



MCT COMPASS

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Is 1.3% Growth Enough?

Historically, U.S. milk production has increased by 1.3% annually. This is true whether comparing 1980 to 2005, 1995 to 2005, or 2000 to estimated 2006. And this is true despite a variety of dairy policy initiatives, including the dairy termination program in the 1980s, enhanced subsidization of exports through the Dairy Export Incentive Program in the 1990s, and the voluntary producer-driven Cooperatives Working Together (CWT) supply management program.

As domestic and global dairy companies that source milk and dairy based ingredients from the United States, plan for the next five years, one has to ask whether a 1.3% increase in milk production is enough to fill the domestic market as well as the growing export market? If a review of the past five years worth of growth in U.S. dairy exports is any indication, then the answer is "no."

Since 2001, U.S. dairy exports have

increased from 410,661 metric tons to 682,002 metric tons in 2005. That translates into an average annual increase of 13%. During that same period, the global milk supply has increased by just 11%, according to USDA's Foreign Agricultural Service.

The Who's Who list of global milk producers is topped by the vast 25-country European Union. According to FAS, the EU-25 is expected to account for 31% of the global milk supply in 2006. This is 3% less than the EU-25's share of global milk production in 2001. Due to production quotas and the absorption of new member states, the EU is not expected to gain in market share, and in addition, exports are expected to decline due to lack of subsidies.

The United States is the second largest producer of milk in the world. Its percent of world production has been stagnant at nearly 20% over the past five years. Countries making up the majority of the remaining half of the global milk supply include the Former Soviet Union (Russia

and Ukraine) with 11%, India with 9%, China with 8%, and Brazil and Oceania both with 6%.

Of all those countries, China posted the greatest volume and share gain. Milk production in China has increased from 10.3 million metric tons (or 22.6 billion pounds) in 2001 to a forecasted 33.8 million metric tons (or 74.5 billion pounds) in 2006. In other words, China has gone from producing as much milk as Wisconsin to producing as much milk as Wisconsin, California, Idaho and Washington combined in just six years.

About half of the 23.5 million metric ton increase in China's production during this period has supplied the growing fluid milk demand. The other half has been converted into whole milk powder production that has increased by 390,000 metric tons since 2001.

Continued on page 2

KEN'S CORNER



*by Ken Meyers
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The U.S. dairy industry is at an important cross-roads. Do dairy producers embrace the global market

as growth for domestic milk production, or do they continue to explore supply management alternatives?

Do dairy processors

expand capacity, or invest in new technology, or add staff to support new global markets with the risk that exchange rate fluctuations could render your product price uncompetitive?

Clearly, the export market is not a bed of roses or for the weak of heart. But without it, the U.S. dairy industry will continue to see contraction, not in terms of volume, but in the number of players needed to serve the domestic market, whether

producer or processor.

Global markets offer the best alternative. The U.S. dairy industry has proven itself time and again that it can be a reliable supplier. Demand for dairy products from the developing world will continue to grow. If the United States doesn't step in to fill some of those needs, other countries will. Therefore, the United States needs to continue the momentum for further growth. **MCT**

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Run-up ahead?

The fourth quarter is typically a strong one for dairy product sales. Butter and cheese markets are trading near highs for the year, but are still below historical averages. Dry product markets from whey to buttermilk powder are strong. Dry whey prices could hit 40 cents per pound by year end. And every penny gain in the NASS whey price translates into a 6-cent increase in the Class III price. In general, dairy

MCT Forecast					
	Block*	Barrel*	Class III	Butter*	Class IV
Sep	1.2881	1.2904	12.29	1.3168	11.10
Oct	1.3300	1.3150	12.80	1.3450	11.60
Nov	1.3350	1.3150	13.00	1.3500	11.65
Dec	1.3200	1.2950	12.60	1.3200	11.50
Jan	1.3200	1.2950	12.40	1.3300	11.30
Feb	1.2850	1.2600	12.25	1.3000	11.20

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

product stocks are manageable to short, so any unforeseen increase in

demand or supply contraction could position the market for a run-up. MCT

Not just a U.S. market ...

Continued from page 1

Given China's increase in milk production and whole milk powder production, one could believe that China would be a net exporter of powder. But this is not the case. China is expected to import 60,000 metric tons of whole milk powder while exporting just 34,000 metric tons, according to FAS.

Even as China has grown its domestic dairy industry, it has increased its dairy imports from the United States. In 2001, China imported 30,419 metric tons of U.S. dairy products and accounted for 7% of all U.S. dairy exports. By 2005, dairy exports to China had increased to 72,470 metric tons and represented 10.6% of U.S. dairy exports. Through August 2006, exports to China are up 11.6% vs. 2005.

While China is a growing and important market for U.S. dairy exports, it ranks a distant second to our southern neighbor Mexico as the No. 1 destination for U.S. dairy exports. In 2005, dairy exports to Mexico totaled 178,396 metric tons and represented more than a quarter of all U.S. dairy exports. The third and fourth largest importers of U.S. dairy products are Japan and Canada. Together these four

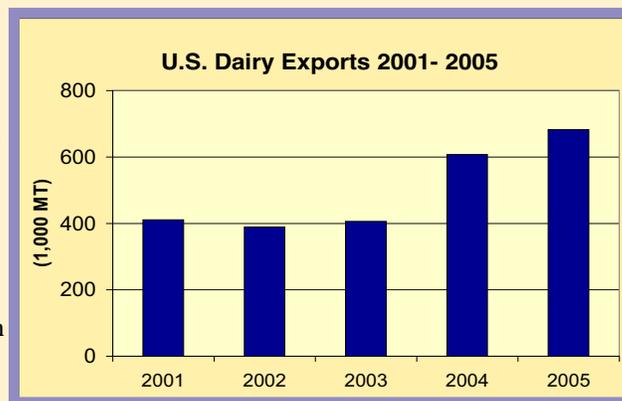
countries accounted for more than 50% of all U.S. dairy exports during 2005. It's important to note that domestic milk production in both Canada and Japan has declined over the past five years while Mexico's domestic milk production has grown on average by just 1%. As a result, the outlook for U.S. dairy exports to these markets remains positive.

Another compelling reason to be optimistic for continual growth in U.S. dairy exports is the rising disposable incomes in developing countries, which are fueling demand for basic food products, higher valued-added branded products, and in some areas, growing food service demand.

In 2006, U.S. dairy exports have been strong, and not only in the traditional whey and lactose markets, up 22.5% and 17%, respectively, through July 2006 vs. the prior year. Skim milk powder exports got off to a slow start in 2006, but 32,474 metric tons (or 71.6 million pounds) were exported in July 2006 alone, bringing year-to-date exports within 4.6% of last year. Perhaps most surprising, and probably the category to

watch for growth is cheese and curd. Through August 2006, exports totaled 40,108 metric tons, up 27% from last year. If the United States continues to expand its output of whey and lactose, both byproducts of cheese making, it's logical to assume cheese exports will also need to increase.

All in all, the international dairy markets offer U.S. dairy producers the opportunity to continue to expand their dairy operations and dairy processors and traders a stronger rate of growth than the domestic market offers. How much more milk does the industry need to fill the demand? Our estimation is closer to a 2% annual average growth rate in U.S. milk production rather than the 1.3% experienced in the past. MCT



Source: USDA Foreign Agriculture Service.



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