



MCT COMPASS

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What to watch in 2003

Market movements are typically predicated on factors that fall into three broad categories: supply, demand and policy. Here's a guidebook for what to look for in each category as we head into 2003.

Supply: Most people agree that production growth will be stymied in 2003, if for no other reason than it'll be tough to post much increase on top of the +2.6% performance of 2002.

There are other legitimate reasons, of course, as well. The low milk prices of 2002 (all-milk average of \$12.10, lowest since 1979) and higher feed costs (corn/alfalfa/soybeans blend presently 10% more expensive than a year earlier) have squeezed profitability on the farm. The milk-feed ratio during the second half of the year will be about 2.36, versus a historical

average of just under 3.00.

Many people are surprised that cow numbers haven't reversed yet in the face of sustained low milk-feed ratios. However, USDA's MILC market-loss payments have mitigated the low milk prices to an extent and delayed the inevitable exits. Additionally, many producers had locked in good supplies of cheap, high-quality feed to get them through this year.

USDA forecasts next year's corn crop to be the smallest since 1995, down half a billion bushels from 2002. The feed situation is particularly rough in the eastern part of the country, where last year's drought took a toll on feed quality and quantity. Productivity will be affected next year by juggled rations to make ends meet.

Though cow numbers haven't turned south yet, they have at least mostly flattened out over the last six

months. The Livestock Slaughter report shows culling activity has increased dramatically since July, running 8% higher than the same period a year ago.

The El Niño developing off the West Coast also is causing some concern. Five winters ago, El Niño soaked California and per-cow productivity was off throughout 1998. Tight milk supplies led to record-high cheese, butter and milk prices that year. However, this year's El Niño is not expected to be as strong.

In sum, by mid-year cow numbers are expected to drop back below year-earlier levels and output-per-cow is forecast flat for 2003. USDA forecasts production to grow 1.2% next year, but we think it'll be closer to flat – maybe even negative.

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KEN'S CORNER



*by Ken Meyers
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There's one more factor to consider for the 2003 outlook: Psychology. Sometimes

just the *expectation* that things will tighten up can be enough to drive

the market higher. It's been a buyers' market for most of the last three years, with cheese prices below \$1.20 as many months as they've been above in this Millennium. But even if supply and demand doesn't quite move back into balance soon, most people are bullish on the 2003 dairy markets.

Class III futures are currently trading at \$12.71 for the second half of 2003,

18¢ above the 12-year average.

Thanks to the dairy support program, when milk supplies get long, volatility in the markets disappears. But if supplies tighten in 2003, as expected, look for much greater volatility in the year ahead.

Best wishes for a happy, healthy and prosperous 2003! □

Rebound due in Jan.

Cheese prices have averaged just a penny above the support price for the last seven months, but the tide is turning.

By mid-January we expect the market to move near \$1.20 and not look back. Blocks are forecast to average in the upper \$1.20s in the second quarter, translating into Class III prices near \$11.20.

Heavy inventories notwithstanding, current butter will get tighter

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
DEC	1.1340	1.1070	9.75	1.1350	10.60
JAN	1.1750	1.1575	9.90	1.1500	10.65
FEB	1.2300	1.2000	10.40	1.1750	10.60
MAR	1.2450	1.2150	11.00	1.2350	10.70
APR	1.2500	1.2200	11.15	1.2450	10.75
MAY	1.2650	1.2350	11.20	1.2700	10.80

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

over the winter and push the butter market higher. March butter futures are trading at \$1.27. But look for

Class IV prices to hold relatively steady as skim milk powder prices decline. □

What to watch in '03 ...

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There is some concern, however, that even declining milk production may not translate into commensurate declines in cheese production. With huge cheesemaking capacity in California and a butter/powder tilt that could push more milk and skim milk powder to the cheese vat, cheese supplies may stay heavy. If that's the case, the market may not respond to reduced milk output.

Demand:

Cheese and butter orders picked up mid-year but demand is still not strong enough yet to put a real push on the market. It looks like commercial disappearance of cheese and butter will be up about 3% for 2002, while fluid milk consumption will be up slightly. Ordinarily figures like these would be enough to jumpstart the markets, but end-users are not yet convinced

supplies will dry up, largely because of the effect of USDA's MILC payments.

The two factors to watch on demand are the overall economy and retail prices.

Retail sales this holiday season was the weakest in more than 30 years, as the nation's economic engine moves in fits and starts. Unemployment is up,

GDP growth is modest and consumer spending on food has declined for the last two quarters. Consumer confidence has risen for consecutive months, but is still down from a year ago.

The CPI for cheese hasn't

dropped much since last year, forestalling promotional activity that helps drive demand. Butter prices, on the other hand, have plunged 10% since the start of the year, helping to buoy sales.

Policy: This year brought us the Farm Bill (and MILC market-loss

payments) and a butter-powder tilt. Next year we don't expect policies to have much of an effect on the markets.

With the turnover of Congress back to the Republicans (and Rep. Larry Combest's retirement in the spring), new committee chairs will be named in 2003. While no official announcements have been made on House and Senate Agricultural Chair positions, the front-runners for the spots are Sen. Thad Cochran (R-Miss.) and Rep. Bob Goodlatte (R-Va.). Neither is likely to advance substantive changes to the Farm Bill provisions.

However, keep an eye on Washington budget discussions as the year unfolds. In this climate, generous programs like MILC – which could cost the government as much as \$1.5 billion in fiscal 2003 – could come under fire.

Bottom line: We look for blocks to average near \$1.30 next year and butter to average in the upper \$1.20s. That will translate into an annual average of about \$11.55 for Class III and \$10.80 for Class IV. These prices are low by historical standards and only slightly improved from 2002's depressed levels. □

2003 Forecasts		
	Class III	Class IV
USDA	\$10.40	\$10.55
Futures	\$11.89	
MCT	\$11.55	\$10.80

MCT 2003 forecast, annual averages: blocks \$1.26-\$1.31; barrels \$1.23-\$1.28; butter \$1.24-\$1.29; smp 82-85¢; and whey 19-22¢.

