The McCully Report

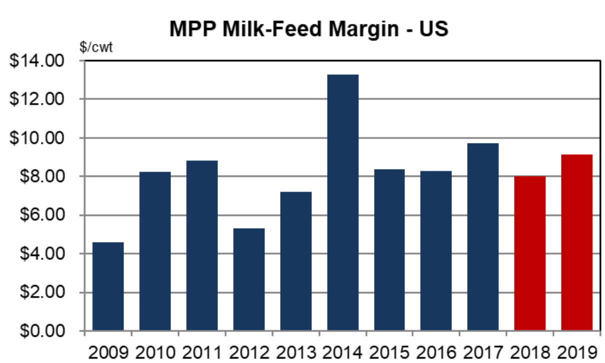
July 2018

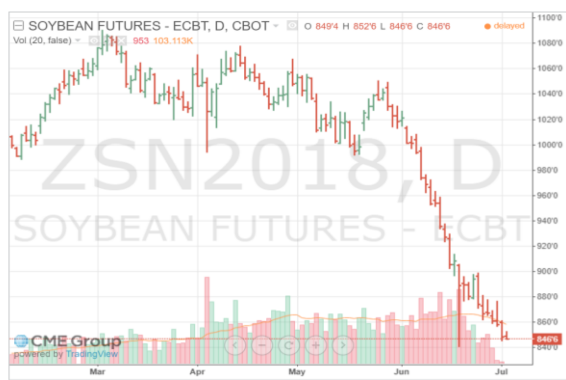
Feed Prices & Dairy Farm Margins

Summary: US dairy farmers were starting to see a rebound in milk prices only to watch them drop over the last month. Margins have actually held steady as grain/feed prices have fallen sharply due to great crop conditions and Chinese tariffs on soybeans.

The combination of excellent crop conditions in the US and Chinese tariffs have pushed grain prices to multi-year lows. Last week, the US corn crop was rated 76% good to excellent while soybeans were 71% good to excellent. Both ratings are a bit lower than prior week given the recent hot weather across the Midwest, but remain historically high. The June 29 Grain Stocks and Acreage reports were both near pre-report estimates, so little movement was seen in prices. The market's focus will now turn to weather during the critical corn pollination and soybean blooming periods over the next 4-6 weeks. Weather remains a watch-out, but the conditions are historically good, which points to very large corn and soybean crops.

While being a dairy farmer hasn't been that much fun lately, it's worse for grain farmers. Soybean prices have plunged to 10-year lows (graph below) and corn prices are down 10% or more in the last month. For the majority of US dairy farmers, this is good news as their feed purchases have gotten cheaper. The lower feed prices has helped offset the drop in milk prices, so the 2018 projected margin is nearly the same as last month. Using current futures prices, the 2019 margin is expected to be about $1/cwt higher than this year – a welcome relief from another year of disappointing farm returns in 2018.



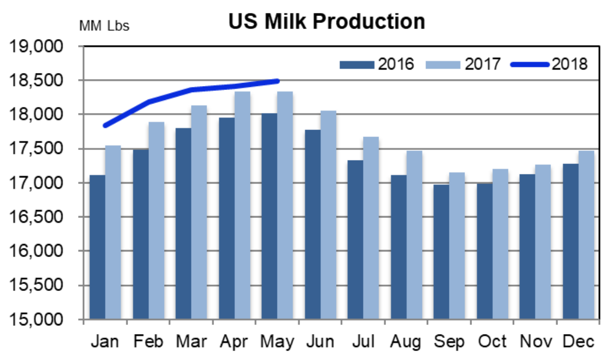


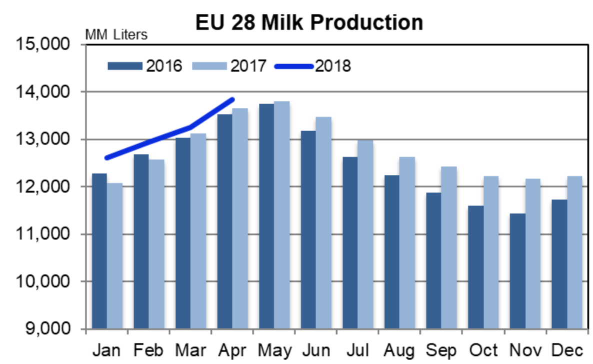
Milk Production

Summary: The rate of milk production growth in the US and Europe has slowed in recent months given poor early spring weather conditions and unfavorable margins (more so in the US).

