

EU Dairy Markets, Situation and Outlook

September - December 2012

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Special report produced for CLAL

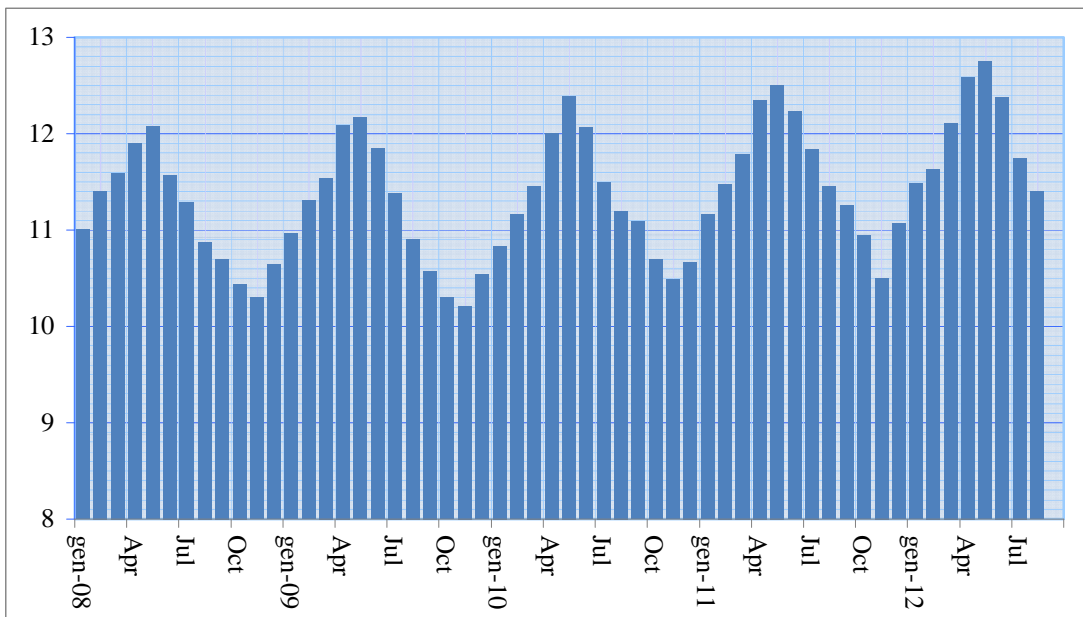
Highlights:

- A radical new assessment of prospective market developments towards the end of 2012 is necessary in view of the sudden end of the cyclical expansion of milk supplies in the EU and beyond.
- With reduced milk supplies and increased requirements for cheese manufacturing the availability of milk and cream in bulk and skim milk concentrates as well is short in the EU, which has led to fast rising prices for those items.
- Also the production of skim milk powder and butter has been reduced and is likely to stay reduced on a year to year basis until spring 2013. This also has created a very firm market situation with fast rising prices for both.
- Because of medium-term commitments the prices of major other dairy products like liquid products and cheeses reacted only modestly or even not yet at all, but it seems to be inevitable that they have to take the same direction.
- So far also milk prices paid to farmers were only increased recently according the usual seasonal profile in the summer months, because most of all milk is used in the sectors where the reaction to the new situation has been poor so far.
- In major producing areas outside the EU, except Oceania and Latin America, the growth of milk production has slowed down and might even turn into a reduction, notably in North America and Eastern Europe.
- Domestic demand in the EU is partly affected by economic problems of many consumers as result of the debt crisis. But the reaction in dairy markets seems to be modest.
- International markets so far this year have absorbed record volumes of dairy products. But it is obvious that both the EU and the United States cannot go on exporting similar volumes over the Northern fall and winter period.
- Regardless of the currency rate the world market will rather have to adjust to European price levels in the next months than the other way round.

Will expansion of milk production be reduced?

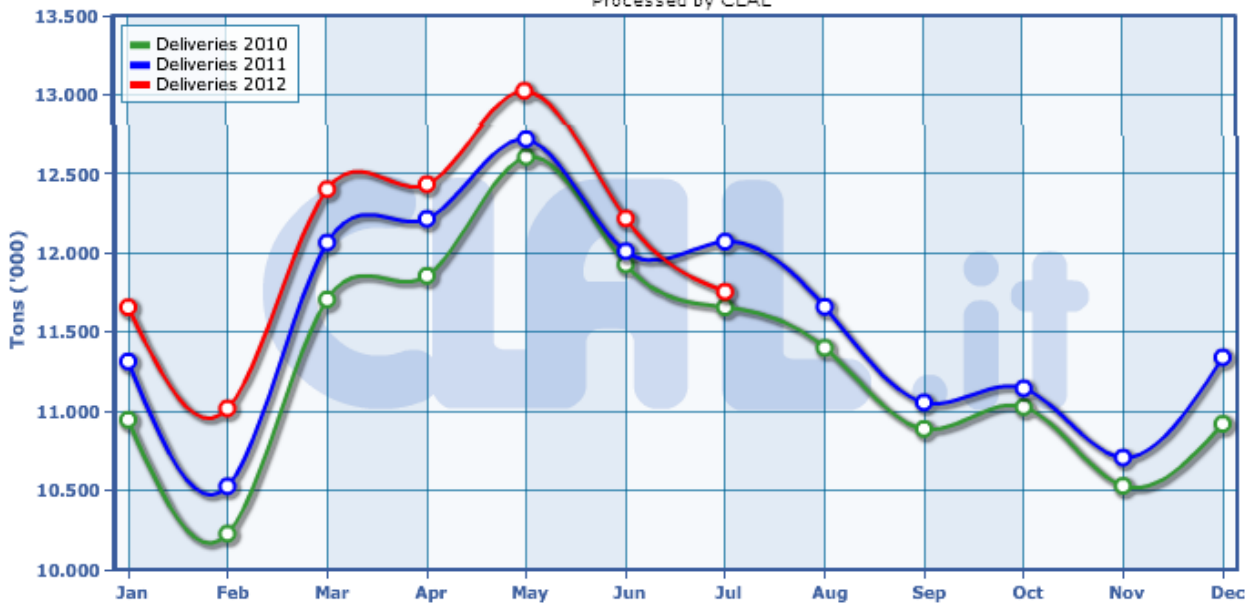
The time of increasing [milk supplies in the EU](#) seems to be over: since May milk deliveries to dairy plants are falling seasonally and the decline has accelerated in July when for the first time since May 2010 milk deliveries fell short of the volumes one year ago. Unfavorable, though adverse weather conditions are the reason: in West European countries like Ireland, the U.K. and parts of France pastures and forage crops were damaged by too much humidity, in Southern countries by heat and drought. Also the feed crop harvests for the winter are poor in some areas, also in Germany and other Central European countries.

