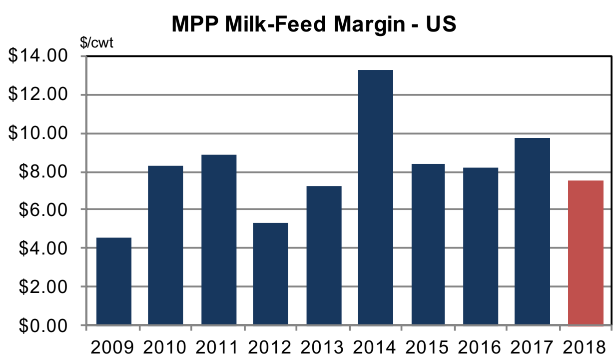
The McCully Report

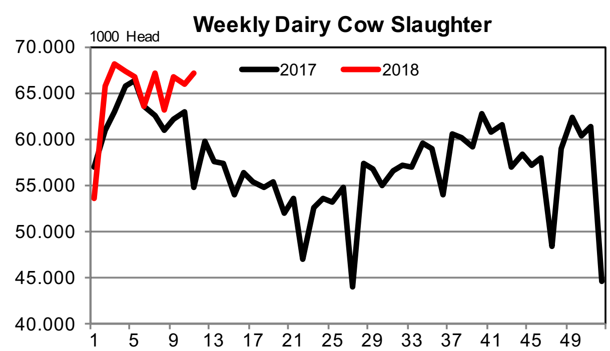
April 2018

Feed Prices & Dairy Farm Margins

Summary: The MPP milk-feed margin outlook has improved slightly since last month as higher milk futures prices offset the rally in grain prices following last week's USDA reports. However, China's threat of higher tariffs on soybeans brings new uncertainty.

The grain markets got two major USDA reports on March 29 – Prospective Plantings and quarterly Grain Stocks. On the bearish side, stocks of corn and soybeans were above pre-report estimates and were record large for March 1. However, the acreage expected to be planted this year for both crops was lower than pre-report estimates– this was bullish for the market. Of note, projected soybean acres will exceed corn acres for the first time ever. New crop futures prices for both spiked higher following the reports... until China announced higher tariffs for US soybeans on April 3. Soybean futures prices plunged 5% as China buys approximately 25% of US soybean production. The market will now have to sort out high stocks, lower acreage than expected, and a looming trade war, as the focus turns to spring weather. The ongoing drought in the Central Plains is a concern for Corn Belt crops and is a watch-out for potential impacts on feed costs and availability. The projected MPP margin currently falls between 2013 and 2016, both years with lower than average dairy farm margins.





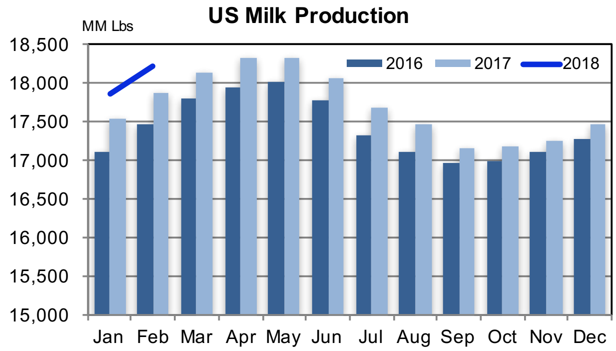
Milk Production

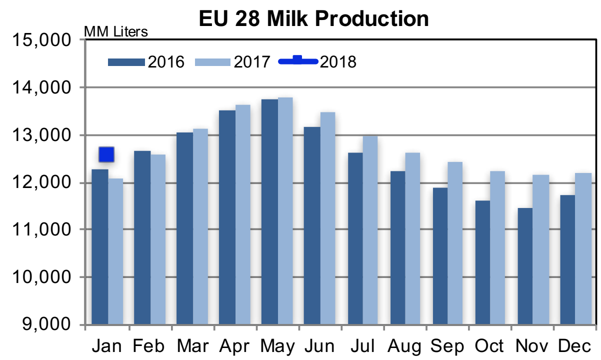
Summary: Milk production growth continued in Europe and the US to start the year, but signs point to a slowdown by mid-year as lower milk prices push farm margins to break-even or below.

