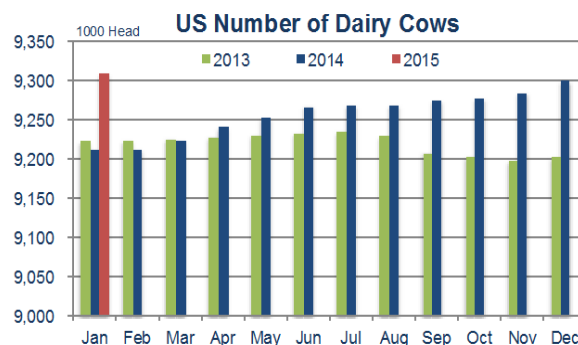
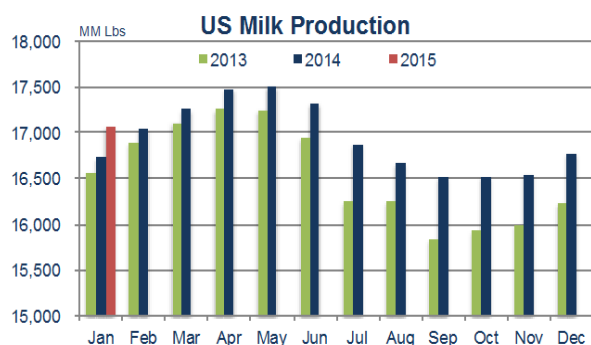


US DAIRY MARKET KEY DRIVERS

Milk Production

The USDA Milk Production report for January was a mix of bearish and bullish signals. US milk production in January was up 2.1% vs. prior year, which was the slowest growth rate since May 2014. Of the top 23 states, 21 posted increases. Dairy cow numbers were up 96,000 from last January and increased 9,000 head from December. At 9.308 million head, the nation's dairy herd is at its largest point since January 2009. On the bullish side, the two states with lower milk output in January were important ones – California (-2.6%) and New Mexico (-1.9%). Cow numbers in California ticked down again, losing 1,000 head from December while milk per cow was down 2.5%. Given their importance in cheese, butter, and milk powder production, both states are a watch-out going forward, particularly given the ongoing California drought.



In other key milk producing regions around the world, milk output is also slowing due to a combination of weather and economic factors. In Europe, milk production growth has slowed in front of the quota elimination along with lower milk prices. There could be a pick-up in milk output after April 1, but farm margins are not favorable to significant expansion at this point. Expect production in the “dairy belt” in northern Europe to continue to grow, which should more than offset losses in southern countries.

The situation in New Zealand has improved slightly in the past month with forecasts for rain in March, which should provide relief for late pasture growth. However, if cows are already drying off, the late grass growth will only help with improving body condition and not milk output for this season. In late January, Fonterra lowered their forecast of milk production for the season to 3% below year ago. To hit that number, milk production will need to fall sharply from last year's high levels. This is possible, but will likely end a bit better than that given rain and improving pasture conditions in March. Recent news reports from New Zealand note Fonterra is expected to raise its payout price from \$4.70 to \$5.00 per kg milk solids as lower milk production due to the drought has negatively impacted dairy product supplies, thereby causing global dairy prices to recover from multi-year lows over the last few months.

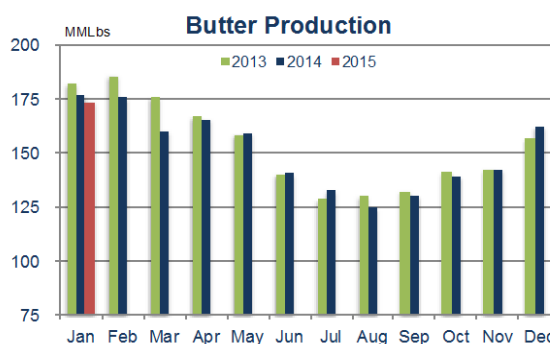
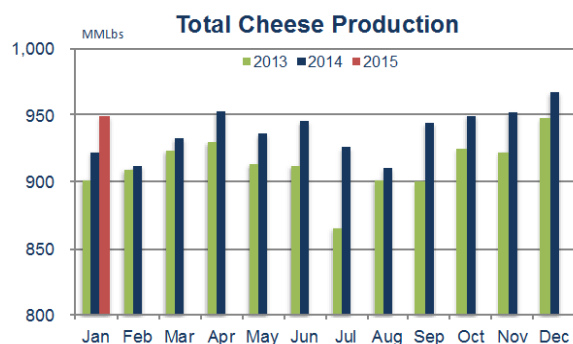
Overall, milk output in the three key dairy exporting regions is slowing, but remains positive to year ago.

