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MCT COMPASS

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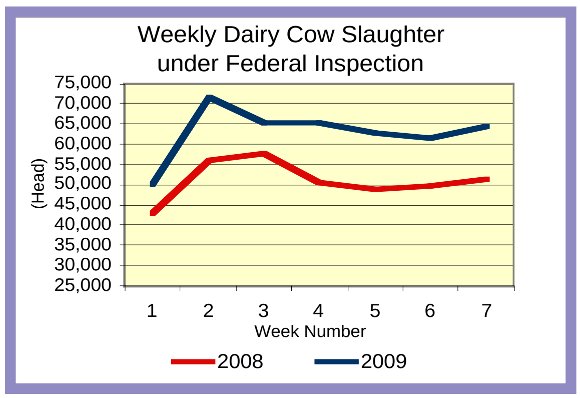
Contraction Ahead

There's an old adage in the dairy industry that makes economists cringe. It goes like this: "When milk prices are high, dairy producers milk more cows, and when milk prices are low, dairy producers milk more cows." But that is not the case today.

According to USDA's weekly dairy cow slaughter reports, slaughter through mid-February 2009 is running 84,375 head ahead of last year. Dairy producers indicate that any cow not covering feed costs is headed to slaughter. While feed costs per hundredweight of milk vary across the country, a range of $7.00 to $10.00/cwt. would cover the majority of milk produced in this country. Feed costs are now dropping, but a key component in the dairy ration is corn and corn prices have not retreated to the same degree as milk prices.

What is uncertain is whether dairy producers are culling aggressively just to make room for more productive, younger cows. According to USDA, 2.909 million dairy heifers are expected to calve in 2009. Simply dividing that number by 12 months indicates that the dairy cull needs to be at least 242,417 head per month just to make room for the replacements. The latest milk production report states that the U.S. dairy herd declined by 14,000 head in January 2009 vs. December 2008. That's a start, but even greater declines are expected through mid-year.

February 2009 milk prices are expected to be the lowest in several years with the California overbase price and the Class III milk price estimated near $9.50/cwt. After paying the feed bill, there isn't much left over. Depending on who one asks, dairy producers are losing from $100 to $200/head per month. Splitting the difference at $150, that translates into a monthly loss of $15,000 for



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KEN'S CORNER

by Ken Meyers
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This is a difficult market to decipher. The industry has never experienced anything like it. Truly, a perfect storm has hit, but skies could clear just as quickly.

Exports came to a near standstill as credit dried up last fall. U.S. consumers, whether they still have a job or not, are showing spending restraint not seen in our lifetimes. A recent Associated Press poll showed that 47% of all consumers are at least somewhat worried about losing their jobs, and consumer confidence has fallen to an all-time low of 25.

The milk price crash has occurred at a time when feed prices are still relatively high, leaving dairy producers in a very precarious position. But producers are a stalwart lot. Most are in business for the long term and they'll likely bite their lips and try to hang on.

Something's got to give, and it will. The economy will recover and consumers will celebrate by dining out, and buying more premium ice creams and artisan cheeses. In the meantime, some producers will call it quits.

However, the timing of this recovery is very difficult to predict, because it hinges on so many factors. MCT

Margins improve...

The CME spot block and barrel cheese markets are unsettled. After bottoming at sub-support price levels last month, the spot block and barrel cheese markets moved 20 cents higher in three weeks of trading just to give up a dime during the last week of this month. It's possible that the stronger manufacturing margins due to the low Class III price in relationship to the rising cheese market prompted additional cheese production, which is now finding its way to the marketplace. MCT

MCT Forecast

	Block*	Barrel*	Butter*	Whey**	NFDM**	Class III	Class IV
Feb	1.2174	1.1993	1.1094	0.1567	0.822	9.31	9.45
Mar	1.2350	1.2000	1.2000	0.1550	0.810	10.45	9.70
Apr	1.2500	1.2250	1.2400	0.1600	0.805	10.50	9.90
May	1.3000	1.2750	1.2750	0.1650	0.810	10.80	10.10
Jun	1.3500	1.3300	1.2850	0.1700	0.820	11.35	10.25
Jul	1.4000	1.3800	1.3300	0.1850	0.835	11.95	10.50

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

Losses mount..

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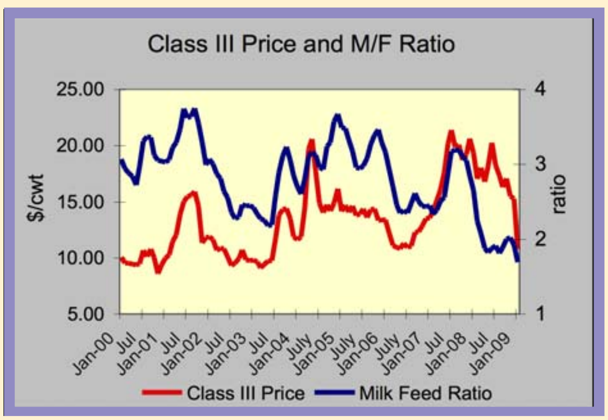
a 100-cow dairy and a $150,000 loss for a 1,000-cow dairy.

What makes the low milk prices of 2009 different from those that occurred in 2000, 2002, and 2006? The figure below illustrates the Class III milk price compared to the milk/feed price ratio. In the previous periods of low milk prices, feed prices were also low. For example, in 2000 the milk/feed ratio was still above 3.0, which means that for every pound of milk a dairy sold, it could buy 3 lbs. of feed. In January 2009, one pound of milk bought only 1.69 lbs. of feed. The milk/feed ratio is expected to be even lower in February prompting an even greater sell-off of the herd.



Many dairy producers did "save for a rainy day" during the strong milk prices of 2007 and 2008. In addition, producers paid down debt and enhanced their equity positions. Today producers are refinancing to enhance cash flow. However, one key challenge is that the value of a milk cow has decreased from $2,500/head to less than $1,500/head.

In the recent past, some banks collateralized a milk cow at $1,500/head but recently reduced that to $1,000/head, thus eroding the borrowing ability of dairy producers and lending ability of bankers. The next six months are expected to be very difficult for dairy operators as they bring production costs in line with revenue.

A recovery in milk prices will depend on more than just a reduction in supply, though. On the demand side, retail sales remain good for many products, but foodservice sales have softened. Technomic's recently released its U.S. Foodservice Industry Forecast, which predicts that total food service sales will drop by 2.2% in 2009. Full service restaurants will feel even more pain, with a 6.0% reduction in sales, according to the forecast. Granted part of this lower estimate is due to declining commodity costs.

Even so, the next six months will be challenging for everyone, processors, producers, and consumers alike. The contraction at the farm level will occur. That's a given. What happens at the consumer level is more uncertain. Not only is the U.S. economy driven by the financial strength of its consumers but so, too, is the dairy industry. And for now, consumers have seen a drastic decline in the value of their homes, their stock portfolios, and their job opportunities. MCT

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