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Rising Tide of Milk Weighs on Sentiment

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Summary

- Market sentiment waned in Q3 2017, as growth in the exportable surpluses across the export regions gained momentum.
- However, the growth in the exportable surpluses has not come without its challenges. The Oceania spring peak has particularly stumbled due to unfavourable weather conditions.
- Meanwhile, geopolitical tensions and dairy policy uncertainty are contributing to the weaker market sentiment.
- Attention is now squarely fixed on production trends in Europe in the coming six months. Growth in production is expanding, but milk price signals and efforts to curb production loom as disruptors.
- Meanwhile, a tinkering of the intervention scheme next season may see an increase in milk diverted to cheese and whole milk powder production in Europe.
- Growth in the global exportable surpluses will continue to expand in the coming period—and as a result, pressure will build in global dairy markets.
- However, Rabobank does not expect exportable surpluses to completely overwhelm global markets—helped by strategies to limit supply growth from processors.
- As expected, China's robust import programme has continued in the past few months, assisted by lower-than-expected milk supply and some improvements in demand.

Regional dairy markets

EU



Milk prices have started falling across Europe. But solid roughage stocks and expanding herds will support milk production growth through 1H 2018.

China



Further downward revisions for Chinese milk production in 2017 have been the catalyst for sustained import volume growth, with a shortfall to persevere into 2018.

US



The pace of growth in milk supply has moderated, and cull rates are increasing. Access to affordable feed is underpinning the growth profile.

South America



The gradual rebuild in milk supply across South America continues. As local consumption is trending higher, there is limited space for growth in exportable surpluses.

New Zealand



Unfavourable weather continues to hamper New Zealand milk production this season. A wet start has quickly become dry, which is restricting grass growth and limiting feed reserves.

Australia



After a slow start to the season, a recovery in milk production is gaining momentum, and favourable conditions will ensure a plentiful supply of feed through the second half of the season.

Global summary

Growth in milk supply—which turned positive in Q2 2017—accelerated in Q3 2017. The pressure of increasing milk supply across the key export regions began to take a toll on global commodity prices in Q3 2017. The entire dairy complex witnessed weakness—including butterfat prices, which had been defying gravity, but have more recently trended towards USD 4,500/tonne, still comfortably above the historical average butter price (*see Figure 1*).

Not surprisingly, skim milk powder prices remain depressed. The closure of the European intervention scheme removed the floor, allowing for prices to soften further—and with it, dragging the whole milk powder price lower.

While the global cheese market faired best—with only a minor drop in the past quarter—heavy stocks of whey continued to push the global market lower (-25%) and are negatively impacting the return from a cheese/whey stream.

Looking forward, growth in milk supply in the Big 7 continued in Q3 2017, at 2.2%—the fastest pace since late 2016. In the current cycle, supply growth in the Big 7 will continue through to Q3 2018—but the rate of growth will peak in Q4 2017, driven by the Oceania spring peak and a return to growth in Europe (*see Figure 2*).

With all eyes fixated on the peak flow in Europe next year, Rabobank expects supply growth to continue—but easing milk prices and efforts to contain supply growth in some regions will constrain growth.

The first signs of weaker milk prices (in local currency) have emerged in a number of export regions. The price falls are off a high base—meaning levels remain above breakeven—but pressure will build, squeezing farmer margins. Other changing aspects on the horizon will tighten farmer margins (*see 'What to watch in Q1 and Q2' section*).

Buoyant dairy demand, particularly for cheese and butterfat, in the northern hemisphere has been a feature on dairy markets in recent times. However, demand growth is starting to moderate following a period of robust growth.

Looking to dairy demand in emerging economies, trade data confirms there is robust import purchasing in key deficit regions, including parts of North Africa and South-East Asia.

The US dollar index, a measure of its strength against a basket of currencies, was relatively rangebound over the past quarter.

In China, milk prices continue to inch higher, but ongoing industry consolidation and unfavourable weather have hampered production growth. As a result, import purchasing remained active—and this trend is forecasted through 2018. There has been active importing from other deficit regions, including South-east Asia and parts of North Africa.

