

The Causes of Volatility

Price volatility in the milk and dairy product markets is not new, but price volatility has arguably become more dramatic over the past decade or two.

Through the 1970s and 1980s milk and dairy product prices were relatively stable due to the ever-increasing price levels of the U.S. dairy support price program. However, when federal budget cuts dictated a reduction in the support prices in the mid-1980s, milk prices became more volatile.



There are numerous factors that contribute to milk price volatility.

There are numerous factors that contribute to price volatility. Most economists point to the fact that milk and dairy products tend to have “inelastic” demand. That is, consumers don’t stop buying dairy products just because prices have moved higher.

On the other side of the equation, dairy producers demonstrate inelastic supply responses to short-term changes in milk prices. That is, producers tend to make small changes in

short-term milk production decisions even as milk prices decline. For example, the all-milk price in 2009 averaged \$12.79/cwt., a decrease of \$5.53/cwt., or 30% vs. 2008. Still, U.S. milk production only decreased 0.1% for the year. Furthermore, USDA indicates that the number of dairy farms in the U.S. totaled 65,000 in 2009, down just 2,000 from 2008. During the record-high milk price years of 2007 and 2008, the U.S. dairy herd decreased by 4,885 and 2,995 head, respectively. The Cooperatives Working Together program accepted 1,800 farms in its herd retirement programs in 2009. As dairy farming has become more capital intensive and asset specific, the rate of exits has become more sluggish. In other words, the core dairy operators are in it for the long run and they are not that responsive to short-term changes in milk prices.

Seasonality of milk production has historically

played a role in milk and dairy product price volatility. A definite seasonal pattern of milk production exists, largely because of the calving cycle. Milk cows predominately calve in the spring resulting in a “spring flush” of milk. Summer heat and humidity typically temper milk production into September. By October, milk production

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Ken's Corner



*by Ken Meyers
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There's no looking back. Milk price volatility is here to stay largely because the days of USDA holding a billion pounds of product or more in inventory are long gone. In an effort to help producers and processors manage volatility, the U.S dairy

industry has been increasingly exposed to futures. The dairy futures markets have come a long way since the first contracts traded in 1995 at the New York Coffee, Sugar, and Cocoa Exchange.

Today, the CME Group offers eight dairy product futures contracts: Class III, Class III midi, Class IV, deliverable butter, cash-settled butter, deliverable nonfat dry milk, cash-settled nonfat dry milk, and whey. A skim milk powder contract is currently under development.

While it is probably impossible for a dairy company to remove all of the volatility from the dairy markets, it is possible to reduce price volatility at the firm or individual level by using dairy futures or forward contracts. The days of letting every little bump that occurs in the domestic and global marketplace affect profitability should also be a relegated to the past. **MCT**

Bad timing...

According to USDA's Milk Production report, dairy farmers added a few cows (+3,000) in January

2010 vs. December 2009 as profitability marginally increased. Unfortunately the timing of additional cows

coincided with a slowdown in demand. American cheese stocks as of January 31, 2010, are 11.6% greater than last year. The spot cheese market is likely to remain weak until we see either a slowdown in American cheese production or a reduction in stocks. **MCT**

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV	Whey**	NFDM**
Feb	1.4530	1.4180	14.20	1.3570	13.05	0.3850	1.1000
Mar	1.3500	1.3100	13.00	1.4450	13.30	0.3800	1.1000
Apr	1.3900	1.3600	13.00	1.4550	13.60	0.3775	1.1250
May	1.4300	1.4150	13.30	1.4750	13.90	0.3675	1.1500
Jun	1.5000	1.4750	13.90	1.5000	14.20	0.3700	1.1750
Jul	1.5500	1.5000	14.40	1.5500	14.30	0.3750	1.1850

* CME prices.

**NASS prices.

for every season...

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begins to seasonally increase but will not peak until May.

Demand also has seasonality. Demand for fluid milk is the greatest during August and September when students return to school. This coincides with the seasonal trough in milk production. In addition, seasonal spikes in milk and dairy products occur from Thanksgiving through the Super Bowl and then again during Easter/Passover.

Technology has played a key role in the growth of U.S. milk production. In 1940, dairy farmers milked more than 24 million cows that produced an average of 4,622 lbs. of milk annually. In 2009, the dairy herd totaled just slightly more than 9.2 million head and production per cow was over 20,500 lbs. Advancements in genetics, feeding, herd health, cow comfort, biotechnology, milking equipment, and refrigeration have all contributed to greater on-farm efficiency. Looking forward, sexed-semen will reduce the biological time line to expand the dairy herd and reduce the barrier to entry. According to USDA, there were 106,000 more dairy heifers weighing at least 500 lbs. as of January 1, 2010, compared with January 1, 2009.

The export market offers U.S. dairy producers and processors the opportunity to expand their markets beyond our borders. That opportunity also presents some

challenges. U.S. dairy companies have been successful global marketers of whey, whey proteins, lactose, and lactose blends for decades. Export opportunities for butter, nonfat dry milk, and cheese have been less certain. During the 1980s and 1990s, large volumes of butter and nonfat dry milk were exported through food aid channels or with subsidies rather than through commercial markets. Since 2001, U.S. exports of nonfat dry milk have increased rapidly. In 2008, additional commercial export opportunities occurred due to lack of supply from Oceania and European competitors, greater purchasing power from oil exporting countries, and the weak dollar. All three of these factors, as well as the timing of export sales, contributed to price volatility.

Last, but certainly not least, is the regulatory framework. The U.S. dairy price support program has become a support price for the world as U.S. product enters government stocks rather than clearing on the global market. The MILC (Milk Income Loss Contract) insulates dairy operators with fewer than 130 cows from lower milk prices than their larger-herd counterparts. Federal and state milk marketing orders dampen market signals to dairy producers, slowing producer response, particularly in a down market. **MCT**



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