



DAIRY ECONOMIC CONSULTING FIRM
WWW.CLAL.IT

EU Dairy Markets, Situation and Outlook

May - August 2012

by Erhard Richarts, Dairy Market Consultant, Chairman of IFE (Institut für Ernährungswirtschaft e. V., Kiel)

Special report produced for CLAL

Highlights:

- Prices on dairy market are under pressure from strong milk supplies, but might recover slightly over the next months.
- EU milk supplies will go down seasonally until November. So far the expected slowing down of expansion has not appeared yet, but is more likely now.
- Most of all additional milk supplies in the EU will be used for more cheese, but also the output of butter and skim milk powder will grow.
- Also outside the EU milk production is growing at record speed, and world milk production has temporarily outpaced demand.
- 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.
- EU exports are in good competitive situation with the expected weakness of the Euro.
- Prices of the major commodities in the EU will be very close to the international levels, for the next half year also those of butter and other products containing milk fat.
- Demand for exports is likely to clear the European market from temporary surpluses of skim milk powder and cheese.
- Also butter and whole milk powder export opportunities could improve as result of lower domestic prices and favorable currency rates.

Will expansion of milk production be reduced?

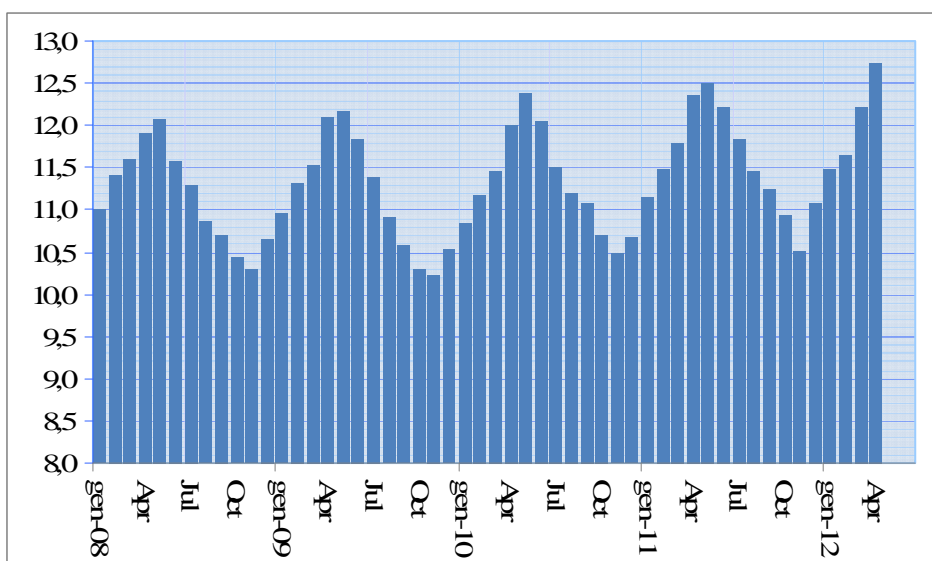
By the mid of May 2012, milk production of the EU-27 is over the usual seasonal peak and has started to go down until November. So far, statistical figures are just available until March and for some countries also until April and the early weeks of May. All these figures do not yet confirm the expectation of a slower growth of milk supplies.

