



Rabobank

Dairy Quarterly Q3 2018

Step by Step

Rabobank

Food & Agribusiness
far.rabobank.com

Lead author

[Emma Higgins](#)

Analyst – Dairy
+64 3 9612908

For a full list of authors,
see back page

Contents

Global summary	2	Australia	7
What to watch in Q4 and Q1	3	Brazil	8
EU	4	Argentina	8
US	5	India	8
New Zealand	6	China	9

Summary

- Combined year-on-year milk supply growth across the Big 7 exporters (the EU, the US, New Zealand, Australia, Brazil, Argentina, and Uruguay) slowed during Q3 2018.
- Lower milk production from drought-impacted areas in the northern hemisphere is at odds with a strong start to the New Zealand milk production season.
- Global dairy commodity markets are mixed, with variable results across regions and products.
- Most Oceania-origin products have lost ground as buyers keenly await the full extent of the favourable New Zealand spring flush, creating a lack of buyer urgency.
- Ultimately, however, milk supply will grow only modestly year-on-year during the coming 12 months, driven by tight margins on-farm and lingering effects of adverse weather.
- Surplus dairy available for export will significantly tighten for an extended period, which will provide some upside to pricing across the dairy complex.
- With globally-rising forage costs, farmgate milk prices will need to move higher to offset the cost impact and improve farmer margins in order to support milk production growth.
- Chinese dairy product imports are expected to increase in 2H 2018, which will help absorb some of the milk supply growth from New Zealand. The full extent of the trade war fall in terms of trade and currency impacts is likely to play out in 2019 and beyond.
- A key risk is the strong US dollar, which will reduce the purchasing power of key importing regions.

Regional dairy markets

EU

EU milk growth continued a 17-month trend into July despite the dry weather, with the weather effect on feed availability to play out from Q4 2018 onwards.



China

China's import growth is anticipated to remain buoyant in 2H 2018, but trade war uncertainties cast a shadow across 2019.



US

Milk prices in Q3 2018 have improved after an initial drop in dairy commodity prices, as key trading partners implement retaliatory tariffs on selected dairy products.



South America

High local grain prices are impacting farmers' margins and will curb milk production growth. Meanwhile, local demand remains fragile, as Argentina's recession continues and Brazil awaits general elections in October.



New Zealand

Favourable weather has provided outstanding conditions for the 2018/19 season so far. But new feed regulations may prove challenging for milk flows at the back end of the season.



Australia

A shortage of feed and fodder has gripped the sector and wiped out any chance of a sustained recovery in milk production in the 2018/19 season.



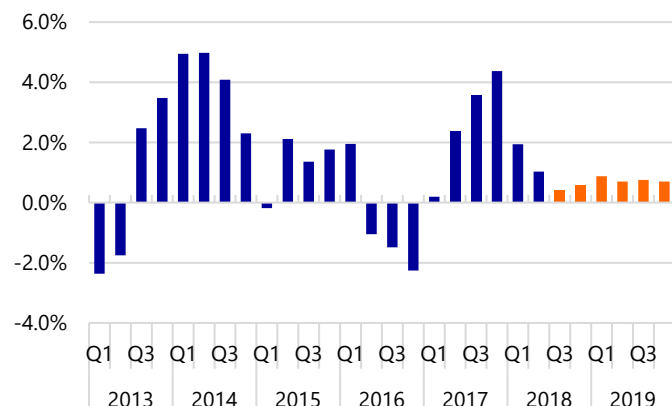
Global summary

The slowdown in Big 7 milk production growth in Q2 2018, at just 1% YOY, has trickled through to Q3 2018. Hot and dry weather has been shrivelling pastures in Australia, while drought conditions in parts of northern and western Europe have reduced milk volumes. The Brazilian truckers' strike earlier in the year curbed milk supply growth, while expensive feed could now start to bite Argentine production. US milk supply growth also continues to track below historical averages. While the onset of the New Zealand season has defied the slowing year-on-year global milk production trend, estimated flows for the Big 7 during Q3 2018 are for just 0.4% YOY – the lowest since 2016 (see Figure 1).

The impact of more expensive feed costs and tighter margins for milk producers globally are now very evident and will continue the squeeze into 2019. National dairy herd numbers are shrinking in Australia, Europe, and the US, as a result of producers scrambling to manage costs. With the exception of New Zealand, milk prices are now moving higher in a number of regions as production growth is tested. Further increases in farmgate milk prices are needed to negate the higher input costs and to improve volume growth.

Oceania dairy products trade at a discount to northern hemisphere commodities – except for SMP, which is largely already committed to buyers. The anticipation of a bumper season from New Zealand and increased product availability on the GDT auction have resulted in buyers sitting on the sidelines, and prices have slipped lower as a result (see Figure 2). European SMP prices have moved higher through better demand for fresh product and higher exports, as well as being competitively priced compared to product from Oceania.

Figure 1: Milk production growth, Big 7 exporters (actual and Rabobank forecast), Q1 2013-Q3 2019f*



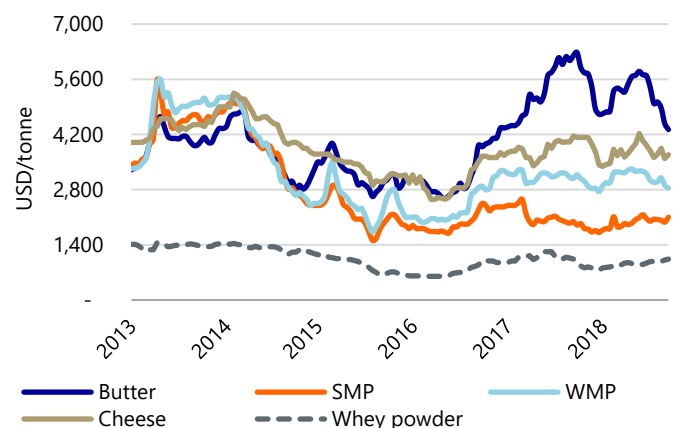
* Note: Big 7 includes EU, US, NZ, Australia, Brazil, Argentina, and Uruguay. Source: Big 7 government trade agencies, Rabobank 2018

European SMP stocks remain burdensome. Some inroads are being made on intervention SMP stocks, albeit slowly. The latest European Commission tender to liquidate aging intervention stocks saw lower volumes sold than the prior event. Another 240,000 tonnes still need to be cleared, and so the two-tiered EU SMP market continues between fresh and aged product. Some of India's growing SMP stockpile has been tagged for export over the coming months, with two state governments and the federal government providing export incentives. US non-fat dry milk stocks are higher than the prior year.

