



Dairy 2012 Situation and Outlook

February Update



February 2012 Update

About this report

The Situation & Outlook process is designed to provide the Australian dairy industry and its stakeholders with an overview of the entire industry supply chain – from dairy farm inputs to consumer markets.

This is the second update to released for the 2011/12 season, following the most recent 2011 annual Situation & Outlook report, and replaces the update published in September 2011.

The report has been compiled with input from industry organisations and dairy companies, as well as a range of information sources.

This updated report:

- Summarises the operating conditions facing the Australian dairy industry supply chain, and ultimately affecting the profitability of dairy farms; and
- Provides a brief overview of the current industry status and the situation and outlook for the key drivers of the Australian dairy industry.

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Australian dairy supply chain in February 2012

Continued two-speed industry – export vs domestic supply regions.

Firm farmgate prices in exporting regions, generally favourable seasonal conditions, and expanding milk production.

Farmgate prices in drinking milk regions are under pressure from brand share losses.

Falling retail milk prices adding to margin pressures for drinking milk processors.

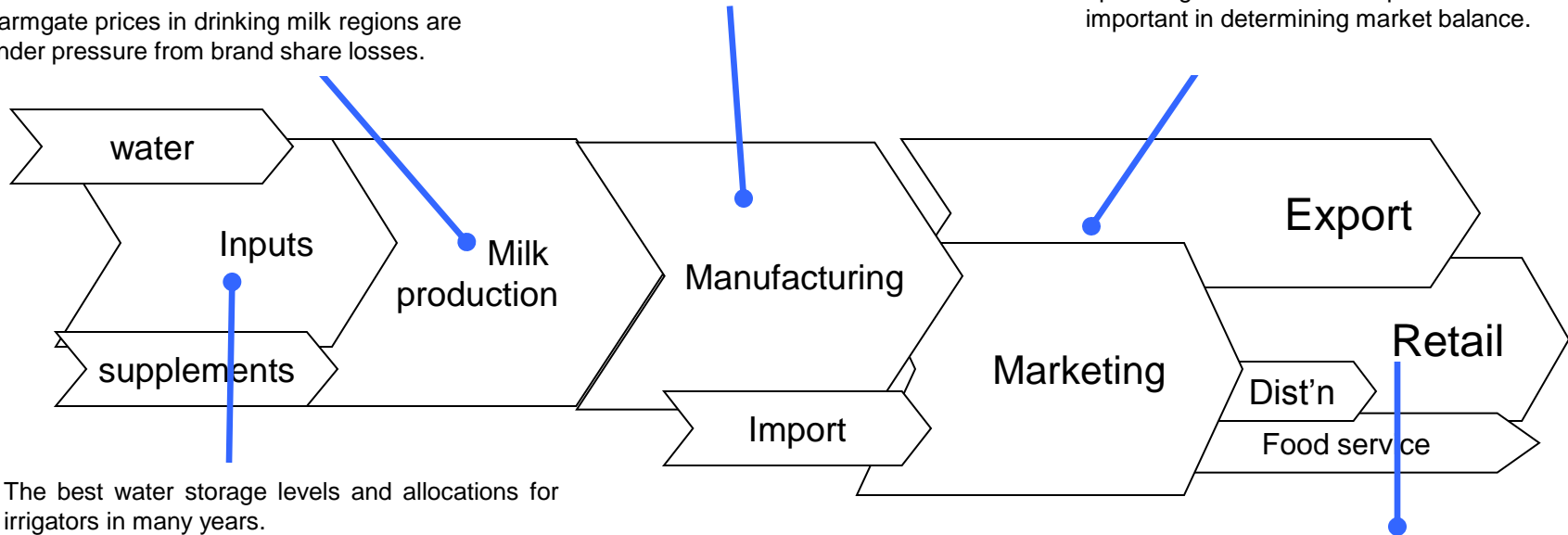
With a steady export market, step-ups have returned to a more traditional pattern.

Strong Australian dollar continues to constrain returns to exporters.

The international dairy market has remained remarkably stable amid wider economic turmoil.

Demand is resilient, led by South East Asia, China, and the Middle East.

Global supply has increased with all exporting regions increasing production – NZ is expected to increase production by between 8 and 10%. The upcoming Northern Hemisphere flush will also be important in determining market balance.



The best water storage levels and allocations for irrigators in many years.

Good soil moisture levels across many regions – although some are too wet.

There is plentiful feed grain supply at reasonable prices.










Lower cull rates, and falling heifer exports, but milking cows remain in short supply.

Consumers remain cautious – non grocery/ foodservice sales are slow, with increasing unemployment concerns.

Supermarket price competition is continuing and looks set to remain a feature of the retail landscape for some time.

Dairy product sales have grown across all categories, in the December quarter. However average prices were lower for milk and cheese.

