Dairy Quarterly Q4 2018

Uncertainty Abounds

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Summary

- Combined year-on-year milk supply growth from the Big 7 exporters (the US, the EU, New Zealand, Australia, Brazil, Argentina, and Uruguay) continued to slow in the final quarter of 2018.
- Milk production growth has stalled in Europe and pulled back in Australia – the effect of weather conditions on feed quality, quantity, and cost.
- However, other regions are posting positive growth, with New Zealand remaining the star producer of the Big 7, setting new milk collection records for peak milk flows in October.
- Global commodity markets trended lower for most regions and products over Q4 2018.
- Ultimately, however, milk supply across the Big 7 for the forecast period will grow only modestly over the coming 12 months.
- China is expected to increase its dairy product imports by double digits for 2019. However, the uncertainty regarding economic growth still remains.
- A challenging environment for expansion lies ahead, and the production squeeze will continue into 2019, driven by tight margins on-farm and lingering effects of adverse weather.
- Combined with generally low private stocks and steady demand, the risk is that the market moves quickly upwards and catches buyers unaware, particularly in 1H 2019.

Regional dairy markets

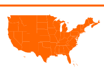
EU

The lingering effects of the drought in north-western Europe – such as the limited availability of quality silage and higher slaughter rates during 2H 2018 – limit the potential for milk production growth into Q1 2019 and will impact dairy farmer margins.

China

Rabobank anticipates China's imports to grow at double-digit pace in 2019. However, China's economic growth outlook is placing a lot of uncertainties over the growth in dairy demand and milk production – at a time when the cost of production is going up as a result of rising feed prices and the trade war with the US.

US



A nearly 25% YOY decrease in margins has contributed to US milk production growth slowing to just 1% in 2018, the lowest year-on-year growth since 2013. The 2019 outlook is also tempered, as significant margin improvement is unlikely prior to Q2 2019.

South America

Milk production is growing in Argentina, Brazil, and Uruguay in Q4, and farmers will start 2019 in a better position than they started 2018. Demand will remain subdued in Argentina, but a gradual recovery is expected for Brazil, with imports set to recover.

New Zealand

Full-year season milk production through to Q2 2019 has been lifted to 4.5%, underwritten by the favourable seasonal conditions to date, with plenty of supplementary feed harvested to plug any feed gaps which may arise.

Australia

Dairy farmer margins will remain under significant pressure well into 2019, with no margin relief in sight from high input costs. Milk production will continue to track well below year-ago levels through the remaining peak spring months and into 2019.

Global summary

The 2018 theme of slowing Big 7 milk production growth has continued to creep into the final months of the year. Q3 2018 growth sunk to just 0.8% YOY, and indicative Q4 2018 numbers show a similarly modest growth rate. Lingering effects from Mother Nature have severely impacted Australian milk flows and stalled European growth, with feed quality and quantity impacted across the second half of 2018. The US looks set to see the lowest year-on-year growth since 2013.

Yet other areas of the dairy-exporting globe are testing this trend. Brazil moved into growth territory during Q3 2018 – a result of more moderate feed costs and profitable milk prices. Argentine producers have overcome inflated milk production costs and continue to make a recovery from the low volumes delivered over the prior two years. But the star performer remains New Zealand, setting a new record for peak milk flows in the month of October. Still, estimated flows for the Big 7 during Q4 2018 are for just 0.6% YOY – the lowest since 2016 (*see Figure 1*).

A challenging environment for expansion lies ahead. Herd numbers continue to shrink in Australia, Europe, and the US, either to mitigate escalating costs and/or overcome disappointing farmgate milk prices – features that will continue into 1H 2019. Australia faces a slow recovery, with industry confidence severely knocked, while consolidation of farm numbers in the US and Argentina is also set to continue. The EU is finding its footing post-quota removal and drought impact, which may provide opportunity for some regions, but challenges for others – particularly farmers in the Netherlands navigating farm phosphate references. New Zealand dairy is facing stronger competition for other land uses, and resource constraints will provide barriers to growth across to 2020. Rabobank expects milk production to be squeezed into 1H 2019. While 2H 2019 will see milk production move upwards, it will only be at modest growth rates.

Most Oceania dairy products continued to slide lower in Q3 2018 and into Q4, as milk flows increased *(see Figure 2)*. Cheese and butter prices in the EU and the US have also joined the downward trajectory.

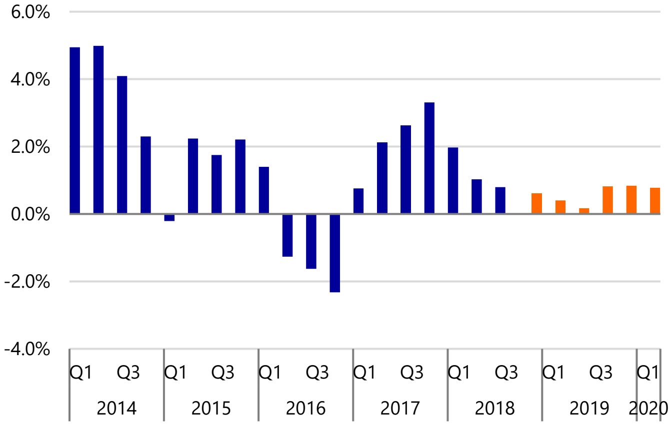
But the lid on SMP prices – firmly held in place over the prior two years – may be lifting, with most regions either holding current prices or lifting further. The latest European Commission tender results have pushed sales of intervention stock over the halfway threshold as tenders ramp up twice-monthly (excluding December).

