Dairy Quarterly Q3 2019

Cautious Growth Keeping the Markets Firm

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Summary

- Despite global dairy prices remaining at relatively high levels, dairy farmers in most export regions have struggled to convert improved market conditions to production growth. Production across the Big 7 exporters in Q2 2019 fell 0.05% versus Q2 2018.
- With weakened supply growth, volumes of globally-traded dairy products slowed through the second quarter of 2019 to 8% versus 2018, down from the 18% growth realized in Q1.
- There is a noticeable slowing of global economic activity and confidence is waning. Uncertainty remains a key adjective as we move into 2020, which is affecting consumers and dairy farmers alike.
- Trade tensions between the US and China have temporarily eased as China granted some limited exemptions to its tariffs for American products, warming talks which had become stagnant, and providing market optimism.
- The outlook for demand growth is more than enough to absorb the modest volumes of increasing milk flows, and the current general firmness in global dairy markets is expected to remain through mid-2020.

Regional Dairy Markets

EU

The effects of dryness through the summer months have limited feed quality and availability in key milk-producing regions of the EU. This will persist through spring, keeping a lid on EU milk supply growth.

China

Mild recovery in production and strong import growth has led to some stock building, considering stable consumption. This will result in lower 2H imports. Production growth in 2020, lured by higher milk prices, could lead to slower import growth on a high comparable base in 2019.

US

Cow numbers in the US declined through August, and strong culling enhanced cash flow. Higher milk prices in 2H 2019 and into 2020 are expected to stabilize the herd and boost milk flows by 1% YOY for the coming 12 months.

South America

Poor pasture and rising cost of production due to currency deflation has hindered milk production in Argentina and Uruguay. Conditions are set to improve, but due to local economic uncertainty, expansions remain limited through 2020.

New Zealand

Favorable winter and early spring weather across New Zealand provide outstanding conditions for the 2019/20 season. But near-term weather warnings are looming and any late inclement weather will impact production.

Australia

Australian milk production is expected to decline during the new season, despite strong price signals. Seasonal risks, and an ongoing squeeze on farmer margins due to high feed and water costs will delay any production recovery.

Global Summary

Since the last quarterly report, pricing dynamics for global dairy commodities have been uneventful, and the market has remained firm, but tension appears to be mounting. This is particularly true for cheese and powder prices, which have shown stability at relatively high levels (*see Figure 1*). Several constraints have prevented supply growth despite higher farmgate milk prices, and a warm summer is partially to blame, particularly in China and Northern Europe.

One dairy commodity that has seen some volatility is international butter prices. European butter prices have fallen over USD 700/mt since June due to reportedly high stocks. Oceania butter prices have responded more dramatically shaving off over USD 1,600/mt since June. Global buyers appear temporarily satisfied with current butter volumes on hand. Meanwhile, strong demand and limited supply growth in the US has kept NDPSR butter prices firm, falling just 4% over the same period.

Demand for dairy imports has been good, increasing by 8% year-to-date through July on a total product-traded basis. Chinese growth has exceeded expectations, with aggregate WMP and SMP import growth up 28% YTD through July versus 2018, but has resulted in rising Chinese stocks.

Economic risks highlighted in previous quarterly reports are turning to reality. China posted its weakest year-on-year GDP growth in 30 years through Q2 2019 versus 2018, and Southeast Asian markets have been impacted. Similar challenges face the EU, as Germany saw its economy contract in Q2 compared with last year, a worrying sign for a market facing other challenges, with a possible challenging end to Brexit. The European Central Bank responded by lowering rates by 0.5% and announcing an open-ended quantitative easing of EUR 20bn a month as recession risks rise. The US has also shown some concerning data, the treasuries 2-10 year yield curve finally inverting fueling speculation of an impending recession.

Despite worsening economic conditions, international SMP, WMP, and cheese prices remain firm through Q3, but still below averages since 2013, at USD 2,694/mt, USD 3,219/mt, and USD 3,811/mt, respectively, and well-below highs exceeding USD 5,000/mt experienced in 2013. The lower price volatility experienced in recent years for SMP and WMP has taken the urgency away from buyers to forward-contract large volumes. The impacts of this have been challenging for traders, resulting in a reduction in the number of trading houses. Fewer traders have left a gap in buffer volumes for end users, particularly for SMP and WMP, resulting in greater risk in price volatility as a surge in buying, particularly in today's low milk output growth environment, could create a significant upswing in pricing and vice versa to the downside if a surge in product availability results in more direct offloading to end users and pushing the market lower.

As we move through the remainder of 2019 and into 2020, it is clear that the market is tighter than Rabobank previously expected, as producers have been even more constrained than foreseen, and demand has remained robust in the face of trade troubles and a global economic slowing. These trends have persisted and there is an increasing chance of market firmness turning to pricing upside as we move forward, primarily due to a lack of supply expansion.

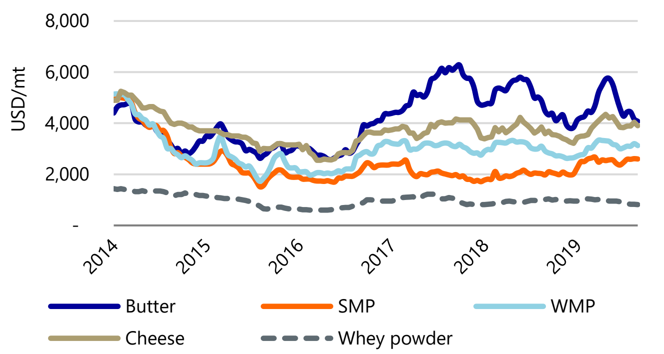
The Big 7 export markets look to have combined growth in milk supply of just 0.4% in Q4 2019 which is still below the three-year average growth rate of 0.5%. As we head into 2020, production growth looks to increase to 0.8% due more to weak comparables than genuine on-farm expansion (*see Figure 2*). Despite farmgate prices, which are generally above breakeven around the world, expanding supply will be a challenge. Respective regional markets each have their own challenges: rising costs of production, lower confidence, capacity constraints, and environmental regulations have, and will continue to, limit farm-level expansions and keep the broader market firm.

