



**Rabobank**

# Dairy Quarterly Q1 2018

*Turn the Pressure Down*

**RaboResearch**

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## Summary

- A robust import programme by Chinese buyers, combined with a weather-impacted shoulder to the New Zealand season, were the perfect ingredients for the short-term rally in Q1 2018.
- In the background, the export engine is firing on most other cylinders, as production growth expanded across all other regions in Q1 2018.
- However, weather risks have now been extended beyond New Zealand. Europe battled the ‘Beast from the East’, Australia had localised bushfires, and there are drought conditions at play in Argentina.
- The peak period of milk production in the Northern Hemisphere still looms as a pressure point for the global market in Q2 2018.
- The European Commission does not intend to purchase any skim milk powder (SMP) at the fixed intervention price in 2018, instead focusing on clearing the 375,700 tonnes of intervention SMP stocks, which will continue to pressure SMP prices and likely divert milk to other product streams.
- Farmgate milk prices continue to weaken in Q1 2018 (albeit from a high base), and more downward pressure is expected. Meanwhile, the risk of higher feed prices is emerging.
- In summary, previous expectations for the extent of pressure on global markets to come in Q2 2018 have moderated, with a global rebalance delayed until 2H 2018.

## Regional dairy markets

<p><b>EU</b></p> <p>As anticipated, supply growth is moderating across Europe ahead of the peak. A cold weather front has been a recent challenge, but is normalising.</p> 	<p><b>China</b></p> <p>Chinese buyers have some short-term cover, but their appetite through 2018 is set to deliver a double-digit increase in import volumes vs. 2018.</p> 
<p><b>US</b></p> <p>High stocks, sluggish fluid milk sales, and milk supply growth above expectations have exerted pressure on wholesale prices. Milk supply growth will moderate.</p> 	<p><b>South America</b></p> <p>A nascent economic recovery across South America should provide the impetus for further dairy demand growth in 2018.</p> 
<p><b>New Zealand</b></p> <p>A very challenging summer, leading to reduced milk volumes, has been a key ingredient for a short-term rally and firmer whole milk powder prices.</p> 	<p><b>Australia</b></p> <p>Dairy farmer confidence levels take a sizeable hit as milk price uncertainty clouds the outlook into the 2018/19 season.</p> 

## Global summary

Since Rabobank's last outlook (in December 2017), the New Zealand drought – at the time, identified as a clear market risk – came into play. As a result, global commodity prices, particularly for Oceania-origin product, received a boost in Q1 2018 (see Figure 1). However, this was always likely to be a short-term driver of global commodity markets, with the Northern Hemisphere spring flush looming large on the horizon. Production is expanding across Europe ahead of the peak, and a favourable shift in currency has triggered some increased export activity from US dairy exporters. As a result, Rabobank is still anticipating some pressure to build on global commodity prices in Q2 2018, in line with the Northern Hemisphere peak.

The export engine has been running on most cylinders since mid-2017. Apart from New Zealand, where dairy farmers have battled with one of the more disruptive seasons in recent times, milk production has been growing in all key export regions. However, as alluded to at the end of 2017, Rabobank does not see the Northern Hemisphere peak milk flows completely overwhelming the global market. EU milk production growth started 2018 on a high note, but is also expected to trend lower throughout the year.

Looking further afield, Rabobank forecasts combined year-on-year milk production growth across the Big 7 to moderate through 2018 (see Figure 2).

Building on-farm margin pressure is a key driver of slowing year-on-year gains in global milk production. Farmgate milk prices have retreated in most export regions and have fallen by as much as 15% in some areas since the start of 2018. Nevertheless, milk supply growth is outstripping import demand and will continue to do so through Q2 2018. As a result, this will limit the upside in global commodity prices and could lead to some downward price pressure.

Over the past quarter, Chinese buyers have done most of the heavy lifting in terms of purchasing. Active buying from

the world's largest import market always helps to keep global markets in balance. The global economy continues to show broad-based growth, which is an important stimulant for dairy demand growth.

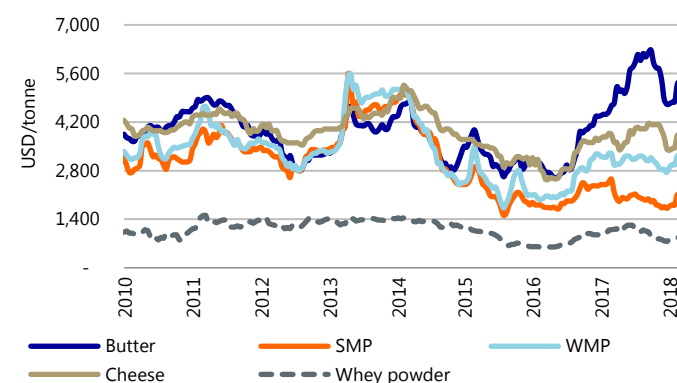
Rabobank sees global economic growth accelerating mildly in 2018. According to anecdotal evidence, consumer demand in South-East Asia generally remains robust. In contrast, economic settings and weak consumer spending in some economies across the Middle East and North Africa are key reasons for less robust dairy demand volume growth.

