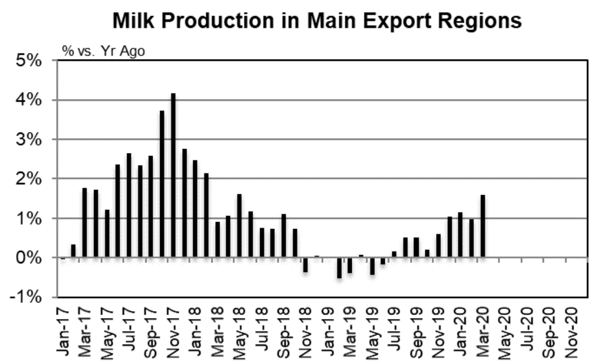
The McCully Report

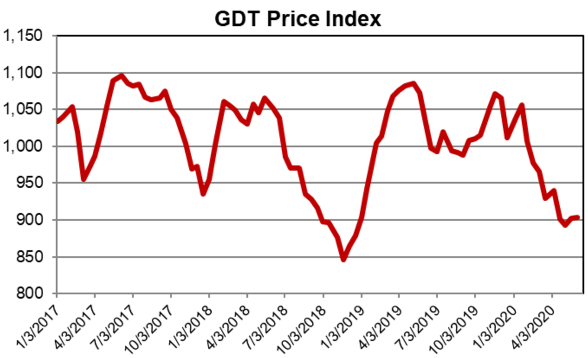
June 2020

Dairy Market Outlook

What a difference a month makes. US cheese and butter prices increased 102% and 60%, respectively, since May 5, leaving many wondering what is going on. For cheese, a perfect storm of increasing demand and shrinking supply led to tight availability of fresh cheese. Similarly, butter prices jumped to $2.00 on June 5 due to very tight cream supplies, despite ample butter stocks. Milk powder and whey product prices have been much less volatile, and are responding to different supply and demand conditions. Like the stock market, at times it seems as if the dairy markets are ignoring the impacts from COVID-19 and what's likely to be a severe recession. The demand outlook is uncertain and the rally in cheese and butter prices appears overdone. Dairy markets are trying to find a new equilibrium point, but that might take a few more months. Until that happens, prices will remain volatile.

Global milk production posted solid growth in Q1 with output from the major exporting regions up 1.6%, the highest in nearly 2 years. The shock from shutting down large portions of the global economy resulted in a sharp drop in demand. As countries re-open their economies, demand is recovering, but at an uneven pace. How much business can a restaurant do with 50% of their tables, and is that sustainable for more than a couple months? The supply outlook is fairly clear, but the demand picture is cloudy at best.





Feed Prices & Dairy Farm Margins

Summary: The outlook for US dairy farm margins has improved dramatically over the last month given the rebound in milk prices and steady to lower grain/feed prices.

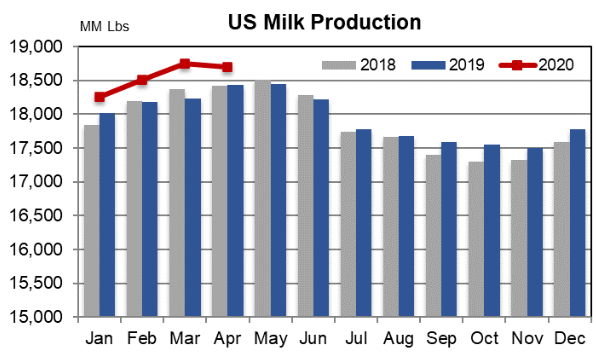
This year's grain crop in the US is off to a far better start than last year's rain-soaked spring. Planting progress is ahead of average, and with good summer weather, this year's corn and soybean crops are projected to be large to record large. Demand is uneven with ethanol production picking up (positive for corn), but uncertainty over Chinese trade pulled prices for soybeans and soybean meal lower.

