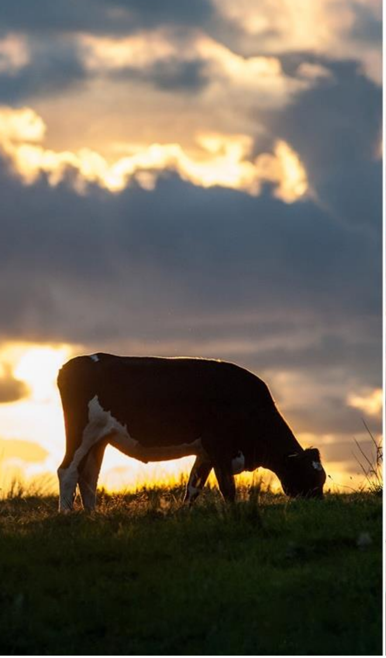
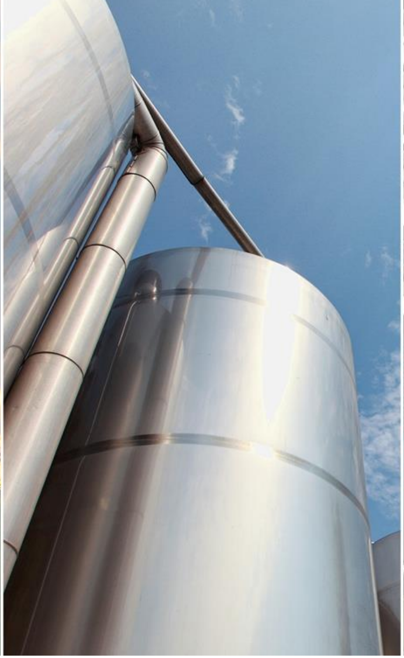

Waiting for the Dust to Settle

Global Dairy Quarterly Q2 2020

RaboResearch Food & Agribusiness June 2020

Rabobank

Summary

- Milk production is forecast to continue expanding across the dairy-exporting regions, despite weather-related issues, lower milk prices, and efforts to bring supply back in balance with demand in many areas. Rabobank forecasts a 1% YOY increase in production across the big-7 dairy regions in 2H 2020, and 0.9% YOY in 1H 2021.
- The Northern Hemisphere has experienced a rebound in milk and dairy product prices toward the end of Q2, but it may be too soon to call this a true recovery. Much of the price support has been driven by government aid that will likely slow in the months ahead. The upcoming US presidential election could extend heightened levels of support in the US.
- Many dairy markets are still dealing with imbalances from demand destruction due to government lockdowns. The heightened retail sales and lower foodservice sales will begin to converge, returning to a more normal balance, but it will take time, and there will be limitations that will prevent a complete return to previous norms, especially in foodservice sales.
- Once government aid and market support slows, market fundamentals will again take hold in a slower economy that will take time to heal from the pandemic's economic damage. Inventory build will put downward pressure on dairy product prices in the months ahead due to the combination of heightened levels of stocks and competition for reduced import demand.
- The world’s largest dairy import market will be more absent in the world market in months ahead. China’s dairy imports are forecasted to drop 15% YOY in 2020. Weaker currencies will challenge imports elsewhere.

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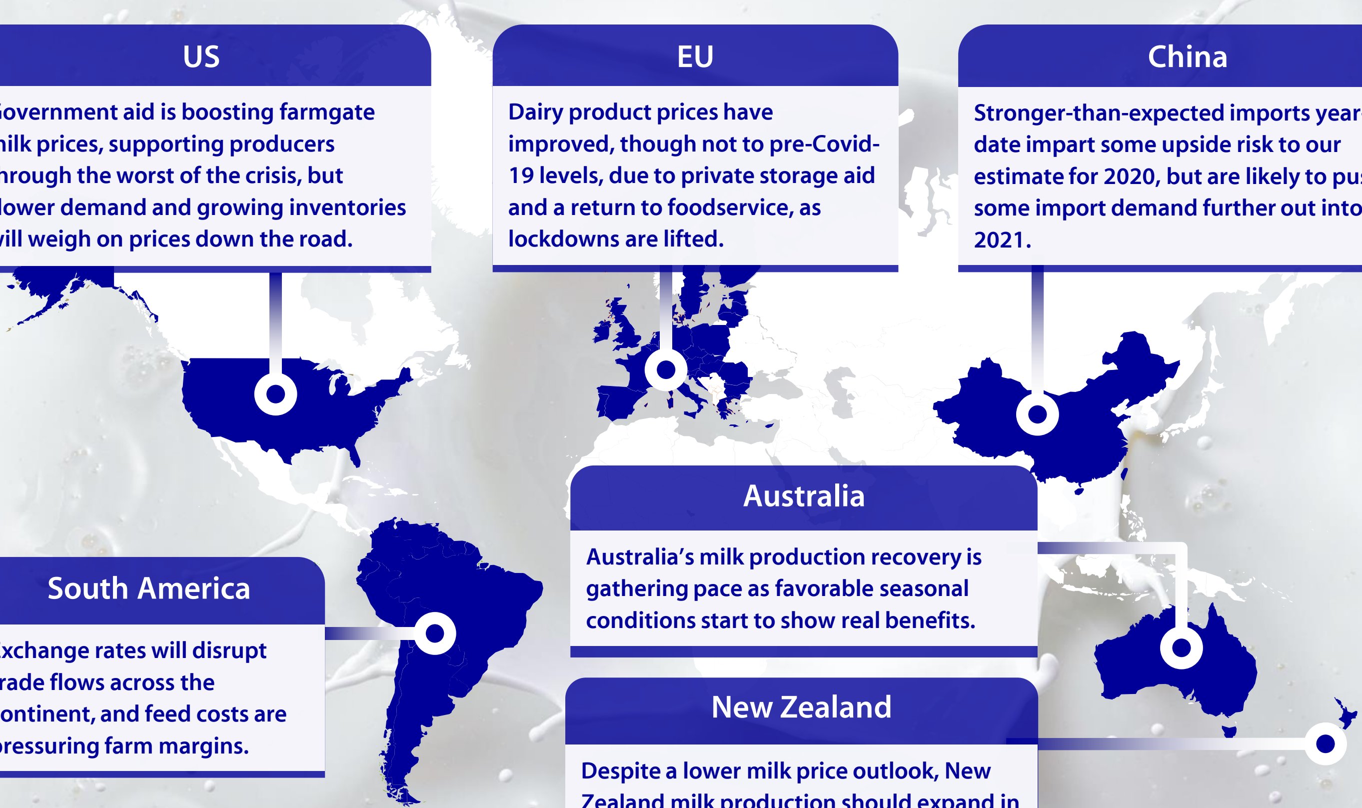
Regional Dairy Markets



US

Government aid is boosting farmgate milk prices, supporting producers through the worst of the crisis, but slower demand and growing inventories will weigh on prices down the road.

EU

Dairy product prices have improved, though not to pre-Covid-19 levels, due to private storage aid and a return to foodservice, as lockdowns are lifted.

China

Stronger-than-expected imports year-to-date impart some upside risk to our estimate for 2020, but are likely to push some import demand further out into 2021.

Australia

Australia's milk production recovery is gathering pace as favorable seasonal conditions start to show real benefits.

South America

Exchange rates will disrupt trade flows across the continent, and feed costs are pressuring farm margins.

New Zealand

Despite a lower milk price outlook, New Zealand milk production should expand in 2020/21; albeit modestly.

Global Summary

Lockdowns are being lifted, foodservice pipelines are refilling, governments are intervening and volatility abounds. But, while price rebounds are welcome, it may be best to wait for the dust to settle to assess the true strength of the current market.

Before the events of the past few months, it would have been impossible for much of the developed world to imagine shutting down all but essential services for multiple months. Now that it has happened, the ante has been upped on what 'uncertainty' means.

Over the past three months, the attention has been on understanding and dealing with the immediate disruptions of wild shifts in consumer behavior and logistical challenges. We now shift our focus to the longer-term implications of a widespread recession and begin to think about a path forward into this era of heightened uncertainty.

The global outlook now is not nearly as dire as it was at the height of the Covid-19 crisis. Government intervention through dairy purchases, direct payments, and storage aid, combined with the reopening of many foodservice outlets has helped jump-start demand. We are on a path toward recovery, but we are not out of the woods.

