# Dairy 2011 Situation and Outlook

**February Update**

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## 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 first update to be released, following the most recent Situation & Outlook Update published in September 2010.

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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## Industry insights



## The seven key drivers

# Australian dairy supply chain

A wet southern spring, drought in WA and summer flooding in northern regions slowing milk production. There is potential for a good finish to the season depending on seasonal conditions.

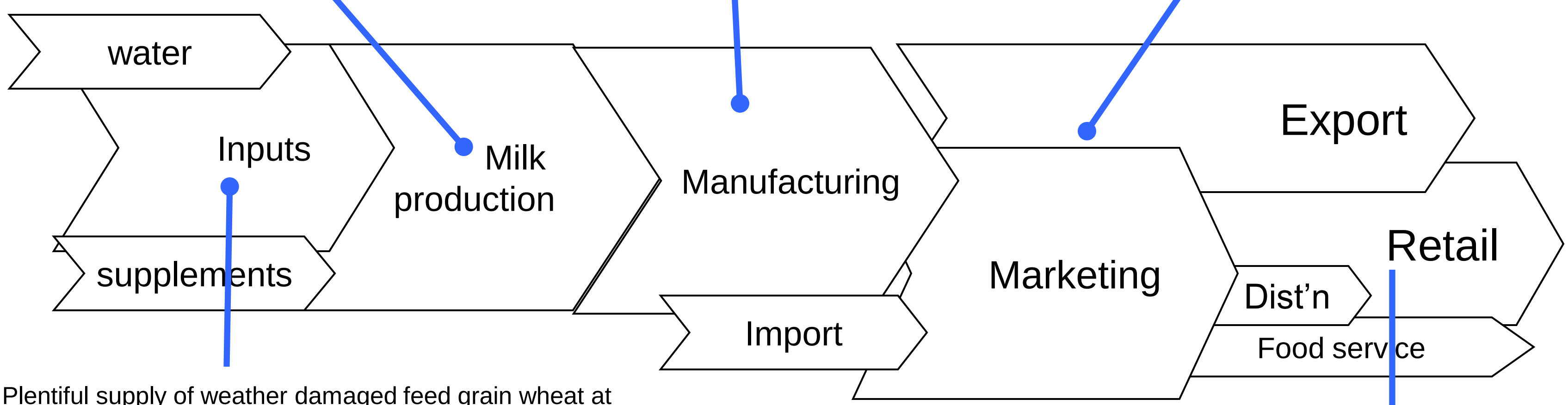
Milk pricing signals steady, but access to tier one prices is a concern for some drinking milk suppliers.

The high Australian dollar is constraining returns to exporters; however major products already contracted for the first half of 2011.

Domestic profit margins are under pressure from discounting activity.

Global supply has been slow to respond to price signals. Demand for some products outstrips supply, but overall market is finely balanced. There is a strong demand outlook for China, but Russian policy changes could impact 2011 import volumes.

The US dollar remains weak while US economy struggles to recover.




Plentiful supply of weather damaged feed grain wheat at reasonable prices. There are good supplies of hay and silage – but quality is lower than in previous years.

There are areas of flood damaged pastures that will need to be recovered over coming months.

Limited cows and heifer availability and high prices continue to limit production expansion.

Consumers remain cautious, with sluggish retail spending.

Domestic sales volumes slowing, but unit prices for categories other than milk are showing improvement.

Major retailers are cutting the price of private label milk, butter and cream as part of a wider price war.

# Key driver outlook

| | Global economy | Global demand | Australian market | Global supply | Inputs | Exchange rates |
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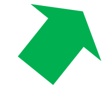
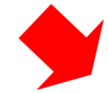
| |  |  |  |  |  |  |
| Major discussion points | Modest global economic recovery post-GFC.<br><br>Continued strong economic growth in China and India.<br><br>US struggling with high unemployment and a weak housing sector. Consumer confidence remains weak.<br><br>Europe mired in sovereign debt crisis. Contagion proving difficult to contain.<br><br>Inflation & unemployment threatening to derail global recovery<br><br>Prolonged Middle East unrest may affect growth outlook. | Overall demand firm, despite strong commodity prices.<br><br>Chinese imports remain strong, reflecting demand from urban consumers.<br><br>Strong Russian imports in 2010, but policy changes threaten continued growth in 2011.<br><br>Substitution and reduced consumption remain risks in more price sensitive markets. | Flood-induced slowing in GDP to defer official interest rate increases until mid-2011.<br><br>Floods to lead to spike in food CPI, but dairy prices unlikely to be impacted.<br><br>Supermarkets waging a 'price war' with private label products; this is likely to flow through to the route channel.<br><br>Domestic sales of major dairy companies slowing in recent months. | Global milk production is responding slowly to stronger milk prices.<br><br>NZ production up 1-3% in 2010/11; but reliant on good autumn conditions.<br><br>Australian production line ball with last season.<br><br>Cold winter in Europe has slowed seasonal production.<br><br>Production growing in the US; but will be curtailed by rising feed grain costs and tight credit conditions. | Sufficient water for a couple of seasons in the south-east – WA still in drought.<br><br>Plentiful feed grain supply from rain-damaged wheat and barley crops.<br><br>Lower quality hay and silage this year following a wet spring - being used earlier than planned due to locusts / floods.<br><br>A wildcard in fertiliser pricing is the political unrest in North Africa. | AUD expected to trade in 85-105 US cents range to the end of 2011.<br><br>Unpredictable currency swings are likely over coming months due to variable recovery rates in developing and developed economies.<br><br>Euro weakness supporting EU exporter competitiveness.<br><br>Stronger Japanese and Chinese currencies are improving import affordability. |