EU-27 Milk Deliveries, adjusted for average length of months, mioTons



EU-27 - Triennial overview of milk deliveries

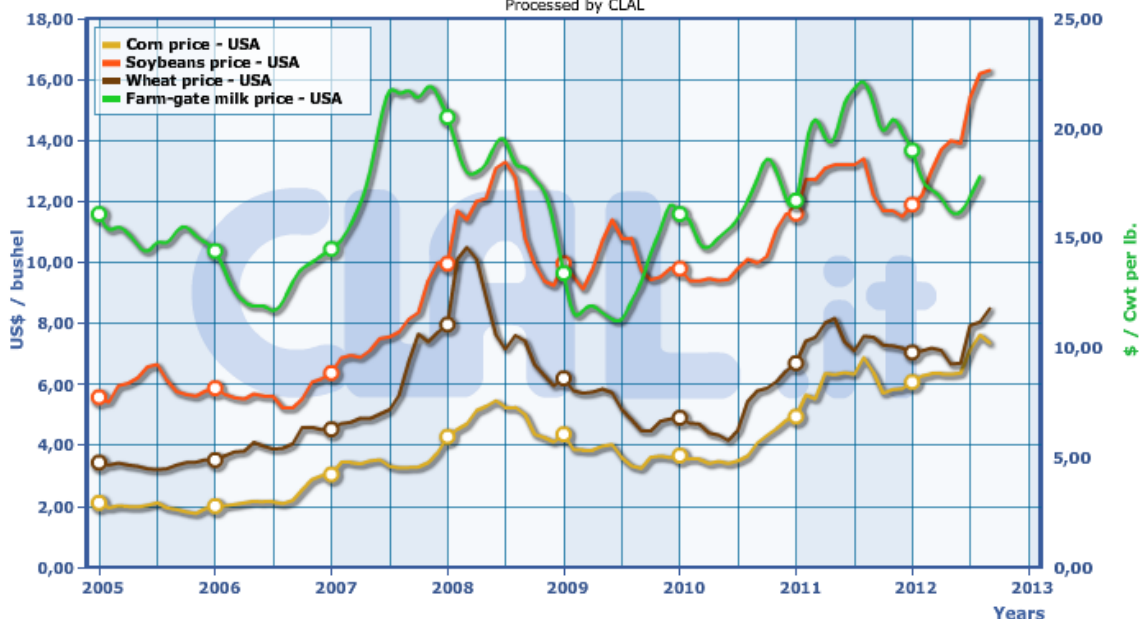
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Moreover, [high prices of grain and soybeans](#) and [low milk prices](#) have reduced the feeding of concentrates. And the prospects for an easing of this situation are minor: Concentrate feed prices will probably stay high until the mid of 2013. With some delay to the dairy product markets, milk prices can go up in the next months. The problem of the late response of milk prices to a changing market situation, be it a bullish or a bearish one, does still exist. One response to the unfavorable relation between milk price and feed costs is increased culling of dairy cows. Under these circumstances the again increased milk quotas are unlikely to become realized by higher milk volumes.

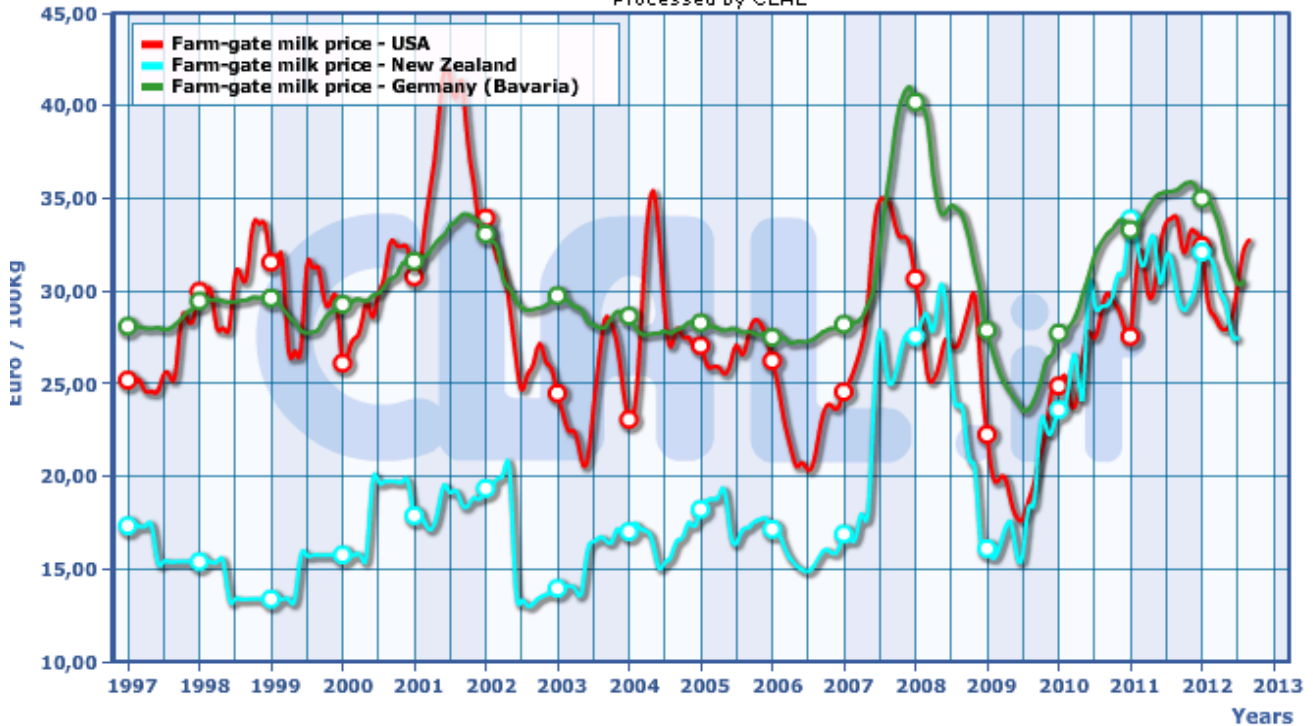
USA - Comparative historical overview of the prices of Corn, Soybeans and Wheat with the Farm-gate milk price