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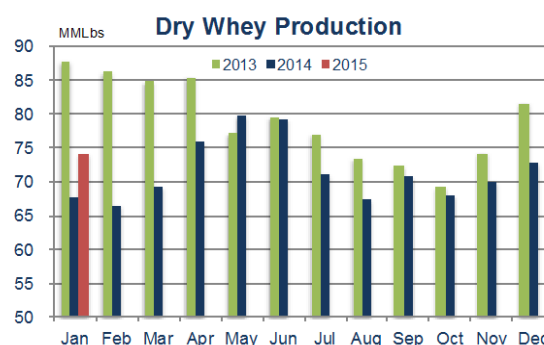
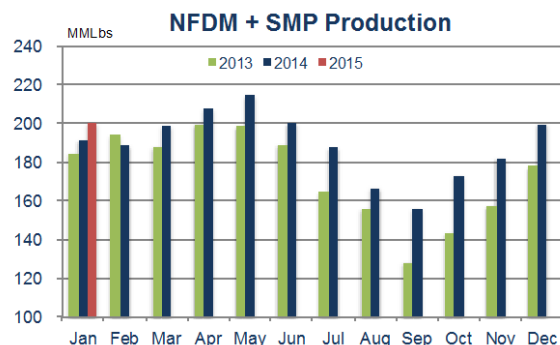
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Dairy Product Production

Given the growth in milk production in January, production of dairy products also increased. Total cheese production was up 2.8% vs. prior year. American and Mozzarella cheese makes up 75% of total cheese production. American cheese production increased 3.4% led by a 5.3% gain in Cheddar. Mozzarella production was up 2.8%. While cheese production was higher, butter production dropped back below year ago levels in January. This was largely due to lower production in California, the top butter producing state in the US. Butter production was down 3% as lower milk supplies resulted in less milk available to butter plants. The trends in cheese and butter production are likely to continue, as milk production is relatively strong in cheese producing states. However, declines in milk production in California are expected to continue given the ongoing drought and lower farm margins.



Production of milk powder was higher in January. Combined nonfat dry milk (NFDM) and skim milk powder (SMP) was up nearly 5% versus prior year. Due to the drop-off in milk powder exports, plants shifted production away from SMP for export (-30%) and made more NFDM (+19%), which is used in the domestic market. In the whey complex, dry whey powder was 9% higher than last January. Whey protein concentrate (WPC) 50-89% production increased 10% as new plant capacity contributed to higher output. As cheese production is expected to continue to grow, whey production will also move higher.

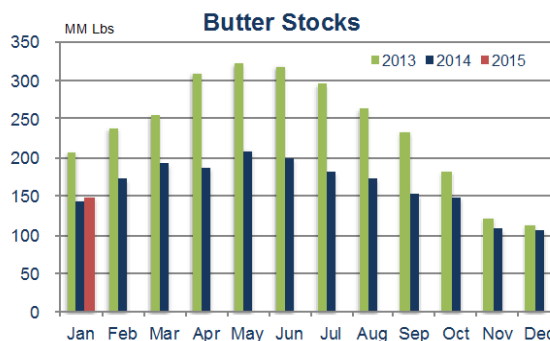
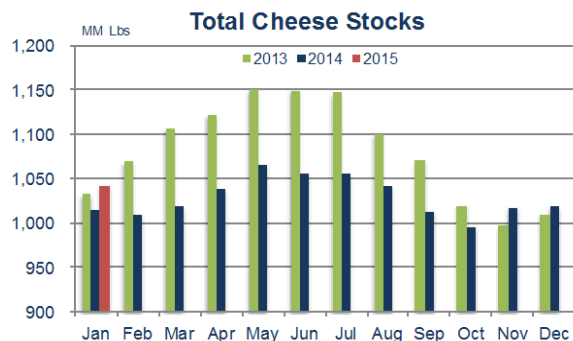


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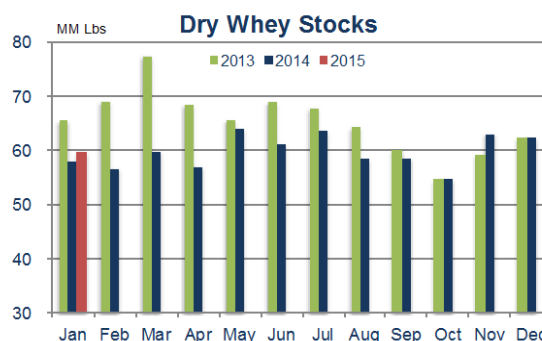
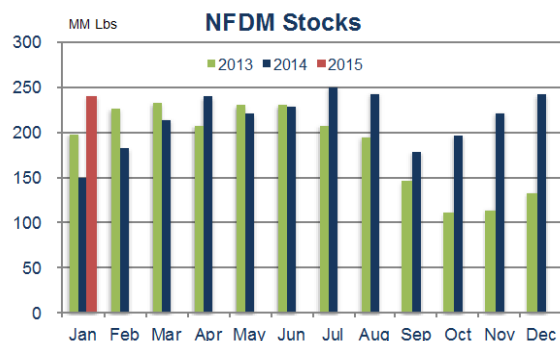
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Dairy Product Stocks