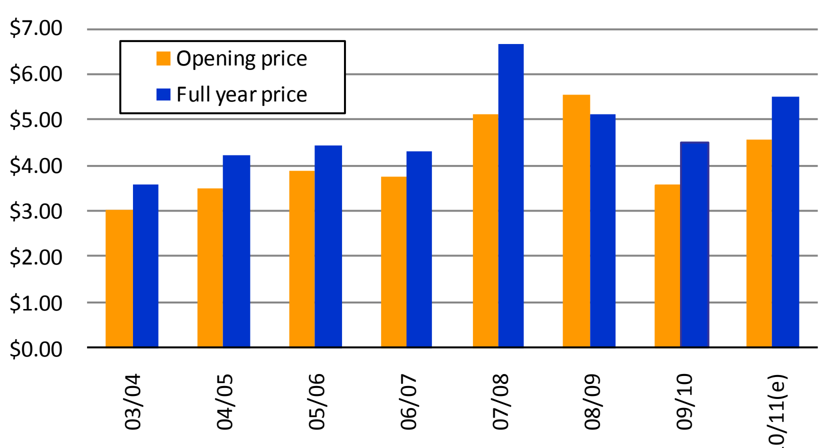
**Operating conditions or key driver status:**

Positive  Steady  Negative 

# The Australian dairy industry in February 2011

- Current operating conditions make it **difficult to give a national overview of the Australian dairy industry**. While market conditions are positive and generally stable, climate continues to throw up challenges for farmers in a number of dairying regions.
- On one hand **seasonal conditions for most producers in south-eastern Australia remain highly favourable**.
- In contrast, the summer months have bought **flooding** to south-east Queensland, northern New South Wales and northern Victoria, and **tropical cyclone** Yasi to far north Queensland. In Western Australia farmers are dealing with severe drought conditions and the collapse of a local manufacturer.
- While the impact has been severe for those farmers and manufacturers directly affected (see box on page 8), the overall impact on milk production remains unclear. **At this stage, Dairy Australia has lowered its 2010/11 milk production forecast slightly to between 9.0 and 9.1 billion litres.**
- **Milk production for the first six months to December was in line with the same period in 2009.** Plentiful home grown feed supplies and good availability of down-graded feed grain offer an opportunity for southern farmers who have not been affected by flooding to increase output. However, **availability and cost of milking cows remains an impediment to significant expansion.**
- Pricing signals to farmers remain steady. **Step-up payments to southern producers have been cautious**, as expected given uncertainty in currency and market conditions and strong opening prices. More recently, rising commodity prices and a relatively stable - albeit strong - Australian dollar have consolidated the farmgate price outlook for the current season.
- DA modelling of current exchange rate and commodity price settings, combined with signals from major manufacturers, suggests the 2010/11 price to **southern producers could average between $5.30 and $5.50 per kg MS**. At least two further step-up payments would be required to reach the upper end of the range.
- **Global market prices are firming, driven by steady global demand** and **limited** global **supplies**. Buyers appear more accepting of a supply constrained dairy market, however **prices are approaching resistance levels**.
- On the demand side, **China's whole milk powder imports** surpassed expectations during 2010 and are expected to **remain strong during 2011**. **China's Customs Authority reported 414,000t of WMP was imported in 2010, up 68% on 2009**. The USDA anticipates China's demand for milk powder will continue at current levels for the 'foreseeable future'.
- **China is** now implementing measures to **combat food and property-price inflation**. Assuming these inflationary pressures are managed appropriately, this is not expected to severely impact GDP growth or import demand for dairy products.
- **Reduced local milk production** in Japan, Korea, Pakistan and Russia has **further increased the need for imported dairy products to maintain consumption**.

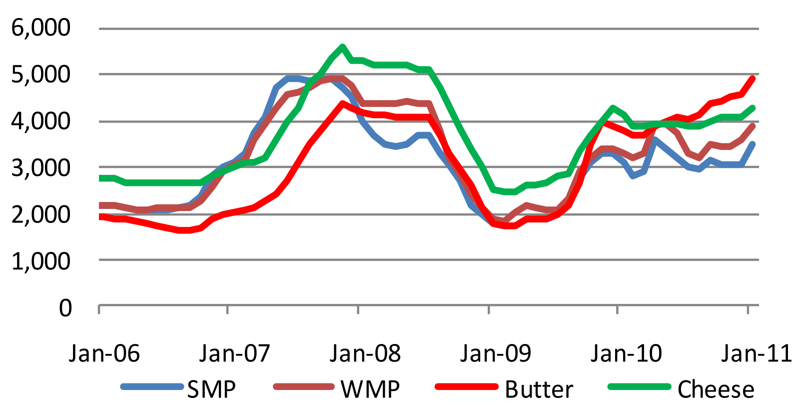
**Fig 1: Indicative Victorian farmgate price (AUD/kg MS)**



# The Australian dairy industry in February 2011

- **Russian import demand increased substantially in 2010**, as a result of reduced domestic production and strong consumption. Trade data to October 2010 indicate **a 50% increase in dairy import volumes** compared to the same period in 2009. The Russian government is attempting to slow imports in order to support local producers, with potential consequences for 2011 trade.
- A weak US dollar has seen **most currencies appreciate against it,** making internationally traded dairy commodities more affordable for importers.
- **Competing vegetable fat and protein prices have increased rapidly** in response to global demand outstripping supply. This offsets some of the substitution risk arising from stronger dairy commodity prices.
- On the supply side, European and US **stockpiles are low**, and the **supply response** to improved farmgate signals **has been slower than expected. Markets are expected to remain steady** as the northern hemisphere production season builds momentum.

**Fig 2: Spot commodity prices (USD/t FOB)**




- Opportunistic exporters from India and parts of South America could re-emerge in response to higher dairy commodity prices. However this may be curtailed by **government policy changes restricting exports** in order to contain domestic food prices.
- **Australian and New Zealand production has been lower than expected in 2010/11.** Drought has affected key NZ dairy regions, reducing production growth from earlier expectations of up to 8% to around 3%. **Production conditions heading into spring in both countries, as well as US export availability, will be critical to the international pricing outlook for the latter part of 2011.**
- While the international market outlook is generally positive for dairy, **domestic market developments** – and in particular **intense retail competition is posing some threat to margins**. The dairy category has been caught in a larger supermarket price war, focussing on lower prices to consumers through housebrand or private label products.
- The supermarket channel accounts for approximately 27% of the industry's milk production, while drinking milk sales through supermarkets account for around 13% of national output. Nevertheless for a number of dairying regions – **including those hit by floods and drought – retail sales of drinking milk are the key market and farmgate price driver.**
- Cuts to **private label milk product prices** announced by the Coles supermarket chain in late January were quickly matched by competitors. This was followed by cuts to private label butter and cream in Coles supermarkets.
- While Coles management has maintained the cuts will be absorbed and not passed through to processors and farmers, the industry has flagged **concerns over the erosion in margins resulting from consumers switching to cheaper private label products, as well as the pressure on future contract negotiations** between processors and retailers. Price pressure is also likely flow through to branded products in the route trade.