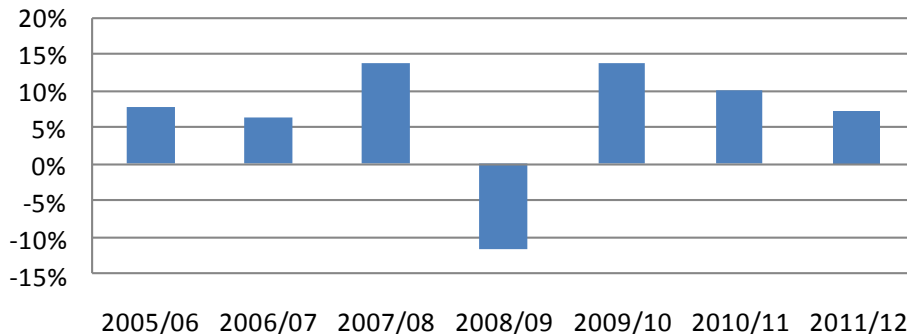
Key driver outlook

	Global economy	Global demand	Australian market	Global supply	Inputs	Exchange rates
Status						
Major discussion points	<p>Global economy slowing with markets susceptible to risks such as a worsening debt crisis in Europe or political unrest in the Middle East that could raise the oil price.</p> <p>Eurozone on the brink of a second recession in three years, with a wave of credit-rating downgrades and Greece likely to default on its debts.</p> <p>Signs of mild recovery in US economy. High unemployment rates easing but consumer confidence remains weak.</p> <p>Economic growth slowing in emerging markets.</p> <p>Chinese economy set to slow further in 2012, but no hard landing.</p>	<p>EU, and to a lesser extent, US economic issues remain the major downside risk for trade finance and ultimately demand.</p> <p>South East Asia, China, the Middle East and North Africa continue to drive demand in the current market.</p> <p>Prices for competing fats and proteins rising – supporting dairy value proposition.</p> <p>Chinese imports remain strong, underpinning global WMP and whey markets.</p>	<p>Concerns about the global economy and jobs keep households wary about spending.</p> <p>Foodservice sector is slow with trend away from “eating out” continuing.</p> <p>Supermarkets ‘milk price war’ is ongoing – no end in sight from retailers, with expansion to other food categories.</p> <p>Domestic sales of major dairy companies mixed across categories – but mostly lifting in value terms.</p>	<p>Significant milk production growth in EU and US. Export availability is likely to grow, but will depend on domestic consumption levels.</p> <p>Australia production up 3.6% year to date.</p> <p>NZ production forecast to increase 8-10% in 2011/12.</p> <p>Strong production growth in South America - Argentina likely to increase export availability.</p> <p>Poor weather hampering Brazil production, but growth of 1-2% still expected.</p>	<p>High water allocations and near full dam storage levels.</p> <p>Plentiful local feed grain stocks with easing prices following a second consecutive large wheat harvest.</p> <p>Potential shortage in supply of quality hay – but on-farm stocks may reduce demand.</p> <p>Fertiliser prices subdued – and likely to remain so in the short term.</p> <p>Fewer cull cows and slowing rate of exports for heifers.</p>	<p>The Australian dollar has appreciated strongly against USD supported by interest rate differentials with major economies.</p> <p>Major banks forecast AUD to trade in 95-110 US cents range to the end of 2012 - a higher range than previous forecasts.</p> <p>A weaker Euro is strengthening EU exporter competitiveness on world markets.</p> <p>Strong Japanese yen has supported imports, but is expected to weaken in 2012.</p>
<p align="center">Operating conditions or key driver status:</p> <p>Positive  Steady  Negative </p>						

The Australian dairy industry in February 2012

- **Generally favourable seasonal conditions, lower feed costs, good soil moisture levels and high irrigation allocations** are supporting profit margins, making this season one of consolidation for most dairy farmers in southern exporting regions.
- While global dairy markets remain steady, wider economic issues and exchange rate movements are major uncertainties in the outlook.
- Following a slow start to the 2011/12 season due to a wet spring, pasture conditions have improved markedly in most key dairying regions. **Northern and western Victoria, together with southern NSW are enjoying the best conditions for many years**, while **Tasmanian production remains strong**.
- Although production in Queensland and Western Australia continues to lag last year, the monthly rates of decline have eased.
- Australia's milk production was **3.6% up on last season** for the six months to December - at 5.6 billion litres. **Dairy Australia is forecasting milk production to grow by between 3 and 4%, reaching 9.4 to 9.5 billion litres in 2011/12.**
- Step-up payments to southern farmers for the season to February represent a smaller proportion of the opening price than in recent years (excluding the 2008/09 step-down), as indicated in Figure 1.

Fig 1: Step-ups to February as % of Opening Price - VIC



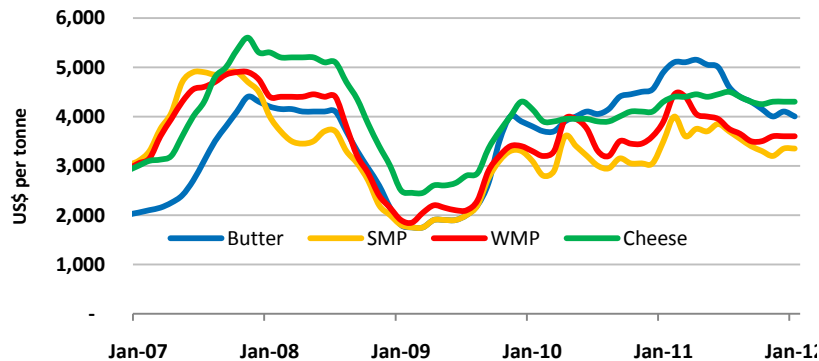
- **This return to a more traditional pattern of step-ups** is in line with **the more stable international market conditions** that have prevailed in 2011/12 compared to previous years.
- **Opening prices from exporting manufacturers now appear to have been closer to the mark than in recent more volatile years**, with less requirement to make additional payments through the season. Current modelling suggests a likely **final average southern price range of \$5.20 to \$5.30 per kilogram of milk solids for the 2011/12 season**. This estimate is indicative, as the proliferation of alternative payment systems means individual farmer payments will vary greatly around this average.
- **The stability of the international dairy market has been remarkable given the ongoing turmoil in global financial markets and the deteriorating outlook for the world's economy.**
- In addition, supply is increasing in all major exporting regions, as farmers respond to the more positive price signals of the past two years.
- European milk production growth is slowing in countries in danger of exceeding milk production quota restrictions, and in response to cold weather. However, a **1.5 to 2% increase in EU production** is still forecast. **US production is up 1.8%** driven by higher cow numbers and production yields and underpinned by policy developments.
- After a strong start to the season, **New Zealand milk production is forecast to increase 8-10%** on last season, supported by good weather conditions, promoting pasture growth.
- **Demand for dairy products** from dairy importers has largely **absorbed the strong global milk production of 2011**. This has supported commodity prices, despite the increase in supply.
- While **Chinese WMP imports slowed** in the second half of 2011, finishing the year down 1.8% on 2010, **total Chinese dairy import volumes jumped more than 20%.**

The Australian dairy industry in February 2012

- There have been **concerns that US and EU dairy consumption** would fall as a result of ongoing economic woes. However, **product sales have increased or remained steady in major member states.**
- **Spot prices for cheese** - Australia's most important export product **been the most stable** throughout 2011, reflecting the longer term nature of the trade. With a large proportion of additional milk production – particularly from New Zealand - used in milk powders, both the supply and demand for cheese has remained relatively consistent.
- While milk powder supplies have increased, strong demand growth in Asia and Brazil has allowed commodity prices to drift rather than fall significantly.
- Competing **vegetable fat and protein prices have increased** in response to supply constraints - and in the case of vegetable oil, strong demand from China, India, Pakistan and Indonesia. This, combined with slightly weaker butter and skim milk powder prices has **reduced the premium for dairy ingredients, encouraging their use by food manufacturers.**
- Currency movements are impacting the competitiveness of exporters. **The Australian dollar (AUD) reached a 6-month high above 107 US cents in early-February.**

- **The relatively high level of interest rates in Australia** is in stark contrast to many other developed economies. This draws in more funds, supporting a stronger currency. The AUD is expected to remain at higher levels given a likely extended period of low interest rates in the US and Eurozone. The high Australian dollar will continue to limit returns to local exporters, at the same time EU exports are becoming increasingly competitive, and US manufacturers will be finding exports more attractive.
- The **currencies of some importing countries have depreciated against the US dollar. However, softening prices have maintained affordability for buyers.** The US Federal Reserve announcement that it will keep US interest rates at 0% until at least 2014 will provide little support to the US currency throughout 2012.
- The **outlook for the international dairy market depends critically on demand for products continuing to absorb additional milk supplies.** While a further deterioration in the world economy would test demand, the resilience of consumption - both in troubled developed regions and the more robust emerging markets is a positive for the industry.
- The local dairy market has continued to perform well amid concerns around cost of living pressures and weakening employment prospects. **However, consumers are still seeking “value” and food prices remain under pressure, as major retailers continue to use lower staple food prices in a bid to maintain market share. This is likely to maintain pressure on milk processor margins and therefore payments to farmer suppliers in 2012.**
- The outlook for **2012/13 farmgate price** in southern exporting regions will be heavily dependant on **exchange rate movements as well as the international dairy market balance.**
- Dairy Australia modelling indicates that an increase in the Australian dollar from 105 to 110 US cents would reduce farmgate prices by 30 cents per kg milksolids or around 2.2 cents per litre. While exporters will have hedged a large proportion of current season sales they will be more exposed to a high and possibly variable exchange rate in the coming year.