Buyers have taken a very relaxed approach to procuring very affordable product, particularly across China and South-East Asia. The full impact of the commodity price slide is yet to be priced into the EU and US farmgate level.

Considerable uncertainty underpins the demand outlook, with many geopolitical irons in the fire: the UK/EU divorce continues; the fine print of a trade truce between the US and China still needs to be written; oil prices have taken a bearish slide; and there are headwinds emerging at the US retail level for dairy demand.

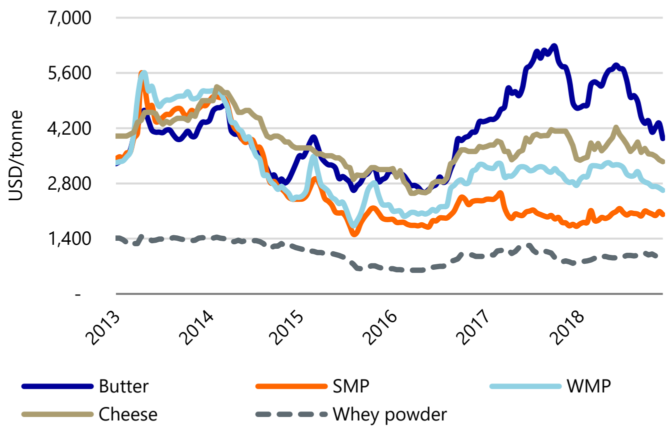
Slow and very modest milk production growth lies ahead for the major export regions over the next 12 months. The net exportable surplus available from the Big 7 will be limited across our forecast period to Q1 2020 – with significant pressure for much of 2019. Coupled with low stocks and steady demand, the risk is that the market moves rapidly upwards and catches buyers unaware, particularly in 1H 2019.

Figure 1: Milk production growth, Big 7 exporters (actual and Rabobank forecast), Q1 2014-Q1 2020f*



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

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



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

What to watch in Q1 and Q2

Emerging market currencies

Emerging market currencies continue to face pressure from a stronger US dollar. In some instances, emerging currencies are hitting lows not seen for many years. Ongoing weakness in currencies will impact the purchasing power of importers and will be exacerbated by rising commodity prices in USD terms.

Brexit

On 25 November 2018, the European Council approved the draft Brexit agreement. Characterised as a soft Brexit aimed at an orderly and gradual exit of the UK out of the EU, the agreement aims to minimise the economic damage on both sides. Under this deal, trade will continue unchanged during the transition period of almost two years, with a possible extension for another two years – good news for the dairy sector. However, great uncertainty remains as to whether this deal will be approved in the European Parliament and, more importantly, the UK Parliament. If either of the two parliaments rejects the deal, the UK will most likely go through a turbulent political process that is likely to increase the odds of a hard Brexit.

China's continued grace period for cross-border e-commerce platforms

Late in 2018, the Chinese government decided to continue to offer an indefinite grace period to cross-border e-commerce (CBE) platforms in the country. Pre-importation registration or licensing requirements for certain products (infant milk formula, cosmetics, health food, etc.) will continue to be waived starting 1 January 2019. This applies to officially registered e-commerce operators in China, whereas *daigou* (aka 'friends-and-family purchases') remain an unofficial grey practice that is subject to a government crackdown at any time. Any tightening in the regulation of CBE to require proper registration and licensing could have some negative impact on overseas infant milk formula manufacturers' access to the Chinese market when it comes to their unregistered products.

Table 1: Quarterly dairy commodity prices (historic and forecast), 2017-Q1 2020f

		2017	2018				2019				2020
		Av	Q1	Q2	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f
Butter											
Europe	EUR/tonne	5,076	4,597	5,462	5,564	4,525	4,150	4,550	4,750	4,500	4,325
US	USD/tonne	5,140	4,765	5,114	5,035	4,881	4,555	4,740	5,180	5,000	4.410
Oceania	USD/tonne	5,364	5,080	5,679	4,782	4,100	4,000	4,150	4,400	4,000	4,000
Cheese											
Europe (Gouda)	EUR/tonne	3,254	2,981	2,965	3,108	3,150	3,000	3,075	3,125	3,150	3.050
US (Cheddar)	USD/tonne	3,604	3,340	3,545	3,450	3,210	3,310	3,470	3,580	3,785	3,310
Oceania (Cheddar)	USD/tonne	3,848	3,602	3,954	3,682	3,400	3,200	3,600	3,600	3,700	3,800
Dry whey powder											
Europe	EUR/tonne	868	684	723	804	825	825	800	800	800	800
US	USD/tonne	978	574	616	814	1,000	880	850	850	850	880
Skim milk powder											
Europe	EUR/tonne	1,784	1,376	1,429	1,547	1,600	1,650	1,700	1,725	1,700	1,700
US	USD/tonne	1,910	1,544	1,706	1,799	1,950	2,040	2,095	2,125	2,185	2,315
Oceania	USD/tonne	2,048	1,882	2,035	2,036	2,030	2,200	2,300	2,300	2,400	2,400
Whole milk											
Europe	EUR/tonne	2,926	2,588	2,727	2,808	2,700	2,550	2,600	2,650	2,700	2,700
Oceania	USD/tonne	3,095	3,113	3,271	2,954	2,650	2,700	2,900	2,900	3,000	3,000
South America	USD/tonne	3,369	3,122	3,057	3,090	3,020	3,050	3,060	3,075	2,950	2,900

Source: Rabobank 2018

EU

The lingering effect of the drought in north-western Europe and high comparable numbers from the prior year pulled the EU milk production curve into a decline in September (-0.2% YOY) – effectively ending 18 months of consecutive growth. As a result, Q3 2018 milk production growth finished at just +0.2% YOY, with year-to-date milk production slowing down to just +1.2% YOY (*see Figure 3*).