# The Australian dairy industry in February 2011

## Good news

- China is expected to continue growing at close to the rapid pace set last year, thereby underpinning import demand.
- Russian import demand for dairy commodities has  been strong.
- Feed grain supplies are plentiful and prices are lower following downgrade of local crop.
- European and US dairy product stockpiles remain at low levels.
- International market conditions have steadied in recent months.
- As expected, the implementation of fortnightly *g*DT auctions has reduced the price volatility between auction events, improving market dynamics.
- Most Australian product is committed for the February to June period.

## Bad news

- The Australian dollar continues trading at high levels potentially squeezing exporter and farmer returns.
- EU and US economies continue to struggle and remain a drag on global economic growth.
- Milk processor Challenge Dairy in WA has collapsed owing substantial amounts of money to farmers.
- Drought conditions have hit south-west WA - with 2010 the driest year on record.
- Flooding is impacting dairy farmers in south east Queensland, northern NSW and northern Victoria – with effects on finances and productive capacity likely to be severe and prolonged.
- Prices and availability of cows and replacement heifers is limiting production expansion.
- Margin pressure increasing in the domestic market as retail discounting activity flows through route channels.

## Key questions

- Will policy changes designed to protect domestic dairy producers disrupt trade with Russia?
- Can China bring inflation under control and rein in growth to a sustainable level?
- Can the US develop a convincing strategy to balance its budget without endangering the tentative recovery?
- Will further fiscal stimulus be required to reinvigorate the global recovery?
- How will US milk production be affected by rising feedgrain prices?
- What will farmgate price settings be for suppliers to drinking milk processors as they renew contracts in mid-2011?

## Issues to look out for

- Currency volatility is a major risk for both importers and exporters.
- Food price inflation in China and India could undermine the purchasing power of households, slow consumer demand and overall economic growth.
- Middle East turmoil – impacts on GDP growth and demand for imported dairy products.
- US Farm Bill comes up for renewal in 2012 with a shift in support systems toward margin insurance for farmers.
- Implementation of free trade agreements and their impact on trade flows and competitiveness in key markets.
- Longer term effects on local regional infrastructure of flooding events.

# Industry insights

## Dairy Futures and *global*DairyTrade

- **The NZX WMP dairy futures has been the most successful dairy derivatives product to date.** Similar **futures products** released **in the US and in Europe** have been **used to a lesser extent.**
- **Part of the NZX WMP futures' success is its association with *global*DairyTrade (*g*DT) to set the final settlement price.**
- **More frequent *g*DT auctions** (twice a month from September 2010) has **smoothed some of the price volatility** because of the shorter waiting period between auctions. The next **milestone for *g*DT** will be when it **becomes a weekly auction**. This will also be a crucial step in on-going success of dairy futures products.
- NZX announced **plans to launch SMP and AMF futures** products from February 18, 2011. Both new futures products will also be cash settled. **NZX Futures** prices for **SMP and AMF** will also be **set from** prices achieved on ***global*DairyTrade.**
- Similar dairy **futures products** released **in the US and in Europe** have seen less activity**.** In general terms, all **the products are slightly different:** either **cash or physical** settled, **Euro or USD** denominated, and focus on a **range of dairy commodities**. **It's too early to write off other derivative products despite the slow start.**
- Because futures products are relatively new in dairy, it will take a couple of years before they become broadly accepted. As time passes and acceptance grows, the **volume of trades will increase** and the **range** between buy and sell prices **will narrow.**
- NZX also announced that **options trading on its futures products will commence in 2011**. Options are another derivative product that allow a futures contract holder to gain some of the upside if the market moves above a contracted price. If the market moves lower the option cost is forfeited.

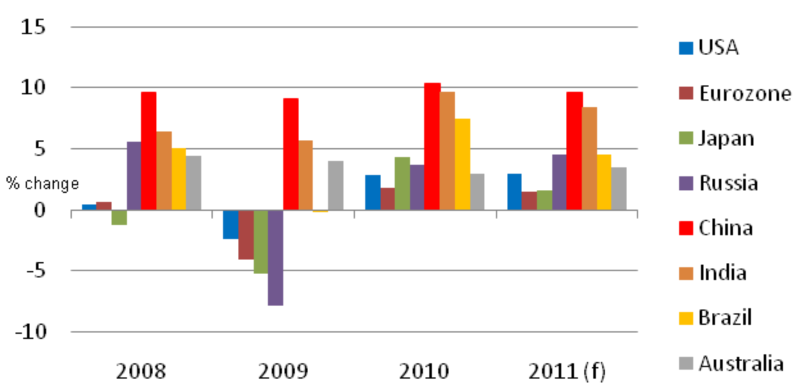
## Flood impacts on the Australian dairy industry

- **The current La Niña event - one of the strongest on record -** has contributed to an extremely wet period in the eastern states. **January rainfall was the highest on record** for southern Queensland and north-west Victoria.
- **In Queensland approximately 350 farms were directly affected by flooding** while 40 were unable to deliver milk for a period. **Production losses are estimated at around 50 million litres, - 9% of the state's production. However this will be largely dependent on the ability of farms to recover over the coming weeks and months.** The immediate disruption to herd operations, crop and pasture production, as well as destruction of infrastructure will be financially devastating for many affected farmers.
- At this stage it is estimated that the **total economic impact on the industry will be at least three times that of the economic loss of milk production**. This effect could become greater as most dairy farmers across the region have been unable to salvage flood damaged crops and pasture, and may now face a forage gap of three to four months.
- **In Victoria over 100 farmers have been affected by floods,** although the severity of inundation is variable. Good availability of feed supplies in the region this year has allowed many of the farms most affected to "park" their cows – relocate them to another farm for milking and feeding. However, the loss of income will significantly affect flooded farms, particularly at a time of year when milk prices are at seasonal highs. Production in the north-western region is significantly down and many farmers are struggling with animal health issues in the wake of these extreme conditions.
- Subsequent to these events, **Cyclone Yasi has caused damage and power disruptions to north Queensland**, while f**looding and bushfires** have affected **different areas of Gippsland.**