Fig 2 - Spot commodity prices (USD/t FOB)



The Australian dairy industry in February 2012

Good news

- The majority of Australian dairy farmers are enjoying favourable seasonal conditions and a profitable season, and production is increasing strongly in 2011/12.
- Successive interest rate cuts have provided stimulus for the local economy, and potentially lifted the interest burden of farm debt, with easing inflation boosting hopes for further cuts.
- While the Chinese economy is expected to slow, it is on track for a soft landing in 2012, maintaining dairy import demand and supporting global economic activity.
- Australia's feed grain supplies are plentiful following a second bumper winter crop.

Bad news

- Most major exporting regions are increasing production in response to improvements in farmgate prices in recent years and generally favourable seasonal conditions.
- The Eurozone is potentially headed for another recession with the debt crisis threatening to Europe's core economies. The Euro is expected to weaken significantly in 2012 making EU exports more competitive.
- High unemployment and weak consumer spending will constrain the US economy into 2012, while Europe's debt crisis threatens to infect the global financial system.
- The Australian dollar has traded at an average rate of 106 US cents since May 2011, reducing returns to Australian dairy exporters.
- Margin pressure is increasing in the domestic market as supermarket discounting activity flows through to non-supermarket or route channels.

Key questions

- Will the debt problems in EU and the still fragile US economy prompt another financial crisis, with a similar impact on commodity trade?
- How will policy and financial market responses to EU and US issues impact currencies? What will be the result for Australia's export returns and the affordability of imports for key customers?
- Will China's economy continue to avoid a hard landing?
- Will the current cold snap affect Europe's milk production?
- Flooding in Queensland and south west New South Wales has had minimal impact on production to date – will this situation deteriorate?

Issues to look out for

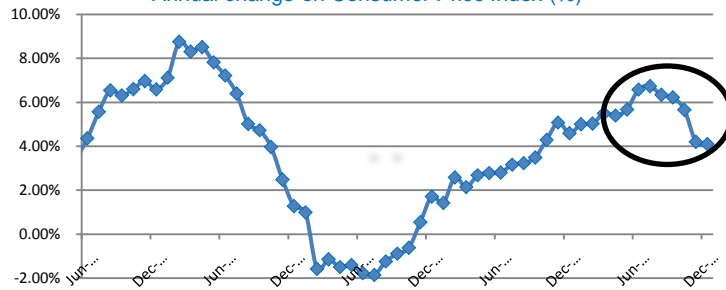
- US moves to keep the dollar low to stimulate exports could create increasing exchange rate tensions with other major economies.
- US milk production increase potentially driven by government policy, reducing the response to market factors.
- The level of dairy imports in early 2012 as tariff cuts mandated under China-NZ FTA are implemented, increasing NZ's advantage over other exporters. The response of Chinese importers will be an important barometer of demand.
- Increased trade protectionism in response to ongoing economic turbulence.
- Much depends on the response of the USA and China to a likely European recession.
- Changes in business direction as a result of the changeover of the senior management in major Australian and New Zealand dairy companies.

Industry insights - China

China economic outlook

- China's economy will continue to slow in Q1 2012. Exports declined in November, led by a sharp fall in shipments to the Eurozone. Data for December showed a third consecutive monthly fall in new export orders, while manufacturing output remains weak.

Fig 3 - China inflation rate
Annual change on Consumer Price Index (%)

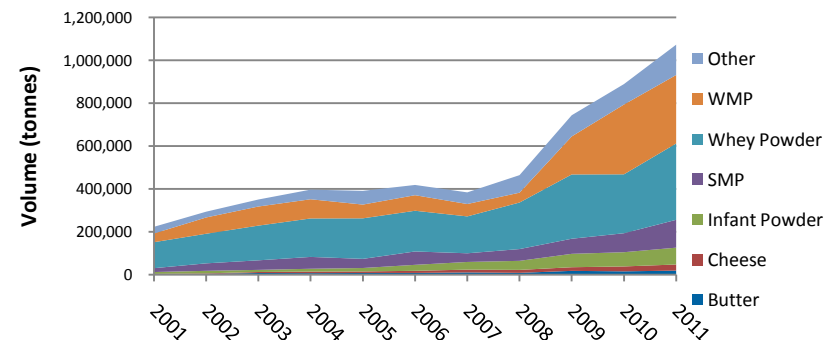


- China's inflation rate eased to a 15-month low of 4.1% in December, as the government continues its cautious policy loosening to support the slowing economy. Although now easing, tight monetary policy has resulted in a dramatic slowing in the property/construction sector.
- Given the sector's importance, a prolonged property downturn would have a significant impact on the economy; last year, real estate construction accounted for 13% of GDP and more than 25% of fixed-asset investment, while the property sector accounts for almost half of Chinese steel use, and is a major driver of demand for other commodities, such as copper. A property slump would be the most likely trigger for a Chinese hard-landing.
- In 2012 China's yuan is forecast to appreciate at its slowest rate since 2009 as Europe's debt crisis curbs exports, which have slowed noticeably as the rest of the world economy has slowed.
- A leadership transition will occur in October, with 7 out of 9 of the Politburo being replaced, including the President and Prime Minister. Policy settings are expected to remain stable throughout.

China - dairy trade

- China's dairy imports have rapidly increased over the past decade, from 220kt in 2001, to more than one million tonnes in 2011.
- WMP imports have been the largest product category in recent years. However Chinese whey powder imports became the largest category once again in 2011, rising from 274kt to 356kt – 33% of total import volumes. Chinese WMP imports decreased slightly in 2011, down about 6kt (1.8%) to 320kt and now represent 30% of total dairy imports.
- While WMP is usually the primary analytical focus for dairy demand, Chinese imports of butter and cheese increased more than 20% in the last year alone, and will continue to grow given changing diets and increasing presence of western style foods.
- In 2012, China will be a key driver of global dairy demand with imports of WMP forecast to grow by 7%, as ongoing urbanisation and continuing concerns about the quality and safety of domestic food production support consumer demand. 2012 being the year of the dragon is expected to have a positive impact on demand for infant formula. This is primarily because of the cultural significance of being born in a dragon year.
- Increasing livestock populations are also likely to support demand for feed grade dairy ingredients.

