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Supply Contraction and Chinese Buying Tighten the Global Market

Rabobank International

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- **March saw the upward phase of global dairy prices enter its ninth month and finally gain momentum.**
- **Upward pressure on prices was created in part by ongoing contractions in milk supply in export regions, as producers worldwide contemplated uninspiring milk prices and the Southern Hemisphere season turned bad.**
- **While demand remained weak in the EU and US, importers continued to search for increased quantities, led by a surge in Chinese buying.**
- **The strength of Chinese buying and the sharp deterioration in the New Zealand season created a huge premium for WMP over other product prices and for international market prices over domestic US wholesale prices.**
- **Despite a grim economic outlook, ongoing supply contraction in key surplus regions and incremental demand for product in import regions should prove enough to keep the international market tight through Q2.**
- **Dairy commodity prices are expected to trade above our target medium-term range in international markets through Q2 and Q3, before an easing of feed costs and a new Southern Hemisphere season enables the market to balance at somewhat reduced pricing in Q4.**

Prices

March saw the upward phase of global dairy prices enter its ninth month and gain momentum. Based on the gDT-TWI, by the first week of March FOB Oceania prices were up 20 percent on late December trading, and 54 percent off their trough in June 2012.

The value of the US dollar strengthened by around 2% on a broad index basis in the 3 months to early March, which is generally a negative for US dollar commodity pricing, underlining the strength of dairy market fundamentals.

The contraction evident in the Northern Hemisphere supply in Q3 2012 spread to the Southern Hemisphere export regions in early 2013. A combination of uninspiring returns, adverse weather and strong comparables caused production to fall below prior year levels in NZ, Australia, Uruguay and Argentina. By February, it appeared that the production engines of all major export regions in the world were in reverse.

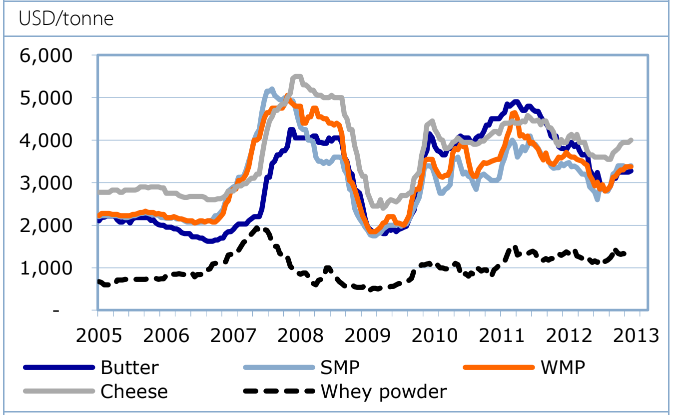
While the economic environment remained poor, some improvement in Asian economic activity and a contraction in Chinese milk supply did generate healthy demand for exportable product, generating the squeeze in FOB pricing in early 2013.

The US wholesale market moved to the beat of a different drum over the same period. Weak local demand, excess supply growth and imperfect linkages to export markets caused stocks to rise and prices to stagnate or fall in key commodity lines. US wholesale prices now sit significantly below FOB Oceania prices, creating an arbitrage opportunity in physical trade in the coming months.

A rebalancing of pricing on various fronts is expected in the coming months as sellers re-allocate milk to higher return product lines and buyers seek out discounted product. This will likely see the gradual narrowing of the current exceptional premiums to making WMP and reduce the discount of US wholesale prices to the global market. But the uneven nature of regional market dynamics at present may mean that normal relativities are not restored until late the year.

In a generally weak economic outlook, price direction in coming months will depend much on how long the current contraction in supply runs and the strength of import buying. The balance of evidence appears to support the case for international prices holding firm for at least six months.

