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Strong Headwinds Weigh on Trade Growth...

Information to Accompany
the World Dairy Map 2016

RaboResearch

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The trade in dairy products has suffered a number of massive blows in the last three years. The Russian trade embargo, the slowing of demand growth from China, the impact of low oil prices on demand from oil exporting countries and the strengthening of the US dollar have all had an impact on the demand for imports. The expansion of production surrounding the removal of production quotas in Europe added to the pain and resulted in a period of extremely low world prices. Looking forward, none of these issues has been resolved. The Russian ban will be in place at least until 2017. Demand from China will continue to grow but at a slower rate, oil prices are forecast to remain at around the USD 50 per barrel mark, and the dollar is forecast to maintain its high value against other currencies. As a result, dairy trade is likely to grow at a slower rate than in recent years, driven more by population growth than per capita consumption increases. Luckily this comes at a time when further rapid expansion of export volumes would be more difficult, with further New Zealand expansion limited by land availability, Europe stabilising after milk quota removal, and the US export ambitions limited by domestic demand growth and the strong US dollar. Dairy trade is also likely to remain dominated by regional rather than global routes with free trade agreements significantly influencing volumes. The exception will be Asia which will continue to be a highly competitive battle ground for exporters from around the globe. All of this must be overlaid with the potential for the renegotiation or cancellation of trade agreements if the new US administration follow through on their campaign rhetoric.

Levels of trade

The period of rapid expansion of trade which occurred at the end of the noughties, and into the early part of this decade, drove a wave of investment and production growth which is still impacting the market. However, a combination of headwinds means that the rate of trade growth has slowed. In 2015, the growth in trade was a meagre 0.3% more than 2014.

The changing world of exporters

Oceania's long-term growth limited

Despite the recent downturn, New Zealand, with 28% of global exports, retains its position as the largest dairy exporter in the world. With few interruptions, dairy production in New Zealand has been rising for over two decades to meet the growth in demand for imports. As time has progressed, New Zealand has focused increasingly on whole milk powder, more than doubling production since 2008, to over 1.5 million tonnes in 2015. A key driver for this has been the growth in demand from China, which has become by far the biggest destination for New Zealand exports, growing by a third to 4.8 million tonnes in liquid milk equivalent (LME) terms since 2011. As the possibility of continued production growth becomes more challenging due to a lack of land and because New Zealand farmers are starting to recover from the extended downturn in prices in 2015/16, a key question arises: Will New Zealand continue to change strategy from competitive commodity production to an added value strategy, and if so how much value can really be achieved.

For New Zealand's neighbour Australia, the path has been more difficult. A combination of climatic events have seen Australia slip from being the third biggest exporter globally in the last decade to its current fourth place. Looking forward, a combination of local issues and

water policy are likely to see Australia producing slightly less surplus for the export market in the next few years.

Coping with the removal of EU milk quotas

The removal of milk quotas, the system which has been in place since the early 1980s to limit the production of milk in Europe, dramatically changed the world market. In the first six months of 2016, European milk production was 9.7% higher than for the same period in 2013. This, from a mature market with slow population growth, meant that much of the extra milk would be surplus for exports. Looking forward, growth is likely to slow as farmers optimise their land's productive capacity, environmental restrictions harden, and lower returns limit interest in investment in new production regions and capacity.

US less willing to compete...for now

The strength of the US dollar compared to the currencies of other major exporters continues to weigh on any US export growth. Strong domestic demand growth has also meant that US processors have been less interested in export trade. The drift of production from West to East has seen less supply for export-focused facilities in states like California, and the potential move for California to join the federal milk orders system would make exports from this state less competitive. While the US has both the land and potential to fill the long-term dairy trade gap, the headwinds suggest that US export growth will be slow for the next couple of years. If the new US administration follows through on its suggestions that it will become more protectionist, this would create further headwinds for both US importers and exporters.

Trade agreements make slow progress

Following the failure of the Doha round of the WTO, moves toward a free trade environment have continued at a snail's pace. The signing of the Trans Pacific Partnership (TPP) in 2015, and continuing negotiations around a Transatlantic Trade and Investment Partnership (TTIP) have been bold attempts to move the trade agenda forward. If implemented, both would provide improved market access for dairy products. However, at the time of writing, ratification of TPP has been pushed back and negotiations for TTIP are moving slowly, with the political atmosphere surrounding the incoming administration in the US, making implementation less likely. The alternative, a series of bilateral agreements will be slow to emerge. However, if and when they do, these will distort the competitive position of export regions.