Demand will continue to expand on par with recent levels through mid-2020 despite increasing economic challenges. China may be the exception where aggressive purchasing through the first half of 2019 has led to stock accumulation, and we expect some slowing of purchasing in the coming months. However, with an early Chinese New Year in 2020, there might be some unexpected purchases earlier than normal. Other import markets that have been on the sidelines – the Philippines and Algeria realized weak Q2 year-on-year import growth of 0% and -29%, respectively – are overdue to come back into the market.

Trade wars remain a logistical headache for dairy exporters although they are unlikely to have a significant impact on the mass balance of product flows over the next 12 months. The global dairy market has become more liquid in recent years, allowing flexibility in supply.

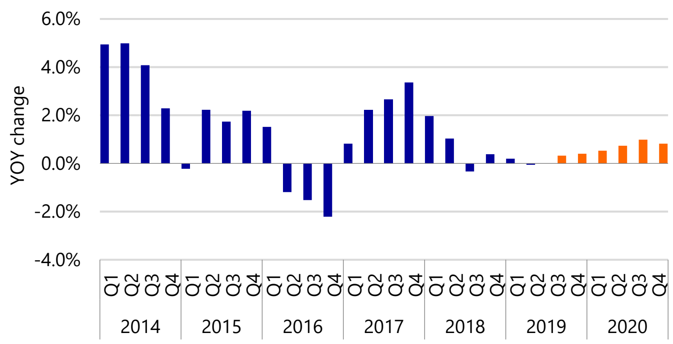
Overall, the global dairy market looks set to remain firm through the coming six months before supply is able to get out ahead of demand growth, at which point we might see some downside pricing pressure.

Figure 1: Dairy commodity prices, FOB Oceania, 2014-2019*



* Whey is FOB in western Europe.
Source: USDA, Rabobank 2019

Figure 2: Milk production growth, Big 7 exporters (actual and Rabobank forecast), Q1 2014-Q4 2020f*



* Big 7 includes EU, US, NZ, Australia, Brazil, Argentina, and Uruguay.
Source: Big 7 government trade agencies, Rabobank 2019

What to Watch in Q4 and Q1

Trade Wars Spreading

Trade tensions have remained an issue since our last quarterly. Most recently, trade challenges have arisen between the EU and Indonesia. The EU is looking to impose anti-subsidy duties on Indonesian palm oils used in biofuels. Indonesia is looking to respond by increasing tariffs on an undisclosed range of EU dairy products by 20%-25%. The effects of the US and China trade war have begun to show signs of pressure and China has backed US agricultural purchases in a welcome warming of trade talks.

African Swine Fever (ASF)

As outlined in Rabobank's recent ASF global update - hog losses in China have reached critical levels, surpassing the world's ability to make up the difference. As ASF spreads further, the disruption will intensify. The effects of the ASF epidemic are increasingly looking like a multi-year and multi-region issue that will likely bring structural change to global animal protein markets. At the time of writing, it appears that rising milk prices in China have offset increasing beef prices, leaving farmers continuing to milk today and consider culling at a later point in time. However, a sudden spike in beef prices would cause China to import more dairy products.

Global Economy

A global recession in the second half of 2020 is now the base case for the Rabobank Global Economics team. The signs of a recession are rising with the European Central Bank lowering rates and announcing quantitative easing. Rate cuts are likely to continue into 2020 as central banks try to stimulate waning growth and prevent a full-blown recession from emerging. Rabobank's quarterly dairy product forecasts (*see Table 1*) do not assume a recession scenario. However, historically during recessions, dairy product prices have declined by 20% to 40%.

Margin Pressure

Dairy operations throughout most dairy export markets have experienced rising production costs for various reasons. US farmers face rising labor costs. Europeans have feed challenges, and increasing environment-related costs, as do dairy farmers in New Zealand. Rising costs are adding financial pressure to dairy farmers, who, after years of low milk prices, could use some relief. In the US, farm exit rates remain above average, and in New Zealand, farm conversions to dairy have all but ceased.

Table 1: Quarterly dairy commodity prices (historic and forecast), Q3 2018-Q4 2020f

		2018		2019				2020			
		Q3	Q4	Q1	Q2	Q3e	Q4f	Q1f	Q2f	Q3f	Q4f
Butter											
Europe	EUR/mt	5,536	4,672	4,332	4,113	3,725	3,825	3,875	3,875	3,950	4,000
US	USD/mt	5,035	4,991	4,977	5,091	5,126	4,850	4,830	4.915	5,050	4,960
Oceania	USD/mt	4,782	4,038	4,482	5,350	4,330	4,100	4,000	4,100	4,100	4,200
Cheese											
Europe (Gouda)	EUR/mt	3,108	3,190	3,101	3,087	3,085	3,100	3,125	3.150	3,150	3,150
US (Cheddar)	USD/mt	3,450	3,225	3,174	3,700	4,190	4,225	3,875	3,770	3,880	3.970
Oceania (Cheddar)	USD/mt	3,682	3,375	3,688	4,154	3,900	3,950	3,750	3,750	3,800	3,800
Dry whey powder											
Europe	EUR/mt	804	829	867	813	710	715	715	715	715	715
US	USD/mt	814	1,013	990	834	809	808	790	740	760	770
Skim milk powder											
Europe	EUR/mt	1,547	1,612	1,868	1,993	2,100	2,150	2,150	2,175	2,175	2,200
US	USD/mt	1,799	1,956	2.124	2,221	2,295	2,375	2,380	2,425	2,475	2,400
Oceania	USD/mt	2,036	2,017	2,528	2,502	2,500	2,550	2,450	2,550	2,550	2,550
Whole milk powder											
Europe	EUR/mt	2,808	2,726	2,827	2,929	2,880	2,825	2,800	2,850	2,850	2,800
Oceania	USD/mt	2,954	2,675	2,982	3,206	3.100	3,000	2,900	2,900	3,000	3,000
South America	USD/mt	3,090	3,020	2,882	3,000	3,180	3,100	3.000	3,000	3,100	3,100

Source: US NDPSR, Rabobank 2019

EU

Dryness and soil moisture deficits through parts of the EU – including regions in Germany, France, the Netherlands and Poland – continued to hinder EU milk production growth through June, which remained flat with only minor growth in the seven main milk producing countries (+0.3% YOY). For July, based on preliminary figures, we expect a growth of less than 0.5% YOY (*see Figure 3*).

