The McCully Report

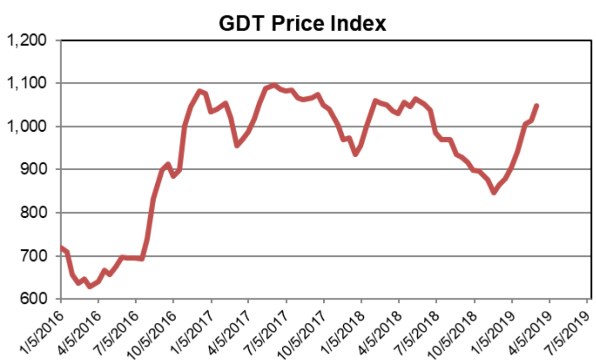
March 2019

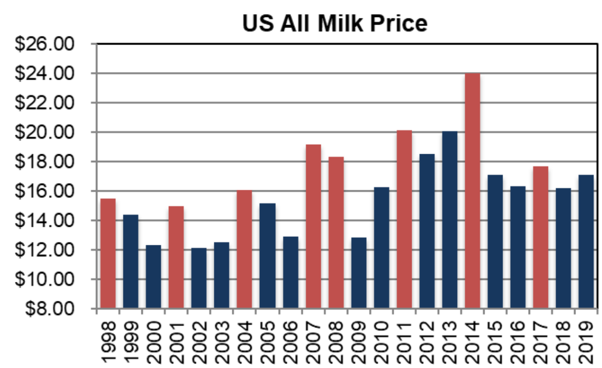
Dairy Market Outlook

The tone of the dairy market remains firm as supply and demand have swung back to balance. Fundamentals and price direction for individual products vary somewhat, but the general direction is for higher prices in 2019. The outlook for milk production in the US has become more concerning over the last month given elevated culling rates and weak growth in output. European milk production is expected to slowly return to positive growth while New Zealand offsets losses in Australia. Stocks of most products remain adequate and global demand is solid, which should maintain steady to slightly higher prices into Q2. Spring weather and milk output in Europe is a key factor for how the rest of the year unfolds for global dairy prices. Several other factors to watch are Brexit, US-China trade talks, and the global economy.

The GDT price index has rallied 22% since early December with WMP making up ground on SMP in the March 5th Event. Additional upside is expected as long as Chinese demand remains solid, but the pace of price increases will likely slow. The GDT index is approaching the high end of the range seen since mid-2014 and additional gains in WMP prices could push the index to 1,100 where it likely levels off.

While 2019 is young, it is worth looking out into 2020. Even though the 3-year cycle of milk/dairy prices has been less apparent in recent years, I believe it still points to a higher price year in 2020, especially given the contraction in the US dairy herd. With a modest inflationary environment and potential recession next year, it's hard to think another 2014 is in the offering. However, a cyclical high looks probable, but the magnitude is difficult to predict. Therefore, it may be prudent to start considering risk management strategies for next year in addition to this year's plans.





Feed Prices & Dairy Farm Margins

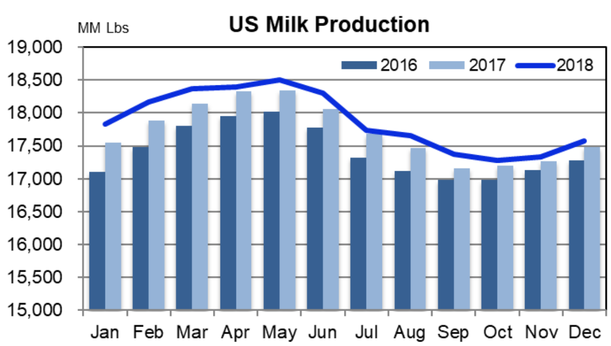
Summary: Dairy farm margins in the US are expected to improve modestly in 2019.