Nonetheless, the impact of the drought varied significantly across regions, resulting in variable milk production growth in the Big 7 European milk-producing countries. In Germany and France, milk production declined by 0.2% and 1.7% YOY, respectively, during September, while preliminary figures for October also hint at a fall in milk production in both countries. At the other end of the spectrum, milk production in the UK and Poland increased by 0.6% and 2.6% on average during September and October. In a season significantly impacted by weather conditions, Irish milk production returned to double-digit growth in September and October.

As a result of phosphate legislation, milk production in the Netherlands dropped by an average 5.0% YOY in September and October. In order to stay within on-farm phosphate limits for 2018, bovine slaughter rates increased by nearly 38,500 head, or 16.9% YOY, in 2H 2018 up to week 46.

EU farmgate milk prices have improved and averaged EUR 35.71/100kg across Europe in October. However, the current farmgate price is still EUR 1.82/100kg lower compared to the same month last year. Moreover, the weakening of most commodity prices over recent months has not yet been fully translated into farmgate prices. As a result, we expect the average EU farmgate price to decline in the remaining months of 2018 and the first months of 2019.

Milkfat prices are particularly under pressure. EU butter prices fell by EUR 880/tonne (-15.7%), to EUR 4,710/tonne, between September and November. Despite this, the price difference for butter with FOB Oceania remains wide, at nearly EUR 1,250/tonne. Since September, EU Gouda prices have improved by EUR 70/tonne, to EUR 3,170/tonne (+2.3%) – but current Gouda spot prices have started to move downwards.

Supported by increased exports and lower stocks, SMP prices increased by EUR 115/tonne (7.9%), to an average of EUR 1,570/tonne over October and November, compared to the first nine months of 2018.

Since the beginning of the year, over 215,000 tonnes of SMP were sold out of intervention. In November, buyers showed a healthy appetite – 56,150 tonnes of SMP were purchased (26% of the total amount sold to date). The latest tender saw a minimum selling price of EUR 1,313/tonne, EUR 62/tonne up from the previous one. For the December tender, the total remainder of over 160,000 tonnes of SMP is up for sale. At the current pace of the recent tenders, Rabobank expects intervention stocks to dry up in 1H 2019.

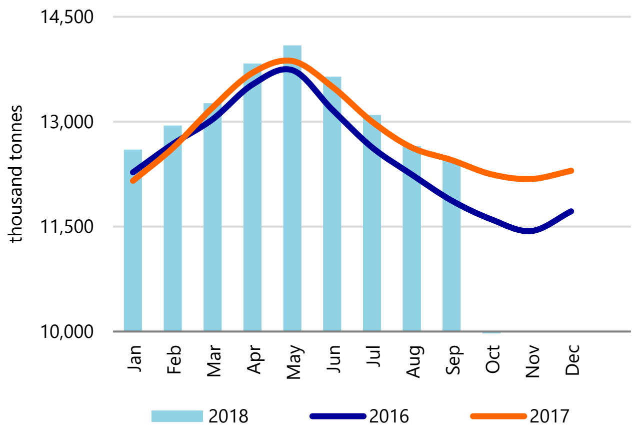
SMP exports increased by 10.1% YOY in Q3 2018, largely supported by higher imports from China (+58.5%, or 28,000 tonnes). Lower demand for EU butter from the Middle East and China – mainly caused by regional price differences – resulted in a decrease of butter exports of 17.2% YOY in Q3 2018. During the same period, cheese exports were down by 1.1% YOY, largely due to lower volumes shipped to the US (-3.6%).

EU cheese production fell by 1.3% YOY in Q3 2018, while butter production went slightly up, by 0.3% YOY. In the same period, SMP output fell by 4.1% YOY, and WMP production rose by 4.6% YOY, boosted by an increase of almost 12% in August. Nonetheless, Rabobank estimates that milkfat will continue to flow into cheese – due to the large quantity of available processing capacity, and the combined value of cheese and whey, compared to other dairy commodities.

Moving forward to the end of 2018 and into 2019, Rabobank expects that the longer-term effects of the recent drought – such as the limited availability of quality silage and higher slaughter rates during 2H 2018 – will limit the potential for milk production growth in Q4 2018 (-0.7%) and Q1 2019 (-0.5%). Even so, parts of Germany, France, the Benelux, and Poland are still coping with significant soil moisture deficits, which could negatively impact the conditions during the start of the pasture season in Q2 2019 (-0.3%).

Rabobank expects consumption growth to remain at a stable pace of nearly 1.0% in 2019.

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



Source: ZMB, Rabobank 2018

US

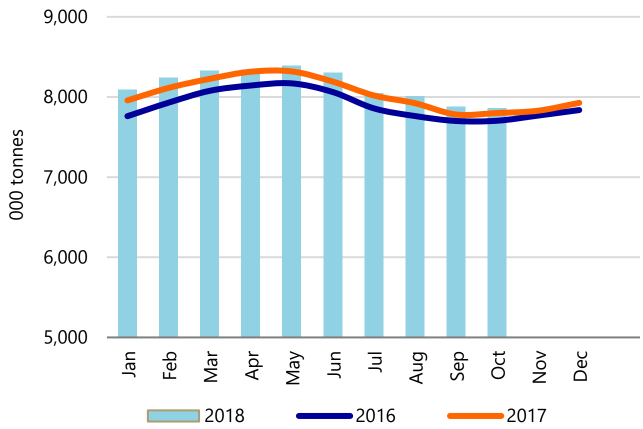
The US is on pace to increase milk production by just 1% in 2018, the lowest year-on-year growth since 2013. October milk production totalled 17.9bn pounds, up 0.8% from a year ago. The average butterfat content during the month averaged 3.95%, an improvement from 3.81% in September and 3.89% in October 2017, respectively. The higher butterfat content helped propel the October 2018 US all milk price to USD 17.40/cwt, up USc 70/cwt from September and the highest pay-out since November 2017. Nevertheless, sub-USD 17/cwt all milk prices for most of 2018 have taken their toll on dairy operations, prompting increased culling to supplement disappointing milk checks. Year-to-date culling through October totalled 2.6m head, up 5.1% vs. last year. However, dairy cow slaughter soared by 11% YOY in October, foreshadowing an even smaller US dairy herd by year-end (*see Figure 4*).

