Dairy Australia

DAIRY SITUATION AND OUTLOOK

MARCH 2022

SEVEN KEY DRIVERS

OF THE AUSTRALIAN DAIRY INDUSTRY

Global supply

Situation Outlook

The global milk pool has continued to shrink this summer, as less milk is produced in the four key exporting regions. While weather challenges continue to impede production in Oceania, higher input costs and increased culling is weighing on growth prospects in the northern hemisphere. Milk supply is expected to remain tight in the short term, supporting commodity prices.

Global demand

Situation Outlook

Global dairy exports increased by 6.5% in the past year, as international demand has continued to firm. With little milk available globally and logistical challenges making accessing products difficult, many buyers have been willing to pay a premium to ensure supply chain security. This has further boosted commodity. values, but growing inventories may weigh on demand in the future.

Global economy

Situation Outlook

While the easing of COVID-19 related restrictions has propelled a recovery for the global economy, many obstacles remain. Further economic growth is hindered by ongoing lockdowns in China, while inflationary pressures, supply chain disruptions and high energy costs also add constraints. As such, the International Monetary Fund (IMF) revised its global economic growth forecast for 2022 down to 4.4%.

Australian market

Situation Outlook

Many consumers adopted pseudo-lockdown behaviour at the start of this year, as COVID-19 case numbers soared. While this has affected foodservice spending, easing of restrictions is expected to drive a recovery later this year. Meanwhile, retail sales of major dairy products eased slightly in volume, while the average price increased.

Inputs

Situation Outlook

While fodder and temporary water prices remain subdued, global dynamics have maintained upward pressure on local grain and fertiliser values. Fuel and chemical prices have also been increasing, as inflation begins to take hold. Rising input costs are likely to weigh on farm margins going forward.

Australian production

Situation Outlook

Following a wet spring, hot and humid weather in January has further weighed on yields. A smaller national herd and subdued per-cow yields are forecast to result in a 1% to 3% reduction in Australia's national milk pool this season. This would equate to a 2021/22 full-year range of between 8.59 and 8.77 billion litres.

Exchange rates

Situation Outlook

Over summer, the Australian dollar (A$) has remained relatively stable, at around US$0.72. Inflationary pressures are likely to see interest rates rise this year, which is expected to increase volatility in exchange rates.

Positive Neutral Negative

EXECUTIVE SUMMARY

Most dairy farmers in Australia are well-placed for another profitable year as market fundamentals remain strong. Nevertheless, increasing costs are starting to affect margins across the supply chain. Add a war in Europe into the mix, and risks abound.

Whether it is consumer goods, agricultural inputs or freight, costs seem to only be heading in one direction at the moment – up. Inflationary pressures are being noticed across the global economy, and Australia's dairy industry is starting to feel the impact. Increasing costs for some inputs are starting to chip away at margins, while others remain difficult to access due to supply disruptions.

Despite these challenges, Australia's dairy industry remains profitable. Strong demand and weak supply have continued to drive commodity values higher, with some flow-on impact on farmgate prices in southern export-focused regions. Additionally, increasing retail prices for many dairy products have continued to support value creation opportunities through the domestic supply chain.

Since the start of 2022, dairy commodity prices have jumped higher. A shrinking global milk pool has been a major driver behind these leaps.

Due to weather challenges, New Zealand's (NZ) production has taken a dive this summer, down by 6.1% in January on a tonnage basis, pulling the full season result towards what local analysts forecast will be around a 3% drop. In Europe, milk flows remain sluggish, despite rising farmgate milk prices. Declining cow numbers, poor quality feed, higher input costs and shortages of workers and fertiliser continue to weigh on growth opportunities. In the United States (US), high input costs and supply chain struggles are also affecting supply. While reports suggest some producers in the west of the country have expanded herds in recent months, overall national milk production fell 1.6% in January 2022.

As slowing milk volumes support prices on a fundamental level, logistical issues continue to cause disruption and delay. Shipping congestion, a lack of containers (especially reefers), late departures and staffing shortages are constant pain points. Russia's invasion of Ukraine is also expected to make freight more challenging going forward. This all seems to have made some buyers more eager to stock up on product now, to avoid being left short in the event of further disruptions.

