FCC Ag Economics

2018 Outlook for the Canadian dairy sector

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FCC Ag Economics helps you make sense of the top economic trends likely to affect your operation in 2018. In this outlook for the Canadian dairy sector, we look at:

- The modest recovery of international dairy prices
- Interest rates and the loonie
- Retail competition supporting demand for dairy products
- Investment in processing capacity benefitting the entire supply chain

Canadian dairy profitability is expected to be positive overall in 2018.

The average production cost is expected to climb by 1.8% after declining 2.2% in 2017. As a result, profit margins in the P5 milk pool are expected to hit anywhere between $1 and $4 per hl throughout 2018. The balance of fluid and industrial milk in the Western pool lowers price pressure for producers; as such, average margins are expected to level out between $5 and $7 per hl in 2018.

The sustained growth in consumer demand for dairy products we've recently seen will continue to pull the demand for butterfat upward. Milk production at the farm level has grown at an annual pace of around 5.0% between 2014 and 2017, and that's expected to continue in 2018.

The 2015-16 pressures on the price of milk stabilized in 2017 with the introduction of a new milk class to deal with the surplus of solids-non-fat. But low world prices continued to depress the Canadian pool price. A slow recovery in world dairy markets combined with a surplus of skim milk implies limited upside for the milk price in 2018. Because of that, the lift to revenues over the next year will almost exclusively come from growth in production.

How will this affect your bottom line?

Stronger demand for butter and resulting increases in quota are great incentives to increase productivity and optimize efficiency on the farm. Determine the desired scale of production on your farm, then review production practices to minimize costs in achieving your production target.

The 2018 economic environment should allow for investments in capacity and efficiency despite likely higher interest rates. Are you able to invest in productivity gains? Examine your ability to meet debt obligation regardless of what happens with revenues and interest rates.

Trends to watch in 2018

Modest recovery of international dairy prices

Canada's introduction of the Class 7 milk minimized the skim milk diverted to lowest-value markets in 2017. That helped to boost dairy revenues last year, even when world dairy prices were still depressed. They aren't projected to rebound significantly in 2018, mainly because of over-supply concerns. Milk production in the U.S. is estimated to have climbed 1.6 in 2017 and the USDA projects that it will grow an additional 1.7% in 2018. As a result, the price of skim milk powder will likely decline about 10.0%. The U.S. prices of cheese and butter are projected to remain at 2017 levels.

The Canadian milk price will be roughly in line with the 2017 average price which, combined with growing Canadian production volumes, yield a favourable outlook for Canadian dairy profits.

Interest rates to remain low while loonie to stay under US$0.80

The Bank of Canada projects economic growth in Canada to be slightly weaker in 2018 relative to 2017. They also expect inflation will trend around 2.0%, the Bank's mid-point target. Financial markets suggest there will be two or three hikes of 25 basis points in the overnight rate for 2018.

Businesses should take note: although interest rate increases will likely be muted, borrowing costs are projected to climb off historical lows reached in 2016 and 2017. Financial markets currently expect bond yields to climb moderately. This would mean, for example, that a 5-year, fixed-rate mortgage would be priced at the end of 2018 around 75 basis points higher than it was at the end of 2017.

The Canadian dollar is expected to average US$0.78 for 2018 – an important consideration for the Canadian dairy sector. Milk marketed in lower-value milk classes is based on pricing in the U.S market. A higher CAD relative to the USD will lower the price of lower value classes. A US$0.01 change in the exchange rate moves the price of milk by $0.15 per hl on average.

Retail competition to support demand for dairy products

Consumer preferences for natural fats have resulted in stronger demand. But retail prices play a role, too. Stiff competition in the retail food market has recently contributed to lower prices for consumers. In the last 12 months, the retail price of cheese dropped an average of 2%, while retail butter prices have remained relatively flat.

Consumer demand will continue growing, assuming competition among retailers will keep dairy prices lower than the overall food inflation trend. Demand will also grow if income rises faster than food prices.

Investment in processing capacity benefits the entire supply chain

Milk processing capacity in Canada has struggled to keep pace with recent growth in milk production. This is about to change. Manitoba and Ontario have already announced investments to build new plants or expand capacity, with more announcements anticipated in 2018. A steady supply of milk and the growing market for dairy products are driving these investments. Together, they'll modernize Canada's aging fluid milk processing infrastructure.

OECD-FAO projections suggest that consumption of butter and cheese in developing countries will grow at an annual pace of 2.5% and 2.0% over the next ten years. That growing global demand has led to large Canadian dairy processing companies establishing manufacturing footprints in the U.S. and across the world – investments likely to continue in 2018.

On the radar

- The outcome of the renegotiations of the North American Free Trade Agreement (NAFTA) will have possible implications for:
  - the value of the Canadian dollar
  - trade taxes and market access rules applied to Canadian exports and imports
  - dispute settlement procedures

  Changes in any of these could impact prices of ag commodities in Canada.
- Possible market access concessions for foreign dairy products if negotiations to revive the Trans-Pacific Partnership (TPP) agreement are successful.
- Shifts in acres devoted to feed grains in the U.S. and other major producing countries in 2018 could possibly result in shrinking global stocks and higher feed prices.

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