The US dairy herd peaked in May, at 9.404m head, but has decreased consistently, to 9.365m head in October, down 30,000 head from last year. The 2018 national average MPP dairy (all milk price minus feed costs) is expected to be less than USD 7.40/cwt, down nearly 25% from 2017's annual average, resulting in increased farm exits and higher slaughter rates.

US cheese and dry whey prices are forecast to remain under pressure until the Mexican and Chinese retaliatory tariffs are removed. As a result, US dairy product prices are forecast to trend lower through year-end and into early 2019, which will place downward pressure on farm-level margins. US milk production is expected to grow by less than 0.75% through 1H 2019, due to a 1.2% gain in milk per cow being offset by a 0.5% decrease in the US dairy herd.

Meanwhile, the US economy continues to charge through 2018, with 3.5% YOY growth for the third quarter. Foodservice sales were up 7% for October vs. last year, and

Figure 4: US milk production, Jan 2016-Oct 2018



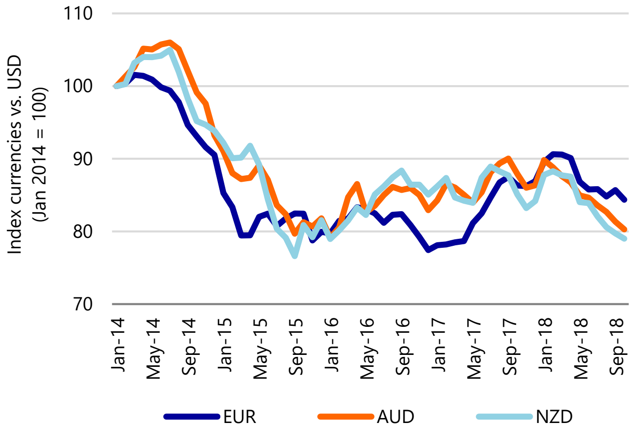
Source: USDA, Rabobank 2018

year-to-date sales are 6% higher, echoing strong growth in consumer spending. However, retail dairy sales data is sobering. IRI data for November shows that retail sales volumes of all key dairy categories (except natural cheese) have all declined vs. 2017. Processed cheese sales fell by 4.1%, followed by sales of yoghurt and fluid milk – down 3.4% and 2%, respectively. Most surprisingly, butter sales were off by 2.6%. On a positive note, natural cheese sales were up 3% through the period, but this was not enough to offset the other declines. The USDA's commercial disappearance in combined milk solids formats reflects weaker demand, with data showing September down 0.4% vs. the prior year, while year-to-date domestic commercial disappearance is up just 0.11%.

Fortunately, US exports have been strong, despite a strengthening dollar and ongoing trade disputes – combined milk solids exports were up 14% for the third quarter, bringing the year-to-date total to 18%. The US has continued to see year-on-year growth in exports to Mexico – up 26% in Q3, led by a whopping 46% increase in SMP over last year and offsetting the tariff-driven declines of 11% in cheese through the period. US exports to China have also been hampered by trade wars, with Q3 exports down 22%, largely driven by lower whey exports. US exporters have made up for the loss to Mexico and China by increasing exports to the Philippines and Indonesia – both up 47% in Q3 vs. last year.

Looking forward, the US economy is anticipated to continue to grow – but warning signs of an economic slowdown are on the horizon, with key indicators turning negative. Assuming recent economic growth trends continue, US consumer spending should remain higher. However, as we have seen over the last quarter, retail dairy sales have not benefited from the uptick in consumer spending. Thus, we are expecting demand growth to remain somewhat lacklustre over our forecast period – at around 1%, with an increasing risk of a decline if a recession develops. The US will need to continue to lean heavily on export growth in order to offset any weakness in domestic demand – a feat it has been able to achieve through much of the last six months, despite an appreciating dollar and challenging trade rhetoric, and a testament to investment in US dairy export capabilities by US dairy companies (*see Figure 5).*

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



Source: UDM Board of Governors of the Federal Reserve System, Rabobank 2018

New Zealand

Export volumes for the three months to October 2018 were down by 6% on the same period last year, driven by very weak September volumes and helped further by softer October exports. Despite shipments to China lifting 6%, exports to Saudi Arabia halved, and both the UAE and Sri Lanka also took significantly less volume over the period. At a product level, butter and liquid milk volumes lifted, yet key commodities SMP and WMP have struggled to match prior-year volumes for the three months to October, tracking lower by 25% and 9%, respectively. Softer numbers have been helped by high comparable volumes from the prior period, where selling surplus inventories were a feature of the tail of FY 2017.

Shipments will track higher year-on-year through the closing months of 2018 and into 2019, as exporters look to shift product to new homes after an exceptionally strong, record-breaking milk production seasonal peak.