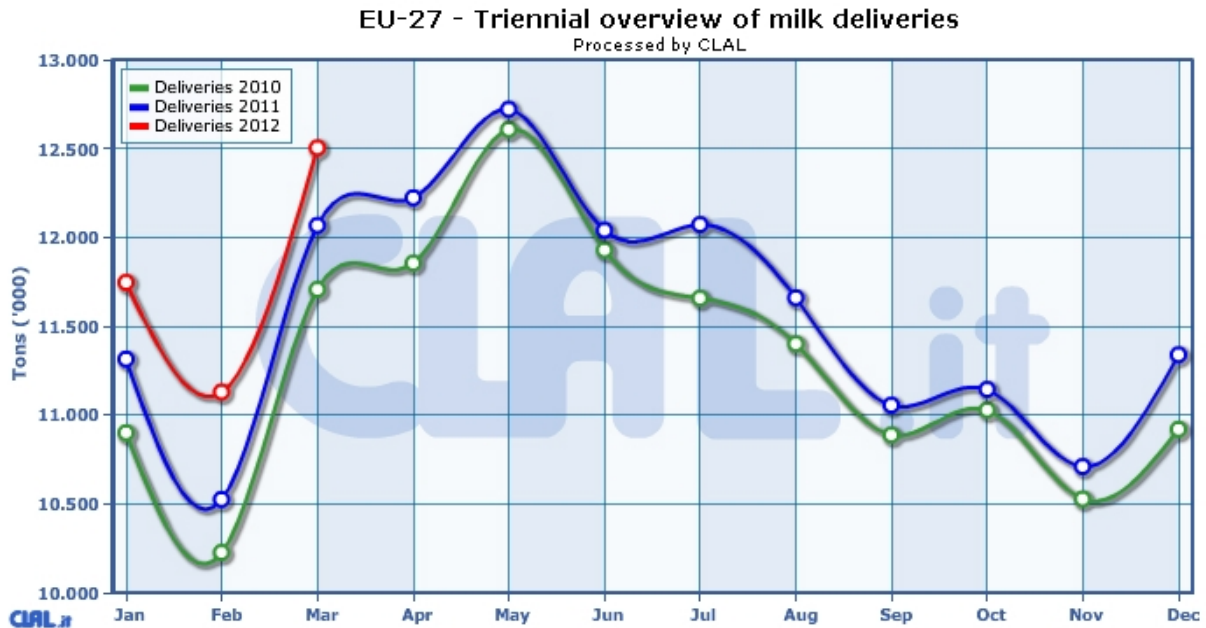
The first estimate for April is still showing an expansion rate of 2,7% vs. the year before after 2,9% in March and 2,4% over the first trimester, in which the reduced rate of 1,3% in February was the result of extreme winter weather. Other than in some years ago there were only poor reactions of dairy farmers towards the end of the quota year 2011/12 on warnings about the thread of super-levy charges on milk supplies which exceeded the quotas.

But the spot milk market has become firmer in the recent weeks, which is a first indication of the seasonal downswing and a possible reduction of expansion rates. Whether it is also a first indication of reduced growth remains to be seen. Possible reasons for a reduced growth in the next months are:

- Increasing costs of milk production in general and in particular also as result of unfavorable feed supplies in the summer and poor prospects for feed crops.
- Reduced milk prices paid to the farmers.

EU-27 Milk Deliveries, adjusted for average length of months, mio. Tons





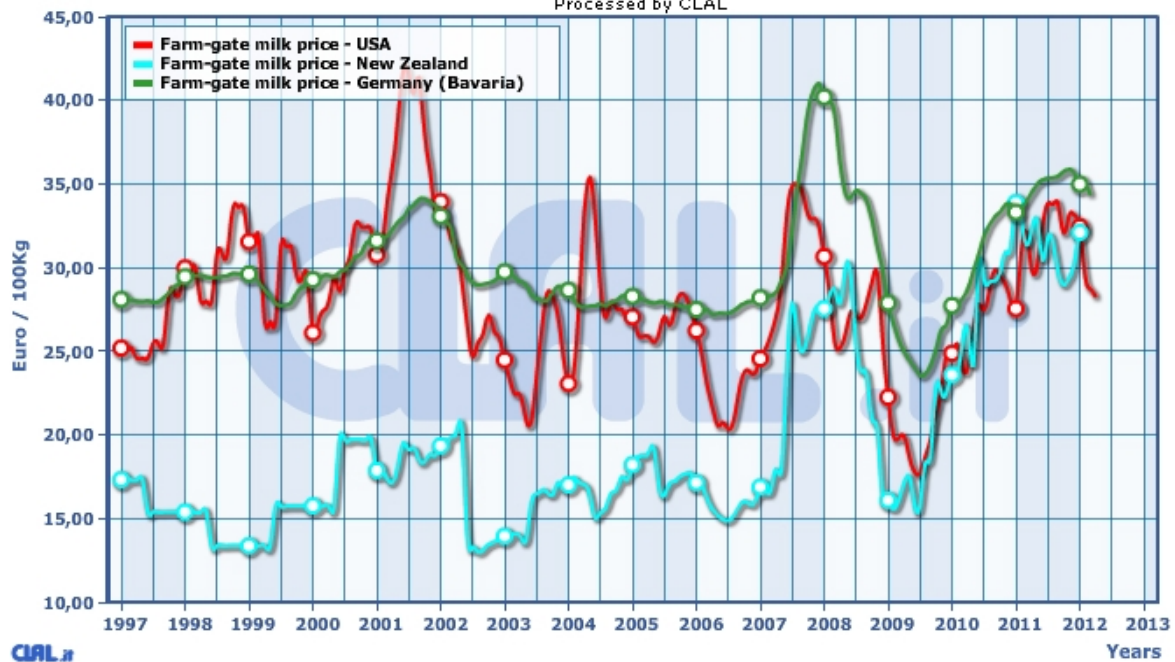
In many European areas the winter and spring weather was characterized by poor rainfalls. Very low temperatures in February had damaged some of the winter grain and rapeseed field. Cold spring weather has negative effects on the seeds for corn silage.