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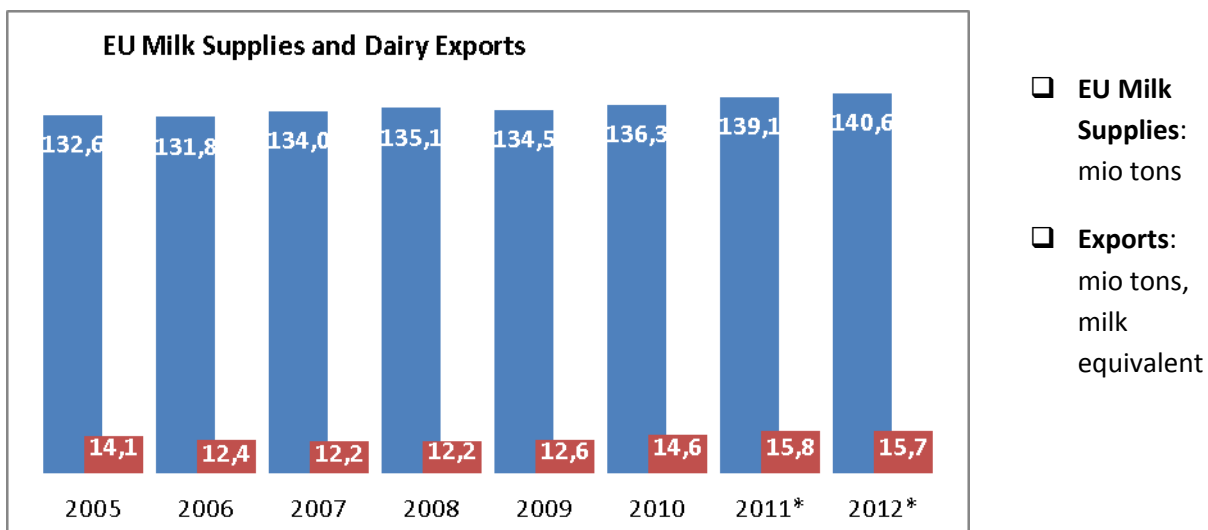


Historical comparative overview on Farm-gate Milk prices in Bavaria (D), the US, New Zealand

Processed by CLAL

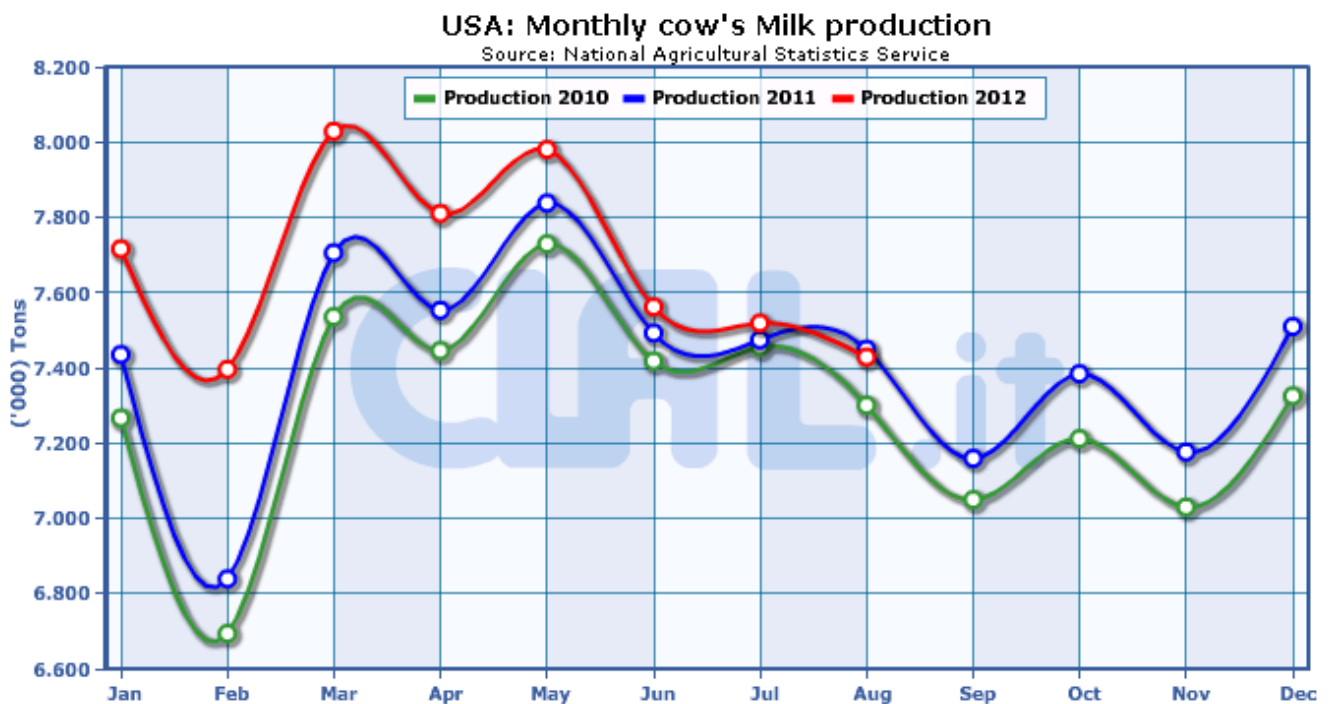


In the first half of 2012, EU milk supplies grew by 1,8 million t, of which 0,8 million t resulted from the extra day in February. In July and August deliveries were reduced and this will probably continue over the next months. This might end up in an increase of only 1,5 million t for the whole year (as shown in the annex table 1), but with the emphasis on reduced volumes in the second semester. This is just half of the increase which was expected in earlier forecasts.