Early-season milk production began with a hiss and a roar, and continued its momentum over the months of October and November 2018. The dry weather risks emerging in our last quarterly report have been allayed with extremely volatile weather for the last month of spring. The heavy rainfall in parts of both islands, along with snow in the South, have provided a top-up for reservoirs and water tables, while the recent humid temperatures have spurred on grass growth.

It's little wonder that milk flows have continued to march along, culminating in a strong seasonal peak period. October milk production reached a new record: +6% on a milk solids basis, to 271m kgMS, just pipping the prior record set in 2014. Season-to-date (October) collections are up by 6% (*see Figure 6*).

Rampant pasture growth has ensured that farmers have been able to harvest supplementary feed that now provides good levels of fodder on hand, in the event of a dry period emerging over the shoulder of the season. However, with some pastures soggier than last year – particularly Canterbury and Otago – the real challenge for farmers now is ensuring grass utilisation. Agricultural contractors are in high demand, to help maintain pasture conditions.

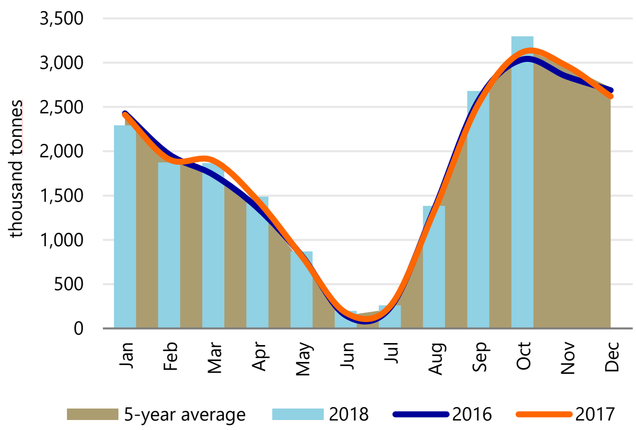
Rabobank's full-year season milk production forecast through to Q2 2019 has been lifted to 4.5%, effectively underwritten by the favourable seasonal conditions to date – and the implication is that farmers will utilise harvested supplementary feed whenever necessary to overcome any climatic issues or feed deficits arising. There is some risk to the upside if frequent unsettled periods bringing rain across summer are received.

The counter to strong milk production has been sliding Oceania commodity prices – a theme evident across much of the season. Fonterra has revised lower its forecast range for the 2018/19 season, to NZD 6.00/kgMS to NZD 6.30/kgMS. Rabobank is forecasting NZD 6.25/kgMS.

2H 2019 milk production (the start of a new NZ season) can be expected to see a modest decline on 2H 2018. The extraordinary seasonal conditions are unlikely to be repeated in 2019, and it will be very difficult to match the volumes seen in 2H 2018.

This current season has been an anomaly, driven by fortuitous weather conditions across much of 2018. With stronger competition from other land uses, along with resource constraints continuing to tighten, the slowdown in New Zealand milk production growth will be evident in 2019 and moving into 2020.

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



Source: DCANZ, Rabobank 2018

Australia

Australian milk production contracted by 4% in the season-to-date (to October), and this rate of decline will accelerate further into Q1 2019. A period of sustained higher feed and fodder costs, along with no major improvement in farmgate milk prices, has put farmer margins under severe pressure. For irrigation farmers in the Murray Dairy district, water trading prices remain near record levels (*see Figure 7*).

To mitigate rising costs, culling activity has escalated since the start of the season, as farmers look to lower feed bills. In the three months between July and September, dairy cow cull rates jumped 15% vs. the same period last year. Dairy farmers may look to make further herd reductions during the summer months should feed shortages worsen.

October and early November did bring some much-needed rainfall across most dairying regions. However, this follows the driest September on record.

The latest seasonal outlook from the Bureau of Meteorology is mixed news for dairy farmers. Some regions are likely to continue to battle drier summer months, but eastern Victoria is forecast to have better-than-average rainfall.

The challenging conditions continue to weigh heavily on farmer confidence. According to Rabobank's latest Rural Confidence Survey, sentiment among dairy farmers is the weakest of all the main agricultural commodity groups.

The operating environment for farmers will continue to be taxing, with input costs expected to remain elevated. This means there is little relief on the near-term horizon for farmer margins.

Not surprisingly, Rabobank has trimmed its expectations for milk production for Australia. National production for the 2018/19 season will fall by as much as 4%, taking the milk pool back below 9bn litres for the first time since 1996/97. The biggest volume declines are in the Murray Dairy irrigation district. In the first quarter of the 2018/19 season, milk production in this region fell by 10% (or 58m litres).

Northern New South Wales and Queensland are also recording sizeable percentage falls as they battle the worst of the drought conditions. The risk for Australian milk supply is that the contraction is worse than feared should margins not improve, ushering in a post-summer cull.

This sizeable drop in milk supply is putting pressure on supply chains and the dairy company sales mix. For ingredient customers, there are some ongoing shortages of milk solids.

In Q3 2018, Australian dairy exports on a volume basis were slightly down – reflecting a tightening milk supply. There has been a significant withdrawal of milk powder exports – with cheese vats taking priority due to better export returns on offer.

The fundamentals of the local consumer market remain solid. Australia's economy continues to perform well, and the labour market is buoyant. This is supporting consumption of some key dairy categories in the retail and foodservice channels. New product innovation from various companies is reportedly helping sales ahead of the Christmas period.

There have been no major changes in announced farmgate milk prices in southern Australia during Q3 2018. This is not surprising, given the weakness in commodity markets since the season began.