# Global economy

- The **two-speed global economic recovery continues in 2011**, with weak growth in advanced economies insufficient to reduce unemployment and emerging markets seeking to avoid overheating and manage strong capital inflows.
- The International Monetary Fund is forecasting **global economic activity will expand by 4.4% in 2011, down from 4.75% in 2010**. The emerging economies in the Asia Pacific region will be the main engine of the global economic recovery.
- The **biggest risks to the global economic recovery are the lingering debt crisis in Europe and the lack of employment growth**. The outlook for Europe remains weak and, unless resolved, the European debt problems will continue to affect currency markets and the global economy.
- The PIIGS (Portugal, Ireland, Italy, Greece and Spain), have very high and potentially unsustainable debt levels, have lost competitiveness and rely on foreign investors to purchase their debt. Ireland's fiscal deficit has risen to 32% of GDP.
- Continuing high unemployment and weak consumer demand in the US, while slowing growth, is likely to contain inflation. However, failure to reduce high unemployment will undermine consumer confidence, slow spending and weaken the global growth outlook.
- Besides the lack of job creation, especially in advanced economies, **volatility in currency markets is generating more economic uncertainty.**
- The US Federal Reserve, concerned about the slow recovery, continues quantitative easing and will buy $600 billion of U.S. government bonds by the end of June 2011 to spur economic growth by driving down interest rates and encourage more borrowing and growth.
- Expansion in the Chinese economy is fuelling concerns over rising inflation. Interest rates are expected to rise in 2011 to subdue the overheating economy and rein in asset bubbles. Nevertheless, **higher inflation is likely in India and China due to surging food prices, with the real danger that food inflation could spread to the wider economy.**
- **Economies of key export destinations in Asia, including Indonesia and the Philippines continue to rebound strongly**, driven by solid internal demand growth. This is good news for dairy consumption. However, Japan remains sluggish as it struggles with deflation, massive public debt and a stable population .
- Brazil's strong domestic demand continues to boost export growth in neighbouring countries. The region is also benefiting from strengthening economic ties with the emerging economies in Asia.
- Recovery has been solid in most of Africa, with the rebound expected to push through at about 5% in 2011 and 2012. However, political unrest in Egypt and Tunisia may impact this outlook.

**Fig 3: Global GDP outlook**

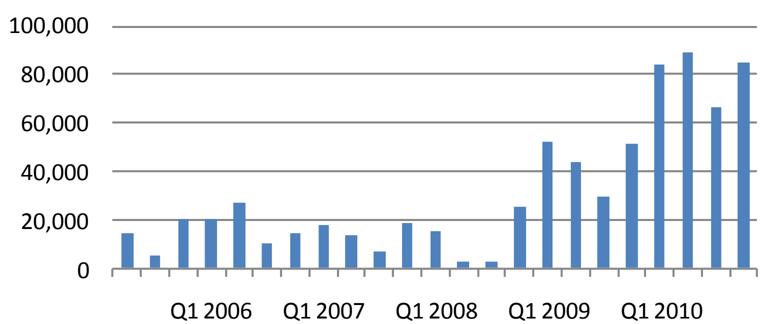



Source: IMF

# Global Demand

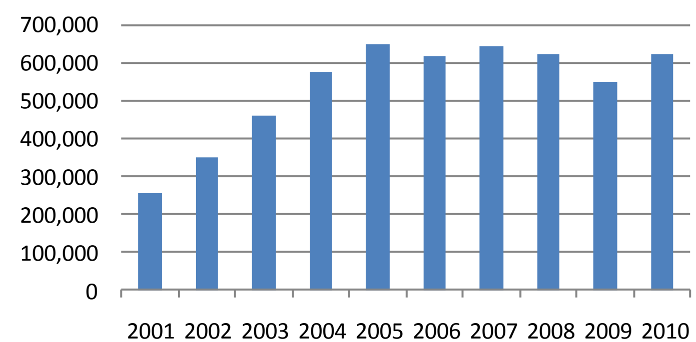
- Milk powder **exports to China remain the major driver of current global market strength**. Tight global dairy supplies have also been stretched by **economic growth in developing nations supporting demand** for dairy products and ingredients.
- **Domestic production in China is struggling to keep pace with demand** growth, but rapidly **rising food commodity prices will limit further increases**. While it would be expected that demand growth in China and other developing economies will eventually be slowed by higher retail food prices, evidence of this is yet to materialise.
- **Chinese importers** are also likely to **take advantage of lower tariffs under new quota arrangements negotiated in the NZ-China FTA** which will boost demand in the first quarter of 2011, before settling down to more normal levels.
- **India plans to contain internal SMP prices by temporarily reducing tariffs** on SMP and AMF imports after a similar move in 2010. SMP usually attracts a tariff of 60% but around 30,000 tonnes of SMP was imported last year at the concessional rate of 5%.
- India's National Rural Employment Programme has driven higher demand, as rural poor can now afford to purchase dairy products.

**Fig 4: China Qtly WMP Imports (tonnes)**




- Domestic **consumption in the US and EU is generally firm** and currently **underpinning global market prices** by reducing exportable surpluses.
- **Russian** reporting agencies note **dairy imports for October were 60% higher than the same time last year.** For Jan-Oct milk and dairy imports increased 50% to 560,000 tonnes – with butter imports up 70% in October (compared to October 2009).
- **Cheese exports to Russia**, (Russia's largest dairy product import) also **increased 5% in 2010** to around 250,000 tonnes. **Increased Russian demand is coming** at a time when the EU (Russia's primary butter supplier) is also short of butter.
- Changes in Russian policy, designed to protect local production by restricting imports, have the potential to disrupt this trade in 2011.
- **As a result of flood induced production shortages, exports to Pakistan increased 9% in 2010** – mostly in the form of dairy mixtures, SMP and whey powder.
- Domestic milk production in Japan and Korea is significantly down, increasing demand for imports to maintain consumption.