Considerable uncertainty underpins the demand outlook due to the potential global economic damage caused by a trade war between the US and China, along with the growing strength of the US dollar against most currencies. Plunging currencies in South America continue to pressure consumer confidence and economic growth, while lifting inflation – all are taking a toll on demand.

While Rabobank expects combined global milk supply across the major export regions to grow, production will only lift very modestly over the next 12 months, well in line with consumption trends. As such, the net exportable surplus available from the Big 7 will be limited for the tail of 2018 and across most of 2019. This paints a period of relative price stability and a balanced global market – but with clear risk, as always.

Figure 2: Dairy commodity prices FOB Oceania, 2013-2018*



* Note: Whey is FOB in western Europe. Source: USDA, Rabobank 2018

What to watch in Q4 and Q1

US/China trade war fallout

The latest iteration of the trade wars resulted in countermoves by both the US and China. Threats of retaliation have now been proven on both sides, and further escalation of the trade tensions is likely. The US is the third-largest dairy exporter to China, dominating the whey market, totalling 240,000 tonnes in 2017 and up 3% during 1H 2018. July 2018 exports foreshadow the impact of the tariffs. July 2018 whey exports, at 13,740 tonnes, were off 25% from the prior month and down 30% vs. the previous year.

The full extent of the effect of the trade war damage on dairy is yet to fully be felt, with significant uncertainty regarding the impact on economic growth in China and on US export volumes, along with the impact on feed costs in both countries.

Currency capers

Most currency values have softened against the US dollar over the course of the year – particularly emerging markets and exporter currencies. Rabobank expects the US dollar to remain well supported moving into 2019,

and expensive inputs for farm cost structures look set to continue. Should commodity prices lift as well, emerging markets could face a double whammy, with weaker buying power in key regions and more expensive goods.

New Zealand milk volumes

The market is watching with anticipation as to how high production numbers will bounce this season – the result of near-perfect weather across winter and spring (so far). Milk flows in the second half of the milking calendar could be tested should rogue weather appear with the implementation of Fonterra's restrictions on PKE use.

NAFTA update

The US and Mexico have completed negotiations, but an agreement between Canada and the US remains allusive. Any opening of the Canadian market would be a bonus for US dairy exporters. It is unclear, however, as to whether the US can move forward with a revamped NAFTA with only Mexico, and some lawmakers say they won't go along with a deal that leaves Canada out. Until a deal is complete, US cheese exports to Mexico are at risk due to the retaliatory tariffs; however, US SMP/NDM exports are not subject to tariffs.

Table 1: Quarterly dairy commodity prices (historic and forecast), Q2 2017-Q3 2019f

		2017			2018				2019		
		Q2	Q3	Q4	Q1	Q2	Q3e	Q4f	Q1f	Q2f	Q3f
Butter											
Europe	EUR/tonne	4,512	6,049	5,413	4,597	5,462	5,600	5,000	4,600	4,950	5,400
US	USD/tonne	4,924	5,726	5,059	4,765	5,147	5,165	4,924	4,555	4,750	5,180
Oceania	USD/tonne	5,307	6,111	5,660	5,080	5,519	4,325	4,300	4,500	4,550	4,550
Cheese											
Europe (Gouda)	EUR/tonne	3,141	3,351	3,361	2,981	2,966	3,100	3,125	3,075	3,000	3,100
US (Cheddar)	USD/tonne	3,428	3,579	3,774	3,340	3,545	3,466	3,711	3,570	3,470	3,580
Oceania (Cheddar)	USD/tonne	3,646	4,054	3,981	3,602	3,838	3,690	3,700	3,800	3,900	3,900
Dry whey powder											
Europe	EUR/tonne	994	862	677	684	723	800	780	800	800	800
US	USD/tonne	1,121	957	765	574	616	787	850	850	850	850
Skim milk powder											
Europe	EUR/tonne	1,844	1,772	1,534	1,376	1,429	1,540	1,550	1,625	1,625	1,650
US	USD/tonne	1,927	1,927	1,682	1,544	1,706	1,792	1,929	2,040	2,095	2,125
Oceania	USD/tonne	2,013	2,000	1,843	1,882	1,950	2,100	2,150	2,200	2,200	2,250
Whole milk powder											
Europe	EUR/tonne	2,865	3,047	2,794	2,588	2,727	2,800	2,650	2,700	2,800	2,800
Oceania	USD/tonne	3,114	3,163	2,974	3,113	3,268	2,838	2,800	2,850	2,900	3,000
South America	USD/tonne	3,485	3,478	3,219	3,122	3,057	3,090	3,020	3,050	3,100	3,150

Source: Rabobank 2018

EU

Drought and heat overshadowed the summer months in northern and western Europe, stalling crop development, causing heat stress among livestock, and resulting in lower milkfat content. Nonetheless, EU milk production continued its 17th month of consecutive year-on-year growth in July (+1.0%), bringing EU milk production up 1.6% YOY in the first seven months of the year (see Figure 3).

The weather impact differed significantly by region because of differences in soil conditions, availability of water for irrigation, and roughage stocks. Stalled grass growth led to a decline in Irish milk production of 3.1% YOY in July.