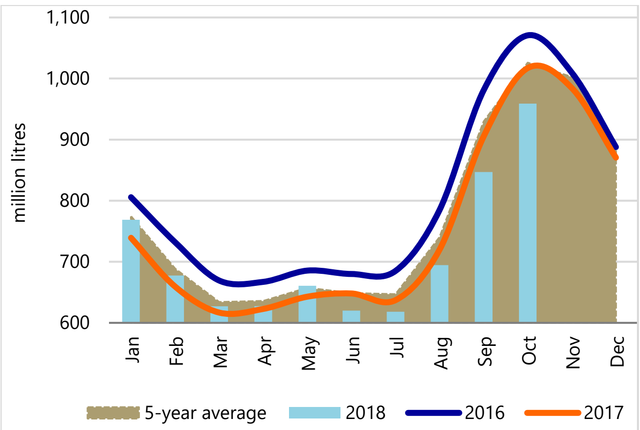
Based on Rabobank's latest seasonal average Oceania commodity prices for the basket of major commodities, the weighted average farmgate milk price for Southern Australia has been trimmed to AUD 5.65/kgMS. This is not surprising. The Australian dollar has averaged USD 0.72 since the season began. This is down 6% on the 2017/18 average and has provided some relief for exporters. However, it has not been enough to offset the weaker Oceania commodity prices since the start of the season.

Australia's exportable surplus will remain under pressure into 2019. With a better start to the growing season next year – contingent on a timely autumn break – the trend in declining milk production could be reversed.

However, it will be a slow recovery, as the industry emerges from this cycle structurally smaller in terms of average herd sizes, less equity, and an accelerated number of farm exits.

Since the last report, Kirin announced the commencement of the sale of Lion Dairy & Drinks.

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



Source: Dairy Australia, Rabobank 2018

Brazil

Milk production has lifted moving into Q4 2018. Farmgate milk prices peaked in August and started declining gradually, yet still remained at levels supportive of profitability – and therefore supportive of milk flows.

More moderate feed costs from lower grain prices also helped margins remain at healthy levels in recent months, incentivising production throughout the key milk basins in the south and south-east regions. As a result, production is expected to close in Q4 with growth of 3% YOY, up from 1% in Q3.

2018 has been very challenging for the dairy sector as a whole, as both farmers and the industry have faced big challenges. The truckers' strike in May was pivotal and caused milk output to decline by 3% in Q2, at the same time sending the farmgate milk price to year-highs.

Nonetheless, milk production at farm level is forecast to increase by 1% for the full 2018 year.

Consumption of dairy products is expected to post growth of around 4% in volume terms for the year; however, in value terms, it will see growth of just 1% compared to 2017, suggesting discounting on retail shelves is a key feature.

Slower economic growth and persistently high unemployment – during a year of political uncertainty and within a challenging business environment – made demand growth more difficult, as family incomes hardly improved.

In terms of trade, Brazil's dairy trade deficit declined by 13% in the first eight months of 2018, to 103,000 tonnes. Imports declined by around 19% as the real lost value and local demand remained weak, while exports also declined by 38% through October.

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

Looking ahead to 2019, projections point to moderate supply-side growth in an environment of improving demand. Farmgate milk prices are showing declines in November/December, but are likely to start 2019 higher than in 2018.

Meanwhile, local corn prices are likely to remain at moderate levels, with soymeal presenting more of a challenge for farmers' feed mix. Depending on what happens in international markets, soymeal prices could rise locally, impacting production costs.

Overall, higher prices and slightly lower feed costs will incentivise farmers to increase output in 1H 2019, and demand will also provide a better outlook for milk processors.

Consumption is showing signs of improvement. Nielsen numbers point to a growth of 6% in volume in the first nine months of 2018. Rabobank believes the overall demand growth number to be considerably lower, but growth is picking up and will likely gain momentum in Q1 2019.

Following the election of a new government in October 2018, plans for economic reform and market-friendly policies by the new administration are helping economic projections to be more optimistic for 2019. Unemployment has been declining gradually in 2H 2018, and economic growth in the new year will bring overall improvement to the business environment. Lower interest rates and more investments are likely to benefit family incomes and create conditions for better demand growth in dairy products.

However, the optimistic outlook for the economy in 2019 will largely depend on whether the new government can deliver on pension reform (which will need approval by congress) to stabilise the fiscal crisis in 1H 2019, and how positive global business and the economy will be in the coming months.

For now, the outlook is moderately optimistic, and stronger demand will help processors perform better after a challenging 2018.

On the trade front, imports are likely to see some growth in 1H 2019, given global price forecasts, but this will depend on the matrix of the exchange rate and local milk prices.

Argentina

2018 will be remembered as challenging and volatile, even by Argentine standards. Inflation at 40% and sharp currency depreciation – with the peso losing over 55% of its value over the past 12 months – severely impacted the cost of milk production in the country. The cost of corn and soymeal increased significantly for farmers as the peso plunged and squeezed margins. Despite a significant recovery in farmgate milk prices in local currency, current prices paid to farmers of around USD 0.23/litre are still quite low by international standards – and they still don't fully compensate farmers for the impact of high costs that have accumulated over the past two years.

Despite tighter margins, however, Argentine milk production has been recovering throughout 2018 and will likely end the year around 5% higher. A combination of good weather, more available forage, and growing exports has helped sustain the recovery in milk production. Overall milk production is still around 12% lower than where it stood at the end of 2015, after a sharp contraction in 2016 and 2017.

Local consumption per capita has been fairly stagnant, and consumers have made some changes to the dairy they purchase as real incomes have dropped due to inflation. Higher-value products continue to suffer, while categories like powdered milk are performing better, with consumers trying to cut costs.