But if crop growth conditions turn to normal, all this might not have longer lasting negative effects. Also no negative effects can be seen yet from reduced cow numbers, after increased culling rates in 2011. Obviously the better selection survived.

With a certain time lag the prices for milk ex farm gate followed the reduced returns in the markets of dairy commodities, also because the prices of liquid products and cheeses have come under pressure. Therefore milk prices below the levels of 2011 can be expected for the rest of the year. With increasing input costs the incentives to expand milk production further are reduced.

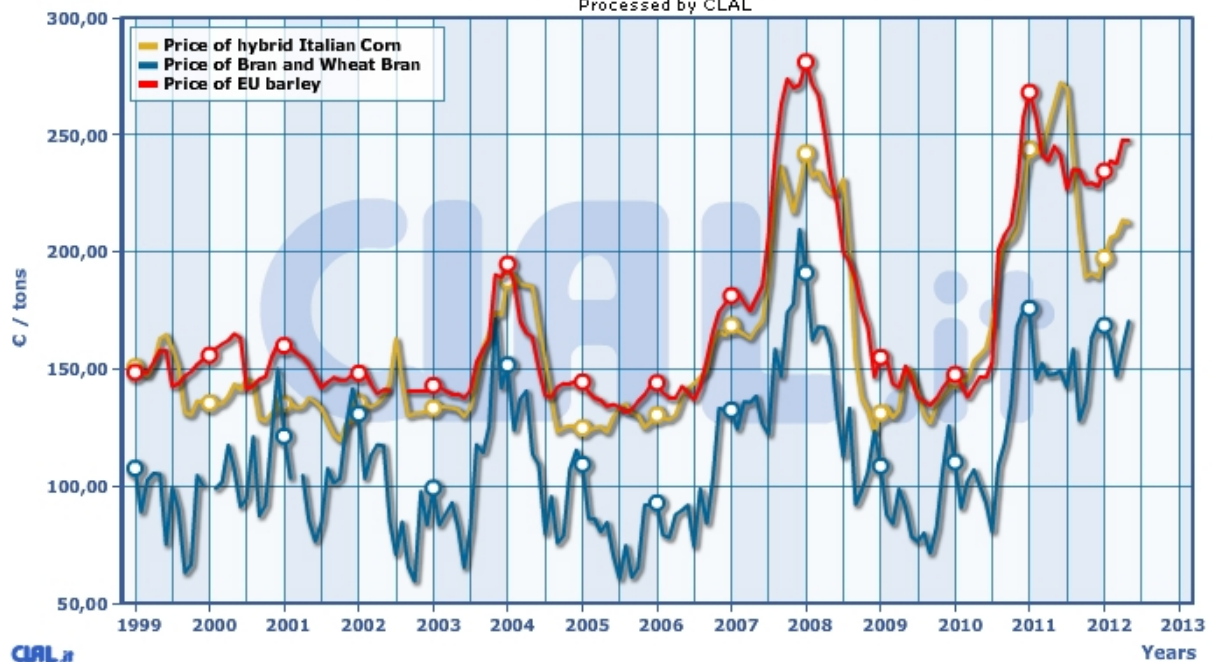
Historical comparative overview on Farm-gate Milk prices in Bavaria (D), the US, New Zealand

Processed by CLAL



Italy, Milan - Comparative historical overview of prices of food for livestock - Cereals and by-products

Processed by CLAL



But after March 31, the quota year's deadline, new space for expansion is given by the next increase of national quotas by 1% (based on 2008/09 quotas, except for Italy). Therefore an increase of milk supplies of more than 2 mio. tons over the whole year is possible and likely, since half of that has already happened in the first trimester.

A similar evolution on the World level could be observed: Milk supplies continued their growth without slowing down, according to recent statistics which are available so far, and against several experts' assessments which were published some months ago.

Prices at the bottom

As already mentioned, the downward movement of the prices of the key commodities butter and skim milk powder has influenced also the evolution of liquid milk product and cheese prices and have finally also curbed down the milk prices which are paid to the farmers.

But it is different to the situation of 2008, because now the main reason was the pressure of growing supplies, whereas in 2008 the main driving force was reduced demand resulting from both high prices and the economic crisis.

Now in 2012, the financial crisis in the Euro-area has no negative effects on the worldwide demand and limited effects on demand within the EU, mainly in the Southern member countries. To some extent so far the demand had reacted in a negative way to the increases of the consumer prices for dairy. It remains to be seen what will be the impact of the now reduced prices. On the short hand it was reported that demand for butter and liquid products has recovered after the recent price cuts for butter and liquid products.

