotel occupancy rates, and reduced tourism and business travel have resulted in lower dairy demand.

- o Reduced discretionary spending is evident in some markets and is affecting some impulse buying (e.g. ice-cream, confectionery and cheese).
- o Some brands are repositioning from top-tier to mid level to take advantage of a growing middle tier of consumers who are focused on quality and branding, but remain sensitive to prices
- o **Lower prices will drive an import demand recovery in some markets in 2009/10**, particularly in Africa, China and Southeast Asia. **Recombining activity in South East Asia will provide some import demand growth for milk powders in 2009.**
- o **The economic downturn and trade finance issues are impacting dairy trade to Russia**, one of the world's largest importers of cheese and butter. Currency realignments have more than offset dairy commodity price falls, making product less affordable, while letters of credit for Russian trade are still difficult to obtain. However, **Russia appears to be returning to the market despite these difficulties.**
- o High **cheese inventories in Japan, and commitments to utilise new production facilities are likely to limit cheese import recovery until 2010.**
- o Subsidised government programs in Algeria and Mexico are likely to hold dairy import volumes steady in 2009. Both countries are significant for world dairy market balance, since they import large volumes of milk powders.
- o There is likely to be **growth demand for imported dairy product in China** (mainly of UHT milk, powders, and infant formula). However the government is attempting to impede import activity.

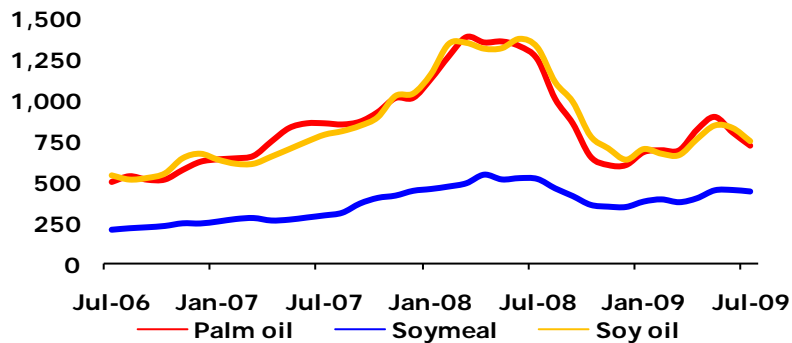
Fig 13: Russian Qtly Dairy Imports (tonnes)



Competitive landscape

- o **Prices for competitive protein commodities are trending upwards, albeit slowly.** A combination of supply and demand factors have swung the market momentum. This is good news for dairy commodity prices as it will provide room for similar upward movements.
- o The US is expecting a bumper soybean crop in 2009/10, with production expected to be up 10%. South American soybean production is expected to recover strongly in 2010 from the drought-reduced level of this year. However, **these increases in supply are expected to be offset by very low levels of stocks worldwide.**
- o There are several uncertainties regarding future price movements, including weather, exchange rates, oil prices and economic and financial developments.
- o Political uncertainties, primarily in Argentina, could pose further threat to supply. The government is considering raising export taxes on soybeans in an effort to lower domestic food costs, which could lead to a new round of strikes as farmers protest against lower prices for their crops.

Fig 14: Competing fat and protein prices (US\$/t)



- o The competing fat product price outlook is more mixed. Weak demand associated with the economic downturn has driven recent falls in prices. Demand has suffered in a number of countries from the loss of income growth. A growing share of demand for vegetable oils is proving to be quite price inelastic.
- o However, world production of palm oil will be considerably lower than expected in the second half of 2009 and in 2010 in Malaysia and Indonesia, mainly due to insufficient rainfall resulting from El Niño.
- o World palm oil stocks are already unusually low in the key exporting countries, but comparatively high in major importing countries like India and China.
- o This uncertainty over fresh supply, coupled with lower than normal stocks is expected to result in a strengthening of oil prices into 2010.