Milk production in the US was up 1.8% vs. year ago in February – the 2nd consecutive month of solid gains. States in the Southwest once again led the way with growth in milk output. California grew 3.5% - the highest rate since July 2014. The Northeast was weak while the Upper Midwest posted only modest growth. Cow numbers continued to move higher in February despite worsening on-farm economics. However, the pace of culling appears to be picking up in March with the third week seeing a 22% increase vs. year ago (graph above). If this continues, it should eventually pull cow numbers lower. I am forecasting milk production growth in the 1.25-1.5% range for Q2, but then expect it to slow to 1% or less in the second half as cow numbers move lower.

Milk production in Europe continued on pace with 4.2% growth in January. Most of the major countries saw another month of solid growth – Germany +5.2%, France +3.9%, Italy +6.3%, and Poland +4.3%.

However, other countries saw weaker gains – Netherlands +0.2%, Ireland +1.5%, and UK +1.5%. Given the relatively severe winter weather in February, the pace of milk production growth is expected to slow. In fact, preliminary data for February from several countries show lower output than prior year. This trend is expected to continue into spring with more modest growth (~1%) in the second half of the year. Reported milk prices remained in the mid-30's in February, although the spot milk values are in the upper 20's. If prices would fall below 30, it would approach break-even for a number of farms and likely lead to a cut-back in milk output in the second half of the year.





New Zealand's milk production season is winding down with projections for the season of down 2-3%. Fonterra's milk intake in February was down 4% vs. prior year – season to date is down 2%. This is below early season estimates due to poor spring and summer weather. However, farmers are enjoying a good year financially. Fonterra recently increased its forecasted farm gate milk price for the 2017/18 season to $6.55 per kilogram of milk solids. This is $0.15 higher than their December forecast. They attributed the payout increase to the ongoing strong international dairy demand and stable global supply, which has supported prices in recent months, particularly for whole milk powder.

Demand

Summary: US dairy product demand is keeping up with supply growth, although fluid milk sales continue to decline. Chinese dairy product imports were lower in February.

US economic growth is helping dairy product demand. Retail sales of cheese improved to start the year with lower prices and aggressive featuring pushing product out the door. However, fluid sales were still down in January (-0.6%). The volatility in the stock market is not helpful for demand growth, so this is a watch-out.

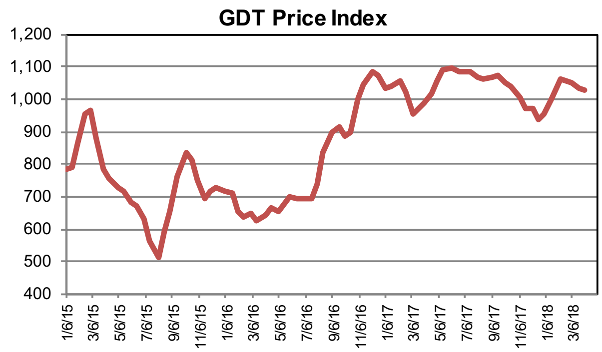
After a rapid start to the year, the pace of Chinese dairy imports slowed in February. This is not unexpected as the large increase in January was due to lower tariff rates. Both whole milk powder and skim milk powder imports were down 11% from prior year in February. Cheese imports fell 43% from last year while whey shipments were down 8%. Infant formula imports were a bright spot – up 25% from year ago and 5% higher than January. As of now, dairy products from the US have not been targeted by the Chinese for retaliation, but this bears watching, especially for whey products.

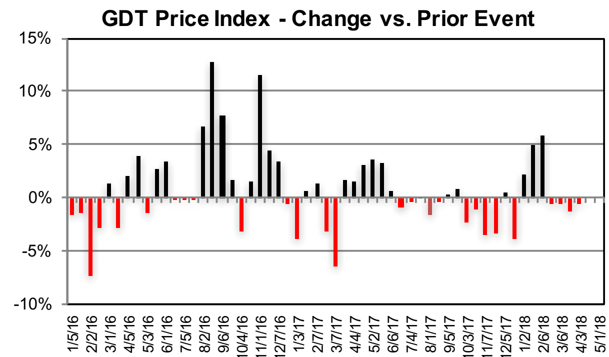
Dairy Market Outlook

Summary: The global dairy market remains long on skim and short on fat. Prices for most products have been relatively stable over the last few months as buyers have had little reason to get more aggressive. Supply fundamentals remain bearish until mid-year with peak milk production in the northern hemisphere. Markets are expected to tighten in the second half of the year.