For many years, a good rule of thumb was if US milk production growth was below 1%, prices would move up while growth over 2.5-3.0% was too much and would push prices lower. The weak growth seen this spring (+0.5% in April and +0.8% in May) would normally set the stage for higher prices and there was a mini-rally in April and early May. However, cow numbers remain historically high despite weekly culling numbers running above year ago. The main growth engine for US milk production remains in the Southwest and Mountain states. California was barely higher than year ago in May while Wisconsin rebounded to post a 1.1% gain. However, the East and Northeast continue to struggle with more farm sell outs and less milk. I expect June to see growth between 0.5-1.0% and then recover to around 1% growth in the second half of the year with the same regional differences. Another wave of hot, humid weather swept across the Midwest and East this past week, which negatively impacted milk output and components. Weather will be a key watch-out for the next 2 months.

The pace of growth in European milk production also slowed following severe winter weather and then a cold, wet start to spring in some countries. March production was up 1.1% while April rebounded slightly with 1.4% growth. Partial data from May shows only a slight increase vs. year ago, but I expect it to finish in the +1.0-1.5% range. Parts of Europe have experienced above normal temperatures this summer, so weather continues to be a challenge in some areas. Milk prices are starting to move higher as the commodity markets stabilize or improve. Friesland Campina recently announced a €1.5 increase to their July price to €35.75 per 100kg. This is the highest guaranteed price since February and they expect other companies to follow their lead by also raising their prices. Milk prices in the mid-30's should be supportive to additional milk output growth in the second half of the year. So, as long as weather doesn't derail things, I forecast milk production to grow 1-2% for the balance of the year, being mindful of the strong year-over-year comparison in Q4.





Trade

Summary: Over the last month, both Mexico and China have retaliated against the US with higher tariffs on cheese (Mexico) and most dairy products (China). The initial reaction by the US dairy market was broadly negative with prices falling sharply. The outcome and timing is uncertain, so the markets will remain nervous until the picture becomes more clear.

While the US focuses on tariffs and trade deficits with steel, aluminum, and automobiles, US agriculture has largely benefitted from exports. With the US now exporting roughly 1 day's milk production every week, sales outside the US are critical to the health of the dairy industry. While the retaliatory tariffs on US dairy products are problematic, there are multiple potential outcomes to these trade disputes.

Starting with Mexico, the US dairy industry sells $1.2 billion worth of dairy products to its southern neighbor each year and it is the #1 customer for US dairy exports. The US shipped nearly $400 million worth of cheese to Mexico in 2017 and accounted for 75% of the imported cheese market. Mexico is the top destination for US cheese exports and represented 28% of the total in 2017. Starting July 5, tariffs will increase by 10% on all cheese types. While the headline is bearish, the actual impact could be more nuanced. For perspective, the higher tariffs will only bring the US to the same level as tariffs on non-NAFTA trading partners such as the EU. Canada could benefit from lower tariff access, but its questionable whether they could be price competitive. In any event, the US will likely remain the lowest cost supplier due to location (cheaper freight), a high market share, and familiarity with buyers. The longer term threat is what happens in 2019 when the new EU-Mexico free trade agreement goes into effect with more access to EU cheese. Another wildcard is the new Mexican President Obrador, who has advocated for populist positions in the past. However, the initial signs are that the election removes a hurdle to completing the NAFTA talks. But then President Trump recently commented that he doesn't like how the deal is progressing and wants to postpone it until after the mid-term elections. Here are several scenarios to how this could play out:

1. Most likely scenario is cheese exports to Mexico fall modestly due to lower demand. Reports point to high inventories as buyers stocked up ahead of the increased tariffs. This could result in fewer purchases for several months, maybe until the tariff/NAFTA situation is resolved. Keep in mind that Mexico is more price sensitive than other countries, so they just might buy less for a while.
2. NAFTA deal renegotiated in Q3 and tariffs removed; this is the second mostly likely scenario. Minimal impact to cheese exports and prices.
3. No resolution to NAFTA deal and tariffs remain in place into 2019. This scenario is bearish to US cheese prices as the US would likely start to lose sales to Europe when the new FTA starts.
4. Trade dispute worsens and tariffs spread to other US dairy products. This is the most bearish scenario, but not that likely. US NFDM/milk powder would be hard hit by Mexican tariffs.