Reduced growth also in other parts of the World

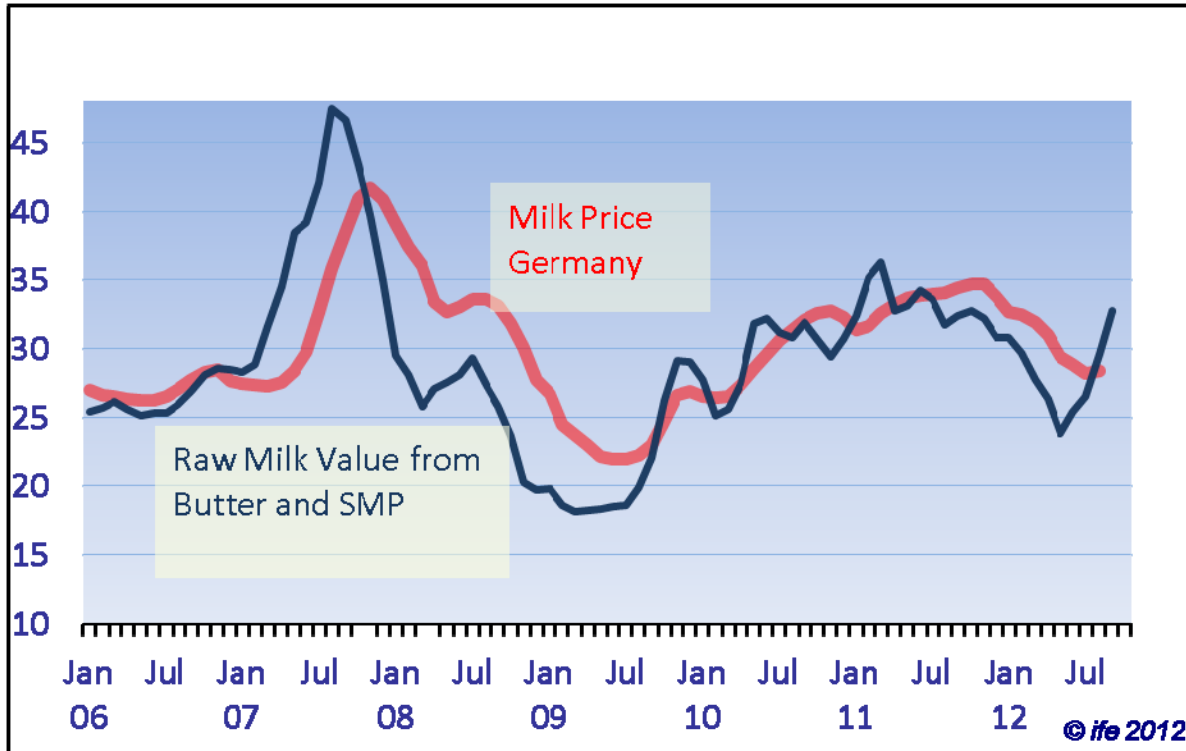
In the [United States milk production](#) has slowed down its expansion in July and in August also here milk production was below previous year levels for the first time since 2010. According to experts' assessments it is will continue to be reduced until the mid of 2013 because of high feed costs and the unfavorable milk/feed price ratio. Therefore also the U.S. will no more in the position to export dairy products in the large volumes which were recorded for the first half of 2012. Reports from Oceania indicate that there higher production volumes can be expected in the new upcoming season 2012/13, but it is unlikely that they can fill the gaps originated by the reduced production of the Northern hemisphere. The situation is also aggravated by reduced expectations also for Russia. On the short term, also the potentials of Latin America to produce more milk are limited to fill the gaps.



Recovery of prices

As markets of the major exporters are highly interlaced, upward price movements might continue in the sector of milk powders both within the EU and on the international market. The scope for a further increase of butter prices, however, seems to be limited. Nevertheless the returns for milk which is processed into butter and milk powders will stay at high levels for a longer time and will attract more milk, unless prices in the sectors of liquid products and cheese follow. So far they are almost unchanged or have only moved a bit.

Market return from butter and skim milk powder and milk price in Germany (Ct/kg, 3,7% fat, 3,4% protein)



Anyway, also exchange rates are important: The recent recovery of the Euro has reduced competitiveness of EU origin products. But in the present market situation of milk products, notably milk powders, it is more likely that the World market has to adjust its prices to EU levels than vice-versa, despite the fact that the EU will lose market shares again because of reduced product availability at least over the next half year.

More milk for cheese, less for skim milk powder and butter

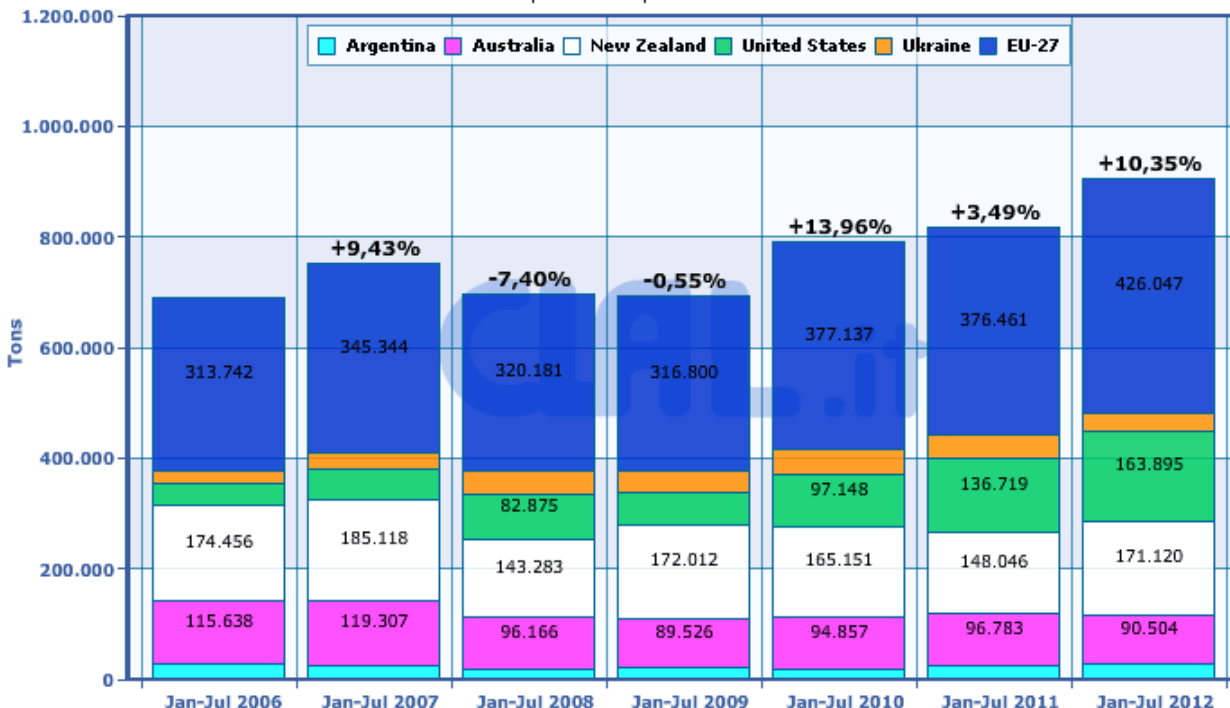
It can be misleading to take the evolution of private households purchases of dairy products as indication for the total market of food products, i. e. liquid milk or butter. Underlying structural changes in consumption habits and socio-economic changes have changed the consumption patterns on the long term. And this phenomenon can be accelerated by policies beyond the agricultural and food industry sector. For example the ongoing introduction of whole day schooling of pupils in Germany within few years which is accompanied by fast growth of serving lunch in schools is changing the demand structure of private households. Similar evolutions are going on or have made even more progress or might follow in other EU countries. Therefore the total markets will not necessarily be in stagnation if household demand does no more grow or even might decline. This is well illustrated by the cheese market, where the results of household

panels showed a different evolution than the total market, and it is not the only example.

