

Keeping an Eye on Margins

Milk prices are starting the year weaker than they did in each of the past six years and feed prices are rising. Increasing feed costs, one of the largest inputs for dairy farms, coupled with low milk prices, signal that on-farm margins could be weaker this



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year. Keeping a keen eye on farm margins is critical. Improving on-farm margins tend to indicate periods of milk supply expansion, while deteriorating margins portend periods of contraction, ultimately influencing the direction of dairy product prices.

Historically, the milk-over-feed margin has been a good indicator of on-farm profitability and the ebb and flow of U.S. milk production. The Margin Protection Program (MPP) dairy calculation assumes that it takes 60.1 lbs. of corn, 7.4 lbs. of soybean meal, and 13.7 lbs. of alfalfa to produce 100 lbs. of milk. The difference between the All-Milk price and the MPP value for feed provides a milk-over-feed margin, or the amount of money left over after a farm buys its feed.

In the past, when the milk-over-feed margin exceeded \$6/cwt., U.S. milk expanded, and when it was less than \$5.50, it tended to contract. The last time U.S. output posted a year-over-year decline was in December 2013. In that year, the milk-over-feed margin fell below the \$5.50 threshold three times. Since then, year-over-year U.S. milk production has expanded for 49 consecutive months. During that time, the milk-over-feed margin remained above \$6/cwt. except in May and June 2016, when the U.S. milk supply outpaced demand at the start of the year largely due to a slowdown in exports. At that time, dairy prices in Europe and Oceania were significantly lower than U.S. dairy product prices.

While the milk-over-feed margin is just one of several indicators for U.S. milk production, in the past it has also provided early warnings regarding potential shifts in U.S. dairy product output. In January, the national milk-over-feed margin was \$8.01/cwt., down \$3.05 vs. the prior year and \$1.31 less than in December 2017. Using closing futures prices for Feb. 27, 2018, and assuming alfalfa

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by Ken Meyers
President, MCT Dairies Inc.

Predicting the future for ever-changing dairy markets is fraught with challenges. A drought in New Zealand or an impulsive political move here or abroad can change the forecast dramatically. But understanding on-farm economics gives buyers and sellers a leg up when trying to anticipate future

dairy product supplies and price.

U.S. producers are starting 2018 with the lowest projected margins since 2013. At the same time, non-feed costs like labor, environmental compliance, and debt have also increased, making a potential downturn theoretically more serious than recent contractions. Deteriorating margins also increase the probability that output could slow—at least in some states.

On-farm economics also tend to favor one type of farm or one part of the country over another. Large farms typically weather lower prices better than small farms due to economies of scale, but small farms, like those that dot the Eastern Seaboard, are also at risk. But even this is not as simple as it sounds. Today, with nonfat dry milk prices so much lower than cheese prices, producers who are already feeling the impact of poor margins are in markets with large farms and high Class IV utilization. Unfortunately, many also buy all or most of their feed and feed costs are rising. Unless milk prices rise soon, output on these farms could weaken further. **MCT**

Recovery or Temporary Increase?

Two months into 2018, dairy product prices are still low but showing signs of firming. Stronger Chinese

imports, better domestic demand, and slowing milk supplies are working to rebalance the supply-demand equation, which seems to be bringing buyers back to the market. U.S. butter prices are moving higher on rising prices overseas and U.S. cream supplies tightened in February. Lower prices at the start of the year likely also sparked promotion activity and in turn more consumption. While still too early to call it a recovery, prices are looking for a way to break out. **MCT**

MCT Forecast							
	Block*	Barrel*	Class III	Butter*	Class IV	Whey**	NFDM**
Feb	1.5157	1.4096	13.44	2.1211	12.94	0.2500	0.7105
Mar	1.5350	1.4625	14.03	2.2100	13.24	0.2475	0.7100
Apr	1.4850	1.3950	13.78	2.2025	13.18	0.2450	0.6800
May	1.4950	1.4050	13.54	2.2425	13.23	0.2500	0.6700
Jun	1.5650	1.5150	14.57	2.3100	13.56	0.2535	0.6675
Jul	1.6350	1.6000	14.99	2.3500	13.93	0.2600	0.7200

* CME prices.
**NASS prices.

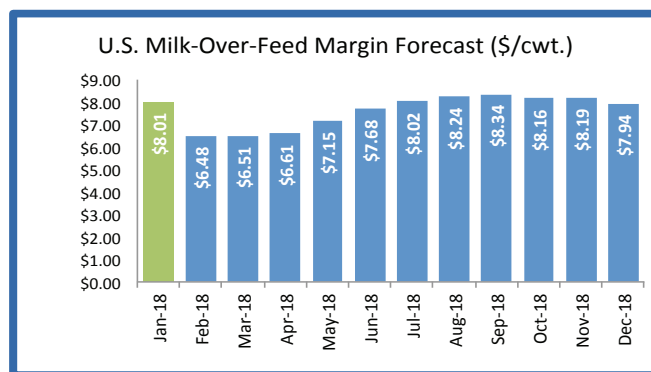
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at \$145/ton, the estimated milk-over-feed margin is \$7.50, the lowest average since 2013—the last time production posted a year-over-year decline. Looking at state economics, though, shows that California’s milk-over-feed margin was \$6.31/cwt. in January, compared to \$8.65 for Wisconsin and \$7.34 for Idaho. That suggests that Golden State producers could adjust operations if margins fade further.

Shrinking milk supplies in California and other western states could affect nonfat dry milk output more so than other products because most U.S. nonfat dry milk is produced in the West. While milk-over-feed margins are lower for Wisconsin and Idaho relative to 2017, they are still at levels that indicate dairy producers will continue to produce more milk. Given that these states are major cheese producers, cheese output is unlikely to be as affected at current price levels.

Small farms, which do not enjoy economies of scale, are also at risk when margins decline as are those operations that buy most of their feed or those that have higher costs due to constantly battling the elements. For instance, in January, New York producers posted a milk production decline of 3.3%, compared to the previous year. Vermont’s output



dropped 2.1% in January and Florida’s declined 1.3%.

At this point, lower milk and dairy product prices are not a forgone conclusion—but futures are projecting a lower first half of the year. While the milk-over-feed margin is just one of many indicators, it helps analysts understand motivation at the farm level and possible shifts or changes in the U.S. milk supply. Dairy producers’ outlook for the future shifts along with milk prices and changes in feed costs. In the end, these numbers, both nationally and by state, provide a leading indication of U.S. dairy product supply months in advance of USDA reports. Today’s futures markets suggest producers could be planning for a downturn in price but hoping markets stabilize in coming months. **MCT**



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