As a result, EU milk production for Q2 2019 finished 0.5% (218,000mt) above the same period last year. In 1H 2019, the most significant growth in volume terms was recorded in Ireland (+394,000mt or +10%), the UK (+223,000mt or +2.9%) and Poland (+139,000mt or +2.3%). Milk production growth in Germany (-76,000mt or -0.5%), France (-139,000mt or -1.1%) and the Netherlands (-195,000mt or -2.7%) remained negative in the same period.

With the results of June in, EU milk production is now up 0.3% YTD. On a milk solids basis, EU fat production increased by 36,300mt (+1.1%) in 1H 2019, while milk protein content grew by 37,500mt (+1.4%). The first and second cut of grass silage were still relatively high in quality and volume across Northwest Europe, especially compared to last year. Nonetheless, low opening roughage stocks from last season and limited grass growth in recent months, moved dairy farmers into using this silage and alternative feed sources instead of building winter stocks. This has led to rising feed costs on farm and a tightening of cash margins.

Compared to June, average EU milk prices inched up by EUR 0.09/100kg to EUR 33.51/100kg in August. This is mainly due seasonal 'summer' premiums in some countries. In France, milk prices jumped by EUR 1.71/100kg to EUR 35.71/100kg. In Ireland, milk prices fell by EUR 0.88/100kg to EUR 31.07/100kg, while German milk prices declined by EUR 0.29/100kg to EUR 32.93/100kg.

Nonetheless, the base milk price at most of the large dairy cooperatives in Northwestern Europe remained relatively stable during this period. For the remainder of 2019, Rabobank does not expect significant changes in the average EU milk price considering the current prices for dairy commodities and 'tight' market conditions.

Butter prices have remained complicated in recent months as buyers and sellers butt heads as to what the real story is. Falling prices have been pinned on rumors of high butter stocks, while many buyers appear to have covered most of their positions for the remainder of 2019 and start of 2020. Since the end of June, EU butter prices dropped by EUR 335/mt (-8.4%) to EUR 3,631/mt, which is EUR 30/mt below the FOB Oceania price. Rabobank expects that the butter floor has been reached for the year considering the competitive price in international markets and the slow trading markets through early summer. EU butter exports have picked up in July at +10,000mt.

EU cheese prices have been less dynamic in recent months, moving sideways during June through August. EU Gouda prices have moved lower by EUR 23/mt (-0.7%) sitting at EUR 3,073/mt. Meanwhile, the market for SMP has continued its upward momentum supported by export opportunities and competitive price in the world market.

SMP prices have increased by EUR 71/mt (+3.5%) to EUR 2,091/mt, which is still EUR 248/mt lower than FOB Oceania prices. EU whey prices fell by EUR 68/mt (-8.7%) to EUR 705/mt during the same period.

During 1H 2019, butter and SMP production increased by +2.6% YOY and +2.3% YOY respectively. Cheese production was flat at 4.8mmt. WMP production dropped by 2.4% YOY over the six months to June, however since May, more milk is flowing into WMP.

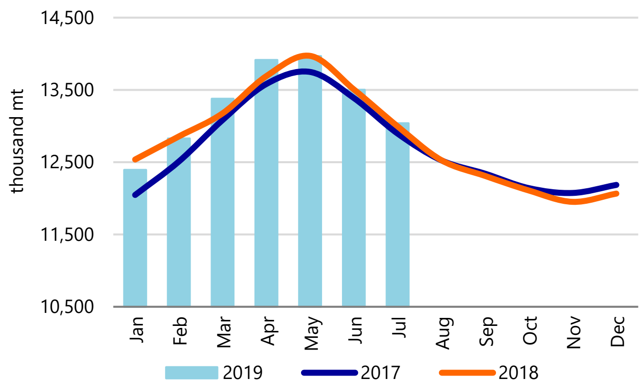
Supported by competitive world market prices, EU butter exports jumped 53% YOY for the three months to July, with main destinations the US, Saudi Arabia, Japan and China. EU SMP exports continued to flourish, with exports rising by 20% YOY in the same period. China's share of SMP exports is rising, while exports to Algeria are shrinking. EU cheese exports returned to growth in July (+9%), so for the three months to July cheese exports showed an increase of 1% YOY, while WMP exports fell by 10% YOY.

Looking further ahead to 2H 2019 and the opening months of 2020, Rabobank still expects to see the impact of the recent droughts on EU milk production. Despite some recent rainfall, soil moisture conditions are still far from normal. The flow-on effects will play an important role during the winter months as roughage stocks will be limited. Furthermore, the sentiment among dairy farmers and current margins do not provide an incentive to really push milk production.

Nevertheless, due primarily to low comparables in 2018, Rabobank forecasts EU milk production to grow by 0.9% in 2H 2019. This will result in a growth of around 0.6% for the full year 2019. Once again, the conditions during the start of the 2020 pasture season will be crucial for the growth of the milk production.