Figure 1: Dairy commodity prices FOB Oceania, 2005-2013



Note: Whey is FOB in western Europe

Source: Rabobank, USDA, 2013

Supply side

EU

- Milk production remains depressed in the EU, falling 1.9% in December and 2.1% in January in YOY terms. Production was down in all key western European countries bar Germany. Production even fell marginally in Poland as producers sought to avoid overrunning their quota (quota year ends 31 March).
- Farmers were hampered by poor quality silage harvested during the cold and wet weather of the 2012 summer.
- Feed costs have remained high throughout the winter with concentrate costs and straight feed costs being between 20%-30% higher than a year ago, keeping the cost of producing milk high and farm profitability marginal.
- Farmers supplying export-oriented processors also saw milk prices fall early in the year as the EUR/USD exchange rate appreciated faster than US commodity prices.
- The contraction in EU milk supply has failed to spark a significant rise in local milk prices, partly as local consumption has been so weak.
- The combination of falling employment, declining real wages and tax increases appeared to take their toll on EU consumers through the closing months of 2012. Available data suggest that consumption of drinking milk across the EU fell to 0.2% in the three months to December, with German sales declining through January. Cheese consumption appears to have declined 1% in the three months to December. Yoghurt and infant formula sales volumes have been declining for some time.
- The lack of domestic market growth enabled EU exporters to boost outgoing shipments in the three months to November 2012, despite falling milk production, before shipments finally fell below prior year levels in December.

Figure 2: Milk production growth in key export regions, Nov 2012-Jan 2013

YOY percent change

	Jan-13	Nov 2012 through Jan 2013
EU	-2.1	-1.8
US	0.5	1.1
NZ* **	-5	1.8
Australia	-5.5	-1.8
Argentina	-9.4	-10.3
Brazil	4.9	5.9
Total*	-0.7	0

*Rabobank estimates, **The three months up to and including Feb

Source: Alimentos Argentinos, AMI, CEPEA, DA, Rabobank, USDA, 2012

- Looking ahead, Rabobank expects that EU milk production will continue to trail prior year levels in the coming months due to tight margins and a lack of quality feed until spring is well underway. Production is forecast to come in 0.7% below prior year levels in 1H 2013.
- The stress this causes locally will be limited by a further small contraction in EU consumption over the same period, amidst a further contraction in the economy and a push further into record numbers of unemployment.
- Nonetheless, EU processors are likely to have less product to export in 1H 2013 than they did twelve months earlier.

US

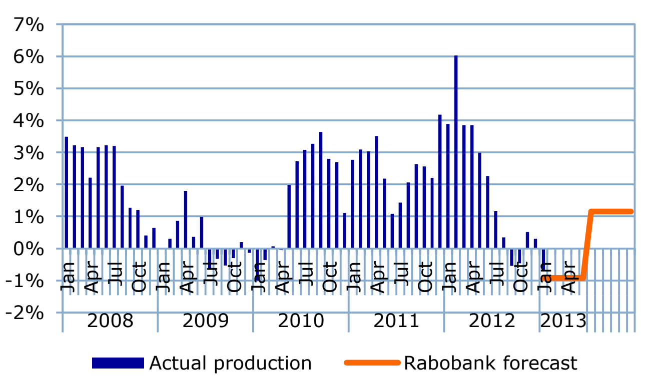
- US milk supply was up 1.1% YOY for the three months to January.
- A drought-induced rally in US wholesale market prices fed through to higher US producer margins in Q4, bringing at least a temporary end to the slow herd reduction evident in the preceding six months, with cow numbers in January marginally up on October levels. Even in California, where margins have remained negative, the herd in January was only 2,000 head below prior year levels.
- Slaughter rates appear high, but have been boosted in part by cattle entering the US from Canada, where two significant slaughterhouses have closed.
- Yields have also risen, partly due to herd replenishment in 2012 from a strong heifer pipeline.
- Unfortunately for US producers, supply expanded at a faster pace than the domestic market could handle. Local consumption appears to have hit a soft patch in late 2012/early 2013.
- With domestic prices trading well above international prices in late 2012, the US also saw a wave of opportunistic importing and falling interest in exports (which were down 7.3% YOY in milk equivalent terms for the three months ending in January).
- The combination of rising milk production, soft domestic sales and reduced exports resulted in stocks of cheese and NFDM jumping in December, but from low levels. January cheese stocks looked comfortable, though excess NFDM inventory had clearly accumulated.
- Mounting domestic supply has pushed local wholesale prices back down, squeezing producer margins again in early 2013.
- Margins remained particularly tight in California and the Southwest, where milk prices are lower and reliance on bought-in feed higher.
- Rabobank expects the lack of margins in several key regions to keep US production below prior year levels in 1H (-0.4% YOY).
- Local consumption should improve fractionally over 1H, largely off the back of recent gains in employment.
- Improving local consumption, together with arbitrage opportunities in international trade, should enable the US to clear excess stocks by the middle of 2013, bringing domestic prices closer to those offshore.
- Export trade will remain heavily constrained by falling local supply, with the US in all likelihood shipping less to the international market in 1H 2013.
- The US export engine will likely restart in 2H 2012. Milk prices are expected to rise and feed costs to fall as a better local crop is harvested. This should restore decent producer margins and generate enough of a supply response to again build shipments abroad.