**Fig 5: Global Dairy Exports to Russia (tonnes)**




Note: 2010 is 11m only

# Substitute Products

- **Vegetable oil and protein products are becoming increasingly expensive as global demand outstrips supply.**
- **Weather-related production losses** have affected crops in South America and Malaysia; while **strong world consumption** is reducing stocks in major producing and consuming nations.
- Vegetable oils and proteins remain significantly cheaper than dairy, however, the reduction in global stockpiles has **significantly increased price volatility**.
- Importantly, **relative pricing is only one of the factors** considered in reformulating products. Other aspects such as functionality, supply continuity, nutrition and flavour influence the decision to reformulate.

### Vegetable oils

- Global oilseed production is expected to fall 2 million tonnes below estimated consumption in 2010/11.
- **Disappointing yields** in Malaysia have been **exacerbated by heavy rainfall and flooding**, prompting crude palm oil **pricing** indicators to **jump 30% in the final quarter of 2010.**
- Prices are likely to come under more pressure as Chinese imports are growing significantly. **Similar to dairy, Chinese vegetable oil production cannot keep pace with demand.**

### Soy protein

- **World soybean production forecasts have been revised down to 258m tonnes, around 2.6m tonnes below production last year.** This is primarily because dry weather in Argentina has cut soybean yields approximately 7%. **Record plantings in Brazil has offset some of the lost production.**
- **Demand for soy meal has increased** due to growing use as animal feed. **World soy meal consumption** is estimated to have increased 9% in 2009/10. US soybean 'stocks-to-use' dropped to 4.2% in 2010, the lowest level since 1964/65.

**Fig 6: Butterfat price premium vs palm oil (US$ per kg fat)**

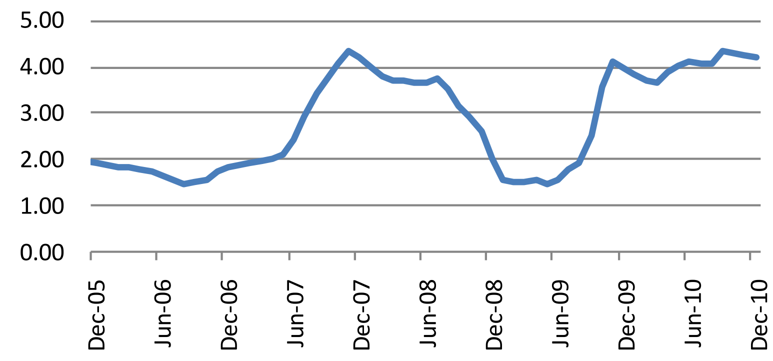
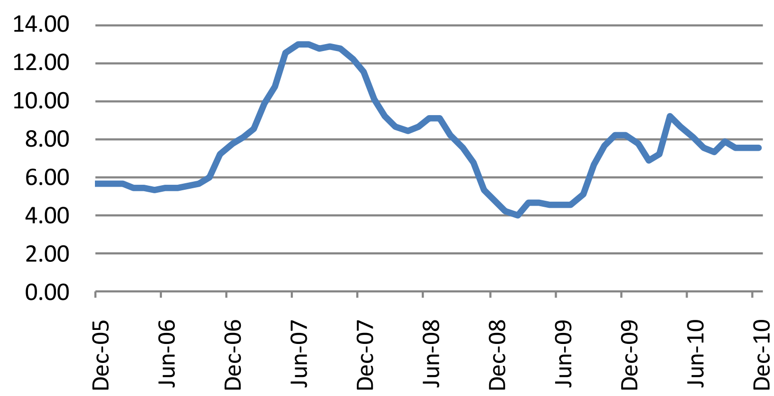