With the rapid rebound in cheese prices in the US, and similar but less extreme increases elsewhere, it may be tempting to assume we have recovered and not look back. But, even if markets have moved back toward, or in some cases above pre-Covid-19 levels, it does not mean that our expectation for the future should be the same as it was pre-Covid-19.

The balance between foodservice sales and retail sales has been one of the most defining features of this crisis. As we begin to lift the lockdowns and the mandated foodservice closures in much of the world, some limitations remain. Foodservice sales will take time to return to normal due to remaining capacity restrictions and cautious consumers.

Retail sales will eventually return to a normal trend over time. However, the extent of the lockdown may have been long enough to form new habits, and some segments of consumers may continue preparing more food at home on an ongoing basis. The renaissance of home cooking may also extend to home entertaining, at least temporarily for some demographics.

Much of the world will emerge from the Covid-19 lockdowns into economic recession. Slower growth will weigh on domestic demand as well as curb import demand in many regions. Southeast Asia has been a critical force in driving import demand opportunities for exports from many milk-producing areas. With an expected demand reduction coming from this region, and lower Chinese import needs, there could be a surplus of milk, contributing to high stock levels in the second half of 2020.

Heavy inventories and reduced demand growth will weigh on global milk prices through 2020 and into 2021. In much of the world, dry weather is also impacting feed availability and cost, which is pressuring margins on dairy farms. Still, we expect a slight increase in production year-on-year across the major milk-producing regions through our forecast period.

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Figure 1: Milk Production Growth, Big-7 exporters (Actual and Rabobank Forecast), Q1 2015-Q3 2021f*

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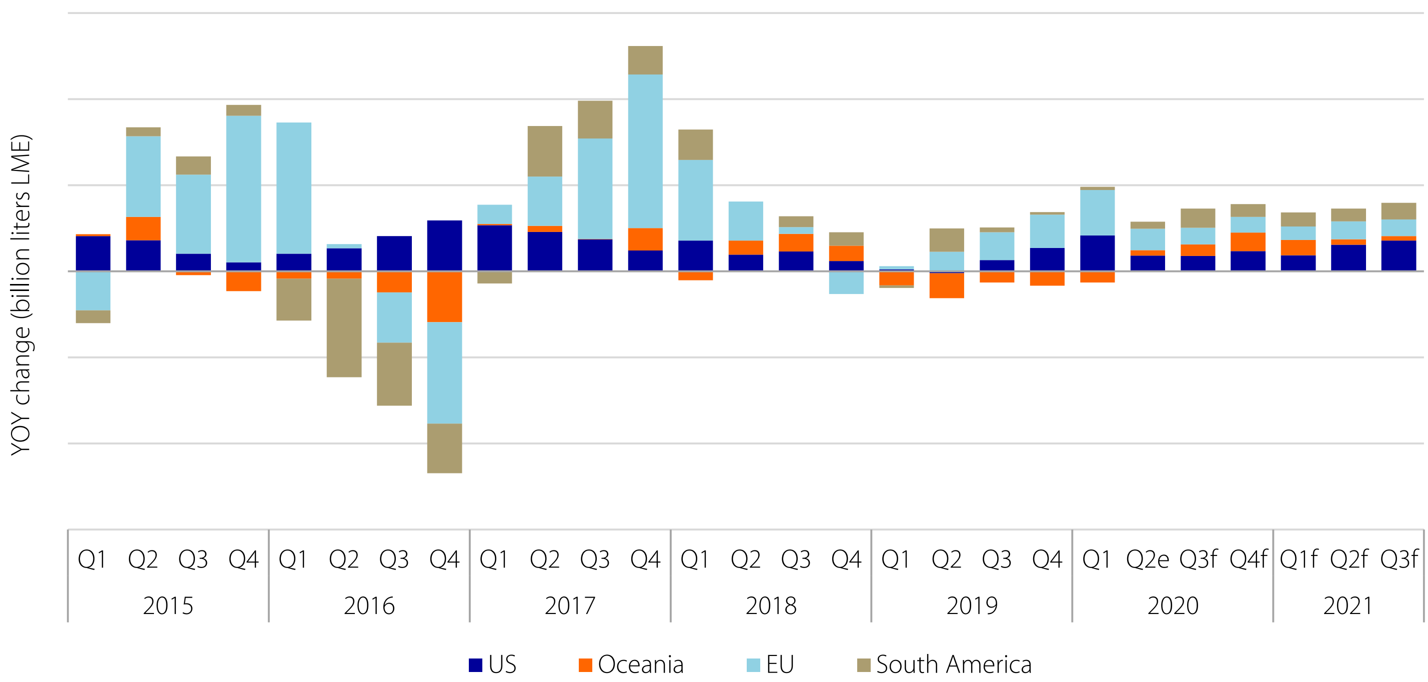
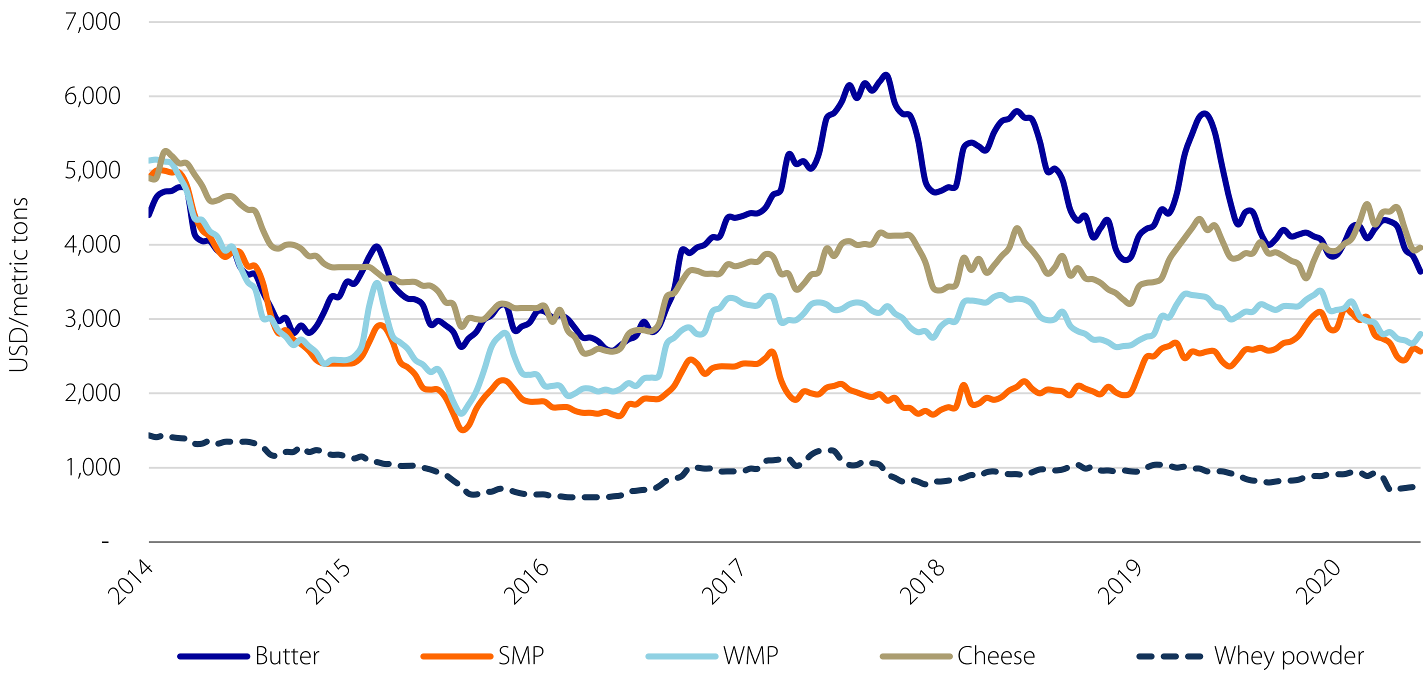


** Big-7 includes EU, US, NZ, Australia, Brazil, Argentina, and Uruguay.*
Source: Big-7 government industry agencies, Rabobank 2020

Figure 2: Dairy Commodity Prices, FOB Oceania, 2014-2020*



** Whey is FOB in western Europe.*
Source: USDA, Rabobank 2020

What to Watch in Q3 and Q4

Dairy is back by popular demand

Covid-19 has rejuvenated the dairy category as consumers returned to a trusted, nutritious product. The Chinese government is re-emphasizing its recommendation to consume 300g of dairy daily (more than three times the current average). This is supported by doctors speaking publically on YouTube-like channels. The dairy industry is expected to double-down on communicating the nutrient-density of dairy products.