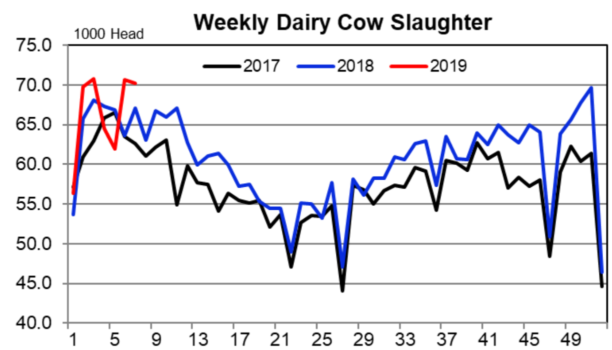
Grain prices continued their sideways pattern over the last month with small declines seen in corn and soybean meal prices. The market is starting to focus on the all-important quarterly grain stocks and prospective plantings reports on March 29. Information from those reports and early forecasts for spring weather will set the tone for grain prices. Steady feed prices have been welcomed by dairy farmers as current prices point to an improvement in margins this year of around $1/cwt. In addition, sign-up for the new Dairy Margin Coverage program will start in mid-June and the payout appears quite attractive for smaller farms. Better margins and DMC payments will help stabilize the national dairy herd.

Milk Production

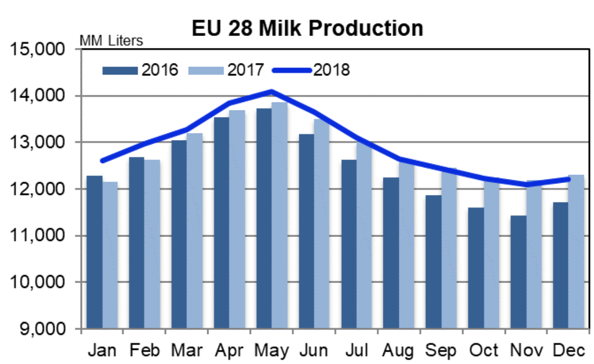
Summary: Milk production in the US is showing additional signs of contraction. Prospects for European milk production are looking up while Oceania output is mixed.

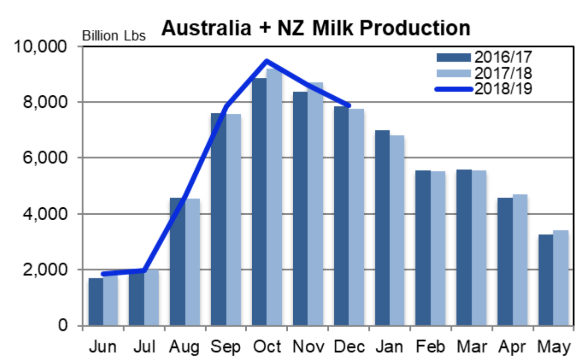
US milk production in December was up only 0.5% vs. prior year. October and November output was revised lower resulting in Q4 milk production increasing just 0.5% vs. Q4 2017 – the weakest Q4 growth rate since 2013. The regional disparities continued to widen with strong output in the West and Southwest offsetting lower production in the East. Six states, all east of the Mississippi, saw production drop more than 4% vs. prior year. Cow numbers fell 3,000 head during December while prior months saw downward revisions. This trend is expected to continue as weekly dairy cow slaughter has run well above year ago since last fall. In fact, through the first seven weeks of 2019, three weeks saw over 70,000 head sent to market, which is remarkable considering from 1996 through 2018 there had only been a total of four weeks above 70,000 head. An additional data point from USDA last week points to continued contraction in the dairy herd as replacement heifers fell to the lowest point since January 1, 2014. This has implications for the US dairy herd and dairy prices for the next several years. Anecdotally, farmers have waited for beef prices to rebound before sending more cows to market or selling out. The farm margin situation is expected to improve, but for some, it's too late. Cow numbers were expected to level off near 9.35 million head, but that looks optimistic now. With more downside forecasted for cow numbers, Q1 production could struggle to grow 0.5% vs. last year. As farm conditions improve, milk output should increase, but only modestly with growth near 1%, a level that has usually resulted in higher dairy prices.





