BATORY FOODS

Dairy Newsletter

Dairy Commodities Summary

February 2016

Global Overview

We started 2016 the way we ended 2015, with nonfat dry milk and whey languishing at low CME and Dairy Market News reported prices, whey proteins in a slump and the butter market perplexing us all. US milk production in the opening of 2016 mirrors the end of 2015, with production good-to-strong in the Midwest and East and poor in the West and Southwest.

2015 saw the end of the European Union's more than 30-year run with a Central Planning style dairy quota system. This frees up farmers to produce what they want without fear of penalty, allowing the market to dictate price and production. That is said slightly tongue-in-cheek. They still have a government-supported intervention program that buys milk when it falls to a set price, not unlike our old Commodity Credit Corporation that would by powder at a default price. The US eliminated that program in favor of farmer-purchased margin protection insurance.

China, long having a voracious appetite for imported dairy products, seems to have gone on a fast. Whether this is a result of working though large purchases of milk powder early on or a move toward more self-sufficiency is yet to be seen. But the result is the same. Less interest in whey, nonfat and, most of all, whole milk powder—coupled with a surge in milk around the world—has led to a surplus of these products.

Milk Production

With quotas lifted, milk production in the EU ended strong. Total EU output grew 2% in 2015. With an El Nino firmly in place, many expected drought conditions in New Zealand. This has not materialized as thought. However, they have experienced dryer than normal conditions, negatively impacting pasture growing conditions. Low farm margins have limited the use of supplemental feed and have resulted in many farms trimming herd size. January experienced a 2% year-over-year decline in milk production, which follows a 4% drop in December.

Milk production expanded 0.3% year-over-year in January, totaling 17.730 billion pounds, according to the USDA Milk Production report. Cow numbers were down 10,000 head from December, driven by a 15,000 head pullback in the Southwest.

In the US, we have seen essentially a continuation of the end of 2015. Fair milk growth has been seen in the Northeast and Northwest—2.4% and 1%, respectively. The largest output of milk continues to be in the Midwest at 3.6%. The Southwestern US is struggling in the aftermath of the unexpected and unprecedented winter storm that killed thousands of head throughout Texas and New Mexico. January production was down a full 9% from the previous January. California continues to struggle as well, with production down 2.7%.

Dry Whey

When dry whey prices hit low levels in Q4 of 2015, there was a substantial buy-up of excess inventories. With the cheese market languishing in large inventory numbers and a potential uptick in an overly sluggish whey protein market, dry whey prices were expected to begin to climb in 2016. This has not happened. Good milk supply in the cheese-heavy Midwest provided an ample raw material supply and continued cheese (whey) production. WPC demand hasn't been what was expected and producers continue to send condensed to the sweet whey production lines versus WPC.

Presently, dry whey futures have been relatively quiet, with small movements up and down. Second quarter futures have dipped slightly, but Q3 and Q4 indicate a return to current levels. Overall, futures would seem to predict more of the same when it comes to dry whey pricing.

Globally, heavy stocks of whey are pressing down on prices. With cheese production continuing its current pace, it seems highly unlikely that this oversupply condition will change and that we will see any change in whey prices soon.

Nonfat Dry Milk

With strong milk production in the EU, fair production in Oceania and good production for the most part in the US, the nonfat dry milk and skim milk powder markets are in an oversupplied position globally. In Europe, SMP production is strong. With an EU intervention program in place, there is no immediate incentive to draw back on production. Farmers have not been hit with sufficiently low milk payments to adversely impact on-farm cash flow.

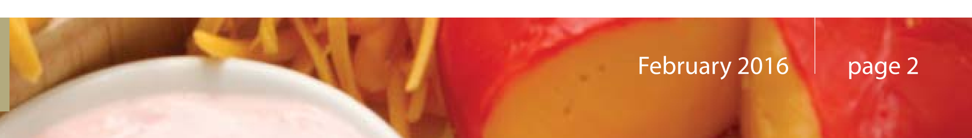
The USDA's Agricultural Marketing Service reported the SMP price in the EU at $0.80. Conveniently, this is the intervention price. Not surprisingly, product is flowing to the program in large numbers.

According to the USDA/AMS, SMP prices in the EU also fall at $0.80. Such convergence shouldn't surprise us, as those values essentially match the EU intervention price. Plenty of product is still moving into the program. By mid-February, the intervention program brought into storage over 37,000 metric tons. The key indicator here is that they have filled 34% of its annual capacity in the first six weeks of 2016.

At some point, intervention pricing is going to impact milk margins on the farm. One would expect a pullback in production and perhaps culling to begin. It's important to point out, though: Dairy farmers have a way of running against conventional wisdom.

The CME spot price has fluctuated between $0.71 and $0.75 for the last six weeks. Some low-price-spurred buying interest appeared but was not sufficient to move the needle off flat. Internationally—with China and Russia apparently firmly entrenched on the sidelines and traditional dairy-buying oil economies pulling back in the face of decade low oil prices—demand remains low; prices continue to languish.

The futures market is a little bullish. The average futures price for the remainder of the first half of 2016 is roughly eight cents higher than the average CME spot and six cents higher than the National Dairy Products Sales Report (NDPSR).



Given the current domestic and international conditions, this would appear optimistic. It is highly unlikely that prices will decline significantly from today's lows, but with spring-flush milk soon to be headed to the dryers and a continued strong SMP production internationally, it's hard to imagine any upward price momentum in the NFDM market.

Butter

If any commodity were the poster child for defying conventional logic, butter would be it. As many are aware (some painfully so), the butter market continued its rollercoaster-like ride in 2015. Late Q2 and early Q3 2014 highs in excess of $3.00/lb on the CME weekly average continued in 2015, reaching $2.90 during the same period. The difference was that, in 2014, the price quickly fell to below $2.00—hitting a weekly average of $1.5950 by the last week in December. Buyers in 2015 were not so lucky. After hitting $2.90, prices fell back into the mid-$2.00's only to return in the final weeks to $2.88 to $2.90. The year finished out at $2.0331.

The run-up was understandable. Cream prices were very strong. Frankly, cooperatives found it much more profitable to sell cream directly rather than move it to the churn. Additionally, domestic demand remained strong, so stocks grew only marginally. The spot price remained strong and equally important; futures prices into 2016 remained elevated.

That is not the case today. Production is good, stocks are growing and a new component, imported butter, is making its appearance. We are now seeing spot prices decline. Futures prices remain firm, however. With fundamentals pointing to lower prices, why do futures remain elevated for Q2 through Q4? In this case, emotion may be playing a role. Hedge demand appears high for 2016. No one wants to be short. In fact, those who chose that strategy the last two years have been hardcore losers. No matter what the fundamentals say, it is highly unlikely that buyers are going to risk product and company profitability betting that 2016 won't be a repeat.

Recently, some wonder if the sudden spot market close just below $2.00/lb will have support going forward. That might be largely dependent on just how much product has already been packed and priced to meet Easter and Passover orders.

Beyond that, the depth of the forward cover will still influence spot market affairs. If bids continue in the $2.10 and above range, it will be challenging for some to imagine how we could see a sustained spot price lower than $2.00. If the forward bid falls off, then CME spot numbers in the mid to upper $1.90's is possible.