

Dairy Market Insights

Third Quarter 2021

1. Summary

Complexity for global market outlook

- The outlook for global dairy markets in coming quarters are now being strongly influenced by tightening milk supplies and will remain supportive of commodity prices.
- There are already tight fat and protein supplies in EU and NZ. A slowing in US milk output growth is under way, although it will likely remain ahead of prior year comparatives for some time. Overall, northern hemisphere milk production will grow at a slower rate and there are now risks that NZ milk supply may be slowed by cool and wet conditions.
- Despite the slow recovery from the economic effects of COVID in some key developing markets, difficult and costly supply chain logistics, and the rising risks that cost inflation will be passed to consumers, dairy demand continues to expand.
- Retail demand for dairy products in the domestic markets of the EU and US continues to provide the cushion from COVID's impacts. As vaccination coverage gradually increases, food service channels will continue to recover as new rules for living with COVID become habit. There is a risk that the damage to household incomes and rising costs of living will affect affordability, while slower retail trade may weaken overall demand in Europe and other regions.
- Ignoring the slump in EU-UK trade, global trade continued to grow at moderate pace through July-2021 despite rising commodity prices. Trade has been dominated by the surge in demand due to China's expanding dairy appetite – growing much faster than local supply – despite its cautious reopening. Demand will likely slow from recent peaks and domestic milk supply will increase, but a large import dependence to provide food security is projected to continue.
- Demand from other developing regions is patchy – mostly positive across South East Asia, but price-sensitivity has been evident at recent elevated prices in Africa and the Middle East.
- What can upset these fundamentals? It is difficult to foresee any major supply side factors that could alter the landscape through to Q2-2022.

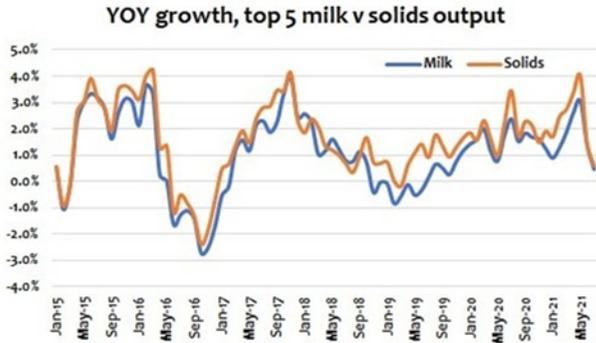
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What it means for Australian dairy farmers

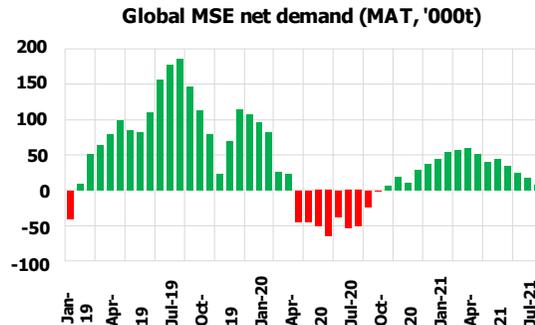
- The spot commodity milk value (CMV) has tracked within a tight band since March. After reaching A\$7.11/kgMS in April, the CMV drifted lower until early September before rising in recent weeks to A\$6.92/kgms at the time of writing.
- Butter prices have added US\$230/t since the end of June, while milk powder prices have eased. Cheddar prices have fallen \$100/t over the same period, while the Australian dollar has fallen by around US\$0.03.
- The direction of the currency remains highly uncertain with macro factors supporting the US\$ as the risk of interest rate rises in the US financial system, offset by the weaker iron ore market.
- The midpoint of our projected CMV for 2021/22 has improved to A\$6.70/kgMS, assuming a forward value of the Australian dollar of US\$0.75. At this stage there appears to be more upside in that projection.
- For 2021/22 opening prices in southern regions settled between \$6.90 and \$7.10/kgMS. While producers will be looking for increases through the season, rising processing and logistics costs, and the uncertain outlook for some sales channels could constrain how much can be passed on through step-ups in the short-term.
- To learn more, visit the Milk Value Portal at milkvalue.com.au