Export volumes advanced 30% YOY from January to October 2018, as rising production and stagnant local consumption increased product available for sending abroad. The depreciation of the Argentine peso also increased the attractiveness of exports, despite softer prices internationally (quoted in USD).

Looking forward to 2019, Rabobank expects milk production in Argentina to continue growing at a moderate pace of around 2% for Q1 and Q2. If the macroeconomic conditions improve – ensuring a more stable exchange rate and declining inflation – production could accelerate with fewer pressure from rising costs.

However, the base scenario remains challenging: inflation is still far from being under control, while high interest rates of around 60% per year or more (seen as necessary by the central bank to remedy inflation) are limiting investments, making it harder for farmers to expand.

The consolidation process in milk production will also continue to advance, as larger farmers grow and smaller farmers continue to exit – partially a result of the crisis that the sector has experienced in the past three years.

Argentine consumers will see another challenging year in 2019, with inflation of around 25% and GDP contracting by around 2%, according to the latest IMF projections (October 2018).

Under a scenario of moderately growing production and stable demand, Argentina's exportable surplus should increase in 2019, allowing companies to continue increasing overseas sales. The exchange rate and international prices will determine the attractiveness of exporting – but in any case, it will be difficult to increase domestic sales under the current scenario of recession and high inflation. Any additional output is likely to be channelled to the global market.

The dairy supply chain is still going through restructuring, and several companies continue to battle financial difficulty – rising costs and a stagnant domestic market have impacted their balance sheets over the past three years.

Multinationals – and exporters in general – are in better shape, but will continue to feel the effect of high finance costs and stubbornly high inflation in their financial results during 2019.

India

India is entering its seasonal peak milk production period, which will last for three to four months and cover different regions. We will see an increase in domestic milk supplies, which in turn will lead to additional SMP manufacturing and stocking.

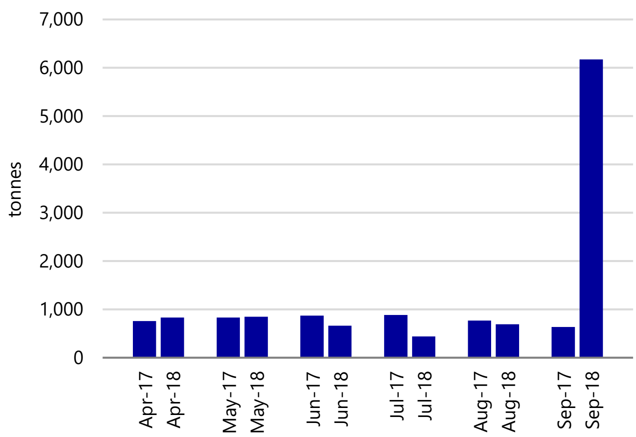
As expected, the government has increased export subsidies to 20% in order to export surplus SMP. In addition, state-sponsored benefits (export-linked benefits by Gujarat and Maharashtra, and a minimum support price for raw milk to farmers in Maharashtra) are also in play. These benefits may be extended through March 2019. As per official estimates, for 1H 2018/19 (Apr-Sep), India exported ~9,600 tonnes, compared to 4,750 tonnes in the same period last year (*see Figure 8*). September alone contributed 6,150 tonnes. SMP exports are expected to surpass 20,000 tonnes by December 2018 (Apr-Dec). The industry estimates that India will export ~35,000 tonnes to 40,000 tonnes of SMP by March 2019.

Milk production estimates for the current year (2018/19, Apr-Mar) remain unchanged and are expected to surpass 180m tonnes. SMP and raw milk prices have also largely remained unchanged over the last quarter – and they are also not expected to move much in the next quarter.

1H 2018/19 (Apr-Sep) results have been announced. Most of the privately-listed companies have shown revenue growth combined with margin improvement over 1H of the previous year. Margins this year are expected to be better than the previous year for most of the companies, with a higher share of consumer-centric retail products.

Fonterra recently announced its re-entry into the Indian dairy sector by way of a JV with Future Consumer. Future Consumer is part of the Future Group, a leading grocery retailer in the country. As per the official announcement, they are planning product launches in 2019.

Figure 8: Indian SMP exports, Apr 2017-Sep 2018



Source: Indian Department of Commerce, Rabobank 2018

China

Average milk prices in China improved 3.5% during most of Q4 2018 compared to the prior quarter and were up just 1% YOY, largely reflecting a seasonal recovery. But prices in US dollar-terms were up by just 1.5% compared to the prior quarter, due to further depreciation of the renminbi vs. the US dollar since Q3 2018.

International WMP prices are at attractive levels for importers, resulting in a higher discount of 20% compared to seasonally higher domestic milk prices – from 10% in 2017 and much of 2018 (*see Figure 9*).

In the latest China Statistics Yearbook 2018, the National Bureau of Statistics of China has revised down the country's milk production data for 2006 to 2017 by a range of 8% to 15%. Despite this substantial change in the baseline data, Rabobank's initial reading is that this should not significantly impact the year-on-year change on which Rabobank builds its forecasts. In most years, the revisions are about a 14% to 15% reduction from what was released previously, with almost a parallel downward shift between 2007 and 2017. What would change is the absolute consumption volume, which, for example, would be about 11% lower than the previous estimate for 2017. In addition, the gap between domestic production and the demand estimate would widen to 29% in 2017, compared to 23% with the previous production data. In the meantime, there is no mention of the number of dairy cows in the newly published yearbook. The revisions are most likely made based on the Third National Agricultural Census conducted (at a ten-year interval) by the government at the end of 2016 (in which the sampling may have been significantly adjusted).