Back to basics

Consumers are opting for simple, familiar, staple dairy products amid the Covid-19 crisis. Some of the premium, differentiated products that gained strength in recent years could face struggles in a slower economy.

Disrupted demand will leave heavy inventories to work through

During the lockdowns, processors scrambled to find the right product mix to meet new levels of retail demand, while diverting milk that would have gone to foodservice into longer shelf-life products like butter, cheese for aging, and powder for storage. These inventories will remain elevated and will weigh on markets.

Recession and changing consumer patterns

Much of the world will emerge from lockdown into an economic recession. High unemployment rates and slower economic growth will put a damper on dairy demand lasting into 2021.

Shift in global trade

Exchange rates and weaker import demand will be headwinds for milk-exporting regions. Demand from Southeast Asia has been critical to the growth in dairy trade in recent years and will be closely watched for signs of slowing.

Potential of a resurgence

While our outlook is based on the assumption that there will be no major resurgence in cases of Covid-19, the possibility cannot be ruled out and adds to the broad uncertainty about the future.

Election year in the US

The US is in an election year with the potential for larger-than-normal stimulus and aid packages. Additional US food aid purchases appear to be on the horizon, adding an additional wild card to market forecasts.

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EU

EU milk deliveries in Q1 2020 finished 1.4% or 544,000 mt above last year, with an estimated growth of 1.2% (161,000 mt) YOY in March. This strong growth was supported by increased milk volumes in the Netherlands (2.6% or 91,000 mt), Germany (0.9% or 68,000 mt), Poland (2.1% or 65,000 mt) and France (1.0% or 64,000 mt). Preliminary figures for April indicate a slowdown in EU milk production growth, including a likely decline in French milk production.

Northern and Western Europe are currently undergoing the third dry season in a row. Some regions experienced the driest spring ever recorded, indicating that this dry period started early in the year and will most likely impact grass growth and crop development for the remainder of the season.

Rabobank economists forecast a ‘V’ shaped recovery for the EU economy, with a GDP loss of 9.1% in 2020 and a recovery of 6.1% in 2021. Across the EU, countries are moving away from total lockdowns as infection rates remain low. In May, the first schools re-opened. As of June foodservice restaurants are partly re-opened for dine-in in most countries. However, Rabobank expects year-on-year decreases for the remainder of 2020 due to remaining restrictions that prevent restaurants from operating at full capacity.

Despite disruptions from Covid-19 in the dairy markets, milk prices remained relatively stable until April. EU farmgate milk prices averaged around EUR 34.00/100kg in April. However, the headwind in the global and EU dairy market hasn’t been fully transmitted to farmgate milk prices yet.

Announced milk prices for May and June indicate that EU-average farmgate milk prices will retreat further but remain above EUR 30.00/100kg for the three months until August. This is a small improvement compared to the previous outlook.

After an initial drop for almost all EU dairy commodity prices in the period from mid-March until mid-April, prices rebounded in the weeks following May 1, when PSA was implemented and pipelines for foodservice began to be re-filled. Furthermore, retail demand remained stronger than anticipated, moving markets above intervention price levels for SMP (EUR 1,698/mt) and butter (EUR 2,217/mt). Spot prices for butter, SMP and Gouda (foil) cheese showed even more price volatility during this period, reflecting the overall uncertainty.

As the smoke started to clear, prices for EU butter dropped by 18.9% (EUR 672/mt) since the end of February to EUR 2,879/mt at the end of May. During the same period, EU SMP prices plummeted by 22.9% (EUR 587/mt) to EUR 1,976/mt, while WMP and whey powder prices decreased by 11.3% (EUR 339/mt) and 9.5% (EUR 77/mt) to EUR 2,662/mt and EUR 740/mt respectively. Supported by strong retail sales, EU Gouda prices softened by only 7.0% (EUR 230/mt) to EUR 3,058/mt. During this period, spot prices for Gouda (foil) cheese dropped from nearly EUR 3,000/mt to levels around EUR 2,200/mt at the end of April, followed by a rebound to EUR 2,600/mt. SMP and butter are currently traded at (spot) prices around EUR 2,200/mt and EUR 3,175/mt respectively.

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EU

Current prices are still well-below pre-Covid-19 levels. Considering the downside risks that are still present in the market, such as likely inventory build-ups and possible working capital constraints, it may be too early to call this a recovery.

Pre-Covid-19, EU-28 exports were strong into March. EU cheese exports posted an increase of 11.03% YOY in Q1 2020, with March up by 9.6% YOY. EU butter exports jumped 70.5% YOY, while WMP exports increased by 6.5% YOY. SMP exports, on the other hand, plummeted by 24.3% YOY due to the high comparables from the EU-intervention-based exports last year and the relatively tight market during the start of this year. Rabobank expects that Q2 and Q3 export volumes will better reflect the Covid-19 headwind on export volumes.

SMP production declined by 1.0% YOY in Q1 2020, while butter production increased by 2.4%. During the same period WMP (+9.6%) and cheese (+1.9%) production gained momentum. Due to the market disruption and the sharp drop in prices for some cheeses, Rabobank expects more milk to be allocated to milk powders and butter.

Rabobank has revised its 2020 EU milk production forecast growth from 0.7% to 0.6% YOY in Q2. Following the narrowing on-farm margins and tempered grass and crop growth for this season, Rabobank revised its milk production growth forecast for 2H 2020 from 0.6% to 0.5% YOY.

The EU implemented a Private Storage Aid program for cheese, butter and SMP on May 7, 42,000 metric tons of cheese, 43,000 metric tons of butter and 9,000 metric tons of SMP have been submitted into the program, which runs through June 30. Product is eligible for 180 days of storage.

Following the Green Deal, the EU Commission published the 'Farm to Fork' proposal, which includes significant changes in the EU budget for agriculture in terms of allocation and targets. However, this proposal still has to pass though the EU Council and EU Parliament and needs to be included in the National Strategic Plans of each individual member state before it is implemented in the new Common Agricultural Policy, which will likely not be implemented until 2022 or 2023.

Due to Covid-19, Brexit has avoided the headlines. Nonetheless, negotiations about the future relationship between the UK and EU are still ongoing. Until the end of June, the UK has the possibility to submit a request to extend the current transition period (ending on December 31 this year) by one or two years. For now it's business (and trade) as usual.

Rabobank expects domestic consumption to be down by 3.0% YOY in the second quarter due to volume losses in foodservice for the remainder of the year and retail sales returning back to normal. After the partial re-opening of foodservice restaurants, normally accounting for about 20 percent of total dairy consumption, the demand loss is expected to narrow to 1.0% YOY in the third quarter of 2020.