While slowing milk output in key global regions is supportive to prices, mostly later in 2015, the stocks situation in the US is either a little or a lot bearish depending on the product. Total cheese stocks have exceeded year ago levels for the last 3 months with additional inventory building in February and March. However, stocks are not burdensome at this point. Butter stocks continue to be relatively tight, although January 31 stocks moved above year ago for the first time since October 2013. With much lower exports in the first half of the year, butter stocks will likely build, but not to 2013 levels.



In contrast to butter stocks, nonfat dry milk powder (NFDM) stocks are markedly higher than prior year. January 31 stocks were up 91 million lbs or 61%. The outlook for first half 2015 is mixed. US milk production is higher, but the key milk powder producing state, California, is lower in milk output, which will probably result in weaker milk powder output there. The whey and lactose stocks situation is mostly bearish. Dry whey stocks on January 31 were up slightly from prior year as production was up 9%. WPC and lactose stocks on January 31 were at or near record highs. Production capacity for WPC 80 and lactose has increased and pushed stocks much higher. Production of high protein WPC (50-89%) was up 10% in January. Stocks of both are considered burdensome and will probably overhang the market most of the year.



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DAIRY PRICE OUTLOOK

What was shaping up to be a period of relatively low dairy prices became a bit more volatile over the last month. Buyers likely were complacent and scrambled to get physical and forward coverage following the Fonterra/New Zealand news in late January. I think that has played a large part of the rally in butter and milk powder prices. But where do markets go from here? It's tempting to think prices will move higher, but I don't think the fundamentals support much change in the outlook for most dairy products.

Starting with cheese, my outlook hasn't changed over the past few months. Exports are softer, but domestic demand, both immediate and stock building/rebuilding, seems to be picking up the slack. I continue to think cheese is \$1.50 +/- \$0.10-0.15 into the summer. At some point in the next few months, I expect to see some stretches of time in the \$1.40's and maybe even a brief dip into the \$1.30's. But given the relative balance of supply and demand over the last 2 months, it seems like \$1.50 is price both buyers and sellers are comfortable with for now. However, futures prices for cheese appear overvalued relative to current industry forecasts.

Butter is the one product where the outlook is more positive. Expectations were for butter to trade around \$1.50 give or take \$0.10-0.15 like cheese. But stocks have not built to a point to make the market comfortable, so prices rallied into the \$1.70's ahead of Easter/Passover. With increasing production into the spring, and a slow export pace, stocks are expected to rebuild to more comfortable levels. Domestic demand for butter remains solid, and the start of ice cream season is close. Those factors should keep butter prices from dropping to levels previously forecasted. Like cheese, a pick-up in exports is expected to result in moderately higher prices in the second half of the year.

For NFDM, the trading activity over the last month has caused buyers to increase their price forecasts, albeit modestly. The Fonterra announcement in late January put a bid in the milk powder market that helped US prices move back above \$1.00. Additionally, milk powder manufacturers have been aggressive in moving product and buyers have been caught short. While prices have rallied over the last month, the underlying fundamentals haven't changed enough to warrant much increase in the forecast. US prices have recently sunk back towards \$1.00 despite another jump in New Zealand prices to \$1.33. However, prices in Europe for skim milk powder will likely remain below NZ prices, so US suppliers will have to compete against lower priced European product to get export business.

Over the past month, dairy markets have experienced a "dead cat bounce" – an old trading term used to describe a rally in a bear market. I am a bit more bullish than other market analysts I've seen, but not nearly as bullish as current futures prices. I don't believe the price action over the last month is a precursor to a significant move higher anytime soon. The supply-demand situation is still tilted toward heavier supplies globally. I don't see that changing until the second half of the year. Wild cards continue to be weather in key milk producing areas (e.g. New Zealand, California), renewed demand from China, and whether or not the Russian dairy import ban continues. Expectations are for range bound prices into the summer and then likely move modestly higher. After last year's record high prices, market participants are more sensitive to developments in supply and demand drivers. As a result, price reaction will probably be more pronounced than in other years. In other words, dairy price volatility is expected to increase as the year goes on.

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