New Zealand

- What had been an extremely productive supply season in New Zealand turned bad in February.
- Hot and dry conditions gripped the North Island (where around 61% of the country's milk is produced), impacting pasture growth. With milk prices too low to justify supplementary feed purchases for many, and with an eye to maintaining cow condition for the 2013/14 season, many cows are being dried off early.
- While the herd is not expected to see a disproportionate reduction by season's end, cull cows are being trimmed early as farmers look to maximise the use of scarce feed heading into autumn. National cow slaughter was up almost 40% (45,000 head) in the four months to January in YOY terms.
- South Island production has held up better due to better weather, irrigation support (in Canterbury) and the underpinning contribution of production from recent farm conversions.
- At the national level, milk supply has been falling below prior year levels since February by an increasing margin with each week that passes.
- Rabobank expects that milk production will fall even further behind the exceptional prior year comparables over the remainder of the season. March has been dry and in the North Island any rain that may fall now will arrive too late to have any significant impact on milk supply. Milk flows may be as much as 15%-20% below prior year levels through Q3.
- Lower milk production flows will exacerbate the seasonal decline in NZ exports in the coming periods. Q2 2013 volumes are likely to be modestly lower, but Q3 2013 will be heavily impacted.
- Despite the difficult end to the current season, NZ should start the 2013/14 season in decent shape. New season price forecasts from processors are likely to be higher and cows should be in good condition. But with a strong NZ dollar, high production costs and increasingly onerous environmental legislation, the rate of milk supply growth is expected to come in below 2% in 2H 2013 on the strong comparables of the prior year.

Figure 3: Milk production growth 'Big 7' exporters (actual and Rabobank forecast), 2008-2013

YOY percent change



Note: includes EU, US, NZ, Australia, Brazil, Argentina and Uruguay

Source: Rabobank

Australia

- As in New Zealand, the Australian milk production season has taken a turn for the worse in recent months.
- National production was down 5.5% YOY in January as flooding impacted the northern dairy regions and hot dry conditions hampered output in the southern export regions.
- Cash flow remains very tight for dairy producers, with reduced farmgate milk prices and high supplementary feed costs adding to the pressure. A recent round of farmgate milk price step-ups will assist cash flow marginally but milk production remains a breakeven scenario this season.
- So far this season, Australian processors have predominantly focused on cheese production rather than WMP. Year-to-date output of cheese is 0.8% higher, while WMP production is running 23% below year-ago levels. Production of most other commodities is largely unchanged.
- Between July and December, Australian dairy exports were running 9.5% higher than year-ago levels. Over this period, SMP exports were 42% stronger (at 88,000 tonnes) suggesting this year's output has mostly been sold. Total cheese exports reached 85,000 tonnes, 3% up on the same period last year.
- As the season winds down, milk volumes are likely to come under further pressure unless weather conditions improve. Farmers are in need of a strong early autumn break.
- Rabobank expects Australian milk production to come in just 0.7% above prior year levels in 1H 2013. With most export supply now sold, trading activity will be quiet until the new selling season begins.