Currency movements limit growth

As dairy products are traded in US dollars, the strength of the US dollar against other currencies dictates the affordability of dairy products in those markets. Many of the emerging markets which have provided demand growth for dairy have currencies which have declined considerably against the US dollar in recent years. The Mexican peso, Nigerian naira, and the South African rand have all declined considerably against the dollar, making imported dairy a less affordable option in these countries and depressing per capita consumption growth.

The changing demand of importers

The impact of low oil prices

Similar to dairy, recent years have seen a relentless growth in oil production from regions including the United States where lower imports mean more oil from the Gulf, North Africa and Nigeria competing for Asian markets. This, plus a steady rise in Canadian, Iraqi and Russian oil production has led to oversupply and dramatic falls in prices—reaching a low of USD 26 per barrel in February 2016. Furthermore, supply and demand outlooks suggest oil prices will remain at around the USD 50 mark for the foreseeable future. The apparent correlation between crude oil prices and the price of dairy commodities is perhaps explained by the fact that, of the 9% of dairy which is exported across borders, a relatively large percentage goes to oil producing countries such as Saudi Arabia, Indonesia, Algeria, Nigeria

and previously Russia and Venezuela. Low oil prices limit or halt GDP growth in these countries and as a result limit affordability of dairy products.

China's opaque market

China's dairy consumption continues to grow, but in recent years, the rate of growth has slowed as Chinese economic growth has eased and dairy consumption becomes more mature in some categories. The Chinese market has constantly evolved since the contamination of infant formula with melamine in 2008 which affected 300,000 babies, causing 6 deaths from kidney failure. Following the scandal, imports of dairy products rose, driven by fears about the safety of local products and a structural change in the upstream farming sector. Local production growth tapered off markedly as smallholders that at one time dominated local supply started to exit and the industry started to shift toward the development of large-scale dairy farming, which was unable to offset the production shortfall quickly. In the meantime, cost of production has been much higher in China. Later, large corporations themselves sought to buy-up supply capability outside China. More recently, as the growth in consumer demand has slowed, the strategies of these major corporations have evolved from capturing volume growth to value growth.

One standout feature of the dairy trade with China has been the rapid growth in exports of liquid UHT milk. In 2016, demand for UHT milk is estimated at around 17 million tonnes with most demand being met from domestic supplies. But, since the start of the decade, imports have been increasing. This has been driven by the consumer preference for imported brands, low freight costs and the availability of supply from surplus regions, particularly Europe, with lower cost raw milk than local supplies. This has resulted in UHT import growth with a CAGR of more than 90% reaching a forecast of over 600,000 tonnes by 2016.

The Chinese will continue to be major importers of dairy products for the foreseeable future as local supply growth continues to face constraints. Demand will be aided by the introduction of the two-child policy, rises in per capita consumption of developing regions as well as consumption of more value-added dairy products in the developed regions, but, at the same time, the continued tightening of food safety regulations and the evolution of the Chinese economy to a more sustainable, if lower, level of growth will lead to dairy import levels finding a 'new norm' with a more moderate growth of imports year-on-year.

The Russian trade embargo

Following the sanctions imposed on the Russian banking, oil and defence sectors by the West in response to Russia's annexation of the Crimea region of Ukraine, the Russian government imposed a ban on food imports from the EU, US, Norway, Canada and Australia effective from 7 August 2014. Although this ban was initially imposed for one year, continued tensions have led to an extension until at least the end of 2017, and given current relations, will likely go on much longer.

At a time when Russia was the second largest importer of dairy in the world, importing 3.2bn litres in LME terms in 2013—representing 5% of global dairy trade in total, but 16% and 11% respectively of the cheese and butter traded—the ban would have a major impact on the industry. Coinciding with farmers in Europe preparing for the removal of production quotas (Europe is the major export region to Russia—33% of all EU dairy exports), and the slowing of demand growth from China, the ban played a major part in extending the downturn of dairy prices on global markets until late 2016. While by 2016, EU export volumes have returned to 2013 (pre-ban) levels, this has resulted in loss of value and displacement of trade from other regions.