Ample roughage stocks from last year eased the pain in the other main milk-producing countries. Milk production in Germany and France, the largest milk-producing countries in the EU milk pool, increased in July by 2.4% and 1.2%, respectively, compared to the same month last year. The UK, Italy, and Poland also recorded year-on-year milk production growth in July.

A combination of phosphate legislation, heat stress, and drought caused Dutch milk production volumes in July to decline by 1.2% YOY and by 2.9% YOY in August.

August milk production volumes in Germany and France are estimated to be down by 0.7% and 2% YOY, respectively.

Moving towards the end of 2018 and into 2019, the longer-term effects of the current drought, such as increasing feed costs and higher slaughter rates, limit the potential for milk production growth. Nonetheless, the current dairy commodity prices are likely to translate into milk prices that result in positive cash margins during the closing months of 2018.

As a result, Rabobank expects Q3 2018 milk production to finish at +0.4% YOY. For Q4 2018 and 2019, Rabobank expects milk production growth to remain below 1.0% YOY.

EU farmgate prices have improved since June, rising 4.6% and averaging EUR 33.50/100kg across Europe in August.

After an early summer break in July, most commodities lifted to higher price levels by mid-September. Gouda prices have gone up by over EUR 100/tonne (+4%), to EUR 3,180/tonne since the last week of July. SMP prices jumped by EUR 135/tonne, to EUR 1,585/tonne (+9%), while whey powder prices went up by EUR 50/tonne (+6%), to EUR 830/tonne, during the same period. Butter prices remain high, but volatile. After peaking at EUR 5,860/tonne in mid-June, EU butter prices fell to nearly EUR 5,500/tonne in July. Since the end of July, EU butter prices increased by EUR 55/tonne, to EUR 5,610/tonne in mid-September. As a result, the price gap between EU and FOB Oceania butter prices widened to just over EUR 1,850/tonne. Rabobank

expects EU butter prices to soften in Q4 2018 and into 1H 2019. In contrast, WMP prices are forecast to remain at relatively stable price levels through year-end and into 2019.

EU cheese production increased by 2% YOY during Q2 2018, while butter production went down by 1% YOY. In Q2 2018, SMP output fell by 6% YOY, and WMP production dropped even more: by 7% YOY.

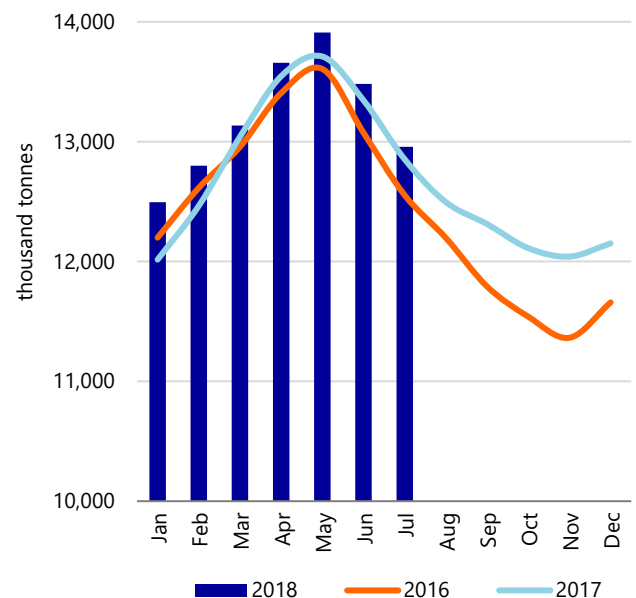
At the September tender, with 154,797 tonnes on offer, only 8,983 tonnes were sold out of the EU SMP intervention stocks, at a minimum price of EUR 1,230/tonne. This is significantly less than the amount sold in August (31,394 tonnes) at the same price. Over 140,000 tonnes of SMP have been sold out of intervention since early 2017, which leaves a stockpile of nearly 240,000 tonnes. As of October, the frequency of the tenders will increase to twice a month.

Supported by higher oil prices, the US dollar value against the euro increased by 5% during the first eight months of 2018. Rabobank anticipates a further strengthening of the euro against the US dollar for the coming six months.

In the three months to July, EU exports declined by 7% YOY in LME terms. Due to challenging reference months and a tight market for fresh SMP, SMP exports declined by 8% YOY. A combination of limited availability of milkfat for butter production, improved domestic demand, and lower stocks caused butter exports to drop by 31% YOY. As a result of a lower WMP production and lower availability, WMP exports dwindled by 18% YOY. Cheese exports declined by 1% YOY.

Favourable economic conditions across Europe have contributed to increases in consumption. As a result, Rabobank forecasts domestic EU dairy demand to expand by 1.0% into 2019.

Figure 3: EU milk production, Jan 2016-Jul 2018



Source: ZMB, Rabobank 2018

US

Several consecutive months of low milk prices and rising forage costs have reduced producers' margins and tempered year-on-year milk production gains. Q2 2018 year-on-year production increased just 0.9%, compared to 1.5% in Q1 2018. August milk production recovered, posting a 1.4% gain vs. the prior year, bringing year-to-date growth to +1.25%, which trails the historical annual average increase of 1.5% (see Figure 4).

The US dairy herd has oscillated from 9.408m head in January 2018 to 9.395m head in July, then rebounding by 5,000 head in August, to 9.4m head, which is down 4,000 head from last year. The national average MPP dairy (all milk price minus feed costs) was less than USD 7.00 during Q2 2018, down nearly 30% from 2017's annual average, resulting in increased farm exits and higher slaughter rates. Dairy cow slaughter through July 2018 is running 5.1% above the prior year. Ample heifer replacements, due in part to the use of gender-selected semen, are supporting higher culling in 2018 and continued year-on-year gains in milk per cow.