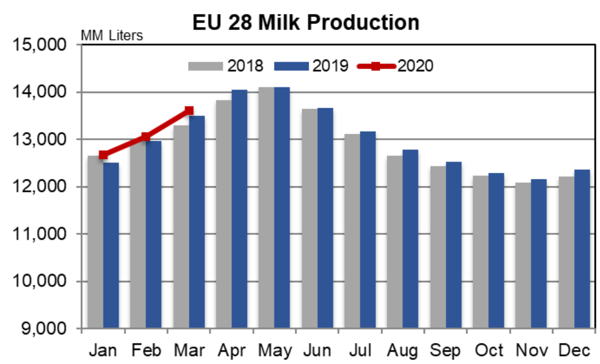
Dairy farmers in the US have seen a rapid change in the milk price outlook since early May. On April 22, June class 3 milk futures hit $10.68. On June 5, they are $19.80 – an increase of 85%! While April and May milk prices were very low, the USDA CFAP payment of $6.20/cwt on Q1 production will help offset those losses, particularly for small to mid-size farms. However, the $250,000 payment limit means large farms won't fully benefit from the program. The recovery in milk prices, low feed prices, and USDA payments should combine to help keep farms and dairy cows in business. This is supportive to more milk production growth in the second half of the year.

Milk Production

Summary: US milk production slowed in April while growth in European output remained steady in Q1 near 1%.

US milk production rose 1.4% vs. year ago in April, dropping from a robust growth rate of 2.8% in March, which was the strongest since November 2016. After large volumes of milk were dumped in the first few weeks of April, supply cut-back programs from cooperatives and milk buyers put the brakes on milk production. In the Northeast, as an example, 131 million lbs. of milk were dumped in April, up 120 million from last year. This is 4 million lbs. more per day on average or 80 tanker loads. In response, farmers quickly adjusted rations, transitioned cows to fewer milkings per day, and either dried off or culled cows, and milk supplies fell quickly. As demand increased in May, the lower milk supplies have played a part in the sharp rebound in prices. But with a much better outlook for farm margins and high milk prices, the signal to dairy farms is to increase production. In recent days and weeks, the supply restrictions placed in April have started to come off. It appears the Southwest will be the last region of the US to remove growth limits. This region experienced the most growth pre-COVID, so it will drag down US milk production growth to some extent. Despite this, I have increased my outlook for milk production for the second half of the year believing the US can grow 1-2%. Cow numbers are forecasted to stabilize and even start to grow again as culling in recent weeks has fallen back below year ago levels.





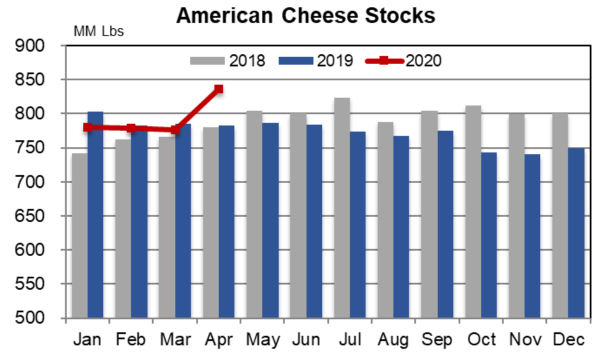
Milk production in Europe grew 0.9% vs. prior year in March resulting in Q1 growth of 1%. There are indications growth is slowing in Q2 as COVID impacts become more visible. The EU average milk price fell to €34.77 per 100 kg in April – down just over €1 from February. Reported prices in May have seen additional erosion with milk prices in Ireland slipping into the upper €20's. Early data for April show continued milk growth in some countries with Ireland up 3% and The Netherlands up 2%, helping to offset a 2% loss in the UK. In May, weekly data point to a drop in French milk production of around 1%. Lower prices and weather challenges in some countries are likely to result in a slower growth rate into the summer. Last month, I lowered my forecast for the year from near 1% to 0.5% or less, which I am holding this month.