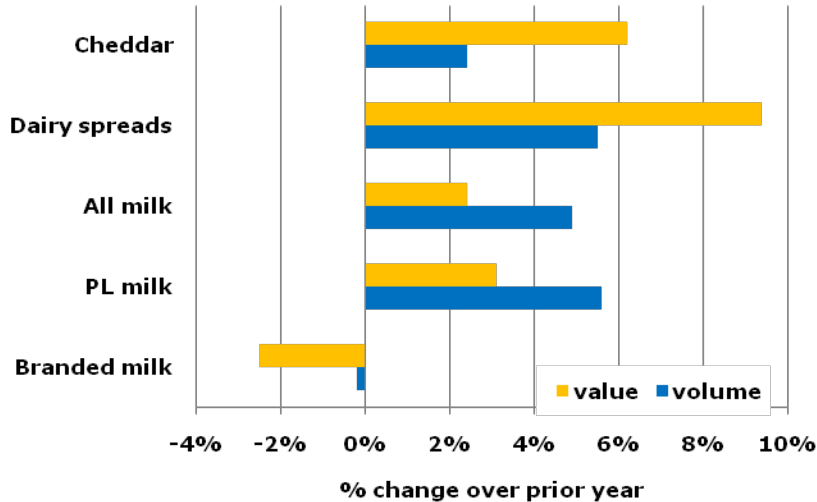
Imitation cheese

- o Imitation (or analog) cheese, is a growing competitor to ingredient cheese, and is an emerging issue for the European dairy sector.
- o This imitation cheese is displacing cheese predominately in the fast food sector, as an alternative cheese topping for the pizza industry.
- o The cheaper alternative is made from vegetable oil, casein and various flavours and salts. The imitation cheese is cheaper than natural cheese.
- o Estimates suggest the imitation cheese usage has surpassed 20,000 tonnes in the EU, which represents less than 1% of the market.

Australian market

- **The Australian market continues to deliver volume and value growth**, with per capita consumption holding firm through 2008/09 at around 300 litres in milk equivalent terms.
- **Volume growth has returned in the cheese category** in recent months, however consumers have continued to **migrate from branded to private label products in the milk category**.

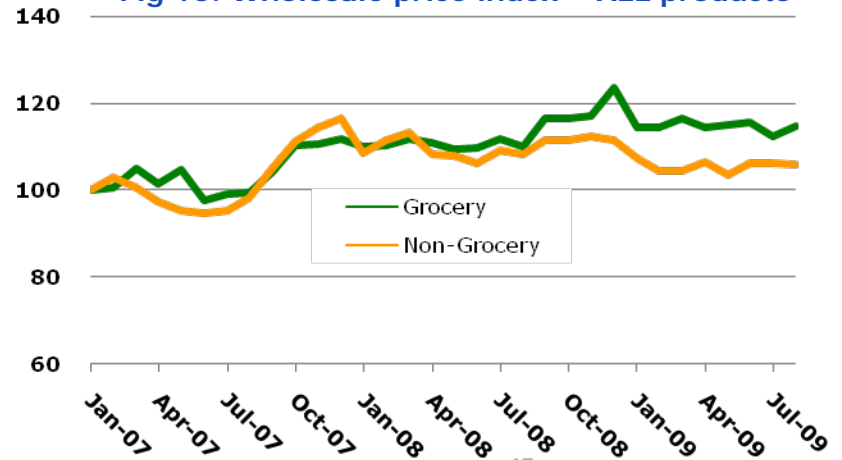
Fig 15: Supermarket sales growth (6 mths to August)



- **Australian consumer spending has been supported by lower interest rates and stimulus funds**. A rising sharemarket has also contributed to **a significant lift in consumer and business confidence** in recent months.
- ABS retail sales data flags **a recovery in the foodservice sector** – eating out-of-home; with growth in sales through cafes, takeaways and restaurants lifting to parity with the supermarket channel.

- **Wholesale prices have held firm across the range of dairy products**. Manufacturers have tended to prioritise the domestic market given the downturn in export returns over the past 12 months. However, there will be some careful assessment of local returns in coming months in the face of a strengthening world market.
- Prices in the non-grocery (foodservice and industrial) sector have followed international commodity trends more closely than grocery prices, as **prevailing supermarket supply contracts have limited price adjustments**.
- **Increases in official interest rates may reduce discretionary spending**. While this is **unlikely to affect the volume of dairy products consumed, it may impact on the channel and value of dairy sales** as consumers seek to economise. This would tend to favour increased sales of private label products through the supermarket channel, while the foodservice sales and branded products are likely to be negatively affected.