The Eurozone economy continues to lose growth, with the likes of Germany showing worrying signs. GDP growth contracted in Q2. Brexit and trade war tensions are also weighing on consumer confidence, which underpins slightly slower demand. As a result, Rabobank foresees EU dairy demand to grow at a modest rate of around 0.2% in 2H 2019 and into 2020. With supply growth remaining subdued, and demand growth remaining positive, the EU will have some incremental growth in terms of exports through 2020, which will fill demand growth in hungry import markets.

Figure 1: EU milk production, Jan 2017-Jul 2019



Source: ZMB, Rabobank 2019

US

Milk production was flat across the first half of 2019, compared to the prior year. Milk cow numbers continue to dwindle, falling by 14,000 head between May and June and another 9,000 head from June to July. In total, the herd stands at 9.31m head, down 82,000 YOY in July.

Since early 2019, US dairy prices have generally been firm, with some recent bullish activity as the block cheese spot price rose 10% in five days in early September, surpassing USD 2.20/lb (USD 4,861/mt), marking its highest level since 2014, and supported by relatively low stocks.

Milk prices have improved on a monthly basis, driven by the lack of supply growth. The US all-milk price for July at USD 18.70/cwt, is up USD 2.10/cwt from January and USD 3.20/cwt higher than July 2018. Combined with an improving outlook on feed costs, better margins are expected through year-end. However, a lack of available processing capacity and tight controls on additional milk from processors and cooperatives are preventing producers from expanding regionally. Those that are expanding are doing so by purchasing existing operations with an associated milk market.

Shifting gears to the demand side, US dairy product demand on a total solids basis (milkfat and skim solids) was up a slim 0.3% YTD July 2019 vs. 2018. Domestic demand was strong in Q2, growing by nearly 4%, offsetting a 18% YOY drop in exports, and pushing total US disappearance 0.9% above Q2 2018. However, facing higher YOY comparables, July demand growth was weaker, with domestic disappearance up just 1%, exports down 7.5%, resulting in total disappearance growth of a mere 0.05% YOY.

Q2 exports fell 18% versus 2018, partly a result of the ongoing trade battle with China but also weaker demand for whey products, as African Swine Fever continued to spread through China and into neighboring markets. US whey exports to China were down 55% through July, with total volumes falling over 100,000mt. But weaker exports have not been isolated to China and whey products. US nonfat milk powders (NFDM) were down 20% in Q2 and cheese exports were off 0.9%. US NFDM/SMP exports to Mexico have been favorable, with July exports increasing nearly 10% versus last year.

Overall, the weakened export activity from the US has been appropriate given the weaker milk flows and product production. US stocks have also managed to stay relatively low – as of July, NFDM stocks were 8% lower than 2018, cheese 3.5% lower (American -5.7%), and dry whey 16% lower. Butter stocks, up 3.6% YOY, have not proven burdensome, but prices have retreated from mid-year highs.

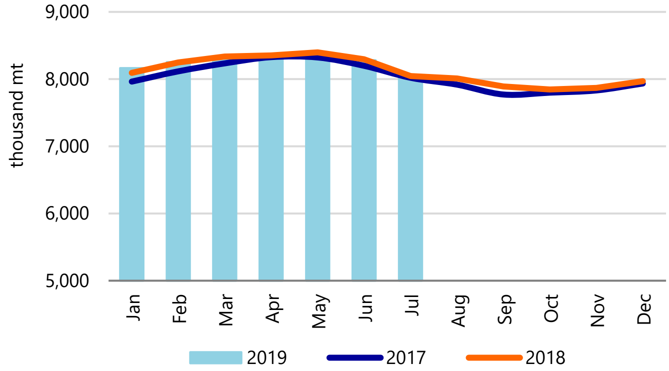
Déjà vu in retail demand with the same ups and downs. Processed cheese, fluid milk, yogurt, and ice cream were all down in volume terms, an average 1.4%, 3.7%, 1.1%, 3.1% respectively in Q2, according to IRI. Retail prices for each of these four products increased about 2% on average, which may contribute to lower sales. Conversely, natural cheese and butter prices declined by around 1% through Q2 2019, perhaps spurring already firm demand in both retail and food service. July and August natural cheese and butter demand was up on average or 3% and 4.6%, respectively. Food service sales increased 4.5% through Q2 2019 compared to 2018, utilizing large volumes of cheese and butter.

The US demand outlook is on track for a 0.8%-1% YOY growth through 2019, consuming over 40,000mt of new milk, mostly as cheese. This is based on stable retail trends. Weak fluid milk, yogurt, and processed cheese growth will continue to be offset by a strong demand for natural cheese and butter, bringing aggregate growth higher.

Food service demand is set to remain flat, however, US consumers may start to feel some pressure from the US-China trade war as higher tariffs ultimately reach general consumer goods. This may have a marginal impact on consumer spending which could hit away-from-home before retail spending.

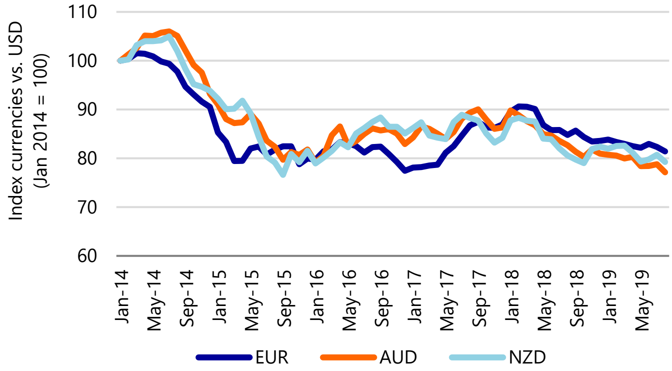
Looking into 2020, supply growth is forecast at 1% YOY, exceeding estimated demand growth of 0.8% YOY, resulting in a minor uptick in exportable surplus. The global market should easily absorb this increase in exports, leaving the US market in a well-balanced position through much of 2020.

