

# GLOBAL DAIRY SUPPLY/DEMAND, “THE BIG PICTURE”

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## Summary

The timing of any price recovery is critical to the sector’s fortunes. As a result, it is not surprising that commentator debate on this topic has been fierce. With the demand picture less contentious, the debate has centred on the (export) supply side. The consensus view is that global prices are likely to remain muted for an extended period and/or that prices have moved lower on a structural basis compared to recent history. This view is predicated on a structural change in supply, often or particularly from EU producers.

In contrast, our non-consensus view is that the global dairy production cycle is alive and well, but merely delayed. We argue that the NZ dairy production cycle has been delayed one season by the vagaries of the Fonterra payment system. This view is supported by the lift in NZ production over 2014/15 and, in turn, by the fall in production so far over the 2015/16 season.

Similarly, the lifting of EU production quotas has created a mirage of ongoing dairy production strength; a closer analysis of EU production, using seasonally-adjusted data, however reveals a plateauing of production from the middle of 2015. This production trend is more consistent with low milk prices biting on EU farmers and the beginnings of cyclical reduction in EU dairy supply. Moreover, if additional data confirm this trend, then the supporting argument for structural change in supply weakens.

In the end, our view is that there has not been a material change in the competitiveness nor otherwise of global dairy exporters. As such with the key global dairy exporters (NZ and the EU) losing money on aggregate, the production response is likely to gather momentum this year. Furthermore as this supply dynamic plays out, and assuming that global demand continues to improve, global prices should lift over the second half of 2016.

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## EU Milk Mirage

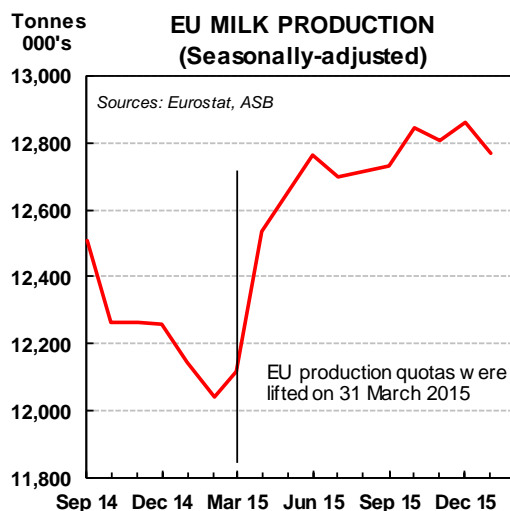
EU milk production growth is slowing. EU farmers, like their NZ counterparts, are indeed feeling the pinch from low milk prices. Certainly post-quota, EU production surged. But the reality of low global milk prices has soon replaced the post-quota euphoria. It's no wonder Euro farmers have their hands out. With this in mind, we emphasise the EU support measures announced earlier in 2016 should be taken at face value. That is, the EU is providing support to farmers under stress from low milk prices.

### ***A better comparison of EU production data***

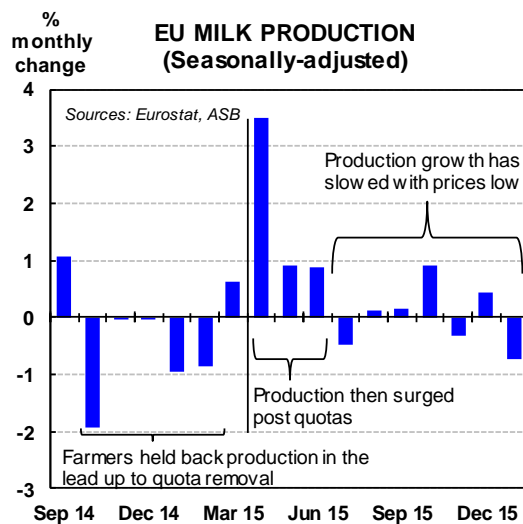
Comparing apples with oranges is difficult. In EU milk production terms, comparing milk production pre and post the quota removal, using annual changes, is dairy's equivalent of doing just that. In this paper, we attempt to skirt the issue by using seasonally-adjusted production data. In particular, we focus on comparing the months, on a like-for-like basis, post the removal of EU production quotas.

The seasonally-adjusted data clearly show three things:

1. Production was held back (and was falling) prior to the removal of quotas at the end of March 2015, as countries avoided paying the penalties associated with producing above quota.
2. Production then surged after the removal of quotas, with April production lifting over 3% on a month-on-month basis.
3. However, this post-quota surge has passed. Production growth has slowed, particularly since July, as farmers have struggled with low milk prices.



**Figure 1.** Seasonally-adjusted EU 28 milk production (less Estonia and Cyprus)



**Figure 2.** Monthly change in seasonally-adjusted EU 28 milk production (less Estonia and Cyprus)

In official EU data, this third point in particular gets lost – as a result, annual comparisons overstate the recent trends in EU production growth. For example, the EU Commission shows that April 2015 to January 2016 was around 4% higher than the same period a year earlier. In comparison, annualising the seasonally-adjusted data over recent months shows that EU production is falling or at best flat.

Moreover, with most dairy market buyers unaware of this data disconnect, we expect some to be caught short of supply later this year. And as this happens global dairy prices are likely to climb.