Import buyers elsewhere have largely been on the sidelines, given the luxury of high stocks and growing year-on-year milk production. On the upside for global pricing, import buyers may begin to accelerate purchasing in order to get some short-term inventory cover, with expectations of a shift in the balance coming in 2H 2018.

Ahead of the European peak, intervention stocks of SMP remain a burden on protein prices. Despite healthy bid volumes to purchase aged product at recent tenders, the European Commission has not yet found an appetite to sell at the offer prices – resulting in only small quantities exiting warehouses. A tweak in the tender system will limit further stock accumulation in 2018 – meaning peak milk supply will need to find alternative streams.

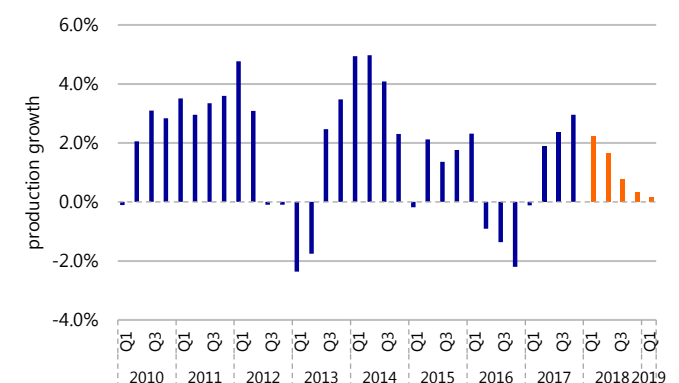
Hence, the expectation that global dairy commodity prices will come under pressure in Q2 2018 still lingers. Given the elevated price levels for cheese and whole milk powder (WMP) vs. other commodity streams, these two products appear more vulnerable than others for more immediate downward pricing pressure. What has changed over the past quarter is that the anticipated seasonal peak in Northern Hemisphere milk output will be less daunting. Rabobank has therefore turned the pressure down on price expectations through Q2 2018, but still sees a rebalancing of the markets over the course of 2H 2018.

**Figure 1: Dairy commodity prices FOB Oceania, 2010-2018\***



\* Note: whey is FOB in western Europe  
Source: Rabobank, USDA, 2018

**Figure 2: Milk production growth, Big 7 exporters (actual and Rabobank forecast), Q1 2010-Q1 2019f\***



\* Note: Big 7 includes EU, US, NZ, Australia, Brazil, Argentina and Uruguay  
Source: Big 7 government trade agencies, Rabobank, 2018

# What to watch in Q2 and Q3

## EU intervention stocks

All eyes are on where the additional milk will flow during the EU peak. Previously, the European Commission (EC) had the authority to clear 109,000 tonnes of SMP (and 60,000 tonnes of butter) between 1 March and 30 September. This is no longer the case, as the EC reduced the ceiling for SMP to zero for the 2018 window. The economics favour cheese production over butter and SMP, but the reality is that all plant capacity is likely to be tapped out in order to clear the anticipated record-high milk output.

## NAFTA

The renegotiation of NAFTA continues, and progress has been made following the seventh round of negotiations. The next round of talks begins in April, with all parties eager to complete the process relatively quickly. Nevertheless, despite no changes to NAFTA tariffs so far, the US market share of the Mexican NFDM market eroded by 10% in 2017, as Mexican buyers opted to purchase more product from the EU and Canada.

## Trade wars

The threat of a trade war has escalated. While there is no immediate impact on dairy trade, the threat of trade wars spreading to broader trade flows and impacting currency valuation fluctuations is real. China accounted for nearly 10% of US dairy exports in 2017, mostly whey-derived

products. The US dairy industry's strategy to grow trade with China as a path to supporting domestic milk production growth is now at risk.

## Chinese registration

China's Certification and Accreditation Administration (CNCA) has announced that four-year certification of a batch of offshore plants (attained in 2014) is up for renewal by the end of 2018. There may be a risk of some failing the renewal audit process and having their certifications revoked.

## Chinese standards

China is in the process of revising national food safety standards for raw milk, pasteurised milk, sterilised milk (UHT), and the testing method for identifying the use of recombinant milk in pasteurised and sterilised products. Under the proposed standards, recombinant milk (from powder) will be excluded as an ingredient in sterilised milk. It is still early in the public consultation process, but the proposal would have implications for trade in WMP.

## Rising feed costs

At a time when milk prices are falling and expected to trend lower in the short term, dairy farmers are confronting the prospect of higher global wheat, soybean, and corn prices. As always, key weather risks persist across the global grain & oilseed complex, but the impact of dairy farmer margins is pertinent in the near term.