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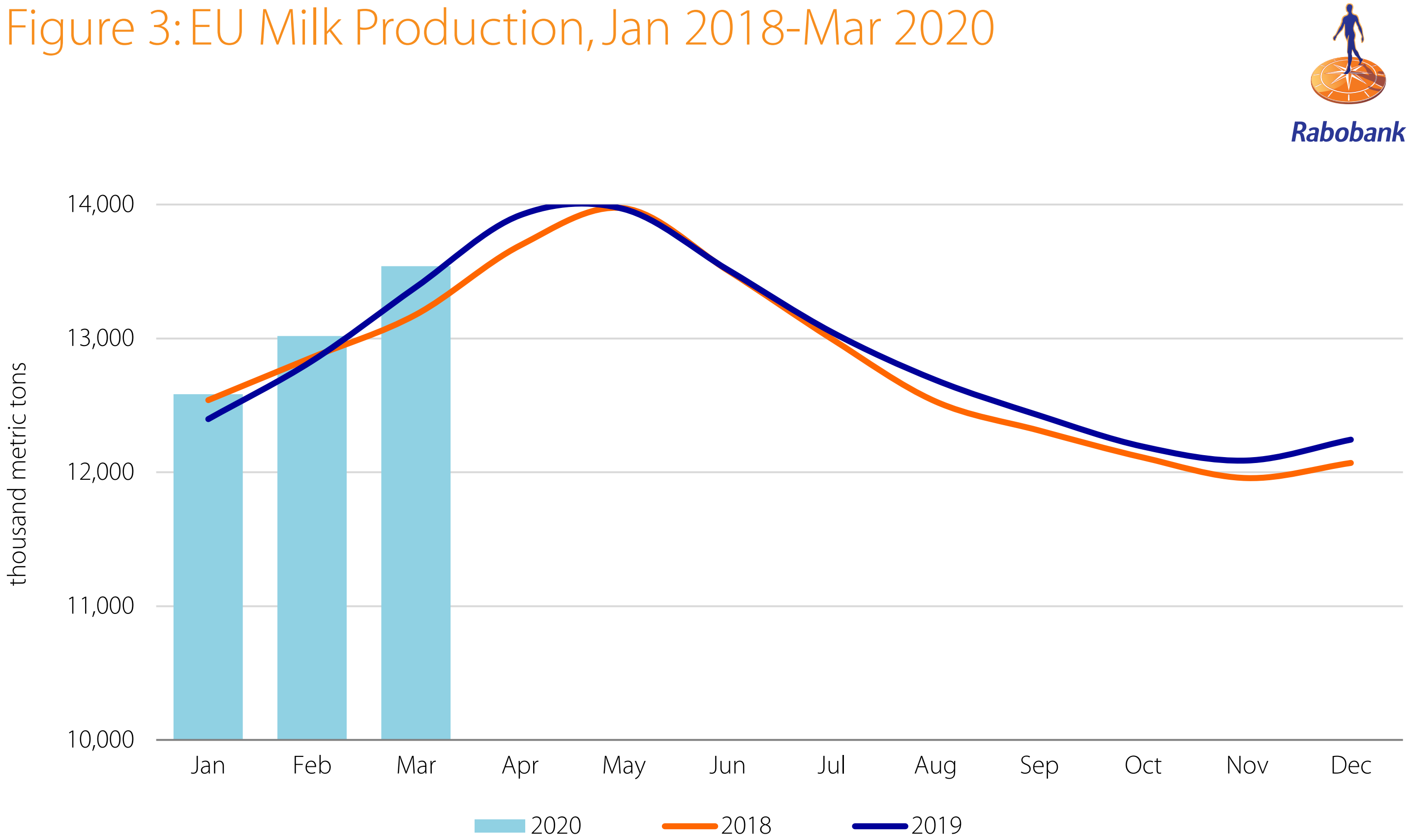
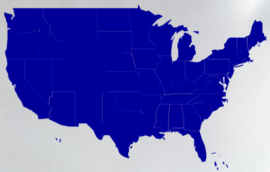
Figure 3: EU Milk Production, Jan 2018-Mar 2020



Source: ZMB, Rabobank 2020

US



US milk producers are being bombarded with rapidly varying price signals and an unfamiliar magnitude of volatility. Uncertainty in milk prices is nothing new, but there is a new uncertainty from one month to the next about whether milk buyers will call for steep reductions in milk shipments or whether they will be seeking extra loads of milk to fulfil large government purchases.

April milk production in the US was up 1.4% YOY, a surprise, perhaps, given the calls for reduced milk and the high slaughter rates. Yet, it's likely that the actual amount of milk delivered to plants was much lower than this, only increasing by less than 0.5% once you subtract milk that was dumped on farm, fed to calves, mixed into rations, or otherwise disposed of before being processed.

The biggest gains in production YOY were from Colorado (up 7.1%), Idaho (up 6.3%), Kansas (up 4.4%), South Dakota (6.6%) and Texas (up 4.9%). These states contributed an extra 195m pounds YOY in April 2020. With expectations of cheap feed, any decrease in the national herd will likely be short-lived. Producers will look for less-permanent means of reducing production.

Milk producers are eligible to receive aid of USD 6.20/CWT multiplied by their Q1 production through the USDA Coronavirus Food Assistance Program. There is a cap of USD 250,000, per operation, with the possibility of an additional USD 250,000 per shareholder up to a total of USD 750,000. This USD 750,000 cap would likely limit payments for farms above 2,000 head. While this will be a meaningful aid package, there is a risk that it mutes the price signals that had been indicating a need for less milk.

Dairy product production saw disruptions in April. Dairy processors diverted milk into longer-shelf-life products including butter (up 25% YOY in April) and nonfat dry milk (up 9.3% YOY). SMP production was down 12.7%, which could indicate pessimism about export markets beyond Mexico. Cheddar production set a new record on a daily average basis in April, but mozzarella fell by 5.4% YOY, reflecting the difference in demand for aging compared to foodservice.

Inventory build coincided with production shifts. Cheese stocks set new records, adding 108m pounds between the end of March and the end of April, up 6% YOY. Similarly, butter stocks grew by 59m pounds between March and April, compared to a build of only 21m over the same period last year. Butter inventories now stand at nearly 370m, up 27% YOY. NDM inventories are up 25% YOY. These elevated inventory levels will weigh on prices through 2H 2020.

Rabobank expects milk production to increase by 0.9% in the second half of 2020 before continuing toward a more normal 1.5% YOY growth rate by Q2 2021. Our Q2 2020 production forecast has been revised upward as the sudden demand pull, largely from government purchase, has quieted some of the calls for less milk. Producers will continue to seek opportunities for increased production, but with some trepidation as images of dumped milk and emergency reduction programs remain front of mind.

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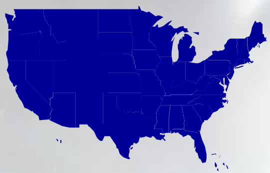
US



US total dairy demand increased 0.2% YOY in Q1 2020, as improved exports offset a slight decline in domestic demand. Measured in total milk solids, year-on-year domestic dairy demand fell by 2.9% and 1.4% during January and February before turning positive, +0.3%, in March. Both domestic and export demand is expected to retreat in Q2 2020 due to the headwinds created by Covid-19. Nearly one-third of US dairy product production is consumed in the foodservice channels.

April 2020 dairy exports show the initial impact from trade disruption from Covid-19. Cheese exports fell 21% YOY in April. Exports to Mexico fell by 24%. NDM/SMP exports have remained fairly stable through April, although exports to Mexico suffered similar to that of cheese, down 23% YOY in April. Whey exports to China surged nearly 240% YOY in April, but against a weak comparable with the combined slowdown in 2019 due to ASF and the US-China trade war.