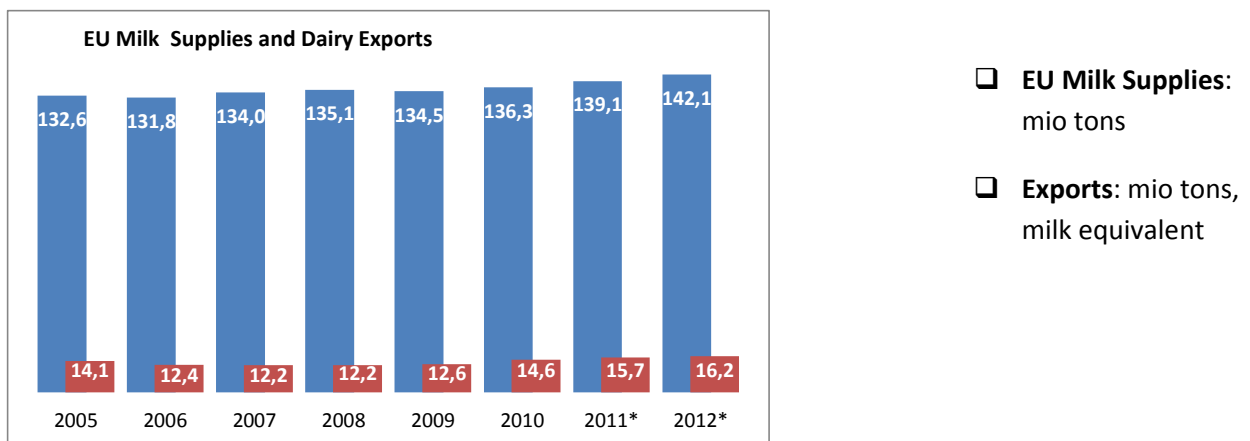
Another reaction is the end of the downward movement of prices by the mid of May, 2012 in the EU, when milk production is still strong but over the seasonal peak. It became visible first in the spot milk market prices and the prices for skim concentrates and bulk cream, which have recovered a bit. That it happened just at that time, has not only to do with the temporary weakness of the Euro, because it did not re-direct immediately strong demand to supplies from the Euro area.

On the world market, the reaction to the weaker Euro rate were lower auction prices at the Global Dairy Trade auctions in May.

But the ongoing demand for exports is also an indication that there is a market for more dairy products within the EU and beyond. This is well demonstrated by the figures on production and exports.

Exports to countries outside the EU are still growing in strong rates, but higher additional milk volumes are absorbed by the domestic European market (though not everywhere): that is the difference to the year 2010, when exports absorbed almost all additional milk volumes of the EU.

One problem, however, is that EU exports not balanced between fat and protein products: More protein products, notably skim milk powder, cheese, whey products and casein have been exported in the first trimester of 2012, but less butter, butter concentrates (AMF) and whole milk powder. The quantities of fat which are exported do not correspond to the protein quantities in a relation which is similar to that in the milk deliveries to dairies.



*)Provisional/ Forecast Source: ife

The Food Outlook which has been published recently by the FAO expects a still ongoing downward trend of dairy commodity prices on the international market. This bearish situation is mainly due to the expectation of an increase of the worldwide milk production by 20 million or 2.7% to 750 million tons in 2012.

Although even in this forecast the increases for both the U.S. and the EU seem to be underestimated, the present development of market prices gives indications to be less pessimistic, because demand has shown elasticity with respect to falling prices.

On the other hand, this elasticity is limiting the possibility of a strong price recovery just in the time of still growing supplies. Anyway, it was only a question of time that the often mentioned volatility has led to falling prices, and it seems that butterfat products are much more affected than dairy protein products.

Market return from butter and skim milk powder and milk price in Germany



More milk for cheese, skim milk powder and butter

The demand of private households for liquid milk products in the EU has been reduced in several member countries of the EU, but the total volumes of milk sold in liquid form are almost unchanged when compared to the year before.

The major part of additional milk supplies has been used to produce more cheese, around 3% in the first three months. Higher are the growth rates of butter and SMP production, but not the absolute volumes of additional milk which have been used for these products. Cheese production followed the greater demand mainly from domestic and a little also from foreign markets, and this will continue in the next months.

However, if exports to Russia are not taken into account, cheese exports to other destinations are rising.

In the European domestic market, demand of private households for cheese is stagnating, but is growing in the other market segments. Again more cheese has been exported in the first trimester of 2012, and more exports are expected for the rest of the year.

Butter market under pressure

As result of increased milk supplies also more butter has been produced. Thus the increase of production, which had started in 2010 after many years of decline will continue, although prices are no more as attractive as last year.