Table 1: Quarterly dairy commodity prices (historic and forecast), Q4 2016-Q1 2019f

		2016		2017			2018				2019
		Q4	Q1	Q2	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f
<b>World (FOB Oceania)</b>											
Butter	USD/tonne	4,108	4,525	5,307	6,111	5,398	5,048	5,200	5,300	5,400	5,300
Skim milk powder	USD/tonne	2,348	2,402	2,013	2,000	1,792	1,873	1,750	1,800	1,900	1,900
Whole milk powder	USD/tonne	3,050	3,190	3,114	3,163	2,898	3,094	3,050	3,100	3,300	3,200
Cheddar cheese	USD/tonne	3,640	3,769	3,646	4,054	3,921	3,598	3,500	3,800	3,900	3,700
Sweet whey powder	USD/tonne	971	1,038	1,154	1,039	809	854	800	800	850	850
<b>US (AMS announced)</b>											
NFDM	USD/lb	0.93	0.96	0.87	0.88	0.76	0.70	0.70	0.75	0.80	0.80
AA butter	USD/lb	1.98	2.21	2.24	2.60	2.29	2.16	2.14	2.36	2.35	2.26
Block cheddar	USD/lb	1.74	1.66	1.57	1.67	1.68	1.53	1.51	1.63	1.72	1.62
Whey powder	USD/lb	0.37	0.48	0.51	0.43	0.34	0.26	0.25	0.26	0.32	0.36
Class III milk	USD/cwt	16.33	16.49	15.74	16.13	16.34	13.85	13.70	14.90	16.17	15.39
Class IV milk	USD/cwt	14.13	15.37	14.80	16.36	14.12	13.00	12.92	14.27	14.68	14.23

Source: USDA, Rabobank 2018

## EU

Supported by profitable margins, low comparables, ample silage/roughage, and relatively mild weather conditions in most regions, EU milk production increased by 4.8% YOY in Q4 2017. Compared to Q4 2015, milk production showed moderate growth of only 1.3%. Due to the strong closing months, 2017 milk production finished 2.1% higher YOY. Preliminary figures for January 2018 indicate a production growth of 3.7% YOY (see Figure 3).

Even though the seven largest milk-producing member states posted year-on-year growth during Q4 2017, production growth by country for all of 2017 varied significantly. Milk production in 2017 for Germany and France, the two largest milk producers, increased by a marginal 0.1% and 0.6% YOY, respectively.

For the full year 2017, Polish and Irish milk production grew by 4.9% and 9.3% YOY, respectively. Despite the phosphate restrictions in the Netherlands and much-anticipated lower milk production, Dutch milk production remained on par (+0.1% YOY). Milk production in the UK and Italy increased by 4.4% and 3.8%, respectively.

Despite the higher level of milk production, according to ZMB, dairy herds in predominant milk-producing countries declined by 0.8% YOY during 2017, indicating yield improvements across the main milk supply regions in Europe. Herd size movements in Germany (-0.5%), France (-1.0%), the UK (+0.2%), and Italy (-1.0%) remained within a bandwidth of 1.0%, while Poland (1.1%) and Ireland (3.7%) noted stronger growth figures. Due to the phosphate and herd reduction programme during 2017, the Dutch dairy herd declined by 7.2% YOY. Based on data from RVO, slaughter rates for cows and young stock in the Netherlands remained at an elevated level during the first 11 weeks of 2018, as each individual dairy farm has to comply with the assigned phosphate rights for 2018.

In response to lower commodity prices, EU farmgate prices have fallen by 6% since November, averaging EUR 35.65/100kg across Europe in January. Several individual processors reduced their pay prices by 10% to 15% during the first three months of 2018.

Current (Q1 2018) farmgate prices and solid roughage stocks still offer possibilities for a positive cash flow for dairy farmers in most regions. Combined with low production comparables for 1H 2018, we expect milk production growth to continue for Q1 2018 (+3.0% YOY) and Q2 2018 (+2.0% YOY). A cold front during February might temper milk production for Q1 2018. Shrinking margins – a result of lower farmgate prices in 1H 2018 – and high comparables for 2H 2018 will temper further production growth in Q3

2018 (0.0%) and Q4 2018 (-1.5%). As we move into Q1 2019, we expect milk production to remain below the current milk wave hitting the market (-1.2%).

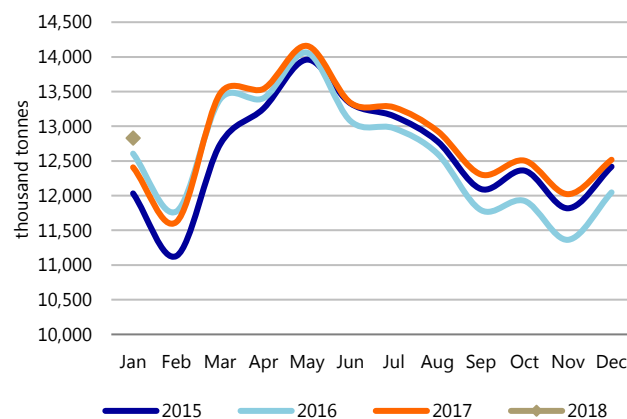
Despite the decline in butter prices since mid-September 2017, EU butter prices remained above the five-year average during Q1 2018, at over EUR 4,800/tonne at the end of March.

The valorisation of protein in the market remained difficult during the opening months of 2018, due to large SMP stocks in Europe and North America. Prices for SMP declined to EUR 1,330/tonne at the beginning of March – the lowest recorded level since 2007 and more than EUR 360/tonne below the 2017 EU intervention price. Prices for whey powder remained at a low level (EUR 680/tonne) during the same period. In the three months to March, gouda cheese prices declined by 13.9%, to EUR 2,920/tonne.

