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MCT COMPASS

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Economic Turmoil

Over the past month, it appears the economy has gone from bad to worse. How can this be? In mid-summer, optimistic analysts and public servants were telling the American people that the economy was possibly going to avoid a recession altogether. At that time, only the pessimists were saying that a mild recession was probably inevitable.

A mere four months later, even the optimists are talking about the U.S. economy entering the worst economic downturn since the Great Depression. Already the United States, the European Union, and Japan have entered a recession, and the ranks of countries joining that list is growing. What happened?

Many attribute today's economic situation to the subprime mortgage crisis. A general lack of oversight and loose underwriting standards resulted in a large number of these mortgages. This led to a housing bubble and unprecedented home price escalation.

At first, only mortgage banks and homebuilders were in trouble. But distress rapidly spread to those who had invested in mortgage-backed securities, many of which were reportedly leveraged well above their original value. Exposure to these securities and the financial instruments sold to protect one's risk exposure to them (called credit-default swaps) threatened a growing number of banks as home prices began to crash.

By July 2007, the current financial crisis had officially begun. Investors were beginning to lose confidence in the value of securitized mortgages, which led to a liquidity crisis. The Federal Reserve began infusing the economy with cash.

Since then, the government has passed the $700 billion TARP (Troubled Asset Relief Program) bill, which has already helped several large financial firms, including Citigroup and AIG, avoid bankruptcy. China has also anted-up more than $500 billion and Germany and France have pledged 1 trillion euros (about $1.3 trillion) to rebuild trust in European banks.

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KEN'S CORNER

by Ken Meyers
President
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It's unlikely the U.S. economy will tailspin into a depression. While it may not always seem like it, today's governments have learned how to prevent such a total collapse. It appears by nearly all accounts, however, that the U.S. and global economies are headed into a deep downturn, one that could usher in many trade disruptions over the next year.

The U.S. dairy industry had better brace itself for turbulent times. Over the past two years, U.S. dairy product prices had been buoyed by rising exports. If export volumes drop as expected, the domestic market will have to absorb these products. This will likely occur at the same time consumer demand for some of the higher-end dairy products weakens, leaving more milk on the marketplace. Fortunately, for most of the dairy sector, many consumers view our products as staples, not discretionary purchases. MCT

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Holiday Weakness

MCT Forecast							
	Block*	Barrel*	Butter*	Whey**	NFDM**	Class III	Class IV
Nov	1.7045	1.6960	1.6218	0.1905	0.867	15.50	12.25
Dec	1.6250	1.6000	1.4500	0.1925	0.840	15.15	11.30
Jan	1.5950	1.5700	1.3500	0.1935	0.830	14.00	10.75
Feb	1.5300	1.5100	1.2800	0.1980	0.825	13.80	10.00
Mar	1.4850	1.4650	1.3000	0.2080	0.832	13.15	10.35
Apr	1.5050	1.4800	1.3300	0.2220	0.853	13.20	10.70

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

The growth in the U.S. milk supply has slowed and indications are it will continue to decline due to the CWT herd retirement program and economic stress at the farm level. Dairy product markets are expected to weaken through year-end and into Q1 2009 due to ample supply and lower exports. The current disconnect between the butter/powder milk price and the cheese milk price is expected to converge during this period as well. **MCT**

Reality sets in...

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Today, on the day before Thanksgiving, it looks like the current U.S. and global economic meltdown is a reality that will last well into 2009, perhaps even into 2010. The only questions now are whether the downturn will be severe enough to lead to deflation and perhaps even a depression, or whether with the proposed influx of cash to the banking sector, inflation takes over leading to what could be just as bad: a period of prolonged stagflation where prices and unemployment rise but there is little growth in consumer demand and business activity.

Over the past couple of years, a weak dollar policy, easy credit, weather, and energy policy also created a commodity bubble that is in the midst of a correction. (See the June, August, and October 2008 MCT Compass issues.) So what does this mean for the dairy sector? Clearly credit accessibility is a key issue for the dairy sector, from farmers to manufacturers to holders of aged cheese. As a result of competition for capital, the price on longer-term loans is less attractive than in the recent past, causing expansions to be delayed or down-sized. Even on short-term loans, access to capital has shrunk causing businesses to manage their inventories and receivables more carefully.

The oil and grain sectors have experienced greater price volatility as whole than the dairy sector. But dairy's time will likely come. The current disconnect between domestic dairy product prices and lower world market prices is not expected to remain indefinitely. Export volumes have already fallen and a rise in imports is expected by year-end. Increased imports will likely continue through the first half of 2009.

Record-high milk prices during the past 18 months resulted in a growing world milk supply that collided with a sharp decrease in demand. Stocks of nonfat dry milk are growing around the world. The European Union, in an unprecedented move, will open its intervention program for butter two months early on Jan. 1, 2009. In the United States, commercial stocks of butter and cheese are not burdensome, but significant quantities of nonfat dry milk are being sold to the government.

In periods of economic turmoil the old adage "know your customer well" has even greater significance. Most consumers will have less disposable income in 2009. Fortunately, many dairy products are staples in the shopping cart; however, expect consumers to trade down. Some may even avoid super-premium products. **MCT**

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