Fig 4 - China Dairy Imports: 2001-2011

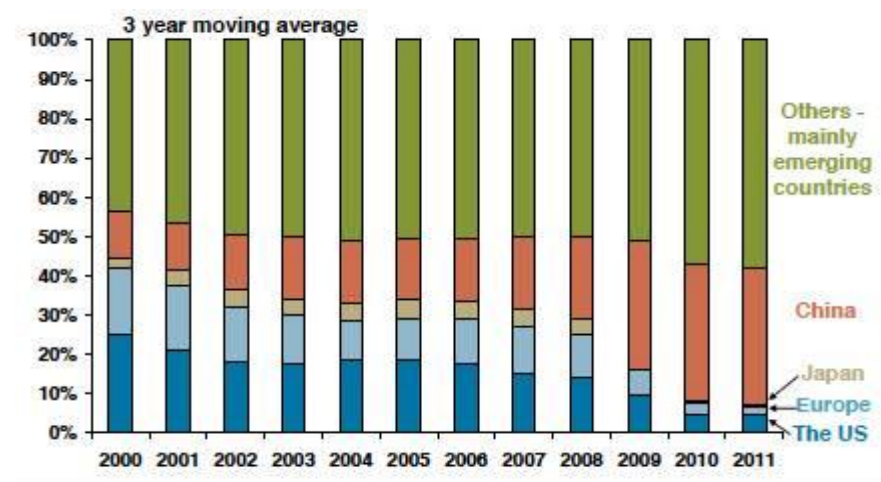


Global economy

- The global economy is losing momentum amid concerns that the **Eurozone is on the brink of a second recession in three years**. Both the World Bank and International Monetary Fund have cut growth projections and warned that the global economy is potentially heading towards another crisis.
- **The IMF has lowered global economic growth forecasts**, even in the emerging markets that have helped drive economic expansion, such as Asia and Latin America. Consumer demand is generally weak as highly indebted consumers in the West can no longer afford to fuel emerging markets' export-led growth.
- Many emerging markets are export-driven, and highly sensitive to currency movements and commodity prices. Vulnerability to a second global crisis may be greater than in 2008, since developed nations don't have the fiscal resources they had previously to support their economies and maintain trade. **Emerging market growth will slow in 2012** but still outstrip growth in developed economies.
- Exports to the Eurozone from key trading partners such as China have shown double-digit declines in recent months, Given that Europe and North America are major trading partners of China, a slowdown in these regions will affect Chinese exports and growth, **ultimately flowing through into Australian commodity exports**
- In January, Standard & Poors cut its ratings of nine Eurozone countries including France, whose triple-A rating was downgraded to AA+. France had been rated AAA for the previous 36 years. This downgrade will increase the cost of debt for the government.
- Should Germany's export orders slow, Europe's largest economy may also struggle to avoid a recession.
- **The US economy is expected to stagnate this year** in the face of fiscal tightening, a likely European recession, and ongoing policy uncertainty around November's presidential election. US economic recovery is likely to remain feeble until the housing market shows signs of recovery. Another round of quantitative easing is a possibility, specifically targeted at the housing market. Retail and employment data is improving and the Federal Reserve is promising to keep interest rates low until late-2014.

- **China's export-oriented economy** has been slowed by softer export demand and a big downturn in the property market. Combined with monetary tightening to gently slow growth, this has resulted in China's economy growing at its slowest pace in two years.
- Japan is mired in deflation and struggling to overcome the economic shock of the earthquake and tsunami last March
- Interest rate cuts and expanding domestic demand should underpin growth in **Brazil's economy**. Brazil, which recently overtook the UK to become the world's sixth largest economy has boomed on the back of exports to China and the far east.
- **Turmoil in the Middle East** is causing serious economic risks as regimes in Syria, Yemen and Iraq remain under threat, and tensions between Iran and the West continue. This ongoing instability suggests that **high oil prices will continue, potentially curbing global growth**.

Fig 5 - Contribution to global growth 2000-2011

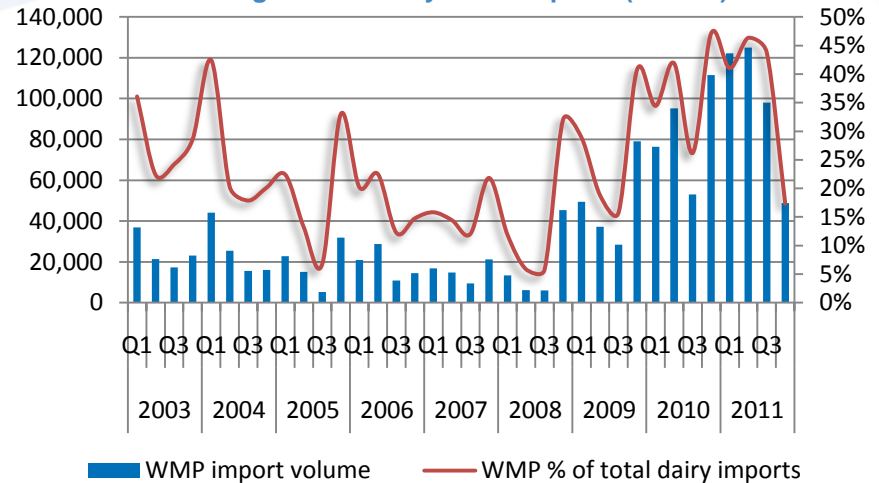


Source: : AMP Capital Investors, IMF

Global demand

- **While ongoing economic uncertainty has subdued demand growth**, easing commodity prices have encouraged buyers to re-enter the market, providing stability.
- Global dairy export volumes slowed as the year progressed. For the ten months to October 2011, exports were 8.6 million tonnes, down 2% compared to the same time in 2010. **Global WMP and SMP exports increased** more than 150,000t to Mexico and Algeria for SMP and Algeria and China for WMP. However, global exports of condensed milk, protein concentrates and cheese decreased.
- Trade data indicates most of the drop in global protein trade is due to a reduction in Brazilian milk protein exports to Europe, (which were being re-exported). Strong demand within Brazil has increased domestic prices and made export returns less attractive. Population and income growth are the driving demand growth in Brazil.
- **Dairy consumption in other South American countries is also growing.** Consumption growth of 1-2% is expected in Argentina, and increased tourism is supporting consumption in Uruguay.
- Chinese WMP imports slowed in the second half of 2011, finishing the year down 1.8% on 2010, to 320kt of WMP. However, **Chinese total dairy imports increased more than 20%** (almost 184kt) to a little over one million tonnes. **WMP now comprises a smaller proportion** of overall dairy imports, possibly because of a **changing product mix** and diversification of ingredient requirements. China will **continue to import significant volumes of dairy product** to fulfil its demand for dairy that is fuelled by increasing incomes, improved storage and distribution capabilities, and desire for Western style products.
- The demand impact of the Arab Spring in the Middle East and North African region has been mixed depending on product category. However, trade data suggests that overall **dairy imports have been steady.**