EU intervention stocks for SMP closed at a level of approximately 375,700 tonnes on 1 October for the 2017 season. During the first three months of 2018, offers were accepted for a total of 10,328 tonnes by the European Commission, with the lowest accepted price at EUR 1,050/tonne. Developments during the recent months suggest that the European Commission is willing to accept lower prices. Nonetheless, the conditions for the 2018 EU intervention arrangement, reopened on 1 March, are unlikely to provide support for SMP price recovery during 2018. During the March tender to sell SMP into intervention, none of the offers – with the lowest offer at EUR 1,349/tonne – were accepted by the European Commission. Statements made by EU Agriculture & Rural Development Commissioner Phil Hogan also indicate that any other support schemes are not to be expected this year.

In LME terms, European exports exceeded the 2016 level by 14.2% in 2017. A buoyant growth of 35.6% YOY in SMP exports indicates the willingness to accept low prices for fresh SMP. Due to low availability, butter exports declined

Figure 3: EU milk production, Jan 2015-Jan 2018



Source: ZMB, Rabobank 2018

by 17.3% YOY. The high valorisation of cheese and whey during most of 2017 supported the expansion of European cheese exports (+3.7%). WMP exports increased by 4.3% during 2017. Nonetheless, WMP remains a relatively small export product stream for the EU.

Despite the higher oil prices, the value of the euro against the US dollar has increased by 16% since the start of 2017, weakening the European export position.

Dairy consumption showed small to moderate growth in 2017, supported by economic growth. For 2018, we expect dairy consumption to grow by 1.5%. Milk supply growth is expected to exceed the growth in dairy consumption, leading to a forecast exportable surplus change of 6.0% YOY for the first six months of 2018.

## US

US milk production is off to an above-trend start in 2018, with year-on-year output in both January and February up 1.8%, besting the 2007-2017 CAGR of 1.5%. The recent impressive gains follow 2017's 1.7% YOY increase (adjusted for 2016's leap day), to 97.7m tonnes. The national dairy herd continues to grow in 2018. At 9.41m head, the US herd currently stands 45,000 head above last year's level.

More favourable winter weather conditions in the western states and the continual expansion of the US dairy herd supported early year-on-year 2018 production growth. Among the major dairy states, California posted a 3.5% YOY increase in milk output in February, Idaho grew by 4.8%, while output in Wisconsin was up a scant 0.1%, and New York – hampered by poor forage quality – showed a decline of 2.3%. At the same time, Colorado posted year-on-year double-digit growth of 7.7% in milk production, followed by Texas, with a 5.5% gain. These two states alone added 28,000 head to the US dairy herd, compared to February 2017 (see Figure 4).

Dairy cow slaughter in the first two months of the year is running more than 5% above last year, and more recent weekly data indicates a similar pace. Ample heifer replacements, due in part to the use of gender-selected semen, are supporting higher culling in 2018. Larger monthly slaughter percentages vs. the prior year are anticipated throughout the year, resulting in a lower year-on-year herd inventory by Q3 2018.

Lower milk prices and narrowing farm margins are key factors contributing to greater culling. The US All-Milk Price in January 2018 averaged USD 16.10/cwt (approximately EUR 29.10/100kg), down 8.5% from the prior month and the lowest level since January 2016. Continued weakness in farmgate milk prices is expected through Q2 2018. In the prior year, corn prices were below USD 3.50/bu, which

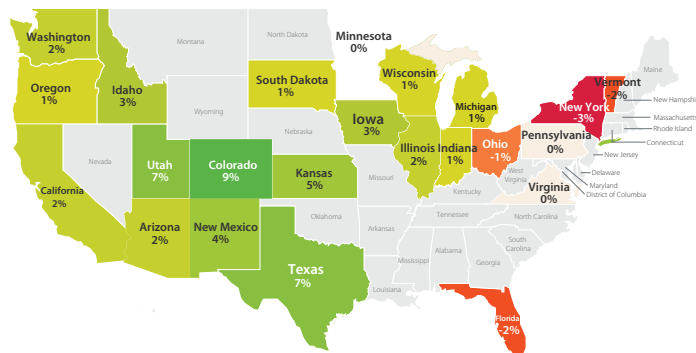
contributed to more favourable margins and spurred more milk production. That is unlikely to occur in 2018, as corn prices rise towards USD 4/bu and milk prices remain below last year's level through Q2 2018. Nevertheless, Rabobank anticipates total 2018 US milk production growth to be slightly below trend, at 1.4%.

Improved global demand and favourable pricing have helped to boost US dairy exports, which were up 4% in LME terms in Q4 2017. Meanwhile, imports were down 6%, as sufficient domestic availability and international premiums made choosing local easy. This trend has sustained into 2018, with imports lagging January 2017 figures across the board. Exports have continued to show growth, led by cheese (+18.9%), butterfat (+24.6%), dry whey (+29.8%), whey protein concentrate (+15.7%), and NFDM (+3.9%), despite stiff global competition and challenging trade rhetoric. Looking ahead, 2018 US exports will remain competitive, with prices generally sitting below international levels and a persistently weak dollar.