Fig 16: Wholesale price index – ALL products

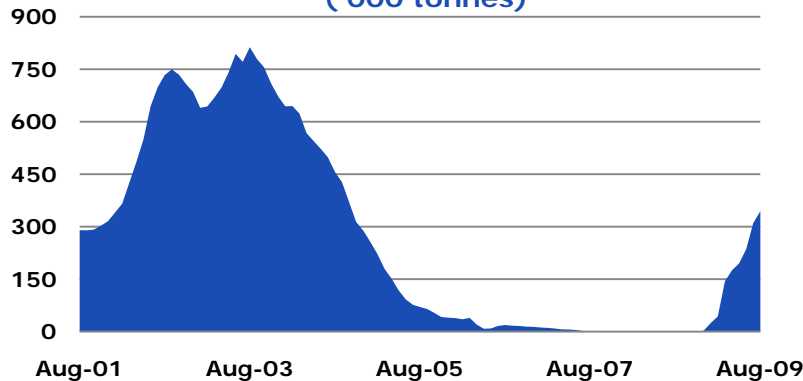


Global supply

Europe

- o In the 2008/09 quota year, total milk production reached 129 billion litres, **which was more than 4% below its total quota**.
- o In 2009/10, milk quotas have been extended a further 1% which provides room for growth.
- o **Reports suggest production is over 1% in the first 4 months of the 2009/10 quota year.** Farmers in the northern dairy belt are boosting supply in order to maintain income levels.
- o **New product entering intervention stores has almost come to a halt** for both butter and SMP. By October over 280,000t of SMP and 83,000t butter had been offered and accepted for intervention.
- o The public butter stocks are equivalent to 4% of annual EU butter production.
- o **The SMP stockpile is more burdensome** as it represents about 30% of annual EU SMP production. There is still no clear policy solution for eliminating the stockpile.

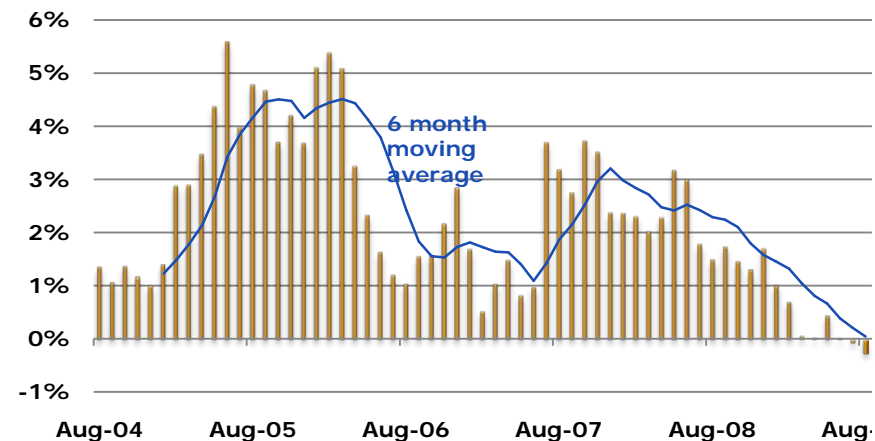
Fig 17: Combined EU and US SMP Stocks ('000 tonnes)



United States

- o US milk production has finally dipped below August 2008 levels. Total milk production in August was estimated down 0.3% from a year ago, while July production was also revised down by 0.1%.
- o Strong output in the Midwest is offset by steep decreases in the West. The rapid drop in cow numbers continued in August, while productivity nationwide remained above last year's levels.
- o Production is expected to fall further in the remaining few months of 2009. As Fig 18 shows production is trending lower.
- o **USDA forecasts milk production to fall 0.8% for 2009, and a further 0.9% in 2010.** This may be revised down now that the CWT has announced plans for a 4th herd retirement program.
- o Sales of surplus milk powder to the government have slowed with the stockpile at 220,000t (25% of annual production). **No sales are forecast for 2010.**

