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Butter meltdown

2004 is lining up to be the year of butter. Or lack thereof.

The last 20 months the butter price has traded in a narrow range near \$1.10, but the market has generated interest for other reasons.

The price has poked its head above \$1.20 just a handful of times, while the support price of \$1.05 has prevented the price from falling too much further. More than a quarter-billion lbs. of butter in inventory hanging over the market will do that.

Butter production soared 10% in 2002 to 1.36 billion lbs., the most since 1992, and just a few loads shy of the highest level ever. Greater production led to bulging stocks that were nearly three times greater at the end of 2002 than they were at the years' beginning.

But lower milk production in 2003, coupled with a disparity in cheese and butter prices this summer that drew cream away from the churn, has led to a dramatic decline in butter production this year. In the first nine months of the year, output was down 7.9% from 2002, and in the third quarter alone, production was off by 19.4%. Commercial inventories, which peaked at 290.6 million lbs. on June 30, were halved within four months, sinking to 150.8 million lbs. on Oct. 31. This figure is still 128% of the 7-year average, but it's clearly reversed course in the last few months.

Vanishing stocks and lower production point to potentially tighter fat markets in 2004. To add additional fuel to this slowly simmering market, as usual the only butter that

can be traded in the CME cash and futures markets after March 1, 2004, is product made after December 2003. Therefore, even if there are sufficient carry-over stocks, most will not be eligible for delivery in the 2004 butter market.

Pit battle

The CME butter market has historically been dominated by butter manufacturers. However, volatile butter prices during 1998 that sent the CME cash butter price to \$2.81 prompted end-users of butterfat to become more active participants in both the cash and futures butter markets. In an effort to be market players rather than just price takers, a variety of butterfat users, including

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KEN'S CORNER



*by Ken Meyers
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The battle between supply and demand of cash butter has been particularly spirited this fall. In the last two months, an average of 1.2 million lbs. of butter has been traded in each

session – including one particularly wild session in mid-November in which 4.6 million lbs. (114 contracts) traded in a single day.

Unfortunately, even with this increase in activity in the cash pits, we still don't have a liquid butter or Class IV futures market. Butterfat/cream users still feel the need to hold butter as a physical hedge – either having taken delivery on a futures contract or

buying on the outside – rather than being able to use futures to manage price risk as they were intended.

The absence of liquidity will be particularly noticeable in 2004, when tighter butter supplies could force prices to break out of their two-year slump.

An increase in participation in the butter futures market would help the industry function more smoothly. **MCT**

Cheese market looking for bottom

After five weeks of falling prices, the cheese market is still trying to figure out where the bottom is. Supplies of natural cheese are relatively balanced, and should remain so through the winter months, but barrels are long due to grocery strikes in California and lack of foodservice promotions on cheeseburgers with beef prices at all-time highs. Production of American type cheese recovered this fall.

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
NOV	1.3930	1.2950	13.46	1.2055	10.30
DEC	1.3050	1.2250	11.65	1.1875	10.25
JAN	1.3000	1.2550	11.55	1.1950	10.20
FEB	1.2850	1.2550	11.60	1.2350	10.40
MAR	1.2950	1.2650	11.60	1.2500	10.45
APR	1.3250	1.2850	11.70	1.2625	10.50

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

However, stocks have fallen below a year earlier. That should keep Class IIIs fairly stable near \$11.60 until next spring.

The butter market won't break out of its present range until Easter. Then, look for stronger prices next summer and fall. **MCT**

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food manufacturers, confectionery companies and ice cream firms, implemented butterfat hedging strategies.

Some butterfat users turned to imported product to cap their butterfat costs. Others that are dependent on fresh cream, like ice cream manufacturers, have chosen to buy butter as a physical hedge. That is, they buy the butter, store it and then sell it into the cash market in hopes of keeping

the lid on butter prices during their peak usage period, the summer months.

Another hedge strategy has been to purchase CME butter futures and "lift" the hedge – sell the contracts back – during the month of maturity or take delivery of the butter and sell it on the cash market.

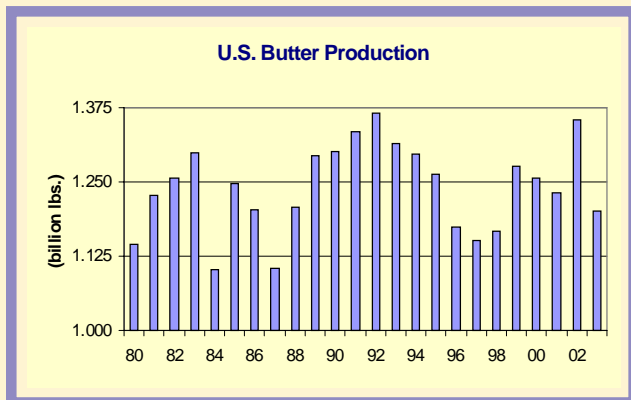
For example, an ice cream manufacturer can currently lock-in its

butterfat price by buying May and July 04 butter futures at approximately \$1.36 and \$1.38 per lb. respectively. As May approaches, the ice cream manufacturer has several options. It may sell the futures to offset its position. It could take delivery of

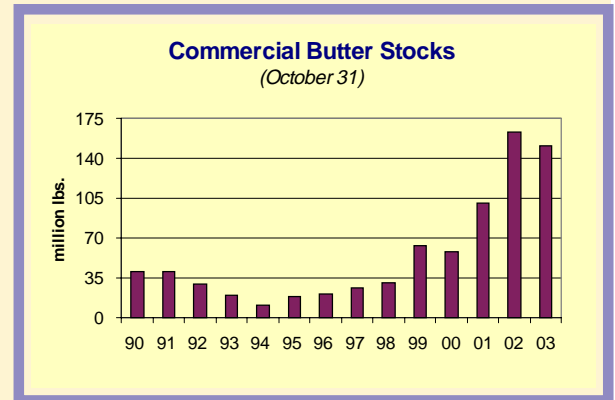
the butter from May 10 until May 28 and sell it on the cash market. Or, it could roll its May future into July by taking delivery in May, selling a May future and buying a July future.

These strategies have resulted in more volume in the cash market as product moves from cream hedgers to butter users, tempering the volatility seen in previous years.

If excess fat isn't available to bring to the cash pits next year, higher prices and more volatility are in the cards. **MCT**



Through September, butter production is off 7.9% this year. Source: USDA.



Butter stocks have soared the last three years, but are finally revers-