US domestic demand for dairy products remains fragmented, with retail sales of natural cheese and butter both up 3% and 6%, respectively, in the first two months of the year vs. 2017, according to IRI. Fluid milk (-1%), processed cheese (-2.8%), yoghurt (-4%), and ice cream (-1%) were all down. Foodservice sales have also helped prop up demand growth, with quick-serve restaurant sales up 5.5% and full-serve up 2.7% in 2017. Much of this growth was driven by pizza restaurant growth, which was up 5.8% through the year, according to Euromonitor.

US dairy product stocks have moved higher, but at different levels of magnitude. As of 28 February, US butter stocks totalled 126,000 tonnes, up 2.6% compared to the prior year, while total cheese stocks topped 596,000 tonnes, up 7%, largely due to a 15% YOY increase in non-American-style cheeses. Lower milk prices during the first two months of the year provided manufacturers of longer-hold-type cheeses the opportunity to put aging cheeses in storage at

**Figure 4: US milk production by state: three-month rolling percentage change (Dec 2017-Feb 2018)**



Source: USDA, Rabobank 2018

favourable prices. February 2018 American cheese stocks, at 346,000 tonnes, were 2.4% above February 2017's level. It comes as no surprise that NFDM stocks remain burdensome. At 154,000 tonnes, NFDM inventories loom 50% above last year's level and are at their highest level since January 2005, when the US government purchased surplus product through the support price programme. NFDM stocks have accumulated – in part due to weaker exports to Mexico – as buyers have sought to diversify their suppliers by importing more NFDM from the EU and Canada. As a result, burdensome NFDM stocks in the US, as well as Europe, continue to weigh on the NFDM and whey product markets.

Looking forward, the demand picture looks to pick up, driven by US economic expansion, which is anticipated to jump to 2.7% in 2018 vs. 2.3% in 2017, according to the IMF. The stronger economic growth is projected to come mostly from tax policy change, which translates to stronger demand for dairy through increased foodservice and retail sales. Much of this demand growth will likely come from natural cheese, butter, and premium dairy products, following recent trends for healthy (low-sugar, high-fat, clean-label) and convenient (single-portion, 'on-the-go') formats.

In summary, the year-on-year US exportable surplus is expected to increase by more than 8%, or 450,000 tonnes, during 1H 2018. However, the optimistic domestic demand outlook, in tandem with slowing year-on-year milk production, could curb the availability of exportable surplus during 2H 2018.

## New Zealand

This summer has been one of the more challenging ones for many New Zealand dairy farmers. Drought conditions across some of the key dairying regions impacted soil moisture and pasture growth in December and January. Total milk production through summer (December-February) reached 575m kgMS – down 5.4% on the corresponding period (or 33m kgMS). This brings season-to-date production to 1,511m kgMS; down 1.1% (see Figure 5).

There was much-needed rainfall in late December; however, January was New Zealand's hottest month on record, with temperatures above-average across the country. February then brought with it two ex-tropical cyclones, which caused some disruptions for dairy farms in affected areas, but delivered high rainfall. By mid-March, soil moisture levels had been restored to the point where some regions are wetter than normal. Relief from the dry/drought conditions helped milk production start to stabilise in some key regions

– particularly in the Waikato. In contrast, production struggled in key regions across the South Island.

In recent times, price premiums for winter milk have been introduced, which triggered a strong start to the season (albeit a very small base). The desire for more winter milk comes from increased demand by foodservice and consumer markets needing flat milk. Markets will be watching with interest as to whether the trend towards incentivising more winter milk is continued in the new season, given the weather challenges from the current season.

Milk production is winding down quickly and will be unable to make up lost ground. Farmers will be weighing up decisions about feed availability and whether to dry off early. As a result, Rabobank expects monthly milk production volumes to trail year-on-year comparisons for the remainder of the season, finishing down 1% for the full season.

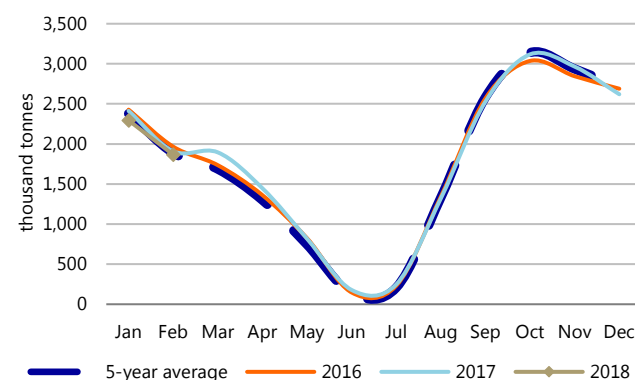
Weather forecasters are expecting normal to above-normal rainfall and soil moisture profiles in the next three months to May.

A drop in production and persistent import purchasing from Chinese buyers have been the key ingredients behind the recent rally in WMP prices. Since the start of December – when dry conditions started to bite – the Oceania WMP has rallied 13%.

The late-season rally in WMP prices has allowed Fonterra to lift its forecast payout to NZD 6.55/kgMS, beating Rabobank's previous forecast of NZD 6.30/kgMS.

According to Rabobank's latest rural confidence survey results, New Zealand dairy farmers are cautiously optimistic about their own farm business expectations over the next 12 months – but more than 50% of farmers are expecting conditions to stay the same. Almost half of those surveyed are anticipating spending more on farm working expenses like feed and fertiliser over the closing months of the season, compared to the prior season.