Fig 6: China Qtly WMP Imports (tonnes)



- SE Asian demand is generally steady, however flooding in Thailand has closed some local dairy business. Thai demand is expected to pick up as manufacturing plants reopen and production resumes.
- **While a significant drop in dairy consumption in the EU has been a concern, it is yet to materialise.** EU dairy consumption has been supported by consumer desires to consume 'natural' products like dairy.
- **US consumer demand continues to be largely unaffected** by difficult economic conditions, consequently US retail prices are not decreasing as fast as wholesale prices.
- In France consumption of cheese and fresh dairy products has increased while the ongoing trend of reduced butter and milk consumption has continued.
- German consumption of cheese and fresh dairy products has also been steady due to low unemployment and strong exports supporting incomes.

Substitute products

Vegetable oils

- The **butterfat price premium has declined** due to easing butter prices, and growing demand for vegetable oils, which has raised prices for alternative fat products.
- Global palm oil production growth is expected to slow from the rapid pace achieved in 2011. However production is still expected to grow by two million tonnes to 52 million tonnes in 2012. Indonesia and Malaysia are expected to continue to drive the production recovery in global palm oil production.
- Despite the increased global supplies, **demand has been particularly strong in India, China, Pakistan and Indonesia, raising commodity prices.**
- Shortages of soy and canola oil also boosted palm oil consumption as many suppliers switched vegetable oil products.
- The primary unknown for vegetable oil pricing in the next 12 months is **biofuel policies in South America.** If increased biofuel use is mandated then prices will stay firm, supporting the economics of using butterfat.

Soy protein

- Similar to vegetable oils, a steady decline in SMP pricing since February 2011, combined with tight soybean markets and higher prices has **reduced the dairy protein premium.**
- Poor growing conditions in South America have stunted soy bean crops and concerns about this years' yield have boosted global soy protein prices.
- Vegetable protein buyers have been concerned by the global supply outlook but are purchasing on temporary price falls - providing some support to prices.
- Increased production of food and fuel crops in India, Russia and the Ukraine have not been able to make up the shortfall.
- Poor weather conditions at the moment in key growing areas in Brazil and Argentina could also affect corn yields, applying further boost to future soy protein pricing.

Fig 7 - Butterfat price premium vs palm oil (US\$ per kg fat)

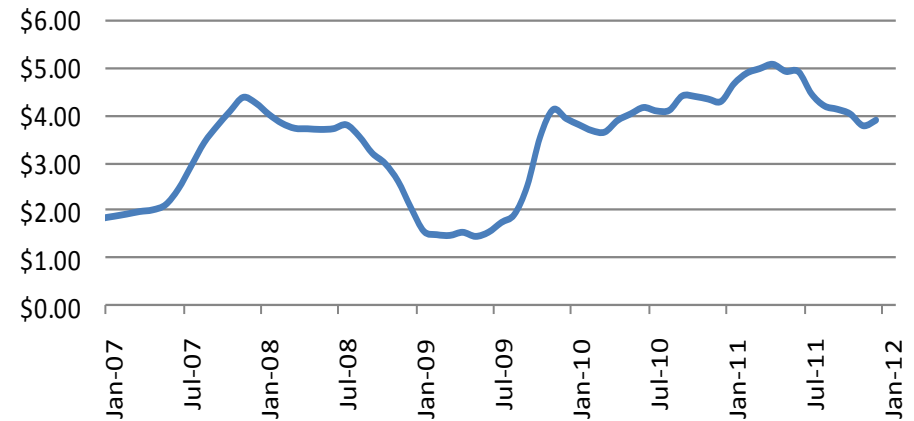
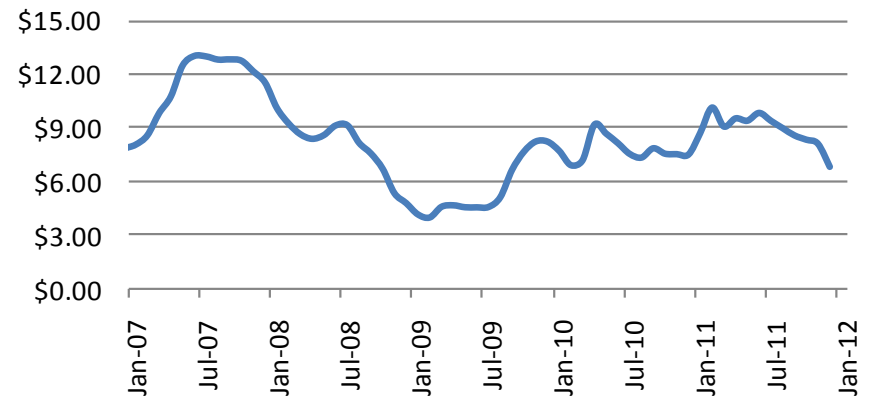


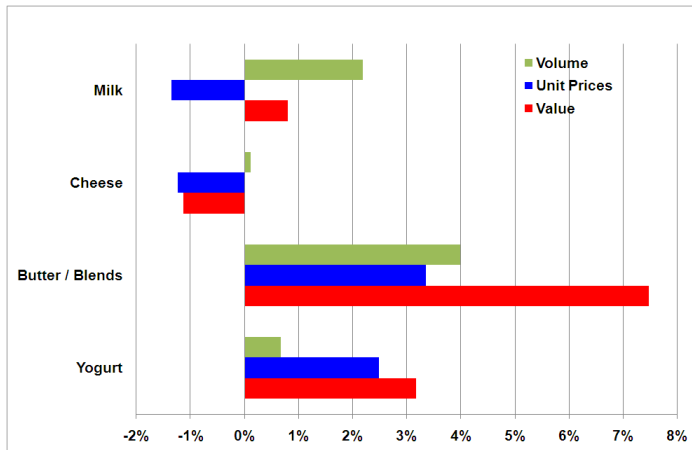
Fig 8 - Dairy protein price premium vs soy meal (US\$/kg protein)