Figure 2: US milk production, Jan 2017-Jul 2019



Source: USDA, Rabobank 2019

Figure 3: Exchange rates, USD vs. exporters, 2014-2019



Source: UDM Board of Governors of the Federal Reserve System, Rabobank 2019

New Zealand

In a theme very similar to last year, the new 2019/20 season got off to a flying start. Higher milk collections for June (+14%) and July (+5%) have resulted in another boost to the seasonal trough volumes (*see Figure 6*).

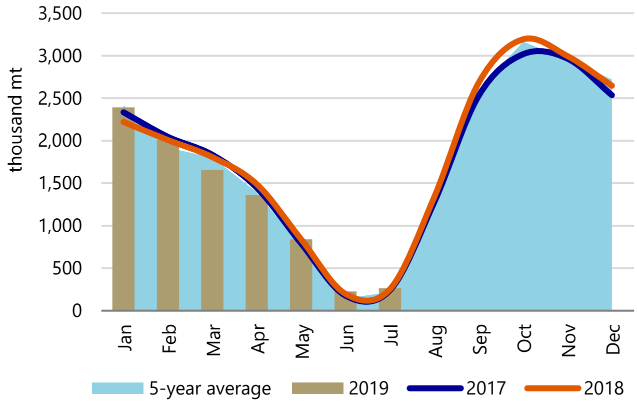
Export volumes for the three months to July 2019 were flat on the prior year period. Lower shipments to Algeria and SEA countries were offset by stronger exports to China and the US. Export volumes for the remainder of 2019 will depend largely on the strength of the spring flush. Export volumes for 1H 2020 will likely be lower than 1H 2019 due to anticipated weaker year-on-year milk flows in 2H 2019. There is also question as to how Chinese import quotas will be managed after NZ exports exceeded quota volumes last year.

With calving well underway, meaningful production volumes will start to appear as the weeks progress. Currently, it looks as though the season is shaping up to provide another healthy spring flush and first half of the production season.

A mild winter has made for near-perfect conditions on-farm in many dairying regions in the lead up to the spring peak. Pasture covers range from good to strong across the country, leading to ample feed reserves and early silage cutting in parts of the North Island. These conditions have helped to keep a lid on feed costs – an important fact given that cash flows have been tight over the winter period due to the nature of delayed milk payments in a seasonal system, combined with tax implications following a profitable 2017/18 season.

However, overshadowing these stellar conditions remains the threat of bumpy weather patterns over September and early October. NIWA have noted the risk of lingering cold temperatures and spring snowfalls in the South Island in particular, and should these forecasts come to pass, there will be an impact on grass growth and therefore milk production volumes – ultimately making it severely challenging to exceed last year's high spring volumes.

Figure 4: New Zealand milk production, Jan 2017-Jul 2019



Source: DCANZ, Rabobank 2019

Our base case scenario is that New Zealand's milk production for the 2019/20 season (ending 31 May 2020) will end up in the range of between -1% to flat growth compared to the prior season. However, if key dairying regions manage to miss the worst of the volatile spring weather, then it's possible that milk production could be in the range of 0%-1% growth for the full period to 31 May 2020.

Fonterra has held its 2019/20 farmgate milk price forecast range steady at NZD 6.25/kgMS to NZD 7.25/kgMS – a healthy milk price range for most farmers.

Farmers continue to find alternative feed sources to PKE for plugging any pasture gaps that might arise. While cost structures and a strong milk price forecast will enable farmers to purchase supplementary feed if any feed deficits arise in the second half of the season, there is still a risk to milk flows at the tail end of the season where the cost of feed outweighs the benefit.

The government recently announced new proposed regulations for fresh water. While much of the longer-term detail and potential cost is very unclear, the near-term certainty is that there will be a cost imposition for farmers from 2020 as part of the regulation's aim to improve on-farm practices such as winter grazing, stock exclusion and reducing nitrogen losses.

Based on global commodity price expectations across the remainder of the 2019/20 season, Rabobank forecast the farmgate milk price to remain at NZD 7.15/kgMS

Australia

The release of June data completes the picture for the 2018/19 season. National milk production in June 2019 showed a 7.4% decrease on June 2018, while national year-to-date was down 5.7%. It worth noting that there was a material revision to the data – mainly in the Northern Victoria numbers (*see Figure 7*).

For the season, national production declined by 5.7% to 8.795bn liters – with recorded falls in all regions. On a volume basis, basis, this represented a loss of 530m liters of milk from the system – with 50% of the falls from the Northern Vic and Southern NSW irrigation districts.

A number of key dairying regions in Southeast Australia have received good rainfall through winter. Weather risk lingers, with the current seasonal outlook from the Bureau of Meteorology suggesting a warm and dry spring ahead.

The new production season is underway, with record-high opening prices on offer across the Southern export region. Reported weighted average prices range between AUD 6.80/kgMS and AUD 7.20/kgMS including supplementary payments. This is welcome news for farm operators and offers cash flow support early in the season.

Based on Rabobank's current forecast for the commodity basket, and a spot currency of USD 0.67, our modelled annual average farmgate price is AUD 6.65/kgMS for the 2019/20 season.

Southern export milk prices being paid are sitting above this level, and are supported by dairy companies needing to reduce processing margins in an environment whereby there is intense competition for available milk supply.

In further good news for dairy farm operators – after a sustained period of discounting – the major retailers have all lifted the shelf price for segments of their private label milk. Some of this is flowing through to milk payments for suppliers.