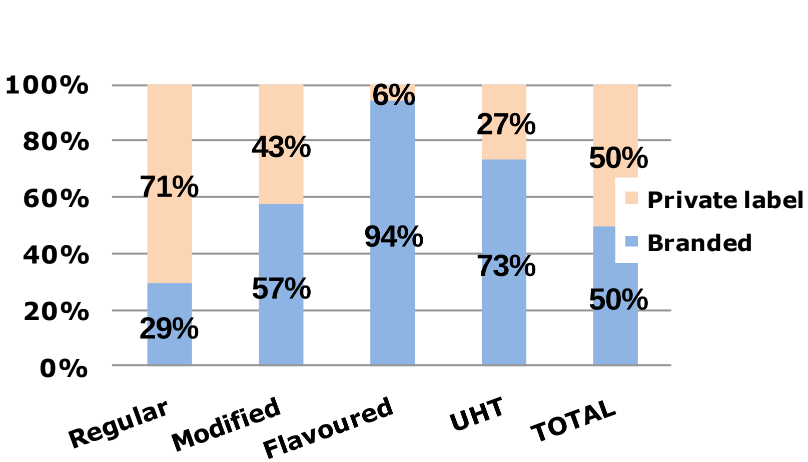

**Fig 7: Dairy protein price premium vs soy meal (US$ per kg protein)**



# Australian market

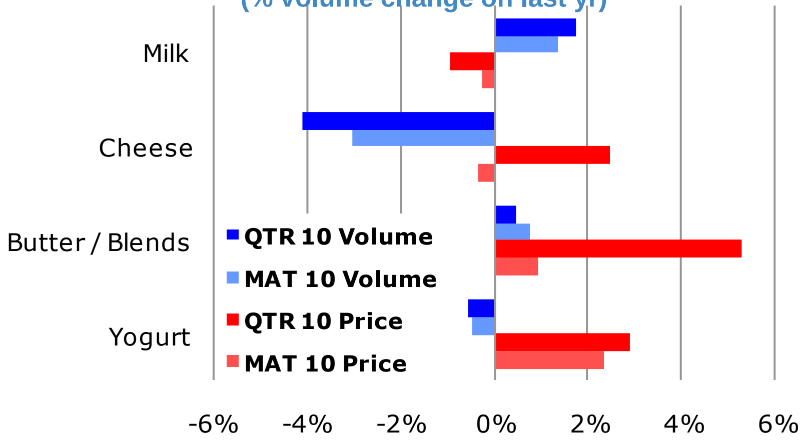
- While employment remains strong, consumer confidence has weakened in early-2011. **Households are continuing to approach their finances with caution**, limiting discretionary purchases and reducing debt. **The Australian household savings rate has risen from less than zero to 10%** in a couple of years – not good news for the housing or retail sectors.
- **CPI inflation slipped to just 2.7% for 2010** – with the RBA's underlying rate of 2.25% the lowest in ten years. While there will be a flood-induced spike in the CPI from fruit and vegetable prices, this won't impact on the underlying rate – which is the measure that tends to drive interest rate decisions.
- **The retail environment remains very competitive** – with the UK management-led Coles supermarket chain consistently making sales share gains against Woolworths and thereby triggering promotional responses mostly based around prices – or 'value to the consumer'.
- This pressure for dairy heightened dramatically following the **announcement** by Coles – quickly followed by Woolworths, Aldi and Franklins – **dropping private label milk prices to around $1-00 per litre** for 2-litre and 3-litre bottles

Fig 8: Market shares [%] by milk segmentation




- This compares to previous prices $1.10 to $1.15 /lt for full cream milk and up to $1.50 /lt for modified milks. While **Coles** indicate that they **are funding the discount**, **Woolworths has said that these prices are unsustainable** and will lead to pressure at the farmgate.
- **Drinking milk utilises around 25%** of Australia's annual milk production; with the **supermarket sales channel share at 51%.** Within supermarkets, the **shares of dairy company branded milk and retailer private label milk is split 50:50.** Consequently, **branded and private label milks both made up approx 6.5% share** each of total milk production last season.
- Supermarket sales data indicates an **annual cost in retail margin** to Coles and Woolworths **approaching $75 million** on current brand shares **– if applied to all their private label 2-litre and 3-litre pack sizes**.
- More broadly, major dairy companies' **domestic sales volumes have slowed** for key dairy categories during the December quarter – when compared with annual trends, although wholesale unit prices have generally improved for categories other than drinking milk.

Fig 9: Domestic sales by dairy category
(% volume change on last yr)



# Global supply

### Europe

– EU milk production increased steadily during the second half of 2010, but a **colder than usual winter has slowed recent growth.**

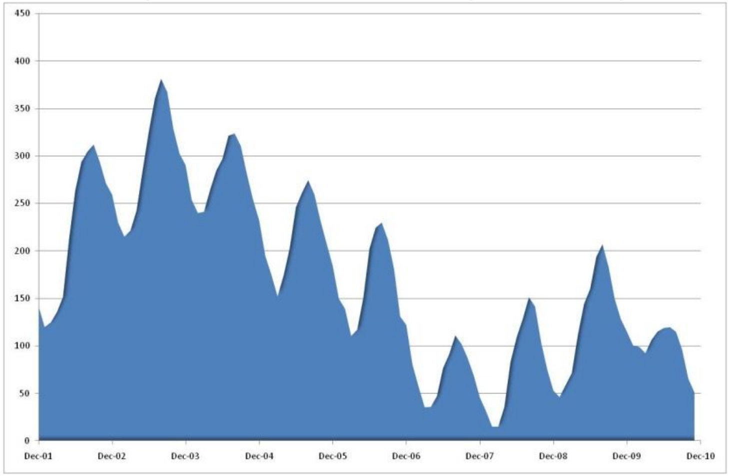
– For the season April to October 2010, **EU milk production is 2% ahead**, driven by the big four producers (France, Germany, Netherlands and the UK). **German milk production increased 1.6%** in 2010 to almost 30bn litres, **supported by higher EU milk prices**.

– **Average EU milk prices are up around 17%** on the previous year – averaging around €0.33 /lt (AUD$0.45 /lt)

– **Tight butter supplies in Europe are reflected by significantly lower public and private inventories.** Combined inventories (public and Private Storage Aid) were 80,000 tonnes lower in December 2010, compared to December 2009.

– **Butter is now trading at unprecedented price levels that are clearly flowing through to world markets**. The last time EU butter stocks were this low was during 2007, Australian butter prices peaked at US$4,400 /t. Australian-origin butter exports are currently around US$4,900 /t.

**Fig 10: EU Butter Stockpile ('000 tonnes)**




Source: EU Commission

### United States

– Total **US milk production for 2010 was 84.5bn litres, up 1.8%** on 2009 production of 83.4bn litres. US milk production growth peaked in September (3.2% month-on-month). However, there is evidence **rising feed costs are biting,** with production growth slowing to around 2.5% in December.

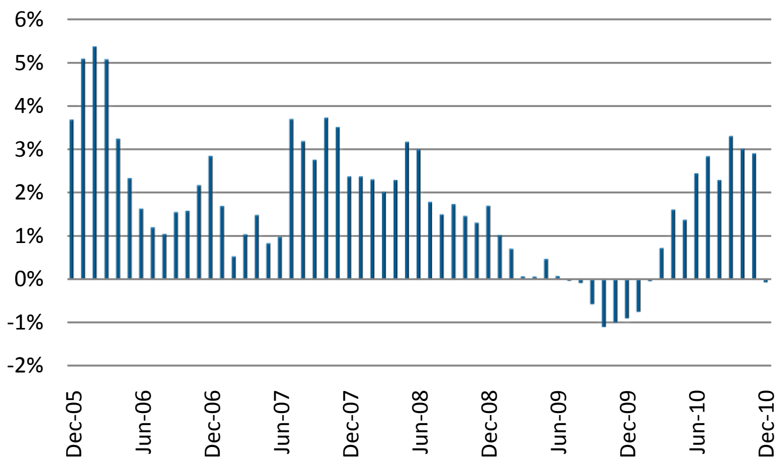
– US Congress voted to extend a subsidy for ethanol refiners which has increased demand, and therefore prices, for feed corn.

– US **cow cull rates are slightly below trend;** with the total US herd around 54,000 head higher than in December 2009 at 9.13 million.