Q3 2018 milk production continued to accelerate from a very low comparison base in the prior year. It was heavily impacted by the summer, driving a growth of 2% YOY, based on the Ministry of Agriculture's raw milk production index. This is broadly in line with our expectations.

Demand for dairy products in China continued to grow. Indicative of demand were the Q3 2018 results of listed dairy companies whose top-line growth was estimated at a high single-digit rate in aggregate, with the leading player further gaining market share. However, this pointed to a slowdown compared with the mid-teens seen at mid-year.

Rabobank maintains its milk production forecast for 2018 at 2% YOY, supported by a strong year-on-year recovery in Q3 2018 due to better preparation on large farms (early investments in cooling). For 2019, we are trimming production growth to 1% YOY (from 1.6% previously).

The downward revision reflects rising uncertainties, both as a result of upward pressure in feed cost and a potential compromise in sourcing lower-quality alfalfa to mitigate feed cost pressure. Corn prices have been rising following two years of production declines, and higher procurement costs of corn silage in 2018 will be felt in the coming year. Soymeal prices have been volatile and trending higher overall, while US alfalfa is now subject to an additional 25% tariff – both a result of the ongoing trade war between China and the US. If a fair amount of milk price improvement is seen over the coming year, to help offset higher feed costs, milk production growth in China could manage to inch up to about 1.5% in 1H 2020.

Rabobank maintains a 1.5% YOY consumption growth for 2019, amid uncertainties surrounding the general economy – resulting from the trade war with the US – and a challenging comparison base in 2018. A modest recovery to 2% is forecast for 1H 2020.

Chinese trade data revealed a surprisingly low year-on-year growth in Q3 2018 dairy imports (LME), at less than 0.5%. This – combined with weak 4% import growth during Q2, seasonally lower production volume in Q3 (QOQ), and a reasonable growth in processing demand – means that inventory in China built during Q1 2018 has been significantly depleted, and the country needs to step back into the international market to replenish the stock.

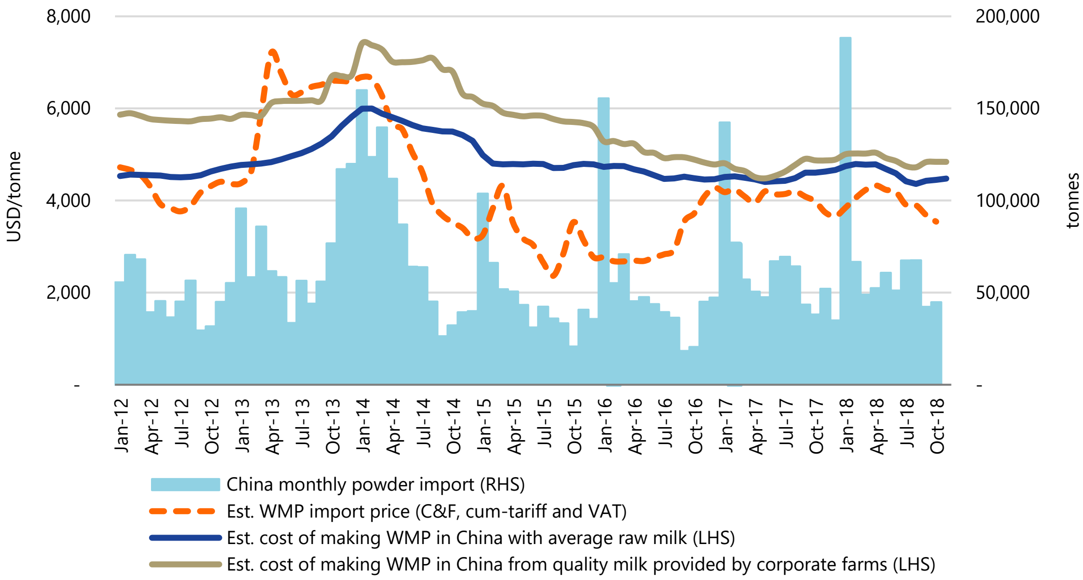
Indeed, October has started to see the first double-digit import growth in five months, and a near 20% YOY growth can be expected for Q4. However, further import momentum is likely to be delayed into January 2019, as importers attempt to take advantage of the zero-tariff rate for New Zealand products within the quota.

As such, China is likely to close 2018 with a lower stock level than 2017. Across various categories, butter saw the highest growth (of near 40% YOY, from January to October, but channel checks have suggested a major build-up in inventory), followed by infant milk formula (a 14% growth, decelerating from above 25% during the past few years, likely due to the impact from the formula registration), and commodities (WMP, SMP, and whey at single-digit growth rate). Meanwhile, liquid milk and cheese were slightly down.

Even with a strong Q4 import growth, Rabobank is trimming the overall 2018 import growth to 8% YOY (previously 14%). Looking ahead – with lower expectations of production growth in 2019 and an unchanged consumption growth forecast – Rabobank is revising up 2019 growth in China's import need, to 11% (vs. 3% to 4% previously). This also incorporates the delay in import decision from 2018 into the beginning of 2019. Despite the expectation of a modest acceleration in both production and consumption for 1H 2020, Rabobank expects only 4% growth in import growth during 1H 2020.

China's economic growth outlook, along with the unbalanced bargaining power between producers and processors, continues to place a lot of uncertainties with regard to growth in dairy demand and milk production – at a time when production costs are rising due to higher feed prices and the trade war with the US. The recent developments in the political relationship between China and Oceania are certainly adding another layer of complexity.

Figure 9: China WMP import parity, Jan 2012-Nov 2018



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

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