While logistical challenges and political tensions have played a part in boosting dairy trades, global demand has also firmed. In the 12 months to November 2021, global dairy exports increased by 6.5% on a tonnage basis, with strong demand from most corners of the world. Combined with the current lack of supply, dairy commodity prices look fundamentally well-supported, though most Australian manufacturers are unlikely to immediately benefit, being already sold out of product this season. Decreasing milk production in Australia has limited export availability and resulted in further rationalisation, with Saputo Dairy Australia announcing line closures at some of its manufacturing sites.

In Australia, a La Niña event has resulted in above average rainfall across eastern states, creating multiple flooding events and affecting the quality of feed grown. Hot weather in January 2022 has subsequently limited pasture growth, especially in southern regions. While overall fodder demand remains muted, high-quality feed is hot property, due to reduced volumes being available in most regions this year. Nonetheless, with ample supply of other grades available around the country, hay prices in general remain below five-year averages. Similarly, temporary water prices in the Murray Irrigation System and northern Victoria remain subdued due to healthy water allocations.

Australia's grain harvest has proven to be one of the largest in history, with Western Australia (WA) setting a new record. Globally, grain prices have surged due to limited supply and weather concerns for the upcoming production season in the northern hemisphere.

Russia has placed export quotas on their product to mitigate rising local prices, while the invasion of Ukraine also is expected to see grain values rise.

While Australia's large harvest and current shipping challenges have maintained a discount of domestic grain as compared to international indicators, prices remain above last year's levels and are expected to rise further. Costs for other key inputs have increased over the past several months, and the war between Russia and Ukraine is predicted to exacerbate market volatility and price pressures. Fertiliser prices continue to rally due to the ongoing global shortage, while fuel, energy and labour costs also inch higher.

Although higher farmgate milk prices will help to mitigate margin impacts, rising input costs are likely to influence production plans. At the same time, labour shortages, farm exits and ongoing culling continue to affect the national milk pool. In January, milk flows slowed by 6.3%, and year-to-date volumes were down by 2.6%. Overall, a smaller national herd and subdued per-cow yields, due to weather challenges and poorer quality feed, are projected to result in a reduction in Australia's national milk pool this season. As such, Dairy Australia has revised its forecast to indicate a 1% to 3% drop in the national milk pool this season. This would equate to a 2021/22 full-year range of between 8.59 and 8.77 billion litres.

In terms of growth, New South Wales (NSW) has quickly emerged as the standout this year. Milk supply in the state has so far outpaced expectations, as good quality feed has helped to boost volumes. Similar conditions in northern Victoria, combined with good access to affordable water, have improved production over the past few months. Milk flows have also picked up in Queensland (Qld) as improved access to feed lifts per-cow yields. While drier weather in South Australia (SA) affected feed production earlier in the season, milk flows have since picked up. In comparison, volumes have continued to slide in Tasmania, western Victoria and Gippsland. Wet weather during spring lowered the quality of feed grown, while hot and particularly humid summer weather further weighed on per-cow yields. Additionally, milk production has continued to decrease in WA, as less supplementary feeding and a smaller state herd impede growth opportunities.

Turning to the domestic market, expectations were high heading into the festive season as the foodservice sector hoped people would turn up in force. Australian consumers did not disappoint, and spending at cafés and restaurants in 2021 leaped by 24% as compared to the year prior. Surging Omicron variant COVID-19 cases in January saw the return of many pseudo-lockdown behaviours, as fewer people ventured out. While this temporarily slowed sales, a more normalised COVID-19 situation and a further easing of restrictions are predicted to spur a recovery in foodservice spending this year.

Meanwhile, retail sales of major dairy products have eased slightly in volume in the past year, but remain elevated compared to pre-pandemic levels. Yoghurt has bucked the trend, with volumes growing by 0.9%. For categories where sales have declined on a volume basis, value has not fallen as much, due to an increase in the average retail price of all major dairy products.[1] This has helped to partially offset decreasing sales and continues to support value creation through the domestic supply chain.

Looking ahead, inflationary pressures are unlikely to abate any time soon. Australia's dairy industry is far from immune, with mounting cost pressures and margin impacts across the supply chain. As prices maintain their upwards trajectory, supportive market fundamentals continue to provide cause for optimism. Increasing demand and weaker supply underpin elevated commodity values, while a smaller national milk pool in Australia is likely to result in strong competition when new season prices are announced.