But the cheese market is still the major growth sector in countries with a high dairy consumption within and beyond the EU. Therefore it absorbed most of the additional milk in the first half of 2012. Thus the potential to increase milk powder and butter production was significantly smaller than the increase of milk supplies. In the second half the availability of milk for milk powders and butter will be not only be reduced by the usual seasonal decline of milk deliveries, but also by the stagnating or smaller volumes in comparison to the year ago and on top by more utilization for cheese. All this already happened in July and August.

It is normal that milk and dairy product prices go up in the second half of each year after milk deliveries are over the spring peak. So it was not unexpected also for this year's summer that milk powder and butter prices would rise. But the speed of price increase was the surprise, also in view of the strong increase of milk volumes until June.

0406 - CHEESE Total Export of selected Countries
(Exporters considered: Argentina, Australia, New Zealand, United States, Ukraine, EU-27)
Data processed by Clal based on GTIS source

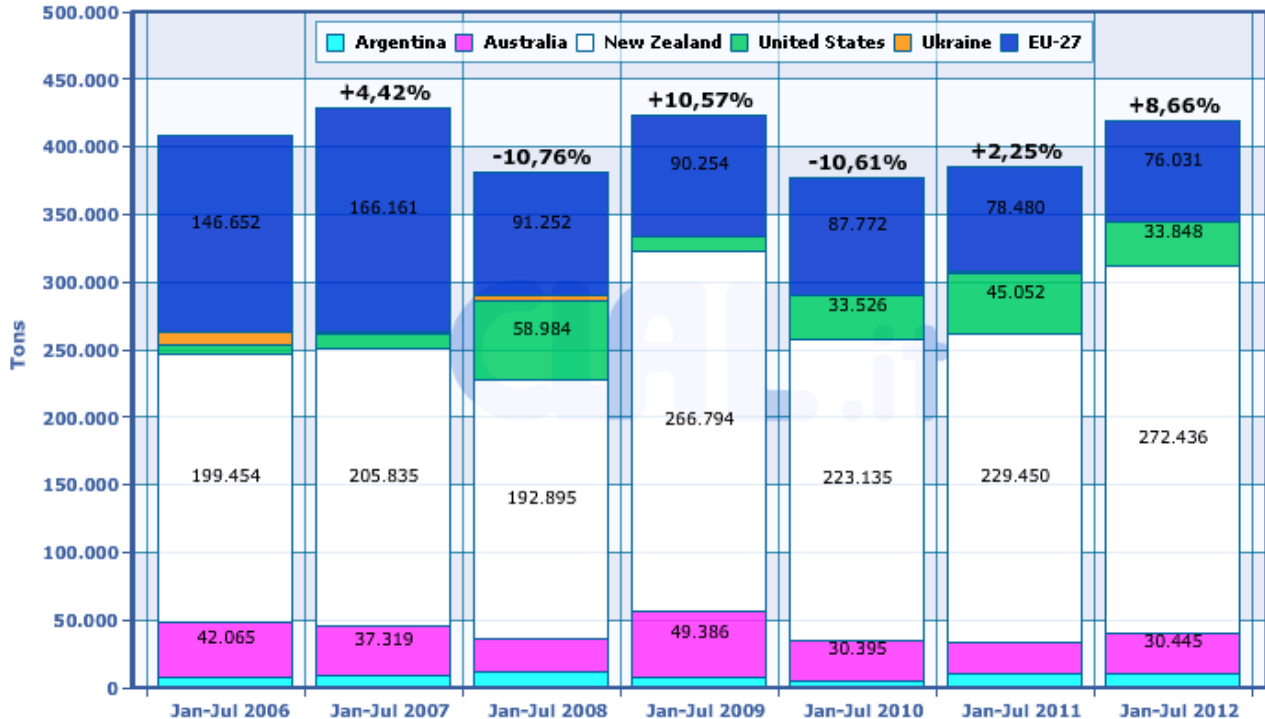


Firm butter market

In particular the butter market was surprising in view of a higher production, reduced exports to countries outside EU and larger quantities being stored under the PSA (Private Storage Aid) scheme of the EU. But after historically high prices in 2011 butter was for private households, caterers, food services and food industries as well available at significantly reduced prices, which certainly was helpful to sell more within the European

market. After the fast decline of milkfat availability for butter manufacturing prices went up rapidly since the mid of the year, which strengthened the confidence in the profitability of private storage for the period from September to March.

0405 - BUTTER Total Export of selected Countries
(Exporters considered: Argentina, Australia, New Zealand, United States, Ukraine, EU-27)
Data processed by Clal based on GTIS source