Australian market

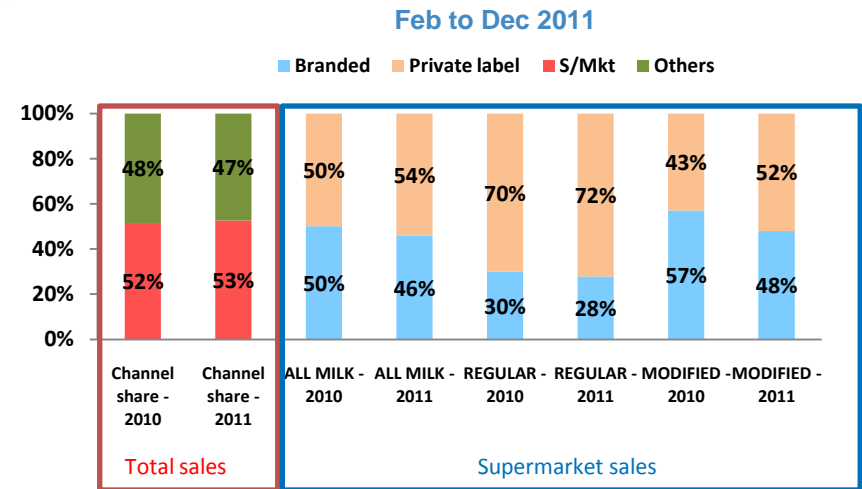
- The **Australian dairy market has been fairly positive** over recent months, despite ongoing consumer cautiousness. Domestic **sales volumes** have lifted for all the key dairy categories; but only very marginally for cheese and yogurt.
- Meanwhile, **wholesale prices have lifted for dairyspreads and yogurt**; but **fallen for milk and cheese**. Consequently, **sales values** have increased across milk, dairyspreads and yogurt; but fallen marginally for cheese.

Fig 9- Domestic sales by dairy category (QTR Dec11 - % change on LY)



- Retail supermarket **price competition has remained intense** throughout 2011. It is 12 months since the launch of \$1 per litre fresh white milk. **Total drinking milk sales volumes increased 2.9%** in the eleven months **Feb to Dec11** - while **supermarket volumes increased 4.9%** - indicating an **increase of 1.0% in the supermarket channel share**.
- However, supermarket **retail sales value fell 1.5%** over the same period - so that average price fell from \$1.64 to \$1.54 per litre. Within supermarkets, **private label milk has increased its share from 46% to 50%** of total milk sales volumes as indicated in figure 10.

Fig 10 – Share impacts of supermarket ‘milk price wars’



- **Consumer confidence remained just below its long-term average in January** – reflecting continuing concerns about the European debt crisis and its impact on the global economy; flat to declining house prices; and job losses in a number of sectors – **despite consecutive RBA interest rate cuts** in November and December 2011.
- While **the major banks passed on the full cuts to variable rate mortgage borrowers (2 x 0.25%)**, this is **unlikely to happen with all future official cash rate reductions** as banks endeavour to break the nexus between official and bank interest rate movements.
- With soft consumer confidence measures, **shoppers remain focussed on retail promotions and value** - including on-going interest in, and support for, private label brands.
- **ABS retail sales remain generally sluggish - with no growth in the foodservice sector**. While cafes and restaurants are up 3%, takeaway outlets are down 2% in the six months to December 2011. This compares with a relatively strong **4% growth for supermarkets**.

Global supply

Europe

- European **milk production for the year to November 2011** was 123.3bn litres, **up 2.1% on the same period 2010** (120.8bn litres). **EU farm-gate prices remained strong for the year** explaining the robust production in a number of key production regions.
- Germany is the EU's largest milk supplier and it's production for the year to November 2011 was 2.4% above the same period in 2010.
- France's milk production increased by 4.9% for the year to November 2011 compared to same period 2010.
- The UK's first 11 months of production in 2011 was 1.6% above 2010 levels. These high levels are predicted to carry into 2012, with production forecast at around 1% higher than 2011.
- The Netherlands is the fourth biggest EU supplier and its output for the year to November 2011 was 1.5% higher than 2010.
- While cold conditions in Europe and quota concerns have the potential to constrain early spring production, **milk deliveries** are still **expected to grow by 1.5 to 2.0% for 2012**, which is a similar growth pattern to previous years.

United States

- Total US **milk production for calendar year 2011** was 86.4bn litres, **a 1.8% increase on the 2010** total of 84.91bn litres. The strong 2011 output growth was driven by an increase in the number of cows in milk as well as higher productivity per cow.
- Production growth had slowed from April to July, but ramped up quickly as both cow numbers and cow production yields rose toward December. Policy factors may also influence production decisions, as farmers position themselves for possible changes in government support.
- Despite the number of **cows being culled increasing by 3.8% from 2010** to 2011 (the most since 1997), the US has an abundant supply of heifers. Over the course of 2011, the US herd increased 80,000 head to 9.2 million cattle. US milk production is forecast to increase a further 1.2% to 87.4bn litres in 2012.
- **Average US milk prices** for January are still **significantly above prices this time last year**, but decreasing wholesale dairy prices signal a more negative farm gate milk price outlook in 2012.
- US feed prices remain well above average. January hay prices were around US\$170/t, - US\$60/t higher than the same time last year. Corn prices were also up more than 10% compared with January 2011, maintaining pressure US farmer margins.

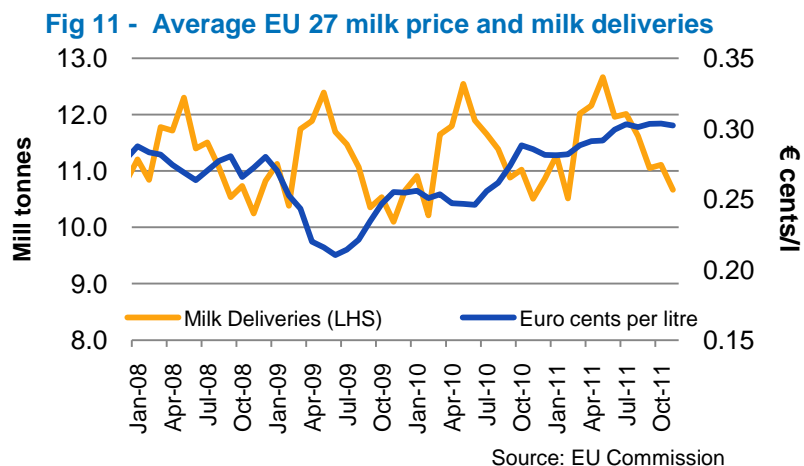
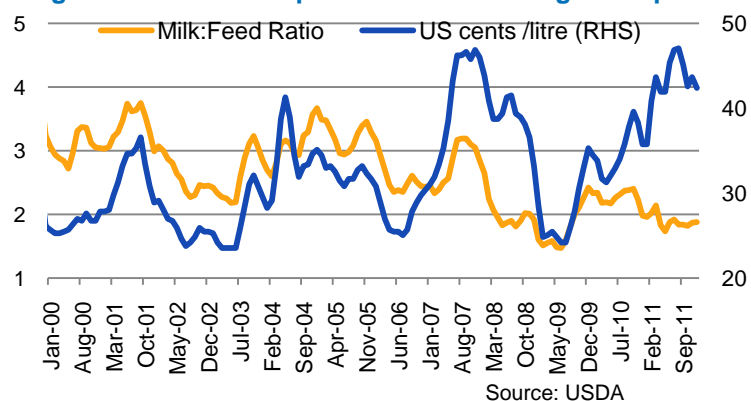