1 Dairy Australia calculation based in part on data reported by NielsenIQ through its Homescan Service for the total milk, cheese, yellow spreads and yoghurt categories to 2 Jan 2022 and 30 Jan 2022, for the Total Australia market, according to the NielsenIQ standard product hierarchy. Copyright © 2022, Nielsen Consumer LLC.

GLOBAL MARKETS

COMMODITY PRICES: UP, UP AND WHAT NEXT?

Propelled by milk-hungry markets and limited availability, global dairy commodity prices took off in mid-2021 and have continued to climb steadily.

Amid the turbulence created by widespread logistical issues, buyers have scrambled to secure supply, and price barriers have been broken as risk calculations and practical reality continue to evolve. Although peak altitude does not appear to have been reached yet, many are beginning to question what the inevitable price descent might look like.

From a supply perspective, there is little to suggest short-term rebalancing, as milk production in the four major exporting regions has been lagging for several months. Higher commodity values and rising farmgate milk prices around the world have so far failed to drive any material increase in supply. Rising costs have squeezed farm margins, while challenging weather conditions across the globe have been a significant hindrance for production growth this season. In Australia, above-average rain during spring affected milk yields, while hot and dry weather in January 2022 further weighed on production.

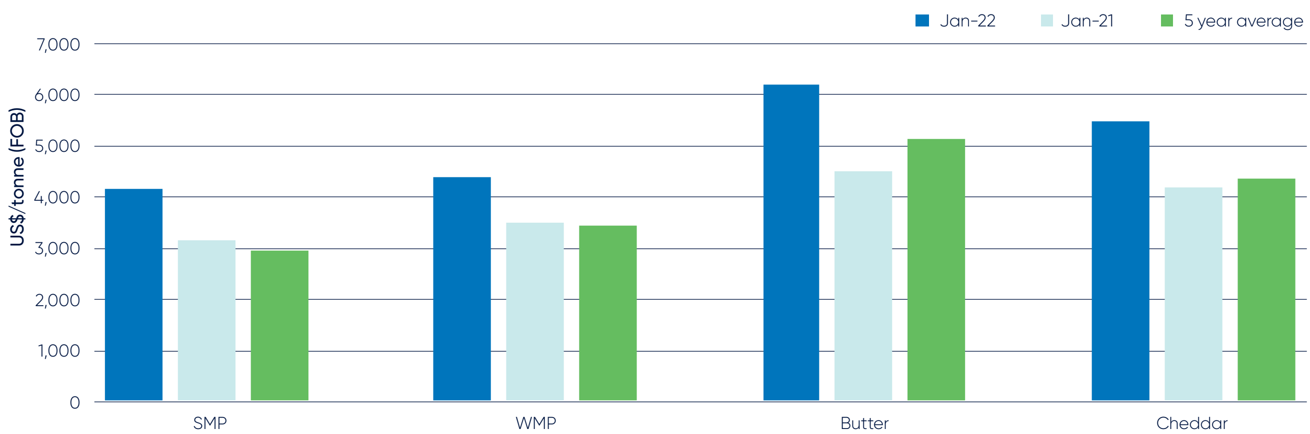
A similar scenario has played out in NZ, where challenging weather conditions have seen milk production fall for six months in a row.

In the northern hemisphere, drier conditions have weighed on feed and milk production, while surging input and energy costs shrink farm margins. The size of the US dairy herd has fallen sharply, which, combined with adjusted rations, has influenced production prospects. Dairy herds across Europe are also in decline, as rising input costs put pressure on margins.

Given these constraints and the timeframes required to reverse them, it appears milk flows are unlikely to pick up any time soon.