In Europe, milk production ended the year as expected with December falling 0.8% vs. prior year, keeping in mind the strong growth seen in Q4 2017. Output in the Netherlands is still suffering from phosphate regulations – December production was 6% below prior year while January was down 5%. Production was also lower in Germany (-1%) and France (-3%) in December while Ireland was sharply higher (+25%). Preliminary data for January point to continued weakness in France and Germany, but the trend is improving in Germany. Spring has arrived early in some parts of Europe and with good weather, as opposed to last year's severe winter and summer drought, there is optimism for solid milk growth this year. Farms are profitable with milk prices in the mid-30's (Euro/100 kg), so there is a market signal to expand production. How this plays out will be a key to the global dairy market for the rest of the year.



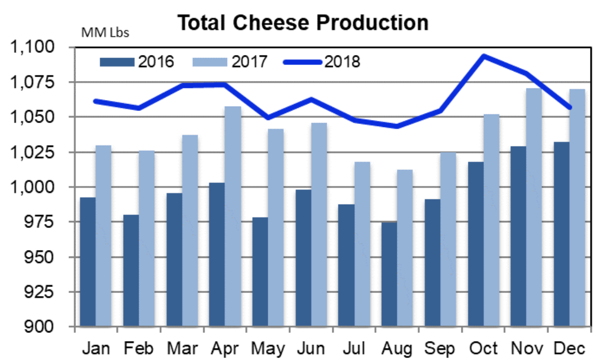


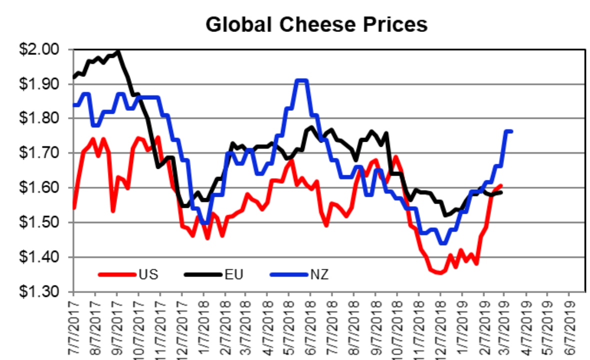
Milk production is mixed in Oceania with output in New Zealand more than enough to offset the declines in Australia given serious drought conditions in parts of the country. Following the increase in GDT prices in mid-February, Fonterra boosted its milk price forecast from NZ$6.00-6.30kg milk solids to NZ$6.30-6.60. This should be supportive to late season production in New Zealand if the weather cooperates.

Cheese

Summary: US cheese market fundamentals have become less bearish in the last month. Following the lead of NZ prices, US and European prices are expected to move higher as the year progresses.

As USDA gets caught up on reports, recent data on US cheese production was surprising. December total cheese production was down 1.2% from prior year – the first year-over-year decline since March 2013 and the largest % drop since July 2011. While Mozzarella production was up 3.7%, American styles were 4.4% below prior year with Cheddar falling 6.3%. Gouda output was off 28% implying weak export demand. December 31 stocks remained above year ago levels, but the gap to prior year narrowed from recent months. The March 7 Cold Storage report will provide more timely data on January 31 stocks levels. CME cheese prices have moved higher over the last month as fresh cheese supplies have become tighter. My Q2 prediction of $1.45-1.60 block cheese came early. I have increased my price forecast over the year as less milk production will eventually manifest itself in less cheese production in some areas. But helping offset that will be new cheese production capacity in South Dakota and Wisconsin by summer. Given what is known today, I do not envision CME block prices exceeding $1.75-1.80 this year unless global prices rally and pull US prices up with them.