Fig 18: US year-on-year monthly milk production



Global supply

Australia

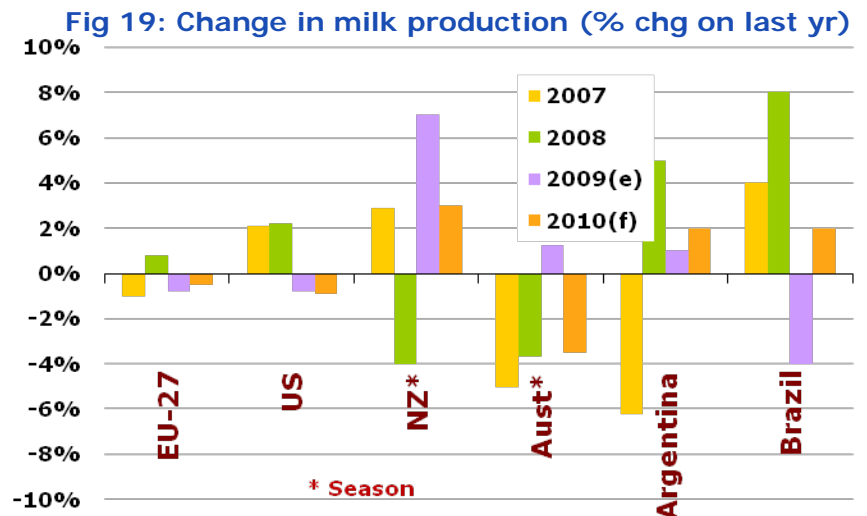
- o National milk production reached 745 million litres for August – down 1.5%. **The first two months of the new season are down 1.6% on last year.**
- o **Winter rainfall has been generally satisfactory** across most southern regions – although it has been **too wet in Tasmania**, which is causing difficulties with cow health condition and could limit production growth over the remainder of the season. Conversely, conditions have been **dry and hot in northern NSW and southern Queensland** very early in the season.
- o Irrigation allocations improved dramatically in October, to 29% for the Murray and 30% for the Goulburn systems. This represents the highest October allocation for 4 years.
- o The **lowest opening farmgate milk prices for 5 years** mean that many dairy farmers are currently operating at or below break-even levels, despite falling input costs.
- o Dairy Australia's current **forecast milk production is for 9.0 billion litres for 2009/10**, a 4% reduction on last year.

New Zealand

- o The New Zealand production season has started slowly (-2% in first 3 months), as producers have rationalised feed and fertiliser costs, lowered stocking rates and adjusted to a lower milk price environment.
- o Production is current trailing the same period last season. Farmers are still expected to make-up any lost ground once the season gets into full swing.
- o There is strong speculation that more moderate to large start-ups are on the cards in New Zealand.
- o This is in addition to the previously announced plans to establish milk processing facilities.

South America

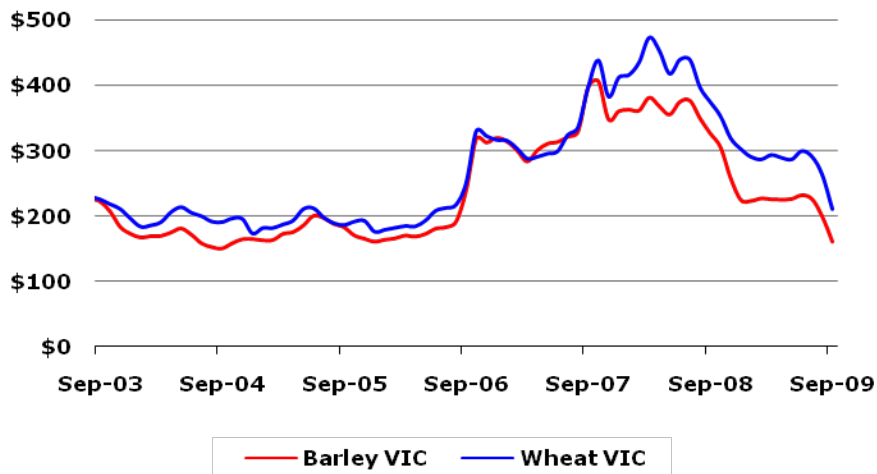
- o In the first half of 2009 Argentina's milk production was up 5%. Since then, growth slowed and is reportedly 3-4% up (to August). This trend is expected to continue with full year forecasts of 1% growth or less.
- o After the worst drought in 40 years, Argentina has received good rainfall in most of the dairying regions.
- o Brazil's milk production has continued to trail previous year levels all year. Production was down 4.7% up until the end of July.
- o A milder recession with a quick recovery across the region will continue to keep food demand at strong levels.
- o Exports have been extremely limited due to domestic prices being more attractive, thereby making the domestic market the primary focus.
- o The domestic market will continue to be the primary focus, but the improvement in international markets will trigger an increase in exports.