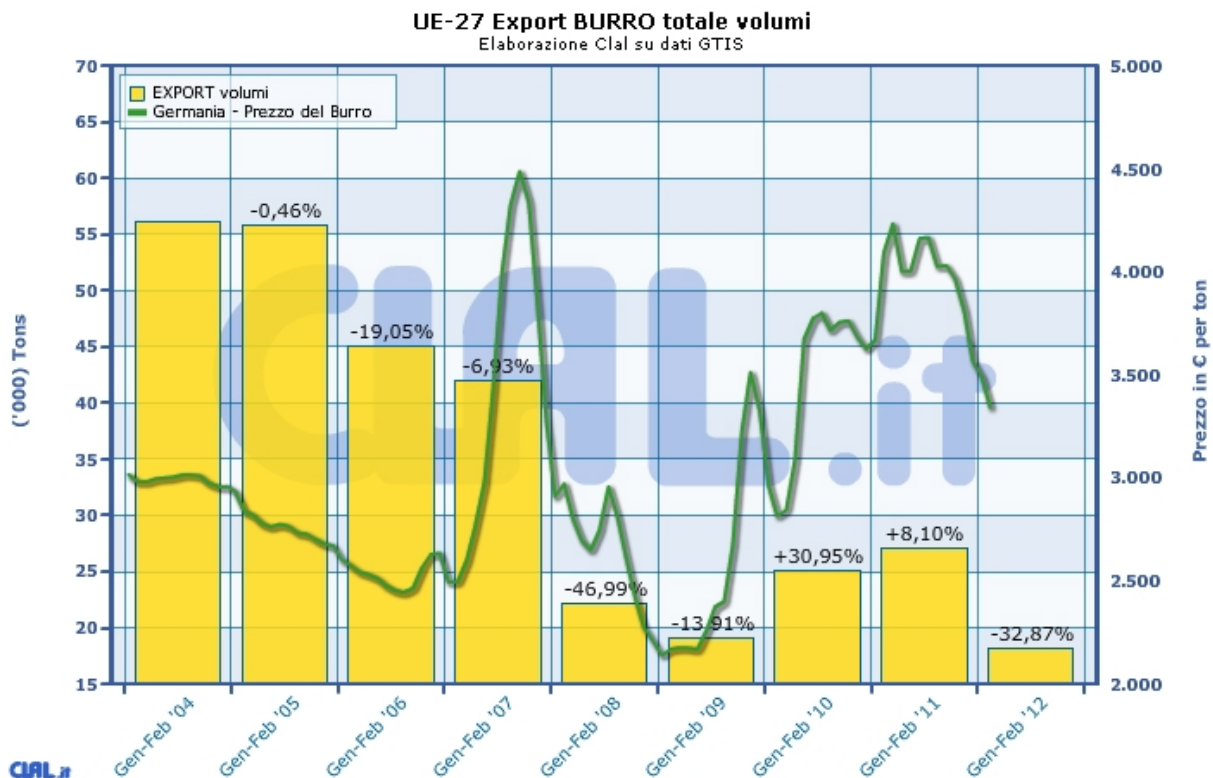
Therefore butter production is back to the function which it had over decades: It is not driven by the market demand, but by the necessity to transform milk fat supplies which cannot be used elsewhere, since the other dairy market segments, notably the liquid markets, cheese and whole milk powder do not absorb milk fat in sufficient volumes.

Butter is the product which can be stored over longer times and transported to remote destinations; or to speak in market theory terms to balance the market over time and distance. Private storing of butter is balancing the butter market between the surplus period in spring to the deficit period in autumn and early winter.

In this year, the volumes of butter entered into private storages with the support of the EU aid scheme are significantly higher than in the years before. So temporary surpluses are absorbed, and butter storing has become attractive by the low market prices.

The low level of bulk butter has also brought down the prices of packaged butter. According to market reports, for both the demand has benefitted from low prices and somewhat increased after the long period of high prices since the spring of 2010. Butter prices will be back to a normal seasonal price evolution with the lower levels in spring and higher levels later in the year. But despite the recent firming up of bulk cream prices the space for higher market prices will be limited because of the increased volumes of butter in private storages and the prospect of a potentially bigger carry-over stock at the end of 2012.

Much also depends on the demand from markets outside the EU. So far the exports to third countries were low, because EU butter was more expensive than that from Oceania and other countries of origin.