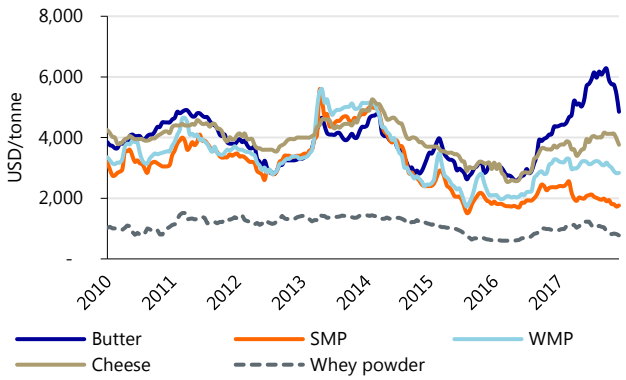
Exportable supply fundamentals will keep pressure on prices through Q2 2018, leading to further downward pressure on the dairy complex. When combined (Q4 2017 and Q1 2018), the global market will confront a wave of exportable surplus that is 3.2bn litres (in liquid milk equivalents) higher year-on-year.

It will not be a smooth recalibration of the dairy complex. There is no immediate end in sight for weak SMP prices, given the stock overhang. Rabobank expects pressure to build on other global commodity prices—particularly butter and cheese. However, low stocks of butter (especially in Europe) will support prices well above the five-year average.

Buoyant importing of cheese in countries like Japan and China is providing support for cheese markets. In contrast, whey prices continued to be weighed down by strong production and growing stocks, along with the possibility of SMP intervention stocks entering the animal feed market adding to the pressure.

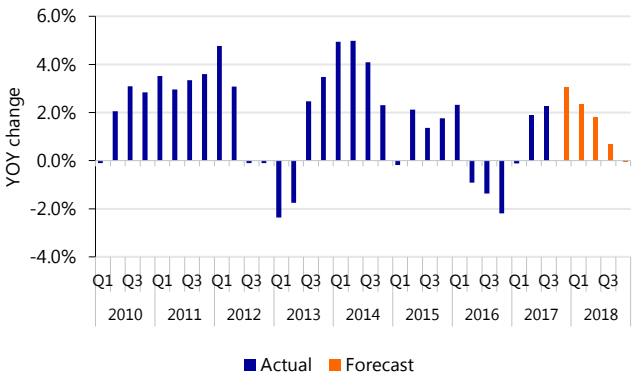
Looking further afield, Rabobank sees a gradual tightening of exportable supplies through the second half of 2018.

Figure 1: Dairy commodity prices FOB Oceania, 2010-2017*



* Note: Whey is FOB in western Europe.
Source: USDA, Rabobank 2017

Figure 2: Milk production growth, Big 7 exporters (actual and Rabobank forecast), Q1 2010-Q4 2018f*



* Note: Big 7 includes EU, US, NZ, Australia, Brazil, Argentina, and Uruguay.
Source: Big 7 government trade agencies, Rabobank 2017

What to watch in Q1 and Q2

New Zealand drought

The impact of weather across the New Zealand shoulder remains a key focus. A weak and short-lived La Niña is on the cards. Milk supply was higher through the peak month, but a further deterioration in soil moisture profiles may clip milk flows.

2018 EU intervention

Intervention stores will open in Europe from 1 March 2018, with the European Commission carrying 376,000 tonnes of skim milk powder. While the product does not have an official expiration date, it is ageing, and the European Commission is mindful about accumulating more stock. Watch for how a tinkering of the intervention system impacts how milk is utilised through the EU peak.

NAFTA

Risk of a US exit from NAFTA has increased after five rounds of 'modernising' the agreement have failed to advance amendments to the existing agreement. Two more rounds are scheduled for early 2018. If NAFTA fails, market impacts could severely upset US and global dairy prices.

Chinese regulations

There are risks for IMF imports in 2018. So far, the majority of the approved formulas reside with local plants. Offshore brands will be eager to receive approval as soon as possible. Meanwhile, China is tightening environmental protection regulations, with local government zones prohibiting animal farming in certain regions (to prevent soil and water pollution). If the impact on milk flows is larger than expected, it would lead to higher imports in 2018.

Political tensions

Tensions in the Middle East have escalated. While there has been no discernible impact on dairy markets to this point, political tensions and looming conflict pose an ongoing threat. Political tensions on the Korean Peninsula also remain worth watching.

Farmer margins

With downward pressure building on milk prices, dairy farmer margins are also facing lower cull cow prices (which have provided good income support) as pressure on global beef prices builds. Dairy farmers also face the prospect of higher feed prices in 2018.