Fig 12 - US milk:feed price ratio and average milk price



Global supply

Australia

- Australia's milk production is **3.6% ahead of last season** for the six months to December 2011 at 5.6 billion litres.
- The 2011/12 **season started slowly** with very wet conditions in southern Victoria. However, drier and warmer weather did arrive in mid-spring and milk production lifted strongly. The **inland irrigation regions in northern Victoria and southern NSW are enjoying the best conditions for many years**; while the **Tasmanian milk flow has continued the strong growth trend** of recent months.
- **DA's current forecast milk production is for growth of 3 to 4% to between 9.4 and 9.5 billion litres** in 2011/12.
- **Dairying conditions are generally very positive around most of the country**; with plentiful water, good quality pasture, and well-priced grain available. On-farm hay and silage stocks are plentiful in many dairying regions, although quality varies. Milk prices remain relatively strong - the milk to grain price ratio is positive and expected to remain so for some time.
- **Milking cows remain in short supply, and continue to constrain production growth.** Retention rather than export of 2011's spring calves will be critical to maintaining production growth into future years.

New Zealand

- **New Zealand milk production is tracking around 9% ahead of last season,** (for the period June to November).
- New Zealand milk production for the 2011-12 **season is forecast to increase by around 8-10%**, driven by strong growth in milking cow numbers and higher milk output per cow. Good rainfall across most of New Zealand has maintained soil moisture levels, promoting good pasture growth through the summer months.
- The weather forecast for February-March is for normal rainfall levels for most of the North Island, and the far north of the South Island should be around normal rainfall or above.

South America

- For the calendar year to November 2011, milk production in **Argentina rose by 12.6% compared with the same period in 2010.**
- **Milk production in Brazil grew 3.5% between January-September 2011. However, adverse weather conditions have hampered Brazilian dairy production.** The country's southernmost state - Rio Grande do Sul – is experiencing a severe drought, whereas heavy rains are impeding leading dairy state, Minas Gerais. **Robust local demand coupled with production problems early in the season has restricted dairy exports from Brazil.**
- **Uruguay's 2011 milk production** is set to **increase 19.7% over 2010.** Chilean estimates are for the **year to finish 5-6% ahead of last year.**

China

- **Milk production for 2012** is forecast to increase by 4.5% in 2012, reaching 31.2 billion litres.
- China's **milk yields are typically lower** than those in the West due to poorer quality dairy herds resulting from inbreeding and over-use of antibiotics.
- The Chinese government **plans to double internal milk production by 2020** to 62.14bn litres. However demand is likely to outstrip supply for the foreseeable future

India

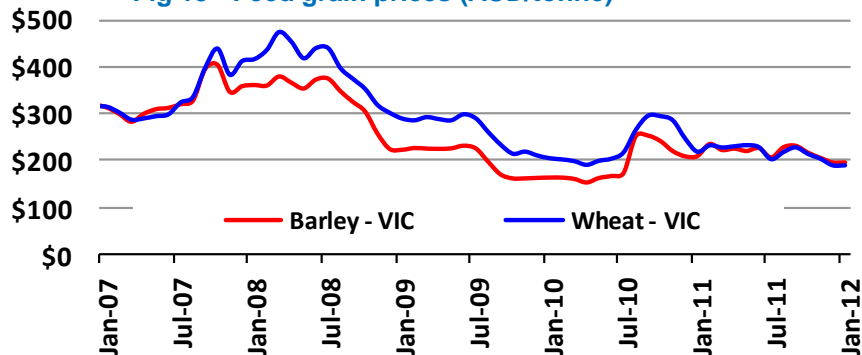
- **Milk production** is forecast to be **118bn litres in 2011**, which is up 4.9% on the 2010 figure of 112.6bn litres.
- In **2012 production is** expected to rise **4% year on year.** This is in line with the average 4% growth per annum experienced over the last 18 years, and is unlikely to generate an exportable surplus.

Inputs

Feed grains

- **ABARES' December Crop report** forecasts **total winter grains production at 43.4 million tonnes in 2011/12 - the largest winter crop on record. Wheat** production is forecast to **increase by 1% to 28.3m tonnes** – and up 48% on the 5-year average - while **barley** production is forecast to **rise by 4% to 8.5m tonnes**.
- Combined with a **very large old crop carry over** - estimated at 9 m tonnes - there will be **plenty of product in the feed grain market**.
- ABS data reports **7.6m tonnes of feed wheat** in bulk grain handler storage at the end of December 2011 - compared to 6.9m tonnes at the same time in 2010 and 2.1m in 2009.
- **Local feed wheat prices** have **continued to slide** over recent months; with Melbourne-delivered **feed wheat around \$195/tonne** and **barley around \$190/tonne** – each down around **\$30 - 35 /tonne over the three months to the end of December 2011**.
- The **International Grains Council** is forecasting **global wheat production at 690m tonnes in 2011/12** – above the previous record volume of 685m tonnes in 2008/09 – although supply of high quality hard and high protein wheat is relatively tight.
- **Large crops** across Russia, Ukraine, China, India and Australia have boosted global production – and **major crop failures have been limited**.

Fig 13 - Feed grain prices (AUD/tonne)



- With **record high global wheat consumption**, inventory levels are only forecast to increase 2% - but with a **comfortable stocks-to-use ratio of 30%** - well above the 20% that triggered the record high wheat prices in 2007/08.
- **World wheat prices have eased considerably** over the past year – particularly from around mid-2011 – as supply concerns have faded.
- Plentiful stocks at lower prices have made **wheat a viable feed grain alternative** in the northern hemisphere, thereby reducing world demand for corn – **alleviating some market concerns about tight corn supplies within the US**.
- **Global corn supplies** – outside the US – **are also increasing** as growers have planted more area in response to the higher prices, and seasons have been generally favourable.
- Hence, the market fundamentals of **plentiful supply suggests that global grain prices aren't likely to increase in the short-term** – without significant weather disruptions in next season 'plantings or government policy changes such as export bans.
- **More Australian feed wheat may be exported** into traditional corn markets – **but plentiful stocks are likely keep a lid on local prices**.

Hay

- As winter crop hay production closed in late-2011, **many contractors reported that they had only baled 25 to 50%** of what they normally do – **as low hay prices** and reasonable grain prices back in mid-2011 **encouraged growers to choose grain crops**.
- Consequently, the **supply of hay to the domestic market might be limited** during the autumn / winter months ahead.
- While **on-farm stocks remain high** from last season – they are generally of **lower quality**.