2. Some key market indicators

Global milk supply growth has slowed to the lowest rate since Q3-2019

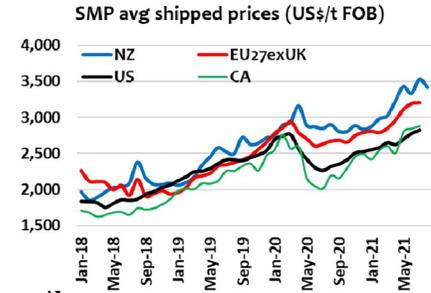


The global milk balance remains tight – but finely balanced as milk growth slows and high commodity prices also slowed some trade

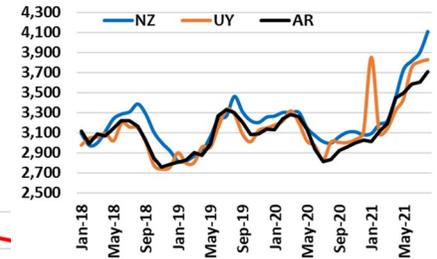


*MSE is a milk equivalents calculation based on the butterfat and protein used in commodity products.

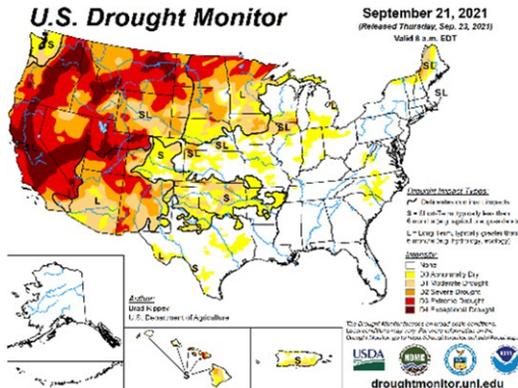
Affordability is a key risk in coming months. Recent trade data shown in this report is at prices well below recent GDT and domestic wholesale prices



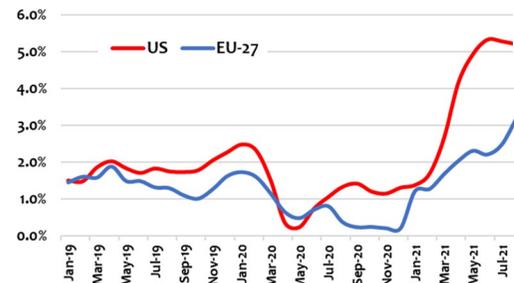
WMP avg shipped prices (US\$/t FOB)



La Nina conditions mean some significant drought watch-outs for the Americas that will impact crop yields in coming months. In New Zealand it's the opposite problem with excess soil moisture in the Nth Island. This could be addressed if the weather warms, as predicted, in coming months.



CPI % on all consumer goods 2019-2021



Rising inflation – which consensus forecasts say is transitory – has sparked fears of interest rate increases by some governments, which could impede economic recovery

3. Watch points

There are several policy and other wildcards that may significantly impact trade in the short to medium term.