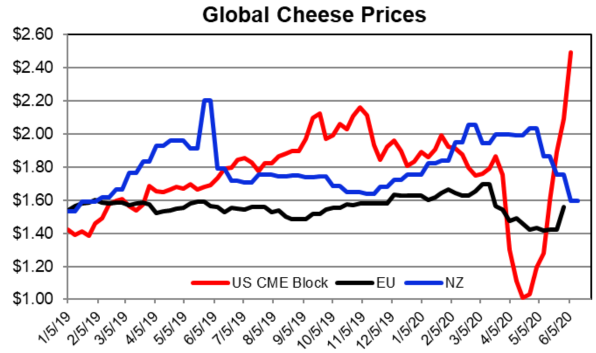
Oceania milk production was up 1.5% in April, the strongest growth rate since January 2019. Milk production was still down in New Zealand with a 0.6% decline vs. prior year, but Australia posted another strong month of growth, up over 6%. However, the shortfall in New Zealand has a larger impact on export markets as a greater percentage of Australian milk is used in the domestic market. The outlook for the next season is for lower prices given the downturn in the global economy. Fonterra recently forecasted a farmgate milk price between NZ$5.40 to NZ$6.90 per kilogram of milk solids for the 2020-21 season. This is down from the current season's range of NZ$7.10-NZ$7.30. Lower milk prices and this season's drought on the North island point to limited growth, or a small decline, in NZ milk production next season. If global demand recovers, tighter supplies would lead to higher prices.

Cheese

Summary: CME cheese prices overreacted on the downside and are now overreacting on the upside. In only 34 trading sessions, prices went from $1.00 to $2.50.

The US cheese market has swung from extreme surplus to extreme deficit in 6 weeks. The surprise news of additional USDA purchases for food box programs got the market moving in early May. Since then, continued strong retail demand, up 20-25% in May, along with aggressive pipeline refilling for foodservice has taken up any extra cheese. In addition, the short spell of really low prices spurred export sales for May and June. In short, this confluence of factors has driven CME cheese prices to record highs… a stunning turnaround in less than 2 months. But the storm is expected to pass soon. By mid-month, export shipments will have been filled, the foodservice pipeline will get replenished, and retail demand could slow. The CME block rally was on very light volume, so the drop in prices could occur as fast as the increase.





The USDA food box program is expected to end soon and there are questions as to how much of the promised aid has actually been delivered. One of the most publicized stories of problems with the program is the San Antonio events planning company CRE8AD8 that got a $39 million contract to deliver 750,000 boxes. A news report on June 3 noted they had delivered only 685 boxes and would have trouble meeting the June 30 deadline. More broadly, if bids were accepted in late April or early May, it's likely those bids were based off cheese and butter prices nearly half of what they cost today. Do those companies renege on the bids or fill them and lose large sums of money? For more reading, here is a link to an article I saw today - https://thecounter.org/usda-food-boxes-wholesale-milk-retail-prices-covid-19-snap/

My forecast for CME cheese prices is for potential additional strength in the short-term, but significantly lower prices into the second half of the year. Last month, I thought prices would rebound to the $1.60-1.70's, but have updated my forecast to a range of $1.75-2.00 in the second half. However, it will be a bumpy ride to get there. Cheese stocks rose sharply in April, but May 31 data is expected to show a drop back to normal levels. The cheese market is searching to find equilibrium and that likely won't happen for a few months. The pendulum rapidly swung from too much to not enough cheese, and will swing back as milk and cheese production and demand find balance.

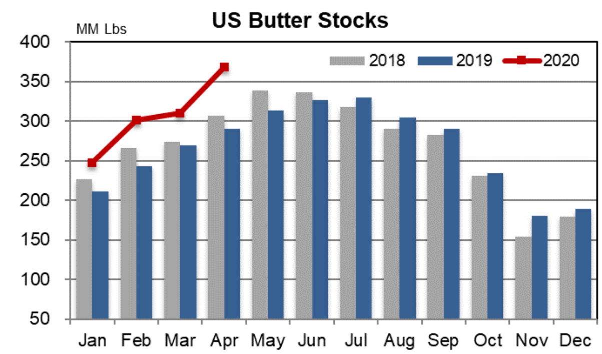
Once again, the US dairy industry needs to ask whether it has the best price discovery methods for dairy products. The CME spot markets for commodity products are used to price a large portion of dairy products and milk in the US. The spot market is by definition volatile as it is the market of last resort. In effect, the US dairy pricing system is driven by the price of the marginal load of product on a thinly traded spot market. There has been significant economic harm across the dairy value chain over the last few months. It is instructive to compare the volatility in US dairy prices to Europe and New Zealand and ask if the US dairy industry is best served by the current pricing system for dairy products and milk. Breaking the link between commodity products and the FMMO milk price formulas would be a good start.

