



MCT COMPASS

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The Disconnects

The dairy industry is navigating through uncharted territory. Typically as the number of cows in the dairy herd increases, the price of milk decreases. That is not the case today. Block Cheddar cheese typically sells at a 3-cent or higher premium to barrel Cheddar cheese. That hasn't been true for several months. Historically, dairy by-products like whey and lactose have been secondary to the production of cheese, the primary product. That relationship is less clear today as by-product prices are nearly double their historical value while cheese prices remain less than \$1.40 per pound.

U.S. milk production increased 2.7% in 2006 to 181.8 billion pounds, following a 3.1% increase in 2005. The key drivers behind the 2.7% gain in 2006 are an 0.8%

increase in the U.S. dairy herd and a 1.9% gain in milk per cow.

Looking forward, the dairy herd is positioned for further growth. In December 2006, the U.S. dairy herd increased by 13,000 head vs. the prior month. In December 2005, the U.S. dairy herd increased by 7,000 head and posted an average monthly gain of 13,667 head each month through June 2006. The chart (see page 2) illustrates a realistic "what if" scenario: what if cow numbers in 2007 were to replicate the same monthly gain during the first half of this year as they did last year? The dairy herd average would be about 60,000 head more each month or 0.7% vs. the prior year and peak at 9.208 million head. That is the highest herd count since November 2000 — the same month the class III price fell to \$8.57/cwt.

Rising cow numbers beg the question: will CWT (Cooperatives Working Together) take out cows in 2007? CWT has not implemented a herd reduction program since 2005. To date, CWT has avoided culling cows when the Chicago Mercantile Exchange butter and cheese prices have been greater than \$1.30/lb. opting to use the program's limited dollars to subsidize exports. Today's class III futures do not warrant a herd reduction; however, the picture could be different by spring. This is the card producers could play to assure prices stay strong.

Despite the anticipated increase in the U.S. dairy herd, class III milk futures continue to increase. If futures hold, dairy producers will see a price of more than \$14.00/cwt

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KEN'S CORNER



*by Ken Meyers
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It appears that future growth in U.S. milk production is

dependent upon both increased cow numbers and greater milk per cow. Historically, the industry has depended upon just

increased milk per cow. We expect milk production to increase 1.7% to 2.2% based upon a 0.5% increase in cow numbers and a modest milk per cow gain of 1.0% to 1.5%. That is less than the historical average growth rate and reflects rising feed costs and lower bST use. Together, the higher cow numbers and increased milk per cow will net a 2.2% gain in milk

production.

Based upon the past two years, the domestic and global markets will absorb this production gain with little price downside and potentially more upside. Instead of the exporter of last resort, the United States will become a consistent global player — no longer just a spot player. **MCT**

Fighting the Bull

CME cheese and butter markets have been unable to sustain gains and trade within a narrow price range. Dry product markets remain strong. Milk production continues to grow and we expect an early flush. Favorable weather in California is already testing plant capacity. While it's dangerous to fight bulls, in the short term, we question whether \$14.00-plus

The product price lag...

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during the first half of the year and prices in excess of \$15.00/cwt during the second half. A \$14.00 Class III price average will depend on the prices of cheese, dry whey, and butter. For example, a cheese price of \$1.535/lb and a dry whey price of 25 cents per pound yields a class III price of \$14.00/cwt.

Likewise, a cheese price of \$1.35/lb and a dry whey price of \$0.55/lb yields a class III price of \$14.00/cwt.

Dairy producers may be indifferent to how the class III price gets to \$14.00, but manufacturers are not. Cheese manufacturers that produce by-products other than dry whey, such as WPC 34, WPC 80, and WPI, face margin squeezes when the sale prices of other whey derivatives do not follow the price change in dry whey. For example, during third quarter 2006, the dry whey price increased on average 8% each month while the WPC 34 price only increased 4% each month.



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MCT Forecast							
	Block*	Barrel*	Butter*	Whey**	NFDM**	Class III	Class IV
Jan	1.3180	1.3316	1.2255	0.4700	1.070	13.58	12.55
Feb	1.3200	1.3300	1.2700	0.5350	1.130	13.75	13.15
Mar	1.3000	1.3100	1.3000	0.5400	1.200	13.55	13.85
Apr	1.3025	1.3225	1.3000	0.5500	1.200	13.70	13.85
May	1.3400	1.3500	1.3400	0.5500	1.200	14.00	14.05
Jun	1.3800	1.3750	1.3850	0.5500	1.200	14.35	14.25

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

class III prices are sustainable. Longer term, rising feed costs and

healthy world markets will set the stage for a strong second half. **MCT**

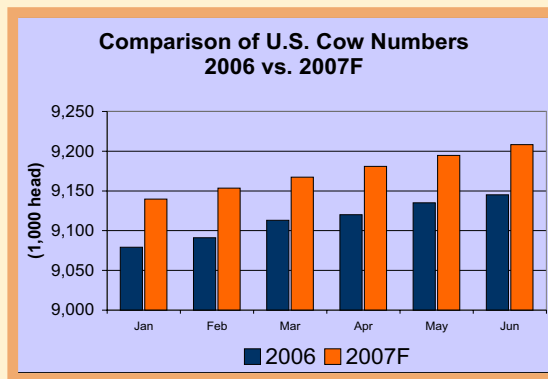
However, by year-end, monthly increases in WPC 34 sale prices caught up with dry whey price changes and both continue to increase.

Neither processor nor producer is immune to rising corn prices. Processors are paying more for high fructose corn syrup and this has contributed to greater lactose and sweet whey demand.

New paradigm priced corn and corn silage is expected to enter feed rations by mid-year. There is tremendous speculation on the impact of higher feed prices on milk production. Some suggest that for every pound of shell corn reduced from the ration, milk production falls

by a pound. Typically, 10 to 15 lbs. of shell corn is in a milk cow's ration. A 2-lb drop in milk per cow during the second half of the year could translate into a 1.5% decrease in milk production. However, it is questionable whether feed rations will change because the price of substitutes has also increased.

As the industry continues to adapt to these changes, one must ask whether today's market conditions are sustainable? In the face of rising feed costs, will dairy producers continue to produce more milk per cow? Can dairy product manufacturers optimize by-product production to either reduce costs or enhance revenues? How producers and manufacturers respond to these changing conditions will not only impact the domestic market but also the global market. With fewer exports sourced from Oceania and Europe, the United States has by default become the balancer of world dairy markets. Now that is uncharted territory. **MCT**



Source: MCT Dairies. F = forecast.