| Issue | Summary | Analysis/impact |
|-------------------------------|---|---|
| COVID vaccine coverage | <ul style="list-style-type: none"> Vaccinations are being rolled out, with coverage high in the west but very low in many developing countries. | <ul style="list-style-type: none"> There will be an uneven recovery in developing markets following the “every man for himself” approach to vaccine distribution, which will slow the potential recovery in those countries and their food markets. |
| Macro economic outlook | <ul style="list-style-type: none"> Inflationary pressures continue to rise and will be a factor through much of 2022 until supply and capacity pressures ease, affecting many inputs to food production and processing. The risk that China’s debt-laden property group Evergrande could be left to fail has been smouldering for some time. It is unlikely that China’s government will allow the group to fail for many reasons – the most important being the financial damage to the large number of depositors who would lose household savings. | <ul style="list-style-type: none"> Inflationary cost pressure puts at risk the economic recovery from COVID, which will worsen if governments prematurely ramp interest rates. It is expected a safety net arrangement will be put in place as well as other devices to manage the crisis away over time. Whether it wishes to teach this property player a lesson is difficult to call. The government will cushion their economy from harm, but the yuan will be a bellwether of success. |
| Energy prices | <ul style="list-style-type: none"> Surging gas prices due to the acute shortages of supplies in Europe are rippling across the world’s energy markets, pulling oil prices higher. The rising costs are adding to industry cost pressures and will impact household spending if the pressure endures. The source of the issue may blow up into a geopolitical crisis if there is a risk that Europe is exposed to a winter without sufficient supplies. | <ul style="list-style-type: none"> Global fertiliser prices are at extreme highs (due to strong demand from crop production regions, crude oil prices and rising prices of mining commodities) putting pressure on farm margins. Watch Chinese electricity restrictions on processing |
| Logistics | <ul style="list-style-type: none"> Shipping and port congestion challenges remain a factor, slowing trade in the global terminals. Higher costs are feeding into inflation and adding to the landed costs of product in developing markets. | <ul style="list-style-type: none"> Slowing export offtake due to port congestion is leading to a build-up of supply chain inventories. Starting to overhang US market fundamentals |
| Government policies | <ul style="list-style-type: none"> The US government has agreed to implement an assistance policy to make up for some gaps in the coverage during 2020. In essence this will steer more assistance into small dairy farms. | <ul style="list-style-type: none"> Measures will be mildly supportive for US milk production but probably the last to be seen for some time. |

4. Commodity overview

| | What will support prices | What will weaken prices | Expected direction in 2021 |
|---------------|--|---|---|
| SMP | <ul style="list-style-type: none"> Relatively low EU availability while manufacturers prioritise cheese production with available milk Slowing output in the south-west of the US will limit growth in NFDM/SMP production, while demand from Mexico improves Higher whey protein prices improving demand for SMP/NFDM (where substitutable) NZ product mix is shifting away from SMP where possible | <ul style="list-style-type: none"> Pushback from some buyers (in short-term) Shipping delays adding to risks of short-term stock-build Competitive pressure on EU/NZ prices from US exporters | Following EU and US lifts with a narrowing premium over competitors  |
| Butter | <ul style="list-style-type: none"> Sustained retail demand in EU-27 countries Product mix is limiting cream supplies to service sustained cheese demand Chinese demand remains strong High competing vegetable oil prices | <ul style="list-style-type: none"> High prices meeting resistance in developing markets Weak overall demand for NZ exports, aided by limited US market access Slow food service recovery in developing markets | Steady with risk of lower demand from developing regions  |
| Cheese | <ul style="list-style-type: none"> Improving food service sales in US and EU-27 markets Food service re-openings in Asian regions Improving UK import demand for EU-27 product with reopening food service channels | <ul style="list-style-type: none"> Strong growth in milk output into the December quarter of 2021 in US cheese-rich regions (Central and California) Intense competition in Asian markets Competition from US exports at low prices for EU-27 and NZ exporters | Steady with firmer protein values, subject to competition in key markets  |
| WMP | <ul style="list-style-type: none"> Persistent Chinese demand supported by import cost advantage Supportive underlying fat and protein values Weaker WMP output in the EU-27 Strong palm oil prices lifting cost of fat-filled alternatives Likely improved Brazilian demand | <ul style="list-style-type: none"> Weaker underlying “synthetic value” with lower fat prices Pushback against elevated prices in developing markets Weaker veg oil prices lowering prices of fat-filled alternatives | Improving fundamentals with stronger supported by underlying fat and protein values  |

5. Australian outlook

Critical issues

- Spring seasonal conditions have improved in southern Australia after wet winter conditions slowed output.
- The rainfall and temperature outlook remains highly supportive of milk production. Major irrigation storage levels in the Murray Darling Basin have improved and water security is the best it has been for many seasons.
- Feed grain prices have recently lifted above long-term averages, which will start to bite into post-peak margins and increase caution felt by some producers in chasing late season milk production.
- Forage supplies are abundant while crop estimates remain favourable, increasing downward pressure on pricing, aided by falling global benchmarks.
- Queensland milk output in 2021/22 has been slightly down despite lower-than-average feed input costs.
- WA milk output has suffered from a wet winter, and feed input costs are above average affecting profitability, particularly relative to beef operations.