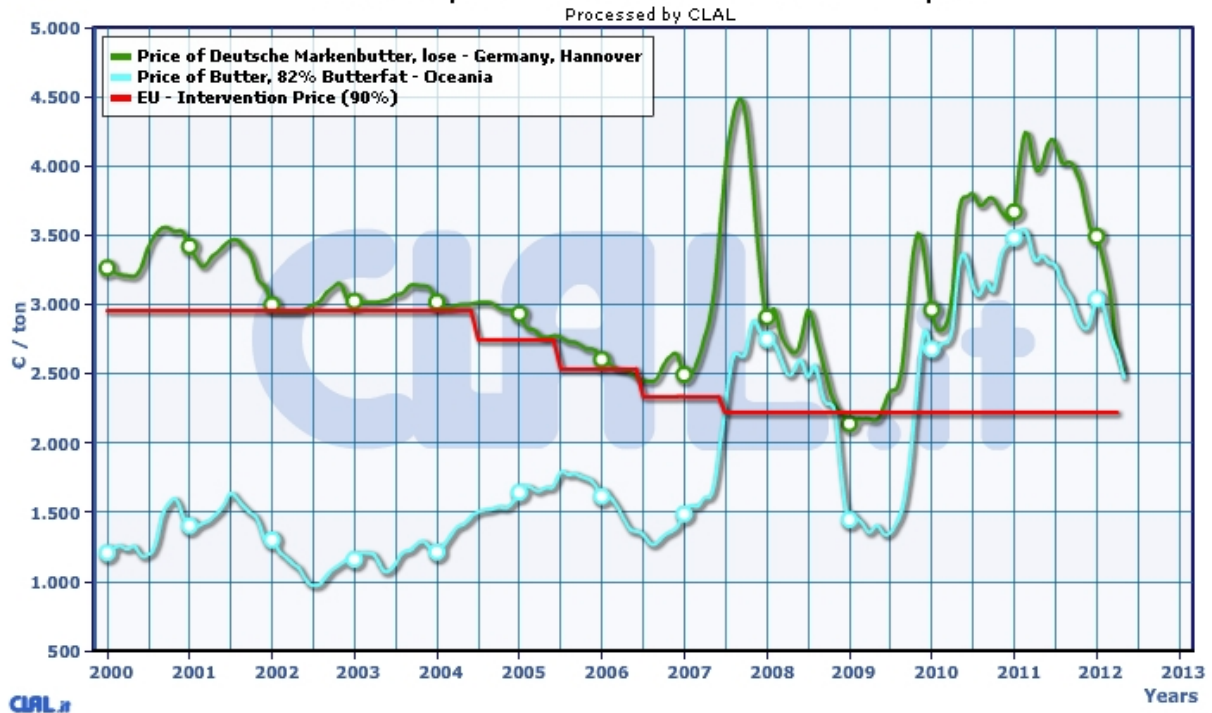


With the recent weakness of the Euro vs. the US-Dollar the situation has changed. The price difference is very small now, and anyway the seaway freight rates for European products to the Middle and Far East are lower than those between Oceania and the respective destinations.

On the other hand, imports of bulk butter from New Zealand within the special tariff quota are now no more attractive since the price differential is lower than the special tariff of 700EUR/ton. With almost 34.000 metric tons imports in the period January through March had been very strong and not far from half of that quota, but it is unlikely that this go on.

Consequently for the EU a relative stable price evolution, though at low levels or only a modest firming up can be expected from mid May until November at least. On the world market it will depend on the Euro/US-Dollar rate, whether prices can stabilize or stay under pressure from competitive European supplies, which also might lead to a certain recovery of butter and AMF exports.

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



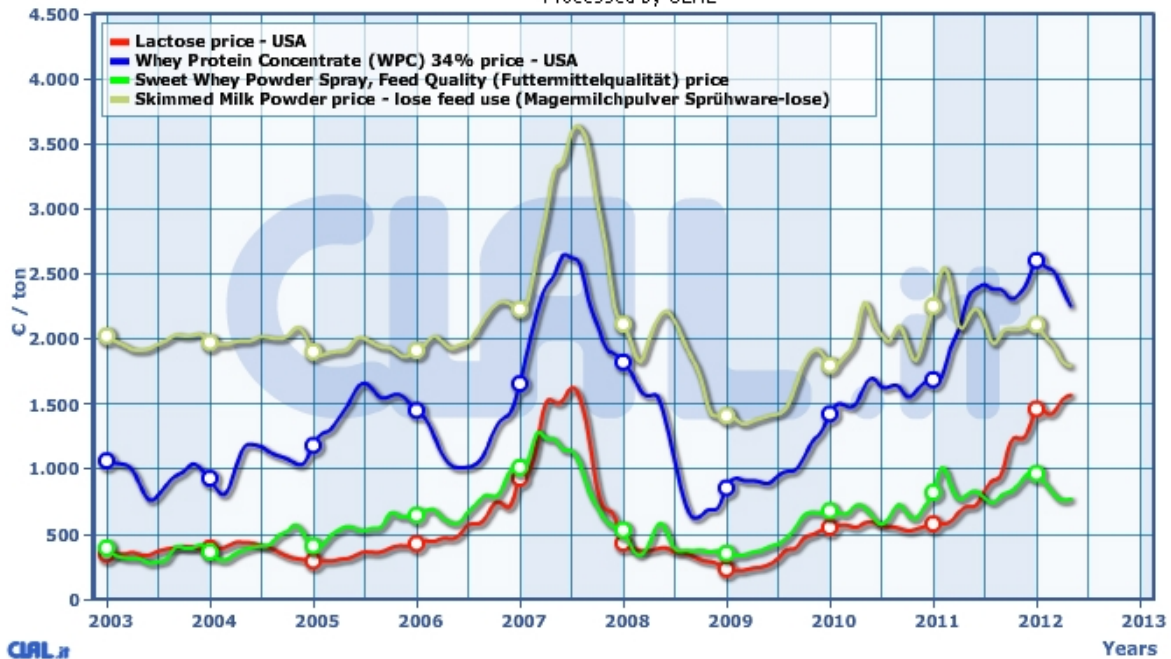
Strong demand for skim, weaker demand for whole milk powder