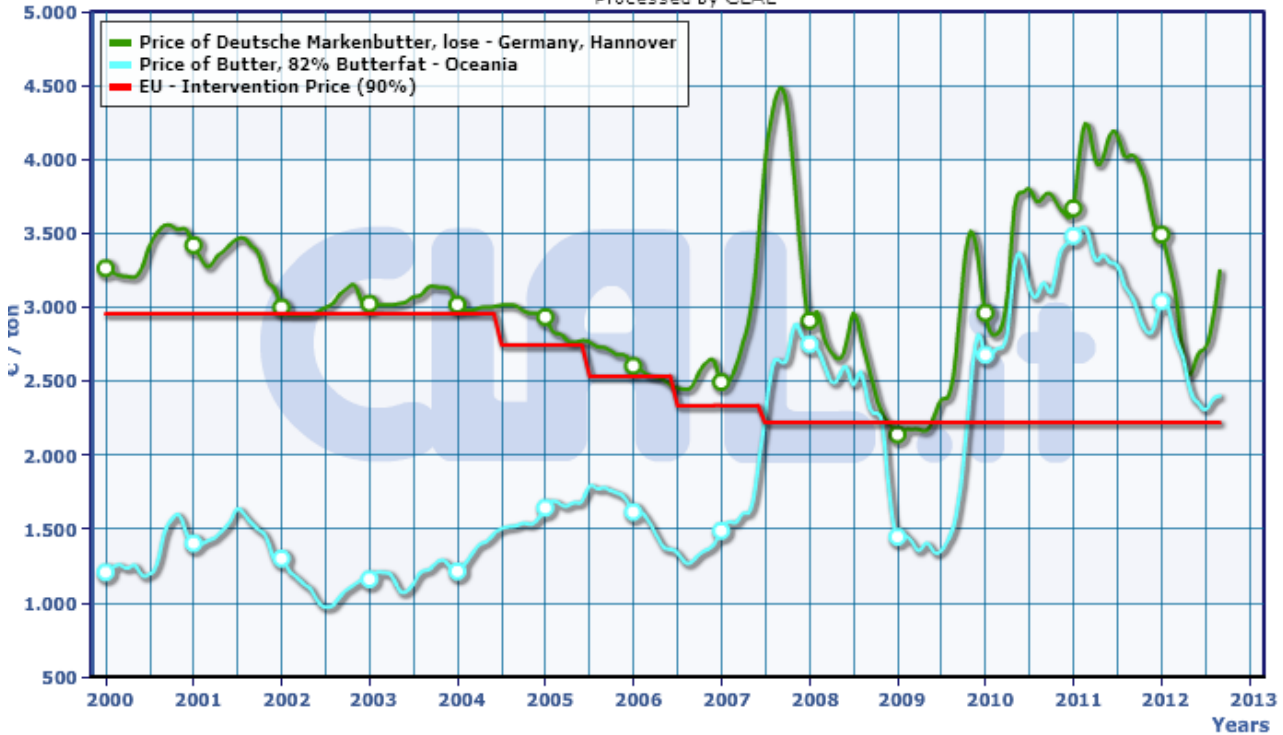


The next months until mid of December will be characterized by the usual strong demand in major market segments which will give the opportunity to clear large amounts of the butter in the private storages, but the balance sheet (Annex table 2) shows that the market might end up with higher stocks than in 2010 and 2011, when they were very low. Thus the scope for further price increases after those which have already been achieved until the end of September seems to be limited.

Also the opportunity to export larger volumes are limited. The prices of ordinary butter in bulk are still higher than those offered from Oceania. Partly exports comprise special qualities, and the contracts for other exports must have been negotiated in the few periods when EU butter prices were close to the World market levels.

Historical comparative overview between Butter prices in Germany and Oceania with EU intervention price

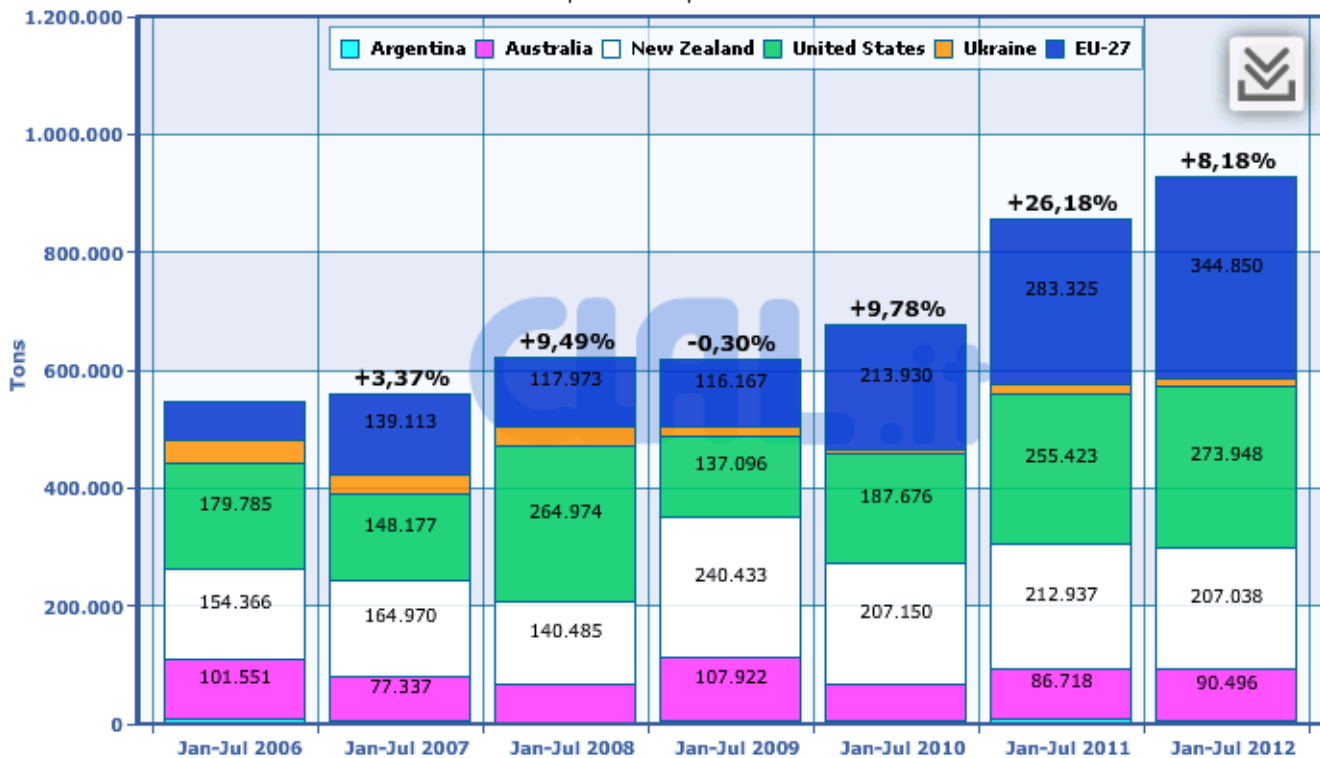
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Milk Powder Prices: When will the upward movement come to an end?