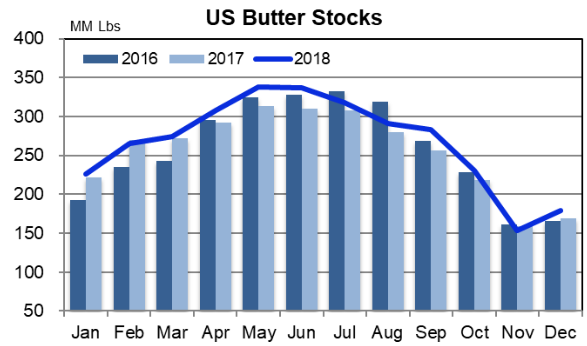


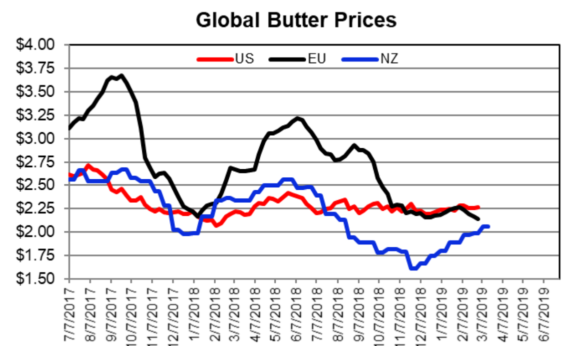
European cheese prices have been flat for most of the year while NZ prices have climbed higher. As milk growth increases seasonally in Europe, cheese production is expected to also rise, although better valorization rates from butter and milk powder could pull some marginal milk away from cheese plants. Brexit is a watch-out as it could be quite disruptive to Ireland's dairy industry given a high percent of their production goes to the UK. Without access to the UK market, Irish dairy companies would be forced to find new homes for their product on the global market.

Butter

Summary: Despite a bearish stocks report, US butter prices remain range bound. European prices show signs of weakness while NZ prices slowly close the gap to the US and Europe.

After months of trading within a narrow range, CME butter prices rallied on March 4 to their highest level since last August, but quickly fell back below $2.30 the next day. The fundamentals are mixed. Cream supplies in the East are reportedly tighter than prior years. Spot cream multiples are higher than year ago, but in the mid-teens, cannot be called expensive. Cream supplies are more abundant in the West with conditions called "sloppy" at times. December production data was benign with a 0.1% drop vs. prior year. However, the December 31 inventory number appeared to be bearish. Butter stocks on December 31 were 179MM lbs. – 6.2% higher than year ago and up nearly 17% from November 30. This was the highest ending stocks for December 31 since 1993. Butter stocks increased by 26MM lbs. during December – well above the 5-year average of 5MM lbs. Yet, butter prices have moved higher since the report. The old saying is when bearish news comes out and prices don't drop, it's not bearish. Also in play is the annual March 1 "old crop-new crop" switch-over that usually results in a brief rally in early March. With a late Easter and Passover this year, butter prices are likely to remain firm in March. However, the March 7 stocks report will be closely watched to gauge inventory build to start the year. My forecast is mostly unchanged as I don't believe there is much upside in US prices at this point. The US is premium to other regions, so exports will be minimal. Pent-up end user demand likely cools in the $2.30's as prices exceed their budgets. I forecast a modest pull-back in prices in the spring although some contacts point to the potential for sub-$2.20 butter during the flush. But as long as global prices remain below the US and cream supplies are adequate, US butter prices are forecasted to continue trading in a narrow band between $2.20 and the low-mid $2.30's.