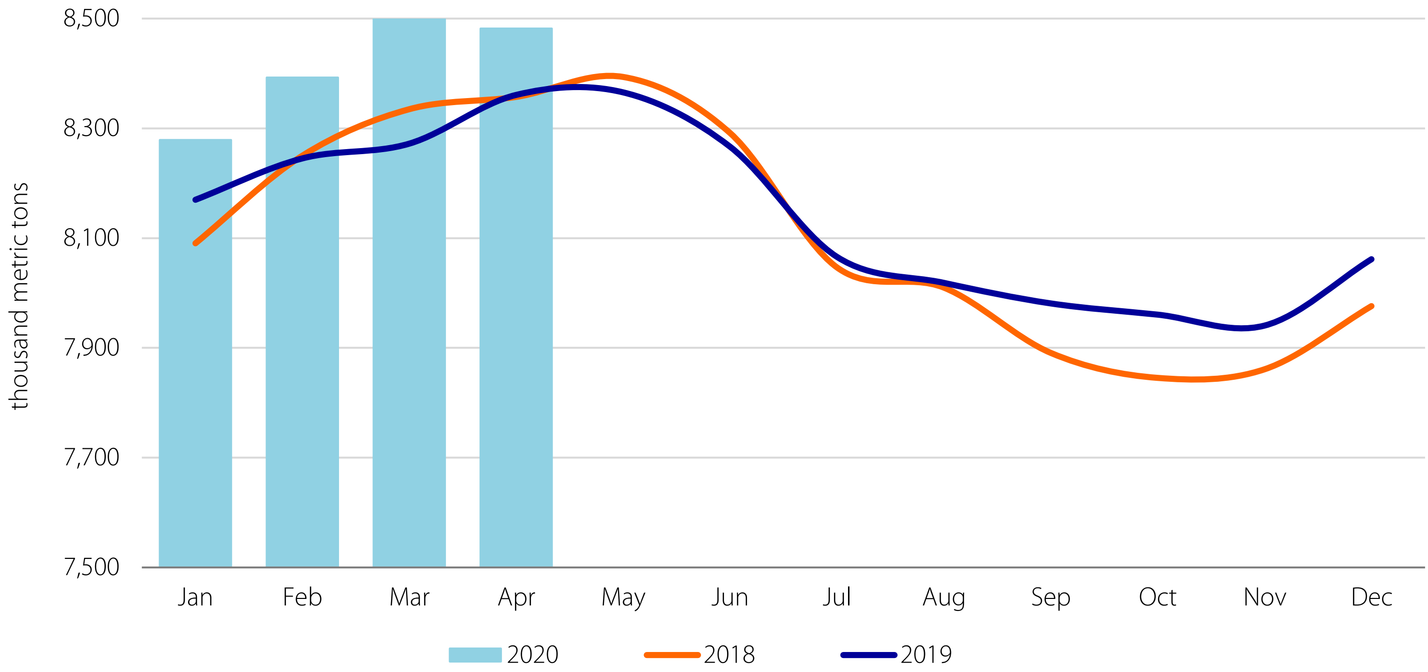
Resurrection of retail dairy. Several dairy categories posting year-on-year volume decline prior to Covid-19 have experienced growth during Covid-19 lockdowns: Private label cheese, ice cream and yogurt are outperforming branded products. For the four-week period ending May 31, year-on-year sales volumes for fluid milk were +6.7%, natural cheese +23%, butter +48%, ice cream +16% and yogurt +3.1%.

US consumers are buying more at the retail level and it's costing them more. US Census Bureau data shows an increase in retail food purchases of 27% and a decrease in foodservice purchases by 30%. The consumer price indices (CPI) jumped in March and April. The CPI for food purchased at home increased 1.1% in March and 4.1% in April. The dairy CPI gains were greater, at 3.7% and 5.2% for the two months. Promotions all but disappeared during the crisis as consumers cleared shelves of staple products at retail.

USDA has spent USD 317m on milk and dairy products for food boxes distributed to food banks and other non-profits by the end of June. Initially, the expectation was that dairy purchases would be USD 100m per month over six months as part of the Coronavirus Food Assistance Program. When combined with ongoing and elevated purchases of Section 32 and other government purchases, there is a sudden pull on cheese, which has driven cheese prices well-above pre-Covid-19 levels in the near term. However, some portion of these distributions will be displacing retail sales rather than generating new demand.

Rabobank has revised its 2020 US demand forecast to -0.8% YOY in 2H 2020 and -2% across the full year 2020. Recovery in domestic demand will gradually improve as the balance of retail sales and foodservice sales converge back toward normal, though that will take time. A weaker economy in the US will impact demand and purchasing patterns through at least 2020. Even as foodservice outlets begin to re-open, there will be restrictions that will limit capacity and there will likely be many restaurants that do not survive the extended lockdown.

Figure 4: US Milk Production, Jan 2018-Apr 2020



Source: USDA, Rabobank 2020

New Zealand

It is a mixed finish to the 2019/20 milk production season in New Zealand. January to April has been dry for many parts of New Zealand, with some regions experiencing their driest period on record.

The effects of the drought are still being felt across much of the North Island. As a result, soil moisture levels remain low, and pasture growth rates have slowed. Not surprisingly, milk production has slowed sharply as the season winds down and as dairy farmers facing feed shortages begin to dry off herds. This compares to a better finish to the season for much of the South Island where milk production has expanded in the current season but will be welcoming rain in the coming months.

On a milksolids basis, milk production was down 0.8% in April year-on-year, bringing season-to-date milk production to 1,800m kgMS, which is 0.2% ahead on the same period last season, adjusted for the leap day. With one month left to round out the 2019/20 season, Rabobank expects New Zealand to close the season at 21.7m metric tons – representing a small decline of 0.6% (in tonnage terms) on the previous season.

Rabobank anticipates a return to growth for milk production in the 2020/21 season. With a return to more favorable seasonal conditions through Spring, and a more normal finish, total milk production is forecast to expand by 1.8% to 22.0m metric tons.

To mitigate against reduced pasture growth, use of purchased feed is increasing heading into winter. There has been some relief on feed costs in recent weeks but prices for feed remain elevated versus year-ago levels – particularly for palm kernel.

There are risk to the milk production outlook. The latest climate outlook from NIWA is expecting normal to below-normal rainfall across much of the country in the three months to July.

Despite expectations of a reduced payout in the 2020/21 season – many New Zealand dairy farmers are looking to reduce discretionary spending as opposed to making major cuts to production systems which would negatively impact milk flows.

In its latest business update, Fonterra tightened their 2019/20 forecast range from NZD 7.10/kgMS to NZD 7.30/kgMS. Rabobank's current modelled farmgate milk price for the 2019/20 season stands at NZD 7.20/kgMS (slightly down on the previous forecast of NZD 7.30/kgMS).

Fonterra also provided a milk price forecast for the 2020/21 season. The initial milk price range stands at NZD 5.50/kgMS to NZD 6.90/kgMS.

Rabobank has revised its forecast payout for 2020/21 higher to NZD 5.95/kgMS. There has been strong appetite for dairy farmers to utilize Fonterra's Fixed Milk Price (FMP) ahead of the 2020/21 season. The monthly allocations of milksolids have been oversubscribed for recent offers. At the time of writing, the two tranches of milksolids offered under the FMP program ranged from NZD 6.42/kgMS to NZD 6.90/kgMS (excluding service fee).

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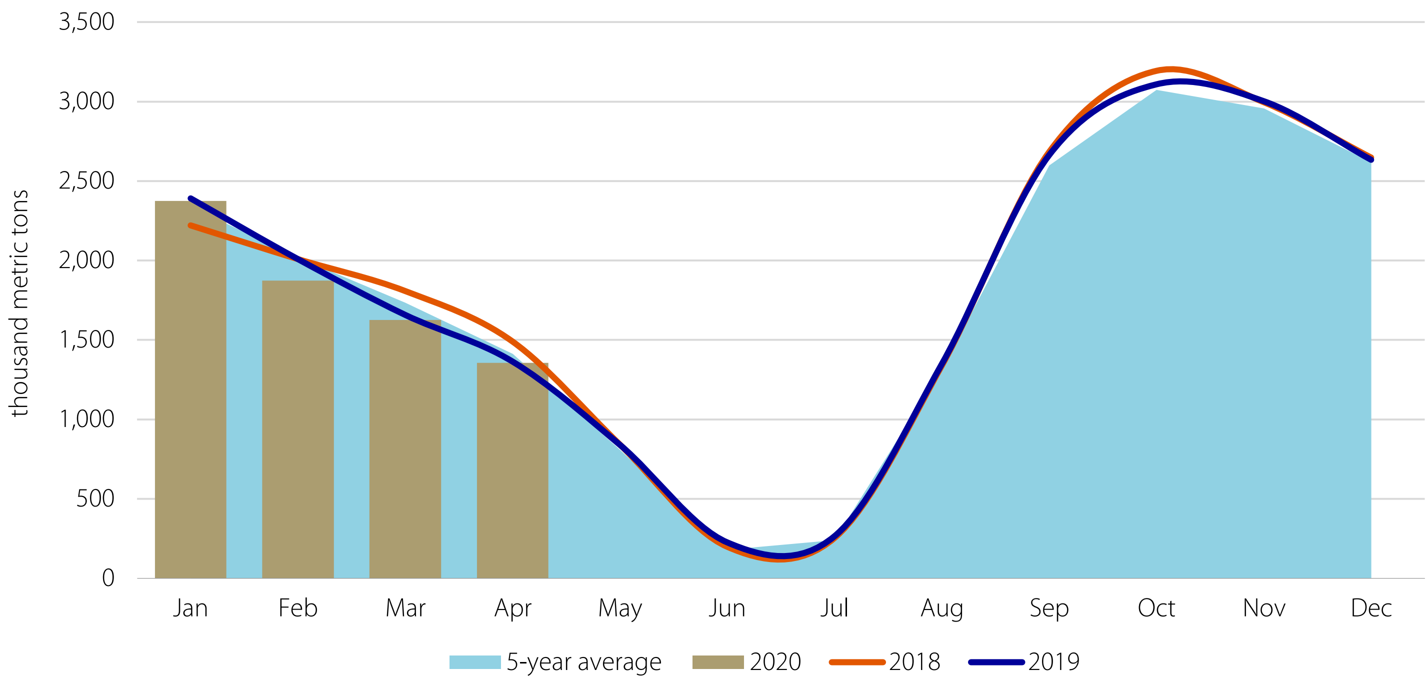
Figure 5: New Zealand Milk Production, Jan 2018-Apr 2020



