

Special Dairy Market Update

Department of Economic Analysis



Due to recent circumstances in the dairy industry, AFBF's Economic Analysis department is issuing a special dairy market update this month. For further information or assistance, please contact AFBF's Dairy and Regulatory Economist, Allison Specht, at 202-406-3622 or allisons@fb.org.

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Economic Woes Wreak Havoc on the Dairy Industry

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Incredibly difficult circumstances await dairy producers in the months ahead. A global economic recession is driving down demand worldwide, and dairy stocks are rising in the U.S. and abroad. This has caused a steep drop in dairy products prices that will be felt in producer milk checks this and several months to come. The cost-price squeeze is being felt across the country, leaving little room for error in individual producers' management and hedging decisions. These thoughts were reiterated at the Southern Dairy Conference in Atlanta, GA two weeks ago.

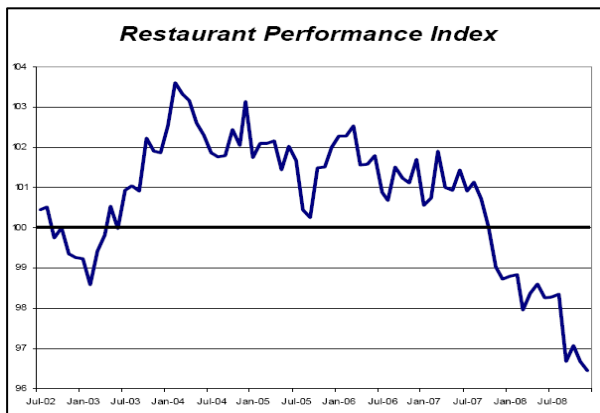
How Did We Get Here?

It is no surprise to many in the dairy industry that dairy product prices have declined. What is surprising is the dramatic correction that took place from the end of December throughout January. March 2009 Class III CME futures traded at \$14.13 on December 1, \$10.28 on December 31, and \$9.30 on February 9. A twenty-seven percent decline in December stunned analysts and will be felt in lighter milk checks in February. USDA set the February Advanced Class I mover at \$10.72, a \$5.02 decline from the previous month and a 46 percent drop from last February's announced price of \$19.68. So, what made dairy prices drop to floor levels so fast?

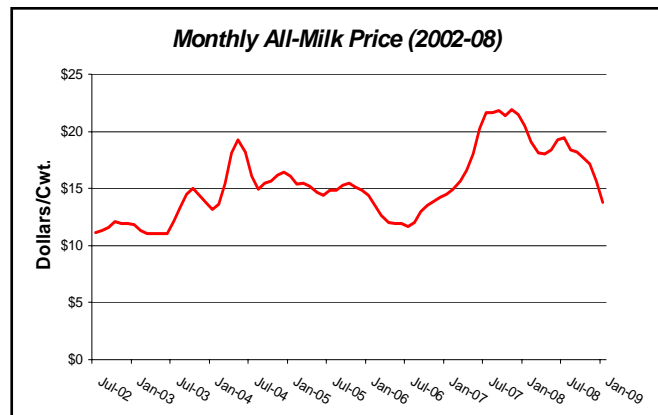


Certainly, the significant jump in milk supplies is a culprit. Early predictions put the U.S.' milk production growth at a little over two percent for the year, driven by herd expansion rather than production per cow gains. But, this is similar to the milk production growth over the past five years. USDA's January *Cold Storage* report showed commercial American cheese stocks at 547.1 million pounds on December 31, 2008, a six percent increase over year-end numbers for 2007 and a 14.8 million pound increase over the previous month. CME's Alan Levitt reports that 2008's year-end total is the highest one on record. Yet, this is not singularly an oversupply problem.

