The global dairy industry – reshaping in a new market era

This report from Rabobank reflects on the changes of recent times in the global dairy industry before going on to predict how the market will evolve.

Globally the industry has had a two year boom but in recent months the market has fallen sharply. A key question is whether or not these recent falls in prices coupled to the 'credit crunch' are the end of the boom or just a temporary blip as new price levels, product shortages and market volatilities see the global dairy industry start to reshape.

The boom in global dairy prices peaked in late 2007 then a downwards drift began and by October 2008 whole milk powder, skim milk powder, butter and cheese all showed price declines of 25-40%. These were not always in parallel, for example whey powder prices fell much earlier than other prices.

Record milk prices

In 2007 more milk was required, with the result that by December of that year farmers in all the major export regions were being offered record prices for milk and the milk price difference between these areas and the EU reduced.

However, higher milk prices were soon to be followed by higher input costs – firstly grain, followed by fertiliser and the cost of cows. This obviously reduced the appeal of high milk prices and impacted negatively on some investment plans. This erosion in margins was then exacerbated in many regions by declines in the price of milk.

Other factors came into play, such as New Zealand's worst drought in 100 years, which cut production across that country by almost 5%, a failure of the rains in Australian grain areas, which drove local grain prices to record highs, and continuing high grain costs in Argentina.

The exception to this was the USA and this country almost single handedly made up for the lack of milk supplies elsewhere as its milk production growth exceeded 2.5%. The USA's growth in exports was remarkable.

Thus, in 2008 prices had to rise until demand was choked off to balance the market. By mid 2008 at least a dozen countries had slashed import tariffs or increased import quotas. Some subsidised the price of dairy products while others legislated price controls. Even so a tidal wave of retail dairy inflation swamped the world's supermarkets in mid 2008.

From late 2007 the price differential between dairy and vegetable fats increased and this induced a strong incentive for processors and consumers to switch from dairy fat to vegetable fat. By mid 2008 dairy consumption appeared to be in decline and this was compounded by the rising value of the US dollar. In practice this meant for many exporters that much of the real drop in product price was washed away by currency shifts.

So, what is the market outlook for our products with the world economy entering a downturn? The IMF expects the global economy to remain under considerable pressure until at least the end of 2009 when a gradual recovery could commence.

Thus, credit availability could be tight for a significant time. Other factors suggest several years of above average economic growth from the end of 2009.

Fertiliser prices are unlikely to yield much before 2010 when several substantial plants will come on stream but fertiliser prices are not expected to return to their previous low levels.

Although world grain prices have reduced since early 2008, higher production costs will significantly impact on grain prices.

Global decline

Global consumption of dairy products has declined and this has been dramatic in China because of the melamine debacle. Demand for dairy products is expected to be muted over the next 12-18 months but thereafter it is expected to improve. Growth in global dairy consumption is forecasted at 1.7% for 2008/9 and 2.5% in the succeeding three years.

In recent years over half the world's growth in demand for dairy products has been in China and India and these countries have met much of this growth on their own. Rabobank expect China will maintain a high rate of self-sufficiency as will India.

South East Asia, North Africa and parts of the Middle East produce 25, 33 and 35-40% of their own needs and many of the countries in these areas will need to continue to rely on imported dairy products.

Key exporters

As 2009 progresses and demand recovers the market will again require additional volumes of milk from key exporters. New Zealand and Brazil (with an increase in prices) could well meet this demand with some increase in production in the EU. Rabobank feel that predicting the future for the USA is not the easiest of tasks even though the USA surpassed Australia in 2008 to become the world's third largest exporter of dairy products.

However, various possible downside price risks are possible and these include:

- A short term sharper slump in economic activity.
- Continued strong growth in USA exports.
- A prolonged slump in economic growth for the medium term.
- Input prices returning to traditional levels.
- Latin American export surpluses developing quicker than expected.

On the upside are climatic disruptions and unexpectedly high demand from India and China. Thus, farmers are likely to have high prices but not necessarily with high margins.

Dairy processors will need to adapt to a changing world and dairy traders can look forward to good times as they invariably prosper in times of dynamic and volatile markets!

When it comes to dairy ingredient users Rabobank feel that they should be re-evaluating their sourcing strategies, including the use of alternative (non-dairy) products.

In essence, Rabobank believes a turnaround will occur in 2009. Milk production costs will be higher, but prices for milk will be higher than their pre 2007 levels. ■