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MCT COMPASS

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Waiting for the Bull

The second half of 2002 is off to the worst start, price-wise, in nearly three decades, a development that's caught just about everyone by surprise. As recently as 11 weeks ago, August Class III futures were trading for near $13.00; that means traders expected the cash cheese price to reach $1.47 before Labor Day. Instead, this week a few loads of cheese moved to CCC and marketers are hoping for decent holiday sales to salvage what's left of the year.

On the surface, it's a simple case of supply outpacing demand. During the first half of the year, production of American cheese was 6-7% higher than a year ago. Meanwhile, commercial disappearance of American cheese was up less than half a percent vs. 2001.

The difference results in a swing of more than 100 million lbs. of American cheese. Last year in the first six months, sales exceeded production by 32 million lbs., according to USDA's figures. This year has been the other way around, with cheesemakers producing about 73 million lbs. more American cheese than the market has been able to use.

Consumption of virtually all dairy products has lagged historical growth rates in the first half of the year, pushing more milk back to the vat for production of American cheese, the most storable variety. Commercial use of milk, measured on a total-solids basis, was down approximately 0.1% in the first half of the year. Typically, commercial use expands by about 2.1% per year.

Soft demand

Analysts have had a difficult time putting a finger on the cause of the demand slowdown. One explanation is that 2002 has been a buyers' market. When product is in excess, buyers have less incentive to "buy ahead" so the volume of cheese needed in the pipeline is reduced.

High retail prices may also have played a role. The Consumer Price Index for cheese during the first half averaged 171.2, up 4.4% from last year. With cheese remaining an expensive buy at the store even as the economy has weakened, shoppers may have cut back on cheese

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KEN'S CORNER

by Ken Meyers
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With today's rally in the cheese pits, the cheese market may have finally turned the corner. A block price near a buck is puzzling; the cheese market is weak, but it's certainly not *that* bad. Product is still moving and the usual summer heat is squeezing production.

Maybe sometimes the price discovery system is dysfunctional. We won't sell any more cheese at $1.00 than we will at $1.20. Meanwhile, retail cheese prices remain lofty. Would lower retail prices help sell more cheese? You bet. So how can we get retailers to pass along these price cuts?

We also have a support price system that's supposed to floor the cheese price near $1.10. But that system didn't work when the market tumbled in 2000 and it's not working this year either. Fiscal policy through grading is counter to the concept of a government floor. Commercial grading and government grading practices need to converge.

On the fat side, the ice cream guys continue battling – and winning – against the print butter guys in the trading pits. Ice cream processors continue bringing butter to the pits, keeping downward pressure on the markets. ❑

Seasonal price rally still in the cards

We're still more bullish on the dairy markets than most.

We look for increasing needs for current cheese, coupled with contracting milk supplies, to spark a rally in cheese prices next month that builds into the upper $1.30s through the fall and holds through the holidays. That will translate into a Class III milk price that peaks at $12.60 in December.

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV
JUL	1.0800	1.0600	9.33	1.0300	10.41
AUG	1.1650	1.1400	9.45	1.0625	10.38
SEP	1.2550	1.2300	10.52	1.1400	10.53
OCT	1.3500	1.3250	11.80	1.2000	10.76
NOV	1.3850	1.3600	12.40	1.2500	10.89
DEC	1.3750	1.3500	12.60	1.1600	10.83

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

Fighting a much larger inventory overhang, the butter market won't be able to sustain a rally of much above $1.25 ahead of Thanksgiving. That will create a Class IV top of just $10.89. ❑

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purchases.

Likewise the high wholesale prices of 2001 may have prompted industrial and foodservice users to cut back on the volumes of cheese they use in their recipes and formulations. One also could speculate that consumers just aren't traveling and entertaining as much since September 11 and the downturn in the economy.

What comes down must go up

But one undeniable fact about the dairy markets is that every bear market has been followed by a bull market. Even with the build-up of stocks, American cheese inventories are still 2.2% below the June 30 average for the previous three years. That means any rebound in demand, or a drop in production, should be enough to turn the market around quickly.

By the fourth quarter, the two- and three-percent gains in milk production that we're seeing today will be tougher to come by. That'll take a bite out of cheese production. Further, lower milk-feed ratios this summer will take a toll on expansion and productivity, potentially causing a shortage of milk – and much higher prices – in 2003.

Butter battered

It will take more than that to inject some life back into the butter market. Production in the first half of the year was up about 15%, an increase of nearly 100 million lbs. of butter without a proportional rise in demand to sop it up. With butter consumption rising just 3.3%, butter inventories have swelled to unprecedented levels. Since the first of the year, butter stocks have increased by more than a million lbs. a day, growing to 242.3 million lbs. At this point a year ago, stocks were 152.7 million lbs.

Low wholesale prices finally give retailers an opportunity to promote butter heavily this holiday season … and the category will need all the help it can get. Manufacturers and marketers typically work stocks down to 25 million by the end of the year. That would require a drawdown of more than 200 million lbs. in the second half, about double the average rate over last three years.

Production slowdowns eventually will bring the butter market back into alignment. But that probably won't occur until well into 2003.

Farm Bill impact

A discussion of 2002-03 dairy markets would be incomplete without mention of the Farm Bill. Cow numbers continue to rise despite falling milk-feed ratios, suggesting that producers are holding out as long as they can for that first windfall government check. Through the first nine months of the program, dairy farmers are in line for $1.04/cwt., up to the eligible volume of milk. For farmers milking at least 130 cows, the first check will be about $25,000.

It remains to be seen how many dairy farmers will be able to stick around for the second and third checks. Low milk prices this summer have put tremendous pressure on cash flow. If enough producers exit over the winter, we could see much lower milk production in 2003. ❑

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