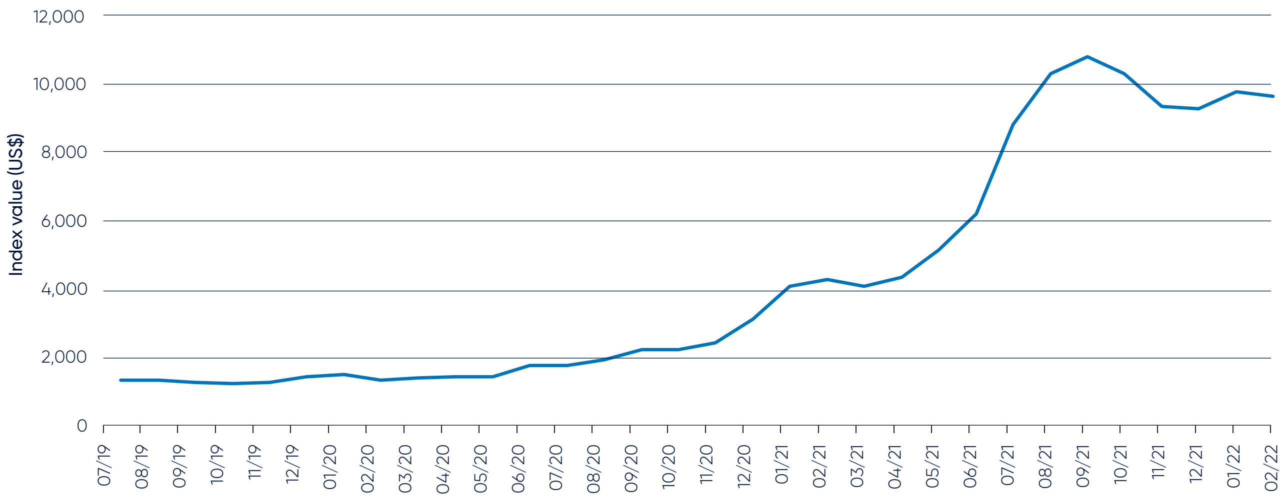
Meanwhile, demand for dairy remains robust. In the 12 months to November 2021, total global exports increased by 6.5%, while imports by Greater China (Mainland China, Hong Kong and Macau) rose by 21%. While China is a key driver for dairy commodity values, strong demand from other markets, such as Southeast Asia, has created a solid foundation for prices. Many buyers who have waited for a market correction now seem to have accepted higher prices, and the resulting flurry of activity to secure supply has only pushed values higher.

Figure 1 Key commodity price indicators



Source: Dairy Australia

Figure 2 Global container freight rate index



Source: Freightos

Logistical challenges are also fuelling elevated commodity prices. Shipping congestion, staffing issues and the lack of available containers continue to make moving and handling products more difficult and costly. Escalating tensions between Russia and Ukraine have also spurred on purchasing activity, as the threat of new disruptions looms. A heightened need to ensure supply chain security has resulted in some buyers shifting between suppliers, willing to pay a premium for guaranteed delivery. This has further supported dairy commodity values, with all major products trading at levels above the five-year average.

Despite supportive market fundamentals, there are some headwinds that could affect the current price trajectory. Demand destruction in price-sensitive markets such as the Middle East and North Africa (MENA) region is an early counterbalance, as affordability declines. In the 12 months to November 2021, global dairy exports to this region fell by 11.5%. Europe is a significant exporter to MENA, but limited product availability and supply chain issues saw exports to the region drop by 13% over the same period. The US managed to pick up the slack, with its exports to MENA surging by 37%, despite milk flow slowdown.

For now, Greater China seems to be well-positioned to continue importing milk, as an appreciating yuan has helped soften the blow of higher commodity values. Nevertheless, there have been reports of China's domestic milk production growing rapidly, reaching record levels in 2021. While this is yet to affect China's position as the world's largest dairy importer, further developments in local milk production could dampen dairy demand in future and encourage prices to descend.

The cyclical nature of the market dictates that, eventually, prices will start to come down. The key to not getting burned is to keep an eye on whether this will be a smooth descent or a rapid spiral. The last time commodity prices reached similar levels, in 2014, the severity of the subsequent market downturn took many by surprise. With global production looking set to remain tight for some time, and supply chain pressures being far from over, a supply-side shock looks less likely this time around. Similarly, while tensions between Russia and Ukraine continue to escalate, and Chinese milk production picks up, broad and ongoing strong demand helps mitigate the impact of a sharp demand-side disruption. Overall, dairy commodity prices look comfortable cruising at altitude for now.

SO WHAT?

In light of decreasing production, competition for milk remains strong among Australian processors. This has seen several farmgate milk price step ups in southern export-focused regions this summer as commodity prices have continued to rise. Due to limited supply, many processors have already sold out for the season and are therefore unable to fully capitalise on attractive values. Nonetheless, as we look ahead, continued market strength is a welcome sign – especially over the next few months, when new season budgets are prepared and opening prices are worked through.

