

# FCC Ag Economics Updated outlook for Canada's dairy sector

July 2018



Canada



*FCC Ag Economics is doing a mid-year check-in on our January 2018 Outlooks. Throughout July, we'll update our expectations about profitability in six Canadian ag sectors (crops East and West, hogs, cattle, dairy and food processing). We'll describe what's happened in 2018-to-date and what we think you should monitor in the next six months.*

Our January forecast for Canadian dairy failed to anticipate the challenges to profitability the sector faced in the first half of 2018. We expect profit margins in the P5 milk pool to be breakeven or slightly negative for the remainder of 2018 (using industry average cost of production and butterfat composition). Margins in the Western pool are projected to be slightly above the cost of production for the rest of 2018. The pools' profitability outlooks differ because of their shares of industrial milk relative to shares of fluid milk.

## Looking back at 2018

Butterfat production expanded 6.0% year-over-year (YoY) in the first four months of 2018, an expansion that increased total revenues and introduced a lower milk price. World skim milk powder prices remain at historical lows, showing little upside for the rest of 2018 according to [USDA](#) projections. The 2018 January-May average milk price was as much as 3.0% lower than the 2017 average. The increase in the [butter support price effective September 1](#) will lift the milk price paid to producers.

Butter stocks have steadily increased since mid-2015 and reached 43,000 tonnes in May, exceeding the industry target of 35,000 tonnes. Production-limiting measures (e.g. fewer incentive days, quota cuts) in the second half of 2018 will help to better align supply with market requirements. They should help sustain a higher milk price, although it's difficult

to predict price patterns without knowing how the pace of consumption growth will compare to changes in actual milk production. We estimate production costs climbed 3.0% to 4.0% YoY, on average, in the first half of 2018 mostly due to higher feed costs, energy prices and interest expenses. Feed grain prices are projected lower for the second half of 2018.

Canadian dairy product retail pricing trends declined 0.5% between June 2017 and June 2018. Retail prices for both butter and cheese fell even more – 4.0% and 2.0%, respectively – in that same period. That softness helped improve dairy's pricing relative to many foods: overall inflation in Canada climbed 2.5% and food inflation increased 1.4% at the same time.

Trends in dairy product consumption remain positive. Cheese and yogurt consumption each grew between 2.0% and 4.0% in the first three months of 2018. The fluid milk market is holding steady and butter demand is still expanding, with over 4.0% annual growth.

## Interest rates slowly trend up while the loonie hovers at US\$0.78

Global market forces played a big part in Canadian competitiveness and the profitability of our agricultural sectors in 2018-to-date. Several macro factors did too – and while we didn't get everything right, our forecasts in January help explain those trends.

Our January forecast of a US\$0.78 loonie was right on the money up to mid-June (see illustration). But the Canadian economy relies on the strength of export sectors. Trade tensions, currently pushing the CAD lower, could continue to pressure the loonie below the \$0.78 projected 2018 average.

However, we underestimated the strength of the world economy and the resulting robustness in global oil demand: despite rising oil production in the U.S., the West Texas Intermediate (WTI) crude oil price averaged close to US\$65, significantly more than our initial projection of US\$55.

The Bank of Canada (BoC) has revised their projections of Canadian economic growth for 2018 since our January outlook. The Bank expects a slower rate of growth, but that the economy will operate close to full capacity this year. Inflationary pressures persist, trending higher than our forecast of 2.0%, the Bank's mid-point target.

We also correctly anticipated the higher short-term rates in the U.S. and Canada that pushed bond yields higher. The average 5-year fixed rate on mortgages has climbed 35 basis points in the first six months of 2018 – in line with our forecast of an annual increase of around 75 basis points.

After hikes to the overnight rate in January and July (of 25 bps each), financial markets suggest one more increase is possible before the end of 2018. We believe however that the uncertain global trade and economic landscapes could make it difficult for the BoC to proceed with an additional rate hike.

## In January, FCC Ag Economics forecasted 2018 ...



### Overnight rate increase Right on Target

FCC forecast: 50-75 bps  
Actual Jan-Jun: 25 bps



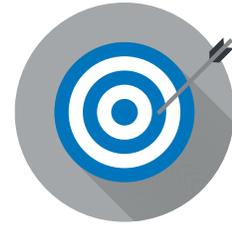
### 5-year fixed rate increase Right on Target

FCC forecast: 75 bps  
Actual Jan-Jun: 35 bps



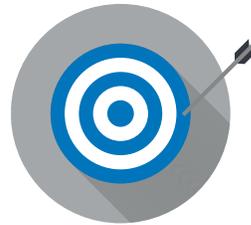
### USD/CAD exchange rate Right on Target

FCC forecast: US\$0.78  
Actual Jan-Jun avg.: US\$0.78



### Inflation So close

FCC forecast: 2.0%  
Actual Jan-Jun avg.: 2.5%



### Oil prices Miss

FCC forecast: US\$55.00  
Actual Jan-Jun avg.: US\$64.88

Sources: Bank of Canada, Bloomberg

## On the radar

- The industry's continued investment in processing capacity to market innovative products, contributing to raise the demand for milk.
- An uncertain global trade environment to close out 2018
  - North American Free Trade Agreement (NAFTA) discussions will continue (with no determined end date).
  - Full ratification of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) agreement is ongoing.
  - The full implementation of the Comprehensive Economic and Trade Agreement (CETA) is conditional on ratification by the EU member states.

### In this series:

- Crops East
- Crops West
- Food processing
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- Cattle and beef
- Dairy

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