



MCT COMPASS

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The Challenge of Being Thin

Every so often, the cash dairy markets in the United States come under fire. Words like “irrational” and “dysfunctional” get thrown out in haphazard conversations. In the early 1990s, cash cheese trading took place at the National Cheese Exchange (NCE) in Green Bay, Wis. The NCE came under fire whenever cheese prices tumbled, taking milk prices down with them. No one questioned why cheese prices increased, but questions inevitably arose when prices fell.

Ironically, more than a decade later, and after the cash cheese market was moved from the NCE to the Chicago Mercantile Exchange (CME), similar allegations have

surfaced in the cash cheese market; however, this time allegations focus on the ability of the market to stay high for so long.

In both cases, the cash cheese market suffered from the same ailment. It's just too thin. Economists describe thin markets as those that have too few players and too little trading volume. As a result, market prices determined by thin markets, like dairy and eggs, are often more volatile than market prices determined in more robust markets like corn and soybeans.

What's up with butter?

Cheese trading on the CME has remained relatively stable since 2000, while butter trading has increased significantly (see chart, page 2).

Despite trading just three days a week, the volume of butter trades is more than double that of cheese trading. Through October 2004, 1,812 loads of butter have been traded at the CME. That's equal to 72.5 million pounds of butter and represents 9% of total butter production through September. In any one month, trading volume has represented as much as 16% of the monthly butter production.

Clearly, manufacturers and end-users of butter are not the only ones interested in the cash butter market. Other market participants, including ice cream

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KEN'S CORNER



*by Ken Meyers
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Similar to ice cream manufacturers' raw material costs being dictated by the cash butter

price, raw material costs for non-cheddar manufacturers are dictated by the cash cheddar price. Virtually all cheese prices,

whether Parmesan, Limburger or other varieties, are based off of the CME cash cheese market. And the price of milk paid by cheese manufacturers from California to Vermont is based off the cash cheddar price.

Unlike non-butterfat milkfat users who have made the cash butter market more robust, few if any, non-American cheese makers or end-users have become active participants in the cash market. Thus, trading volume of cash cheddar has changed little since 2000.

Prior to the CME going public, there was a dairy products committee comprised of industry members and CME members that met regularly to address industry issues. A similar committee does not exist under the new CME structure. The time has come for the industry to reinstate a dairy products committee that will once again meet regularly to address industry issues. **MCT**

Correction Ahead

Strong seasonal dairy product demand is likely to buoy milk and dairy product prices through November. A market correction is expected by year end. Milk production, driven by 3% to 5% production gains in the West, will bolster dairy product production

causing prices to fall to more historical average price levels

during the first quarter of 2005. **MCT**

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
Oct	1.5170	1.4688	14.20	1.6475	12.85
Nov	1.4525	1.4300	14.15	1.5250	12.05
Dec	1.3475	1.3150	13.00	1.3675	11.45
Jan	1.3050	1.2750	12.15	1.3200	11.10
Feb	1.2850	1.2550	11.95	1.3275	11.00
Mar	1.2650	1.2350	11.70	1.3975	11.25

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

Way too thin...

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 manufacturers and marketers whose pricing formulas are highly dependent upon the price of butterfat, have also entered this market.

The learning curve in dairy markets can be steep and cumbersome, but it is doable. Take butter, only product produced after December 1 can be delivered on the CME cash and futures butter markets after March 1 of the following year.

Those who want to trade face many hurdles, including the logistics of sourcing butter, both on and off the exchange; maintaining grading certificates, and perhaps even arranging for new certificates; locating storage facilities; freezing and thawing butter; delivering the butter against futures contracts; taking delivery of butter futures; and potentially finding a market for the butter off the exchange.

Analysts can only speculate how high butter prices would have gone in 2004, had not a cross section of interested parties participated in this market.

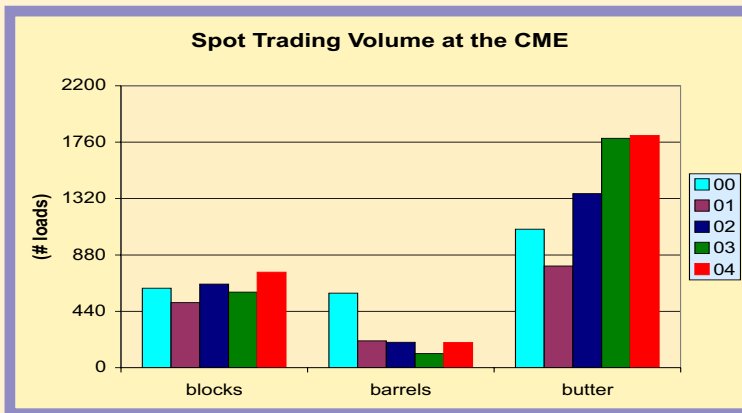
Where's the cheddar?

The cash cheese market at the CME is for cheddar cheese in the form of 40-lb. blocks and 500-lb. barrels that is less than 30 days of age. During 2000, the volume of block and barrel cheddar cheese traded at the CME reached 48 million pounds and accounted for 1.7% of total Cheddar cheese production in that year. At most, the trading volume in any one

month has account for 6.3% of total cheddar cheese production (August 2000).

Why is cash cheese trading so much thinner than cash butter trading? Industry participants note that it is easier to trade butter because of the storability of the product. Cheddar cheese must be sold within 30 days of make. This leads to market situations where a single load of block or barrel cheese can move the market significantly lower, simply because the seller must move the cheese before it becomes ineligible to trade.

Other factors contributing to the thinness of the cash cheese market include: ever-declining production of cheddar cheese as a percent of the American cheese category; the shifting from 40-lb. block and 500-lb. barrel cheese production to 640-lb. block production; and the more rapid growth in non-American cheeses. **MCT**



Only butter trading volume on the CME has risen steadily since 2004. Source: MCT Dairies. Data for 2004 is through October 2004.