INFLATION RISING

SHOULD WE BE WORRIED?

"I tell you that inflation is the biggest destroyer of all – of industry, of jobs, of savings and of society." So thundered British Prime Minister Margaret Thatcher in 1980.

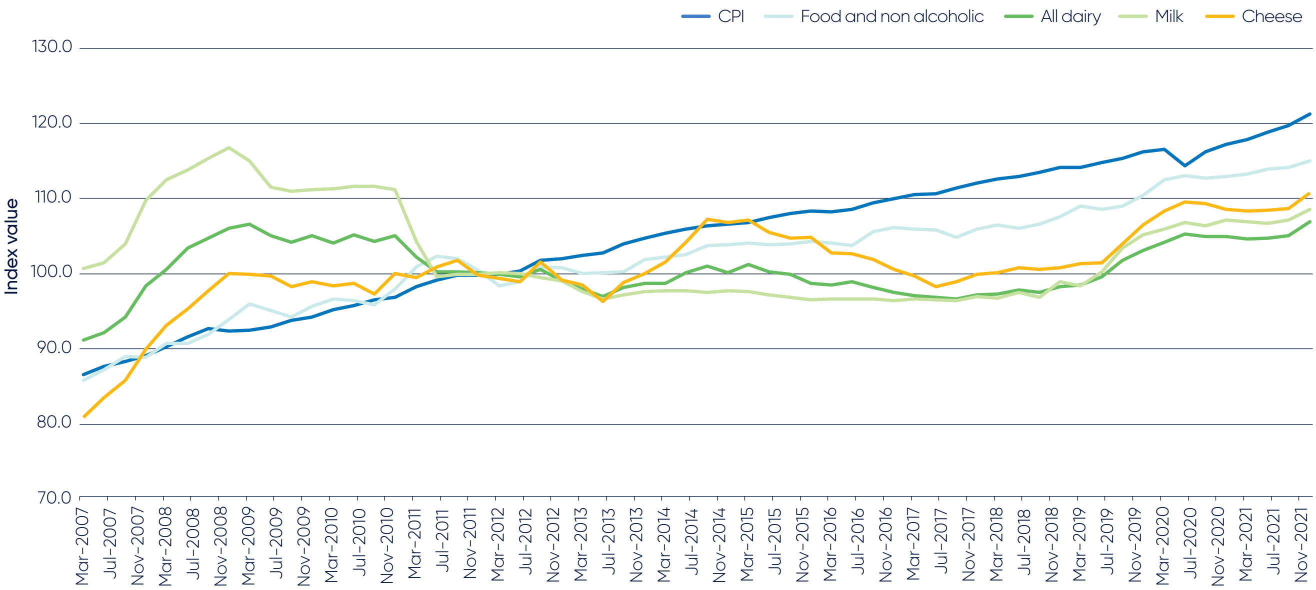
This quote, and others like it, are starting to reappear in opinion pieces across Europe and the US, where inflation is rapidly regaining prominence. The beginnings of an awakening are also forming in Australia as, after several decades, inflation is becoming a widespread concern again.

Logistics providers are already acutely aware of inflationary pressures, with Adblue prices abruptly quadrupling in late 2021. Dairy manufacturers and exporters have seen container rates skyrocket, along with port charges and all manner of ancillaries. Farmers are all too conscious of surging fertiliser and diesel prices, adding to the ongoing challenge finding and housing workers. All across the commercial world, costs are going up, thanks to a combination of pandemic-related disruption, geopolitical tensions and a messy energy transition. None of this looks likely to change any time soon.

In the near future, this means margins will get squeezed, right along the supply chain. Strong dairy commodity values thanks to a tight global milk balance, and firm farmgate prices due to supply constraints in Australia, have cushioned milk processors and farmers, respectively. However, the incentive to invest and take risks is somewhat less than headlines proclaiming 'record prices' might suggest. In turn, as higher prices at the commercial level are inevitably passed on to consumers, spending is likely to be reined in.