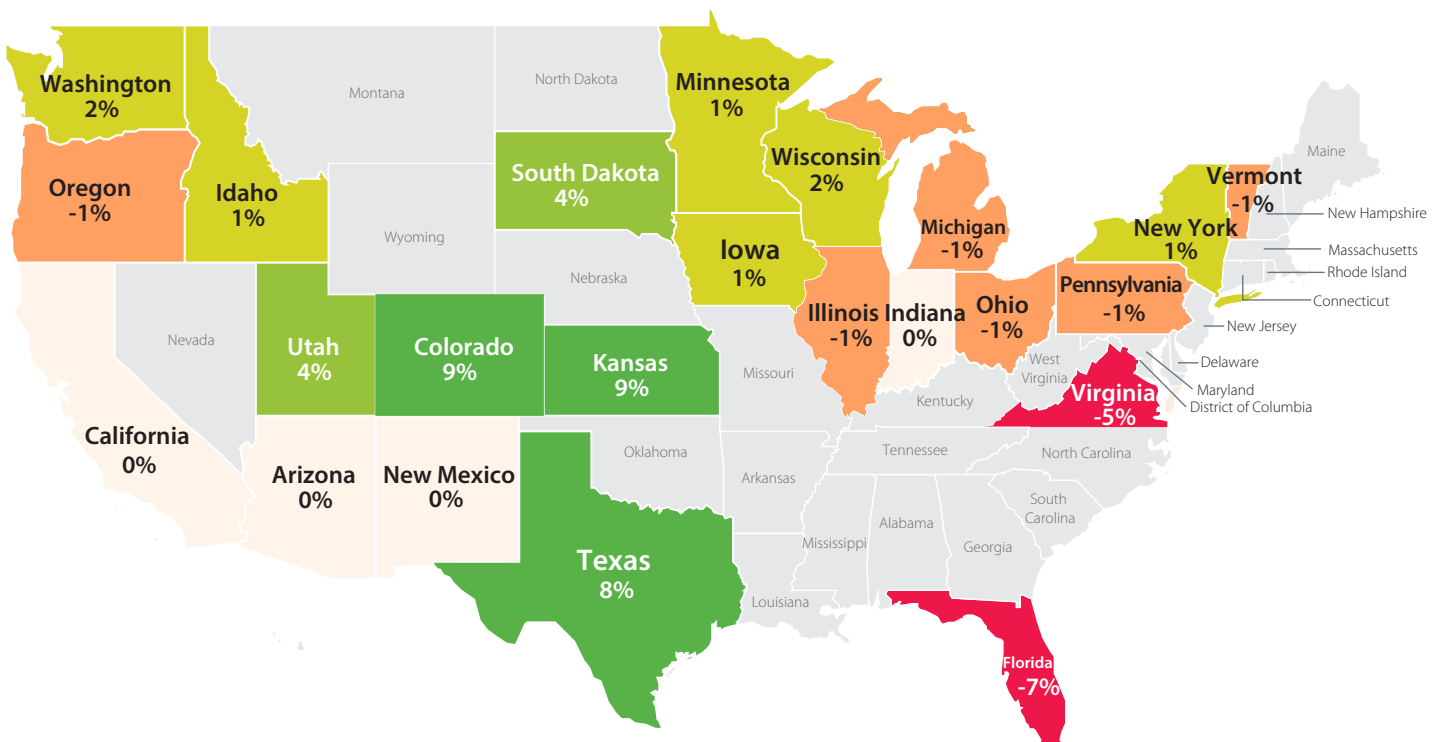
Looking forward, state-level data of recently issued permits for dairy confined feeding operations (CAFO) suggests there is more production growth to come. CAFO permits issued since February 2018 could potentially add nearly 38,000 milk cows in Texas, over 12,000 milk cows in both Colorado and Minnesota, 9,500 head in South Dakota, 5,000 milk cows in Kansas, and more than 3,700

head in Wisconsin. With a slight recovery in milk prices in the coming months, along with low soybean and corn prices, Rabobank expects the dairy herd to stabilise and US milk production to slowly recover to on-trend gains in the next 12 months.

The US economy has roared ahead in 2018, with Q2 GDP growth of 4.1% setting the highest rate seen since 2014. US consumer spending grew at 2.5% through the quarter. Unfortunately, dairy demand (total milk solids) was less robust at 1.2%, due to headwinds from lower year-on-year sales of fluid milk, yoghurt, and butter. According to the USDA, fluid milk sales declined by 2.2% in Q2, persisting into Q3, with July sales also down by 2.2% compared to the prior year. IRI retail yoghurt sales have not posted growth since January 2016, with Q2 sales down 3.6% in volume terms. Meanwhile, Q2 butter demand slipped by 0.3%, most likely due to the timing of spring holiday butter sales being earlier in 2018. Fortunately, stronger year-on-year cheese sales – up 6.8% in July – have offset declines in other categories. Demand has been strong in foodservice where the US total foodservice/retail growth rate was up 5.7% in Q2 2018 and 6.6% for Jul/Aug vs. 2017.

US exports have exceeded expectations, considering a 5% appreciation in the USD index since January 2018. Part of this is the result of buyers securing supply ahead of new tariff rates, particularly Mexico at the start of the year. Non-fat dry milk/skim milk powder exports have set records through part of 1H 2018, with July exports up 30% vs. the prior year. According to the US Dairy Export

Figure 4: US milk production by state, three-month rolling percentage change (Jun 2018-Aug 2018)

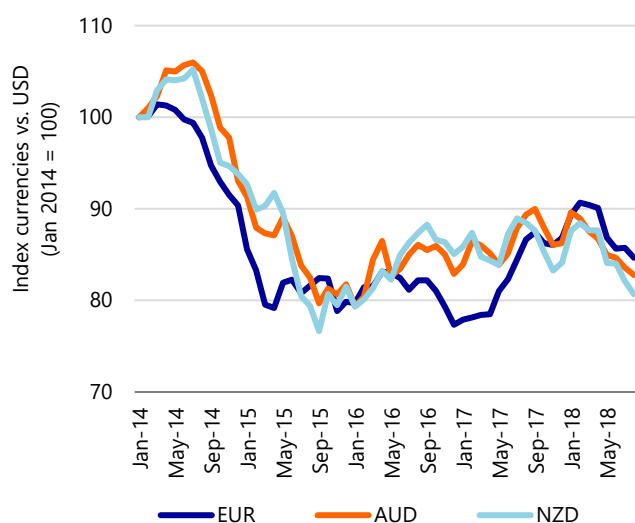


Source: USDA, Rabobank 2018

Council, US exports accounted for 16.6% of US milk production through July 2018. Going forward, US exports face some strong headwinds, with the US dollar remaining firm and mounting tariffs on US dairy products (see Figure 5).