Feed grains

- **ABARE's** September Crop report forecasts a **winter crop of 36 million tonnes – up 8% on last year** – reflecting an improvement in yields in Victoria and South Australia, and up 1.2 million tonnes from the June forecast.
- **Wheat** production is forecast to **increase 6% to 22.7 million tonnes** (+16% on the 5-year average); **barley** volumes are forecast to be **up 16% to 7.9 million tonnes** (+1% on the 5-year average).
- The **winter crop forecast by State** indicates that volumes will be up on last year in Victoria (+80%) and South Australia (+42%); but down in Queensland (23%), NSW (-5%) and Western Australia [-4%].
- **Grain prices are continuing to fall** due to **lower world prices**, as northern hemisphere harvests are larger than expected. **A very strong \$A** is putting downward pressure on local prices, and **some excellent rains through south-east Australia** have provided confidence to supplies from new crops in Nov-Dec 2009.

Fig 20: Feedgrain prices - \$A / tonne



- **Feed grain prices** are now approaching 3-year lows – **below half the peak levels** of mid-2008.
- With grain prices dropping significantly and a round of milk price step-ups, **the economics of feeding grain to dairy cows has changed markedly** over the past few months.
- Grain prices are currently quite volatile **on small volumes**, so caution is required on price & quality.
- In **northern Victoria** dairy farmers have **sown large areas to cereal crops** – some are being grazed regularly – but most being held for grain following good September rains.
- The situation throughout **central and south-western NSW remains quite serious**, with some crops having already failed and having insufficient bulk to be cut for hay. While overall grain supplies in Australia are more than sufficient, this area of southern NSW-Riverina is one of the most intensive demand regions for intensive livestock industries - feedlots, poultry, pigs and dairy; so expect strong local competition for the grain as well as significant grain stock being freighted into the region.

Hay

- Rain across the southern hay producing areas has made a big impact on potential hay production. **Grain crops that were to be cut for hay will now be retained for grain** and hay production will suffer.
- Lack of demand from dairy farmers is diverting crops from hay to grain, or ploughing in for green manure.
- While there is **downward pressure on southern hay prices** with new seasons hay about to be delivered, dairy farmers may consider buying opportunities during harvest for storage and financing of hay from eager sellers.

Inputs

Fertiliser

- o In Australian dollar terms, **international prices are now close to pre-boom levels**. This has been supported by the ongoing strengthening of the Australian dollar.
- o **The international outlook for fertiliser prices is for continued weakness at or about the current level.**
- o **Local pricing** resisted the downward trend in international pricing from June through to August, but has **started to fall in recent weeks**.
- o A Dairy fertiliser mix index is back to where it was two years ago due to the strong AUD.
- o There appears to be further opportunity for falls in local prices for phosphate and potassium back to international parity levels, whilst nitrogen is expected to stabilise at or around current levels.
- o It has been notable that **local market prices for composite fertiliser mixtures have been much slower to follow down the fall** in international and local prices. Buyers should check the comparative value of these mixtures with an equivalent mix of the basic raw ingredients.