For dairy, this could see consumers turning to cheaper products, rather than buying less overall. This could possibly include purchasing fewer convenience or discretionary items, buying larger pack sizes and favouring private label offerings. Even if volumes are not as severely affected, lower average unit prices constrain value generation within the supply chain, which restricts the opportunity for pass-through to farmers via milk prices.

Figure 3 Selected ABS indices – quarterly



Source: ABS

Those who have been through this cycle before will remember that inflation leads to rising interest rates – effectively, the 'bucket of water' used by the Reserve Bank of Australia (RBA) to take the heat out of the economy. Although rates are coming off historic lows, for those carrying significant debt, this can lead to a new round of pain. RBA Governor Phillip Lowe recently described rate rises this year as 'plausible', while financial markets have priced in around 1.15% in hikes by the end of the year. Fortunately, although milk production has not shown significant growth since the dairy downturn five years ago, successive seasons of improved returns have allowed many farmers to reduce debt – and hence exposure to interest rate movements.

If something approaching Mrs Thatcher's appraisal of inflation is borne out in 2022 and beyond, the broader economy could be in for a challenging time. Australia's dairy industry is closely linked to the rise and fall of consumer fortunes, both locally and in key export markets, and it will not be immune to pressure. However, the combination of recovering profitability, rising asset values, limited impact from COVID-19 and the risk aversion of recent years means farmers are entering this period in better financial shape than many businesses and, indeed, households.

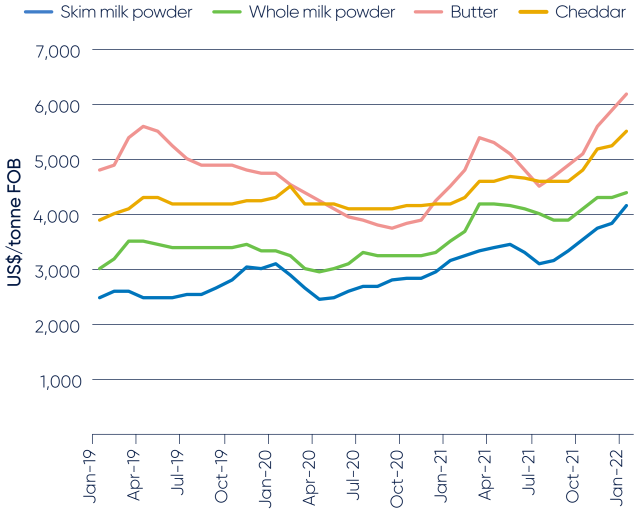
SO WHAT?

Dairy markets look strong, and milk prices are expected to remain high in the short term. However, costs are rising all along the supply chain. These increases are beginning to break out of the commercial sector, and broader inflation is likely to hit the headlines this year. Margins are projected to tighten as a result of higher production costs and, ultimately, affect consumer spending. In addition, interest rates will almost certainly rise. The good news is that, with the improved profitability of the past few years, many farmers will face rising inflation in a stronger financial position. Approaching this period with caution will set businesses up for success in navigating the turbulence.

MARKET DASHBOARD

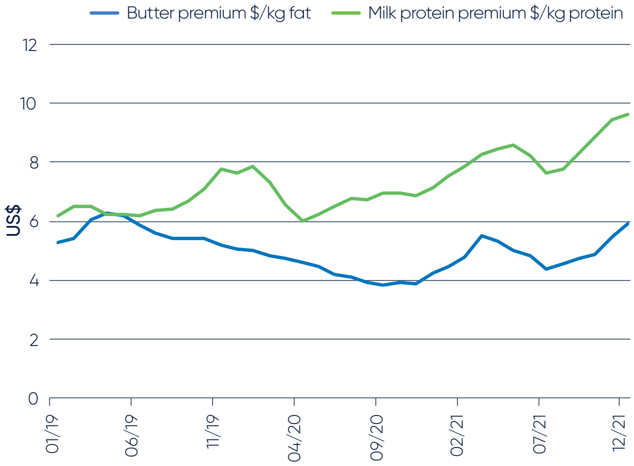
Commodity prices

Figure A1 Key dairy commodity price indicators



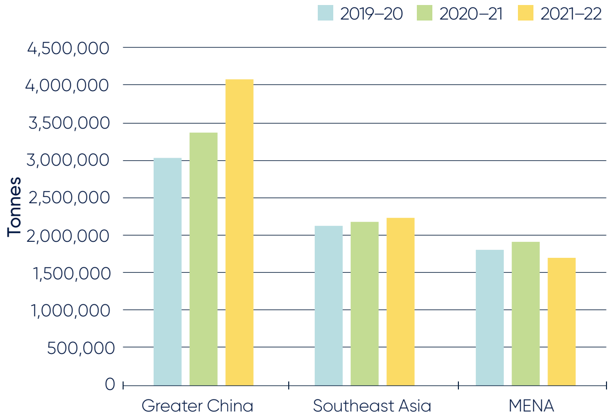
Source: Dairy Australia.