Source: DCANZ, Rabobank 2020

Australia

Australia's milk production recovery in the Southern export pool is gathering pace. Milk production was up 6.7% in April year-on-year. This brings season-to-date milk production to 7.5bn liters, down 1.6% YOY. Growth is led by exceptionally strong gains in Tasmania and Gippsland, both recording double-digit growth in recent months. Rabobank is forecasting milk production to finish at 8.7bn liters, which would represent a decline of just 0.7% YOY.

Favorable seasonal conditions will be supportive of milk production growth continuing in the 2020/21 season – despite lower milk prices. Rabobank is forecasting milk production to expand by 3.4% in the 2020/21 season. This is against low comparables. Nonetheless, this would bring national production back above 9bn liters and would underpin a return to growth in the exportable surplus from Q2 2020 - for the first time since 2018.

Rabobank's revised farmgate milk price model forecasts AUD 6.35/kgMS for 2020/21. Official minimum prices have been released by all dairy companies, with offers ranging between AUD 6.10/kgMS and AUD 7.20/kgMS across the Southern export region, highlighting the range of business models in the sector.

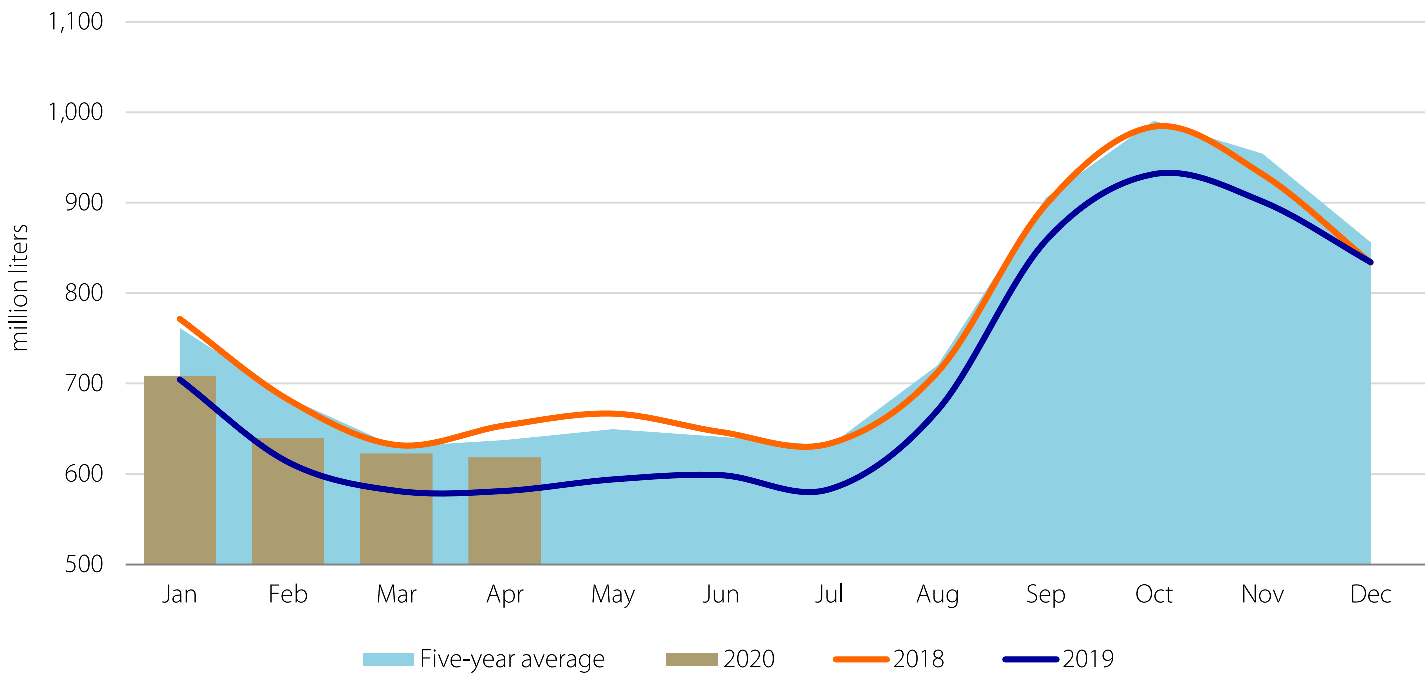
For irrigation dairy farmers in the southern Murray Darling Basin, flows into the major storages since the start of April provided a welcome increase in water availability. This provides a better foundation for irrigation dairy regions heading into the new season – the biggest falls in Australian milk production in recent seasons have come from this production region. The latest Bureau of Meteorology climate outlook for June to August favors wetter-than-average conditions across all major dairy production regions.

Better seasonal conditions have translated into a slowing of culling rates as farmers look to rebuild stocks. Purchased feed markets have continued to trend lower since the start of the year providing margin support for dairy farm businesses. While there is optimism among dairy farmers that there will be further relief on the horizon as the next winter crop gets underway, current prices are still trading above the long-term averages.

The latest statistics show that against a backdrop of reduced milk availability, milk is being prioritized for cheese and whey. Between July 2019 and January 2020, cheese production was up 0.6% versus a decrease of more than 20% in milk powder output over the same period in 2019.

Australian dairy exports have been softer this season on the back of reduced milk availability. Total exports were down 6% on volume basis compared to the previous year. Australian dairy companies have enjoyed a strong start to the year in terms of retail dairy sales. However, consumer purchasing patterns have found a new normal. Lockdown restrictions started to ease by mid-May, with reports of modest improvement in trade.

Figure 6: Australia Milk Production, Jan 2018-Apr 2020



Source: Dairy Australia, Rabobank 2020

Brazil

Milk production remains under pressure. High feed costs continue to be an issue for Brazilian dairy farmers, with corn and soymeal prices impacting margins. Currency depreciation and the close correlation of domestic grain prices with CBOT prices (USD denominated), has pushed both corn and soymeal domestic prices in Brazil to two-year highs. With farmgate milk prices failing to rise due to weaker demand, farmer profitability has been under pressure thus far in 2020.

Production is expected to post a decline in 1H 2020. Low margins have contributed to a reduction in milk output at farm level in Brazil during 1H 2020. Rabobank estimates that production will contract by 1.8% during the first half of the year. Low margins are the main factor behind the drop in production. However, dry weather in the south of the country has also been a factor, limiting production in recent weeks.

Lockdown measures are being relaxed from June onwards. Some states in the south of the country started to lift restrictions on economic activity in May, due to lower Covid-19 infection levels. Meanwhile, the government of São Paulo has announced plans to gradually ease the lockdown in the country's most populous state from June 1.

Pizza restaurants and many other outlets are likely to continue to see most of their sales via delivery, however, foodservice sales via restaurants, cafes and bakeries, that have remained mostly closed, will provide a gradual boost to on-trade dairy sales in Q3.

Trade balance deficit continues to decline. Brazil remains a net importer of dairy. However, the trade deficit has declined in 2020. Imports contracted by 31% in volume terms during the first four months of the year, while exports increased moderately by 11%.

Imports will remain under pressure in 2020. A weaker real means that, for now, imported dairy products have lost competitiveness. Milk powder and cheese imports from Uruguay and Argentina are set to remain below 2019 levels during Q3. As a result, Brazil should import less milk in 2020, compared to 2019.

