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MCT COMPASS

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Parched earth, but no drought of milk. Yet.

So far the drought of 2002 has left the U.S. milk production sector virtually unscathed. While a significant portion of the country remains in Dust-Bowl-esque dryness, milk production continues to flourish above prior year levels. Cow numbers are rising month after month, and production per cow is running 2.7% higher this year than last.

Actually, that shouldn't come as too much of a surprise. During the two most recent drought years – 1995 (relatively milder drought) and 1988 (severe drought) – milk production increased 1.1% and 1.6%, respectively.

But it's in the subsequent year that the true impacts of a drought are historically felt. In both 1996 and 1989, milk production declined 0.8%. In both cases, crippled grain harvests in the drought year led to skyrocketing feed costs.

In both 1988 and 1995, U.S. corn production plunged by about 30% from the prior year. Resulting shortages caused corn prices to shoot up 31% in 1988 and 43% in 1995. Dairy farmers, no longer able to justify feeding as many low-end cows, culled dramatically the following winter.

Throughout 1989, cow numbers dropped almost 500 head per day. In '96, culling reached 250 head per day.

The subsequent milk shortages, of course, caused spikes in the dairy markets in 1989 and 1996.

In the second half of 1989, you may recall, blocks climbed above $1.50 for the first time. By December, the M-W manufacturing grade milk price had run up to $14.93, a dramatic increase after averaging $11.26 in the preceding four years.

A similar scenario took place in 1996. Cheese prices took off in early summer and didn't look back until they had hit $1.6950 in September. After averaging $11.71 for the previous five years, the M-W ran up to $15.37 in September 1996 and averaged $13.39 for the entire year.

So what can we learn from these years to help us gauge what's in store for 2003? Consider some of this year's characteristics:

- The corn crop is projected to fall "only" 7% this year, much less than the 26-31% declines seen in

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KEN'S CORNER

by Ken Meyers
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With the milk-feed ratio at 2.20 – a five-year low – dairymen are enduring considerable stress this fall. Government market-loss payments will provide some modest relief, but for many that won't be enough to save the farm.

We expect many producers hung on through this period of low milk prices in order to receive their checks, and that could be delaying the expected reduction in cow numbers. Even for producers who get the full benefit of $1.59/cwt. for October milk, the effective milk-feed ratio will be in the neighborhood of 2.60, still low enough to crimp profitability.

Once the checks are cashed, we could see a scramble to the exits.

On the larger operations in the West, the market-loss payments will amount to just pennies per hundredweight. That may not slow expansion in California, New Mexico, Idaho, Arizona and Oregon. But producers in Wisconsin, Minnesota, Missouri, Texas and Pennsylvania will continue shipping cows to slaughter. ❑

Recent rally welcome

After floundering near support all summer, the cheese market is enjoying a nice seasonal rally here in late September. Supplies of current natural cheese have tightened up and orders are solid. The large block-barrel spread will have to be reconciled in the weeks ahead, and we expect barrels to move higher as production slows. We may not see much, if any, drop-off after the holidays.

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV
SEP	1.2040	1.1100	9.90	0.9640	10.25
OCT	1.3125	1.2125	10.82	1.0925	10.55
NOV	1.3300	1.2600	11.47	1.1500	11.05
DEC	1.3000	1.2600	11.54	1.1050	11.00
JAN	1.3000	1.2700	11.52	1.0675	10.35
FEB	1.2825	1.2525	11.50	1.1500	10.40

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

Class III prices also are being bolstered by a recovery in the whey market. Every cent gain in the whey price tacks 6¢ onto the Class III. In the last two months, the whey price has improved by almost 7¢. ❑

Drought ...

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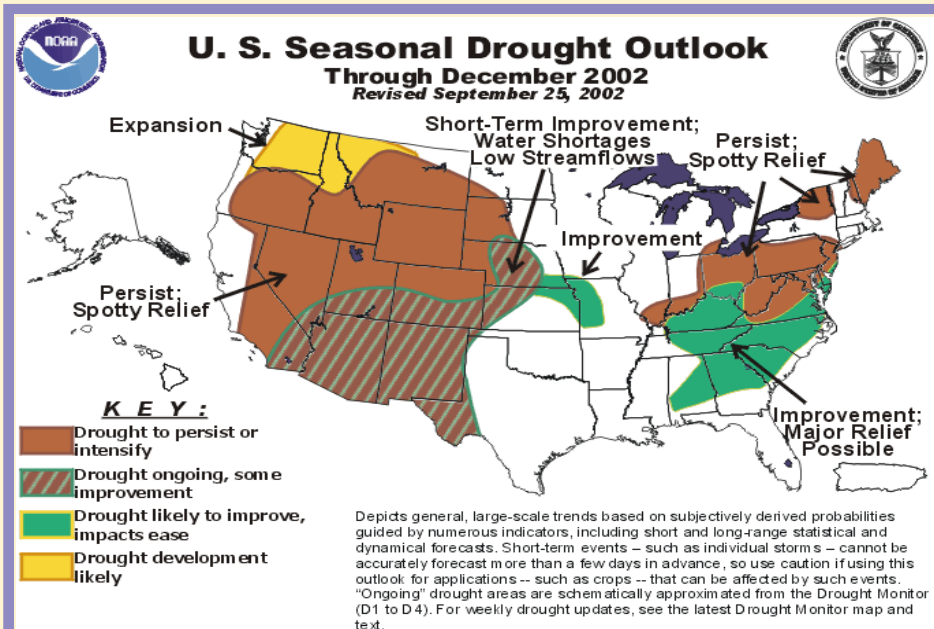
prior drought years. But more importantly, USDA still projects prices to shoot up approximately 28% this year – to $2.55/bushel. If that price holds, it'll put a serious dent in milk-feed ratios.

- This year's crop of alfalfa, the other major feed component, varies by region. Supplies are in good shape in the Western region, but mediocre in the Upper Midwest, and awful in the Northeast. Overall, though, prices are expected to trend higher in the months ahead.
- Recent rains and cooler weather have eased drought conditions in many parts of the country, particularly the Southeast and parts of the Southwest. However, the Northeast all the way to Ohio and most of the Western region are expected to remain severely dry. In the Northwest, conditions are expected to worsen *(see chart)*.
- Since the previous droughts, a much greater percentage of milk is produced in arid regions that depend on irrigated water. In 1988, the 11 western states produced 22% of the nation's milk. Today, that figure is 38%.
- Dairy producers also have made strides to mitigate the impacts of heat stress on their herds. New facilities usually include climate control curtains, fans and misters to cater to cow comfort.

Based on history and declining milk-feed ratios – now down more than 40% from a year ago – we look for a significant production response in 2003 that should pull prices up out of the doldrums. If producers pull back as expected, cheese prices could average $1.30 or higher next year. ❑



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