**Figure 5: New Zealand milk production, Jan 2016-Jan 2018**



Source: DCANZ, Rabobank 2018

Over the past three months to January, New Zealand total dairy exports expanded by a moderate rate of just 3%, reaching 307,000 tonnes. Not surprisingly, WMP exports have been quite strong, with export volumes up 15% in the same period. There has been an ongoing thirsty import appetite from Chinese buyers. In the past three months, total dairy export to China reached 360,000 tonnes, which was 14% higher vs. the same period the previous year. Not surprisingly, January saw a surge of exports into China as buyers made use of the tariff-advantage window.

New Zealand's exportable surplus has taken a hit over summer, with the trend lower through the remainder of the season. The exportable surplus is unlikely to begin growing again until the new season spring gets underway.

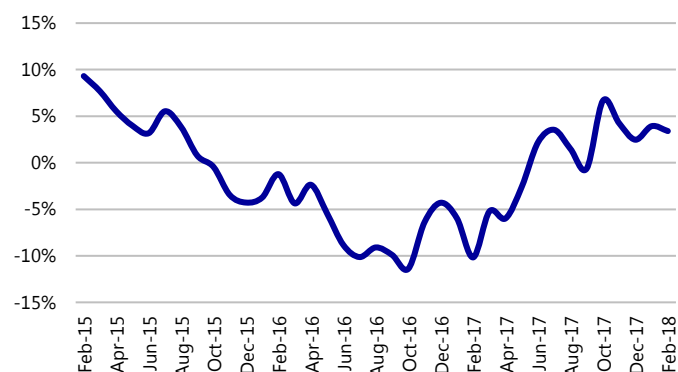
## Australia

Australian national milk production stands at just above 6bn litres as at the end of January 2018. This is 3.1% higher than the same period in the previous season. More than 80% of the volume growth has come from Northern Victoria and Gippsland combined (see Figure 6).

Summer rainfall has been highly variable across the dairying regions. The reality is that summer crops have been negatively impacted. Of the main production regions, Western Victoria was the hardest-hit in terms of below-average summer rainfall. Australia's milk production is expected to continue the current as the season draws to a close, with Rabobank forecasting national milk production to finish 3.2% higher for the 2017/18 season.

A timely autumn break will be vital in helping to establish a strong production base for the new season to kick off on 1 July. At this early stage, the seasonal outlook for the critical autumn period is mostly benign, with expectations of average rainfall. Milk production is expected to track 3.5% higher in the first half of 2018, supported by a low comparable.

**Figure 6: Australian year-on-year change in milk production, Feb 2015-Feb 2018**



Source: Dairy Australia, Rabobank 2018

Bushfires throughout Western Victoria in March will impact milk production for that region, given the stock losses.

Irrigators in the Northern Victorian region are expecting to have good seasonal determinations in 2018/19, despite the dry summer and seasonal outlook for autumn – largely because of established operating reserves from the current season.

The latest guidance from Australian dairy processors following milk price reviews has seen farmgate milk prices on hold at current levels. This is not surprising, given that Rabobank's full-season farmgate commodity milk price for 2017/18 stands at AUD 5.65/kgMS – which excludes any supplementary payments.

Rabobank's latest rural confidence survey found sentiment down significantly across the dairy sector. The major contributing factor was dairy farmers' expectations of milk price conditions deteriorating in the coming 12 months, stemming from weaker global conditions.

The cheese/whey stream has been a key focus for dairy manufacturers so far this season. Up to the end of December, Australian cheese production has increased 7.8%, to 180,000 tonnes. This is not surprising, given the relative returns (vs. SMP/butter) and the commissioning of cheese capacity coming on-stream.

The Australia consumer market for dairy product is tracking on trend, with some volume growth across categories in the dairy case. However, consumer spending power remains dogged by the rising cost of living and low wage inflation.

In the first half of the season (July-December), Australian dairy exports are running 4.5% higher than the same period the previous season (in liquid milk equivalents). Exports of liquid milk, mixtures, and cheese are the best-performing products.

Australian exporters should enjoy a continued recovery in exportable surplus through much of 2018. However, the structural loss of milk supply will take more time, so there will need to be an ongoing prioritising of the product and market mix.

The Australian Competition and Consumer Commission (ACCC) has ruled that Saputo must sell its Western Victoria plant (at Koroit) if the purchase of Murray Goulburn assets is to proceed, amid concerns regarding competition for farmgate milk supply in the region. Meanwhile, the fate of Murray Goulburn will be voted on at the pending extraordinary general meeting (EGM), to be held on 5 April.

With the expected completion of the transaction, dairy processors are preparing for another period of heightened competition for milk supply, as dairy companies look to retain and hold milk supply.

## Brazil

The rate of year-on-year growth in Brazilian milk production started to decelerate in Q1 2018. This comes after the industry recorded growth of 2% in Q4 2017.

Low farmgate milk prices and higher grain prices have reduced farmer margins, resulting in lower milk output from key dairying regions. Worsening drought conditions in Argentina have propelled domestic soymeal and corn prices higher for Brazilian farmers. This is a concern for dairy farmers, as margins are already under pressure due to lower milk prices. Rabobank's current expectations are for Argentina soybean production to fall to its lowest levels in six years, due to weather risks.