Despite recent declines, farmgate prices should see some gains in Q3. Farmgate prices have been lower in 2020 compared to 2019. However, the decline in production combined with lower imports is putting pressure on processors to secure more milk from farmers. Farmgate prices are set to see a mild recovery in Q3 as a result of lower production and lower imports.

Brazil to remain a net importer, but with a lower trade deficit in 2020. The weaker real is likely to continue to limit imports, while exports gain competitiveness. Demand will likely remain weak in 2020 and help postpone any significant increases in imports during 2H 2020.

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Argentina

Production continued recovering in Q2. Rabobank estimates that milk production in Argentina will rise by around 8% in the first half of 2020 compared to the same period in 2019. Higher profitability and substantial reserves of silage enabled farmers to increase production in 1H 2020.

Profitability is dropping fast in Q2 after a favorable Q1 for farmers. The measures taken by the new government to increase export taxes on grains, helped to reduce the domestic prices of corn and soymeal, which, combined with higher farmgate milk prices at the start of the year, boosted farmers' margins. However, farmgate prices have stabilized at around ARS 19/liter (USD 0.29/liter), and with increasing inflation and less forage available, due to dry weather in Cordoba and Santa Fe, farmer's profitability will approach zero by July.

The government imposed one of the longest quarantines anywhere in the world as a response to the Covid-19 pandemic. Argentina was one of the first in the region to impose a lockdown and measures will be extended into June, surpassing the 70 day mark. The country entered the crisis already in recession, and under severe fiscal pressure. The recession has helped to tame inflation in the past two months, however prices are expected to rise faster in Q3, further eroding consumer spending power.

Consumers are trading down as a result of the recession. Local demand saw a boost during March as consumers prepared for the lockdown. However, sales are shifting from more expensive categories into basic products, with yogurt, desserts and hard cheese set to suffer a decline in volume sales, while fresh cheese and liquid milk are set to see some increases.

Exports advanced in Q1 but the exchange rate is a problem. Exports increased by 16% in Q1 2020 compared to Q1 2019, with total sales of 84,000 metric tons. However, the overvalued official exchange rate is becoming a problem for Argentine dairy exports. The government has artificially fixed the official FX at around 65 per dollar, compared to the unofficial exchange rate of around 125 per dollar. This means that exporters have to sell their products at around half price internationally, which limits the attractiveness of exports.

Exchange rate and declining consumption could lead to higher inventories. The Argentine dairy industry will face a challenging situation in coming months, as higher milk production comes at a time of weakening local demand and a less competitive export market due to the artificially strong exchange rate. Inventories of milk powder and cheese could rise in coming months, but some exports at low margins to Brazil or other buyers are also likely. Argentine exports are set to decline in the coming months with no relief in sight for exporters from an overvalued exchange rate.

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India

India's milk production in Q1 2020 improved over 2019. Better soil moisture and feed quality, along with improved payouts to farmers, helped improve milk supplies. However, the lockdown from the second half of March has led to supply-chain disruptions, impacting demand for dairy products in the B2B channel.

Farmgate milk prices have gone down by over 25% in India. Disappearance of the unorganized channels (individual/ intermediary) has pushed farmers to supply more milk to the organized channels (coops and private companies). The price of raw milk in Maharashtra has come down from over INR 30/liter (USD 0.43/liter) at the end of February to INR 22/liter (USD 0.31/liter) at the start of April. Farmgate milk prices are expected to remain at lower levels in the next quarter due to Covid-19 challenges.

Demand for milk and dairy products has remained high. The shift from unorganized (loose/unprocessed) to organized (processed, packed) channels has accelerated, aided by supply-chain disruption due to Covid-19. Demand for packed liquid milk has remained strong. Dairy products with a higher share of B2B and foodservice sales (like cheese with a 50% share) have been significantly impacted. Premium categories, like ice cream, have also seen a significant impact in sales (more than 50%) due to supply-chain disruptions.

Local milk powder prices have fallen by 25% to 30%. SMP prices have come down by 25% to 30% from INR 320/kg (USD 4,500/mt) in March to INR 210/kg (USD 3,000/mt). Some companies are even selling at prices below the INR 200/kg mark (USD 2,850/mt). Rabobank is expecting SMP prices to remain at these levels over the next quarter because of increasing SMP inventory.

Rabobank expects SMP exports to remain negligible for FY20 (April-March 2020). Trade activity in dairy has remained muted with insignificant exports and imports. Official full year numbers are not yet available.

Companies are expected to show revenue growth in FY20 (April-March 2020). Full year numbers (including last quarter) have not yet been published by the listed dairy companies, but most of the companies have posted strong revenue growth in first nine months, and the last quarter performance is expected to be modest, factoring in the impact of the lockdown in the second half of March.

Increasing SMP inventories will lead to lower SMP prices. This will mean lower income for dairy farmers due to low farmgate milk prices. A shift in product mix in favor of SMP and ghee/butter will lead to increases in the inventory of SMP in the country. This will continue during the lockdown period. Closure of foodservice, which is not expected to come back to normal in the coming months, will also support this trend of conversion to SMP. SMP prices are expected to remain depressed in the coming months. This will keep raw milk prices depressed and strain the profitability of dairy farmers.

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China

Rabobank maintains its estimate that 1H 2020 dairy demand (in LME) will fall by 7% YOY, factoring in a mild decline in Q2. Leading processors have largely destocked in the retail channel via aggressive promotions, and ex-factory sales are likely to recover to a normal growth trajectory in 2H 2020. Consumers have become more rational about spending, so promotions are likely to persist over the next six months to drive volume. Milk prices are showing early signs of stabilizing, but it remains to be seen whether an upswing is imminent due to promotions and discounts of retail products. International prices of WMP are at a 23% discount to the domestic milk price.

Foodservice has shown a slow recovery, with April sales declining by a narrower 31% YOY (compared to -44% YOY during Q1 2020). Our Consumer Foods team estimates that year-on-year sales are unlikely to turn positive until the end of Q3 or in Q4.

Rabobank expects demand to normalize in 2H 2020 and grow by 1.5% YOY. Still, full-year dairy consumption is forecast to decline by 2.7% YOY.

Milk production is forecast to increase by 4.3% YOY in 1H 2020 and 2% YOY for 2H 2020. The lower 2H slowing in growth reflects lower profitability as a result of farmgate milk price pressure, and a challenging 2H 2019 comparable. Milk prices remain under stress seasonally due to a limited recovery in end-market demand, and an international WMP price that is at a 23% discount to the domestic milk price. With gradual improvement in the retail channels, the pressure to dry milk has largely disappeared as of May.

Rabobank revises the forecast for the decline in dairy import requirement (in LME) to 15% YOY, from the previous forecast of a 19% decline YOY, to reflect higher-than-expected imports during January to April 2020. China's April 2020 LME dairy imports returned to growth by 7% YOY, largely driven by year-on-year growth in WMP (+22%) and whey (+15%). Headline growth in April WMP import volume seems to have surprised to the upside, but the average CIF price was over USD 3,400/mt, suggesting that the purchase decisions had been made before Covid-19.

Rabobank expects that with domestically-produced WMP during late January to April sitting in inventory and higher-than-expected imports, actual import volume is likely to see visible declines from Q2 onward. **Whey imports rose by 15% YOY, supported by some improvement in the ASF-hit hog industry, but still short of pre-ASF volumes, and imports from the US grew a strong 26% YOY as the additional trade war tariff was removed.**

While Rabobank revises the import requirement decline to a narrower 15% YOY in 2020, the knock-on effect will likely lead to a delay in China's increase in purchases to 2H 2021, with the estimate for 1H 2021 import requirement declining by 8% YOY (+6% previously) before rebounding by 13% YOY (+8% previously) in 2H 2021. This makes for a relatively flat import requirement (+0.3% YOY) for full year 2021 (vs. +7% YOY previously). This hinges on an unchanged +5% YOY recovery in dairy consumption in 2021 and a production growth just shy of 2% YOY.