The outlook for dairy products remains mixed with stable cheese, whey, and WMP prices, lower SMP, but higher butter/fat. The GDT price index has eased slightly lower over the last 2 months with WMP trading in a narrow range ($3,225-3,275/MT). Fonterra announced they will increase the amount of WMP offered on

GDT over the next 12 months with a small reduction in cheese. I expect the sideways pattern to continue in Q2 with some brief rallies, which should set the stage for a more sustained recovery in the second half.

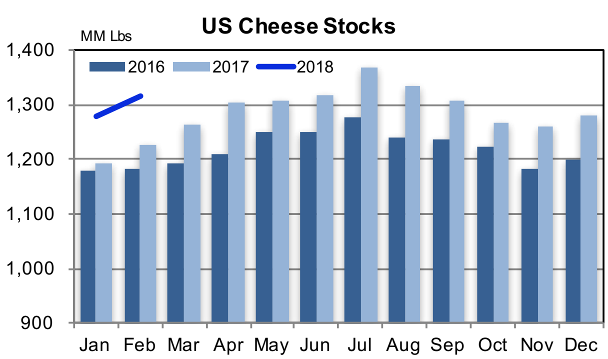


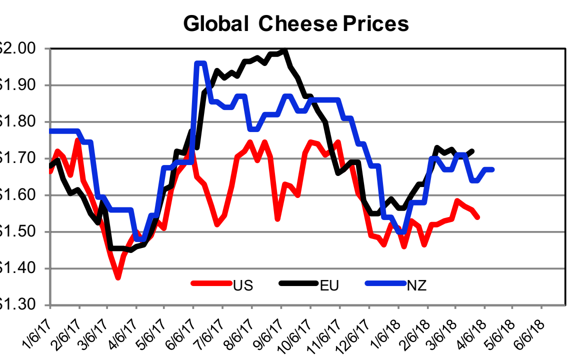


Cheese

Summary: There is not much new in the cheese market. European and NZ cheese prices remain at a premium to US prices, which have been range bound for several months. Increasing supplies are forecasted to put downward pressure on prices in Q2.

US cheese prices experienced some unexpected strength in March, but appear to be weakening as April starts. Global prices are hovering around the $1.70 level with the US trading at a discount. The story remains mostly unchanged from prior months – stocks remain ample and milk is growing in key cheese producing states, yet demand has been able to keep pace. As a result, US cheese prices continue to trade in the $1.40-1.50's. My outlook is unchanged with some seasonal weakness expected into the spring as production peaks. Last month, I bumped my forecast back up to $1.65-1.70 for the fall and am holding with that this month. I believe cheese stocks will remain above year ago levels, but demand, both domestic and exports, should be able to provide some support later this year.



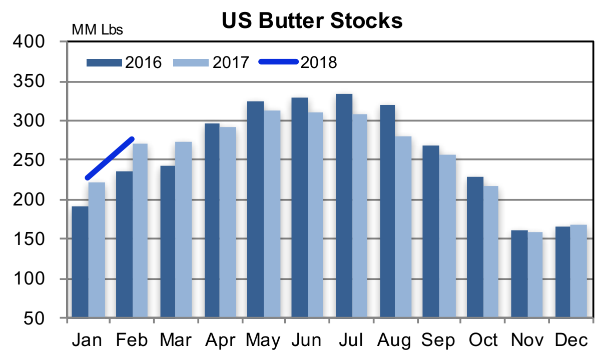


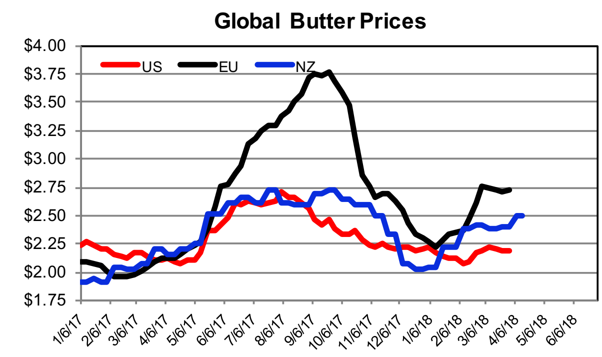
Butter

Summary: Butter prices in Europe have rallied over 20% since the start of the year while US and NZ prices have traded at a discount. With European butter stocks at historically low levels to start the year, the market will remain nervous until stocks rebuild.