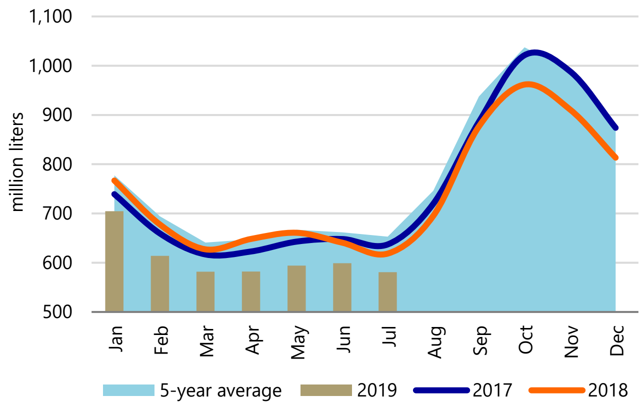
On a positive note, the strong price signals to farm operators has started to flow through to confidence levels. The latest rural confidence survey results from Rabobank show dairy clients are looking for improved margins. Importantly, investment confidence is also picking up.

Rabobank is still forecasting national milk production to decline in the 2019/20 season. The current forecast is for national milk production to fall another 3% – led by a further contraction in the Murray Irrigation District. Favorable seasonal conditions over spring will be critical.

The fundamentals of the Southern Murray Darling Basin (SMDB) market are not favorable for dairy operators. Opening allocations are low, and more rainfall and inflows are required to see any major improvement to 100% allocation. At the same time, demand is firm and allocation prices are trading near record levels at the start of the season.

There is relief for dairy farmers on the purchased feed front. Purchased feed markets remain elevated but have eased from recent highs. When coupled with milk prices, this has improved the milk income to feed ratios. Close attention from grain buyers will be on Australia's winter wheat crop when harvesting begins in the coming weeks.

Figure 5: Australian monthly milk production, Jan 2017-Jul 2019



Source: Dairy Australia, Rabobank 2019

On a volume basis, Australia dairy exports fell 2.6% in 2018/19 reaching 819,000mt. This is not surprising given the decline in milk intake. Liquid milk exports continue to set the pace in terms of volume growth with exports up 9% for the year to 237,000mt. Milk powder exports (SMP and WMP) were down 15% at a combined volume of 245,000mt.

Australian exporters will continue to face constrained exportable surpluses in the near-term. This will mean there is an ongoing prioritizing of the product mix and market mix.

Brazil

Brazilian dairy farmers have seen a significant reduction of margins since June. Following a first half of 2019 characterized by high prices and relatively low feed costs, gross milk prices declined from BRL 1.63/liter (USD 0.4/liter) to BRL 1.45/liter (USD 0.36/liter) and feed prices have increased through a weaker real.

Furthermore, a long dry season through August has impacted pasture growth in several regions, which has hurt feed quality and caused prices to rise.

As a result, Brazilian milk production growth has slowed dramatically from the 3% growth seen in 1H 2019 to closer to 1% in July.

With weaker supply growth, Brazil has seen imports increase in more recent months. Higher domestic milk prices relative to landed product have enabled imports to grow 2.5% in volume terms for August. This comes after a slow start to the year. The trade balance through the end of August, posted a deficit of 80,000mt, in line with the first eight months of 2018.

But demand in Brazil has struggled. The Brazilian economy has remained weak and GDP growth is projected to be less than 1% in 2019. Low growth has prevented unemployment from dropping faster, and dairy consumption remained low as a result.

The weak growth has been tough on dairy processors as it has prevented brand owners from passing on higher farmgate milk prices to final products. As a result, their margins have been squeezed, causing most UHT brands to operate under negative margins.

Looking forward, consumption is likely to show a moderate improvement in the second half of 2019 compared to the first six months of the year. A recent national pension reform should be approved by Congress in late September/ October, and is a positive step in improving conditions for economic growth, helping improve demand for dairy.

Conditions will remain challenging for Brazilian dairy farmers through the forecast period. The improving economic conditions and higher consumption is unlikely to help sustain farmgate milk prices. Brand owners will struggle to maintain retail prices due to their own margin pressure and, as such, will pass lower prices on to dairy farmers.

Also, due to the dry conditions over the last few months feed quality and storage remains low, which will weigh down on yields. Combined with a weakened real, import costs have risen. As a result of tight margins and lower yields, Rabobank expects Brazilian milk production to grow by just around 1.5% through the forecast period, a much slower rate than the 3% levels seen recently.

In terms of import demand, recent declines in the real will also impact the purchasing power of imports and, as a result, should limit imports in the second half of 2019.

Argentina

Argentine dairy farmers enjoyed an improvement in margins during Q2 2019 compared to Q1 that translated into stronger production. Farmgate milk prices per liter increased from ARS 9.6 in January to ARS 15.1 in June, and margins turned positive with a more stable exchange rate that helped keep feed prices in check.

Production accelerated from March onwards and recovered some of the Q1 declines, as farmers' finances saw a boost and Q2 output ended 3% lower than for the same period of 2018, after tumbling by 8% in Q1.

However, that period of relative stability came to an abrupt end with the primary presidential elections in August. The opposition candidate, Alberto Fernandez, surprised the markets, with voters leaning towards ousting the incumbent Macri administration in the upcoming October elections.

Fear of a return to populist policies, capital controls and fiscal expansion caused a sharp depreciation of the peso, which tumbled 23% against the US dollar the following day, with the stock exchange dropping an astonishing 48% on the same day. Since the elections, the currency has stabilized at around ARS 55 per USD, compared to around ARS 44 per USD before the elections.

This sharply weaker exchange rate has hit dairy farmers hard. With domestic soymeal and corn prices closely tracking CBOT prices in USD, farmers have to pay around 20% more per kg of feed, while milk prices are yet to fully readjust so that the impact is absorbed.

Meanwhile, inflation remains stubbornly high (close to 50%), impacting other production costs. The economy is in a recession, and that is leading to deteriorating local dairy consumption (expected to contract by at least 2% in volume terms during the first half).

The depreciation in August brought a considerable reduction in the purchasing power of farmers and a sharp worsening of margins, after a more stable and promising second quarter had allowed production to pick up from the lows of Q1.