The trade dispute with China is more complex and will probably take longer to resolve, which is not good news for US dairy exporters. Unlike Mexico where only cheese is impacted, China retaliated with higher tariffs on most US dairy products. The US claims China has stolen US technology and limits market access in a variety of industries, among other issues. The tariffs charged by the US on Chinese imports have been met with quick retaliation from the Chinese government. In a meeting with a group of US and European CEO's several weeks ago, Chinese President Xi explained the difference in reaction between the West and China. To paraphrase, in the West, when slapped in the face, you turn the other direction. In China, you punch back. A headline on AP yesterday read "China says fully prepared if trade war kicks off this week." Bottom line – China is a formidable foe in this dispute. Here are several potential scenarios:

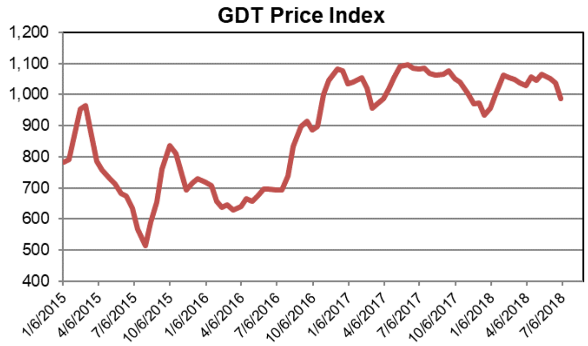
1. Most likely scenario is the tariffs stick around for a while. US dairy exports fall modestly, but prices decline to offset some of the tariff increase. Do US sellers discount prices to make the sale?
2. US dairy exports drop 25-50% as buyers shift to other supply regions. This is obviously bearish for US dairy prices, but less likely than #1.
3. The trade dispute drags into 2019. This would have more negative impacts on trade due to the uncertainty of future tariffs. Unfortunately, this scenario has a pretty high likelihood given the current dynamics of talks between the 2 countries.

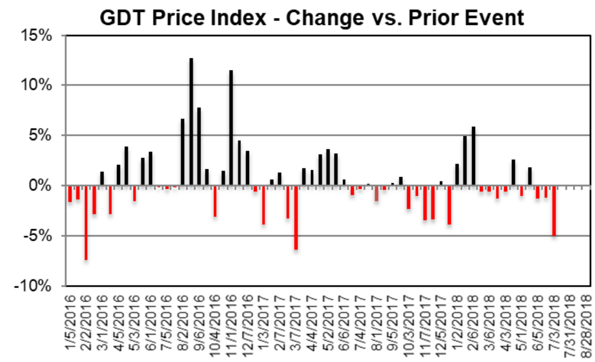
Dairy Market Outlook

Summary: Since early April, the market fundamentals had become more balanced and it appeared dairy prices were building a sustainable base to mount a modest rally in the second half of the year. But in the last month, a cascade of bearish news has hit dairy markets and pushed prices back near the lows seen earlier this year for some products. As detailed above, the trade disputes and tariffs are currently overwhelming the improving fundamental picture.

Milk output in early spring in the EU and US was below expectations and global dairy product demand was firm. As a result, prices for most products staged a mini-rally in April to mid-May. Prices leveled off for a few weeks, but then were hit with a raft of bearish news. The Mexican cheese tariffs and Chinese tariffs were followed by a bearish US Cold Storage report. In addition, EU butter prices have weakened, the EU SMP tender was disappointing and they announced the move to twice monthly auctions later this year, and then a rumor out of India claimed they would sell 60,000 MT of SMP over the next 6 months. The recovery in prices was fragile and the repeated body blows over the last month have been too much. As a result, dairy product prices have retreated, most significantly in the US, where the direct impact of the tariffs are being felt. However, the US trade issues are reverberating around the world. The July 3 GDT Event saw prices move lower across all major products. The 5% decline in the index is the largest since early March 2017 and the index is at the lowest point since January 2, 2018.