As the US economy continues to push through Q3 2018 at 4% growth rates, upbeat consumer demand should translate into strong seasonal demand for cheese, butter, and cream products. Rabobank forecasts US year-on-year domestic dairy demand to grow by 1.2% over the coming 12 months, lifting 2019 dairy product prices above 2018 levels.

Figure 5: Exchange rates, USD vs. exporters, 2014-2018



Source: OANDA, Rabobank 2018

New Zealand

Export volumes for the three months to July 2018 were lower by 4% (31,700 tonnes) on the prior year – with milk flows largely flat over a comparable period, lower shipments to Algeria (30,700 tonnes) and China (16,000 tonnes), and patchy export volumes to South-East Asia (Vietnam, Singapore, Malaysia, and Thailand all lower) all contributing factors.

As previously anticipated, milk production finished the 2017/18 season flat on the prior season, helped by yet another season of very favourable autumn conditions with a mild winter. The new season, however, has started with a bang, with growth over the seasonal trough period from June to August up by 5% YOY. Great weather, more winter milk contracts, and additional cows carried over into the new season helped propelled milk output (see Figure 6).

With calving well underway, meaningful production volumes will start to appear as the weeks progress. With mild weather conditions persisting thus far early spring, combined with ample feed availability, it is difficult to see

conditions arising that would derail a good spring flush and first half of the production season (2H 2018), particularly with lower comparable volumes in 2H 2017 – the effect of a very wet spring last year, particularly in the North Island.

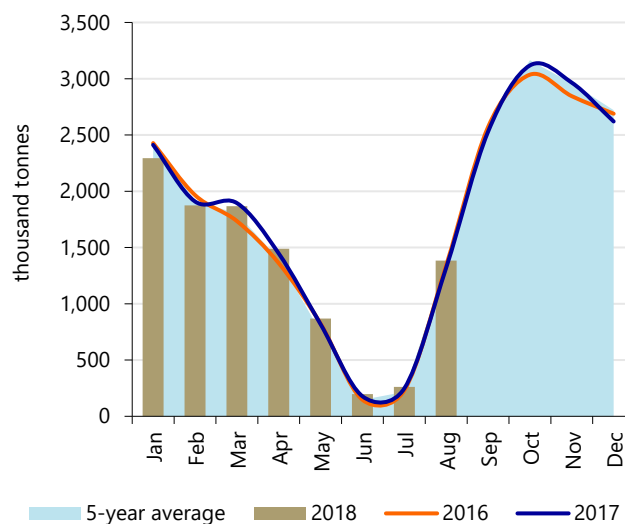
International guidance suggests a 65% chance of El Niño conditions developing over the coming months to November 2018, and increasing to a 78% probability between March and May 2019. However, if an El Niño eventuates, NIWA suggests that the event will not be in the strong category, so it is not expected to be of a similar intensity to what has previously been experienced.

Fonterra has revised its 2018/19 farmgate milk price lower, from NZD 7.00/kgMS to NZD 6.75/kgMS – still a healthy milk price for most farmers. Usually, this would provide farmers with sufficient confidence to utilise supplementary feed whenever necessary, to overcome any climatic issues or feed deficits arising. However, with Fonterra's penalties for excessive PKE use now in effect, more uncertainty lies in 1H 2019 production – and particularly the tail months of the season, with a drop in milk production possible for the final few months and one of the key feed options limited, should the weather stall pasture growth. Rabobank anticipates milk production growth of 2% for the full 2018/19 season.

Based on global commodity price expectations across the remainder of the 2018/19 season, Rabobank forecasts the farmgate milk price to NZD 6.65/kgMS.

Export volumes will trend above the previous year for 2H 2018 and moving through to 1H 2019, due to higher milk flows, coupled with steady demand. However, they are expected to come under pressure 2H 2019, in line with lower production.

Figure 6: New Zealand milk production, Jan 2016-Aug 2018



Source: DCANZ, Rabobank 2018

Australia

Australia finished the 2017/18 season with 9.3bn litres of milk, representing a lift in production of 3.3%, or 300m litres above the prior season. However, the rate of growth began to slow as unfavourable seasonal conditions began to take hold at the onset of the 2018/19 season (see Figure 7).

For most dairying regions, autumn rainfall came later than normal, and the volume received was below-average. This created a very difficult start to the production season for dairy operators. The New South Wales and Queensland regions continue to be hardest-hit by drought conditions. Highlighting the severity, some areas of New South Wales recorded their lowest-ever monthly rainfall in July.

Australian dairy farmers will be hoping to maximise the spring period by growing as much homegrown feed as possible. The outlook through the next few months is less than favourable, with the latest seasonal outlook from the Bureau of Meteorology pointing toward below-average rainfall across most of the major dairying regions.

A major shortage of fodder in Australia has seen prices rise significantly, with buyers scrambling to secure any available supply. Hay stocks are low, and new-season supply is selling quickly. At the same time, alternative fodder supplies have become more expensive.

As a result, most dairy farmers are bracing for a sustained period of feed shortages and a margin squeeze. To mitigate the impact, dairy farm operators are making business decisions to reduce costs. The latest data shows a spike in culling activity, with the number of dairy cows sent to slaughter up 14% YOY for the month of July.