– If there is a margin squeeze later this year, it will have a **larger impact on production than previously** because US farmers won't have the financial cushion to ride-out periods of negative cash flow.

– **Butter stored in approved warehouses is 68% lower** than this time last year – but US cheese inventories are around 2% higher.

**Fig 11: US Monthly Change in Milk Production**




Source: USDA

# Global supply

### Australia

- Australia's milk production volume is **similar to last season** for the six months to December 2010 at 5.1 billion litres.
- This season has **varied significantly around the country** – from drought in south-west WA, to a very wet spring and early summer in many southern regions, to extensive flooding in northern regions. In northern Victoria, localised locust damage to summer crops and pastures, has been followed more recently by flooding .
- DA's **current forecast for milk production is slightly lower than in September at 9.0 to 9.1 billion litres** for 2010/11.
- The **major uncertainties for this forecast** are centred around the on-going impact of the **excessive rain and extensive flooding in some regions over recent weeks and months**; and the timing and amount of any **milk price step-ups** in the second half of the season.
- Nevertheless, it is anticipated that the positive pasture growing conditions in most southern regions, together with a positive outlook for feed grain volumes and prices, will offset milk production shortfalls in flood affected areas.

### New Zealand

- NZ milk production started the season strongly but initial expectations of 4-8% production growth were held back by drought, snow storms and earthquakes.
- The weather was close to ideal for the peak production months of **October and November** which **saw production rise to record daily levels** before dry conditions set in again to close the year.
- **NZ milk production could grow around 3% in 201/11 but this would rely on good autumn conditions to finish the season.** Pasture growth in the North Island has slowed following drought conditions, but it's hoped recent rains will reinvigorate pastures.
- Following drought, **supplemental feeding has increased** significantly and is **placing additional pressure on cash flows. However,** higher milk payouts are supporting feeding at the moment.
- A recent survey of NZ dairy farmers undertaken by NZ Federated Farmers reports 28% or farmers note weather as their primary concern. **Around 25% expect to increase production, while 25% expect their production will contract over the next 12 months.**
- South Island production growth continues with Fonterra receiving resource consents to construct a new processing plant at Darfield in the Canterbury region – around 40km from a competing processor's plant (Synlait) at Rakaia.
- The NZD 150m plant will produce high specification milk powders and is capable of processing 2.2m litres of milk a day, which equates to being supplied by around 200 farms.

### Rest of World

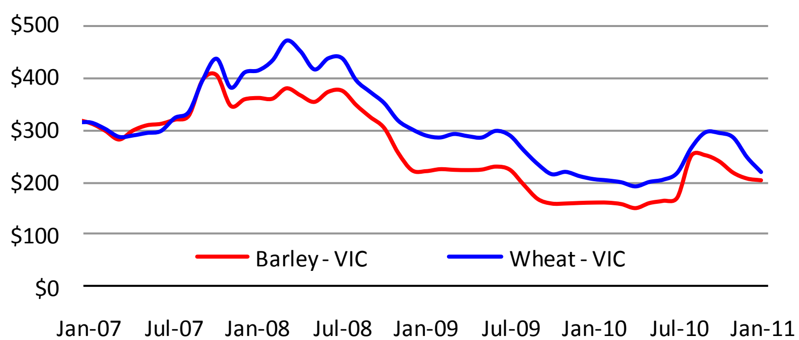
- Production in South America **is improving, but pressure to keep domestic prices steady may limit potential exports**.
- La Nina weather patterns around South America pose a risk for local growth of corn and soybean crops which may flow into feed prices for both South America and the US.
- Milk production in **Argentina** was estimated at 10.9bn litres for 2010, up 2.4% on 2009 and the highest since 1999. **Milk production is estimated to grow around 4% in 2011.**
- Despite solid production growth, **India will continue to require imports,** and has lowered tariffs for dairy products to help contain domestic price increases.
- **Russian milk production** for Jan-Nov was around 30bn litres, down **1.7%** on the same period in 2009. **November month production was down 13% compared to the previous year.**

# Inputs

### Feed grains

- **ABARES' December Crop report** forecast **a record wheat crop** of around **26.8 million tonnes**, 22% up on last year; with the **barley crop** up 24% to **9.8 million tonnes**.
- **On-going rainfall through December and January** caused **considerable harvest delays and reduced the quality of cereal crops** with significant downgrades from food grade to feed grain quality for east coast producers, **although yields and hence volumes remain high**.
- ABS data to end-Dec10 reports **6.9 million tonnes of feed wheat** in storage of bulk grain handlers – compared to 2.4 million tonnes last year.
- **Record volumes of down-graded wheat and barley mean that supply is not an issue,** perhaps for up to two years, although **export demand** for feed grains will remain strong, replacing high priced corn into the Philippines, Vietnam and other south-east Asian markets. This **demand may push prices up** in coming months.
- **Local feed wheat prices** slid over the harvest period, with Melbourne-delivered feed wheat **currently around $225 /tonne,** and **the barley around $210 /tonne.**

**Fig 12: Feed grain prices (AUD/tonne)**




Source: AWF

- **Milling wheat prices are about $100 /tonne higher than feed wheat this season** – up from a more 'usual' $25 /tonne - with **ASX futures prices** at around $335/tonne for both March 2011 and January 2012 delivery dates. Barley prices are closer at $225 /tonne for March 2011 delivery and $235 /tonne for January 2012 delivery.
- **Internationally, US grain futures have risen to their highest levels** since August 2008, as stocks remain tight until the northern hemisphere harvest is available mid-year. A recent driver has been increased demand from Middle East and North African nations, with unprecedented demand being used as a **hedge against rising food prices and concerns about food security** pushing up prices in an environment of political unrest.
- Political unrest is also **pushing oil prices higher,** improving ethanol margins. As 40% of US corn is now consumed by the US ethanol industry, it **also drives corn prices.** With corn the biggest crop in the world, this in turn sets the direction of wheat and oilseeds prices.
- Tight global stocks of corn and soybeans indicate strong prices and **a 'battle for acres' in the US** in coming months. While wheat is less affected, poor weather during the planting season may mean some areas will be ploughed under for more profitable crops.