The trade embargo with the West has created an opportunity for Russia's free trade partner Belarus, whose dairy exports to Russia in 2015 had grown to 3.6m tonnes. This relationship, together with the deterioration in value of the rouble and the stresses on the Russian economy caused by low oil prices, mean that even were the ban to be lifted, Russia's trade with Europe and the West would be unlikely to return to 2013 levels.

Mexico, the US's backyard market

Since the NAFTA removed all tariffs on dairy trade between the US and Mexico in early 2004, the US has dominated exports to its southern neighbour, supplying 80% of import needs. Despite the growth of domestic supply (Mexico is 65% self-sufficient), growth in per capita consumption and population growth means that imports have continued to increase. LICONSA, a government body buying and distributing milk powder for welfare purposes, means that skimmed milk powder continues to be the biggest imported commodity. For the foreseeable future, the US is likely to continue to dominate dairy trade with Mexico. In the seemingly unlikely event that the Trans-Pacific Partnership is ratified, New Zealand and Australia would gain some access to the Mexican market, and the trade talks between the EU and Mexico in 2016 may at some point grant some access to EU exporters. But in the meantime, until President Trump follows through with a promise to renegotiate the NAFTA, Mexican imports will continue to be US dominated.

Middle East and North Africa seek more dairy hydration

The arid climate of the MENA region makes dairy production difficult. Together with the traditional role of dairy in local diets (103kg/year in Algeria, 69kg/year in Saudi Arabia), a rapidly growing population and the emergence of the middle class means that the region continues to be a net importer of dairy. Government involvement in buying through bodies such as ONIL in Algeria, and changes in water use policy in Saudi Arabia have both helped to further bolster demand.

In 2016, however, low oil prices have begun to bite, and despite low commodity prices, social programmes and consumer programmes have been cut back. As a result, trade in an already price sensitive region has become more difficult, with New Zealand exports to the region reduced by around a third and European exports to the MENA region by around 6%. As the region continues to adjust to longer term lower oil prices, competition will be fierce. However, the region is likely to see growth in demand of above 2.5% per year.

Continued growth of SEA countries

The tropical heat in South-East Asia has hampered the development of successful dairy production. Low self-sufficiency levels mean that demand growth is satisfied with imports and the region has become a target destination for imports from particularly New Zealand. However, the region remains highly competitive with exporters from Europe and the US also targeting the region, particularly with supplies of whey powders. With predicted GDP growth out to 2020 of above 5%, South-East Asia will remain a key target for exporters.

Affordability and Africa

Many see Sub-Saharan Africa as the next frontier for the global dairy industry. Most trade activity has been focused in West Africa, particularly Nigeria, with low tariff barriers and easy market access—East Africa with higher barriers to trade, is more of interest to those developing local supply. However, in 2015, dairy demand growth has stalled due to low oil prices and the weakening of the Nigerian naira against the US dollar to around half of its value in 2012.

There is good reason to expect the growth to return as oil prices rise again, with the population set to double, and in some states triple by 2050. High birth rates will mean that 43% of the population will be in the key dairy demographic, aged under 15. Urbanisation, with 37% living in cities, will drive formalisation of the supply chain, paving the way for further import growth. However, affordability will remain crucial. The high level of trade in 'fat filled' powder using skimmed milk powder with a cheaper plant-sourced fat illustrates the importance of a low price point for Africa.

Conclusions

Much has changed since we drew the last dairy trade map three years ago. In the next three years, growth in dairy trade will decrease slightly, due to the strong US dollar, low oil prices, the Russian trade embargo and slowing Chinese growth. China will find a 'new norm' which is likely to mean lower volume growth but more focus on value. This will mean that while price volatility is likely to continue, long run average price increases are likely to be limited. However, at a time of weaker global demand there are also issues weighing on the growth of export surpluses. The strong US dollar and healthy domestic demand growth will mean that the US is less willing to compete in global dairy markets. Despite even moderate US dollar prices transferring into farmgate prices—which incentivises milk production in other export regions due to currency factors—New Zealand production growth will struggle as land availability becomes a limiting factor and in Europe, once production levels have stabilised after the removal of milk quotas, there is no preparation for 'further' strategic expansion which would require new land, infrastructure, and processing investment. But perhaps even more than in recent years we live in uncertain times where the new US administration, deteriorating Russian relations, uncertainty in the Middle East, Chinese economic performance, Brexit, and the fate of TPP and TTIP can all have a major effect on dairy trade development.

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