Table 1: Quarterly dairy commodity prices (historic and forecast), Q3 2016-Q4 2018f

		2016		*2017*				*2018*			
		Q3	**Q4**	**Q1**	**Q2**	**Q3**	**Q4e**	**Q1f**	**Q2f**	**Q3f**	**Q4f**
Butter	USD/tonne	3,194	4,108	4,525	5,307	6,111	5,706	4,500	4,600	5,000	5,300
Skim milk powder	USD/tonne	2,027	2,348	2,402	2,013	2,000	1,819	1,700	1,700	1,800	2,100
Whole milk powder	USD/tonne	2,485	3,050	3,190	3,114	3,163	2,950	2,800	2,900	3,100	3,200
Cheddar cheese	USD/tonne	3,131	3,640	3,769	3,646	4,054	4,084	3,550	3,550	3,600	3,800
Sweet whey powder	USD/tonne	785	971	1,038	1,154	1,039	831	810	830	900	1,100
NFDM	USD/lb	0.85	0.93	0.96	0.87	0.88	0.79	0.68	0.71	0.74	0.77
AA butter	USD/lb	2.22	1.98	2.21	2.24	2.60	2.34	2.04	2.09	2.27	2.36
Block cheddar	USD/lb	1.70	1.74	1.66	1.57	1.67	1.73	1.54	1.57	1.63	1.78
Whey powder	USD/lb	0.29	0.37	0.48	0.51	0.43	0.37	0.27	0.28	0.33	0.45
Class III milk	USD/cwt	16.18	16.33	16.49	15.74	16.34	17.02	13.99	14.35	15.34	17.44
Class IV milk	USD/cwt	14.58	14.13	15.89	14.80	16.37	14.51	12.34	12.79	13.81	14.44

Source: USDA, Rabobank 2017

EU

Supported by rising farmgate milk prices (and good weather), EU milk production has continued to show strong gains. In the three months to September, EU milk production increased by 2.6%, compared to the same period last year (*see Figure 3*).

All seven biggest milk-producing member states, except for the Netherlands, showed growth. Production in Germany and France, the two largest milk producers, finally returned to growth in Q3 2017, with increases of 1.1% and 0.6% YOY, respectively. Meanwhile, Irish production growth continued uninhibited (up 10.4%), while Poland recorded a 5.8% gain, having posted 11 straight months of milk production growth. Italy and the UK grew by 4.0% and 3.9%, respectively.

As environmental restrictions placed on Dutch farmers continued to bite, the Netherlands was the exception among the key dairying countries. Milk production growth has been stifled throughout 2017—with the year-to-September running 0.3% behind 2016—and it was 1.1% down in the three months to September. However, even in the Netherlands, the good conditions and a weak comparable meant that production in the month of September was up 0.6% YOY.

Farmgate prices, which increased an average of 11% (from EUR 33.10/100kg to EUR 36.83/100kg) between June and September (a significant 43% higher than the July 2016 low of EUR 25.68/100kg) are driving the production growth in Europe.

But the end to the boom is now in sight, as European commodity prices and EEX futures move lower, and support for the current farmgate pricing levels is dwindling.

By November, butterfat prices had fallen by EUR 1,200/tonne from peak prices—but remain at elevated levels. Continued downward pressure on protein prices, following the closure of intervention-buying SMP, meant the gap between fat and protein remains intact.

In the three months to November, whey prices fell by 22% (EUR 630/tonne). During the same period, prices for SMP decreased to EUR 1,510/tonne (-11%). WMP prices also declined 11%. In contrast, cheese prices (gouda and cheddar) remained relatively stable, providing further incentive for processors to turn milk into cheese/whey, instead of SMP/butter or WMP.