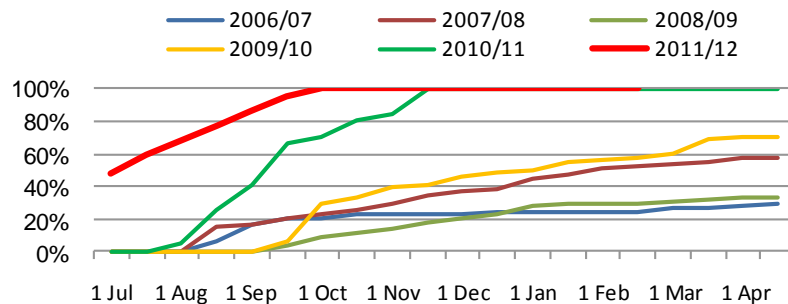
Inputs

Fertiliser

- Rabobank and NAB forecast the current weakness in fertiliser prices to continue in the short term. Uncertainty around crop prices, risk averse investors liquidating agri-commodity positions and lower farmer confidence - due to weaker grain prices and high input costs - are all leading to softer short-term demand as buyers postpone product purchases – particularly in Europe and North America.
- The key planting period between March and June could see an increase in demand, supporting prices.
- Furthermore, inventory levels in the supply chain are relatively low; while renewed civil unrest in the Middle East and North Africa [MENA] has caused disruptions to supply.
- The prices of most fertiliser feedstocks – such as natural gas – remain high in key production regions.
- Nevertheless, the greatest impact on fertiliser prices in 2012 will probably come from any spill-over effects from a sluggish global economy. If negative sentiment leads to weaker than expected agri-commodity prices, then demand will soften and prices could ease further.

Water

Fig 14 – Water allocations – Goulburn system

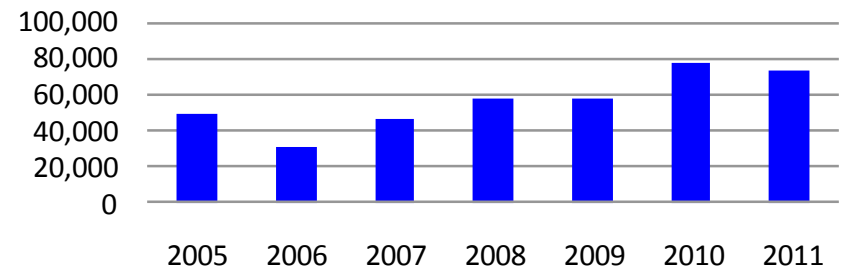


- All northern Victorian and southern NSW irrigation water systems now have a 100% allocation for the first time since 2001/02.
- Additional water in the Murray and Goulburn systems is being reserved to support entitlements in the 2012/13 season.
- La Niña conditions remain in place, but indicators have weakened over the past fortnight. The majority of climate models surveyed by the Bureau of Meteorology suggest a gradual decline of the current La Niña, with most models suggesting an end of the event during the coming autumn season.

Cows

- Cull cow sales were down 8% over the six months to December 2011 – and down 20% on the 9-year average – as farmers retained cattle where possible to take advantage of relatively stable milk prices and positive seasonal conditions around most of the country.
- Live dairy cattle exports have also slowed, down 4% to 73,900 in the twelve months to December 2011. Over the last decade some 500,000 head have been exported to around 30 countries. Many farmers now regard export heifer sales as an integral part of their dairy business.

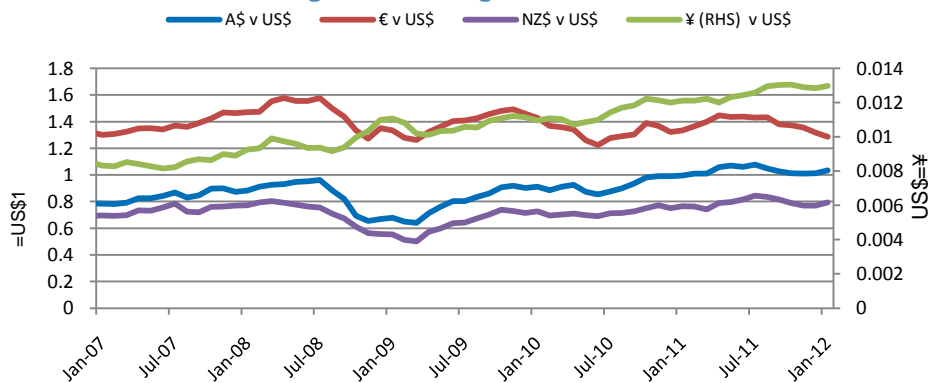
Fig 15 - Dairy cattle export volumes – No. head



Exchange rates

- With an uncertain global economic outlook and the possibility of widespread recession, it is likely that the **US dollar (USD) will remain a safe haven for investors**. The USD strengthened against some currencies from mid-October 2011. However the near-zero interest rates expected for the next three years may undermine the USD.
- Speculators are making big returns from borrowing in Euros and investing in stronger currencies like the Australian dollar, leading to **the Australian dollar (AUD) reaching a 6-month high above 107 US cents in early-February**.
- **The relatively high level of interest rates in Australia** is in stark contrast to many other developed economies. This draws in international funds, and supports a stronger currency. The AUD is expected to remain at higher levels given a likely extended period of extremely low interest rates in the US and Eurozone.
- Having fallen more than 4 per cent in three months the **Euro is recovering slowly** as tensions ease in the Middle East and better than expected economic data emerges from China and the US.
- China, US, Europe and emerging market governments are all pursuing policies which will effectively **weaken their currencies and bolster export competitiveness** amid slowing global growth. Weaker currency and better trade balances would assist in restoring growth and boosting recovery.

Fig 16 - Exchange rates vs USD



- Currency movements in recent months have made **European dairy exporters much more competitive on global markets**.
- In 2011 China's yuan appreciated 4.7% against the USD and 8% against the Euro. However this was a tightly managed appreciation, and many commentators still consider the yuan to be hugely undervalued against the greenback.
- The Japanese yen has been the best-performing major currency, gaining 6.9% against the U.S. dollar and 7.4% versus the euro in the past year. **The yen is expected to weaken a little in 2012** as post-Tsunami rebuilding efforts moderate.
- Aside from the yuan and yen, **most Asian currencies weakened in 2011**. If China's economy continues to weaken in 2012, it could have a notable affect on other currencies with high trade exposure, particularly the Australian and New Zealand dollars.
- The big four Australian banks have a **forecast range for the AUD of 95-110 US cents by the end of 2012**. This is in line with a Bloomberg survey of 35 financial institutions, which produced a range for the AUD of between 93 and 112 US cents by the end of this year.
- **Import affordability has remained steady for SMP, as the weakening currencies in importing countries has been offset by falls in SMP prices.**

Fig 17 - Import affordability index