Milk production

- The spot commodity milk value has moved within a tight band since March and after drifting weaker until early September, it has recently jumped as commodity prices improved and the A\$ lost value against the US\$.
- There have been gains across commodities in September and a small dip in the A\$, which lifted the CMV by A54c. The CMV indicator was back near A\$6.90/kgms by the end of September.
- The direction of the currency remains highly uncertain with macro factors supporting the US\$ as the risk of interest rate rises in the US financial system, offset by the weaker iron ore market.

Milk prices

Outlook factors

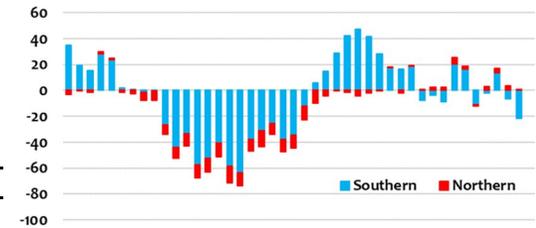
- Milk growth is still expected to remain sluggish in southern regions, under pressure from farm exits prompted by strong land values and high beef prices.
- Queensland and WA milk growth also limited by profitability and labour concerns.



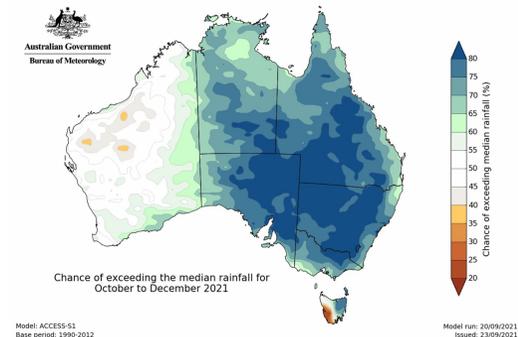
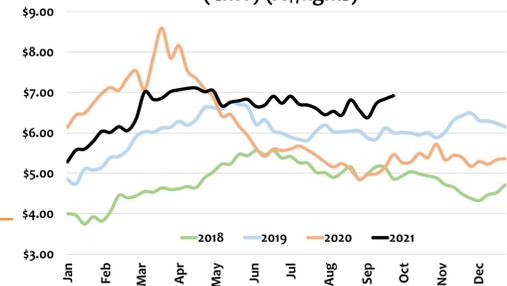
| | Milk | Fats | Cheese | SMP | WMP |
|---------------|-------|-------|--------|--------|-------|
| 2020 | 8,666 | 54 | 367 | 172 | 33 |
| 2021 | 8,786 | 61 | 387 | 213 | 44 |
| 2022 | 8,874 | 61 | 398 | 176 | 45 |
| YOY % changes | | | | | |
| 2021 | 1.4% | 13.5% | 5.6% | 24.0% | 34.1% |
| 1H-21 | 1.8% | 8.1% | -1.0% | 55.3% | 30.6% |
| 2H-21 | 1.1% | 17.2% | 11.3% | 6.5% | 36.7% |
| 2022 | 1.0% | -0.8% | 2.8% | -17.5% | 2.5% |
| 1H-22 | 1.0% | 0.7% | 5.2% | -31.9% | 4.5% |
| 2H-22 | 1.0% | -1.6% | 0.9% | -5.7% | 1.0% |

- The midpoint of our projected CMV for the 2021/22 season remains around A\$6.70/kgms, based on the forward A\$ = US75c.
- If the A\$ remains close to the current level of \$0.72, the full year CMV would average near A\$7.00/kgms.
- Milk prices for the 2021/22 season settled in a A\$6.90-7.10/kgms range. While producers would like to see as much paid out as possible, the uncertainty in some sales channels and the significant rises in processor input costs could limit uplifts or 'step-ups'

YOY growth, Australian milk output (mn litres)



Australian Spot Commodity Milk Value (CMV) (A\$/kgms)