### Cash is king for the NZ production cycle

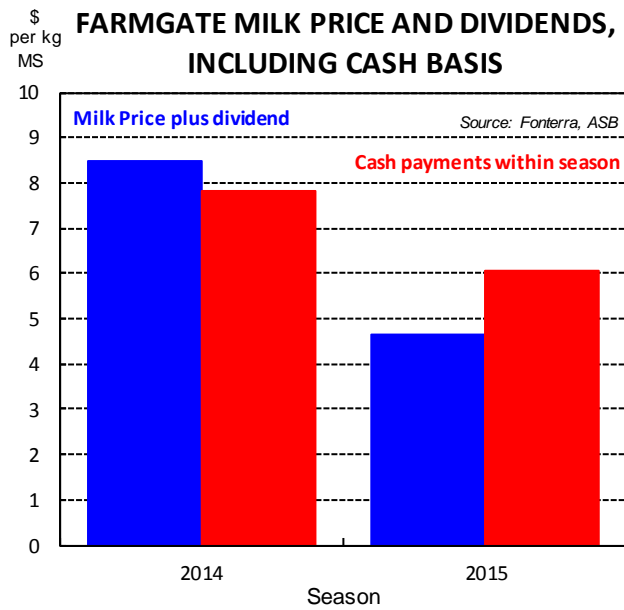
The NZ production cycle is also alive and well, but the cycle has been delayed. Normally, the milk price is the main determinant of the production cycle. However, during this cycle there is has been a large disconnect between the milk price and farm cashflows.

This disconnect has delayed the cycle, keeping production higher than it would have been otherwise. For example, in the 2014/15 season, the Fonterra milk price was \$4.40/kg MS. At

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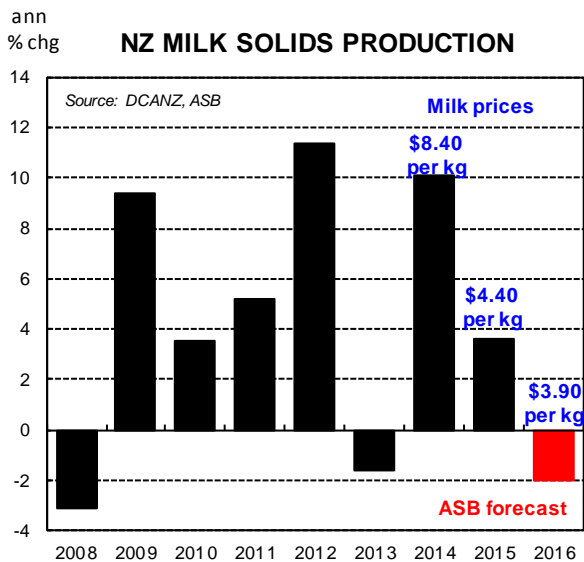
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this level, the milk price was well below the break-even point for the majority of farmers at that time. However, farm cashflows were closer to \$6.00/kg MS.



**Figure 3.** Farmgate milk price and dividends, including cash basis

On this basis, farmers did not respond to the low headline milk price – indeed 2014/15 production grew by nearly 4% on the season prior. In fact, production would have been higher, if not for the short sharp drought in summer 2015. Moreover, this increase came on top of the bumper 10% increase for the season prior.

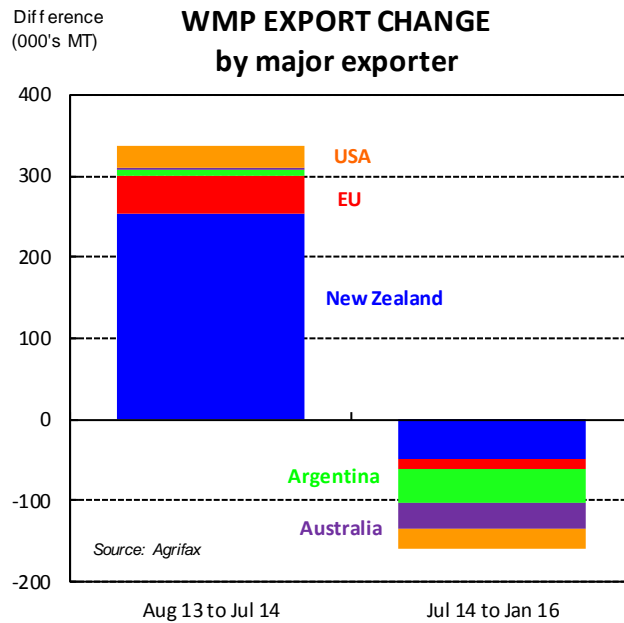


**Figure 3.** NZ milk production growth

The change in NZ’s whole milk powder (WMP) exports illustrates this point well. In the 12 months leading up to the cyclical high, NZ exports increased by around 250,000MT. NZ’s

increase accounted for 13.9 percentage points (or around three-quarters) of the 18.4% combined increase by the major exporters.

Post-peak NZ's contribution has been much less and consistent with the delayed production response. Of the 7.3% decline post-peak, NZ has only accounted for 2.2% (or around 30%).



**Figure 4.** Whole milk powder (WMP) export change pre- and post-cycle peak by major exporter

However over the 2015/16 season so far, with a low milk price and, importantly, similarly tight cashflow, NZ farmers have responded. Production for the season-to-date is running 1.7% behind the same time a season ago. Our full season forecast is for NZ production to fall 2% on the season prior.

Moreover, with the 2016/17 milk price likely to start low, we expect ongoing tight cashflows to result in further production falls.

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## **Implications**

With the export supply cycle turned and turning in the key export regions of NZ and EU, respectively, in our view, we see that the conditions are in place for the global dairy price cycle to also turn this year. As a result, our expectation is that production data and then price data over 2016 will confirm that the global dairy cycle is alive and well. After all, agricultural cycles have been around for millennia – and the current evidence does not convince us otherwise.