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The Dilemma of Barrels

The CME Cheddar block–barrel price spread has expanded and collapsed this year. Toggling between the high and low spreads has changed the historical relationship between blocks and barrels, shifting profitability for dairy producers and buyers and sellers of cheese alike. Between 2000 and 2016, the CME block-barrel spread averaged 3.3 cents, with the annual average expanding to 4.8 cents and contracting to 1.7 cents and the multi-year average near 3 cents—the level assumed in the National Dairy Products Sales Report (NDPSR) price. In 2017, the average block-barrel price spread widened to 8 cents. This year, it's even larger at 12 cents, a significant departure from past trend. Understanding the drivers behind the price spread could shed light on whether to expect a more disparate gap in the future.

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CME spot markets are a reference price for most of the cheese sold in the country. As such, the CME spot trading session provides buyers and sellers a forum for price discovery. For the reference price to be valid, the market needs sufficient volume, good information, adequate liquidity, and effective rules. Over the past two years, each aspect of market function has challenged the CME markets.

In June 2017, the CME Group migrated spot cheese trading from an open-outcry system to an electronic platform in an effort to provide anonymity to sellers and increase sell-side liquidity. Between September 1998 and June 2017, the average monthly trading volume for blocks and barrels was 40 and 37 loads, respectively. Subsequent to electronic trading, the average weekly block and barrel trade has been 40 and 157 loads, respectively. The enormous increase in barrel trading could indicate volumes are excessive due to extenuating circumstances, but the higher volume also could be skewing price signals and disrupting price discovery.

In late 2016, U.S. cheesemakers added Cheddar barrel capacity, most of it slated for processed cheese production. U.S. output of processed cheese increased

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Ken's Corner

by Ken Meyers
President, MCT Dairies Inc.

A gradual decline in the popularity of barrel cheese along with outdated CME and Federal Order pricing practices have combined to create unwarranted incentives for cheese manufacturers to produce and sell barrel cheese at the CME spot market.

First, the commercial share of barrel cheese as a part of total Cheddar sales has been declining, in part, because millennials are gravitating away from processed cheeses toward natural varieties.

In addition, it appears that weekly mandatory pricing under Federal Order rules might not accurately reflect commercial activity, resulting in barrels having too much influence on the cheese price used in the Class III milk pricing formula. Barrels typically represent about half the total volume of cheese in the NDPSR price, while commercially they only represent between 30% and 40% of total Cheddar production. Overweighting barrels in the weekly survey effectively lowers the Class III price paid to producers.

Moreover, the NDPSR cheese price includes only 40-lb. blocks and 500-lb. barrels, but most new block production is being made into 640-lb. blocks. Adding 640-lb. blocks to the NDPSR survey would be a good first step toward recalibrating the weight given to barrels, and it would better reflect commercial activity. **MCT**

Prices Uncharacteristically Low

At the height of the holiday season, U.S. dairy markets remain uncharacteristically low. Higher milk and cheese output compared to last year have pressured prices lower. American cheese stocks rose in October—only the fourth time in the past 35 years that October inventories increased—but the butter stock drawdown was the strongest in 25 years. Producers have been feeling the pressure. Culling, sell-outs, and retirements have climbed. On-farm economics could slow output in 2019, and second-half prices could rise if demand remains consistent with this year. But persistent tariffs or a weakening global economy could usher in a prolonged period of lower prices. **MCT**

MCT Forecast

	Block*	Barrel*	Class III	Butter*	Class IV	Whey**	NFDM**
Nov	1.3975	1.3050	14.48	2.2450	15.02	0.4650	0.8875
Dec	1.4000	1.2900	14.05	2.1850	14.80	0.4600	0.8850
Jan	1.4075	1.2950	13.98	2.1450	14.55	0.4525	0.8825
Feb	1.3925	1.3125	13.92	2.0800	14.24	0.4400	0.8675
Mar	1.4525	1.3350	14.40	2.0575	13.97	0.4275	0.8500
Apr	1.4775	1.4300	14.90	2.1475	14.12	0.4200	0.8400

** CME prices.*
***NASS prices.*

...barrel production outpaces demand

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to 1.75 billion pounds in 2017, or 7.7% more than the prior year, while production of processed cheese foods and spreads fell 10% below 2016 levels. The net impact was that processed cheese production increased 2.7% in 2017 vs. 2016, while total processed cheese and cheese food consumption grew only 2.4%. With little ability to age processed cheese and production outpacing consumption, marketers of excess barrels could see the CME as an easy outlet.

Given slower demand, one would expect processors to cut production of barrels and increase output of blocks. However, the Federal Order system provides processors a make allowance of 20.03 cents for each pound of cheese produced based on Federal Order pricing. Thus whether cheese is $3/lb. or $1/lb., cheesemakers still receive 20.03 cents per pound of cheese, making them somewhat indifferent to the cheese price.

However, white whey captures a premium in the market because it typically is used in nutritional products such as infant formula. Because most U.S. Cheddar is colored, the resulting whey goes through a food-grade bleaching process. Food companies prefer to buy whey that does not have to go through the bleaching process; therefore, cheese manufacturers prefer to make whey from white cheeses, such as Mozzarella, Monterey Jack, white Cheddar, or Cheddar barrels. Cheese manufacturers are thus more likely to continue to make barrels because they receive the make allowance and a premium for whey.

U.S. transportation costs are also climbing, making it less costly for West Coast shippers to send cheese to Beijing than to Chicago. The CME spot market provides freight allowances intended to split the cost of transportation between the buyer and seller. However, CME freight allowances have not been updated since 1998, which is a problem. For example, to move cheese from Idaho to Chicago costs about 4.5 cents per pound each for the buyer and seller, or a total of 9 cents. The same cheese sold at the CME results in only a 3-cent cost to the seller, creating a 1.5-cent per pound incentive. Unless changes are made, outdated rules, incentives for white whey, and slowing demand will continue to skew the block-barrel price spread. **MCT**

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