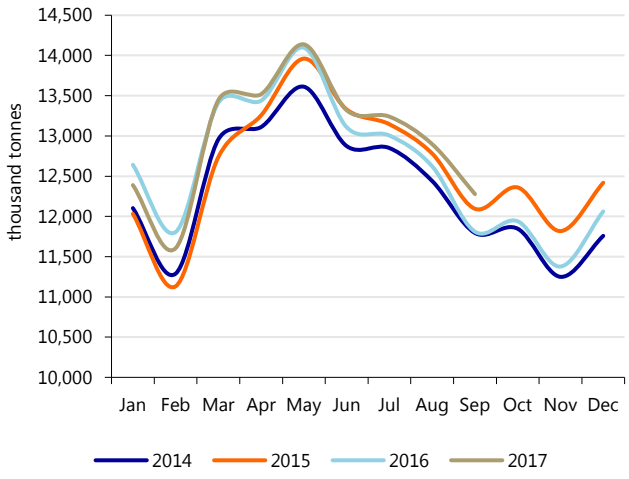
SMP stocks continue to overhang the market. The European Commission has made little progress in selling the 22,000 tonnes set out to tender for sale over a year ago. Intervention buying is closed, but during the closing month, with the anticipation that market prices would fall, 20,000 tonnes more were added at the statutory price, making the total volume approximately 376,000 tonnes. Efforts continue to sell the stock back to the market. With the majority of stock between 18 months and 24 months old, the question remains as to what loss on sale is acceptable. Despite bids to buy more than 33,000 tonnes (ranging from EUR 800/tonne to EUR 1,390/tonne) in a sale tender at the end of November, the European Commission accepted bids for just 40 tonnes at 1,390/tonne: over EUR 300/tonne less than the intervention purchase price. Meanwhile, Private Storage Aid SMP and butter stocks are at a three-year low (6,177 tonnes and 66 tonnes, respectively).

Part of the reason stock is not being stored privately is that extra-European trade has continued to expand during Q3 2018. SMP exports during the first nine months of 2017 are now up 41%, compared to the same period in 2016. Cheese exports have also been buoyant (+5.0%). Butter exports trail last year (-19%), hampered by lack of supply.

At the beginning of December, a number of dairy processors began lowering farmgate milk prices—yet levels of farm profitability are encouraging farmers to expand. Solid roughage stocks and expanding herds will support milk production growth into the last months of 2017 and 1H 2018. As a result, we expect Q4 2017 to finish 4.0% above 2016. However, milk prices have now peaked, and a higher comparable will start to temper production growth as we move through 2018, with Q1 2018 (+3.0%) and Q2 2018 (+2.0%) exceeding the 2017 production level. By Q3 2018, the comparable will be strong enough to cancel growth (0.0%), resulting in a production decline in the last quarter of 2018 (-1.5%)—dependent on how quickly lower milk prices bite.

Consumption of cheese and butter continued to grow in 2017, compensating for falls in liquid milk sales. Rabobank forecasts EU dairy demand to expand by 1.5% into 2018.

Figure 3: EU milk production, Jan 2014-Sep 2017



Source: ZMB, Rabobank 2017

US

US milk production continues on trend and is ahead 1.5% YOY. There was a modest slowdown in September and October, with growth of 1% and 1.4%, respectively (*see Figure 4*). The US dairy herd contracted modestly in October, by 0.04% from the August high, but is still 0.7% larger year-to-date compared to 2016. Most of the growth in production can be attributed to increased efficiencies and abundant feed, with corn prices hovering below USD 3.50/bu.

We continue to see production declines in California and regional dynamics favouring central states, yet on-farm investments are not likely to materialise in the coming year, due to the current price outlook.

US economic growth has continued to boost disposable incomes for Americans, enticing consumers to eat out at restaurants. US foodservice sales were up 4% YOY in 2017. Consumption of dairy at restaurants tends to be higher than at general retail channels, due to the higher volumes of cheese (pizza, hamburgers) and milk fat (bakeries, sandwiches) which tend to be sold via these channels. As a result, the strong growth in foodservice sales has provided a much-needed tailwind to weakening retail sales of dairy products, as natural cheese and butter sales have slowed significantly from year-ago levels, fluid remains in decline, and yoghurt sales have also slipped into modest contraction.

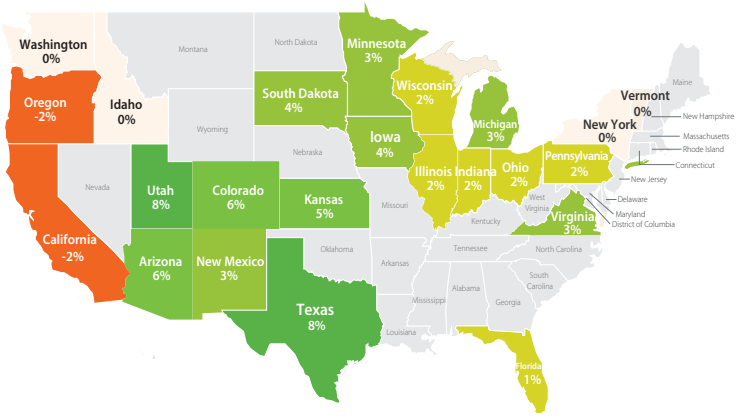
Stocks are up 11% in LME terms, driven by whey powder (estimated to be up 43%) and NFDM (up 76%) in October. Cheese and butter stocks have seen seasonal drawdowns, keeping inventories relatively low, at 4% and -4%, respectively.