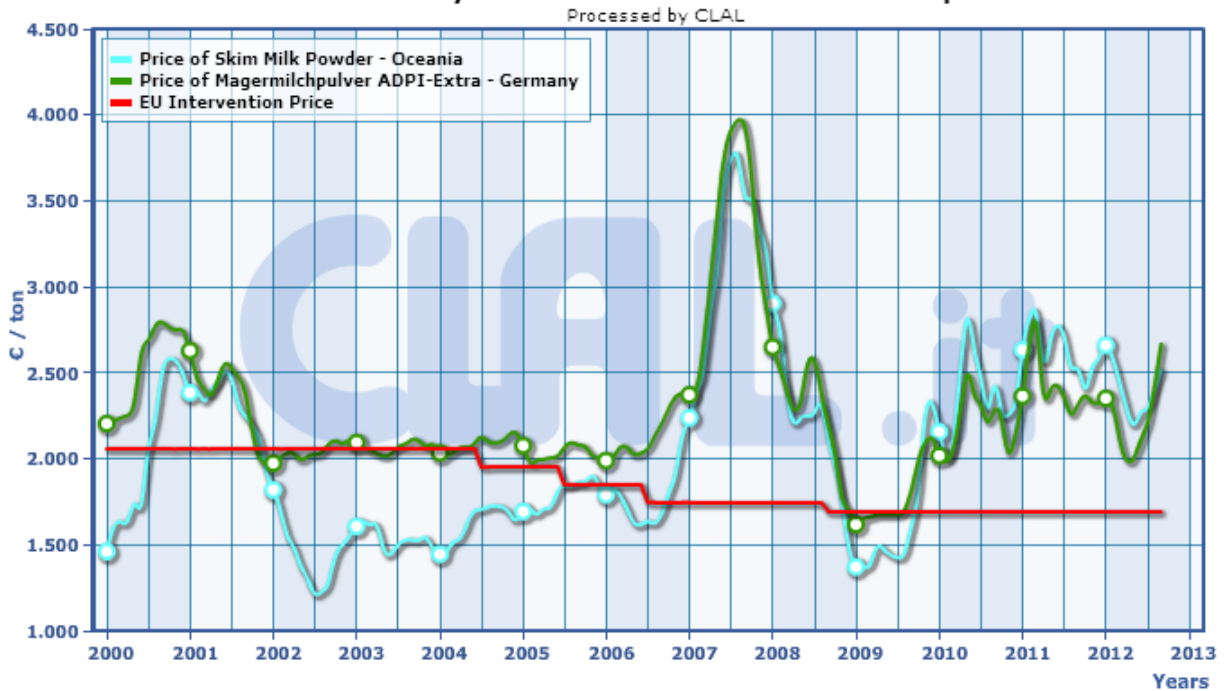
The situation in the milk powder sector is different to the butter market. Here more opportunities can be seen that market prices continue to rise. The demand from the world market is still strong and is focussing to supplies from the EU. The first half year saw an outstanding increase of the world trade in skim milk powder and also a modest increase in the trade in whole milk powders, and demand does not yet seem to be covered for a longer time in advance. But as result of the reduced expectation of milk supplies on both sides of the Atlantic ocean the EU and the United States will not be in the position to produce enough milk powders that they can continue to export similar volumes as in the first half of 2012.

040210 - SMP Total Export of selected Countries
(Exporters considered: Argentina, Australia, New Zealand, United States, Ukraine, EU-27)
Data processed by Clal based on GTIS source



In the EU consumption had been increased in the first half year of 2012 by favorable prices for skim milk powder. High prices for whey derivatives might have led to some extent to increase the share of skim milk powder in milk replacers instead of whey. But with high prices for both skim milk and whey and still low milk prices for milk many farmers have reduced feeding of milk replacers to calves. But this behaviour cannot change the soaring market situation fundamentally. Even with reduced consumption and exports of skim milk powder in the second half of 2012 the year will end with very low stocks, a situation which will keep prices at high levels. (Annex table 5)

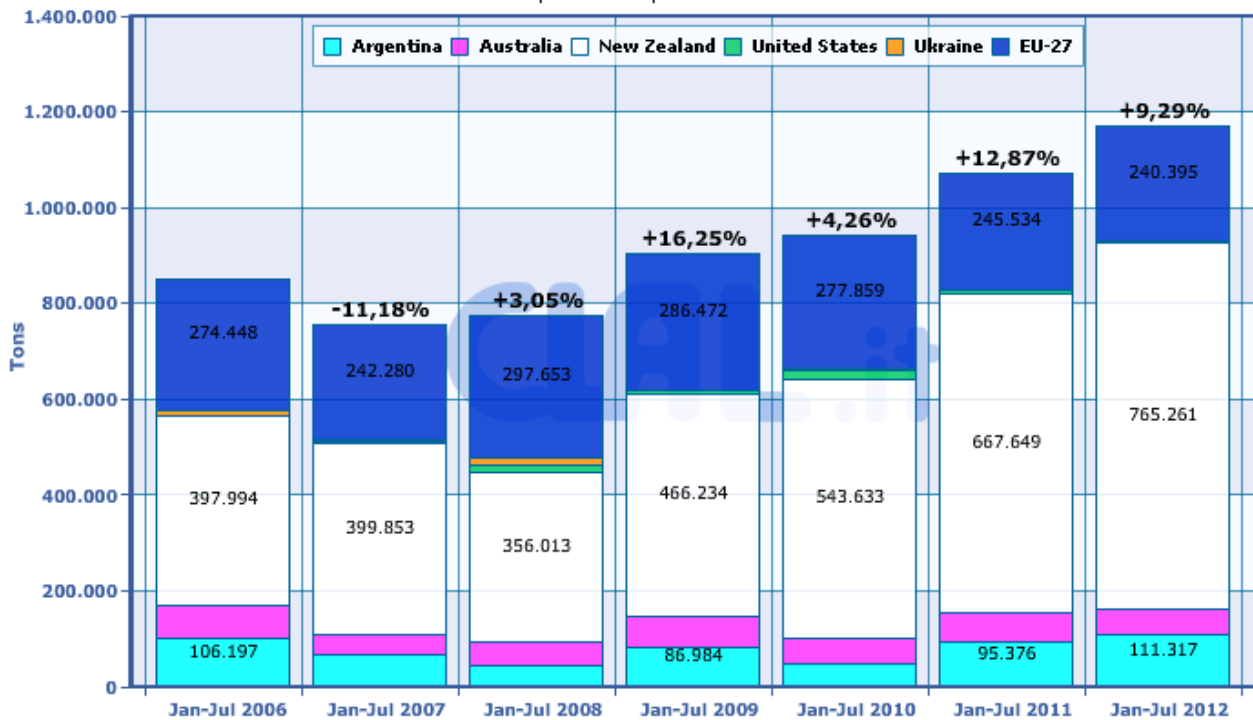
Comparative historical overview between SMP market prices in Germany and Oceania and EU intervention price



Despite a good start into the new dairy year and ongoing good prospects for milk production it seems to be unlikely that New Zealand can repeat a season with the same growth speed as the recent one. Last information from Australia indicate a poorer start into the new season, which, however, at that point would be premature to expect that unfavorable conditions will reduce milk production over the whole dairy year. But optimistic estimates are that the combined milk production of both Oceania countries will go up by one extra million of metric tons. This is not enough to increase powder output and exports of both countries to volumes that the international milk powder trade can be maintained at the high levels of the first semester 2012. Also the potentials of Argentina and Uruguay are not large enough to fill the gap.