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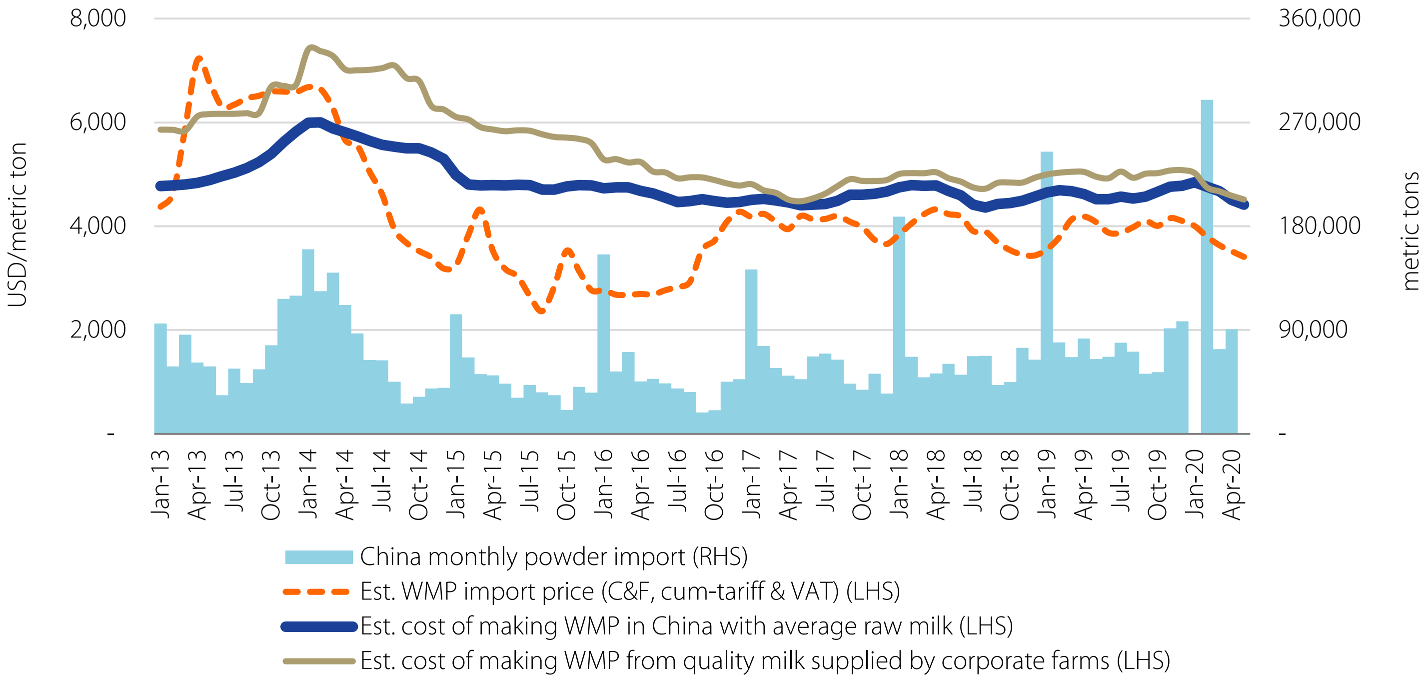
Figure 8: China WMP Import Parity, Jan 2013-May 2020



Source: China Customs, Eucolait, Chinese Ministry of Agriculture, Rabobank 2020

Table 1: Quarterly Dairy Commodity Prices (Historic and Forecast), Q2 2019-Q3 2021f

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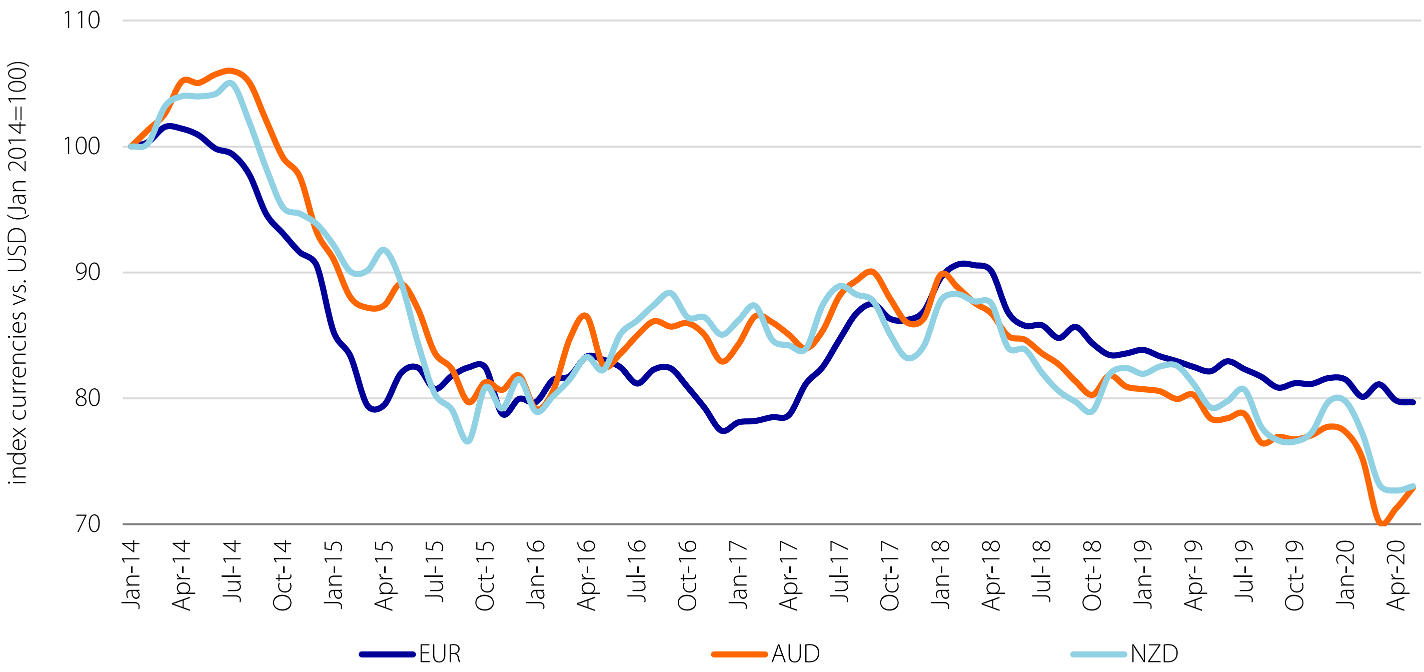
		2019			2020				2021		
		Q2	Q3	Q4	Q1	Q2e	Q3f	Q4f	Q1f	Q2f	Q3f
Butter											
Europe	EUR/mt	4,077	3,669	3,635	3,575	3,050	3,300	3,300	3,400	3,400	3,450
US	USD/mt	5,091	5,136	4,576	4,025	3,210	3,825	3,600	3,525	3,725	3,850
Oceania	USD/mt	5,354	4,227	4,075	4,143	4,000	3,600	3,425	3,400	3,450	3,500
Cheese											
Europe (Gouda)	EUR/mt	3,112	3,112	3,178	3,284	3,125	3,075	3,100	3,125	3,150	3,150
US (Cheddar)	USD/mt	3,700	4,083	4,551	3,900	3,600	4,250	3,850	3,450	3,525	3,710
Oceania (Cheddar)	USD/mt	4,154	3,896	3,796	4,229	4,300	3,750	3,700	3,700	3,750	3,750
Dry whey powder											
Europe	EUR/mt	781	683	735	793	740	750	750	750	750	750
US	USD/mt	834	808	717	795	820	815	840	810	825	825
Skim milk powder											
Europe	EUR/mt	1,994	2,101	2,430	2,511	2,035	2,250	2,300	2,250	2,200	2,200
US	USD/mt	2,221	2,296	2,547	2,650	2,025	2,275	2,225	2,100	2,200	2,260
Oceania	USD/mt	2,502	2,527	2,902	2,946	2,550	2,350	2,300	2,250	2,250	2,300
Whole milk powder											
Europe	EUR/mt	2,926	2,879	3,016	2,998	2,630	2,475	2,500	2,500	2,600	2,600
Oceania	USD/mt	3,206	3,157	3,240	3,039	2,550	2,550	2,450	2,350	2,400	2,425
South America	USD/mt	3,000	3,180	3,100	3,050	2,750	2,800	2,800	2,750	2,800	2,900

Source: USDA, forecasts by Rabobank 2020

Figure 9: Exchange Rates, USD vs. Exporters, 2014-2020



Source: UDM Board of Governors of the Federal Reserve System, Rabobank 2020

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