Like cheese, US butter prices have traded in a narrow range with some upward drift over the last month before shooting higher on April 4. CME spot trading has been very active over the last week or so and futures have held a solid premium, which has supported cash prices through the carry trade. Stocks remain abundant with February stocks growing over 50 million lbs – the fastest rate for the month since 1994. Cream has been plentiful and cheap so far this year, so butter churns have taken advantage and made more butter. New Zealand prices had been stuck around $2.40 since early February, but moved higher in this week's GDT Event. European prices eased slightly in recent weeks, but moved back up over €4900/MT this week ($2.75/lb). End of January stocks were near 70,000 MT – historically low for the date. As a result, fat buyers in Europe remain on edge given last year's astonishing run to record high prices. EEX futures point to further gains towards €5200/MT ($2.90/lb).

Bearish US fundamentals are being offset by a more bullish global outlook. On their own, I don't believe US butter prices have much upside from current levels (low-mid $2.30's). However, from a psychological standpoint, higher global prices will provide support to US prices. I have increased my forecast, but could see prices dropping back into the $2.20's just as easily as moving up to $2.40-2.50.

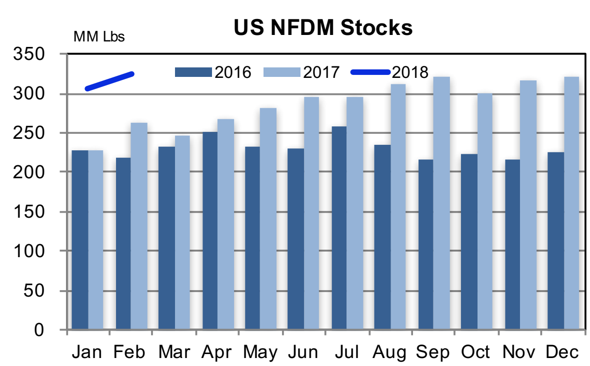


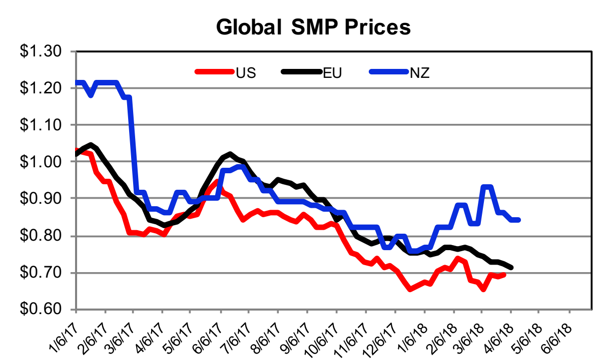


NFDM/SMP

Summary: The world is still long skim milk powder and the market tone is weak. The EU Commission is slowly selling their SMP stocks, but there is much more to go.

February milk powder production in the US was up 7.5% vs. year ago as strong milk growth and new plants resulted in more powder. NFDM production was 12% higher while SMP dropped 9% from last year. Not surprisingly, February stocks grew to a new record high. However, there was a big downward revision to January stocks (33MM lbs less), so the stocks situation, while still burdensome, isn't as severe as it looked last month. The spring flush should keep powder plants full and another plant is expected to come online later this year, adding to an already oversupplied market. My outlook for prices is about the same as last month – flat prices near $0.70/lb for Q2 with a slow increase to $0.80 by Q4. As noted in prior reports, NFDM/SMP has the most bearish set of fundamentals in the dairy complex and will likely lag behind in any price recovery this year. The Chinese retaliation is grabbing headlines this week, but the NAFTA renegotiation lurks in the background and could have a major impact on US NFDM/SMP prices.