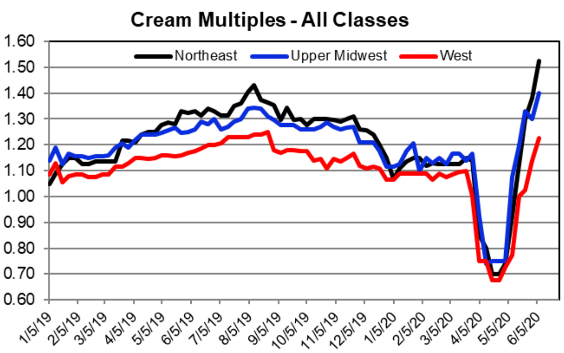
Last month, there was a very wide gap between US and New Zealand cheese prices with the US well below NZ. That has now reversed itself with US prices far above both NZ and European prices which are converging near $1.60/lb. (€3,200-3,300/MT). European prices have rallied 10-15% off their lows, yet remain below NZ and US prices. This should help European exports and could push prices higher in the second half of the year if that is combined with lower milk and cheese output.

Butter

Summary: US butter prices surged above $2.00 despite high stocks, but dropped back the next day.

The market outlook for butter has also changed dramatically in the last month. While April butter production was 25% above prior year and April 30 butter stocks rose to the highest level since the early 1990's, CME butter prices staged a surprising rally crossing over $2.00 on June 4. The rally wasn't long-lived as prices fell $0.09 on June 5. My price forecast back in January, pre-COVID, was for US butter prices to trade in a range from $1.75-2.00 in the second half of the year. And while butter stocks could approach 400 million lbs. on May 31, tight cream supplies and 30-60+% growth in retail butter sales have supported higher prices than envisioned last month. Cream multiples went from historic lows in April to the 1.50-1.60's this week on very strong demand. Ice cream plants are reportedly running strong and cheese plants can buy cream cheaper than class 3 milk components, so less cream is going to churns. More so than cheese, butter stocks will matter at some point, whether they are in bulk or print format. Cream markets are generally tight through the summer, but are expected to cool off this fall, if not sooner. Butter prices will remain on edge, but the supply fundamentals do not support sustained prices above $2.00.



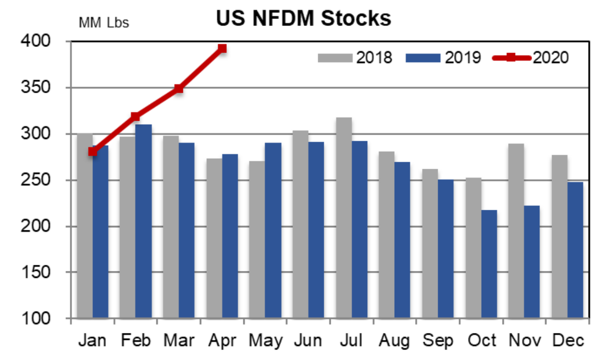


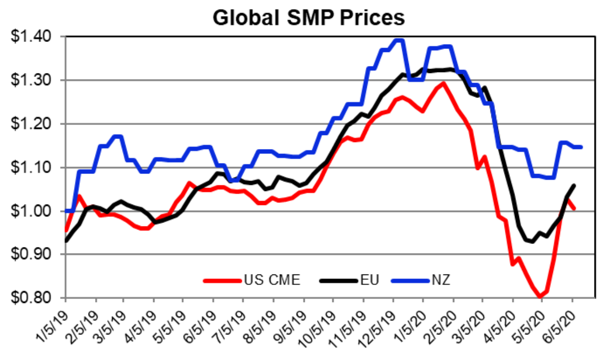
European butter prices have recovered over the last month while NZ prices have fallen, converging in the $1.50-1.60 area (€3,100/MT). EEX butter futures moved up €500/MT over the last month and range from €3,200-3,500/MT for the rest of the year. Fat supplies remain long given the drop in foodservice demand, so upside in butter and AMF prices is limited for now.

Milk Powders

Summary: The mood in the milk powder market is less bullish given buyer push-back at higher prices and abundant supplies.