Even though farmgate milk prices are likely to move higher in the coming months, as milk production seasonally declines during Q2, farmgate prices remain at a much lower level than last year, approaching breakeven prices for average farmers.

The seasonal peak in supply – usually achieved during June-August – could disappoint the market. Low farmgate prices, coupled with higher feed costs, will continue to squeeze margins and keep a lid on production. Rabobank expects milk production to grow by just 1% in Q1 2018.

Meanwhile, dairy demand remains subdued. While the local economy is growing – and set to register GDP growth of at least 2% in 2018 – unemployment remains elevated, and consumers' spending power is still lower than before the start of the recession in 2014, due to the rising cost of living.

As a result, some retail dairy categories are set to fall in volume terms during 2018, as consumers make hard decisions on food purchases.

In terms of trade, the Brazilian dairy trade deficit shrank during the first two months of 2018, with imports dropping by 43%, compared to the same period in 2017.

Low domestic prices and weaker demand have reduced the incentive for importers to purchase products from the international market. Even with international prices at low levels, imports are still set to underperform, with domestic stocks of milk powder still at comfortable levels and sluggish domestic demand.

The Brazilian real is forecast to remain at around the current levels (BRL 3.2/USD to BRL 3.3/USD), but currency volatility is expected to continue as political direction and the pending presidential elections (in October) drive currency markets.

The enduring legal battles surrounding Lactalis' acquisition of Itambe remain, with various lawsuits yet to be resolved before that deal can be completed. The market continues to await a decision from the courts, but at this stage, there is limited visibility as to when the transaction will be completed.

## Argentina

Milk production in Argentina posted a large year-on-year jump of 11% during Q1 2018. The result was assisted by a low comparable basis of Q1 2017, when a severe flood hit the key producing regions in the provinces of Santa Fe and Córdoba. Nevertheless, this was the largest Q1 production since 2014.

The drought and dry conditions that have hit Argentina in recent weeks have caused higher feed costs due to lower availability, and higher international prices for corn and soy. This has naturally translated into more expensive domestic grains for Argentine dairy farmers.

However, alfalfa is a critical part of the dairy cattle feed mix in Argentina, and the present drought has failed to impact its production thus far. This, in part, has helped to compensate for higher grain prices.

In addition, temperatures have been low in recent weeks, which has favoured animal welfare and allowed milk production to trend higher. Dry weather also meant limited mud in the fields and fewer fleas during the hotter summer months (Q1 in the Southern Hemisphere). The absence of mud has caused fewer difficulties for milk collection and transportation, which was a key issue during the floods of Q1 2017.

Looking forward, Rabobank expects milk production to moderate in Q2 2018 – as the comparable basis is higher, but also due to tighter margins for farmers and stable farmgate milk prices that remain at around ARS 5.7/litre (USD 0.28/litre).

Dairy demand looks set to continue its slow road to recovery. The economy continues to show gradual signs of improvement, but inflation is still stubbornly high and will remain so during Q2 2018. The immediate focus for the government is to readjust transport prices, which had been left artificially low by the previous administration. Inflation is likely to finish 2018 at an annual rate of around 20%, which will continue impacting consumers' purchasing power.

In addition, unemployment rates will be slow to recover as key labour-intensive industries have adjusted to more efficient production methods during the recent economic downturn.

With high inflation and only marginal rises in employment levels, consumers will struggle to increase consumption of dairy products in a significant way in 2018.

In 2013, the country's trade surplus reached a record 415,000 tonnes, but has declined since, recording a fourth consecutive year of decline in surplus in 2017. Annual data shows that the trade surplus shrank to 210,000 tonnes in 2017, down from 291,000 tonnes in 2016.



Looking forward, Argentina's exportable surplus is expected to expand in 2018. As a result, the sector will continue to look for new export opportunities, particularly within Mercosur.

The market awaits news on the potential purchase of Sancor by an international company, with reports indicating that Fonterra is involved in the negotiations. The transaction is widely recognised as an important step for resolving the crisis at one of the largest dairy processors in the country, which has battled with rising production costs and processing inefficiencies for quite some time.

## China

Average farmgate milk prices in China eased in March, to CNY 3.45/kg (USD 0.54/kg), as production starts to gain momentum and demand enters a quieter period post-Chinese New Year. Current prices are down by 2.3% since the beginning of the year and down by the same magnitude year-on-year.

The weaker milk prices are largely offset by a strengthening renminbi in US dollar terms, leaving US dollar prices largely unchanged from the beginning of the year and vs. the same period last year.

According to the National Bureau of Statistics of China, 2017 milk production fell by 1.6% YOY to 35.4bn litres, implying an almost 3.2% YOY decline in 2H 2017. This follows a 4.1% YOY decline in milk production in 2016, and, as such, Chinese milk production has declined by almost 6% since 2015.

The decline was mostly attributable to heat stress, continuous farm exits by small/medium-size operators due to a lack of profitability, and, to some extent, more stringent enforcement of environmental protection regulations. This compares with Rabobank's original expectations of a 0.7% decline for the full year.