For irrigation farmers in the Murray irrigation district, there have been some slight improvements in seasonal determinations of late, which will be welcome news. Water flows into major storages have supported the lift in determinations and provided some relief to very high allocation prices. However, catchments are at lower levels vs. the same time last year, and inflows are expected to remain low because of the dry outlook. At the same time, demand for water will remain strong across the Murray irrigation district and will mean a season of high water prices for dairy farmer operators in the region.

Expectations of a lower herd and reduced feed availability have triggered Rabobank to revise down the milk production forecast for Australia. Milk production started the new season with a fall of 4.2% YOY, with a drop in output across the majority of dairying regions. Australia milk production is expected to trail last season through Q3 2018 by 3.5%, finishing the season down around 2%, at 9.1bn litres.

Cheese continues to be the preferred product stream with available milk supply. In the full 2017/18 season, cheese production expanded by 9%, with total production reaching 360,000 tonnes. Output of whole milk powder also saw volumes increase – lifting 30%, to 83,000 tonnes. Australian dairy exports expanded by 5.7%, to 842,000 tonnes, in 2017/18.

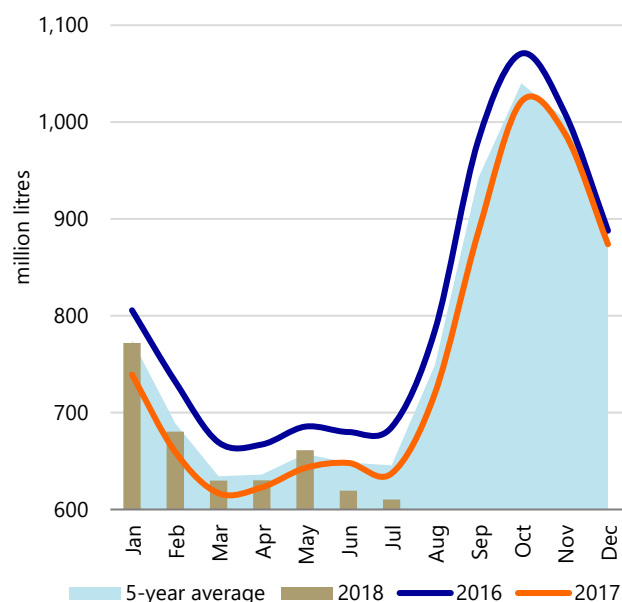
There has been no shift in farmgate milk prices for the Southern export region. Based on Rabobank's forecast, commodity prices for the full 2018/19 season and a spot currency rate of USD 0.73, the full-year average commodity farmgate milk is AUD 5.90/kgMS.

In Northern Australia, Norco announced an AUc 5/litre increase in its milk price for September and October, to assist their drought-affected suppliers.

The local retail and foodservice channels continue to face some headwinds for dairy companies. Ongoing weakness in consumer spending has impacted the dairy case, and competition for shelf space remains strong. However, there are some reported bright spots across the dairy case.

Corporate activity in the Australian dairy sector stays apace as the industry continues to be going through a major period of transition. Saputo has completed the sale of the Koroit plant in Victoria, transferring ownership to Bega Cheese. At the same time, Bega Cheese is raising more capital to finance the purchase, but also with a purpose of future investments. Meanwhile, Kirin has announced a strategic review of the Lion Dairy and Drinks unit, which could potentially result in a sale of the assets.

Figure 7: Australian monthly milk production, Jan 2016-Jul 2018



Source: Dairy Australia, Rabobank 2018

Brazil

Brazilian milk production bounced back in June and July, after a sharp contraction in May during the truckers' strike. Initially, reports indicated that many farms were struggling to stay supplied with feed, which caused concerns regarding the cows' condition for the remainder of the lactation period. However, the actual impact on feed stocks was lower than what had initially been reported, and production recovered swiftly in June, bringing the contraction of Q2 2018 to just 3%. Despite some growth observed in July and August – mainly driven by much higher farmgate milk prices – production in Q3 2018 is set to end around 2% lower than the same quarter of 2017. Comparable production levels from last year are high, and farmers are still facing high costs for grains, which have accelerated after the devaluation of the real in recent weeks.

In terms of trade, imports continue to be affected by weak domestic demand and devaluation. Imports were down by 28% by volume in the first eight months of the year. Exports have had an even weaker performance thus far in 2018, with a decline of 50% in volume terms, which has helped expand the overall trade deficit.

Looking ahead, production is set to have a weak end to the year, with production anticipated to decline by 1% in Q4 2018, due to the high comparable levels from Q4 2017 and worsening margins for farmers.

Farmgate prices peaked in August and are already declining in September, as seasonal supplies increase in the later part of the year.

Consumer demand is still frail due to high unemployment and low economic growth, which will help keep farmgate prices at low levels in the coming months, also limiting production.

Rabobank expects overall 2018 production to end the year around 1% lower than in 2017, with local demand ending the year flat at best.

Argentina

Milk production advanced in Q2 2018 by 5% in volume over Q2 2017, due to the low comparable level and relatively good weather across key milk basins. However, a sharp devaluation of the peso in recent weeks has increased production costs, with grains becoming more expensive compared to the price of milk. As Argentina is a major exporter of grains and grain by-products, domestic prices tend to follow international prices for soy and corn in US dollars. The Argentine peso has devalued by 50% YTD, from a level of less than ARS 20/USD at the beginning of the year to around ARS 40/USD in September. The sharp devaluation

is helping fuel an already high level of inflation that could reach 40% this year, causing other cost inputs (labour, fertiliser, equipment, etc.) to increase in addition to grains. Meanwhile, farmgate milk prices are not keeping up with the higher cost of grains in recent weeks, and at ARS 7.40/litre, Argentina's farmgate milk price is probably the lowest among exporters, at USD 0.19/litre.