Like butter, NFDM prices have moved higher over the last month despite high stocks levels. Milk powder production in the US was 4.5% above year ago in April as excess milk moved to balancing plants. While exports were strong, up 20% from last April, April stocks grew 44 million lbs. (+12.5% vs. March) and ended April at 393 million lbs., the highest private stocks level in history. Conditions did change in May which supported the recovery in prices. Buyers in Mexico took advantage of lower US prices as did buyers in other regions. Exports have reportedly been much stronger in recent weeks and there is a huge incentive to add powder to cheese vats. But, as prices crossed over $1.00, buyers started to ease up and CME NFDM prices slumped back to $0.98 on June 5. My forecast has been raised since last month, but not to the same degree as cheese and butter. I expected prices to range between $0.90-1.00 in the second half, but the forecast has been increased by about $0.10 vs. last month given stronger European prices and a better than expected rebound in demand.





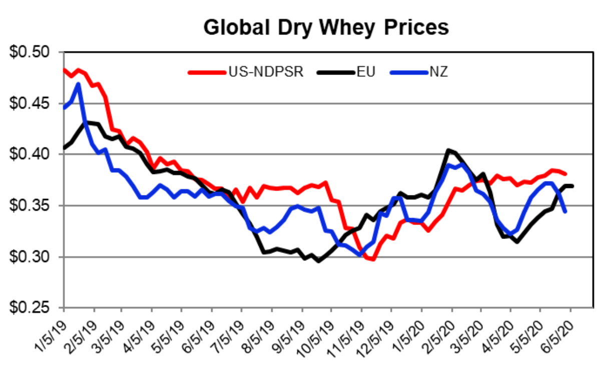
Global trade in milk powder has been disrupted over the last few months due to COVID, but there are signs of recovery. In April, Mexico's imports of SMP fell 31% vs. last year, the lowest in 39 months. For the first 4 months of the year, imports were down 11% vs. 2019 as domestic milk production increased 2.3%, and buyers' purchasing power was negatively affected by a sharply lower Peso. Anecdotal reports point to a recovery in May imports as buyers took advantage of low prices. China's recovery was evident in April with WMP imports up 22% vs. last year although SMP imports were 4% below prior year. Low oil prices hurt the buying power of some key milk powder importers, but there are signs of the oil market stabilizing as well, albeit at lower than pre-COVID levels.

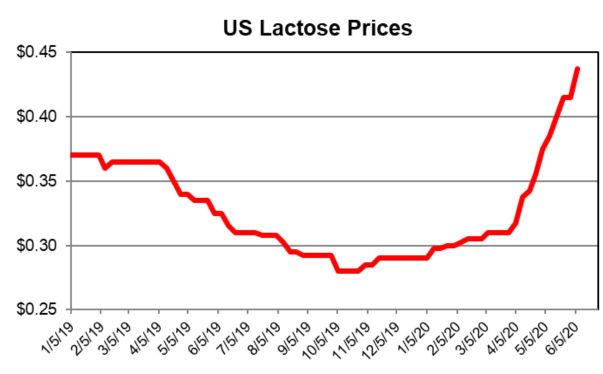
SMP prices in Europe have moved higher over the last month while NZ/GDT prices bounced back up to March-April levels. In Europe, EEX SMP prices rose to over €2,100/MT this week, the highest price since late March. NZ/GDT prices have been $2,500-2,550 over the last 2 trading sessions, and are expected to trade at a premium to European and US prices until the new season begins in several months. The talk of SMP going into the EU intervention program has long passed, and the amount of dairy products that went into the private storage scheme probably won't have much impact on the market.

Whey Products

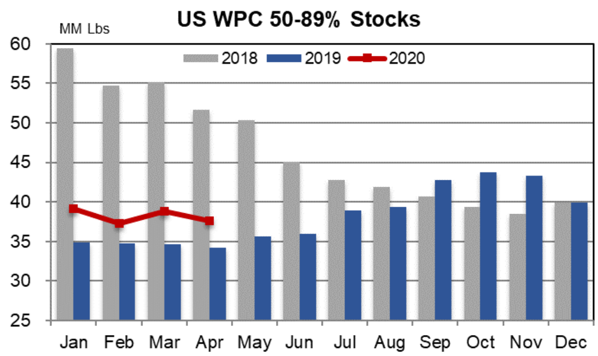
Summary: The tone of the whey market has changed over the last month with downward pressure seen on prices for dry whey, WPC 80, and WPI, while lactose continues to spike higher.