Probably the biggest degree of blame lies in the general economic situation. The financial condition of consumers has changed domestic food consumption patterns, and dairy is feeling the negative effects of this trend. Exports had insulated the dairy industry from feeling losses in away-from-home demand, but this is no longer the case. While grocery dairy-buying *may* be expanding slightly, losing any food service demand, which accounts for 40 percent of dairy consumption, is bad news. The National Restaurant Association tracks the industry's health and performance, and December's index marked the fourteenth consecutive month that the index was below 100. An index below 100 signals industry contraction, thus less dairy buyers in the marketplace.



Source: National Restaurant Association



Source: USDA

At the World Dairy Forum in Orlando, FL, Connie Tipton, CEO of the International Dairy Foods Association, reminded attendees that high cheese prices early in the year made restaurants, especially pizza chains, cut back on mozzarella use or begin offering smaller products. One would hope that current low prices will stimulate demand and reverse this trend, but it is too soon to tell.

International dairy supply and demand factors are another set of major contributors to milk price declines. In 2008, the U.S. dairy industry exported around 11-12 percent of all milk production (on a milk solids basis) to international buyers. Most U.S. excess production through the first part of 2008 was moved to world markets, but the re-emergence of favorable weather in New Zealand added more milk to the international marketplace. The knee-jerk reaction of Asian consumers to melamine-laced infant formulas and the economic slowdown led to a sharp draw down in dairy consumption in emerging markets. Indications are positive that dairy will make a comeback in these regions, but the short-term problems are still being felt. Credit problems have

besieged exporters, as well. Beginning in October, loans needed to move products dried up and credit availability will still be a problem until the banking sector stabilizes.

The good news is that many market analysts believe the market is close to the bottom – it cannot go much further down. With butter and powder prices at support levels, the CCC has purchased nearly 162.3 million pounds of NFD and almost 2.67 million pounds of butter between October 1, 2008 and February 6, 2009. Although cheddar block and barrel prices have reached support levels, the government has not begun purchasing cheese due to increased transactions cost for manufacturers and new restrictions in the 2008 farm bill to end purchases of processed cheese. It is likely that some cheese will find itself in government coffers in the coming months; although, it is unclear how much will be purchased.

Government Interventions Will Kick in Soon...

The current dairy situation has sparked attention on Capitol Hill and throughout farm country. USDA Secretary, Tom Vilsack, stressed the need for assistance to dairy producers in his confirmation hearing; although, less specific as to what measures to undertake besides buying more dairy products for nutrition programs. Last week, thirty-five U.S. Senators sent a letter to the newly-minted secretary asking for assistance for the dairy industry through purchasing and export programs. Milk prices that are half of what they were last year have elevated this to a crisis.

Rumors have been swirling throughout Washington about whether or not a dairy buyout via the private Cooperatives Working Together (CWT) program would be installed in the ballooning Stimulus package. Last year, the CWT program removed about 80,000 cows from the national herd. Thus far, money for a USDA loan guarantee to retire cows has not been added. National Milk Producers Federation (NMPF), the operator of the CWT program, has been mum on the issue but is now focused on securing funding through a private lender for the program. A government-guarantee for CWT would be problematic for a variety of reasons: 1) it could make the program reportable under WTO obligations; 2) it brings back memories of the unstable beef cattle markets after the 1986 dairy buyout; and 3) does not address demand-side concerns that are driving current markets.

Whether or not a dairy herd retirement is expanded, the Dairy Price Support Program and the Milk Income Loss Contract (MILC) will be triggered. National Milk Producers Federation sent a letter to USDA on January 8, asking the department to buy more dairy products by voluntarily adjusting support prices, expanding CCC purchasing authority, and the relaxing packaging and grading requirements. However, the three product approach to prices will likely spend more money on CCC purchases than the old 9.90 program and was scored as such by CBO in the farm bill process. The previously mentioned Senate letter asked the Secretary to purchase consumer-ready dairy products that could be utilized in domestic feeding programs. This approach could eventually displace dairy purchases from the marketplace.

Economists at NMPF, Cornell University, and University of Wisconsin are predicting Milk Income Loss Contract (MILC) payments beginning in February and lasting throughout the year. February payments could be between \$1.34 (NMPF and Cornell) and \$1.55 (U-W) per hundredweight. All three outfits estimate payments over a dollar through June.