Dairy cannot escape the volatility being seen in other markets either. The price of US WTI crude oil hit the highest point since November 2014 this morning before falling sharply. There is talk of $80-85/barrel oil in the second half of the year, but higher Saudi output could be bearish to prices. Obviously, the uncertainty created by the Mexican and Chinese tariffs have been negative to dairy prices and other ag commodities. With the tariffs and potentially higher oil prices in the background, dairy prices in the second half of the year are expected to be more volatile with wider trading ranges.



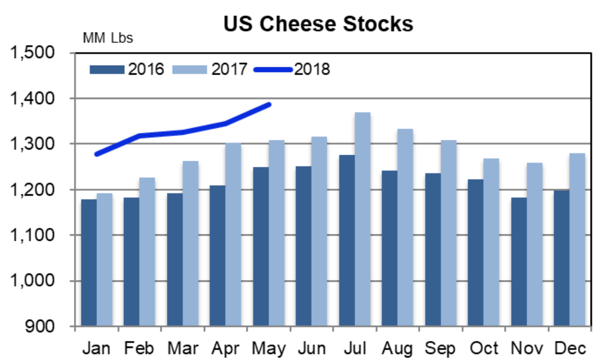


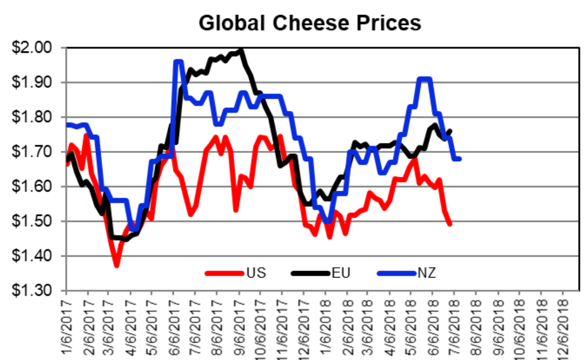
For buyers, prices look attractive relative to just a month or two ago. But, it's like catching a falling knife. For end-users that need some more second half coverage, take advantage to buy on the dips. Prices in 2019 are a little rich for some products, but with budget season starting, any further weakness could present a buying opportunity. For farmers or others at risk from lower prices, the market tone is weak, so take advantage of any rallies to place new hedges.

<u>Cheese</u>

Summary: US cheese prices have moved sharply lower over the last month under the weight of record high stocks and tariffs.

CME block cheese prices topped out near $1.70 in mid-May and have fallen $0.20/lb or so since then. The block-barrel spread has opened back up to the teens ($0.20's for a few days). Last month, I thought prices were establishing a base in the $1.60's-1.70's for the second half. But I think the Mexican and Chinese tariffs have taken $0.10 or so off of cheese prices, maybe more from a psychological standpoint than actual impact on trade. On the bullish side, weaker milk growth has translated to a little less cheese being produced and the discount US prices carry vs. Europe and NZ should keep exports moving. But the bearish side of the ledger has more entries – record high cheese stocks, less than robust domestic demand, additional cheese production capacity coming online, and the tariffs. I lowered my forecast back to where it was a few months ago with average cheese prices in the $1.50's and $1.60's for the balance of the year. For the upside risk, there would need to be a significant supply problem to see a sustained move above $1.75-1.80 - that is not expected at this time.

