June 2020 Enhance Webinar: Addressing Changing Market Conditions: Q&A

Presented by Mary Ledman, Rabobank

Summary of Mary's Presentation:
Change is one of the most certain things we will face in life and perhaps at no other time has this been more apparent than in the past few months. Mary Ledman walked through much of the volatility we have been facing in our June Enhance webinar. Mary has been a longtime advisor of the Dairy Girl Network and has a broad history in the global agriculture industry, currently in the role of Global Dairy Strategist for Rabo Agrifinance.

The primary takeaway, as you may have guessed, is that the COVID19 pandemic has led to much volatility in the dairy market as stay at home orders alter food service demand and processors scramble to adjust to the "new normal." Mary mentioned that she and her team expect to see growth in the seven primary dairy regions through the end of 2020 and into the first half of 2021. The food service industry will most probably be unable to absorb this growth. We will see Chinese dairy imports decrease as they put a large portion of their milk into powder in Q1. Mary said we will see "heightened volatility and uncertainty paving the path to normality" as we move into the second half of 2020.

There are some bright spots in the story, however. We were not sitting on a large inventory here in the US at the beginning of the pandemic and in much of the country cow numbers and production were already trending lower (primarily driven by processor limits). With an expected production increase of 0.6% in Europe and only 1% in the US, market recovery will be aided. Slaughter has slowed as milk prices rally and this trend is expected to continue.

Market volatility is at its highest in recent history and producers should expect PPD spread close to -$5. PPD is calculated by subtracting Class III price from blend price. This will vary by region, but producers need to prepare for this increased spread. We should expect to see a decreased amount of dumped milk in June as compared to May.

Butter production is strong as stocks are being built and Mary noted she would expect prices to remain around $1.75 for the immediate future. We have pumped the breaks on cheese production due to the large amount used in food service. Of the 1.1 billion pounds produced each month, 50% is typically used in the food service industry. Specialty cheeses have been hit

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the hardest, however we are seeing increased stocks of aged cheese. Exports to Mexico are up but those to South Korea, Japan and China are down as their demand typically springs primarily from the food service industry. With milk being dumped, we did not see growth. This was not helped by decreased export to Mexico due to the Peso being greatly devalued and the oil industry situation.

Year over year volume changes in dairy products saw that most products experienced an increase after February of this year as food at home rose sharply due to mandated restaurant shutdowns and decreased travel. The meat, poultry, egg, cereal and bakery categories all experienced a similar rise. However, with 25% of fluid milk being used in food service, even a 3% decrease will not make up for decreased demand.

When looking at futures, Mary noted that it is challenging not to get caught up in the emotion of the market when forecasting monthly during COVID. She noted that it is important to note that when futures exceed forecasts, it is vital to look at risk management as a drop is probable. Despite how helpful government assistance has been, we will need to pay for USDA debt. As an interesting side note, Mary's team calculated that for every 1% increase in unemployment there is a 0.27% decrease in demand for dairy. Dairy strength likely won't be there in 2021 and it is therefore vital for producers to manage risk and take advantage of the current market. To paraphrase a comment by Mary "things don't look as bad as we thought but may not look as good once the dust settles." Improved prices in addition to government payments will be stabilizing in the US but trade remains uncertain.

Questions:
Mary was kind enough to offer her thoughts on a variety of questions in a Q&A session during the second half of the webinar. Themes and responses are summarized below:

- Risk Management:
  - Recommended a puts and calls strategy
  - Try to get into forward contracting if possible
  - Must sign up for DMC
  - Rabo offers a unique risk management service via their dairy risk management team including managing margin calls
- Production Cutbacks:
  - Many producers are now allowed to return to old production capacity
    - It will be challenging to return to that level due to seasonality

- We may still be facing some feed quality issues
  - September and October will be a more reasonable time for production increases to occur in full force
- Once we increase production past what the market can absorb it becomes a concern as we have lost demand.
  - Must evaluate both sides (supply and demand) of dairy production
- If you have milk booked at a low-price Mary recommended there may be an incentive to overproduce to take advantage of the value of excess production if your processor can handle it.

- Triggers for Expecting the Unexpected
  - Election year can often mean a “blank Check year”
    - While government support will probably continue, we cannot count on it
  - There must be a reason for a bull market to continue
    - We need to have protection if this market cannot be sustained into fall
  - As a business, we must ask what we can be doing to make money.
- Second Wave of COVID concerns
  - Forecasts cannot be made based on unknown waves and are currently based on the slow recovery model
  - Growth over the past 10 years has been in the food service industry. We should not avoid processors simply because they have a food service focus as most processors are working to pivot and “future-proof.”
  - There is potential for more on farm processing to allow for greater market control
- Processor Consolidation
  - Unlikely that mergers and acquisitions will happen among competitors as most processors are looking to diversify.
    - Companies must consider where they are the most vulnerable
  - May be opportunity for international investment but COVID has not been so detrimental as to invoke a fire sale on US dairy assets
- Advice for Interacting with Processors
  - Legal advice would be wise, it is always best to involve a lawyer on the front end as opposed to the reactionary end of a potential issue
  - Get volume and time frame information on contracts
  - Contracts are going to need to be more than handshake agreements

- Make sure they are terms and conditions that you can live with

Conclusion:
The first 4 months of 2020 are not a good indicator of the effects of Coronavirus. The last 8 months on the other hand most certainly will be. New outbreaks will have a large effect on exports. We see this most notably in a decreased backhaul of dairy to China. Our current market may not factor in these uncertainties well and therefore it is important to consider risk management now.

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