

Welcome surprise

- Fonterra lifts its 2016/17 milk price forecast by 50 cents to \$5.25/kg.
- As dairy auction prices consolidated their recovery.
- We expect prices to remain firm over the remainder of this season, leading to a final milk price of \$6.00/kg.

Summary

Fonterra caught us by surprise this morning, lifting its milk price forecast by 50 cents to \$5.25/kg. However, it was the timing, not the lift itself, that caught us by surprise.

In a way, the new milk price forecast will steal some of the thunder from tomorrow's Fonterra annual results announcement. Indeed, we expect a much-improved Fonterra result for the 2015/16 year and indications of further improvement over 2016/17.

Secondly, the milk price forecast upgrade signals that Fonterra is increasingly confident that recent auction price lifts will stick. In that sense, Fonterra is coming around to our view sooner than we had anticipated.

Specifically our view is that dairy markets have fundamentally shifted. In particular, farmers have changed behavior in response to low milk prices by lowering production levels. Moreover, we expect there is further production weakness to come over 2016. In this respect, this season is different and we expect that August and September's price recovery is sustainable.

With that in mind and likely further global production weakness, we expect prices to stabilise around current levels, before lifting again later in the season. As a result, we continue to expect a finalised milk price of \$6.00/kg for 2016/17.

Auction comments

Dairy prices consolidated their recent gains overnight. Overall prices rose 1.7%, while WMP prices were largely unchanged (down 0.2%) after big moves in the three previous auctions.

In view of the recent price surge, it is not surprising that dairy markets wanted to catch their breath. WMP prices, for example, have spiked 35.1% over August and September.

Aside from the WMP result, prices were firm. SMP, AMF and butter all lifted by between 3.0% and 4.6%. Indeed, seven out of eight products on offer recorded price gains.

From here, we expect prices to consolidate over coming auctions as markets will need to take stock. In our view, we expect continued production weakness to lift prices again later in the season. On that basis, we look to NZ spring data that support or challenge our view that there is further global production weakness to come over 2016.

Implications

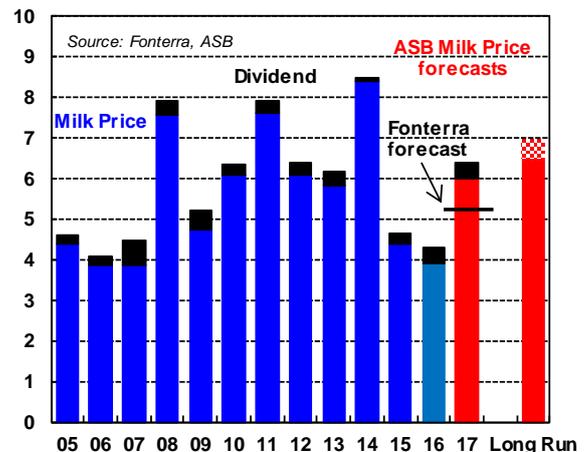
Last night's auction result reaffirms our 2016/17 milk price forecast of \$6.00/kg. Meanwhile, the milk price forecast upgrade adds circa \$900m to farm incomes. This increase will build on recent improvements in rural confidence. However, at this stage rural spending is likely to remain constrained as farmers focus on debt repayment in the first instance.

Season-end Forecasts

	2015/16	2016/17		Long Run
	Fonterra/ASB	Fonterra	ASB	ASB
Milk Price*	\$3.90	\$5.25	\$6.00	\$6.50-\$7.00

* per kg of milk solids (excluding dividend).

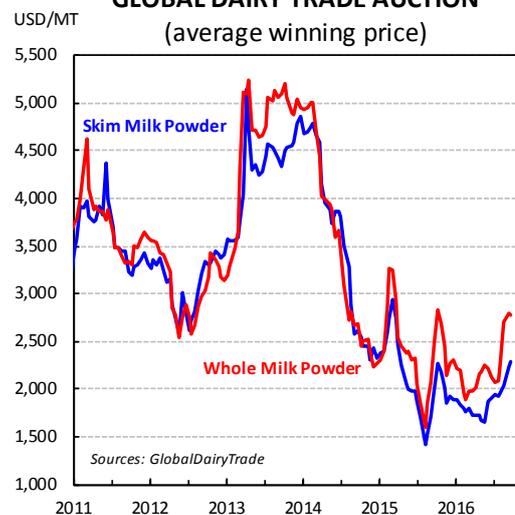
MILK PRICE AND DIVIDENDS (per kg milk solid)



Auction Results

Product	% change in index since last auction	Annual % change in index	Weighted Average Price US\$/MT
Whole Milk Powder (WMP)	-0.2%	16.9%	2,782
Skim Milk Powder (SMP)	3.0%	14.2%	2,293
Anhydrous Milk Fat (AMF)	4.6%	46.4%	4,998
Butter	3.6%	23.1%	3,892
GDT Price Index	1.7%	19.8%	n.a.

GLOBAL DAIRY TRADE AUCTION (average winning price)



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