The raw milk production index by the Ministry of Agriculture suggests production started to turn the corner, with January 2018 milk production volume 0.2% higher YOY. This was the first positive month of growth in ten months.

Rabobank expects milk supply growth to continue to gain momentum and is forecasting milk production growth of 2.2% for 2018 (2% for 1H 2018 and 2.5% in 2H 2018), assuming more normalised summer conditions. We expect a sustained period of production growth of 1.6% YOY extending into 1H 2019, largely driven by yield improvements.

Following relatively strong consumption growth in 2017, Rabobank maintains existing demand forecasts, with a consumption growth of 1.5% in 1H 2018, and forecasting a mild slowdown in 2H 2018, to 1.2%, amid a strong

comparable base. While our demand forecast remains steady, an escalated trade war could have potentially negative implications on the renminbi exchange rate and economic growth in China, which could, in turn, hurt demand growth via possibly higher pricing (in renminbi) and uncertainty over income.

This takes into consideration the rising dairy consumer price index, which started to move into positive territory from mid-2017, with momentum continuing into 2018.

Recent channel checks by Rabobank indicate that major brands began raising retail prices for most liquid milk products in Q4 2017. Retail price increases are mostly driven by rising input costs from dairy ingredients, such as sugar and packaging, all of which are putting increasing pressure on margins of downstream processing companies.

Rabobank is expecting dairy consumption growth to continue to expand into 2019, by 2% YOY.

Chinese net dairy import volumes (in liquid milk equivalents) finished last year on a weaker note. Imports in December were 13% higher for the month, which was below the annual growth of 17% (vs. previous Rabobank expectations of 20% growth), to 10.8bn litres. Lower-than-expected production growth in 2H 2017 and weaker-than-expected import growth in 2017 indicate that inventory levels have been further drawn down at the beginning of 2018.

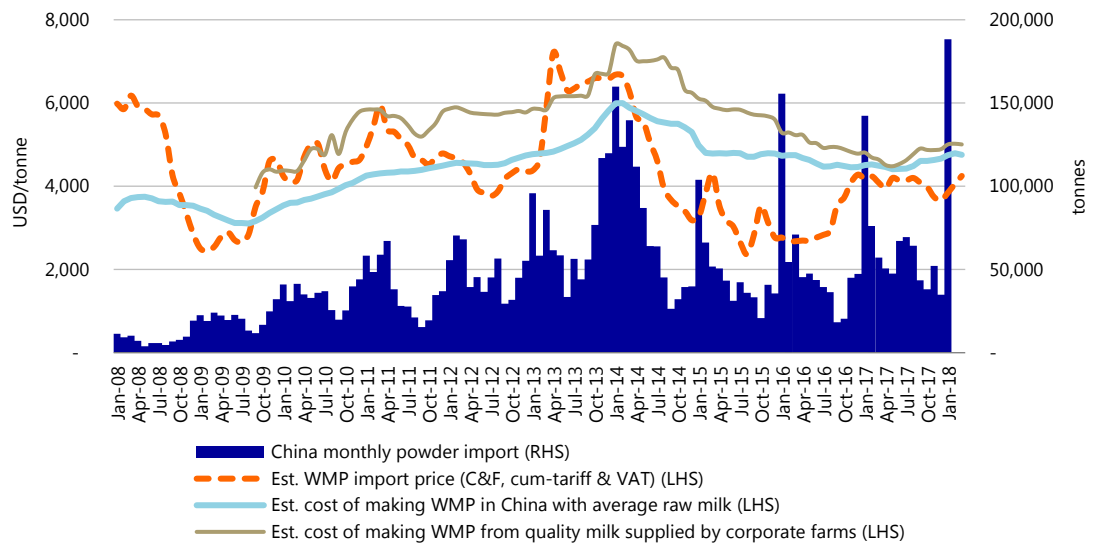
The new year started with a bang, with a jump in January net dairy imports growth – with a record high for WMP (+28% YOY) and SMP (+42% YOY) – driven by a rush to fill lower tariff rate quotas on New Zealand imports and off of an unusually low base in January 2017. Rabobank believes that the stock has been more than replenished temporarily, and a leading indicator based on New Zealand export data confirms that the import momentum slowed in February.

Rabobank has raised the annual net import growth of 13.8% for 2018 on a liquid milk equivalent (vs. a previous forecast of 8%), meaning 2018 import growth will be only marginally lower than the growth seen in 2017 – which was itself a record high. We expect to see faster growth in liquid milk, cheese, butter, SMP, and IMF than in WMP and whey.

This will maintain year-end 2018 stock levels at just below one month, unchanged from the year-beginning level. With new forecasts for both production and demand growth through 1H 2019, Rabobank is forecasting a slowdown in import purchasing, with a forecast 3.4% growth in 1H 2019.

There is still an appeal for import purchasing from Chinese buyers. However, Rabobank's WMP parity analysis shows the discount for Oceania-origin product vs. local product has narrowed due to the recent rally in global commodity prices. The discount is nearing 11% vs. the domestic average milk price, and 15% vs. the corporate farm milk price (see *Figure 7*).

Figure 7: China WMP import parity, Jan 2008-Feb 2018



Source: China Customs, Chinese Ministry of Agriculture, Rabobank 2018

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