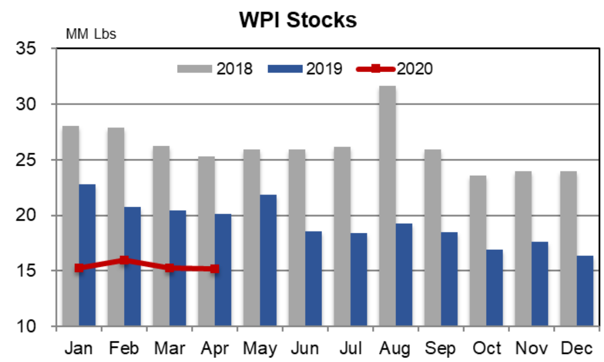
The 1.7% drop in US cheese production in April drove production of most whey products lower, except for dry whey. Stocks of dry whey increased 4% from March, but April 30 stocks were flat vs. prior year given a 20% jump in exports during April. However, as cheese production picked back up in May, whey production has moved higher, and prices have reacted by falling from $0.40 back to the low-mid $0.30's on the CME. Prices across the different indices and regions are within a few cents of $0.35, and are forecasted to remain in the mid-upper $0.30's for the balance of the year.





Lactose prices continue to hit multi-year highs, driven by aggressive Chinese buying. The European price on GDT jumped to $1,341/MT on May 19, the highest price ever on the GDT platform. The US AOM price moved up to $0.4375 this week with more gains expected. There have been scattered reports of $0.50 lactose for Q3, but demand is expected to slow. The GDT price fell 5% this week and there are reports of aggressive stockpiling by Chinese buyers. My forecast is for firm prices for the next 1-2 months and then easing lower given weaker dry whey prices and a drop-off in demand. April 30 stocks in the US were 16% below year ago, so it will take a few months of stronger production and stock building to cool the rally off.





The WPC 80 and WPI market is unsettled with strong demand and pricing for Asia, but weak demand and pricing for other regions and the US market. Prices for WPC 80 had been around $2.20-2.30 earlier this year as strong demand for energy bars and other products kept stocks relatively tight and supported prices. The current market for WPC 80 and WPI is solid into Asia with Chinese buyers noted to be more concerned about supply surety than prices. But buyers in other regions have pulled back considerably. In the US market, manufacturers in the Midwest and East are seeing soft prices with one contact noting spot prices for 80 under $2.00. The re-opening of gyms and fitness/nutrition stores should help, but like restaurants, it's uncertain how long it will take for customers to come back. I lowered my outlook for the year given the softer demand and increasing production.

FYI – here is a Reuters story on the recovery in Chinese pork production

BEIJING, May 18 (Reuters) - New Hope Group, one of China's biggest pig breeders, expects the country's hog production to recover to normal levels by 2021, chairman Liu Yonghao told reporters on Monday. The fatal pig disease, African swine fever, reduced China's huge hog herd by around half last year, but the government has offered a series of incentives to farmers to spur a rapid recovery. Liu said pork prices will remain relatively high this year, but they could fall below production costs in coming years as new players rush into farming.

He said New Hope's pig breeding business New Hope Liuhe was well positioned to cope with low prices as its production costs are as low as 11 yuan per kilogramme in some of its farms. The company sold 3.6 million pigs in 2019 and plans to produce 15 million by 2021 and 25 million the following year. It will slaughter 8 million this year, a company official said on Monday. Liu said pork prices, which have been on a steady decline since early February, will continue falling until later this year, pressured by increased production and a surge in imports.

Retail prices for pork, China's favourite meat, surged to nearly 60 yuan in early November and reached those highs again this February when slaughterhouses closed for an extended period during the peak of China's Covid-19 epidemic. But live hog prices have dropped 30% in the last three months. Last week, they dipped below 30 yuan per kg for the first time since October, as pigs that had been raised to heavier weights than normal when processors were shut during February and March went to slaughter. Weak consumption is also pressuring prices, analysts say, with many canteens in schools and workplaces not yet open and a slowing economy denting purchasing power.