High inflation, a recession, escalating feed prices, and contracting local consumption will all weigh on Argentine farmers through the second half of 2019 and likely remain a factor into 2020, as Argentina remains in a volatile and challenging period.

In terms of trade, exports were 13% lower so far in 2019 compared to 2018, which reflects the lower milk availability seen to date. With production set to continue shrinking at around 3% in the second half of 2019, exports are expected to end the year 10% lower than in 2018.

The processing sector is also facing challenges, with output down by 5% for the first eight months of the year, compared with the same period of 2018, according to official statistics published by the INDEC.

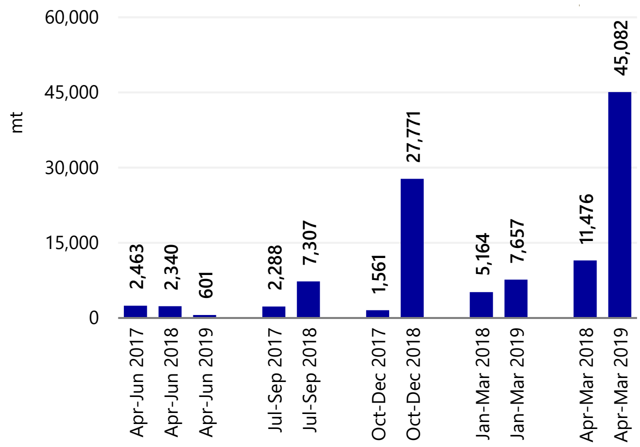
Lower milk availability and contracting domestic consumption reflect lower industrial dairy production and Argentina will see a contraction in its exportable surplus through the forecast period.

India

Monsoon rains were delayed in India this June, delaying the sowing of crops. Monsoon conditions picked up in the second half of July and through August, to achieve a modest surplus of rainfall. However, regionally there are pockets of India with either excess or deficit rainfall. This is expected to impact milk supply in some important milk-producing states such as Maharashtra.

Farmgate milk prices have improved by 10%-15% over the last three months, reaching INR 28/liter to INR 30/liter (USD 0.39/liter to USD 0.42/liter) in Maharashtra and are expected to maintain this through the rest of 2019, with increasing demand for milk in the festival season.

Figure 8: Indian SMP exports, Apr 2017-Jun 2019



Source: Indian Department of Commerce, Rabobank 2019

Depleting SMP stocks have led to a continuous increase in domestic prices. Currently, India's domestic prices for SMP are trading in the range of INR 290/kg to INR 300/kg (USD 4,050/mt to USD 4,200/mt), representing a 25% increase over last three months. SMP prices are expected to remain at higher levels through October due to high demand during festival season.

SMP and milkfat exports have been strong. As per the official estimates, for the year between April 2018 and March 2019, India exported 45,082mt of SMP. This compares to 11,476mt exported over the same period the prior year (*see Figure 8*). In the same period, milkfat exports reached 46,138mt versus 16,616mt the previous year.

Rabobank expects exports to reduce significantly through the remainder of the year and into the first half of 2020. This is due to very low carryover stocks and attractive domestic prices due to weak milk supply growth compared to previous year. As such, SMP exports are expected to be negligible through our forecast period.

Milkfat exports have been strong in Q1 (April to June 2019) due to better prices in export markets, and also with an urgency to clear some aging stock. Looking forward, milkfat export opportunities will remain limited, with good domestic demand and higher prices in the ongoing festival season.

Overall, Rabobank expects milk production to grow by around 3.5%-4% through 2020 (compared with recent averages annual growth rates of 5%-6%), with total production of 190mmt in FY 2020.

China

Average milk prices in China rose through June due to the hot summer, impacting domestic milk supply growth. Milk prices have risen to CNY 3.68/kg (USD 0.52/kg), up 4% from May, and up 8% YOY.

As such, current domestically-produced WMP have a price premium of around 10%-12% versus WMP imports, supporting strong import growth. In turn, Chinese imports have continued to defy our expectation, with Q2 LME import growth (excluding whey) increasing 24% YOY (similar to 25% YOY in Q1) year-to-date July, aggregate WMP and SMP import grew by a strong 28% YOY (*see Figure 9*).

The National Bureau of Statistics (NBS) has indicated that milk production during 1H 2019 grew by 1.7% YOY (vs. our expectation of 2% YOY). This, though, is at odds with 5.2% production growth implied by the Ministry of Agriculture (MOA)'s milk production index. The NBS' lower number may be attributed to a larger sample including more small farms which have continued to shrink.

The top-three dairy companies reported headline sales growth of 14% YOY, down from 16% in 1H 2018. Adjusted for the effects of price inflation and premiumization, we estimate that volume-driven growth accelerated to 7% YOY during 1H 2019 for China's top-three dairy players (from about 5% in 2018). The top-three industry players have continued to gain retail market share, at the expense of smaller players, across most categories including: UHT liquid milk, milk beverages, and fresh/chilled milk and yogurt. We are cautious of the top-three's reported sales growth outpacing reported retail value growth by Nielsen for UHT liquid milk products, chilled liquid milk products and milk powder by 3%, 0.7%, and 8.8% respectively during 1H 2019.

Rabobank has trimmed production growth to 1.7% in 1H 2019, while maintaining production growth of 1% YOY in 2H 2019, which is hindered by high comparables. Rabobank's view is that the domestic milk price needs to remain at least around current levels in order to drive supply growth.

There is some good news for China-US trade relations. China has agreed to exemptions of tariffs on US whey permeate and alfalfa over a one-year period (September 17, 2019 to September 16, 2020). The government has also promised to refund the additional tariffs on alfalfa already paid by importers since the punitive tariff was imposed. This should alleviate the pressure on large farms that rely on US alfalfa over the next 12 months. The exemption of tariffs on whey permeate is somewhat of an empty gift as ASF has significantly impacted demand and imports are likely to remain low regardless.