Less dramatic than in the butter sector is the decline of milk powder prices since the end of 2011. The production of SMP has been increased because more skim milk was available, but also because SMP can be well placed in the markets within and outside the EU. Anyway demand has taken advantage from the lower prices.

To this adds the situation of competing dairy products, notably whey powder and whey derivatives including lactose as well, where prices are very strong in relation to skim milk powder. One major application is the incorporation into milk replacers for calves. The protein in skim milk powder is now less expensive than the protein in whey products, therefore the skim milk powder content in the milk replacers will be increased again, which is against the long term trend observed since 1990.

Comparative historical overview between WPC and Lactose prices in USA with Sweet Whey Powder Spray and SMP Feed Quality price in Germany

Processed by CLAL



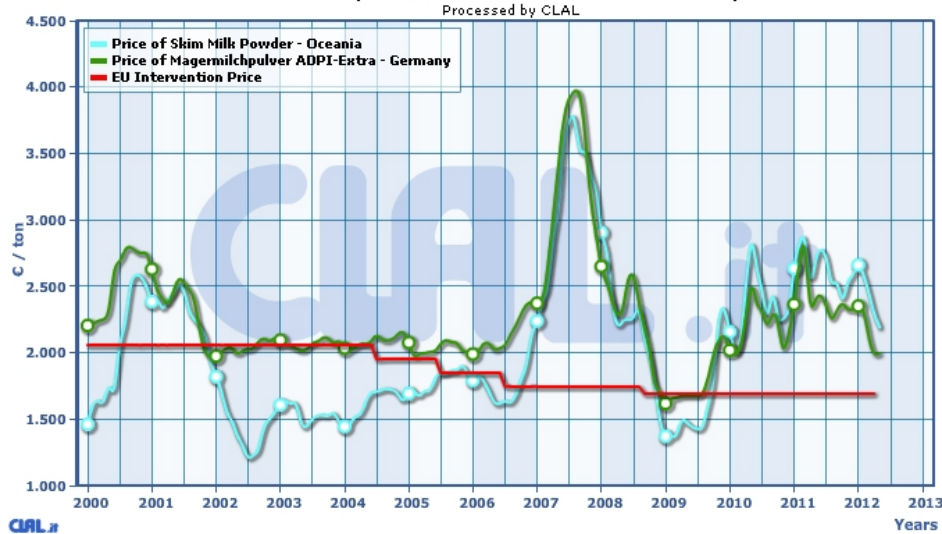
Moreover, the protein in skim milk powder fits better into the dietary requirements of the calves stomach. In other applications it might be now the sheer price advantage which determines the preference for skim milk products.

One of the reasons for the high whey prices is the strong demand for whey products from emerging markets and for permeates generated by the milk protein concentrate production via membrane technologies and for lactose which are needed for the down standardization of protein in skim milk powder to 34%.

The stronger competitiveness of skim milk powder is a worldwide phenomenon with the exception of these markets where the specific features of whey derivatives are required, in particular in the infant formula sector and the market for piglet starters in East Asia, which both are booming sectors.

Under these conditions the demand also from export markets will continue to be strong, in particular also as EU domestic prices in spring 2012 were lower than the Oceania export prices. Also a certain recovery of skim milk powder prices is likely, when the spring milk flush in the EU and other areas of the Northern hemisphere is over and Oceania is at its seasonal lowest point in May and June.

