BATORY FOODS

Dairy Newsletter

Dairy Commodities Summary

July/August 2016

Milk Production

The US has a lot of milk. Milk production here has kept up a steady pace this year. Through July, milk production gained 1.4% year-over-year. California and the Southwest were in negative territory through much of the early part of the year, while the upper Midwest was showing tremendous gains. Those factors, coupled together, signaled to the market average production for 2016.

Over the last two months, however, the Southwest reversed course, posting gains. While not in positive territory, California was down only 0.8% in July. To give some perspective, a production number of -0.8% was the best for California since 2014. This trend points to stronger numbers through the remainder of 2016.

Milk production in Europe seems to have finally reversed course. EU output numbers for June were down 1.6% with two of the largest producers—Germany and France—down 1.5% and 3.3%, respectively. The government has been buying in product under their intervention program. The small amounts paid appear to have finally made it back to the farmgate milk checks. This appears to be signaling to farmers to slow milking down and, perhaps, contract herd size.

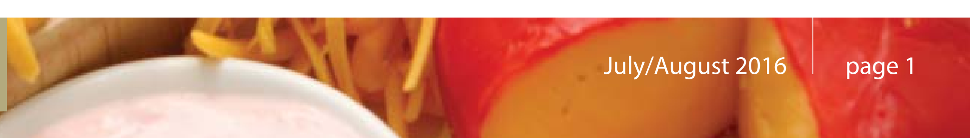
What we are now beginning to see is the movement of milk from the dryers to the bottlers. As schools across the country open and students return, fluid milk bottling increases. We have seen some processors shutting down dryers entirely as multiple truckload milk deliveries a day have trailed off to zero. While not shutting production down completely, others have scaled back drying significantly as fluid is diverted to the carton.

Butter

At the beginning of the summer, we expected butter prices to remain elevated. The US did not experience the typical market softening that comes in the first half of the year. Prices remained firm—well above what was expected or predicted. Our expectations were met. Despite a few movements that would suggest a weakening, buyers jumped in and kept prices elevated. Of course, we are not talking elevated in the sense that we saw in 2014 and 2015, but it was still strong.

We may now be seeing a change to that narrative. Anyone watching the spot market recently would think it resembles popcorn in a popper, with prices bouncing up and down. A closer look reveals more, however. Over the last several weeks, the market has been seeing lower and lower highs. Prices hit the year-to-date ceiling at $2.38 per pound on June 17 before retreating. On June 30, prices rebounded—but this time it peaked at $2.35 before fading. The market reached its next high on July 15 when prices rose to $2.32. The subsequent fade was followed by a run to $2.3075 on July 21. The week ending August 5, prices faded but again climbed to $2.27. The week of August 8, prices dropped anew, sinking to $2.2200 on Wednesday. By week's end (8/12), the price bounced back to $2.25/lb, still down two cents from the prior week's high. Finally, we started the week of August 12 at $2.25/lb and moved steadily downward to close at $2.19.

Could this be the turning point? It has been impossible to ignore the market factors. For instance, reports continue to indicate that warehouses are fully stocked. The latest USDA cold storage report revealed 333.1 million pounds in storage, up 31.0% year-over-year and up 1.5% versus June



2016. In absolute terms, stocks increased by 5.0 million pounds from June to July (compared to a five-year average of -10.9 million pounds) and are 78.8 million pounds higher than last year. Frankly, we are making and storing a lot of butter. Because of the large difference between US and world butter prices, our exports remain MIA. Cream remains relatively inexpensive and readily available. With schools starting and milk flowing to the bottlers, there will likely be more available.

With relatively inexpensive cream, churns that are still operating and very strong stocks reports, we don't think that there is support for the $2.30's spot prices the market has seen of late. We feel the market is ripe for continued softening.

Non Fat Dry Milk

At the most recent Global Dairy Trade auction, dairy powder price increases generated upward activity for the CME market. Spot prices increased $0.0325 within a day to reach $0.8650 per pound. However, as has been the story this year, movement fizzled and the week ended dropping $0.0075 to decline to $0.8575. Spot trading volume also faded. This marks the lowest weekly total since late April. Similarly, nonfat futures gained early on and then reversed course.

On the international front, warehouses in the EU held nearly 300,000 metric tons of skim milk powder purchased through the intervention program. That's about 660 million pounds, more than what Germany produced in all of 2015, and equal to what the US makes in a calendar quarter. That's a lot of powder out there that will at some point need to be released. When you couple this with what is held in China and New Zealand, more than a billion pounds of powder could be available to the world market.

Despite what appears to be good pasture conditions for the upcoming season, New Zealand product is expected to have a lackluster production this year. Finally, China, the world's biggest importer of SMP/NFDM, continues to sit on the sidelines, buying only relatively small amounts when needed.

So we have milk production in the EU reversing course, huge stocks worldwide, projected fair production in the US, tame New Zealand production and the biggest consumer of milk seemingly content to stay out of the market. These factors all combine to produce a market that seems destined to remain in neutral. For the foreseeable future, it is likely that the nonfat CME spot market will continue to trade in the range we are seeing now.

Whey

Whey is a different story. Languishing for weeks in the mid-twenties, market factors seem to be putting upward pressure on a product that one could almost guarantee wasn't going to move significantly. Dairy reports such as Dairy Market News and NDPSR have been showing small but steady gains over the last several weeks. Prices in the EU, arguably the main competitor to the US, have seen prices climb. To some analysts, this perhaps signals a shortage of sweet whey in that market. There has been renewed interest in whey exports to China to support its pork industry. We have also seen a reported increase in WPC 80 exports.

One of the biggest signals to what will happen in the sweet whey market is the whey protein arena. The raw material for both is liquid whey. When prices and demand for whey protein are low, processors move liquid whey to sweet whey dryers. This is what we have seen for months.

Whether it ever went away to begin with, consumers are showing rekindled interest in nutritional proteins, increasing demand for dairy proteins. This increased demand has resulted in a steady increase in the price of whey proteins—both concentrate and isolates. The increasing WPC 80 exports, along with the price resurgence of proteins domestically, are causing liquid whey to divert from sweet whey production to protein production. The net result is a slowly increasing price for whey and, more importantly, an increase forward bid.

Ultimately, we believe that slow, steady price growth is what the sweet whey market will see over the next few months. We have a lot of inventory here and cheese production is still strong. This will keep a lid on big jumps in price. What can't be ignored, however, are the increasing exports of whey and the greater interest on whey protein production and price. As long as those keep trending upward, sweet whey will follow along.