5. Australian outlook

Critical issues

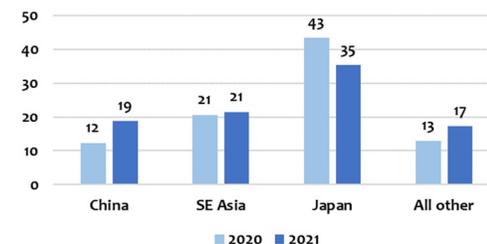
- Grocery sales growth has jumped again with lockdowns affecting NSW and Victoria through August and September and lasting into November on current vaccination trends and the various staged plans for re-opening.
- The disruptions to food service trading with COVID outbreaks hampers a broad-based recovery of demand from the sector.
- Australia has continued to lift SMP exports, which grew 14% in the 3 months to July, and were 28% ahead in the 7 months to July. All the growth came from China, with year-to-date almost doubling. Cheese exports are 5% stronger in 2021, with China and US markets providing strong gains, offsetting losses in Japan.
- Imports of cheese slowed appreciably in the 3 months to July but are slightly lower (3%) on a rolling 6-month basis with higher local production and weaker demand outside retail. Butter imports picked up in recent months with a large jump in NZ exports in July.

Outlook factors

- The food service market will remain subdued and uncertain despite gradual reopening of those channels as vaccination rates pass thresholds for restrictions to be removed in locked-down areas in Q4-2021.
- Food manufacturers facing rising input costs will be seeking to pass through price increases to protect dwindling margins. Meanwhile retailers are facing the end of widespread lockdowns which have improved their top line, while COVID-related costs will continue to affect the bottom line. If the retailers are looking to gain food spending share through price discounting this sets up a potential contest with suppliers.

Markets

Australian cheese exports 7 months to July '000t



Glossary and explanation of key terms

| Acronym | | Explanation |
|---------|------------------------------|---|
| AMF | Anhydrous Milk Fat | Removal of water from cream or butter yielding 99.8% milk fat product used in preparing reconstituted product and in food processing |
| CMV | Commodity Milk Value | The CMV calculation utilises actual or forecast spot prices for major commodities (SMP, WMP, cheese and butter) converted to local currency and the average industry product mix to generate revenue estimate. Direct conversion, overhead costs and allowance for profit retention to generate an estimate of returns available to the relevant milk pool. The CMV is used as a useful forward indicator of how the global market might affect the farmgate and is tracked weekly here . |
| EU-27 | European Union | European trading bloc including 27 member states |
| FMP | Farmgate Milk Price | The average FMP that is paid by processors in the southern exporting region of Australia (including southern NSW, Victoria, Tasmania and South Australia) is made up of the underlying commodity value of milk (CMV) and a value-add or premium that depends on the product and market mix of each processor. This includes fresh and other retail dairy products as well as higher value specialised dairy ingredients. |
| FOB | Free on Board | A shipment term used to indicate whether the buyer or seller is liable for goods that are damaged or destroyed during shipping |
| MS | Milk Solids | The protein and fat content of milk which is the basis of payments from processors to farm suppliers. According to Australia in 2019/20 the average Australian litre of milk comprised 4.15gms of fat (4.15%) and 3.45gms of protein (3.45%) and therefore was 7.60gms of milk solids (7.6%). |
| NFDM | Non-Fat Dry Milk | Shelf-stable milk powder derived from the evaporation and spray drying of skimmed milk. NFDM is defined by the US Code of Federal Regulations and is similar in composition to the more widely produced and traded skimmed milk powder at 34% protein. |
| NZ | New Zealand | |
| LatAm | Latin America | Mainly focused on major dairy producing and importing countries Argentina, Uruguay and Brazil. |
| MENA | Middle East and North Africa | |
| SMP | Skimmed Milk Powder | Shelf-stable milk powder derived from the evaporation and spray drying of skimmed milk. SMP is defined by the globally recognized Codex Alimentarius as comprising 34% protein and 1.5% milkfat. |
| US | United States of America | |
| WMP | Whole Milk Powder | Shelf-stable milk powder derived from the evaporation and spray drying of whole milk. SMP is defined by the globally recognized Codex Alimentarius as comprising 34% protein and a minimum 26% and less than 42% milkfat. |