A recovery in production and sluggish domestic demand have fuelled exports from Argentina. Export volumes were 34% higher for the first seven months of the year, compared to the same period in 2017. Domestic demand is struggling with rising inflation and a weakening economy – and as a result, higher production this year and a favourable exchange rate are helping exports to grow.

The Argentine government has announced new export tariffs in an attempt to improve its fiscal deficit and alleviate concerns on liquidity. Exporters will now have to pay an export tariff or ARS 3 for every dollar of exports. At the current exchange rate of ARS 40/USD, the tariff amounts to a 7.5% export tax. For now, the devaluation of recent weeks limits the tax's impacts on Argentine competitiveness. However, future inflation might make the tariff seem more expensive down the road and limit the country's competitiveness in export markets.

Looking ahead, the growth of Argentina's milk production is likely to slow down significantly in Q3 2018, to just 1.5%, stopping growth altogether in Q4 2018 (compared to the same quarters in 2017).

Higher feed costs are putting a brake on production output and are causing a significant number of small dairy farmers to leave the activity. The end of the southern winter will bring some relief to farmers, as alfalfa and grass become available, helping to reduce the dependency on grains for feed, thus slightly alleviating the costs of production.

India

Monsoon rains (for the season to date) have been normal in the key milk-producing regions, apart from a deficit in parts of Gujarat (West India), Karnataka, and Andhra Pradesh (South India). Milk production for the current year (March to April) is anticipated to grow between 4% to 5%, crossing 180m tonnes. Indian dairy will be entering the flush season as of the end of November, which will lead to an increase in milk supplies.

Demand for milk and dairy products is expected to receive a boost in the current quarter with the incoming Diwali festival season. This will also increase consumption of ghee and SMP, which is used for manufacturing Indian milk sweets. This will result in a small draw-down on SMP stocks.

The surplus of SMP in India has forced the government to provide export-linked incentives to reduce SMP inventories. The government has provided a 10% export benefit under the Merchandise Exports from India Scheme (MEIS) in the form of duty credit scrip. This benefit can be availed against imports, or this instrument can be traded with other importers. It is widely expected that this benefit will be raised to 20%. Also, the Maharashtra and Gujarat state governments have proposed benefits of INR 50/kg of SMP exported, which translates to ~USD 700/tonne of additional benefit to exporters from these states.

The industry estimates that 15,000 tonnes to 20,000 tonnes of SMP have been contracted for exports so far – though the actual exported quantity may be ~25%. The industry is expecting that these volumes should double by March 2019 – factors include products nearing expiry and carrying costs driving some of the companies to sell off.

Raw milk prices have not changed significantly since Q2 and are expected to remain at that level for the incoming flush season. The Maharashtra state government is paying INR 25/litre (USD 0.35/litre) to farmers, an increase of 20% to 25% over farmgate cow milk prices in the state. The additional cost will be borne by the government and will be refunded to processors buying milk from farmers. This is intended to safeguard the interest of farmers in the state.

China

Average milk prices in China were 1% lower during most of Q3 compared to the prior quarter and flat year-on-year. But prices in US dollar-terms fell more significantly, by 7% with the rapid devaluation of the renminbi vs. the US dollar since April 2018. As a result, the competitiveness of domestically produced milk has improved compared to imported WMP (see *Figure 8*). Rabobank channel checks suggest that milk prices have been gaining more upward momentum, driven by seasonal factors in recent weeks.

Q2 2018 milk production started to accelerate, leading 1H production to grow by 1.1% YOY, based on the Ministry of Agriculture's raw milk production index.

Half-year results of four listed dairy-farming companies indicated an increase of 13% YOY in milk sales volume. The aggregate of these four represents about 7% of milk production volume in 1H 2018.

Demand for dairy products in China also remained robust during 1H 2018. Six listed downstream processing companies have reported a strong set of results, with aggregate domestic sales growth of near 16% YOY for dairy products (driven by premiumisation and volume growth) – although this has taken market shares away from smaller and regional players. This means an acceleration of sales

growth during Q2, particularly driven by the top two dairy players in China, on the back of aggressive marketing during the World Cup Soccer event, where a major Chinese dairy company was one of the sponsors. Restocking of infant milk products following the formula registration should also have contributed toward the growth in headline sales.

Rabobank is revising its forecast upwards for 2H 2018, to 3% YOY, from 2.5% YOY previously. We believe that better-equipped large farms (early investments in cooling) should drive volume during summer months, compared with a poor summer last year. This slightly lowers full-year production growth to 2% YOY (2.2% previously). We retain our production forecast of 1.6% for 2019.