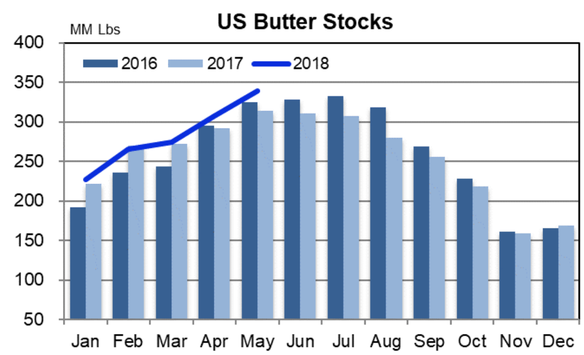


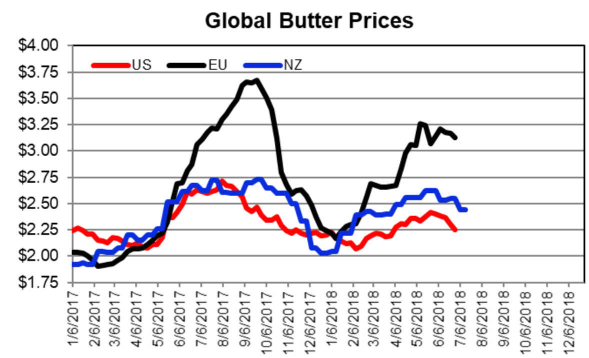


<u>Butter</u>

Summary: For months, the story in butter was the rally in European butter prices, but it is now about how they have moved lower in the last few weeks.

Last month, I bravely (or foolishly) predicted the rally in EU butter prices was about over. The day after I sent the report, EEX butter futures prices fell nearly €500/MT. Reported EU cash prices have also eased in the last month, which has taken the air out of the US butter market. I increased my forecast last month to $2.40-2.50 in the second half following a run into the $2.40's with futures in the $2.50's But the rally proved to be short-lived and butter, while not directly implicated in the ongoing tariff battles, became collateral damage in a broader downturn in US dairy prices. It looked like $2.25 would hold, but the CME price dropped to $2.20 on July 3. The cream and butter market fundamentals seem to be improving – less milk, hot weather, more cream demand (ice cream) – but the May 31 stocks number showed butter inventories to be more than adequate. A drop in GDT butter prices also feeds into the bearish tone of the butter market. At some point soon, I expect CME prices to stabilize and rebound. Given the problems in cheese and milk powder, I think butter will be hard pressed to get out of the $2.20-2.30 range until fall. At this point, a move beyond $2.40-2.50 is unlikely and would be a result of an unforeseen supply shock.





NFDM/SMP

Summary: Milk powder continues to be the weakest product in the dairy category with a new set of challenges coming out in the last month.

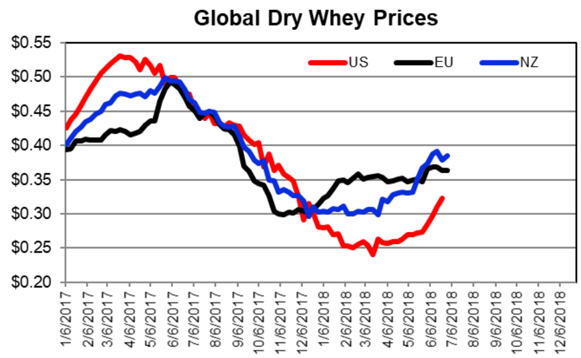
A month ago, the outlook for US NFDM/SMP prices appeared to be brighter. Stocks fell in April as exports were strong. Milk production growth with weak and milk powder production fell below year ago for the first time in over a year. Prices moved from $0.70 to the mid-$0.80's with active buying. The rally didn't last long as buyers were suspicious of higher prices and pulled back on purchases. The Chinese tariffs are troublesome for milk powder. While only 6% of total sales, that equates to 80 million lbs. – not an insignificant amount of product, particularly in an already oversupplied market. The market has retraced most of the spring rally with CME NFDM prices leveling out in the mid-$0.70's in the last week or so. I lowered my forecast, but believe prices can recover to the $0.80-0.85 range later this summer into fall.