Brazil

- Defying trends evident in most other export-linked regions, Brazilian production advanced strongly in the three months to January 2013. Economics of farming improved marginally in January, with a small milk price rise and softening feed costs. But the primary drivers of growth appear to have been favourable weather and weak year-ago comparables.
- Rising milk supply and increased cheese production may partly explain the significant YOY drop in cheese imports over the same period. However, powder imports were again well up.
- After a positive start to the year, conditions for milk production appeared to deteriorate in some regions as Q1 progressed. Weather conditions were particularly tough in the northeast, where production was affected by drought. Though this was likely offset by gains elsewhere, especially in the south.
- Rabobank expects milk production to continue to grow in the coming months, but at a slower rate than earlier in the year, coming in around 1%-2% up for 1H 2013 as a whole.
- Early reports suggest that farmgate milk prices moved higher in February and early March. Prices are expected to remain high at least until May due to local market prices and gains in international prices.
- At a time when sugarcane and soybeans, among other crops, are providing healthy margins to farmers, some milk producers are considering reducing their exposure to dairy in favour of other crops, in particular those with low levels of technology. Some investments have been put on hold.

- Domestic demand is expected to pick up modestly in 2013 as an improving economy offsets the impact of rising retail prices.
- This will likely bring a further increase in Brazilian import demand for the period. However, the potential upside in incoming shipments is limited by regulations.
- Import controls have been renewed for 2013. Quotas on Argentine imports were fixed at 3,600 tonnes per month until January 2014. However, if Brazil were to import more than 7,200 tonnes from Mercosur in a given month, the Argentine quota would move up to 4,000 tonnes automatically.
- Anti-dumping measures that include taxes on imports from New Zealand and the EU were also extended for another five years. Local producers are adding pressure on the government to tax and limit Uruguayan imports, which increased by 50% in 2012 to USD 220 million, but so far no measures have been announced.

Argentina

- The contraction in Argentine milk supply evident since August has continued and accelerated in the early months of 2013, with January and February production down by 10% YOY.
- High grain prices and general cost inflation have reduced the incentives to produce milk this season. The milk price/cost ratio in 2H 2012 was at similar levels to those of 2009, one of the worst years for dairy in recent history. Excessive rain has also damaged the pasture base.
- With milk supply falling and better returns available on the domestic market, exports fell 26% YOY in the three months to January.
- Farmgate milk prices improved in early 2013, following the positive trend in international dairy prices. But the returns to milking remain uninspiring. Rabobank expects production to continue declining for the rest of 1H, though at a diminishing rate as comparables become less demanding.
- While retail price inflation is running at over 25%, local dairy consumption appears to be holding up, and in an election year, will probably continue to do so.
- This will see the volume of production available for export continue to fall through Q3 2013.
- We remain relatively bearish on the prospects for strong recovery in milk supply in 2H 2013, given ongoing cost issues and the failure of expected investment in drying capacity to materialise.

Demand side

The demand side of the global dairy market remains a tale in two parts, and in recent months, both have disappointed.

The EU and US, which account for a third of all global dairy sales, remained stuck in an economic rut. The US economy was stagnant in Q4 with consumer spending still clearly impacted in the new year by rising fuel prices and the end of the payroll tax cut. The EU economy contracted again in Q4, with consumers battling rising (and now record) unemployment and tax increases.

In relatively mature dairy markets, such economic headwinds are proven enough to blow out any flickers of hope for meaningful consumption growth, despite the best efforts of innovators and marketers.

Weak economic fundamentals in the US were compounded by rising retail dairy prices through late 2012. Local dairy consumption appears to have expanded by an anaemic 1% YOY in Q4 in LME terms, with ongoing growth in foodservice cheese and yoghurt sales offset in part by falling sales of retail cheese, fluid milk and infant formula.

Having held up well in 1H 2012, EU consumption appeared to deteriorate in Q4, with available data suggesting that domestic consumption actually fell in the last three months of the year in LME terms. Liquid milk sales appeared to fall 0.2% YOY in the three months to December, cheese sales appear to have contracted by 1%, and sales of formula and yoghurt continued to fall at low single digit rates.