That said, corn prices are likely to continue to rise over the next year. Chinese corn production forecasts have been reduced through the forecast period as planting was lower, governmental reserves have fallen, and army worms pose a threat to yields.

China's milk supply is set for limited growth in 2019 despite improved milk prices and greater dairy heifer imports (+40,000 head YTD July 2019 and the first increase since 2017) with some improvement in the domestic farming sector, largely with smaller dairies. After a few years of thin margins or losses, large dairies are still trying to rebuild their equity rather than aggressively expand their herds.

Dairy processors have continued to show interest in seizing control over domestic farms, suggesting an improvement in the domestic supply-and-demand balance, and growing demand for domestic 'premium' and/or fresh milk products. Domestic processors are finding it increasingly difficult and expensive to source raw milk, which may continue to drive their decisions to invest in dairy farming.

Rabobank maintains 2020 milk production growth at 2%. Accelerated culling of dairy cattle for beef presents a downside risk to this forecast, with prices of beef (a substitute for pork albeit much more expensive) rising, as pork prices have increased due to ASF.

Rabobank maintains dairy demand growth of 1% (estimated at 1.9% excluding lower demand of whey) for 2019.

Rabobank maintains a 2% demand growth forecast in 2020, as the impact of drastic reduction in whey demand between 2H 2018 to 1H 2019 (a double whammy from the US-China trade war and ASF outbreak) starts to wear off.

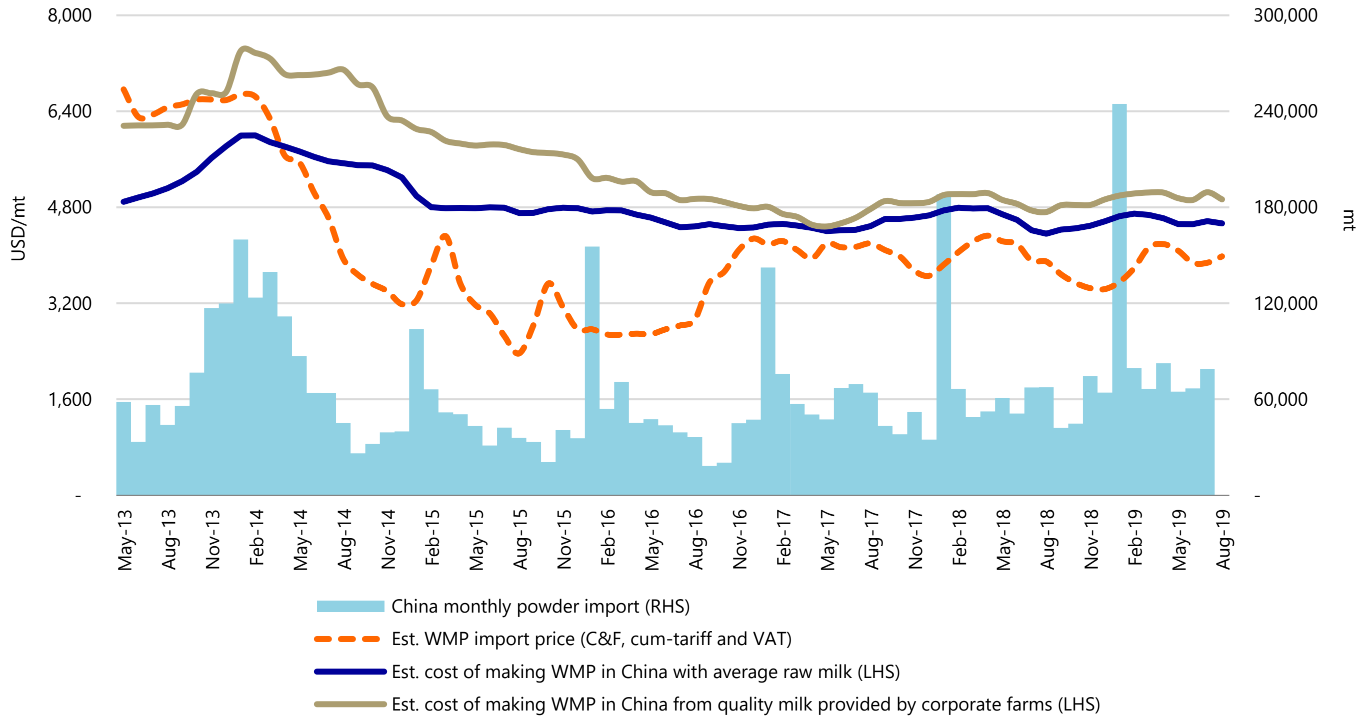
There were big year-on-year declines in whey and butter imports, coupled with a slowdown in infant milk formula import growth, which drove dairy imports growth at 17% YOY (LME) during 1H 2019 (vs. our previous expectation of 22% for 1H 2019), despite near 30% YOY growth in WMP and SMP.

With a slightly lower-than-expected 1H 2019 milk production in China, and stable consumption, Rabobank continues to estimate that inventory is at a two-year high driving the need to destock in 2H 2019. We anticipate LME imports to decline by 2% YOY (previously -7% YOY). This makes for total import growth of 8% YOY in 2019 (roughly on par with 2018). Excluding whey, total import growth would be near 13% YOY in 2019.

Looking into 2020, Rabobank expects LME import to grow slightly by 1% YOY (previously declining by 3% YOY) on a high comparison base in 1H 2020, but this should turn into 4% YOY growth as we head into 2H 2020 (previously 11% YOY), making for a full-year import growth of 3% YOY, (previously 2% YOY).

Our new forecasts are based on a set of cautiously optimistic assumptions, particularly on China's consumption front, given the uncertainties from the continued pressure on economic slowdown, currency devaluation, and the US-China trade war.

Figure 9: China WMP import parity, May 2013-Aug 2019



Source: China Customs, Eucolait, Chinese Ministry of Agriculture, Rabobank 2019

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