Figure A2 Dairy fat and protein – pricing relative to substitutes



Source: Dairy Australia, Oil World.

Figure A4 Exports to key markets



Source: Dairy Australia, TDM. Data represents 12-months to November 2021.

Australian market

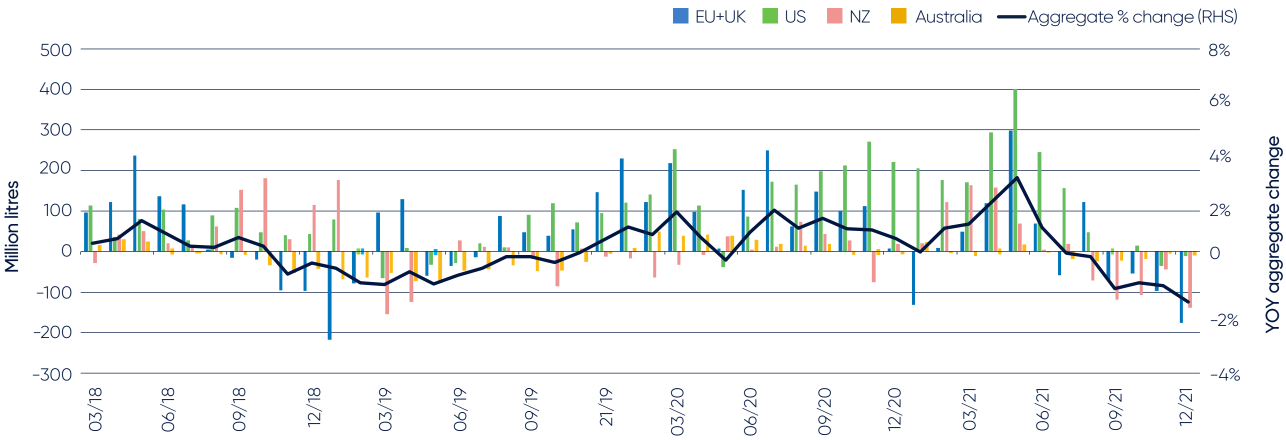
Figure A5 Australian retail sales

	Take home volume	YoY growth	Take home value $m	YoY growth
Milk *As of 30/01/22*	1,542m. L	↓ -2.4%	2,644	↓ -0.7%
Cheese *As of 02/01/22*	187kt	↓ -1.4%	2,450	↑ 0.9%
Yellow spreads *As of 30/01/22*	92.9kt	↓ -5.8%	830	↓ -4.0%
Yoghurts *As of 02/01/22*	180kt	↑ 0.9%	1,192	↑ 1.4%

Source: Dairy Australia calculation based in part on data reported by NielsenIQ through its Homescan Service for the total milk, cheese, yellowspreads, and yoghurt categories to 30 Jan 2022 and 02 Jan 2022, for the Total Australia market, according to the NielsenIQ standard hierarchy. Copyright © 2022, Nielsen Consumer LLC.

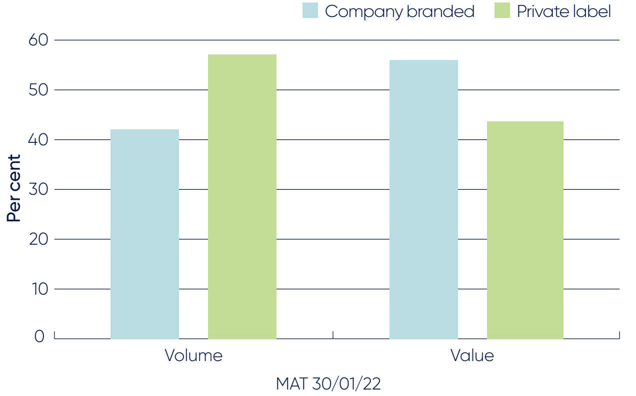
Global supply and demand

Figure A3 Milk production year-on-year changes



Source: AHDB, Dairy Australia, DCANZ, Eurostat, USDA.