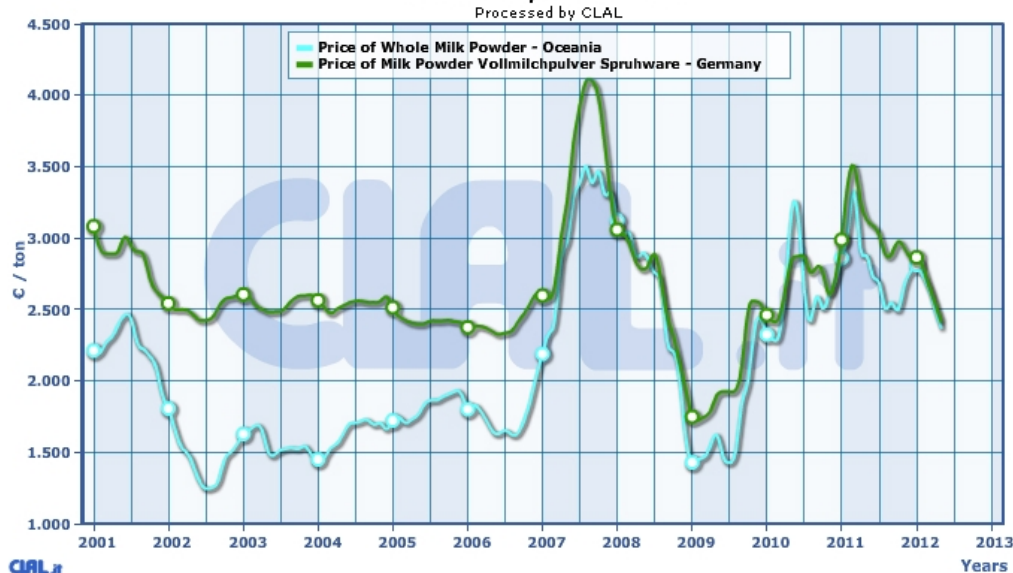
Comparative historical overview between SMP market prices in Germany and Oceania and EU intervention price



Quite different is the situation of the whole milk powder market. Whole milk powder is the product within the dairy range with the highest share of international trade and to a large extent required from markets with strong purchasing power, i. e. in the Middle East. Here the demand from international markets is also characterized by strong growth. But in recent years the EU did not participate in this growth by higher exports, because EU-origins were less competitive.

The value of the fat part of whole milk powder is largely linked with the butter prices, which often are above the world market level. This also might change now as the European butter market prices are now well and are expected to stay in line with the world market level over the next half year. At present, demand from outside the EU has not yet improved, but this might be just a question of time.

Comparative historical overview between WMP prices in Germany and Oceania



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	142.100
Liquid Products	45.818	45.577	45.200	45.791	46.400	47.000
Butter						
Production	2.110	2.100	2.050	2.010	2.100	2.180
Consumption	1.994	1.968	1.984	1.970	1.992	2.085
Cheese						
Production	9.248	9.339	9.333	9.480	9.540	9.660
Consumption	8.728	8.853	8.841	8.917	8.932	9.040
Skim Milk Powder						
Production	1.090	1.040	1.160	1.080	1.210	1.350
Consumption	870	775	800	800	810	820
Whole Milk Powder						
Production	773	835	735	755	710	680
Population m. head	496	498	500	502	503	503

*) Provisional. **) Forecast. Updated May 2012

Source: ife, Kiel; ZMB, Berlin.

Table 2
EU Butter Balance Sheet

1.000 t	2007	2008	2009	2010	2011*	2012*
Total production	2.110	2.100	2.050	2.010	2.100	2.180
Imports	85	65	62	40	43	65
Exports	211	147	150	155	121	100
Final stocks	100	150	135	60	90	150
- in intervention	0	0	80	2	0	0
Consumption	1.994	1.968	1.984	1.970	1.992	2.085

*) Estimated. ife May 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	9.290	9.400
Imports	94	89	84	83	74	90
Processed cheese impact	265	255	250	260	250	260
Exports	594	555	576	676	682	690
Stock change	+20	+10	+0	-30	+0	20
Consumption	8.728	8.853	8.841	8.917	8.932	9.040
-per capita (kg)	17,6	17,8	17,7	17,8	18,0	18,0

*) Estimated.

ife May 2012

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

Table 4

EU SMP Balance Sheet

1.000 t	2007	2008	2009	2010	2011*	2012*
Production	1.090	1.040	1.160	1.080	1.210	1.350
Imports	10	8	6	4	0	2
Consumption	870	775	800	800	810	820
- as Feed	245	150	160	165	190	190
Exports	201	179	230	378	518	600
Ending stocks	124	217	353	259	142	74
- in intervention	-	-	260	190	50	0

*) Estimated.

ife May 2012

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

Table 5

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

*) Estimated.

ife May 2012

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