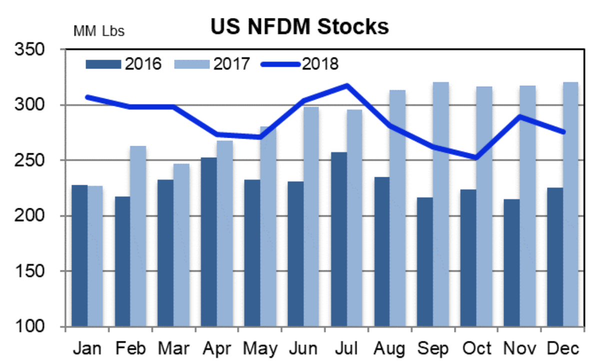


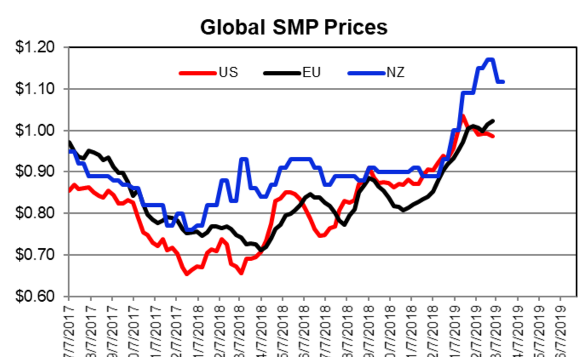
European butter prices have shown signs of weakness over the last month slipping over €200/MT ($0.11/lb.). EEX futures for the year are in the low-mid €4,000's, likely a good place for buyers to get coverage given the volatility of the last few years. New Zealand prices are slowly making their way back up after hitting a 2-year low last October. I expect global butter prices to converge by Q2, and with balanced supply-demand conditions, remain relatively stable in the second half of the year.

Milk Powders

Summary: The rally in SMP/NFDM prices has stalled out.

In the US, December NFDM/SMP production continued its seasonal recovery with output hitting the highest point since June. However, total production was still 10% below prior year levels. The outlook varies regionally with lower milk supplies in the East expected to short powder plants while more milk is pushed into the powder plants in the West. One previously shuttered plant in California has re-opened to handle the spring flush (condensed milk only at this time) while a new, large plant is preparing to open in Texas. My forecast reflects continued weakness into the spring flush, but prices are not expected to fall below the mid-$0.90's where there is likely strong demand from buyers. I continue to believe prices will rebound by mid-year with prices moving up to $1.05-1.10 with additional upside possible to $1.15-1.20.



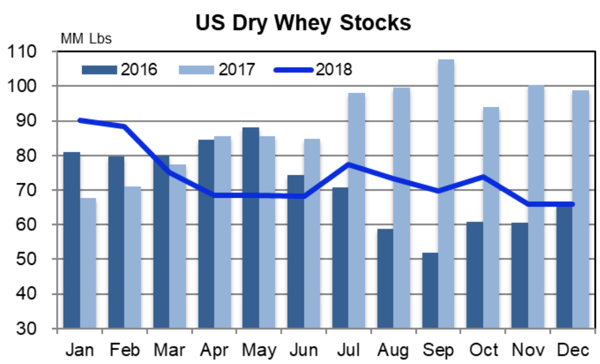


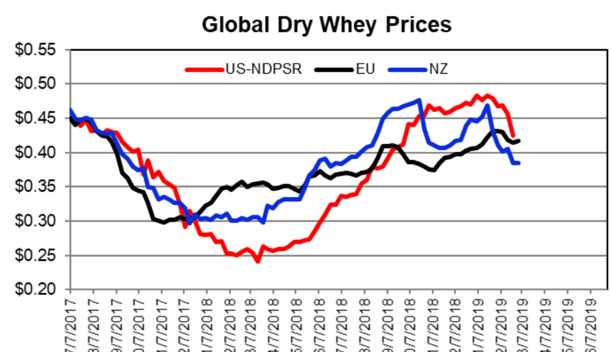
Global SMP prices have been firm with European prices approaching €1,950/MT although NZ/GDT prices dropped 5% on March 45 after rallying 24% since the beginning of the year. In Europe, the SMP intervention stocks are practically gone and export demand has been strong. SMP exports in December were 75K MT, 35% above prior year and 11% above November, fueled by solid growth in China and Southeast Asia. Chinese milk powder imports are off to a strong start in January. China imported 129 million pounds of SMP, 25% above last year's record volume. WMP imports were just over 400 million pounds, 32% higher than last year's total. Infant formula imports were also up considerably – 38% higher than last year. This helps explain the strength in NZ/GDT prices as NZ supplied a large share of Chinese milk powder imports in January – 98% of WMP and 76% of SMP. While Europe is the key watch-out on the supply side, China remains the key factor for global dairy demand in 2019. I continue to forecast NZ WMP prices to trade in a range between $3,000-3,500/MT with SMP prices falling back to the middle of their range ($2,300-2,700/MT) as WMP vs. SMP+butter/AMF values come back into balance.