### Hay

- For many local dairy farmers **home grown fodder will make up a larger share** of the feed portfolio than it has for some years, although the recent flooding will change this expectation for some.
- Conserved **fodder yields and quality were quite variable** across southern regions due to the cool, wet conditions in spring making it difficult to harvest and cure at optimal times.
- **Consequently, volumes are high but quality is generally low** meaning there could be a shortage of high quality hay in autumn / early-winter. Many dairy farmers are opening **silage pits and finding the quality is not as expected,** with protein levels lower than in recent years.

# Inputs

## Fertiliser

– **International prices have been stable in the last quarter** with the continuation of weakness in the economies of Europe and the US being offset by stronger demand from Asia.

– **The Australian dollar has risen** by 10% over the time – **offsetting the P and K international price rises and half the increase in N.**

– **The international price outlook for N and P is flat** which reflects a quieter trading period during the Northern hemisphere winter. A strong grain price will take fertiliser with it when spring plantings begin. There are indications of further immediate **rises of 5 -10% in the price of K,** while **crude oil is projected to rise back above USD100 /barrel** in 2011 and that would lead **N prices up**.

– The **strength of the AUD has continued to keep local pricing in balance** with international benchmark prices.

– A wildcard in fertiliser pricing is **the political unrest in North Africa -** currently in Tunisia and Egypt. The risk is that further unrest could spread to Morocco, Jordan or Syria, which are significant producers and exporters of urea and of phosphate rock and the derived products of DAP and MAP.

**Fig 13: Indicative fertiliser prices (AUD /t)**

| | August | December | March forecast |
|---|---|---|---|
| **Urea** | 500 | 540 | 500-550 |
| **DAP** | 740 | 770 | 750-800 |
| **Single super** | 350 | 330 | 300-350 |
| **Potash** | 620 | 640 | 650-700 |

Source: Xcheque

## Water

– **Extensive on-going rainfall over wet catchments since mid-2010** has greatly improved water storage levels in the Goulburn-Murray system, and **provided irrigation allocations across all northern Victoria systems for the first time since 2001/02.** As a result, temporary water is **trading as low as $20 to $25 per megalitre**. Limited use of water so far, plus carryover, will likely provide **irrigation supplies for the next two seasons** in northern Victoria.

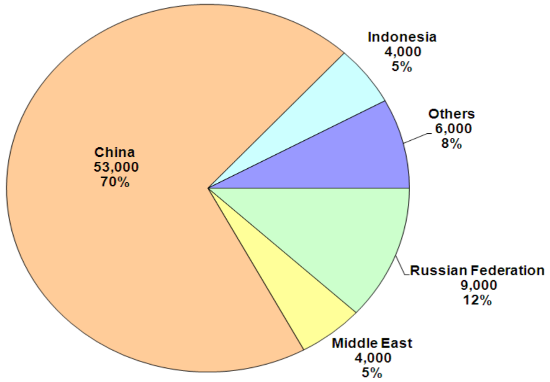
– After its wettest year on record, Murray-Darling Basin water storages increased from 26% of capacity at the end-December 2009 to **over 80% at end-December 2010**.

## Cows

– **Cull cow sales were in line with the previous year over the first six months of the season.** However, rising beef prices pushed cull cow prices up 29% over the **last four weeks, driving volumes up by 22%.**

– **Live dairy cattle exports reached** 75,000 in the 12 months to December 2010, a 28% increase on the previous year. Competition for export and replacement heifers has increased with limited availability and improved milk production conditions in some regions.

**Fig 14: Dairy cattle export markets – 12 mths to end-Dec10**



# Exchange rates

- The divergence between the strength in emerging markets and the high levels of **uncertainty in the world's major economies could cause huge volatility in currency markets this year.**
- The Euro zone's debt problems coupled with the Federal Reserve continuing to inject liquidity into the American economy mean unpredictable currency swings are likely over coming months.
- The **AUD continues to trade near parity with the USD due to stronger interest rates in Australia and a weak American dollar**. The high AUD is keeping local inflation under control. As a commodity currency, the AUD has a very strong correlation with commodity prices, attracting interest from buyers looking to diversify their reserves outside the USD.
- The rise of interest rates in Australia is also in stark contrast to many other developed economies, and this draws in more funds, supporting a stronger currency.
- **A strong AUD makes Australia's dairy less competitive on global dairy markets, and reduces returns to local exporters** with dairy commodities generally traded in US dollars.
- In contrast, the **Euro has weakened** against the USD, **making European exports more competitive**. Fears of sovereign debt contagion spreading to more EU member countries could drive the Euro lower.
- The big four Australian banks have a **forecast range for the AUD of 85-105 US cents by the end of this year.** This is in line with a Bloomberg survey of 35 financial institutions produces a range for the AUD of between 85 and 108 US cents by the end of this year.
- Despite higher commodity prices, **import affordability has improved, particularly for SMP, as the currencies of most importing countries have strengthened against the USD.**

**Fig 15: Exchange rates vs USD**

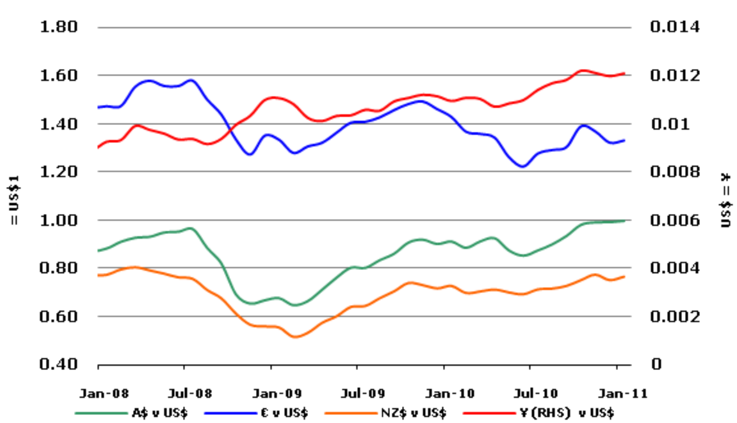



**Fig 16: Import affordability index**
**Feb 2005 = 100**