The difficult sales conditions in the US and EU were reflected in the earnings reports of publicly listed dairy companies on both sides of the Atlantic in the opening months of 2013.

The other part of the global demand tale features the emerging markets. While many of these economies are still growing at mid-single digit rates, Q4 proved disappointing when compared to recent performance. Chinese growth may have slightly improved, but India and Indonesia posted the lowest quarterly growth in years, Russia remained a weak spot and Brazil barely grew at all.

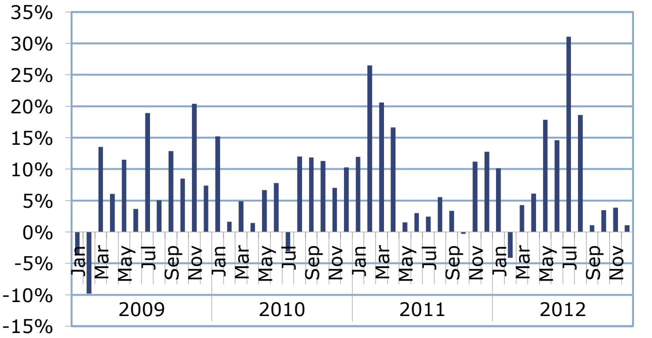
Available data and company reports from these markets suggest that dairy consumption is rising less quickly than twelve months ago, but it is expanding nonetheless.

Slowing demand in emerging markets, together with some forward buying in Q3, in turn reduced the pressure to import in Q4. International shipments rose just 2.7% YOY, compared to the double digit growth registered in the previous six months.

The main engine behind trade growth was yet again China. Imports rose by a staggering 30% in Q4 in YOY terms and 68% in the first month of 2013. With consumption still rising and a bad winter pushing local milk production below prior year levels, China clearly needed more product from the world market. But buyers have also likely bought forward in the face of the NZ drought. Moreover, importers may also have been rushing to clear product required for 1H 2013 before a change in legislation regulating the inspection and quarantine of imports kicks in on 1 May, lest its implementation be accompanied by any hiccups.

Figure 4: Change in export volumes for 'Big 7' exporters

YOY percent change



Note: Includes NZ, EU, US, Australia, Argentina, Uruguay and Brazil

Source: Government Trade Agencies of "Big 7", Rabobank

It is difficult to envisage a sharp improvement in global dairy consumption over the next twelve months, with the most likely scenario being anaemic growth in the west and below trend growth in emerging markets.

Rabobank expects no growth from the combined EU and US markets in 1H, with a decline in the former offsetting fractional growth in the latter. Employment growth and improving sentiment in the US, and improved conditions in the EU will bring improvement in 2H, but on aggregate, less than 1% growth.

Emerging markets should grow quicker than the west and faster than they did in late 2012. The economies in these regions will recover somewhat faster, particularly now that China appears to be in recovery mode. Medium-term trends supporting dairy demand growth, including population growth, income growth and dietary shifts, also continue to tick along.

With significant milk production growth proving generally elusive in deficit regions, growth in demand should continue for additional imports through 2013.

The recent explosion of Chinese import buying will ease back, with an unusually large degree of forward buying assumed to have taken place in recent months. But other buyers will likely take up the slack.

Outlook

Rabobank expectations

- The global market tightened considerably in mid-March, and looks set to remain tight through the next six months.
- As anticipated, the back end to the Southern Hemisphere season has been poor, exacerbated by the arrival of extreme weather in several regions, particularly in NZ.
- With the weak close to the Southern Hemisphere season expected to overlap with a weak Northern Hemisphere supply peak (in May), total milk production in export regions will fall below prior year levels in 1H 2013.
- Lower milk production will not be much of a problem in surplus regions, where demand remains weak, but it will reduce supply availability for the international market (even after accounting for stock sales from the US).
- While Chinese buying will inevitably slow somewhat in the coming months, buyers in other import regions will be looking for additional supply to top up local market requirements.
- The quest for additional supply should ensure a tight global market environment through Q2 and Q3, before a new Southern Hemisphere season and an easing of global feed prices enables the market to balance at somewhat lower prices in Q4.
- The sharp divergences in prices evident between different product lines and regional markets should slowly abate as 2013 progresses.
- In particular, US wholesale market prices, significantly discounted in early 2013, should move back to lower discounts by mid-year as the global market tightens and US stocks are cleared.
- But regional market rigidities will likely ensure that normal relativities are not fully restored until late in the year.

