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MCT COMPASS

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What goes up must come down

The global milk protein markets, from whey powder to skim milk powder (SMP) and most derivatives in between, soared to market highs in 2001 only to reach near historic lows so far in 2002. The downward spiral in SMP prices precipitated lower world dairy markets, with other proteins following suit. Since mid-2001, EU SMP prices have fallen 40%, or $850 per ton, to $1,275 per ton.

There is clearly a glut of product on the market, in part because of a modest increase in production but moreso from a slowdown in demand. U.S. production has been flat over the last 12 months; New Zealand and Australia are wrapping up their milk production seasons with expected growth of 3-4% over last year; and production in Europe is steady, capped by quota and the residual effects of last year's Foot-and-Mouth Disease outbreak. (Though one wonders how much more of an excess we'd be facing if Europe hadn't had to cull so aggressively last year.)

Perhaps the most significant factor hanging over the world market is the United States' huge stockpiles sitting in government storage. Stocks are quickly approaching 450,000 tons. Meanwhile, since the EU opened its intervention warehouses on March 1, it's been acquiring about 4,500 tons of SMP per week.

Demand has softened for several reasons:

- Last year's outbreak of FMD in Europe made less product available for export, tightening world supply. When prices rose in response, some users felt the sticker shock and, where possible, food formulators switched to less expensive alternatives like soy proteins.
- The global economic slowdown of 2001 trimmed purchasing power throughout the world, including the developing countries that are the primary importers of SMP.
- In a declining market, buyers become passive, waiting for prices to hit bottom before purchasing in earnest.

An onslaught of subsidies hasn't helped prices, either. In an effort to jump-start demand for SMP, the

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KEN'S CORNER

by Ken Meyers
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The rising powder mountain in the U.S., in tandem with the extremely low world market price, has placed USDA between a rock and a hard place. USDA would like to slow the flow of SMP into its warehouses. USDA could do this by lowering or tilting the SMP support price from 90¢/lb. to 75¢/lb. and raising the butter support price from 86¢ to $1.15. But this would not be enough to make domestic powder competitive in the current world market, where product is currently trading for 55¢. Even worse, USDA could even find itself in a situation of buying both powder and butter.

Long term, the 15¢ tilt will place U.S. SMP and other proteins in a more market-oriented position domestically and globally. The lingering question is what is likely to happen to the butterfat market. About 40% of the butterfat produced in the U.S. is used in cheese production. Lowering the SMP support price will serve as a disincentive to produce powder. More milk is likely to end up in the cheese vats, boosting cheese supplies, but causing the butterfat market to tighten. ❑

Milk recovers in Q1

During the first quarter, milk production increased much faster than consumption, putting downward pressure on prices. Output bounced back by 2.4% in the 50 states. Commercial American cheese stocks increased 9.7%, while butter stocks gained 163.5% during the quarter.

We expect cheese prices to climb into the $1.30s by June and peak near $1.50 by September. That will translate into a Class III price approaching $13.40. The butter market is poised for a rally once ice cream processing picks up. We look for the price to near $1.40 in June and $1.50 in September. ❑

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV
APR	1.2465	1.2170	10.84	1.2010	11.17
MAY	1.2750	1.2500	10.96	1.2875	11.42
JUN	1.3450	1.3200	11.61	1.3825	11.51
JUL	1.3750	1.3500	12.20	1.4200	11.67
AUG	1.4425	1.4175	12.49	1.4500	11.79
SEP	1.4750	1.4500	13.36	1.4700	11.87

** Block, barrel and butter are monthly averages of CME prices.*

What goes up...

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EU has increased its export subsidy five times since November. Earlier this month, it pushed refunds up to 650 euros (about $575) per ton, from zero just five months ago.

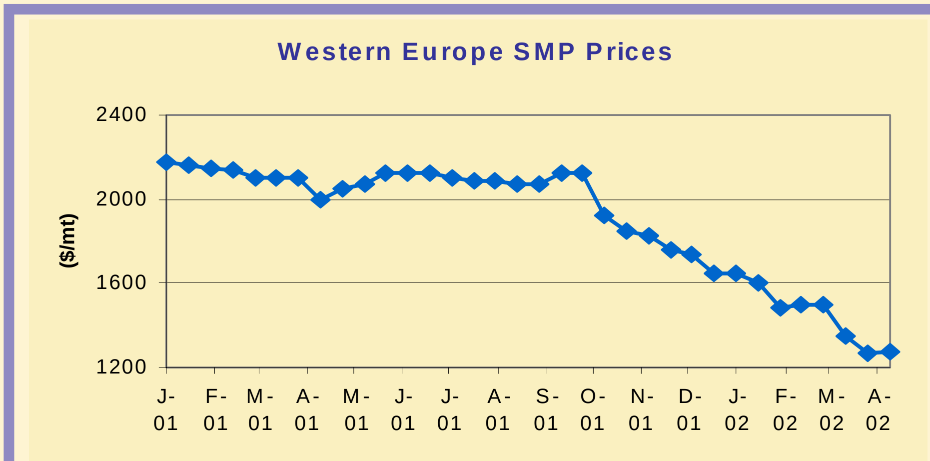
The United States has willingly upped the export-subsidy ante. Under the Dairy Export Incentive Program (DEIP), USDA paid bonuses as high as $950 per ton in mid-March. USDA maxed out this year's DEIP allocations last month by approving bonuses for 15,867 tons of powder to Mexico. New allocations aren't allowed until July.

The whey market isn't any better. The United States exports about one-third of the whey it produces, and international demand has slowed considerably in the last six months, for much the same reasons as the powder market. Prices got too high, buyers sought alternatives, product started backing up, prices went into a tailspin.

On the butterfat side, plunging world prices have made the United States a very attractive market. World prices have sunk near 50¢/lb., ex-works, creating the incentive for U.S. food processors to use imported fat from Oceania, Europe and Canada. This could serve to limit butter prices rallies this year.

Perhaps those are the two overriding lessons to take away from 2002's weak global markets:

1. Like any other agricultural market, the global dairy market is cyclical;
2. U.S. markets are inextricably linked to global markets. Weakness abroad translates into weakness at home, and vice versa. In the past, we felt we were immune from gyrations in global markets. But we are not as insulated as we once were. ❑



European SMP prices have plunged 40% since late September.

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