Looking forward, continuing global supply pressure will trickle down to US farmgate prices, putting downward pressure on margins, seeing many fall back below breakeven. As a result, Rabobank forecasts a noticeable slowdown in US supply growth in 2018, hovering at around 1.2% in the next 12 months. We expect continuing consolidation and increased efficiencies to encourage more investment in 2019.

US economic growth is expected to increase to 2.5%, benefiting from the highest consumer confidence in 17 years, possible tax breaks, and wage growth.

On the demand side, moving into 2018, growth rates are expected to moderate after two years of exceptionally strong growth. Rabobank forecasts US dairy demand to expand at a rate of 1.5%—not fast enough to offset the ever-increasing surplus growth of US product—resulting in the US having sizeable volumes of export potential in 2018.

Figure 4: US production by state: YOY percentage change, Aug 2017-Oct 2017



Source: USDA, Rabobank 2017

New Zealand

Unfavourable seasonal conditions have continued to be disruptive to New Zealand milk production. A wet winter has quickly been replaced by a dry spring, with the latest profiling from NIWA confirming soil moisture levels to be well below average levels.

Production during August and September was impacted by seasonal conditions, meaning season-to-date production is up just 1.1% (at 695m kg of milk solids). Milk production showed a solid result in October, with output up 2.9% YOY (on a milk solids basis). Milk production has now peaked, and the seasonal outlook presents more risk to milk flows through the closing months due to ongoing risk of drought and weather disruption. Rabobank is forecasting national milk production to finish at slightly lower than previous expectations, at 2.5% growth for the full year (*see Figure 5*).

Rabobank's most recent rural confidence survey showed a significant dip in confidence in the New Zealand agricultural economy. Dairy farmers recorded the largest drop of all sector groups—attributed mostly to the uncertainty around the change of government, but the potential for milk price revisions would also have played a role.

Recent falls in global dairy prices put the spotlight on Fonterra's current full-year payout forecast. In December, Fonterra revised its forecast milk price lower, from NZD 6.75/kgMS to NZD 6.40/kgMS. Rabobank forecasts payout for the 2017/18 season to be slightly lower, at NZD 6.30/kgMS.

New Zealand dairy exports have been sluggish in the past three months (August to October). Export volumes for the period totalled 549,000 tonnes: 12% lower than the same period the previous year. Shipments to Algeria have taken a

notable hit this year, with volumes down 80% in the past three months (a drop of 40,000 tonnes).

However, export volumes to China continue to track above prior-year levels. In the past three months (August to October), New Zealand's dairy export volumes to China totalled 133,000 tonnes: 24% higher than the same period last year (and led by a 45% jump in whole milk powder shipments).

Milk production has now peaked for the season. There are clear risks to milk flows during the summer months, due to threat of drought. Meanwhile, autumn milk flows are unlikely to match last year's strong results.

As a result, many New Zealand dairy farmers are battling damaged pastures and lower-than-normal feed reserves heading into the shoulder. However, high import volumes of palm kernel so far this year ensure a feed reserve is available ahead of a new Fat Evaluation Index (FEI) Grading System from September 2018 (three months later than originally planned).

Rabobank has lowered its forecast for national milk production marginally. National milk production is forecast to finish 2.5% higher for the full year.

Australia

Australian milk production has had a mixed start to the season. In particular, September production was abnormally sluggish. Nevertheless, October production was up 6.7% nationally and brought the season-to-date volume up 2.7%. Not surprisingly, the growth is driven by a recovery of milk production across the southern export regions—particularly Victoria. The benefits of improving milk prices and favourable seasonal conditions are flowing through to a recovery in milk production (*see Figure 6*).

The latest rainfall outlook for summer suggests drier-than-normal conditions across much of Australia's dairying regions. Nevertheless, a good reserve of high-quality fodder, good soil moisture, and high water entitlement for irrigators bode well for a strong shoulder and solid finish to the season. There will also be a plentiful supply of supplementary feed available.

As a result, Rabobank is forecasting milk production growth to continue and national milk production to finish at a 2.7% increase for the full 2017/18 season.