Whey Products

Summary: The whey market has split with firm pricing on the higher protein products, but softer prices for the carbohydrates.

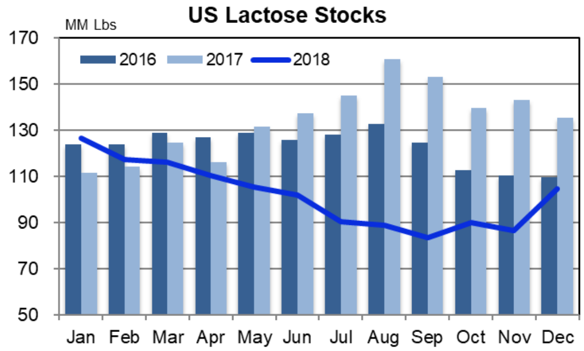
Prices for dry whey and whey permeate are under pressure in the US. CME dry whey prices have traded in the mid-$0.30's for over a month and the NDPSR price has dropped to the low $0.40's. The market tone is weak as exports have fallen, particularly whey permeate to China. Despite production being down 13% vs. year ago in December, dry whey stocks were unchanged from November implying soft demand. Stocks remained well below year ago levels on December 31. However, some production has shifted to dry whey out of high protein products and the Lake Norden expansion is reportedly going to only make dry whey when they start up. A resolution in the US-China trade talks would be positive for the US whey market. But until then, NDPSR prices are forecasted to slide lower and trade near $0.40, an area where global prices have converged. Lactose prices have also likely seen their highs for the year and are forecasted to slowly decline as the year progresses as supplies become more available.

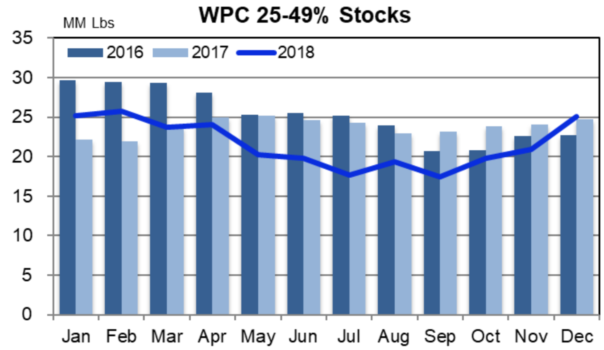




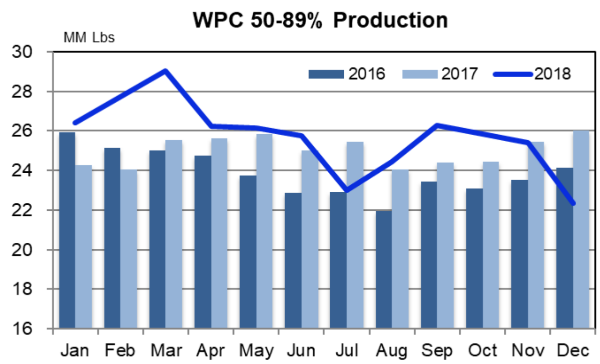
Chinese whey demand has eased lower in recent months as tariffs on US products and African swine fever dampen demand. Total whey product imports in January were 1.2% lower than last year's high volumes. Due to the trade war, US whey suppliers have lost market share, largely to Europe, with January's share dropping to 30% - the second lowest in the last decade only behind November 2018. The total volume for US whey powder exports were the second lowest in nearly three years. In another bearish sign for whey demand, African swine fever has reportedly spread to Vietnam, which is one of the largest pork producers in the world. Vietnam represents about 10% of US whey exports.

