June 30, 2004

MCTCOMPASS

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Keeping our Powder Dry

A year ago, the USDA was buying more than 20 million lbs. of surplus nonfat dry milk a week and government-owned inventories exceeded 1.2 billion lbs. USDA concocted several new nonfat dry milk disposal programs from *nonfat for casein* to *nonfat for cheese* and, oh yes, the *nonfat for drought relief* to chip away at the mountain of nonfat dry milk.

Shortly after the ever-flowing supply of surplus nonfat dry milk to government storage evaporated, lower milk production resulted in less powder production. That was followed by a cheese price run-up that attracted virtually every pound of nonfat solids into cheese vats. The industry even went to USDA during the spring of 2004 to buy back powder to supplement commercial markets. After a few weeks of sales, USDA disbanded the "sell back" of fresh powder in fear of not having enough for its committed programs.

Current government holdings of low-heat nonfat dry milk total 631.7 million lbs. Half is committed to several different disposal programs, and USDA has had to scale back some of its initial commitment levels. For example, the nonfat dry milk for casein program was initially promised 300 million lbs. of powder. The current annual allocation is 19.2 million lbs.

USDA points out that industry demand was far less than anticipated, but potential end-users fear that USDA is pulling the rug out from under them. They point out that it has taken several months to retool plants and manufacturing processes to make the conversion. Now in a position to commercialize the product, they face uncertainty over availability and price. Past bids for the *nonfat for casein* supply have ranged from 22¢ to 25¢ per lb. However, USDA recently sold the same powder for animal feed at twice that price.

Animal feed is the key outlet because the vast majority of government-owned nonfat dry milk is more than 24-months-old (see chart). Supply and demand conditions for nonfat dry milk look entirely different from last year. The bulging inventory of fresh powder is depleted. If the industry runs into any supply or demand bumps in the road ahead, USDA stocks won't be there to cushion the market.

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KEN'S CORNER

by Ken Meyers
President
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It's tough to manage a business during these volatile dairy markets. It's easy to get caught up in the day-to-day market fluctuations without thinking about what lies ahead. Hopefully, our insights on *Bumps in the Road* may provide some signals as to what may lie ahead.

In other words, don't get lulled into thinking that today's lower prices will last. Summer weather appears to be delayed, but it will come. If we do hit a bump, fewer safety nets will be available than in the past.

The government coffers of fresh nonfat dry milk are limited and committed to other programs. Moreover, the world market is tight, with few, if any, supplies available until the next Oceania production cycle. MCT

Post Sticker Shock Recovery?

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
June	1.7105	1.6850	17.72	1.9250	13.72
July	1.4400	1.4150	15.10	1.9350	13.75
Aug	1.6100	1.5875	14.70	2.1200	14.15
Sept	1.7200	1.6900	16.35	2.1500	14.55
Oct	1.5400	1.5100	15.95	2.0100	14.25
Nov	1.4500	1.4250	14.00	1.7800	13.10

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

It took the CME block market two weeks in March to increase from $1.50 to $1.95 per lb., yet most of the gains were wiped out in only two trading days in June, when block prices fell from $1.80 to $1.45. Just as prices were probably too high for too long, the market will now likely fall too low, setting up the possibility of a rebound later this summer. A rebound to former levels, however, will depend on whether consumers return to the dairy case after several months of sticker shock. MCT

Keeping it dry..

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Bumps in the Road

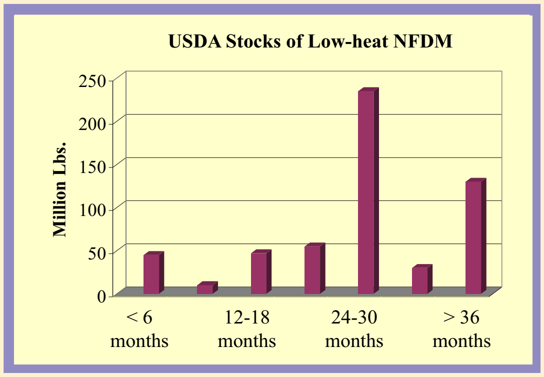
Despite the recent respite from historically high cheese and butter prices, now is not the time to get lulled into thinking that low, or lower, prices are here to stay.

Domestic Production: On the milk production front, wet conditions stretching from the Upper Midwest to the Northeast have negatively affected both quality and quantity of alfalfa, corn and soybeans. The Western region also lacks ample supplies of premium-quality dairy hay. As a result, gains in milk per cow are likely to be less than previously expected during the second half of 2004.

World Market: The world market is tight. Southern hemisphere production is completed for the season and European production, like U.S. output, is headed downward.

Imports: Despite record-high butter and cheese prices, dairy product imports during the first half of 2004 were kept in check due to a limited world supply and unfavorable exchange rates. From January through May, cheddar and American cheese imports at the high-tariff level totaled just 12 million lbs., down more than 500,000 lbs. *vs.* last year. Butter imports at the high-tariff rate were more robust, reaching 10.8 million lbs. *vs.* last year's 100,000 lbs. but are about half the volume imported in 2001, when domestic butter prices soared. Given world market tightness, imports are not expected to be a factor until at least Q4 2004.

Exports, including DEIP: The new Dairy Export Incentive Program (DEIP) year begins July 1, 2004, and runs through June 30, 2005. That brings the potential export opportunity for 150.4 million lbs. of nonfat fat dry milk, 66.8 million lbs. of cheese and 46.5 million lbs. of butterfat. In the past, USDA has filled nonfat and cheese allocations in stages and strong domestic butter demand has prevented butter exports. It is unknown when USDA will announce the new allocations. However, with the world market for nonfat dry milk above 90¢ per lb., modest commercial exports of nonfat are likely with or without DEIP.



Nonfat dry milk stocks have dwindled significantly in the past few years. *Source: USDA.*

CWT: Last is the *Cooperatives Working Together* program that aims to bolster dairy product prices through herd reduction and exports of butter and cheese whenever wholesale butter and cheese prices fall to $1.20 and $1.30 per lb., respectively.

The only factor that could lead to a fundamental shift in supply is the opening of the border to live Canadian cattle, not expected until 2005, if then. In the meantime, the bumps in the road are likely to keep markets unsettled. MCT

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