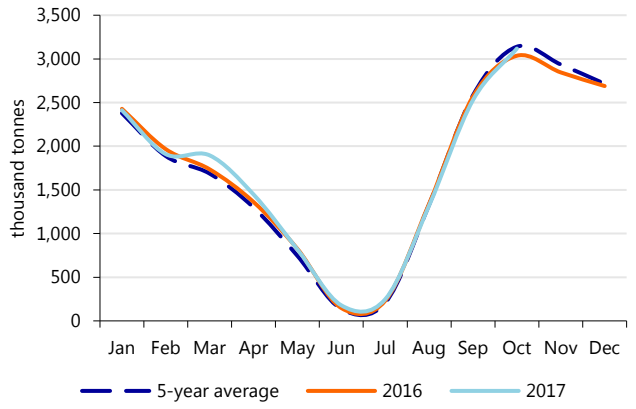
Corporate activity continues to dominate headlines in Australia—with Saputo's proposed takeover of Murray Goulburn, which, if successful, would make it the largest processor, with around 3bn litres of milk supply. While a number of hurdles need to be overcome, ambitions are for the transaction to be complete for the start of the new season from 1 July 2018.

For existing Murray Goulburn suppliers, the offer is supportive of cash flow. If the transaction is approved, the weighted average payout for Murray Goulburn suppliers would be AUD 6.00/kgMS in the 2017/18 season. This is an AUD 0.80/kgMS increase on current pricing, and in line with competitors. Most importantly, it would provide immediate cashflow benefits and leave the milk price above breakeven.

Cheese vats continue to be kept busy. Through the first quarter of the season, Australian cheese production was up 6.6%. In contrast, butter and SMP production were down 33% and 23%, respectively. Since the start of this season, WMP has also been prioritised, with volumes up 24% season-to-date.

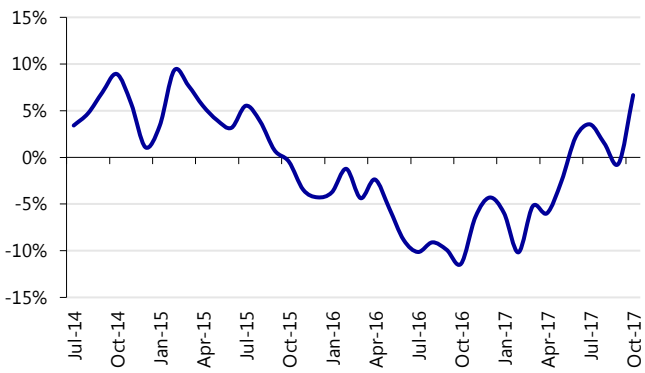
Rabobank's current full-year farmgate milk price in southern export regions for 2017/18 is AUD 5.50/kgMS (commodity milk price), excluding any supplementary payments and market premiums. This is lower (-AUD 0.20/kgMS) on previous forecasts, due to a stronger currency and weaker commodity prices.

Figure 5: New Zealand milk production, Jan 2016-Oct 2017



Source: DCANZ, Rabobank 2017

Figure 6: Australian YOY change in milk production, Jul 2014-Oct 2017



Source: Dairy Australia, Rabobank 2017

The local dairy market remains buoyant, despite weaker economic settings brought about by low wage inflation and a rising cost of living. Across the dairy case, volume growth is being supported by a growing consumer appetite for butter, flavoured milk, and retail cheese.

In the last three months (to October), Australian export volumes were running 4.4% higher than the same period the previous year (in liquid milk equivalents). Given the milk production curve, product inventory levels in Australia are at their annual peak, but broadly in line with expectations.

Australia's exportable surplus has contracted significantly over the past 18 months. It is only now that the benefit of improving milk supply will start to drive a recovery in exportable surpluses. As a result, Australia's rapidly expanding import volumes of dairy products have started to moderate more recently.

Beyond the significant transaction involving Murray Goulburn's operating assets, its Kiewa and Edith Creek plants have new owners.

Brazil

After registering rapid growth in Q3 2017, of around 5% in volume terms, milk production is set to slow down to around 2% in Q4 2017. Ample supply and weak demand caused stocks to increase during Q2 and Q3 2017, and farmgate prices moved lower in recent months. Despite access to affordable grain for feed, low farmgate prices have reduced farmers' margins to lows not seen since the beginning of 2016. Lower margins have reduced farmers' appetite for expansion.

A delay in the start of the rainy season in the south-east of Brazil, which normally begins in late September, caused some concerns for farmers. However, rains have now normalised and will help reduce producers' dependence on supplementary feed in some regions in Q4 2017, helping to sustain moderate growth, despite lower margins.