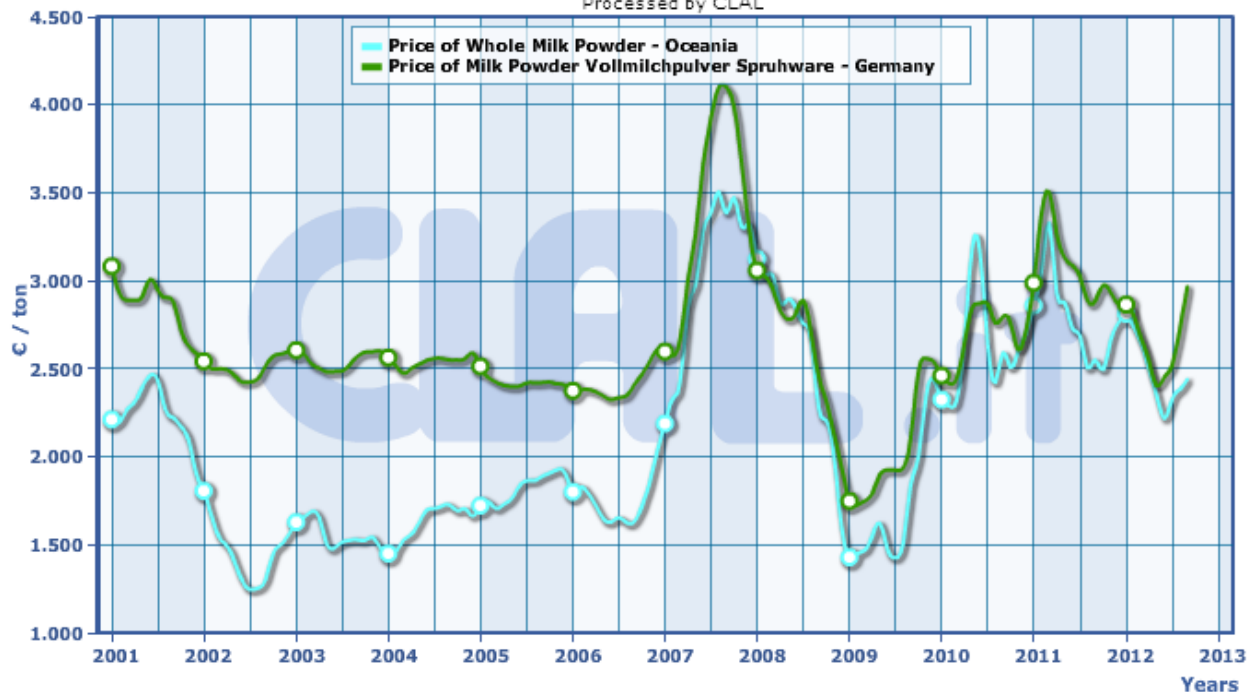
The demand from international markets for whole milk powder is strong, but with more modest growth. So far also this year the EU did not participate in this growth by higher exports, because EU-origins continued to be less competitive.

040221 - WMP Total Export of selected Countries
(Exporters considered: Argentina, Australia, New Zealand, United States, Ukraine, EU-27)
Data processed by Clal based on GTIS source



Comparative historical overview between WMP prices in Germany and Oceania

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Annex

Table 1

EU- Dairy Market 2007 - 2011 and Forecast 2012

1.000 t	2007	2008	2009	2010	2011*	2012**
Milk deliveries	133.969	135.103	134.525	136.273	139.080	140.600
Liquid Products	45.818	45.577	45.200	45.791	46.000	46.300
Butter						
Production	2.110	2.100	2.050	2.010	2.090	2.090
Consumption	1.994	1.968	1.984	1.970	1.976	1.990
Cheese						
Production	9.248	9.339	9.333	9.480	9.550	9.690
Consumption	8.728	8.863	8.841	8.917	8.942	9.025
Skim Milk Powder						
Production	1.090	1.040	1.160	1.080	1.210	1.200
Consumption	870	775	800	800	810	790
Whole Milk Powder						
Production	773	835	735	755	710	680
Population m. head	496	498	500	502	503	504

ife September 2012

*) Provisional. **) Forecast.

Source: ife, Kiel; ZMB, Berlin.

Table 2

EU Butter Balance Sheet

1.000 t	2007	2008	2009	2010	2011*	2012*
Production	2.110	2.100	2.050	2.010	2.090	2.090
Imports	85	65	62	40	47	60
Exports	211	147	150	155	131	120
Final stocks	100	150	135	60	90	130
- in intervention	0	0	80	2	1	0
Consumption	1.994	1.968	1.984	1.970	1.976	1.990

*)Provisional/ Estimated. *ife September 2012*

Sources: ife, Kiel; ZMB, Berlin; EU Commission

Table 3

EU Cheese Balance Sheet

1.000 t	2007	2008	2009	2010	2011*	2012*
Production	8.983	9.084	9.083	9.220	9.300	9.440
Imports	94	89	84	83	74	85
Processed cheese impact	265	255	250	260	250	250
Exports	594	555	576	676	682	750

Stock change	+20	+10	+0	-30	+0	0
Consumption	8.728	8.863	8.841	8.917	8.942	9.025
<i>-per capita (kg)</i>	<i>17,6</i>	<i>17,8</i>	<i>17,7</i>	<i>17,8</i>	<i>17,8</i>	<i>17,9</i>

**)Provisional/ Estimated. ife September 2012*

Sources: ife, Kiel; ZMB, Berlin; EU Commission

Table 4

EU WMP Balance Sheet

1.000 t	2007	2008	2009	2010	2011*	2012*
Production	773	835	735	755	710	680
Imports	2	2	2	2	2	2
Exports	366	485	463	447	390	360
Stock change	20	15	-55	-20	10	0
Consumption	389	337	329	330	312	322

**)Provisional/ Estimated. ife September 2012*

Sources: ife, Kiel; ZMB, Berlin; EU Commission

Table 5

EU SMP Balance Sheet

1.000 t	2007	2008	2009	2010	2011*	2012*
Production	1.090	1.040	1.160	1.080	1.210	1.200
Imports	10	8	6	4	0	2
Consumption	870	775	800	800	810	790
<i>- as Feed</i>	<i>245</i>	<i>150</i>	<i>160</i>	<i>165</i>	<i>190</i>	<i>180</i>
Exports	201	179	230	378	518	500
Ending stocks	124	217	353	259	142	54
<i>- in intervention</i>	<i>-</i>	<i>-</i>	<i>260</i>	<i>190</i>	<i>50</i>	<i>0</i>

**)Provisional/ Estimated. ife September 2012*

Sources: ife, Kiel; ZMB, Berlin; EU Commission