Figure A6 Retail sales – private label share



Source: Dairy Australia calculation based in part on data reported by NielsenIQ through its Homescan Service for the total milk category to 30 Jan 2022, for theTotal Australia market, according to the NielsenIQ standard hierarchy. Copyright © 2022, Nielsen Consumer LLC.

Inputs

Hay and grain

Australian dairy regions	Shedded cereal hay		%	Stockfeed wheat		%
1 Atherton Tablelands*	$290	↓	-8	$400	↑	+15
2 Darling Downs	$260	↓	-16	$299	↓	-2
3 North coast NSW	$230	↓	-16	$280	↑	+2
4 Central west NSW	$200	↓	-17	$283	↑	+13
5 Bega Valley	$285	↓	-12	$352	↑	+23
6 Goulburn/Murray Valley	$190	↓	-7	$356	↑	+24
7 Gippsland*	$100	↓	-18	$379	↑	+25
8 South-west Victoria	$200	→	0	$355	↑	+18
9 South-east SA	$210	↓	-11	$347	↑	+18
10 Central districts SA	$206	↓	-8	$345	↑	+17
11 South-west WA	$275	↓	-13	$323	↓	-2
12 North-west Tasmania	$246	↓	-2	$469	↑	+19

Shedded cereal hay: mid-range product without weather damage, of good quality and colour

The relevant stockfeed wheat available in a region (ASW, AGP, SFW1 or FED1)

Prices are estimates in $/tonne at January 2022. Compared to equivalent date January 2021.

* Note that all regions other than Atherton Tablelands and Gippsland is cereal hay.
* Atherton Tablelands and Gippsland is pasture hay.

Source: Australian Fodder Industry Association (AFIA), Profarmer.

Fertiliser

Urea (granular Black Sea)	DAP (US Gulf)	MOP (granular Vancouver)
846 US$/t	699 US$/t	221 US$/t
↑ +219% LY	↑ +66% LY	↑ +9% LY
↑ +134% 5Y	↑ +64% 5Y	↑ +1% 5Y

Price is January 2022 average, compared to the January 2021 average (LY) and 5-year (5Y) January average.

Source: World Bank.

Cows

Cull cows

590 c/kg	69,161 head
↑ +6% LY	↑ +12% LY
↑ +25% 4Y	↑ +22% 4Y

Dairy cattle exports

88,139 head	↑ +10% LY
	↑ +12% 5Y

Price is January 2022 average, compared to January 2021 (LY) and 4-year (4Y) average. Number of head is last 12 months (cull cows to January 2022, dairy cattle exports to December 2021) compared to year earlier (LY), 4-year (4Y) average and 5-year (5Y) average.

Source: NLRS, ABS.

Water

Northern Victoria	Murray Irrigation System
86 $/ML	39 $/ML
↓ -41% LY	↓ -70% LY
↓ -66% 5Y	↓ -75% 5Y
2,515,723 ML	204,427 ML
↑ +13% LY	↑ +251% LY
↑ +10% 5Y	↑ +185% 5Y
Monthly average(12 months)	
98 $/ML	76 $/ML
209,644	17,036

Price of water traded is January 2022 average compared to January last year (LY) and 5-year (5Y) average. Volume of water is 12 month total, to January 2022, and compared to same period last year (LY) and last 5 year (5Y) average. Monthly average is the average price and volume over the past 12 months to January. Northern Victoria prices are averaged from three key trade zones, details can be found in the monthly Production Inputs Monitor report: **dairyaustralia.com.au/industry-statistics/industry-reports/production-inputs-monitor**

Source: Victorian Water Register, Murray Irrigation Ltd.

For ongoing information and updates on farm inputs, readers can subscribe to Dairy Australia's weekly Hay and Grain Reports, or the monthly Production Inputs Monitor, found on the Dairy Australia website **dairyaustralia.com.au/industry-statistics/industry-reports/production-inputs-monitor**

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