In terms of trade, Brazil's deficit declined by 30% over the first ten months of the year, totalling 120,000 tonnes thus far in 2017, compared to 167,000 tonnes for the same period in 2016. Shipments of WMP from Uruguay were stopped during October, but were freed on 6 November, after an auditing process confirmed that product from other origins was not entering Brazil via its southern neighbour.

The Brazilian economy continues on a slow path of recovery, with official GDP numbers confirming three consecutive quarters of growth after the country experienced a severe recession between 2014 and 2016. Projections for 2018 point to growth of 2% in GDP, low inflation, and interest rates remaining at a record-low level. All of these factors favour an ongoing recovery in demand, as consumers' incomes stabilise through lower unemployment and slightly higher disposable incomes. Rabobank expects dairy consumption to expand by 1.5% in Q1 2018.

Meanwhile, corn prices are set to be slightly higher in the domestic market in 2018—due to a smaller crop and higher domestic consumption—while soymeal prices will remain around current levels. Higher corn prices will cause feed costs to increase in Q1 2018. However, farmgate milk prices are set to gradually improve from Q1 2018, once the seasonal peak period for production ends in the south-east (December/January), helping to protect margins.

As a result, Rabobank expects milk production to increase by around 1.5% in Q1 2018. Our current outlook shows that Brazil will remain in a net import position throughout 2018—and there is a possibility that the trade deficit will increase if international prices trend lower and the Brazilian real remains at current levels.

Argentina

Argentina's milk production expanded by 4% in Q2 2017 and was the starting point of a recovery. However, production data in Q3 2017 was below expectations, registering a slight drop of 0.6% YOY. Excessive rains in August and September, and ongoing cost inflation were in part responsible for lower-than-expected output in Q3 2017. The speed of increases in farmgate milk prices also slowed and was a contributing factor to the slowdown in production growth.

Meanwhile, domestic demand continues to gradually improve as the economy starts to perform better. According to official statistics, sales of cheese grew 9%, and creams, yoghurts, and desserts increased by 6% for the first three quarters of 2017, in comparison to 2016. Liquid milk sales continued to underperform and contracted by 6% during the same period, in part reflecting a shift in demand—from liquid milk to other products like cheese, yoghurts, and desserts.

Argentina's dairy exports dropped by 30% during the first three quarters of 2017, compared to 2016. Lower milk production and currency fluctuations affected trade.

Milk production is expected to register growth of 1% in Q4 2017 and 2% in Q1 2018, given the low comparison basis of 12 months prior, when the sector's contraction was still in full flow. Production growth will take some time to consolidate, but stronger economic growth in 2018 should help the domestic sector via stronger demand.

The cost of soy and soymeal is set to increase domestically in Argentina in 2018, with the soy export tariff declining by

0.5% every month throughout 2018 and 2019. This will bring domestic soy prices more in line with Chicago prices (currently 30% lower), causing feed costs to escalate in Argentina and reducing the potential for faster milk production growth.

In the short term, dairy trade volumes will remain subdued, given the limited availability of raw milk for processing—at a time when domestic demand is improving and persistently high inflation limits the competitiveness of Argentina's milk in the international market.

As a result, Argentina's role in the international market will remain limited for now, with no significant growth in the exportable surplus during 1H 2018.

China

Average farmgate milk prices in China in late November inched higher, reaching CNY 3.50/kg (USD 0.53/kg). This has increased by 2.5% since the trough this year, seen at the beginning of Q3 2017. Milk prices for large farms have also shown a similar pattern of recovery, largely due to a tightening of supply.

A recently released set of data by the Ministry of Agriculture suggested that milk production in Q3 2017 was down by as much as 3% on the same period last year. This means year-on-year production was down 1.3% during the first nine months.

The decline may very well have been attributable to heat stress, continuous farm exits by small to medium-sized operators due to a lack of profitability, and, to some extent, more stringent enforcement of environmental protection regulations.

To reflect the weaker-than-expected Q3 2017 production, Rabobank has revised milk production expectations downwards for 2H 2017, to -1.5% YOY (previously +0.5%).

This leads to a cut in the full-year production forecast by 0.7% YOY for 2017, down from +0.2% as previously forecasted. This has resulted in a 1% reduction in 2017 production volume, compared with the forecast in the previous quarter. Looking to 2018, Rabobank forecasts 2.2% growth in milk production, largely driven by yield improvements.