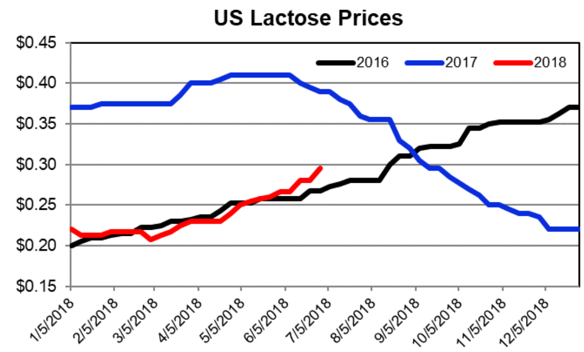
The global SMP market has been hit with some bearish news in the last 2 weeks as well. The European Commission sold 23.5K MT of SMP out of intervention stocks in June – that was down considerably from May's sale of 42K MT. Most of the product was sold at the minimum price of €1,195/MT ($0.67/lb). Intervention stocks currently sit at 585 million pounds, down from more than 800 million pounds earlier this year. In addition, it is reported that the European Commission will double the number of monthly tenders in an attempt to sell off its stock by the end of the year. There will be an additional tender in August and then twice per month starting in October. Some fear the additional product will put downward pressure on SMP prices. The other bearish piece of news for SMP was last week's rumor involving the potential sale of 60,000 MT of SMP from India over the next 6 months. This would be the most India has exported since 2014. Reports point to large domestic stocks of milk powder resulting in the need to export surplus product. In short, there is still plenty of milk powder in the global market.

Whey Products

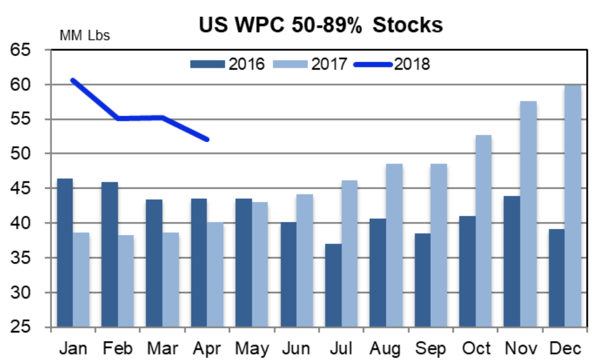
Summary: The fundamentals of the whey market have probably improved the most since early in the year with declining stocks and higher prices. However, the impact of Chinese tariffs on US whey products is still being sorted out.

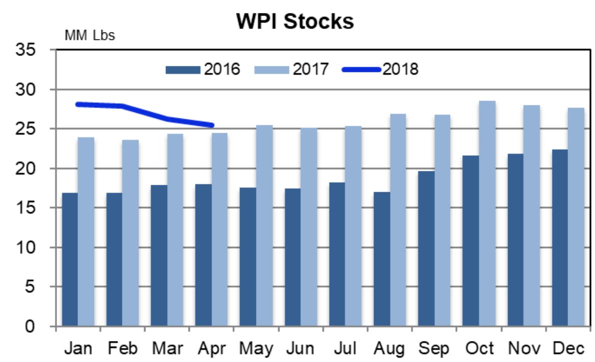
Dry whey stocks were 20% below year ago on April 30, demand is reportedly solid, and the gap between US and global prices is shrinking. For now, prices haven't shown much impact from the new Chinese tariffs. Given China buys roughly 50% of US dry whey exports, this would seemingly be a problem for the market. If sales to China actually drop, plants could shift production to WPC and WPI. But the WPC 80 and WPI markets are fragile and could likely tip back lower with additional supplies. Squeezing the whey balloon just moves the problem from one product to another. Given the resiliency in whey prices so far, I have kept my forecast the same as last month with NDPSR prices moving into the mid-$0.30's by Q4. Global prices have remained in the mid-upper $0.30's/lb. which is helping pull up the US NDSPR price.





The rest of the whey complex has more solid fundamentals for higher second half prices. The lactose market has advanced to near $0.30 with more gains expected as higher Q3 pricing gets reflected in the Dairy Market News price series. Demand has been strong for the last few months and some manufacturers are sold out for Q3 and even the rest of the year. I'm forecasting lactose prices to trade on par with dry whey prices.





The WPC and WPI markets also show signs of coming back into balance. The blow-out low prices seen earlier this year have removed the old stocks from the marketplace and have allowed prices to stabilize. Going forward, second half asking prices for WPC 80 range from $1.75-2.00 with limited sales above $2.00/lb. for preferred brands or specifications. WPI prices are near or above $3.00 per lb. depending on specification. As noted above, a shift out of dry whey into WPC or WPI could result in weaker prices. My forecast is slightly higher for WPC 80 for the second half of the year, but still with average prices below $2.00 per lb. Given dry whey prices in the low-mid $0.30's, margins at WPC manufacturers remain challenged.