Fig 21: Indicative fertiliser prices (\$/t)

	Urea	DAP	Single super	Potash
May09	\$590	\$850	\$380	\$1,010
Sept09	\$480	\$570	\$290	\$1,000
Dec 09(f)	\$400-\$480	\$500-\$550	\$270-\$300	\$700-\$800

Source: Xcheque

Water

- o **Water trading has increased** by 43% on last year in the three months to September, for a total volume of just 3,240 ML at **an average price of \$365/ML** – down 40% from \$610/ML at this time last year.
- o **Water levels** in the Goulburn-Murray system in northern Victoria have **increased strongly** after good September rains. **The total G-M system is at 27% – up from just 13% four months ago and 23% at this time last year.**
- o **GM-Water** announced **large increases** in its latest **2009/10 allocations to the highest 1 Oct levels in four years**, with the **Murray system at 29% and the Goulburn system at 30%**.
- o The **rainfall outlook** for the December quarter has the odds favouring **a drier than normal season** across north-east Queensland, parts of Victoria, south-east South Australia and Tasmania. This is **not a particularly promising outlook for the key dairying regions**.
- o The national outlook for **maximum temperatures indicates moderate to strong shifts in the odds favouring higher than average temperatures** across Australia.

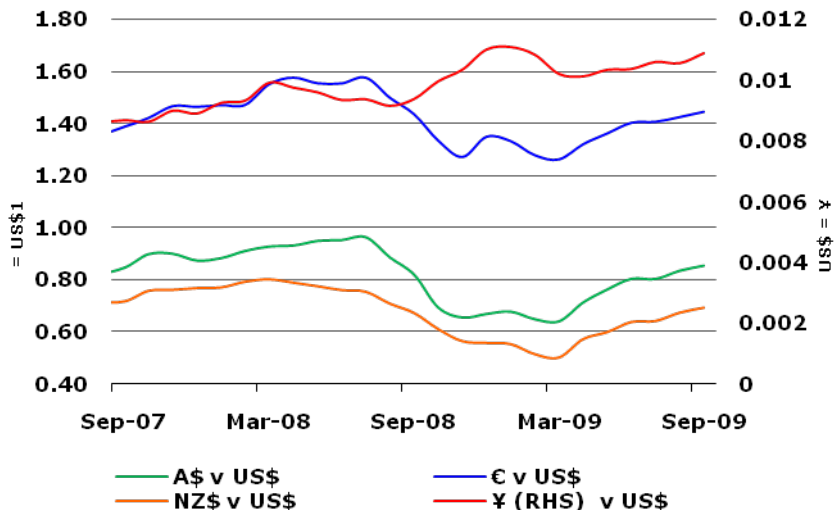
Cows

- o **Cull cow sales volumes increased 45% in the first six months of 2009, on very low volumes in 2008**, as farmers held onto cows to take advantage of strong milk prices at that time. The increase was a more realistic 13% on the six-year average.
- o The rate of sale has **slowed markedly in the last two months**: +12% and +1% over August and September respectively.
- o **Prices have also softened**, down -10% and -17% over the past two months.

Exchange rates

- o Volatility remains a central feature in exchange rates, with no contraction in the range of Australian dollar forecasts in 2010.
- o A Bloomberg survey of **34 financial institutions reveals a range of 68-95 US cents in 2010**. Those at the upper end of the range expect significant increases in Australian interest rates, which would push the Australian dollar higher, while those at the lower end expect a significant downturn in the global economy.
- o The big four **Australian banks are forecasting the AUD to range between 85-93 US cents by end-2010**.
- o The AUD is benefitting from the resilience of the Australian economy, demonstrated by 0.6% GDP growth in Q2 2009, driven by steady household and business spending.
- o When the RBA begins increasing rates, the first 1% of rate rises could occur quickly. By the end of 2010, banks are forecasting a cash rate between 4.25%-4.75%. The RBA commenced increasing rates at it's October meeting.

Fig 22: Exchange rates versus US\$



- o The **general weakness of the US dollar against most major currencies is providing support to commodity prices**, by increasing the buying power of importing countries, and increasing the offer prices of exporters.
- o However, in some countries, dairy is now more expensive for consumers in local currency terms than it was at the height of the global commodity boom. Russia, Mexico and Korea, have been most affected, while China has been protected by virtue of its currency being pegged against the US dollar.
- o Exchange rates are expected to stabilise once frozen global credit markets begin to thaw, but the import affordability index implies demand may suffer in a number of major global dairy export markets.
- o The appreciation of the Japanese yen has magnified the effect of the commodity price falls in imported price terms.

Fig 23: Import Affordability Index (SMP)
100 = Feb 2005