Despite some strengthening of retail dairy prices from Q2 2017 and the likelihood of lower levels of promotions through 2H 2017 (as local dairy companies combat higher costs of raw materials and packaging costs), consumption will maintain momentum.

A number of major local dairy, beverage, and consumer food companies reported signs of a solid recovery in Q3 2017 top-line numbers.

In addition, major listed Chinese IMF companies also reported a strong rebound in top-line numbers during Q3 2017—confirmation that restocking is underway as more formula registrations are announced by the Chinese authorities.

As a result, Rabobank has increased its estimated demand growth in 2H 2017, to 2% YOY (previously 1%). This brings full-year 2017 consumption growth to 2% YOY—0.5% ahead of previous forecasts.

Rabobank maintains consumption growth of 1.5% in 1H 2018, before a mild slowdown in 2H 2018, to 1.2%.

With stronger-than-expected demand growth in 2017, the new demand forecast for 2018 is now 0.4% ahead of Rabobank's forecast as of Q3 2017.

Chinese dairy import volumes maintained strong growth momentum in the past quarter. Q3 2017 import growth (in liquid milk equivalents) was 44% higher, and October continued with a record 43% surge.

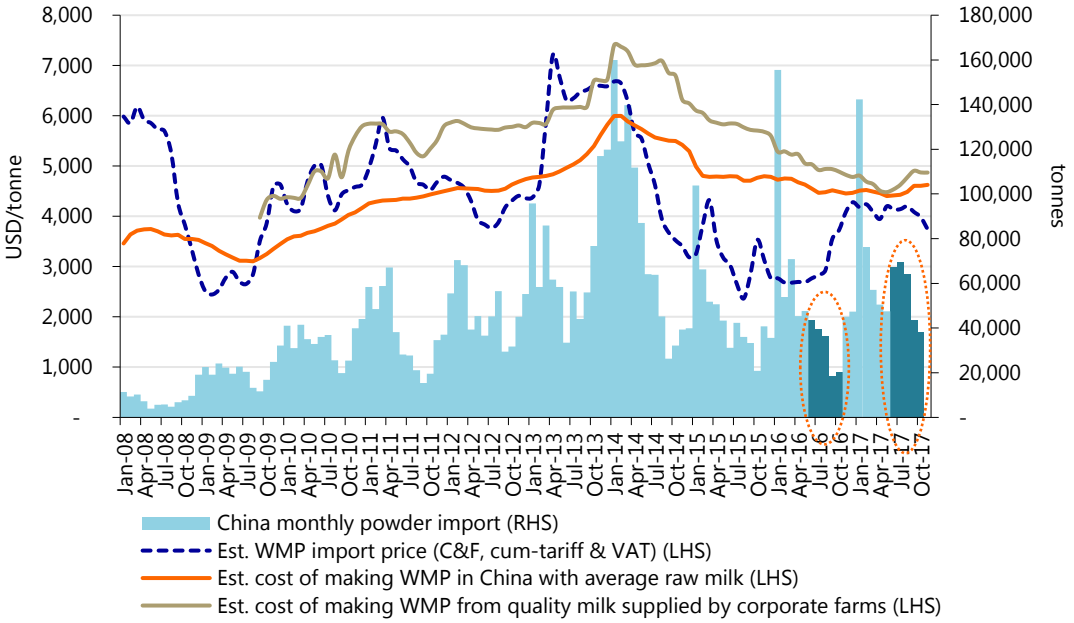
Improvements in demand growth, combined with the unexpected supply issues, have led Rabobank to adjust the annual import volume growth to 20.2% for 2017 (up from the previous 19% forecast).

As a result, Rabobank expects a slowdown in November and December import volumes, as shipments are delayed to time product arrival in early January 2018. This will further draw down the estimated inventory level in China at year-end 2017, to marginally below one month of annual consumption.

Revised consumption and production forecasts for 2018 suggest that China's imports in 2018 will continue to grow, albeit at a slower pace of 8% YOY.

Imports will continue to be attractive to local dairy companies during the early stages of 2018. Based on Rabobank's WMP parity analysis, the discount between the Oceania imported product price and local milk prices is widening again. The gap has widened to around 20% when referenced to the domestic average milk price and a 24% gap when compared to the corporate farm milk price (*see Figure 7*).

Figure 7: Chinese WMP import parity, Jan 2008-Oct 2017



Source: China Customs, Chinese Ministry of Agriculture, Rabobank 2017

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