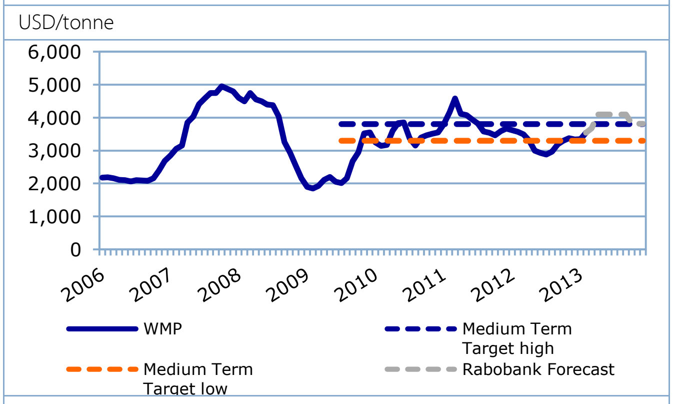
Upside influences

- We remain bearish on EU and US consumption prospects, factoring in net growth of zero in consumption from these two giant markets in 1H. If either outperforms expectations, less product will be available for export, contributing to more market upside.
- We assume a better Northern Hemisphere crop year will unleash the potential of widespread planting of grains and oilseeds, driving down global feed costs in Q4. Another poor crop would generate further market upside.

Downside influences

- An early and favourable spring in the EU would boost EU milk supply in Q2 2013, limiting the contraction in EU exports during the period.
- We factor in a further improvement in emerging market economies in 2H. If the recovery stalls, import demand will be less strong also.
- We are assuming other import buyers have been squeezed out of the market by China in recent months and will come back when possible. If rather than being squeezed out, they simply require less product, there is further price downside.

Figure 5: WMP FOB Oceania (historic and forecast)



Source: Rabobank forecasts, USDA,

Figure 6: Quarterly Dairy Commodity Prices (historic and forecast)

		Q4-2011	Q1-2012	Q2-2012	Q3-2012	Q4-2012	Q1-2013	Q2-2013	Q3-2013	Q4-2013
World (FOB Oceania)										
Whole milk powder	USD/tonne	3,573	3,554	3,075	3,004	3,338	3,679	4,100	4,100	3,813
Skim milk powder	USD/tonne	3,390	3,323	2,865	3,036	3,388	3,611	3,792	3,848	3,694
Butter	USD/tonne	3,900	3,804	3,240	2,982	3,263	3,593	3,845	3,806	3,616
Cheddar cheese	USD/tonne	3,996	4,036	3,642	3,650	3,958	4,018	4,179	4,179	3,970
Sweet whey powder	USD/tonne	1,292	1,304	1,160	1,261	1,344	1,348	1,281	1,281	1,255
US (AMS announced)										
NFDM	USD/lb	1.46	1.36	1.16	1.28	1.51	1.56	1.57	1.67	1.62
AA butter	USD/lb	1.72	1.50	1.40	1.74	1.75	1.53	1.65	1.68	1.59
Block cheddar	USD/lb	1.77	1.53	1.54	1.76	1.96	1.70	1.72	1.75	1.68
Whey powder	USD/lb	0.64	0.64	0.54	0.54	0.64	0.64	0.64	0.62	0.59
Class III milk	USD/cwt.	18.62	16.28	15.53	17.80	20.17	17.90	18.13	18.32	17.47
Class IV milk	USD/cwt.	17.72	15.94	13.97	15.87	18.34	17.74	18.32	19.28	18.48

Source: AMS, Rabobank forecasts , USDA

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