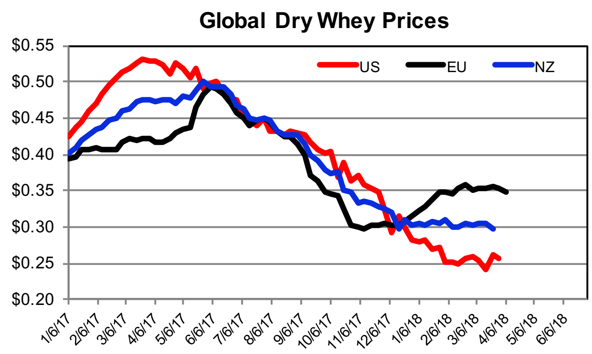


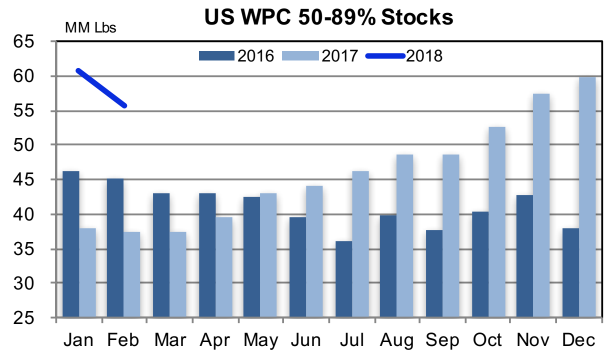


The EU Commission is making it clear they want to reduce their SMP stockpile. They recently rejected offers to buy fresh product and they continue to sell "old" powder through tenders. However, the volumes sold are very small and so far, represent less than 3% of the total. Bids as low as €1,050 per metric ton ($0.59/lb) were accepted, down from €1,100 last month and €1,190 in January. Like the US, seasonally stronger milk output will find its way to milk powder plants this spring, only adding to an already bearish stocks picture. SMP prices have gradually moved lower under pressure from sinking intervention stock values. Not all is bearish as lower prices have attracted solid demand from fat-filled milk powder buyers. This should help stabilize the market in Q2.

Whey Products

Summary: There are signs of green shoots in a few whey products. Stocks remain above year ago, but prices have firmed in recent weeks for dry whey and lactose.





Dry whey prices have been stable with more of the same expected this spring. As the year started, global whey prices had converged near $0.30/lb. Since then, NZ prices have held steady while European prices moved up and US prices sank. I expect European prices to ease lower in Q2 with US prices remaining in the mid-$0.20's. February dry whey production was nearly 15% above last year, but stocks fell 2% during the month implying good demand. Reportedly, Asian demand has picked up in recent weeks, resulting in a firmer market tone. However, with peak milk and cheese production in Q2, it will be difficult for whey prices to move higher until the second half. While dairy has been untouched in the Chinese tariff retaliation, whey would be the most impacted for US dairy products if it were targeted.

The lactose market appears to be showing early signs of recovery. February production in the US was up 2.3% vs. year ago, but like dry why, stocks fell 7% from January. Some manufacturers report being sold out for Q2 while others still have ample inventories. Dairy Market News prices have moved up for the last 4 weeks and the latest GDT auction had lactose trade in both the US and Europe after several months of stagnant demand. My forecast is for additional gains through the end of the year – to the upper $0.20's by Q4.

February data for WPC and WPI saw lower WPC 34 and WPI output, but much higher WPC 80 production. Low protein (25-49%) WPC production was down about 3% from prior year, yet stocks were 17% higher. Demand continues to be highly fragmented with value-added product (e.g. infant formula) commanding significant premiums, but lower quality product discounted to near NFDM prices. Higher protein (50-89%) WPC saw production up 19% in February, but stocks fell 8% during the month implying good demand. Stocks remain well above year ago levels, so prices are expected to remain in the $1.75-2.00 range for most of the year. Spot or distressed product continues to see bargain hunting near or below $1.50/lb. WPI production in February fell 12% vs. last year, which helped pull stocks down 5% from January. Stocks remain 14% higher than last year, so it will take a few more months to bring the market back into balance. I am forecasting prices of WPI to get back to $3.00 by the second half of the year.