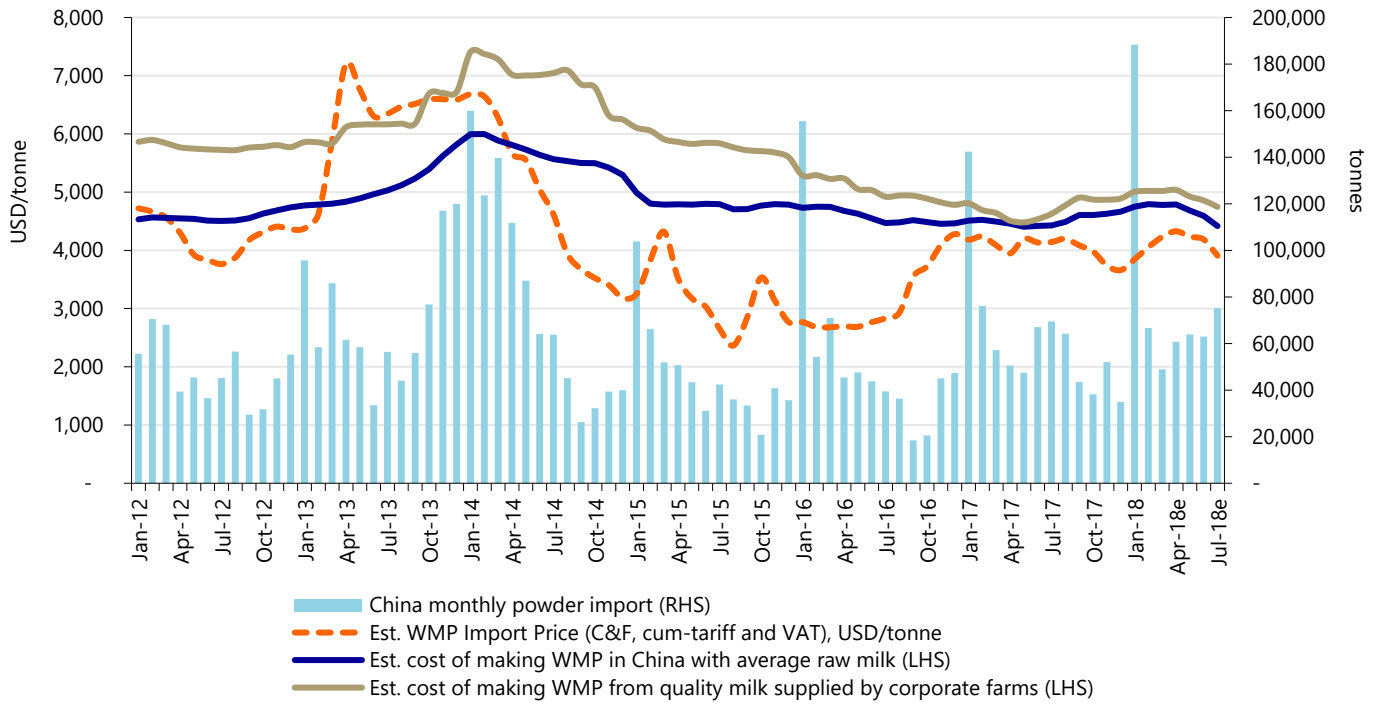
Rabobank reduces consumption growth to 1% in 2H 2018 (previously 2%), amid uncertainties surrounding the general economy, resulting from the trade war with the US, which will likely hit China's export sector to start with. This leads to a slower growth for 2018 overall, of 1.5% YOY (previously 2%).

Chinese trade data remains absent. Eurolait estimates China's dairy imports from data from main export regions, indicating about 11% YOY growth in Chinese imports in Jan-Jul 2018 (in LME) – average growth in WMP and SMP, very strong butterfat and infant formula imports, but falling cheese imports. The sharp devaluation of the renminbi vs. the US dollar from April to August (averaging 8%) may have dampened some interest in imports.

With production revised higher and consumption lower for 2H 2018, Rabobank expects China's 2H 2018 import needs to nevertheless remain buoyant, with a forecast growth of 16% YOY. The full-year growth forecast is slightly lowered, to 13% to 14% YOY (previously 16% to 17%). In 2019, the expectation of a slower 1.6% production growth, coupled with 1.5% consumption growth, should lead to the import needs rising at a much slower 3% to 4% YOY.

Reservations over production growth in the next six to 12 months could be rising if milk prices remain depressed – at a time when the cost of production is going up as a result of rising feed grain prices and the trade war with the US, which has put an additional 25% tariff on imported US alfalfa (on top of a lower CNY/USD exchange rate). Uncertainties in consumption and import lie in the extent to which the Chinese economy is negatively impacted by the trade war with the US, as well as the direction of the CNY/USD exchange rate.

Figure 8: China WMP import parity, Jan 2012-Jul 2018



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

Imprint

RaboResearch

Food & Agribusiness
far.rabobank.com

Mary Ledman	Global Strategist	mary.ledman@rabobank.com +1 312 408 8203
Michael Harvey	Australia	michael.harvey@rabobank.com +61 3 9940 8407
Andrés Padilla	Brazil	andres.padilla@rabobank.com +55 11 5503 6936
Sandy Chen	China	sandy.chen@rabobank.com +86 21 2893 4691
Peter Paul Coppes	Europe	peter.paul.coppes@rabobank.com +31 6 1324 5191
Saskia van Battum	Europe	saskia.van.battum@rabobank.com +31 30 712 3809
Richard Scheper	Europe	richard.scheper@rabobank.com +31 30 712 3788
Shiva Mudgil	India	shiva.mudgil@rabobank.com +91 22 2481 7724
Emma Higgins	New Zealand	emma.higgins@rabobank.com +64 3 961 2908
Tom Bailey	US	thomas.bailey@rabobank.com +1 212 916 7831
Aga Dobrowolska	US	aga.dobrowolska-perry@rabobank.com +1 314 317 8352

© 2018 – All rights reserved

This document has been prepared exclusively for your benefit and does not carry any right of publication or disclosure other than to Coöperatieve Rabobank U.A. ("Rabobank"), registered in Amsterdam. Neither this document nor any of its contents may be distributed, reproduced or used for any other purpose without the prior written consent of Rabobank. The information in this document reflects prevailing market conditions and our judgement as of this date, all of which may be subject to change. This document is based on public information. The information and opinions contained in this document have been compiled or derived from sources believed to be reliable, without independent verification. The information and opinions contained in this document are indicative and for discussion purposes only. No rights may be derived from any potential offers, transactions, commercial ideas et cetera contained in this document. This document does not constitute an offer or invitation. This document shall not form the basis of or cannot be relied upon in connection with any contract or commitment whatsoever. The information in this document is not intended and may not be understood as an advice (including without limitation an advice within the meaning of article 1:1 and article 4:23 of the Dutch Financial Supervision Act). This document is governed by Dutch law. The competent court in Amsterdam, The Netherlands has exclusive jurisdiction to settle any dispute which may arise out of or in connection with this document and/or any discussions or negotiations based on it. This report has been published in line with Rabobank's long-term commitment to international food and agribusiness. It is one of a series of publications undertaken by the global department of Rabobank Food & Agribusiness.