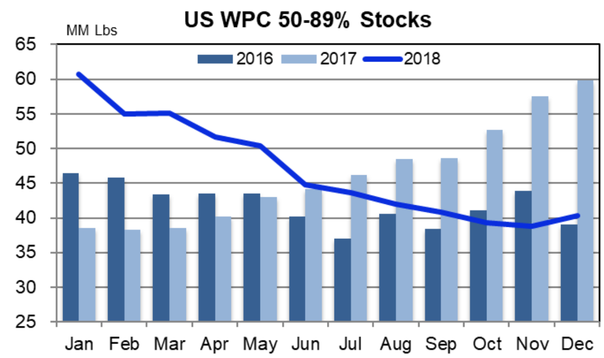
While prices for the carbohydrates in the whey complex move lower, proteins remain firm. The average US WPC 34 price hit $0.90 last week, the highest point since June 2017. Production in December was nearly 18% above prior year levels and stocks have been building in recent months. On December 31, WPC 34 stocks were above prior year levels for the first time since March 2018. Prices are forecasted to stabilize near current levels in Q2 and then increase to the mid-upper $0.90's in the second half of the year. Stronger NFDM/SMP prices will provide support, but will be offset by increased production.





The WPC 80 and WPI markets remain firm with good demand and confident sellers. Commodity WPC 80 prices are reportedly in the $2.35-2.50 range while instantized products with additional specs are $2.75-3.00. December production of WPC 80 was 14% below last year while WPI production was up 9%. But stocks moved in opposite directions from production with WPC 80 stocks increasing 4% during the month while WPI stocks dropped about 4% from November. Stocks for each are considerably below last year's levels with WPC 80 down 33% and WPI stocks 15% below last December 31. In discussions with buyers and sellers, it seems the updraft in prices last fall caught some buyers off guard with some short product. The scramble pushed prices up to levels not seen in over a year. Prices have leveled off and are forecasted to remain firm. Manufacturers are trying to recapture lost margins over the past year. Even with $2.75 WPC 80 and $0.40 dry whey, they have only got back to a normal, profitable margin. And with falling whey permeate prices, the economics are still not fantastic. My forecast is for modest gains through the balance of the year, contrary to some other estimates I've seen for lower prices. Production is expected to remain weak, which is supportive to prices. Of the new cheese production capacity coming online this year, only one will produce WPC 80, and it is a small expansion.





The Giants Tumble

While the poor economic conditions for US dairy farms have been well publicized over the last year or more, recent weeks have seen pretty awful news from two of the biggest names in the US dairy industry – Kraft Heinz and Dean Foods. On February 21, Kraft announced quarterly results that missed analyst calls for revenue and earnings. They also slashed their dividend by a third, wrote down over $15 billion in goodwill and intangibles, and disclosed an SEC probe into their accounting and procurement practices. Investors pummeled KHC stock the next day sending it down nearly 30% at one point. The stock price eroded more last week before stabilizing, but has lost nearly two-thirds of its value in the last 2 years.

Kraft Heinz Stock Price

The news was even worse from Dean Foods on February 27 as they posted weaker than expected earnings and suspended their dividend. But the most dramatic news was the announcement they are exploring strategic options, including a potential sale of the company. The stock price has lost over half its value since July 2018. In addition to macro headwinds facing fluid milk, Amazon has a new private label milk brand and announced last week they are entering retail grocery, which pushed stock prices of other grocery chains lower. The question is whether Dean Foods can create a strategy that both stabilizes their business and allows it to grow in the future. Their recent 8K and 10K SEC filings make for somber reading and highlight the challenges they have in front of them.

Dean Foods Stock Price

What does this say about the US dairy industry and its future? Everyone seems to be losing money – farms, processors, traders, brands, etc. There is a crisis in the US dairy industry, yet no one seems to be talking much about it. Why are dairy companies in other countries making money and US companies are not? Would dairy farmers say Federal Orders are helping them? Does the US have the right policies in place to attract investment and reward risk? Can the US compete in the world market? And how will dairy companies respond to non-dairy entrants into their market like Perfect Day? Over the next few months, I plan on exploring these issues in more depth and offer thoughts on how the industry can move forward. I believe it is imperative to the future of the US dairy industry to develop a long-term strategy to ensure the viability of every sector of the dairy supply chain.