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MCT COMPASS

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There's a New Contract in the Industry

On September 19th, the Chicago Mercantile Exchange launched its latest hedge product, the cash settled butter contract. The cash settled butter contract has been a long time in the making. The concept was first introduced in 1999. The contract lay dormant until enough industry support and a market maker could be found. The CME selected Modern Dairy Markets LLC as the market maker. The market maker ensures liquidity in the market by providing competitive bids and offers.

The contract is also testing the waters of electronic trading. It is the exchange's first dairy futures contract to trade solely on the CME Globex electronic trading platform. There are several differences between the physical delivery grade AA butter futures and the cash settled butter futures. Cash settled butter futures trade in every month while the physical delivery futures trade just six months during the year. The cash settled butter contract is only 20,000 lbs. vs. the 40,000-lb. physical delivery contract.

The cash settled butter contract is a butterfat-user friendly contract. It allows end users of butterfat, such as ice cream and cheesecake manufacturers, to hedge their butterfat costs without the hassle of taking delivery of the physical product — butter — which they do not use to manufacture their finished products.

It is important to note that the new contract settles against the weighted average USDA National Agricultural Statistic Service (NASS) surveyed butter price that is used in the Class II, III and IV pricing formulas, rather than the monthly average CME grade AA spot butter market.

Using the current spot CME butter market to predict the NASS butter price can be tricky business. On average, the CME annual average spot butter price is 2.0 to 3.0 cents per pound higher than the NASS annual average butter price (see table, page 2). However, the monthly variation between the two markets can be much greater. The graph on page 2 illustrates that the CME spot market averaged

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KEN'S CORNER

by Ken Meyers
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The dairy industry is still in its futures infancy stage when it comes to developing and supporting futures contracts. The tireless efforts of several key dairy industry participants are to be welcomed by the users of the cash settled butter futures contact. The new contract provides Class II and IV users a more effective tool to hedge their butterfat.

The contract also highlights some of the differences in industry practices. For example, USDA surveys FOB plant prices for 68-lb. boxes while the industry is producing an ever greater supply of 25-kg. boxes. The exclusion of 25-kg. boxes in the USDA surveyed price reduces the volume of surveyed prices and results in a price that is less representative of the entire bulk butter market.

Similar to the introduction of other dairy futures contracts, initial trading volume has been light. But this is just the beginning and volume begets volume. Hopefully the new contract will add to the volume of all butter futures rather than splitting the liquidity between the physical and cash settled futures contracts. MCT

Where's the Cheese?

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
Sep	1.5630	1.4975	14.25	1.7040	13.80
Oct	1.5025	1.4700	14.60	1.7050	13.75
Nov	1.4450	1.4225	13.75	1.6350	13.60
Dec	1.4000	1.3700	13.25	1.5075	12.85
Jan	1.3800	1.3400	12.90	1.4025	12.40
Feb	1.3500	1.3200	12.50	1.3775	12.15

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

Once again a very robust milk production report was followed by a bullish cold storage report. August was the fourth consecutive month of year-over-year milk production gains of more than 3%. Despite those exceptional gains, the marketplace is absorbing the increased supplies with little gain in inventories. USDA reports that commercial stocks of American cheese are just 0.5% greater than August 2004 while butter stocks are 6.7%, or almost 11 million pounds, less. USDA also reports that for the first time since the start of the price support program in 1949, the current marketing year will end on September 30, 2005, without any surplus of any dairy product. MCT

Large Fluctuations...

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24 cents higher than the NASS butter price in November 2000. The following month, the CME price averaged about a dime less than the NASS price.

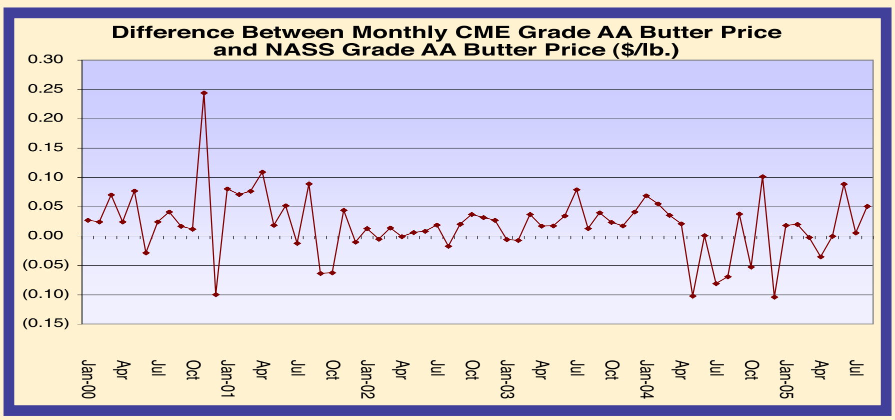
The primary differences between the CME spot butter price and the NASS butter price are the timeliness in reporting and location adjustments. For example, the CME butter price is the spot price for butter located in CME warehouses in Chicago. Meanwhile, the NASS butter price is derived from weekly FOB sales prices of bulk butter.

Since the majority of bulk butter (68-lb boxes) is produced in the West and trades at a transportation discount relative to Chicago, the NASS surveyed butter price tends to be less than the CME spot butter price. Large variations in the monthly averages are due to precipitous drops or large gains in the market at the end of the month, that are not captured into the NASS surveyed price until the following month.

Comparison of Annual NASS and CME Butter Prices

	NASS Monthly Butter ($/lb.)	CME Monthly Spot Butter ($/lb.)	Difference CME Minus NASS
2000	$1.1408	$1.1768	$0.0360
2001	$1.6304	$1.6631	$0.0327
2002	$1.0931	$1.1059	$0.0128
2003	$1.1194	$1.1450	$0.0256
2004	$1.8239	$1.8166	$(0.0074)

Source: MCT Dairies.



During its first week of trading, the cash settled butter futures posted open interest of 63 contracts. Daily trading volume in the physical delivery contract was often double that of the cash settled contract. This could be coincidence or perhaps reflect an arbitrage opportunity between the two contracts, only time will tell. MCT

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