In response to the European Union's reestablishment of its infamous dairy export subsidy program, NMPF and U.S. Dairy Export Council (of which AFBF is a member) have called for additional resources for the Dairy Export Incentive Program (DEIP) to funnel more U.S. products to foreign markets. However, a fully-funded DEIP will not be nearly enough to compete against the EU-subsidized products. According to the US Dairy Export Council, the USDA can assist in the movement of 150 million pounds of milk powder if DEIP is funded at authorized levels. The EU has the capacity to dump nearly 600 million pounds of skim milk powder to the global market per year. However, in a press conference last week, Secretary Vilsack was less excited about removing products through exports.

Oceania milk production – once estimated to grow by 8 percent this season – now looks like it will be closer to 2 percent growth according to market analyst, Mary Ledman. While some of this production has yet to be committed, this pull back should help the world situation. However, dumping cheap EU powder will certainly take away potential U.S. export opportunities should they exist.

Southern Dairy Conference Recap...

The Southern Dairy Conference in Atlanta, hosted by the University of Georgia, allows producers, processors, academics, and allied-industry representatives the opportunity to learn about factors that impact the dairy industry in the Southern U.S, but many implications of this meeting can be applied to all dairy production.

Dr. Mark Stephenson of Cornell University kicked off the meeting with his outlook for U.S. dairy and projected the average milk price to be down by \$4.88 in 2009 from 2008 levels. Dr. Stephenson reviewed dairy changes in the Farm Bill, stressed concern about milk supply and utilization in 2009, estimates a 40 percent loss in exports, and expected some producers to not be able to cover their variable costs in 2009. Yet, he was positive about the dairy industry's long-term outlook – as long as the U.S. does not become the world dairy supplier of last resort.

Sue Mosley, Southeast Federal Milk Marketing Order 7 Administrator, discussed changes to rules in her order and challenges of a region that imports about 48 percent of its fluid milk needs from other regions of the U.S. U.S. Dairy Export Council representative, Margaret Speich, discussed challenges dairy exports will face in 2009 and stressed that the recovery of the U.S. dairy industry hinges on a global economic recovery. Dr. David Anderson of Texas A&M presented research done in conjunction with the Food and Agricultural Policy Research Institute at University of Missouri, analyzing twenty-two representative farms across the country and their abilities to withstand upcoming market scenarios. Anderson believes that individual situations (debt load, feed costs and availability), duration of low market prices, and availability of credit will matter greatly.

Other topics covered potential changes to federal milk pricing and federal orders, milk safety and quality, transportation, sustainability, animal welfare, and genomic testing.

A Murky Outlook for 2009...

Unfortunately, I decided to major in agricultural economics in college rather than join the circus as a fortune teller. Since I have not honed my crystal ball skills, I will consult the all-knowing WASDE (World Agricultural Supply and Demand Estimates) dairy outlook instead. USDA is projecting an average all-milk price of \$11.80 to \$12.60 in 2009, driven by weak prices for the first 6-9 months of the year. Depending on corn planting reports this spring and expected crude oil price increases, dairy producers could feel a harsh cost-price squeeze in March and April that will hasten culling activity. 2009 milk production increases will be marginal at best. Most analysts foresee depressed prices through the duration of the recession; however, optimists foresee a mid to late-year turn around. The conventional wisdom is that the U.S. has been in a recession for at least a year already, and this summer will mark the two-year point.

A fortunate circumstance for dairymen could be a market turnaround that drives demand higher at the same time that Kiwi cows are dried-off. The wildcard is how much market share the U.S. might be able to reclaim with an expanded EU export subsidy regime assuming overseas buyers being purchasing again. The dairy industry is positioned very well in the long-term (post 2009) assuming a growing world economy, but individual producer survival is dependent on management decisions and how long the short-term economic woes will last.